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CEE

Quarterly

Economics, FI/FX & Commodities Research
Credit Research
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4Q 2012

"Your Leading Banking Partner in Central and Eastern Europe"

Contents

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

Gillian Edgeworth, Head of EEMEA Economics (UniCredit Bank London)
+44 0207 826 1772, gillian.edgeworth@unicreditgroup.eu

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

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

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

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

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

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

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

Rozália Pál, Ph.D., Macro and Strategic Analysis Coordinator, Romania (UniCredit Tiriac Bank)
+40 21 203 3911, rozalia.pal@unicredit.ro

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

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

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

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V.i.S.d.P.:
Erik F. Nielsen, Global Chief Economist
(UniCredit Bank London)
120 London Wall
London
EC2Y 5ET

Imprint:
UniCredit Bank
UniCredit Research
Arabellastrasse 12
D-81925 Munich

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www.research.unicreditgroup.eu

CEE: Growing pains

EMU may well have reached a turning point…

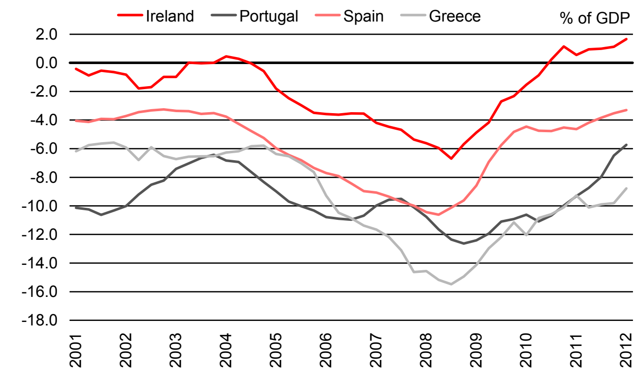
We compile this quarterly at a time of continued change in Europe but at this stage change that has the potential to turn what has been two and a half years of crisis in a more positive direction. EMU as a whole has now experienced its fourth consecutive quarter of contraction, in part because of signs that the crisis in the periphery is increasingly impacting activity in the core, in part because weakness across emerging markets (e.g. China, Brazil) is impacting European export performance. But at least on the former, the case for a gradual, albeit bumpy, recovery in economic activity in EMU as we near 2013 is becoming more convincing as a chunk of tail risk have been removed.

…now that real economies are adjusting and the ECB has delivered a more credible firewall…

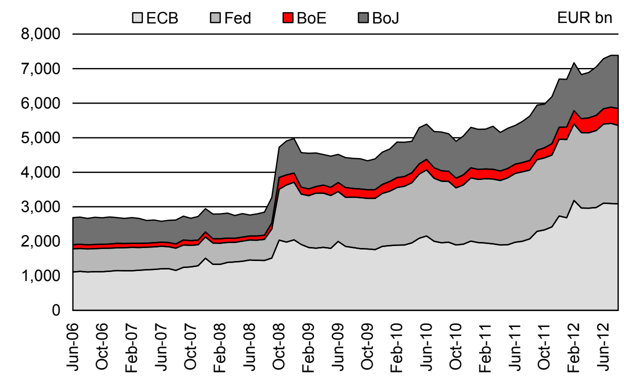
Though a period of multi-year adjustment remains ahead, the Euro Area has achieved a considerable amount in terms of structural reform over the past two years, much of which is now being captured in the closure of C/A balances in periphery economies, though we remain concerned about Greece. The ECB has already provided a large amount of liquidity to smooth this adjustment in the face of rapid portfolio outflows from periphery economies but on 6th September detailed a more ambitious plan in the form of its outright monetary transaction programme, combined with increased flexibility on the collateral it accepts, which has a more realistic chance of removing tail risk from sovereign bond markets than its previous interventions via the SMP. This should translate into improved confidence, tighter sovereign spreads and in turn lower corporate/bank funding costs, all of which should aid EMU and in turn CEE growth prospects. That the Fed followed the ECB and opted to expand its balance sheet further in the form of QE3, if only at the margin, provides further support to economic activity.

ADJUSTMENT WITHIN EMU

C/A deficits in the periphery will continue to tighten…



…as central banks in the developed world continue to increase liquidity provision



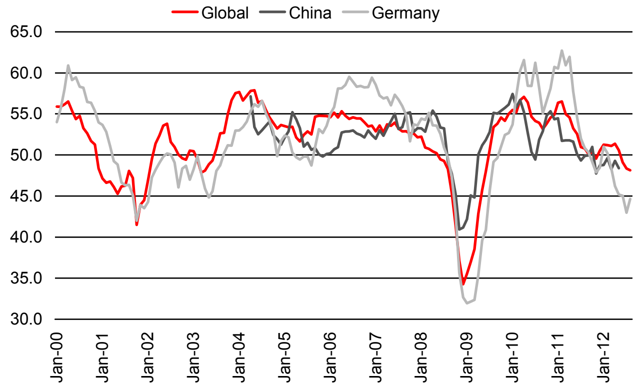
Source: ECB, Federal Reserve, BoE, BoJ, UniCredit Research

…but we are concerned about the slowdown in the pace of GDP gains more globally…

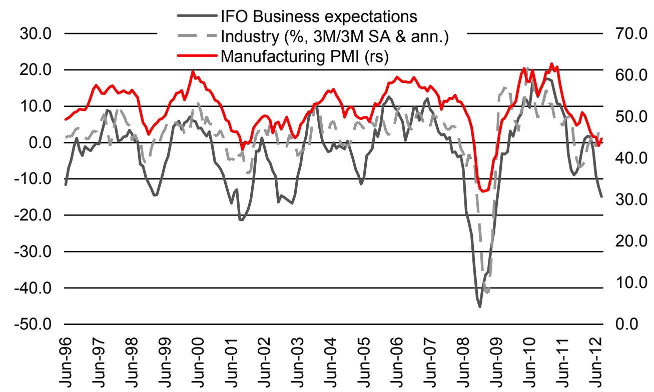
While our concerns in terms of the EMU crisis are easing, we see increasing uncertainty on the pace of global growth, generated by signs of a slowdown in Germany and emerging markets globally. August saw the global PMI reach its weakest level since June 2009, having spent 3 months below 50. China's manufacturing PMI has been at its weakest level since March 2009, having been below 50 throughout this year. Germany's manufacturing PMI has been below 50 for the past 6 months, with the IFO signalling an even sharper decline in output. The positive news, at least to date, is that the hard industrial production data from Germany has not shown the same degree of weakening as the IFO, though the slowdown since 4Q last year is evident.

WORRISOME SIGNS OF A GLOBAL GROWTH SLOWDOWN

The PMIs signal a slowdown not only in EMU but more globally



Germany: IP & PMI hold up better than IFO but none are particularly encouraging



Source: Markit, IFO, Eurostat, UniCredit Research

…and have reduced our expectations for EMU GDP.

All of the above has prompted us to reduce our growth forecast for EMU for this year and next to reflect a more gradual recovery in economic activity. We have reduced 2012 and 2013 by 0.1pp and 0.3pp to -0.5% and 0.3% respectively. We expect 4Q this year to represent the bottom in the cycle, with GDP on a qoq basis to show gradual recovery throughout next year. For the US we forecast growth at 2.1pp and 2.3pp respectively.

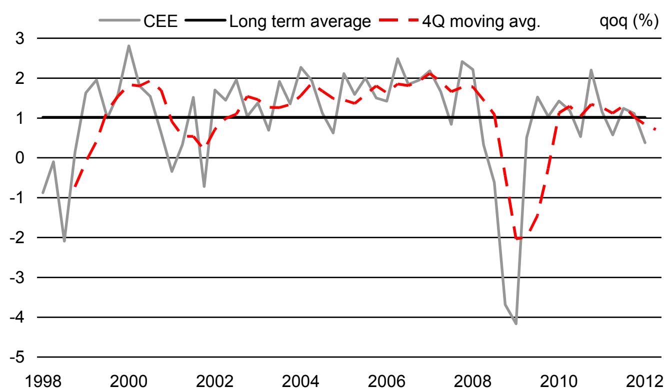
CEE is struggling amidst weaker external demand

Growth has weakened in many CEE economies, confirming an extended period of lacklustre GDP gains in the region.

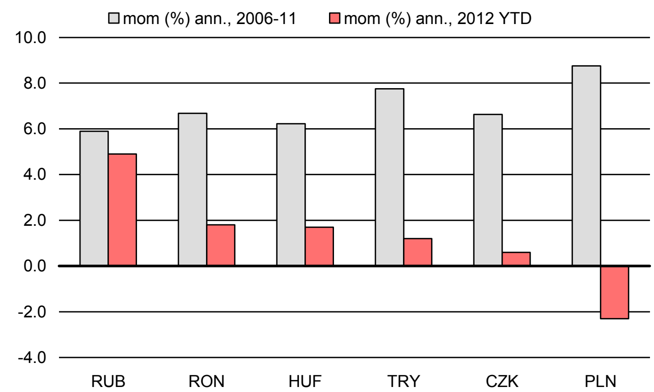
Within CEE the slowdown in growth, and in some cases outright recession (Czech, Hungary, Slovenia, Croatia, Serbia), represents the primary concern for policy makers at this stage. The combination of downward revisions to our growth forecasts for EMU for this year and next, weaker CEE data over recent months and uncertainty on the pace of recovery in economic activity in large EM economies in Latam and Asia has prompted us to take our forecast for 2012 and 2013 growth down by 0.1pp and 0.3pp to 2.5% and 3.1% respectively. While this is still a significant outperformance relative to EMU, the past four quarters will represent the lowest period of growth in the region in a decade.

NOT SINCE 1998 HAS GROWTH BEEN THIS SLUGGISH FOR THIS LONG

An extended period of low growth



…as industry performance remains sluggish with downside risks



Source: National statistics offices, UniCredit Research

Industry is supporting gains in real GDP much less…

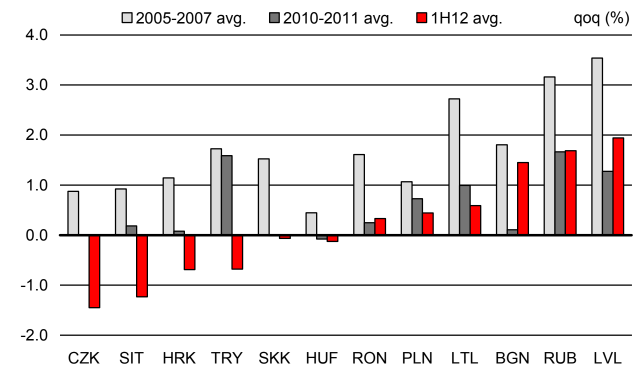
Industry is suffering from weaker external demand. This is in sharp contrast with 2011 where industry provided a key aid to overall GDP gains. Over the first 6 months of the year, industry output contracted in Romania, Czech, Turkey and Poland while gains in Hungary (aided by new car production) and Russia were below their long term average. July industrial production data showed some modest improvement but the sustainability of this remains in question. The August manufacturing PMI data remained weak while our global forecasts suggest that such a recovery will begin to materialize gradually as we enter 2013.

Inflation stalls the consumer recovery…

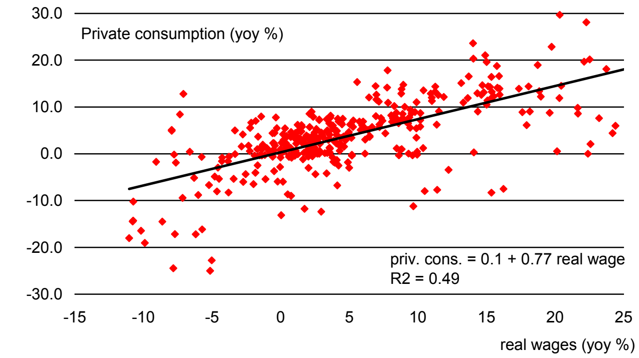
…while the consumer is either weakening or remains weak…

This weakness in industry combines with a weak consumer in many cases, reflecting a combination of poor sentiment, weak labour markets and sluggish credit extension. Russia and the Baltics are the outliers. At the other extreme, Czech, Slovenia, Croatia, Turkey, Slovakia and Hungary have all seen consumption contract YTD. While in Turkey we view this as a much needed pause, what is underway in Croatia, Slovenia and Hungary may prove to be a more permanent adjustment. In Poland private consumption remains positive but slower than what it was in the past.

Consumption growth has weakened in many economies



Low real wage growth in many cases is constraining the consumer



Source: National statistical agencies, DOTs, UniCredit Research

…as moderate nominal wage growth and higher inflation constrains purchasing power.

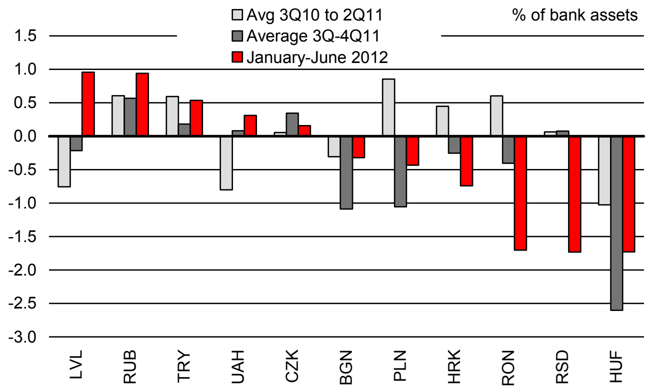
Weak labour markets are a key contributor to weak consumption trends as the consumer is constrained by a combination of higher inflation and weak nominal wage growth. In Croatia, Czech, the Baltics, Poland, Romania, Slovakia and Slovenia real wage growth does not exceed 2% yoy and in some cases is negative. Kazakhstan, Russia, Turkey and Ukraine were the only countries in the region to post notable real wage growth (as per latest available 1Q data) but in the case of the CIS countries this is partly attributable to record low inflation due to food prices. Over the course of the coming quarters we expect this to reverse. Without a convincing recovery in external demand, employment and wage prospects remain uncertain, with smaller countries more vulnerable than larger economies.

…as does lending growth

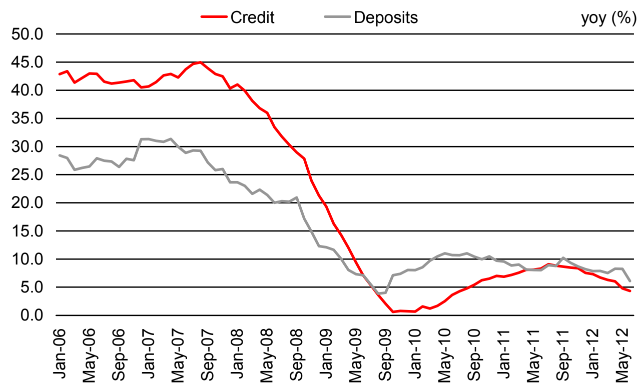
Russia and Turkey enjoy foreign inflows to their banking sectors but many other countries continue to experience outflows.

Meanwhile there is limited change in foreign flows to banking sectors in the region over the last quarter. The more elevated stresses of Q4 last year have eased, helped by the ECB's LTROs but credit growth remains capped by deposit growth on average. Moreover the data suggests that corporates in CEE that borrowed abroad directly are struggling to rollover these loans. There is differentiation across the region in terms of bank flows, with Russia and Turkey outperforming, reflecting a lower reliance on funding from mother banks. But Hungary, where policy uncertainty remains rife, and the Balkans, with weaker growth performance and more exposure to Greece, continue to see outflows. There is little reason to expect that these trends will change rapidly. Instead any improvements in the weaker economies are likely to materialise only gradually as EMU recovers.

Banking sector foreign inflows



CEE credit growth is capped by deposit growth



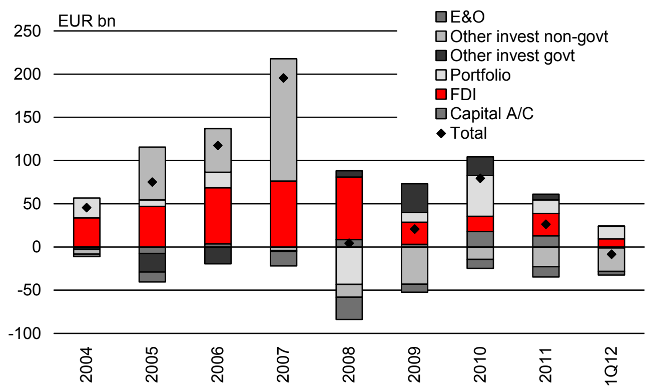
Source: National central banks, UniCredit Research

Portfolio flows filter down the credit spectrum

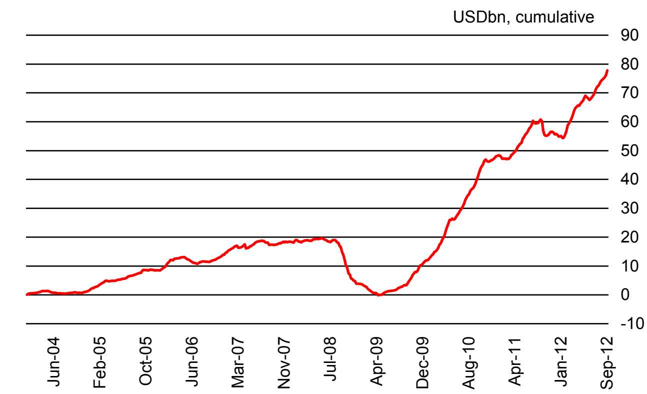
Portfolio flows continue to dominate capital inflows…

The positive news is that the region continues to enjoy strong portfolio inflows. As we have discussed numerous times in the past, there has been a large shift in the composition of capital flows to the region post 2008 away from FDI and medium to long term bank capital and towards portfolio flows. This is part of a broader global emerging markets trend, much of which should be structural in nature. As shown below, EM fund flows saw a cumulative inflow of USD 20bn over the 5 years to 2008, almost USD 80bn since 2009.

Breaking down capital flows to CEE



Cumulative portfolio flows to EM funds



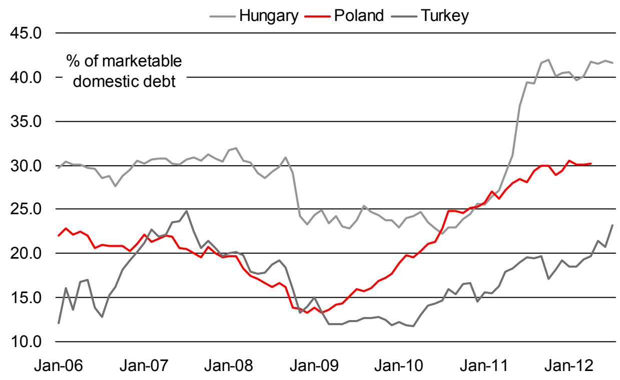
Source: National central banks & statistics agencies, EPFR, UniCredit Research

…and are moving down the credit spectrum…

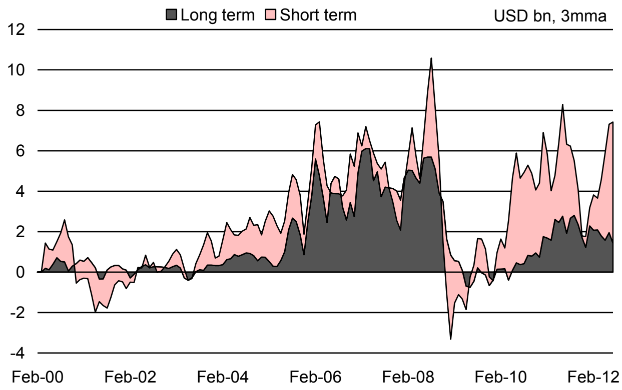
1Q data for CEE shows that in total capital flows to the region were negative but portfolio inflows stood at EUR14.7bn, equivalent to total inflows in 2011. For those countries with data available for 2Q, flows remained positive but not as strong as 1Q. Foreign holdings of domestic debt have increased significantly in Turkey, Hungary and Poland. Moreover portfolio flows have filtered down the credit spectrum, facilitating sovereigns such as Ukraine coming to the market.

SHORT TERM INFLOWS FIND THEIR WAY INTO CEE COUNTRIES

Foreign holdings of domestic debt



Turkey: Still some way to go in diversifing financing sources



Source: UniCredit Research

…but central banks are not building much ammunition to protect against outflows.

Medium to long term, we remain concerned about the risks surrounding these sort of flows to the region. While a large chunk are arguably structural in nature, H2 last year highlighted the risks of a sudden stop which was more due to external developments (in particular the EMU crisis) than domestic events. As inflows turned to outflows, Poland and Turkey were forced towards FX intervention, Hungary towards the announcement of negotiation on a new EU/IMF package. The primary recipient of these flows in the region have been Turkey and Poland – should they at any stage even partially reverse, neither central bank has accumulated sufficient FX reserves to meaningful smooth a large outflow.

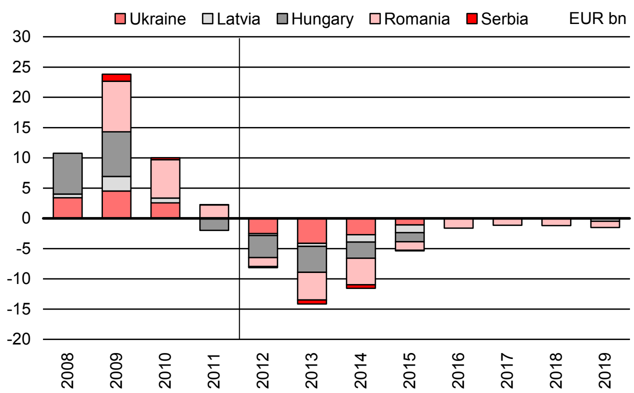
…but new IMF/EU financing packages are needed in Hungary, Serbia and Ukraine

We are skeptical that Hungary, Ukraine and Serbia can achieve macro stability in the absence of a new EU/IMF programme.

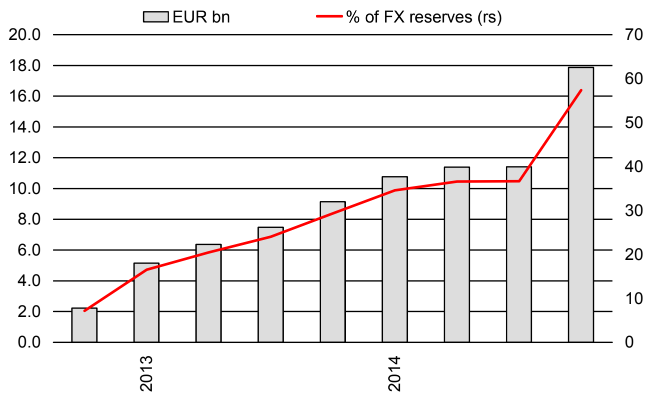
Despite such large portfolio inflows, the combination of sovereign rollover requirements, weak growth and poor budget performance means that there remains a group of countries in the region where we see the need for a new IMF package, both to act as an anchor for policy and to provide the funding needed to cover rollover of original IMF/EU loans. Repayments in Serbia, Hungary, Latvia, Romania and Ukraine have already begun but peak next year at a total of almost EUR 15bn and remain in excess of EUR10bn in aggregate in 2014. Romania is the only country at this stage that remains in a programme while Ukraine can only access hard currency markets at elevated spreads. A drawdown of central bank FX reserves is possible but, if persistent, will also lead to instability. For example if Hungary was to draw off FX reserves to cover all EUR 18bn coming due between now and end-2014, it would translate into a 65% decline in FX reserves. Near term progress on this front remains uncertain, however. We do not exclude that Serbia and Romania return to the IMF before year-end but in Hungary, 1Q is more likely.

REFINANCING CHALLENGES CANNOT BE IGNORED INDEFINITELY

IMF/EU repayments are significant in 2012 but peak in 2013



Hungary: Cumulative sovereign external redemptions



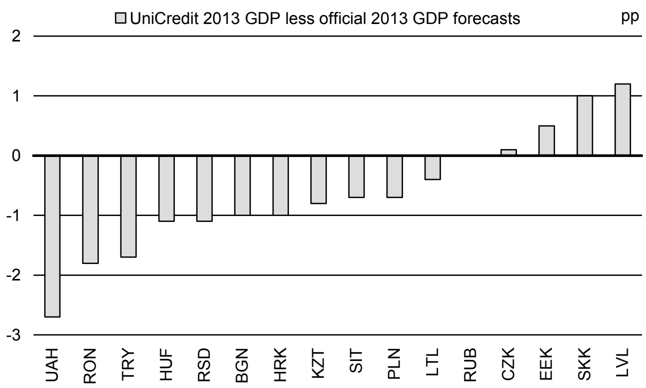
Source: IMF, EU, UniCredit Research

In most cases fiscal is under control

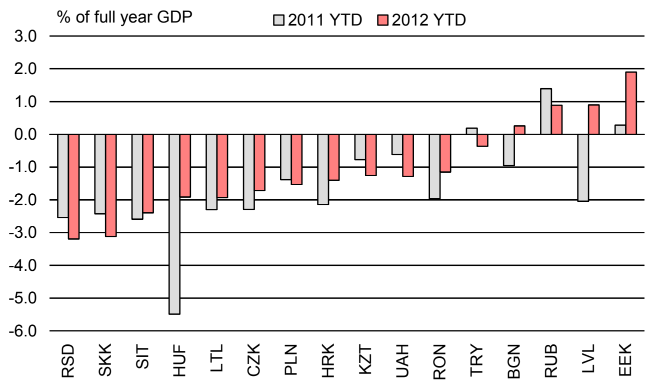
Countries enter budget season with less upbeat GDP prospects than what they originally planned for.

This lackluster growth environment means that countries are entering budget season facing GDP growth rates below what they planned this time last year. As shown below there is over 2.5pp of a differential between our projection for GDP growth next year in Ukraine and what the authorities put forward in the 2012 budget. In Turkey the government forecast 2012 and 2013 GDP in last October's Medium Term review at 4% and 5% respectively, both of which now seem out of reach. Romania had hoped that most of the hard work was now done but there is over 1.5pp of a differential between our growth projection for next year and that of the authorites in this year's Convergence Programme submitted to the European Commission. Hungary is over 1pp of GDP short, according to our forecasts. In the Baltics, Russia and Czech Republic, differentials are smaller.

Most countries this time last year planned for higher 2013 GDP than is now likely



Budget performance YTD shows little signs of aggressive expansion



Source: IMF, European Commision, NBH, UniCredit Research

Russia, Kazakhstan, Turkey, Poland, Czech and the Baltics all have some scope to use fiscal policy to support economic activity, if they wished.

A number of countries have scope to use fiscal policy to smooth the downturn in economic activity, reflecting solid public sector balance sheets and efforts to consolidate over recent years. YTD there has been limited deterioration in fiscal positions, despite growth often coming in below what countries had originally hoped for. Even weak growth performers like Croatia and Czech Republic have managed to narrow their budget deficits. Public debt to GDP stood at 46% end last year in CEE ex-CIS, 13% of GDP in CIS. In terms of scope to use fiscal policy to aid activity from here, this is largest in Russia and Kazakhstan, followed by Turkey, Czech Republic and Poland. There is some evidence already emerging of countries pushing out fiscal consolidation plans.

Hungary, Ukraine, Serbia, Croatia and Slovenia must continue to tighten.

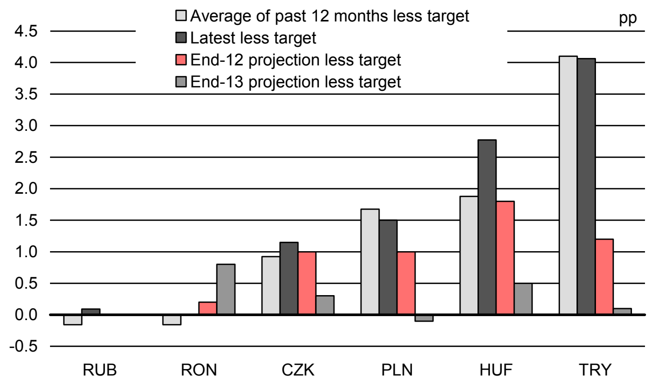
Unfortunately for many of the weaker credits in the region, this sort of counter cyclical fiscal policy is not possible. Hungary, in the midst of renewed recession, must press ahead with further fiscal consolidation. This is a process which began in 2006 but the composition of the consolidation has significantly hampered potential growth while 2010-11 saw much of what the previous government had achieved reversed. Serbia and Ukraine, struggling with excessive twin deficits, must also act. Serbia has taken some measures but must follow with considerably more. Ukraine will need to act soon after parliamentary elections. Croatia's current efforts represent a huge change from what was present in the past decade but also are only the start of a much needed multi-year adjustment. Slovenia faces a similar task, albeit with a significant risk that the sovereign's balance sheet must also absorb the cost of banking sector recaps.

Monetary policy: Playing a helping hand in some places

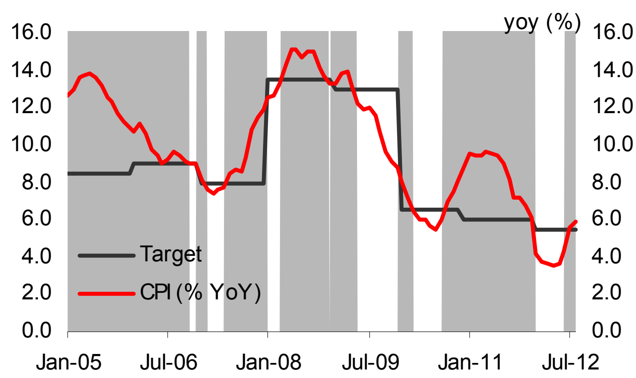
Above target inflation complicates monetary policy making.

It is not only governments but central banks that are keen to aid the downturn but this is complicated by persistent inflation pressures. Particularly striking is the fact that despite such a sluggish period of growth, inflation is above target in all inflation targetters in the region with the exception of Romania. Moreover this is not a new phenomenon. Hungary has had inflation above target now since March 2009, in Turkey since April 2011.

Inflation is above target and likely to stay so for some time, even according to some central bank projections



Russia acts to build credibility



Source: National central banks, Rosstat, UniCredit Research

Czech, Poland and Turkey will ease further, no opposition to FX losses.

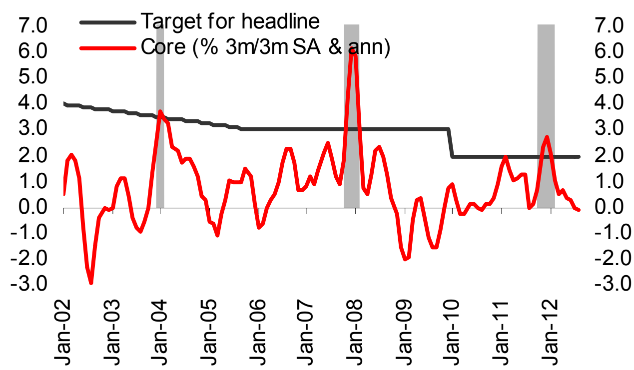
At this stage growth takes priority but inflation has delayed easing over recent months. Turkey has acted most aggressively already and the combination of a decline in inflation ahead, uncertainty on the pace of recovery and QE3/ECB actions means that there is more to come. In Poland we expect the NBP to begin to ease policy, potentially as soon as it's next rate meeting, and cut by at least 75bp over the next 6-8 months. Czech faces constraints to the extent that its policy rate is already at 0.5% but further easing is nonetheless likely. We doubt that any of the three central banks above would oppose a weakening of monetary conditions from here via gradual FX weakness but at this stage central banks will only act to generate this indirectly, i.e. via lower interest rates rather than outright FX intervention. Russia represents the exception. As the downside surprises to growth have been more limited to date while inflation once again edges above target, the CBT has taken the opportunity to hike and build on its inflation targetting credibility. We see scope for another 25-50bp in hikes.

Romania is on hold, Russia gradually tightening

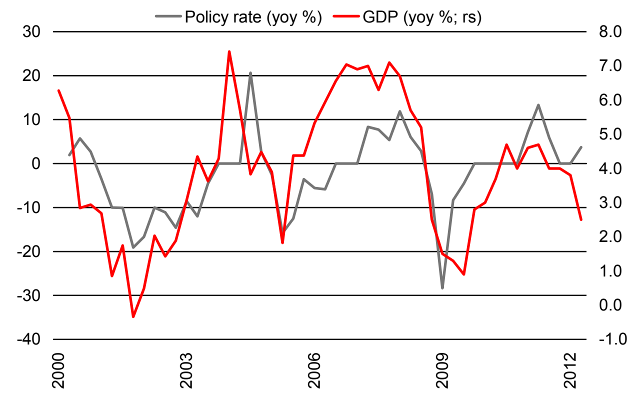
Romania is more likely to stay on hold, concerned about a combination of FX and inflation performance. Russia represents the exception. As the downside surprises to growth have been more limited to date while inflation once again edges above target, the CBT has taken the opportunity to hike and build on its inflation targetting credibility. We see scope for another 25-50bp in hikes.

CZECH AND POLAND HAVE SCOPE TO CUT RATES

Core inflation in Czech is well contained



Poland: Wrong way for the policy rate



Source: GUS, NBP, CSO, CNB, UniCredit Research

Ukraine, Serbia and Hungary will ease only if currencies facilitate this.

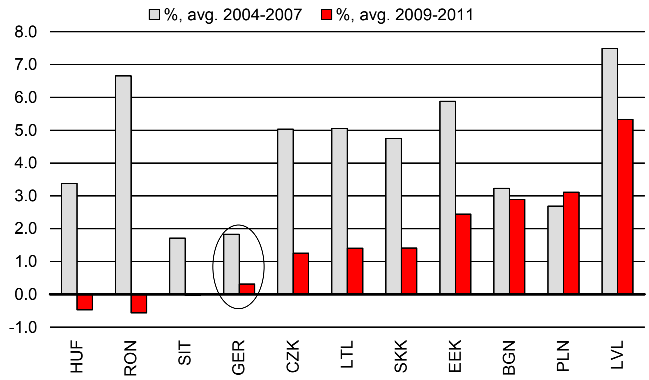
In the weaker performers in the region, just as counter-cyclical fiscal policy is not viable, neither is counter-cyclical monetary policy – sustained policy easing is only possible in an environment where fiscal policy is first tightened. In Ukraine, protection of UAH is viewed as the priority, keeping rates elevated. In Serbia the combination of RSD weakness, public debt and financial sector vulnerabilities to FX losses and rising core inflation means the risks are weighted towards further hikes. Hungary recently initiated a rate cutting cycle and, assuming continued favourable risk appetite, may continue but should this extend beyond a further 25-50bp, risks forced rapid reversal in the future.

Convergence cannot be taken for granted but must be worked upon

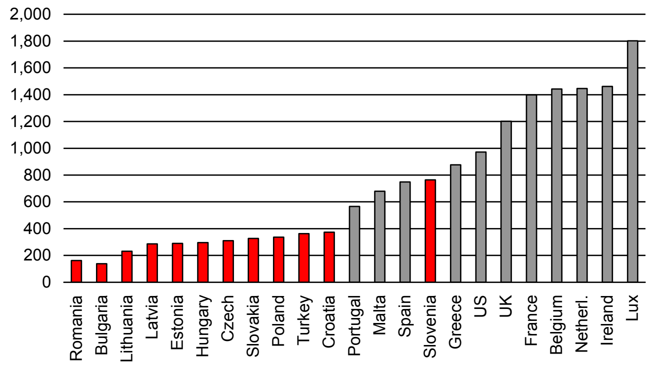
Countries must act to maximize their ability to take advantage of improvements in global growth.

The past couple of quarters provide a reminder of the fact that the post-crisis growth path in CEE is neither smooth nor guaranteed. Convergence can no longer be taken for granted. Trade and financial linkages with EMU act as a drag and though this should improve from here, the path will at best be gradual. The more recent slowdown in EM activity globally casts a further shadow over the timing of any recovery while there is only so much that can be expected in terms of stimulus from fiscal and monetary policy in the region.

Real labour productivity: New EU still outstips old EU in most cases



Monthly minimum wages are competitive (EUR)



Source: European Commission, UniCredit Research

In terms of labour productivity, costs and competitiveness, there are plenty of bright spots in the region…

There are numerous reasons for optimism. As shown above, amongst those CEE economies in the EU the rate of growth of labour productivity has slowed since the crisis but in the vast majority of cases still continues to significantly outstrip Germany. Meanwhile labour costs remain competitive, though Slovenia represents an exception, as the minimum wage in the region (EU countries in CEE, Croatia and Turkey) averages only 23% of that in France. The World Economic Forum's Global Competitiveness indices, recently released for this year, show improvement in Turkey, Poland, Kazakhstan, Bulgaria, Romania, Ukraine and Bosnia relative to pre-2008. But the region is no longer viewed as one. While asset prices in countries such as Poland and Turkey can more than hold their own even in this weakening growth environment, financing in other economies in the region remains more problematic, e.g. Hungary, Slovenia. In this environment, just as is needed in EMU, countries must continue to act to maximize their chances of sustainable medium to long term growth, even if this materializes at rates well below those experienced pre-4Q08.

Gillian Edgeworth, Chief EEMEA Economist (UniCredit Bank London)
+44 0207 826 1772
gillian.edgeworth@unicreditgroup.eu

Countries

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

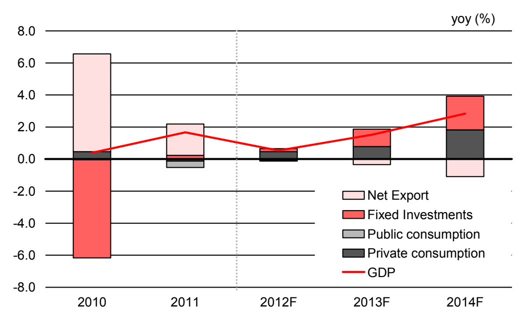
Outlook – Despite faltering global growth, the Bulgarian economy has demonstrated more signs of strength in the three months since our last Quarterly. GDP growth remained stagnant on a yoy basis in 2Q12, but the outlook has improved, as several important indicators (such as the price and availability of corporate loans, bank capital flows and the equity portion of FDI) moved in a growth-friendly manner. As all these were largely incorporated in our projection already, we decided to keep our GDP growth forecast unchanged: up 0.5% this and 1.5% next year. With the exception of the one-off spike in foods inflation this year, headwinds facing the economy next year will remain unchanged but their scale will diminish. With the euro zone sovereign debt crisis ebbing, confidence should return easing deleveraging pressure and jumpstarting investments.

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

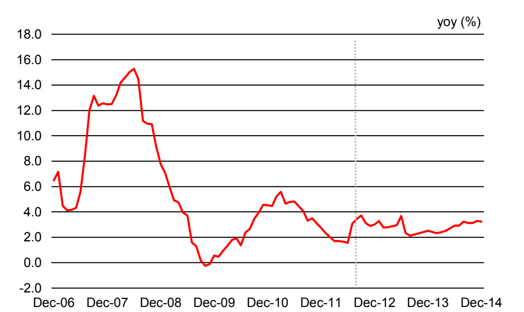
KEY DATES/EVENTS

- 8 Nov – Number of employees under labor contract for 3Q12
- By 15th Nov – Bulgaria needs to make a final decision on a possible participation in the 'South stream' gas project
- 15 Nov – Flash estimates of 3Q12 swda GDP figures

GDP GROWTH AND CONTRIBUTION TO GROWTH



INFLATION (CPI) YOY



Source: NSI, BNB, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2010	2011	2012F	2013F	2014F
GDP (EUR bn)	36.1	38.5	39.7	41.3	43.7
Population (mn)	7.5	7.3	7.3	7.2	7.2
GDP per capita (EUR)	4,804	5,252	5,445	5,703	6,067
Real economy yoy (%)					
GDP	0.4	1.7	0.5	1.5	2.8
Private Consumption	0.6	-0.2	0.6	1.0	2.4
Fixed Investment	-18.3	-9.7	0.7	5.2	9.3
Public Consumption	-0.5	-4.9	-1.0	0.1	0.1
Exports	14.7	12.8	3.6	3.8	5.4
Imports	2.4	8.5	3.4	4.1	6.5
Monthly wage, nominal (EUR)	331	362	384	413	446
Unemployment rate (%)	11.3	11.8	12.9	12.7	12.0
Fiscal accounts (% of GDP)					
Budget balance	-3.9	-2.1	-1.2	-1.0	-0.7
Primary balance	-3.3	-1.4	-0.4	-0.2	0.1
Public debt	16.7	17.0	19.8	18.1	21.4
External accounts					
Current account balance (EUR bn)	-0.4	0.4	-0.4	-0.9	-1.3
Current account balance/GDP (%)	-1.0	0.4	-1.1	-2.2	-3.0
Basic balance/GDP (%)	-1.1	0.4	4.2	-1.4	2.2
Net FDI (EUR bn)	0.7	1.4	1.3	1.4	1.8
Net FDI (% of GDP)	1.8	3.5	3.2	3.5	4.2
Gross foreign debt (EUR bn)	37.1	35.4	36.5	35.9	37.0
Gross foreign debt (% of GDP)	102.8	91.9	92.1	86.8	84.6
FX reserves (EUR bn)	13.0	13.3	15.0	14.4	15.4
Inflation/Monetary/FX					
CPI (pavg)	2.4	4.2	2.5	2.7	2.9
CPI (eop)	4.5	2.8	3.0	2.5	3.2
USD/BGN(eop)	1.47	1.51	1.50	1.44	1.46
EUR/BGN (eop)	1.96	1.96	1.96	1.96	1.96
USD/BGN (pavg)	1.48	1.41	1.53	1.46	1.46
EUR/BGN (pavg)	1.96	1.96	1.96	1.96	1.96

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

Economic conditions are improving but growth remains weak

GDP growth in 2Q12 stalled at 0.5% yoy for a second consecutive quarter.

GDP growth remained lackluster in 2Q12 at 0.3% qoq, equivalent to 0.5% yoy for a second quarter in a row. The detail was more encouraging as growth was attributable to stronger individual consumption and exports. Exports rose 3.4% qoq and 3.9% yoy, highlighting that the manufacturing sector is the brightest spot of the ongoing recovery as productivity has increased markedly, while unit labor costs have risen only marginally, thus supporting competitiveness. The sharp 2.4% qoq jump in the private consumption came as a positive surprise. This was the strongest qoq print since 2Q01, which came against the backdrop of a persistently weak labor market and retail credit data (employment was down 2.8% yoy in 2Q12 while household credit remained negative at 1.1% yoy in end-June). At least in part we see stronger nominal wage growth at play, up 8.4% up yoy in 2Q12. But this has been broadly the case over the last two and half years, whereas the growth in private consumption remained negative. All these seem to suggest that the private consumption reading for 2Q12 probably overstates the true improvement on the ground which opens the door for some revisions going forward. But GFCF was up 1.5% qoq, reconfirming indications from other relevant data releases that, albeit gradually, appetite for investment is returning.

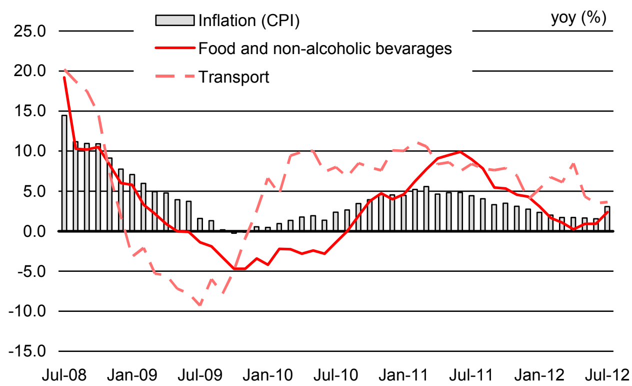
Stronger capital inflows next year should not only help to improve further the availability and price of credit to the real economy, but should also make it easier for debt-laden companies to roll over their maturing liabilities.

The Bulgarian economy should begin showing more signs of recovery in 2013. With the financial market tensions hopefully not escalating much further, Bulgaria should increasingly win back foreign investors' confidence. This on top of already very solid absorption of EU funds should be enough to push GFCF around 5% higher next year, adding roughly 1.1 pp to the GDP. Though to a smaller scale, the final consumption expenditures are also seen improving. The planned increase in the minimum salary and pensions, after the latter have been kept frozen over the last three years, should alone boost the average households' income by a nominal 3%, while weaker food prices pressure should boost purchasing power. Given all that, we decided to keep our GDP growth forecast unchanged at 0.5% in 2012 and 1.5% in 2013. Next year, recovery will face unchanged headwinds(with the noticeable exception of higher food prices), but the scale should diminish. Above all, with the euro zone crisis ebbing, confidence should return easing deleveraging pressure and jumpstarting investments.

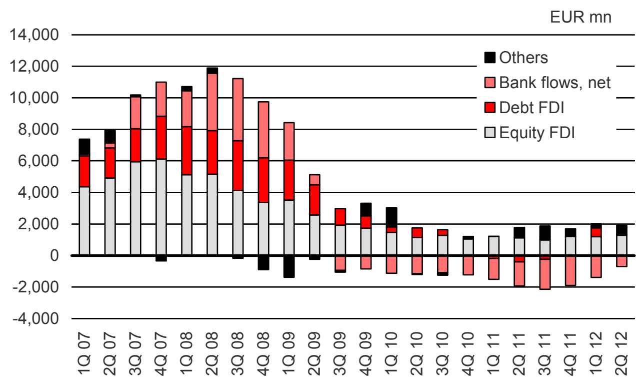
Food and energy prices are the key drivers of inflation.

Food and energy prices jump in July not only caused CPI to post its strongest mom rise (1.5%) in four years, but also reduced purchasing power. Meanwhile core inflation, which excludes volatile energy and food components, rose a meager 0.1% mom and 0.2% yoy, reflecting the significant slack in the economy which continues to operate below capacity. Inflation expectations have also inched a tad higher as crude oil costs are creeping up, while the recent spike in agricultural commodity prices will need time to pass through to producer and consumer prices.

Inflation, yoy (%)



Capital flows, 4Q MA (EUR mn)



Source: NSI,BNB

But the increase in the food prices is likely to be rather short lived.

Solid wheat harvest at home (with output this year 11% above its 10Y long-term average) has helped mitigate this only marginally because most food prices in Bulgaria are set externally. But in the present environment of elevated private sector debt and a weak domestic recovery, the recent uptick in inflation is not entirely a bad news. Higher inflation helps alleviate borrower's woes as it reduces the real value of debt. But perhaps most importantly, it creates more stimuli for consumption, and thus can be part of the medicine needed to end cash hoarding which is among the factors that hold back domestic recovery. Going forward, we expect energy prices to stabilize close to their current level. The weather-related nature of the current agricultural commodities price shock, on the other side, implies that it is likely to be temporary and its effects contained compared, for instance, to the one in the 2008-09 period. Given all that we estimate eop and avg. CPI at 3.0% and 2.5% this year. Next year the combination of stronger favorable base effects will dampen food and energy price dynamics and a tad more solid demand side price pressure, as the domestic recovery looks set taking a somewhat stronger footing, translating into eop and avg. CPI of 2.4% and 2.7% respectively.

The budget is running a 0.3% of GDP surplus relative to GDP in the seven months to July, while the end-year fiscal deficit target is set at 1.35% of GDP.

Amid signs that there are no risks to the government's 2012 budget deficit target of 1.35% of GDP, attention has shifted to the draft budget plan for 2013. The plan focuses on striking the right balance between what is needed to preserve fiscal discipline (which is central to the government's strategy to win investor confidence) and measures to increase pensions and the minimum wage (to boost the ruling-CEDB party's approval rating ahead of general elections in mid-2013). We think such a plan is challenging but doable. As the draft 2013 Budget is in an early phase of preparation, there are only sketchy details as to its underlying macro assumptions. Finance Minister Djankov said that the economy will expand by 1.8% next year – in line with consensus and only three tenths above our own forecast. At the same time, there is more clarity as to the scale of pension increases which, as a guiding principle, should fully compensate for the cumulative CPI since CEDB's government took office in 2009. Assuming 12% cumulative inflation, pension spending next year should increase by BGN 875mn, or 1.1% of the GDP. Another BGN 30 mn is needed to raise the minimum salary from BGN 290 now to BGN 310. As no tax rises are envisaged and the government remains committed to sustaining fiscal discipline (meaning to deliver a narrower deficit in 2013 compared with the target of 1.35% of GDP in 2012), the compensation of pension should be fully funded via strengthened tax compliance. This generally looks realistic to us. Note, that the connecting of cash register devices of all commercial entities with the control systems of the National Revenue Agency pushed tax revenues by 7.8% nominally so far in 2012, while the monetary value of output was up by 2.5%. This has generated BGN 902mn (or 1.2% of GDP) of extra revenues for the first seven months so far this year. The important thing to highlight here is that even though most cash devices have been already connected to the tax authorities, there are still some sectors where this has not yet been fully implemented. It follows then that the corresponding positive implications are likely to go beyond the end of this year and well into next.

To make its 2013 budget deficit target easier to achieve, the government might also use part of the fiscal revenues windfall in 2012 to frontload payments on some capital spending that have originally been envisaged to take place in 2013.

The average monthly price of corporate credit in July 2012 was 7.36%, versus 7.87% in December 2012 and 8.03% twelve months earlier.

Risk appetite is gradually returning, reflected in the moderate increase in equity capital inflows, positive reversal of bank flows and improved availability and costs of corporate credit. Corporate credit growth accelerated to 6.9% on yoy basis in July from 5.3% yoy in April (when adjusted for the repurchased and sold balances it was even more impressive – up 8.4% yoy in July versus 6.5% in April). Moreover the process of reducing external borrowing by banks seems to have entered its final phase. Quarterly bank flows in 2Q12 posted a EUR 320mn inflow for the first time since 4Q09. In response, the banking sector's net external liabilities to total liabilities ratio edged a shade higher to 3.7% in June, as compared with already very strong print of 3% in end-April. Even more encouraging, after decreasing by just 11bp for the whole 2011, the average interest rate on corporate loans fell by 27bp in 1Q12 and another 20bp in 2Q12. These developments, combined with an increase in equity FDI and a raising number of class "A" investment projects (as registered by the specialized state agency for promotion of foreign investments), confirm the signs of risk appetite improvement that, in our view, should help provide further support to investments and growth over the coming quarters.

Strategy: Smooth sailing in 4Q

All bond redemptions for 2012 have already been covered.

The Bulgarian sovereign should easily meet all 2012 financing requirements, entering 2013 in a strong position. The 4Q issuance calendar is light as the key financing operations for the fiscal year have already been completed, including all redemptions on the domestic bond market. Furthermore, the successful return of the sovereign to the hard currency market in July facilitated the accumulation of significant cash reserves to cover a redeeming Eurobond at the beginning of 2013. Financing of maturing domestic bonds and the deficit has been secured via frontloaded debt issuance – 48% of all 2012 planned government bonds were auctioned in 1Q with only 21% of the FY plan left for 4Q. The financing efforts of the government will be further supported by a privatization push towards the end of 2012 which should ensure circa EUR 100mn of fresh liquidity for the budget in 4Q.

The most likely scenario for 4Q privatization includes the sale of the government's minority stakes in two of the three electricity companies in Bulgaria generating approximately EUR 100mn.

The bulk of the financing needs for 2013 have already been secured.

In 2013, we expect the government to issue a modest sum below EUR 600mn, favoring issuance further out on the curve. The domestic redemption calendar for next year is light, totaling just over EUR 90mn (compared to EUR 316mn in 2012). Thus the MinFin will be able to shift a larger proportion of the deficit (forecast at 1% of GDP) financing to domestic bond issuance and away from the fiscal reserve. This should allow the fiscal reserve to be kept comfortably above EUR 2600mn or 6.7% of GDP (with a floor set in the 2010, 2011 and 2012 budget laws at EUR 2300mn) once the EUR-denominated bond (worth EUR 818mn) is paid down 15 January 2013. Some low impact risks for the government finances are likely to emerge with the upcoming general elections (to be held mid-2013) as policymakers from the ruling CEDB party increase discretionary spending to support their push for a second term in office. Yet with easily manageable financing requirements and an elevated revenue stream due to increased tax compliance efforts, this should not be a problem for the sovereign coffers. With gross external debt elevated, but on a downward path and public debt extremely low and trending lower, the Bulgarian sovereign should continue to trade considerably tighter than its other Balkan peers. Given the extent to which Bulgaria's recently issued 2017 bond in EUR has rallied, we are reluctant to increase positions in this at this stage, but would use any sell-off due to another increase in uncertainty in Greece to do so.

Continued improvement in fiscal fundamentals should allow for upward movement in bond prices and tightening of CDS spreads.

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2011	2012E	2013F	2014F
Gross financing requirement	**1.5**	**1.2**	**1.7**	**1.1**
Budget deficit	0.8	0.5	0.4	0.3
Amortization of public debt	0.5	0.6	1.1	0.6
Domestic	0.4	0.4	0.2	0.4
Bonds	0.4	0.4	0.2	0.4
Bills	0	0	0	0
External	0.1	0.2	1.0	0.2
WB/EIB/JBIC/Others	0.2	0.2	0.2	0.2
Financing	**0.9**	**2.0**	**0.9**	**2.1**
Domestic borrowing	0.6	0.6	0.6	0.5
Bonds	0.6	0.6	0.6	0.5
Bills	0	0	0	0
External borrowing	0.3	1.2	0.3	1.6
Bonds	0	1.0	0	1.3
WB/EIB/JBIC	0.3	0.3	0.3	0.3
Other	0.1	0.2	0.1	0

Source: BNB, MF, UniCredit Research

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2011	2012E	2013F	2014F
Gross financing requirement	**16.3**	**15.3**	**15.9**	**14.6**
C/A deficit	-0.4	0.4	0.9	1.3
Amortization of medium to long term debt	5.4	4.8	5.2	4.1
Government/central bank	0.3	0.4	1.1	0.3
Banks	0.8	0.5	0.4	0.3
Corporates	4.3	4.0	3.7	3.5
Short term debt amortization	11.3	10.0	9.9	9.2
Financing	**16.6**	**17.0**	**15.3**	**15.6**
FDI	1.2	1.3	1.4	1.8
Portfolio flows	-0.4	-0.2	-0.2	0
Borrowing	1.7	2.8	2.0	3.2
Government/central bank	0.3	1.2	0.3	1.6
Banks	0.5	0.5	0.4	0.3
Corporates	0.9	1.1	1.3	1.3
Short-term	10.0	9.9	9.2	8.7
EU transfers	0.2	1.1	1.1	1.0
Other	3.8	2.1	1.8	0.9

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

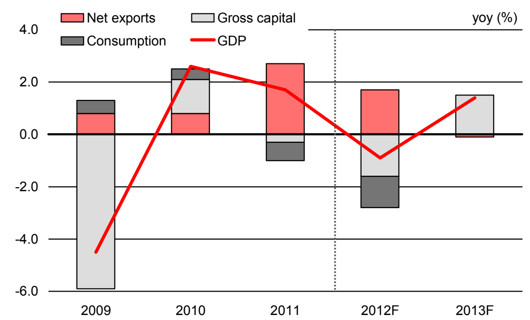
Outlook – Recession extended to a third consecutive quarter in 2Q, with declining household consumption acting as the primary driver. In the absence of convincing signs of a turnaround for 3Q and lower EMU growth forecasts, we have revised full-2012 GDP down to -0.9%. The CNB may cut the repo rate once more to 0.25% in September but no additional or non-standard easing steps are envisaged thereafter. After the Parliament's recent failure to pass the government's package aimed to reduce the fiscal imbalance, risks of budget slippage in 2013 are on the rise, as are uncertainties over the tax regime and government stability.

Author: Pavel Sobisek, Chief Economist (UniCredit Bank)

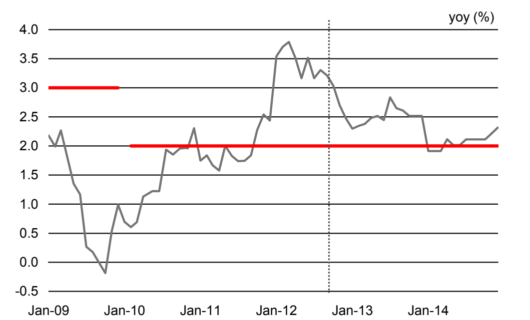
KEY DATES/EVENTS

- CNB Board meetings – 27 Sep, 1 Nov, 19 Dec
- Parlt vote on tax package, budget draft, govt .confidence – Dec
- Manufacturing PMI – 1 Oct, 1 Nov, 3 Dec

GDP DOWN AGAIN



HEADLINE INFLATION TO REMAIN ABOVE TARGET



Source: CSO, CNB, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2010	2011	2012F	2013F	2014F
GDP (EUR bn)	149.2	154.8	154.2	163.2	174.5
Population (mn)	10.5	10.5	10.5	10.5	10.5
GDP per capita (EUR)	14,185	14,746	14,670	15,499	16,556
Real economy yoy (%)					
GDP	2.6	1.7	-0.9	1.4	2.7
Private Consumption	0.5	-0.6	-2.2	0.3	2.5
Fixed Investment	0	-0.9	-2.0	0	5.0
Public Consumption	0.6	-1.7	-0.9	-1.0	0
Exports	16.0	11.1	4.4	6.0	8.0
Imports	15.7	7.5	2.1	7.0	9.0
Monthly wage, nominal (EUR)	944	994	1,005	1,054	1,117
Unemployment rate (%)	9.0	8.6	8.5	8.7	8.0
Fiscal accounts (% of GDP)					
Budget balance	-4.8	-3.1	-3.0	-3.4	-3.0
Primary balance	-3.5	-1.7	-1.7	-1.9	-1.5
Public debt	38.1	41.2	43.8	45.6	46.4
External accounts					
Current account balance (EUR bn)	-5.8	-4.4	-1.0	-0.7	-0.9
Current account balance/GDP (%)	-3.9	-2.9	-0.7	-0.4	-0.5
Basic balance/GDP (%)	-0.8	-0.4	1.9	2.4	2.5
Net FDI (EUR bn)	4.6	3.9	4.0	4.5	5.2
Net FDI (% of GDP)	3.1	2.5	2.6	2.8	3.0
Gross foreign debt (EUR bn)	70.5	72.6	78.5	85.8	0
Gross foreign debt (% of GDP)	47.3	46.9	50.9	52.6	0
FX reserves (EUR bn)	31.8	31.1	32.0	32.0	32.0
Inflation/Monetary/FX					
CPI (pavg)	1.5	1.9	3.3	2.5	2.1
CPI (eop)	2.3	2.4	2.5	2.5	2.3
Central bank target	2.0	2.0	2.0	2.0	2.0
Central bank reference rate (eop)	0.75	0.75	0.25	0.25	1.75
3M money market rate	1.09	0.97	0.75	0.45	1.20
USD /CZK (eop)	18.8	19.4	19.0	17.6	17.9
EUR/ CZK (eop)	25.1	25.8	24.7	24.0	24.0
USD/CZK (pavg)	19.1	17.6	19.4	18.3	17.9
EUR/CZK (pavg)	25.3	24.6	24.9	24.5	24.0

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

Still waiting for the consumer comeback

Real GDP dropped additional 0.2% qoq in 2Q.

Recession extended to a third consecutive quarter in Q2 as real GDP declined 0.2% qoq. While the scale of contraction in previous quarters narrowed slightly, the yoy change stood at -1.0% in 2Q. Component-wise, consumption and gross capital formation subtracted from yoy GDP by 1.9 pp and 1.3 pp respectively, whilst net exports contributed positively by 2.1 pp Declining household spending (a significant -3.3% yoy in 2Q) came as a particular burden for GDP whilst huge de-stocking explained the negative gross capital input.

Reluctance of households to spend and systemic flaws in public capital spending stood behind poor performance.

We attribute Czech's underperformance relative to EMU at this stage to two factors. First and foremost, Czech households seem ovewhelmed by concerns about rising living costs as well as by media reports about the financial crisis in general. Admittedly, the VAT rate hike from 10% to 14% at the start of 2012 hit disproportionally low income households and could stand behind a deeper reduction in household spending than the change in household real income suggests. Secondly, public sector capital spending is negatively impacted by multiple corruption charges within government, cancelled or repeated public tenders and a delay in the drawdown of EU funds.

Recession is seen unabated in 3Q but lower inflation and base effects in the inventory stock cycle may help 4Q.

Looking ahead, 3Q has started on a more positive note. July industrial output as well as the trade balance surprised moderately on the upside, whilst new industrial orders saw a nice 16.0% yoy rise. However, we don't read much into those figures, as statistics for July are known to be a poor predictor due to variable timing of summer breaks in many plants and the impact of two public holidays. We continue to see recession unabated in 3Q, which is why we revised our full-2012 GDP growth downwards to -0.9%. That said, domestic inflation is set to start losing momentum gradually after staying in a narrow 3.2% to 3.5% yoy range since April. With unemployment (hopefully) changing little in the remainder of 2012, household purchasing power may start to be less of a drag to GDP in 4Q. Base effects in the inventory stock cycle will also render GDP a sizable yoy push in the same period.

External demand, food price inflation and private capex are seen as hot topics for 2013.

Three topics are seen to particularly shape up the environment in 2013. The first is external demand where UCG expects a slow pick-up alongside waning fiscal restrictions in the EU. Second, while higher exports would in general be good for consumer sentiment, food price inflation remains a major risk following this year's poor harvest. Despite that, we still expect real wage growth to turn (marginally) positive again, as wage bargaining may allow for one-off adjustments once the economic situation of corporations improves. Third, private capex may take longer to revive, as it will only follow higher external demand, but 2H13 could see this brightening up as well.

Risks of budget slippage in 2013 are on the rise, as are uncertainties over the tax regime and government stability.

As for policy issues, lower public capital spending may prevent the government deficit from exceeding 3% of GDP in 2012. However, risks of budget slippage next year are on the rise. It's not only due to the possibility that infrastructure expenditure accelerates to compensate for a lost 2012. The key area of our concern is the Parliament's recent failure to pass the government's package of tax measures aimed to reduce the fiscal imbalance (in the order of 0.8% of GDP for 2013). A similar measure is set to enter the legislative process soon. With final voting on it impossible before December, businesses remain exposed to uncertainty over the tax regime in 2013 and the state budget draft will wait for approval until the last moment. The government's very existence is at risk as it intends to attach Parliament's voting on the new tax package to a confidence vote.

EUR/CZK seen lower than before, CNB expected to cut once more.

After UniCredit's changed call on EUR/USD we have moved down our EUR/CZK forecasts to year-end 24.70 for 2012 and 24.00 for 2013. We remain convinced the EUR/CZK range of 24 to 25 would be fully manageable for businesses. On monetary policy, the CNB model prefers the market rates well below current, already record low levels. Opinion may prevail in the CNB board to cut the repo rate once more to 0.25% (possibly already in September) but no additional or non-standard easing steps are envisaged thereafter.

Estonia (AA- negative / A+ stable)*

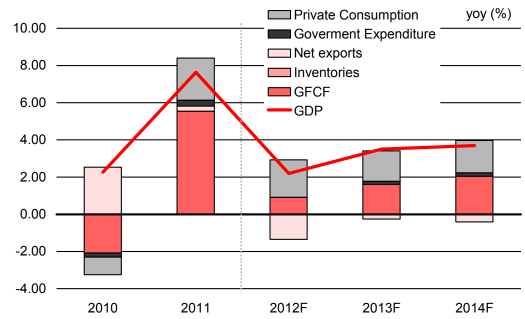
Outlook – 2Q GDP growth eased to 2.0% yoy (0.4% qoq sa) from 3.6% yoy (0.3% qoq sa) in 1Q12, reflecting a slowdown on the back of weaker external conditions. Industrial production is contracting but retail sales growth is still strong, albeit slowing. So far this year the budget balance has followed the same dynamic as in 2011, posting a surplus of 0.7% of GDP in 1H. For the rest of the year we see growth remaining in positive territory due to relatively strong domestic demand. The 2Q C/A posted a smaller deficit than in 1Q, bringing the 1H deficit to 0.9% of estimated FY12 GDP. We expect the C/A balance to improve towards the end of the year, moving into positive territory (mostly on the back of seasonal patterns) and to post a deficit within 1% of GDP this year.

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

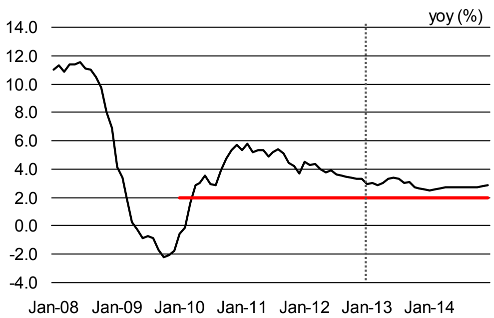
KEY DATES/EVENTS

- 12 Nov, 10 Dec – 2Q GDP (prelim/final)
- 01 Oct, 31 Oct, 30 Nov – Industrial production
- 28 Sep, 30 Oct, 30 Nov – Retail trade

CONSUMPTION TO SUPPORT GROWTH



INFLATION TO DECELERATE



Source: Statistics Estonia, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2010	2011	2012F	2013F	2014F
GDP (EUR bn)	14.5	16.4	17.4	18.5	19.7
Population (mn)	1.3	1.3	1.3	1.3	1.3
GDP per capita (EUR)	10,871	12,311	13,047	13,914	14,811
Real economy yoy (%)					
GDP	3.1	7.6	2.2	3.5	3.7
Private Consumption	-2.1	6.6	4.0	3.2	3.4
Fixed Investment	-9.6	26.8	3.7	6.5	8.0
Public Consumption	-2.0	1.6	0.1	0.9	1.1
Exports	21.2	24.8	5.3	8.5	10.2
Imports	20.5	27.3	7.2	9.3	11.2
Monthly wage, nominal (EUR)	788	820	890	910	930
Unemployment rate (%)	16.8	11.6	9.5	7.9	6.8
Fiscal accounts (% of GDP)					
Budget balance	-0.8	0.3	0	0.5	0
Primary balance	-0.8	0.2	0	0.5	0
Public debt	7.7	6.5	6.1	5.2	4.9
External accounts					
Current account balance (EUR bn)	0.5	0.5	0.1	-0.1	-0.3
Current account balance/GDP (%)	3.6	3.0	0.8	-0.6	-1.4
Basic balance/GDP (%)	11.0	12.8	3.0	0.4	0
Net FDI (EUR bn)	0.9	1.2	0.5	0.2	0.3
Net FDI (% of GDP)	7.4	9.8	2.2	1.0	1.4
Gross foreign debt (EUR bn)	16.6	15.7	15.0	14.0	13.8
Gross foreign debt (% of GDP)	114.2	95.6	86.4	75.6	70.0
FX reserves (EUR bn)	2.6	2.3	2.5	2.5	2.5
Inflation/Monetary/FX					
CPI (pavg)	3.0	5.0	3.7	3.0	2.7
CPI (eop)	3.9	3.7	3.2	2.6	2.9
Euribor 3M	1.02	1.42	0.25	0.75	1.00
USD/EEK (eop)	11.76	EUR	EUR	EUR	EUR
EUR/EEK (eop)	15.65	EUR	EUR	EUR	EUR
USD/EEK (pavg)	11.79	EUR	EUR	EUR	EUR
EUR/EEK (pavg)	15.65	EUR	EUR	EUR	EUR

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

Soft landing in sight

GDP growth slowed down further.

2Q GDP further decelerated to 2.2% yoy (0.5% qoq sa) from 3.6% yoy (0.3% qoq sa) in 1Q and 4.5% yoy in 4Q11. The current reading reflects weaker external conditions while domestic demand is holding up better. The biggest contribution came from GFCF at 5.5pp, while private consumption added only 0.9pp. Interestingly, public consumption added roughly the same number to the final growth figure with a 0.8pp input. Net exports deducted -1.1pp.

IP is contracting but should improve
.

In July, industrial production contracted a further 7.4% yoy, the fifth consecutive month of negative growth and the steepest yoy contraction since 2009. In April-June, IP posted decreases of between 0.5% and 4.1% (2.8% on average). On a positive note, we have some grounds to expect a recovery in IP going forward. According to Statistics Estonia, the main reason for the decline in IP in July (as well as the previous decline in June) was the decrease in energy and mining production and was mostly caused by "the growth of imports due to low-priced electricity from Nordic countries", so we expect the IP weakness to be only temporary.

Retail sales continue to post good results, driven by labor market developments.

Meanwhile, retail sales increased 6.0% yoy in July, following 7.0% yoy in June and 9.0% yoy in May. The impressive dynamic in retail sales stems from positive labor market dynamics. Gross wages in 2Q increased by 5.0% yoy, somewhat decelerating from 6.9%. However, as inflation over the same period also decreased to 3.9% yoy in 2Q vs. 4.4% in 1Q, the deceleration of real wage growth was less pronounced. Going forward, we expect wage growth to exceed inflation, especially as the latter decelerates toward the year end. Some signs of easing inflation are already visible, with inflation easing from this year's peak of 4.0% yoy posted in May to 3.6% in July.

C/A remains in negative territory, structure highly volatile.

The 2Q C/A posted a smaller deficit than in 1Q, bringing the 1H deficit to 1.0% of estimated FY12 GDP. The balance of goods and services, however, remained positive, posting a EUR 141mn surplus in 2Q, thus recoding a 51% yoy contraction, which in turn is a sharp acceleration of the pace of contraction from only 4.4% yoy posted in 1Q12. Interestingly enough, the result was generated by an increase in the goods exports deficit by EUR 175mn from 1Q11, while the surplus in services net exports even grew by EUR 24mn over the same period. Looking further into the numbers, the dynamics of goods net exports came from a decrease in the export of goods by 3.1% yoy vs. import growth of 2.5% yoy, while both services exports and imports posted positive yoy growth in 2Q, increasing by 13.5% and 7.5% yoy, respectively. The income balance drain accelerated as the deficit on this item increased by EUR 53mn in 2Q, or 18% wider than a year ago. The capital account surplus came in at EUR 108mn, thus slightly decreasing in yoy terms by 5.0%. The performance of direct investments improved, increasing to EUR 405mn, which translates into 3.7% yoy growth. Overall, the financial account balance improved to EUR 79mn surplus, recovering from the negative readings posted both a year and a quarter ago.

Fiscal outlook, as always, looks strong.

In terms of fiscal policy, the outlook remains very strong. So far this year the budget balance has followed the same dynamic as in 2011, posting a EUR 59.7mn surplus for 1H12 (0.7% of 1H GDP), slightly down from the EUR 62.7mn surplus a year ago. This came in as a result of cumulative 6M revenue growth of 3.0% yoy to EUR 127.5mn vs. approx. 11.0% yoy growth in spending to EUR 67.7mn.

At the end of August, the Finance Ministry raised its forecast for 2012 economic growth from April's forecast of 1.7% to 2.2%, which even exceeded our view of 1.9% growth (in 2011 Estonia posted 7.6% growth – the highest in the EU). The main drivers of economic expansion in 2012, according to the MinFin statement, will come from investment and private consumption. Also, the MinFin cited the better-than-expected "economic standing of neighboring countries" as the reason for the upward revision of its forecast. 2Q growth in three of Estonia's major trading partners (Sweden, Finland and Russia), together accounting for over 45% of Estonia's exports, came in at 1.6-4.0% according to preliminary data.

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

Outlook – The new government has less than 20 months to the next election while it has failed to deliver on many of its macro promises. EU/IMF repayments represent a persistent risk to HUF performance, economic activity and currency stability and will ultimately be central in forcing the government back to the IMF. Any new IMF/EU programme will have to tackle Hungary's dismal growth potential and such be wide-ranging in its scope, though we doubt this materializes this year. Rate cuts from here all down to risk appetite for Hungarian assets.

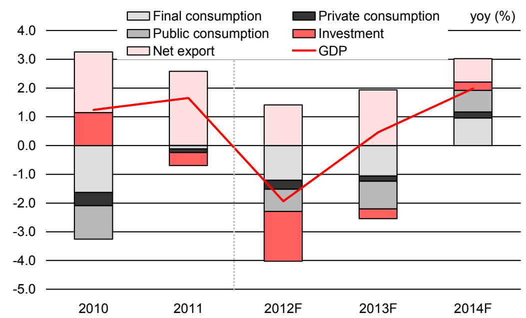
Strategy – With EUR/HUF acting as the primary signal of risk appetite for the NBH, we favour selling HUF sub 280/EUR. In CDS space, we believe that Hungary trades too tight to Croatia.

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

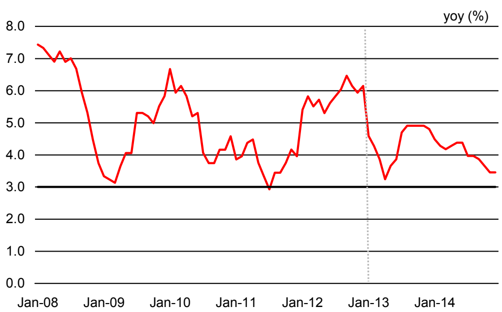
KEY DATES/EVENTS

- NBH rate meetings: 25 Sep, 30 Oct, 27 Nov
- Q3 GDP data: Nov 15th
- IMF/EU repayments: EUR1.1bn in Q4-12

GDP DRIVERS



HEADLINE INFLATION VS. TARGET



Source: CSO, NBH, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2010	2011	2012F	2013F	2014F
GDP (EUR bn)	97.2	100.5	96.1	104.1	111.0
Population (mn)	10.0	10.0	10.0	10.0	10.0
GDP per capita (EUR)	9,696	10,045	9,604	10,410	11,108
Real economy yoy (%)					
GDP	1.3	1.6	-1.9	0.5	1.8
Private Consumption	-2.7	0.2	-1.5	-1.9	1.5
Fixed Investment	-9.7	-5.5	-5.5	-2.3	1.8
Public Consumption	1.1	-2.4	-1.5	-0.9	1.0
Exports	14.3	8.4	2.9	6.4	6.4
Imports	12.8	6.3	1.7	5.3	6.5
Monthly wage, nominal (EUR)	736	763	744	800	841
Unemployment rate (%)	11.1	11.0	11.2	10.8	9.9
Fiscal accounts (% of GDP)					
Budget balance	-4.2	4.3	-2.9	-2.8	-2.2
Primary balance	0.0	-2.7	1.3	1.6	2.3
Public debt	82.2	81.6	78.9	77.1	75.7
External accounts					
Current account balance (EUR bn)	1.2	1.4	1.1	1.3	0.5
Current account balance/GDP (%)	1.2	1.4	1.2	1.2	0.5
Basic balance/GDP (%)	3.0	4.4	3.7	3.3	3.0
Net FDI (EUR bn)	1.7	3.0	2.4	2.2	2.8
Net FDI (% of GDP)	1.8	3.0	2.5	2.1	2.5
Gross foreign debt (EUR bn)	138.2	131.7	130.9	128.1	124.3
Gross foreign debt (% of GDP)	142.3	130.9	136.3	123.1	112.0
FX reserves (EUR bn)	33.7	37.7	32.0	29.8	30.9
Inflation/Monetary/FX					
CPI (pavg)	4.9	3.9	5.9	4.3	3.7
CPI (eop)	4.7	4.1	6.1	4.8	3.5
Central bank target	3.0	3.0	3.0	3.0	3.0
Central bank reference rate (eop)	5.75	7.00	6.25	6.25	6.00
3M money market rate	5.48	6.10	6.65	6.40	5.95
HUF/USD (eop)	210	234	223	206	207
HUF/EUR (eop)	279	311	290	280	277
HUF/USD (pavg)	208	199	231	213	208
HUF/EUR (pavg)	275	279	297	285	279

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

No news is bad news

The new government has less than 20 months to the next election…

The Hungarian government enters the last quarter of 2012 facing a sharp collapse in popularity, recession, mounting EU/IMF repayments and 20 months to the next general election. Fortunately for them asset prices continue to do well! But the economy will centre stage as the government works towards maximizing its re-election prospects in less than 20 months.

…while it has failed to deliver on many of its macro promises.

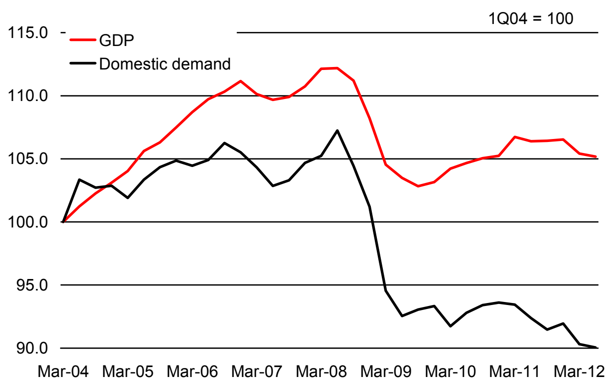
To set the scene, there is a huge gap between what the government hoped for in terms of macro performance and what has materialized in Hungary over the past two years:

- In the past 8 quarters, real GDP in Hungary has contracted by 1.1pp. Retail sales in volume terms are down 1% and 12.6% below their 2006 peak while industrial production has managed to eek out a 1.6% gain in the past 8 quarters. Net FDI to the country has totalled only EUR1.7bn over the 7 quarters to Q1;
- These weaknesses are also captured in the labour market. Unemployment is down a marginal 0.2pp since June 2010. One of the government's achievements has been to improve labour force participation and increase the size of the labour force by over 2% since its election but much of this is due to an increase in public sector employment;
- Both this year and next will be characterized by fiscal consolidation as the government strives to meet its 3% budget deficit target and avoid a halt to EU cohesion funds. 2010/11 was unfortunately characterized by a reversal of much of the consolidation progress put in place over 2007-09;
- New credit extension remains negative. There have been only 6 months since January 2009 when banks have extended new credit – all other months have seen contraction. Banks have paid down EUR 3.1bn of foreign funding YTD, EUR 17bn since January 2009.

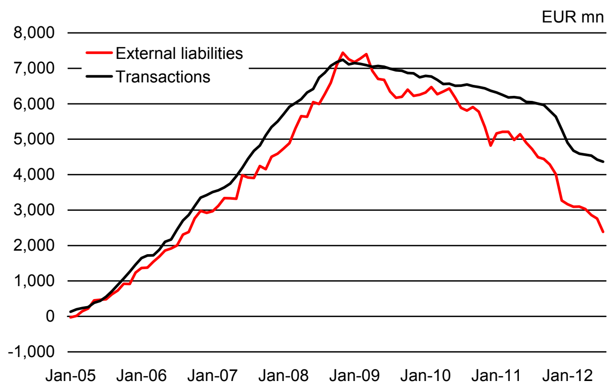
EU/IMF repayments represent a persistent risk to HUF performance, economic activity and currency stability…

It is against this backdrop that the government must continue to pay down EU and IMF loans between now and 1Q15, bringing the government's gross external financing requirement in 4Q this year to EUR 2.3bn, 2013 and 2014 to EUR6.9bn and EUR 8.7bn respectively. The government has not accessed Eurobond markets throughout this year while its FX deposits at the NBH stood at EUR 0.3bn at end-July, their lower since March 2009. This suggests that the government will have to either pay what is required to access hard currency markets or run down central bank FX reserves.

GDP is in the doldrums due to domestic demand…



…as the banking sector continues to delever and contract credit (transactions-based data)



Source: KSH, NBH, UniCredit Research

…and will ultimately be central in forcing the government back to the IMF.

This leaves PM Orban choosing between the lesser of two evils over the coming months. While a decline in FX reserves in itself will not be seen as problematic by the government, it will not want to risk a currency crisis in the lead up to elections. The alternative, which we consider to view as most likely, is a return to the IMF to access funding to help cover upcoming redemptions. We see this materializing at the earliest end this year but more likely 1Q next year. But the path between here and agreement on an IMF programme will not be smooth. The government will have to compromise on a number of issues, many of which are core policies that the current government has put in place since its election. Economy Minister Matolcsy has already signaled a willingness to halt the introduction of the financial transactions tax on the central bank but there is much more than has to be done but agreement with the IMF, EU and potentially ECB is achieved. Assurances on central bank independence and taxation of the banking sector, given that the majority of this is foreign owned while the government's FX mortgage conversion scheme was to a large extent a unilateral policy on the government's behalf, will be required. The programme will focus in part on correcting deficits but more on addressing Hungary's dismal growth potential (which the central bank puts at 0.8% this year) and elevated public and external debt stock. Amongst the issues to be tackled are an oversized public sector, reform of local and regional governments and some state-owned enterprises, the phasing out of industry-specific taxes and a simplification of the tax system.

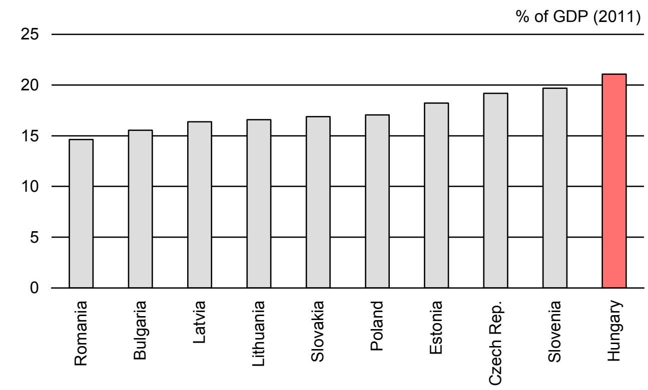
Any new IMF/EU programme will have to tackle Hungary's dismal growth potential and such be wide-ranging in its scope.

Rate cuts from here all down to risk appetite for Hungarian assets.

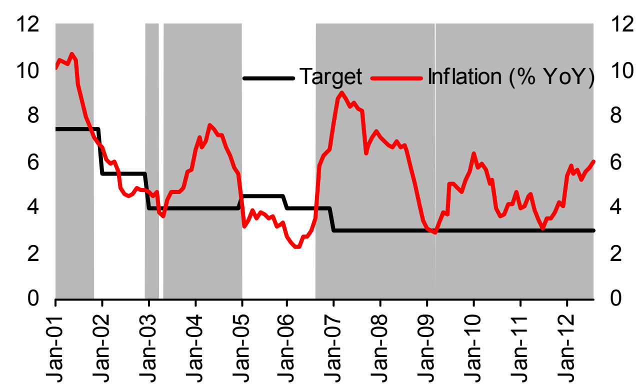
Lack of progress on an IMF deal has not stopped the NBH to initiating an easing cycle – the extent to which it continues from here will be determined by the performance of Hungarian assets. ASSUMING that risk appetite remains broadly unchanged while the government reaches a deal with the EU/IMF by end-1Q next year, August's 25bp rate cut should represent the first in a series of cuts over the coming quarters. A central bank rarely initiates a rate-cutting cycle expecting it to consist of just one move. In such a risk environment, it is viable that the NBH delivers a further 50bp in rate cuts over the course of the last 4 rate decisions of this year and continues to bring the policy rate towards its all time low of 5.25% by mid next year. What was clear from the last rate decision is that the four external members are now willing to out-vote the three internal members (i.e. the governor and two deputy governors). Once replaced in March next year, it seems likely that the Governor and Deputy Governor replacements will add to the more dovish tone. Should risk appetite for Hungarian assets change, the NBH's strategy is also likely to change quickly. HUF higher than 290/EUR would likely give the NBH pause for thought but not necessarily call a halt to the cycle. Should HUF break 300/EUR, the NBH's appetite for cuts would fall much more significantly.

NEITHER EXTERNAL FINANCING REQUIREMENTS NOR INFLATION SUGGEST THAT HUNGARY SHOULD CUT

Share of general government in GDP



Inflation relative to target



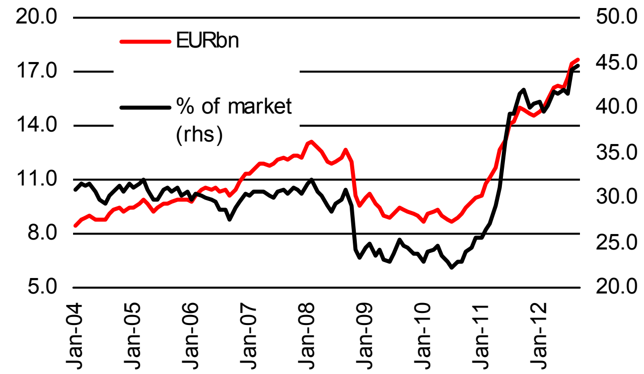
Source: National Statistic Offices, AKK, NBH, UniCredit Research

Strategy: Short on a relative basis

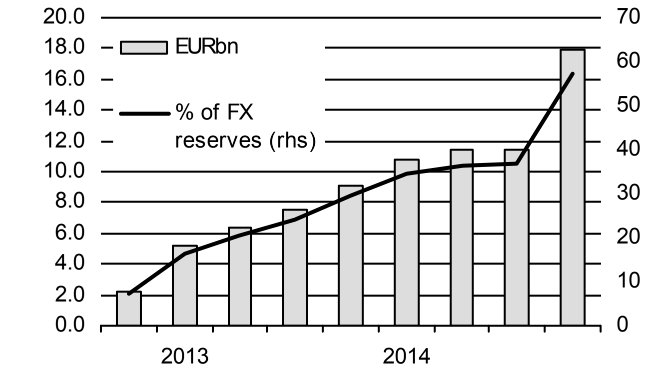
Sell HUF sub-280/EUR as NBH will continue to cut, in CDS Hungary trades too tight to Croatia.

Being short Hungarian assets in 2012 has proved expensive as the government continues to hold out the option of an IMF deal while EM enjoys large inflows, leaving the investor community still short domestic fixed income despite having increased holdings over the course of this year. We expect market pressure to increase as year-end draws to a close and the government's redemption profile becomes more challenging but given current risk appetite we doubt that this will materialize already in the very near term. With 50bp of further cuts priced at this stage, we do not see value in receiving rates. We favour selling HUF sub-280/EUR. In CDS space, great policy certainty and a much less challenging redemption profile means that we prefer to sell protection on Croatia while buying protection on Hungary.

Foreigners accumulate domestic debt



Sovereign's external financing requirement by quarter



Source: Bloomberg, UniCredit Research

GOVERNMENT GROSS FINANCING REQUIREMENTS[1]

EUR bn	2011	2012F	2013
Gross financing requirement	**9.3**	**17.9**	**20.9**
Budget deficit	-4.3	2.8	2.9
Amortization of public debt	13.7	15.1	18.0
Domestic	11.7	10.7	11.6
Bonds	4.1	4.1	4.3
Bills	7.5	6.6	7.4
External	2.0	4.4	6.4
IMF/EU	0.0	2.4	4.7
Financing	**15.4**	**17.9**	**20.9**
Domestic borrowing	10.9	11.4	14.4
Bonds	4.2	4.0	4.6
Bills	6.6	7.4	9.9
External borrowing	4.5	0.5	6.5
Bonds	4.0	0.0	5.0
IMF/EU	0.0	0.0	1.5
Other	0.5	0.5	0.0
Pension funds	-	6.0	-

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2011E	2012F	2013F
Gross financing requirement	**36.5**	**32.8**	**34.7**
C/A deficit	1.4	1.2	1.2
Amortisation of medium to long term debt	5.0	5.0	6.9
Amortization of medium to long term debt	8.4	4.6	5.2
Banks	6.5	3.4	4.1
Corporates	1.9	1.2	1.1
Short term debt amortization	24.5	24.4	23.8
Financing	**41.5**	**34.9**	**34.7**
FDI (net in and out)	-0.1	1.4	1.3
Portfolio flows	6.6	1.5	1.5
Borrowing	8.8	8.3	8.9
Government/central bank	1.0	4.5	2.7
IMF	0.0	0.0	1.5
Banks	5.9	2.7	3.7
Corporates	2.0	1.1	1.0
Short-term	24.4	22.6	21.5
EU transfers	1.2	0.6	1.5
Other	0.5	0.5	0.0

Source: AKK, IMF, NBH, UniCredit Research

[1] In external borrowing we kept all financing need in the Eurobond line but we expect this to be partly covered from IMF-EU sources and the actual issuance will be smaller. Whether it will cover 2012 needs as well will depend on the timing of the deal.

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

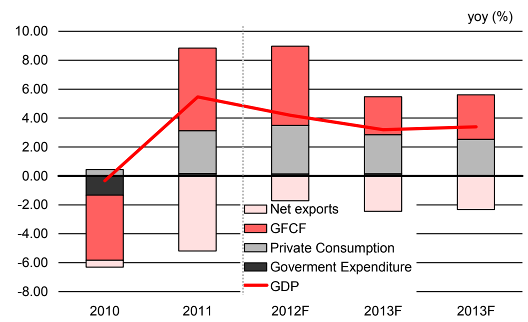
Outlook – 2Q GDP growth slowed to 5.0%, but some deceleration in yoy terms might have been expected. The biggest contribution came from private consumption, followed by gross fixed capital formation, Going forward, we expect the growth to finish at over 4% for FY12, and domestic demand to remain the main driver of economic expansion. Retail sales and IP in 2Q continued to post impressive results, despite some (expected) deceleration, even accelerating towards the end of 2Q. The C/A in 2Q was virtually unchanged from 1Q, but the negative surprise came from FDI. Inflation in 2Q12 further decelerated by an impressive 1.1pp to 2.3% yoy, partially due to tax reduction measures. Performance of the fiscal side is very stable – in January-June the surplus stood at approx. 0.9% of 1H GDP vs. -3.3% for 1H11.

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

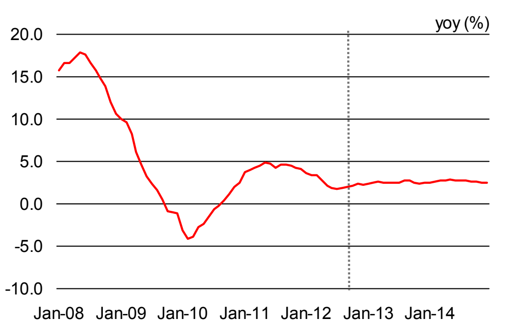
KEY DATES/EVENTS

- 9 Nov, 7 Dec – 3Q GDP (prelim., final)
- 10 Sep, 8 Oct, 10 Nov, 10 Dec – Consumer price index
- 4 Oct, 5 Nov, 5 Oct, 4 Dec – Industrial production

CONSUMPTION TO DRIVE GROWTH



INFLATION TO DECREASE FURTHER



Source: Central Statistical Bureau of Latvia, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2010	2011	2012F	2013F	2014F
GDP (EUR bn)	18.0	19.7	20.9	22.2	23.5
Population (mn)	2.3	2.2	2.2	2.2	2.2
GDP per capita (EUR)	7,989	8,753	9,351	9,869	10,470
Real economy yoy (%)					
GDP	-0.3	5.5	4.2	3.2	3.4
Private Consumption	0.4	4.4	4.7	4.0	3.7
Fixed Investment	-21.7	24.6	11.9	8.5	10.6
Public Consumption	-9.7	1.3	1.0	1.1	0.1
Exports	11.5	12.6	13.2	11.5	9.1
Imports	11.5	20.7	6.6	13.2	10.7
Monthly wage, nominal (EUR)	629	663	679	697	625
Unemployment rate (%)	14.3	12.7	11.3	10.9	10.7
Fiscal accounts (% of GDP)					
Budget balance (incl. bank costs)	-7.8	-4.0	-2.6	-2.5	-2.5
Primary balance	-9.9	-1.9	-1.8	-1.6	-1.1
Public debt	44.7	44.9	44.8	44.8	44.8
External accounts					
Current account balance (EUR bn)	0.6	-0.1	-0.2	-0.2	-0.3
Current account balance/GDP (%)	3.6	-0.6	-0.9	-1.0	-1.2
Basic balance/GDP (%)	5.0	5.0	2.2	1.4	1.2
Net FDI (EUR bn)	0.2	1.1	0.6	0.8	0.9
Net FDI (% of GDP)	1.4	5.6	3.1	2.4	2.4
Gross foreign debt (EUR bn)	29.8	30.9	31.7	33.2	34.7
Gross foreign debt (% of GDP)	165.3	157.1	151.1	149.6	147.4
FX reserves (EUR bn)	6.9	7.4	7.5	7.3	7.4
Inflation/Monetary/FX					
CPI (pavg)	2.5	4.4	2.3	2.5	2.6
CPI (eop)	-1.1	4.2	2.2	2.5	2.6
RIGIBOR 3M	1.90	1.03	0.25	0.75	1.00
USD/LVL (eop)	0.53	0.53	0.54	0.52	0.52
EUR/LVL (eop)	0.70	0.70	0.70	0.70	0.70
USD/LVL (pavg)	0.53	0.50	0.55	0.53	0.52
EUR/LVL (pavg)	0.70	0.70	0.70	0.70	0.70

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

Growth amid external uncertainty

GDP growth has decelerated but remains above 5% yoy.

2Q GDP growth decelerated to 5.0% but on qoq sa basis the pace of growth accelerated to 1.3% (1Q12: 0.9%, 4Q11: 0.9%). However, as growth in 3Q11 came in at 6.6% yoy, the fastest pace of recovery since 2008, some deceleration in yoy terms might have been expected. Looking at the structure of the growth, the biggest contribution came from private consumption, which added 4.9pp to the final yoy growth number. Gross fixed capital formation was the second biggest contributor, adding 4.3pp. Exports added 2.1pp while imports took off 2.4pp, bringing to net exports contribution at -0.3pp. Inventories added a negative 4.1pp to the growth number. Public spending contributed a marginal 0.1pp. Retail sales and IP in 2Q, continued to post impressive results, despite some (expected) deceleration, even accelerating towards the end of 2Q. Retail trade in July grew 10.3% yoy (2.7% mom sa) – the steepest rate of growth since the beginning of this year and the second highest yoy since 2009. The number followed on from the 7.6-8.8% yoy rates of growth posted in April-June. IP growth came in at only 3.8% yoy in April, but accelerated to 6.0-7.7% in May-July.

Retail sales and IP growth decelerated but regained by 2Q end.

C/A remains slightly in the red.

The C/A in 2Q was virtually unchanged from 1Q, posting an LVL 103mn deficit (0.7% of expected FY12 GDP) vs. LVL 104mn a quarter earlier. The 2Q figure brings the cumulative 1H deficit to 1.4% of expected FY12 GDP. 2Q now comes as the fifth consecutive quarter of C/A deficit, after the C/A posted a very marginal surplus (LVL 7.7mn) in 1Q11. In yoy terms, the 2Q12 deficit widened 2.3x compared to 1Q12. Looking at the structure, the biggest changes came from goods and services, where the deficit widened by LVL 65mn (63% yoy) – with the deficit on goods widening by LVL 96mn (28% yoy), which could not be offset by LVL 32mn (13%) growth in the services surplus. The income deficit narrowed by LVL 5mn (22% yoy), while the current transfers surplus contracted by LVL 8mn (11% yoy). The capital account surplus grew LVL 47mn from 1Q11 (increasing four-fold), mostly on the back of EU structural funds and Cohesion Fund transfers.

FDI surprise on the downside.

On the financing side, the negative surprise came from the FDI, which contracted almost 16x from the level seen a year ago, to a marginal LVL 10mn – the lowest level in two years. This was due to a decrease in foreign investments into Latvia, while Latvia's direct investments abroad remained roughly unchanged from the 2Q11 level. Portfolio investments and financial derivatives moved sharply into negative territory, decreasing by LVL 299mn to negative LVL 154mn and by LVL 135mn to negative LVL 96mn, respectively. All in all, we see deteriorating access to financing is taking its toll on Latvia, while exports continue to perform relatively well, supporting our expectation of only a moderate C/A deficit in FY12. Going further into next year, we see approximately the same picture with some risks on the downside, as recovering private consumption may support acceleration in the growth of imports.

Inflation seems to be well controlled.

Inflation in 2Q12 further decelerated by an impressive 1.1pp to 2.3% yoy from an average of 3.4% yoy in 1Q, and continues to show signs of further easing, coming in at only 1.7% yoy in July. Apart from the stabilization of food and commodity prices – the main drivers of CPI in 2011, this performance is generated by the tax reduction program introduced by the government as the country is aiming for euro adoption in 2014 and meet the Maastricht inflation criteria by the end of this year. According to our calculation, as of July, Latvia is 0.4pp above the threshold, which currently stands at 2.3%. .

Fiscal situation is of little risk.

Performance on the fiscal side also seems stable. Having finished 2011 with a deficit of 3.5% of GDP, for 2012 the government is targeting a budget deficit of 2.5% of GDP, under the assumption of 2.5% GDP growth for FY12. However, as the economic expansion in 1H has beaten even the most optimistic views at the start of the year, we anticipate few problems in bringing the full year deficit within 3% of GDP. The government was confident enough to put in place a tax reduction program, concentrating on fighting inflation, at the cost of tax revenues. In January-July 2012 revenues grew by a strong 17.5% yoy, while expenditure grew only by 2.1%. The January-June surplus stood at approx. 0.9% of 1H GDP vs. -3.3% for 1H11, supported by surpluses in both central and local governments.

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

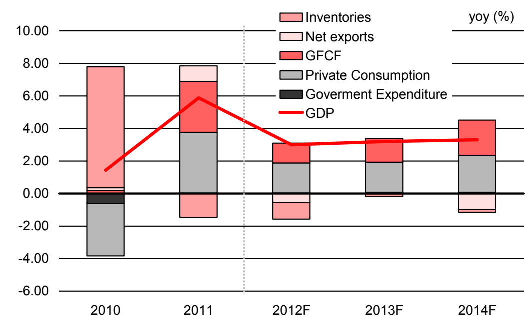
Outlook – Lithuania's 2Q GDP increased 2.2% yoy (0.5% sa qoq). As a reminder, in 1Q12 GDP grew by 3.9% (0.3% sa qoq). Looking at the 2Q GDP structure, as we expected the biggest contribution came from personal consumption. The situation remains quite sound, although there is plenty of evidence of a slowdown in the pace of growth from last year's bumper rates of 5.8%. Going forward, we expect FY12 growth to come in at over 3%, also mostly on the back of relatively strong domestic demand. On the fiscal side, the situation seems quite stable and we are optimistic that the government will reach its general government deficit target of under 3% of GDP. However, we see some risks stemming from the general election on 14 October.

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

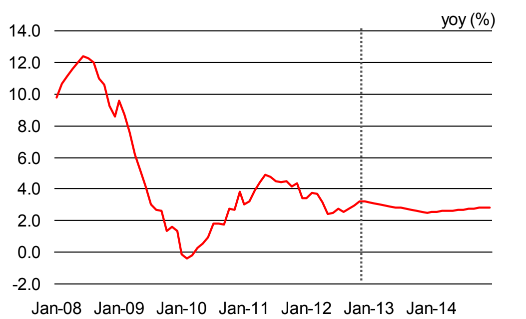
KEY DATES/EVENTS

- 14 Oct – General elections, referendum on construction of Visaginas nuclear power plant
- 29 Oct, 29 Nov - 3Q GDP (prelim., final)
- 22 Oct, 21 Nov, 21 Dec – Industrial production

CONSUMPTION TO SUPPORT GROWTH



INFLATION TO SLOW DOWN



Source: Statistics Lithuania, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2010	2011	2012F	2013F	2014F
GDP (EUR bn)	27.4	30.2	32.3	34.3	36.4
Population (mn)	3.3	3.3	3.3	3.3	3.3
GDP per capita (EUR)	8,257	9,161	9,851	10,461	11,087
Real economy yoy (%)					
GDP	1.2	5.9	3.0	3.2	3.3
Private Consumption	-4.1	4.7	3.0	3.0	3.7
Fixed Investment	-0.3	17.1	6.0	7.0	10.0
Public Consumption	-3.0	0.9	0.2	0.5	0.5
Exports	16.3	13.7	6.5	8.8	9.8
Imports	17.6	12.7	7.4	9.0	11.1
Monthly wage, nominal (EUR)	600	615	638	647	664
Unemployment rate (%)	14.5	11.7	10.0	9.0	7.8
Fiscal accounts (% of GDP)					
Budget balance	-7.5	-4.2	-3.1	-2.5	-2.5
Primary balance	-4.6	-3.1	-1.1	-0.5	-0.7
Public debt	35.0	35.9	36.7	37.1	37.5
External accounts					
Current account balance (EUR bn)	0.3	-0.5	-0.9	-0.7	-0.7
Current account balance/GDP (%)	1.6	-1.7	-2.9	-2.0	-1.9
Basic balance/GDP (%)	4.3	1.3	-1.7	0.5	1.2
Net FDI (EUR bn)	0.7	0.9	0.4	0.9	1.1
Net FDI (% of GDP)	2.6	3.0	1.2	2.5	3.1
Gross foreign debt (EUR bn)	24.1	24.8	25.4	25.9	25.0
Gross foreign debt (% of GDP)	87.8	82.1	78.7	75.6	68.7
FX reserves (EUR bn)	4.9	5.2	5.5	5.2	5.1
Inflation/Monetary/FX					
CPI (pavg)	1.1	4.1	3.0	2.8	2.7
CPI (eop)	3.6	3.4	3.2	2.5	2.8
VILIBOR 3M	1.56	1.77	0.75	1.00	1.05
USD/LTL (eop)	2.60	2.60	2.66	2.54	2.58
EUR/LTL (eop)	3.45	3.45	3.45	3.45	3.45
USD/LTL (pavg)	2.60	2.47	2.68	2.59	2.58
EUR/LTL (pavg)	3.45	3.45	3.45	3.45	3.45

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

Slowing down, but still positive

Economy is gradually decelerating.

Lithuania's 2Q GDP increased 2.2% yoy (0.5% sa qoq). As a reminder, in 1Q12 GDP grew by 3.9% (0.3% sa qoq). These two quarters translate into 3.0% yoy growth in 1H12, which supports our view of a smooth growth slowdown in the country. Looking at the 2Q GDP structure, as we expected, the biggest contribution of 2.5pp came from personal consumption (which increased 4.1% yoy). The exports contribution significantly decreased to only 0.6pp (this item grew by only 0.8% yoy). On the other hand a contraction in imports (by 3.8% yoy) brought the contribution from net exports to a positive 3.5pp. GFCF and public consumption each added a marginal 0.2pp. While not a surprise for public consumption, the low contribution from GFCF reflects a significant deceleration of this component's growth (to 0.9% yoy) from the double-digit growth rates posted just a year ago (e.g. 45.7% in 1Q11 and 20.7% in 2Q11).

Net exports contribution remains positive due to a steep decrease in imports.

We maintain our view for GDP growth at approximately the same level.

All in all, the situation remains quite sound, although there is plenty of evidence of a slowdown in the pace of growth from last year's bumper rates of 5.8%. We marginally adjust our forecast to 3.0% (+0.1pp) for 2012, mostly on the back of a slower-than-expected deceleration of growth in 1Q-2Q and overall good regional performance.

Retail sales were supportive for 1Q figures, while IP lagged behind.

After a slump in April to 1.6% yoy, the rate of growth in retail sales recovered to a healthy 5.0-5.4% over the next three months. Overall, 2Q, despite some deceleration in the average pace of retail sales growth to 3.8% from 8.6% in 1Q, recorded growth in line with the same period of 2011.

The somewhat worrying 14.4% yoy decline in industrial production in May came as a result of the closure of Orlen Lietuva AB oil refinery (subsidiary of Polish PKN Orlen SA) for seasonal maintenance. Looking at manufacturing excluding energy products, we see a much more positive picture, as it grew 8.7% yoy. As the production on Orlen Lietuva was resumed at the beginning of June, IP growth recovered to 0.5% in the same month and further to 6.2% yoy in July.

Export/import dynamic is also slowing down

The balance of payments picture is mixed. The growth of combined exports of goods and services fell to 3.3% yoy in 2Q vs. 12.3% in 1Q. However, due to a contraction in imports, the C/A moved back into a marginal LTL 91mn surplus in 2Q following an LTL 2.3bn deficit in 1Q. The 1H aggregate deficit stood at 1.9% of full-year GDP. The capital account posted a strong quarter in 2Q, increasing by LTL 718mn. FDI posted a weak performance, decreasing two-fold to LTL 304mn, bringing cumulative 1H FDI to LTL 1.2mn (1.1% of FY12 GDP). Going forward, we expect the FDI inflow to stabilize and end up approximately at the same level to GDP, while the C/A deficit will continue to grow, albeit at a slower pace, driven by growing private consumption.

Fiscal seem supportive for government plans.

As of June, general government revenues reached 46.3% of the annual plan (vs. 45.2% of annual plan for the same period of 2011). In absolute terms, revenues increased by 7.6% yoy. The situation seems quite stable and we are optimistic that the government will reach its general government deficit target of under 3% of GDP, The government projection real GDP growth, as of 1Q, saw 2012 growth at 2.4%, while the central bank in August estimated economic expansion would reach 3.0% for FY12.

However, we see some risks stemming from the October elections.

The next general election will be held on 14 October (the referendum on the construction of a new nuclear plant to be held simultaneously). The current government coalition won 46% of votes in the last elections in 2008, enabling them to take 72 seats in the 141-seat parliament. According to the latest available polls (as of June), the coalition may receive as little as 20% of votes in the elections. The weak results of the governing collation may be influenced by the breakdown of the second-biggest party in the ruling collation (National Resurrection party), which won approx. 15% of the votes (16 seats). However, what should not be missed is the decrease in the popularity of the leading party (Homeland Union – Lithuanian Christian Democrats), from 19.6% in 2008 to only 8.5% in June 2012. The current Prime Minister Andrius Kubilius is the leader of the party. We see some marginal risk from the elections for the current budget policy, as the ruling center-right coalition influence would be at least decrease and the left-leaning opposition advance.

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

Outlook – We have revised our GDP growth expectations for this year to 2.6% from 3.0% and for next year to 2.2% from 2.6% amid a quicker-than-expected deterioration of domestic demand combined with the weakening European growth outlook. Weaker growth will facilitate a faster return of inflation to the MPC target range (1.5-3.5%) – we expect end-2012 CPI of around 3.2% yoy. The softer GDP growth path and declining inflation will likely prompt the MPC to cut interest rates – we expect total cuts of 50bp by the end of the year, and a total of 75-100bp in cuts by mid-2013.

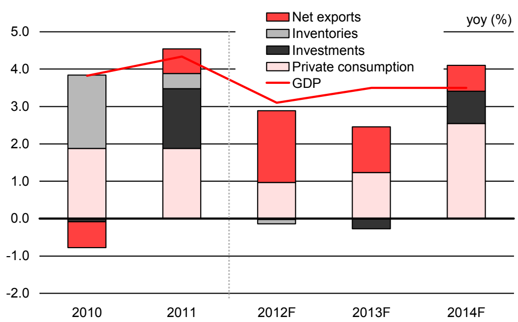
Strategy outlook – We look for a steepening of POLGB curve, with short end well anchored with rate-cut expectations, but long end vulnerable to possible deterioration of sentiment on weakening fiscal outlook. Zloty has limited further upside potential, as weakening growth outlook increases probability of fiscal underperformance, and rate cuts reduce carry.

Author: Marcin Mrowiec, Chief Economist (Bank Pekao)

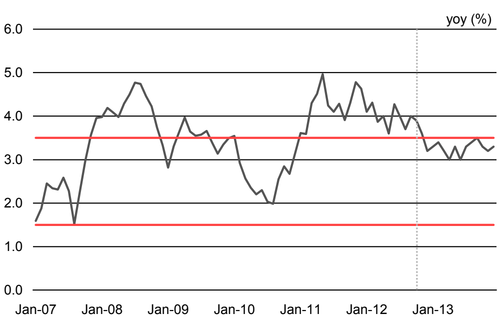
KEY DATES/EVENTS

- The NBP releases update to inflation projection – early Nov
- MPC decision-making meetings – 2-3 Oct, 6-7 Nov, 4-5 Dec
- PM Tusk to set key objectives for his Cabinet in the coming years ("second expose") – end Sep/early Oct
- 2Q GDP – end-November

GDP TO CONTINUE ITS SLOWDOWN



CPI TO ENTER MPC TOLERANCE ZONE BY YEAR-END



Source: GUS, Unicredit Research:

MACROECONOMIC DATA AND FORECASTS

	2010	2011	2012F	2013F	2014F
GDP (EUR bn)	354.6	370.1	377.5	403.0	427.1
Population (mn)	38.2	38.1	38.1	38.1	38.0
GDP per capita (EUR)	9,282	9,718	9,917	10,591	11,230
Real economy yoy (%)					
GDP	3.9	4.3	2.6	2.2	3.4
Private Consumption	3.2	3.1	1.6	2.0	3.2
Fixed Investment	-0.4	8.1	-0.1	-1.4	3.8
Public Consumption	4.1	-1.3	-1.0	0.0	1.8
Exports	12.1	7.5	1.9	1.6	4.4
Imports	13.9	5.8	-2.3	-1.1	4.2
Monthly wage, nominal (EUR)	860	875	882	941	988
Unemployment rate (%)	12.1	12.4	12.8	13.5	13.2
Fiscal accounts (% of GDP)					
Budget balance	-7.9	-5.1	-3.5	-3.6	-2.8
Primary balance	-0.7	0.7	1.0	0.8	0.0
Public debt	54.8	56.3	56.5	57.1	56.3
External accounts					
Current account balance (EUR bn)	-16.5	-16.0	-13.2	-12.9	-15.6
Current account balance/GDP (%)	-4.6	-4.4	-3.5	-3.2	-3.6
Basic balance/GDP (%)	-2.8	-1.4	-2.2	-0.8	-1.1
Net FDI (EUR bn)	6.7	10.8	5.0	9.5	10.7
Net FDI (% of GDP)	1.9	2.9	1.3	2.4	2.5
Gross foreign debt (EUR bn)	236.0	249.1	258.0	278.4	300.3
Gross foreign debt (% of GDP)	66.6	67.3	68.3	69.1	70.3
FX reserves (EUR bn)	70.0	75.7	77.6	75.8	78.9
Inflation/Monetary/FX					
CPI (pavg)	2.6	4.3	3.9	3.3	3.2
CPI (eop)	3.1	4.6	3.2	3.3	3.6
Central bank target	2.5%±1.0	2.5%±1.0	2.5%±1.0	2.5%±1.0	2.5%±1.0
Central bank reference rate (eop)	3.50	4.50	4.25	4.00	3.75
3M money market rate	3.94	4.54	4.90	4.42	4.20
USD/PLN (eop)	2.98	3.32	3.22	2.94	2.95
EUR/PLN (eop)	3.96	4.42	4.18	4.00	3.95
USD/PLN (pavg)	3.01	2.94	3.30	3.09	3.06
EUR/PLN (pavg)	3.99	4.12	4.24	4.12	4.10

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

Slowdown more pronounced than expected

2Q12 saw 2.4% GDP growth, following 3.5% the previous quarter. This was significantly below expectations, suggesting a steeper-than-expected slowdown.

After solid 1Q GDP of 3.5%, 2Q saw 2.5% yoy growth, significantly weaker than the 2.9% expected. This suggests the slowdown will be more pronounced than previously expected. In qoq sa terms, 2Q saw 0.4% growth, after 0.6% in the previous quarter and 0.8% in final quarter of 2011. The biggest surprise was the fall in domestic demand in 2Q (-0.2% yoy, after 2.7 in 1Q; in qoq sa terms -0.7%, the first qoq decline since 2Q09), and fairly weak investment growth (1.9% yoy, 0.3% qoq). It was expected that investments would be stronger in 2Q, as many pre-EURO 2012 investment projects were finished during the quarter. Another weak sign was the negative contribution from inventories, mirroring companies negative outlook for the future, which prompted them to run down inventories rather than import or produce more. What "saved" the figures was a very strong contribution of net exports (2.6pp), as exports increased by 3.6% yoy and imports fell by 2% yoy.

We have revised our GDP forecast for 2012 to 2.6% from 3.0% previously, and for 2013 to 2.2% from 2.6% previously.

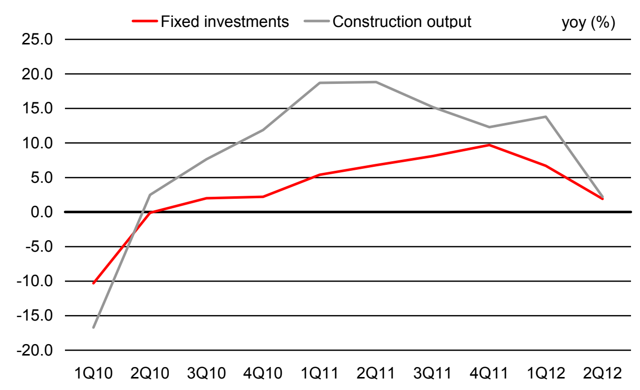
We have revised our 2012 GDP forecast down to 2.6% from 3.0% previously, and for 2013 down to 2.2% from 2.6% previously. 2Q data showed that the pace of slowdown will be steeper than we had previously anticipated, and that infrastructure investments not only saw their peak in 1H (which had been broadly anticipated), but were also much weaker than expected. In 2H, the pace of public investments will slow down further which, combined with continued weakness in private sector investments, will likely mean 2H investments of around -1% to -2% yoy, and full-year 2012 total investments of around zero (vs. 4.3% yoy expected so far, following 8.1% yoy in 2011). Another key GDP variable, private consumption, remains under pressure from the weak labor market. Employment in the corporate sector is currently running at 0% yoy, and will likely turn slightly negative in the remainder of the year. Contrary to 1H12, when wages (4.6% yoy average in 1H) increased at a faster pace than CPI (4.1% yoy on average), in 2H12 wage growth (expected 3.0% yoy) will be below inflation (3.7% yoy) – a factor hardly supportive of private consumption growth. This year's economic growth is likely to be continually supported by a strong positive contribution from net exports. In 2Q, this contribution amounted to 2.6pp, and whereas it is likely to be slightly less pronounced in 2H, it should remain the key engine of growth.

CPI inflation will rebound towards 4.0% in September and October, and then decline towards 3.2% at end-December.

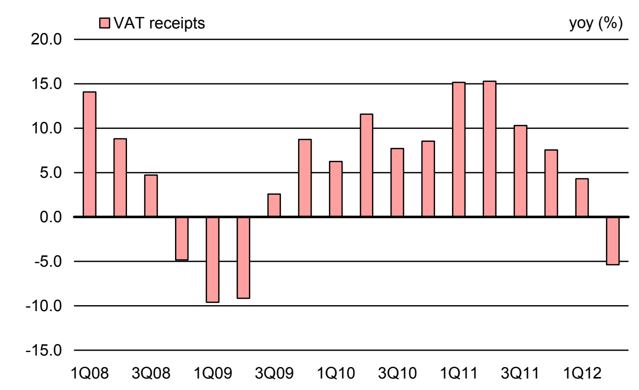
CPI inflation will likely rebound towards 4.0% yoy in September and October, and then decline towards 3.2% yoy at end-December, on strong statistical base effects and a widening output gap. The key risk factors to this scenario are uncertainties regarding the oil price (mainly geopolitical risks) and elevated food commodity prices. The supportive factor will be the weak economic growth outlook, muting any demand-driven inflationary pressures. Other positive signs come from PMI input and output price indicators, which suggest that price growth should continue to decelerate.

WEAKENING CONSUMPTION AND FIXED INVESTMENTS TAKE THEIR TOLL ON TAX REVENUE

Weakening flow of EU funds has dampening impact on construction output and fixed investment



Weakening investments and domestic demand translate into weaker VAT revenue, (50% of tax revenue)



Source: GUS, UniCredit Research

The NBP will likely start a rate-cutting cycle in October, and we expect it to deliver 50bp of cuts this year, followed by another 25-50bp in 1H13.

The MPC will likely start a rate-cutting cycle in 4Q. We expect a total of 50bp in rate cuts by the end of the year. It is now crystal clear that the May 25bp rate hike by the MPC was a mistake and that the MPC is under increasing pressure to cut interest rates. After the September MPC sitting, NBP President Marek Belka signaled that "the possibility of a rate cut has opened", but the MPC post-meeting communique was somewhat less dovish than market expectations. In our baseline scenario we assume the first rate cut already in October. In our view, a 50bp cut would be justified, but the MPC may prefer to act in smaller steps, and we therefore expect a 25bp cut in October, followed by another 25bp the following month, or in December, followed by another 25-50bp in cuts in 1H13.

The state's budget deficit is likely to exceed the planned PLN 35bn in 2012, as VAT revenue is much weaker than expected. Also, the 2013 planned deficit of PLN 35.6bn seems optimistic, and additional steps will have to be taken to ensure it is met.

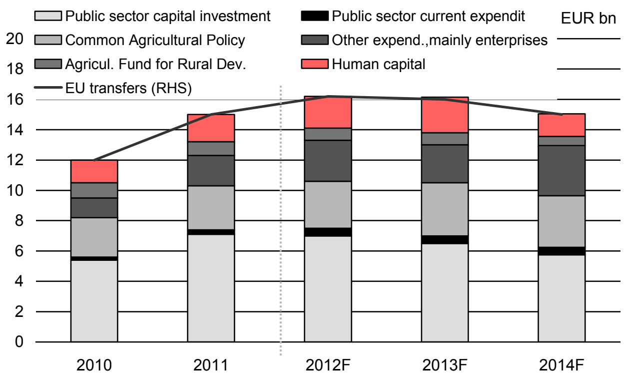
The 2012 budget deficit is likely to be higher than expected, amid disappointing VAT revenue. The first quarter of the year was fairly positive for the state budget, with budget revenue in line with plans, inflation high, and some (higher-than-expected) PLN 8.2bn from the NBP profit flowing into state coffers. However, 2Q was a concern in that tax revenue was weaker than expected. VAT revenue, which in 1Q was plus 4.3% yoy, was already at minus 5.4% yoy in 2Q. This was not only due to weaker economic growth, but also its structure: weak consumption and investments. Given that this situation is unlikely to reverse in 2H, VAT revenue will unlikely meet plans for a PLN 11.3bn increase in 2012 but will instead likely go deeper into the red, with January-July VAT revenue already lower by PLN 1.1bn than in the same period of 2011. The government will therefore have to take additional steps to ensure that the official target of PLN 31.7bn deficit is met. The cabinet has released plans for the 2013 budget, with GDP growth assumed at 2.2% and inflation at 2.7% on average. Macro assumptions seem realistic, but tax revenue projections less so, with assumed double-digit corporate income tax revenue growth, relatively optimistic VAT growth assumptions and a strong level of revenue (PLN 20bn) from non-tax items. It also seems that 2013 budget revenues will have to be strengthened with additional steps if the projected deficit of PLN 35.6bn is to be met. It is widely expected that PM Tusk presents the government anti-crisis strategy during his speech ("second expose") in the Parliament, scheduled for end-September or early October.

EUR-PLN seems to be in danger of weakening, as domestic dataflow will be soft, and global volatility usually weakens the PLN.

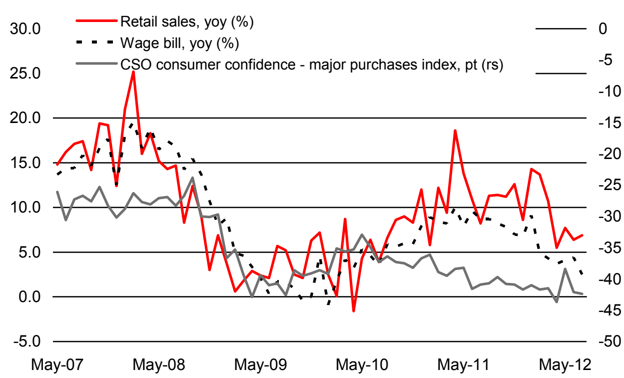
The PLN remains highly volatile and we expect it to stay under pressure, amid soft domestic macro data, upcoming rate cuts and a bleak external growth outlook. In the previous issue of our quarterly, with the zloty close to 4.40 vs. the EUR, we favored going long on the PLN. This worked well, with the zloty dropping towards 4.03 in August. However, we now expect global volatility plus domestic weak real economy dataflow and prospects of rate cuts to push the zloty weaker again, towards 4.30 vs. the EUR, from the current 4.10 level.

EU FUNDS POSITIVE IMPACT TO BE WEAKER THAN IN PREVIOUS YEARS, CONSUMPTION TO WEAKEN ON SOFT LABOR MARKET

Contrary to 2008-2012, EU funds inflow will slow in the coming 2-3Y



Deterioration in the labor market to cause weakening domestic consumption



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

Strategy: Fiscal risks are not priced, PLN underperform n-t

We look for steepening of the curve over coming months, with 2Y sector anchored close to record lows by rate cut expectations, long end of curve may suffer from worsening fiscal outlook.

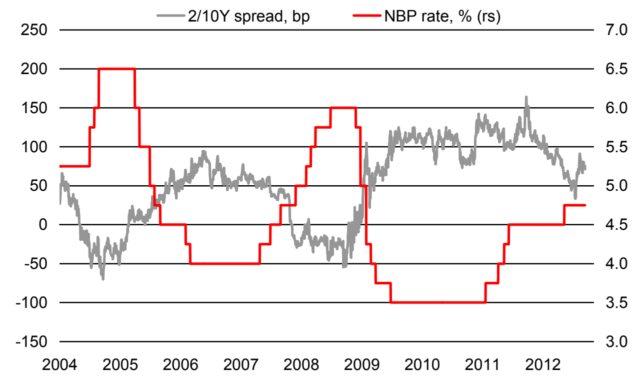
Polish T-bonds benefited from a global tendency of looking for higher return in an environment of cheap financing. Weaker local macroeconomic data supported rally and bull steepening as well. Interest rates cuts by some 100bp had been priced in. We see no room for testing lower targets. High foreign demand for POLGB will likely stabilize yields around record-low levels n-t. Underperformance of German Bunds and the deteriorating local fiscal outlook may be key risk factors regarding long-term bonds. The curve will likely steepen by some 20-30bp in coming months. On the other hand losses on long end should be moderate due to limited debt supply. The Ministry of Finance already cover more than 90% of its this year's borrowing needs.

Look for better entry point to go long EUR-PLN.

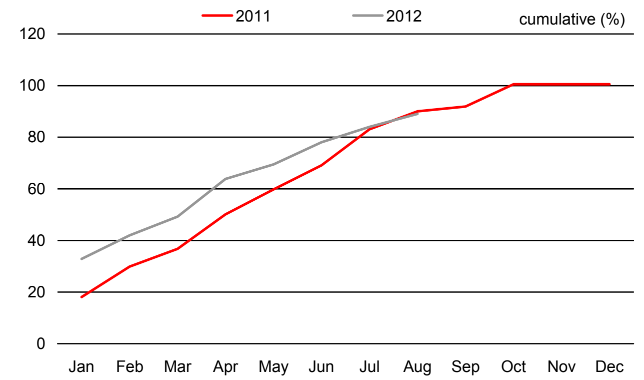
In FX we see little further upside for the zloty in the near term . Weak macro outlook increases the probability of rate cuts (zloty-negative) as well as deterioration of budget stance (also zloty-negative). Foreign investors continue to purchase POLGB (they had PLN177.4bn at end-July, 34.2% of total amount outstanding) which is zloty-supportive, but at the same time means increasing potential danger in case some of them decide to trim their positions, e.g. on fiscal worries. Therefore, we'd wait for better entry point to go long EUR/PLN in 4Q12 or 1Q12.

CURVE STEEPENING EXPECTED, FISCAL RISKS NOT PRICED IN THE LONG END OF THE CURVE

We look for curve steepening



More than 90% of 2012 borrowing needs has already been covered,



Source: MinFin, NBP, UniCredit Research

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2011	2012F	2013F
Gross financing requirement	**47.8**	**40.5**	**46.1**
Budget deficit	21.3	15.6	17.2
Amortization of public debt	26.5	24.9	28.9
Domestic	25.0	24.6	25.6
Bonds	18.2	21.8	24.1
Bills	6.8	2.8	1.5
External	1.5	0.3	3.3
IMF/EU	0	0	0
Financing	**47.8**	**40.5**	**46.1**
Domestic borrowing	38.1	33.7	36.8
Bonds	34.6	29.7	31.0
Bills	3.5	4.0	5.8
External borrowing	9.7	6.8	9.3
Bonds	5.5	3.7	5.5
IMF/EU	0	0	0
Other	4.2	3.0	3.8

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2011	2012F	2013F
Gross financing requirement	**94.5**	**105.4**	**101.3**
C/A deficit	16.0	13.2	12.9
Amortization of medium to long term debt	15.2	18.8	15.2
Government/central bank	5.5	5.3	4.9
Banks	3.2	7.2	6.0
Corporates	6.5	6.3	4.3
Short term debt amortization	63.3	73.4	73.2
Financing	**94.5**	**105.4**	**101.3**
FDI	10.8	5.0	9.5
Equity	2.0	2.0	3.0
Borrowing	91.3	103.1	102.6
Government/central bank	13.3	11.5	14.0
Banks	28.6	37.0	36.5
Corporates	49.4	54.6	52.1
EU transfers	8.5	9.0	7.8
Other	-18.2	-13.7	-21.6

Source: MinFin, NBP, UniCredit Research

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

Outlook – GDP expansion has accelerated in the second quarter of the year, but growth path is likely to deteriorate over next quarters. Inflation is also likely to deteriorate due to poor crop yields and imported inflation. With repayments to the IMF exceeding EUR 10bn in 2013 and 2014, the government will have to step up bond issuance. Fiscal policy will help, as the budget deficit could fall below 3% of GDP in 2013, but the political scene will remain noisy.

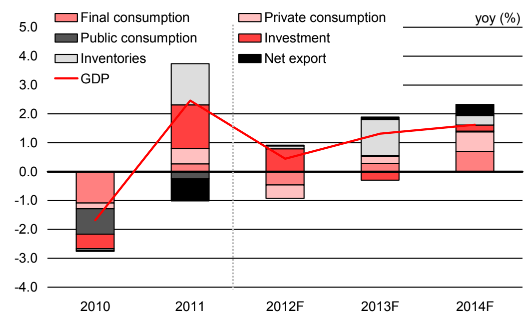
Strategy – Romania missed out on the risk rally of July, its 10Y CDS spread trades too close to Hungary's and too far off the ASW of the 10Y USD bond.

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

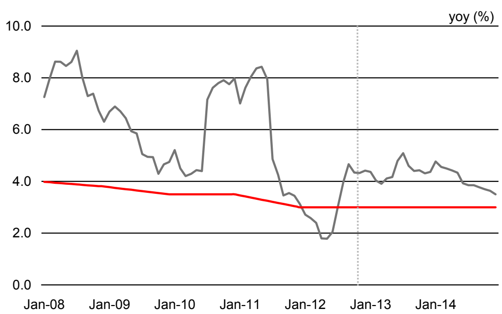
KEY DATES/EVENTS

- 2 Nov 2012 – NBR rate decision
- 6 Dec 2012 – National Accounts - flash estimate
- 9 Dec 2012 – Parliament elections

GDP GROWTH TO FLATTEN



INFLATION ACCELERATES



Source UniCredit Research, NBR, CSO

MACROECONOMIC DATA AND FORECASTS

	2010	2011	2012F	2013F	2014F
GDP (EUR bn)	124.1	136.5	136.4	140.4	143.5
Population (mn)	21.5	19.0	19.0	19.0	19.0
GDP per capita (EUR)	5,774	7,169	7,181	7,387	7,551
Real economy yoy (%)					
GDP	-1.7	2.5	0.5	1.3	1.6
Private Consumption	-2.0	0.7	-0.7	0.4	1.0
Fixed Investment	-13.1	6.4	3.2	-1.1	0.8
Public Consumption	-3.2	-3.5	0.2	0.5	0.4
Exports	13.1	9.9	-0.3	3.4	5.7
Imports	11.6	10.5	-0.3	2.8	4.3
Monthly wage, nominal (EUR)	334	346	351	361	372
Unemployment rate (%)	7.3	7.4	7.3	7.0	6.5
Fiscal accounts (% of GDP)					
Budget balance	-6.4	-4.1	-3.0	-2.5	-2.0
Primary balance	-5.0	-2.6	-1.6	-1.1	-0.6
Public debt	35.0	36.3	33.0	32.1	30.9
External accounts					
Current account balance (EUR bn)	-5.5	-6.0	-4.9	-4.2	-3.1
Current account balance/GDP (%)	-4.4	-4.4	-3.6	-3.0	-2.2
Basic balance/GDP (%)	-2.6	-3.0	-2.5	-1.5	-0.3
Net FDI (EUR bn)	2.2	1.9	1.5	2.0	2.6
Net FDI (% of GDP)	1.8	1.4	1.1	1.4	1.8
Gross foreign debt (EUR bn)	92.5	98.6	99.8	101.7	99.9
Gross foreign debt (% of GDP)	74.5	72.2	73.2	72.4	69.7
Fx reserves (EUR bn)	32.4	33.2	30.6	28.2	23.4
Inflation/Monetary/FX					
CPI (pavg)	6.1	5.8	3.2	4.2	4.1
CPI (eop)	8.0	3.1	4.4	4.2	3.5
Central bank target	3.5	3.0	3.0	2.5	0
Central bank reference rate (eop)	6.25	6.00	5.25	5.25	4.75
3M money market rate	5.90	5.28	5.09	5.55	4.85
USD/RON (eop)	3.22	3.25	3.46	3.44	3.47
EUR/ RON (eop)	4.28	4.32	4.50	4.68	4.65
USD/RON (pavg)	3.17	3.03	3.46	3.43	3.50
EUR/RON (pavg)	4.21	4.24	4.45	4.58	4.69

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

Weathering negative shocks from the euro zone

GDP expansion accelerates in 2Q12 supported by construction and services.

Economic growth accelerated in 2Q12 to 0.5 % qoq (+1.2% yoy) helped by construction (+5.2% yoy) and services (+6.1% yoy). Domestic demand offset weaker demand from abroad, gross fixed capital formation rising fastest (+15.2% yoy), spurred by public capital expenditure. Private consumption (+1.4% both qoq and yoy) was boosted by higher wages in the public sector (+8% in June 2012) and by improving sentiment. Despite healthy growth in 1H12 (+0.8% yoy), Romania's GDP could contract by 0.5% yoy in 3Q12 due to poor crops and public investment cuts (-39% yoy in June and July 2012) in order to meet the 2012 budget deficit target of 2.2% of GDP. Hence, only a recovery of foreign demand will prevent Romania from re-entering technical recession by the end of the year. We forecast GDP growth of around 0.5% in 2012, but see strong downside risks.

GDP growth to pick up gradually in 2013 and 2014, in line with the EA recovery.

GDP growth could pick up gradually in 2013 and 2014 to 1.3% and 1.6% respectively, in line with a mild recovery of economic activity in the euro area. GDP dynamics remain too slow for Romania to resume real convergence to EA activity levels and we expect below-potential growth until the end of 2014, slowed down by poor demand from the EA and meagre fund inflows.

C/A deficit contracts, but goods trade deficit remains elevated.

Foreign capital flows weakened in 2012. Portfolio investment registered net outflows of EUR 2bn between May and July 2012 and FDI could peak at EUR 1.5bn this year (EUR 0.9bn in 7M12). At the same time, the slow deleveraging in the banking system continues amid subpar rollovers of funding lines from parent banks. Beside poor inflows, Romania faces repayments to the IMF of EUR 1bn until the end of 2012, EUR 5.3bn in 2013 and EUR 4.9bn in 2014.

Despite the RON losing approximately 5% against the EUR and 18% vs. the USD over the past 12 months, the goods trade deficit is still stuck at EUR 10bn (12-month rolling). The weaker RON doesn't boost exports, dependent mainly on demand. In this environment, the 35% yoy narrowing of the C/A deficit in 7M 2012 was driven mainly by a lower deficit of the revenue account (-41.5% yoy in 7M 2012) and a larger surplus of the services balance. The former is the result of lower profits registered by multinational companies and also explains poor FDI. The C/A deficit could correct to 3.6% of GDP in 2012, 3.0% in 2013 and 2.2% in 2014.

Budget deficit targets likely to be missed during the following years, despite fiscal consolidation.

Public policies will have a major impact on growth dynamics as the complete reversion of the public sector wage cuts of 2010 and refunds to pensioners will further squeeze investment and co-financing for EU funds. The budget deficit could fall towards 3% of GDP (accruals) in 2012 and remain above 2% in 2013 and 2014, missing deficit targets. A stronger correction below 2% of GDP would entail an unlikely improvement in tax collection or higher taxes.

The current governing coalition (the Social Liberal Union – USL) is likely to remain in power after parliamentary elections (to be held on 9 December). Within the USL, the views on taxation are very different, with the social-democrats (PSD) favouring progressive tax rates on wages and the liberals (PNL) preferring the current flat tax of 16% (or an unfeasible "regressive" tax system of 8%/12%/16%). Hence, the next budget will be the first real test for the governing coalition. 8% and 12% tax rates for low wages could exert significant pressures on the budget deficit. Furthermore, if the policy were to be offset by higher taxes on the better off, the aggregate effect on consumption and retail sales would be negative. High earners have larger consumption elasticity to revenues and are more indebted, so a fall of revenues also hits future consumption by reducing the propensity to borrow.

In order to avert the rapid depletion of its reserves, the Government will have to step up issuance. Foreign borrowing has increased significantly since the MinFin reduced the rollover ratio of RON debt to 58% between May and August 2012, diminishing its reserves by EUR 1.4bn over the same period. Current reserves amount to EUR 3.2bn after the MinFin sold EUR 0.75bn in eurobonds with a residual maturity of 6 years. The MinFin could try tapping again foreign markets for a similar volume before the end of 2012.

The Government may tap international debt markets again this year and will have to step up issuance in 2013 and 2014.

The MinFin will have to increase issuance in 2013 and 2014, but outflows to the IMF are unlikely to be financed entirely on foreign markets, subtracting at least EU 2bn and EUR 1.5bn from FX reserves in 2013 and 2014 respectively. The MinFin would benefit greatly from an inclusion in Emerging Markets indices, but recent focus on issuing T-Bills instead of increasing liquidity for benchmark bonds is hindering the process. At the same time, FX denominated bonds have enjoyed healthy demand, with the 2012 USD 10Y bond trading above 110% mid-September and the 2018 EUR bond reopened in September 2012 at 5.1% (vs 6.7% when it was first sold in 2008).

The NBR will probably keep the monetary policy interest rate at 5.25% at least until the end of 2013.

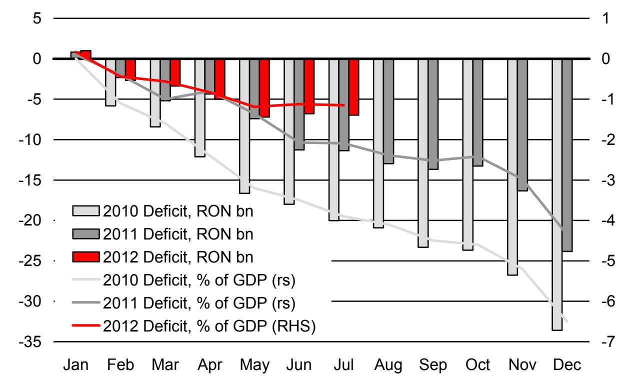
With adverse fund flows and an uncertain political landscape, the National Bank of Romania is unlikely to change its policy line, continuing to favour the RON over interest rates. Facing a rapid depletion of FX reserves (EUR -3.7bn or -10.5% between March and August 2012), the central bank opted to let the RON depreciate close to 4.7 RON/EUR in July. The central bank resumed its support for the currency in August, when it limited repos for 3 weeks, pushing interest rates above 6%. Improved risk appetite worldwide and a calmer political situation helped the RON appreciate below 4.5 RON/EUR, but we believe that appreciation is temporary and depreciation towards 4.70 RON/EUR could resume in 2013 or even earlier if external risks flare up.

Consumer price inflation fell to 1.8% in May, helped by last year's good crops and by falling fuel prices worldwide. The picture changed completely at the beginning of 2H12, when RON depreciation, a poor harvest and surging energy prices pushed inflation above 3%. We forecast inflation at 4.4% in 2012, 4.2% in 2013 and 3.5% in 2014. Food prices will be the main inflation driver in 2012, while the weaker RON and a series of administered price hikes will probably keep headline inflation above target until the end of 2014. Despite repeatedly missing inflation targets, the NBR will probably keep the monetary policy rate at 5.25% at least until the end of 2013. Sub-potential economic growth and supply-side price shocks argue against rate hikes, while depreciation pressures and above-target inflation will avert cuts. Facing depreciation and deleveraging in the banking sector, the NBR will be reluctant to cut minimum reserve requirements for RON and FX liabilities from the current levels of 15% and 20%.

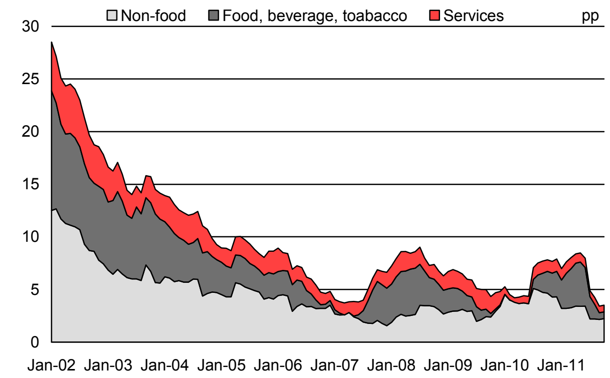
Funding conditions in the banking system remain heterogeneous. CB stands ready to act in case of Grexit.

The deleveraging picture is very different among local banks, with Greek and smaller players facing outflows, while some of the larger banks still receive support from their groups. The solvency ratio was 14.7% at the end of 2Q12. Having to rely on local funding, banks maintain high interest rates for deposits and can't afford to cut lending rates since the spread squeeze has already pushed the system in the red. The absence of alternative longer-term local funding sources (i.e., the money market and the central bank) provides for further interest rate volatility and leaves the market exposed to interest rate spikes. Besides funding, the other three big problems for the BS remain demand, asset quality and a possible Grexit. Recent RON depreciation has deterred households and companies from borrowing in FX, while RON loans bare real interest rates in excess of 3%, failing to provide a viable funding alternative.

YTD budget performance remains positive



Inflation is mostly driven by food and energy



Source: UniCredit Research, MinFin, NIS

Underperformance in CDS market creates opportunities

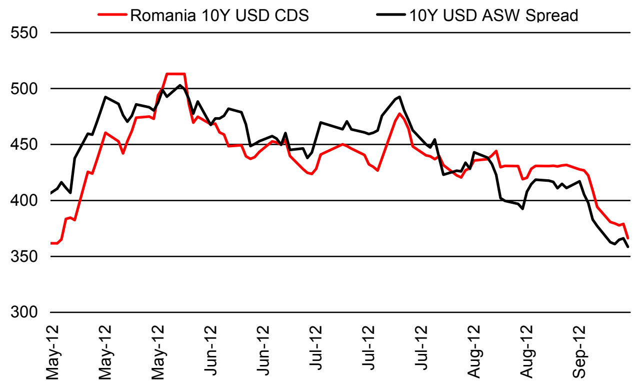
Romania missed the risk rally in July. We believe that Romania's CDS spread will outperform Hungary's CDS spread…

Since Romania missed out on the risk rally of July, its 10Y CDS spread trades too close to Hungary's and too far off the ASW of the 10Y USD bond. The spread is currently 30bps, but has receded from around 150bps in May. Going short Romania's CDS vs. long Hungary's with a target spread of 70% of average before May entails the risk of a rally in Hungary following an IMF deal, but we believe such a deal is still months away (probably 1Q13) and markets could be in for negative news over the next months.

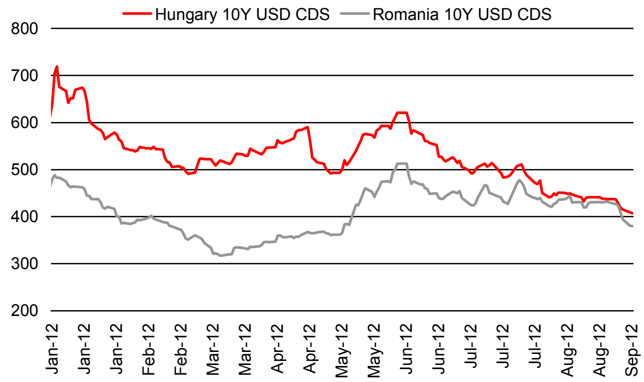
…and the 10Y USD bond.

The spread between 10Y CDS and ASW for the 10Y USD bond has been mostly negative since February because of an 80 bps issuance premium, but turned positive mid-August. The USD bond has rallied while the CDS spread has underperformed markedly. The spread is currently trading at 8bps and could narrow towards the pre-May levels of -50bps.

Romania minus Hungary 10Y CDS



Romania 10Y CDS vs. USD ASW spread



Source: Bloomberg, UniCredit Research

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2011	2012F	2013
Gross financing requirement	**16.4**	**15.0**	**13.9**
Budget deficit	5.6	4.1	3.5
Amortisation of public debt	10.8	10.9	9.6
Domestic	10.8	10.2	9.6
Bonds	2.0	4.7	5.2
Bills	8.8	5.5	4.4
External	0	0.7	0
IMF/EU	0	0	0.8
Financing	**18.2**	**15.4**	**13.9**
Domestic borrowing	13.7	11.4	10.9
Bonds	4.7	5.7	5.9
Bills	9.0	5.7	5.0
External borrowing	4.5	4.0	3.0
Bonds	1.5	3.0	3.0
IMF/EU/WB	2.6	1.0	0
Other	0	0	0

Source: MinFin, NBR, UniCredit Research:

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2011	2012F	2013F
Gross financing requirement	**39.1**	**36.1**	**32.8**
C/A deficit	6.0	4.9	4.2
Amortisation of medium to long term debt	11.0	10.7	11.8
Government/central bank	2.8	3.2	5.6
Banks	2.6	2.5	1.5
Corporates	5.6	5.0	4.7
Amortisation of short term debt	22.1	20.5	16.8
Government/central bank	5.9	3.3	2.4
Banks	12.1	12.8	10.2
Corporates	4.1	4.4	4.2
Financing	**38.8**	**36.1**	**32.8**
FDI	1.9	1.5	2.0
Equity	1.1	0.8	1.6
Borrowing	34.0	32.6	26.2
Government/central bank	8.2	7.1	7.5
Banks	15.5	15.3	10.8
Corporates	10.3	10.2	7.9
EU Funds	1.8	1.2	3.0

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

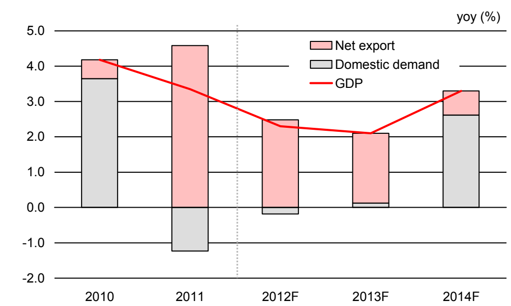
Outlook – The new government confirmed strong commitment to narrow the budget deficit within 3% of GDP in 2013, approving several measures mostly on revenue side. However, to reach the goal additional measures worth circa 0.7% of GDP are required. The economy continued to deliver relatively strong growth, still driven by net exports. Our baseline scenario includes a gradual slow-down of GDP growth in coming quarters backed by lower demand in the euro zone (in 2012) and the government's austerity package (in 2013). But to the extent that the fiscal package is not business friendly, it is expected to postpone the recovery of both private investments and household consumption. The lower attractiveness of country as an investment destination should be reflected in slower FDI. A record high FT surplus is expected to shrink only with a recovery in domestic demand (2014).

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

KEY DATES/EVENTS

- 9 Oct, 9 Nov, 10 Dec – Industrial production
- 12 Oct , 12 Nov, 12 Dec – CPI
- 15 Nov – flash GDP
- 6 Dec – GDP and its structure

NET EXPORT AS MAIN GROWTH DRIVER OF SLOVAK ECONOMY



INFLATION ACCELARATING DRIVEN BY FODD

Source: Statistical Office SR, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2010	2011	2012F	2013F	2014F
GDP (EUR bn)	65.7	69.1	71.5	74.1	77.8
Population (mn)	5.4	5.4	5.4	5.4	5.4
GDP per capita (EUR)	12,105	12,716	13,165	13,635	14,320
Real economy yoy (%)					
GDP	4.2	3.3	2.3	2.1	3.3
Private Consumption	-0.8	-0.4	-0.3	-0.1	0.9
Fixed Investment	12.4	5.7	-1.0	0.5	3.0
Public Consumption	1.1	-3.5	-0.5	-1.5	3.5
Exports	16.5	10.8	6.2	4.8	7.6
Imports	16.3	4.5	4.0	3.2	7.9
Monthly wage, nominal (EUR)	769	786	804	830	865
Unemployment rate (%)	14.4	13.5	13.8	13.9	13.9
Fiscal accounts (% of GDP)					
Budget balance	-7.7	-4.8	-4.6	-2.9	-2.5
Primary balance	-6.9	-3.6	-2.9	-0.6	0.1
Public debt	41.1	43.3	50.9	52.0	52.0
External accounts					
Current account balance (EUR bn)	-3.1	0	0	0	0
Current account balance/GDP (%)	-2.5	0.1	1.2	1.6	1.1
Basic balance/GDP (%)	-1.9	2.3	2.5	2.5	2.6
Net FDI (EUR bn)	1.8	0	0	0	0
Net FDI (% of GDP)	0.6	2.2	1.3	0.9	1.5
Gross foreign debt (EUR bn)	49.7	52.9	55.8	60.0	62.3
Gross foreign debt (% of GDP)	75.5	76.7	78.0	81.0	80.2
Inflation/Monetary/FX					
CPI (pavg)	1.0	3.9	3.6	3.2	3.3
CPI (eop)	1.3	4.4	3.7	3.0	3.4
EURIBOR 3M	1.02	1.42	0.25	0.75	1.00
FX/USD (eop)	EUR	EUR	EUR	EUR	EUR
FX/EUR (eop)	EUR	EUR	EUR	EUR	EUR
FX/USD (pavg)	EUR	EUR	EUR	EUR	EUR
FX/EUR (pavg)	EUR	EUR	EUR	EUR	EUR

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

Economy driven by cars, expected to slow-down

Government approved first measures to cut public finance deficit.

A new left-wing government took over in March 2012 and immediately confirmed commitment to cut the budget deficit below 3% GDP in 2013. The proposed measures concentrate mostly on revenue side for now, while measures on expenditures side should be delivered only in coming years. The government and parliament have already approved several measures – an increase of corporate tax from 19% to 23% (effective 2013), a special levy for large companies in selected (regulated) sectors such as energy, communication and insurance, a change in the bank levy (the base for calculation of bank levy to be extended to include retail deposits), introduction of special bank levy for 2012 (the bank levy rate to increase by 0.01%), an increase in excise duty on tobacco (effective October 2012 instead of March 2013), progressive taxation of individual income. The government also prepared changes in the pension system, decreasing transfers to the 2nd pillar (from 9% to 4% of gross earnings), with a positive impact on the budget in the coming years. The ruling party would like to redesign the liberal labour code approved by the previous right-wing government of Radičová and to strengthen employee protection (to be approved by Parliament in September) and labour unions. As the social democrats have a safe majority in Parliament, there is no political tension for now.

Additional measures to be approved to cut deficit below 3% of GDP in 2013.

These fiscal measures are welcome to the extent that the state budget deficit (on a cash basis) reached 5.5% of GDP as of August, driven mostly by decreasing VAT collection efficiency and missing EU funds. The first proposal of 2013 budget is based on an assumption of 2.6% GDP growth. The deficit is currently projected at 3.7% of GDP but as Slovakia is obliged to narrow the budget deficit within 3% in 2013, the government decided to approve additional measures of EUR 629.3mn (not specified yet), which should be included in the final version of budget proposal. Nevertheless public debt is expected to exceed 50%/GDP (i.e. the first local "debt brake") in 2012. After that, the Minister of Finance is forced to inform the Parliament about the situation and to present proposals for the improvement. There are no sanctions yet.

Slovakia has been relatively successful on the financial markets and has already covered all financing needs for this year. The demand in scheduled primary auctions in the rest of the year will be probably accepted only in case of favorable price.

Economy continue to growth…

…driven by supply side shocks in automotive.

Fortunately and in contrast with many other economies in the region, GDP growth remains strong, gaining 0.7% qoq/2.8% yoy in Q2, driven mostly by net exports (stimulated by autos) while the domestic demand remains weak. Industrial production showed double-digit growth in 2Q12 (11.1% yoy), clearly driven by automotive (53.9% yoy), while ex-auto manufacturing declined. The dynamic growth of automotive is driven by increased production capacities (VW introduced production of small cars), reasonable mix of models (low-class – VW, mid-class – PSA, KIA, SUV – VW, KIA) and strong demand from China and USA (SUV). Growing automotive and weak domestic demand contributed to extension of the foreign trade surplus (5.6% of GDP) which is expected to shrink only with a recovery of domestic demand, probably not sooner than 2014.

Economy expected to slow-down, still driven mostly by external demand.

External demand is expected to be main driver of the growth also in 2013, while domestic demand should be inhibited by fiscal consolidation. We expect 2012 GDP growth to be at 2.3% yoy, slightly decelerating to 2.1% yoy in 2013 (supported by fiscal tightening). GDP growth is likely to remain almost jobless, keeping unemployment relatively high. Real wages are expected to decline further in 2012 and stabilize in 2013, postponing the recovery of household consumption to 2014.

CPI accelerating driven by supply factors (food and oil).

Inflation reached a bottom at 3.4% yoy in May 2012 and started to accelerate again in summer months driven by food prices (seasonal food). Demand inflation remained relatively stable slightly above 2.0% due to low household consumption (retail sales continue to decline, mainly in non-food segment). Inflation should not decelerate in coming months driven by food and oil prices moving in range of 3.6%-3.7% yoy. Food prices growth should be offset by slowing growth of regulated energy prices and still relatively weak demand-pulled inflation in 2013. Inflation is expected to slow down to 3.2% yoy in 2013.

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

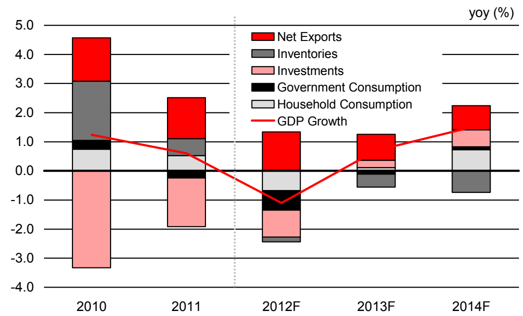
Outlook – We expect Slovenia to post a year of contraction this year, with GDP to fall 1.1% following a weak 1H, continued uncertainty on both government financing and central bank recapitalization and a slower recovery in EMU GDP. On the positive side, the current account reverted into positive territory, with a 2Q12 surplus reading of EUR 344.9mn. On the negative, we expect higher government interest expenditures and further recapitalization needs for Slovenian banks, raising our budget deficit forecasts for FY12 to -4.5% of GDP. Sovereign spreads have widened significantly in recent months. We remain on the sidelines until a full dissection of the banking sector is provided, an issue that will most likely be addressed once banking issues in Spain are resolved more comprehensively.

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

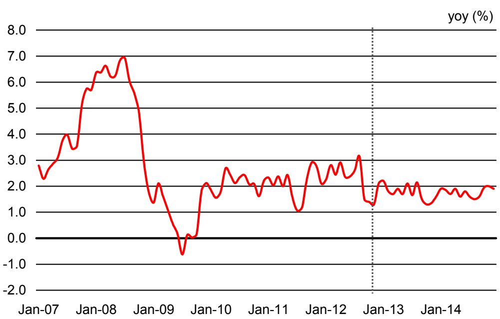
KEY DATES/EVENTS

- 28 Sep, 30 Oct, 30 Nov, 28 Dec – Consumer Price Index
- 28 Sep, 30 Oct, 30 Nov, 28 Dec – Retail Trade
- 8 Oct: Presidential Election
- 10 Oct, 9 Nov, 10 Dec – Industrial Production
- 30 Nov : 3Q 12 GDP

GDP GROWTH TO CONTRACT



INFLATION SET TO MODERATE



Source: IMF, MinFin, Eurostat, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2010	2011	2012F	2013F	2014F
GDP (EUR bn)	35.6	36.2	35.9	36.7	37.9
Population (mn)	2.0	2.1	2.1	2.1	2.1
GDP per capita (EUR)	17,381	17,628	17,497	17,895	18,491
Real economy yoy (%)					
GDP	1.2	0.6	-1.1	0.7	1.5
Private Consumption	1.3	0.9	-1.2	0.2	1.3
Fixed Investment	-13.8	-8.1	-4.9	1.4	3.2
Public Consumption	1.5	-1.2	-3.4	-0.6	0.5
Exports	10.1	7.0	2.0	5.1	5.6
Imports	7.9	5.2	0.2	4.2	4.9
Monthly wage, nominal (EUR)	1,495	1,525	1,569	1,608	1,651
Unemployment rate (%)	7.3	8.2	9.2	9.5	9.3
Fiscal accounts (% of GDP)					
Budget balance	-6.1	-6.4	-4.5	-3.7	-2.2
Primary balance	-4.5	-4.4	-2.0	-1.1	0.3
Public debt	38.8	47.6	51.8	54.3	54.8
External accounts					
Current account balance (EUR bn)	-0.2	0	0	0.2	0.3
Current account balance/GDP (%)	-0.6	0	0.1	0.5	0.8
Basic balance/GDP (%)	0.6	1.8	1.6	1.8	1.9
Net FDI (EUR bn)	0.4	0.6	0.5	0.5	0.4
Net FDI (% of GDP)	1.2	1.8	1.5	1.3	1.1
Gross foreign debt (EUR bn)	40.7	40.2	40.2	40.2	40.2
Gross foreign debt (% of GDP)	114.4	111.2	112.2	109.7	106.2
Inflation/Monetary/FX					
HICP (pavg)	2.1	2.1	2.2	1.7	1.8
HICP (eop)	2.2	2.1	2.1	1.6	1.9
EURIBOR 3M	1.02	1.42	0.25	0.75	1.00
EUR/USD (eop)	EUR	EUR	EUR	EUR	EUR
EUR/EUR (avg)	EUR	EUR	EUR	EUR	EUR

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

Weak banking sector to complicate fiscal consolidation

GDP contracts 3.2% yoy in 2Q12, the steepest decline in economic activity since 2009.

No signs of economic recovery. GDP growth in 2Q12 contracted 3.2% yoy (1.0% qoq SA). In all, this resulted in a 1.2% yoy growth drop for 1H12, highlighting Slovenia's struggle to recover since the 2008 crisis. In particular, the biggest retrenchment has come from investment spending – with gross fixed capital formation contracting by 8.9% yoy – followed by private and government consumption respectively. Particularly worrisome is the drop in exports by 0.5% yoy, as thus far it has been the primary support for GDP gains. For 2012, we expect GDP to decline 1.1% yoy, on the back of weakening EMU growth prospects and the persistence of domestic credit contraction to non-financial enterprises. Going forward, Slovenia's growth outlook remains a concern as it continues to lose world market export share and competitiveness. While it is true that the increase in real and nominal unit labour costs in Slovenia have come to a halt since 2009, there is no sign of reversal and costs still remain comparatively worse than its regional peers. On the other hand, we see the government's initiative to close part of the output gap via corporate income tax reductions and tax relief increases for R&D and investments as positive, though their impact on the economy will likely take time given the current funding constraints and still difficult external environment.

Current account surplus in 2Q – a pleasant surprise.

Annual inflation up again, current account stabilised. In August HICP rose 0.8% from July, with annual growth jumping by 3.1% yoy. By year-end we see average inflation rising to 2.2% but declining to 1.7% in 2013 due to moderate energy inflation. In both years inflation should remain below the euro-area average, forecasted at 2.4% and 1.8% in 2012 and 2013 respectively. The current account is also on an upward path, reverting from a EUR 5.8mn deficit in 1Q12 to a surplus of EUR 344.9mn in 2Q12 (or 3.8% of GDP). Looking forward, we expect the C/A to stabilise close to 0.5% of GDP, a clear improvement from the 6.2% deficit in 2008. As for its net international investment position, it stood at a negative 41.7% last year, broadly unchanged since 2009 and less than half what we see in Greece, Ireland and Spain. Moreover the construction sector has clearly adjusted, with real output down 57.1% since 2Q08.

Nonetheless, fiscal consolidation remains a challenge due to rising interest rate expenditures and weakening growth prospects.

Fiscal consolidation remains a challenge despite the supplementary budget. Last year's general government deficit peaked at 6.4% of GDP, mainly as a consequence of the EUR 459mn deficit-increasing one offs used for capital-support operations. In response, the government passed a supplementary budget of EUR 1.1bn (or 3% of GDP), with the aim of bringing the deficit to 3.5% of GDP this year and 3% by 2013. While the government's effort in strongly reducing expenditures is encouraging, we nonetheless expect the deficit to remain somewhat higher than targeted. We perceive budget deficits in 2012 and 2013 to drop to 4.5% and 3.7% of GDP respectively as weak growth prospects and increasing interest expenditures from rising debt and higher interest rate spreads on long-term government bonds are likely to persist over the forecast horizon. Public debt would thus continue its upward path, hovering close to 55% by 2014.

The banking system's need for further recapitalization is increasing the risk of further contingent liabilities crystallizing for the sovereign.

Banking sector continues to struggle. After having received EUR 250mn of a capital injection last year, Slovenian authorities estimated that NLB requires a further capital injection of up to EUR 400mn. Given KBC's refusal to participate, the sovereign expects to find another private sector buyer by year-end, yet the task is likely to prove difficult. Moreover, funding constraints for Slovenian banks persist, potentially increasing ECB liquidity reliance above the current EUR 4.1bn (8.2% of total bank assets). What's more worrying, banks' asset quality continues to deteriorate with bad loans at Slovenia's two largest banks, NLB and NKBM, soaring to EUR 2.7bn. The risk of further contingent liabilities crystallising for the sovereign is therefore present, potentially complicating even more the government's task of stabilising public debt to GDP. It is a very clear risk that recapitalization needs have been so far undersized by authorities, estimated by Moody's to range between 2% and 8% of GDP for the three largest banks. While we see those estimates as plausible, we believe that any attempt to seek EMU assistance will come only after Spain is addressed.

Bosnia Herzegovina (B3 stable/ B stable)*

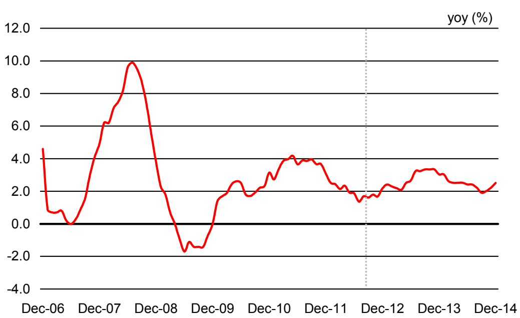
Outlook – Weak domestic with unsupportive external demand will keep the economy in recession this year, before recovering gradually in 2013. A new Stand-by Arrangement (SDR 338.2 mn) with the IMF should increase stability but events before October local elections and disagreements regarding constitutional reform increase the risk of submitting a credible application for the EU candidate status, though efforts from the international community could positively influence this. During summer, Moody's affirmed B3 rating, improving outlook to stable. A new SBA should be an anchor for the sovereign rating in the upcoming period.

Author: Hrvoje Dolenec, Chief Economist (Zagrebačka Banka)

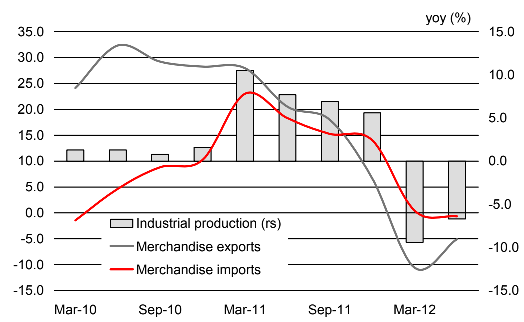
KEY DATES/EVENTS

- 25 Oct CPI and Industrial production
- 25 Nov Wages and Unemployment
- Dec 2012 External Government Debt 3Q12
- Dec 2012 Balance of payments 3Q12

CPI EXPECTED TO MODERATE



MERCHANDISE EXPORTS UNDER PRESSURE



Source: IMF, MinFin, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2010	2011	2012F	2013F	2014F
GDP (EUR bn)	12.6	13.0	13.2	13.6	14.2
Population (mn)	3.8	3.8	3.8	3.8	3.8
GDP per capita (EUR)	3,271	3,392	3,430	3,556	3,706
Real economy yoy (%)					
GDP	0.7	1.3	-0.9	0.8	1.8
Monthly wage, nominal (EUR)	622	650	663	676	692
Unemployment rate (%)	42.9	43.3	44.0	43.7	43.4
Fiscal accounts (% of GDP)					
Budget balance	-2.5	-1.2	-2.4	-2.0	-1.8
Primary balance	-1.9	-0.4	-1.6	-1.1	-1.0
Public debt	37.4	39.7	42.0	43.3	43.6
External accounts					
Current account balance (EUR bn)	-0.7	-1.1	-1.2	-1.3	-1.3
Current account balance/GDP (%)	-5.7	-8.8	-9.1	-9.7	-8.9
Basic balance/GDP (%)	-4.6	-6.5	-8.4	-8.6	-6.7
Net FDI (EUR bn)	0.1	0.3	0.1	0.2	0.3
Net FDI (% of GDP)	1.1	2.3	0.7	1.1	2.2
Gross foreign debt (EUR bn)	6.6	6.7	6.9	7.4	7.8
Gross foreign debt (% of GDP)	52.8	51.6	52.6	54.5	55.2
FX reserves (EUR bn)	3.3	3.3	3.1	3.2	3.3
Inflation/Monetary/FX					
CPI (pavg)	2.2	3.7	2.0	2.8	2.4
CPI (eop)	3.1	3.1	2.2	3.0	2.5
3M money market rate	0.57	1.18	0.40	0.46	0.95
USD/BAM (eop)	1.47	1.47	1.50	1.44	1.46
EUR/BAM (eop)	1.96	1.96	1.96	1.96	1.96
USD/BAM (pavg)	1.47	1.40	1.52	1.47	1.46
EUR/BAM (pavg)	1.96	1.96	1.96	1.96	1.96

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

New Stand-by Arrangement with the IMF as an anchor

Real GDP forecast left unchanged both for 2012 and 2013.

Real GDP forecast left unchanged: -0.9% yoy for 2012 and 0.8% yoy for 2013. The combined impacts of domestic structural weaknesses and unsupportive economic environment in Europe will push full year GDP into contraction this year. Despite the fact that the contraction in exports yoy slowed in 2Q compared to 1Q12, the timing and pace of recovery remains very uncertain. Industrial output fell by 6.7% yoy in 1H12 as a consequence of both weak domestic and external demand but one should not neglect that production capacity deteriorates in industrial sector and it needs to be extended with further investments, especially in the energy sector. 2013 should be characterized by a modest recovery in economic activity and we forecast real GDP gains next year 0.8% but the uncertain external environment implicates that forecast should remain well below potential growth.

A new SBA with the IMF for SDR 338.2 mm will be subject to approval in the following weeks.

Negotiations with the IMF have intensified – proposed amount of a new Stand-By Arrangement is SDR 338.2mn (EUR 408mn, equivalent to 3.1% of 2012 GDP), with a duration of 24 months. The IMF and BH authorities reached agreement on a new programme in July and the approval of a new SBA by the Executive Board of the IMF is expected soon after September budget rebalance for 2012 (in the Federation BH). Despite the requested amount covers only disbursed tranches from a previous SBA (SDR 338.2mn), successful completion of a new SBA will contribute to overall economic stability and mitigate pressures on the budget deficit and rising external imbalances which saw FX reserves decline 8.4% in 1H12 to EUR 3.0bn. In relation to the current dimension, budgets on the entity levels should be more investment-oriented and further boost infrastructure investments. The public debt will be defined by upcoming budget rebalance, recording upward trend from 39.7% of GDP to 42.0% in 2012, as budget deficit could increase to 2.4% of GDP this year while it is expected to decline to 2% in 2013. An increase of T-bills issuance on account of lower domestic bond issuance in Federation BH could be expected, but restrained growth of the public debt should be continued.

Inflationary pressure lower in 2012, inflation slightly to increase in 2013.

Inflation forecasts revised to 2.0% yoy (from 2.4%) for 2012 and 2.8% yoy (from 3.0%) for 2013 due to declining inflationary pressures. The summer months brought prolonged disinflation as together with decline of prices of food and clothes on one side, falling purchasing power due to limited wage growth and modest loan growth also affects domestic demand. Autumn should be marked by usual increase of administered prices with a potential increase in food and beverages prices, which account for almost 1/3 of the consumer basket. In 2013, we see moderate inflation generated by expected oil prices developments and administered prices increases.

Current account deficit forecasts are revised down due to slower decline in exports as, despite weak external demand, exports improved in 2Q qoq.

The current account deficit forecast has been revised as exports decline slower. Significant improvement was recorded in 2Q exports compared to 1Q slowing overall decline in exports. However a risk of slower recovery in EMU is influencing demand for domestic low value-added products and as a result we see a gradual widening of the C/A deficit to 9.1% (revised from 9.8%) and 9.7% (revised from 10.5%) of GDP in 2012 and 2013 respectively. In 2013, given that Croatia, the main trading partner, will exit CEFTA, foreign trade developments will be exposed to downside risks on both the export and import side.

Moody's confirmed B3 rating in July, improving outlook to stable. European Commission provides BiH with an opportunity to apply for candidate status.

Sovereign rating and EU candidate status. Moody's affirmed its B3 rating, improving its outlook to stable from negative in July, supported by negotiations with the IMF and slow but notable progress with the EU. The Brussels meeting between BH authorities and the European Commission in June offered an opportunity for the government to submit its application for EU candidate status by year end, though. October local elections and disagreements among leading parties on constitutional reform have recently put this timeline at risk.

Croatia (Baa3 negative / BBB- negative / BBB - stable)*

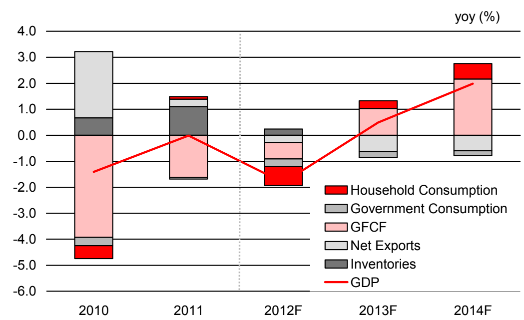
Outlook – We revise GDP forecasts for 2012 to -1.8% yoy (from -1.0%) and for 2013 to 0.5% yoy (from 1.5%). Recent fiscal consolidation measures are narrowing the budget deficit but the government has yet to place a much stronger focus on expenditures, structural reforms, privatization activities, improvement of the investment climate and unlocking of substantial external financing sources. The recent outlook revision by Fitch ratings from negative to stable is very encouraging and this, coupled with the light redemption profile of the external portion of public debt in 2013-2015, presents an opportunity to focus on delivering results from the demanding multi-year reform programme.

Author: Hrvoje Dolenec, Chief Economist (Zagrebačka Banka)

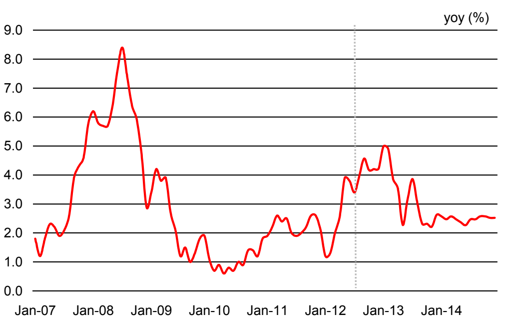
KEY DATES/EVENTS

- 28 Sep: BoP for 2Q and Foreign debt for 2Q
- 18 Oct: Full report – Labour force survey for 2Q
- 15 Nov: Government submits Budget 2013 draft to the parliament
- 30 Nov: 3Q GDP flash estimate

GDP GROWTH



INFLATION OUTLOOK



Source: IMF, MinFin, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2010	2011	2012F	2013F	2014F
GDP (EUR bn)	44.9	44.9	44.8	46.6	48.9
Population (mn)	4.4	4.4	4.4	4.4	4.4
GDP per capita (EUR)	10,158	10,205	10,211	10,632	11,187
Real economy yoy (%)					
GDP	-1.4	0	-1.8	0.5	2.0
Private Consumption	-0.9	0.2	-1.3	0.5	1.0
Fixed Investment	-11.3	-7.2	-3.0	5.0	10.0
Public Consumption	-0.8	-0.2	-1.5	-1.2	-1.0
Exports	5.2	2.0	-1.0	1.2	3.0
Imports	-1.4	1.2	-0.3	2.5	4.0
Monthly wage, nominal (EUR)	1,054	1,049	1,040	1,053	1,084
Unemployment rate (%)	11.8	13.5	15.0	14.5	13.5
Fiscal accounts (% of GDP)					
Budget balance	-4.9	-5.2	-4.3	-3.7	-2.9
Primary balance	-3.0	-2.9	-1.9	-0.8	0.1
Public debt	42.1	49.5	54.7	56.0	56.4
External accounts					
Current account balance (EUR bn)	-0.5	-0.4	-0.4	-0.8	-1.0
Current account balance/GDP (%)	-1.1	-1.0	-0.9	-1.6	-2.0
Basic balance/GDP (%)	-0.2	1.3	1.6	1.1	1.1
Net FDI (EUR bn)	0.4	1.0	1.1	1.3	1.5
Net FDI (% of GDP)	0.9	2.3	2.5	2.7	3.1
Gross foreign debt (EUR bn)	46.5	45.7	47.5	49.0	50.5
Gross foreign debt (% of GDP)	103.6	101.8	106.0	105.2	103.3
FX reserves (EUR bn)	10.7	11.2	11.8	12.4	12.9
Inflation/Monetary/FX					
CPI (pavg)	1.1	2.3	3.2	3.1	2.5
CPI (eop)	1.8	2.1	4.2	2.6	2.5
Central bank reference rate (eop)	6.00	6.00	-	-	3.00
3M money market rate	1.18	1.28	1.50	1.75	2.50
USD/HRK (eop)	5.55	5.66	5.85	5.55	5.60
EUR/HRK (eop)	7.39	7.53	7.60	7.55	7.50
USD/HRK (pavg)	5.49	5.31	5.87	5.64	5.60
EUR/HRK (pavg)	7.29	7.43	7.55	7.53	7.50

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

Focus shifts from short term to medium term agenda

Real sector developments continued to follow the trend from 1Q.

GDP in 2Q12 contracts 2.1% yoy. The flash estimate does not provide detailed information on the various components of GDP but the decline in retail sales in 2Q implies weaker personal consumption with export falling due to weaker external demand. It should also be noted that Croatia's leading oil company has lost significant revenues and production potential from its oil fields in Syria, shipyards exports have declined in anticipation of the restructuring process, steel mills have significantly reduced their production while undergoing restructuring and one of the largest chemical industry enterprises has stopped its production amidst uncertainties regarding its future. Although necessary, government expenditure cuts have reduced public consumption. On the positive side, an increase in tourist arrivals and overnight stays should result in an improved tourism contribution. Combining all of the above with a weaker EMU growth profile, we revise GDP forecasts for 2012 to -1.8% yoy (from -1.0%) and for 2013 to 0.5% yoy (from 1.5%). Looking forward, EU entry in 2013 should help accelerate the reform process and privatization activities, improve the investment climate, unlock substantial external financing sources and additionally strengthen fiscal policy.

For 2013, EU entry can serve as an accelerator for policy that should intensify reforms and privatization activites, improve investments, unlock EU financial resources and strengthen fiscal policy.

Current account outlook: In 2012, we forecast another year of very modest deficit as a result of two factors. Tourism revenues should cover most of the trade balance. Imports are under pressure due to weakening domestic demand. Net FDI inflows in 1Q were on the level of 2% of GDP as reinvested earnings accounted for a major share of FDI (EUR 0.2bn) with low equity investments, while simultaneously both debt to and claims on affiliated enterprises abroad were cut by EUR 0.3 bn and 0.2 bn, respectively. FDI inflows should remain constrained as long as uncertainties persist in financial markets and the domestic investment environment. Both the current account and fiscal deficit continue to weigh on external debt, especially in light of the USD 1.5 bn sovereign eurobond issue in April. However, despite a relatively large stock of external debt (106.1% of GDP), short term financing requirements are covered by international reserves.

Fiscal consolidation remains on track, while a new budget is in the pipeline. It should serve as an anchor for economic policy.

Fiscal policy outlook: Following a series of fiscal consolidation measures, the budget deficit in 1H has narrowed to HRK 5.8bn (33% to 1H 2011). Revenues increased by 3.4% yoy during 1H, reflecting improvements in tax compliance and increased VAT since March. Government expenditure is down by 1.8% ytd as capital expenditure and subsidies are reduced, although the wage bill rose by 1.5% yoy and social security transfers and pensions by 1.0%. In an effort to tackle expenditure, the government has concluded negotiations with civil sector unions, while negotiations with public sector unions are scheduled to be concluded over the coming weeks. These aim at reducing the wage bill for 2H12 and 2013. The government continues to also target reductions in subsidies and has made progress with regards to shipyards subsidies, although their restructuring and privatization is expected to add a one-off 2.7pp to public debt to GDP this year. More focus must be placed on subsidies in the agriculture and railways sectors. The 2013 budget will be a key test for the government as it should incorporate both expenditure reductions and broader structural reforms, including labour market reforms. The fiscal responsibility law stipulates that expenditures, representing 42% of GDP, must decline by 1pp every year until a primary balance surplus is achieved.

Current monetary policy settings remain unchanged.

Monetary policy outlook: Monetary policy continues to operate in the established setup where exchange rate stability is preserved. So far, monetary relaxation seems not to be an option as long as fiscal sustainability in the medium term is not ensured. However, it is expected that monetary policy will become supportive if reforms and investment activities accelerate.

Meeting fiscal targets and reforms to return GDP to sustainable path presents key rating drivers.

Sovereign credit rating outlook: The Fitch rating agency improved its outlook from negative to stable, while still keeping Croatia only one notch within investment grade. Fitch praised short term measures developed to address fiscal challenges. Expenditure reductions, structural reforms and compliance with the fiscal responsibility law will be the key rating driver in a short term, but the recovery of GDP growth through reforms will be observed in the medium term.

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

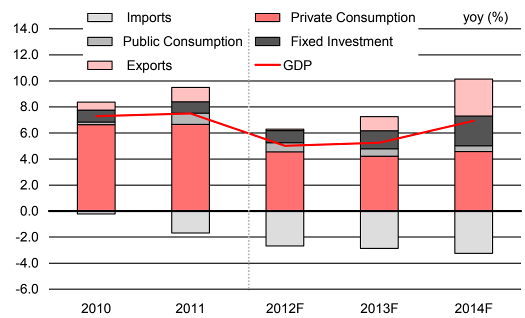
Outlook – Real GDP growth slowed to 5.6% yoy in 1H12 from 7.5% yoy in 2011. We expect it to decelerate further to 5% for 2012 as a whole because of sluggish industry and decelerating income growth. Fiscal policy has been supportive of growth in 2012. It is planned to be tightened over 2013-15 but we believe that more Oil Fund money might be counter-cyclically transferred to the budget to stimulate growth. Higher oil and metal prices and production should help support GDP growth of 5.2% in 2013 and 6.9% in 2014. With the basic balance in surplus and inflation on the rise, we don't expect the central bank to allow severe KZTUSD weakening while there is also little room for appreciation given that the trade-weighted inflation adjusted fx-rate has reached levels seen last time in June 2010 and September 2008.

Author: Hans Holzhacker, Chief Economist (ATF Bank)

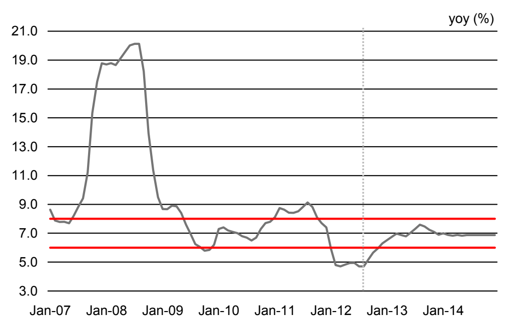
KEY DATES/EVENTS

- Agreement (or final disagreement) with BTA's foreign creditors on second debt restructuring, 2H12
- Launch of Kashagan's oil production, early 2013, but we assume only at small scale
- WTO entry, early 2013

CONTRIBUTION BY CONSUMPTION TO GROWTH TO DECREASE, BY INVESTMENT TO INCREASE



INFLATION TO RETURN TO TARGET – FROM BELOW



Source: ASRK, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2010	2011	2012F	2013F	2014F
GDP (EUR bn)	111.5	133.9	157.8	167.6	188.9
Population (mn)	16.4	16.6	16.7	16.9	17.0
GDP per capita (EUR)	6,781	8,072	9,430	9,926	11,083
Real economy yoy (%)					
GDP	7.3	7.5	5.0	5.2	6.9
Private Consumption	10.9	11.0	7.5	7.0	7.5
Fixed Investment	3.8	3.6	3.9	5.8	9.4
Public Consumption	2.7	11.3	9.2	7.3	5.8
Exports	1.9	3.5	0.3	3.4	8.9
Imports	0.9	6.9	11.0	11.7	13.3
Monthly wage, nominal (EUR)	397	441	540	576	647
Unemployment rate (%)	5.8	5.4	5.3	5.2	5.0
Fiscal accounts (% of GDP)					
Budget balance	3.0	6.1	5.5	5.0	6.3
Primary balance	3.5	6.8	6.3	5.8	7.2
Public debt	14.8	12.4	12.8	13.5	14.2
External accounts					
Current account balance (EUR bn)	3.3	10.1	10.4	8.2	9.9
Current account balance/GDP (%)	2.9	7.6	6.6	4.9	5.2
Basic balance/GDP (%)	9.5	14.5	12.4	10.2	9.9
Net FDI (EUR bn)	7.4	9.3	9.2	8.8	8.7
Net FDI (% of GDP)	6.6	6.9	5.8	5.3	4.6
Gross foreign debt (EUR bn)	86.9	91.8	99.3	101.2	108.0
Gross foreign debt (% of GDP)	77.9	68.5	62.9	60.3	57.2
FX reserves (EUR bn)	20.8	22.2	28.2	29.4	31.2
Inflation/Monetary/FX					
CPI (pavg)	7.1	8.3	5.2	7.1	6.9
CPI (eop)	7.8	7.4	6.3	6.9	6.9
Central bank target	7.0	7.0	7.0	7.0	7.0
Central bank reference rate (eop)	7.00	7.50	6.00	6.00	6.50
3M money market rate	2.03	1.79	2.23	3.76	4.92
USD/KZT (eop)	147	148	150	151	152
EUR/KZT (eop)	195	192	194	205	203
USD/KZT (pavg)	147	147	149	150	151
EUR/KZT (pavg)	196	204	192	201	203

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

More oil money likely put to domestic use to prop up growth

GDP growth has slowed due to weak industry, particularly oil and metals.

Oil extraction grows only very slowly. Kashagan's production begin has been again delayed (realistically until after the winter at earliest) due to technical difficulties and haggling over the redistribution of power among the consortia companies.

Growth in real GDP slowed to 5.6% yoy in 1H12 from 7.5% in 2011 as growth in manufacturing eased to 4.4% yoy from 7.5%. Value added in mining contracted 0.2% yoy in 1H12 after mediocre growth of 1.0% in 2011. Oil extraction (84% of mining, 54% of industry in value terms) remained flat after increasing only +0.5% in 2011. Consumption-driven industries such as food, apparel, furniture held up well, but the output of ferrous metals (17% of manufacturing) slumped 11.0% yoy in Jan-July and the output growth of non- ferrous metals (24% of manufacturing) slowed to 3.0% yoy from 8.2% in 2011. Value added in services, in stark contrast to manufacturing, grew at 8.9% only marginally less in 1H2012 than in 2011 (9.0%), mainly thanks to trade.

Exports and FDI also somewhat weaker in 2Q12.

This weakness was captured in exports. In 2Q2012, exports (BoP) fell 2.1% yoy in USD terms vs a rise of 30.9% yoy in 1Q. Oil exports were down 9% yoy in 2Q to USD 14.9bn on 18% lower shipments (17mn tons), though from on all time high in 2Q2011. This narrowed the trade surplus to USD 13.4bn in 2Q from USD 14.7bn a year earlier, but left the overall 1H surplus at USD 25.3bn, above the USD 24.0bn of 1H 2011. The current account was USD 4.0bn in surplus in 2Q vs USD 5.3bn a year earlier, but unchanged at USD 7.6bn in 1H. Net non-resident FDI decreased to USD 6.9bn in 1H2012 from USD 7.8bn in 1H2011.

Incomes and employment have nevertheless held up well (so far) but…

...company finances are already affected.

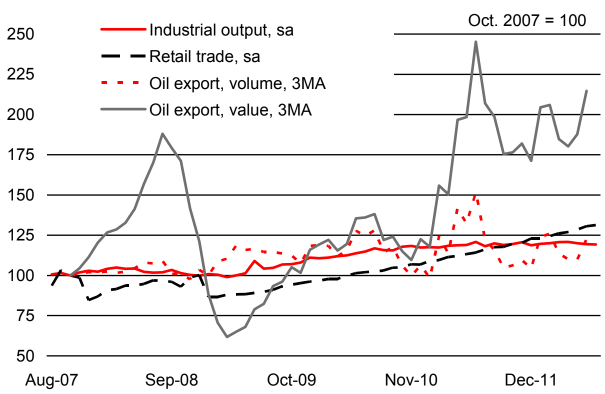
The slow-down in production has not yet negatively affected income growth and employment. Real incomes per capita grew 9.2% yoy in 1H12 (to KZT 50.6th, EUR 270 per month in June). Real wages were 13.3% higher in June 2012 than 12 months earlier thanks to public sector wages but also an 11% yoy increase in industry. Employment was at 8.5mn, 3.9% higher than a year earlier in 2Q12. The share of "self-employed" (more often underemployed) fell to 31.9% from 33.0%. Finances of companies have, however, begun to deteriorate. The pretax profit of large and medium enterprises was 9% lower than a year earlier in May-July as profits in mining (73% of the total) fell 6% yoy and in manufacturing (9% of the total) 30% yoy. Construction did a bit better than last year, but profits in trade and transportation have also begun to decline.

Investment (in mining) continues to fall short of our hopes.

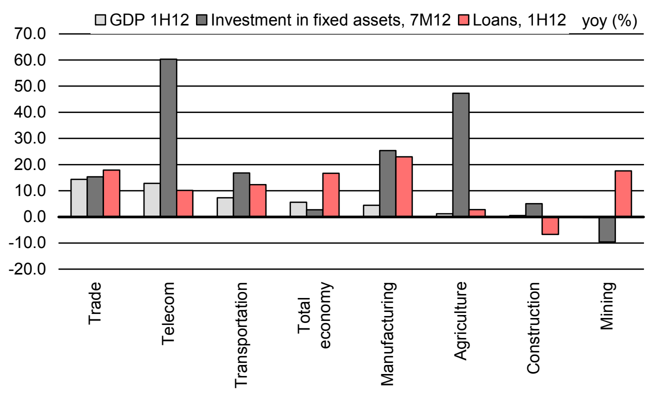
Though non-mining investment did relatively well, constant price investment outlays rose only 2.7% yoy in Jan-July 2012, just marginally up from 2.4% in 2011. Investment in manufacturing (11% of the total) was up 25.4% yoy, in the power industry (7%) 8.6% yoy and in transportation (18%) 6.8% yoy. Agriculture (3%) saw investment outlays grow 47.3% yoy. However, investment in mining, 1/3 of total, fell another 10% yoy, after a 10% decline in 2011.

OIL PRICES & CONSUMPTION DRIVE GROWTH SINCE 2011

Industrial output, retail trade vs oil exports in volumes and prices



GDP, investment and loan growth by sectors



Source: ASRK, NBRK, UniCredit Research

Government spending increased substantially, thus supporting growth.

The overall fiscal surplus has nevertheless remained unchanged thanks to oil revenues but should narrow slightly until year-end.

The fiscal surplus is likely to narrow but stay high. State budget (central+local) expenditures rose 20.7% yoy (15% yoy in real terms) in Jan-July 2012. Revenues increased 17.2% yoy, though tax revenues (63% of revenues) were up only 5.0% because of high tax refunds. This was offset by higher non-tax revenues and a 35.2% increase in transfers from the Oil Fund (30% of revenues). The deficit widened to 1.5% of GDP from 0.7% a year earlier. Oil Fund revenues increased 31.6% yoy (in KZT) in Jan-July, its surplus to 6.1% of GDP from 5.3%. The overall fiscal surplus thus remained unchanged from a year earlier at 4.6% of GDP. We expect a 5.5% of GDP surplus for 2012 as a whole, somewhat below the 6.1% of 2011, when tax collection in 2H was very high.

Probably more Oil Fund money will be put to domestic use.

The government's oil price forecast is 90 USD pb for 2013, our own 120 USD.

To what extent will oil revenues be used to support the budget? We believe that in the face of a slowdown in growth, more Oil Fund money than currently budgeted might be used domestically under the new rule which allows USD 8bn +/- 15% in transfers to the budget and upcoming budget legislation changes allowing "conditional expenditures", i.e. countercyclical budget policy. FX-reserves and Oil Fund foreign assets cover more than 2 years of (goods) imports or of state spending, are more than M3 and almost equal to total net banking assets. The Ministry of Economic Development and Trade foresees a gradual narrowing of the state budget deficit from 2.5% of GDP in 2012 (we expect rather 1.5% of GDP) to 1.0% of GDP in 2015 while transfers from the Oil Fund would shrink to KZT 1188bn from KZT 1380bn in 2012. This is based on an oil price of USD 90 pb and a fall in metal prices by 15% from current levels. State budget expenditures would shrink to 15.8% of GDP in 2015 from 21.7% in 2013, the non-oil deficit narrow to 3.4% of GDP from 6.9% in 2012, the assets of the Oil Fund rise to over USD 100bn by 2015 from currently USD 53bn.

Monetary conditions have tightened a bit as money growth has slowed and the real effective fx-rate became stronger.

With inflation set to accelerate, no new rate cut is likely however.

Rate cut, probably the last for a while. Money supply has slowed in 2012 in line with growth in net foreign assets. Growth in M3 decelerated to 8.6% yoy in July from 15.0% yoy at end-2011. The 3M KazPrime finally has begun to move a bit since end-July and rose to 2.55% at the end of August from 2.00%, where it basically stood since May 2010. Inflation eased to 4.7% yoy in July and August, significantly below target (6%-8%). The NBRK cut its 1W refinancing rate another 50bp to an all-time low of 5.5% as of 6 August 2012 in response, after 50bp decreases in June and April 2012. However, higher food prices and hikes of utility tariffs in autumn will bring back inflation pressures. We expect inflation to remain within target thanks to sufficient grain inventories and close price monitoring by the authorities, but believe that a 50 or 100bp hike in the NBRK's 1W refinancing rate in 4Q is quite likely.

Resolving banking problems has remained slow. Credit supply seems able to meet credit demand for now, but longer term more progress is needed.

The cleansing of the balance sheets of banks and companies has remained slow although the "Problem Asset Fund" has become operative. In the short run, smaller banks with lower NPL ratios, eager to gain market shares, will likely provide sufficient credit to meet the rather sluggish credit demand of the current business cycle phase. Credit to residents was 14.8% higher in June than the year before (15.6% yoy corporate, 14.1% retail). Credit to manufacturing and transportation, to some extent drivers last year, grew more slowly YTD. New credit has mostly been extended to households and various services. Client deposits rose 13.5% yoy (6.2% yoy corporate, 25.9% retail). Longer term, more cleansing and funding will be needed to finance the non-resources sector.

Corporate governance might improve, if the "Peoples IPOs" accompanies reform of the Samruk-Kazyna state holding.

In terms of structural reforms, an overhaul of industrial relations and corporate governance is on the agenda. President Nursultan Nazarbayev called in a speech on 10 July 2012 for "social modernization", likely an echo to oil workers' and other's strikes this year and last. A concept is to be worked out by the government and the ruling Nur Otan party by April 2013, including new relations between the private sector, the government and the trade unions. In August, the government approved a strategic reform plan for the Samruk-Kazyna state holding, which foresees the shedding of non-core assets and cutting the number of board members while increasing the share of independent directors. Samruk-Kazyna will also organize a council of trade unions and develop a "Social Stability Map".

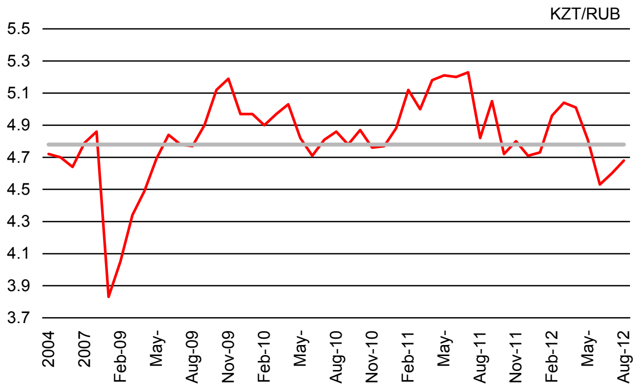
Strategy: Are the NDFs right?

The likelihood of KZT weakening beyond 150 to the USD has increased.

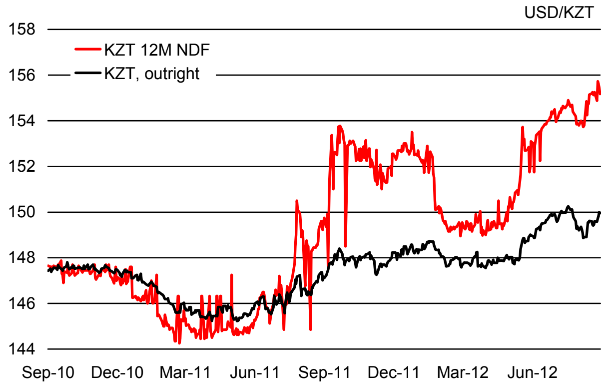
We believe however that the KZT will not follow the RUB fully and that the NDF implied fx-rate is over-pessimistic.

12M NDFs imply a USDKZT of higher than 155 in late 2013. Given our RUB forecast and keeping the RUBKZT at current levels the KZT would approach 157 to the USD eop 2013. We believe both numbers are too high, given that Kazakhstan's current account surplus together with non-resident FDI inflows is likely to reach almost 10% of GDP. We expect oil prices to rise to 120 (Brent) in 2013. On the other hand, the trade weighted inflation-adjusted foreign exchange rate, an indicator closely watched by the central bank, has strengthened in June 2012 due to EUR and RUB weakness to levels seen last in June 2010 and before in September 2008 (i.e. a few month before the February 2009 devaluation). The threat of re-accelerating inflation due to the drought globally and partially also in Kazakhstan vs the high real effective fx-rate poses a policy dilemma. A strong KZT would help keep import prices and inflation expectations low, but further erode competitiveness. After intervening to support KZT in June and July, the NBK bought FX in August. The likelihood that the NBRK will allow fluctuations to above 150 to the USD has however increased. We expect some weakening of the KZT, substantially less though than that of the RUB.

The KZT rarely deviates much from the RUB for a long time



12 M NDFs imply significant KZT weakening



Source: NBRK, Bloomberg, UniCredit Research

GOVERNMENT GROSS FINANCING REQUIREMENTS

KZT bn	2011	2012F	2013F
Gross financing requirement	**851.0**	**694.3**	**786.2**
Budget deficit*	576.0	518.0	572.0
Amortisation of public debt	275.0	176.3	214.2
Financing	**851.0**	**694.3**	**786.2**
Borrowing**	779.9	870.0	800.0
Other	71.1	-176.7	-13.8

*Republican budget

**Of this, less than one-tenth external, we estimate

Source: MinFin, NBRK, UniCredit Research

GROSS EXTERNAL FINANCING REQUIREMENTS

USD bn	2011	2012F	2013F
Gross financing requirement	**-1.7**	**-1.9**	**-2.0**
C/A deficit	-14.1	-13.2	-10.6
Amortisation (loans)	12.4	11.3	8.6
Government/central bank	0.1	0.3	0.3
Banks	4.0	2.3	2.2
Corporates	8.3	8.7	6.2
Financing	**-1.7**	**-1.9**	**-2.0**
FDI (non-resident net)	12.9	11.6	11.4
Equity	0.04	0	0.1
Borrowing (loans)	13.1	11.8	10.5
Government/central bank	0.8	0.5	0.5
Banks	2.0	1.5	2.0
Corporates	10.3	9.8	8.0
Other (resident FDI, portfolio, lending, reserves)	-27.7	-25.3	-24.0

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

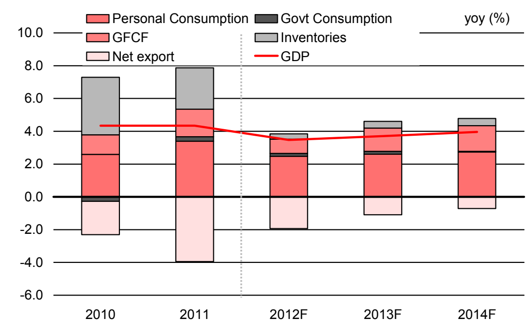
Outlook – Despite joining the WTO in the summer and considerable political noise, economic developments dominate the debate. Oil price volatility in 2Q12 re-ignited discussions on whether or not the Russian economy had a sufficient cushion against external shocks. GDP growth slowed to 2.6% yoy in July (vs. 4.9% yoy in 1Q12) and inflation now exceeds the upper bound of the CBR's target for this year at 6%. These challenges should be eased by a combination of CBR policies, institutional changes and fiscal policy efforts. Indeed the CBR has already made progress, significantly increasing RUB flexibility and building credibility on its inflation targeting framework. But much remains to be done on institution building and reducing the reliance of the budget on oil. We expect the CBR to hike interest rates by another 50bp this year.

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

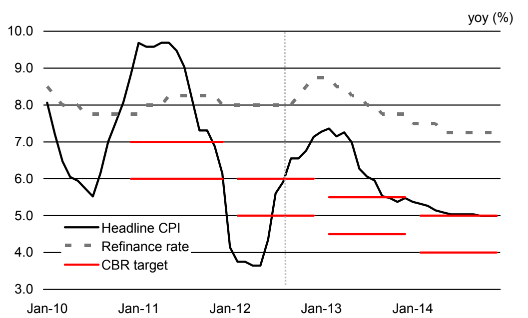
KEY DATES/EVENTS

- 18th-22th of each month – Monthly indicators
- 1st half of every month – CBR decision on rates
- October – budget for 2013-2015 is passed to State Duma

DOMESTIC DEMAND DRIVES THE ECONOMY



INFLATION INCREASES PRESSURE TO KEEP INTERESTS RATES HIGH



Source: Federal Statistical Service, CBR, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2010	2011	2012F	2013F	2014F
GDP (EUR bn)	1,102.0	1,335.5	1,530.0	1,694.1	1,816.7
Population (mn)	142.9	143.1	142.9	142.7	142.5
GDP per capita (EUR)	7,714	9,336	10,710	11,875	12,753
Real economy yoy (%)					
GDP	4.3	4.3	3.5	3.7	4.0
Private Consumption	5.1	4.8	4.8	5.0	5.2
Fixed Investment	6.2	5.2	4.0	6.5	7.0
Public Consumption	0.7	-0.1	1.0	1.0	0.2
Exports	11.1	2.2	2.5	2.5	2.1
Imports	25.4	7.5	11.8	7.5	5.3
Monthly wage, nominal (EUR)	518	580	675	714	789
Unemployment rate (%)	7.5	6.6	6.0	5.8	5.8
Fiscal accounts (% of GDP)					
Budget balance	-6.6	0.8	-0.3	-0.5	-0.2
Primary balance	-5.8	1.3	-0.2	-0.3	0.0
Public debt	8.3	9.8	10.2	11.0	11.6
External accounts					
Current account balance (EUR bn)	55.9	79.5	62.6	30.4	13.6
Current account balance/GDP (%)	5.1	6.0	4.1	1.8	0.7
Basic balance/GDP (%)	4.2	4.8	3.3	1.1	0.5
Net FDI (EUR bn)	-9.8	-11.8	-12.7	-11.3	-4.2
Net FDI (% of GDP)	-0.9	-1.2	-0.8	-0.7	-0.2
Gross foreign debt (EUR bn)	356.3	424.3	474.3	515.9	559.7
Gross foreign debt (% of GDP)	32.3	31.8	31.0	30.5	30.8
FX reserves (EUR bn)	358.2	384.7	397.0	378.7	369.4
Inflation/Monetary/FX					
CPI (pavg)	6.9	8.6	5.2	6.3	5.1
CPI (eop)	8.8	6.1	7.1	5.5	5.0
Central bank target	8.5	8.0	8.8	7.8	7.0
Central bank reference rate (eop)	5.00	5.25	6.00	5.50	5.00
3M money market rate	4.00	6.60	6.90	6.50	5.75
USD/RUB (eop)	30.7	31.3	30.6	32.2	32.8
EUR/RUB (eop)	40.8	41.7	39.8	43.8	43.9
USD/RUB(pavg)	30.4	29.2	30.9	30.4	31.5
EUR/RUB (pavg)	40.4	40.9	39.8	40.6	42.2

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

Policy measures not enough to support growth

Many economic indicators started to demonstrate considerable weakness in 2Q…

Russian economic and social conditions in 1H12 changed considerably. Russia joined the WTO in the summer while political noise was plentiful as the opposition tried to make its mark but the economy continued to dominate. In particular, the volatility of the oil price in 2Q12 brought a new round of discussions on whether the Russian economy was adequately protected from external shocks or if additional measures were necessary. These discussions were triggered by weakness across a number of indicators. From 4.9% yoy in 1Q12, GDP growth slowed to only 2.6% yoy by July. The slowdown was broad based: industrial production in 1Q was 4.0% yoy but in 1H12 only 3.1%. Fixed investment grew at a high two-digit pace in January-March at 16% yoy but in 2Q at only 6.7% while by July, the figure fell to 3.8% yoy. The high base effect will not permit a significant improvement later this year. As a result we reduced our forecast for economic growth of Russia this year by 0.2pt to 3.5%.

…while inflation is accelerating due to food prices and tariff hike. The CBR's FY12 target for inflation of 5-6% will not be achieved.

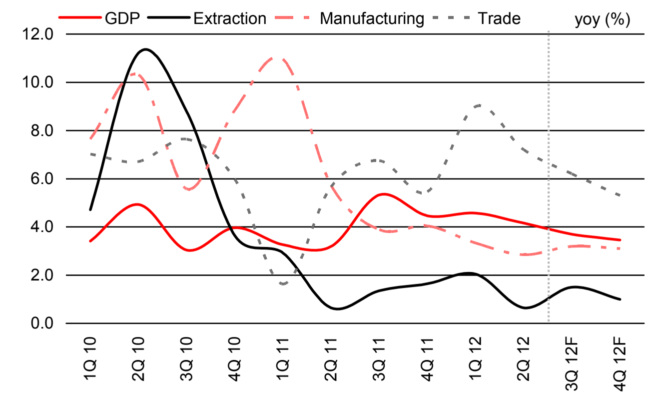
Inflation dynamics also changed. Although a significant decrease in the headline indicator was widely expected in 1H12 due to a 6 month delay in tariff hikes, a fall to less than 4% was positive for many real indicators. However, as soon as tariffs were raised, the annual figures went back to their "ordinary" levels. Moreover, a drought in Russia and poor agricultural output elsewhere globally created significant pressure on food prices. According to our calculations, growth of different world food price indices affects Russian food inflation with a one or two month lag and the pressure will last for several consecutive months. As a result, the CBR is unlikely to achieve the targeted level of inflation (FY12 at 5-6%). The Ministry of Economic Development forecasts inflation for this year at 7% (UniCredit: 7.1% yoy).

Oil-driven RUB became even more volatile, in medium term factors seem to be negative for the currency.

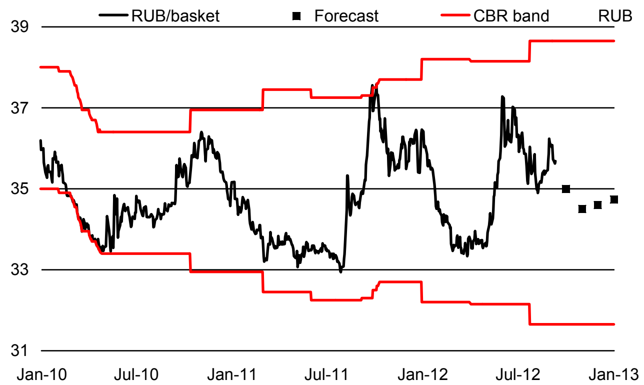
RUB depreciation in 2Q was mainly driven by weak commodity prices, and the local currency lost about 10% of its value to the bi-currency basket, returning RUB to close to where it started the year. Although imports are likely to accelerate as usual in 2H, a search for yield on the back of G7 liquidity provision, a hawkish CBR stance and the expected introduction of Euroclear for state securities (OFZ) might attract capital into Russia, despite outflows from locals. However, weak fundamentals on the real side of the economy and seasonal factors would not allow for sustainable appreciation over a multi quarter horizon. Our projected value for the RUB basket at year-end is 34.7, which implies RUB/USD at 30.6. Although the correlation of oil price and RUB increased from circa 30% in 1Q12 to more than 65% in 3Q12, the high oil price was not enough to drive RUB upwards automatically as physical volumes of exports were falling.

ECCONOMIC INDICATORS TURN LESS OPTIMISTIC IN 2H12 WHILE CURRENCY BECAME MORE VOLATILE

Growth indicators are slowing down…



…but RUB flexibility increasingly acts as a stabilizer



*Represent sectors covering about 70% of GDP

**Shifted by 45 days.

Source: Rosstat, Bloomberg, CBR, UniCredit Research

The CBR continued its policy of increasing the degree of freedom for the RUB. Now if the shocks in oil prices are temporary, federal budget revenues are safer.

From a structural perspective, we are encouraged by the CBR's actions to continue to increase RUB flexibility, providing the economy with a more credible adjustment mechanism in the face of a global slowdown in economic activity. In July it widened the bi-currency basket corridor to 7 RUB (one year ago this stood at 5 RUB) and reduced by 10% (to USD 450mn) the amount of interventions required before it shifts this corridor. This sort of increased RUB flexibility provides a cushion for the budget against a decline in the oil price. Monthly revenues averaged USD 33.4bn per month, with 2Q revenues exceeding those of 1Q by 10%, despite a 20-25% decrease in the oil price.

The CBR also forced banks towards a more comprehensive management of short term liquidity. While initially many market participants were skeptical about the increasing maturity of repo operations with the CBR from o/n to 1 week, this materialized. In 1Q overnight and 1 week facilities were used in similar volumes (RUB 36bn vs. RUB 58bn), while in 3Q banks mostly relies on weekly money (RUB 102bn vs. RUB 1034bn, respectively). Apart from improving liquidity management on the micro level, this also helps to develop local money market.

CBR might stay committed to its inflation target but this might strongly hurt the real economy.

Unfortunately, inflation rising to levels above the CBR's target reduces the scope for accommodative monetary policy, despite a slowdown in real economy indicators. Indeed, the CBR raised its targeted rates at its last meeting in September by 25 bp, pushing the refinancing rate to 8.25%. The CBR also left the door open to further hikes as inflation is likely to reach its peak in early 2013 at 7.3%, 100pb higher than its current rate. We expect the regulator to try to reduce the pace of lending, which is expanding by more than 23% yoy. We expect that it will hike its targets by an additional 50bp this year but we doubt that the hiking cycle extends beyond this year.

Fiscal performance demonstrated a considerable improvement: the government consumption path is smoother than in the past, and the budget rule should improve policy credibility

Turning to fiscal performance, in 1H12 it demonstrated a considerable improvement compared to previous years. Revenues rose by 17% yoy, broadly in line with government expectations. Monthly expenditures as proportions of total budget for the year exceeded averages for the last five years, demonstrating a smoother government consumption path. This implies higher spending discipline and lower inflation pressure later in the year. However, there is more news to come from this sector in the next few months. The government approved the introduction of the budget rule, which implies that expenditures of the federal budget would be closely linked with revenues and the latter would be calculated on the basis of the 10-year oil price average. This rule would start effectively working in 2015-2018. Additionally, the government is preparing a draft budget in case of a severe global economic and financial crisis, assuming an oil price of USD 60 p/b, and a significant drop in economic activity. This document is to become a part of the Budget Law, and is intended to be used as a rule in case the adverse scenario occurs in the next three years.

We are moderately positive on Russia in 2013-2014, with some acceleration to come on the basis of institutional developments, including WTO accession.

On the basis of our analysis, we expect that internal demand will be a key economic driver for Russia in 2012-2014. For the next few quarters, it is household demand which will determine growth dynamics, with investment activity being subdued until 2H13. Apart from fewer political and external risks, we expect that a set of measures aimed at improving the institutional environment for doing business in Russia will be in place within 1 year. For instance, realization of projects of the National Entrepreneurial Initiative in customs administration, power supply, export support and other spheres has accelerated. According to our estimates, as compared to the last report of the World Bank (Doing Business 2012), Russia's ranking improved by 30 positions from 160th place in customs, by 6 positions (from 183rd) in power supply, etc. This, together with the WTO accession, will provide businesses with an incentive to improve efficiency. Moreover, despite the difficulties in targeting Russian headline inflation (particularly, administratively set tariffs and the high influence of monopolistic prices), next year we see a reasonable chances that the CBR will achieve its medium-term inflation targets. A high base effect of 2012 and a continuation of non-expansionary policy will support that goal.

Looking ahead to euroclear

Top Russian officials from the Federal Securities Markets Service and Finance Ministry have indicated that foreign investors will get a better access to Russian OFZ market already in 3Q12. This improvement would be based on a permission to provide clearing granted to Euorclear and Clearsteam. At the moment applications and all related documents are being analysed by the Service for almost a month (the maximum period allowed for consideration is 2 months). However, documents necessary to register the Central Securities Depository as an institution are behind the projected timeline for several months, and available procedures allow at least 3 more months period for consideration of this issue in different authorities. We think that access for Russian securities markets would be eased for foreign investors in late 2012.

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2011	2012F	2013F
Gross financing requirement	**34.3**	**40.8**	**49.9**
Budget deficit	-10.7	4.6	8.5
Amortisation of public debt	10.5	16.6	18.4
Domestic	7.3	14.8	16.8
Bonds	7.3	14.8	16.8
Bills	-	-	-
External	3.2	1.8	1.6
Sovereign Fund	34.4	19.6	23.0
Financing	**34.3**	**40.8**	**49.9**
Domestic borrowing	33.7	35.6	45.0
Bonds	33.7	35.6	45.0
Bills	-	-	-
External borrowing	0.6	5.1	5.0
Bonds	0.6	5.1	5.0
Other			

Source: MinFin, CBR, UniCredit Research:

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2011	2012F	2013F
Gross financing requirement	**-22.7**	**-2.9**	**29.6**
C/A deficit	-79.5	-62.6	-30.4
Amortisation of medium to long term debt	46.8	47.6	50.4
Government/central bank	3.2	1.8	1.6
Banks	18.80	17.20	19.00
Corporates	24.80	28.60	29.80
Errors and omissions	9.99	12.11	9.58
Financing	**-22.7**	**-2.9**	**29.6**
FDI	20.8	19.8	22.6
Equity	-	-	-
Borrowing	64.6	64.1	66.8
Government/central bank	0.6	5.1	5.0
Banks	23.2	23.0	21.7
Corporates	40.8	36.0	40.2
Other	-	-	-
Domestic investments abroad	-134.6	-99.0	-41.5
Official reserves change / other	26.6	12.2	-18.3

Serbia (BB- negative / BB- negative)*

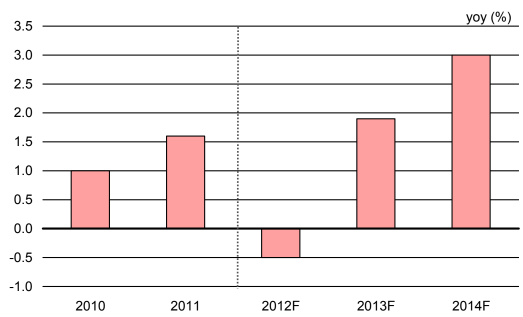
Outlook – Our GDP forecast for 2012 has been revised downwards by 0.7pp to -0.5% on the back of weaker foreign demand and a poor agricultural season. While we remain confident that the new government's supplementary budget will cap this year's deficit within 7% of GDP, we nonetheless see the authorities' target of 4% by FY13 as challenging. Moreover, we do not rule out further rate hikes or FX intervention by the NBS to support the RSD over the forecast horizon. On the positive side, the C/A should benefit from Fiat's production plan, estimated by the NBS to add 2pp to real GDP in 2013.

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

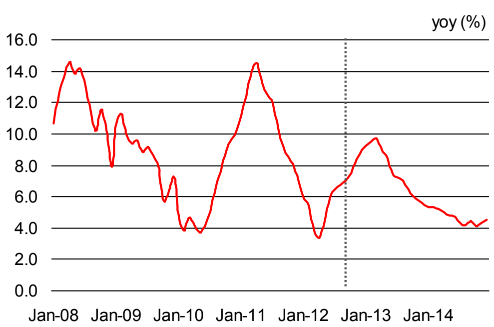
KEY DATES/EVENTS

- 28 Sep: 2Q12 GDP (final)
- 31 Oct, 28 Dec: 3Q12 GDP (prelim., final)
- 28 Sept, 31 Oct, 30 Nov, 28 Dec – Retail Trade
- 28 Sept, 31 Oct, 30 Nov, 28 Dec – Industrial Production
- 12 Oct, 13 Nov, 12 Dec – Consumer Price Index

GDP GROWTH TO CONTRACT MODERATELY



INFLATION SET TO PEAK IN 1H13



Source:National Stat Office, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2010	2011	2012F	2013F	2014F
GDP (EUR bn)	28.0	31.1	31.0	32.0	33.0
Population (mn)	7.5	7.6	7.6	7.6	7.6
GDP per capita (EUR)	3,735	4,116	4,088	4,205	4,338
Real economy yoy (%)					
GDP	1.0	1.6	-0.5	1.9	3.0
Monthly wage, nominal (EUR)	461	518	526	532	546
Unemployment rate (%)	19.2	23.0	25.5	25.8	24.3
Fiscal accounts (% of GDP)					
Budget balance	-4.7	-5.0	-6.7	-4.5	-3.5
Primary balance	-3.5	-3.4	-5.1	-3.0	-2.1
Public debt	43.4	44.6	53.1	57.7	55.9
External accounts					
Current account balance (EUR bn)	-2.1	-2.7	-3.3	-2.6	-2.7
Current account balance/GDP (%)	-7.4	-8.7	-10.7	-8.1	-8.2
Basic balance/GDP (%)	-4.4	-2.9	-9.3	-4.3	-3.7
Net FDI (EUR bn)	0.9	1.8	0.4	1.2	1.5
Net FDI (% of GDP)	3.1	5.9	1.4	3.8	4.5
Gross foreign debt (EUR bn)	23.8	24.1	25.0	28.0	27.0
Gross foreign debt (% of GDP)	84.9	77.5	80.6	87.5	81.8
FX reserves (EUR bn)	10.0	12.1	10.0	10.0	10.0
Inflation/Monetary/FX					
CPI (pavg)	6.2	11.2	6.3	7.6	4.7
CPI (eop)	10.3	7.0	9.0	5.5	4.5
Central bank target	6%±2%	4.5%±1.5%	4.0%±1.5%	4.0%±1.5%	4.0%±1.5%
Central bank reference rate (eop)	11.50	9.75	10.75	9.75	9.00
BELIBOR 3M	10.72	12.88	11.67	11.75	11.40
USD/RSD (eop)	79.3	78.7	86.2	86.8	91.0
EUR/RSD (eop)	105	105	112	118	122
USD/RSD (pavg)	77.6	72.8	84.2	86.1	89.6
EUR/RSD (pavg)	103	102	108	115	120

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

Turning a corner at last

GDP growth forecast for FY12 is reduced by 0.7pp as a consequence of a bad agricultural season.

Serbia's government is under significant pressure to act at this stage to bolster currency stability, public debt to GDP dynamics, inflation and C/A performance. While pre-2008 a budget and C/A deficit of approximately 7% and 11% of GDP respectively may have been just about permissable, post-2008 this sort of performance is rapidly judged unsustainable by markets. That these sort of twin deficits are combined with a contraction in economic activity this year further adds to the weak picture. We now forecast GDP growth this year at -0.5%, 0.7pp lower than our previous forecast. The good news is that Serbia's newly appointed government now seems willing to take measures to ease these deficits, though Serbia' past track record leaves uncertainty on how far they progress.

The supplementary budget aims to bring the deficit within 7% of GDP.

We welcome the presentation of a supplementary budget for this year. The supplementary budget will most likely contain hikes to VAT and excise taxes, effective October. This should be enough to cap the budget deficit within 7% of GDP. With the sovereign wishing to raise over EUR 1bn between now and year-end in FX, it will hope to quickly follow this with a eurobond, though volatility in policy over recent quarters means that this may only come at a price. The media reports a USD1bn loan from Russia as an alternative.

NBS could be forced to hike rates further to prevent RSD weakness

Should this materialize, central bank commitment to currency stability will remain. Over the first 4-5 months of this year, the NBS acted to smooth RSD weakness largely by drawing off its FX reserves. More recently it has acted to stabilize RSD by soaking up RSD liquidity. The end result has been an RSD which has traded between 114-119/EUR since late May. From here, it is clear that the NBS is willing to take further measures to prevent RSD weakness. It sees the currency as important to financial stability (as most loans are FX-denominated), public debt sustainability (as over 80% of all public debt is in FX) and inflation (which is likely to significantly breech the NBS' target persistently over the coming quarters and reach double digits, with core also on the increase). Though considered far from ideal, the NBS did not rule out further rate hikes or FX intervention. We also do not rule out further increases to reserve requirements.

Further assurances on central bank legislation and more ambitious fiscal reforms will be needed to secure IMF funding

Reaching agreement with the IMF on next year's budget will be more difficult. Firstly this may require some assurances/compromises on recently passed central bank legislation. Secondly it will require more far reaching fiscal measures to bring the deficit to(wards) 4.5% of GDP next year. Since 2008 Serbia has had two IMF programmes but has still seen public sector employment grow, its weighty pension bill remain unaddressed and privatization progress little. By the end of this year public debt to GDP will be over 20pp higher than at end-2009 when it stood at 34% of GDP. The sovereign's interest bill has tripled since end-2008, with little reason to believe that this will peak in the near term. Ideally the government would pass a budget for next year that has the IMF's seal of approval. Following a ‘mini-mission’ in mid September, the IMF has left open the option of returning in October as preparation for next year's budget gets underway. This would undoubtedly be a positive if it materialises but further commitment from the authorities to austerity will be required. The Fund has already referred to the supplementary budget for this year as insufficient.

The Serbian economy is expected to recover in 2013 thanks to Fiat's car production plans and growing greenfield FDI.

Should the authorities succeed in stabilizing public debt to GDP dynamics, there is considerable growth potential elsewhere in the economy. The C/A should benefit from car production from Fiat in 4Q this year and 2013 (30,000 units by year-end, 150,000 units in 2013). The NBS estimates that this will add 2pp to real GDP in 2013 and narrow the C/A balance to within 8% of GDP next year. Given competitive labour costs relative to their peers, Serbia is also in a better position to continue to attract greenfield FDI. Russia has announced a USD 800mn investment in railways while there is considerable potential to develop both the agriculture and energy industries. RWE recently signed an agreement for EUR2.2bn of investment in energy. Serbia's corporate income tax rate stands at only 10%, though it may rise to 12% next year. Serbia should be the Balkan's Slovakia but the authorities will have to put a large number of fiscal and structural changes in place if they are to bring their economy in this direction.

Turkey (Ba1 positive / BB stable / BB+ stable)*

Outlook – What a difference a year makes! Both the CBT and government are exploring options to aid economic activity in the face of a contraction in domestic demand, easing inflation and a relatively stable TRY. Fiscal performance is weakening but does not threaten the downward trajectory in public debt at this stage. The CBT has eased interest rates significantly but expect more ahead, particularly given the risk of rising short term inflows in the face of actions from the ECB and Fed. Turkey's shortfall remains its low FX reserve coverage ratios, which threaten economic activity should capital inflows reverse at any stage.

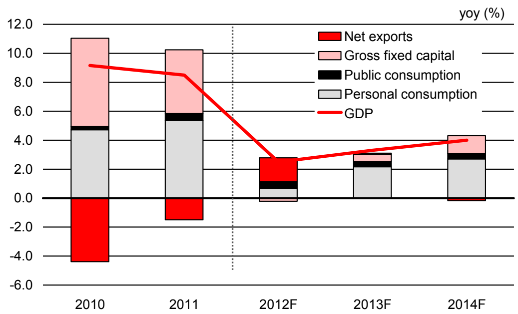
Strategy – Though having rallied significantly, we see the risks at this stage as weighted towards a CBT that puts further downward pressure on short end rates, accompanied by a stable to weaker TRY.

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

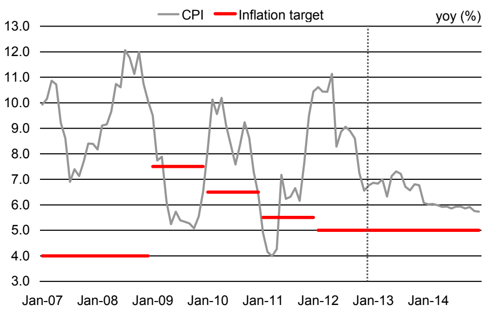
KEY DATES/EVENTS –

- October: Release of government's medium term programme
- Central bank rate decisions: 18 Sep, 18 Oct, 20 Nov
- Inflation: 3 Oct, 5 Nov, 3 Dec

DOMESTIC DEMAND SLUMPS, LEAVING THE BURDEN ON NET EXPORTS



INFLATION TO EASE ONLY GRADUALLY BUT REMAIN OUT OF TARGET



Source: TurkStat, CBT, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2010	2011	2012F	2013F	2014F
GDP (EUR bn)	552.4	558.7	625.6	656.6	688.8
Population (mn)	73.0	74.0	74.9	75.8	76.7
GDP per capita (EUR)	7,567	7,555	8,354	8,661	8,979
Real economy yoy (%)					
GDP	9.2	8.5	2.5	3.3	4.0
Private Consumption	6.7	7.8	1.0	3.2	4.0
Fixed Investment	30.5	18.5	-0.8	2.0	5.0
Public Consumption	2.0	4.5	4.5	3.5	3.5
Exports	3.4	6.4	7.5	6.5	5.5
Imports	20.7	10.9	0.5	5.5	5.5
Monthly wage, nominal (EUR)	796	783	903	972	1,050
Unemployment rate (%)	11.9	9.8	9.3	9.6	9.7
Fiscal accounts (% of GDP)					
Budget balance	-2.7	-0.3	-2.1	-3.0	-2.5
Primary balance	1.0	2.3	0.7	-0.3	-0.1
Public debt	42.4	39.6	37.5	37.0	35.9
External accounts					
Current account balance (EUR bn)	-35.2	-55.5	-42.2	-40.5	-40.6
Current account balance/GDP (%)	-6.4	-9.9	-6.8	-6.2	-5.9
Basic balance/GDP (%)	-5.3	-8.2	-4.9	-4.3	-4.0
Net FDI (EUR bn)	5.7	9.6	11.5	12.2	13.3
Net FDI (% of GDP)	1.0	1.7	1.8	1.9	1.9
Gross foreign debt (EUR bn)	218.7	237.6	267.4	289.8	319.3
Gross foreign debt (% of GDP)	39.6	42.5	42.7	44.1	46.4
FX reserves (EUR bn)	59.2	59.4	60.9	65.0	64.9
Inflation/Monetary/FX					
CPI (pavg)	8.6	6.5	8.9	6.8	5.9
CPI (eop)	6.4	10.4	6.8	6.1	5.7
Central bank reference rate (eop)	6.50	5.75	5.75	5.75	6.50
3M money market rate	7.56	11.00	6.2	7.5	7.5
FX/USD (eop)	1.52	1.85	1.90	1.96	1.93
FX/EUR (eop)	2.02	2.46	2.47	2.66	2.59
FX/USD (pavg)	1.51	1.67	1.80	1.82	1.91
FX/EUR (pavg)	2.00	2.34	2.32	2.43	2.56

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

Turkey: Focusing on growth

Considerable adjustment has materialised, though the reliance on short term capital inflows remain a concern

What a difference a year makes! This time last year the CBT was facing double digit domestic demand growth, the prospect of acccelerating inflation, in part because of a depreciating TRY, and stubborn widening of its C/A deficit. Now the CBT faces an economy which has slowed more than it expected in recent quarters due to a contraction in domestic demand, inflation which is now coming in below rather than above its projection (though still above target) and a currency which is stable. The C/A deficit, though still wide, is narrowing at an impressive rate. The key shortfall in this adjustment to date has been the persistence of short term inflows. While there is considerable debate on what should and should not be considered a short term inflow, our measurement puts average short term inflows over the first 7 months of this year at USD4.5bn per month compared with USD3.3bn per month in H1-11[2].

Export performance has been central to gains in economic activity as domestic demand slumped – the pace of recovery from here is uncertain

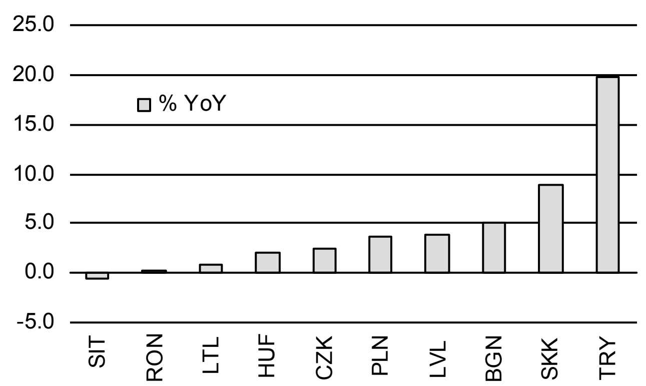
At this stage the government's growth forecasts for both this year and next appear optimistic, though there is uncertainty on how 2H pans out. Turkey's export performance is impressive, with exports up almost 20% yoy in 2Q, outpacing all other countries in the region by a considerable margin. But domestic demand has slumped, down 2.6% yoy in 2Q, with household consumption down 0.5% and gross fixed capital formation down 7.4%. More recent data has been slightly more upbeat. July IP was up 1.6% mom but this only reverses June's losses while PMI data for August was not impressive. Export volumes, on a 3m/3m SA and annualized basis are up 7.5% in July, notably outpacing import volume growth. Lower inflation ahead should help the consumer. But food price inflation is on the rise globally while there is increasing uncertainty on the pace of growth in emerging markets in Latam and Asia, casting a shadow over the pace of recovery from here.

Fiscal policy has scope to act…

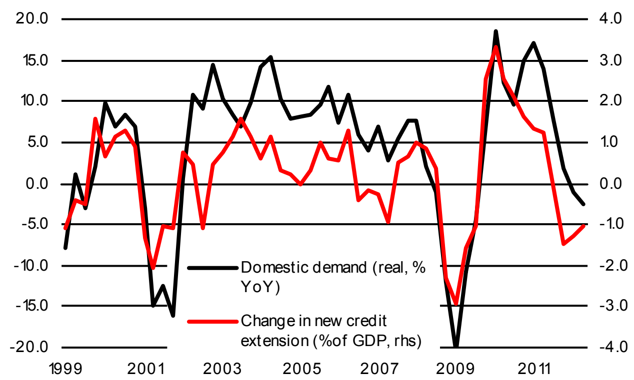
There is scope for fiscal policy to aid economic activity. Turkey's public debt stood at below 40% of GDP last year and remains on a downward track this year, despite the slowdown in growth. Over 1H12 the general government balance widened from a surplus of TRY 2.5bn (0.2% of full year GDP) to a deficit of TRY7.4bn (-0.5% of GDP) as revenue growth slowed but expenditure growth accelerated significantly (18.5% YTD compared with 6.5% for 2011 as a whole). Should the government presents a more gradual consolidation path going forward relative to what was set out in last October's Medium Term Programme (0.8% and 0.4% of GDP in 2013 and 2014 respectively), it would remove some of the uncertainty on economic activity.

SWITCHING FROM DOMESTIC-LED TO EXPORT-LED GROWTH

Impressive export (volume) outperformance



Credit growth has decelererated, forcing a (needed) halt to domestic demand



Source: Turkstat, CBT, UniCredit Research

[2] With short term inflows we count portfolio flows, short term bank and non-financial corporate loans and currency and deposit flows.

…while the CBT looks set to do more.

The CBT has already reacted to the lower inflation/lower growth environment and looks set to continue to do so. The past 2.5 months have already seen a significant easing of policy by the CBT. The average funding rate for the banking sector fell from 9.75% in May to 6.2% by mid-September. The CBT is also no longer reducing the stock of liquidity that it provides to the banking sector via open market operations while we expect a reduction in the upper end of its interest rate corridor (5.0-11.5%) ahead.

Gradual TRY losses will not be opposed by the CBT but any sharp gains could be, if only indirectly.

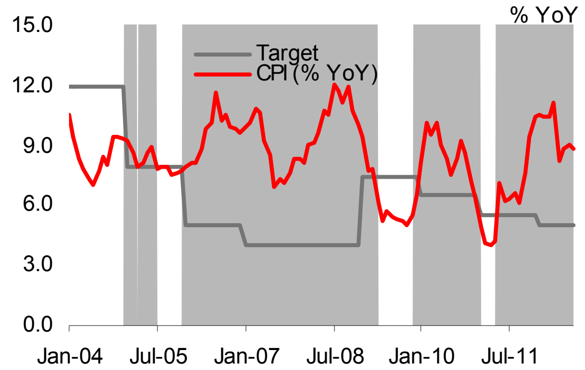
We also see the CBT as much less adverse to a weakening of monetary conditions from here via gradual TRY losses than was the case in Q4 last year and Q1 this year. At this stage, inflation is firmly on a downward trajectory, with much if not all of the impact from last year's TRY losses having fallen from the base. October and November will see the impact of last year's administered price hikes, which added 1.55pp to CPI, fall from the base. That inflation expectations have remained relatively stable in the face of the spike in headline inflation in the past 12 months will also be encouraging to the CBT. We doubt at this stage that the CBT is willing to actively push TRY weaker via FX reserve intervention, though this may change should we see renewed pressure on TRY due to QE3 and ECB flows. More likely is that the CBT counts on a further lowering of interest rates to reduce any appreciation pressures on TRY that may materialize. Any excessive depreciation pressure, at least if experienced only for a short period of time, can be counteracted by a further reduction in the size of liquidity provided to the banking sector via open market operations and changes in the CBT's relatively new systems of simultaneously managing TRY liquidity, while bolstering FX reserves, namely its reserve option coefficient (ROC) approach.

Turkey's reliance on short term capital remains its primary vulnerability.

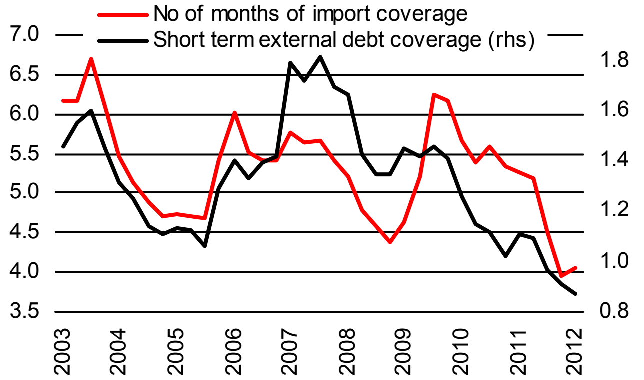
More medium to long term, our primary concern remains the same, namely an inability to tackle a more persistent outflow of foreign capital from the economy. The CBT has shifted from a policy of FX reserve accumulation via intervention to reserve accumulation via a shifting of FX from the banking sector to the CBT. But even taking account of this, FX reserve coverage of both imports and short term external debt are at a multi-year low. This discussion is not meant to suggest that we expect a reversal of short term capital in the near term – to the contrary, we see the risks as weighted towards an acceleration of inflows. Moreover, part of these flows capture a structural shift from developed to emerging markets which should prove sticky in nature. But at least some of these flows may be subject to reversal at some stage, most likely for reasons outside of Turkey's control. Given the elevated stock of short term capital present in Turkey now relative to the past, the amount of outflows relative total could be considerably less than in 4Q08/1Q09 but have a similar impact on economic activity. In this case one could argue that the CBT will in any case be happy to let the currency adjust – its limited tool kit also suggests that it will have no choice but to do so.

LONG TERM CHALLENGES

Inflation is improving but lots to be done to build strong track record



FX reserve coverage ratios are uncomfortable low

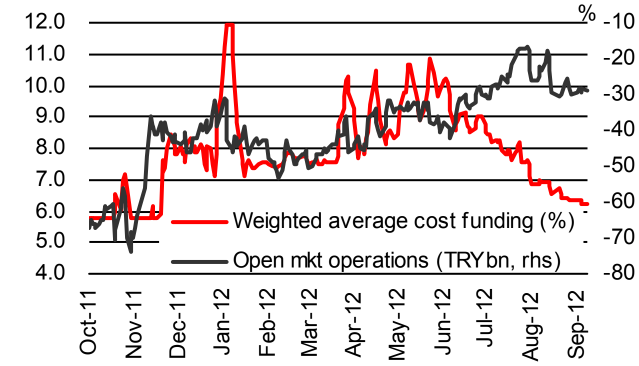


Source: CBT, Turkstat, UniCredit Research

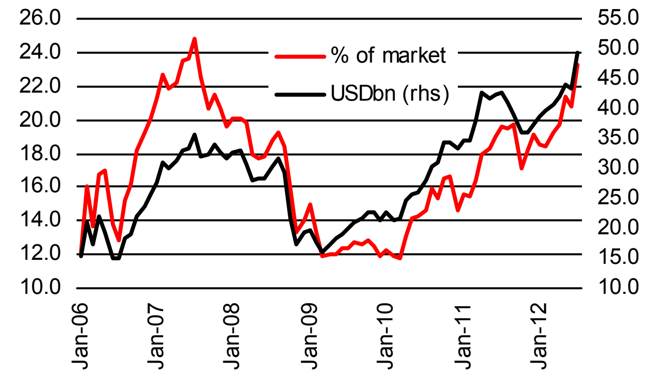
Strategy: Biased in favour of continued low(er) rates

Though having rallied significantly, we see the risks at this stage as weighted towards a CBT that puts further downward pressure on short end rates, accompanied by a stable to weaker TRY. The CBT's policy has already lowered short end rates to record lows, translating into some weakness in TRY. The combination of weak growth, potential for an acceleration in short term foreign inflows following announcements by the ECB and Fed and easing inflation means that the risk to short end rates is weighted in favour of a further decline, even if in real terms rates are now negative across the curve. We favour trading the TRY basket within the 2.0-2.1, driven by lower rates on the one hand but the potential for an increase in foreign portfolio inflows on the other, supported by continued expansion of central bank balance sheets in the developed world.

CBT stabilises liquidity provision while it pushes bank funding lower



Foreigners continue to accumulate debt



Source: CBT, Treasury, UniCredit Research

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2010	2011F	2012F	2013F
Gross financing requirement	117.2	74.8	74.9	77.6
Budget deficit	19.8	9.4	9.7	8.6
Amortisation of public debt	97.4	65.4	65.2	69.0
Domestic	89.05	57.8	58.4	61.5
Bonds	77.5	51.4	52.0	54.8
Bills	11.6	6.4	6.4	6.8
External	8.35	7.6	6.8	7.5
Financing	97.4	65.4	65.2	69.0
Domestic borrowing	79.5	55.7	54.4	57.0
Bonds	70.0	51.2	48.4	50.7
Bills	9.6	4.5	6.0	6.3
External borrowing	7.45	5.4	5.6	5.5
Bonds	4.9	3.2	3.2	3.1
IMF/WB	0.0	0.0	0.0	0.0
Other	2.6	2.1	2.4	2.4

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2010	2011F	2012F	2013F
Gross financing requirement*	-67.2	-72.7	-71.4	-75.6
C/A deficit	-36.0	-56.3	-45.7	-46.5
Amortisation of medium to long term debt	-34.6	-27.1	-25.7	-29.1
Government/central bank	-6.0	-5.7	-5.7	-4.1
Banks	-5.1	-4.7	-4.9	-4.7
Corporates	-23.6	-16.8	-15.1	-20.3
Errors and omissions	3.5	10.7	0.0	0.0
Financing	67.2	72.7	71.4	75.6
FDI	5.9	7.9	8.3	10.9
Equity (private, net)	2.6	0.8	1.9	3.6
Borrowing Medium to Long term	29.0	33.3	35.6	34.4
Government/central bank	5.1	4.7	4.5	4.0
Banks	5.8	8.6	8.3	8.7
Corporates	18.2	20.0	22.7	21.8
Other (incl. reserve accumulation)	29.7	30.8	25.6	26.7

* Short term debt (the stock from the previous period) is mostly trade related and we assume it will be rolled over.

Ukraine (B2 negative / B+ negative / B stable)*

Outlook – The domestic authorities have been successful in covering much of their external financing requirements to date but growth remains lacklustre while Ukraine's twin deficits remain a concern. End-October elections is the near term focus but beyond that the government will need to act. Ongoing dialogue with the IMF means that there is the potential for progress on planned fiscal measures post election but currency adjustment is trickier

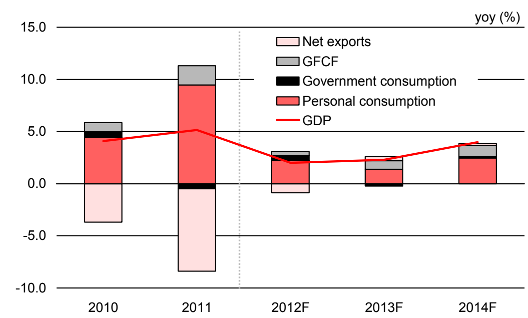
Strategy outlook – Despite favourable positioning, we are reluctant to initiate long positions in sovereign hard currency space at this stage but instead wait until there is more clarity available post October's election. We remain of the view the view that the authorities will do what they can to combat large currency losses.

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

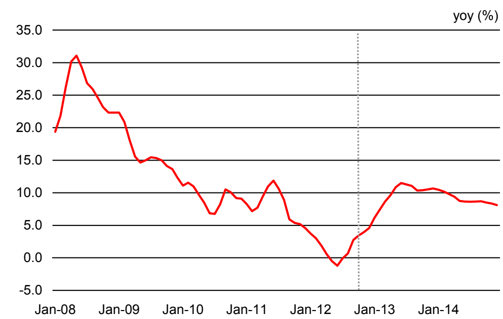
KEY DATES/EVENTS

- October 28th parliamentary elections
- 5-10th of each month: FX reserve data
- 15-18th of each month: Industrial production data

GDP GROWTH SLOWING SHARPLY



INFLATION AT RECORD LOW BUT SET TO RISE



Source: Ukraine State Committee Statistics; UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2010	2011	2012F	2013F	2014F
GDP (EUR bn)	102.6	118.4	128.2	130.0	137.0
Population (mn)	45.8	45.5	45.3	45.1	44.9
GDP per capita (EUR)	2,241	2,603	2,830	2,883	3,051
Real economy yoy (%)					
GDP	4.1	5.2	2.0	2.3	4.0
Private Consumption	7.0	15.0	3.5	2.2	3.9
Fixed Investment	4.9	10.1	2.0	4.5	6.0
Public Consumption	2.7	-2.4	2.5	-1.1	0.6
Exports	4.5	2.2	0.5	4.5	8.7
Imports	11.1	16.8	2.1	3.5	7.9
Monthly wage, nominal (EUR)	213	237	277	287	323
Unemployment rate (%)	8.4	8.2	8.0	8.3	8.3
Fiscal accounts (% of GDP)					
Budget balance	-5.7	-2.7	-5.7	-4.8	-4.2
Primary balance	-4.1	-0.8	-3.5	-2.5	-1.8
Public debt	40.1	36.5	41.6	43.8	43.0
External accounts					
Current account balance (EUR bn)	-2.3	-6.9	-11.4	-8.2	-7.8
Current account balance/GDP (%)	-2.2	-5.8	-8.9	-6.3	-5.7
Basic balance/GDP (%)	2.0	-1.3	-5.0	-2.2	-1.4
Net FDI (EUR bn)	4.3	5.4	5.1	5.4	5.9
Net FDI (% of GDP)	4.2	4.5	4.0	4.1	4.3
Gross foreign debt (EUR bn)	88.2	95.5	99.1	105.7	97.4
Gross foreign debt (% of GDP)	86.0	80.6	77.3	81.3	71.1
FX reserves (EUR bn)	25.1	23.3	20.7	17.7	19.2
Inflation/Monetary/FX					
CPI (pavg)	9.4	8.0	1.9	9.9	9.6
CPI (eop)	9.1	4.6	4.6	10.7	8.5
Central bank target	tentative target of 5% by 2014				
Central bank reference rate (eop)	7.75	7.75	7.50	7.50	7.00
USD/UAH (eop)	7.97	7.80	8.44	9.29	9.56
EUR/UAH (eop)	10.6	10.4	11.0	12.6	12.8
USD/UAH (pavg)	7.95	7.94	8.30	8.84	9.49
EUR/UAH (pavg)	10.5	11.1	10.7	11.8	12.7

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

Buying time until elections

The domestic authorities have been successful in covering much of their external financing requirements to date…

The Ukrainian authorities have been successful in diversifying their financing sources over recent months, buying themselves some valuable time as they near elections at the end of October in the face of pending EU/IMF payments:

- Of the USD 2bn due to VTB in July, USD1bn was repaid while USD 1bn was rolled into a 2 year eurobond, removing rollover risk until mid-2014;
- Ukraine seems to have made progress in securing a large amount of funds from China. In most cases this is directed at specific industries and will surely include a large amount of investment imports from China but nonetheless should help boost economic activity. As well as USD 2.4bn of a currency swap line, the authorities have approved up to USD 3bn in loans for agriculture, with the potential for a further USDS 3.7bn to go to the energy sector to help reduce reliance on gas. USD 0.4bn was also pledged to railways;
- July saw the sovereign step into the eurobond market for the first time this year, issuing USD 2bn in bonds.

FDI represents another USD 3.4bn YTD while within the C/A there has been progress on gas imports. Despite facing a sharp rise in gas prices this year from Russia, Ukraine has managed to keep its overall gas import bill stable for the year by lowering import volumes.

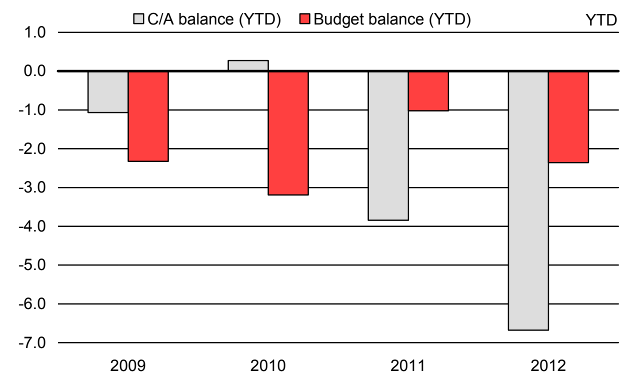
…but the growth environment remains lacklustre…

In the face of these improved financing conditions and a decent 2Q GDP performance, we raise our full year forecast for GDP for this year by 0.3pp to 2.0%. Improved carryover for next year along with the potential for a bounce in agriculture prompts us to push our 2013 forecast 0.4pp higher to 2.3%. But as per even these revised GDP forecasts, gains in real economic activity are lacklustre. YTD industry is up 5.0% yoy (30.1% for the first 7 months of 2011), metal production a modest 1.3% YTD. The agricultural sector is also set for a weak year, down 4.2% in the first 7 months of the year compared with gains of 9.1% for the same period last year. 2011 saw agriculture add 1.4pp to GDP, manufacturing 1.5pp. This year agriculture will subtract from GDP, manufacturing make only a very modest positive contribution. Exports in USD terms grew only 2.7% in 1H in part because of declining metal prices. The bright spot is the consumer, aided by record low inflation which has boosted consumer purchasing power, though new lending has ground to halt once again. But the consumer will be more constrained in 2H as favorable food price trends reverse.

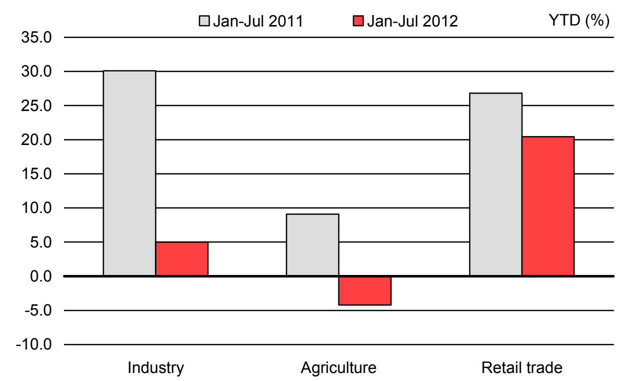
…while Ukraine's twin deficits remain a concern.

We are concerned that growth will remain subdued until Ukraine meaningfully addresses its twin deficits problem and more broadly rising external and government financing requirements. Despite having stabilized the gas import bill, Ukraine's C/A deficit continues to widen. The deficit over January-July stood at USD 6.7bn, almost double January-July 2011.

Budget performance weakens as the C/A widens significantly



Growth momentum weakens, supported only by the consumer



Source: National statistics agency, NBU, State Committee Statistics, UniCredit Research

The 12 month C/A deficit now stands at 7.9% of GDP, though there are some signs that this is down to investment imports. Ukraine's budget balance also continues to widen, capturing a combination of weaker than expected economic activity and populist policies ahead of October parliamentary elections. YTD the general government deficit is 2.3 times wider than it was for the first 7 months of last year. The central bank has increased its holdings of domestic government debt YTD to USD 1.1bn, leaving it holding just under 50% total.

End-October elections is the near term focus…

For now the authorities' focus is to maintain stability ahead of end-October parliamentary elections. They have been more successful than many expected to date. From official data available until July, the domestic deposit base continues to rise and the NBU has taken measures to add to banking sector stability, e.g. increases in deposit insurance. This has come at the cost of high short end rates but is something the government is willing to endure. FX reserves are down 'only' USD 2bn.

…but beyond that the government will need to act.

But even assuming that the government controls any FX pressures in the lead up to the election, the combination of such wide deficits, pending EU/IMF payments, a limited FX defence cushion and domestic financing pressures are likely to force the government to act as we enter next year. We assume re-election of the Party of Regions. FX reserve coverage of short term external debt and imports is either back at its 2009 low or below. Meanwhile Ukraine faces EUR 2.5bn in repayments to the IMF this year, EUR 4.1bn next year. Under any new IMF programme, the two key areas to be addressed are fiscal policy and currency flexibility.

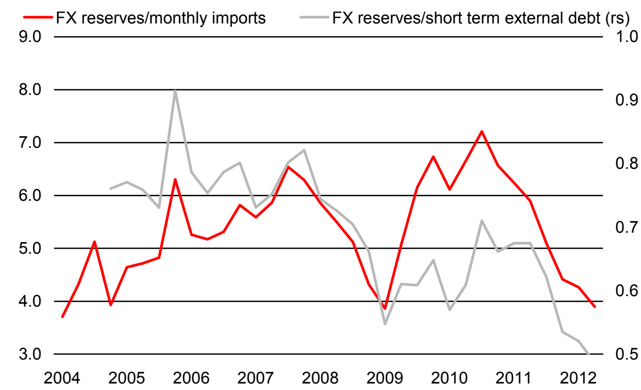
Ongoing dialogue with the IMF means that there should already be progress on planned fiscal measures…

The positive news is that discussion with the IMF has been ongoing all year, signaling a stronger relationship than is the case in Hungary. This should facilitate the presentation of a consolidation budget relatively rapidly after election, though there is uncertainty about whether the authorities would be willing to hike gas prices already in Q4 or attempt to avoid this until 1Q13.

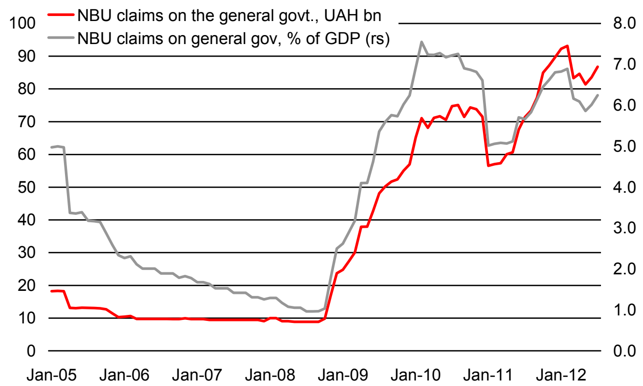
…but currency adjustment is trickier.

Managing the introduction of currency flexibility can be potentially more difficult. The authorities are already showing signs of moving towards a more flexible currency, with UAH trading above 8.05/USD throughout the summer. But the political costs involved in a disorderly FX move are large. We exclude the option of an immediate shift to a free float and instead expect a gradual shift towards a currency basket, potentially without making either end of the band publicly known. Ukraine's BoP position is such that in the event of the NBU facilitating it, UAH will come under immediate depreciation pressure. A new IMF programme would significantly increase the chances of executing a smooth adjustment over a multi-quarter period.

FX reserve coverage ratios as weak…



…as the NBU supports government financing

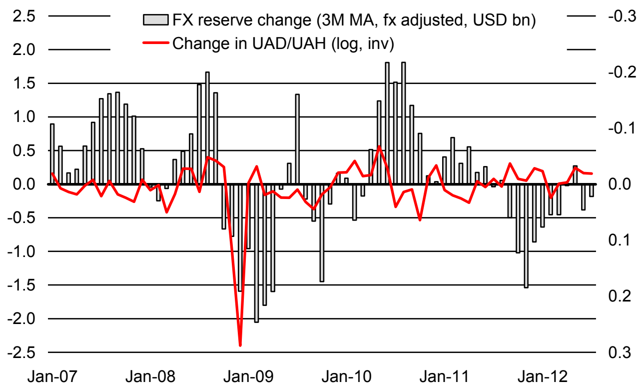


Source: MinFin, NBU, State Treasury, UniCredit Research

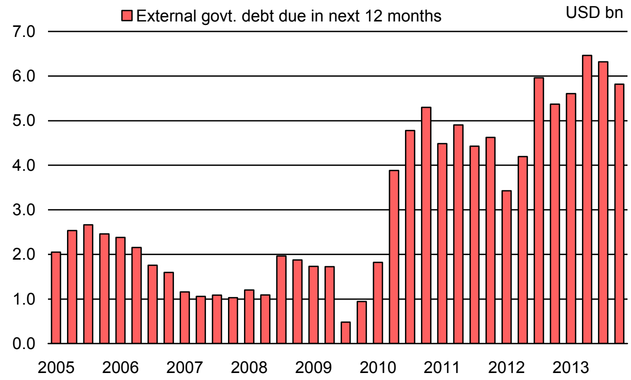
Strategy: Waiting for election uncertainty to be priced

Even given the risks inherent to the banking system and overall macro stability arising from an election in Ukraine, we are reluctant to take an outright short position given Ukraine's high spread on a relative basis in the region and favourable technicals. Should the market price in more of a risk premium reflecting Ukraine's hefty redemption profile and election uncertainty, based on the view that Ukraine will return to an IMF programme post elections (though not necessarily until 2013), we would use this as an opportunity to go long sovereign exposure. Should our view on an IMF programme prove correct, we believe that the market is pricing an excessive amount of FX losses but wait until there is more clarity on the post-election environment before initiating a shoft USD/UAH trade.

NBU continues to exert control over FX market



Sovereign external redemptions means market access essential



Source: Bloomberg, NBU, UniCredit Research

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2011	2012F	2013F
Gross financing requirement	**7.9**	**20.5**	**22.2**
Budget deficit (excl Nafto)	0.9	5.0	4.0
Amortisation of public debt	6.1	11.1	13.2
Domestic	5.2	6.7	8.3
Short term	0.6	0.9	1.4
Medium to long term	4.6	5.8	6.9
External	0.9	4.4	4.9
of which IMF	0	2.5	4.1
Financing	**7.7**	**20.3**	**21.8**
Domestic borrowing	4.6	14.1	15.3
of which NBU	1.8	2.5	1.0
Short term	0.9	1.4	2.0
Medium to long term	3.7	12.7	13.3
External borrowing	3.1	6.2	6.5
Bonds	2.1	2.7	2.5
IMF	0	0.0	2.5
Other	1.0	3.5	1.5

Source: MinFin, NBU, UniCredit Research

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2011	2012F	2013F
Gross financing requirement	**54.5**	**61.6**	**53.2**
C/A deficit	6.9	11.8	9.3
Medium to long term amortisation	**17.5**	**18.0**	**14.4**
Banks	6.8	5.7	4.6
Corporates	8.3	8.0	6.4
Government/central bank	2.5	4.3	3.4
Short term debt amortisation	**19.5**	**26.4**	**24.0**
Banks	3.4	4.7	2.3
Corporates	14.5	20.1	20.1
Government/central bank	1.6	1.6	1.6
Other (incl. intercompany lending, capital flight	10.6	5.5	5.5
Financing	**54.5**	**61.6**	**53.2**
FDI	5.4	5.3	6.1
Portfolio flows	0.4	0.5	0.5
Medium to long term borrowing	**18.2**	**20.1**	**19.2**
Banks	2.5	2.9	2.3
Corporates	11.0	14.0	12.0
Government/central bank	4.7	3.2	4.9
Short term borrowing	**21.0**	**27.8**	**24.0**
Banks	4.1	4.7	2.3
Corporates	15.3	20.1	20.1
Government/central bank	1.6	3.0	1.6
Other	7.8	6.0	0.4
Change in reserves	1.8	2.0	3.0

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h) UniCredit Bank Czech Republic (UniCredit Bank Czechia), Na Príkope 858/20, CZ-11121 Prague, Czech Republic
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j) ZAO UniCredit Bank Russia (UniCredit Russia), Prechistenskaya emb. 9, RF-19034 Moscow, Russia
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l) UniCredit Tiriac Bank (UniCredit Tiriac), Bucharest 1F Expozitiei Boulevard, RO-012101 Bucharest 1, Romania
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Banking network

UniCredit Group CEE banking network – Headquarters

Azerbaijan

Yapi Kredi Azerbaijan
Yasamal District, Cafar Cabbarlı Str., 32/12,
AZ 1065, Baku/Azerbaijan
Phone +99 4C97 77 95
Fax +99 412 497 0276
E-mail: yapikredi@yapikredi.com.az

The Baltics

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

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

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

Bosnia and Herzegovina

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

UniCredit Bank Banja Luka
Marije Bursac 7,
BH-78000 Banja Luka
Phone: +387 51 243 200
E-mail: info-bl@unicreditgroup.ba
www.unicreditbank-bl.ba

Bulgaria

UniCredit Bulbank
Sveta Nedelya Sq. 7,
BG-1000 Sofia
Phone: +359 2 923 2111
www.unicreditbulbank.bg

Croatia

Zagrebačka banka
Paromlinska 2,
HR-10000 Zagreb
Phone: +385 1 6104 000
www.zaba.hr

Czech Republic

UniCredit Bank
BB Centrum – Budova FILADELFIE
Želetavská 1525/1
CZ-140 92 Praha 4 – Michle
Phone: +420 955 911 111
E-mail: info@unicreditgroup.cz
www.unicreditbank.cz

Hungary

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

Kazakhstan

ATFBank
100, Furmanov Str.
KZ-050000 Almaty
Phone: +7 (727) 2 583 111
E-mail: info@atfbank.kz
www.atfbank.kz

Kyrgyzstan

JSC "UniCredit Bank"
493, Jibek Jolu. Ave.
720070 Bishkek, Kyrgyzstan
Phone: + 996 312 37 47 47
E-mail: bank@unicreditbank.kg
http://www.unicreditbank.kg

Macedonia

Bank Austria Representative Office
Dimitrie Cupovski 4/2/6,
MK-1000 Skopje
Phone: +389 23 215 130
E-mail: office@ba-ca.com.mk

Montenegro

Bank Austria Representative Office
Hercegovacka 13,
ME-81000 Podgorica
Phone: +382 81 66 7740
E-mail: ba-ca@cg.yu

Poland

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

Romania

UniCredit Tiriac Bank
Bd. Expozitiei Nr. 1F,
RO-012101 Bucharest 1,
Phone: +40 21 200 2000
E-Mail: office@unicredit.ro
www.unicredit-tiriac.ro

Russia

UniCredit Bank
Prechistenskaya emb. 9,
RF-119034 Moscow
Phone: +7 495 258 7200
www.unicreditbank.ru

Serbia

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

Slovakia

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

Slovenia

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

Turkey

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

Ukraine

UniCredit Bank
14-A Yaroslavov Val St.,
UA-01034 Kiev
Phone: +380 332 776210
E-mail: info@unicredit.com.ua
www.unicreditbank.com.ua

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

UniCredit Group CEE banking network – Corporate customers

Austrian contact

Bank Austria

Sonja Holland
Phone: +43 50505 56344

Alexandra Kaufmann
Phone: +43 50505 51054

E-mail: business_development@unicreditgroup.at

German contact

UniCredit Bank AG

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

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

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

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

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

Italian contact

UniCredit Corporate Banking

Patrizia Conte
Phone: +39 0422 654 001
E-mail: CBBM-CIB@unicredit.eu

Barbara Zabotti
Tel: +39 0422 645 008
E-mail: CBBM-CIB@unicredit.eu

International contact

Azerbaijan

Sinan AGIRBAS
Phone: +994 12 497 7095
E-mail: sinan.agirbas@yapikredi.com.az

Bosnia and Herzegovina

UniCredit Bank
Ilvana Dugalija
Phone: +387 33 49 16 56
E-mail: ilvana.dugalija@unicreditgroup.ba

UniCredit Bank Banja Luka
Milijana Misic
Phone: +387 51 243 405; +387 51 243 200
E-mail: milijana.misic@unicreditgroup.ba

Bulgaria

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

Croatia

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

Czech Republic

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

Estonia

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

Hungary

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

Kazakhstan

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

Tatyana Kazaeva
Phone: +7 727 258 3000 (ext. 2648)
E-mail: t.kazaeva@atfbank.kz

Latvia

Dagna Rezeberga
Phone: +371 67085 584
E-mail: dagna.rezeberga@unicreditgroup.lv

Lithuania

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

Macedonia

Milan Djordjevic
Phone: +389 23 215 130
E-mail: milan.djordjevic@unicreditbank.rs

Montenegro

Milan Djordjevic
Phone: +382 20 667 740
E-mail: milan.djordjevic@unicreditbank.rs

Poland

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

Romania

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

Russia

Inna Maryasina
Phone: +7 495 554 5352
E-mail: inna.maryasina@unicreditgroup.ru

Serbia

Zoran Jevtovic
Phone: +381 11 3204 533
E-mail: zoran.jevtovic@unicreditbank.rs

Slovakia

Fabio Bini
Phone: +421 2 4950 2373
E-mail: fabio.bini@unicreditgroup.sk

Slovenia

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

Turkey

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

Ukraine

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

UniCredit Research*

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

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

Economics & FI/FX Research

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

Economics & Commodity Research

European Economics

Marco Valli, Chief Eurozone Economist
+39 02 8862-8688
marco.valli@unicredit.eu

Dr. Andreas Rees, Chief German Economist
+49 89 378-12576
andreas.rees@unicreditgroup.de

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

Tullia Bucco
+39 02 8862-2079
tullia.bucco@unicredit.eu

Chiara Corsa
+39 02 8862-2209
chiara.corsa@unicredit.eu

Dr. Loredana Federico
+39 02 8862-3180
loredana.federico@unicredit.eu

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

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

Chiara Silvestre
chiara.silvestre@unicredit.eu

US Economics

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

China Economics

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

Commodity Research

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

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

EEMEA Economics & FI/FX Strategy

Gillian Edgeworth, Chief EEMEA Economist
+44 0207 826-1772, gillian.edgeworth@unicredit.eu

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

Dan Bucsa, Chief Economist, Romania
+40 21 200-1376, dan.bucsa@unicredit.ro

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

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

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

Marcin Mrowiec, Chief Economist, Poland
+48 22 656-0678, marcin.mrowiec@pekao.com.pl

Rozália Pál, Ph.D., Economist, Romania
+40 21 200-1378, rozalia.pal@unicredit.ro

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

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

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

Global FI/FX Strategy

Michael Rottmann, Head
+49 89 378-15121, michael.rottmann1@unicreditgroup.de

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

Chiara Cremonesi, FI Strategy
+44 20 7826-1771, chiara.cremonesi@unicredit.eu

Elia Lattuga, FI Strategy
+39 02 8862-2027, elia.lattuga@unicredit.eu

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

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

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

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

Publication Address

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

Bloomberg
UCGR

Internet
www.research.unicreditgroup.eu

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