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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)
+385 1 6006 678, hrvoje.dolenec@unicreditgroup.zaba.hr

Hans Holzhacker, Chief Economist, Kazakhstan (ATF Bank)
+7 727 244 1463, h.holzhacker@atfbank.kz

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

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

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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: Establishing a new norm post crises

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

- CEE has had to work through an external demand and credit shock but industry is showing signs of bottoming. The region has also adjusted to funding new credit extension with deposits, albeit with some important exceptions. Full year growth numbers this year will be unimpressive in many cases but Q4 last year should have marked the bottom in the cycle. Slovenia, Croatia and Hungary continue to lag on growth while Turkey, Russia and the Baltics lead.

- The inflation environment has turned much less problematic in many cases, allowing central banks to ease policy. Looking ahead in Czech the CNB would happily step away from its intervention threat, data-permitting. In Poland many in the NBP would like to believe that the easing cycle is over but may be forced to deliver a little more first. Russia and Turkey are reluctant to choose between inflation and growth.

- Potential growth across the region has fallen, firstly in the midst of the 2008/09 crisis, followed by the EMU crisis of 2012, but there is significant differentiation due to domestic policies. That said, to date this divergence is not translating into significant differentiation in access to foreign portfolio capital, though it is impacting its cost.

- The next challenge for economies across CEE from here will be to work through the various stages of a normalisation in monetary policy across the developed world. This will not materialise rapidly but instead will unfold in a number of stages over a multi-year horizon. For some the initial stages can prove problematic but can be overcome. For others the more lasting impact, namely a significant increase in external financing costs, risks challenging domestic policies and the prospects of a sustainable recovery in activity.

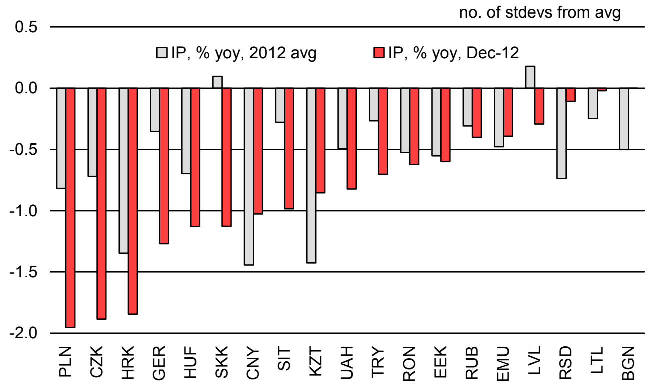
The recovery in external demand is more convincing…

The region has had to work through a credit and external demand shock…

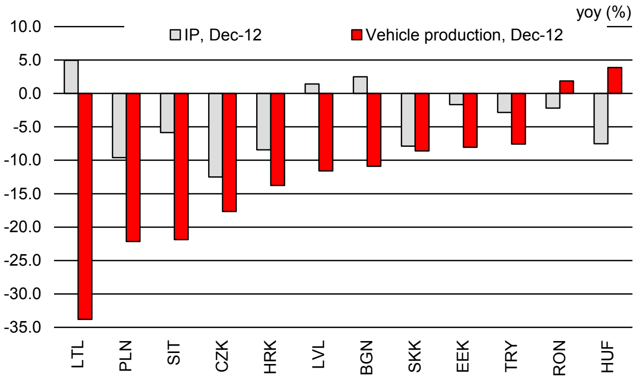
Evidence of a gradual recovery in activity across CEE is gathering pace as the region works its way through two shocks, namely a slump in external demand and credit. The end of 2012 was weak, in particular because of industrial production, but the composition of the slump towards the end of last year combined with the limited amount of hard data released YTD and a variety of survey indicators point to a better start to the year.

WEAKER EXTERNAL DEMAND AND INDUSTRY CONTRIBUTED TO A SLOWDOWN LAST YEAR BUT ARE IMPROVING NOW

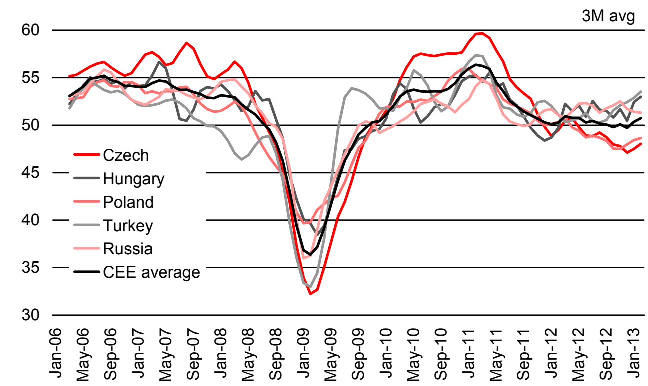
IP was weak in 2012 across CEE, in particular at year-end…



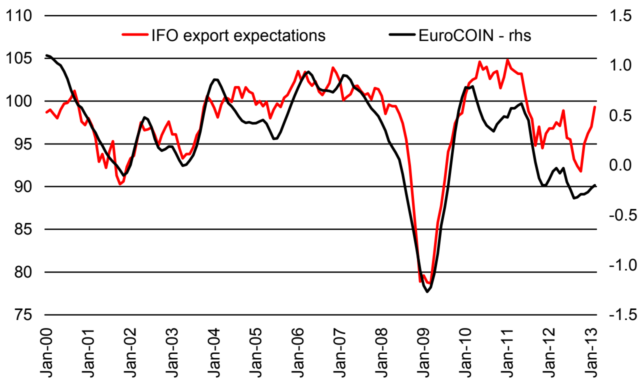
…in part due to a slump in car production at year end…



…but the PMIs signal some recovery…



…as do soft external indicators, in particular German manufacturing



Source: Markit, national statistical agencies, IFO, CEPR, UniCredit Research

…but industry has shown signs of bottoming…

Last year saw industry across the region weaken, in particular at year end. Vehicle production underperformed headline industry which may, at least in part, signal a wait and see approach from producers. The good news is that soft indicators, both domestic and external, are showing improvement. In all 5 countries that publish manufacturing PMIs, their averages over the first 2 months of 2013 are higher than Q4 last year. Examining external demand indicators, Germany's manufacturing PMI is up over 4 points YTD while export expectations within the IFO have bounced impressively. Eurocoin, capturing GDP trends across EMU, is showing signs of modest improvement. Shifting to the limited hard data that we have available YTD, January IP data also showed improvement in CEE. Of the 14 countries that have released data to date for January, 10 showed gains in mom SA terms.

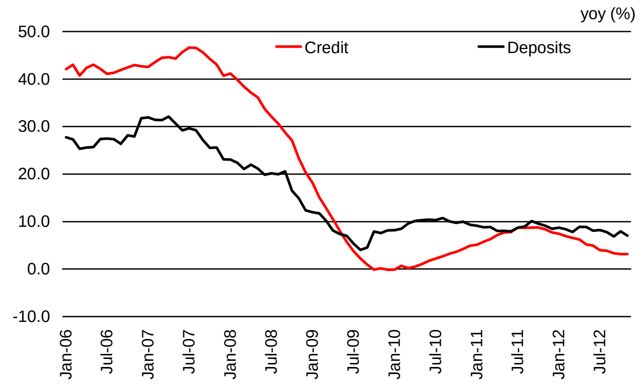
….while the region has worked through a credit shock[1]…

….while the region has adjusted to funding new credit from deposits, with some exceptions

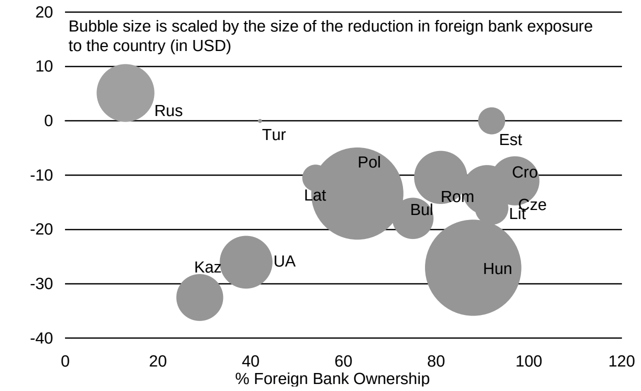
We also believe that we are close to, if not at, the bottom of the credit cycle and that over the course of 2013 credit conditions will be more supportive of domestic demand. The past 6 quarters in CEE have seen the region undergo a supply side credit shock as foreign funding was withdrawn and deposit growth moved lower in line with activity. In contrast with the 2008 crisis, a high share of foreign ownership of the banking sector did not offer protection. Simultaneously a slump in activity took demand for credit lower in a number of economies.

MUCH OF THE IMPACT OF LAST YEAR'S CREDIT CRUNCH HAS FED THROUGH

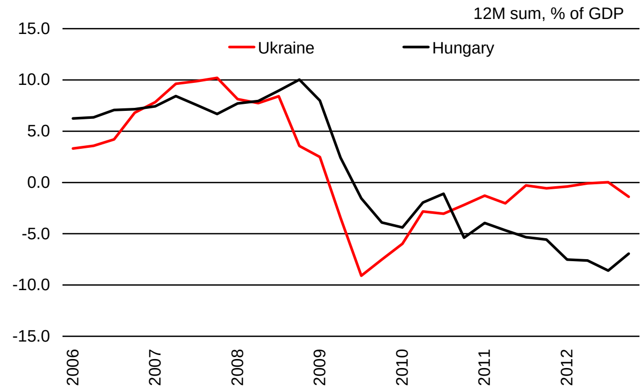
Credit growth has eased below deposit growth…



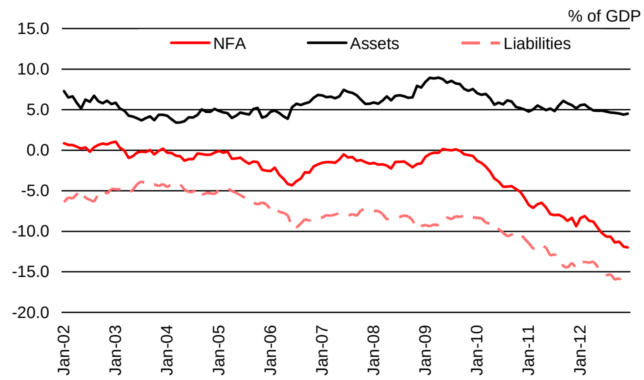
…as a high share of foreign ownership did not offer protection in recent quarters



Hungary and Ukraine have seen foreign banks run down exposure (fx adjusted change in external liabilities)…



…while Turkey enjoys strong inflows (net foreign asset position of banking sector)



Source: National central banks, IMF, BIS, UniCredit Research

At this stage the pace of withdrawal of foreign funding has slowed while in most countries in the region deposit growth exceeds credit growth. While we do not see a sharp acceleration in credit growth this year (in part because of demand-side constraints), we also do not expect credit growth to ease much further from here. This in itself will generate more positive momentum in domestic demand. From the data released to date, credit growth in yoy terms improved in Czech, Hungary, Latvia, Lithuania, and Ukraine in January, though from a weak starting point. Poland ticked downwards slightly (4.9% YoY) but a recent decision by the financial regulator to ease lending restrictions for consumers will help, taking effect no later than July.

[1] For a more detailed discussion of the relationship between credit and domestic demand, as well as a series of projections for credit and domestic demand based on various funding scenarios, please refer to our October *CEE Navigator, "CEE credit and growth shocks: A turning point".*

Turkey and Russia are exceptions

Turkey is an exception to the extent that its banking sector has borrowed aggressively abroad, pushing its net foreign asset position to a negative 12% of GDP while new credit extension is increasing once again. Russia is experiencing strong consumer credit growth while funding constraints mean its banks have returned to borrow offshore again.

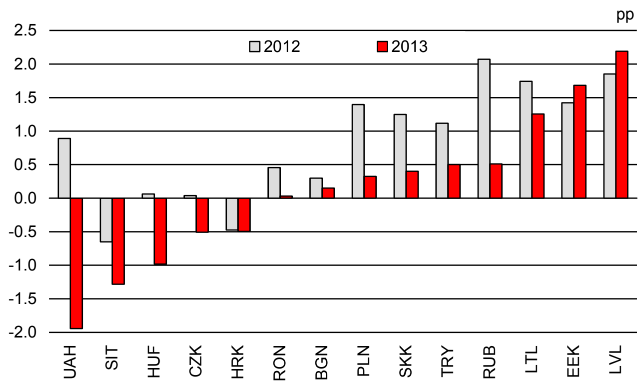
…but any recovery will be gradual…

Weak to negative carryover drags on full year growth

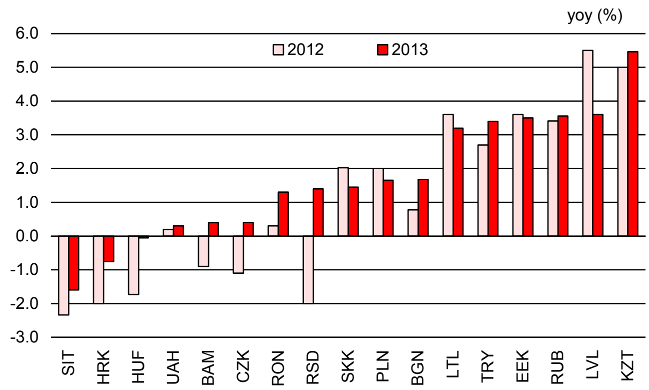
While we are confident of an improvement in real economy data from here, we do not expect this to be rapid and full year 2013 real GDP growth will remain unimpressive in many countries. The weak finish to 2012 has a role to play, creating a much less flattering carryover in most countries. For example, in Hungary should qoq GDP remain unchanged throughout 2013, full year GDP will still post a decline of 1%. In 2012 full year GDP was broadly unchanged by the same metric. In Turkey, Poland and Russia, the carryover is positive but significantly lower than last year.

GENERATING A GRADUAL RECOVERY IN GDP GROWTH

Carryover flatters GDP much less in 2013 relative to 2012[2]



Full year forecasts ranked….and where countries stood last year



Source: National statistics offices, UniCredit Research

Slovenia, Croatia, Hungary remain the underperformers, Turkey, Russia and the Baltics the outperformers

As was the case in 2012, GDP growth will be differentiated across the region. We expect Slovenia, Croatia and Hungary to remain in recession, albeit just about in the case of Hungary while Poland will generate growth of close to 2%. Turkey, Russia and the Baltics will lead the pack, posting growth in excess of 3% in 2013. Our GDP forecast for the region as a whole continues to edge downwards, now standing at 2.8% for this year (previously 2.9%) while we maintain our forecast of 3.4% for next year.

…aided by easy monetary policy

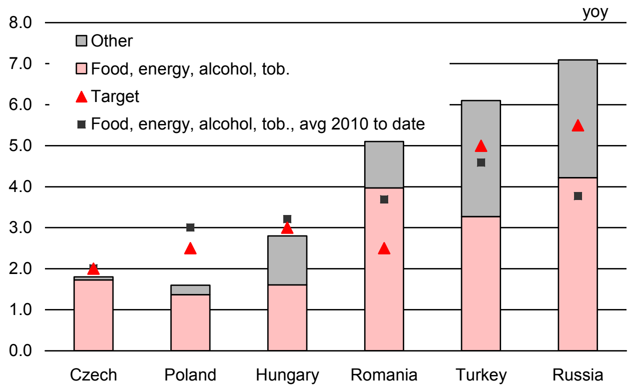
The inflation environment has turned much less problematic

This bottoming in activity is combined with much more manageable inflation pressures. This time last year many central banks in the region feared a slowdown in activity but still struggled with above target inflation, capturing persistent increases in energy and food prices over previous quarters and the impact of currency depreciation, all of which contributed to higher headline and core inflation. Four quarters later the inflation environment has turned as we enjoy a period of prolonged stability in oil prices which, according to our in-house forecasts, will last through this year also. Food price inflation in many cases has eased while FX is adding much less to inflation. Fiscal policy and regulation are also less onerous this year. For example Poland did not repeat its VAT hike of 2012 while Hungary has cut electricity and gas prices, though in an unorthodox manner. These factors combined are also aiding core inflation. In the case of Czech Republic, core inflation has turned negative. Turkey is comforted by the stability of longer term inflation expectations in the face of an increase in inflation volatility over 2011-12, though core inflation is ticking upwards once again.

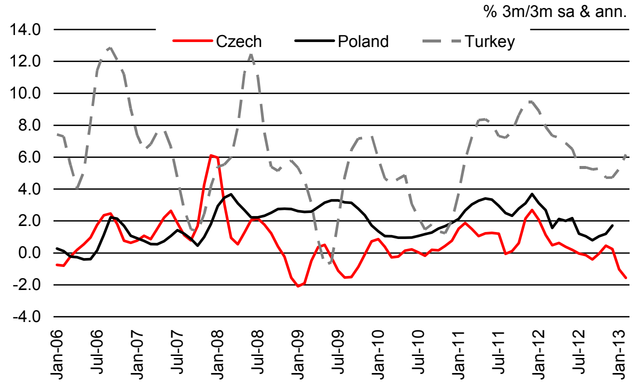
[2] Full year GDP growth assuming in qoq terms GDP is unchanged from the end of the previous year

INFLATION HAS TURNED MUCH LESS PROBLEMATIC

Contributions to headline inflation from food, energy and other, relative to target[3]



Core inflation is low in Poland, negative in Czech but accelerating in Turkey



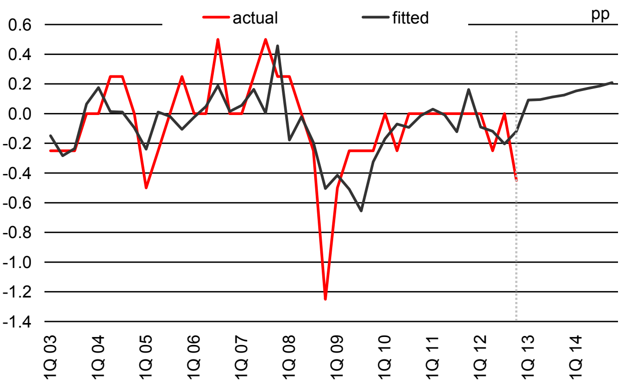
Source: National statistics offices, UniCredit Research

In Czech the CNB would happily step away from its intervention threat, data-permitting

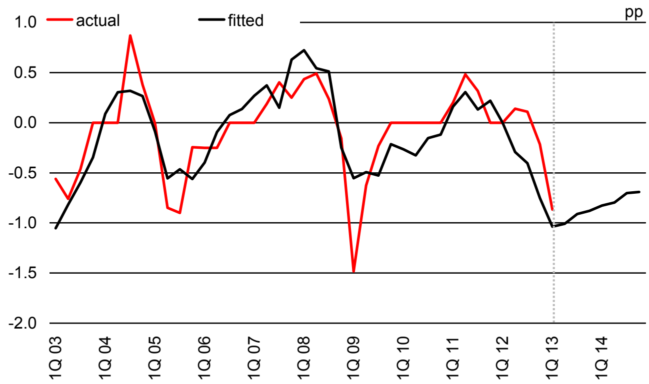
Against this backdrop of weak growth and easing inflation, a number of central banks across the region have eased monetary policy. In Czech Republic and Poland the bias remains in favour of further easing but we see this slowly changing towards a more neutral stance. This applies in particular to Czech Republic. The policy rate is at 0.05% and while the CNB threatens FX intervention, we believe that this is a policy option that the Bank would much prefer to avoid. Drawing off our reaction function to estimate the change in the policy rate on a quarterly basis, our estimates suggest that the CNB is done with easing from here and will shift towards some modest tightening, assuming their forecasts on GDP growth and inflation are correct. This is driven largely by the exchange rate, which the Bank assumes remains above 25.0/EUR until Q2-14, re-enforcing our view that the move in CZK has already done some work for the CNB. That said, lower inflation has translated into a tightening of real monetary conditions.

CENTRAL BANK REACTION FUNCTIONS: ESTIMATING *CHANGES* IN POLICY RATES

Czech: If the CNB's forecasts are correct, the Bank's bias will turn less dovish[4]



Poland: Policy to remain more dovish for longer than in Czech[5]



Source: National statistics offices & central banks, UniCredit Research

[3] For sake of comparison, all countries with the exception of Russia show the latest available reading for HICP.

[4] Change in policy rate = 0.003 + 0.038*GDP growth (% yoy) + 0.095*[core CPI inflation (% qoq annualised) – target] + 0.015*[EUR/CZK % deviation from linear trend] + error term, R^2 = 0.49, estimated over Q1-01 to Q4-12

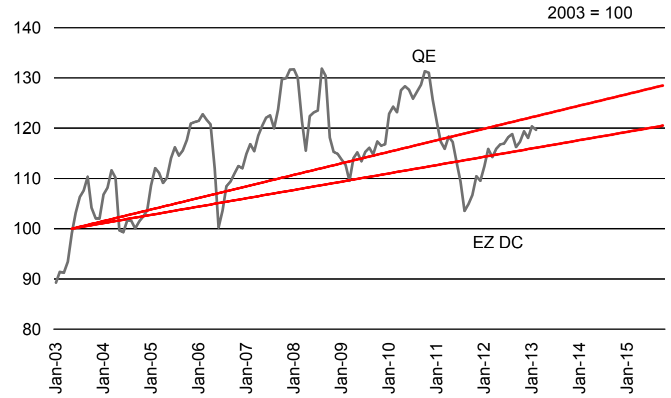
[5] Change in policy rate = -1.07 + 0.21 * GDP (% yoy) + 0.22 * (inflation – target) + error term, R^2 = 0.72, estimated over Q1-02 to Q4-12.

In Poland the NBP would like to be done with cuts but may be forced to deliver a little more

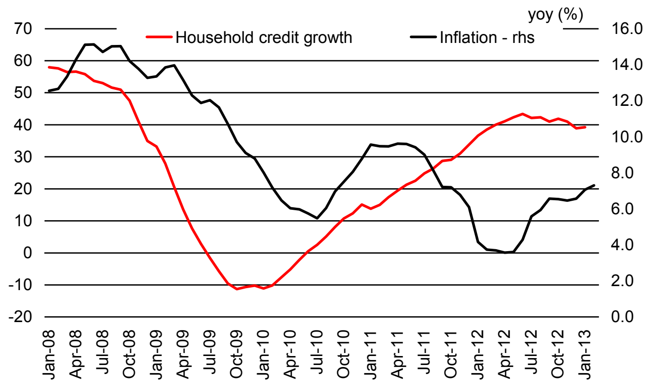
In Poland our reaction function suggests a more dovish stance for longer, with the NBP to continue easing over the course of this year and next. This is due to a combination of below target inflation and GDP growth which is forecast by the NBP to stay below 2% yoy this year and 3% yoy next. Counteracting this is the record low policy rate in Poland and a bias within the MPC to maintain a positive real interest rate. Another rate cut over the coming 1-2 months would require consistently poor data but we do not exclude that the Bank eases by a further 25-50bp over H2-13.

TURKEY & RUSSIA: GROWTH VERSUS INFLATION

Turkey is focussed on its real effective exchange rate…



…while Russia is excessively reliant on domestic demand for growth



Source: National statistics offices & central banks, UniCredit Research

Turkey and Russia are reluctant to choose between growth and inflation

Monetary policy is trickier in Turkey and Russia. Turkey is one of a small number of economies in the region where the recovery in domestic demand growth is leading external demand. The CBT faces a combination of above target credit growth, above target inflation (core and headline) and some modest signs of a renewed widening in the C/A deficit. To balance the risks of a C/A deficit widening against higher inflation, expect the CBT to continue to manage TRY within a narrow range, with interest rates rather than FX to be used as an adjustment mechanism. Russia also currently faces excessive consumer credit growth, though unlike in Turkey this is not matched by corporate credit growth, while inflation has increased and is above target. Looking ahead, the combination of a more favourable inflation performance and management changes at the CBR tips the balance in favour of easing.

Structural differentiation across the region is increasing

Potential growth across the region has fallen, firstly in the midst of the 2008/09 crisis, followed by the EMU crisis of 2012…

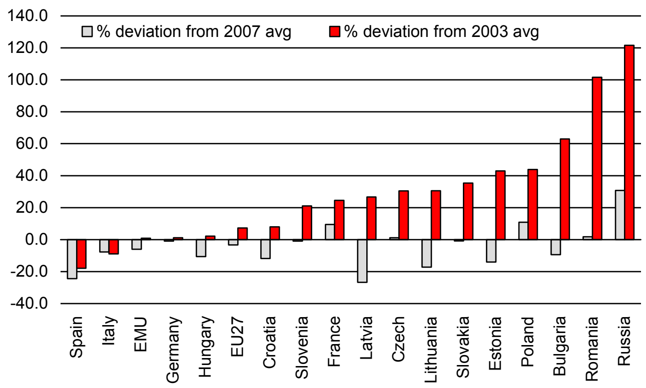
More broadly the period ahead will be about determining the 'new norm' for growth across CEE. A number of key external contributors to growth have changed relative to pre-Lehman and will cap potential growth below pre-crisis rates:

- As we discussed above, for those banking sectors which are foreign owned, the funding model has changed and while much of the region has adjusted to funding credit from deposit growth, a return to the rates of credit growth that we saw pre-2008 is neither likely nor desirable. In some countries NPLs are high and still increasing, further weighing on lending;
- For much of the region, the period over 2003/04 to 2007 saw a sharp acceleration in FDI inflows not only to the non-tradables but also to the tradables sector, much of which was sourced from Germany as its manufacturing sector opted in favour of investing in the more cost effective CEE economies than at home. This source of FDI to the region has now slowed while capacity utilisation across German manufacturing has fallen. With the global economy to grow at a slower pace than in the past, it is likely to recovery only gradually;

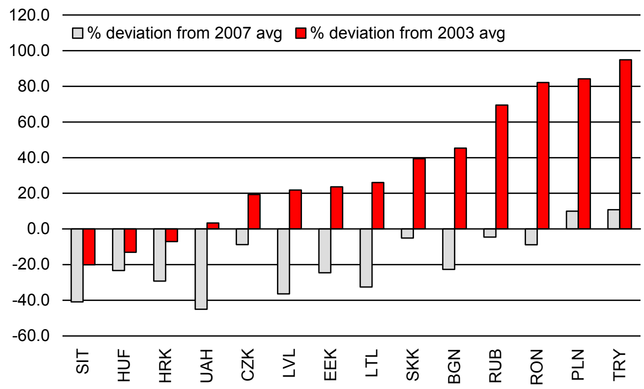
- The region is missing an anchor for policy. For many, EU accession followed by EMU entry helped discipline policy in the past. While the excessive deficit procedure now has more influence than pre-2008, EMU entry has been pushed out significantly. Latvia and Lithuania are exceptions. EU accession has largely disappeared from the debate in Turkey, though Serbia is making slow progress. IMF/EU programmes filled the gap in weaker economies over 2009/10 but, with the exception of Romania, these are no longer in place.

THERE ARE LARGE DIFFERENCES IN GROWTH PERFORMANCE ACROSS THE REGION

Retail sales volumes



Gross fixed capital formation



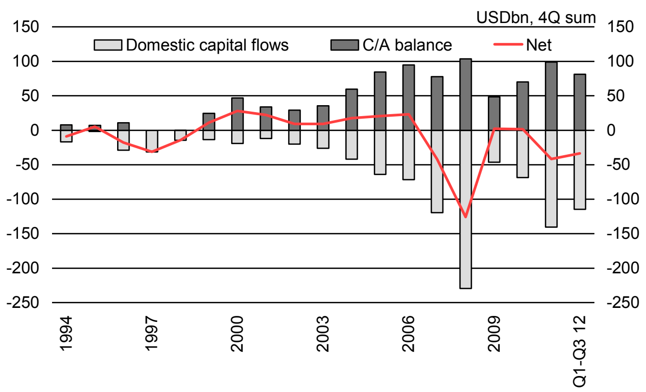
Source: National statistical agencies, DOTs, UniCredit Research

…but there is significant differentiation across the region…

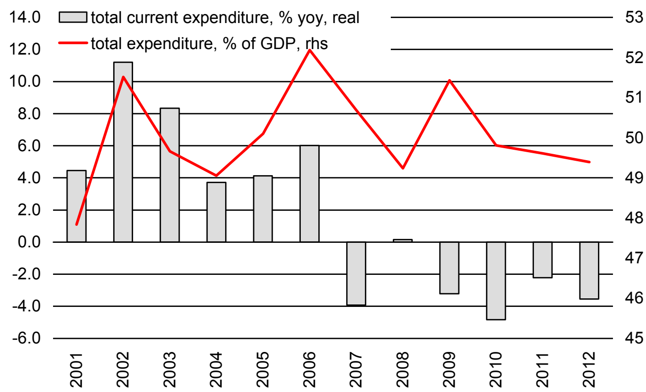
But there is significant differentiation in growth performance within the region, as well as across time. While consumption growth has slowed since 2008, on aggregate over the past decade retail sales volumes have still shown significant gains in most countries. Hungary and Croatia are bottom of the pack. In Hungary retail sales volumes are broadly flat relative to 10 years ago. We see similar differentiation in investment. Over the past decade, investment has gained over 70% in Russia, Romania, Poland and Turkey. In contrast Slovenia, Hungary and Croatia last year all saw investment below 2003 levels.

COUNTRY-SPECIFIC FACTORS PLAY A ROLE

Russia: In need of foreign capital to cover shortfall



Hungary: 6 years of consolidation but public expenditure remains high



Source: National statistical agencies, DOTs, UniCredit Research

…due to a variety of country-specific factors

Country-specific factors play a role:

- **Russia** has undergone a structural shift in capital flows post 2008. Over 2000-07, the C/A and domestic capital flows averaged a positive 3.4% of GDP, i.e. some but not all of Russia's oil revenues were recycled. Over the past two years these averaged a negative 2.0% of GDP. Foreign inflows are also sparser than in the past while the economy is being forced to adjusted to a multi-quarter and potentially multi-year period of stable, rather than rising, oil prices. The authorities more recent response was the appointment of a more growth-friendly CBR chairperson;

- In **Hungary** the authorities' most recent measures include the appointment of a government-friendly governor and a variety of other management changes at the NBH, removing a considerable amount of crisis management experience that had been accumulated. PM Orban's decision to change the powers of the constitutional court has once again drawn negative criticism from the EU while further measures to see private sector companies cut utility prices are being considered. It is against this backdrop that Hungary is now in its 6th year of fiscal consolidation, having reduced current expenditure in real terms in 5 of the last 6 years but total government expenditure remains stubbornly close to 50% of GDP;

- **Serbia and Ukraine** run some of the widest twin deficits globally but have discarded IMF programmes while eroding central bank independence to ensure currency stability (and in Ukraine's case to help finance the government). In both countries fiscal consolidation has been delayed. Ukraine requires market access of approximately USD0.5bn per month to maintain FX reserves at an already low level while Serbia has seen public debt rise almost 30pp in the last 4 years to 63%. GDP contracted 2pp in Serbia last year while Ukraine gained 0.2pp;

- **Croatia** continues to struggle with a re-balancing between the tradables and non-tradables sector, translating into meagre growth prospects, but Slovenia has made progress with the passage of reforms on fiscal consolidation, pensions, labour and the banking sector. The primary shortfall there is the persistent political uncertainty. In Croatia the government continues to delay much needed reform efforts, in part hoping that EU accession in July will boost output.

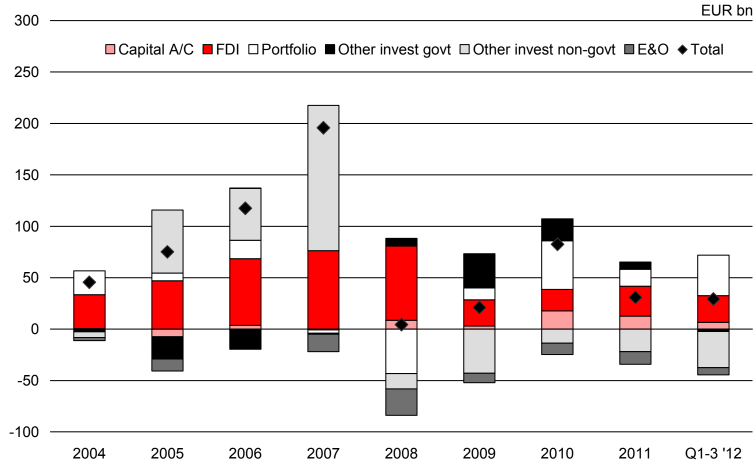
A normalisation in developed market monetary policy

This differentiation in domestic policies is translating into less and less differentiation across countries in terms of their access to foreign portfolio flows…

These policies are facilitiated, at least in part, by ample foreign portfolio flows. Post the 2008 crisis, there was a structural shift in capital flows to emerging markets amidst a re-assessment of a combination of sovereign, banking sector and external balance sheets relative to many developed markets. But ultra-easy monetary policy in the developed world, including various liquidity extension measures, has been layered on top of this and the vast majority of economies can now easily draw off foreign financing, albeit at a differentiated price, irrespective of domestic policies. Portfolio flows are the most dominant form of capital flow to CEE since 2010 in the face of a decline in FDI and a reversal of longer term lending.

COMPOSITION OF CAPITAL FLOWS

Portfolio flows are much more dominant post crisis



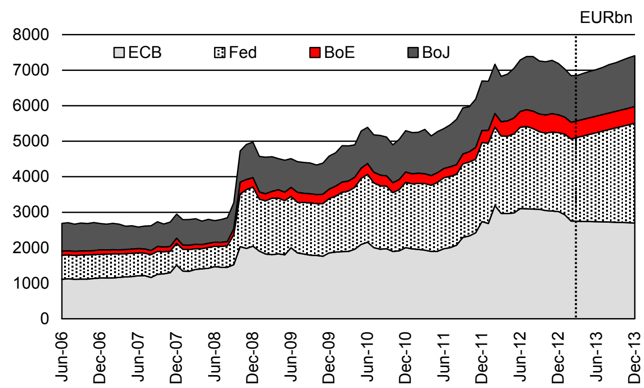
Source: National central banks, UniCredit Research

…but the risks to global liquidity are now more balanced than in the past…

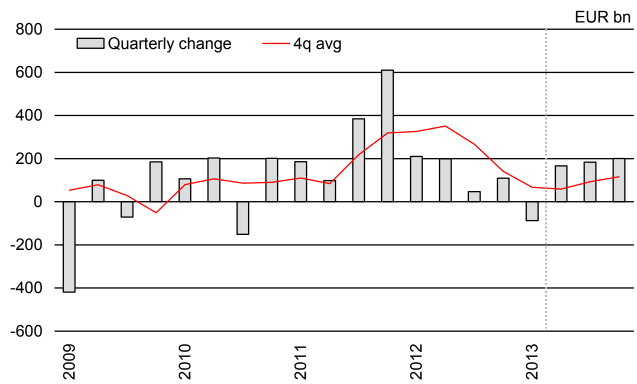
Looking ahead the region faces a multi-year adjustment in relation to these and past capital flows. This will materialise only gradually and progress through a variety of stages. Currently we are transitioning from a multi-year period where the risks were consistently weighted towards a scenario where central banks in the developed world increase their pace of balance sheet expansion towards one where the risks are more balanced. The ECB has already begun to contract its balance sheet but the Fed will continue with its QE programmes this year, before gradually winding down next year. The BoJ is currently the only central bank that plans to increase its pace of balance sheet expansion next year. According to our estimates, the pace of balance sheet expansion over the rest of this year across the ECB, Fed, BoE and BoJ will remain positive at all times but ease below the quarterly average over 2011-12.

CENTRAL BANK BALANCE SHEETS: OUR TAKE ON THEIR PLANS FROM HERE

ECB, Fed, BoJ & BoE balance sheets, EUR bn



ECB, Fed, BoJ & BoE: FX adjusted balance sheet changes from here



Source: BoE, Fed, ECB, BoJ, UniCredit Research

…as is the case for portfolio flows to CEE

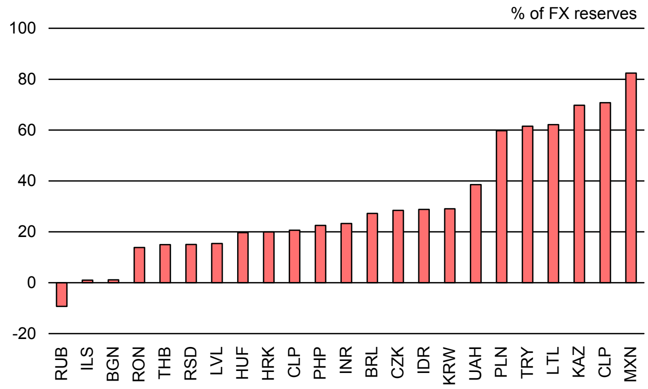
This "peak" in the liquidity cycle, combined with a substantial move tighter in spreads, has already prompted a slowdown in inflows to hard currency debt funds, as well as a diversion in flows to local currency debt. But there is at least some element of these flows that lags rather than leads performance while CEE central banks are unlikely to facilitate any large amounts of FX appreciation this year. With this in mind, we may well have reached the "peak" in terms of portfolio flows to the region.

Countries are short on FX reserves

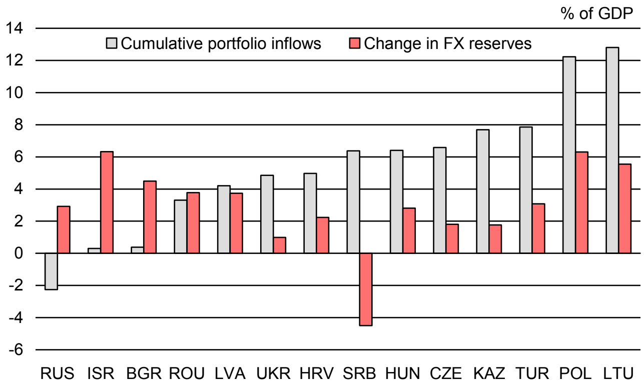
When considering the next stages to a normalisation of G7 monetary policy and their implications for CEE, we see them as twofold. The first is the risk of a sharp decline in short term inflows or even a sudden stop/reversal which prompts financing problems. The second refers to the ability of economies to service their external debt at a higher cost. This second risk is one that feeds through over a much longer period of time but has the potential to act as a significant drag on both balance of payments and activity.

FX RESERVE ACCUMULATION HAS NOT KEPT PACE WITH PORTFOLIO INFLOWS

Cumulative portfolio inflows since end-09



Portfolio inflows since end-09 relative to the change in FX reserves over the same period



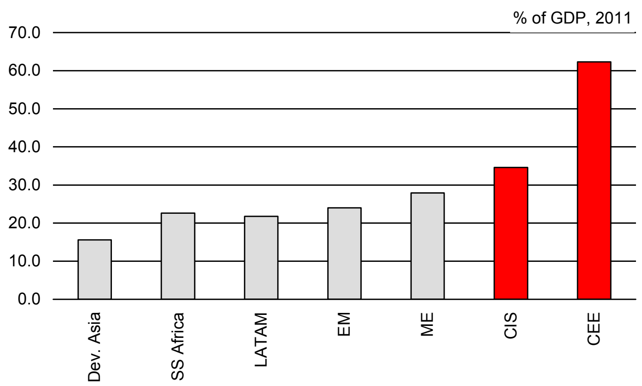
Source: IMF, national central banks, UniCredit Research

FX reserve accumulation has not kept pace with portfolio inflows

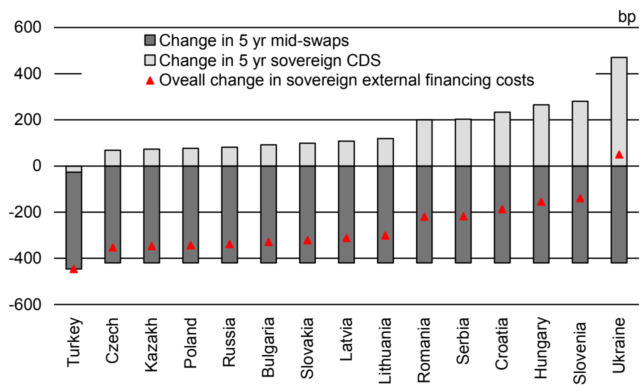
In most countries across CEE but also across EM economies more broadly, portfolio inflows over recent years have reached a significant portion of FX reserves. Across emerging markets as a whole, this is largest in Mexico but in Poland, Turkey and Ukraine cumulative portfolio inflows since end-09 account for between 40% and 60% of FX reserves. Examining aggregate portfolio inflows over the same period to changes in FX reserves, FX reserve accumulation lags significantly. For example, in Poland portfolio inflows have exceeded a cumulative 7% of GDP while FX reserve accumulation stands at just over 2% of GDP. In Turkey reserve accumulation is equivalent to approximately 1/3 of inflows. This is a blunt metric to the extent that it does not take account of buffers such as Poland's FCL or Turkey's ROC mechanism. But neither does it account for other forms of short term borrowing such as the large amount of short term external loans drawn down by banks in Turkey.

SERVICING EXTERNAL DEBT

Gross external debt is higher in CEE than elsewhere



Change in financing costs, avg. Q4-12 versus avg. 2007



Source: IMF, Bloomberg, UniCredit Research

Gross external debt puts CEE at a disadvantage to other EM regions…

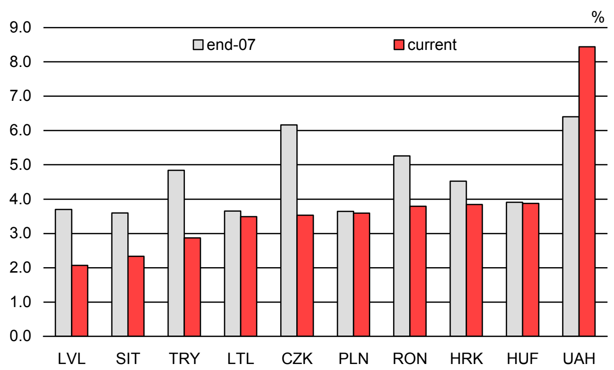
It is the second channel, namely the cost channel, which puts CEE at more of a disadvantage relative to other emerging market regions given much higher levels of external indebtedness. Gross external debt in CEE ex CIS stands in excess of 60% of GDP and in excess of 30% of GDP in CIS, compared with just 16% and 22% in developing Asia and Latam (IMF aggregates). Much of this funding has been borrowed at cheap interest rates in the past, pre-2008 because of an aggressive pricing of 'convergence' and in some cases much lower debt levels and post-2008 because of a collapse in financing costs in the developed world combined with cheaper IMF/EU funding.

…but financing costs to date have been non-problematic

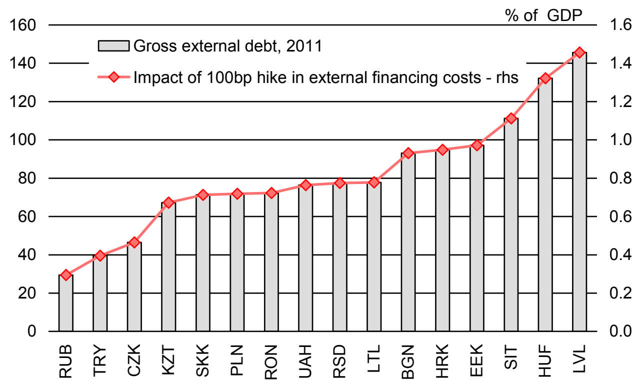
To date Ukraine is the only country across the region that has experienced an increase in the aggregate interest rate costs that it pays on its external debt. As a measure of financing costs, we examine the change in CDS spreads and US swap rates between 2007 and the last quarter of last year. As shown above, with the exception of Ukraine, most countries have seen a decline in external financing costs despite higher sovereign risk premiums. We also estimate external debt servicing costs by drawing off interest payments from incomes accounts of balance of payments (less interest payments on intercompany loans) and compare this to the stock of external debt (less intercompany loans). Once again, Ukraine is the exception, being the only country forced to pay a higher rate of interest. But as developed market rates normalise and begins to feed through more widely, this risks acting as a signifcant drag on balance of payments in some countries across the region. For example in Hungary, every 100bp increase in its external financing costs, when layered across its entire gross external debt stock, adds almost 1.5pp of GDP to its incomes deficit.

SERVICING COSTS ON EXTERNAL DEBT

Average interest rate paid on external debt (less intercompany loans)



The impact of a 100bp increase in external debt servicing costs



Source: National central banks, UniCredit Research

Differentiation is here to stay

In the absence of a shift in policies within the weaker economies in CEE, expect the divergence in economic activity to intensify within the region

2008 marked a turning point in the region to the extent that growth could no longer be taken for granted. 2011/12 added to this uncertainty. But there are a number of economies across the region that have emerged in strong positions, in part because of a sensible policy mix and in part because of a build-up in buffers. For example we remain confident that there are few structural impediments that will prevent Czech Republic or Poland from taking advantage of a recovery in global manufacturing. Poland has added to its buffers via its FCL. Romania has made significant progress in solidifying its sovereign balance sheet and while vulnerabilities have increased in Turkey, its balance sheets allow some scope for slippage. The Baltics are the outperformers. But amongst some of the weaker economies in the region, many of whom were forced to seek IMF/EU help over 2008/09, follow-through on the reform agenda beyond an initial period of fiscal consolidation has either been limited or counter-productive. Contrasting the Baltics with Hungary, both opted to protect their balance sheets in 2008/09 from the negative impact of currency depreciation (though to a much greater extent in the Baltics than Hungary) but Hungary has fallen short in terms of structural adjustment to compensate for the lack of currency adjustment. In the weaker economies in the region, this has resulted in governments relying on a combination of central bank support and favourable global liquidity conditions but success in boosting growth prospects has been limited. Should these economies remain on this path over the coming quarters, it may offer some short term relief but a sustainable recovery in growth will remain even further in the distance.

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

CEE Corporates: Supported by hunt for value

We expect Emerging European corporate credit spreads to tighten by some 40bp by the end of the year

We have revised our spread forecasts on corporate credits, and now expect the JPM CEMBI Emerging European spread index component to tighten by some 40bp to 309bp by the end of this year (vs. our 270bp forecast published last December). Taking into account our economists' 10Y UST yield forecast of 2.3% by the end of the year, this translates into an expected total return of 4-5% for the rest of 2013. The revision is based primarily on increased upside risks in new corporate bond supply, which already reached YTD 23% of our full year target in Emerging Europe (see next page for a more detailed discussion). From a fundamental point of view, we keep our constructive view on regional credits, supported by positive credit metrics, which is confirmed in most cases by regional issuers during the current reporting season. Expectations of moderate but positive economic growth in the region, i.e. in domestic markets – where issuers generate a large part of their EBITDA – is also supportive, as it limits the scope for shareholder-friendly corporate policies, albeit higher dividend disbursements by Russian issuers need watching. The expected spread tightening should also be supported by expectations of more investors rotating from sovereign into corporate credits in search for yield; in this context, we also expect to see more real money XO and HG investors looking for yield pickup in respective credit quality brackets in the EM corporate universe.

CEE corporates still offer a decent premium vs. sovereigns...

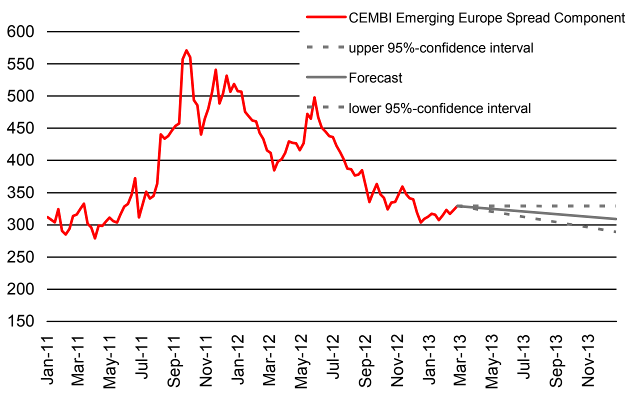
The European component of the JPM CEMBI offers, together with the Asian component, the highest pick-up over the respective EMBIG regional component. Country-wise, Russian and Kazakh corporates offer the highest spread pick-up over the respective EMBIG component with a comparable rating. Moreover, as our right hand chart shows, Russian corporate risk premia lagged the tightening Emerging European corporate credit risk premia over the sovereign, suggesting catch-up potential.

...and are well above post-crisis lows

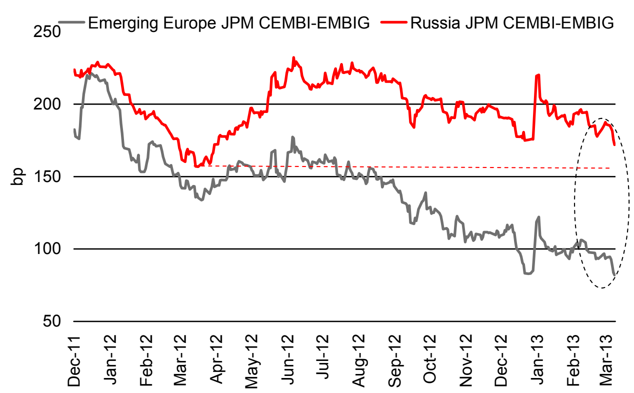
Yield levels on JPM CEMBI indices close to all-time lows raise some valuation concerns; however, this is the case in most credit markets due to very low yield levels in UST and Bunds. In this context, note that the spread levels both on the JPM CEMBI as well as the Emerging European component are some 60-70bp above the post-crisis lows, and thus offer a decent premium. At the same time, the current reporting season does not justify concerns about credit quality deterioration. Despite the low yields, we continue to see the hunt for yield being supportive for the asset class, with key risk stemming from a renewed loss of global risk appetite, as the Italian political backdrop remains uncertain.

CEE CORPORATE CREDIT SPREADS TO TIGHTEN, WITH RUSSIAN CORPORATES OFFERING VALUE VS. SOVEREIGN

JPM CEMBI Emerging Europe spread forecast



Emerging European Corporate vs. Sovereign credit risk premia



Source: JPM, Bloomberg, UniCredit Research

We expect USD 77bn full year issuance from CEE corporates...

We see the technical backdrop from Emerging European corporates becoming more challenging. Although we stick to our forecast of USD 77bn (+20% increase from last year) of new bond issuance for the full 2013, the risks are clearly to the upside, as YTD issuance exceeds USD 18.7bn (USD 10bn Financials and USD 8.7bn from Non-Financials) or 22% of the full year target. Although, after intensive issuance activity in January-February, primary market activity slowed down in March, we expect it to increase after the Russian corporate reporting season ends at the end of April. Expected cash flows from Emerging European corporate Eurobonds amount to USD 27bn (redemptions and coupon payments), resulting in net issuance of USD 31bn, which roughly corresponds with net issuance during the same period last year.

...with upside risks stemming from synloans refinancing via bond markets

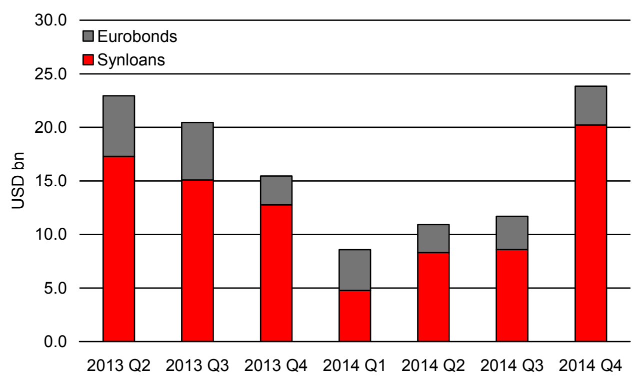
Upside risks in issuance result from the bulky maturity of USD 74.8bn syndicated loans from Emerging European corporates, with a majority of them coming in 2Q-3Q13, rather than upside revisions of issuers' capex plans or M&A activity. Syndicated loans amount to USD 16.8bn YTD, which includes USD 14bn in loans to Rosneft to finance its stake acquisition in TNK-BP – i.e. a one-off item. Excluding the latter, syndicated loans would have dropped by 44% yoy. We assume that, amid new regulatory framework implementation by European banks and related higher capital requirements, a part of the syndicated loans will be refinanced through the Eurobond market, creating upside risks in new bond supply. Against this backdrop, issuers continue placing inaugural bonds (SIBUR and Phosagro bond issues are two latest examples in this context), as they try to set up an alternative funding source to banks. Thus, the relevance of the bond market as a corporate funding source will likely increase going forward, leading to supply risk.

New supply effects alleviated by inflows and issuance in local currencies

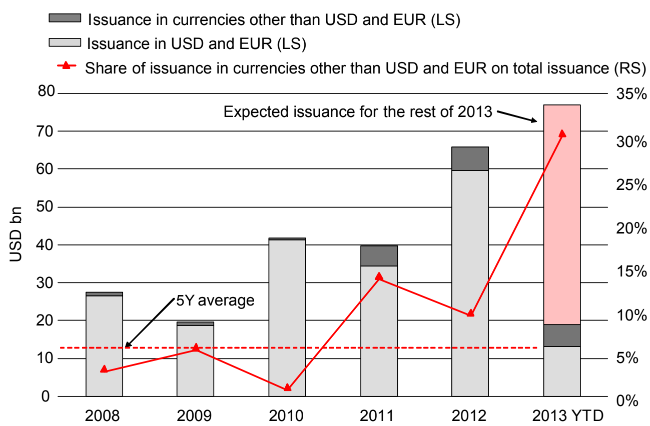
While major upside risks stem from refinancing needs of syndicated loans, rather than higher capex or M&A activities, which does not affect issuers' leverage ratios, we expect new net issuance to be easily absorbed by inflows in the asset class. Inflows into EM-dedicated bond funds will remain supported by: **1.** a prolonged period of ultra-low yields in major economies, coupled with attractive valuations in EM credits, as well as, **2.** global investors' increased need to diversify portfolios, an issue highlighted, for example, by the eurozone debt crisis. Separately, increased issuance in local currencies – notably in CNY and RUB, which jumped to 30% of total issuance YTD vs. a 7% average share over the last five years (see chart) as issuers tap alternative markets, reduces to some extent supply pressure on existing USD or EUR denominated issues.

EMERGING EUROPEAN ISSUANCE TO INCREASE, AS SYNDICATED LOAN MATURITIES WILL PICK UP

CEE redemption schedule – Eurobonds vs. Syndicated loans



CEE corporate Eurobond issuance



Source: BondRadar, Dealogic, UniCredit Research

CEE corporates are fair valued vs. average rating

We see CEE corporate credits as fairly valued vs. their average rating. The chart below shows the deviation of the individual country components from the implied fair value. Accordingly, Hungarian and Polish credits look slightly cheap, while Russian, Kazakh and Czech corporates appear fairly valued, and Turkish and Ukraine corporates slightly rich. The fair valuation of Russian and Kazakh corporates coupled with their highest spread vs. the respective EMBIG country component is supportive for further rotation into the two corporate markets from the respective sovereign debt. From a sector point of view, EM Financials and Utilities look cheap, while Oil & Gas and Metals & Mining already look slightly rich (see right-hand chart). Against this backdrop, we think that there is better value in Financials and Utilities rather than in Metals & Mining, which are also vulnerable to economic cycles. Although from this point of view, the EM Oil & Gas sector looks some 40bp richer vs. its average rating, we like Russian Oil & Gas in particular due to very solid credit metrics. We expect an increasing number of real money HG and XO investors to move into CEE corporates in their search for yield, and see the Russian Oil & Gas sector with its investment grade rated issuers with solid credit metrics being a top choice. Notably, the Russian Oil & Gas sector is the least leveraged sector in the Russian Eurobond universe, making it – together with strong links to the government – less vulnerable to external funding closure. We also like it because the spread between the Russian sovereign and Oil&Gas credits is unjustifiably wide and we expect it to tighten to 30bp in the medium term.

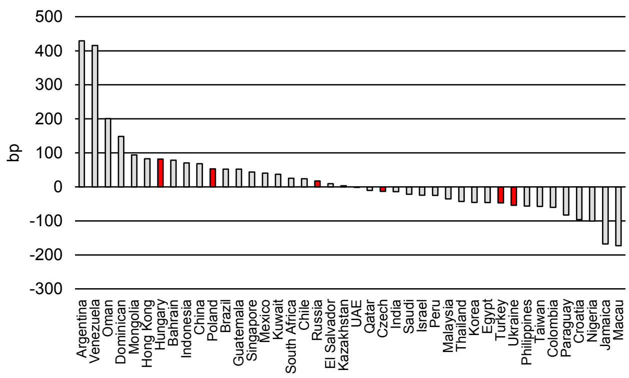
Our key CEE corporate bonds recommendations

Our key positioning recommendations in the Emerging European corporate universe are:

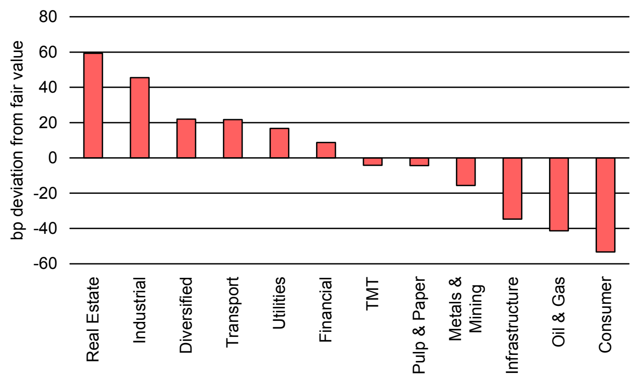
- In the Oil & Gas sector, we recommend to OW GAZPRU (USD 4/2019 at 246bp z-spread and 4/2018 at 233bp z-spread, EUR 3/2017 at 163bp z-spread), LUKOIL USD 11/2020 at 229bp z-spread, NVTKRM USD 12/2022 at 231bp z-spread, TMENRU USD 3/2018 at 210bp z-spread and ROSNRM USD 3/2022 at 220bp z-spread.
- In Telecoms, we recommend holding the VIP USD 3/2017 issue at 302bp z-spread, and keep sell recommendation on MTS and TPSA bonds.
- In Utilities, we recommend to holding CEZCP 5/2015 at 35bp z-spread and EESTI 10/2018 at 146bp z-spread.

EMERGING EUROPEAN CORPORATES ARE FAIR VALUED

JPM CEMBI sectors fair value vs. rating



Spread per rating notch dur. adj. within JPM CEMBI M&M sector



Source: JPM, Bloomberg, S&P, Moody's, UniCredit Research

Dr. Stefan Kolek, Strategist (UniCredit Bank)
+49 89 378-12495
stefan.kolek@unicreditgroup.de

Countries

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

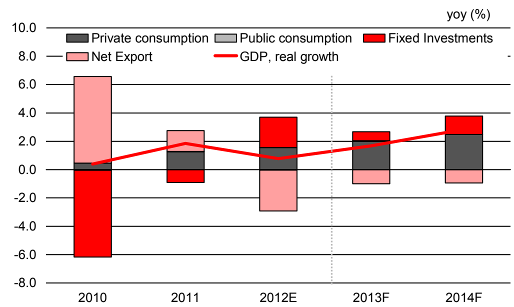
Outlook – Full-year GDP growth for 2011 and 2012 was revised upward to 1.8% and 0.8% (from 1.7% and 0.5%). We see export and GFCF a tad weaker in 2013 than what was anticipated three months ago, as demand-side conditions in the euro zone are likely to need more time to improve, while higher uncertainty surrounding snap elections will prolong the time in which companies will remain in a "wait and see" mode. This will be offset, however, by a somewhat more supportive fiscal policy, as the next government is expected to invest more to start tackling the poverty problem. Consequently, we keep our GDP growth forecast for 2013 and 2014 unchanged at 1.7% yoy and 2.8% yoy, respectively.

Author: Kristofor Pavlov, Chief Economist (UniCredit Bulbank)

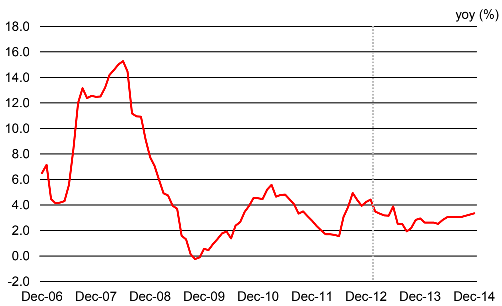
KEY DATES/EVENTS

- 10 May – Number of employees under labor contract for 1Q
- 12 May – General elections
- 15 May – Flash estimates for swda real GDP for 1Q

GDP GROWTH AND CONTRIBUTION TO GROWTH



INFLATION (CPI) YOY



Source: NSI, BNB, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2010	2011	2012E	2013F	2014F
GDP (EUR bn)	36.1	38.5	39.7	41.5	43.9
Population (mn)	7.5	7.3	7.3	7.2	7.2
GDP per capita (EUR)	4,804	5,255	5,446	5,731	6,097
Real economy yoy (%)					
GDP	0.4	1.8	0.8	1.7	2.8
Private Consumption	0.6	1.7	2.0	2.6	3.2
Fixed Investment	-18.3	-6.5	0.8	2.8	5.6
Public Consumption	-0.5	0.3	-0.4	0.6	0
Exports	14.7	12.3	-0.4	2.3	4.5
Imports	2.4	8.8	3.7	3.5	5.3
Monthly wage, nominal (EUR)	331	351	392	425	459
Unemployment rate (%)	11.3	11.8	12.3	11.9	11.1
Fiscal accounts (% of GDP)					
Budget balance	-3.9	-2.1	-0.5	-1.9	-2.2
Primary balance	-3.3	-1.4	0.3	-1.0	-1.3
Public debt	14.7	15.3	17.6	17.6	21.7
External accounts					
Current account balance (EUR bn)	-0.5	0.1	-0.3	-1.0	-1.6
Current account balance/GDP (%)	-1.5	0.3	-0.7	-2.3	-3.6
Basic balance/GDP (%)	-1.1	0.4	5.4	1.6	4.9
Net FDI (EUR bn)	0.6	1.6	1.2	1.6	2.0
Net FDI (% of GDP)	1.7	4.1	3.1	3.9	4.5
Gross foreign debt (EUR bn)	37.0	35.8	37.8	37.3	38.5
Gross foreign debt (% of GDP)	102.7	93.1	95.4	89.7	87.6
FX reserves (EUR bn)	13.0	13.3	15.6	16.2	18.4
Inflation/Monetary/FX					
CPI (pavg)	2.4	4.2	3.0	3.0	2.9
CPI (eop)	4.5	2.8	4.2	2.9	3.3
Central bank reference rate (eop)	0.2	0.2	0	0.1	0.6
USD/BGN (eop)	1.47	1.51	1.48	1.40	1.37
EUR/BGN (eop)	1.96	1.96	1.96	1.96	1.96
USD/BGN (pavg)	1.48	1.41	1.52	1.44	1.39
EUR/BGN (pavg)	1.96	1.96	1.96	1.96	1.96

Source: UniCredit Research

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

Bulgaria to invest in a more meaningful growth recovery

GDP growth slowed down in the last quarter of the previous year

GDP growth qoq came to a standstill in 4Q12 (slowing down to 0.5% yoy), as exports and individual consumption lost further momentum. At the same time, full-year GDP growth was revised up to 1.8% and 0.8% in 2011 and 2012, from 1.7% and 0.5%. Looking at the GDP expenditure breakdown, the revised data showed that the pace of recovery in consumption was weaker which however was balanced by stronger GFCF of broadly the same scale. Early indications for economic activity in the first month of the current year have been moderately encouraging. Industrial production and construction output added 1.1% and 3.8% in January 2013 on a mom basis, while retail sales posted a smaller-than-expected contraction of just 0.4% mom. All these developments are supportive of our fundamental view, which remains one of a gradual recovery led by individual consumption and, to a lesser extent, by exports and GFCF. We expect export and GFCF to be a tad weaker this year than what was anticipated three months ago, as demand-side conditions in the euro zone are likely to need more time to start improving, while higher uncertainty surrounding snap elections will prolong the time in which companies will remain in a "wait and see" mode. On the positive side, this will be offset by a more supportive fiscal policy as the next government is expected to invest more to start tackling the poverty problem. We keep our GDP growth forecast for 2013 and 2014 unchanged at 1.7% yoy and 2.8% yoy, respectively. Our quarterly GDP path also remains broadly the same – we see relatively weak positive growth in 1Q and 2Q followed by a gradual acceleration in the pace of recovery in 3Q and 4Q.

We keep our long-held constructive growth view unchanged, despite the recent increase in uncertainty surrounding snap elections

Fiscal austerity was taken to extremes at the end of 2012

In the current environment, sound macroeconomic policy is necessary, but not sufficient to boost growth

Fiscal austerity took excessive proportions in 4Q 2012, when the outgoing government overshot its end-year deficit target by an amount equivalent to 0.8% of the country's GDP. As expected, the deficit increased to BGN 536mn (from BGN 298mn a year ago) in the first month of the current year, driven by one-off temporary factors, including higher debt servicing costs, higher contribution to the EU budget and lower corporate income tax revenues, where the latter reflects changes in the tax administration rules which made possible collection periods to be extended. But when what started as street protests against fiscal austerity and deteriorating living standards forced the right-wing GERB government to resign only four months ahead of the next general elections, it became clear that the policy needs to change. It was the failure of the outgoing government to boost growth and create jobs which finally put social and political stability of the country to its most serious test since the anti-corruption protests in early 2009. Growth is likely to take center stage as a result and become the number one policy priority for the next government, regardless of its composition and how broadly based the governing coalition is. But boosting growth will require more than just keeping a sound macroeconomic framework intact. There are three main reasons for this. First, structural reforms can generate growth, but at least several years will be needed to see their effect on economic activity and jobs to materialize. Second, domestic demand remains fragile and will continue to recover only very gradually due to the lingering effect of the macroeconomic imbalances built up in the credit boom period. Lastly, and perhaps most disappointingly, the escape route which exports should provide does not exist because most of the countries to which Bulgarian export is traditionally channeled are in recession. This combination of factors implies that the Bulgarian government needs to invest more to encourage a more meaningful growth recovery. The growth strategy of the next government is therefore likely to combine preserving sound macroeconomic policies, accelerating structural reforms and avoiding any back-pedaling on EU funds absorption with some carefully designed fiscal stimuli. More than anything else, these fiscal stimuli need to focus on productive investments that have the strongest potential to improve the capacity of the economy to produce more goods and services in the long run, while also boosting demand in the short run. In addition, importantly, the scale of these fiscal stimuli should be carefully calibrated so that there are no risks to the sustainability of public sector finances.

We see moderate fiscal easing as justified at this stage of the economic cycle

At the same time, there can be no doubt that the country's fiscal position is sufficiently comfortable to make such a shift in policy possible. Most recent data put the deficit and debt in the public sector at 0.5% (end-2012) and 15% (January 2013) of GDP, respectively. Total general government expenditures were only 35.4% of GDP in 2012, which makes Bulgaria's reallocation of resources through the budget the lowest in the EU. This reflects not only the fact that Bulgaria has one of the lowest taxation levels in the EU, but also that over the last four years since the start of the crisis the outgoing right-wing GERB government was able to consolidate public sector finances without resorting to any major tax increases.

All these provide a sufficient space for a moderate and risk-free increase in fiscal expenditures, in case these are channeled into initiatives that improve competitiveness and help to start addressing the poverty problem. Against this backdrop, we see the budget deficit edging higher to 1.9% of GDP in 2013 and further to 2.2% in 2014, as compared with 1.3% and 0.9% in our previous quarterly publication three months ago.

Given the sticky unemployment numbers in early 2013, we doubt that the labor market will provide any support to the household spending recovery in the first half of this year

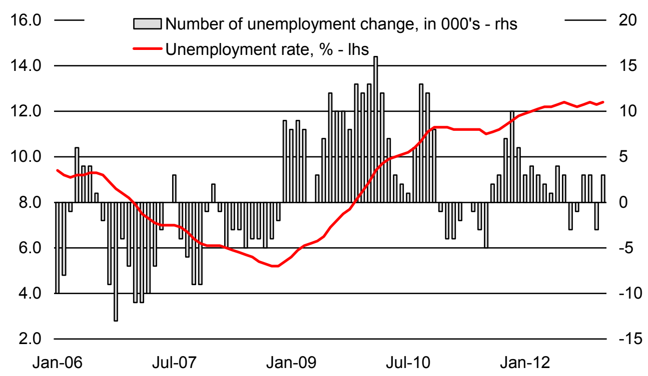
Unemployment rate suffered another setback in Jan 2013 and there are no signs that the labor market recovery will gain more strength any time soon. The seasonally adjusted unemployment rate remained stacked in between 12.2% and 12.4% for a tenth consecutive month, adding to the evidence that strong fiscal fundamentals and sound macro framework more generally is important, but not enough to boost growth and jobs creation. Looking into the next several months, there are no reasons for optimism either, as the most recent surveys of companies' employment intentions have failed to produce enough encouraging news. The balance between managers hiring and firing intentions remained negative in all sectors of the economy in January 2013, despite some marginal and driven mostly by seasonal factors mom improvement in industry, retail trade and construction. The government's resignation is likely to become another setback for the labor market recovery in the short-run, as it adds to the uncertainty and prolongs the time in which companies will abstain from starting major new projects and hiring new staff. Given all that, we doubt that there will be any fall in the unemployment rate in 1H 2013. The hopes for a more meaningful labor market recovery remain associated with 2H 2013, when growth enhancing fiscal stimulus, moderately stronger exports and a reacceleration of EU funds absorption should help the unemployment rate to ease marginally to 11.9% in December.

Broad-based improvement of BOP trends continues

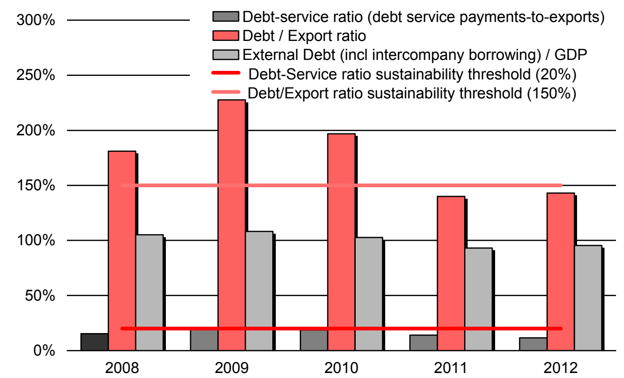
External vulnerability has been markedly reduced but has not gone away

The CA posted a small deficit (0.7% of GDP) for the whole 2012, from a surplus of broadly the same proportion (0.3% of GDP) one year earlier. The financial account, on the other hand, shifted from a deficit equivalent to 2% of the country's GDP in 2011 to a sizeable 5.4% surplus in 2012. This reflects a large scale improvement in the volume of capital channeled through practically all institutional sectors in the economy, as the financial situation has improved markedly after the middle of 2012. External debt sustainability indicators including foreign debt to GDP ratio, debt service payment to export ratio, and debt to export ratio have likewise reported a significant improvement, and are now below the levels seen as problematic for the standards of emerging market economies. But the large stock of foreign liabilities in the non-financial corporate sector means that deleveraging is not over, and will continue to act as a drag on the pace of economic recovery over the next several years. Looking ahead at the rest of this year and further into 2014, we see no need to alter significantly our BOP forecast. For us, the resignation of the government is not a game changer, as it came only four months before the end of its original mandate. Of course, we are likely to see marginally weaker capital inflows (including somewhat softer FDI numbers) this year as the "wait and see" approach that investors usually take in the run-up to elections will now continue somewhat longer. But apart from this short-term softening in the capital flows channeled to Bulgaria, the ongoing political turmoil, in our view, is likely to have no major implications on the country's long-term capacity to attract investments.

Labour market



Debt sustainability indicators



Source: BNB, NSI, UniCredit Research

Strategy: Limited scope for positive movements in GB prices

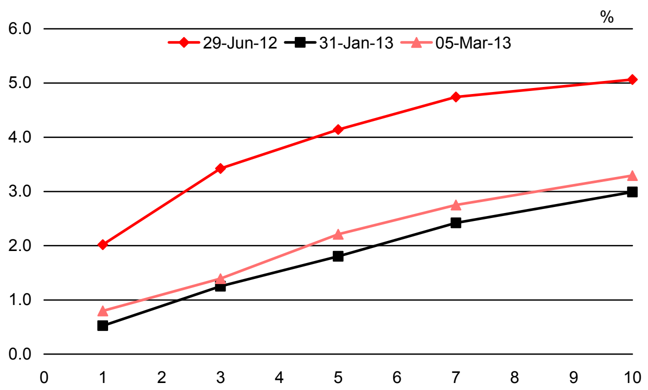
GB yields and CDS premia have already started moving south following a peak in early March – 2 weeks after the government resigned

Most of the upside potential in GB prices has already been absorbed by the market and any improvement in yields from here has only limited scope. This is despite the recent deterioration in GB yields due to the ongoing political crisis. Yet, as investors see this as a short-lived disturbance to debt market dynamics, CDS spreads have already begun to tighten again, while yield curve changes have also been limited and are still much more favorable than in 2012 (see charts below). As political noise abates in 2Q and heading into 3Q, we see CDS premia returning to a stable level just above 100bp (from their latest peak of 138bp), with 1/3 of the tightening already absorbed by the market. As far as GB yields are concerned, we see limited scope for improvement to around 3% at the 10Y part of the curve (from circa 3.30% in recent weeks), and to 0.60% in the short end of the curve (from 0.80%). This is mainly due to the fact that fiscal fundamentals remain intact.

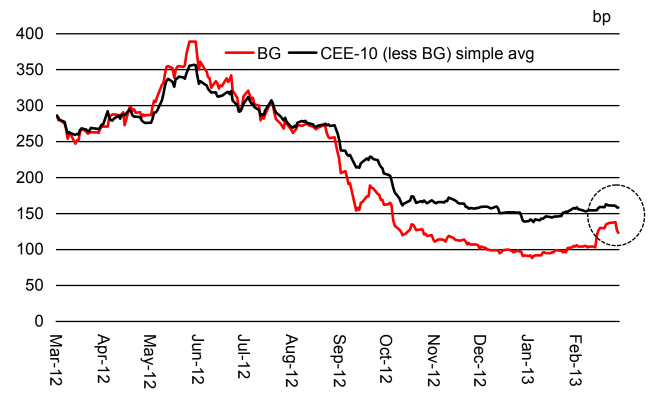
Author: Nikola Georgiev, Economist and FI/FX Strategist (UniCredit Bulbank)

POLITICAL NOISE IN FEBRUARY HAD ONLY LIMITED EFFECT ON SOVEREIGN DEBT DYNAMICS

Domestic GB yield curve



5Y sovereign CDS



Source: BNB, MF, Bloomberg, UniCredit Research

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2011	2012E	2013F	2014F
Gross financing requirement	**1.5**	**0.9**	**2.6**	**1.8**
Budget deficit	0.8	0.2	0.8	1.0
Amortization of public debt	0.5	0.5	1.6	0.6
Domestic	0.4	0.4	0.6	0.5
Bonds	0.4	0.4	0.2	0.5
Bills	0	0	0.4	0
External	0.1	0.1	1.0	0.1
WB/EIB/JBIC/Others	0.2	0.2	0.2	0.2
Financing	**0.9**	**1.4**	**1.7**	**2.6**
Domestic borrowing	0.6	0.6	1.5	1.0
Bonds	0.6	0.6	1.1	1.0
Bills	0	0	0.4	0
External borrowing	0.2	0.8	0.2	1.6
Bonds	0	1.0	0	1.5
WB/EIB/JBIC	0.2	-0.2	0.2	0.1
Other	0.1	0	0	0
Fiscal reserves change (- =increase)	0.5	-0.6	0.9	-0.8

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2011	2012E	2013F	2014F
Gross financing requirement	**16.5**	**15.6**	**16.4**	**15.4**
C/A deficit	-0.1	0.3	0.9	1.5
Amortization of medium to long term debt	5.4	5.4	5.8	4.6
Government/central bank	0.3	0.3	1.2	0.3
Banks	0.8	0.8	0.7	0.6
Corporates	4.3	4.3	4.0	3.8
Short term debt amortization	11.2	9.9	9.7	9.2
Financing	**16.9**	**17.8**	**17.1**	**17.6**
FDI	1.6	1.2	1.6	2.0
Portfolio flows	-0.4	-1.6	-0.2	-0.1
Borrowing	5.6	6.6	7.2	4.5
Government/central bank	0.3	0.8	0.2	1.6
Banks	0.8	0.8	0.2	0.3
Corporates	4.5	5.0	6.9	2.6
Short-term	9.9	9.7	9.2	8.8
EU transfers	0.7	1.0	1.1	1.0
Other	-0.6	0.8	-1.9	1.4
Change in FX reserves (- =increase)	0.4	2.2	0.7	2.2

Source: BNB, MF, UniCredit Research

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

Outlook – Stabilization of GDP in qoq terms, following four consecutive periods of contraction, is possible in 1Q. This is supported by an improving economic situation in Germany as well as better domestic leading indicators and will generate some modest positive full year growth this year. The CNB will focus its policy on the exchange rate. Market interventions are unlikely at current EUR/CZK levels. The CNB would like avoid adopting this policy at any stage this year but it cannot be ruled out during CZK appreciation spells envisaged later in 2013.

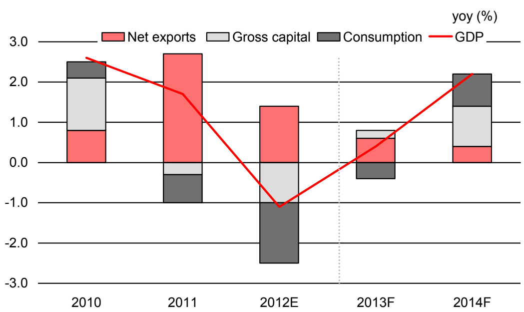
Strategy outlook – The CNB policy of zero interest rates will be maintained throughout this year and into next, keeping bond yields low, but the recovery in activity combined with the potential for upward pressure on bund yields means that the risks are weighted towards a weakening in bonds.

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

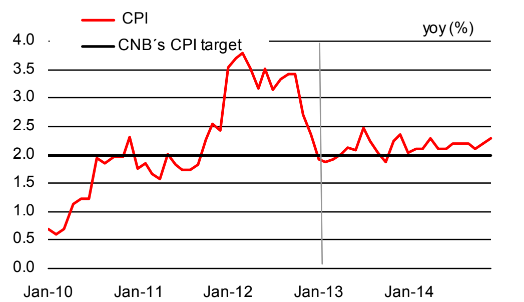
KEY DATES/EVENTS

- 2012 public deficit notification – April
- CNB policy meetings – 28 Mar, 2 May
- Manufacturing PMI – 2 Apr, 2 May, 3 Jun

MORE BALANCED GDP STRUCTURE IN 2013, PRIVATE SPENDING TO REBOUND ONLY IN 2014



THE FALL OF CPI BELOW THE 2% TARGET IS DEEMED TEMPORARY



Source: NSO, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2010	2011	2012E	2013F	2014F
GDP (EUR bn)	150.1	156.1	153.0	155.8	166.1
Population (mn)	10.5	10.5	10.5	10.5	10.5
GDP per capita (EUR)	14,274	14,874	14,553	14,800	15,755
Real economy yoy (%)					
GDP	2.3	1.9	-1.1	0.4	2.2
Private Consumption	0.9	0.7	-2.8	-1.0	1.5
Fixed Investment	0.6	-0.7	-1.1	-1.2	3.0
Public Consumption	0.5	-2.5	-1.0	-1.0	0.5
Exports	15.0	9.4	4.3	6.3	8.8
Imports	15.3	6.7	2.3	6.0	9.4
Monthly wage, nominal (EUR)	944	994	993	1,004	1,060
Unemployment rate (%)	7.0	6.7	6.8	7.5	7.0
Fiscal accounts (% of GDP)					
Budget balance	-4.8	-3.3	-5.2	-3.1	-3.0
Primary balance	-3.5	-1.9	-3.8	-1.7	-1.5
Public debt	37.8	40.8	45.7	47.5	48.5
External accounts					
Current account balance (EUR bn)	-5.8	-4.4	-3.6	-2.4	-2.0
Current account balance/GDP (%)	-3.9	-2.8	-2.3	-1.5	-1.2
Basic balance/GDP (%)	-0.8	-0.4	3.1	2.7	3.0
Net FDI (EUR bn)	4.6	3.9	8.4	6.5	7.0
Net FDI (% of GDP)	3.1	2.5	5.5	4.2	4.2
Gross foreign debt (EUR bn)	70.5	72.6	77.2	81.4	89.8
Gross foreign debt (% of GDP)	47.0	46.5	50.4	52.3	54.1
FX reserves (EUR bn)	31.8	31.1	34.0	34.0	34.0
Inflation/Monetary/FX					
CPI (pavg)	1.5	1.9	3.3	2.1	2.2
CPI (eop)	2.3	2.4	2.4	2.4	2.3
Central bank target	2.0	2.0	2.0	2.0	2.0
Central bank reference rate (eop)	0.75	0.75	0.05	0.05	1.00
3M money market rate	1.09	0.97	0.75	0.30	0.60
USD/CZK (eop)	18.8	19.4	19.0	18.1	17.1
EUR/CZK (eop)	25.1	25.8	25.1	25.3	24.5
USD/CZK (pavg)	19.1	17.6	19.6	18.7	17.7
EUR/CZK (pavg)	25.3	24.6	25.1	25.4	24.9

Source: UniCredit Research

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

Economy at a turning point

4Q12 was the fourth quarter in a row showing negative qoq GDP

The flash GDP estimate for 4Q12 showed a seasonally-adjusted drop of 0.2% qoq and 1.7% yoy, suggesting that the recession in the economy extended to a fourth consecutive quarter. Comments by CZSO on the GDP components confirmed general expectations that the positive contribution of foreign demand failed to offset declining household consumption and gross capital formation. On the production side, all major sectors, including industry, were reported to have been a drag on 4Q GDP. A positive impact, on the other hand, came from the tobacco tax hike (from January 2013) which brought forward purchases of tobacco products. In regard to full-2012 GDP, CZSO revealed that the contraction reached 1.1%, driven mainly by a drop in household consumption of more than 3%. Fixed investment was also said to be lower yoy, while foreign trade pushed GDP up as export growth (4.3%) outpaced import growth (2.3%).

A number of one-off factors seem to have dampened 4Q12 GDP

The 4Q12 GDP figure seems to have been affected by a number of specific factors. First, the uncertainty surrounding VAT changes for this year, lasting until the very final days of 2012 might have led many businesses to postpone activities to the beginning of the new year. Second, the disproportionately weak car production in December (-17.7% yoy) may have reflected not only poor final demand but in addition the distributors' one-off reduction of inflated stock levels. And finally, a specific decomposition of Christmas holidays likely prompted some firms to interrupt production for longer than is usual at year-end. This view is supported by an abrupt deterioration in the working-day adjusted industrial output in 4Q (-5.1% yoy) vs. 3Q (-1.0% yoy) that was inconsistent with business sentiment developments. Despite all the factors, the qoq GDP contraction in 4Q12 actually eased from previous periods, which raises hope for a turnaround in the economic cycle.

Leading indicators are supportive of a stabilisation in GDP in 1Q13 GDP

With hard data on activity in the actual quarter still sparse, it is mainly economic sentiment that is shaping our view on 1Q GDP. In industry, leading indicators suggest that the most important sector of the economy bottomed out in 4Q. After hitting a low at 46.0 in December, the manufacturing PMI rose to 48.3 in January and to 49.9 in February. More importantly, four out of five major PMI components posted an improvement from January, with new orders jumping above the neutral 50.0 mark. Similarly, the CZSO's confidence index for industry rebounded in February to hit the highest level since mid-2012. Confidence among consumers in February even rose to the highest reading since late 2011, albeit still staying low by historical standards. The improvement captures the removal of uncertainty on tax changes and the perception of a recent sharp slowdown in inflation. Arguably, the economic upturn around the beginning of the year may also be highlighted by state budget figures showing increases in VAT collection (up 35% yoy for Jan-Feb period) that go well beyond the rate hike impact. Here, however, we caution on the need to wait for more data before making a firm conclusion. In any case, we believe the economy will exit recession in 1Q, with GDP at 0.0% or 0.1% qoq.

2013 GDP growth should be primarily driven by reviving external demand, fixed investments and household spending are likely to recover only with a delay

Looking beyond Q1,growth should gradually gain momentum. Foreign demand will likely be the first component to start driving GDP higher. This assumption is based on positive signs from Germany, expectations of stable oil prices and milder fiscal consolidation in eurozone countries compared to last year. Recovery of capital expenditures should follow later this year and post a moderate rise on a full-year comparison. Nonetheless, the rise will likely be attributable to a pick-up in the inventory cycle, while fixed investments are set to revive only with a delay. Household consumption is expected to continue contracting in 2013, albeit milder than last year. Nominal wage growth will hardly exceed average inflation at a projected 2.1%, whereas the indexation of pensions will stay about 1 p.p. below it. The impact of the recession will continue to be felt in unemployment, which is projected to keep growing for most of this year. For full-2013, we expect GDP to expand by 0.4%, 0.3 p.p. less than previously anticipated.

Inflation fell sharply, close to the 2% CNB target

Inflation has eased significantly as in just three months to January CPI fell yoy from 3.4% to 1.9%. The drop appears to be a function of the sluggish economy, declining fuel prices, smaller price increases in the housing segment but also confusion surrounding the VAT rise at the turn of the year.

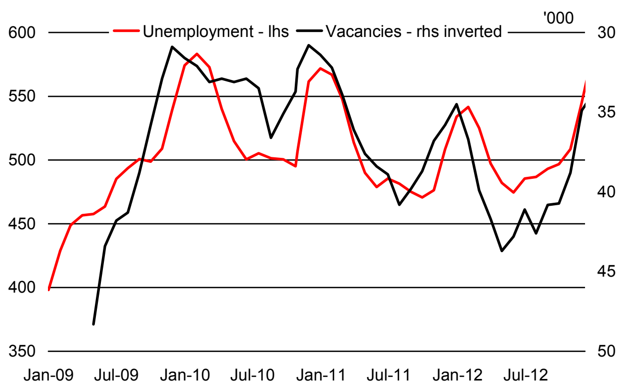
We expect that, due to uncertainty lasting until the last days of the year, many retailers postponed their planned price adjustments, and these will push inflation a bit higher in coming months. That said, although we expect CPI to return to or be slightly above 2% in the next few months, the inflation picture is set to remain favorable. We project average 2013 inflation to reach 2.1%, down from last year's 3.3%.

Basic balance development confirms sound external position of the country

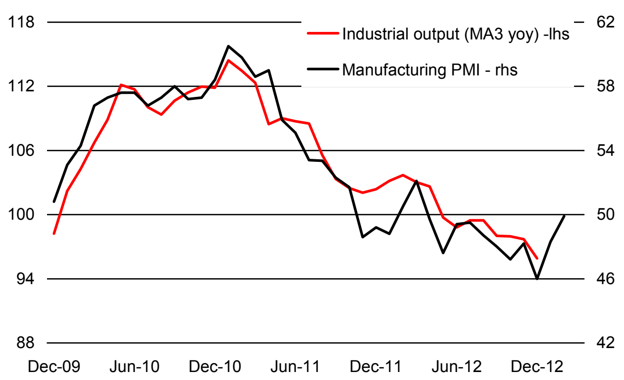
According to preliminary 2012 BoP data, the C/A deficit amounted to 2.3% of estimated GDP, down from 2.8% in 2011. The improvement came solely from a foreign trade surplus rising to a new record level, while the other components of C/A posted a small deterioration. On the financial account, net FDI to GDP ratio surged to 4.8%, the highest ratio since 2007, versus the previous year's 2.0%, thanks mainly to a reviving inflow of base capital. We expect the basic balance will continue showing surpluses in 2013-2014.

MIXED DATA ARE COMING FROM THE ECONOMY, AS IS TYPICAL FOR THE EARLY STAGES OF A CYCLE

Labor market still reflecting the 2012 recession…



Industrial output stabilization gathers pace



Source: Markit, CZSO, UniCredit Research

CNB will continue to focus its policy on the exchange rate

In its latest forecast revision, the CNB boosted its CPI forecasts for 1H14 by a notch to 1.7% and cut 2013 GDP growth by 0.5pp. to -0.3%. It also raised the 2013 outlook for 3M PRIBOR to 0.4% from the previous 0.2% and made a marginal upward change in the EUR/CZK projection for 2013 to 25.3 from the previous 25.1. The small scale of CZK target depreciation came as a surprise for markets but looking ahead the zero interest rate policy is almost certain to be maintained for the rest of 2013 (and probably longer), while the CNB's focus will remain on the exchange rate. The CNB's preferred scenario is to steer CZK through occasional verbal interventions and to avoid battles on the FX market. It now looks as if this may not be unrealistic. With our EUR/CZK forecasts at 25.4 for 2013-average and 25.3 for year-end, we remain close to the CNB's target level. However, crunch time for CNB policy will come when the Czech economy starts rebounding and the market risk-on mood emerges later in the year. Recent remarks of Governor Singer who identified market interventions as being likely in 2H13 suggest that part of the CNB board works with the same risk.

Fiscal policy is considered more restrictive by CNB than by other institutions

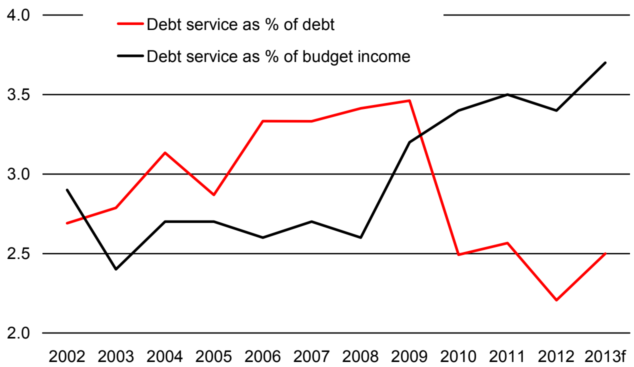
The efforts of the CNB to maintain loose monetary conditions also stem from the assumption of fiscal policy staying considerably restrictive in 2013. Indeed, the structural budget deficit is estimated by the CNB to narrow to 1.8% from last year's 2.9% of GDP. However, the CNB apparently bets on budgetary consolidation measures also proving efficient in non-structural terms, as its projected public deficit at 2.7% of GDP is below estimates of FinMin (2.9%) and the European Commission (3.1%). Our forecast is consistent with the higher end of the spectrum, meaning the deficit will hardly improve from 2011 when it reached 3.3% of GDP.

Strategy: Low-risk, low-yield environment for debt holders to be maintained

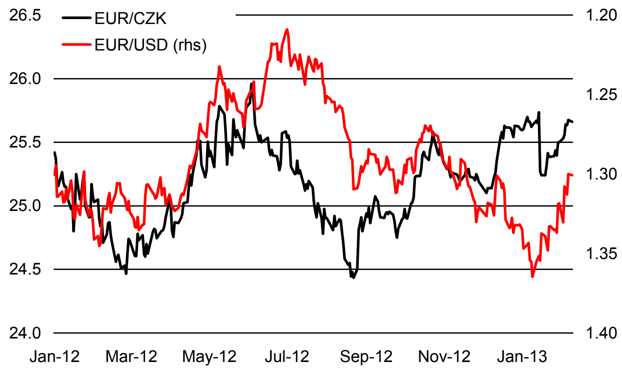
Hefty cash reserves of the government may serve as a safeguard against financial stress

Parameters of state debt financing are set to be similar to 2012. The gross borrowing requirement should amount to CZK 231.7bn, of which a maximum of CZK 219bn should be financed via domestic bonds, both the fixed coupon (with tenors up to 15 years) and the floaters. The state also intends to place at least one syndicated Eurobond issue and wants to continue issuing domestic retail bonds. Last year borrowing hit CZK 309bn, but it boosted the government's cash reserves by an estimated CZK 51bn to as much as CZK 135bn. That said, public debt to GDP will rise at least until 2014, when it is projected to reach 48.5%. Debt service may hit an all-time high of 3.6% of budget revenues in 2013, despite ongoing low average interest rates on debt financing. As for expected bond yields, the CNB policy of zero interest rates will keep short-term bond yields rather unattractive for investors. Nevertheless, hefty cash reserves of the government will cushion some potential pressure from higher bund yields. On balance, we expect CZK bonds to trace German Bunds, with only a moderate upward yield drift envisaged throughout 2013.

Debt service is on the rise despite a drop in average interest rates



Hopes for CNB FX interventions temporarily moved EUR/CZK from its EUR/USD pattern through early 2013



Sources: MoF, CNB, UniCredit Research

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2012E	2013F	2014F
Gross financing requirement	**18.8**	**16.5**	**17.6**
Budget deficit	4.0	3.9	3.8
Amortization of public debt	12.7	12.5	13.9
Domestic	12.5	12.4	13.9
Bonds	5.0	5.0	6.3
Bills	7.5	7.4	7.6
External	0.2	0	0.1
Change of govt. cash reserve	2.0	0.1	-0.1
Financing	**18.8**	**16.5**	**17.6**
Domestic borrowing	15.9	14.5	15.6
Bonds	8.4	7.1	8.0
Bills	7.5	7.4	7.6
External borrowing	2.9	2.0	2.0
Bonds	2.7	2.0	2.0
IMF/EU	0	0	0
Other	0.2	0.1	0

GOVERNMENT DEBT AND FINANCIAL ASSETS

EUR bn	2012E	2013F	2014F
Gross government debt	**66.3**	**69.7**	**74.7**
Bills	7.5	7.4	7.6
Domestic bonds	41.4	42.6	48.3
Eurobonds	12.4	14.2	12.9
Retail bonds	2.2	2.9	3.5
EIB credits	2.8	2.6	2.4
State financial assets (SFA)	**7.5**	**7.6**	**7.7**
Nuclear portfolio	0.7	0.8	0.9
Pension portfolio	0.9	0.9	0.9
SFA special accounts	0.4	0.4	0.4
Lending	0.1	0.1	0.1
Cash reserves	5.4	5.4	5.4

Source: NSO, CNB, MinFin, UniCredit Research

Estonia (AA- stable/A+ stable)*

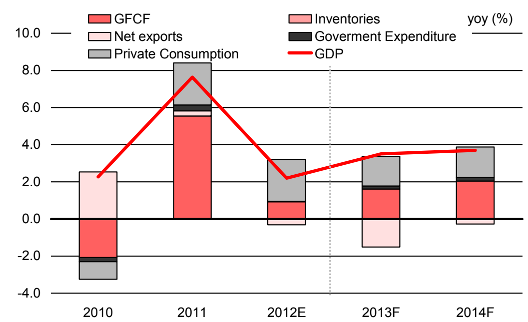
Outlook – According to the preliminary data, 4Q GDP growth peaked again at 3.7% yoy (+0.9% qoq sa) versus 3.5% yoy (+1.6% qoq sa) in 3Q, translating into 3.6% yoy FY12 growth. For 2013, we expect GDP growth to stabilize also at around 3.5%. We see domestic demand in 2013 as the main driver of economic expansion, supporting the economy through a period of external instability and trade balance deterioration. IP rebounded in November-January, thanks to the recovery of external demand for electronic products. Retail sales in line with 2012 continue to show sound growth. 4Q C/A data showed deterioration, especially on the trade balance side, but, based on the history of statistical data revisions, we do not rule out a review of the C/A numbers to give a more positive picture in 4Q C/A final release.

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

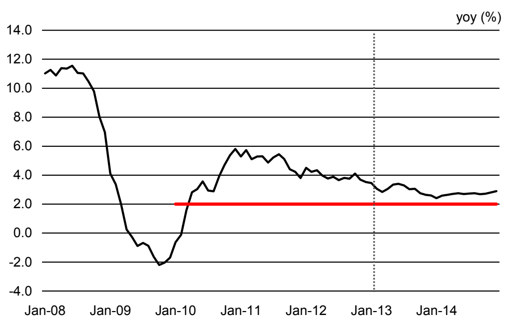
KEY DATES/EVENTS

- 13 May, 10 Jun – 1Q GDP (prelim/final)
- 2 Apr, 30 Apr, 31 May – Industrial production
- 2 Apr, 30 Apr, 31 May – Retail trade

CONSUMPTION TO SUPPORT GROWTH



INFLATION TO REMAIN CONTAINED



Source: NSO, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2010	2011	2012E	2013F	2014F
GDP (EUR bn)	14.5	16.4	17.6	18.8	20.0
Population (mn)	1.3	1.3	1.3	1.3	1.3
GDP per capita (EUR)	10,871	12,311	13,252	14,132	15,043
Real economy yoy (%)					
GDP	3.1	7.6	3.6	3.5	3.7
Private Consumption	-2.1	6.6	4.5	3.1	3.2
Fixed Investment	-9.6	26.8	3.7	6.5	8.0
Public Consumption	-2.0	1.6	0.1	0.9	1.1
Exports	21.2	24.8	6.3	8.5	10.2
Imports	20.5	27.3	7.2	9.3	11.2
Monthly wage, nominal (EUR)	788	820	890	910	930
Unemployment rate (%)	16.8	11.6	10.2	7.9	6.8
Fiscal accounts (% of GDP)					
Budget balance	0.2	1.1	-0.2	-0.5	0
Primary balance	0.2	1.0	-0.2	-0.5	0
Public debt	7.7	5.7	5.5	5.7	5.3
External accounts					
Current account balance (EUR bn)	0.5	0.5	-0.4	-0.1	-0.3
Current account balance/GDP (%)	3.6	3.0	-2.1	-0.6	-1.4
Basic balance/GDP (%)	11.0	12.8	-0.9	0.4	0
Net FDI (EUR bn)	0.9	1.2	0.2	0.2	0.3
Net FDI (% of GDP)	7.4	9.8	1.2	1.0	1.4
Gross foreign debt (EUR bn)	16.6	15.7	15.0	14.0	13.8
Gross foreign debt (% of GDP)	114.2	95.6	85.0	74.4	68.9
FX reserves (EUR bn)	2.6	2.3	2.5	2.5	2.5
Inflation/Monetary/FX					
CPI (pavg)	3.0	5.0	3.9	3.0	2.7
CPI (eop)	3.9	3.7	3.5	2.6	2.9
Euribor 3M (since 2010)	0.80	EUR	EUR	EUR	EUR
USD/EEK (eop)	11.8	EUR	EUR	EUR	EUR
EUR/EEK (eop)	15.6	EUR	EUR	EUR	EUR
USD/EEK (pavg)	11.8	EUR	EUR	EUR	EUR
EUR/EEK (pavg)	15.6	EUR	EUR	EUR	EUR

Source: UniCredit Research

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

Holding up against external headwinds

GDP is stabilizing, the risk from extern trade downturn is limited

According to the preliminary data, 4Q GDP growth peaked again at 3.7% yoy (+0.9% qoq sa) versus 3.5% yoy (+1.6% qoq sa) in 3Q, translating into 3.6% yoy FY12 growth. For 2013, we expect GDP growth to stabilize also at around 3.5%. We see domestic demand in 2013 as the main driver of economic expansion. At the same time, we expect the external environment to have only a limited impact on Estonia's economy through net exports – according to the Statistics Estonia, growth of export accelerated to 10%yoy in 4Q.

IP recovered by year-end, while retail sales remained strong

Following a series of negative yoy numbers recorded through May-August, IP rebounded 1.2% yoy in November, 6.0% yoy in December and 5.5% yoy in January. The July and August results at -7.2% and -2.9% yoy may be attributed to a decline in energy production affected by the growth of imports of electricity from Nordic countries, where prices for the period were lower than in the local market. The end-of-year recovery was also boosted by external factors, this time by the recovery in external demand for electronic products (which was contrary to our expectation, as we expected demand in this segment to remain low due to the global backdrop). Meanwhile, retail sales in line with the rest of 2012 continued to show a sound growth rate, increasing by 5.0% yoy in November-December, but showing some signs of deceleration to 4.0% yoy in January, The impressive dynamic in retail sales is supported by the positive labor market dynamics, as unemployment fell to 9.3% in 4Q12 from 11.4% in 4Q11, while gross wage growth in 4Q accelerated to 5.9% yoy from 5.7% yoy in 3Q and 5.0% in 2Q. Meanwhile, inflation remained broadly unchanged over the period at 3.7% in 4Q. The spike in inflation to 4.1% yoy in October proved to be short lived (we attribute this only to temporary one-off adjustments of energy prices) and it stayed in the 3.4-3.6% range for 4Q12.

4Q C/A showed deteriorating performance, but we wait for the final numbers to clarify the picture

FY12 C/A data showed deterioration, finishing the year at a deficit of 2.1% of GDP, versus a moderate 9M C/A deficit at 0.7% of expected FY12 GDP. Moreover, the goods and services trade surplus in 4Q posted a negative performance. The combined goods and services trade balance moved into the red to EUR 52mn from an EUR 250mn surplus in 4Q11, bringing FY12 surplus on this item down to EUR 400mn, or 2.4% of FY12 GDP. Overall, for FY12 import posted +9.3% yoy growth compared with export growth of only 4.9% yoy. The deficit on the incomes balance remained unchanged in 4Q (EUR 248, flat yoy) and in FY12 widened by 10.9% to EUR 1,032mn. Current transfers fell by 10.3% yoy to EUR 117bn in 4Q12, to EUR 261mn for FY12. The capital account surplus grew by around a quarter to EUR 252mn in 4Q12, and for FY12 remained almost flat yoy with an EUR 661mn surplus. FDI again posted a disappointing result, as the deficit on this item in 4Q12 widened by 2.5x, or around 2.5% of GDP, which partially eradicated earlier 1-3Q gains and cut FY12 FDI surplus to EUR 1.2% of GDP. Other investments surprised on the upside, as they recorded a sound EUR 226mn surplus in 4Q12 versus an EUR 732mn deficit in 4Q11, representing a return of money to the Estonia-based bank from foreign parents, following a deleveraging process registered through 2010-2011. However, for FY12 this item remained deep in the red with negative EUR 296mn figure (1.7% of FY12 GDP). All that said, based on the history of C/A data revisions we do not rule out a significant revision of the above-mentioned numbers in the 4Q C/A final release to a more positive picture.

The deficit marginally widens, but public finances are under very strict control

According to preliminary estimates, the 2012 budget posted a 0.2% deficit – as a reminder, the 2013 budget sees the deficit at 0.7%, under an assumption of 3% economic growth (for more details on the structure of the 2013 budget, please see our previous Quarterly publication). According to Statistics Estonia, in FY12 the revenues increased by 9.12% yoy vs. 7.3% growth of expenditures. Despite that the methodology used here is different from the one used by EUROSTAT, these numbers again re-confirm the sound state of public finance. According to the Ministry of Finance data, the collected taxes by 2.3% exceeded the scheduled amount.

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

Outlook – The government managed to reduce the budget deficit below 2.7% of GDP in 2012 at the expense of a deepening recession. Real GDP fell 1.7% and could contract by another 0.1% this year. Since the fiscal adjustment is not sustainable, monetary policy could be used to spur growth ahead of general elections in March 2014. We expect rate cuts to 4.5%, cheap liquidity provisions to kick-start lending and secondary market bond buys if needed. Going forward, public policies are likely to weigh on the HUF.

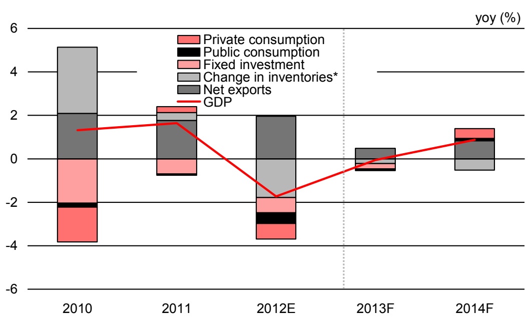
Strategy – We expect a steepening of the 1Y – 5Y segment of the yield curve: the short end might react more to base rate cuts, since it is mostly purchased by local investors. We believe that the authorities are more comfortable with EUR-HUF close to 300 and we expect the pair to trade around that level in 2013.

Author: Dan Bucşa, Economist (UniCredit Bank London)

KEY DATES/EVENTS

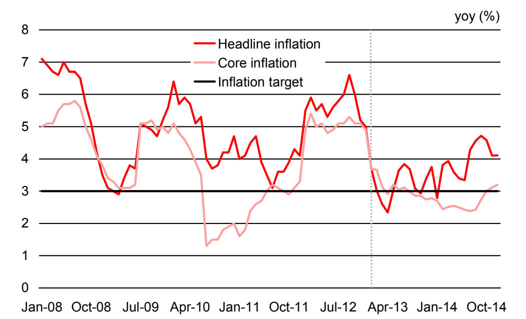
- NBH rate meetings: 26 Mar, 23 Apr, 28 May, 25 June
- Q1 GDP data: 15 Apr
- 3 May: European Commission spring forecast
- 14 May or 21 June: ECOFIN discusses EDP for Hungary

GDP DRIVERS



*Adjusted for statistical error

INFLATION VS. TARGET



Source: CSO, NBH, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2010	2011	2012E	2013F	2014E
GDP (EUR bn)	97.2	100.5	99.2	100.1	105.9
Population (mn)	10.0	10.0	10.0	10.0	10.0
GDP per capita (EUR)	9,696	10,045	9,923	10,011	10,597
Real economy yoy (%)					
GDP	1.3	1.6	-1.7	-0.1	0.9
Private Consumption	-2.7	0.2	-1.4	-0.1	0.9
Fixed Investment	-9.7	-5.5	-3.8	-1.3	0.4
Public Consumption	1.1	-2.4	-2.3	-0.4	0.2
Exports	14.3	8.4	2.0	1.4	2.9
Imports	12.8	6.3	0.1	1.0	2.4
Monthly wage, nominal (EUR)	736	763	771	770	799
Unemployment rate (%)	11.1	10.9	11.0	10.8	10.7
Fiscal accounts (% of GDP)					
Budget balance	-4.2	4.3	-2.7	-3.1	-3.4
Primary balance	-0.7	-2.7	1.2	0.9	0.5
Public debt	82.2	81.6	78.0	78.1	77.1
External accounts					
Current account balance (EUR bn)	1.2	0.9	1.0	1.5	1.6
Current account balance/GDP (%)	1.2	0.9	1.0	1.5	1.5
Basic balance/GDP (%)	3.0	3.8	2.5	3.6	3.6
Net FDI (EUR bn)	1.7	3.0	1.5	2.1	2.2
Net FDI (% of GDP)	1.8	3.0	1.5	2.1	2.1
Gross foreign debt (EUR bn)	138.2	131.7	131.9	127.2	122.8
Gross foreign debt (% of GDP)	142.3	130.9	132.9	127.1	115.9
FX reserves (EUR bn)	32.3	35.1	31.8	31.8	30.5
Inflation/Monetary/FX					
CPI (pavg)	4.9	3.9	5.6	3.1	3.9
CPI (eop)	4.7	4.1	5.0	3.5	4.1
Central bank target	3	3	3	3	3
Central bank reference rate (eop)	5.75	7.00	5.75	4.50	5.50
3M money market rate	5.48	6.10	6.98	4.77	4.97
USD/HUF (eop)	209.59	233.93	225.10	214	210
EUR/HUF (eop)	278.75	311.13	291.29	300	300
USD/HUF (pavg)	207.54	199.48	225.10	219	210
EUR/HUF (pavg)	275.32	279.27	289.34	298	296

Source: UniCredit Research

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

Restarting growth could prove a mighty chore

The budget deficit fell below 3% of GDP at the expense of a deepening recession…

In 2012, the Hungarian government sacrificed growth in order to push the budget deficit below 3% of GDP, reduce the debt to GDP ratio and exit the excessive deficit procedure initiated by the European Commission in 2004. While managing to achieve the first target, the government also pushed the economy deeper into recession, with GDP falling by 0.9% qoq in 4Q12 and 1.7% in 2012, the worst performance among new EU members. Industrial production plunged 4.1% qoq in the last quarter of 2012, falling 7.6% yoy in December and 7.1% yoy in November mainly due to a sharp drop in demand from Western Europe. The new production capacities at Audi and Mercedes were offset by Suzuki's reduced output in November and December and the production of transport equipment declined 3.3% qoq. Exports fell 7.9% and the trade surplus decreased by 36% yoy in December and by 8.0% yoy in 4Q12. Construction and retail sales contracted in 4Q12 by 5.7% yoy and 3.5% yoy, respectively.

…and a GDP recovery will be subdued…

Despite the very poor growth numbers, we believe that GDP bottomed out in 4Q12. Better sentiment indicators (both GKI and PMI) and improving industrial orders in Germany might support a recovery of industrial output in 1Q13. Nevertheless, weak lending remains a strong drag on domestic demand, limiting investment, consumption and future potential growth. Even if GDP recovers gradually, the negative carryover into 2013 is -1%, meaning that the economic growth could remain flat in 2013 (-0.1%), with risks skewed to the downside. In 2014, real GDP could grow 0.9%, but not enough to return to the 2010 level.

…since fiscal constraints remain very strong…

With one year left until general elections, we expect public policies to focus on reigniting growth. The task is very difficult since the fiscal adjustment doesn’t seem sustainable. New Economy Minister Mihaly Varga is confident that current fiscal policies are tight enough to help Hungary exit the EDP, but the European Commission expects the budget deficit at 3.4% of GDP in both 2013 and 2014. This means that a new fiscal package worth at least HUF 200bn[6] should be implemented by April in order to push the deficit below 3% of GDP in 2013. The Hungarian government remains trapped: the need to deliver rapid fiscal results can be met only by increasing taxes on certain economic sectors (services could be targeted again), since cutting expenditures would be unpopular before elections. Meaningful structural reforms that could alleviate fiscal pressures are unlikely because they could prove costly with voters and won’t generate short-term results. Since Mr. Varga believes that Hungary should avoid adopting a populist budget for election year 2014, the new NBH board could try to help the government by using monetary stimuli.

…shifting the focus to monetary policy to stimulate growth…

…by cutting further the base rate to 4.5% and adopting additional measures, such as…

The new central bank governor and former economy minister, György Matolcsy, declared that the central bank should have three tasks: fighting inflation, maintaining financial stability and supporting the economic recovery by collaborating more closely with the government. Going forward, quick changes in central bank policies are unlikely, but uncertainties regarding the conduct of monetary policy might add to EUR-HUF volatility. Rate cuts will probably continue (we expect three more to 4.5%), despite foreign investors reducing their HGB portfolios. Although the easing cycle has been very abrupt, both markets and economic data validated the cuts in 2012. The demand for HGBs remained strong in 2H12, with net debt purchases from foreign investors at HUF 837bn (EUR 3bn or 3% of GDP). Meanwhile, annual headline inflation fell from 6.6% in September 2012 to 2.8% in February 2013. Moreover, the underlying inflation figures followed by the NBH point to very low demand pressure on prices: the tax-adjusted core inflation rate stood at 1.7% in February 2013, with demand-sensitive inflation at 1.8% and sticky-price inflation at 1.6%. Were it not for administered price increases and potential tax hikes, all three measures would be compatible with headline inflation remaining close to the medium-term target of 3%.

[6] The new package would have to account for lower budget revenues following the cut of electricity prices, eventual tax rebates for banks and a much weaker GDP performance than the government expects (+0.9% in real terms in 2013 vs. general expectations of no growth or a recession in 2013).
The Fiscal Council identified risks to the 2013 budget amounting to HUF 736bn, only partly offset by budgetary reserves (HUF 500bn).

…cheap liquidity provisions to lenders…

The incoming NBH management declared it could implement at least three policy changes before the end of the year. First, the central bank could start providing cheap liquidity to banks that want to lend. With loan demand at historic lows and private sector deleveraging continuing, the scheme will have limited effects at best. Household loans fell by 13% in 2012, most of the contraction coming from the early repayment scheme for FX mortgage loans. Corporate lending fell 10% last year due to widespread economic weakness. The NPL ratio hit 20% amid a lack of new lending, but banks brought EUR 1bn in new capital in order to ensure a capital adequacy ratio of 15.7%. Adding huge bank levies (augmented from 2013 on by a financial transaction tax), the banking system lost HUF 161bn (EUR 550mn) over the year.

…and schemes reducing the FX exposure of households and local authorities…

…in order to allow for more HUF weakness

Second, the NBH and the government could try to reduce the FX exposure of households and local administrations in order to increase the scope for HUF weakness, but authorities will be uncomfortable with FX spikes ahead of elections. With EUR-HUF above 300, the take-up ratio of the fixed exchange rate loan repayment scheme could increase and FX impaired loans could be converted in HUF at a discount. At the same time, the government could take over a larger share of the FX debt of local authorities. Meanwhile, the HUF underperformed all other CEE currencies in 2013 due to portfolio outflows, although bank deleveraging seems to be slowing down (foreign liabilities stopped falling in January after 19 months of outflows).

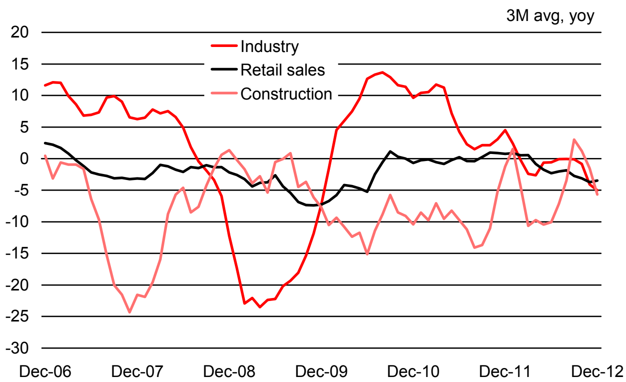
Interventions in the secondary bond market could be used in case of strong portfolio outflows

Third, the NBH could intervene in the secondary market and buy HGBs if risk appetite sours. Since the beginning of the year, foreign investors reduced their HGB holdings by HUF 5.0bn on average per day, in a U-turn from 2H12, when average daily inflows were HUF 5.9bn. So far, local banks offset the lower appetite of foreign investors and increased their T-bond portfolios, attracted by yields that still exceed their funding costs. In that situation, the NBH could intervene to stabilize HUF yields. Foreign investors have been more interested in FX debt, the debt management agency (AKK) issuing USD 3.25bn in FX bonds mid-February to cover 41% of FX sovereign debt repayments for 2013. The AKK could try to issue a similar amount on foreign markets to meet the issuance plan of EUR 4.0-4.5bn, but will also rely on selling more FX retail bonds. These bonds are linked to euro area HICP and currently pay between 4.7% and 5.1% for three years, offering a significant pickup over other FX Hungarian bonds. The outstanding amount for the retail bond was EUR 1.5bn at the end of February 2013, local institutional clients owning 85.7% of the amount.

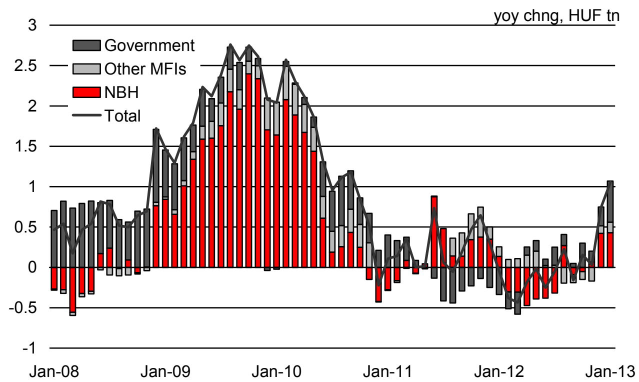
Unpredictable public policies could affect the HUF

The main risks to the HUF stem from changes to public policies. Looser monetary policies could affect FX flows given Hungary's strong reliance on foreign investors to buy its marketable debt. Moreover, the European Commission could react to changes to the constitution by extending the EDP and/or stopping EU fund payments.

Widespread weakness in economic activity accelerated in 4Q12



Local banks park liquidity in HGBs and 2-week bills at the NBH



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

Strategy: Scope for HUF underperformance

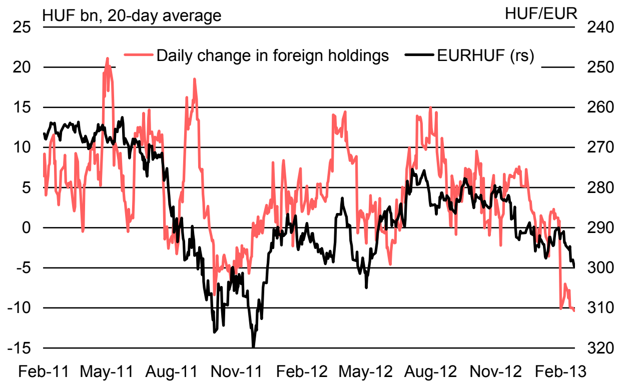
Limited potential for a rally in the short end of the curve due to further rate cuts...

With the central bank continuing to cut rates, we expect a steepening of the 1Y-5Y segment of the yield curve on top of the 40bp registered since the beginning of 2013. While the short end might react more to base rate cuts, since it is mostly owned by local investors, foreign investors could keep the 5Y – 10Y segment closer to current levels. We don't see scope for a rally in the 5Y – 10Y segment of the curve even with central bank support.

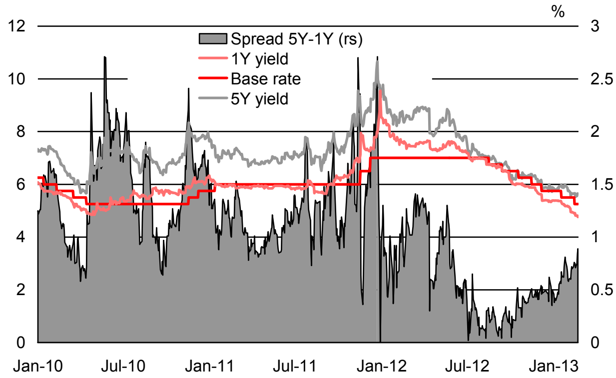
...with rising pressure on the HUF

Hungarian authorities seem more comfortable with EUR-HUF close to 300 and we expect the pair to trade around that level in 2013. If the take-up ratio of the fixed FX loan repayment scheme increases towards the government's target of 90% and/or the government uses other instruments to reduce the FX exposure of individuals and local authorities, the risk is that the HUF will weaken to all-time highs already this year.

Foreign investors are selling HGBs, putting pressure on the HUF



5Y – 1Y yield spread to increase further amid further policy easing



Source: AKK, Bloomberg, UniCredit Research

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2012E	2013F	2014F
Gross financing requirement	**18.7**	**21.9**	**21.0**
Budget deficit	2.7	3.1	3.6
Amortization of public debt	16.0	18.8	17.4
Domestic	9.0	12.6	11.8
Bonds	3.4	6.1	4.8
Bills	5.5	6.5	7.1
Other	1.5	1.2	0
External	5.6	5.0	5.5
IMF/EU and other loans	3.7	3.6	2.9
Bonds	2.0	1.4	2.7
Financing	**18.9**	**21.9**	**21.0**
Domestic borrowing	17.6	17.7	18.0
Bonds	8.1	10.6	10.8
Bills	9.5	7.1	7.2
External borrowing	0	3.6	3.0
Bonds	0	3.6	3.0
IMF/EU	0	0	0
Pension funds	1.3	0	0

Source: AKK, IMF, NBH, UniCredit Research

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2012E	2013F	2014F
Gross financing requirement	**31.4**	**28.6**	**29.4**
C/A deficit	-1.0	-1.5	-1.5
Amortisation of medium to long term debt	10.0	11.6	14.7
Government/central bank	3.9	7.1	8.8
Banks	4.5	3.5	4.0
Corporates	1.6	1.0	2.0
Amortisation of short term debt	22.4	18.5	16.1
Government/central bank	7.2	5.0	4.3
Banks	10.9	9.4	8.3
Corporates	4.3	4.1	3.6
Financing	**31.4**	**28.5**	**29.4**
FDI	0.9	1.3	1.3
Equity	1.6	0.8	1.5
Long-term borrowing	3.6	7.3	7.6
Government/central bank	0	3.6	2.5
IMF	0	0	0
Banks	2.4	2.8	3.3
Corporates	1.2	0.9	1.8
Short-term borrowing	18.5	16.1	14.2
Government/central bank	5.0	4.3	3.7
Banks	9.4	8.3	7.3
Corporates	4.1	3.6	3.2
EU transfers	3.5	3.0	3.5
Change in FX reserves (reduction(+)/increase(-))	3.3	0	1.3

Latvia (Baa3 positive/BBB positive/BBB positive)*

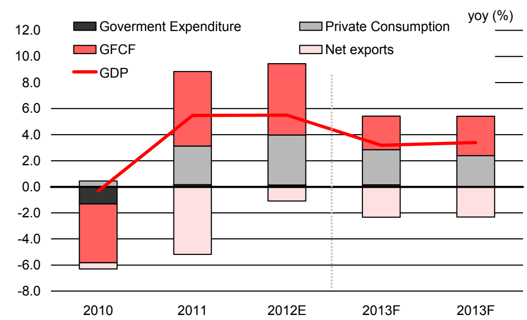
Outlook – GDP growth remains strong, posting gains of 5.1% yoy (+1.3% qoq sa) in 4Q. For FY12, this translates into a 5.5% gain. Latvia continues to outperform other Baltic peers in terms of its pace of growth. We expect growth to moderate to a more sustainable 3.6% this year (with risks to the upside). Retail sales and IP growth rates are volatile, but show signs of stabilization. The decline in unemployment has slowed, however. This may signal some structural inefficiencies which risk creating bottlenecks for growth going forward. Inflation, which for most of 2012 remained a hurdle, has slowed and is now safely within the Maastricht criteria. In the beginning of May, the government initialized a formal eurozone accession procedure and we are positive on the prospects of this bid.

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

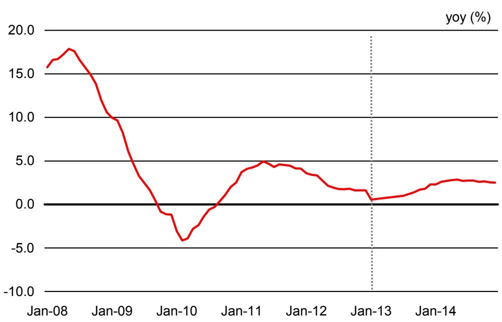
KEY DATES/EVENTS

- April-May – Release of the extraordinary convergence report
- 5 May, 07 Jun – 1Q GDP (prelim., final)
- 03 Apr, 07 May, 03 Jun – Industrial production

CONSUMPTION TO SUPPORT GROWTH



INFLATION HAS BOTTOMED DOWN



Source: NSO, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2010	2011	2012E	2013F	2014F
GDP (EUR bn)	18.0	19.7	21.1	22.4	23.8
Population (mn)	2.3	2.2	2.2	2.2	2.2
GDP per capita (EUR)	7,989	8,753	9,412	9,972	10,579
Real economy yoy (%)					
GDP	-0.3	5.5	5.5	3.6	3.4
Private Consumption	0.4	4.4	5.7	4.2	3.5
Fixed Investment	-21.7	24.6	11.9	8.5	10.6
Public Consumption	-9.7	1.3	1.0	1.1	0.1
Exports	11.5	12.6	14.3	11.7	8.9
Imports	11.5	20.7	14.0	13.2	10.7
Monthly wage, nominal (EUR)	629	663	679	697	625
Unemployment rate (%)	14.3	12.7	10.5	10.9	10.7
Fiscal accounts (% of GDP)					
Budget balance (incl. bank costs)	-7.8	-4.0	-2.6	-2.5	-2.5
Primary balance	-9.9	-1.9	-1.8	-1.6	-1.1
Public debt	44.7	44.9	44.5	44.4	44.4
External accounts					
Current account balance (EUR bn)	0.6	-0.1	-0.4	-0.2	-0.3
Current account balance/GDP (%)	3.6	-0.6	-1.9	-1.0	-1.2
Basic balance/GDP (%)	5.0	5.0	1.1	1.4	1.2
Net FDI (EUR bn)	0.2	1.1	0.6	0.6	0
Net FDI (% of GDP)	1.4	5.6	3.0	2.4	2.4
Gross foreign debt (EUR bn)	29.8	30.9	31.7	33.2	34.7
Gross foreign debt (% of GDP)	165.3	157.1	150.1	148.1	145.9
FX reserves (EUR bn)	5.6	5.4	5.5	6.4	7.8
Inflation/Monetary/FX					
CPI (pavg)	2.5	4.4	2.3	2.5	2.6
CPI (eop)	-1.1	4.2	1.6	2.5	2.6
RIGIBOR 3M	1.90	1.03	0.25	0.75	1.00
USD/LVL (eop)	0.53	0.53	0.53	0.50	EUR
EUR/LVL (eop)	0.70	0.70	0.70	0.70	EUR
USD/LVL (pavg)	0.53	0.50	0.55	0.52	EUR
EUR/LVL (pavg)	0.70	0.70	0.70	0.70	EUR

Source: UniCredit Research

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

En route to the Euro

GDP growth is impressive

In 4Q GDP growth remains strong, posting gains of 5.1% yoy (+1.3% qoq sa). For FY12, this translates into a 5.5% gain. 4Q12 GDP growth is in line with the pace of growth posted in the preceding two quarters (5.0% yoy in 2Q and 5.2% in 3Q), but is a deceleration from the 6.9% yoy recorded for 1Q (which came in as the highest pace of expansion in the current economic cycle). In qoq sa terms, the current reading represents a return to 1H12 growth rates and some deceleration from the 1.7% qoq seen in 3Q12. On a regional perspective, Latvia continues to outperform other Baltic peers in terms of its pace of growth. However, this may at least to some extent be attributed to the fact that Latvia is still catching up with its peers, having missed the earlier stage of economic recovery in 2010. In line with previous quarters, we expect private consumption to remain the main driver of economic growth in Latvia, which has so far added approx. 4.1pp to the 1-3Qs 5.6% economic expansion. In 2013 we expect the economic expansion to moderate to a more sustainable 3.6% rate of growth (with risks to the upside), and private consumption to remain the main contributor to economic expansion. Planned EMU accession should also support further economic expansion from 2014 onwards. The government estimates that growth for FY13 will reach 3.7%. The EC, in its latest Autumn 2012 forecast, published an estimate of 3.6% growth for 2013.

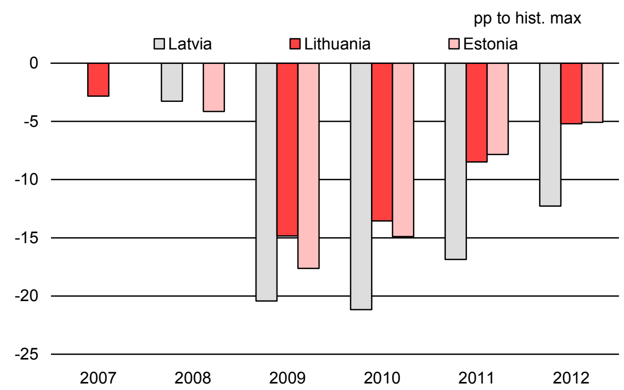
Retail sales and IP growth rates are volatile, but show signs of stabilization

Industrial production growth which decelerated to 3.1% yoy (2.7% mom sa) in September (the slowest rate of growth since the end of 2010) started to peak up to 3.7% yoy in November and spiked to 10.7% in December. Retail trade also seems to be stabilizing at a more moderate level compared to that seen in 2012, following the 9.7% yoy average growth rate of 4Q, in January it recorded 5.2%.

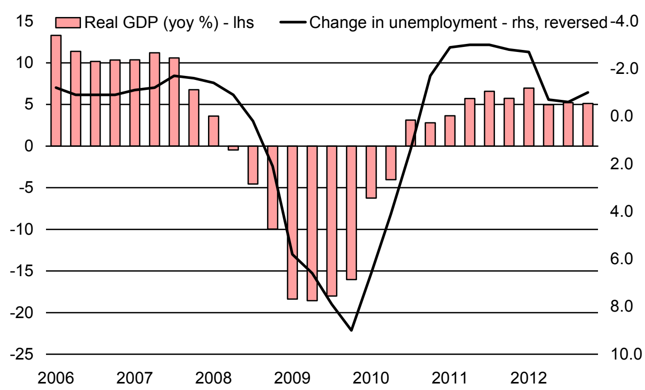
Unemployment is still high, labor market inefficiencies may weigh on the economic expansion

Unemployment in Latvia fell to 10.5% in December from 10.6% in November. The current number represents the ninth month of gradual unemployment decline and significant progress from the historical high of 17.3% recorded in March 2010. On a longer-term perspective, however, it remains high – the lowest unemployment rate for December of only 4.9% was registered in 2007. We take the latest reading to be fairly neutral. Given the economic expansion in 2012, we would have expected a decline towards 10%, but there was a drop in unemployment reduction in the last two quarters, especially given the current still relatively high level of unemployment. However, the progress is very stable and we expect the decrease to continue through 2013. On the other hand, the drop in the unemployment reduction rate may signal some structural inefficiencies of the labor market (e.g. mismatch between skills required and offered), which may create bottlenecks for economic growth going forward.

GDP still below its pre-crisis peak



Unemployment declines at a slower pace



Source: NSOs, UniCredit Research

Inflation has slowed down and is now safely within Maastricht criteria

Inflation in Latvia, as reported by Central Statistical Bureau of Latvia, decelerated to 0.6% yoy in January, dropping further from the 1.6% yoy recorded for the last three months of 2012 (average 2012 inflation was in line with our forecast at 2.3%). Based on this reading, we estimate the 12M HICP average inflation rate to decline to 2.0% from 2.3% in December (historically, the difference in CPI inflation as reported by CSB and Eurostat's HICP inflation readings was marginal). The Maastricht criteria as of end-2012 stands at 3.3% (excluding Greece and Ireland), or around 2.8% (including Greece and Ireland into the threshold calculation) – for more details on the Maastricht criteria calculation and Latvia's progress, please see our note on Latvia's EMU bid published on 28 January.

The fiscal performance was impressive in 2012

According to preliminary figures released at the beginning of January, the budget deficit in 2012 narrowed to 1.2% of GDP (vs. 2.5% scheduled in the budget). Going forward, an EC forecast sees the deficit at 1.5% of GDP in 2013 and 1.7% of GDP in 2014. The structural deficit is estimated at approximately the same level as the headline deficit over 2012-14. That represents a dramatic recovery from 2008-2009 when it reached over 7.0% of GDP. The 2012 results are even more impressive given that the government introduced a tax reduction program in mid-2012, which included a cut in VAT by 1pp to 21% from 1 July and a three-to five-year program for PIT reduction by 5pp to 20%, thus providing additional stimulus for further economic expansion.

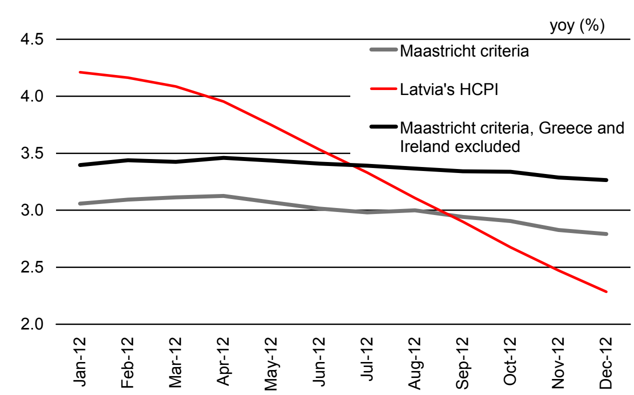
..and the government initialized a formal eurozone accession procedure

The government on 5 March sent a formal request to the European Commission and European Central Bank for a release of extraordinary 'convergence reports' accessing Latvia's adherence to the EUR adoption criteria. This marked the first step in the formal application process (for more details, please see our note *Latvia's EMU bid* published on 28 January). As Latvia is requesting an extraordinary assessment, we expect the convergence report to be published earlier, compared to the usual mid-June dates. However, this earlier publication will not affect the dates of the process going forward. In mid-June, during the EU finance ministers' meeting, some further evaluation is to be made, which includes assessing the sustainability of the country's economy and finances. The formal invitation is made one month later during the ECOFIN Council meeting. From a political perspective, this request however is an important milestone, finalizing the period of political turmoil with the decision to apply for EUR adoption as early as in 2013. As a reminder, Latvia's law, adopted at the beginning of February by Parliament, set 1 January 2014 as the EUR accession date.

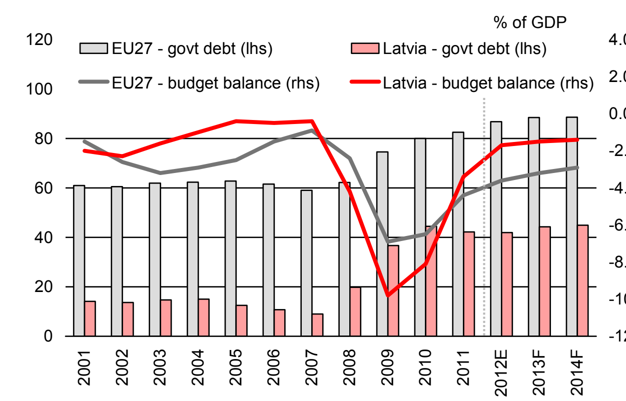
Rating upgrades are underway

In the first half of November, S&P upgraded Latvia's rating to BBB from BBB-, while also posting a positive outlook. According to S&P, a successful eurozone application could lead to a further rating upgrade by one or two notches. Given our positive expectations for the EUR application, we expect further upgrades in 2H13.

HICP inflation in Latvia vs. the Maastricht criteria



Government finances in Latvia and EU



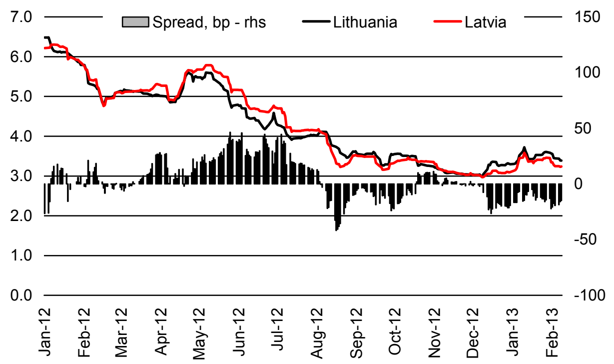
Source: Latvia Statistics, Eurostat, UniCredit Research

Strategy: Expecting rating upgrades

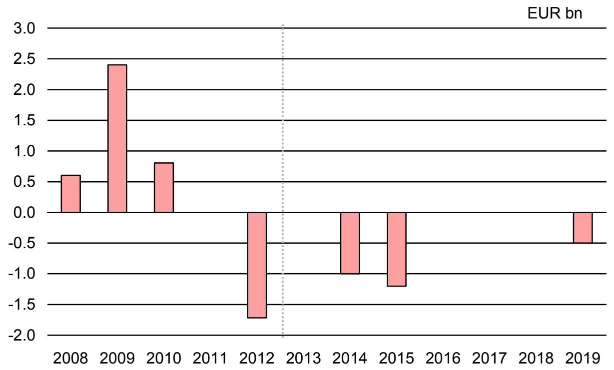
Latvia vs. Lithuania spread to widen by 1H13, as Latvia's rating is upgraded and the supply to remain limited

We see Latvia's vs. Lithuania's hard-currency bonds as fairly priced, although the potential upgrades linked to eurozone accession leave room for further spread widening. We estimate the spread will widen by at least another 30bp (reaching the historical maximum seen in August-September 2012), as Latvia secures an invitation to join the EMU by mid-2013. In addition, we expect decreasing supply to push yields lower as the IMF has now been repaid. Early repayment for the EU part of the loan is not allowed but we do not expect Latvia to return to international markets for EU refinancing until 2014 (EUR1.0bn due, followed by EUR 1.2bn repayment in 2015, EUR 0.5 in 2019). As over the last three years Latvia's financial program has been shifting towards Eurobond issuance (in 2012, Eurobonds made up around 95% of sovereign issuance), we expect that, as eurozone accession approaches, the government will opt to fulfill all its borrowing needs in international markets. This year's issuance is unlikely to exceed EUR 1.0bn and could be capped to EUR 0.5bn if this year's budget outperforms.

Latvia vs. Lithuania hard-currency 21s yields



Installments and repayments to IMF/EU in 2008-19: Most repaid, limiting issuance going forward



Source: Bloomberg, IMF, EC, UniCredit Research

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2012E	2013F	2014F
Gross financing requirement	**1.9**	**1.0**	**2.4**
Budget deficit	0.3	0.6	0.6
Amortisation of public debt	1.7	0.4	1.8
Domestic	0.2	0.2	0.2
Bonds	0.1	0.1	0.1
Bills	0.1	0.1	0.1
External	0	0	0.4
IMF/EU loans*	1.3	0	1.0
Financing	**2.2**	**1.2**	**2.6**
Domestic borrowing	0.2	0.2	0.2
Bonds	0.1	0.1	0.1
Bills	0.1	0.1	0.1
External borrowing	1.8	0.8	2.2
Bonds	1.8	0.8	2.2

*IMF part of the loans is fully repaid, for EU part no early repayment is allowed

Source: Bank of Latvia, MinFin, NSO, UniCredit Research

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2012E	2013F	2014F
Gross financing requirement	**3.3**	**1.8**	**2.8**
C/A deficit	0.4	0.2	0.3
Amortisation of medium to long term debt	2.9	1.6	2.5
Government/central bank	1.3	0	1.0
Banks	0.7	0.6	0.5
Corporates	0.9	1.0	1.0
Errors and omissions	-	-	-
Financing	**3.3**	**1.8**	**2.8**
FDI	0.6	0.6	0.8
Equity (private, net)	0.2	0.1	0.1
Borrowing Medium to Long term	3.4	2.4	3.6
Government/central bank	1.8	0.8	2.1
Banks	0.7	0.6	0.5
Corporates	0.9	1.0	1.0
Change in FX reserves (reduction(+)/increase(-))	-0.9	-1.2	-1.7

Lithuania (Baa1 stable/BBB stable/BBB stable)*

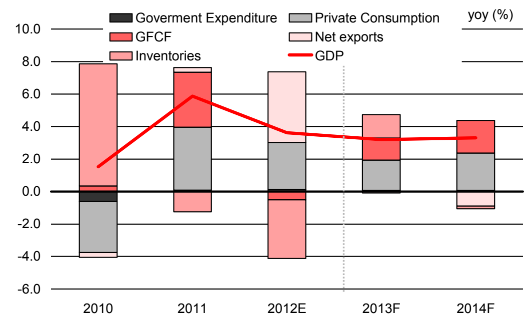
Outlook – 4Q12 GDP came in at 4.1% yoy, translating into a FY12 economic expansion of 3.6%. In 2013, we expect the economic expansion to stabilize at around 3.2%. On a shorter-term perspective, we expect a pronounced growth deceleration in 1H13 compared to 4Q12 figures due to the maintenance of the Orlen Lietuva oil refinery, which accounts for over a quarter of the country's IP. Inflation is stabilizing at a rate of around 2.8%. Similar to 2012, we expect fuel and energy prices to remain the main drivers of inflation, but the development of the regional energy market will allow the country to better control inflation. The international trade position remains very strong and C/A developments are positive. The new PM, A. Butkevicius, secured approval for a budget deficit of 2.5% of the GDP for 2013 and made some clear statements indicating 2015 as the planned EMU accession year.

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

KEY DATES/EVENTS

- 30 Apr, 30 May – 1Q GDP (prelim., final)
- 21 Mar, 22 Apr, 21 May – Industrial production
- 9 May, 10 Jun, 8 Jun – CPI

CONSUMPTION TO DRIVE GROWTH



INFLATION TO REMAIN AT CURRENT LEVELS

Source: NSO, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2010	2011	2012E	2013F	2014F
GDP (EUR bn)	27.4	30.2	32.2	34.2	36.3
Population (mn)	3.3	3.3	3.3	3.3	3.3
GDP per capita (EUR)	8,257	9,161	9,832	10,430	11,066
Real economy yoy (%)					
GDP	1.2	5.9	3.6	3.2	3.3
Private Consumption	-4.1	4.7	3.0	3.0	3.7
Fixed Investment	-0.3	17.1	6.0	7.0	10.0
Public Consumption	-3.0	0.9	0.2	0.5	0.5
Exports	16.3	13.7	7.0	8.4	9.5
Imports	17.6	12.7	7.4	9.0	11.1
Monthly wage, nominal (EUR)	600	615	638	647	664
Unemployment rate (%)	14.5	11.7	10.8	9.5	8.0
Fiscal accounts (% of GDP)					
Budget balance	-7.5	-4.2	-3.0	-2.5	-2.5
Primary balance	-4.6	-3.1	-1.0	-0.5	-0.7
Public debt	35.0	35.9	36.7	37.1	37.4
External accounts					
Current account balance (EUR bn)	0.3	-0.5	-0.2	-0.7	-0.7
Current account balance/GDP (%)	1.6	-1.7	-0.9	-2.0	-1.9
Basic balance/GDP (%)	4.3	1.3	3.2	0.5	1.2
Net FDI (EUR bn)	0.7	0.9	0.2	0.9	1.1
Net FDI (% of GDP)	2.6	3.0	0.7	2.5	3.1
Gross foreign debt (EUR bn)	24.1	24.8	25.4	25.9	25.0
Gross foreign debt (% of GDP)	87.8	82.1	78.9	75.8	68.9
FX reserves (EUR bn)	4.9	5.2	5.5	5.2	5.1
Inflation/Monetary/FX					
CPI (pavg)	1.1	4.1	3.0	2.8	2.7
CPI (eop)	3.6	3.4	2.8	2.5	2.8
VILIBOR 3M	1.56	1.77	0.75	1.00	1.05
USD/LTL (eop)	2.60	2.60	2.61	2.47	2.41
EUR/LTL (eop)	3.45	3.45	3.45	3.45	3.45
USD/LTL (pavg)	2.60	2.47	2.68	2.54	2.45
EUR/LTL (pavg)	3.45	3.45	3.45	3.45	3.45

Source: UniCredit Research

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

Normalising growth

GDP growth is stabilizing

We expect the economic expansion to stabilize at around 3.2% in 2013, with private consumption and net exports being the main drivers of growth. On a shorter-term perspective, we expect a pronounced growth deceleration in 1H13 compared to 4Q12 figures due to the maintenance of the Orlen Lietuva oil refinery, which accounts for over a quarter of the country's IP. Work is scheduled for March-May this year. 4Q12 GDP growth came in at 4.1% yoy (+0.7% qoq sa vs. +1.0% qoq sa based on the preliminary estimate), translating into a FY12 economic expansion of 3.6%. Looking at the yoy dynamics of the GDP components, the most pronounced trend is the accelerated growth of exports vs. imports – as exports increased by a hefty 19.3% yoy in 4Q12 vs. only 10.1% yoy growth in imports. Private consumption growth remained relatively stable (compared to the previous quarter) at 3.2% yoy. The gross fixed capital formation continued to contract for the third consecutive quarter, this time by 7.7% yoy, mostly thanks to the high base effect, as the country saw some intensive infrastructure developments in 2011.

IP growth is unstable (mostly thanks to the oil refinery industry cycles), but retail sales are showing very positive dynamics

Industrial production growth accelerated to 9.3% yoy in January from 3.7% yoy in December of last year. The current reading continues the zigzag pattern of yoy IP growth rates, as these moved from 10.5% in August of last year to 4.4% in September, recovering to 14.8% in October before decelerating to 9.4% in November and further in December. Retail sales growth also remains very volatile, but is still holding up very well. Having decelerated from 5.8% yoy in October to 2.6% in November and further to only 1.4% in December, growth recovered to 2.7% in January. The FY12 numbers showed average retail trade growth of 4.9%, but that came on the back of exceptionally strong 1Q numbers, when growth remained above 5%. Going forward, we expect retail sales to expand at a more moderate pace, compared to that recorded in January. All in all, the latest IP and retail numbers look very encouraging, especially given the external backdrop.

Inflation is moderating, but energy problems remain a risk

CPI inflation, came in at 2.6%yoy (+0.2 mom) in January, decelerating from the 2.8% yoy posted in December of last year (3.0% for FY12). The latest reading is the lowest since mid-2012. The main 2012 drivers of inflation showed diverging tendencies in January: food and non-alcoholic beverages inflation fell to 2.8% yoy in January from 3.2% in December, while housing, water, electricity and gas services posted a significant pick-up to 3.6% in January from December's 1.9%. Part of the latter group's price increase comes from the planned hike of electricity prices for private consumers by over 10% from January 2013. We expect inflation to remain roughly at the same rate for the rest of 2013, with some risks on the upside. Similar to 2012, we expect fuel and energy prices to support inflation going forward (mostly thanks to the increased electricity prices and the gas price setting mechanism employed by Gazprom), but at a more moderate rate of around 2.8%. At the same time, further development of the general electricity market in the region (developing interconnections with Baltic and Nordic neighbors), as well as diversification from Russia's gas imports (construction of LNG terminal is scheduled for this year), will allow the country better control inflation.

Export/import dynamic is very positive

Based on the preliminary figures, the FY12 C/A deficit came in at under 0.9% of FY12 GDP, exceeding our expectations. Direct investments, on the other hand, surprised on the upside at 2.1% of GDP. Looking at the yearly dynamics, both C/A and FDIs to GDP posted a significant decrease, as in 2011 they came in at -3.5% and 3.0% to GDP, respectively. The trade in goods and services posted very strong dynamics, as exports growth accelerated in 4Q to 22.4% yoy vs. imports' growth decelerating to 13.3% yoy. Overall for FY12, that translated into respective growth of these two items by 15.0% and 10.1% yoy.

EMU accession is in the cards

Following the political noise surrounding the elections of October last year, the situation seems very stable again. The new PM, Algirdas Butkevicius, on top of securing support from his political allies for a smooth approval of the 2.5% of GDP deficit budget for 2013, already made some clear political statements indicating 2015 as the planned EMU accession year.

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

Outlook – Domestic economic activity is bottoming out, supporting our baseline scenario of an acceleration in growth from 2Q13 onwards. Inflation is likely to continue on its downward trajectory and, after reaching the lower end of the MPC target (1.5%) in February, will likely continue to fall until June, albeit at a slower pace than in recent months. In our view with the 50bp cut in March the MPC completed the current easing cycle and is to adopt a wait-and-see approach over the next couple of months. The main policy rate is currently at all-time-low of 3.25%.

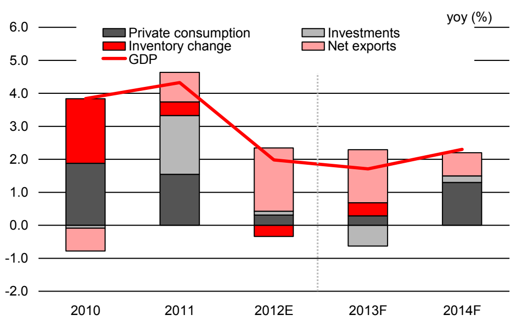
Strategy outlook – We look for a steepening of the POLGB curve, with the short end stabilizing as markets expect rates to be kept on hold for some time but long end vulnerable to possible deterioration in sentiment due to a weakening fiscal outlook. Zloty should remain range bound.

Author: Marcin Mrowiec, Chief Economist (Bank Pekao)

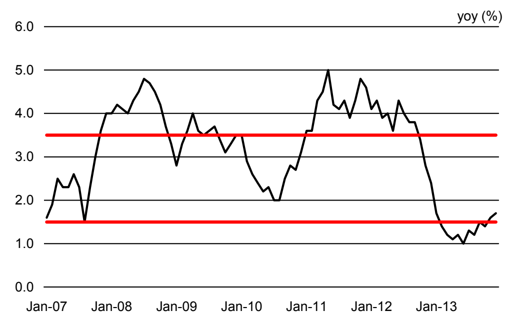
KEY DATES/EVENTS

- MPC decision-making meetings – 7-8 May, 4-5 June, 2-3 July
- 1Q GDP – end-May
- 31st May: MinFin relases official 2012 data on public debt
- Mid June: Macro assumptions for 2012 budget bill

GDP TO START REBOUNDING FROM 2Q13 ON, BUT MORE ROBUST GROWTH ONLY IN 2014



CPI EXPECTED TO CONTINUE FALLING TILL MID-2013



Source: NSO, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2010	2011	2012E	2013F	2014E
GDP (EUR bn)	354.6	369.7	380.5	392.8	417.7
Population (mn)	38.2	38.1	38.1	38.1	38.0
GDP per capita (EUR)	9,283	9,709	9,994	10,320	10,981
Real economy yoy (%)					
GDP	3.9	4.3	2.0	1.7	2.3
Private Consumption	3.2	2.6	0.5	0.5	2.1
Fixed Investment	-0.4	9.0	0.6	-3.2	1.3
Public Consumption	4.1	-1.7	0	0.3	0.6
Exports	12.1	7.7	2.4	0.8	3.1
Imports	13.9	5.4	-1.8	-0.8	2.4
Monthly wage, nominal (EUR)	860	874	890	920	975
Unemployment rate (%)	12.1	12.4	12.8	14.0	14.0
Fiscal accounts (% of GDP)					
Budget balance	-7.9	-5.0	-3.5	-3.8	-3.0
Primary balance	-0.7	0.7	1.0	0.8	0
Public debt	54.8	56.4	55.7	57.2	57.1
External accounts					
Current account balance (EUR bn)	-18.1	-18.0	-13.5	-11.4	-13.9
Current account balance/GDP (%)	-5.1	-4.9	-3.5	-2.9	-3.3
Basic balance/GDP (%)	-2.2	-1.2	-2.8	-0.6	-0.8
Net FDI (EUR bn)	10.5	13.6	2.9	9.0	10.7
Net FDI (% of GDP)	3.0	3.7	0.7	2.3	2.6
Gross foreign debt (EUR bn)	237.4	248.1	257.4	267.4	289.8
Gross foreign debt (% of GDP)	66.9	67.1	67.6	68.1	69.4
FX reserves (EUR bn)	70.0	75.7	82.6	73.7	74.0
Inflation/Monetary/FX					
CPI (pavg)	2.6	4.3	3.7	1.4	2.4
CPI (eop)	3.1	4.6	2.5	1.7	3.0
Central bank target	2.5 +/- 1	2.5 +/- 1	2.5 +/- 1	2.5 +/- 1	2.5 +/- 1
Central bank reference rate (eop)	3.50	4.50	4.25	3.25	3.50
3M money market rate	3.94	4.54	4.91	3.46	3.60
USD/PLN (eop)	2.98	3.32	3.17	2.94	2.88
EUR/PLN (eop)	3.96	4.42	4.18	4.12	4.12
USD/PLN (pavg)	3.01	2.94	3.26	3.07	2.91
EUR/PLN (pavg)	3.99	4.12	4.19	4.18	4.10

Source: UniCredit Research

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

Economy to bottom out in early 2013

Dataflow at the beginning of the year is supportive for the scenario of gradual economic recovery in 2013, led by exports

High-frequency data released in early 2013 suggest that Poland's economy is close to the bottom of current downturn and gradual (albeit slow) recovery should be expected in the coming months. Industrial output rose by 0.2% yoy in January after falling by 10.6% yoy in December 2012. Real retail sales went up by 2.4% yoy vs. 3.6% yoy decline in December. While we expect poor performance in Q1 as a whole, gradual recovery is foreseen in the coming quarters on the back of improving external demand. The manufacturing PMI remains below 50 pts but has been improving in the last 5 months, indicating that the downturn in the industrial sector is losing momentum. The decline in new exports orders moderated to its slowest pace in nearly a year in February. Looking ahead, the poor condition of the automotive industry will weigh on the pace of recovery in manufacturing as FIAT's decision to stop manufacturing Panda in Poland reduces the total output of factory in Tychy this year and other automaker plants in Poland cut output and employment. Nonetheless we expect net exports to contribute 1.6 percentage points to GDP growth this year vs. 2.0 pp in 2012.

Domestic demand is to remain in doldrums in the first half of the year but is foreseen to start improving in the second half of 2013

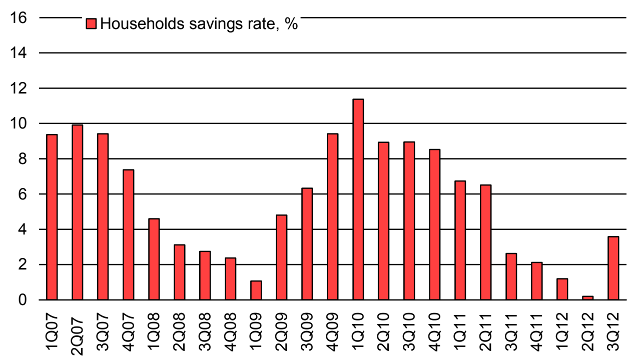
Domestic demand will recover more gradually, gaining only 0.1% after rising by 0.1% in 2012. Private consumption is set to continue shrinking in the first half of the year as a rising household savings rate more than neutralises a gradual improvement in real wage growth stemming from falling inflation. Some improvement is foreseen in in the second half of 2013 as the improvement in real wage bill is expected to have some positive effect on spending and the increase in savings comes to an end. Real wages in enterprise sector are seen to expand by 1.3% yoy vs. a 0.2% yoy decline in 2012. At the same time high indexation of pensions (4.4% from March onwards) and lower inflation should also support gradual recovery of individual consumption. Still uncertain prospects for aggregate demand discourage private sector from investing into output capacity expansion, while public investment will drop visibly in 2013. Funds from the 2007-2013 EU budget are waning while funds from the 2014-2020 budget will not be seen before 2014 at earliest. A series of bankruptcies of large construction firms engaged in road construction hit some lenders driving upwards the value of impaired loans and the banking sector became cautious in granting new corporate loans last year.

Inflation will fall towards 1.0% by mid-2013

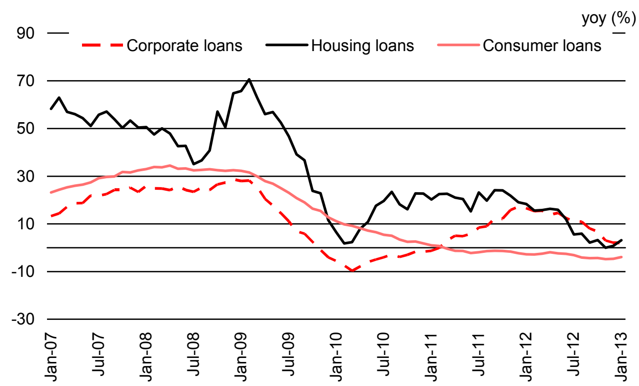
CPI inflation will be below the lower end of the MPC's inflationary target (1.5%) by end-1Q, and is set to decline towards 1.0% in June. It will likely rebound towards 2.0% by end-2013, as growth accelerates and a less-favourable base effect kicks in.

HOUSEHOLD SAVING RECOVER AS NEW CREDIT GROWTH REMAINS WEAK

Household savings started recovering in 3Q12



Sluggish growth for both corporate and household loans



Source: GUS, NBP, UniCredit Research

Subdued domestic demand keeps inflation threats muted. Pressure from food and energy prices is expected to ease amid lower global pressure on food and energy commodities. Energy prices have already moderated markedly in early 2013 as gas prices for household fell by some 10% after national energy giant PGNiG managed to reach more favourable price agreement with Gazprom – the main gas supplier to Poland. The decline in prices will more than mitigate the upward pressure from a hike in garbage prices which is to materialize in mid-2013 as the new garbage management law comes into force. Taking all that into account we expect net core inflation to drop to 1.1% yoy at the end of 2013 down from 1.4% yoy at the end of 2012.

March's 50bp cut by the NBP, which drove the main policy rate to all-time-low of 3.25%, should mark the end of the current easing cycle

In our baseline scenario we assume that after the 50bp cut in March, the MPC completed the easing cycle and rates are expected to remain unchanged until the end of 2013. Currently the main policy rate is at all-time-low of 3.25% i.e. below the previous bottom seen after downturn linked to global recession after Lehman Brothers collapse. In the post-meeting press release the Council stated that the March policy decision "*complements the monetary policy easing cycle*". According to the statement recent reductions in the main NBP rate (rates went down by 150pb during the cycle) "*will allow inflation to run close to the target in the medium term and at the same time supports the recovery of the Polish economy*". In other words, the NBP has adopted a wait and see approach, with a firm emphasis on wait at this stage.

March update to the NBP inflation projection will be an important document for multi-month MPC rates strategy

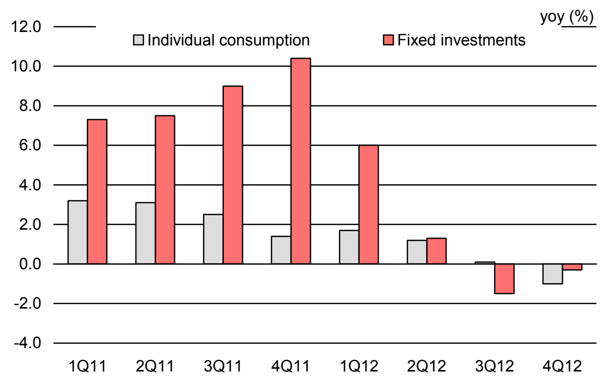
Risks to our baseline scenario are skewed to the downside (i.e. towards lower rates). Should headline inflation fall below levels indicated by the March inflationary projection in the coming months, the Council might deliver another cut. It should be kept in mind that according to the central path of March projection, inflation remains below the NBP target of 2.5%. As a result, real interest rates are to remain at a relatively high level and there seems to be some room for further accommodation in monetary policy.

General government deficit is estimated to have reached some 3.5% of GDP in 2012, enough to exit the excessive deficit procedure

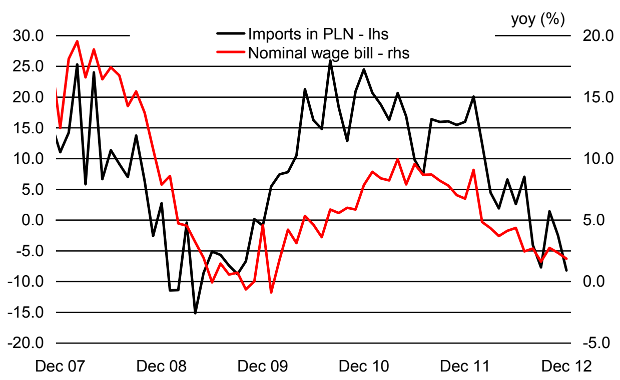
According to preliminary estimates, local authorities reduced their deficit in 2012 to approximately PLN 2.7bn from PLN 10.3bn PLN in 2011, helping to reach the target of 3.5% of GDP for the general government deficit. Therefore, Poland is likely to exit the excessive deficit procedure imposed in 2007 and meet the 2012 deadline set by the Ecofin council for deficit correction. When assessing whether Poland's deficit shrank to the level required by the Stability and Growth Pact, the European Council will take into account the cost of pension reform (~0.4% of GDP) so the procedure is to be abrogated provided the budget outcome is sufficiently close to the reference value. The most recent European Commission forecasts suggest that the general government budget will fall in 2013 and 2014. In our view, further improvements in the budget balance in 2013 are questionable as the budget is under strong pressure from falling tax revenues due to shrinking domestic demand and imports. We expect the state budget act to be revised in mid-2013 and the deficit target to be raised.

GDP GROWTH DRIVEN BY NET EXPORTS AMID FALLING IMPORTS, AS DOMESTIC DEMAND REMAINS WEAK

We expect a slow recovery of the weak domestic demand



Weaker private consumption translates into weaker imports



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

Strategy: Limited upside in POLBGs, PLN range-bound

POLGBs will be supported by declining CPI, and thanks to positive newsflow from rating agencies – but we still see a slight yield increase over the next few months as the most likely scenario, esp. if the economy starts gaining momentum

POLGB yields have very limited upside potential. Although long-term Polish T-bonds found support due to the rally in Bunds following the political uncertainty in Italy, we maintain our baseline scenario of a gradual increase in yields, nearing 4.40% during the year due to a combination of rates normalization in core markets and an improving economic outlook. On the other hand, the sell-off should be limited thanks to large pre-funding efforts and solid foreign demand for domestic assets. Positive newsflow from rating agencies will be another supportive factor. Short-term paper may lose on the rising risk of the end of the cycle of interest rate cuts but we still expect a steepening of the curve by some 10-20bp in the coming months.

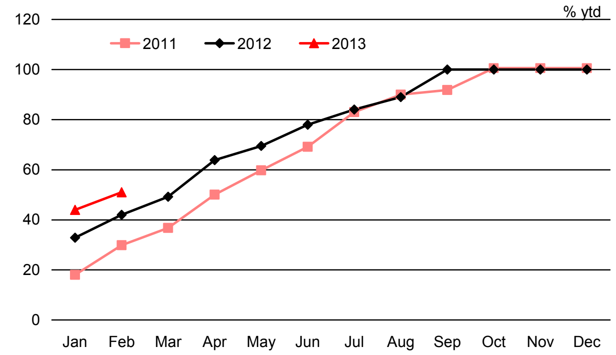
EUR-PLN will likely remain under pressure, mostly in the 4.10-4.20 range vs. EUR

We would start looking for attractive entry points to go long PLN sometime in 2Q-3Q13

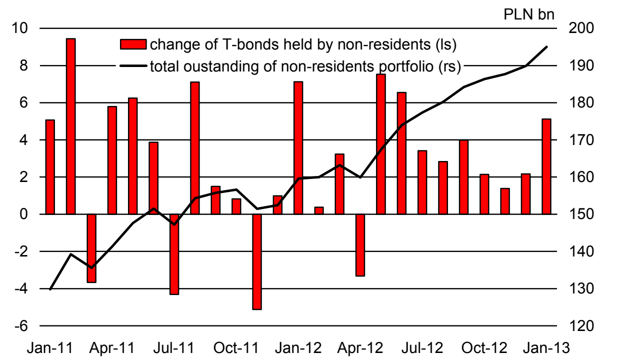
The PLN will likely stay under pressure in the next couple of months, mostly in the 4.10-4.20 range vs. the EUR. Soft economic data, uncertainty over growth in the largest EU countries, as well as worries over political and economic dynamics in Italy, will likely keep the zloty under pressure. We expect the zloty to gradually start gaining ground in the second half of the year, as dataflow becomes positive. We would start looking for good entry points for strategic long zloty positions sometime in 2Q-3Q13, and would consider levels above 4.30 as attractive entry points.

FOREIGN INVESTORS BECAME DOMINANT HOLDERS OF POLGBS

The sovereign has frontloaded borrowing, ensuring a large cash cushion and easing the pressure on T-bond yields



Foreign investors increased POLGBs holdings to a new record high PLN 195.0 bn and have the dominant market share of 36.5%



Source: MinFin, NBP, UniCredit Research

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2011	2012E	2013F
Gross financing requirement	**42.8**	**41.1**	**40.1**
Budget deficit	17.6	12.5	15.6
Amortisation of public debt	25.2	28.6	24.5
Domestic	23.5	24.6	21.0
Bonds	16.7	21.7	19.5
Bills	6.8	2.9	1.5
External	1.7	4.0	3.5
IMF/EU	0	0	0
Financing	**42.8**	**41.1**	**40.1**
Domestic borrowing	37.2	32.7	32.5
Bonds	28.5	31.4	28.4
Bills	3.1	2.3	4.3
Other	5.7	-1.0	-0.2
External borrowing	5.6	8.4	7.6
Bonds	5.6	6.2	5.1
IMF/EU	0	0	0
Other	0.1	2.2	2.5

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2011	2012E	2013F
Gross financing requirement	**87.5**	**87.0**	**73.0**
C/A deficit	18.0	13.5	11.4
Amortisation of medium to long term debt	12.9	18.6	12.4
Government/central bank	1.7	4.0	3.5
Banks	3.7	6.7	2.3
Corporates	7.5	7.9	6.5
Short term debt amortisation	56.7	54.9	49.2
Financing	87.5	87.0	73.0
FDI	**11.6**	**3.7**	**12.2**
Equity	3.7	3.6	3.6
Borrowing	74.5	74.7	66.4
Government/central bank	5.6	8.4	7.6
Banks	18.8	17.2	14.4
Corporates	50.0	49.0	44.4
EU transfers	8.9	12.3	11.9
Other	-11.1	-7.3	-21.1

Source: NSO, NBO, MinFin, UniCredit Research

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

Outlook – Romania managed to reduce the budget deficit below 3% of GDP at the end of 2012 and will probably exit the EDP this year. This fiscal performance caps public debt below 40% of GDP. Going forward, the country's primary challenge is pushing growth towards potential, an impossible task under the current economic setup. We remain skeptical about meaningful structural reforms being implemented. The likelihood of a third IMF agreement (second precautionary) has fallen, further undermining reforms, though we expect fiscal performance to remain on track.

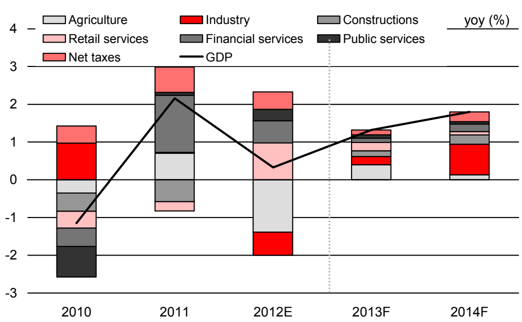
Strategy – We expect positive debt dynamics and manageable financing needs to support RON yields in 2013. However, significant RON appreciation is not in the cards due to negative structural FX flows and a NBR bias towards a stable currency.

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

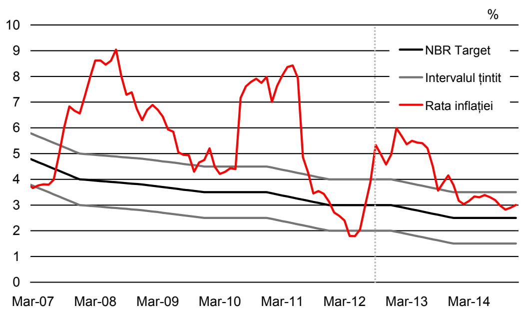
KEY DATES/EVENTS

- 28 March, 2 May, 1 July – NBR rate decisions
- June 2013: 4Q GDP
- June 2013: second IMF agreement ends

GDP GROWTH RECOVERS GRADUALLY



INFLATION TO MODERATE AT THE END OF 2013



Source UniCredit Research, NBR, CSO

MACROECONOMIC DATA AND FORECASTS

	2010	2011	2012E	2013F	2014F
GDP (EUR bn)	124.4	131.4	131.8	142.2	150.3
Population (mn)	21.5	21.4	21.4	20.0	20.0
GDP per capita (EUR)	5,786	6,139	6,161	7,108	7,513
Real economy yoy (%)					
GDP	-1.1	2.2	0.3	1.3	1.8
Private Consumption	0.2	1.1	0.8	1.3	1.3
Fixed Investment	-1.8	7.3	4.0	3.8	5.4
Public Consumption	-13.7	-0.3	2.8	1.0	0.4
Exports	13.2	10.3	-3.2	0.9	5.0
Imports	11.1	10.0	-1.3	1.1	3.6
Monthly wage, nominal (EUR)	334	348	347	369	387
Unemployment rate (%)	7.3	7.4	7.0	6.7	6.5
Fiscal accounts (% of GDP)					
Budget balance	-6.8	-5.7	-2.8	-2.5	-2.5
Primary balance	-5.4	-4.1	-1.0	-0.6	-0.7
Public debt	30.5	34.7	39.0	38.7	37.9
External accounts					
Current account balance (EUR bn)	-5.5	-5.9	-5.0	-4.9	-4.6
Current account balance/GDP (%)	-4.4	-4.5	-3.8	-3.5	-3.0
Basic balance/GDP (%)	-2.6	-3.1	-2.6	-2.0	-1.3
Net FDI (EUR bn)	2.2	1.8	1.6	2.0	2.6
Net FDI (% of GDP)	1.8	1.4	1.2	1.4	1.7
Gross foreign debt (EUR bn)	92.5	98.7	99.2	101.2	105.0
Gross foreign debt (% of GDP)	74.3	75.2	75.3	71.2	69.9
Fx reserves (EUR bn)	32.4	33.2	31.2	30.2	30.2
Inflation/Monetary/FX					
CPI (pavg)	6.1	5.8	3.3	4.9	3.1
CPI (eop)	8.0	3.1	5.0	3.8	3.0
Central bank target	3.5	3.0	3.0	2.5	2.5
Central bank reference rate (eop)	6.25	6.00	5.25	5.25	5.00
1M money market rate	5.90	5.28	5.22	5.60	5.05
USD/RON (eop)	3.20	3.34	3.36	3.14	3.08
EUR/RON (eop)	4.28	4.32	4.43	4.40	4.40
USD/RON (pavg)	3.18	3.05	3.43	3.23	3.11
EUR/RON (pavg)	4.21	4.24	4.46	4.40	4.39

Source: UniCredit Research

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

Restarting growth – more difficult than reducing the deficit

The budget deficit fell below 3% of GDP in 2012 and public debt will peak below 40% of GDP

Romania's fiscal woes seem to be a thing of the past. The budget deficit fell below 3% of GDP in 2012 for the first time since 2007. Notably, the fiscal adjustment happened during an election year and while EU transfers were blocked during 2H12. This is likely to help Romania out of the excessive deficit procedure this year. Going forward, the risks to the deficit exceeding 3% of GDP are limited and the public debt to GDP ratio will probably peak close to 40% of GDP in 2013 (ESA methodology), keeping Romania in a comfortable fiscal position. Annual public financing needs will increase slightly from EUR 15.6bn in 2013 to EUR 16.5bn next year only because of higher local bond repayments (RON 5.8bn vs. RON 4.5bn in 2013).

Strong demand for sovereign bonds helped the MinFin cover a third of annual financing needs by the end of February…

Since the beginning of the year, the MinFin has issued debt equivalent to EUR 5.1bn, covering a third of the ministry's financing needs for 2013. The inclusion in local bond indices (JP Morgan and Barclays) and the stabilisation of the political situation boosted demand for ROMGBs, helping Romanian authorities issue the equivalent of EUR 4.0bn this year on the local debt market and USD 1.5bn abroad. The average cost of newly-issued debt (5.76%) is below that of maturing domestic debt (6.1% in 2013), allowing the MinFin to replace the cheap IMF loan (bearing an interest rate of below 3%) with more expensive market debt.

…and the financing requirements in 2013 look manageable

The MinFin's financing requirement in 2013 is EUR 15.6bn and should be easily covered:

1. EUR 6bn is in T-bills and EUR 4.5bn in RON and EUR T-bonds issued on the local market and expiring in 2013, 95% of which are owned by local financial institutions. According to NBR data, local banks have increased their ROMGB holdings by at least RON 10bn per year between 2009 and 2012, so a very conservative estimate would be that local financial institutions will roll their exposure;

2. EUR 1bn due to the IMF[7], covered by the new 10Y USD bond worth EUR 1.1bn;

3. EUR 4.1bn representing the 2013 deficit and bank loans will have to be covered by loan rollovers, FX bond issuance, foreign purchases of ROMGBs or out of MinFin reserves. Assuming loans are rolled over and foreign investors have bought half of the sovereign paper issued locally in 2013, the remaining financing gap falls to just EUR 2.0bn. This is covered more than four times over by current MinFin deposits.

GDP growth was just 0.3% in 2012 amid poor external demand and weak harvest…

Fiscal tightening, poor foreign demand and local political quarrelling affected the RON, FX inflows and investment in 2H12. The economy stalled in 2012 (+0.3%), after GDP rose by 0.1% qoq in the fourth quarter. Industrial production took a milder hit compared to more open CEE economies, contracting just 0.6% qoq in 4Q12, supported by exports outside the EU. Meanwhile, domestic demand remained weak: retail sales dipped 2.1% qoq, while construction fell by 1.2% qoq in 4Q12 as public financing for infrastructure works dried up.

…but is expected to accelerate to 1.3% in 2013 and 1.8%in 2014…

We expect the economy to resume growth in 1Q13 and the expansion to accelerate to 1.3% in 2013, helped by stronger demand from the European Union, new production capacities for car manufacturers and producers of brown goods, a positive base effect from agriculture – assuming that harvests are better than in 2012 –, a less severe fiscal adjustment in 2013 and better absorption of EU funds (disbursements were blocked in 2H12 after a negative audit from the European Commission). Nevertheless, the growth pick-up will be gradual, since the carry-over from 2012 is zero. In 2014, growth might accelerate further to 1.8%.

…remaining below potential growth in the absence of structural reforms

Growth will probably remain below potential – currently at 2-2.5% per annum – and we can't anticipate a pickup unless further structural reforms are implemented. But the probability of accelerating reforms is falling, while the chances of a third IMF agreement decline. The country fell behind the reform schedule of the second (first precautionary) arrangement and a last-moment push until the end of June 2013 might not be enough to keep the Fund on the side.

[7] The remaining EUR 4.0bn will be repaid to the IMF by the central bank, which held FX reserves of EUR 32.2bn at the end of February 2013.

Meanwhile, the reform agenda remains very long: privatising the loss-making energy and transportation companies, shifting the structure of public spending from social protection to public investment to support growth and cap the widening deficit of the social security budget, improving the absorption of EU funds, reducing bureaucracy, streamlining taxation, and reducing labour taxes. All these measures are needed to keep Romanian producers cost-competitive, since FDI per capita is the lowest in CEE[8] and doesn't allow for a rapid switch to producing higher value-added goods.

The C/A deficit fell below 4% of GDP in 2012, being financed mainly by portfolio inflows…

Portfolio investment recovered in 4Q12 on the back of foreign investors buying ROMGBs, and ended the year at EUR 3.3bn, surpassing the combined amount of FDI (EUR 1.6bn) and EU fund transfers (EUR 1.6bn). Although the trade balance did not correct significantly, the current account deficit fell below 4% of GDP (to EUR 5.0bn) for the first time in 10 years, as multinational companies transferred fewer profits (either abroad for dividends or locally for investment), helping the revenues balance. The C/A deficit could remain below 4% of GDP in 2013 and 2014 if the trade deficit falls on higher exports and lower food and fuel imports.

…but RON volatility is squeezed by NBR policies…

The reliance on portfolio investment to cover the C/A deficit remains the highest among new EU members, increasing the potential for RON volatility if only the central bank would not manage tightly the exchange rate, sacrificing RON interest rates in the process. Strong FX inflows allowed the RON to outperform other CEE currencies, but the NBR intervened indirectly to keep EUR-RON close to 4.4 and will continue to use liquidity in order to minimise FX volatility.

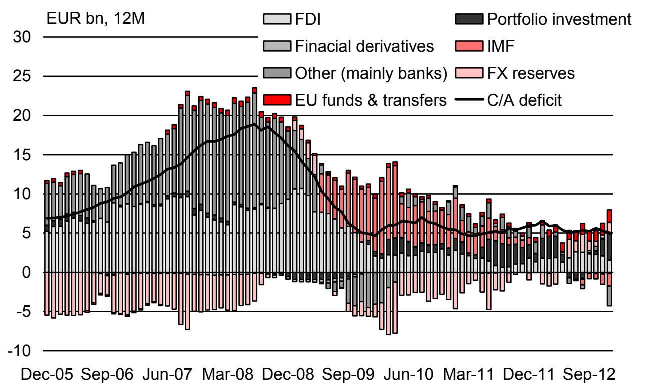
…at the expense of tighter monetary conditions

The inflation rate might fall below 4% this year, but administered price hikes and nominal rigidities will probably keep it above the target band (1.5%-3.5%) in 2013. Hence, we don't expect monetary policy rate cuts this year, but further monetary easing through improved liquidity injections after the NBR scrapped the repo cap. As long as all demand is met at weekly repos, short-term interest rates should fall gradually, bringing interbank rates in line with the monetary policy rate and pushing down the yield curve.

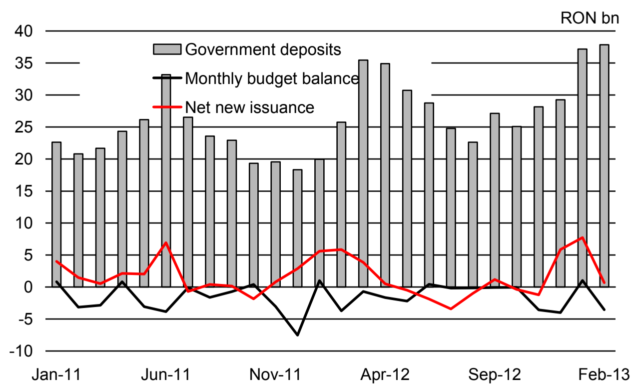
The banking sector remains loss making amid rising NPLs and weak demand for loans

The banking sector lost RON 2.12bn in 2012 amid a 34.4% jump in provisioning[9]. The stock of loans to the private sector decreased by 0.2% in 2012 (adjusted for FX moves), allowing the NPL ratio to reach 18.2% by the end of the year. Despite difficult economic conditions, private sector deposits rose by 3.7% (FX adjusted), remaining the main (and most expensive) source of funds for local banks. In these circumstances, a significant resumption of lending in 2013 is unlikely, since FX resources are scarce and RON resources are expensive.

Capital account flows are mainly EU funds and portfolio investment...



…the latter going mostly into ROMGBs, boosting MinFin reserves



Source: MinFin, NBR, UniCredit Research

[8] The per capita FDI stock in Romania was EUR 2,617 at the end of 2012, 60% of the level in Poland and less than a third of the level in the Czech Republic, Hungary or Slovakia.
[9] Provisions are not perfectly comparable in 2011 and 2012 because of a move from Romanian Accounting Standards to IFRS.
Higher provisions came from a poorer quality of the loan portfolio, but also from a downward revaluation of loan collaterals required by auditors and the central bank.

RON bonds – looking for a steepening of the curve

ROMGBs rallied in line with our expectations…

Our prediction for a RON bond rally was proven correct, as ROMGBs yields rallied 65-120 bp since the last quarterly report was published. Since 4 March, three RON bonds are part of JP Morgan's GBI-EM Indices. In anticipation of this, foreign investors increased their share in ROMGBs holdings above 20% in February 2013 from 5% in November 2012.

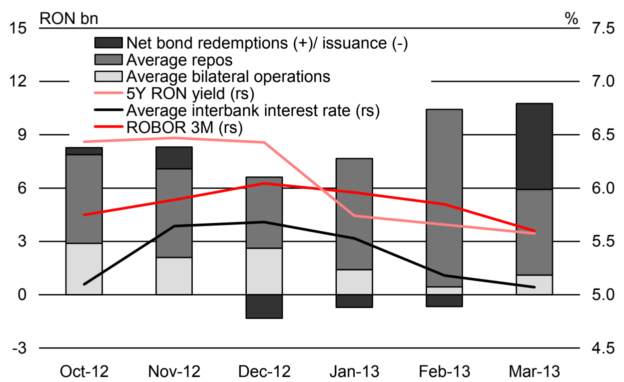
…and we see scope for a further bull steepening of the curve amid laxer liquidity conditions

Going forward, we expect a bull steepening of the curve amid falling RON interest rates. If the NBR will cover all bids at its weekly repo operations, short-term money market interest rates might fall below the monetary policy rate of 5.25%, pushing 1Y-3Y yields towards 5%. Longer-term bonds (7Y-15Y) could rally up to 20bp if the MinFin increases issuance.

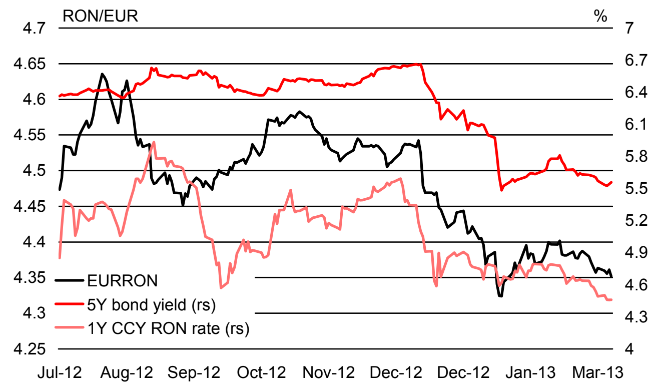
An unexpected tightening from the NBR could hit ROMGB yields and the RON

The main risk to our outlook comes from changes in RON liquidity. We believe that the NBR would help the RON more by providing liquidity to the market than by restricting it, since falling RON interest rates increase the scope for a further bond rally and for more ROMGB purchases by foreign investors. Capping liquidity supply might trigger a wave of profit-taking and subsequent portfolio outflows could weigh on the RON.

Scope for interest rates and yields to fall towards policy rate (5.25%)



Lower interest rates benefit the RON via demand for ROMGBs



Source: NBR, MinFin, Bloomberg, UniCredit Research

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2012E	2013F	2014F
Gross financing requirement	**15.5**	**15.6**	**16.5**
Budget deficit	3.3	3.1	3.2
Amortisation of public debt	12.2	12.5	13.3
Domestic	10.4	11.0	11.8
Bonds	2.3	4.5	5.8
Bills	7.5	6.0	5.5
Loans	0.6	0.5	0.5
External	1.7	0.5	0.5
IMF/EU	0.1	1.0	1.0
Financing	**20.1**	**15.6**	**16.5**
Domestic borrowing	13.8	13.3	14.0
Bonds	7.3	7.5	8.5
Bills	5.9	5.3	5.0
Loans	0.6	0.5	0.5
External borrowing	6.3	2.3	2.5
Bonds	4.7	2.3	2.5
IMF/EU/WB	1.0	0	0
Other	0.6	0	0

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2012E	2013F	2014F
Gross financing requirement	**40.2**	**38.6**	**37.7**
C/A deficit	5.0	4.9	4.6
Amortisation of medium to long-term debt	12.4	13.2	13.1
Government/central bank	3.8	5.7	5.5
Banks	3.0	2.6	2.0
Corporates	5.6	4.9	5.6
Amortisation of short-term debt	22.8	20.5	20.0
Government/central bank	2.0	1.2	1.0
Banks	7.5	5.2	5.0
Corporates	13.3	14.1	14.0
Financing	**40.2**	**38.6**	**37.7**
FDI	1.6	2.0	2.6
Equity	-0.9	0.8	1.0
Borrowing	36.5	32.3	31.1
Government/central bank	8.0	5.5	5.0
Banks	8.3	7.3	7.0
Corporates	20.2	19.5	19.1
EU Funds – capital transfers	1.6	2.5	3.0
Change in FX reserves (reduction(+)/increase(-))	1.5	1.0	0

Source: NBR, NSO, MinFin, UniCredit Research

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

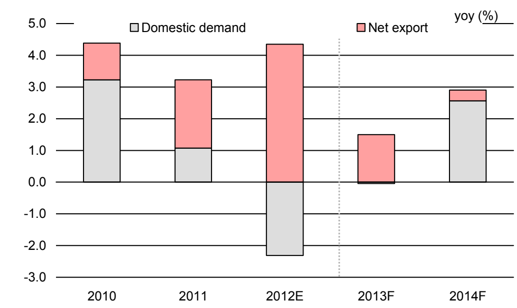
Outlook – Growth slowed at the end of previous year due to a worsening of external demand. The expected recovery of euro-zone economies could boost the Slovak economy again already in the first months of this year. GDP growth is still expected to be driven by net exports, while domestic demand remains weak, suppressed by fiscal tightening and low consumer confidence. The main downside risk to our projection comes from European new car sales. A record high FT surplus is expected to shrink only with domestic demand recovery (2014). The CA should thus remain in moderate surplus. The government confirmed its ambition to cut the budget deficit below 3% of GDP in 2013, and in case of lower-than-expected revenues is ready to prepare a new austerity package targeting mostly expenditure cuts.

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

KEY DATES/EVENTS

- 10 Apr, 10 May, 10 June – Industrial production
- 15 Apr , 14 May, 13 June – CPI
- 15 May – flash GDP
- 5 Jun – GDP and its structure

NET EXPORTS AS MAIN GROWTH DRIVER OF SLOVAK ECONOMY



INFLATION DECELERATES

Source: NSO, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2010	2011	2012E	2013F	2014F
GDP (EUR bn)	65.9	69.1	71.5	73.0	76.1
Population (mn)	5.4	5.4	5.4	5.4	5.4
GDP per capita (EUR)	12,128	12,725	13,158	13,441	14,014
Real economy yoy (%)					
GDP	4.4	3.2	2.0	1.5	2.9
Private Consumption	-0.8	-0.5	-0.6	-0.7	0.8
Fixed Investment	6.5	14.2	-3.7	2.1	3.0
Public Consumption	1.0	-4.3	-0.6	-1.5	0
Exports	16.0	12.7	8.6	4.0	5.9
Imports	14.9	10.1	2.8	2.8	6.5
Monthly wage, nominal (EUR)	769	786	805	821	849
Unemployment rate (%)	14.4	13.5	14.0	14.5	14.2
Fiscal accounts (% of GDP)					
Budget balance	-7.7	-4.8	-4.6	-2.9	-2.5
Primary balance	-6.9	-3.6	-2.9	-0.5	0.2
Public debt	41.1	43.3	52.0	53.8	54.1
External accounts					
Current account balance (EUR bn)	-2.5	-1.4	1.6	1.6	1.2
Current account balance/GDP (%)	-3.7	-2.1	2.3	2.2	1.6
Basic balance/GDP (%)	-2.2	-0.8	4.2	4.1	3.5
Net FDI (EUR bn)	1.3	1.5	2.5	0.7	1.1
Net FDI (% of GDP)	2.0	2.2	3.5	0.9	1.5
Gross foreign debt (EUR bn)	49.7	52.9	55.5	56.9	59.5
Gross foreign debt (% of GDP)	75.4	76.6	77.7	78.0	78.2
FX reserves (EUR bn)	EUR	EUR	EUR	EUR	EUR
Inflation/Monetary/FX					
CPI (pavg)	1.0	3.9	3.6	2.4	3.0
CPI (eop)	1.3	4.4	3.2	2.4	3.2
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
USD/EUR (pavg)	EUR	EUR	EUR	EUR	EUR
EUR/EUR (pavg)	EUR	EUR	EUR	EUR	EUR

Source: UniCredit Research

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

External Demand Key to Economic Recovery

Political situation remains stable with Social-Democrats enjoying a comfortable majority

The political situation in Slovakia remains stable, with the Social Democratic SMER party having a safe majority in Parliament. As the fragmented right-wing opposition is relatively weak, there has been no major turbulence.

Government to cut budget deficit below 3% of GDP in 2013

The Ministry of Finance has updated its GDP growth forecast for 2013 to 1.2%, which represents a downward revision compared to the autumn forecast of 2.1%. Given the MinFin estimate, the lower projected economic growth will have a negative impact on tax revenues of about EUR -361 million (-0.5% of GDP), which is to be covered by use of the reserve created for pension fund reform (higher-than-expected outflow of pensioners from the 2nd pillar is having a positive impact on public finances at present) and higher dividends from state-owned companies. Prime Minister Robert Fico wants to keep his commitment to reduce the budget deficit to within 3% of GDP by the end of 2013 in line with the excessive deficit procedure. The budget for 2013 includes a number of revenue measures approved last year. Extra revenues should come from an increase of the corporate and personal income tax rate and an increase in social security contributions for self-employed. In case of a worse-than-expected development of revenues, the government is ready to adopt additional austerity measures on the expenditure side.

2012 state budget deficit on cash basis slightly worse than budgeted

The state budget cash deficit in 2012 amounted to EUR -3.8bn, exceeding the plan by EUR 135 million. According to preliminary data, it reached 5.3% of GDP compared to the planned 5.1%. The revenue side was negatively impacted by shortfalls in VAT and personal income tax and lower income from EU funds. The substantial revenue decrease was offset mainly by a reduction of public investment activities and spending cuts. Moreover, additional revenue came from consolidation efforts in the second half of 2012 (shifting part of pension contributions from the second to the first pillar, special levy for regulated sectors, extension of bank levy on retail deposits, increase of excise duty on tobacco and administrative fees). The total general government deficit in ESA95 for 2012 is estimated to be 4.6%.

Economic growth slowed-down due to worsening of external demand

Although the pace of economic growth has slowed down, it was showing a positive tone at the end of the year. Q4 GDP gained by 0.2% qoq and 0.7% yoy. 2012 GDP growth thus reached 2.0% (compared to 3.2% in 2011). GDP was driven by net exports, while domestic demand is expected to remain weak. Consumer confidence worsened again at the end of the year, backed by increasing unemployment and by slowing industrial production, sending retail sales even further south, posting the weakest Christmas sales since 2005. Investment activity of local companies is still inhibited by increasing taxes and weak and unsteady new orders.

Collapse of industry at the end of the year together with amended Labor Code contributed to increase of unemployment

Weak domestic demand contributed to a continuation of the foreign trade surplus (5.1% of GDP in 2012) supported by a sluggish export performance due to weaker euro-zone demand. Industrial production collapsed at the end of the year, showing the first annual decline since October 2009 – concentrated mostly in export-oriented sectors, including automotives. We expect a gradual recovery of industry already in 1Q, backed by strengthening demand coming from Germany. The FT surplus is expected to shrink only with a recovery of domestic demand, probably not sooner than in 2014. Weaker industrial performance supported by changes in the Labor Code (making the firing of employees more expensive) resulted in a more significant unemployment increase at the end of the year. Seasonally adjusted unemployment (in Labor Office methodology) increased by 1pp since July to January.

Economy expected to recover at the beginning of this year…

External demand is expected to be main driver of growth also in 2013, while domestic demand should be inhibited by fiscal consolidation. We expect 2013 GDP growth at 1.5% yoy (carry- over effect for 2013 expected to be only 0.4% vs. 1.2% in 2012). As domestic demand is still projected to remain weak, the main downside risk to our projection comes from the external environment, mainly from European new car sales (automotives is one of the key sectors of Slovak industry, while 2/3 of Slovak car production is exported to EU markets). A one-off downside risk comes also from speculation about U.S. Steel selling its Slovak plant. New potential non-EU buyers could reduce part of the production (more expensive due to EU legislation). Value added created by U.S. Steel represents an estimated 0.5-0.6% of GDP.

…but labor market continues to suffer

Weak economic growth should mean less job creation, keeping the unemployment rate at relatively high levels with a reasonable labor cost increase. Real wages are expected to stabilize in 2013, driven by slowing inflation.

Inflation decelerates

Inflation slowed down at the end of the year, reaching 3.2% in December. 2012 CPI thus was 3.6%. January brought a further deceleration of consumer price growth (2.4% yoy), backed by slower growth of regulated prices of energy. Demand-pull inflation is expected to remain weak, while food prices are expected to continue to rise, peaking in the spring. We expect inflation to be close to a level of 2.5% over next few months.

Slovenia (Baa2 negative/A- stable/A- negative)*

Outlook – The Slovenian economy contracted in 2012 by 2.3% yoy, mainly due to the steep retrenchment in domestic demand. Against this backdrop, the economy is expected to remain in recession until year-end, with the FY13 GDP drop estimated at 1.6% yoy. Fiscal consolidation will also prove challenging this year, as the budget deficit could widen to 6.6% of GDP on the back of the direct bank recaps. Moreover, we do not expect any major change to the Banking and State Holding Company Acts under the new government, as any watering down of these reforms could put the sovereign at risk of needing EMU assistance.

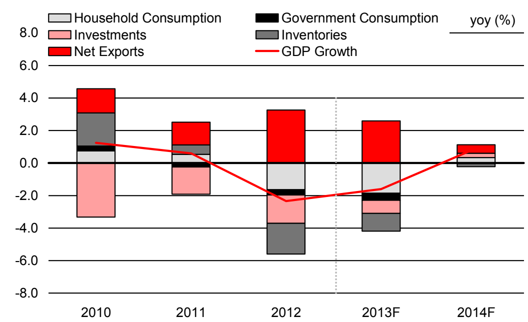
Strategy outlook – Despite underperforming during much of 1Q13, we maintain our long position on Jan 21s as Slovenia's fundamentals and recently adopted reforms still create scope for value generation.

Author: Carlos Ortiz, Economist (UniCredit Bank London)

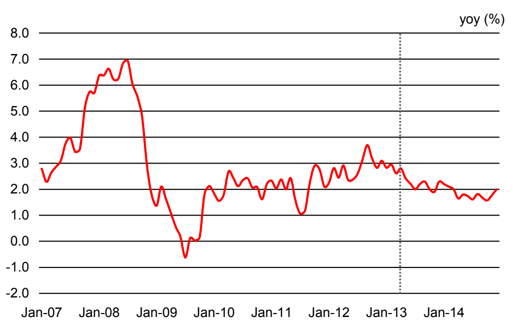
KEY DATES/EVENTS

- 31 May – 1Q13 GDP
- 29 Mar, 30 Apr, 31 May – Consumer Price Index
- 29 Mar, 30 Apr, 31 May – Retail Trade
- 22 Mar, 10 Apr, 10 May, 10 Jun – Industrial Production

RECESSION TO PERSIST IN 2013



HICP SET TO MODERATE



Source: Eurostat, NBS, Unicredit Research

MACROECONOMIC DATA AND FORECASTS

	2010	2011	2012E	2013F	2014F
GDP (EUR bn)	35.6	36.2	35.5	35.5	36.2
Population (mn)	2.0	2.1	2.1	2.1	2.1
GDP per capita (EUR)	17,381	17,628	17,254	17,257	17,422
Real economy yoy (%)					
GDP	1.2	0.6	-2.3	-1.6	0.9
Private Consumption	1.3	0.9	-2.9	-3.3	0.6
Fixed Investment	-13.8	-8.1	-9.3	-4.6	1.6
Public Consumption	1.5	-1.2	-1.6	-2.2	-0.2
Exports	10.1	7.0	0.3	1.5	3.3
Imports	7.9	5.2	-4.3	-2.1	3.0
Monthly wage, nominal (EUR)	1,495	1,525	1,526	1,535	1,553
Unemployment rate (%)	7.3	8.2	8.9	9.5	9.8
Fiscal accounts (% of GDP)					
Budget balance	-5.8	-6.4	-4.4	-6.6	-4.2
Primary balance	-4.2	-4.5	-2.0	-3.7	-1.1
Public debt	38.6	46.9	52.2	64.3	67.3
External accounts					
Current account balance (EUR bn)	-0.2	0	0.9	1.2	1.0
Current account balance/GDP (%)	-0.6	0	2.5	3.4	2.8
Basic balance/GDP (%)	0.6	1.8	3.0	4.3	3.6
Net FDI (EUR bn)	0.4	0.6	0.2	0.3	0.3
Net FDI (% of GDP)	1.2	1.8	0.6	0.9	0.8
Gross foreign debt (EUR bn)	40.7	40.2	40.6	41.6	43.0
Gross foreign debt (% of GDP)	114.4	111.2	114.6	117.1	118.6
Inflation/Monetary/FX					
HICP (pavg)	2.1	2.1	2.8	2.4	1.8
HICP (eop)	2.2	2.1	3.1	2.3	2.0
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

A difficult year ahead

4Q12 GDP contracted by 3% yoy due to a further weakening of domestic demand

The Slovenian economy contracted by 2.3% yoy in 2012, after posting its third consecutive quarter of falling GDP. The 4Q12 reading, which was -3% yoy, was largely as expected and mainly corresponded to a further weakening of domestic demand (-7% yoy). Component-wise, gross fixed capital formation led the decline (-10.6% yoy), followed by private (-4.6% yoy) and government (-1.3%) consumption. In contrast, net external trade rose by 4.9% yoy (up from 3.8% in 3Q12), due to the ongoing retrenchment of import demand, which stood a 2-year lows. On an annual basis, the data were equally disappointing, with the yoy contraction in both private and public consumption at all-time lows (-2.93% and -1.64%, respectively). The export performance was also weak, at just 0.28% yoy growth last year, while import demand collapsed by 4.3% yoy.

Net external demand will limit the GDP contraction next year

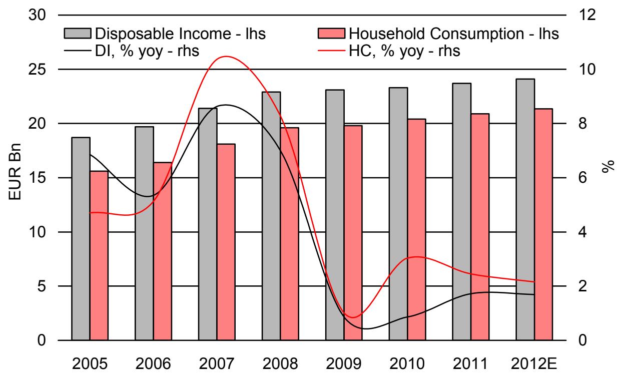
Such a poor finish points to a weak performance this year, with the economy expected to remain in recession until early 2014. In particular, we expect FY13 GDP to contract close to 1.6% yoy, as increased austerity and deleveraging at home will continue to weigh on consumption and investment levels. In particular, we see the drop in private consumption widening to 3.3% yoy, mainly because of cuts in public sector wages, ongoing contraction in household credit (-8.15% yoy in 2012) and increased unemployment prospects. Government consumption is also set to contract due to the recent cuts in pensions, public sector pay and reinforced restraint in social transfers. As for capital investment, it will improve vis-à-vis 2012, although it will still remain subdued because of the sluggish recovery of its main trading partners and tightened credit constraints. On the other hand, net external demand will make a positive contribution to GDP growth this year, mainly due to a further contraction of import demand (expected at -2.1% yoy). Consequently, we see a recovery in trend growth remaining sluggish in the medium term, with potential growth of between 1.7-2.1% of GDP by 2017.

FY13 HICP inflation expected at 2.4% yoy, 0.6pp higher than the euro-average

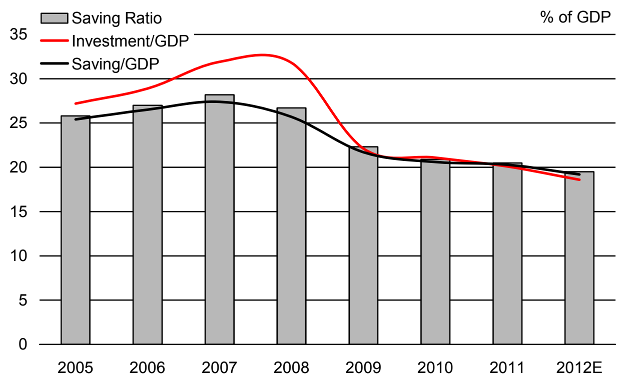
Inflation up in February, current account surplus to widen this year. Following a 2.8% yoy HICP reading in January, inflation rose to 2.95% yoy in February, due mostly to the surge in prices of food, beverages and tobacco. In contrast, energy prices remained subdued, which, together with weakening domestic demand prospects, should help bring average HICP down to 2.4% yoy this year. As for the current account, the 4Q12 surplus rose to EUR 408mn (from EUR 360.9mn in 3Q13), mainly due to the EUR 101mn boost in net current transfers. This placed the FY12 surplus reading at EUR 874mn (or 2.47% of GDP), an all-time high. Not surprisingly, most of the funding came from portfolio flows, particularly in 4Q12 after October's USD 2.25bn Eurobond. FDI however remained weak, with net outflows for the year totaling EUR 441mn. Going forward, we expect the C/A balance to remain in surplus in the coming years (FY13 at 3.4% of GDP, FY14 at 2.8% of GDP), with most of the funding coming from both portfolio flows and trade credits.

REDUCED HOUSEHOLD CONSUMPTION AND INVESTMENT TO HAMPER GDP GROWTH IN 2013

Drop in disposable income is weighing on consumption…



...keeping saving and investment at minimum levels



Source: NBS, SORS, UniCredit Research

Political crisis has raised concerns for the advancement of reforms…

Political developments took another step backwards in January after the Commission for the Prevention of Corruption accused PM Janša and PS opposition leader Jancović of fiscal fraud. Janša's refusal to resign was then followed by a progressive exit of three of its coalition partners (DL, DeSUS and SLS), finally resulting in his replacement as PM by PS-head Bratusek after the success of a no-confidence vote on his cabinet on 27 February. Since then, negotiations have been taking place for the formation of a new government, with the left (PS, SD and DeSUS) trying to secure the support of Virant's Civil List (DL). Nonetheless, this has proved tough because of the DL's strong opposition to the left's intention to end austerity measures and review the legislated bad bank and state holding company acts. Despite this, an agreement was finally reached between the four parties on March 13, meaning the risk of early elections in May is now off the table. That said, we still expect early elections to take place no later than in a year's time, as both the SD and DL have openly stated their intention to push for them.

...but bank reform should in any case remain non-optional

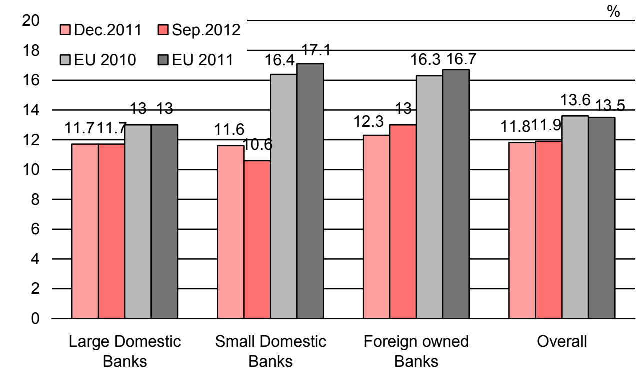
Early elections or not, the creation of the bad bank (BAMC) should occur, as not doing so would leave the country no other option but to request EMU assistance. Note that Slovenia's banking sector remains deeply loss-making, with pre-tax losses just in 2012 amounting close to EUR 664mn. Moreover, system-wide NPLs continue to spiral upwards (14.2%) at a time where capital adequacy ratios remain at minimums (11.5%). So far, legislation on the appointment of the BAMC's non-executive board has been approved, although the technical criteria covering the carve-out process of NPLs is still under scrutiny by the Ministry of Finance. As for the state holding company, no details have yet been provided on the final criteria to be applied for the transfer of state assets, although the government has made clear that it will maintain a controlling stake in most strategic asset classes. While it is true that the PS and SD have already manifested their willingness to amend parts of this Act to allow for a greater control over the privatization process, we nonetheless expect any changes to the legislation to be minor and mostly management-oriented.

The FY13 budget deficit is expected to be 6.6% of GDP after the inclusion of bank recaps

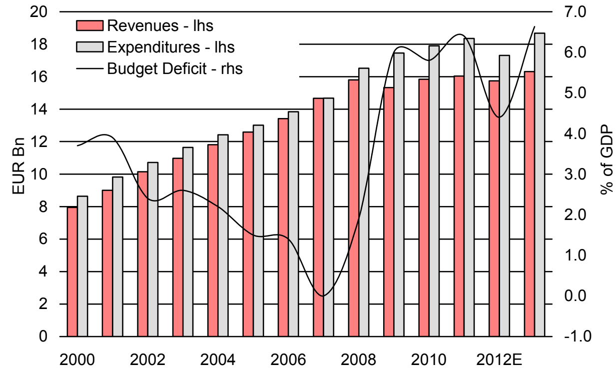
Even so, fiscal consolidation remains a challenge, as this year's budget will fall short of capping the deficit at below 3% of GDP. In particular, we see revenues increasing to around EUR 16.3bn due to last year's savings package and announced increase in indirect taxes (particularly excise duties). As for expenditures, they will see a structural drop due to the recently approved pension reform (EUR 150mn to be saved this year) and the cuts to municipalities' expenses and public sector pay. Nonetheless, these will remain insufficient to offset the increase in the use of EU funds, meaning that net expenditures will likely increase. After adding both the government hybrid debt-equity loan to NKBM and the expected direct recaps to its domestic banks (expected at EUR 650mn), our deficit forecast for this year rises to around 6.6% of GDP. Next year, however, the deficit should fall back to 4.2% of GDP, which should place the debt-to-GDP ratio at around at 67%. Note that this figure already includes a maximum 50% write-down to the EUR 4bn worth of NPLs to be transferred to the BAMC.

WEAK BANKING SECTOR TO COMPLICATE FISCAL CONSOLIDATION

Capital adequacy ratios remain among the lowest in the EU



Public expenditure to rise due to direct bank recaps



Source: NBS, ECB, UniCredit Research

Eurobond issuance expected in 2Q13

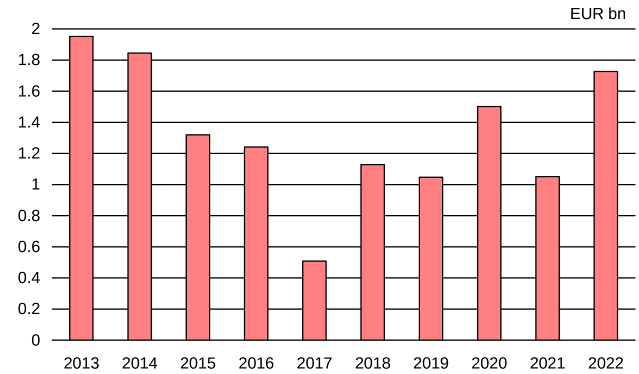
Long-term issuance cannot be delayed beyond 2Q13

Financing needs for this year are manageable, assuming favourable external liquidity conditions. In nominal terms, these amount to EUR 4.4bn (or 13.6% of GDP), of which EUR 1.6bn has already been pre-financed thanks to last October's USD 2.25bn Eurobond. The net financing amount this year hence comes to EUR 2.8bn, of which EUR 2bn will likely come via long-term (Eurobond) issuance. With political uncertainty now somewhat eased, we expect the government tapping the market no later than mid-2Q13, as debt redemptions during that period will come in excess of EUR 1.2bn.

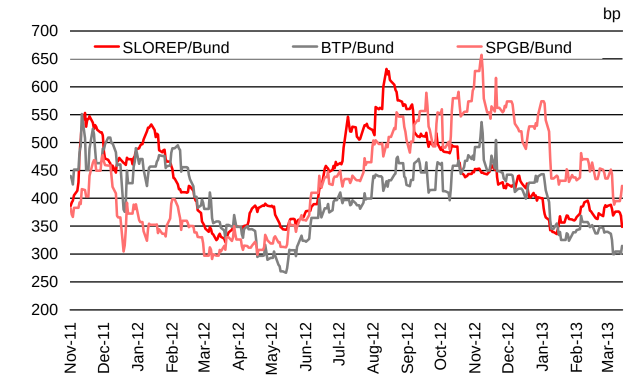
Despite a underperforming during much of 1Q13, we still see Slovenian bonds as a good value for money periphery trade as low debt levels combined with a series of reform measures over recent months (labor, pension, banking, budget consolidation) generate value. Should the recently formed centre-left coalition fail to set up a bad bank and state holding company, the possibility of a troika program will once again increase, although this will also force Slovenia towards further fiscal and banking sector reforms.

FINANCING CONDITIONS COMPARE WELL VIS-À-VIS 2H12

Total debt redemption profile as of March 2013



Spreads still at manageable levels



Source: MinFin, IMF, Bloomberg, UniCredit Research

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2012E	2013F	2014F
Gross financing requirement	**3.6**	**4.4**	**4.1**
Budget deficit	1.6	2.4	1.5
Amortization of public debt	2.0	2.1	2.6
Domestic	2.0	2.1	2.6
Bonds	1.2	0.2	1.9
Bills	0.9	1.9	0.7
External	0	0	0
IMF/EU	0	0	0
Financing	**3.3**	**4.4**	**4.1**
Domestic borrowing	1.5	2.4	3.1
Bonds	0	1.2	2.1
Bills	1.5	1.2	1.0
External borrowing	1.7	2.0	1.0
Bonds	1.7	2.0	1.0
IMF/EU	0	0	0
Other	0	0	0

Source: MinFin, NBS, UniCredit Research

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2012E	2013F	2014F
Gross financing requirement	**11.0**	**11.8**	**11.9**
C/A deficit	-0.9	-1.2	-1.0
Amortisation of medium to long term debt	3.5	2.8	2.1
Government	0	0	0
Central Bank	0	0	0
Banks	2.4	1.7	1.2
Corporates	1.1	1.1	0.9
Amortisation of short term debt	8.4	10.3	10.8
Government	0	0	0
Central Bank	2.8	4.5	4.7
Banks	1.2	1.3	1.4
Corporates	4.4	4.5	4.7
Financing	**11.0**	**11.8**	**11.9**
FDI	0.2	0.3	0.3
Medium to long-term borrowing	5.0	2.9	1.8
Government	1.7	2.0	1.0
Central Bank	2.3	0	0
Banks	0.6	0.5	0.4
Corporates	0.4	0.4	0.5
Short-term borrowing	5.3	7.9	9.1
Government	0	0	0
Central Bank	2.8	4.5	4.7
Banks	0.4	0.4	1.1
Corporates	2.2	3.1	3.3
EU Funds	0.5	0.6	0.7

Bosnia Herzegovina (B3 stable/B stable)*

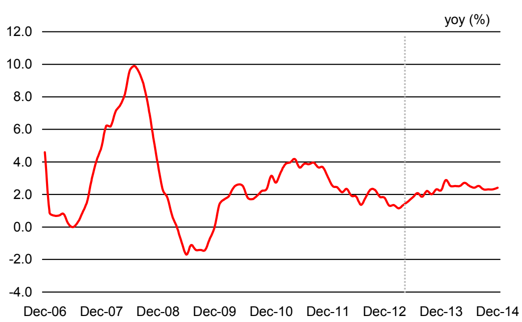
Outlook – We have revised our GDP forecast for 2013 to 0.4% yoy (from 0.8% yoy) and for 2014 to 1.2% yoy (from 1.5% yoy). We see domestic demand being constrained by lower employment and poor wage growth. Accompanied by the stronger recessionary environment in neighboring countries, and GDP contraction in the eurozone, it will weaken the economic recovery dynamics in B&H. Key support to a stable environment and, consequently, sovereign rating is coming from continued implementation of the SBA with the IMF. Resolution of some outstanding technical issues in implementation of new legislation, while receiving a positive assessment of the IMF staff, should allow the disbursed amount under the current SBA to climb to 40% of total programme allocation, underpinning financial stability. In addition, acceleration of the reform process towards the end of the year will be necessary to allow for submission of an application for EU candidate status.

Author: Hrvoje Dolenec, Chief Economist (Zagrebačka banka)

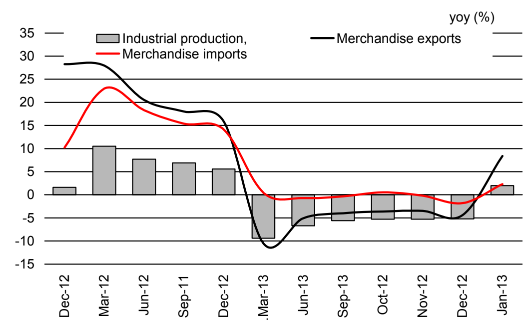
KEY DATES/EVENTS

- 25 April CPI and Industrial production for March 2013
- 25 May Wages and Unemployment
- 30 June Budget balance for 2012
- June/July Balance of payments 1Q 2013

CPI EXPECTED TO SLOW



MERCHANDISE EXPORTS



Source: IMF, MinFin, NSO, Eurostat, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2010	2011	2012E	2013F	2014F
GDP (EUR bn)	12.7	13.1	13.3	13.6	14.1
Population (mn)	3.8	3.8	3.8	3.8	3.8
GDP per capita (EUR)	3,296	3,417	3,459	3,536	3,668
Real economy yoy (%)					
GDP	0.7	1.0	-0.9	0.4	1.2
Monthly wage, nominal (EUR)	622	650	660	669	686
Unemployment rate (%)	42.9	43.3	44.1	44.3	44.1
Fiscal accounts (% of GDP)					
Budget balance	-2.5	-1.3	-2.5	-2.3	-1.4
Primary balance	-1.9	-0.5	-1.8	-1.4	-0.4
Public debt	37.1	39.4	41.4	40.0	39.0
External accounts					
Current account balance (EUR bn)	-0.7	-1.2	-1.3	-1.3	-1.2
Current account balance/GDP (%)	-5.7	-9.5	-9.6	-9.4	-8.9
Basic balance/GDP (%)	-4.2	-7.4	-6.4	-6.0	-5.2
Net FDI (EUR bn)	0.2	0.3	0.4	0.5	0.5
Net FDI (% of GDP)	1.5	2.1	3.2	3.4	3.6
Gross foreign debt (EUR bn)	6.6	6.7	6.9	7.1	7.4
Gross foreign debt (% of GDP)	52.4	51.2	51.9	52.5	52.3
FX reserves (EUR bn)	3.3	3.3	3.3	3.3	3.4
Inflation/Monetary/FX					
CPI (pavg)	2.2	3.7	2.1	1.8	2.5
CPI (eop)	3.1	3.1	1.8	2.3	2.4
3M money market rate	0.57	1.18	0.33	0.33	0.80
USD/BAM (eop)	1.47	1.47	1.48	1.40	1.37
EUR/BAM (eop)	1.96	1.96	1.96	1.96	1.96
USD/BAM (pavg)	1.47	1.40	1.52	1.44	1.39
EUR/BAM (pavg)	1.96	1.96	1.96	1.96	1.96

Source: UniCredit Research

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

Recovery being tested

GDP growth forecasts for 2013 and 2014 reduced to 0.4% yoy and 1.2% yoy, respectively

We are revising our GDP forecast for 2013 down to 0.4% yoy (from 0.8% yoy), and to 1.2% yoy (from 1.5% yoy) for 2014. Although the economic data for January show an improving trend in merchandise exports (8.4% yoy) and industrial production (2.0% yoy), sluggish domestic demand affected by moderately lower employment and poor growth in wages significantly constrain domestic private consumption. Weak demand for loans should additionally constrain economic activity and consumer spending this year. The external environment and strengthening of recessionary developments in some neighboring countries, with expectations of a GDP contraction for the eurozone, additionally weigh on the economic recovery dynamics in B&H in 2013. Lower base values from 1Q 2012 enable exports and industrial production to benefit and contribute to growth. Improved energy potential and more favorable hydrological conditions create opportunities for a substantial increase in energy production during the first half of the year, while expected investments in the energy infrastructure should support investment cycle dynamics.

We see inflation to slow amid weak domestic purchasing power and stable oil prices

Inflation outlook: A decrease in real wages and weakened purchasing power resulted in lower inflationary pressures at the end of 2012, while inflation declined notably to 1.3% yoy in January, driven by the external impact of oil prices and EUR-USD (BAM-USD) exchange rate at the beginning of the year. The rise in food prices will probably not be sufficient to dominate mostly stagnant prices in other areas, in spite of the high share of food in the consumer basket at approximately 1/3. We have therefore revised the inflation outlook for 2013 to 1.8% yoy (from 2.8% yoy). A modest upward inflation trend should be recorded in Autumn, due to food price increases and arise in administered prices.

Resolving technical issues on privileged pensions leaves SBA implementation on track

SBA agreement: With two tranches disbursed so far, the withdrawn amount from a 24-month SBA with the IMF (SDR 338.2mn - about EUR 400mn) has reached 30% of programme allocation. Only in January, repayment of obligations from the previous SBA was realized in the amount of SDR 22.8mn. A drawdown of the March tranche is conditioned on the adoption of the Law on Privileged Pensions. Compliance with this requirement and resolution of outstanding technical issues will be crucial for a positive assessment of the IMF staff and consequent March disbursement (SDR 33.8mn), which should increase the total disbursed amount to 40%. It should be noted that the overall disbursements will be used to repay previous SBA borrowings (SDR 140mn due this year).

C/A deficit forecast is revised slightly narrower as imports are adversely affected by weak domestic demand

Balance of payments outlook: We have made a slight revision to our C/A deficit forecast for 2013 to 9.4% of GDP (from 9.7% of GDP). The figure reflects slightly lower merchandise imports as a result of weak domestic demand, while imports will be mostly driven by demand for raw materials from domestic export-oriented industry. Merchandise exports should increase in 1Q, considering lower base levels in 2012. In addition, growth of exports of energy should contribute significantly to the full-year export performance. FX reserves continued to recover, up in December too (4.7% mom), reaching EUR 3.3bn or BAM 6.5 bn. This confirmed their resilience to cyclical trends in FX demand, which could be tested again in the coming months.

Sovereign rating remains unchanged, with SBA implementation the main driver

Sovereign rating and political environment. The sovereign rating has not been changed recently – Moody's (B3 stable, July 2012); S&P (B stable, April 2012). Proper implementation of the SBA is a key variable which supports the stability of the sovereign rating. Acceleration of the reform process towards the end of year should contribute to the submission of an application for EU candidate status. As for political environment, there are two processes to be followed – new entity government in Republic of Srpska should be confirmed during March, while in the Federation BH new government have to be formed and this process is expected to accelerate in the period ahead.

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

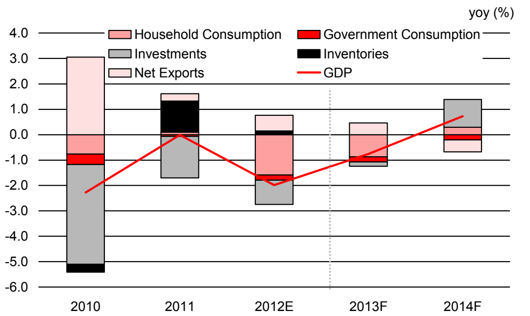
Outlook – Croatian GDP declined for the fourth year in a row, falling 2.0% in 2012. We see this trend continuing in 2013, when we expect GDP to decline by 0.8% yoy. The lack of reforms and sufficient fiscal consolidation is adversely affecting the investment climate, resulting in a lack of recovery in investment activity, as well as domestic consumption, both private and public, and external demand remaining sluggish. Such developments are limiting the potential benefits of EU accession.

Author: Hrvoje Dolenec, Chief Economist (Zagrebačka banka)

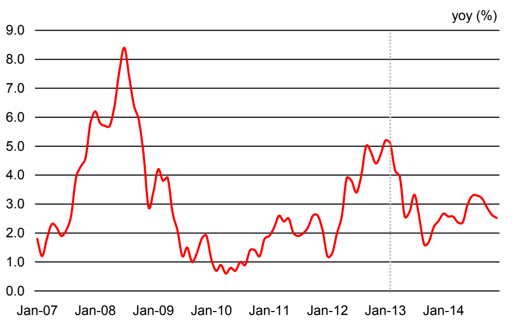
KEY DATES/EVENTS

- 20 March: GDP 2012 estimate
- 27 March: First results-Labor Force Survey for Q4 2012
- 29 March: BoP and Foreign Debt for Q4 2012
- 18 April: Full report – Labor Force Survey for Q4 2012
- 19 May: Regional and local elections
- 29 May: GDP Q1 2013 flash estimate

GDP GROWTH



INFLATION OUTLOOK



Source: IMF, MinFin, Eurostat, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2010	2011	2012E	2013F	2014F
GDP (EUR bn)	44.4	44.9	45.0	46.0	47.7
Population (mn)	4.4	4.4	4.4	4.4	4.4
GDP per capita (EUR)	10,060	10,205	10,251	10,509	10,916
Real economy yoy (%)					
GDP	-2.3	0	-2.0	-0.8	0.7
Private Consumption	-1.3	0.2	-2.7	-1.5	0.5
Fixed Investment	-15.0	-7.2	-4.5	-0.8	5.3
Public Consumption	-2.1	-0.3	-1.0	-1.0	-1.0
Exports	4.8	2.0	-0.1	0.8	2.5
Imports	-2.8	1.2	-1.5	-0.3	3.5
Monthly wage, nominal (EUR)	1,054	1,049	1,047	1,051	1,082
Unemployment rate (%)	11.8	13.5	15.2	16.0	15.5
Fiscal accounts (% of GDP)					
Budget balance	-4.9	-4.9	-4.2	-4.4	-4.2
Primary balance	-3.0	-2.6	-1.8	-1.6	-1.3
Public debt	42.1	49.5	54.6	57.6	60.0
External accounts					
Current account balance (EUR bn)	-0.5	-0.4	-0.2	-0.1	-0.3
Current account balance/GDP (%)	-1.1	-1.0	-0.5	-0.3	-0.5
Basic balance/GDP (%)	-0.2	1.4	1.2	1.7	1.8
Net FDI (EUR bn)	0.4	1.0	0.8	0.9	1.1
Net FDI (% of GDP)	0.9	2.3	1.8	2.0	2.3
Gross foreign debt (EUR bn)	46.5	45.7	46.0	47.5	49.5
Gross foreign debt (% of GDP)	104.6	101.8	102.2	103.2	103.8
FX reserves (EUR bn)	10.7	11.2	11.2	11.8	12.8
Inflation/Monetary/FX					
CPI (pavg)	1.1	2.3	3.4	3.2	2.5
CPI (eop)	1.8	2.1	4.7	2.4	2.5
Central bank reference rate (eop)	6.00	6.00	-	-	-
1W money market rate	1.18	1.28	1.39	1.75	2.50
USD/HRK (eop)	5.55	5.66	5.72	5.39	5.24
EUR/HRK (eop)	7.39	7.53	7.55	7.55	7.50
USD/HRK (pavg)	5.49	5.31	5.85	5.54	5.32
EUR/HRK (pavg)	7.29	7.43	7.52	7.53	7.50

Source: UniCredit Research

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

In search of recovery

GDP declined 2.0% yoy in 2012, with negative trends spilling over to 2013

Economy contracted by 2.0% in 2012. GDP declined by 2.3% yoy in 4Q as a result of unfavorable trends in almost all economic sectors – retail sales, industrial production, construction, the labour market, banking sector and public finances. As a consequence, FY GDP declined 2.0% in 2012, bringing real GDP to less than 90% of pre-crisis levels. Investment activity continued to contract due to the absence of reforms and unresolved fiscal drag.

Additional risks in the economic environment are pronounced and therefore, despite EU accession benefits, we expect recessionary developments to continue

EU accession on 1st July offers the government a turning point. Structural reforms do not bring results in the short term, but the start of their implementation signals readiness for change. The absence of such developments in 2012, combined with growing expectations of continued recession in neighboring countries or main trading partners, resulted in a downward revision of GDP growth to -0.8% for this year. To this, we must attach some additional downside risks, as funding conditions remain threatened by sovereign rating downgrades and any potential deterioration in international financial markets. Furthermore, uncertainties are being created by announcements of changes in the domestic regulatory framework and tightening in regulations of the banking sector, as the latter can additionally harm credit activity already depressed by weak demand and the rise in NPL. Finally, the risk of a further deterioration of EU growth prospects cannot be neglected.

The government is working on a supplementary budget due to the unsustainability of the 2013 plan, while attempting to obtain favorable funding conditions to tap international markets

Fiscal policy outlook: Fiscal consolidation did not develop as planned last year. Initial targets focussed on cutting the wage bill and subsidies were not achieved, and this was compensated for by cuts in capital expenditures and the improved collection of tax revenues. Although this helped the deficit to decline, compliance with the fiscal rule was questioned. Despite criticism, the 2013 budget was approved in line with the proposal projecting an increase in expenditures, revenues and the deficit target, based on an optimistic economic outlook. This once again brought about a divergence from the fiscal rule and increased the adverse impact on the business climate through the resulting rating downgrades, and increased uncertainties over business conditions. This forced the MoF to postpone a new debt issue on international markets, missing the opportunity to obtain very favorable funding conditions at the beginning of the year. As a result of the pressure created in the market due to the unsustainability of budget plans and the basic economic scenario, a supplementary budget has been announced, without a clear timeframe, but is expected soon. However, in the meantime, the government formalized cuts in the public service salaries (by 3%), expressed a preliminary intention to cut the capital expenditure plans and tap international markets in the near term (March/April).

The current account deficit is shrinking due to the growth of tourism and faster growth in the export of goods compared to imports

Current account outlook: Favourable developments in tourism, accompanied by the slower growth of imports than exports of goods, helped the balance of payments approach equilibrium. The current account deficit is tightening. Such a trend is expected to continue in 2013, with a further weakening of personal and private consumption and sluggish investment, while tourism should continue to rise. Regarding capital account developments, EU accession should encourage capital inflows, including FDIs, as well as intensify capital transfers from the EU budget through investments in public infrastructure financed by EU funds. In 2012, inward FDIs were significantly lower than in 2011 (50% in the first three quarters), however such a fall was compensated for by repatriation of outward FDIs of domestic companies abroad.

Sovereign rating was downgraded due to lack of reforms, lack of sufficient fiscal consolidation and lack of new sources of growth

Credit rating outlook: In mid-December, S&P for the first time downgraded the Croatian sovereign rating to non-investment grade. Moody's followed at the beginning of February, while Fitch used the same arguments to revise its outlook to negative while keeping its rating still within investment grade. These arguments include the lack of reforms and sufficient fiscal consolidation, as well as constrained potential for economic growth, all of which limit the potential benefits of EU accession.

Kazakhstan (Baa2 stable/BBB+ stable/BBB+ stable)*

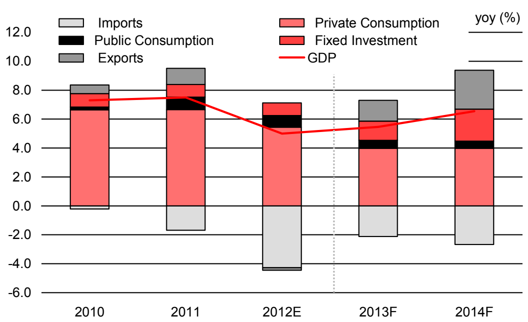
Outlook – Due to deteriorating external balances and sluggish investment, Kazakhstan's economic growth slowed to 5% in 2012 (4.5% yoy in 4Q 12) from 7.5% in 2011. 2013 also began on a weak note. We foresee some acceleration later in 2013 thanks to higher oil extraction and investment, but we regard the government's target of 6% growth for 2013 as ambitious and expect 5.5%. Kazakhstan should return to 6-7% real GDP growth in 2014-15 as production at the Kashagan oil field rises. More than for growth, 2013 could be remembered for structural changes, most prominently new ownership and consolidation in the banking sector and a radically different pension approach. The KZT was under some pressure in 2012. However, we expect the central bank to continue to (successfully) tap some reserves in 2013 (seasonally, particularly in H2) and to keep the FX-rate at about 151 to the USD.

Author: Hans Holzhacker, Chief Economist (ATF Bank)

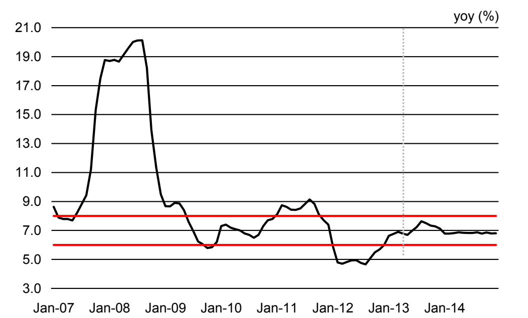
KEY DATES/EVENTS

- Exit of Samruk-Kazyna from the banking sector, 2013
- Establishing of a single, government-owned pension fund, mid-late 2013
- Launch of Kashagan's oil production, mid-2013, but we assume only on a small scale

CONTRIBUTION OF INVESTMENT TO INCREASE, OF NET EXPORTS TO BECOME LESS NEGATIVE



INFLATION TO STAY WITHIN TARGET



Source: ASRK, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2010	2011	2012E	2013F	2014F
GDP (EUR bn)	111.5	133.9	156.9	160.7	180.6
Population (mn)	16.4	16.7	16.9	17.1	17.2
GDP per capita (EUR)	6,781	8,031	9,277	9,415	10,486
Real economy yoy (%)					
GDP	7.3	7.5	5.0	5.5	6.5
Private Consumption	10.9	11.0	9.0	6.6	6.6
Fixed Investment	3.8	3.6	3.6	5.5	9.2
Public Consumption	2.7	11.3	10.5	7.2	6.4
Exports	1.9	3.5	-0.6	4.5	8.4
Imports	0.9	6.9	17.5	8.6	10.9
Monthly wage, nominal (EUR)	397	441	533	549	611
Unemployment rate (%)	5.8	5.4	5.3	5.2	5.1
Fiscal accounts (% of GDP)					
Budget balance	3.0	6.1	4.9	4.5	4.8
Primary balance	3.5	6.8	5.7	5.3	5.6
Public debt	14.8	12.4	12.1	12.8	13.5
External accounts					
Current account balance (EUR bn)	3.3	9.8	6.8	4.7	6.8
Current account balance/GDP (%)	2.9	7.3	4.3	2.9	3.8
Basic balance/GDP (%)	9.5	14.7	11.4	9.2	9.3
Net FDI (EUR bn)	7.4	9.9	11.0	10.0	10.1
Net FDI (% of GDP)	6.6	7.4	7.0	6.3	5.6
Gross foreign debt (EUR bn)	86.9	92.7	107.8	110.0	112.3
Gross foreign debt (% of GDP)	77.9	69.2	68.7	68.4	62.2
FX reserves (EUR bn)	20.8	22.2	21.0	20.1	20.3
Inflation/Monetary/FX					
CPI (pavg)	7.1	8.3	5.1	7.1	6.8
CPI (eop)	7.8	7.4	6.0	7.2	6.9
Central bank target	7.0	7.0	7.0	7.0	7.0
Central bank reference rate (eop)	7.00	7.50	5.50	5.50	6.50
3M money market rate	2.03	1.79	2.51	4.48	5.66
USD/KZT (eop)	147	144	151	151	152
EUR/KZT (eop)	195	192	199	211	217
USD/KZT (pavg)	148	146	149	151	151
EUR/KZT (pavg)	196	204	192	205	214

Source: UniCredit Research

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

Towards higher investment & financial sector changes

Real GDP growth slowed to 5.0% in 2012 from 7.5% in 2011, January data was weak

Output and consumption started 2013 on a weak note. Growth in industrial production was at 0.7% yoy (-0.9% mom sa), only marginally higher in January than the 0.5% achieved in 2012 (as a whole). Mining was up 1.6% yoy (ore +4.7%, oil +1.5%, coal +0.5%), slightly up from the 0.2% in 2012, but manufacturing output fell 0.8% yoy (metals -6.4%, food -3.4%, but engineering +15.1%) after a tiny +0.7% gain in 2012. Employment rose 0.7% yoy in January, significantly below the 4% yoy increases in 1H 2012 and the 1% in 2H 2012. Real wages rose 0.9% yoy in January, a far cry from the 12% yoy seen at the beginning of 2012. The meager January data followed a slowdown in real GDP growth to 5.0% in 2012 from 7.5% in 2011. Services were up 10.0% yoy in 2012 (among them, trade +14.6% at a very low deflator of 1.1%), industry up a mere 0.5%, agriculture down 1.3%. In 4Q 2012 alone, real GDP grew 4.5% yoy, according to our estimates.

Inflation has slightly accelerated, but should remain within target

This slow growth environment is accompanied by manageable inflation. Inflation rose to 6.6% yoy (0.6% mom sa) in January from an average 5.2% in 2012 and 6.0% yoy eop. The acceleration was due to hikes in tariffs that were delayed in 2012. Monetary factors played little role. Food prices increased 5.3% yoy, non-food prices 3.4% yoy, while tariffs were up 11.6%. We expect inflation to accelerate moderately further, mostly because of hikes in (regulated) fuel prices, but to remain within the central bank's 6%-8% target corridor.

Corporate deposits sluggish, banking system funding to become more of an issue in 2013 than in 2012 and 2011

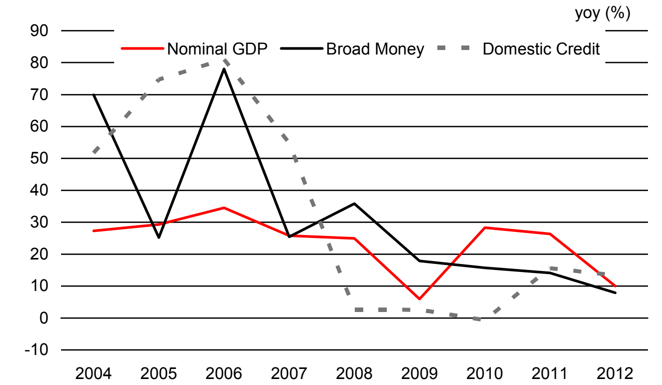
Growth in broad money has significantly slowed. M3 increased 7.9% yoy in the 12 months to December 2012, compared with 15.0% in 2011. Base money was up a mere 1.9% vs. 10.3% in 2011 due to slower rising net foreign central bank assets and because banks began to withdraw their reserve holdings with the central bank. Client deposits with the banking system grew 7.3% yoy eop 2012 vs. 14.3% in 2011. Retail deposits held up well at +23.8% (+24.1% in 2011), but corporate deposits fell 0.7% (+10.2% in 2011) as company finances became more strained. Bank loans increased +13.4% in 2012 (15.7% in 2011), among them retail 21.7% (10.9% in 2011) and corporate loans 10.4% (17.5% in 2011). We expect more moderate retail credit growth in 2013 and some recovery in corporate deposits. However, funding is likely to be more of an issue in 2013 than it was in 2011 and 2012. The 3M KazPrime interbank rate has remained above (a still low) 3% since November 2012 and was temporarily above 4% – previously, it had been 2% or less since March 2010.

Central bank intends to increase transmission efficiency

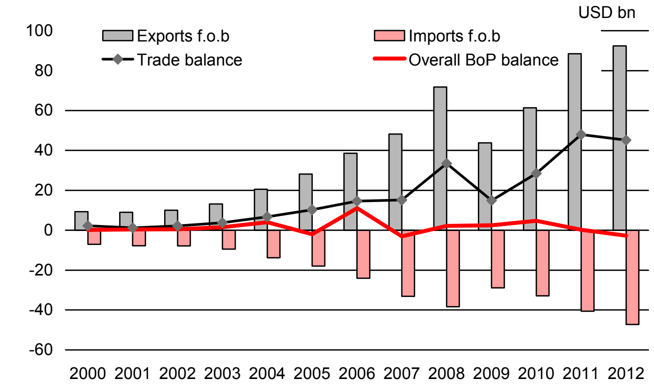
The NBRK's stance is to be rather accommodating in 2013. The "Monetary Policy Guidelines for 2013" call for a more effective transmission mechanism and list several potential new instruments which might be introduced, among them a corridor of maximum deviations from the base interest rate for the seven day operations, two week (reverse) repos via auctions with a minimum yield, the exclusion of KZT cash from the minimal reserves calculation, new types of eligible collateral (e.g. high quality bank loans).

GROWTH IN BROAD MONEY HAS SLOWED IN LINE WITH LOWER GDP GROWTH AND A WEAKER BOP

Broad money grows less than nominal GDP and (since 2012) credit



The BoP turned negative in 2012



Source: ASRK, NBRK, UniCredit Research

Monetary policy likely neutral to accommodative in 2013

Given that GDP growth has slowed below target and that the NBRK's money growth forecasts are at 15%-16% for the money base as well as broad money and deposits slightly higher than our own, we expect the NBRK to use the new (and old) instruments in a rather accommodating way in 2013 and to keep its 1-W refinancing rate unchanged at 5.5%.

The year 2012 saw some fiscal easing. We expect this to continue in a moderate way also in 2013, even though budget figures indicate otherwise

Budget law figures signal fiscal tightening, but we have some doubts. The budget law foresees a narrowing of the Republican (central state) budget to 2.1% of GDP in 2013 from an actual 3.0% in 2012. Revenues are supposed to rise 12% from the actual 2012 level, with tax revenues growing 25.5% while transfers from the Oil Fund remain flat. Expenditures are set to grow 14.5%. A 25.5% increase in tax receipts hardly looks achievable. We believe that transfers from the Oil Fund might again be increased during the year in order to reach the target. State budget (Republican+local, but ex Oil Fund) revenues grew 8.2% yoy in 2012 and totaled 19.4% of GDP. Tax revenues (70.5% of revenues) rose 2.8% but were compensated for by 15% higher Oil Fund transfers (23.7% of revenues) than in 2011. Personal income tax revenues exceeded plan, but corporate tax proceeds remained below plan. Expenditures (ex net crediting, financial operations) increased by 15.6% yoy. The State budget deficit thus widened to 3.0% of GDP from 2.3% of GDP in 2011, even though (mostly agricultural) net credits remained well below 2011 levels. The combined Oil Fund and State Budget surplus narrowed to an estimated 4.9% of GDP from 6.1% in 2011. We see it narrowing further to 4.6% in 2013.

Pension reform aimed at centralizing pension assets in the hand of the State could combine with new ownership in the banking sector and tougher action on NPLs to substantially alter Kazakhstan's financial intermediation sector

Moving towards a new financial architecture? The 10 pension funds currently operating in Kazakhstan under the obligatory pillar of the pension system shall be consolidated into a single one by 1 July 2013. The new single fund would be owned by the government and managed by the central bank in line with a strategy decided by a "Council for the management of the Single Pension Fund's Assets" whose members are to be approved by the President. The four pension funds, which are currently daughter companies of the central bank, Halyk, Kazkommerts (KKB) and BTA have currently together a market share of 75%. The state holding Samruk-Kazyna (SK) owns 97% of BTA, 80% of Temir, 67% of Alliance and 18% of KKB as of 1 January 2013. SK might exit KKB by exchanging its shares in the bank for KKB's pension fund, deputy Prime Minister Kairat Kelimbetov said, according to Interfax Kazakhstan. The purchase of Halyk's pension fund could be paid for with shares in BTA. Alliance and Temir shall be sold to a single investor, who would merge them. If the authorities were able to proceed as outlined, this would fundamentally change both the pension fund landscape and the banking system. A picture emerges of some sort of cooperation between Halyk (the second largest bank by assets after KKB as of 1.1.2013) and BTA (the third largest), while a new powerful retail bank Alliance-Temir (together fifth largest by assets) would most likely go to a domestic investor. This would probably also open the way for more speedy action in tackling NPLs. The "Monetary Policy Guidelines" indicate that an upper limit for non-performing loans might be set by the supervisor in order to force the banks to dispose of NPLs to SPVs or the Problem Asset Fund.

We slightly increase our GDP forecast for 2013 from 5.0% to 5.5% because investment has begun to pick up and in the belief that economic policies will be supportive of growth

We expect real GDP growth to slightly accelerate in 2013 from the 5.0% in 2012 to perhaps 5.5% and 6.0% in 4Q thanks to more investment and higher production in the oil and also metal industry and also some progress in the diversification of the economy. We regard the official target of 6% or more for 2013 as a whole as quite ambitious and very hard to reach, but we see growth to re-accelerate to 6-7% in 2014 and 2015. Investment has finally begun to look better: constant price investment outlays were up 7.5% yoy in January after a disappointing 3.8% in 2012 and 2.4% in 2011. This was due to a 19.6% increase in mining investment (accounting for 50% of investment outlays in January), after a 6% fall in 2012 and a 10% fall in 2011. However, it remains to be seen how robust the recovery really is and how much is due to the extraordinarily low base in January 2012. Projects such as the Tengiz-Chevron "Future growth project" and also projects in the metal industry should support investment in 2013. Investment in manufacturing did quite well already – in part as a result of the government's import substitution policies – and was up 18.1% yoy in 2012 and 35.1% yoy in January.

Strategy: Less central bank support for the KZT?

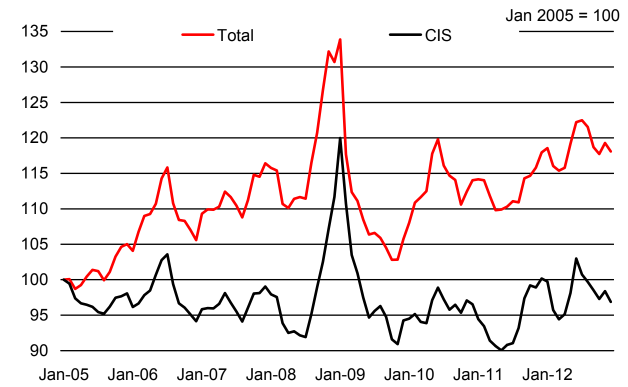
The current account surplus significantly narrowed in 2012, despite substantial terms of trade gains

Kazakhstan's current account surplus narrowed to USD 8.8bn (4.3% of GDP) in 2012 from USD 13.6bn (7.3% of GDP) in 2011, according to preliminary NBRK data. Exports grew 4.4% yoy, imports 16.5% yoy in USD terms. Export prices rose 5% (mineral commodities +10%), whereas import prices fell 4% yoy. Capital inflows were decent, but capital outflows were even higher. Non-resident FDI in Kazakhstan rose 2.8% from the previous year to USD 14.1bn, medium- and long-term lending to residents totaled USD 5.0bn in 2012 vs. USD 0.8bn in 2011. However, resident portfolio investment abroad (mostly by the Oil Fund) grew 5.1% yoy to USD 14.2bn. This combined with short-term capital outflows to leave the overall BoP balance at -USD 2.8bn (-USD5.3bn in 2H). The net international reserves fell by USD 4bn in 2H 2012 and another USD 1.3bn in January to USD 26.4bn (5.3 months of 2012 imports of goods and services) while the foreign assets of the Oil Fund rose by USD 6.4bn in 2H 2012 by and USD 0.7bn in January to USD 58.5bn. The "Monetary Policy Guidelines for 2013" indicate that the NBRK might reduce FX-interventions as soon as the interest rate channel becomes more effective. However, we believe that this will take some time and that the NBRK still has sufficient appetite and reserves to keep the KZT rather stable. We expect more moderate import growth in 2013, given that GDP and income growth slowed. Oil Fund investment abroad might be reduced as more funds will be dedicated to domestic use. The real effective FX-rate, an important competitiveness indicator for the NBRK, weakened by 3.6% from its peak in July 2012 to December. We therefore continue to see the KZT at 151 per USD eop 2013.

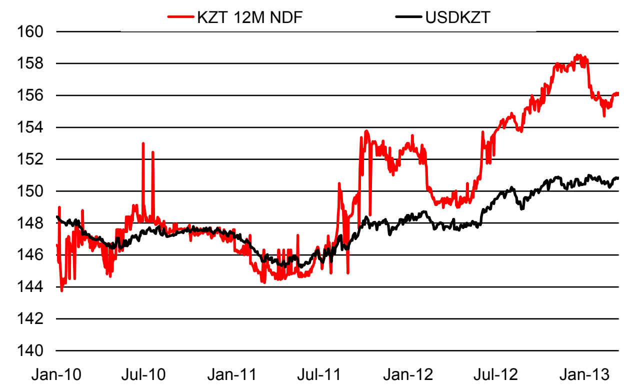
The NBRK lost a significant amount of reserves

We nevertheless keep our forecast of only very moderate KZT weakness in 2013, thanks to lower import growth and continued NBRK support

The real effective FX-rate has weakened from its peak in July 2012



12M NDFs imply KZT weakening



Source: NBRK, Bloomberg, UniCredit Research

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2011	2012E	2013F	2014F
Gross financing requirement	**4.2**	**6.1**	**4.9**	**4.8**
Budget deficit*	2.8	4.7	3.8	3.6
Amortization of public debt	1.3	1.4	1.1	1.2
Financing	**4.2**	**6.1**	**4.9**	**4.8**
Borrowing	3.8	6.2	5.4	5.3
Other	0.3	-0.1	-0.5	-0.4

*Republican budget

Source: MinFin, NBRK, UniCredit Research

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2011	2012E	2013F	2014F
Gross financing requirement	**-0.2**	**2.5**	**3.1**	**-1.6**
C/A deficit	-9.8	-6.8	-4.7	-6.8
Amortization (loans)	9.6	9.3	7.8	5.2
Government/central bank	0.1	0.2	0.3	0.3
Banks	3.1	1.5	1.7	0.9
Corporates	6.4	7.6	5.8	4.0
Financing	**-0.2**	**2.5**	**3.1**	**-1.6**
FDI (non-resident net)	7.7	11.0	10.0	10.1
Equity	0	0.1	0.1	0.1
Borrowing (loans)	10.2	10.3	9.8	7.4
Government/central bank	0.6	0.3	0.4	0.4
Banks	1.6	0.3	1.1	1.1
Corporates	8.1	9.7	8.3	5.9
Other (resident FDI, portfolio, lending, reserves)	-18.1	-18.9	-16.8	-19.2

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

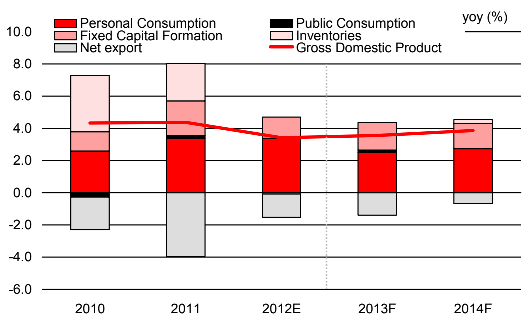
Outlook – Russia's growth performance is weak, although we see green shoots coming from acceleration in large-scale state projects, from results of industry restructuring and generally better sentiment of producers. Among all the possible sources of growth stimulation we still see slightly less restrictive monetary policy than in 2012, with a cut in repo rate by 25bps. This is likely to be delayed until the late summer due to higher inflation readings (7.3% yoy in Feb.) and coming appointment of the new Chairman of the Bank of Russia. Fiscal policy has less scope to act given newly introduced budget rules.

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

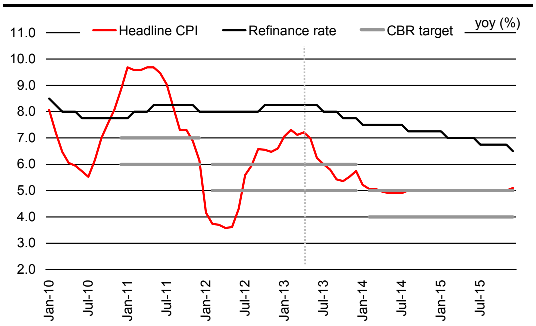
KEY DATES/EVENTS

- 18th-22th of each month – Monthly indicators
- 1st half of every month – CBR decision on rates
- March – introduction of the new CBR Chairman
- May – the Ministry of economic development reviews its mid-term economic outlook

DOMESTIC DEMAND DRIVES THE ECONOMY



INFLATION INCREASES PRESSURE TO KEEP INTERESTS RATES HIGH



Source: NSO, CBR, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2010	2011	2012E	2013F	2014F
GDP (EUR bn)	1,102	1,336	1,562	1,712	1,798
Population (mn)	142.9	143.1	142.9	142.7	142.5
GDP per capita (EUR)	7,714	9,336	10,936	11,998	12,619
Real economy yoy (%)					
GDP	4.3	4.3	3.4	3.6	3.9
Private Consumption	5.1	4.8	6.6	4.7	5.1
Fixed Investment	6.2	5.2	6.0	7.5	6.5
Public Consumption	0.7	-0.1	0	1.0	0.2
Exports	11.1	2.2	1.8	1.0	2.1
Imports	25.4	7.5	8.7	7.0	5.3
Monthly wage, nominal (EUR)	518	580	675	704	765
Unemployment rate (%)	7.5	6.6	5.3	5.3	5.4
Fiscal accounts (% of GDP)					
Budget balance	-6.6	0.8	0	-1.0	-0.5
Primary balance	-5.8	1.3	0.2	-0.7	-0.2
Public debt	8.3	9.8	10.2	11.2	12.0
External accounts					
Current account balance (EUR bn)	55.9	79.5	63.2	27.1	8.0
Current account balance/GDP (%)	5.1	6.0	4.0	1.6	0.4
Basic balance/GDP (%)	4.2	4.8	3.7	1.5	1.1
Net FDI (EUR bn)	-9.8	-11.8	-4.7	-1.1	12.2
Net FDI (% of GDP)	-0.9	-1.2	-0.3	-0.1	0.7
Gross foreign debt (EUR bn)	356.3	424.3	485.1	492.6	521.4
Gross foreign debt (% of GDP)	34.7	31.9	31.1	28.8	29.0
FX reserves (EUR bn)	358.2	384.7	407.0	367.9	346.2
Inflation/Monetary/FX					
CPI (pavg)	6.9	8.6	5.1	6.3	5.1
CPI (eop)	8.8	6.1	6.6	5.7	5.0
Central bank target refinance rate	8.5	6-7	5-6	5-6	4-5
Central bank reference rate (eop)	5.0	5.25	5.50	5.25	5.00
3M money market rate	4.00	6.60	7.45	6.80	5.75
USD/RUB (eop)	30.5	32.2	30.0	31.4	31.9
EUR/RUB (eop)	40.8	41.7	40.5	44.0	45.6
USD/RUB (pavg)	30.3	29.4	31.0	30.2	30.9
EUR/RUB (pavg)	40.4	40.9	39.9	41.1	43.6

Source: UniCredit Research

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

Falling short on growth

The economy is dominated by deceleration in all the segments of demand…

GDP growth is slowing. While we continue to wait on Q4 data, Q3 saw GDP growth slow to 2.9% while monthly data showed January GDP easing to 1.6% yoy. This slowdown in activity is widespread. Weaker external demand has slowed export growth. Consumption is under pressure from both regulation and incomes. First, the CBR is taking measures to limit retail lending by 10pp from a current rate of growth of almost 40%. These measures include an increase in weights for RWA calculation for some retail loans (with interest exceeding 25% p.a.). Secondly, election-related budget spending was responsible for a solid 80% of the increase in wages in several months of 2012 but will not be repeated this year, once again dragging on consumption. Despite a solid 6.6% growth in 2012, fixed investment does not seem to be a source of stable demand as of now in large part due to the passive role of of government spending, which is mostly concentrated on one-off large-scale projects.

…which is partially related to structural changes

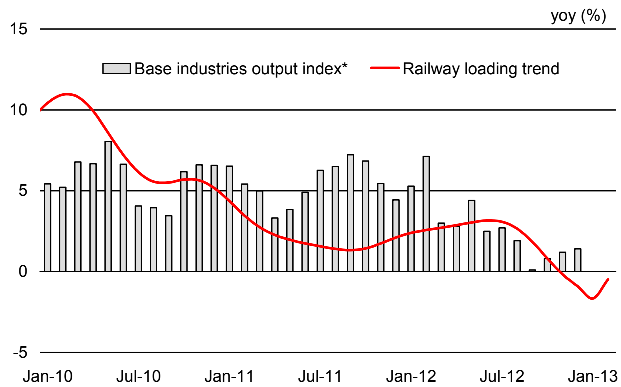
We relate these changes in part to economic restructuring, mostly in industry, linked to the end of post-crisis recovery and also to the WTO accession. For example, annual growth rates in industry after adjustment for seasonality vary from -20% to 15% yoy in all the sub-segments, including investment and intermediate consumption goods. Similar processes are happening in services. One of the signals for this is a weakened demand for corporate loans: their volume added only 12.7% FY12 vs. 26% FY11. The CBR and sector surveys reported only 15% of borrowed money went to new capital investment while the rest was directed to serve refinancing and working capital needs.

However, despite a weak start in 2013, there are some green shoots

Despite this, we expect GDP growth this year to remain broadly similar to last year at 3.6%. The need to complete preparations for Olympic Sochi 2014 will be supportive of construction. According to available estimates, total spending on this project in 2013 will account for RUB 260-390bn (1.4-2.0 times more than average annual spend on this project over recent years), equivalent to about 2% of annual investments in Russia. President Vladimir Putin visited Sochi earlier in the year and dismissed several bureaucrats because of delays in construction. Last year harvests were quite weak, and negatively affected growth since the downturn happened after record-high harvests of 2011. This year, if agriculture is also weak, the effect on GDP will be minor, and an upside surprise is possible if harvests are better than in 2012 (which is likely to be the case). Some economic activity indicators show that currently the bottom has been reached. For instance, the rail cargo loading deceleration is likely to be over. Finally, in February, the Federal Statistics Service reported an improvement in producer confidence. PMI indicators are also improving, although the services sector is outperforming production.

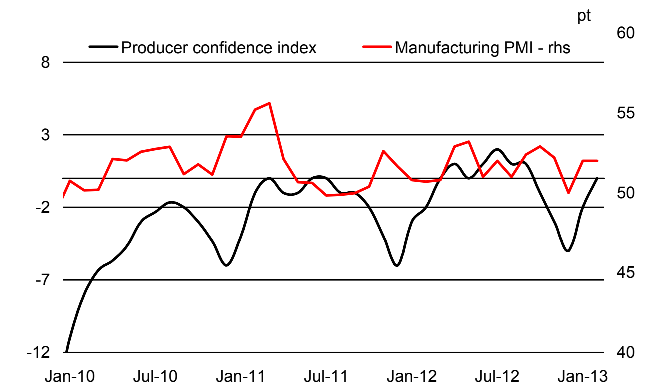
REAL SECTOR TRENDS IMPLY ACCELERATION IN COMING MONTHS

Deceleration of activity stopped…



Represent 70% of GDP by production

…and producers demonstrate optimism.



Source: Federal Statistics Service, Bloomberg, CBR, UniCredit Research

The budget rule constrains spending to ensure steadiness of state finance on a long-term basis

Starting from this year, fiscal policy is constrained by the newly accepted budget rule. This rule says that spending cannot exceed revenues more than by 1% of GDP, while revenues are calculated as a function of past long-term average oil price. This year total federal budget revenues will reach RUB 12.9trl (+1.5% yoy), while spending will be at RUB 13.4trl (+4.4% yoy). Thus the budget will post a deficit at 0.8% of GDP (our more conservative forecast assumes a deficit of -1%). Within the next three years it will be decreased to 0%. The introduction of the budget rule is related to the increased reliance on oil (form 52% of total budget revenues) and the need to stimulate growth in the efficiency of spending.

We confirm the base-case scenario of a single 25bp cut in the repo rate although high headline inflation might delay the beginning of the easing cycle till the late summer

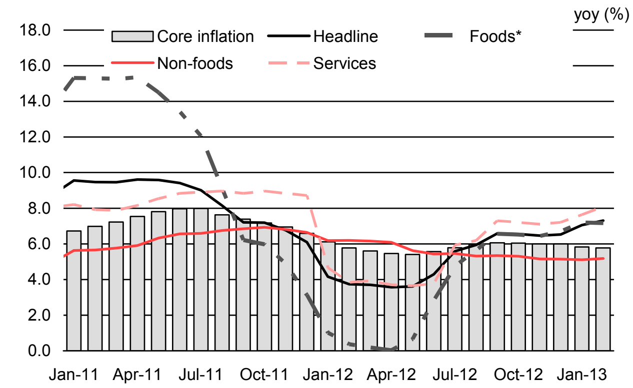
With all of the above in mind, we see scope for a modest easing of monetary policy this year. Our base-case scenario is a single 25bp rate cut in the auction-based overnight repo rate to 5.25% and a couple of cuts in the refinancing rate from its current 8.5% level. This is less than we forecast one quarter ago but in the interim the effects of transport tariff growth and excise tax hikes together with a low base effect brought a significant acceleration in inflation. In February, prices increased by 7.3% yoy (vs. FY12 at 6.6%). Key inflation drivers are food prices (rose by 8.7% yoy) and services prices (+8.2% yoy), while non-food prices are a drag on inflation. The stability of non-food prices (they add some 5.3% yoy) and of core inflation at 5.7% implies that inflation is related to temporary and seasonal factors. Taking into account all of these trends, the CBR is likely to avoid changing interest rates at its next few meetings. The beginning of the easing cycle should be delayed until the late summer when base effects and slower utility tariff growth will allow headline CPI to decelerate to approximately 6%.

Watch for the replacement of the CBR chairman

In mid March, President Vladimir Putin nominated Elvira Nabiullina to replace the current chairman Sergey Ignatiev, whose term is scheduled to expire in June 2013. In order to comply with procedure, President Putin had to name his successor in March. Mrs. Nabiullina, ex-minister of economic development, might be considered to be a more "growth-friendly" chairman, which is in line with Mr. Putin's rhetoric on the CBR's increased responsibility for growth. In this respect, this nomination is indeed a positive surprise for the economy. However, consistency of CBR policy towards inflation targeting might now be under question, thus possibly having a mixed effect on the ruble.

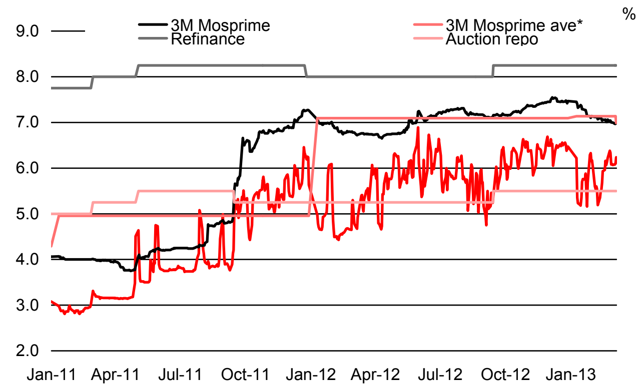
INFLATION AND INTEREST RATES

Acceleration of headline inflation is temporary…



*Excluding alcohol

…and we see some modest scope for interest rates to decrease



*During the calendar year

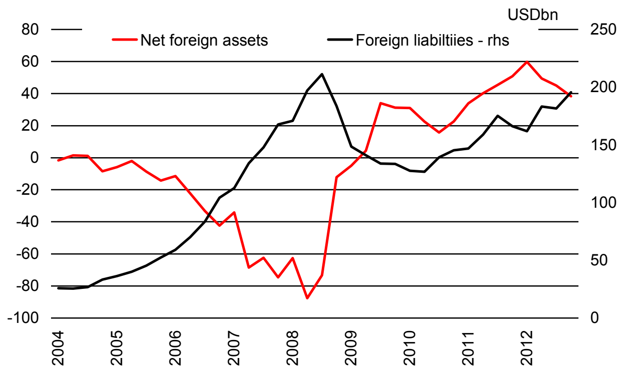
Source: FOM, Bloomberg, CBR, UniCredit Research

Strategy: Still waiting for RUB to perform

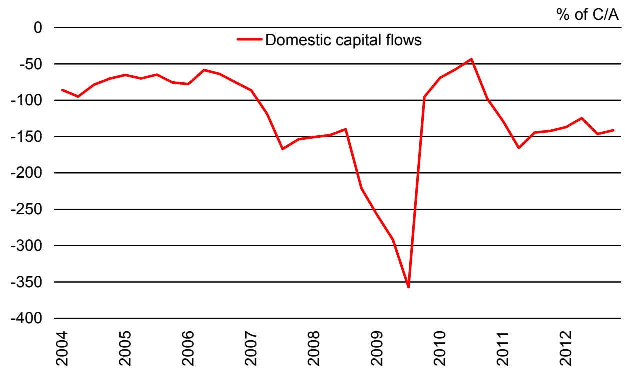
RUB performance YTD has been disappointing, but we continue to see some scope for RUB to perform over the rest of the quarter

RUB performance YTD has been disappointing. Despite an increase in oil prices early in the year, the announcement on the euroclearability of OFZs and favourable BoP seasonality in Q1, RUB has failed to perform and instead is moderately weaker. In part this reflects heavy positioning, with RUB representing a consensus trade as we entered 2013 but in part it also reflects underlying BoP deterioration. Though slower than in 2011, domestic capital outflows last year totaled USD 115 bn, equivalent to 5.9 % of GDP or 141% of the C/A surplus. As a % of the C/A surplus, this was unchanged from 2011. Looking ahead, we continue to see some scope for RUB to perform over the rest of the quarter and into April, supported by a variety of foreign capital inflows and a relatively high carry, including a surge in corporate external issuance following the announcement of full year 2012 financial results beginning the middle of this month. Constraints on banking sector funding should also see the banks continue to borrow abroad. Finally the announcement on the euroclearability of OFZs should also see some delayed follow-through in terms of foreign purchases of OFZs. BoP seasonality turns less favourable June onwards.

Net foreign asset position of banking sector peaks as banks begin to borrow offshore again



Locals withdraw capital equivalent to 140% of Russia's C/A surplus



Source: CBR, IMF, UniCredit Research

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2011	2012E	2013F	2014F
Gross financing requirement	**34.3**	**36.1**	**55.7**	**50.4**
Budget deficit	-10.7	-	17.1	9.0
Amortisation of public debt	10.5	16.5	18.2	20.8
Domestic	7.3	14.8	16.6	19.5
Bonds	7.3	14.8	16.6	19.5
Bills	-	-	-	-
External	3.2	1.8	1.6	1.4
Sovereign Fund	34.4	19.5	20.3	20.5
Financing	**34.3**	**36.1**	**55.7**	**50.4**
Domestic borrowing	33.7	31.0	50.8	45.8
Bonds	33.7	31.0	50.8	45.8
Bills	-	-	-	-
External borrowing	0.6	5.1	4.9	4.6
Bonds	0.6	5.1	4.9	4.6
Other	-	-	-	-

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2011	2012E	2013F	2014F
Gross financing requirement	**-22.7**	**-3.9**	**29.9**	**48.0**
C/A deficit	-79.5	-63.2	-27.1	-8.0
Amortisation of debt	46.8	47.6	49.1	51.4
Government/central bank	3.2	1.8	1.6	1.4
Banks	18.80	17.20	18.50	20.00
Corporates	24.80	28.60	29.00	30.00
Errors and omissions	9.99	11.73	7.84	4.65
Financing	**-22.7**	**-3.9**	**29.9**	**48.0**
FDI	-11.8	-4.7	-1.1	12.2
Equity	-	-	-	-
Borrowing	64.6	63.1	80.8	65.8
Government/central bank	0.6	10.0	9.9	4.6
Banks	23.2	34.5	31.0	27.0
Corporates	40.8	18.6	39.9	34.2
Domestic investments abroad	-102.0	-84.5	-25.0	-15.0
Official reserves change / other	26.6	22.2	-24.8	-15.0

Source: MinFin, NSO, CBR, UniCredit Research

Serbia (BB- negative/BB- negative)*

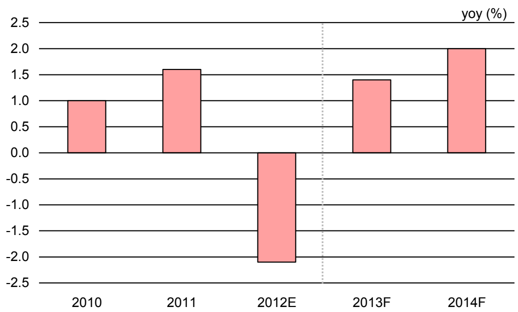
Outlook – The Serbian economy slid further into recession in 4Q12 after posting a preliminary GDP contraction of 1.5% yoy. Such a poor finish points to a GDP drop in 2012 of close to 2% yoy, though the economy should start recovering as soon as 1Q13 due to Fiat's strong export push. This should also improve the C/A by year-end, though the long-term funding gap remains a concern. That said, we see the budget deficit this year narrowing to just 4.3% of GDP, though it will still miss its target. With inflation pressure easing from 2Q13 onwards, we see the NBS cutting rates a minimum of 200bp by year-end which should help stabilize the RSD at close to 115/EUR.

Author: Carlos Ortiz, Economist (UniCredit Bank London)

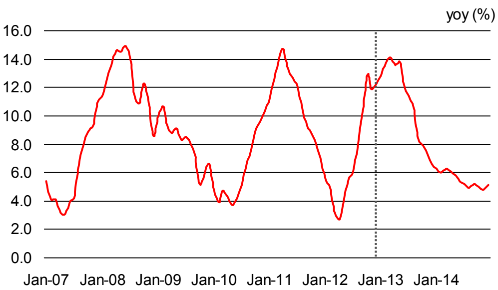
KEY DATES/EVENTS

- 29 Mar, 30 Apr: 4Q12 GDP (final), 1Q13 GDP (prelim)
- 29 Mar, 30 Apr, 31 May – Industrial Production
- 29 Mar, 30 Apr, 31 May – Retail Trade
- 11 Apr, 13 May, 6 June – NBS rate decisions
- 12 Apr, 13 May, 12 June – Consumer Price Index

GDP GROWTH RESUMING IN 2013



INFLATION SET TO PEAK IN 1Q13



Source: NBS, MinFin, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2010	2011	2012E	2013F	2014F
GDP (EUR bn)	28.0	31.1	28.9	32.2	33.7
Population (mn)	7.5	7.6	7.6	7.6	7.6
GDP per capita (EUR)	3,735	4,116	3,810	4,233	4,434
Real economy yoy (%)					
GDP	1.0	1.6	-2.0	1.4	2.0
Monthly wage, nominal (EUR)	461	518	504	536	560
Unemployment rate (%)	19.2	23.7	22.9	22.4	22.0
Fiscal accounts (% of GDP)					
Budget balance	-4.7	-5.0	-6.4	-4.3	-3.4
Primary balance	-3.5	-3.6	-4.3	-2.1	-0.9
Public debt	43.4	46.5	61.1	60.5	62.4
External accounts					
Current account balance (EUR bn)	-2.1	-2.8	-3.1	-2.7	-3.1
Current account balance/GDP (%)	-7.4	-8.9	-10.8	-8.5	-9.2
Basic balance/GDP (%)	-4.4	-3.0	-10.1	-2.6	-4.8
Net FDI (EUR bn)	0.9	1.8	0.2	1.9	1.5
Net FDI (% of GDP)	3.1	5.9	0.7	5.9	4.4
Gross foreign debt (EUR bn)	23.8	24.1	25.7	26.6	27.4
Gross foreign debt (% of GDP)	84.9	77.5	89.0	82.7	81.2
FX reserves (EUR bn)	11.7	12.9	12.0	12.2	11.7
Inflation/Monetary/FX					
CPI (pavg)	6.8	11.6	7.3	11.0	5.5
CPI (eop)	10.3	7.0	12.2	6.6	5.1
Central bank target	6%±2%	4.5%±1.5%	4.0%±1.5%	4.0%±1.5%	4.0%±1.5%
Central bank reference rate (eop)	11.50	9.75	11.25	10.00	9.50
BELIBOR 3M	10.72	12.88	11.64	11.48	11.05
USD/RSD (eop)	79.3	78.7	86.1	82.5	82.9
EUR/RSD (eop)	105	105	114	116	119
USD/RSD (pavg)	77.6	72.8	87.9	83.9	83.0
EUR/RSD (pavg)	103	102	113	114	117

Source: UniCredit Research

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

Recovery ahead despite twin deficit problem

Provisional 4Q12 GDP drop at 1.5% yoy, placing FY12 GDP contraction at 2% yoy. FY13 growth expected at 1.4% yoy

Flash GDP data point to a weak finish for 2012, with 4Q12 GDP contracting by close to 1.5% yoy. This is 1pp lower than in 3Q12, while being the fourth consecutive quarter of contraction. Further details will be known on March 29, although we expect such a drop to have been heavily influenced by the contraction in agricultural production (-17.1% yoy in 3Q12). Going forward, we see FY13 GDP growth at close to 1.4% yoy, due mainly to Fiat's rising car production plans (114,000 units in 2013). Nonetheless, we expect both private and public consumption growth to remain in negative territory until end-2013 as a result of increased austerity and tightened credit conditions at home. The budgeted 10% reduction in pensions and real wages and past hikes in indirect taxes should also further weigh on household consumption. That said, investment expenditure should catch-up, as close to EUR 2bn in energy and infrastructure FDI projects are expected this year alone.

C/A expected to improve this year as a result of Fiat's growing exports and greater net remittance inflow

C/A deficit to improve in 2013, funding gap still a concern. Serbia's C/A deficit increased in November to EUR 2.7bn, although it will likely widen to 10.6% of GDP for FY12 because of December's weak trade balance data (deficit of EUR 637mn). Nonetheless, it should narrow to 8.5% of GDP this year on the back of Fiat's exports-boost and a modest pick-up in net remittance inflows. However, financing of the C/A remains a concern as foreign capital flows continue to fall short of funding needs (avg. basic balance at -7.1% of GDP since 2008). Moreover, the non-bank corporate sector continues to underperform, with capital outflows averaging EUR 136mn/Q since 1Q09, at a time where trade credits spiral downwards. While it is true that portfolio flows stand at all-time highs following the past two Eurobond issuances (USD 2.25bn in total), these may well reverse should appetite for risk cease. Drawing down of FX reserves to cover the funding gap cannot be sustained should the NBS commit to guaranteeing RSD stability, implying that attracting net FDI becomes crucial. To achieve this, further progress on the government's side is required, particularly regarding the improvement of Serbia's business climate (still ranks 86/185 in WB's Ease of Doing Business 2013) and its privatization process.

CPI growth to ease from 2Q13 on, with the NBS expected to cut rates a minimum of 200bp by year-end

Inflation to decelerate, RSD stabilized. As expected, CPI growth continued to accelerate in January to 12.8% yoy, mainly because of persistent pressure from food and administered prices and ongoing effects of last October's VAT hike. The reading, which was well above the NBS's target, is expected to peak by end-1Q13, though it should reverse thereafter due to of the high base effects and deflationary impact from local demand weakness. Nonetheless, inflation will still remain above target (eop CPI expected at 6.6%) and only reach the NBS’s upper level of its 4 ± 1.5% tolerance band by early-2014. With this in mind, we expect the NBS to cut rates from mid-2Q13 on, with scope for a very minimum of 200bp of rate cuts by year-end. Such a move, however, is unlikely to prompt a significant RSD depreciation, as the NBS can still soak up RSD liquidity, draw down its FX reserves or even increase reserve requirements to support it. The RSD should thus stabilize at around 112.2/EUR by the end of March, with scope for a slight depreciation to 115.5/EUR by year-end.

Fiscal consolidation remains a challenge due to excessive subsidies and interest payments

Budget deficit to exceed target, financing secured for 1H13. Following a pre-election surge in expenditures in 1H12, the budget deficit increased to 6.4% of GDP at end-2012, 1.4pp higher than in 2011. This year, the government aims to cap the deficit at just 3.6% of GDP, though it will likely come close to 4.3% of GDP, as both the increase in taxes (VAT to 20%, corporate income tax to 5%) and savings resulting from lower wage and pension indexations will fall short of offsetting the increase in subsidies, employee outlays and interest payments. Public debt, currently at 60% of GDP, will thus continue spiralling upwards (30pp increase since 2008), making a debt-reversal to its 45% constitutional limit only possible by 2020. As for financing needs this year, these stand at around EUR 4.5bn, of which EUR 1.85bn (or 41% of total) has already been issued in 1Q13 (most of it from February's USD 1.5bn Eurobond). This places the sovereign in a comfortable position for 1H13, although this should not affect the government's efforts to secure an IMF deal by Spring.

Turkey (Ba1 positive/BB stable/BBB- stable)*

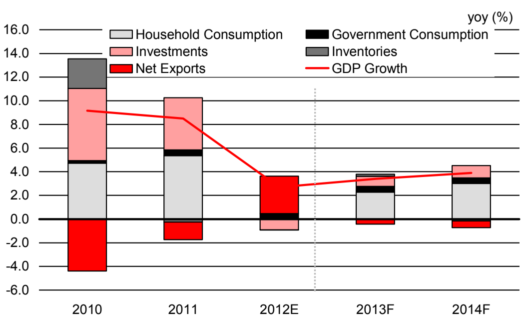
Outlook – Expect the tools that the CBT uses to balance developments on inflation, credit and the C/A deficit to remain multifold, including interest rate changes, reserve requirements, FX management and its reserve option mechanism. The composition of the financing of the C/A deficit and a shortage of FX reserves remain Turkey's largest vulnerabilities. In the near term we are relatively neutral on TRY and local rates, of the view that the external environment is sufficiently friendly to continue to support the CBT's strategy. Over a multi quarter horizon, upside risks to inflation and the C/A deficit, signs of a peak in inflows to EM and eventual a gradual normalisation in G7 interest rates mean that the risks are biased towards higher rates and a weaker TRY. We see industrial production/exports and credit as particularly important in the coming months.

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

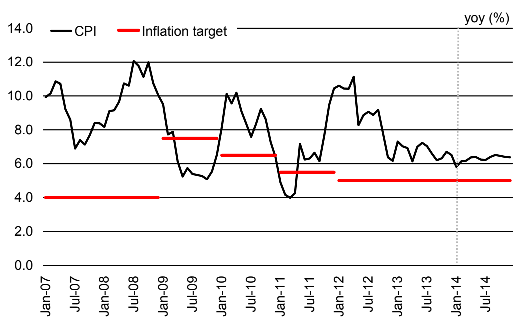
KEY DATES/EVENTS

- 1 Apr, 11 June – 4Q13 GDP, 1Q13 GDP
- 26 Mar, 16 Apr, 16 May – Repo Rate Decision
- 3 Apr, 3 May, 3 Jun - CPI
- 8 Apr, 8 May, 10 Jun – Industrial Production

DOMESTIC DEMAND SLUMPS, LEAVING THE BURDEN ON NET EXPORTS



INFLATION TO EASE ONLY GRADUALLY BUT REMAIN OUT OF TARGET



Source: TurkStat, CBT, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2010	2011	2012E	2013F	2014F
GDP (EUR bn)	552	559	627	670	723
Population (mn)	73.0	74.0	74.9	75.8	76.7
GDP per capita (EUR)	7,567	7,555	8,372	8,832	9,426
Real economy yoy (%)					
GDP	9.2	8.5	2.7	3.4	3.9
Private Consumption	6.7	7.8	0	3.4	4.5
Fixed Investment	30.5	18.5	-3.5	3.5	4.2
Public Consumption	2.0	4.5	4.5	4.7	4.5
Exports	3.4	6.4	14.0	4.8	6.0
Imports	20.7	10.9	0.5	6.0	7.5
Monthly wage, nominal (EUR)	796	783	912	999	1,111
Unemployment rate (%)	11.9	9.8	9.2	9.8	9.7
Fiscal accounts (% of GDP)					
Budget balance	-2.7	-0.3	-2.1	-2.4	-2.9
Primary balance	1.0	2.3	0.7	0.2	-0.4
Public debt	42.4	39.6	36.9	35.3	34.7
External accounts					
Current account balance (EUR bn)	-35.3	-55.5	-38.0	-45.7	-54.2
Current account balance/GDP (%)	-6.4	-9.9	-6.1	-6.8	-7.5
Basic balance/GDP (%)	-5.4	-8.2	-5.0	-5.8	-6.5
Net FDI (EUR bn)	5.7	9.8	6.5	6.9	7.3
Net FDI (% of GDP)	1.0	1.8	1.0	1.0	1.0
Gross foreign debt (EUR bn)	218.5	236.6	240.4	272.3	316.4
Gross foreign debt (% of GDP)	39.6	42.3	38.3	40.7	43.8
FX reserves (EUR bn)	59.2	59.4	74.5	80.4	79.7
Inflation/Monetary/FX					
CPI (pavg)	8.6	6.5	8.9	6.7	6.3
CPI (eop)	6.4	10.4	6.2	6.5	6.4
Central bank target	7.5	6.5	5.5	5.0	5.0
Central bank reference rate (eop)	6.50	5.75	5.50	6.00	7.00
3M money market rate	11.56	11.00	5.75	6.10	7.20
USD/TRY (eop)	1.52	1.87	1.79	1.74	1.73
EUR/TRY (eop)	2.02	2.46	2.35	2.43	2.47
USD/TRY (pavg)	1.51	1.68	1.80	1.76	1.73
EUR/TRY (pavg)	2.00	2.34	2.32	2.39	2.45

Source: UniCredit Research

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

The balancing act intensifies

Following an impressive adjustment last year, 2013 is at risk of seeing rising credit growth, higher inflation and a wider C/A deficit

After the boom of 2010 and 2011, 2012 saw the CBT make progress in 'normalising' a variety of indicators. By year-end inflation had eased 4.5pp to 6.2% yoy. From in excess of 40% yoy in Dec-10 and 30% yoy in Dec-11, headline credit growth eased to below 20% yoy by Dec-12. The current account deficit narrowed by 4pp to 6% of GDP while domestic demand growth in yoy terms was negative in each of the first three quarters of 2012.

But a number of the factors that materialised over 2011/12 will not repeat this year:

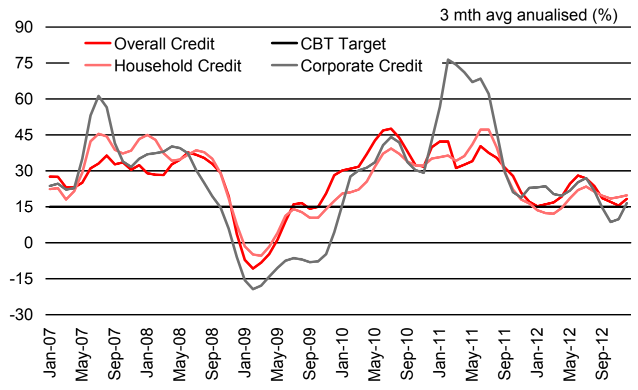
- Over Jan-Feb, CPI is up 1.9pp, eroding 36% of the CBT's full year target (assuming 5.3%, as per its inflation report projection). Much of the decline in inflation last year is attributable to TRY appreciation. According to our estimates, FX added almost 3pp to headline inflation in Q4-11 but by Q4 last year this had fallen to zero. In contrast this year is likely to see TRY weaken moderately, adding slightly to inflation. Food prices finished last year up only 3.9%, a rate of inflation which is 1.5 standard deviations below its 5 year average but there has already been payback for this over the first couple of months of this year. We currently forecast year-end inflation at 6.5%, 1.2pp above the CBT's projection;
- We see some renewed widening of the C/A deficit this year also. Last year saw the C/A tighten by USD 28.8bn, of which USD 10.5bn was due to net gold exports. But January data showed some tentative evidence that the gold balance is deteriorating. We assume a deterioration in net gold exports of USD 4.0bn, followed by another USD 2.0bn 2014. This, combined with stronger import growth, will see the C/A deficit widen towards 7% of GDP this year and to 7.5% of GDP next year;
- Lastly the CBT's soft target for credit growth of 15% this year looks unrealistic. Credit growth, as measured by average, annualised growth over a 13 week period, exceeds 22% currently.

We do not expect a return to 2010/11 excesses but targets will be overshot

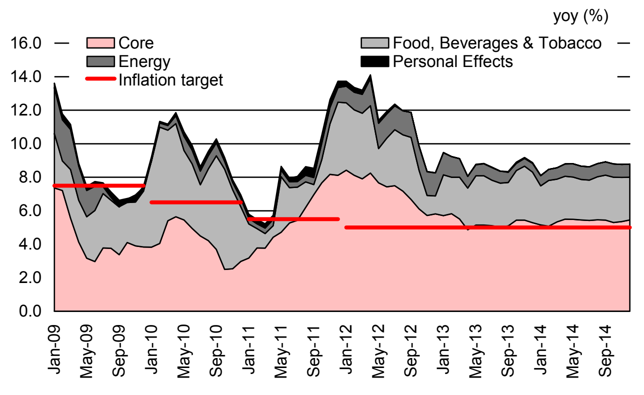
This does not mean a return to the sort of imbalances posted in 2010/11 for a number of reasons. Firstly the banking system is unlikely to be able to fund credit growth much in excess of its current rate given that the loan to deposit ratio has hit one. Deposit growth is running at approximately half of credit growth, leaving banks reliant on a continued increase in foreign funding. IMF data puts the net foreign asset position of the banking sector at the end of the year at a negative 11.3% of GDP. At end-09 this stood at a negative 0.7% of GDP, suggesting that banks have already exhausted significant potential on this front.

TARGETS ARE BECOMING MORE DIFFICULT TO MEET

Credit growth vs. target



Different contributions to inflation vs. target



Source: Turkstat, CBT, UniCredit Research

Secondly, at least the initial impact from the decline in interest rates that Turkey has enjoyed since 2009 has fed through. Thirdly, the CBT has adopted a stable currency policy to prevent excessive appreciation from contributing to a wider C/A deficit and excessive depreciation from pushing inflation higher once again. More specifically the Bank has signalled that it sees scope for REER gains of 2% per annum, an upper limit of 9% cumulative REER gains over the three years to end-2015 (an index just short of 130). Based on the CBT's inflation projections for Turkey, this implies a 1% NEER loss annually. Our inflation projections suggest a NEER loss of over 2% per annum, significantly smaller than TRY losses in 2010/11.

Turkey's primary vulnerabilities remain an excessive reliance on short term foreign capital inflows and a shortage of FX reserves

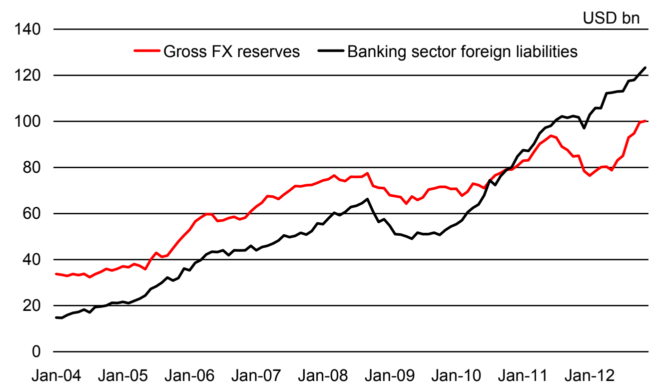
The risks to this scenario remain an excessive reliance on short term foreign capital inflows to fund the C/A deficit and a shortage of FX reserves. This means that Turkey remains vulnerable to mini balance of payments crises. Examining the composition of capital flows to Turkey, the improvement last year was much less impressive than that observed in the C/A. The primary positive is the fact that the overall size of flows required fell. But FDI also fell, in line with trends elsewhere in the region while almost 80% of the net capital flows were short term in nature. Shifting to FX reserves, these have increased in gross nominal terms from less than USD 80bn at end-11 to USD 100bn at end-12, to a large extent because of the CBT's new reserve option coefficient mechanism. But this increase does not cover the increase in banks' foreign liabilities while a variety of other measures, including net reserves and reserves to short term debt, are unimpressive.

With this in mind, expect the CBT to remain active, using a variety of tools, to balance the recovery between domestic and external demand

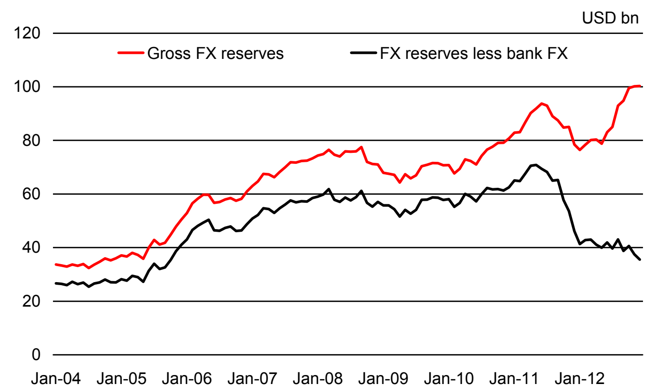
In terms of policy actions from here, expect the CBT to remain active, adjusting reserve requirements, the interest rate corridor and its ROC weights, as required. The Bank's objective is to ensure as balanced a recovery as possible between domestic and external demand. The Bank is clear that it currently sees itself in tightening mode but that it wants to move at a measured pace. At this stage, further modest reductions in the interest rate corridor are possible, as are hikes in reserve requirements, but not necessarily at the next rate decision meeting. Each move will be determined by data flow in the weeks leading up to the decision. In the event that capital inflows slow to the extent that they are insufficient to fund the C/A deficit, expect the Bank's ROC mechanism to be the first tool that it draws off, shifting the adjustment burden from the exchange rate to interest rates. As the CBT discussed in our January monthly, the size of funds accumulated to date under this mechanism gives it more influence than its open market operations over the course of 2012 in terms of TRY liquidity absorption. Thereafter expect a shift to the use of reserve requirements, in this case reducing RRs to release FX into the system. Only then will the CBT very reluctantly return to FX intervention.

FX RESERVES DO NOT OFFER SUFFICIENT CUSHION

FX reserves cannot keep pace with external bank borrowing



Gross reserves rise, net reserves fall



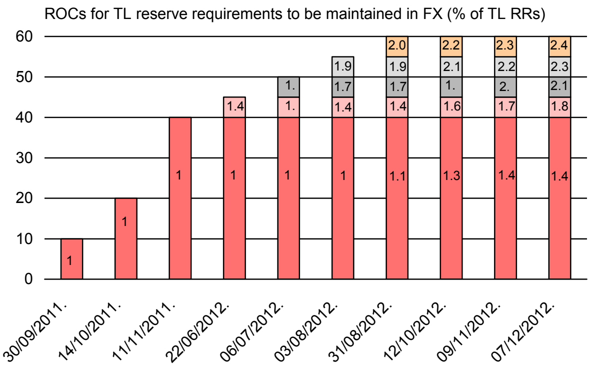
Source: CBT, Turkstat, UniCredit Research

Strategy: In search of direction

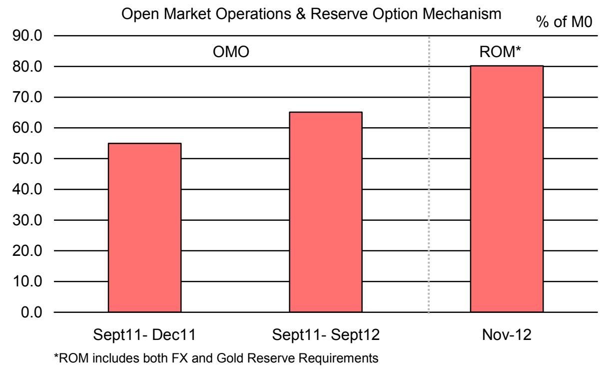
Current TRY equilibrium seems sustainable in the near term. In event of currency pressures, expect interest rates to absorb the burden of the adjustment, at least for now

It is difficult to forecast a large move in TRY, either stronger or weaker, in the near term. In the current environment, the CBT has sufficient tools to hand to continue to micro-manage TRY. Interest rates will continue to absorb the burden of adjustment, lower in the event of a renewed acceleration in foreign inflows and higher in the case of a C/A financing shortfall. Looking beyond a 1-2 month horizon, any multi week/month sudden stop or more permanent slowdown in capital inflows will push interest rates higher. Over time a repricing in G7 rates, most likely led by a normalisation of monetary policy, will also carry implications for the price of external funding. The extent of the increase in rates will depend on the severity and duration of the slowdown/sudden stop but we do not expect the CBT to be as reluctant to draw off its tool box next time as it was in withdrawing liquidity via OMOs in late 2011. That said, in the event of a particularly nasty sudden stop, the CBT will have to weigh the implications of a withdrawal in TRY liquidity and the second sharp spike in interest rates that the banking sector is forced to deal with since late 2011. Growth risks suffering at a time when investment may continue to lag consumption while exports recover only gradually.

Covering TRY RRRs via FX



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



Source: CBT, Treasury, Bloomberg, UniCredit Research

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2011	2012E	2013F	2014F
Gross financing requirement	**62.5**	**74.4**	**93.7**	**105.5**
Budget deficit	1.5	13.2	16.1	21.0
Amortisation of public debt	61.0	61.2	77.6	84.5
Domestic	53.6	53.1	70.9	77.9
Bonds	47.6	53.1	70.9	60
Bills	6.0	0.0	0	0
External	7.4	8.1	6.8	6.6
Financing	**62.5**	**74.4**	**93.7**	**105.5**
Domestic borrowing	58.7	68.6	88.1	100.6
Bonds	54.5	68.6	88.1	100.6
Bills	4.20	0	0	0
External borrowing	3.8	5.8	5.6	4.8
Bonds	3.8	5.4	5.2	4.4
IMF/WB	0.0	0.4	0.4	0.4
Other	0.0	11.8	10.0	8.6

Source: CBT, Treasury, Bloomberg, UniCredit Research

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2011	2012E	2013F	2014F
Gross financing requirement	**181.5**	**165.9**	**206.1**	**234.6**
C/A deficit	77.2	48.9	62.6	76.7
Amortisation of medium to long term debt	38.5	39.0	42.5	46.8
Government/central bank	5.7	4.5	3.6	2.9
Banks	6.9	9.4	11.2	13.5
Corporates	25.8	25.2	27.7	30.5
Short term debt	77.4	82.1	101.0	111.1
Government/central bank	5.9	8.3	12.1	13.3
Banks	47.6	46.6	58.5	64.3
Corporates	23.9	27.2	30.4	33.4
Errors & omissions	-11.6	-4.0	0	0
Financing	**181.5**	**165.9**	**206.1**	**234.6**
FDI	13.7	8.3	9.1	10.0
Portfolio	22.0	40.8	32.6	26.1
Borrowing medium to long term	47.7	40.5	45.8	50.9
Government/central bank	4.9	2.7	2.2	1.8
Banks	12.6	8.9	11.8	14.2
Corporates	30.2	28.9	31.8	34.9
Short term borrowing	82.1	101.0	111.1	122.2
Government/central bank	8.3	12.1	13.3	14.7
Banks	46.6	58.5	64.3	70.8
Corporates	27.2	30.4	33.4	36.8
Other	17.8	-24.6	7.5	25.4
Reserve accumulation	1.8	-20.8	0	0

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

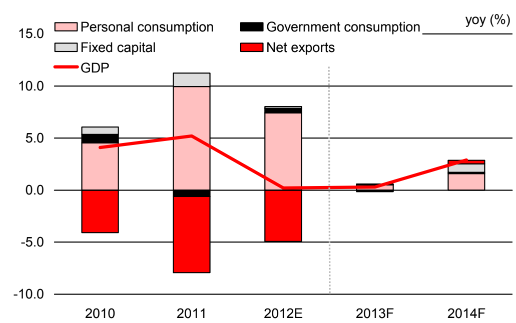
Outlook – In Ukraine this year we monitor commodity prices, global risk appetite and any decision from the authorities on a deal with the IMF, Europe or Russia. In the near term we expect the status quo to be maintained, i.e. broad currency stability in the absence of an IMF or Russia deal, aided by the authorities' ability to issue Eurobonds and a decline in pressure on UAH/local money markets. Looking beyond a 1-2 month horizon, it remains easy to forecast an intensification of Ukraine's balance of payment problems but also relatively easy to see a solution. The absence of access to Eurobond markets or renewed increase in domestic demand for FX represent the two most likely triggers for an intensification of any market pressures. In contrast with Hungary, however, the domestic authorities are likely to react quicker in securing outside assistance.

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

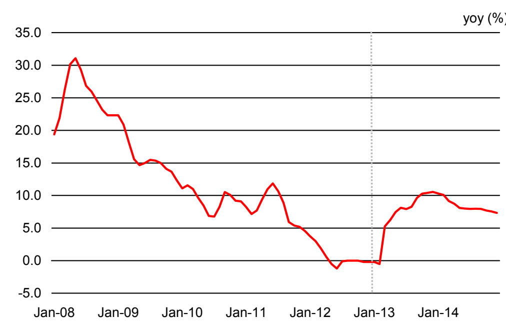
KEY DATES/EVENTS

- End-March: IMF visit
- 5-10th of each month: FX reserve data
- 15-18th of each month: Industrial production data
- May: EU deadline for progress on judicial, electoral reform

GDP GROWTH SLOWING SHARPLY



INFLATION AT RECORD LOW BUT SET TO RISE



Source: Ukraine State Committee Statistics, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2010	2011	2012E	2013F	2014F
GDP (EUR bn)	102.6	117.1	134.2	130.1	130.1
Population (mn)	45.8	45.5	45.3	45.1	44.9
GDP per capita (EUR)	2,241	2,574	2,963	2,886	2,897
Real economy yoy (%)					
GDP	4.1	5.2	0.2	0.3	2.9
Private Consumption	7.1	15.7	11.7	0.8	2.5
Fixed Investment	3.9	7.1	0.9	0.2	4.5
Public Consumption	4.0	-3.0	2.2	-0.7	0.6
Exports	3.9	4.3	-7.7	2.0	6.5
Imports	11.3	17.7	1.9	1.8	5.5
Monthly wage, nominal (EUR)	213	237	281	284	306
Unemployment rate (%)	8.4	8.2	8.0	8.3	8.3
Fiscal accounts (% of GDP)					
Budget balance	-5.7	-2.7	-5.7	-4.8	-4.2
Primary balance	-4.1	-0.8	-3.5	-2.5	-1.8
Public debt	40.1	36.5	41.6	45.4	45.3
External accounts					
Current account balance (EUR bn)	-2.3	-7.8	-11.2	-7.3	-5.7
Current account balance/GDP (%)	-2.2	-6.7	-8.3	-5.6	-4.3
Basic balance/GDP (%)	2.0	-2.1	-4.5	-1.5	-0.6
Net FDI (EUR bn)	4.3	5.4	5.1	5.3	4.9
Net FDI (% of GDP)	4.2	4.6	3.8	4.1	3.7
Gross foreign debt (EUR bn)	88.2	95.5	100.4	107.3	111.1
Gross foreign debt (% of GDP)	86.0	81.5	74.8	82.5	85.4
FX reserves (EUR bn)	25.1	23.3	17.1	16.0	17.5
Inflation/Monetary/FX					
CPI (pavg)	9.4	8.0	0.8	7.4	8.3
CPI (eop)	9.1	4.6	1.2	10.0	7.3
Central bank target	tentative target by 5% in 2014				
Central bank reference rate (eop)	7.75	7.75	7.50	7.50	7.00
USD/UAH (eop)	7.97	8.04	8.05	9.00	9.27
EUR/UAH (eop)	10.6	10.4	10.6	12.6	13.3
USD/UAH (pavg)	7.95	7.99	8.08	8.35	9.14
EUR/UAH (pavg)	10.5	11.1	10.5	11.6	12.9

Source: UniCredit Research

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

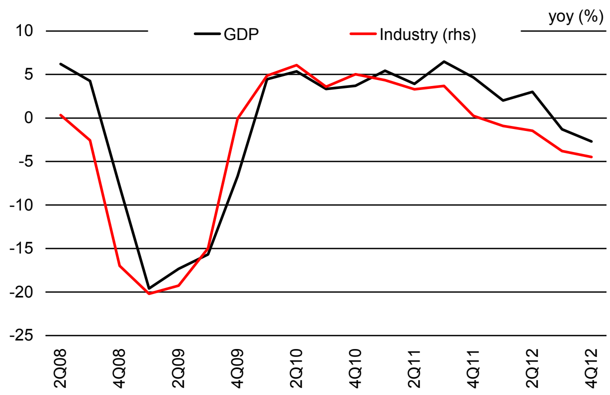
Delaying decisions

GDP in decline, C/A set to narrow but remain wide as gross external financing requirements stay challenging

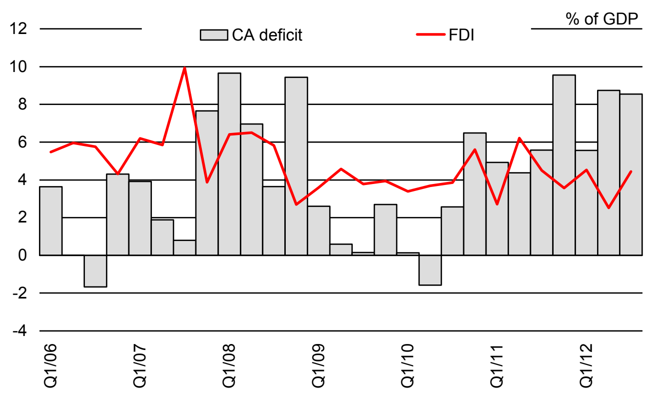
Macro performance in Ukraine remains weak on a number of fronts:

- For 2012 as a whole GDP gained only 0.2% while we do not expect this year to be meaningfully better. Last year's weak performance reflects a terms of trade shock, a poor year for agriculture, a credit crunch and tight monetary conditions. 2012 saw steel prices fall 23%, lowering metal exports while gas prices increased (though lower volumes stabilised the overall gas import bill). Meanwhile new credit extension in 2012 was less than 25% of 2011 volumes, in part because external bank rollover ratios remain low at 0.7 for 2012. Monetary conditions were tightened significantly, with 3m Kievprime trading above 20% over Jul-Dec as the authorities acted to ease currency pressure. There has been improvement since but the negative carryover from the second half of last year makes it difficult to generate any sort of respectable growth rate this year;
- Ukraine's C/A deficit widened another 2.0pp to 8.2% of GDP while, driving this, the budget deficit doubled in nominal terms. The wider budget deficit captures overly optimistic growth assumptions and populist fiscal policies in the lead up to parliamentary elections in November. Though considerably short of IMF demands, consolidation efforts should help tighten the deficit this year but Ukraine will firmly remain a twin deficits country. The government targets a budget deficit of 3.2% of GDP, assuming growth well above our forecast of 3.5%;
- FX reserves fell by over a quarter or USD7.7bn in 2012 to their lowest level since early 2007 due to a combination of IMF repayments, gas imports and currency defence. This pushes FX reserves to almost 3 months of imports and less than 70% of short term external debt. With much of the winter now behind us and FX pressures having eased, FX reserves stabilised in February at USD22.8bn but risk remaining on a downward trajectory given continued IMF repayments;
- Ukraine's gross external financing requirement remains large. Though low rollover ratios on foreign bank debt have long been the norm, non-bank financial corporate rollover ratios remain above one (1.64 last year) while Ukraine also boasts high FDI inflows (USD 6.6bn or 46% of last year's deficit). But the sovereign's external financing requirement, at EUR4bn this year, is problematic, particularly given a multi-year low cash balance. This is dominated by IMF repayments. As a financing source, central bank holdings of government debt are on the increase, rising to almost 60% of total domestic debt in February.

Economy slips back into recession



Ukraine remains reliant on debt-creating flows



Source: NBU, national statistics office, UniCredit Research

The authorities's commitment to the currency

A number of factors have helped avoid a BoP crisis to date. Firstly the authorities remain steadfast in their commitment to prevent large, sudden UAH losses, even at the expense of FX reserves and tight monetary conditions. Secondly 2012 saw Ukraine access external markets when needed, even if this was at times costly. They have repeated this once this year. Thirdly the authorities are keeping their options open and can access either a Russia or EU/IMF deal relatively rapidly. Given that Ukraine has maintained close contact with both, discussions on conditionality for both are well progressed.

We don't expect a decision in the very near term…

In the near term, our baseline view is that the authorities continue to go it alone. But the sovereign's external financing requirement is such that it needs to access foreign markets every 6-8 weeks, while inflows to EM funds have eased significantly. As a result, this is a strategy which is vulnerable to any sort of downturn in global risk appetite. Meanwhile we struggle to envisage a scenario whereby Ukraine manages to accumulate much needed FX reserves, leaving it vulnerable to any increase in either domestic or external demand for FX even if the authorities manage to engineer a gradual improvement in their twin deficits this year. At some stage Ukraine will be forced to take a decision, even if the timing is uncertain.

…but Ukraine has choices

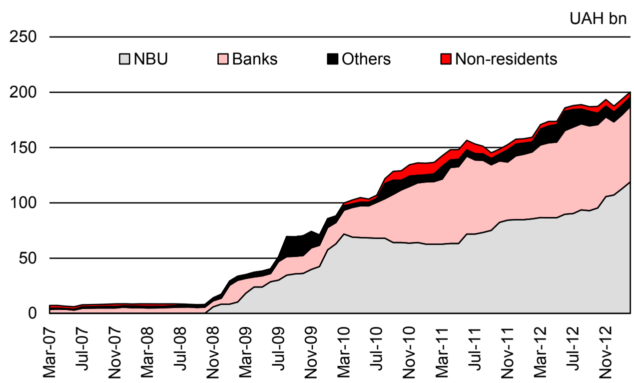
In Ukraine's favour is that both East and West have an interest in ensuring that Ukraine opts for their solution. Russia would like to expand membership of the customs union beyond Kazakhstan and Belarus to Ukraine – in return it would likely offer Ukraine lower gas prices and some hard currency, in part for its pipelines. A deal has been considered close to signing for some time. A deal with the West would entail a free trade agreement with the EU, combined with a new IMF agreement. Ukraine was given until May by the EU to make progress on reforms, mostly in terms of the judicial and electoral system. The EU suggested that an agreement could be signed by November this year.

In the near term an EU/IMF deal will be more difficult than a deal with Russia

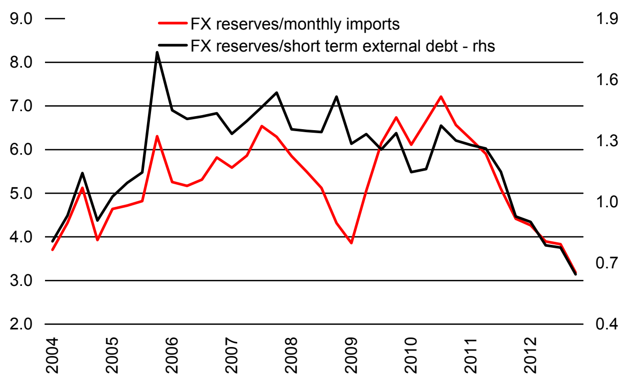
A deal with the EU represents near term pain but long term gain. It would have to be accompanied by a new IMF programme, within which two conditions will be non-negotiable, namely a hike in gas prices and more currency flexibility. In Ukraine's favour is that any gas price hikes will be presented within a framework of overall improved energy efficiency, including investment spending aimed at this as well as measures to alleviate the impact of gas price hikes on those most impacted. More importantly, given that locals are not demanding FX in large size, as was the case in 2008, Ukraine still has the potential to engineer the gradual introduction of currency flexibility rather than being forced towards a sharp adjustment. We see this as most likely to materialise in the form of a currency basket surrounded by a band which over time is widened. A deal with Russia would likely provide more hard currency funding upfront, allowing the authorities to boost FX reserves and maintain UAH stable. Over the longer term, it has much less potential to generate FDI and an increase in trade.

UNCOMFORTABLY LOW FINANCING CUSHIONS

Central bank helps finance government



FX reserves at a record low



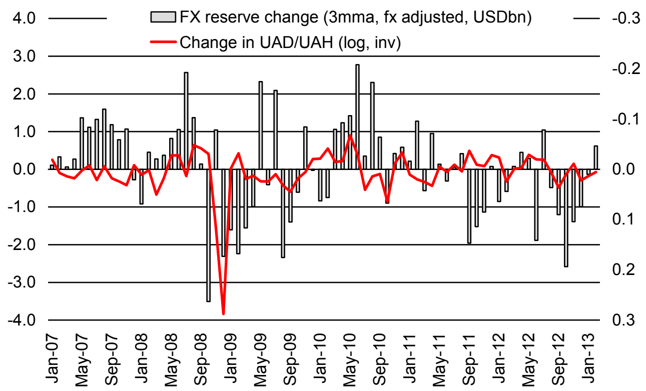
Source: MinFin, NBU, State Treasury, UniCredit Research

Strategy: Forced to choose?

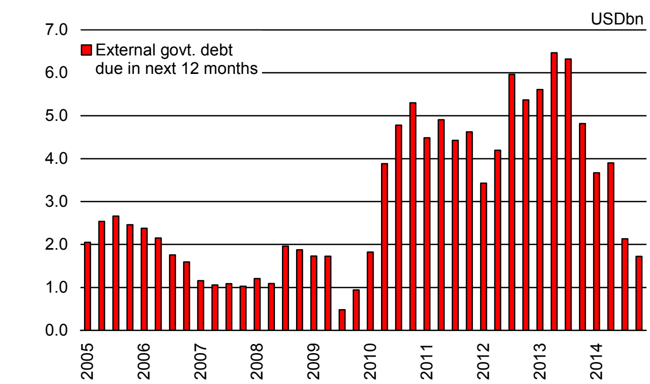
Concentrate any outright longs at the short end of the curve

A deal with either the EU/IMF or Russia is positive for the shorter end of the curve, once taken, but longer dated bonds will benefit more from an IMF/EU deal given that it will contain currency adjustment and improved growth prospects via a trade agreement. In the interim, there is a risk that Ukraine continues to attempt to access external markets to cover financing needs while further delaying a decision. Moreover, lower inflows to emerging markets combined with a historically low cash balance increases the risks of a sell-off in bonds. With all this in mind, we prefer to position ourselves at the shorter end of the curve.

Currency pressure was significant but has eased



While Ukraine remains a high yielder, bonds have already at least partially priced an announcement on a deal



Source: Bloomberg, NBU, UniCredit Research

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2012E	2013F	2014F
Gross financing requirement	**16.1**	**20.5**	**20.3**
Budget deficit (excl Nafto)	5.0	3.6	2.9
Amortisation of public debt	11.1	16.8	17.5
Domestic	6.7	11.9	13.1
Short term	0.9	5.0	5.5
Medium to long term	5.8	6.9	7.6
External	4.4	4.9	4.4
of which IMF	2.5	4.1	2.7
Financing	**16.1**	**20.5**	**20.3**
Domestic borrowing	11.5	13.8	15.1
of which NBU	2.5	1.0	0
Short term	5.0	5.5	6
Medium to long term	6.5	8.3	9.1
External borrowing	3.8	5.5	5.0
Bonds	3.8	3.0	5
IMF	0	2.5	0
Other	0.8	1.2	0.2

Source: MinFin, NBU, UniCredit Research

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2012E	2013F	2014F
Gross financing requirement	**61.6**	**55.4**	**52.3**
C/A deficit	11.2	7.3	5.7
Medium to long term amortisation	17.6	18.3	16.9
Banks	5.5	4.4	3.5
Corporates	7.7	9.0	9.0
Government/central bank	4.4	4.9	4.4
Short term debt amortisation	25.4	24.8	24.8
Banks	4.5	4.2	4.2
Corporates	19.4	19.0	19.0
Government/central bank	1.6	1.6	1.6
Other (incl. intercompany lending, capital flight	7.3	5.0	5.0
Financing	**60.7**	**55.7**	**53.9**
FDI	5.1	5.3	5.0
Portfolio flows	0.5	0.5	0.5
Medium to long term borrowing	21.1	22.7	22.5
Banks	3.3	2.2	2.5
Corporates	13.0	14.0	14.0
Government/central bank	4.8	6.5	6
Short term borrowing	24.8	24.8	24.8
Banks	4.2	4.2	4.2
Corporates	19.0	19.0	19.0
Government/central bank	1.6	1.6	1.6
Other	2.2	0.4	1.2
Change in reserves	7.0	2.0	0

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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

l) ATF Bank, 100 Furmanov Str., KZ-050000 Almaty, Kazakhstan
Agency of the Republic of Kazakhstan on the state regulation and supervision of financial market and financial organisations, 050000, Almaty, 67 Aiteke Bi str., Kazakhstan

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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
Fax +994 12 497 0276
E-mail: info@yapikredi.com.az

The Baltics

UniCredit Bank Estonia Branch
Liivalaia Street 13
EST-10118 Tallinn
Phone: +372 66 88 300
www.unicreditbank.ee

UniCredit Bank Lithuania Branch
Lvovo str. 25
LT-09320 Vilnius
Phone: +370 5 2745 300
www.unicreditbank.lt

UniCredit Bank (Latvia)
Elizabetes Iela 63
LV-1050 Riga
Phone: +371 708 5500
www.unicreditbank.lv

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 51 243 200
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
Trg bana Jelačića 10
HR-10000 Zagreb
Phone: +385 1 6104 169
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

Kazakhstan

ATF Bank
100, Furmanov Str.
KZ-050000 Almaty
Phone: +7 (727) 2 583 000
E-mail: info@atfbank.kz
www.atfbank.kz

Kyrgyzstan

JSC "UniCredit Bank"
493, Jibek Jolu. Ave.
720070 Bishkek, Kyrgyzstan
Phone: + 996 312 37 670047
E-mail: bank@unicreditbank.kg
http://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 42
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
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.ua
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@unicreditgroup.de
(Czech Republic, Slovakia, Slovenia, Turkey)

Monika Jurowicz-König
Phone: +49 89 378 25647
E-mail: monika.jurowiczkoenig@unicreditgroup.de
(Austria, Poland)

Sebastian Modlmayr
Phone: +49 89 378 28546
E-mail: sebastian.modlmayr@unicreditgroup.de
(Estonia, Kazakhstan, Latvia, Lithuania, Russian Federation, Ukraine, Hungary)

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

Peter Ulbrich
Phone: +49 89 378 25282
E-mail: peter.ulbrich@unicreditgroup.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 7767 3383
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
Ilvana LOKVANČIĆ
Phone: +387 33 49 16 56
E-mail: ilvana.lokvancic@unicreditgroup.ba

UniCredit Bank Banja Luka
Milijana Majic
Phone: +387 51 243 405;
E-mail: milijana.majic@unicreditgroup.ba

Bulgaria

Vanya Buchova
Phone: +359 2 923 2933
E-mail: vanya.buchova@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

Estonia

Diana Pill
Phone: +372 66 88 355
E-mail: diana.pill@unicreditgroup.ee

Hungary

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

Kazakhstan

Indira Askarova
Phone: +7 727 258 3000 (ext. 0650)
E-mail: indira.askarova@atfbank.kz

Latvia

Alessandro Natili
Phone: +371 67085 545
E-mail: alessandro.natili@unicreditgroup.lv

Lithuania

Martyna Trimonis
Phone: +370 5 2745 349
E-mail: martynas.trimonis@unicreditgroup.lt

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@unicreditgroup.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 89 378-12576
andreas.rees@unicreditgroup.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

Mauro Giorgio Marrano, Economist
+39 02 8862-8222
mauro.giorgiomarrano@unicredit.eu

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

Commodity Research

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

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

Hans Holzhacker, Chief Economist, Kazakhstan
+7 727 244-1463
h.holzhacker@atfbank.kz

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
+44 207 826-12288
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

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@unicreditgroup.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@unicreditgroup.de

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

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Internet
www.research.unicreditgroup.eu

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