

CEE

Quarterly

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Contents

4 CEE: Rebalancing proceeding fast, but don't fall for a false dawn...

EU members

- 10 Bulgaria
- 12 Czech Republic
- 14 Estonia
- 16 Hungary
- 18 Latvia
- 20 Lithuania
- 22 Poland
- 24 Romania
- 26 Slovakia
- 28 Slovenia

EU candidates and other countries

- 30 Bosnia & Herzegovina
- 32 Croatia
- 34 Kazakhstan
- 36 Russia
- 38 Serbia
- 40 Turkey
- 42 Ukraine

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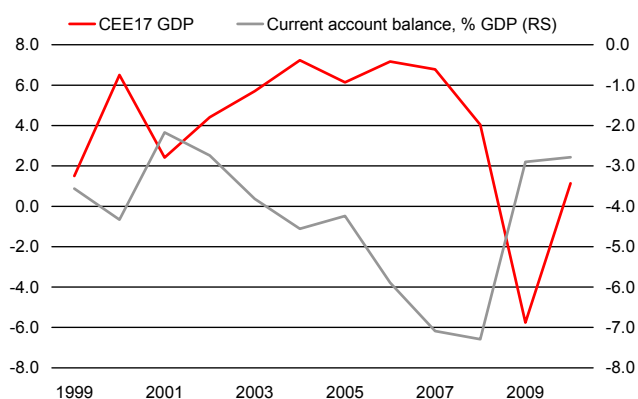
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CEE: Rebalancing proceeding fast, but don't fall for a false dawn...

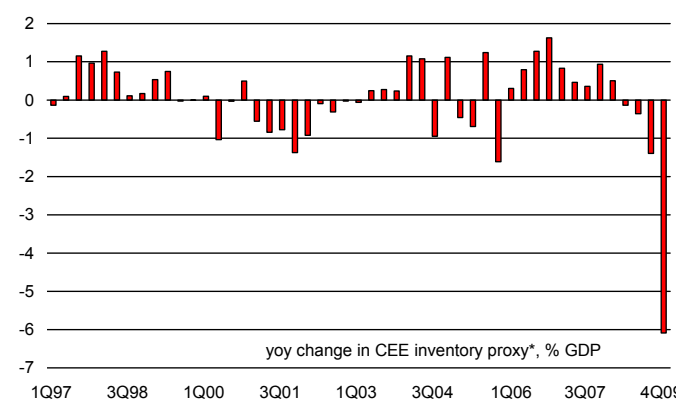
- **Rebalancing proceeding fast: We revised further lower our 2009 GDP forecasts during 2Q, though significantly improved our current account outlook.** To the extent that the CEE rebalancing process is proceeding faster than expected, changes to our 2010 forecasts in 2Q were limited. We now forecast full year 2009 CEE17 GDP to contract 5.8% (from 3.5% previously) and for the regional current account balance – ex Kazakhstan and Russia – to improve to 2.8% (from 4.2% forecast previously).
- **CEE no longer the bogey man:** Following a tough 1H09, we see 3Q09 proving relatively benign for CEE. The sharpest period of rebalancing is behind us, ECB policy is set to remain accommodative and regional financial stability risks will only likely crystallize in the medium term (e.g. 2010). This should prove relatively FX and sovereign credit friendly in the near term.
- **We'd be careful about falling for a false dawn, however:** A combination of slow burning second round risks from 1Q09's growth crunch and a likely challenging longer-term global backdrop means near-term stabilization could to some extent mark a false dawn. From this perspective, 2H09 marks a window of opportunity for regional policymakers to put in place realistic medium-term fiscal plans, issue debt and bolster FX reserves. Countries which do are likely to see the most positive sovereign credit ratings newsflow.
- **Latvian devaluation risk continues, despite EU payout in July:** Although devaluation is not inevitable, it is our central scenario in the next 18 months given: the scale of nominal GDP contraction, the level of LVL overvaluation, the extent of private sector FX short positions and 2010 parliamentary elections. We see contagion risks from any Latvian devaluation as being relatively contained, however.

GDP CONTRACTS, LEADING TO A SIGNIFICANT REDUCTION IN REGIONAL IMBALANCES

GDP contracts, but current account has radically improved...



CEE inventories likely collapsed in 1Q09



*Changes in inventory are not released for all countries yet. We proxy changes in inventory as the difference between Gross capital formation and gross fixed capital formation as a % of GDP.

Source: UniCredit Research

Forecast changes: Rebalancing proceeding fast

1Q09 likely to have been the low in terms of activity

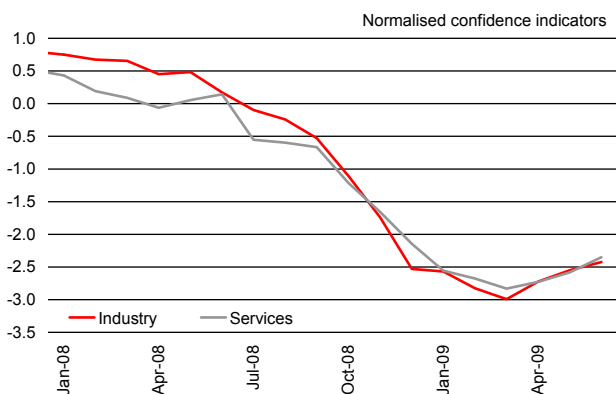
The good news – Rebalancing proceeding fast: GDP was softer than expected across the region in 1Q09, with the flipside being a faster-than-expected improvement in regional balance of payments. Importantly, many countries are now recording a “basic balance” surplus, providing scope to reduce net external debt levels. This, coupled with evidence of both an uptick in Euroland and still relatively decent external debt rollover ratios, suggests that in most cases 1Q09 may have marked the weakest point in terms of economic activity (in qoq seasonally adjusted terms, which would imply a 3Q09 bottom in yoy GDP). Put differently, economies have largely adjusted to the first round impact of the credit crunch and associated lower capital inflows.

Another important positive point is that 1Q09 GDP data pointed to significant inventory rundowns across most countries (though the exact extent of this is still uncertain in some countries given that specific inventory figures have not been released yet). Our simple CEE inventory indicator is now at an all-time low. The implication is that as demand does recover it should feed more significantly through to output growth.

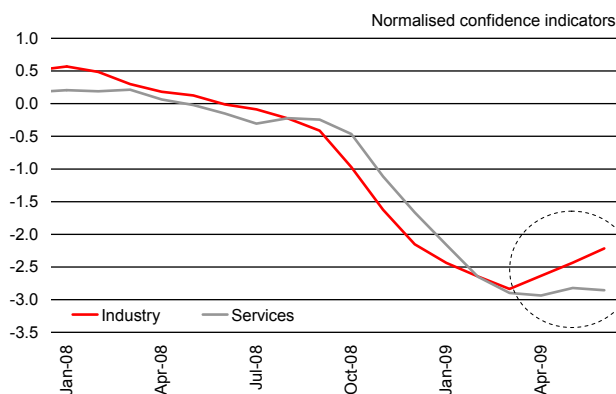
Although the worst is likely behind us, we still revised our full year GDP forecasts lower during 2Q09 given: 1. 1Q growth was lower than expected – putting the recovery trajectory on a lower path. 2. 2Q indicators have underlined that the bounce from 1Q09 is gradual, rather than explosive (see chart below). 3. Higher commodity prices look set to act as a drag on the pace of 2H09 recovery.

INDUSTRIAL AND SERVICES SENTIMENT: MIND THE GAP

EMU: Industry and services improving together



CEE: Services sentiment has not improved



Source: European Commission, UniCredit Research

Recovery prospects

CEE services sentiment has so far failed to consistently improve

The meaningful recovery in global economic sentiment indicators, coupled with some normalization in capital flows, underlines the focus on when the recovery will more broadly show up in CEE economic sentiment and activity data. So far, CEE industrial sentiment has shown some sign of improvement (on less weak export demand), though notably services sentiment (which is largely domestically driven) has failed to meaningfully improve (see chart above). Looking ahead, we see better CEE domestic demand recovery prospects in those countries with lower macro vulnerabilities, less extreme spare capacity (hence more contained unemployment, profitability, NPL and deflation risks) and a more aggressive fiscal and monetary response to the slowdown.

A simple ranking based on these factors suggests Russia, the Czech Republic, Poland and Turkey have better recovery prospects and Baltic States and Hungary more challenging prospects. The key factors impeding recovery in the latter are high external debt levels coupled with only a limited fiscal and exchange rate response to the slowdown. There are some caveats worth making with respect to this simple comparison, however:

1. It doesn't take into account significant structural differences in economies, which on the one hand likely puts Russia too high in the rankings and on the other hand the Baltic states too low.
2. It does not take into account differences in the timing of cycles in each country (e.g. Poland slowed down later than other countries).

RECOVERY PROSPECTS RANKING

	Actual data				Ranking				overall ranking
	external debt, % GDP	simple output gap*	yoy change in FX	yoy change in fiscal deficit	external debt, % GDP	simple output gap	yoy change in FX	yoy change in fiscal deficit	
RU	41.2	-9.6	24.1	-12.2	2.0	9.0	1.0	1.0	3.3
CZ	42.1	-3.3	8.3	-3.7	3.0	2.0	5.0	4.0	3.5
PL	56.6	2.5	22.0	-1.6	5.0	1.0	2.0	10.0	4.5
TK	37.9	-8.8	13.4	-3.2	1.0	8.0	4.0	7.0	5.0
BG	105.5	-3.4	0	-5.5	9.0	3.0	7.0	2.0	5.3
SK	55.3	-4.9	-3.7	-4.1	4.0	4.0	12.0	3.0	5.8
SI	105.1	-8.0	0	-3.6	8.0	6.0	7.0	5.0	6.5
HR	84.2	-6.7	3.2	-2.1	7.0	5.0	6.0	8.0	6.5
HU	113.2	-8.2	14.9	-0.5	10.0	7.0	3.0	11.0	7.8
LT	77.4	-11.8	0	-1.9	6.0	10.0	7.0	9.0	8.0
LV	127.0	-18.0	0	-3.5	12.0	12.0	7.0	6.0	9.3
EE	122.9	-16.2	0	-0.5	11.0	11.0	11.0	12.0	11.3

*Simple output gap = 1Q09 seasonally GDP minus 10y trend

Source: UniCredit Research

Latvian devaluation: Not inevitable, but still likely

LVL devaluation is not inevitable, but still remains the most likely scenario...

Significant EU balance of payments support for Latvia, coupled with the impressive resilience of the population in the face of massive fiscal cuts, means a LVL devaluation is not completely inevitable. Having said that, we still see an LVL devaluation over the next 18 months as the most likely scenario for four key reasons:

1. As we note above, spare capacity is significant, the fiscal and monetary response to the crunch has been muted, while macro vulnerabilities remain high – these mean a high risk of negative GDP in 2010, alongside deflation.
2. Against the present growth/inflation outlook, a further round of fiscal cuts is necessary in 2010 – as large or larger – than in 2009. It's not clear whether the population will remain as stoic in the face of these measures, especially if they hit social welfare. October 2010 parliamentary elections further muddy the picture. If the fiscal cuts are not made, balance of payments support and the country's EMU entry strategy will be called into question.
3. Latvia's private sector is sitting on a 65% of GDP FX short position. If confidence dries up, the state will not have enough reserves to hold the peg.
4. The exchange rate looks overvalued by most metrics. This means that for the peg to stay, deflation would need to occur, while it also questions whether supra-national agencies will remain onboard with the bailout.

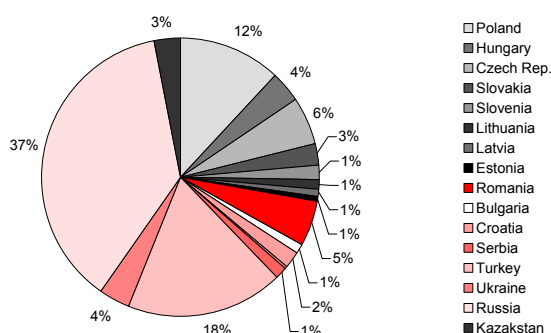
In terms of timing, we see the run-up to the 2010 parliamentary elections as most likely, partly because second round effects will have built up by then, reducing scope for fiscal cuts, and partly given the risk of the peg becoming a political talking point ahead of the elections (please see Latvia country section for full details).

Although a devaluation in Latvia is by no means any longer fully priced in, there are four key reasons to expect Latvian contagion to broader CEE to be relatively contained:

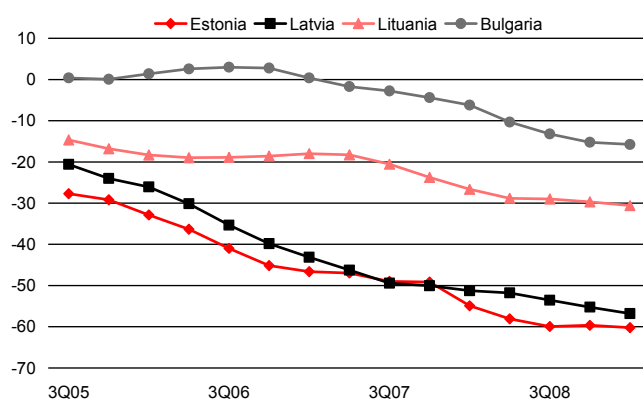
1. The lack of common lender inter-linkage between CEE and the Baltics (i.e., a different group of non-resident parent banks are active).
2. Markets and policymakers have had a long time to prepare for devaluation. By the time it comes, most countries will have IMF packages.
3. Latvia is very small on a regional comparison – at just 0.8% of our estimate of 2009 CEE17 GDP.
4. Latvia had the most strained macro variables in terms of leverage, external financing gap and lack of policy flexibility. Thus, the fundamental pressure for weakness is lower elsewhere.
5. Many CEE countries have already had significant exchange rate adjustments.
6. The EU policy response is likely to prove stabilizing to the extent that Latvia is in ERM2 (meaning a new central parity fix in a band at a weaker level is not out of the question).

This means that, once the initial knee-jerk market reaction has occurred, we only really see a more meaningful contagion risk to Estonia and Lithuania. Although their fundamentals are less weak than Latvia's – implying a lower stand-alone devaluation risk – they do rely on a common pool of lenders, while net private FX positions are also heavily negative in both (implying a meaningful risk of domestically-led contagion). Bulgaria would clearly also see some stress, post LVL devaluation, though to the extent that it doesn't suffer from a common lender, that its households are long FX and that BGN still looks undervalued (based on our spot discount to PPP vs. GDP per capita methodology), the ability of the BNB to maintain the BGN currency board in the face of LVL contagion is reasonable.

LATVIA: A SMALL SLICE OF A BIG PIE – 1% OF CEE17 GDP



NET PRIVATE SECTOR FX POSITION IN COUNTRIES WITH FX FIXES

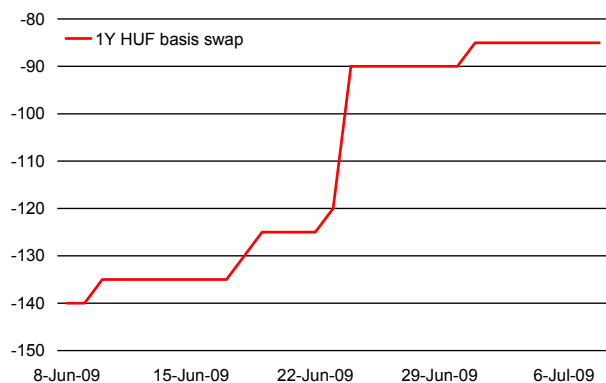
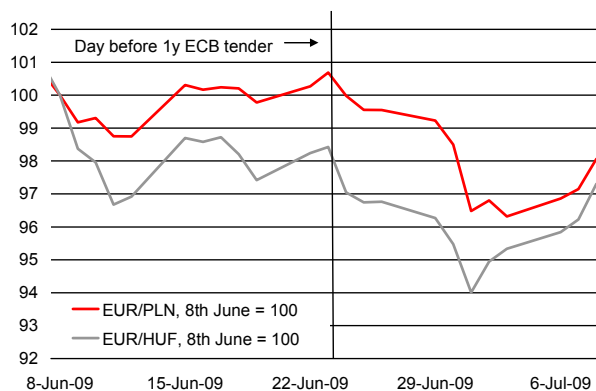


Source: UniCredit Research

FX Outlook

	Current	End 3Q09
EUR/CZK	26.10	27.00
EUR/HUF	278	291
EUR/PLN	4.43	4.24
EUR/HRK	7.34	7.51
EUR/RON	4.22	4.38
EUR/RSD	92.51	97.40
USD/KZT	150.55	150.00
RUB basket	37.40	40.10
USD/TRY	1.56	1.66
USD/UAH	7.75	8.15
EUR/USD	1.389	1.35

CEE FX had a firm 2Q with all currencies firmer on the quarter, alongside a 15% gain in the S&P500 and a broad based decline in volatility. Looking ahead, in most countries we forecast modest depreciation during the next 3 months, given a combination of country specific factors (rate easing, lower commodity prices and Latvia devaluation risk) and potentially some pullback in risk appetite. Having said that, over a slightly shorter time horizon (next 1 month), we see scope for CEE FX to perform relatively well, given the significant improvement in regional balance of payments, a likely gradual improvement in growth indicators and the reality of a supportive ECB backdrop. More broadly, we see some scope for CEE to outperform Latam and Asian FX, given CEE FX remains relatively cheap versus 2008 levels, whilst CEE specific market concerns continue to ease from a short-term perspective.

HUF 1Y BASIS SWAP NARROWED SIGNIFICANTLY FOLLOWING ECB 1Y LIQUIDITY TENDER...

...AND HUF & PLN RALLIED POST ECB 1Y TENDER.


Source: UniCredit Research

Monetary policy

Emerging European central banks start 3Q on a more cautious tone versus 2Q, with some signaling a pause in their easing cycles (CNB and NBP) and others easing only very gradually (NBR). Only the CBR and CBT maintain a clear easing cycle. Looking ahead, we see 2H09 being dominated by the interplay between commodity price inflation on the one hand and core disinflation on the other.

At the start of 3Q09, the regional core inflation picture is still quite mixed (with previous FX weakness still passing through to CPI in some countries), though we continue to look for a somewhat firmer 2H09 regional FX environment coupled with still significant spare capacity to ultimately see disinflationary forces win the day and core inflation head lower across the region in 4Q09. The implication for monetary policy is that we see a mixed 3Q policy story giving way to a more broad based CEE rate easing story in 4Q.

Bottom line: CEE hysteria gives way to a more balanced appraisal of risks

CEE hysteria gives way to a more balanced appraisal of risks

1H09's CEE hysteria has recently given way to a more balanced market appraisal of risks, based increasingly on country specific differentiation. The reason for this improvement has been threefold: **1.** CEE economies pulled off an impressive rebalancing in 1H, pushing current accounts into surplus across the board, negating the need for net external financing. **2.** Feared financial stability risks have so far not materialized in a cross region way, with bank concerns remaining localized. **3.** A supportive ECB policy backdrop.

Looking ahead, keeping in mind that the current account improvement has already occurred, ECB policy is set to remain accommodative for the time being and that regional financial stability risks will only likely crystallize in the medium term (2010), we see 3Q09 proving relatively benign for the region.

From a longer-term perspective, we'd be careful about falling for a false dawn, however, and we see a combination of slow burning second round risks from 1Q's growth crunch and a likely challenging 2010 global backdrop potentially seeing the bogey man return to CEE. From this perspective, 2H09 marks a window of opportunity for regional policymakers to put in place realistic medium-term fiscal plans, issue debt, bolster FX reserves and in some countries clean up financial sectors. In short, the battle is only half won.

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SOVEREIGN CREDIT RATING OUTLOOK

Country	Rating, LT FC (Moody's/ S&P/Fitch)	Fiscal balance, % GDP, 2009 forecast	Gross external debt/GDP, 2008	Current account balance % GDP, 2009 forecast	FX reserves, % GDP, end 2008	2009 GDP forecast minus 5y average	Rating Outlook
Bulgaria	Baa3s/BBBn/BBB-n	-2.5	105.5	-8.0	37.3	-12.3	We see risk of further rating downgrade in the coming months due to further downside pressure on growth not only in 2009 but in 2010 as well. A quick IMF agreement following the July parliamentary elections might improve the outlook, though.
Croatia	Baa3s/BBBn/ BBB-n	-3.9	92.2	-5.4	19.7	-9.1	We see risk of negative rating newsflow in the coming 3M given that the fiscal deficit overshooting might lead to higher financing requirements, while FX failed to provide a meaningful competitive gain. A potential IMF deal might stabilize the outlook again.
Czech Republic	A1s/As/A+s	-5.2	45.3	-2.6	17.9	-8.5	We still see the Czech economy as one of the best placed within Europe to recover. Accordingly, the long-term ratings outlook remains positive . Key near term remains deteriorating fiscal policy on weak growth-related tax revenue shortfall.
Estonia	A1n/An/BBB+n	-4.0	130.9	1.1	17.7	-18.8	We continue to see a meaningful downgrade risk (possibly more than one notch), given the economy is still experiencing a hard landing, while the currency board limits the scope for policy to respond to this. Estonia however looks somewhat better than Latvia given its fiscal reserves.
Hungary	Baa1n/ BBB-n/BBBn	-3.9	128.0	-3.5	22.7	-9.3	We still see high probability of further sovereign downgrades (particularly from Moody's) due to increasing public sector debt and high long-term interest rates. We would not rule out sub-investment grade till the end of the year, particularly if the negative impact of higher CPI on growth will be more meaningful than expected.
Kazakhstan	Baa2n/BBB-s/ BBB-n	-9.9	103.8	-9.4	16.4	-10.8	A deteriorating fiscal balance, falling FX reserves and banking sector concerns are to some extent offset by higher commodity prices. We expect ratings to be left on hold in the coming months.
Latvia	Baa3n/BB+n/BB+n	-7.6	139.9	1.1	15.1	-22.4	Although the payout of the next IMF/EU support is positive, we do not think that Latvia is out of the woods given risk of second round effects (potential need for further sizeable expenditure cuts in 2010). Accordingly, our ratings outlook remains negative .
Lithuania	A3n/BBBn/ BBBn	-6.3	91.0	2.2	14.2	-19.5	Although imbalances in Lithuania are less extreme than those in Latvia, the external financing and growth outlook are still challenging. Ratings outlook is negative .
Poland	A2s/A-s/A-s	-5.5	65.1	-2.8	12.3	-5.8	We see the ratings outlook as neutral , with the negatives of a recession and relatively high public debt being offset by a relatively low external financing gap in relation to the size of the economy.
Romania	Baa3s/BB+n/ BB+n	-5.0	49.2	-6.7	20.6	-12.0	Given the IMF/EU package reduced tail risk for Romania, we see rating dynamics stabilizing in the coming 3M. Downside growth risks and associated fiscal overshooting however mean we would not completely rule out further downgrades though.
Russia	Baa1s/BBBn/BBBn	-7.6	30.0	4.6	26.6	-14.4	Stabilizing oil prices and RUB will likely have a stabilizing effect on Russia's rating in the coming 3M. Neutral .
Serbia	-/BB-n/BB-n	-4.0	76.3	-10.2	24.0	-11.3	IMF package reduces tail risks, but the relatively wide external financing gap, coupled with an uncertain long-term growth outlook, means that we are cautious on the ratings outlook.
Slovakia	A1s/ A+s/ A+s	-6.3	60.7	-4.8	20.9	-12.8	Euro-zone membership is a stabilizing factor, though to the extent that this is reflected in the rating already, we are neutral on the outlook. If global manufacturing turns into a double dip, however, downside ratings risk would increase.
Slovenia	Aa2s/AAs/ AAs	-3.8	115.9	-3.4	1.9	-9.1	Euro-zone 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	Ba3s/BB-n/ BB-s	-6.0	45.4	-1.7	10.1	-11.3	Deteriorating fiscal policy underlines the need for an IMF agreement. We expect the rating to be kept stable in the coming months but further delay in the IMF deal might have a negative implication on rating outlook.
Ukraine	B2n/CCC+n/ Bn	-9.0	82.2	0.8	15.7	-18.8	We remain negative on the ratings outlook. Upcoming elections, a weak UAH and a severe recession, do not bode well. The main challenge will be to keep private debt roll-over ratios high and maintain local confidence.

Source: UniCredit Research

Bulgaria



Outlook

We expect the downturn to deepen in 2Q09 and in 3Q09, given the limited ability of local policy makers to loosen fiscal and monetary policy, keeping the overall GDP decline at -6% in 2009. However, the anticipated IMF package and the new government's measures ought to provide support during the adjustment process.

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

	2007	2008	2009F	2010F	2011F
GDP (EUR bn)	28.9	34.1	32.8	31.0	32.3
Population (mn)	7.6	7.6	7.6	7.5	7.5
GDP per capita (EUR)	3782	4485	4328	4123	4310
GDP (constant prices yoy %)	6.2	6.0	-6.0	-3.0	2.5
Private Consumption, real, yoy (%)	5.1	4.5	-7.9	-5.6	-0.5
Fixed Investment, real, yoy (%)	21.7	20.4	-26.9	-12.1	-2.0
Public Consumption, real, yoy (%)	3.4	-1.4	-2.4	0.5	0.5
Exports, real, yoy (%)	5.2	2.9	-16.8	-3.3	4.3
Imports, real, yoy (%)	9.9	4.9	-24.1	-8.9	-1.5
CPI (average, yoy %)	8.4	12.4	2.0	-2.2	1.5
Central bank reference rate	4.58	5.77	4.00	3.05	4.80
Monthly wage, nominal (EUR)	220	268	238	224	231
Unemployment rate (%)	6.9	6.3	12.0	16.0	15.7
Budget balance/GDP (%)	3.5	3.0	-2.5	-3.0	-3.0
Current account balance (EUR bn)	-7.3	-8.6	-2.6	-0.9	0.3
Current account balance/GDP (%)	-25.1	-25.3	-8.0	-2.9	1.0
Net FDI (EUR bn)	8.3	5.7	2.3	1.9	1.8
FDI % GDP	28.7	16.7	6.9	6.0	5.5
Gross foreign debt (EUR bn)	29.0	36.7	34.6	32.4	32.6
Gross foreign debt (% of GDP)	100.2	107.7	105.5	104.5	101.0
FX reserves (EUR bn)	11.9	12.7	8.9	8.3	10.1
(Cur.Acc-FDI)/GDP (%)	3.5	-8.6	-1.1	3.1	6.5
FX reserves/Gross foreign debt (%)	41.2	34.6	25.8	25.6	30.9
Exchange rate to USD eop	1.34	1.40	1.35	1.45	1.45
Exchange rate to EUR eop	1.96	1.96	1.96	1.96	1.96
Exchange rate to USD AVG	1.43	1.33	1.43	1.40	1.40
Exchange rate to EUR AVG	1.96	1.96	1.96	1.96	1.96

Source: UniCredit Research

STRENGTHS

- Favorable public sector debt and reserves metrics
- Flexible labor market (according to the World Bank's Doing Business Survey)
- No FX risk in the balance sheet of the household sector

WEAKNESSES

- Large private sector funding gap
- Unfavorable economic policy framework to deal with the global financial crisis impact
- High FX leverage in domestic private corporate sector

Recession takes the steering wheel

Growth outlook deteriorated markedly

All indicators point to a deepening of the recession. Activity indicators in the export oriented industries dropped off a cliff, with many companies implementing temporary shutdowns and shifting employees to a four-day working schedule to minimize layoffs. The collapse in external demand has been feeding through into other related sectors, such as business services and transportation, while sectors which benefited mostly from the previous investment boom have also experienced a sharp slowdown as private capital inflows dried up. Private consumption fundamentals also worsened. If on the one hand, consumers are feeling some relief in the decline of inflation, on the other hand the increase in debt servicing costs and abrupt turnaround in the labor market prevent any rise in consumption expenditures that may help mitigate the severity of the economic downturn.

We expect economy to hit bottom in 2Q and in 3Q, as recession is feeding through into services sectors

The most recent confidence surveys have failed to produce any indication that the economy has already reached a bottom and we expect the downturn to deepen in 2Q09 and in 3Q09. Against this backdrop, we revised downward our yoy GDP growth forecast to -6% in 2009 and -3% in 2010. We expect the Bulgarian economy to experience below potential growth for a longer period of time than most of the CEE economies, given heightened macro vulnerability readings and limited ability of local policy makers to loosen fiscal and monetary policy. After reporting mom deflation for the last three months (adjusted for the impact of higher excise rates on cigarettes), we see CPI receding by -2.5% at the end of 2009. On the flipside, sharply lower investment spending and a contraction in private consumption this year will allow the CA deficit to narrow markedly to 8% of GDP.

Government announced more aggressive spending cuts, as recession takes hold

Until recently, the very existence of the crisis was denied as, apparently, the outgoing Socialist led government was afraid that its approval rating might suffer heavy losses just a couple of months ahead of general elections. The implication was that the stimulus packages implemented were not enough to offset the depth of the ongoing recession. Only in early June did the government embark on more aggressive cost-cutting measures, as it became clear that major budget rebalancing will be needed later this year to avoid a dangerous deficit widening.

A clear political majority by GERB allows for effective policies to be implemented

Parliamentary election in Bulgaria gave the center-right opposition party GERB (Citizens for European Development of Bulgaria), founded by Sofia Mayor Boiko Borissov, a 40% share of the vote, helping beat the ruling Socialists who gained 18%. GERB is now expected to form a coalition government with the Blue Coalition – but still remain in control of the agenda. The key immediate consequence of the election ought to be the initiation of talks with the IMF for a support package, and the revision of the 2009 budget.

Prospects of an IMF-led external support increased

We believe that an external support package, if agreed upon, would be instrumental in smoothing out the hard landing and in minimizing job and economic growth losses that will necessarily arise. More importantly, external support will, as one local analyst put it, “buy some time” to allow crisis management measures undertaken by the next government to start taking effect.

The country may suffer more rating downgrades

Similar to other CEE countries, the sovereign ratings of Bulgaria reached their peaks in 2H07 and have seen downward dynamics ever since. At the moment, the outlook of the sovereign ratings assigned by two of the leading rating agencies is negative, while that of Moody's remains stable. We think further rating downgrades should not be ruled out, given the scale of economic adjustment that is occurring.

Czech Republic



Outlook

High frequency data suggest that GDP momentum is past the bottom in 2Q but no clear uptick has been observed either. Accordingly, we forecast a deeper recession in 2009 than three months ago (-3.2% vs. -1.8% contraction). Looking ahead, we still see the Czech economy among the best placed in Europe to recover given its strong banking sector and flexible monetary policy. In this vein we do not rule out another rate cut by the CNB during 3Q.

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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	2009F	2010F	2011F
GDP (EUR bn)	127.3	148.2	136.6	142.7	154.5
Population (mn)	10.3	10.4	10.5	10.5	10.6
GDP per capita (EUR)	12336	14209	13025	13528	14574
GDP (constant prices yoy %)	6.1	3.0	-3.2	0.7	3.5
Private Consumption, real, yoy (%)	4.9	2.7	-0.2	-0.5	3.0
Fixed Investment, real, yoy (%)	10.8	-0.1	-6.5	-3.5	4.0
Public Consumption, real, yoy (%)	0.7	1.7	2.2	0	2.0
Exports, real, yoy (%)	15.0	6.7	-12.0	6.2	9.0
Imports, real, yoy (%)	14.3	4.6	-11.5	4.8	8.5
CPI (average, yoy %)	2.8	6.3	1.5	1.4	2.5
Central bank reference rate	3.50	2.25	1.25	1.50	3.25
Monthly wage, nominal (EUR)	781	944	895	940	1017
Unemployment rate (%)	6.6	5.5	8.2	9.5	9.0
Budget balance/GDP (%)	-0.6	-1.5	-5.2	-4.8	-4.4
Current account balance (EUR bn)	-4.0	-4.6	-3.6	-3.0	-3.2
Current account balance/GDP (%)	-3.1	-3.1	-2.6	-2.1	-2.1
Net FDI (EUR bn)	7.6	7.3	4.4	4.6	5.9
FDI % GDP	6.0	4.9	3.3	3.2	3.8
Gross foreign debt (EUR bn)	51.6	57.8	61.9	68.6	72.5
Gross foreign debt (% of GDP)	38.9	42.1	45.3	46.6	47.0
FX reserves (EUR bn)	23.7	26.6	28.0	29.0	29.0
(Cur.Acc-FDI)/GDP (%)	2.8	1.9	0.7	1.1	1.8
FX reserves/Gross foreign debt (%)	45.9	46.0	45.3	42.3	40.0
Exchange rate to USD eop	18.25	19.30	18.62	18.89	18.89
Exchange rate to EUR eop	26.62	26.93	27.00	25.50	25.50
Exchange rate to USD AVG	20.25	16.96	19.73	18.79	18.21
Exchange rate to EUR AVG	27.76	24.94	27.00	26.30	25.50

Source: UniCredit Research

STRENGTHS

- External financing at comfortable levels
- Flexible monetary policy
- Low vulnerability of financial sector

WEAKNESSES

- Heavy reliance on external demand
- High share of the automotive sector in total value added
- Interim government lacks political mandate

GDP growth: Past the bottom but lacks clear upturn

Sharp drop in business investment is set to exacerbate the contraction

The GDP contraction deepened to -3.4% yoy in 1Q09 from -0.1% yoy in 4Q08, with gross capital formation becoming the key drag. Inventories reduced GDP by 3.3 percentage points, fixed investments took away 0.8 percentage points, while net exports cut an additional 1.7 percentage points off GDP. Household spending, in contrast, shocked with a 3% yoy gain, stemming supposedly from a weather-induced hike in energy consumption. The economic downturn left its mark on inflation which continued to fall to 1.3% in May. Marked growth in prices in yoy terms continued only in those items which were subject to administrative adjustments, like cigarettes and housing. It was positive that the external financing remained almost unaffected by the crisis, with the estimated 1Q C/A surplus to GDP ratio rising a slight 0.1 percentage point from the prior year's 3.1%.

2Q dataflow leads us to believe that the decline in GDP may be bottoming out. That said, no clear uptick in economic activity has yet been observed either, meaning that we forecast a deeper 2009 recession than projected three months ago. In addition, with private spending in 1Q boosted by one-off factors, it is set to slow sharply from 2Q onwards. Our downward revision to the household consumption forecast, which we now expect to contract marginally both this year and next, reflects a grimmer outlook for the jobless rate and nominal wage growth. On the other hand, we left unchanged the size of negative contribution of net exports to 2009 GDP, as a shift to a deeper export contraction was accompanied by a similar deterioration in the import dynamics. Assuming a sharper reduction in economic activity, we now expect inflation to bottom below 1% yoy at the turn of 3Q and 4Q, with the base effect lifting it up again in late 2009.

Interest rates believed to be held at record lows until late 2010

Against the backdrop of a downward revision to its growth and CPI forecasts, the CNB cut the repo rate by 25bp to 1.50% in May and kept rates on hold in June. Looking ahead further, we do not rule out rate cuts later in the year, however hawkish June CNB minutes suggest this will not happen in August, unless CZK meaningfully appreciates further. We do expect the first small interest rate hike as late as end-2010 in our baseline scenario, since much of the required monetary tightening next year should be provided by the firming CZK. Should EUR/CZK fail to retreat or even turn upwards, however, a shift to a tightening cycle would have to come earlier and with more intensity.

The economic downturn has squeezed government tax revenues and lifted social spending, with the end-May state budget deficit climbing to almost double the level seen in the corresponding period last year. Moreover, the budget is set to suffer from political compromises on economic stimulus measures and from spending expected in the run-up to early elections. Hence, we expect the public budget gap to surge to 5.2% of GDP this year.

A new political subject may emerge ahead of October elections

An interim government will lead the country until October early elections. Obviously, activity of the government will hardly go much beyond drafting the 2010 state budget. Taking the June EP vote outcome as a poll for the upcoming general elections, only four parties (ODS, CSSD, KSCM, KDU-CSL) would make it into Parliament, which would dramatically reduce coalition potential for the center-right. However, the chance exists that mergers of smaller parties boost their ability to pass the 5% threshold.

CZK assumed to get back on a firming path in 2010

EUR/CZK volatility has abated, with the exchange rate settling in a narrower band between 26.0 and 27.0 since mid-April. Nevertheless, scope for protracted domestic political wrangling around October elections have made us lift our EUR/CZK year-end forecast up 2% to 27.0. What's more, an elevated interest rate gap between CZK and its regional peers has increased the risk of returning carry trades, which might result in a more pronounced CZK depreciation.

Estonia



Outlook

Estonia's officials plan to introduce the euro as early as in 2011, which means that they target to meet the Maastricht-criteria already this year. We think that given Estonia's sharp economic contraction, meeting this target is very ambitious and the probability of this happening is low.

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Long-term foreign currency credit rating	Moody's A1 negative	S&P A negative	Fitch BBB+ negative
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MACROECONOMIC DATA AND FORECASTS

	2007	2008	2009F	2010F	2011F
GDP (EUR bn)	15.3	15.9	14.7	13.3	12.2
Population (mn)	1.3	1.3	1.3	1.3	1.3
GDP per capita (EUR)	11379	11842	10978	9982	9162
GDP (constant prices yoy %)	6.3	-3.5	-12.8	-2.1	6.0
Private Consumption, real, yoy (%)	7.9	-3.7	-10.8	-1.5	1.1
Fixed Investment, real, yoy (%)	4.8	-8.0	-20.9	-3.9	1.2
Public Consumption, real, yoy (%)	3.9	4.4	2.5	-2.3	-4.0
Exports, real, yoy (%)	0	-1.1	-11.2	-3.9	3.9
Imports, real, yoy (%)	4.2	-7.9	-17.7	-4.5	-2.5
CPI (average, yoy %)	6.6	10.4	-0.1	-2.1	1.7
Monthly wage, nominal (EUR)	725	819	795	725	598
Unemployment rate (%)	4.7	5.5	13.7	15.4	15.6
Budget balance/GDP (%)	2.7	-3.0	-4.0	-5.9	-5.1
Current account balance (EUR bn)	-2.8	-1.5	0.2	0.1	0.2
Current account balance/GDP (%)	-18.1	-9.4	1.1	1.1	1.6
Net FDI (EUR bn)	0.8	0.6	0.2	0.2	0.2
FDI % GDP	5.3	3.8	1.4	1.3	1.7
Gross foreign debt (EUR bn)	17.2	19.0	19.2	18.6	16.6
Gross foreign debt (% of GDP)	112.4	120.0	130.9	139.8	136.1
FX reserves (EUR bn)	2.2	2.8	2.3	2.0	2.2
(Cur.Acc-FDI)/GDP (%)	-12.8	-5.7	2.5	2.3	3.3
FX reserves/Gross foreign debt (%)	13.0	14.7	12.0	10.7	13.3

Source: UniCredit Research

STRENGTHS

- Political determination to introduce the EUR as soon as possible
- Sharp fiscal contraction adopted
- Fast adjustment process of external imbalances in place

WEAKNESSES

- High FX leverage in domestic private sector
- Very strong economic contraction

Very ambitious goals...

GDP contraction sharper than anticipated

Estonia experienced a very sharp economic contraction in 1Q 2009: GDP came in at -15.1% yoy from -9.7% yoy seen in 4Q 2008; the sharpest decline was seen in imports which fell by 26.7% yoy in 1Q, down from -11.9% in the fourth quarter of 2008. Gross fixed capital formation was nearly as weak as imports, falling by 26.6% yoy (from -24.0% yoy in 4Q), while private consumption declined by 16.9% yoy (from -10.0% in 4Q) and exports by 16.0% yoy (from -3.2% in 4Q). The weaker-than-expected data led us to change our full-year 2009 GDP forecast to -13.0% yoy.

In May 2009, the headline CPI yoy growth rate came in at -0.3%, which means that Estonia is the first of the Baltic countries to face deflation. Our calculations of the seasonally adjusted core inflation point at Estonia registering negative (or very close to zero) monthly growth rates since November 2008. We expect this to continue over the course of this year and also well into next year.

The C/A registered a surplus for the last three consecutive months, something that has not happened in the last ten years. We expect this development to continue and pencil in a full-year surplus for 2009 of 1.1% o GDP.

Euro adoption planned as soon as possible

The answer of politicians to the current problems (i.e. the sharp economic downturn) is clear-cut: like Lithuania and Latvia, they want to introduce the euro as soon as possible. This means that they have to meet all Maastricht criteria this year. With an expected decline in economic activity of 13.0%, this is a very ambitious target. The government already endorsed sharp amendments to public finances, e.g., it increased the VAT to 20%, cut some public wages and reduced social support payments. Nevertheless, the 3% of GDP budget deficit target seems overly ambitious, given the broad-based sharp contraction. More specifically, given the decline in internal demand and the rise in unemployment; we pencil in a budget deficit of 4% in 2009.

It should be noted that despite the already made amendments to the budget deficit, there seems to be growing consensus among Estonia's officials that another round of amendments need to be made to the budget. These further cuts will not only be very difficult to implement for economic reasons, but also due to political reasons: Estonia faced a government crisis in late May/early June, nearly bringing down PM Andrus Ansip – he had to reshuffle the government, which in the end led to a minority administration, clearly a negative development that could endanger the plans of further budget cuts.

High contagion risk from Latvia given the high local net FX indebtedness

The FX net indebtedness of households and companies stood at about 60% of GDP last year – this is a very large figure and results in a higher probability that any event in Latvia that puts the LVL under pressure will also result in mounting pressure on the Estonian kroon. To be more specific, we think that any change in Latvia's currency regime (i.e., a devaluation) would most likely also lead to a change in the Estonian regime – if Latvians convert their euros into local currency in anticipation of a devaluation, Estonians will probably do the same, given the high level of outstanding net debt being shouldered. A devaluation of the EEK would probably lead to the government taking over some of the losses of companies and households due to the lower value of the kroon, which would in turn increase the budget deficit.

Estonia's ratings are the highest compared to the two other Baltic states – all ratings have a negative outlook however. We expect any change in the currency regime to have negative implications on the ratings; watch especially S&P whose rating is two notches above that of Fitch.

Hungary



Outlook

Due to higher inflation, we slightly reduced our 2009 GDP forecast to a contraction of 6.4% and expect positive GDP growth only in 2011 at 2.5%. Although the fiscal and monetary policy mix remains restrictive, the recent HUF appreciation has opened the door for more meaningful rate cuts. We expect a 100bp rate cut till the end of 2009. This implies that we do not expect the currency to appreciate from its current levels. The risk of a sovereign downgrade is still high.

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Long-term foreign currency credit rating	Moody's BAA1 negative	S&P BBB- negative	Fitch BBB negative
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MACROECONOMIC DATA AND FORECASTS

	2007	2008	2009F	2010F	2011F
GDP (EUR bn)	101.4	106.0	88.2	87.5	95.0
Population (mn)	10.1	10.1	10.0	10.0	10.0
GDP per capita (EUR)	10072	10542	8783	8729	9477
GDP (constant prices yoy %)	1.2	0.6	-6.4	-1.9	2.5
Private Consumption, real, yoy (%)	-1.4	0.1	-7.2	-3.8	0.1
Fixed Investment, real, yoy (%)	1.8	-2.6	-11.4	-4.0	2.1
Public Consumption, real, yoy (%)	-4.5	-1.9	-1.6	-1.6	0.0
Exports, real, yoy (%)	16.4	4.8	-12.2	2.1	1.2
Imports, real, yoy (%)	13.4	4.7	-15.9	0.8	0.7
CPI (average, yoy %)	8.0	6.1	4.5	4.2	1.9
Central bank reference rate	7.50	10.00	8.50	7.00	6.50
Monthly wage, nominal (EUR)	736	799	693	687	739
Unemployment rate (%)	7.4	7.8	10.3	11.5	11.0
Budget balance/GDP (%)	-4.9	-3.4	-3.9	-4.2	-4.0
Current account balance (EUR bn)	-6.6	-8.9	-3.1	-4.3	-4.5
Current account balance/GDP (%)	-6.5	-8.4	-3.5	-4.9	-4.8
Net FDI (EUR bn)	0.8	3.6	1.4	1.5	1.7
FDI % GDP	0.8	3.4	1.6	1.7	1.8
Gross foreign debt (EUR bn)	98.5	119.9	112.9	131.2	123.4
Gross foreign debt (% of GDP)	97.2	113.2	128.0	150.0	130.0
FX reserves (EUR bn)	16.4	24.0	32.0	28.0	27.0
(Cur. Acc-FDI)/GDP (%)	-5.7	-5.0	-1.9	-3.2	-2.9
FX reserves/Gross foreign debt (%)	16.6	20.0	28.3	21.3	21.9
Exchange rate to USD eop	173.30	190.27	206.90	211.11	207.41
Exchange rate to EUR eop	252.72	265.49	300.00	285.00	280.00
Exchange rate to USD AVG	183.33	171.09	210.87	208.93	201.79
Exchange rate to EUR AVG	251.31	251.66	288.55	292.50	282.50

Source: UniCredit Research

STRENGTHS

- Significant IMF and EU balance of payments support
- Strong influence on fiscal policy by IMF/EU

WEAKNESSES

- High public sector debt levels (above 80% in 2009)
- Still wide external financing gap
- High FX leverage in domestic private sector

Still bearish but HUF opens door for cautious rate cuts

1Q GDP was broadly in line with our previous forecast

1Q GDP contracted by 6.7% yoy, which was broadly in line with our previous scenario. Meanwhile, inflation delivered several negative surprises in the last two months as the negative impact of previous HUF weakness gradually appeared in core inflation and food prices moved higher. The monthly trade balance statistics showed sharp improvement and we expect the current account data confirm similar dynamics.

Higher CPI means we slightly reduced our 2009 forecast

We increase our year-end CPI forecast to 6.5% yoy (from 4.5%) due to higher-than-expected numbers released in April and May. Due to our higher CPI estimate, we slightly reduce our real household consumption forecast and headline GDP (to negative 7.2% and to 6.4%, respectively) and reduce the 2009 and 2010 current account forecasts. We also included 2011 forecasts for the first time in our current report. We expect growth to remain poor but already in positive territory (2.5% yoy), while inflation will be below the NBH target (2%). The “rebound” in GDP will be largely driven by some pick-up in investments. Somewhat improving GDP growth means that we do not forecast further material improvement in the current account balance for 2011.

We expect positive growth in 2011 but still at a relatively low level

Fiscal policy has been under IMF/EU control

Fiscal policy lost a large amount of its independence already last October when the government signed an IMF deal (consequently, we do not think that the government can do a major trick this time and introduce fiscal loosening measures as evidenced in the monthly reporting requirement to the EU, etc.). On the other hand, the IMF and the EU agreed to raise the deficit target to 3.9% from 2.9%. We do not think that this will do much in terms of growth stimulus (this deficit will still be the best in the region and potentially one of the best in the whole EU). On the other hand, the slightly wider budget deficit means that under the current growth-inflation mix the government does not need to implement further measures this year. Due to still limited capital market financing capabilities, we expect the government to start negotiating a new IMF deal around the end of the third quarter. Given our relatively bearish 2010 growth forecast, we see some risk of a wider deficit next year.

Monetary policy remains cautious but will start easing soon

Monetary policy has also lost some of its independence as the central bank has to focus on financial stability as well. We think that the MPC was “scared” enough with EUR/HUF at 315 that this time it will try to remain cautious. Following the recent stellar HUF performance and its stabilization at around 275, we reduced our end-year NBH rate forecast to 8.50% (the 100bp implied rate cut is still more cautious than the market is pricing). 2010 will still be characterized by a cautious monetary policy as the underlying problem of easier monetary conditions vs. financial stability concerns will not disappear (share of private sector FX loans will remain very high despite very limited new business). Accordingly, we only expect a 150bp rate cut in 2010 despite the more than 400bp fall in inflation.

Probability of early elections increased...

The Hungarian governing parties suffered a serious defeat in the EU parliamentary elections. The Socialist party got only 17%, while the Free Democrats received only 2% of the votes. The biggest advance was registered by the far-right party Jobbik which got 14.7%. The bigger opposition party Fidesz got 56% of the votes. We think that particularly the extremely poor support of the Free Democrats poses some serious challenges in terms of government support. As such, we think that the probability of early elections has considerably increased following the EU elections. We think that in case the Fidesz is not forced into an unwanted coalition (i.e. they will be able to gain more than 50% at the election), the early elections do not represent a meaningful medium-term risk.

...but if Fidesz is not forced into a coalition this does not represent a meaningful medium-term risk

We continue to see high risk of a sovereign credit downgrade

We continue to see high risk of a sovereign credit downgrade in the coming six months (possibly to sub-investment grade), as current long end yields are way too high vs. the current GDP and primary balance to keep public sector debt dynamics under control, although the cautious monetary policy and improving trade balance provide n-t support.

Latvia



Outlook

The very sharp contraction in economic activity makes the currency regime look increasingly unjustifiable from an economic point of view; politicians, however, seem to be determined to stick to it, no matter what the costs are. With the recent amendments to the budget deficit in place, we think that the fiscal deficit should be manageable this year; next year, however, will be especially challenging, resulting in increasing pressure to change the parity of the lat.

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Long-term foreign currency credit rating	Moody's Baa3 negative	S&P BB+ negative	Fitch BB+ negative
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MACROECONOMIC DATA AND FORECASTS

	2007	2008	2009F	2010F	2011F
GDP (EUR bn)	21.0	23.1	19.4	16.7	14.7
Population (mn)	2.3	2.3	2.3	2.3	2.2
GDP per capita (EUR)	9218	10177	8596	7421	6530
GDP (constant prices yoy %)	10.0	-4.6	-15.0	-3.9	7.2
Private Consumption, real, yoy (%)	14.8	-10.6	-21.4	-5.6	1.6
Fixed Investment, real, yoy (%)	7.5	-12.7	-25.3	-4.7	1.3
Public Consumption, real, yoy (%)	3.7	1.5	-11.4	-9.6	-3.1
Exports, real, yoy (%)	10.0	-1.3	-18.2	0.7	10.5
Imports, real, yoy (%)	14.7	-13.6	-31.1	-4.4	-3.5
CPI (average, yoy %)	10.1	15.5	3.7	-2.9	1.5
Central bank reference rate	6.00	6.00	3.50	4.50	3.00
Monthly wage, nominal (EUR)	565	682	499	407	345
Unemployment rate (%)	6.0	7.5	14.7	17.2	15.4
Budget balance/GDP (%)	-0.4	-4.0	-7.6	-7.5	-5.1
Current account balance (EUR bn)	-4.6	-2.9	0.2	0.4	0.6
Current account balance/GDP (%)	-23.8	-12.6	1.1	2.1	3.8
Net FDI (EUR bn)	1.4	0.8	0.1	0.3	0.2
FDI % GDP	6.8	3.3	0.7	2.0	1.5
Gross foreign debt (EUR bn)	28.4	29.6	27.1	24.9	19.3
Gross foreign debt (% of GDP)	135.1	128.2	139.9	149.1	131.7
FX reserves (EUR bn)	3.8	3.5	2.9	1.9	2.5
(Cur. Acc-FDI)/GDP (%)	-14.9	-9.3	1.7	4.1	5.3
FX reserves/Gross foreign debt (%)	13.4	11.8	10.7	7.6	13.0

Source: UniCredit Research

STRENGTHS

- Previously wide current account deficit adjusted quickly and is in surplus now
- Strong commitment by politicians to reign in the widening budget deficit
- Recent approval by the EU to reimburse a EUR 1.2bn tranche of the international loan

WEAKNESSES

- Sharp broad-based contraction in economic activity
- High FX leverage in private sector
- Rising unemployment

To devalue or not to devalue – that is the question

Sharp decline in economic activity in 1Q

The economy contracted by a sharp 18.0% yoy in 1Q on a broad-based slowdown in all key indicators. Gross fixed investment plummeted by 34.1% yoy in 1Q (from -15.0% in 4Q) and private consumption was down by 17.4% yoy (from -20.1% yoy). Exports performed poorly too and were down a seasonally adjusted 14.0% between December 2008 and April 2009, though more positively imports (seasonally adjusted) fell by 26.7% over this period. The more pronounced fall in imports than in exports helped to bring the C/A into surplus in 1Q for the first time since at least 2000.

Inflation moved considerably lower over the first months of 2009; our calculations of the seasonally adjusted mom core inflation give negative mom growth rates since February of this year; given the further expected fall in domestic demand and more broadly economic activity, we expect core inflation to continue on its negative path. This however won't lead to a one-to-one feed through into the headline figure because of increases in excise taxes.

The adjustment process of the C/A (which stood at -12.6% to GDP in 2008) happened more quickly than anticipated and led us to revise our full-year 2009 C/A forecast to a 1.1% of GDP surplus. The fact that the economy evolved slightly differently in 1Q versus our initial assumptions (namely a stronger-than-anticipated fall in imports and a sharper decline in investment activity) made us change our forecasts of the sub-components which ultimately resulted in an only slightly changed full-year 2009 GDP forecast of -15.0% yoy.

Large budget cuts implemented with more to come

Given the bad shape of the economy (i.e. rising unemployment and falling tax revenues because of declining internal demand), the government faces increasing difficulties to keep the budget under control. This is all the more so as it is determined to introduce the euro as soon as possible, which in turn means that it wants to meet the Maastricht criteria as soon as possible. We think that the fiscal criterion is the hardest one to fulfill – our calculations point to a general consolidated 2009 budget deficit of 7.6% (based on the ministry's figures published on the occasion of the recent budget amendments with the strong assumption that the government manages to implement the recently passed budget deficit cuts of LVL 500mn – the risk is therefore strongly to the downside). Even with another LVL 500mn cut in expenditures in 2010, the budget deficit is likely to stay very close to this level, which will make the government's strategy of introducing the EUR in 2013 increasingly look like wishful thinking. The obvious strategy by the government, namely implementing additional expenditure cuts in 2010, will be very difficult, especially given the October 2010 elections.

We see a devaluation with a probability of above 50% over 18 months, despite the EU loan payout, given: **1.** Difficulty in managing the fiscal books. **2.** The economic drag from debt and FX sustainability issues. **3.** Large households and non-financial corporate sector FX short (57% of 2008 GDP).

Having said that, it should be noted that a devaluation is only the beginning of a whole new raft of problems: households and companies are heavily indebted in euro – in order to prevent a large wave of private and corporate bankruptcies and a further downward move in private consumption, the government would probably need to assume some of the losses from the devaluation, which would represent another blow to the stretched public finances.

Although above 50% probability, a devaluation is not completely inevitable, however, and we identify two key potential mitigating factors: i) a more benign-than-expected global backdrop which would stimulate exports and increase local sentiment; ii) very strong will-power and communication-power by local politicians, supported by the EC/IMF, pushing through structural reforms that reduce public expenditures without leading to a largely dissatisfied public.

Lithuania



Outlook

Lithuania's economy is set to contract sharply this year. Although very restrictive fiscal policies are already in place, we see the need for further cuts to be implemented if the government really wants to achieve a fiscal deficit of 5% to GDP this year – a big challenge amid the sharp economic contraction and an already dissatisfied public.

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Long-term foreign currency credit rating	Moody's A3 negative	S&P BBB negative	Fitch BBB negative
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MACROECONOMIC DATA AND FORECASTS

	2007	2008	2009F	2010F	2011F
GDP (EUR bn)	28.4	32.3	29.7	27.7	25.3
Population (mn)	3.4	3.4	3.4	3.3	3.3
GDP per capita (EUR)	8420	9595	8842	8272	7568
GDP (constant prices yoy %)	8.9	3.0	-12.5	-1.9	6.5
Private Consumption, real, yoy (%)	12.4	5.0	-19.5	-4.3	2.6
Fixed Investment, real, yoy (%)	20.8	-5.5	-20.8	-1.1	2.6
Public Consumption, real, yoy (%)	3.3	4.3	-7.8	-11.9	-3.2
Exports, real, yoy (%)	4.3	11.3	-32.1	-12.1	4.0
Imports, real, yoy (%)	11.6	10.0	-38.0	-15.8	-5.7
CPI (average, yoy %)	5.7	11.0	4.6	0.5	1.1
Monthly wage, nominal (EUR)	522	654	556	471	360
Unemployment rate (%)	4.3	5.8	17.2	18.1	18.2
Budget balance/GDP (%)	-1.2	-3.2	-6.3	-4.6	-2.8
Current account balance (EUR bn)	-4.1	-3.8	0.7	0.5	1.5
Current account balance/GDP (%)	-14.6	-11.9	2.2	1.9	5.9
Net FDI (EUR bn)	1.0	1.0	0.9	0.9	1.1
FDI % GDP	3.6	3.1	2.9	3.2	4.5
Gross foreign debt (EUR bn)	20.5	23.0	27.0	24.8	22.6
Gross foreign debt (% of GDP)	72.3	71.4	91.0	89.7	89.2
FX reserves (EUR bn)	5.2	4.6	4.1	3.9	4.3
(Cur. Acc-FDI)/GDP (%)	-11.0	-8.7	5.1	5.1	10.4
FX reserves/Gross foreign debt (%)	25.3	20.0	15.2	15.7	19.0

Source: UniCredit Research

STRENGTHS

- Quickly unwinding external imbalances
- Politicians' strong determination to rein in the fiscal deficit

WEAKNESSES

- Sharp contraction in economic activity
- Widening fiscal deficit

Still getting worse...

Broad-based plunge in 1Q with an especially strong decline in investment activity

Although Lithuania had previously seemed to be better prepared to sail through the global economic downturn, recent economic data suggest that the country too is facing a very sharp contraction, as are its two Baltic neighbors. 1Q GDP came in at -13.6% yoy (4Q in 2008 saw -2.2% yoy); gross fixed investment collapsed -37.1% yoy (from -17.9% in 4Q) and private consumption fell by 15.1% yoy (from -3.0% yoy in 4Q). Exports and imports moved lower considerably, with exports posting a 1Q decline of 14.7% (after a positive 10.2% yoy in 4Q) and imports moving lower by 32.9% yoy (after -1.1% yoy in 4Q). As seen in Latvia, the 1Q C/A moved into positive territory, something not seen for a long time.

CPI moved lower since the beginning of this year to reach 5.2% yoy in May; our calculations of the seasonally adjusted core inflation show a negative mom growth rate since the two last months. We expect core inflation to move lower over the course of this year; headline average CPI is forecast to come in at 4.6% yoy.

The weaker-than-expected 1Q GDP figure led us to revise our full-year forecast to -12.5% yoy. The downward revision came on the back of weaker-than-anticipated data across the board; data on retail sales and industrial production, released on a monthly basis, point out that the worse is still to come: industrial production came in at an average of -22.5% yoy in April and May, down from an average of -13.6% yoy in 1Q; retail sales moved slightly higher in April and May but are still deeply in the red (May at -28.7% yoy from -29.4% yoy).

Sharp fiscal contraction in place...

As a consequence of the economic downturn and with the goal of adopting the euro as soon as possible, the government has been repeatedly concerned with amending the 2009 budget. Over the course of the year, the government cut public expenditures by 7% to GDP. The fact that former EU budget commissioner Dalia Grybauskaite, determined to get the state finances under control and obviously not a novice with regard to the subject of public finances, was voted into the post of Lithuania's president in May was widely seen as a positive, more important for the public finances was however the recent replacement of FinMin Semeta by Simonyte who, according to a first interview, backs the current restrictive policies.

...and worse to come

The government, supported by President Grybauskaite, is determined to keep the budget deficit below 5% of GDP this year. We think, however, that this will be very difficult, given the sharp decline in economic activity and the rise in unemployment – even with the envisaged amendments in place (the government decided at the beginning of July on a 5 to 24.5% cut in public wages which still needs to be approved by Parliament) we pencil in a higher-than-intended budget deficit in 2010. It should be noted that Lithuania saw some serious riots at the beginning of this year which showed that (parts of) the public is prepared to manifest its unwillingness to accept overly restrictive fiscal policies. This, in turn, means that politicians' hands are bound as far as further fiscal measures are concerned.

For 2011, we expect a more benign fiscal deficit; this, however, depends strongly on developments in Latvia. If the Latvian currency is devalued over the course of next year, this could likely represent the trigger for a devaluation of the lita as well. Having said that, it should be noted however that Lithuania seems to be best positioned of all three Baltics: net indebtedness of households and companies in EUR is "relatively" low – about 30% to 2008 GDP and the real exchange rate (calculated based on the purchasing power parity) is overvalued by 3% as opposed to Latvia's 16.3% overvaluation and Estonia's 6.0%. Nevertheless, we think that it would be difficult for Lithuania to withstand any storm ravaging Latvia and Estonia and triggering a devaluation in those two countries without leading to a change in the exchange rate of the lita as well.

Poland



Outlook

Poland has broadly outperformed the rest of the region, given relatively loose 2008 fiscal policy and a relatively smaller export sector. Looking ahead, Poland is in a good position to recover in 2010/11, though this will mean the rate easing cycle remains on hold until the outlook for inflation clarifies.

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

	2007	2008	2009F	2010F	2011F
GDP (EUR bn)	310.8	360.2	295.3	338.4	370.7
Population (mn)	38.1	38.1	38.1	38.1	38.1
GDP per capita (EUR)	8154	9453	7751	8885	9739
GDP (constant prices yoy %)	6.7	4.8	-0.5	1.9	3.1
Private Consumption, real, yoy (%)	5.0	5.3	-0.8	2.2	3.8
Fixed Investment, real, yoy (%)	17.6	7.8	-4.8	0	1.0
Public Consumption, real, yoy (%)	3.7	0	2.7	2.5	3.5
Exports, real, yoy (%)	9.1	5.8	-5.2	4.8	7.0
Imports, real, yoy (%)	13.6	6.2	-6.2	3.6	6.1
CPI (average, yoy %)	2.5	4.2	3.3	3.0	2.2
Central bank reference rate	5.00	5.00	3.50	4.00	4.50
Monthly wage, nominal (EUR)	762	905	751	863	933
Unemployment rate (%)	12.7	9.8	11.4	13.5	13.1
Budget balance/GDP (%)	-2.0	-3.9	-5.5	-4.6	-3.9
Current account balance (EUR bn)	-14.6	-19.6	-8.4	-10.1	-13.2
Current account balance/GDP (%)	-4.7	-5.5	-2.8	-3.0	-3.6
Net FDI (EUR bn)	16.7	11.0	7.0	10.0	11.0
FDI % GDP	5.4	3.0	2.4	3.0	3.0
Gross foreign debt (EUR bn)	158.4	171.8	192.2	198.6	0
Gross foreign debt (% of GDP)	48.3	56.6	65.1	58.7	0
FX reserves (EUR bn)	44.7	44.1	48.6	52.4	0
(Cur.Acc-FDI)/GDP (%)	0.7	-2.4	-0.5	0	-0.6
FX reserves/Gross foreign debt (%)	28.2	25.7	25.3	26.4	25.8
Exchange rate to USD eop	2.47	2.97	2.76	2.85	2.74
Exchange rate to EUR eop	3.60	4.15	4.00	3.85	3.70
Exchange rate to USD AVG	2.76	2.39	3.18	2.80	2.70
Exchange rate to EUR AVG	3.78	3.52	4.35	3.93	3.78

Source: UniCredit Research

STRENGTHS

- Positive GDP growth in 1Q
- PLN-denominated exports in positive yoy territory after March – weak zloty a significant cushion against global slowdown
- Government determined to keep the deficit as low as possible

WEAKNESSES

- High public sector borrowing needs
- Risk of upward revision of 2009 deficit, risk of wide budget deficit in 2010
- High FX leverage in domestic private sector

Poland keeps fighting against the tide

Key forecast changes and rationale

The 1Q09 GDP data showed that the Polish economy managed to stay “above water” (+0.8% yoy), quite an achievement against the background of the rest of Europe. What is even more positive, the breakdown showed: **1.** Very strong positive contribution of net exports (1.9pp) to GDP – which bodes well for the positive impact of this factor on the whole year’s GDP growth, when the international environment becomes more conducive for exports than in very tough 1Q. **2.** There has been a very significant decline of inventories, which suggests that when enterprises become less scared, they will rebuild the stock of inventories to more normal levels, which will be another positive for both industrial output and GDP growth in the coming quarters. 1Q09 GDP data make us think about revising up our 2009 GDP projection (currently at negative 0.5%), but we will wait to see the 2Q09 data. First, all 1Q09 GDP statistics are based on weaker evidence than in the following quarters, and hence there’s room for revisions as 2Q data are released. Second, we estimate that 2Q09 will likely be the weakest quarter in the entire 2009, and so after viewing these data one will be able to see how low the bottom was & how “tough” it is.

The key forecast change (apart from the budget deficit, see below) regards our 2009 CPI expectations, which have been revised higher due to relatively high Q209 inflation (on previous FX weakness) and our expectation of food/fuel price inflation upside in H2. Having said that, we do look for core inflation pressure to diminish relatively rapidly in H209/10 against the backdrop of a firmer PLN and a negative output gap and look for inflation to be below the mid-point of the NBP’s target in 2011. We also revised our C/A forecasts, given the better-than-expected performance year-to-date (though we note that net errors and omissions remain wide, implying the financing gap has not shrunk that much).

Policy response

The MPC cut interest rates from 5.0% in end-2008 to 3.75% in March, and a further 25bp to 3.50% in June. The NBP MPC has given a clear signal that it’s now in a wait and see mode and we don’t see further easing until September at the earliest. Separately, the government announced a fiscal amendment in July, which will push the central government deficit up to PLN 27.2bn (2.1% of GDP) from PLN 18.2bn previously. This points to a general government deficit of circa 5.5% of GDP in 2009.

Political outlook

The ruling Civic Platform (PO) is getting very high public support (about 50%, better than they got in elections) in spite of the economic slowdown. This is to a large extent a function of weakness of the opposition. We do not expect major threats from the political scene in the coming months.

FX and sovereign credit rating outlook

Rating agencies are expressing appreciation of the governments’ determination to keep the deficit as low as possible, recognize the relatively high resilience of the domestic economy to contagion from the global economic crisis, and are not suggesting any near-term changes to Poland’s sovereign rating.

Romania



Outlook

Due to worse-than-expected 1Q figures, we revised our 2009 GDP forecast slightly lower to negative 5.2%. Due to limited fiscal and monetary policy flexibility, we also reduced our 2010 GDP forecast to 0.5%. Although the IMF/EU agreement reduced the tail risk the economy was facing, the upcoming presidential election (November) and associated fiscal policy represent a near-term risk. Accordingly, we expect EUR/RON at 4.50 at the end of the year.

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Long-term foreign currency credit rating	Moody's Baa3 stable	S&P BB+ negative	Fitch BB+ negative
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MACROECONOMIC DATA AND FORECASTS

	2007	2008	2009F	2010F	2011F
GDP (EUR bn)	123.7	136.9	127.3	141.6	162.5
Population (mn)	21.5	21.4	21.3	21.2	21.1
GDP per capita (EUR)	5745	6391	5973	6676	7702
GDP (constant prices yoy %)	6.2	7.1	-5.2	-0.5	2.5
Private Consumption, real, yoy (%)	9.8	8.4	-9.6	-0.4	1.6
Fixed Investment, real, yoy (%)	29.0	19.3	-8.1	-0.5	1.4
Public Consumption, real, yoy (%)	7.6	3.7	-2.2	2.0	1.2
Exports, real, yoy (%)	7.9	19.4	-14.9	3.9	7.0
Imports, real, yoy (%)	27.2	17.5	-24.0	4.3	8.3
CPI (average, yoy %)	4.8	7.9	6.1	4.3	3.9
Central bank reference rate	7.50	10.25	8.50	7.00	6.25
Monthly wage, nominal (EUR)	312	348	324	353	395
Unemployment rate, yearly avg (%)	4.3	4.0	7.3	7.6	7.0
Budget balance/GDP (%)	-2.3	-4.8	-5.0	-4.5	-4.0
Current account balance (EUR bn)	-16.7	-16.9	-8.5	-7.9	-8.4
Current account balance/GDP (%)	-13.5	-12.3	-6.7	-5.6	-5.1
Net FDI (EUR bn)	7.2	9.0	4.6	4.7	6.5
FDI % GDP	5.8	6.6	3.6	3.3	4.0
Gross foreign debt (EUR bn)	38.7	50.8	62.6	71.9	77.9
Gross foreign debt (% of GDP)	31.3	37.1	49.2	50.8	48.0
International reserves (EUR bn)	27.2	28.3	29.3	26.3	23.7
(Cur. Acc-FDI)/GDP (%)	-7.7	-5.7	-3.1	-2.3	-1.1
Int. reserves/Gross foreign debt (%)	70.2	55.6	46.8	36.6	30.4
Exchange rate to USD eop	2.45	2.89	3.10	3.17	2.96
Exchange rate to EUR eop	3.58	4.03	4.50	4.28	4.00
Exchange rate to USD AVG	2.43	2.50	3.14	3.14	2.96
Exchange rate to EUR AVG	3.34	3.68	4.29	4.39	4.14

Source: UniCredit Research

STRENGTHS

- Significant IMF and EU balance of payments support
- Low public sector debt levels and high roll-over rates of banks' external financing
- EU convergence with long-term growth potential supported by EU structural and cohesion funds

WEAKNESSES

- High budget deficit with risk of revenue shortfalls
- Wide external financing gap and C/A rebalancing risk
- High FX leverage in domestic private sector

Risks have not disappeared

The worst is not behind us – 2Q09 brings acceleration in GDP drop

The Romanian economy contracted 6.2% yoy in the first quarter, compared with 2.9% growth in the fourth quarter of last year and 7.1% real growth in 2008. The qoq figures reveal that the economy has already been contracting for three quarters in a row. The expenditure breakdown displayed a record drop of inventory investment that resulted in a 36.6% yoy slump of gross capital formation (including fixed investments and inventory investments). An even deeper economic drop in the second quarter is expected, mainly driven by worsening investment figures and depressed consumption that led to a downward adjustment of our GDP forecast from -4% towards a -5.2% real drop in 2009. With pro-cyclical fiscal tightening, domestic demand can hope for neither fiscal stimulus nor for improved borrowing conditions which raises serious uncertainty about the near-term economic recovery, with the first positive growth figures postponed for 3Q of 2010.

Inflationary pressures to resurface

The disinflation process gained some force recently (annual inflation slowdown to 5.95% yoy in May from April's 6.5%), but even so we think that it is improbable to reach the central bank's end-year forecasts and target band (4.4% end-2009 forecasts and disinflation target band between 2.5-4.5%). We see inflationary risk resurfacing from RON depreciation, higher food prices due to the less favorable harvest and a slight upward movement of oil prices. We keep our inflation forecast at 5.4% yoy.

Sharper than previously expected C/A correction for 2009

We revise downward our C/A deficit forecasts, given the sharper 4M correction that softens significantly the financing needs of the private sector (C/A deficit shrank 78.9% yoy, on the back of a contracting trade deficit -67% yoy). We also re-assessed higher outflows of FX reserves through the further release of liquidity through MRR cut and possible FX interventions (set to stabilize at EUR 29bn this year).

Monetary policy effectiveness improved in 2Q09, although less room left for policy rate cut in 2H09

The central bank recently made serious efforts to re-launch lending activity, reflected also by the 50bp policy rate cut and its active presence on the interbank market. Monetary transmission became more effective by bringing the interbank rates closer to the policy rate (stabilizing at 10.5% from 16% in January 2009). Moreover, EUR 0.8bn liquidity has been also released through the MRR cut. Given the still sluggish lending and very optimistic CB inflation outlook, a bigger than 50bp cut is expected at the next meeting, followed by less significant cuts once it becomes clear that the inflation target is hard to reach.

Poor YTD fiscal performance so far in line IMF program

On the fiscal side, Romania's government showed so far little interest in implementing structural reforms and adjusting its lax fiscal policy. From January through May, the public deficit reached 2.2%/GDP, triggered by the sharp plunge of public revenues and rigidity of social spending costs (public wages, pensions). The 1H deficit target of 2.7% of GDP set under the stand-by agreement with the IMF thus seems still viable, but below-expectations full-year GDP could trigger a further contraction of revenues, putting additional pressure on this year's budget deficit target of -4.6% of GDP.

Presidential election to be held in November 2009 fueling some inter-coalition instability

Presidential elections are set to be held in November, with the main contenders President Basescu, Mircea Goana, head of the PSD and Crin Antonescu, leader of the opposition party PNL. The electoral fight might threaten the coalition's stability.

Failure to stick to IMF conditions is the biggest risk for the sovereign credit rating outlook

Inter-coalition disagreements combined with inappropriate fiscal policy continue to be the major risks of the country. While the IMF/EU arrangement acts as a major stabilizer at the current stage, any mismatch of its targets might be severely penalized by rating agencies and the investor community. We keep our call for end-year RON/EUR 4.5. Depreciation pressures are expected to resurface due to a weakening of economic fundamentals, negative wealth effect of the private sector and worsening fiscal policy performance.

Slovakia



Outlook

Euro makes Slovak produce more expensive, sending shoppers across the border, but simultaneously keeps the price of debt low. Even so, industry remains linked to the eurozone (esp. German) performance, which is starting to witness some stabilization.

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

	2007	2008	2009F	2010F	2011F
GDP (EUR bn)	54.9	64.9	63.4	65.5	69.5
Population (mn)	5.4	5.4	5.4	5.4	5.4
GDP per capita (EUR)	10158	12004	11730	12142	12878
GDP (constant prices yoy %)	10.4	6.4	-5.4	1.6	3.5
Private Consumption, real, yoy (%)	7.1	6.1	-1.1	1.4	2.0
Fixed Investment, real, yoy (%)	8.7	6.8	-8.5	-0.7	6.7
Public Consumption, real, yoy (%)	-1.3	4.3	3.5	3.5	1.0
Exports, real, yoy (%)	13.8	3.2	-17.5	1.6	7.0
Imports, real, yoy (%)	8.9	3.3	-16.0	0.7	6.3
CPI (average, yoy %)	2.8	4.6	2.1	2.5	3.5
Central bank reference rate	4.25	2.50	EUR	EUR	EUR
Monthly wage, nominal (EUR)	669	723	741	767	805
Unemployment rate (%)	11.0	9.6	12.5	12.9	12.6
Budget balance/GDP (%)	-1.9	-2.2	-6.3	-5.8	-4.3
Current account balance (EUR bn)	-3.3	-4.2	-3.9	-3.1	0
Current account balance/GDP (%)	-5.3	-6.5	-4.8	-5.0	-5.4
Net FDI (EUR bn)	2.7	1.7	1.2	1.8	0
FDI % GDP	4.4	2.5	1.8	2.7	2.2
Gross foreign debt (EUR bn)	32.4	35.9	38.5	42.1	44.7
Gross foreign debt (% of GDP)	59.0	55.3	60.7	64.2	64.2
(Cur. Acc-FDI)/GDP (%)	-1.1	-3.9	-4.4	-2.0	0
Exchange rate to EUR AVG	33.78	31.29	30.13 = 1 EUR	EUR	EUR

Source: UniCredit Research

STRENGTHS

- Euro adoption prevents short-term currency volatility
- Banking sector in good shape
- Some FDI interest due to euro adoption

WEAKNESSES

- Euro adoption does not allow depreciation to improve competitiveness, neighboring countries benefit.
- Cyclical sectors important for the economy (autos, electronics)
- No reform agenda, small fiscal stimulus package adopted.

Plunging with Germany

Slovak GDP forecasts

	2009	2010
NBS	-4.2	2.4
UCB	-5.4	1.6
MinFin	-6.2	1.1

As the new data become available, the Slovak economy shows increasing signs of economic weakness. The huge revision of the recession in Germany to -6.2% this year has had a corresponding, direct and more immediate impact on Slovak growth than we had previously expected. The 1Q09 contraction of 5.6% was a particularly weak figure, especially after taking into account that some support came through from a one-off positive excise tax effect. Looking at quarter on quarter dynamics, the development in the first quarter was a total collapse, though it is reasonable to assume that the numbers for 4Q08 will be revised downward in the coming months.

We assume more domestic pain compared to CB forecast

The difference between a more optimistic NBS figure of -4.2% and our forecast is that we assume more domestic pain. The Slovak central bank pencils in stronger domestic consumption and positive real wage growth. We expect less of a consumption smoothing, with savings increasing as a result, and some consumption diverted away to neighboring CEE countries (since the prices are lower after double-digit local currency depreciations). What's more, we also assume a 0.9% higher unemployment rate and are more skeptical about a highway construction boost via PPP scheme.

We expect some revival in industry in 2H09 on improving German sentiment

The difference between a cautious MinFin figure of -6.2% and our forecast is the size of the contraction of exports/industry. While we cling to some hope of improving German expectations (Ifo, ZEW), the MinFin is working with the figures of Slovak confidence indicators showing no improvement at all. The MinFin also claims that there will be a 2Q-3Q lagged reaction of Slovak industry to the improving German situation (not supported by recent data though).

Euro makes Slovak produce more expensive, keeps the price of debt low

Slovakia continues to enjoy ECB low interest rates. The 10Y spread has increased but is relatively contained at 170bp.

Halt in reforms boosts fiscal deficit despite no need for one-off expenditures in the banking sector

The fiscal deficit mirrors the dramatic turnaround in Slovak growth. Despite no need to re-capitalise the local banks and a limited fiscal stimulus package at 0.5% of GDP, the cyclical pressures are enormous, pushing the fiscal deficit from 2.2% of GDP last year to an estimated 6.1% of GDP this year. The scheduled parliamentary elections in June 2010 will prevent the government from taking real "belt-tightening" measures to cut the deficit. Indeed, a threat of tax rate hikes (either direct or indirect ones via social contributions) could be on the agenda and the second private pension pillar will continue to be unpopular with the government.

A threat of tax hikes for the future

No reform agenda planned. Even possible government collapse would not have major consequences

The government coalition might face pressure as the elections countdown nears. A possible break-up should not have major consequences since there is no reform agenda planned and the opposition parties will not support early elections.

No more rating upgrades for Slovakia

Euro adoption limits the short-term currency risk. A relatively low public debt level will buy Slovakia some leniency with rating agencies despite a booming fiscal deficit. However, the improving trend in ratings has definitely ended.

Slovenia



Outlook

Private sector liquidity issues and export orientation of economy mean that we are not as bullish about the pace of recovery in 2010. However, government policy to jump start economic activity with an EUR1.2bn loan guarantee scheme for business will support growth.

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Long-term foreign currency credit rating	Moody's Aa2 positive	S&P AA stable	Fitch AA stable
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MACROECONOMIC DATA AND FORECASTS

	2007	2008	2009F	2010F	2011F
GDP (EUR bn)	34.5	37.1	36.0	36.9	38.7
Population (mn)	2.0	2.0	2.0	2.1	2.1
GDP per capita (EUR)	17169	18366	17665	18015	18792
GDP (constant prices yoy %)	6.8	3.5	-4.2	0.6	2.3
Private Consumption, real, yoy (%)	5.3	2.2	-0.6	0.2	1.9
Fixed Investment, real, yoy (%)	11.9	6.2	-14.0	2.5	3.5
Public Consumption, real, yoy (%)	2.5	3.7	3.4	3.0	2.5
Exports, real, yoy (%)	13.8	3.3	-14.1	2.1	3.7
Imports, real, yoy (%)	15.7	3.5	-12.6	3.1	3.8
CPI (average, yoy %)	3.6	5.7	1.3	1.9	2.5
Central bank reference rate	4.00	2.50	1.00	1.50	2.00
Monthly wage, nominal (EUR)	1284	1391	1400	1441	1498
Unemployment rate (%)	4.9	4.5	5.8	6.2	5.5
Budget balance/GDP (%)	-0.1	-0.2	-3.8	-2.5	-2.0
Current account balance (EUR bn)	-1.5	-2.2	-1.2	-1.2	-1.4
Current account balance/GDP (%)	-4.2	-5.9	-3.4	-3.2	-3.5
Net FDI (EUR bn)	-0.3	0.3	0.3	0.5	0.7
FDI % GDP	-0.8	0.7	0.7	1.4	1.8
Gross foreign debt (EUR bn)	34.8	39.0	41.8	44.0	46.0
Gross foreign debt (% of GDP)	100.7	105.1	115.9	119.1	118.8
(Cur.Acc-FDI)/GDP (%)	-5.0	-5.2	-2.7	-1.9	-1.7
Exchange rate to USD eop	164.33	171.75	165.27	177.51	177.51
Exchange rate to EUR eop	239.64	239.64	239.64	239.64	239.64
Exchange rate to USD AVG	174.82	162.92	175.13	171.17	171.17
Exchange rate to EUR AVG	239.64	239.64	239.64	239.64	239.64

Source: UniCredit Research

STRENGTHS

- Low public debt levels
- Foreign debt essentially denominated in local currency
- Early in electoral cycle

WEAKNESSES

- Sharp reduction in access to capital for companies
- High loan/deposit ratio of the banking sector
- Export oriented economy dependent on EU recovery

Opportunity cost of shunning FDI laid bare

Massive drop in investment spending prompts downward revision in growth forecast

1Q GDP falls a record 8.5% yoy. The main features were that fixed investment fell 23.6% yoy in 1Q and the reduction in inventories lopped 4.2 percentage points off growth. Imports of goods and services fell 22.7% yoy and exports 21.1% yoy, underlining the impact the EU's recession has had on Slovenia's export-oriented economy. Inflation was only 0.7% yoy in May, while the current account deficit in 1Q narrowed 66% yoy to only EUR 154mn. The only surprise in the GDP numbers was that private consumption actually rose 0.1% yoy. The twin shock of tighter liquidity and collapsing export markets have hit the Slovenian economy hard. Industrial production, which contracted 21.2% yoy in 1Q, fell another 24% yoy in April, although the value of new orders rose over 4% compared to March, foreshadowing that industrial production may have bottomed out.

As a result, we lower our growth forecast from -2.1% to -4.2% this year. While we expect the economy to post growth of 0.4% in 2010, given the export orientation of the economy, the extent of any recovery will largely depend on a return to growth in Slovenia's major trading partners. Although the current account deficit has narrowed sharply in 1Q, given the sharp reduction in inventories, we expect investment activity and therefore imports to pick up in the remainder of the year. In addition, in May the sentiment indicator rose 3 percentage points in seasonally adjusted terms, having literally fallen off a cliff since September 2008 (by over 30 points). Hence, we forecast a current account deficit of 3.4% of GDP.

Fiscal stimulus drives widening of the budget deficit...

Budget deficit rises as expenditures increase. In 1Q09, the consolidated budget deficit amounted to EUR 592.4mn (1.7% of GDP). Tax revenues fell 1.6% yoy over this period and total revenues 2.6% yoy. Expenditures, however, rose 14.4% yoy over this period as wage expenditure rose 19.2% yoy and spending on transfers rose 17.3% yoy. Unemployment allowances rose 44.7% and subsidies to enterprises rose sharply as a result of the government's shorter working week subsidy program and other assistance. All in all, we see the budget deficit rising to 5.2% of GDP this year.

...state guarantee program latest effort to kick start economic activity

The latest government policy to kick start economic activity was an EUR 1.2bn loan guarantee scheme for business. Following EC approval, the state-owned development bank began auctioning government guarantees on 17 June – the program will run until the end of 2010, enabling companies to secure financing for investment and working capital purposes. Parliament has also increased the public sector borrowing limit to EUR 5bn (from an initial limit of EUR 2.3bn). The government's strong fiscal position coming into the recession has allowed it to support the real sector. The underlying issue, however, is that the policy of shunning FDI and maintaining domestic ownership of most companies (and banks) has proved to come with a high opportunity cost – without international strategic partners many companies (and locally-owned banks) are finding access to credit constrained, forcing the government to flood the financial system with money in an effort to jump start investment activity. This support will see public debt increase in the coming years. Meanwhile, the export orientation of the economy has also been a brake on growth, given the global nature of the economic downturn.

Policy debate to continue over the summer

The main domestic issue is the fallout from banks which have received government assistance refinancing loans used for management buyouts of companies. The government in May banned this practice. The economy will continue to present problems for the government but we do not expect the recession to force an early election.

Sovereign credit rating stable on low public debt

Slovenia's low public debt is a big plus for its sovereign credit rating. Even though we forecast a rise in public debt to over 30% of GDP this year, access to international finance for the government is not a problem.

Bosnia & Herzegovina



Outlook

Bosnia's recession will continue through 2010, but the currency board arrangement (an anchor of stability) is safe given the strong international support (IMF and EU). Political developments, especially given the need for fiscal cuts, still remain a source of instability.

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

MACROECONOMIC DATA AND FORECASTS

	2007	2008	2009F	2010F	2011F
GDP (EUR bn)	11.1	12.5	12.3	12.5	12.8
Population (mn)	3.8	3.9	3.9	3.9	3.9
GDP per capita (EUR)	2876	3253	3187	3236	3333
GDP (constant prices yoy %)	6.8	5.8	-3.0	-1.0	0.8
CPI (average, yoy %)	1.5	7.4	1.0	2.6	2.2
Monthly wage, nominal (EUR)	488	568	605	600	593
Unemployment rate (%)	44.0	40.3	42.0	44.0	43.5
Budget balance/GDP (%)	1.0	-0.9	-2.5	-2.0	-1.5
Current account balance (EUR bn)	-1.2	-1.9	-1.0	-0.7	-0.7
Current account balance/GDP (%)	-10.4	-15.0	-7.9	-5.5	-5.1
Net FDI (EUR bn)	1.5	0.7	0.2	0.4	0.5
FDI % GDP	13.8	5.5	1.7	3.3	4.0
FX reserves (EUR bn)	3.4	3.2	2.6	2.5	2.7
(Cur.Acc-FDI)/GDP (%)	3.4	-9.5	-6.2	-2.3	-1.1
Exchange rate to USD eop	1.34	1.40	1.35	1.45	1.45
Exchange rate to EUR eop	1.96	1.96	1.96	1.96	1.96
Exchange rate to USD AVG	1.43	1.33	1.43	1.40	1.40
Exchange rate to EUR AVG	1.96	1.96	1.96	1.96	1.96

Source: UniCredit Research

STRENGTHS

- Significant IMF and EU balance of payments support
- Currency Board arrangement reduces policy uncertainty
- Foreign-owned banks supporting subsidiaries

WEAKNESSES

- Fractured political environment
- Wide external financing gap
- Commodities and steel main exports

Deflation signals recession

Domestic demand is clearly slowing...

Inflation data most clearly reflect a slowdown in economic activity. Data from the Federation and Republika Srpska for May foreshadow a fall of 0.9% yoy in the CPI at a national level, implying that in seasonally-adjusted terms the mom inflation rate has been negative in Bosnia Herzegovina since November 2008. Meanwhile, in 1Q09 the current account deficit narrowed almost 60% yoy to BAM 307mn, with imports of goods and services down over BAM 875mn (23% yoy). In the absence of GDP data, these numbers, in our opinion, most starkly reveal the slowing of the economy in recent quarters, especially considering that wages rose 14.9% yoy in 1Q09. Industrial production data show a somewhat split personality, with major investments in three sub-sectors in Republika Srpska seeing industrial production up 16.6% yoy in January-April, while in the Federation industrial output contracted 9.6% yoy at the same time, the GDP weighted average of industrial production over this period in BiH was -1.1% yoy.

...no major changes to forecasts

Hike of excise tax will see inflation rise, but our forecast remains unchanged at 1% yoy. This is because, despite the inflationary impact of the rise in tobacco, alcohol, fuel and coffee excise tax hikes which will likely be revealed in the June CPI numbers, inflationary pressures remain muted. While the recession in Bosnia Herzegovina is deep, the fact that industrial production will mildly fall this year nonetheless leads us to forecast the smallest GDP contraction (-3% yoy) among Southeast European economies that we follow.

Politicians agree to unpopular spending cuts and tax increases to secure 3-year EUR 1.2bn IMF deal

In the absence of up-to-date fiscal data, the IMF deal speaks volumes. Final 2008 consolidated fiscal data are not yet available, yet the fact that Bosnia Herzegovina's various levels of government have agreed to find BAM 580mn in combined spending cuts and tax cuts speak volumes of the impact the recession is having on the country's fiscal position. So does the announcement by the Federation government in May that it had finally agreed on a loan deal with local banks to clear arrears of approximately BAM 250mn arising from obligations in the 2008 budget. Since 1 May, the mandatory reserve requirement on term deposits greater than one year has been lowered to 7% from 10%, generating BAM 262mn in additional liquidity, according to the central bank.

Fiscal adjustment under the auspices of the 3-year EUR 1.2bn IMF agreement was the main policy response. The reduction in public sector salaries and most social welfare programs 10% below end-2008 levels in the Federation (which has to contribute BAM 414mn of the total BAM 580mn adjustment) and similar cuts in Republika Srpska along with excise tax increases at the national level aim to reduce the public sector borrowing requirement and support the currency board.

Fractional political environment persists

Tensions between Republika Srpska and the High Representative plus a backlash to public spending ensure an eventful summer. In May, the Republika Srpska Parliament passed a resolution stating that it would not assent to the transfer of powers to the central government. The High Representative can rescind that resolution; however, the issue was still playing out in June and serves to underline that the reform process in Bosnia Herzegovina faces many twists and turns. While the presence of the IMF will enable politicians to deflect some criticism for unpopular economic policy measures, politicians will still be under pressure to explain the rationale behind their policies.

Currency board arrangement secure after IMF-inspired policy response

IMF deal buttresses credit rating, while Bosnia's currency board arrangement looks safe. The main reason we believe the arrangement is not at risk is due to the sustainable path fiscal policy is now on. The other, no less important, factor is the international community's presence in the country. Given the deep-seated and often evident political difficulties, jeopardizing the currency board arrangement (the one genuine source of certainty in the sphere of economic policy) would be an extremely expensive option.

Croatia



Outlook

External imbalances adjusting quickly, but lack of adequate fiscal policy response to date raises concerns. However, the new, Kosor led, government has the freedom to implement decisive measures, one of which would be asking for help from the IMF. For now, public sector borrowing requirements are crowding out private sector access to credit, and prolonging the GDP contraction.

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

	2007	2008	2009F	2010F	2011F
GDP (EUR bn)	42.9	46.4	43.4	45.3	48.0
Population (mn)	4.4	4.4	4.4	4.4	4.4
GDP per capita (EUR)	9662	10462	9787	10209	10832
GDP (constant prices yoy %)	5.5	2.4	-4.9	-0.2	1.7
Private Consumption, real, yoy (%)	6.2	0.8	-5.2	0	1.2
Fixed Investment, real, yoy (%)	6.5	8.2	-9.1	-1.5	3.2
Public Consumption, real, yoy (%)	3.4	1.9	1.3	-0.9	1.0
Exports, real, yoy (%)	4.3	1.7	-12.3	-3.0	1.5
Imports, real, yoy (%)	6.5	3.6	-14.6	-2.4	2.2
CPI (average, yoy %)	2.9	6.1	3.2	3.3	3.1
Monthly wage, nominal (EUR)	961	1044	1021	1048	1092
Unemployment rate (%)	9.6	8.4	10.5	11.0	9.8
Budget balance/GDP (%)	-2.0	-0.8	-3.9	-2.8	-2.5
Current account balance (EUR bn)	-3.2	-4.4	-2.3	-2.1	-1.9
Current account balance/GDP (%)	-7.6	-9.6	-5.4	-4.6	-3.9
Net FDI (EUR bn)	3.5	3.2	1.5	1.7	2.0
FDI % GDP	8.1	6.9	3.5	3.8	4.2
Gross foreign debt (EUR bn)	33.3	39.0	40.0	42.0	45.0
Gross foreign debt (% of GDP)	77.6	84.2	92.2	92.8	93.7
FX reserves (EUR bn)	9.3	9.1	8.5	8.0	8.5
(Cur.Acc-FDI)/GDP (%)	0.6	-2.7	-1.9	-0.9	0.3
FX reserves/Gross foreign debt (%)	28.0	23.4	21.3	19.0	18.9
Exchange rate to USD eop	5.03	5.29	5.34	5.63	5.56
Exchange rate to EUR eop	7.33	7.37	7.75	7.60	7.50
Exchange rate to USD AVG	5.35	4.91	5.48	5.36	5.32
Exchange rate to EUR AVG	7.34	7.22	7.50	7.50	7.45

Source: UniCredit Research

STRENGTHS

- External imbalances adjusting quickly
- Well capitalized banking sector
- New government free from legacy – free in policy choice

WEAKNESSES

- Widening fiscal deficit is crowding out private sector
- High FX leverage in household and private sector
- Rising unemployment not accounted for properly in budget

Can the new government reduce public spending?

Sharp contraction in domestic demand evident from high frequency data

1Q GDP contracted 6.7% yoy. Domestic demand fell sharply as private consumption plummeted 9.9% yoy and gross fixed capital investment fell 12.4% yoy. At the same time, the rundown in inventories contributed 4 percentage points to the fall in GDP, while imports fell 14.2% yoy and exports fell 20.9% yoy. The collapse in demand for imports was reflected in the balance of payments data for 1Q09, which revealed a 28.2% yoy reduction in the current account deficit to EUR 1.82bn, largely as a result of the reduced merchandise trade deficit. In the first 5 months of the year, the merchandise trade deficit has narrowed by almost EUR 1.7bn, with imports of motor vehicles down by approximately EUR 400mn.

Headline GDP forecast consistent with high frequency data, but composition of growth changes...

GDP forecast revised down to 4.9% contraction, inflation forecast upped to 3.2% yoy. Given the sharper-than-expected fall in inventories and gross fixed capital investment, we lower our GDP forecast from a 3.7% to 4.9% contraction. The risks remain to the downside given that rising public sector borrowing requirements are crowding out private sector access to credit. Although inflation is heading seasonally lower over the summer, the increases seen in 1Q09 will flow into the full-year figure, which we raise to 3.2% yoy, with a year-end figure of 4.0% yoy.

...Inflation forecast upped to 3.2% on higher 1Q outcome

Still waiting for an appropriate adjustment in public spending...

Monetary conditions stable in recent months, budget revenue figures weak while expenditures rise substantially. 1W money market rates have oscillated between 6-9% since mid-March and look set to remain stable during 3Q. 1Q budget figures revealed a very weak fiscal position with expenditures rising over 10% yoy and revenues down 4.8% yoy. VAT revenues were down almost 19% yoy in 1Q and were it not for the 1.5% increase in social welfare contributions, the HRK 3.5bn deficit recorded in 1Q would have been substantially higher. Current expenditures in 1Q rose 10.7% yoy, with wages up 11.3% yoy to HRK 8.9bn, and the purchase of other goods and services rising 23.3% to HRK3.65bn. The 12.7% increase in social welfare spending is also worrying given that the expected impact of higher unemployment is yet to be fully felt in the budget. Compared to the government's HRK 5.5bn budget deficit forecast, we look for a deficit of HRK13bn (3.9% of GDP), underlining that this does not include the Motorway Authority (HAC), development bank (HBOR) or pensioner debt repayments.

...the only question is will the government muster the courage to cut spending on its own, or will it need to call in the IMF to help?

Another budget rebalance is likely in the autumn months. In April, the central bank governor criticized the lack of adjustment in fiscal policy and has since repeated calls for the government to cut public spending or call in the IMF to assist. He also repeated that the bank will not loosen monetary policy any more this year. Moral suasion by the governor to kick-start the fiscal adjustment process has become increasingly evident in recent weeks. The new government is planning a budget rebalance before parliament breaks for summer (it may well sit beyond 15 July to ensure the budget rebalance is passed) but is also flagging the possibility of another rebalance in September.

Surprise resignation of PM Sanader

PM Sanader resigns, new government installed 4 days later. After PM Sanader's surprise resignation on 1 July, his deputy Jadranka Kosor was confirmed as prime minister of a new government. This has allayed any immediate fears of political instability with the new government gaining the support of 83 of the 153 MPs.

FX and sovereign credit rating outlook revolve around fiscal policy developments

Fiscal developments the main factor for FX and credit rating outlook. During 3Q, tourism-related inflows will see the EUR/HRK near current levels; however, after the peak tourist season, depreciation pressures on the currency are likely to resurface, especially if there is no fiscal adjustment. Given that public external debt obligations are minimal in the remainder of the year, the sovereign credit rating should remain stable in the near term, but with public debt redemptions rising again in 1Q10, a cut in public spending will be the key factor going forward for Croatia's sovereign rating.

Kazakhstan



Outlook

Signs of stabilization are evident, and the large fiscal stimulus ought to support the economy in 2H09 and onwards. While positive spillover effects from the large investment in infrastructure will also give a boost. The situation of Kazakh banks remains tense, as deep restructuring is underway.

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Long-term foreign currency credit rating	Moody's Baa2 negative	S&P BBB- stable	Fitch BBB- negative
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MACROECONOMIC DATA AND FORECASTS

	2007	2008	2009F	2010F	2011F
GDP (EUR bn)	76.1	89.8	75.2	79.0	90.2
Population (mn)	15.5	15.7	15.8	16.0	16.1
GDP per capita (EUR)	4912	5729	4753	4945	5598
GDP (constant prices yoy %)	8.9	3.3	-2.3	3.0	5.1
Private Consumption, real, yoy (%)	10.8	3.8	-3.0	1.8	4.5
Fixed Investment, real, yoy (%)	17.3	1.7	-6.8	6.8	10.8
Public Consumption, real, yoy (%)	14.0	5.5	5.0	3.4	3.7
Exports, real, yoy (%)	9.0	1.8	-10.0	6.5	16.0
Imports, real, yoy (%)	25.5	-11.5	-7.0	6.0	15.0
CPI (average, yoy %)	10.8	17.2	8.2	7.5	6.8
Central bank reference rate	11.00	10.50	8.50	8.00	7.75
Monthly wage, nominal (EUR)	313	343	334	339	369
Unemployment rate (%)	7.6	6.6	7.7	7.8	6.6
Budget balance/GDP (%)	5.2	1.2	-9.9	-4.0	0.0
Current account balance (EUR bn)	-5.4	4.7	-7.1	-2.8	-3.3
Current account balance/GDP (%)	-7.0	5.3	-9.4	-3.5	-3.7
Net FDI (EUR bn)	7.4	9.9	7.8	10.3	12.1
FDI % GDP	9.8	11.0	10.4	13.1	13.4
Gross foreign debt (EUR bn)	65.8	77.3	78.1	81.1	84.1
Gross foreign debt (% of GDP)	86.5	86.0	103.8	102.7	93.2
FX reserves (EUR bn)	12.7	14.8	10.3	11.8	14.8
(Cur. Acc-FDI)/GDP (%)	2.7	16.3	0.9	9.5	9.7
FX reserves/Gross foreign debt (%)	19.3	19.1	13.1	14.5	17.6
Exchange rate to USD eop	120.68	120.88	150.00	150.00	147.78
Exchange rate to EUR eop	175.99	168.66	217.50	202.50	199.50
Exchange rate to USD AVG	122.54	120.32	147.60	150.00	143.57
Exchange rate to EUR AVG	167.98	176.98	201.97	210.00	201.00

Source: UniCredit Research

STRENGTHS

- Anti-crisis program significant
- Commodity prices have recovered
- FDI has proved even more resilient than expected

WEAKNESSES

- 1Q GDP, other 1H figures slightly worse than assumed
- 1Q CA deficit widens strongly despite devaluation
- Sharp rise in distressed banking assets

Economy stabilizing, but banking to get worse before better

With 1H figures somewhat below expectations, we reduce our 2009 real GDP forecast further to -2.3% from -2.0%

Industrial production, wages and sentiment point however to an easing of the downturn

Commodity prices, devaluation support CA, but we want to remain on the safe side

Banking: the worst is still to come. BTA and some other banks in default; restructuring of debt takes place

Further interest rate cuts

No devaluation

Transfer of government funds in support of banks, housing, SME to be completed in early 2H

Large, long-term infrastructure projects should help elevate GDP growth to 3% in 2010, some 5% in 2011

Real GDP contracted by 2.2% yoy in 1Q and leading indicators point to a further decline in 2Q. Industrial output remained 3.8% below the May 2008 level, after a 4.8% decline in 1Q and 5.5% in April, but seasonal adjustment indicates a second month of improvement – an early sign of stabilization. Retail trade turnover at constant prices declined 13.5% in May after an estimated decline of 3.7% in 1Q. After three months of negative values, consumer sentiment as reported by the StatAgency survey became neutral in May 2009. Real wages increased 3.8% yoy in Jan-April thanks to hikes in mining and public services. Although further substantial increases this year are unlikely, this combined with higher government spending ought to bolster consumption.

The CA turned into a deficit of USD 1.1bn in 1Q09 from a surplus of USD 2.3bn in 1Q08. Exports decreased by 49% yoy in USD terms in 1Q09, imports by 16% yoy. With the demand for metals weak in 1H09, we fear the deficit could widen to USD 9.6bn or 9.4% of GDP in 2009. Higher oil prices, the February tenge devaluation and “buy Kazakh” policies might help, but until the recent rally in commodity prices proves to be sustainable, we remain cautious. We see the oil price (Brent) average at USD 61 in 2009 and USD 74 in 2010.

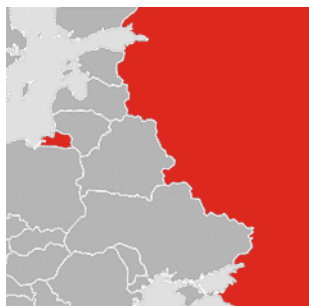
Banking is set to undergo deep restructuring, including fundamental changes in ownership, relative positions, and business models (from channeling easy foreign money into the economy to more complex services). Banks made an aggregate loss of EUR 1.5bn in Jan-April (according to local accounting standards) because of high provisioning. The share of doubtful assets increased from 10.8% at end-2008 to 18.8% as of 1 May 2009. A further substantial increase is to be expected. The case of the formerly largest bank by assets, BTA, now 75.1% state-owned, is of special interest. On 29 April 2009, the Credit Derivatives Determinations Committee decided that a “Failure to Pay Credit Event” has taken place. The 10th of June CDS settlement auction set the recovery rate as low as 10.25%.

In a move to provide further liquidity to the banking system, the central bank cut its key one-week refinancing rate to 8.5% from 9.0%, effective from 10 June 2009, pointing to ongoing disinflation. Inflation eased to 8.4% yoy in May from 8.7% yoy in January, despite a 19% devaluation of the tenge against the dollar in February. We expect it to reach a low of 7.0% by August, but to increase then again due to a base effect and hikes in electricity prices to perhaps 8.4% in December. Despite the rate cut and a wide current account deficit, we do not expect a further devaluation of the KZT against the USD anymore, thanks to recovered oil prices, resilient FDI – net inward FDI inflows amounted to USD 2.5bn in 1Q, only 6% below the 2008 figure – and the restructuring of some bank foreign debt.

The combined surplus of the consolidated budget of the central and local governments and the National Oil fund equaled 6.1% of GDP in Jan-April 2009, compared with 7.9% of GDP a year earlier. We expect a balanced outcome for 2009 after a 2.1% of GDP surplus in 2008; this does not however reveal the full extent of state support to the economy. The Oil fund is replacing foreign assets with domestic bonds of the Samruk-Kazyna state holding, which in turn subsidizes the economy. The operation leaves the overall amount of Oil fund assets unchanged, but is in effect a spending position. Counting this, we expect a deficit of the public finances of almost 10% of GDP. About KZT 720bn (EUR 3.4bn, 4.8% of GDP) of Samruk-Kazyna money is being distributed for banking stabilization, housing and SME support. The funds have reached banks, and the transfer to final users should be completed in early 2H.

Sizable funds from the government, international financial institutions and foreign investors will be spent on other infrastructure projects. The long-term nature of many of these projects, especially in the energy sector, should combine with the recovery in the global economy to lift real GDP growth rates to some 3% in 2010 and 5% in 2011.

Russia



Outlook

Optimism for a quick recovery, based on the +7% fiscal stimulus and rising oil prices, may have run ahead of itself as real economy indicators remained poor, prompting a revision in our GDP forecast down to -7.4% in 2009.

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Long-term foreign currency credit rating	Moody's Baa1 stable	S&P BBB negative	Fitch BBB negative
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MACROECONOMIC DATA AND FORECASTS

	2007	2008	2009F	2010F	2011F
GDP (EUR bn)	945.2	1139.8	919.0	1007.4	1181.5
Population (mn)	142.0	141.7	141.2	140.8	140.4
GDP per capita (EUR)	6656	8044	6507	7154	8413
GDP (constant prices yoy %)	8.1	5.6	-7.4	0.8	3.3
Private Consumption, real, yoy (%)	13.6	11.5	-8.3	2.9	7.2
Fixed Investment, real, yoy (%)	21.1	9.1	-12.5	1.0	3.0
Public Consumption, real, yoy (%)	3.4	2.5	4.6	2.6	1.0
Exports, real, yoy (%)	6.4	0.2	-10.2	0.9	3.5
Imports, real, yoy (%)	26.6	17.7	-13.8	7.8	10.1
CPI (average, yoy %)	9.0	14.1	11.5	7.9	8.5
Central bank reference rate	6.08	13.00	10.00	9.00	8.50
Monthly wage, nominal (EUR)	386	471	413	433	500
Unemployment rate (%)	5.6	6.3	9.5	8.6	7.4
Budget balance/GDP (%)	6.0	4.8	-7.6	-5.6	-4.4
Current account balance (EUR bn)	55.6	55.6	42.3	54.8	60.0
Current account balance/GDP (%)	5.9	4.9	4.6	5.4	5.1
Net FDI (EUR bn)	38.3	28.7	21.3	25.5	30.6
FDI % GDP	4.1	2.5	2.3	2.5	2.6
Gross foreign debt (EUR bn)	314.0	365.5	276.9	289.7	281.2
Gross foreign debt (% of GDP)	35.9	41.9	30.0	27.4	23.0
FX reserves (EUR bn)	326.4	302.9	300.2	357.0	392.8
(Cur. Acc-FDI)/GDP (%)	9.9	7.4	6.9	8.0	7.7
FX reserves/Gross foreign debt (%)	104.0	82.9	108.4	123.3	139.7
Exchange rate to USD eop	24.64	30.53	32.85	33.26	32.60
Exchange rate to EUR eop	35.93	42.59	47.63	44.90	44.01
Exchange rate to USD AVG	25.55	24.78	32.92	33.05	31.75
Exchange rate to EUR AVG	35.02	36.46	45.05	46.27	44.45

Source: UniCredit Research

STRENGTHS

- Lack of external financing gap
- Low public debt, and significant fiscal stimulus
- Improving sentiment

WEAKNESSES

- Dependence on commodity prices
- Structural inefficiencies , lack of domestic investment base
- Rising NPLs ratios

Optimism flares as reality burns

Following gloomy winter, optimism gained ground

...but economy continued to deteriorate in 5M09

By early summer, Russia had seen a remarkable buildup of optimism regarding the prospects of economic recovery supported by an over 100% jump of equity markets. The strength of the ruble and continued improvement in manufacturing and services PMI indices, which approached the 50 threshold level in June, are supportive indicators. However, readings of the real economy have been mixed, providing a picture of an intensified decline: investment drop intensified from -15% yoy in 1Q09 to -23.1% yoy in May, driving industrial output in May down 17.1% yoy, vs. a negative 14.2% yoy in 1Q09. Widespread production cuts have consequently led to jitters on the labor market, with the unemployment rate jumping to around 10% April-May, even as real wages and disposable incomes remained on a downward trend. As a result, retail sales and services started to contract in early 2009 for the first time in years, falling by over 5.6% yoy and 7.5% yoy in May. Overall, the data might actually suggest that 2Q09 real GDP could be even worse than the 9.8% yoy contraction recorded in 1Q09.

Balance of payments remains robust, as inflation slows

On a more positive note, Russian balance of payments remained strong, as the 47.4% yoy slump in 4M09 exports on lower oil prices was offset by the similarly strong 38.4% yoy drop in imports. Moreover, the sharp easing in domestic demand started to slow inflation, which has slowed from the 14% peak in March to 11.9% in May.

We cut our real GDP outlook to a contraction of 6.6% in 2009 on a deeper consumption fall

We cut our real GDP outlook for 2009F from a contraction of 3.6% to 7.4% yoy to account for poor data and revised oil price assumptions. A continued deceleration of consumer demand is set to continue, prompting us to cut our forecast by 1.3% to 8.3% in 2009 as unemployment remains at a 9.5% high. We also reduce our investment forecast to a 12.5% yoy decline, from a previous 10% decline, mostly on the stronger-than-expected fall in the first months of 2009.

7.4% budget deficit should boost consumption in 2H09

Overall, we see several factors in the economy supporting a substantial improvement in 2H09. First of all, the economy is expected to benefit from a substantial boost from domestic fiscal policy, as the 2009 federal budget envisages a deficit of nearly RUB 3,000bn (USD 95bn or over 7% of GDP). This new budget was enacted in April-May, suggesting that the stimulus will reach the economy only in 2H09. In addition, the Russian Central Bank is proceeding with monetary easing, which should eventually lead to a stabilization of investment demand later in the year. Moreover, a rebound of demand for major Russian exports, due to continued demand strength in China, but also due to technical factors, following the sharp 1Q09 slump, is expected to benefit the economy.

Monetary easing should stabilize investment

Firmer oil prices benefit ruble

We cut our exchange rate forecast to USD/RUB 32.9 for 2009 eop and average, down from an earlier USD/RUB 34.1/ and USD/RUB 34.8, respectively. We continue to expect that the ruble should ease in the near future, pressured by liquidity inflows from the budget, falling interest rates and external debt redemptions in the coming months. However, firmer oil prices clearly provide a support to the currency, which is the main reason behind our revision.

First protests to test government's ability to deal with the crisis

Deteriorating economic conditions have led to some public protests. Even so, the government retains a strong capability to deal with the crisis. But given the scale of the economic problems, the importance of political factors and ability to maintain stability are clear.

NPL rise is in the spotlight

The end of reserve losses, and the accompanied gradual devaluation, has shifted the policy focus to the deterioration of banking assets and rising NPLs ratios. Negative surprises in this area could potentially trigger adverse rating actions, with S&P and Fitch already having negative outlooks, and paying close attention to current developments.

Serbia



Outlook

Inflationary pressures cast doubt on ability to continue cutting rates and maintaining currency stability, even as GDP is set to fall by -4.8% this year and -0.7% next year on weak industrial production and falling domestic demand.

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	Moody's	S&P	Fitch
Long-term foreign currency credit rating	–	BB- negative	BB- negative

MACROECONOMIC DATA AND FORECASTS

	2007	2008	2009F	2010F	2011F
GDP (EUR bn)	29.5	34.0	29.8	30.1	32.3
Population (mn)	7.4	7.4	7.4	7.4	7.4
GDP per capita (EUR)	4002	4614	4053	4086	4388
GDP (constant prices y-o-y %)	7.1	5.4	-4.8	-0.7	1.3
CPI (average, y-o-y %)	6.5	11.7	9.3	7.3	6.1
Central bank reference rate	10.00	17.75	14.00	15.00	16.00
Monthly wage, nominal (EUR)	484	561	490	495	528
Unemployment rate (%)	18.1	18.0	21.0	21.5	20.5
Budget balance/GDP (%)	-1.5	-2.0	-4.0	-2.8	-2.2
Current account balance (EUR bn)	-4.6	-5.9	-3.0	-2.8	-2.4
Current account balance/GDP (%)	-15.6	-17.5	-10.2	-9.3	-7.6
Net FDI (EUR bn)	1.8	1.8	1.1	1.2	1.4
FDI % GDP	6.2	5.4	3.7	4.1	4.3
Gross foreign debt (EUR bn)	17.8	21.8	22.8	24.8	27.0
Gross foreign debt (% of GDP)	60.2	64.2	76.3	82.3	83.6
FX reserves (EUR bn)	9.6	8.2	9.0	9.0	9.2
(Cur. Acc-FDI)/GDP (%)	-9.4	-12.0	-6.5	-5.3	-3.3
FX reserves/Gross foreign debt (%)	54.2	37.4	39.6	36.4	34.1
Exchange rate to USD eop	54.03	64.34	68.97	77.78	77.78
Exchange rate to EUR eop	78.79	89.78	100.00	105.00	105.00
Exchange rate to USD AVG	58.34	55.40	70.84	73.21	73.21
Exchange rate to EUR AVG	79.98	81.49	96.93	102.50	102.50

Source: UniCredit Research

STRENGTHS

- Significant IMF balance of payments support
- Weaker currency helping adjustment process

WEAKNESSES

- Persistent inflationary pressure
- Wide external financing gap
- High FX leverage in domestic private sector

Policy response to recession in the spotlight

GDP fell less than expected in Q1 2009, the current account deficit narrowed sharply, but inflationary pressures remain

Current account deficit narrowing rapidly, but inflation heads up. The Q109 GDP data revealed only a 3.5% y-o-y fall, which was a surprise. In particular, given the 20% + contraction in external trade, the 10.7% y-o-y increase in transport and communications stood out. In April, the current account deficit was EUR 142mn, with imports of goods and services down 37% y-o-y (for the Jan-April period the deficit is down 50% to EUR 940mn). Industrial production fell 21.1% y-o-y in April, yet the fall in retail sales was only 4.4% yoy in April (and 9.6% yoy in January-April), suggesting private consumption could turn positive in 2H09. Inflation, however, remains a concern, rising to 9.1% yoy in May. Tax increases in June will push the inflation rate higher still in the near term, while recent food price dynamics also point to n-t inflationary pressures. Our estimates also suggest core inflation is rising.

GDP forecast cut from -2.5% to -4.8% in 2009, NBS CPI target in jeopardy

GDP forecast marked down to -4.8%, while year-end inflation raised to 10.0% yoy. Much weaker industrial production data, the double-digit fall in retail sales and plummeting imports combined with lower tax revenues all point to a sharp reduction in domestic demand in 1Q, which will spill over into 2Q. We therefore lower our growth forecast from -2.5% to -4.8% for 2009. At the same time, we see CPI at the end of the year at 10.0% yoy, the top of the central bank's inflation target of 6-10%. Administered price rises, a sharp rise in food prices in May (3.8% mom vs. April), pass through effects from the depreciation in the RSD earlier this year, as well as the pressure from easy monetary policy, are all reasons behind our increased inflation forecast.

We do not think the NBS will be able to continue cutting rates for much longer

During 2Q, the National Bank of Serbia cut its policy rate 375bp to 13%. With immediate depreciation pressures on the RSD receding during March (minimal FX interventions since) in part as the first tranche (EUR 788mn) of the IMF agreement arrived and headline inflation falling below 9% in April, the central bank aggressively cut rates. Nonetheless, with inflation rising again in May and set to climb higher in June on tax and fuel price increases, the question remains for how long the NBS will be able to cut rates. The consolidated government deficit at the end of June was RSD 52.9bn vs. a target RSD 35bn under the IMF agreement, as revenue performance underperforms during the recession. There is therefore a risk the next tranche of IMF money (USD 940mn), due to be disbursed on 25 August, may be delayed until further measures to rein in the deficit are enacted. Since February, the Ministry of Finance has issued over EUR 500mn in 3M T-bills and began issuing 6M T-bills on 18 June.

Further spending cuts/tax rises needed to achieve IMF deficit target

The government is seeking IMF approval to increase the budget deficit target from 3% to 4% of GDP. The argument runs that growth is slowing, therefore the deficit will rise; however, the IMF is rejecting these overtures in public statements, suggesting the second tranche of the country's EUR 3bn program could be delayed as a result. Meanwhile, it is evident that the monetary authorities would like to continue cutting interest rates, thus reducing the government's borrowing costs, its own sterilization costs and softening the impact of the recession. However, we believe that rate hikes will be necessary given rising inflation and pressure on the RSD stability; we see interest rates at 14% by year-end (and further hikes in 2010 are likely). Should the second tranche of IMF money be delayed, upward pressure on EUR/RSD would increase.

Arguing for reforms will not be easy

Possible lifting of EU visa requirements. While the government will be in a position to deflect criticism of unpopular economic policy choices onto the IMF, in the coming quarter the potential lifting of visa requirements by the EU would provide a welcome boost.

Sovereign credit rating safe for now, but EUR/RSD remains at risk

IMF agreement should preclude ratings cut. Even though the second tranche of IMF funds may be delayed due to missed fiscal policy targets, we do not see Serbia's sovereign credit rating being cut n-t. The currency, however, remains exposed to the risk of depreciation, especially if the central bank continues to cut interest rates aggressively. We maintain our exchange rate forecast of EUR/RSD 100 at year end.

Turkey



Outlook

The Central Bank of Turkey conducted aggressive rate cuts as of last fall, generating a drastically different exchange rate/interest rate mix as opposed to the last few years thanks to the global contraction. To the extent that the new mix can be more or less preserved, Turkey's growth dynamics should benefit significantly as the global setting continues to normalize. Due to worse-than-expected 1Q data, we reduced our 2009 GDP forecast but increased the 2010 forecast (3.2% from 1.4%).

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Long-term foreign currency credit rating	Moody's Ba3 stable	S&P BB- negative	Fitch BB- stable
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MACROECONOMIC DATA AND FORECASTS

	2007	2008	2009F	2010F	2011F
GDP (EUR bn)	472.1	498.3	450.8	507.4	578.3
Population (mn)	70.6	71.5	71.9	72.7	73.5
GDP per capita (EUR)	6688	6968	6271	6979	7869
GDP (constant prices yoy %)	4.7	1.1	-5.2	3.2	4.5
Private Consumption, real, yoy (%)	4.6	0.3	-4.6	3.5	5.5
Fixed Investment, real, yoy (%)	5.4	-4.6	-25.0	3.0	4.0
Public Consumption, real, yoy (%)	6.5	1.8	12.0	4.5	3.0
Exports, real, yoy (%)	7.3	2.6	-10.0	6.5	7.0
Imports, real, yoy (%)	10.7	-3.1	-21.5	8.0	9.0
CPI (average, yoy %)	8.8	10.5	6.3	6.4	4.7
Central bank reference rate	15.75	15.00	8.25	7.75	7.00
Monthly wage, nominal (EUR)	907	943	855	845	950
Unemployment rate (%)	9.9	11.0	16.0	15.0	15.0
Budget balance/GDP (%)	-1.6	-1.8	-6.0	-4.0	-3.5
Current account balance (EUR bn)	-28.0	-28.3	-7.6	-12.2	-20.0
Current account balance/GDP (%)	-5.9	-5.7	-1.7	-2.4	-3.5
Net FDI (EUR bn)	16.1	12.3	9.1	11.0	12.7
FDI % GDP	3.4	2.5	2.0	2.2	2.2
Gross foreign debt (EUR bn)	182.1	188.8	204.8	216.7	242.0
Gross foreign debt (% of GDP)	38.6	37.9	45.4	42.7	41.8
FX reserves (EUR bn)	48.4	50.2	46.6	50.0	52.7
(Cur. Acc-FDI)/GDP (%)	-2.5	-3.2	0.3	-0.2	-1.3
FX reserves/Gross foreign debt (%)	26.6	26.6	22.8	23.1	21.8
Exchange rate to USD eop	1.17	1.54	1.60	1.56	1.48
Exchange rate to EUR eop	1.71	2.15	2.32	2.11	2.00
Exchange rate to USD AVG	1.30	1.30	1.60	1.58	1.46
Exchange rate to EUR AVG	1,79	1,91	2,20	2,21	2,05

Source: UniCredit Research

STRENGTHS

- Stable banking sector with low level of private sector FX exposure
- Significant rate cuts by the central bank

WEAKNESSES

- Uncertain government support for an IMF agreement
- Revenue shortfalls led to deficit overshoot and need for higher bond roll-over ratios

Betting on Recovery and Disinflation, but Not Overdoing It

Key forecast changes and rationale

1Q GDP figures took everyone by surprise as the 13.8% (yoy) plunge was the most severe contraction since the end of WW II. Domestic demand was exceptionally weak with private consumption shrinking by 9.2% and private investment by an astonishing 35.8%. Government expenditures were up but to no avail due to their low weights in GDP (public consumption 11.1% and public investment 3.8% in the latest figures). Net exports contributed 7.1 percentage points which was exactly offset by destocking. We revised downwards our 2009 GDP growth forecast to -5.2% and upwardly revised the 2010 forecast to 3.2%.

Inflation came in at 0.11% in June, bringing the yoy rate to 5.73%. Our year-end estimate stands at 6.0%. Core inflation indices are on a downward trend across the board, and June figures verify the disinflation trend that the contraction initiated. The most positive development in inflation dynamics has been the reduction in services inflation which traditionally stood out as the most inertial component of inflation. The CBRT had announced forecasts of 5.3% and 4.9% for CPI inflation in 2010 and 2011, which are in the vicinity of our figures of 5.0% and 4.5%.

The 12-month rolling current account deficit shrank to USD 26.7bn in April, with a reduction of roughly USD 3.3bn on average in the last six months. The reduction will be slowing down somewhat in the coming months but we estimate the year end deficit at USD 10bn. The 12-month rolling capital account is at a surplus of USD 12.8bn and non-debt flows (FDI plus equity sales, both net) have naturally slowed down as well, but equity sales turned back into positive territory. Our current account deficit/GDP ratio forecasts for 2009 and 2010 currently stand at 1.7% and 2.4%, respectively.

May budget figures provide some hope with respect to prospects for the fiscal outlook as non-interest expenditure growth finally slowed and registered a mere 2.4% nominal growth rate in May following four months of excessive increases of at least 24%. Revenue growth looked weak but that was mostly due to the high base from last year and the decisive element in deficit and debt dynamics will continue to be non-interest expenditures. The IMF saga continues and the most palpable inference at this moment is that PM Erdogan is not in favor of an IMF stand-by facility.

Policy response

The CBRT has conducted an aggressive easing cycle as it cut O/N policy rates by 8% within the last eight months, and the governor claimed very recently that there was still some margin for further cuts. We believe that the Bank will go for another 50bp and then pause, making any further move data-dependent. If the growth outlook looks dismal, expect some further easing on the part of the CBRT, but visible signs of recovery will lead to a more cautious stance and probably end up in "hold" decisions for the remainder of the year.

Political outlook

Tensions between the AKP government and the military occasionally flare up as some new evidence or suspect (from within the military mostly) pops up regarding the infamous Ergenekon case which is before a court (alleged attempts to overthrow the government through schemes co-designed and jointly run by NGOs and certain sections of the military). President Gul has assumed the role of powerbroker and is trying to come up with compromise solutions that serve as face-saving ones for both parties. The military feels the need to be more transparent and accountable, and that in itself is a quantum leap for the political scene. With the elections coming up in 2011, the big question is whether the AKP will resort to populist policies and whether that may be the reason as to why it has been so half-hearted at best regarding an IMF stand-by agreement. The government recently announced a comprehensive three-part recovery and incentive program, entailing both regional and sectoral aspects, intended to ameliorate the sluggish economic performance of the last nine to ten months.

Ukraine



Outlook

Deep correction to maintain its pace in 2009, as weak global demand and absence of a clear domestic strategy will push economy deeper into the red. IMF support is helping the country hold up through the crisis, but politicians need to do more to aid a recovery, given the spare capacity. However, a meaningful pick-up is to be expected by mid-2010, when a better external environment and infrastructure projects fully kick in.

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Long-term foreign currency credit rating	Moody's B2 negative	S&P CCC+ negative	Fitch B negative
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MACROECONOMIC DATA AND FORECASTS

	2007	2008	2009F	2010F	2011F
GDP (EUR bn)	103.1	123.4	87.9	102.5	131.2
Population (mn)	46.6	46.4	46.1	45.8	45.5
GDP per capita (EUR)	2210	2661	1906	2238	2882
GDP (constant prices yoy %)	7.6	2.1	-12.5	0.5	3.6
Private Consumption, real, yoy (%)	17.1	11.6	-17.5	-2.5	3.0
Fixed Investment, real, yoy (%)	24.8	4.2	-40.0	5.0	6.0
Public Consumption, real, yoy (%)	2.8	-0.4	1.3	1.5	1.8
Exports, real, yoy (%)	2.8	6.7	-12.0	5.5	6.0
Imports, real, yoy (%)	20.2	17.5	-30.0	2.5	8.1
CPI (average, yoy %)	12.8	25.2	16.2	11.5	9.1
Central bank reference rate	8.00	12.00	10.50	9.50	9.00
Monthly wage, nominal (EUR)	195	234	175	191	240
Unemployment rate (%)	6.4	6.4	11.8	10.4	8.2
Budget balance/GDP (%)	-1.4	-1.3	-9.0	-2.2	-0.5
Current account balance (EUR bn)	-4.1	-8.5	0.7	3.0	1.5
Current account balance/GDP (%)	-3.9	-6.9	0.8	2.9	1.1
Net FDI (EUR bn)	6.3	7.1	2.1	5.0	7.5
FDI % GDP	6.1	5.8	2.4	4.9	5.7
Gross foreign debt (EUR bn)	56.7	74.0	67.3	70.3	75.2
Gross foreign debt (% of GDP)	55.0	60.0	76.5	68.6	57.3
FX reserves (EUR bn)	21.8	19.4	10.3	11.5	15.0
(Cur.Acc-FDI)/GDP (%)	2.2	-1.2	3.1	7.8	6.9
FX reserves/Gross foreign debt (%)	38.4	26.2	15.3	16.3	20.0
Exchange rate to USD eop	5.09	7.81	8.05	7.40	6.80
Exchange rate to EUR eop	7.42	10.90	11.67	9.99	9.18
Exchange rate to USD AVG	5.05	5.24	7.97	7.74	6.85
Exchange rate to EUR AVG	6.92	7.70	10.91	10.83	9.58

Source: UniCredit Research

STRENGTHS

- Significant IMF support
- Rapidly improving C/A balance
- Industrial spare capacity, and high potential growth

WEAKNESSES

- Rising NPL ratios
- Largest 1Q09 GDP fall among the CEE economies
- Political instability

Ukraine – holding up despite the pain

Deep correction to maintain pace in 2009, but base effects to kick in by 4Q...

A deep correction has maintained pace, with re-jigging and rebalancing touching all sectors of the economy. Steel has been disproportionately hit, with output now back to 2000 levels. The overall lack of funds has forced companies to accumulate wage arrears, at UAH 5bn in June, with the industrial Donetsk Region particularly hard hit – standing at 21% of the national level. High export intensity and continued sluggishness in global demand and the absence of a clear domestic policy, has led us to further lower the 2009 growth outlook to -12.5% yoy (GDP fell by 20.3% yoy in 1Q and stagnation is expected in 2Q and 3Q, but base effects ought to kick in 4Q). Investment contraction is set at a disproportionately large -40% this year (after contracting 48.7% in 1Q), as a lack of loans and poor prospects hurt. A meaningful pick-up is expected by mid-2010, when a better external environment and infrastructure projects fully kick in, helping to drive a broad recovery. Beyond the two-year horizon, reform (esp. institutional) will be key in lifting growth back up to 5% potential.

Weak global demand and absence of a clear domestic strategy to push growth deeper into the red

Carbon trades help to earn FX and bring C/A into surplus

The flipside of the collapse has been a rapid improvement in trade balances, with the current account moving into surplus in May (at USD 239mn, after a cumulative deficit of USD 890mn in 4M09, and USD 13bn in 2008). The acute 50% fall in imports, is the main reason for the improvement, but the innovative ability to sell carbon contracts (worth USD 204mn in May) is supportive. Moreover, officials say that advanced talks to sell some additional USD 3.5bn carbon emission rights are underway, whether all will be realized in 2009 remains unclear.

Keeping high debt roll-over ratios remains key, but some sporadic defaults are likely

Risks tend to be centered on rising NPL ratios and potential for default among companies. This feeds through to debt-rollover ratios, which have declined to 80% in May, but ways and means to restructure debt have been flexible, and the IMF expects these to fall further to 75% for full 2009 (with a mere 30% roll-over for local banks). Naftogaz also continues to be a constant problem – government support was necessary to pay for May gas supplies, with FX coming from NBU reserves, and negotiations are underway for a USD 2-4bn loan to help meet monthly gas payments as gas is pumped into storage for the winter.

Inflation slows

Slowing inflation is proving to be supportive, and deflation appears on the agenda until autumn, as food prices decrease on improved supplies and weak demand. This also ought to help bring real wage growth closer to zero by year end from the current 10% yoy decline, but we do not expect real wages to grow before end-2010.

Ad hoc measures implemented, but lack clear strategy

Up to now, the government has failed to provide a credible anti-crisis package, instead dealing on an ad hoc basis. Policy measures have been in response to IMF payouts, and have dealt with maintaining a financeable budget deficit, as well as recapitalizing banks. The latter has been a mixed blessing, with the government recapitalizing three banks so far, and taking large stakes in them (Kiev 99.93%, Ukrengazbank 81.57%, Rodovid 99.97%).

Personality politics to dominate the election cycle

Politicians are set to hammer it out, in the run-up to the January 2010 presidential elections. The main players remain unchanged: Yulia Tymoshenko, Arseniy Yatsenyuk and Viktor Yanukovich (who has a 10% lead over his rivals). We do not expect significant reform in the coming months and a continued absence of a clear domestic policy to tackle the crisis. Once elections are out of the way, however, we expect a pragmatic policy, resulting in closer cooperation with Russia and an improvement in the economy.

FX stability for now, but risks still exist

UAH stability is helping to return local confidence as short-term depreciation pressure has abated. In May, for the first time since July 2008, the population sold more dollars (USD 77mn) than it bought. The key building block behind this trend has been the USD 2.8bn May disbursement of IMF funds, with the next USD 3.2bn disbursement expected in July. NBU regulation and FX auctions have also done their part. Even so, potential for UAH weakness remains acute in Aug/Sept on higher debt repayments and rating downgrades are possible.

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