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CEE: An opportunity to turn divergence to convergence

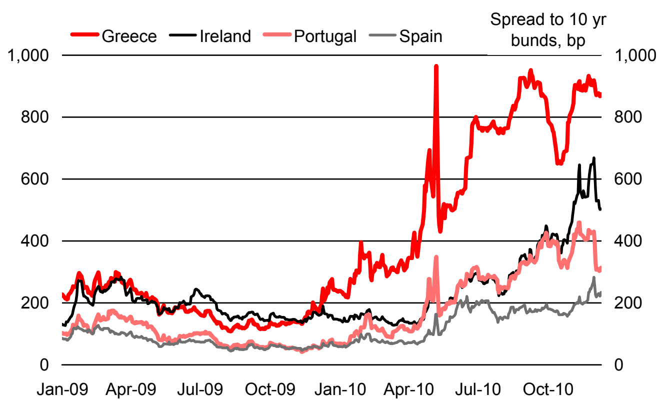
A positive global backdrop but watch for tail risks

Our global backdrop is supportive of CEE in 2011…

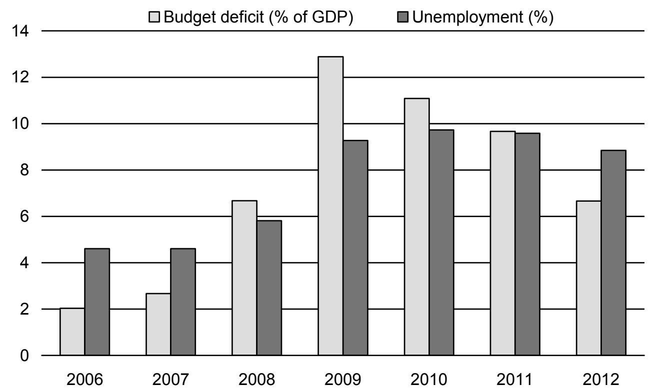
Our baseline global macro backdrop is supportive of CEE next year. We expect CEE's core export markets to continue to perform well. Germany is running on all cylinders and we forecast GDP growth there next year at 2.5%, down from 3.6% this year but still well above its average over 2000-07 (1.6%). Q3 GDP grew by a robust 0.7% QoQ while the manufacturing PMI showed renewed gains over Oct-Nov. With labour markets strengthening and consumer confidence outperforming other EMU economies, the recovery can no longer be attributed just to exports but reflects more broad-based improvement. We expect growth to be broadly unchanged in France and Italy next year at 1.4% and 1.1% respectively. Demand from Asia also remains robust. China's manufacturing PMI continued its upward trend over Oct-Nov while the IMF projects GDP growth next year at 9.6%, down very modestly from 10.5% this year. Supported by lose fiscal and monetary policy, we expect the US next year to post gains of 2%, down moderately from 2.7% this year. Decent gains in global demand should in turn support commodity prices at current, if not slightly higher, levels.

Central banks remain keen to support the recovery. Early November saw the Fed announce a further USD600bn in quantitative easing while Bernanke has since refused to rule out an enlargement of the programme. We do not expect any rate hikes from the Fed before H2-12. Meanwhile the ECB is struggling to balance a strong Germany against a weak periphery and as a result will probably only initiate a very gradual hiking cycle towards the end of next year.

Eurozone periphery spreads signal continued tensions



The US is increasingly impatient with stubbornly high unemployment



Source: Bloomberg, IMF, UniCredit Research

…but watch for the Eurozone periphery and rumblings in the US

That said, the tail risks are plentiful. Financial market tensions in the periphery are back in full swing. IMF programmes in Greece and Ireland are sufficient to allow the sovereign to step away from market issuance for at least a 2 year period but the market remains unconvinced that Portugal and, of much more concern, Spain will continue to be able to 'go it alone'. Portugal struggled to 'converge' during its first decade in EMU despite on average running a double digit current deficit, a reflection of large scale borrowing from abroad at cheap interest rates. To date its C/A deficit has not adjusted while from an external perspective the economy remains the most indebted in the Euro Area. The real threat is, of course, Spain, given that in the case that it was forced towards an EFSF/IMF programme, the bill could near EUR 400bn. Q1 is likely to remain a testing time for EMU. Any signs of financing stress for sovereigns could push policy makers rapidly towards a solution.

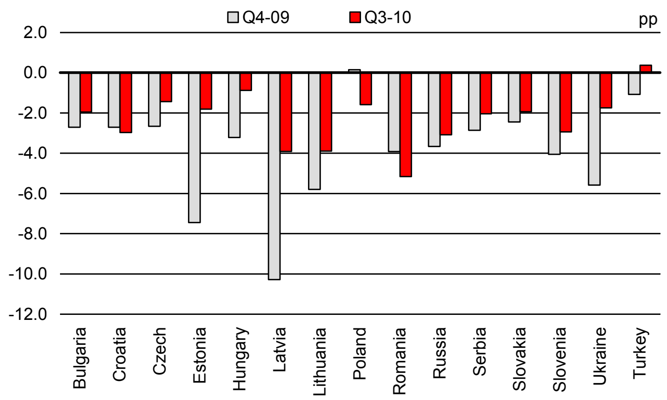
In the US in the face of expansionary fiscal policy and loose monetary policy, unemployment remains stubbornly high while fixed income markets are showing increasing impatience with the policy mix. We are concerned that the Fed's QE programme cannot address the core of the issue – that such an uncomfortably high rate of unemployment is structural rather than cyclical in nature and rather than generate real output gains, it may ultimately instead prove inflationary, especially in an environment where fiscal consolidation remains unaddressed.

CEE: Narrower output gaps, strong industry and recovering domestic demand

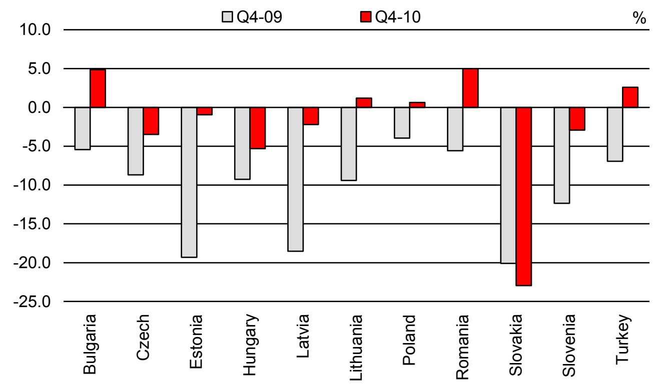
CEE GDP growth of 3.8% next year, up from 3.6% this year

In CEE we expect GDP growth in the region next year of 3.8%, up from 3.6% this year, with every country in our group to show gains for the first time in 4 years. We enter 2011 with output gaps significantly narrower than was the case a year ago and in some countries economic activity could move back above potential once again. For some of the weaker economies in the region, full year positive GDP growth is finally in sight, though the strength of the recovery is still in question.

In most cases output gaps have narrowed to within 2pp of GDP



Capacity utilization – % deviation from long term average[1]



Source: National statistics offices, UniCredit Research

Output gaps are narrowing and are set to close in Poland and Turkey

According to our estimates output gaps in Turkey, Poland and the Czech Republic have now reached a point whereby, if we allow for a 1-2pp margin of error, it is likely that at least in the case of Turkey and Poland economic activity moves back above un**potential over the course of 2011.** We acknowledge a significant margin of error surroding output gaps globally and as well as more specifically within CEE given the uncertainty on the outlook for capital flows and the potential need for a re-orientation of some countries' 'business models.' In gauging the size of output gaps, we draw off a few estimates. Firstly we run a simple Hodrick Prescott filter on quarterly GDP data, available until Q3-10. This estimate suggests that output gaps in Czech, Poland and Turkey, as well as Hungary and Estonia, lie within 2pp of potential GDP as of end-Q3 and in most cases are significantly tighter than was the case a year ago. We also examine capacity utilization in industry against its long term average. As of Q4 capacity utilization in Poland and Turkey is now above its long term average while in Czech Republic slack has tightened significantly over the past 4 quarters. To the extent that industry led the recovery, any estimates of actual output versus potential likely overestimate that for the economy as a whole but do capture the trend. Central bank estimates are broadly in line. In Poland the NBP expects economic activity to move moderately back above capacity next year from just below potential this year. In Turkey the

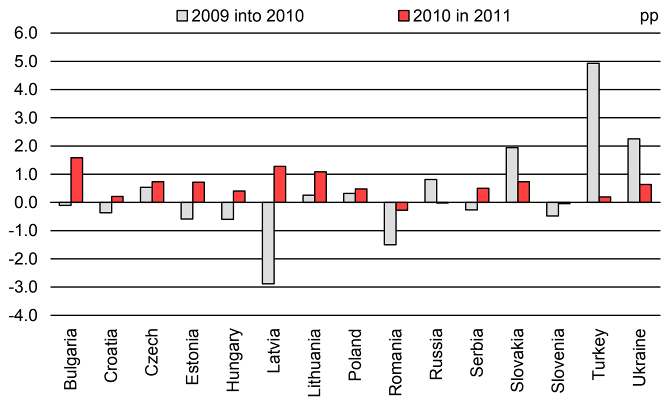
[1] For new EU countries data refers to set from Eurostat, with long term average based on Q1-00 to Q4-10. Time series from Turkey is based on central bank data but is only available from Q1-07.

CBT expects the output gap to close by Q1-12 but sees it within 1pp of GDP from Q2 next year (-6pp of GDP at end-09). In Czech the CNB expects the output gap to turn positive only by the end of 2012 as fiscal consolidation mutes the recovery next year.

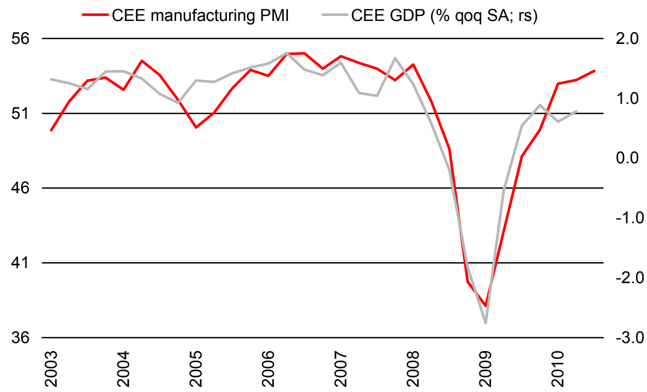
In Russia and the Balkans, GDP will remain well below its pre-crisis peak even at the end of next year

More slack remains in other economies, though their high degree of reliance on foreign borrowing and credit growth prior to the crisis means that the size of output gaps is uncertain. In Russia we expect GDP growth of 4.2% next year, compared with an average of 7.6% over 2004-07. In the Baltics we expect a continued recovery but not rapid enough to reassert inflation pressures at this stage. The Balkan economies should finally show full year GDP gains but economic activity still remains well below its pre-crisis peak. As we enter 2011, GDP in Turkey, Poland and Slovakia has recovered to its pre-crisis levels but even by end-2011 GDP in Russia, Hungary, Romania and the Baltics will remain below pre-crisis levels.

Positive carryover for most countries next year, even assuming that Q4 GDP growth not show any QoQ gains



Manufacturing PMIs points to strong finish to 2010 for industry[2]



Source: National statistics offices, UniCredit Research

A more broadbased recovery supported by IP but also a stronger consumer

Industry should remain a key support for the region next year, though its contribution should slow moderately from this year. Most economies in the region showed gains in Q3. As we enter 2011, the PMIs have hit a 53 month high and point to an even better Q4 for the region in terms of economic activity. The new EU countries in particular have benefited from a stronger German recovery as well as higher demand from Asia. CIS should benefit from high and stable, if not higher, commodity prices. We should also see a more broad-based recovery in domestic demand in 2011, not only in the stronger economies, but across the board. Unemployment has peaked in most economies while the recovery in retail sales, though lagging, is beginning to move in line with industrial production gains.

From an accounting perspective, all countries should also benefit from positive carryover next year, i.e. even assuming that in QoQ terms GDP does not show expansion for the 4 quarters of 2011, full year GDP will still be higher than in 2010. In the weaker economies, e.g. Bulgaria, Croatia, the Baltics, the carryover was negative last year but turns positive this year. Turkey and Ukraine have much less significant carryover into 2011 than in 2010.

[2] Our CEE PMI refers to a simple average of Czech Republic, Hungary, Poland, Russia and Turkey.

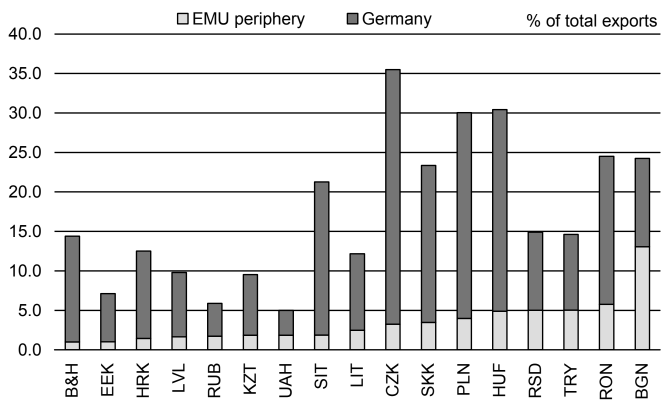
Risks from the peripheral EMU economies are manageable

Most economies in the region are well protected from developments in the periphery. Bulgaria is the exception, with Romania a distant second.

To the extent that we are concerned that the problems in the periphery Euro Area countries will only be meaningfully addressed once markets push the Euro Area to do so, we see the potential for negative news ahead but do not see this as sufficient to derail the recovery in CEE. We identify three channels of contagion:

1. **External demand:** We see the potential for developments in the periphery to derail the recovery in industry and exports in CEE as small in the vast majority of countries. In 2009 only 3.3% of CEE exports were destined for the periphery economies while 15.1% of exports found their way to Germany last year. 4.1% of all exports from the new EU countries went to the periphery last year but Germany accounted for 24.1% of all exports. Bulgaria is the only country in the region where exports to the periphery exceed those to Germany, reflecting close ties with Greece. Romania is a distant second.
2. **Financial flows**: To the extent that there are any banks located in CEE from the periphery of EMU, there is an obvious risk of outflows on that front. For the region as a whole pressures are relatively contained as capital inflows were dominated by larger economies such as Germany, Austria, France and elsewhere. However there are pockets of risk, in particular centered around Greece. BIS data shows that entities in Turkey, Romania, Bulgaria, Poland and Serbia account for 17.6%, 13.7%, 10.1%, 5.0% and 4.2% of all external funding provided by Greek banks respectively. With the exception of Turkey all have experienced outflows. The EBRD appears well aware of the risks, having announced in late October EUR300mn of lending for Greek bank subsidiaries in the region. Risks from Portugal and Spain are more contained with the exception of one investment by a Portuguese bank in Poland.
3. **EMU entry**: The final channel of contagion is the potential for delays to further expansion of the EU and entry into ERM II/EMU. Without doubt the EU is likely to be tougher on new candidates for both. There was already clear evidence of this prior to the crisis. For example Croatia's compliance with the acquis is being much more thoroughly examined than was the case with Romania/Bulgaria. Bulgaria has been refused entry into ERM II despite, at least in theory, the absence of any entry criteria. It was not sufficient for Estonia to meet the fiscal criterion by a narrow margin but by a comfortable margin and show a strong track record before its entry into EMU in January was confirmed.

Exports to Germany of much more importance than exports to periphery



% of funds lent by developed country banks abroad to CEE

	Germany	Greece	Portugal	Spain
Bulgaria	0.1	10.1	0.0	0.0
Czech	0.3	0.0	0.0	0.0
Estonia	0.0	0.0	0.0	0.0
Hungary	0.9	0.1	0.3	0.1
Latvia	0.1	0.0	0.0	0.0
Lithuania	0.1	0.0	0.0	0.0
Poland	1.7	5.0	8.6	0.3
Romania	0.1	13.7	0.4	0.0
Slovakia	0.1	0.0	0.1	0.0
Slovenia	0.1	0.0	0.0	0.0
B&H	0.0	0.0	0.0	0.0
Croatia	0.1	0.1	0.0	0.0
Kazakhstan	0.1	0.0	0.1	0.0
Russia	0.9	0.5	0.1	0.2
Serbia	0.0	4.2	0.0	0.0
Turkey	0.6	17.6	0.5	0.0
Ukraine	0.1	1.4	0.0	0.0

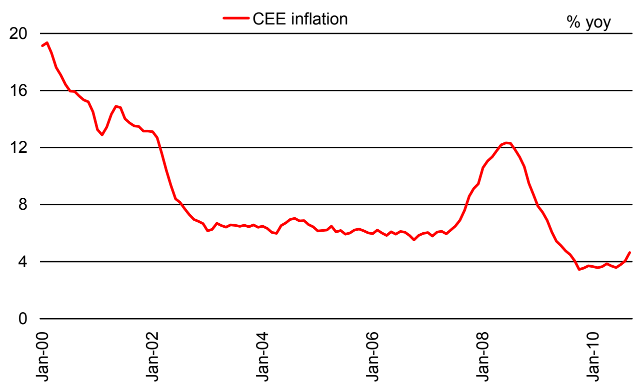
Source: National statistics offices, UniCredit Research

Meeting inflation targets in 2011 is tougher than this year

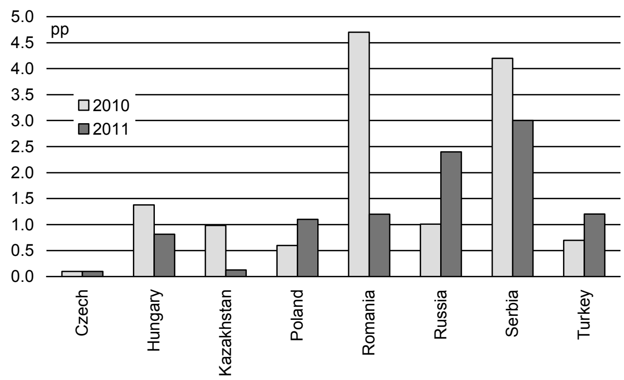
A number of countries look set to exceed inflation targets next year

Meeting inflation targets in a number of countries next year looks problematic. We expect average inflation in Hungary, Kazakhstan, Poland, Romania, Russia, Serbia and Turkey to be above target next year due a combination of factors. These include lackluster currency performance, higher global food prices over recent months, higher oil prices, as well as domestic factors such as VAT hikes in Poland (Jan-11) and Romania (Jul-10), sectoral taxes in Hungary and rapid money supply growth in Russia. Evidence of this has already begun to emerge over recent months as inflation in the region ticks higher, albeit from a record low level. Fortunately to date there is little evidence that higher headline is infiltrating core or services inflations.

Inflation is ticking up but from a record low rate



End of period inflation less inflation targets (mid point): Turkey and Russia amongst overshooters next year



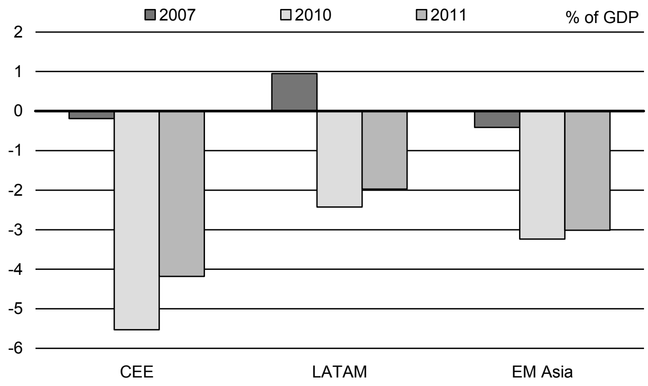
Source: National statistics offices, Unicredit Research

Fiscal moves in the right direction but still some work to be done

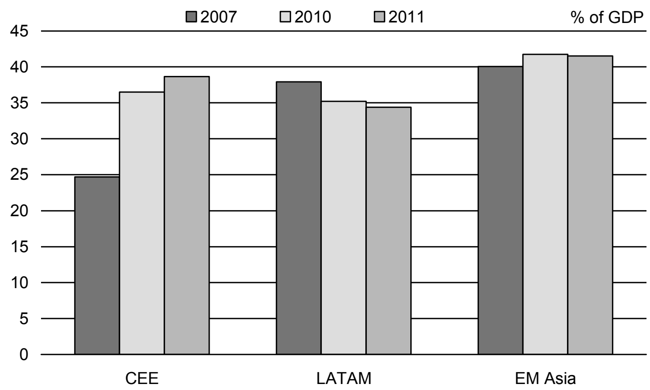
Budget deficits are wider than other EM regions but public debt is broadly in line

Budget deficits in the region continue to consolidate but on the whole remain wider than in other emerging market regions and pre-crisis ratios. From an average budget deficit of 7% of GDP in 2009, this year budget deficits in the region should average 5.4% of GDP before narrowing to 4.7% of GDP next year. Public debt on the whole will continue to rise next year but remain broadly in line with other emerging market regions at less than 40% of GDP. Eurostat estimates show structural budget deficits next year for the new EU countries on average 1.5pp of GDP wider than in 2007. Romania is an outperformer, showing an improvement of 1.5pp over 2007-11 while Poland is an underperformer, showing a deterioration of 3.0pp of GDP over 2007-11. To the extent that Eurostat estimates structural budget deficits next year in excess of the EMU periphery average (5.9% of GDP) in Poland, Latvia and Lithuania, further consolidation ahead is required in some cases to return public debt to a more sustainable path.

More work to be done on budget deficits in CEE than elsewhere



Public debt to GDP has caught up with other EM regions but remains low

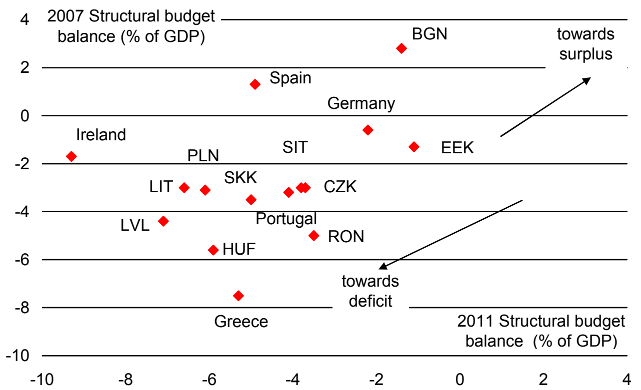


Source: IMF, UniCredit Research:

Watch out for the Excessive Deficit Procedure in the new EU countries next year

	2004	2005	2006	2007	2008	2009	2010
Bulgaria	1.6	1.9	3	0.1	1.8	-3.9	-4.5
Czech	-3	-3.6	-2.6	-0.7	-2.7	-5.9	-5.3
Estonia	1.6	1.6	2.5	2.6	-2.7	-1.7	-1.3
Hungary	-6.4	7.9	-9.3	-5	-3.8	-4	-3.8
Latvia	-1	-0.4	-0.5	-0.3	-4.1	-9	-8.6
Lithuania	-1.5	-0.5	-0.4	-1	-3.3	-8.9	-8.1
Poland	-5.4	-4.1	-3.6	-1.9	-3.7	-7.1	-7.9
Romania	-1.2	-1.2	-2.2	-2.5	-5.4	-8.3	-6.8
Slovakia	-2.4	-2.8	-3.5	-1.9	-2.3	-6.8	-7.8
Slovenia	-2.2	-1.4	-1.3	0	-1.7	-5.5	-6

In many of the new EU countries there is still plenty of work to be done on structural budget deficits



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

Turkey outperforms

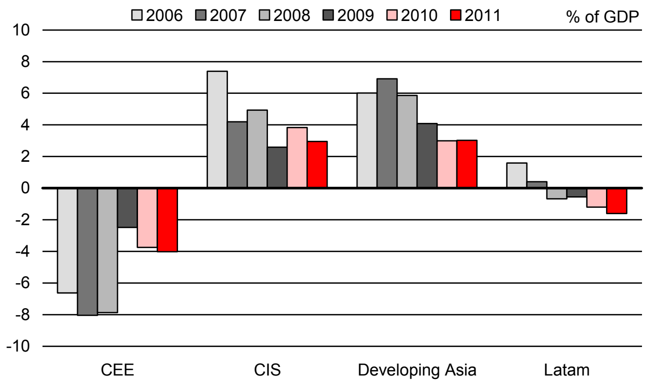
Turkey is a clear outperformer this year. Over the first 10 months of the year the deficit was half that for the same period in 2009. The fiscal rule has been put on hold while some pre-election spending is a risk over the first half of next year but for now the deficit continues to narrow. Efforts in Bulgaria, Estonia, Czech and Slovakia to narrow deficits are commendable and in Czech and Slovakia include reductions to the public sector wage bill. To the extent that Ukraine and Romania remain under IMF supervision, budget deficits continue to move in the right direction also here.

In Croatia, Poland and Hungary there is more to be done

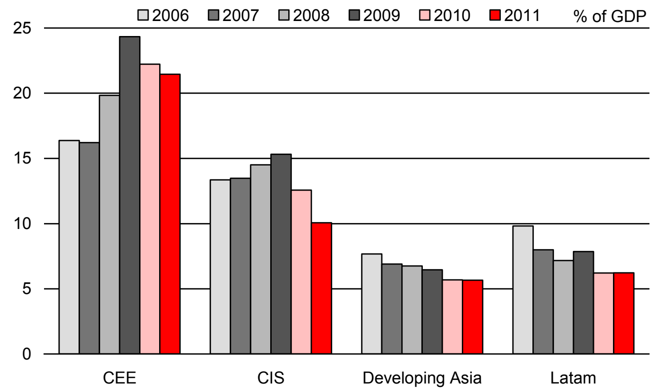
Trends in Croatia, Poland and Hungary are of more concern and all three risk repercussions under the excessive deficit procedure. In Hungary the government has reversed the second pillar pension system in full, abandoned the fiscal council and put in place a series of taxes on various sectors which risk constraining the recovery over the medium to long term, discouraging FDI and damaging potential growth. In Poland the government faces an increasingly difficult balancing act between maintaining a wide fiscal deficit while at the same time trying to continue to encourage foreign investors into its domestic debt market. Croatia is the only (essentially/more or less) fixed currency country in the region since the crises which has not managed to reign in its deficit at least partially (when one accounts for various off-budget items). Assuming completion of EU accession talks during 2011, Eurostat will soon start insisting that the various below the line items are brought back above the line and properly accounted for.

C/A BALANCES HAVE CONSOLIDATED BUT FINANCING REQUIREMENTS REMAIN HIGHER THAN ELSEWHERE

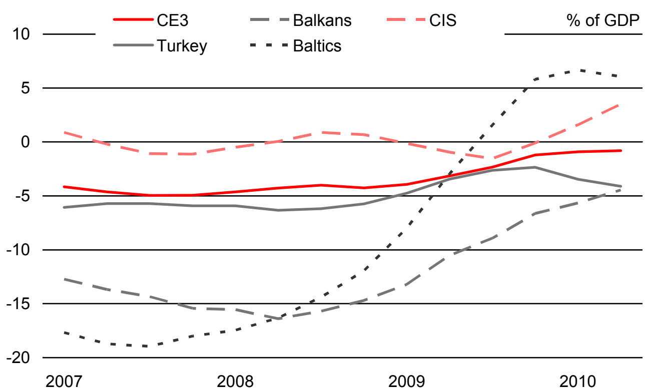
CEE remains the primary C/A deficit region in EM



Higher indebtedness means a higher external debt service (interest & amortization) for CEE



C/A balances across CEE



Only some countries want to roll IMF programmes

	Date of arrangement	Expiration	Total amt. agreed	Undrawn balance	IMF credit outstanding under GRA
Bosn & Her	8-Jul-09	30-Jun-12	1.34	0.81	0.54
Hungary	6-Nov-08	5-Oct-10	16.1	4.4	11.7
Iceland	19-Nov-08	31-Aug-11	2.1	1.0	1.2
Latvia	23-Dec-08	22-Dec-11	2.3	1.0	1.4
Romania	4-May-09	3-May-11	17.2	3.6	13.6
Serbia	16-Jan-09	15-Apr-11	4.0	2.1	1.9
Ukraine	28-Jul-10	27-Dec-12	15.1	13.3	12.5

Source: IMF, national central banks, UniCredit Research

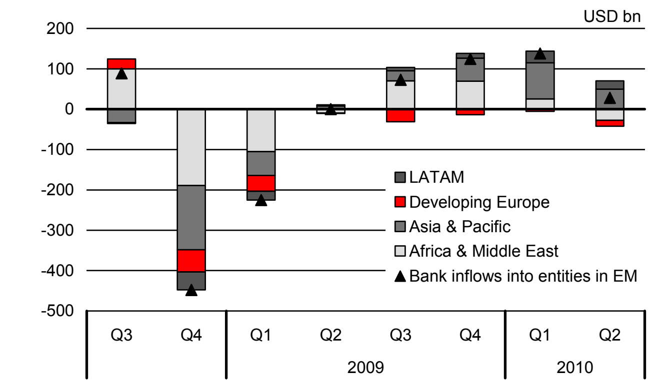
C/A balances have consolidated

From an external perspective CEE does not stack up well relative to other EM regions globally but C/A deficits have improved significantly. The CEE region will run a C/A deficit of 4.0% of GDP next year, half of its pre-crisis ratio and moderately wider than last year. This compares to a C/A surplus of 3.0% of GDP in developing Asia and a deficit of 1.6% of GDP in LATAM. The C/A surplus in CIS should narrow a little to 3% of GDP. The combination of wider deficits and higher levels of gross external debt translate into higher external debt service relative to other regions globally. Interest and amortisation in the CEE region next year stands at 21.5% of GDP, though down slightly from this year. In the CIS region it is a more manageable 10.1% of GDP. In developing Asia and LATAM these ratios stand at 5.7% and 6.2% of GDP respectively.

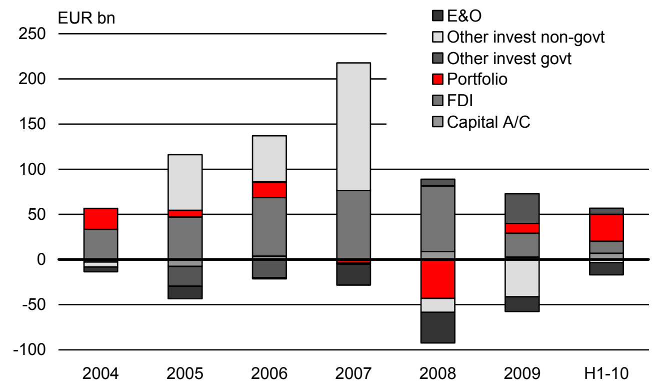
Within the region Turkey and Poland lead the C/A widening trend. In Russia the C/A should narrow to 3.0% of GDP, its tighest since 1998. Within the smaller economies, C/A surpluses have peaked out in the Baltics. Hungary's current account also continues to register a modest surplus. The Balkans remain the outliers. Bulgaria, Romania and Serbia continue to post C/A deficits of 5% of GDP or more, though these have narrowed significantly from double digit deficits.

EXTERNAL FLOWS: WATCH FOR THEIR COMPOSITION

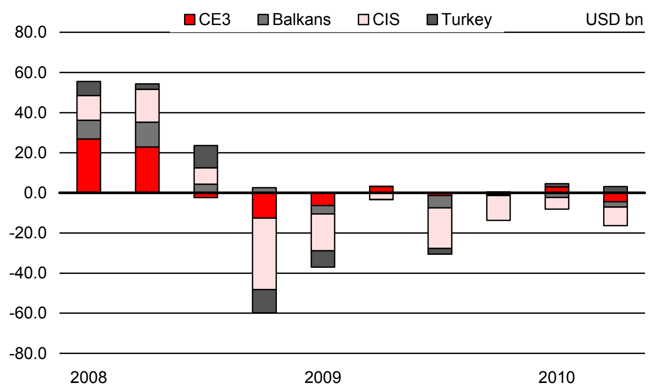
Foreign banks continue to show little willingness to invest in entities in CEE in contrast with Asia and LATAM



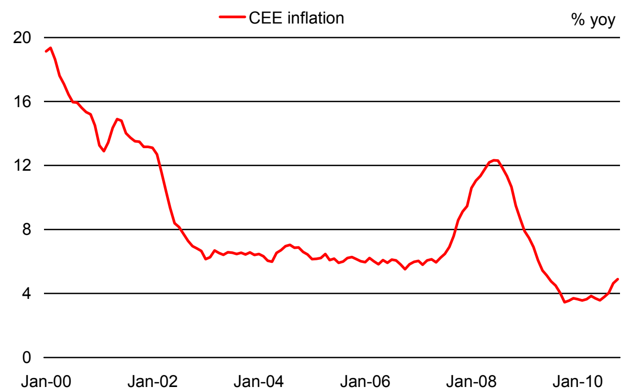
Portfolio flows dominate capital inflows to the region



Foreign bank lending to entities in CEE: Turkey outperforms, Russia underperforms



Little sign of FDI to the region accelerating



Source: BIS, national central banks, UniCredit Research

Capital inflows lag other EM regions

Going forward the pace of recovery in capital inflows will be central to determining C/A trends and gains in economic activity in the region. During the crisis all EM regions experienced outflows. Asia and LATAM have since enjoyed a recovery but CEE lags, as per the first chart above. BIS data shows bank inflows into entities in emerging market countries of USD 166bn over H1-10 but outflows from developing Europe of USD20bn over the same period. Inflows were concentrated primarily in Asia, followed by LATAM.

Inflows YTD have been mostly portfolio flows

To date the recovery in capital inflows in CEE has been dominated by portfolio flows. Compared with inflows of EUR19bn for 2009 as a whole, over H1-10 CEE saw inflows of EUR 40bn, i.e. on an annualized basis capital inflows over H1 quadrupled. Portfolio inflows account for 75% of the total and are concentrated in a few countries. FDI has yet to show any real signs of recovery, as is also the case with bank inflows.

Some countries see more than their fair share, others lag

The recovery in capital inflows is concentrated in only a couple of countries. Poland and Turkey have been the primary destination for inflows. For example foreign holdings of domestic government debt in Poland have risen by EUR 16.7bn and EUR 10.6bn since end-08 and end-09 respectively to reach EUR 28bn. Turkey has also seen an increase in foreign holdings of domestic debt (up EUR 6.1bn to EUR 18.8bn) since end-08 but inflows into their equity market have been larger – EUR 9.5bn since the start of the year to reach EUR2.6bn. There have also been significant inflows into the Ukrainian domestic debt market. The clear underperformers are Hungary and Russia where foreign banks decrease rather than increase exposure. Foreigners have shown limited willingness to increase their holdings of HGBs while in Russia locals take funds offshore. The Balkans have yet to see a renewal of inflows, though a recovery in economic activity this year bodes well for some improvement at least. Outflows by Greek entities remains a risk though the EBRD recently announced an EUR300mn facility for subsidiaries of Greek banks active in the CEE region.

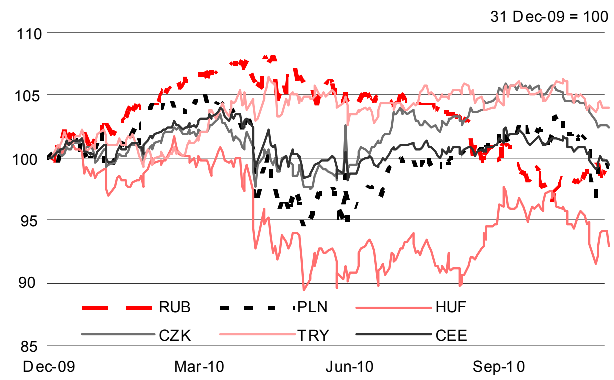
There are reasons to be optimistic on 2011. Our global scenario points to a continued recovery in both Germany and Asia. Germany is a key source of FDI for the new EU countries while capacity utilization in industry in Germany has shown a strong recovery. FDI to the new EU countries should follow suit. Some countries in the region have also been successful in growing their export base in Asia. To the extent that higher commodity prices encourage not only improved trade balances but also higher capital inflows, the CIS should also benefit. That said we see a risk that some countries, albeit a smaller number, continue to lag. Hungary is an obvious example where government policy risks keeping investors on the sidelines. The stronger economies, i.e. Poland and Turkey, must not only manage inflows but also remain alert to the risk of rapid outflows in the event of a sharp turn in risk appetite.

Monetary policy heading towards tightening mode

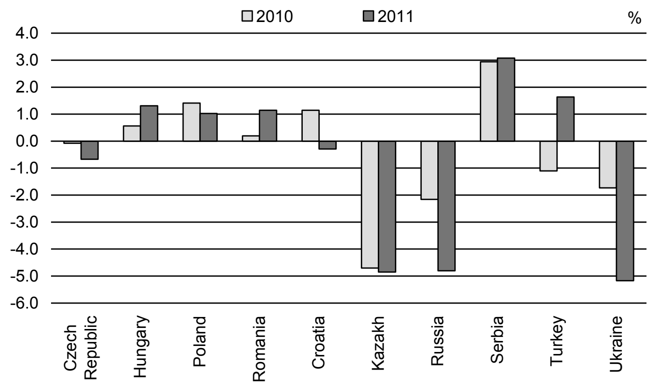
Rate hikes ahead

With output gaps narrowing, if not moving into positive territory and inflation being pushed moderately higher, a number of central banks in the region are likely to gradually tighten rates from here. With the exception of Czech and Turkey, nominal effective exchange rates look set to finish the year weaker than at end-09 and have done little to help central banks in tightening monetary conditions. Rates currently stand at record lows, with CIS standing out in terms of negative real rates and in the absence of rate hikes next year will continue to run negative rates of approximately 5%. Czech is also running negative real interest rates and looks set to continue to do so into next year in the absence of rate hikes.

With the exception of Czech and Turkey, nominal effective exchange rates finish the year stable to weaker



Average real interest rate assuming 3m interbank rate unchanged from here



Source: Bloomberg, National central banks, UniCredit Research

Hungary and Serbia have already initiated hiking cycles

To date we have seen rate hikes only in some of the weaker economies in the region. Despite lackluster growth, higher inflation and currency weakness has pushed Serbia to hike rates 350bp since August. In November Hungary initiated a hiking cycle to combat another round of upward revisions to its inflation projection, though once again against a very weak growth backdrop. At this stage both central banks look likely to push ahead with further hikes, though a peak in inflation in Q1 in Serbia should also mark the peak in rates next year. Privatisation of Telekom Srbija or renewal of the IMF programme could also help support RSD and in turn tighter monetary conditions. One of the largest policy risks faced by Hungary next year is the replacement of 4 of the monetary council's 7 members. In the event that PM Orban appoints all 4 (rather than Governor Simor and PM Orban appointing two members each), we could well see an aggressive reversal of the hikes currently underway, threatening HUF stability.

Russia and Poland should do so by end-Q1 at the latest

Russia and Poland look set to follow next with hikes. In Russia we are expecting the CBR to hike rates by 150bp by end-Q1 next year, with the first hike to materialize potentially by year-end. At its last rate meeting the Bank did not state that monetary policy would remain supportive 'for the nearest months' unlike previous decisions. November's PMI data pointed to acceleration in price pressures while there has been a sharp decline in bank deposits at the CBR – these are now at their lowest level since Oct-09 - reflecting a recovery in bank lending. In Poland the only element missing to generate a rate hike is wage pressure. Last week saw Q3 GDP surprise on the upside at 4.2% YoY (1.3% QoQ) – in the past the MPC has been much more likely to hike once real GDP growth exceeds 4.0% YoY. Inflation expectations last month surprised on the upside while inflation is in the upper end of the NBP's 2.5% +/-1% target band. The NBP seems concerned about the potential for excessive PLN appreciation should it hike but the currency has performed poorly this year. Continued moderate wage growth supports the doves, at least for now, but that could also come under pressure as German labour markets are opened up to new EU countries in May next year. We see scope for the NBP to act by end-Q1.

Turkey and Czech will probably do so later

In Turkey 2011 will be a key test for the CBT. More than any other central bank in the region, it is clearly concerned about balancing inflation targetting against managing capital inflows. Headline inflation is on a downward trend as we enter Q1 while core inflation is close to record lows. That said the economy has recovered rapidly while the pace of widening of the C/A deficit shows strong domestic demand pressures which can pose an upward risk to inflation over time. While the CBT is limiting TRY gains with its intervention policy, this is not being fully sterilized and as a result the CBT's balance sheet continues to expand. More fundamentally this cycle provides the CBT with an opportunity to move ahead of the curve and establish its inflation targeting credentials. However the timing of the first hike is complicated. The CBT has floated the option of a near term rate cut to moderate capital inflows. The MPC is unlikely to initiate a tightening cycle before April due to the replacement of the central bank governor. Should the government drag its feet on announcing a replacement, it will risk a repeat of Apr-06 given the extent of portfolio inflows into Turkey over recent quarters. We cannot exclude that the general election in June also influences the timing of any rate moves. Our baseline is that the CBT does not push ahead with a rate cut, though this is a clear risk. We forecast the first rate hike in Q4 next year but the risks are weighted towards an earlier move. **From an output gap or inflation perspective, the case for a hike in Czech is weaker,** particularly given planned fiscal consolidation next year. That said at least some CNB board members seem concerned about the need to 'normalise' rates given that the currently stand at 0.75%, 25bp below the ECB.

Re-building the business model

Each country will be judged on its merits from here

The crisis of 2008-09 brought into question the CEE's 'business model' and each country is not being assessed much more on its merits than as part of a group. The region can no longer take for granted an endless stream of capital inflow extended at low interest rates while developments since the crisis have removed some key anchors for policy in the region. For example Euro periphery woes will no doubt re-inforce reluctance to expand the EU and Euro Area further. Estonia's entry into EMU has been confirmed for January while Croatia may already have generated sufficient political support for its entry into the EU in late 2012/early 2013. However thereafter we do not see any further expansion of the EU over the course of this decade while we see 2017 as the earliest possible date for acceptance of the next countries into the Euro Area. Hungary and Poland assume the EU presidency in January and July of next year respectively – should they successfully succeed in steering policy during this difficult period for the EU, reluctance towards further expansion may ease. To date however, PM Orban's relationship with his EU counterparts has been strained.

E(M)U EXPANSION: OUR TAKE ON THE EARLIEST POSSIBLE DATE THAT CEE COUNTRIES CAN PUSH AHEAD TO THE NEXT STAGE[3]

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Bulgaria	EU	EU	EU	ERM II	ERM II	EMU	EMU	EMU	EMU	EMU	EMU
Croatia	Acquis	Acquis	EU	EU	EU	EU	EU	EU	EU	EU	EU
Czech	EU	EU	EU	EU	EU	ERM II	ERM II	EMU	EMU	EMU	EMU
Estonia	ERM II	EMU	EMU	EMU	EMU	EMU	EMU	EMU	EMU	EMU	EMU
Hungary	EU	EU	EU	EU	EU	EU	ERM II	ERM II	EMU	EMU	EMU
Latvia	ERM II	ERM II	ERM II	ERM II	ERM II	ERM II	ERM II	EMU	EMU	EMU	EMU
Lithuania	ERM II	ERM II	ERM II	ERM II	ERM II	EMU	EMU	EMU	EMU	EMU	EMU
Poland	EU	EU	EU	EU	EU	ERM II	ERM II	EMU	EMU	EMU	EMU
Romania	EU	EU	EU	EU	EU	EU	EU	ERM II	ERM II	EMU	EMU
Serbia			Acquis	Acquis	Acquis	Acquis	Acquis	Acquis	Acquis	Acquis	Acquis
Slovakia	EMU	EMU	EMU	EMU	EMU	EMU	EMU	EMU	EMU	EMU	EMU
Slovenia	EMU	EMU	EMU	EMU	EMU	EMU	EMU	EMU	EMU	EMU	EMU
Turkey	Acquis	Acquis	Acquis	Acquis	Acquis	Acquis	Acquis	Acquis	Acquis	Acquis	Acquis

Source: UniCredit Research:

3 In determining the earliest possible we made the following assumptions. Firstly though not part of the criteria in Maastricht, we assume that a country will have to run a budget deficit within 3% of GDP for at least 3 years before getting into ERM II. Secondly though not part of the criteria in Maastricht, we assume that any country will be refused entry to both ERM II and EMU until all IMF/EU loans have been repaid. Thirdly once countries join ERM II, a country will spend the minimum period required in there, i.e. as per Slovakia join ERM II mid-year and adopt the Euro 2.5 years later.

Turkey, Poland, Czech and Estonia have shown their ability to bounce back impressively. In Turkey a strong and well regulated banking system helped, in Poland an ability to rely on domestic demand and draw off expansionary fiscal policy (though we are concerned that the government is leaving this in place for too long). Czech benefitted from strong balance sheets and a return of capital onshore by locals while Estonia enjoys a flexible economy and showed an impressive willingness to push through tough fiscal measures.

Other countries in the region still have some work to do before convincingly returning to a sustainable growth path. In Russia the absence of capital inflows casts a question mark over the financing of investment. CBR and government decisions next year will be important in determining whether the government opts to mobilize domestic savings by re-inforcing the inflation targeting framework, in part via FX gains. Alternatively the authorities may opt to maintain a weak RUB to enlarge oil inflows to finance expansion but this strategy will put their inflation target much more at risk. The Balkan economies will finally emerge from recession but more work remains to be done on fiscal policy and other structural issues. In Ukraine the government must continue to show its commitment to narrowing the budget deficit – further gas price hikes and pension reform will be a key test next year. Latvia and Lithuania have made commendable progress but also need to continue to plough ahead on fiscal. Hungary is the one country in the region that has visibly taken large step backwards in terms of reform over recent quarters. 2011 will prove a key test for all of the above economies. Assuming continued efforts by policy makers in the right direction, these lagging economies will be able to narrow the gap between themselves and stronger economies in the region over the coming 12 months.

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CEEMEA strategy: little value left in credit, bearish on rates and bullish on selected FX

Top leveraged trades:

1) Pay 5y Poland CDS
2) Sell 5y Ukraine CDS
3) Sell 5y Sovx CEEME vs. pay 5Y France/Germany CDS
4) Buy Romania Eurobonds vs. local currency bonds
5) Pay 1y RUB CCS
6) Pay 1y-5y PLN IRS
7) Pay 1y-5y TRY CCS
8) Sell EUR/CZK
9) Sell USD/UAH
10) Sell USD/KZT
11) Long RUB vs. basket

Potential tactical trades:
1) Sell EUR/PLN on spikes
2) Sell USD/TRY on spikes
3) Receive HUF rates/buy HGBs on potential policy change after intensifying market/rating pressure

- **The solid 2010 EM sovereign credit performance is unlikely to be repeated in 2011.** We are anticipating a further steepening of the US Treasury curve, which in recent months has had an adverse impact on EM credit performance. At the same time, inflows into EM bond funds should remain strong and supportive for credit spreads, but the incremental improvement from here is limited. Given that the EMU core has been a more important driver of CEE credit than the EMU periphery, we would look to hedge CEEMEA credit exposure by core EMU positions. On the back of that, we anticipate a narrowing of the spread between Sovx CEEMA and core EMU. Although CEEMEA credit is cheap vs. its rating within the EM universe, adding EMU periphery countries and fundamental variables modifies the picture significantly, with only Ukraine standing out as being cheap. We remain sellers of 5y Ukraine CDS and recommend paying 5y Poland CDS on our concerns regarding the fiscal stance of the government.

- The timing of monetary tightening by CEE central banks is a key point; we see more and more **countries opting for rate hikes during 2011, something that would also diminishing the case for duration exposure in the CEEMEA universe**. We see only Hungarian and South African real rates close to attractive levels, however, in the former significant policy risks make the case less compelling for the moment. As the Polish and Turkish yield curves are already pricing significant rate hikes we see some scope for a dovish surprise pushing these curves steeper. We continue to see value in paying RUB rates on an outright basis, given the anticipated monetary tightening and declining liquidity in the banking sector.

- **FX should deliver most of the total return in 2011:** CEEMEA currencies are not cheap compared to LatAm and Asia, therefore we would play this story selectively. We see CZK outperforming CEE peers given the very close links to an outperforming Germany and the likely widening rate differential vs. the EUR. We would play long PLN and TRY only tactically, given that we see some risk of dovish surprises vs. market expectations and some policy risks in both. We remain on the sidelines with HUF and RON, given fiscal risks in the former and the scope for a returning easing cycle in the latter. We are strategically long CIS currencies with the main arguments being supportive forward pricing, relatively cheap valuation and likely higher rates.

Sovereign credit is not an attractive asset class in 2011

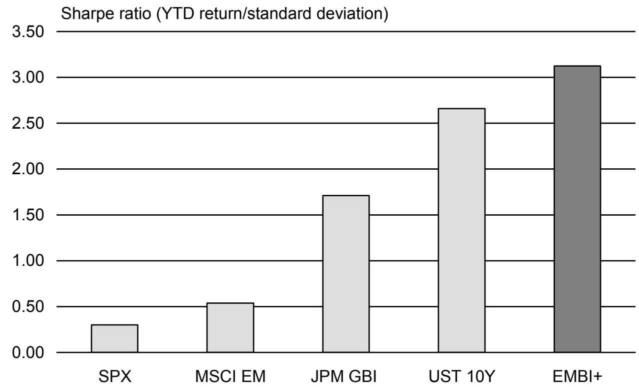
EM sovereign debt has been the best performing asset class in 2010

This will unlikely be repeated in 2011

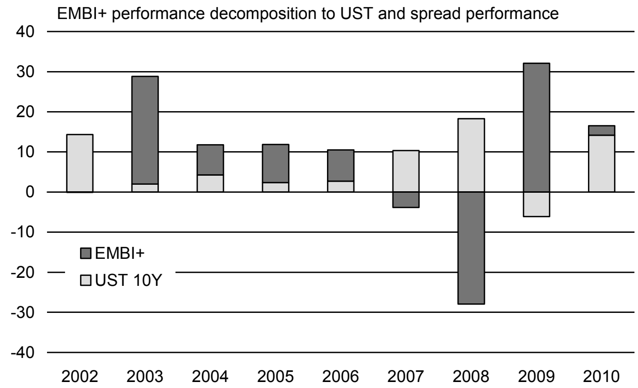
The good news is that EM sovereign debt has been the best performing asset class in 2010. It delivered YTD 16.5% profit, vs. 11.75% by EM equities and 12% by EM local currency debt. Moreover, the volatility of this return has been the lowest, which has resulted in the highest Sharpe ratio (return/volatility) among all asset classes (chart). The bad news is that we do not think that this performance could be repeated in 2011. We note that more than 85% of the return has come from the significant fall in UST yields (90bp in 10Y UST YTD) while the contribution from credit spread tightening was relatively low. Indeed, looking at individual countries one can notice that apart from Ukraine (-450bp in 5Y CDS) the credit spread of other countries has hardly tightened during the year. We also note that this is in stark contrast compared to 2009 when tighter credit spreads were the sole drivers of the EMBI+ performance (chart). As UST yields are unlikely to move significantly lower from here, we do not think that EM debt could remain the top performing asset class in 2011.

THE 2010 EMBI PERFOMANCE IS UNLIKELY TO BE REPEATED IN 2011

EMBI has been the best performing asset class in 2010



UST has been the sole driver of EM debt performance in 2010*



*We get performance decomposition by deducting 10Y UST total return from EMBI+ total return

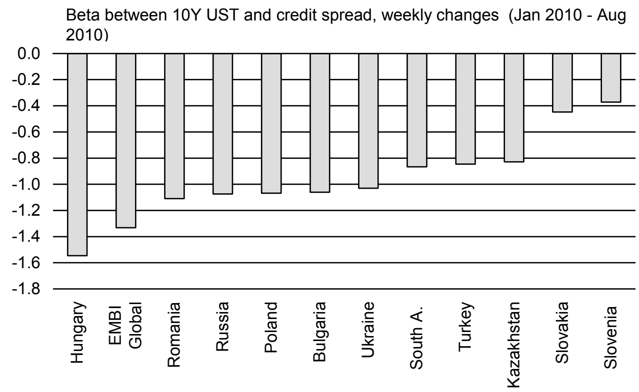
Source: Bloomberg, JPM, UniCredit Research

The relationship between UST yields and CEEMEA credit spreads has been negative in 2010

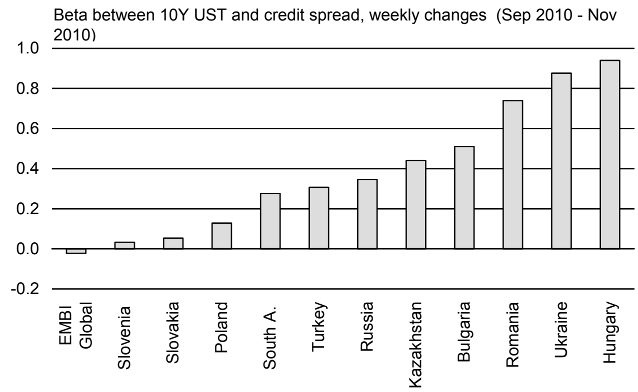
Although UST duration performance was the key driver of EMBI total returns in 2010, their day to day impact on credit spreads has been negative. Looking at the relationship between the credit spreads and UST yields reveals that the correlation was negative during the first nine months of the year (the average beta between the weekly changes of 5Y CEEMEA CDS spreads vs. 10Y UST yields has been around negative 1.00, chart). Moreover, we note that in the fourth quarter when long-end UST yields started to increase, the beta turned positive (i.e. higher yields led to wider credit spreads, see chart). The 4Q swing in the correlation suggests that from a mark-to-market perspective the UST would hardly support credit spread tightening during 2011. From a portfolio perspective we believe this (albeit changing) relationship could make EM sovereign debt a relatively unattractive asset class particularly compared to EM equities.

UST YIELD CHANGES HAD AN UNFAVOURABLE CORRELATION WITH EM SPREADS

Relationship vs. UST when yields were falling



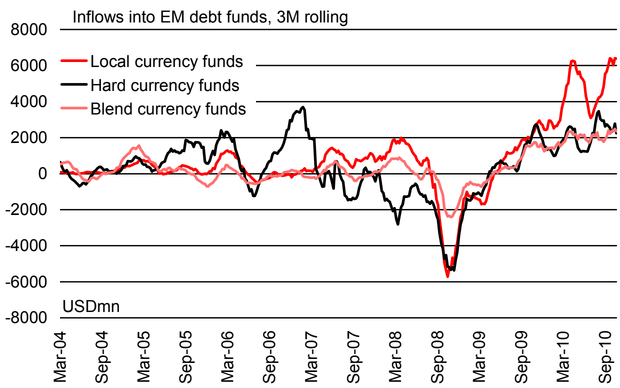
Relationship vs. UST when yields were increasing



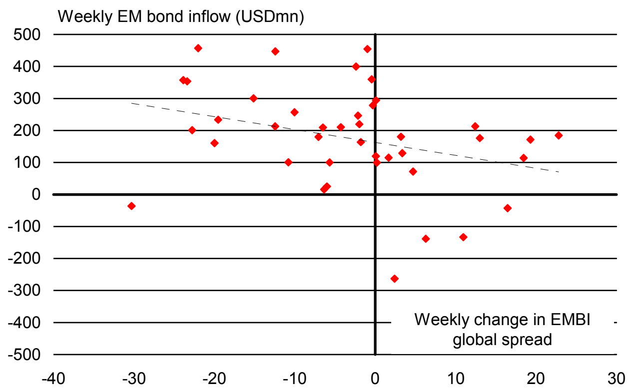
Source: Bloomberg, UniCredit Research

FUND FLOW BACKDROP HAS BEEN SUPPORTIVE

Inflows into EM bond funds were exceptionally strong in 2010…



…which contributed to some spread tightening



Source: EPFR, Bloomberg, UniCredit Research

But strong inflows into EM bond funds "protected" spread levels

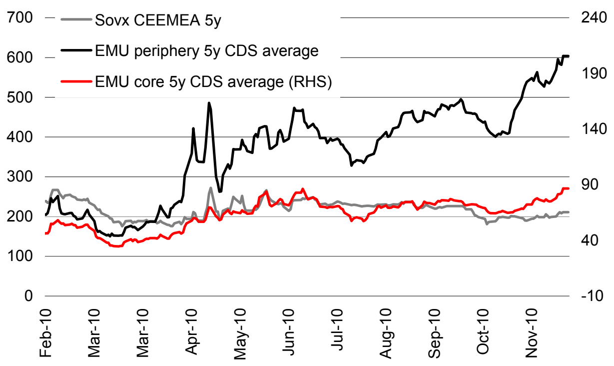
Although the relationship between the UST and EM credit spreads has been negative, the exceptionally strong inflows into EM local and external bond funds had a positive impact. In 2010 dedicated EM local currency bond funds received inflows of USD 18bn while hard currency funds received inflows of USD 8.3bn. Although it might look surprising that these huge inflows (see chart) did not push spreads tighter, we believe that with the negative headwind from UST, these inflows were "only" enough to stabilize credit spreads at the current levels (the chart above shows that the relationship between inflows and spreads has only been marginally positive in 2010). Looking at 2011 we believe that inflows could remain strong but they are unlikely to accelerate much more from the current levels, meaning less support against any potential further UST headwind.

Although EMU periphery has been in focus, EMU core credit has been a more important driver of CEEMEA credit performance

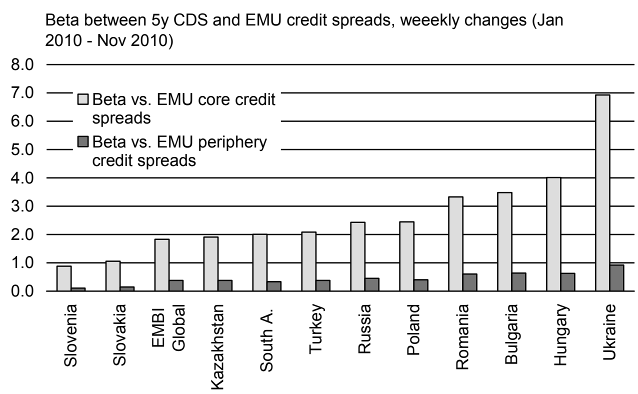
There has been a lot of focus on EMU periphery contagion during the whole year but the CEEMEA credit spread is now only one third of the EMU periphery spread level (see chart). Although many market participants argued that the correlation between CEEMEA credit and EMU periphery increased during 2010, we note that the beta between these remained fairly low during the whole year and averaged only 0.5. From a hedging and contagion perspective, we believe it is more important to focus on the correlation between CEEMEA and core Eurozone sovereign credits, where the relationship is much stronger (see chart). For example, in the cases of Ukraine and Hungary the betas vs. the Eurozone core credit spreads are significantly higher than the same measure vs. EMU periphery credit. We believe the stronger correlation vs. EMU core credits fits nicely with the view that from a trade linkages perspective the growth developments in the core countries are much more important (apart from Bulgaria, which has a disproportional trade relationship with Greece). Moreover, this also underscores that CEEMEA credit could only come under meaningful pressure if general credit conditions in the whole EMU deteriorate. The investment implication of this is fairly simple, in our view: it makes much more sense to hedge existing CEEMEA credit exposures through buying CDS on EMU core sovereign names. Accordingly, although we are not positive on EM debt from a total return perspective, we believe that the spread between CEEMEA and the EMU core could tighten further during 2011. We hence recommend **selling 5Y Sovx CEEMA vs. buying 5Y CDS of France, Germany at a 110bp spread and targeting 50bp. Given our bearish view, we would not be outright long in CEEMEA credits.**

EMU DRIVERS: EMU CORE HAS BEEN A MORE IMPORTANT DRIVER THAN EMU PERIPHERY

CEEMEA significantly outperformed EMU periphery credits



EMU core has been a more important driver than EMU periphery



Source: Markit, Bloomberg, UniCredit Research

Several credit spreads look cheap vs. ratings, but not if fundamental variables and EMU periphery are added to the model

The Ukraine spread remains about 100bp wide in the extended model

Given fiscal-related risks we pay 5Y Poland CDS

CEEMEA rating dynamics have been positive and we see them staying supportive in 2011. We expect positive rating actions in Turkey, Romania, Ukraine, the Baltic countries and – depending on the EU membership progress – Croatia. On the other hand, we see room for negative rating actions in Hungary and Poland (for further details, see the separate table). Although the generally positive rating dynamics could provide further room for credit spread tightening, we continue to see significant dislocations between the credit rating and credit spreads within the CEEMEA universe (for example, the 5Y Hungary CDS is trading 50bp wider than Romania despite a 1-2 notch difference in ratings; the Turkish credit spread is pricing in about a 3-4 notch upgrade). Accordingly, we think it makes sense to add further variables to the simple rich/cheap analysis.

As such we modified the simple rating versus CDS model with fundamental variables (by adding GDP, public sector deficit and current account deficit as explanatory variables). The explanatory power of this model improves significantly (R^2 increases to 0.58 from 0.35). We applied this extended model not only to the EM universe but also added several EMU periphery countries. The results are shown in charts below (simple rating vs. CDS and extended model with fundamental variables and EMU periphery countries). In the extended model, only Ukraine remains about 100bp wide vs. its fair value, while Hungary, Turkey and Poland move closer to their fair value. Conversely, this model shows Croatia, Romania and Bulgaria too tight vs. their fair value. In our view, this underlines that from a fundamental perspective CEEMEA sovereign credit is not cheap within the EM universe. Accordingly, we would remain careful with adding new outright bullish positions, even though ratings would appear to justify it. As Ukraine remains cheap in the extended model, **we remain sellers of 5Y Ukraine. Given our concerns regarding the Polish fiscal outlook (see the economic part of this publication), we also recommend paying 5Y Poland CDS (either against the Ukraine trade or on outright basis)**

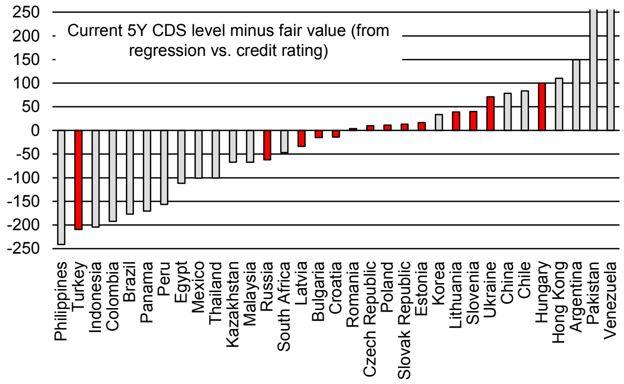
UCG credit real money portfolio allocation vs. benchmarks

CZK	M/W
BGN	U/W
HRK	U/W
HUF	M/W
KZT	M/W
LVL	M/W
LTL	O/W
PLN	M/W
TRY	M/W
RON	O/W
RUB	M/W
UAH	O/W

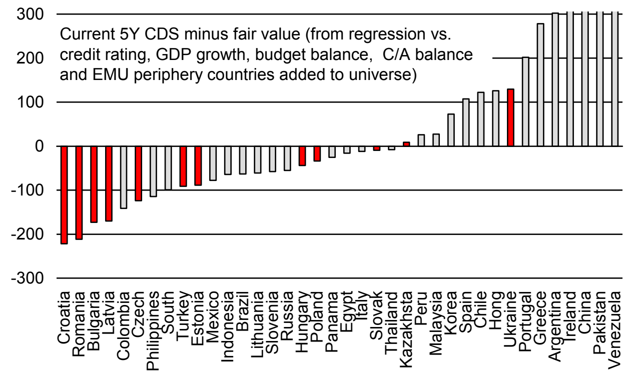
M/W: market weight
U/W: underweight
O/W: overweight

CEEMEA SOVEREIGN CREDIT DOES NOT LOOK CHEAP IF FUNDAMENTAL VARIABLES ARE CONSIDERED

EM CDS vs. credit rating: some CEEMEA look cheap



But adding fundamental variables and EMU periphery countries changes the picture



Source: Bloomberg, UniCredit Research

External debt is cheaper than local currency debt

Local currency bonds are expensive compared to Eurobonds

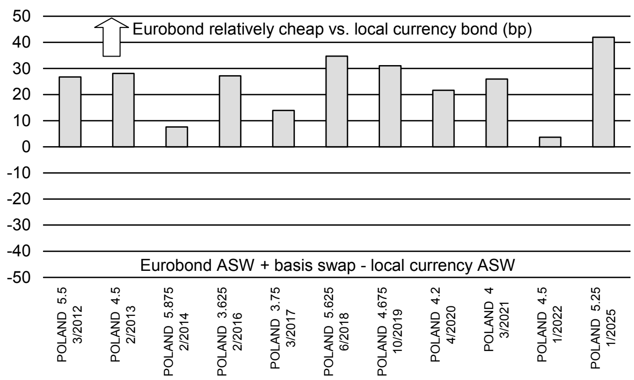
Local currency vs. external debt: as local banking sectors in several CEEMEA countries are still lacking hard currency liquidity, the cost of hedging FX risk is still relatively expensive. This is particularly evident when one compares the spread of FX-hedged local currency debt vs. the ASW spread of similar maturity hard currency bonds. Our calculations show that CEEMEA Eurobonds are cheap compared to the FX-hedged local currency bonds in all countries (see charts). The biggest divergence is observed in Romania where the 2015 and 2018 Eurobonds are about 100-150bp cheaper than their local currency counterparts. The additional implication of this comparison is that if one chooses to invest into local currency bonds it does not make sense to hedge the FX exposure. **Investment implication: although EM debt is not attractive from an absolute return perspective, CEEMEA Eurobonds are still attractive in relative value terms vs. the local currency paper. This will likely see these spreads gradually diminishing during the year. As long-end Romanian Eurobonds still look particularly cheap compared to ROMGBs, we continue to recommend switching out of local currency paper. We also see several REPHUNs about 70-80bp cheaper than local currency bonds.**

Romania 2015 and 2018 is about 100-150bp cheaper

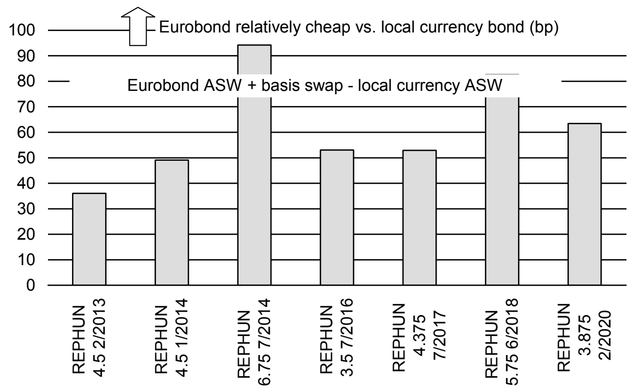
Several REPHUNs are also significantly cheaper than LC bonds

EUROBONDS ARE CHEAPER THAN LOCAL CURRENCY BONDS

Poland Eurobonds vs. FX-hedged local currency bonds

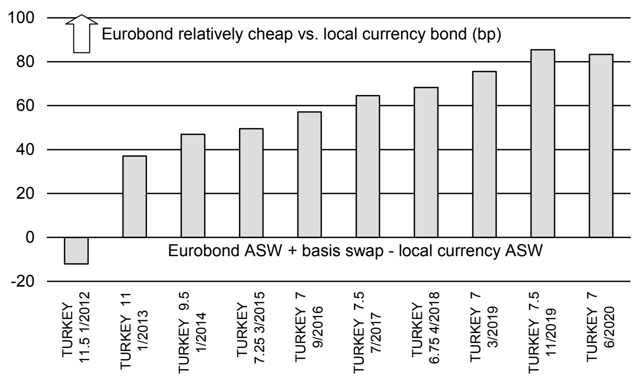


Hungary Eurobonds vs. FX-hedged local currency bonds

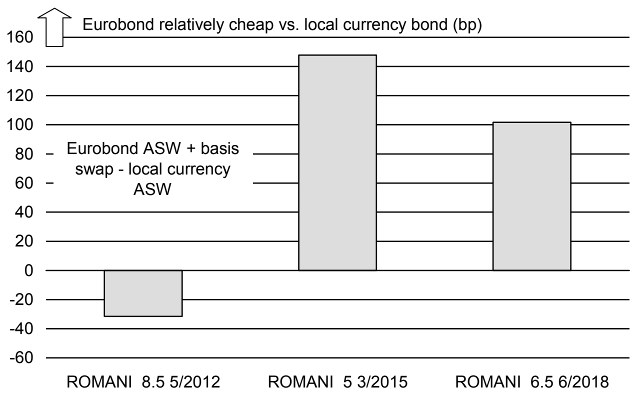


Source: UniCredit Research

Turkey Eurobonds vs. FX-hedged local currency bonds



Romania Eurobonds vs. FX-hedged local currency bonds



Source: Bloomberg, UniCredit Research

Local backdrop to turn bond unfriendly in 2011

Higher policy rates vs. low level of real rates makes duration exposure unattractive

UniCredit policy rate forecast

	Current	12M UniC	12M FRA
CZK	0.75	1.50	1.77
HUF	5.50	5.50	6.70
PLN	3.50	4.25	4.95
TRY	7.00	7.75	8.00
RON	6.25	5.50	-
RUB*	5.00	6.50	6.95

*1day repo rate

Apart from the expensive valuation (vs. Eurobonds), we see the local backdrop turning increasingly bond unfriendly in 2011. Even though CEEMEA countries lagged their EM counterparts with rate hikes in 2010, we expect more central banks will opt for higher rates in 2011 amid closing output gaps and increasing domestic demand inflation pressure (with food prices contributing to inflation expectations). We expect Poland to hike rates by 75bp, Turkey by 75bp, Russia by 150bp and Czech Republic by 75bp in 2011. We would also not rule out further hikes from Hungary in the near term, although we also see a dovish turn in March 2011 when four new MPC members are to be appointed, which would provide a majority vs. the governor and two deputy governors. We see only Romania returning to the easing cycle in 2H11 (cutting by 75bp). **From a real yield valuation perspective,** we note that while most EM countries are on the lower end of their historical real yield ranges, some CEEMEA countries are actually on the top end (Hungary and South Africa are currently above their longer-term average, see chart). Adjusting for country risk and FX volatility, we note that Hungary becomes a much less compelling story. That said, we still see that Hungarian rates are close to attractive levels, but first we would like to see stabilization away from the negative newsflow we saw in the last couple of weeks. Given our ratings outlook, we fear that the situation could deteriorate more in the near term before it gets better.

Poland and Turkey could surprise on the dovish side vs. market pricing

Given our outlook for higher rates, we would stick to defensive duration exposure. On the other hand, as yield curves are already pricing in rate hikes from several countries, we believe that there is a risk that some central banks could fall behind the curve, which in turn could lead to steeper yield curves. We believe the most likely candidates for this are Poland and Turkey, where yield curves are pricing in 100bp and 110bp rate hikes over 12M, and this might look excessive. **Given our concerns related to the Polish fiscal outlook, we would play this story through paying 1Y-5Y PLN IRS spread. Following the recent flattening, we also recommend paying 1Y-5Y TRY CCS spreads.**

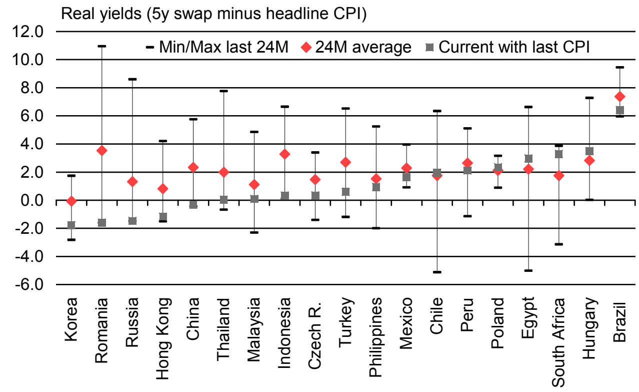
LC duration recommendations

CZK	Short
HUF	Short (to increase on potential policy change)
PLN	Neutral
TRY	Neutral
RUB	Short

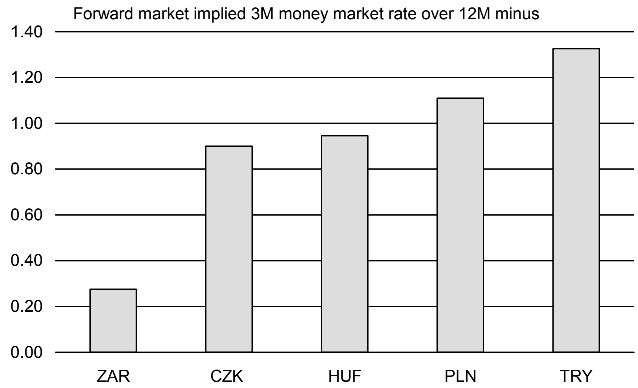
In terms of outright bearish rate positions, we recommend paying RUB rates, which ought to move higher independently from the CBR monetary policy, given the declining liquidity in the banking sector, while the previous money supply growth and economic recovery should push CPI in the neighborhood of 9%. As paying RUB rates is fairly expensive due to the low level of money market rates, we would look to increase the maturity of the payer leg. For the time being we would remain payers of 1Y RUB CCS rates.

REAL YIELDS VS. MARKET PRICING

Real yields are on the low end of the preceding range



PLN & TRY curves are already pricing in significant rate hikes



Source: national statistics agencies, Bloomberg, UniCredit Research

FX should deliver returns in 2011, we favor CZK and CIS

Similar to 2007, FX should decouple from rates and credit and should be the main contributor to total returns

FX should deliver most of the returns in 2011: Although one could have said the same one year ago, we believe the case for diverging interest rate policy in emerging markets versus developed markets is now stronger (i.e. higher EM rates). Given the tight valuation of external credit and the number of countries moving toward higher local rates, we believe performance in CEEMEA FI/FX should come mostly from the FX side in 2011. Looking backward we believe the period between February 2007 and February 2008 could best characterize the outlook for 2011. Namely, in the above-mentioned period the rate spread between CEEMEA and EUR/USD widened by about 200bp, which in turn led to a circa 10% FX average appreciation (see chart). Although output gaps are clearly not at the same level as in 2007, we believe that in some countries they are not as closed as they might appear. On a more negative note, CEEMEA currencies are not cheap compared to LatAm and Asia (see chart). Accordingly, we would play this story selectively in our region.

CZK could see disproportional support due to Germany outperforming vs. EMU

As the Czech Republic is the most strongly tied CEE country to the German economy, we believe the CZK could receive disproportional benefit from German economic outperformance vs. the Eurozone. Specifically, although CZK rates are strongly correlated to EUR rates, this time around they could decouple (EUR rates have been kept lower for longer due to EMU periphery concerns), and we believe CZK rates might move independently higher. This in turn would provide support for CZK where we see real yield normalization as increasingly likely in 2011. **Although we also see scope for higher PLN rates** (by 75bp during 2011) given our concerns related to the Polish fiscal outlook and the significant rate hikes already priced in the yield curve, we would play the PLN only from the tactical side and look to sell EUR/PLN at meaningful spikes only. **We would not be structurally long HUF and RON,** given that in the former higher rates could be a reflection of increasing risk premiums (as we highlight in our country page, we see scope for further deterioration in the newsflow in the near term). In Romania we actually see scope for further rate cuts (the only instance in CEEMEA, in our view) during the course of 2011, most probably in 2H11. **Higher rates in Turkey** could also provide support to the TRY, but given this will most likely occur alongside a wider current account deficit and, of course, stronger growth, we see relatively limited room for TRY appreciation. Moreover, we see some risk that the CBT would fall behind the curve, particularly if the election of the new CBT governor provides any further uncertainty. That said, we remain neutral on TRY for the moment and similar to PLN would only add to bullish positions in the event of meaningful moves.

Would only play PLN and TRY longs tactically

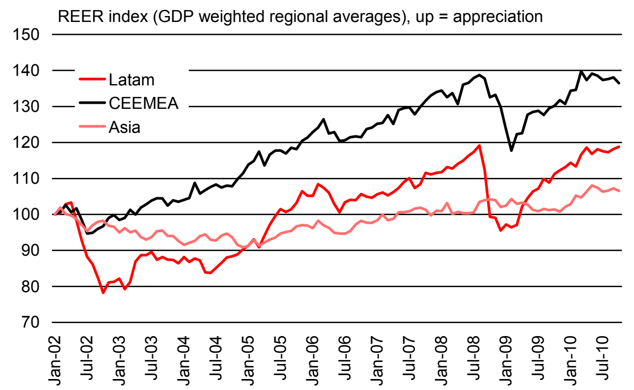
FX portfolio allocation recommendations

CZK	O/W
HUF	U/W
PLN	M/W
RON	U/W
TRY	M/W
RUB	O/W

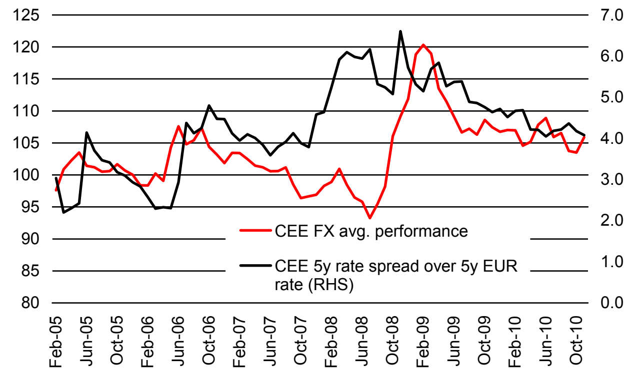
M/W: market weight
U/W: underweight
O/W: overweight

CEEMEA FX COULD DECOUPLE FROM RATES, DESPITE VALUATION NOT BEING CHEAP VS. ASIA AND LATAM

CEEMEA currencies are not cheap as a whole



Rates and FX already decoupled once in 2007



Source: BIS, Bloomberg, UniCredit Research

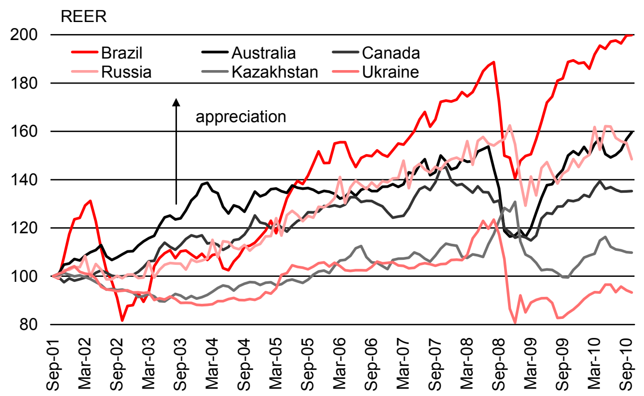
Forward FX rates, bid

	KZT	RUB	UAH
Current	147.5	31.20	7.95
3M	147.2	31.44	8.14
6M	147.1	31.75	8.32
12M	147.0	32.46	8.70

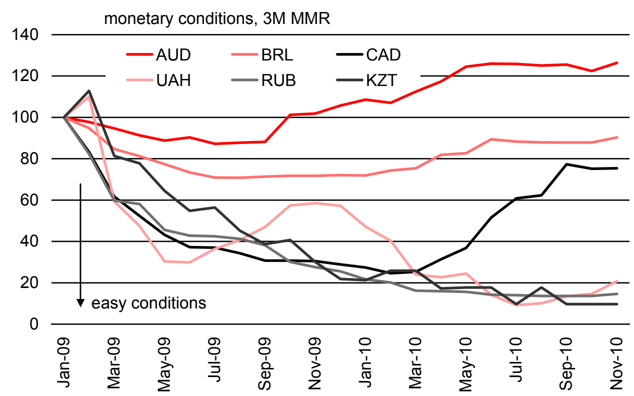
We are mostly bullish on the CIS currencies: The NDF market continues to price in a bearish view on the CIS currencies, with the premium (vs. the current level) most notable in Ukraine. However, we think that following a year of underperformance in 2010, a more bullish view is warranted. Part of the story is the strong commodity linkage of all three CIS (Kazakhstan, Russia and Ukraine). The other less obvious point is the general cheapness of CIS FX vs. other EM currencies. In terms of REER, Ukraine and Kazakhstan look particularly undervalued relative to their commodity peers, while in Russia the case is less clear cut by this metric, although its figure is still significantly below that of Brazil. **Another point that strikes us is the relative underperformance of FX in nominal terms throughout 2010,** which we believe is linked to the lax monetary conditions policy makers have created in the region and the associated negative real yields. Whereas policy, as measured by the 3M money market rates, was gradually tightened in selected EM peers (Australia, Brazil and Canada), policies continued to become looser in the CIS. Ukraine has made some marginal tightening in the past weeks, and rates are also going higher in Russia – both on a pick-up of activity and anticipated central bank hikes in 2011. However, tighter conditions are only part of a step-by-step process that we see taking place in the region next year: a) policymakers start to battle inflation and withdraw liquidity; b) local rate curve steepens on tighter policy; and c) carry/volatility ratio improves the attractiveness of FX investments

FUNDAMENTAL SUPPORT FOR CIS FX

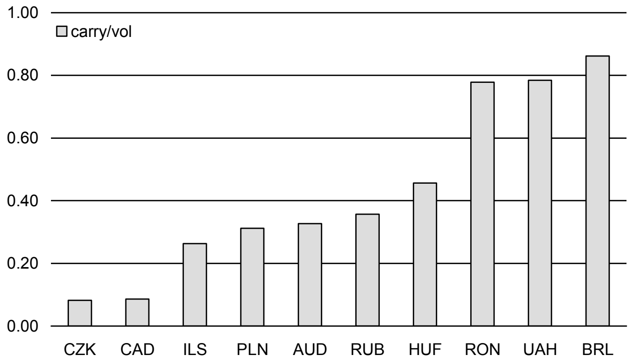
Ukraine and Kazakhstan lag other EM FX in REER terms



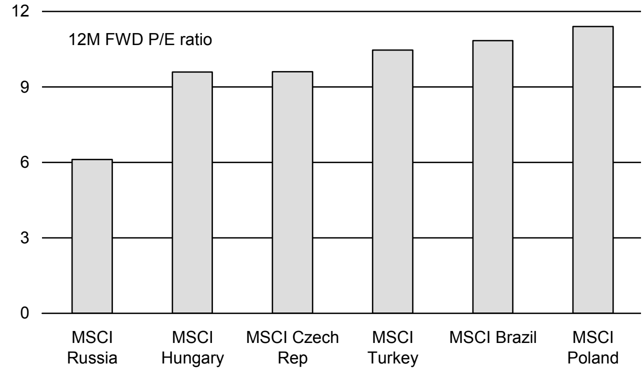
Lax monetary conditions have played a role



Carry/volatility not too attractive, but rate hikes should play their role



Russian equity looks undervalued to its EM peers



Source: BIS, Bloomberg, UniCredit Research

KZT and UAH to see some nominal appreciation

We see at least a 5% nominal appreciation of the KZT and UAH in 2011, which would appear to be an attractive opportunity compared to what the market is currently pricing in. NBK Governor Grigory Marchenko's recent statement on the expected abolition of the wide USD/KZT corridor of 127.5-150 is an implicit signal of the expected move to a managed float. We believe the rationale behind the NBK move is a current account surplus coupled with a capital account surplus, and the continuous accumulation of FX reserves at the NBK and in the Oil Fund – i.e. a basic balance-driven appreciation. The downside risk to the NBK move is that any RUB weakness could lead to a change of mind at the NBK; we think that the bank carefully monitors the RUB/KZT in an effort to speed up speed economic integration with Russia and Belarus under the Customs Union. In Ukraine, more robust growth rates in 2011 coupled with an ambitious structural reform program and IMF inflows should build confidence, and once energy imports subside should create an environment of excess FX on the market towards the end of 1Q11 and allow the UAH to get stronger. The danger to our bullish outlook on the UAH stems chiefly from the confidence level of the local population, whose demand for FX has been higher than expected during 4Q10, forcing the NBU to be more actively present on the market selling FX – although we attribute this spike in demand to seasonal factors. In Russia we see 5% nominal appreciation, but only following the anticipated rate hikes by the CBR, which should come as early as 1Q11. We also see a good degree of probability that that once the political uncertainty is out of the way during 1H11 (we do not expect any major changes in the Medvedev/Putin tandem) the equity market should become a topic of prime attention, given its cheapness to other EM peers – something that has the potential to mimic the inflows we saw in Turkey and Brazil in 2010. Moreover, the potential for WTO accession in 2011 is another bullish factor for Russia as it would open up the domestic market for foreigners, which ultimately leads to more competition and a better investment climate, something that would nicely supplement the recently announced privatization program worth USD60bn in 2011-2015, but also open up foreign markets to Russian producers.

RUB to appreciate following rate hikes by the CBR

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Sovereign credit rating outlook

Country	Rating, LT FC (Moody's/ S&P/Fitch)	Fiscal balance, % GDP, 2011 forecast	Gross external debt/GDP, 2011	Curr. account balance % GDP, 2011 forecast	FX reserves, % GDP, end 2011, forecast	2011 GDP forecast minus 5y average	Outlook	Rating Outlook
Bulgaria	Baa3p/BBBs/ BBB- n	-2.80	99.24	-2.40	36.2	-0.09	neutral	Rating outlook has stabilized on the back of re-established fiscal discipline and the commitment of the new government to uproot corruption and press ahead with structural measures.
Croatia	Baa3s/BBBn/ BBB-n	-6.80	101.51	-3.55	24.4	0.54	stable	Although Croatia's fiscal backdrop is a concern for the longer term rating outlook in the near term the potentially positive EU membership newsflow coud stabilize rating.
Czech Republic	A1s/Ap/A+p	-4.50	48.00	-2.49	22.1	-0.92	neutral	We still see the Czech economy as one of the most stable ones and with a credible government in power we should not expect to see too many surprises in 2011. We do not expect rating changes in the next months.
Estonia	A1s/As/As	-2.10	106.42	4.90	18.8	3.51	positive	The Eurozone entry in 2011 makes us **positive** on the rating outlook that with improving macro fundamentals is likely to pave way for further upgrades in 2011.
Hungary	Baa3n/ BBB-n/BBBn	-2.81	123.05	-0.43	26.8	2.54	negative	Following the recent move by the Moody's we expect Fitch taking similar decision in the near term with the big question weather the government can convince the rating agencies not to downgrade it to subinvestment grade. For the time being we are **negative** on Hungarian credit rating outlook.
Kazakhstan	Baa2s/BBB-s/ BBB-s	-2.00	81.60	-2.77	20.3	-0.71	neutral-to-positive	Thanks to a prudent fiscal balance, increasing FX reserves and high commodity prices and largely completed bank restructuring **ratings might be lifted by one notch** in the coming months.
Latvia	Baa3s/BB+s/BB+s	-5.60	149.79	6.20	28.6	4.15	Positive	The country is benefiting from a better external environment and the Estonian Euro accession path. Further improvements in the rating can be expected, partially reversing the downgrades of 2008-09. **Positive**
Lithuania	Baa1s/BBBs/ BBBs	-5.66	85.44	1.70	16.7	2.61	Positive	All three rating agencies have now moved their outlooks from negative to stable on improving conditions. We believe, the economic outlook will continue to improve. **Positive**
Poland	A2s/A-s/A-s	-6.60	60.63	-3.42	23.2	-0.32	negative	Despite the solid macro fundamentals, risks of fiscal slippage have increased in Poland over the past couple of months, and we increasingly see a higher probability of markets demanding a premium on the uncertain outlook. A large public deficit this year and next is of no help in this respect. **Negative**.
Romania	Baa3s/BB+s/ BB+s	-5.00	63.79	-5.59	23.3	-0.62	positive	The government has been a dilligent student of the IMF, and has stuck through thick and thin with the implementation of the unpopular refoms – we would expect the rating agencies to start picking up on this. **Positive**
Russia	Baa1s/BBBs/BBBp	-5.35	26.94	2.97	24.8	0.81	neutral	High oil prices remain the key source of stability on Russia's rating, should commodities surprise in 2011 Russia could inch closer to a budget balance inducing rating agencies to give the country an upgrade. **Neutral for now.**
Serbia	-/BB-s/BB-s	-4.20	85.75	-8.92	36.3	-0.56	neutral	IMF package reduces tail risks for the coming quarter, but the relatively wide external financing gap, coupled with an uncertain long-term growth outlook, means that we are cautious on the ratings outlook and would expect the government to do more, risks of fiscal slippage remain as we approach an election cycle in 2012.
Slovakia	A1s/ A+s/ A+s	-4.80	88.86	-3.23	-	-1.69	neutral	Eurozone membership is a stabilizing factor, though this is reflected in the rating, we are **neutral** on the outlook. Both a risk and a strengh is the strong linkages to manufacturing, which has a disproportionate share in the economy.
Slovenia	Aa2s/AAs/ AAs	-5.80	118.90	-0.64	-	0.58	neutral	Eurozone membership is a key supportive factor for Slovenia's ratings, as are low public sector debt levels. We hence see ratings remaining on **hold**, despite high overall external debt levels.
Turkey	Ba2p/BBp/BB+p	-3.20	40.41	-5.78	9.5	1.10	positive	We expect further improvements in the next 12 months. 2010 fiscal performance has been surprisingly robust and with further robust economic growth in the pipeline fiscal performance should be on a good track. **Positive.**
Ukraine	B2s/B+s/Bs	-3.38	66.86	-1.67	22.3	3.86	positive	A benign 2011 budget, coupled with ambitious plans for reform in 2011 ought to pave way for further upgrades by the agencies, watch April/May when the government is due to show commitment to reform.

EEMEA Corporates: Ready for another solid performance

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EEMEA corporate credits will remain an appealing asset class within the credit universe in 2011, but we doubt that the 2010 performance can be repeated (15% total return YTD). However, risk-adjusted return of EEMEA credits was lower than in Asia and MEA. Their performance next year will be a function of global liquidity, corporate fundamentals and positive technicals, driving spreads moderately tighter. Higher expected UST yields pose a challenge, but the above arguments of the EEMEA credit story should dominate, with the EEMEA JPM CEMBI spread index expected to tighten by some 60bp.

Credit metrics should improve further

Regional issuers continued to deleverage during 2010, their EBITDA generation recovered and P/L returned, on average, to profitability. We expect credit metrics across the covered issuer universe to improve further in 2011, being conducive to further declines of already very low default rates to 0.6% from 1% in 2010 (Tristan Oil [USD 420mn], Interpipe [USD 200mn], and IIB [EUR 200mn]) as regional economies return to positive growth and oil prices stabilize on average at USD 85pb. What is important to highlight is that default rates in EM remained well below default rates in Developed Markets (DM) throughout the credit cycle.

Technicals are positive

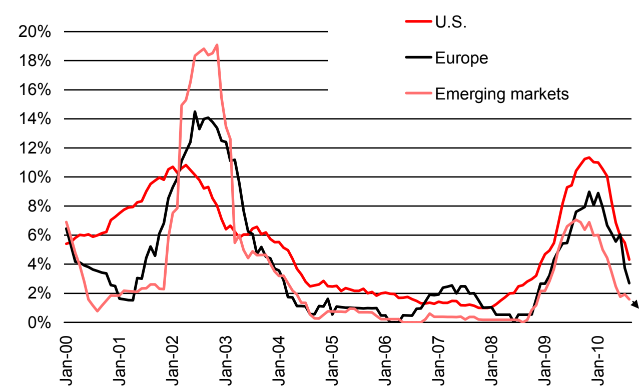
Strong inflows into EM funds on the back of a diverging development of overall macro fundamentals between DM and EM, regional coupon payments from corporates estimated at USD 10bn and ample global liquidity should help absorb new bond issuance, which we actually expect to decline from USD 41.2bn this year to USD 25bn in 2011, on the back of moderate redemptions (USD 15bn) and moderate capex as well as only sporadic M&A deals. However, expected tightening by local central banks (Russia, Turkey), may lead some issuers to switch from local currency to USD/EUR funding, thus increasing the forecasted volume.

We recommend to tactically hedge longs in cash bonds via sovereign CDS as eurozone periphery risks continue

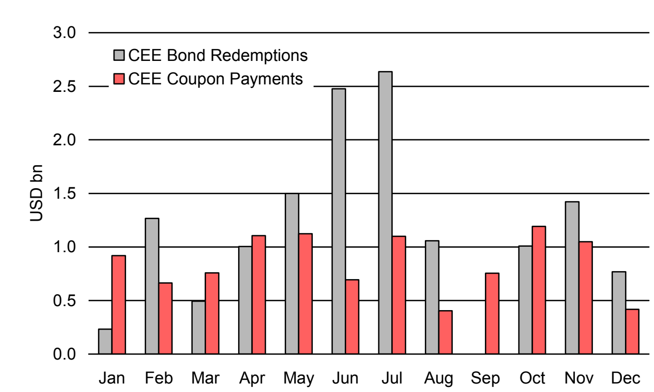
While being fairly constructive on EEMEA credits, we are aware of eurozone periphery and double-dip recession risks (not our core scenario). Note that EM fund flows dynamics recently became more correlated with eurozone periphery developments. Against this backdrop, we stick to high-quality quasi-sovereign and private credits, but advise to hedge tactically long cash bond positions by sovereign CDS. The latter show a high beta with eurozone sovereign credits (see the sovereign credit part), higher liquidity than the respective corporate CDS, and offer a negative basis. Corporate policy risks are modest compared to external risks: dividend payments will increase as companies return to profitability but only moderately. M&A activity will pick up on the back of privatization in CIS, as should IPOs.

DEFAULT RATES TO DECLINE FURTHER, WHILE THE TECHNICAL PICTURE REMAINS BENIGN IN EEMEA CORPORATES

Net debt/EBITDA 2010 vs. 2011 forecast



External bond redemptions vs. coupon payments



Source: Bloomberg, UniCredit Research

Corporate credit recommendations

Country	Rating, (Moody's/ S&P/Fitch)	Recommendation	Recommended paper	Price	YTM (%)	ASW (bp)	Comment
AGROK	B2p/Bs/--	Hold	EUR 12/16	106.6	596	8.53	While Agrokor is expected to continue its expansion pace, thereby limiting deleveraging potential, we take comfort from management's track record in pursuing acquisitions and its prudent response (i.e. reduced expansion speed) to worsening market conditions.
GAZPRU	Baa1s/BBBs/BBBs	Overweight	USD 4/19 EUR 6/15	122.5 105.4	5.81 4.50	320 212	Our overweight recommendation is based on the expected favorable development of the domestic price regime, the company's monopoly position in gas exports, the strong state support, as well as the massive asset base with large reserves. Credit ratios are still well above rating agencies' thresholds.
LUKOIL	Baa2s/BBB-s/BBB-s	Hold	USD 11/14				Our hold recommendation is based on the company's strong market position in Russia (No. 2) and its high degree of integration. Furthermore, the profile benefits from management's good relationship with the Russian government.
MOLHB	--/BB+s/BBB-s	Hold	EUR 4/17	92.0	7.49	431	Credit ratios of MOL have improved and the company benefits from the recovery in oil prices and improved downstream margins. We assume that current bond prices discount for all uncertainty, and keep our hold recommendation.
TNEFT	Baa1s/BBBs/--	Marketweight	USD 3/14	106.0	3.67	245	We have a marketweight recommendation for the name, although its credit metrics might deteriorate in the future due to an ambitious capex program. However, we assume that this is offset by Transneft's monopoly position in crude oil transportation in Russia and the supportive regulatory framework, enabling very stable cash flows. In addition, the company's strategic importance for the Russian economy provides it with strong state support.
TMENRU	Baa2s/BBB-s/BBB-s	Buy	USD 3/18	113.7	5.55	300	We have a buy recommendation on TNK-BP, which is based on its sound market position as one of the largest vertically integrated oil producers in Russia, its solid reserves and production base, and the high degree of operational and cost efficiency. We also expect a positive impact from the influence of 50%-owner BP on management, operations and corporate governance. Furthermore, the shareholder conflict has been resolved.
VIP	Ba2wn/BB+wn/--	Sell	--	--	--	--	Our sell recommendation reflects the negative impact on ratings and leverage from the Weather Investment acquisition.
MOBTEL	Ba2s/BBp/BB+p	Hold	USD 1/12	105.6	2.86	244	Our hold recommendation reflects the improving operating performance, which is mitigated by the expansion plans of the company and its parent.
TPSA	A3s/BBB+s/BBB+s	Buy	EUR 5/14	109.7	2.97	90	TPSA bonds offer a significant spread advantage to pure FRTEL bonds and are attractive as a "quasi" France Telecom (FT) investment, as TPSA is almost 50% owned by FT.
CEZCO	A2s/A-s/A-s	Marketweight	EUR 10/21	102.2	4.73	136	We keep our marketweight recommendation for the name, which is based on the company's dominant market position in the Czech Republic, its strong cash-flow generation and the very competitive generation mix. Current spreads appear to discount for all uncertainties, and trade fair compared to peers.
ESTONE	A1s/As/As	Hold	EUR 11/20	100.0	4.5	118	We assign a hold recommendation to the name, which is based on strong support from the Estonian government and its dominant position in the Estonian energy market. In addition, the company's business profile also benefits from own full oil shale mining operations, reducing fuel price risk.
RSHB, BKMOSC, VTB, SBERRU, MDMBK		No recommendation					Coverage in transition

Bulgaria

Outlook – Though slow and uneven, Bulgaria's economic recovery remained on track in 3Q10. In our view, the outlook for growth improved on two fronts: firstly, the export-led portion of the economy fully regained its competitiveness and is again creating new jobs; secondly, we expect the recovery to broaden also in terms of growth drivers: investment stabilized in 2010 and is likely to turn positive next year. However, we believe that excessive enthusiasm would be premature; the economy still needs to face the challenge of rebalancing domestic demand-oriented sectors, which we expect to keep growth below its potential for at least several more quarters.

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	Moody's	S&P	Fitch
Long-term foreign currency credit rating	Baa3 positive	BBB stable	BBB- negative

MACROECONOMIC DATA AND FORECASTS

	2008	2009	2010E	2011F	2012F
GDP (EUR bn)	35.4	35.0	35.9	38.1	40.6
Population (mn)	7.6	7.6	7.5	7.5	7.5
GDP per capita (EUR)	4,658	4,633	4,767	5,070	5,434
GDP (constant prices yoy %)	6.2	-4.9	0.1	2.8	3.5
Private Consumption, real, yoy (%)	3.0	-4.0	-4.6	-2.0	1.1
Fixed Investment, real, yoy (%)	21.9	-29.0	-11.3	4.9	5.0
Public Consumption, real, yoy (%)	-1.5	-4.9	-0.9	-2.5	0.3
Exports, real, yoy (%)	3.0	-10.3	12.1	6.2	5.0
Imports, real, yoy (%)	4.2	-21.5	1.2	2.1	2.6
CPI (average, yoy %)	12.4	2.8	2.4	3.2	3.3
Central bank reference rate (LEONIA, avg)	4.07	0.23	0.19	0.29	0.76
Monthly wage, nominal (EUR)	279	302	320	333	349
Unemployment rate (%)	6.3	9.1	9.1	8.7	8.2
Budget balance (% of GDP, cash basis)	3.0	-0.8	-4.3	-2.8	-2.5
Current account balance (EUR bn)	-8.2	-3.5	-0.6	-0.9	-1.4
Current account balance (% of GDP)	-23.1	-9.9	-1.6	-2.4	-3.5
Net FDI (EUR bn)	6.2	3.4	1.4	2.0	1.9
FDI (% of GDP)	17.5	9.6	3.8	5.3	4.6
Gross foreign debt (EUR bn)	37.1	37.8	37.1	37.8	39.6
Gross foreign debt (% of GDP)	104.7	107.9	103.2	99.2	97.5
FX reserves (EUR bn)	12.7	12.9	12.7	13.8	15.5
(Cur.Acc-FDI)/GDP (%)	-5.6	-0.3	2.2	2.9	1.1
FX reserves/Gross foreign debt (%)	34.3	34.2	34.3	36.5	39.2
Exchange rate to USD eop	1.40	1.36	1.43	1.39	1.34
Exchange rate to EUR eop	1.96	1.96	1.96	1.96	1.96
Exchange rate to USD avg	1.33	1.40	1.47	1.45	1.35
Exchange rate to EUR avg	1.96	1.96	1.96	1.96	1.96

Source: UniCredit Research

STRENGTHS

- Regained competitiveness of export-oriented sectors
- Very low public sector debt
- Improved EU funds absorption

WEAKNESSES

- High corporate private sector debt
- Significant exposure to Greek economic difficulties
- Limited policy room to respond to new shocks

Growth outlook has improved, but risks still high

Though slow and uneven, Bulgarian recovery remained on track in 3Q10

Bulgaria's GDP was two notches higher qoq in 3Q10 (0.7%) after a lackluster 0.5% in 2Q10, seasonally and working day adjusted data show. Annual GDP growth finally returned to positive territory (0.5% in 3Q10) after five consecutive quarters of negative readings. Looking at the composition of growth, exports accelerated further (8.9% qoq and 18.5% yoy), with the 3Q10 reading a solid 7.1% above the pre-crisis level (as reported in 3Q08). We believe the strong export growth reflects a solid rebound of Bulgaria's manufacturing competitiveness. In 3Q10 GVA/hour worked in the industry was striking: 13% above its level two years ago when the crisis began. More recently, the picture of Bulgarian industrial revival was made more convincing by a solid rise in the headline industrial confidence indicator: -7 in November, much better than its weakest reading (-15 in August 2009) and closer to its 10Y long-term average (-1). Although still 15% below its pre-crisis level, industrial output in September was well above its February 2010 nadir (-26%), driven by a solid positive reversal over the past two quarters. More importantly, after losing 105,625 jobs over eight straight quarters, manufacturing created 4,040 jobs (net) in 3Q10, suggesting that the negative trend has ended, with sector managers back in the hiring mode.

Optimism about the pace of manufacturing recovery reconfirmed by recent labor market data…

…But the economy still needs to solve its problems with competitiveness and debt in domestic demand-oriented sectors

Although output and employment in export-led industry improved, suggesting that roughly a third of the economy is out of the red zone, data on domestic demand-oriented sectors is less encouraging. The sharp contraction of individual consumption in 3Q10 (down 2.6% qoq and 5.9% yoy) highlighted the household sector's need for more time to join the recovery. The loss of 30,029 jobs in 3Q10 (as reported in the quarterly survey on employees, hours worked, wages and salaries, and other employer expenditures) again supported our view that labor market improvement in 2Q10 was short-lived and driven by temporary factors. Retail credit remains weak and precautionary savings continue to rise, underscoring the household sector's lack of strength. Additionally, sentiment indicators in trade and construction (two key domestic demand-oriented sectors) remain depressed despite recent gains, suggesting that rebalancing in these sectors is likely to need more time to fully materialize. Retail sales (except motor vehicles, including motorcycles) in September were 16.6% below their level of two years ago and far from levels consistent with positive growth of individual consumption. Overall, we believe strong export growth cannot by itself rescue the rest of the economy and individual consumption increasingly becomes the Achilles heel of Bulgarian recovery.

Newsflow related to investment has improved, suggesting that recovery is set to broaden in terms of growth drivers

Perhaps most encouragingly, GFCF (measuring investments in national accounts) showed stronger signs of stabilization in 3Q10 (flat qoq) after mixed readings earlier this year (up 3.8% qoq in 1Q10 and down 3% in 2Q10). We see this as crucial, as it suggests Bulgaria's recovery is set to broaden also in terms of drivers, and after the strong YTD upturn in export and inventories, fixed investment is also likely to contribute positively to growth from next year onward.

We have penciled in a 0.6pp increase in our GDP growth forecasts for 2010 and 2011

We believe the growth outlook has improved, as signs for stabilization of investments are mounting and manufacturing started to create new jobs again. In response, we raise our 2010E GDP growth forecast to 0.1% (from -0.5%) and to 2.8% in 2011E (vs. our previous 2.2%) while remaining skeptical about growth coming close to its potential (estimated at around 4% yoy) before mid-2012. Adjustment in the number of jobs in some non-tradable sectors seems not over, which, along with high precautionary savings, should continue to weigh on individual consumption. Sizeable free production capacity suggests capex are going to rise onlygradually looking forward, with structural reform delays and uncertainty regarding the government's policy on business regulation likely to constrain further investment and jobs. Perhaps most importantly, some investors seem confident that the toughest tests for the Greek recovery still lie ahead, which also negatively affects both the inflow of foreign capital and debt servicing costs for the Bulgarian economy.

Czech Republic

Outlook – Leading economic indicators suggest that economic activity should remain strong at least into early 2011, though a consolidation in fiscal policy next year means that some moderation in GDP growth is unavoidable. Price pressures are well contained but the CNB has concerns about leaving policy rates this low for an extended period. We see potential for the first hike to materialise in Q2.

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	Moody's	S&P	Fitch
Long-term foreign currency credit rating	A1 stable	A positive	A+ positive

MACROECONOMIC DATA AND FORECASTS

	2008	2009	2010E	2011F	2012F
GDP (EUR bn)	147.9	137.1	145.8	156.3	167.9
Population (mn)	10.4	10.5	10.5	10.5	10.6
GDP per capita (EUR)	14,181	13,069	13,860	14,825	15,901
GDP (constant prices yoy %)	2.5	-4.1	2.3	1.8	3.3
Private Consumption, real, yoy (%)	3.6	-0.2	0.5	0.2	2.4
Fixed Investment, real, yoy (%)	-1.5	-7.9	-1.0	1.0	4.0
Public Consumption, real, yoy (%)	1.1	2.6	0.7	-1.5	0.0
Exports, real, yoy (%)	6.0	-10.8	13.0	10.2	10.0
Imports, real, yoy (%)	4.7	-10.6	12.8	8.6	9.8
CPI (average, yoy %)	6.3	1.0	1.4	2.1	2.4
Central bank reference rate	2.25	1.00	0.75	1.50	3.00
Monthly wage, nominal (EUR)	906	888	949	1,004	1,066
Unemployment rate (%)	5.5	8.1	9.0	8.7	8.0
Budget balance (% of GDP)	-2.7	-5.8	-5.0	-4.5	-3.5
Current account balance (EUR bn)	-0.9	-1.4	-4.6	-3.9	-5.6
Current account balance (% of GDP)	-0.6	-1.0	-3.2	-2.5	-3.3
Net FDI (EUR bn)	4.4	2.0	5.9	6.1	7.1
FDI (% of GDP)	3.0	1.4	4.1	3.9	4.2
Gross foreign debt (EUR bn)	59.7	60.1	70.6	76.3	80.8
Gross foreign debt (% of GDP)	43.6	43.8	47.6	48.0	48.1
FX reserves (EUR bn)	26.6	28.9	32.5	34.5	36.5
(Cur.Acc-FDI)/GDP (%)	2.4	0.4	0.9	1.4	0.9
FX reserves/Gross foreign debt (%)	44.5	48.1	46.1	45.2	45.2
Exchange rate to USD eop	19.21	18.39	18.10	17.02	16.44
Exchange rate to EUR eop	26.80	26.35	24.80	24.00	24.00
Exchange rate to USD avg	16.97	18.96	19.02	18.11	16.61
Exchange rate to EUR avg	24.96	26.43	25.30	24.40	24.00

Source: UniCredit Research

STRENGTHS

- External financing at comfortable levels
- New government sticking to fiscal consolidation
- Low vulnerability of financial sector

WEAKNESSES

- Fiscal restrictions set to slow 2011 GDP growth
- Concept of structural reforms not yet outlined
- Solar power investments coming to an abrupt end

Near-term prospects positive, medium-term uncertainty high

3Q10 GDP unexpectedly strong, gaining momentum vs. 2Q10 both yoy and qoq

3Q10 GDP growth surprised on the upside, with the adjusted figure up from the previous quarter yoy (to 2.8% from 2.3%) and qoq (to 1.0% from 0.8%). Stronger growth was driven by manufacturing and trade, while the value added in services continued to stagnate. Agriculture growth declined, as unfavorable weather conditions cut into value.

Solar boom, better confidence indicators, stronger German economy should support GDP growth in 4Q10

Leading indicators suggest that economic activity should stay firm at least into early 2011. The manufacturing PMI has been steady since March – consistent with a double-digit yoy rise in industrial output – while the similar confidence indicator calculated by the local statistics office recently strengthened. Near-term growth prospects also look promising, thanks to new industrial order strength and robust sentiment indices from Germany, the Czech Republic's main trading partner. The peaking boom in solar power investment before end-2010 should help boost to 4Q10 GDP, and we project yoy expansion at a still-comfortable 2.7%. This estimate, combined with the surprisingly strong 3Q10 GDP growth, lifts our full-year GDP forecast 2.3%, three notches higher than previously.

We expect the cyclical recovery to continue in 2011, despite a number of headwinds

The outlook for 2011 is uncertain, as reflected in the substantial forecast variations among analysts and institutions. The CNB cut its GDP growth forecast to just 1.2% (previously 1.8%), but some international institutions expect growth of nearly 3%. We are close to the middle of the range, projecting 1.8%. The main source of uncertainty appears to be the impact of government fiscal measures on private spending and public investment; we expect this effect to reduce next year's GDP growth by about 0.6pp. There are also doubts as to the impact of photovoltaic investment, which we expect to add 0.2pp-0.3pp to GDP growth this year, reducing 2011 growth by roughly the same extent. Slower external demand is the final element of uncertainty. Overall, however, we do not consider the headwinds noted above strong enough to outweigh cyclical recovery.

We maintain our previous view of inflation staying close to 2% throughout 2011E, with interest rates first hiked in 2Q11

Price pressures have been well contained, with November inflation at 2% yoy (the CNB's target), and we see little room for a sharp deviation from this level in the months to come. The fear of a steep rise in electricity prices due to generous subsidies to solar energy has abated, following the lower house's approval of measures curbing the increase. According to the energy regulator, the measures, if also passed by the Senate (which we view as likely) would make it possible to increase electricity prices by just 4.6% from January 2011 (contributing 0.2pp to the CPI). A rise of this size, coupled with a potentially sharper increase in food prices, should be fully compensated by the effect of January 2010 VAT and excise tax hikes (excluded from a yoy comparison). Nevertheless, with our GDP forecasts for the next two years above the CNB's and several CNB policymakers stressing the risk associated with low interest rates, we expect policy tightening to begin before 4Q11 (implied in the latest CNB inflation report) and thus feel comfortable leaving our bet on the first hike's timing at 2Q11.

Government austerity measures passed by parliament, opening the way for fiscal gap reduction

The stronger-than-expected economic rebound, boosting budget revenues, allowed the Finance Ministry to put its latest 2010 fiscal gap forecast at 5.1% of GDP, two notches below its original projection. For 2011, the ministry is keeping to its deficit forecast at 4.6% of GDP, after the austerity bills factored into the 2011 budget were easily passed by parliament. We currently have little doubt that the government can meet the outlined targets.

Estonia

Outlook – Estonia will become EMU's 17th member in January, an event which for many domestically will be viewed as drawing a line in the sand behind the crisis (despite current EMU troubles). With a recovery firmly underway, we see potential for GDP gains next year of almost 4%. Fiscal policy remains tight while despite the crisis public debt stands at only 8% of GDP. Estonia's EMU entry will hopefully act as an anchor for policy in Latvia and Lithuania. The risk to sovereign ratings next year is firmly weighted towards upgrades.

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	Moody's	S&P	Fitch
Long-term foreign currency credit rating	A1 stable	A stable	A stable

MACROECONOMIC DATA AND FORECASTS

	2007	2008	2009	2010E	2011F
GDP (EUR bn)	15.6	16.1	13.7	14.2	15.0
Population (mn)	1.3	1.3	1.3	1.3	1.3
GDP per capita (EUR)	11,644	12,001	10,246	10,667	11,259
GDP (constant prices yoy %)	7.2	-3.6	-14.1	2.4	3.9
Private Consumption, real, yoy (%)	9.0	-4.7	-18.5	-0.4	3.0
Fixed Investment, real, yoy (%)	9.0	-12.1	-34.4	-9.0	5.5
Public Consumption, real, yoy (%)	3.7	4.1	-0.5	1.0	0.7
Exports, real, yoy (%)	0.0	-0.7	-11.2	16.8	9.1
Imports, real, yoy (%)	4.7	-8.7	-26.8	11.0	8.6
CPI (average, yoy %)	6.6	10.4	-0.1	2.2	2.4
Monthly wage, nominal (EUR)	725	819	781	832	843
Unemployment rate (%)	4.7	5.5	13.8	18.2	16.8
Budget balance (% of GDP)	2.6	-2.8	-1.7	-1.4	-2.1
Current account balance (EUR bn)	-2.8	-1.5	0.6	0.6	0.7
Current account balance (% of GDP)	-17.7	-9.4	4.6	4.5	4.9
Net FDI (EUR bn)	0.8	0.6	0.2	0.7	0.8
FDI (% of GDP)	5.2	3.7	1.1	5.1	5.2
Gross foreign debt (EUR bn)	17.4	19.0	17.4	17.2	16.8
Gross foreign debt (% of GDP)	111.0	118.5	126.7	120.6	112.4
FX reserves (EUR bn)	2.2	2.8	2.3	2.6	2.8
(Cur.Acc-FDI)/GDP (%)	-12.5	-5.7	5.7	9.6	10.1
FX reserves/Gross foreign debt (%)	12.9	14.7	13.2	15.2	16.7
Exchange rate to USD eop	10.73	11.21	10.92	10.94	10.72
Exchange rate to EUR eop	15.65	15.65	15.65	15.65	15.65
Exchange rate to USD avg	11.41	10.64	11.22	11.66	10.99
Exchange rate to EUR avg	15.65	15.65	15.65	15.65	15.65

Source: UniCredit Research

STRENGTHS

- Sound fiscal position
- Euro adoption in January
- Flexible labour market

WEAKNESSES

- External indebtedness
- Limited adjustment mechanisms within a fixed currency regime
- A track record of high inflation

Welcoming EMU's 17th member

Estonia enters EMU in January

Estonia joins the euro area in January, an event which for many domestically will be viewed as drawing a line in the sand behind the crisis (despite current EMU troubles). Reaching this point took significant effort. In the face of a 13.9pp decline in GDP in 2009, the government managed to contain the deficit at 1.7% of GDP, the second narrowest of all EU27 countries. Having kept its deficit within 3% of GDP every year since 2000, the Euro Area could not question Estonia's fiscal track record. Public debt is projected at 8.0% of GDP this year, up from 3.7% of GDP in 2007.

GDP growth has been reliant on external demand

Q3-09 marked the end of the recession, following 7 consecutive quarters of decline, and since then the economy has performed well. GDP showed a gain of 0.7% QoQ in Q3 but between Q4-09 and Q2-10 real GDP gains averaged 1.5% per quarter. External demand has been a key support for economic activity over recent quarters, due to recoveries in Sweden, Russia and the Euro Area. Q3 showed some evidence of a tentative recovery in private consumption – with unemployment down 1.8pp over the past 12 months and likely to continue to head south, this has the potential to gather further momentum from here. At this stage the recovery in investment remains uneven but capacity utilization in industry has almost recovered to its long term average, suggesting some scope for increased investment from here also. We see the potential for GDP gains of almost 4% next year, with a positive carryover contributing at least 0.7pp.

Inflation rises due to supply and one-off factors

Inflation has accelerated rapidly. From a negative 2.1% YoY in Nov-09, CPI rose by 5.3% YoY over the 12 months to Nov-10. There are a number of factors at play, including higher energy prices, hikes in excise duties and a spike in food prices. Though difficult to believe in demand-side inflation pressures in Estonia at this stage, the economy does have a history of relatively high inflation and as such a risk of feed-through into inflation expectations from this current bout of supply side pressure cannot be excluded.

Rate hikes on top of reversal of liquidity flows from the budget should continue to raise money market rates

Estonia's C/A has now consolidated at a surplus in excess of 4% of GDP but is likely to gradually move back into a small single digit deficit over a multi-quarter horizon. The C/A adjustment was severe. Over the 4 quarters to Q3-07 the deficit stood at 17.9% of GDP – over the 4 quarters to Q1-10 the C/A had managed to register a surplus of 4.8% of GDP. Assuming 2% of GDP in EU inflows and 1-2% of GDP in net FDI, Estonia should be able to manage a C/A deficit of 3-4% of GDP per annum, though external debt is high at 131% of GDP. We cannot exclude that the economy is forced to pay some of this down, thereby limiting potential growth from here. Encouragingly the first half of 2010 saw a tentative recovery in FDI.

Fiscal policy remains Estonia's primary adjustment mechanism

Fiscal policy will remain policy maker's primary tool in moderating the cycle once a member of EMU. The government showed willingness to take tough measures during the crisis, 2/3rds of which were permanent in nature. The remaining 1/3 were temporary and as the economy recovers, the government will have to resume state contributions to the second pillar pension scheme and lower dividends from state owned companies.

Estonia as an anchor for policy elsewhere

Looking ahead, Estonia's entry will hopefully act as an anchor for policy in the other Baltic countries and if its initial period in EMU is viewed as successful, it may encourage European authorities towards further expansion. The sovereign has already managed to claw back any ratings downgrades it underwent during the crisis. We cannot exclude the potential for upgrades from here should the economy continue to show recovery and fiscal policy remain on the right track.

Hungary

Outlook – We believe the success of the underlying economic policy of the government represents the greatest risk to Hungarian markets. The government's "vision" is to accelerate domestic demand via lower personal income tax and corporate income tax on SMEs which would be financed from the crisis taxes on multinational companies and the abolition of the second pillar of the pension system. The succes of the underlying strategy relies on future GDP growth, which is a risky strategy in our view. This coupled with a potential change in the monetary policy framework in 1Q could see further market underperformance. We would also not rule out further negative rating changes in the coming months.

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	Moody's	S&P	Fitch
Long-term foreign currency credit rating	Baa3 negative	BBB- negative	BBB negative

MACROECONOMIC DATA AND FORECASTS

	2008	2009	2010	2011F	2012F
GDP (EUR bn)	106.5	92.9	97.8	104.4	111.4
Population (mn)	10.1	10.0	10.0	10.0	10.0
GDP per capita (EUR)	10 600	9 249	9 759	10 427	11 140
GDP (constant prices yoy %)	0.6	-6.3	1.2	2.5	3.4
Private Consumption, real, yoy (%)	-0.6	-6.7	-1.9	1.3	2.3
Fixed Investment, real, yoy (%)	0.4	-6.5	-3.8	6.5	2.9
Public Consumption, real, yoy (%)	0.2	2.2	1.9	0.6	1.3
Exports, real, yoy (%)	5.6	-9.1	14.5	6.3	14.7
Imports, real, yoy (%)	5.7	-15.4	13.4	7.1	14.6
CPI (average, yoy %)	6.1	4.2	4.9	4.4	3.4
Central bank reference rate	10.00	6.30	5.50	5.50	5.00
Monthly wage, nominal (EUR)	792	712	742	756	812
Unemployment rate (%)	7.8	9.8	11.2	9.5	8.3
Budget balance (% of GDP)	-3.4	-3.9	-3.7	-2.8	-2.0
Current account balance (EUR bn)	-7.8	-0.4	0.9	-0.9	0.3
Current account balance (% of GDP)	-7.3	-0.5	0.9	-0.9	0.6
Net FDI (EUR bn)	5.1	1.5	3.8	6.1	4.4
FDI (% of GDP)	4.7	1.6	3.9	5.9	3.9
Gross foreign debt (EUR bn)	123.5	135.8	130.5	129.8	123.8
Gross foreign debt (% of GDP)	123.2	140.9	136.5	123.0	111.0
FX reserves (EUR bn)	24.0	30.7	33.0	28.0	
(Cur.Acc-FDI)/GDP (%)	-12.0	-2.1	-3.0	-6.7	-3.7
FX reserves/Gross foreign debt (%)	20.7	21.0	24.7	22.5	.6
Exchange rate to USD eop	187.9	188.1	205.8	199.9	184.9
Exchange rate to EUR eop	264.8	270.8	282.0	270.0	270.0
Exchange rate to USD avg	171.8	202.3	206.5	202.5	186.9
Exchange rate to EUR avg	251.5	280.6	275.8	272.9	270.0

Source: UniCredit Research

STRENGTHS

- Stable public support of the government
- Relatively low budget deficit for the region
- High level of FX reserves

WEAKNESSES

- High public and private sector debt levels
- Uncertainties about the long-term growth outlook
- High FX leverage in the household sector

The success of the underlying policy is our main concern

The government is now pursuing a risky strategy seemingly without a plan B

Since the publication of our last quarterly, Hungarian newsflow has been extremely intense with the government bringing out new fiscal ideas on a weekly basis. Although it is clearly difficult to fully understand the strategy behind the moves, as a lot of the measures look ad hoc, from a big picture perspective the government's "vision" is to accelerate domestic demand via lower taxes (PIT and CIT) which would be financed from the crisis taxes on several sectors (banks, retailers, energy, telecom) and the abolition of the second pillar pension system (obligatory privat pensions). As a result the government has created a confortable fiscal position for 2011 but it is also trying to push for a looser monetary policy. The succes of the underlying strategy – beyond the initial 1-2 year phase when the pension inflows would cushion public debt – clearly lies on future GDP growth, that needs to accelerate significantly while at the same time the activity rate should increase (from 56%). In our view, this strategy bears significant risks, particularly against the current global backdrop, and we believe that at some point the government would need to adopt more orthodox fiscal measures. EcoMin already indicated the announcement of expenditure side measures in February. Provided decent inflows from pension funds in 2011, we fear that the government would not have the appetite for any major measurs and hence we might need to wait for until 2012 when significant IMF/EU repayment needs would become more evident.

Meanwhile the growth backdrop improved significantly with GDP, retail sales and export growth all moving higher

Meanwhile the macro numbers are improving: 3Q GDP growth significantly surprised on the upside (1.7% yoy versus 1.2% in 2Q) with qoq seasonally adjusted growth accelerating from 0.4% to 0.8%. The more forward looking PMI accelerated to 54.9, and it is now above 50 for more than six months. Retail sales growth also moved into positive territory in July (albeit mostly on the back of the base effect). Although private sector credit growth is still extremely sluggish (0% yoy in October) what matters for domestic demand is the development of the debt burden (through FX) and credit supply. As banks stop tightening lending conditions we see a chance of improving dynamics (i.e. the second derivate of credit flow). This implies that even if credit is not growing but it stops falling, we would likely see a more meaningful rebound in domestic demand. Exports are still doing extremely well, mostly on the back of German outperformance (3M average growth at 23% yoy), while the trade balance remains in unusually high surplus (likely reaching EUR5bn, 5% of GDP in 2010). For a small open economy such a big surplus is clearly unusual. Inflation surprised on the upside due to negative impacts from commodity prices, while core inflation remained fairly low. In line with the expectaton of the NBH we see the sector taxes pushing CPI up by 30-50bp in 2011. The bank is concerned that inflation expectations are not anchored around the medium term target despite weak wage pressure amid loose labour market conditions. We still do not see significant underlying inflationary pressure in the economy but agree with the central bank that permanent fiscal-related CPI shocks could lead to higher expectations.

But CPI started edging higher on food prices and fiscal measures

The NBH hiked rates by 25bp and we see significant uncertainty beyond March 2011

Monetary policy: although the central bank hiked rates by 25bp at the November meeting and indicated the possibility of more rate hikes in the future, we see significant uncertainty in the course of monetary policy beyond March 2011. In that month the mandates of four MPC members are to expire and the government intends to appoint all of them on its own, which in turn could put the current governor and the two deputy governors in a minority. This coupled with the government's desire to stimulate lending and plans to increase the CPI target from 3.0% to 3.5%, could in theory lead to a more dovish policy outlook. On the other hand, if the market reaction is overly negative on these measures (given pressure on the central bank independence) the new MPC might be forced to continue hiking rates.

We still see Hungarian assets/ratings underperforming

As the government looks determined to continue with the domestic demand stimulating strategy with above outlined risks, we see ongoing downside risks to ratings (just above investment grade), the HUF, local and hard currency bonds. The relatively light non-resident positioning in the local market could offset some negative reaction. We would consider adding more constructive positions if there are clear signs of a policy change and/or the market pressure pushes Hungarian assets to extreme levels.

Latvia

Outlook – The economy has shown signs of recovery, aided by stronger external demand. More recently there are also signs of a recovery in consumption. Latvia has taken significant measures to consolidate fiscal policy and restore competitiveness but more needs to be done. A recent upgrade by S&P is a sign of confidence in the government's reform efforts. Should the government opt to roll the IMF/EU programme next year, it would provide a continued anchor for policy and ensure further upgrades ahead.

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	Moody's	S&P	Fitch
Long-term foreign currency credit rating	Baa3 stable	BB+ stable	BB+ stable

MACROECONOMIC DATA AND FORECASTS

	2007	2008	2009	2010F	2011F
GDP (EUR bn)	21.1	23.0	18.5	18.0	18.9
Population (mn)	2.3	2.3	2.3	2.3	2.2
GDP per capita (EUR)	9,254	10,145	8,221	8,002	8,407
GDP (constant prices yoy %)	10.0	-4.6	-18.0	-0.9	3.9
Private Consumption, real, yoy (%)	14.8	-5.5	-22.4	-4.3	3.0
Fixed Investment, real, yoy (%)	7.5	-15.6	-37.7	-7.0	7.4
Public Consumption, real, yoy (%)	3.7	1.5	-9.2	-6.0	-1.7
Exports, real, yoy (%)	10.0	-1.3	-13.9	7.2	7.6
Imports, real, yoy (%)	14.7	-13.6	-34.2	-1.0	4.0
CPI (average, yoy %)	10.1	15.5	3.6	-1.4	1.4
Central bank reference rate	6.00	6.00	4.00	3.50	3.75
Monthly wage, nominal (EUR)	565	682	654	595	595
Unemployment rate (%)	6.0	7.5	17.2	15.1	14.1
Budget balance (% of GDP)	-0.3	-4.1	-9.0	-7.7	-5.6
Current account balance (EUR bn)	-4.6	-3.0	1.6	1.2	1.2
Current account balance (% of GDP)	-23.8	-13.0	9.6	6.4	6.2
Net FDI (EUR bn)	1.4	0.7	0.1	0.1	0.2
FDI (% of GDP)	6.7	3.0	0.6	0.3	1.0
Gross foreign debt (EUR bn)	28.4	29.8	27.2	29.2	28.3
Gross foreign debt (% of GDP)	134.6	129.2	147.0	162.2	150.1
FX reserves (EUR bn)	3.8	3.5	4.8	5.5	5.4
(Cur.Acc-FDI)/GDP (%)	-14.8	-10.0	9.3	6.7	7.2
FX reserves/Gross foreign debt (%)	13.4	11.8	17.6	18.9	19.1
Exchange rate to USD eop	0.48	0.50	0.49	0.49	0.48
Exchange rate to EUR eop	0.70	0.70	0.70	0.70	0.70
Exchange rate to USD avg	0.51	0.48	0.50	0.52	0.49
Exchange rate to EUR avg	0.70	0.70	0.70	0.70	0.70

Source: UniCredit Research

STRENGTHS

- IMF/EU anchor
- Recovery in economic activity
- Strong support from banking system from mother banks

WEAKNESSES

- High external indebtedness
- Further need for fiscal consolidation
- Continued competitiveness shortfalls

Sticking with the programme

The economy has bottomed out and returned to growth

Latvia has finally emerged from recession. That said, GDP remains 22.6% below its pre-crisis peak. The IMF programme is on track but more work remains to be done on government finances before we can finally draw a line behind the crisis.

As in the other Baltic economies, exports have been central to the recovery in economic activity. Industrial production has boasted double digit YoY gains since May. The consumer recovery remains more tentative but has the potential to accelerate. Retail sales growth in YoY terms has moved back into positive territory. The adjustment in the labour market has been severe, with the number of unemployed increasing almost 4 fold but latest data suggests that that has also now begun to decline. Private sector de-leveleraging continued but its pace is slowing. As elsewhere in the region, inflation has picked up (though it was in negative territory in YoY terms between Nov-09 and Jun-10), in part because of higher food prices.

Much has been done to consolidate fiscal policy but there are still challenges ahead

Though much has been done, fiscal policy remains a key challenge. To date the government has taken measures worth approximately 13% of GDP, including a 4% of GDP cut to the public sector wage bill and a 3% of GDP cut to the investment bill. Higher taxes raised another 2% of GDP. However the IMF continues to express concerns about the quality and sustainability of some of the measures while this year's deficit will still be in excess of 8% of GDP (excl. banking sector costs). The Fund estimates that a further 6pp of GDP in new measures are required over 2011-12 to bring the deficit within 3% of GDP by 2012. The re-election of PM Dombrovski's government in October was a clear signal of support for the adjustment strategy adopted by the government to date but more work remains to be done. The government's plans to put in place a fiscal rule are encouraging. The crisis has taken its toll on public debt more than elsewhere. From 16.9% of GDP in 2007, public debt will near 50% of GDP by end-2012.

Latvia has clawed back some competitiveness losses but again there is also more to do on this front

The second challenge is restoration of competitiveness. On this front Latvia has also made progress. The real effective exchange rate (CPI-based) has eased over 10pp from its peak. To the extent that these measures include CPI that was pushed higher by a VAT hike but is not paid by exporters, the gains in competitiveness may be understated. IMF estimates suggest that there is still some work to be done however. Fiscal consolidation and continued wage moderation in the public sector should help on this front.

The C/A should slowly move into deficit from here

The C/A surplus should move gradually lower from here and over time edge back into a small deficit. From a deficit of almost 25% of GDP over mid-07, the C/A registered a surplus of 10.6% of GDP over the 4 quarters to Q1-10, though part of the surplus was boosted by accounting issues related to bank losses that did not relate to actual currency flows. From an external perspective, Latvia remains heavily indebted, with gross external debt at in excess of 150% of GDP.

Latvia has shifted from downgrades to upgrades.

Latvia's IMF/EU programme is scheduled to expire in December, with IMF repayments to begin in 2012. Rollover into a precautionary agreement would extend these repayments as well as act as a continued anchor for policy. Estonia's entry into EMU in January should also provide an incentive for policy makers to push ahead with reform. As members of ERM II, the authorities favour quick entry into the euro area but we expect them to face push back, at least in part because of recent turmoils in the periphery. That said S&P's recent upgrade acts as a vote of confidence in the authorities' policies to date. Should the authorities remain on their current path and push ahead with further fiscal consolidation over the next 1-2 years, their bid for EMU entry would strengthen significantly while the sovereign should also see S&P and Fitch move its rating back into investment grade territory.

Lithuania

Outlook – As with the rest of the Baltic economies, Lithuania has emerged from recession, having posted positive GDP growth in Q2 and Q3. Next year should see average inflation rise from this year, in part due to higher global food and energy prices. The government has taken extensive measures to narrow the budget deficit but more remains to be done. Meanwhile the C/A adjustment is more or less done. EMU entry remains the government's primary target but 2015 looks like the earliest possible date.

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	Moody's	S&P	Fitch
Long-term foreign currency credit rating	Baa1 stable	BBB stable	BBB stable

MACROECONOMIC DATA AND FORECASTS

	2007	2008	2009	2010F	2011F
GDP (EUR bn)	28.4	32.2	26.7	27.1	28.5
Population (mn)	3.4	3.4	3.4	3.3	3.3
GDP per capita (EUR)	8,420	9,569	7,971	8,296	8,525
GDP (constant prices yoy %)	8.9	2.8	-15.0	0.9	3.7
Private Consumption, real, yoy (%)	12.1	3.6	-17.0	-6.8	2.7
Fixed Investment, real, yoy (%)	23.0	-6.5	-38.7	11.0	4.9
Public Consumption, real, yoy (%)	3.2	7.9	-2.3	-1.2	-2.3
Exports, real, yoy (%)	3.0	12.2	-15.5	22.5	10.3
Imports, real, yoy (%)	10.7	10.5	-29.3	15.0	7.3
CPI (average, yoy %)	5.7	11.0	4.5	1.0	1.9
Monthly wage, nominal (EUR)	522	654	625	609	611
Unemployment rate (%)	4.3	5.8	13.5	17.3	15.9
Budget balance (% of GDP)	-1.0	-3.3	-8.9	-7.5	-5.7
Current account balance (EUR bn)	-4.1	-3.8	1.0	-0.5	0.4
Current account balance (% of GDP)	-14.5	-11.9	3.8	1.7	1.7
Net FDI (EUR bn)	1.0	1.2	-0.1	0.0	0.6
FDI (% of GDP)	3.6	3.2	0.5	0.1	2.0
Gross foreign debt (EUR bn)	20.5	23.1	24.5	23.5	24.4
Gross foreign debt (% of GDP)	72.3	71.6	91.6	86.7	85.4
FX reserves (EUR bn)	5.3	4.6	4.6	4.8	4.8
(Cur.Acc-FDI)/GDP (%)	-11.0	-8.1	3.4	-1.7	3.3
FX reserves/Gross foreign debt (%)	25.7	19.8	18.9	20.3	19.6
Exchange rate to USD eop	2.37	2.47	2.41	2.41	2.36
Exchange rate to EUR eop	3.45	3.45	3.45	3.45	3.45
Exchange rate to USD avg	2.52	2.35	2.48	2.57	2.42
Exchange rate to EUR avg	3.45	3.45	3.45	3.45	3.45

Source: UniCredit Research

STRENGTHS

- Low level of public sector indebtedness
- ERM II membership and prospects for EMU entry
- Some restoration of competitiveness via lower wages

WEAKNESSES

- Further austerity measures required to narrow deficit
- Uncertainty on the post-crisis rate of potential growth
- High NPLs in banking system

Recovery momentum gathers pace

Economy begins to growth once again

As with the rest of the Baltic economies, Lithuania has emerged from recession, having posted positive GDP growth in Q2 and Q3. To date external demand remains the primary driver of the recovery. There are some tentative signs of a recovery in domestic demand, though at this stage they are less pronounced than in the other Baltic economies. Retail sales growth has returned to positive territory while unemployment has shown signs of topping out. By end-Q3 GDP was still more than 15pp below its peak. Next year should see the economy continue to claw some of this back, with full year GDP growth to near 4%. From an accounting perspective the carryover is much more favourable. Even assuming flat GDP between Q3-10 and Q4-11, full year 2011 GDP will still show gains of 1.1% next year.

Inflation on the rise but demand-side pressures are contained

Next year should see average inflation rise from this year, in part due to higher global food and energy prices. The government has also scheduled an increase in excise taxes on tobacco and fuel for the start of next year while a reduced VAT rate on heating is scheduled to expire in September, also putting upward pressure on inflation. The output gap remains convincingly large however and as such any second round impacts should be limited.

Difficult measures have been put in place to narrow the deficit but more remains to be done

The government has taken extensive measures to narrow the deficit but more remains to be done. Following up on approximately 8% of GDP in measures in 2009, the government has put in place 3.7% of GDP in new measures this year. Politically difficult decisions include extending temporary reductions in wages for politicians, lawyers and government officials and reductions to maternity benefits. That said, the deficit remains close to 8% of GDP this year. Next year's budget targets a deficit of 5.8% of GDP, in line with what was agreed under the excessive deficit procedure but is reliant on revenue gains. Should revenue fall short of expectations, the government is required to pass a supplementary budget. In 2012 a series of temporary measures on wages, social benefits and pensions expire. Unless new measures at put on the table, the deficit will return towards 7% of GDP. Public debt remains low and well within the Maastricht 60% of GDP threshold but has risen rapidly from 16.9% of GDP in 2007 to 37.4% of GDP by the end of this year.

C/A adjustment has been severe but is pretty much done

As in the rest of the Baltic economies, the C/A adjustment has been severe. From a deficit of 15.9% of GDP over the 4 quarters to Q1-08, the C/A showed a surplus of 5.5% of GDP over the 4 quarters to Q2-10. Over a multi quarter period from here, the C/A show move back into a narrow deficit. Fortunately Lithuania is less indebted from an external perspective than Estonia and Latvia – gross external debt remains below 90% of GDP while in Estonia and Latvia it stands at in excess of 130% and 155% of GDP respectively. The same applies to private sector credit. From a competitiveness perspective there are positives. The IMF notes that in contrast to Estonia and Latvia, Lithuania managed wage restraint in export sectors such a manufacturing where costs relative to trade partners actually fell between 2000 and 2008 while its export market share more than doubled, with gains particularly marked in some high value-added areas such as capital goods.

EMU entry remains the primary target but it is still some time away

As with Latvia, the government's ultimate aim in addressing this crisis is EMU entry. Estonia's entry in January provides evidence that this is possible but the political landscape is changing rapidly, not least because of EMU periphery woes. As a member of ERM II the hurdles are lower than in other cases, e.g. Bulgaria, but the government will most likely have to be successful in keeping its deficit within the 3% threshold for longer than just a one year period. Assuming that the deficit must stay within 3% of GDP for at least a two year period, 2015 would represent the earliest possible entry date. Lithuania has yet to reverse the ratings downgrades that it suffered during the crisis, though it holds an investment grade rating from all 3 agencies. Further evidence of commitment to fiscal consolidation would also help on this front.

Poland

Outlook – Economic activity in 2011 should be well supported by an inflow of EU funds ahead of the 2012 football championships, tighter labour markets and a competitive zloty. Inflation will remain above the mid-range of the MPC's target band. Combining this with a strong recovery, we see 75bp in hikes next year. A reluctance to consolidate the budget is a concern but stronger growth next year could help narrow the deficit.

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	Moody's	S&P	Fitch
Long-term foreign currency credit rating	A2 stable	A- stable	A- stable

MACROECONOMIC DATA AND FORECASTS

	2008	2009	2010E	2011F	2012F
GDP (EUR bn)	362.0	310.6	350.0	382.1	419.6
Population (mn)	38.1	38.2	38.1	38.1	38.1
GDP per capita (EUR)	9,492	8,137	9,187	10,039	11,027
GDP (constant prices yoy %)	5.1	1.7	3.8	4.4	3.9
Private Consumption, real, yoy (%)	5.7	2.1	3.1	3.6	3.8
Fixed Investment, real, yoy (%)	9.6	-1.1	-0.1	9.8	5.4
Public Consumption, real, yoy (%)	7.4	2.0	3.2	3.3	2.8
Exports, real, yoy (%)	7.1	-6.8	12.1	9.8	9.1
Imports, real, yoy (%)	8.0	-12.4	11.5	10.9	8.8
CPI (average, yoy %)	4.2	3.5	2.6	3.5	3.7
Central bank reference rate	5.00	3.50	3.50	4.25	4.50
Monthly wage, nominal (EUR)	767	854	906	991	1,041
Unemployment rate (%)	9.8	11.0	12.1	11.2	9.8
Budget balance (% of GDP)	-3.6	-7.2	-7.9	-6.6	-5.5
Current account balance (EUR bn)	-17.4	-6.7	-10.0	-13.1	-15.5
Current account balance (% of GDP)	-4.8	-2.1	-2.8	-3.4	-3.8
Net FDI (EUR bn)	10.1	9.9	8.0	10.0	11.0
FDI (% of GDP)	2.8	3.2	2.9	2.6	2.7
Gross foreign debt (EUR bn)	174.3	195.0	205.0	230.0	249.4
Gross foreign debt (% of GDP)	57.1	59.6	58.6	60.2	59.4
FX reserves (EUR bn)	44.1	55.2	72.5	88.0	105.0
(Cur.Acc-FDI)/GDP (%)	-2.0	1.0	-0.6	-0.8	-1.1
FX reserves/Gross foreign debt (%)	25.3	28.3	35.4	38.3	42.1
Exchange rate to USD eop	2.97	2.86	2.99	2.77	2.60
Exchange rate to EUR eop	4.15	4.10	4.10	3.90	3.80
Exchange rate to USD avg	2.39	3.10	3.05	2.97	2.70
Exchange rate to EUR avg	3.52	4.33	4.05	4.00	3.90

Source: UniCredit Research

STRENGTHS

- Sound corporate and banking sector
- Accelerating labor market and private consumption
- Acceleration of spending of EU funds in 2011 due to EURO2012 Football Championships

WEAKNESSES

- High budget deficits and accompanying borrowing needs
- Inflation may surprise on the upside in 2011
- Upcoming parliamentary elections (Fall 2011) make it unlikely that any fiscal reforms will be proposed prior to this

Poland: Solid growth ahead

We raised our GDP forecasts due to strong private consumption

In the previous quarterly we wrote that our 3.7% forecast for GDP was still prudent, and upside revisions could occur should the risk of a "double dip" weaken. This risk indeed dissipated, and recent 3Q GDP numbers also prompt further optimism, in our view, as it turned out that private consumption continued to rebound stronger than expected. Regarding 4Q10 and 1Q11, we expect some shift in demand; as the base VAT rate is hiked from 22% to 23%, and some changes in taxation in the purchase of company cars is implemented, quite a lot of demand from early-2011 should be transferred to end-2010, helping 4Q10 GDP to be even stronger than the 4.2% in 3Q. This should slightly lower private consumption at the beginning of 2011, especially in 1Q, but in terms of total GDP, this effect would likely be offset with stronger investment numbers in 1Q11 due to the very low base from the previous year caused by an extremely severe winter.

2011 should see solid GDP growth of 4.4%

The labor market will likely accelerate further, supporting private consumption

EU funds will likely boost public investment

We are fairly optimistic on the growth outlook for 2011 as a whole, expecting 4.4%, as several factors should come into play. Firstly, the labor market should continue to accelerate, with the real wage bill at close to 5% yoy, compared to less than 2% in 2010. The labor market may get an additional boost from the German labor market opening for Polish workers in May 2011. We do not expect a radical impact from "day 1", but nonetheless, given the wage differential, some companies will be forced to increase wages, increasing the disposable income of employees. Given that households appeared fairly willing to spend recently, additional disposable income would likely be largely utilized in consumption. Secondly, EU funds (discussed in detail in our previous quarterly) should provide an additional boost to the economy, mostly through very strong public investments, but in the "second round" of money should also be felt elsewhere. Thirdly, the zloty remains at levels attractive for exporters, which – even at stronger zloty levels – reported an increase of new orders from abroad in recent PMI readings.

Inflation may offer negative surprises in 2011

We expect 75bp of hikes by MPC in 2011

The scenario mentioned above includes serious inflation risks, however. At end-2010 inflation is likely to stay at 3.0% yoy (or a notch higher), and in 2011 we expect CPI to move higher around mid-year, probably even exceeding the upper end of the MPC "tolerance zone" of 3.5%. This would prompt rate hikes – we expect the reference rate to increase by 75bp in 2011, and with the cycle starting as soon as in 1Q11.

The zloty is likely to stay under pressure at the beginning of the year, we expect a strengthening trend later on

Our forecast of EUR-PLN above 4.00 at end-2010 (which was an anti-consensus call, with the consensus view of around 3.85 for most of the year) has a good chance of being correct. Regarding 1Q11, we expect further volatility (mostly on external factors), and this suggests EUR-PLN could see levels above 4.20. If this happened, it could be a good chance to buy PLN, as fundamentals seem strong, and later in the year we would expect the zloty to strengthen, with EUR-PLN below 4.00 in end-2011. Against this backdrop, 2011 will likely push POLGBs yields by 70-80bp (2Y) and by 40-60bp in the 5Y and 10Y tenors.

The clear risk in our optimistic scenario remains public finance. In our view, a lack of reforms will likely act as a "beta-booster". Strong growth would mean strong budget revenue and could strengthen investors' optimism for PLN assets, whereas any negative surprises would be multiplied by fiscal worries.

Political outlook

The political situation remains stable, with the governing Civic Platform party getting around 35%-40% of support, and the key opposition party in trouble, as some of its MPs decided to set up a new party.

FX and sovereign credit rating outlook

We do not expect any changes in credit outlook in the next few months. However, we see the rating agencies clearly signaling that if the government does not start serious public finance reforms after the parliamentary elections, ratings will likely suffer.

Romania

Outlook – The decoupling of the Romanian economy from the regional and EU recovery is related to local factors, in our view. We see the country now facing the harming effects of the pro-cyclical fiscal policy of the last couple of years. Very weak domestic demand has been hit by the tightening fiscal policy and relatively high interest rates, with no more room for monetary policy softening given the accumulating inflationary pressures. Nevertheless, by reaching the bottom after two years of contraction, some positive growth numbers are in the pipeline for 2011.

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	Moody's	S&P	Fitch
Long-term foreign currency credit rating	Baa3 stable	BB+ stable	BB+ stable

MACROECONOMIC DATA AND FORECASTS

	2008	2009	2010E	2011F	2012F
GDP (EUR bn)	136.9	115.9	118.7	124.5	140.3
Population (mn)	21.5	21.5	21.4	21.3	21.2
GDP per capita (EUR)	6,360	5,393	5,550	5,851	6,624
GDP (constant prices yoy %)	7.1	-7.1	-2.5	1.7	3.4
Private Consumption, real, yoy (%)	8.4	-9.2	-2.2	2.0	4.7
Fixed Investment, real, yoy (%)	19.3	-25.3	-14.9	6.6	5.5
Public Consumption, real, yoy (%)	3.7	1.2	-3.6	-2.0	2.0
Exports, real, yoy (%)	19.4	-5.5	17.0	10.0	8.5
Imports, real, yoy (%)	17.5	-20.6	15.7	10.8	10.0
CPI (average, yoy %)	7.9	5.6	6.1	6.1	3.7
Central bank reference rate	10.25	8.00	6.25	5.50	4.50
Monthly wage, nominal (EUR)	347	326	332	342	382
Unemployment rate (%)	4.0	6.3	7.6	7.2	7.0
Budget balance (% of GDP)	-4.9	-7.4	-7.0	-5.0	-4.5
Current account balance (EUR bn)	-16.9	-5.1	-6.5	-7.0	-8.2
Current account balance (% of GDP)	-12.3	-4.4	-5.5	-5.6	-5.8
Net FDI (EUR bn)	9.0	4.9	3.6	5.0	7.0
FDI (% of GDP)	6.6	4.2	3.0	4.0	5.0
Gross foreign debt (EUR bn)	51.8	65.6	74.1	79.4	86.9
Gross foreign debt (% of GDP)	37.8	56.6	62.4	63.8	62.0
FX reserves (EUR bn)	26.2	28.3	30.7	29.0	27.4
(Cur.Acc-FDI)/GDP (%)	-5.7	-0.1	-2.5	-1.6	-0.8
FX reserves/Gross foreign debt (%)	50.7	43.1	41.4	36.5	31.5
Exchange rate to USD eop	2.83	2.94	3.14	2.98	2.77
Exchange rate to EUR eop	4.03	4.23	4.30	4.20	4.05
Exchange rate to USD avg	2.52	3.05	3.17	3.19	2.85
Exchange rate to EUR avg	3.68	4.24	4.22	4.30	4.13

Source: UniCredit Research

STRENGTHS

- Significant IMF and EU balance of payments support
- Low public sector debt levels
- Stable C/A deficit

WEAKNESSES

- High public deficit with risk of overshooting
- High FX leverage in domestic private sector
- Deteriorating loan portfolio quality

2011 expectations moderately encouraging

Depressed local demand to bottom out in 2010

The Romanian economy dropped by 2.5% yoy (-0.7% qoq) in 3Q10, deepening the contraction from the 0.5% yoy drop in 2Q10. Consumption contracted by less than we expected at -1.1% yoy, while more negative figures were released for fixed investments, which contracted by 14.7% yoy. On the positive side, the economy, especially the manufacturing industry (4.2% yoy real growth) has been boosted by the strong external demand. Net exports had a slight positive contribution on a yearly basis with stronger growth in exports than imports in real terms (14.6% yoy vs. 11.9% yoy). Inventories brought the strongest positive contribution (around +3 pp). for the second quarter in a row. Nevertheless, the inventory cycle is very volatile during the economic cycle and we believe its recovery should be more or less over in Romania. Consequently, this positive contribution might disappear in subsequent quarters. Looking ahead, we see a stronger setback in growth for the last quarter of 2011. However, more encouraging is that in 2011 we would expect Romania to gain further support from export markets amid a slow recovery of domestic demand, but still underperforming the region (1.7% yoy growth). We see the decoupling of the Romanian economy from the EU and other CEE countries as driven by local factors and it represents a major risk for recovery. At a time when investors are very sensitive to country-specific imbalances, the competitiveness of the country might be harmed.

Worsening inflationary risks: after the 5 pp VAT hike, food prices to lift the CPI further with a less certain outlook

We adjust upward our expectation for 2010 inflation at 8.0% yoy eop, and we still see a real chance that inflation would return to its normal range in 2H11, decelerating towards 4.2% yoy. This year's inflation was marked by a one-off jump due to the VAT increase (+5pps) as of July 2010, and escalating food prices on the international market. The NBR estimated the transmission coefficient of the VAT hike at 61%, since the depressed demand slammed the brakes on a price hike. Due to the jump in headline inflation, real rates turned negative. Nevertheless, a policy rate hike amid the persistent, negative output gap would likely do more harm than good. Accordingly, we expect the NBR to keep the monetary policy rate at the current level of 6.25% until year-end. Nevertheless, due to additional inflationary pressures the probability for an upward movement has been increasing and giving less space for softening in 2011 (5.5% instead of previous scenario of 5%).

Ambitious 2011 budget draft to be endorsed in December

On the fiscal side, Romania recorded a consolidated budget deficit of RON 23.7 bn (4.6% of GDP vs. an end-year target of 6.8%) at the end of October, narrowing by 7.2% yoy. In August VAT collections showed a significant improvement, accelerating to 10.3% yoy. A 25% reduction in public sector wages was reflected in personnel expenditures for 10M10 dropping by 6.7% yoy. Social assistance remains the biggest component on the expenditure side, amounting to 35.6% of total public expenditure (11% of GDP). Nevertheless, Romania is currently trying to address part of the problem in social spending through passing a new pension law that should index pensions to inflation instead of gross wages. We still see the budget deficit target as reachable this year. **The government announced that it would endorse the 2011 budget law and submit it to the parliament in the beginning of December.** The budget draft envisages a deficit of 4.4% of GDP with fewer funds for local administration and social benefits. The budget is based on the assumption of relatively flat budget expenditures while revenues are expected to increase by 7% yoy. Further tightening of the fiscal stance amid a prolonged recession could be very ambitious, escalating the social pressures (lower social benefits like a reduction in maternity benefits). Moreover, even tighter macroeconomic policies might harm the recovery of the struggling economy and would indirectly increase the risk of fiscal slippage through lower-than-expected growth.

Neutral on sovereign outlook, RON is not ready for a sustainable rally

Fiscal performance and external financing conditions (the final IMF/EU tranches are to be received in 1Q11), continue to be crucial for Romania's sovereign credit outlook. Due to some uncertainties in external financing and ongoing fiscal-related risks, we believe the RON is not yet ready for a sustainable recovery, and hence we expect EUR/RON to fluctuate at the current level of 4.30 with some slight appreciation towards end-2011 at 4.20.

Slovakia

Outlook – The economy has been rebounding strongly in 2010 but is predicted to slow-down somewhat in 2011 on the back of the government's austerity package, anemic household consumption and lower growth in the euro-zone. The new government is committed to implementing a multi-year fiscal consolidation program bringing the deficit to below 3% in 2013 and tackling structural issues to further enhance the economy's competitiveness. However, political fragilities will have to be managed carefully for the coalition government to remain in power for the whole four-year term.

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	Moody's	S&P	Fitch
Long-term foreign currency credit rating	A1 stable	A+ stable	A+ stable

MACROECONOMIC DATA AND FORECASTS

	2008	2009	2010E	2011F	2012F
GDP (EUR bn)	64.6	63.1	66.1	70.6	76.0
Population (mn)	5.4	5.4	5.4	5.4	5.4
GDP per capita (EUR)	11,928	11,670	12,243	13,074	14,073
GDP (constant prices yoy %)	5.8	-4.8	3.9	3.1	4.5
Private Consumption, real, yoy (%)	6.2	0.3	0.0	-0.2	3.9
Fixed Investment, real, yoy (%)	6.1	5.6	2.4	2.2	1.6
Public Consumption, real, yoy (%)	1.0	-19.9	2.0	-5.0	2.5
Exports, real, yoy (%)	3.1	-15.9	14.5	6.2	7.0
Imports, real, yoy (%)	3.1	-18.6	12.5	3.5	6.4
CPI (average, yoy %)	4.6	1.6	1.0	4.1	3.7
Central bank reference rate	2.50	EUR	EUR	EUR	EUR
Monthly wage, nominal (EUR)	723	745	770	792	837
Unemployment rate (%)	9.6	12.1	14.5	14.2	13.2
Budget balance (% of GDP)	-2.3	-8.0	-7.8	-4.8	-3.5
Current account balance (EUR bn)	-4.4	-2.0	-2.6	-2.3	-2.3
Current account balance (% of GDP)	-6.5	-3.2	-3.9	-3.2	-3.1
Net FDI (EUR bn)	2.2	-0.2	1.1	1.0	1.5
FDI (% of GDP)	3.3	-0.3	1.6	1.4	2.0
Gross foreign debt (EUR bn)	35.8	46.8	55.7	62.7	66.4
Gross foreign debt (% of GDP)	55.4	74.2	84.2	88.9	87.4
(Cur.Acc-FDI)/GDP (%)	-3.3	-3.5	-2.3	-1.8	-1.1

Source: UniCredit Research

STRENGTHS

- A reform-ambitious new government
- Industry gained competitiveness recently
- Banking sector in good shape

WEAKNESSES

- Some political intra-coalition disputes
- Very dependent on foreign trade (extremely open economy)
- Poor state of the labor market feeding into anemic household demand

Reforms back on the agenda

Slovak 2010 GDP forecasts

	Previous	New
Market	4.1	4.0
CB	3.7	4.3
MinFin	4.0	-
UCB	**4.3**	**3.9**

Slovak 2011 GDP forecasts

	Previous	New
Market	3.6	3.6
CB	4.3	3.0
MinFin	3.3	-
UCB	**3.1**	**3.1**

The government committed to fiscal consolidation and structural reforms

The new Iveta Radicova government has been working on details of its economic reform program since coming to power in July 2010. However, given the coalition nature of the government, which includes pragmatic and reform-minded SDKU, liberals (SAS), conservatives (KDH) and moderate Hungarians (MOST-HID), several fragilities appeared. Some had to do with efforts to optimally design the fiscal consolidation program as the speed and depth of reform measures needed to be balanced with regard to their impact on the socially vulnerable segments of population. Another source of tension are the attempts to strengthen the rule of law and reduce corruption – choosing a new attorney general proved to be a very contentious issue that potentially could lead to a collapse of the government. Going forward, politically astute opposition head Robert Fico will likely attempt to destabilize the coalition government by trying to lure some of the coalition parties to form a new government with him. Hence, based on the half-year experience with the Radicova government, it appears that the new prime minister would be faced with the challenge of managing political fragilities very carefully if she wants the coalition government to remain in power for the whole four-year term so that it can implement a complex reform program that will put the economy on a high-growth path again.

The crisis hit Slovakia hard due to heavy export dependence and loss of currency flexibility

Meanwhile, the Slovak economy continued to rebound from what was the worst downturn since the transformational recession in the early 1990's. The country was hit hard by the crisis as its economy is extremely open with a high share of manufacturing and with its exports concentrated in consumer durables such as cars or electronics. The introduction of euro, while providing some financial shelter, further complicated the situation as it deprived the country of one important channel of adjustment – currency depreciation – which could have allowed it to preserve competitiveness at a time when neighboring currencies depreciated.

Industry back at the pre-crisis level and gained competitiveness

However, industry rebounded strongly and recouped the losses since the onset of the crisis, reaching its pre-crisis levels in September 2010 (based on seasonally adjusted data). Manufacturing of consumer electronics, heavy machinery, cars, chemicals and pharmaceuticals spearheaded the recovery. Industry, which shed nearly 20% of its workforce during the crisis, has created substantial buffer of competitiveness as the recent recovery was nearly job-less.

Household consumption continues to be weak

Although there was a meager improvement of the labor market in 2Q-3Q10, after the unemployment rate reached its peak in 1Q10 (15.1%), high unemployment is one of significant legacies of the crisis (currently at 14.1% in 3Q10). The poor state of the labor market helps explain weak household consumption this year. The recent figures, which break down 3Q10 GDP growth of 3.8% yoy on the demand side, show household consumption contracting by 0.3% yoy. The main driver of 3Q growth was investment and stocks – they increased 17.9% yoy (of that fixed capital by 4.8% yoy). Net exports no longer contributed to growth, despite high growth in exports (due to heavy investment goods imports). Government expenditures increased by 0.9% yoy. We revised our year-end 2010 GDP estimate to 3.9% yoy.

Investment activity and exports should be the key growth drivers in 2011

Economic growth should be more subdued in 2011 (3.1%) predominantly on the back of the government's austerity package. VAT and excise tax increases, as well as government expenditure cuts, should weigh on the economy. With expected increases in food and energy prices also feeding into higher inflation (4.1%), real wages may stagnate or even decline somewhat in the current year. This means that household consumption would not be among the key growth drivers in 2011. Rather, we expect investment activity to increase in the current year as some of the investments put on hold during the crisis should be put on stream and some restocking should take place. External demand should continue being positive for growth – in this case it is welcome news that Germany's economic recovery seems to be broad-based and sustainable in the medium term. A recent moderate revival of bank lending to the corporate sector should further support the ongoing recovery.

Slovenia

Outlook – Economic recovery is under way, but efforts to implement structural reforms are still the key to ensuring price competitiveness and longer-term growth prospects. The government is entering the second half of its mandate. General elections are due in 2H 2012, but the government's efforts to reform pension, health and labor legislation amid deficit reduction should result in occasional tensions in the ruling coalition.

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	Moody's	S&P	Fitch
Long-term foreign currency credit rating	Aa2 Stable	AA Stable	AA Stable

MACROECONOMIC DATA AND FORECASTS

	2008	2009	2010E	2011F	2012F
GDP (EUR bn)	37.3	35.4	36.5	38.3	40.4
Population (mn)	2.0	2.0	2.1	2.1	2.1
GDP per capita (EUR)	18,468	17,345	17,796	18,577	19,532
GDP (constant prices yoy %)	3.7	-8.1	1.2	2.5	2.8
Private Consumption, real, yoy (%)	3.5	-1.9	-0.1	1.2	2.5
Fixed Investment, real, yoy (%)	8.5	-21.6	-7.3	3.8	5.5
Public Consumption, real, yoy (%)	6.2	3.0	0.5	0.0	0.5
Exports, real, yoy (%)	3.3	-17.7	8.9	6.5	7.0
Imports, real, yoy (%)	3.8	-19.7	6.4	7.2	6.7
CPI (average, yoy %)	5.7	0.9	1.9	2.4	2.9
Central bank reference rate	2.50	1.00	1.00	1.25	2.25
Monthly wage, nominal (EUR)	1,391	1,439	1,490	1,530	1,570
Unemployment rate (%)	4.5	5.9	7.0	6.7	6.3
Budget balance (% of GDP)	-1.7	-5.5	-6.3	-5.8	-5.1
Current account balance (EUR bn)	-2.5	-0.5	-0.1	-0.2	-0.5
Current account balance (% of GDP)	-6.7	-1.5	-0.3	-0.6	-1.2
Net FDI (EUR bn)	0.4	-0.5	0.3	0.4	0.6
FDI (% of GDP)	1.0	-1.5	0.8	1.0	1.5
Gross foreign debt (EUR bn)	39.0	40.1	42.5	45.5	47.0
Gross foreign debt (% of GDP)	104.5	113.4	116.5	118.9	116.2
(Cur.Acc-FDI)/GDP,%	-5.7	-3.0	0.5	0.4	0.3

Source: UniCredit Research

STRENGTHS

- Continued recovery in export growth
- Industrial production
- Signs of more robust private consumption

WEAKNESSES

- Reform initiative implementation delays
- Wage trends potentially exceed productivity gains
- Real effective exchange rate appreciation

Mild recovery continues

Recovery on track, driven by net exports

Net exports are driving Slovenia's recovery. The economy grew 1.7% in 3Q10, and the trend qoq figures reveal growth of 0.3%, with net exports the main driver of economic activity on the back of recovery in Germany and other key Eurozone trading partners. Private consumption rose 0.6% yoy in 3Q10, the first increase since 4Q08, even with unemployment holding at 7%. Nevertheless, investment activity remains in deep negative territory, down 9.3% yoy (vs. a drop of 4.9% yoy in 2Q10); this is partly due to the strong ongoing contraction in the construction industry.

Inflationary pressures remain low and the current account deficit continues to narrow

Inflation remains low, as external imbalances narrow; given the weak domestic demand conditions we see minimal risk in this domain in 2011E. Exports of goods and services rose nearly 12% yoy 9M10, likewise imports. As a result, the balance of goods and services trade in September improved by about EUR 50mn. Nevertheless, the current account deficit is likely to have contracted to only 0.3% of GDP in 2010 due to a much lower income balance and smaller transfers deficit.

We lower our inflation forecast for 2011F by 50bp, but maintain our GDP forecast at 2.1%

Our forecasts are largely unchanged. We maintain our growth projection (2.5%) and reduce our inflation forecast (2.4% vs 2.9% previously), while projecting a less pronounced increase in the current account deficit in 2011E (to only 0.6% of GDP). However, the economy is not without its risks. Slovenia's price competitiveness has fallen since joining the Eurozone (Eurostat unit labor cost-based estimates of the real effective exchange rate show appreciation of 7% in 2009, with unit labor costs, as estimated by the Bank of Slovenia, increasing just 1% in 1H10 after an 8.5% rise in 2009), implying slower export growth in the medium term; public debt continues to rise, as deficit reduction efforts lag (see below).

We project the consolidated general deficit at 5.8% of GDP in 2011F, as reform initiatives take time to implement

Implementing reforms will take time. The government plans to bring the fiscal deficit within the Masstricht criterion of 3% of GDP by 2013, but this could be challenging. Consolidated general government data for 9M10 show the primary deficit up more than 20% yoy to EUR 1.25bn, with the headline deficit up more than 25% to almost EUR 1.7bn. Revenue growth improved in 3Q10, but this still implies a consolidated general government budget deficit of 6.3% of GDP in 2010, according to our estimates. We believe delays in the implementation of key pension and health care reforms are likely (the minimum retirement age is to be increased to 65, but less than a month remains before planned implementation on 1 January), likely pushing back the timing of fiscal deficit reduction and impacting public debt levels, which we project at close to 45% of GDP as of end-2011F; we would not expect this to alarm financial markets, but we will keep an eye on the trend.

Government enters second half of mandate

The government is entering the second half of its mandate. General elections are due in 2H 2012, but the government's efforts to reform pension, health and labor legislation amid deficit reduction should result in occasional tensions in the ruling coalition. We see the likelihood of early elections as low.

Sovereign credit rating stable

We expect no change in the sovereign rating. Our view on Slovenia is unchanged, with low public debt, fiscal deficit reduction efforts and evidence of a recovery in export growth being the main reasons that we expect no change in the sovereign rating over the next 12 months.

Bosnia & Herzegovina

Outlook – A few areas of the manufacturing sector are driving recovery, as the country and investors wait for new governments to be formed. In the mean time we expect to see a very gradual recovery in domestic demand coming through, but export growth will remain the main driver. We expect the sovereign rating to remain stable, as authorities are keeping up their end of the bargain, so the IMF program, which expires in July 2012, is on track.

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	Moody's	S&P	Fitch
Long-term foreign currency credit rating	B2 Stable	B+ Stable	–

MACROECONOMIC DATA AND FORECASTS

	2008	2009	2010E	2011F	2012F
GDP (EUR bn)	12.6	12.3	12.6	13.1	13.7
Population (mn)	3.9	3.8	3.8	3.8	3.8
GDP per capita (EUR)	3,281	3,193	3,275	3,403	3,577
GDP (constant prices yoy %)	5.4	-2.9	0.5	1.8	2.5
CPI (average, yoy %)	7.4	-0.4	2.1	2.1	2.6
Monthly wage, nominal (EUR)	568	616	622	635	655
Unemployment rate (%)	40.3	41.5	43.0	42.5	41.5
Budget balance (% of GDP)	-4.0	-5.7	-4.5	-3.7	-3.1
Current account balance (EUR bn)	-1.8	-0.8	-0.8	-1.0	-1.2
Current account balance (% of GDP)	-14.4	-6.8	-6.5	-7.7	-8.9
Net FDI (EUR bn)	0.6	0.2	0.0	0.3	0.5
FDI (% of GDP)	5.0	1.5	0.0	2.0	3.7
FX reserves (EUR bn)	3.2	3.2	3.2	3.2	3.3
(Cur.Acc-FDI)/GDP (%)	-9.4	-5.4	-6.5	-5.8	-5.1
Exchange rate to USD eop	1.40	1.36	1.43	1.39	1.34
Exchange rate to EUR eop	1.96	1.96	1.96	1.96	1.96
Exchange rate to USD avg	1.33	1.40	1.47	1.45	1.35
Exchange rate to EUR avg	1.96	1.96	1.96	1.96	1.96

Source: UniCredit Research

STRENGTHS

- IMF program provides a credible policy anchor
- Export growth
- Real exchange rate supportive of exports

WEAKNESSES

- Hiatus between election and government formation
- Domestic demand remains weak
- Large disparities among sectors

More variable recovery than headline figures suggest

Some manufacturing segments doing very well

Aggregate figures mask greater differences below the surface. Industrial production expanded 0.4% yoy in 3Q10, but contracted 0.1% in October. There is wide variation among manufacturing segments, with textiles, base metals, steel, refined fuel, rubber, plastics and car parts all posting double-digit gains in 10M10, even though the aggregate index rose just 0.8% yoy during the period. Sectors attracting investment (often from overseas) are performing well, while others decline. Apart from food and live animals (exports up almost 20% yoy in 10M10), these same sectors are among those recording the largest export growth. At the aggregate level, we estimate that real gross wages contracted 1.2% yoy in 9M10, but this masks the difference between the two main entities: in the Federation, real gross wages were essentially flat in 9M10, but in Republika Srpska in 10M10 we estimate them down about 3%. This suggests that private consumption should recover more quickly in the larger Federation, albeit at a moderate pace. Inflationary pressures remain minimal: in October headline inflation rose 2.2% yoy, largely reflecting the introduction of winter energy tariffs; we estimate core inflation down 0.6% yoy.

Our forecasts are largely unchanged. Apart from the fiscal deficit forecast we have not changed our view for 2011F. We estimate GDP expanding by 1.8% yoy, with consumer price growth averaging 2.1% and the current account deficit widening to 7.7% of GDP. We expect a very gradual recovery in domestic demand next year, with export growth again the main driver. Encouragingly for Bosnia Herzegovina, IMF estimates of price competitiveness suggest the currency board regime has not been detrimental to export growth, but import growth associated with the production process should underpin import expansion (much as in 2010), leading to a larger trade deficit. We expect a moderate rise in foreign direct investment in 2011F, with the basic balance improving by 0.7pp to -5.8% of GDP.

Deficit reduction efforts to continue, but exposed to risk of delay

Achieving the 3% of GDP fiscal deficit target could be challenging. Until all governments in Bosnia Herzegovina are formed, which we expect in 1Q11, reform initiatives will be on hold, impacting efforts to reduce expenditures. The main risks we see for the revenue side of fiscal policy include low inflation, investment activity and private consumption. Although the political cycle appears to be ideal for implementing reforms, the more complex nature of Bosnia Herzegovina's institutional structure increases the risk of coordination issues. We expect the country to keep the IMF program on track, but see significant scope for delays in achieving at least some targets and therefore project a consolidated general government budget deficit of 3.7% of GDP.

Formation of new governments should improve sentiment and provide greater vision on the pace of reforms

The formation of new governments should improve the investment environment. In 1Q11 governments at the national and entity levels should be formed (general elections were held in October 2010), likely improving the overall investment environment and the scope for ensuring Bosnia Herzegovina's adherence to the current IMF program.

No change to sovereign rating expected

We expect the sovereign rating to remain stable. The authorities are keeping up their end of the bargain, so the IMF program, which expires in July 2012, is on track. The program is a key policy anchor for the country and the main reason we expect no change to Bosnia Herzegovina's sovereign rating over the next 12 months.

Croatia

Outlook – The economy has bottomed out, though the recovery remains tentative. The main positive we see for 2011 is the expected completion of EU accession talks, which could generate the confidence needed to spur a new investment cycle. The C/A deficit has narrowed while the central bank remains committed to a stable currency. However fiscal reform continues to face delays given a general election scheduled for next November. The new government will have to quickly push ahead with fiscal consolidaiton.

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	Moody's	S&P	Fitch
Long-term foreign currency credit rating	Baa3 stable	BBB negative	BBB- negative

MACROECONOMIC DATA AND FORECASTS

	2008	2009	2010E	2011F	2012F
GDP (EUR bn)	47.4	45.4	45.5	47.0	49.4
Population (mn)	4.4	4.4	4.4	4.4	4.4
GDP per capita (EUR)	10,681	10,245	10,264	10,620	11,160
GDP (constant prices yoy %)	2.4	-5.8	-1.5	1.6	2.0
Private Consumption, real, yoy (%)	0.8	-8.5	-2.4	1.6	1.8
Fixed Investment, real, yoy (%)	8.2	-11.8	-9.3	3.5	5.3
Public Consumption, real, yoy (%)	1.9	0.2	-0.8	1.0	0.0
Exports, real, yoy (%)	1.7	-16.3	5.8	3.9	4.2
Imports, real, yoy (%)	3.6	-20.7	-0.8	4.7	4.6
CPI (average, yoy %)	6.1	2.4	1.0	2.3	2.8
Monthly wage, nominal (EUR)	1,044	1,050	1,054	1,072	1,106
Unemployment rate (%)	8.4	9.4	11.5	10.8	10.0
Budget balance (% of GDP)	-1.4	-3.9	-6.5	-6.8	-5.2
Current account balance (EUR bn)	-4.3	-2.5	-1.2	-1.7	-2.4
Current account balance (% of GDP)	-9.2	-5.5	-2.6	-3.5	-4.9
Net FDI (EUR bn)	3.2	1.2	0.8	1.3	2.0
FDI (% of GDP)	6.8	2.7	1.8	2.7	4.0
Gross foreign debt (EUR bn)	40.0	44.6	46.0	47.8	50.3
Gross foreign debt (% of GDP)	84.4	98.2	101.2	101.5	101.7
FX reserves (EUR bn)	9.1	10.0	10.7	11.5	12.5
(Cur.Acc-FDI)/GDP (%)	-2.3	-2.8	-0.9	-0.9	-0.9
FX reserves/Gross foreign debt (%)	22.8	22.4	23.3	24.1	24.9
Exchange rate to USD eop	5.29	5.09	5.39	5.21	5.01
Exchange rate to EUR eop	7.37	7.30	7.38	7.35	7.32
Exchange rate to USD avg	4.91	5.26	5.48	5.43	5.05
Exchange rate to EUR avg	7.22	7.34	7.29	7.32	7.30

Source: UniCredit Research

STRENGTHS

- EU accession talks nearing completion
- External imbalances narrowing
- Stable currency

WEAKNESSES

- Influence of political cycle on reform agenda
- Widening fiscal deficit
- Weak economic recovery

Source: UniCredit Research

2011: the year EU accession talks should be completed

Economic recovery remains tentative

Recovery remains tentative. The flash estimate for GDP growth in 3Q10 was 0.2% yoy, the first growth since 4Q08. Nevertheless, the recovery remains tentative. Industrial production surprised on the downside in October, falling 4.4% yoy on a working day adjusted basis, with the mom trend figures weaker. Retail sales data remain weak, while rising unemployment and falling real wages (gross wages in real terms were down 0.7% yoy in 9M10) suggest continued weak private consumption. Investment activity remains in deep recession, and inflation data point to a slow recovery: in October inflation was 1.4% yoy and core inflation was only 0.7% yoy.

Main economic forecasts unchanged

Our main economic forecasts for 2011 are unchanged, with expansion projected at 1.6% yoy and consumer price growth averaging 2.3%. The current account deficit for 2010 should be lower than expected: we now forecast a deficit of only 2.6% of GDP, but expect a deficit of 3.5% in 2011E. Compared to 2010, the basic balance should remain unchanged at -0.9% of GDP. Our views on the economy are essentially unchanged; we still expect only a gradual recovery in domestic demand next year, with export growth slowing following this year's rebound amid better external conditions. This implies inflation remaining low, although a larger statistical carry over into 2011 and potential increases in some administered prices should boost the average inflation rate to 2.3%.

Central bank signals willingness to tighten policy conditions if necessary; EUR/HRK should remain stable in 2011F

The central bank is prepared to tighten monetary conditions if the EUR/HRK rate moves too far. In late November/early December the EUR/HRK was heading towards 7.43 on the back of corporate demand for FX as the government reduced its stock of FX-linked t-bills and issued an HRK 4bn bond on the domestic market. Two FX interventions in November for EUR 350mn, statements by the central bank that the authorities would tighten liquidity conditions to stem any depreciation pressures, and the announcement of an offer by the strategic partner to shareholders in O&G company INA in early December brought the EUR/HRK back below 7.40. We expect a stable EUR/HRK next year, given the basic balance, slower accumulation of foreign debt, and the expected slight reduction in absolute external debt service obligations.

We see a slightly higher budget deficit in 2011F, with elections approaching at year end

The budget should be on autopilot in 2011. Heading into an election year the government surprised no one by leaving the fiscal settings largely unchanged. The 2011 budget should benefit from the full-year effect of the elimination of personal income tax deductions and the continued freeze of public sector salaries and pensions. Of more interest later in the year is whether (or to what extent) the government decides to unfreeze these salaries and pensions from 2012 onwards. Our consolidated general deficit forecast for 2011 is 6.8% of GDP, up slightly from our estimate of 6.5% of GDP for the 2010 deficit. Ongoing concerns about the Eurozone periphery could complicate the government's external debt issuance plans in 2011 (especially in 1Q11), but with t-bill yields still heading lower and domestic bond issuance always available the government has options for covering the public sector borrowing requirement.

Self-imposed goal of completing EU accession talks in 1H11

The government wants EU accession talks completed in 1H11; this is the government's goal rather than an EU forecast, with completion dependent on achieving progress on competition policy and legal affairs. It should be easier to gauge a completion date once the EC releases its opinion on shipyard restructuring plans; we expect completion by end-2011.

No change to credit rating

We expect no change in the credit rating. After March 2011 the government has no external bonds maturing until April 2014, suggesting reduced scope for stress on spreads after 1Q11. We expect the EU accession talks to be completed next year, so despite fiscal policy dynamics and a weak growth outlook, we expect no change to Croatia's sovereign credit rating over the next 12 months.

Kazakhstan

Outlook – Supportive commodity prices will continue to stimulate the economy, while the robust infrastructure spending and the associated multiplier effects will ripple through the economy, with growth expected to be one of the highest in the region at 5.3% yoy, slightly weaker than in 2010. The central bank hinted it might return to managed float in early 2011, we expect the NBK to allow some 5% nominal appreciation taking place in 2011.

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	Moody's	S&P	Fitch
Long-term foreign currency credit rating	Baa2 stable	BBB- stable	BBB- stable

MACROECONOMIC DATA AND FORECASTS

	2008	2009	2010E	2011F	2012F
GDP (EUR bn)	89.8	77.3	102.4	115.0	126.6
Population (mn)	15.7	16.2	16.3	16.5	16.6
GDP per capita (EUR)	5,729	4,772	6,265	6,977	7,608
GDP (constant prices yoy %)	3.3	1.2	6.0	5.3	5.5
Private Consumption, real, yoy (%)	3.8	-2.8	6.6	5.5	5.0
Fixed Investment, real, yoy (%)	1.7	1.9	1.6	8.8	11.1
Public Consumption, real, yoy (%)	5.5	1.1	2.9	4.6	3.9
Exports, real, yoy (%)	0.8	-6.2	12.0	5.0	13.6
Imports, real, yoy (%)	-11.5	-15.9	10.0	16.0	18.1
CPI (average, yoy %)	17.2	7.3	7.1	7.2	7.1
Central bank reference rate	10.50	7.00	7.00	7.25	7.50
Monthly wage, nominal (EUR)	343	329	408	453	491
Unemployment rate (%)	6.6	6.6	5.8	5.4	5.1
Budget balance (% of GDP)	1.2	-4.3	-4.1	-2.0	-1.0
Current account balance (EUR bn)	4.7	-2.4	1.9	-3.2	-4.3
Current account balance (% of GDP)	5.3	-3.2	1.9	-2.8	-3.4
Net FDI (EUR bn)	9.9	9.0	8.4	8.4	11.1
FDI (% of GDP)	11.0	11.7	8.2	7.3	8.8
Gross foreign debt (EUR bn)	79.9	75.5	91.0	93.9	98.3
Gross foreign debt (% of GDP)	88.9	97.7	88.9	81.6	77.7
FX reserves (EUR bn)	14.8	15.9	21.0	23.4	26.3
(Cur.Acc+FDI)/GDP (%)	16.3	8.5	10.1	4.5	5.3
FX reserves/Gross foreign debt (%)	18.5	21.0	23.0	24.9	26.8
Exchange rate to USD eop	120.88	148.36	147.40	140.00	135.82
Exchange rate to EUR eop	168.66	212.61	201.94	197.40	198.30
Exchange rate to USD avg	120.32	147.65	147.40	143.50	137.90
Exchange rate to EUR avg	176.98	205.89	196.04	193.37	199.27

Source: UniCredit Research

STRENGTHS

- Solid growth
- Large infrastructure programs
- Commodity environment favorable

WEAKNESSES

- Still meager investment activity
- Little credit growth
- Poor credit quality hurts non-resource recovery

Oil and infrastructure to fuel economy in 2011-2012

Our real GDP forecast is now 6.0% for 2010E, lower than the 7.5% of 1Q-3Q, mainly because of the high 4Q09 base

The Kazakhstani economy has strongly recovered from weak growth of 1.2% in 2009, with net exports playing a major role in lifting GDP expansion. Consumption and trade have also contributed, with investment remaining weak. In 2011-2012 we expect investment to recover on the back of high infrastructure spending. With high oil prices boosting corporate and government finances, domestic demand should take over as the main growth driver.

High oil prices should combine with large infrastructure investment to keep growth above 5% in 2011F-2012F

Oil and gas account for about 18% of GDP (25%, together with related services), with the impact much stronger due to large intermediate consumption and investment. We project oil prices averaging USD 85 and USD 90 in 2011F and 2012F, respectively, so with metals prices also on the rise, the Kazakhstani economy looks promising. The three-year budget projects spending on infrastructure and power station construction in 2011-2013 at KZT 1,745bn (EUR 9.2bn, annually about 2.3% of GDP), with KZT708bn of this for transportation (including the Western Europe-Western China corridor, railroads should be another target for upgrades, particularly terminals and rolling stock) and KZT 586bn for agriculture. Investment from all sources under the accelerated industrialization program should be about KZT 6.5tn (EUR 35bn, annually about 6% of GDP) in 2010-2014. The high multiplier of infrastructure spending should offset the negative growth implications of fiscal tightening in other spheres.

GDP growth slowed somewhat in 3Q10, but 2010 was a year of strong recovery overall

The weak spot up to now has been investment, but stronger investment to boost the economy in 2011-2012

Growth slowed a bit in 3Q10 from 1H10, but was still robust: real GDP growth in 9M10 was 7.5% yoy, which translates to 6.8% yoy (1.3% qoq sa) in 3Q10, somewhat less than the 8.8% (2.0%) in 2Q10. Employment was up 3.4% yoy in 3Q10, and monthly wages reached KZT 78,805 (EUR394) in September, up 17% yoy in nominal and 9.6% in real terms. Constant price retail trade grew 12.8% yoy in 10M10, industrial output 10.4%, mining 5.4% and manufacturing 18.7%. There was a particularly sharp increase in engineering, chemicals and construction materials, which suffered most from the 2008-2009 crisis. Mining held up well during the crisis, but manufacturing is now the most dynamic sector. Investment in fixed capital fell 1.8% yoy in 10M10, but was up 16.4% yoy in manufacturing. Housing prices have bottomed out since mid-2010 even in real terms; sales have begun to pick up and affordability has improved, giving an additional boost to 2011-2012 investment prospects.

Bank lending has recovered slightly, but credit quality remains the Achilles heel of recovery

Inflation within target despite the drought

Bank loans to resident companies and households have finally returned to modest growth, up 0.5% between August in October despite more write-offs, particularly by BTA. Credit quality remains a concern, but as investment activity becomes stronger, credit growth should recover more decisively. Inflation accelerated in 2H10 due to the drought in Russia and western Kazakhstan, but began to decelerate in November (0.8% mom sa vs. 0.9% in October). We revise our end-2010 inflation forecast from 8.1% yoy to 8.0% and expect inflation to remain within the central bank's target of 6%-8%.

Current account moves into deficit, but reserves to rise in 2010-2012

We keep our eop 2011 USDKZT prognosis of 140.

According to preliminary data, the current account deficit was USD 142mn in 3Q10 (Q1-Q3: USD+4.8bn) after a surplus of USD2.2bn in Q2, as growth in imports began to accelerate. The third quarter was the second straight quarter with nearly balanced BoP inflows and outflows after a significant surplus in 1Q10, so there was little movement in the exchange rate, despite few interventions by the central bank. Net international reserves rose by USD 1.2bn to USD 28.4bn in October after stagnating since April. The foreign assets of the oil fund reached an all-time high of USD 29.4bn in October. With borrowing from abroad likely to increase as investment recovers, we expect FX reserves to rise in 2011-2012. We revise our eop 2010E USD/KZT forecast from 144 to 147 because of the recent RUB weakness, but keep our eop 2011E forecast at 140. The central bank hinted it might return to managed float in 2011; we believe the KZT will move in line with the RUB as coordination within the Customs Union has increased in importance.

Russia

Outlook – Accelerating inflation, which is set to extend well into 2011, should call for increasingly aggressive rate hikes, which would test to the Central Bank of Russia's commitment to inflation targeting. We expect a cumulative 150bps rate hike, which would likely keep real interest rates in positive territory and should support firmer capital inflows sufficient to maintain the RUB stability, despite further contraction of the current account surplus. Economy is also expected to show more robust gains in 2011, with 4.3% yoy GDP growth pencilled in for now on more robust investment demand and further recovery in consumer spending.

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	Moody's	S&P	Fitch
Long-term foreign currency credit rating	Baa1 stable	BBB stable	BBB positive

MACROECONOMIC DATA AND FORECASTS

	2008	2009	2010E	2011F	2012F
GDP (EUR bn)	1,136.7	877.9	1,147.9	1,271.5	1,333.5
Population (mn)	141.6	141.3	141.0	140.4	140.1
GDP per capita (EUR)	8,027	6,213	8,141	9,055	9,520
GDP (constant prices yoy %)	5.2	-7.9	3.4	4.3	4.1
Private Consumption, real, yoy (%)	10.8	-7.7	6.1	5.0	4.8
Fixed Investment, real, yoy (%)	9.9	-16.2	4.5	7.5	7.0
Public Consumption, real, yoy (%)	2.8	2.0	0.8	-1.7	-2.8
Exports, real, yoy (%)	0.6	-4.7	2.5	6.4	4.9
Imports, real, yoy (%)	14.8	-30.4	29.8	8.5	4.1
CPI (average, yoy %)	14.1	11.7	6.8	9.1	7.5
Central bank reference rate	8.50	6.00	5.50	6.50	6.50
Monthly wage, nominal (EUR)	471	420	509	557	599
Unemployment rate (%)	6.3	8.4	7.6	7.1	6.5
Budget balance (% of GDP)	4.9	-9.3	-5.4	-5.3	-5.0
Current account balance (EUR bn)	70.2	34.9	49.2	37.7	15.7
Current account balance (% of GDP)	6.2	4.0	4.3	3.0	1.2
Net FDI (EUR bn)	28.7	21.3	25.5	30.6	36.7
FDI (% of GDP)	2.5	2.4	2.2	2.4	2.8
Gross foreign debt (EUR bn)	340.8	329.8	347.6	325.8	321.5
Gross foreign debt (% of GDP)	35.5	35.2	31.2	26.9	23.8
FX reserves (EUR bn)	302.9	307.3	324.8	315.2	297.3
(Cur.Acc-FDI)/GDP (%)	8.7	6.4	6.5	5.4	3.9
FX reserves/Gross foreign debt (%)	88.9	93.2	93.4	96.7	92.5
Exchange rate to USD eop	30.53	30.04	30.43	29.55	29.00
Exchange rate to EUR eop	42.59	43.04	41.69	41.67	42.34
Exchange rate to USD avg	24.78	31.65	30.33	29.89	28.74
Exchange rate to EUR avg	36.46	44.13	40.34	40.28	41.53

Source: UniCredit Research

STRENGTHS

- Strong balance of payments
- Low public debt and considerable fiscal reserves
- Low leverage of the economy in general

WEAKNESSES

- Dependence on commodities prices
- Structural inefficiencies
- Lack of domestic investment resources

Big test for inflation targeting goal

Inflation continues to accelerate, highlighting limited importance of supply shock

Continued acceleration of inflation leaves little room for discussion of non-monetary nature of an increase. The supply shock of the country's summer droughts seems to have finally faded by the end of 2010, giving way to genuine inflationary pressures in practically all CPI and PPI components, which show robust acceleration in seasonally adjusted terms and which we expect to continue to do so in the next several months. As a result, we reiterate our expectation that inflation would continue to accelerate to around 10% in mid-2011, gaining support from robust expansion of the money supply, which has been growing at over 30% yoy since early 2010.

Inflation already pushed real lending rates into negative territory, boosting robust investment demand growth

Rising inflation amid low or falling interest rates already pushed real borrowing costs close to zero or even below. We think that this is among the key reasons behind the strong recovery of investment demand in 2H10 and the notable growth of bank lending over the last several months of 2010. With robust commodities prices and the likely further acceleration of inflation, such a recovery of investment demand is likely to continue, triggering our upward revision in our investment forecast from 6% to 7.5% in 2011 on top of a stronger-than-expected 4.5% expansion in 2010E.

Interest rates seemed to have already bottomed out

Lending growth has already triggered a rebound of money market rates by draining excess liquidity from the banking system. Interbank rates finally decoupled from the floor set by CBR depo rates, triggering a drastic drop in bank deposits at the CBR, which we regard as the closest proxy for an excess of liquidity. We think this makes a potential CBR rate hike a potent liquidity sterilization and anti-inflationary tool through possible resumption of deposit accumulation at higher rates. On the other hand, we point out that a tightening cycle is among the key risks to the expected rebound of investment.

We expect a cumulative 100-150bp rate hike in 2011

Rate hikes on top of the reversal of liquidity flows from the budget should continue to raise money market rates

We reiterate our expectation of a cumulative 150bp rate hike from current levels in 2011. We continue to believe that the CBR is determined to proceed with its shift to a policy focus of inflation targeting, even despite the potential risks to economic recovery. The CBR already hinted at a hike in the near future, with the first hike possible as soon as in 2010. Additionally, we expect the federal budget to become a net borrower in 2011, with nearly RUB 1,500bn in planned gross OFZ issuance and expect the Reserve Fund to drain already by the end of 2010. Therefore, we expect that both of these factors would support further growth of interest rates and forecast the 3M Mosprime rate rising to 6.25% by the end-2011 or close to the expected 6.5% CBR direct auction repo rate at that time.

Higher interest rates should support the RUB amid contraction of current account and trade surpluses

We think that higher interest rates should give the RUB firmer support by attracting stronger capital inflows. We think this should help the RUB withstand intensified pressure from the likely further drop of the current account and trade surplus, due to continued expansion of imports. Therefore, we reiterate our expectations of the RUB strengthening to RUB 35/basket in 2011 eop and RUB34.6/basket on average.

Economic growth is likely to be more robust in 2011 than in 2010

Another weather shock is unlikely in 2011

We also reiterate our expectations that real GDP growth in 2011 is likely to be more robust than in 2010. We reiterate our forecast of 3.4% real GDP growth in 2010E and 4.3% in 2011E. We see the factors that constrained recovery in 2010, such as stagnating investment due to high real interest rates, strong recovery of imports, as well as reversal of fiscal support, no longer being in place in 2011. Apart from robust investment demand, we note the relatively higher budgeted public spending, partly due to upcoming elections, as well as continued expansion of private consumption. Import growth is likely to slow sharply in 2011 simply due to the high base effect of strong 2010 growth, which should also benefit GDP numbers. Moreover, in 2010 Russia had the worst drought in a century, which we believe is unlikely repeat in 2011. We think this should give real GDP a technical boost in 3Q11 yoy through a considerable low base effect, thereby supporting annual growth.

Serbia

Outlook – Economic growth ought to be more robust in 2011 with continued investment in the automotive sector and higher pensions/public sector salaries boosting domestic demand. However, inflation will also continue to rise, and we expect the inflation target not to be met in 2011, something that in our view exposes the RSD to further depreciation pressures – in reaction to this we see the National Bank continuing its policy of rate hikes through Q1. We do not expect the Serbian authorities to seek renewal of the IMF program when it expires in April.

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	Moody's	S&P	Fitch
Long-term foreign currency credit rating	Not rated	BB- stable	BB- stable

MACROECONOMIC DATA AND FORECASTS

	2008	2009	2010E	2011F	2012F
GDP (EUR bn)	33.4	29.9	29.6	30.3	32.8
Population (mn)	7.4	7.3	7.3	7.2	7.2
GDP per capita (EUR)	4,545	4,099	4,072	4,184	4,546
GDP (constant prices yoy %)	5.5	-3.1	1.8	2.7	3.5
CPI (average, yoy %)	11.7	8.4	6.3	9.4	6.7
Central bank reference rate	17.75	9.50	11.50	10.50	8.50
Monthly wage, nominal (EUR)	561	470	460	453	474
Unemployment rate (%)	13.7	16.1	20.0	18.8	17.5
Budget balance/GDP (%)	-2.0	-4.2	-4.7	-4.2	-3.7
Current account balance (EUR bn)	-7.1	-2.1	-2.3	-2.7	-2.9
Current account balance (% of GDP)	-21.1	-7.0	-7.9	-8.9	-8.8
Net FDI (EUR bn)	1.8	1.4	1.0	2.2	2.0
FDI (% of GDP)	5.5	4.7	3.4	7.3	6.1
Gross foreign debt (EUR bn)	21.8	22.8	24.0	26.0	28.0
Gross foreign debt (% of GDP)	65.3	76.1	81.0	85.7	85.3
FX reserves (EUR bn)	8.2	10.6	9.6	11.0	10.5
(Cur.Acc-FDI)/GDP (%)	-15.7	-2.3	-4.5	-1.7	-2.7
FX reserves/Gross foreign debt (%)	37.4	46.5	40.0	42.3	37.5
Exchange rate to USD eop	64.34	67.11	78.83	82.98	76.71
Exchange rate to EUR eop	89.78	96.17	108.00	117.00	112.00
Exchange rate to USD avg	55.40	67.45	77.22	83.49	79.24
Exchange rate to EUR avg	81.49	94.05	102.70	112.50	114.50

Source: UniCredit Research

STRENGTHS

- Basic balance to improve as FDI inflows rise
- Better outlook for investment activity in 2011

WEAKNESSES

- Depreciating currency
- Rising inflation

On the lookout for a turning point in EUR/RSD

More and more signs of stronger domestic demand

Recovery continues. Our 3Q10 flash estimate for GDP growth was 2.1% yoy, implying 2010E expansion of 1.8%. Trends in industrial production and merchandise exports also point to Serbia achieving a moderate recovery this year.

With stronger growth comes the risk of wider external imbalances and higher inflation

We revise our inflation forecast upwards. We maintain our GDP forecast of 2.7% for 2011E, reflecting expectations of continued investment in the automotive sector, with higher pensions and public sector salaries boosting domestic demand. Our main focus, however, is inflation, which we project at 7.5% as of end-2011E, 150bp above the central bank's ceiling target. We expect inflation to peak near 12% yoy in 1Q11E, with base effects pushing it lower, especially in 4Q11E. Food prices have been a major factor behind inflation dynamics in 2010, and harvest surprises on the upside would have a downward impact. However, as this autumn's milk shortages in Serbia demonstrated, imperfect market structures influence inflation dynamics regardless of the vagaries of the agricultural season.

We see the policy rate peaking at 14% in March or April 2011

We expect tighter monetary policy in response to currency weakness. The National Bank of Serbia responded to renewed currency weakness in late October by intervening heavily through early December (total FX interventions were EUR 388mn over this period) and raising interest rates another 150bp to 11.5% during 4Q 10. This is the main reason we lower our end-2010E EUR/RSD projection from 110 to 108. We expect policy rates to peak at 14% next March or April (implying yields of about 16% for t-bills) and, as inflationary pressures ease, to be cut to 10.5% by end-2011E. We still see upside risk for the EUR/RSD rate and forecast an end-2011F figure of 117, implying slower depreciation. However, we do not discount the fact that high real yields on t-bills could lead to a turning point in the EUR/RSD post 1Q 11.

On the plus side for the RSD, we project the current account deficit widening to 8.9% of GDP in 2011E, but investment in the automotive sector and the privatization of Telekom Srbije, the state-controlled fixed-line operator, should narrow the basic balance sharply from -4.5% of GDP this year to -1.7% in 2011E. For the telecom privatization we pencil in EUR 1bn in government receipts, although some local media reports have mentioned higher proceeds from the sale. Our best guess is that a deal would be completed in autumn 2011.

The negatives include higher external debt servicing next year (the IMF estimates an increase of EUR 500mn to EUR 6.2bn) and inflation, which we see peaking in 1Q11. The highly likely non-renewal of the IMF program could negatively affect sentiment toward the RSD, and the central bank is due to release additional RSD liquidity into the system in February-April as part of the mandatory reserve requirement changes initiated in 2010.

IMF program on target, fiscal responsibility legislation in place

We do not expect the Serbian authorities to seek renewal of the IMF program when it expires in April. Serbia has not drawn down the full allotment of available IMF funds, instead financing the gap in the 2010 budget with a syndicated EUR 250mn loan while the government has announced the issuance of either inflation linked or FX-linked t-bills auctions on 22 and 29 December this year; there has been talk of international financial institutions issuing local currency bonds next year, and privatization revenue should also ensure easier deficit financing. Additionally, fiscal responsibility legislation is in place, which although exposed to election year risk – general elections are scheduled for May 2012 – does provide more guidance on fiscal policy trends.

Turkey

Outlook – The recovery in IP is beyond doubt and strong bounce back effect is likely to end up in a drastic growth in 1Q2010. Turkey will definitely overperform on the growth front relative to peers in her region, and for more than one year. Fiscal rule could prove to be a huge plus for rerating purposes and investment grade status even before elections next year has a high probability of occurrence in the face of continued fiscal discipline.

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	Moody's	S&P	Fitch
Long-term foreign currency credit rating	Ba2 positive	BB positive	BB+ positive

MACROECONOMIC DATA AND FORECASTS

	2008	2009	2010E	2011F	2012F
GDP (EUR bn)	499.5	442.7	557.1	616.2	668.5
Population (mn)	71.5	72.6	73.4	74.2	75.0
GDP per capita (EUR)	6,985	6,101	7,593	8,307	8,918
GDP (constant prices yoy %)	0.7	-4.7	7.4	4.1	5.1
Private Consumption, real, yoy (%)	0.5	-2.2	6.4	3.6	5.0
Fixed Investment, real, yoy (%)	-8.2	-19.1	20.5	9.2	10.0
Public Consumption, real, yoy (%)	1.7	7.8	1.5	3.0	2.5
Exports, real, yoy (%)	2.7	-5.3	4.3	4.1	6.0
Imports, real, yoy (%)	-4.2	-14.3	17.7	6.9	8.9
CPI (average, yoy %)	10.5	6.3	8.6	5.8	6.9
Central bank reference rate	15.00	6.50	7.00	7.75	8.75
Monthly wage, nominal (EUR)	734	634	790	889	945
Unemployment rate (%)	11.0	14.0	11.6	10.7	10.1
Budget balance (% of GDP)	-1.8	-5.5	-3.6	-3.2	-2.4
Current account balance (EUR bn)	-28.2	-10.0	-33.1	-35.6	-34.3
Current account balance (% of GDP)	-5.6	-2.3	-5.9	-5.8	-5.1
Net FDI (EUR bn)	12.3	4.1	6.0	7.4	8.3
FDI (% of GDP)	2.5	0.9	1.1	1.2	1.2
Gross foreign debt (EUR bn)	188.6	192.9	222.8	237.2	260.7
Gross foreign debt (% of GDP)	37.8	43.6	40.0	38.5	39.0
FX reserves (EUR bn)	50.2	49.3	53.3	54.6	52.7
(Cur.Acc-FDI)/GDP (%)	-3.2	-1.3	-4.9	-4.6	-3.9
FX reserves/Gross foreign debt (%)	26.6	25.6	23.9	23.0	20.2
Exchange rate to USD eop	1.54	1.49	1.51	1.44	1.42
Exchange rate to EUR eop	2.15	2.14	2.07	2.03	2.07
Exchange rate to USD avg	1.30	1.55	1.50	1.48	1.43
Exchange rate to EUR avg	1.91	2.16	2.00	1.99	2.07

Source: UniCredit Research

STRENGTHS

- Solid financial sector improving on the back of recovery
- Sustainable public debt dynamics
- Political risk mitigated following the September referendum

WEAKNESSES

- Reliance on external financing for growth purposes
- Rapid increases in the C/A deficit as the economy recovers
- EU convergence process stalled

Growth to moderate but remain impressive

Growth momentum to slow but remain relatively strong

Turkish growth continues to post strong gains. It registered a 3Q growth rate of 5.5% YoY, below consensus estimates of 6.5% and slightly above our significantly less upbeat forecast of 4.7%. Private consumption expenditure grew 7.6% while capex growth was impressive for a second consecutive quarter at 31.3%, driven mostly by private sector expenditures. Exports fell by 2.0% and imports surged by 16.9%. Hence the leakage from net exports amounted to 4.6 percentage points. This is a growth story that is too reliant on domestic absorption leading to an external deficit at a very fast pace. We do not believe this will ultimately have an impact on the currency, but authorities will probably be keener on cooling down scenarios than they would have been in the presence of better external balance prospects. Our take is that Turkey will end the year with a growth rate that is in the vicinity of 7.4%, a strong bounce back effect from last year's minus 4.7%, and post gains of 4% next year.

Inflation remains non-problematic

Annual inflation took a nose dive and fell to 7.3% in November from 8.6% a month. A decline in food prices following three months of increases was the primary driver. The CBRT's favored core inflation index (I) (which excludes food products, energy, alcoholic beverages, tobacco products and gold) remained at a historic low of 2.5%. The CBRT's most recent inflation note purports that headline inflation will continue to fall in the upcoming months but that core inflation indices will display limited upward movements.

Fiscal performance is impressive

Central budget government figures as of end-October point to a stellar performance but this is likely to deteriorate over Nov-Dec. Nevertheless, the deficit is currently at 46.1% of the year-end target and primary surplus realization 3 times the year-end target. As such the target is not at risk. The government's approach to fiscal policy over H1 next year ahead of the election is important. Finance Minister Simsek has hinted at some populist policies ahead of the election, with some reversal soon afterwards. Though not our baseline, we see significant signalling advantages to prudence on fiscal front to the extent that it has the potential to generate a ratings upgrade.

The CBT sticks to its plan of rate hikes in Q4, though the risks are weighted towards earlier

There is still nothing in inflation readings to date that will induce the CBT to divert from its intended course of "low for longer" and "hikes as of 4Q2011" for now. Nonetheless the risks are weighted towards earlier hikes. The Bank recently announced that given the continued low growth prospects in developed markets which will support inflows to EM, a new plausible scenario option has also emerged. An appreciating TRY, resulting from FX inflows, will put downward pressure on inflation as the economy continues to operate below capacity. That in turn will support further credit expansion which increases the risk of asset bubbles. This new mixture of events will lead the CBRT to cut policy rates AND actively use tools other than policy rate for liquidity contraction purposes. At this stage, this is not our baseline scenario for CBT policy next year but nonetheless worthy of mention.

AKP is on track for strong election win

Political risk in Turkey is by and large seen as minimal following the Constitutional Package referendum in September that ended with a landslide victory for the ruling AKP against a very wide opposition coalition including nationalists, the Kurdish party, the main opposition CHP, all sorts of extremist leftist fractions, etc. If the AKP moves tactfully and avoids blatant mistakes for the next 6 months, they may end up with an election victory that could beat their current forecast hands down. The main opposition party CHP is trying (to give the impression of) a structural overhaul with a more social democrat and embracing approach to all segments of the society including the conservative and the pious, but it is likely to bear little fruit before election time. It looks safe to bet on another landslide victory by the AKP and a third consecutive tenure period on their part – a first for Turkish politics.

Ukraine

Outlook – Economy enters 2011 on a solid footing, with preparation for EURO2012 and recovery in consumer spending to play a key role. IMF stand-by agreement, remains an anchor of stability and a driver of reform, with key reforms to be initiated during 2011. A faster than expected widening of the current account will keep pressure on the UAH in the coming months, but we see more potential towards appreciation in spring.

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	Moody's	S&P	Fitch
Long-term foreign currency credit rating	B2 stable	B+ stable	B stable

MACROECONOMIC DATA AND FORECASTS

	2008	2009	2010E	2011F	2012F
GDP (EUR bn)	123.4	81.4	106.1	127.1	148.8
Population (mn)	46.4	46.1	45.8	45.5	45.3
GDP per capita (EUR)	2,661	1,766	2,317	2,792	3,285
GDP (constant prices yoy %)	2.1	-15.1	4.0	5.0	5.0
Private Consumption, real, yoy (%)	11.6	-14.2	1.8	4.5	4.5
Fixed Investment, real, yoy (%)	4.2	-46.2	8.5	17.0	17.0
Public Consumption, real, yoy (%)	-0.4	-8.8	1.5	0.7	0.9
Exports, real, yoy (%)	6.7	-25.6	9.0	9.5	10.0
Imports, real, yoy (%)	17.5	-38.6	8.5	14.0	13.0
CPI (average, yoy %)	25.2	16.0	9.4	11.0	10.4
Central bank reference rate	12.00	10.25	7.75	8.50	8.75
Monthly wage, nominal (EUR)	234	170	197	230	259
Unemployment rate (%)	6.4	8.8	7.2	6.4	6.0
Budget balance (% of GDP)	-1.3	-11.3	-6.0	-3.4	-3.0
Current account balance (EUR bn)	-8.8	-1.4	-1.5	-2.1	-3.4
Current account balance (% of GDP)	-7.1	-1.7	-1.4	-1.7	-2.3
Net FDI (EUR bn)	7.3	3.2	4.4	6.6	6.8
FDI (% of GDP)	5.9	3.9	4.1	5.2	4.6
Gross foreign debt (EUR bn)	75.1	72.6	82.2	85.0	88.9
Gross foreign debt (% of GDP)	60.8	89.1	77.5	66.9	59.8
FX reserves (EUR bn)	19.9	17.9	25.9	28.4	30.0
(Cur.Acc-FDI)/GDP (%)	-1.2	2.2	2.8	3.5	2.3
FX reserves/Gross foreign debt (%)	26.6	24.7	31.5	33.4	33.7
Exchange rate to USD eop	7.81	8.01	7.95	7.60	7.30
Exchange rate to EUR eop	10.90	11.48	10.89	10.72	10.66
Exchange rate to USD avg	5.24	8.06	7.95	7.78	7.45
Exchange rate to EUR avg	7.70	11.24	10.57	10.48	10.77

Source: UniCredit Research

STRENGTHS

- Ambitious reform program by the government
- Significant NBU FX reserves
- Significant spare capacity

WEAKNESSES

- C/A balance deteriorating on import recovery
- Ageing population
- Fiscal slippage risk at end of 2011 on pre-election spending

A year to reform, and a year to build

Economy enters 2011 on a solid footing

The economy enters 2011 on solid footing, with growth momentum surprising on the upside in 2H10. We are starting to see a broad-based recovery of domestic demand, with investment demand picking up on EURO 2012 preparations and the associated infrastructure revamp. Furthermore, we anticipate a more robust pick-up of consumer spending in the coming quarters as confidence recovers – already in 3Q-4Q10 we have been seeing robust signs in retail trade. The relatively low unemployment level and high real wage growth averaging 9.8% in 2010, along with our expectations of at least 5% growth in 2011 are supportive. Moreover, an improvement in the credit growth environment should provide an additional boost: at 1.4% yoy in November, and even more robust in terms of local currency, which we saw accelerating to 13.4% yoy. Thus **the growth story for upcoming years is one of domestic-led factors**, while net trade will likely be a drag on growth. We nudged our 2010E GDP forecast to 4% on the better performance we saw in 3Q and we keep our **growth rate forecasts above market expectations of 5% for 2011 and 2012** – which we believe will be close to potential GDP.

domestic led factors to drive economic performance

IMF policy a key anchor of stability and a driver of reform

The USD 15.2bn stand-by program with the IMF remains a key policy anchor, and the government should keep it on track to keep market funding open. The second USD 1.6bn tranche is expected to be disbursed by the end of December, given that IMF conditions for a benign 3.1% budget deficit in 2011 have been met. However, the government will need to do more to receive future tranches, the first big test will come with the anticipated 50% gas price hike in April. Furthermore, we expect to see some kind of reform in the pension system, further consolidation of the banking system and privatization of the energy sector, and would welcome to see the implementation of the ambitious administrative reform, which could reduce the bureaucracy apparatus by 30-50%. We hold with a high degree of probability that many reforms will be met, given the absence of a political cycle in 2011. **Indeed, we see 2011 as a window of opportunity to do what has been long neglected before the October 2012 parliamentary elections are held.** Should all of the above come to fruition, we should see further tightening of CDS premiums during 2011, which are still too high to their fair value, but would be more cautious about 2012 when the country is to begin repayment of IMF funds.

2011 is a window of opportunity to reform

After the autumn food price spike, prices moderated during the winter months, helping the authorities to keep inflation in single digits toward year-end, although there were reports that forms of mild price control were used. In 2011, however, we expect to see the danger of accelerating inflation reflected in high food prices and utility hikes, especially from 2Q onwards, which would keep average inflation at 11% – higher than the 9.4% in 2010.

C/A widening faster than expected, to keep pressure on the NBU for a stable UAH

A faster than expected pick-up in the current account deficit signals accelerating growth, in our view; we estimate a 1.3% deficit for 2010 and a further 1.6% for 2011. These ought to be fully covered by FDI flows in the coming years – so we are not concerned. However, given the faster than anticipated widening the National Bank will be reluctant to allow a freer float in the coming months, despite IMF guidance, and ought to continue to keep the USD/UAH stable, coming out on the market to buy/sell when necessary. We expect to see a continuation of this policy during 1Q, however, after that on **accelerating inflation and subsiding monthly gas payments we see a greater potential for UAH appreciation to 7.6** – although USD/UAH 7.95 has been factored in for the 2011 budget. Further supportive factors for the exchange rate are the relative cheapness of the UAH in terms of REER in comparison to its commodity peers and anticipated privatization flows, with the end-December Ukrtelecom USD 1.6bn privatization to set the tone. Furthermore, the relative attractiveness of the Ukrainian t-bills ought to continue to support non-resident investor interest. We would also expect to see demand for FX from the population subsiding in 1Q11, which would take additional heat off the NBU to intervene on the FX market. In this respect **we stand contrary to market expectations, where NDF continue to price in a further devaluation in 2011, with the 6M and 1Y forwards pricing in a 10% weaker UAH.**

But once inflation accelerates and energy imports subside, there will be more pressure towards appreciation

Notes

Notes

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