CEE

Quarterly

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

2Q 2014

"Your Leading Banking Partner in Central and Eastern Europe"

Bank Austria Member of UniCredit

HypoVereinsbank Member of UniCredit

UniCredit Bank

UniCredit Bank Banja Luka

UniCredit Bulbank

UniCredit Ţiriac Bank

Zagrebačka banka UniCredit Group

Bank Pekao Member of UniCredit

YapıKredi

Contents

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

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

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

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

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

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

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

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

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

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

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

Published on 18 March 2014

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: A time of change

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

- The risks to the macro environment within CEE are evolving rapidly. Since our last CEE quarterly, the primary positive has been the continued recovery in EMU, supporting industry and exports in Central Europe and facilitating an improvement in domestic demand. But geopolitical developments introduce a host of negative risks to the outlook for the region. Developments between Russia and Ukraine not only threaten economic activity and financial stability in those two countries but also put growth and financial stability elsewhere in the region at risk, should tensions escalate further. This materialises as a number of countries, both in CEE and emerging markets more broadly, face elections while being forced to adjust from a period of excessive domestic demand growth.

- Assuming no imposition of significant trade and financial sanctions, we have marked down our GDP forecast for Russia this year to close to zero, followed by a muted recovery in 2015. The CBR's rate hike, for the most part, is set to prove permanent while the domestic authorities will struggle to reverse persistent RUB depreciation amidst lower rollover ratios on foreign borrowing and the risk of a further increase in domestic demand for FX. We expect Ukraine to show a sharp contraction in GDP this year while international lenders will struggle to cover the country's financing gap in full given large twin deficits, a low level of FX reserves and a weak banking sector.

- Though much less immediate, politics also adds risks to macro stability in Turkey. The economy is undergoing a much-needed adjustment, generated by insufficient foreign financing and a related tightening of monetary conditions, which should see the C/A narrow significantly this year. An improving EMU is helping to cushion the downturn but since our last quarterly we have still reduced our forecast for growth this year by 2pp to zero. Local elections at the end of this month will provide an accurate assessment of the extent to which AKP has been able to weather persistent negative political news as it moves to presidential elections in August and general elections next year. We monitor the risks that weak growth and declining government popularity pose to fiscal performance.

- Central Europe remains the diamond in the rough. Recent months has been characterised by further improvement in external demand. This, combined with past consolidation efforts, is feeding through to better domestic demand. An extended period of below trend growth and low inflation means that central banks are not yet under pressure to tighten monetary policy. As many of the newer EU states prepare to celebrate ten years within the union, policy makers will welcome this return to a more convincing convergence path. Hungary is an example of a country where real convergence has stalled but the upcoming general election offers the domestic authorities a unique opportunity to formulate a series of policies to support potential growth and bolster catch-up.

- In contrast with Central Europe, the Balkans lag. With the exception of Bulgaria and Romania, the need for fiscal consolidation is a common theme. In Serbia the outcome of the general election and the government's dialogue with the IMF is welcome from this perspective. Croatia's entry into the excessive deficit procedure should also help introduce more discipline. Slovenia has made important progress but more remains to be done. That said, the region's growth challenge extends beyond the numerator and to the denominator. An increase in labour force participation is the most obvious source of improvement to potential growth.

- And if tensions between Russia and the West escalate further? Russia will quickly tip itself into recession but such an escalation would also generate negative spillovers to the rest of the region. We identify three channels, namely trade, financial integration and portfolio flows to EM as a whole. In a scenario where all three channels take their toll, our forecast of continued recovery in Central Europe would require revision, at least for one to two quarters. The more muted recovery in the Balkans would also come into question while our baseline for Turkey would shift to outright contraction for this year.

Key drivers: (Geo)politics, global recovery, capital flows

Divergence within CEE continues to increase

Differentiation within CEE continues to grow. As many of the newer EU states celebrate their first decade in the union, a multi-faceted recovery in economic activity is taking shape. In contrast, Russia and Turkey have exhausted all easily accessible sources of growth and are undergoing a sharp slowdown in economic activity. At least in the former, this is likely to prove more structural than cyclical in nature. Serbia needs to do much more to correct its budget deficit, while the adjustment process is only just beginning in Ukraine.

Over the coming quarters geopolitics represents the dominant risk but we also highlight three other themes:
1. Domestic politics
2. The pace of global recovery
3. Foreign & domestic capital flows

Looking ahead to the coming quarter, geopolitics represents the most prominent risk to the region. All the forecasts presented in our quarterly assume no imposition of significant sanctions on Russia from the West but if we reach a stage where meaningful trade and financial sanctions are imposed, it will have a negative impact on economic activity. We also highlight three other themes which we expect to play a role, both in our baseline scenario and in a scenario whereby tensions with Russia and the West deteriorate:

- **Domestic elections**: Amidst a busy election calendar across emerging markets, in Turkey AKP has shifted from representing a pillar of political stability to one of increased uncertainty, with implications for overall economic performance. Local elections at the end of March, followed by Turkey's first Presidential election in August, will act as a key test of public support for PM Erdogan to extend his 12 year period in power. Serbia's new government faces immediate challenges, not only in terms of narrowing its budget deficit but re-assessing the role of the public sector in its economy. Hungary's government, for the first time in the history of the Republic, will emerge from a general election in April without facing the risk of an immediate fiscal crisis. Uncertainty is likely to remain in Ukraine at least until the second round of the presidential election in mid-June. Meanwhile the newer EU states celebrate 10 years of enlargement in May as we enter European parliamentary elections across the EU28.

EMERGING MARKETS ELECTION SCHEDULE: A BUSY 2014

Turkey, Hungary and Ukraine to dominate

		Country	Election type
March	15th	**Slovakia**	**President (1st round)**
	29th	**Slovakia**	**President (2nd round)**
	30th	**Turkey**	**Local**
April	6th	**Hungary**	**Parliament**
	7th	India	Parliament
	9th	Indonesia	
	9th	Indonesia	
May	7th	South Africa	Parliament
	11th	**Lithuania**	**President (1st round)**
	23-25	**EU**	**European parliament**
	25th	**Ukraine**	**President (1st round)**
	25th	**Lithuania**	**President (2nd round)**
June	15th	**Ukraine**	**President (2nd round)**
August	10th	**Turkey**	**President (1st round)**
	24th		**President (2nd round)**
September	9th	Indonesia	President
October	5th	Brazil	President
		Brazil	Federal senate
		B&H	**President**
		B&H	**Parliament**
	10th	**Latvia**	**Parliament**
November	2nd	**Romania**	**President (1st round)**
	16th	**Romania**	**President (2nd round)**

Source: UniCredit Research

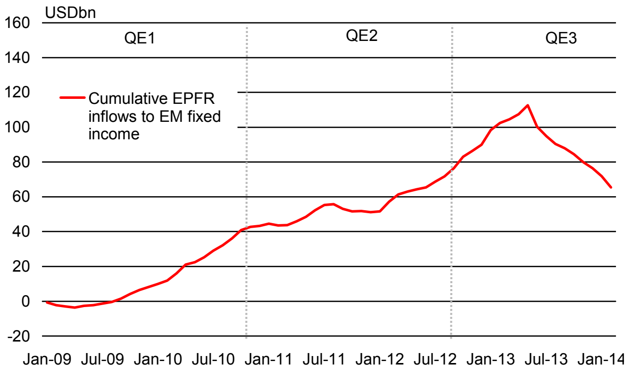
- **Global growth**: Year-to-date, the recovery in EMU has brought benefits to Central Europe and Turkey, a trend which we expect to continue over the coming quarters. But more broadly the reversal of foreign portfolio flows to EM, combined with an extended period of stable rather than rising commodity prices, has highlighted the extent to which emerging markets have exhausted many of the easy sources of growth. Russia is the most obvious example within CEE, followed by Turkey. Looking ahead, we expect the recovery in the advanced world to continue to assert itself but reform commitment will still act as a much more important differentiator of asset performance across EM countries. A more significant slowdown in China is another risk that we monitor carefully;

- **Capital flows**: A variety of consolidation efforts in many of the newer EU states in recent years means that for the most part they have been able to weather a reversal of foreign portfolio capital to EM, though Croatia, Serbia and Slovenia remain in the process of reducing their sovereign external financing requirements to more manageable levels.

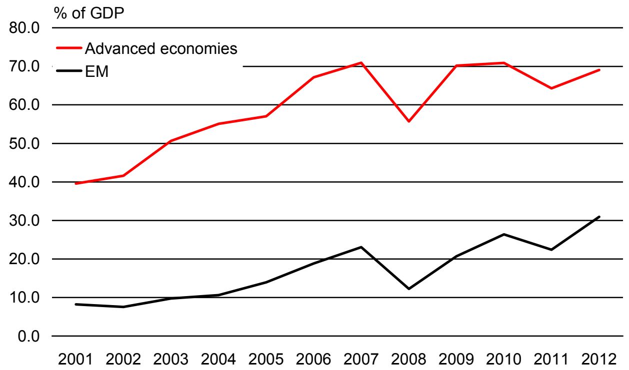
Turkey has proven much more vulnerable to shifts in foreign capital but has also been challenged by a sharp increase in domestic demand for FX. In Russia domestic capital outflows remain most problematic. The extent to which foreign portfolio capital continues to reverse over the coming quarters is a function of all of the factors above. The fact that two thirds of all QE2- and QE3-related inflows to EM, as measured by the EPFR, have already reversed is encouraging, as is the fact that the stock of portfolio capital within EM is less than half of that in the developed world. Nonetheless the risks remain significant. Domestic politics and reform efforts will be central to determining domestic capital flows, in particular in Turkey, Russia and Ukraine.

PORTFOLIO FLOWS TO EM: THE SPEED OF INFLOWS RATHER THAN AN INFLATED STOCK PROMPTS CORRECTION

A cyclical correction in portfolio flows to EM…



….amidst what is likely to prove a structural increase in the long term (stock of portfolio liabilities/GDP)



Source: EPFR, IMF, UniCredit Research

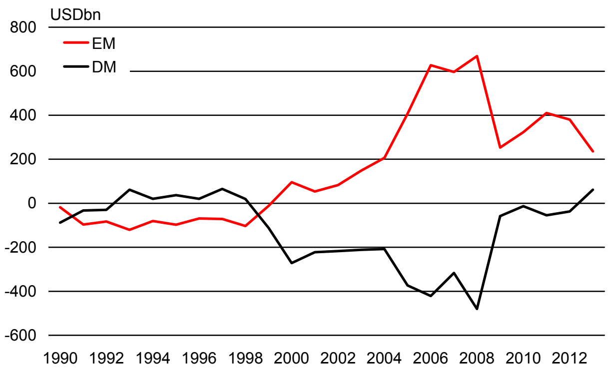
Russia and Turkey: Cyclical vs. structural adjustment

Larger EMs have exhausted their ability to rely on domestic demand to compensate for weaker growth in advanced economies

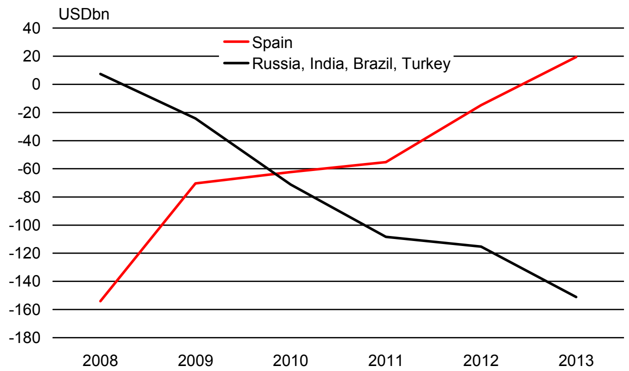
Russia and Turkey are amongst a large group of emerging market economies globally that is being forced towards a new growth model. Over recent years in Central Europe domestic demand weakened in line with the developed world but in most large emerging markets the combination of strong balance sheets post-2008 and readily accessible foreign capital facilitated a shift towards a more domestic demand-led growth model to offset trends in the developed world. Capturing this trend, C/A balance deterioration across Brazil, India, Russia and Turkey since 2008 was sufficient to compensate only for Spain's shift to a C/A surplus. But this growth model within EM has to a large extent been exhausted at this stage. Correspondingly, we expect Turkish GDP growth to remain unchanged this year while in Russia GDP growth is also set to ease to close to zero.

EM COMPENSATES FOR DECLINING DM DEMAND

EM has eroded its C/A surplus to compensate for consolidation in DM



Spanish improvement = disimprovement in Russia, India, Brazil, Turkey



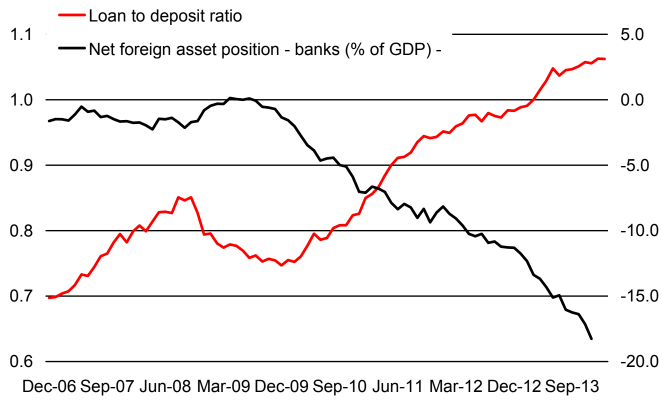
Source: IMF, UniCredit Research

In Turkey the absence of foreign financing prompts an adjustment in domestic demand

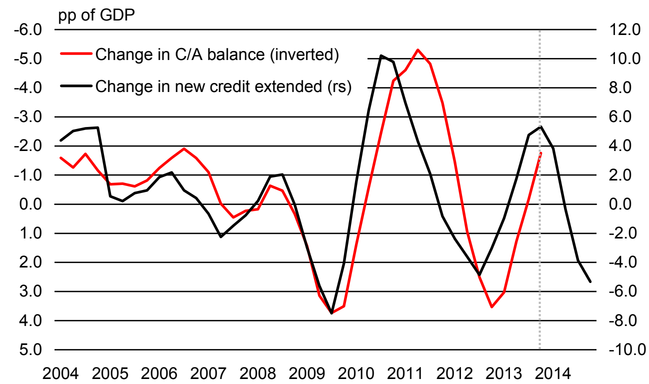
Turkey's primary constraint is an absence of C/A deficit financing, generated by a halt in foreign portfolio capital to emerging markets. Turkey is particularly vulnerable on this front given the size of its C/A deficit. By April of last year, the C/A deficit was covered in full by foreign portfolio flows. This slowdown in foreign financing has already translated into a sharp slowdown in credit growth, with our credit impulse indicator signaling a contraction in domestic demand this year even assuming credit growth does not undershoot the CBRT's reference rate of 15%. This will be accompanied by a narrowing of the C/A deficit. To the extent that the loan to deposit ratio now exceeds one while the banking sector has significantly increased its borrowing offshore, the recovery in credit and GDP more broadly over the second half of 2014 and into 2015 will be more gradual and modest than in the past.

TURKEY: CREDIT CANNOT SUPPORT ACTIVITY IN 2014

Loan to deposit ratio – and external borrowing



C/A balance v credit impulse



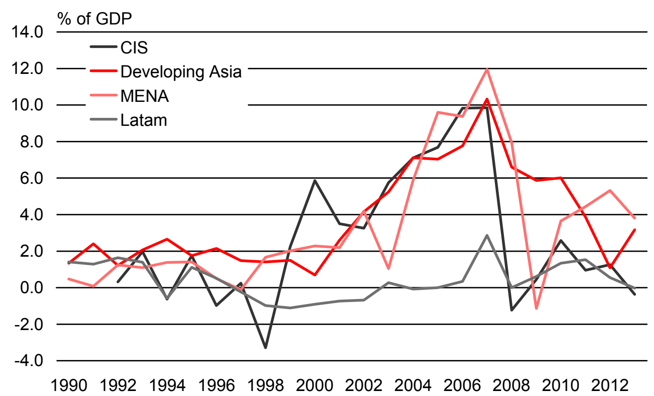
Source: CBRT, IMF, UniCredit Research

Russia's ability to generate domestic demand growth is also running out of steam

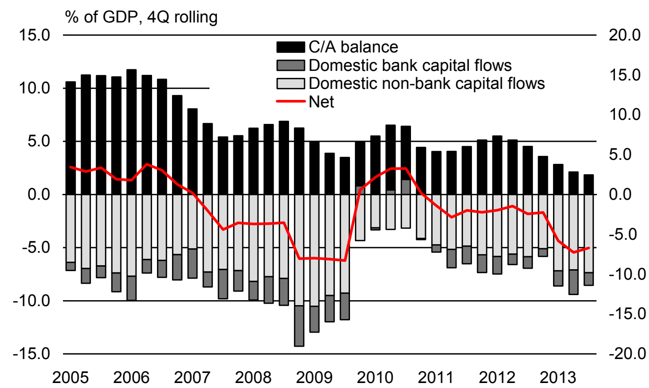
Russia continues to struggle to generate growth in an environment of stable rather than improving terms of trade. Much-needed banking sector reform, aimed in part at slowing excessive retail credit growth, adds to the downward pressure on activity. As a result the domestic demand-led growth model is rapidly running out of steam. Russia's C/A surplus is at its narrowest since 1998 while FX reserve accumulation is reversing. More so than any other EM region, the shift in reserve accumulation since 2008 is largest.

RUSSIA: A RELIANCE ON DOMESTIC DEMAND GROWTH COMES WITH COSTS

FX reserve accumulation: CIS has seen a larger shift than elsewhere



Russia: A declining C/A surplus & rising capital outflows



Source: IMF, CBR, UniCredit Research

…as political change heightens uncertainty

Political uncertainty puts domestic capital flows at risk

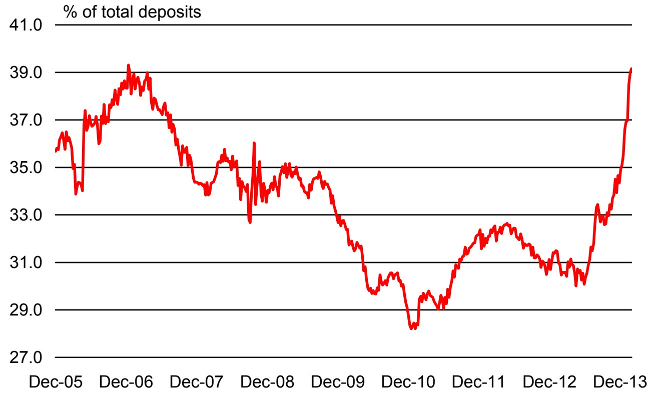
The above macro dynamics mean the timing of increased political uncertainty in both countries is particularly unfortunate, though events in Russia risk generating more immediate and sizeable implications for economic activity there and in CEE more broadly than is the case in Turkey. In both countries, both foreign and domestic capital flows are at risk.

Russia faces risks from both foreign and domestic capital…

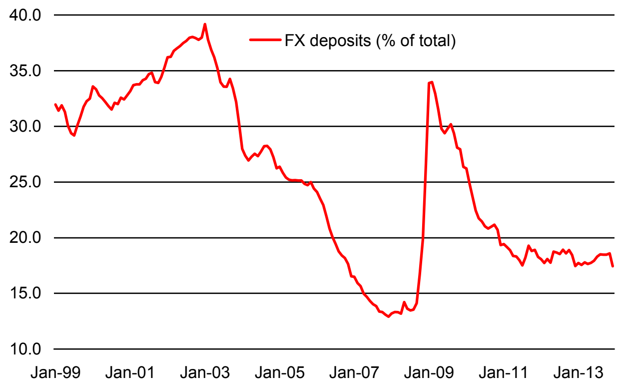
In Russia, even prior to events in Ukraine, domestic capital outflows had increased well beyond a natural recycling of oil revenues, though there was limited evidence of household demand for FX. This significant increase in geopolitical noise increases the risk of further domestic capital outflow while households have a track record of demanding FX at times of stress. This last materialized in 2008 when FX deposits of households rose from less than 14% to more than 34% of total deposits. Meanwhile reliance on foreign capital is larger than Russia's C/A surplus suggests, with the economy as a whole facing USD 83bn and USD 166bn (cumulative) of external debt coming due in the next 12 and 24 months. This is equivalent to 17% and 34% of FX reserves respectively.

POLITICS RISKS CONTRIBUTE TO DOMESTIC DEMAND FOR FX

Turkey: A rapid rise in domestic demand for FX



Russia: Households have demanded FX at times of stress



Source: CBRT, CBR, UniCredit Research

…as does Turkey

As Turkey heads towards local elections at the end of this month, followed by Presidential elections in August and general elections next year, local deposits in FX have reversed over seven years of de-dollarisation within less than one year. There is evidence that the CBRT's rate hike has slowed demand for FX but risks remain while a variety of government efforts to quell the opposition risk permanently slowing foreign capital flows to the economy.

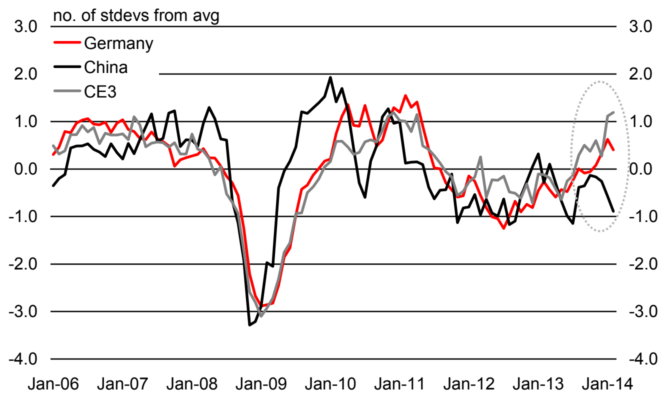
Central Europe: Recovery underway…

Central Europe differentiates itself due to consolidation efforts and a stronger EMU

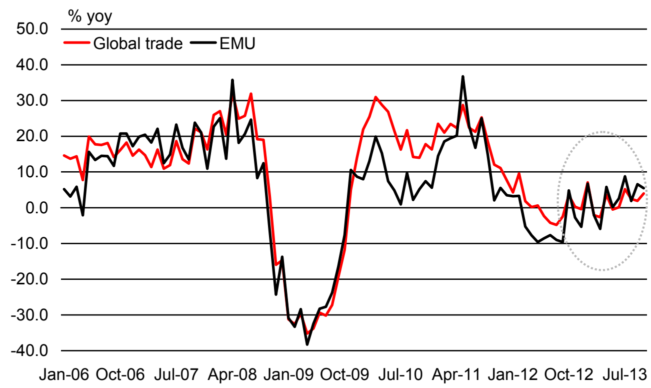
Central Europe continues to differentiate itself from emerging markets as recovery takes hold, facilitated by consolidation efforts within a number of areas of these economies (fiscal, credit, construction) and an improving EMU. Industry and external demand remain central to the improvement in economic activity, with momentum captured in manufacturing PMIs (in contrast with other EM regions), IFO export expectations and the European Commission's survey showing export orders' volumes. The gradual recovery in global trade is of some concern but at least momentum is improving while evidence that global manufacturers view the newer EU states as a competitive production base continues to emerge. As Czech Republic benefits from Skoda's introduction of re-modelled production lines, Ford and Mercedes are building capacity in Romania. This also extends to Serbia where Mercedes plans expansion by year-end. We have not made any significant changes to our GDP forecasts for Czech, Poland, Hungary or Slovakia since the last quarterly, forecasting all to generate 2.5% growth or more this year.

INDUSTRY IS SUPPORTING A RECOVERY IN ACTIVITY

Manufacturing PMIs: CE3 moves in line with Germany



Global trade: Recovering to a lower equilibrium growth rate



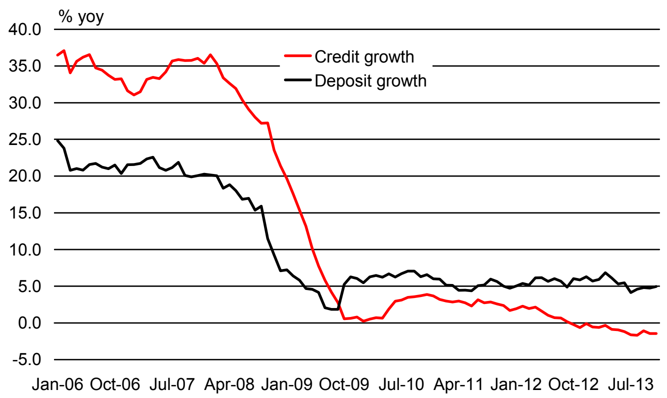
Source: Markit, IMF, UniCredit Research

The consumer is following, though investment lags

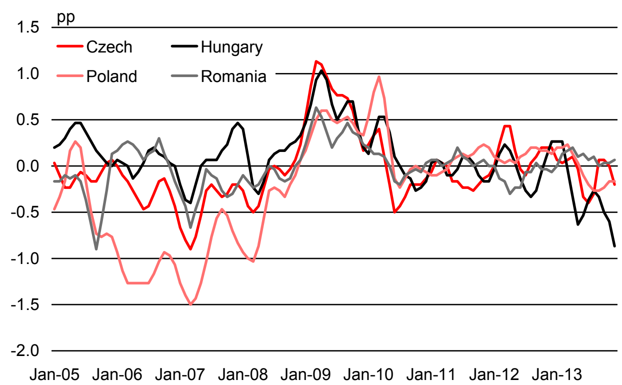
This recovery is visibly spilling over into domestic demand and should continue to do so. The drag from a multi-year period of fiscal consolidation is easing and in some countries the fiscal impulse has turned positive, e.g. Hungary. A bounce in government revenue in countries such as Poland is also indicative of improving domestic demand growth. Below target inflation in many countries helps to boost consumer purchasing power while keeping central bank policy rates at record lows. Credit growth is considerably below deposit growth, creating some scope for improvement, while our credit impulse indicator has turned positive in Czech, Hungary, and some Baltic states. Unemployment has stabilised and in some countries is ticking downwards. All of the above should support a recovery in consumption following a multi-year period of stagnation in some countries. Investment remains the missing piece to the puzzle, though there are some modest signs of recovery in Hungary and Czech Republic. Poland and Romania lag.

DOMESTIC DEMAND HAS BEEN WEAK FOR SOME TIME BUT IS GRADUALLY SHOWING RECOVERY

Credit growth has scope to recover



Labour markets are stable to slightly stronger (change in unemployment, 3m avg)



Source: Eurostat, national central banks, UniCredit Research

…as the region celebrates 10 years in the EU

While much more volatile than expected…

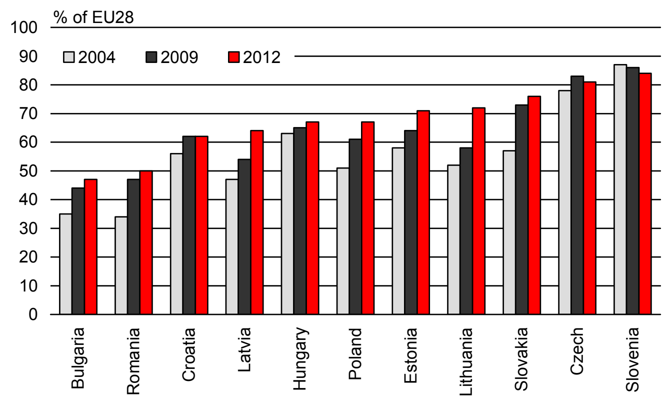
This recovery in economic activity will be welcomed as governments of the newer EU states prepare to celebrate 10 years of EU membership[1]. There is little doubt but that economic performance over the past 10 years has been more volatile than most expected. A boom in economic activity between 2004 and 2008 proved unbalanced, with an excessive reliance on growth in the non-tradables sectors. Many countries have spent recent years working through these excesses, a process that was complicated by the EMU crisis.

…convergence has materialised in most cases

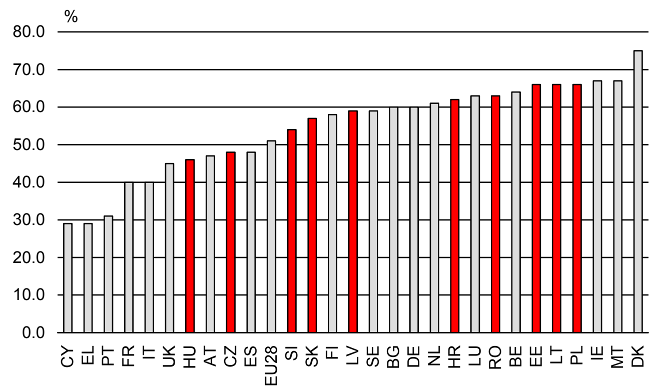
But this does not distract from the fact that GDP per capita (PPP) has converged towards the EMU average over the past decade in all countries with the exception of Slovenia (which benefited from the most favourable starting position). There is of course differentiation across countries – the Baltics, Slovakia and Poland have performed well while Hungary has shown much less catch-up. In terms of domestic public opinion of the EU, Eurobarometer surveys also suggest that new member states see the EU as a source of optimism regarding the future. With the exception of Malta, all EU countries are less optimistic about the future of the EU compared with the peak in the economic cycle in 2007 but in the newer EU states, Czech and Hungary are the only countries where the general public is less optimistic about the future of the EU than the EU average. While EMU membership has been delayed significantly for a number of countries, banking union has the potential to generate renewed integration momentum over the coming quarters.

(VOLATILE) PROGRESS OVER THE FIRST DECADE OF ENLARGEMENT

GDP per capita (ppp): An upward trajectory for most



Eurobarometer: "Are you optimistic about the future of the EU?"



Source: Markit, UniCredit Research

EU parliamentary elections may not offer much insight on EU membership – general elections in Hungary offer a unique opportunity to build buffers

Against this backdrop, upcoming elections across the region will act as an opportunity for policy makers to push ahead with reform efforts to ensure continued catch-up. The newer EU states will hold EU parliamentary elections over 22-25 May but these are much more likely to act as a litmus test of government popularity than support for the EU. In many countries voter turnout is also low. For the first time since the fall of communism, Hungary is set to emerge from a general election on 6th April without finding itself forced towards a series of emergency fiscal consolidation measures[2]. This offers the authorities a unique opportunity to address a number of structural fiscal shortfalls to help boost a sub-standard rate of potential growth. Amongst the EU member states under our coverage, Slovakia's presidential election at the end of March acts as an important measure of reform enthusiasm. Latvia, EMU's latest entrant, is scheduled to hold parliamentary elections in October.

[1] In May 2007, 10 countries joined the EU, namely Cyprus, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia and Slovenia. In January 2007 Bulgaria and Romania followed while in January 2014 Croatia joined

[2] For further discussion, please refer to our CEE Navigator of 21 February, *"Hungary: An opportunity for change"*

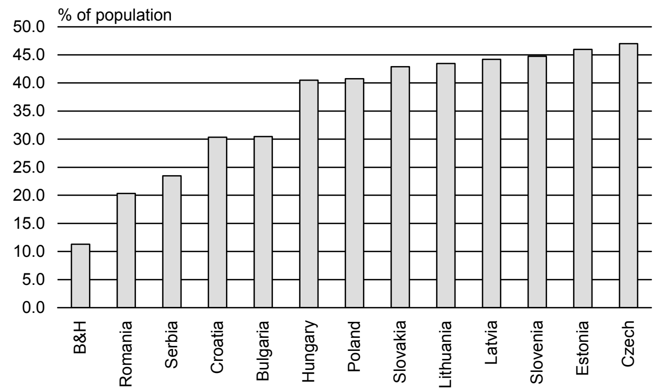
The Balkans: More work to be done

The recovery is both more muted and more diverse across the Balkans

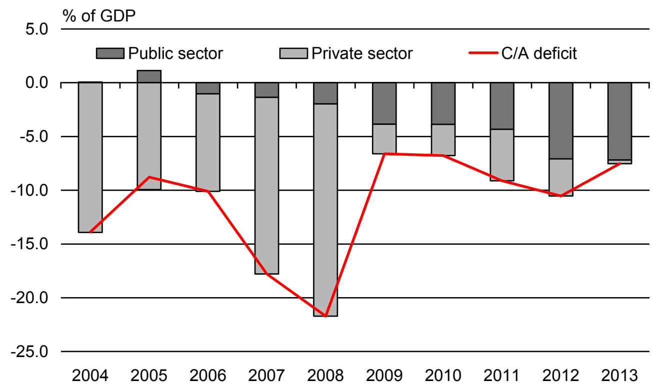
Many economies within the Balkans lag Central Europe. For example, while we see all countries in Central Europe growing by 2.5% or more this year, 2014 is likely to represent the 6th consecutive year when Croatia fails to show GDP gains. Slovenia faces its third year of recession, though there are some signs of recovery. In Bulgaria momentum is improving but growth will remain below 2% this year. Serbia and B&H will also see growth capped below 2% this year.

THE BALKANS: CALLING FOR A COMBINATION OF FISCAL CONSOLIDATION AND STRUCTURAL REFORM

The labour market: An obvious source of much needed structural growth



Serbia: Public sector crowds out private sector



Source: IMF, National statistics offices, UniCredit Research

Fiscal consolidation is increasingly unavoidable…

With the exception of Bulgaria, a need for fiscal consolidation remains a dominant theme. This is most evident in Serbia as public debt to GDP has more than doubled since 2008 while this year's budget deficit is set to remain at 7% of GDP without further efforts, significantly crowding out the private sector. From this perspective, the new government's willingess to engage in a new IMF programme is crucial to public debt sustainability. Croatia has entered the excessive deficit procedure, forcing the authorities to pass some fiscal consolidation but these measures were largely revenue-based. In B&H the authorities have adhered to IMF conditionality but in the face of protests from the general public and ahead of upcoming general elections.

…but structural reform must also follow

The region's growth challenge extends beyond the numerator (the deficit) and to the denominator (GDP). But this in itself is not sufficient and reform efforts require a re-think of the extensive role of the public sector in many of these economies. For example despite GDP per capita being amongst the lowest in the region in Serbia, public expenditure stands in excess of 47% of GDP. Meanwhile one of the most striking features of the region is the low level of employment. At its worst it stands at just over 10% of the total population in B&H but reaches just 30% in Croatia and Bulgaria. In various forms the EU acts an anchor for the region, in the form of monetary union for Slovenia, the EU for Bulgaria and Romania and in the form of the prospect of EU accession for Serbia. Bulgaria's and Romania’s increased use of EU funds of late is a positive. But more needs to be done to improve potential growth.

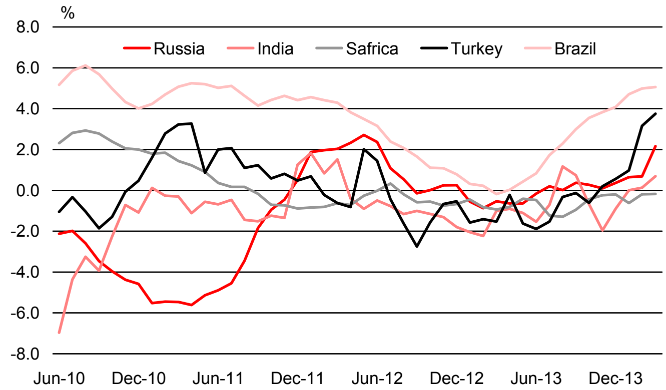
Various approaches to tightening monetary policy

Inflation and financing constraints have pushed Turkey towards a positive real interest rate…

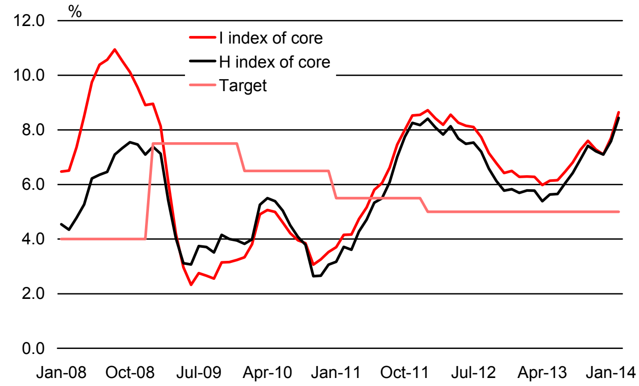
Differentiation in inflation performance and capital flow vulnerabilities is translating into very different approaches to monetary tightening across the region. Turkey has found itself once again engaging in procyclical monetary tightening as currency weakness unveils underlying inflation pressures while the need to offer both foreigners and locals a positive real interest rate to stabilise capital flows takes priority over the impact of a higher cost of credit on activity. We cannot exclude that further capital flow stress pushes the CBRT to hike once again but we view January's rate move as convincing in terms of a return to a more sustainable real interest rate. We see limited scope for the CBRT to reverse its rate hikes this year.

TURKEY AND RUSSIA FACE INFLATION CHALLENGES

Russia and Turkey are adjusting real interest rates upwards, in line with other EMs (money market rates less headline inflation)



Turkey: Core inflation is not anchored



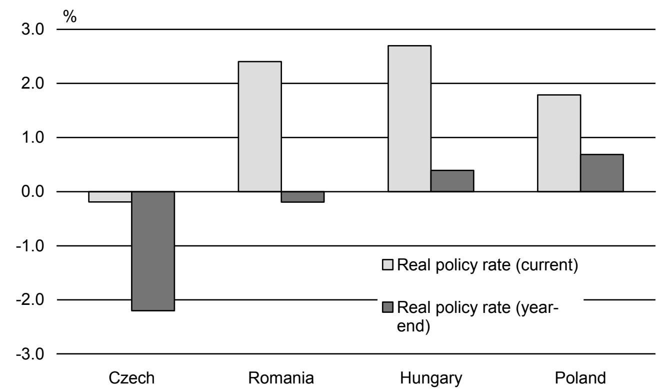
Source: National statistics offices, Bloomberg, UniCredit Research

…as well as Russia…

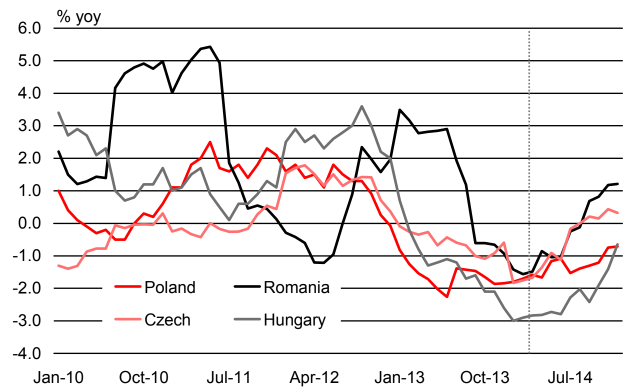
Though the CBR hiked its policy rate to 7% in response to financial stability concerns, Russia is also being forced to adjust to a positive real interest rate. The CBR initially described the move as temporary but going forward is likely to find its scope to return to a negative real interest rate as limited. Negative balance of payments dynamics, even prior to the increase in geopolitical tensions, were translating into persistent RUB depreciation, complicating the CBR's inflation targeting challenge.

CENTRAL EUROPE FACES A MORE GRADUAL NORMALISATION OF INTEREST RATES

Inflation to erode real interest rate by year-end…



…amidst an upward trend (inflation less target)



Source: National statistics offices & central banks, UniCredit Research

…but the process should be much smoother in Central Europe

Central Europe should enjoy a much more gradual normalisation of interest rates, materialising most likely from early 2015. Inflation across the region is in the process of bottoming out and the scope for further rate cuts is small, though Hungary looks set to push rate reductions further. Below target inflation across Poland, Czech, Hungary and Romania captures a genuine improvement in underlying inflation due to an extended period of weak to negative growth. But low food price inflation and reductions in regulated energy prices are also at play. As these normalise and activity continues to improve, inflation will move much closer to inflation targets by year end, though since the last quarterly we have reduced our year-end projections in all four countries. This should trigger a gradual increase in interest rates and in the case of Czech Republic a re-assessment of the CNB's currency floor[3].

[3] For further discussion, please refer to our publication of 30 January, *"Czech monetary policy: An evolving challenge"*

The risk of a more rapid increase in interest rates is limited by the gradual nature of the recovery in growth, a negative output gap and low short end interest rates across the developed world. Of all of the above countries, Hungary is most obviously at risk of a more rapid increase in interest rates, though we see some appetite for currency depreciation over rate hikes. Serbia is the outlier across CEE to the extent that we see scope for further rate cuts, should the government prove committed to fiscal consolidation.

CEE's primary risk: Ukraine, Russia and the West

Ukraine will struggle to close a large financing gap but…

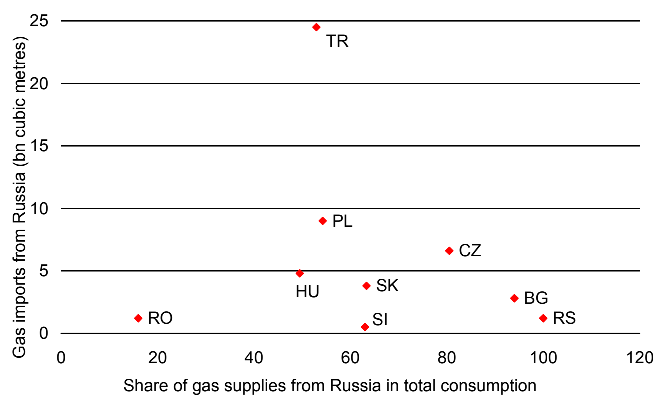
Ukraine is undergoing significant political change. In an optimistic scenario, this will generate space for much needed economic reforms and provide the economy with a new business model via agreement on a Deep and Comprehensive Free Trade Agreement with the EU. But uncertainty remains rife in many forms. It is unclear if May's presidential election can generate a president with a clear reform mandate. Russia can add to downward pressure via many channels, including trade, gas and by calling for repayment of its USD 3bn bond as public debt to GDP increases. While a variety of control measures have helped to slow currency depreciation, domestic demand for FX remains a real risk. The combination of a weakened banking system, wide twin deficits and low FX reserves means that, even if we assume a positive outcome on all of the above, any IMF package will have to be of much larger size than in the past. In the absence of significant international support to complement the programme and close the financing gap, the potential for a rescheduling of public debt will increase.

…geopolitical tensions surrounding Ukraine also represent a significant risk to the region…

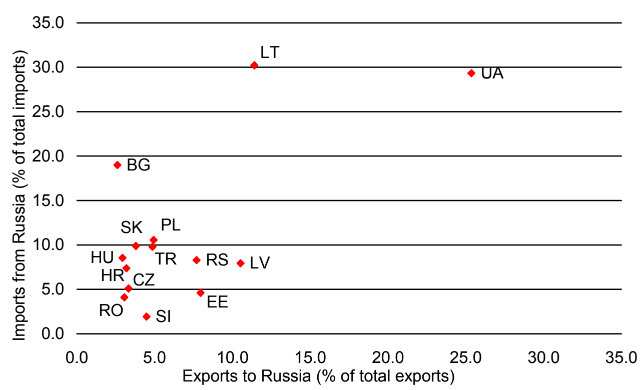
But the importance of developments in Ukraine extends much beyond Ukraine, particularly in a scenario where tensions between Russia and the West escalate further. As we have already indicated, our forecasts assume that sanctions do not increase beyond some modest restrictions on travel and selective freezing of assets. In large part, we anchor that view on the fact that a halt to gas exports by Russia benefits neither East nor West. But if this does materialize, we see negative spillovers via three channels, namely trade, financial integration and portfolio flows and would be forced to revise our forecasts for the region much more significantly.

ASSESSING CEE'S EXPOSURE TO RUSSIA

CEE: A significant reliance on Russia for energy



Diversified trade linkages with Russia



Source: IMF, UniCredit Research

…via trade, gas and financial linkages

1. **Trade:** With the exception of Romania, CEE countries import at least 50% of all gas from Russia. In most cases exports to Russia are limited at less than 10% of the total but the Baltics and Serbia are more exposed. Should we reach a stage where all exports from the rest of the region to Russia come to a halt, it would neutralize a large part of the gains in exports to EMU that we pencil in for this year, in particular for Central Europe and Turkey.

2. Financial linkages are not insignificant to the extent that Russia has increased its banking exposure to some countries in the region over recent years. The net international investment position of Russia's banking sector is favourable but masks a large increase in offshore investments financed by an increase in external borrowing, with one offsetting the other. Much of this has occurred within CIS but there is also evidence that this has materialized elsewhere in the region. Corporate Russia has also increased its investments within CEE, most visibly within energy. Plans surrounding Southstream in Serbia and the financing of a nuclear plant in Hungary are two examples.

3. In the event of an escalation in tensions between Russia and the West, risk aversion more globally is likely to come under renewed pressure, generating the potential for another significant round of portfolio outflows from EM. This is reinforced by the fact that a debt restructuring in Ukraine would also become more likely. In this scenario we highlight Turkey as particularly vulnerable but Central Europe could also find itself at risk of an increase in the pace of outflows from domestic bond markets.

Countries

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

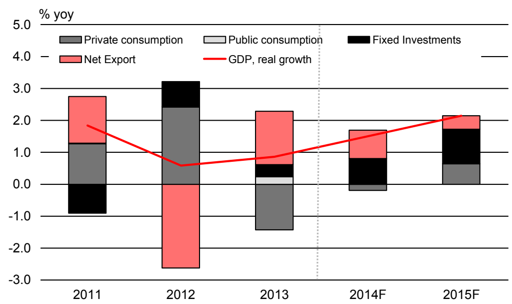
Outlook – More constructive demand conditions in Bulgaria's key export partners in the euro zone and a moderate increase in spending related to EU funds absorption will help GDP growth to gain some momentum this year. But the unemployment rate is likely to remain high, while the necessary balance sheet adjustments in the non-financial corporate sector will continue to weigh on the pace of domestic recovery. In the presence of a non-negligible number of financially stressed borrowers, the ultralow inflation expected in the months ahead will prove painful, as it increases the real value of existing debt and further undermines already weak stimulus for a reinvigoration of consumption and private sector investment.

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

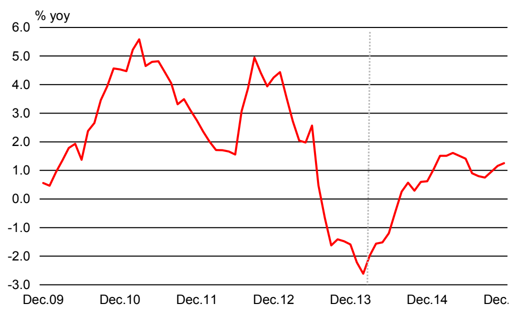
KEY DATES/EVENTS

- 14 May – Number of employees under labor contract for 1Q14
- 15 May – Flash estimates for swda real GDP for 1Q14
- 25 May – European Parliament elections

GDP GROWTH REMAINS SLOW AND UNEVEN



INFLATION BOTTOMING OUT



Source: NSI, BNB, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2011	2012	2013E	2014F	2015F
GDP (EUR bn)	38.5	39.9	39.9	40.2	41.6
Population (mn)	7.3	7.3	7.2	7.2	7.2
GDP per capita (EUR)	5,255	5,481	5,514	5,585	5,807
Real economy yoy (%)					
GDP	1.8	0.6	0.9	1.5	2.1
Private Consumption	1.7	3.2	-1.8	-0.3	0.9
Fixed Investment	-6.5	4.0	-0.3	3.0	5.0
Public Consumption	0.3	0.3	2.9	0.1	0.1
Exports	12.3	-0.4	8.9	7.2	6.3
Imports	8.8	3.3	5.7	5.5	5.3
Monthly wage, nominal (EUR)	351	374	413	420	434
Unemployment rate, avg (%)	11.3	12.3	12.9	13.1	12.8
Fiscal accounts (% of GDP)					
Budget balance	-2.1	-0.5	-1.8	-2.2	-2.2
Primary balance	-1.4	0.3	-1.0	-1.3	-1.3
Public debt	15.3	17.6	17.9	24.7	26.6
External accounts					
Current account balance (EUR bn)	0	-0.5	0.8	0.3	-0.2
Current account balance/GDP (%)	0.1	-1.3	2.1	0.8	-0.4
Basic balance/GDP (%)	3.2	1.7	4.9	3.8	3.0
Net FDI (EUR bn)	1.2	1.2	1.1	1.2	1.4
Net FDI (% of GDP)	3.1	3.0	2.8	3.0	3.4
Gross foreign debt (EUR bn)	36.2	37.6	37.1	36.7	36.3
Gross foreign debt (% of GDP)	94.1	94.2	93.0	91.2	87.2
FX reserves (EUR bn)	13.3	15.6	14.4	15.5	16.3
Inflation/Monetary/FX					
CPI (pavg)	4.2	3.0	0.9	-0.8	1.2
CPI (eop)	2.8	4.2	-1.6	0.6	1.3
Central bank reference rate (eop)	0.22	0.04	0.07	0.18	0.50
EUR/BGN (eop)	1.51	1.48	1.42	1.40	1.35
USD/BGN (pavg)	1.96	1.96	1.96	1.96	1.96
EUR/BGN (pavg)	1.41	1.52	1.47	1.43	1.39
EUR/BGN (eop)	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

Stronger exports and EU funds remain central to recovery

All high frequency indicators released in January 2014 were consistent with a slow acceleration of growth momentum, which is in line with our forecast from the last CEE Quarterly

Full year 2013 GDP growth came at a better than expected 0.9% (UniCredit: 0.6%), though 2012 was revised to 0.6% (previously 0.8%). All activity indicators have seen decent mom gains in January 2014, while survey-based confidence indicators up to February have improved further from low levels, pointing out to a continuation of the gradual real GDP recovery in early 2014.

All incoming information confirms that the slow recovery of the Bulgarian economy is proceeding more or less in line with our previous assessment. The same relates to the composition of GDP growth, which we continue to see as dominated by exports and a moderate increase in spending related to EU funds absorption. On the other hand, the disappointing pace of the household sector recovery, captured once again via downward revisions within GDP data, continues to weigh on the growth outlook. The number one factor here seems to be pronounced labor market weakness, which makes consumers reluctant to increase spending. Subdued credit growth doesn't help either, despite the fact that the slowdown of credit channeled to the real economy is more about rising real interest rates than about the capacity of the banking sector to lend more, especially after funding conditions improved markedly last year.

To a non-negligible extent, recent improvements in the participation rate reflects an accelerating contraction in the number of people aged between 15-64 years

Recent labor market data failed to impress on the positive side. Eight thousand people departed the labor force in 4Q13 vis-a-vis 4Q12, as the economy lost 30K jobs while 21K people were added to the number of unemployed. It was also disappointing to the extent that it came after a series of six consecutive quarters of positive yoy prints. In the context of a rapidly decreasing population aged 15-64 years, however, the participation rate – which measures the share of the population that is working or looking for work – has improved to 68.6% in 4Q13, from 67.9% in 4Q12 and is already above its pre-crisis 4Q08 peak.

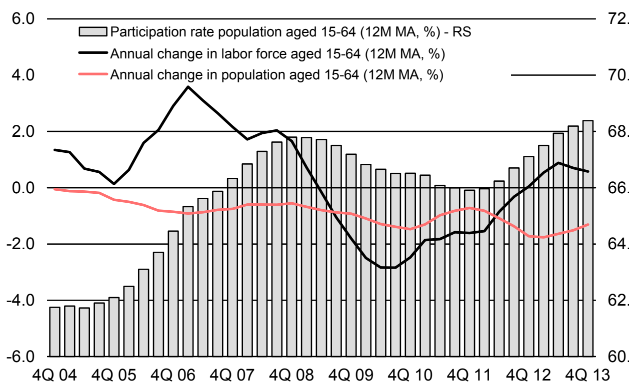
Wage gains in the last four consecutive quarters far exceeded the pace of productivity improvement, suggesting weaker wage growth ahead

At the same time, the unemployment rate (13.1% in January 2013) including youth (29% in 4Q13) and long-term unemployment (55.5% in 3Q13) remained close to its worst reading ever, but the pace of deterioration slowed down recently vis-a-vis 1H13 and particularly 2012 (see rhs chart). Employment expectations, as measured in the survey-based confidence indicators were more mixed in the last three months, however, marginally deteriorating in the household sector, while improving in industry, services, retail trade and construction. Real household disposable income posted another hard to rationalize yoy increase (7.7%) in 4Q13, underpinned by a double digit rise in wages (13%) and pensions (10.7%), which was also helped by a hefty upsurge in unemployment benefits (53.5%) and other social payments (31.7%).

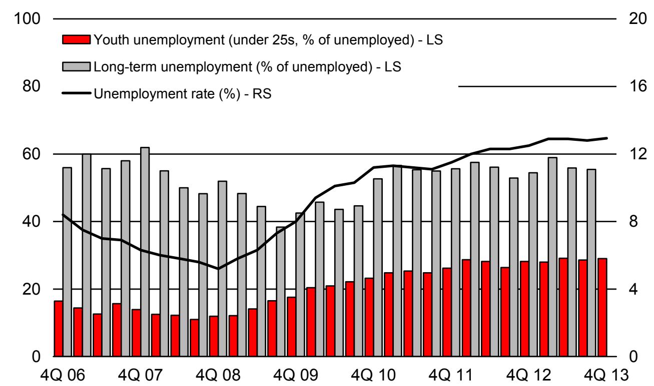
Mixed data over the last several months make it more difficult to agree on a right diagnosis of the local labor market. Nevertheless, we think, it would be fair to say that the labor market is stabilizing, after a prolonged and painful adjustment which started in 2008 when the economy was overtaken by a series of external shocks. But this is stabilization at a very low level and any meaningful improvement from here is likely to take place only very gradually.

MOST RECENT DATA RECONFIRMED THE PATCHY NATURE OF LABOR MARKET RECOVERY

The labour force is growing but…



…unemployment rate continues to break records



Source: Eurostat, NSI, UniCredit Research

Deflation remains the key downside risk for our baseline macroeconomic scenario

Both headline and core inflation continued trending downward over the last three consecutive months. CPI retreated to its lowest reading ever (-2.6% yoy in February 2014 from -1.6% in December 2013) on the back of renewed government cuts in electricity prices, lower prices of fuels and a seasonally driven drop in clothing costs. Although less pronounced when compared with the headline price dynamics, the fall in core prices continued to break records too (down to -0.7% yoy in January 2014 from -0.3% in December 2013).

We remain of the view that there is no sufficient evidence of classic deflation in Bulgaria, i.e., of widespread, self-fulfilling price declines. Among goods and services in the basket used to estimate consumer price dynamics, 45% dropped in February 2014 from a year ago. While this is a non-negligible increase when compared with December 2013 (40%) and particularly with November 2013 (35%) readings, outright price declines in the country (see lhs chart) prove less pervasive than those prevailing in Japan during the 1990s (60% on average), which are broadly seen as characterizing price declines as widespread. There are few indications that deflation is becoming self-fulfilling either, i.e. that expected inflation is dragging down current inflation. It is true that short-term inflation expectations (to the extent that survey-based confidence indicators can be used as a proxy for the lack of a well-developed interest rate swap market in Bulgaria) have been very subdued recently (see rhs chart). But they are still at levels above those experienced back in 2009, when the event passed without deflationary consequences. What is perhaps even more important is that there is no evidence of people postponing expenditure plans to take advantage of lower prices, which is something one expects to witness in a deflationary environment.

Current deflationary pressure is more of a transitory phenomenon, while ultralow inflation is something that is going to stay with us for an extended period of time

We mostly see deflation as prompted by the considerable slack in the economy, which reflects a weak recovery after a series of shocks, in combination with subdued credit dynamics. There is a significant one-off component also. Strong wheat harvest last year pushed food prices inflation into the negative territory. On top of this, a string of highly controversial cutbacks in household electricity and heating prices, implemented by the government in 2013, have also contributed to the negative price dynamics. All this seems to suggest that current deflationary pressure is more of a transitory phenomenon, as the impact of one-offs is fading away, while the gradual economic recovery, which our baseline scenario envisages, should reduce output gap thereby easing downward prices pressure. Given all of the above, we changed our avg and eop inflation forecast to -0.8% and 0.6% for this year and 1.2% and 1.3% for 2015, respectively.

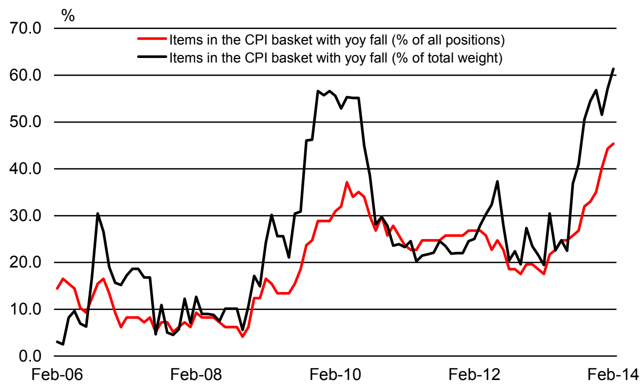
Given significant one-offs, when looking at the causes of the ongoing negative prices dynamics, we see only a small-to-moderate risk of deflation…

For us, there is only a small-to-moderate risk for a classic self-perpetuating deflationary spiral ahead. It should be pointed out however that, in the presence of a non-negligible number of financially stressed borrowers, even ultralow inflation can be problematic as it implies higher real value of debt, rising real interest rates and less relative prices adjustment which all weigh on the pace of an already slow economic recovery. What's more, given stickiness in nominal wages, persistent negative price dynamics can provoke further drops in demand which, in turn, can prompt companies to cut back even more jobs in order to remain competitive.

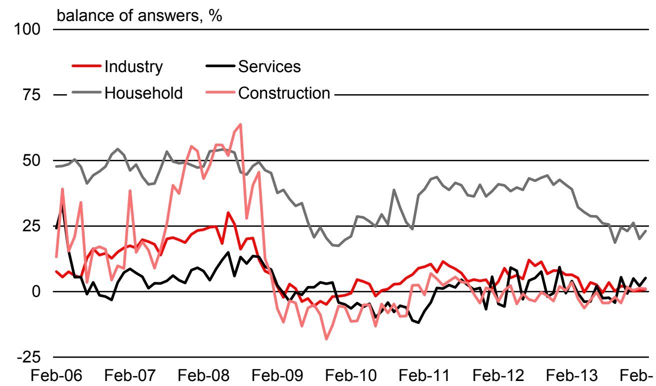
…though there is limited space to absorb another negative shock

AT THIS POINT, THERE SEEMS TO BE NO SUFFICIENT EVIDENCE OF CLASSIC DEFLATION

Share of outright price declines in the CPI basket is on a rise



Short-term inflation expectation has been very subdued recently



Source: Eurostat, NSI, UniCredit Research

Domestic frontloading done, external issuance to go

Issuing ST paper at the start of the year was under more favorable financing costs for the government in 2014 when compared to 2013

The MinFin has easily passed its first test for its 2014 debt management operations and is already preparing to make the second key step in its issuance policy for the current year. In what is likely to become the new normal for Bulgarian domestic GB issuance, the MinFin issued large amounts of ST paper in January and February to smoothen seasonality in government receipts and expenditures. The accumulated liquidity buffers had to tackle the uneven debt maturity profile for the issuer and interest payments on external liabilities as well, against the background of negative one-time factors (yearly payment of subsidies to agricultural producers). Making good use of elevated liquidity in the banking sector and stable demand for ST government debt, the MinFin was able to sell 3M, 6M and 9M bills totaling BGN 1.2bn or 1.52% of estimated 2014 GDP at a weighted average yield of 0.54% and a bid to cover ratio of 1.89x. These results compared favorably to the parameters from one year ago when 6M bills worth BGN 800mn (1.02% of 2013 GDP) were sold at 1.00% and a bid to cover ratio of 1.45x.

Accumulating FX reserves later this year is also likely to lower the financing costs of the government

During 1Q, the MinFin has also made progress on preparing for accumulating FX reserves to meet the maturity of a USD 1.086bn bond in January 2015. The issuer missed the January window when many CEE peers tapped FX markets, and latest indications put the date of the auction after the elections for the European Parliament (25 May) and the volume at EUR 1.5bn. Despite the later date, the financing cost for the government is unlikely to suffer due to a number of factors. First, demand is expected to be high, including from residents and particularly from the banking sector, as the yield of domestic debt with similar maturity is slightly less attractive. Second, recent regional market volatility has had only very limited impact on Bulgarian debt assessment by investors. The 5Y CDS in March has moved just 1% above its 2013 eop reading (to 125.5bp), while the long-term harmonized interest rate for convergence purposes is just 15bp higher in February when compared to its 2013 eop level.

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

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2012	2013E	2014F	2015F
Gross financing requirement	**0.9**	**2.5**	**2.2**	**2.4**
Budget deficit	0.2	0.7	0.9	0.9
Amortization of public debt	0.5	1.6	1.1	1.3
Domestic	0.4	0.6	1.0	0.4
Bonds	0.4	0.2	0.3	0.2
Bills	0	0.4	0.8	0.2
External	0.1	1.0	0.1	0.9
WB/EIB/JBIC/Others	0.2	0.2	0.2	0.2
Financing	**0.9**	**2.5**	**2.2**	**2.4**
Domestic borrowing	0.6	1.2	1.4	0.8
Bonds	0.6	0.6	0.7	0.6
Bills	0	0.6	0.6	0.2
External borrowing	1.3	0.6	2.0	0.6
Bonds	1.0	0	1.5	0
WB/EIB/JBIC/Others	0.4	0.6	0.5	0.6
Privatization	0	0	0.1	0.1
Fiscal reserves change (- = increase)	-1.1	0.7	-1.1	1.0

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2012	2013E	2014F	2015F
Gross financing requirement	**16.1**	**15.8**	**14.4**	**15.0**
C/A deficit	0.5	-0.8	-0.3	0.2
Amortization of medium to long term debt	5.5	6.2	5.0	5.4
Government/central bank	0.3	1.2	0.3	1.1
Banks	0.8	0.8	0.8	0.7
Corporates	4.4	4.2	3.9	3.6
Short term debt amortization	10.1	10.4	9.7	9.4
Financing	**16.1**	**15.8**	**14.4**	**15.0**
FDI	1.2	1.1	1.2	1.4
Portfolio flows	-0.9	-0.1	0.6	0.2
Borrowing	6.9	5.6	6.3	4.7
Government/central bank	1.3	0.6	2.0	0.6
Banks	0.8	0.7	0.5	0.5
Corporates	4.7	4.3	3.8	3.7
Short term	10.4	9.7	9.4	9.1
EU transfers	1.0	1.3	1.4	1.3
Other	-0.4	-2.9	-3.4	-0.8
Change in FX reserves (- = increase)	-2.2	1.1	-1.1	-0.8

Source: Bulgarian National Bank, Ministry of Finance, UniCredit Research

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

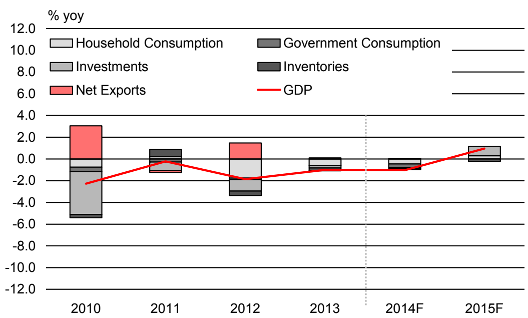
Outlook – We see a GDP contraction in 2014 of 1%, as downside risks continue to dominate the outlook for the Croatian economy. A general economic recovery in EU countries is reducing external risks, but, with the current credit rating, market access for Croatia is exposed to turmoil within the EM asset class and only marginally helped by EU membership. The fiscal gap continues to weigh on the credit rating and funding conditions, though at least fiscal consolidation within the excessive deficit procedure (EDP) mechanism is becoming a framework for reinvigorating structural reforms.

Author: Hrvoje Dolenec, Chief Economist (Zagrebačka banka)

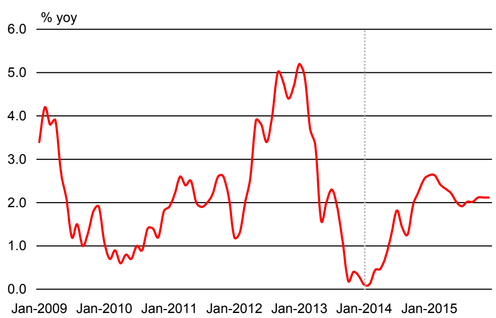
KEY DATES/EVENTS

- 31 March: BoP for 4Q 2013 and foreign debt for 4Q13
- 15 April: Redemption of Eurobond issue – EUR 500mn
- 25 May: Elections for European Parliament
- 30 May: GDP flash estimate 1Q14
- 26 June: First results – Labor Force Survey 1Q
- 30 June: BoP for 1Q and foreign debt for 1Q14

GDP GROWTH



INFLATION OUTLOOK



Source: IMF, MinFin, Eurostat, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2011	2012	2013E	2014F	2015F
GDP (EUR bn)	44.2	43.7	43.3	43.3	44.8
Population (mn)	4.3	4.3	4.3	4.2	4.2
GDP per capita (EUR)	10,332	10,243	10,181	10,189	10,577
Real economy yoy (%)					
GDP	-0.2	-1.9	-1.0	-1.0	1.0
Private Consumption	0.2	-3.0	-1.0	-0.8	0.5
Fixed Investment	-7.2	-4.6	-1.0	-0.7	4.0
Public Consumption	-0.3	-0.8	0.5	-1.5	-1.0
Exports	1.7	0.9	-1.8	-0.5	3.4
Imports	2.1	-2.5	-1.7	-0.2	3.3
Monthly wage, nominal (EUR)	1,049	1,048	1,048	1,050	1,069
Unemployment rate (%)	13.5	15.8	17.2	17.5	16.8
Fiscal accounts (% of GDP)					
Budget balance	-7.8	-5.0	-5.8	-5.0	-4.6
Primary balance	-5.5	-2.3	-2.6	-1.5	-1.0
Public debt	51.9	55.8	66.6	68.2	70.6
External accounts					
Current account balance (EUR bn)	-0.4	0	0.2	0.4	0
Current account balance/GDP (%)	-0.9	0	0.5	0.8	-0.1
Basic balance/GDP (%)	1.6	2.6	1.4	2.5	1.9
Net FDI (EUR bn)	1.1	1.2	0.4	0.7	0.9
Net FDI (% of GDP)	2.4	2.7	0.9	1.7	2.0
Gross foreign debt (EUR bn)	45.9	44.9	45.9	46.4	47.9
Gross foreign debt (% of GDP)	103.8	102.6	105.9	107.3	106.9
FX reserves (EUR bn)	11.2	11.2	12.8	13.3	14.0
Inflation/Monetary/FX					
CPI (pavg)	2.3	3.4	2.2	1.2	2.2
CPI (eop)	2.1	4.7	0.3	2.5	2.1
1W money market rate	1.28	1.39	0.68	0.78	0.80
USD/HRK (eop)	5.66	5.71	5.57	5.43	5.24
EUR/HRK (eop)	7.53	7.55	7.64	7.60	7.60
USD/HRK (pavg)	5.31	5.85	5.70	5.55	5.37
EUR/HRK (pavg)	7.43	7.52	7.57	7.60	7.58

Source: UniCredit Research

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

Looking for growth drivers

Downside risks continue to dominate the outlook for the Croatian economy

GDP decline remains our baseline scenario. We expect a 1.0% GDP contraction in 2014. An economic recovery in the EMU is positive but insufficient to offset declining private consumption and cuts in government spending triggered by EDP. An investment recovery still looks distant without evidence of an acceleration in public and private investment. This is despite rising expectations from the efforts to create an attractive investment environment through Investments Promotion Act and Strategic Investment Projects Act. The investment climate has deteriorated as a result of frequent and uncoordinated changes in the regulatory and legal framework and inconsistent application of the existing legislative package. Uncertainty has been exacerbated by rather unconventional communication of further actions in fiscal policy and the tax environment. However, the main missing element for a positive economic outlook involves delays in the implementation of reforms. The EDP framework for fiscal consolidation can serve as a trigger to resurrect the reform process. Restructuring of the non-financial sector, particularly SOEs, has to be accelerated with improvements in the accompanying framework (pre-bankruptcy settlements). The deteriorated environment took its toll on the banking sector performance – lower profitability and assets quality, with half of the banks in the domestic market making losses - yet another risk to overall economic stability. Therefore, significant downside risks continue to prevail in the short-term forecast horizon.

Activated EDP is becoming a framework for reinvigorating structural reforms…

…and forces the government to amend the budget, cutting the deficit to reach recommended fiscal targets

Fiscal outlook: Fiscal consolidation became an important pillar of macro stability in the country. Within the recessionary environment, reducing the fiscal drag for the economy becomes a priority. However, lacking reforms, Croatia loses an opportunity to implement expenditure-side adjustments and consequently lower the tax burden for the rest of the economy. EDP activation in late January creates the framework for adjustment as it requires the general government deficit to be reduced to 4.6%, 3.5% and 2.7% of GDP in 2014, 2015 and 2016, respectively. Without adjustment measures, the EC assessed that the deficit could reach 6.5% in 2014 and remain above the 6% threshold in 2015 and 2016. With expenditures making up around 47% of GDP, Croatia remains well above most of its peers (except Hungary and Slovenia), whose ratios are close to or below the 40% threshold. The government introduced 2014 budget amendments to respond to EDP requirements, but is again putting greater emphasis on revenues rather than expenditures, and yet again proposing new revenues with one-off characteristics, which should be negotiated with the EC. The biggest effects should be felt in the transfer of pensions to beneficiaries with an accelerated retirement scheme from mandatory pension funds (pillar II of existing three pillar pension system) to a generation solidarity fund (pillar I), totaling ca. 1% of GDP, and from increased health contributions (by 2pp to 15% of gross salary), reversing the measure from 2012, when the government cut this levy on salaries from 15% to 13%. Overall effects of the whole set of measures on both revenue and expenditure side amount to up to 2.7% of GDP, but the net effect will be lower due to reduced revenues caused by the weaker economic performance and introduction of some new expenditures (health sector arrears). Only some of the proposed measures have a clear structural character. However, such measures could significantly reduce the fiscal gap (by ca. 1.5pp) and ease gross financing needs for the government (which would breach 20% of the GDP threshold for the general government with the deficit above 6%). While the redemption profile in the domestic market looks demanding, there is only one foreign bond (EUR 500mn) coming due in April. Despite tapping the market in late November (USD 1.75bn) in pre-financing activity, we expect additional activity.

Deficit cuts should ease the pressure arising from demanding gross financing needs in the short term

A rating upgrade can be triggered only by accelerated efforts to address reforms and budgetary challenges

Rating outlook: After the recent actions of two (out of three) largest rating agencies, the Croatian credit rating is now at between one and two notches below investment grade. It reflects further risks for stability if the medium-term consolidation strategy or economic growth further impairs public debt sustainability. Only accelerated efforts toward addressing key structural economic and budgetary challenges can lead to an upgrade in rating.

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

Outlook – The economic recovery remains on track but is yet to become broad-based. For the moment, we are happy with our above-consensus forecast of 2014 GDP growth of 2.5% but we are not yet ready to raise it. The CNB is set to stick to its FX intervention policy at least until early 2015. The fiscal impulse will be positive in 2014, with the government using higher tax receipts to finance healthcare expenditures.

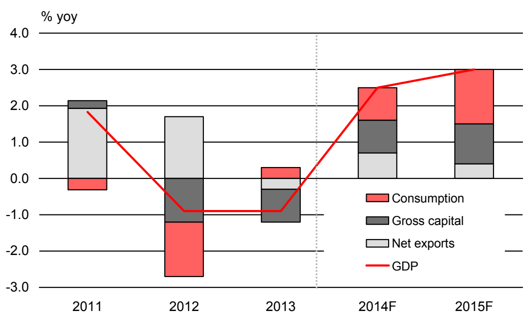
Strategy outlook – The expected inflation spike in 2H14 may be a challenge to constantly low CZGB yield premia versus Bunds. Our current yield forecast nevertheless leaves us without a strong preference for any particular yield curve segment.

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

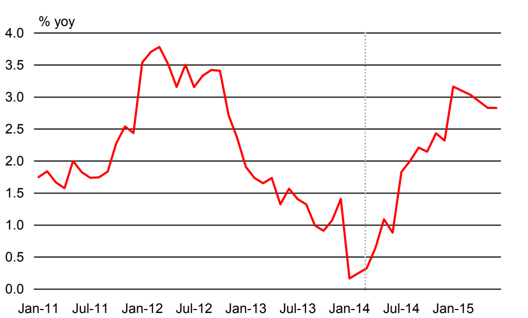
KEY DATES/EVENTS

- CNB policy meetings – Mar 27, May 7, Jun 26
- Manufacturing PMI – Apr 1, May 2, Jun 2
- EP elections – May 23-24

2014 GDP: IMPROVEMENTS TO BE SEEN IN ALL DEMAND COMPONENTS



CPI INFLATION HEADING FOR A SPIKE



Source: CZSO, UniCredit Research Research

MACROECONOMIC DATA AND FORECASTS

	2011	2012	2013E	2014F	2015F
GDP (EUR bn)	155.4	153.0	149.4	149.1	159.8
Population (mn)	10.5	10.5	10.5	10.5	10.5
GDP per capita (EUR)	14,804	14,557	14,214	14,177	15,202
Real economy yoy (%)					
GDP	1.8	-0.9	-0.9	2.5	3.0
Private Consumption	0.5	-2.1	-0.1	1.5	2.2
Fixed Investment	0.4	-4.3	-3.3	1.5	4.5
Public Consumption	-2.7	-1.9	1.9	1.9	1.0
Exports	9.6	4.7	0.1	5.2	6.4
Imports	7.0	2.5	0.5	5.0	6.5
Monthly wage, nominal (EUR)	995	999	967	943	999
Unemployment rate (%)	6.7	6.8	7.7	7.6	7.1
Fiscal accounts (% of GDP)					
Budget balance	-3.2	-4.4	-2.5	-2.9	-2.9
Primary balance	-1.9	-2.9	-1.0	-1.3	-1.3
Public debt	41.4	46.2	47.4	48.1	48.6
External accounts					
Current account balance (EUR bn)	-4.2	-3.7	-1.5	-1.8	-2.2
Current account balance/GDP (%)	-2.7	-2.4	-1.0	-1.2	-1.4
Basic balance/GDP (%)	-1.5	2.3	-0.4	0.9	0.7
Net FDI (EUR bn)	1.9	7.2	0.9	3.1	3.4
Net FDI (% of GDP)	1.2	4.7	0.6	2.1	2.1
Gross foreign debt (EUR bn)	72.8	77.2	75.1	80.9	87.9
Gross foreign debt (% of GDP)	46.8	50.5	50.3	54.3	55.0
FX reserves (EUR bn)	31.1	34.0	40.8	42.0	42.0
Inflation/Monetary/FX					
CPI (pavg)	1.9	3.3	1.4	1.4	2.6
CPI (eop)	2.4	2.4	1.4	2.3	2.2
Central bank target	2.0	2.0	2.0	2.0	2.0
Central bank reference rate (eop)	0.75	0.05	0.05	0.05	0.75
3M money market rate	1.19	1.00	0.46	0.40	0.65
USD/CZK (eop)	19.40	19.04	20.02	19.43	18.28
EUR/CZK (eop)	25.80	25.14	27.43	27.20	26.50
USD/CZK (pavg)	17.56	19.55	19.56	19.93	19.01
EUR/CZK (pavg)	24.59	25.14	25.97	27.30	26.80

Source: UniCredit Research

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

Demand shifting westwards, risks eastwards

Economic recovery gets on track, policies will stay broadly neutral throughout 2014

Although the 4Q13 GDP data was heavily influenced by exceptional items, **the recovery of the Czech economy remains firmly on track**. In early 2014, industrial output is set to further accelerate and private consumption may react positively to an inflation decline. That said, the recovery is yet to become more broad-based. For the moment, we are happy with our above-consensus GDP forecast for 2014 at 2.5%, but we are not yet ready to revise it further upwards. From a policy standpoint, we expect the CNB to stick to its commitment of maintaining EUR/CZK at or above 27.0 until early 2015. The government is set to utilize improving tax collection to try to resolve the most acute problems, particularly those in healthcare financing.

4Q13 GDP data look impressive, underlying picture remains mixed

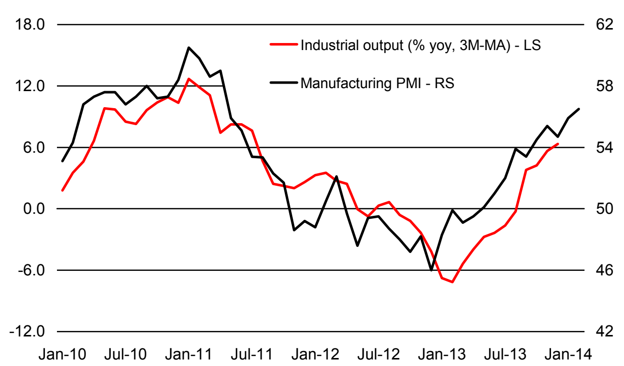
4Q13 growth was 1.9% qoq, the strongest since 2007, and managed to reverse the previous decline in GDP to 1.3% yoy growth. On a positive note, fixed capital formation has started to contribute to annual growth (0.8 pp.), as capex spending for machinery equipment improved. Net exports added 0.4 pp to growth. On a less positive note, much of the consumption growth came from the government side (presumably via higher expenditures of health care insurers), while the CZK-depreciation-induced private spending boom, heralded by the CNB, remained subdued. On the production side, GVA in industry recovered, adding 3.0% yoy. GVA was up a mere 0.6%, contracting in annual terms for all major service sectors. Taxes less subsidies contributed more than a half of the GDP growth on the production side, driven by enormous stockbuilding of tobacco wholesalers ahead of a tax hike. Indeed, government statistics confirm that tobacco tax collection for the first two months of 2014 equaled 50% of the full-year expectations.

Short-term activity indicators point to growth in industry, exports, capex and private consumption in the first part of 2014

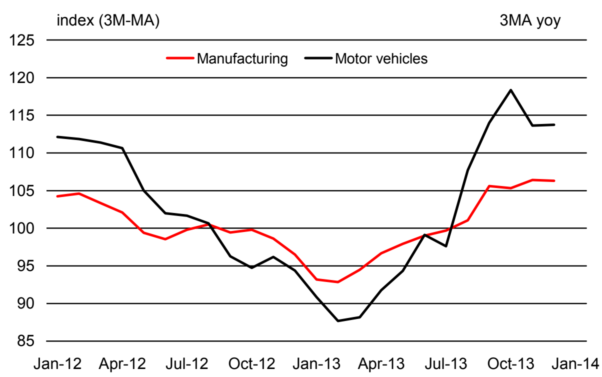
Although the frontloaded tobacco purchases will surely prove a drag on GDP growth in 1H14, **more fundamental tendencies in the economy look fairly promising**. Short-term signals from industry (PMI, new orders) point to above-trend output (and subsequently export) growth in the first months of 2014. Indeed, January exports, rising 17.8% yoy in CZK terms, have confirmed that strong external demand is underway. With the trade balance improving by CZK 13bn versus January 2013, net exports also appear to become a more important contributor to GDP growth. The automotive sector is set to be the main – but not the only – accelerator in industry, with its last year's low base for production and Skoda Auto catching up in sales thanks to its new models. Machinery, electrical equipment and fabricated metal producers are enjoying a cyclical recovery as well. New passenger car registrations have been running at 13% yoy and 21% yoy, respectively, in the first two months of 2014, but were outpaced by LUVs, buses and trucks. Under these circumstances, we believe the boost in capex seen in 4Q13 was not a blip, even though construction investment will recover with a delay.

SHORT-TERM ACTIVITY INDICATORS LOOK FAIRLY PROMISING

PMIs suggest several months of above-trend industrial output ahead



The automotive industry is recovering after 2013's cyclical downturn



Sources: Markit, CZSO, UniCredit Research

The spell of low inflation, albeit temporary, should boost household purchasing power in 1H14

CPI surprised on the downside, remaining at 0.2% yoy for the last two months, as price cuts on energy proved sizeable and the pass-through of a weaker CZK to consumer prices has been delayed. Households' purchasing power is set to benefit in early 2014 from low inflation. Part of the excess purchasing power may result in higher consumption in summer, as reflected in reports of a considerable boost in the purchase of package holidays. Nevertheless, the spell of low inflation is to prove temporary. In line with the CNB forecast, we expect CPI to peak at around 3% yoy in 1Q15 by which time the CZK-induced pass-through will have been completed and signs of demand-driven inflation may have emerged.

Exit strategy of the CNB from its FX commitment remains unclear but debate is ongoing

The CNB has confirmed its commitment to **maintain EUR-CZK at or above 27.0 at least until early 2015,** driving EUR-CZK volatility to historical lows. Meanwhile, debate is under way on how and when to alter the current FX regime. The latest news appears to be that the CNB would prefer to terminate its commitment without shifting gradually its EUR/CZK target. This leads us to two conclusions. First, exiting the current FX regime would only make sense under certain market conditions (need to hike interest rates and limited appreciation pressure on CZK). Second, once opting for an exit, the CNB will probably have to make its interest rate policy much more flexible than in the past, in order to mitigate potential FX volatility. In any case, we see a good chance that the current FX regime will be maintained beyond early 2015.

This year, a fiscal impulse should alter the previous four-year consolidation

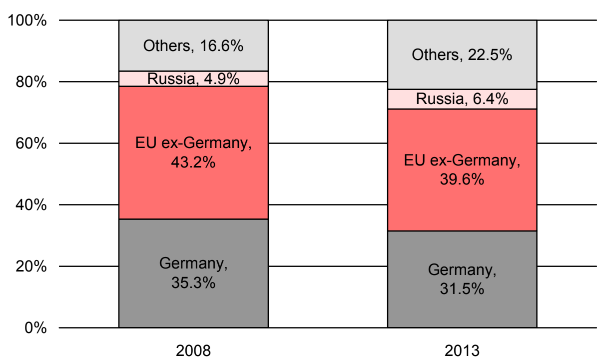
The fiscal under-spending in 2013 forms the basis for a significant fiscal impulse in 2014 when an elevated deficit of CZK 112bn is planned. With the government deficit only at CZK 80bn instead of the budgeted CZK 100bn, fiscal policy was restrictive for a fourth year running in 2013. It is unclear to what extent additional government expenditures meaningfully support economic growth. The first target of extra spending will surely be the healthcare system where financing imbalances have been worsening despite the state paying more on behalf of non-earners since 2014. In contrast, higher infrastructure spending, which would make more sense from a macroeconomic viewpoint, is difficult given a lack of suitable projects in the pipeline. This also threatens the full utilization of EU funds.

Slowdown in China, in Russia and the Crimean crisis are becoming more relevant as risks to Czech growth

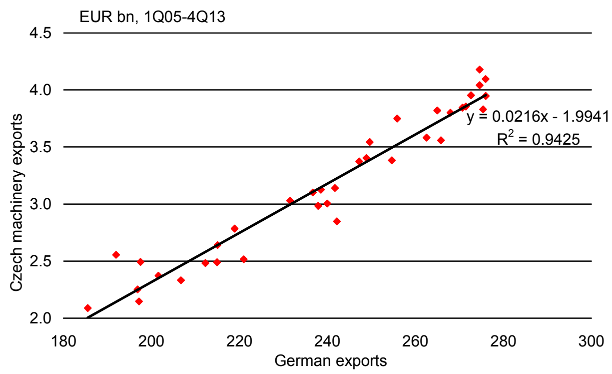
The key risks for the Czech performance are external, as is typical for a very open economy. Signs of a cyclical upturn in the euro area reduce the growth risks coming from developed Europe, the Czech Republic's main trading partner. At the same time, however, a slowdown in China, in Russia and the Crimean crisis are becoming more relevant. The second and third risks are more relevant to the Czech economy than to the EU as a whole. Russia accounts for just below 4% of total Czech exports (with Ukraine adding 1%) but disproportionately more in the high value-added machinery production. EU sanctions on trade with Russia still remain a tail risk but if imposed, they would affect the Czech economy.

MACHINERY EXPORTS ARE ON THE RISE BUT ECONOMIC SLOWDOWN IN RUSSIA POSES A RISK

Export markets of the Czech machinery production have been moving eastwards but Germany and the rest of the EU still dominate



Czech machinery export volumes are almost perfectly linked to German export volumes



Source: CZSO, UniCredit Research

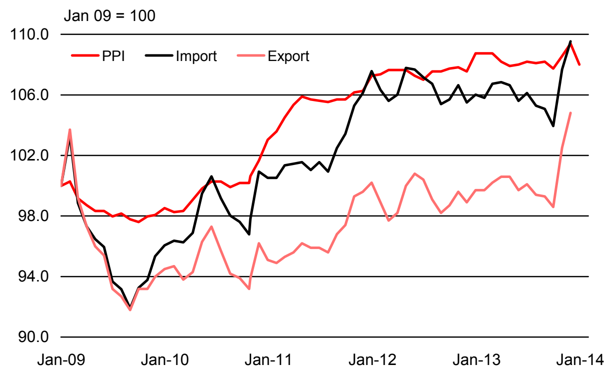
Strategy: CZGB to keep tracing Bunds

Covering the financing needs of the state should be relatively easy in 2014…

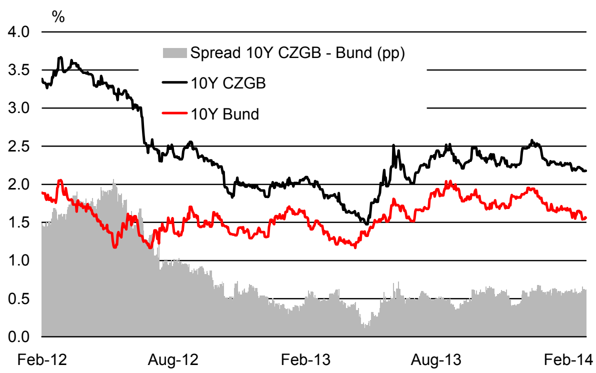
…with CZGB yields under pressure only when inflation will pick up

The Czech government seems to be facing yet another year of ease in financing its borrowing needs. The first bond auctions of 2014 saw excellent cover ratios, as the appetite of domestic investors was boosted by last December's break in issuance activity. Thereafter, the downward yield correction on developed markets turned the focus of global investors on CZGB as a reasonable investment alternative. March has been characterized by low issuance activity in the run-up to a EUR-denominated bond issue, likely coming in April. In addition, short-term borrowing needs have been reduced by a surplus in the state budget which hit CZK 50bn at the end of February, a record high for the month. The issuance strategy for the whole of 2014 assumes higher volumes on offer in the tenors of over 10 years. Low inflation has supported bond yields remaining low as well and only the CZK devaluation-induced inflation spike may later in the year challenge the constantly low yield premia for CZGB versus German Bunds.

The November depreciation of CZK won an immediate response in export and import prices but a more muted reaction in PPI



CZGB will continue tracing Bunds



Sources: CZSO, Bloomberg, UniCredit Research

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2013E	2014F	2015F
Gross financing requirement	**15.0**	**14.7**	**14.5**
Budget deficit	3.1	4.1	4.5
Amortization of public debt	11.8	10.5	10.1
Domestic	4.5	6.0	5.5
EIB loans	0.1	0.1	0.1
Other	7.3	4.4	4.5
Financing	**15.0**	**14.7**	**14.5**
Domestic borrowing	11.7	12.7	12.5
Bonds	7.1	8.2	8.0
Bills	4.6	4.4	4.5
External borrowing	0.2	2.0	2.0
Bonds	0	2.0	2.0
EIB/IMF	0.2	0	0
Change of cash reserve	3.1	0	0

GROSS MLT EXTERNAL FINANCING REQUIREMENTS

EUR bn	2013E	2014F	2015F
Gross financing requirement	**10.2**	**10.5**	**7.2**
Banks	0.8	0.7	0.8
Government and central bank	1.6	3.8	1.4
Other sectors	7.8	6.1	5.0
Financing	**10.2**	**10.5**	**7.2**
Banks	**4.6**	**2.3**	**1.8**
Government and central bank	0.2	2.0	2.0
Multilateral institutions	0.7	0.9	0.8
Companies	2.3	2.3	1.3
Other investors	2.3	3.1	1.3

Source: UniCredit Research

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

Outlook – The government is well positioned to retain a supermajority in parliament. The economy is gaining speed, foreign demand and public spending supporting a broad-based recovery. The momentum is unlikely to last into 2015 due to competitiveness problems and public finance constraints. High financing needs compound regional risks to keep the HUF and yields vulnerable to external shocks.

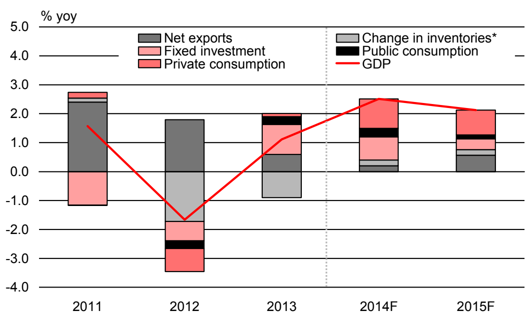
Strategy – In 1Q14, the AKK issued short term and in size to offset the lack of demand from foreign investors, driving a wedge between short-term yields and the base rate. Despite HGB underperformance, REPHUNs remain cheaper when comparing z-spreads. New USD issuance remains attractive due to large financing needs that reduce the AKK's sensitivity to borrowing costs.

Author: Dan Bucşa, Economist (UniCredit Bank London)

KEY DATES/EVENTS

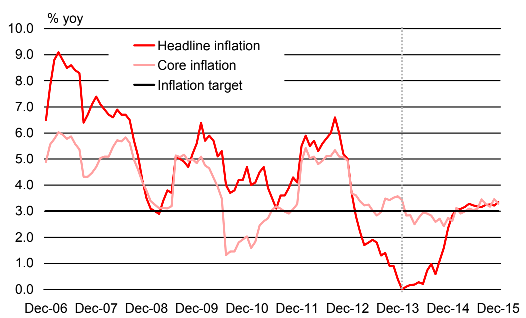
- 6 April 2014: parliamentary elections
- 25 May 2014: EU parliament elections
- 25 Mar, 29 Apr, 27 May, 24 Jun: NBH rate meetings

GDP DRIVERS



*Adjusted for statistical error

HEADLINE INFLATION VS. TARGET



Source: CSO, NBH, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2011	2012	2013E	2014E	2015F
GDP (EUR bn)	99.9	97.6	98.0	100.0	104.5
Population (mn)	10.0	10.0	10.0	10.0	10.0
GDP per capita (EUR)	9,975	9,762	9,802	10,006	10,462
Real economy yoy (%)					
GDP	1.6	-1.7	1.1	2.7	2.0
Private Consumption	0.4	-1.9	0.2	2.1	1.9
Fixed Investment	-3.6	-3.8	5.9	4.5	2.5
Public Consumption	-0.3	0	1.3	1.8	0.7
Exports	6.3	2.0	5.3	5.4	5.0
Imports	5.0	0.1	5.3	5.9	5.3
Monthly wage, nominal (EUR)	763	771	776	771	789
Unemployment rate (%)	10.9	10.7	9.1	8.9	8.7
Fiscal accounts (% of GDP)					
Budget balance	4.3	-1.9	-2.7	-2.9	-2.9
Primary balance	-2.8	2.1	0.9	1.0	1.0
Public debt	81.6	79.8	78.9	80.2	77.7
External accounts					
Current account balance (EUR bn)	0.8	1.7	2.4	2.3	2.2
Current account balance/GDP (%)	0.8	1.7	2.5	2.3	2.1
Basic balance/GDP (%)	3.8	3.3	2.0	1.7	1.7
Net FDI (EUR bn)	0.7	2.0	-0.4	-0.6	-0.4
Net FDI (% of GDP)	3.0	1.5	-0.4	-0.6	-0.4
Gross foreign debt (EUR bn)	131.7	131.2	129.1	126.2	122.1
Gross foreign debt (% of GDP)	131.9	134.4	131.7	126.2	116.8
FX reserves (EUR bn)	37.8	33.9	33.9	32.4	34.2
Inflation/Monetary/FX					
CPI (pavg)	3.9	5.7	1.6	0.8	3.2
CPI (eop)	4.1	5.0	0.4	2.4	3.4
Central bank target	3.0	3.0	3.0	3.0	3.0
Central bank reference rate (eop)	7.0	5.75	3.0	2.5	3.0
3M money market rate	6.2	7.0	4.3	2.7	3.2
USD/HUF (eop)	240.7	220.9	222.2	217.4	224.6
EUR/HUF (eop)	311.1	291.3	296.9	308.0	315.0
USD/HUF (pavg)	201.1	225.1	224.4	217.4	221.0
EUR/HUF (pavg)	279.3	289.3	297.0	308.8	310.6

Source: UniCredit Research

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

Good growth momentum, public finance under pressure

The government will probably retain a supermajority…

Fidesz stands a very good chance to retain a 2/3 parliamentary majority after the 6 April general elections. The reasons are: a favourable new election law, an unconvincing campaign from the left-wing coalition and the absence of a pro-business, right-leaning party to attract the middle class voters who don't back nationalistic and socialist parties.

…at a time when growth is improving and is broader-based…

…although export growth is capped by competitiveness issues…

…and domestic demand depends too much on public spending

Elections come at a time when economic growth is picking up, with 1Q14 data expected to build upon the strong 2.7% yoy from 4Q13 (the carry-over into 1Q14 is 0.9pp). At 2.7%yoy, the expected growth rate for 2014 exceeds the current potential growth of the economy (estimated below 1.5% by the IMF and the OECD), helping close the negative output gap that has persisted since 2009. Yet the growth momentum is unlikely to last beyond 2014 and GDP growth could slow down to 2.0% yoy in 2015. While the GDP recovery looks broad-based, the two underlying generators of growth are external demand and public spending. Exports perform well, with 2013's goods trade surplus posting a new all-time high of EUR 7.0bn. While the trade surplus with developed Europe (EU15) rose by 23.6%yoy to EUR 5.8bn, the one with new EU members shrank by 30.6% yoy to EUR 3.7bn, a sign that competitive adjustments are due. Meanwhile, domestic demand will struggle to gain traction beyond election year 2014 due to limited scope for a fiscal impulse. Fixed investment benefited from public infrastructure works and the FGS in 4Q13 (+10.4% yoy), but both drivers are losing steam (4.4% yoy expected for 2014 and 2.5%yoy in 2015). Low inflation is boosting real wage growth (+3.6% yoy in 4Q13) and private consumption (0.2% yoy in 2013, 2.1% yoy and 1.9% yoy expected in 2014 and 2015 respectively), public consumption is picking up, ballooning again to 20.5% of GDP in 2013. So far, the government has paid for this effort by eating into reserves and taxing the services sector, but there is very limited scope left (if any) for either.

The debt stock problem persists…

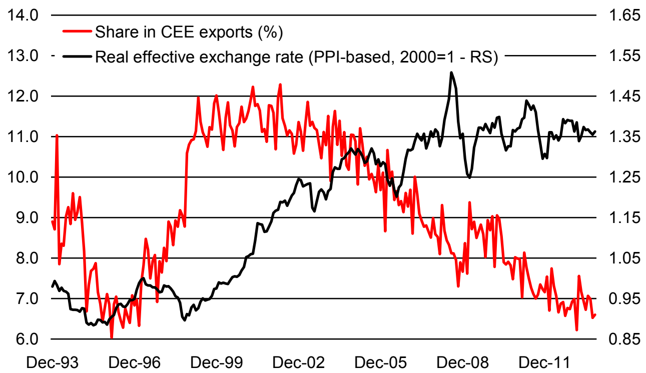
…and will worsen due to the loan from Russia…

…and potential buy-backs in the utilities sector…

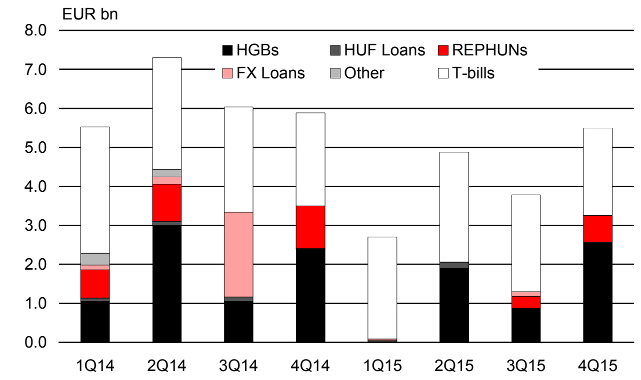
…at a time when financing needs remain very high

Hungary's ambitious plans for a public sector-led, long-lasting growth period are thwarted by the persisting stock imbalances. Public debt to GDP remained below 80% in 2013 only by exhausting the money left from the second-pillar pension system. The government jeopardised its pledge to reduce debt to GDP annually until it reaches 50% by borrowing EUR 10bn (10% of GDP) from Russia to extend the nuclear power plant in Paks. The project is considered unnecessary by most analysts, including those of national energy company MVM, the loan beneficiary. Moreover, the government wishes to buy back utility companies from foreign investors and turn the sector into a non-profit one. This would only add to debt at a time when debt redemptions are high. Until the end of 2014, Hungary faces repayments of 5-7% of GDP per quarter. Excluding T-bills (bought mostly by local investors), the amount that has to be rolled over is 3-5% of GDP per quarter. Hence, the country can't be sensitive to borrowing costs and runs the risk of a higher interest bill (currently at 3.9% of GDP per year)[5].

HUF too strong to counteract the loss of external competitiveness



The government faces sizeable redemptions in 2014 and 4Q15



Source: IMF, AKK, NBH, UniCredit Research

[5] For an analysis of financing needs, please see our publication *"CEE: Stress testing external financing shortfalls"* from 5 July 2013.
For details about Hungary's fiscal challenges, please refer to the *"CEE Navigator - Hungary: An opportunity for change"* published on 19 February 2014

The budget deficit remains under control…

…although the risk of ad-hoc tax changes persists

The flow story remains a good one, with the budget deficit unlikely to exceed 3% of GDP in 2014, the best fiscal performance in an election year for 25 years. Improving activity will spur tax revenues and budget buffers provide for an extra cushion of 0.7% of GDP. Yet the risk of ad-hoc tax changes has not passed completely, especially if the government starts acquiring private companies. While the scope for sectoral taxes has declined, the budget relies more on indirect rather than direct taxes and some excise duties (e.g. for alcohol and tobacco) could continue to rise at a fast speed.

Inflation will rebound despite further price cuts…

Consumer price inflation will rebound from the all-time low of 0% yoy from January 2014, rising to approximately 2.4% yoy by the end of the year when accounting for three rounds of price cuts (6.5% for gas on 1 April, 5.7% for electricity on 1 September and 3.3% for district heating on 1 October). In 2015, HUF depreciation, higher food prices and negative base effects from 2013 price cuts could push headline inflation to 3.4%, in line with core inflation.

…but the NBH will keep cutting the base rate…

…with little effect on lending and the quality of the loan portfolio…

Despite rising inflation, **the National Bank of Hungary will continue cutting the base rate at least to 2.50%**, implying a negative real rate that will have little impact on the economy, but will leave the HUF unprotected by carry. With the Funding for Growth Scheme (FGS) frozen after its successful first round, new lending fell sharply, as did the willingness of banks to lend and of the private sector to borrow. Ignoring a one-off capital transaction at MKB, the banking sector remained in the red in 2013, both NPLs and provisions rising to new highs. With extraordinary bank levies made permanent, the banking sector faces another difficult year, in which the AQR will provide a supplementary pressure on provisioning. In these circumstances, the deleveraging process will continue, although its rhythm will be slower than previously expected in the absence of a scheme to convert FX mortgage loans to HUF.

…but with benefits for central bank's and government borrowing costs

The HUF remains sensitive to market turbulence…

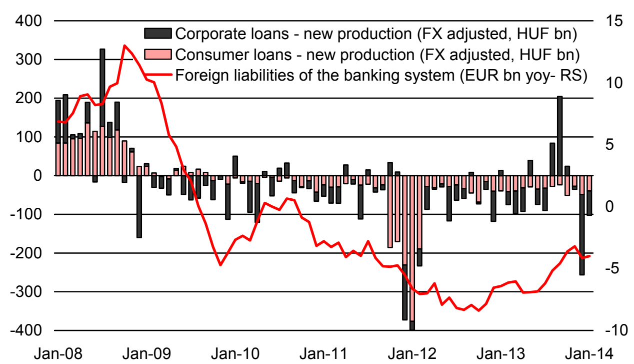
A rapid reversal of rate cuts in 2015 carries a lower probability than before. Rate cuts aim primarily at reducing the borrowing costs of the NBH and the government and these concerns will persist next year. The recent troubles in Ukraine led to CEE assets underperforming other EM, but in Hungary's case, the vulnerability is compounded by sizeable financing needs this year. Financial, rather than commercial linkages are the ones that could hurt Hungary more if the uncertain situation in Ukraine persists.

…but authorities will tolerate depreciation…

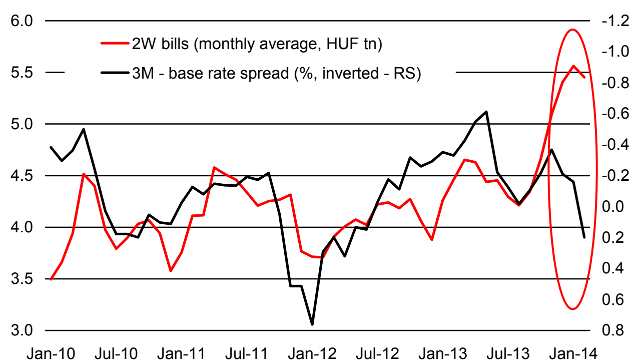
…due to positive effects on competitiveness and the fiscal costs of NBH policies

Authorities will tolerate a weaker HUF due to the implicit and explicit FX hedging provided to households, SMEs and local authorities. Moreover, FX depreciation failed to make a dent in the government's approval ratings. More weakening will follow after elections, having two positive effects: improved price competitiveness and lower central bank losses: depreciation leads to a positive revaluation of the central bank's FX reserves at the end of the year, reducing the fiscal costs of sterilising excess liquidity and of the FGS.

Bank outflows continue amid a contraction of credit



Short-term yields decoupled from the base rate despite good liquidity



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

Strategy: We prefer credit over HGBs

Increased HUF volatility has kept HGB investors away…

…adding pressure on HGB yields

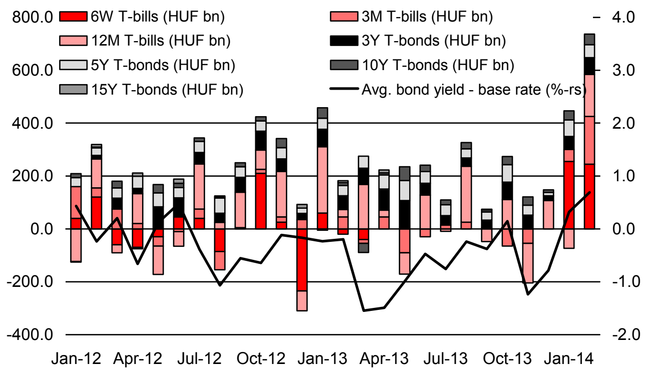
One negative effect of HUF depreciation has been a reduced interest of foreign investors for HGBs, despite sizeable T-bond and T-bill redemptions at the end of 2013 and the beginning of 2014. Hence, the foreign holdings of HGBs fell to the equivalent of EUR 14.8bn, the lowest level in 21 months and 16.4% (EUR 2.9bn) lower than in July 2013. The AKK tried to offset the feeble foreign interest by issuing 6W and 3M T-bills in large amounts and at yields above the policy rate. The spread between 3M yields and the base rate, currently at 22bp, is still widening and marks a 40bp turnaround since the beginning of the year.

New USD issuance looks attractive…

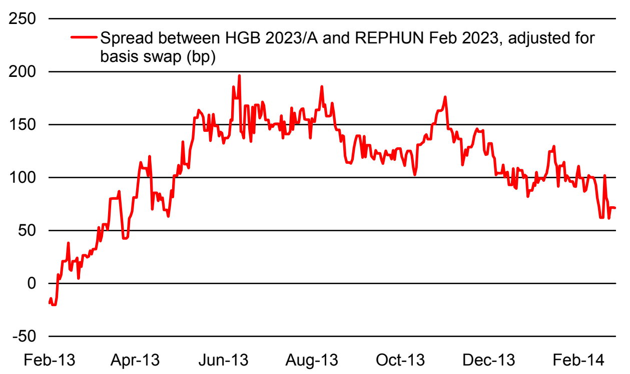
…as does the long end of the HGB curve if the HUF stabilises

In these circumstances, the AKK will return to external markets after selling 5Y and 10Y USD bonds (announced at the time when this CEE Quarterly is published). With 10Y USD bonds some 70bp cheaper than HGBs in z-spreads, REPHUNs remain more attractive than local paper and don't carry the FX risk. At the same time, the steep HGB curve offers value in the longer end if the HUF stabilises.

Net issuance is dominated by T-bills, especially 6W and 3M



Despite HGB underperformance, REPHUNs remain cheaper



Source: AKK, Bloomberg, UniCredit Research

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2013E	2014F	2015F
Gross financing requirement	**22.0**	**17.4**	**14.8**
Budget deficit	2.6	2.9	3.0
Amortization of public debt	19.3	14.5	11.8
Domestic	8.7	8.4	10.4
Bonds	2.4	3.2	5.3
Bills	6.3	5.2	5.1
Other	3.3	0.8	0.2
External	7.3	5.2	1.2
IMF/EU and other loans	4.9	2.5	0.2
Bonds	2.4	2.8	1.0
Financing	**22.0**	**17.4**	**14.8**
Domestic borrowing	15.1	13.7	11.3
Bonds	5.5	5.5	5.1
Bills	9.6	8.2	6.2
External borrowing	5.8	3.7	3.5
Bonds	3.5	3.0	3.0
Other	2.3	0.7	0.5
Pension funds	1.1	0	0

Source: AKK, IMF, NBH, UniCredit Research

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2013E	2014F	2015F
Gross financing requirement	**31.2**	**31.6**	**26.4**
C/A deficit(+)/ surplus(-)	-2.4	-2.3	-2.2
Amortisation of medium to long term debt	11.0	12.2	7.5
Government/central bank	6.8	7.3	3.7
Banks	2.8	2.7	1.8
Corporates	1.4	2.2	2.0
Amortisation of short term debt	22.6	21.6	21.1
Government/central bank	5.6	5.1	4.8
Banks	10.7	9.6	9.1
Corporates	6.3	7.0	7.2
Financing	**31.2**	**31.6**	**26.4**
FDI	-0.4	-0.6	-0.4
Equity	-0.2	-0.1	0
Long-term borrowing	7.3	6.5	6.8
Government/central bank	3.5	2.0	3.5
Banks	2.5	2.4	1.5
Corporates	1.4	2.1	1.8
Short-term borrowing	21.6	21.1	19.4
Government/central bank	5.1	4.8	4.3
Banks	9.6	9.1	8.2
Corporates	7.0	7.2	6.8
EU transfers	2.8	3.2	2.5
Change in FX reserves (reduction(+)/increase(-))	0.1	1.4	-1.8

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

Outlook – On 1 January 2015, Lithuania is expected to become the nineteenth member of the euro zone. President Grybauskaite is favourite to win a second term in May. Growth could accelerate to 3.6% yoy in 2014 and remain well in excess of EMU but several factors prevent faster dynamics: trade vulnerabilities vs. Russia and energy products, sluggish lending, the need for fiscal tightening, and a temporary slowdown in EU fund absorption.

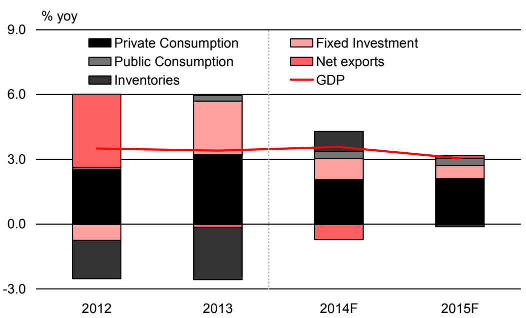
Strategy – LITHUN bonds look attractive after recent underperformance due to imminent access to ECB financing and further economic integration with Europe. We look for a 35bp widening in z-spreads between ROMANI USD 7/2022 and LITHUN USD 9/2012.

Author: Dan Bucşa, Economist (UniCredit Bank London)

KEY DATES/EVENTS

- 30 April 2014: 1Q14 flash GDP release
- 11 and 25 May 2014: presidential elections
- 25 May 2014: EU parliament elections
- 1 January 2015: planned euro adoption

GDP DRIVERS



HEADLINE INFLATION HAS BOTTOMED OUT

Source: Statistics Lithuania, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2011	2012	2013E	2014F	2015F
GDP (EUR bn)	31.0	32.9	34.6	36.2	38.2
Population (mn)	3.1	3.1	3.0	3.0	2.9
GDP per capita (EUR)	9,853	10,791	11,520	12,194	12,984
Real economy yoy (%)					
GDP	6.0	3.7	3.4	3.6	3.1
Private Consumption	4.8	3.9	5.3	3.3	3.4
Fixed Investment	20.7	-3.6	12.7	4.6	2.9
Public Consumption	0.3	0.6	1.7	2.1	2.1
Exports	14.1	11.8	9.5	3.4	3.7
Imports	13.7	6.1	10.3	4.4	3.8
Monthly wage, nominal (EUR)	593	615	646	677	713
Unemployment rate (%)	11.7	10.8	10.9	8.0	0
Fiscal accounts (% of GDP)					
Budget balance	-5.5	-3.3	-2.9	-2.3	-2.2
Primary balance	-3.7	-1.4	-1.0	-0.4	-0.3
Public debt	39.1	41.0	41.9	42.3	42.3
External accounts					
Current account balance (EUR bn)	-1.2	-0.1	0.3	0	0
Current account balance/GDP (%)	-3.7	-0.2	0.9	-0.1	0
Basic balance/GDP (%)	-0.4	1.4	2.8	1.9	2.3
Net FDI (EUR bn)	1.0	0.5	0.7	0.7	0.9
Net FDI (% of GDP)	3.4	1.7	2.0	2.0	2.3
Gross foreign debt (EUR bn)	24.0	24.8	24.3	24.6	24.8
Gross foreign debt (% of GDP)	77.4	75.4	70.3	67.9	64.9
FX reserves (EUR bn)	6.3	6.4	5.9	5.7	5.2
Inflation/Monetary/FX					
CPI (pavg)	4.1	3.1	1.0	0.8	2.0
CPI (eop)	3.4	2.8	0.4	1.2	2.4
USD/LTL (eop)	2.60	2.61	2.52	2.47	EUR
EUR/LTL (eop)	3.45	3.45	3.45	3.45	EUR
USD/LTL (pavg)	2.47	2.68	2.60	2.52	EUR
EUR/LTL (pavg)	3.45	3.45	3.45	3.45	EUR

Source: UniCredit Research

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

Gearing towards euro entry

Growth remains solid, but the scope for acceleration is small…

Economic growth remains solid. In 2013, real GDP grew by 3.4% yoy, decelerating from 3.7% yoy in 2012 due to a negative contribution of net exports. Domestic demand picked up significantly, private consumption growing 5.3% yoy, with fixed investment adding a robust 12.7% yoy. In 2014, growth is expected to accelerate to 3.6% yoy. This is in excess of EMU, facilitating continued catch up. Moreover its sustainability is encouraging to the extent that it is accompanied by a modest C/A surplus. But a number of factors cap a further acceleration:

…due to export reliance on Russia…

…a sizeable trade deficit with oil, gas and energy…

First, **the structure of exports cannot help to accelerate growth.** Since Lithuania joined the EU, exports to the euro area fell to 30% of total from 33% in 2003. Meanwhile, exports to Russia doubled to 20% of total between 2003 and 2013. CEE and Nordic countries account for almost 29% of total exports, little changed in ten years. Even before the conflict in Ukraine, the Russian economy was slowing down and its deceleration will probably affect Lithuanian exports (we forecast 3.4% yoy in 2014 and 3.7% yoy in 2015 from 9.5% yoy in 2013). Moreover, the widening trade deficit with coal, oil, gas and electricity (7.5% of GDP in 2013) bodes ill for the country if oil and gas prices rise amid the standoff between Russia and NATO.

…weak lending amid ongoing deleveraging...

…weighing on domestic demand…

…but negative effects from NPLs and Russian links are contained

Second, **domestic demand cannot rely on a meaningful recovery of lending**. Due to the slowdown of bank deleveraging, the credit impulse is positive for the moment. But with the loan-to-deposit ratio at 1.21% in December 2013, outflows of banks' foreign liabilities are likely to continue. In these circumstances, we forecast lower growth rates for private consumption (3.3% yoy in 2014 and 3.4% yoy in 2015) and fixed investment (4.6% yoy expected in 2014, 2.9% yoy in 2015) compared to 2013. In the aftermath of the financial crisis, both the supply and the demand for credit remain subdued. There are two positives to the banking sector situation. First, authorities are addressing the problem of impaired loans and the NPL stock fell to 11.3% of total loans in 3Q13 from 20% in early 2010. Second, Lithuania is more protected via the banking channel from the current situation in Russia because it does not have a large share of non-resident deposits present in its system as Latvia does.

Stabilising public debt calls for further fiscal tightening

President Grybauskaite is expected to win a second term

Third, **the fiscal adjustment needs to continue before the debt to GDP ratio stabilises**. Lithuania exited the excessive deficit procedure in 2013 and plans to reduce the budget deficit to 1.9% of GDP in 2014 from 2.9% of GDP in 2013. We expect an overshoot of that target as the government has little room for extra spending in election year 2014. Lithuania goes to polls twice in May to elect the president and 11 members of the EU parliament. The current president Dalia Grybauskaite is favourite to return to the job.

EU fund inflows could slow down temporarily

Fourth, between 20014 and 2016, **Lithuania could be the victim of its own success in attracting EU funds**, since it will take a while for disbursements from the new programming period 2014-2020 to pick up. Lithuania managed a very impressive absorption ratio of 75.6% by March 2014, with the annual inflows exceeding 3.2% of GDP between 2009 and 2013 and compensating for weak FDI (an annual average of 1.8% of GDP over the same period).

On track to adopt the Euro in January 2014

On 1 January 2015, Lithuania is likely to become the nineteenth member of the euro zone. While the convergence report has yet to be issued, the Council has made positive noises while the Maastricht Criteria are met. That said, real convergence has a long way to go: in purchasing power parity, per capita GDP is only two thirds of the euro area average.

LITHUN bonds remain attractive, despite short term underperformance

Despite recent underperformance, **LITHUN bonds remain attractive** due to the country's imminent euro adoption. ECB access and further economic integration should re-widen the bond spreads vs. Romania. We look for a 35bp widening in z-spreads between ROMANI USD 7/2022 and LITHUN USD 9/2012. The countries have comparable budget deficit and debt-to-GDP metrics, while Lithuania's external financing needs (external bonds expiring are EUR 3.3bn or 9% of 2014 GDP until 2017) compare well with Romania's.

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

Outlook – The recovery in activity should continue to gain momentum, supported by stronger domestic demand, while exports remain buoyant on the back of rising orders from abroad. Since the domestic demand recovery will be gradual, inflationary pressure should be well contained, with headline inflation close to the National Bank of Poland (NBP) target of 2.5%. The Monetary Policy Council (MPC) may prolong the period of policy rate stability until end-2014. Changes to the pension system will generate a one-off surplus of the general government and permanently reduce the public debt by about 9%.

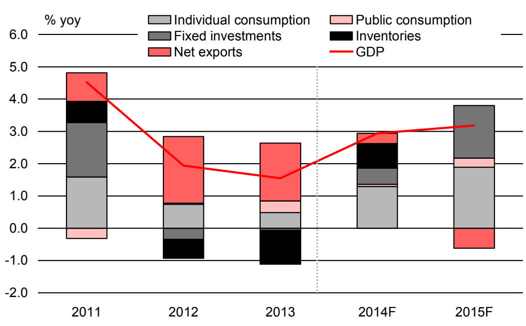
Strategy – The zloty should outperform in the coming months. POLGBs will remain under pressure and we anticipate moderate yield increases in the 5Y-10Y part of the curve.

Author: Marcin Mrowiec, Chief Economist (Bank Pekao)

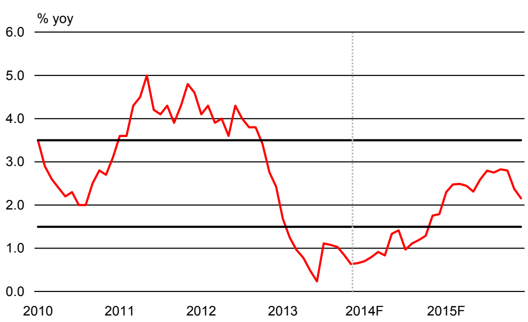
KEY DATES/EVENTS

- MPC decision-making meetings 8-9 Apr, 1-2 July, 2-3 Sep
- GDP data release: 30 May
- EU Parliament elections: 22-25 May

GDP COMPONENTS



HEADLINE INFLATION VS. TARGET



Source: StatOffice, NBP, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2011	2012	2013E	2014F	2015F
GDP (EUR bn)	370.9	381.2	388.8	410.9	453.6
Population (mn)	38.1	38.1	38.1	38.0	38.0
GDP per capita (EUR)	9,740	10,013	10,217	10,802	11,932
Real economy yoy (%)					
GDP	4.5	1.9	1.6	2.9	3.2
Private Consumption	2.6	1.2	0.8	2.1	3.1
Fixed Investment	8.5	-1.8	-0.4	2.7	8.8
Public Consumption	-1.7	0.2	2.0	0.4	1.6
Exports	7.7	3.9	4.3	7.8	7.5
Imports	5.4	-0.7	0.7	7.5	9.1
Monthly wage, nominal (EUR)	874	890	910	962	1,056
Unemployment rate (%)	12.4	12.8	13.5	12.9	12.3
Fiscal accounts (% of GDP)					
Budget balance	-5.0	-3.9	-4.5	4.5	-3.0
Primary balance	-2.3	-1.1	-1.8	6.7	-0.8
Public debt	56.2	55.6	57.0	49.2	48.7
External accounts					
Current account balance (EUR bn)	-18.5	-14.2	-5.9	-7.0	-8.9
Current account balance/GDP (%)	-5.0	-3.7	-1.5	-1.7	-2.0
Basic balance/GDP (%)	-1.0	-2.5	-2.3	0	0.2
Net FDI (EUR bn)	14.9	4.8	-3.0	7.0	10.0
Net FDI (% of GDP)	4.0	1.2	-0.8	1.7	2.2
Gross foreign debt (EUR bn)	250.1	277.3	273.0	276.9	301.9
Gross foreign debt (% of GDP)	67.4	72.7	70.2	67.4	66.6
Fx reserves (EUR bn)	75.7	82.6	77.1	79.7	85.5
Inflation/Monetary/FX					
CPI (pavg)	4.3	3.7	0.9	1.2	2.5
CPI (eop)	4.6	2.4	0.7	1.8	2.2
Central bank target	2.5±1pp	2.5±1pp	2.5±1pp	2.5±1pp	2.5±1pp
Central bank reference rate (eop)	4.50	4.25	2.50	2.50	3.25
3M money market rate	4.54	4.91	3.02	2.74	3.28
USD/PLN (eop)	3.32	3.10	3.03	2.89	2.69
EUR/PLN (eop)	4.42	4.09	4.15	4.05	3.90
USD/PLN (pavg)	2.94	3.25	3.16	3.01	2.79
EUR/PLN (pavg)	4.12	4.19	4.20	4.13	3.93

Source: UniCredit Research

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

The economy accelerates in spite of geopolitical headwinds

GDP growth is set to accelerate to 2.9% in 2014, after 1.6% in 2013…

GDP growth is set to accelerate to 2.9% yoy in 2014, with domestic demand becoming the core engine of growth. Labor market conditions are improving gradually, with real wages in the corporate sector rebounding from negative readings in early 2013 to 2.4% yoy in 4Q13 and expected to accelerate to 3.7% yoy in 2H14. Leading indicators are getting strong, with some (e.g., labor PMI) at an all-time high, confirming the gradual recovery of domestic demand. We expect real private consumption to accelerate to 2.1% yoy in 2014 vs. 0.8% yoy in 2013 and fixed investment to grow by 2.7% yoy in 2014 after -0.4% yoy in 2013. The reasons for a gradual pick-up are: uncertainties in the private sector, the conflict in Ukraine and lower EU fund absorption until 2015, when inflows from the new programming period 2014-2020 could gain traction. With the PMI for new export orders at the highest levels since late 2010, we expect real export growth to accelerate to 7.8% yoy (in PLN) from 4.3% yoy in 2013. However, increasing domestic demand will boost imports (7.5% yoy in 2014 vs. 0.7% yoy in 2013), reducing the contribution of net exports to GDP from 1.8pp in 2013 to 0.3pp in 2014.

…with domestic demand recovering gradually

The situation in Ukriane represents the main risk to growth…

The main risk for growth comes from the increasing tension in the Ukraine-Russia dispute. In terms of direct trade relationships, Ukraine absorbs 2.8% of Poland's exports and acquires only 1% of Poland's total imports. The direct impact of a fall in exports is hard to gauge at the moment, but given economic disruptions and UAH weakening, one can roughly estimate a fall in exports of 20-40%. The impact of that on the economy of Poland will be rather limited, as it will be outweighed by very strong demand from Western Europe, and especially from Germany. Russia absorbs 5.3% of Poland's exports and provides 12.3% of Poland's imports. Russia exports to Poland mainly energy – ca. 96% of crude oil consumed in Poland comes from Russia, as well as 72% of the gas. However, the risk of disruptions in energy deliveries seems rather low at this stage. The risk would increase if Russia decided to impose trade barriers for Polish exporters and importers and/or gas deliveries to Ukraine, which is the main route of energy exports to the West. Assuming that the situation does not escalate further and assuming Russia does not implement significant bans on exports from Poland, the impact on growth would be confined to specific sectors (like pork exports, shoes, and furniture), and will be completely offset by strong exports to the West.

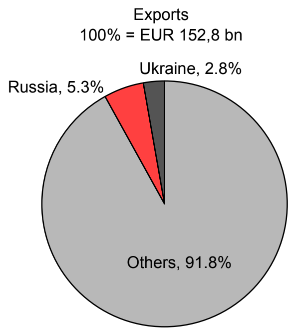
… but the impact should be contained and offset with strong exports to the West if the situation does not deteriorate further

May EU elections will show real level of support for the main political parties…

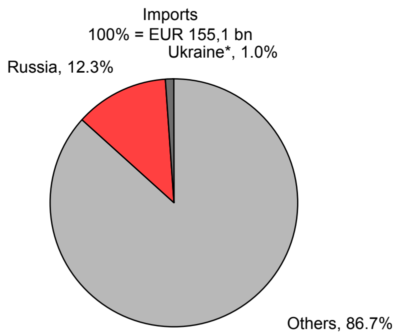
The European Parliament elections in May will be an important test for the governing coalition. Support for the ruling Civic Platform eroded in the past few years, as many of its former voters were disenchanted with the lack of much-needed reforms, increasing tax burdens and mistakes in many of its policies.

DIRECT IMPACT OF UKRAINIAN CRISIS ON TRADE BALANCE WILL BE LIMITED UNLESS RUSSIA IMPOSES TRADE SANCTIONS

Ukraine receives only 2.8% of Polish exports



Only 1% of Poland's imports come from Ukraine



Source: StatOffice, UniCredit Research

…and set the stage for parliamentary and presidential elections in 2015

The polls show that the main opposition party, Law and Justice, has stronger popular support than the ruling Civic Platform, but the difference varies from 1 to as much as 11 percentage points between polls from different polling agencies. In this respect, the outcome of EU elections will deliver "hard data" on public support for the main political parties. This, in turn, will be important information prior to 2015 parliamentary and presidential elections.

CPI is expected to gradually increase from 0.7% yoy in January towards 1.5% in June…

…then decline in July due to base effects and rise up to 1.6% by year-end

We look for a very gradual increase of inflation in 2014 from 0.7% yoy in January 2014, with the headline figure reaching 1.5% yoy (the lower end of the target range) around June. In July, inflation is set to decline temporarily due to the strong base effect from last year (waste disposal price changes). In the second half of the year, demand factors will have a stronger impact on inflation, as will food prices, pushing inflation to 1.6% yoy by year-end. However, we do not expect the target itself to be reached sooner than in 1H15. In terms of average yearly inflation, better-than-expected readings in the past quarter set a lower base for 2014, and this, combined with the benign picture for the coming months, prompted our revision of 2014 average CPI inflation from 1.7% yoy to 1.2% yoy.

The MPC sent a clear message that interest rates will stay unchanged "at least till end-3Q14"…

…but we expect the first hike in early 2015

The MPC vowed to leave interest rates unchanged at least until the end of 3Q14. In line with the March projection of the central bank, prepared under the assumption of unchanged NBP interest rates, average inflation in 2014 will amount to 1.1% (as compared to 1.6% in the November 2013 projection), 1.8% in 2015 (as compared to 1.9%) and 2.5% in 2016. At the same time, annual GDP growth is estimated at 3.6% in 2014 (as compared to 3.0% in the November 2013 projection), 3.8% in 2015 (as compared to 3.3%) and 3.6% in 2016. NBP Governor Marek Belka said at the press conference that "there is no promise" that interest rates will be hiked in 4Q14. We maintain our long-held forecast that the MPC will keep interest rates unchanged until the end of this year, a scenario that is becoming the consensus view. We expect the first rate hikes at the beginning of next year.

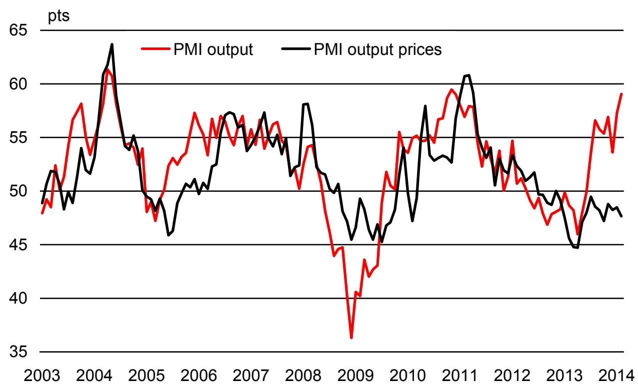
2014 will see a small widening of the C/A deficit to 1.7% of GDP from 1.5% in 2013…

…but also better FDI than in 2013

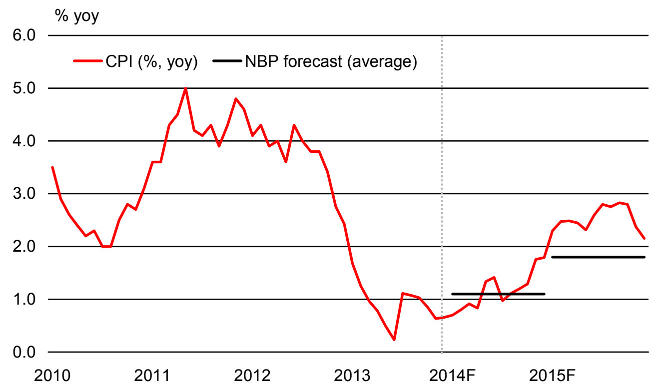
1Q14 should see a return to a trade surplus with export growth outpacing import growth. Thereafter, a moderate trade surplus should be sustained despite imports rebounding due to the recovery of domestic demand. In 4Q13, Poland's C/A registered a similar deficit to that in 3Q13, i.e., around EUR 2.0bn. Due to seasonal patterns, there was a slight deficit on the trade account versus surpluses in the two previous quarters, but it was offset by a smaller income deficit and a larger surplus of current transfers. According to our estimates, in 2014, the C/A deficit will increase slightly to 1.7% of GDP from 1.5% of GDP in 2013. 2014 should bring higher FDI after a poor 2013, thanks to an improvement of both domestic and global economic sentiment.

THE NBP WILL POSTPONE HIKES IN A GOOD GROWTH – LOW INFLATION ENVIRONMENT

The growth momentum is very strong…



…but inflation pressures remain subdued



Source: StatOffice, UniCredit Research

Zloty outperformance, POLGB yields under pressure

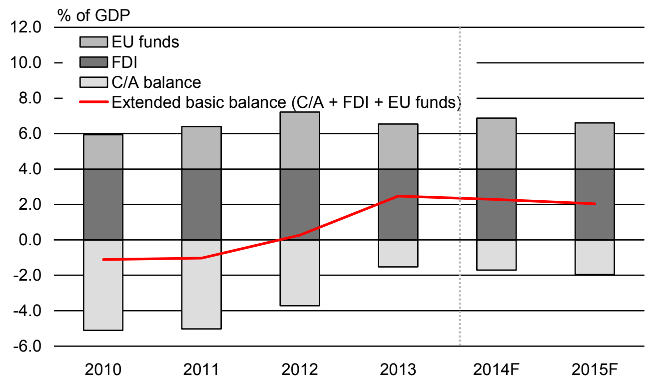
PLN expected to appreciate in 2014…

We expect the PLN to outperform other CEE currencies due to a very supportive basic balance. While the current account deficit is expected to widen slightly, FDI and EU fund flows could offset completely the larger C/A shortfall, thus providing support to the currency. Unlike in the Czech Republic or Romania – where the basic balance is also supportive – Polish authorities don't have an anti-appreciation bias and are comfortable with EUR-PLN above 3.9. While regional turmoil might prevent the currency from firming in the short term, we expect EUR-PLN to decline to 4.05 by the end of the year.

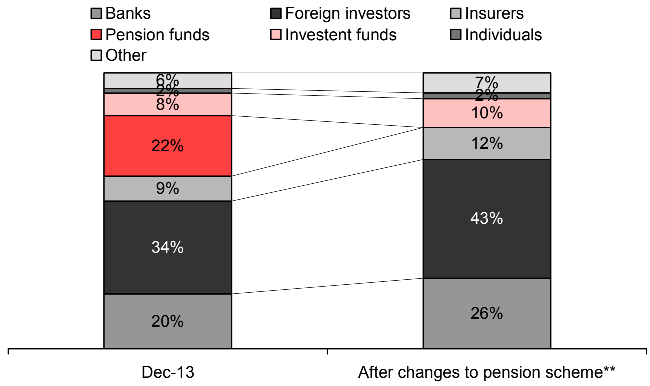
…while local bond yields will come under pressure

With economic growth and inflation expected to pick up throughout the year, local bond yields will come under pressure. Even if the NBP fails to deliver any rate hikes in 2014 (our baseline scenario), the market will start pricing higher interest rates as macroeconomic data improves. The liquidity declined on the POLGB secondary market after the second-pillar pension funds (OFE) transferred their bond holdings to the state pension fund. Foreign investors remain the most important buyers of medium- and long-term bonds, so POLGBs will remain under pressure and we anticipate moderate yield increases in the 5Y-10Y part of the curve.

The basic balance remains supportive for the PLN



The structure of investors in POLGBs changed after the OFE reform



**Assuming cancelation of securities held by pension funds and stock of securities held by other sectors unchanged at the 1H13 level

Source: MinFin, NBP, UniCredit Research

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2013E	2014F	2015F
Gross financing requirement	**38.9**	**31.3**	**41.8**
Budget deficit	14.5	10.9	13.5
Amortisation of public debt	24.4	20.4	28.3
Domestic	20.9	16.4	23.7
Bonds	19.4	16.4	23.7
Bills	1.5	0	0
External	3.5	4.0	4.6
IMF/EU/IFIs	0	0	0
Financing	**38.9**	**31.3**	**41.8**
Domestic borrowing	31.6	23.4	33.2
Bonds	31.9	24.5	33.4
Bills	1.5	0	0
Other	-1.8	-1.1	-0.2
External borrowing	7.3	7.9	8.6
Bonds	4.1	6.2	6.9
IMF/EU/WB	0	0	0
Other	3.1	1.6	1.7

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2013E	2014F	2015F
Gross financing requirement	**73.2**	**74.6**	**70.3**
C/A deficit	5.9	7.0	8.9
Amortisation of medium to long term debt	17.0	17.3	14.1
Government/central bank	3.5	4.0	4.6
Banks	2.6	6.2	3.5
Corporates	10.9	7.1	5.9
Amortisation of short term debt	50.4	50.2	47.3
Financing	**73.2**	**74.6**	**70.3**
FDI	-0.3	7.0	10.0
Equity	1.2	2.8	2.8
Borrowing	73.0	65.2	73.3
Government/central bank	7.3	7.9	8.6
Banks	13.6	18.2	16.7
Corporates	52.2	39.1	48.0
EU transfers	9.9	11.8	11.8
Other	-10.6	-12.2	-27.7

Source: MinFin, NBP, UniCredit Research

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

Outlook – Two rounds of elections will provide for occasional political noise and will prevent the government from changing the tax system in 2014. Excluding agriculture, GDP growth will pick up from 2.4% yoy in 2013 to 2.7% yoy this year and 2.8% yoy in 2015. Inflation could spike to 3.7% by the end of the year, missing the target and adding pressure on short-term rates. The RON is expected to trade range-bound, helped by a positive basic balance.

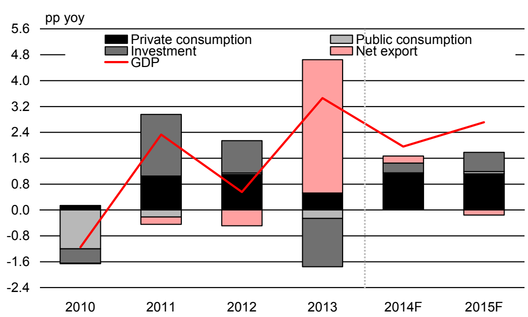
Strategy – The short end of the ROMGB curve will look unattractive until 1Q15 due to higher inflation. We remain positive the long end of the credit curve and look for dislocations in the spread between ROMANI and ROMGB bonds as a good entry point into the latter.

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

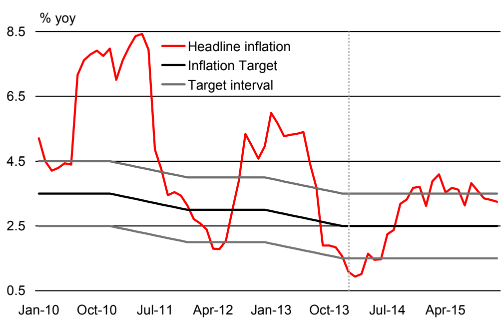
KEY DATES/EVENTS

- 28 March, 6 May, 1 July: NBR rate decisions
- 25 May: EU Parliament elections
- 15 May: 1Q GDP (flash estimates)
- 2 and 16 November: Presidential elections

GDP COMPONENTS



INFLATION OUTLOOK



Source UniCredit Research, NBR, Statistical Office

MACROECONOMIC DATA AND FORECASTS

	2011	2012	2013E	2014F	2015F
GDP (EUR bn)	131.5	131.7	142.8	148.3	159.1
Population (mn)	21.4	21.4	21.3	21.3	21.3
GDP per capita (EUR)	6,146	6,153	6,705	6,960	7,469
Real economy yoy (%)					
GDP	2.3	0.6	3.5	2.0	2.7
Private Consumption	1.4	1.5	0.7	2.1	2.2
Fixed Investment	7.7	3.8	-5.7	3.3	2.8
Public Consumption	-3.0	0.7	-4.1	2.2	1.8
Exports	11.6	-1.5	12.8	6.1	5.6
Imports	10.5	-0.2	2.3	5.9	6.1
Monthly wage, nominal (EUR)	348	347	368	382	408
Unemployment rate (%)	7.4	7.0	7.3	7.2	7.0
Fiscal accounts (% of GDP)					
Budget balance	-5.6	-2.9	-2.8	-2.8	-2.4
Primary balance	-4.1	-1.1	-1.0	-1.0	-0.7
Public debt	34.7	37.8	37.5	37.3	36.0
External accounts					
Current account balance (EUR bn)	-5.9	-5.8	-1.5	-1.5	-2.3
Current account balance/GDP (%)	-4.5	-4.4	-1.1	-1.0	-1.5
Basic balance/GDP (%)	-3.1	-3.1	0.8	0.7	0.1
Net FDI (EUR bn)	1.8	1.7	2.6	2.5	2.5
Net FDI (% of GDP)	1.4	1.3	1.8	1.7	1.6
Gross foreign debt (EUR bn)	98.7	99.7	96.4	96.5	96.6
Gross foreign debt (% of GDP)	75.0	75.7	67.5	65.1	60.7
FX reserves (EUR bn)	33.2	31.2	29.1	28.5	29.4
Inflation/Monetary/FX					
CPI (pavg)	5.8	3.3	4.0	2.2	3.5
CPI (eop)	3.1	5.0	1.6	3.7	3.2
Central bank target	3.0	3.0	2.5	2.5	2.5
Central bank reference rate (eop)	6.00	5.25	4.00	3.50	3.50
3M money market rate	5.28	5.22	4.05	2.99	3.40
USD/RON (eop)	3.34	3.36	3.26	3.18	3.02
EUR/RON (eop)	4.32	4.43	4.48	4.45	4.38
USD/RON (pavg)	3.05	3.47	3.33	3.27	3.03
EUR/RON (pavg)	4.24	4.46	4.42	4.47	4.39

Source: UniCredit Research

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

Slower growth, but broader-based

Romania cleared the first political hurdle in election year 2014…

Romania cleared the first political hurdle of the year, the break-up of its governing coalition, with a new government already in place and the IMF memorandum sent to Washington for approval. On 25 May, EU Parliament elections will reconfirm the Social Democratic Party (PSD, the senior ruling party) as the most important party in the country. After that, the PSD will choose a candidate for presidential elections, scheduled for 2 and 16 November. Only a united right-leaning opposition would stand a chance to defeat the PSD frontrunner (Prime Minister Victor Ponta is the favourite for the nomination).

…but two rounds of elections will follow…

…putting pressure on public expenditure…

With public spending slippages likely ahead of elections**, the new government can't afford any tax changes in order to keep the budget deficit below 3% of GDP**. Among the fiscal plans that seem unfeasible in 2014 are: a reduction of social security contributions for employers by 5pp, a progressive revenue tax system that would peak at the current flat tax of 16% and VAT cuts for some food staples like meat (the VAT for bread was reduced last year from 24% to 9% in an attempt to shrink tax evasion). One good piece of news for the government is that tax revenues could increase as the structure of economic growth changes away from agriculture.

…and postponing the tax changes planned by authorities

Economic growth will pick up when excluding agriculture…

Economic growth will probably slow down to 2.0% yoy in 2014 from 3.5% yoy in 2013, but this expected deceleration is due only to a weaker harvest compared to the 24-year record from 2013. Excluding agriculture, economic growth could pick up to 2.7% yoy in 2014 and 2.8% yoy in 2015 from 2.4% yoy in 2013. On the supply side, industry will probably remain the main growth engine (6.1% yoy in 2014, 4.7% yoy in 2015), with retail and construction adding 0.2pp and 0.3pp to growth in 2014 and 2015 respectively, amid real wage growth and higher EU co-funding for infrastructure works. On the demand side, exports (6.1% yoy in 2014, 5.6% yoy in 2015) will continue to outpace private consumption (2.1% yoy in 2014, 2.2% yoy in 2015).

…with industry and exports remaining the main drivers…

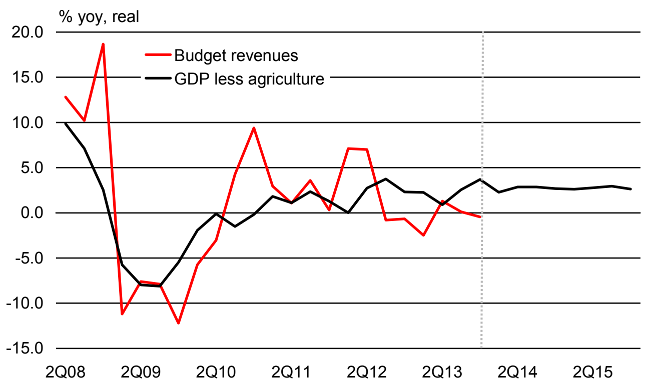
…and domestic demand recovering gradually

The basic balance surplus remains sizeable

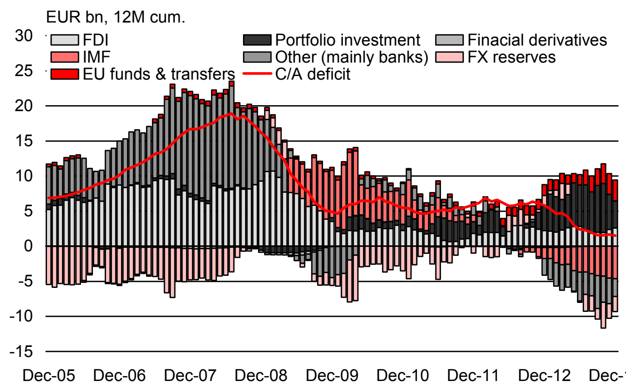
Romania's trade deficit could narrow further due to a widening surplus for services (mainly transportation and IT). Yet a further reduction of the current account deficit is unlikely due to a wider deficit for the income account. Besides a larger interest bill for the foreign holdings of bonds, reinvested profits from foreign direct investors are rising amid surging industrial production. But adding FDI and EU fund inflows (up a combined 47% yoy to EUR 5.6bn in 2013, EUR 5.9bn forecasted for 2014 and EUR 6.1bn for 2015), the extended basic balance provides support to the RON.

STRONG EXPORTS DRIVE AN IMPROVEMENT OF GROWTH, FISCAL REVENUES AND BALANCE OF PAYMENTS

A steady GDP recovery should spur budget revenues…



…and help the current account deficit remain low



Source: Statistical Office, NBR, UniCredit Research

FX outflows will slow down in 2H14 due to lower IMF repayments…

…and slower bank deleveraging

Meanwhile, **fund outflows will slow down in 2H14 due to lower IMF-EU repayments and bank deleveraging**. The former amount to EUR 2.8bn in 1H14 only to fall to EUR 1.5bn in the second half of the year. The deleveraging will slow down because of two factors. First, the loan-to-deposit ratio has fallen to 1 (lower for top 10 banks) and any other fund outflows would mirror mainly deleveraging at smaller banks. Second, the AQR will probably require higher provisioning at some banks. The National Bank of Romania (NBR) already asked for higher provisions in 4Q13, but more is to come, since non-performing loans remain on the rise.

The NPL issue has to be addressed through other measures than the currently proposed ones

New law drafts contribute little to solve the NPL problem. A two-year tax holiday proposed by the government to allow low-income borrowers to increase leverage would only lead to more credit delinquency in the future, if accepted by banks. Meanwhile, the NBR doesn't change the rigid framework that regulates the recovery and the accounting of NPLs. In these circumstances, the exchange rate remains very important for FX borrowers (2/3 of loans) and for domestic demand.

The RON remains weak relative to the basic balance…

The RON is weak relative to the strength of the basic balance, which will continue to cover bank deleveraging throughout 2014. A preference for excess liquidity and ambiguous communication from the central bank at the beginning of the year kept EUR-RON close to 4.50, as did risk aversion and the Ukrainian conflict afterwards. This is a level at which NPLs continue to rise. Going forward, Romania would need higher portfolio investment to help the currency stabilise closer to EUR-RON 4.40. The support will not come from ROMGBs and the government should speed up privatisations and the issuance of quasi-sovereign bonds.

…and needs the support of further sovereign FX issuance

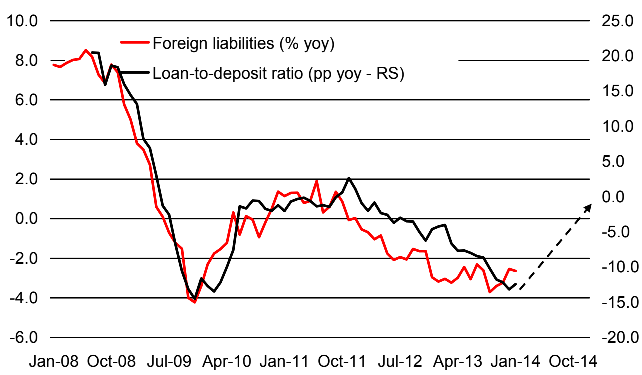
The MinFin will most likely issue abroad in order to offset the poor demand for bonds coming from local investors. A new EUR bond could be issued already in 1H14 according to budget minister Liviu Voinea.

Inflation will start rising in April, exiting the target interval in 2014…

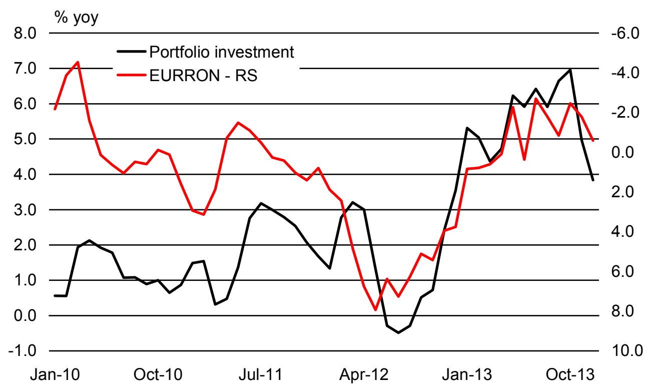
…and adding pressure on short-term yields

Starting from April, inflation will rise fast from current all-time lows, exiting the 1.5-3.5% target interval by the end of the year. An excise hike to fuel prices in April, followed by negative base effects from food prices from July onwards is expected to push headline inflation to 3.7% yoy in December. In 2015, inflation could return inside the target interval. Hence, short-dated local bonds will not be attractive before 1Q15. The almost 3pp inflation turnaround this year will affect the short-term yields and to a lesser extent longer-term rates, regardless of how loose liquidity conditions will be. The NBR will keep excess liquidity in the market as long as the RON does not come under depreciation pressure, either by not sterilising temporary surpluses or by releasing more minimum reserve requirements. This means that short-term real interest rates will be negative in 2H14 and 1H15, a stark change in the central bank's behaviour from previous years.

Bank deleveraging should slow down after the loans- to-deposits ratio fell to 1



The correlation between EURRON and portfolio flows increased with the participation of foreign investors on the bond market



Source: MinFin, NBR, UniCredit Research

Positive FX bonds, constructive long-term ROMGBs

In the short term we prefer ROMANI bonds to ROMGBs…

…but look for good entry points in long-term ROMGBs…

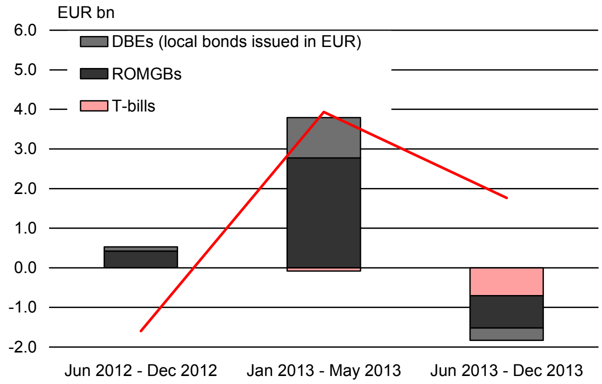
…and to a widening of spreads vs. Serbia

Over the next six months, we prefer FX bonds to ROMGBs for three reasons: relative value, stronger resilience to higher inflation, and relative value vs. regional peers. First, USD bonds remain cheaper than ROMGBs in z-spreads. The basis-adjusted spread varies between 40 and 120bp due to volatile RON swaps. Second, higher inflation in 2H14 could have an impact on the ROMGB curve (stronger on the short end). Third, in both USD and local bonds, the spreads vs. Serbia, Croatia and Hungary have tightened recently, despite Romania's much better fundamentals. We look for a 30bp spread widening between ROMANI USD 9/2020 and SERBIA USD 9/2021 if Serbia's IMF agreement is postponed to late 2014.

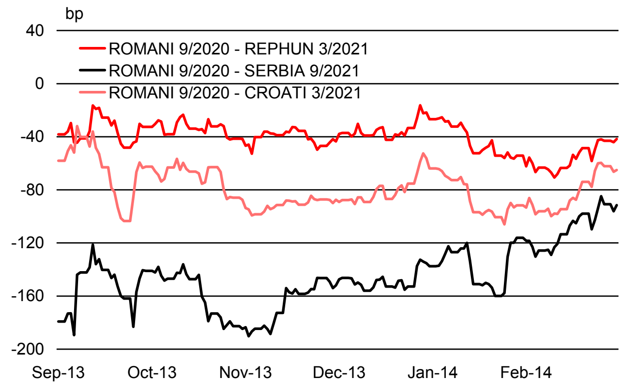
In the medium term, long-end ROMGBs remain attractive

From 4Q14 onwards, we see any spread widening between credit and local yields as a good entry level into long-term ROMGBs. Two things speak in favour of ROMGBs: light positioning and low financing needs. Foreign investors reduced their ROMGB holdings by EUR 0.8bn to EUR 4.1bn between May and December 2013 and their share fell by 4.7pp to 20.2%. As Romania's deficits stabilise below 3% of GDP, the average monthly issuance needed to cover local redemptions and the budget deficit is RON 4.5bn for the rest of 2014 vs. RON 5.1bn in 2013. Moreover, existing government reserves cover 5 months of gross financing needs.

Foreign holdings of Romanian T-bonds and T-bills fell in 2H13



Romanian FX bonds underperformed regional peers in 2014



Source: NBR, MinFin, Bloomberg, UniCredit Research

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2013E	2014F	2015F
Gross financing requirement	**15.9**	**14.0**	**13.3**
Budget deficit	3.6	3.7	3.5
Amortisation of public debt	12.3	10.3	9.8
Domestic	11.2	9.1	7.0
Bonds	4.7	6.2	3.9
Bills	6.1	2.6	2.8
Loans	0.4	0.4	0.3
External	1.1	1.2	2.9
Bonds and loans	0.2	0.2	1.2
IMF/EU/IFIs	0.9	1.0	1.7
Financing	**15.9**	**14.0**	**13.3**
Domestic borrowing	12.6	11.5	10.8
Bonds	9.6	7.9	8.0
Bills	2.6	3.3	2.5
Loans	0.4	0.4	0.3
External borrowing	3.3	2.5	2.5
Bonds	3.1	2.5	2.5
IMF/EU/WB	0	0	0
Other	0.2	0	0

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2013E	2014F	2015F
Gross financing requirement	**38.2**	**37.0**	**36.0**
C/A deficit	1.5	1.5	2.3
Amortisation of medium to long term debt	16.4	16.0	14.4
Government/central bank	4.7	4.6	4.1
Banks	4.5	4.9	4.4
Corporates	7.1	6.6	5.9
Amortisation of short term debt	20.3	19.5	19.3
Government/central bank	1.1	0.5	0.4
Banks	5.3	4.8	4.5
Corporates	13.9	14.2	14.4
Financing	**38.2**	**37.0**	**36.0**
FDI	2.6	2.5	2.5
Equity	0.6	0.3	0.1
Borrowing	29.8	30.2	30.5
Government/central bank	3.2	2.1	2.7
Banks	7.3	8.3	8.3
Corporates	19.3	19.8	19.5
EU Funds - capital transfers	3.1	3.4	3.8
Change in FX reserves (reduction(+)/increase(-))	2.1	0.6	-0.9

Source: UniCredit Research

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

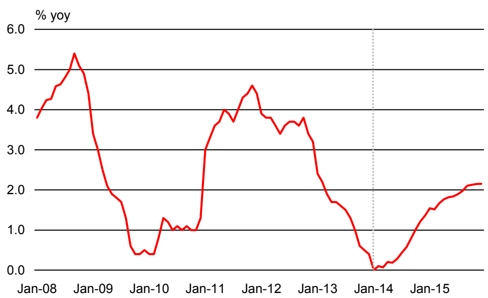
Outlook – Economic growth is expected to rebound in the coming quarters, driven by a recovery of external demand and rebounding domestic demand supported by positive fiscal impulses in 2014. FT surplus will narrow due to accelerating imports, driven by recovering domestic demand, but will still remain a main driver of the CA surplus. Fiscal tightening is supposed to end in 2014 due to several elections, but the public finance deficit is still projected to be within 3% of GDP. If PM Fico is elected president, he will most likely be pro-active in increasing the government's role in the economy, while the debt brake will be suspended for the next four years. If not, he will remain prime minister, while public debt is legal thresholds.

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

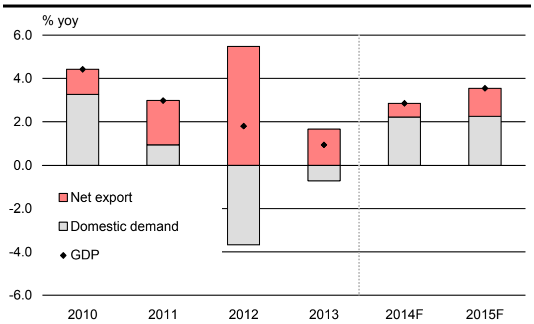
KEY DATES/EVENTS

- March 29 – Presidential elections
- Apr 10, May 12, Jun 10 – Industrial production
- Apr 14, May 14, Jun 12 – CPI
- May 15 – flash GDP
- Jun 4 – GDP and its structure

INFLATION DECELERATES



NET EXPORTS AS A MAIN GROWTH DRIVER OF SLOVAK ECONOMY



Source: Statistical Office SR, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2011	2012	2013E	2014F	2015F
GDP (EUR bn)	69.0	71.1	72.1	74.3	77.4
Population (mn)	5.4	5.4	5.4	5.4	5.4
GDP per capita (EUR)	12 777	13 147	13 325	13 728	14 297
Real economy yoy (%)					
GDP	3.0	1.8	0.9	2.9	3.6
Private Consumption	-0.5	-0.2	-0.1	1.8	2.5
Fixed Investment	14.2	-10.5	-4.3	3.9	3.8
Public Consumption	-4.3	-1.1	1.4	0.5	1.0
Exports	12.2	9.9	4.5	5.8	7.2
Imports	9.7	3.3	2.9	6.0	6.9
Monthly wage, nominal (EUR)	786	805	824	842	867
Unemployment rate (%)	13.5	14.0	14.2	13.8	13.3
Fiscal accounts (% of GDP)					
Budget balance	-5.1	-4.5	-2.9	-2.8	-2.6
Primary balance	-3.5	-2.5	-1.0	-0.9	-0.5
Public debt	43.4	52.4	54.9	56.7	57.0
External accounts					
Current account balance (EUR bn)	-1.4	1.6	1.7	1.2	1.1
Current account balance/GDP (%)	-2.1	2.3	2.4	1.6	1.4
Basic balance/GDP (%)	-0.8	4.2	3.8	3.1	2.9
Net FDI (EUR bn)	1.5	2.2	1.1	1.4	1.6
Net FDI (% of GDP)	2.2	3.1	1.6	1.9	2.1
Gross foreign debt (EUR bn)	52.9	53.8	61.6	64.3	67.1
Gross foreign debt (% of GDP)	76.7	75.6	85.4	86.5	86.7
FX reserves (EUR bn)	EUR	EUR	EUR	EUR	EUR
Inflation/Monetary/FX					
CPI (pavg)	3.9	3.6	1.4	0.5	1.9
CPI (eop)	4.4	3.2	0.4	1.4	2.2
EURIBOR 3M	EUR	EUR	EUR	EUR	EUR
EUR/USD (eop)	EUR	EUR	EUR	EUR	EUR
EUR/USD (pavg)	EUR	EUR	EUR	EUR	EUR

Source: UniCredit Research

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

Presidential elections to determine future of debt brake

Presidential elections scheduled for March

The second round of presidential elections is scheduled for 29 March. No president was elected in the first round, as he would have needed to get 50% of all possible votes (not only of those participating in the elections). The winner of the first round was PM Robert Fico, but the results were closer as expected as part of the PM's supporters did not attend the first round considering it a formality. PM Fico decided to run a presidential campaign as prime minister, while he will only resign in case he is elected. His rival for the second round will be one of the right-wing candidates, entrepreneur and locally well-known philanthropist Andrej Kiska. Kiska's main strength (and at the same time main weakness) is a lack of political experience. The second round is expected to be open and very close, depending on the mobilization of those opposed to Fico and on support of defeated right-wing candidates for the one advancing to the second round. We see the chances of PM Fico being elected president at 50:50. Nevertheless, if he is elected, it will have meaningful economic and political implications.

If PM Fico is elected, the debt brake will be suspended for the next four years

Technically, a new government would be set up after the PM resigns. However, the debt brake law includes two years of suspension after a new government takes office. Taking into account regular general elections scheduled for 2016, the debt brake would be suspended for the next four years. Consolidation of public finances stopped already in 2014 due to elections, pushing public debt closer to the 57% of GDP threshold, implying a balanced budget proposal for election year 2016. Suspending the debt brake will allow the government to exceed the threshold without consequences. It is likely that the new government will try to keep public debt close to the threshold, as ruling Social Democrats are very sensitive to financial market reactions, but any radical measures will be probably not be considered. If PM Fico is not elected, new measures, incl. unconventional measures, are likely to be approved to a balanced budget in an election year. If elected, Robert Fico will probably be a very pro-active president, maintaining a strong influence on the ruling Social Democrats, even though the president has mostly a representative role in the political system of the country.

Debt Agency already covered almost 40% of 2014 financing needs

The state budget suggests that the deficit is in line with the approved budget. Slightly higher expenditures are compensated for by better-than-expected tax revenues. Approved tax fraud measures started to deliver their first results, while those extra-revenues were not budgeted, as the government tried to be conservative. Meanwhile, after a quiet 2H of 2013, the debt agency was again more active, issuing EUR 2.8 bn of new bonds (incl. syndicate and private placement) in the first two months of this year, covering almost 40% of 2014 financing needs.

Economic growth is expected to accelerate, driven by both domestic and external demand

Economic growth in 4Q exceeded expectations, rising 0.4% qoq sa / 1.5% yoy, driven by recovering industry and rebounding construction supported by favorable weather conditions and a resumption of public investment (highways). We expect GDP to accelerate further, reaching 2.9% in 2014 and 3.6% in 2015. The trends from the end of the year should continue in 2014. GDP should be driven mainly by domestic demand, while the contribution of net exports should decrease due to increasing imports.

Foreign trade surplus to shrink due to accelerating imports

Foreign trade surplus already started to shrink due to recovering imports (driven by rebounding domestic demand) in 4Q, declining from 6.4% of GDP in September to 5.9% of GDP in December. FT surplus should continue to narrow in 2014, even despite accelerating exports of manufactured goods driven by recovering external demand. Nevertheless, FT is expected to be still a main driver of the CA surplus in coming years.

No inflation at the moment

Economic growth is expected to have a positive impact on the labor market – employment should resume growth, pushing down the unemployment rate again below 14%. Nominal wage growth should lag behind labor productivity growth, but low inflation will boost real wages. Inflation should remain anchored at low levels, with some acceleration only in 2H, driven by recovering demand-pull inflation.

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

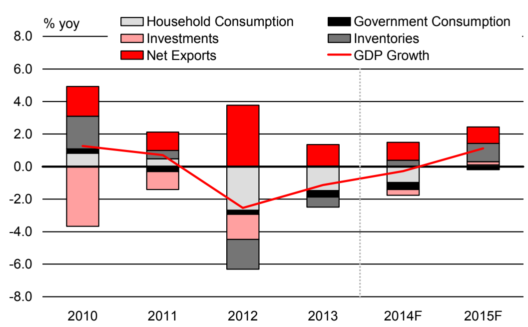
Outlook – Despite encouraging 4Q13 GDP growth numbers, the Slovenian economy is expected to remain in recession this year, resulting from a vicious circle of strained corporate and bank balance sheets, weak domestic demand and required austerity. The bank recapitalizations that followed the AQR and ST exercises are a step in the right direction, but the size of NPLs transferred to the BAMC should be increased to include restructured loans from over-indebted companies to avoid further erosion of restored bank capital buffers. Meanwhile, additional budget savings of 1.4pp of GDP will be required this year to bring the deficit into balance, while the debt ratio will surge to 80% of GDP by end-2015. On a more positive note, market conditions have improved while sovereign cash buffers are large, which should help meet this year's funding needs and avoid any form of foreign assistance.

Author: Carlos Ortiz, Economist (UniCredit Bank London)

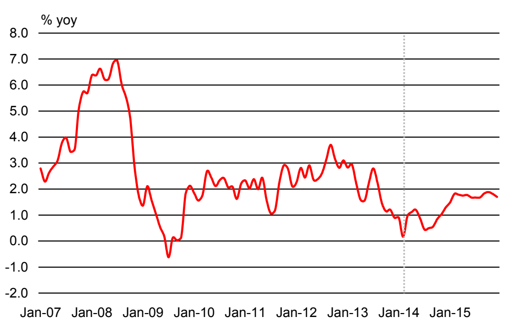
KEY DATES/EVENTS

- 25 Mar, 10 Apr, 09 May, 10 June – Industrial Production
- 31 Mar, 30 Apr, 30 May – Retail Sales
- 31 Mar, 30 Apr, 30 May – Consumer Price Index
- 09 Apr, 09 May, 09 Jun – Trade Balance
- 30 May – 1Q14 GDP

GDP GROWTH TO RESUME IN 2015



INFLATION TO REMAIN STABLE



Source: NBS, MinFin, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2011	2012	2013E	2014F	2015F
GDP (EUR bn)	36.2	35.3	35.5	35.7	36.5
Population (mn)	2.1	2.1	2.1	2.1	2.1
GDP per capita (EUR)	17,610	17,183	17,236	17,242	17,604
Real economy yoy (%)					
GDP	0.7	-2.5	-1.1	-0.3	1.1
Private Consumption	0.8	-4.8	-2.7	-1.8	0.2
Fixed Investment	-5.5	-8.2	0.2	-2.0	1.1
Public Consumption	-1.6	-1.3	-2.0	-2.2	-1.0
Exports	7.0	0.6	2.9	3.5	4.2
Imports	5.6	-4.7	1.3	2.4	3.4
Monthly wage, nominal (EUR)	1,525	1,526	1,523	1,546	1,554
Unemployment rate (%)	8.2	8.9	10.2	10.6	10.3
Fiscal accounts (% of GDP)					
Budget balance	-6.3	-3.8	-14.7	-4.8	-3.7
Primary balance	-4.4	-1.7	-11.9	-1.7	-0.5
Public debt	47.1	54.4	71.9	77.9	79.9
External accounts					
Current account balance (EUR bn)	0.1	1.2	2.3	2.4	2.3
Current account balance/GDP (%)	0.4	3.3	6.4	6.6	6.3
Basic balance/GDP (%)	2.2	3.8	4.9	7.3	7.5
Net FDI (EUR bn)	0.6	0.2	-0.5	0.3	0.4
Net FDI (% of GDP)	1.8	0.5	-1.5	0.7	1.2
Gross foreign debt (EUR bn)	40.1	40.8	39.6	41.1	43.1
Gross foreign debt (% of GDP)	110.9	115.7	111.4	115.2	118.2
Inflation/Monetary/FX					
HICP (pavg)	2.1	2.8	1.9	0.8	1.7
HICP (eop)	2.1	3.1	1.1	1.3	1.7
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

Not out of the woods yet, but recovery is underway

GDP contraction is expected to ease to 0.3% this year, followed by a mild recovery in 2015

The Slovenian economy has seen a slowdown in the pace of its contraction, but is expected to remain in recession this year on the back of fragile domestic demand. However, 4Q13 GDP showed welcoming signs of adjustment, after the economy expanded by 2.1% yoy for the first time in eight quarters. Most of the upswing was attributed to strong GFCF (up 5.9% yoy vs. -9% in 9M13), as well as to outperforming exports (up 3.7% yoy). Altogether, this allowed the economy to ease its contraction last year to 1.1% yoy, 1.3pp higher than forecasted. Looking ahead, we expect the economy to contract by 0.3% yoy (vs. prior estimate of -0.9% yoy), with a fragile recovery starting only from mid-2H14. Weak private consumption will continue to weigh on growth, albeit to a lessen extent than last year, on the back of increased austerity and tighter consumption credit (down 10.8% yoy in 2013). Public consumption and investments will subtract a further 0.8pp from GDP growth, although offset by the strong push of net external demand due to the EMU recovery. This should also help keep the C/A surplus in excess of 6% of GDP throughout the entire forecast horizon.

Recaps to Slovenia's three largest state-owned banks came in at a manageable EUR 3bn…

Banking sector reform is finally underway, but over-leveraged corporate sector will keep NPLs at high levels. As expected, the AQR and ST exercise conducted during 2H13 showed system-wide baseline bank recap costs of EUR 4bn (stress case EUR 4.8bn), of which EUR 3bn was required at Slovenia's three largest domestic banks. However, only 2/3 of the capital injected on 18 December was financed in cash (EUR 2.1bn), with the remaining 1/3 (or EUR 0.9bn) via government bonds. This followed the transfer of EUR 1.1bn in NPLs from NLB (EUR 0.7bn) and NKBM (EUR 0.4bn) to the BAMC, with the remaining EUR 0.5bn from Abanka expected to be completed by April once DG COMP gives approval of its restructuring program. Even so, transfers will only bring the NPL ratio at the three domestic banks down to just over 12% this year (from 21.6% in November), still much higher than the 4-5% pre-crisis levels. What's more, the transfers do not include restructured loans to over-indebted companies (possibly representing 'ever-greening'), although these account for more than half of all new loans (64% in the three state-owned banks) and over 30% of banks' NPLs. Hence, we favor transferring a greater share of impaired assets to the BAMC, as otherwise this risks further increasing provisioning needs and gradually erode restored bank capital buffers.

…at the expense of a soaring budget deficit and public debt ratio

Public finances are in need of further consolidation, as banking sector support and unaccounted expenditure one-offs have proved larger than planned. In particular, the budget deficit in 2013 increased to 14.7% of GDP (from 3.8% of GDP in 2012), with bank and SOE recapitalizations accounting for as much as 10.4pp of GDP. This year, the budget deficit is projected at 4.8% of GDP, still considerably higher than the 3.3% EDP objective. This adds EUR 240mn (or 0.7pp of GDP) in recap needs for Abanka, in addition to unbudgeted expenditure items totaling EUR 0.5bn (or 1.3pp of GDP) resulting from the ice storm, higher public sector wages and compensation to persons removed from the Slovenian registry after independence. While we welcome the recent tax reforms, the temporary suspension of the real estate tax by the Constitutional Court on 1 January poses additional downside risks to budgeted revenues. Consequently, additional consolidation measures of 1.4pp of GDP will be required this year to meet EDP targets, preferably centered on cuts to subsidies, transfers and public sector employment. Even so, public debt will continue to rise rapidly, with the debt-to-GDP ratio expected at 77.9% of GDP by year-end. This compares to an EU average of 89.7% of GDP, while doubles the debt stock enjoyed in 2010.

Improved market conditions are keeping the government's funding plan on track

The good news is that funding and liquidity conditions have improved, with the yield on May 2023 USD paper dropping as much as 251bp to 4.8% since end-June. February's 5Y (USD 1.5bn) and 10Y (USD 2bn) Eurobonds also priced favorably vis-à-vis May of last year (down 45bp and 48bp, respectively), while covering half of this year's gross funding needs (EUR 5.1bn). Adding pre-funding funding plans for 2015 (EUR 1.4bn), coverage stands at 42%. Even more importantly, the government's cash position stands at a comfortable EUR 5bn, enough to accommodate April's EUR 1.7bn bond redemption and any potential recapitalizations to Gorenska Banka (EUR 0.3bn) and Banka Celije (EUR 0.4bn) should they fail to attract private capital by end-June.

Bosnia and Herzegovina (B3 stable/B stable/Not Rated)*

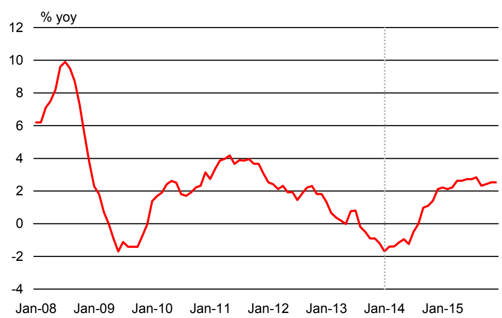
Outlook – As the pace of recovery in economic activity during the second half of 2013 was much stronger than expected, we have upgraded our GDP growth estimate for 2013 from 0.9 % to 1.5%. For 2014, we keep our earlier forecast of 1.5%, as we do not see the possibility for a significant acceleration of growth in an environment of high unemployment and low households' disposable income. Private investment is still weak, while contributors to growth will be foreign demand and pending infrastructure projects (focus on highway construction on Corridor Vc). The IMF approved an extension and augmentation of the Stand-By Arrangement by an additional nine months until June 2015 and an additional EUR 154mn, but some of the conditions could become very challenging in light of the upcoming general elections.

Author: Hrvoje Dolenec, Chief Economist (Zagrebačka banka)

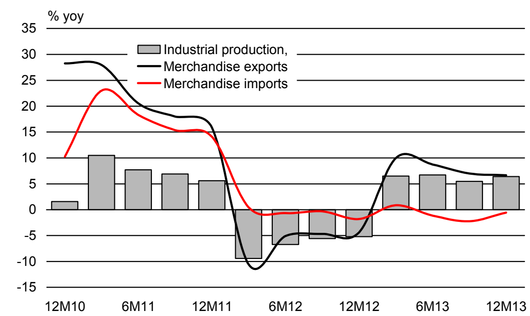
KEY DATES/EVENTS

- 22 April: Foreign trade Jan-Mar 2014
- 20 June: GDP for 4Q13 and FY 2013
- July 2014: Preliminary results of population census
- October 2014: General elections

CPI EXPECTED TO SLOW



MERCHANDISE EXPORTS



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

MACROECONOMIC DATA AND FORECASTS

	2011	2012	2013F	2014F	2015F
GDP (EUR bn)	13.2	13.2	13.3	13.6	14.3
Population (mn)	3.8	3.8	3.8	3.8	3.8
GDP per capita (EUR)	3,432	3,430	3,479	3,542	3,717
Real economy yoy (%)					
GDP	1.0	-1.2	1.5	1.5	2.5
Monthly wage, nominal (EUR)	650	660	661	675	691
Unemployment rate (%)	43.3	44.1	44.6	44.3	44.0
Fiscal accounts (% of GDP)					
Budget balance	-1.3	-2.0	-2.3	-2.1	-1.6
Primary balance	-0.5	-1.3	-1.4	-1.2	-0.7
Public debt	38.7	40.7	42.7	42.7	40.3
External accounts					
Current account balance (EUR bn)	-1.3	-1.3	-0.9	-0.9	-1.0
Current account balance/GDP (%)	-9.7	-9.6	-6.7	-7.0	-7.3
Basic balance/GDP (%)	-7.2	-7.5	-4.1	-3.6	-3.3
Net FDI (EUR bn)	0.3	0.3	0.4	0.5	0.6
Net FDI (% of GDP)	2.6	2.1	2.7	3.4	3.9
Gross foreign debt (EUR bn)	6.7	6.9	7.0	7.2	7.4
Gross foreign debt (% of GDP)	51.0	52.3	52.3	52.8	52.2
FX reserves (EUR bn)	3.3	3.3	3.6	3.7	3.7
Inflation/Monetary/FX					
CPI (pavg)	3.7	2.1	-0.1	-0.2	2.5
CPI (eop)	3.1	1.8	-1.2	2.1	2.5
3M money market rate	1.18	0.33	0.12	0.13	0.75
USD/BAM (eop)	1.51	1.48	1.42	1.40	1.35
EUR/BAM (eop)	1.96	1.96	1.96	1.96	1.96
USD/BAM (pavg)	1.41	1.52	1.47	1.43	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, S&P and Fitch respectively

Challenging environment for reform implementation

GDP growth estimate for 2013 raised due to strong recovery in exports and industrial production

As domestic demand is still subdued, the impulses for a moderate pace of growth come from external demand and highway construction. Preliminary data for 3Q13 point to an identical moderate pace of growth as during 2Q – real GDP has again increased by 1.7% yoy. Following a faster pace of growth in 1Q (2.3% yoy), overall growth in 2013, assuming a slowdown in 4Q, should reach 1.5%. Less favourable base effects and some one-off impulses (e.g. favorable hydrological conditions for strong growth in production and exports of electricity) probably reduced the pace of growth in the fourth quarter and at the beginning of 2014. The major contribution to growth in 2013 came from manufacturing industry, production and distribution of electrical power, and agriculture on the production side, while on the expenditure side net exports made a crucial impact. Industrial production rose by 6.4% in 2013, with capital goods production growth of 19.3%. The textile and chemical industry also made a huge contribution to overall manufacturing growth, with a rise of 32.4% and 17.9%, respectively. Construction activity is still weak, especially its residential component (construction of apartments fell by more than 30% in comparison with 2012).

Current account deficit continued to narrow to the 6.7% of GDP on the back of exports of goods growth of 6.6% yoy

During the last year, merchandise exports increased 6.6%, while at the same time imports decreased by 0.5 % yoy. Therefore, the current account deficit continued to narrow to an estimated level of 6.7% of GDP. Exports of electricity, with growth of 214.3% yoy, were the most important component of overall export growth. Exports of agricultural products also increased by more than 30%, as well as exports of mineral fuels and plastics in primary forms. Net FDI remained at a low level, with a GDP share lower than 3%. With the very low level of employment (only slightly higher than 34% on ILO methodology) and stagnant real wages, a revival of private consumption seems very unlikely. Moreover, with some methodological changes in CPI calculations and weak domestic demand, deflationary developments dominated – the year-end level of consumer prices declined by 1.2% yoy, while the average CPI for the full year was lower by 0.1%. During 2014, a moderate increase in inflation can be expected (to levels of around 2% by year-end). However, due to the base effect and negative carry-over from 2013, the average price level could be again lower than in the preceding year (-0.2%).

Compliance with negotiated SBA extension preconditions becomes challenging in a year of general elections

SBA agreement: Fulfilling the criteria associated with the fiscal consolidation targets of the Stand-By Arrangement with the IMF (limiting the general government deficit to around 2% of GDP) also restrained a potentially more powerful revival of the economy. So far, five reviews were concluded, allowing for disbursement of EUR 288mn (out of EUR 384mn from the original arrangement). Continued adherence to conditionality will be a very challenging task for policy makers in an election year, given an unemployment rate of 44.6% and recent short but occasionally violent protests from some of the population. With such a backdrop, it is unlikely that policy makers will reach a compromise on labor law changes before October general elections, which would allow for more flexibility. However, this became one of the most important preconditions, set by the IMF, for an extension and augmentation of the current Stand-By Arrangement (extension until June 2015 and an additional EUR 154mn). According to the last statement, released after the conclusion of the IMF mission in February for the sixth review, the IMF is demanding that BH authorities strengthen tax collection, contain government spending and improve the business environment. This also includes measures to tackle corruption, such as a new procurement law and legislation to fight money laundering.

Sovereign rating remains stable, but lack of agreement on high level policy agenda continues to affect the reform dynamics

EU accession and sovereign rating. The inability to resolve another political issue – constitutional changes to satisfy the electoral rights of persons belonging to national minorities after the Sejdic–Finci ruling – remains a fundamental obstacle for starting the EU accession process. A further delay in finding a solution could bring into question not only the submission of applications of Bosnia and Herzegovina for candidate status, but also further slow down the necessary reforms, and indirectly threaten the current level of credit rating (B3 stable at Moody's, B stable at S&P).

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

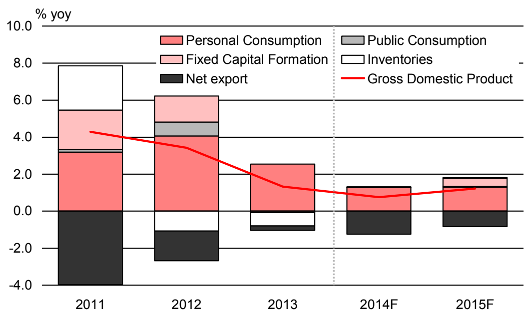
Outlook – Amidst significant uncertainty, we are reducing our growth forecast for both this year and next. This downward revision captures the combination of a cyclical downturn but also structural constraints to recovery. Geopolitical uncertainty adds to downward pressure on growth, not least via both domestic and foreign capital flows. The CBR has hiked interest rates while also increasing its sales of FX to the market. While from a fundamental perspective RUB is undervalued, the BoP is not supportive of currency appreciation. Despite heightened uncertainty and weak growth, we see limited scope for either fiscal or monetary policy to support activity.

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

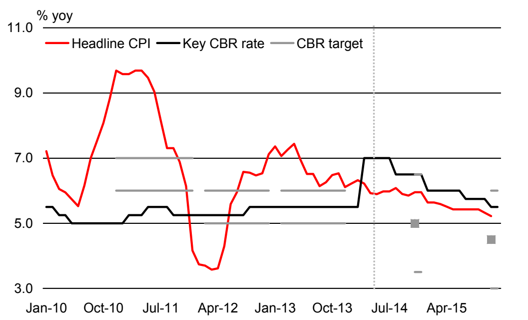
KEY DATES/EVENTS

- 18-23 of every month – short-term statistical overview
- April 25 and June 16 – CBR decision on rates
- 1-5 of every month: Manufacturing & services PMI

DOMESTIC DEMAND WEAKENS



INFLATION TO DECELERATE



Source: Federal Statistical Service, CBR, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2011	2012	2013E	2014F	2015F
GDP (EUR bn)	1,335.5	1,556.1	1,572.6	1,417.2	1,437.8
Population (mn)	143.1	142.9	142.7	142.5	0.1
GDP per capita (EUR)	9,336	10,893	11,023	9,948	10,107,142
Real economy yoy (%)					
GDP	4.3	3.4	1.3	0.5	1.2
Private Consumption	6.8	7.9	4.7	2.3	2.3
Fixed Investment	9.1	6.4	-0.3	0	1.8
Public Consumption	1.4	4.2	-0.1	0	0.1
Exports	0.3	1.4	3.8	-1.0	0
Imports	20.3	8.8	5.9	2.5	3.2
Monthly wage, nominal (EUR)	580	675	696	638	635
Unemployment rate (%)	6.6	5.3	5.4	5.8	6.2
Fiscal accounts (% of GDP)					
Budget balance	0.8	0	-0.5	-0.2	-1.2
Primary balance	1.3	0.2	-0.1	0.2	-0.7
Public debt	9.8	10.2	11.7	11.9	13.4
External accounts					
Current account balance (EUR bn)	79.5	63.2	24.8	20.2	14.1
Current account balance/GDP (%)	6.0	4.1	1.6	1.4	1.0
Basic balance/GDP (%)	4.8	3.8	1.0	1.2	0.9
Net FDI (EUR bn)	-11.8	-4.7	-9.5	-3.7	-1.1
Net FDI (% of GDP)	-1.2	-0.3	-0.6	-0.3	-0.1
Gross foreign debt (EUR bn)	424.3	485.1	531.6	565.4	575.1
Gross foreign debt (% of GDP)	31.8	31.2	33.8	39.9	40.0
FX reserves (EUR bn)	384.7	407.3	387.1	349.7	351.9
Inflation/Monetary/FX					
CPI (pavg)	8.6	5.1	6.8	6.1	5.8
CPI (eop)	6.1	6.6	6.5	6.1	5.4
Central bank inflation target	6-7	5-6	5-6	5.00	4.50
Central bank reference rate (eop)	5.25	5.50	5.50	6.75	6.00
3M money market rate	6.60	7.45	7.08	7.50	6.75
USD/RUB (eop)	31.33	30.23	32.82	37.44	37.71
EUR/RUB (eop)	41.67	39.92	44.97	52.42	54.68
USD/RUB (pavg)	29.19	31.28	31.93	36.62	37.53
EUR/RUB (pavg)	40.87	40.23	42.41	50.17	52.91

Source: UniCredit Research

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

On the brink of recession

Uncertainty is rife and we are marking down our growth forecasts

We are writing this quarterly at a time of significant uncertainty, generated by geopolitical developments between Russia, Ukraine and the West. We work under the assumption that sanctions imposed by the West on Russia will not escalate significantly but that these will remain contained to some limited bans on travel and selective freezing of assets. We also work under the assumption of no significant resumption of violence in Ukraine. Nonetheless we are aware that this situation remains subject to rapid change.

As such, while we have made substantial revisions to our forecasts, these remain subject to change. More specifically, we have reduced our growth forecast for this year to only 0.5% (previously 2%) while next year we also see growth just above 1% (previously 2.1%). A combination of poor activity YTD, further evidence of structural constraints and uncertainty generated by geopolitical developments all play a role.

Macro indicators fell short of expectations or worsened:

Macro performance in recent months has been weak…

- Industrial production remains at a standstill while Russia's manufacturing PMI is a clear underperformer across the region. Fixed investment growth has also slowed significantly and in January turned negative (-2.2% yoy), though there were base effects at play;
- The consumer continues to outperform industry, remaining the primary driver of real GDP growth, but is also experiencing a slowdown. By January retail sales growth had slowed to 2.4% yoy. This is in line with measures taken by the CBR to slow retail credit growth from high rates.

…while structural constraints to growth are increasingly evident

This cyclical downturn is not translating into evidence of increasing spare capacity, highlighting the structural constraints to recovery. As Russia is forced to adjust to stable rather than ever-improving terms of trade and the economy slows, capacity utilisation remains high while unemployment is low.

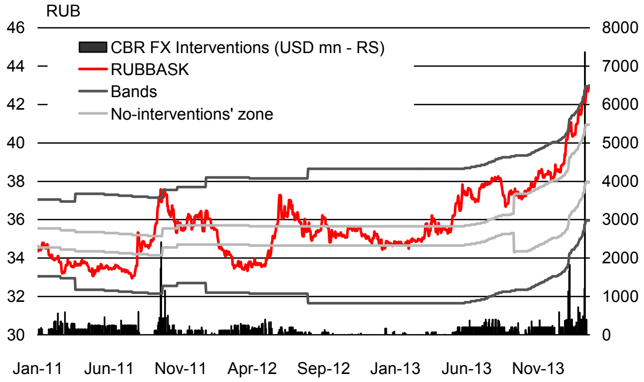
The uncertainty generated by developments in Ukraine adds further downward pressure on growth. Capital flows in particular are vulnerable:

Geopolitical developments serve only to increase uncertainty, including on capital flows

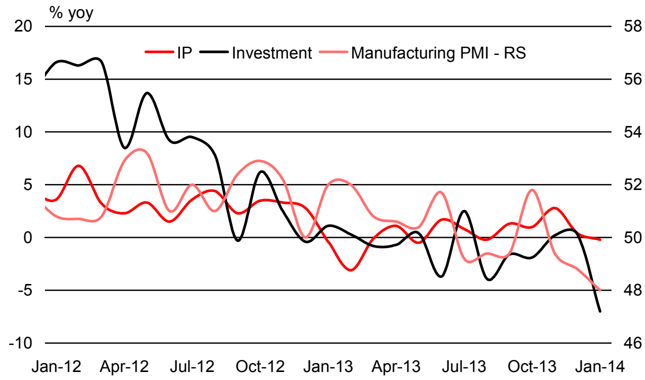
- Even prior to the removal of President Yanukovych in Ukraine, domestic capital flows in Russia were proving increasingly problematic, extending well beyond a natural recycling of oil revenues. The Ministry of Economy forecast full-year private capital flows for 2014 at USD 35bn but already in January these outflows reached USD 17bn. There is also a risk of domestic household deposit conversion of RUB deposits into FX. In late 2008 household FX deposits rose from less than 15% to over 30% of total within a matter of months;

RAPID RUB DEPRECIATION THIS YEAR WAS LINKED TO GENERALLY WEAK ECONOMIC PERFORMANCE

The RUB depreciated despite strong FX interventions…



...as the economy continues its structural slowdown



Source: Rosstat, CBR, UniCredit Research

- Russia's C/A surplus and domestic capital flows sum to a negative 7.3% of GDP. By the end of last year, Russia's C/A surplus was at its narrowest since 1998. All of the above leaves the economy increasingly reliant on foreign capital inflows. There is positive news to the extent that FDI represents the largest single component of capital flows to Russia but foreign borrowing has also increased significantly in recent years. For example within the banking sector, the net foreign asset position is positive but increased offshore invesmtent masks foreign liabilities. These are now in excess of their pre-Lehman peak.

All of the above is also captured in the fact that the shift in accumulation of foreign reserves since 2008 is larger in CIS than in all other EM regions. While in 2007 CIS accumulated 10% of GDP in FX reserves, this have now turned negative in Russia.

Policy action has been concentrated at the CBR…

The policy reaction to date has been concentrated within the CBR. The Bank has hiked its policy rate by 150bp to 7% while it increased the threshold for intervention for moving the currency bank from USD 350mn to USD 1.5bn. On 3 March, the CBR sold over USD 11bn of FX to the market while it had sold at least another USD6bn since. The MinFin has announced a postponement of transfers to the reserve fund which would entail it selling RUB to the market.

…as both the CBR and MinFin watch RUB losses

The combination of RUB depreciation and a weak growth environment has implications for both institutions. The CBR is acting to protect financial stability, followed by its inflation target. At 6.2% in February, inflation is more than 1pp above the CBR target while vulnerable to pass-through from currency depreciation. The MinFin wishes to protect its budget balance. Following RUB basket losses of more than 10% YTD, our fair value model suggests that RUB is undervalued while under current commodity prices the budget should be close to balanced. But the BoP is not supportive of RUB gains while there is a risk that persistent RUB depreciation feeds uncertainty and domestic capital outflows, translating into weaker growth and lower than expected government revenue, as well as further RUB losses. Government financing conditions have already deteriorated as the MinFin cancelled OFZ issues over the past two weeks. If investors do not want to buy Russian government bonds for an extended period of time, compliance with the budget rule will become more difficult.

No easy solution to weak growth

All of the above means that there is no obvious stimulus to compensate for weaker growth. At its most recent rate decision, the CBR signalled that the rate hike will remain in place for a number of months. We are concerned that the combination of BoP dynamics and above target inflation will mean that most if not all of it will prove irreversible. The government's budget rule constrains any fiscal stimulus.

THE RUSSIAN FINANCIAL MARKET HAS BEEN UNDER PRESSURE IN 2014

THE CBR intervened to smooth depreciation

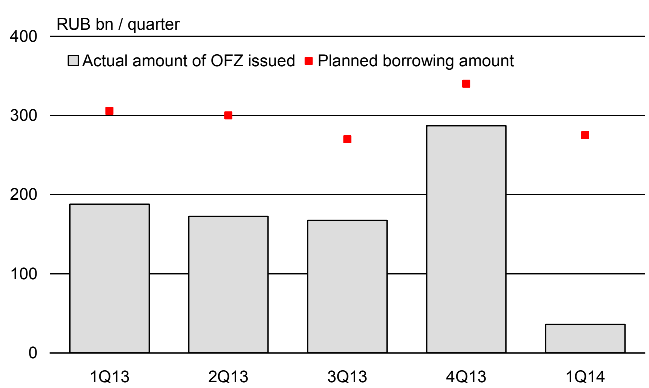
Date		< 7-Oct	7-Oct	21-Oct	10-Dec	13-Jan	3-Mar	
CBR policy intention		Total daily interventions, USD mn						
		-400	-400	-400	-400	-400	-400	
RUB support		-200	-200	-200	-200	-200	-200	***
	Basket width 7 RUB	-70						
'Neutral band'		0	0	0	0	0	0	
		70						
FX purchase		200	200	200	200	200	200	
		400	400	400	400	400	400	
Daily targeted interventions*		120	120	60	60	0	0	
Accumulated int. to shift band**		400	400	400	350	350	1500	

** do not influence the band, USD mn*

*** interventions that affect the basket*

*** special technical band for MinFin's operations

OFZ issuance fell well below plan in 1Q14



Source: CBR, UniCredit Research

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2013E	2014F	2015F
Gross financing requirement	**32.0**	**22.3**	**39.0**
Budget deficit	7.9	2.8	17.3
Amortization of public debt	19.6	16.1	18.6
Domestic	18.0	15.2	16.5
Bonds	18.0	15.2	16.5
Bills	-	-	-
External	1.6	0.8	2.1
Sovereign Fund	4.6	3.4	3.2
Financing	**32.0**	**22.3**	**39.0**
Domestic borrowing	24.8	17.3	27.9
Bonds	24.8	17.3	27.9
Bills	-	-	-
External borrowing	5.3	4.5	6.0
Bonds	5.3	4.5	6.0
Other	1.8	0.5	5.1

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2013E	2014F	2015F
Gross financing requirement	**34.5**	**39.2**	**52.2**
C/A deficit	-24.8	-20.2	-14.1
Amortization of debt	52.1	53.8	62.1
Government/central bank	1.6	0.8	2.1
Banks	21.50	18.00	22.00
Corporates	29.00	35.00	38.00
Errors and omissions	7.24	5.56	4.20
Financing	**34.5**	**39.2**	**52.2**
FDI	-9.5	-3.7	-1.1
Equity	-	-	-
Borrowing	128.8	105.8	83.9
Government/central bank	5.3	4.5	6.0
Banks	36.5	34.2	33.6
Corporates	87.0	67.1	44.3
Domestic investments abroad	-64.7	-25.5	-32.8
Official reserves change / other	-20.2	-37.4	2.2

Source: Rosstat, CBR, UniCredit Research

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

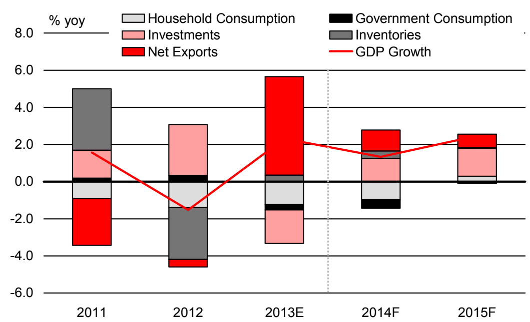
Outlook – The recovery seen in 2013 is expected to ease this year before picking up again in 2015. High base effects alongside weak domestic demand are responsible for the slowdown but increased investments linked to EU accession prospects and reforms are expected to lead the growth upswing in the medium-term. Moreover, external imbalances have corrected considerably with the C/A deficit expected to remain below 5% of GDP throughout the forecast horizon. But fiscal slippage remains a great concern, as the budget deficit is expected to widen to 7% of GDP this year in the absence of additional fiscal consolidation measures. The landslide victory of Vucic's SNS should help accelerate the pace of reform but adopting the labour, privatization and bankruptcy bills by June is a must. Securing an IMF deal this year is crucial, as Serbia requires a much needed fiscal anchor to balance its unsustainable public finances.

Author: Carlos Ortiz, Economist (UniCredit Bank London)

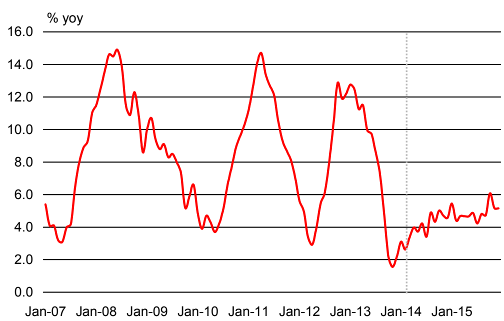
KEY DATES/EVENTS

- 31 Mar, 30 Apr – 4Q13 GDP (final), 1Q14 GDP (prelim)
- 20 Mar, 17 Apr, 20 May – Current Account Balance
- 31 Mar, 30 Apr, 30 May – Industrial Production
- 31 Mar, 30 Apr, 30 May – Retail Sales
- 11 Apr, 12 May, 12 June – Consumer Price Index
- 17 Apr, 08 May, 12 June – Policy rate decision

GDP GROWTH TO EASE IN 2014



CPI TO STABILIZE WITHIN THE TARGET BAND



Source: NBS, MinFin, Unicredit Research

MACROECONOMIC DATA AND FORECASTS

	2011	2012	2013E	2014F	2015F
GDP (EUR bn)	31.5	29.9	33.0	33.4	35.2
Population (mn)	7.6	7.6	7.6	7.6	7.6
GDP per capita (EUR)	4,160	3,945	4,335	4,390	4,616
Real economy yoy (%)					
GDP	1.6	-1.7	2.3	1.3	2.5
Private Consumption	-1.1	-1.9	-1.2	-1.4	0.6
Fixed Investment	8.4	-3.4	-6.1	5.2	8.7
Public Consumption	-0.1	1.8	-2.9	-2.3	-0.4
Exports	3.4	4.5	12.8	5.8	7.2
Imports	7.0	2.3	1.2	2.4	2.7
Monthly wage, nominal (EUR)	518	508	532	426	369
Unemployment rate (%)	23.0	23.9	22.1	22.4	21.8
Fiscal accounts (% of GDP)					
Budget balance	-4.9	-6.4	-4.8	-5.2	-4.8
Primary balance	-3.5	-4.4	-3.2	-3.7	-2.6
Public debt	48.2	59.3	60.9	67.2	69.6
External accounts					
Current account balance (EUR bn)	-2.9	-3.2	-1.5	-1.6	-1.7
Current account balance/GDP (%)	-9.1	-10.5	-4.5	-4.7	-4.8
Basic balance/GDP (%)	-3.3	-9.8	-2.2	-1.4	-1.4
Net FDI (EUR bn)	1.8	0.2	0.8	1.1	1.2
Net FDI (% of GDP)	5.8	0.8	2.3	3.3	3.4
Gross foreign debt (EUR bn)	24.1	25.7	25.8	27.3	29.5
Gross foreign debt (% of GDP)	76.7	85.9	78.3	81.6	84.0
FX reserves (EUR bn)	12.1	10.9	11.2	11.4	10.9
Inflation/Monetary/FX					
CPI (pavg)	11.6	7.3	7.9	4.0	4.9
CPI (eop)	7.0	12.2	2.2	5.5	5.1
Central bank target	4.5±1.5%	4.0±1.5%	4.5±1.5%	4.5±1.5%	4.5±1.5%
Central bank reference rate (eop)	9.75	11.25	9.50	8.50	9.00
BELIBOR 3M	12.88	11.64	10.15	8.20	9.30
USD/RSD (eop)	78.68	86.12	83.68	84.64	83.45
EUR/RSD (eop)	104.64	113.72	114.64	118.50	121.00
USD/RSD (pavg)	72.82	87.97	85.16	85.80	85.11
EUR/RSD (pavg)	101.95	113.13	113.09	117.55	120.00

Source: Unicredit Research

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

New government in need of deep fiscal reform

GDP growth in 2013 revised up 0.5pp to 2.3% yoy due to a stronger expansion in 2H

Following a year of recovery in 2013, led by exports, growth is set to slow down this year as the expected (and welcomed) uptick in investments is neutralised by weak domestic consumption. High base effects will also a play a role, particularly after the strong GDP upswing seen in 2H13. Final 4Q13 GDP data will be released on 31 of March, but the preliminary figure already showed growth at 2.6% yoy (vs. 3.7% yoy in 2Q13), bringing FY13 growth to 2.4% yoy (vs. government forecast of 2% yoy). The strong contraction of the trade deficit in 4Q13 (down 16.6% yoy) suggest that most of this growth came from Fiat-driven intermediate and capital goods exports in addition to the strong agricultural yields derived from the good harvest. We do not expect much of an improvement in 4Q13 GDP to come from domestic demand.

Base effects and weak domestic consumption behind the GDP slowdown this year….

…though expected to pick-up in 2015 due to growing investments and private consumption

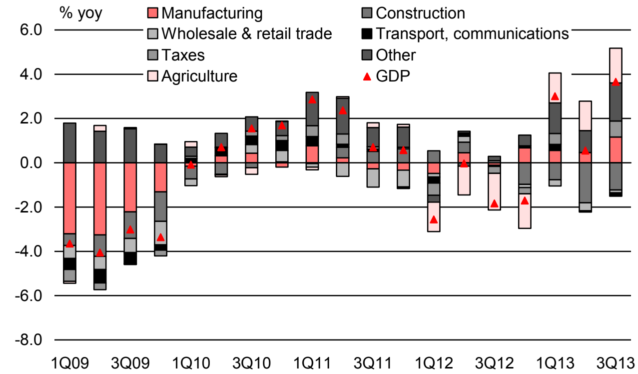
Growth this year is expected to ease to 1.3% yoy, as base effects will bring export growth to 5.8% yoy. The contribution from Fiat is expected to flatten on the back of unchanged production plans, with most of the export push coming from German-led EMU recovery (EMU: 0.9% yoy; Germany: 2.5% yoy). Weak domestic consumption will also contribute to the slowdown, with the biggest hit likely to be seen on public expenditures due to austerity (FY14 drop at 2.1% yoy). Note that a revised budget is to be presented in 2H14, and likely to result in budget savings of close to 1pp of GDP. Private consumption is also set to weaken further (FY14 drop at 1.4% yoy), in response to the solidarity tax, reduced wage and pension indexations, and freezing of public sector hiring. By contrast, investment activity is expected to catch-up and add close to 1.2pp to GDP this year. This assumes improving FDI as well as a slow but steady improvement in the business environment following the expected adoption of the privatization, bankruptcy and labour bills at end-June. Strong investments are also behind the growth pick-up in 2015, and are expected to have a prominent role in Serbia's recovery on the back of EU accession progress.

We expect the NBS to cut rates in 2H14 by a minimum of 100bps provided the dinar and inflation stabilize

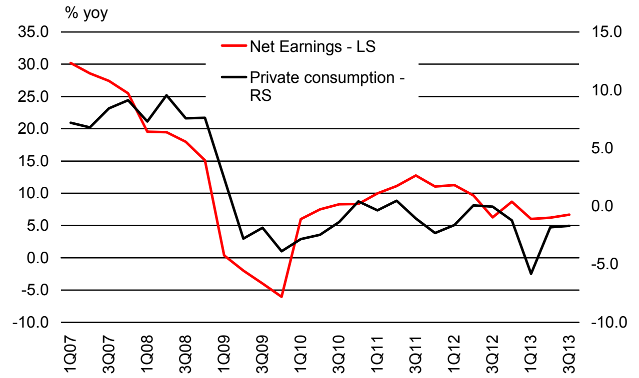
Dinar weakness and heightened EM risks means the NBS maintains a cautious rate stance. Note that inflation has been accelerating since November, converging to within the NBS's 4±1.5% target band already in January (i.e. 3.1% yoy). The 2pp hike to the reduced VAT rate and seasonal increases in vegetable and transport prices supported this, but are expected to continue feeding into headline CPI in the coming months. FX pass-through from dinar depreciation (up 1.1% YTD) will add further pressure, but growing EM contagion and impact of Fed taper pose the biggest risks. An unchanged policy rate in the coming quarter will help contain these pressures. The NBS is also stabilising RSD via FX intervention (EUR 760mn sold YTD). That said, we welcome rate cuts during 2H14, provided inflation and the dinar stabilize and fiscal consolidation takes hold. Otherwise, this would keep Serbia running high real rates for an unnecessarily long period of time.

GDP GROWTH CONSTRAINED BY WEAK PRIVATE DEMAND

Manufacturing and agriculture are supporting GDP growth…



…but weak private consumption continues to drag domestic demand



Source: National Bank of Serbia, MinFin, UniCredit Research

C/A deficit to remain below 5% of GDP until 2015; funding to improve due to rising FDI

External imbalances have improved at a rapid pace, with the C/A deficit between Jan-Nov 2013 narrowing by 54.7% yoy to EUR 1.2bn (or 3.6% of GDP). This has been mainly due to rising automobile and agricultural exports, alongside with rising net transfers, up 7.3% yoy to EUR 2.9bn up to November. For end-2013, we expect the C/A balance at EUR 1.5bn (or 4.5% of GDP). That said, the room for further adjustment in the C/A deficit is likely to be exhausted by 2015 on the back of unchanged Fiat production plans and slow but steady recovery of domestic and import demand. Funding-wise, the C/A remains highly dependant on net portfolio capital (FY13 at EUR 1.8bn or 5.4% of GDP) while FDI remains smaller (EUR 0.7bn or 2.3% of GDP). On a more positive note, FDI has improved from 2012 lows (EUR 0.2bn) and is expected to grow this year to EUR 1.1bn (or 3.2% of GDP) following increased FDI projects with the UAE (i.e. agriculture, IT, reconstruction of Belgrade river bank), and new automotive deals with Truck-Lite and Mercedes. Starting the construction of the Southstream gas pipeline would add further to the FDI impulse, but is currently on halt after Srbijagas failed to secure EUR 75mn in initial capital from state guarantees at end-2013.

Additional budget savings of at least 1pp of GDP per year will be required to reduce the deficit to 3% by 2017

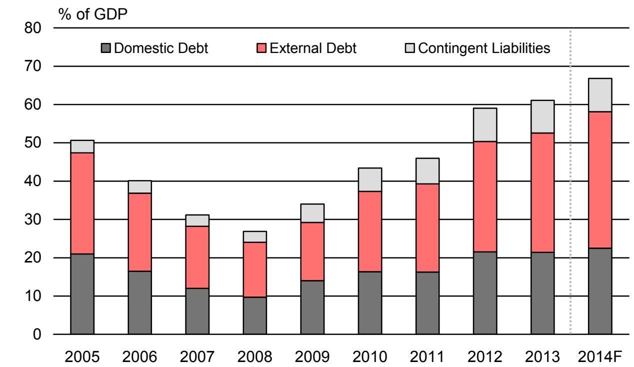
Fiscal slippage remains a big concern but the new SNS-led government should speed up reforms ahead. In particular, we see the budget deficit this year widening to 5.2% of GDP (vs. 4.8% in 2013), attributed mainly to rising purchases of goods and services and interest payments. Adding below-the-line contingent payments (est. 1.7% of GDP), the deficit this year would rise to 6.9% of GDP (vs. 5.6% in 2013), placing the public debt ratio at 65% of GDP. While we welcome October's fiscal package, we believe additional savings of at least 1pp of GDP will have to be made in the revised budget, particularly if the government aims to secure an IMF deal this year. Note that expenditures on both pensions (13% of GDP) and public sector wages (10% of GDP) remain well above permissible levels (10% of GDP and 8% respectively) and should be further trimmed. A thorough revision of the subsidy and bonus payment policies is also encouraged, as well as an expansion of tax base. In its absence, public debt sustainability will be increasingly called into question. On a more positive note, the landslide victory of Aleksandar Vučić's SNS on 16 March should speed up the reform process ahead, including the adoption of the labour, privatization and bankruptcy bills needed to speed up the restructuring of Serbia's loss-making SOEs. On a medium-term basis, the privatization of a number of state-owned banks would also be welcomed.

Eurobond issuance expected in 2Q14, but signing an IMF deal is a first priority

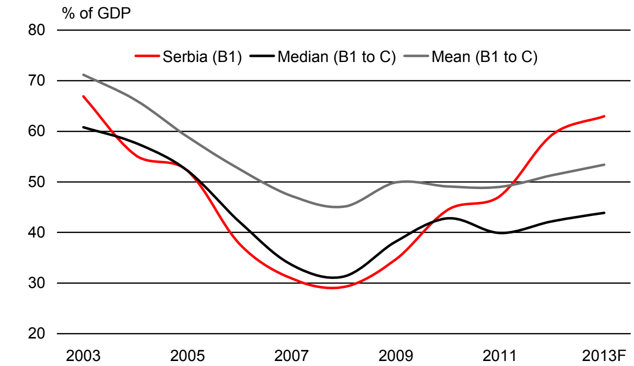
Funding conditions have improved but are subject to downside risk, with yields in the local and external debt markets having compressed considerably since June last year. In view of this, we expect the MinFin to tap the Eurobond market by June, once the revised budget is presented and the labour, privatization and bankruptcy bills are adopted. But both Eurobond and domestic issuance will be significantly larger than planned (EUR 3.4bn combined) as the UAE loan was finally agreed at a lower USD 1bn (vs. aimed EUR 3bn). On a more positive note, the MinFin expects the low interest rate on the loan (i.e. 2%) to save close to USD 40mn per year over its 10-year grace period. What's more, no explicit conditionality has been attached to the deal meaning the government can use the proceeds to fill budgetary gaps and refinance expensive loans. In addition, the first tranche (USD 240mn) in WB loans was disbursed at end-February, of which USD 40mn will be used to fund the health sector while USD 200mn to strengthen the Deposit Insurance Agency. The second tranche (USD 250mn) is expected to be signed by 3Q13 once the bills are approved by Parliament, while the USD 0.2bn loan from Russia should be disbursed as soon as an IMF deal is signed.

ADDITIONAL FISCAL CONSOLIDATION IS REQUIRED TO BALANCE PUBLIC FINANCES

The sovereign has heavily increased its reliance on foreign funding



Public debt dynamics compare poorly to B-rated peers



Source: NBS, MinFin, Moody's Investors Service, UniCredit Research

IMF deal required as a fiscal and financial anchor

An acceleration of portfolio outflows would pose a risk to the dinar and Serbia's FX-denominated debt…

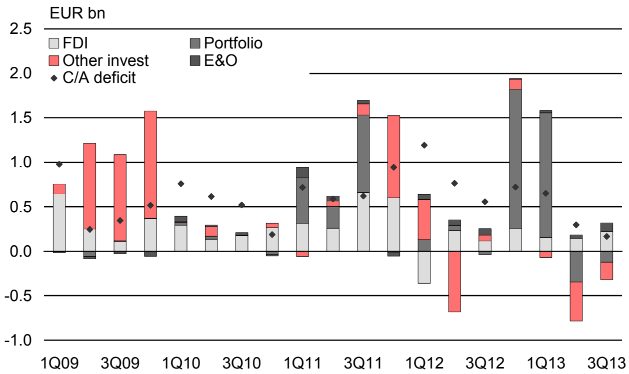
Guaranteeing currency stability is key to preserving Serbia's financial stability, but growing EM contagion risks and the start of Fed taper are adding pressures to portfolio capital. According to EPFR data, portfolio outflows from EM since QE3 have totaled USD 20bn, of which USD 6bn has been YTD. In Serbia, the pace of portfolio reversal has been less dramatic (USD -0.3bn between Apr-Nov 2013), but RSD has lost 5% since QE3 (1.2% YTD). The NBS has responded by selling close to EUR 0.8bn in FX YTD. While further weakening is envisaged, the authorities are likely to do their best to limit this given that 80% of Serbia's debt is in FX while most private sector loans are FX-denominated.

…as well as run down considerably the NBS's FX reserves

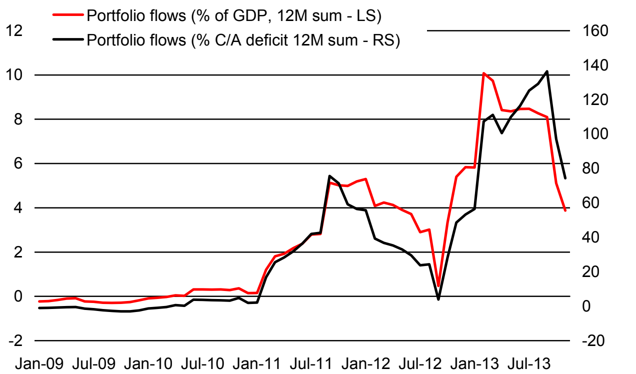
An IMF deal at this stage is essential to consolidate public finances, and help ease funding and dinar pressures. A significant run-down of FX reserves at times of stress will also be avoided. The IMF's visit in early February is a welcome sign, but for the deal to be signed (expected by end-3Q13) a much tougher stance on fiscal consolidation and privatization will have to be adopted.

ACCELERATING CAPITAL OUTFLOWS ARE A RISK TO SERBIA

C/A funding remains too dependant on portfolio capital…



…but is reversing at a rapid pace



Source: NBS, MinFin, UniCredit Research

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2013E	2014F	2015F
Gross financing requirement	**5.0**	**5.2**	**6.1**
Budget deficit	1.9	2.3	2.0
Amortization of public debt	3.1	2.9	3.9
Domestic	2.5	1.9	3.3
Bonds	0	0.3	1.9
Bills	2.5	1.6	1.4
External	0.6	1.0	0.6
IMF	0.2	0.6	0.1
Financing	**5.0**	**5.2**	**6.1**
Domestic borrowing	3.6	2.8	3.6
Bonds	2.2	1.5	2.1
Bills	1.4	1.3	1.5
External borrowing	2.0	3.0	1.9
Bonds	1.8	0.7	1.4
IMF/WB	0	1.1	0.5
Other	0.2	1.2	0
Change in cash reserves (+ = decline)	-0.6	-0.6	0.6

Source: MinFin, NBS, Unicredit Research

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2013E	2014F	2015F
Gross financing requirement	**7.0**	**7.5**	**6.9**
C/A deficit	1.5	1.6	1.7
Amortization of medium to long term debt	5.1	5.8	4.9
Government/Central Bank	0.6	1.0	0.6
IMF	0.2	0.6	0.1
Other	0.4	0.5	0.5
Banks	1.1	1.0	0.9
Corporates	2.8	2.8	2.7
Amortization of short term debt	0.5	0.2	0.3
Government/Central Bank	0	0	0
Banks	0.4	0.2	0.2
Corporates	0.1	0	0.1
Financing	**7.0**	**7.5**	**6.9**
FDI	0.8	1.1	1.2
Equity	0	0	0
Borrowing	5.7	6.3	5.2
Government/Central Bank	2.0	3.0	1.9
IMF/WB	0	1.1	0.5
Bonds	1.8	0.7	1.4
Other	0.2	1.2	0
Banks	1.1	0.8	0.8
Corporates	2.6	2.6	2.5
Change in FX reserves (+ = decline)	0.5	0.1	0.5

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

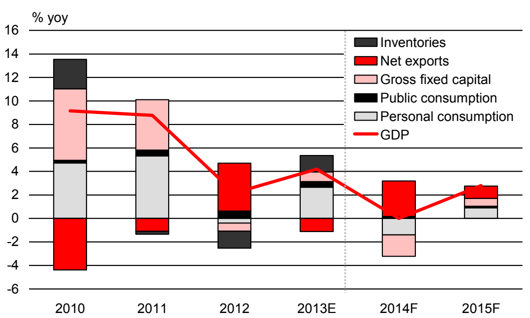
Outlook – Economic and political developments in Turkey point to a continued adjustment in domestic demand as captured by the higher cost of private credit, lower credit growth and falling import volumes. Weakened portfolio inflows will add to the adjustment of the C/A deficit and domestic demand, since long-term sources of C/A funding like FDI remain modest. But improving industry and export activity will help cushion GDP growth, expected to remain unchanged from last year. Meanwhile, inflation continues to edge upwards despite January's rate hike and will remain above target throughout the forecast horizon. On the fiscal front, we expect revenue growth to undershoot the government's forecast which, alongside growing interest payments, should place the budget deficit this year at 3.4% of GDP. Local elections at end-March constitute a first test of AKP support, but are unlikely to ease political tensions in the near-term.

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

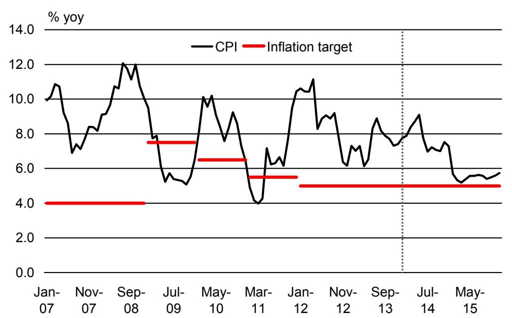
KEY DATES/EVENTS

- 31 Mar, 10 Jun – 4Q13 GDP (final); 1Q14 GDP (prelim)
- 18 Mar, 24 Apr, 22 May – Repo rate decision
- 3 Apr, 5 May, 3 Jun – Consumer price index
- 12 Apr, 13 May, 12 Jun – C/A balance
- 8 Apr, 8 May, 9 Jun – Industrial production
- 30 Mar – Local elections

GDP GROWTH TO MODERATE IN 2014



INFLATION TO REMAIN ABOVE TARGET



Source: TurkStat, CBRT, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2011	2012	2013E	2014F	2015F
GDP (EUR bn)	558.6	611.5	625.9	556.5	558.6
Population (mn)	74.0	74.9	75.8	76.7	77.6
GDP per capita (EUR)	7,553	8,165	8,256	7,254	7,197
Real economy yoy (%)					
GDP	8.8	2.2	4.2	0	2.8
Private Consumption	7.7	-0.6	4.0	-2.1	1.4
Fixed Investment	18.0	-2.7	3.3	-7.5	2.9
Public Consumption	4.7	6.1	4.5	1.5	1.3
Exports	7.9	16.7	4.1	6.5	6.0
Imports	10.7	-0.3	8.0	-4.4	2.5
Monthly wage, nominal (EUR)	788	922	951	879	917
Unemployment rate (%)	9.8	9.2	9.5	9.5	9.3
Fiscal accounts (% of GDP)					
Budget balance	-0.7	-1.6	-1.3	-3.4	-2.8
Primary balance	2.0	1.2	1.2	-0.9	-0.2
Public debt	39.1	36.2	35.7	37.8	37.7
External accounts					
Current account balance (EUR bn)	-53.9	-37.7	-49.2	-26.9	-23.8
Current account balance/GDP (%)	-9.7	-6.2	-7.9	-4.8	-4.3
Basic balance/GDP (%)	-7.9	-5.0	-6.7	-3.2	-2.3
Net FDI (EUR bn)	9.9	7.1	7.2	9.1	11.0
Net FDI (% of GDP)	1.8	1.2	1.2	1.6	2.0
Gross foreign debt (EUR bn)	235.8	255.3	294.5	307.0	314.6
Gross foreign debt (% of GDP)	42.2	41.8	47.0	55.2	56.3
FX reserves (EUR bn)	59.4	74.5	82.8	77.9	77.2
Inflation/Monetary/FX					
CPI (pavg)	6.5	8.9	7.5	7.7	5.5
CPI (eop)	10.4	6.2	7.4	7.3	5.7
Central bank target	7.5	6.5	5.5	5.0	5.0
Central bank reference rate (eop)	5.75	5.50	4.50	10.00	8.50
3M money market rate	8.55	7.69	6.25	10.50	9.00
USD/TRY (eop)	1.85	1.78	2.07	2.29	1.68
EUR/TRY (eop)	2.46	2.35	2.83	3.20	2.43
USD/TRY (pavg)	1.67	1.80	1.91	2.24	1.71
EUR/TRY (pavg)	2.34	2.32	2.53	3.07	2.41

Source: UniCredit Research

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

Adjustment underway but more to go in 2014

Real GDP growth expected to flatten this year…

The combination of Fed tapering, calling a halt to a multi-year period of foreign portfolio flows to EM, concerns surrounding the EM growth outlook and domestic political developments is forcing the Turkish economy to adjust. The fact that the CBRT did not accumulate net FX reserves over recent years limits their ability to cushion this adjustment. In our CEE quarterly of September last year, we reduced our forecast for Turkish growth to 2.0% for this year. While H2-13 has proved stronger than we expected, downward pressure on domestic demand has increased significantly since the end of 2013. With this in mind, we now expect real GDP to remain unchanged this year in Turkey as a contraction in domestic demand is neutralised by a positive contribution from net exports.

…partly due to weakened portfolio flows

The crux of the issue lies with the balance of payments. Given that the primary source of financing for the C/A deficit in Turkey is no longer present, a forced consolidation is unavoidable. Turkey's C/A deficit stood at almost 8.0% of GDP last year. Turkey has run a large C/A deficit for almost a decade but over more recent years, vulnerabilities have been re-inforced by an increased reliance short term rather than long term capital flows. For example, by April of last year portfolio inflows were equal in size to the C/A deficit.

The CBRT's limited stock of net FX reserves has limited its ability to fill the funding gap…

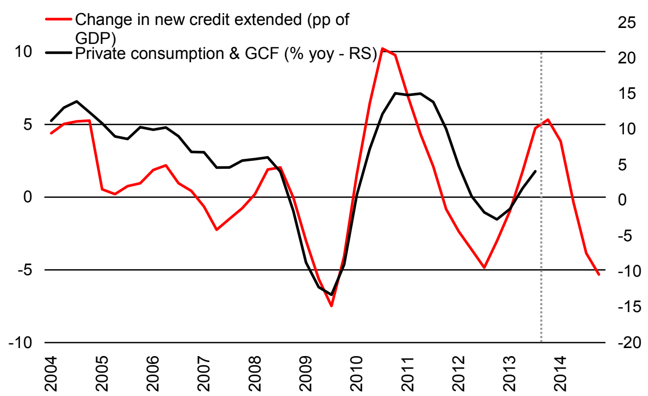
A variety of strategies have been employed to finance Turkey's C/A but we do not believe that these are likely to continue going forward. The CBRT sold USD 17.6bn of its FX reserves to the market between June and December last year. The banks have impressively increased rollover ratios, generating a further USD 6.7bn. Combined, both of the above sum to 74% of Turkey's C/A deficit over the last 7 months of last year. Having run down net reserves considerably, the CBRT has stepped back from FX intervention to a large extent. Given that the banking sector has already widened its net foreign asset position to a negative 18% of GDP (IMF data), further significant funding from this source also seems unlikely.

…pointing to a forced adjustment of the C/A deficit and domestic demand

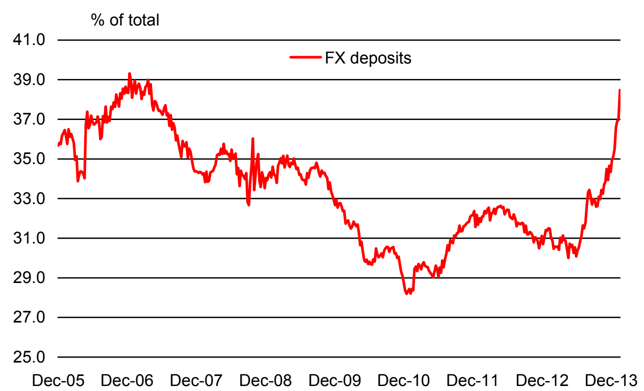
The adjustment in domestic demand is already being captured in lower credit growth, a trend that we expect will continue over the coming months. As per the CBRT's preferred metric, credit growth has already almost halved since August to less than 22% (13 week average annualised). But credit growth remains above deposit growth. Higher yields and increased risk aversion means that banks are more likely to accumulate domestic government debt, at the expense lending. The cost of credit has increased significantly (up 245bp and 285bp on corporate and consumer credit since the start of the year respectively) while recently introduced macro-prudential measures will also take their toll on consumer credit growth. TRY losses represent a further adjustment mechanism, primarily via import volumes.

EXTERNAL DEMAND FILLED SOME OF THE GAP CREATED BY DOMESTIC DEMAND

Easing credit growth to contract domestic demand this year



Local deposit conversion from TRY into FX is at 7 year highs



Source: Turkstat, CBRT, Treasury, UniCredit Research

Heightened political tensions are weighing on AKP support…

The re-introduction of political risk in Turkey adds to the adjustment burden and is unlikely to ease significantly in the near term. This first escalated in Q2 last year with the emergence of the Gezi park protests. Looking ahead the election schedule remains busy. Local elections are scheduled for the end of March, Turkey's first Presidential election for August while currently general elections are scheduled to be held next year. AKP is under increasing pressure from the Gulen movement via a variety of recordings which are only likely to increase in number in the lead up to local elections. Given the speed at which events are unfolding, it is difficult to place too much emphasis on the outcome of opinion polls but AKP support seems to be edging downwards.

…while triggering a sharp conversion of deposits into FX

This political uncertainty has already taken its toll on the economy in the form of a sharp increase in conversion of deposits from TRY into FX. While over June/July last year less than 31% of deposits were in FX, this has now increased to over 39%, a ratio last seen in 2006. Turkey's negative real interest rate also played a role and from this perspective the CBRT's rate hike at the end of January has helped to slow the pace of conversion. But any reversal of these FX purchases will likely require a significant decline in political noise.

Strong industry and export performance will offset the decline in domestic demand

The most obvious positive within this weak domestic demand and political environment is a solid performance from industry and exports. Both are benefitting from a recovery in EMU in particular, with the share of Turkey's exports going to EMU on the increase. On a 3m/3m sa and annualised basis, IP gained 12.6% in December while in February the manufacturing PMI continued to move further above its long term average. These positive industry and export trends will provide an important cushion in the face of a decline in domestic demand this year.

The CBRT's rate hike in January is proving insufficient to curb inflationary pressures…

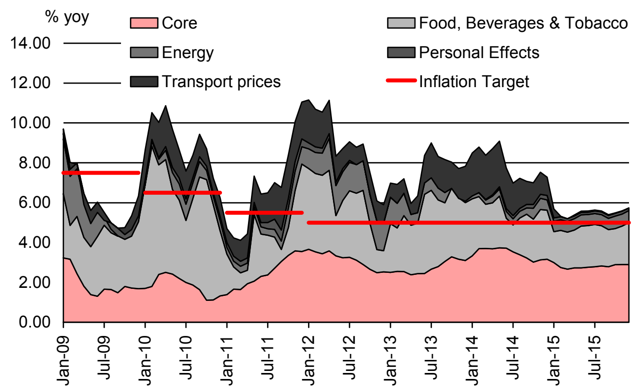
Despite the CBRT's sizeable rate hike to 10%, we do not see scope for the CBRT to ease interest rates in any meaningful way, at least for the next two quarters. Inflation ended 2013 significantly above the NBS's 5% target and currently stands above 7.9%. Looking ahead, we expect the uptick in food prices and strong FX pass-through to keep headline inflation above 8% until mid-2Q14, with the year-end forecast standing at 7.3% yoy (vs. NBS projection of 6.6%). Core inflation will also hedge upwards and expected to add 3.45pp on average to headline inflation.

….while revenue under-performance this year is expected to widen the budget deficit by 1.7pp of GDP

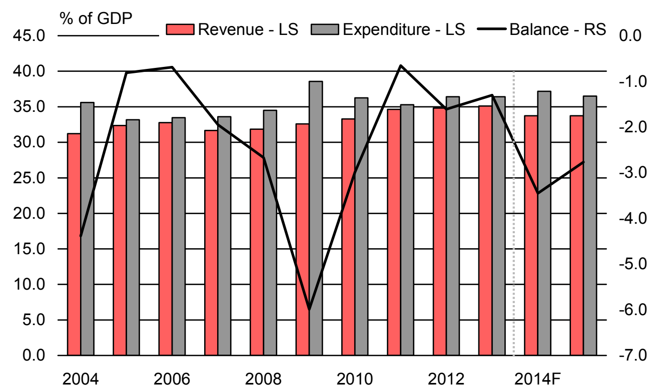
This leaves fiscal policy at risk. In recent years strong domestic demand growth has flattered revenue, allowing the government to boost expenditure while still outperforming on its fiscal targets. This year we expect revenue growth to undershoot the government's forecast of 6.6% growth. A higher interest bill will also put pressure on government expenditure. With this in mind, we forecast a budget deficit of 3.4% of GDP this year, compared with the government's target of 1.7% of GDP. We do not exclude that the government is forced to push through some tax hikes in October, risking further upward pressure on inflation.

HEADLINE INFLATION AND BUDGET DEFICIT TO EXCEED TARGETS

Inflation to remain above target throughout the forecast horizon…



…while falling revenues will lift the budget deficit above 3% this year



Source: CBRT, Turkstat, UniCredit Research

Requirements for a TRY rally

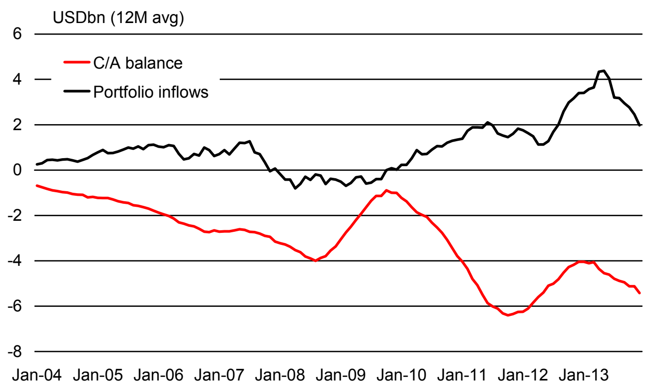
The stage is not set for a rally in TRY

Turkey is not a stranger to the sort of adjustment that it is currently undergoing – its low savings ratio and wide C/A deficit means that it has long proven vulnerable to sudden stops. But in the lead up to 2008, currency weakness associated with these sudden stops was often followed by a currency rally while since 2008 any recovery in TRY has been more muted. In part this captures policy choices by the CBRT but a wider C/A deficit has also played a role.

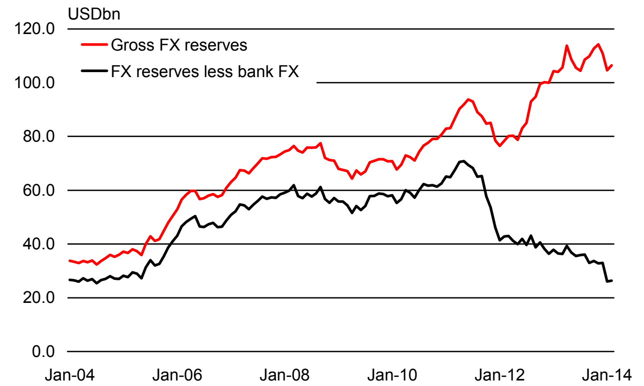
Within EM FX, there tends to be four shortfalls currently, namely a weakening growth trajectory, an insufficiently positive real interest rate, insufficient foreign capital inflows and domestic demand for FX. Following the CBRT's rate hike, Turkey delivers a positive real interest rate but growth is set to slow further, domestic demand for FX persists while we struggle to see foreign portfolio flows returning to the sort of size that was experienced over 2012 and early 2013. This implies that further C/A adjustment and an improvement in domestic political noise is required before TRY can stage any sort of meaningfully rally. And should we reach this stage, the CBRT's shortfall of FX reserves means that reserve accumulation as a policy option is likely to quickly come under consideration.

BOP VULNERABILITIES REMAIN SIGNIFICANT AND FORCING THE CBRT TO STEP BACK FROM FX INTERVENTION

Portfolio outflows are forcing a major adjustment of the C/A deficit…



…as net FX reserves remain insufficient to fill the funding gap in full



Source: CBRT, Bloomberg, UniCredit Research

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2013E	2014F	2015F
Gross financing requirement	**56.4**	**59.9**	**57.8**
Budget deficit	8.1	19.5	15.6
Amortisation of public debt	48.2	40.4	42.2
Domestic	45.2	36.8	40.2
Bonds	45.2	36.8	39.2
Bills	0	0	1
External	3.0	3.6	2.0
Financing	**56.4**	**59.9**	**57.8**
Domestic borrowing	53.1	45.7	45.2
Bonds	53.1	45.7	45.2
Bills	0	0	0
External borrowing	4.8	6.0	6.0
Bonds	4.8	6.0	6.0
Other	10.1	7.6	8.5
Change in cash reserves(+ = decline)	-11.6	0.6	-1.8

Source: CBRT; Treasury, Bloomberg, Unicredit Research

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2013E	2014F	2015F
Gross financing requirement	**204.8**	**191.2**	**183.3**
C/A deficit	65.0	36.9	33.6
Amortisation of medium to long term debt	42.6	29.0	24.4
Government/central bank	3.8	2.8	2.8
Banks	9.1	11.6	9.0
Corporates	29.7	14.7	12.7
Short term debt	101.0	125.3	125.3
Government/central bank	12.1	17.5	17.5
Banks	58.5	73.3	73.3
Corporates	30.4	34.4	34.4
Errors & omissions	-3.8	0	0
Financing	**204.8**	**191.2**	**183.3**
FDI	9.6	12.5	14.9
Portfolio	23.7	5.0	5.0
Borrowing medium to long term	53.0	32.3	27.7
Government/central bank	4.8	6.0	6.0
Banks	18.6	11.6	9.0
Corporates	29.6	14.7	12.6
Short term borrowing	114.5	127.0	128.9
Government/central bank	17.5	19.3	21.2
Banks	65.0	73.3	73.3
Corporates	32.0	34.4	34.4
Other	13.9	9.5	6.8
Reserve accumulation	-9.9	5.0	0

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

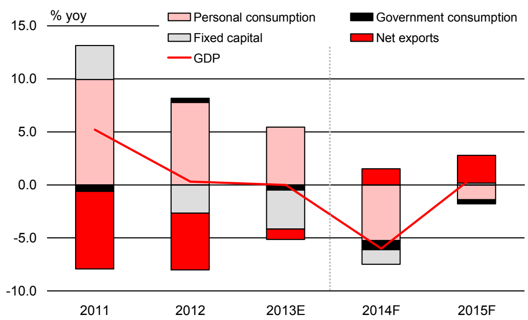
Outlook – We compile this quarterly at a time of significant change for Ukraine. In formulating a new set of forecasts, we assume an optimistic scenario made up of a stable transition to a new government which adheres to an IMF programme while also progressing to sign the DCFTA without generating backlash from Russia. We see three key inter-related issues for IMF programme negotiation, namely the currency, fiscal performance and the banking sector. In this scenario, public debt to GDP will rise in excess of 60% this year. Adopting the same approach as was the case in the 2008 IMF programme, we estimate a financing gap of close to USD 41bn until end-2015. Ukraine's weak starting point combined with the considerable uncertainty surrounding the political and economic means that we cannot rule out a re-scheduling or even a re-structuring of public debt. The more positive element is that an IMF programme would likely be accompanied by the EU's DCFTA and a World Bank programme aimed at improving energy efficiency.

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

KEY DATES/EVENTS

- 21 March: Conclusion of IMF mission
- 25 May: First round of presidential election
- 4-8 of every month: Foreign reserves data
- End April: Q1 GDP, first release

GDP: SET FOR SHARP CONTRACTION



Source: State Statistics Service of Ukraine, UniCredit Research

INFLATION TO SUFFER FROM FX LOSSES

Source: State Statistics Service of Ukraine, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2011	2012	2013E	2014F	2015F
GDP (EUR bn)	117.1	135.5	129.7	97.6	98.1
Population (mn)	45.6	45.5	45.4	45.3	45.2
GDP per capita (EUR)	2,568	2,979	2,857	2,154	2,171
Real economy yoy (%)					
GDP	5.2	0.3	0	-6.0	1.0
Private Consumption	15.7	11.7	7.8	-7.5	-2.0
Fixed Investment	7.1	0.9	-6.6	0	0
Public Consumption	-3.0	2.2	-2.5	-4.5	-2.0
Exports	4.3	-7.7	-8.8	-4.0	2.2
Imports	17.7	1.9	-5.9	-6.0	-2.5
Monthly wage, nominal (EUR)	237	292	294	293	294
Unemployment rate (%)	8.2	7.8	7.5	7.6	8.0
Fiscal accounts (% of GDP)					
Budget balance	-2.8	-4.5	-4.5	-7.1	-4.6
Primary balance	-0.8	-2.6	-2.0	-4.5	-2.0
Public debt	36.8	37.4	32.2	38.0	37.8
External accounts					
Current account balance (EUR bn)	4.1	-7.3	-3.6	-4.2	-0.8
Current account balance/GDP (%)	3.5	-5.4	-2.8	-4.3	-0.9
Basic balance/GDP (%)	1.1	-2.9	-2.2	-1.1	1.0
Net FDI (EUR bn)	-2.8	3.4	0.7	3.1	1.8
Net FDI (% of GDP)	-2.4	2.5	0.6	3.2	1.9
Gross foreign debt (EUR bn)	90.6	105.0	105.0	116.0	122.4
Gross foreign debt (% of GDP)	77.4	77.5	81.0	118.9	124.8
FX reserves (EUR bn)	21.8	17.6	14.2	25.2	31.6
Inflation/Monetary/FX					
CPI (pavg)	8.0	0.6	-0.3	6.7	6.6
CPI (eop)	4.6	-0.2	0.5	9.8	5.0
Central bank target	tentative target of 5% by 2014				
Central bank reference rate (eop)	7.75	7.50	6.50	7.00	7.00
3M money market rate (Dec avg)	9.92	19.82	11.27	16.00	8.50
USD/UAH (eop)	6.04	6.11	6.01	8.21	7.24
EUR/UAH (eop)	8.03	8.07	8.24	11.50	10.50
USD/UAH (pavg)	5.70	6.29	6.14	7.85	7.80
EUR/UAH (pavg)	7.98	8.08	8.15	10.75	11.00

Source: UniCredit Research

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

Time for change

Uncertainty is rife on many fronts in Ukraine

We compile this quarterly at a time of significant change for Ukraine. Uncertainty on many fronts is rife, not least in terms of Russia's involvement in Crimea and potentially beyond. At the time of writing, Crimea had voted overwhelmingly in favour of of joining Russia while protests were gathering pace across Eastern Ukraine in favour of Russia. This injects further uncertainty into May's presidential election (second round, 14 June), leaving the IMF with little direction in terms of future policy in Ukraine, including commitment to the EU's Deep and Comprehensive Free Trade Agreement (DCFTA). Russia also has the potential to re-inforce an unavoidable contraction in GDP via a number of channels, including by halting trade, gas or demanding repayment of its USD 3bn bond.

Our forecasts (optimistically) assume a smooth political transition, a large and comprehensive IMF programme and agreement on the DCFTA

In formulating a new set of forecasts, we assume an optimistic scenario made up of a stable transition to a new government which adheres to an IMF programme while also progressing to sign the DCFTA without generating backlash from Russia. Even in this scenario, the combination of the need to consolidate a large budget and C/A deficit, the impact of deposit flight, currency depreciation, a sharp slowdown in tax collection between now and the election and Ukraine's low level of FX reserves means that a large contraction in economic activity is set to prove unavoidable this year. Public debt to GDP will move sharply higher. Should Russia opt to halt trade with Ukraine, cut gas or call for repayment of its USD 3bn bond bought in December, any IMF financing gap estimate will have to increase further.

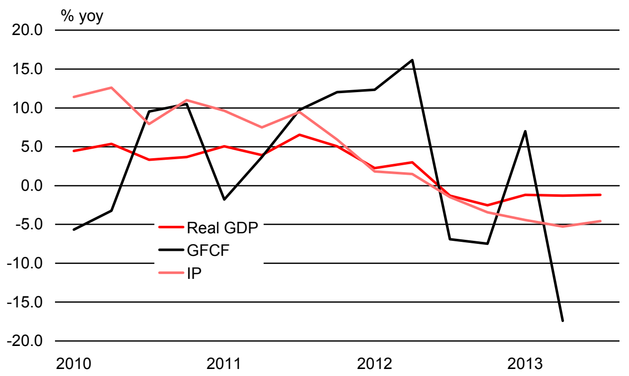
Fiscal policy, including gas price hikes, fx flexibility and the banking sector are likely to represent the IMF's key priorities

We see three key inter-related issues for IMF programme negotiation, namely the currency, fiscal performance and the banking sector:

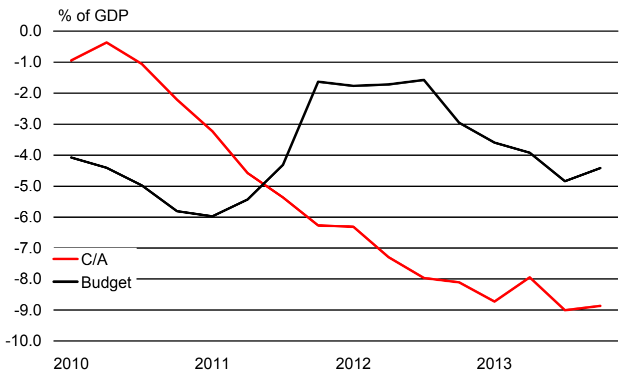
- FX: The Fund has long favoured a flexible currency but this has implications for financial stability and public debt sustainability. Recent currency depreciation is a step forward, given overvaluation and a low level of FX reserves. To temper depreciation pressures, the domestic authorities have introduced some controls on deposit withdrawals. We expect the IMF to push for further UAH depreciation to aid adjustment;
- Fiscal policy: Even prior to the violence that erupted in Ukraine, fiscal performance was weak. A general government budget deficit of 4.5% of GDP likely widens to at least 8% of GDP if the shortfall for Nafto and some arrears are taken into account. Any programme will have to reckon with a fall in tax collection. The authorities' cash position is exceptionally weak. Poor adherence to conditionality in the past means that gas price hikes before the Presidential election will likely prove unavoidable, if a programme is agreed upon, with a pledge to do more following elections. A reversal of past increases in pensions and public sector wages will also likely be required;

AN EXCEPTIONALLY WEAK MACRO BACKDROP

A weak starting point for activity…



…amidst wide twin deficits



Source: NBU, national statistics office, UniCredit Research

- Banking sector: Ukraine's banking sector contains approximately 175 banks, with domestic ownership accounting for approximately 50% of all assets. From a funding perspective, newly appointed Governor Kubiv reported deposit withdrawal equivalent to 7% of the deposit base over 18-20 February. In terms of asset quality, NPLs are reported in double digits while one third of all loans are in FX. Moreover, the banks hold USD6bn of local law government bonds denominated in USD. Maturities stretch out to 2018, though most are scheduled to mature by 2016. All of the above calls for a thorough stress test of the banking system.

The authorities will struggle to maintain public debt below 60% of GDP this year…

In this scenario, public debt to GDP will rise in excess of 60% this year. This assumes a 6% decline in real GDP this year, though this is largely neutralised by a spike in inflation. UAH finishes the year at 11.5/USD. Despite consolidation measures, arrears, a higher interest bill and weak revenue performance push the budget deficit to in excess of 7% of GDP this year. Nafto represents a further push on public debt. We do not account for a capital injection to the banking system - capital injection equivalent to 50% of the FX loan book for the domestically-owned portion of the banking system would amount to 5.6% of GDP. The above also does not take account of the bonds that the government recently issued to Naftogaz, the costs of a Nafto re-structuring to domestically owned banks or NPLs within the UAH loan book.

…while the financing gap is set to be much larger compared with Ukraine's quota than was the case in the past

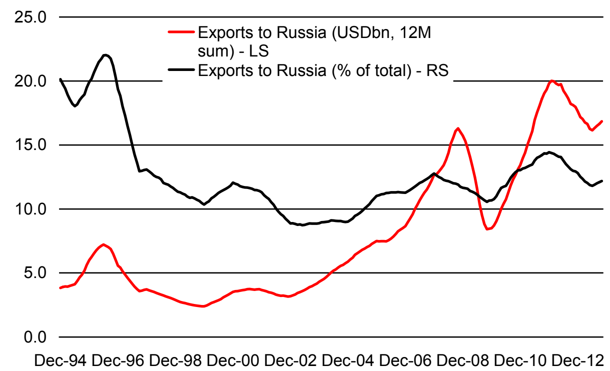
Adopting the same approach as was the case in the 2008 IMF programme, we estimate a financing gap of close to USD 41bn until end-2015. Once again we warn that the assumptions underlying it are subject to significant change. The above estimate assumes a contraction in the C/A deficit of USD 13bn or to 2.6% of GDP by 2015 and a return of FX reserves to 78% of short term external debt by the end of next year from the most recent estimate from the NBU of USD 13.7bn. This is equivalent to almost 2000% of quota. In contrast the 2008 IMF programme provided 802% of quote, equivalent to USD 16.5bn at the time. At the end of December last year, the IMF's executive board concluded that in the future programmes focusing on critical areas, accompanied by less financing and strong prior actions (as well as potentially a shorter time horizon), may increase the probability of success.

Near term pain for longer term gain?

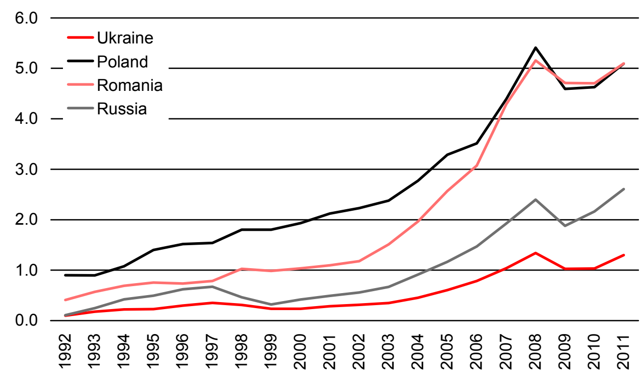
Ukraine's weak starting point combined with the considerable uncertainty surrounding the political and economic outlook over the coming quarters means that we cannot rule out a re-scheduling or even a re-structuring of public debt. The more positive element of all of the above is that an IMF programme would likely be accompanied by the EU's DCFTA and a World Bank programme aimed at improving energy efficiency in Ukraine. Over a multi-year horizon, the former would help introduce a new business model into Ukraine while the latter would sreve to aid public finances and improve competitiveness.

A HIGH DEGREE OF ECONOMIC RELIANCE ON RUSSIA

Russia is Ukraine's first trading partner



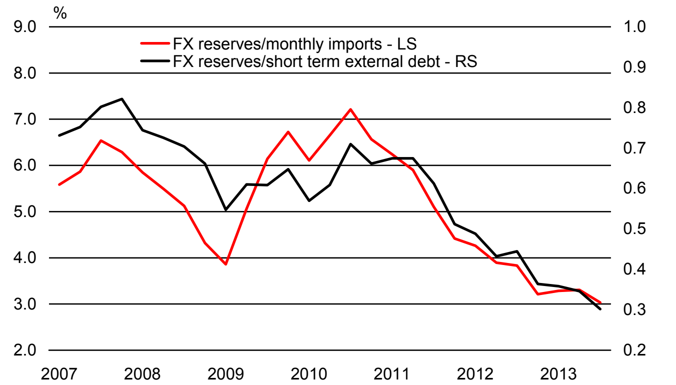
GDP in USD per kg of oil/oil equivalent: Plenty of scope for improvements in energy and efficiency



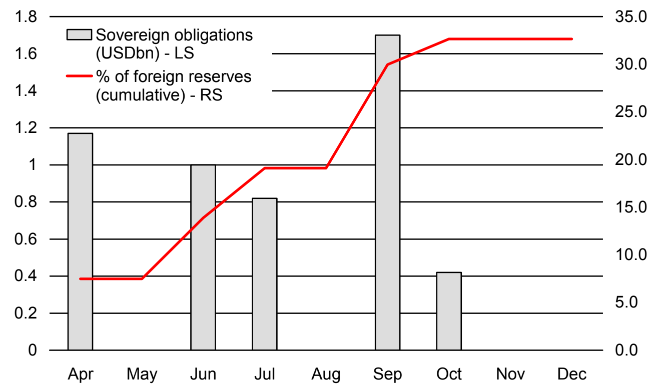
Source: IMF DoTs, World Bank, UniCredit Research

EXTERNAL FINANCING CHALLENGES ARE SIGNIFICANT

FX reserves have fallen to unmanageably low levels…



…and face further declines ahead



Source: NBU, IMF, Bloomberg, UniCredit Research

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2013E	2014F	2015F
Gross financing requirement	**14.1**	**14.8**	**13.6**
Budget deficit (excl Nafto)	3.2	5.0	2.6
Amortisation of public debt	10.8	9.8	11.1
Domestic	6.2	5.7	7.0
Short term	0.6	0.3	1.0
Medium to long term	5.7	5.4	6.0
External	4.6	4.1	4.1
of which IMF	3.0	2.7	1.1
Financing	**14.1**	**14.8**	**13.6**
Domestic borrowing	10.8	9.0	9.0
of which NBU	3.7	3.5	0
Short term	0.8	1.0	1.0
Medium to long term	10.0	8.0	8.0
External borrowing	2.2	5.8	4.6
Bonds	2.2	0	1.0
IMF	0	5.8	3.6
Other	1.1	0	0

Source: MinFin, NBU, UniCredit Research

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2013E	2014F	2015F
Gross financing requirement	**58.0**	**54.2**	**46.2**
C/A deficit	12.2	4.4	2.1
Medium to long term amortisation	**18.9**	**20.3**	**18.6**
Banks	5.4	6.0	4.8
Corporates	8.0	9.6	9.6
Government/central bank	5.4	4.6	4.1
Short term debt amortisation	**24.2**	**26.8**	**22.8**
Banks	3.1	3.2	2.7
Corporates	21.0	23.5	20.0
Government/central bank	0	0	0
Other (incl. intercompany lending, capital flight	2.7	2.7	2.7
Financing	**58.0**	**54.2**	**46.2**
FDI	2.5	3.3	4.6
Portfolio flows	5.9	0	2.0
Medium to long term borrowing	**16.3**	**31.6**	**27.7**
Banks	3.1	4.2	3.4
Corporates	11.0	9.6	14.0
Government/central bank	2.2	17.7	10.3
Short term borrowing	**24.2**	**22.8**	**22.8**
Banks	3.1	2.7	2.7
Corporates	21.0	20.0	20.0
Government/central bank	0	0	0
Other	5.7	7.6	-4.4
Change in reserves	3.5	-11.0	-6.4

Notes

Notes

Disclaimer

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

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

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

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

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

b) UniCredit Bank AG London Branch (UniCredit Bank London), Moor House, 120 London Wall, London EC2Y 5ET, United Kingdom.
Regulatory authority: “BaFin“ – Bundesanstalt für Finanzdienstleistungsaufsicht, Lurgiallee 12, 60439 Frankfurt, Germany and subject to limited regulation by the Financial Conduct Authority, 25 The North Colonnade, Canary Wharf, London E14 5HS, United Kingdom and Prudential Regulation Authority 20 Moorgate, London, EC2R 6DA, United Kingdom. Further details regarding our regulatory status are available on request.

c) UniCredit Bank AG Milan Branch (UniCredit Bank Milan), Piazza Gae Aulenti, 4 - Torre C, 20154 Milan, Italy, duly authorized by the Bank of Italy to provide investment services.
Regulatory authority: “Bank of Italy”, Via Nazionale 91, 00184 Roma, Italy and Bundesanstalt für Finanzdienstleistungsaufsicht, Lurgiallee 12, 60439 Frankfurt, Germany.

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

e) 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

f) 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

g) 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

h) 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

i) 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

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

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

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

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

ADDITIONAL REQUIRED DISCLOSURES UNDER THE LAWS AND REGULATIONS OF JURISDICTIONS INDICATED

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

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

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

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

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

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

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

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

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

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

This document may not be distributed in Canada.

EFI e 2

Banking network

UniCredit Group CEE banking network – Headquarters

Azerbaijan

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

Bosnia and Herzegovina

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

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

Bulgaria

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

Croatia

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

Czech Republic

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

Hungary

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

Macedonia

UniCredit Bank Austria AG Rep.Office Macedonia
11 Oktomvri 6/2-1, 1000 Skopje, Macedonia
MK-1000 Skopje
Phone: +389 2 321 51 30
E-mail: milan.djordjevic@unicreditgroup.mk

Montenegro

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

Poland

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

Romania

UniCredit Tiriac Bank
F, Blvd. Expozitiei
RO-012101 Bucharest 1
Phone: +40 21 200 2202
E-mail: office@unicredittiriac.ro
www.unicredit-tiriac.ro

Russia

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

Serbia

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

Slovakia

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

Slovenia

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

Turkey

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

Ukraine

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

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

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

Austrian contact

Bank Austria

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

German contact

UniCredit Bank AG

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

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

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

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

Italian contact

UniCredit Corporate Banking

Cross Border Business Management Italy
E-mail: cbbm-cib@unicredit.eu

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

International contact

Azerbaijan

Ozgur Sesen
Phone: +994 12 497 0255
E-mail: ozgur.sesen@yapikredi.com.az

Bosnia and Herzegovina

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

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

Bulgaria

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

Croatia

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

Czech Republic

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

Hungary

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

Macedonia

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

Montenegro

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

Poland

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

Romania

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

Russia

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

Serbia

Natali Jovic
Phone: +381 11 3204 530
E-mail: natali.jovic@unicreditgroup.rs

Slovakia

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

Slovenia

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

Turkey

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

Ukraine

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

UniCredit Research*

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

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

Economics & FI/FX Research

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

Economics & Commodity Research

European Economics

Marco Valli, Chief Eurozone Economist
+39 02 8862-0537
marco.valli@unicredit.eu

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

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

Tullia Bucco, Economist
+39 02 8862-0532
tullia.bucco@unicredit.eu

Chiara Corsa, Economist
+39 02 8862-0533
chiara.corsa@unicredit.eu

Dr. Loredana Federico, Economist
+39 02 8862-0534
loredanamaria.federico@unicredit.eu

Chiara Silvestre, Economist
chiara.silvestre@unicredit.eu

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

US Economics

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

China Economics

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

Commodity Research

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

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

EEMEA Economics & FI/FX Strategy

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

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

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

Anna Bogdyukevich, CFA, Russia
+7 495 258-7258 ext. 11-7562
anna.bogdyukevich@unicredit.ru

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

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

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

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

Marcin Mrowiec, Chief Economist, Poland
+48 22 524-5914
marcin.mrowiec@pekao.com.pl

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

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

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

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

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

Global FI Strategy

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

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

Chiara Cremonesi, FI Strategy
+44 207 826-1771
chiara.cremonesi@unicredit.eu

Elia Lattuga, FI Strategy
+39 02 8862-0538
elia.lattuga@unicredit.eu

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

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

Global FX Strategy

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

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

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

Publication Address

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

Bloomberg
UCCR

Internet
www.research.unicreditgroup.eu

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

EFI 3