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# CEE

## Quarterly

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# 3Q 2012

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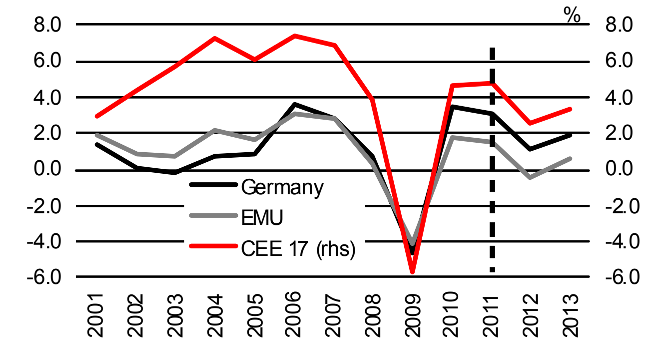
# CEE: Diverse success in battling headwinds

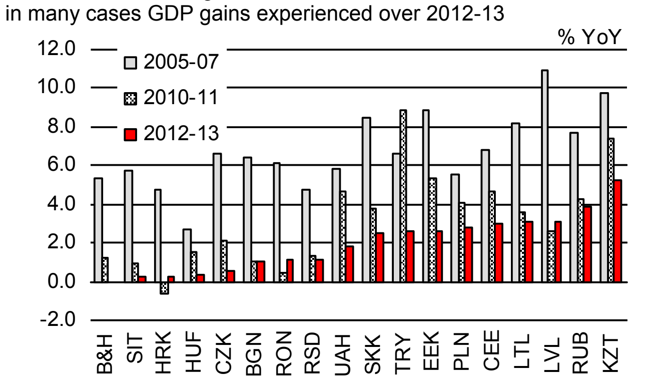
**We are marking down GDP for this year and next to 2.6% and 3.4% respectively**

The persistence of the EMU crisis and the prospect of a more gradual recovery ahead has pushed us to mark down our GDP forecasts for the region. We are taking 0.7pp and 0.5pp off 2012 and 2013, bringing our full year GDP forecasts to 2.6% and 3.4% respectively. There is divergence across the region to the extent that we have marked up some countries due to a stronger than expected Q1 but most have been marked down. Hungary, Czech and Romania are already in technical recession while financing pressures leave us cautious on the outlook for Hungary, Turkey and Ukraine over 2H. That said, CEE is still set to significantly outperform EMU which we now forecast at -0.4% and 0.6% this year and next.

CEE to outperform but still feel the impact of the EMU crisis




Post crisis real GDP gains remain well out of reach, as do in many cases GDP gains experienced over 2012-13




Source: National statistics offices, UniCredit Research

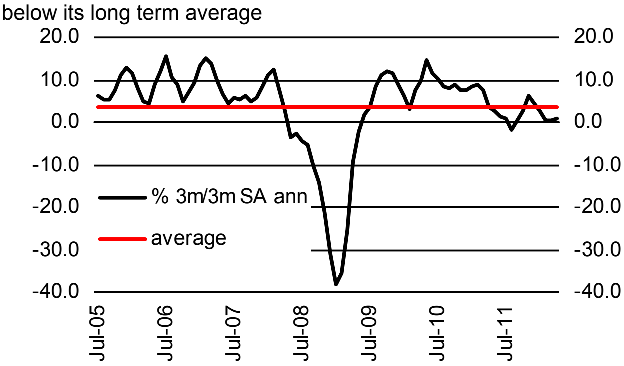
We have approached our analysis of the impact of the EMU crisis on CEE via three channels for a number of quarters now, namely **1)** trade and industrial production, **2)** banking sector flows and **3)** broader capital flows. At this stage all three channels are weighing on economic activity.

## Channel 1: Trade takes its toll in 1H

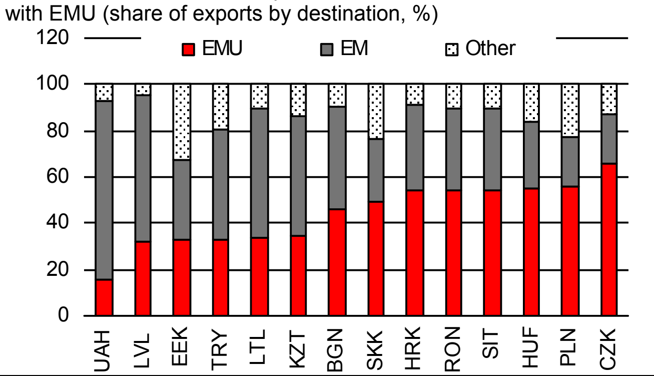
**Weaker external demand has slowed industry growth but has not brought it to a halt**

We follow industrial production trends closely in the region as we find it the best single standalone indicator of overall economic activity. Following a stronger than expected finish to last year, industrial production YTD has shown definitive slowdown. In 1Q our regional indicator showed a gain on a simple average basis of only 0.1% qoq. Due to volatility, our average excludes the Baltics and Kazakhstan. April was stronger, posting gains of 0.6% mom, in part reflecting payback from poor weather conditions in 1Q. However averaging 1Q and 2Q gives us 0.3-0.4pp of gains per quarter, half the long term average. Meanwhile May PMI data showed weakness in Czech and Poland while Turkey also dipped down once again. Though far from in freefall, the slowdown in EMU is having a visible impact on CEE economic activity.

Industrial production has spent most of the past year below its long term average




Some countries are more exposed than others to trade with EMU (share of exports by destination, %)




Source: National statistical agencies, DOTs, UniCredit Research

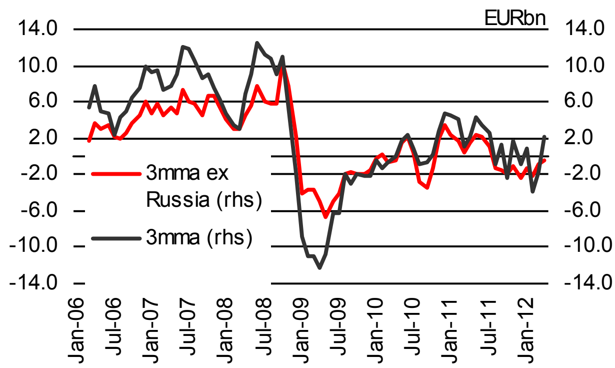
Some countries are more exposed than others. For example over 60% of Czech exports go to EMU while over 50% of exports from Croatia, Romania, Slovenia, Hungary and Poland go to EMU. By this metric, Ukraine is best positioned while less than 40% of total exports from the Baltics, Turkey and Kazakhstan go to EMU.

## Channel 2: Banking sector acts as a drag

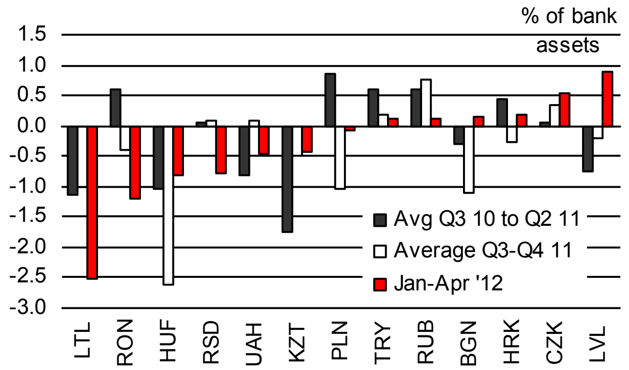
**There has been a shift in bank flows to the region since 2H last year**

The second half of last year saw a clear shift in foreign bank flows to CEE banking sectors. Digging into the numbers and excluding Russia, total inflows stood at EUR 7.8bn in 1H11 but turned to outflows of EUR 11.5bn in 2H11. YTD outflows slowed to EUR 1.7bn. We exclude Russia from above as the size of the flows involved are larger and crowd out developments elsewhere. However in terms of foreign flows to Russia, these remained positive throughout last year (EUR 18.5bn) and turned negative only in 1Q, reaching EUR 6.8bn. All of the above is derived from FX-adjusted changes in external liabilities of commercial banking sector balance sheets. It does not include changes in foreign assets of the banking sector and direct lending by foreign banks to corporates where we see more of a risk of leakage.

Foreign capital flows to CEE banking sector




Foreign capital flows to CEE banks: Differentiation across countries




Source: National central banks & statistics agencies, UniCredit Research

In terms of country specifics, there has been differentation:

- Turkey, Russia, Bulgaria, Czech, Croatia and Latvia all posted inflows over the first four months of the year, in contrast with outflows in 2H last year in Bulgaria, Croatia and Latvia. This suggests that outflows from Greek banks in Bulgaria have been well monitored and managed while in Croatia the appointment of a new government and central bank co-ordination may have played a role. In the face of a difficult external environment, Turkish banks have managed to maintain access to external capital;

- Poland, Kazakhstan, Ukraine, Serbia and Hungary have all posted outflows YTD, though these outflows are less than 1% of banking assets and in Poland's case less than 0.1% of total banking assets. Outflows eased in Hungary relative to 2H last year, in part related the bulk of the FX mortgage transactions being executed at that time. Serbia has shifted from inflows in 2H last year to outflows over the first four months of this year, in line with currency weakness, suggesting that the Greek banking system may have proved more problematic than desired;

- Romania showed a significant outflow YTD equivalent to 1.2% of bank assets and three times that in 2H11. Again we fear that the presence of Greek banks may have been at play. In Lithuania there was an outflow equivalent to 2.5% of total banking assets, though here the re-structuring of Snoras may have played a role.

**Uncertainty on bank flows will likely persist, at least over the coming months**

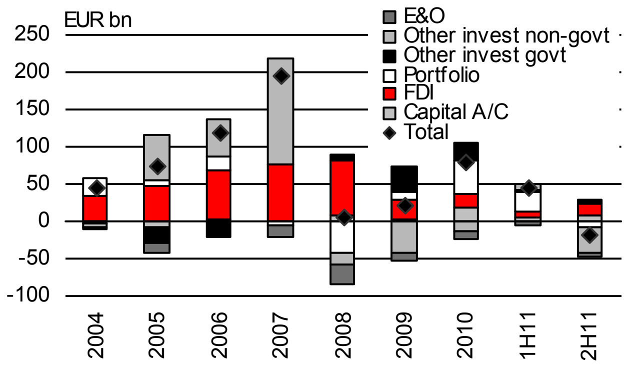
The positive news is that since late 2008, new credit extension on aggregate across the region has in any case been deposit financed. However looking ahead, it is difficult to call for regional stabilisation in this metric in the near term. Though launched in January, Vienna 2.0 has made little progress. Meanwhile EMU banks continue to delever. While we see scope for inflows into some countries in the region where domestic policies are benign and private credit relatively low but others are likely to struggle more (Hungary, Ukraine).

## Channel 3: Global risk appetite and CEE

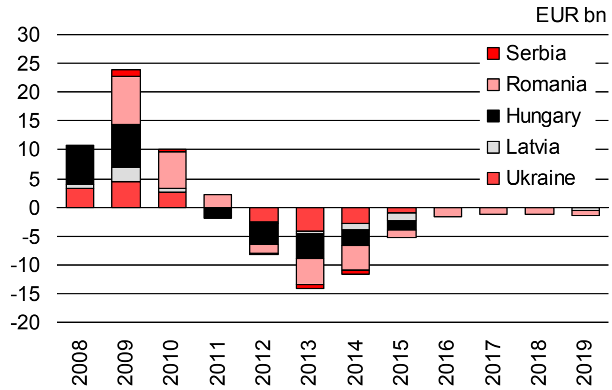
**Portfolio flows dominate but are more volatile…**

The third channel that we monitor closely is risk via portfolio flows. As we have discussed many times in the past, portfolio flows represent the primary source of financing to the region since 2008. For example, in 2010 we estimate that EUR 80bn of capital flowed into the region, of which EUR 47bn was portfolio, by far the highest on record. The past four quarters have, however, acted as a reminder of the potential volatility surrounding these flows. 2H11 saw a reversal of EUR 8.3bn. 1Q this year saw improvement, most likely due to the ECBs LTROs but 2Q is likely to be weaker once again.

Portfolio flows dominate capital flows to the region




IMF scheduled to withdraw capital next year, though that will likely have to be revised




Source: National statistics agencies, UniCredit Research

**…and selective in terms of destination**

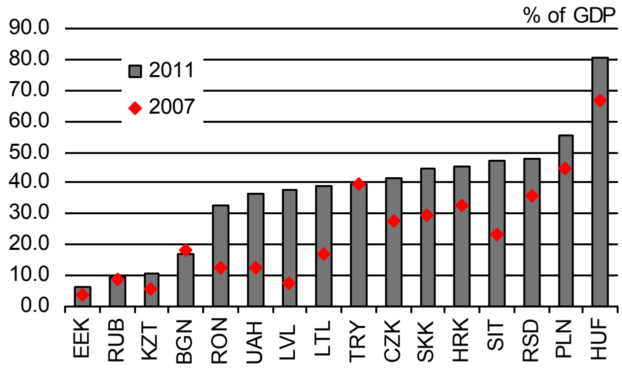
The implications of this are twofold. Firstly the countries that have enjoyed inflows are at risk of a sudden stop. Turkey towards the end of last year provides an example of the cost of defending a currency in the face of volatile capital flows. Serbia has also struggled YTD. Secondly there are a number of countries in the region that continue to struggle to access external markets despite the size of these portfolio inflows. Most obviously this is related to Hungary and Ukraine. Though recent statements suggest that both countries are moving closer to re-engagement with the IMF(/EU), Hungary is unlikely to reach a deal before 4Q while in Ukraine the authorities target only 1Q next year.

## Fiscal policy is much less of a risk than in EMU

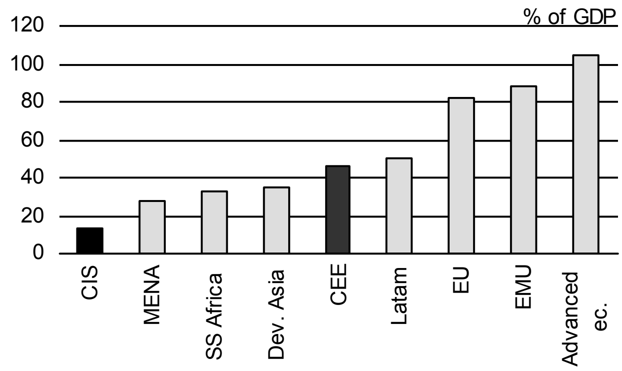
**On the whole CEE in much better fiscal shape than EMU**

One of the primary victims of the 2007/08 crisis has been sovereign balance sheets in advanced economies, with many struggling to return public debt to GDP to a more sustainable path. CEE is in a more fortunate position. Though the crisis has had a notable impact on sovereign balance sheets, in most cases this was manageable, not least because of favourable starting positions. From a public debt to GDP perspective, the region can be divided into three:

Ranking CEE economies in terms of public debt to GDP




Public debt to GDP v other regions globally end-11




Source: IMF, UniCredit Research

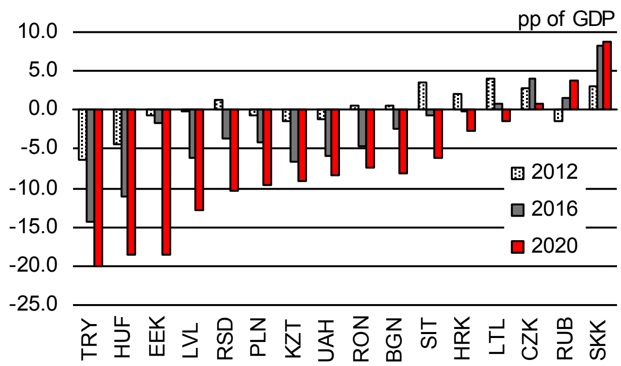
**The oil exporters, combined with the fixed currency countries Bulgaria and Estonia, are best placed in terms of public debt to GDP while Hungary fares worst**

1. The region's two oil exporting countries, Russia and Kazakhstan, as well as Estonia and Bulgaria all run gross public debt comfortably below 20% of GDP. There has been no notable deterioration in the last four years, though there has been a run-down in cash reserves in Estonia and Bulgaria. In Kazakhstan the authorities opted to support the economy and banking sector via draw downs from the oil fund and Samruk-Kazyna, in Russia via its oil reserve fund;
2. The vast majority of the region posts public debt within 30% to 50% of GDP. This ranges from 33% of GDP in Romania to 48% of GDP in Serbia. At over 55% of GDP last year in Poland (ESA '95 methodology), public debt is the second highest the region, though the second pillar pension system plays a role in pushing it above some of its peers. In terms of the change in debt to GDP since 2007, this was highest in Latvia (30pp of GDP), followed by Ukraine and Slovenia (24pp of GDP), Lithuania (22pp of GDP ) and Romania (20pp of GDP). In Turkey, public debt to GDP is now slightly below 2007 ratios. Poland stands in second place, posting a 10pp increase.
3. Hungary is the underperformer, posting public debt in excess of 80% of GDP at end-11. Since end-2007, public debt to GDP is over 13pp higher. Were it not for nationalisation of the second pillar pension fund system, it would stand over 20pp of GDP higher.

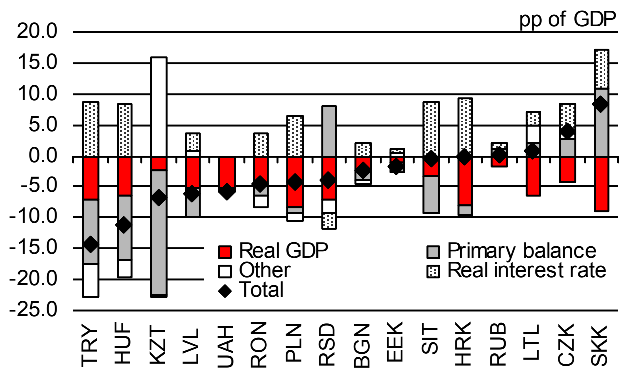
**CEE does not perform poorly relative to regional peers**

From a global perspective, the CEE region stacks up favourably. CIS posts the lowest public debt ratio globally. CEE ex-CIS has a higher public debt to GDP ratio than MENA, Sub-saharan Africa and developing Asia but comes in 4pp of GDP below Latam. Public debt is 42pp of GDP below EMU.

Change in public debt to GDP end-11 v 2012, 2016, 2020




Breaking down contributions to its changing profile (from 2012 to 2016)




Source: IMF, national ministries of finance, European Commission, UniCredit Research

**We draw off official assumptions on macro variables and budget trends to determine the path for public debt to GDP across CEE**

There has also been more work done on fiscal consolidation than in EMU and the majority of governments in the CEE region expect public debt to GDP to decline from here. To path their baseline public debt to GDP projections, we draw off official forecasts put forward by each set of authorities for a variety of macro indicators, including real GDP growth, inflation, expenditure and revenue and interest payments. If no exchange rate assumption is available, as is the case for most countries, we assume exchange rates are unchanged at end-11 rates. Given that projections are available in most cases to 2015/16, we assume that an unchanged FX rate thereafter, as well as a budget deficit ratio, deficit, real GDP growth and GDP deflator equal to the last year available.

**By 2016, assuming official forecasts materialise, public debt to GDP will be back below pre-crisis ratios in the vast majority of CEE economies…**

Our estimates indicate that by this year, public debt to GDP should already be on a downward path in 8 of the 16 countries in our analysis. By 2016, 75% of the countries that we follow will have brought public debt to GDP back below pre-crisis ratios. Based on the authorities' own assumptions, Turkey will lead the pack, reducing public debt to GDP by almost 15pp by 2016. Hungary comes in second place, on track to reduce public debt to GDP by 11pp within 5 years. Amongst the weaker performers, Croatia and Slovenia just about manage to reduce public debt below 2007 ratios, according to their own assumptions. Czech, Russia and Slovakia fail to reduce public debt to GDP below 2007 ratios.

**GDP growth is crucial**

However we are well aware that all governments in the region, based on their own forecasts, are reliant on GDP gains going forward to lower public debt to GDP. In Turkey, real GDP growth should subtract almost 7pp off the public debt to GDP ratio assuming the authorities' forecasts are on the mark. In Poland the authorities' assumptions imply that real GDP growth subtracts 8.4pp from GDP between now and. Croatia stands out as being particularly optimistic, with real GDP set to subtract 8.0pp off public debt to GDP.

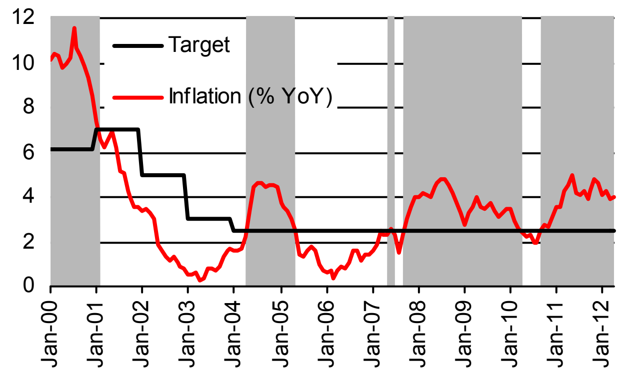
Is that at risk already this year and, if so, will governments have to put more forward in terms of consolidation measures. Relative to our revised forecasts, government assumptions on GDP growth in Hungary, Bulgaria, Czech, Kazakhstan, Eseetonia, Turkey, Croatia and Ukraine are too optimistic for this year. In contrast in Poland, Latvia and Lithuania, government assumptions on GDP growth are low relative to our forecast, providing a cushion. Amongst the 'too optimistic', Kazakhstan, Bulgaria and Estonia have cash buffers while solid debt dynamics mean that Turkey also has scope to facilitate some slippage. Hungary and Ukraine are in more difficult positions, however. Hungary may be forced to put forward further measures already this year given the need to comply with the excessive deficit procedure. In Ukraine the government continues to facilitate an ever wider budget deficit, in part because of populist election spending, via increased domestic debt issuance but we are concerned that the economy will be forced towards a raft of difficult fiscal measures next year.

## Monetary policy is 'stuck' in many places

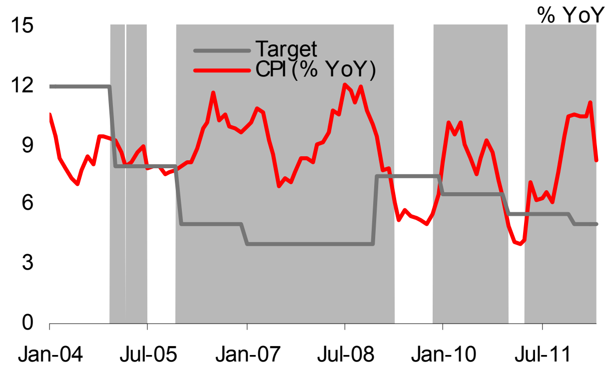
**We see limited scope for monetary policy to ease the downturn**

Unfortunately we see little scope for additional measures from monetary policy to ease the downturn in economic activity in the region at this stage as central banks battle a combination of above target inflation, financing pressures and currency volatility. Poland most recently hiked its policy rate 25bp to 4.75% while Turkey continues to keep short end rates in double digits, both concerned about poor track records on inflation and in Turkey's case in particular further currency losses. In Hungary, Serbia and Ukraine, financing and currency weakness concerns override inflation, prompting the NBH to keep rates on hold (following rate hikes last year), Serbia to recently hike by 50bp to 10% (despite inflation standing at only 3.9%) and Ukraine to cut by only 25bp in the past year (despite inflation currently standing at a negative 0.5% yoy in May). Russia has left its policy rate on hold since end last year amid strong 1Q groth and more recently a sharp sell-off in RUB. Czech stands out as an economy where we see the potential for a rate cut due to declining GDP and contained core inflation.

Poland: Inflation track record




Turkey: Inflation track record




Source: CBT, NBP, national statistics offices, UniCredit Research

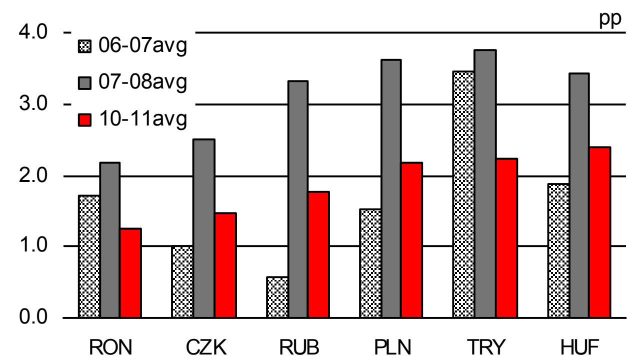
**Lower oil prices will continue to ease inflation over the coming months but watch for rising good prices in CIS**

The good news is that in the near term, the recent decline in oil prices should help on inflation. Recent data has already shown signs of this, with inflation in Turkey, the Baltics, Hungary and Poland all coming in below expectations for May. At least in Poland, this lowers the risk of another hike. Note that energy accounts for between 12% of the inflation basket in Turkey and Romania to 19% of the inflation basket in Slovakia. In contrast in CIS, Romania and Serbia, food price inflation, the primary driver of lower inflation over the past 12 months, looks set to accelerate as the impact of last year's bumper harvest bottoms out.

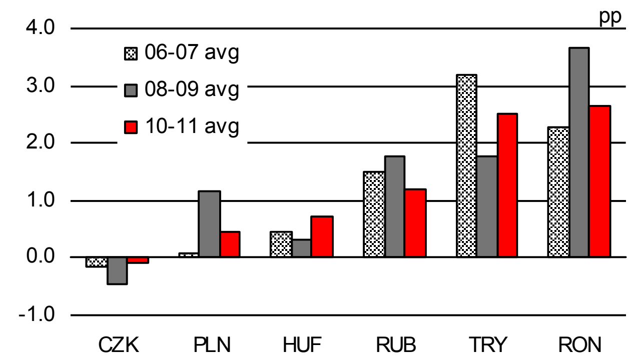
**Central banks can depend less on currency gains oing forward**

More structurally, a combination of currency volatility and less convincing appreciation paths for currencies in the region is also making inflation targetting more complicated. Over 2008-09, foreign exchange losses contributed significantly to inflation but in 2009, economies were operating below capacity, allowing central banks to look through this. Over 2010 and 2011, FX has continued to push inflation higher. Over 2010-11, we estimate that PLN losses added on average 0.4pp to inflation, accounting for almost 20% of the central bank target. Over 2006-07, this averaged 0.1pp. In Turkey over 2010-11, FX added 2.5pp to inflation, up from 1.8pp over 2008-09, though lower than the 3.2pp on average over 2006-07. In Hungary the contribution of FX to inflation has increased from 0.5pp and 0.3pp over 2006-07 and 2008-09 on average to 0.7pp over 2010-11.

FX volatilty has not returned to pre-crisis levels




FX contribution to inflation




Source: National central banks and statistics offices, Eurostat, UniCredit Research

**External risk appetite will determine monetary policy**

Looking ahead to 2H12, we see the external envrionment as the primary determinant of monetary policy changes. Inflation projections will not support cuts in many countries but below trend GDP growth will keep central banks from hiking. Unfortunately monetary policy in a number of countries in the region is pro-cyclical in nature at this stage. For example, external imbalances means that a 'risk-off' environment makes Turkey and Hungary more likely to hike. In Poland and Romania, central banks are more likely to facilitate an easing of monetary conditions via FX instead.

## Closely monitoring external risks

**The primary risks remain EMU-related**

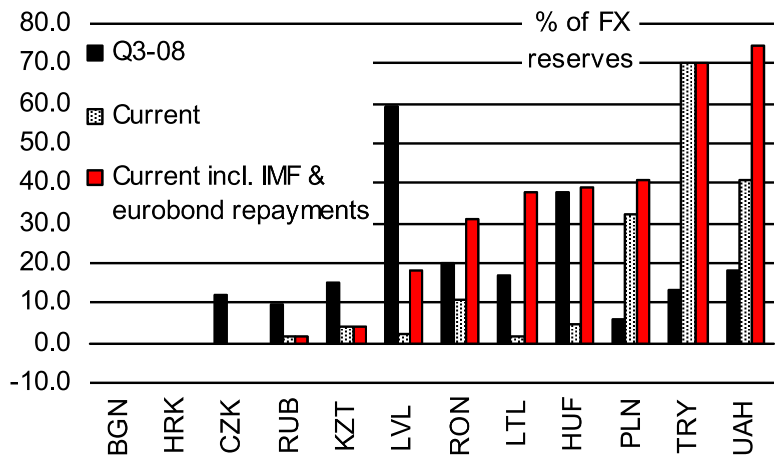
At this stage there is unfortunately a number of scenarios emanating from Europe that would generate, at least temporarily, much more elevated risk aversion in EMU, with knock on implications for CEE. The most obvious scenario is a Greek exit from the common currency.

**We gauge central bank defence capabilities**

To measure the ability of central banks to defend against a sharp withdrawal of capital from CEE, we do the following:

1. We sum portfolio inflows and short term external borrowing (banks, non-bank corporates and governments) between 1Q07 and 3Q08;
2. We then calculate the percentage of these inflows that reversed between 4Q08 and 2Q09, as well as external sovereign debt coming due, all as a % of FX reserves;
3. We repeat step 1 for the period 3Q10 to 4Q11. From step 2 we apply the same ratio of outflows to inflows as over 4Q08-2Q09. In the event that outflows exceeded 100% of inflows after the 2008 crisis, i.e. all short term borrowing portfolio flows not only fall back to end-06 levels but even further, we capped the outflows at 100%. Finally we add sovereign external debt and IMF repayments coming due until year-end.

**FX RESERVE COVERAGE OF SHORT TERM CAPITAL INFLOWS & SOVEREIGN REDEMPTIONS**




Source: IMF, national central banks, UniCredit Research

**...but many emerge vulnerable**

Turkey and Ukraine emerge particularly vulnerable. To cover all of the above, central banks would need to use 70% and more of FX reserves, up from less than 20% in both cases in 2008. Poland also emerges more vulnerable, though there we see the authorities mounting much less of a defence but instead taking the view that currency adjustment will aid economic activity. Hungary's balance sheets means that defence is more likely but relative to 2008 the NBH is not in a better position to do so. Romania also has seen disimprovement since 2008.

This reflects the fact that countries are either heavily indebted from an external perspective in the region and as a result face large external rollover requirements (e.g. Hungary and Ukraine to the IMF and foreign banks), or, if not, run large C/A deficits which makes currency defence costly (e.g. Turkey, Serbia). In Russia's case, it is domestic rather than external capital flows that are proving problematic. Though May showed some improvement, net outflows over the first 5 months of the year stood at USD 46.5bn, compared with a trade surplus for the first four months of the year of USD 80bn. This, combined with a sharp decline in oil prices of late, quickly translated into RUB losses.

**Policy makers must remain nimble**

Of course this is a very negative scenarios and one that is likely to be met with action from the ECB and EMU governments. We have compiled this Quarterly publication at a time of extreme volatility across Europe, with a number of crucial events upcoming, including the second Greek general election on 17th June, the G20 summit on 18-19th June and the (next) EU leaders summit on 28-29th June. Our baseline, though more conservative, is more positive than above. We take the view that EMU undergoes a gradual process of stablisation, followed by recovery, albeit one that is initially muted, supported by the wide range of reforms that have been undertaken over the past two years and more to come over the coming months. However even in this scenario, business cycles will remain shorter than previously was the case and are more subject to volatility. Policy makers in CEE will have to remain nimble for some time to come.

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# CEEMEA FI/FX: Stick to low beta, combine with RV trades

**Given its close proximity to the eurozone, we think the CEEMEA region will continue to follow the broad EMU periphery patterns and will be unable to stage any meaningful idiosyncratic rally or sell-off.** As directionless trading with high volatility will likely continue in the coming quarter, we think relative-value trades can generate positive returns while on an outright basis we focus on low-beta exposure. One of the key differentiation factors for our portfolio recommendations in the next quarter will be sovereign flexibility in terms of issuance and potential timing of external assistance.

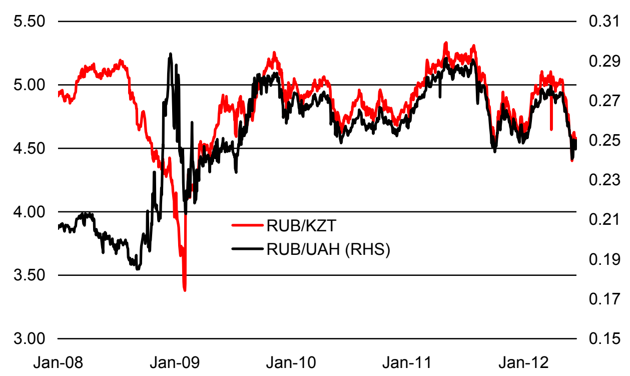
**Add long PLN/CZK and RV trades in the CIS**

**FX:** It is difficult to argue that risk reward is attractive on any CEE currencies on an outright basis given that slowing economies are pushing central banks toward further monetary easing while external debt repayment requirement are significant in the countries which need external assistance. Within the EUR-referenced group of countries, we believe long PLN/CZK properly reflects the relative growth and monetary policy outlook. As the Polish growth continues to outperform the region and sharply outperforms Czech growth we think monetary policy will continue to diverge in the coming quarter (Czech Republic will likely cut rates whilst we expect unchanged rates in Poland). The rate differential ought to support higher PLN/CZK in our view and we recommend adding a long position. We set a target at 6.10 and stop loss at 5.80.

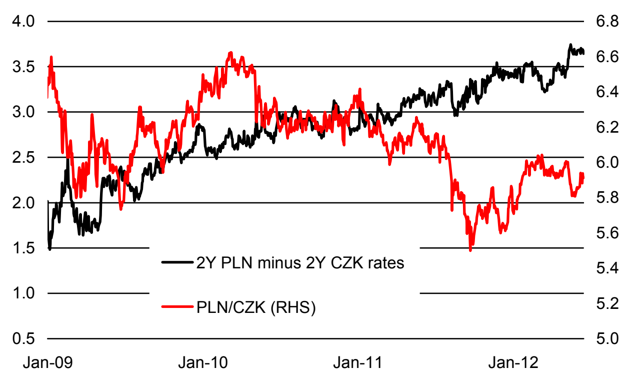
We think the CIS region also provides attractive opportunities based on relative value. Within CIS, due to the sharp depreciation of the RUB, the RUB/KZT and RUB/UAH have moved significantly lower. Although the NDF market is pricing UAH devaluation, it does not price KZT devaluation. We do not expect a move in the KZT spot rate but we think implied rates are too low. On the other hand we think UAH NDF implied rates are too high at the short end (up to 3M) as we believe the NBU will likely keep the spot rates unchanged till the elections and we recommend selling NDF. We do not see any particular opportunity in other CEE currencies.

**FX RELATIVE VALUE OPPORTUNITIES**

RUB/KZT and RUB/UAH moved lower




PLN/CZK vs. rate differential




Source: Bloomberg, UniCredit Research

**Buy locally funded long end TURKGB and locally funded CZGB**

**Local rates:** Given our currency views we do not see attractive opportunities in terms of unhedged currency exposure. In the local currency space we would hold exposure in the wings, namely to locally-funded long-end TURKGBs and ASW trade in the Czech Republic. In the Czech Republic we think local-currency credit risk is still not in line with hard-currency credit risk. Our chart shows the 10Y CZGB ASW versus the 5Y CDS and it suggests that the local currency ASW spread should be about 50bp tighter at least. We think the previous Eurobond and solid YTD pre-financing (see next chapter) should see CZGBs outperforming

Meanwhile in Turkey the adjusting economy and a central bank that continues to control money-market liquidity favors FX-hedged long-end TURKGBs. Moreover we note that the Treasury is currently focusing on the short end and hence supply is limited at the long end. As we still have concerns about the currency in a risk-off scenario, we would keep this position FX hedged (funded via 3M TRY FX swaps).

**Polish Eurobonds are cheaper than FX hedged local currency bonds**

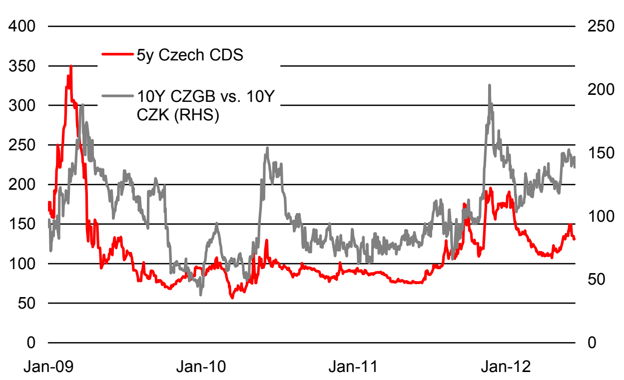
Although Poland has the most room for flexibility in terms of funding, FX-hedged local-currency government bonds are more expensive than Eurobonds and we recommend buying the Eurobonds as opposed to the local currency government bonds.

**Buy HGBs once we get more clarity on IMF talks**

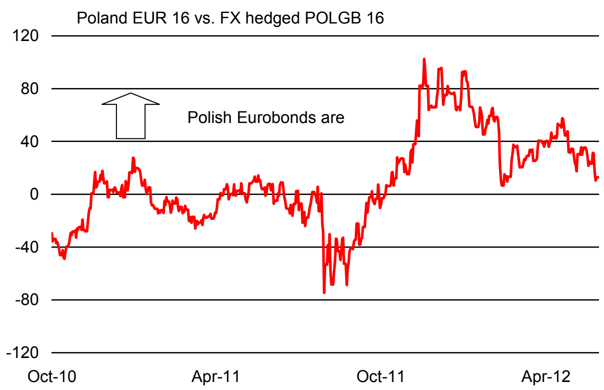
From a tactical perspective we would be long on HGBs but only once we get more clarity on the IMF talks. This time we prefer local-currency bonds as we think the official start of the talks is likely to lead to rate cut(s) from the NBH whilst issuance pressure is also significant in the Eurobond space. Although Russian OFZs should tighten on the back of the introduction of Euroclear, we prefer to get more clarity about the timing (after having been delayed from July) before stepping back into the market.

**LOCAL VS. HARD CURRENCY CREDIT OPPORTUNITIES**

Czech local current credit risk appears too wide vs CDS




Polish Eurobonds are cheaper than FX hedged local currency bonds




Source: Bloomberg, UniCredit Research

**Buy low beta Czech, Polish and Slovakian Eurobonds**

**In credit** we recommend sticking to the low-beta countries (the Czech Republic, Poland and Slovakia) as they should continue to benefit from the ongoing diversification of European real money funds and insurance companies, particularly the EUR-denominated papers. We also prefer the Romanian and Baltic (Latvia and Lithuania) macro stories but, given their higher beta status, we would not add to those positions yet. They will be our first choice if there is any more meaningful increase in risk appetite.

Among the countries that we think need external assistance (Hungary, Serbia and Ukraine), we believe that from a timing perspective Serbia is the closest to a deal and we expect the Serbia USD 22 paper to outperform. In Ukraine we continue hold only the short-end bond (Ukraine USD 2013) as the timing of the deal and post-election scenarios are uncertain.

Hungarian Eurobonds remain tied to the IMF talks but in the event that the deal is delayed beyond 3Q this will lead to FX reserve depletion. We keep the high beta Russia and Turkey credits underweight given the level of global uncertainty.

**CEEMEA REAL MONEY COUNTRY ALLOCATIONS**

| | FX | LC bond | Credit | Comment |
|---|---|---|---|---|
| Croatia | U/W | U/W | U/W | Too high beta, fiscal adjustment is positive though |
| Czech | U/W | O/W | O/W | FX could weaken as CNB turns more dovish |
| Hungary | U/W | U/W | M/W | Look to buy at extreme levels |
| Kazakhstan | M/W | - | M/W | Solid economic backdrop and ongoing strong control on FX |
| Lithuania | - | - | U/W | Too high beta and hence only switch to O/W if risk appetite improves |
| Poland | M/W | M/W | O/W | Hard currency bonds are cheap |
| Romania | M/W | M/W | M/W | Cheap credit valuation vs. rating, wait for new Eurobond |
| Russia | O/W | O/W | M/W | Cheap local currency bonds (OFZ), credit remains a hedge tool |
| Turkey | M/W | O/W | M/W | Slowing economy, active CBT and solid public finances |
| Ukraine | U/W | M/W | U/W | Short end credit is cheap |

**CEEMEA LEVERAGED RECOMMENDATIONS**

| Recommendation | Entry | Target | Exp. return | Rationale |
|---|---|---|---|---|
| Long PLN/CZK | 5.90 | 6.10 | 3.4% | Relative growth and monetary policy directions |
| Sell 3M USD/UAH NDF | 8.43 | 8.10 | 3.9% | Near term UAH outlook is not as bearish as NDF market is pricing it |
| Pay 3M USD/KZT NDF | 150.50 | 153.00 | 3.0% | Although we do not expect the spot to move, implied yields are low |
| Buy FX swap funded Jan/22 TURKGB | 8.90% | 8.40% | 50bp | Attractive carry vs. slowing economy and relatively hawkish CBT |
| Buy 10y CZGB vs pay 10y CZK IRS | 145bp | 80bp | 65bp | Local currency credit spread is too wide |
| Buy Slovak USD 22 vs. Poland USD 22 | 70bp | 0bp | 70bp | Slovakia USD appears to be too wide versus Poland USD |
| Buy Ukraine USD 13 | 9.53% | 8:0% | 150bp | We think carry is attractive on short-end Ukraine |

Source: UniCredit Research

## Funding to play a major role in differentiation

**The region as a whole has covered 50% of its 2012 gross borrowing needs YTD but there are huge differences**

YTD, the Czech Republic, Hungary, Poland, Romania, Russia and Turkey have issued a combined total of EUR 86bn in bonds (EUR 71bn in local currency and EUR 15bn in hard currency). This compares with the combined 2012 funding plan of EUR 172bn for the whole region, which represents 50% coverage. The region covered 47% of the local issuance plan and 64% of the hard currency issuance plan but the individual countries show significant differences both in terms of the total funding amount and currency composition.

In terms of overall financing, Poland is performing best, as it has already covered about 65% of its annual funding plan. Russia is on the other end of the scale, having covered only 37% of its annual funding plan. Romania and the Czech Republic have both covered about 57% of their annual funding target, Hungary 51% and Turkey 43%. In terms of hard-currency issuance, Russia and the Czech Republic are unlikely to come to the market for the rest of the year, while Poland, Turkey and Romania have already covered 63%, 65% and 70% of their hard-currency issuance plans. So far, Hungary has not tapped the Eurobond market despite the EUR 5bn plan. Hungary is performing much better in the local-currency universe, having covered about 77% of its gross borrowing plan. Poland stands at 63%, while Russia fares the worst, having covered only 26% of its local gross issuance plan.

**Hungary is ahead of its plans in local currency but far behind in hard currency**

In the case of Hungary, the significant underperformance on hard-currency issuance is purely due to the lack of external assistance programs and we think this will remain the case until the program is concluded. Even in that case, we think official funding is a cheaper alternative to issuing Eurobonds at current levels. Given overfunding in the local market, we think that if an IMF/EU deal is not concluded before the available FX at the AKK's account runs out, we expect the NBH to cover the remaining FX funding needs in exchange for local currency.

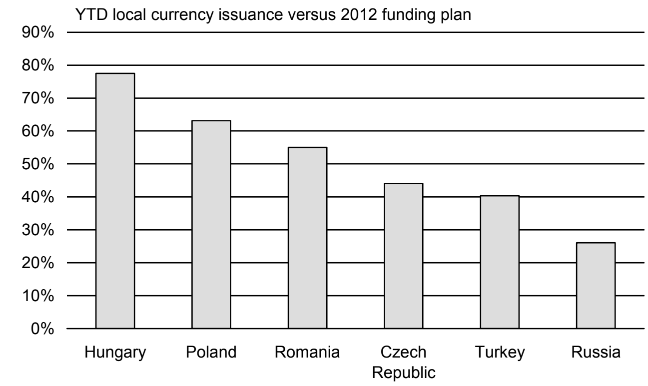
Given the AKK had about EUR 2.5bn cash available at the end of April, this conversion could reduce NBH FX reserves by about EUR 1.0-1.5bn (taking into account the FX payment needs till the end of the year).

**Russia is significantly lagging with its local currency issuance**

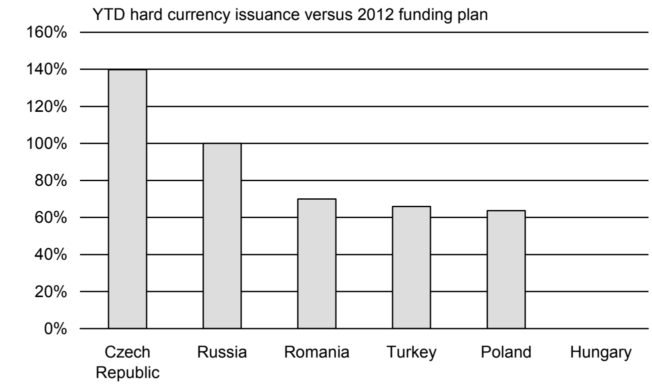
In the case of Russia, the underperformance compared to plan comes exclusively from the local currency side where the MinFin planned EUR 30bn in gross issuance and have so far only completed EUR 7.4bn. We note however that the funding plan was very flexible and Russia fares much better than any other country in terms of cash buffer. Accordingly we do not expect the MinFin to push ahead and complete the full 2012 plan. In the worst case, the MinFin could also use part of the stabilization fund. We also expect that the MinFin will accelerate the local issuance plan if local bonds become euroclearable as non-resident participation could increase significantly.

**YEAR TO DATE GROSS BORROWING VERSUS 2012 FUNDING PLANS**

Local currency issuance versus 2012 plans




Hard currency issuance versus 2012 funding plan




Source: Ministries of Finance, Debt Management Agencies, UniCredit Research

## Cash reserves versus maturities

**We also considered how long current cash reserves could last**

Although public financing YTD versus the original plan shows significant differences and in several cases the overfunding provides an important cushion in times of market stress, room for manoeuver is also determined by the actual level of cash reserves and the maturity profile of public sector debt. The absolute level of cash reserves (local and hard currency combined) of the treasuries with the respective central banks at the end of April was relatively similar in Turkey, Romania, Hungary and the Czech Republic at around EUR 6bn. Russia and Poland had slightly higher cash reserves at around EUR 7.5bn and EUR 9bn[1]. In order to assess the room for flexibility, we compared these cash reserve levels to the upcoming bond maturities (again T-bond, T-bill and hard-currency bonds combined) and to forecast fiscal balances.

**The short maturity profile of Turkish debt makes the treasury less flexible**

**Hungary has also little room for maneuver, underlying the need for an IMF program**

Our chart shows the development of cash reserves as a percentage of initial cash reserves (from the end of April 2012), taking into account the sovereign maturities and our projected cash fiscal balances. We assumed a very low 70% rollover rate for both local and hard-currency bonds. To put this rollover number into perspective, the first Hungarian IMF program, which was implemented in November 2008 had a 75% public sector debt-rollover assumption for the first two quarters. We also assume full IMF repayment in the case of Hungary (obviously a potential new program could have significant implications for this projection) and Romania. As our chart shows, Turkey has the tightest position, which is followed by Hungary and Romania, all exhausting their cash buffers by the end of 1Q13. Poland follows with 3Q13,

[1] The cash buffer number in case of Russia does not include the stabilization fund.

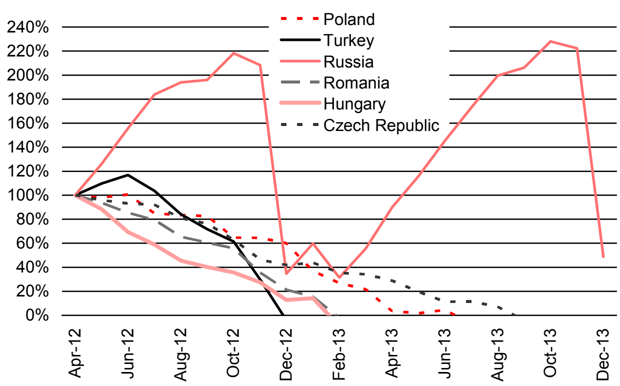
while Czech Republic could maintain a very low debt rollover rate until 4Q13. We note that the relatively rapid drying up of the Turkish cash balance comes from the fact that Turkish public debt has the shortest maturity. Russia is in the strongest position given that the headline fiscal surplus fully compensates for debt repayments and its cash balance never reaches zero in our simulation. As can be seen on the right hand chart below, heavy seasonality makes 4Q more challenging than the other quarters.

**Public sector debt rollover ratios need to fall significantly, even in the case of Turkey and Hungary to exhaust cash buffers by the end of the year**

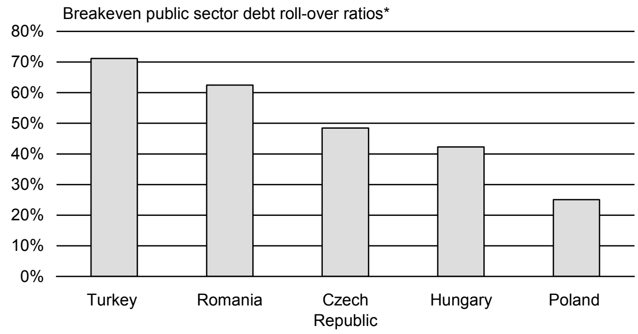
As a nice way to show relative strength in times of stress, we calculated breakeven rollover ratios country by country. We wanted to find out the public sector rollover ratio that would completely exhaust the current cash reserves by the end of 2012. We excluded Russia from this part of the exercise given its heavy fiscal surplus. We found that Turkey has the least flexibility with the above-defined breakeven rollover ratio standing at 70%. Romania comes next with a 62% breakeven rollover. Czech Republic and Hungary have breakeven rollover rates of 48% and 42% respectively. As we highlighted before, in the case of Hungary this would mean about EUR 1.0-1.5bn FX reserve usage, which in turn could put additional pressure on the currency and longer term borrowing costs. Poland has the most flexibility with only 25% breakeven debt rollover ratio due to its strong fiscal position coupled with heavy prefunding.

**DEBT PROFILE VERSUS CASH BUFFERS**

Cash balance as % of the April level assuming 70% public debt roll-over ratios




Turkey has to maintain the highest level of debt roll-over




*The chart shows the public sector debt roll-over ratio that would completely exhaust the current cash buffers by end of 2012.

Source: Bloomberg, National central banks and ministries of finance, UniCredit Research

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# Countries

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

**Outlook** – GDP growth came to a standstill in 1Q12, as exports lost ground. Amid signs of a growth deceleration in EMU and the global economy more generally, Bulgaria is likely to remain a relative underperformer in the CEE region as deleveraging and the uncompleted housing market adjustment will hold back domestic recovery. The country's exposure to Greece is another key growth setback. We see some scope to relax the deficit-reduction targets, allowing the government to boost capital spending and domestic demand more generally.

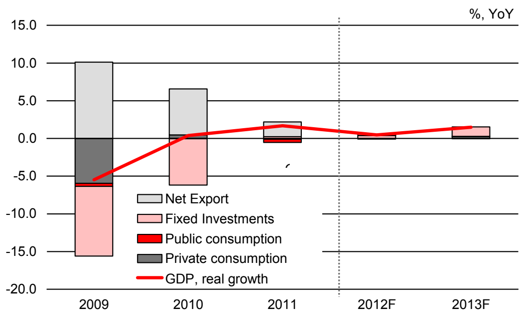
**Strategy –** Against the backdrop of global uncertainty, the MinFin has left all options for repaying the Jan 2013 bond maturity (Eurobond, domestic market and fiscal reserves). We still think that Eurobond issuance is the preferred and look to add if price is attractive.

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

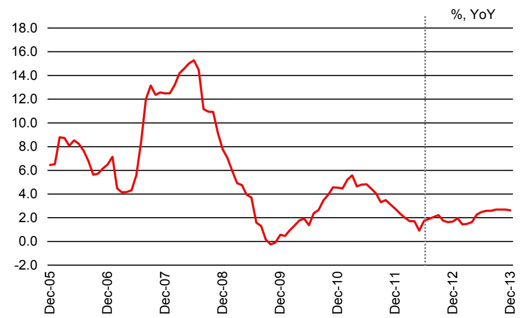
### KEY DATES/EVENTS

- 9 Aug – Number of employees under labor contract, 2Q
- 14 Aug – Flash estimates of 2Q12 GDP swda figures
- Up to 14 Sep – Submission of draft 2013 Budget law in parliament

### GDP GROWTH AND CONTRIBUTION TO GROWTH




### INFLATION (CPI) YOY




Source: NSI, BNB, UniCredit Research

### MACROECONOMIC DATA AND FORECASTS

| | 2009 | 2010 | 2011 | 2012F | 2013F |
|---|---|---|---|---|---|
| GDP (EUR bn) | 34.9 | 36.1 | 38.5 | 39.4 | 40.8 |
| Population (mn) | 7.6 | 7.5 | 7.3 | 7.3 | 7.2 |
| GDP per capita (EUR) | 4,618 | 4,804 | 5,252 | 5,404 | 5,635 |
| **Real economy yoy (%)** | | | | | |
| GDP | -5.5 | 0.4 | 1.7 | 0.5 | 1.5 |
| Private Consumption | -7.6 | 0.6 | -0.2 | -0.1 | 0.3 |
| Fixed Investment | -17.6 | -18.3 | -9.7 | 1.7 | 6.0 |
| Public Consumption | -4.9 | -0.5 | -4.9 | -0.1 | 0.2 |
| Exports | -11.2 | 14.7 | 12.8 | 0.8 | 2.6 |
| Imports | -21.0 | 2.4 | 8.5 | 0.5 | 2.5 |
| Monthly wage, nominal (EUR) | 311 | 331 | 362 | 384 | 413 |
| Unemployment rate (%) | 8.4 | 11.3 | 11.8 | 13.1 | 13.0 |
| **Fiscal accounts (% of GDP)** | | | | | |
| Budget balance | -0.8 | -3.9 | -2.1 | -2.0 | -2.0 |
| Primary balance | 0 | -3.3 | -1.4 | -1.2 | -1.1 |
| Public debt | 15.6 | 16.7 | 17.0 | 20.9 | 20.7 |
| **External accounts** | | | | | |
| Current account balance (EUR bn) | -3.1 | -0.4 | 0.4 | 0 | -0.5 |
| Current account balance/GDP (%) | -8.9 | -1.0 | 0.9 | 0.1 | -1.3 |
| Basic balance/GDP (%) | -1.9 | -1.1 | 0.4 | 0.6 | 1.4 |
| Net FDI (EUR bn) | 2.5 | 0.7 | 1.2 | 1.3 | 1.6 |
| Net FDI (% of GDP) | 7.2 | 1.8 | 3.1 | 3.2 | 3.9 |
| Gross foreign debt (EUR bn) | 37.8 | 37.1 | 35.4 | 34.2 | 33.7 |
| Gross foreign debt (% of GDP) | 108.3 | 102.8 | 91.9 | 87.0 | 82.6 |
| FX reserves (EUR bn) | 12.9 | 13.0 | 13.3 | 13.6 | 14.2 |
| **Inflation/Monetary/FX** | | | | | |
| CPI (pavg) | 2.8 | 2.4 | 4.2 | 1.8 | 2.3 |
| CPI (eop) | 0.6 | 4.5 | 2.8 | 1.7 | 2.6 |
| Central bank reference rate (eop) | 0.2 | 0.2 | 0.2 | 0.2 | 0.3 |
| USD/BGN (eop) | 1.36 | 1.47 | 1.51 | 1.67 | 1.59 |
| EUR/BGN (eop) | 1.96 | 1.96 | 1.96 | 1.96 | 1.96 |
| USD/BGN (pavg) | 1.41 | 1.48 | 1.41 | 1.54 | 1.66 |
| EUR/BGN (pavg) | 1.96 | 1.96 | 1.96 | 1.96 | 1.96 |

Source: UniCredit Research

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

## Bulgaria: Feeling the pinch

**The 1Q GDP data showed that Bulgaria's GDP growth had slowed down significantly even before the most recent escalation of the eurozone's sovereign debt crisis.**

GDP growth came to a standstill in 1Q12, as exports lost ground even before the latest escalation of the EMU crisis. Real GDP growth was flat qoq in 1Q12, while it was down yoy for a fifth consecutive quarter to just 0.5%. The 4Q11 qoq reading was revised down from +0.3% to +0.1%. The detailed data also failed to impress. The slowdown was mostly attributable to net exports, which reduced GDP growth by 1.3pp in 1Q12, as the export slowdown (-2.9% qoq) was steeper than that of imports (-0.8% qoq). Five of the top ten Bulgarian export markets suffered double-digit drops in yoy volumes. There was little surprise that exports to neighboring Greece, Romania and Turkey were among them, as growth in these countries was already showing pronounced signs of weakness even before the start of the current year. But the negative surprise came from exports to Germany and Belgium, where volumes suffered contractions of broadly the same proportions, meaning that Bulgaria failed to benefit from the relatively solid growth momentum in some of its key EU trading partners, even before the most recent escalation of the eurozone's sovereign-debt crisis. On the positive side, exports to China and some Arab states posted very impressive growth, suggesting that efforts to diversify the geographical composition of exports away from the EU (which dominates with an 80% relative share) towards other promising export markets is starting to produce the desired results.

**Exports to China and Arab states accelerated rapidly, helping to diversify geographical composition of exports.**

**But household consumption recovery disappointed.**

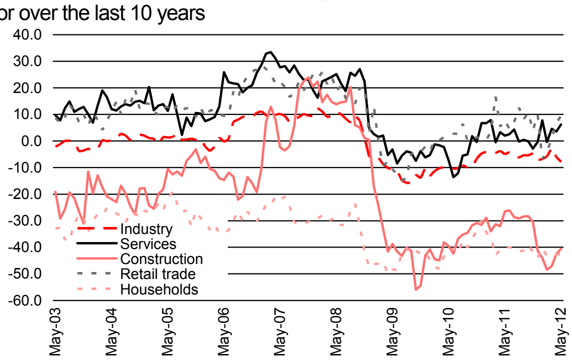
As expected, 1Q12 GDP data has confirmed the frustratingly slow pace of recovery inhousehold consumption. Individual consumption was up by a modest 0.5% qoq, corresponding to a 1% rise yoy, but was still 5.4% below its pre-crisis peak. Apparently, the support that individual consumption has drawn from rising wages (8.9% yoy) and easing inflation (2.0% yoy) was strong enough to counterbalance the negative impact that came from the falling job numbers (1.6% yoy). After four consecutive quarters of negative qoq growth, GFCF showed signs of stabilization by rising 0.4% in 1Q12. On top of the constantly improving absorption of EU funds, which boosts infrastructure investments, some anecdotal evidence also suggests that investments have bottomed out and are likely to see some modest positive growth this year. Russian company Lukoil has started a USD 1.5bn investment project to raise the productivity and efficiency of its oil refinery in Burgas, which will make it the largest catalytic hydrocracking plant in Eastern Europe and will place it among the most competitive such installations in the world.

**Reassuringly, GFCF showed clear signs of stabilization in 1Q12.**

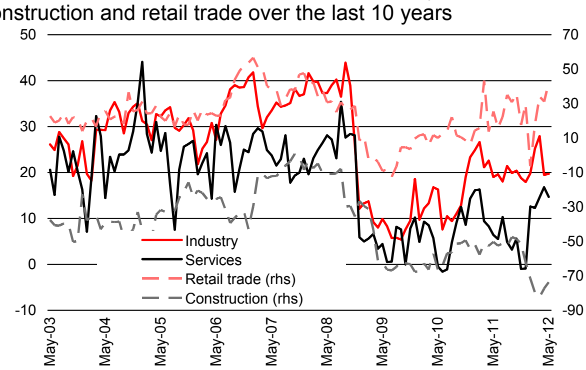
**Previous GDP data revisions reduced carryover effect.**

1Q12 GDP growth was marginally weaker than we predicted three months ago (0.0% versus our 0.1% estimate), but revisions to previous data reduced the positive carryover effect entering into 2012 to 0.2% from 0.5% initially. The recent dip in the survey data and business managers' output expectations in particular seem to suggest that industry is already feeling the negative effects from the apparent downturn in Germany since the start of 2Q12. Moreover, some of the downside risks to our growth projection, as outlined in previous quarterly publications, seem to be materializing. The Greek crisis took a turn for the worse, adding to the already significant deleveraging pressure on local banks and firms. Companies also hoard cash, as yields on presumably risk-free bank deposits are between 5% and 6%, thus dampening investments and growth. As a result, we now forecast real GDP growth of 0.5% this year (versus our 1.2% estimate in April) and 1.5% next year (versus our 2.7% estimate in April).

Headline economic sentiment indicators by sector over the last 10 years




Output expectation component of ESI in industry, services, construction and retail trade over the last 10 years




Source: NSI, Unicredit Research

**Inflationary pressure subsided further in the first 4M of this year.**

**But slow domestic recovery and weak labor markets in particular will keep price pressure in check this year and well into next year.**

Year-on-year CPI receded to 1.7% in April, which is the lowest reading since March 2010 and 2.9pp below where it was one year earlier. As the Bulgarian economy operates significantly below its full capacity, demand-side inflationary pressure remains low. Core CPI, when calculated on a yoy basis, has remained below the 1% benchmark since December 2009. The gap between PPI and CPI has also narrowed over the last six months (from 3.8% in October 2011 to 1.9% in April 2012), suggesting that lower pass-through effects should be expected in the months to come. Inflationary expectations inched up slightly in March and April, as the state-controlled regulator is set to increase some utility prices later this month, but as a whole remained well anchored nevertheless. All these have confirmed our view that when the pass-through effects from the supply-side shocks to global energy prices come to an end, the future inflation will mostly depend on domestic factors and particularly on the labor market recovery. The labour market looks set to remain weak, with unemployment stuck above the 12% mark over the next two years, while real wages are expected to continue to increase, but marginally. In response, real earnings are likely to see only modest gains which means that price pressure coming from the labor market will remain well contained next year. Given all that, we see avg CPI at 2.2% in 2012, rising marginally higher to 2.9% eop and 2.5% avg in 2013.

**Introduction of remote, real-time connection between all cash registers and the control systems of the tax authorities helped to improve tax collection.**

Public sector finances showed solid improvement. The cumulative budget deficit for the first four months of 2012 narrowed to just 0.3% of GDP, compared to the already solid 0.7% one year earlier. Despite practically stagnant domestic demand, fiscal revenues were spectacular at 7.4% higher in the four months to April this year, propelled by an ample 22% raise in VAT revenues. While the combination of stronger imports and weaker exports played its role in pushing VAT revenues higher, it is the progress that the government made in improving tax compliance that was key to explaining this very positive result. More specifically, the introduction of remote connection between the cash registers of practically all commercial entities operating in Bulgaria and the control systems of the National Revenue Agency at the end of March, helped push VAT revenues 35% higher mom in April.

**European Commission recommended excessive budget deficit procedure against Bulgaria to be abrogated.**

Amid signs of slowing growth in the eurozone economy, focus has increasingly shifted to boosting infrastructure construction. To this end, the government is cutting maintenance costs not only to keep the budget deficit below EU-mandated limits, but also to open more room for capital spending in a country where the road network is sorely in need of rebuilding and expansion. Wages and maintenance costs, including social insurance contributions paid from the state coffers, were up by just 0.7% yoy, which enabled capital spending to grow by 13.1% yoy in the first four months of 2012, after a 13.4% yoy slump for the whole 2011. And even though capital spending is set to rise further later this year to keep up pace with the constantly-improving EU funds absorption, we see no major implementation risk for the budget. All this has confirmed our view, that the government is on track to keep the budget deficit close to 2% of GDP this year. Underscoring further the country's strong public sector balance sheet, on 30 May the European Commission recommended that the Council abrogates the excessive budget deficit procedure against Bulgaria.Against this backdrop, we see some scope to relax the deficit-reduction targets, which the government could use to boost capital spending and domestic demand more generally. But to be realistic, this is likely to be too modest to avoid domestic demand stagnation and to produce any material boost to the number of jobs.

## Strategy: 2012 debt management, driven by 2013 specifics

**Policymakers are bracing for challenges to the economy and a debt repayment at the start of 2013.**

With deteriorating global market conditions and elevated volatility in asset prices, Bulgarian policymakers have taken a defensive stance and are already bracing for both a softer economic patch and a key external debt repayment in 2013. Despite the ease with which the current financing needs are going to be met, the government is taking advantage of favorable domestic issuance conditions and is amassing cash buffers in the form of a rising fiscal reserve. This should not only help deal with any challenges in the immediate future, but also help meet a debt repayment in January 2013 of EUR 0.818bn (or 2% of 2012 GDP). Against the backdrop of global uncertainty, the MinFin has left all options for meeting this obligation wide open – the 2012 Budget law envisages a Eurobond issue of circa EUR 1bn, while domestic markets will be tapped for a gross sum of EUR 0.625bn (a sum which could easily rise during the year, although concerns over banking sector liquidity might inhibit such a move), with healthy levels of fiscal reserves still standing as a last resort. It is not yet clear what combination of the three will be used, but our view is that the MinFin will aim at addressing the Eurobond market as soon as market conditions allow, thus keeping domestic liquidity unchanged. With a one notch rating upgrade in the pipeline, but not seen to be around the corner (in our view – sometime in 2H12 or early 2013) the government's priority will likely shift from the reduction of funding cost to a focus on volumes with a more aggressively biased issuance policy in external markets.

**A Eurobond issue will be the main tool of government financing in 2012.**

**Author: Nikola Georgiev, Economist (Nikola.R.Georgiev@UniCreditGroup.bg)**

**GOVERNMENT GROSS FINANCING REQUIREMENTS**

| EUR bn | 2011 | 2012F | 2012F |
|---|---|---|---|
| **Gross financing requirement** | **1.5** | **1.5** | **2.1** |
| Budget deficit (excl Nafto) | 0.8 | 0.8 | 0.8 |
| Amortisation of public debt | 0.5 | 0.6 | 1.1 |
| Domestic | 0.4 | 0.4 | 0.2 |
| Bonds | 0.4 | 0.4 | 0.2 |
| Bills | 0 | 0 | 0 |
| External | 0.1 | 0.2 | 1.0 |
| of which IMF | 0.2 | 0.2 | 0.2 |
| **Financing** | **0.9** | **2.1** | **1.2** |
| Domestic borrowing | 0.6 | 0.7 | 0.8 |
| Bonds | 0.6 | 0.7 | 0.8 |
| Bills | 0 | 0 | 0 |
| External borrowing | 0.3 | 1.2 | 0.3 |
| Bonds | 0 | 1.0 | 0 |
| IMF | 0.3 | 0.3 | 0.3 |
| Other | 0.1 | 0.2 | 0.2 |

Source: MinFin, BNB, UniCredit Research

**GROSS EXTERNAL FINANCING REQUIREMENTS**

| EUR bn | 2011 | 2012F | 2012F |
|---|---|---|---|
| **Gross financing requirement** | **16.3** | **15.4** | **15.0** |
| C/A deficit | -0.4 | 0 | 0.5 |
| Amortisation of debt | 5.4 | 4.8 | 5.0 |
| Government/central bank | 0.3 | 0.4 | 1.1 |
| Banks | 0.8 | 0.5 | 0.3 |
| Corporates | 4.3 | 4.0 | 3.6 |
| Short term debt amortisation | 11.3 | 10.6 | 9.4 |
| **Financing** | **16.6** | **15.6** | **15.6** |
| FDI | 1.2 | 1.3 | 1.6 |
| Portfolio flows | -0.4 | 0.2 | 0.2 |
| Borrowing | 1.7 | 2.8 | 2.0 |
| Government/central bank | 0.3 | 1.2 | 0.3 |
| Banks | 0.5 | 0.5 | 0.4 |
| Corporates | 0.9 | 1.1 | 1.3 |
| Short term | 10.6 | 9.4 | 9.1 |
| EU transfers | 0.2 | 1.1 | 1.2 |
| Other | 3.2 | 0.9 | 1.4 |

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

**Outlook** – Deep recession in 1Q and little hope of a turnaround in 2Q make us reduce our full-2012 GDP forecast to -0.6%. Alongside signs of easing inflation, the poor growth outlook opens the door to the CNB interest rates cut already in June. The government's fiscal plans remain ambitious but are at risk due to the growth outlook.

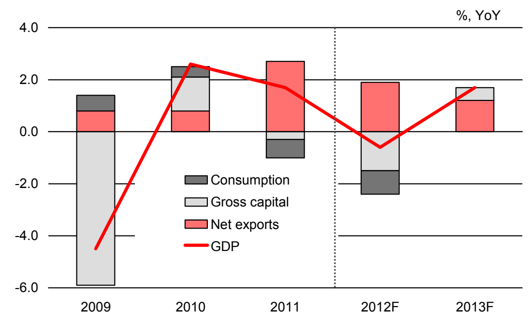
**Strategy outlook** – We think Czech assets will benefit from their regional safe heaven status. From portfolio perspective we recommend O/W allocation both in local currency bonds and Eurobonds. From outright perspective we would only consider locally funded CZGBs which continue to be cheap on ASW basis.

**Author: Pavel Sobisek, Chief Economist (UniCredit Bank)**

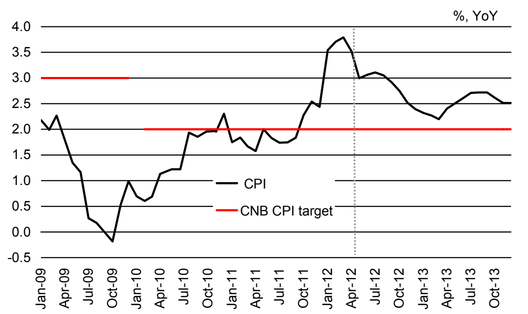
### KEY DATES/EVENTS

- CNB Board meetings – 28 Jun, 2 Aug
- Final parliamentary vote on government's tax proposals – Sep
- Manufacturing PMI – 2 Jul, 1 Aug, 3 Sep

### BREAKDOWN OF GDP GROWTH BY DEMAND COMPONENTS




### CONSUMER PRICE INDEX – HISTORY AND OUTLOOK




Source: CSO, CNB, UniCredit Research

### MACROECONOMIC DATA AND FORECASTS

| | 2009 | 2010 | 2011 | 2012F | 2013F |
|---|---|---|---|---|---|
| GDP (EUR bn) | 141.5 | 149.2 | 154.8 | 151.7 | 159.3 |
| Population (mn) | 10.5 | 10.5 | 10.5 | 10.5 | 10.5 |
| GDP per capita (EUR) | 13,491 | 14,185 | 14,749 | 14,430 | 15,132 |
| **Real economy yoy (%)** | | | | | |
| GDP | -4.5 | 2.6 | 1.7 | -0.6 | 1.7 |
| Private Consumption | -0.3 | 0.5 | -0.6 | -1.7 | 0.5 |
| Fixed Investment | -11.4 | 0 | -0.9 | -4.5 | 2.0 |
| Public Consumption | 3.8 | 0.6 | -1.7 | -1.0 | -1.0 |
| Exports | -9.7 | 16.0 | 11.1 | 4.1 | 7.9 |
| Imports | -11.4 | 15.7 | 7.5 | 2.4 | 7.5 |
| Monthly wage, nominal (EUR) | 883 | 944 | 994 | 986 | 1,026 |
| Unemployment rate (%) | 8.1 | 9.0 | 8.6 | 8.6 | 8.7 |
| **Fiscal accounts (% of GDP)** | | | | | |
| Budget balance | -5.8 | -4.8 | -3.1 | -3.4 | -3.4 |
| Primary balance | -4.6 | -3.5 | -1.7 | -1.9 | -1.9 |
| Public debt | 34.4 | 38.1 | 41.2 | 43.9 | 45.6 |
| **External accounts** | | | | | |
| Current account balance (EUR bn) | -3.4 | -5.8 | -4.4 | -2.0 | -1.6 |
| Current account balance/GDP (%) | -2.4 | -3.9 | -2.9 | -1.3 | -1.0 |
| Basic balance/GDP (%) | -0.9 | -0.8 | -0.4 | 1.4 | 2.1 |
| Net FDI (EUR bn) | 2.1 | 4.6 | 3.9 | 4.1 | 4.9 |
| Net FDI (% of GDP) | 1.5 | 3.1 | 2.5 | 2.7 | 3.1 |
| Gross foreign debt (EUR bn) | 61.9 | 70.5 | 72.6 | 75.5 | 83.1 |
| Gross foreign debt (% of GDP) | 43.8 | 47.3 | 46.9 | 49.8 | 52.1 |
| FX reserves (EUR bn) | 28.9 | 31.8 | 31.1 | 33.0 | 33.0 |
| **Inflation/Monetary/FX** | | | | | |
| CPI (pavg) | 1.0 | 1.5 | 1.9 | 3.1 | 2.5 |
| CPI (eop) | 1.0 | 2.3 | 2.4 | 2.4 | 2.5 |
| Central bank target | 3.0 | 2.0 | 2.0 | 2.0 | 2.0 |
| Central bank reference rate (eop) | 1.0 | 0.8 | 0.8 | 0.5 | 1.0 |
| 3M money market rate | 1.9 | 1.1 | 1.0 | 0.8 | 0.7 |
| USD/CZK (eop) | 18.4 | 18.8 | 19.4 | 22.0 | 20.2 |
| EUR/CZK (eop) | 26.5 | 25.1 | 25.8 | 25.7 | 24.8 |
| USD/CZK (pavg) | 19.0 | 19.1 | 17.6 | 20.3 | 21.4 |
| EUR/CZK (pavg) | 26.4 | 25.3 | 24.6 | 25.5 | 25.3 |

Source: UniCredit Research

## Growth prospects become bleaker

**1Q GDP fell sharply on lower stock-building and declining private spending.**

1Q saw the economy fall into technical recession, with GDP posting a 0.8% qoq contraction after a 0.2% qoq drop in 4Q. In yoy terms, 1Q GDP fell 0.7%, pulled down chiefly by lower stock-building and by an accelerating decline in household consumption. Net exports continued to contribute positively to growth while fixed capital formation growth also surprisingly turned positive after contracting in the previous two quarters.

**Signs are increasing that economic weakness is deepening in 2Q.**

Many signs have emerged lately that economic activity has been declining further through 2Q. The manufacturing PMI fell back into contraction territory in April before extending its decline to May's 47.6, the weakest value since August 2009. The state budget deterioration in May came largely from the revenue side, with social contributions and VAT collection taking the strongest hits. A slowdown in credit growth and a surprisingly strong decline in retail sales in April appeared as additional signals of deepening economic weakness at the start of 2Q.

**A weak Q1 combined with a downward revision to our G7 forecasts means we cut our GDP forecast for Czech.**

On a more positive note, industrial production has so far avoided contraction in yoy terms, with April seeing an above-consensus increase of 2.2% yoy. However given the prevailing negative news coming from the rest of Europe, we believe that exports have probably lost their ability to prevent the economy from slipping into a deeper contraction. Hence, we have reduced our FY12 GDP forecast to -0.6% from the previous 0.4%.

**Fulfilment of fiscal targets looks in danger due to irregularities in EU funds' drawdown.**

The budget deficit dropped more than envisaged to 3.1% of GDP last year, in part due to a slowdown in public investment. Subsequently, the 2012 deficit target was set at 3.0% of GDP, down from the original 3.5%. Nevertheless, we see the possibility of missing this target as rather significant. While poorer tax collection may be broadly offset by delays in local government investment projects following several related corruption charges, another specific factor may outweigh this. This regards the EU funds, whose drawdown has been frozen due to irregularities surrounding their administration. Prime Minister Petr Nečas warned (admittedly, in a politically motivated statement) that a failure to secure these funds may balloon this year's deficit to as high as 6.0% of GDP. Looking at 2013, the deficit target of 2.9% of GDP is hoped to be achieved using the government's new package of tax hikes, which gained a preliminary nod from the lower house in early June. Importantly, the vote showed that Mr. Nečas has parliamentary backing for his fiscal consolidation plans despite a recent split in the ruling coalition having narrowed its parliamentary majority.

**Inflation is set to continue declining in the remainder of 2012.**

With volatile food and fuel prices now reversing their previous sharp increases, the past two months have seen inflation retreating from its peak of 3.8% yoy in March. We expect CPI to continue declining towards year-end, bringing some alleviation to strained household purchasing power. As for 2013, we assume the planned rise in VAT will add 1pp to CPI, similar to the 2012 VAT adjustments. Hence, we expect inflation to hover around 2.5% yoy throughout next year.

**Yet another 25bp interest rate cut looks to be in the pipeline.**

Considering declining consumer and producer price inflation, the deteriorating economic environment and dovish signals from the CNB, we now see a solid chance that the Bank will cut interest rates at the end of June. In fact, a quarter-point easing would bring the repo rate to 0.50%, 50bp below the ECB's benchmark rate. We also think that the first hike will only come in 2H13 when it is hoped that clearer signs of sustainable economic recovery will be apparent. Although two 25bp hikes in the repo rate to 1.00% at the end 2013 are included in our baseline scenario, we are aware that the timing of further steps in interest-rate normalization is highly uncertain at the moment.

**CZK seen weaker than before against EUR.**

With EUR/CZK moves remaining closely correlated with EUR/USD fluctuations, UniCredit's more bearish view on the EUR has made us lift our EUR/CZK predictions slightly for this year and next. We now see the rate at 25.5 at end-2012 and at 24.8 a year later.

# Estonia (AA- negative / A+ stable)*

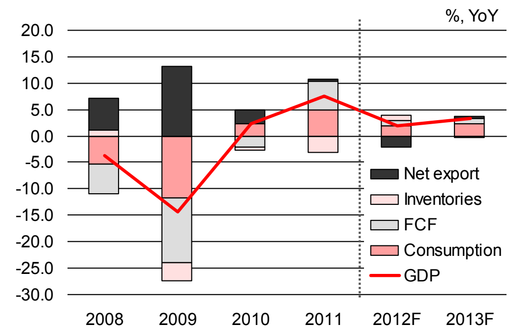
**Outlook** – 1Q GDP came in at 3.6% yoy (0.3% qoq sa). This, as expected, is a slowdown from the 4.5% posted in 4Q12 and 7.4% for FY11. However, the current reading shows that the economy is quite exposed to the external slowdown. The IP index posted negative yoy numbers for most of 1Q and also remained in negative territory at the beginning of 2Q. Retail sales however continued to post impressive results in 1Q and at the beginning of 2Q. We expect growth figures to moderate to 1.9% for FY12, but surely remain in positive zone. The budget balance followed the same dynamic as in 2011 when the country posted a 1.0% surplus.

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

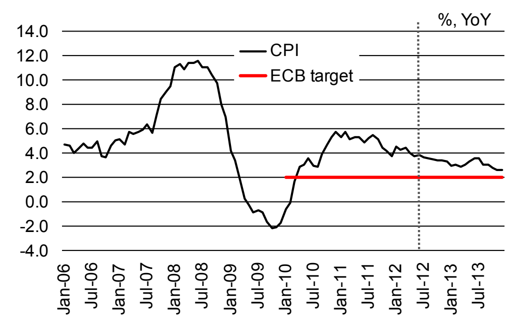
## KEY DATES/EVENTS

- 10 Aug, 7 Sep – 2Q GDP (prelim/final)
- 29 Jun, 31 Jul, 31 Aug – Industrial production
- 29 Jun, 30 Jul, 30 Aug – Retail trade

## CONSUMPTION TO SUPPORT GROWTH




## INFLATION TO DECELERATE




Source: Statistics Estonia, UniCredit Research

## MACROECONOMIC DATA AND FORECASTS

| | 2009 | 2010 | 2011 | 2012F | 2013F |
|---|---|---|---|---|---|
| GDP (EUR bn) | 13.9 | 14.5 | 16.4 | 17.3 | 18.4 |
| Population (mn) | 1.3 | 1.3 | 1.3 | 1.3 | 1.3 |
| GDP per capita (EUR) | 10,344 | 10,871 | 12,311 | 12,970 | 13,819 |
| **Real economy yoy (%)** | | | | | |
| GDP | -13.9 | 3.1 | 7.6 | 1.9 | 3.4 |
| Private Consumption | -18.8 | -2.1 | 6.6 | 2.7 | 3.2 |
| Fixed Investment | -32.9 | -9.6 | 26.8 | 3.5 | 4.0 |
| Public Consumption | 0 | -2.0 | 1.6 | 0.1 | 0.9 |
| Exports | -18.7 | 21.2 | 24.8 | 4.5 | 9.5 |
| Imports | -32.6 | 20.5 | 27.3 | 7.2 | 9.6 |
| Monthly wage, nominal (EUR) | 782 | 788 | 820 | 845 | 878 |
| Unemployment rate (%) | 13.8 | 16.8 | 11.6 | 11.0 | 10.3 |
| **Fiscal accounts (% of GDP)** | | | | | |
| Budget balance | -1.7 | -0.8 | 0.3 | 0 | 0.5 |
| Primary balance | -1.7 | -0.8 | 0.2 | 0 | 0.5 |
| Public debt | 7.2 | 7.7 | 6.5 | 6.2 | 5.3 |
| **External accounts** | | | | | |
| Current account balance (EUR bn) | 0.6 | 0.5 | 0.5 | 0.2 | -0.1 |
| Current account balance/GDP (%) | 4.5 | 3.6 | 3.0 | 1.0 | -0.4 |
| Basic balance/GDP (%) | 6.0 | 11.0 | 12.8 | 3.6 | 1.8 |
| Net FDI (EUR bn) | 0.1 | 0.9 | 1.2 | 0.5 | 0.4 |
| Net FDI (% of GDP) | 1.5 | 7.4 | 9.8 | 2.6 | 2.2 |
| Gross foreign debt (EUR bn) | 17.4 | 16.6 | 17.3 | 18.0 | 19.8 |
| Gross foreign debt (% of GDP) | 125.5 | 114.2 | 105.6 | 104.5 | 107.5 |
| FX reserves (EUR bn) | 2.3 | 2.6 | 2.3 | 2.5 | 2.5 |
| **Inflation/Monetary/FX** | | | | | |
| CPI (pavg) | -0.1 | 3.0 | 5.0 | 3.4 | 3.0 |
| CPI (eop) | -0.8 | 3.9 | 3.7 | 2.8 | 2.6 |

Source: UniCredit Research

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

## Soft landing in sight

**GDP growth slowed down and is increasingly reliant on domestic demand.**

**1Q GDP came in at 3.6% yoy (0.3% qoq sa).** This, as expected, is a further slowdown from the 4.5% yoy posted in 4Q12 and 7.4% for FY11. The current reading shows that the economy continues to be exposed to external forces. The growth deceleration may partially be attributed to base effects, although we must admit that GDP in absolute terms is still 7.3% below the 1Q peak registered in 2007. In 1Q12 the biggest contribution to economic expansion came from domestic demand. Private consumption (increasing 3.2% yoy), added 1.7pp, while gross fixed capital formation (+17.2% yoy) contributed a further 3.6pp. Public consumption (+1.8% yoy) added 0.6pp. Net exports removed 2.4pp (with exports adding 6.5pp due to 6.8% yoy growth vs. imports taking off 9.0pp due to 9.9% yoy increase). As in other Baltic countries, in 1Q we see an increasing contribution of domestic demand to GDP growth vs. growing downward pressure from net exports, due to the deteriorating external environment.

**IP data are mixed while retail sales remain strong.**

**Looking at the industrial production data, we see a deteriorating picture.** The IP index posted negative yoy numbers for most of 1Q (-0.5% in January and -6.1% in March, interrupted by 1.6% yoy growth in February) and also remained in negative territory at the beginning of 2Q (-4.0% yoy in April). However, the numbers did not mean a contraction in GDP due to support from retail sales, registering in January and February the highest yoy growth rates since 2007 at 15.0% yoy and 12.0% yoy, respectively, followed by 6.0% yoy growth in the next two months. The impressive dynamic in retail sales is stemming from the positive dynamics in the labor market. Employment steadily continued to grow, pushing the unemployment rate (seasonally adjusted) to a post-crisis low of 10.6%, which is sharp improvement versus the reading in 1Q10 of 19.0% and even versus the 1Q11 reading of 13.5%. In January-April, inflation peaked slightly, up from the 3.7% yoy December reading to the 4.0%-4.5% yoy range; however, in April it still posted the lowest reading of a year at 4.0% yoy. We expect inflation to decelerate further, which should support domestic demand. CPI-adjusted wages, as in previous quarters, also showed mostly positive dynamics, keeping a healthy balance between supporting competitiveness of exports and contributing to growth of domestic demand.

**C/A moved into negative territory with FDI remaining strong.**

**However, we see some potential risks on the upside for FDI (and GDP overall) from the LNG construction project.**

**1Q C/A, based on monthly data, posted a deficit of EUR 323mn (vs. a deficit of EUR 53mn a year ago).** This is a only a second negative number since 1Q09. Most of the result was determined by a twofold widening of the trade deficit and reduction of services surplus. The financing side in 1Q showed good results, with a strong FDI inflow of EUR 166mn (approx. 4.2% of 1Q GDP). However, we expect the FDI inflow to moderate and to finish FY12 at under EUR 0.5bn or slightly above 2.5% of GDP. This follows EUR 1.1bn in FDI inflow last year. We see some risks to this scenario on the upside, as in October of last year a study was completed on the LNG terminal construction in Estonia. We now believe that this project is temporarily out of the question, since LNG construction is about to be launched in Lithuania, which may act as a LNG hub for the region. However, Estonia up until now was one of the active candidates for designation as a site for the construction, and according to the latest reports, EU mediation and assistance will be requested to decide on the best location for the terminal (the EU agreed to provide funding for the construction only if the terminal will supply LNG to all Baltic states). If a positive decision for Estonia is made, we see a further inflow of FDI in Estonia in 2012 and 2013 as well as a boost for GDP in the next few years, but for the time being we do not include this scenario in our forecast

**Fiscal outlook, as always, looks extremely strong.**

**The fiscal outlook remains very strong.** Although the budget includes annual inflation of 2.0% yoy and real GDP growth of 4.0% yoy, so far this year the budget balance followed the same dynamic as in 2011, when the country posted a 1.0% surplus. We forecast a moderate deficit this year.

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

**Outlook** – We think Hungary will eventually have no option but to sign up for an IMF/EU deal. With continued weak global risk appetite, the sovereign continues to struggle to access external markets. Meanwhile the growth outlook is deteriorating (we now expect GDP to contract by 0.7% yoy in 2012), increasing the risks to this year's budget deficit target. Although headline inflation is well above the NBH target, we think the NBH still has a dovish bias and will start cutting rates as soon as the IMF talks start.

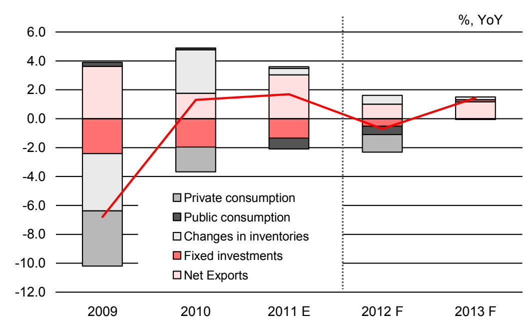
**Strategy** – Although the risk of further delay in the IMF negotiations is still relatively high, the end game is a programme albeit with significant bumps on the road. Accordingly we are looking to add selectively to local currency exposure if the opportunity arises.

**Author: Gyula Toth, Head of EEMEA FI/FX Strategy (UniCredit Bank)**

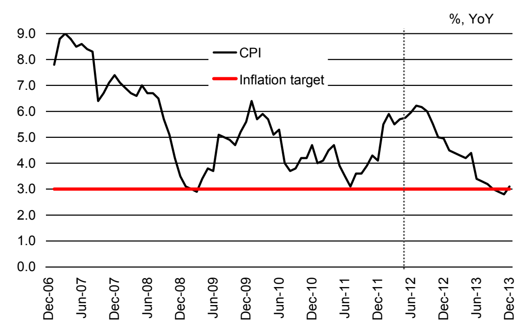
### KEY DATES/EVENTS

- 22 Jun – EcoFin meeting about cohesion funds
- 26 Jun, 24 Jul, 28 Aug – NBH MPC meetings
- 28 Jun – Inflation Report
- End Jun – Parliament should approve amended NBH bill
- 14 Aug – 2Q GDP

### GDP DRIVERS




### HEADLINE INFLATION VS. TARGET




Source: CSO, NBH, UniCredit Research

### MACROECONOMIC DATA AND FORECASTS

| | 2009 | 2010E | 2011 | 2012F | 2013F |
|---|---|---|---|---|---|
| GDP (EUR bn) | 91.3 | 97.2 | 100.8 | 98.1 | 108.5 |
| Population (mn) | 10.0 | 10.0 | 10.0 | 10.0 | 10.0 |
| GDP per capita (EUR) | 9,096 | 9,696 | 10,071 | 9,810 | 10,855 |
| **Real economy yoy (%)** | | | | | |
| GDP | -6.8 | 1.3 | 1.7 | -0.7 | 1.4 |
| Private Consumption | -5.7 | -2.7 | -0.1 | -1.9 | 0 |
| Fixed Investment | -11.0 | -9.7 | -5.4 | -3.1 | 0.9 |
| Public Consumption | 2.7 | 1.1 | -5.4 | -5.8 | -0.5 |
| Exports | -10.2 | 14.3 | 8.4 | 2.9 | 8.2 |
| Imports | -14.8 | 12.8 | 6.3 | 1.9 | 7.8 |
| Monthly wage, nominal (EUR) | 712 | 736 | 763 | 744 | 828 |
| Unemployment rate (%) | 9.8 | 11.1 | 11.0 | 11.2 | 10.8 |
| **Fiscal accounts (% of GDP)** | | | | | |
| Budget balance | -3.9 | -4.2 | 4.3 | -2.5 | -2.8 |
| Primary balance | 0.1 | -0.1 | -8.3 | 1.6 | 2.0 |
| Public debt | 79.8 | 82.2 | 81.4 | 77.1 | 77.0 |
| **External accounts** | | | | | |
| Current account balance (EUR bn) | -0.2 | 1.2 | 1.4 | 1.3 | 1.7 |
| Current account balance/GDP (%) | -0.2 | 1.2 | 1.4 | 1.4 | 1.5 |
| Basic balance/GDP (%) | 1.4 | 3.0 | 4.8 | 3.8 | 3.6 |
| Net FDI (EUR bn) | 1.5 | 1.7 | 3.4 | 2.4 | 2.2 |
| Net FDI (% of GDP) | 1.6 | 1.8 | 3.4 | 2.5 | 2.0 |
| Gross foreign debt (EUR bn) | 137.1 | 138.2 | 131.7 | 148.9 | 138.8 |
| Gross foreign debt (% of GDP) | 150.2 | 142.3 | 130.6 | 151.7 | 127.9 |
| FX reserves (EUR bn) | 30.7 | 33.7 | 37.7 | 45.3 | 30.0 |
| **Inflation/Monetary/FX** | | | | | |
| CPI (pavg) | 4.2 | 4.9 | 3.9 | 5.7 | 4.1 |
| CPI (eop) | 5.6 | 4.7 | 4.1 | 5.0 | 3.6 |
| Central bank target | 3.0 | 3.0 | 3.0 | 3.0 | 3.0 |
| Central bank reference rate (eop) | 6.3 | 5.8 | 7.0 | 7.0 | 6.5 |
| 3M money market rate | 8.7 | 5.5 | 6.1 | 7.1 | 6.8 |
| USD/HUF (eop) | 188 | 210 | 234 | 239 | 228 |
| EUR/HUF (eop) | 271 | 279 | 311 | 280 | 280 |
| USD/HUF (pavg) | 201 | 208 | 199 | 236 | 236 |
| EUR/HUF (pavg) | 281 | 275 | 279 | 297 | 279 |

Source: UniCredit Research

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

## Slow progress on IMF as growth deteriorates

**Very gradual progress is being made on an IMF deal.**

**We started the year with the expectation that Hungary would sign up for an IMF/EU deal relatively quickly, most probably in 1Q-2Q** but unfortunately progress has been slow. On a positive note, the EU decided in late April to close the infringement procedure against Hungary on some central bank issues while two other issues (the data protection authority's independence and the early retirement of judges) were referred to the European Court. However the government has still not reached an agreement with the IMF and the ECB regarding the central bank law. The IMF and ECB still have major concerns about the shift of executive powers from the executive board to the MPC, amongst other things. According to the latest statement from the leader of the Fidesz parliamentary group (Antal Rogan) a new central law will be submitted within two weeks. If this is in line with the IMF/ECB requirements it will open the door to negotiations.

**Growth outlook deteriorated quickly.**

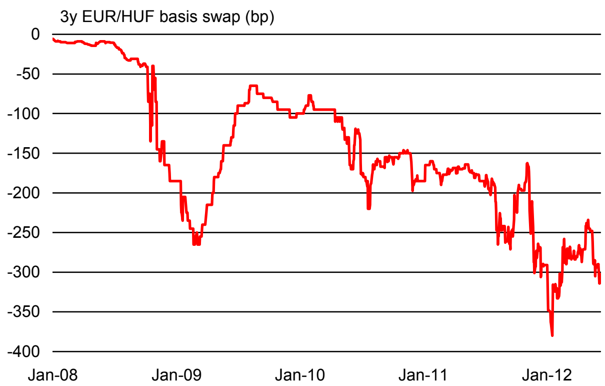
**Meanwhile the growth outlook is deteriorating quickly.** The 1Q GDP surprised strongly on the downside shrinking by 1.3% qoq and 0.7% yoy. Details show that gross capital formation represented the bulk of the quarterly decline (contributing negative 1.4% qoq). On the positive side this was driven by inventories and less by GFC. Assuming flat GDP for the rest of the year, annual GDP would contract by 1.2% yoy. High frequency indicators show further deterioration in April but some improvement in May. The April industrial production shrank by 2.4% mom which was broadly in line with the April PMI release but this surprised strongly on the upside in May. We think the high volatility of the PMI and IndOut numbers is probably coming from the start of the Daimler car plant in March. Against this backdrop we have revised our 2012 annual GDP growth forecast to a negative 0.7% yoy from flat in our previous forecast.

**Current account will stay in surplus.**

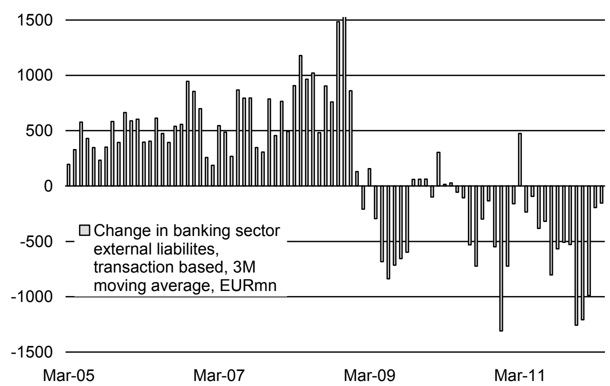
**Current account stays in surplus.** Although the 1Q current account number is not available yet, the monthly trade balance numbers suggest it remained in surplus. The Jan-March trade surplus was EUR 2.1bn vs. EUR 2.5bn in the same period of last year. Based on this, we expect the 1Q current account to come at around EUR 250mn of a surplus whilst for the full year we forecast EUR 1.4bn surplus. This will not lead to appreciation pressure on the HUF as the financial account continues to leak as banks repay their external liabilities. In Jan-May banks repaid EUR 810mn external liabilities (note that the Jan-Feb numbers were still influenced by the FX mortgage early repayment scheme).

**The updated convergence program and the Kalman Szell 2.0 plan** (2.2%/GDP correction) was enough to halt the cohesion fund suspension but it won't be enough for an IMF program as the prime focus of the official lenders is a need for more broad-based fiscal adjustment that works toward improving rather than reducing growth prospects.

The banking sector is facing some liquidity constraints




But outflows from the banking sector slowed in Jan-April




Source: Bloomberg, NBH, UniCredit Research

**Reaching a deal will not be easy however.**

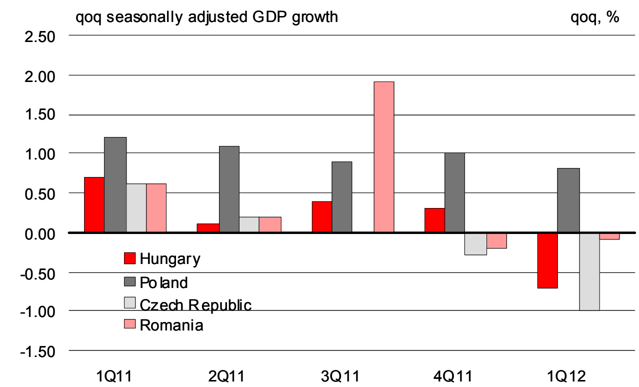
**Once they start, at least in part we expect the IMF discussions to center on the following:** #1 The financial transactions tax: It is challenging to calculate the real economic impact of the financial transaction tax as it could have some negative growth consequences. In order to offset the uncertainty, the government used only the bottom end of revenue estimates (HUF 130bn) but suggested that the actual number could be significantly higher. More broadly, the banking sector is set to suffer once again, albeit indirectly this time, further increasing uncertainty on its ability/willingness to lend in the future; #2 Along with the FTT, the government has failed to remove the sector tax on energy while the telecoms tax is shifted from the producer to the consumer. In contrast, the IMF's January document specifically noted the need for a reduction in outsized crisis taxes; #3 The improvement in the local government balance (total HUF 90bn in the two years) is at risk of delay given the difficulties involved in such a fundamental reform. Long-awaited implementation of public transport reform, primarily the railways, will be viewed as crucial as well; #4 Reductions in ministry expenditure carry downside risks to the extent that following 6 years of fiscal consolidation and there is limited fat left in the system in terms of scope for across-the-board cuts without underlying restructuring; #5 The flat tax, this year's 18% hike to the minimum wage and across-the-board reductions in social transfers: While a combination of measures has helped to generate an increase in labor force participation, official lenders will likely express concern on the impact to competitiveness from an 18% hike in the minimum wage, preferring instead some progressivity in terms of the flat tax and more of a buffer for those disadvantaged by the sharp reduction in unemployment benefits.

**The NBH has to remain cautious, but dovish bias is still there**

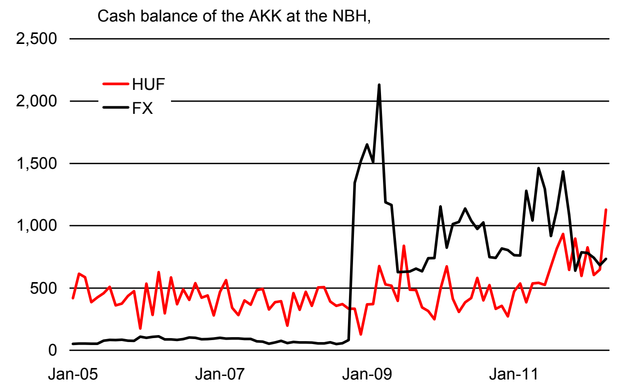
**Meanwhile the National Bank of Hungary** will concentrate on safeguarding financial stability. Although inflation is well above the NBH target (currently running at 5.7% yoy vs. the 3.0% yoy target), this is partly due to administrative price changes and hence in the medium term it is expected to return close to the target (assuming no further fiscal driven price shocks) mostly driven by the wide negative output gap. Meanwhile the MPC remains divided as evidenced at the last two meetings when one member voted for a rate cut, one member voted to hike rates, and five members voted to keep rates on hold. This notwithstanding and given the majority of the members are close to the government, we think the central bank will opt to cut rates quickly once the government has made some progress in the IMF/EU talks. We think a 50-75bp cut can easily be on the cards in this case.

**GROWTH IS UNDERPERFORMING WHILE AKK STILL HAS ROOM FOR MANEUVER**

Hungary GDP growth vs. the region




Both HUF and FX deposits of the AKK are above long-term average




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

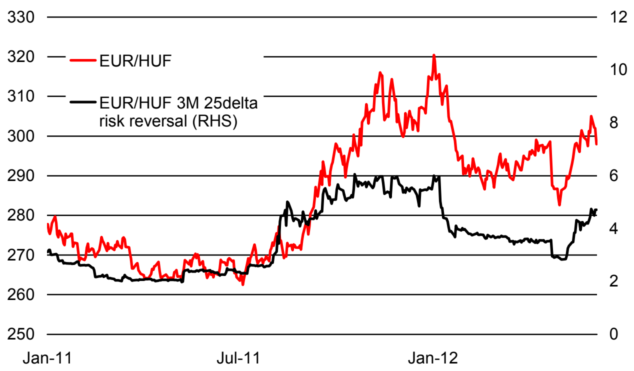
## Strategy: Position on local currency tactically

**As IMF program is the end game we look to add local currency exposure tactically.**

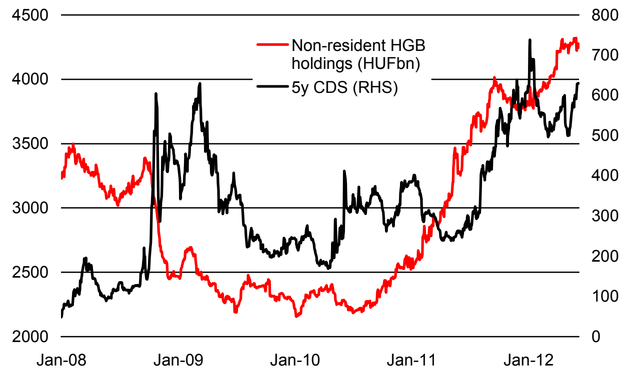
We do not see Hungarian markets close to a turning point without the actual start of the IMF/EU negotiations, but we do think that the end game is a deal. Even if this eventually starts we see the road to a deal being bumpy. This backdrop makes all Hungarian assets exposed to swings in global risk appetite and we expect the Hungarian beta to remain high. Given the lack of Eurobond issuance YTD, the AKK is under pressure to issue. Although we do not think that this is possible before the deal, we actually see high risk that they try to issue during the talks. We think this could well mean another heavy bump in the discussion process. The government's original plan included EUR 10.9bn gross local currency issuance and EUR 4.6bn external debt issuance. So far the government has covered about 77% of its funding plans locally and issued no Eurobond. Given the potential hard currency issuance we prefer to focus on the local currency markets and look to buy HUF and HGBs but only tactically speculating on the on the official talk timing.

**Author: Gyula Toth, Head of EEMEA FI/FX Strategy (UniCredit Bank)**

Bearish HUF positioning is not as strong as it was in 4Q11




Non-resident HGB positioning remains high




Source: Bloomberg, UniCredit Research

**GOVERNMENT GROSS FINANCING REQUIREMENTS[2]**

| EUR bn | 2011 | 2012F | 2013 |
|---|---|---|---|
| **Gross financing requirement** | 16.7 | 15.5 | 17.5 |
| Budget deficit | **3.2** | **3.0** | **3.0** |
| Amortization of public debt | 13.5 | 12.5 | 14.5 |
| Domestic | 9.6 | 7.9 | 9.5 |
| Bonds | 4.2 | 3.1 | 4.5 |
| Bills | 5.4 | 4.8 | 5.0 |
| External | 3.9 | 4.6 | 4.9 |
| IMF/EU | 2.0 | 3.3 | 3.5 |
| **Financing** | **16.7** | **15.5** | **17.5** |
| Domestic borrowing | 12.8 | 10.9 | 12.5 |
| Bonds | 7.4 | 6.1 | 7.5 |
| Bills | 5.4 | 4.8 | 5.0 |
| External borrowing | 3.9 | 4.6 | 4.9 |
| Bonds | 3.9 | 4.6 | 4.9 |
| IMF/EU | 0 | 0 | 0 |
| Other | 0 | 0 | 0 |

**GROSS EXTERNAL FINANCING REQUIREMENTS**

| EUR bn | 2011E | 2012F | 2013F |
|---|---|---|---|
| **Gross financing requirement** | **38.0** | **38.4** | **39.5** |
| C/A deficit | -1.4 | -1.3 | -1.7 |
| Amortisation of medium to long term debt | 39.4 | 39.7 | 41.2 |
| Government/central bank | 7.4 | 9.1 | 10.3 |
| Banks | 18.5 | 17.1 | 16.3 |
| Corporates | 13.5 | 13.6 | 14.6 |
| **Financing** | **37.7** | **37.2** | **40.1** |
| FDI | 3.4 | 2.4 | 2.2 |
| Equity | 3.6 | 0.3 | 0.4 |
| Borrowing | 32.6 | 30.9 | 31.8 |
| Government/central bank | 9.5 | 6.2 | 7.1 |
| Banks | 15.6 | 17 | 16.2 |
| Corporates | 7.5 | 7.7 | 8.5 |
| Other (IMF/EU repayment) | -6.9 | -4.5 | -4.6 |

Source: AKK, IMF, NBH, UniCredit Research

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

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

**Outlook** – GDP growth accelerated to 6.9% yoy in 1Q – the fastest pace of recovery since 2008. On the back of this result, we revised our FY12 GDP forecast up to 3.0%. The main challenge for Latvia in 2012 remains observance of Maastricht inflation criteria but we see some steady progress in this direction. Inflation decelerated to 2.8% yoy in April and further down to 2.2% in May but as of April the criteria stands at 2.5% according to our calculations. Tax changes look set to further reduce inflation rates.

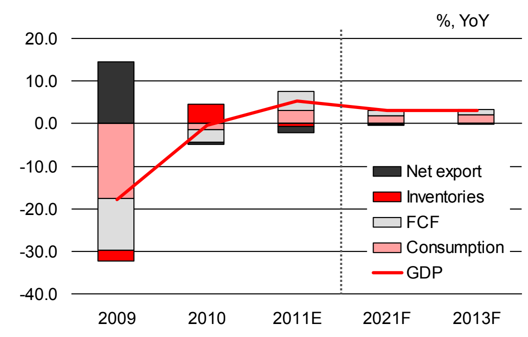
**Strategy outlook** –In relative value trades and due to supply dynamics we continue to favor Lithuania over Latvia due to supply dynamics. From regional portfolio perspective we think both credits should outperform the countries which are behind in terms of fiscal adjustments.

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

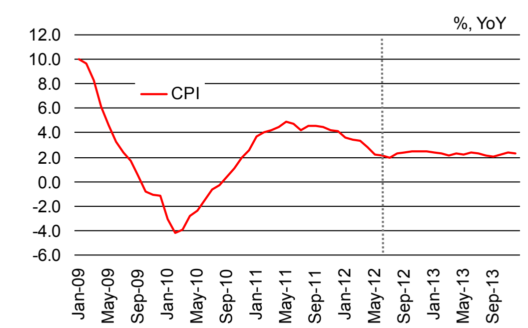
**KEY DATES/EVENTS**

- 9 Aug, 7 Sep – 2Q GDP (prelim., final)
- 9 Jul, 8 Aug, 10 Sep – Consumer price index
- 4 Jul, 3 Aug, 3 Sep – Industrial production

**CONSUMPTION TO DRIVE GROWTH FURTHER**




**INFLATION TO STABILISE IN 2012-2013**




Source: Central Statistical Bureau of Latvia, UniCredit Research

**MACROECONOMIC DATA AND FORECASTS**

| | 2009 | 2010 | 2011 | 2012F | 2013F |
|---|---|---|---|---|---|
| GDP (EUR bn) | 18.5 | 18.0 | 19.7 | 20.8 | 22.0 |
| Population (mn) | 2.3 | 2.3 | 2.2 | 2.2 | 2.2 |
| GDP per capita (EUR) | 8,184 | 7,989 | 8,753 | 9,297 | 9,782 |
| **Real economy yoy (%)** | | | | | |
| GDP | -17.8 | -0.3 | 5.5 | 3.0 | 3.2 |
| Private Consumption | -22.7 | 0.4 | 4.4 | 3.4 | 3.5 |
| Fixed Investment | -36.1 | -21.7 | 24.6 | 15.0 | 8.0 |
| Public Consumption | -8.9 | -9.7 | 1.3 | 1.0 | 1.0 |
| Exports | -13.3 | 11.5 | 12.6 | 9.5 | 12.1 |
| Imports | -32.9 | 11.5 | 20.7 | 10.3 | 13.2 |
| Monthly wage, nominal (EUR) | 651 | 629 | 663 | 684 | 700 |
| Unemployment rate (%) | 16.1 | 14.3 | 12.7 | 11.3 | 10.9 |
| **Fiscal accounts (% of GDP)** | | | | | |
| Budget balance (incl. bank costs) | -6.4 | -7.8 | -4.0 | -2.6 | -2.5 |
| Primary balance | -6.2 | -9.9 | -1.9 | -1.8 | -1.6 |
| Public debt | 36.7 | 44.7 | 44.9 | 45.0 | 45.2 |
| **External accounts** | | | | | |
| Current account balance (EUR bn) | 1.6 | 0.6 | -0.1 | -0.2 | -0.3 |
| Current account balance/GDP (%) | 8.6 | 3.6 | -0.6 | -0.9 | -1.1 |
| Basic balance/GDP (%) | 9.2 | 5.0 | 5.0 | 2.2 | 1.3 |
| Net FDI (EUR bn) | 0.1 | 0.2 | 1.1 | 0.6 | 0.5 |
| Net FDI (% of GDP) | 0.6 | 1.4 | 5.6 | 3.1 | 2.4 |
| Gross foreign debt (EUR bn) | 28.9 | 29.8 | 30.9 | 30.7 | 32.2 |
| Gross foreign debt (% of GDP) | 156.3 | 165.3 | 157.1 | 147.2 | 146.4 |
| FX reserves (EUR bn) | 5.2 | 6.9 | 7.4 | 7.5 | 7.4 |
| **Inflation/Monetary/FX** | | | | | |
| CPI (pavg) | -1.3 | 2.5 | 4.4 | 3.0 | 2.2 |
| CPI (eop) | 3.5 | -1.1 | 4.2 | 2.8 | 2.3 |
| RIGIBOR 3M | 3.89 | 1.90 | 1.03 | 0.80 | 0.90 |
| USD/LVL (eop) | 0.49 | 0.53 | 0.53 | 0.60 | 0.57 |
| EUR/LVL (eop) | 0.70 | 0.70 | 0.70 | 0.70 | 0.70 |
| USD/LVL (pavg) | 0.50 | 0.53 | 0.50 | 0.56 | 0.59 |
| EUR/LVL (pavg) | 0.70 | 0.70 | 0.70 | 0.70 | 0.70 |

Source: UniCredit Research

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

## Growth amidst external uncertainty

**GDP growth has finally caught up with Baltic peers.**

**Strong domestic demand and IP were supportive for 1Q figures.**

**1Q GDP figures show an acceleration in growth** to 6.9% yoy (1.1% qoq SA) from 5.7% (1.1% qoq SA) in 4Q11 – the fastest pace of growth since 2008. Given exceptionally strong IP and retail sales in 1Q, where volumes increased by 9.7% yoy and 12.3% yoy vs. 1Q11 respectively, we were expecting a strong GDP reading but this exceeded our expectations and translates into a upward revision to your full year growth forecast. Looking at the growth structure, the biggest contribution to 1Q growth came from domestic demand. Private consumption (increasing 5.4% yoy), added 3.9pp to the final figure. Gross fixed capital formation (+39% yoy) added a further 7.1pp, but change of inventories took off 3.7pp, bringing the gross capital formation input down to 3.4pp. Public consumption (+1.8% yoy) added a marginal 0.3pp, while net exports took off 0.7pp (as a result of exports growing 10.0% yoy vs. imports 9.5% yoy). In line with our expectations, in the 1Q GDP breakdown, we see an increasing contribution of domestic demand (personal consumption and fixed capital formation) to GDP growth. We expect that these components will support the national economy through the period of international trade slowdown in 2012.

**C/A as expected moved into the red.**

**Analysis of the external demand component reveals an important development.** Although both exports and imports recorded a deceleration in growth in 1Q12 compared to 4Q12 (to 13.2% yoy vs. 20.1% yoy and to 18.5% yoy vs. 20.1% yoy respectively) we see a steeper deceleration of imports. This development partially may offset the decreasing contribution of exports to GDP growth. First quarter BoP, as we expected, also moved into negative territory, posting a LVL 121mn deficit, equivalent to approximately 3.9% of 1Q12 GDP. FDI inflows, however, continued, although at a slower pace, amounting to LVL 103mn, or around 3.0% of GDP. Given some expected infrastructure improvements (mostly linked to the transit of Russian energy export), we expect FDI to continue in the rest of the year and end up at slightly above 3% of GDP for FY12 (up from our previous quarter forecast).

**Inflation so far remains the main problem on the way to EMU accession in 2014.**

Inflation in 1Q12 decelerated to 3.4% yoy from 4.2% yoy for FY11, and continues to show signs of further easing, coming in at 3.3% at the end of 1Q12, and further down at 2.8% and 2.2% in April and May respectively. We expect inflation to come in under 3.0% for FY12, assuming stability in oil and food prices, which so far have been the main drivers of inflation in the region. On top of that, given the government's aim to adopt the Euro in 2014, it has adopted fiscal measures to reduce inflation in line with Maastricht. The measures include tax reductions, which introduced a cut in VAT by 1pp to 21% from 1 July and a three-to five-year program for PIT reduction by 5pp to 20%.

**Fiscal situation is of little risk.**

**Looking at the observance of other convergence criteria, we see stable progress on the fiscal side.** As a reminder, having finished 2011 with a deficit of 3.5% to GDP, for 2012 the government targets a budget deficit of 2.5% of GDP under the assumption of 2.5% GDP growth for FY12 (down from 3.0% during talks with the IMF and EU in mid-November 2011). Up to March, the deficit in nominal terms remained approximately two-thirds of where it stood for the same period in 2011. Looking ahead, should the positive economic dynamics prevail, we anticipate few problems to finish FY12 in line with the Maastricht criteria.

**New Eurobond issues.**

At the end of February 2012, Latvia sold a new benchmark 5Y Eurobond of USD 1.0bn. Some anecdotal evidence implies that this issue completes Latvia's external borrowing program for this year. However, we expect the country will still borrow another EUR 300-400mn in international markets in 2012 (potentially to cover financing needs to 2013), as we estimate external financing needs for 2012 at EUR 1bn, in part to cover EUR 325mn due to the IMF (repayments to the EU start in 2014).

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

**Outlook** – Growth in Lithuania decelerated to 3.9% yoy in 1Q12 from 4.4% one quarter earlier. This was the second consecutive quarter of economic slowdown. Retail sales decelerated in 1Q but remained strong, while industrial production growth recovered from negative territory to 6.8% in May. As most of these developments have already been priced into our current forecast, we maintain our view on the economic growth in the country at 2.9% level for FY12.

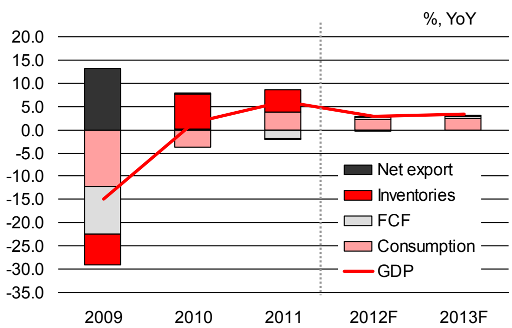
**Strategy outlook** – In relative value trades and due to supply dynamics we continue to favour Lithuania over Latvia due to supply dynamics. From regional portfolio perspective we think both credits should outperform the countries which are behind in terms of fiscal adjustments. We are looking to buy Lithuania USD 2022 on spikes.

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

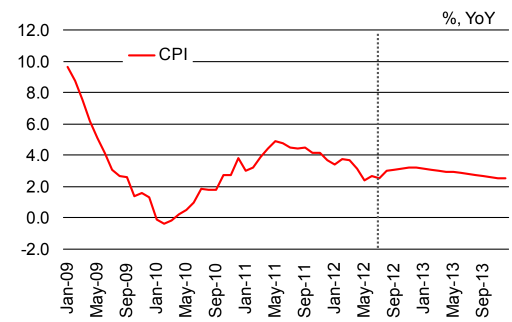
### KEY DATES/EVENTS

- 09 Aug, 07 Sep – 2Q GDP (prelim., final)
- 09 Jul, 08 Aug, 10 Sep – Consumer price index
- 04 Jul, 03 Aug, 03 Sep – Industrial production

### CONSUMPTION TO SUPPORT GROWTH IN 2012




### INFLATION TO SLOW DOWN




Source: Statistics Lithuania, UniCredit Research

### MACROECONOMIC DATA AND FORECASTS

| | 2009 | 2010 | 2011 | 2012F | 2013F |
|---|---|---|---|---|---|
| GDP (EUR bn) | 26.5 | 27.4 | 30.2 | 32.1 | 34.1 |
| Population (mn) | 3.3 | 3.3 | 3.3 | 3.3 | 3.3 |
| GDP per capita (EUR) | 7,939 | 8,257 | 9,161 | 9,774 | 10,403 |
| **Real economy yoy (%)** | | | | | |
| GDP | -14.7 | 1.2 | 5.9 | 2.9 | 3.3 |
| Private Consumption | -17.7 | -4.1 | 4.7 | 2.8 | 3.0 |
| Fixed Investment | -39.2 | -0.3 | 17.1 | 8.0 | 7.0 |
| Public Consumption | -1.9 | -3.0 | 0.9 | 0.2 | 0.5 |
| Exports | -12.7 | 16.3 | 13.7 | 6.5 | 7.8 |
| Imports | -28.4 | 17.6 | 12.7 | 6.7 | 9.0 |
| Monthly wage, nominal (EUR) | 625 | 600 | 615 | 638 | 647 |
| Unemployment rate (%) | 9.5 | 14.5 | 11.7 | 10.0 | 9.0 |
| **Fiscal accounts (% of GDP)** | | | | | |
| Budget balance | -7.9 | -7.5 | -4.2 | -3.8 | -2.5 |
| Primary balance | -6.7 | -4.6 | -3.1 | -1.4 | 0 |
| Public debt | 29.5 | 35.0 | 35.9 | 37.7 | 37.9 |
| **External accounts** | | | | | |
| Current account balance (EUR bn) | 1.1 | 0.3 | -0.5 | -0.9 | -0.7 |
| Current account balance/GDP (%) | 4.3 | 1.6 | -1.7 | -2.9 | -2.0 |
| Basic balance/GDP (%) | 4.1 | 4.3 | 1.3 | 1.9 | -2.0 |
| Net FDI (EUR bn) | 0 | 0.7 | 0.9 | 1.5 | 0 |
| Net FDI (% of GDP) | -0.1 | 2.6 | 3.0 | 4.8 | 0 |
| Gross foreign debt (EUR bn) | 23.1 | 24.1 | 24.8 | 25.4 | 25.9 |
| Gross foreign debt (% of GDP) | 87.2 | 87.8 | 82.1 | 79.3 | 76.0 |
| FX reserves (EUR bn) | 4.5 | 4.9 | 5.2 | 5.5 | 5.3 |
| **Inflation/Monetary/FX** | | | | | |
| CPI (pavg) | 4.5 | 1.1 | 4.1 | 3.1 | 3.0 |
| CPI (eop) | 1.3 | 3.6 | 3.4 | 2.9 | 2.5 |
| VILIBOR 3M | 7.10 | 1.56 | 1.70 | 1.52 | 1.35 |
| USD/LTL (eop) | 2.40 | 2.60 | 2.60 | 2.95 | 2.81 |
| EUR/LTL (eop) | 3.45 | 3.45 | 3.45 | 3.45 | 3.45 |
| USD/LTL (pavg) | 2.47 | 2.60 | 2.47 | 2.74 | 2.92 |
| EUR/LTL (pavg) | 3.45 | 3.45 | 3.45 | 3.45 | 3.45 |

Source: UniCredit Research

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

## Holding up against headwinds

**Economy is still posting strong results.**

**Growth in Lithuania decelerated to 3.9% yoy in 1Q12** from 4.4% one quarter earlier. This was the second consecutive quarter of economic slowdown since 3Q11, when growth peaked at 6.7% – the fastest pace of economic recovery since 2008. As we expected, the contribution of personal consumption to GDP growth in 1Q11 increased with this component adding 4.2pp to the economic growth. An unpleasant surprise was the reduction of the GFCF contribution to GDP falling to 1.3pp – the lowest level since mid-2012. However, with big investment projects in the pipeline (see next paragraph), we expect this component to recover quickly and support the economy through 2012. On a positive note, net exports recorded a positive 0.7pp contribution, showing resilience in the face of external headwinds. All in all, the result was quite in line with our expectations and we maintain our forecast of economic growth in the country at 2.9% level in 2012.

**Net exports contribution remains positive.**

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

Retail sales growth showed a decline from the peak of 4Q11 and slightly decelerated in 1Q, however continuing to grow: in January, retail sales increased by 11.3% yoy, while in April growth came in at only 1.5%. At the same time, industrial production growth recovered from negative territory at -2.1% yoy in December of last year to 5.9% yoy above zero in April and further to 6.8% yoy in May. We expect the weakness in retail sales to be temporary like that of IP, as consumption is supported by the increasing number of employed (in absolute terms)) on one hand (1.8% yoy in 1Q from 1.0% in 4Q12) and falling inflation, on the other (3.2% in April from over 4.0% in 4Q12).

**Exports/imports dynamics.**

**Looking at international trade, we still see a positive picture.** Despite slowing export growth in 1Q12 to 11.9% yoy (vs. that of imports to 13.4%), in absolute terms they posted a new all-time 1Q peak, exceeding the previous record of 2008 by 13.2%. FDI also demonstrated very positive dynamics, with the flow staying in the positive territory in 1Q, at approximately EUR 248mn. We see quite positive prospects for FDI going forward. Even given the continuing debate about the construction of the Visaginas nuclear power plant (which has the potential to attract record high international investment for its completion by 2022), the already approved (at the end of May) construction of a LNG terminal in Klaipeda port, to be completed by the end of 2014, should attract enough FDI to support this scenario for 2012.

**EU funds issue is resolved, it had no effect on the government's financing position or on economic developments.**

**At the end of February, the EU Commission temporarily suspended payments from the cohesion fund and regional development fund (ERDF)** to Lithuania. The local press reported that, according to the EC representatives' initial estimates, around 4.5% of the aid was misused (management of the aid is supervised by Lithuania's MinFin). The government estimated the size of misuse to be at a much lower level of around only 1%. In the end, the calculation of the estimated size of misuse was found to be only 0.683%. In the 2012 budget EU aid was scheduled to reach LTL 7.1bn from a total LTL 28bn in revenues. However, all disputes with the EU Commission were quickly resolved and according to a MInFin statement, the payments were resumed in mid-May.

**Snoras case had no effect on the budget performance in 2011.**

**The situation with Snoras also was successfully resolved,** involving no costs for the budget. According to the MinFin's numbers, the remaining assets or proceeds from the sale of the bank will be enough to repay the government LTL 3.3bn loan, which was extended to the insurance fund for Snoras deposit repayment.

**New Eurobond issues were successful.**

**The financing situation also remains very sound.** Given a tap of the 2021 Eurobond for USD 750mn at the beginning of November 2011, the government entered 2012 with a further EUR 1.5bn of borrowing needs in international markets, in part to cover EUR 1bn of a Eurobond maturity. At the end of January, Lithuania tapped the 2022 Eurobond issue for USD 1.5bn and in mid-April the 2018 Eurobond issue for EUR 400mn. Given a gross external requirement next year of EUR 2.5bn, we expect the government to pre-finance some of 2013 needs by the end of this year. In addition, in May of this year the MinFin repaid the EUR 1.0bn Eurobond – the biggest repayment in Lithuania's history.

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

**Outlook** – We expect Poland's GDP to grow at around solid 3% yoy this year, with outlook for 2013 a bit more cloudy (2.6% yoy), amid softer EU growth and weaker support from infrastructure investment. The Cabinet started implementing reforms, like raising retirement age to 67 years, which was welcomed by the markets and rating agencies. CPI inflation is likely to stay above the upper end of MPC target (1.5-3.5%) for most of the year, but should start down at the turn of 2012 and 2013. The MPC decided to hike key rate by 25bp in May, and maintains hawkish rhetoric, though our baseline scenario assumes no changes in monetary policy in 2013. State budget situation is well under control, with 70% of this year's borrowing needs secured after May.

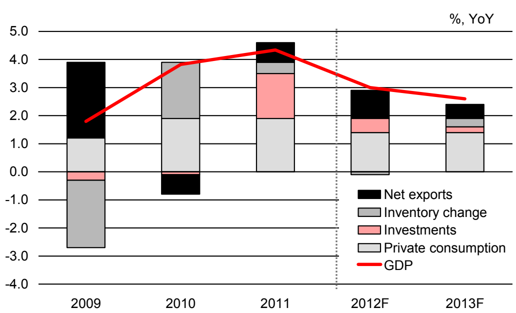
**Strategy outlook** – We remain positive on Polish assets but due to more volatile FX we prefer to express this view on credit as FX hedge local currency is still more expensive.

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

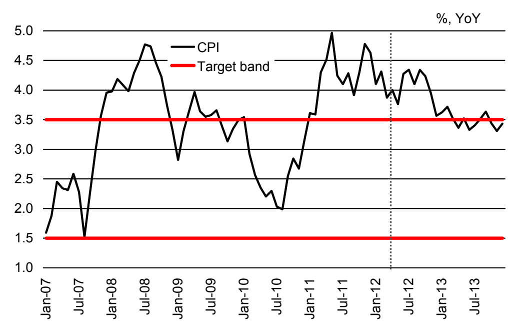
### KEY DATES/EVENTS

- The NBP releases update to inflation projection – early July
- MPC decision-making meetings – 3-4 Jul, 4-5 Sep, 2-3 Oct
- 2Q GDP – 30 Aug

### ORDERLY SLOWDOWN IN GDP




### CPI STILL ABOVE EXPECTATIONS




Source: GUS, UniCredit Research

### MACROECONOMIC DATA AND FORECASTS

| | 2008 | 2009 | 2010E | 2011F | 2012F |
|---|---|---|---|---|---|
| GDP (EUR bn) | 310.7 | 354.6 | 340.6 | 379.3 | 408.7 |
| Population (mn) | 38.2 | 38.2 | 38.1 | 38.1 | 38.1 |
| GDP per capita (EUR) | 8,140 | 9,282 | 8,944 | 9,965 | 10,740 |
| **Real economy yoy (%)** | | | | | |
| GDP | 1.6 | 3.9 | 4.3 | 3.0 | 2.6 |
| Private Consumption | 2.1 | 3.2 | 3.1 | 2.2 | 2.0 |
| Fixed Investment | -1.2 | -0.4 | 8.1 | 4.3 | 1.1 |
| Public Consumption | 2.1 | 4.1 | -1.3 | 0.5 | 1.8 |
| Exports | -6.8 | 12.1 | 7.5 | -0.6 | 2.1 |
| Imports | -12.4 | 13.9 | 5.8 | -2.2 | 1.4 |
| Monthly wage, nominal (EUR) | 767 | 860 | 805 | 883 | 945 |
| Unemployment rate (%) | 11.0 | 12.1 | 12.4 | 12.6 | 12.9 |
| **Fiscal accounts (% of GDP)** | | | | | |
| Budget balance | -7.4 | -7.9 | -5.1 | -2.9 | -2.5 |
| Primary balance | 0.6 | -0.7 | 0.7 | 1.0 | 0.8 |
| Public debt | 50.9 | 54.9 | 56.4 | 55.6 | 54.7 |
| **External accounts** | | | | | |
| Current account balance (EUR bn) | -12.2 | -16.5 | -15.9 | -13.4 | -17.1 |
| Current account balance/GDP (%) | -3.9 | -4.6 | -4.3 | -3.5 | -4.2 |
| Basic balance/GDP (%) | -0.9 | -2.8 | -1.6 | -2.1 | -1.7 |
| Net FDI (EUR bn) | 9.9 | 6.7 | 10.3 | 5.5 | 10.0 |
| Net FDI (% of GDP) | 3.0 | 1.9 | 2.8 | 1.4 | 2.4 |
| Gross foreign debt (EUR bn) | 194.4 | 236.0 | 249.1 | 283.5 | 274.9 |
| Gross foreign debt (% of GDP) | 62.6 | 66.6 | 73.1 | 74.7 | 67.3 |
| FX reserves (EUR bn) | 55.2 | 70.0 | 75.7 | 86.3 | 83.9 |
| **Inflation/Monetary/FX** | | | | | |
| CPI (pavg) | 3.5 | 2.6 | 4.3 | 4.1 | 3.5 |
| CPI (eop) | 3.5 | 3.1 | 4.6 | 3.6 | 3.4 |
| Central bank target | 2.5 | 2.5 | 2.5 | 2.5 | 2.5 |
| Central bank reference rate (eop) | 3.50 | 3.50 | 4.50 | 4.75 | 4.75 |
| 3M money market rate | 4.41 | 3.94 | 4.54 | 5.09 | 5.02 |
| USD/PLN (eop) | 2.86 | 2.98 | 3.32 | 3.57 | 3.25 |
| EUR/PLN (eop) | 4.11 | 3.96 | 4.42 | 4.18 | 4.00 |
| USD/PLN (pavg) | 3.10 | 3.01 | 3.20 | 3.38 | 3.51 |
| EUR/PLN (pavg) | 4.33 | 3.99 | 4.48 | 4.26 | 4.15 |

Source: UniCredit Research

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

## Gradual slowdown underway

**The first quarter of the year saw 3.5% GDP growth, following 4.3% in the previous quarter. This was in line with expectations of a gradual slowdown in 2012.**

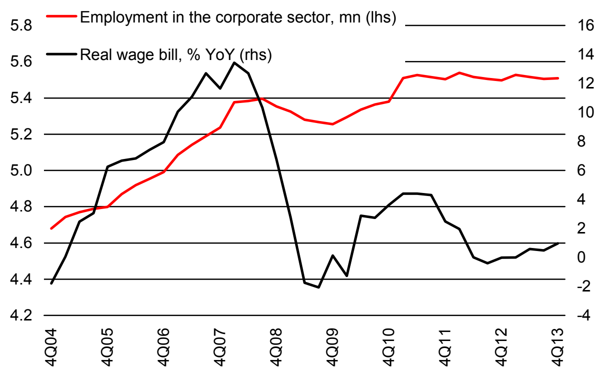
**GDP growth was solid in 1Q at 3.5% yoy, in line with market expectations of a gradual slowdown throughout 2012,** versus. growth of 4.3% yoy in 4Q12. Individual consumption was flat at 2.1% yoy vs. the previous quarter. Gross fixed capital formation growth decelerated in 1Q to 6.7% from 9.7% a quarter earlier. The increase in domestic demand amounted to 2.7% yoy (3.2% in 1Q), while the contribution from net exports to real GDP growth was 0.7pp. (vs. 1.0 pp in 4Q).

**We slightly lowered our 2012 GDP forecast, to 3.0% yoy from 3.1%, for 2013 down to 2.6% from 3.5% previously.**

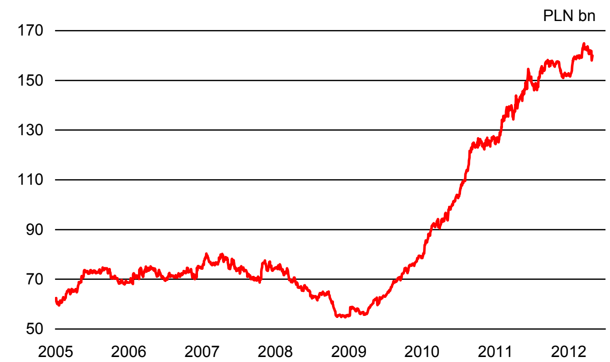
**We revised our 2012 GDP forecast down to 3.0% from 3.1% previously, and for 2013 down to 2.6% from 3.5% previously.** 1Q data confirmed the slowdown, but its pace is gradual, which is what we have been anticipating for many months. There are no major surprises in the general domestic picture, but the outlook for EU growth has become much weaker (especially for 2013), which has pushed GDP forecasts lower. When it comes to the next few quarters, the situation in the labor market – after a post-crisis rebound – will likely stabilize. The number of employed in the corporate sector, after an average of 3.3% yoy growth in 2011, saw an increase of a mere 0.7% yoy in 1Q, and has now entered a period of flat readings (0.3% yoy expected in 2Q, and 0.0 in the second half of the year). As wages tend to increase by no more than 1-2pp above inflation, this translates into visible slowdown of the real wage bill – from an average of 3.9% yoy in 2011, to 1.9% yoy in 1Q, and towards 0.5%-0.8% in the second half of the year. This will impact private consumption, which we expect to slow to 2.3% yoy in 2012, from 3.1% yoy the previous year. Another key variable in GDP, investments, will decline, driven mostly by a slowing inflow of EU funds. In 2012, and especially in 1H, will see a peak in EU money being used for public investments. This, combined with weak private sector investments (an NBP quarterly poll shows no signs of a rebound in the near future), will mean a further downward trend of investments from their peak in 4Q11 at 9.7% yoy, towards readings close to 2%-3% in the final quarter of 2012. In yearly terms, we expect 2012 investments to be 4.3% yoy, after 8.1% yoy in 2011. In 2013, investments are nevertheless likely to be only slightly above zero in yoy terms. However, on a positive note, the recent weakening of the zloty will be helping to make Polish exports more competitive abroad, while at the same time prohibiting imports – and thus doubly helping domestic manufacturers. Given that most exporters quote 3.70 EUR-PLN as their break-even level for exports' profitability, current levels of 4.30-4.40 are an opportunity for exporters to expand abroad and enjoy healthy profit margins. Should the situation in Western Europe stabilize in the second half of the year (as we assume in our baseline scenario), this may prompt exporters to increase investments, and to be more generous towards their employees – these may prove to be important growth drivers in 2013.

**ECONOMY TENDS TO SLOW DOWN, BUT THIS IS SUPPORTING THE POLGB MARKET**

The situation in the labor market, after post-crisis rebound, will likely stabilize




A relatively soft growth outlook is one of the factors supporting the T-bond market, with foreign holdings of POLGBs close to record highs




Source: European Commission, Ministry of Finance, UniCredit Research

**CPI inflation should bottom out in May at around 3.8%, rebound for most of 2012, and then return to May levels at year-end.**

**CPI inflation will probably bottom out in May at 3.6%**, rebound towards 4.5% for most of the remainder of the year, and then decline towards 3.7% in the last two months of the year, on strong base effects. Most of the surprises to CPI YTD have been to the upside, and given the extraordinarily loose central bank polices in key economies, and the weak zloty, one should take into account the risk of further upside surprises. However, in our baseline scenario we expect CPI to come close to the upper end of the MPC "tolerance zone" (+/- 1pp around central target of 2.5% CPI) at year-end. One of the key questions will be the impact of the Euro 2012 football championships on price indices. There are no strong indications that it will have a strong impact on general price levels throughout the country (and let's keep in mind that for Poland, a country with 38mn inhabitants, Euro 2012 in practice means 15 football matches in 4 big cities – i.e. the impact of the event itself should be pretty limited, in line with experiences of other countries). Gauging by the big football events in Greece, Portugal and Germany, the impact of price increases on "accommodation" should be no more than 0.1-0.2% of CPI – and should be reversed in the subsequent 2-3 months. However, there remains some room for surprises, i.e. some (services) businesses may try to use this opportunity as an excuse to hike prices.

**The NBP decided to hike key rates by 25bp in May, and there is a risk of another hike at year-end if inflation persists at high levels.**

**The MPC decided to hike key rates by 25bp, to 4.75% in May, signaling a lack of acceptance of persistently high inflation**. The move was somewhat surprising (it would have been much more comprehensible earlier in 2011, when the real economy was stronger and inflation was higher), but the MPC emphasized its lack of tolerance for persistently high inflation (which had stood above the upper end of the MPC tolerance zone since the beginning of 2011), and at the same time its willingness to make real interest rates "more positive". Our baseline scenario assumes no further changes in the key rate until end-2012, but the risk profile seems skewed towards the risk of one more hike in 4Q, should inflation stay high and/or "refuse" to fall at end-2012, when it is broadly expected to fall. However, for the next couple of months, the MPC is likely to remain in "wait-and-see" mode.

**Euro 2012 football championships are the key event in 2012, though we do not expect a major impact on economic readings, except for tourist-related items.**

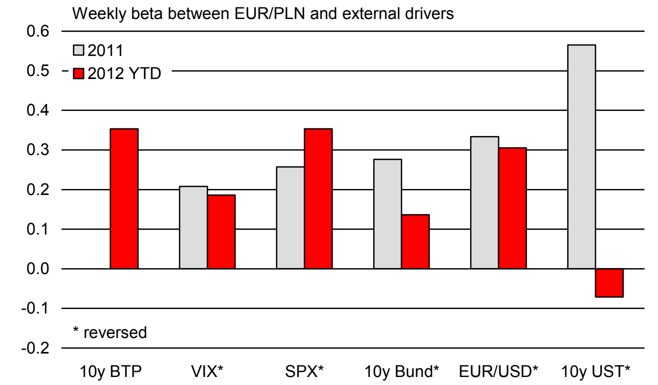
**The key event of the year in Poland is co-hosting (together with Ukraine) the Euro 2012 European football championships in June.** In terms of its impact on the economy, key is the acceleration of the construction of infrastructure projects (highways, railroads etc). However, one should bear in mind that these were planned anyway (with significant help from EU-funds), so the impact of Euro 2012 has simply accelerated things. These projects were estimated to constitute three quarters of the entire impact of the event on the economy, according to an official report prepared for the company organizing Euro 2012 in Poland ("Raport Impact"). In terms of revenue from tourism, the hotel industry expects the increased inflow of tourists to add an "additional month of revenue" to 2012 results. In terms of other factors (temporary increase in employment, increase of sales in cities organizing matches, etc.), the impact will likely be limited, and rather transitory. Therefore, we do not expect to see a noticeable impact of the event on macro readings, except for hotel utilization (and prices of accommodation, as discussed in the inflation section above), increased beer sales, and possibly also sales of TV sets. In terms of a rise in consumption, it will likely be recorded in the places where tourists gather, but probably to a large extent offset elsewhere (as people stay at home to watch matches on TV). The literature review shows that analyses of big sporting events (not just football-related, but also the Olympics, the US Super Bowl, etc.) hardly shows any significant impact of them on the economy, though there can be some more long-term change in the perception of the country. This is an area where there are hopes for the Polish economy in the coming years, i.e. that Euro 2012 will be an event that accelerates tourism in the years to come.

## Strategy: keep O/W in Polish Eurobonds

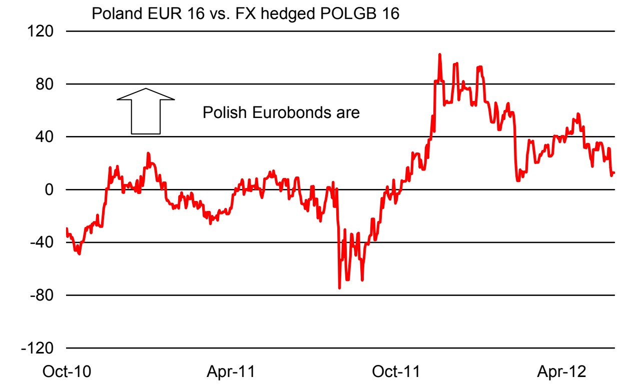
The PLN remains heavily driven by external factors, with the large increase of the beta between EUR/PLN and BTP YTD suggesting that the EMU debt crisis became almost the sole driver or market performance. Although investors might wait for the NBP/BGK to step in given the change in the debt calculation method there is no single reference point as opposed to the previous years. This is the main reason why we think that although local bonds are attractive as Poland already covered close to 70% of its borrowing need for this year, it would only makes sense in FX hedged form. On the other hand the FX hedged POLGBs are currently more expensive than the Polish Eurobonds. Currently the Polish EUR 16 Eurobonds provide about 10bp pickup over the FX hedged 2016 POLGBs. This spread is below the last October/November levels around 80bp. Overall we recommend an O/W positioning in Polish Eurobonds, neutral in POLGBs and U/W in PLN.

**Author: Gyula Toth, Head of EEMEA FI/FX Strategy (UniCredit Bank)**

PLN is highly sensitive on EMU volatility




Polish Eurobonds are still cheaper than FX hedged POLGBs




Source: UniCredit Research, Bloomberg

**GOVERNMENT GROSS FINANCING REQUIREMENTS**

| EUR bn | 2011 | 2012F | 2013F |
|---|---|---|---|
| **Gross financing requirement** | **47.5** | **40.7** | **45.1** |
| Budget deficit | 21.0 | 15.2 | 15.0 |
| Amortization of public debt | 26.5 | 25.5 | 30.1 |
| Domestic | 25.0 | 25.2 | 26.7 |
| Bonds | 18.2 | 22.3 | 25.1 |
| Bills | 6.8 | 2.9 | 1.5 |
| External | 1.5 | 0.3 | 3.5 |
| IMF/EU | 0 | 0 | 0 |
| **Financing** | **47.6** | **40.7** | **45.1** |
| Domestic borrowing | 38.1 | 34.5 | 37.0 |
| Bonds | 34.6 | 30.4 | 32.0 |
| Bills | 3.5 | 4.1 | 5.0 |
| External borrowing | 9.5 | 6.1 | 8.1 |
| Bonds | 4.7 | 3.8 | 5.7 |
| IMF/EU | 0 | 0 | 0 |
| Other | 4.8 | 2.3 | 2.4 |

Source: MinFin, NBP, UniCredit Research

**GROSS EXTERNAL FINANCING REQUIREMENTS**

| EUR bn | 2011 | 2012F | 2013F |
|---|---|---|---|
| **Gross financing requirement** | **94.8** | **108.4** | **116.7** |
| C/A deficit | 15.9 | 13.4 | 17.1 |
| Amortization of medium to long term debt | 15.2 | 19.3 | 16.6 |
| Government/central bank | 5.5 | 5.3 | 4.9 |
| Banks | 3.2 | 7.5 | 6.8 |
| Corporates | 6.5 | 6.5 | 4.9 |
| Short term debt amortization | 63.7 | 75.7 | 83.0 |
| **Financing** | **94.8** | **108.4** | **116.7** |
| FDI | 10.3 | 5.5 | 10.0 |
| Equity | 2.0 | 2.0 | 3.0 |
| Borrowing | 24.0 | 27.4 | 28.2 |
| Government/central bank | 12.6 | 11.5 | 14.0 |
| Banks | 4.1 | 8.6 | 8.8 |
| Corporates | 7.3 | 7.3 | 5.4 |
| Short term borrowing | 68.5 | 80.3 | 88.3 |
| EU transfers | 8.5 | 9.0 | 7.8 |
| Other | -18.5 | -15.9 | -20.6 |

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

**Outlook** – Expected GDP growth for 2012 has been downgraded to 0.5% on the back of weaker foreign demand and one-off shocks to industrial output and exports. The biggest threat to Romania's economy comes from economic and financial woes in the euro area. While local banks with Greek capital will continue deleveraging, a significant drawdown of capital is unrealistic because of low liquid assets.

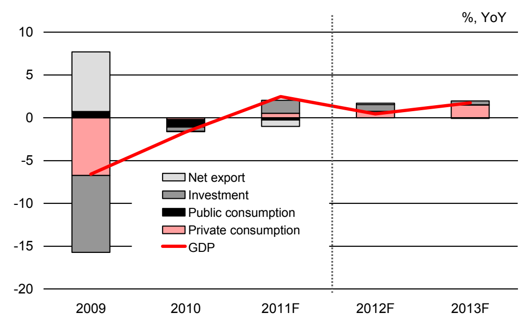
**Strategy** – Although we closed our previous short EUR/RON position form regional perspective we think the RON could outperform the HUF and PLN. We also favour Romanian Eurobonds over Hungary and Croatia. At better entry levels we look to buy FX hedged ROMGBs.

**Author: Dan Bucsa, Chief Economist (UniCredit Tiriac Bank)**

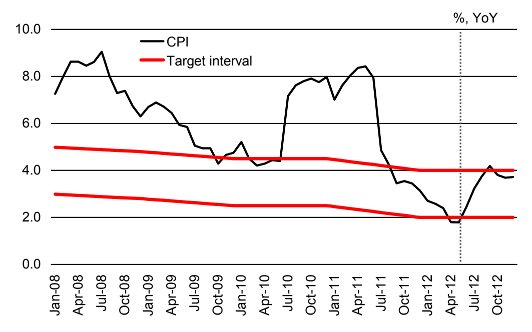
### KEY DATES/EVENTS

- Late June: IMF evaluation
- 27 June 2012 – NBR rate decision
- 2 August 2012 – NBR rate decision
- 6 September – Q2 GDP

### GDP GROWTH TO FLATTEN




### SHARP DISINFLATION




Source NBR, CSO, UniCredit Research

### MACROECONOMIC DATA AND FORECASTS

| | 2009 | 2010 | 2011F | 2012F | 2013F |
|---|---|---|---|---|---|
| GDP (EUR bn) | 118.3 | 124.1 | 136.5 | 138.3 | 149.4 |
| Population (mn) | 21.5 | 21.5 | 19.0 | 19.0 | 19.0 |
| GDP per capita (EUR) | 5,501 | 5,774 | 7,169 | 7,281 | 7,865 |
| **Real economy yoy (%)** | | | | | |
| GDP | -6.6 | -1.7 | 2.5 | 0.5 | 1.7 |
| Private Consumption | -9.2 | -2.0 | 0.7 | 1.1 | 2.1 |
| Fixed Investment | -25.3 | -13.1 | 6.4 | 3.2 | 1.8 |
| Public Consumption | 1.2 | -3.2 | -3.5 | -0.1 | 0.5 |
| Exports | -5.5 | 13.1 | 9.9 | 3.3 | 7.9 |
| Imports | -20.6 | 11.6 | 10.5 | 2.5 | 7.1 |
| Monthly wage, nominal (EUR) | 326 | 334 | 346 | 356 | 381 |
| Unemployment rate (%) | 6.9 | 7.3 | 7.4 | 7.3 | 7.0 |
| **Fiscal accounts (% of GDP)** | | | | | |
| Budget balance | -7.3 | -6.4 | -4.1 | -3.0 | -2.5 |
| Primary balance | -6.1 | -5.0 | -2.6 | -1.5 | -1.0 |
| Public debt | 27.2 | 35.0 | 36.3 | 36.4 | 35.4 |
| **External accounts** | | | | | |
| Current account balance (EUR bn) | -4.9 | -5.5 | -6.0 | -5.4 | -5.6 |
| Current account balance/GDP (%) | -4.2 | -4.4 | -4.4 | -3.9 | -3.8 |
| Basic balance/GDP (%) | -3.6 | -4.2 | -4.1 | -3.4 | -3.5 |
| Net FDI (EUR bn) | 3.6 | 2.2 | 1.9 | 1.5 | 2.0 |
| Net FDI (% of GDP) | 3.0 | 1.8 | 1.4 | 1.1 | 1.3 |
| Gross foreign debt (EUR bn) | 81.0 | 92.5 | 98.6 | 101.1 | 107.0 |
| Gross foreign debt (% of GDP) | 68.5 | 74.5 | 72.2 | 73.1 | 71.6 |
| Fx reserves (EUR bn) | 28.3 | 32.4 | 33.2 | 31.7 | 26.5 |
| **Inflation/Monetary/FX** | | | | | |
| CPI (pavg) | 5.6 | 6.1 | 5.8 | 3.1 | 3.8 |
| CPI (eop) | 4.7 | 8.0 | 3.1 | 4.2 | 3.9 |
| Central bank target | 3.5 | 3.5 | 3.0 | 3.0 | 2.5 |
| Central bank reference rate (eop) | 8.00 | 6.25 | 6.00 | 5.25 | 5.25 |
| 3M money market rate | 10.43 | 6.25 | 6.30 | 4.80 | 4.60 |
| USD/RON (eop) | 2.94 | 3.20 | 3.34 | 3.74 | 3.50 |
| EUR/RON (eop) | 4.23 | 4.28 | 4.32 | 4.38 | 4.30 |
| USD/RON (pavg) | 3.05 | 3.18 | 3.05 | 3.51 | 3.66 |
| EUR/RON (pavg) | 4.24 | 4.21 | 4.24 | 4.39 | 4.32 |

Source: UniCredit Research

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

## Weathering negative shocks from the euro zone

**GDP growth slowed down as a result of poor foreign demand.**

The Romanian economy had a bad start to 2012, contracting 0.1% qoq in 1Q. The carry-over from 2011 when growth was 2.5% (or 1.9% ignoring agriculture) was offset by negative events, three having a very strong impact:

1. In November 2011, Nokia closed down its Jucu factory, the second largest Romanian exporter at the time;
2. The economy of the euro area failed to grow in 1Q12, reducing demand for Romanian exports;
3. The weather was very harsh in February.

Output in industry was the most affected, with the sector slumping to -0.4% yoy vs. our initial forecast of 1.3% growth. While February weather prompted a strong increase in the production of energy, manufacturing contracted for the first time since the 2009 recession. RON depreciation provided the strongest mitigating factor for weak industrial production: a 20% drop vs. the USD between May 2011 and March 2012 helped price competitiveness outside the EU to completely offset Nokia's departure by the end of 1Q12. We expect output in industry to recover to +0.4% yoy in 2012, relying on the strong German economy rather than on weaker traditional partners. The dependence on the German manufacturing has risen steadily over the past three years, but the drag from weaker euro area economies remains significant.

**Domestic demand to support growth in 1H 2012. Slower growth expected in 2012 and 2013.**

Domestic demand is currently driving GDP growth, retail sales growing 3.8% yoy in 1Q12 and infrastructure works rising 14.8% yoy, the latter providing the strongest boost to investment (+11.8%). Private consumption slowed down to 0.9% yoy and shrank 1.9% vs. 4Q11, the first contraction since 3Q10. An 8% wage hike for public sector employees in June, another one of 7.4% in December, tax reimbursements for pensioners and other populist decisions that could be implemented before general elections in November 2012 will prop up consumption and consumer morale into 2013. With strong budget targets in place, decisions boosting household revenues will likely crowd out public investment. After a downward revision to European growth, we expect Romania's GDP to rise 0.5% in 2012 and 1.7% in 2013 (down from 1.2% and 2.3% previously).

**C/A deficit flat at around 4% of GDP, financed mainly by EU funds.**

Romania's current account deficit has hovered at 4.4% of GDP for the past two years. While exports have improved, their high import content has hampered a stronger reduction of the trade deficit. In the meantime, the C/A deficit has been financed mainly by portfolio investment and by EU funds. EUR 3bn of EU funds could be absorbed by the end of 2012, double the forecasted amount of 2012 FDI. We forecast a marginal narrowing of the C/A deficit below 4% of GDP, but acknowledge two divergent risks:

1. A short term widening if increased household revenues will boost imports of consumption goods;
2. A sharper narrowing if risk aversion spikes and external financing dries up temporarily.

**Budget deficit could fall to 3% of GDP, above the 2.2% target because of populist spending.**

The budget deficit will probably improve again this year, narrowing to around 3% of GDP from 4.1% in 2011 (on a cash basis). The official deficit target is 2.2% of GDP, but it is already under threat, the 4M budget deficit standing at 0.8% of GDP. In addition, the current government is preparing to spend some 0.25% of GDP on returning the remainder of the 25% wage cut from July 2010 to public employees and on giving back health contributions from pensions below RON 740 (both measures required by the Constitutional Court). The official deficit target could be reached by crowding out public investment, so the most important focus is not the actual level of the deficit, but the structure of spending: if it reverts to favoring wages and social security over investment, Romania will achieve a stronger fiscal impulse in the short run, but will also boost imports and make tax hikes inevitable.

The decision to finance three quarters of 2012's expiring T-bonds and bills during the first five months of the year proved fortunate: Romania entered the current market turmoil with the largest cash buffer it ever held (equivalent to EUR 4.3bn), covering the budget deficit and all redemptions up to mid-October 2012 (if one takes into account a EUR 1bn loan from the World Bank that will be disbursed at the end of June 2012).

**Inflation inside target band in 2012, flat in 2013.**

Annual inflation fell to 1.8% at end-May. The stronger-than-expected disinflation is due to a combination of weaker FX pass-through, 2011's bumper harvest, lower international food prices and lower oil prices. We have revised downward our 2012 and 2013 inflation forecasts to 3.8% and 3.9% yoy respectively.

**Monetary policy easing on hold.**

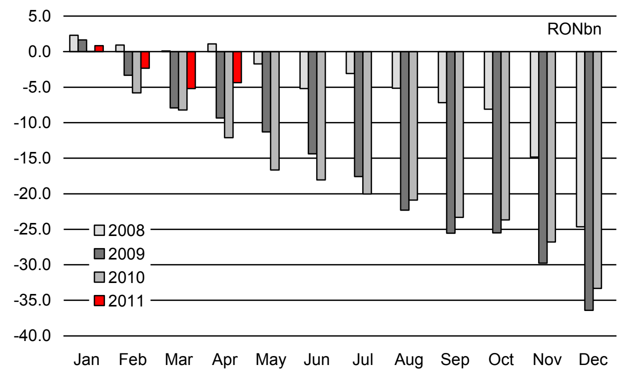
**EUR/RON weakening less than regional peers. NBR will try to cap volatility.**

The NBR ended the easing cycle sooner than expected, leaving the monetary policy rate at 5.25% on 2 May. The main reason for the more hawkish stance was turmoil on international markets. The decision left Romania with the highest real interest rates in Europe (above 2% until 2014, using the NBR's inflation forecast) as economic activity slows. In order to relax monetary conditions, the NBR allowed the RON to depreciate and the pair reached all-time highs of around 4.49 RON/EUR in late May. While the weaker RON made exports more competitive, it also affected the financial position of Romania's private sector: two thirds of loans are granted in FX (mostly EUR) and according to our computations, RON depreciation weighs on the quality of the loan portfolio (both FX and RON components) for up to 10 mont. The NPL ratio could rise further from 15.9% in March 2012.

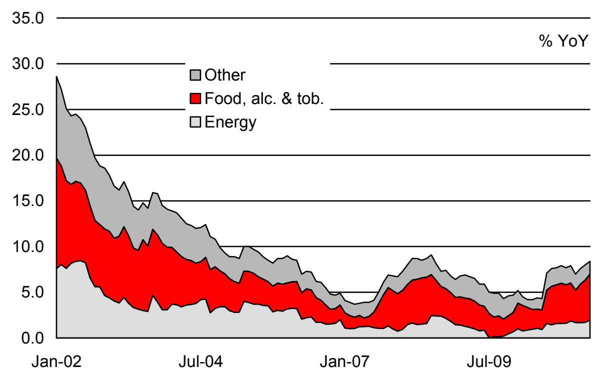
**Greek banks expected to deleverage gradually, rather than withdraw significant amounts of capital over a short period of time.**

Romania has the second largest exposure to the Greek banking sector after Bulgaria. At the end of 2011, Greek banks held 13.3% of banking sector assets, having a funding gap of EUR 6.8bn. While the market share remained constant, the funding gap fell to approximately EUR 5.4bn at the end of 1Q12. In the extreme case where the Greek banking system would face strong pressure, we expect the deleveraging process to accelerate in Romania. However, we don't expect a rapid drawdown of capital, since 70% of lines extended by Greek to local subsidiaries have maturities longer than one year (according to the NBR) and liquid assets are limited to less than EUR 2bn. In more extreme scenarios both commercial banks and the NBR has experience in successfully managing deposit runs in 2000, though such an event would likely push interest rates higher and damage economic activity. A rapid sale of liquid assets would put pressure on RON yields as the biggest two local banks with Greek capital held some EUR 0.6bn in ROGBs in March 2012. Should one or more of the give local banks with Greek ownership need public intervention, a bridge bank funded by the Deposit Guarantee Fund would take over the assets at the end of 2011, its resources could be boosted from MinFin coffers (according to law) or even from NBR reserves. If a reserve depletion occurs (through FX interventions and capital injections), Romania could draw from the EUR 5bn precautionary agreement it has signed with the IMF, effectively extending the maturity of the first IMF loan on which it has to pay EUR 1.5bn in 2012 and EUR 2.5bn in 2013. All in all, we expect Greek deleveraging to be a gradual process, with foreign news having a much larger negative impact than the actual condition of Romanian banks with Greek capital would warrant.

Impressive budget performance YTD




Inflation is mostly driven by food and energy



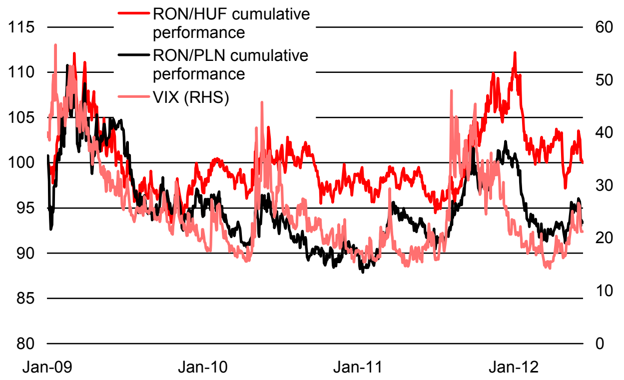

Source: NIS, MinFin, UniCredit Research

## Strategy: stay flat for now

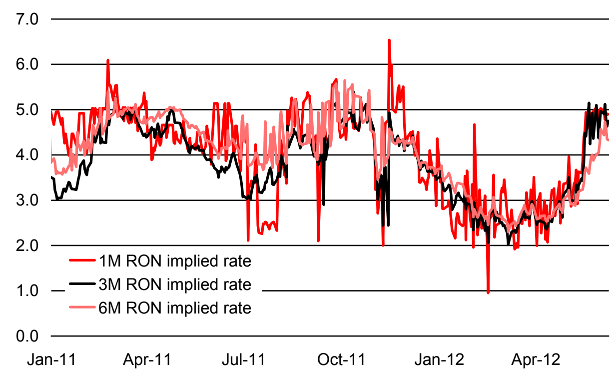
Although Romania appears to be the most prepared for further Greek pressure and the country also has the unique IMF safety net in the region it is difficult to argue that the currency will appreciate significantly from the current levels against the current external backdrop whilst the NBR proved that its put option is non-granted. That is why we decided to close our previous short EUR/RON with about 2.6% loss at the end of May. From portfolio perspective we however think that the RON could outperform in case pressure on all CEE currencies increase. In the local currency yield space we think the solid pre-funding YTD (about 60% of the annual plan) and the possibility to be included in the main EM bond benchmarks could represent a cap on yields. As FX implied yields increased by about 200bp recently the carry on FX hedged ROMGBs is not attractive at the moment but at better levels we would look to add to those positions. In the credit space the Romani USD 22 bonds outperformed the regional peers and we think this is justified and continue to prefer Romania over Hungary and Croatia.

**Author: Gyula Toth, Head of EEMEA FI/FX Strategy (UniCredit Bank)**

RON outperforms CEE FX in risk off periods




RON implied rates spiked




Source: Bloomberg, UniCredit Research

**GOVERNMENT GROSS FINANCING REQUIREMENTS**

| EUR bn | 2011 | 2012F | 2013F |
|---|---|---|---|
| **Gross financing requirement** | **16.4** | **15.5** | **14.3** |
| Budget deficit | 5.6 | 4.2 | 3.8 |
| Amortisation of public debt | 10.8 | 11.2 | 9.8 |
| Domestic | 10.8 | 10.5 | 9.8 |
| Bonds | 2.0 | 4.8 | 5.6 |
| Bills | 8.8 | 5.7 | 4.2 |
| External | 0 | 0.7 | 0 |
| IMF/EU | 0 | 0 | 0.7 |
| **Financing** | **18.2** | **15.7** | **14.3** |
| Domestic borrowing | 13.7 | 12.2 | 12.3 |
| Bonds | 4.7 | 6.4 | 7.1 |
| Bills | 9.0 | 5.8 | 5.2 |
| External borrowing | 4.5 | 3.5 | 2.0 |
| Bonds | 1.5 | 2.5 | 2.0 |
| 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** | **38.7** | **35.5** |
| C/A deficit | 6.0 | 5.4 | 5.6 |
| Amortisation of medium to long term debt | 11.0 | 10.6 | 11.8 |
| Government/central bank | 2.8 | 3.1 | 5.6 |
| Banks | 2.6 | 2.5 | 1.5 |
| Corporates | 5.6 | 5.0 | 4.7 |
| Amortisation of short term debt | 22.1 | 22.7 | 18.1 |
| Government/central bank | 5.9 | 3.8 | 2.4 |
| Banks | 12.1 | 13.1 | 10.2 |
| Corporates | 4.1 | 5.8 | 5.5 |
| **Financing** | **38.8** | **38.7** | **35.5** |
| FDI | 1.9 | 1.5 | 2.0 |
| Equity | 1.1 | 0.8 | 1.6 |
| Borrowing | 34.0 | 33.4 | 27.9 |
| Government/central bank | 8.2 | 7.1 | 7.5 |
| Banks | 15.5 | 15.3 | 10.8 |
| Corporates | 10.3 | 11.0 | 9.6 |
| EU Funds | 1.8 | 3.0 | 4.0 |

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

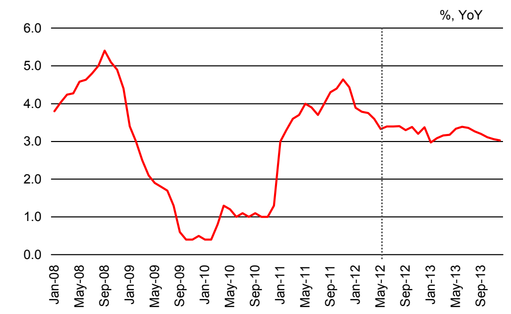
**Outlook** – March elections brought a clear victory for the social democrats, led by PM Fico. The goal to reduce the budget deficit to within 3.0% of GDP in 2013 was confirmed immediately. Proposed measures are focused on the income side, including the introduction of new levies for chosen sectors and eradicating the concept of a flat tax. Meanwhile, the economy continued to deliver relatively strong growth, still driven by net exports. Our baseline scenario includes a gradual slowdown of GDP growth in coming quarters backed by lower demand from the eurozone (in 2012) and the government austerity package (in 2013). The C\A is expected to remain almost balanced, while FDI inflows should slow, negatively affected by the country's lower attractiveness due to proposed austerity measures and lack of pro-business reforms.

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

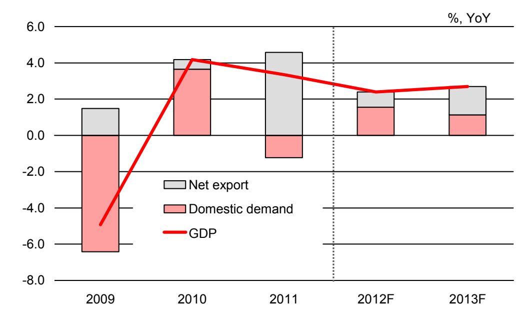
## KEY DATES/EVENTS

- 10 Jul, 9 Aug, 10 Sep – Industrial production
- 13 Jul , 13 Aug, 12 Sep - CPI
- 14 Aug – flash GDP
- 6 Sep – GDP and its structure

## INFLATION IS EXPECTED TO DECELERATE




## NET EXPORTS ARE MAIN ENGINE OF GROWTH




Source: Statistical Office SR, UniCredit Research

## MACROECONOMIC DATA AND FORECASTS

| | 2009 | 2010 | 2011 | 2012F | 2013F |
|---|---|---|---|---|---|
| GDP (EUR bn) | 62.8 | 65.7 | 69.1 | 72.2 | 75.4 |
| Population (mn) | 5.4 | 5.4 | 5.4 | 5.4 | 5.4 |
| GDP per capita (EUR) | 11,589 | 12,105 | 12,716 | 13,290 | 13,891 |
| **Real economy yoy (%)** | | | | | |
| GDP | -4.9 | 4.2 | 3.3 | 2.4 | 2.7 |
| Private Consumption | 0.1 | -0.8 | -0.4 | 0.4 | 0.3 |
| Fixed Investment | -19.7 | 12.4 | 5.7 | 2.3 | 3.0 |
| Public Consumption | 6.1 | 1.1 | -3.5 | -0.5 | -2.5 |
| Exports | -15.9 | 16.5 | 10.8 | 4.5 | 5.2 |
| Imports | -18.1 | 16.3 | 4.5 | 3.7 | 3.9 |
| Monthly wage, nominal (EUR) | 745 | 769 | 786 | 816 | 848 |
| Unemployment rate (%) | 12.1 | 14.4 | 13.5 | 13.7 | 13.7 |
| **Fiscal accounts (% of GDP)** | | | | | |
| Budget balance | -8.0 | -7.7 | -4.8 | -4.6 | -2.9 |
| Primary balance | -6.5 | -6.9 | -3.6 | -2.9 | -0.6 |
| Public debt | 35.6 | 41.1 | 43.3 | 50.9 | 51.6 |
| **External accounts** | | | | | |
| Current account balance (EUR bn) | -1.6 | -1.6 | 0 | -0.3 | -0.4 |
| Current account balance/GDP (%) | -2.6 | -2.5 | 0.1 | -0.5 | -0.6 |
| Basic balance/GDP (%) | -1.9 | -0.9 | 1.3 | 0.7 | 0.6 |
| Net FDI (EUR bn) | 0 | 0.4 | 1.5 | 0.9 | 0.7 |
| Net FDI (% of GDP) | -0.1 | 0.6 | 2.2 | 1.3 | 0.9 |
| Gross foreign debt (EUR bn) | 45.2 | 49.7 | 52.9 | 56.3 | 61.1 |
| Gross foreign debt (% of GDP) | 71.9 | 75.5 | 76.7 | 78.0 | 81.0 |
| **Inflation/Monetary/FX** | | | | | |
| CPI (pavg) | 1.6 | 1.0 | 3.9 | 3.5 | 3.2 |
| CPI (eop) | 0.5 | 1.3 | 4.3 | 3.4 | 3.0 |

Source: UniCredit Research

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

## New left-wing government, economy still growing

**Elections brought victory for social democrats of Fico.**

The right-wing government of PM Iveta Radicova collapsed after a junior coalition partner, the liberal SaS, refused to back the vote for the EFSF in autumn 2011. Early elections took place in March 2012 delivering a clear victory for the social democrats, previously in power in 2006-2010, led by PM Robert Fico (SMER-SD). Elections ensured a safe majority for SMER-SD in Parliament (83 seats out of 150). The new PM immediately confirmed Slovakia's commitment to cut the budget deficit below 3% of GDP in 2013. The deficit reached 4.8% of GDP in 2011 but the pace of consolidation is expected to ease in 2012 with a planned deficit of 4.6%/GDP. The main part of consolidation should be thus delivered in 2013. The new left-wing government has focussed largely on revenue generating measures.

**Fiscal consolidation to be mostly on revenue side.**

Already published proposals include an increase to the corporate tax rate from 19% to 23%, progressivity of the individual tax rate (tax rate for high-income at 25% instead of 19%), a special levy in 2012-2013 for large companies in chosen sectors (energy, communication, insurance etc, set at 4.2% of net profit) and corrections in the bank levy (the base for calculation of the bank levy is to be expanded to include retail deposits). There is also a discussion about increasing the excise duty (possibly already in 2012), real-estate taxes, restoration of taxes on dividends (most likely only for individuals), changes in health and pension insurance and in taxes for small entrepreneurs. The new government would like to reform the pension system, reduciing transfers to the 2$^{nd}$ pillar (from current 9% to 3%-6% of gross earnings). The social democrats have ruled out the possibility of a VAT hike.

**Public debt to exceed debt brake in 2012.**

The left-wing government would like to use part of the additional income from above to boost economic activity. The PM has already mentioned a need to support employment. To finance this new priority, the government proposed increased use EU funds. All in all, above should be sufficient to reduce the budget deficit below 2.9% of GDP in 2013. However, as they are focused mostly on the corporate sector (mainly foreign investments), it could have a negative impact on FDI and investment rates in coming years. In terms of the potential for further fiscal stimulus, there are safeguards in place. If the public finance deficit for this year is at the budgeted level (4.6% of GDP), public debt is expected to exceed 50%/GDP, i.e. the first level of local "debt brake". After that, the Minister of Finance is forced to inform Parliament about the situation and to present proposals for the improvement, though there are no sanctions yet.

**1Q GDP surprises on positive side, still driven by net exports.**

The economy continued its dynamic growth in 1Q12, gaining 0.7% qoq/3.0% yoy and exceeding average market expectations at 1.8% yoy. Growth was again driven mainly by net exports (stimulated also by increasing production capacities in local car plants). On the other side, domestic demand remains weak. Household consumption and fixed investments declined, while only public spending delivered small yoy growth (supported by "elections driven spending"). The level of stocks fell to an historical low. Continued destocking is expected to cease, which could deliver some statistical growth in coming quarters. The CA should remain almost balanced, turning back into a slight deficit. External demand is expected to be the main driver of the growth also in 2013, while domestic demand should be inhibited by fiscal consolidation. We expect 2012 GDP growth at 2.4% yoy (benefiting from strong carry-over at 1.2%), slightly accelerating to 2.7% yoy in 2013 (backed by recovery of eurozone growth). Economic growth should remain almost jobless, keeping the unemployment rate at relatively high levels with reasonable labor cost increases. However, real wages could record minor yearly growth up to 1% in 2012-2013, once again thanks to slowing inflation and growing labor productivity.

**CPI gradually slowing.**

Inflation peaked at 4.6% yoy in November 2011 and have eased since, reaching 3.6% yoy in April. Regulatory prices and oil prices are still the main driver but demand-pulled inflation accelerated slightly above the level of 2.0% yoy. Disinflation was driven mainly by slowing food inflation. We forecast inflation at 3.0%-3.5% yoy in coming months, supported by slower growth in regulatory prices offset by renewed growth of food prices.

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

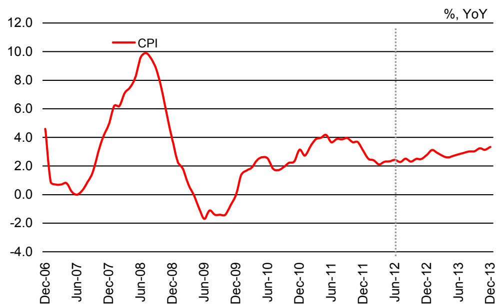
**Outlook** – A worsening external environment affects the domestic economy more strongly than expected, reflected in a substantial decrease in exports and industrial production in 2012. Accordingly, we revised downwards our GDP forecasts for 2012 and 2013. The recently adopted budget and discussions of a new stand-by arrangement with the IMF should provide confidence in international financial relations. S&P left sovereign ratings unchanged, improving the outlook to stable in March. After Moody's downgrade in April, the recent pro-active approach of the domestic national government should contribute to stabilisation.

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

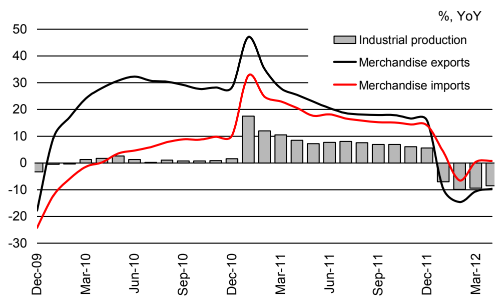
### KEY DATES/EVENTS

- 25 Jun, CPI and Industrial production
- Jun/Jul, balance of payments 1Q12
- 30 Jun, consolidated budget for 2011
- Jul, GDP for 2011 – preliminary data

### CPI EXPECTED TO MODERATE




### MERCHANDISE EXPORTS UNDER PRESSURE




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

### ECONOMIC DATA AND FORECASTS

| | 2009 | 2010 | 2011 | 2012F | 2013F |
|---|---|---|---|---|---|
| GDP (EUR bn) | 12.3 | 12.6 | 13.3 | 13.5 | 14.0 |
| Population (mn) | 3.8 | 3.8 | 3.8 | 3.8 | 3.8 |
| GDP per capita (EUR) | 3,201 | 3,271 | 3,451 | 3,504 | 3,636 |
| **Real economy yoy (%)** | | | | | |
| GDP | -2.9 | 0.7 | 1.8 | -0.9 | 0.8 |
| Private Consumption | 0 | 0 | 0 | 0 | 0 |
| Fixed Investment | 0 | 0 | 0 | 0 | 0 |
| Public Consumption | 0 | 0 | 0 | 0 | 0 |
| Exports | 0 | 0 | 0 | 0 | 0 |
| Imports | 0 | 0 | 0 | 0 | 0 |
| Monthly wage, nominal (EUR) | 616 | 622 | 650 | 660 | 686 |
| Unemployment rate (%) | 41.5 | 42.9 | 43.3 | 44.3 | 44.0 |
| **Fiscal accounts (% of GDP)** | | | | | |
| Budget balance | -4.4 | -2.5 | -2.9 | -3.4 | -3.0 |
| Public debt | 34.5 | 37.4 | 39.5 | 43.1 | 44.2 |
| **External accounts** | | | | | |
| Current account balance (EUR bn) | -0.8 | -0.7 | -1.1 | -1.3 | -1.5 |
| Current account balance/GDP (%) | -6.2 | -5.7 | -8.6 | -9.8 | -10.5 |
| Basic balance/GDP (%) | -4.7 | -4.6 | -6.4 | -9.1 | -9.5 |
| Net FDI (EUR bn) | 0.2 | 0.1 | 0.3 | 0.1 | 0.2 |
| Net FDI (% of GDP) | 1.5 | 1.1 | 2.3 | 0.7 | 1.1 |
| Gross foreign debt (EUR bn) | 6.6 | 6.6 | 6.7 | 7.1 | 7.7 |
| Gross foreign debt (% of GDP) | 53.6 | 52.8 | 50.7 | 52.8 | 55.4 |
| FX reserves (EUR bn) | 3.2 | 3.3 | 3.3 | 3.2 | 3.3 |
| **Inflation/Monetary/FX** | | | | | |
| CPI (pavg) | -0.4 | 2.2 | 3.7 | 2.4 | 3.0 |
| CPI (eop) | 0 | 3.1 | 3.1 | 2.8 | 3.3 |
| Central bank reference rate (eop) | 0 | 0 | 0 | 0 | 0 |
| 3M money market rate | 0.91 | 0.57 | 1.18 | 0.40 | 0.36 |
| USD/BAM (eop) | 1.36 | 1.47 | 1.47 | 1.67 | 1.59 |
| EUR/BAM (eop) | 1.96 | 1.96 | 1.96 | 1.96 | 1.96 |
| USD/BAM (pavg) | 1.40 | 1.47 | 1.40 | 1.55 | 1.65 |
| EUR/BAM (pavg) | 1.96 | 1.96 | 1.96 | 1.96 | 1.96 |

Source: UniCredit Research

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

## Weakening external environment triggers moderate recession

**Real GDP forecast changed to -0.9% yoy for 2012, primarily because of growing pressures from external developments.**

**We have lowered our real GDP forecast to -0.9% yoy (previously 0.5%) for 2012,** as a result of a weakening external environment against a backdrop of persistent weakn domestic demand. Recessionary pressures in the region and the eurozone were reflected in a significant decline in exports of 9.7% yoy during the first four months of this year while imports posted a slight increase of 0.8% yoy. When February's adverse weather conditions are added to the mix, industrial production fell by 9.7% yoy in 1Q12 (decline in all main sectors of manufacturing and electricity production). Looking ahead, a moderate improvement in the external environment should trigger a slight recovery in economic activity with forecasted real growth of 0.8% yoy in 2013, primary based on stronger external demand.

**Lower inflationary pressure in 2012 but unfavourable base effects in 2013.**

**We are accompanying our forecast for lower GDP growth this year with a lower inflation forecast** of 2.4% yoy (previously 2.8%), led by weak private consumption, growing unemployment and weaker domestic purchasing power, despite pressure on consumer prices from rising oil product prices and communal services in 1Q12. Next year, base effects will be less favourable while a moderate increase in administered prices and oil will also take a toll.

**New Stand-by Arrangement by year-end will provide additional stability.**

**Domestic debt issuance has increased.** In the Federation, BAM80mn of 3 year bonds were issued with an average coupon of 5.257% and a decent bid-to-cover ratio of 1.36. T-bill issuance also increased. May saw the initiation of negotiations with the IMF which will be intensified in the coming months and should bring a new Stand-by Agreement by year-end. After implementation, T-bill issuance should decline. In the period ahead, we see stabilization or slight decline in government yields. Rationale behind it lies in a moderate level of public debt, particularly low level of external debt and expectations of progress on a new SBA.

**Widening of current account deficit in 2012, with lower merchandise exports.**

**A stronger decrease in external demand has resulted in lower exports, generating a higher current account deficit in 2012.** Foreign trade data points to a widening of the deficit during the first four months of 2012, resulting in a revised current account deficit forecast of 9.8% of GDP for 2012. Next year should bring moderate external demand growth for domestic low value-added products. However when accounting for a significant import of raw materials and a slight recovery in domestic demand, we expect the widening of the current account deficit to continue in 2013. Low levels of FDI and portfolio investment inflows therefore also create a need for agreement with the IMF on a new Stand-by Arrangement.

**National government finally formed and state budget for 2012 recently approved.**

**A government at the national level was formed at the beginning of the year.** The new government and the parliament have recently made positive steps, finally adopting the state budget for 2012. A reduction of wages in public administration and austerity measures through lower social expenditures will help reduce the budget deficit in 2013. Bigger government involvement in creating a positive economic environment through a quicker reform process is expected, as well as through continuity of investments in infrastructure and energy projects.

**Divergent actions of two rating agencies.**

**Sovereign rating.** Standard&Poor's confirmed its sovereign rating B and changed the outlook to stable from negative at the end of March 2012 while Moody's lowered it by one notch to B3 in April (negative outlook and on review). Although actions of state government significantly reduce the risk of further Moody's downgrades, governments at the state and entity levels will need to implement consolidation measures to neutralize downside threats to the sovereign rating. Agreement on the new SBA with the IMF by year-end and fulfillment of commitments will be crucial to strengthen overall stability and stabilize the sovereign rating.

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

**Outlook** – The weaker global outlook in 2012, combined with expected developments in domestic demand, is pushing the economy back into recession. The main focus in the near term remains on policy actions. Croatia's sovereign credit rating remains at the bottom of investment grade with all three agencies.

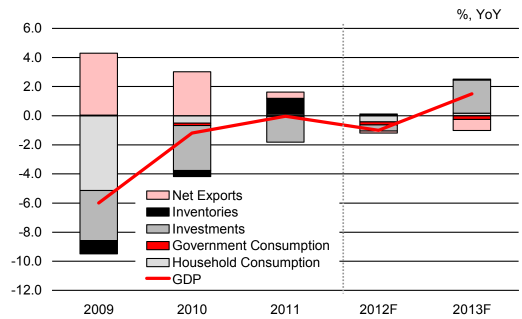
**Strategy outlook** – Croatian Eurobonds benefit from the fact that the country does not have external issuance need till 2014 whilst they already tapped the market for USD1.5bn. Given the uncertain global backdrop we would only trade Croatia as an RV trade. The current z-spread between Rephun USD 21 and Croati USD 21 is in line with the last year's average and hence we do not see a particular trade now.

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

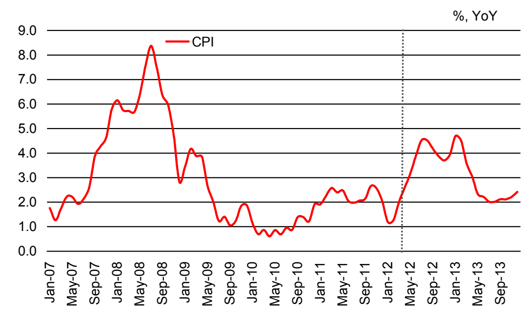
### KEY DATES/EVENTS

- 20 Jun: 1Q GDP release
- 28 Jun: First results – labor force survey for 1Q
- Jun/Jul: Election of new CNB Governor
- 31 Aug: Flash estimate for 2Q GDP

### GDP GROWTH




### INFLATION OUTLOOK




Source: NSO, UniCredit Research

### MACROECONOMIC DATA AND FORECASTS

| | 2008 | 2009 | 2010E | 2011F | 2012F |
|---|---|---|---|---|---|
| GDP (EUR bn) | 44.8 | 45.0 | 45.0 | 45.4 | 47.6 |
| Population (mn) | 4.4 | 4.4 | 4.4 | 4.4 | 4.4 |
| GDP per capita (EUR) | 10,111 | 10,192 | 10,224 | 10,313 | 10,804 |
| **Real economy yoy (%)** | | | | | |
| GDP | -6.9 | -1.2 | 0 | -1.0 | 1.5 |
| Private Consumption | -8.5 | -0.9 | 0.2 | -0.7 | 0.3 |
| Fixed Investment | -11.8 | -11.3 | -7.2 | -1.8 | 10.0 |
| Public Consumption | 0.2 | -0.8 | -0.2 | -1.0 | -1.2 |
| Exports | -17.3 | 6.0 | 2.2 | 0 | 1.2 |
| Imports | -20.4 | -1.3 | 1.0 | 0.3 | 2.5 |
| Monthly wage, nominal (EUR) | 1,051 | 1,054 | 1,049 | 1,062 | 1,096 |
| Unemployment rate (%) | 9.1 | 11.8 | 13.5 | 13.9 | 13.4 |
| **Fiscal accounts (% of GDP)** | | | | | |
| Budget balance | -3.9 | -4.9 | -5.8 | -4.8 | -3.8 |
| Primary balance | -2.5 | -3.0 | -3.0 | -1.6 | -1.0 |
| Public debt | 35.8 | 42.1 | 50.4 | 54.2 | 55.7 |
| **External accounts** | | | | | |
| Current account balance (EUR bn) | -2.3 | -0.5 | -0.4 | -0.4 | -0.7 |
| Current account balance/GDP (%) | -5.1 | -1.0 | -1.0 | -0.9 | -1.5 |
| Basic balance/GDP (%) | -1.7 | -0.1 | 1.3 | 1.6 | 2.1 |
| Net FDI (EUR bn) | 1.5 | 0.4 | 1.0 | 1.1 | 1.8 |
| Net FDI (% of GDP) | 3.4 | 0.9 | 2.3 | 2.5 | 3.7 |
| Gross foreign debt (EUR bn) | 45.2 | 46.5 | 45.7 | 46.5 | 48.0 |
| Gross foreign debt (% of GDP) | 101.0 | 103.2 | 101.6 | 102.4 | 100.9 |
| FX reserves (EUR bn) | 10.4 | 10.7 | 11.2 | 11.8 | 12.4 |
| **Inflation/Monetary/FX** | | | | | |
| CPI (pavg) | 2.4 | 1.1 | 2.3 | 3.2 | 2.8 |
| CPI (eop) | 1.9 | 1.8 | 2.1 | 3.9 | 2.4 |
| Central bank reference rate (eop) | 6.00 | 6.00 | 6.00 | 6.00 | 6.00 |
| 3M money market rate | 8.25 | 1.18 | 1.20 | 2.50 | 3.00 |
| USD/HRK (eop) | 5.08 | 5.55 | 5.66 | 6.45 | 6.06 |
| EUR/HRK (eop) | 7.31 | 7.39 | 7.53 | 7.55 | 7.45 |
| USD/HRK (pavg) | 5.26 | 5.49 | 5.31 | 5.98 | 6.34 |
| EUR/HRK (pavg) | 7.34 | 7.29 | 7.43 | 7.53 | 7.50 |

Source: UniCredit Research

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

## Recession looms, first steps taken to tackle negative trends

**1Q macroeconomic data indicate recession in 2012.**

**GDP in 1Q12 contracted 1.3% yoy (flash estimate).** Macroeconomic data releases pointed to negative trends for the beginning of 2012. Industrial production in 1Q fell 5.3% yoy, experiencing an even stronger decline in April. Retail sales data in 1Q hinted at some recovery in private consumption but the rationale for such a development can be found in the government decision to hike the VAT rate 2pp to 25% from March, causing frontloading in private consumption. The retail sales drop in April confirmed expectations of weaker private consumption in 2012. With exports falling in 2012, we lose the positive contribution of merchandise trade from 2011. The outlook for 2012 deteriorated further on the downward revision of GDP growth for the eurozone, which hurts external demand. In such an environment, the new government already introduced some announced steps that should lead to fiscal consolidation and a revival of investments. While fiscal consolidation includes action on both the expenditure and revenue side, some changes have been introduced in the tax system, which tends to stabilize revenues. Lowering the health contribution rate in wages (2pp to 13%) also decreases the burden for entrepreneurs in a move towards a more business friendly environment. Public-sector reform is the next important step to improve competitiveness and create an opportunity for recovery.

**Acceleration of investments, tourism and public-sector reform could create opportunity for recovery.**

**Current account – a modest deficit to continue.** In 2012 we forecast another year of very modest deficit with tourism revenues as the main positive contributor. There is a risk of widening if investments pick up later in the year and increase imports of capital goods. With a slight pickup in FDI to EUR 1.1bn, the basic balance would move to a surplus of 2.5% of GDP in 2012. Both current account and fiscal deficit continue to push external debt higher. However, while we expect the public sector and banking sector will generate inflows of debt, although banking sector to a lesser extent than in previous years, corporates should further moderately reduce exposure to external debt in 2012.

**Fiscal consolidation acknowledged while risks remain.**

**Fiscal policy outlook.** The government has stepped up fiscal consolidation, which should result in a trend of a narrowing deficit. Uncertainties connected to decreasing expenditures related primarily to the wage bill, subsidies and public administration reform attach some risk to achieving the planned targets set in the budget plan (3.8% of GDP for 2012). We therefore continue to forecast the deficit more conservatively at 4.8% of GDP for 2012. Together with the refinancing needs of the general government, this implies a further increase in public debt in 2012. We have also witnessed correction of the gap between market and administrative prices charged by public companies, as prices of electric energy and gas have been hiked. It has pushed 2012 inflation higher, but without longer term consequences for inflation outlook.

**Monetary policy remains unchanged.**

**Monetary policy outlook.** We see modest appreciation pressures on the domestic currency in the summer due to given external account deficit,lower external debt service needs,revenues from tourist season and modest credit activity. By the end of the year return to current level of the EUR/HRK is expected without any stronger movements. Monetary policy remains unchanged. However, a new measure introduced by the CNB ensures government access to domestically-available FX while some steps were taken also to support credit activity through Croatian Bank for Reconstruction and Development (HBOR).

**No change to credit rating for now although outlook put on negative.**

**Sovereign credit rating outlook.** Credit rating agencies began to evaluate the first steps of the new government in the spring, with the focus shifting to concrete economic policy measures. To date the rating has been maintained unchanged but prior to government announced, the outlook was changed to negative and has not since been improved upon.

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

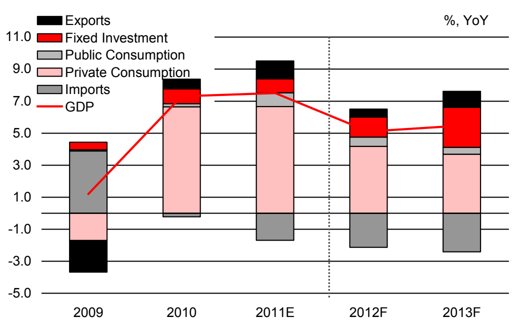
**Outlook** – Real GDP growth has begun to slow in early 2012 to 5.6% yoy in 1Q12 from 7.5% yoy in 2011. We foresee it to decelerate further to 5.1% in 2012 as a whole because the strong terms of trade gains of 2011 will not be repeated. We expect however an improvement in the growth structure thanks to higher investment brought about by a recovery in investments in the oil and power industries. This will also help to accelerate GDP growth slightly again to perhaps 5.5% in 2013. Economic policies should be moderately growth supportive in 2012 and 2013, mostly via higher transfers by the National Oil Fund to the budget. We believe that the central bank is willing and able to keep the KZT in a 145-150 corridor to the USD over the forecast period unless the global economic environment deteriorates substantially more or the RUB weakens sharply further over an extended period of time.

**Author: Hans Holzhacker, Chief Economist (ATF Bank)**

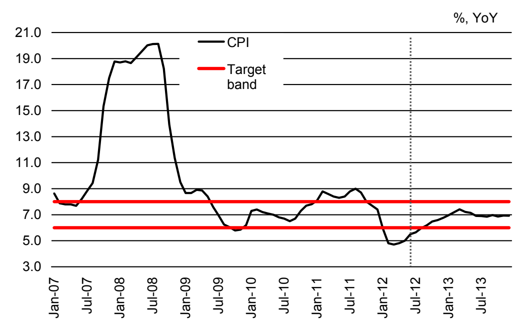
### KEY DATES/EVENTS

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

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




### INFLATION TO RETRUN TO TARGET – FROM BELOW




Source: ASRK, UniCredit Research

### MACROECONOMIC DATA AND FORECASTS

| | 2009 | 2010 | 2011 | 2012F | 2013F |
|---|---|---|---|---|---|
| GDP (EUR bn) | 77.3 | 111.5 | 133.9 | 160.1 | 191.3 |
| Population (mn) | 16.2 | 16.4 | 16.6 | 16.7 | 16.9 |
| GDP per capita (EUR) | 4,769 | 6,781 | 8,072 | 9,564 | 11,328 |
| **Real economy yoy (%)** | | | | | |
| GDP | 1.2 | 7.3 | 7.5 | 5.1 | 5.5 |
| Private Consumption | -2.8 | 10.9 | 11.0 | 6.9 | 6.1 |
| Fixed Investment | 1.9 | 3.8 | 3.6 | 5.1 | 10.3 |
| Public Consumption | 1.1 | 2.7 | 11.3 | 7.7 | 5.7 |
| Exports | -6.2 | 1.9 | 3.5 | 1.6 | 3.2 |
| Imports | -15.9 | 0.9 | 6.9 | 8.7 | 9.9 |
| Monthly wage, nominal (EUR) | 328 | 397 | 441 | 543 | 642 |
| Unemployment rate (%) | 6.6 | 5.8 | 5.4 | 5.2 | 5.0 |
| **Fiscal accounts (% of GDP)** | | | | | |
| Budget balance | -4.3 | 3.0 | 6.1 | 4.8 | 5.0 |
| Primary balance | -3.9 | 3.5 | 6.8 | 5.6 | 5.9 |
| Public debt | 13.9 | 14.8 | 12.4 | 13.7 | 14.4 |
| **External accounts** | | | | | |
| Current account balance (EUR bn) | -2.4 | 3.3 | 10.1 | 8.3 | 8.5 |
| Current account balance/GDP (%) | -3.2 | 2.9 | 7.6 | 5.2 | 4.5 |
| Basic balance/GDP (%) | 8.5 | 9.5 | 14.5 | 10.8 | 9.1 |
| Net FDI (EUR bn) | 9.0 | 7.4 | 9.3 | 9.1 | 8.8 |
| Net FDI (% of GDP) | 11.7 | 6.6 | 6.9 | 5.7 | 4.6 |
| Gross foreign debt (EUR bn) | 75.5 | 86.9 | 91.8 | 108.4 | 112.0 |
| Gross foreign debt (% of GDP) | 97.7 | 77.9 | 68.5 | 67.7 | 58.6 |
| FX reserves (EUR bn) | 15.9 | 20.8 | 22.2 | 27.0 | 28.2 |
| **Inflation/Monetary/FX** | | | | | |
| CPI (pavg) | 7.3 | 7.1 | 8.3 | 5.7 | 7.0 |
| CPI (eop) | 6.2 | 7.8 | 7.4 | 6.8 | 6.9 |
| Central bank target | 7.0 | 7.0 | 7.0 | 7.0 | 7.0 |
| Central bank reference rate (eop) | 7.0 | 7.0 | 7.5 | 6.0 | 6.0 |
| 3M money market rate | 9.59 | 2.03 | 1.79 | 2.24 | 3.79 |
| USD/KZT (eop) | 148 | 147 | 144 | 149 | 149 |
| EUR/KZT (eop) | 213 | 195 | 192 | 174 | 183 |
| USD/KZT (pavg) | 147 | 148 | 146 | 148 | 149 |
| EUR/KZT (pavg) | 206 | 196 | 204 | 187 | 176 |

Source: UniCredit Research

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

## Towards lower consumption growth, but higher investment

**Nominal GDP grew 25.3% as exports rose 42% in 2011. Real GDP grew 7.5%.**

**Strong national income growth resulted mainly in higher consumption and government spending.**

**Value added in mining rose less than in other sectors as income was redistributed.**

**The Kazakhstani economy has strongly profited from high oil prices.** Net exports of goods and services (22% of GDP) increased 86.2% yoy nominally (in KZT) in 2011 as exports (50% of GDP) rose 42% yoy and imports 20% yoy. This allowed GDP to grow 25.3% yoy. The wage sum increased 22.7%, private consumption rose 19.2% as a result. Net taxes were up 45.5%, government spending 24.7%. "Gross profit and mixed income" increased 24.5%, fixed investment however only 7.5%. In real terms, GDP grew 7.5%, consumption 11.0% yoy, government spending 11.3%, imports 6.9%. Exports increased only a meager 3.5% yoy, fixed investment 3.6%. The economy benefited from high oil prices via the redistribution of income from mining: Value added in mining – the main export industry – grew a nominal 17.6% yoy in 2011, significantly below nominal GDP. The income from mining exports was redistributed due to taxation and the price setting power of other sectors. While mineral exports prices increased 58% yoy in 2011, the mining deflator rose only 16.2%.

**While services continued to grow strongly in early 2012, mining contracted.**

**Overall GDP growth has begun to slow as well as growth in consumption.**

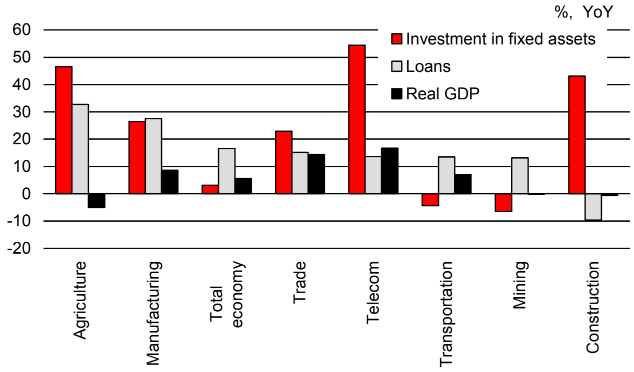
**With oil prices unlikely to increase much further (and some risk they fall), growth is set to slow.** Unicredit Research expects Brent to average USD 117pb in 2012 and USD 120pb in 2013, only slightly up from 115 in 2011. This leaves little room for further income redistribution. Real GDP growth has already begun to slow: to 5.6% yoy in 1Q12 (1.4% qoq sa according to our estimates) from 8.7% yoy, 1.9% qoq (our estimates) in 4Q11. Manufacturing held up well at 8.6% yoy after 6.5% yoy in 2011, mostly thanks to engineering and consumption related goods, but value added in mining contracted 0.2% yoy in real terms after growing only 1.2% in 2011. Services were up 8.0% yoy, only marginally below the 8.7% yoy of 2011, but such high growth seems hardly sustainable. No figures have been published yet on GDP by expenditure, but growth in consumption – though still high – has also likely begun to decelerate. Yoy growth in constant price retail sales was at 14.4% yoy in Jan-April 2012, little changed from the 14.5% of 2011. However, seasonal adjustment indicates a deceleration to 2.5% qoq sa in 1Q12 from 3.1% qoq sa in 4Q11 and 3.5% qoq sa in 3Q11, in line with real wage growth slowing to 1.7% qoq sa from 3.7% and 4.0% respectively.

**Growth in investment has, by contrast, begun to accelerate.**

**Towards higher investment.** Investment outlays rose 4.1% yoy in Jan-April 2012, up from 2.4% in 2011 and -0.5% in 2010. Investment in education, public services and defense, telecom, agriculture and manufacturing increased strongly and also trade has begun to recover. Investment in mining, one-third of the total, continued to fall, but at a slower pace (-6% yoy in Jan-April vs -10% in 2011). Agreements reached between the government and oil companies on the redistribution of ownership in the Karachaganak consortium and on some Kashagan issues, as well as upcoming projects at other companies and in the electricity sector, should lift investment substantially in late 2012 and in 2013.

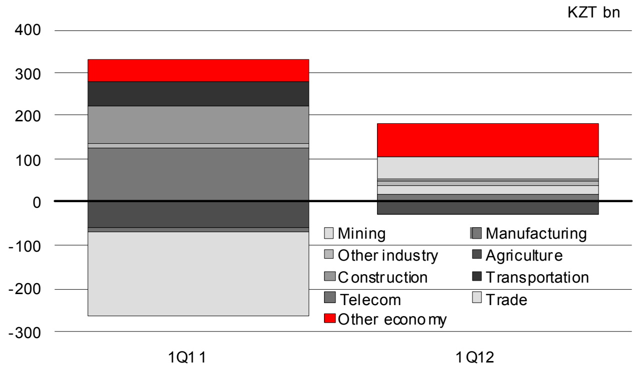
**LOANS, GDP, INV. NOW HIGHER IN MOST INDUSTRIES**

Loans, investment and GDP growth by sectors, 1Q12 (yoy %)




**TURN-AROUND IN LENDING TO TRADE, OTHER VOLUMES SMALL**

Loans by industry, flows calculated as change in stocks, KZT bn




Source: ASRK, NBRK, UniCredit Research

**Fiscal policy to ease thanks to higher transfers from the Oil Fund to the budget.**

**Economic policies will be slightly growth supportive, mostly through higher transfers from the National Oil Fund to the budget.** State budget (central+local) revenues increased 12% yoy in Jan-April 2012. Tax revenues (72% of revenues) were up only 3.1% because of very high customs income from the Customs Union last year. This was in part offset by a 2.6 times yoy hike in transfers from the National Oil Fund (26% of revenues). State budget expenditures rose 22.1% yoy (ex net crediting and financial operations, which fell), the deficit widened marginally to 1.2% of GDP from 1.1% a year earlier. The surplus of the Oil Fund increased to 9.8% of GDP from 9.0% of GDP despite the higher transfers (revenues were up 34% yoy). The overall fiscal surplus thus widened by 0.7% of GDP. The transfers from the Oil Fund will remain above last year's also in the whole of 2012. Earlier they were fixed at KZT1.2trn (USD 8bn) per year, but are now allowed to deviate countercyclically +/-15% from this amount. We believe that this will allow government spending to increase further and result in a narrowing of the overall fiscal surplus to 4.8% of GDP in 2012 from 6.1% in 2011.

**Some monetary easing is also underway, though currently still little needed.**

**The NBRK cut its 1W refinancing rate another 50bp to 6.0% as of 4 June after a 50bp decrease on 2 April 2012**. **May inflation came in at 5.0% yoy** after a low of 4.8% yoy in April. This is still comfortably within the NBRK corridor and will allow the central bank to remain supportive to the (few) banks which need central bank refinancing. With yoy inflation accelerating again, we do not expect further rate cuts any soon. The direct impact of the rate cut will be moderate. Interbank rates have remained close to the lower limit of the central bank's policy rates (the refi rate and the 1W-deposit rate, currently at 0.5%): the 1W-KIBOR stood at 1.00%, the 3M-Kaz-Prime at 2.00% in early June.

**Credit growth has recovered to some extent, even though progress in resolving banking problems is rather slow and gradual.**

**Credit to residents was 14.9% higher in April 2012 than the year before** (16.0% yoy corporate, 13.9% retail). However new credit volumes were in most industries low in early 2012. The yoy increase in corporate lending was largely thanks to the recovery in lending to trade after significant deleveraging. The repair of banks' and companies' balance sheets has remained rather slow and on the agenda. However, some – though gradual – progress is under way thanks to the work out by banks and initiatives such as the Impaired Asset Fund, SPVs, supposed to deal with real estate collateral, and new legislation on taxing write-offs. Credit expansion is likely to continue, with lending by middle segment banks with lower NPL ratios growing the fastest.

**We believe the KZT to stay in a 145-150 corridor to the USD over the forecast period.**

**The NBRK allowed the KZT to follow the weakening of the RUB a little bit.** The KZT weakened 0.1% mom vs the USD in May to 147.9 and further to 148.9 in early June. The NBRK purchased over USD 2bn in Jan-May to prevent the KZT from strengthening, including about USD 600mn in FX in late May. We do not believe, however, that the NBRK has any appetite to allow the build up of serious devaluation expectations. The net international reserves of the central bank decreased by USD 744mn in May – predominantly on the weaker euro – to USD 33.8bn, but were up USD 5.0bn ytd. The foreign assets of the Oil fund rose by USD 7.9bn ytd May to USD 51.6bn. The NBRK has thus sufficient reserves to hold the KZT below 150 unless the international situation worsens sharply and the RUB significantly further weakens to the USD over an extended period of time.

**We expect the CA surplus to narrow from the 7.6% of GDP in 2011, but to remain sufficiently high to keep pressures on the KZT limited.**

**Some narrowing of the CA surplus should take place, but not dramatic enough to put the KZT under serious pressure.** The current account surplus reached USD 3.8bn (7.5% of GDP sa) in 1Q12 (preliminary data) vs USD 2.4bn (5.6% of GDP sa) in 4Q11. Exports were up 31.7% yoy to USD 22.0bn, imports 32.5% to USD 9.7bn. Net non-resident FDI increased slightly to USD 4.6bn in from USD 4.2bn the year before. Oil exports to non Customs Union countries increased 39.1% yoy in USD and 10% in tons. However, industrial output figures show a decrease in oil production of 1.3% yoy, indicating that export growth will slow. We expect a CA surplus of 5.2% of GDP in 2012 and 4.5% in 2013. This should be still high enough to keep the overall BoP in surplus and pressures on the KZT limited.

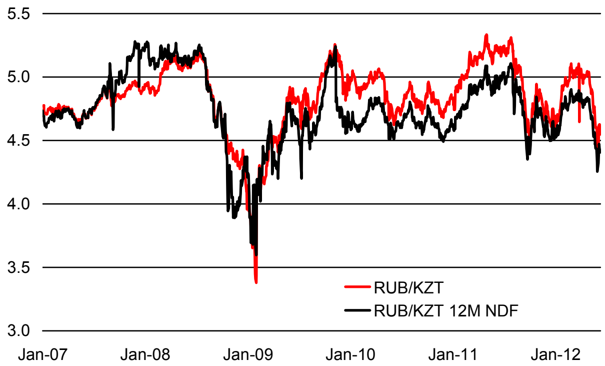
## Strategy: RUB/KZT spot is not low enough to go short but KZT NDF implied yield appears to be too low

**RUB/KZT is not low enough but KZT implied yields are low.**

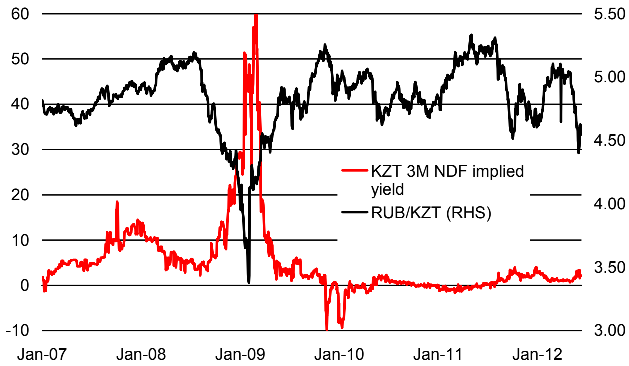
Following the sharp RUB depreciation the RUB/KZT cross is now trading close to the bottom end of the last three years trading range of 4.50-5.25 whilst the 12M RUB/KZT non-deliverable forward is around 4.40. We think these levels are not low enough to go long in RUB/KZT as back in 2008 to cross deviated from the long term average much more sharply before the NBK finally let it depreciate. One interesting aspect is that the KZT implied yields (in our chart we show the 3M) are significantly lower than the current RUB/KZT level would justify. The 3M is around 2.15% whilst with the same level of RUB/KZT it was already around 30% at the beginning of 2009. We think this does not properly reflect the risk characteristic and see some logic in paying KZT NDF swap rates.

**Author: Gyula Toth, Head of EEMEA FI/FX Strategy (UniCredit Bank)**

RUB/KZT low but not extreme low




KZT implied yield to low compared to the level of RU/KZT




Source: Bloomberg, UniCredit Research

### GOVERNMENT GROSS FINANCING REQUIREMENTS

| KZT bn | 2011 | 2012F | 2013F |
|---|---|---|---|
| **Gross financing requirement** | **851.0** | **956.1** | **688.4** |
| Budget deficit* | 576.0 | 779.8 | 474.2 |
| Amortisation of public debt | 275.0 | 176.3 | 214.2 |
| **Financing** | **851.0** | **956.1** | **688.4** |
| Borrowing** | 779.9 | 940.0 | 800.0 |
| Other | 71.1 | 16.1 | -111.6 |

* Republican budget

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

### GROSS EXTERNAL FINANCING REQUIREMENTS

| USD bn | 2011 | 2012F | 2013F |
|---|---|---|---|
| **Gross financing requirement** | **-1.7** | **-0.7** | **-2.0** |
| C/A deficit | -14.1 | -10.4 | -10.1 |
| Amortisation (loans) | 12.4 | 9.7 | 8.1 |
| Government/central bank | 0.1 | 0.5 | 0.3 |
| Banks | 4.0 | 2.5 | 2.0 |
| Corporates | 8.3 | 6.7 | 5.8 |
| **Financing** | **-1.7** | **-0.7** | **-2.0** |
| FDI (non-resident net) | 12.9 | 11.4 | 10.4 |
| Equity | 0.04 | -0.1 | 0.1 |
| Borrowing (loans) | 13.1 | 10.2 | 10.5 |
| Government/central bank | 0.8 | 0.5 | 0.5 |
| Banks | 2.0 | 1.5 | 2.0 |
| Corporates | 10.3 | 8.2 | 8.0 |
| Other (resident FDI, portfolio, lending, reserves) | -27.7 | -22.2 | -23.0 |

Source: MinFin, NBRK, UniCredit Research

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

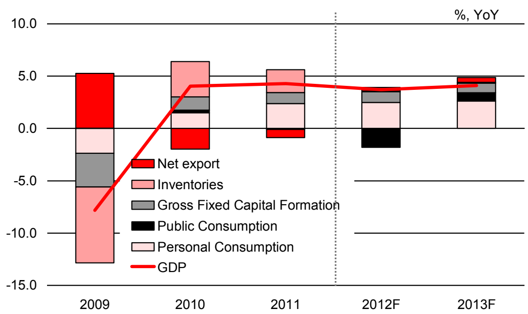
**Outlook** – The inauguration of President Vladimir Putin, and the appointment of a new government has established a new agenda for future development. It includes (among other things) an improvement in the country's investor perception. Current economic indicators provide a good basis for growth this year (GDP growth at 4.9% yoy in 1Q12 and low inflation), but market turbulence highlights embedded risks: the high volatility of the RUB, increased dependency of the federal budget on oil prices, and persistent capital outflow. We have revised our forecast to reflect a higher degree of conservatism and a higher risk of RUB weakening.

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

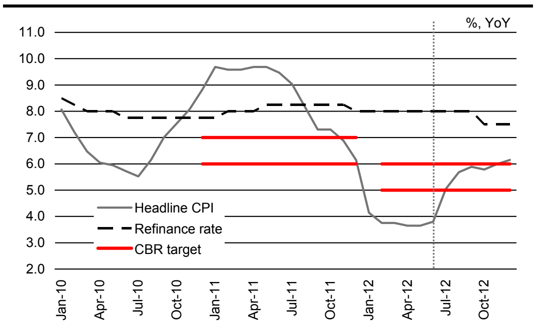
## KEY DATES/EVENTS

- 18th-22th of each month – Monthly indicators
- 1st half of every month – CBR decision on rates
- Aug – new budget project appears

## DOMESTIC AND INVESTMENT DEMAND WILL REMAIN STRONG




## INFLATION IS LIKELY TO REMAIN BELOW REFINANCE YEAR RATE




Source: Federal Statistical Service, CBR, UniCredit Research

## MACROECONOMIC DATA AND FORECASTS

| | 2009 | 2010 | 2011 | 2012F | 2013F |
|---|---|---|---|---|---|
| GDP (EUR bn) | 871 | 1,102 | 1,336 | 1,538 | 1,763 |
| Population (mn) | 141.9 | 142.9 | 143.1 | 142.9 | 142.7 |
| GDP per capita (EUR) | 6,138 | 7,714 | 9,336 | 10,769 | 12,360 |
| **Real economy yoy (%)** | | | | | |
| GDP | -7.8 | 4.3 | 4.3 | 3.7 | 4.1 |
| Private Consumption | -4.8 | 5.1 | 4.8 | 5 | 5.1 |
| Fixed Investment | -16.2 | 6.2 | 5.2 | 4.4 | 4.4 |
| Public Consumption | -0.5 | 0.7 | -0.1 | -1.8 | 0.8 |
| Exports | -4.7 | 11.1 | 2.2 | 4.7 | 4.6 |
| Imports | -30.4 | 25.4 | 7.5 | 5.8 | 5 |
| Monthly wage, nominal (EUR) | 422 | 518 | 580 | 660 | 730 |
| Unemployment rate (%) | 8.3 | 7.5 | 6.6 | 6.2 | 6.0 |
| **Fiscal accounts (% of GDP)** | | | | | |
| Budget balance | -12.4 | -6.6 | 0.8 | -0.6 | -1.5 |
| Primary balance | -11.6 | -5.8 | 1.3 | -0.2 | -1 |
| Public debt | 7.8 | 8.3 | 9.8 | 10.2 | 11.2 |
| **External accounts** | | | | | |
| Current account balance (EUR bn) | 35.7 | 55.9 | 79.5 | 60.9 | 20.4 |
| Current account balance/GDP (%) | 4.1 | 5.1 | 6.0 | 4.0 | 1.2 |
| Basic balance/GDP (%) | 3.5 | 4.2 | 6.4 | 3.2 | 2 |
| Net FDI (EUR bn) | -5.5 | -9.8 | -11.8 | -14.7 | -11.9 |
| Net FDI (% of GDP) | -0.6 | -0.9 | -1.2 | -1.0 | -0.7 |
| Gross foreign debt (EUR bn) | 329.8 | 356.3 | 424.3 | 479.2 | 506.5 |
| Gross foreign debt (% of GDP) | 34.7 | 34.7 | 31.9 | 30.2 | 32.0 |
| FX reserves (EUR bn) | 307.3 | 358.7 | 388.7 | 444.1 | 411.3 |
| **Inflation/Monetary/FX** | | | | | |
| CPI (pavg) | 11.7 | 6.9 | 8.6 | 4.8 | 5.9 |
| CPI (eop) | 8.8 | 8.8 | 6.1 | 6.2 | 5.3 |
| Central bank target refinance rate | | 8.5 | 8.0 | 7.75 | 7.25 |
| Central bank reference rate (eop) | 6.0 | 5.0 | 5.25 | 5.25 | 5.0 |
| 3M money market rate | 7.5 | 4.0 | 6.6 | 6.25 | 5.75 |
| USD/RUB (eop) | 30.0 | 30.7 | 31.3 | 33.9 | 34.3 |
| EUR/RUB (eop) | 43.1 | 40.8 | 41.7 | 39.6 | 42.2 |
| USD/RUB (pavg) | 31.9 | 30.4 | 29.2 | 31.3 | 32.8 |
| EUR/RUB (pavg) | 44.5 | 40.4 | 40.9 | 39.4 | 38.8 |

Source: UniCredit Research

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

## New and old challenges

**After politics-driven news flow from Russia in 1Q12, this quarter sets a new agenda for future development…**

After politics-driven newsflow from Russia in 1Q12, this quarter the focus has changed considerably following the inauguration of the new president, Vladimir Putin. One of the first decrees that the President signed on his first day in office specified the most important KPIs and strategic goals to be achieved within next six years. These include boosting labor productivity by 50% from 2011 levels and creating 25 million high-productivity jobs by 2020. The size of the labor force will decrease due to demographic factors, so these measures provide capacity for the economy to grow in the medium-term. Another goal is to increase the volume of investment to above 25% of GDP by 2015 and above 27% by 2018. This is a challenging task given that the indicator is at 22% currently, while investments in developed countries average 19% of GDP.

**…including a goal to improve Russia's rank in the World's Bank's Ease of Doing Business Index from 120th in 2011 to 50th in 2015.**

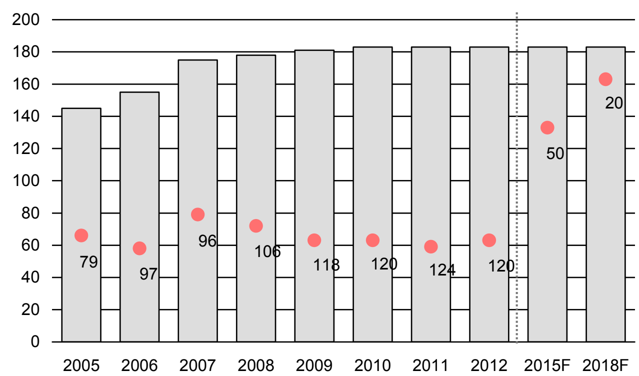
The goal to improve Russia's rank in the World's Bank's Ease of Doing Business index from 120th in 2011 to 50th in 2015 and then to 20th in 2018 deserves special attention for three reasons. Firstly, such a rapid shift in the country's rank is unique for economies of a similar size. Secondly, while to achieve 50th position Russia would have to leave behind many economies including Poland (62) and the Czech Republic (64); to achieve 20th place, the local business environment would need to be comparable to Germany and Japan. Finally, this is the first time that a KPI in the presidential decree has been externally determined and objectively testable.

**The newly appointed government (headed by Dmitry Medvedev) seems to consist of professionals. Thus it is reasonable to expect gradual step-by-step changes rather than reformist rhetoric.**

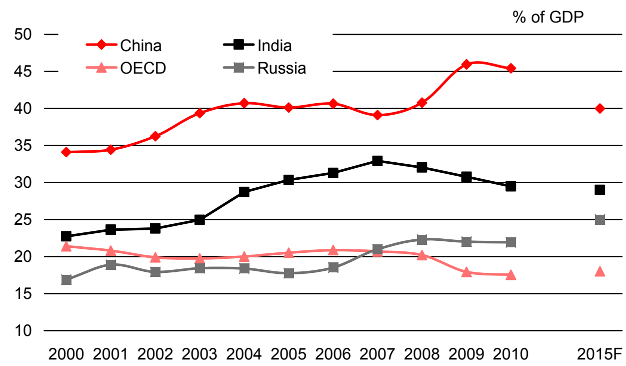
The goals are ambitious, and this puts a high degree of responsibility on the government as the key executive body. 60% of the newly-appointed government (headed by Prime Minister Dmitry Medvedev) are new faces. Some of them have joined from business, others are highly professional bureaucrats. Our view is that the economic bloc is both strong and balanced. On the one hand, investor-friendly people (e.g. Vice Prime Ministers Arkady Dvorkovich and Igor Shuvalov) will strive to stimulate economic development and modernization. On the other hand, Finance Minister Anton Siluanov is likely to be a proponent of macroeconomic and fiscal stability. It is reasonable to expect gradual step-by-step changes aimed at improving and stimulating the evolution of existing institutions, rather than rapid, immediate reformist rhetoric. In this respect we are optimistic about the government's potential to achieve Putin's targets.

**PRESIDENT PUTIN SETS VERY AMBITIOUS LONG-TERM GOALS**

Russia's rank in the World Bank's Ease of Doing Business index should improve by 100 positions in six years…




…thus driving up fixed investment considerably.




Source: IMF, OECD, World Bank, UniCredit Research

**GDP grew by a solid 4.9% yoy in 1Q12, with inflation at a low 3.6% yoy.**

Apart from political will, current economic indicators also suggest optimism – at least for this year. Indeed, in 1Q12 Russian GDP increased 4.9% yoy, which is one of the best post-crisis results. What is also positive in the real sector is that the industrial production dynamic is supported by manufacturing. Another undisputable achievement is low headline inflation – currently this indicator is at 3.6% yoy. Tariff hikes in July and acceleration of food-price growth in 2H12 could add about 1.5-2.5pp to inflation, but all in all the CBR has a chance to be close to its targeted range of 5%-6% this year.

**Still market turbulence and exhaustion of pre-election stimuli highlighted certain risks embedded in Russian economy…**

Still, market turbulence and exhaustion of pre-election stimuli have highlighted certain risks embedded in the Russian economy. Indeed, a drop in oil price by over 20% in two months brought it to levels below USD 100/bbl. Three quarters of this decrease happened in May, and hence the value of the RUB fell by almost 11% against the bi-currency basket. Depreciation against the USD was even higher, indicating almost unit elasticity. This demonstrated Russia's extremely high dependence on commodity prices but there are differences between the current situation and 2008.

The first difference concerns the funding structure of the banking system – its dependence on foreign currency has declined twofold to 8%. Another significant difference is the FX policy of the CBR. While in 2008 the CBR targeted a fixed exchange rate, now the bi-currency corridor is wide (about RUB 6) and the CBR plans to widen it further with the aim of achieving a freely floating currency within two years. This exchange rate flexibility has allowed the CBR to avoid losses in its reserves. On the basis of these and other developments, we think that the banking sector in Russia seems to be much stronger now than it was in 2008.

**…including increased dependence of federal budget on oil prices.**

However, the budget position differs. The formal dependence on oil-related revenues is little changed from 51.9% of total federal budget revenues in 1Q08 to 52.1% in 1Q12, but the non-oil-and-gas budget deficit grew from 4.6% of GDP to 12.5% over the same period. The Reserve Fund is also much weaker than it was in 2008 – 8.7% of GDP vs. 3.3%. At the same time, with government debt/GDP ratio at below 10%, the fiscal sector is still firm

**…mixed signals coming from industry and retail segments,…**

**…and persistent capital outflow.**

More recent economic indicators suggest some weakness in industry, with IP growth slowing from +4.0% yoy in 1Q12 to only 1.3% in May. This growth is the lowest in last 2.5 years, and reflects full inventories and high lending costs (9.0%). On the other hand, business confidence has suddenly improved significantly in recent months, e.g. PMI in manufacturing added 2.1 in April and additional 0.3 in May to reach 53.2. In services, the PMI also turned to reflect more optimism after dropping to low levels in 1Q12. Meanwhile retail lending in Russia is booming at 40% yoy, which drives growth in consumption demand by almost 7.0% yoy. However, real disposable income seems to be stagnating: its change by +2.1% yoy in April is too close to the difference between synthetic medium-term inflation (6.2% yoy) and its current level (3.6% yoy). Moreover, the population remains cautious, purchasing about USD 1bn per month in 2H10-2011 and in 1Q12 USD 1.7bn. Removal of capital by locals offshore also continues. In May it was USD 5.8bn, the lowest figure for last six months, but accumulated outflow in 5M12 stand at USD 46.5bn. Although our research found it to be due to structural factors, this suggests an additional pressure on the local currency.

**We slightly revised our forecast for this year to reflect a higher conservatism, with increased risk of RUB weakening later in the year.**

All the factors mentioned above resulted in an update of our forecasts for this year. Although the risks for the economy have increased considerably, we think that growth of real sector is relatively safe – at least from temporary fluctuations in oil price. However, we think that the RUB is more susceptible to depreciation later in the year than before, hence as long as the EUR weakens against the USD, the value of the RUB value will fall as well.

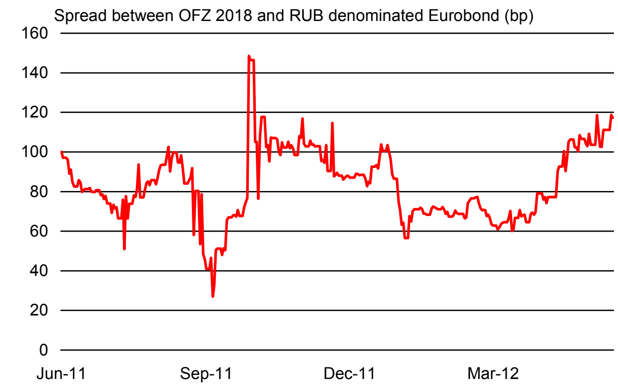
## Strategy: CCS payer looks an attractive hedge

Our strategy at the beginning of the year was centered around the introduction of the Euroclear for Russian OFZs. This would have removed the existing gap between locally traded OFZs and the RUB denominated Eurobonds (the average spread since the issuance of the RUB denominated Eurobonds is around 85bp). The spread narrowed significantly at the beginning of the year to around 60bp but due to the delay it widened out again and is currently trading around 120bp. This is on the top end of the range (see chart) and hence the valuation looks attractive. On the other hand it is not clear when Euroclear is introduced but in case of any concrete indication we will likely re-enter (most probably at the long end). We are still concerned about the RUB due to the above outlined macro risks and would not take a bullish FX position despite the recent weakness.

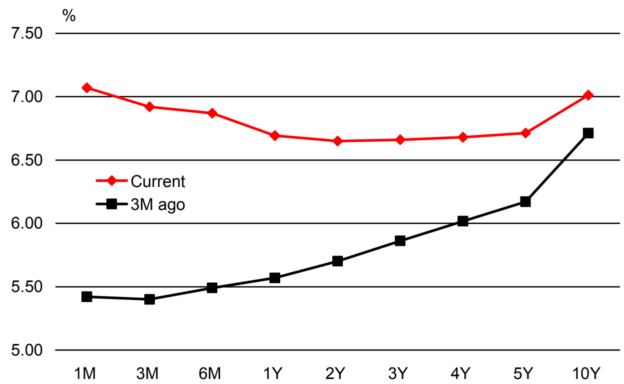
In other asset classes we note that the belly of the RUB/USD yield curve appears to be too low (see chart). This means that paying 1y or 2y RUB CCS provides positive carry and it is an attractive hedge in our view. As capital outflows continue, we think RUB liquidity might deteriorate in the banking sector pushing RUB rates higher. We note that the excess liquidity in the system (currently around RUB700bn) is already less than half than in the same period last year.

**Author: Gyula Toth, Head of EEMEA FI/FX Strategy (UniCredit Bank)**

OFZs are again cheap to the RUB denominated Eurobonds




RUB CCS curve: belly looks too low




Source: Bloomberg, UniCredit Research

**GOVERNMENT GROSS FINANCING REQUIREMENTS**

| EUR bn | 2011 | 2012F | 2012F |
|---|---|---|---|
| **Gross financing requirement** | **-0.7** | **20.6** | **37.9** |
| Budget deficit | -10.6 | 9.2 | 26.4 |
| Amortisation of public debt | 9.9 | 11.4 | 11.5 |
| Domestic | 9.9 | 11.4 | 11.5 |
| Bonds | 9.9 | 11.4 | 11.5 |
| Bills | 0 | 0 | 0 |
| External | 0 | 0 | 0 |
| of which IMF | 0 | 0 | 0 |
| **Financing** | **36.7** | **35.8** | **35.0** |
| Domestic borrowing | 34.6 | 29.2 | 27.9 |
| Bonds | 34.6 | 29.2 | 27.9 |
| Bills | | | |
| External borrowing | 2.1 | 6.7 | 5.1 |
| Bonds | 2.1 | 6.7 | 5.1 |
| IMF | | | |
| Other | | | 2.0 |

**GROSS EXTERNAL FINANCING REQUIREMENTS**

| EUR bn | 2011 | 2012F | 2012F |
|---|---|---|---|
| **Gross financing requirement** | **-11.8** | **39.0** | **32.4** |
| C/A deficit | -79.5 | -60.9 | -20.4 |
| Amortisation of debt | 60.5 | 99.9 | 52.8 |
| Government/central bank | 3 | 2.1 | 2.0 |
| Banks | 21.8 | 39.9 | 17.0 |
| Corporates | 35.7 | 57.9 | 33.8 |
| Errors and omissions | 7.2 | 0 | 0 |
| **Financing** | **-11.8** | **39.0** | **32.4** |
| FDI | -11.8 | -14.7 | -11.9 |
| Equity | -12.8 | -4.0 | -4.2 |
| Borrowing | 68.0 | 42.1 | 67.0 |
| Government/central bank | 2.1 | 6.7 | 5.1 |
| Banks | 25.1 | 12.3 | 21.7 |
| Corporates | 40.8 | 23.1 | 40.2 |
| Other | -55.2 | 15.6 | -18.4 |

Source: MinFin, CBR, UniCredit Research

# Serbia (not rated / BB stable / BB- stable)*

**Outlook** – On the back of a deteriorating international backdrop and the more limited current account financing possibilities, we have reduced our GDP forecast to 0.2% yoy for 2012 and only see a moderate recovery in 2013 (1.7% yoy). With EUR/RSD moving significantly higher YTD, the NBS was forced to hike rates in June. The future policy path largely depends on the restart of the IMF SBA. Following the parliamentary and presidential elections, the new government still has to be formed. After the formation of the government, the restart of the IMF program is crucial for the multi-month macro and market outlook.

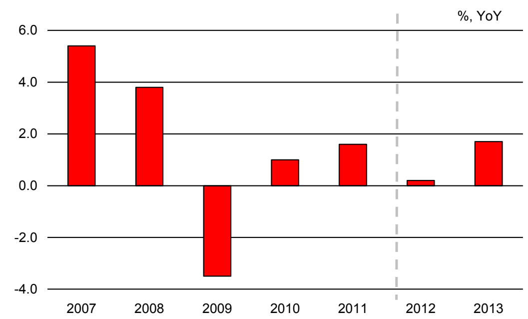
**Strategy outlook** – We believe from the group of Hungary, Ukraine and Serbia, the latter may have the best chance to benefit from an IMF program in the near term and hence Serbian Eurobonds have room to outperform.

**Author: Gyula Toth, Head of EEMEA FI/FX Strategy (UniCredit Bank)**

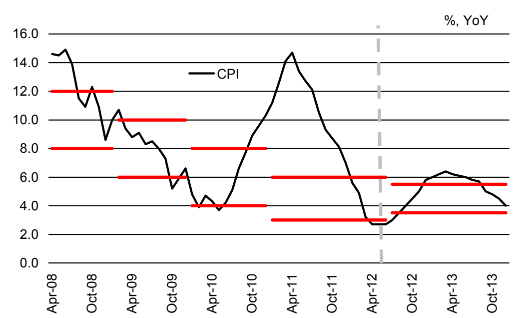
### KEY DATES/EVENTS

- 12 Jul, 9 Aug, 9 Sep - NBS MPC meeting
- 30 Jul – 2Q GDP
- 12 Jul, 13 Aug, 12 Sep – CPI

### GDP FORECAST




### INFLATION FORECAST




Source: National Stat Office, UniCredit Research

### MACROECONOMIC DATA AND FORECASTS

| | 2009 | 2010 | 2011 | 2012F | 2013F |
|---|---|---|---|---|---|
| GDP (EUR bn) | 28.9 | 27.8 | 32.3 | 29.7 | 31.5 |
| Population (mn) | 7.3 | 7.3 | 7.3 | 7.2 | 7.2 |
| GDP per capita (EUR) | 3,943 | 3,818 | 4,455 | 4,111 | 4,356 |
| **Real economy yoy (%)** | | | | | |
| GDP | -3.5 | 1.0 | 1.6 | 0.2 | 1.7 |
| Private Consumption | 0 | 0 | 0 | 0 | 0 |
| Fixed Investment | 0 | 0 | 0 | 0 | 0 |
| Public Consumption | 0 | 0 | 0 | 0 | 0 |
| Exports | 0 | 0 | 0 | 0 | 0 |
| Imports | 0 | 0 | 0 | 0 | 0 |
| Monthly wage, nominal (EUR) | 470 | 454 | 520 | 496 | 532 |
| Unemployment rate (%) | 16.1 | 20.0 | 23.7 | 24.0 | 23.5 |
| **Fiscal accounts (% of GDP)** | | | | | |
| Budget balance | -4.5 | -4.7 | -4.6 | -4.2 | -4.1 |
| Primary balance | -3.6 | -3.5 | -3.1 | -2.5 | -2.5 |
| Public debt | 34.1 | 43.7 | 43.0 | 52.2 | 54.6 |
| **External accounts** | | | | | |
| Current account balance (EUR bn) | -2.1 | -2.1 | -2.7 | -2.2 | -2.5 |
| Current account balance/GDP (%) | -7.2 | -7.5 | -8.4 | -7.5 | -7.8 |
| Basic balance/GDP (%) | -2.5 | -4.4 | -2.8 | -4.1 | -3.1 |
| Net FDI (EUR bn) | 1.4 | 0.9 | 1.8 | 1.0 | 1.5 |
| Net FDI (% of GDP) | 4.8 | 3.1 | 5.6 | 3.4 | 4.8 |
| Gross foreign debt (EUR bn) | 22.8 | 23.8 | 24.1 | 25.0 | 28.0 |
| Gross foreign debt (% of GDP) | 78.9 | 85.5 | 74.6 | 84.0 | 88.8 |
| FX reserves (EUR bn) | 10.6 | 10.0 | 12.1 | 10.0 | 10.0 |
| **Inflation/Monetary/FX** | | | | | |
| CPI (pavg) | 8.4 | 6.2 | 11.2 | 4.1 | 4.3 |
| CPI (eop) | 6.6 | 10.3 | 7.0 | 4.3 | 4.2 |
| Central bank target | 8.0±2.0% | 6.0±2.0% | 4.5±1.5% | 4.0±1.5% | 4.0±1.5% |
| Central bank reference rate (eop) | 9.5 | 11.5 | 9.8 | 10.0 | 9.0 |
| 3M money market rate | 14.50 | 10.04 | 12.33 | 10.08 | 9.50 |
| USD/RSD (eop) | 66.8 | 79.9 | 80.5 | 98.3 | 93.5 |
| EUR/RSD (eop) | 96.0 | 106.3 | 107 | 115 | 115 |
| USD/RSD (pavg) | 67.4 | 78.7 | 72.4 | 91.4 | 97.3 |
| EUR/RSD (pavg) | 94.0 | 104.4 | 101 | 115 | 115 |

Source: UniCredit Research

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

## Restart of the IMF SBA is crucial

**GDP growth forecast is reduced but 2H should improve due to the FIAT plant launch.**

**Growth slows as the international environment deteriorates.** The flash estimate for 1Q12 GDP was negative at 1.3% yoy, which was broadly in line with the monthly indicators and partly reflects the temporary closure of the Smederevo steel plant (the country's largest exporter) in February. Since then the government has restarted the plant and this has been reflected in the monthly industrial production numbers. After a seasonally-adjusted 9.2% mom decline in February, industrial production was up by 10.5% mom in March and down by 0.5% mom in April. Looking ahead, the launch of the FIAT plant ought to have a large positive impact on industrial production and GDP growth already in the second quarter. Overall we expect GDP to grow by only 0.2% yoy (vs. 1.0%yoy in our previous forecast) in 2012 which is slightly below the 0.5% yoy forecast by the IMF and WB, mostly due to our reduced EMU-area growth forecast.

**NBS is forced to hike rates despite low inflation and slower growth.**

**Monetary policy – NBS is forced to hike rates despite slower growth.** Despite inflation having dropped to 2.7% yoy in April and the growth outlook having deteriorated, the National Bank of Serbia hiked rates by 50bp to 10% reversing its latest cut in December. The bank expects inflation to rise starting in May 2012 and move above the upper end of the target (5.5%) in 1H13 before gradually reaching the target in the second half of next year. The Bank expects food and energy prices to be the main inflationary force in the coming period. Despite the bank's inflation view, we think the main reason for the rate hike was RSD, which has sold off significantly YTD (10.5% before reversing some of the losses after the rate hike). Looking ahead we think the policy rate outlook largely depends on how quickly a deal with the IMF is reached ON restarting the SBA, which would have a stabilizing impact on RSD. If this deal is reached quickly, we do not expect further hikes. We currently forecast a 10% policy rate by the end of the year unchanged from current levels.

**The current account financing YTD is poor, leading to NBS FX reserve depletion, contributing to the need for the restart of the IMF SBA.**

**Current account financing:** The Jan-March current account deficit reached EUR 1.16bn, which is EUR 400mn wider than in the same period last year. The deterioration is partly explained by the one-off effect of the steel plant closure (about EUR 150m). For the whole year we forecast a current account deficit of 7.4% of GDP, which is 80bp lower than in 2011. On the financing side, the Jan-Mar FDI inflows stood at a negative EUR 372mn but we see room for gradual improvement in the second half of year. Despite this, we see downside risk to our EUR 1bn FDI inflow forecast for the whole year, which is already EUR 800mn lower than in 2011. On the portfolio side, although the Jan-March number shows an EUR 75mn inflow, we think it moved into reverse in April and May when 53-week T-bills matured and non-resident investors did not roll over their exposure (also evidenced in the poor auctions). Another risky month will be August when the 18-month T-bills start maturing. Banks repaid EUR 147mn in loans in Jan-March and we expect a similar trend in the rest of the year. The deteriorating current account, coupled with relatively poor financing, means that the NBS has had to intervene with EUR 1.1bn. In the event that the SBA is not restarted soon, the NBS could well be forced to think more closely on the trade-off between currency defence and FX reserve loss.

**The IMF should return to Serbia in the coming weeks.**

**Fiscal policy, elections and the IMF.** The new DS, SPS and Liberal coalition is expected to be formed soon. The immediate task of the government will be to present the new fiscal program, which is likely to lead to a restart of the IMF talks, probably as soon as June-July as was indicated in the last statement from the Fund. Although the government has three months to publish the new program, we expect this to happen sooner. Recent comments from Fitch suggest that forming a new government without delay and restarting the IMF SBA is crucial for the rating. We expect the talks to mainly focus on the expenditure side and the sustainability of public-sector debt. Relatively poor current account financing, uncertainty surrounding Greek bank exposure and FX reserve depletion means that the restart of the SBA is crucial for the market outlook, both on the local currency and hard currency markets. From a regional and a timing perspective, we think Serbia is the closest to reaching a deal with the Fund.

# Turkey (Ba2 positive / BB positive / BB+ stable)*

**Outlook** – Data flow over past months has shown definitive signs of adjustment. Moreover the peak in inflation should now be behind us. The primary tasks that the domestic authorities face over a multi-quarter horizon is to manage a gradual but sustainable re-acceleration in economic activity against a backdrop of improving but still significant external financing needs and weakening economic activity but the pitfalls are worrisome. The CBT's strategy of controlling TRY via by managing both the cost and amount of its liquidity comes at a growth cost. Meanwhile its FX reserve ammuition is limited.

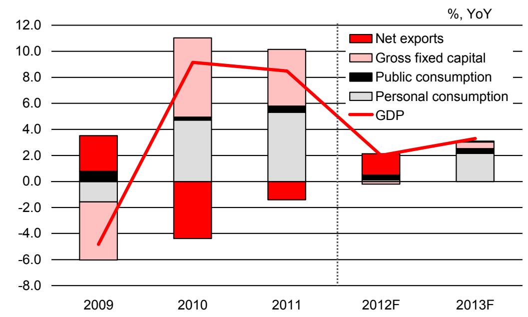
**Strategy** – We recommend keeping locally funded long end TURKGB for about 60bp positive carry. From portfolio perspective we recommend to O/W TRY versus CEE currencies due to EUR/USD proxy.

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

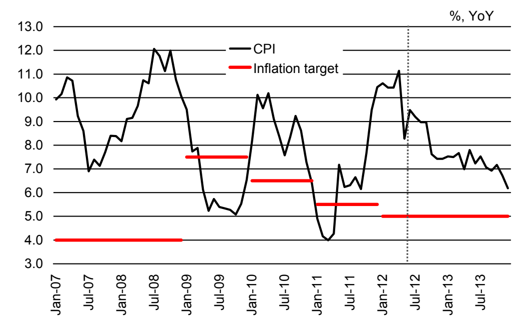
## KEY DATES/EVENTS –

- 21 Jun, 19 Jul, 16 Aug: MPC meetings
- 3 Jul, 3 Aug, 3 Sep: CPI/PPI releases
- 11 Jul, 13 Aug, 10 Sep: BoP releases

## DOMESTIC DEMAND SLUMPS, LEAVING THE BURDEN ON NET EXPORTS




## INFLATION TO EASE ONLY GRADUALLY BUT REMAIN OUT OF TARGET




Source: TurkStat, UniCredit Research

## MACROECONOMIC DATA AND FORECASTS

| | 2009 | 2010 | 2011E | 2011F | 2013F |
|---|---|---|---|---|---|
| GDP (EUR bn) | 441.0 | 551.9 | 548.0 | 577.3 | 625.3 |
| Population (mn) | 71,613 | 72,799 | 74,681 | 75,763 | 76,786 |
| GDP per capita (EUR) | 6,158 | 7,581 | 7,337 | 7,619 | 8,143 |
| **Real economy yoy (%)** | | | | | |
| GDP | -4.7 | 9.0 | 7.5 | 2.8 | 4.2 |
| Private Consumption | -2.3 | 6.7 | 7.1 | 3.6 | 3.9 |
| Fixed Investment | -19.1 | 29.9 | 16.4 | 2.4 | 6.2 |
| Public Consumption | 7.8 | 2.0 | 6.4 | 2.5 | 2.5 |
| Exports | -5.0 | 3.4 | 7.4 | 10.0 | 10.0 |
| Imports | -14.3 | 20.7 | 18.5 | 9.8 | 9.0 |
| Monthly wage, nominal (EUR) | 248.5 | 295.0 | 275.9 | 288.1 | 309.3 |
| Unemployment rate (%) | 14.0 | 11.9 | 10.5 | 10.8 | 11.0 |
| **Fiscal accounts (% of GDP)** | | | | | |
| Budget balance | -5.5 | -3.6 | -1.7 | -1.8 | -1.5 |
| Primary balance | 0.1 | 0.9 | 1.5 | 1.1 | 0.9 |
| Public debt | 45.5 | 41.6 | 39.5 | 39.0 | 38.5 |
| **External accounts** | | | | | |
| Current account balance (EUR bn) | -9.7 | -35.7 | -58.3 | -44.0 | -45.8 |
| Current account balance/GDP (%) | -2.3 | -6.5 | -10.4 | -7.8 | -7.7 |
| Basic balance/GDP (%) | -3.2 | -5.8 | -7.7 | -5.7 | - |
| Net FDI (EUR bn) | | 6.8 | 8.9 | 8.0 | 10.7 |
| Net FDI (% of GDP) | 1.37 | 1.24 | 1.56 | 1.42 | 1.80 |
| Gross foreign debt (EUR bn) | 124.2 | 144.7 | 136.7 | 136.7 | 143.3 |
| Gross foreign debt (% of GDP) | 43.7 | 39.4 | 41.6 | 43.9 | 43.7 |
| FX reserves (EUR bn) | 49.0 | 60.3 | 70.4 | 67.2 | 70.7 |
| **Inflation/Monetary/FX** | | | | | |
| CPI (pavg) | 6.3 | 8.6 | 6.3 | 9.0 | 6.5 |
| CPI (eop) | 6.5 | 6.4 | 9.1 | 7.2 | 6.5 |
| Central bank target | 7.5 | 6.5 | 5.5 | 5.0 | 5.0 |
| Central bank reference rate (eop) | 6.5 | 6.5 | 5.8 | 5.8 | 6.0 |
| 3M money market rate | 6.92 | 7.56 | 11.00 | 9.50 | 8.50 |
| USD/TRY (eop) | 1.49 | 1.54 | 1.84 | 1.85 | 1.83 |
| EUR/TRY (eop) | 2.15 | 2.06 | 2.48 | 2.54 | 2.56 |
| USD/TRY (pavg) | 1.55 | 1.51 | 1.67 | 1.88 | 1.84 |
| EUR/TRY (pavg) | 2.16 | 2.00 | 2.34 | 2.48 | 2.54 |

Source: UniCredit Research

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

## Turkey's delicate balancing act

**Domestic demand growth has shifted into contraction, as reflected in a much slower pace of credit growth and a contraction in imports…**

Data flow over past months has shown definitive evidence of adjustment:

- Credit growth slowed significantly over 2H11 and though it has shown some recovery in the past couple of months, it remains well below the excesses of 2010. The amount of new credit over the twelve months to both end-4Q last year and end-1Q this year were more than 1pp of GDP less than for the same 4 quarter period the previous year, suggesting that domestic demand growth has not only ground to a halt but could already be in contraction in yoy terms. As a reminder, total domestic demand growth stood at 1.9% yoy in 4Q compared with 14.9% yoy in 4Q10;

- Weaker domestic demand growth is also reflected in the improvement in Turkey's trade balance. Over the first four months of this year, Turkey's trade balance is 20% narrower relative to 2011 as export growth reached almost 11% yoy YTD while import growth stands at a negative 2.7% yoy YTD. In volume terms imports have contracted on average 0.3pp per month over the 12 months to April, compared with volume growth of 1.5% per month over the previous 12 months. Meanwhile export volume growth stands on average at 0.9% per month over the 12 months to April and has accelerated in recent months. Examining domestic demand on a qoq basis, contraction in the last three quarters of last year looks set to be matched by broadly flat domestic demand in 1H this year.

**…while the peak in inflation is now behind us.**

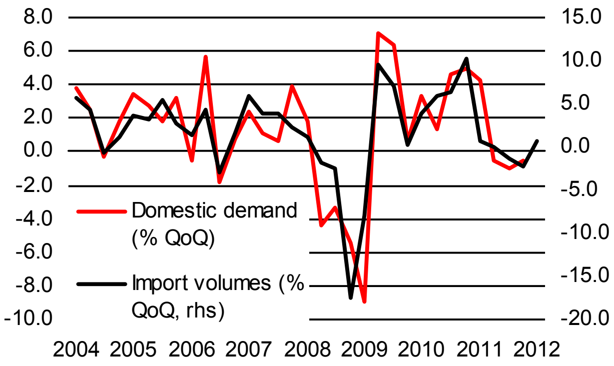
Moreover the peak in inflation should now be behind us. After five months in double digit territory and having reached 11.1% yoy in April, inflation eased to a below market consensus 8.3% yoy in May. A number of factors played a role in such elevated inflation. For example administered price hikes added 1.6pp to inflation over Oct-Nov last year and a further 0.5pp to inflation in April. Last year's 20% loss in the TRY basket saw the contribution from FX to inflation reach 3.4pp by year-end, 1.2pp above the average contribution of FX to inflation since 2006. This has begun to ease and assuming a stable TRY should fall to zero by August. Lastly high energy prices have taken their toll YTD but that should reverse in the coming months.

**There remains a considerable adjustment ahead.**

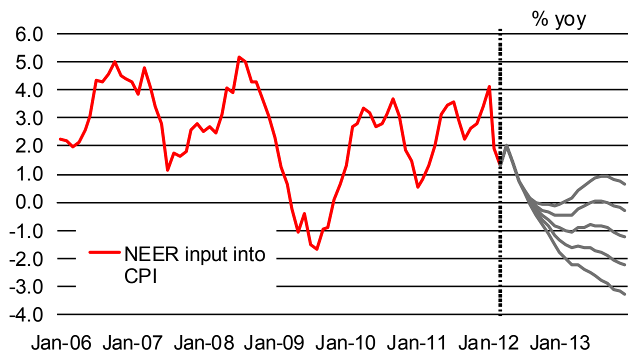
The primary task that the domestic authorities face over a multi-quarter horizon is to manage a gradual but sustainable re-acceleration in economic activity against a backdrop of improving but still significant external financing needs and weakening economic activity. The pitfalls are

**ADJUSTING IMBALANCES**

Import growth has come to a halt, in line with modestly negative to flat domestic demand growth




Contribution of FX to inflation: Assuming (from top to bottom) a gradual 2 and 1 standard deviation TRY loss, a flat TRY and a 1 and 2 standard deviation gain in TRY




Source: Turkstat, CBT, UniCredit Research still worrisome. In particular Turkey's large gross external financing requirement of USD 180bn puts economic activity at risk of sudden stop. The C/A deficit accounts for almost USD 60bn of this, shoft term debt USD84bn, of which USD 48bn is owed by banks. Bank short term external debt has almost trippled since end-2007. More broadly, we estimate that of the USD 132bn in foreign capital that has entered Turkey since end-2009, USD 92bn is short term in nature (accounted for in part by USD 45bn and USD 19bn in portfolio and short term bank loans) and as such poses more of a risk of rapid reversal.

**…leaving the CBT continuing to closely manage TRY.**

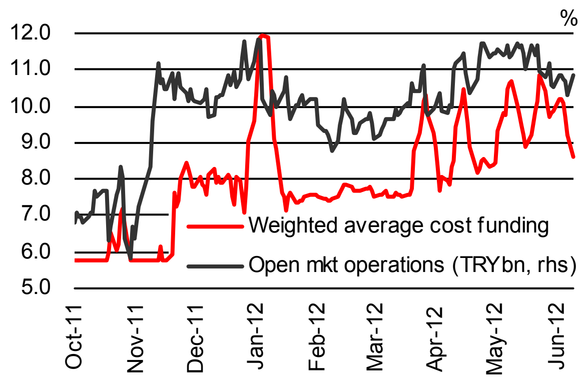
This 'management' to date is done via a combination of controlling both the price and amount of liquidity that the CBT provides in an effort to stabilise TRY within a relatively small range, preventing excess depreciation that would push inflation higher and excess appreciation that could push growth lower. Since the beginning of the year, the CBT has largely abandoned a strategy of active FX sales or intervention, aware of its limited ammunition. But the CBT still risks having its strategy put to the test for a couple of reasons:

1. Its current policy also comes with a growth cost. Over the past month, the average cost of funding to the banking sector stood at 9.75%, over the previous month 9.3% and within the most recent month varied from a low of 8.59% to a high of 10.83%. This casts considerable uncertainty over the banking sector's cost of funding and, in turn, its willingness to lend. A combination of a weak 1Q and expectations of continuing external uncertainty through 2Q and into 3Q has prompted us to take our growth forecast for this year to 2.0%, well below the government's 4% target.

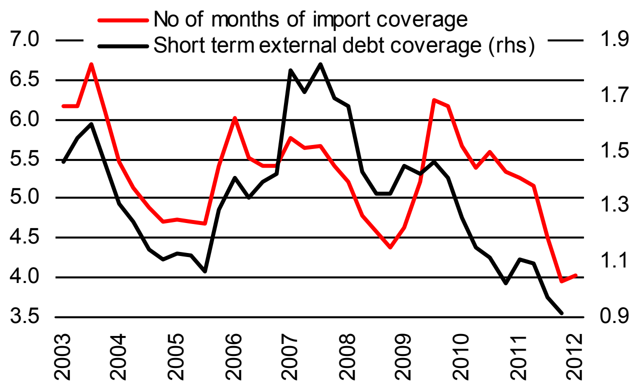
2. In the event of a more persistent escalation of currency depreciation pressure, potentially due to external events that are outside of the CBT's control, the CBT does not have sufficient FX reserves to deal with this in a convincing manner. Turkey still needs to attract USD4bn a month on a seasonally adjusted basis to finance its C/A balance while FX reserves stand only 4 months of imports and less than one times short term external debt. Its primary approach to building FX reserves YTD has been to allow banks to cover more of their TRY reserve requirements with FX, adding USD 5.9bn YTD, USD 19.7bn over the past 12 months. YTD TRY has not strengthened sufficiently to allow the CBT to return to purchasing FX.

**TOOLS AND CHALLENGES**

The CBT is managing TRY both via the cost and amount of liquidity provided




FX reserve coverage ratios are uncomfortable low



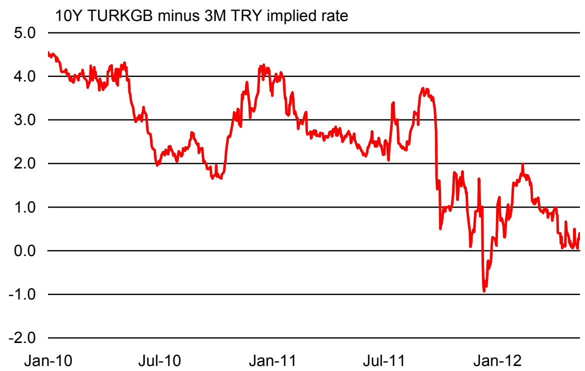

Source: CBT, UniCredit Research

## Strategy: keep locally funded long end TURKGBs

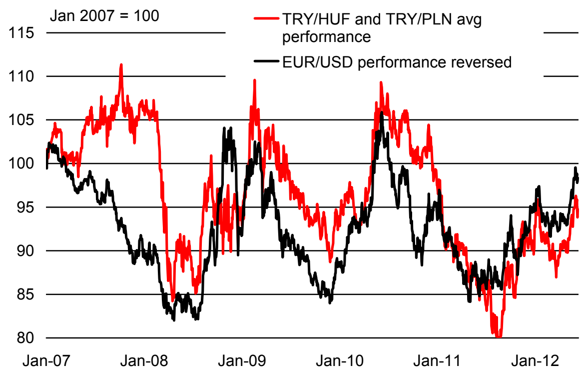
Although the TURKGB curve is inverted, we think long end yields have more room to go lower given limited supply, falling headline inflation, slowing domestic demand and less exposure to CBT liquidity operations. While the economy is slowing and the TRY is vulnerable to risk appetite swings, the CBT will continue to operate its dual policy, keeping short end rates elevated and leading to further curve flattening. We have been positioned with a CPI linker since 3rd February at 3.85% real yield. The real yield shrank to 3.3% at end May and we switched to the 10y nominal TURKGB benchmark at 9.26% yield. Since then the yield shrank about 30bp and we expect another 50bp tightening. In order to position on the flatter yield curve and our currency worries, we think it makes sense to fund this position via 3M FX swaps at around 8.35%. The position provides about 65bp positive carry. From portfolio perspective, we think TRY could still outperform PLN and HUF due to the lower EUR/USD. We recommend a M/W allocation.

**Author: Gyula Toth, Head of EEMEA FI/FX Strategy (UniCredit Bank)**

FX hedged 10y TURKGB still provides positive carry




TRY outperforms CEE FX if EUR/USD falls




Source: Bloomberg, UniCredit Research

### GOVERNMENT GROSS FINANCING REQUIREMENTS

| EUR bn | 2011 | 2012F | 2013F |
|---|---|---|---|
| **Gross financing requirement** | **62.9** | **75.8** | **82.7** |
| Budget deficit | 1.5 | 10.6 | 13.6 |
| Amortisation of public debt | 61.4 | 65.2 | 69.1 |
| Domestic | 53.9 | 58.4 | 61.6 |
| Bonds | 48.0 | 52 | 54.8 |
| Bills | 6.0 | 6.4 | 6.8 |
| External, medium to long term | 7.4 | 6.8 | 7.5 |
| **Financing** | **62.9** | **75.8** | **82.7** |
| Domestic borrowing | 55.5 | 65.3 | 70.1 |
| Bonds | 51.3 | 58 | 62 |
| Bills | 4.20 | 7.3 | 8.1 |
| External borrowing, medium to long term | 7.4 | 10.5 | 12.6 |
| Bonds | 6.0 | 8.1 | 10.2 |
| IMF/WB | 0.0 | 0 | 0 |
| Other | 1.5 | 2.4 | 2.4 |

Source: MinFin, CBT, UniCredit Research

### GROSS EXTERNAL FINANCING REQUIREMENTS

| EUR bn | 2011 | 2012F | 2013F |
|---|---|---|---|
| **Gross financing requirement** | **127.0** | **138.2** | **164.3** |
| C/A deficit | 55.5 | 46.7 | 49.1 |
| Amortisation of medium to long term debt | 24.4 | 28.5 | 31.1 |
| Government/central bank | 3.7 | 5.5 | 5.0 |
| Banks | 4.2 | 4.5 | 5.5 |
| Corporates | 16.5 | 18.5 | 20.6 |
| Short term debt | 55.7 | 67.6 | 89.0 |
| Government/central bank | 4.2 | 6.7 | 8.5 |
| Banks | 34.3 | 38.8 | 50.8 |
| Corporates | 17.2 | 22.2 | 29.7 |
| Errors & omissions | -8.6 | -4.6 | -4.9 |
| **Financing** | **129.4** | **138.1** | **164.3** |
| FDI | 9.6 | 11.9 | 15.0 |
| Portfolio | 18.1 | 0 | 0 |
| Borrowing medium to long term | 33.0 | 34.7 | 40.3 |
| Government/central bank | 7.8 | 8.9 | 10.2 |
| Banks | 7.0 | 4.8 | 6.4 |
| Corporates | 18.2 | 21.0 | 23.7 |
| Short term borrowing | 60.2 | 84.7 | 99.2 |
| Government/central bank | 6.0 | 8.1 | 10.2 |
| Banks | 34.5 | 48.4 | 55.1 |
| Corporates | 19.8 | 28.2 | 33.9 |
| Other | 7.2 | 6.9 | 9.9 |
| Reserve accumulation | 1.3 | 0 | 0 |

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

**Outlook** – Ukraine has muddled through 1H this year, suffering from a sharp slowdown in growth and a weak balance of payments but manageable FX reserve losses. However there has been no progress on an IMF deal, fiscal performance has weakened while external debt repayments increase over 2H12 and into 2013. The government will do its best to maintain stability ahead of October's parliamentary elections but Ukraine's twin deficits cannot go unaddressed for much longer.

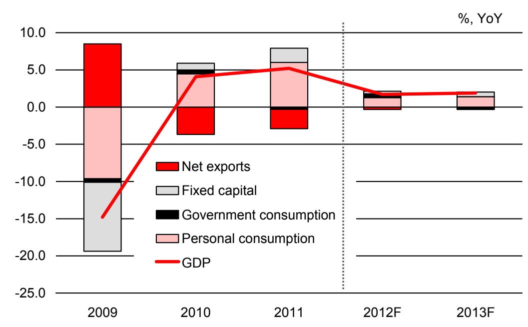
**Strategy outlook** – We recommend tactically selling very short dated NDF (up to 3M). In the Eurobond space we hold a long position in the Ukraine USD 2013 paper but avoid any longer term exposure.

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

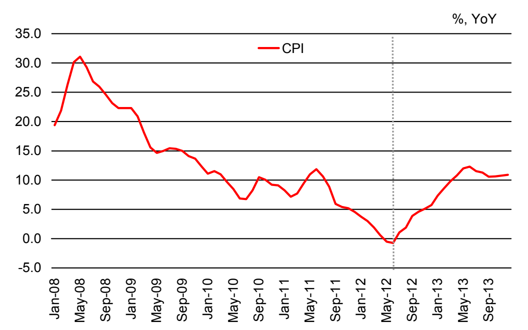
### KEY DATES/EVENTS

- 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

| | 2009 | 2010 | 2011 | 2012F | 2013F |
|---|---|---|---|---|---|
| GDP (EUR bn) | 84.2 | 86.6 | 97.4 | 129.0 | 128.4 |
| Population (mn) | 46.0 | 45.8 | 45.5 | 45.3 | 44.8 |
| GDP per capita (EUR) | 1,831 | 1,891 | 2,140 | 2,847 | 2,866 |
| **Real economy yoy (%)** | | | | | |
| GDP | -14.8 | 4.1 | 5.2 | 1.7 | 1.9 |
| Private Consumption | -14.9 | 7.0 | 9.5 | 2.0 | 2.2 |
| Fixed Investment | -50.5 | 4.9 | 10.5 | 2.0 | 3.5 |
| Public Consumption | -2.4 | 2.7 | -1.5 | 2.5 | -1.5 |
| Exports | -22.0 | 4.5 | 6.0 | 5.5 | 7.6 |
| Imports | -38.9 | 11.1 | 10.5 | 5.8 | 7.2 |
| Monthly wage, nominal (EUR) | 170 | 213 | 228 | 268 | 322 |
| Unemployment rate (%) | 8.8 | 8.1 | 7.9 | 8.2 | 8.4 |
| **Fiscal accounts (% of GDP)** | | | | | |
| Budget balance | -6.2 | -5.7 | -4.5 | -6.9 | -4.5 |
| Primary balance | -5.1 | -4.2 | -2.6 | -4.9 | -2.5 |
| Public debt | 35.0 | 42.2 | 41.1 | 46.1 | 45.2 |
| **External accounts** | | | | | |
| Current account balance (EUR bn) | -1.2 | -2.3 | -5.5 | -6.2 | -4.5 |
| Current account balance/GDP (%) | -1.5 | -2.6 | -5.7 | -4.8 | -3.5 |
| Basic balance/GDP (%) | 2.3 | 2.6 | 1.5 | -1.3 | 0 |
| Net FDI (EUR bn) | 3.2 | 4.5 | 7.0 | 4.5 | 4.5 |
| Net FDI (% of GDP) | 3.8 | 5.2 | 7.2 | 3.5 | 3.5 |
| Gross foreign debt (EUR bn) | 72.6 | 88.2 | 95.5 | 96.1 | 93.3 |
| Gross foreign debt (% of GDP) | 86.2 | 101.9 | 98.1 | 74.5 | 72.7 |
| FX reserves (EUR bn) | 17.7 | 25.1 | 23.3 | 21.3 | 21.1 |
| **Inflation/Monetary/FX** | | | | | |
| CPI (pavg) | 16.0 | 9.4 | 8.0 | 2.5 | 10.5 |
| CPI (eop) | 12.3 | 9.1 | 4.6 | 5.7 | 10.9 |
| Central bank reference rate (eop) | 10.25 | 7.75 | 7.75 | 8.00 | 8.00 |
| USD/UAH (eop) | 8.00 | 7.97 | 7.80 | 8.59 | 9.21 |
| EUR/UAH (eop) | 11.5 | 10.6 | 10.4 | 10.0 | 11.3 |
| USD/UAH (pavg) | 8.07 | 7.95 | 7.94 | 8.11 | 9.04 |
| EUR/UAH (pavg) | 11.3 | 10.5 | 11.1 | 10.2 | 10.7 |

Source: UniCredit Research

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

## Tick tock, tick tock

**The authorites face a race against time…**

The European football championships are underway. Afterwards the government will focus in full on parliamentary elections at end-October. Whether Ukraine manages until October or not, it seems unlikely that the current status quo can be convincingly maintained beyond 4Q and into 2013 given its ever more problemtic twin deficits problem. Last year saw Ukraine's C/A deficit widen to 6.0% of GDP, almost 4pp of GDP wider than in 2010. YTD it has not shown improvement. Gross external debt stood at 76.4% of GDP by end-4Q last year, almost 20pp above the ex-EU CEE average and 2.6 times and 2.8 times the average for Asia and Latam respectively. We now estimate this year's budget deficit at close to 7% of GDP, with public debt still on an upward trajectory.

**…as ever larger financing requirements prove more troublesome.**

Such a debt burden in the face of no access to eurobond markets translates into problematic financing requirements. A combination of this year's C/A deficit and external debt due for repayment (short term as well as medium to long term) sums to EUR 56bn, of which almost half is short term external debt. We estimate the government's gross financing requirement this year at EUR 21bn, with the government reliant on every increasing amounts of domestic debt issuance. This is against a backdrop where growth has already slowed significantly, reaching 2.0% yoy in 1Q. We now forecast full year growth at 1.7%. YTD while IP has slumped, record low inflation has supported the consumer but this is set to reverse from here.

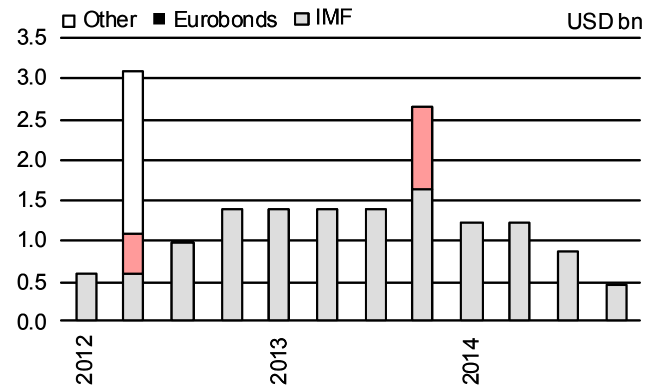
**We worry about the size of Ukraine's import bill, sovereign debt redemptions and the risk of capital flight.**

**Our sources of concern are threefold:**

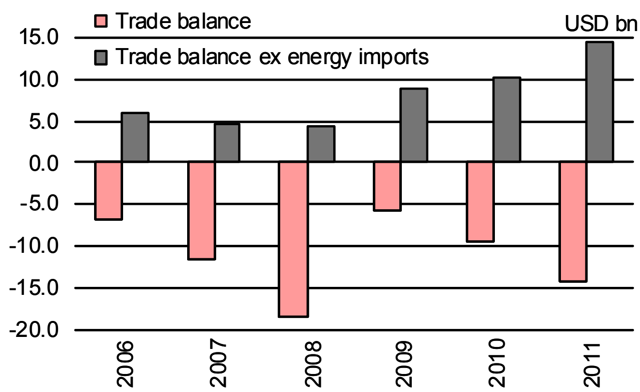
Ukraine's energy import bill last year stood at USD 28.6bn, almost double what it was in 2009, equivalent to almost 18% of GDP and accounting for the full C/A deficit widening and more. Compared with an average import price of 320 per thousand cubic metres last year, Ukraine paid USD 415 for gas in 1Q, USD 425 for gas in 2Q, with knock on impacts for the trade balance, fiscal accounts and overall economic activity. Gazprom extend Naftogaz a USD 2.0bn of a loan earlier this year, on top of the USD 550mn extended in November last year. More recently it announced that Gazprom will prepay USD2bn for transit fees.

The sovereign's financing requirement, though concentrated to the IMF, increases significantly from here. Having begun in 1Q, repayments to the IMF stand at well over USD 1.0bn per quarter between 4Q12 to 2Q14. VTB recently rolled USD1.0bn of its loan while also purchasing USD 1.0bn of domestic bonds. June's USD 0.5bn eurobond redemption is followed by another eurobond redemption in 4Q. The sovereign has not been able to return to external markets.

The sovereign's external repayment schedule does not ease any time soon




Energy imports weigh more and more on the trade balance




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

1. Against this backdrop, increased capital flight is a risk. The country saw a USD 11.6bn withdrawal of 'cash outside banks' out of the country over the 12 months to February, up from USD 6.2bn over the previous 12 months.

The banking sector is another weak spot, having been forced to adjust to rollover ratios well below 1.0 for some time now. Only USD 3.2bn of the USD 7.9bn in medium to long term external bank debt coming due last year was rolled. Adding USD 0.7bn in short term bank inflows last, the sector posted an outflow of USD 4bn or 2.4% of GDP. The banking sector has a further USD 12.9bn in borrowings coming due this year, USD 7.1bn of which is medium to long term debt.

**Economic policy is in need of an anchor.**

With all of the above in mind, we see the economy at real risk of a sudden stop as we enter 2013. In a favourable scenario the domestic authorities will manage a gradual improvement in the C/A and a reversal of its populist fiscal policies but an external anchor in the form of a new IMF programme may well be required.

**There are many question marks surrounding the viability of Ukraine's current FX regime.**

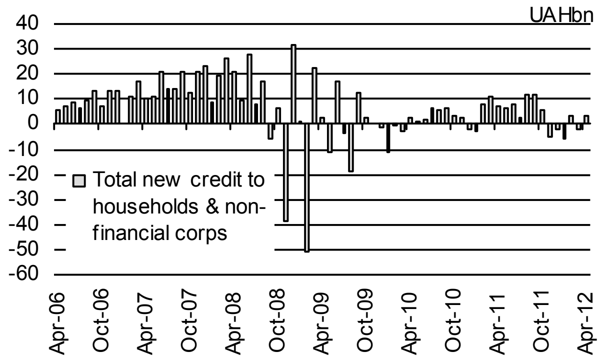
Even assuming Ukraine manages all of the above, a question mark medium to long term will remain over the viability of Ukraine's current FX regime:

1. At USD 29.1bn at end-April, FX reserves cover less than 5 months of imports and less than 60% of external debt coming due over the coming 12 months. Import cover has not been this low since early-09, short term external debt coverage since 1H10. The original IMF programme set a target for FX reserve coverage of short term external debt at 0.75, suggesting a need for a USD 25bn increase from here.

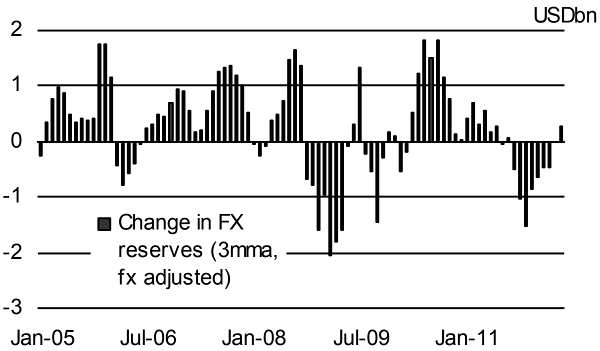
2. Ukraine's main trading partner, Russia (accounting for 31.6% of all trade in 2010), is moving towards an ever more flexible currency regime, with the RUB over time biased to depreciation. In the event of persistent RUB losses, challenges to Ukrainian competitiveness would be greater.

In the event of a new IMF programme, changes to Ukraine's current FX regime will be a priority. A quick glance at Ukraine's real effective exchange rate suggests that any overvaluation is significantly more limited than was the case in 2Q-3Q08. That said Ukraine's yawning C/A deficit, if only due to gas imports, could benefit from a weaker currency, if it translated into a more competitive export sector. Anchoring any discussions on a change in currency regime will be the authorities' concerns on related political costs. We see a gradual shift towards a basket as most likely but the risk to this is that FX reserve loss increases around/after elections as we enter winter and repayments to the IMF escalate while Ukraine fails to reach a deal with Russia/IMF in a timely manner. In this scenario the risks of an abrupt currency adjustment would be much greater.

Banks have not convincingly returned to new lending…




…but for now FX reserves have been stabilised



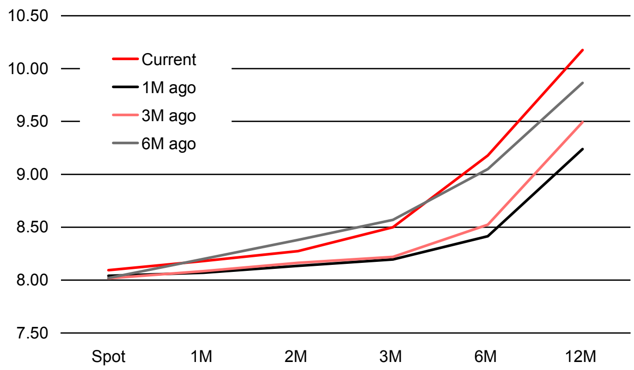

Source: MinFin, NBU, State Treasury, UniCredit Research

## Strategy: keep short dated Eurobonds

Given the above outlined macro risks we believe risk reward is not attractive on long UAH positions beyond the elections even though the NDF market is pricing about 30% devaluation over 12M. Tactically it however makes sense to sell short dated USD/UAH NDFs but only up to 3M maturity. Annualized implied yields also stay around 20% for these maturities. In the Eurobond space given heavy financing requirements we would only focus on the very short end part of the curve the June 2013 paper. This bond is still yielding about 9.5% which we think is fair whilst any post election devaluation should ease downward pressure on FX reserves which in turn is positive for the credit. Accordingly we recommend holding these papers. Given the higher beta status of the longer dated Ukraine Eurobonds we do not recommend holding those papers.

**Author: Gyula Toth, Head of EEMEA FI/FX Strategy (UniCredit Bank)**

Implied UAH path from USD/UAH NDF market




Ukraine Eurobond sensitivity versus SPX


Source: Bloomberg, UniCredit Research

**GOVERNMENT GROSS FINANCING REQUIREMENTS**

| EUR bn | 2011 | 2012F | 2013F |
|---|---|---|---|
| **Gross financing requirement** | **9.8** | **21.0** | **26.6** |
| Budget deficit (excl Nafto) | 2.4 | 6.3 | 3.2 |
| Amortisation of public debt | 6.4 | 10.2 | 18.4 |
| Domestic | 5.5 | 5.8 | 13.5 |
| Short term | 1.6 | 0.7 | 8.5 |
| Medium to long term | 3.9 | 5.1 | 5.0 |
| External | 0.9 | 4.4 | 4.9 |
| of which IMF | 0 | 2.5 | 4.1 |
| **Financing** | **6.9** | **21.0** | **25.0** |
| Domestic borrowing | 3.8 | 19.0 | 16.0 |
| of which NBU | 1.9 | 4.0 | 1.5 |
| Short term | 0.7 | 8.5 | 9.0 |
| Medium to long term | 3.2 | 10.5 | 7 |
| External borrowing | 3.1 | 2.0 | 9.0 |
| Bonds | 2.1 | 0 | 2.0 |
| IMF | 0 | 0 | 6.0 |
| Other | 1.0 | 2.0 | 1.0 |

Source: MinFin, NBU, UniCredit Research

**GROSS EXTERNAL FINANCING REQUIREMENTS**

| EUR bn | 2011 | 2012F | 2013F |
|---|---|---|---|
| **Gross financing requirement** | **53.2** | **56.0** | **48.4** |
| C/A deficit | 5.5 | 6.2 | 4.5 |
| 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** | **53.2** | **56.0** | **48.4** |
| FDI | 5.4 | 5.4 | 5.4 |
| Portfolio flows | 0.4 | 0 | 0 |
| Medium to long term borrowing | 21.2 | 10.8 | 13.6 |
| Banks | 3.5 | 2.9 | 2.3 |
| Corporates | 13.0 | 8.0 | 6.4 |
| Government/central bank | 4.7 | 0 | 4.9 |
| Short term borrowing | 21.0 | 30.3 | 24.0 |
| Banks | 4.1 | 4.7 | 2.3 |
| Corporates | 15.3 | 22.6 | 20.1 |
| Government/central bank | 1.6 | 3.0 | 1.6 |
| Other | 3.5 | 6.5 | 2.5 |
| Change in reserves | 1.8 | 3.1 | 3.0 |

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