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# CEE in 2015: Great opportunities, multiple risks, growing divergence

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- 2015 ought to be a good year for Central and Eastern Europe (CEE). Growth in the euro area seems finally to have gained some momentum, to 1.4% this year and 1.8% in 2016, a marked acceleration from 2014. Plagued by oversupply and sluggish demand, oil prices look set to remain subdued, at around USD 60 per barrel this year before firming only slightly next year. The launch of the ECB QE should keep EA bond yields near record lows, with ample liquidity supporting strong risk appetite and tight spreads. Economic activity would be supported by the weak euro likely to stay in the 1.08-1.15 range against the dollar.
- All these developments ought to benefit the region. The eurozone recovery should provide a boost to exports, while ECB's QE should keep capital inflows ample and borrowing costs low. Low oil prices should help increase disposable incomes and support consumption, while constraining further the already low inflation and helping strengthen current account balances in energy importing countries. Output growth should firm as a result, while macroeconomic imbalances ought to be reduced.
- Moreover, the favorable external environment would provide scope for continued monetary accommodation, enabling central banks to keep interest rates at record lows for an extended period of time. Lower borrowing costs could free space for some fiscal accommodation, especially where deficits and debt are at reasonable levels.
- Not everybody stands to reap the full benefits from the favorable external circumstances. Much will depend on the degree to which reforms have advanced, the magnitude of the macroeconomic imbalances, the quality of economic policies, and the political cohesion of societies. On all these metrics, the region has become increasingly divergent since the 2008 global financial crisis.
- Countries with advanced reforms and solid fundamentals stand to benefit the most. Those include the new EU members form Central Europe and the Baltics. On the other hand, countries with sizable macroeconomic imbalances and heavy dependence on capital inflows such as Turkey, Croatia and Serbia, while getting some reprieve amid the search for yield, will remain vulnerable to shifts in market sentiment.
- For the region's two commodity exporters, Russia and Ukraine, external circumstances have deteriorated sharply. Both have suffered not just from the drop in commodity prices, but also from the loss of access to foreign markets (albeit for different reasons) and the fallout of the proxy war in Eastern Ukraine. Plagued by major structural rigidities and unfinished reform agendas, both face deep and prolonged recessions.
- The generally favorable external environment notwithstanding, a number of risks remain. Key among them would be renewed intensification of fighting in Eastern Ukraine. While contagion has been absent thus far and the fallout mostly limited to bilateral trade, renewed fighting could have a much stronger and broader adverse impact on the rest of the region, especially if energy supplies are suspended or sanctions tightened further.
- The expected rate hikes by the Fed later this year present another potential risk, especially if they affect adversely global risk appetite. A sudden stop or reversal of capital inflows could have a major impact on the countries with sizable macroeconomic imbalances and high dependence on foreign capital such as Turkey, Croatia and Serbia, with potentially significant risks for growth and financial stability. At the same time, the absence of such imbalances and only limited financing needs should leave newer EU member states largely unscathed.

## Newer EU members: near-term upside, medium-term challenges

**CE stands to benefit the most from the favorable external environment…**

With a high degree of integration – both in terms of trade as well as financial linkages – newer EU member states (EU-CEE)[1] look set to benefit the most from the fledging recovery in the eurozone. True, the recovery would be slow and uneven, but given the strong correlation with Germany and their strong competitiveness advantages, the export-oriented EU-CEE economies should get an important lift.

**…thanks to its greater degree of integration within the EU…**

**…and increased scope for accommodative policies thanks to ECB's QE**

ECB's QE would be another supportive factor, not so much in terms of capital inflows (all EU-CEE countries have current accounts in surplus or broad balance), but through the exchange rate and increased space for policy accommodation. The weaker euro, to which most EU-CEE currencies are linked, would provide a substantial boost to exports outside the eurozone. On the other hand, ECB's QE should enable central banks to hold interest rates at record lows for an extended period of time. Accommodative monetary policies would be facilitated also by record low inflation, afforded in part by the drop in oil prices. All this, together with the anticipated increased utilization of EU funds as the new financing period gathers speed, should provide welcome support to domestic demand.

**Growth would accelerate, but at a moderate pace, given the moderate recovery in the eurozone**

Output growth should accelerate across the EU-CEE as a result, mainly to the 2-3% range (except for Poland, where growth should remain above 3%). Higher growth looks unlikely at present, as this would require a much stronger recovery in the euro area – something that looks unlikely at present. Growth would also be constrained by continued sluggish bank lending, hampered by still weak credit demand and risk-aversive banks trying to cope with tightened regulation and a heavy load of NPLs in most countries.

**After a temporary dip into negative territory, inflation should pick up gradually…**

**…but would stay below targets, allowing for prolonged monetary accommodation**

Even though headline inflation has entered negative territory in most of EU-CEE, sustained deflation looks unlikely. With most of the drop in inflation due to cheaper oil and cuts in administered prices, the trough in terms of consumer prices seems to be behind us. The weaker euro, moderately recovering oil prices and firming demand are likely to pull inflation back into positive territory later this year. The easing cycle in EU-CEE seems to have been completed, but with inflation likely to remain below targets, central banks look set to keep interest rates low for longer. Rate hikes could come onto the agenda by the end of this year or early next year, depending mostly on the fallout of Fed rate hikes.

**Scope for fiscal accommodation is much smaller however**

With budget deficits and government debt within reasonable limits (except for Hungary) and growth stronger, there seems to be no need for major fiscal consolidation anywhere except for Bulgaria, which needs to undo the spike in the deficit triggered by the rescue of a large private bank. Hungary's high debt level and still significant dependence on foreign investors for budget financing warrants some caution, especially once Fed rate hikes get underway.

**Vulnerability to Fed tightening should be limited given the absence of macroeconomic imbalances…**

**…but renewed intensification of fighting in Ukraine poses major risks**

Given solid external positions and minimal external financing needs, potential risks to EU-CEE stemming from Fed tightening appears modest. However, renewed intensification of fighting in Ukraine would present a major challenge. (Although this is not our baseline scenario, which assumes a continuation of the fragile ceasefire, a renewed flare-up of hostilities cannot be excluded). Should renewed fighting in Ukraine disrupt natural gas supplies, the impact on EU-CEE would be severe. The loss of output would be significant, ranging from less than 1% of GDP for Romania to as much as 3-4% of GDP or more for the countries with fewer alternative supply sources (Bulgaria, Hungary, Slovakia, Latvia) and these would suffer the most.

[1] We include in this group the countries that joined the EU in 2004 and 2007: Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia and Slovenia.

**Despite the improved outlook, growth remains subpar, deferring convergence…**

Despite the firming growth outlook and resilience to external shocks, the achieved equilibrium does not appear to be sustainable over the medium term, both politically and socially. Growth of 2-3% a year would slow the pace of convergence with the older EU members to a crawl, especially under the current low-inflation environment. Slow convergence would prompt even more people to emigrate to "Old Europe", which would further reduce potential growth and leave the region behind for decades.

**…with potentially serious adverse effect on long-term growth potential and fiscal sustainability**

Low growth and adverse demographics would boost ageing costs over time to unsustainable levels. To tackle these issues, EU-CEE countries would need to take important but politically difficult decisions to reform pension and healthcare systems now to prepare them for the future. However, there has been little appetite thus far to tackle these reforms, especially when near-term financing seems secure.

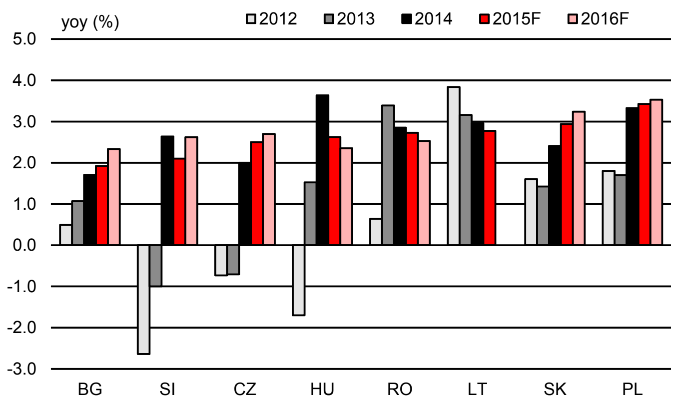
**The reforms needed to boost growth are of a long-term nature and would require consensus…**

**…which has proven elusive thus far**

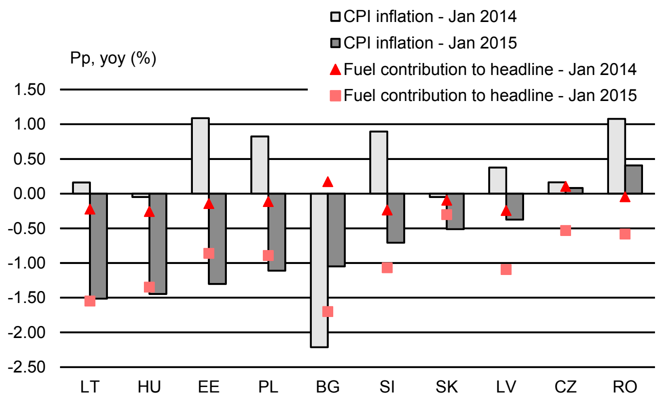
Over the medium term, raising potential growth becomes the key challenge. There is no quick fix, with the required measures (improving the investment climate, boosting domestic savings and improving education) all of a long-term nature and these require political consensus across party lines. This has proven elusive, however, with populist and nationalist parties gaining ground. Political infighting has intensified to an extent making reaching consensus all but impossible in most countries.  While this may have a limited impact in the near term, it acts as a major impediment to deeper reforms.

**NEWER EU MEMBERS BENEFIT FROM ROBUST GDP GROWTH AND LOW INFLATION**

GDP growth in newer EU member states




Low inflation is explained to a large extent by falling fuel prices




Source: Eurostat, UniCredit Research

## Western Balkans: Stuck in Recession, Growing Vulnerability

**The favorable external environment is likely to suffice to pull the Western Balkans out of recession…**

Unlike their CE peers, the Western Balkans are unlikely to benefit as much from the favorable external environment. True, lower oil prices would subdue inflation and reduce current account imbalances, while the chase for yield would improve temporarily financing conditions, enabling central banks to cut rates without jeopardizing stability. However, this is unlikely to be enough to pull them out of recessions, both because of supply-side and demand-side factors.

**…due to the need to pursue further fiscal consolidation…**

On the demand side, the need for further fiscal consolidation requires further fiscal tightening. The benefits from the recovery in the EU would also be hindered by the orientation of exports mainly to the slower-growing eurozone countries (Italy and Slovenia). Finally, high unemployment should limit the scope for wage hikes.

**…but also supply-side constraints and long-standing structural rigidities**

Supply-side factors are likely to have a similar if not stronger impact. The economies in the Western Balkans are dominated by nontradables, with a limited industrial base, adverse investment climates, labor market rigidities and generally high relative labor unit costs constraining exports. The limited manufacturing base, along with the belated relative to CE opening to foreign investment, has deterred FDI inflows.

**Large fiscal deficits and high public debt leave the sub-region susceptible to external shocks…**

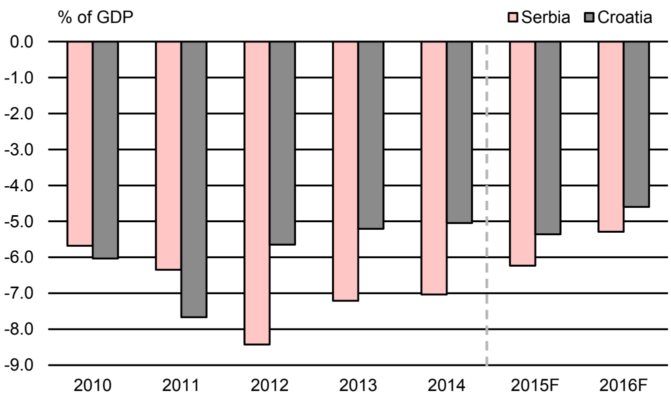
Macroeconomic imbalances remain substantial – not so much on the external side, where domestic demand adjustment in recent years and lower oil prices more recently have reduced or eliminated current account deficits, as much as on the fiscal front and the dependence on foreign capital. Substantial fiscal deficits and government debt around 80% of GDP pose serious potential risks for financial stability should inflows stop or reverse. Progress has been made towards fiscal consolidation, but has remained relatively slow and uneven and is lacking in quality. The situation is especially worrisome in Serbia, where fiscal deficits are accompanied by large losses of numerous state-owned companies, which the government has shown only a tentative will to tackle.

**…especially if global risk appetite weakens in response to Fed tightening**

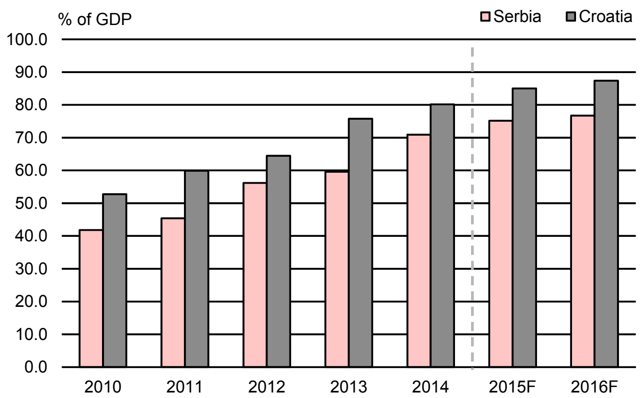
As long as the current enabling environment remains in place, the Western Balkans should be in a position to finance themselves without recourse to the IMF – albeit at a cost, with spreads a few hundred basis points above those in CE. However, should global risk appetite weaken as a result of the Fed rate hikes, this region stands as the most exposed to significant financing pressures, especially given the already adverse starting point (high debt, large structural deficits, no growth and low inflation).

**SERBIA AND CROATIA NEED TO TACKLE FISCAL IMBALANCES**

Serbia and Croatia failed to reduce budget deficits…




…leading to sharp rises in public debt




Source: MinFins, statistical offices, UniCredit Research

## Turkey: A opportunity not to be missed

**Turkey ought to benefit the most from the external environment…**

**…but dysfunctional politics and structural rigidities will constrain the upside potential**

Turkey, as the most dynamic economy in the region, with the best demographics, reasonable investment climate and one of the best-developed capital markets, ought to benefit the most from the favorable external environment. However, a combination of long-running structural deficiencies and growing political tensions are likely to limit the positive effects and increase vulnerability to external shocks. As a result, the macroeconomic performance will improve this year, but less so than what could be expected in the absence of the above constraints.

**Domestic politics are the key near-term risks…**

The key near-term risks are domestic politics. Relentless pressure from the government and President Erdogan on the central bank to cut rates faster to support growth unsettled financial markets. The currency has weakened and risk premia have risen, delaying further rate cuts.

**…raising odds for a policy error**

The risk of a policy error in the form of a premature and excessive cut remains, weighing on market expectations. This, along with worries about the course of economic policy after the June parliamentary election, is likely to keep the recovery subdued this year and the currency on the weak side.

**Turkey remains among the most vulnerable globally to shifts in market sentiment…**

**…with a sudden stop likely to have a major impact**

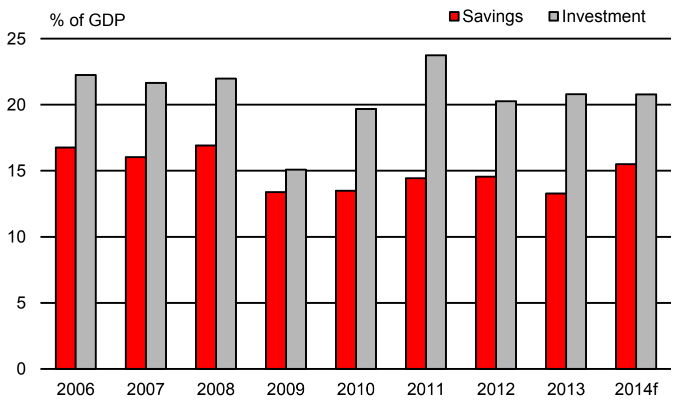
In addition, Turkey remains among the most vulnerable emerging markets globally to shifts in market sentiment. This vulnerability stems from a structurally large current account deficit financed mainly via short-term borrowing and portfolio inflows. A “sudden stop” or reversal of capital inflows therefore is likely to have a strong adverse impact on Turkey, decimating the TRY and prompting the central bank to tighten sharply. Both would have a major negative impact on growth.

**There is no quick fix to the low savings problem, which requires a long-term approach**

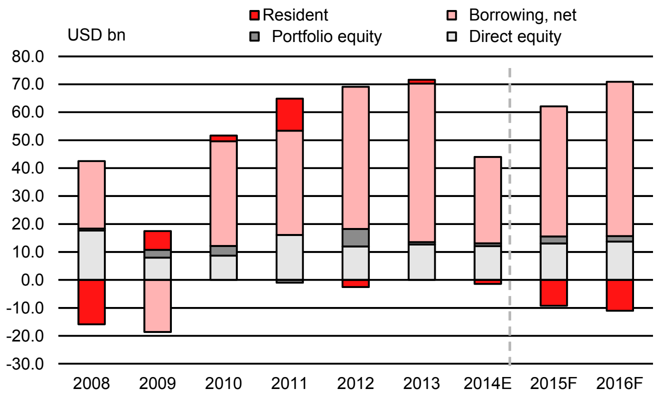
With the problem rooted in the low savings rate, there is no quick fix. Major reforms are needed well beyond macroeconomic management– and some have been initiated, with even more announced. However, there seems to be little appetite for the key measure needed – sustained and forceful measures to reduce the chronically high inflation that has been constraining savings for decades.

**TURKEY IS VULNERABLE TO FINANCING IMBALANCES**

Structural savings shortfall




High reliance on external borrowing




Source: CBRT, TURKSTAT, UniCredit Research

## Russia/Ukraine: Going the wrong way

**Russia and Ukraine will suffer from a combination of low oil prices, the fallout of the war and deeply rooted structural problem…**

Russia and Ukraine will remain the weakest performers in the region. This of course would reflect the drop in commodity prices (and especially of oil for Russia), as well as the proxy war in Ukraine and the sanctions and countersanctions it has triggered. However, the weakness in both countries has become apparent long before the conflict started and is rooted in the major structural rigidities and incomplete reform agenda in both countries that has brought potential growth to near zero.

**…pushing both into recession…**

**…and Ukraine to the verge of a meltdown**

Both Russia and Ukraine will be in recession this year and probably next, but the magnitude of the problems is vastly different. With the war-related damages destroying nearly one-tenth of Ukraine’s economic potential and decimating confidence, the economy is in a tailspin, with odds for a complete financial and economic meltdown rising by the day.

**The new IMF program may prevent a collapse…**

**…but a major debt restructuring is unavoidable**

The new IMF program may prevent a meltdown for now, but is unlikely to put the economy on a sustained growth path until peace is achieved. This, however, looks unlikely at present. In the meantime, Ukraine would seek the restructuring of 100% of the principal and interest with private creditors through 2018. Achieving a voluntary restructuring will be difficult, however, which would pose a major risk to the program.

**Russia is facing a much different problem…**

**…how to cope with the excessive reliance on oil and foreign capital**

Russia is facing different but not much easier challenges. The collapse in oil prices, in conjunction with the loss of access to foreign markets due to the sanctions, has exposed the fundamental weakness of Russia's economy – excessive reliance on oil and gas, and on capital inflows. The major financing gap that has evolved has forced the authorities to let the ruble depreciate sharply despite losing a quarter of FX reserves.

**A new equilibrium has been achieved with oil and the ruble at 60…**

**…but at the cost of a major recession…**

A new tenuous equilibrium appears to be achieved at present, but at the cost of a major contraction in demand and incomes. Under our baseline scenario, assuming a continuation of the current state of the conflict, the economy will remain in moderate recession both this year and next. A much sharper contraction is likely in the case of intensification of the warfare and the tighter sanctions this would likely trigger.

**…that would increase odds of defaults among second-tier banks and companies**

Risk premia will remain elevated and financing pressures among banks and firms would grow as a result. The quasi-sovereigns and major companies are likely to be bailed out by the government. However, most of the existing buffers would be exhausted by late 2016, raising odds for defaults among second-tier companies and banks.

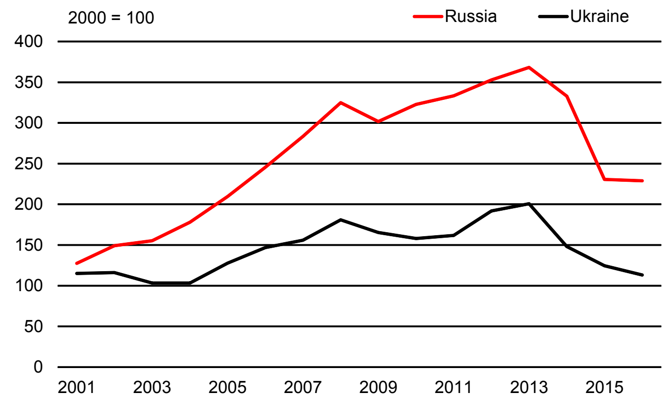
**The medium-term outlook is troubled…**

**…with no reforms in sight to boost output potential**

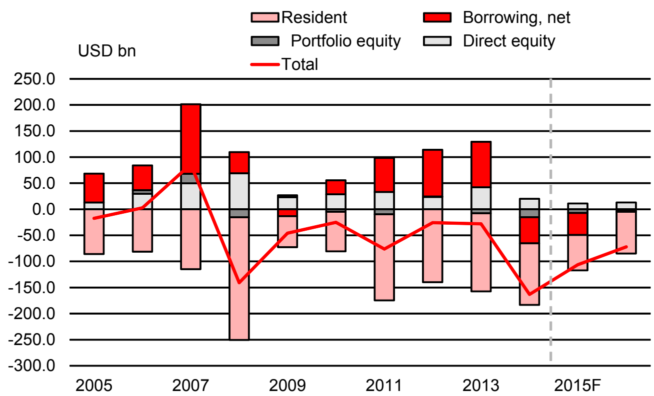
The medium-term outlook remains troubled. With oil output set to decline, domestic investment moribund in the absence of foreign funding and the opaque and difficult business environment, growth is likely to stagnate in the years to come, reversing the trend would require major reforms aimed at opening the economy, removing administrative barriers and red tape and strengthening the rule of law. None of this looks likely at present, however.

**RUSSIA AND UKRAINE FACE SHARP MACROECONOMIC ADJUSTMENTS**

ULC will correct for both countries following the ongoing recession




Capital outflows from Russia are likely to continue




Source: National statistics offices, CBR, UniCredit Research

# CEE Strategy: Bond market headwinds ahead

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- In 2Q15, we expect local bond market returns to come under pressure. Inflation has bottomed out in Central and South Eastern Europe and is expected to rebound gradually from here. Upward pressure on US rates is weighing on long-end bonds in Central Europe, which are failing to benefit from tightening in Bund yields. Greater divergence across CEE is likely following the start of ECB QE, with bond returns in the eurozone (Baltics, Slovenia and Slovakia) set to decouple from CE3. We think that there could be a period of short-term deterioration in the risk environment with tail risks still present, and we think some local CEE bond markets are vulnerable.
- Divergence in local bonds continues. In Central Europe, easing cycles should give way to higher inflation and growth, putting pressure on local bonds in Poland, Hungary and Romania; thus, we see better value in the belly and we think most curves will steepen over 2Q15. Political and structural risks in Turkey and Russia should be key market drivers, with the former particularly vulnerable in a the run-up to the June election. We recommend being underweight in both. In the Balkans, high real yields have us favoring local bonds in Serbia on the balance of risks.
- On the whole, we think that hard currency bonds offer better value than local bonds. We expect the rotation from local to hard currency bonds to continue amid rising US rates, currency risk and attractive hard currency bond yields and Z-spreads. We think this trend will intensify over 2Q15. In CE3, we favor long end USD bonds and recommend being overweight POLAND USD 22s and 24s, REPHUN USD 41s and ROMANI USD 44s. We prefer hard currency debt in both Russia and Turkey due to significantly lower risks, and we think TURKEY USD 22s have an attractive Z-spread. Downward pressure on local bonds should provide some impetus to hard currency bonds in Slovenia, and we favor the SLOVEN USD 23s, and in the Baltics we like being long LITHU USD 17s vs. short LATVIA USD 17s.
- With growth, inflation, easing cycles out of sync across CEE and a number of idiosyncratic risks present, we expect that 2Q15 will provide greater opportunities for relative value trades. We will look to take advantage of oil reaching a floor to be long 2Y Russia local against short 2Y TURKGB. On diverging easing cycles in Poland and Hungary, we recommend going long 3Y HGB against short 3Y POLGB, and on significantly wide yield and Z-spreads between hard and local currency bonds, we recommend long POLAND USD Jan 24s against short POLGB Oct 23s.

## Prelude to asset class rotation

**Local CEE bonds have underperformed other asset classes,…**

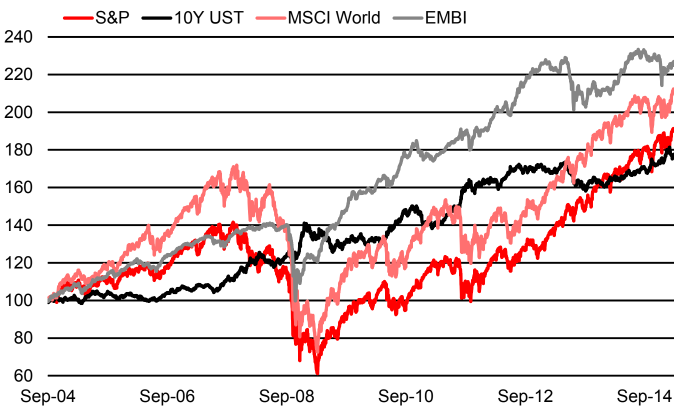
**…but outperformed EM bonds in LatAm and underperforming Asia**

**We see significant headwinds for CEE bonds ahead**

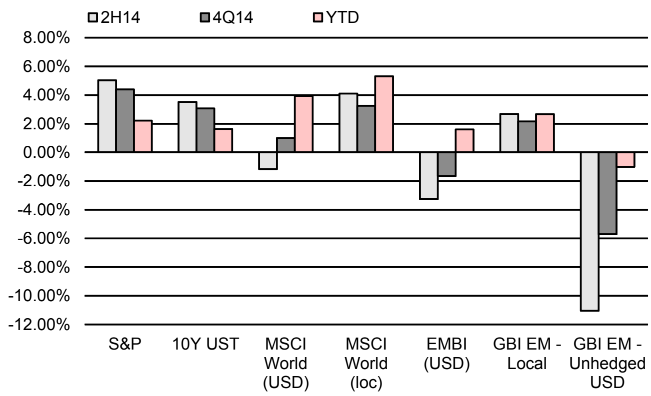
The year 2014 finished strongly, as the buoyant US economy and loose monetary conditions worldwide boosted returns across asset classes. US equities outpaced US 10Y Treasuries on improving labor market conditions and the housing sector crystalizing expectations of Fed hikes. Equity returns globally continue to strengthen, particularly in Europe on anticipated ECB QE, while global bond markets have also performed strongly but underperformed equities. EM local bond yield curves have bull flattened, with EM Asia outperforming EMEA and LATAM. Positive returns across CEE YTD were marked by record-low yields in anticipation of ECB QE. OFZs rebounded amid stable oil prices and a fragile truce in East Ukraine. Despite the rally, we think there are significant headwinds ahead and we see five main themes which could indicate that the fixed income rally across CEE is ending.

EM DEBT MARKET PERFORMANCE IN A GLOBAL CONTEXT

Asset returns




YTD returns




Source: Bloomberg, UniCredit Research

## Key themes for 2Q15

### 1. Inflation has bottomed out in Central and South Eastern Europe (CSEE)

**Negative inflation in central Europe will end by 4Q15**

In Central Europe, improved domestic demand resulting from stronger labor markets and from the absence of food and fuel price shocks means that inflation will turn positive by 4Q15. Unless oil prices drop significantly, inflation will increase in the Czech Republic, Hungary, Poland and Romania. Despite inflation bottoming out, central banks in Hungary and Romania will likely ease further, while in Poland the easing cycle seems to be over.

**Inflation bottomed out in the Balkans but could decline further in Turkey**

Inflation has troughed in the Balkans as well. Energy price hikes will push prices higher in Serbia, but the sizeable real interest rate (the highest in EM) will prompt further monetary easing as long as portfolio capital keeps flowing in. Domestic demand in Croatia remains weak but reflation will happen as past price shocks exit the base. In Russia, inflation is expected to peak in 2Q15 as the FX pass-through runs its course, while in Turkey inflation should continue to fall in 2Q15 due to base effects, even though the FX pass-through will slow disinflation. Both the CBR and the CBBRT are expected to cut rates further in support of domestic demand, but idiosyncratic factors such as geopolitical tensions and political interference in central bank activity will reduce the positive impact on bonds in both countries.

**This could be the start of a rotation out of fixed rate local bonds**

In a reflation environment, the scope for significant easing seems small and this could spell the start of a greater rotation out of fixed rate local bonds and receiver swaps and into hard currency and floating rate bonds, payer swaps and other asset classes such as equities.

### 2. Rising US yields to put pressure on long-end Central European bonds

**Rising US yields will put pressure on CEE bonds…**

Rising US Treasury yields ahead of US Fed rate hikes are raising volatility in CEE bonds via the impact on spreads and currency. Signals from the FOMC turned more hawkish this year due to strong US labor data and we are expecting a June rate hike, although the OIS curve shows that the market is pricing in later cuts. Either way, we expect US Treasuries to rise from here and this will prompt USD-based investors to demand higher yields in CEE. While overall bearish for fixed rate bonds, the correlation of long-end CEE bonds to US Treasuries is significantly higher than at the front end due to the higher share of foreign investors. This is why we recommend shifting duration from the long end to the belly in most CEE local bond curves.

**…creating significant duration risk in long-dated bonds**

Three separate cases stand out. First, many investors expected Russia to be the trade of 2015 once the RUB stabilizes and geopolitical tensions subside. The former condition was enough to prompt a rally in the front and belly of the OFZ curve. But with foreign ownership of OFZs remaining close to 18% while Russia's weight in the GBI-EM Global Diversified index fell below 4%, the scope for adding exposure in Russia could be limited. Second, the potential Turkish rally was undermined by political interference in central bank decisions, but further disinflation could help TURKGBs rally for a very short period before general elections in June. Third, Serbia's larger-size issuance attracted investors due to big real yields. While macroeconomic fundamentals do not warrant a rally, it is difficult to argue against investors' search for yield and the rally could continue.

### 3. ECB QE to create divergence across CEE

**ECB QE will cause divergence across CEE...**

**...as central European bond yields start to decouple from Bunds…**

**…while eurozone members benefit from direct central bank buying**

The announcement of ECB QE caused a collapse in most CEE bond yields but we believe that the actual buying program will create greater divergence across the region. In Central Europe, correlations with Bund yields have historically been high, but there has been a decoupling since the bond purchases started, as long end CE3 bonds failed to match the tightening in Bund yields. While QE is still in its infancy, we worry that this could be a more serious divergence longer term, as investors become more concerned with potential policy tightening amid rising inflation and improving macro stories and a re-pricing of risk in Central Europe.

The Baltics along with Slovenia and Slovakia will benefit directly from ECB bond buying and we expect yields to tighten significantly more. Based on capital key, we anticipate the ECB will own the maximum allocation of every bond issue in 12 – 14 months from now.

### 4. Short-term deterioration of risk environment with tail risks present

**Risk appetite could deteriorate in the short term…**

**…with tail risks steming from…**

**…rising US yields…**

**…Greece's standoff with creditors , and…**

**…political risk in Russia and Turkey**

Risk appetite could deteriorate in the short term. While we are not expecting a full EM selloff, we think the market could be in store for a month of weaker price action. To provide some context, we draw from our risk on/risk off model where indicators like the VIX Index, US 10Y swap spreads and FX volatility are starting to rise. In addition, we fear iTraxx Europe Senior Financial and iTraxx Xover CDS spreads are getting closer to the tights reached in 2014, indicating that overall risks to EM are to the upside.

We are also concerned about tail risks. In the US, rate hikes could generate significant capital re-allocation and volatility globally. In addition, how US equity valuations and dollar strength will affect foreign sales revenue (in S&P 500 companies ~41% of revenue is generated outside the US) remain uncertain at a time when the S&P 500 Index is experiencing the longest time period between drawdowns greater than 10%, in 17 years. In Europe, Greece remains an issue with a non-zero probability the country will opt out of the eurozone. In CEE, political risk in Russia remains elevated, as the Minsk agreement has been broken repeatedly. In Turkey, potential policy mistakes could weigh on the lira and bonds at a time when net FX reserves remain close to the lowest level in 11 years and the private sector continues to leverage.

### 5. Central Europe stands out as less vulnerable than most EM

**We see limited vulnerability from portfolio flows in CEE…**

**…with the exception of Turkey and Serbia**

EPFR bond flows highlight a rotation from local bonds to hard currency bonds that is likely to impact most EM. Year-to-date inflows into EM bond funds are positive but all inflows have come via hard currency bond funds, with local currency bonds experiencing large outflows. Countries that rely on volatile capital to cover C/A deficits will suffer the most, with Turkey and Serbia being the most exposed in CEE, while Central Europe stands out with its large, positive extended basic balances.

**High foreign ownership of bonds is an issue for Hungary, Poland and Turkey…**

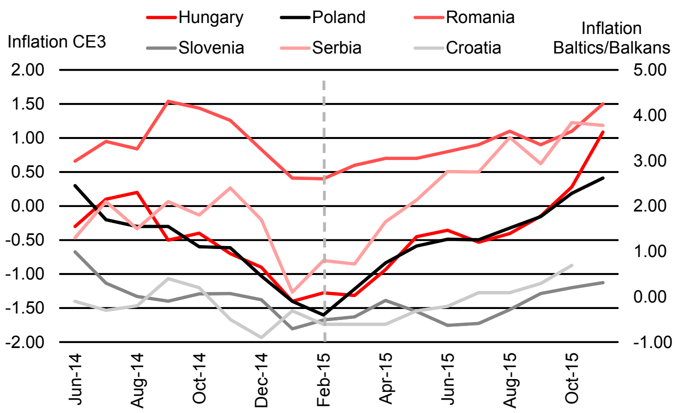
That said, foreign holdings of local bonds are close to 12-month highs in Hungary and Poland, mostly concentrated in the long end. Foreign TURKGBs holdings have been relatively stable since June 2014, hovering at 25%, but could decline in case of risk aversion. Foreign holdings of Romanian and Russian local bonds remained stable at 18-23%, despite the contrasting performance, and we see limited scope for further outflows.

**…but less so for Romania and Russia**

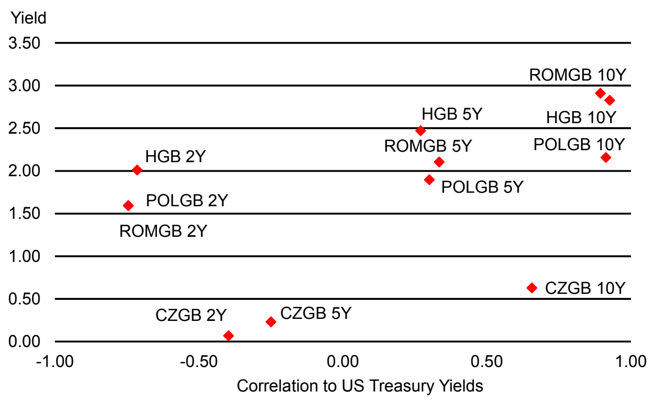
**Auction support is waning**

As a first indication of potential risks ahead, support for local bond auctions is starting to wane. A combination of high average accepted yields, declining bid to cover ratios and an absence of support for longer-dated issues suggests that investors see that scope for a further rally as limited

**INFLATION BOTTOMING OUT IN CENTRAL EUROPE & THE BALKANS**

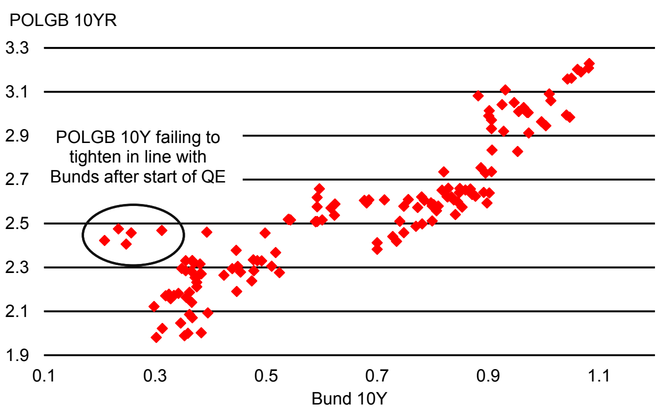



**2Y, 5Y & 10Y CORRELATION WITH UST YIELDS**

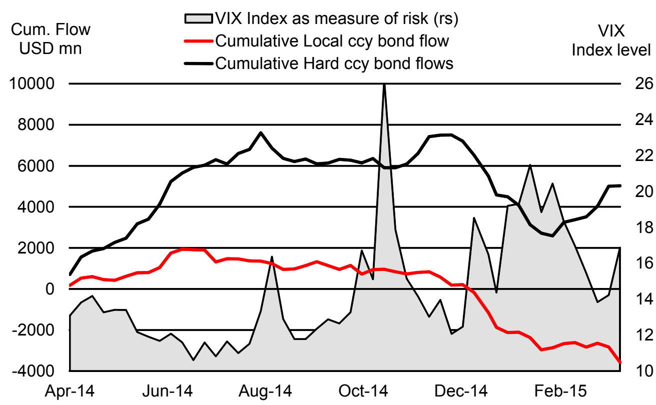



Source: Bloomberg, EPFR, UniCredit Research

**AFTER START OF QE POLGB 10Y VS 10Y BUNDS DECOUPLING**




**RISING RISK LEVEL IMPACTING PORTFOLIO FLOWS**




Source: Bloomberg, EPFR, UniCredit Research

## Local currency bonds: Another step in divergence

**We recommend shifting duration to the belly of the curve in POLGBs, HGBs and ROMGBs…**

**…and see value in a 2s10s and 3s 10s steepner in Poland and Hungary**

In Central Europe, the economic recovery means further convergence in inflation. Bond price risks are to the downside particularly at the long end. With the easing cycle over in Poland (although not in Hungary), high foreign bond holdings and significant correlation with US yields, we recommend shifting duration to the belly of the curve in both countries. We are favoring the POLGB 21s and 22s and also the HGB 20s. We recommend a 2s10s steepener and paying 10Y swaps in Poland due to the flat POLGB curve. HGBs may see short-term support on the back of rate cuts, high real yields and expectations of a rating change. With the timing uncertain and on the balance of risks, we suggest a 3s10s steepener into the expected easing and paying 10Y swaps in the second half of 2Q15.

The first half of 2Q15 should see continued support for ROMGB on expected rates cut, very small financing needs, and low foreign holdings of ROMGBs. We recommend moving duration from the long end to the ROMGB 20s.

**...and move from marketweight to underweight beyond April in TURKGBs**

Political and structural risks in Russia and Turkey will create short-term opportunities. In Turkey, real yields could rise again amid falling inflation in March and April[2] and could prompt renewed buying interest. This will continue as long as the president and the government recognize that their verbal interventions are weakening the TRY and doing more damage than smaller rate cuts, We recommend being marketweight TURKGBs, moving to underweight beyond April in the run-up to parliamentary elections scheduled for 7 June. We recommend avoiding the front end of the curve due to lira risk and we favor the belly, in particular the TURKGB 22s.

**Underweight Russian locals, but opportunity for relative value trade vs. TURKGB 22s**

In Russia, a lack of growth, fragile Minsk agreement and weak oil price mean that we recommend staying underweight local bonds. Balancing medium-term risks, Russia's higher reserves make it less vulnerable to market shocks than Turkey. We recommend beyond April a long position in RFLB 7.6% 2022 versus short TURKGB 8.5% 2022. Timing is key as OFZs could be downgraded in April and exit the Barclays Aggregate Index, creating selling pressure. The short TURKGB position is based on mounting political risks beyond April in the run-up to elections.

**We favor the 3Y and 7Y benchmark Serbia bonds …**

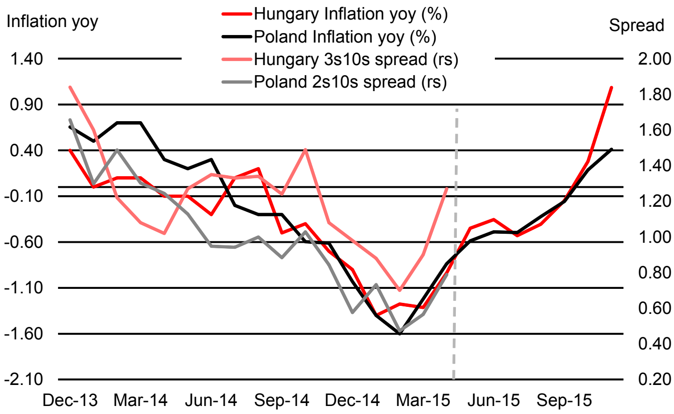
In the Balkans, significant fiscal tightening will weigh on growth, while inflation will remain low amid poor domestic demand in Croatia and Serbia. High real yields, improved liquidity and a likelihood the NBS will have to cut rates support SERBGBs, and we like the 3Y and 7Y local benchmark bonds.

**…and expect yields to tighten significantly for eurozone members due to ECB QE**

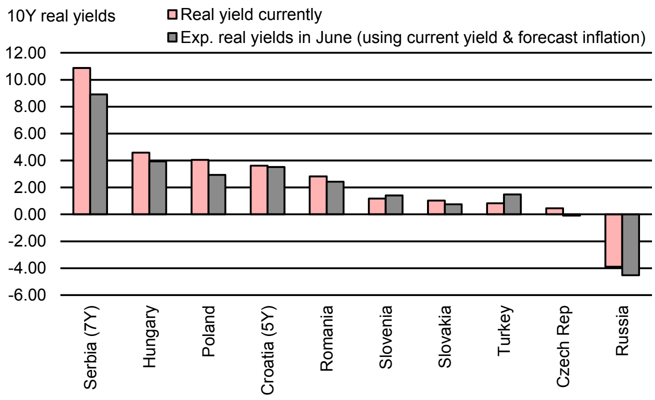
For eurozone members, ECB QE will be the main driver of local bond markets. We expect to see significant tightening in Latvian, Lithuanian, Slovenian and Slovakian bonds. ECB demand will likely outweigh any other global or domestic bond headwinds. We recommend being long the SLOREP 26s on the local Slovenian curve.

[2] Data released on 3 April and 4 May.

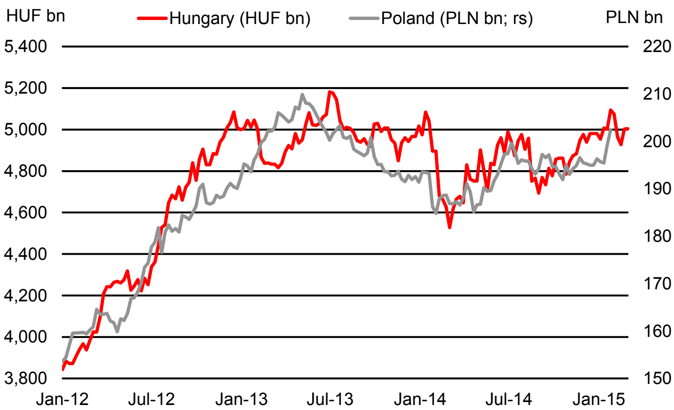
2S10S and 3S10Ssteepener in Poland and Hungary…



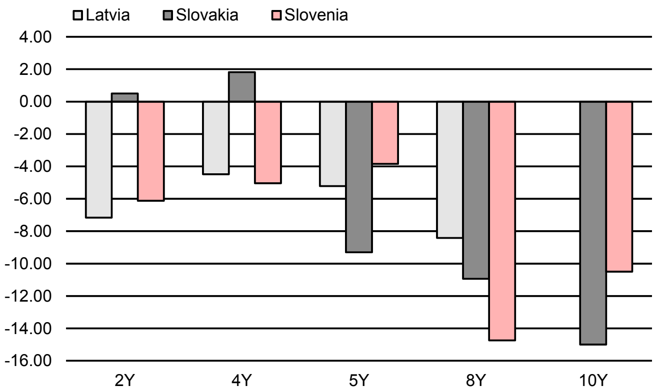

Real yields and change expected by June 2015




Foreign holdings in POLGBs and HGBs elevated…




Yield tightening after 7 days of ECB QE




Source: Bloomberg, UniCredit Research

## Hard currency markets: Start of greater rotation

**Hard currency bonds are still better value than local currency bonds…**

Rising US yields resulted in significant US dollar strength and hard currency bonds outperforming local bonds. Higher yields and Z-spreads and insulation from rising US rates make hard currency bonds better value than local currency bonds. Thus, we expect outflows from local bonds into hard currency bonds to continue.

**…we prefer being overweight on the POLAND, REPHUN and ROMANI USD curves**

We recommend switching from local to USD bonds due to lower FX risk and scarcity value in Poland, Hungary and Romania. We expect no FX issuance in Hungary this year, while Poland and Romania could issue in EUR. In Poland, we favor the POLAND USD 22s and 24s, and in Hungary the REPHUN USD 23s and 41s. We think the POLAND EUR 25s and REPHUN EUR 20s offer good value, especially for EUR-based investors amid negative Bund yields. In Romania, we favor the ROMANI USD 44s and ROMANI EUR 24s.

**In Turkey, we like hard currency bonds over local bonds …**

With the local curve in Turkey inverted, making FX hedging costly amid significant currency and political risks, we think that TURKEY USD 22s and 36s and TURKEY EUR 21s offer good value and a higher Z-spread than local bonds with similar maturities.

**…while in Russia we think relative value trades are the least risky option**

After the Moody's downgrade and removal of Russian hard currency bonds from Barclays Global Bond indexes, we think that much of the pressure on hard currency bonds is behind us. While CBR rate cuts and stable oil prices could support local bonds, we still prefer hard currency ones. In addition, we favor long RUSSIA EUR 20 against short TURKEY EUR 20 on balance of country risks.

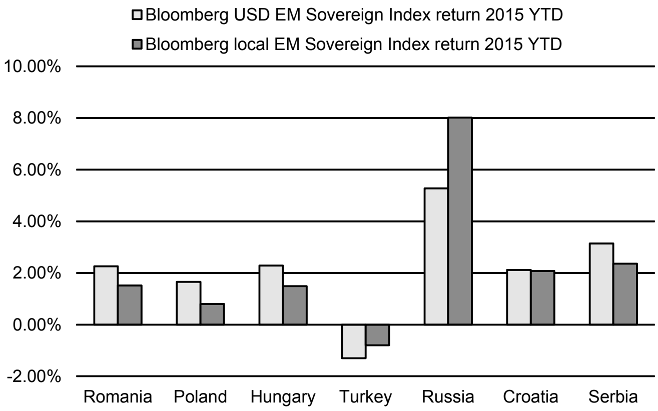
**We prefer overweight SLOVEN 23s, and long LITHUN USD 17s vs. short LATVIA USD 17s…**

Spreads should tighten across CEE eurozone members on ECB QE amid a lack of issuance. USD-denominated bond yields should fall as local bond yields drop. We favor the SLOVEN USD 23s and flattening trade of long SLOVEN USD 24s vs. short SLOVEN USD 18s. Tight fiscal policies and low remaining financing should support Lithuania. We recommend long LITHUN USD 17s against short LATVIA USD 17s on lower energy and financing dependency on Russia.

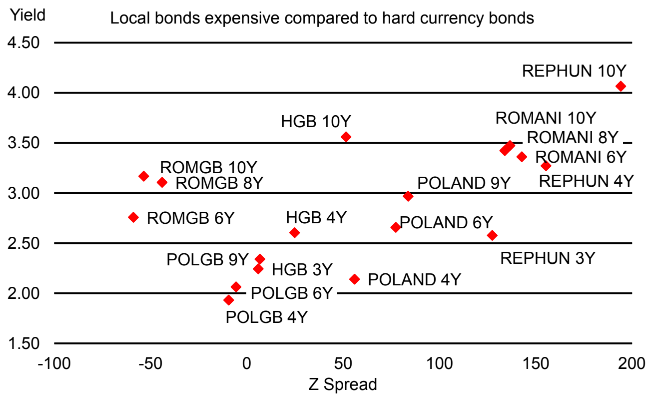
**…and see relative value trades in the spread between SERBIA USD and CROATIA USD**

In the Balkans, we advocate trading the CROATIA USD vs. SERBIA USD spread. Both economies have significant reform issues and face recession, but Croatia remains a better credit with access to EU funds, so should trade inside Serbia. We advocate being long Croatia when the Serbian 20s or 21 USD bonds are trading inside Croatia USD 20s and 21s, and long Serbia against Croatia when the spread is more than 40bp.

**ROTATION TO HARD CURRENCY…**




**…BETTER VALUE IN HARD VS LOCAL CURRENCY BONDS**




Source: Bloomberg, UniCredit Research

## Relative value: greater opportunities ahead

**We see greater scope for relative value trades in 2Q15…**

We expect that the differing speed of inflation, growth, monetary easing and idiosyncratic events across CEE will provide greater scope for relative value trades over the course of 2Q15. We identify a few opportunities we will be looking to take advantage of:

**…on different scope for currency support and diverging rating reviews**

1. **Fundamental vulnerabilities:** We have highlighted FX reserves size in Turkey versus Russia and the short-term risk in Turkey of political interference in CBRT decisions, excessive easing and potential event risk before the June elections. We will also see opportunities in upcoming rating reviews where we see the possibility of upgrades in Hungary and Poland and likelihood of downgrades in Russia, Turkey, Serbia and Croatia.

**Oil price floor will create opportunity in the front end in Turkey and Russia…**

2. **Oil price impacts:** the high negative correlation of oil to Russia 2Y and positive correlation to Turkey 2Y creates opportunities to trade the spread. When oil finds a floor beyond current supply issues, risks will be to the upside and we will look to be long Russia 2Y against Turkey 2Y, expecting the spread to compress.

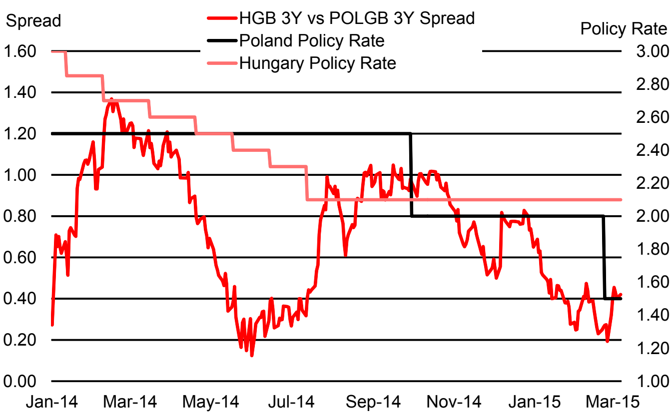
**…while differing stages in the easing cycle support a long HGBY 3Y position vs. short POLGB 3Y**

3. **Decoupling in monetary policy cycles:** The easing cycle finished in Poland but will probably continue in Hungary and Romania. We recommend a long HGB 3Y position against short POLGB 3Y. We expect Hungary to cut up to 60bp, bringing the base rate in line with Poland's. Inflation risks in Poland are skewed to the upside on improving domestic demand, which should put pressure on front end rates once supply-side shocks wane. These opposing factors should see the spread tighten 25bp from current levels.

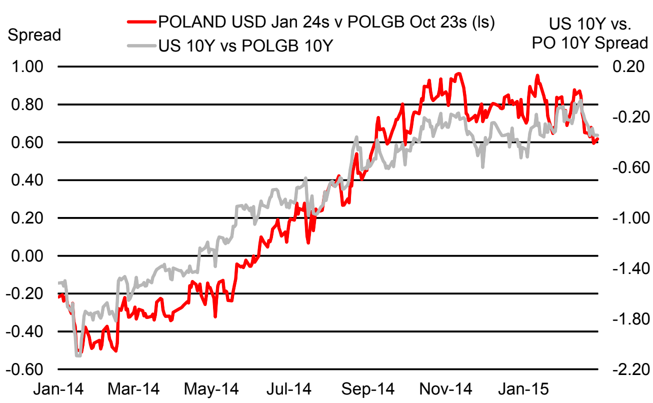
**Yield and Z-spreads between hard and local currency bonds should converge with rising US rates**

4. **Hard currency vs. local currency bond spreads:** we think that Z-spreads and yield spreads between local and hard currency bonds remain too high. The rotation out of local currency bonds into hard currency should help the spread narrow and may turn negative. We recommend a long POLAND USD Jan 24s vs. short POLGB Oct 23. With the current positive carry and the spread at 62bp, we think the spread can tighten 40bp from this level.

**CHANGING EASING CYCLES HGB 3Y VS POLGB 3Y**




**SPREAD OF HARD CCY AND LOCAL BONDS TO NARROW**




Source: Bloomberg, UniCredit Research

# CEE Fixed Income Trade recommendations

### CLOSED TRADES SINCE 1Q15 QUARTERLY – LEVELS IN BASIS POINTS

| Date Initiated | Trade | Entry level | Target | Stop loss | Current level | P&L | Comment |
|---|---|---|---|---|---|---|---|
| 22 Oct | Long BGARIA EUR 24s vs. LATVIA EUR 24s | 104 | 84 | 118 | | -14 | We thought the formation of a government in Bulgaria could solve the banking crisis ahead of plans to join the EU; however, we were not expecting the S&P downgrade as conditions looked like they would improve. |
| 23 Oct | Long TURKGB 23s vs. TURKGB 18s | 31 | 10 | 60 | | 20 | With the CBRTs desire to have a flat yield curve, we expected that demand increases in longer-dated tenors as investors extended duration in the anticipation of lower inflation. |
| 29 Oct | Long ROMANI EUR 24s vs. POLAND EUR 24s | 134 | 94 | 150 | | 40 | With investment growth slowing, we expect Romania to remain in an easing cycle longer than Poland. We also saw better support for ROMANI EUR-denominated bonds in the advent of ECB QE. |
| 14 Nov | Long Hungary EUR 20 vs. BTP EUR 20s | 97 | 80 | 115 | | 17 | Hungary euro-denominated bond spreads versus BTPs were high. We expected yields would tighten faster in Hungary due to the higher real yields and as investors looked beyond central European markets for yield. |
| 14 Nov | Long Turkey EUR 20 vs. BTP EUR 20s | 134 | 100 | 160 | | -26 | Falling inflation in Turkey prompted rate cuts but political criticism of the CBRT resulted in a significant depreciation of the lira, putting pressure on yields. |
| 20 Nov | Long ROMGB 23s vs. HGB 23s | 16.5 | -35 | 40 | | 52 | We expected that Romania would remain in an easing cycle longer than Hungary and get additional support due to a lack of issuance in Romania and in the event of a period of EM risk aversion. |
| 19 Dec | Long SLOVENIA USD 23s vs. ROMANI USD23s | 71 | 15 | 100 | | 56 | With ECB QE likely to be announced, we envisaged yields in Slovenia tightening faster than in Romania, as the ECB would be buying Slovenian bonds directly, whereas ROMANI bonds would tighten due to secondary effects. |
| 23 Dec | Long TURKGB 16s vs. TURKGB 20s | 45 | -15 | 80 | | -35 | With the curve inverted, we expected inflation to fall and the CBRT would cut rates which it did, but pressure on the currency from political criticism of the CBRT caused front end yields to spike, hitting our stop loss. |
| 2 Jan | Received 2Y Turkey cross currency swaps | 727.5 | 650 | 780 | | -53 | We expected that, with a significant drop in inflation in January, the CBRT would cut rates aggressively, but the political backlash due to rates not being cut enough spooked the market, causing 2Y rates to sell off. |
| | | | | Total | | 56bp | |

Source: Bloomberg, Unicredit Research

### OPEN TRADES – LEVELS IN BASIS POINTS

| Date Initiated | Trade | Entry level | Target | Stop loss | Current level | P&L | Comment |
|---|---|---|---|---|---|---|---|
| 9 Oct | Rec 10Y Poland vs. Pay 10Y Hungary | 103 | 175 | 50 | 72 | -31 | We expect the NBP to ease rates further and at the time of instigating the trade expected inflation to pick up in Hungary due to base effects and excise taxes. We think that Hungarian rates are more vulnerable to an EM-wide sell off. |
| 22 Jan | Long POLGB 23s vs. short HGB 23s | -78 | -120 | -65 | -100 | 22 | With the onset of ECB QE, we expect that the long end in POLGBs should tighten faster than HGBs due to the higher correlation with Bunds and should also be better supported in the event of a period of risk off. |
| 30 Jan | Long Croatia USD 20s vs. short Serbia USD 20s | -7 | 27 | -20 | 2 | 9 | Serbian bonds should not trade inside Croatia, as Croatia has a better credit rating, is further along the reform path, has lower financing needs, more diverse exports and has the support of the EU. |
| 2 Feb | Long POLGB 17s vs. short 2Y Bunds | 173 | 138 | 200 | 187 | -14 | With negative yields, we expect that 2Y Bunds should reach a floor, but we expect that with rate cuts priced in for Poland the spread between the two should tighten. |
| 27 Feb | Long Serbia 3Y local bonds | 967 | 916 | | 964 | 3 | On balance of risks, better support for local benchmark bond auctions have provided higher liquidity to the local curve. This should see the liquidity premium decline and the high real yields are likely to attract investors. |
| 27 Feb | Long Serbia 10Y local bonds | 1190 | 1110 | | 1168 | 22 | On balance of risks, better support for local benchmark bond auctions have provided higher liquidity to the local curve. This should see the liquidity premium decline and the high real yields are likely to attract investors. |
| | | | | Total | | 10 | bp |

Source: Bloomberg, Unicredit Research

**TRADE RECOMMENDATIONS FROM THE QUARTERLY 1Q15 (NOT INCLUDED ABOVE) – LEVELS IN BASIS POINTS**

| Date Initiated | Trade | Entry level | Current leve | P&L | Comment |
|---|---|---|---|---|---|
| 10 Dec | BGARIA EUR 24s | 2.60 | 2.19 | 41 | We were not expecting the S&P downgrade, as we thought conditions were improving after the banking crisis. However, the positive ECB QE news helped yields tighten further beyond the initial back-up in yields. |
| 10 Dec | RUSSIA USD 23s | 6.31 | 5.96 | 35 | Significant volatility in the ruble, not helped by declining oil prices, rising inflation followed by rate hikes and then cuts. The USD-denominated bonds outperformed the local OFZ curve even before the currency was considered. |
| | RUSSIA USD 22s | 6.19 | 5.78 | 41 | |
| | Russia 2s5s flattener | -0.14 | 0.58 | -72 | Initially, the curve flattened as the CBR hiked rates 650bp on 15 Dec; however, front end rates declined after the CBR abandoned inflation targeting in favor of cutting rates to reduce the interest rate burden on the economy. |
| 10 Dec | TURKGB 20s | 8.04 | 8.34 | -30 | For TURKGBs and USD-denominated bonds, we failed to predict the aggressiveness of criticism aimed at the CBRT for not cutting rates more significantly. This more than offset the positive events we did forecast in the form of a sharp fall in inflation, improving current account and rate cuts. However, this was not enough to stop the lira from depreciating and putting significant upward pressure on front end rates, keeping the curve inverted. |
| | TURKEY USD 22 | 4.07 | 4.31 | -24 | |
| | TURKEY USD 40 | 5.11 | 5.29 | -19 | |
| 10 Dec | ROMGB 23s | 3.42 | 3.05 | 37 | A positive environment for bonds in low inflation, relatively strong fundamentals, further monetary easing and low bond issuance provide an attractive backdrop for bonds to rally further. Hard currency bonds were able to benefit on the back of yield search by European investors. |
| | ROMANI USD 44s | 4.68 | 4.49 | 19 | |
| | ROMANI EUR 24s | 2.43 | 1.84 | 59 | |
| | Long ROMANI USD 24s vs. short POLAND USD 24s | 0.37 | 0.50 | -12 | There has been a short-term period of weakness in this pair after widening in yields in Romania, We expect that the spread will tighten from here now that Poland's easing cycle has ended, but with more cuts expected in Romania. |
| 10 Dec | POLGB 22s | 2.43 | 2.30 | 12 | There was a significant rally in POLGBs over the last quarter following the announcement of ECB QE. Additional stimulus came from benign inflation and additional rate cuts. However, monetary easing has now ended and inflation is set to rise, and hence hard currency bonds are starting to outperform. |
| | POLGB 25s | 2.59 | 2.45 | 14 | |
| | POLAND USD 22s | 3.04 | 2.83 | 20 | |
| | POLAND USD 24s | 3.21 | 2.98 | 23 | |
| 10 Dec | HGB 22s | 3.40 | 3.31 | 10 | A combination of high real yields, deflationary factors and the onset of ECB QE helped yields tighten significantly. However, the currency remains vulnerable and the lack of hard currency bond issuance in 2015 is likely to mean that hard currency bonds remain well supported. |
| | HGB 20s | 3.16 | 2.98 | 18 | |
| | REPHUN EUR 20s | 1.92 | 1.37 | 55 | |
| | REPHUN USD 41s | 5.21 | 4.84 | 36 | |
| | REPHUN USD 23s | 4.10 | 4.01 | 9 | |
| | | | | **272** | |
| | | | **Overall Total** | **338bp** | |

Source: Bloomberg, Unicredit Research

# CEEMEA FX: mind the "ECB-Fed" gap

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The interaction of divergent Fed and ECB monetary policies will impact CEEMEA FX crosses greatly, depending on which market paradigm is dominating. We highlight the following:

1. **Higher US rates: Sell TRY vs. PLN and USD whenever US yield increases on Fed normalization are the main market driver.** Deleveraging and improving current account balances suggest CE4 currencies are far better placed to weather any EM FX storm.
2. **Use ECB QE flow effect to your advantage.** Sell into EUR-PLN rallies so long as ECB QE flow impact remains the dominant market paradigm. Buy **PLN-HUF** and **EUR-HUF** on signs ECB flow effect is waning.
3. **TRY: Not just about politics.** Buy **USD-TRY** on dips and look to sell TRY-PLN when US rates move sharply higher while EUR rates move sideways. To play a surprise recovery on reduction of political risk premium, buy **TRY-IDR** targeting a 3-5% return.
4. **EUR-CZK:** Still play the ranges. Buy **EUR-CZK** whenever the pair falls towards 27.2, targeting levels above 27.5 supported by verbal interventions.
5. **RUB:** Highly dependent on energy prices and outlook for financial sanctions. We think that CBR could replenish FX reserves on any RUB rally, curtailing moves in USD-RUB to the downside.

## CE4: A harbor of stability in any EM FX storm

**CE4 stands out as among the more resilient EM currencies to higher US rates…**

Movements in emerging market currencies will hinge quite heavily on the interaction of two opposing forces: a Federal Reserve intent on normalizing policy but with the European Central Bank moving in the opposite direction. On a relative basis, we would argue that CE4 currencies (CZK, HUF, PLN, RON) hold up well against currencies in Turkey and large parts of Asia and LATAM given **(a)** lower external financing needs, **(b)** C/A surpluses and significant inflows of EU funds and **(c)** less reliance on USD funding costs. However, gauging which driver (Fed tightening or ECB easing) is dominating market behavior will be key.

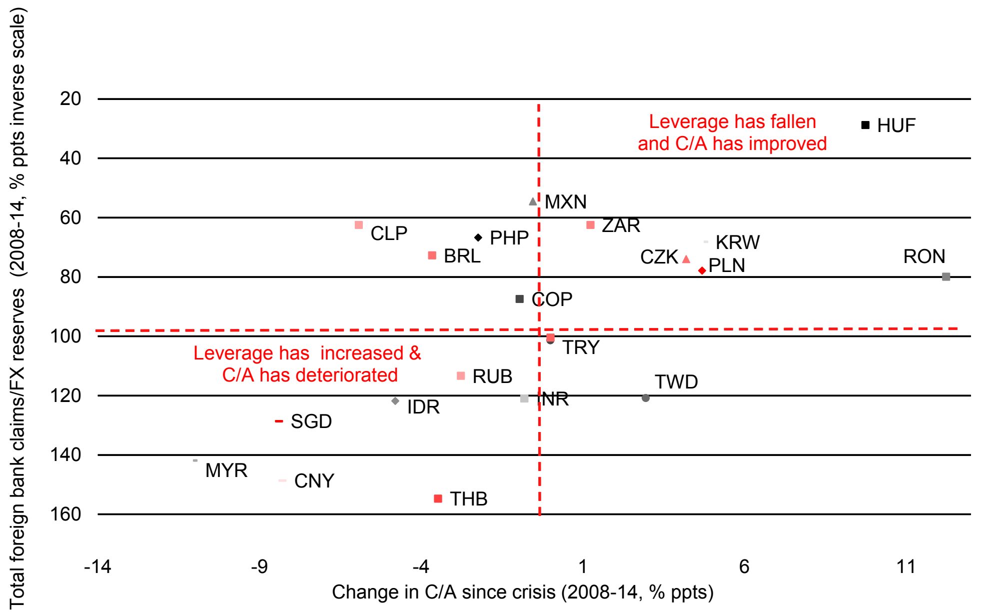
**…with leverage and external balances having improved after 2009…**

**…in contrast to TRY and several Asian currencies**

Chart 1 plots the several EM currencies, comparing the change in total foreign bank claims to gross FX reserves (y-axis) to the cumulative change in the current account as a percent of GDP (x-axis) between 2008 and 2014. The currencies in the upper-right quadrant represent those currencies where leverage has been reduced the most during the period of low US rates and hence there has been a reduction in external balance vulnerabilities. These include the CE4 and ZAR, MXN in LATAM and KRW in Asia. The currencies in the bottom-left quadrant include those that have become more exposed to higher US funding costs. We think that these currencies will be the most at risk as US rates go higher. As can be seen, the biggest vulnerabilities lie in the Asian countries where USD funded leverage has been built up the most during the period of low US rates .

**LEVERAGE AND EXTERNAL BALANCES DETERMINE WHICH EM FX CAN WEATHER HIGHER US RATES**

Chart 1: Changes since 2008: Foreign bank claims/FX reserves vs. current account balances




Source: Bank of International Settlements (BIS), Bloomberg, UniCredit Research

## Monitoring interaction of US and EUR yields key

**TRY and RUB can cheapen further…**

The US Treasury international capital system (TICS) report highlights that, as a proportion of the total, US bank claims on Asia have increased from under 5% before 2008 to 15% as of the end of 2012[3]. As can be seen, Russia and Turkey stand as being more vulnerable in CEEMEA. In the case of Turkey, while political pressure on the CBRT has intensified, fundamentally things haven't necessarily gotten worse, but they have not improved either. Inflation is still high, the current account deficit still wide and the real exchange rate still overvalued. We think that higher US funding costs will continue to weaken the lira on a multi-month horizon. Similarly, our view on Russia is still negative, but so long as there is no escalation (or de-escalation) of financial sanctions and assuming energy prices do not decline sharply from here, USD-RUB should remain range bound.

**…RUB will depend heavily on energy prices and outlook for financial sanctions…**

**We like PLN but dislike HUF…**

As mentioned at the outset, CE4 currencies should remain relatively resilient to increases in US yields. Among our favored currencies is the PLN, while we think the HUF will remain weaker on a relative basis due to higher total and remaining financing needs for 2015 and Hungary's higher reliance on USD-based investors in the long-end of the HUF yield curve. We like buying **PLN-HUF, USD-HUF** and selling **TRY-PLN.**

**For expressing fundamental views via CEEMEA FX crosses….**

**…monitoring relative interaction of US and EUR real yields will be very important**

However, through all these views we would be extremely cognizant of the relative interaction of US real yields (when Fed tightening dominates) and EUR real yields (when ECB bond purchases dominate). The relative interaction of these forces can hamper expressing directional views via intra-CEEMEA FX cross trades. This is because, while higher US yields should pressure C/A deficit currencies like TRY and ZAR, by the same token when EUR real yields are falling sharply (as they are currently), there is a tendency for CE4-crosses to track EUR-crosses lower.

[3] See http://www.treasury.gov/ticdata/Publish/exhibitb.pdf

We are already starting to see this happen; by way of example, the $R^2$ of a regression of TRY-HUF on TRY-EUR is 82% (on levels) over the past month, up from 63% over the preceding 30-day time-frame (mid-January to mid-February). This is a factor worth considering when expressing a fundamental view within CEEMEA that is not hampered by correlations to broader movements in EUR and USD real yields as monetary actions by the Federal Reserve and the ECB diverge in the months ahead.

## #1: PLN

**PLN one of our top picks**

The **Polish zloty remains one of our more favored currencies in the region**. We like buying **PLN-HUF,** given almost diametrically opposite official stances towards the respective currencies in the short term. We also like selling **TRY-PLN**, particularly where we have increases in US yields (on Fed tightening) being the prominent driver and on evidence that the ECB QE flow effect is weakening. We expect **EUR-PLN** to remain in a 4.05-4.25 range this year and next, being closer to the bottom when the ECB QE flow effect is running at its maximum (just like at the time of writing). We expect a move up towards the top of the range in the event that US yields rise sharply.

**ECB QE and CHF movements will be important drivers near term**

In the near term, two important factors for EUR-PLN direction will be: **(a)** movements in EUR real yields on ECB QE, and **(b)** movements in the Swiss franc (CHF-PLN). On **(a)**, EUR-PLN remains very directional on EUR real yields and we believe the strong flow effect of the ECB's sovereign bond purchases has been an important driver for EUR-PLN trading so heavily[4]. We would need to see signs of the impact of ECB's bond purchases petering out in order to obtain a buy signal.

**…CHF strength will likely prompt PLN supportive rhetoric**

On **(b)**, we would be closely watching broader movements in CHF-PLN, given the still present financial stability risks associated with CHF strength[5]. The NBP has identified CHF-PLN at 4.20 (or PLN 7.65% weaker from current levels) as a pain threshold in its stress tests. Finance Ministry officials have also mentioned recently a clear preference that CHF-PLN eventually moves down to 3.00 rather than rise to 5.00. With parliamentary elections scheduled for October, the CHF mortgage issue will remain a politically-sensitive one, reducing the upside potential in CHF-PLN and EUR-PLN. We think in instances where the Swiss franc is strengthening, authorities' verbal intervention towards a stronger currency will increase and/or they may sound more hawkish.

**Looking towards FDI trends to provide a longer term buy signal**

Further out, we will be closely monitoring the balance of payments support for the zloty. We find that directionally flows of foreign direct investment (FDI) provide the strongest clues as to the future direction for the currency (Chart 2), over and above trends in portfolio investment flows. Should a stronger growth outlook result in an improvement in FDI inflows, we would take that as a longer term bullish signal for PLN. In recent years, EU funds have also been having a strong positive impact on PLN's demand-supply balance.

[4] YTD correlation between EUR-PLN and German 5Y real yields is very high at 82%, but lower at 37% since 2012.
[5] NBP estimates that foreign currency housing loans constitute 19% of the total loan portfolio for the non-financial sector and 47% of the housing loan portfolio, according to the NBP's financial stability report.

Chart 2: Authorities sensitive to movements in CHF-PLN

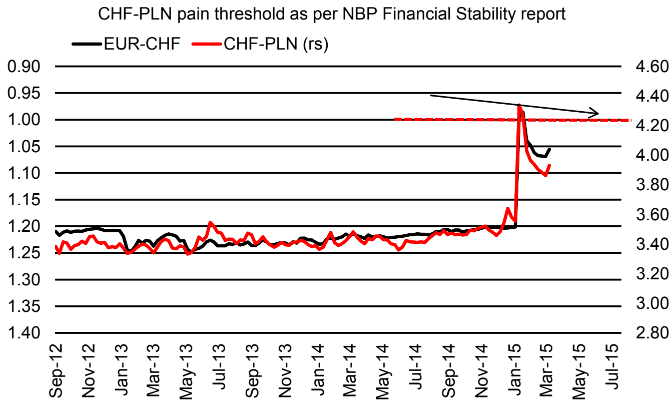
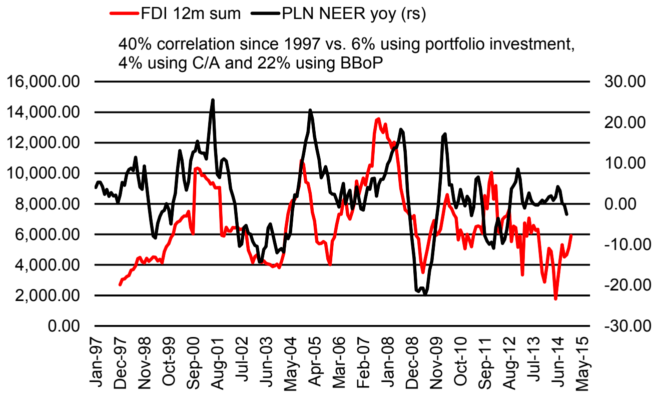



Chart 3: FDI inflows important for PLN trend direction




Source: Bloomberg, Haver, UniCredit Research

## #2: HUF

**HUF our least favored CE4 currency…**

The Hungarian forint remains our least favored currency among the CE4, given: **(a)** NBH bias to ease and weaken the currency, **(b)** large exposure of HGB market to US investors, and **(c)** general abundant HUF liquidity given further easing measures. We like buying USD-HUF and PLN-HUF, the latter especially on signs that the ECB's QE actions are having a diminishing effect. We think EUR-HUF could rally near term should the market's focus switch away from ECB QE to higher US rates around the FOMC meeting in June. Thereafter, EUR-HUF will likely move to a lower range as we enter 3Q15.

**…with further monetary policy easing and a strong preference for a weak currency to weigh on HUF**

The NBH will be one of the few central banks easing policy this year in the region. We look for a 10bp cut this month and a cumulative 60bp by 3Q15. Further measures to flatten the yield curve and increase HUF liquidity, which should reduce HUF FX implied yields further, cannot be ruled out. We think this will weigh on the currency. The central bank will be keen to promote a weaker currency with financial stability concerns (stemming from a weaker currency) having receded following the reduction in foreign currency liabilities after the FX mortgage conversion. That's not the case for other countries, like Poland. We like buying PLN-HUF and USD-HUF.

**A strong flow effect of ECB purchases could constrain any EUR-HUF rally…**

Of the CE4 currencies, the Hungarian forint will be the currency most volatile following the flow impact of the ECB's bond buying operations. We think that further evidence of a diminishing effect of ECB bond purchases would be a pre-requisite for turning bullish on EUR-HUF. Looking at the link with 5Y German real yields, most EUR/CE4 pairs are correlated but none more than EUR-HUF; correlation on daily data since 2012 is 59%, and a much higher 81% YTD (chart 1).

**A rise in US yields and stabilization in EUR real yields should allow PLN-HUF to rally**

Further out, we will be closely monitoring the balance of payments support for the forint. We find that directionally portfolio investment flows into fixed income have been strongly tied to direction in the currency in the short term. We have highlighted that the dominance of a few US investors in the HGB market remains a vulnerability for HUF. Weekly data on foreign holdings of Hungarian treasury notes show that, while foreign purchases of bonds have been strong, they have been highly volatile recently. Moreover, some of the recent bond auctions have been coming in on the weaker side. That said, we do not expect a disorderly decline in the currency due to the strong support from a large, positive extended basic balance: the C/A surplus, FDI and EU fund inflows exceed 5% of GDP (12M rolling).

**HUF: HELPED WITHIN CE4 BY FALLING EUR YIELDS, HURT BY RISING US YIELDS**

Chart 4: EUR-HUF most sensitive to ECB QE

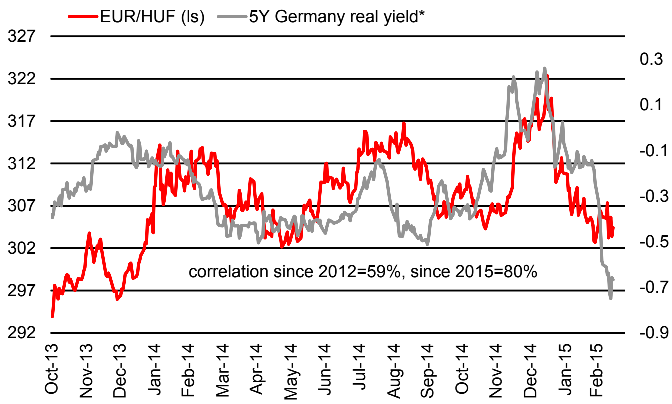
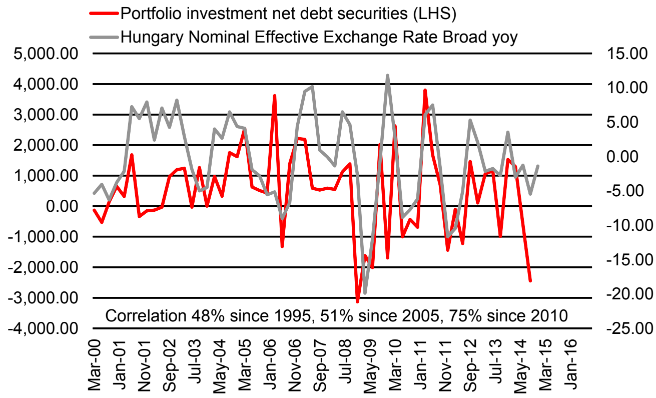



Chart 5: Fixed income flows important for trends in HUF




*German 5Y real yield is calculated as German Government Bonds 5 Yr Obl yield minus Germany Breakeven 5 Year

Source: Bloomberg, Haver, UniCredit Research

## #3: TRY: Weakness not just about politics

**TRY was weak before the politicization of CBRT easing cycle…**

Turkish lira has been the biggest underperformer in our region. Political pressure on CBRT decisions was a big factor, and the risk is unlikely to go away. But for the currency specifically, it wasn't just about politics. A weaker demand-supply picture was apparent even before the unexpectedly large CBRT cut in January. Despite portfolio inflows and lower energy prices, Turkey was hardly able to build up its net FX reserves over 4Q14, even as oil prices were falling. This is in contrast with other EM oil importers[6].

**…high proportion of short-term FX liabilities amid limited FX reserves a key factor…**

We believe a major reason involves vulnerabilities specific to Turkey, given its relatively high short-term external debt, limited FX reserves[7] and high proportion of foreign currency liabilities (Turkish companies have an outstanding net open FX position of more than USD 180bn). By way of comparison, the South African rand, the other high beta currency in CEEMEA, has a high proportion of short-term external debt, but importantly, the bulk of liability is owed in ZAR, which is a differentiating factor explaining its stronger performance despite higher US yields.

**Record USD-TRY highs but TRY still not cheap…**

Even though USD-TRY is close to record highs, TRY is far from cheap. Using the IMF's external balance assessment valuation measures, TRY was still substantially overvalued on a REER basis as of February, despite the currency having sold off heavily vs. USD.

**CBRT policy tactics won't help so long as US rates rise…**

Recently, the CBRT has adopted mini-policy measures like altering the price and quantity of TRY liquidity or foreign exchange liquidity and attempting to provide short-term FX liquidity and increase the carry. Such measures worked when US rates were stable (2012) but will prove less effective in an environment of rising US rates (as seen in 2013).

**… in lower probability of change in tone from politicians, TRY-IDR should rally 3-5%.**

What could spur a TRY rally? We think a reduction of the political risk-premium, i.e. if President Erdogan changes his stance towards the CBRT, and a delay in Fed tightening could see TRY rebound. We recommend pursuing long TRY-IDR as a relative value trade. The cross is at a one-year low and Indonesia also faces similar vulnerabilities to higher US rates and above-target inflation.

[6] From June-December 2014, gross FX reserves increased in South Africa, India (both oil importers) and Indonesia by 2.1%, 2.3% and 4.6%, respectively. Those of Turkey fell 5%. We use IMF country data on foreign exchange for the comparison.

[7] Turkey's gross FX reserves comprises mostly of bank FX reserves (near 80% of total). Subtracting the latter, net FX reserves – available for direct FX intervention - were just USD 24bn, at the end of 2014, covering just 15% of short term external debt.

**CEEMEA FX: SENSITIVITY TO REAL EUR RATES**

Chart 6: TRY: Still expensive after the sell-off

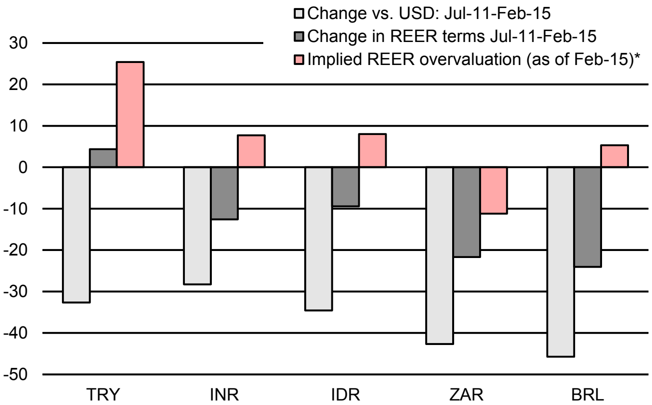
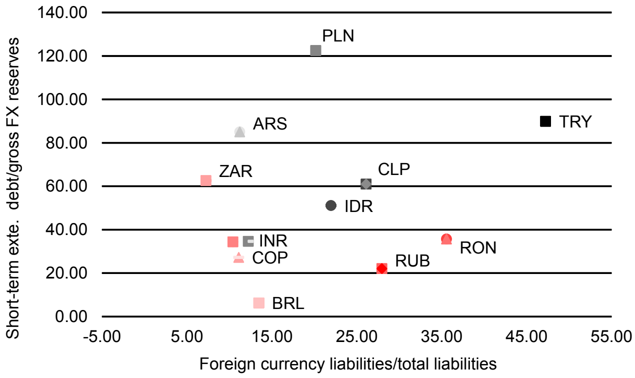



Chart 7: Selected EM FX: Short-term external debt/reserves vs. FX liabilities/total liabilities




* Implied REER gap = IMF REER gap as of 2013 + REER increase from end-2013 to Feb-2015

Source: Haver, Bloomberg, IMF External Balance Assessment, UniCredit Research

## #4: RUB: A matter of crude prices and financial sanctions

**USD-RUB should remain in a wide range …**

Following the sharp weakness seen in the currency following the steep fall in energy prices over 2H14, we think the worst may be behind us as far as the Russian ruble is concerned. We are more likely to stay in a wide range in USD-RUB, and any meaningful movements from here on will be a function of: **(a)** broad movements in energy prices and **(b)** financing flows linked to financial sanctions. The MinFin's preferred level of USD-RUB 61 should provide an indication, but could act more as a floor to the pair as private capital outflows could come close to last year's USD 151.5bn when they were almost three times larger than the C/A surplus.

**Outlook for energy prices and financial sanctions to determine RUB trend …**

Our base-case scenario for Russia remains one of a frozen conflict in Eastern Ukraine, leading to a situation where financial sanctions will likely remain in place. As a result, the Russian economy is expected to contract this year by 4.5%, falling another 1.4% in 2016, and we expect the Central Bank of Russia to look through near-term rises in inflation and cut rates to support growth.

**A lot of bad news is in the price of RUB, unlike in other asset classes …**

As far as the currency is concerned, we suspect a lot of bad news is already reflected in the price, though this may not be the case for other asset classes. Following the earlier-than-expected downgrade by Moody's in the third week of February, interestingly local currency bonds sold off relative to hard currency bonds, even as USD-RUB edged lower tracking firmer energy prices (chart 1). Accordingly, while foreign investors may still be overweight on local currency bonds (as per December CBR data), we suspect such positions may be less relevant for the currency.

**A recovery in energy prices should weigh on USD-RUB…**

In our view, the predominant driver for the RUB will continue to be energy prices, something which is corroborated by the recent empirical evidence[8]. It is plausible that energy prices could come under pressure in the near term with the oil curve having flattened with news of oversupply having brought more short-sellers into the market. At current levels of energy prices, a simple regression model suggests USD-RUB should be trading closer to 64.00.

**…but capital outflows amid financial sanctions should limit RUB gains…**

On the outlook for financial sanctions, a de-escalation of the conflict between Russia and Ukraine may be required for the United States to ponder lifting financial sanctions and allowing Russian firms to tap foreign financing once again. Since the financial sanctions were put in place, outflows from the private sector have intensified (chart 2), which will continue to weaken the overall demand-supply situation for the RUB.

[8] The $R^2$ of linear regression of USD-RUB on Brent crude oil prices is over 95% over the past three months (on levels).

Chart 8: USD-RUB vs. bond market implied FX risk premium (Russia 2023 OFZ – USD bond spread[9])

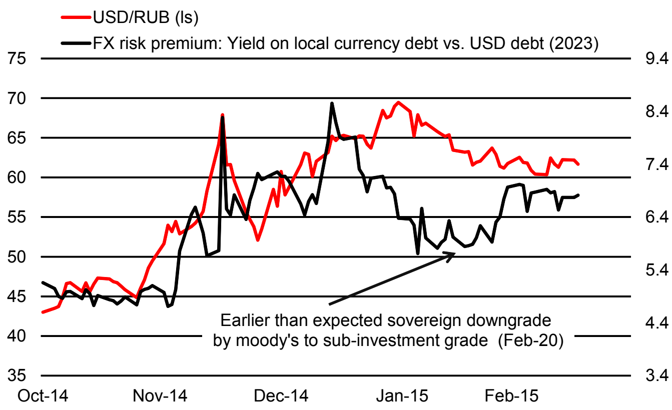
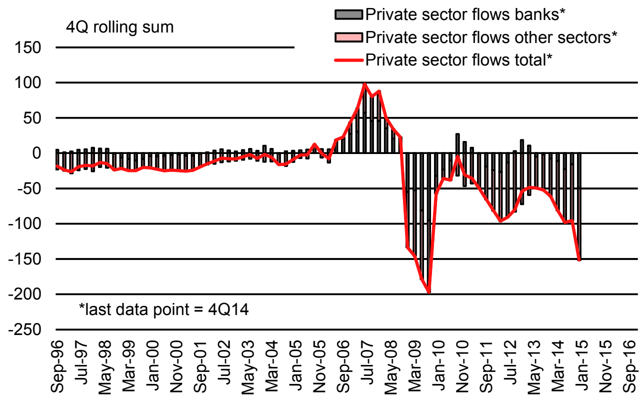



Chart 9:
Private sector outflows have intensified due to sanctions




*Last data point is as of 4Q14

Source: Haver, Bloomberg, Central Bank of Russia, UniCredit Research

## #5: CZK : Floor to be tested and defended

**EUR-CZK to remain in a narrow range…**

EUR-CZK will remain in a narrow range 27.20 to 27.70 range. We think the floor will be tested but believe the CNB has the means to successfully defend the floor. We think expectations of the floor being taken off before 2016 will prove premature, as the CNB made it clear that it will allow inflation to overshoot the target before tightening policy.

**Actual intervention likely closer to 27.00, with verbal intervention unlikely to help….**

The interventionist rhetoric at the Czech National Bank has heated up in recent days with EUR-CZK once again near the 27.00 intervention zone. We don't think such verbal intervention in itself will help CZK weaken from here (as it had done in early January), considering that we are now operating in a backdrop of sharply lower EUR real yields, which is the exact opposite of the situation at the beginning of January when EUR real yields had spiked (and all EUR/CE4 pairs moved higher). Hence, it is likely the CNB will have to conduct actual intervention if the cross gets closer to the 27.00 floor.

**..but levels above 28.00 unlikely to persist…**

A test of EUR-CZK 28.0 is unlikely given that: **(a)** EUR is broadly weaker amid ECB QE, **(b)** any easing of policy (a future rise in the floor) seems unlikely amid improving domestic demand and an expected rise in core inflation, and **(c)** a strong trade balance will support the currency if profit repatriation from multinationals subsides.

**CNB has the ability and willingness to intervene further with limited side-effects so far**

We expect the CNB to be able to undertake further interventions without any problem. The scale of interventions has been modest compared to that seen in Switzerland or even Denmark in recent years, with the CNB's FX reserves increasing by 30.9% between the launch of interventions in November 2013 and March 2014.

FX reserves were 16.2% higher at the end of February 2015 than in October 2013 and represented 30.2% of GDP. In addition, unlike in Switzerland, there has so far not been any side effect of excess liquidity resulting in financial stability concerns or irregular activity in mortgage markets.

We do not expect a significant change in monetary policy before the end of the current MPC's mandate in July 2016.

[9] The Bloomberg ticker is RFLB 7 08/16/2023 Corp - EJ827000 Corp .

Chart 10: Actual intervention needed now (unlike in January)

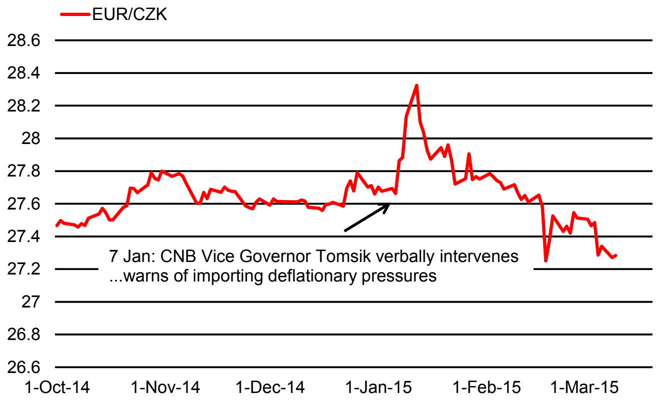
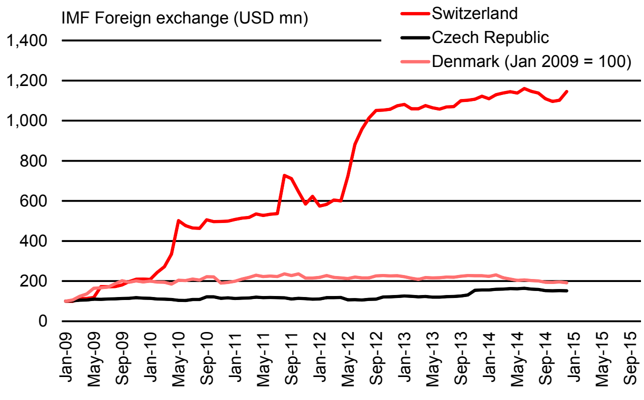



Chart 11: FX reserve buildup manageable so far




Source: Bloomberg, Haver, UniCredit Research

# Countries

# Bulgaria (Baa2 stable/BB+ stable/BBB- stable)*

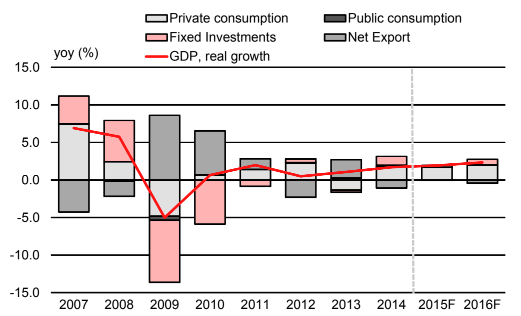
**Outlook** – With a stronger euro-zone recovery and sharper-than-expected drop in the euro now in the cards, we feel comfortable enough to revise our 2015 GDP forecast for Bulgaria to 1.9% from 1.5%. The revision takes into account a higher growth trajectory in the base year (2014 GDP growth came in at 1.7%, above our forecast for 1.5%), as well as a gradual acceleration of qoq growth dynamics from 0.4% in 1Q15 to around 0.6-0.7% in 4Q15. Domestic demand and private consumption in particular (adding 1.9 and 1.7pp to 2015 GDP) will remain the main growth drivers, while the net export contribution to growth should be neutral in 2015, after having shaved 1.1pp in 2014.

**Author: Kristofor Pavlov, Chief Economist (UniCredit Bulbank)**

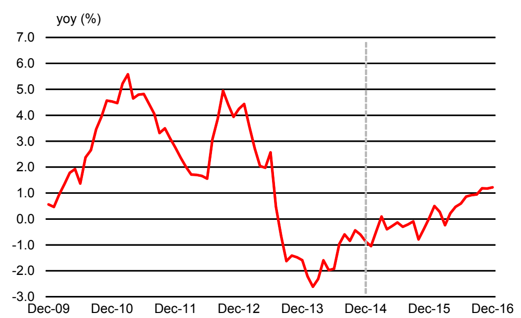
### KEY DATES/EVENTS

- End-Mar: New Eurobond sale
- Mid-May: GDP flash estimate 1Q15
- Mid-May: Number of employees 1Q15

### GDP GROWTH WILL REMAIN SUBDUED




### DEFLATION TO CONTINUE ON CRUDE OIL PRICE DYNAMICS




Source: NSI, BNB, MoF, UniCredit Research

### MACROECONOMIC DATA AND FORECASTS

| | 2012 | 2013 | 2014E | 2015F | 2016F |
|---|---|---|---|---|---|
| GDP (EUR bn) | 40.9 | 41.0 | 42.0 | 42.7 | 44.0 |
| Population (mn) | 7.3 | 7.2 | 7.2 | 7.2 | 7.1 |
| GDP per capita (EUR) | 5 618 | 5 665 | 5 831 | 5 961 | 6 176 |
| **Real economy yoy (%)** | | | | | |
| GDP | 0.5 | 1.1 | 1.7 | 1.9 | 2.3 |
| Private Consumption | 3.2 | -1.8 | 2.4 | 2.4 | 2.8 |
| Fixed Investment | 2.0 | -0.1 | 4.5 | 1.9 | 4.3 |
| Public Consumption | 0.5 | 3.6 | 2.7 | 0.6 | -0.3 |
| Exports | 0.8 | 9.2 | 2.2 | 2.6 | 3.1 |
| Imports | 4.5 | 4.9 | 3.8 | 2.5 | 3.5 |
| Monthly wage, nominal (EUR) | 374 | 396 | 423 | 443 | 469 |
| Unemployment rate, avg (%) | 12.3 | 12.9 | 11.4 | 10.4 | 9.5 |
| **Fiscal accounts (% of GDP)** | | | | | |
| Budget balance | -0.4 | -1.8 | -3.7 | -3.1 | -2.8 |
| Primary balance | 0.3 | -0.9 | -3.0 | -2.2 | -1.8 |
| Public debt | 17.6 | 17.9 | 26.9 | 26.7 | 28.5 |
| **External accounts** | | | | | |
| Current account balance (EUR bn) | -0.5 | 0.8 | 0 | 0.2 | -0.3 |
| Current account balance/GDP (%) | -1.1 | 2.1 | 0 | 0.4 | -0.7 |
| Basic balance/GDP (%) | 1.0 | 4.7 | 2.4 | 2.9 | 2.0 |
| Net FDI (EUR bn) | 0.9 | 1.1 | 1.0 | 1.1 | 1.2 |
| Net FDI (% of GDP) | 2.1 | 2.7 | 2.4 | 2.5 | 2.7 |
| Gross foreign debt (EUR bn) | 37.7 | 37.3 | 39.6 | 39.7 | 39.7 |
| Gross foreign debt (% of GDP) | 92.2 | 91.0 | 94.2 | 93.0 | 90.3 |
| FX reserves (EUR bn) | 15.6 | 14.4 | 16.5 | 18.3 | 19.4 |
| **Inflation/Monetary/FX** | | | | | |
| CPI (pavg) | 3.0 | 0.9 | -1.4 | -0.3 | 0.7 |
| CPI (eop) | 4.2 | -1.6 | -0.9 | 0 | 1.2 |
| Central bank reference rate (eop) | 0.04 | 0.07 | 0.02 | 0.02 | 0.03 |
| USD/BGN (eop) | 1.48 | 1.42 | 1.61 | 1.81 | 1.69 |
| EUR/BGN (eop) | 1.96 | 1.96 | 1.96 | 1.96 | 1.96 |
| USD/BGN (pavg) | 1.52 | 1.47 | 1.47 | 1.81 | 1.73 |
| EUR/BGN (pavg) | 1.96 | 1.96 | 1.96 | 1.96 | 1.96 |

Source: UniCredit Research

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

## A touch stronger growth trajectory ahead

**2014 GDP growth came in at a stronger-than-expected 1.7% yoy, above the government's (1.5%), EC (1.2%) and our own forecast (1.5%)**

The negative impact that political uncertainty, frozen EU funds and June's bank crisis had on the pace of the economic recovery was compensated for by the long-anticipated jobs recovery in external demand-oriented sectors and a shift towards a more growth supportive fiscal policy, which both helped real GDP growth to strengthen to 1.7% last year, from 1.1% in 2013 and 0.5% in 2012. Perhaps even more importantly, growth became more broadly based, with household consumption and, to a lesser extent, investments joining industry and exports, as drivers of the recovery. Meanwhile, 4Q14 GDP growth was revised up to 0.4% qoq, from 0.3% according to the flash estimate, and 0.4% in 3Q14. When measured in yoy terms, 4Q14 growth slowed down to 1.3% yoy, from 1.5% in 3Q14 and 1.8% in 2Q14.

**Recent high frequency and confidence indicators leave little doubt that yoy GDP growth is on course to accelerate in 1Q15**

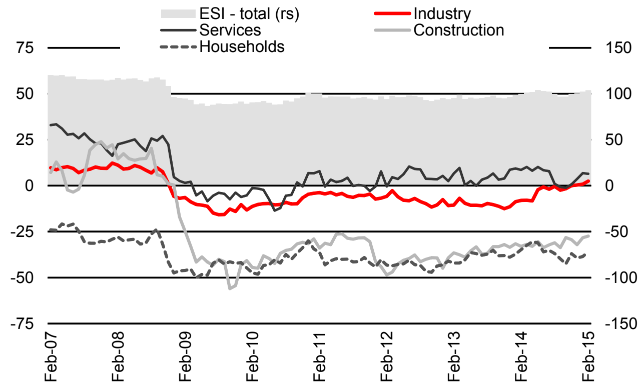
The fourth consecutive mom rise in the headline economy-wide ESI in February shows that the economy started 2015 in a more optimistic mood. Barring May 2014's (104.1) reading, the most recent headline ESI (103.8) print is at its highest level since November 2008. The improvement was led by services and industry, where sentiment is at its highest level in more than six years, but the slow pace of improvement in the household and especially construction sector (see lhs chart) reinforces our view that GDP growth will continue to pick up only gradually from here. January's high frequency indicators brought further evidence that growth is on course to accelerate at the start of 2015 (see rhs chart). Industrial production added 2% mom, with export-oriented manufacturing and investment goods production in particular being the strongest contributors. Retail sales, on the other hand, were down 0.1% mom in January, but this came after a remarkably strong finish to 2014 (up 1.4% mom in December).

**We raised our 2015 GDP forecast to take into account the improving outlook for the euro area and more pronounced positive impact associated with the fall in crude oil prices**

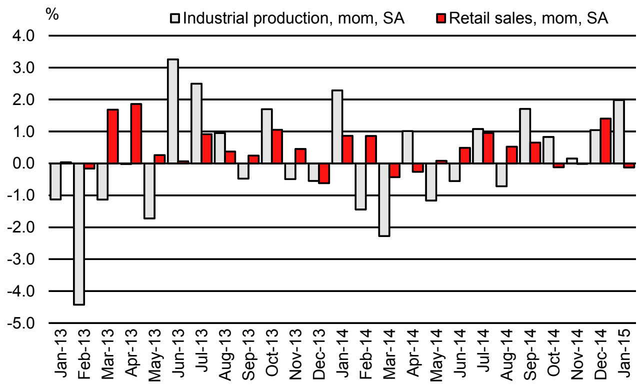
**Domestic demand and private consumption in particular will be the main growth drivers, adding 1.9 and 1.7pp to 2015 GDP**

We revised up our 2015 GDP forecast to 1.9% from 1.5%. On a technical level, the revision takes into account the higher growth trajectory in the base year in combination with a stronger carry-over from better-than-expected GDP growth in 4Q14. More fundamentally, however, the revision reflects the improved growth prospects in the euro area (as our GDP growth forecast for the eurozone was revised up to 1.4% from 1%) where almost half of Bulgarian merchandise exports is channeled. In contrast to our previous forecast, we now see euro depreciation as a much more supportive factor to export growth in 2015 due to the size of depreciation and the likely persistence of a weak euro, given the scale of the open-ended asset purchase program which the ECB has just launched. The crude oil price slump, on the other hand, has been much deeper than we envisaged in our last forecast in January and therefore is set to provide a more solid boost to the purchasing power of household income this year. All this would be more than enough, in our view, to compensate for moderately weaker credit growth, which we now expect in 2015, as deleveraging pressure on privately owned domestic lenders is likely to be a touch sharper than what we had anticipated three months ago.

Led by industry, confidence indicators are trending upwards…




High frequency indicators point to a solid start of 2015…




Source: Eurostat, NSI, UniCredit Research

**Net export's contribution to GDP is likely to be broadly neutral in 2015, after having shaved 1.1pp from GDP in 2014**

Going into 2015, the quarterly pace of GDP expansion is likely to accelerate gradually from 0.4% in 1Q15 (pretty much the level seen in 2H14) to around 0.6-0.7% in 4Q15. Risks to the growth outlook are broadly balanced. There is high uncertainty on the magnitude and timing of the combined boost from lower crude oil prices and a weaker euro. On the downside, risks stem from escalation of the conflict in Ukraine as well as a disorderly Grexit scenario.

**Labor market was the bright spot last year**

**In 2014, Bulgaria experienced the first positive gross change in employment (47K) since the onset of the global crisis**

Labor market improvement proceeded at a stronger-than-expected pace. The unemployment rate fell to 10.9% in December 2014 and further to 10.8% in January 2015 (2.4pp below April 2013's peak), driven by a visible improvement in job creation. The economy added 58k jobs in 4Q14 (equivalent to a 2% rise – see lhs chart), which is the strongest yoy print since 4Q08. It is particularly encouraging that nearly two-thirds of the new jobs came from the external demand-oriented sectors, as these continued losing jobs throughout the entire period since the start of the global crisis in 2008 (except for 3Q12), even though real exports in end-2013 were already more than a quarter above the pre-crisis level. Real labor cost growth remained subdued, at the same time, as indicated by the seasonally and working day adjusted wages and salaries index, which posted a subpar 2.4% annualized gain in 3Q14. Perhaps most encouragingly, rising employment expectations (see rhs chart) are further evidence that, albeit slowly, labor market conditions are likely to continue improving this year. Given considerable remaining slack in the economy, however, it seems that we are still far from the point when rising jobs will begin to exercise upward pressure on wage dynamics.

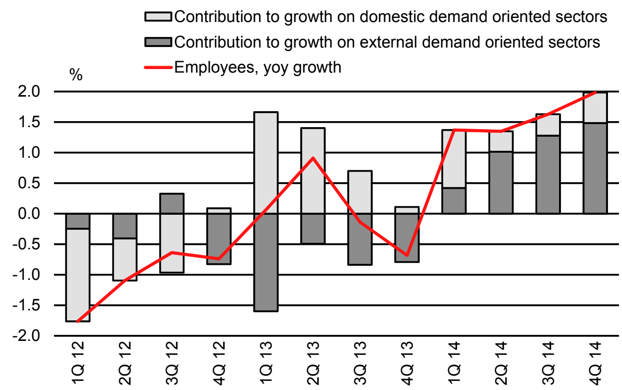
**Deflationary pressure has remained intense…**

**…but has become less broadly based at the same time**

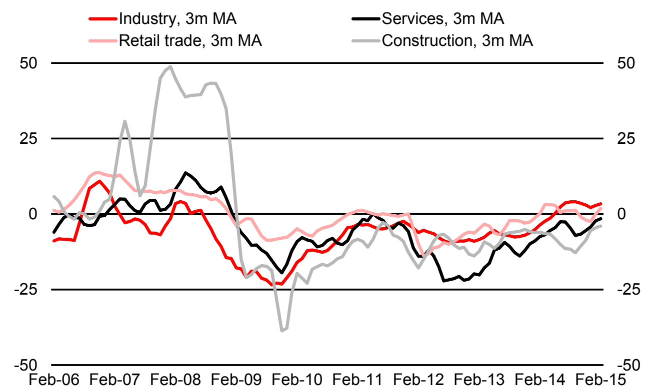
**We have marginally revised our avg and eop inflation forecast to -0.3% and 0.0% in 2015, from -0.5% and -0.3%, respectively**

Both headline and core prices evolution over the last several months brought further evidence that deflationary pressure remains intense. The annualized headline inflation decline to -1% in January, from -0.9% in December 2014 and -0.6% in November, was almost entirely driven by weaker energy prices. Core inflation, on the other hand, rose to -1.0% in January, from -1.2% in December and -1.6% in November, pushed by a favorable baseline effect on top of a small uptick in recreation and culture costs. Among the basket of goods and services used to estimate consumer price dynamics, 49% posted an outright yoy fall in January 2015. While this represents a marked improvement when compared with the record high 68% print reported in June last year, it still suggests that deflationary pressure remains broadly based. Looking ahead, it seems that headline inflation has already bottomed out, but is likely to turn positive only early next year, when the large base effect on the energy price component will fully run its course. While it is true that the weaker euro will push import prices higher, the impact is likely to be relatively muted, in our view, and will be far from what is needed to rapidly bring the ongoing deflation trend to an end. This is because the reasons for deflationary pressure are not limited to falling oil and energy prices alone, but also reflect considerable spare capacity in the economy and the resulting slow domestic demand recovery.

Long-anticipated recovery of jobs in the export oriented part of the economy has started to materialize…




Recent employment expectations have posted a marked improvement…




Source: Eurostat, NSI, UniCredit Research

## Strategy: sovereign continues efforts to construct a higher and more predictable external issuance trajectory

**The MinFin plans to enter a medium-turn program for external debt management**

Efforts of the MinFin, outlined in the 2015 Budget Law, to make a material shift to a higher external debt issuance trajectory have now taken a clearer medium-term form. In end-February, the National Assembly passed a law to ratify the government's contract regarding its recently proposed Global Medium Turn Note (GMTN) program. The document is the continuation of a 6M EUR 1.5bn syndicated bridge-to-bond bank loan which the issuer tapped in December 2014, and which provided an option for entering into a medium-term contractual obligation with involved institutions.

**External issuance limits for 2015 (EUR 3.5bn) and up to 2017 (EUR 8bn) have already been set…**

**… as domestic issuance remains more limited**

The main aspects of the GMTN include an upper limit of external debt issuance set at EUR 8bn over the course of 2015-17. The maturity and currency structure of each transaction will be set within the marketing process for the respective tranche. On the other hand, limits within each of the three periods will be set by the Budget Law for the respective year, with the indicative threshold for 2015 already outlined at EUR 3.5bn or 44% of the total size of the GMTN. This covers most of the gross financing requirements of the sovereign, which we estimate at EUR 5.0bn (or 11.6% of GDP). We see this target as easy to reach (particularly due to pre-financing for EUR 0.9bn in 2014) via a balanced combination of all channels (see table below) and therefore, we do not expect external debt issuance to actually reach the EUR 3.5bn upper limit. Over the life of the program, the upper limit of EUR 8bn compares to gross financing requirements of the government estimated at EUR 9.8bn, which leaves us to believe that it will not be used in full due to pre-financing and efforts to support the domestic GB market at decent, albeit lower, levels.

The GMTN should also support debt management efforts of the sovereign to construct a uniform yield curve on the external market (which currently consists of only two bonds for a total of EUR 2.4bn) as it shifts the issuer's financing focus away from the domestic GB market. The program has already been assigned a provisional senior unsecured rating at par with that of the sovereign at Baa2 or two notches above investment grade. The rating has been matched by a stable outlook of the issuer.

**Author: Nikola Georgiev, Economist (UniCredit Bulbank)**

**GOVERNMENT GROSS FINANCING REQUIREMENTS**

| EUR bn | 2014 | 2015F | 2016F |
|---|---|---|---|
| **Gross financing requirement** | **2.3** | **5.0** | **2.1** |
| Budget deficit | 1.6 | 1.3 | 1.2 |
| Amortization of public debt | 0.5 | 3.5 | 0.7 |
| Domestic | 0.5 | 1.0 | 0.7 |
| Bonds | 0.4 | 0.1 | 0.6 |
| Bills | 0.2 | 1.0 | 0.2 |
| External | 0 | 2.4 | 0 |
| IMF/EU/Other | 0.2 | 0.2 | 0.2 |
| **Financing** | **2.3** | **5.0** | **2.1** |
| Domestic borrowing | 1.6 | 0.6 | 0.7 |
| Bonds | 0.6 | 0.5 | 0.5 |
| Bills | 1.0 | 0.2 | 0.2 |
| External borrowing | 2.5 | 3.1 | 1.5 |
| Bonds | 3.0 | 3.0 | 1.4 |
| IMF/EU/Other | -0.5 | 0.1 | 0.1 |
| Privatization | 0 | 0 | 0 |
| Fiscal reserves change (- = increase) | -1.8 | 1.2 | 0 |

**GROSS EXTERNAL FINANCING REQUIREMENTS**

| EUR bn | 2014 | 2015F | 2016F |
|---|---|---|---|
| **Gross financing requirement** | **14.4** | **17.3** | **14.4** |
| C/A deficit | 0 | -0.2 | 0.3 |
| Amortization of medium to long term debt | 4.8 | 7.2 | 4.3 |
| Government/central bank | 0.2 | 2.6 | 0.2 |
| Banks | 0.8 | 0.6 | 0.5 |
| Corporates | 3.9 | 4.0 | 3.6 |
| Short term debt amortization | 9.5 | 10.3 | 9.7 |
| **Financing** | **14.4** | **17.3** | **14.4** |
| FDI | 1.0 | 1.1 | 1.2 |
| Portfolio flows | 1.3 | 1.7 | 1.2 |
| Borrowing | 6.6 | 7.6 | 5.5 |
| Government/central bank | 2.5 | 3.1 | 1.5 |
| Banks | 0.3 | 0.5 | 0.4 |
| Corporates | 3.8 | 4.0 | 3.6 |
| Short-term | 10.3 | 9.7 | 8.9 |
| EU transfers | 1.2 | 1.1 | 1.2 |
| Other | -3.9 | -2.1 | -2.5 |
| Change in FX reserves (- = increase) | -2.1 | -1.8 | -1.1 |

Source: BNB, MoF, UniCredit Research

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

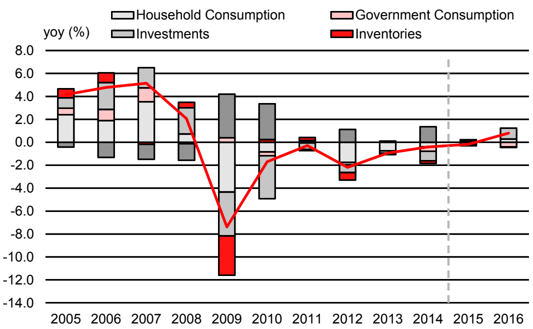
Outlook – GDP growth in 4Q14 brought some tailwind to the domestic economy, but we keep the view of a further GDP decline by 0.2% in 2015. Domestic growth drivers remain constrained, while external demand growth, following the improved EU outlook, will not be sufficient to stimulate a GDP recovery. However, we cannot neglect the fact that risks are now more to the upside. Investment recovery should be the driver we are looking for in the short term, but we still face a lot of uncertainty and there is little evidence of an investment pipeline. Furthermore, Croatia is still faced with excessive macroeconomic imbalances. European Commission will therefore request the Croatian authorities to respond to such risks and could be more involved in policy creation in the short term.

**Author: Hrvoje Dolenec, Chief Economist (Zagrebačka banka)**

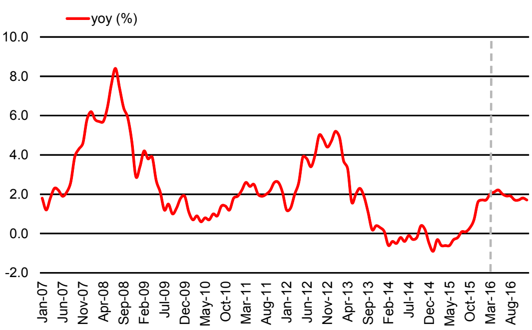
### KEY DATES/EVENTS

- Apr/May: Commission discussion within EDP
- May: Commission decision on EIP (within MIP)
- 11 May: Labor Market Survey FY14
- 29 May: GDP flash estimate 1Q
- 5 June: GDP estimate 1Q
- 30 June: BoP 1Q

### GDP GROWTH




### INFLATION OUTLOOK




Source: IMF, MinFin, Eurostat, UniCredit Research

### MACROECONOMIC DATA AND FORECASTS

| | 2012 | 2013 | 2014E | 2015F | 2016F |
|---|---|---|---|---|---|
| GDP (EUR bn) | 44.0 | 43.6 | 43.1 | 42.9 | 44.4 |
| Population (mn) | 4.267 | 4.257 | 4.247 | 4.237 | 4.227 |
| GDP per capita (EUR) | 10,302 | 10,240 | 10,150 | 10,129 | 10,498 |
| **Real economy yoy (%)** | | | | | |
| GDP | -2.2 | -0.9 | -0.4 | -0.2 | 0.8 |
| Private Consumption | -3.0 | -1.3 | -0.7 | -0.3 | 0.5 |
| Fixed Investment | -3.3 | -1.0 | -4.0 | 0.5 | 4.8 |
| Public Consumption | -1.0 | 0.5 | -1.9 | -0.7 | -2.0 |
| Exports | -0.1 | 3.0 | 6.3 | 2.9 | 3.7 |
| Imports | -3.0 | 3.2 | 3.0 | 2.7 | 4.0 |
| Monthly wage, nominal (EUR) | 1,048 | 1,048 | 1,042 | 1,048 | 1,072 |
| Unemployment rate (%) | 15.8 | 17.2 | 17.1 | 17.5 | 17.0 |
| **Fiscal accounts (% of GDP)** | | | | | |
| Budget balance | -5.6 | -5.2 | -5.0 | -5.4 | -4.6 |
| Primary balance | -3.0 | -2.0 | -1.5 | -1.7 | -0.6 |
| Public debt | 64.5 | 75.7 | 80.2 | 85.0 | 87.1 |
| **External accounts** | | | | | |
| Current account balance (EUR bn) | -0.1 | 0.3 | 0.2 | 0.4 | 0.2 |
| Current account balance/GDP (%) | -0.1 | 0.8 | 0.5 | 0.9 | 0.5 |
| Basic balance/GDP (%) | 2.6 | 2.8 | 2.5 | 3.8 | 4.3 |
| Net FDI (EUR bn) | 1.2 | 0.9 | 0.9 | 1.3 | 1.6 |
| Net FDI (% of GDP) | 2.7 | 2.0 | 2.0 | 3.0 | 3.7 |
| Gross foreign debt (EUR bn) | 45.3 | 45.9 | 46.4 | 47.9 | 49.8 |
| Gross foreign debt (% of GDP) | 103.0 | 105.3 | 107.6 | 111.6 | 112.2 |
| FX reserves (EUR bn) | 11.2 | 12.9 | 12.7 | 13.0 | 13.8 |
| **Inflation/Monetary/FX** | | | | | |
| CPI (pavg) | 3.4 | 2.2 | -0.2 | 0 | 1.9 |
| CPI (eop) | 4.7 | 0.3 | -0.5 | 1.6 | 1.7 |
| 1W money market rate | 1.4 | 0.7 | 0.6 | 0.7 | 0.9 |
| USD/HRK (eop) | 5.73 | 5.55 | 6.30 | 7.16 | 6.59 |
| EUR/HRK (eop) | 7.55 | 7.64 | 7.66 | 7.73 | 7.65 |
| USD/HRK (pavg) | 5.85 | 5.71 | 5.75 | 6.95 | 6.80 |
| EUR/HRK (pavg) | 7.52 | 7.57 | 7.63 | 7.65 | 7.62 |

Source: Unicredit Research

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

## Macroeconomic imbalances weigh over growth recovery

**Although risks have now moved to the upside, a GDP decline is expected in 2015 in the absence of sustainable domestic growth drivers**

**GDP to decline further in 2015, but now with risks moving to the upside. The** GDP release for 4Q indicated growth of 4Q GDP by 0.3% yoy, the first annual increase in 13 quarters. Such growth was already indicated in monthly indicators and translated into a strong performance of manufacturing and exports. By expenditure, the main contribution came from external demand (contribution of 2pp to 4Q GDP growth), with 4.5% yoy growth of exports and a 0.4% decline of imports. Domestic demand was, in contrast, disappointing, shaving -1.7pp off GDP growth – private consumption declined -0.6% yoy, gross fixed capital formation -3.7% yoy and, confirming expectations based on the need for fiscal consolidation, public consumption declined 0.5% yoy. Following such a positive performance in 4Q, the FY 2014 decline in GDP was cut to -0.4% yoy, the lowest in three years but still marking the sixth year of GDP decline. After such a performance in 4Q, we see some upside risks to our 2015 outlook. However, we stick to our baseline view of a GDP decline of 0.2% as, besides the improved outlook for the EU economy and therefore external demand, domestic growth drivers remain subdued. Fiscal consolidation will remain the focus of the relationship with the European Commission within the excessive deficit procedure; however, it will be challenged throughout the year ahead of general elections. The private sector still remains in a deleveraging mode, which suppress the prospects of recovery in both private consumption and investment. Investors still miss sufficient evidence of a recovery in investment activity. We note however that positive developments in this area, accompanied by strong external demand, can bring some positive momentum to the GDP recovery in the short run.

**Investment recovery remains out of sight, but any positive development in this area could trigger an exit from recession**

**European Commission steps up pressure on Croatia to tackle macroeconomic imbalances**

**European Commission signals risks of excessive macroeconomic imbalances.** Even with the weak signs of recovery potential for the Croatian economy, Croatia is still facing challenging environment. The College of Commissioners clearly stated, “Croatia is experiencing excessive macroeconomic imbalances, which require decisive policy action and specific monitoring. The Commission will take in May, on the basis of the National Reform Programs (NRPs) and other commitments to structural reforms announced by that date, the decision to activate the Excessive Imbalance Procedure (EIP). In a context of subdued growth, delayed restructuring of firms and dismal performance of employment, risks related to weak competitiveness, large external liabilities and rising public debt coupled with weak public sector governance, have significantly increased.” The authorities are being requested to present reforms and further steps to mitigate those imbalances, with an indication they will do so during April. Croatia is also under scrutiny for its performance within the excessive deficit procedure where it misses the fiscal deficit target for 2014 (target of 4.6% versus an estimated deficit of 5.0%) with unfavorable public debt dynamics (rising to 80.2% of GDP).

**Risks of wider fiscal gap exist, but remain under scrutiny of excessive deficit procedure framework**

**Fiscal outlook:** The Ministry of Finance stated that approximately HRK 2.8bn of savings was achieved during December, some 0.8-0.9% of GDP, which should result in an ESA2010 general government deficit of 5.0% of GDP in 2014. The budget proposal for 2015 still raises doubts whether it is feasible to expect the deficit to be cut, as we still see many risks in both revenue collection and expenditure cuts following the measures introduced to ease the tax burden on citizens and SMEs. Yet again, public sector reforms were not introduced to ensure control over wage bill costs and pension disbursement. Without additional measures, we see risk that deficit even widens, while the expected alignment with EDP targets remains out of sight. Such deficits, accompanied by significant primary deficits, will increase public debt and will generate sizeable additional funding needs. The government recently tapped the market with a 10Y Eurobond for EUR 1.5bn at 3.25% yield. Combined with the February 1.5Y T-bill issue of EUR 1.225bn, Croatia successfully covered funding needs on international markets for 2015, giving some breathing space in public finances. However, further local bond issuance can be expected up to EUR 2bn following the financing plan for 2015.

**Market conditions allowed sovereign funding at favorable conditions despite Croatia lagging its peers**

**Credit rating outlook:** Lack of reforms and the sustainability of public debt continue to weigh on the credit rating outlook and country risk premium in the medium term. Recent actions by rating agencies (no change with stable outlook) and interest for sovereign bonds provided some comfort, but recent reports from the Commission will keep Croatia under scrutiny.

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

**Outlook** – Domestic demand is set to boost momentum in the Czech economic recovery, bringing GDP growth to 2.5% in 2015. The fiscal policy is viewed as mildly stimulative, while monetary policy is broadly neutral. Key downside risks from the domestic side may be offset on the external side by the expected rebound in eurozone GDP growth.

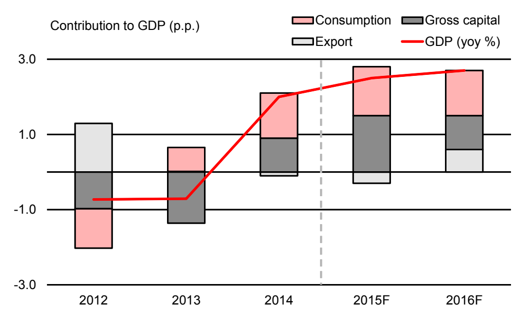
**Strategy outlook** – Positive, although negligible, yields on the CZK curve contrast with much of Europe, making local short-term assets attractive in relative value terms. The underlying appreciation of CZK has however not much room to continue, as there is no doubt the CNB would protect its EUR/CZK 27.0 intervention floor.

**Authors: Pavel Sobisek, Chief Economist (UniCredit Bank Czech Republic and Slovakia)**
**Patrik Rozumbersky, Economist (UniCredit Bank Czech Republic and Slovakia)**

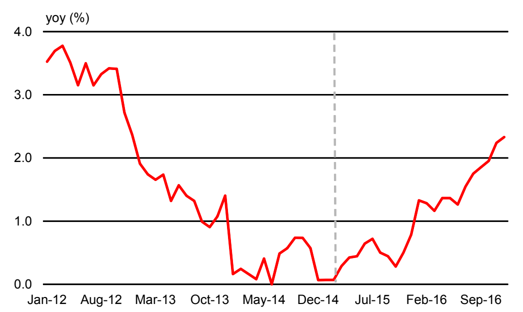
### KEY DATES/EVENTS

- 26 Mar, 7 May: CNB policy meetings
- 1 Apr, 4 May, 1 June: Manufacturing PMI
- 15 May, 29 May: 1Q15 GDP (flash estimate, structure)

### GDP DRIVEN BY DOMESTIC COMPONENTS IN 2015, WHILE NET EXPORTS TO IMPROVE ONLY IN 2016




### CPI TO ACCELERATE VISIBLY FROM EARLY 2016




Source: CZSO, Unicredit Research

### MACROECONOMIC DATA AND FORECASTS

| | 2012 | 2013 | 2014E | 2015F | 2016F |
|---|---|---|---|---|---|
| GDP (EUR bn) | 161.0 | 157.3 | 155.0 | 161.6 | 170.2 |
| Population (mn) | 10.5 | 10.5 | 10.5 | 10.5 | 10.5 |
| GDP per capita (EUR) | 15,321 | 14,968 | 14,727 | 15,357 | 16,170 |
| **Real economy yoy (%)** | | | | | |
| GDP | -0.7 | -0.7 | 2.0 | 2.5 | 2.7 |
| Private Consumption | -1.7 | 0.4 | 1.7 | 2.2 | 2.0 |
| Fixed Investment | -2.8 | -4.4 | 4.7 | 4.0 | 3.5 |
| Public Consumption | -1.0 | 2.3 | 1.6 | 1.0 | 1.0 |
| Exports | 4.3 | 0.3 | 8.8 | 7.8 | 8.0 |
| Imports | 2.6 | 0.3 | 9.6 | 8.8 | 7.8 |
| Monthly wage, nominal (EUR) | 997 | 966 | 933 | 960 | 995 |
| Unemployment rate (%) | 6.8 | 7.7 | 7.7 | 6.8 | 6.5 |
| **Fiscal accounts (% of GDP)** | | | | | |
| Budget balance | -4.0 | -1.3 | -1.7 | -2.5 | -2.5 |
| Primary balance | -2.5 | 0 | -0.4 | -1.2 | -1.2 |
| Public debt | 45.5 | 45.7 | 44.1 | 44.6 | 45.2 |
| **External accounts** | | | | | |
| Current account balance (EUR bn) | -2.5 | -2.2 | 0.5 | 0.1 | 0.3 |
| Current account balance/GDP (%) | -1.6 | -1.4 | 0.3 | 0.1 | 0.2 |
| Basic balance/GDP (%) | 1.4 | 0 | 3.4 | 3.3 | 3.5 |
| Net FDI (EUR bn) | 4.8 | 2.2 | 4.8 | 5.3 | 5.7 |
| Net FDI (% of GDP) | 3.0 | 1.4 | 3.1 | 3.3 | 3.3 |
| Gross foreign debt (EUR bn) | 96.8 | 98.8 | 102.8 | 110.9 | 119.0 |
| Gross foreign debt (% of GDP) | 60.1 | 62.8 | 66.3 | 68.6 | 69.9 |
| FX reserves (EUR bn) | 34.0 | 40.8 | 44.9 | 50.0 | 50.0 |
| **Inflation/Monetary/FX** | | | | | |
| CPI (pavg) | 3.3 | 1.4 | 0.4 | 0.4 | 1.6 |
| CPI (eop) | 2.4 | 1.4 | 0.1 | 0.8 | 2.3 |
| Central bank target | 2.0 | 2.0 | 2.0 | 2.0 | 2.0 |
| Central bank reference rate (eop) | 0.05 | 0.05 | 0.05 | 0.05 | 0.05 |
| 3M money market rate | 1.00 | 0.46 | 0.36 | 0.33 | 0.33 |
| USD/CZK (eop) | 19.06 | 19.89 | 22.8 | 25.5 | 23.5 |
| EUR/CZK (eop) | 25.14 | 27.43 | 27.73 | 27.50 | 27.30 |
| USD/CZK (pavg) | 19.58 | 19.57 | 20.7 | 25.3 | 24.5 |
| EUR/CZK (pavg) | 25.14 | 25.97 | 27.53 | 27.60 | 27.40 |

Source: UniCredit Research

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

## Domestic demand faces an upswing

**Domestic demand will bolster the economy in 2015, partly helped by fiscal expansion**

Growth expectations for the Czech economy improved, with both private consumption and fixed capital formation facing an upswing. Inflation is seen to have reached a bottom, but not rising above 1% yoy until the start of 2016. The central bank's preferred stance for the coming 18 months is to leave monetary conditions weak without further interference. Fiscal policy is deemed moderately supportive, unless public infrastructure projects falter.

**The slowdown of GDP growth in 4Q proved largely technical; domestic demand remained the main growth driver**

**4Q14 GDP rose 0.4% qoq and 1.5% yoy, well below the levels from previous periods with growth rates exceeding 2% yoy.** That said, the change in gross value added in 4Q14 accelerated to 2.9% yoy, suggesting that the main reason for the slowdown in growth was technical (uneven collection of taxes on production). On a positive note, the growth structure looked well balanced. The full-2014 GDP increment was reported at a bit lower-than-expected 2.0% due to downward revisions to previous quarters. What improved the overall picture, however, was a spike in the terms of trade, which helped boost nominal GDP growth to a six-year high of 4.4% yoy.

**The key sector from GDP's production side – manufacturing – is likely to maintain the solid pace from late 2014**

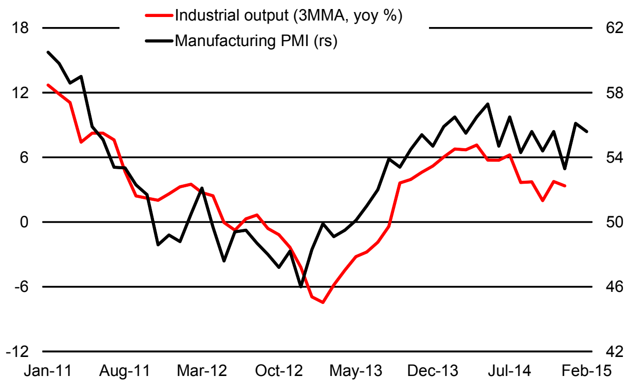
In 2015, manufacturing is set to act as an engine of economic growth from the production side. The latest PMI figures remained at levels consistent with stable output growth of around 5% yoy. Unlike 2014 when the output expansion was largely due to car manufacturing, we expect more balanced growth in 2015, helped by improving demand in the eurozone. The recent acceleration of credit growth in manufacturing, namely the auto sector, points to ongoing investments of major producers. Construction output may add to the positive picture as well, as suggested by growing confidence indicators.

**Consumption supported by the recovery in the labour market**

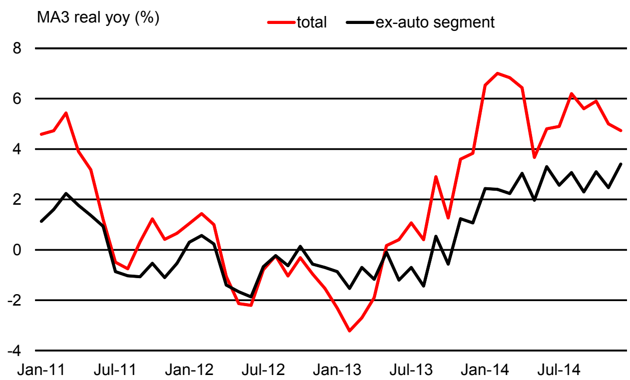
From the demand side, the situation of consumers looks encouraging. New job creation, negligible inflation and hefty pay raises in the public sector are the factors we consider to be important. Indeed, consumer confidence remained near its eight-year high in February, while new car registrations added more than 30% yoy, the latter being also the sign of rising capex. If, in addition, private sector wages accelerate (as we expect) and public infrastructure investments improve, domestic components will be able to add more to GDP growth than in 2014.

**INDUSTRIAL OUTPUT AND RETAIL SALES ARE SET TO STABILIZE AT LOWER LEVELS COMPARED TO 2014**

A rebound in manufacturing PMI in early 2015 bodes well for industrial activity in the coming months




The auto segment drove retail sales growth last year. With car sales set to weaken, retail trade will count more on its core segment




Sources: CZSO, UniCredit Research

Two important technical factors influencing our 2015 GDP forecast are the negative carry-over effect from the downward GDP revision for 2014 and the positive effect from net taxes expected in 1H15. These may, on balance, net-off, which leads us to project GDP growth at 2.5%, only marginally up from our former forecast but distinctly higher than in 2014.

**Headline CPI has likely bottomed out, but no substantial pick-up is to be expected in 2015**

The assumed economic acceleration is not expected to lift inflation substantially this year. In February, CPI inflation stayed at 0.1% yoy for the third consecutive month. With a hike in the excise tax on tobacco and the upturn in global oil prices feeding through to domestic CPI, we believe that headline inflation has bottomed out. At the same time, the existing negative output gap will curb upward pressure from domestic demand on core inflation. Thus, upside risks for headline inflation are seen as limited, at least for the remainder of 2015. A spike in CPI above 1% yoy may only arrive at the start of 2016.

**CNB is seen to maintain broadly neutral monetary conditions over the whole monetary policy horizon**

Facing a significant downward shift in its inflation forecast, the CNB decided at its February meeting to extend its commitment to the EUR-CZK floor until at least 2H16. Nevertheless, this was the CNB's only policy reaction. The MPC statement said that lifting the interventions floor from EUR-CZK 27.0 would require strong prerequisites, such as persistent deflation that would threaten to be a drag on economic growth. Importantly, this means that the CNB will look through the spell of negative headline CPI, which it expects to occur in 3Q15 (unlike us) due to an oil price-induced drop in gas prices. This means the repo rate will likely remain technically zero over the next 18 months. Whether the ECB's QE policy will challenge the CNB's aim in some aspect is yet to be seen.

**Moderate fiscal easing this year will follow tightening in 2013 and broadly neutral policy in 2014**

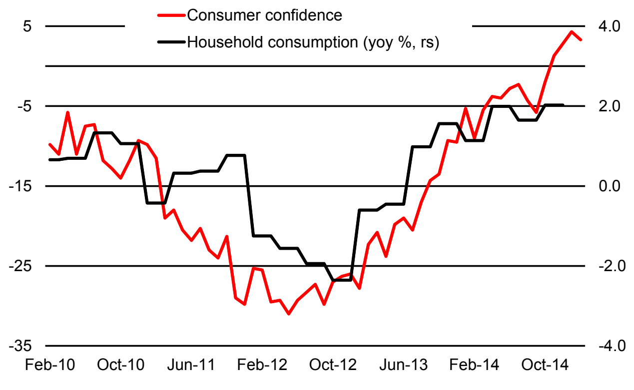
Fiscal policy is set to provide the economy with a moderate boost this year following its broadly neutral impact in 2014. The 2015 state budget deficit was approved at CZK 100bn, CZK 20bn above last year's. EU funds may also add to the fiscal impulse. Admittedly, the budgeted deficit was well undershot in the last two years (by CZK 19bn in 2013 and CZK 34bn in 2014) mainly due to unspent funds on infrastructure projects. The pipeline of new projects appears to be still filling very slowly.

**The perception of domestic downside and external upside risks seem broadly balanced**

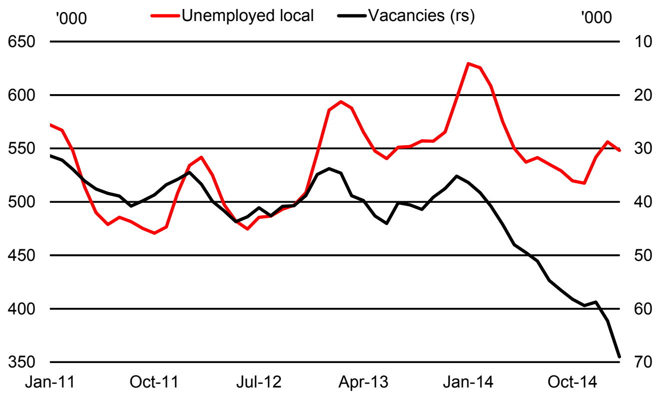
Downside risks to our 2015 forecasts from the domestic side are associated with slower nominal wage growth than our projected 3.1% and public infrastructure spending faltering on a disappointing project pipeline. The key external upside risk to growth may stem from a larger impact of better demand from the eurozone. Thus, upside and downside risks appear as broadly balanced.

**PRIVATE SPENDING SHOULD BENEFIT FROM IMPROVED CONSUMER SENTIMENT AND LABOR MARKET DEVELOPMENTS**

Consumer confidence near its 8-year high points to solid growth of private consumption in early 2015




Job vacancies have been soaring, opening room for a decrease in unemployment



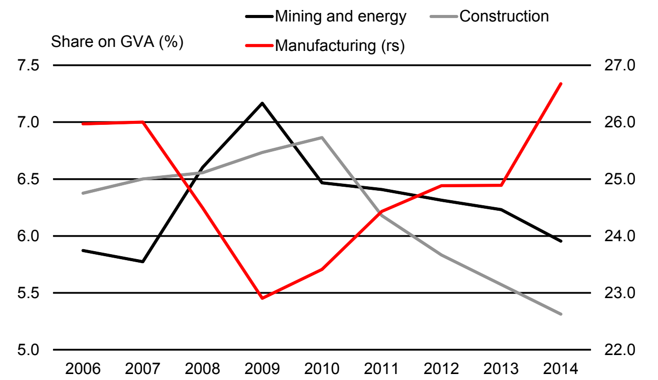

Source: CZSO, Labor Ministry, UniCredit Research

## Strategy: limited scope for CZGB rally and appreciation pressure

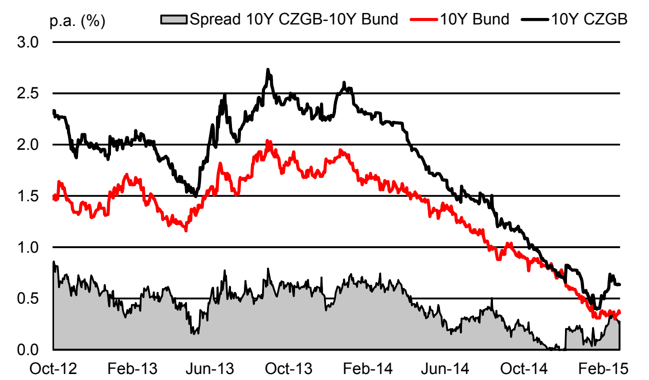
**The CNB's FX intervention commitment may be challenged by market forces**

Despite low yields, CZGBs could enjoy a limited rally as the launch of ECB's QE is widening the spreads vs. Bunds. As a result, shorter tenors in particular have been heavily bid in recent local bond auctions and we expect this pattern to continue. Financial, rather than real economy flows are also seen as behind the latest CZK appreciation. Broad currency support from the extended basic balance (C/A + FDI + EU funds) could push EUR-CZK closer to the 27.0 floor. As a result, central bank officials returned to verbal interventions. If the FX floor is tested, we expect the CNB to defend it by intervening in the market. The central bank has enough firepower to keep its currency commitment until 2H16, with FX reserves up 16.2% since the floor was introduced in November 2013, but remaining below 30% of GDP. Thus, the CNB is not in danger of facing the same type of constraints that drove the SNB to remove the EUR-CHF floor in January 2015.

Since, 2009, manufacturing has been constantly gaining share on total GVA; mining & energy and construction have been losing




The restored CZGB issuance early this year helped lift CZGB yields from their lows, moving up the spread versus German Bund yields




Sources: CZSO, Macrobond, UniCredit Research

**GOVERNMENT GROSS FINANCING REQUIREMENTS**

| EUR bn | 2014E | 2015F | 2016F |
|---|---|---|---|
| **Gross financing requirement** | **13.3** | **13.3** | **14.9** |
| Budget deficit | 2.9 | 3.6 | 3.7 |
| Amortisation of public debt | 10.4 | 9.7 | 11.2 |
| Bonds | 5.7 | 5.6 | 6.7 |
| EIB loans | 0.4 | 0.1 | 0.1 |
| Bills | 4.4 | 3.9 | 4.0 |
| **Financing** | **13.3** | **13.3** | **14.9** |
| Domestic borrowing | 10.2 | 10.5 | 11.7 |
| Bonds | 5.8 | 6.5 | 7.3 |
| Bills | 4.4 | 4.0 | 4.4 |
| External borrowing | 0.0 | 0.1 | 2.3 |
| Bonds | 0.0 | 0.0 | 2.2 |
| EIB/IMF | 0.1 | 0.1 | 0.1 |
| Change in cash reserve | -3.1 | -2.7 | -0.8 |

**GROSS EXTERNAL FINANCING REQUIREMENTS**

| EUR bn | 2014E | 2015F | 2016F |
|---|---|---|---|
| **Gross financing requirement** | **48.3** | **47.4** | **50.4** |
| C/A balance (+ surplus) | 0.5 | 0.1 | 0.3 |
| Amortisation of MT-LT debt | 7.0 | 6.3 | 9.1 |
| Banks | 0.8 | 0.5 | 1.0 |
| Government and central bank | 1.6 | 1.3 | 2.8 |
| Other sectors | 4.6 | 4.6 | 5.4 |
| Amortisation of ST debt | 40.7 | 41.0 | 41.0 |
| **Financing** | **48.3** | **47.4** | **51.0** |
| FDI | 4.8 | 5.3 | 5.7 |
| Borrowing | 42.0 | 40.3 | 42.6 |
| Banks | 18.9 | 18.9 | 19.0 |
| Government and central bank | 2.5 | 2.3 | 3.8 |
| Companies | 20.6 | 19.1 | 19.8 |
| EU transfers and other | 1.5 | 1.8 | 2.1 |

Sources: CZSO, MoF, UniCredit Research

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

**Outlook** – Economic growth is expected to slow to 2.6% in 2015 and 2.4% in 2016 from 3.6% in 2014. Despite robust growth in industrial production and retail sales, public investment could be crowded out by other types of expenditure, especially public acquisitions of private companies. The banking system recorded its largest annual losses ever in 2014 due to the FX mortgage loan conversion and compensation on "unfair" loan provisions. The worst should be behind us, with lower bank taxes expected from 2016 and the deleveraging process slowing.

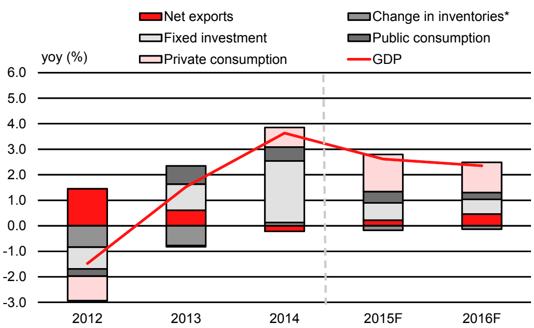
**Strategy** – We recommend being marketweight in HGBs, preferring the belly of the curve. More easing from the NBH and ECB supports the front and belly of the yield curve, but the long end is tied to UST yields. We recommend HGBs 20s and a 3s10s steepener in local rates, REPHUN USD 41s, REPHUN USD 23s and REPHUN EUR 20s in FX.

**Author: Dan Bucşa, Economist (UniCredit Bank London)**

### KEY DATES/EVENTS

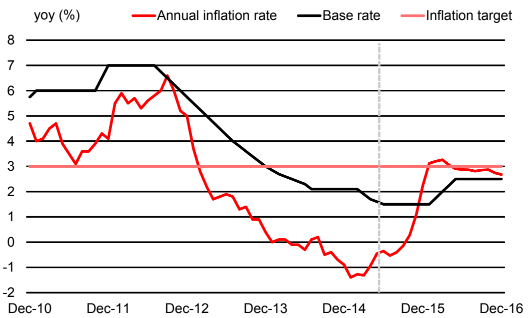
- 13 May, 5 June: 1Q15 GDP (flash estimate, structure)
- 24 Mar, 21 Apr, 26 May, 23 Jun: NBH rate meetings
- 20 Mar, 22 May: rating assessment from S&P, Fitch

### GDP DRIVERS




* adjusted for statistical error

### HEADLINE INFLATION VS. TARGET




Source: CSO, NBH, UniCredit Research

### MACROECONOMIC DATA AND FORECASTS

| | 2012 | 2013 | 2014E | 2015F | 2016F |
|---|---|---|---|---|---|
| GDP (EUR bn) | 97.6 | 100.5 | 103.3 | 107.5 | 111.9 |
| Population (mn) | 9.9 | 9.9 | 9.9 | 9.8 | 9.8 |
| GDP per capita (EUR) | 9,832 | 10,141 | 10,458 | 10,912 | 11,394 |
| **Real economy yoy (%)** | | | | | |
| GDP | -1.7 | 1.5 | 3.6 | 2.6 | 2.4 |
| Private Consumption | -1.9 | -0.1 | 1.6 | 3.0 | 2.4 |
| Fixed Investment | -3.8 | 5.2 | 11.7 | 3.1 | 2.6 |
| Public Consumption | 0.0 | 3.3 | 2.5 | 2.0 | 1.2 |
| Exports | 2.0 | 5.9 | 8.7 | 7.2 | 5.5 |
| Imports | 0.1 | 5.9 | 10.0 | 7.8 | 5.6 |
| Monthly wage, nominal (EUR) | 771 | 776 | 768 | 772 | 776 |
| Unemployment rate (%) | 11.0 | 10.2 | 7.7 | 7.2 | 7.1 |
| **Fiscal accounts (% of GDP)** | | | | | |
| Budget balance | -2.3 | -2.4 | -2.4 | -2.7 | -2.9 |
| Primary balance | 2.3 | 2.2 | 1.7 | 0.4 | 0.2 |
| Public debt | 78.5 | 77.3 | 76.9 | 77.5 | 78.3 |
| **External accounts** | | | | | |
| Current account balance (EUR bn) | 1.9 | 4.2 | 4.1 | 3.7 | 4.0 |
| Current account balance/GDP (%) | 1.9 | 4.1 | 4.0 | 3.4 | 3.5 |
| Basic balance/GDP (%) | 3.5 | 4.5 | 3.6 | 3.1 | 4.4 |
| Net FDI (EUR bn) | 2.0 | 0.4 | -0.4 | -0.4 | 0.9 |
| Net FDI (% of GDP) | 1.5 | 0.4 | -0.4 | -0.4 | 0.8 |
| Gross foreign debt (EUR bn) | 127.2 | 119.1 | 117.2 | 113.5 | 109.4 |
| Gross foreign debt (% of GDP) | 130.3 | 118.6 | 113.4 | 105.6 | 97.8 |
| FX reserves (EUR bn) | 33.9 | 35.2 | 35.1 | 33.1 | 31.5 |
| **Inflation/Monetary/FX** | | | | | |
| CPI (pavg) | 5.7 | 1.6 | -0.2 | -0.4 | 2.8 |
| CPI (eop) | 5.0 | 0.4 | -0.9 | 2.2 | 2.7 |
| Central bank target | 3.0 | 3.0 | 3.0 | 3.0 | 3.0 |
| Central bank reference rate (eop) | 5.75 | 3.00 | 2.10 | 1.50 | 2.50 |
| 3M money market rate (avg) | 6.99 | 4.31 | 2.41 | 1.55 | 2.35 |
| HUF/USD (eop) | 220.9 | 215.7 | 252.5 | 274 | 271 |
| HUF/EUR (eop) | 291.3 | 296.9 | 314. 9 | 320 | 325 |
| HUF/USD (pavg) | 225.1 | 223.7 | 232.4 | 265 | 274 |
| HUF/EUR (pavg) | 289.3 | 297.0 | 308.7 | 314 | 319 |

Source: UniCredit Research

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

## The visible hand

**The government continues to intervene in the economy…**

Losing patience with market adjustments, the Hungarian government continues its interventions to fix or reduce perceived economic dysfunctions. While some of these actions look providential with the benefit of hindsight, the danger of policy mistakes persists. As a result, Hungarian assets remain vulnerable to event risk despite lower flow imbalances.

**… with the banking sector being its main focus…**

**… via acquisitions…**

State interventionism is most visible in the banking sector. The decision to convert FX mortgage loans to HUF was vindicated by the SNB abandoning the EUR-CHF floor in January, yet the government avoided a huge negative wealth effect for households at the cost of unprecedented losses in the banking system (1.4% of GDP in 2014). These losses postponed the natural consolidation of the sector, but the government addressed that by buying two banks[10] and a 15% stake in Erste's Hungarian subsidiary (the EBRD bought another 15%). Other purchases could follow at a time when the fair banking law caps interest rates charged on household loans, ignoring the high cost of risk. The government pledged to start cutting the bank tax from 2016 onwards, with the expected levy falling by HUF 60bn (0.2% of GDP) from approximately HUF 140bn (0.5% of GDP) in 2016. Losses from fraud at three brokerage firms could impact bank results mainly via more volatile asset prices[11].

**… and the expansion of the FGS**

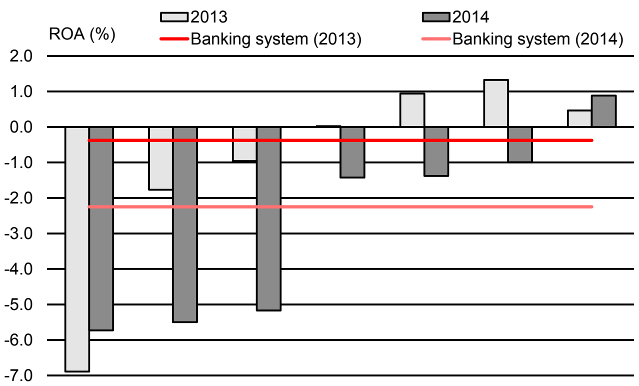
The deleveraging process slowed markedly, with bank's foreign liabilities falling by 2.0% yoy in January 2015 (FX-adjusted), the lowest rate since November 2010. Net new corporate lending turned positive in December 2014 (12M cumulated) and was the highest in six years in January 2015, helped by SME lending under the Funding for Growth Scheme (FGS). But with the FGS slowing below HUF 20bn per month (0.06% of GDP, SA) in 2014, the NBH launched the FGS+ aimed at riskier SMEs. The scheme is unlikely to have a major impact on lending, despite the central bank assuming part of the credit risk[12]. If the FGS and its offshoot fail to boost lending, the resourceful NBH could address this issue with new measures. The central bank might try to boost the mortgage bond market by becoming an active player in the secondary market and by imposing thresholds for types of long-term bank financing.

**We expect rate cuts to resume in March**

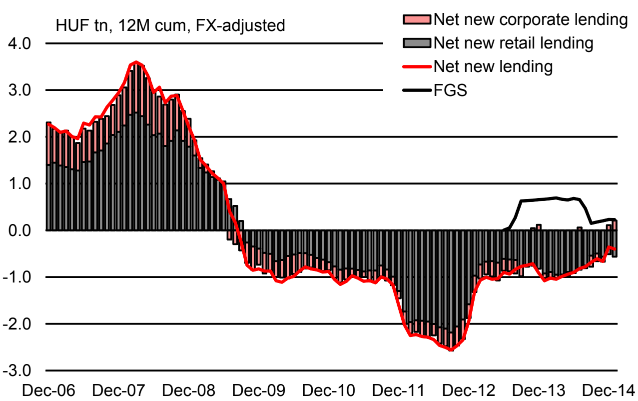
Monetary easing is also on the cards, with rate cuts expected to resume in March. The NBH could slash up to 60bp off its base rate before the end of the summer in steps of 10-20bp. ECB's QE and negative inflation until the beginning of 4Q15 will support policy easing in 2015. Base effects and stronger domestic demand could push inflation to 3% yoy in 1Q16, probably requiring rate hikes of up to 100bp, but no rapid return to positive real interest rates.

**BANKS RECORDED THE LARGEST LOSSES EVER IN 2014, BUT ALSO A SLOWDOWN IN DELEVERAGING**

The results of the 7 largest private-owned banks worsened in 2014




The FGS helped new corporate lending, but is running out of steam




Source: NBH, commercial bank reports, UniCredit Research

[10] Budapest Bank from GE and the loss-making MKB from BayernLB.
[11] For details, please refer to the *EEMEA Macro Flash - Hungary: brokerage market turmoil adds volatility to HUF asset prices* from 10 March 2015.
[12] For details, please refer to the *EEMEA Macro Flash - Hungary: the NBH expands the FGS and stands ready to assume credit risk* from 18 February 2015.

**Inflation will recover gradually, reaching target only in 2016**

The economy is expected to grow faster than potential in 2015, with monetary conditions remaining easy. Inflation could bottom out in March 2015 at around -1.5% yoy and rebound to approximately 2.2% yoy by year-end. A negotiated cut in gas prices imported from Gazprom could be passed onto consumer prices, offsetting some of last year's administered price cuts (gas, energy) that will exit the base before the end of the year. In 2016, base effects will turn negative, probably keeping inflation close to the 3% target.

**Growth will rely on domestic demand in 2015 and 2016…**

**… consumption being the main driver**

Economic growth will continue to rely on domestic demand in 2015, but a slowdown to 2.6% yoy and 2.4% yoy in 2016 from 3.6% yoy in 2014 is on the cards amid a shift of drivers from investment to consumption. The positive credit impulse, real wage growth and rising employment could help consumption rise by 3.0% yoy in 2015 and 2.4% yoy in 2016. Even though the FGS and a rebound in housing will continue to support private investment, public investment could be crowded out by other types of public spending. Moreover, EU fund inflows could decline in 2015 to EUR 2.7bn from EUR 3.8bn in 2014, rebounding to EUR 3.3bn in 2016 amid higher outlays from the new programming period. Import growth could offset export growth and neutralise its impact on GDP dynamics in both 2015 and 2016.

**We expect the HUF to weaken again**

We expect the HUF to weaken again towards EUR-HUF 320. Among long-term foreign exchange drivers, low interest rates reinforced by further cuts and liquidity injections are expected to offset the support from the large C/A surplus. Among short-term FX drivers, the announced ECB QE led to bond inflows, but the expected rate hikes from the Fed could affect the HUF due to Hungary's reliance on USD-based bond investors. The authorities' bias towards a weaker currency (discussed in previous publications) remains in place.

**The government could overshoot its deficit and debt targets…**

**… jeopardizing the return to investment grade**

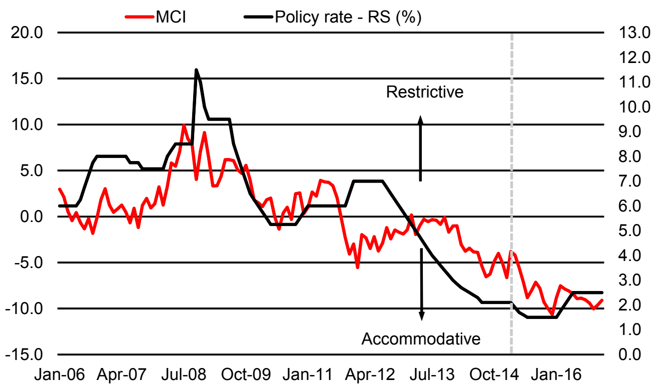
The government will struggle to meet a very ambitious budget deficit of 2.4% of GDP for 2015 amid optimistic revenue forecasts. Unlike in recent years, potential windfall revenues from ad-hoc taxes are limited. At the same time, expenditure could exceed plan due to public acquisitions of private companies in the banking, the energy and the utility sectors. Another concern is the fiscal cost of losses at state-owned banks and brokerage firms. Thus, the government is jeopardising its goal of reducing the public debt to GDP ratio, which fell in 2014 to 76.9% of GDP from 77.3% of GDP in 2013 mostly due to a high GDP deflator (3.1% yoy in 2014). This would postpone Hungary's return to investment grade. While a first upgrade to investment could come this year, we do not expect a second one before 2016.

**In 2015, sovereign financing needs are the lowest since the financial crisis**

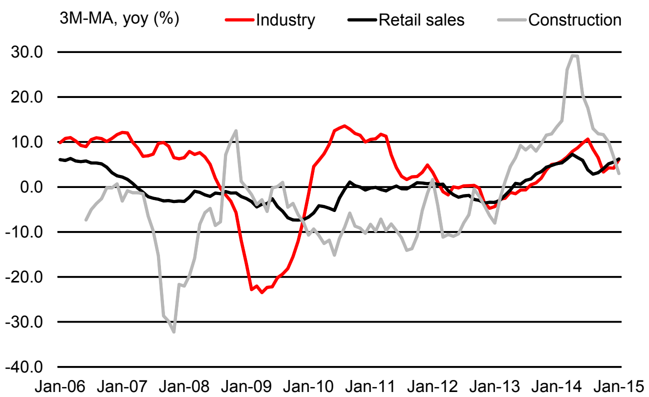
The government faces potential rate hikes in the US with the lowest financing needs of the decade amid no IMF and EC repayments in 2015, but at 20% of GDP gross financing needs remain the largest in Central Europe. If borrowing costs rise, the NBH could start its own QE program and/or the government could backtrack on its plans and issue FX bonds.

**REAL MONETARY CONDITIONS WILL REMAIN ACCOMMODATIVE, AS GROWTH DRIVERS SHIFT TO INDUSTRY AND RETAIL SALES**

Accommodative monetary conditions expected until the end of 2016




The period of strong growth fuelled by construction is over




Source: CSO, AKK, NBH, Bloomberg, UniCredit Research

## Strategy: Support for HGBs but move duration to the belly

**We recommend marketweight HGBs on expected rate cuts, high real yields and change in rating outlook**

We recommend being marketweight in HGBs. We expect rate cuts and low inflation to support the front end of the HGB yield curve in 2015. A potential upgrade to investment grade later this year would also offer support. While we expect an all-important second upgrade only in 2016, changes in the outlook from 'Stable' to 'Positive' would be positive for bonds.

**The long end of the curve remains vulnerable…**

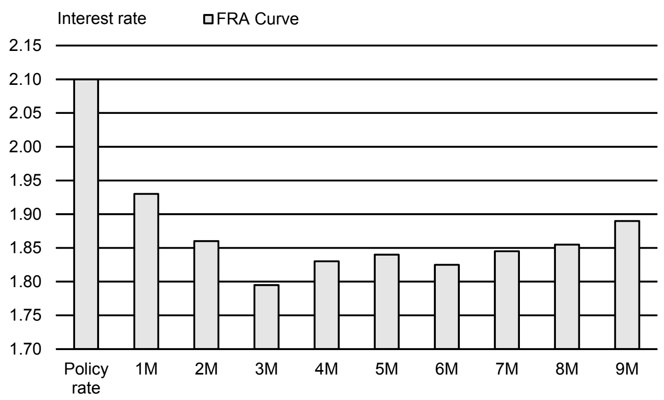
**… due to high foreign ownership and correlation to rising UST yields**

**We recommend moving duration from the long end to the belly of the local curve …**

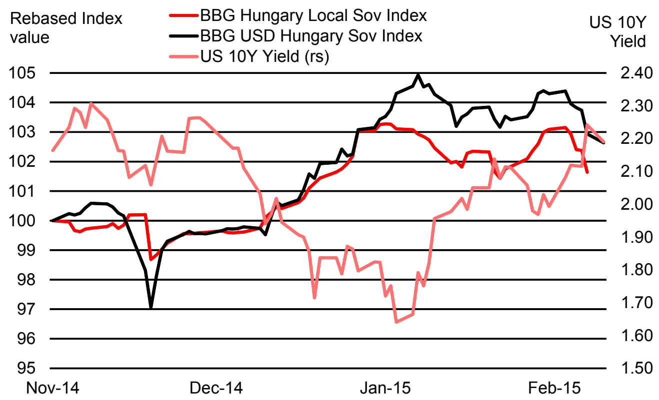
**...but favour better value and less risky REPHUN bonds in USD and EUR**

However, we think that the long end of the local curve remains vulnerable to the large weight of foreign investors in that segment of the curve (probably more than 50%), most of which are USD-based. Auctions in longer-dated bonds are starting to show signs of weakness, despite the launch of ECB's QE. 10Y HGB yields are much more correlated to UST yields than those in the belly or front end, making them vulnerable to rising US rates and this is why we recommend moving duration from the long end to the belly, favouring the HGB 20s. The local curve could steepen and we recommend a 3s10s steepener, with a target spread of 130bp. There is value in paying 10Y swaps, but in the event of severe market weakness, the NBH may implement new instruments to support long-end bonds. That said, USD REPHUN bonds offer much better value due to their lower US Treasury risk, higher yield and scarcity value. We recommend the REPHUN USD 41s and the REPHUN USD 23s. ECB's QE could offer support to the REPHUN EUR 20s.

Hungary FRA curve pricing in additional rate cuts




Outperformance of USD bonds vs. local when US yields start rising




Source: AKK, Bloomberg, UniCredit Research

### GOVERNMENT GROSS FINANCING REQUIREMENTS

| EUR bn | 2014E | 2015F | 2016F |
|---|---|---|---|
| **Gross financing requirement** | **28.0** | **19.4** | **23.2** |
| Budget deficit | 2.4 | 2.9 | 3.2 |
| Amortization of public debt | 25.6 | 16.5 | 20.0 |
| Domestic | 19.2 | 15.1 | 14.5 |
| Bonds | 7.8 | 4.2 | 3.7 |
| Bills | 6.2 | 5.3 | 4.9 |
| Other | 5.2 | 5.6 | 5.9 |
| External | 6.4 | 1.4 | 5.5 |
| IMF/EU and other loans | 3.5 | 0.3 | 2.2 |
| Bonds | 2.9 | 1.1 | 3.3 |
| **Financing** | **28.0** | **19.4** | **23.2** |
| Domestic borrowing | 25.6 | 19.4 | 20.7 |
| Bonds | 13.4 | 7.5 | 9.0 |
| Bills | 5.1 | 4.9 | 4.9 |
| Loans and retail securities | 7.1 | 7.0 | 6.8 |
| External borrowing | 2.4 | 0.0 | 2.5 |
| Bonds | 2.2 | 0.0 | 2.5 |
| Other | 0.2 | 0.0 | 0.0 |
| Pension funds, govt. reserves | 0.0 | 0.0 | 0.0 |

Source: AKK, IMF, NBH, UniCredit Research

### GROSS EXTERNAL FINANCING REQUIREMENTS

| EUR bn | 2014E | 2015F | 2016F |
|---|---|---|---|
| **Gross financing requirement** | **24.1** | **18.7** | **18.6** |
| C/A deficit(+)/ surplus(-) | -4.0 | -3.4 | -3.5 |
| Amortisation of medium to long term debt | 11.4 | 5.6 | 9.7 |
| Government/central bank | 6.8 | 2.3 | 5.9 |
| Banks | 2.2 | 1.0 | 1.7 |
| Corporates | 2.4 | 2.3 | 2.3 |
| Amortisation of short term debt | 16.7 | 16.5 | 12.3 |
| Government/central bank | 4.2 | 3.4 | 2.0 |
| Banks | 7.9 | 8.6 | 6.0 |
| Corporates | 4.6 | 4.5 | 4.3 |
| **Financing** | **24.1** | **18.7** | **18.6** |
| FDI | -0.4 | -0.4 | 0.9 |
| Equity | -1.9 | -0.9 | -0.9 |
| Long-term borrowing | 6.0 | 3.0 | 5.4 |
| Government/central bank | 1.8 | 0.5 | 3.0 |
| Banks | 1.9 | 0.4 | 0.4 |
| Corporates | 2.3 | 2.1 | 2.1 |
| Short-term borrowing | 16.5 | 12.3 | 8.3 |
| Government/central bank | 3.4 | 2.0 | 1.2 |
| Banks | 8.6 | 6.0 | 3.0 |
| Corporates | 4.5 | 4.3 | 4.1 |
| EU transfers | 3.8 | 2.7 | 3.3 |
| Change in FX reserves (reduction(+)/increase(-)) | 0.1 | 2.0 | 1.6 |

# Lithuania (Baa1 positive/A- stable/A- stable)*

**Outlook** – Lithuania became the nineteenth member of the eurozone this year, at a time of increased geopolitical tensions. Russia remains Lithuania's main trading partner, rendering it vulnerable to the current standoff with the West. At the same time, Lithuania will reduce its energy dependency on Russia by building a liquefied natural gas terminal and connecting its energy system to the Polish, Swedish and Norwegian ones. Economic growth is expected at 2.8% in 2015 and 2016, with consumption, public investment and exports to the eurozone and outside the EU and the CIS being the main drivers.

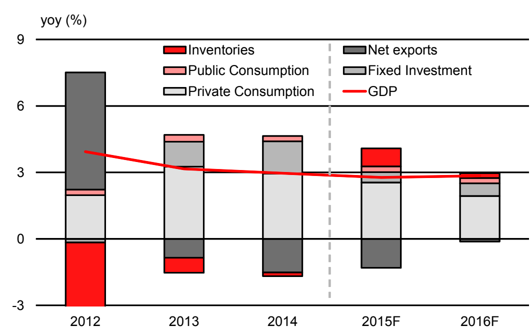
**Strategy** – ECB QE, tight fiscal policies and low remaining financing needs are expected to support Lithuanian bonds this year. We recommend being long the LITHUN USD 17s against short LATVIA USD 17s amid lower energy and financing dependency on Russia.

**Author: Dan Bucşa, Economist (UniCredit Bank London)**

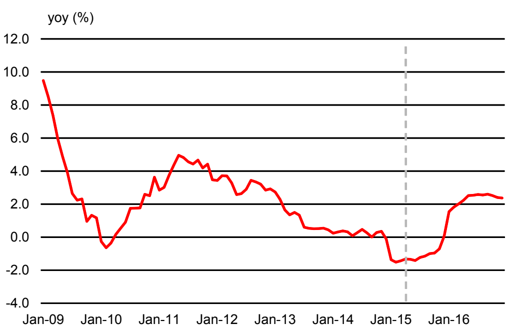
**KEY DATES/EVENTS**

- 30 April, 29 May: 1Q15 GDP (flash release, structure)
- 23 Mar, 21 Apr, 21 May: industrial production
- December 2015: opening of NordBalt and LitPol energy links

**GDP DRIVERS**




**HEADLINE INFLATION HAS BOTTOMED OUT**




Source: Statistics Lithuania, UniCredit Research

**MACROECONOMIC DATA AND FORECASTS**

| | 2012 | 2013 | 2014E | 2015F | 2016F |
|---|---|---|---|---|---|
| GDP (EUR bn) | 33.3 | 35.0 | 36.3 | 37.4 | 39.4 |
| Population (mn) | 3.1 | 3.0 | 3.0 | 2.9 | 2.9 |
| GDP per capita (EUR) | 10,913 | 11,638 | 12,210 | 12,707 | 13,494 |
| **Real economy yoy (%)** | | | | | |
| GDP | 3.8 | 3.2 | 3.0 | 2.8 | 2.8 |
| Private Consumption | 3.6 | 5.2 | 4.6 | 3.9 | 3.0 |
| Fixed Investment | -1.6 | 6.2 | 7.8 | 2.4 | 2.9 |
| Public Consumption | 1.2 | 1.7 | 1.4 | 1.5 | 1.4 |
| Exports | 12.2 | 9.4 | 3.3 | 3.1 | 3.6 |
| Imports | 6.6 | 11.0 | 5.4 | 4.8 | 3.7 |
| Monthly wage, nominal (EUR) | 630 | 661 | 691 | 719 | 757 |
| Unemployment rate (%) | 13.4 | 11.8 | 10.7 | 10.1 | 9.7 |
| **Fiscal accounts (% of GDP)** | | | | | |
| Budget balance | -3.3 | -2.2 | -1.9 | -1.5 | -1.5 |
| Primary balance | -1.4 | -0.4 | -0.2 | 0.1 | 0.1 |
| Public debt | 40.5 | 38.9 | 42.9 | 43.1 | 42.5 |
| **External accounts** | | | | | |
| Current account balance (EUR bn) | -0.4 | 0.6 | -0.2 | -0.7 | -0.8 |
| Current account balance/GDP (%) | -1.2 | 1.6 | -0.5 | -1.8 | -1.9 |
| Basic balance/GDP (%) | 0.2 | 3.1 | -1.6 | -0.9 | -0.3 |
| Net FDI (EUR bn) | 0.5 | 0.5 | -0.4 | 0.4 | 0.7 |
| Net FDI (% of GDP) | 1.4 | 1.5 | -1.0 | 0.9 | 1.7 |
| Gross foreign debt (EUR bn) | 25.9 | 24.4 | 24.5 | 24.2 | 24.6 |
| Gross foreign debt (% of GDP) | 77.8 | 69.8 | 67.5 | 64.6 | 62.4 |
| FX reserves (EUR bn) | 6.4 | 5.9 | 5.1 | 0.0 | 0.0 |
| **Inflation/Monetary/FX** | | | | | |
| CPI (pavg) | 3.1 | 1.0 | 0.1 | -1.1 | 2.3 |
| CPI (eop) | 2.8 | 0.4 | -0.3 | 0.1 | 2.4 |
| Central bank reference rate (eop) | 1.50 | 0.75 | 0.70 | EUR | EUR |
| 3M money market rate | 1.08 | 0.51 | 0.40 | EUR | EUR |
| LTL/USD (eop) | 2.61 | 2.51 | 2.47 | EUR | EUR |
| LTL/EUR (eop) | 3.45 | 3.45 | 3.45 | EUR | EUR |
| LTL/USD (pavg) | 2.69 | 2.60 | 2.52 | EUR | EUR |
| LTL/EUR (pavg) | 3.45 | 3.45 | 3.45 | EUR | EUR |

Source: UniCredit Research

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

## Between strong fundamentals and geopolitical tensions

**Lithuania joined the euro on 1 January 2015…**

**… at a time of mounting geopolitical tensions…**

Lithuania became the nineteenth member of the eurozone in 2015, at a time when geopolitical tensions reached a post-independence high. Amid tensions between Russia and the West, Lithuanian authorities reinstated compulsory conscription and increased defense spending, although the country borders directly only the Russian enclave of Kaliningrad. Moreover, its Russian minority is the smallest of all Baltic states at 5.8% of the population.

**… that affect the country's trade with Russia**

From an economic point of view, Lithuania is vulnerable to a standoff with Russia due to stronger trade ties: at 20.8% and 21.6% of the total, the country's exports to and imports from Russia made it the third most-reliant European country on trade with Russia in 2014 after Belarus and Ukraine. A 22.2% fall in imports due mostly to lower energy imports reduced Lithuania's deficit with Russia by 5.1% of GDP in 2014 and the narrowing will continue.

**Lithuania will reduce its energy dependency on Russia…**

**… by building a LNG terminal…**

**… and interconnections with Poland and Sweden**

A redesign of Lithuania's energy trade will see it reduce sharply its dependency on Russia. In the past few years, Russia began circumventing the Baltic states as hubs for energy exports by building terminals in the Gulf of Finland. Lithuania addressed this in three main ways. First, it built the Klaipeda liquefied natural gas terminal that can process 4bn cubic meters of gas per year[13]. Second, Lithuania will open in 2015 the LitPol link that interconnects Lithuania's and Poland's electricity infrastructure and the NordBalt link that will provide access to Norwegian energy via Sweden. Third, Lithuania will connect its gas infrastructure to Poland's by 2019. Part of the costs are covered by the Baltic Gas Energy Market Interconnection Plan of the European Commission, which is meant to reduce the dependency on Russian gas (formerly 100% for the three countries) and, in Lithuania's case, on Russian electricity[14].

**We expect GDP growth at 2.8% in 2015 and 2016 supported by consumption…**

**… and exports to the eurozone and to non-EU, non-CIS countries…**

**… but slowed by the impact of trade with Russia…**

**… the end of the post-crisis GDP recovery…**

**… and a negative credit impulse**

GDP growth will probably remain close to, but below 3% yoy this year and next. Private consumption is expected to be the main driver due to wage growth of around 4% this year vs. 5.5% yoy in 4Q14. In addition, better demand is expected to boost exports to the eurozone, while a weak euro will help exports outside the EU and the CIS. At the same time, three main factors could prevent economic growth from remaining above 3% for a fourth successive year. First, the geopolitical situation remains unfavourable for Lithuania's external trade and impacts business confidence, which fell to a two-year low in January 2015. Fixed investment contracted in 2H14 for two consecutive quarters, a first since the financial crisis, and in 2015 will be boosted mostly by government expenditure on defense and energy infrastructure. While the diversification of energy imports is positive, it will not solve existing competitiveness issues[15]. Second, the country's GDP finally rose in real terms above the pre-crisis level in 3Q14, ending the catching-up process after the deep 2008-2009 recession. As a result, the real convergence with EU levels could slow from here. Third, the credit impulse turned negative in 2014, with corporate credit falling by 1.8% yoy and household lending stagnating.

**ECB QE, fiscal policies and low financing needs will support Lithuanian bonds in 2015…**

**… and we expect LITHUN bonds to outperform LATVIA**

ECB QE, tight fiscal policies and low remaining financing needs[16] are expected to support Lithuanian bonds this year. Under the QE program, the Bank of Lithuania could buy 25% of Lithuania's EUR 4.5bn QE-eligible bonds before the end of this year. The geopolitical situation and the lower dependency on Russian energy[17] and bank funding[18] favour Lithuanian vs. Latvian bonds. We recommend being long the LITHUN USD 17s against short LATVIA USD 17s, with the spread expected to tighten 15bp from the current level of 22bp.

[13] This allowed the country to get a 23% price discount from Gazprom. Lithuania's natural gas imports from Russia were approximately 2.5bn cubic meters in 2014.
[14] 70% of consumption after the closing of the Ignalina nuclear power plant in 2009.
[15] The most important example is Orlen Lietuva, the only oil refinery in the Baltics and Lithuania's largest company, exporter and taxpayer. Shut off from Russian oil, the company needs expensive imports to function and incurred losses in 2013 and 2014. As a result, the Polish parent wants to sell the company.
[16] The budget deficit and remaining bond redemptions amount to approximately 2.4% of GDP in 2015 and less than 5% of GDP in 2016.
[17] Latvia remains much more dependent on Russian energy: its largest gas distribution company, Latvijas Gaze, counts Gazprom as a main shareholder and benefits from a monopoly on the gas market until April 2017, reducing Latvia's possibilities of benefiting from the Klaipeda LNG terminal.
[18] The Latvian banking sector remains dependent on foreign funding: in January 2015, 38.1% of bank liabilities were deposits from private, non-financial foreign investors, most of them being Russian. In Lithuania, non-EU depositors accounted for a much lower 4.3% of banking sector liabilities in December 2014.

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

**Outlook** – An upward growth revision to 3.4% in 2015 and 3.5% in 2016 is based on strong domestic demand (helped by improving labour market conditions and EU fund inflows) and a rebound in demand from the eurozone. We expect inflation to rise to 0.8% yoy by the end of 2015 and to 2.0% yoy by next year, triggering two rate hikes in 2H16. The budget deficit should decline below 3% of GDP in 2015, triggering the exit from the EDP and a likely rating upgrade. Elections could bring changes to the governing coalition, without threatening fiscal and economic policies.

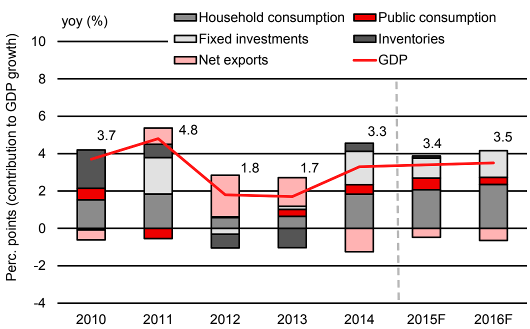
**Strategy** – In the very short term, ECB's QE will support POLGBs. But the end of the easing cycle, rising inflation and a normalization in US rates could lead to a steeper curve. We prefer the belly of the POLGB curve and believe that USD and EUR bonds offer more value than local bonds. The PLN could come under pressure in the short term amid capital outflows.

**Author: Marcin Mrowiec, Chief Economist (Bank Pekao)**

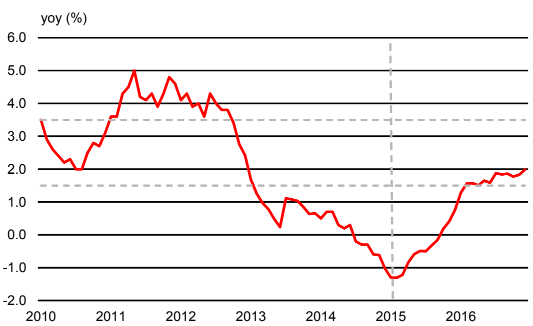
## KEY DATES/EVENTS

- 14-15 Apr, 5-6 May, 2-3 June: MPC decision-making meetings
- 10 (and 24) May 2015: Presidential elections
- October 2015: Parliamentary elections

## GDP COMPONENTS




## HEADLINE INFLATION VS. TARGET




Source: StatOffice, NBP, UniCredit Research

## MACROECONOMIC DATA AND FORECASTS

| | 2012 | 2013 | 2014E | 2015F | 2016F |
|---|---|---|---|---|---|
| GDP (EUR bn) | 386.1 | 395.7 | 411.6 | 423.1 | 450.2 |
| Population (mn) | 38.1 | 38.1 | 38.0 | 38.0 | 38.0 |
| GDP per capita (EUR) | 10,143 | 10,399 | 10,822 | 11,129 | 11,850 |
| **Real economy yoy (%)** | | | | | |
| GDP | 1.8 | 1.7 | 3.3 | 3.4 | 3.5 |
| Private Consumption | 1.0 | 1.1 | 3.0 | 3.5 | 4.0 |
| Fixed Investment | -1.5 | 0.9 | 9.5 | 5.5 | 7.2 |
| Public Consumption | 0.2 | 2.1 | 2.8 | 3.5 | 2.1 |
| Exports | 4.3 | 5.0 | 5.6 | 6.6 | 6.5 |
| Imports | -0.6 | 1.8 | 8.7 | 7.9 | 8.2 |
| Monthly wage, nominal (EUR) | 891 | 911 | 948 | 976 | 1,035 |
| Unemployment rate (%) | 12.8 | 13.5 | 12.3 | 10.8 | 10.2 |
| **Fiscal accounts (% of GDP)** | | | | | |
| Budget balance | -3.7 | -4.0 | -3.4 | -2.8 | -2.5 |
| Primary balance | -1.1 | -1.5 | -1.3 | -0.7 | -0.5 |
| Public debt | 54.4 | 55.7 | 48.6 | 49.3 | 49.0 |
| **External accounts** | | | | | |
| Current account balance (EUR bn) | -13.7 | -5.2 | -5.3 | -6.0 | -7.4 |
| Current account balance/GDP (%) | -3.5 | -1.3 | -1.3 | -1.4 | -1.6 |
| Basic balance/GDP (%) | -2.1 | -1.3 | 1.2 | 1.4 | 1.2 |
| Net FDI (EUR bn) | 5.6 | 0.1 | 10.4 | 12.0 | 13.0 |
| Net FDI (% of GDP) | 1.4 | 0.0 | 2.5 | 2.8 | 2.9 |
| Gross foreign debt (EUR bn) | 278.0 | 277.5 | 309.6 | 311.5 | 290.8 |
| Gross foreign debt (% of GDP) | 72.0 | 70.1 | 75.2 | 73.6 | 64.6 |
| Fx reserves (EUR bn) | 82.6 | 77.1 | 82.6 | 96.9 | 90.7 |
| **Inflation/Monetary/FX** | | | | | |
| CPI (pavg) | 3.7 | 0.9 | 0.0 | -0.4 | 1.7 |
| CPI (eop) | 2.4 | 0.7 | -1.0 | 0.8 | 2.0 |
| Central bank target | 2.5±1pp | 2.5±1pp | 2.5±1pp | 2.5±1pp | 2.5±1pp |
| Central bank reference rate (eop) | 4.25 | 2.50 | 2.00 | 1.50 | 2.00 |
| 3M money market rate | 4.91 | 3.02 | 2.51 | 1.72 | 2.00 |
| USD/PLN (eop) | 3.10 | 3.01 | 3.51 | 3.89 | 3.52 |
| EUR/PLN (eop) | 4.09 | 4.15 | 4.26 | 4.20 | 4.08 |
| USD/PLN (pavg) | 3.26 | 3.16 | 3.15 | 3.69 | 3.72 |
| EUR/PLN (pavg) | 4.19 | 4.20 | 4.19 | 4.23 | 4.17 |

Source: Unicredit Research

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

## Strong domestic demand makes Poland a CEE outperformer

**We revised our 2015 GDP growth forecast from 3.3% to 3.4%**

**We revised our GDP forecast to 3.4% from 3.3% for 2015 and to 3.5% from 3.4% for 2016, as labor market and external conditions continue to improve.** UniCredit's upward revisions to growth forecasts for the eurozone (from 1.0% to 1.4%) and especially for Germany (from 1.4% to 2.0%) bode well for Polish exports. However, strong domestic demand means stronger imports, so the contribution from net exports will still be negative (-0.5pp), but less so than previously. The key driving force of GDP growth remains robust domestic demand, which in turn is supported by a stronger labor market, with both wages and employment increasing.

**Solid performance of the labor market is supportive for domestic demand**

**The situation on the domestic labor market keeps improving**. In January 2015, the real wage bill increased by 6.3% yoy, the fastest pace since November 2008, and is expected to increase by 5.5% yoy for the whole of 2015. Both employment and wages are expected to drive growth: the number of employed could rise by 1.3% yoy growth in the corporate sector and wages are expected to grow by 4.0% yoy in 2015. Entrepreneurs anticipate an increase in jobs, the PMI employment sub-index surging to the highest level in six years.

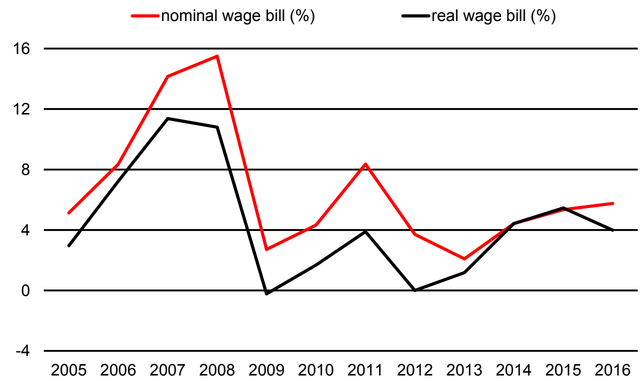
**Fresh EU fund inflows from the 2014-2020 programming period should be an additional growth stimulus in a few months' time**. This could be the key supportive factor for domestic demand, which is expected to increase by 4.0% yoy this year. We look for investment to add around 6% this year (after very strong growth of 9.5% last year), with risks skewed to the upside.

**CPI is to stay negative till October, then rebound towards 0.8-1.0% yoy in end-2015**

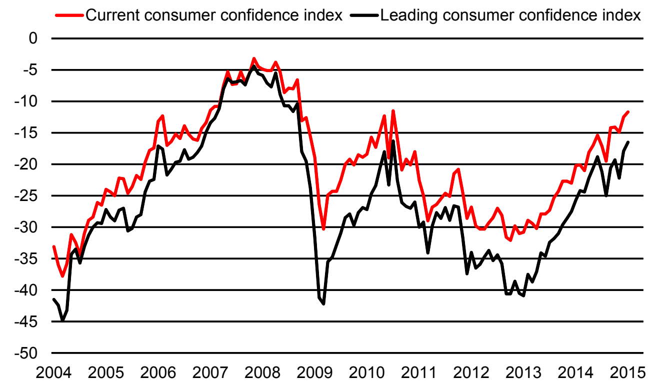
**Consumer price inflation is expected to stay negative until the end of 3Q15, but then should rebound, with the end-2015 forecast at 0.8% yoy.** While most of the food and fuel price shocks have probably passed through to volatile consumer prices, their second-round effects on core inflation are not over yet. This will delay the return to positive consumer price inflation, despite strong economic growth and accommodative monetary conditions. As a result, the lower bound of the inflation target interval (1.5%) may be reached only in 1Q16, as negative price shocks start exiting the base. We expect CPI inflation to be close to 2.0% yoy by the end of 2016, thus being much more hawkish than the central bank. We believe that, by the end of next year, domestic demand will put significantly more pressure on core inflation.

**IMPROVEMENT IN THE LABOR MARKET AND RISING CONSUMER CONFIDENCE WILL SUPPORT PRIVATE CONSUMPTION**

The real wage bill will continue to increase at a healthy pace




Improvement in consumer confidence will support consumption




Source: StatOffice, UniCredit Research

**The MPC officially declared the end of the easing cycle. We look for rates to stay unchanged till late 2016, when we pencil in two hikes of 25bp**

**After the March cut of 50bp, the Monetary Policy Council officially declared the end of the easing cycle.** The depth of the cut was a bit surprising, but the MPC made it clear in its post-meeting press release that the easing cycle is over. As a result, markets stopped pricing in any further cuts. Therefore, the universal expectation is that rates will stay flat till year-end, and most probably till the end of the term of the current MPC in February 2016. As we expect annual CPI inflation to be close to 2% yoy at the end of 2016, we assume two rate hikes in late 2016, although this probably contrasts with the central bank's current expectations. The March 2015 NBP inflation projection shows the central forecast for headline inflation below 1.2% yoy until the end of 2017. Thus rates could stay unchanged for much longer, at least theoretically. We consider the NBP's inflation forecast as being too conservative for two reasons. First, most of the supply-side shocks from lower food and fuel prices that pushed headline inflation in negative territory will leave the base this year. Second, demand pressure prices could be stronger amid faster economic growth both domestically and in the eurozone. The NBP seems to be downplaying the closing of the negative output gap, although its GDP growth forecast of 3.3-3.5% for 2015-2017 would imply something else.

**2014 budget deficit is likely to be higher than expected, but plans to reduce the deficit below 3% in 2015 look realistic…**

**Even though Poland's GDP growth accelerated markedly and its composition was favorable for tax revenues, the 2014 general government outcome may disappoint on the downside.** Official data are not available yet, but several factors that unfolded in 2014 acted as a drag on the fiscal position. Among others, the default of SKOK Wołomin triggered payouts from the Bank Guarantee Fund (BFG) of some PLN 2.0-2.5bn, reducing the cash buffers of the general government rather than supporting them like in previous years, when contributions to BFG far exceeded payouts. The general government deficit most likely amounted to some 3.6-3.7% of GDP rather than the 3.2-3.3% of GDP targeted by the government (in 2013, the deficit stood at 4.0% of GDP). Still the task of reducing the deficit below 3% of GDP in 2015 is achievable, but may require additional fiscal efforts.

**… and could trigger a rating upgrade in early 2016**

**A rating upgrade is possible in early 2016.** The excessive deficit procedure should be abrogated in 2016, paving the way for an upward adjustment of Poland's ratings. In February, Fitch affirmed Poland's sovereign rating at "A-" and S&P confirmed the rating of "A-", upgrading its outlook to positive on steady economic growth. An upgrade by S&P in 1Q16 is possible if Poland fulfills its European fiscal obligations, i.e., if the 2015 deficit falls below 3% GDP.

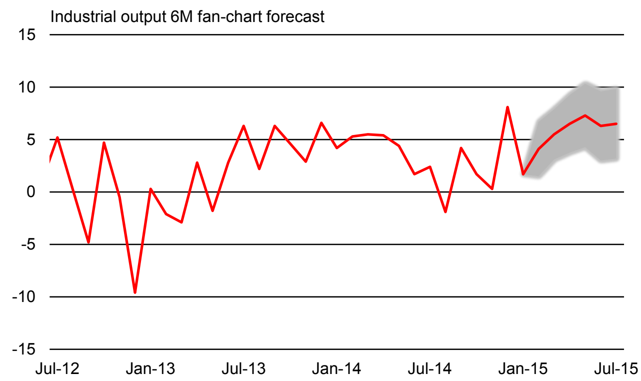
**Poland will see both Presidential and Parliamentary elections in 2015. These could bring some changes…**

**… but there's no risk of populist parties rising to power**

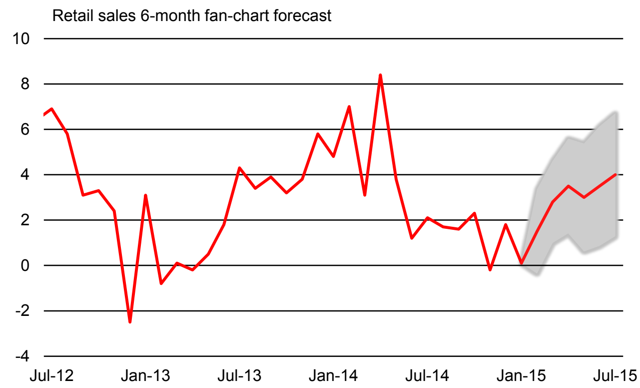
**Parliamentary and presidential elections will take place in autumn and May, respectively.** With the main governing party and the main opposition party registering similar support in opinion polls, parliamentary elections are an important event. From an investment point of view, the political situation (and possible change of governing coalition) should not present significant risks for the outlook of fiscal and economic policies. As a positive, in Poland there has been no increase in support for populist parties, as opposed to many Western European countries.

**WE LOOK FOR FURTHER ACCELERATION OF INDUSTRIAL OUTPUT AND RETAIL SALES**

Industrial output should accelerate in the coming months




Improvement in labor market will propel growth of retail sales




Source: StatOffice, UniCredit Research

# Easing cycle over, QE supports POLGBs, PLN vulnerable

**The PLN should remain range-bound in the long term…**

**…on stable interest rates and improved macro outlook, but short term the zloty is vulnerable.**

**Upside risks to POLGBs initially due to impact of QE…**

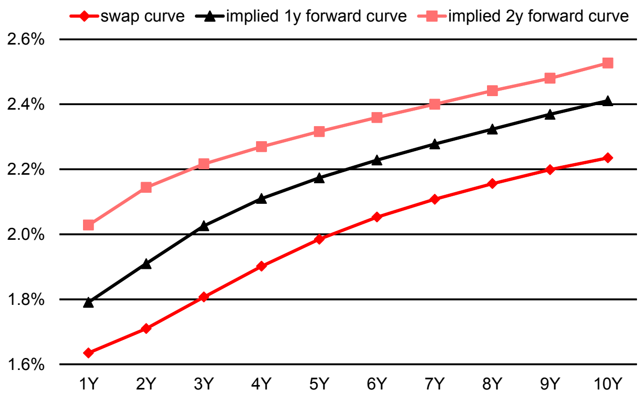
**…but downside risks are increasing due to end of easing cycle, inflation outlook and rising US yields.**

**We favour the belly over the long end in the POLGB yield curve but overall prefer USD-denominated debt**

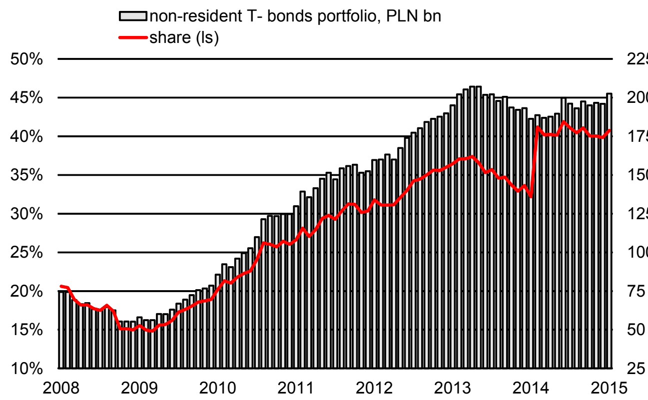
Stable interest rates and an improving macro outlook should limit the pressure on the zloty, but there is a greater risk of foreign investors reducing POLGB holdings amid an end to rate cuts and rising inflation outlook. In addition, a rebound in EURUSD could see EUR-PLN test 4.20. The risk of capital outflows from emerging markets towards USD denominated assets may also affect POLGBs in the coming months although in the very short term, a rise in USD yields could be offset by bond purchases in the euro-zone under ECB's QE.

In the second half of 2Q15, risks to POLGB prices are increasingly to the downside, with the exception of a possible change in Poland's outlook to 'Positive' by Moody's. With the easing cycle over, inflation set to pick up, and long-end POLGBs correlated with US yields, a bear-steepening of the local curve seem likely. On balance, we recommend being marketweight POLGBs but moving duration from the long end to the belly by mid-April. We favour POLGB 21s and 22s. The curve is too flat and we like 2s10s steepeners and paying 10Y swaps. We prefer the hard currency bonds to the local curve due to the lower risk into a Fed hiking cycle. We recommend the POLAND USD 22s and 24s. We also see some value in the POLAND EUR 25s. At the end of 2015, we see local 2Y at 2.00%, 5Y at 2.40% and 10Y at 2.80%.

Markets price in moderate rate hikes going forward




Non-residents increased POLGB holdings above PLN 200bn in Jan.




Source: Finance Ministry, NBP, UniCredit Research

**GOVERNMENT GROSS FINANCING REQUIREMENTS**

| EUR bn | 2014E | 2015F | 2016F |
|---|---|---|---|
| **Gross financing requirement** | **26.5** | **31.6** | **34.1** |
| Budget deficit | 8.4 | 10.0 | 10.8 |
| Amortization of public debt | 18.0 | 21.6 | 23.4 |
| Domestic | 15.0 | 18.6 | 20.2 |
| Bonds | 15.0 | 18.6 | 20.2 |
| Bills | 0 | 0 | 0 |
| External | 3.0 | 3.0 | 3.1 |
| IMF/EU/IFIs | 0 | 0 | 0 |
| **Financing** | **26.5** | **31.6** | **34.1** |
| Domestic borrowing | 21.0 | 26.1 | 29.8 |
| Bonds | 23.5 | 26.8 | 31.0 |
| Bills | 0 | 0 | 0 |
| Other | -2.5 | -0.8 | -1.2 |
| External borrowing | 5.5 | 5.5 | 4.3 |
| Bonds | 3.4 | 3.9 | 4.3 |
| IMF/EU/WB | 0 | 0.2 | 0 |
| Other | 2.1 | 1.3 | 0 |

**GROSS EXTERNAL FINANCING REQUIREMENTS**

| EUR bn | 2014 | 2015F | 2016F |
|---|---|---|---|
| **Gross financing requirement** | **90.6** | **95.0** | **94.6** |
| C/A deficit | 5.3 | 6.0 | 7.4 |
| Amortization of medium to long term debt | 38.0 | 43.4 | 42.7 |
| Government/central bank | 3.0 | 3.0 | 3.1 |
| Banks | 5.6 | 5.1 | 5.3 |
| Corporates | 29.4 | 35.4 | 34.3 |
| Amortization of short term debt | 47.3 | 45.5 | 44.4 |
| **Financing** | **90.6** | **95.0** | **94.6** |
| FDI | 5.9 | 7.5 | 8 |
| Equity | 1.0 | 2.0 | 2 |
| Borrowing | 74.8 | 59.0 | 60.0 |
| Government/central bank | 5.5 | 5.5 | 4.3 |
| Banks | 16.4 | 18.0 | 17.8 |
| Corporates | 53.0 | 35.5 | 37.9 |
| EU transfers | 10.7 | 31.0 | 29.6 |
| Other | -1.9 | -4.5 | -5.0 |

Source: CSOP, NBP, Ministry of Finance, IMF, Unicredit Research

# Romania (Baa3 stable / BBB- stable / BBB- stable)*

**Outlook** – This year's main themes in Romania are the anti-corruption campaign, political uncertainty, stalled reforms and sub-3% growth. The government plans to cut taxes, jeopardizing its fiscal goals, public investment and the IMF agreement, which could be abandoned as early as April. Economic growth, expected at 2.7% in 2015 and 2.5% in 2016, will be supported by consumption and exports. The banking sector reduced NPLs at the cost of large losses in 2014 and will continue to address impaired assets. RON lending is recovering, especially for households. We expect below-target inflation and a stable RON for most of 2015 and 2016.

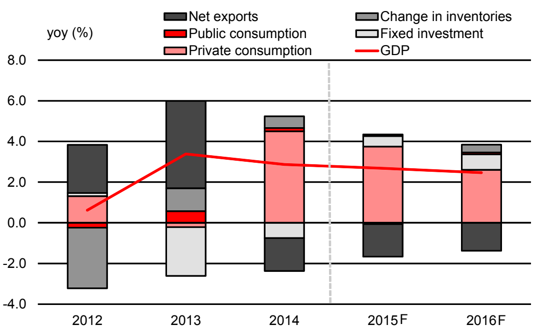
**Strategy** – Further easing by the NBR and low inflation will support local yields in the very short term. Longer term, we prefer the belly of the ROMGB curve in the run-up to Fed hikes. ROMANI USD 44 and EUR 24 bonds offer more value and better protection in case of market volatility than local currency bonds.

**Authors: Dan Bucşa, Economist (UniCredit Bank London)**

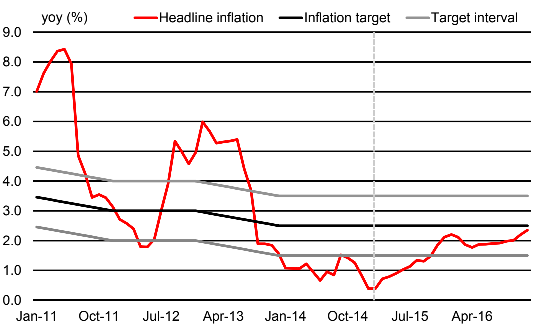
### KEY DATES/EVENTS

- 31 March, 6 May, 1 July: NBR rate decisions
- 13 May, 4 June: 1Q15 GDP (flash estimate, structure)
- April, June: final revues under the third IMF SBA

### GDP COMPONENTS




### INFLATION OUTLOOK




Source UniCredit Research, NBR, Statistical Office

### MACROECONOMIC DATA AND FORECASTS

| | 2012 | 2013 | 2014E | 2015F | 2016F |
|---|---|---|---|---|---|
| GDP (EUR bn) | 133.9 | 144.3 | 150.6 | 158.7 | 169.8 |
| Population (mn) | 20.1 | 20.0 | 19.9 | 19.9 | 19.8 |
| GDP per capita (EUR) | 6,663 | 7,207 | 7,553 | 7,980 | 8,564 |
| **Real economy yoy (%)** | | | | | |
| GDP | 0.6 | 3.4 | 2.9 | 2.7 | 2.5 |
| Private Consumption | 1.7 | -1.2 | 4.7 | 3.9 | 2.7 |
| Fixed Investment | 0.1 | -7.9 | -3.6 | 2.4 | 3.6 |
| Public Consumption | -5.6 | 13.6 | 3.7 | 1.7 | 2.0 |
| Exports | 1.0 | 16.2 | 8.1 | 5.3 | 5.8 |
| Imports | -1.8 | 4.2 | 7.7 | 5.6 | 5.6 |
| Monthly wage, nominal (EUR) | 479 | 507 | 531 | 557 | 587 |
| Unemployment rate (%) | 6.9 | 7.0 | 6.8 | 6.5 | 6.3 |
| **Fiscal accounts (% of GDP)** | | | | | |
| Budget balance | -3.0 | -2.2 | -2.2 | -1.8 | -1.7 |
| Primary balance | -1.2 | -0.5 | -0.7 | -0.3 | -0.3 |
| Public debt | 37.3 | 38.0 | 39.6 | 38.9 | 38.6 |
| **External accounts** | | | | | |
| Current account balance (EUR bn) | -6.1 | -1.2 | -0.7 | -0.2 | 0.0 |
| Current account balance/GDP (%) | -4.5 | -0.8 | -0.5 | -0.1 | 0.0 |
| Basic balance/GDP (%) | -2.7 | 1.2 | 1.2 | 1.6 | 1.8 |
| Net FDI (EUR bn) | 2.4 | 2.9 | 2.5 | 2.7 | 3.0 |
| Net FDI (% of GDP) | 1.8 | 2.0 | 1.6 | 1.7 | 1.8 |
| Gross foreign debt (EUR bn) | 100.9 | 98.1 | 94.3 | 88.4 | 87.9 |
| Gross foreign debt (% of GDP) | 75.3 | 68.0 | 62.6 | 55.7 | 51.8 |
| FX reserves (EUR bn) | 31.2 | 32.5 | 32.2 | 31.6 | 37.2 |
| **Inflation/Monetary/FX** | | | | | |
| CPI (pavg) | 3.3 | 4.0 | 1.1 | 1.1 | 2.0 |
| CPI (eop) | 5.0 | 1.6 | 0.8 | 2.1 | 2.4 |
| Central bank target | 3.0 | 2.5 | 2.5 | 2.5 | 2.5 |
| Central bank reference rate (eop) | 5.25 | 4.00 | 2.75 | 2.00 | 2.00 |
| 3M money market rate | 5.22 | 4.05 | 2.14 | 0.89 | 1.64 |
| USD/RON (eop) | 3.35 | 3.32 | 3.67 | 3.83 | 3.73 |
| EUR//RON (eop) | 4.43 | 4.48 | 4.48 | 4.40 | 4.40 |
| USD/RON (pavg) | 3.46 | 3.35 | 3.35 | 3.78 | 3.78 |
| EUR/RON (pavg) | 4.46 | 4.42 | 4.44 | 4.45 | 4.39 |

Source: Unicredit Research

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

## Anticorruption, procrastination and consumer optimism

**An unprecedented anticorruption campaign bodes well for the quality of Romanian politics…**

This year's main themes in Romania are the anti-corruption campaign, political uncertainty, stalled reforms and stable growth. For the past three years, the independence and efficiency of Romania's judicial system, especially of the National Anticorruption Directorate (DNA), improved amid a split in political power between the parliamentary majority and two presidents from the opposition. The European Commission's Mechanism for Cooperation and Verification provided another anchor. As a result, a former prime minister, half of the 40 county heads and dozens of former and current ministers and politicians went to jail or are under investigation. The shake-up of Romania's political landscape is not irreversible, but is impressive: the DNA charged 1,100 people last year with corruption, graft and related crimes.

**… but brings political uncertainty and stalled reforms in the short term**

While long-run results will be positive, the immediate effects of the anticorruption campaign are political uncertainty and the stalling of reforms. DNA prosecutions and 2014's presidential elections weakened party leaderships and political alliances. As a result, the current government could lose its majority before the general elections scheduled for autumn 2016.

**The IMF agreement remains suspended…**

**… and could end before its September deadline…**

**… reducing Romania's chances of maintaining access to IMF emergency funding**

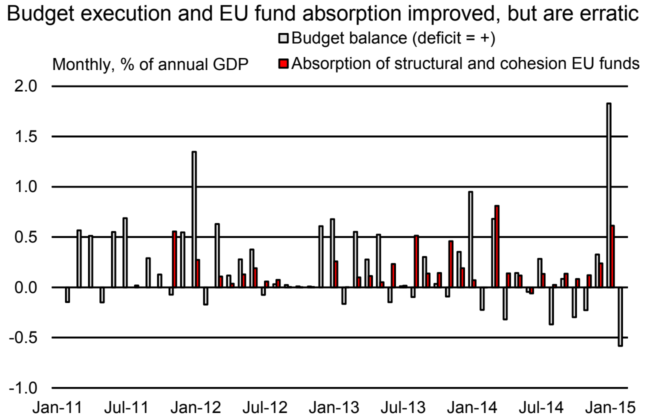
The prospect of elections (in 2016 or earlier) led to a populist political agenda and stalled structural reforms. In January 2015, the government failed to agree with the IMF on a calendar for gas price hikes and the liquidation of two loss-making energy producers. As a result, Romania's third consecutive stand-by agreement remains suspended[19]. The SBA could be abandoned after the April review amid plans for sizeable tax cuts, undermining Romania's access to emergency funding from the IMF via a precautionary and liquidity line after September 2015, when the third consecutive SBA should end. In addition, the country is facing the risk of losing the 10% top-up for EU fund co-financing from the EC.

**Planned tax changes threaten fiscal targets from 2016 on**

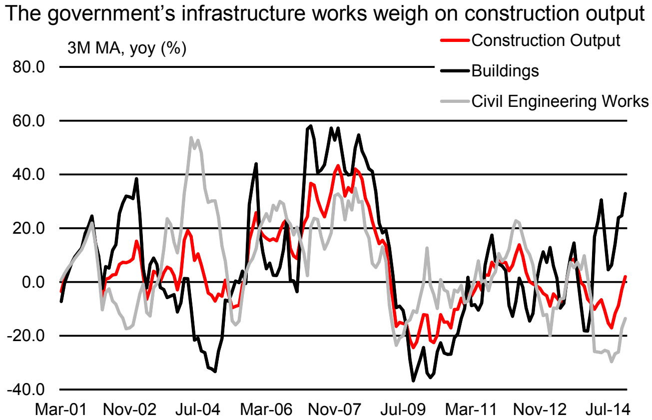
The planned changes to the Fiscal Code are threatening fiscal targets as long as tax compliance does not improve. Cuts in indirect and direct taxation would lead to large revenue shortfalls, the 2016 one being estimated by the government at 2.4% of GDP[20]. This gap contrasts with the authorities' commitment to fiscal consolidation that should reduce the budget deficit to 1.8% of GDP (cash) in 2015 and below 1.5% in 2016. The government failed to provide credible offsetting measures for the suggested tax cuts[21], raising the prospect of a clash with the IMF and the European Commission and the risk of ad-hoc tax hikes.

**DOMESTIC DEMAND SUPPORTED BY EU FUND INFLOWS, BUT PUBLIC INVESTMENT REMAINS A DRAG**

Budget execution and EU fund absorption improved, but are erratic




The government's infrastructure works weigh on construction output




Source: MinFin, Ministry for EU funds, NIS, UniCredit Research

[19] The SBA has been suspended since June 2014 due to disagreements on reducing social security contributions (SSC) and dealing with poor managements at state owned enterprises (SOE). The government managed to cut SSC and public expenditure, thus meeting the deficit target. SOE management remains an issue.
[20] The government could cut the main VAT rate from 24% to 20% already in 2015, if other budget revenues increase according to plan.
[21] The government assumes that 58% of the shortfall will be covered through higher revenues due to better economic growth and tax compliance. The first assumption is based on optimistic hypotheses regarding fiscal multipliers (approximately 0.9, according to the Fiscal Council). The second assumption has been proven wrong in the past, when VAT cuts for bakery products reduced tax avoidance from 70% to "just" 40-45%, according to the bakers' association Rompan.

**Growth expected above 2.5% yoy this year and next…**

**… driven by private consumption…**

**… and to a lesser extent by investment**

Economic growth is expected at 2.7% in 2015 and 2.5% in 2016, but could surprise on the upside amid a steady improvement in private consumption and a rebound in exports. Consumer confidence rebounded to a six-year high in 4Q14 due to a combination of real wage growth (expected flat at 4% yoy in 2015 amid low inflation) and stronger consumer lending in RON (short and medium-term loans rose by 18% yoy in 2014). Yet businesses are less optimistic, private investment lagging amid the ongoing deleveraging and persisting slack. Moreover, public investment, which fell by 4.0% yoy in 2014, could be crowded out again due to planned fiscal tightening. Three factors helping investment growth in 2015 are the low base, the gradual recovery of the construction market and good EU fund absorption. The latter could halve in 2016, as inflows from the 2004-2013 programming period will end this year.

**A small trade deficit for goods…**

**… will be offset by the services trade surplus…**

**… keeping the C/A deficit below 1% of GDP…**

**… and supporting the RON via a large extended basic balance**

Export growth in excess of 5% yoy in 2015 and 2016 are expected to cover higher imports. Demand from the EU could remain the main export driver, with sales of electronics and car parts registering the strongest growth rates. A slightly wider trade deficit with goods could be fully covered again by a larger service trade surplus, mostly due to transport services and IT. As a result, the 2015 C/A deficit could fall to 0.1% of GDP from 0.5% of GDP in 2014. Adding FDI and EU fund inflows and subtracting bank deleveraging, the net support to the RON exceeded 2.3% of GDP in 2014 and is expected to increase to more than 3% of GDP this year. With a low dependency on portfolio investment, EUR-RON could trade in the 4.40-4.50 range for most of 2015, with the NBR ready to cap excessive volatility.

**We expect another rate cut to 2.0% and several MRR cuts**

We expect the NBR to deliver another rate cut to 2.0% on 31 March and to reduce gradually minimum reserve requirements (MRR). FX MRR releases will fuel bank deleveraging without putting pressure on the RON. Cuts in RON MRR will keep market interest rates below the policy rate as long as depreciation pressures remain low. With inflation likely to stay below the 2.5% target throughout 2015, the NBR will continue to favour easy monetary conditions.

**Banks could sacrifice profits in order to reduce NPLs…**

**… postponing the consolidation of the banking sector**

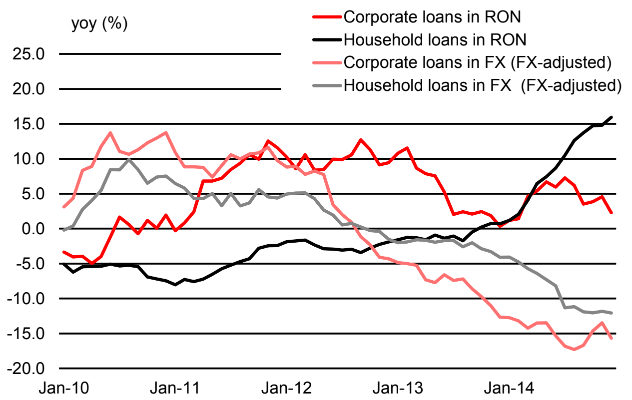
Banks are expected to deleverage further, despite the loan-to-deposit ratio falling to 91% in December 2014. This reflects the belated adjustment in the portfolio of impaired loans, with the NPL ratio falling by approximately 6pp to 13.9% in 2014. More impaired asset disposals and write-offs are on the cards in 2015. Therefore, banks are unlikely to post significant profits in 2015, after losing approximately EUR 1.0bn last year. This could postpone the consolidation of the fragmented banking sector, despite a long list of banks available for sale.

**Issuance should not put pressure on yields due to manageable funding needs**

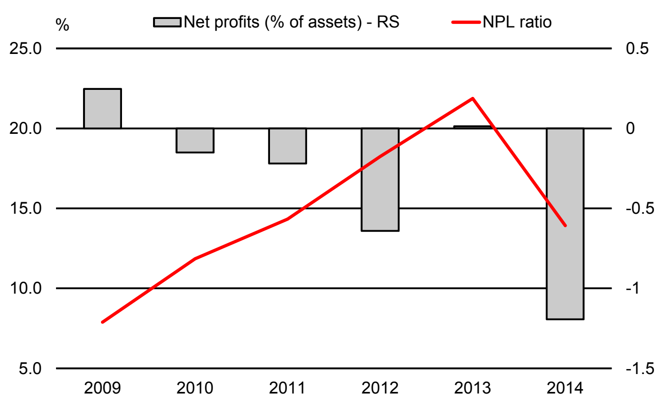
Issuance is unlikely to exert strong pressure on yields this year. 16.9% of 2015's gross financing needs (8.7% of GDP) were covered in the local market by 18 March. EUR issuance planned for 2H15 will target sub-2.5% yields at maturities of at least 10Y. The drawdown of fiscal buffers would cover 2/3 of this year's official net financing needs of 1.9% of GDP.

**THE ONGOING DELEVERAGING IN FX AND NPL MANAGEMENT AFFECT BANK RESULTS**

RON lending is recovering, deleveraging continues on FX debt




The reduction in NPLs caused large losses for the banking system




Source: NBR, UniCredit Research

## ROMANI bonds expected to outperform ROMGBs

**ECB QE, expected rate cuts and lower issuance likely to support ROMGBs in the short term…**

Although ROMGB yields could tighten slightly more in the very short term, they face increasing headwinds in the second half of 2Q15. The onset of ECB QE and likelihood that the NBR will cut rates further will support the market. In addition, issuance is set to be low in 2Q15, with recent bond auctions supported particularly in longer-dated bonds. The local curve remains structurally sound with foreign holdings stable at around 20%. Improving fiscal metrics and steady growth could increase the chances that some rating outlooks will be upgraded from 'Stable' to 'Positive' before the end of the year.

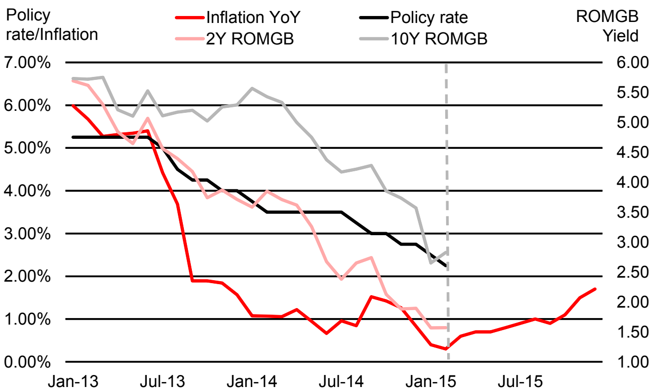
**In the second half of 2Q15, rising inflation and US yields pose risks to ROMGBs**

**We favour moving duration toward the belly on the local curve.…**

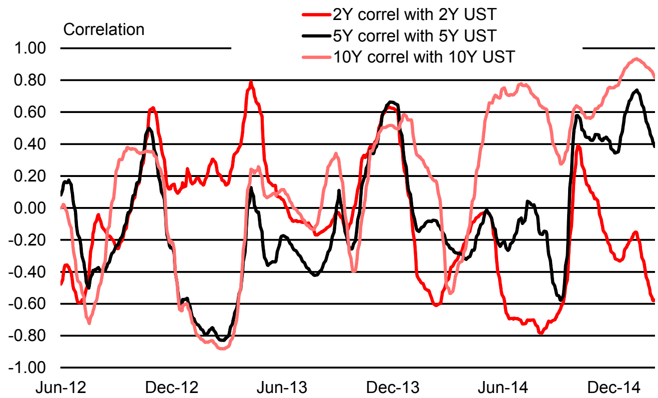
**…and favour ROMANI USD and EUR bonds**

In the second half of 2Q15, the outlook is more mixed. We expect inflation to pick up gradually, Bund yields to bottom out and rising US yields to become a greater driver of local bond yields. This will create significant risk for long-dated ROMGB due to the stronger correlation with US Treasuries than for shorter-dated bonds. We recommend staying overweight ROMGBs until the March rate decision, then moving duration toward the belly of the curve; we favour the ROMGB 20s. We think that USD denominated bonds are less risky and we like the ROMANI USD 44s which should gain support in the run-up to Fed hikes. We also see value in the ROMANI EUR 24s.

Forecast path of inflation and 2Y & 10Y ROMGB yields




Rolling 6M correlation of ROMGBs with US Treasury Yields




Source: NBR, MinFin, Bloomberg, UniCredit Research

### GOVERNMENT GROSS FINANCING REQUIREMENTS

| EUR bn | 2014E | 2015F | 2016F |
|---|---|---|---|
| **Gross financing requirement** | **12.7** | **13.1** | **13.3** |
| Budget deficit | 2.8 | 3.4 | 2.8 |
| Amortisation of public debt | 9.9 | 9.7 | 10.5 |
| Domestic | 8.9 | 7.0 | 9.0 |
| Bonds | 6.3 | 4.2 | 6.7 |
| Bills | 2.2 | 2.5 | 2.0 |
| Loans | 0.4 | 0.3 | 0.3 |
| External | 1.0 | 2.7 | 1.5 |
| Bonds and loans | 0.0 | 1.0 | 1.5 |
| IMF/EU/IFIs | 1.0 | 1.7 | 0.0 |
| **Financing** | **12.7** | **13.1** | **13.3** |
| Domestic borrowing | 9.7 | 8.9 | 10.8 |
| Bonds | 6.9 | 6.6 | 8.5 |
| Bills | 2.5 | 2.0 | 2.0 |
| Loans | 0.3 | 0.3 | 0.3 |
| External borrowing | 4.9 | 2.5 | 2.5 |
| Bonds | 4.3 | 2.0 | 2.5 |
| IMF/EU/WB | 0.6 | 0.5 | 0.0 |
| Fiscal reserves (reduction(+)) | -1.9 | 1.7 | 0.0 |

Source: NBR, MinFin, Unicredit Research

### GROSS EXTERNAL FINANCING REQUIREMENTS

| EUR bn | 2014E | 2015F | 2016F |
|---|---|---|---|
| **Gross financing requirement** | **37.9** | **34.7** | **29.0** |
| C/A deficit | 0.7 | 0.2 | 0.0 |
| Amortisation of medium to long term debt | 23.5 | 23.5 | 18.3 |
| Government/central bank | 9.8 | 10.8 | 6.6 |
| Banks | 7.1 | 6.4 | 5.7 |
| Corporates | 6.6 | 6.3 | 6.0 |
| Amortisation of short term debt | 11.3 | 9.9 | 9.2 |
| Government/central bank | 0.3 | 0.4 | 0.2 |
| Banks | 4.8 | 3.4 | 3.0 |
| Corporates | 6.2 | 6.1 | 6.0 |
| Other | 2.4 | 1.1 | 1.5 |
| **Financing** | **37.9** | **34.7** | **29.0** |
| FDI | 2.5 | 2.7 | 3.0 |
| Equity | 0.3 | 0.1 | 0.1 |
| Borrowing | 30.7 | 27.5 | 27.1 |
| Government/central bank | 9.8 | 7.4 | 7.8 |
| Banks | 9.0 | 8.4 | 7.9 |
| Corporates | 11.9 | 11.7 | 11.4 |
| EU Funds - capital transfers | 4.0 | 4.4 | 2.2 |
| Change in FX reserves (reduction(+)/increase(-)) | 0.4 | 0.0 | -3.4 |

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

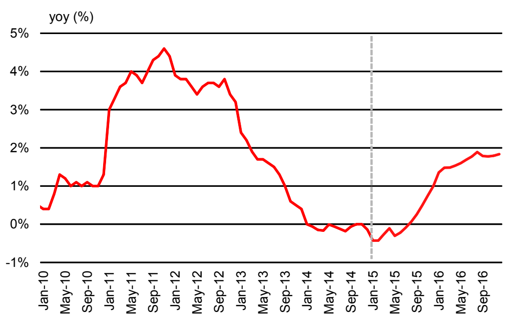
**Outlook** – We expect GDP growth at 2.9% in 2015 and 3.2% in 2016 due to external factors such as low oil prices, a weak euro and ECB QE. Domestic factors such as improving consumer confidence, fiscal spending due to approaching general elections and positive expectations in industry will also contribute to growth. We expect the foreign trade surplus to shrink from 6.2% to 5.6% GDP in 2015 resulting in an almost balanced C/A. Improving labor market conditions and fast wage growth will be key drivers of household consumption in 2015 and 2016. Inflation is expected to remain subdued due to supply shocks (oil, food). The fiscal stance will remain neutral in pre-election year 2015. The Social Democrats are favorites to win elections in spring 2016 amid a fragmented right-wing opposition.

**Author: Ľubomír Koršňák, Analyst (UniCredit Bank Czech Republic and Slovakia)**

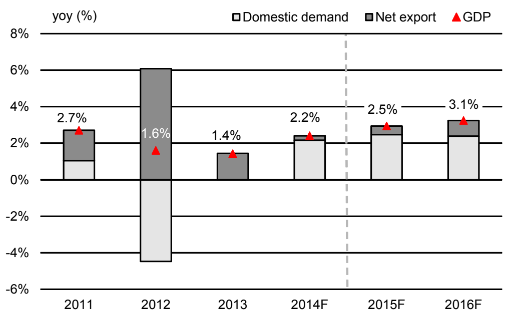
## KEY DATES/EVENTS

- 10 Apr, 12 May, 10 Jun – Industrial production
- 14 Apr, 13 May, 12 Jun – CPI
- 13 May – flash GDP
- 5 Jun – GDP structure

## INFLATION TO REMAIN SUBDUED




## GDP DRIVEN BY RECOVERING DOMESTIC DEMAND




Source: Statistical Office SR, UniCredit Research

## MACROECONOMIC DATA AND FORECASTS

| | 2012 | 2013 | 2014E | 2015F | 2016F |
|---|---|---|---|---|---|
| GDP (EUR bn) | 72.2 | 73.6 | 75.2 | 77.4 | 80.3 |
| Population (mn) | 5.4 | 5.4 | 5.4 | 5.4 | 5.4 |
| GDP per capita (EUR) | 13 349 | 13 594 | 13 894 | 14 298 | 14 840 |
| **Real economy yoy (%)** | | | | | |
| GDP | 1.6 | 1.4 | 2.4 | 2.9 | 3.2 |
| Private Consumption | -0.5 | -0.8 | 2.2 | 2.8 | 2.5 |
| Fixed Investment | -9.3 | -2.7 | 5.7 | 3.9 | 3.8 |
| Public Consumption | -2.0 | 2.4 | 4.4 | 1.9 | 1.3 |
| Exports | 9.3 | 5.2 | 4.6 | 5.9 | 5.9 |
| Imports | 2.6 | 3.8 | 5.0 | 5.8 | 5.5 |
| Monthly wage, nominal (EUR) | 805 | 824 | 858 | 877 | 903 |
| Unemployment rate (%) | 14.0 | 14.2 | 13.2 | 12.1 | 11.2 |
| **Fiscal accounts (% of GDP)** | | | | | |
| Budget balance | -4.2 | -2.6 | -2.9 | -2.5 | -1.5 |
| Primary balance | -2.7 | -0.8 | -1.3 | -0.9 | 0.1 |
| Public debt | 52.1 | 54.6 | 54.0 | 54.8 | 54.3 |
| **External accounts** | | | | | |
| Current account balance (EUR bn) | 0.7 | 1.1 | 0.1 | 0.0 | 0.2 |
| Current account balance/GDP (%) | 0.9 | 1.4 | 0.2 | 0.1 | 0.2 |
| Basic balance/GDP (%) | 2.8 | 2.8 | 1.0 | 0.9 | 1.0 |
| Net FDI (EUR bn) | 2.3 | 0.4 | 0.5 | 1.2 | 1.5 |
| Net FDI (% of GDP) | 3.2 | 0.6 | 0.7 | 1.5 | 1.9 |
| Gross foreign debt (EUR bn) | 53.8 | 59.7 | 68.9 | 72.7 | 76.1 |
| Gross foreign debt (% of GDP) | 74.5 | 81.1 | 91.5 | 94.0 | 94.7 |
| **Inflation/Monetary/FX** | | | | | |
| CPI (pavg) | 3.6 | 1.4 | -0.1 | 0.1 | 1.7 |
| CPI (eop) | 3.2 | 0.4 | -0.1 | 1.0 | 1.8 |
| Central bank reference rate (eop) | EUR | EUR | EUR | EUR | EUR |
| 3M money market rate | EUR | EUR | EUR | EUR | EUR |
| EUR/USD (eop) | EUR | EUR | EUR | EUR | EUR |
| EUR/EUR (pavg) | EUR | EUR | EUR | EUR | EUR |

Source: Unicredit Research

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

## Economy boosted by growing domestic demand

**Economic growth is expected to accelerate to 2.9% in 2015 and 3.2% in 2016, driven by domestic demand…**

**… and a gradual rebound in exports**

We revised upward our GDP forecasts to 2.9% from 2.5% for 2015 and we expect further acceleration to 3.2% in 2016. Risks to our 2015 outlook are skewed to the upside due to external factors such as low oil prices, a weak euro and ECB QE. Domestic factors will also contribute to growth, the most important being improving consumer confidence, fiscal spending in the run-up to general elections and optimism among industrial producers. In addition, the carry-over from 4Q14 was higher than expected. GDP growth positively surprised in 4Q14 at 0.6% qoq sa / 2.4% yoy, being driven mainly by domestic demand. A key contributor was the strongly rebounding household consumption, supported by improving labor market, dynamic wage growth, zero inflation, low interest rates and improving consumer confidence. Investment improved as well, driven mostly by public investments in the run-up to local elections. On the other side, export performance was affected by falling demand for cars amid decreasing Russian demand and the end of production for several models. The introduction of new models and increasing European demand could support car manufacturing in the coming months. Thus, export growth is expected to complement domestic demand as a growth driver. The biggest risks to economic growth stem from tensions between the EU and Russia and from Greece's financial woes.

**The C/A balance benefited from falling energy imports.**

We expect the foreign trade surplus to shrink from 6.2% to 5.6% GDP in 2015 resulting in an almost balanced C/A. In 2014, the foreign trade surplus improved mainly due to declining gas imports in the last few months, while exports stagnated. Once gas imports will normalize, imports are expected to increase again, driven by increasing domestic demand.

**Labor market to support household spending**

Improving labor market conditions and fast wage growth will be key drivers of household consumption in 2015 and 2016. Before 2008, GDP growth had to exceed 3% yoy in order to reduce unemployment, but growth was slower in recent years. Faster economy growth should help reduce the unemployment rate below 10% in 3-4 years. Wage growth is expected to slow from 4.4% in 2014 to 2.2% in 2015, shaped by two opposite trends: zero inflation will constrain nominal wage growth in the private sector, while approaching elections will boost wages in the public sector.

**Supply-driven deflation to continue**

Average inflation was -0.1% yoy in 2014 due to a decline in regulated energy and food prices, lower fuel prices and free railways tickets for students and pensioners at the end of the year. The zero-inflation environment is expected to continue in 2015 with supply factors (oil prices, regulated gas prices, etc.) keeping inflation subdued. Inflation could turn positive only at the end of the year, when oil price shocks will exit the base. At the same time, we expect a moderate rebound in demand-pull inflation, although the recovery of core inflation will be slowed down by second-round effects from low energy prices.

**Fiscal consolidation stopped by approaching elections**

The cash balance of the state budget suggests that the government was able to cap the budget deficit below 3% of GDP in 2014. Nevertheless, fiscal consolidation took a break last year as the general government deficit went up from 2.3% of GDP in 2013. Despite that, public debt is expected to remain below the debt brake threshold of 55% of GDP, allowing the government to set fiscal policy freely. The 2015 budget deficit is expected at 2.5% of GDP, without big fiscal changes expected in this pre-election year. That said, if budget revenues surprise on the upside, spending will increase accordingly due to the election campaign. After the elections, the new government will enjoy a two year break from the debt break, although the risk of exceeding the 55% of GDP threshold is low. The public financing needs for 2015 are projected at EUR 5.1bn, the debt management agency already covering 38% of the amount.

**Social Democrats could win elections due to fragmented right-wing opposition**

General elections are scheduled for the spring 2016. Polls suggest that the ruling Social Democrats will win elections, while the right-wing opposition is fragmented with several parties just on the edge of the 5% minimum threshold needed to enter Parliament.

# Slovenia (Baa3 stable/A- stable/BBB+ stable)*

**Outlook –** The Slovenian economy is expected to slow down to 2.1% this year, driven by weaker infrastructure investments and contracting government consumption. Export growth will remain strong due to lower oil prices and a more vigorous recovery in the euro area, and will keep the C/A surplus in excess of 6% of GDP throughout the forecast horizon. Banking sector NPLs have been reduced following the transfers to the bad bank (BAMC), but these remain large and a drag on a resumption of credit activity. On a positive note, we expect public debt to decline from 2016 on, supported by contracting budget deficits, but a speedier and enlarged privatization program is still required to anchor credibility.

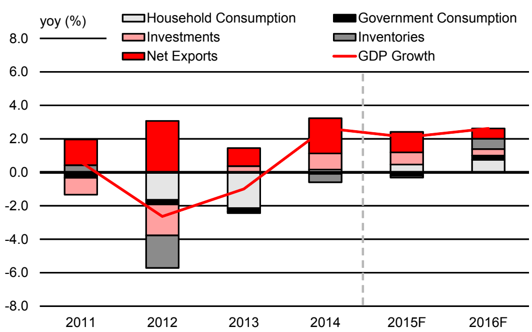
**Strategy –** Low inflation, reduced borrowing and chance of a rating upgrade should see Slovenian bonds continue to be well supported over 2Q15. ECB QE will likely be the key driver of lower yields and, as the spread on the local curve declines, we favor being long SLOVEN USD 23s and a flattener position in SLOVEN USD 24s against SLOVEN USD 18s.

**Author: Carlos Ortiz, Economist (UniCredit Bank London)**

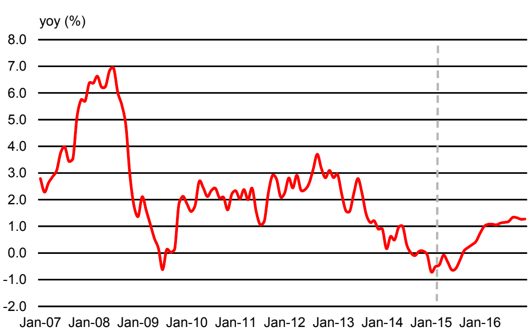
**KEY DATES/EVENTS**

- 31 Mar, 30 Apr, 29 May – Consumer Price Index
- 23 Mar, 10 Apr, 8 May – Industrial output
- 31 Mar, 29 Apr, 29 May – Retail sales
- 29 May – 1Q15 (P) GDP

**GDP GROWTH TO SLOW DOWN IN 2015**




**INFLATION TO REMAIN SUBDUED IN 2015**




Source: NBS, MinFin, Unicredit Research

**MACROECONOMIC DATA AND FORECASTS**

| | 2012 | 2013 | 2014E | 2015F | 2016F |
|---|---|---|---|---|---|
| GDP (EUR bn) | 36.0 | 36.1 | 37.2 | 38.2 | 39.4 |
| Population (mn) | 2.1 | 2.1 | 2.1 | 2.1 | 2.1 |
| GDP per capita (EUR) | 17,506 | 17,550 | 18,071 | 18,494 | 19,101 |
| **Real economy yoy (%)** | | | | | |
| GDP | -2.6 | -1.0 | 2.6 | 2.1 | 2.6 |
| Private Consumption | -2.9 | -4.0 | 0.3 | 0.9 | 1.5 |
| Fixed Investment | -8.9 | 1.9 | 4.8 | 3.5 | 1.9 |
| Public Consumption | -1.5 | -1.1 | -0.5 | -1.1 | 1.4 |
| Exports | 0.3 | 2.6 | 6.3 | 5.8 | 5.6 |
| Imports | -3.9 | 1.4 | 4.1 | 4.9 | 5.6 |
| Monthly wage, nominal (EUR) | 1,526 | 1,523 | 1,540 | 1,556 | 1,584 |
| Unemployment rate (%) | 8.9 | 10.1 | 9.8 | 9.4 | 8.9 |
| **Fiscal accounts (% of GDP)** | | | | | |
| Budget balance | -3.7 | -14.5 | -5.4 | -3.2 | -2.9 |
| Primary balance | -1.7 | -12.0 | -2.1 | 0.0 | 0.6 |
| Public debt | 53.4 | 70.4 | 79.5 | 83.6 | 82.1 |
| **External accounts** | | | | | |
| Current account balance (EUR bn) | 1.0 | 2.0 | 2.2 | 2.4 | 2.5 |
| Current account balance/GDP (%) | 2.7 | 5.6 | 5.9 | 6.2 | 6.4 |
| Basic balance/GDP (%) | 3.9 | 5.8 | 8.9 | 9.9 | 9.7 |
| Net FDI (EUR bn) | 0.5 | 0.1 | 1.1 | 1.4 | 1.3 |
| Net FDI (% of GDP) | 1.3 | 0.2 | 3.0 | 3.7 | 3.3 |
| Gross foreign debt (EUR bn) | 41.5 | 40.2 | 44.4 | 45.9 | 46.9 |
| Gross foreign debt (% of GDP) | 115.3 | 111.2 | 119.2 | 120.3 | 118.9 |
| **Inflation/Monetary/FX** | | | | | |
| CPI (pavg) | 2.8 | 1.9 | 0 | -0.2 | 1.1 |
| CPI (eop) | 3.1 | 1.1 | -0.1 | 0.4 | 1.3 |
| 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

## A gradual recovery ahead

**The economy expanded by 2.6% yoy in 2014, driven by investments and net exports….**

**The Slovenian economy recovered strongly in 2014, supported by infrastructure investments and strong export growth**. In line with our expectations, 4Q14 GDP decelerated to 2.4% yoy, down from 3.2% yoy in 3Q14. The slowdown was entirely attributed to domestic demand (-1.7% yoy), which contracted for the first time since 3Q13. Component-wise, gross capital formation saw the biggest retrenchment (-7% yoy), due to declining fixed investments (-0.9% yoy) and inventories (-1.2% yoy). Nevertheless, fixed investment in 2014 saw the strongest performance since 2008 (+4.8% yoy), thanks in part to the exceptionally high level of infrastructure projects co-funded by the EU. Final consumption in 4Q14 also disappointed (-0.3% yoy), driven by declining household consumption (-0.8% yoy), which was also reflected in weak retail sales (-1.1% yoy in 4Q14). On a more positive note, net exports accelerated strongly (+4% yoy), owing to a combination of booming exports (+8.4% yoy) and lower imports (+3.3% yoy). This stronger impulse helped the economy grow by 2.6% yoy in 2014 (vs. forecast of 2.5% yoy), the strongest performance since pre-crisis years.

**…but is expected to slow down in 2015 due to decelerating domestic demand**

**Exports will strengthen due to stronger EMU demand …**

**...and lift Slovenia's CA surplus above 6% of GDP**

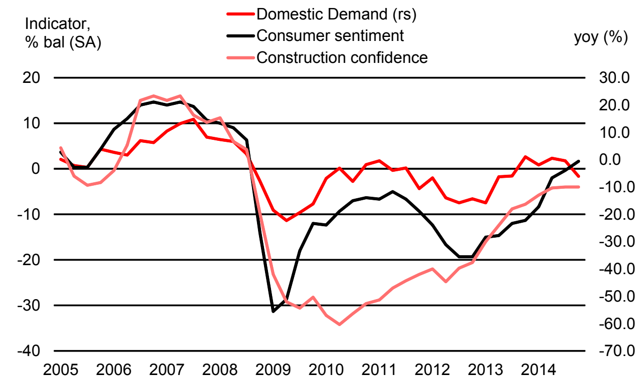
**We expect the economy to grow by 2.1% yoy in 2015 and by 2.6% yoy in 2016**. The slowdown this year is mainly attributed to weakened domestic demand (+0.5% yoy), which will be dragged down by decelerating infrastructure investments co-financed by the EU and shrinking public consumption (-1.1% yoy). The fall in inventories will add further to the slowdown, but should be partially offset by the recovery in private sector investments as hinted at by high capacity utilization levels and rising profitability. On a more positive note, private consumption is expected to recover (2015F: +0.9% yoy), helped by lower oil prices, improving consumer confidence indicators and higher real wages. Households' exposure to CHF-denominated loans also remains small (EUR 0.8bn or 3.4% of total loans at end-2014), limiting its negative spillover on household consumption. Export growth will remain strong over the forecast horizon due to a more vigorous recovery in the euro area and Germany, but the contribution from net exports will weaken as domestic demand gathers pace. Even so, this will not prevent the current account from remaining in surplus and from reaching 6.4% of GDP by end-2016.

**Inflation is at historical lows and is expected to remain below the euro area average until 2016**

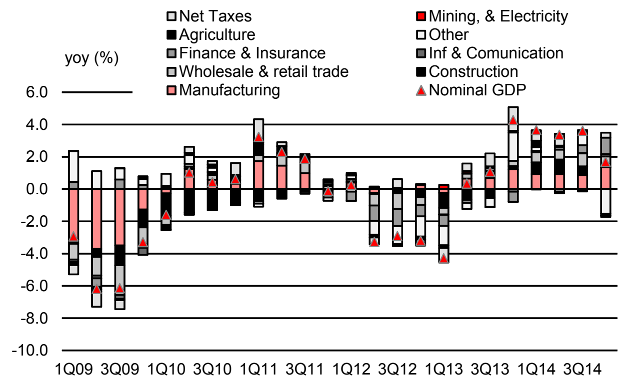
**Lower oil and food prices will keep inflation negative until 2H15.** In February, HICP inflation contracted by 0.5% yoy constituting the third consecutive month inflation remains in negative territory. Lower food (-0.3% yoy) and transport (-4.9% yoy) inflation were mainly to blame, the latter driven by lower fuel prices (-11.2% yoy). Looking ahead, we expect inflation to flatten only by August, and accelerate mildly to 0.4% yoy by year-end. In 2016, the recovery in domestic demand and slow rise in oil prices should feed into inflation (2016F avg. at 1.1%), although still remaining lower than in the euro area average (1.3% yoy).

**GROWTH IN 2015 TO BE SUPPORTED BY PRIVATE CONSUMPTION AND INVESTMENTS**

Consumer indicators have improved significantly in 2014…




…supporting the recovery of manufacturing and construction activity




Source: MinFin, Haver, UniCredit Research

**Weak lending activity and low interest rates are constraining domestic banks' profitability and capitalization levels**

**The outlook for the banking sector has improved, but profitability and capitalization levels remain weak**. At end-October, the banking system recorded a net loss of EUR 10mn (vs. EUR -3.5bn in 2013), due mainly to the contraction in lending activity and low interest rates. Of Slovenia's three largest domestic banks, only Abanka suffered losses (EUR 0.2bn), while NKBM and NLB had net profits of EUR 35.9mn and EUR 62.3mn, respectively (vs. a total loss of EUR 2bn in 2013). This means no additional state recapitalizations will follow for both banks, since profits are ample enough to cover their potential capital shortfalls, estimated by the ECB to total EUR 65mn. Capitalization levels of the banking system improved but remain weak (CT1 ratio at 15.9%), particularly among smaller domestic banks (CAR at 10.7%).

**Non-performing loans have been scaled down, but are still well above pre-crisis levels**

**Non-performing loans remain high, hampering credit growth.** System-wide NPLs reached 13.2% of total loans at end-October (vs. 13.4% in 2013), even after including the gross transfers to the BAMC (ca. EUR 5bn). Current NPLs are three to four times higher than during pre-crisis years, and concentrated in the corporate sector (22.1% of total). For large firms, NPLs are highly concentrated, with 50 companies accounting for a third of total NPLs, but only a third of these have been transferred to the BAMC. In our view, a larger portion of these should be transferred to the BAMC, even at the cost of higher public debt since these risk hampering banks' profitability and credit growth further (down 7% yoy in 2014).

**We expect the budget deficit to meet the EDP target of 3% of GDP only in 2016….**

**…which should help reduce public debt to 82% of GDP**

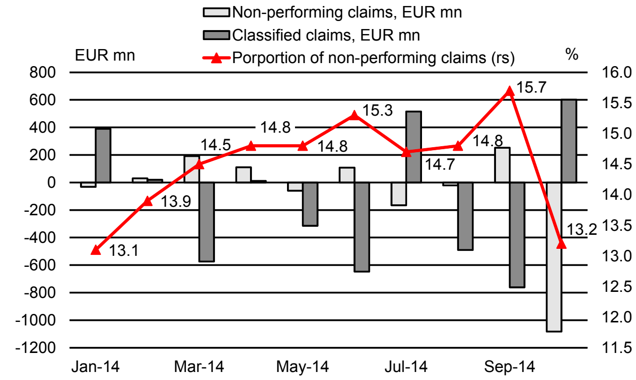
**The 2015 supplementary budget is welcome but falls short of structural reforms**. On 23 February, Parliament approved the supplementary budget for 2015, targeting a budget deficit under ESA 2010 methodology of 2.9% of GDP (from 5.3% of GDP in 2014). The adjustment in 2015 is targeted mainly through expenditure savings, namely subsidy reforms and the prolongation of measures to reduce the public sector wage bill. On the revenue front, measures include a number of excise taxes and procedures to enhance revenue collection, but in our view their revenue enhancing potential is overstated, and far insufficient to offset the scrapped real estate tax. Keeping this in mind, and a stronger interest bill, we forecast the deficit this year at 3.2% of GDP and at 2.9% in 2016 thanks in part to the reduction in fixed investments caused by the end of the drawdown period from the 2007-13 EU programs. Public debt will peak at 83.6% in 2015, before declining to 82% of GDP in 2016.

**The government needs to speed up and enlarge the privatization process to anchor credibility**

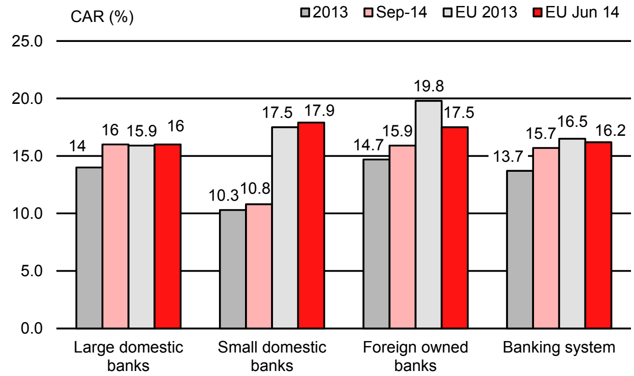
**The privatization process has slowed down, but is unlikely to be overturned.** The planned sale of Telekom Slovenia and NKBM in 1Q15 has been delayed due to investors' concerns over the liabilities that could arise from a number of lawsuits facing both companies. While the outcome of both court cases is highly uncertain, we doubt that this new obstacle will deter the sale of both companies since the process is already at an advanced stage and potential liabilities can always be discounted in the bidding rounds. Be that as it may, the delay does not help boost credibility in the process, creating the need for authorities to adopt a more ambitious and comprehensive management strategy for SOEs in the coming months.

**THE BANKING SECTOR HAS IMPROVED, BUT HIGH NPLS REMAIN A DRAG ON CREDIT AND CAPITAL**

NPLs have been scaled down, but remain at high levels…




…constraining credit and banks' ability to generate internal capital




Source: NBS, UniCredit Research

## Strategy: ECB to support further yield tightening

**Positive environment for Slovenian bonds due to….**

**…low inflation and reduced borrowing.**

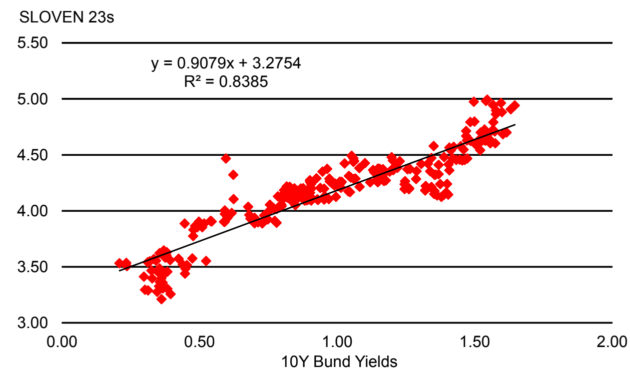
The backdrop looks positive for Slovenia bonds. Inflation remains negative, and consumer prices face downward pressure from slow domestic demand and low oil prices. The burden on bond yields from borrowing in 2015 is small due to significant pre-financing in 2014. Moody's upgraded Slovenia on 26 January which narrowed the gap between the rating agencies ratings and highlighted the stabilizing banking sector which we view as bond positive.

**Main driver of tighter yields will be ECB QE**

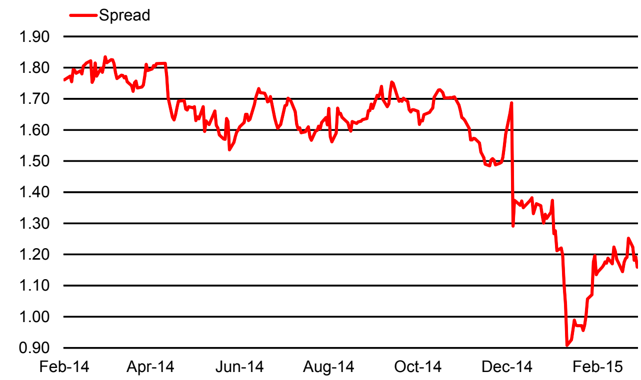
**We favor SLOVEN USD 23s and a SLOVEN USD 24s vs. 18s flattener**

ECB QE should drive further yield tightening. The ECB will purchase approx. EUR 296mn of Slovenia bonds each month based on the capital key. Given the size of the bond market, we estimate that the ECB will own 25% of all issues in 12 months, driving yields in the local and hard currency bonds tighter. Among local bonds, we think the SLOREP 26s are the most attractive. We prefer USD-denominated bonds and think yields of the SLOVEN USD 23s should tighten further. We also favor a flattening trade long SLOVEN USD 24s vs short SLOVEN USD 18s, which we think can tighten 25bp as the change spread between the USD and domestic curve due to ECB QE should see the USD continue to tighten.

SLOVEN USD 23s yield likely tightens as Bund yields decline




Spread between SLOVEN USD 24s vs. 18s should narrow




Source: Bloomberg, UniCredit Research

**GOVERNMENT GROSS FINANCING REQUIREMENTS**

| EUR bn | 2014 | 2015F | 2016F |
|---|---|---|---|
| **Gross financing requirement** | **5.8** | **3.3** | **5.0** |
| Budget deficit | 2.0 | 1.2 | 1.1 |
| Amortization of public debt | 3.8 | 2.1 | 3.9 |
| Domestic | 3.8 | 2.1 | 2.4 |
| Bonds | 1.9 | 1.1 | 1.3 |
| Bills | 1.9 | 1.0 | 1.1 |
| External | 0 | 0 | 1.5 |
| IMF | 0 | 0 | 0 |
| **Financing** | **5.8** | **3.3** | **5.0** |
| Domestic borrowing | 4.6 | 2.8 | 3.5 |
| Bonds | 3.0 | 1.5 | 2.0 |
| Bills | 1.6 | 1.3 | 1.5 |
| External borrowing | 2.7 | 1.5 | 1.0 |
| Bonds | 2.7 | 1.5 | 1.0 |
| IMF/EU | 0 | 0 | 0 |
| Other | 0 | 0 | 0 |
| Change in cash reserves (+ = decline) | -1.5 | -1.0 | 0.5 |

**GROSS EXTERNAL FINANCING REQUIREMENTS**

| EUR bn | 2014 | 2015F | 2016F |
|---|---|---|---|
| **Gross financing requirement** | **7.1** | **5.2** | **5.8** |
| C/A deficit | -2.2 | -2.4 | -2.5 |
| Amortization of medium to long-term debt | 3.1 | 2.7 | 3.6 |
| Government | 0 | 0 | 1.5 |
| Central Bank | 0 | 0 | 0 |
| Banks | 1.3 | 1.2 | 0.9 |
| Corporates | 1.7 | 1.5 | 1.2 |
| Amortization of short-term debt | 6.2 | 4.8 | 4.7 |
| Government | 0 | 0.2 | 0.1 |
| Central Bank | 1.1 | 0 | 0 |
| Banks | 0.8 | 0.7 | 0.4 |
| Corporates | 4.3 | 3.9 | 4.2 |
| **Financing** | **7.1** | **5.2** | **5.8** |
| FDI | 1.1 | 0 | 0 |
| Medium to long-term borrowing | 3.3 | 2.6 | 1.8 |
| Government | 2.7 | 1.5 | 1.0 |
| Central Bank | 0 | 0 | 0 |
| Banks | 0.3 | 0.5 | 0.4 |
| Corporates | 0.3 | 0.6 | 0.5 |
| Short-term borrowing | 1.7 | 1.7 | 3.0 |
| Government | 0 | 0 | 0 |
| Central Bank | 1.1 | 0 | 0 |
| Banks | 0.2 | 0.4 | 0.4 |
| Corporates | 0.4 | 1.3 | 2.6 |
| EU Funds | 1.0 | 0.9 | 1.0 |

Source: MinFin, UniCredit Research

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

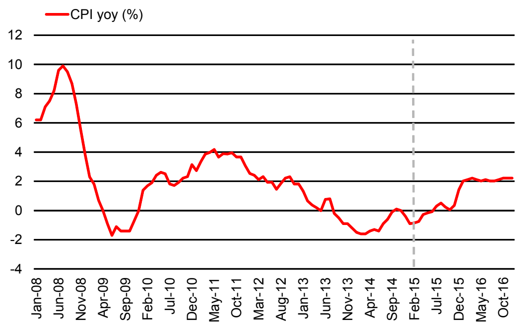
**Outlook** – A gradual recovery of economic activity started in Q3 and continued during 4Q, but its pace is still relatively weak. Industrial production and exports of goods are losing momentum, whereas construction activity is reviving on the back of initiated reconstruction of damaged/destroyed property in catastrophic spring floods. Based on available information, we keep our view of no GDP growth in 2014, as well as our forecast of 2% GDP growth in 2015. General elections for members of the assembly of both entities and all cantons of the Federation took place in October, but the composition of the executive bodies at all levels is still not finished. Recent agreement on composition of Federation BH government pave the way for composition of the state government and adoption of the Federation budget, mitigating risks that country could be left without financing. It impacts reforms envisaged by SBA and therefore the IMF has put on hold its 8th review and disbursement of pending tranches of the program.

**Author: Hrvoje Dolenec, Chief Economist (Zagrebačka banka)**

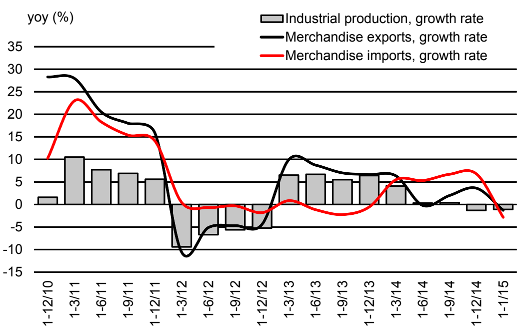
### KEY DATES/EVENTS

- 20 Apr: CPI March 2015
- 20 Apr: Foreign trade March 2015
- 25 Apr: Industrial production February 2015
- 11 May: Balance of payments FY14

### DEFLATION PERIOD LEFT BEHIND




### MERCHANDISE EXPORTS: DEFICIT TO WIDEN AGAIN




Source: IMF, Ministry of Finance, Eurostat, UniCredit Research

### MACROECONOMIC DATA AND FORECASTS

| | 2012 | 2013 | 2014E | 2015F | 2016F |
|---|---|---|---|---|---|
| GDP (EUR bn) | 13.2 | 13.4 | 13.3 | 13.6 | 14.4 |
| Population (mn) | 3.8 | 3.8 | 3.8 | 3.8 | 3.8 |
| GDP per capita (EUR) | 3,430 | 3,507 | 3,478 | 3,550 | 3,755 |
| **Real economy yoy (%)** | | | | | |
| GDP | -1.2 | 2.1 | 0.0 | 2.0 | 3.5 |
| Monthly wage, nominal (EUR) | 660 | 661 | 659 | 665 | 686 |
| Unemployment rate (%) | 44.1 | 44.6 | 43.9 | 43.6 | 43.1 |
| **Fiscal accounts (% of GDP)** | | | | | |
| Budget balance | -1.9 | -2.3 | -4.0 | -3.3 | -2.1 |
| Primary balance | -1.2 | -1.4 | -3.0 | -2.4 | -1.1 |
| Public debt | 39.7 | 42.5 | 45.3 | 44.6 | 42.8 |
| **External accounts** | | | | | |
| Current account balance (EUR bn) | -1.2 | -0.8 | -1.1 | -1.2 | -1.2 |
| Current account balance/GDP (%) | -9.2 | -5.9 | -8.1 | -8.6 | -8.2 |
| Basic balance/GDP (%) | -7.3 | -4.3 | -4.6 | -4.4 | -3.9 |
| Net FDI (EUR bn) | 0.3 | 0.2 | 0.5 | 0.6 | 0.6 |
| Net FDI (% of GDP) | 2.0 | 1.7 | 3.5 | 4.1 | 4.3 |
| Gross foreign debt (EUR bn) | 6.9 | 7.0 | 7.4 | 7.7 | 8.1 |
| Gross foreign debt (% of GDP) | 52.3 | 51.9 | 55.3 | 56.5 | 56.1 |
| FX reserves (EUR bn) | 3.3 | 3.6 | 4.0 | 4.1 | 4.1 |
| **Inflation/Monetary/FX** | | | | | |
| CPI (pavg) | 2.1 | -0.1 | -0.9 | 0.0 | 2.1 |
| CPI (eop) | 1.8 | -1.2 | -0.4 | 1.4 | 2.2 |
| 1M money market rate | 0.33 | 0.12 | 0.15 | 0.15 | 0.50 |
| USD/ BAM (eop) | 1.48 | 1.42 | 1.61 | 1.81 | 1.69 |
| EUR/BAM (eop) | 1.96 | 1.96 | 1.96 | 1.96 | 1.96 |
| USD/ BAM (pavg) | 1.52 | 1.47 | 1.47 | 1.78 | 1.75 |
| 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

## Recovery initiated after floods to continue, but at slow pace

**GDP rose by 0.6% in 3Q yoy, pushing growth into positive territory**

**A gradual recovery of economic activity began after 2Q but growth remains weak.** GDP data are only available up to 3Q14 and confirm that a recovery of economic activity following the catastrophic floods and landslides in May began during 3Q. According to seasonally adjusted data, the decreasing trend of GDP recorded in the first two quarters of the year at the rate of -0.1% and -0.2% qoq, respectively, has turned to growth of 0.1% qoq in 3Q. Annual growth in 3Q (preliminary) was at 0.6%, coming after the (revised) decline in 2Q of 0.5%. Transportation and storage, financial activities, trade and manufacturing saw the largest increase in GVA in 3Q, whereas a decline was recorded in agriculture and forestry, electricity production, construction and mining. Available monthly data indicate that construction activity has revived in 4Q (+4.4% yoy), both in building construction and civil engineering works, while industrial production declined again in 4Q by 0.5% yoy. Such a slow pace of recovery led us to keep our previous forecasts of zero GDP growth in 2014. The cumulative growth of industrial production in 2014 was merely 0.2%, with the energy sector, having significant weight, recording a decline of 6.9%. The construction sector achieved cumulative growth of 6.2% in 2014, on the back of construction of the Corridor Vc motorway and initiated reconstruction of damaged/destroyed property in May's natural disaster – cost and damages are estimated to be 15% of GDP. However, we expect GDP growth of at least 2% in 2015, although the current slow pace of recovery and delays in the formation of a new government on Federation BH and state level do not seem encouraging, harming the reform impetus. A slightly more favorable outlook for the main trading partners and an expected acceleration of reconstruction should help growth to speed up in 2015.

**Growth to accelerate in 2015, but remains exposed to the risk of slow reform implementation**

**Foreign trade deficit rose by 10.7% in 2014 due to the slowdown in exports and continued significant import growth – resulting in widening gap in current account**

**The gap in foreign trade continues to grow.** Although merchandise exports in the fourth quarter accelerated (by 8.5% yoy) and imports generally kept their growth pace from the beginning of the year (by 7% yoy), 2014 saw a considerable widening of the foreign trade gap to more than EUR 3.8bn (by 10.7%). Exports of goods reached EUR 4.4 bn in 2014, increasing by 3.6% yoy, while imports reached EUR 8.3bn, rising 6.8% yoy. C/A deficit for the first nine months in 2014 was 50% higher than in 2013, mainly due to a much higher merchandise deficit, although decreasing services surplus also made a contribution. Therefore, we see a further widening of the C/A gap in 2015. Consumer prices in 2014 recorded a negative trend for the second consecutive year. Year-end saw a -0.4% decline in consumer prices and -0.9% for the year on average, primarily due to the decline in food and clothing prices, which is partly attributable to low households' disposable income in an environment of high unemployment. However, 2014 saw a slight decrease in registered unemployment (by -1.2%), but at year-end there was were more than 547 thousand persons unemployed or 43.6%, according to administrative data (27.5% is the last figure according to ILO methodology). Furthermore, there was an increase of employment of 2.7% in 2014 following growth recovery.

**Fiscal position hurt by flood damages, but improved revenue collection and augmented SBA ensure stability**

**Fiscal gap widened, reflecting the costs of floods with the budget run by a technical government.** However, indirect tax revenues increased, indicating improvement in fiscal procedures. In 2014, revenues collected from indirect taxes rose by 6.1%, indicating more efficient collection in a stagnant economic environment (one of the targets within SBA). VAT revenue, as a dominant source, rose by 6.9% or by EUR 140mn. Revenue from duties rose by 10.6%, excise taxes on imported goods by 5.2%, whereas other revenues rose by 20%.

**8th review of SBA currently suspended, due to delayed formation of new governments and stalling of reforms after October's general elections**

**The formation of new governments at federal and state level has yet to be finalized, but has created a drag for the implementation of SBA with IMF and reforms needed to accelerate EU accession process.** IMF has put on hold its 8th review under SBA until a new government is formed. The disbursement of pending tranches under the extended SBA has also been suspended for the same reason. There is a considerable delay in the formation of governments on Federation BH and state level after October's general elections. The agreement on FBH government partially mitigates existing risks for needed budget approval and reforms. Yet all political parties on February 23 signed a declaration on their commitment and indispensable reforms towards EU integration, based on German and UK initiatives.

# Russia (Ba1 negative/BB+ negative/BBB- negative)*

**Outlook** – We project a recession in 2015-16, with domestic demand affected by poor access to external financing and a negative balance sheet and wealth effect from depreciation. Inflation accelerated further amid a gradual pass-through from the weaker RUB. The central bank has already cut the key interest rate by 300bp YTD to ease monetary conditions and address the issues of financial stability. Despite apparently negative current real interest rates, the central bank is not giving up on inflation targeting, and will continue to pursue this goal in the medium term.

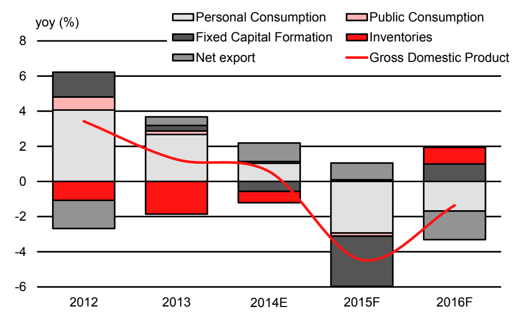
**Strategy** – The situation in Russia remains difficult and on balance of risks we prefer hard currency bonds over local bonds. We see the better opportunities in relative value trades

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

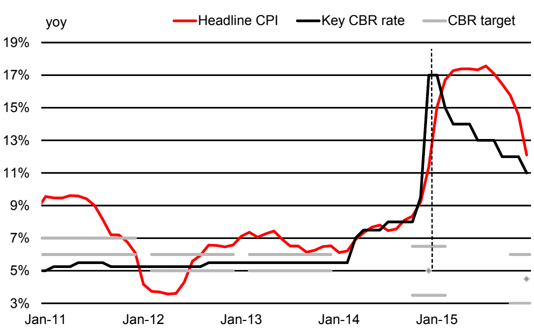
**KEY DATES/EVENTS**

- 30 April – MPC meeting
- April – initiation of the budget process for 2016
- 18-23 of every month – short-term statistical overview

**DOMESTIC DEMAND WEAKENS**




**INFLATION ABOVE TARGET FOR NOW**




Source: Federal Statistical Service, CBR, UniCredit Research

**MACROECONOMIC DATA AND FORECASTS**

| | 2012 | 2013 | 2014E | 2015F | 2016F |
|---|---|---|---|---|---|
| GDP (EUR bn) | 1,556 | 1,573 | 1,395 | 1,107 | 1,124 |
| Population (mn) | 143.0 | 143.3 | 143.7 | 143.7 | 143.7 |
| GDP per capita (EUR) | 10,882 | 10,974 | 9,710 | 7,706 | 7,823 |
| **Real economy yoy (%)** | | | | | |
| GDP | 3.4 | 1.3 | 0.6 | -4.5 | -1.4 |
| Private Consumption | 7.8 | 5.0 | 1.2 | -5.2 | -3.0 |
| Fixed Investment | 6.6 | 1.4 | -7.2 | -13.0 | 5.0 |
| Public Consumption | 2.6 | 1.1 | 0.0 | -1.0 | 0.0 |
| Exports | 1.1 | 4.6 | -1.0 | -8.0 | -3.0 |
| Imports | 8.7 | 3.8 | -5.1 | -15.0 | 3.5 |
| Monthly wage, nominal (EUR) | 675 | 696 | 641 | 470 | 461 |
| Unemployment rate (%) | 5.3 | 5.4 | 5.6 | 6.9 | 7.0 |
| **Fiscal accounts (% of GDP)** | | | | | |
| Budget balance | 0.0 | -0.5 | -0.5 | -0.2 | -0.4 |
| Primary balance | 0.2 | -0.1 | 0.1 | 0.3 | 0.1 |
| Public debt | 10.2 | 11.7 | 12.0 | 14.6 | 15.6 |
| **External accounts** | | | | | |
| Current account balance (EUR bn) | 63.2 | 24.8 | 46.5 | 47.6 | 19.1 |
| Current account balance/GDP (%) | 4.1 | 1.6 | 3.3 | 4.3 | 1.7 |
| Basic balance/GDP (%) | 3.5 | 1.6 | 0.8 | 3.2 | 1.0 |
| Net FDI (EUR bn) | 1.4 | -11.7 | -28.5 | -13.9 | 11.0 |
| Net FDI (% of GDP) | 0.1 | -0.7 | -2.0 | -1.3 | 1.0 |
| Gross foreign debt (EUR bn) | 485.1 | 546.7 | 491.0 | 504.8 | 458.2 |
| Gross foreign debt (% of GDP) | 31.2 | 34.8 | 35.2 | 45.6 | 40.8 |
| FX reserves (EUR bn) | 407.3 | 377.4 | 319.3 | 305.1 | 273.7 |
| **Inflation/Monetary/FX** | | | | | |
| CPI (pavg) | 5.1 | 6.8 | 7.8 | 16.2 | 7.9 |
| CPI (eop) | 6.6 | 6.5 | 11.4 | 12.1 | 7.2 |
| Central bank inflation target | 5-6 | 5-6 | 5.00 | n.a. | n.a. |
| Central bank reference rate (eop) | 5,50 | 5,50 | 17,00 | 11,00 | 7,00 |
| 3M money market rate | 7.45 | 7.08 | 18.30 | 12.25 | 8.00 |
| USD/RUB (eop) | 31.07 | 32.73 | 54.40 | 70.23 | 69.12 |
| EUR/RUB (eop) | 39.92 | 44.97 | 68.34 | 75.85 | 80.18 |
| USD/RUB (pavg) | 30.37 | 31.85 | 38.46 | 65.25 | 66.82 |
| EUR/RUB (pavg) | 40.23 | 42.41 | 50.87 | 71.17 | 75.01 |

Source: UniCredit Research

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

## 2015: Plenty of challenges ahead

**Despite a relatively strong end to 2014, the first data releases of the current year have already revealed weakening internal drivers**

Despite a relatively strong end to 2014 (according to the preliminary estimates by Rosstat, Russian GDP expanded 0.6% last year), the first data releases of the current year have already revealed weakening internal drivers. A sharp decrease in retail sales was registered in January (-4.4% yoy) amid falling real wages (-8.0% yoy), while capital investment continued to decline (-6.3% yoy). Business sentiment indicators were volatile, but still dominated by pessimism. Services PMI, for example, dropped to 41.3 in February 2015, which is the lowest level since February 2009.

**GDP sensitivity to oil is asymmetric, and it is at times higher when the oil price is falling**

Although the oil price has stabilised after a short-term dip below USD 50 per barrel in January, the average price in 2015 is likely to be substantially lower than last year (USD 60 per barrel in our base-case scenario vs. USD 99.5 per barrel in 2014), putting pressure on export revenues and government finances. The YTD Brent crude price averaged USD 54 per barrel, so our current base case FY2015 forecast implies a slight rebound from current levels. However, it is worth mentioning that GDP sensitivity to oil is asymmetric, and it is at times higher when the oil price is falling. According to our estimates, in the past few years, a 1% drop in the oil price subtracts up to 0.26 pp from the headline GDP dynamic, while a 1% increase in the value of the key export commodity adds only 0.06 pp to GDP growth. This time the situation is not likely to be better than before, as current account flexibility (achieved by a contraction in import volumes following the RUB depreciation) is likely to be offset to a large extent by persistent capital outflows. At the same time, there will be little support to the headline GDP figure from consumption amid falling real incomes.

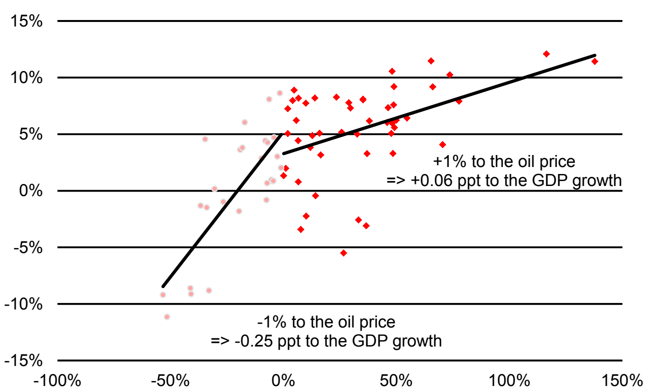
**Due to different weights in the overall GDP, even a high correlation between the volume of imports and internal demand is not enough to provide a sufficient cushion and ensure positive GDP dynamics**

Export revenues contracted by 5.7% in 2014, mostly driven by lower prices for key commodities, but the overall trade balance even demonstrated modest growth due to a sharp contraction in import volumes (by 9.8%) – due to both a formal restriction on the purchases of certain foreign products and a deterioration in the terms of trade because of the RUB weakness. As a result, the current account last year was strongly positive at USD 56.7bn. This year, the import deterioration is likely to continue: the first two months already indicated a more than 35% drop in imports, and we expect such a decline to continue throughout the year. Presumably, consumer imports will suffer the most, although investment and intermediate imports will all experience a severe deterioration. In real terms, import volumes demonstrate a high sensitivity to changes in internal demand. On average, a 1.0% decline in internal demand was associated with a contraction in imports of 2.0%, on average. However, due to different weights in the overall GDP, even such a high correlation between the two is not enough to provide a sufficient cushion and ensure positive GDP dynamics. As a result, we expect headline GDP to contract by 4.5% this year instead of the 3.4% we previously anticipated.

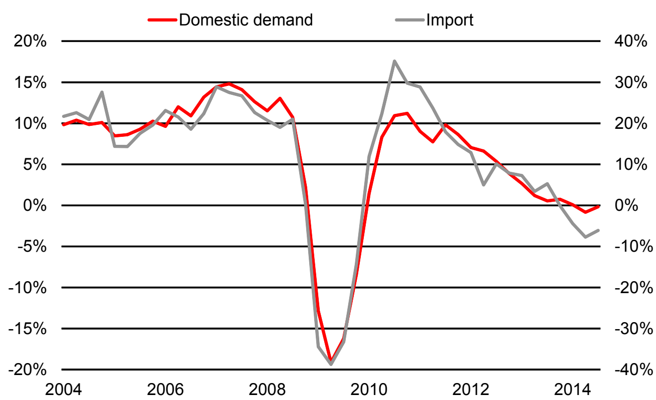
**We expect the headline GDP to contract by 4.5% this year instead of the 3.4% we previously anticipated**

**REAL ECONOMY IS STRUGGLING WITH HEADWINDS**

Oil price increase is not enough to boost growth….




...although import dynamics act as a stabilizing factor




Source: Rosstat, Bloomberg, UniCredit Research

**In addition to the traditional accumulation of foreign assets, capital outflow was fuelled by deleveraging amid limited access of Russian companies to international capital markets**

The financial account, in contrast, was strongly negative in 2014 (at USD -125.6bn) and worsened as compared to 2013. In addition to the traditional accumulation of foreign assets, capital outflow was fuelled by deleveraging amid limited access of Russian companies to international capital markets. The total amount of external debt declined by USD 129bn, or by 18%, in the past year. The RUB devaluation inflated the overall relative amount of external debt (mostly private) – to 48% of GDP (from 36% at the beginning of 2014), even despite deleveraging in FX terms. The financial account will remain a problem for Russia this year as well. This is likely due to low rollover ratios of external liabilities (as a result of imposed sanctions) rather than due to an accumulation of assets abroad, unlike in previous years. In 2015, Russia has to repay in total another USD 125bn, and a hefty USD 36bn in 1Q15. At the same time, the debt is pretty evenly distributed throughout the year, and a substantial portion of it is pseudo-foreign debt: almost half of Russia's external debt came from various off-shore jurisdictions, and is usually considered to be de facto Russian money.

**Potential refinancing issues, decreasing foreign reserves, and low diversification of the Russian economy resulted in a series of sovereign rating downgrades**

Potential refinancing issues, decreasing foreign reserves, and low diversification of the Russian economy resulted in a series of sovereign rating downgrades, with S&P and Moody's having already placed Russia below investment grade (BB+ and Ba1, respectively). A similar decision by Fitch, most likely, is only a matter of time – despite the relatively solid state of finance indicators (total public debt is still below 12% of GDP – even after the FX revaluation of external obligations).

**We expect CPI growth will peak at above 18% yoy in 1H15, but is likely to slow down to ca. 12% by the end of the year. The CBR will target perspective inflation, and so will cut by 100bp every quarter this year to reach 11%**

With all these external developments, all eyes are now on government policies. Indeed, the CBR presumably changed its priorities this year from "purely" inflation targeting to assigning more weight to the financial stability of the banking system. For instance, while CPI growth has accelerated significantly in the first months of 2015, the CBR cut its key rate by 200bp in January, and by another 100bp in March. YTD inflation has already reached 6.2%, and the yoy pace rose to 16.7% as of the mid of March. We believe that this represents an ongoing adjustment in the general price level to the changes in the exchange rate, but once this process is completed (and assuming that the pace of RUB depreciation slows down) inflation should decelerate later in the year. Nevertheless, with such a beginning of the year, inflation is likely to stay in the double-digit area in 2015, limiting the CBR's ability to reduce interest rates. We expect that the CPI rise will peak at above 18% yoy in 1H15, but is likely to slow down to ca. 12% by the end of the year. The CBR will target perspective inflation, and so will cut by 100bp every quarter this year to reach 11%. It will use other instruments to stimulate the economy as well – e.g. specialized schemes aimed at particular spheres or lending types, like SME lending, investment project financing, etc.

**The strength of the USD and the weak oil price throughout the year will not allow the RUB to appreciate much from observed levels. Our base-case scenario suggests USD-RUB will end 2015 at 70**

The strength of the USD and the weak oil price throughout the year will not allow the RUB to appreciate much from observed levels. Moreover, the potential rebound in the oil price towards the end of the year will likely be offset by the impact of sanctions and geopolitical risks. Additionally, monetary policy will also subtract from potential RUB strength, as will the need to exchange the Reserve Fund's hard currency into rubles. Our base-case scenario suggests USD-RUB will end 2015 at 70.

**We project the Russian economy to be in recession in 2016 as well – mostly driven by the lack of investment and slow recovery in other areas**

Yet the challenges for the Russian economy will not end in 2015. We project the Russian economy to be in recession in 2016 as well – mostly driven by the lack of investment and slow recovery in other areas. The ongoing contraction in investment spending is not only due to sanctions – it started much earlier, and is likely to be related to low confidence in the future economic model. The current situation will ease pressure on capacity constraints – both equipment and labor – but this is not enough to re-start the engine. As a result, economic activity may fall as much as 1.4% in 2016. RUB is likely to remain depressed despite the projected (modest) rebound in oil prices. A weak RUB may provide some impulse for import substitution, but high reliance on raw material exports and obsolescence of capacity in most industries is likely to limit the potential impact. Risks and developments in the period 2016-17 are especially interesting ahead of the new political (election) cycle.

## Strategy: Short-term relative value opportunities, longer term deterioration

**The bond market in Russia remains difficult due to….**

**…political risks, high inflation amid CBRT rates cuts and likelihood of further downgrades**

The Russia situation remains precarious with significant unpredictable political risks and internal structural problems. We expect sanctions to remain in 2Q15 and growth to stay weak. Modest rate cuts by the CBR to alleviate the pressure of high interest rates look set to continue. S&P and Fitch are expected to downgrade the local debt in April, which will see local bonds removed from the Barclays Aggregate Index, possibly pushing yields wider. We also think oil prices could decline further, putting pressure on the ruble and front-end rates. Inventories have been rising and a rise of short sellers caused the futures curve to flatten, making it less economical to store oil. Consequently we expect more stock will be pushed onto the market, depressing prices.

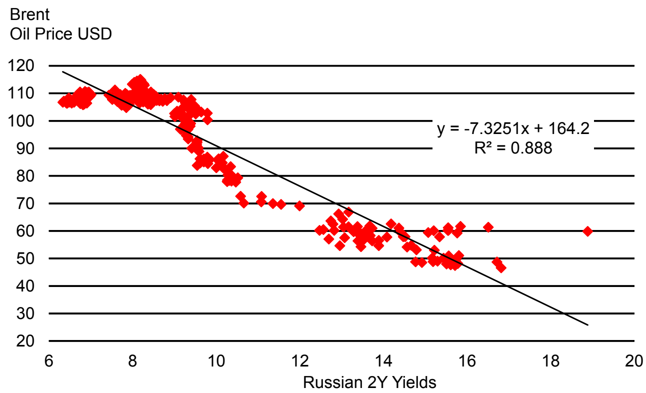
**We recommend being underweight local bonds…**

**…and see less risk in the hard currency curves, however…**

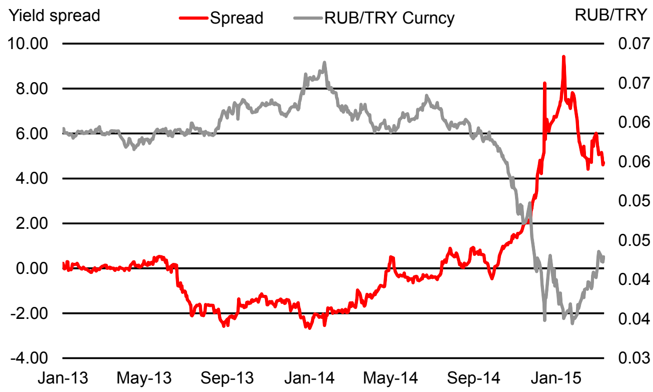
**..we see better value in short-term relative value opportunities**

Against this backdrop, we recommend an underweight in local OFZ bonds. We see lower risk in the long end. We think hard currency denominated bonds are lower risk, but see better value in relative value trades. Despite economic weakness, provided there is no deterioration in the conflict and expected rate cuts are gradual we think the economy has some insulation due to its high reserves. We see less insulation in Turkey and think the chance of short-term deterioration in rates and currency is greater than in Russia. We recommend a short-term trade in long RFLB 7.6% 2022s versus short TURKGB 8.5% 2022 – FX hedged. We expect the spread can tighten 80bp and would exit the trade prior to the rating meeting on 17 April. We also see value in long RUSSIA EUR 20s versus short TURKEY EUR 20s.

Front end will be under pressure if oil drops further




Spread between RFLB 22s and TURKGB 22s




Source: Rosstat, CBR, Bloomberg; UniCredit Research

### GOVERNMENT GROSS FINANCING REQUIREMENTS

| EUR bn | 2014E | 2015F | 2016F |
|---|---|---|---|
| **Gross financing requirement** | **11.6** | **6.4** | **9.1** |
| Budget deficit | 6.6 | 2.2 | 4.5 |
| Amortisation of public debt | 5.1 | 12.3 | 11.6 |
| Domestic | 5.1 | 12.3 | 11.6 |
| Bonds | 5.1 | 12.3 | 11.6 |
| Bills | n.a. | n.a. | n.a. |
| External | n.a. | n.a. | n.a. |
| Sovereign Fund | n.a. | -8.1 | -8.0 |
| **Financing** | **11.6** | **6.6** | **9.1** |
| Domestic borrowing | 9.8 | 6.0 | 6.4 |
| Bonds | 9.8 | 6.0 | 6.4 |
| Bills | n.a. | n.a. | n.a. |
| External borrowing | n.a. | n.a. | n.a. |
| Bonds | n.a. | n.a. | n.a. |
| Other | 1.8 | 0.6 | 1.7 |

### GROSS EXTERNAL FINANCING REQUIREMENTS

| EUR bn | 2014E | 2015F | 2016F |
|---|---|---|---|
| **Gross financing requirement** | **52.1** | **45.4** | **60.5** |
| C/A deficit | -46.5 | -47.6 | -19.1 |
| Amortisation of debt | 93.0 | 88.8 | 72.5 |
| Government/central bank | 0 | 2.0 | 0 |
| Banks | 28.0 | 24.0 | 28.5 |
| Corporates | 65.0 | 62.8 | 44.0 |
| Errors and omissions | 5.6 | 4.2 | 7.1 |
| **Financing** | **52.1** | **45.4** | **60.5** |
| FDI | -28.5 | -13.9 | 11.0 |
| Equity | 0 | 0 | 0 |
| Borrowing | 51.2 | 37.0 | 54.3 |
| Government/central bank | 0 | 0 | 5.0 |
| Banks | 15.6 | 11.0 | 15.9 |
| Corporates | 35.6 | 26.0 | 33.4 |
| Domestic investments abroad | 87.5 | 36.5 | 26.5 |
| Official reserves change/other | -58.1 | -14.2 | -31.4 |

Source: Rosstat, CBR, Unicredit Research

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

**Outlook –** The Serbian economy will remain in recession this year due to weakened domestic consumption, but is expected to return to growth in 2016 on the back of growing investments and net external demand. Low oil prices and frail import demand will help narrow the C/A deficit throughout the entire forecast horizon, while the low inflation environment and stable dinar are set to boost the easing cycle in 2Q15. We welcome the government's 2015-17 fiscal strategy and the IMF deal, but we believe fiscal consolidation reforms will need to be extended into 2018 to curb the unsustainably high public debt trend.

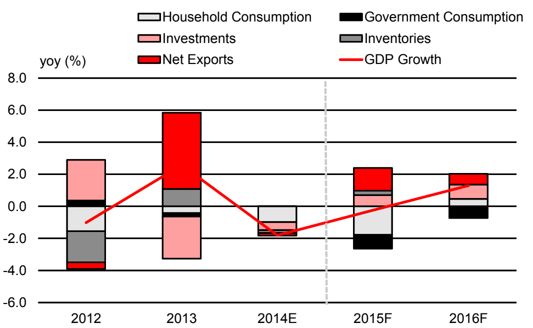
**Strategy –** Despite significant risks, we are becoming more positive on Serbia due to the well supported 3Y and 7Y benchmark bond issues and secondary buying, improved liquidity and reduction of the liquidity premium, high real yield and more favorable bond environment. We favor 3Y and 7Y benchmark bonds and think these could rally to levels around 9.00% and 10.80%, respectively. On the USD curve, we think the SERBIA USD 20s are overvalued in relation to the Croatia USD 20s.

**Author: Carlos Ortiz, Economist (UniCredit Bank London)**

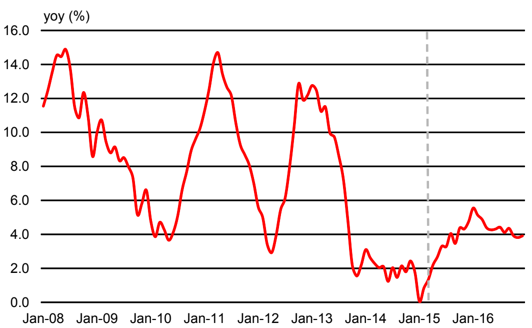
## KEY DATES/EVENTS

- 20 Mar, 20 Apr, 18 May – Current account balance
- 31 Mar, 30 Apr, 29 May – Industrial output
- 09 Apr, 11 May, 11 June – Policy rate decision
- 14 Apr, 12 May, 12 June – Consumer Price Index

## ECONOMY TO REMAIN IN RECESSION IN 2015




## INFLATION TO STABILIZE WITHIN TARGET IN 2H15




Source: NBS, MinFin, Unicredit Research

## MACROECONOMIC DATA AND FORECASTS

| | 2012 | 2013 | 2014E | 2015F | 2016F |
|---|---|---|---|---|---|
| GDP (EUR bn) | 31.7 | 34.3 | 33.1 | 32.7 | 33.4 |
| Population (mn) | 7.2 | 7.2 | 7.2 | 7.2 | 7.2 |
| GDP per capita (EUR) | 4,401 | 4,785 | 4,594 | 4,542 | 4,637 |
| **Real economy yoy (%)** | | | | | |
| GDP | -1.0 | 2.6 | -1.8 | -0.3 | 1.3 |
| Private Consumption | -2.0 | -0.6 | -1.3 | -2.4 | 0.6 |
| Fixed Investment | 13.2 | -12.0 | -2.7 | 2.7 | 4.9 |
| Public Consumption | 1.9 | -1.1 | 0.1 | -4.6 | -4.0 |
| Exports | 0.8 | 21.3 | 3.9 | 4.7 | 5.8 |
| Imports | 1.4 | 5.0 | 3.3 | 0.9 | 3.5 |
| Monthly wage, nominal (EUR) | 508 | 537 | 524 | 468 | 471 |
| Unemployment rate (%) | 23.9 | 22.1 | 19.8 | 21.2 | 20.5 |
| **Fiscal accounts (% of GDP)** | | | | | |
| Budget balance* | -8.4 | -7.2 | -7.0 | -6.2 | -5.3 |
| Primary balance | -6.5 | -4.8 | -4.1 | -2.6 | -1.3 |
| Public debt | 56.2 | 59.6 | 70.9 | 75.2 | 76.8 |
| **External accounts** | | | | | |
| Current account balance (EUR bn) | -3.6 | -2.1 | -2.0 | -1.6 | -1.6 |
| Current account balance/GDP (%) | -11.5 | -6.1 | -6.1 | -5.0 | -4.7 |
| Basic balance/GDP (%) | -9.4 | -2.5 | -2.1 | -0.4 | 0.1 |
| Net FDI (EUR bn) | 0.7 | 1.2 | 1.3 | 1.5 | 1.6 |
| Net FDI (% of GDP) | 2.1 | 3.6 | 4.0 | 4.6 | 4.8 |
| Gross foreign debt (EUR bn) | 25.6 | 25.8 | 26.0 | 27.7 | 28.2 |
| Gross foreign debt (% of GDP) | 80.9 | 75.2 | 78.7 | 84.6 | 84.5 |
| FX reserves (EUR bn) | 12.0 | 12.1 | 11.9 | 11.5 | 11.1 |
| **Inflation/Monetary/FX** | | | | | |
| CPI (pavg) | 7.3 | 7.9 | 2.1 | 2.9 | 4.4 |
| CPI (eop) | 12.2 | 2.2 | 1.8 | 4.8 | 3.9 |
| Central bank target | 4.0±1.5% | 4.0±1.5% | 4.0±1.5% | 4.0±1.5% | 4.0±1.5% |
| Central bank reference rate (eop) | 11.25 | 9.50 | 8.00 | 6.5 | 7.00 |
| 3M money market rate (Dec avg) | 11.64 | 10.15 | 8.26 | 8.67 | 7.75 |
| USD/RSD (eop) | 86.18 | 83.13 | 98.73 | 114.81 | 110.34 |
| EUR/RSD (eop) | 113.72 | 114.64 | 121.50 | 124.00 | 128.00 |
| USD/RSD (pavg) | 87.96 | 85.16 | 88.45 | 111.69 | 111.94 |
| EUR/RSD (pavg) | 113.13 | 113.09 | 117.26 | 121.64 | 125.99 |

*Includes below-the-line items

Source: UniCredit Research

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

## An increasing fiscal challenge

**We expect the economy to contract by 0.3% yoy in 2015…**

**The Serbian economy is facing a mild recession this year**, softened by falling oil prices and the recovery of demand of its main export partners. Private investments are set to rebound this year, after having troughed in 2014, and contribute positively to growth throughout the forecast horizon. Even so, we expect the economy to contract by 0.3% yoy this year, as the austerity reforms included in the 2015 budget will weigh negatively on domestic consumption. A return to growth is only expected in 2016, as private consumption recovers and external demand is firmly anchored.

**…driven by the austerity-driven contraction in private and public consumption**

**Domestic consumption will weaken this year,** and remain a drag on growth throughout the entire forecast horizon. In 2014, the economy contracted by 1.8% yoy, driven entirely by shrinking domestic demand (down 1.5% yoy). As expected, private consumption declined by 1.3% yoy and subtracted close to 1pp from GDP growth. In part, this is explained by falling real wages (-1.5% yoy), but also by the notable decline in remittances (-14% yoy). The extension of loans for current consumption (consumer and cash loans) also lost vigour, but was partly compensated for by a decrease in new saving deposits. In 2015, we expect the drop in private consumption to deepen by -2.4% yoy, following the cuts to public sector wages and pensions in November 2014[22] and the planned 5% annual reduction in public sector employment. The appreciation of the CHF will also worsen households' repayment burden for CHF-indexed debt, estimated by the central bank to amount to RSD 96.8bn at end-November (or 13.7% of total household loans). Public consumption is expected to contract by 4.6% yoy this year, driven by the reforms to the SOE sector and the reduction in subsidies to agriculture and a number of public companies (i.e. Serbian Railways). A return to growth of public consumption is not expected until 2018, provided the 2015-17 MTP fiscal strategy is implemented.

**Private investments and exports are set to accelerate this year…**

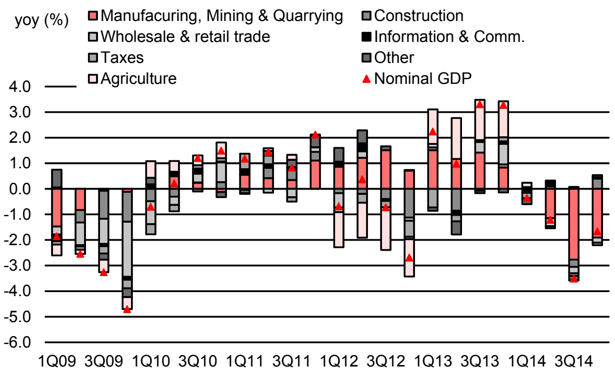
**Investment activity and exports will rebound this year and support growth throughout the forecast horizon**. At end-2014, fixed investments reached their lowest level since 2010 despite accelerating credit growth (+1.8% in 3Q14). The cut in investments was primarily seen in the construction sector, though these are expected to rebound in 1H15 due to renewed reconstruction works in the flood-hit areas. Investment activity will also be supported by a number of infrastructure projects in the transport and energy sectors and the low base, and is expected to contribute positively to growth by an average of 0.7pp of GDP annually until 2017.

**...and add an average of 3pp to GDP until end-2016**

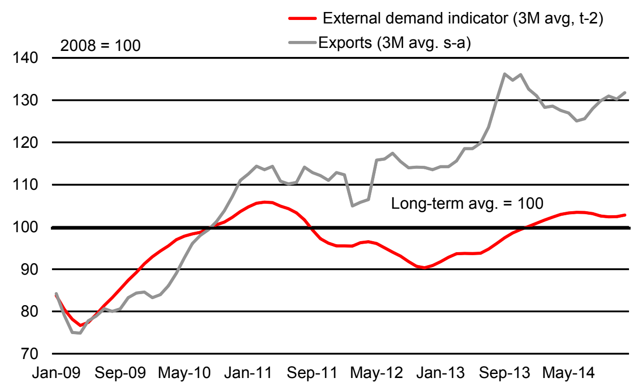
More importantly, net exports are expected to rebound from 2014 lows, driven by a stronger recovery in the euro area (UniCredit: +1.5% yoy in 2015), namely in Germany, and the slowdown in import demand. That said, we expect the contribution from Fiat exports to flatten this year due to unchanged production plans (i.e., 100,000 units).

**WEAK CONSUMPTION TO REMAIN A DRAG ON GROWTH**

May floods and austerity are keeping economic activity subdued…




…but this is expected to rebound amid recovering demand in Europe




Source: Haver, EC, SORS, NBS, UniCredit Research

[22] The decrease in salaries consists of a linear 10% cut to net wages of all public sector employees receiving more than RSD 25,000 per month. By contrast, the cuts to pensions will be progressive, with those amounting to between RSD 25,000-40,000 to be cut by 22% and pensions over RSD 40,000 to be cut by 25%.

**The C/A deficit is expected to contract to 5% of GDP in 2015**

**Lower oil prices and a stronger eurozone will help narrow the C/A deficit ahead.** In 11M14, the C/A deficit widened by 9.3% yoy to EUR 1.9bn, due mainly to a notable slowdown in exports (up 3% yoy vs. +22% yoy in 11M13) and weaker primary income. Imports of goods and services continued on a moderate growth path (+1.6% yoy in 11M15), and are expected to result in a much lower negative contribution of net exports to total demand in 2014 (i.e. -0.2pp of GDP). This year, we expect the C/A deficit to drop to 5% of GDP, down from an estimated deficit of 6.1% of GDP in 2014. The adjustment will be mainly supported by lower prices of crude oil, although the stronger recovery in the euro area and falling consumer goods imports will also help. According to our estimates, lower oil prices should reduce the C/A deficit by EUR 300mn in 2015 (or 0.9pp of GDP), provided the euro averages 1.08 per dollar and oil prices remain at an average of USD 60 per barrel.

**Inflation will remain tame and is expected to reach the NBS target band only by June…**

**…opening the door for a minimum of 50bp in rate cuts in 2Q15 and 150bp by year-end**

**The low inflation environment and stable dinar argue for additional rate cuts in 2Q15**. In February, headline inflation increased by 0.9% yoy, constituting the 12th consecutive month inflation remained below the lower-end of the NBS 4±1.5% target tolerance band. The inflation uptick was driven by food inflation, which will continue to accelerate given the low base. We expect inflation to hit the lower end of the NBS's target band only by June, after the hikes to gas and electricity prices and the depletion of the disinflationary effects from falling agricultural products. Even so, both headline and core inflation will remain weak (avg. of 2.9% yoy in 2015) due to suppressed domestic demand, and weak PPI and euro area inflation. In view of this, and the weak state of domestic demand, the NBS resumed the rate easing cycle in March, with a 50bp cut to 7.5% yoy. Looking ahead, and provided EM risk appetite is maintained, we expect the NBS to cut rates by a minimum of 50bp in 2Q15, with scope for 150bp to 6.5% by year-end.

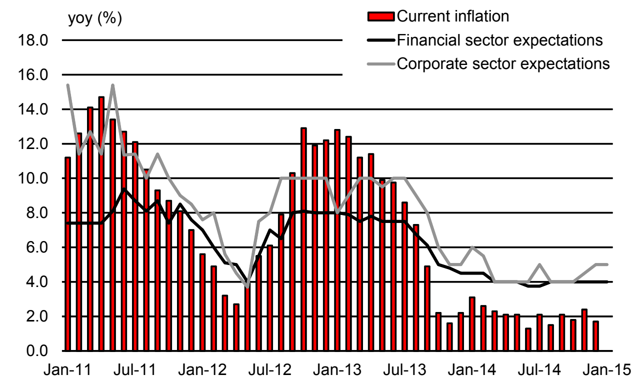
**The IMF agreement will provide a much-needed fiscal anchor**

**We do not expect a decline of public debt until 2018, due to a rising interest rate bill and high SOE liabilities**

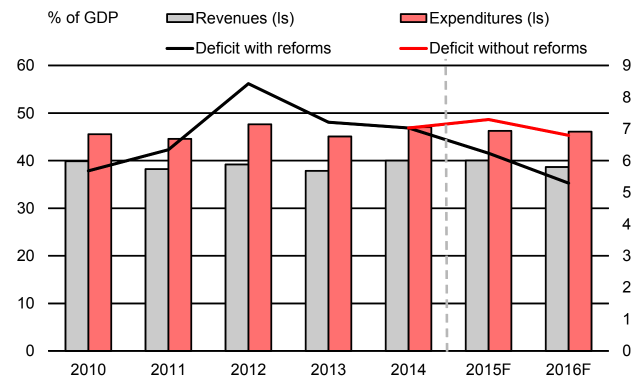
**We welcome the Fiscal Strategy for 2015-17, but additional fiscal effort will be required to curb public debt by end-2017.** As part of the IMF-driven agreement, signed on 23 February, the government agreed to cut the budget deficit by EUR 1.4bn (or 3.3pp of GDP) by end-2017. The bulk of the adjustment is planned for 2015, with the budget deficit (including below-the-line items) targeted at 5.9% of GDP. We see the 2015 budget as optimistic, since the recessionary environment and cuts to pensions and public sector wages could mean value added tax and personal income tax proceeds lower than planned. Moreover, we see risks from the planned cuts to SOE guarantees (ca. 1.4pp of GDP just in 2015) as the restructuring of the biggest loss-making companies could take longer and prove more costly than expected. On this note, the sale of the Smedrevo steel mill to Essmark Inc. failed in February, while there is an increasing risk that budget guarantees for EPS could be disbursed later this year. Keeping this in mind, and rising interest payments, we expect the deficit to fall to 6.2% of GDP in 2015 and to 5.3% in 2016. Public debt is expected to rise further, impacted also by the appreciation of the dollar, and reach 77% of GDP by end-2016, double that in 2010.

**LOW INFLATION AND FISCAL CONSOLIDATION POINT TO THE NEED FOR LOOSER MONETARY POLICY IN 2015**

Inflation and expectations remain at minimum levels…




…while expenditure-driven cuts will constrain domestic demand




Source: Ipsos, Gallup, Ninamedia, NBS, Haver, UniCredit Research

## Strategy: Despite risks, local bonds opportunity to rally

**Despite the risks, we are more positive on local bonds due to…**

There are significant risks in Serbia amid a recession, an ambitious 2015 budget and complex reform agenda. Despite these risks, we are becoming more positive on Serbia for a number of reasons. First, the recent 3Y and 7Y benchmark bond issues were very well supported and there should be a flow effect from buying in the secondary market. Second, the improvement in liquidity on the local curve should attract more investors, reducing the illiquidity premium. Third, local bonds have the highest real yields in the CEE region. We also see a better bond environment with the IMF agreement in place, the reforms advancing and low inflationary environment. We favor the 3Y and 7Y benchmark bonds and think these could rally to levels around 9.00% and 10.80%, respectively.

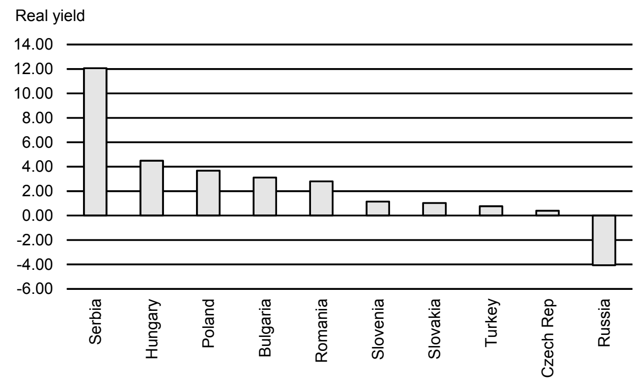
**….the strong benchmark issue, declining liquidity premium, high real yield and better bond environment**

**On the USD curve, we think the SERBIA USD 20s are overvalued**

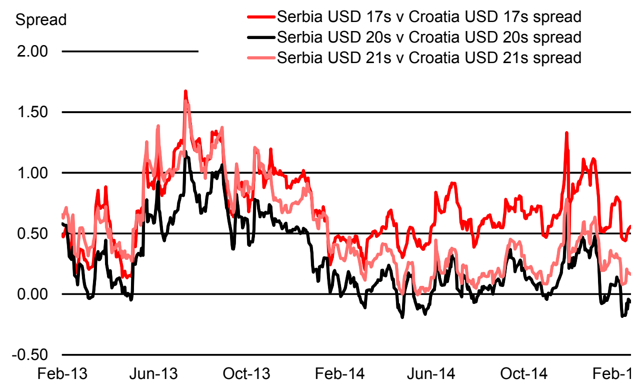
In regard to external debt, we think the SERBIA USD 17s and 21s are trading close to fair value relative to Croatia, but that the SERBIA USD 20s are overvalued compared to CROATI USD 20s. Croatia is a better credit than Serbia due to its access to EU funds, and its bonds should not trade wider than Serbia's. We recommend being long CROATI USD 20 against short SERBIA USD 20 and exiting the trade when the yield spread returns to +20bp.

**LOCAL BONDS HAVE ATTRACTIVE YIELDS, BUT SERBIA USD 20S OVERVALUED**

10Y local real yields in CEE




Serbia USD bonds against Croatia USD Bonds




Source: Bloomberg, UniCredit Research

**GOVERNMENT GROSS FINANCING REQUIREMENTS**

| EUR bn | 2014E | 2015F | 2016F |
|---|---|---|---|
| **Gross financing requirement** | **5.1** | **5.6** | **5.3** |
| Budget deficit | 2.3 | 2.0 | 1.8 |
| Amortization of public debt | 2.8 | 3.5 | 3.6 |
| Domestic | 2.2 | 2.9 | 3.0 |
| Bonds | 0.3 | 1.7 | 1.8 |
| Bills | 1.9 | 1.1 | 1.2 |
| External | 0.6 | 0.6 | 0.6 |
| IMF | 0.6 | 0.1 | 0 |
| **Financing** | **5.1** | **5.6** | **5.3** |
| Domestic borrowing | 3.9 | 3.7 | 3.9 |
| Bonds | 2.5 | 2.4 | 2.5 |
| Bills | 1.3 | 1.3 | 1.4 |
| External borrowing | 1.2 | 2.2 | 1.1 |
| Bonds | 0 | 1.5 | 0 |
| IMF/EU | 0.1 | 0.2 | 0.2 |
| Other | 1.1 | 0.5 | 0.9 |
| Change in cash reserves (+ = decline) | 0 | -0.3 | 0.3 |

**GROSS EXTERNAL FINANCING REQUIREMENTS**

| EUR bn | 2014E | 2015F | 2016F |
|---|---|---|---|
| **Gross financing requirement** | **7.0** | **6.5** | **6.1** |
| C/A deficit | 2.0 | 1.6 | 1.6 |
| Amortization of medium to long term debt | 4.8 | 4.7 | 4.5 |
| Government/Central Bank | 0.6 | 0.6 | 0.6 |
| IMF | 0.6 | 0.1 | 0 |
| Other | 0 | 0.5 | 0.5 |
| Banks | 1.0 | 0.8 | 0.7 |
| Corporates | 2.7 | 2.8 | 2.7 |
| Amortization of short term debt | 0.2 | 0.1 | 0.1 |
| Government/Central Bank | 0 | 0 | 0 |
| Banks | 0.2 | 0.1 | 0.1 |
| Corporates | 0 | 0.1 | 0 |
| **Financing** | **7.0** | **6.5** | **6.1** |
| FDI | 1.3 | 1.5 | 1.6 |
| Equity | 0 | 0 | 0 |
| Borrowing | 4.8 | 5.9 | 4.5 |
| Government/Central Bank | 1.2 | 2.2 | 1.1 |
| IMF | 0.1 | 0.2 | 0.2 |
| Bonds | 0 | 1.5 | 0 |
| Other | 1.1 | 0.5 | 0.9 |
| Banks | 1.1 | 0.8 | 0.7 |
| Corporates | 2.5 | 2.8 | 2.7 |
| Change in FX reserves (+ = decline) | 0.9 | -0.9 | 0 |

Source: NBS, MinFin, UniCredit Research

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

**Outlook –** The drop in oil prices and ample global liquidly have provided Turkey with a great opportunity to boost growth while lowering inflation and reducing its large current account deficit. The upside has yet to materialize, however, as growing concerns about central bank independence have shaken confidence, causing the lira to plunge and risk premia to rise. While the macroeconomic performance should still improve, the upside is likely to be limited with market volatility likely to persist, fueled by worries about domestic politics. The upcoming hike in U.S. interest rates or intensification of the conflicts in Russia and the Middle East present major risks, too, given the heavy reliance on volatile foreign capital inflows.

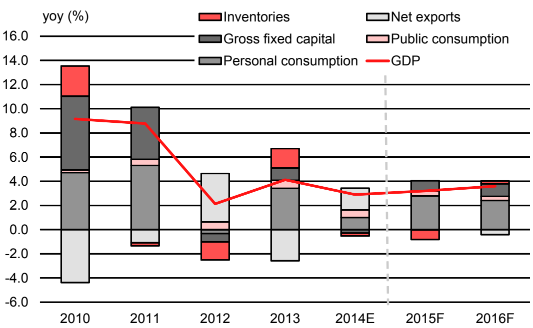
**Strategy –** Falling inflation should support TURKGBs in the short term. However, beyond April we think rising risks in the run-up to the election warrant moving to underweight, shifting duration to the belly of the curve. We see less risk in hard currency bond curves and recommend the TURKEY USD 22s and TURKEY EUR 21s

**Author: Lubomir Mitov, Chief CEE Economist (Unicredit Bank London)**
**Carlos Ortiz, Economist (UniCredit Bank London)**

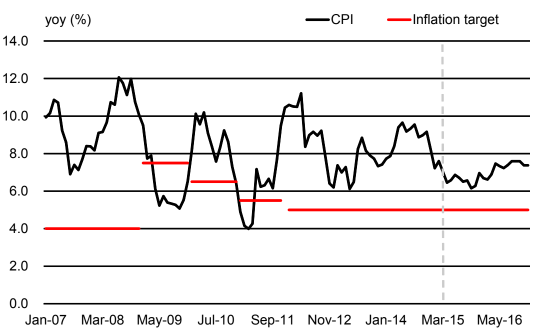
## KEY DATES/EVENTS

- 3 Apr, 4 May, 3 June – CPI
- 22 Apr, 20 May – Policy rate decision
- 13 June – General elections

## GROWTH TO RECOVER AT A MODEST PACE




## INFLATION TO DECELERATE IN 2Q15




Source: Turkstat, CBRT, UniCredit Research

## MACROECONOMIC DATA AND FORECASTS

| | 2012 | 2013 | 2014E | 2015F | 2016F |
|---|---|---|---|---|---|
| GDP (EUR bn) | 608.3 | 616.8 | 606.1 | 708.5 | 725.1 |
| Population (mn) | 75.8 | 76.5 | 77.3 | 78.2 | 79.0 |
| GDP per capita (EUR) | 8,025 | 8,065 | 7,838 | 9,066 | 9,183 |
| **Real economy yoy (%)** | | | | | |
| GDP | 2.1 | 4.0 | 2.9 | 3.2 | 3.6 |
| Private Consumption | -0.5 | 4.6 | 1.5 | 4.2 | 3.6 |
| Fixed Investment | 6.1 | 5.9 | 5.6 | 3.6 | 3.0 |
| Public Consumption | -2.7 | 4.3 | -1.2 | 3.6 | 4.4 |
| Exports | 16.3 | 0.1 | 5.7 | 4.6 | 3.8 |
| Imports | -0.4 | 8.5 | -1.1 | 4.5 | 5.1 |
| Monthly wage, nominal (EUR) | 912 | 999 | 953 | 1,082 | 1,101 |
| Unemployment rate (%) | 8.7 | 8.4 | 9.0 | 9.1 | 9.2 |
| **Fiscal accounts (% of GDP)** | | | | | |
| Budget balance | -1.5 | -1.7 | -1.4 | -2.5 | -3.0 |
| Primary balance | 1.9 | 1.5 | 1.6 | 0.5 | 0.2 |
| Public debt | 36.2 | 36.3 | 33.1 | 33.4 | 33.3 |
| **External accounts** | | | | | |
| Current account balance (EUR bn) | -36.7 | -49.0 | -34.4 | -36.4 | -37.8 |
| Current account balance/GDP (%) | -6.0 | -7.9 | -5.7 | -5.1 | -5.2 |
| Basic balance/GDP (%) | -4.9 | -5.9 | -4.7 | -3.2 | -3.3 |
| Net FDI (EUR bn) | 7.1 | 12.4 | 5.9 | 13.4 | 13.8 |
| Net FDI (% of GDP) | 1.2 | 2.0 | 1.0 | 1.9 | 1.9 |
| Gross foreign debt (EUR bn) | 257.0 | 283.4 | 318.4 | 366.7 | 385.3 |
| Gross foreign debt (% of GDP) | 42.2 | 46.0 | 52.5 | 51.8 | 53.1 |
| FX reserves (EUR bn) | 77.2 | 82.3 | 77.9 | 96.0 | 100.7 |
| **Inflation/Monetary/FX** | | | | | |
| CPI (pavg) | 9.0 | 7.5 | 8.9 | 6.7 | 7.3 |
| CPI (eop) | 6.2 | 7.4 | 8.2 | 7.0 | 7.4 |
| Central bank target | 5.0 | 5.0 | 5.0 | 5.0 | 5.0 |
| Central bank reference rate (eop) | 7.50 | 4.50 | 8.25 | 6.25 | 7.50 |
| 3M money market rate (Dec avg) | 5.75 | 8.42 | 9.79 | 7.50 | 8.50 |
| USD/TRY (eop) | 1.79 | 2.07 | 2.30 | 2.67 | 2.70 |
| EUR/TRY (eop) | 2.35 | 2.83 | 2.83 | 2.88 | 3.13 |
| USD/TRY (pavg) | 1.80 | 1.91 | 2.19 | 2.60 | 2.68 |
| EUR/TRY (pavg) | 2.33 | 2.53 | 2.92 | 2.80 | 3.03 |

Source: UniCredit Research

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

## An opportunity not to be missed

**Favorable external conditions present a great opportunity for Turkey…**

The current extraordinarily favorable external environment has afforded Turkey a great opportunity to boost growth while reducing its large macroeconomic imbalances. Falling oil prices should help lift consumption and markedly reduce the large current account deficit while lowering inflation. This outlook, which would be a welcome reprieve after a year marred by lackluster growth, rising inflation and heightened market volatility, should boost investor confidence, cutting risk premia and supporting Turkish assets.

**But developments so far have disappointed...**

However, developments so far have disappointed. Industrial production fell 2% saar in the fourth quarter and further still this year. Export growth has all but ceased, while weak imports point to a sluggish recovery in domestic demand. While lower oil prices and abating food inflation slowed the increase in consumer prices, the decline was smaller than anticipated, with core inflation elevated at 8-9% despite the deflationary external environment.

**…mainly due to increased market volatility that has hurt the TRY…**

The disappointing start of 2015 was mainly due to heightened market volatility that has led to sustained pressure on the TRY, and to a lesser extent, on bond yields. Portfolio inflows have reversed, with locals shunning the TRY, too. With global risk appetite strong and liquidity ample, this volatility is entirely domestically driven and rooted in domestic politics.

**…because of political tensions between the president and the central bank**

Financial markets have been upset by growing concerns about central bank independence. Both the government and President Erdogan have repeatedly pressured the central bank to embark on aggressive rate cutting to support growth, disregarding the still significant price pressures. Ironically, the TRY depreciation which this standoff has triggered (15% since the start of the year) has actually limited the scope for faster easing.

**Economic performance should still improve, albeit not as much as initially thought...**

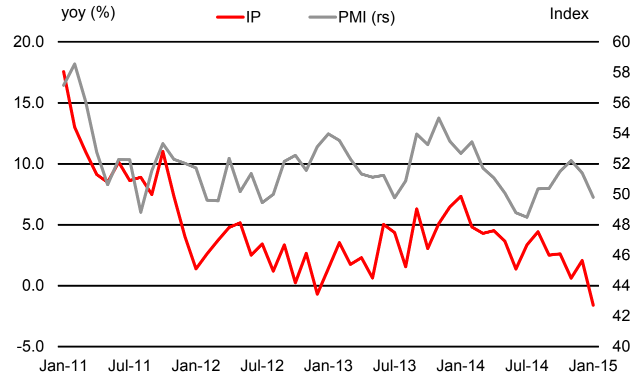
With food inflation subdued, energy prices lower and demand pressures largely absent, inflation looks set to ease faster once the TRY stabilizes, to around 6% yoy by the late summer. As base effects lapse and oil prices firm, inflation could rise again, to 7% yoy by yearend and near 7.5% by the end of 2016. Terms-of-trade gains as large as 3.2% should cut the current account deficit to USD 39 billion, or 5% of GDP this year, from USD 45 billion last year, even though the underlying position won't change much.

**…but would still provide ample scope for rate cuts in the near term**

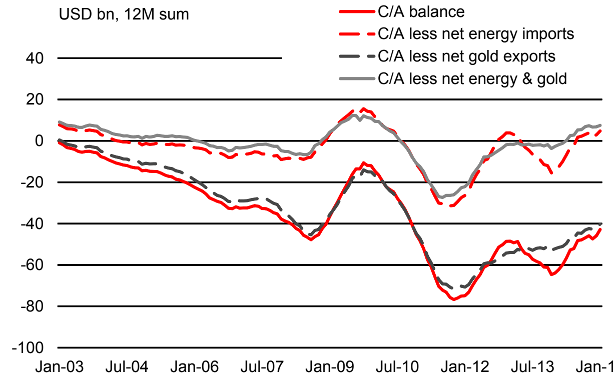
An environment like this should provide ample scope for further rate cuts. After taking a pause in March, we expect the central bank to lower its policy rate to 6.25% by the late summer and keep it on hold as long as financial market conditions allow. Rate hikes would begin at a measured pace once the Fed starts tightening, bringing the policy rate back to 7.5% or so by the end of 2016. Under these conditions, and assuming no major market upheavals, real GDP would expand 3.2% this year before accelerating modestly to 3.7% next year. (The slight downgrade in our projection takes account of the first-quarter weakness, but still assumes a substantial pickup later in the year).

**SUPPLY-SIDE SHOCKS HAVE OPPOSING EFFECTS**

Industrial producers turning more bearish amid TRY depreciation




C/A benefiting from lower oil prices and weaker TRY




Source: CBRT, Haver, Unicredit Research

**Turkey faces numerous risks, both domestic and external…**

However, whether Turkey will be able to fully benefit from the favorable external environment depends on the policy response and on how the authorities handle the numerous political risks, both domestic and external. The relentless pressure on the central bank has raised the odds of a policy error. A premature or excessive rate cut could trigger another wave of TRY depreciation. This, in turn, would force, as early last year, a major tightening with a serious adverse effect on growth.

**…such as a policy error…**

**…intensified geopolitical tensions in the region…**

**…and the fallout of Fed tightening**

Turkey also has to cope with numerous external risks. Intensified geopolitical tensions – both between Russia and Ukraine to the North and the ISIS war in Iraq-- pose serious challenges, with all parties involved among Turkey's top trading partners. The expected rate hikes by the Fed later this year represent another risk. The risk aversion they could trigger could cut capital inflows to emerging markets, with Turkey, with its still sizable current account deficit and reliance on volatile portfolio and short-term capital, likely to be among the hardest hit.

**Domestic politics represent the major risk**

Domestic politics, however, represent perhaps the major risk. The outcome of the June parliamentary election will be crucial – not in terms of the winner, with the ruling AK Party expected to easily win a majority again, but rather whether the size of the majority would enable it to change the constitution and boost the power of the presidency. A change in the constitution would be viewed as market-negative given already intense efforts by President Erdogan to impose control on the central bank.

**The outcome of the June elections will be crucial…**

**.. as it might determine the future of economic policy management**

Another election-related uncertainty is related to the fate of the current economic team led by Deputy Prime Minister Babacan. A reshuffle of the team, which has demonstrated a commitment to prudent policies, especially if accompanied by an early departure of the central bank governor, is likely to have a major adverse impact on markets, especially if they were to be replaced by political appointees.

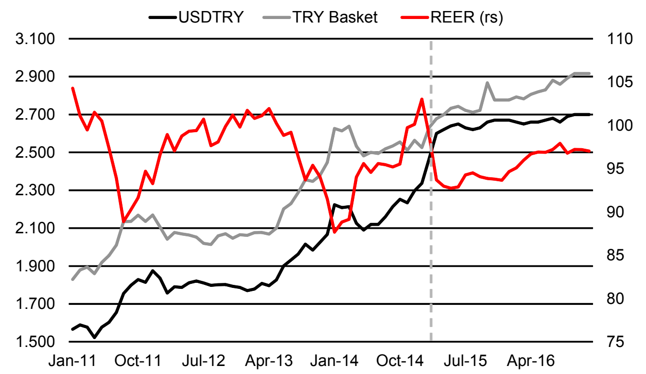
**Any improvement will be transitory if not underpinned by forceful reforms…**

**…the odds for which remain uncertain**

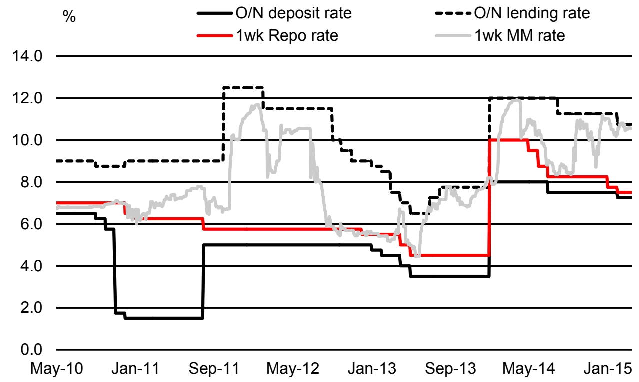
The current favorable external environment presents a chance for Turkey to boost growth while reducing its vulnerabilities. However, any improvement would prove to be transitory and would reverse if not accompanied by broader reforms. With no elections scheduled for the next four years after June, political conditions should be ideal for pushing ahead with reforms. It remains to be seen whether the new government would have the political resolve to do so (something which has been absent since 2006) and whether there will be enough institutional capacity to implement the complex program.

**REAL MONETARY CONDITIONS ARE NOT EASING**

Nominal TRY depreciation does not translate into real depreciation




Despite rate cuts, market interest rates trended higher in 2015




Source: Bloomberg, IIF, CBRT, Unicredit Research

## Strategy: Market weight to underweight on rising risks

**We recommend a short-term marketweight in TURKGB into the next inflation print…**

We recommend short-term market weight to Turkey in advance of a marked decline in inflation. We think that the CBRT criticism will soften as the weak lira could stall Erdogan's economic growth plans. Lira stabilization and stemming of TURKGB outflows should provide support to bonds. After the April inflation print though, we believe risks are to the downside.

**…but beyond April risks are to the downside due to…**

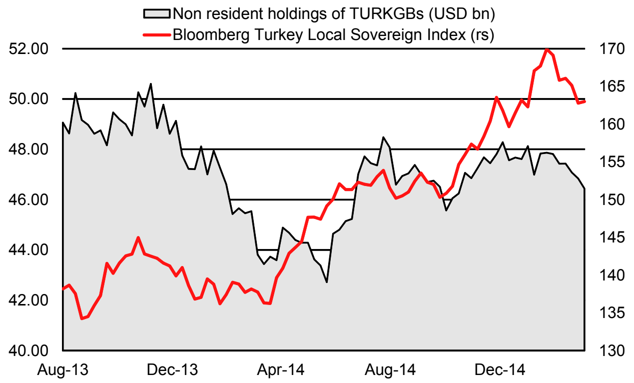
**…borrowing needs, possible outlook change, lira vulnerability and run-up up to the election**

**After April, we recommend shifting duration to the belly of the curve in TURKGB, but…**

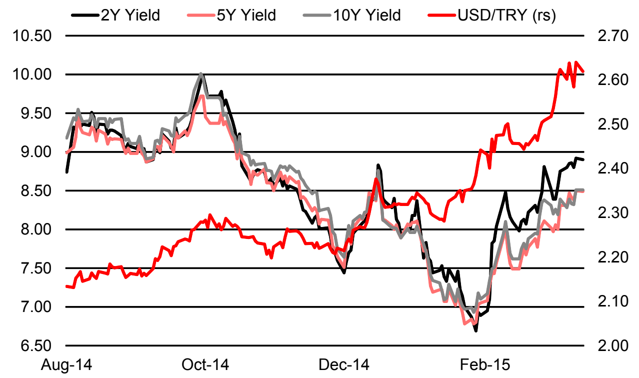
**…see less risk in hard currency bonds**

We think auction support may wane beyond April due to the borrowing needs, while Moody's may change Turkey's outlook from 'Stable' to 'Negative' with chance of a downgrade. The lira remains vulnerable to risk sentiment and rising US yields, given the lack of FX reserves, while the political rhetoric in the run-up up to the June election could create considerable downside risk. We recommend moving to underweight avoiding the front end and shifting duration to the belly of the curve. We like the TURKGB 22s. However, we see better value on hard currency curves due to the lower lira and US yield risk and favor the TURKEY USD 22s and TURKEY EUR 21s. We also recommend paying 10Y swaps after the inflation print in April.

TURKGB outflows have undermined performance…..




Belly of curve attractive, less duration and currency risk




Source: UniCredit Research

**GOVERNMENT GROSS FINANCING REQUIREMENTS**

| EUR bn | 2014E | 2015F | 2016F |
|---|---|---|---|
| **Gross financing requirement** | **56.8** | **48.7** | **47.2** |
| Budget deficit | 8.2 | 17.8 | 21.8 |
| Amortization of public debt | 48.6 | 30.8 | 25.4 |
| Domestic | 41.6 | 23.3 | 16.0 |
| Bonds | 41.6 | 23.3 | 16.0 |
| Bills | 0 | 0 | 0 |
| External | 7.0 | 7.6 | 9.4 |
| **Financing** | **56.8** | **48.7** | **47.2** |
| Domestic borrowing | 45.2 | 30.6 | 25.6 |
| Bonds | 45.2 | 30.6 | 24.6 |
| Bills | 0 | 0 | 1 |
| External borrowing | 7.0 | 10.6 | 9.9 |
| Other | 11.6 | 10.1 | 7.7 |
| Change in cash reserves (+ = decline) | -7.0 | -2.6 | 4.0 |

Source: CBRT, Turkstat, MinFin, UniCredit Research

**GROSS EXTERNAL FINANCING REQUIREMENTS**

| EUR bn | 2014E | 2015F | 2016F |
|---|---|---|---|
| **Gross financing requirement** | **167.9** | **196.5** | **192.7** |
| C/A deficit | 34.5 | 36.4 | 36.8 |
| Amortization of medium to long term debt | 29.4 | 27.2 | 26.2 |
| Government/Central Bank | 4.7 | 5.9 | 6.1 |
| Banks | 7.2 | 9.8 | 6.6 |
| Corporates | 17.5 | 11.5 | 13.4 |
| Short term debt | 102.2 | 132.9 | 129.7 |
| Government/central bank | 2.3 | 1.6 | 3.0 |
| Banks | 72.3 | 93.8 | 90.6 |
| Corporates | 27.6 | 37.4 | 36.1 |
| Errors & omissions | 1.8 | 0.0 | 0.0 |
| **Financing** | **167.9** | **196.5** | **192.7** |
| FDI | 5.9 | 13.4 | 13.8 |
| Portfolio | 1.9 | 1.7 | 1.9 |
| Borrowing medium to long term | 51.2 | 54.6 | 46.9 |
| Government/central bank | 5.7 | 7.4 | 7.3 |
| Banks | 21.2 | 20.4 | 24.1 |
| Corporates | 24.2 | 26.9 | 15.5 |
| Short term borrowing | 108.1 | 139.6 | 144.3 |
| Government/central bank | 1.3 | 3.2 | 2.3 |
| Banks | 76.3 | 97.5 | 103.2 |
| Corporates | 30.4 | 38.9 | 38.7 |
| Other | 0.5 | -7.3 | -8.1 |
| Reserve accumulation | 0.4 | -5.6 | -6.0 |

Source: CBRT, UniCredit Research

# Ukraine (Caa3 negative/CCC- negative/CC negative)*

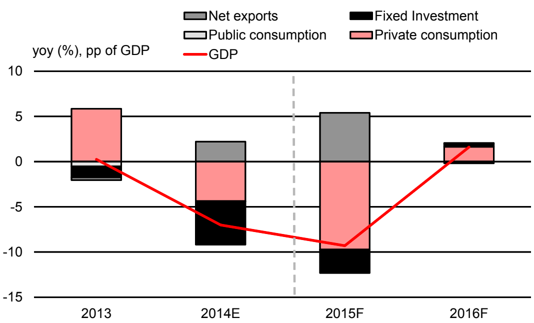
**Outlook** – The war-related destruction of significant part of the industrial and export potential and financial market paralysis have brought Ukraine to the verge of an economic and financial meltdown. Supply-side constraints have been exacerbated by lagging reforms and a collapse in domestic demand. The tenuous truce agreed in February, agreement on a new IMF program and the debt relief afforded by the likely restructuring of USD 14bn in obligations due private creditors through 2018 could help avoid an outright collapse. The economy will contract sharply this year, but could begin a modest recovering in 2016 provided the conflict in the East is settled, reforms advance aggressively and the prospective debt rescheduling is implemented in a market-friendly manner. Downside risks remain extraordinarily high, due to the uncertain prospects for durable peace in the East and continued infighting within the political elite that has hampered reforms.

**Author: Lubomir Mitov, Chief CEE Economist (Unicredit Bank London)**

**KEY DATES/EVENTS**

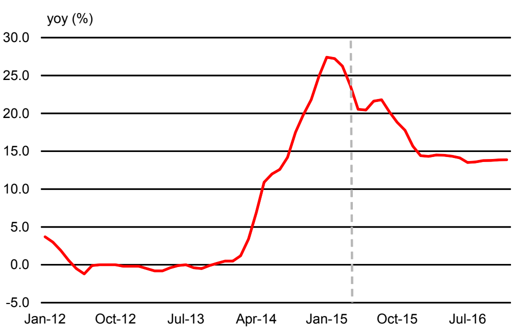
- 20 Mar: 4Q14 final GDP
- 11 Mar: IMF approval of extended arrangement – USD 5bn
- 15 June: First IMF review – USD 1.7bn
- 5-10 of each month: FX reserves data

**GDP GROWTH COULD RESUME ONLY IN 2016**




Source: State Statistics Service of Ukraine, UniCredit Research

**INFLATION EXPECTED TO PEAK IN 1H15**




Source:State Statistics Service of Ukraine; UniCredit Research

**MACROECONOMIC DATA AND FORECASTS**

| | 2012 | 2013 | 2014E | 2015F | 2016F |
|---|---|---|---|---|---|
| GDP (EUR bn) | 135.6 | 132.0 | 99.5 | 76.2 | 84.8 |
| Population (mn) | 45.5 | 45.5 | 45.4 | 45.2 | 45.2 |
| GDP per capita (EUR) | 2,979 | 2,907 | 2,192 | 1,686 | 1,877 |
| **Real economy yoy (%)** | | | | | |
| GDP | 0.2 | 0 | -7.0 | -9.3 | 1.6 |
| Private Consumption | 11.7 | 1.0 | -5.8 | -12.0 | 2.0 |
| Fixed Investment | 0.9 | 0 | -26.0 | -15.0 | 2.5 |
| Public Consumption | 2.2 | 0 | -0.2 | -0.2 | -1.0 |
| Exports | -7.7 | -5.0 | -23.6 | -10.3 | 5.1 |
| Imports | 1.9 | -6.0 | -21.4 | -17.4 | 3.4 |
| Monthly wage, nominal (EUR) | 292 | 294 | 217 | 146 | 130 |
| Unemployment rate (%) | 7.8 | 7.3 | 10.5 | 11.5 | 11.0 |
| **Fiscal accounts (% of GDP)** | | | | | |
| Budget balance | -4.8 | -4.6 | -4.6 | -4.5 | -3.9 |
| Primary balance | -2.3 | -1.2 | -1.2 | 0.8 | 1.9 |
| Public debt | 37.4 | 40.6 | 69.1 | 99.3 | 89.7 |
| **External accounts** | | | | | |
| Current account balance (EUR bn) | -11.0 | -12.4 | -3.7 | -0.3 | -0.9 |
| Current account balance/GDP (%) | -8.2 | -9.2 | -3.7 | -0.4 | -1.0 |
| Basic balance/GDP (%) | -4.7 | -2.6 | -4.0 | 0.1 | 0.4 |
| Net FDI (EUR bn) | 4.2 | 3.5 | -0.3 | 0.4 | 1.4 |
| Net FDI (% of GDP) | 3.1 | 2.6 | -0.3 | 0.5 | 1.7 |
| Gross foreign debt (EUR bn) | 102.3 | 103.7 | 105.8 | 123.8 | 124.4 |
| Gross foreign debt (% of GDP) | 75.5 | 78.5 | 106.4 | 162.5 | 146.6 |
| FX reserves (EUR bn) | 17.2 | 14.6 | 5.0 | 11.4 | 13.7 |
| **Inflation/Monetary/FX** | | | | | |
| CPI (pavg) | 0.6 | -0.3 | 12.1 | 21.6 | 28.1 |
| CPI (eop) | -0.2 | 0.5 | 24.9 | 15.7 | 13.9 |
| Central bank target | | tentative target of 5% | | | |
| Central bank reference rate (eop) | 7.5 | 6.5 | 14.0 | 22.0 | 15 |
| 3M money market rate (Dec avg) | 24.4 | 12.0 | 21.00 | 25.00 | 18.00 |
| USD/UAH (eop) | 8.1 | 8.2 | 15.7 | 22.8 | 24.5 |
| EUR/UAH (eop) | 10.6 | 11.1 | 19.0 | 27.4 | 29.4 |
| USD/UAH (pavg) | 8.1 | 8.1 | 12.0 | 22.1 | 23.7 |
| EUR/UAH (pavg) | 10.4 | 10.8 | 16.0 | 23.9 | 26.9 |

Source: UniCredit Research

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

## Fighting for Survival

**The war in the East has dealt a heavy blow to the economy…**

In early 2015, Ukraine has come to the verge of an economic and financial meltdown. Activity has imploded as the demand shock triggered by the need to correct the unsustainably large macroeconomic imbalances has been reinforced by a supply-side shock due to the loss of major production facilities in the war zone. (These account for about 8% of GDP and 12% of exports). Real GDP fell 15% yoy in the fourth quarter as exports slumped 30%.

**…reinforced by a virtual halt in financial markets and loss of confidence…**

The recession has been reinforced by financial market paralysis. The UAH remains under intense pressure with the current account in deficit, no access to private markets and official funding deferred. The central bank responded with pervasive capital controls that have made FX virtually unavailable. Even so, FX reserves hit an 11-year low in early March of just three weeks of imports. Confidence in banks, riddled with large NPLs and open net foreign exchange positions, has vanished, too, with bank deposits plummeting 25% during 2014.

**…amid inconsistent policies and lagging reforms**

Two elections, only tenuous political resolve and the heavy cost of the war have constrained policy options. The public sector deficit more than doubled to 14% of GDP last year amid falling revenues, rising defense spending and a tripling in Naftogaz' losses to 8% of GDP, with energy price hikes delayed. Some 80% of the public sector deficit was financed by the central bank, along with major liquidity support to domestic banks. The resulting surge in money supply has greatly diminished scope for monetary policy. Structural reforms have lagged amid infighting among the ruling coalition and opposition by powerful business interests, resulting in the deferral of IMF disbursements.

**A new enhanced IMF program envisages a sizable increase in foreign official financing…**

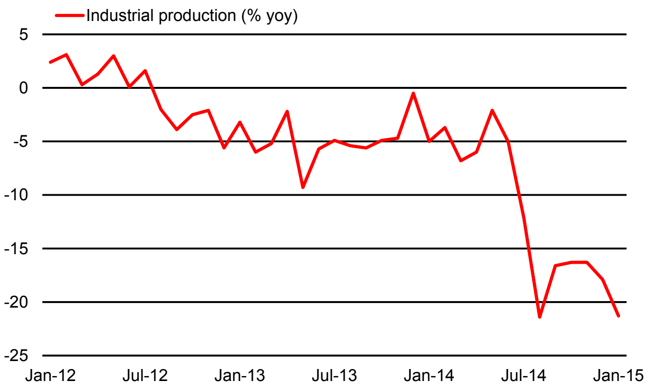
The dire economic and financial situation and the heightened geopolitical tensions prompted the IMF to revise its program. The two-year SBA was replaced with a four-year EFF program. The program estimates external financing gap of EUR 36 billion through 2018, EUR 15bn of which this year and nearly EUR 9bn next. The new program raises the IMFs contribution by EUR 6bn to EUR 15.6bn, with another EUR 7bn or so committed by other official creditors.

**…complemented by a comprehensive PSI operation**

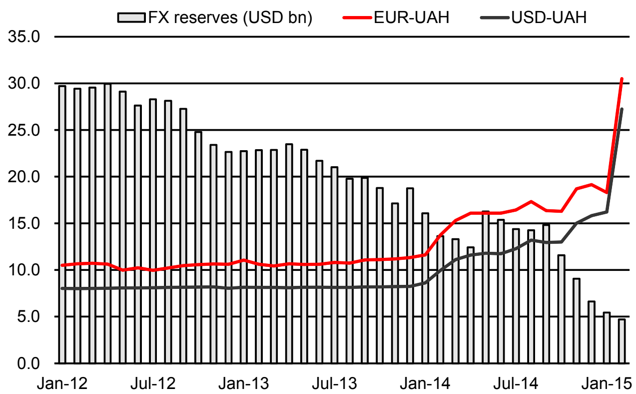
The remaining EUR 14.5bn needs to be provided by private creditors. With the program assuming EUR 0.9bn in new bond issuance, some EUR 13.6bn would need to be secured via a PSI operation. This corresponds to all principal and interest payments on government and government-guaranteed debt due private creditors through 2018. However, securing 100% participation will be difficult, given the high concentration of some bond issues among certain creditors.

**THE ECONOMY HAS NOT BOTTOMED OUT YET**

The conflict in the East weighs heavily on industrial production




FX reserves too low to provide support to the currency




Source: NBU, national statistics office, UniCredit Research

**Securing a high participation rate will be problematic given the high concentration in bond holdings**

Particularly problematic will be the rescheduling of the USD 3bn in bonds held by Russia issued in the final days of the Yanukovich regime and due in December. Russia has already indicated that it would not agree to voluntary rescheduling. However, the program has no allocations for repaying the bonds, while their full repayment would violate the principle of equal treatment of all creditors, which could result in more holdouts or lengthy lawsuits.

**A voluntary and fair debt restructuring should pave the way for a return to financial markets by 2018**

The PSI is to be finalized by June and most likely would involve maturity extension with at least four years of grace and maturity of up to 10 years. Rescheduling along these lines would provide the needed cash-flow relief, while avoiding principal haircuts. If done in a cooperative way and at reasonable terms, the prospective PSI should enable Ukraine to return to capital markets by 2018, assuming the economy has stabilized by then and growth resumes.

**The new IMF program should help avert a collapse for now, but risks remain very high…**

While the new IMF program should help prevent a major financial and economic meltdown, risks are extraordinarily high, especially in the near term. The first disbursement in March is likely to amount to EUR 7bn, including other official financing. This is unlikely to be large enough to provide the firepower needed to stabilize the FX market while removing or at least easing exchange market restrictions in order to support the recovery.

**…with the program underfunded at the front end…**

The program also has no allocations for bank recapitalization. A stress test last year found a capital hole of EUR 8.5bn, or 11% of GDP, two-thirds of which needs to be provided by the government. (Actual capital needs will be larger given the significant deterioration in economic conditions since the stress test was done). Swift recapitalization is essential for restoring confidence in the banks and stemming deposit outflows. Including bank recapitalization, financing needs amount to at least EUR 14bn upfront, twice that available under the program.

**…and macroeconomic assumptions extremely optimistic…**

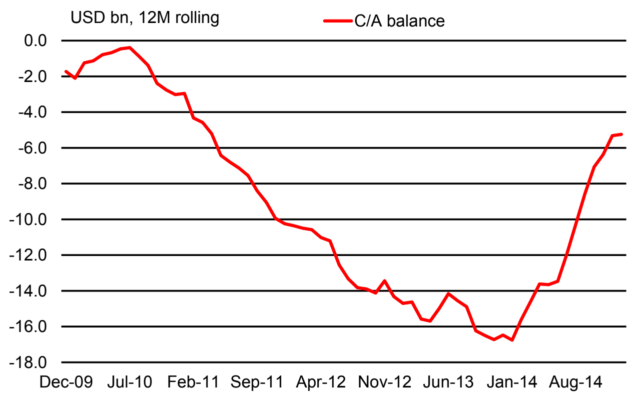
Macroeconomic risks are substantial, too. Given developments to date, the magnitude of the fiscal tightening targeted by the program (some 6-7% of GDP, including Naftogaz) and the hit on consumption due to the depreciation and the sharp hikes in administered energy prices, real GDP is more likely to drop 9% or so this year before recovering 1.6% in 2016. This compares with a program assumption for a decline of just 5.5% this year. Weaker growth would hurt revenues, requiring additional tightening or extra financing.

**...and geopolitical and implementation risks particularly high**

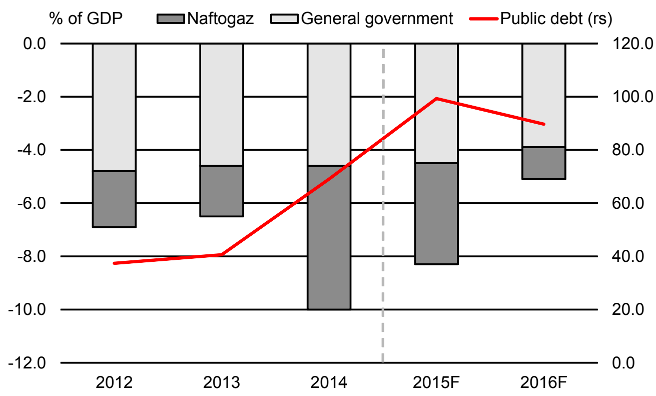
Ultimately, the success of the program will be determined by the pace of structural reforms and on resolving the conflict in the East. On both accounts odds are uncertain. The difficulties the authorities encountered with adopting the prior measures required by the IMF suggest that reforms are unlikely to proceed smoothly, while the odds for durable peace seem elusive for now.

**TRADE IMBALANCES CORRECTED FASTER THAN FISCAL ONES**

The C/A deficit corrected sharply…




…but the budget shortfall will remain a bigger problem




Source: NBU, Bloomberg, UniCredit Research

### GOVERNMENT GROSS FINANCING REQUIREMENTS

| EUR bn | 2014E | 2015F | 2016F |
|---|---|---|---|
| **Gross financing requirement** | **10.4** | **8.9** | **6.4** |
| Budget deficit | 4.6 | 3.4 | 3.3 |
| Amortization of public debt | 5.8 | 5.5 | 3.1 |
| Domestic | 3.4 | 0.4 | 1.2 |
| Bonds | 2.6 | 1.7 | 1.2 |
| Bills | 0.8 | 3.3 | 0 |
| External | 2.4 | 5.1 | 1.9 |
| **Financing** | **10.4** | **8.9** | **6.4** |
| Domestic borrowing | 3.1 | 1.7 | 2.4 |
| Bonds | 2.7 | 1.7 | 2.4 |
| Bills | 0.4 | 0 | 0 |
| External borrowing | 5.9 | 7.2 | 5.5 |
| Other | 0.7 | 0 | 0 |
| Change in cash reserves (+ = decline) | 0.7 | 0 | -1.4 |

Source: National Bank of Ukraine, MinFin, UniCredit Research

### GROSS EXTERNAL FINANCING REQUIREMENTS

| EUR bn | 2014E | 2015F | 2016F |
|---|---|---|---|
| **Gross financing requirement** | **49.9** | **47.5** | **45.0** |
| C/A deficit | 3.7 | 0.4 | 1.0 |
| Amortisation of medium to long term debt | 30.5 | 34.5 | 31.3 |
| Government/central bank | 5.5 | 6.4 | 2.8 |
| Banks | 2.2 | 2.3 | 2.2 |
| Corporates | 22.8 | 25.8 | 26.3 |
| Short term debt | 17.2 | 12.6 | 12.7 |
| Government/central bank | 0 | 0 | 0 |
| Banks | 3.5 | 0.9 | 1.1 |
| Corporates | 13.7 | 11.7 | 11.6 |
| Errors & omissions | -1.4 | 0 | 0 |
| **Financing** | **49.9** | **47.5** | **45.0** |
| FDI | -0.3 | 0.4 | 1.4 |
| Portfolio | -0.4 | 0.1 | 0 |
| Borrowing medium to long term | 23.8 | 37.7 | 33.2 |
| Government/central bank | 4.6 | 12.4 | 6.5 |
| Banks | 1.3 | 1.8 | 2.2 |
| Corporates | 18.0 | 23.5 | 24.4 |
| Short term borrowing | 16.5 | 15.6 | 13.5 |
| Government/central bank | 0 | 0 | 0 |
| Banks | 2.6 | 0.7 | 1.3 |
| Corporates | 13.9 | 14.9 | 12.2 |
| Other | 0.7 | 0 | 0 |
| Reserve accumulation | 9.3 | -6.2 | -3.1 |

Source: CBRT, Turkstat, UniCredit Research

# Key dates over 2Q15 – Rate and rating decisions

| | | |
|---|---|---|
| **March** | 17-Mar | Turkey rate decision |
| | 20-Mar | Turkey – Fitch rating |
| | 20-Mar | Croatia – Moodys rating |
| | 20-Mar | Hungary – S&P rating |
| | 24-Mar | Hungary rate decision |
| | 26-Mar | Czech Republic rate decision |
| | 27-Mar | Lithuania – Fitch rating |
| | 27-Mar | Slovenia – Fitch rating |
| | 27-Mar | Lithuania – S&P rating |
| | 31-Mar | Romania rate decision |
| | 31-Mar | Bulgaria rate decision |
| **April** | 9-Apr | Serbia rate decision |
| | 10-Apr | Turkey – Moodys rating |
| | 10-Apr | Romania – S&P rating |
| | 10-Apr | Ukraine – S&P rating |
| | 15-Apr | Poland rate decision |
| | 17-Apr | Russia – Fitch rating |
| | 17-Apr | Slovakia – Moodys rating |
| | 17-Apr | Russia – S&P rating |
| | 21-Apr | Hungary rate decision |
| | 22-Apr | Turkey rate decision |
| | 24-Apr | Romania – Moodys rating |
| | 30-Apr | Russia rate decision |
| | 30-Apr | Bulgaria rate decision |
| **May** | 6-May | Poland rate decision |
| | 6-May | Romania rate decision |
| | 7-May | Czech Republic rate decision |
| | 8-May | Czech Republic – Fitch rating |
| | 8-May | Lithuania – Moodys rating |
| | 8-May | Turkey – S&P rating |
| | 11-May | Serbia rate decision |
| | 15-May | Latvia – Fitch rating |
| | 15-May | Poland – Moodys rating |
| | 20-May | Turkey rate decision |
| | 22-May | Hungary – Fitch rating |
| | 22-May | Slovenia – Moodys rating |
| | 26-May | Hungary rate decision |
| | 29-May | Bulgaria rate decision |
| | 29-May | Latvia – S&P rating |
| **June** | 3-Jun | Poland rate decision |
| | 5-Jun | Bulgaria – Moodys rating |
| | 11-Jun | Serbia rate decision |
| | 12-Jun | Latvia – Moodys rating |
| | 12-Jun | Bulgaria – S&P rating |
| | 15-Jun | Russia rate decision |
| | 19-Jun | Bulgaria – Fitch rating |
| | 19-Jun | Czech Republic – Moodys rating |
| | 19-Jun | Slovenia – S&P rating |
| | 23-Jun | Turkey rate decision |
| | 23-Jun | Hungary rate decision |
| | 25-Jun | Czech Republic rate decision |
| | 30-Jun | Bulgaria rate decision |

Source: UniCredit Research

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EFI 17