# CEE

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# CEE: Managing new norms

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- Events in Russia and Ukraine have introduced geopolitical uncertainty into Central and Eastern Europe which has not been present for an extended period of time. This, combined with other factors, has prompted downward revisions to our growth outlook for EMU but also means a more accommodative ECB as Fed tapering comes to an end. All of the above will impact CEE in the coming quarters but with significant differentiation across the region.
- In our baseline scenario, the Russian authorities remain successful in protecting economic activity against sanctions in the near term. CBR rate hikes have aided financial stability, domestic capital outflows have slowed while Russia has generated some success in diversifying trade and funding partners via China. Over a longer term horizon, however, we are increasingly concerned that potential growth in Russia will fall further while the sovereign's buffers will be slowly but surely eroded. Tail risks have increased significantly.
- Turkey will suffer less than elsewhere from events in Russia and Ukraine while easy external financing conditions have prompted us to raise our growth forecast for this year. Easier monetary conditions and supportive fiscal policy aid near term growth prospects but they also generate vulnerabilities further out, as does the erosion of institutional structures in an economy highly reliant on continued foreign capital inflows.
- Developments in Russia, Ukraine and EMU are taking their toll on Central European growth but some countries in the region continue to benefit from new production capacities while we expect domestic demand to show resilience. Low inflation should also facilitate easier monetary policy for longer. Meanwhile as ties between Russia and the EU weaken, Poland continues to grow its position within the EU, as captured by the appointment of former PM Tusk to the role of President of the European Council. The election schedule in the region turns busier in the coming months as local elections are scheduled in Hungary and Poland while Romania moves towards Presidential elections. At this stage we do not expect these to generate any significant shifts in policy.
- Persistent growth underperformance in the Balkans relative to Central Europe, combined with a variety of domestic events in recent months, highlights the need for public sector reform across this part of the region. In part this growth underperformance captures lower growth rates in trading partners but efforts to narrow budget balances, reduce oversized public sectors and facilitate a more business friendly environment are also required. Croatia and Serbia stand out as the two economies where public debt dynamics require anchoring.

## Imposing (geo)political and economic change

**Geopolitical risks have increased significantly**

There is a considerable amount of (geo)political, economic and policy change happening both within and outside of Central and Eastern Europe, prompting meaningful shifts to the outlook. For Central and Eastern Europe, geopolitical developments in Russia and Ukraine are of importance, introducing a sort of uncertainty to the region that has not been present for an extended period of time. This, combined with unrest in the Middle East, has knock-on implications for trade, investment and corporate profitability in our region.

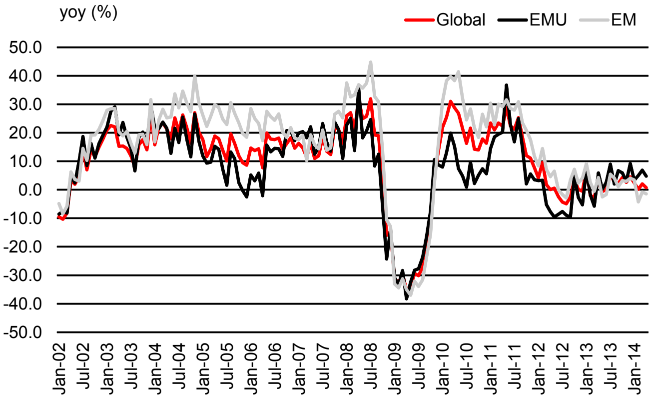
**Our baseline assumes that sanctions between Russia and the West do not escalate from here but we also do not assume any improvement**

Our baseline does not include any significant de-escalation of tensions or a reversal of sanctions imposed to date on or by Russia but it also does not include a further escalation from here. We do not exclude an agreement between the Ukrainian government and the rebels, addressing Russia's concerns on the expansion of NATO and the EU free trade agreement. But we also remain aware that we have been surprised by Russia's actions on a number of occasions YTD, including by the annexation of Crimea, Russia's continued support for rebels following the tragic events of MH17 and as per recent NATO reports a significant increase in Russian troop presence in the region in August following Ukrainian government progress against the rebels.

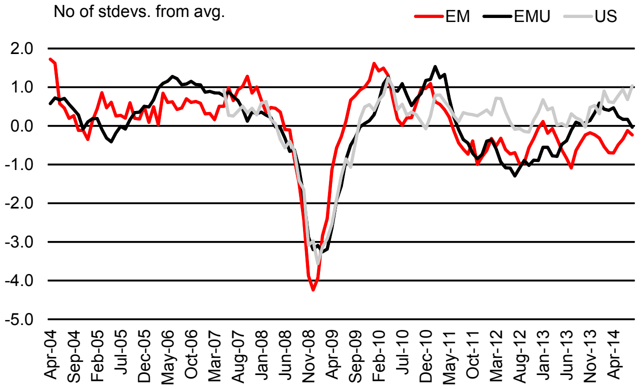
Meanwhile events in the Middle East raise tail risks to the global economy but within CEE in Turkey in particular. Within this persistent stream of negative newsflow, a small positive is the fact that the global economy has not had to deal with an increase in energy prices, at least for now.

**GLOBAL TRADE AND MANUFACTURING REMAINS STUBBORNLY LOW**

Though EMU has outperformed, global trade remains sluggish…




Manufacturing PMIs: EM has not been a driver for some time



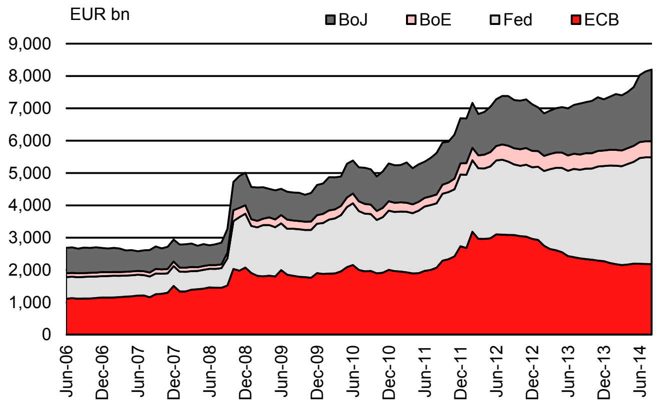

Source: IMF, Markit, UniCredit Research

**...and, as well as a number of other factors, have prompted us to revise downwards our forecasts for EMU growth**

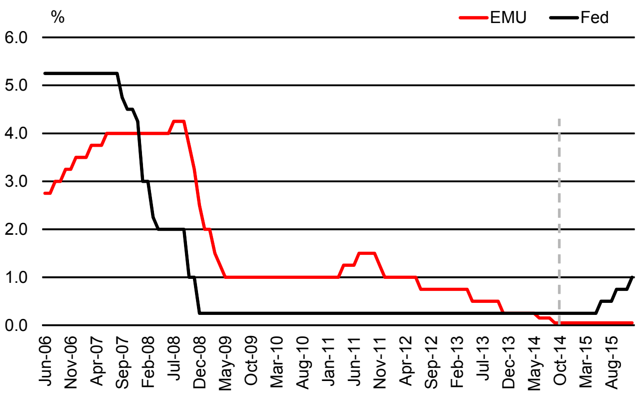
These geopolitical developments, as well as a weaker than expected 2Q and continued lackluster global trade performance, has prompted us to revise downwards our forecasts for EMU growth both this year and next. We now forecast EMU growth at 0.8% and 1.2%, reducing each by 0.5-0.6pp since the last quarterly. Crucially we have also revised downwards our forecasts for German growth to 1.4% (prev.: 2.5%) and 1.7% (prev.: 2.5%) for 2014 and 2015 respectively.

**FINANCING CONDITIONS IN THE DEVELOPED WORLD TO REMAIN ACCOMMODATIVE**

The ECB is about to reverse contraction in its balance sheet…




…as policy rates stay low for a long time




Source: ECB, Federal Reserve, UniCredit Research

**As the Fed turns more hawkish, the ECB turns more dovish, keeping the cost of liquidity in the developed world at or close to historically cheap rates**

Against this backdrop, financing conditions for emerging markets will not tighten rapidly but are more likely to be characterized by a tug of war between an increasingly dovish ECB and a gradually more hawkish Fed. We are close to the end of quantitative easing in the US while we edge towards higher short end rates. Despite this UST yields have proven much lower than we expected and we have revised downwards our forecast for 10 year UST (year-end of 2.7%, prev.: 3.1%) and bund yields (year end of 1.1%, prev.: 1.8%) for the coming quarters.

Meanwhile, in part due to the disappointing pace of the recovery, the ECB has turned more dovish. Over the coming months this should take the form of large liquidity injections – the TLTROs represent an injection equivalent to 6 months of full-speed US QE – and an ABS programme. While it is not our baseline that the ECB presses ahead with a fully-fledged programme of quantitative easing, its rhetoric is set to remain dovish over the coming months, if only to prevent a reversal of recent EUR losses.

**Macro performance is set to continue to turn more differentiated across the region**

Within this environment, macro performance and policy space is turning increasingly more differentiated across the region. Russia is undergoing forced structural change, pushing potential growth lower while in Turkey the combination of an increasingly populist policy mix and the erosion of institutional structures leaves the economy more vulnerable to the next correction in foreign capital flows to emerging markets. In Central Europe prospects are brighter, despite a weakened growth outlook, but in the Balkans inadequate reform momentum continues to cap growth while pressuring sovereign balance sheets.

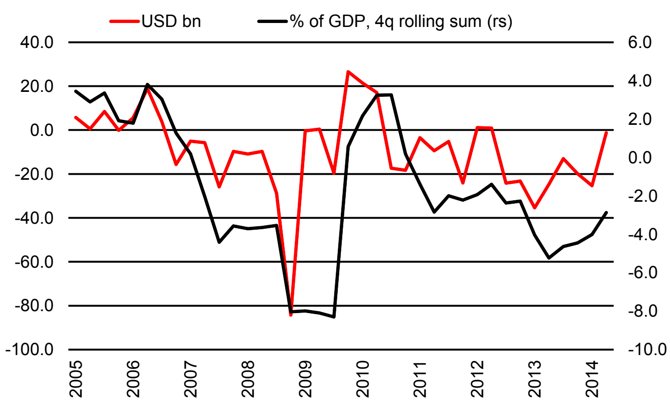
## Russia: Forced adjustment

**Rate hikes, slower domestic capital outflows and a diversification in Russia's funding base towards China all buy the economy some near term relief…**

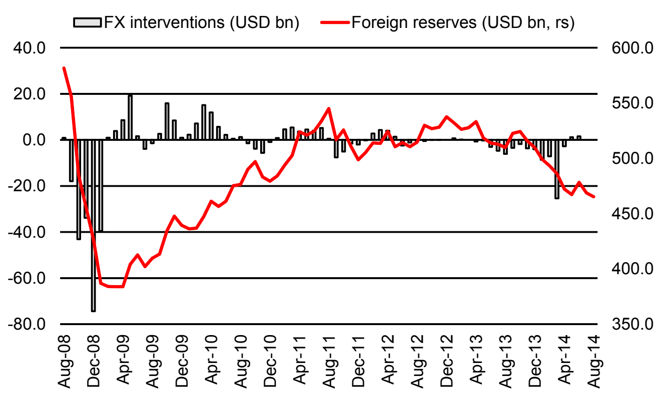
Assuming a broadly unchanged geopolitical environment, we are confident on two fronts. First, the authorities are likely to prove able to continue to manage near term financial stability and growth risks. In this environment, CBR rate hikes YTD should continue to facilitate a manageable depreciation of RUB over the rest of this year, in contrast with speedier losses late last year and earlier this year. This should be re-inforced by financial sanctions which slow the large outflows of domestic capital from Russia. RUB weakness late last year and earlier this year has protected headline budget performance while the authorities are increasingly drawing off buffers such as the NWF to support the banking system and economic activity more broadly. Russia has also been able to access some new sources of funding, either in the form of the sale of foreign assets (e.g. Severstal's sale of foreign assets) or by attracting foreign investment from elsewhere (e.g. a new pipeline and gas contract with China). Combining all of the above with the fact that the economy has proved more resilient than we expected in recent quarters, we have revised upwards our forecast for GDP growth for this year by 0.3pp to -0.4%.

**BUFFERS PROVIDE PROTECTION IN THE NEAR TERM**

C/A balance & domestic capital flows[1]




Foreign reserves and FX interventions




Source: CBR, UniCredit Research

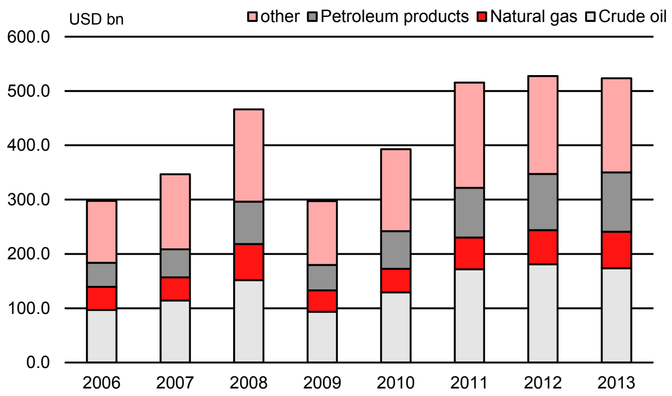
[1] Data excludes last year's large Rosneft transaction.

**…but over a longer time horizon the sovereign is likely to find itself eroding its foreign reserve buffers while further eroding potential growth**

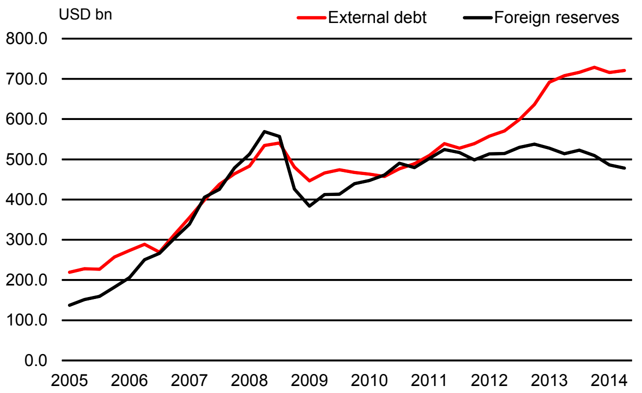
Second, our medium to long concerns surrounding the outlook for growth, the currency and the sovereign balance sheet in Russia have increased significantly. The starting point was already weak amidst negative demographics, a shift away from improving towards stable to deteriorating terms of trade and a shortfall in investment. Meanwhile even prior to events surrounding MH17, Russia's annexation of Crimea and developments in Donetsk and Luhansk had increased the risk that the EU makes progress in diversifying its sources of gas supply over a multi-year horizon. While Russia's deal with China helps to partially compensate, it will not be sufficient to cover any meaningful reduction in European contracts. Amidst an already low rate of potential growth, a shift amongst corporates away from investment and towards cash accumulation will weaken economic prospects further. Moreover fiscal performance and financial stability are likely to gradually come under increasing pressure as the authorities grow impatient with persistent weak growth performance while banks and corporates struggle to role any external borrowing.

**MOVING AWAY FROM A HIGH DEGREE OF TRADE AND FINANCIAL INTEGRATION**

Russia have not diversified its export base…




…while it has increased its reliance on foreign capital




Source: CBR, Rosstat, UniCredit Research

**The tail risks are tilted towards a more negative scenario**

The risks to all of the above are tilted to the downside. An escalation of sanctions to include Russia's exclusion from SWIFT, the forced sale of outstanding (as opposed to newly-issued) debt and equity by foreign holders or a lasting halt in gas supplies from Russia to the rest of Europe would have a much more significant impact on the macro outlook. A more notable decline in oil prices would serve to re-inforce pressure on RUB.

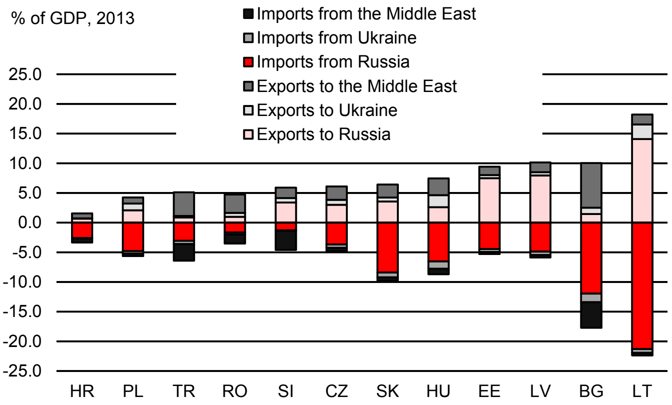
## Turkey: Short term gain at a likely cost of long term pain

**Turkey will suffer less than elsewhere from events in Russia and Ukraine while easy external financing conditions have prompted us to raise our growth forecast for this year**

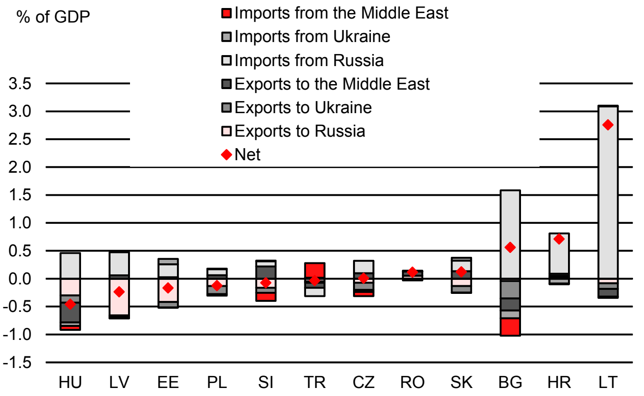
The spillovers from the Russia/Ukraine crisis to Turkey are smaller than most other countries in the region given that sanctions between the two countries do not apply. A lower degree of trade openness also provides some protection against a weaker EMU. Events in the Middle East risk generating negative spillovers in the form of elevated levels of violence and geopolitical uncertainty at Turkey's borders while exports to Iraq are contracting but developments may also bring positive spillovers in the form of access to cheaper energy and a flight to safety for capital based elsewhere in the Middle East. Taking account of much easier global financing conditions than we originally expected for this year as well as all of the above, we have increased our forecast for real GDP growth by 0.4pp to 2.9%.

### TURKEY IS SET TO SUFFER LESS FROM RUSSIA-RELATED SANCTIONS

Trade integration with areas suffering geopolitical pressure




Impact on net exports YTD



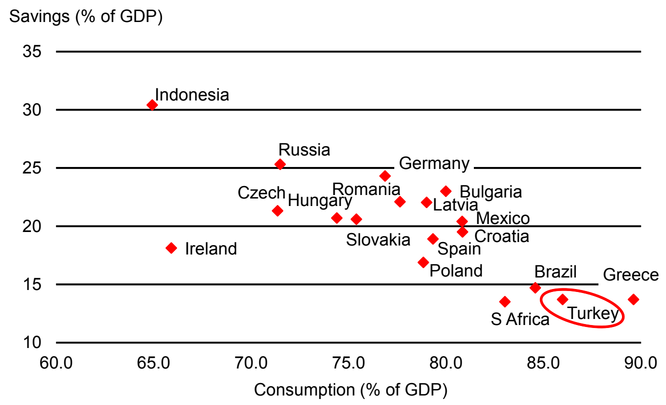

Source: Eurostat, IMF, Turkstat, UniCredit Research

**Easier monetary conditions and supportive fiscal policy aid near term growth prospects but generate vulnerabilities further out…**

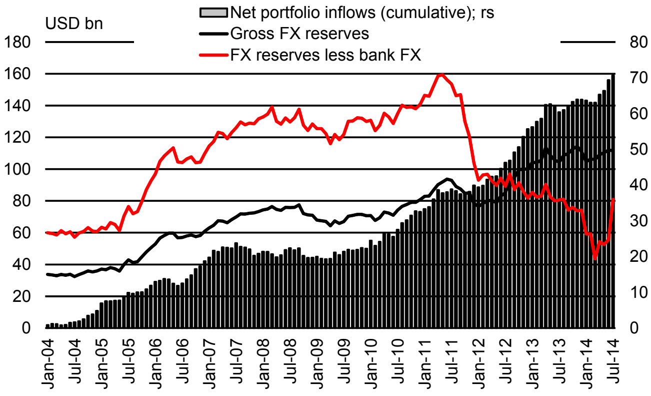
But Turkey's pro-growth policy mix is of concern as the CBT opted for rate cuts over much needed foreign reserve accumulation in recent months. This is most obvious within monetary policy. In contrast with most of the rest of the region, Turkey continues to struggle with above target inflation, in part capturing a food price shock and pass-through from TRY depreciation which is now declining. But to the extent that it is possible to separate core inflation from headline, core has also remained above target against a backdrop of a poor inflation targeting track-record. We forecast year-end inflation at almost 9% this year compared with a current policy rate of 8.25% and the CBT's target of 5%. In the face of political pressure, we cannot exclude further rate cuts from here, though the CBT continues to keep the option of a relatively rapid tightening of monetary conditions via an increase in market rates towards the upper end of the corridor on the table.

### TURKEY: A DANGEROUS MIX OF A LOW SAVINGS RATIO AND A SHORTFALL IN FOREIGN RESERVES

Turkey: Elevated consumption and low savings




Foreign reserves since 2010, foreign reserves ex bank fx deposits at the cbt since 2010, cumulative foreign portfolio inflows to turkey since jan-2010




Source: CBT, IMF, Eurostat, UniCredit Research

**…as does the erosion of institutional structures in an economy highly reliant on continued foreign capital inflows**

This monetary policy not only calls central bank independence into question but also materializes at a time when government policy decisions risk damaging Turkey's underlying fiscal stance, the business environment and structural growth. At the level of fiscal policy, headline budget performance remains solid but real revenue growth ground to a halt YTD.

This questions the ability of the government to continue to contribute to headline GDP growth, as it has in the past, without putting the budget deficit at risk ahead of next year's general election. To the extent that, like many other large emerging markets, Turkey has exhausted many easy sources of growth, the government's growth targets are unlikely to be met this year or next (2014: 4%, 2015-16: 5%). This also risks forcing tougher choices on fiscal policy in the coming quarters. Risks to institutional infrastructure extend beyond the central bank to the independence of the judiciary and police force as well as freedom of the media and access to the internet and other forms of social media. All of this is materializing in an environment of a low savings ratio and a shortfall in foreign reserves, though the trend in foreign portfolio capital will remain central in determining the timing of any change in trends in domestic demand, currency and interest rate trends.

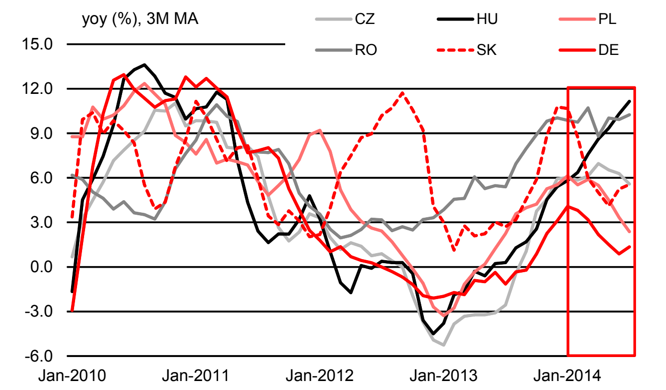
## Central Europe: Weathering the storm

**Despite weakness in EMU, manufacturing has proven resilient in some economies**

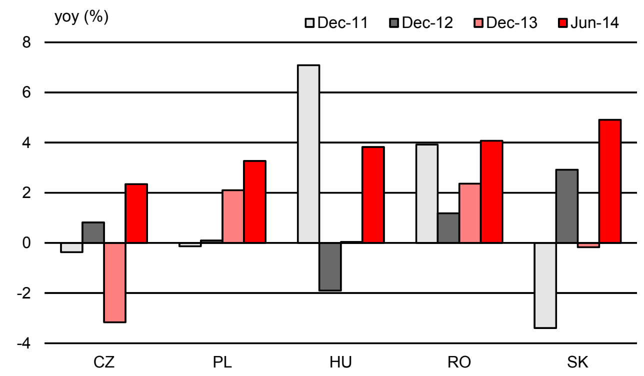
Recent months have already provided some evidence that events in Russia and Ukraine and the slowdown in EMU are denting the recovery in the region but to date this has been manageable. Following a bumper start to the year, both exports and industry have weakened in some economies but with differentiation across the region. Hungary and Czech Republic continue to enjoy the benefits of new production facilities coming on line.

**CENTRAL EUROPE ENJOYS SOME BUFFERS**

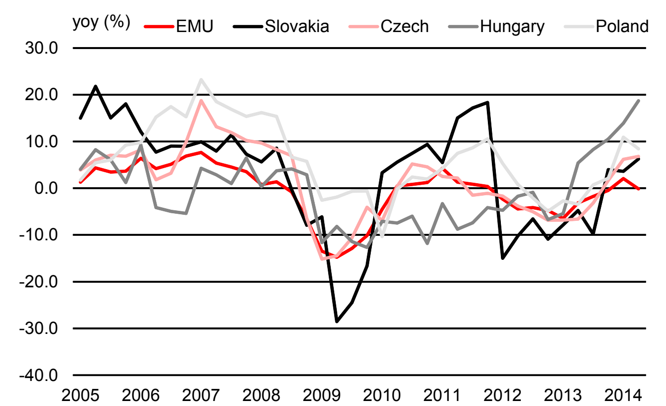
Industry performance has followed Germany down only in some countries…



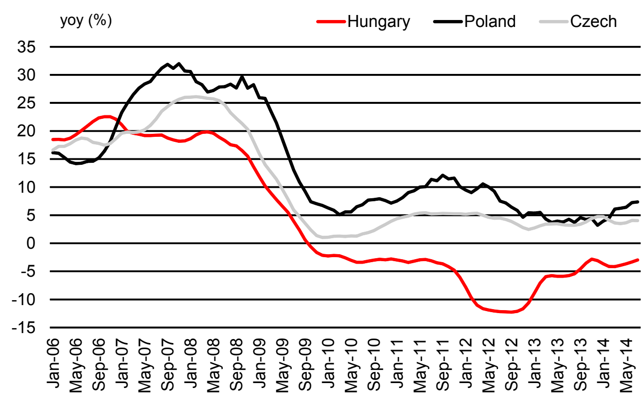

…while domestic demand is supported by positive real wage growth




Investment enjoys a recovery across Central Europe…




…while credit turns more growth supportive, in particular in Poland[2]




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

[2] Credit growth is FX-adjusted

**We expect domestic demand to continue to show gains…**

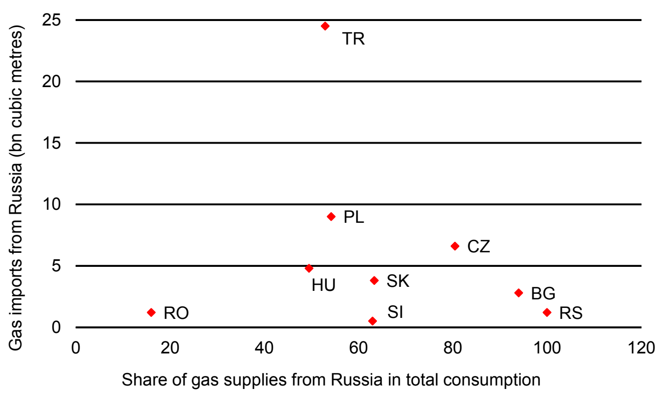
Domestic demand should prove relatively robust, supported by positive real wage growth. Poland in particular is enjoying a recovery in credit growth while a slower pace of contraction in credit in Hungary is supportive of domestic demand. Investment trends are particularly encouraging, in part because of good use of EU funds, while funds from the 2014-20 EU budget should also begin to filter through. All of the above was visible in 2Q GDP data, though going forward many of our forecasts have been downgraded to show a stable to slowing pace of real GDP growth rather than further acceleration. Since our last CEE quarterly, downgrades to our GDP forecasts were most sizeable in Romania and Slovakia but we continue to expect growth in both Poland and Hungary to remain above 3% this year and in Poland's case next year also.

**…while monetary policy is set to turn more accommodative for longer**

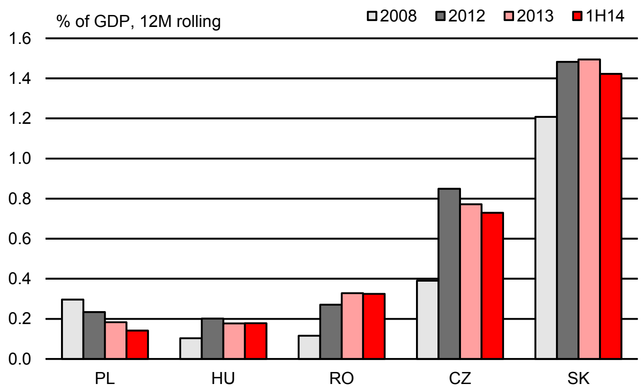
This weakened growth backdrop has been accompanied by downside risks to inflation at a time when inflation is already well below target in the region and in some countries has turned negative in yoy terms. In Czech Republic this has already resulted in an extension of the CNB's commitment to its currency floor throughout next year. In both Poland and Romania we expect 50bp in rate cuts over the coming quarter.

**RUSSIA HAS THE POTENTIAL TO WEAKEN GROWTH, IF GEOPOLITICS DETERIORATE FURTHER**

CEE: A significant reliance on Russia for energy




Direct car exports to Russia vary significantly




Source: IMF, National statistics offices, Eurostat, UniCredit Research

**We monitor carefully downside tail risks to the region**

We remain alert to the increase in tail risks in the region, however. The sort of geopolitical uncertainty experienced in the region has not been present in over 2 decades. While EU and US sanctions against Russia are likely to weaken the Russian economy slowly but surely, counter-sanctions from Russia risk a more immediate impact on Central Europe. To date this has filtered through via food imports but a halt to car imports would do more damage, both directly and indirectly via Russian imports from Germany. With the exception of Romania, a halt to gas exports would also quickly take its toll.

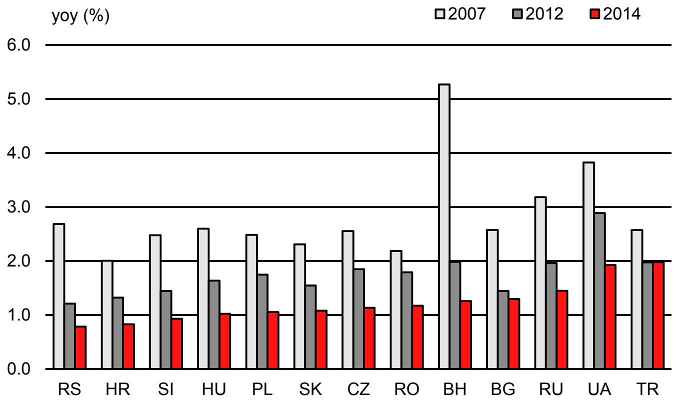
## The Balkans: Time for action

**Weaker growth performance in the Balkans is in part structural due to differentiation in trading partners...**

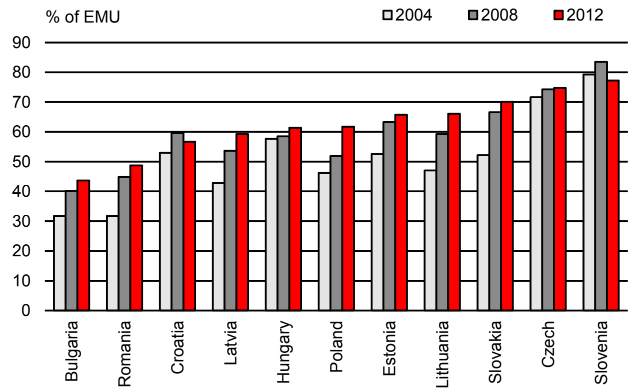
Persistent growth underperformance in the Balkans relative to Central Europe, combined with a variety of domestic events in recent months, highlights the need for reform across the region. In part the region's growth underperformance captures lower growth rates in its trading partners. With the exception of Slovenia, the region has enjoyed limited integration into the German production chain during the boom in global trade over the past decade. Italy remains within the top two trading partners for the region, while there is a considerable amount of inter-regional trade between the Balkan economies. Serbia has shown some modest progress via Fiat in the past couple of years. Bulgaria and Serbia are also at risk from a higher trade exposure to Russia.

## STRUCTURAL CHALLENGES TO GROWTH

Trading partner growth has sometimes suffered more than elsewhere..




…while performance in terms of real convergence is disappointing

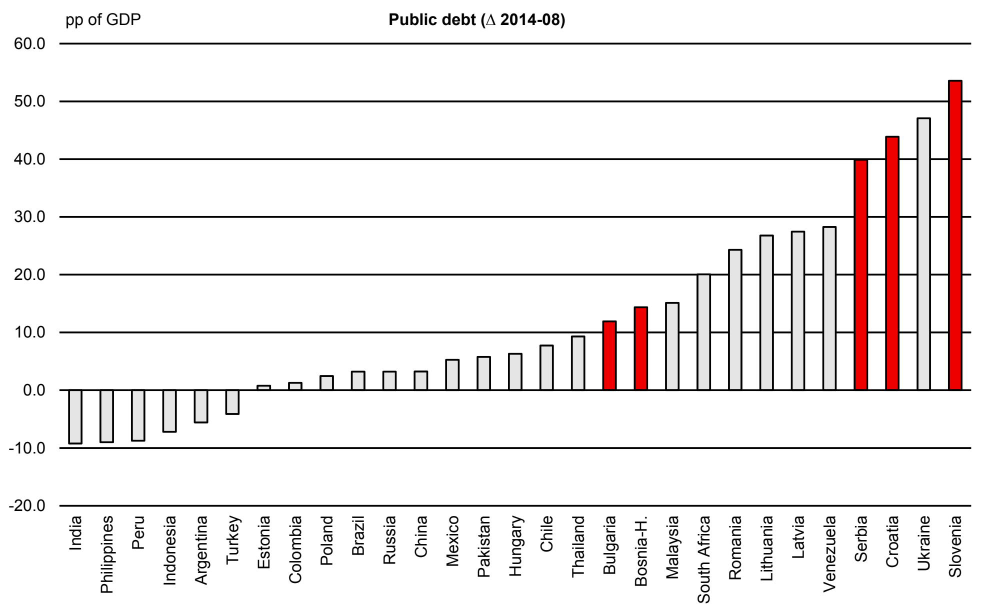



Source: IMF, National statistics offices, Eurostat, UniCredit Research

**…but also captures a shortfall in fiscal and administrative reforms**

But there are a variety of domestic policy issues also at play. A less competitive business environment in many of these countries is of real concern. Recent events within the banking system in Bulgaria have not proven systemic due to the dominance of foreign banks but highlight risks associated with corruption and a lack of regulation. In Croatia some fiscal discipline is being imposed by the country's entry into the excessive deficit procedure but the authorities lack commitment to a more ambitious plan aimed to containing crowding out and boosting potential growth. This is despite the fact that 2014 represents the sixth consecutive year of recession.

### CROATIA AND SERBIA HAVE FAILED TO STABILISE PUBLIC DEBT TO GDP AFTER LARGE INCREASES




Source: IMF, UniCredit Research

**The coming quarter will be important in determining whether or not the region draws off election opportunities to push through reforms**

Election schedules in the region offer an opportunity for change – the coming quarter will be important in determining whether or not these are put to use. Both Serbia and Slovenia have already held general elections this year but Serbia's historically-large majority in parliament has not yet been put to use in terms of reforms, in part because of issues surrounding flooding earlier this year. In the absence of an IMF agreement over the coming quarter, our already significant concerns on public debt sustainability will increase further. We have concerns that the newly formed, left-wing government in Slovenia will halt the privatization process beyond the most immediate plans, fostering the risk of increased contingent liabilities to the sovereign at a later date. The willingness of the government to emerge in reform efforts, including better usage of EU funds, following Bulgaria's general election in October will be important in determining whether or not Bulgaria's GDP per capita remains the lowest within the EU28, following modest catch-up over the past decade. Prospects are more muted in Croatia as general elections remain over 12 months in the future.

# CEE Strategy: A volatile run to the end of the year

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- As we enter the last quarter of 2014, the global backdrop for EM is likely to be dominated by a tug of war between a more accommodative ECB and a less accommodative Fed. This, combined with rising geopolitical shocks, will manifest itself primarily in a continued increase in volatility in asset prices, albeit from a low level. Price action in USTs is likely to be much more two way than the downside pressure on yields that has dominated YTD but with any meaningful increase in financing costs in the developed world will be capped by ECB efforts to protect against downside risks to both growth and inflation;
- The combination of significant spread tightening across EM fixed income YTD, a slowdown in foreign portfolio inflows to emerging markets, a stronger USD and more volatile global risk appetite means that most of the gains in EM fixed income for 2014 may have already materialized, though we continue to expect Q4 to post positive returns. Just as is the case more globally, our baseline scenario includes more volatile price action in EM for the last quarter but with hard currency offering better value than local currency debt;
- In local markets, spillover from a more accommodative ECB, plentiful government financing, scope for rate cuts and stronger balance of payments positions means that we favour Poland and Romania over Hungary. For those who have to hold positions in Hungary, we prefer the front end of the curve given the NBH's liquidity policies while to minimize the impact of potential USD strength, we favour spread compression in long POLGB 10Y v bunds. Amongst the two large liquid high yielders in the region, we recommend a flattener between the two and five year part of the local currency curve in Russia. We think the front end of the curve is vulnerable to rate hikes while currency risk is a key concern but watch for value in the 5 year tenor in the event of a more lasting stabilization of geopolitical tensions between Russia and the West given the CBR's commitment to inflation targeting. In Turkey, we prefer to be market weight in local bonds at the front end of the curve while carefully monitoring the key risk to this trade, namely a shift in trends in foreign portfolio capital to emerging markets.
- On the whole, we see more value in hard currency rather than local currency debt. In particular we highlight the long end in Poland, Hungary and Slovenia. Once adjusted for basis, USD debt beyond the 7yr tenor in Poland and Hungary and beyond the 5yr tenor in Slovenia, yields in excess of local currency debt, despite the absence of currency risk. We favour the Bulgaria 24s in EUR and see benefit in being overweight REPHUN 21s against being underweight CROATI 21s and SERBIA 21s in USD. In Russia, we prefer the RUSSIA USD 23s which offer a better z spread than the shorter dated RUSSIA USD 20s. Though we prefer Russia to Turkey hard currency debt, we see value in TURKEY 24s in USD for those unwilling to take TRY risk but comfortable in hard currency space.

## Setting the scene

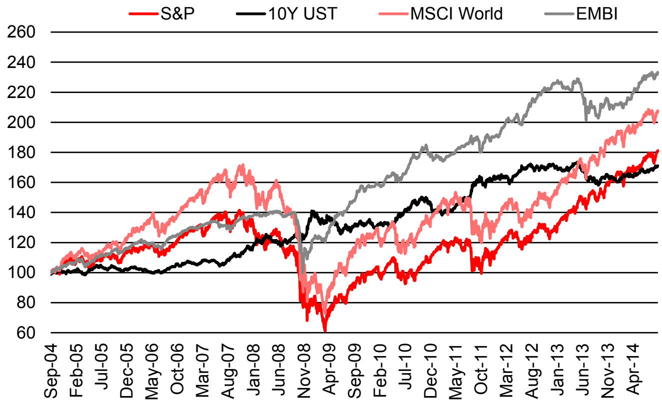
**Local debt in CEE has performed well but has lagged equities.**

We enter the last quarter of 2014 following a strong performance in both hard and local currency bonds YTD but gains in the past quarter have slowed. Though outpaced by equities, returns in hard currency debt over the first 8 months of the year have neared double digits. Local currency debt within CEE has lagged but has nonetheless performed well. With the exception of Russia, the average CEE local currency yield curve has tightened 123bps so far in 2014, despite two significant periods of risk off in February – March and at the end of July. With the exception of Russia and Turkey, this leaves local currency yields in CEE at all-time lows in actual levels and in most cases close to 4 year lows in spread terms against US 10y treasuries and 10y bunds. With the exception of Russia, hard currency bonds in CEE have rallied YTD with the average hard currency USD curve 111bps tighter. Currently spreads are close to YTD lows reached in early August against the 10y US treasuries.

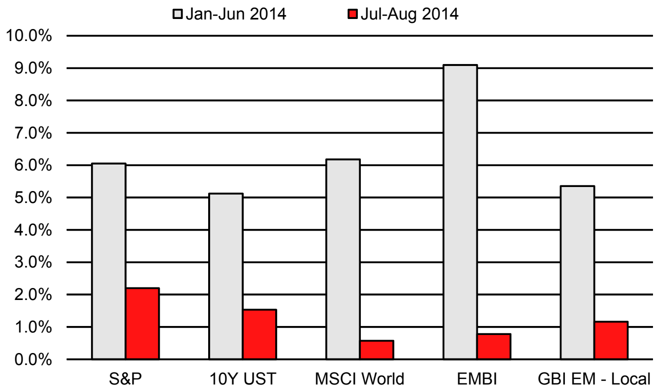
**Local currency yields are close to 4y lows against US 10y treasuries and 10y bunds.**

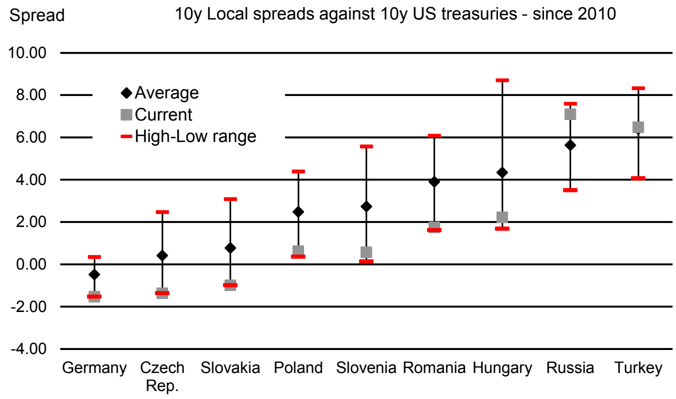
## EM DEBT MARKET PERFORMANCE IN A GLOBAL CONTEXT

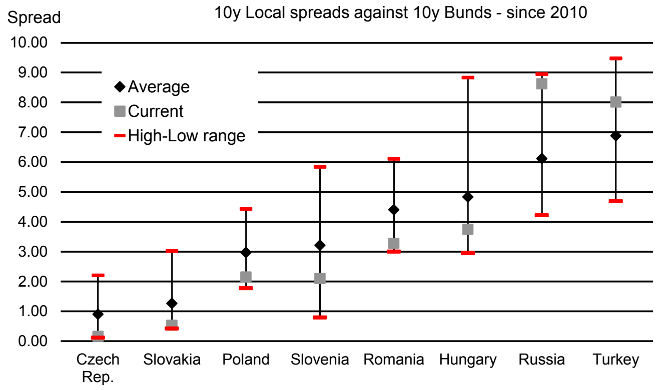
**Asset returns**




**YTD returns**




Source: Bloomberg, UniCredit Research

**Flows to EM being driven by hard currency funds…**

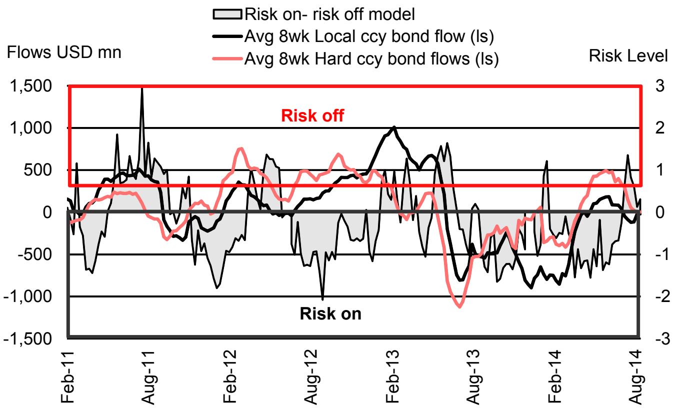
**…with hard and local funds holdings 44% away from the all-time highs…**

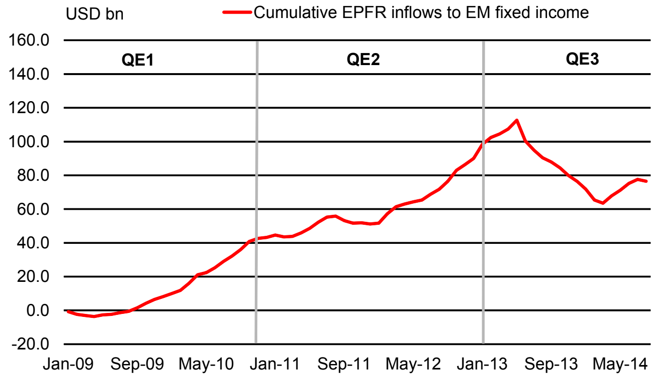
**Levels are close to 2013 highs but signs of weakness are creeping in**

In line with performance, inflows to EM have also slowed, following a bumper first half to the year. Aggregate flows to EM, as measured by weekly EPFR data, peaked in July but have since at times turned negative. Local currency flows have accounted for most outflows and while not fully immune, hard currency has held up better. At current levels, local and hard currency bond holdings are down 1% and 4% from the peak reached in July 2014 and down 44% from the all-time highs reach in May 2013.

This is also captured in trends in foreign holdings of local currency bonds. The significant outflows seen in 1Q mostly recovered by the end of 2Q and in many cases in CEE, levels are back close to the highs reached in 2013. There are signs of weakness creeping in in recent weeks. Inflows to Turkey are slowing while Hungary has seen outflows accelerate. We fear that this trend is may also be occurring in Russia and Poland.

**RISK LEVEL EFFECT ON PORTFOLIO FLOWS**




Source: Bloomberg, EPFR, UniCredit Research

## 4Q: Increased volatility is the name of the game

**We expect 4Q to be a tug of war between a more neutral Fed and accommodative ECB…**

The impact of higher valuations and a renewed build-up in positioning, albeit still much better than in May last year, is likely to be combined with a tug of war between a more neutral Fed but more accommodative ECB in the last quarter of the year. The ECB's latest policy rate cuts, its schedule of asset purchases and the planned T-LTROs are all supportive of a yield-seeking environment. But this contrasts with our expectations for the Fed. QE is expected to finish in October while the US economy is showing signs of improvement. A change in the Fed's dovish rhetoric could risk a re-test of the upper end of the year's trading range for US yields. This is likely to leave us shifting between ECB rate decisions and inflation releases on the one hand and FOMC outcomes and non-farm payrolls on the other in terms of data releases between here and year-end.

**…leaving the market to trade between major Fed and ECB news events**

**We expect increased volatility until the end of the year…**

Combining the above with increased geopolitical risks within Central and Eastern Europe and beyond, we expect an increase in volatility to be a key theme over the course of the rest of this year. Recent weeks have already provided some evidence of this with the US 10y widened 27bps between the 28th August to the 12 September. This saw 10y bunds widen 20bps and 10y local and hard currency bonds in Poland and Turkey widened by similar margins. However in the case of Hungary and Slovenia the local currency bonds were much more sensitive than hard currency while in Romania, Russia and Slovakia the reverse was true.

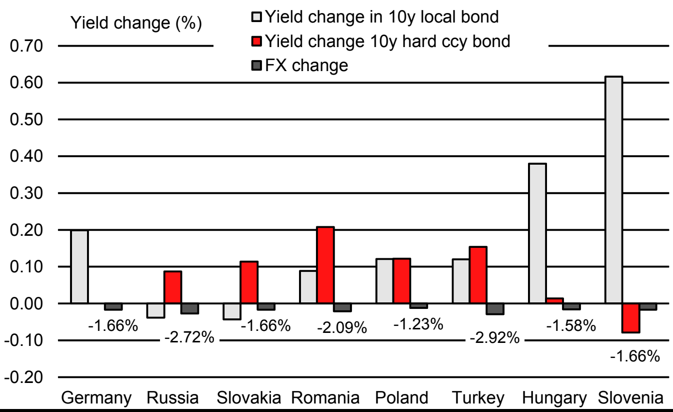
**…but the effect of potential rising US yields is likely to have differing impacts on CEE bonds...**

Extending the analysis over a multi-quarter horizon and excluding currency implications, our analysis once again suggests that in the event of rising US 10y yields investors should switch from local to hard currency bonds in Slovenia and Hungary as the beta is less than half. In Poland the sensitivity is roughly the same while in Romania, Turkey, Slovakia and Russia they should remain in local currency bonds. Against 10y bunds the betas are markedly higher – in the case of rising bund yields investors should switch from local to hard currency bonds in Poland, Hungary and Slovenia. In Russia and Turkey it makes little difference while in Romania and Slovakia they should remain in local currency bonds. Given the cycles these economies are in though, the relationships are non-stationary.

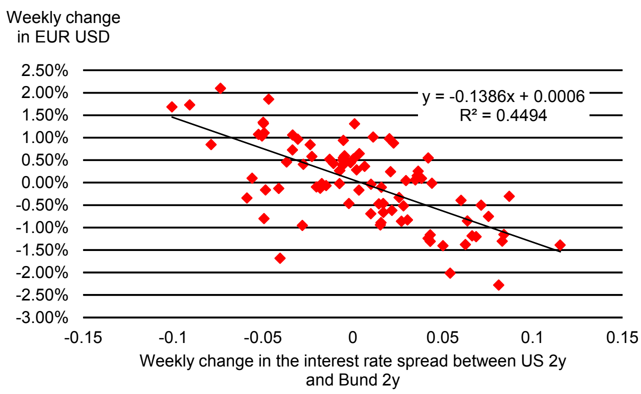
With changing spreads we can also expect further currency volatility. Our regression analysis suggests that for every 1bps increase the US 2y vs. Bunds 2y spread we can expect EURUSD to selloff 13bps. With exception of Turkey and Russia, most CEE currencies have a correlation with the euro over 0.8. Our concern is that Bloomberg market year-end estimates for US 2y is 0.7% while 2y Bund yields are unchanged. This is an increase of 13bps from current spread levels which will inevitably put downward pressure on CEE currencies.

### BETAS AND SPREADS AGAINST USTS AND BUNDS

Effect of the 27bps increase in US 10y yields – 28 Aug-12 Sep




Effect of changing 2y UST Bund spread on the Euro




Source: Bloomberg, UniCredit Research

## Hard currency: Set to out-perform local currency debt

**We expect hard currency bonds to outperform local currency bonds…**

In an environment of USD strength, with the risks weighted towards a shift in Fed rhetoric towards a more neutral stance, we expect a better performance from hard rather than local currency debt over the rest of this year. This is re-enforced by the fact that across CEE many policy makers are not particularly adverse to gradual currency weakness, either as an aid to growth (e.g. Poland, Turkey) or to flatter fiscal performance (e.g. Russia).

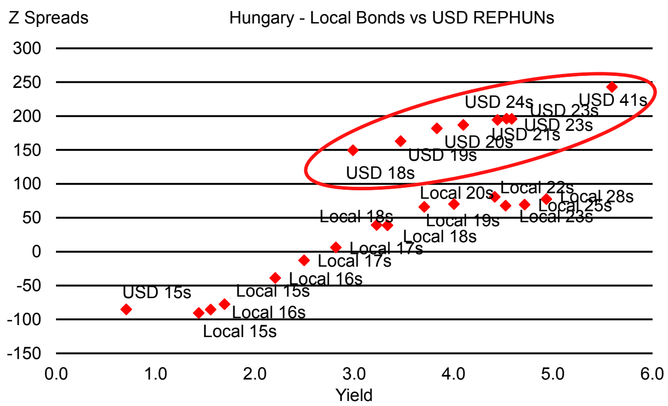
**…in Russia we like hard currency bonds over local, while…**

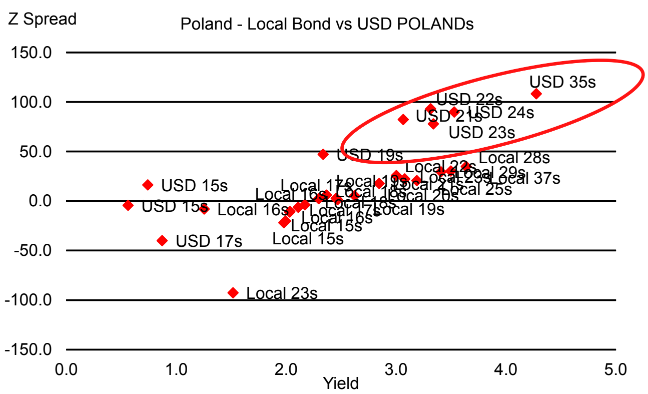
Balancing the significant tail risks against the sell-off in assets over the past quarter in Russia, we prefer to be positioned in hard rather than local currency debt. We think the hard currency USD RUSSIA 23s are a less risky option compared to the local equivalent, yielding 5.07% and having widened by 67bp since end of 2Q. This combined with a rally in hard currency debt in Turkey has seen the spread between the two narrow by 122bps to 76bps over the past 12 months.

**…in Poland and Hungary we see value in switching to hard currency bond beyond the 7y tenor**

Within Central Europe, with better yields and lower FX risk, we recommend that investors in Poland and Hungary switch to USD hard currency bonds in tenors beyond 7y on the curve. In Romania we think the ROMANI 44s offer good value given the sovereign's continued adherence to a narrow budget deficit and low public debt to GDP.

### LOCAL BONDS VS USD




Source: Bloomberg, UniCredit Research

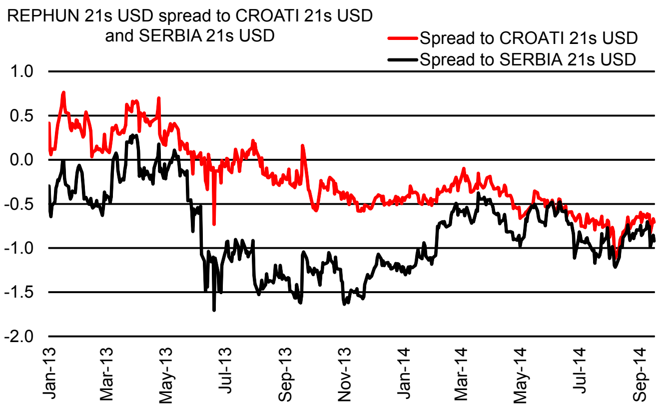
**We prefer overweight REPHUN 21s in USD against underweight CROATI 21s and SERBIA 21s, and…**

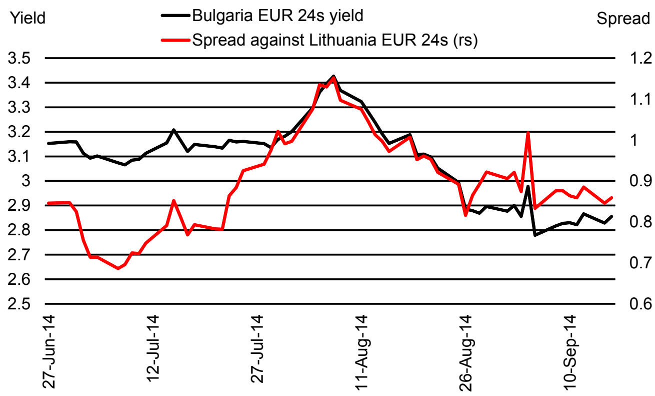
Hungary offers an attractive alternative to Serbia and Croatia. We like being overweight in REPHUN 21s in USD against underweight CROATI 21s and SERBIA 21s in USD Though trading 71 and 91bps narrower, Hungary's public debt dynamics are more convincing given higher growth and a narrower budget deficit. In contrast public debt to GDP has increased substantially in the two Balkan economies since 2008 and remains on an upward trajectory. While the Hungarian sovereign does not plan to access hard currency markets over the coming quarters in an effort to reduce its stock of FX-denominated public debt, wide budget deficits leave Croatia and Serbia will little choice but to issue when market conditions allow. In the past few months spreads in SERBIA 21s have been trading in an 80bps range against REPHUN 21s, in contrast to CROATI 21s where spreads have continued to widen since the start of the year but have recently moved to the back toward the average 12M spread of 60bps. We see this as a good entry level.

**…like being overweight Bulgaria 24s in EUR**

We like being overweight in Bulgaria 24s in EUR. Despite the negative impact of the collapse of the fourth largest lender, we believe that the sovereign's strong fiscal track record, low public debt to GDP, lasting commitment to its currency board and the potential for reform generated by upcoming general elections should allow scope for the bond to rally once again.

**RELATIVE VALUE ACROSS CEE**




Source: Bloomberg, UniCredit Research

## Local markets: diverging trends

**We do not see issuance pressuring yields for the remainder of 2014, but…**

In most countries we do not expect issuance to pressure yields in the last quarter of the year. Poland, Turkey and Slovenia have already met their issuance targets for 2014 and are pre-funding for 2015. Others like Hungary, Czech Republic, and Romania have completed the majority of their issuance needs but enjoy comfortable cash cushions. Russia continues to cancel auctions and is unlikely to meet its 2014 borrowing target but its large reserves mean further issuance is not required. Bid to cover ratios have fallen since mid-August in a number of countries but at least for the coming months we do not expect this to prove problematic.

**…see a divergence across CEE in inflation and monetary policy trends…**

But while issuance needs are relatively comfortable across most countries in the region, inflation and monetary policy trends differ significantly. In Central Europe central banks are grappling with a combination of some downgrades to the growth outlook and below target inflation. In some countries inflation has turned negative in yoy terms. This leaves scope for further monetary easing in some countries while many central banks are also unlikely to be adverse to further gradual currency depreciation, though Hungary may be the exception on this front. The market currently prices 50bp of cuts in Poland and in Romania. In contrast Turkey and Russia are struggling with above target inflation while balance of payments pressures and related currency risks are greater. We see little scope for the CBR to cut interest rates in the coming one to two quarters, with risks instead being tilted to the upside.

**…expecting further cuts in Poland and Romania ahead**

In Turkey we do not exclude further rate cuts but these are likely to be modest in size. The OIS curves and FX implied yields at time of writing, are pricing in by year end 125bps of hikes in Russia and 25bps of cuts in Turkey.

**We expect POLGBs to outperform Bunds with further easing…**

Drawing off a key theme in Central Europe, namely the increased willingness of central banks to protect against downside risks to inflation and growth, we recommended being overweight long-end POLGBs, expressing this view through a long 10y POLGB vs. short 10y bunds in anticipation of monetary-easing into year end. Bund yields are close to historic lows, but better German economic numbers and a high correlation to US treasuries should provide support on the short side. The compression trade has seen the spread compress 22bps since initiation, 19bps away from the target level at 200bps.

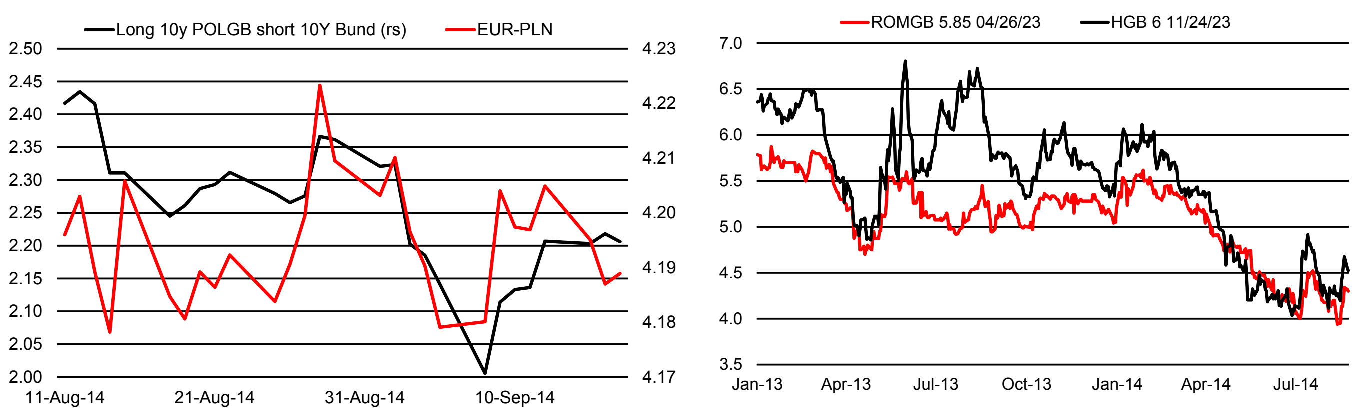
**…and are positive on ROMGBs on slowing growth and dovish policy**

We also recommend an overweight allocation to ROMGBs as the economy is showing signs of slowing, with growth in investment and Q2 GDP surprising to the downside. Rates have been cut rates 75bps this year but inflation remains below the lower end of the target band. With a strong harvest, slowing growth and disinflationary factors ahead we think the NBR will cut 50bps before year end. Low integration with Russia, falling inflation, low financing needs, high reserves and presence of local buyers should keep the curve well supported. The primary risk to our trade centers around the potential for the central bank to withdraw liquidity from the banking sector.

**We remain cautious on long end HGBs given banking sector risk and positioning…**

We recommend an underweight allocation to the long end of the HGB curve. With the introduction of the new IRS auction program and nationalisation of private pension funds, local participation at long end of the curve is likely to be muted. Risks to the banking system as banks are forced to repay FX spreads and interest rates changes on FX loan repayments and rising public debt as the government continues to buying back utility companies and centralize public services remain. With most bond issues dominated by a few institutional investors we think the long end of the curve could be vulnerable. As we already indicated, we recommend that investors shift exposure into hard currency USD bonds at the long end of the curve. In contrast with Poland and Romania the short end of the curve is unlikely to benefit from further rate cuts at this stage.

**PREFERRED TRADES: 10Y POLGB V 10Y BUND AND LONG 10Y ROMBG**




Source: Bloomberg, UniCredit Research

**…and are cautious about TURKGBs due to a variety of risks**

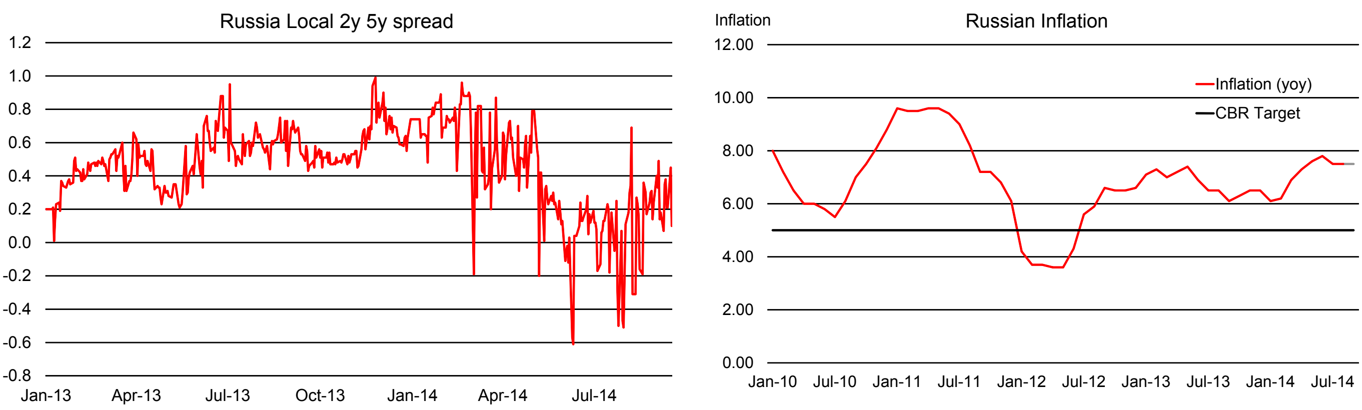
We recommend being market weight in TURKGBs but acknowledge a variety of risks. These include the Iraq conflict, the likely slowdown in the pace of improvement in the current account deficit, above target inflation and an excessively dovish CBT. Normally this would be enough for us to want to be underweight but continued inflows, additional pending rate cuts and very attractive yields could provide further support. We will change our view to underweight if we start seeing outflows.

**We are negative Russia on slowing growth and high inflation, but…**

We recommend an underweight allocation to Russia local currency bonds. A sharp escalation in geopolitical risks, significant structural growth challenges and a forced adjustment away from an environment of consistent terms of trade gains to one of stable to deteriorating terms of trade are all of concern. The OIS curve is pricing in 50bp of hikes already for the next meeting, with the possibility of additional hikes before the end of 2014. The one positive in this is the fact that domestic bank demand for OFZs remains high while supply is limited, given the MinFin's sensitivity to price. With this in mind, we expect a flattening of the Russian yield curve, we recommend a long position in Russia 5y against a short in Russia 2y. The positive yield pickup is 10bp currently but we would targeting an entry level at above 20bps

**…see benefit in a 2y 5y flattener at the right level**

**RUSSIA: 2Y 5Y FLATTENER ATTRACTIVE AT THE RIGHT ENTRY LEVEL**




Source: Bloomberg, UniCredit Research

# Countries

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

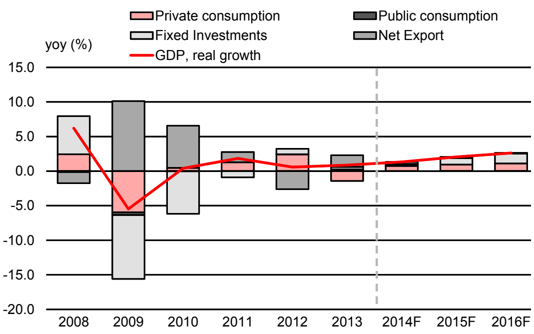
**Outlook** – A combination of both domestic and external factors will weigh on the growth outlook for the rest of this and early next year. These include weaker-than-expected growth in emerging markets (BRIICS + Turkey) and the negative impact that recent escalation of the geopolitical tension is likely to have on global trade, on the external front, as well as heightened uncertainty caused by the collapse of the fourth largest local lender, domestically. In response, we decided to revise downward our GDP growth forecast for 2014 (to 1.3% from 1.5%) and 2015 (to 1.9% from 2.1%). Snap elections are likely to shift power to the hands of the main right-wing opposition GERB party. We expect that the post-election environment will be more conducive to unpopular reforms and the quality of economic policy will improve.

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

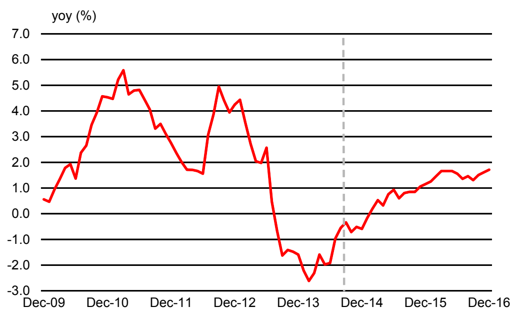
## KEY DATES/EVENTS

- 5 Oct – General elections
- 4Q – 2014 Budget revision and 2015 Budget approval
- 4Q – Resolution of COCB crisis
- 14 Nov – flash estimate for 3Q GDP

## GDP GROWTH REMAINS LOW AND UNEVEN




## CONSUMER PRICES HAVE BOTTOMED OUT




Source: NSI, BNB, UniCredit Research

## MACROECONOMIC DATA AND FORECASTS

| | 2011 | 2012 | 2013 | 2014F | 2015F |
|---|---|---|---|---|---|
| GDP (EUR bn) | 38.5 | 39.9 | 39.9 | 39.9 | 41.0 |
| Population (mn) | 7.3 | 7.3 | 7.2 | 7.2 | 7.2 |
| GDP per capita (EUR) | 5,255 | 5,481 | 5,512 | 5,542 | 5,722 |
| **Real economy yoy (%)** | | | | | |
| GDP | 1.8 | 0.6 | 0.9 | 1.3 | 1.9 |
| Private Consumption | 1.7 | 3.2 | -1.8 | 1.0 | 1.2 |
| Fixed Investment | -6.5 | 4.0 | -0.3 | 3.3 | 4.3 |
| Public Consumption | 0.3 | 0.3 | 2.9 | 0.7 | -0.2 |
| Exports | 12.3 | -0.4 | 8.9 | 2.3 | 3.1 |
| Imports | 8.8 | 3.3 | 5.7 | 1.7 | 2.6 |
| Monthly wage, nominal (EUR) | 351 | 374 | 413 | 425 | 442 |
| Unemployment rate, avg (%) | 11.3 | 12.3 | 12.9 | 12.0 | 11.1 |
| **Fiscal accounts (% of GDP)** | | | | | |
| Budget balance | -2.1 | -0.4 | -1.9 | -5.0 | -2.7 |
| Primary balance | -1.4 | 0.3 | -1.0 | -4.1 | -1.8 |
| Public debt | 15.3 | 17.6 | 17.9 | 27.4 | 30.6 |
| **External accounts** | | | | | |
| Current account balance (EUR bn) | 0 | -0.3 | 0.8 | 0.6 | 0.5 |
| Current account balance/GDP (%) | 0.1 | -0.8 | 1.9 | 1.6 | 1.1 |
| Basic balance/GDP (%) | 3.2 | 1.2 | 4.3 | 4.0 | 4.1 |
| Net FDI (EUR bn) | 1.2 | 0.8 | 1.0 | 1.0 | 1.2 |
| Net FDI (% of GDP) | 3.1 | 2.0 | 2.4 | 2.4 | 3.0 |
| Gross foreign debt (EUR bn) | 36.2 | 37.8 | 37.3 | 36.4 | 36.1 |
| Gross foreign debt (% of GDP) | 94.1 | 94.6 | 93.5 | 91.2 | 88.2 |
| FX reserves (EUR bn) | 13.3 | 15.6 | 14.4 | 14.9 | 16.3 |
| **Inflation/Monetary/FX** | | | | | |
| CPI (pavg) | 4.2 | 3.0 | 0.9 | -1.4 | 0.7 |
| CPI (eop) | 2.8 | 4.2 | -1.6 | -0.6 | 1.2 |
| Central bank reference rate (eop) | 0.22 | 0.04 | 0.07 | 0 | 0.02 |
| USD/BGN (eop) | 1.51 | 1.48 | 1.42 | 1.44 | 1.40 |
| EUR/BGN (eop) | 1.96 | 1.96 | 1.96 | 1.96 | 1.96 |
| USD/BGN (pavg) | 1.41 | 1.52 | 1.47 | 1.44 | 1.42 |
| 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

## Domestic and external factors cloud the outlook

**After a weak start to the year the positive surprise that net trade in goods and services offered was crucial for the stronger-than-expected output growth posted in 2Q14**

**Domestic demand posted a more mixed picture in 2Q14: investment rose for a sixth consecutive quarter (0.8% qoq), while the 0.2% qoq drop in private consumption was seen by many as an expected correction after an excessively strong 1.2% rebound in 1Q14**

**GDP growth in 2Q14 accelerated to its strongest qoq reading (0.5%) in two years, but due to a combination of both domestic and external factors the growth outlook for the rest of this and early next year seems less promising.** Starting with external factors, it is the export performance that has not gone exactly as expected, because after a solid start of the year global trade has lost momentum, while we had anticipated a small acceleration in the course of 2014 or at least stabilization close to the levels already reached in end-2013. More precisely, exports to emerging markets (BRIICS + Turkey), which altogether account for roughly 15% of Bulgarian merchandise export volumes, have fallen short of our expectations. The outlook for exports is further marred by the rising geopolitical tension associated with the Russian incursion in Ukraine, whose negative impact was underestimated in our forecasts three months ago. We have long argued that Russia and Ukraine are export destinations of secondary importance for Bulgaria, while the mutual exchange of sanctions remains concentrated on a limited number of sectors and therefore is likely to have a relatively small impact on the real economy. But the recent escalation of the conflict calls for reconsideration of its impact on the global economy and more specifically Europe. We in UCG now take the geopolitical shock triggered by this conflict very seriously, and we think that it will cause an intensification of the global trade weakness in the short run. Assuming a high probability of more sanctions and counter-sanctions in the next several months, we decided to pencil in a significant hit to Bulgarian export volumes in 2H14 and 1H15 in our new baseline scenario.

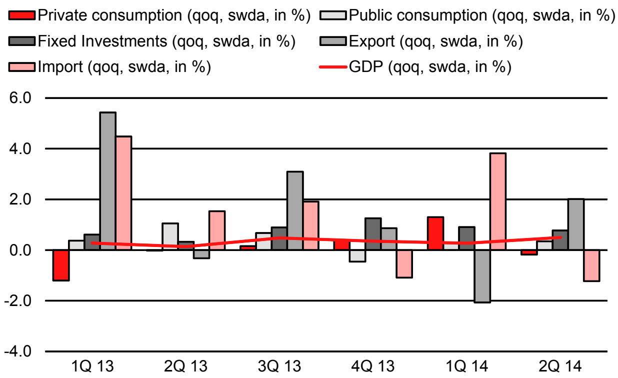
**We revised downward our real export growth forecast for 2014 (to 2.3% from 4.6%) and 2015 (to 3.1% from 5.0%)**

On the domestic front, the economy remains in a state of uncertainty, as the fate of the fourth largest bank (COCB) is in limbo, while the third largest lender (FIB) has received significant liquidity support from the state. Our baseline scenario envisages resolution of the troubled COCB through bankruptcy and full repayment of the liquidity support that FIB has received from the state, though this would require more time than initially planned. As part of the response measures, IMF and WB will launch Financial Sector Assessment Program, while a private sector consultant would be appointed to carry out a comprehensive and in-depth analysis of distressed local lenders and to identify actions for improving their financial health.

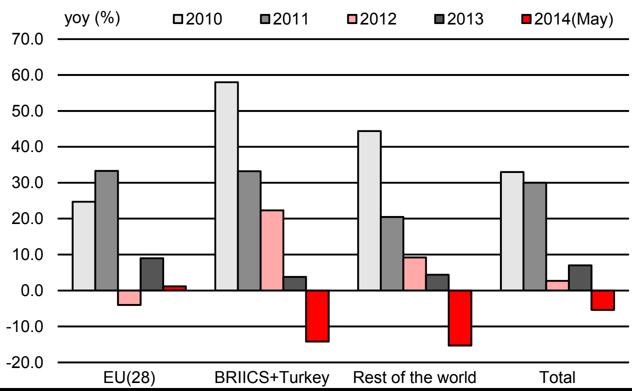
**While impossible to calculate with precision, heavy flooding in July and more recently in September seems to have also had a non-negligible negative effect on output**

Weaker external demand combined with heightened uncertainty caused by the crisis in the privately-owned domestic banks segment is also likely to negatively affect private consumption and perhaps to a somewhat lesser extent investments via the sentiment channel. Indeed, sentiment has already weakened, as a worsening in the ESI expectations component over the last three months and particularly in August shows. It was deepest in domestic-demand oriented sectors, while at least for the time being mostly export-oriented industry has largely escaped that trend. This is likely to gradually change, however, as setbacks facing exports become more pronounced in the rest of this and early next year.

Solid exports growth in 2Q14 helped offset most losses from 1Q




…but exports to BRIICS + Turkey have disappointed this year




Source: NSI, UniCredit Research

**We revised downward our already lackluster real private consumption growth forecast for 2014 (to 1.0% from 1.1%) and 2015 (to 1.2% from 1.4%)**

Importantly, sentiment in the household sector also trended downward, with detailed data showing that consumers are inclined to hold back spending and further increase savings in the short run. To capture all these developments, including stronger-than-expected 2Q14's output growth which helped to partially neutralize the hit that weaker growth in the eurozone and banking problems at home will have this and next year, we penciled in a small reduction in our GDP growth forecast for 2014 to 1.3% (from 1.5%) and to 1.9% (from 2.1%) in 2015.

**We think there are decent chances for Bulgaria to produce a stable government after elections scheduled for 5 October**

**Recent public opinion polls suggest that snap elections are likely to shift power into the hands of the main right-wing opposition GERB party.** We think that the quality of post-election policy-making will improve. We also believe that the post-election political environment will be more conducive to implement potentially unpopular reforms.

**Whether GERB will control sufficient seats in the next Parliament to form an independent government or have to forge a coalition with some of the smaller right-leaning parties remains to be seen**

GERB understands that the fiscal situation is disappointing (deficit apart from one-off costs associated with the banking sector crisis shows significant deterioration this year), but is hardly a disaster given the country's debt to GDP ratio. GERB is unlikely to repeat their past mistakes on the fiscal policy front, in our view. They seem convinced that in the presence of negative core and headline inflation (see lhs chart below) and elevated unemployment (most recent unemployment reading in July 2014 was only 1.6 pp below its peak posted fifteen months ago – see rhs chart below) any push toward aggressive fiscal consolidation will risk submerging the economy into recession once again.

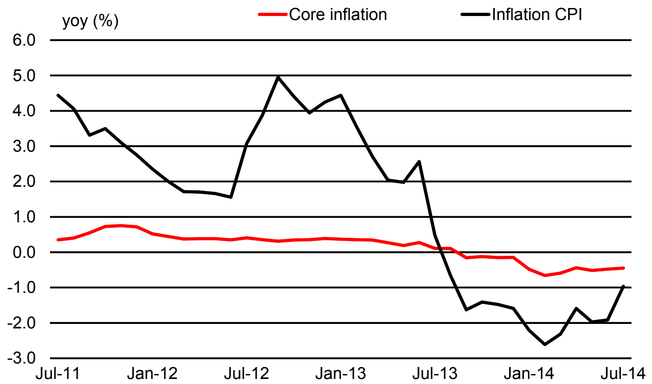
**GERB seems to have a better track record than socialists in terms of implementation of reforms and is also likely to be under stronger pressure to press ahead with the hard work that is needed to reduce the existing structural rigidities on many important fronts in the economy**

Good progress in pension reform also looks likely, taking into account GERB's determination to implement some of the difficult policy choices needed to balance the system, including strengthening the disability certification process, raising the contribution rate by about 2 pp and perhaps even tying pensions indexation to actually collected contribution payments.

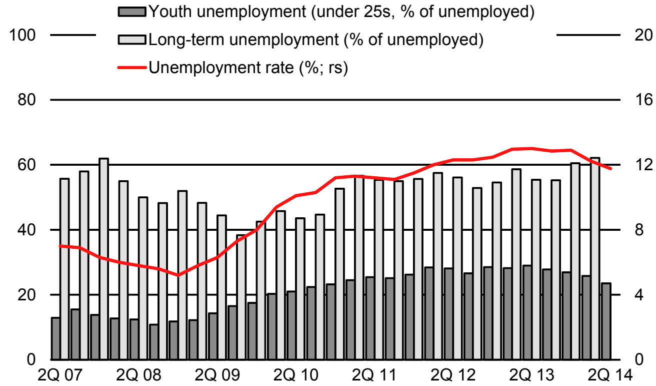
It is widely expected that GERB will reverse populist cuts in energy prices undertaken by the previous administration and will broaden access of the poor to state funded electricity and heating assistance. But while GERB understands that addressing the deep structural dislocations in this part of the economy requires much more than just raising output prices, it remains unclear how far they are ready to go when it comes to reducing the Russian grip on the local energy sector via diversification of sources of supply of primary energy resources and perhaps even more importantly via bold steps aimed at improving the efficient use of energy.

We are less optimistic about the outlook for reforms in health care and education. Only limited progress is expected here, in our view, given the lack of clarity on the reform agenda that is needed and especially given the reluctance of GERB and right-wing parties more generally to raise public funding for these two sectors before their structural weakness are fully addressed.

Core inflation remains stuck in negative territory on weak demand…




…as unemployment levels improve only very gradually




Source: NSI, UniCredit Research

## Strategy: Constructive issuance ahead

**We see the MinFin moving to rebuild fiscal buffers, while managing to contain financing costs…**

**Following recent developments in the Bulgarian economy and hits to public finances (associated with privately-owned domestic banks segment crisis and the freezing of EU funds) we believe that the MinFin is about to undertake a shift towards higher fiscal buffers.** We expect this policy change to become visible as soon as November when the 2014 Budget law will be revised and the 2015 Budget law will be approved, all of these under a new government, to be elected on 5 October.

In a nutshell, we expect the rebuilding of fiscal reserves (to 8% of GDP), which are likely to shrink to a multi-year low in January (to circa 4.8% of GDP from a 5Y average of 7.6%) on maturing external and domestic debt and the financing of what we expect would be a prolonged period of a more growth-supportive budget position, to leave the MinFin with a busier issuance calendar. In 4Q, given time constraints to organize another successful return to external markets, we see this as a surge in domestic GB issuance, which we have penciled in at circa BGN 2bn, concentrated in November and December.

**…by tapping the Eurobond market in 1H15…**

We expect that the MinFin will make use of favorable financing conditions on international markets in early 2015. With bond prices and CDS premia having already recovered most of their losses at the peak of the domestic banking crisis in June and July, we see no difficulties for the sovereign in taping the Eurobond market for circa EUR 1.4bn in 1H15.

**…and slightly increasing domestic bond issuance next year**

With abundant liquidity in the domestic banking sector and demand for new credit still very weak, we expect that financing costs will be contained on the domestic GB market as well. This will be further supported by an influx of liquidity from the domestic and external bond market amounting to BGN 2.7bn or 3.5% of 2014 GDP over Nov-Jan. Yet, to avoid crowding out of local investors, we see sovereign bond issuance in 2015 only slightly above that in previous periods (2014 excluded), while the forecasted sharp increase in bill issuance will be associated with covering the immediate financing needs at the start of the year and leveling out seasonality in the budget over the course of 2015.

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

**GOVERNMENT GROSS FINANCING REQUIREMENTS**

| EUR bn | 2013 | 2014F | 2015F |
|---|---|---|---|
| **Gross financing requirement** | **1.8** | **4.0** | **2.9** |
| Budget deficit | 0.7 | 2.0 | 1.1 |
| Amortization of public debt | 0.9 | 1.8 | 1.6 |
| Domestic | 0.1 | 1.8 | 0.8 |
| Bonds | 0.1 | 0.4 | 0.1 |
| Bills | 0 | 1.4 | 0.8 |
| External | 0.8 | 0 | 0.8 |
| WB/EIB/JBIC/Others | 0.2 | 0.2 | 0.2 |
| **Financing** | **1.8** | **4.0** | **2.9** |
| Domestic borrowing | 1.2 | 2.7 | 1.7 |
| Bonds | 0.6 | 1.3 | 0.7 |
| Bills | 0.6 | 1.4 | 0.9 |
| External borrowing | 0.6 | 2.0 | 2.0 |
| Bonds | 0 | 1.5 | 1.4 |
| WB/EIB/JBIC/Others | 0.6 | 0.5 | 0.6 |
| Privatization | 0 | 0 | 0 |
| Fiscal reserves change (- = increase) | 0 | -0.7 | -0.8 |

**GROSS EXTERNAL FINANCING REQUIREMENTS**

| EUR bn | 2013 | 2014F | 2015F |
|---|---|---|---|
| **Gross financing requirement** | **15.7** | **13.9** | **14.0** |
| C/A deficit | -0.8 | -0.6 | -0.5 |
| Amortization of medium to long term debt | 6.1 | 4.8 | 5.1 |
| Government/central bank | 1.0 | 0.2 | 1.0 |
| Banks | 0.8 | 0.7 | 0.6 |
| Corporates | 4.2 | 3.9 | 3.5 |
| Short term debt amortization | 10.4 | 9.7 | 9.4 |
| **Financing** | **15.7** | **13.9** | **14.0** |
| FDI | 1.0 | 1.0 | 1.2 |
| Portfolio flows | -0.1 | 1.3 | 1.0 |
| Borrowing | 5.5 | 6.1 | 5.9 |
| Government/central bank | 0.6 | 2.0 | 2.0 |
| Banks | 0.6 | 0.5 | 0.4 |
| Corporates | 4.3 | 3.7 | 3.5 |
| Short term | 9.7 | 9.4 | 8.7 |
| EU transfers | 1.4 | 1.2 | 1.1 |
| Other | -2.9 | -4.6 | -2.5 |
| Change in FX reserves (- = increase) | 1.1 | -0.5 | -1.4 |

Source: BNB, Ministry of Finance, UniCredit Research

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

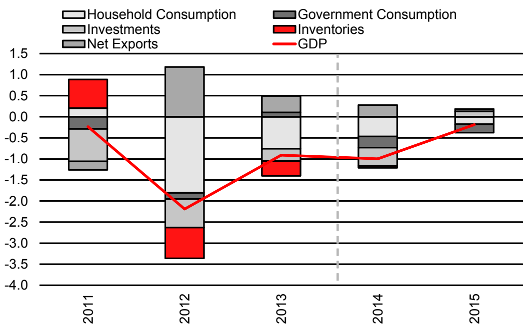
**Outlook –** We continue to expect a contraction in GDP this year of 1%, representing the sixth consecutive year of contraction. The reform outlook remains broadly stalled, as does public investment while external demand is weak. We revise our forecast for 2015, now expecting a GDP decline of -0.2%. Fiscal performance continues to weigh on the economic environment with compliance with the EDP deficit target being challenged, while growing public debt could be significantly affected by expected methodological changes.

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

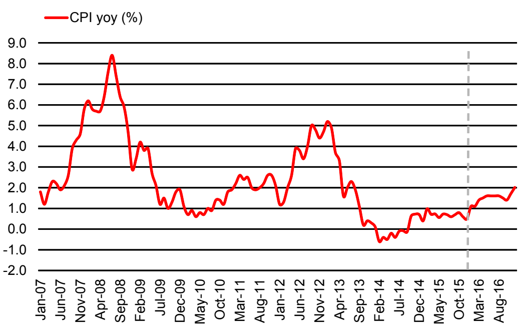
## KEY DATES/EVENTS

- Sep/Oct: 2014 Budget amendments
- 20 Oct: EDP Inventory
- 28 Nov: GDP flash estimate 3Q14
- Nov/Dec: 2015 Budget Proposal
- 10 Dec: GDP estimate 3Q14
- Dec/Jan: Presidential elections

## GDP GROWTH




## INFLATION OUTLOOK




Source: IMF, MinFin, Eurostat, UniCredit Research

## MACROECONOMIC DATA AND FORECASTS

| | 2011 | 2012 | 2013 | 2014F | 2015F |
|---|---|---|---|---|---|
| GDP (EUR bn) | 44.2 | 43.5 | 43.2 | 42.4 | 42.7 |
| Population (mn) | 4.280 | 4.267 | 4.257 | 4.247 | 4.237 |
| GDP per capita (EUR) | 10,332 | 10,195 | 10,138 | 9,986 | 10,088 |
| **Real economy yoy (%)** | | | | | |
| GDP | -0.2 | -2.2 | -0.9 | -1.0 | -0.2 |
| Private Consumption | 0.2 | -3.0 | -1.3 | -0.8 | -0.3 |
| Fixed Investment | -7.2 | -3.1 | -1.3 | -2.0 | 0.6 |
| Public Consumption | -0.3 | -0.8 | 0.5 | -1.3 | -1.0 |
| Exports | 1.7 | 0.3 | -1.2 | 2.0 | 2.9 |
| Imports | 2.1 | -2.4 | -2.0 | 1.3 | 2.7 |
| Monthly wage, nominal (EUR) | 1,049 | 1,048 | 1,048 | 1,038 | 1,049 |
| Unemployment rate (%) | 13.5 | 15.8 | 17.2 | 17.5 | 17.8 |
| **Fiscal accounts (% of GDP)** | | | | | |
| Budget balance | -7.8 | -5.0 | -4.9 | -5.1 | -4.8 |
| Primary balance | -5.5 | -2.3 | -1.7 | -1.5 | -1.0 |
| Public debt | 51.9 | 56.2 | 67.4 | 73.2 | 77.6 |
| **External accounts** | | | | | |
| Current account balance (EUR bn) | -0.4 | 0 | 0.4 | 0.5 | 0.3 |
| Current account balance/GDP (%) | -0.9 | -0.1 | 0.9 | 1.3 | 0.7 |
| Basic balance/GDP (%) | 1.5 | 2.4 | 2.4 | 3.2 | 3.1 |
| Net FDI (EUR bn) | 1.1 | 1.1 | 0.7 | 0.8 | 1.0 |
| Net FDI (% of GDP) | 2.4 | 2.5 | 1.6 | 1.9 | 2.3 |
| Gross foreign debt (EUR bn) | 45.9 | 44.9 | 45.6 | 46.1 | 47.6 |
| Gross foreign debt (% of GDP) | 103.8 | 103.1 | 105.7 | 108.8 | 111.4 |
| FX reserves (EUR bn) | 11.2 | 11.2 | 12.9 | 13.3 | 14.0 |
| **Inflation/Monetary/FX** | | | | | |
| CPI (pavg) | 2.3 | 3.4 | 2.2 | 0 | 0.7 |
| CPI (eop) | 2.1 | 4.7 | 0.3 | 0.7 | 0.5 |
| 1W money market rate | 1.3 | 1.4 | 0.7 | 0.5 | 0.7 |
| USD/HRK (eop) | 5.82 | 5.73 | 5.55 | 5.63 | 5.46 |
| EUR/HRK (eop) | 7.53 | 7.55 | 7.64 | 7.65 | 7.65 |
| USD/HRK (pavg) | 5.34 | 5.85 | 5.71 | 5.65 | 5.51 |
| EUR/HRK (pavg) | 7.43 | 7.52 | 7.57 | 7.63 | 7.61 |

Source: UniCredit Research

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

## Recovery remains out of sight

**2015 could represent the seventh consecutive year of contraction**

**GDP contraction could extend into 2015.** We continue to expect a 1.0% GDP contraction in 2014 as we see further evidence of contraction both in 2Q and 3Q. Recent data releases showed that personal consumption is weak, with retail sales still declining, industrial production is stagnating, investments are declining more than envisaged, and construction is plunging, while tourism growth is weaker than expected. Export performance was strong in 1H, which made us revise up our figures for exports and imports and the C/A surplus, but July numbers already revealed how fragile this can be with growth slowing down in main trading partners. The deteriorated outlook for the EMU economy and neighboring countries led us to revise down our outlook for 2015 too. We see a further mild GDP contraction during 2015 of -0.2% as our baseline scenario. Stimulus from external demand is declining, while a recovery in domestic investment is uncertain. Expectations of implementation of larger public investments in 2015 are fading, with only a few remaining in the pipeline, while the investment environment is not improving with announcements and hints of changes in the tax environment. With changing tax and regulatory measures and the government entering the last year of its mandate, uncertainty is rising, which in turn harms private investment initiatives despite a framework for investment promotion already in place. Markets are missing any incentive for introducing important reforms which could initiate the change in economic cycle.

**Signs of reforms and recovery in factors expected to ignite the growth are fading**

**Fiscal outlook:** Fiscal data for 1H provided a mixed picture of public finance developments. Croatia is set to face a demanding autumn; it is tasked with complying with EDP targets for the government deficit. It will require new budget amendments. However, the country still lacks any significant reform to ignite stronger effects on government expenditure and to instigate public debt developments. With the weak GDP performance, the size of government revenues is being put to the test as tax revenues are declining (by 3.4% yoy in 1H14), even though there has been some increase in tax levels, excises and levies. However, the transfer of part of pension contributions from private mandatory pension funds (pillar II) to generation solidarity funds (pillar I) under government management has helped overall revenues to increase in 1H14 by 6.6% yoy. Nevertheless, the government will have a challenging task to comply with the EDP target of 4.6% of GDP in 2014. To tackle the situation, the government has announced new budget amendments for the autumn, but the proposal is still to be finalized. However, the budget revision will also contain a few measures that can create additional shortage in revenues with mitigation steps not yet known. Namely, the government already confirmed that it will introduce changes in personal income tax, increasing nontaxable amounts and widening the brackets so the highest tax rate will be applied only to higher income earners. It is intended to be in effect already in 2014, shortly after revision is approved. A further measure is directed at easing pressure on small entrepreneurs, increasing the coverage of entrepreneurs who will be allowed to pay VAT liabilities only after receipts' collection. Both measures are business friendly, but they will first impact public revenues at a time when EDP compliance is already doubtful. This could mean additional funding requirements. Although the government heavily tapped both domestic and international markets during 1H, it will still need additional funding to close the 2014 funding gap. Alongside challenging redemption requirements abroad early next year (EUR 750mn in January), we should see the government considering tapping international markets during the autumn with bond issuance of EUR 1-1.5bn, taking advantage of current favorable funding conditions, even though Croatian 5Y CDS have been floating at around 250bp for some time now.

**Fiscal policy is set to face a demanding autumn**

**Government funding needs are still high, but current funding conditions and market access are supportive**

**Public debt developments will be challenged both with existing fiscal gap and methodological changes in debt coverage**

**Credit rating outlook:** Lack of reforms and sustainability of public debt in the medium term led Fitch to cut the credit rating for Croatia to BB stable (aligned with S&P now) in early August. Public debt will be challenged also by methodological revisions which will most likely include the debt of domestic highway operators (around 9.2%) and raise debt figures, already above 70% of GDP, to 80%+ levels. The government is considering renting the highway network through concessions to use such receipts to cut a big share of this debt.

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

**Outlook** – The economy is facing a genuine recovery, driven largely by domestic demand. Under our baseline scenario, the Czech economy is set to outperform the eurozone also in 2015; in case of extreme geopolitical tensions, it could however be the opposite. We foresee EUR/CZK trendless, CPI to hit 2% yoy around mid-2015 and CNB policy tightening no earlier than 2H16.

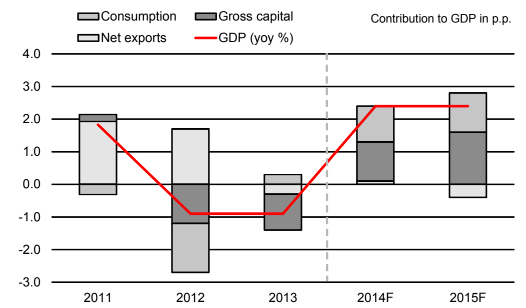
**Strategy outlook** – Local issuance could be capped at CZK 54bn in September-December as the government looks to spend more out of its reserves. The bond supply should be easily covered by local banks, which still hold sizeable excess liquidity. That said, Czech bonds (both local and hard currency) remain expensive compared to regional peers.

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

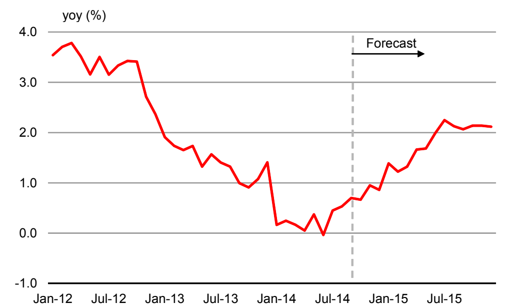
### KEY DATES/EVENTS

- CNB policy meetings – 25 Sep, 6 Nov
- Manufacturing PMI – 1 Oct, 3 Nov, 1 Dec
- Local and Senate elections – 10-11 Oct

### GDP GROWTH OUTLOOK: INCREASING RELIANCE ON DOMESTIC DEMAND




### CPI TO KEEP GOING UP, PEAKING ATAROUND 2%




Source: CZSO, Unicredit Research

### MACROECONOMIC DATA AND FORECASTS

| | 2011 | 2012 | 2013 | 2014F | 2015F |
|---|---|---|---|---|---|
| GDP (EUR bn) | 155.4 | 153.0 | 149.5 | 146.9 | 153.5 |
| Population (mn) | 10.5 | 10.5 | 10.5 | 10.5 | 10.5 |
| GDP per capita (EUR) | 14,804 | 14,557 | 14,225 | 13,966 | 14,595 |
| **Real economy yoy (%)** | | | | | |
| GDP | 1.8 | -0.9 | -0.9 | 2.4 | 2.4 |
| Private Consumption | 0.5 | -2.1 | 0.1 | 1.8 | 2.0 |
| Fixed Investment | 0.4 | -4.3 | -3.6 | 5.0 | 4.0 |
| Public Consumption | -2.7 | -1.9 | 1.6 | 1.2 | 1.0 |
| Exports | 9.6 | 4.7 | 0.2 | 8.3 | 4.5 |
| Imports | 7.0 | 2.5 | 0.6 | 9.1 | 5.4 |
| Monthly wage, nominal (EUR) | 995 | 997 | 966 | 935 | 967 |
| Unemployment rate (%) | 6.7 | 6.8 | 7.7 | 7.7 | 7.1 |
| **Fiscal accounts (% of GDP)** | | | | | |
| Budget balance | -3.2 | -4.2 | -1.5 | -1.7 | -2.5 |
| Primary balance | -1.8 | -2.7 | -0.1 | -0.3 | -1.1 |
| Public debt | 41.4 | 46.2 | 46.0 | 45.9 | 46.3 |
| **External accounts** | | | | | |
| Current account balance (EUR bn) | -4.2 | -2.0 | -2.2 | 0.1 | -1.6 |
| Current account balance/GDP (%) | -2.7 | -1.3 | -1.4 | 0.1 | -1.0 |
| Basic balance/GDP (%) | -1.5 | 1.8 | -0.6 | 3.0 | 1.6 |
| Net FDI (EUR bn) | 1.9 | 4.8 | 1.3 | 4.4 | 4.0 |
| Net FDI (% of GDP) | 1.2 | 3.2 | 0.9 | 3.0 | 2.6 |
| Gross foreign debt (EUR bn) | 72.8 | 77.7 | 80.8 | 84.8 | 90.9 |
| Gross foreign debt (% of GDP) | 46.8 | 50.8 | 54.0 | 57.8 | 59.2 |
| FX reserves (EUR bn) | 31.1 | 34.0 | 40.8 | 43.5 | 43.8 |
| **Inflation/Monetary/FX** | | | | | |
| CPI (pavg) | 1.9 | 3.3 | 1.4 | 0.4 | 1.8 |
| CPI (eop) | 2.4 | 2.4 | 1.4 | 0.9 | 2.1 |
| Central bank target | 2.0 | 2.0 | 2.0 | 2.0 | 2.0 |
| Central bank reference rate (eop) | 0.75 | 0.05 | 0.05 | 0.05 | 0.05 |
| 3M money market rate | 1.19 | 1.00 | 0.46 | 0.36 | 0.35 |
| USD/CZK (eop) | 19.94 | 19.06 | 19.89 | 20.4 | 19.6 |
| EUR/CZK (eop) | 25.80 | 25.14 | 27.43 | 27.70 | 27.50 |
| USD/CZK (pavg) | 17.69 | 19.58 | 19.57 | 20.3 | 20.0 |
| EUR/CZK (pavg) | 24.59 | 25.14 | 25.97 | 27.56 | 27.60 |

Source: UniCredit Research

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

## Testing resilience to external weakness

**The economy relies increasingly on domestic demand**

**The economy is facing a genuine recovery, driven largely by domestic demand.** The structure of growth provides the economy with a certain shield against external headwinds, but doesn't make it immune. Our new scenario of more sluggish growth in the eurozone looks consistent with a broadly stable, rather than accelerating Czech GDP expansion. We forecast GDP growth at 2.4% in both 2014 and 2015. A further shift of demand to domestic components is to be expected, with investment outperforming after two years of contraction.

**In 2Q14, all demand-side components except for net exports contributed to GDP growth**

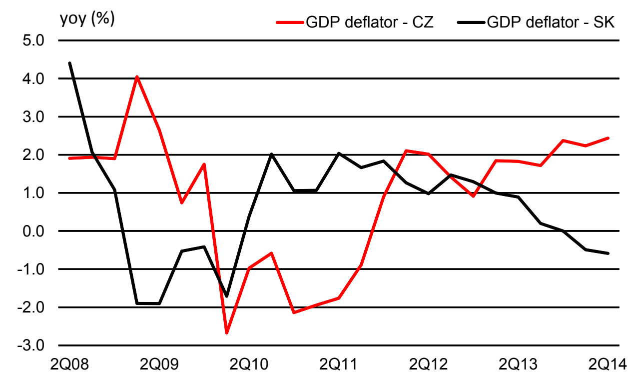
**In 2Q14, GDP posted only a marginal slowdown to 2.7% yoy from 2.9% yoy in 1Q14.** GDP was flat qoq after two quarters of very strong growth bolstered by one-offs. Domestic demand saw a positive and growing contribution to annual growth from all its key components (private consumption, 1.0 pp; government consumption, 0.5 pp; fixed capital, 1.5 pp) and, unlike in 1Q14, inventories worked in the same direction (0.8 pp). Net exports, in contrast, subtracted 1.1 pp from annual growth as imports outpaced exports (real exports and imports up 11.3% yoy and 8.9%, respectively). Positive terms of trade helped to lift the GDP deflator to a five-year high of 2.5% yoy, partially reflecting the CZK depreciation from November 2013. From the production side, manufacturing continued to act as the key driver of growth, but all other major sectors except for financials also grew in annual terms.

**New construction-related investment projects and supply-side improvements in the automotive industry are expected to keep the economy growing**

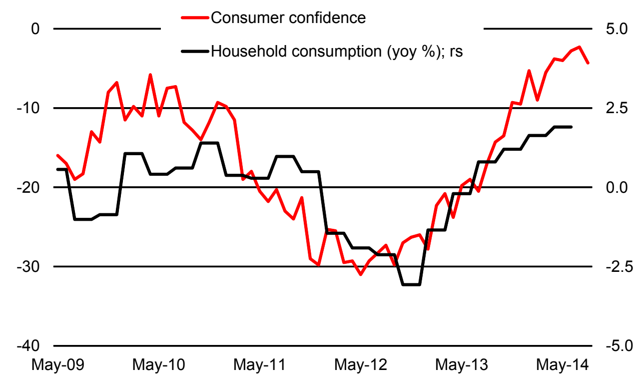
**Three factors make us relatively optimistic on the near-term outlook.** First, a growing share of fixed capital formation has been driven by non-residential construction activity. Its breakdown into public versus private for 2Q14 is not yet available, but we believe the latter was dominant. A healthy banking system and smaller balance sheet problems than in other CEE countries bode well for a broad recovery in lending. New investment will probably go to manufacturing and logistics, further boosting their (already large) share in GDP. Second, two of the three car producers in the country, Skoda Auto and TPCA, are in the middle of revamping their model portfolios. In case of sufficient demand for cars in Europe, this should secure solid production growth in the sector over the next 12 months. Considering our weak recovery story for the EMU this year and next, the new lines could reach full capacity over a longer period, making the positive effect for the economy more gradual and hence longer-term. Thirdly, new residential building may soon boost construction activity as housing starts hit a 3-year high for 2Q in 2014. Moreover, public infrastructure projects could also increase amid a larger fund allocation from the government in 2015.

**TWO PILLARS OF THE CURRENT EXPANSION: IMPROVING TERMS OF TRADE AND IMPROVING CONSUMER SENTIMENT**

Positive terms of trade have been adding to nominal GDP growth continuously since 2012; the situation contrasts with that of Slovakia




Consumer sentiment hit a six-year high; household consumption is also picking up but has more room to go




Sources: CZSO, UniCredit Research

**Downward revisions to our CPI outlook suggest that household revenues will grow faster in real terms**

**Household consumption has the potential to strengthen further against the backdrop of solid consumer sentiment and low inflation.** CPI inflation ticked up to 0.6% yoy in August, the highest level of this year. With all probability, inflation has bottomed out and the risk of deflation has substantially subsided. That said, inflation will pick up gradually and hardly reach 1% yoy at the end of 2014 despite the FX depreciation pass-through and firmer economy providing some stimuli. Our more benign inflation outlook compared to three months ago now foresees CPI to hit 2% around mid-2015 before hovering around this level in the rest of the year. Inflation will remain low by historical standards and is expected to provide an additional boost to real spending of households, which we expect to grow by 2.0% yoy in 2015 after 1.8% yoy forecast for this year.

**EUR-CZK seen trendless given the CNB's existing FX commitment**

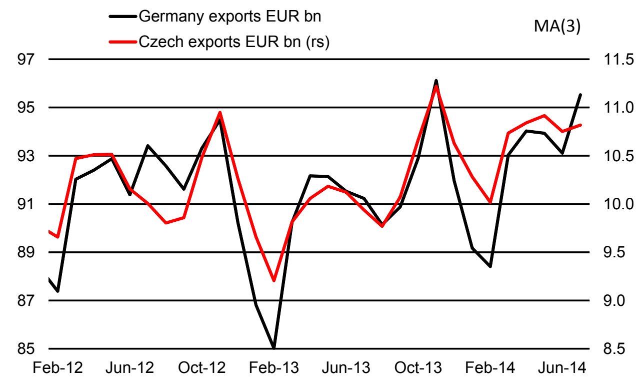
**Considering inflation is still too low, the CNB decided at the end of July to extend its commitment to keep EUR/CZK at or above 27 by one year, i.e. until 2016.** The decision is in particular important insofar as it also extends the period of no action on policy interest rates as well. We have subsequently delayed our expected first repo rate hike until 2H16. The spell of CZK weakness seen in August, with EUR-CZK testing a 5-year high at 28, was rather unrelated to the latest CNB policy step. Nevertheless, it served as evidence that the market was getting used to EUR-CZK post-intervention levels above 27. This leads us to shift our EUR-CZK forecast over the next 12 months slightly up to just above 27.5, which may in turn leave the cross with more room to move in either direction, causing volatility to rise. We continue to expect EUR-CZK trendless, as it may be driven by the conflicting forces of EUR-USD downward drift (pushing CZK weaker) and a faster expansion of the Czech versus eurozone's economy (pushing CZK in the opposite direction).

**Fiscal policy set to be neutral in 2014 and , but a positive fiscal impulse could follow in 2015**

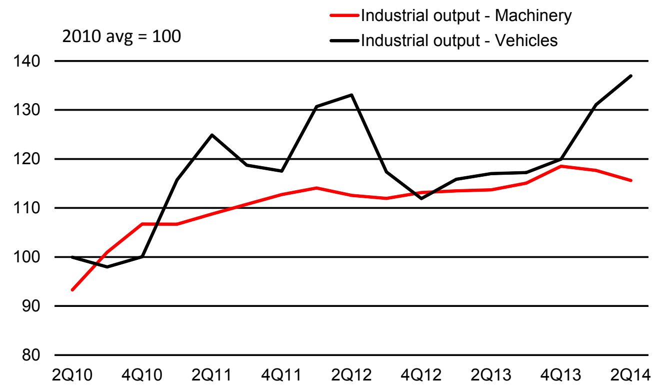
**Fiscal policy is assessed as broadly neutral this year and moderately stimulative in 2015.** Central government revenues increased by 5.1%yoy in 8M14, while expenditure rose by a more moderate 1.9% yoy. Expenditure fell behind plan this year due to delays to some infrastructure projects and the incapacity of the governing coalition to agree on revenue-boosting measures. Hence, the central government announced that its deficit could be around CZK 90bn versus the scheduled CZK 112bn. For 2015, the budget draft of the central government is said to show a deficit of CZK 100bn, implying a positive fiscal impulse. We also expect a spending hike in other tiers of the government versus 2014.

**DESPITE A GROWING ROLE OF DOMESTIC DEMAND, EXPORTS AND MANUFACTURING REMAIN KEY**

Recent outperformance of Czech exports yoy dynamic versus Germany was broken in July by a firm German figure




Car manufacturing and machinery have long belonged to drivers of GDP growth; of the two sectors, only the former is currently booming




Source: CZSO, UniCredit Research

**Escalation of geopolitical tensions poses more risk for Czech Republic than eurozone**

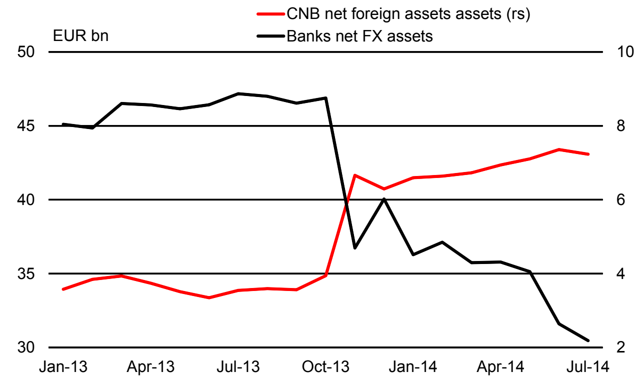
**With a constructive outlook, we need to answer the question of what may go wrong.** We are not overly concerned about direct drags from sanctions on and from Russia, which would hit only a limited part of the economy. Czech exports to Russia (-6.6% yoy in 1H14) underperformed exports to the EU (+10.2% yoy). However, exports to non-EU countries excepting Russia and Ukraine fell even more (-18.9% yoy). Escalation of geopolitical tensions would however bear the risk of not only adversely affecting external demand (which alone would be more of a problem for an open economy like the Czech one), but also suspending some investment projects that are underway. Furthermore, consumer sentiment could be hit. Hence, while under our baseline scenario the Czech economy is set to outperform the eurozone, it could be the other way around in an extreme risk case.

## Strategy: no opportunity for multi-currency investors

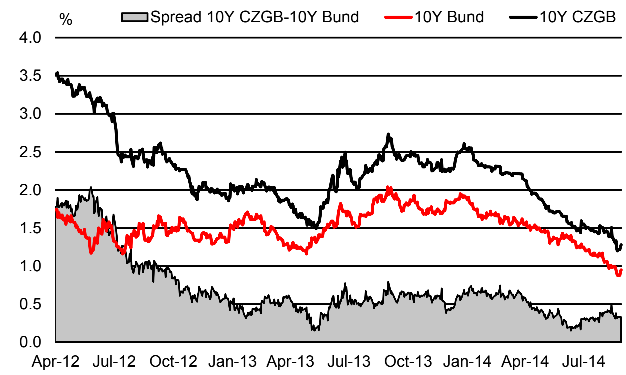
**CZK 54bn worth of local bonds to be issued by the year-end**

**The state treasury's aim to reduce cash reserves** is estimated to keep this year's CZK bond issuance within a CZK 176bn limit and the issuance to be made in September-December at CZK 54bn. Despite extremely low yields, new bonds are set to see demand from local banks which are facing the problem of rolling over their excessive CZK liquidity. For multi-currency investors, better options than CZGB probably exist at the moment.

Since last November's CZK depreciation, net FX assets of banks have been declining owing to a rise of customer FX deposits




Fresh all-time lows have been seen on both the CZGB yields and the yield premiums over German Bunds




Sources: CZSO, MoF, UniCredit Research

**GOVERNMENT GROSS FINANCING REQUIREMENTS**

| EUR bn | 2013 | 2014F | 2015F |
|---|---|---|---|
| **Gross financing requirement** | **15.0** | **10.8** | **14.1** |
| Budget deficit | 3.1 | 3.1 | 4.3 |
| Amortisation of public debt | 11.8 | 7.7 | 9.8 |
| Bonds | 4.5 | 3.2 | 5.3 |
| EIB loans | 0.1 | 0.1 | 0.1 |
| Bills | 7.3 | 4.4 | 4.4 |
| **Financing** | **15.0** | **10.8** | **14.1** |
| Domestic borrowing | 11.7 | 10.8 | 12.2 |
| Bonds | 7.1 | 6.4 | 7.8 |
| Bills | 4.6 | 4.4 | 4.4 |
| External borrowing | 0.2 | 0 | 2.0 |
| Bonds | 0 | 0 | 2.0 |
| EIB/IMF | 0.2 | 0 | 0 |
| Change in cash reserve | 3.1 | -2.8 | 0 |

**GROSS EXTERNAL FINANCING REQUIREMENTS**

| EUR bn | 2013 | 2014F | 2015F |
|---|---|---|---|
| **Gross financing requirement** | **33.7** | **31.3** | **32.2** |
| C/A deficit | 2.2 | 0.1 | 2.0 |
| Amortisation of MT-LT debt | 10.2 | 10.2 | 9.2 |
| Banks | 0.8 | 0.7 | 0.5 |
| Government and central bank | 1.6 | 3.8 | 1.4 |
| Other sectors | 7.8 | 5.7 | 7.2 |
| Amortisation of ST debt | 21.4 | 21.0 | 21.0 |
| **Financing** | **33.7** | **31.3** | **32.2** |
| FDI | 1.3 | 3.8 | 4.1 |
| Borrowing | 23.6 | 21.4 | 22.5 |
| Banks | 18.9 | 16.9 | 17.1 |
| Government and central bank | 0.2 | 0 | 0 |
| Multinational institutions | 0.8 | 0.6 | 0.7 |
| Companies | 3.7 | 3.8 | 4.6 |
| EU transfers and other | 8.8 | 6.1 | 5.5 |

Sources: CNB, MoF, UniCredit Research

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

**Outlook** – Above-potential growth in 2014 is spurred by fixed investment that continues to perform strongly due to public investment in infrastructure and good EU fund absorption. Industrial production and exports have been resilient, but face risks from sanctions on and by Russia and a modest recovery in EMU. Limited fiscal space reduces growth expectations due to a need to cap the debt to GDP ratio. The banking sector will lose 3% of GDP by February 2015 from repayments on FX retail loans, whose conversion to HUF could follow in 2015.

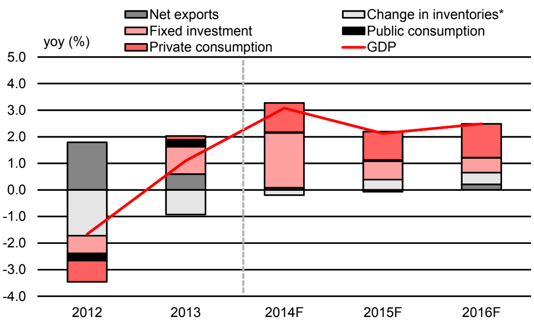
**Strategy** – The HUF remains well supported by the basic balance and could trade range-bound until the end of the year. In the medium term, the gradual depreciation could continue. HGB issuance has been more successful in 2014 than in 2013, but the curve remains sensitive to risk off episodes.

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

### KEY DATES/EVENTS

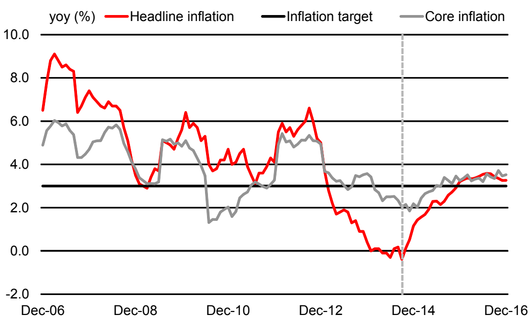
- 14 Nov: 3Q14 GDP (flash estimate)
- 23 Sep, 28 Oct, 25 Nov, 16 Dec: NBH rate meetings
- Oct: Set-up of a bad bank
- Autumn: a roadmap for converting FX retail loans to HUF

### GDP DRIVERS




*Adjusted for statistical error

### HEADLINE INFLATION VS. TARGET




Source: CSO, NBH, UniCredit Research

### MACROECONOMIC DATA AND FORECASTS

| | 2011 | 2012 | 2013 | 2014F | 2015F |
|---|---|---|---|---|---|
| GDP (EUR bn) | 99.9 | 97.6 | 97.9 | 99.1 | 102.6 |
| Population (mn) | 10.0 | 9.9 | 9.9 | 9.9 | 9.8 |
| GDP per capita (EUR) | 9,999 | 9,832 | 9,880 | 10,035 | 10,415 |
| **Real economy yoy (%)** | | | | | |
| GDP | 1.6 | -1.7 | 1.1 | 3.1 | 2.1 |
| Private Consumption | 0.4 | -1.9 | 0.3 | 2.2 | 2.1 |
| Fixed Investment | -3.6 | -3.8 | 5.8 | 11.1 | 3.5 |
| Public Consumption | -0.3 | 0 | 1.2 | 0.1 | 0.2 |
| Exports | 6.3 | 2.0 | 5.3 | 5.9 | 4.0 |
| Imports | 5.0 | 0.1 | 5.3 | 6.5 | 4.5 |
| Monthly wage, nominal (EUR) | 763 | 771 | 776 | 764 | 778 |
| Unemployment rate (%) | 10.9 | 10.7 | 9.1 | 8.2 | 8.4 |
| **Fiscal accounts (% of GDP)** | | | | | |
| Budget balance | 4.3 | -1.9 | -2.2 | -2.9 | -2.9 |
| Primary balance | -2.8 | 2.1 | 1.6 | 0.7 | 0.9 |
| Public debt | 81.6 | 79.8 | 79.4 | 79.3 | 79.2 |
| **External accounts** | | | | | |
| Current account balance (EUR bn) | 0.8 | 0.8 | 3.0 | 2.8 | 2.2 |
| Current account balance/GDP (%) | 0.8 | 0.8 | 3.1 | 2.9 | 2.2 |
| Basic balance/GDP (%) | 3.8 | 2.4 | 2.7 | 1.8 | 1.8 |
| Net FDI (EUR bn) | 0 | 0 | -0.4 | -1.0 | -0.4 |
| Net FDI (% of GDP) | 3.0 | 1.5 | -0.4 | -1.0 | -0.4 |
| Gross foreign debt (EUR bn) | 133.3 | 124.8 | 117.9 | 115.7 | 101.7 |
| Gross foreign debt (% of GDP) | 133.5 | 127.9 | 120.4 | 116.7 | 99.1 |
| FX reserves (EUR bn) | 37.8 | 33.9 | 35.8 | 35.8 | 23.2 |
| **Inflation/Monetary/FX** | | | | | |
| CPI (pavg) | 3.9 | 5.7 | 1.6 | 0.2 | 2.3 |
| CPI (eop) | 4.1 | 5.0 | 0.4 | 1.2 | 3.2 |
| Central bank target | 3.0 | 3.0 | 3.0 | 3.0 | 3.0 |
| Central bank reference rate (eop) | 7.00 | 5.75 | 3.00 | 2.10 | 2.50 |
| 3M money market rate (avg) | 6.19 | 6.99 | 4.31 | 2.42 | 2.55 |
| HUF/USD (eop) | 240.68 | 220.93 | 222.22 | 217.4 | 224.6 |
| HUF/EUR (eop) | 311.13 | 291.29 | 296.91 | 308.0 | 315.0 |
| HUF/USD (pavg) | 201.05 | 225.10 | 224.40 | 217.4 | 221.1 |
| HUF/EUR (pavg) | 279.27 | 289.34 | 297.01 | 310.1 | 312.9 |

Source: UniCredit Research

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

## Balancing risks to growth

**The government will continue to be a major player in the economy…**

Hungary's broad-based economic growth surprised strongly on the upside in 1H14 and was due to strong manufacturing and public policies. Domestic demand will help growth exceed 3% yoy in 2014, despite a weak recovery in the EU. The government will continue to pursue three policy goals in 2015, but limited fiscal scope is likely to cap growth at 2.1% yoy.

**…its support for investment and industry paying off in 1H14…**

**…while low inflation boosted real wage and consumption growth**

**The conflict in Ukraine poses the largest risks to growth…**

**…more important being the indirect ones via an EU slowdown**

First, the government wants industry and exports to be the main growth engines, supporting manufacturing, FDI and cost competitiveness via low direct taxes[3], lax monetary conditions, and low energy and utility prices. So far, these policies have paid off. In 2Q14, Hungary was the growth outperformer in CEE (+3.9% yoy). Fixed investment rose by 21.7% yoy in 1H14, due to public spending for transport infrastructure (+35.1% yoy), but also to investment in manufacturing (+30.8% yoy) amid strong demand from the eurozone for cars[4], car parts, chemicals and construction materials. Industrial production and exports increased by 8.9% yoy and 6.0% yoy in 1H14, with eurozone demand (+9.3% yoy) offsetting lower exports outside the EU (-3.3% yoy). Domestic demand benefited from cheaper and longer-term lending to SMEs through the Funding for Growth Scheme (FGS), which reached HUF 295.2bn in 7M14 (1.0% of GDP). According to the NBH, the FGS added 0.5-1.0pp to GDP growth since its launch in 2H13. Meanwhile, low inflation boosted private consumption growth (+2.4% yoy in 2Q14, the fastest rate in eight years) via real wage growth. Going forward, the crisis in Ukraine poses the biggest risks to above-potential growth. Direct effects are limited: although exports to Ukraine and Russia fell by 18.1% yoy in 1H14, the net trade loss was just 0.06% of GDP. More important are indirect risks via an expected slowdown in the EU (which receives 78% of Hungary's exports) due to sanctions and a deterioration of expectations.

**Public debt needs to shed 5.7% of GDP by the end of 2014…**

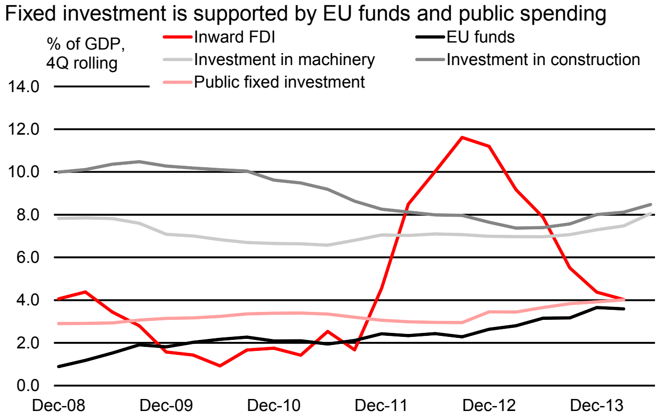
**…which can be achieved by spending from government reserves…**

**…and cutting investment to allow for public acquisitions…**

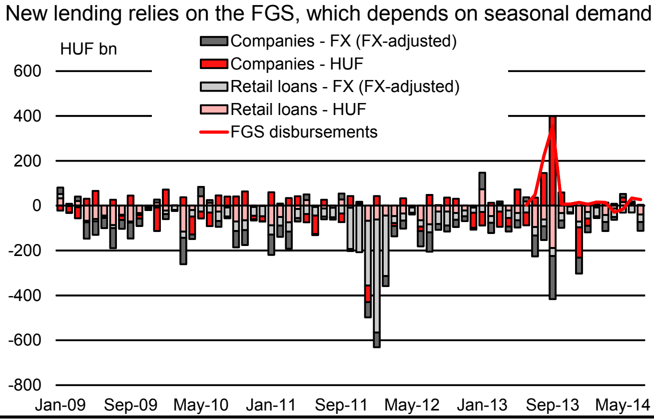
**…but the scope for a large fiscal impulse is declining**

The second goal is fiscal restraint in order to reduce public debt, which reached 85.1% of GDP in June and will have to fall below 79.4% this year in order to comply with constitutional and European Commission requirements. Net of FX debt repayments (3.0% of GDP) and maturing bonds (1.1% of GDP), the AKK is planning debt buybacks of 1.5% of GDP by the end of the year in order to meet the debt target. Meanwhile, the government could spend out of reserves (approximately 5.5% of GDP in August 2014) to offset lower issuance. Authorities balanced spending by cutting public investment by HUF 110bn (0.3 % of GDP), while public acquisitions continued[5], as the government expands public ownership in utilities and finance in support of its first policy goal. But the limited fiscal room will prevent the government from sustaining the current level of public spending, leading to a growth deceleration next year.

Fixed investment is supported by EU funds and public spending




New lending relies on the FGS, which depends on seasonal demand




Source: NBH, NSO, UniCredit Research

[3] The government aims to cut the personal income tax below 10% before its current mandate ends in 2018.
[4] Audi introduced a third work shift at its Hungarian plant. Mercedes operates close to full capacity at its Kecskemet factory.
[5] The latest public acquisition was MKB, the fourth largest local bank. Since 2011, the government spent in excess of 3.8% of GDP on buying companies.

**Labor participation rate increased to the highest level in 20 years**

The government's third goal is to increase the labor participation rate[6]. One way to achieve that is by increasing public employment while curtailing social security outlays. Although public employment fell by 5.2% in June vs. April, it was up 3.2% yoy (+3.0% yoy in the private sector) and 8.9% since Fidesz returned to power in 2010. Total employment exceeded 4mn in 2014 for the first time since 1995. The government's next target is 5mn workers.

**Monetary conditions will ease further due to the FGS and the discount IRS…**

**…higher inflation…**

With the rate-cutting cycle over, the NBH will focus on easing monetary conditions through its two main instruments: the FGS and the less successful 3Y and 5Y interest rate swap (IRS) provided at discount rates to encourage banks to buy HGBs. Adding HUF depreciation, monetary conditions have not been more growth-conducive since the financial crisis, a situation that could be reinforced by rising inflation. Base effects from past cuts in administered prices will push headline inflation above 1% yoy by the end of 2014, but the 3% target will not be reached before late 2015.

**…significant excess liquidity that will last until FX loans are converted to HUF…**

**…and stronger temporary demand for T-bills**

Excess liquidity will keep short-term interest rates close to 2.1% for most of 2015 even if inflation rises. Excess liquidity exceeds 15% of GDP but will fall significantly once the FX loans granted to households (12% of GDP) will be converted to HUF. This is why a rapid conversion is not in the best interest of the central bank. The transformation of 2W bills into 2W deposits cut the access of foreign institutions to the facility. The subsequent rally in 3M and 1Y T-bills probably relates to this through two channels: some foreign institutions choosing to switch from 2W bills into T-bills and some local banks looking for liquid assets in order to improve their liquidity coverage ratio (for which the 2W deposits are not eligible). Hence, the fall in T-bill yields below the base rate should only be temporary.

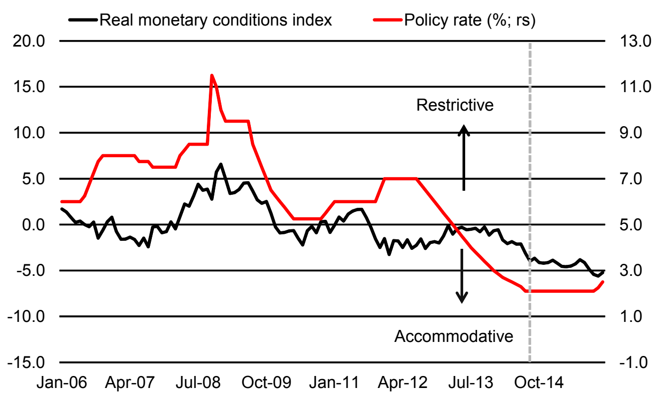
**The banking sector will incur losses amounting to 3% of GDP by February 2015**

**Retail FX loans will be converted to HUF next year**

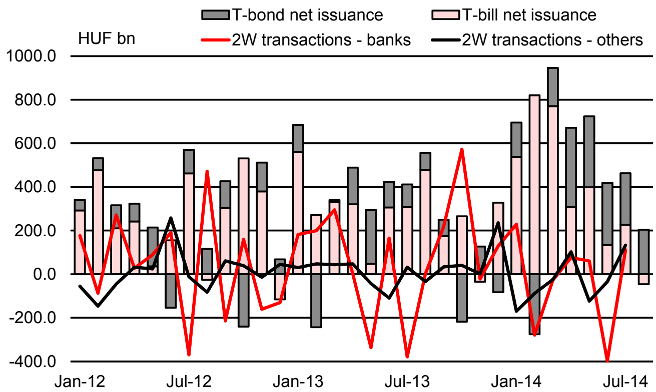
**A bad bank set up in October 2014 will help banks clean up their balance sheets**

The squeeze on the banking system increased with penalties for "unfair" provisions in FX retail loan contracts and the conversion of FX retail loans due in 2015. The repayments on bid/ask FX spreads and interest rate fluctuations will occur by February 2015 and will amount to approximately EUR 3bn (3% of GDP). The timing and conditions of the FX loan conversion will be decided in 4Q14. While the exchange rate for the conversion is under debate, a preferential one granting a 10-15% discount would add 1.2-1.8% of GDP to bank losses and would require further capital injections for some of the largest banks. The specter of system-wide losses reduces the scope for new lending in 2014 and 2015 beyond the seasonal increase in FGS disbursements expected in 2H14. A bad bank will be set up in October to help banks recover some money from overdue loans (14.1% of total loans in June 2014). In the first six months, the bank could buy defaulted mortgage and project loans representing 0.2% of GDP. As of mid-September, the financing source for the bad bank is unknown, as is the method of computing market prices for foreclosed projects.

Monetary conditions are accommodative and could stay so in 2015




Outflows from 2W bills supported issuance in 2014




Source: National Statistics Office, AKK, NBH, UniCredit Research

[6] 44.2% in March 2014, the second lowest among new EU members after Croatia's.

## Strategy: The long end of the curve remains vulnerable

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**We expect EUR-HUF to trade range-bound until end-2014 but gradual depreciation could follow in the medium term**

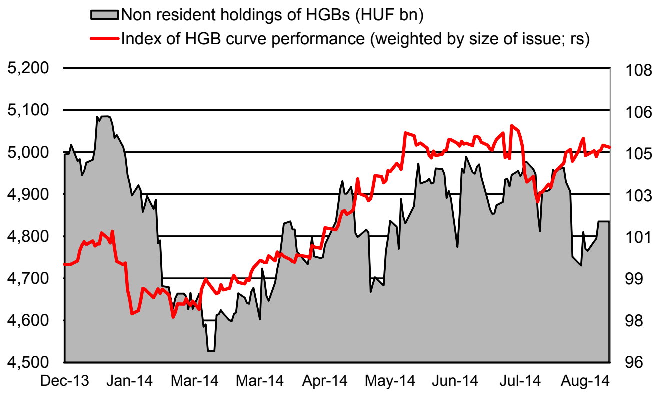
**Net HGB issuance increased in 3Q14, probably helped by the discount IRS with the AKK prepared to forego FX issuance in 2014 and 2015**

**The long end of the HGB curve remains vulnerable in a move to a 'risk off' environment and we prefer long-end USD REPHUNs to HGBs**

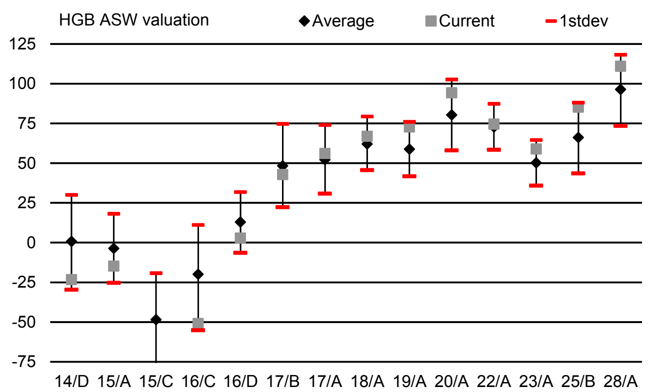
The currency could trade range-bound until year-end as more HUF weakness would slow the reduction of the public debt to GDP ratio. EUR-HUF below 310 would be in line with fundamentals due to C/A and EU fund inflows offsetting bank and FDI outflows. The HUF could depreciate in the medium term due to lax monetary conditions and large refinancing needs.

Primary issuance improved in 2014 (more than 70% of the revised target has been covered). While demand for the discount IRS fell gradually, the facility helped the AKK increase net bond issuance by HUF 257bn yoy (0.8% of GDP) in July-August 2014. Authorities are convinced that demand for HGBs will be strong enough to forego FX bond issuance in 2014 and 2015, pushing the FX portion of public debt below 35%. Yet long-end HGBs remain vulnerable, particularly in a 'risk off' environment, amid lack of local support and high financing needs. Non-resident holdings dropped significantly in 3Q14, suggesting that the proceeds of maturing bonds have not been fully reinvested. The next bond redemption on 2 December (USD ~2.16bn) will be an indication of whether support for HGBs is waning. REPHUN USD bonds are less risky than the local equivalent at the long end of the curve, despite yields being at a discount – approx. 20bps in the 10y. Risks from either geopolitical tensions or widening of US treasury yields would help the USD long end bonds outperform HGBs. In the front end of the curve, HGBs are better value due to larger yield differential and local support.

Bond performance is flattening with nonresident holdings falling…




..with the longer, 22/A, 23/A and 25/B bonds looking expensive




Source: AKK, Bloomberg, UniCredit Research

### GOVERNMENT GROSS FINANCING REQUIREMENTS

| EUR bn | 2013 | 2014F | 2015F |
|---|---|---|---|
| **Gross financing requirement** | **24.6** | **24.4** | **20.6** |
| Budget deficit | 2.2 | 2.9 | 3.0 |
| Amortization of public debt | 22.5 | 21.6 | 17.6 |
| Domestic | 16.2 | 15.2 | 15.1 |
| Bonds | 7.2 | 4.5 | 6.5 |
| Bills | 9.0 | 10.7 | 8.5 |
| Other | 0.6 | 1.3 | 0.2 |
| External | 5.7 | 5.1 | 2.3 |
| IMF/EU and other loans | 4.3 | 2.7 | 0.2 |
| Bonds | 1.5 | 2.5 | 2.1 |
| **Financing** | **24.6** | **24.4** | **20.6** |
| Domestic borrowing | 20.2 | 17.5 | 18.1 |
| Bonds | 8.8 | 9.0 | 9.9 |
| Bills | 11.4 | 8.5 | 8.2 |
| External borrowing | 3.6 | 4.9 | 1.5 |
| Bonds | 2.5 | 2.2 | 0.0 |
| Other | 1.1 | 2.7 | 1.5 |
| Pension funds / Govt. reserves | 0.9 | 2.0 | 1.0 |

Source: AKK, IMF, NBH, UniCredit Research

### GROSS EXTERNAL FINANCING REQUIREMENTS

| EUR bn | 2013 | 2014F | 2015F |
|---|---|---|---|
| **Gross financing requirement** | **25.1** | **25.2** | **31.9** |
| C/A deficit(+)/ surplus(-) | -3.1 | -2.9 | -2.2 |
| Amortisation of medium to long term debt | 11.0 | 11.5 | 11.1 |
| Government/central bank | 6.8 | 6.9 | 3.1 |
| Banks | 2.8 | 2.2 | 6.0 |
| Corporates | 1.4 | 2.4 | 2.0 |
| Amortisation of short term debt | 17.2 | 16.6 | 23.0 |
| Government/central bank | 5.6 | 4.2 | 3.4 |
| Banks | 7.3 | 7.9 | 15.0 |
| Corporates | 4.3 | 4.5 | 4.6 |
| **Financing** | **25.1** | **25.2** | **31.9** |
| FDI | -0.4 | -1.0 | -0.4 |
| Equity | -2.4 | -1.0 | -1.0 |
| Long-term borrowing | 9.6 | 8.6 | 5.1 |
| Government/central bank | 5.8 | 4.4 | 2.0 |
| Banks | 2.5 | 1.9 | 1.2 |
| Corporates | 1.4 | 2.3 | 1.8 |
| Short-term borrowing | 16.6 | 15.5 | 13.2 |
| Government/central bank | 4.2 | 3.4 | 2.0 |
| Banks | 7.9 | 7.5 | 6.8 |
| Corporates | 4.5 | 4.6 | 4.4 |
| EU transfers | 3.6 | 3.2 | 2.5 |
| Change in FX reserves (reduction(+)/increase(-)) | -1.9 | -0.1 | 12.6 |

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

**Outlook** – Poland's growth could decelerate in 2H14 to 3% yoy from 3.4% yoy in 1H14 as the economy faces headwinds from events in Ukraine and trade sanctions between EU and Russia. Domestic demand will probably continue to rebound, with consumption supported by real wage growth and investment backed by lending and EU funds. Given growth headwinds and low inflation, the NBP could deliver two 25bp rate cuts in October and November. The 2014 budget deficit is lower due to higher revenues, but the fiscal impulse could increase in election year 2015.

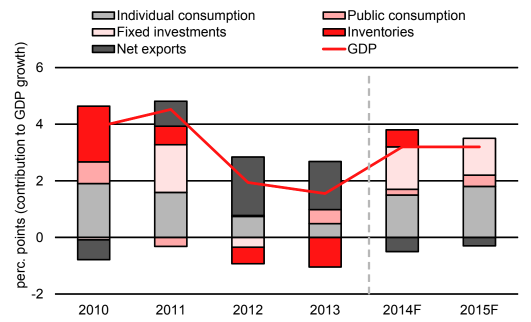
**Strategy** – The zloty trades weaker than fundamentals would suggest, with geopolitical risks and monetary easing adding to volatility. Rate cut expectations, steady risk appetite and the coverage of 2014 financing needs support POLGBs. We prefer 10Y POLGBs to 10Y bunds. We also like USD hard currency bonds from the 5y point of the curve onwards.

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

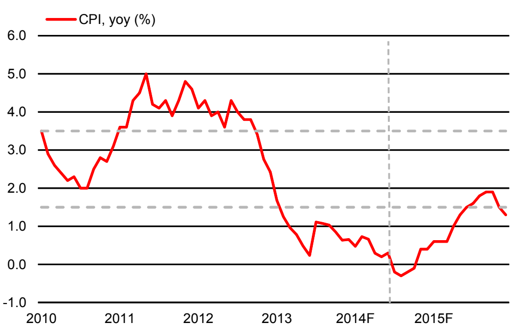
### KEY DATES/EVENTS

- MPC decision-making meetings 7-8 Oct, 4-5 Nov, 2-3 Dec
- NBP releases update to inflation projection: 5-7 Nov
- New Prime Minister to be sworn in by end-September, including re-shuffling of the Cabinet, as PM Tusk leaves for Brussels to become President of the European Council

### GDP COMPONENTS




### HEADLINE INFLATION VS. TARGET




Source: National Statistics Office, NBP, UniCredit Research

### MACROECONOMIC DATA AND FORECASTS

| | 2011 | 2012 | 2013 | 2014F | 2015F |
|---|---|---|---|---|---|
| GDP (EUR bn) | 370.9 | 381.5 | 389.5 | 406.1 | 427.7 |
| Population (mn) | 38.1 | 38.1 | 38.1 | 38.0 | 38.0 |
| GDP per capita (EUR) | 9,740 | 10,020 | 10,234 | 10,675 | 11,251 |
| **Real economy yoy (%)** | | | | | |
| GDP | 4.5 | 2.0 | 1.6 | 3.2 | 3.2 |
| Private Consumption | 2.6 | 1.3 | 0.8 | 2.5 | 2.9 |
| Fixed Investment | 8.5 | -1.6 | -0.2 | 8.1 | 6.9 |
| Public Consumption | -1.7 | 0.2 | 2.8 | 1.0 | 2.0 |
| Exports | 7.7 | 3.9 | 4.6 | 5.7 | 5.2 |
| Imports | 5.4 | -0.7 | 1.2 | 7.3 | 6.0 |
| Monthly wage, nominal (EUR) | 874 | 891 | 911 | 954 | 1,015 |
| Unemployment rate (%) | 12.4 | 12.8 | 13.5 | 12.5 | 12.0 |
| **Fiscal accounts (% of GDP)** | | | | | |
| Budget balance | -5.1 | -3.9 | -4.3 | 5.6 | -3.0 |
| Primary balance | -2.4 | -1.0 | -1.7 | 7.8 | -0.7 |
| Public debt | 56.2 | 55.5 | 57.0 | 49.6 | 50.7 |
| **External accounts** | | | | | |
| Current account balance (EUR bn) | -18.5 | -14.2 | -5.3 | -5.2 | -8.1 |
| Current account balance/GDP (%) | -5.0 | -3.7 | -1.4 | -1.3 | -1.9 |
| Basic balance/GDP (%) | -1.0 | -2.5 | -2.3 | 0.4 | 0.4 |
| Net FDI (EUR bn) | 14.9 | 4.8 | -4.6 | 7.0 | 10.0 |
| Net FDI (% of GDP) | 4.0 | 1.2 | -1.0 | 1.7 | 2.3 |
| Gross foreign debt (EUR bn) | 250.1 | 277.3 | 275.5 | 288.0 | 291.0 |
| Gross foreign debt (% of GDP) | 67.4 | 72.7 | 70.7 | 70.9 | 68.0 |
| Fx reserves (EUR bn) | 75.7 | 82.6 | 77.1 | 85.8 | 95.3 |
| **Inflation/Monetary/FX** | | | | | |
| CPI (pavg) | 4.3 | 3.7 | 0.9 | 0.4 | 1.1 |
| CPI (eop) | 4.6 | 2.4 | 0.7 | 0.4 | 1.3 |
| Central bank target | 2.5±1pp | 2.5±1pp | 2.5±1pp | 2.5±1pp | 2.5±1pp |
| Central bank reference rate (eop) | 4.50 | 4.25 | 2.50 | 2.00 | 2.00 |
| 3M money market rate | 4.54 | 4.91 | 3.02 | 2.60 | 2.35 |
| USD/PLN (eop) | 3.42 | 3.10 | 3.03 | 3.19 | 3.17 |
| EUR/PLN (eop) | 4.42 | 4.09 | 4.15 | 4.15 | 4.12 |
| USD/PLN (pavg) | 2.96 | 3.26 | 3.16 | 3.11 | 3.11 |
| EUR/PLN (pavg) | 4.12 | 4.19 | 4.20 | 4.17 | 4.10 |

Source: UniCredit Research

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

## Economy to feel headwinds from weaker external growth

**GDP growth could slow down to 3% yoy in 2H14 from 3.4% yoy in 1Q14 and at 3.3% yoy in 2Q14 in the face of external headwinds**

**We expect GDP to grow at around 3% yoy in 2H14, slightly weaker than the 3.4% yoy and 3.3% yoy seen in 1Q and 2Q, as the economy feels headwinds from weaker growth in the eurozone and the tensions in Ukraine.** Internally, the situation can be described as the early stages of recovery, fuelled by rising private consumption and investment. This picture will continue to be valid in the coming quarters, but external risks could overshadow the rebound of domestic demand. The conflict in Ukraine affected Polish trade, the trade surplus with Poland's Eastern neighbor falling by EUR 652mn in 1H14 (the largest bilateral trade deterioration). The negative impact is 0.2% of GDP when adding net trade with Turkey, which shrank by EUR 271mn in 1H14 Sanctions between Europe and Russia led to the latter banning some food imports from the EU. In 2013, Poland's food exports to Russia were 7.5% of total food exports and 0.3% of GDP. That said, in 7M14, the 10.5% yoy fall in exports to Russia was accompanied by a 4.3% yoy reduction of imports, so that the trade balance widened by just EUR 11.4mn, having an insignificant impact on GDP. While energy imports could rise seasonally in 2H14, the direct trade impact from sanctions could be limited by the higher-than-expected elasticity of Poland's non-energy imports from Russia. .

**We revised our GDP growth forecast to 3.2% in both 2014 and 2015, 0.1pp and 0.4pp lower than before**

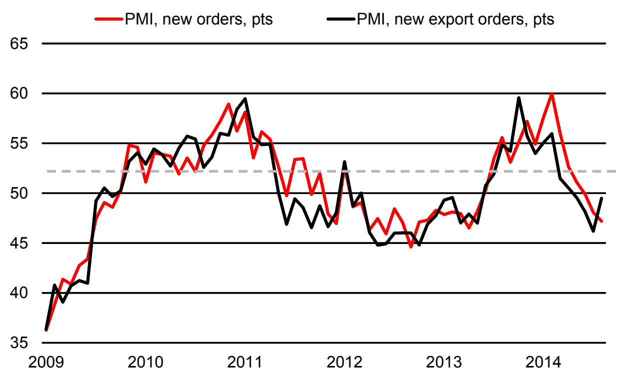
**Taking the external risks into consideration, we revised down our GDP forecasts to 3.2% yoy in 2014 (3.3% previously), and 2015 (vs. 3.6% previously).** We anticipate private consumption growth of 2.9% in 2015 (after 2.5% in 2014), fixed investment growth of 6.9% in 2015 (8.1%). As highlighted above, much will depend on external developments. Should the situation improve, domestic growth could be higher, as consumption only just began gaining momentum, and there's also room for stronger investments in the corporate sector, supported by fresh EU money propelling public sector investment growth.

**CPI is to stay negative till October, then rebound to 0.4% yoy at year-end and around 1.5% yoy in mid-2015**

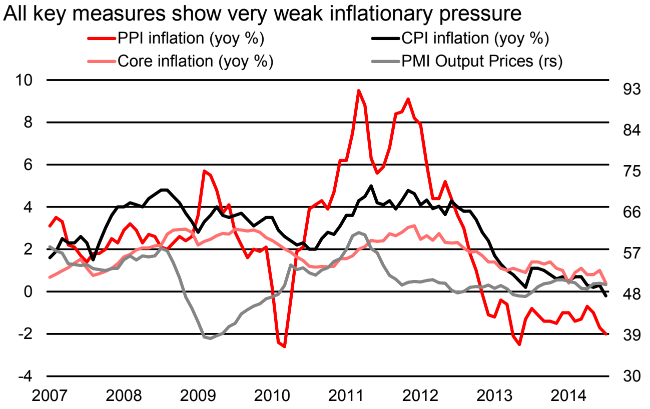
**CPI deflation might continue until October. A gradual rebound in headline inflation could see it at 0.4% yoy by year-end and close to 1.5-1.7% yoy by mid-2015.** Weak demand and supply-side shocks (bumper crops, the Russian embargo on food imports, falling fuel prices and stable commodity prices) pushed consumer price dynamics to all-time lows, but their effects are expected to peter out gradually. Very low producer price inflation[7] reflects underlying demand weakness that could disappear only at the end of next year, according to the NBP.

**RECENT DATAFLOW SUGGESTED WEAKENING GROWTH MOMENTUM AND DOWNWARD PRESSURE ON PRICES**

Fall of new orders was the main driver of PMI declines




All key measures show very weak inflationary pressure




Source: National Statistics Office, UniCredit Research

[7] PPI inflation has been negative since end-2012, with the July reading at -2.0% yoy.

**The MPC is likely to deliver two 25 bp rate cuts: one in October and another in November**

**Faced with lower-than expected inflation and growth risks, the Monetary Policy Council signaled the need for more rate cuts.** From mid-August onwards, comments from MPC members turned more dovish, indicating an increasing willingness to ease monetary policy. This was triggered by weak sentiment readings (PMI below 50 for a second month in a row), weak industrial output and retail sales data and CPI deflation, with more headwinds from Russia's ban on imports of fruits and vegetables from the EU. The press conference after the September MPC meeting reinforced the dovish stance, with- NBP President Belka stating that monetary easing is likely, that more than one cut is to be expected, and that the NBP "does not have to wait" for the November update to the inflation projection. In our view, this means two 25bp cuts by year-end: one in October and another in November.

**Pension funds (OFE) will maintain almost 30% of the previous level of funds inflow, much better than feared. The risk of complete marginalization of OFE was avoided**

**Open pension funds (OFE) will continue to receive almost 30% of the previous stream of fresh funds inflows from 15% of contributors[8].** This bodes well for the Polish equity market, where OFE have been one of the most important investors. The ratio of opt-ins surged in June-July and should be enough to prevent their total marginalization. After the government took over more than 50% of OFE's assets (mostly T-bonds) in February, people were expected to decide by end-July whether they want to continue to direct part of the previous stream of funds to OFE, or if all their pension savings should go to state-managed ZUS (ZUS being the default option).

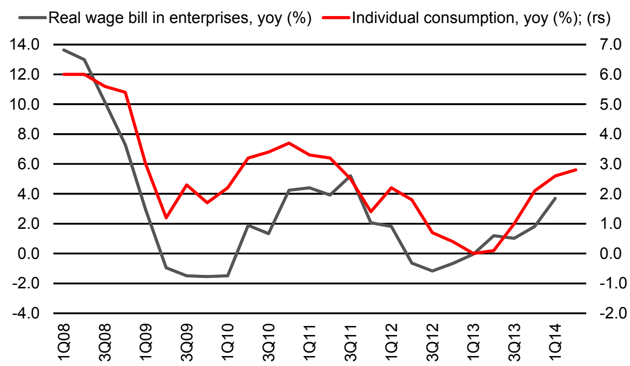
**The budget execution is better than forecasted. We continue to expect the deficit to be ca. PLN 10bn lower than the MF target of PLN 47.5bn for 2014…**

**…but the fiscal impulse might increase in 2015, ahead of general and presidential elections**

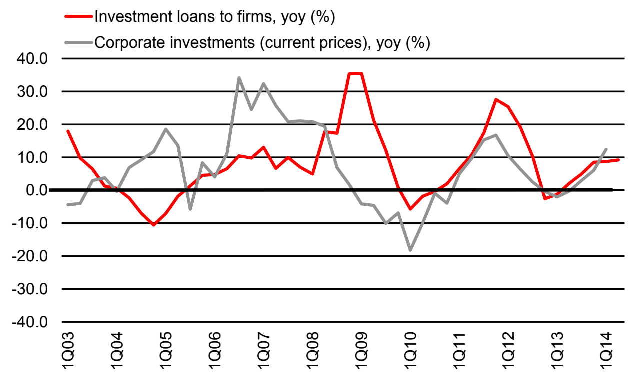
**The budget execution in 2014 is better than planned**. The recovery of domestic demand activated automatic stabilizers beyond official expectations. Tax revenues were PLN 5.2bn higher than anticipated in 1H14, with expenditures falling PLN 3.2bn short of plan. As a result, the state budget deficit amounted to PLN 25.3bn, i.e. 53.3% of the annual target of PLN 47.5bn, while the government envisaged the deficit at 71.0% of the plan. Even though we expect economic conditions to improve more slowly in the remainder of the year than in the first half, we still foresee the deficit to be at least PLN 10bn lower than the annual target. The fiscal impulse could increase next year. Despite mounting external risks, uncertainty surrounding 2015 GDP growth and the low inflation environment, the government aims for a generous indexation scheme and additional tax relief in 2015 in order to regain some public support ahead of general elections. While former PM Donald Tusk will move to the position of President of the European Council, the governing coalition is likely to remain in power until next year's parliamentary elections (expected in autumn), with new PM Ewa Kopacz not expected to change policy course.

**DOMESTIC DEMAND REMAINS ON A GROWTH PATH: BOTH PRIVATE CONSUMPTION AND INVESTMENT CONTINUE RISING**

Improvement in labor market leads improvement in consumption




Both corporate investments and demand for loans rebounded nicely




Source: National Statistics Office, UniCredit Research

8 Mostly high-earners opted to contribute to OFE, explaining the discrepancy between the percent of contributors and contributions.

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## Zloty under pressure from Ukraine, POLGB yields stable

**The PLN is trading at levels slightly weaker than what fundamentals would suggest, pressured by uncertainty over Ukraine**

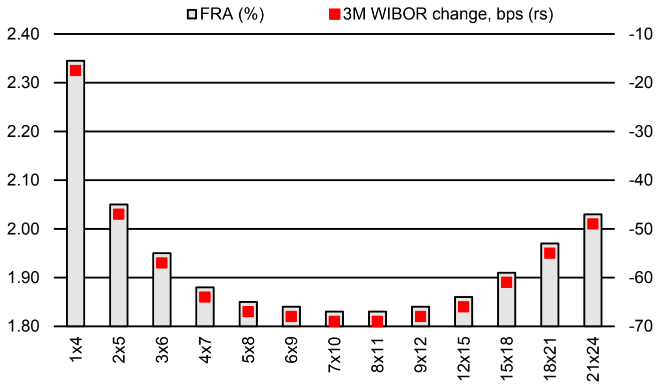
The zloty remains under pressure from developments in Ukraine and rising US yields. Based on fundamentals, we expect a lower EUR-PLN by year-end, but the Ukrainian factor plus domestic rate cuts may mean near-term volatility. Robust economic growth, a good budget performance and a high coverage of borrowing needs bode well for the currency. The C/A deficit is expected to stay below 2% of GDP, and will be covered by FDI and EU fund flows.

**Domestic yield curve will be well supported amid deflation and rate-cut expectations. However, fresh yield lows would require new impulses**

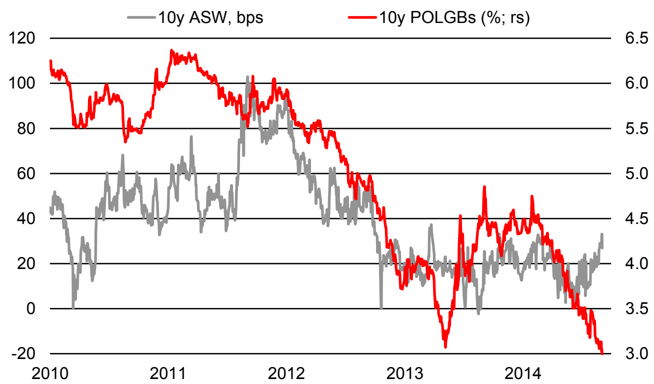
POLGB yields reached the lowest levels in history on dovish ECB policy and expectations for rate cuts in Poland, confirmed by MPC communication. FRAs priced in three cuts of 75bp in six months. However, the FI market would need additional impulses for yields to fall further. An ABS purchase program in the eurozone may be a supportive factor and help maintain market rates close to record-low levels in coming weeks.

We recommended a compression trade of long 10y POLGB vs. short 10y Bund position on 11 August when the spread was 241bps in anticipation of downward pressures on inflation and the likelihood of policy cuts ahead. Since inception the trade has seen spreads compress 29bps while the effective short EURPLN position on the trade is largely unchanged. We also see value in the USD hard currency curve from the 5y point of the curve onwards. We think the POLAND 24s offer particularly good risk adjusted value against the local equivalent from both a yield and z spread basis. They will also provide currency protection from the expected rate cuts and in the event of further USD strength.

FRAs priced in three rate cuts in the cycle




Asset swap spread widened at the long end of the curve




Source: Finance Ministry, NBP, UniCredit Research

### GOVERNMENT GROSS FINANCING REQUIREMENTS

| EUR bn | 2013 | 2014F | 2015F |
|---|---|---|---|
| **Gross financing requirement** | **40.8** | **28.5** | **39.1** |
| Budget deficit | 14.3 | 10.4 | 14.5 |
| Amortization of public debt | 26.5 | 18.1 | 24.6 |
| Domestic | 23.6 | 15.1 | 21.3 |
| Bonds | 20.2 | 15.1 | 21.3 |
| Bills | 3.4 | 0 | 0 |
| External | 2.9 | 3.0 | 3.3 |
| IMF/EU/IFIs | 0 | 0 | 0 |
| **Financing** | **40.8** | **28.5** | **39.1** |
| Domestic borrowing | 34.0 | 22.5 | 33.0 |
| Bonds | 34.9 | 24.8 | 34.2 |
| Bills | 2.0 | 0 | 0 |
| Other | -2.8 | -2.3 | -1.2 |
| External borrowing | 6.8 | 6.0 | 6.1 |
| Bonds | 2.0 | 3.4 | 5.5 |
| IMF/EU/WB | 0 | 0 | 0 |
| Other | 4.8 | 2.6 | 0.7 |

### GROSS EXTERNAL FINANCING REQUIREMENTS

| EUR bn | 2013 | 2014F | 2015F |
|---|---|---|---|
| **Gross financing requirement** | **71.2** | **71.8** | **66.5** |
| C/A deficit | 5.3 | 5.2 | 8.1 |
| Amortization of medium to long term debt | 16.2 | 16.3 | 12.5 |
| Government/central bank | 2.9 | 3.0 | 3.3 |
| Banks | 2.6 | 6.2 | 3.4 |
| Corporates | 10.7 | 7.1 | 5.8 |
| Amortization of short term debt | 49.7 | 50.2 | 45.9 |
| **Financing** | **71.2** | **71.8** | **66.5** |
| FDI | -0.9 | 3.5 | 4.0 |
| Equity | 0.4 | 0.8 | 1.0 |
| Borrowing | 71.7 | 63.3 | 57.3 |
| Government/central bank | 6.8 | 6.0 | 6.1 |
| Banks | 13.4 | 18.2 | 16.2 |
| Corporates | 51.5 | 39.1 | 35.0 |
| EU transfers | 9.9 | 11.8 | 12.0 |
| Other | -9.9 | -7.6 | -7.8 |

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

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

**Outlook** – 2014 will probably see GDP growth decelerate towards 2% if public policies are not changed. Fixed investment are unlikely to recover after a 11.2% yoy drop in 1H14 due to higher excise duties on fuels, new taxes on construction and green energy, low EU fund inflows and public investment. Industrial production faces mostly indirect risks (via the impact on EU) from EU and Russia bilateral sanctions. On a brighter note, RON lending is recovering, the NPL ratio is declining and rate cuts will continue, supporting ROMGBs.

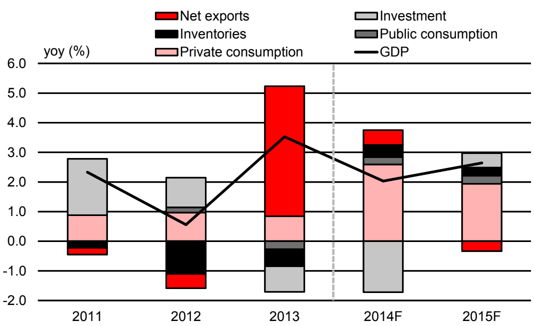
**Strategy** – A rangebound EUR-RON faces headwinds from a shrinking basic balance. ROMGB yields face limited pressure from new issuance, while there is still scope for the long end to rally due to more monetary easing.

**Authors: Dan Bucşa, Economist (UniCredit Bank London)**
**Cătălina Molnar, Chief Economist (UniCredit Ţiriac Bank)**

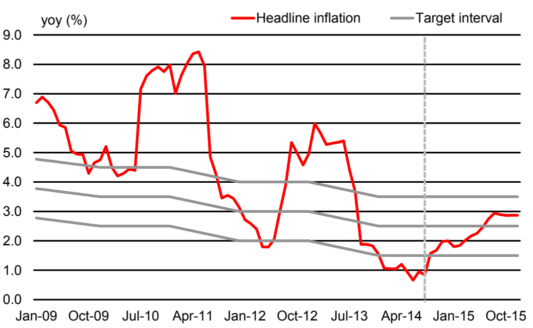
### KEY DATES/EVENTS

- 30 Sep, 4 Nov: NBR rate decisions
- 14 Nov, 3 Dec: 3Q GDP (flash estimates, structure)
- 2 and 16 Nov: Presidential elections

### GDP COMPONENTS




### INFLATION OUTLOOK




Source UniCredit Research, NBR, Statistical Office

### MACROECONOMIC DATA AND FORECASTS

| | 2011 | 2012 | 2013 | 2014F | 2015F |
|---|---|---|---|---|---|
| GDP (EUR bn) | 131.5 | 131.7 | 142.2 | 148.5 | 155.8 |
| Population (mn) | 21.4 | 21.4 | 21.3 | 21.3 | 21.3 |
| GDP per capita (EUR) | 6,146 | 6,153 | 6,678 | 6,973 | 7,315 |
| **Real economy yoy (%)** | | | | | |
| GDP | 2.3 | 0.6 | 3.5 | 2.0 | 2.6 |
| Private Consumption | 1.4 | 1.5 | 0.9 | 3.9 | 2.9 |
| Fixed Investment | 7.7 | 3.8 | -3.3 | -7.3 | 2.3 |
| Public Consumption | -3.0 | 0.7 | -1.7 | 1.2 | 1.8 |
| Exports | 11.6 | -1.5 | 13.5 | 9.4 | 5.5 |
| Imports | 10.5 | -0.2 | 2.4 | 8.1 | 6.2 |
| Monthly wage, nominal (EUR) | 479 | 479 | 507 | 529 | 554 |
| Unemployment rate (%) | 7.4 | 7.1 | 7.3 | 7.1 | 7.0 |
| **Fiscal accounts (% of GDP)** | | | | | |
| Budget balance | -5.6 | -2.9 | -2.3 | -2.2 | -2.7 |
| Primary balance | -4.1 | -1.1 | -0.6 | -0.6 | -1.2 |
| Public debt | 34.7 | 38.0 | 38.4 | 37.9 | 37.7 |
| **External accounts** | | | | | |
| Current account balance (EUR bn) | -5.9 | -5.8 | -1.5 | -2.2 | -3.1 |
| Current account balance/GDP (%) | -4.5 | -4.4 | -1.1 | -1.5 | -2.0 |
| Basic balance/GDP (%) | -3.1 | -3.1 | 0.8 | -0.1 | -0.6 |
| Net FDI (EUR bn) | 1.8 | 1.7 | 2.6 | 2.0 | 2.2 |
| Net FDI (% of GDP) | 1.4 | 1.3 | 1.9 | 1.3 | 1.4 |
| Gross foreign debt (EUR bn) | 98.7 | 99.7 | 96.1 | 91.7 | 89.2 |
| Gross foreign debt (% of GDP) | 75.0 | 75.7 | 67.5 | 61.7 | 57.2 |
| FX reserves (EUR bn) | 33.2 | 31.2 | 32.5 | 31.3 | 31.2 |
| **Inflation/Monetary/FX** | | | | | |
| CPI (pavg) | 5.8 | 3.3 | 4.0 | 1.3 | 2.5 |
| CPI (eop) | 3.1 | 5.0 | 1.6 | 2.0 | 2.9 |
| Central bank target | 3.0 | 3.0 | 2.5 | 2.5 | 2.5 |
| Central bank reference rate (eop) | 6.00 | 5.25 | 4.00 | 2.75 | 2.75 |
| 3M money market rate | 6.30 | 6.04 | 2.44 | 2.20 | 2.20 |
| USD/RON (eop) | 3.34 | 3.36 | 3.26 | 3.27 | 3.14 |
| EUR//RON (eop) | 4.32 | 4.43 | 4.48 | 4.45 | 4.40 |
| USD/RON (pavg) | 3.05 | 3.47 | 3.33 | 3.28 | 3.15 |
| EUR/RON (pavg) | 4.24 | 4.46 | 4.42 | 4.45 | 4.42 |

Source: UniCredit Research

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

## The growth – public policy nexus

**Growth slowed down to just 1.2% yoy in 2Q14…**

**…as base effects from agriculture and FDI faded…**

**…and tax changes affected investment and the absorption of EU funds**

**Private consumption was more resilient…**

**…but the value added in industry slowed down…**

**…and could face headwinds due to the Ukrainian crisis**

Romania's poor growth numbers are the result of persistently weak fixed investment and public policies. While we expected the Romanian economy to slow down in 2014, the speed of adjustment took us by surprise: annual growth fell to 1.2% yoy in 2Q14 and will struggle to close the year above 2% yoy. Once the impact of positive base effects faded away (2013's bumper harvest and new production capacities in industry), the lack of structural growth drivers pushed the economy back into technical recession. Moreover, public policies affected growth in 1H14 through a mix of makeshift tax changes that ultimately hide a lack of much-needed progress on improving tax collection. Among them were a hike of fuel excise duties in April that backfired[9], the so-called "pillar tax" on construction (other than buildings) that belong to companies and lower subsidies for green energy projects. The latter two measures, combined with very little new public investment projects and dismal EU fund absorption[10] led to a massive drop in fixed investment (-11.2% yoy in 1H14) that bodes ill for future growth. On a positive note, private consumption grew 4.4% yoy in 1H14 amid 4.3% yoy real wage growth, but both could slow down as inflation picks up. Even more worrying, the value added in industry grew by just 2.1% yoy in 2Q14 and faces headwinds from external demand amid an expected slowdown in Europe. The direct impact of the conflicts in Ukraine and the Middle East has been -0.02% of GDP in 1H14, but the indirect impact via the EU (the recipient of 72% of Romania's exports) could be much stronger. Higher exports of services and food could mitigate part of the weakness in industry, but remain too small to drive a recovery.

**The public policy mix is unlikely to change before presidential elections…**

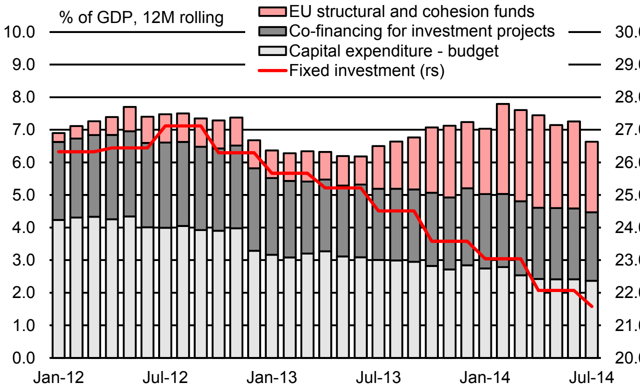
**…with limited fiscal scope at central government level…**

**…and further reforms needed on the structure of public spending and tax collection**

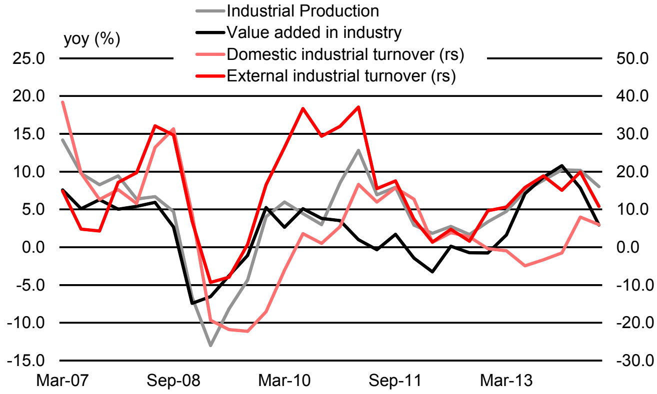
Going forward, the public policy mix needs to be changed for domestic demand to recover, but this is unlikely before November's presidential elections. The budget deficit was just 0.2% of GDP in 7M14 compared to an annual target of 2.2% of GDP, but this probably hides significant spending at the level of local administrations that could show up in the deficit number in 4Q14, reducing the scope for a significant fiscal impulse from central government spending[11]. Nevertheless, the additional spending recorded in 4Q14 should improve domestic demand numbers. The two trends that need reversing are the crowding out of public investment and EU fund co-financing by other types of spending[12] and the deterioration of tax collection, which impacts the need to reduce labour taxation. The proposed 5pp cut to social security contributions is welcome[13], but needs to be mitigated by other measures to avoid a widening of the budget deficit to 2.6% of GDP in 2015.

**INVESTMENT CONTINUES TO SHRINK, WHILE WEAKER EXTERNAL DEMAND AFFECTS INDUSTRY**

EU fund inflows offset lower public investment, but are decelerating




The slowdown in industry is driven by external turnover




Source: Ministry of Finance, Ministry for EU funds, StatOffice, UniCredit Research

[9] The growth rate of revenues from excise duties fell to 8.5% yoy in 2Q14 from 14.0% yoy in 1Q14, as large transporters chose to buy fuels abroad.
[10] Just EUR 0.5bn or 0.3% of GDP between April and August 2014 after EUR 1.4bn in 1Q14.
[11] 2014 is an election year, EU parliament elections in May and presidential elections in November.
[12] Especially a worrying reversal of past pension and revenue reforms done under IMF and World Bank supervision.
[13] The ratio of labour costs to net wage is 1.8, the fifth-highest in the EU.

**Replacing the flat personal income tax would plunge the economy back into recession**

Replacing the 16% flat tax with a progressive tax system is a bad option for cost competitiveness, short term[14] and potential growth. Reforming the tax collection framework and pursuing large corporate tax evaders is the way forward. Hoping for an improvement, we pencil in growth at 2.6% yoy in 2015 and 3.0% yoy in 2016, but downside risks are high.

**Positive developments in the banking system: Romania will join the banking union…**

**…and the NBR allows banks to write off bad loans**

The banking sector remains a drag on growth, but recent events are a step in the right direction. Romania wants to join the European banking union by 4Q16, providing an extra cushion for a system where foreign ownership exceeds 80%. The NBR recently allowed banks to write off bad loans if those are fully provisioned. Hence, the NPL ratio improved from 20.5% in April to 17.7% in July that is expected to continue, although the gap to Poland and the Czech Republic remains large. The deleveraging process is expected to continue, albeit at a slower pace, meaning that the credit impulse will turn growth-supportive from 2015.

**Monetary policy will remain lax…**

**…as long as there is no pressure on the RON…**

**…with a positive impact on RON lending**

The central bank has pursued laxer policies in 2014, cutting the key rate by 0.75pp to 3.25%. 50bp more could follow by the end of the year, bringing the policy rate closer to market rates. Excess liquidity persists, keeping money market and swap rates below the policy rate for tenors up to one year. The situation will last as long as EUR-RON remains below 4.50. With inflation set to return inside the target interval of 1.5-3.5% in 1Q15, the scope for more aggressive rate cuts is limited. Moreover, the central bank should not try to offset the lack of growth-conducive fiscal policies with more monetary easing. Due to interest rates falling in line with laxer monetary conditions, RON lending resumed at a brisk pace (+8.6% yoy in July 2014), but is still offset by deleveraging on FX lending. FX loans represented 57.5% of total private sector lending in July 2014 (-4.8pp yoy). Risks of negative balance sheet and wealth effects from RON volatility reinforce the NBR's bias against depreciation.

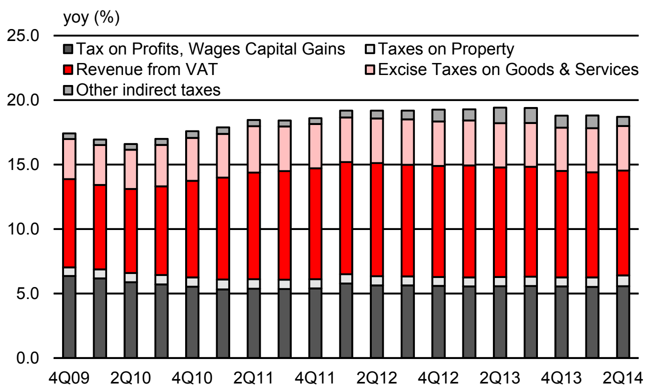
**The basic balance cushion of the RON is shrinking…**

**…and could fail to cover bank deleveraging if EU fund absorption does not resume**

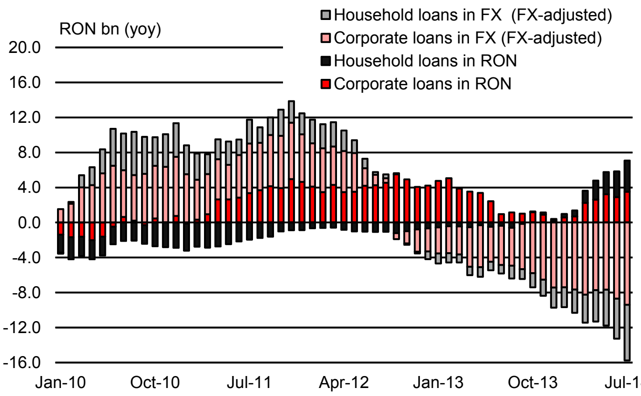
**Steady demand for ROMGBs is helping the currency**

In 1H14, the RON was cushioned by a positive extended basic balance (C/A + FDI + EU funds) that exceeded bank deleveraging. But the 12M-rolling difference between the two aggregates fell from EUR 2.6bn in April to EUR 1.5bn (1% of GDP) in June, mainly due to a halt in EU fund outlays. Hence, EU fund and FDI inflows could fail to cover bank deleveraging (expected at EUR 2.6bn in 2014 vs. EUR 3.2bn in 2013) and the C/A deficit in 2014, requiring the depletion of FX reserve (done already this year via cuts in reserve requirements). Steady portfolio inflows due to stable demand for ROMGBs are RON-supportive. A gradual shift from US to European investors and a constant proportion of foreign ownership[15] bode well for future issuance, as do MinFin reserves of approx. EUR 6bn and manageable financing needs in years to come.

Tax collection is worsening, especially for indirect taxes




RON lending is recovering, but is offset by EUR deleveraging




Source: MinFin, StatOffice, NBR, UniCredit Research

[14] The short term effects would be significant: the personal income tax would increase for high earners, i.e., those who account for the largest part of fiscalized consumption, despite most of them facing negative equity from mortgage loans taken before the financial crisis. The negative revenue shock would trigger a reduction of consumption, higher tax evasion and higher NPLs, eventually plunging the economy into recession.
[15] The foreign ownership of ROMGBs hovers at 20% of the outstanding, remaining low by regional standards and suggesting that the market is not overweight ROMGBs.

## Long-end ROMGBs still favoured

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**We recommend long end ROMGBs as we think the rate cutting cycle has not ended and…**

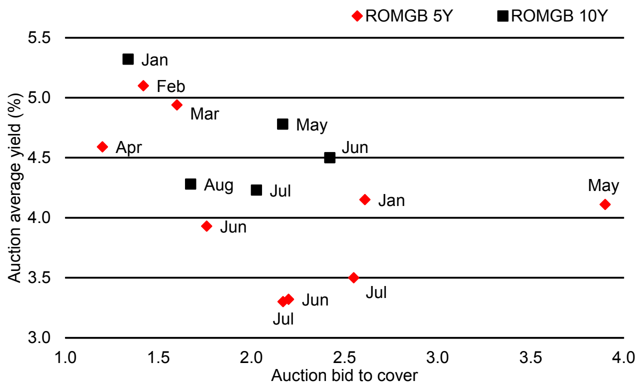
**…disinflationary pressures and low growth will put pressure on the NBR to cut…**

**…but there are risks, but we continue to see good support from the market for ROMGBs**

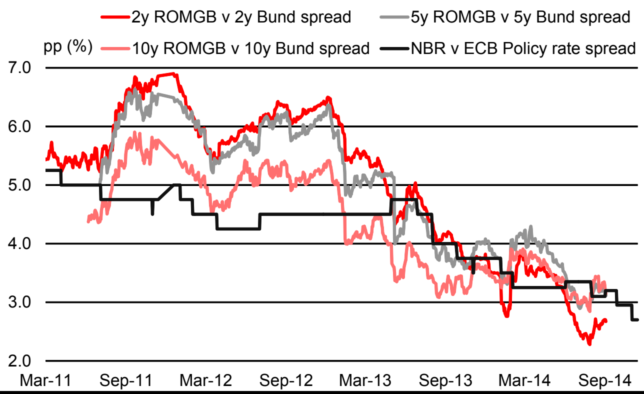
We recommend an overweight allocation to long-end ROMGBs, as we believe that the rate cutting cycle will continue and the NBR retains a preference for lax monetary conditions in the short term. Additional support comes from low financing needs, high reserves, local buyers (pension funds) of the long end and high yields relative to the rest of CEE. Yields declined by 124bp on average and the bid to cover ratio rose since the start of the year.

Although spreads versus Bunds are at the tightest levels in four years – and tightened more than for POLGBs and HGBs – more policy easing should benefit long-end ROMGBs. Risks come from a withdrawal of excess liquidity from the banking system if EUR-RON exceeds 4.50 and from a risk-off environment that would affect CEE markets. In hard currency bonds we see value in the ROMANI 44s yielding 5.00%. The USD issues yield in most cases 40bps below the local curve and, although they will be more stable in the event of higher US treasury yields, we think the local curve will rally more if the NBR cuts rates. We believe that EUR-based investors should remain in the local curve and USD-based investors should look to switch to long-end USD bonds when the yield differential narrows.

Strong auction support; yields declining and high bid to cover ratio




Spreads against Bunds suggest that 10Y ROMGB should tighten further if cuts materialize




Source: NBR, MinFin, Bloomberg, UniCredit Research

### GOVERNMENT GROSS FINANCING REQUIREMENTS

| EUR bn | 2013 | 2014F | 2015F |
|---|---|---|---|
| **Gross financing requirement** | **15.6** | **13.3** | **14.1** |
| Budget deficit | 3.6 | 3.2 | 4.2 |
| Amortisation of public debt | 12.1 | 10.1 | 9.9 |
| Domestic | 10.9 | 8.9 | 7.0 |
| Bonds | 4.5 | 6.3 | 4.2 |
| Bills | 6.1 | 2.2 | 2.5 |
| Loans | 0.4 | 0.4 | 0.3 |
| External | 1.1 | 1.2 | 2.9 |
| Bonds and loans | 0.2 | 0.2 | 1.2 |
| IMF/EU/IFIs | 0.9 | 1.0 | 1.7 |
| **Financing** | **16.2** | **13.6** | **14.1** |
| Domestic borrowing | 12.6 | 10.6 | 11.3 |
| Bonds | 10.0 | 7.8 | 8.2 |
| Bills | 2.3 | 2.5 | 2.7 |
| Loans | 0.4 | 0.4 | 0.4 |
| External borrowing | 3.6 | 3.0 | 2.8 |
| Bonds | 2.7 | 2.4 | 2.7 |
| IMF/EU/WB | 0.7 | 0.6 | 0.1 |
| Other | 0.2 | 0 | 0 |

### GROSS EXTERNAL FINANCING REQUIREMENTS

| EUR bn | 2013 | 2014F | 2015F |
|---|---|---|---|
| **Gross financing requirement** | **39.7** | **38.6** | **36.9** |
| C/A deficit | 1.5 | 2.2 | 3.1 |
| Amortisation of medium to long term debt | 17.3 | 17.3 | 16.4 |
| Government/central bank | 4.7 | 5.2 | 4.7 |
| Banks | 5.5 | 5.3 | 4.9 |
| Corporates | 7.0 | 6.8 | 6.8 |
| Amortisation of short term debt | 20.9 | 19.1 | 17.4 |
| Government/central bank | 1.2 | 0.4 | 0.4 |
| Banks | 5.3 | 4.8 | 3.0 |
| Corporates | 14.4 | 13.9 | 14.0 |
| **Financing** | **39.7** | **38.6** | **36.9** |
| FDI | 2.6 | 2.0 | 2.2 |
| Equity | 0.6 | 0.3 | 0.1 |
| Borrowing | 35.0 | 32.0 | 31.2 |
| Government/central bank | 6.1 | 4.5 | 4.4 |
| Banks | 7.6 | 7.5 | 6.8 |
| Corporates | 21.3 | 20.0 | 20.0 |
| EU Funds - capital transfers | 3.1 | 3.0 | 3.3 |
| Change in FX reserves (reduction(+)/increase(-)) | -1.6 | 1.3 | 0.1 |

Source: NBR, MinFIn, UniCredit Research

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

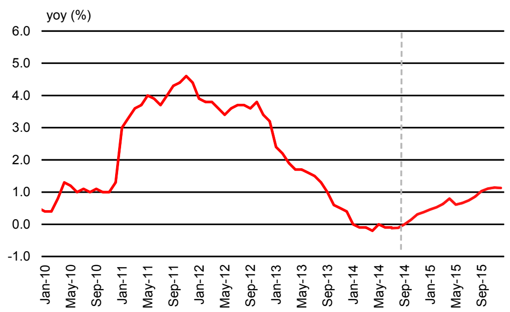
**Outlook** – Economic growth is expected at 2.2% in 2014 and 2.5% in 2015, driven mainly by recovering domestic demand supported by low inflation and an improving labor market. Approved sanction on exports to Russia will have a relatively small direct impact on Slovakia's economy, but worsening sentiment will influence growth dynamics negatively. The foreign trade surplus should narrow due to accelerating imports, but will still remain a key driver of the C/A surplus. Public debt broke two thresholds within the debt brake in 2013, resulting in a freeze of government expenditures for this and next year, although low inflation makes this measure less painful. This should be enough to keep the deficit safely below 3% GDP in the next few years.

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

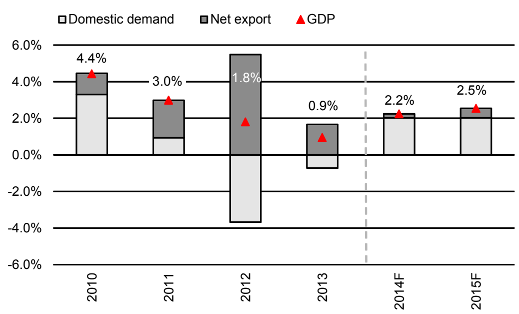
**KEY DATES/EVENTS**

- 10 Oct, 10 Nov, 10 Dec – Industrial production
- 13 Oct, 12 Nov, 12 Dec – CPI
- 14 Nov – flash 2Q GDP
- 3 Dec – GDP and its structure

**A SHORT PERIOD OF NEGATIVE INFLATION**




**GDP DRIVEN BY DOMESTIC AND EXTERNAL DEMAND**




Source: Statistical Office SR, UniCredit Research

**MACROECONOMIC DATA AND FORECASTS**

| | 2011 | 2012 | 2013 | 2014F | 2015F |
|---|---|---|---|---|---|
| GDP (EUR bn) | 69.0 | 71.1 | 72.1 | 73.3 | 75.0 |
| Population (mn) | 5.4 | 5.4 | 5.4 | 5.4 | 5.4 |
| GDP per capita (EUR) | 12,777 | 13,147 | 13,325 | 13,545 | 13,854 |
| **Real economy yoy (%)** | | | | | |
| GDP | 3.0 | 1.8 | 0.9 | 2.2 | 2.5 |
| Private Consumption | -0.5 | -0.2 | -0.1 | 2.6 | 1.9 |
| Fixed Investment | 14.2 | -10.5 | -4.3 | 2.8 | 2.9 |
| Public Consumption | -4.3 | -1.1 | 1.4 | 1.1 | 0.0 |
| Exports | 12.2 | 9.9 | 4.5 | 4.3 | 4.4 |
| Imports | 9.7 | 3.3 | 2.9 | 4.7 | 4.5 |
| Monthly wage, nominal (EUR) | 786 | 805 | 824 | 845 | 861 |
| Unemployment rate (%) | 13.5 | 14.0 | 14.2 | 13.9 | 13.9 |
| **Fiscal accounts (% of GDP)** | | | | | |
| Budget balance | -4.8 | -4.5 | -2.8 | -2.6 | -2.5 |
| Primary balance | -3.2 | -2.7 | -0.8 | -1.1 | -0.9 |
| Public debt | 43.7 | 52.7 | 55.4 | 56.9 | 57.9 |
| **External accounts** | | | | | |
| Current account balance (EUR bn) | -1.4 | 1.6 | 1.5 | 1.2 | 0.7 |
| Current account balance/GDP (%) | -2.1 | 2.3 | 2.1 | 1.7 | 1.0 |
| Basic balance/GDP (%) | 0.2 | 5.4 | 2.8 | 3.2 | 2.5 |
| Net FDI (EUR bn) | 1.5 | 2.2 | 0.4 | 1.1 | 1.1 |
| Net FDI (% of GDP) | 2.2 | 3.1 | 0.6 | 1.5 | 1.5 |
| Gross foreign debt (EUR bn) | 52.9 | 53.8 | 59.7 | 61.3 | 63.2 |
| Gross foreign debt (% of GDP) | 76.7 | 75.6 | 82.7 | 83.6 | 84.3 |
| **Inflation/Monetary/FX** | | | | | |
| CPI (pavg) | 3.9 | 3.6 | 1.4 | 0 | 0.8 |
| CPI (eop) | 4.4 | 3.2 | 0.4 | 0.4 | 1.1 |
| Central bank reference rate (eop) | EUR | EUR | EUR | EUR | EUR |
| 3M money market rate | EUR | EUR | EUR | EUR | EUR |
| EUR/USD (eop) | EUR | EUR | EUR | EUR | EUR |
| EUR/EUR (pavg) | EUR | EUR | EUR | EUR | EUR |

Source: UniCredit Research

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

## Economy boosted by recovering domestic demand

**Economic growth expected to be driven mainly by domestic demand**

GDP is projected to rise 2.2% in 2014 (from 3.0% in the previous forecast) and 2.5% (from 3.5% previously) in 2015, while growth is expected to be driven mostly by domestic demand boosted by zero inflation and pre-election spending. Economic growth was in line with market expectations in 2Q14, at 0.6% qoq SA/2.5% yoy. As expected, the trends from the previous quarters were confirmed: GDP growth was driven mostly by rebounding domestic demand (mainly household consumption), while the contribution of net exports turned negative for the first time since 2Q11 due to weakening external demand and rising imports driven by domestic consumption. The direct impact of Russian sanctions on the Slovakian economy will be relatively small, but we expect a deceleration of GDP growth in 2H14 as a result of worsening business and consumer sentiment, pushed down by rising uncertainty in the economy due to escalating Ukraine tensions and a potential slowdown in the eurozone.

**Labor market to support household spending**

Labor market conditions improved in 1H14, employment growing by 2.3% yoy and real wage growth exceeding 4% yoy in industry and services. However, rising uncertainty could postpone new hires and we expect flat employment from here, while the unemployment rate is projected to stabilize just below 14%. In recent quarters, wage growth has exceeded significantly labor productivity growth, an unusual situation for the Slovakian economy in the past. Thus, the widening gap between wages and labor productivity is gradually closing and unit labour costs are rising. We expect a correction in these dynamics in coming quarters, but nominal wage growth will probably still exceed labor productivity growth. Real wage growth is supported by low inflation, boosting household consumption.

**The economy remains in deflation, but could return to positive inflation by year-end**

Deflation persisted in 2Q14 (-0.1% yoy), resulting from a decline in regulated energy prices and food prices, while demand-pull inflation remained subdued. We expect a return to small positive inflation in the coming months, driven by base effects, while inflation is expected to remain subdued in 2015 due to low food prices and a further decline in regulated prices as a result of the election campaign – the prime minister already pre-announced cuts in gas prices for households and free railway tickets for students and pensioners. The economy is also suffering huge price pressure in the manufacturing sector. Producer prices, both domestic and export-related, showed a significant decline in recent months (-2.8% yoy and -3.3% yoy respectively in July 2014) and we expect pressure on producers' margins to continue in coming quarters due to weaker currencies in neighboring countries (mainly CZK) and potential negative effects on the situation in Ukraine on demand from the eurozone.

**Debt brake activated, budget expenditures to be frozen in 2014 and 2015**

The government could increase its efforts in the area of soft measures (improvement of business environment) to support economic growth rather than promote fiscal easing as the debt brake was activated requiring the 2015 budget proposal to freeze adjusted expenditures at the current level. Low inflation makes it easier, although it also reduces nominal revenue growth. We think that public debt will remain below the next threshold (57% of GDP) this year. The risk of exceeding the threshold increases next year but is neutralized by general elections in 2016, as it provides the new government with a two-year holiday from the debt brake. Nevertheless, the government will most likely try to minimize cash reserves at the end of the year to avoid repeating last year's overshoot. A buy-back of more than EUR 3bn of bonds due in January 2015 will also help to reduce debt stocks (EUR 48mn was bought so far). The debt agency issued EUR 4.1bn of new bonds (including syndicate and private placement) in the first eight months of the year, covering 55% of 2014 financing needs.

**Polls suggest declining support for ruling Social Democrats**

2015 will be a pre-election year, with general elections scheduled for spring 2016. Any unpopular measures will be most likely postponed. Polls suggest that the ruling Social Democrats keep their leading position, but with weakening support, while the right-wing opposition is fragmented with several parties just on the edge of the 5% needed to enter Parliament.

# Slovenia (Ba1 stable/A- negative/ BBB+ stable)*

**Outlook** – Slovenia posted strong real GDP gains in 1H14, but this is at risk of flattening out in 2H14 due to weaker EMU growth. Despite this, we expect net exports and GFCF to remain strong and lift growth this year to 1.4% yoy. Domestic consumption however will remain weak and is not expected to recover until 2015. Politically, the SMC agreed to form a left-wing coalition government with the SD and DeSUS, but in our view this risks a watering down in the depth and pace of structural reforms. More positively though, the privatization programme has resumed and should continue as planned helping to limit contingent liabilities in the future.

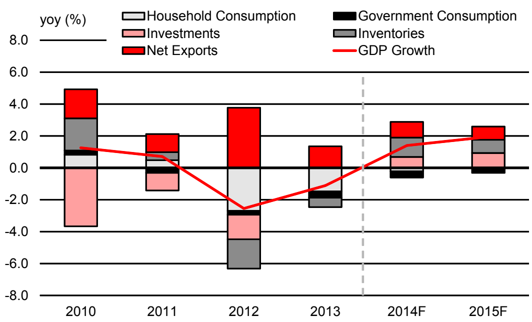
**Strategy** – Improved debt service-ability combined with an expected increased liquidity in the euro area via the ECB should see the Slovenia curve tighten further. We think hard currency USD bonds offer better value than local currency paper.

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

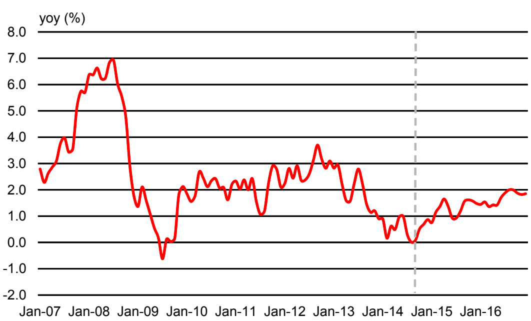
### KEY DATES/EVENTS

- 30 Sep, 30 Oct, 28 Nov – Consumer Price Index
- 30 Sep, 30 Oct, 28 Nov – Retail Sales
- 10 Oct, 7 Nov, 10 Dec – Trade Balance
- 10 Oct, 10 Nov, 10 Dec – Industrial Production
- 28 Nov – 3Q14 GDP (Prelim)

### GDP DRIVERS




### INFLATION OUTLOOK




Source: NBS, MinFIn, Unicredit Research

### MACROECONOMIC DATA AND FORECASTS

| | 2011 | 2012 | 2013 | 2014F | 2015F |
|---|---|---|---|---|---|
| GDP (EUR bn) | 36.2 | 35.3 | 35.3 | 36.1 | 37.3 |
| Population (mn) | 2.1 | 2.1 | 2.1 | 2.1 | 2.1 |
| GDP per capita (EUR) | 17,610 | 17,183 | 17,124 | 17,442 | 17,997 |
| **Real economy yoy (%)** | | | | | |
| GDP | 0.7 | -2.5 | -1.1 | 1.4 | 1.9 |
| Private Consumption | 0.8 | -4.8 | -2.7 | -0.4 | 0.1 |
| Fixed Investment | -5.5 | -8.2 | 0.2 | 3.8 | 4.9 |
| Public Consumption | -1.6 | -1.3 | -2.0 | -2.0 | -1.6 |
| Exports | 7.0 | 0.6 | 2.9 | 4.1 | 4.2 |
| Imports | 5.6 | -4.7 | 1.3 | 3.2 | 3.6 |
| Monthly wage, nominal (EUR) | 1,525 | 1,526 | 1,523 | 1,546 | 1,554 |
| Unemployment rate (%) | 8.2 | 8.9 | 10.1 | 10.0 | 9.8 |
| **Fiscal accounts (% of GDP)** | | | | | |
| Budget balance | -6.4 | -4.0 | -14.7 | -3.3 | -3.4 |
| Primary balance | -4.5 | -1.9 | -12.1 | 0 | -0.3 |
| Public debt | 47.1 | 54.4 | 71.7 | 75.5 | 76.6 |
| **External accounts** | | | | | |
| Current account balance (EUR bn) | 0.1 | 1.0 | 2.1 | 1.8 | 2.4 |
| Current account balance/GDP (%) | 0.4 | 2.9 | 6.0 | 5.1 | 6.5 |
| Basic balance/GDP (%) | 2.2 | 3.4 | 4.3 | 9.7 | 9.9 |
| Net FDI (EUR bn) | 0.6 | 0.2 | -0.6 | 1.6 | 1.3 |
| Net FDI (% of GDP) | 1.8 | 0.5 | -1.7 | 4.6 | 3.5 |
| Gross foreign debt (EUR bn) | 40.1 | 41.3 | 39.9 | 41.5 | 43.5 |
| Gross foreign debt (% of GDP) | 110.9 | 116.8 | 113.2 | 114.9 | 116.7 |
| **Inflation/Monetary/FX** | | | | | |
| HICP (pavg) | 2.1 | 2.8 | 1.9 | 0.6 | 1.5 |
| HICP (eop) | 2.1 | 3.1 | 1.1 | 1.1 | 1.5 |
| EURIBOR 3M | EUR | EUR | EUR | EUR | EUR |
| EUR/USD (eop) | EUR | EUR | EUR | EUR | EUR |
| EUR/USD (pavg) | EUR | EUR | EUR | EUR | EUR |

Source: Unicredit Research

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

## An encouraging outlook

**GDP growth surprised to the upside in 2Q14 due to stronger domestic demand…**

**Slovenia enjoyed strong broad-based growth in 1H14**, which is expected to flatten in the second half of the year on the back of weaker EMU growth. GDP growth accelerated strongly to 2.9% yoy in 2Q14 from 2.1% yoy in 1Q14. GDP growth in 1H14 thus stood at 2.5% yoy, the strongest since 1H08. Net exports added 1.8pp to 2Q14 GDP growth. But domestic demand was also supportive (+1.1pp), accelerating from 1Q14 (from 0.8% yoy to 1.4% yoy) due to GFCF (+5.5% yoy) and inventories, reflecting a positive change in investment sentiment. This was also reflected in July IP, up 7.8% yoy (from 4.4% yoy in 2Q14). That said, domestic consumption started to contract again (-0.3% yoy) on the back of weak government expenditure (-1.9% yoy). A hike in excise taxes last May and caps to public sector wages and pensions kept private consumption growth at just 0.2%.

**…forcing us to raise our GDP growth forecasts to 1.4% in 2014 and to 1.9% in 2015**

**In view of the above, we have revised our GDP growth forecasts up to 1.4% yoy in 2014 (+1pp) and 1.9% in 2015 (+0.4pp).** Our revision mainly responds to the strong rebalancing in domestic demand seen in 1H14, particularly private consumption, which turned positive after nine quarters of continuous contraction. That said, consumption is expected to remain weak (FY14: -0.4% yoy) but to recover slightly in 2015, since it will remain constrained by weak net income growth, tight credit conditions and a sluggish labor market. While the 2015 budget still has to be agreed on, additional expenditure cuts lie ahead and are expected to keep government consumption subdued until end-2015. We have revised downwards our export growth numbers for 2H14 and 2015 due to a weaker EMU, most importantly due to the slowdown in Germany and Italy, which remain Slovenia's main trading partners. Trade sanctions involving Russia will also play a role, albeit less pronounced, since they only represent 4% of Slovenian exports (vs. 58% to the eurozone).

**Inflation to remain tame due to base effects and low food inflation pressures**

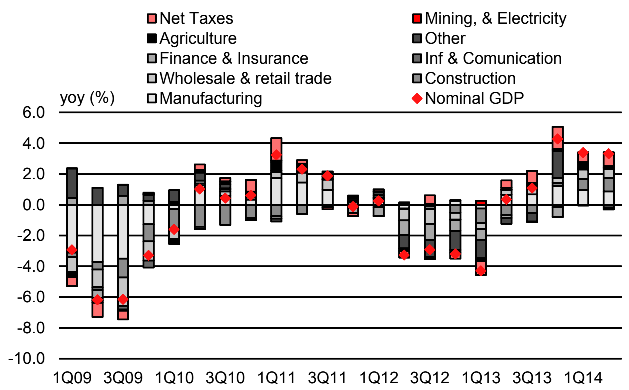
**Inflation remains weak,** in line with that observed in other eurozone and Central European countries. In August, harmonized CPI inflation remained flat, from 0.3% in July. Year-to-date, it is up 0.5% yoy, but should accelerate from here on the back of the seasonality-driven increase in clothing and footwear prices. That said, it will remain tame (FY14: 0.6% yoy), due to the high base from last year and slowdown in the eurozone. The Russian food embargo will also keep food and headline inflation down, given its strong weight in the HICP basket (ca. 17%).

**The SMC opted for a left-leaning government coalition with the SD and DeSUS…**

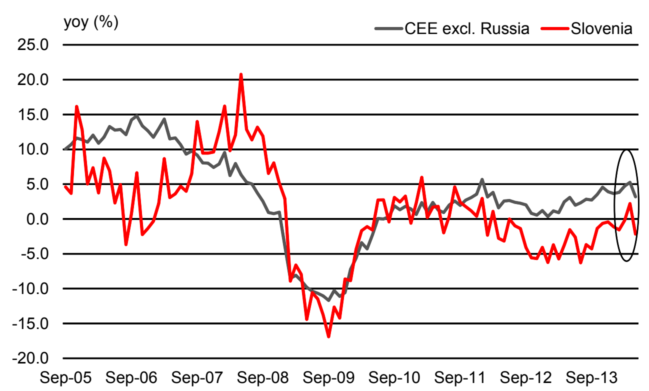
**On the political front, the SMC agreed to form a coalition government with DeSUS and the SD on 3 September**. The decision was expected, since SMC-head Miro Cerar had long supported an ample left-wing coalition. Alenka Bratusek's Party (ZAB) was left out due to misunderstandings related to her nomination for EU commissioner. The SMC-DeSUS-SD coalition has 52 seats in Parliament, above the required majority (46/90). The new Cabinet will consist of 16 ministries, and is expected to be approved by Parliament on 18 September.

**RECOVERY SUPPORTED BY IMPROVING DOMESTIC DEMAND**

Manufacturing and construction activity are leading the recovery…




...but retail activity will remain subdued due to weak consumption




Source: National Bank of Slovenia, MinFin, Haver, UniCredit Research

**…but this risks giving the leftist-oriented coalition partners excessive power and watering down structural reforms**

**The ideological leaning of the coalition parties bodes well for government stability, but risks moderating the pace and depth of reforms.** ZAB would have provided a much-needed pro-reform counterbalance to the leftist DeSUS-SD camp and especially to the populist Pensioner's Party (DeSUS). The coalition agreement hints at the government's preference for state control, with the privatization program continuing only 'if it preserves and creates news jobs and generates growth for privatized companies'. This is a big IF in our view, giving the government room to veto any future enlargement of the program. On a more positive note, the program continues to cap social transfers (incl. pensions) and public sector wages, while it does not rule out the re-introduction of the real estate tax.

**The privatization program is expected to continue in 4Q14 and 2015…**

**The privatization process is advancing as planned**, after the Constitutional Court rejected the decision by outgoing PM Bratusek to freeze the program early in July. Since then, the State Holding Company (SDH) has sold Aerodrom Ljubljana to German airport operator Fraport for EUR 117mn, and initiated the second phase of the sale process of NKBM. The privatization of Telekom Slovenije was put on hold, but is expected to resume as soon as the new government takes office in late September. It remains to be seen, however, whether the new Cabinet will divide the telecom's activity into two parts (infrastructure and services) to privatize only the latter. This option is certainly unwelcomed as it will reduce significantly the sale price of the telecom and jeopardize significantly the credibility of the new government.

**…and help reduce SOE contingent payments**

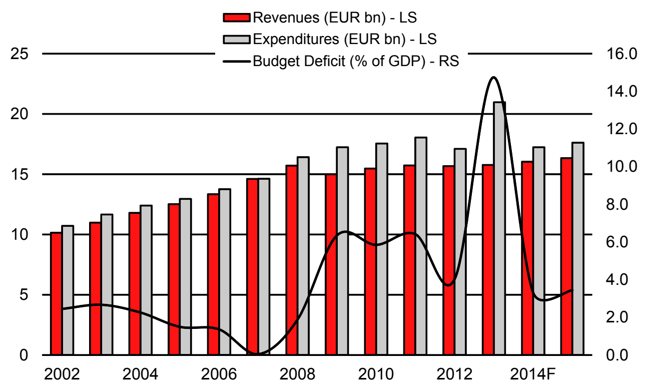
**Budget performance to date has been adequate.** In 1H14, the general government budget deficit contracted by 42.5% yoy to EUR 0.7bn, driven by stronger revenue growth (up 9% YTD). Yet a significant decrease in July (-17.7% yoy) widened the deficit to EUR 0.9bn (or 2.5% of GDP). This year, we expect the budget deficit to narrow to 3.3% of GDP, broadly in line with the EDP objective. Our forecast adds EUR 0.4bn in recapitalization costs to Abanka and Banka Celje, but excludes those to Gorenska Banka, which has until December to find private sector capital. Proceeds from the sale of Aerodrom Ljubljana and NKBM (EUR 0.3bn) were also included. We have omitted the potential revenue proceeds from Telekom Slovenije. By year-end, there is a need for the new MinFin to deliver a sensible fiscal consolidation package as, in the absence of additional measures, the deficit would widen above target (i.e. 3% of GDP). This would place the public debt above 76% of GDP, double the level in 2011.

**The banking sector has turned profitable and benefits from adequate capital buffers**

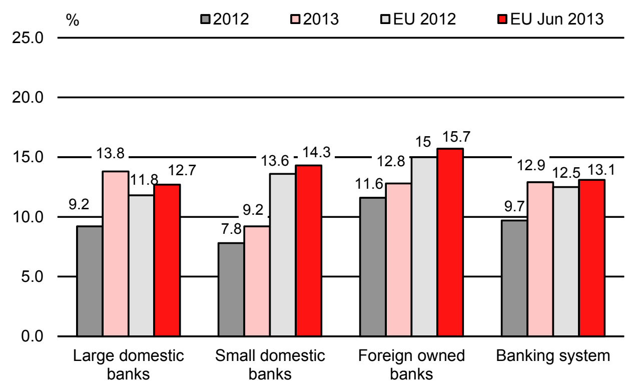
**The outlook of the Slovenian banking sector has improved, but NPLs remain a concern.** Latest data from the central bank showed system-wide profits of EUR 81mn in 1H14, vs. a loss of EUR 0.2bn in 1H13. This results from stronger net interest (+ 9.4% yoy) and non-interest income (+19.4%) but also to declining loan-loss provisions (down 59% yoy). NPLs accelerated further in 1H14 to 15.3% from 13.4% at end-2013. Meanwhile, capital adequacy ratios remain strong (14%). All these led Moody's to upgrade the Slovenian banking sector from negative to stable.

**PUBLIC FINANCES ARE IN NEED OF FURTHER BALANCE**

Revenue growth is helping the budget deficit adjustment




System-wide Tier 1 capital ratios have converged to EU levels




Source: National Bank of Slovenia, MinFin, Haver, UniCredit Research

# Strategy: Better outlook, more room to tighten

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**We think Slovenian bonds can tighten further as debt serviceability is improving, and required issuance for 2014 has been met**

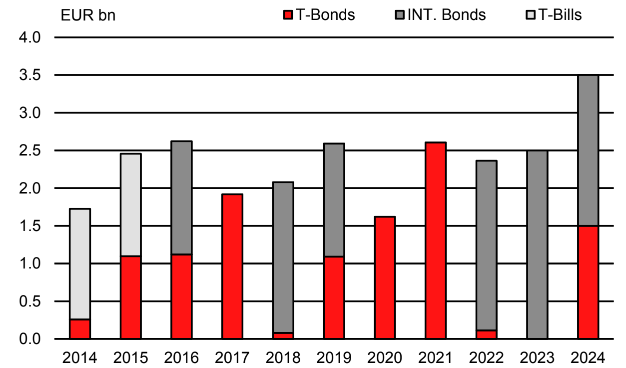
**We think the ECB action to provide further liquidity will see the Slovenia bond curve tighten further, although we think USD hard currency bonds offer better value than local currency paper**

**Slovenian bonds have further scope to tighten.** Local currency bonds have tightened 209bp since the start of the year, with hard currency USD curve 143bp tighter. Scope for further tightening could come from a debt serviceability perspective, due to a stronger banking system, better scope for growth, and the privatization program which will provide short-term revenue growth and a longer-term reduction in fiscal spending. Slovenia finished issuing for the year (EUR 5.4bn vs. a target of EUR 3.6bn) so supply could fall in the coming months.

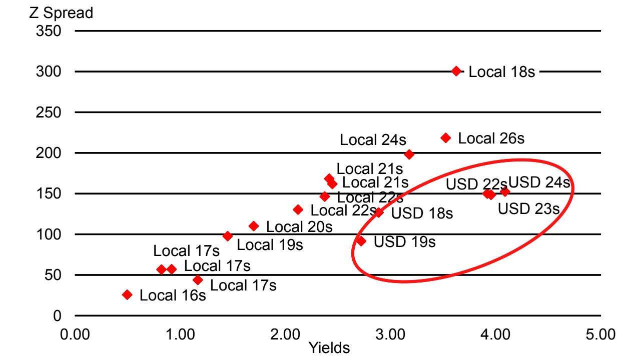
Deflation danger in the eurozone prompted aggressive action by the ECB, cutting policy rates 10bp and announcing plans to buy Asset Backed Securities (ABS). Combined with the T-LTRO, this will provide significant liquidity to the eurozone, causing Slovenian curves to flatten further. We recommended being long the USD SLOVEN 23s on 10 July. We hit our target of 4.00 and we extended it to 3.80%. The USD SLOVEN 23s yields are 149bps higher than the local 24s and should provide better protection in the event of rising US yields.

**ISSUANCE FINISHED, LIKELY BETTER LIQUIDITY – EXPECT FURTHER TIGHTENING ESPECIALLY IN HARD CURRENCY USD BONDS**

Debt redemption profile as of September 2014




Hard currency bonds look cheaper relative to local currency bonds




Source: Bloomberg, MinFin, UniCredit Research

**GOVERNMENT GROSS FINANCING REQUIREMENTS**

| EUR bn | 2013 | 2014F | 2015F |
|---|---|---|---|
| **Gross financing requirement** | **7.2** | **5.4** | **3.7** |
| Budget deficit | 5.2 | 1.6 | 1.3 |
| Amortization of public debt | 2.0 | 3.8 | 2.4 |
| Domestic | 2.0 | 3.8 | 2.4 |
| Bonds | 0.2 | 1.9 | 1.1 |
| Bills | 1.9 | 1.9 | 1.3 |
| External | 0 | 0 | 0 |
| IMF | 0 | 0 | 0 |
| **Financing** | **7.2** | **5.4** | **3.7** |
| Domestic borrowing | 2.2 | 3.5 | 2.6 |
| Bonds | 0 | 2.0 | 1.0 |
| Bills | 2.2 | 1.5 | 1.6 |
| External borrowing | 4.1 | 2.5 | 1.5 |
| Bonds | 4.1 | 2.5 | 1.5 |
| IMF/EU | 0 | 0 | 0 |
| Other | 0 | 0 | 0 |
| Change in cash reserves (+ = decline) | 1.0 | -0.6 | -0.4 |

Source: MinFin, UniCredit Research

**GROSS EXTERNAL FINANCING REQUIREMENTS**

| EUR bn | 2013 | 2014F | 2015F |
|---|---|---|---|
| **Gross financing requirement** | **11.9** | **7.7** | **6.3** |
| C/A deficit | -2.1 | -1.8 | -2.4 |
| Amortization of medium to long-term debt | 3.6 | 3.3 | 3.4 |
| Government | 0 | 0 | 0 |
| Central Bank | 0 | 0 | 0 |
| Banks | 2.1 | 1.7 | 1.6 |
| Corporates | 1.5 | 1.7 | 1.8 |
| Amortization of short-term debt | 10.4 | 6.2 | 5.3 |
| Government | 0 | 0 | 0.1 |
| Central Bank | 4.5 | 1.1 | 0.2 |
| Banks | 1.3 | 0.8 | 0.8 |
| Corporates | 4.6 | 4.3 | 4.2 |
| **Financing** | **11.9** | **7.7** | **6.3** |
| FDI | -0.6 | 1.6 | 1.3 |
| Medium to long-term borrowing | 4.8 | 3.0 | 2.2 |
| Government | 4.1 | 2.5 | 1.5 |
| Central Bank | 0 | 0 | 0 |
| Banks | 0.4 | 0.3 | 0.3 |
| Corporates | 0.3 | 0.2 | 0.4 |
| Short-term borrowing | 6.8 | 2.3 | 2.0 |
| Government | 0 | 0 | 0 |
| Central Bank | 3.4 | 0.9 | 0.2 |
| Banks | 0.6 | 0.4 | 0.4 |
| Corporates | 2.8 | 1.0 | 1.4 |
| EU Funds | 0.9 | 0.8 | 0.8 |

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

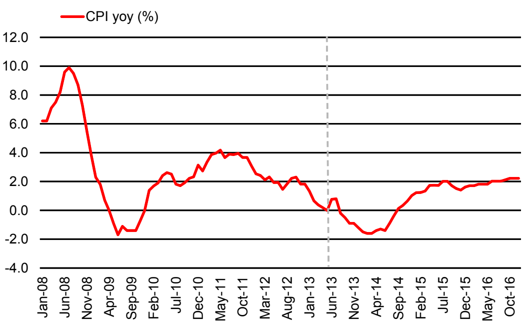
**Outlook** – Economic activity, already decelerating during the spring, completely halted due to the devastating floods in mid-May. Therefore, we keep our previous forecast of GDP stagnation in 2014. We also reduced our previous forecast of 2.9% GDP growth for 2015 to 2%, given the less optimistic forecasts for the euro area recovery and gloomier outlook for neighboring countries. We assume that most of the work on reconstruction in flooded areas will take place in the following years. Available financial aid from the international community and cooperation with newly-constituted local and central authorities after October's elections will define the speed and the impact of the reconstruction. A more efficient rebuilding process could mean upside potential for economic growth. Effects of the floods will be also visible in fiscal accounts, where compliance with SBA will be crucial to keep discipline and sustainability.

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

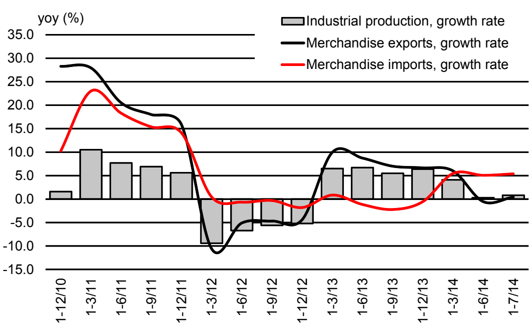
### KEY DATES/EVENTS

- Sep (pending): Eight SBA review
- 12 Oct: General elections
- 31 Oct: GDP 2Q preliminary
- Dec: Ninth SBA review
- 19 Dec: Balance of payments 3Q14

### CPI EXPECTED TO SLOW




### MERCHANDISE EXPORTS




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

### MACROECONOMIC DATA AND FORECASTS

| | 2011 | 2012 | 2013 | 2014F | 2015F |
|---|---|---|---|---|---|
| GDP (EUR bn) | 13.2 | 13.2 | 13.4 | 13.3 | 13.8 |
| Population (mn) | 3.8 | 3.8 | 3.8 | 3.8 | 3.8 |
| GDP per capita (EUR) | 3,432 | 3,430 | 3,504 | 3,482 | 3,611 |
| **Real economy yoy (%)** | | | | | |
| GDP | 1.0 | -1.2 | 2.1 | 0 | 2.0 |
| Monthly wage, nominal (EUR) | 650 | 660 | 661 | 664 | 678 |
| Unemployment rate (%) | 43.3 | 44.1 | 44.6 | 44.1 | 43.9 |
| **Fiscal accounts (% of GDP)** | | | | | |
| Budget balance | -1.2 | -1.9 | -2.3 | -4.0 | -3.3 |
| Primary balance | -0.4 | -1.2 | -1.4 | -3.0 | -2.4 |
| Public debt | 38.8 | 39.7 | 42.5 | 45.3 | 44.6 |
| **External accounts** | | | | | |
| Current account balance (EUR bn) | -1.3 | -1.2 | -0.7 | -1.1 | -1.2 |
| Current account balance/GDP (%) | -9.7 | -9.3 | -5.5 | -8.1 | -8.4 |
| Basic balance/GDP (%) | -7.1 | -7.2 | -3.5 | -4.6 | -4.4 |
| Net FDI (EUR bn) | 0.3 | 0.3 | 0.3 | 0.5 | 0.6 |
| Net FDI (% of GDP) | 2.6 | 2.1 | 1.9 | 3.5 | 4.1 |
| Gross foreign debt (EUR bn) | 6.7 | 6.9 | 7.0 | 7.4 | 7.7 |
| Gross foreign debt (% of GDP) | 51.0 | 52.3 | 52.0 | 55.2 | 55.5 |
| FX reserves (EUR bn) | 3.3 | 3.3 | 3.6 | 3.7 | 3.7 |
| **Inflation/Monetary/FX** | | | | | |
| CPI (pavg) | 3.7 | 2.1 | -0.1 | -0.7 | 1.6 |
| CPI (eop) | 3.1 | 1.8 | -1.2 | 1.0 | 1.6 |
| 1M money market rate | 1.18 | 0.33 | 0.13 | 0.10 | 0.10 |
| USD/ BAM (eop) | 1.51 | 1.48 | 1.42 | 1.44 | 1.40 |
| EUR/BAM (eop) | 1.96 | 1.96 | 1.96 | 1.96 | 1.96 |
| USD/ BAM (pavg) | 1.41 | 1.52 | 1.47 | 1.45 | 1.42 |
| 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

## May floods and landslides deteriorate outlook

**With industrial production and exports weaker, we see GDP stagnating in 2014, with growth resuming in 2015**

**Slowdown in economic activity was exacerbated by the impact of disastrous floods and landslides.** Industrial production growth turned from positive in 1Q14 to decline already in April/May. After the flood in May, there was a certain revival of production, but cumulative growth until July was cut to only 0.8% yoy. A significant slowdown has been also observed in construction activity, but it remains in positive territory, due to extensive infrastructure works, mainly on new sections of the Corridor Vc motorway. Preliminary assessments point to the most severe production decline in agriculture, forestry and transport. Mining, timber industry and energy sector are also among the most affected sectors of the economy. As a result of a deterioration in the real sector, exports of goods also recorded a significant decline after 1Q, recording cumulative growth for the first seven months in 2014 of just 0.4% yoy. Imports of goods, however, remained strong, leading to a widening of the foreign trade deficit. Therefore, with a general election nearing and uncertainty rising, we continue to expect GDP will stagnate in 2014. We expect the economy will resume expanding again in 2015, but the speed and intensity will be dependent on how rapidly and efficiently new authorities are constituted, on the inflow of international community financial aid and the ability of domestic authorities to successfully manage reconstruction activities. Reflecting this risk, we lower our growth outlook for 2015 to 2.0%, with potential to increase if reconstruction proves speedier. With almost 90,000 people still displaced after May flooding, in addition to the very low level of employment and nearly stagnant real wages, there is no room for a revival of private consumption. In this scenario, deflationary tendencies have continued to dominate, leaving our average inflation outlook negative in 2014, while an increase is expected in the following period with food and administrative prices as potential drivers.

**Foreign trade deficit is widening in 2014 due to slowdown in exports growth, as import growth remains virtually unchanged**

**Floods and landslides in May had large negative impact: fiscal deficit to widen to 4% of GDP on expenditure growth**

**May events will cause a significant deterioration of the fiscal position.** Although it looks like revenues from indirect taxation, according to newly published data for January-August, have not been affected by the disaster in May (they are some 4% higher than those collected in the same period of last year, based primarily on more efficient collection), it seems inevitable that the fiscal gap should widen by the end of the year with rising expenditures, i.e., from costs arising from direct and indirect damage of floods and landslides. The assessment of the damages, losses and effects has been made by the European Union, the United Nations and the World Bank in July. Following this, "the total economic impact of the disaster (destruction or severe damage to property, infrastructure and goods as well the effects of destruction on livelihoods, incomes and production, among other factors) is estimated to have reached BAM 3.98 billion. Most of it impacted the private sector; families, small, medium and large businesses, and agricultural producers, including and undefined number of vulnerable sectors of the population... The floods are estimated to have caused the equivalent of nearly 15 percent of GDP in damages (9.3% of GDP) and losses (5.6% of GDP) in 2014 in B&H... A significant public sector financing gap of 1.7% of GDP has opened up, despite identified additional (to pre-floods needs) financing from domestic and international sources."[16] Recovery needs are estimated at BAM 499.3mn and the reconstruction needs at EUR 2.95bn, out of which in the short term BAM 256.4mn and BAM 1bn, respectively. However, a donor conference in July in Brussels resulted in donor commitments of EUR 809.2bn.

**Compliance with extended and augmented SBA ensures financial stability of the government**

**IMF is conducting the eighth review of SBA:** The IMF announced in June an increase in available funds for BH of EUR 95mn (in addition to the EUR 95mn disbursement available to the authorities of BH upon combined sixth and seventh review in June) to mitigate the negative effects of the disaster on fiscal performance (increased expenditure). It supplements the extension and augmentation of the SBA from January. SBA now amounts to 330% of the quota or EUR 620mn. An IMF mission arrived in September for the eighth review where it will discuss compliance with SBA and new fiscal targets in light of natural disaster costs and fiscal performance after the general elections in October. However, the SBA in place should ensure fiscal sustainability and timely execution of financial obligations of the government.

[16] 'Bosnia and Herzegovina Recovery Needs Assessment', Floods 14-19 May, Executive Summary, Brussels, 16 July 2014

# Russia (Baa1 negative/BBB- negative/BBB negative)*

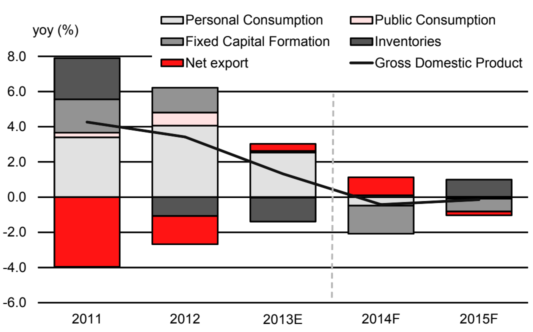
**Outlook** – Russian economic performance has held up better than we had feared, given the string of negative geopolitical developments and related sanctions that have been announced in recent months. Tight monetary policy, a slower pace of domestic capital outflows, fiscal support and a deal with China have all helped. But over a longer term horizon potential growth is likely to decline further while the sovereign runs down its buffers to support activity. Within this outlook, RUB flexibility provides a cushion while higher policy rates have protected financial stability. Still RUB depreciation is possible, if needed to aid fiscal performance.

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

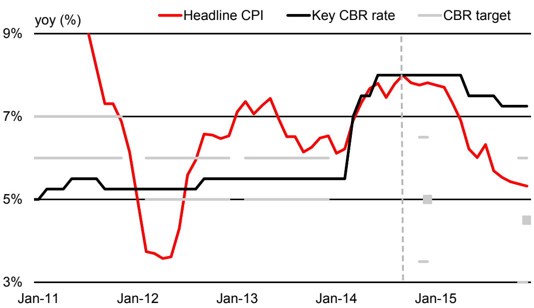
### KEY DATES/EVENTS

- 1 Oct – budget submission to the State Duma
- 31 Oct – MPC meeting
- Nov – approval of the monetary policy priorities for 2015-17
- 18-23 of every month – short-term statistical overview

### DOMESTIC DEMAND WEAKENS FURTHER




### INFLATION ABOVE TARGET FOR NOW




Source: Federal Statistical Service, CBR, UniCredit Research

### MACROECONOMIC DATA AND FORECASTS

| | 2011 | 2012 | 2013 | 2014F | 2015F |
|---|---|---|---|---|---|
| GDP (EUR bn) | 1,335.5 | 1,556.1 | 1,572.6 | 1,473.0 | 1,458.8 |
| Population (mn) | 143.1 | 142.9 | 142.7 | 142.6 | 142.5 |
| GDP per capita (EUR) | 9,336 | 10,893 | 11,023 | 10,333 | 10,240 |
| **Real economy yoy (%)** | | | | | |
| GDP | 4.3 | 3.4 | 1.3 | -0.4 | -0.1 |
| Private Consumption | 6.8 | 7.9 | 4.7 | -0.9 | -0.2 |
| Fixed Investment | 9.1 | 6.4 | -0.1 | -7.2 | -3.5 |
| Public Consumption | 1.4 | 4.6 | 0.5 | 0 | 0.1 |
| Exports | 0.3 | 1.4 | 4.2 | -0.4 | -0.5 |
| Imports | 20.3 | 8.8 | 3.7 | -4.6 | 0.3 |
| Monthly wage, nominal (EUR) | 580 | 675 | 696 | 652 | 654 |
| Unemployment rate (%) | 6.6 | 5.3 | 5.4 | 6.0 | 6.5 |
| **Fiscal accounts (% of GDP)** | | | | | |
| Budget balance | 0.8 | 0 | -0.5 | 0.5 | -0.7 |
| Primary balance | 1.3 | 0.2 | -0.1 | 0.8 | -0.2 |
| Public debt | 9.8 | 10.2 | 11.7 | 11.1 | 12.0 |
| **External accounts** | | | | | |
| Current account balance (EUR bn) | 79.5 | 63.2 | 24.8 | 30.6 | 21.5 |
| Current account balance/GDP (%) | 6.0 | 4.1 | 1.6 | 2.1 | 1.5 |
| Basic balance/GDP (%) | 4.8 | 4.2 | 0.8 | 1.8 | 2.0 |
| Net FDI (EUR bn) | -11.8 | 1.4 | -11.7 | -3.6 | 7.3 |
| Net FDI (% of GDP) | -1.2 | 0.1 | -0.7 | -0.2 | 0.5 |
| Gross foreign debt (EUR bn) | 424.3 | 485.1 | 546.7 | 565.1 | 574.8 |
| Gross foreign debt (% of GDP) | 31.8 | 31.2 | 34.8 | 38.4 | 39.4 |
| FX reserves (EUR bn) | 384.7 | 407.3 | 377.4 | 357.4 | 339.4 |
| **Inflation/Monetary/FX** | | | | | |
| CPI (pavg) | 8.6 | 5.1 | 6.8 | 7.4 | 6.3 |
| CPI (eop) | 6.1 | 6.6 | 6.5 | 7.8 | 5.3 |
| Central bank target | 6-7 | 5-6 | 5-6 | 5.0 | 4.5 |
| Central bank reference rate (eop) | 5.25 | 5.50 | 5.50 | 8.00 | 7.25 |
| 3M money market rate | 4.97 | 7.09 | 7.01 | 9.30 | 8.50 |
| USD/RUB (eop) | 32.20 | 31.07 | 32.73 | 37.26 | 38.28 |
| EUR/RUB (eop) | 41.67 | 39.92 | 44.97 | 50.67 | 53.60 |
| USD/RUB (pavg) | 29.39 | 30.37 | 31.85 | 35.71 | 37.67 |
| EUR/RUB (pavg) | 40.87 | 40.23 | 42.41 | 48.41 | 51.89 |

Source: UniCredit Research

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

## Intensified uncertainty causes "slow motion" effect

**Geopolitical situation is forcing change in Russia's economy…**

The Russian economy has held up well in recent months amidst a raft of negative geopolitical news and further sanctions. Following a qoq gain of 0.1% in 1Q, GDP posted gains of 0.3% in 2Q. A contraction in imports amidst tighter monetary policy, slowing credit growth and RUB weakness late last year and earlier this year plays a role but industrial production has been broadly unchanged while retail sales remain modestly positive in yoy terms.

**…but in the near term our headline GDP forecast has not changed much…**

This has fed into our decision to revise our full year growth forecast for 2014 higher to -0.4%. The revision is driven by industrial production, a better-than-expected harvest and strong performance in the financial sector, concentrated in refinancing the external debts of Russian corporates. The detail has changed more than the underlying, capturing weaker domestic demand but a positive contribution from net exports. (for instance, current account added 50% yoy in 1H14 reaching USD 44bn). In USD terms, imports fell almost 5% over the first seven months of the year.

**…as we expect the authorities to be able to protect the economy against output shocks**

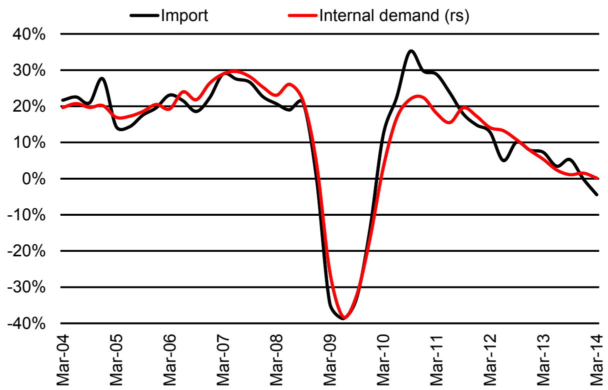
In the near term we expect the authorities to continue to be able to protect the economy against any significant collapse in output by continuing to draw off its buffers. We expect the CBR to maintain a tight monetary stance to protect against any financial stability risks surrounding deposit flight. The CBR has also provided the banking sector with liquidity, having increased the volumes of refinancing to RUB 5.2 trillion (or 9% of the sector assets, comparable to the support during 2008-2009 crisis) while the CBR has signaled a willingness to increase this amount to RUB 7 trillion this year, if needed. This year, the government has already used RUB 239bn from the National Well-being Fund to increase capital of VTB and Russian agricultural banks (both being under sanctions). The authorities have also been successful in securing a gas deal with China - the construction has already been officially launched.

**More longer term events will drag on an already low rate of potential GDP growth**

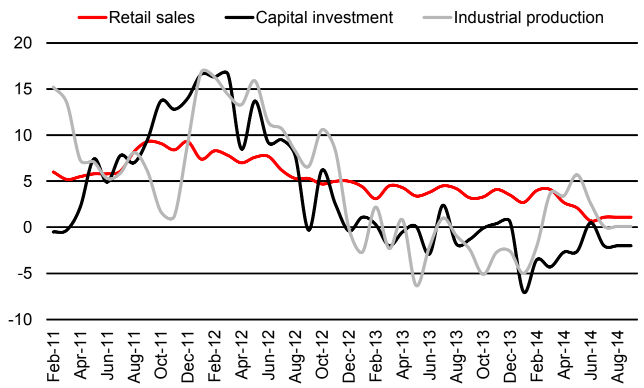
More longer term we have grown more concerned about Russia's outlook. This deterioration in political and economic relations between Russia and some of its largest trade and financing partners, i.e. the US and EU, is likely to drag on an already low level of potential growth. This adds to pressures such as high levels of capacity utilisation, negative demographic trends, weakening terms of trade, increasing constraints on private consumption as the primary driver of growth. Our baseline scenario does not assume any significant worsening in tensions from here but we also do not assume a speedy removal of sanctions or improvement in international relations. Tail risks, both near and longer term, to our baseline scenario have also increased significantly.

**CONFLICTING SIGNALS**

Import contraction has added to resilience…




...although major activity indicators remain weak




Source: Rosstat, CBR, UniCredit Research

**We reduced our 2015 GDP growth forecast to -0.1% due to weakened consumption…**

As a result we have reduced our GDP growth forecast by 0.9pp to -0.1% yoy for 2015. More than two thirds of this revision is related to the weakening of the primary growth driver – private consumption. There is already evidence of a more cautious consumer in vehicle sales, down 25% yoy in 3Q14 while we expect that in 2015 nominal wage growth will at best compensate for inflation. We have also turned more skeptical about a recovery in investment next year. While the government is likely to increasingly draw off its buffers to support activity, sanctions limit the ability of Russian banks' to finance new projects. Those sectors in need of modernization, e.g. energy and defense, account for a solid portion of total investment spending but face restrictions in imports and uncertainty about much-needed foreign investment.

**Monetary policy will not be accommodative in 2015 due to high inflation…**

Under these conditions the CBR plans to keep its policy quite tight. In a recently-published action plan for 2015-17, it stressed that inflation is its only quantitative target. This has been affected by sanctions: in August, the effects of the import ban added 0.2pp to headline inflation and before year-end the total impact could reach 1pp. Inflation accelerated to 7.6% in August, exceeding the CBR's "acceptable range" by more than 100bp, and the figure could increase even further. However, in late-2015 inflation could decelerate to CBR's acceptable range (4.5% +/-150bps) in the absence of further shocks, though average price growth next year will remain above 6.3%.

**…but the CBR's commitment to a freely-floating currency regime seems firm**

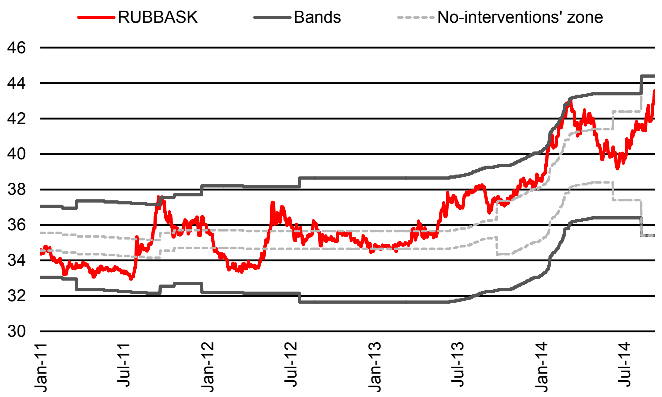
The CBR's commitment to a freely-floating currency regime seems firm as well. The regulator plans to avoid any rule-based FX interventions, acting only to protect financial stability. Within this strategy it has already widened the bi-currency basket band to 9 rubles (from 7 rubles since July 2013) in August and abandoned interventions within this range. It has returned required intervention amounts for a shift in the basket to pre-March levels of USD350mn from USD 1.0bn until recently.

**There is more uncertainty surrounding fiscal policy, though increased government support for activity is likely**

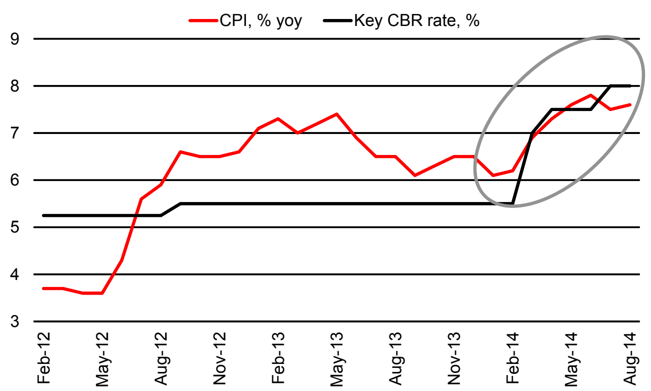
There is more uncertainty surrounding the outlook for fiscal policy. On the one hand, the MinFin seems to defend its budget rule, which requires a transfer of all the windfall revenues to the Reserve Fund (in 2015, an estimated RUB 200bn). However a loosening of the mandate of the National Well-being Fund could serve as a source of financing for investment projects by the state and state-owned enterprises. As of now, the Fund amounts to USD 85.3bn out of which circa USD 26.5 bn has been utilized. A weaker RUB is also an option, should government revenue fall short. We estimate that the federal budget will be balanced at an average exchange rate of 37.8 per USD (even if oil is below our forecast). This implies that further RUB depreciation from current level is no longer essential but possible if required. Having in mind our oil price forecast at USD 103 pb, BoP and budget trends and recent market reaction, we see RUB at 38.3 by the end of 2015.

**INFLATION TARGETING AMID GREATER RUB FLEXIBILITY**

RUB flexibility within the band is increasing…




...while the CBR is committed to fight inflation




Source: Rosstat, CBR, UniCredit Research

## Strategy: Currency weakness erodes returns

**Martin Rea,**
**EM Fixed Income Strategist**
**(UniCredit Bank London)**
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martin.rea@unicredit.eu

**We recommend an underweight allocation to Russia local bonds due to…**

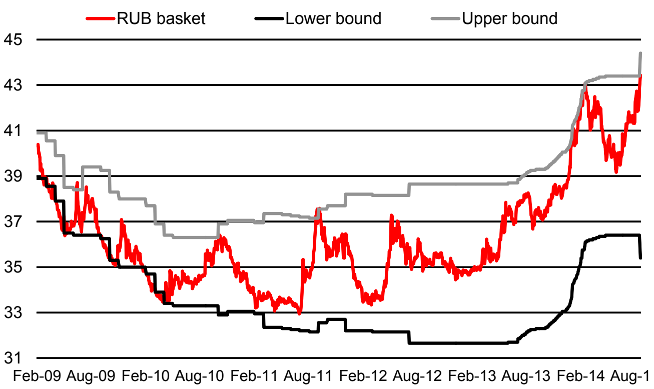
**…structural challenges and deteriorating conditions**

**We expect further currency weakness and…**

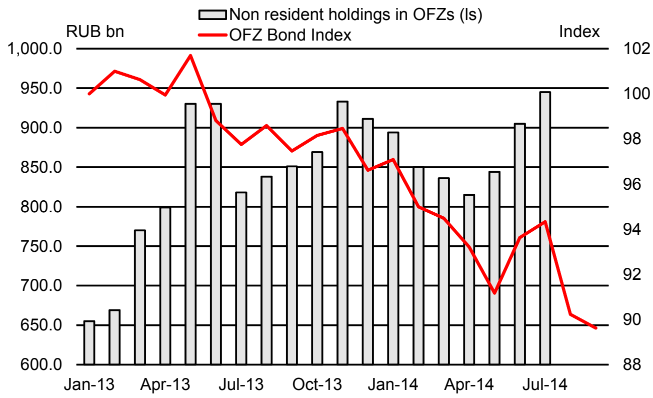
**…see less risk in USD hard currency bonds**

We recommend an underweight allocation to Russia local currency bonds. Significant structural growth challenges and the possibility of further deteriorating in terms of trade and rising inflation is creating significant risks, particularly to the currency. The CBR has only recently extended the RUB basket trading band but despite this, deterioration has meant we are already close to breaching the upper band. The recent sell off in RUB and demand for USD from locals, is likely to continue, and we suspect could result in the bond market being led by the currency. We think inflation targeting and flexibility currency ambitions could see further hikes ahead as inflation accelerates. The OIS curve pricing is currently pricing in at least 50bp of hikes before year end. The local bond has bear flattened YTD despite foreign holdings of OFZs hitting an all-time high at the start of July 2014 (although we expect with recent performance these levels are unlikely to be maintained). We think the front end remains vulnerable to hikes but think that the belly of the curve is starting to look more attractive comparatively, although the currency risk is significant. We prefer to be involved in the RUSSIA 20s USD hard currency bonds where the FX risk is significantly reduced and the z spread is attractive compared to the shorter dated RUSSIA USD 19s.

The RUB has traded near the upper end of the CBR's trading band




The non-resident share of OFZs has likely peaked




Source: Rosstat, CBR, Bloomberg; UniCredit Research

**GOVERNMENT GROSS FINANCING REQUIREMENTS**

| EUR bn | 2013 | 2014F | 2015F |
|---|---|---|---|
| **Gross financing requirement** | **39.5** | **40.2** | **48.0** |
| Budget deficit | 11.2 | 16.4 | 20.0 |
| Amortisation of public debt | 19.6 | 15.7 | 20.8 |
| Domestic | 18.1 | 14.8 | 18.5 |
| Bonds | 18.1 | 14.8 | 18.5 |
| Bills | 0 | 0 | 0 |
| External | 1.6 | 0.9 | 2.3 |
| Sovereign Fund | 8.7 | 8.2 | 7.2 |
| **Financing** | **39.5** | **40.2** | **48.0** |
| Domestic borrowing | 26.8 | 29.5 | 29.1 |
| Bonds | 26.8 | 29.5 | 29.1 |
| Bills | 0 | 0 | 0 |
| External borrowing | 5.4 | 5.0 | 8.9 |
| Bonds | 5.4 | 5.0 | 8.9 |
| Other | 7.4 | 5.7 | 10.0 |

**GROSS EXTERNAL FINANCING REQUIREMENTS**

| EUR bn | 2013 | 2014F | 2015F |
|---|---|---|---|
| **Gross financing requirement** | **26.3** | **43.3** | **58.2** |
| C/A deficit | -33.0 | -16.2 | -8.4 |
| Amortisation of debt | 52.1 | 53.9 | 62.3 |
| Government/central bank | 1.6 | 0.9 | 2.3 |
| Banks | 21.50 | 18.00 | 22.00 |
| Corporates | 29.00 | 35.00 | 38.00 |
| Errors and omissions | 7.24 | 5.56 | 4.20 |
| **Financing** | **26.3** | **43.3** | **58.2** |
| FDI | -14.7 | -5.7 | -2.5 |
| Equity | 0 | 0 | 0 |
| Borrowing | 125.9 | 96.6 | 86.7 |
| Government/central bank | 5.4 | 5.0 | 8.9 |
| Banks | 33.5 | 34.5 | 33.5 |
| Corporates | 87.0 | 57.1 | 44.3 |
| Domestic investments abroad | -75.8 | -34.5 | -30.2 |
| Official reserves change / other | -9.0 | -13.1 | 4.2 |

Source: Rosstat, CBR, UniCredit Research

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

**Outlook** – The Serbian economy is facing a challenging period ahead. May floods pushed the economy back into recession while bringing the C/A improvement in 2Q14 to a halt. Public debt remains on an upward trajectory amidst a budget overshoot again this year. On a more positive note, inflation is expected to stabilize within the NBS's target band which should help resume the easing rate cycle in 4Q14. The adoption of the privatization and bankruptcy bills during the summer are welcomed, though a much tougher stance on fiscal consolidation will be needed in the upcoming budgets to balance public finances and secure an IMF deal by year end.

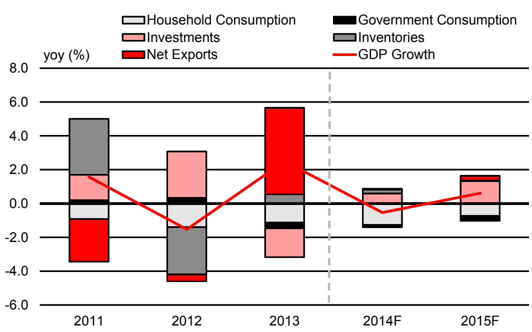
**Strategy** – If the crucial IMF deal is delivered the yield curve should tighten further. We recommend being invested in the hard currency USD 21s (7Y) but economic risks remain.

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

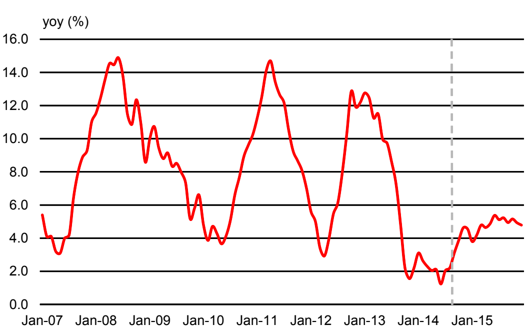
### KEY DATES/EVENTS

- 30 Sep, 31 Oct – 2Q13 GDP (final), 3Q14 GDP (prelim)
- 22 Sep, 21 Oct, 20 Nov – Current Account Balance
- 30 Sep, 31 Oct, 28 Nov – Industrial Production
- 30 Sep, 31 Oct, 28 Nov – Retail Sales
- 13 Oct, 12 Nov, 12 Dec – Consumer Price Index
- 16 Oct, 13 Nov, 12 Dec – Policy rate decisions

### GDP GROWTH TO RESUME IN 2015




### CPI TO REACH THE TARGET BAND IN 4Q14




Source: NBS, MinFIn, Unicredit Research

### MACROECONOMIC DATA AND FORECASTS

| | 2011 | 2012 | 2013 | 2014F | 2015F |
|---|---|---|---|---|---|
| GDP (EUR bn) | 31.5 | 29.9 | 32.0 | 31.4 | 32.0 |
| Population (mn) | 7.3 | 7.2 | 7.2 | 7.1 | 7.1 |
| GDP per capita (EUR) | 4,335 | 4,158 | 4,463 | 4,399 | 4,502 |
| **Real economy yoy (%)** | | | | | |
| GDP | 1.6 | -1.5 | 2.5 | -0.5 | 0.6 |
| Private Consumption | -1.1 | -1.8 | -1.5 | -1.7 | -1.0 |
| Fixed Investment | 8.4 | 14.4 | -7.7 | 3.0 | 6.4 |
| Public Consumption | 1.0 | 1.7 | -1.7 | -0.7 | -1.5 |
| Exports | 3.4 | 1.8 | 16.6 | 4.0 | 5.1 |
| Imports | 7.0 | 1.9 | 2.0 | 2.9 | 3.4 |
| Monthly wage, nominal (EUR) | 518 | 508 | 537 | 530 | 483 |
| Unemployment rate (%) | 23.0 | 23.9 | 22.1 | 21.3 | 21.0 |
| **Fiscal accounts (% of GDP)** | | | | | |
| Budget balance* | -5.0 | -6.6 | -5.0 | -5.8 | -4.6 |
| Primary balance | -3.6 | -4.5 | -2.4 | -4.8 | -3.0 |
| Public debt | 48.2 | 60.2 | 63.8 | 73.3 | 78.6 |
| **External accounts** | | | | | |
| Current account balance (EUR bn) | -2.9 | -3.6 | -2.1 | -2.0 | -1.9 |
| Current account balance/GDP (%) | -9.1 | -12.2 | -6.5 | -6.4 | -5.8 |
| Basic balance/GDP (%) | -3.3 | -9.9 | -2.7 | -1.3 | -0.5 |
| Net FDI (EUR bn) | 1.8 | 0.7 | 1.2 | 1.6 | 1.7 |
| Net FDI (% of GDP) | 5.8 | 2.2 | 3.8 | 5.1 | 5.3 |
| Gross foreign debt (EUR bn) | 24.1 | 25.6 | 25.8 | 27.3 | 28.5 |
| Gross foreign debt (% of GDP) | 76.7 | 85.7 | 80.6 | 86.9 | 89.1 |
| FX reserves (EUR bn) | 12.9 | 12.0 | 12.1 | 10.3 | 10.2 |
| **Inflation/Monetary/FX** | | | | | |
| CPI (pavg) | 11.6 | 7.3 | 7.9 | 2.8 | 4.8 |
| CPI (eop) | 7.0 | 12.2 | 2.2 | 4.5 | 4.8 |
| Central bank target | 4.0±1.5% | 4.0±1.5% | 4.0±1.5% | 4.0±1.5% | 4.0±1.5% |
| Central bank reference rate (eop) | 9.75 | 11.25 | 9.50 | 7.75 | 7.50 |
| BELIBOR 3M | 12.88 | 11.64 | 10.15 | 8.24 | 7.45 |
| USD/RSD (eop) | 80.87 | 86.18 | 84.92 | 88.97 | 87.86 |
| EUR/RSD (eop) | 104.64 | 113.72 | 114.64 | 121.00 | 123.00 |
| USD/RSD (pavg) | 73.35 | 87.96 | 85.67 | 86.74 | 88.00 |
| EUR/RSD (pavg) | 101.95 | 113.13 | 113.09 | 117.82 | 121.88 |

*Excludes below-the-line items

Source: Unicredit Research

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

## An increasing growth and fiscal challenge

**Weak IP and trade activity behind the steep fall in 2Q14 GDP…**

**The severe floods that hit Serbia in mid-May pushed the economy back into recession in 2Q14**, reinforcing the significant challenges which the government faces. The drop in 2Q14 GDP was estimated at 1.1% yoy, down from a revised (but weak) 0.1% expansion in 1Q14 (preliminary at 0.4% yoy). As expected, the costs of the floods were substantial (EUR 1.5bn), and centered in the mining and energy (EUR 0.5bn) and agricultural (EUR 0.2bn) sectors. This has brought IP performance in 2Q14 to two-year lows (-5.2% yoy), also the lowest in the region. In this regard, the production of electricity saw the steepest fall in 2Q14 (-13.8% yoy), as the flooding of the Kolubara mines halted the supply of coal to the Nikola Tesla power plant, which generates 50% of Serbia's electricity. Manufacturing output was also hit, albeit to a lesser extent (-2.5% yoy), since it continues to be supported by the strong production of motor vehicles (up 5.2% yoy). In contrast, retail activity spiked in July (+5.3% yoy in real terms vs. 0.5% in 1H14). However, we view this increase as temporary since it was mainly attributed to the stocking of food supplies and purchases of essential goods in the aftermath of the floods. In line with 1H14, we expect retail activity to stagnate in 2H14, hit by the combination of renewed austerity and poor employment conditions.

**…forcing us to revise our 2014-15 GDP forecasts down to -0.5% and 0.6% yoy, respectively**

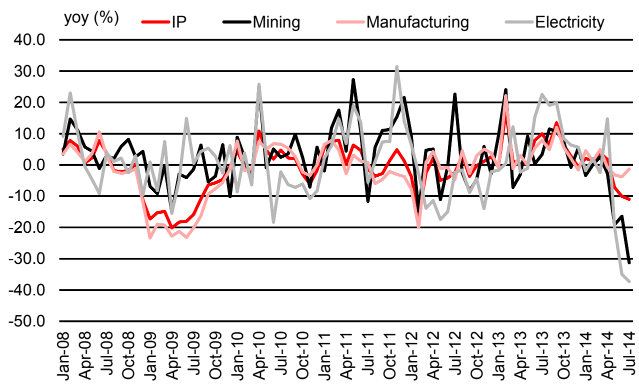
**Against this backdrop and a weaker EMU, we have lowered our GDP growth forecasts by 0.9pp to -0.5%, and by 1.2pp to 0.6% in 2015.** The revision predominantly reflects a weaker trade environment, challenged by a sluggish eurozone and rising geopolitical tensions between Russia and Ukraine. May floods will affect net exports through a combination of lower manufacturing exports and higher electricity and coal imports as the mine at Kolubara continues to operate below capacity. Next year, we expect the contribution from net exports to improve by close to 0.3pp, driven by base effects. In contrast, domestic consumption will remain weak and should contribute negatively to growth until mid-2016 on the back of austerity measures. Private consumption will be the worst hit (avg. drop of 1.5% between 2014-15) due to the planned cut in public sector wages and employment and tightened household credit conditions. That said, the recently launched subsidized loan program and restoration works in the flood-hit areas will benefit investment. The adoption in August of the bankruptcy and privatization laws will also help, provided they speed up the sale of non-performing SOEs and visibly improve business conditions in the period ahead.

**C/A deficit expected to narrow at a slower pace on the back of stronger energy imports and weaker export growth to the eurozone**

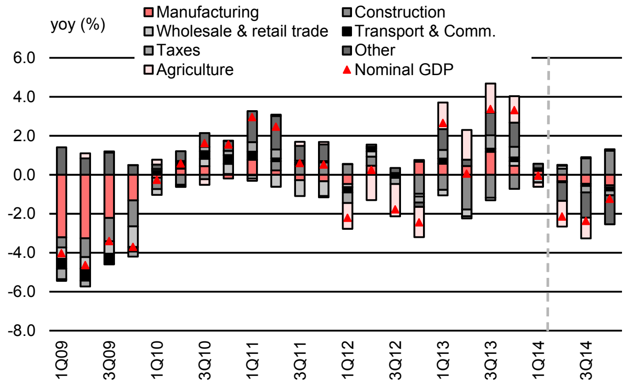
**The C/A will continue to adjust, albeit at a slower pace than before.** As expected, May floods adversely affected the trade balance in 2Q14, widening the C/A deficit (+ 0.2% yoy) for the first time in five quarters. In 1H14, the C/A deficit was down by 17.1% yoy to EUR 0.8bn, though this compares poorly to the adjustment seen in 1H13 (down 45.8% yoy). Looking ahead, we expect the C/A deficit to narrow to EUR 2bn (or 6.3% of GDP) by year-end, 0.2pp lower than in 2013. Weaker foreign demand and higher energy imports will reduce the pace of adjustment.

**MAY FLOODS BEHIND THE STEEP FALL IN INDUSTRIAL PRODUCTION AND GDP IN 2Q14**

The mining and electricity sectors have been severely hit in 2Q14…




… but reconstruction activity should limit the decline of GDP in 2H14




Source: National Bank of Serbia, MinFin, UniCredit Research

**Headline inflation expected to accelerate and converge towards target in 4Q14**

**Headline inflation remained below the target band in 2Q14,** although it should accelerate from here on the back of higher energy prices. 2Q14 inflation eased to 1.8% yoy, considerably below our forecast (2.5%) and the inflation print in 1Q14 (+2.7% yoy). The slowdown was mainly attributed to the decline of unprocessed food prices (-2.9% yoy), although reduced aggregate demand and relative stability of the dinar in 2Q14 (+0.3%) also helped. Looking ahead, we expect inflation to remain weak on the back of falling fruit and vegetable prices. Even so, we see inflation converging towards the target band already by October, driven by the planned 12% hike in electricity prices. Provided the dinar stabilizes, inflation should go to 4.5% yoy by year-end and stay within the target band throughout the entire forecast horizon.

**NBS expected to cut rates by 75bp in 4Q14, provided inflation stabilizes and the dinar behaves**

**The low inflation environment should lead to a resumption of the easing cycle in 4Q14,** provided risk appetite towards EM is maintained. Since May, the benchmark policy rate has been cut by a cumulative 100bp, but remains unchanged at 8.5% since July. This responds, in part, to the escalation of Ukrainian tensions, which has prompted investors to adopt a more cautious stance on CEE. For Serbia, this has meant weak foreign portfolio inflows (USD 0.1bn in 2Q14) and lower rollover ratios for the government (1.3 in June from 1.7 in January). The depreciation of the dinar since end-2Q14 has also been notable (down 2.9% to 118.6/EUR), reinforced by higher demand for FX by energy importers. For year-end, we expect the currency to weaken to 121/EUR, although this level could be exceeded if the NBS decides to reduce FX interventions (USD 125mn since July; USD 0.7bn YTD) amid a reduction of FX reserves at the NBS (EUR 10.1bn). That said, we doubt a higher FX pass-through onto inflation will prevent the NBS from cutting rates in 4Q14.

**The adoption of the privatization and bankruptcy bills are a good step forward to limit contingent payments…**

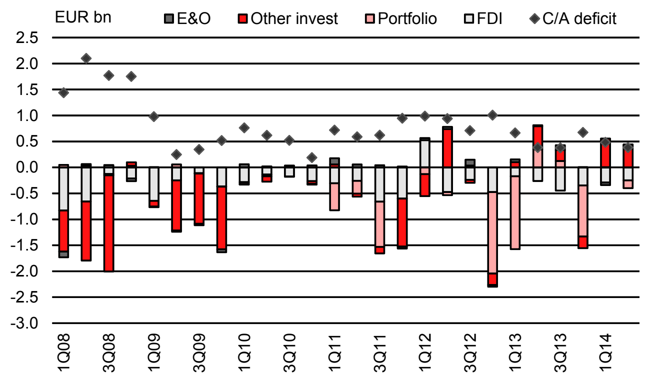
**On the political front, several welcomed laws have been approved during the summer.** Of these, the privatization and bankruptcy bills are most commendable since, if properly implemented, they should speed up the restructuring of Serbia's oversized and unprofitable SOE sector and improve its business climate by making bankruptcy procedures more efficient and transparent. The laws affect around 584 loss-making SOEs, of which 181 are already undergoing restructuring. The deadline for the completion of the restructuring process has been set at 31 December 2015, and should save the state close to EUR 450mn by 2017.

**…but should be complemented with additional expenditure-driven cuts in the upcoming budgets**

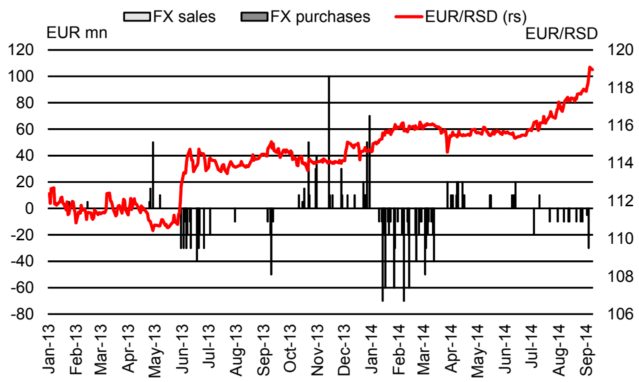
**Nevertheless, there is a need to consolidate public finances** as the budget deficit this year is expected to widen to EUR 1.8bn or 5.7% of GDP (from 5% of GDP in 2013). If below-the-line items are included, the deficit would reach 8.3% of GDP and lift public debt to 73% of GDP, double its 2009 level. A cut in public sector wages and pensions of 10-12% would be welcome, as they remain well above their sustainable levels (i.e. 2pp and 4pp of GDP above respectively) but should be complemented with hikes of VAT of 1-2pp. According to our calculations, this would bring savings of EUR 0.8bn (2.5% of GDP) just in 2015. In the medium term, however, this should be combined with a downsizing of the public sector.

**SERBIA REMAINS HIGHLY VULNERABLE TO CHANGES IN EM RISK SENTIMENT**

Portfolio capital remains weak due to lessened EM risk appetite




FX sales by the NBS have been insufficient to curb dinar weakness




Source: National Bank of Serbia, MinFin, Haver, UniCredit Research

## Funding on track, IMF deal key to further curve tightening

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**Domestic issuance remains on track; IMF deal expected at end 4Q14**

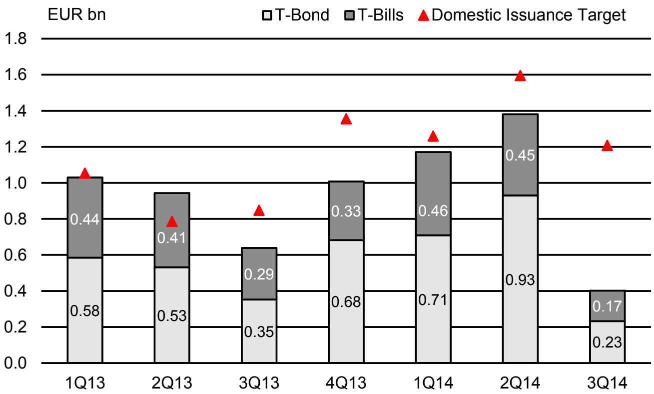
**We recommend being invested in the USD 7Y bond on expected IMF deal and additional rate cuts**

**Funding needs are large, but manageable.** Serbia's total 2014 financing needs are estimated at EUR 5.8bn. Funding is on currently on track, with issuance totaling EUR 3bn (70% of the domestic target). Domestic issuance is larger than expected after the floods but has been helped by better market conditions. We expect the MinFin to tap the Eurobond market once the 2014 budget re-write is adopted and 2015 budget is approved. After an IMF mission is expected to start negotiations over the IMF loan with final agreement expected by December.

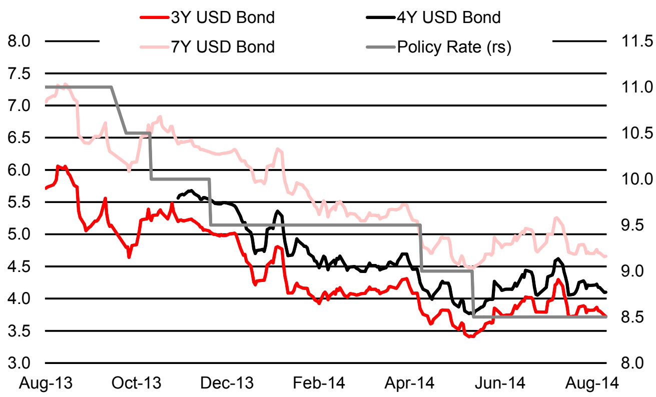
**Strategy: If, and only if, the IMF deal is approved, further curve tightening could occur.** Bonds have rallied this year but an IMF deal could prompt further curve tightening. USD bonds are the only way to trade this as the local bonds market is illiquid. There are significant downside risks in Serbia however, which include a large increase in debt to GDP, budget deficit, and a weak balance of payments. However if the IMF deal is secured we think in the short term the 21s (7Y) have the potential to tighten a further 20-30 bps.

**WE SEE SCOPE FOR A FURTHER FLATTENING OF THE CURVE GIVEN EXPECTED IMF DEAL**

Debt issuance in the domestic market, including EUR issues.




Yield trend of the 2Y, 3Y and 5Y USD hard currency bonds




Source: Bloomberg, MinFin, UniCredit Research

**GOVERNMENT GROSS FINANCING REQUIREMENTS**

| EUR bn | 2013 | 2014F | 2015F |
|---|---|---|---|
| **Gross financing requirement** | **5.8** | **6.1** | **5.9** |
| Budget deficit | 2.6 | 2.1 | 1.9 |
| Amortization of public debt | 3.2 | 3.8 | 4.0 |
| Domestic | 2.2 | 3.2 | 3.4 |
| Bonds | 0.3 | 1.8 | 1.8 |
| Bills | 1.9 | 1.4 | 1.6 |
| External | 1.0 | 0.6 | 0.6 |
| IMF | 0.6 | 0.1 | 0 |
| **Financing** | **5.8** | **6.1** | **5.9** |
| Domestic borrowing | 4.3 | 3.5 | 3.8 |
| Bonds | 3.1 | 2.2 | 2.3 |
| Bills | 1.2 | 1.3 | 1.5 |
| External borrowing | 2.5 | 1.9 | 1.9 |
| Bonds | 0.7 | 0.5 | 1.4 |
| IMF/EU | 0.8 | 0.5 | 0.4 |
| Other | 0.9 | 0.8 | 0.1 |
| Change in cash reserves (+ = decline) | -0.9 | 0.7 | 0.2 |

Source: MinFin, NBS, UniCredit Research

**GROSS EXTERNAL FINANCING REQUIREMENTS**

| EUR bn | 2013 | 2014F | 2015F |
|---|---|---|---|
| **Gross financing requirement** | **7.6** | **7.8** | **7.0** |
| C/A deficit | 2.1 | 2.0 | 1.9 |
| Amortization of medium to long term debt | 5.0 | 5.6 | 5.0 |
| Government/Central Bank | 0.6 | 1.0 | 0.6 |
| IMF | 0.2 | 0.6 | 0.1 |
| Other | 0.4 | 0.4 | 0.5 |
| Banks | 1.1 | 1.0 | 0.9 |
| Corporates | 2.8 | 2.8 | 2.8 |
| Amortization of short term debt | 0.5 | 0.2 | 0.2 |
| Government/Central Bank | 0 | 0 | 0 |
| Banks | 0.4 | 0.2 | 0.2 |
| Corporates | 0 | 0 | 0 |
| **Financing** | **7.6** | **7.8** | **7.0** |
| FDI | 1.2 | 1.6 | 1.7 |
| Equity | 0 | 0 | 0 |
| Borrowing | 5.8 | 5.8 | 5.2 |
| Government/Central Bank | 2.1 | 2.5 | 1.9 |
| IMF | 0 | 0.8 | 0.5 |
| Bonds | 1.9 | 0.7 | 0.5 |
| Other | 0.2 | 0.9 | 0.8 |
| Banks | 1.1 | 0.8 | 0.7 |
| Corporates | 2.6 | 2.6 | 2.6 |
| Change in FX reserves (+ = decline) | 0.6 | 0.4 | 0.1 |

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

**Outlook –** The Turkish economy has benefited from an impressive adjustment in 1H14, but we are concerned this is now slowing and in some variables reversing once again. In part, this can be explained by the CBT's dovish stance, which is feeding into a lower cost of credit and accelerating credit growth. Meanwhile, inflation remains well above the CBT's projection and target, at a time when revenues are slowing down and the government is pushing on fiscal to stimulate activity. This points to an acceleration in domestic demand ahead but leaves Turkey increasingly vulnerable to a correction in foreign portfolio flows given the CBT's limited firepower to act.

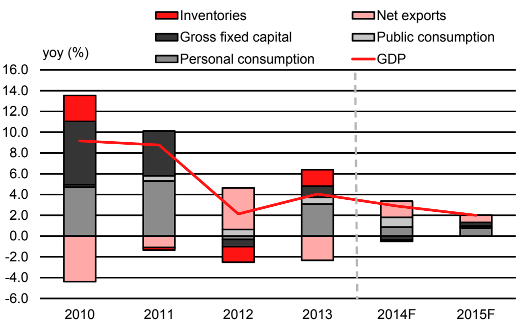
**Strategy –** We recommend being market weight Turkey. The yield curve is very flat and we suggest shifting duration to the front end of the curve. We see significant risks but yields are attractive. If we started seeing outflows from non-residents we would move to underweight.

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

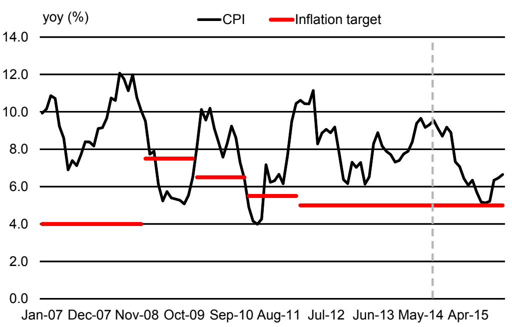
## KEY DATES/EVENTS

- 10 Dec – 3Q13 GDP
- 25 Sep, 23 Oct, 20 Nov – Policy rate decision
- 30 Sep, 31 Oct, 28 Nov – Trade Balance
- 3 Oct, 03 Nov, 3 Dec – Consumer Price Index
- 10 Oct, 10 Nov, 8 Dec – Industrial Production
- 15 Oct, 13 Nov, 11 Dec – Current Account Balance

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




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




Source: TurkStat, CBRT, UniCredit Research

## MACROECONOMIC DATA AND FORECASTS

| | 2011 | 2012 | 2013 | 2014F | 2015F |
|---|---|---|---|---|---|
| GDP (EUR bn) | 558.6 | 611.9 | 616.3 | 594.7 | 598.4 |
| Population (mn) | 74.0 | 74.9 | 75.8 | 76.7 | 77.6 |
| GDP per capita (EUR) | 7,553 | 8,171 | 8,130 | 7,753 | 7,711 |
| **Real economy yoy (%)** | | | | | |
| GDP | 8.8 | 2.1 | 4.0 | 2.9 | 2.0 |
| Private Consumption | 7.7 | -0.5 | 4.6 | 1.3 | 1.2 |
| Fixed Investment | 18.0 | -2.7 | 4.3 | -1.5 | 1.5 |
| Public Consumption | 4.7 | 6.1 | 5.9 | 8.5 | 1.5 |
| Exports | 7.9 | 16.3 | 0.1 | 8.0 | 4.5 |
| Imports | 10.7 | -0.4 | 8.5 | 1.8 | 1.9 |
| Monthly wage, nominal (EUR) | 788 | 919 | 961 | 941 | 979 |
| Unemployment rate (%) | 9.1 | 8.4 | 9.1 | 9.2 | 9.3 |
| **Fiscal accounts (% of GDP)** | | | | | |
| Budget balance | -0.7 | -1.8 | -1.5 | -2.7 | -3.3 |
| Primary balance | 2.0 | 1.1 | 1.1 | -0.1 | -0.8 |
| Public debt | 39.1 | 36.2 | 36.2 | 35.5 | 36.6 |
| **External accounts** | | | | | |
| Current account balance (EUR bn) | -53.9 | -37.7 | -49.2 | -32.7 | -34.5 |
| Current account balance/GDP (%) | -9.7 | -6.2 | -8.0 | -5.5 | -5.8 |
| Basic balance/GDP (%) | -7.9 | -5.0 | -6.8 | -3.9 | -4.0 |
| Net FDI (EUR bn) | 9.9 | 7.1 | 7.3 | 9.2 | 10.8 |
| Net FDI (% of GDP) | 1.8 | 1.2 | 1.2 | 1.5 | 1.8 |
| Gross foreign debt (EUR bn) | 235.8 | 255.3 | 294.4 | 316.8 | 336.0 |
| Gross foreign debt (% of GDP) | 42.2 | 41.7 | 47.8 | 53.3 | 56.2 |
| FX reserves (EUR bn) | 59.4 | 74.5 | 82.8 | 77.9 | 77.2 |
| **Inflation/Monetary/FX** | | | | | |
| CPI (pavg) | 6.5 | 8.9 | 7.5 | 8.9 | 6.2 |
| CPI (eop) | 10.4 | 6.2 | 7.4 | 8.9 | 6.7 |
| Central bank target | 5.5 | 5.0 | 5.0 | 5.0 | 5.0 |
| Central bank reference rate (eop) | 5.75 | 5.50 | 4.50 | 8.00 | 7.50 |
| 3M money market rate (Dec avg) | 8.55 | 7.69 | 9.47 | 9.64 | 8.16 |
| USD/TRY(eop) | 1.87 | 1.79 | 2.07 | 2.20 | 2.37 |
| EUR/TRY (eop) | 2.46 | 2.35 | 2.83 | 3.00 | 3.31 |
| USD/TRY (pavg) | 1.68 | 1.80 | 1.91 | 2.17 | 2.29 |
| EUR/TRY (pavg) | 2.34 | 2.32 | 2.53 | 2.94 | 3.17 |

Source: Unicredit Research

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

## An increasingly unstable equilibrium

**Turkey remains increasingly vulnerable to a change in EM risk sentiment**

The combination of increased geopolitical tension in the Middle East, a persistent erosion of institutional structures and the authorities' decision against accumulating foreign reserves in favor of rate cuts means that the Turkish economy remains very vulnerable to future corrections in foreign portfolio capital to emerging markets.

**1H14 was marked by an impressive adjustment…**

The first half of 2014 was characterised by rebalancing but we are concerned that this is now slowing and in some variables reversing. In the first seven months of the year, the C/A deficit narrowed by almost 40% to a cumulative USD 27bn. This improvement was driven primarily by the trade balance amidst rising exports and a contraction in imports. This captures a USD 8bn improvement in the gold balance but the impact of currency depreciation and tighter monetary policy were also at play. Within GDP net exports made a positive contribution in each of the first two quarters of the year while private consumption showed clear signs of slowdown (from 3.1% in 1Q to 0.39% in 2Q). Yet government consumption continues to grow well above headline GDP growth, while private investment adjusted (-1.5% and -4.1% yoy in 1Q and 2Q respectively).

**…but credit growth is up again, reinforced by the CBRT's dovish stance**

Portfolio inflows to emerging markets have reduced balance of payments pressures on Turkey, allowing the CBRT to ease monetary conditions once again. Despite inflation continuing to come in well above the CBT's inflation target and its own inflation projection, the CBT has reduced its policy rate by a cumulative 175bp, which has been negative in real terms since May. This is feeding into a lower cost of credit (avg. cost down 71bp to 12.6% since end-June) while credit growth accelerated to 20.1% during the first week of September (as per the CBRT's preferred metric, credit growth 13W/13W avg., annualized), and is now 5.1pp higher than the CBRT's target.

**Inflation remains well above the CBRT's target and projection…**

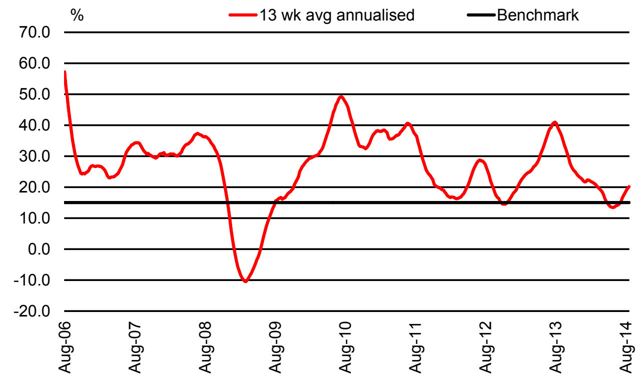
We have some sympathy with the CBRT's view that above target inflation is due to factors outside of its control but its poor track record, elevated core inflation and deterioration in core inflation expectations all point to an need for a more cautious stance. Despite peaking in May, inflation was up by 9.5% yoy in August. Unlike much of the rest of the region where food prices have surprised to the downside, Turkey is currently suffering from the impact of a drought and as such food prices are up 14.4% yoy (adding 3.4pp to the annual headline CPI). But neither the I-core inflation index (9.6% yoy) nor non-food inflation eased much in August. Though inflation should decline from here owing to lower FX pass-through, we remain unconvinced of the CBRT's year-end projection (7.6% yoy). In view of this, and the deterioration in inflation expectations by year-end (up 0.4pp in August to 8.7%) we have revised our year-end inflation forecast upwards to 8.9% yoy (from 8.1% yoy previously).

**...but this is unlikely to force the CBRT to halt the easing cycle in 4Q14**

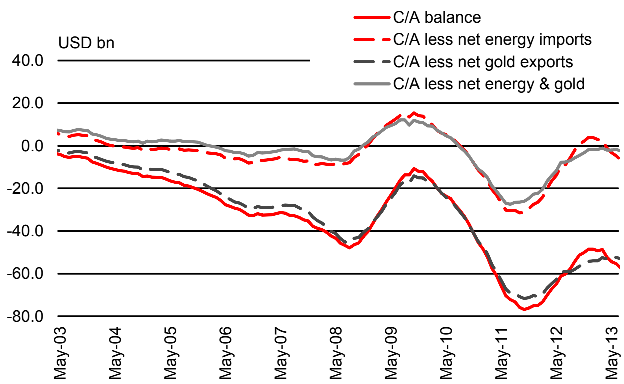
The central bank's reaction function to date suggests that in an environment of continued TRY stability, the risks remain weighted towards some further monetary easing ahead. From 8.25% currently, we forecast the policy rate at year-end at 7.5% while we do not exclude further reductions in the upper end of the corridor from the current 11.25%.

**THE BEST OF THE REBALANCING IS BEHIND US**

Credit growth is accelerating above target




Weak export growth will slow down the C/A adjustment in 2H14




Source: TurkStat, Haver, CBRT, UniCredit Research

**Fiscal targets endangered by weaker revenues and strong capital expenditure**

This is happening at a time when the government is pushing on fiscal policy to support activity, both in the form of higher current (18% yoy in 2Q14) and capital expenditure (1.7% yoy in 2Q14) growth. Latest data from August has shown a slowdown in primary expenditures (down 11.8% yoy) but we doubt this reflects a shift towards more prudence, particularly with the general elections round the corner. A higher interest bill will also put pressure on budget expenditures, while weakening tax revenues (up 8% YTD vs. 17% yoy in 8M13) will weigh on revenue growth. We forecast a budget deficit of TRY 46bn (or 2.7% of GDP) this year, higher than the government's target of TRY 33bn or 1.9% of GDP. Even so, we do not see Turkey turning into a twin deficit story as the Simsek-Babacan duo will avoid losing the fiscal anchor.

**Export growth expected to slowdown in 2H14 due to Iraq and weaker EMU**

All of the above, combined with events in Iraq, means that we expect the current account deficit to improve to 5.5% of GDP this year, 2.5pp lower than in 2013. Following a strong start to the year, export volume growth has slowed over recent months. Moreover in nominal USD terms events in Iraq are taking their toll. In July shows exports to Iraq fell by 45% yoy, subtracting 3.7pp from headline export growth. On a positive note, higher exports to Russia could mitigate indirect risks on total exports via a weaker EU.

**The erosion of institutional structures in Turkey is becoming of increasing concern…**

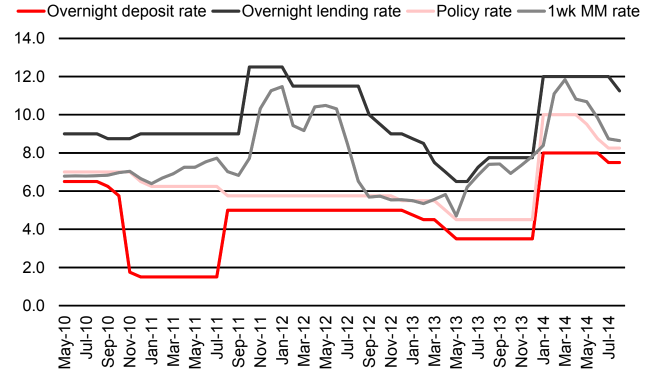
Meanwhile political and institutional developments are of concern when we consider the longer term growth outlook for Turkey. Local and presidential elections this year brought no significant surprise. At this stage a weak opposition means that AKP remains on track to win next year's general election. Following twelve years as PM, Erdogan has moved to the role of President and looks set to play a much more active role than his predecessor. Meanwhile, institutional structures in Turkey continue to erode. Government representatives have persistently questioned central bank independence over the past year. Large personnel changes materialized within the central bank, judiciary and police force. Most recently the freedom of the press was once again jeopardized by laws allowing the government to limit internet access for periods of time. Relations with the EU and US are increasingly frosty.

**...as well as its lack of defence mechanisms against a potential correction in foreign portfolio flows**

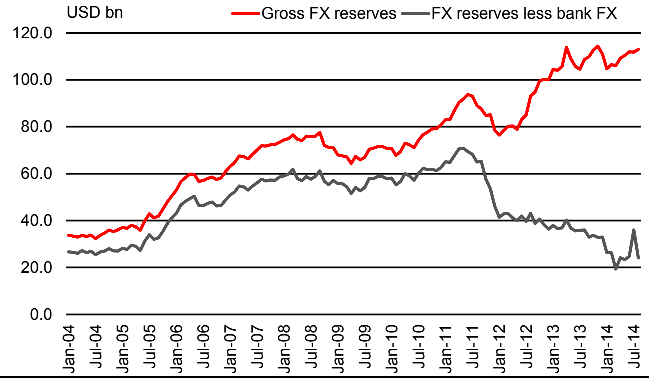
The above leaves us concerned that Turkey has not only missed another opportunity over the past couple of quarters to build defence mechanisms against another correction in foreign portfolio flows to EM but that its vulnerability to such an event is likely to continue to grow further. The core of the problem is twofold, namely Turkey's low savings ratio (20.3% in 2013) and elevated consumption ratio (85.9% of GDP), and the CBRT's low level of foreign reserves. Gross foreign reserves stand at USD 113bn but net of bank FX deposited at the CBRT reserves decline to USD 24.1bn vs. cumulative foreign portfolio inflows YTD of USD 15bn. The past couple of quarters have provided the authorities an opportunity to accumulate foreign reserves without any significant disruption to TRY while efforts to rein in current government expenditure would have helped narrow the current account deficit. But authorities opted for near term gains in the form of higher growth this year. In this environment, the government will struggle to meet its growth targets both next year and beyond.

**THE CBRT IS BECOMING INCREASINGLY VULNERABLE TO A CHANGE IN EM RISK SENTIMENT**

The CBRT continues to ease monetary conditions…




…at the expense of accumulating net FX reserves




Source: CBRT, Turkstat, UniCredit Research

## Strategy: Positioning for significant risks

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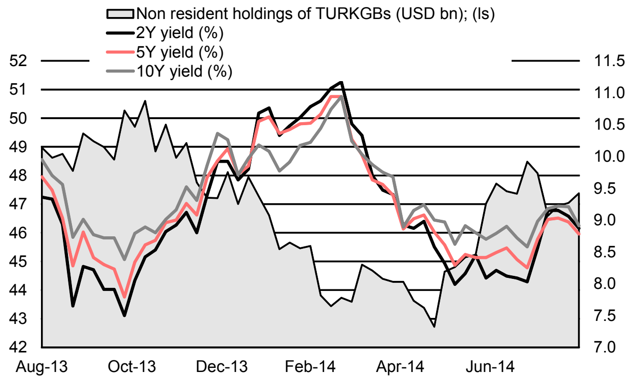
**We recommend being market weight in TURKGBs but there are substantial potential downside risks**

**TURKGBs still has very attractive yields but with the curve so flat we recommended shifting to the short end, and if we start seeing outflows we would change our view to underweight**

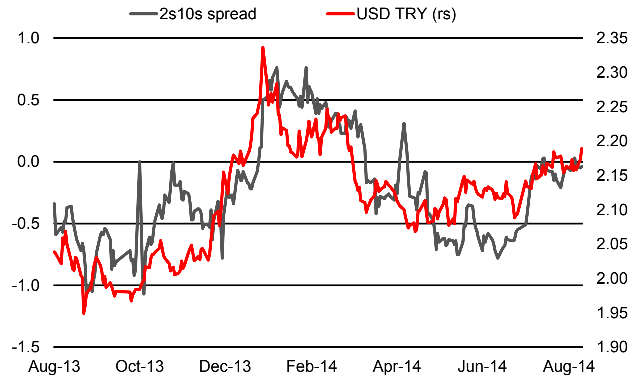
We recommend being market weight in TURKGBs. We see a number of potential risks for bonds, namely the conflict in Iraq, slowing improvements in the C/A, high inflation and a dovish CBRT. Negative real interest rates and risks of a deficit overshoot would normally be enough for an underweight TURKGB recommendation. But Turkey continues to attract inflows (USD 169mn YTD) and bonds have some of the highest EM yields, making it costly to be underweight.

Notwithstanding our underlying concerns, the curve has tightened 134bps this year and is now very flat with only 10bps separating the 2 and 10y points. We recommend that real money accounts should shift duration to the front end of the curve. We would change our view to underweight if we start seeing outflows from non-residents. If this was combined with deteriorating economic conditions, further rate cuts, and rising US treasury yields we would look to initiate a 2s 10s flattener. Under such a scenario we would expect TRY to depreciate and given the lack of net FX reserves this would likely cause the TURKGB curve to invert.

TURKGB nonresident flows are key to stability




In outflows and FX weakness – look to initiate a 2s 10s flattener




Source: CBRT, Treasury, Bloomberg, Unicredit Research

**GOVERNMENT GROSS FINANCING REQUIREMENTS**

| EUR bn | 2013 | 2014F | 2015F |
|---|---|---|---|
| **Gross financing requirement** | **57.6** | **59.1** | **61.2** |
| Budget deficit | 9.4 | 15.9 | 20.1 |
| Amortisation of public debt | 48.2 | 43.2 | 41.1 |
| Domestic | 45.2 | 39.3 | 34.4 |
| Bonds | 45.2 | 39.3 | 34.4 |
| Bills | 0 | 0 | 0 |
| External | 3.0 | 3.8 | 6.7 |
| **Financing** | **57.6** | **59.1** | **61.2** |
| Domestic borrowing | 49.8 | 48.8 | 45.9 |
| Bonds | 49.8 | 48.8 | 45.9 |
| Bills | 0 | 0 | 0 |
| External borrowing | 4.8 | 9.0 | 9.0 |
| Bonds | 4.8 | 9.0 | 9.0 |
| Other | 10.1 | 9.1 | 7.8 |
| Change in cash reserves(+ = decline) | -7.0 | -7.8 | -1.5 |

Source: CBRT, Turkstat, UniCredit Research

**GROSS EXTERNAL FINANCING REQUIREMENTS**

| EUR bn | 2013 | 2014F | 2015F |
|---|---|---|---|
| **Gross financing requirement** | **155.1** | **145.5** | **142.3** |
| C/A deficit | 49.2 | 32.7 | 34.5 |
| Amortisation of medium to long term debt | 32.3 | 25.4 | 19.4 |
| Government/central bank | 2.9 | 2.0 | 2.0 |
| Banks | 6.9 | 11.8 | 8.7 |
| Corporates | 22.5 | 11.6 | 8.7 |
| Short term debt | 76.5 | 92.3 | 92.3 |
| Government/central bank | 9.2 | 12.9 | 12.9 |
| Banks | 44.3 | 54.0 | 54.0 |
| Corporates | 23.0 | 25.4 | 25.4 |
| Errors & omissions | -2.9 | -4.9 | -3.9 |
| **Financing** | **155.1** | **145.5** | **142.3** |
| FDI | 7.3 | 9.2 | 10.8 |
| Portfolio | 18.0 | 8.8 | 10.9 |
| Borrowing medium to long term | 41.3 | 32.4 | 26.4 |
| Government/central bank | 4.8 | 9.0 | 9.0 |
| Banks | 14.1 | 11.8 | 8.7 |
| Corporates | 22.4 | 11.6 | 8.7 |
| Short term borrowing | 92.3 | 92.3 | 92.3 |
| Government/central bank | 12.9 | 12.9 | 12.9 |
| Banks | 54.0 | 54.0 | 54.0 |
| Corporates | 25.4 | 25.4 | 25.4 |
| Other | 3.8 | 5.8 | 2.0 |
| Reserve accumulation | -7.5 | -3.0 | 0 |

# Ukraine (Caa3 negative/CCC stable/CCC)*

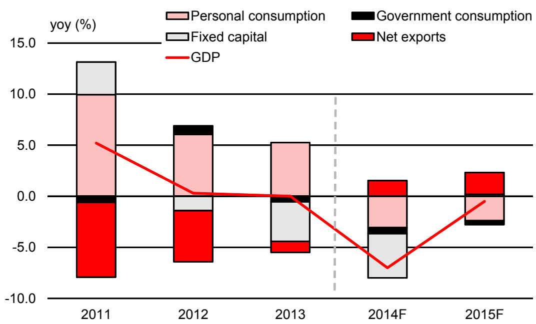
**Outlook** – Geopolitical tensions have rendered an ambitious IMF programme even less workable. October's parliamentary elections may help aid the reform agenda in parliament but without a lasting solution to geopolitical tensions, this will not be sufficient to set the economy on a sustainable growth path. Economic activity is weaker than expected, in part because of the impact of Donetsk and Luhansk while fiscal targets have been missed, with more to do next year. Foreign reserve accumulation has not progressed as planned. In the absence of a significant improvement in relations with Russia, the sovereign will find itself forced either to seek large amounts of additional financing or take measures to ease the maturity profile of its debt.

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

### KEY DATES/EVENTS

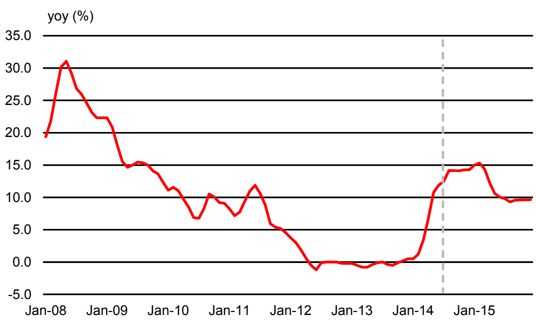
- 26 Oct: Parliamentary elections
- 23 Sep, Nafto redemtpion
- 4-8 of every month: Foreign reserves data

### GDP: SET FOR SHARP CONTRACTION




Source: State Statistics Service of Ukraine, UniCredit Research

### INFLATION TO SUFFER FROM FX LOSSES




Source:State Statistics Service of Ukraine, UniCredit Research

### MACROECONOMIC DATA AND FORECASTS

| | 2011 | 2012 | 2013 | 2014F | 2015F |
|---|---|---|---|---|---|
| GDP (EUR bn) | 117.1 | 135.8 | 134.3 | 94.1 | 87.0 |
| Population (mn) | 45.6 | 45.5 | 45.4 | 45.3 | 45.2 |
| GDP per capita (EUR) | 2,568 | 2,984 | 2,958 | 2,077 | 1,925 |
| **Real economy yoy (%)** | | | | | |
| GDP | 5.2 | 0.3 | 0 | -7.0 | -0.5 |
| Private Consumption | 15.7 | 9.1 | 7.7 | -4.5 | -3.5 |
| Fixed Investment | 7.1 | 2.8 | -6.5 | 0 | 0 |
| Public Consumption | -3.0 | 4.6 | -2.8 | -3.0 | -2.0 |
| Exports | 4.3 | -7.2 | -9.3 | -8.0 | 1.5 |
| Imports | 17.7 | 1.8 | -6.2 | -9.5 | -2.3 |
| Monthly wage, nominal (EUR) | 237 | 292 | 294 | 293 | 300 |
| Unemployment rate (%) | 8.2 | 7.8 | 7.5 | 7.6 | 8.0 |
| **Fiscal accounts (% of GDP)** | | | | | |
| Budget balance | -2.8 | -4.5 | -4.5 | -6.0 | -4.6 |
| Primary balance | -0.8 | -2.6 | -2.0 | -2.6 | -0.8 |
| Public debt | 36.8 | 37.4 | 41.0 | 67.6 | 71.3 |
| **External accounts** | | | | | |
| Current account balance (EUR bn) | -7.4 | -11.1 | -12.3 | -2.9 | -2.1 |
| Current account balance/GDP (%) | -6.3 | -8.2 | -9.2 | -3.1 | -2.4 |
| Basic balance/GDP (%) | -2.0 | -4.4 | -7.3 | -1.2 | 0 |
| Net FDI (EUR bn) | 5.0 | 5.2 | 2.5 | 1.8 | 2.1 |
| Net FDI (% of GDP) | 4.3 | 3.8 | 1.9 | 1.9 | 2.4 |
| Gross foreign debt (EUR bn) | 97.4 | 102.4 | 105.8 | 107.7 | 115.3 |
| Gross foreign debt (% of GDP) | 83.2 | 75.4 | 78.8 | 114.5 | 132.5 |
| FX reserves (EUR bn) | 23.4 | 17.2 | 13.7 | 16.5 | 21.5 |
| **Inflation/Monetary/FX** | | | | | |
| CPI (pavg) | 8.0 | 0.6 | -0.3 | 9.8 | 11.3 |
| CPI (eop) | 4.6 | -0.2 | 0.5 | 14.3 | 9.7 |
| Central bank target | | tentative target of 5% by 2014 | | | |
| Central bank reference rate (eop) | 7.75 | 7.50 | 6.50 | 12.50 | 11.50 |
| 3M money market rate (Dec avg) | 21.9 | 24.4 | 16.0 | 18.0 | 14.0 |
| USD/UAH (eop) | 10.4 | 10.6 | 11.3 | 18.5 | 19.6 |
| EUR/UAH (eop) | 8.0 | 8.1 | 8.2 | 13.6 | 14.0 |
| USD/UAH (pavg) | 8.0 | 8.1 | 8.2 | 12.0 | 13.8 |
| EUR/UAH (pavg) | 11.1 | 10.4 | 10.8 | 15.9 | 19.0 |

Source: UniCredit Research

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

## In need of much larger international financial support

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**Geopolitical tensions render an ambitious IMF programme even less workable**

Since the announcement of the IMF programme at the end of April, tensions with Russia have persistently escalated. Following delays, the IMF's first review documents were concluded internally by 18 August and highlighted the fact that at the time of its inception the programme did not assume an intensification of the conflict or a gas dispute with Russia. Since 18 August, fighting escalated, reversing some of the Ukrainian government's progress in the region while NATO has put forward evidence of significant Russian troop presence in Ukraine. At the time of writing a ceasefire was agreed but neither side appears to have much conviction on its lasting power while there was no sign of an agreement on gas deliveries with Russia. All of the above materialises against a backdrop whereby the initial programme was already too optimistic, including on the ability of the authorities to push through fiscal consolidation measures, the costs of banking sector recapitalization and the prospects for foreign reserve accumulation.

**October's parliamentary elections may help aid the reform agenda in parliament but without a lasting solution to geopolitical tensions, this will not be sufficient**

Our baseline, though subject to rapid change, is that Ukraine moves towards parliamentary elections in late October, with President Poroschenko's bloc likely to significantly lead all others in parliament. This should provide the President with more influence in parliament, allowing for more progress on IMF conditionality. But none of the above will keep the programme on track without a lasting resolution to geopolitical tensions in the East. Unfortunately we view this as much less likely at this stage.

**Economic activity is weaker than expected, in part because of the impact of Donetsk and Luhansk…**

All of the above has left the Ukrainian economy more vulnerable than assumed under the initial programme. The contraction in GDP accelerated to 4.6% yoy in 2Q, with investment leading the way (-18.5%), while a positive contribution from net exports helped to cushion the downturn. Recent geopolitical developments mean that the contraction is set to turn more pronounced in 3Q while an escalation in the gas dispute over the winter with Russia risks adding further downward pressure to activity. The regions of Donetsk and Luhansk account for over 15% of GDP and 23% of industrial production but not surprisingly have shown much sharper contractions across a range of economic indicators (industrial production, agriculture, construction, retail trade) in recent months.

**…while fiscal targets have been missed, with more to do next year**

The combination of weaker than expected economic activity, geopolitics and a larger Nafto shortfall means that this year's deficit target has been widened by 1.6pp of GDP to 10.1% of GDP (ex-Nafto 0.6% of GDP to 5.8%). Monthly central government data have performed much better but largely due to an advanced profit transfer from the NBU. The authorities have committed to further fiscal measures (wages, pensions, goods and services) to bring next year's deficit in line with the original target of 6% of GDP. This overshoot, with a large shortfall from the banking system and a weaker UAH also pushes public debt to GDP above the 70% of GDP threshold put forward as high risk in the original programme documents and over 11pp of GDP higher than the April projection.

**Foreign reserve accumulation has not progressed as planned**

This deterioration in the outlook for public debt is accompanied by a weaker trajectory for an already low level of foreign reserves. From a low of USD 14.2bn in April, foreign reserves should exceed USD 16bn by September, aided by a cumulative USD 4.6bn in IMF disbursements YTD and some World Bank funding. But the Fund has marked down its forecast for foreign reserves by the end of this year by USD 3bn to USD 16.2bn, assuming that NBU can still accumulate USD 1bn in the market. This, combined with the risks surrounding deposit flight and the impact of a weaker currency on banking and public sector balance sheets, further increases pressure on the NBU to maintain higher interest rates for an extended period of time (the discount rate has been increased by 600bp since March to 12.5%).

**In the absence of a significant improvement in relations with Russia, the sovereign will find itself forced either to seek large amounts of additional financing or take measures to ease the maturity profile of its debt**

Against this backdrop, we expect the sovereign to remain current on its external debt obligations this year (following the USD 1.6bn Nafto bond to be paid at the end of September, the next external sovereign bond matures in Sep-14). Without a meaningful solution to the conflict in the east over the coming months, however, Ukraine's international partners risk being forced to contributed a sizeable amount of additional funds or consider easing the government's debt redemption profile.

## Notes

## Notes

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