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3Q **2010**

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V.i.S.d.P.:
Marco Annunziata,
Chief Economist (UniCredit Group)
Global Head of Economics,
Fixed Income & FX Research
120 London Wall
London
EC2Y 5ET

For publication requests in Austria and CEE please refer to:

Bank Austria Identity & Communications Department
pub@unicreditgroup.at
+43 50505 52826

Marco Annunziata, Chief Economist UniCredit Group, Global Head of Economics, Fixed Income & FX Research (UniCredit Group)
+44 207 826 1770, marco.annunziata@unicreditgroup.eu

Gyula Toth, Head of EEMEA FI/FX Strategy (UniCredit CAIB)
+43 5 05 05 82362, gyula.toth@caib.unicreditgroup.eu

Cevdet Akcay, Ph.D., Chief Economist, Turkey (Yapi Kredi)
+90 212 319 8430, cevdet.akcay@yapikredi.com.tr

Matteo Ferrazzi, Economist, EEMEA (UniCredit Bank Milan)
+39 02 8862 8600, matteo.ferrazzi@unicreditgroup.eu

Dmitry Gourov, Economist, EEMEA (UniCredit CAIB)
+43 5 05 05 82364, dmitry.gourov@caib.unicreditgroup.eu

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

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

Vladimir Osakovskiy, Ph.D., Head of Macroeconomic Analysis and Research (UniCredit Bank Russia)
+7 495 258 7258 ext. 7558, vladimir.osakovskiy@unicreditgroup.ru

Rozália Pál, Ph.D., Macro and Strategic Analysis Coordinator, Romania (UniCredit Tiriac Bank)
+40 21 203 2376, rozalia.pal@unicredit.ro

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

Goran Šaravanja, Chief Economist, Croatia (Zagrebačka banka)
+ 385 1 6006 678, goran.saravanja@unicreditgroup.zaba.hr

Pavel Sobisek, Chief Economist, Czech Republic (UniCredit Bank)
+420 2 211 12504, pavel.sobisek@unicreditgroup.cz

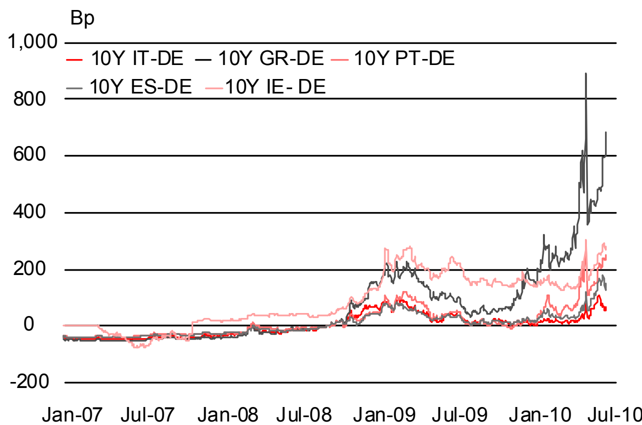
Jan Toth, Chief Economist, Slovakia (UniCredit Bank)
+421 2 4950 2267, jan.toth@unicreditgroup.sk

Eurozone risks are the main threat

Once again, the main risks to growth and financial stability to the EEMEA region seem to emanate from the global picture, and in particular from the developments in Europe and the rest of the advanced economies. Europe is still in the throes of a debt crisis, where concerns about the sustainability of public finances and about the health of the banking sector risk feeding on each other. In the financial sector in particular, we have seen the reappearance of signs of stress and dislocation that are eerily reminiscent of the period around the Lehman debacle: Libor-OIS spreads have widened, there is evidence of perceived counterparty risk having increased again, and some banks have again been encountering difficulties in raising liquidity and funding. While we are far from the levels of stress that we experienced at the height of the sub-prime crisis, there is a clear risk that if these dislocations persist, they could at the very least restrain the flow of bank credit and thereby hinder the recovery.

FINANCIAL MARKET VOLATILITY INCREASED

Peripheral sovereign spreads



OIS spreads

Source: Bloomberg, UniCredit Research

Concerns on the banking system are twofold. First, some investors believe that Europe has never revealed a sufficiently clear picture of its banking system, and that some banks might therefore be lagging behind in the process of deleveraging and recapitalization. Second, investors are worried that adverse developments on the sovereign debt front, ranging from further spread widening to possible episodes of debt restructuring, might deal a fatal blow to banks. To try and bolster confidence, EU policymakers have recently decided that they will release the results of a new round of bank stress tests, in an effort to clear the air and persuade investors that the bulk of the European banking system is fundamentally solid and resilient. As usual, some degree of skepticism on coordinated EU action is in order; however, in this case individual countries have both the ability and the incentive to proceed on their own. Spain, which is under heavier pressure, appears to be leading the way towards greater transparency.

As this new phase of the crisis has originated from concerns about the sustainability of public finances, much of the action is currently unfolding on the fiscal adjustment front. Greece is of course targeting a draconian adjustment under its IMF/EU program, but Portugal and Spain has also launched fairly ambitious new measures, and Italy has also proactively approved a new set of measures to underpin its deficit targets for the coming years. This has created a fierce debate on whether fiscal adjustment is being accelerated in an imprudent way, with a risk that the European economy might be plunged back into a double-dip recession.

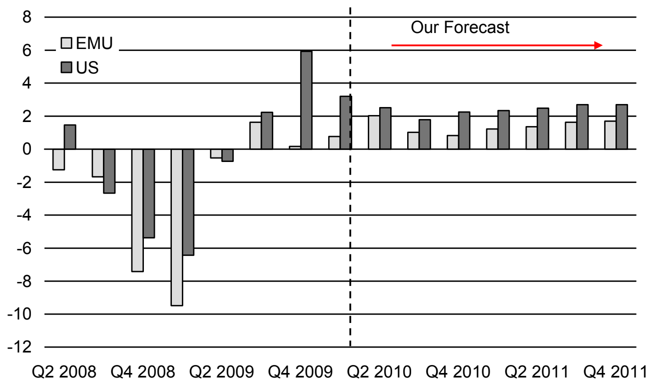
There is an additional international dimension to the debate: the US in particular has expressed concern that a premature rush to austerity in Europe could not only threaten the global recovery, but also undermine the ongoing reduction of global imbalances: if Europe constrains its domestic demand and relies increasingly on exports to drive its recovery, helped also by a weaker EUR, then the global recovery would again become excessively reliant on a resumption of US consumer spending.

We believe concerns that European fiscal consolidation might trigger a double-dip recession in Europe and undermine the global recovery are exaggerated. First, the more ambitious fiscal consolidation programs have been launched in smaller member countries, and should therefore not have a great impact on the Eurozone's overall rate of growth. The three largest economies do not appear to be pursuing an excessively ambitious consolidation. Both Italy and Germany start off with already a relatively low fiscal deficit, and therefore can afford to target a moderate reduction in the years ahead. France, which suffers from a high deficit, seems to rely heavily on an acceleration of growth to close the gap, and has so far not released any specific details of austerity measures. In addition, the Eurozone is benefiting from the marked depreciation of the EUR to date, which we estimate will add about 0.8 percentage points to growth over the second half of this year and the first half of 2011. We have therefore left our Eurozone growth forecasts unchanged, at 1.0% this year and 1.3% next year. The recovery is lackluster, but remains on track. Moreover, the country which maintains the most robust outlook within the Eurozone is probably Germany, which is especially important for the growth outlook in EEMEA.

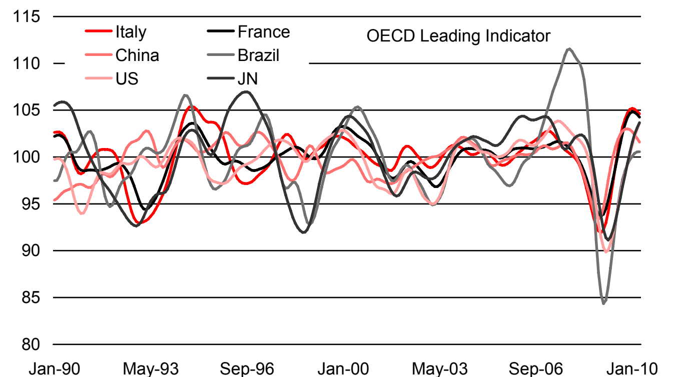
We are also relatively sanguine about the global backdrop. It is true that the additional 0.8pp of growth that the Eurozone gets from a weaker exchange rate are in a sense "stolen" from the rest of the world. However, growth in the largest emerging markets remains robust, especially in Asia. China has very recently indicated greater confidence that its recovery is well entrenched, to the extent that it might now feel more confident to allow a somewhat greater pace of yuan appreciation. The recovery in the US also appears on track, even though data remain mixed. Overall, therefore, we believe that fears of a double-dip recession are exaggerated. At the same time, we would caution that the momentum of the global rebound seems to have peaked, so that global growth is now likely to settle on a more subdued pace, with some downside risks.

SOME SLOWDOWN AHEAD BUT CONCERNS ABOUT EUROPEAN FISCAL DRIVEN DOUPLE DIP LOOK OVERDONE

Our growth forecasts for US, eurozone



OECD leading indicators



Source: Bloomberg, UniCredit Research

Additional support should continue to come from monetary conditions. The ECB has again stepped up its liquidity provisions, and it has begun buying peripheral government bonds outright, putting its exit strategy on hold for the time being. It can afford it: inflation remains subdued, with a downward trend in core inflation which is well entrenched and which compensates for some revival in pressure from commodity prices. Inflation expectations also remain well-anchored, notwithstanding the public debate on whether the ECB might have lost both credibility and independence. Any rate hikes will be postponed well into next year, and for the coming months we expect the ECB to keep providing ample liquidity to stabilize the financial system. This implies that short term rates are set to remain low for at least the coming quarter – and the ongoing fiscal consolidation effort should limit the upside risk on longer term rates over the next few months. On the currency side, after losing a lot of ground over the past months we expect the EUR to stabilize and range-trade in the coming quarter, as negative sentiment on the Eurozone might have bottomed out for the time being. Investors might draw some comfort from the bank stress tests, and reassess the growth risks posed by fiscal consolidation; at the same time, the fundamental weaknesses and challenges of the Eurozone remain extremely serious, ranging from fiscal consolidation to structural reforms, and will continue to negate any meaningful EUR upside going forward.

Author:
Marco Annunziata, Ph.D., Chief Economist (UniCredit Group)
+44 207 826 1770
marco.annunziata@unicreditgroup.eu

CEE outlook: sensibly better than a year ago, but worse than 2 months ago

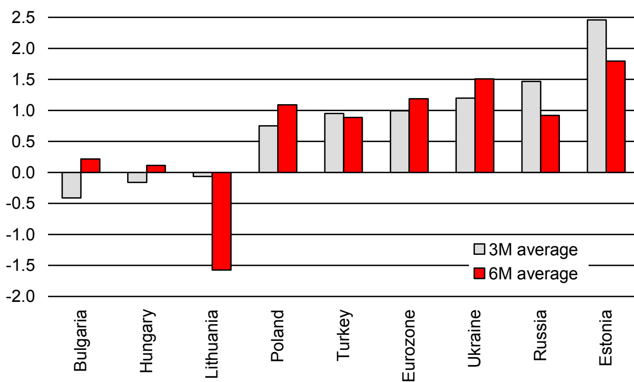
CEE: growth held up relatively well with the usual suspects lagging the recovery

But it remains a two speed recovery with domestic demand remaining relatively weak

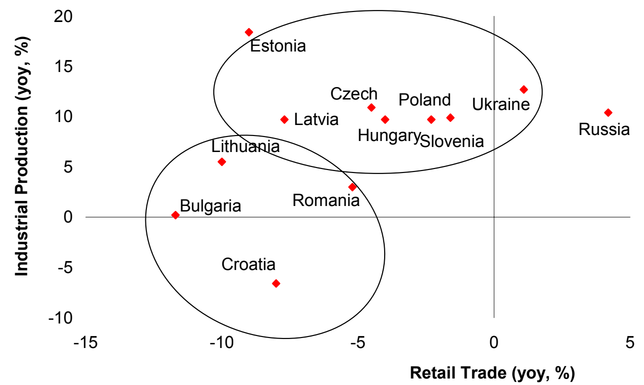
The EEMEA region has weathered the European sovereign debt crisis relatively well to date, as growth indicators continued to improve during 2Q (chart 1) albeit the difference between confidence indicators and real production data has widened somewhat. As regards dynamics, we see the strongest momentum in Turkey, while the previous slower growth economies (having overheated before the crisis) are still lagging behind both in terms of momentum and in terms of levels. We believe this broad difference is likely to continue in the coming months as will the growth differential. In the current recovery phase countries most open to the global trade cycle are seeing the greatest benefits, as exports are still a key source of growth across the region. On the other hand, the recent downside surprises in German confidence indicators are somewhat worrying. Meanwhile, as we outlined in our previous Quarterly publication (titled “Two speed recovery”) domestic demand (mostly household) is still very weak (chart 2) and we do not foresee a meaningful change in this picture in the coming quarter. Firstly, lending dynamics are still very soft (apart from a few countries) and secondly wage growth is much slower now than during the pre-crisis period whilst unemployment has yet to stabilize across the region.

INDUSTRY IS LEADING THE RECOVERY, BUT MOMENTUM WILL LIKELY REMAIN LOOSE

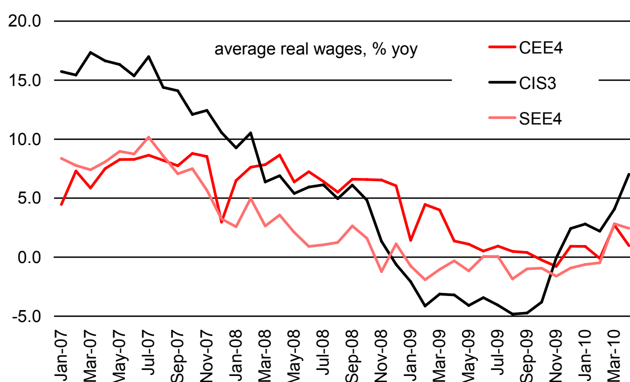
Seasonally adjusted mom industrial production – usual suspects lag



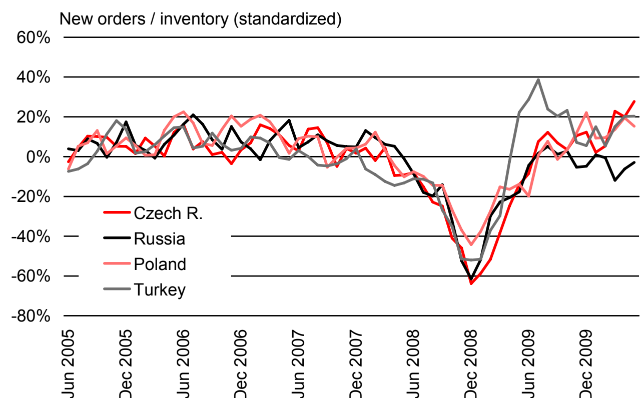
Household demand remains weak, particularly vs. industry



Real wages are below pre-crisis levels



Inventory cycle is still supportive in some countries



Source: Markit, Bloomberg, Statistic offices, UniCredit Research

On a more positive note, regarding domestic demand, we note a number of countries are undertaking wide-ranging infrastructure development programs (Poland and Ukraine in preparation for EURO2012, Kazakhstan in a drive to modernize its infrastructure, Russia in preparation for the Sochi 2014 Olympics and Serbia has a meaningful agenda too), something that is spilling into increased levels of construction activity and helping to ease the hang-over from the previous construction boom.

The Eurozone debt problem ought to have limited effect on CEE markets in the near term as long as core Eurozone performs and EUR weakens in an orderly way

Will the Eurozone debt problems negatively affect EEMEA growth? So far the Eurozone sovereign debt crisis has manifested itself in a sharp depreciation of the EUR, wider bond spreads and a diverging growth differential between core and periphery countries. Although a full-blown crisis would certainly have negative implications for capital flows (and hence on the EEMEA region) we believe till the growth divergence of core and periphery Eurozone economies holds, **the EEMEA region will continue to perform relatively well**. Firstly, the weaker EUR is making German exports even more competitive (indeed our Eurozone colleagues increased their German GDP forecast to 2% from 1.8% for 2010). A broad divergence between core Eurozone and periphery is obviously not a new phenomenon (chart 6) but on balance it is still supportive for the CEE region. In addition, the EUR referenced EEMEA currencies (HUF, PLN, CZK and RON) are the only ones in the world that are weaker against the EUR YTD (chart 5), which is making them more competitive towards other trade zones (Asia, LatAm). In this vein, the USD or basket referenced EEMEA currencies (TRY, RUB and ZAR) are somewhat less competitive (but they have more trade relationship vs. Asia).

We believe the biggest risk is a global double dip and its negative implication on capital flow

Over the coming months, we believe a lot of attention will focus on the likelihood of a global double dip and its negative implications on capital flows – something that we see as the most meaningful risk to EEMEA growth. However, the immediate environment remains supportive, and the near term EUR weakness remains stable, while core Eurozone economies (Germany and France) are holding up relatively well. These considerations and somewhat better than expected 1Q GDP numbers have prompted us to slightly increase our regional GDP forecast for 2010 to 3.1% from 2.8%. On the other hand given the above outlined uncertainties we did not reflect these changes in the 2011 forecast fully (4.3% from 4.1%). With these forecasts we are above consensus in Turkey and Russia for 2011 and somewhat below consensus in Hungary, Czech Republic, Romania and Poland for 2011 (table 1).

UNICREDIT GDP FORECAST CHANGES AND COMPARISON VS. CONSENSUS

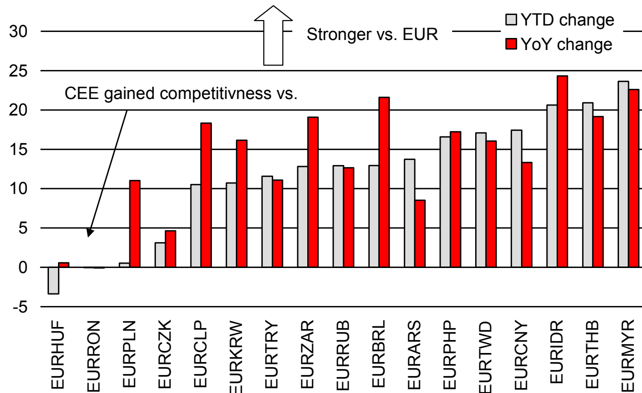
	UniCredit Jul 2010 Forecast		UniCredit Apr 2010 Forecast		Focus Economics	
GDP	2010	2011	2010	2011	2010	2011
Bosnia-Herz.	0.5	1.2	-1.0	0.8	1,3*	3,2*
Bulgaria	-1.0	1.8	-1.0	2.2	-0.4	2.7
Croatia	-1.5	1.6	-1.0	1.3	-0.6	2.1
Czech Rep.	1.8	2.2	1.6	2.4	1.6	2.6
Estonia	1.2	3.2	-1.3	3.4	0.3	3.3
Hungary	0.5	2.2	-0.1	2.8	0.3	2.7
Kazakhstan	5.0	6.0	3.5	5.0	2.7	4.3
Latvia	-1.3	3.9	-2.5	5.5	-3.1	2.9
Lithuania	-0.9	3.3	-3.0	3.0	-1.5	2.8
Poland	2.6	2.8	2.6	2.7	2.9	3.5
Romania	-0.9	2.5	0.4	3.5	0.4	2.8
Russia	3.4	5.0	3.4	5.0	4.7	4.3
Slovakia	3.5	3.5	3.1	3.8	2.7	3.4
Slovenia	0.9	1.9	0.6	1.5	0.7	2.2
Serbia	0.0	2.2	-0.5	2.2	1.3*	3.3*
Turkey	5.6	5.2	4.5	4.5	5.4	4.3
Ukraine	3.0	4.0	3.0	4.0	3.7	4.1
CEE-17	3.1	4.3	2.8	4.1	-	-

*Consensus Economics

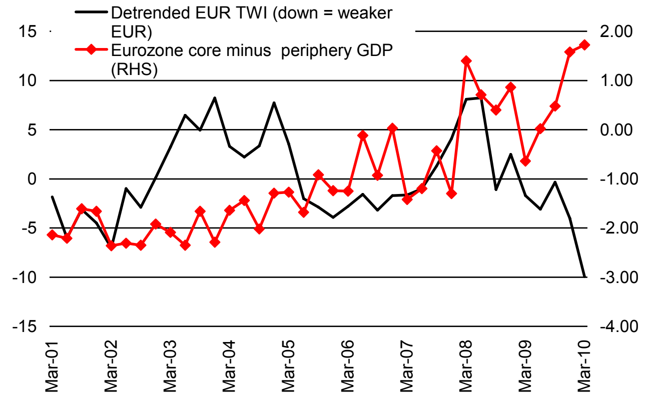
Source: Focus Economics, Consensus Economics, UniCredit Research

CEE BENEFITS FROM STRONGER CORE EUROZONE AND WEAKER EUR

FX changes vs. EUR: gain vs. Asia



Core Eurozone outperforms periphery



Source: Bloomberg, UniCredit Research

Inflation pressure remains limited

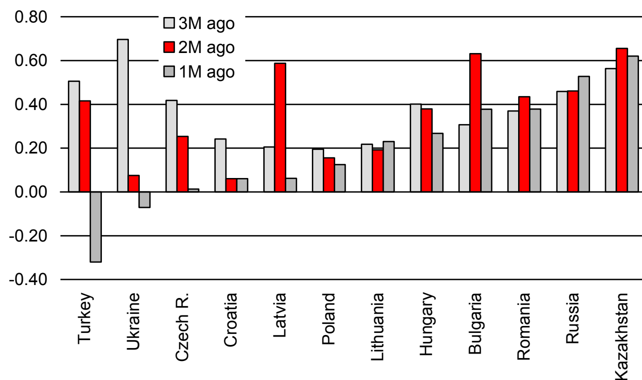
CPI (eop) forecasts

	2010	2011
BG	1.62	3.14
HR	2.60	2.80
CZ	2.00	2.10
HU	4.60	4.05
KZ	8.10	7.28
PL	2.40	2.90
RO	4.40	4.00
RU	6.58	6.90
SRB	7.00	6.20
SK	1.85	3.30
SL	2.50	3.20
TK	8.30	6.70
UA	10.40	11.50

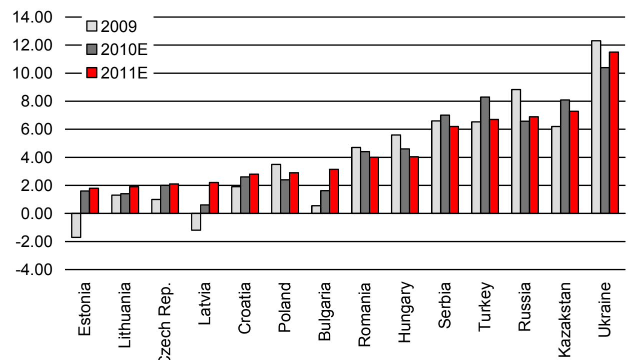
Inflation has remained off the agenda for a good number of months (chart 7), apart from that we see increasing upside risks in the next few months driven by #1 weaker currencies and #2 the fact that spring floods that have been much heavier in some countries than usual. This will likely drive up the fuel and food components of inflation, potentially pushing the yoy headline numbers higher. This development has prompted us to increase our 2010 inflation forecast for some countries but given the still relatively weak domestic demand (regional money multipliers have continued to inch down, showing that money demand remains weak) we have largely kept our 2011 numbers unchanged or in some cases slightly reduced them. Turkey remains the inflation outlier in the EEMEA region because of the very strong growth momentum and rising inflation expectations, although we note that the short term dynamics are encouraging. The near term implication for monetary policy is less clear cut but on balance we maintain our view that Turkey will be the only country in the EEMEA region that will enter into more meaningful monetary tightening during the year (we continue to expect 125bp in 4Q) whilst we do not see other countries hiking rates during 2010. Looking at 2011, we still expect inflation to remain relatively contained whilst the monetary policy will be more of the function of when the ECB and the FED will start tightening rates. Overall, we believe that the Eurozone sovereign debt crisis might postpone the beginning of the ECB's tightening cycle.

TURKISH INFLAITON SLOWED SHARPLY IN THE LAST MONTH BUT THE Y-O-Y LEVEL IS STILL HIGH

Seasonally adjusted mom headline inflation: slowing down further



Yoy end of period CPI



Source: National Statistic Office, Bloomberg, UniCredit Research

CEE public debt is lower than Eurozone but many countries had to address fiscal problems during the last few months, leading to austerity programs

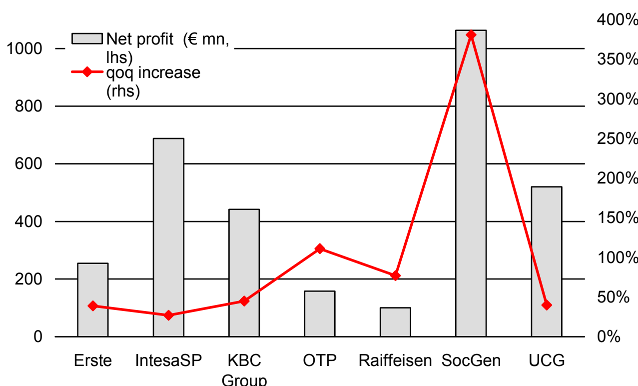
Fiscal policy: Although the focus has been clearly on the Eurozone sovereign debt crisis during the last quarter we believe there have been important developments on the EEMEA fiscal front and mostly in the right direction: **Hungary**: the country with the highest public sector debt in the region (around 80%/GDP) held general elections in April which produced a very strong two thirds majority. The new government after some "hesitation" has accepted the deficit targets agreed by the previous government (3.8%/GDP for 2010 and 2.9%/GDP for 2011) and announced a relatively significant package which aims to reduce taxation and public expenditures mostly via taxation of the banking sector. We think a bank tax might be considered by other countries during the coming months as well. **Romania**: the government has introduced a sweeping spending cuts program during the quarter which after the failure of the no-confidence vote will likely underpin the most recently agreed IMF deficit target (at 6.8%). In **Bulgaria**: noise has increased about the reliability of the fiscal figures in June but we believe the underlying fiscal trends are relatively solid and the government has already unveiled measures to offset the probably 2pct point increase in the deficit stemming from the accounting difference (ESA vs. cash). Regarding the **Czech Republic and Slovakia**: general elections were held recently and the results delivered relatively pro market winners (albeit in both countries there will be coalition governments comprising more than 2 parties and discussions about government formations are still ongoing). The only country where the momentum has faded somewhat this quarter was **Ukraine**, as the resumption of an IMF program has been pushed back on the lack of meaningful reforms and public debt has continued to grow. We see the *status quo* remaining in place during the coming months and reforms only starting to be implemented after the local elections this fall.

Banking sector remained resilient

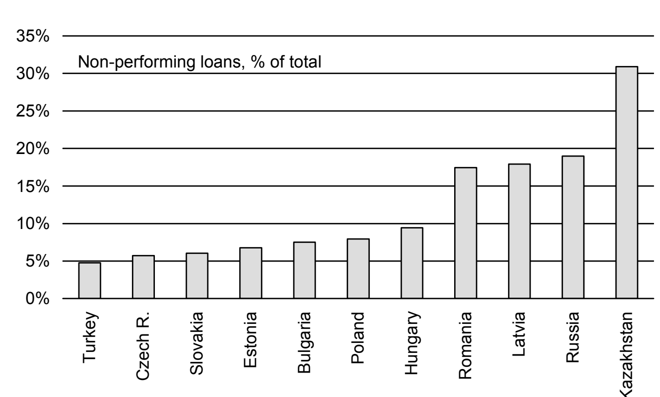
Banking sector: The CEE banking sector, considered last year as the Achilles' heel of the region (but one year later we can say the concerns were exaggerated), is still delivering good results on average. The NPL ratio in the various countries are peaking (NPLs at the end of 2009 more than doubled since 2007 on average, but the increase was significantly higher in the Baltics and the CIS) and are expected to move lower in the coming months. Moreover, all the top 7 CEE players by assets (they control around 1/3 of total assets in Central and South Eastern Europe, dominated by foreign banks, which control around 80% of total assets) were profitable in 1Q10 as well and improved upon the performance of the previous months (apart from KBC, they were all profitable in 2009 as well).

BANKING SECTOR HOLDING UP

1Q10 results of the major CEE banking players



The health of the banking sector – Impaired loans ratio



Source: Company data, UniCredit CEE Strategic Analysis, UniCredit Research

The years of the credit boom are over and the banking sector is now playing an active part in the macroeconomic rebalancing we have mentioned before: #1 The loans to deposits ratio is gradually moving towards the more healthy 100%-105% from a 116% average seen in 2008 (with the more leveraged countries, like the Baltics, experiencing the more significant adjustment); #2 banks' external liabilities were down by almost EUR 60bn in 2009 on average, from 21% to 17% of total banking liabilities; #3 Banking sector recapitalization was already evident in 2009 with state capital injections worth more than EUR 8bn in Ukraine, EUR 36bn in Russia and EUR 1.8bn in Kazakhstan. Bottom line, the CEE banking sector will not be an impediment for the development of the region in the coming years and will be able to provide some stimulus for the countries with a more solid industrial sector.

FX market outlook

FX portfolio allocation recommendations

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

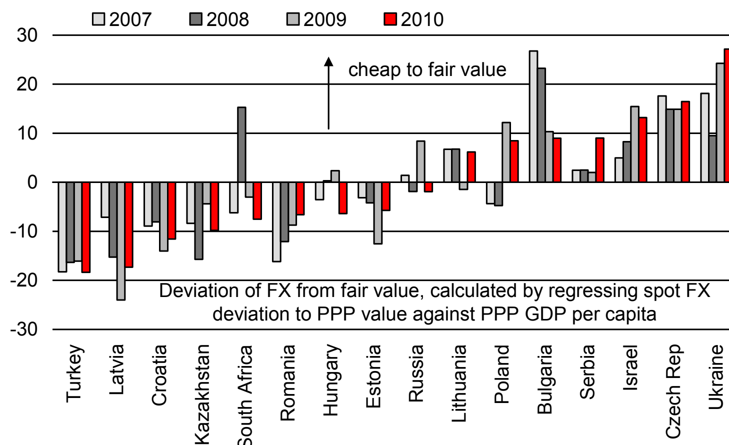
M/W: market weight,
U/W: underweight,
O/W: overweight

#1 Relative growth ranking and monetary policy direction matter: given our relative growth ranking and expected monetary policy divergence we see no reason to change our overweight TRY vs. the rest of the region call in the coming quarter. In individual cases we believe that central banks still do not favor too strong currencies and this was evidenced in the actions of the Polish and Czech central banks but also by the ongoing presence of the Russian and Ukrainian central banks (this remains a tricky job given significantly improved current account balances in many countries). This suggests that on balance we do not expect strong nominal currency gains during the next quarter and accordingly we play the recent ranges and would add constructive positions on more meaningful spikes (like we did recently with our HUF recommendation).

#2 Longer term fundamental drivers: On a different note, our fundamental analysis, where we compare spot FX deviation to its PPP based value vs. GDP PPP per capita – the concept implying that countries with higher productivity ought to have a spot currency that is closer to their PPP based FX value. This implies that Israel, Czech Rep. and Ukraine are cheapest to their fair value – something that has not changed significantly since 2008 (some countries became cheaper). In contrast, Turkey and Latvia have continued to remain expensive vs. their PPP values. By this logic and to slightly counter balance our relatively constructive TRY view from the first point we would increase CZK exposure to market weight from the previous under weight.

EEMEA FX HAS SOME NICE OPPORTUNITIES LEFT

FX in Ukraine, Czech and Israel look cheap to fair value



Source: Bloomberg, IMF, UniCredit Research

FI market outlook

Local currency duration recommendations

CZK	Neutral
HUF	Mod short
PLN	Neutral
RUB	Neutral
TRY	Short

UCG credit rating outlook

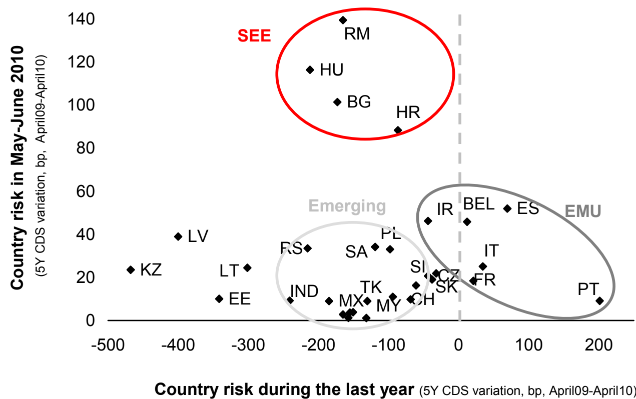
CZK	Stable
HUF	Stabilizing
PLN	Stable
RUB	Neutral
TRY	Positive
UAH	Neutral

Rates strategy: As we do not believe that any of the countries (apart from Turkey) will enter into a more meaningful tightening strategy, and if anything, lower G3 rates and too strong currency appreciation might even prompt further rate cuts. Resultantly we would remain wary of outright bearish rate positions (payers). On the other hand, we do not believe that all countries will be able to follow G3 rates lower in a global deflationary environment and hence we would add/keep bearish rate positions on countries with higher financial and fiscal stability risks (Hungary and Romania) as general hedging strategies. We hence would reduce Hungarian debt duration further. We also believe that positioning is a risk in Poland and accordingly would not add fresh positions at current levels.

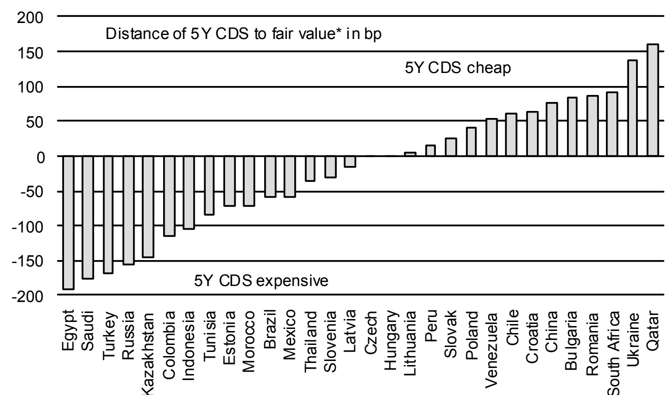
Credit strategy: On balance, we believe that most of the credit mispricing disappeared during the last quarter and similar to our FX strategy we would position on playing the range during the coming months. In this vein we think the recent sell off opened up an interesting opportunity in Bulgaria and we would also look to add constructive positions on Poland and Slovakia. On the higher beta space we would remain neutral for now.

SOME EEMEA CDS LEVELS ARE TOO WIDE VS. FUNDAMENTALS

Risk profile sensibly better than a year ago



Sovereign risk - CEE is still relatively cheap vs. EMU



*We estimated fair value based on credit rating, GDP, CPI and C/A using 32 EM countries as a sample

Source: Bloomberg, IMF, UniCredit Research

Authors:

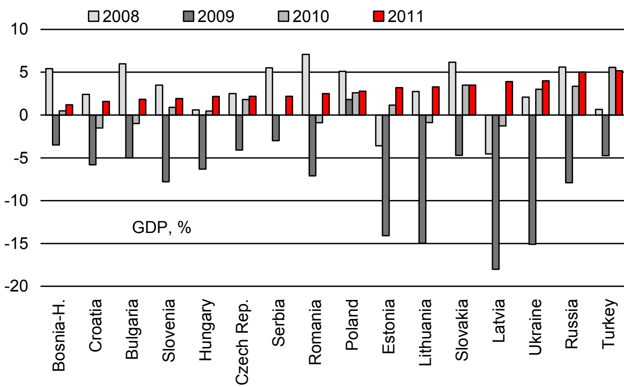
Gyula Toth, Head of EEMEA FI/FX Strategy (UniCredit CAIB)
+43 5 05 05 82362
gyula.toth@caib.unicreditgroup.eu

Matteo Ferrazzi, Economist, EEMEA (UniCredit Bank Milan)

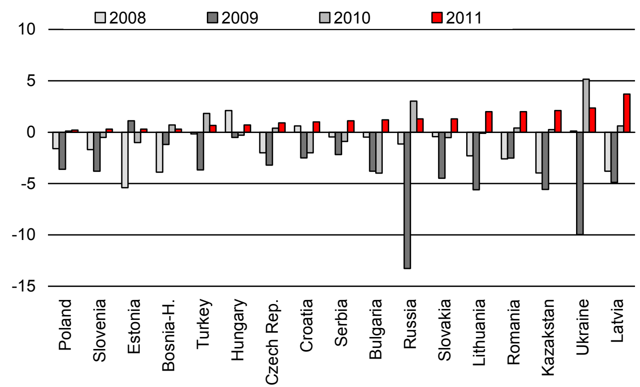
Dmitry Gourov, Economist, EEMEA (UniCredit CAIB)

Structural Indicators

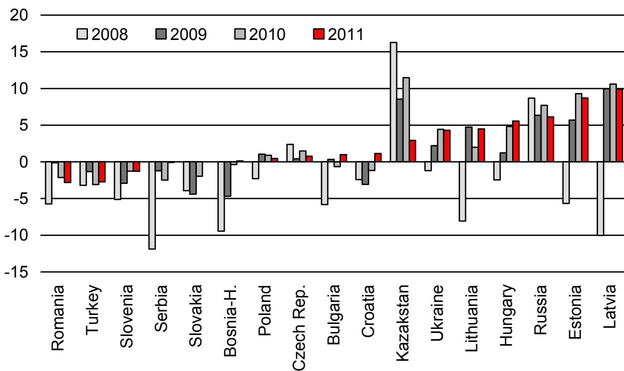
Growth differentiation to remain intact



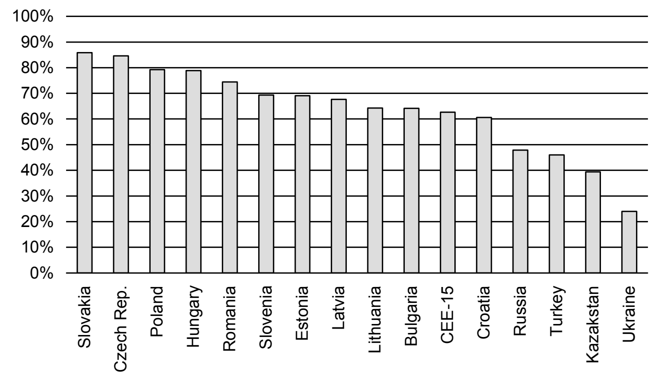
Changes in fiscal balance, % of GDP



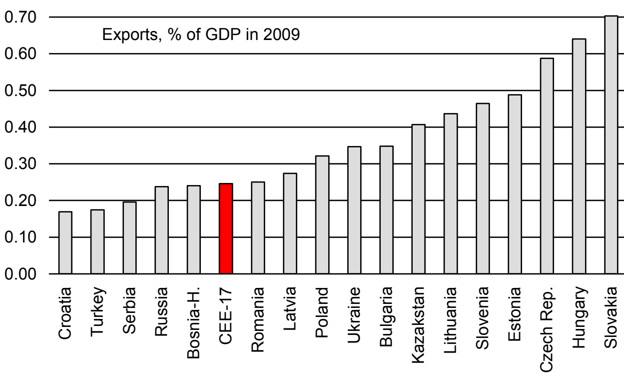
C/A + FDI, % of GDP



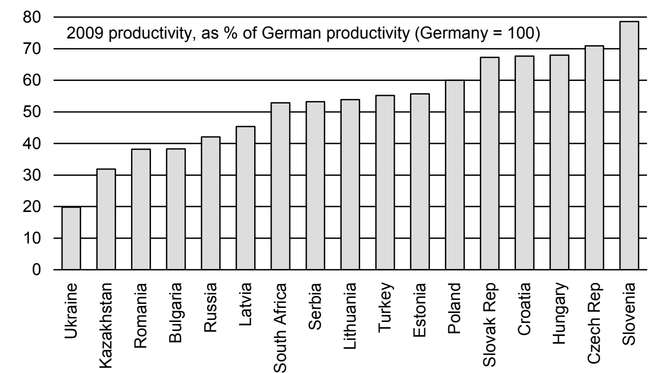
CEE exports to EMU (% of total export)



Exports, % of GDP



CEE productivity lags that of Germany



Source: Bloomberg, IMF, UniCredit Research

Regional Politics

		Relevant Political Events/Main Achievements	Main Political issues to be faced
Central Europe	CZECH REPUBLIC	At the May general election, leftist CSSD who gained most of the votes fell short of a majority while Centre-right parties (ODS, TOP09 and VV) won a combined 118 seats in the 200-seat Parliament. Miroslav Singer has been appointed the new CNB Governor, Governor Zdenek Tuma, is stepping down as of 30 June.	Ongoing coalition talks between right-wing parties ought to be finalized by early July with a new government hopefully in place by mid-July, so that the parties can start preparations for the 2011 budget in good time.
	HUNGARY	In the latest elections (April) the conservative Fidesz-Hungarian Civic Union party succeeded in winning a 2/3 absolute majority enabling it to easily implement fundamental reforms. In June the government unveiled its economic package.	IMF-EU review mission expected for July. Growing tensions with Slovakia. Implementing the reform package.
	POLAND	Following President Leck Kaczinski's death, Bronisław Komorowski (Civic Platform's presidential candidate) has stepped in to fulfill the presidential functions.	Presidential elections: B. Komorowski and L. Kaczynski are contesting in a run-off on 4 July.
	SLOVAKIA	At the June general election, despite the PM Fico's left-leaning Smer party emerged as the largest single party, the 4 centre-right parties gained together a comfortable majority of 79 out of 150 seats.	The four centre-right parties are expected to form a reform-oriented government.
	SLOVENIA	In May Slovenia has been invited to join the OECD. Approval (via referendum) of the border arbitration deal with Croatia.	
Baltics	ESTONIA	The European Commission confirmed Estonia can join the euro-area in January 2011.	
	LATVIA	The 3rd review of IMF Standby Arrangement has successfully completed (€108 mn will be disbursed).	Assuring the political stability until next parliamentary elections (October). Respecting IMF conditions to allow the next tranches' disbursement.
	LITHUANIA	The minority Government succeeded in winning a number of important votes in parliament during May.	
South Eastern Europe	BULGARIA	EU Commission has decided to send a Eurostat mission to assess the reliability of Bulgarian statistics. A 2010 budget update was presented.	The Government intends to introduce a package of economic measures to fight the economic crisis and reduce the fiscal deficit.
	ROMANIA	The Government adopted its letter of intent outlining controversial austerity measures, 25% salary cuts and 15% pensions and benefit cuts. The government survived a no confidence vote in June.	Growing tensions between the Government and the largest trade unions. Respecting IMF conditions to allow the disbursement of the next tranches'.
	BOSNIA-H.	NATO Membership Action Plan (MAP) was awarded in April, while in May the IMF gave additional weeks to complete the spending cuts and reach agreement on wage and pensions reform in order to obtain the 4th tranche of the loan.	Expected liberalization of the visa regime for Bosnians travelling to the Schengen area. Forthcoming general elections: 3 October.
	CROATIA	Croatia's PM Kosor unveiled the economic recovery program which has been appreciated by the IMF. Slovenia's referendum approval of border agreement with Croatia clears Croatia's path towards EU. In April the chapter "free movement of goods" was closed (now 18 chapters out of 33 closed).	Croatia plans to open the remaining chapters: foreign policy, judiciary and competition. Growing tensions between the Government and trade unions on the intention to reduce the size of the public sector and cut wages.
	SERBIA	The IMF completed the 4th loan agreement review, allowing access the next 380-million-euro tranche. In June the EU agreed to start implementing the Stabilisation and Association Agreement.	Forthcoming (expected in July) International Court of Justice advisory opinion on the legality of Kosovo's declaration of independence.
Other countries	TURKEY	In March PM Erdogan declared that a stand-by loan deal with the IMF is not needed. Parliamentary approval of the constitutional reform. Popular referendum needed (12 Sept. 2010). After the resignation of Baykal as CHP's leader, Kilicdaroglu has been elected as new leader.	Constitutional Court's decision on the constitutional reform and next popular referendum. Strong tensions with Israel.
	KAZAKHSTAN	In early June, two constitutional laws awarded President Nazarbayev a "Leader of the Nation" status and gave him criminal and administrative immunity.	How negotiations are going forward with Russia and Belarus on the concrete shaping of the Customs Union and the Common Economic Zone.
	RUSSIA		Russia, Kazakhstan and Belarus agreed to launch a customs union from 1 July.
	UKRAINE	Yanukovich closed a state body that was set up to oversee country's accession to NATO. Lease of Russia's Black Sea Fleet base was extended in return for sharply lower natural-gas price. In May, the 2010 budget was approved.	To restart the stand-by loan agreement with IMF. Local elections potentially scheduled for end-October.

Source: UniCredit Political Studies

Sovereign credit rating outlook

Country	Rating, LT FC (Moody's/ S&P/Fitch)	Fiscal balance, % GDP, 2010 forecast	Gross external debt/GDP, 2010	Curr. account balance % GDP, 2010 forecast	FX reserves, % GDP, end 2010, forecast	2010 GDP forecast minus 5y average	Rating Outlook
Bulgaria	Baa3p/BBBs/BBB-n	-4.8	105.9	-4.1	33.6	-7.25	Rating outlook has stabilized recently on the back of re-established fiscal discipline and the commitment of the new government to uproot corruption and press ahead with structural measures, needed to boost competitiveness under the fixed FX regime.
Croatia	Baa3s/BBBn/ BBB-n	-5.9	104.1	-3.4	23.0	-5.71	We see risk of negative rating news flow in the coming 3M given that fiscal deficit overshooting might lead to higher financing requirements, while FX failed to provide a meaningful competitive gain.
Czech Republic	A1s/As/A+p	-5.5	44.7	-0.9	21.6	-3.44	We still see the Czech economy as one of the best placed within Europe to recover. And with strong commitment expected from the new coalition towards expenditure cuts, this is good news. We do not expect rating changes in the next months.
Estonia	A1s/As/BBB+s	-2.7	122.2	5.9	20.6	-4.87	The Eurozone entry in 2011 makes us **positive** on the rating outlook. Rating agencies as well underlined this possibility of the Euro adoption process will be completed successfully.
Hungary	Baa1n/ BBB-s/BBBn	-4.2	124.0	1.0	31.5	-2.33	We see rating agencies taking a wait and see approach to assess the actual fiscal policy of the new government and see if they agree about a new IMF/EU supported program. **Neutral**
Kazakhstan	Baa2s/BBB-s/ BBB-s	-4.1	70.5	2.8	20.7	-3.44	Despite a prudent fiscal balance, increasing FX reserves and high commodity prices **ratings are likely to be left on hold** in the coming months. However, after bank restructuring will be completed in autumn, ratings might be lifted one notch.
Latvia	Baa3s/BBs/BB+n	-8.4	162.3	8.0	30.7	-8.66	We see credit rating outlook **neutral** in the coming quarter.
Lithuania	Baa1s/BBBs/ BBBs	-9.0	93.2	-1.8	16.0	-7.81	Imbalances in Lithuania are less extreme than those in Latvia, but the external financing and growth outlook are challenging. All three rating agencies have now moved their outlooks from negative to stable on improving conditions. **Neutral.**
Poland	A2s/A-s/A-s	-7.1	64.7	-2.0	23.2	-2.80	We see the ratings outlook as **neutral** for now, with the negatives of a growth slowdown and relatively high public debt being offset by a relatively low external financing gap in relation to the size of the economy. However, a large public deficit this year and next poses a medium term risk to the fiscal accounts, and ratings.
Romania	Baa3s/BB+s/ BB+s	-7.0	64.7	-5.6	24.7	-7.68	Given the IMF/EU package reduced tail risk for Romania and the government approved a significant austerity package we expect rating dynamics stabilizing in the near term. On the other hand implementation risk might offset this. **Neutral**
Russia	Baa1s/BBBs/BBBs	-5.4	33.2	5.5	32.8	-3.63	Stabilizing oil prices and RUB will likely have a stabilizing effect on Russia's rating in the coming 3M. Besides we are starting to witnesses a more robust recovery in the economy, which is supportive. **Neutral.**
Serbia	-/BB-s/BB-n	-5.1	84.1	-6.7	34.0	-6.30	IMF package reduces tail risks, but the relatively wide external financing gap, coupled with an uncertain long-term growth outlook, means that we are cautious on the ratings outlook and would expect the government to do more. **Neutral.**
Slovakia	A1s/ A+s/ A+s	-7.3	80.3	-1.6	-	-3.89	Eurozone membership is a stabilizing factor, though to the extent that this is reflected in the rating already, we are **neutral** on the outlook. If global manufacturing turns into a double dip, however, downside ratings risk would increase.
Slovenia	Aa2s/AAs/ AAs	-6.0	118.6	-0.7	1.7	-4.06	Eurozone membership is a key supportive factor for Slovenia's ratings, as are low public sector debt levels. We hence see ratings remaining on **hold**, despite high overall external debt levels.
Turkey	Ba2s/BBp/BB+s	-3.7	40.0	-4.5	10.6	-0.43	We cannot rule out further upgrades in the next twelve months especially as YTD fiscal performance has been surprisingly robust, this, we think ought to continue on the robust growth in the economy, and earn upgrades in the end.
Ukraine	B2n/Bs/B-s	-6.1	79.1	0.1	18.4	-3.32	We turn **neutral** on the ratings outlook given the lack of meaningful reforms in the first months of the new government in office. The restoration of an IMF programme later in the year would be supportive, but no upgrades are likely before then.

Source: UniCredit Research

Bulgaria

Outlook

The economy has bottomed out in 4Q09 and has started to improve, with exports expanding at a healthy pace. However, persistent domestic demand weakness suggests that near-term growth outlook remains bleak. What's more, downside risks remain elevated as concerns over proliferation of the sovereign debt crises in Europe has not evaporated. We stick to our longstanding growth forecast for 2010 (-1% real growth), but marginally revise downward our projection for 2011 to 1.8%, from 2.2% initially.

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

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

MACROECONOMIC DATA AND FORECASTS

	2007	2008	2009	2010F	2011F
GDP (EUR bn)	28.9	34.1	33.9	34.1	35.5
Population (mn)	7.6	7.6	7.6	7.5	7.5
GDP per capita (EUR)	3,782	4,485	4,479	4,532	4,739
GDP (constant prices yoy %)	6.2	6.0	-5.0	-1.0	1.8
Private Consumption, real, yoy (%)	5.1	4.5	-6.2	-4.0	-1.1
Fixed Investment, real, yoy (%)	21.7	20.4	-26.9	-8.9	3.7
Public Consumption, real, yoy (%)	3.4	-1.4	-5.7	-1.7	-3.6
Exports, real, yoy (%)	5.2	2.9	-9.8	5.2	4.0
Imports, real, yoy (%)	9.9	4.9	-22.3	-2.4	0.2
CPI (average, yoy %)	8.4	12.4	2.8	1.7	2.2
Central bank reference rate (LEONIA, avg)	4.56	4.07	0.23	0.27	0.48
Monthly wage, nominal (EUR)	220	279	302	314	320
Unemployment rate (%)	6.9	6.3	9.1	10.9	10.6
Budget balance (% of GDP, cash basis)	3.5	3.0	-0.8	-4.8	-3.6
Current account balance (EUR bn)	-7.8	-8.2	-3.2	-1.4	-1.0
Current account balance (% of GDP)	-26.8	-24.0	-9.4	-4.1	-2.9
Net FDI (EUR bn)	8.8	6.2	3.3	1.2	1.4
FDI (% of GDP)	30.6	18.2	9.8	3.4	3.9
Gross foreign debt (EUR bn)	29.0	37.1	37.7	36.1	36.4
Gross foreign debt (% of GDP)	100.4	108.7	111.3	105.9	102.5
FX reserves (EUR bn)	11.9	12.7	12.9	11.5	12.4
(Cur.Acc-FDI)/GDP (%)	3.7	-5.8	0.3	-0.7	1.0
FX reserves/Gross foreign debt (%)	41.1	34.3	34.3	31.7	34.1
Exchange rate to USD eop	1.34	1.40	1.36	1.60	1.58
Exchange rate to EUR eop	1.96	1.96	1.96	1.96	1.96
Exchange rate to USD avg	1.43	1.33	1.40	1.55	1.62
Exchange rate to EUR avg	1.96	1.96	1.96	1.96	1.96

Source: UniCredit Research

STRENGTHS

- Very strong fiscal metrics
- Strong progress in fighting corruption and organized crime
- Well capitalized and liquid banking sector

WEAKNESSES

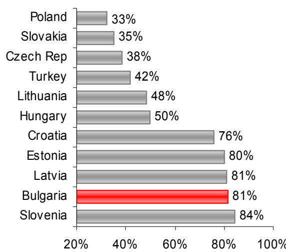
- Large private sector debt
- Lack of control on domestic monetary conditions
- Limited policy space to respond to new adverse shocks

Domestic sources of growth remain subdued

The worst is over…

Export is the only significant growth driver: the more benign GDP growth figure in 1Q10 (-3.6% yoy) compared with 4Q09 (-5.9%) was almost entirely due to stronger external demand. But while export looks set to expand at a healthy pace, it will not be enough to generate a sustained revival. Unfortunately, there are still no signs that the external upturn, endangered by the sovereign debt crisis in Europe, is feeding through to stronger domestic demand. Recent retail sales and confidence indicators provide further evidence of the weakness of the consumer sector. Fundamental determinants of households' consumer spending also bode ill: the rebalancing of the labor market does not look to be over with wages and employment still under downward pressure. What's more, **belt-tightening measures related to public administration are likely to enfeeble the already weak household recovery**. Rebalancing of the external position, on the other hand, has progressed at a faster than expected pace (the 12M current account gap as of April shrunk to 5.6% of GDP, from 9% in the end of 2009 and 24% in 2008), but still looks some way off.

DOMESTIC CREDIT AND EXTERNAL DEBT OF NF CORPORATIONS TO GDP (2009)



Source: Eurostat, UniCredit Research

Funding conditions have deteriorated. Real interest rates on new loans extended by domestic banks (as calculated by UniCredit research) have inched up from 7.02% on avg in 2009 to 8.53% in Jan-Apr 2010. The cost of external borrowing – as measured by 5Y CDS – has tracked higher, as investors became worried about the possible spread of the European sovereign debt crisis. Yields of 5Y BGN denominated GB rose sharply from 4.20% in March to 4.88% in May, while the last auction for 10½ Y GB was canceled as the Treasury and investors failed to agree on the paper's price. Official reserves - key gauge for liquidity under the currency board – slid 5.5% in Jan-May 2010, after inching up a meager 1.6% for the whole 2009. Credit growth has come to a halt, with loans to households and non-financial corporations down 0.6% in Jan-April 2010. **Given the large private sector debt (see chart), the worsening of funding conditions has added significantly to the headwinds for Bulgarian economy.** Funding conditions are likely to remain less benign going forward: #1 inflow of foreign capital is expected to stabilize on lower levels, #2 costs of external borrowing is likely to be put under pressure when the monetary stimulus in the eurozone starts to peter out.

Cuts in public administration should open up room for growth-enhancing fiscal spending, which is seen as key to offset monetary tightening

To counter monetary tightening and to buy the time needed for the structural measures to kick start growth, the authorities decided to temporarily steer the fiscal balance into deficit. The budget revision (to be passed by the Parliament soon) envisages a budget deficit target of 3.8% of GDP this year, which is just a notch below the 3.9% deficit posted in 2009 (according to the Eurostat methodology). To create more room for growth-enhancing fiscal spending, the authorities plan to implement drastic cuts in the public administration. The implication is that more public funds will be made available to upgrade infrastructure which in turn should prop up the recovery process. Given the healthy fiscal fundamentals (public debt well below 20% of GDP and budget deficit very close to the 3% Stability Pact ceiling) this policy response seems justified to us. It is further vindicated by the fact that under the currency board, the Bulgarian authorities have very limited control of the local monetary conditions. The quantity of money in circulation is a function of the balance of payments development and when investors move capital out of the country this automatically translates into monetary contraction which threatens to sink the economy into even deeper recession. This leaves fiscal policy the only policy instrument in the short-to-medium run to deal with the external shocks caused by the global financial and economic crisis.

Near term growth prospects are deemed bleak

Against this backdrop, we stick to our longstanding GDP forecast for 2010 (-1%), while we revise marginally downward our forecast for 2011 to 1.8% (from 2.2%). Adverse shifts in the sentiments of international investors, which threatens to exacerbate deleveraging in the debt-laden private non-financial sector, remains the key downside risk for our baseline scenario. On the other hand, risks for the implementation of domestic reforms have eased, as despite suffering caused by the ongoing recession, public support for reforms remains strong.

Czech Republic

Outlook – Economic activity has been gathering pace, with growth expected to come in higher than previously expected for 2010. The improvement, however, is chiefly based on better external demand feeding into a revival of manufacturing, while domestic consumption remains weak, as mimicked by sluggish retail sales developments. For 2011, given the expected fiscal austerity measures at home and abroad, growth risks are to the downside.

Authors:
Pavel Sobisek, Chief Economist (UniCredit Bank)
+420 2 211 12504, pavel.sobisek@unicreditgroup.cz
Patrik Rozumbersky, Economist (UniCredit Bank)
+420 2 211 12506, patrik.rozumbersky@unicreditgroup.cz

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

MACROECONOMIC DATA AND FORECASTS

	2007	2008	2009	2010F	2011F
GDP (EUR bn)	127.3	147.9	137.2	143.7	154.7
Population (mn)	10.3	10.4	10.5	10.5	10.6
GDP per capita (EUR)	12,336	14,181	13,077	13,661	14,660
GDP (constant prices yoy %)	6.1	2.5	-4.1	1.8	2.2
Private Consumption, real, yoy (%)	4.9	3.6	-0.2	-0.6	1.2
Fixed Investment, real, yoy (%)	10.8	-1.5	-9.2	-3.0	4.0
Public Consumption, real, yoy (%)	0.7	1.0	4.2	0.5	-1.0
Exports, real, yoy (%)	15.0	6.0	-10.8	9.5	7.8
Imports, real, yoy (%)	14.3	4.7	-10.6	8.6	7.3
CPI (average, yoy %)	2.8	6.3	1.0	1.4	2.0
Central bank reference rate	3.50	2.25	1.00	0.75	1.50
Monthly wage, nominal (EUR)	755	910	888	935	1,000
Unemployment rate (%)	6.6	5.5	8.1	9.1	8.8
Budget balance (% of GDP)	-0.7	-2.7	-5.9	-5.5	-4.6
Current account balance (EUR bn)	-4.1	-0.9	-1.4	-1.4	-2.8
Current account balance (% of GDP)	-3.2	-0.6	-1.0	-0.9	-1.8
Net FDI (EUR bn)	7.6	4.4	2.0	3.5	4.0
FDI (% of GDP)	6.0	3.0	1.4	2.4	2.6
Gross foreign debt (EUR bn)	51.6	59.7	60.1	66.0	70.6
Gross foreign debt (% of GDP)	38.9	43.6	43.8	44.7	45.1
FX reserves (EUR bn)	23.7	26.6	28.9	31.0	31.0
(Cur.Acc-FDI)/GDP (%)	2.8	2.4	0.4	1.5	0.8
FX reserves/Gross foreign debt (%)	45.9	44.5	48.1	47.0	43.9
Exchange rate to USD eop	18.19	19.21	18.39	20.49	19.76
Exchange rate to EUR eop	26.52	26.80	26.35	25.00	24.50
Exchange rate to USD avg	20.25	16.97	18.96	20.40	20.50
Exchange rate to EUR avg	27.75	24.96	26.43	25.70	24.80

Source: UniCredit Research

STRENGTHS

- External financing at comfortable levels
- Center-right parties have a convincing parliamentary majority
- Low vulnerability of financial sector

WEAKNESSES

- Sharply weakening FDI inflow
- No quick end to private consumption contraction
- Fiscal restrictions set to slow 2011 GDP growth

Election outcome boosts chance for radical fiscal reforms

GDP switched to growth in yoy terms in 1Q, helped chiefly by a shift in the inventory cycle

The economy started to grow again on a yoy basis in 1Q, with GDP rallying to 1.1% from -3.2% in 4Q. The expenditure structure of 1Q's growth revealed that private spending and fixed capital formation continued to contract, down 0.5% and 6.6% yoy respectively. On the other hand, inventories started to contribute positively to growth while government spending kept rising. Net exports remained the key growth pillar, adding 1.9 percentage points to the expansion. With the absence of domestic demand, the quickening of inflation to 1.2% yoy in May from this year's low at 0.6% yoy in February is unlikely to ring alarm bells. In fact, inflation was driven by a mixture of external and/or short-term factors, such as surging oil prices, a hike in natural gas costs, rising prices of cigarettes mirroring a hike in excise taxes. The current account posted a CZK 16.1bn surplus in 1Q, shrinking by CZK 8.9bn from a year ago. With a higher trade surplus being just offset by a deteriorating services balance, the drop in C/A surplus was due to current transfers slipping into the red and the income balance gap widening moderately. In annualized terms, the current account deficit to GDP ratio rose mildly to a still comfortable 1.3% in 1Q from 1.0% in 2009. Within the financial account, the net FDI inflow increased by CZK 21.5bn yoy to CZK 36.2bn in 1Q. However, most of the CZK 53.3bn gross FDI inflow was related to repayments of loans previously provided by domestic companies to their foreign owners while the inflow to the base capital continued to disappoint (CZK 2.9bn in 1Q).

Foreign demand is set to continue pulling the economy in the coming quarters

Economic activity has been gathering steam in the last few months suggesting that 2Q GDP growth will continue to accelerate. April industrial output and exports maintained the strong growth of previous months, up 10.9% yoy and 13.0% yoy respectively. Meanwhile, new factory orders also saw double-digit gains in April and together with the ongoing rise in manufacturing PMI in May indicate solid production in the coming months. Retail sales, however, slipped back into the red in April, down 4.5% yoy, highlighting that consumption is lagging in the economic cycle behind a revival in manufacturing. We expect GDP growth to pick up to 2.4% yoy in 2Q before moderating slightly towards the end of the year on a less favorable base. Since our forecast three months ago, we have raised our full-2010 GDP forecast by 0.2 percentage points to 1.8%, assuming a milder drop in domestic consumption. This reflects the improved outlook for unemployment, which has continued to surprise on the downside, and also a slightly higher prediction of public sector wage growth. However, we stick to our view of the economic recovery being underpinned primarily by foreign demand in the coming quarters, with domestic demand remaining pretty subdued. For 2011, by contrast, we have cut our growth outlook to 2.2% from 2.4% taking into account the risk that fiscal austerity measures at home and abroad could be a drag on expansion.

With inflation risks looking balanced, interest rates are most likely to remain stable for some time

Prospects for continuing economic revival, albeit slow, make us believe that the surprise monetary policy easing in May will not be extended. Actual inflation exceeding the CNB forecast, CZK holding at weaker levels and recent solid activity data all add to the arguments against a further interest rate lowering. On the other hand, the space for an early policy tightening is limited by subdued domestic demand and a low credit dynamic. We believe that the repo rate will be held steady at 0.75% at least until 1Q11.

Prospects for rapid fiscal consolidation improved substantially after centre-right parties gained a majority in the lower house

The May parliamentary elections saw victory for the center-right parties which, if they are able to reach a deal, will form the strongest and most reform-minded government since the early 1990s. The leader of the biggest right-wing party – ODS – Necas, who was asked by President Klaus to lead the negotiations, has pledged to reach a coalition agreement by 7 July and to form a government by mid-July so that the parties can start preparations for the 2011 budget in good time. So far, the three parties have agreed in principle on a number of issues, including a radical overhaul of the not-yet-reformed pension system and a rapid reduction of the public sector deficit achieved mainly via cuts in expenditures. We thus remain optimistic that the ambitious fiscal targets set by the outgoing interim government in the country's convergence program will be met.

Estonia

Outlook

Euro adoption from 1 January 2011 will be the main driver of the coming months' economic trends in Estonia: it could have some positive effects on consumer and investor confidence and spur trade and foreign direct investments. At the moment the growth path is developing along the lines that see a quick rebound in industrial production and continuing very weak local demand.

Author:
Matteo Ferrazzi, Economist (UniCredit Bank Milan)
+39 02 8862.8600, matteo.ferrazzi@unicreditgroup.de

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

MACROECONOMIC DATA AND FORECASTS

	2007	2008	2009	2010F	2011F
GDP (EUR bn)	15.6	16.1	13.7	13.8	14.5
Population (mn)	1.3	1.3	1.3	1.3	1.3
GDP per capita (EUR)	11,644	12,001	10,272	10,355	10,892
GDP (constant prices yoy %)	7.2	-3.6	-14.1	1.2	3.2
Private Consumption, real, yoy (%)	9.0	-4.7	-18.5	-4.0	2.0
Fixed Investment, real, yoy (%)	9.0	-12.1	-34.4	-6.0	8.0
Public Consumption, real, yoy (%)	3.7	4.1	-0.5	-1.5	0.9
Exports, real, yoy (%)	0.0	-0.7	-11.2	10.2	5.6
Imports, real, yoy (%)	4.7	-8.7	-26.8	2.0	5.5
CPI (average, yoy %)	6.6	10.4	-0.1	2.0	1.7
Monthly wage, nominal (EUR)	725	819	781	758	732
Unemployment rate (%)	4.7	5.5	13.8	19.1	17.0
Budget balance (% of GDP)	2.6	-2.8	-1.7	-2.7	-2.4
Current account balance (EUR bn)	-2.8	-1.5	0.6	0.8	0.7
Current account balance (% of GDP)	-18.1	-9.4	4.7	5.9	5.0
Net FDI (EUR bn)	0.8	0.6	0.2	0.5	0.5
FDI (% of GDP)	5.3	3.7	1.1	3.4	3.7
Gross foreign debt (EUR bn)	17.4	19.0	17.4	16.9	17.0
Gross foreign debt (% of GDP)	111.0	118.5	126.7	122.2	117.2
FX reserves (EUR bn)	2.2	2.8	2.3	2.8	2.9
(Cur.Acc-FDI)/GDP (%)	-12.5	-5.7	5.7	9.3	8.7
FX reserves/Gross foreign debt (%)	12.9	14.7	13.2	16.9	17.1
Exchange rate to USD eop	10.73	11.21	10.92	12.83	12.62
Exchange rate to EUR eop	15.65	15.65	15.65	15.65	15.65
Exchange rate to USD avg	11.41	10.64	11.22	12.42	12.93
Exchange rate to EUR avg	15.65	15.65	15.65	15.65	15.65

Source: UniCredit Research

STRENGTHS

- Euro adoption in 2011
- Fiscal position
- Rapid unwinding of external imbalances

WEAKNESSES

- Weak internal demand
- External indebtedness
- Social effects of the economic slowdown

Euro introduction at the horizon

Euro adoption in January 2011

Estonia will be the 17th Eurozone member, the third of the ex-communist countries after Slovenia (2007) and Slovakia (2009) to join the common currency, the euro, in January 2011. Indeed, the EU authorities (EU Commission, the ECB and the ECOFIN) gave a positive assessment on Estonia's readiness to join the Eurozone. The decision by the EU authorities (formal approval from the European Council will granted during the ECOFIN meeting on 13 July) is an important step for Estonia, the Baltics and other Central Eastern European countries. The risk of a different decision was tangible, since Estonia was knocking on the Eurozone's door at the worst possible moment, in the midst of turmoil affecting the area following the Greek troubles. This could have prompted Brussels to tighten the Maastricht criteria for Eurozone entry, possibly stressing the issue of "sustainability".

Continuing weak domestic demand

Euro adoption will also be the main driver of the coming months' economic trends in Estonia: it could have some positive effects on consumer and investor confidence and spur trade and foreign direct investments. At the moment **the growth path is developing along the lines that see a quick rebound in industrial production** (+18% yoy in May) **and continuing weak local demand** (retail sales at -9% yoy in May). These variables are signaling, all things considered, that real GDP growth could move into positive territory in 2Q and during the coming quarters, following the 2.3% drop in 1Q10. We hence revise our full 2010 GDP forecast to +1.2% (from -1.3%), whilst marginally revising down (to 3.2%) our 2011 forecasts on the renewed uncertainty surrounding the global outlook.

From deflation to inflation

On the inflation front, the recent surge in CPI inflation was relevant, as it moved from a negative 2% in January this year to +3% yoy in May, with oil and food prices playing the major role in the increase. However, this upward trend will halt during the next few months, given the fading out of the base effect and the effects of the hikes in taxation. All in all, we expect average inflation for 2010 to be slightly lower than 2%.

Fiscal solidity one of the country strengths

Despite the forecast increase in fiscal deficit and public debt, the fiscal solidity of the country is not under threat: **Estonia is probably the best-placed country in terms of fiscal metrics in Europe**. The country has clearly achieved the Maastricht criteria. The public deficit is moving upward, but increasing from 1.7% of GDP to only 2.5%-3% in 2010 (while it is likely to remain higher than 6.5% this year on average in the Eurozone). Most of the adjustment measures were already implemented in 2009 (cuts in budgetary expenditure, VAT rise, a new law on pension). Estonia has the lowest level of public debt in percentage of GDP among EU members; and interest expenses will remain around 0.3%-0.4% of GDP this year (again the lowest level among the 27 EU members also on these metrics). Meanwhile, Estonia's problems lie in the very high external indebtedness (driven by the private sector exposure), expected to remain between 120% and 130% this year.

The political landscape is not expected to deliver any surprises before the March 2011 Parliamentary elections. PM Ansip will continue to lead the minority government formed in late 2009, comprising the Reform Party and the Pro Patria-Res Publica Union (IRL): it governs with 50 seats out of a total of 101. The disputes over fiscal policy are still the most apparent element of tension between the two coalition parties, but the common goal of euro adoption could contribute to the minority government remaining in place until 2011.

Further positive rating actions forecast

Regarding the rating, during the first months of 2010, **both Moody's and S&P's improved their outlook to "stable", while in June this year S&P's upgraded the rating from A- to A** (two notches higher than Lithuania and Latvia). **We believe further upgrades could be in the pipeline**. Estonian country risk (in terms of 5Y USD CDS) decreased visibly during 2009 and early 2010, and it is now lower than that of many Eurozone countries (including Italy and Spain).

Hungary

Outlook – Growth is improving on the back of export and inventory rebuild while other domestic elements of growth continue to disappoint. The newly elected government announced its fiscal program with considerable delay and relatively opaque details. Although it might ensure meeting the fiscal targets the financial sector tax could have negative implication on lending. We see increasing financial stability risks driven by the recent upward spike in CHF/HUF. This will likely limit the NBH's ability to cut rates further.

Authors:
Gyula Toth, Head of EEMEA FI/FX Strategy (UniCredit CAIB)
+43 50505 82362, gyula.toth@caib.unicreditgroup.eu
Istvan Horvath (UniCredit Hungary)
+3613011808, istvan.horvath@unicreditgroup.hu

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

MACROECONOMIC DATA AND FORECASTS

	2007	2008	2009	2010F	2011F
GDP (EUR bn)	101.1	105.7	93.0	98.5	105.5
Population (mn)	10.1	10.1	10.0	10.0	10.0
GDP per capita (EUR)	10,044	10,517	9,264	9,833	10,542
GDP (constant prices yoy %)	1.0	0.6	-6.3	0.5	2.2
Private Consumption, real, yoy (%)	-1.6	-0.6	-6.7	-3.4	1.3
Fixed Investment, real, yoy (%)	1.6	0.4	-6.5	1.5	9.2
Public Consumption, real, yoy (%)	-4.3	-0.3	1.1	0.2	1.8
Exports, real, yoy (%)	16.2	5.6	-9.1	11.2	5.4
Imports, real, yoy (%)	13.3	5.7	-15.4	11.8	6.8
CPI (average, yoy %)	8.0	6.1	4.2	5.0	3.9
Central bank reference rate	7.50	10.00	6.25	5.25	5.50
Monthly wage, nominal (EUR)	455	485	442	489	0
Unemployment rate (%)	7.3	7.8	9.8	10.7	9.5
Budget balance (% of GDP)	-5.5	-3.4	-3.9	-4.2	-3.5
Current account balance (EUR bn)	-6.6	-7.5	0.2	1.0	0.4
Current account balance (% of GDP)	-6.5	-7.1	0.2	1.0	0.4
Net FDI (EUR bn)	4.0	4.9	1.0	3.8	5.5
FDI (% of GDP)	3.9	4.6	1.1	3.9	5.2
Gross foreign debt (EUR bn)	98.8	122.9	130.3	123.3	117.4
Gross foreign debt (% of GDP)	98.6	122.6	135.2	124.0	111.1
FX reserves (EUR bn)	16.4	24.0	30.7	31.0	28.0
(Cur.Acc-FDI)/GDP (%)	-2.6	-2.5	1.2	4.8	5.6
FX reserves/Gross foreign debt (%)	16.6	19.6	23.5	25.1	23.9
Exchange rate to USD eop	173.32	190.12	188.81	221.31	217.74
Exchange rate to EUR eop	252.86	265.62	270.39	270.00	270.00
Exchange rate to USD avg	183.38	171.07	200.90	214.29	223.14
Exchange rate to EUR avg	251.39	251.68	280.22	270.00	270.00

Source: UniCredit Research

STRENGTHS

- Significant IMF and EU balance of payments support
- Low budget deficit in the region
- A new government with very solid majority

WEAKNESSES

- Highest public sector debt level in the region
- Uncertainties around the long term growth outlook
- High FX leverage in domestic private sector

Bumpy start for the new government

Strong support for the new government…

Newly elected Fidesz government secures comfortable two-thirds majority in April parliamentary elections. Contrary to relatively high expectations, the fiscal program came with a significant delay and with opaque details only after controversial communications about Hungary's financial situation and some pressure from external lenders (e.g. EU). In the new program, the government has maintained the original budget deficit targets both for 2010 and 2011 (3.8%/GDP and 2.9%/GDP), and announced several measures to reach these targets. The most important measures are the following: 1) the introduction of a flat personal income tax at 16%; 2) a 15% cut in the public sector wage bill; 3) a financial sector tax with total revenues per year around 0.7%/GDP. With these measures we believe the 2010 target is achievable. On the flip side, we have concerns about the potential negative growth implications of the financial sector tax, which may lead to a depressed level of lending activity in the coming years.

…but start was bumpy

Q1 GDP surprised on the upside

Partly as a reflection of the positive 1Q10 GDP surprise we raise our 2010 GDP forecast to a positive 0.5%yoy from a negative 0.2%yoy. In addition, we believe net export and inventory rebuilding will likely contribute to growth momentum. To show our growing concerns regarding the fiscal measures and their implication on lending, we, however, reduce our 2011 growth forecast to 2.2% from 2.8%. With this forecast, we are now significantly more conservative than the Central Bank or market consensus.

Long term inflation is still not a risk but n-t might see upward pressure

Regarding inflation, we inch down our CPI forecast compared to our February assumption. Due to extreme weakness in household demand we still see the core inflation as well-contained, even though headline inflation was on a rollercoaster in 1H10 mostly due to administered price changes, and, since spring, in response to the HUF. Looking ahead, we believe the most recent floods and adverse weather conditions may have a near-term negative impact on inflation and we see the CPI bottoming out in mid-2010 at around 3.8% yoy. If the price increase moratorium of gas and district heating is introduced as promised by the government, the year-end inflation could moderate to 4.0%, bringing the annual average rate to 4.7%. Without the price-cap measure we estimate December inflation at around 4.6% and average annual CPI at 5%.

Higher financial stability risks could limit the NBH's ability to cut rates further

We see increasing financial stability risk in the coming months driven by the significant upside move of the CHF/HUF rate in the past couple of weeks. This is the result of the weaker HUF vs. the EUR and the downside pressure on the EUR/CHF. As a substantial part of FX mortgages are denominated in CHF, we believe the recent spike could cause some financial stability concerns. According to the latest NBH financial stability report, the loan-to-value ratio of FX mortgages was around 80% at the end of 2009 and we reckon this ratio probably moved considerably higher in the first two quarters in 2010. Room for further monetary policy easing looks extremely limited to us, and in an extreme case the CenBank may be even forced to hike interest rates, we believe. Additionally, these developments call for an extension (or a new one) of the current IMF/EU program.

Overall, we believe market optimism, which surrounded the April elections, driven by the anticipation of a very stable government, has significantly declined in the past couple of weeks. This may well have an ongoing negative impact on Hungarian asset prices particularly on bonds, which will likely not be supported by monetary easing. Accordingly, we remain fairly cautious in terms of Hungarian investments and, hence, we reduce duration exposure to moderate short while keeping our already cautious view on the HUF.

Latvia

Outlook

The gradual adjustment process implies that export-driven growth will materialize first. Local demand is still very weak. We forecast negative GDP growth in 2010 and 3.9% in 2011. The implementation of further austerity measures is not on the cards before the general elections in October 2010, while euro adoption is possible in 2013-14 at the earliest.

Author:
Matteo Ferrazzi, Economist (UniCredit Bank Milan)
+39 02 8862.8600, matteo.ferrazzi@unicreditgroup.de

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

MACROECONOMIC DATA AND FORECASTS

	2007	2008	2009	2010F	2011F
GDP (EUR bn)	21.1	23.0	18.5	18.0	19.0
Population (mn)	2.3	2.3	2.3	2.3	2.2
GDP per capita (EUR)	9,254	10,145	8,221	7,995	8,446
GDP (constant prices yoy %)	10.0	-4.6	-18.0	-1.3	3.9
Private Consumption, real, yoy (%)	14.8	-5.5	-22.4	-4.3	2.5
Fixed Investment, real, yoy (%)	7.5	-15.6	-37.7	-7.0	6.9
Public Consumption, real, yoy (%)	3.7	1.5	-9.2	-10.1	-4.0
Exports, real, yoy (%)	10.0	-1.3	-13.9	7.2	6.5
Imports, real, yoy (%)	14.7	-13.6	-34.2	-2.0	2.8
CPI (average, yoy %)	10.1	15.5	3.6	-1.7	1.5
Central bank reference rate	6.00	6.00	4.00	3.50	3.75
Monthly wage, nominal (EUR)	565	682	654	542	440
Unemployment rate (%)	6.0	7.5	17.2	19.9	18.2
Budget balance (% of GDP)	-0.3	-4.1	-9.0	-8.4	-4.7
Current account balance (EUR bn)	-4.6	-3.0	1.8	1.4	1.3
Current account balance (% of GDP)	-23.8	-13.0	9.6	8.0	7.0
Net FDI (EUR bn)	1.4	0.7	0.1	0.5	0.5
FDI (% of GDP)	6.8	3.0	0.4	2.6	2.9
Gross foreign debt (EUR bn)	28.4	29.8	27.2	29.2	28.3
Gross foreign debt (% of GDP)	135.1	128.5	147.0	162.3	149.4
FX reserves (EUR bn)	3.8	3.5	4.8	5.5	5.4
(Cur.Acc-FDI)/GDP (%)	-14.8	-10.0	10.0	10.6	9.9
FX reserves/Gross foreign debt (%)	13.4	11.8	17.6	18.9	19.1
Exchange rate to USD eop	0.48	0.50	0.49	0.58	0.57
Exchange rate to EUR eop	0.70	0.70	0.70	0.70	0.70
Exchange rate to USD avg	0.51	0.48	0.50	0.56	0.58
Exchange rate to EUR avg	0.70	0.70	0.70	0.70	0.70

Source: UniCredit Research

STRENGTHS

- Significant IMF and EU support
- Improvements in fundamentals

WEAKNESSES

- Possible fragmented coalition in the next elections
- Negative effects of the currency regime
- High foreign indebtedness

Internal devaluation: a long and painful process

Internal devaluation strategy weighing on growth

The Latvian economy is still in the midst of a challenging process of re-establishing a sound fiscal position and its competitiveness via the so called internal devaluation process (substitute for the nominal devaluation strategy). The worst performer of the three Baltic economies during 2009 (the Latvian drop in real GDP – a negative 18% – had no comparison at world level last year: Latvia has been the worst performer among the almost 200 countries monitored by the IMF), it is also lagging behind during the first part of this year. Latvian real GDP growth in 1Q was registered at -6% (between -2% and -3% for Estonia and Lithuania) in qoq terms, GDP increased by a seasonally adjusted 0.3%, the first qoq growth since end-2007. The latest available information on industrial production are clearly showing some improvements – +9.7% yoy in April – as export is driving the recovery, but domestic demand is still very weak: retail sales posted a 7.7% contraction in yoy terms in April. The credit crunch is still visible (lending is down 8% yoy in April) and affecting the recovery: the very high loans/deposits ratio, effect of the credit boom of the previous years, is adjusting downward quite rapidly (from 2.5 in 2009 to 2.1 in March 2010), but it will need a further contraction. In the meantime deflation is still biting but has eased somewhat: CPI inflation, which reached -4.2% in February, was at -2.3% in May.

The Latvian economy is not yet out of the woods

The draconian Latvian austerity package and the numerous elements of uncertainty surrounding the global scenario (the sovereign debt crisis in Europe, the austerity measures in many countries and the possible effects on consumer and investor confidence) **mean we remain cautious on the evolution of the Latvian economy during the coming quarters**: we expect both 2Q and 3Q real GDP numbers to remain negative in yoy terms. The full 2010 real GDP growth is expected to be around -1.3%. Unemployment – one of the most undesired by-products of the very painful adjustment process of the Latvian economy – has skyrocketed recently: the unemployment rate has breached the 20% threshold – the highest level among the three Baltic states – up from 6.5% in 2008. Many years of vigorous economic growth will be needed to bring the unemployment rate to below 10%.

Pressure on thelat is fading

The adjustment process has resulted in a much-needed rebalancing of the external sector: the current account deficit (more than 20% of GDP in 2006 and 2007) moved to a very high surplus in 2009. This means that **the pressures on the Lat are radically lower than a few months ago.** The share of household deposits denominated in foreign currency – an indication of the population's confidence in the local currency – reached a peak in July 2009 (31% of total) and then started to decrease and moved to less than 28% in April 2010. The level of reserves, hovering around EUR 5.53bn in May 2010, has almost doubled from the negative dip seen last year. If the fiscal consolidation plan – that comprises revisions of the State-fund pension system, cut in public spending and pensions, rise in VAT, and an increase in income tax (from 23% to 26%) – is successful, the budget deficit should approach 3% by 2011 (according to the government's target) or more probably by 2012 and allow euro adoption between 2013 and 2014.

Parliamentary elections next October

October's Parliamentary elections (on 2 October) are the key event during the next few months. Popular discontent remains high, given the Government's austerity measures, which are part of the conditions attached to the international financial aid Latvia received. The centre-right coalition government led by PM Dombrovskis (in power since March 2009) became a minority government after the People's Party quit the government in March 2010. The government will continue to work quite smoothly over the coming months as a minority government with the support of the opposition party, Latvia's First Party. The implementation of further austerity measures is unlikely before the general elections. The result of October's elections will probably lead to another multi-party coalition. The make-up of the next government is likely to depend on the state of relations between the centre-right parties that manage to pass the 5% threshold.

Lithuania

Outlook

The worst is over for the Lithuanian economy but the good times are still a long way off. The massive increase in unemployment will leave its mark on domestic demand during the next few years: domestic demand is extremely weak and the recovery will be very gradual. The major test for the government will come towards the end of the year, when parliament has to vote on a budget for 2011.

Author:
Matteo Ferrazzi, Economist (UniCredit Bank Milan)
+39 02 8862.8600, matteo.ferrazzi@unicreditgroup.de

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

MACROECONOMIC DATA AND FORECASTS

	2007	2008	2009	2010F	2011F
GDP (EUR bn)	28.4	32.2	26.7	26.7	28.0
Population (mn)	3.4	3.4	3.4	3.3	3.3
GDP per capita (EUR)	8,420	9,569	7,971	7,979	8,378
GDP (constant prices yoy %)	8.9	2.8	-15.0	-0.9	3.3
Private Consumption, real, yoy (%)	12.1	3.6	-17.0	-7.8	2.7
Fixed Investment, real, yoy (%)	23.0	-6.5	-38.7	24.0	4.9
Public Consumption, real, yoy (%)	3.2	7.9	-2.3	-2.0	-2.3
Exports, real, yoy (%)	3.0	12.2	-15.5	4.8	6.0
Imports, real, yoy (%)	10.7	10.5	-29.3	1.0	3.0
CPI (average, yoy %)	5.7	11.0	4.5	0.7	1.7
Monthly wage, nominal (EUR)	522	654	625	557	565
Unemployment rate (%)	4.3	5.8	13.5	18.0	16.8
Budget balance (% of GDP)	-1.0	-3.3	-8.9	-9.0	-7.0
Current account balance (EUR bn)	-4.1	-3.8	1.0	-0.5	0.4
Current account balance (% of GDP)	-14.5	-11.9	3.8	-1.8	1.3
Net FDI (EUR bn)	1.0	1.2	0.3	1.0	0.9
FDI (% of GDP)	3.6	3.2	0.3	3.8	3.2
Gross foreign debt (EUR bn)	20.5	23.1	24.5	24.9	25.1
Gross foreign debt (% of GDP)	72.3	71.6	91.6	93.2	89.7
FX reserves (EUR bn)	5.2	4.6	4.7	4.3	4.4
(Cur.Acc-FDI)/GDP (%)	-11.0	-8.1	4.8	2.0	4.5
FX reserves/Gross foreign debt (%)	25.3	20.0	19.0	17.2	17.4
Exchange rate to USD eop	2.37	2.47	2.41	2.83	2.78
Exchange rate to EUR eop	3.45	3.45	3.45	3.45	3.45
Exchange rate to USD avg	2.52	2.35	2.48	2.74	2.85
Exchange rate to EUR avg	3.45	3.45	3.45	3.45	3.45

Source: UniCredit Research

STRENGTHS

- Euro adoption perspectives
- Commitment to reign in the public deficit
- No risk in sight for currency parity adjustment

WEAKNESSES

- Sharp contraction in economic activity
- Further austerity measures to be implemented
- High and increased unemployment

Some relief, but domestic demand is still a drag on growth

Recovery ahead, but domestic demand still very weak

The worst is over for the Lithuanian economy but the good times are still a long way off: only mild positive signs for manufacturing activity and export – industrial production grew 5.5% in April – and a still difficult situation on the household sector. GDP growth in 1Q (-2.8% yoy) significantly improved thanks to exports but was dragged down by private consumption (-10% yoy) and investments (-30% yoy). **The huge jump in unemployment** – the unemployment rate reached 18.1% in the first quarter of this year, up from an average of 13.5% in 2009 (and 5.8% in 2008) – **will leave its mark on domestic demand during the coming years**. Domestic demand remains extremely weak: retail sales posted a 10% yoy drop in April (down from -6.9% yoy in March) despite the positive base effect. The fragile global situation could represent a further drag on growth. Moreover, as with the other two Baltic states, **the Lithuanian economy is also feeling the effects of the credit crunch**, as #1 the banking sector is gradually reducing its "leverage" to more balanced levels (the loans to deposits ratio will have to be reduced); #2 the amount of available lending is lower than one year ago (-8% yoy in April); #3 the peak of impaired loans will materialize between now and 2011 and will reach around 20% of total lending similar to Latvia, while it will be much lower for Estonia).

In deflation since the beginning of 2010

Lithuania slipped into the deflationary zone in early 2010: the sharp recession coupled with the austerity measures resulted in a negative inflation rate in yoy terms in January, February and March 2010; but the CPI was registered at 0.7% yoy in May. At the same time the deterioration in the trade balance during the first months of this year could bring the current account back into a deficit (after the 3.8% surplus of 2009).

Further austerity measures possible

Following the sharp deterioration of the budget balance in 2009, this year's deficit will not be that different from last year. **The Lithuanian government is planning austerity measures to save LTL 1.5bn next year**: the mix will comprise 1# extension of cuts in public sector wages (they were due to end next year); #2 increasing the retirement age; #3 reduction in some social benefits. The cuts are also related to the efforts Lithuania is undertaking to adopt the euro as soon as possible. The government is targeting euro adoption from 2014.

Minority government's main test is next year's budget

The major test for the government will come in December, when parliament has to vote on a budget for 2011. Indeed, in March 2010, PM Kubilius already saw his parliamentary majority whittled away due to an internal split with a coalition partner. Despite the government's lack of a majority, it will likely be able to rely on support from some deputies who are formally part of the opposition. Kubilius needs their support to pass a tough budget for 2011.

Room for rating upgrades

In terms of rating outlook, **all three rating agencies have now moved their outlooks from "negative" to "stable" during the first part of the year**. And as soon as the fiscal accounts show clear signs of sustainable improvement (and the euro adoption target is in sight), there will be ample room for some rating upgrades that will go together with lower country risk in terms of CDS. Estonia's euro adoption (from January 2011) is working as a stabilizer for all three Baltic Countries.

Poland

Outlook – After a relatively strong H1 we anticipate some slowdown of economic growth, as domestic demand is set to remain muted in the coming quarters. Demand induced inflationary pressures are negligible and we expect CPI inflation to fall until early summer 2010, only to rebound towards 2.3%-2.5% by year end. The combination of the above raises the probability that NBP will keep rates on hold for the rest of 2010. With budget deficits of around 7% this year and next, lack of fiscal reform remains a key risk over the medium term.

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

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

MACROECONOMIC DATA AND FORECASTS

	2007	2008	2009	2010F	2011F
GDP (EUR bn)	310.8	362.0	310.7	338.7	361.0
Population (mn)	38.1	38.1	38.2	38.1	38.1
GDP per capita (EUR)	8,154	9,492	8,140	8,893	9,485
GDP (constant prices yoy %)	6.8	5.1	1.8	2.6	2.8
Private Consumption, real, yoy (%)	4.9	5.7	2.3	2.2	2.7
Fixed Investment, real, yoy (%)	17.6	9.6	-0.8	-4.1	3.0
Public Consumption, real, yoy (%)	3.7	7.4	1.9	2.6	2.9
Exports, real, yoy (%)	9.1	7.1	-7.9	6.9	7.7
Imports, real, yoy (%)	13.7	8.0	-13.6	6.5	6.4
CPI (average, yoy %)	2.5	4.2	3.5	2.5	2.6
Central bank reference rate	5.00	5.00	3.50	3.50	4.00
Monthly wage, nominal (EUR)	762	820	834	889	909
Unemployment rate (%)	12.7	9.8	11.0	12.3	12.0
Budget balance (% of GDP)	-2.0	-3.6	-7.2	-7.1	-6.9
Current account balance (EUR bn)	-14.7	-18.3	-5.0	-6.9	-8.3
Current account balance (% of GDP)	-4.7	-5.1	-1.6	-2.0	-2.3
Net FDI (EUR bn)	17.2	10.0	8.3	10.0	10.0
FDI (% of GDP)	5.5	2.8	2.6	2.9	2.8
Gross foreign debt (EUR bn)	159.1	172.8	193.9	219.3	238.9
Gross foreign debt (% of GDP)	48.4	56.7	59.3	64.7	66.2
FX reserves (EUR bn)	44.7	44.1	55.2	78.5	92.1
(Cur.Acc-FDI)/GDP (%)	0.8	-2.3	1.0	0.9	0.5
FX reserves/Gross foreign debt (%)	28.1	25.5	28.5	35.8	38.6
Exchange rate to USD eop	2.47	2.97	2.86	3.44	3.23
Exchange rate to EUR eop	3.60	4.15	4.10	4.20	4.00
Exchange rate to USD avg	2.76	2.39	3.10	3.28	3.36
Exchange rate to EUR avg	3.78	3.52	4.33	4.13	4.07

Source: UniCredit Research

STRENGTHS

- Sound corporate and banking sector
- Large EU funds offset decline in private sector investments
- Stronger growth

WEAKNESSES

- High budget deficits and accompanying borrowing needs
- Weak private consumption and private investments
- Politicians cautious on fiscal reform

Poland: Economic growth to soften in 2H10

Softer growth ahead

After a relatively strong H1 we anticipate some slowdown of economic growth, as domestic demand is set to remain muted, and foreign demand will likely lose momentum, with the global economy receiving less “steroids” from crisis-induced extraordinary monetary and fiscal stimuli. 1Q10 saw solid growth of 3.0% yoy, and the data for 2Q are likely to be even stronger (by 0.2-0.3pp), but 2H10 is likely to see numbers of 2.5%-2.7%. A closer look at 1Q10 GDP data reveals a slightly worrisome growth structure – the contribution of transitory, crisis-triggered factors was strong, with inventory building contribution at +2.1pp and net exports’ at +2.0pp, whereas total consumption contributed +2.0pp and investments -1.8pp. Transitory factors will lose power in the coming quarters, as inventory rebuilding ends and as a weaker zloty will no longer be so supportive for exports and prohibitive for imports. On the other hand, consumption will be limited by stagnation in the labor market, whereas investments will come mainly from the public sector, with the private sector unwilling to invest amid low capacity utilization. Public investment will not be able to completely offset the decline in private investments, and hence we expect the total to be negative in 2010.

Inflationary pressure still muted

For many months and against the consensus, we have looked for the zloty to reverse its strengthening trend in 1Q-2Q10. This call proved correct and we now expect further pressure on the zloty, with the local currency being susceptible to changes in global risk appetite, it will also likely anticipate weaker growth momentum and more visible state budget problems in H2 2010. Our scenario for inflation remains unchanged; we expect CPI inflation to fall until early summer 2010, bottom around 1.8%-2.0% yoy and rebound towards 2.3%-2.5% at end-2010. We remain constructive on POLGBs: domestic inflationary pressure looks muted, the economy is likely to decelerate and thus rate hike expectations will weaken, while the global deceleration of monetary aggregates creates a risk of deflationary pressures.

We do not expect rate hikes this year

To date our base scenario for MPC rates assumed one rate hike in 4Q10, but we also signaled that a “no hikes” scenario would not be a big surprise. Now, given the benign inflationary picture and GDP growth that is set to stay below potential GDP growth (and slow down in 2H10), we are switching to “no hikes” as the base scenario for 2010. One risk factor for this call will be the release of MPC inflation projection at the end of June (which will likely see slightly higher inflation, due to previously overoptimistic assumptions regarding food prices), and it should be watched closely, though we think it will not change the general view of a soft economy and soft inflation pressure in the medium term.

Lack of fiscal reforms remains the key negative for the domestic economy. The deficits are likely to stay around 7% this and next year, and only later, as the political calendar allows, might there be some more ambitious reforms. The statements from the EU that the proposed “public finance reforms are hardly ambitious” and that – except for the strong growth scenario – they are insufficient to allow the Maastricht criteria to be met in the next few years, continue to sound true. No changes in credit outlook are expected, though rating agencies reiterate the need for fiscal reforms in the medium term.

Presidential elections at center stage

The first round of Presidential elections (held on June 20) produced a close call among the two key candidates: representative of the ruling Civic Platform (PO) B.Komorowski received 41.54% of votes, whereas J.Kaczynski of the opposition Law and Justice (PiS) gained 35.46%. The shifts of votes in the second round, suggest that B.Komorowski has higher chances of becoming the President. His election would likely mean a smooth cooperation with the Cabinet, especially regarding economic reforms. However, it seems unlikely that any major reforms will be presented in the run-up to next year’s Parliamentary elections, so these hopes may not be fulfilled soon. On the other hand, the winning of J.Kaczynski would likely not be particularly negative for the economy – during his term as the PM a few years back, he managed to lower taxes and he put de-regulation high on the agenda.

Romania

Outlook

A prolonged recession is on the cards in 2010, marked by worsening social conditions and depressed consumption, even as painful fiscal austerity measures are rolled out - public sector restructuring and expenditure cuts (25% cut in public wages and 15% drop in pension and social benefits). On the back of this we expect a worse than initially predicted deterioration in consumption and lower GDP growth (to -0.9% from +0.4%) during the rest of 2010. Fiscal slippage remains a key risk given the weak economic performance.

Author: Rozália Pál, Ph.D., Macro and Strategic Analysis Coordinator (UniCredit Tiriac Bank)
+40 21 203 2376, rozalia.pal@unicredit.ro

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

MACROECONOMIC DATA AND FORECASTS

	2007	2008	2009	2010F	2011F
GDP (EUR bn)	123.7	136.9	115.9	122.2	132.8
Population (mn)	21.5	21.4	21.3	21.2	21.1
GDP per capita (EUR)	5,745	6,391	5,439	5,763	6,294
GDP (constant prices yoy %)	6.2	7.1	-7.1	-0.9	2.5
Private Consumption, real, yoy (%)	9.8	8.4	-9.2	-1.0	4.0
Fixed Investment, real, yoy (%)	29.0	19.3	-25.3	-2.1	4.8
Public Consumption, real, yoy (%)	7.6	3.7	1.2	1.0	2.0
Exports, real, yoy (%)	7.9	19.4	-5.5	5.7	6.0
Imports, real, yoy (%)	27.2	17.5	-20.6	6.5	9.5
CPI (average, yoy %)	4.8	7.9	5.6	4.7	4.1
Central bank reference rate	7.50	10.25	8.00	5.75	5.00
Monthly wage, nominal (EUR)	312	347	326	345	372
Unemployment rate (%)	4.3	4.0	6.3	8.5	7.0
Budget balance (% of GDP)	-2.3	-4.9	-7.4	-7.0	-5.0
Current account balance (EUR bn)	-16.7	-16.9	-5.1	-6.9	-9.0
Current account balance (% of GDP)	-13.5	-12.3	-4.4	-5.6	-6.8
Net FDI (EUR bn)	7.2	9.0	4.9	4.3	5.3
FDI (% of GDP)	5.8	6.6	4.2	3.5	4.0
Gross foreign debt (EUR bn)	38.7	51.8	65.6	72.2	78.3
Gross foreign debt (% of GDP)	31.3	37.8	56.6	59.1	59.0
FX reserves (EUR bn)	25.3	26.2	28.3	30.7	29.0
(Cur.Acc-FDI)/GDP (%)	-7.7	-5.7	-0.1	-2.1	-2.8
FX reserves/Gross foreign debt (%)	65.4	50.7	43.1	42.5	37,0
Exchange rate to USD eop	2.45	2.89	2.95	3.44	3.31
Exchange rate to EUR eop	3.58	4.03	4.23	4.20	4.10
Exchange rate to USD avg	2.43	2.50	3.04	3.33	3.43
Exchange rate to EUR avg	3.34	3.68	4.24	4.19	4.15

Source: UniCredit Research

STRENGTHS

- Significant IMF and EU support
- Low public sector debt levels
- Strongly improved external position

WEAKNESSES

- High public deficit with risk of overshooting
- High FX leverage in domestic private sector
- Worsening of the loans portfolio quality

Fiscal austerity measures at top of agenda

Further deterioration in consumption on the back of the implementation of fiscal austerity measures

The Romanian economy is still suffering the effects of the international crisis: indeed, it remained in recession in 1Q10 with a 2.6% yoy (-0.3% qoq) decline. Exports (+19.5% yoy) and inventories (+80% yoy) continued to be the main drivers of the improvement; investments registered a slight improvement compared to the previous quarter (+1.2% qoq), despite remaining at depressed levels (-28.9% yoy); consumption is the Achilles' heel (-4.1% yoy and -1.7% qoq). On the supply side, industry brought significant value added in 1Q, while the laggard was the construction sector (-17.3% yoy). On the back of the two bills for public sector restructuring and expenditure cuts (25% cut in public wages and 15% drop in pension and social benefits), we expect a worse than initially predicted deterioration in consumption during the rest of the year. Our new scenario assumes implementation of these measures in the second half of 2010, resulting in a further drop in real GDP (-0.9% yoy) in 2010, a significant downward revision from our previous forecast of +0.4% yoy real growth.

Disinflation trend to continue in 2010

The weak local demand will help the disinflation trend to continue during 2010. The inflation rate is still expected to enter the target band in 2010 with a slight upward revision from 4.2% to 4.4% due to the announced administrative price changes (eliminating part of the price compensation of medical expenditure).

Trade deficit continues to narrow

Romania's external deficit was offset in 2009 by a further narrowing of the trade deficit during the first four months of 2010 (-21% yoy after the -65% yoy contraction last year). On the negative side we note some drying up of external funds in the form of current transfers (-61% yoy) and FDI (-37% yoy) as of April 2010. We expect a similar trend for the whole year and we forecast the current account deficit at 5.6% of GDP in 2010. The external debt trend rose marginally, which might indicate that the deleveraging process of the private sector has reached its end.

Monetary policy softening to continue in 2010

Monetary softening is set to continue, in our view. The Central Bank (CB) implemented a 175bp policy rate cut this year supported by the strengthening of the RON and the disinflation process. However, the end of the second quarter has been characterised by increased uncertainties, which brought higher interest rate volatility together with depreciation pressures. As a next step, we expect two additional 0.25% policy rate cuts, mainly aimed at sustaining consumption. Moreover, the revival of lending activity is still not visible, which also calls for further monetary policy softening. Additional banks' marginal reserve requirements cuts are also plausible in 2H.

Strong social pressures and risk ahead of budget deficit slippage

The fiscal side is the more delicate and also more important for the stability of the Romanian economy: Romania ran a consolidated budget deficit of 2.2% of GDP in the first four months of 2010; moreover, it aims to reduce the general government deficit from 7.4% of GDP in 2009 to 6.8% of GDP in 2010 (the new target agreed with the IMF in May 2010). In order to achieve this, the Romanian government approved two bills under which the wages in the budgetary sector as well as social payments, including maternity pay, will drop by 25%, while pension and unemployment benefits will be lowered by 15%. **While the government has survived the public outcry and the no-confidence vote filed by the opposition parties as a reaction to the bills, it still needs to receive the approval of the Constitutional Court** that has been asked to decide if the two laws are in line with country's constitution. The Romanian government's fiscal spending cuts amount to around 2% of GDP. Our baseline scenario assumes a budget deficit close to the targeted level for this year, with further rebalancing in the coming years; however, we still see some risk of budget deficit overshooting upon delays on implementing the planned measures and weak management of additional structural changes (efficiency measures, personnel cutback, etc.).

Slovakia

Outlook – Slovak elections are likely to produce a repeat of the super reform oriented government of 2002-2006, with reform of the opaque social contributions system, labor market, judicial system and anti-corruption measures being on the agenda. A close connection to Germany remains supportive for the strong bounce back with Slovakia posting the highest qoq growth in 1Q10 inside the EU. We expect growth to reach 3.5% this year, on good trade performance, while some slowdown is possible next year should 2 out of 3 highway PPP projects be stopped, although that will mean healthier fiscal accounts.

Author:
Jan Toth, Chief Economist (UniCredit Bank) +421 2 4950 2267, jan.toth@unicreditgroup.sk

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

MACROECONOMIC DATA AND FORECASTS

	2007	2008	2009	2010F	2011F
GDP (EUR bn)	54.9	64.8	63.3	65.2	69.1
Population (mn)	5.4	5.4	5.4	5.4	5.4
GDP per capita (EUR)	10,165	11,966	11,722	12,068	12,800
GDP (constant prices yoy %)	10.6	6.2	-4.7	3.5	3.5
Private Consumption, real, yoy (%)	7.1	6.1	0.2	1.0	2.5
Fixed Investment, real, yoy (%)	9.1	1.8	-10.5	2.4	2.2
Public Consumption, real, yoy (%)	0.1	5.3	2.8	3.0	-0.5
Exports, real, yoy (%)	14.3	3.2	-16.5	15.0	7.2
Imports, real, yoy (%)	9.2	3.1	-17.6	14.6	6.4
CPI (average, yoy %)	2.8	4.6	1.6	1.3	3.0
Central bank reference rate	4.25	2.50	EUR	EUR	EUR
Monthly wage, nominal (EUR)	669	723	745	768	805
Unemployment rate (%)	11.0	9.6	12.1	13.9	13.5
Budget balance (% of GDP)	-1.9	-2.3	-6.8	-7.0	-5.8
Current account balance (EUR bn)	-3.3	-4.2	-3.9	-3.1	0
Current account balance (% of GDP)	-5.3	-6.5	-3.2	-2.1	-1.9
Net FDI (EUR bn)	2.7	1.7	1.2	1.8	0
FDI (% of GDP)	3.8	3.3	-0.3	1.5	1.3
Gross foreign debt (EUR bn)	32.4	35.9	45.4	52.3	58.9
Gross foreign debt (% of GDP)	59.0	55.4	71.6	80.3	85.2
(Cur.Acc-FDI)/GDP (%)	-1.1	-3.9	-4.4	-2.0	0

Source: UniCredit Research

STRENGTHS

- A likely reform-ambitious new government
- Some FDI interest due to euro adoption and tax system
- Banking sector in good shape

WEAKNESSES

- Euro adoption does not allow currency depreciation to improve price competitiveness
- Very dependent on world trade as industry the main engine of growth (autos, electronics, steel)
- A rise in perceived corruption during the last government

Déjà vu?

Slovak 2010 GDP forecasts

	Previous	New
market		3.0
CB	3.2	3.7
MinFin	2.8	3.2
UCB	**3.1**	**3.5**

Slovak 2011 GDP forecasts

	Previous	New
market		3.8
CB	4.4	4.3
MinFin	3.3	3.8
UCB	**3.8**	**3.5**

The new government is a complete change

Slovaks voted out the current leftist government parties despite the fact that the senior coalition party SMER received 35% of the vote. Meciar's HZDS party did not make it through the 5% threshold to get into Parliament. The market-oriented center-right parties (previous opposition) got 79 seats out of 150 and are about to form a new government. The government will be a complete change. The two bigger parties include ex-PM Dzurinda's liberal SDKU (a sociologist Radicova is the expected new PM) and the new liberal SaS party headed by the flat-tax advocate Sulik (he was a former advisor to SDKU ex-finance minister Miklos), both are very reform-ambitious parties. The smaller parties consist of the moderate ethnic Hungarians as well as the Christian Democrats KDH.

It is basically a repeat of a super-reform government during 2002-2006 period

The government is basically a repeat of the super-reform government during 2002-2006 (flat tax introduction, 3-pillar pension reform, labor market reform, limited healthcare reform, euro adoption timetable). Soon-to-be PM Radicova has called for the return of the "economic tiger" label for Slovakia. FinMin hopeful Sulik wants to reform the opaque social contributions system and cut the fiscal deficit to more sustainable levels (we now expect a deficit of 7.0% of GDP this year, up from 6.8% last year). The new government is likely to try to reform the messy judicial system, improve transparency (Slovakia is again behind the rest of CE4 in the perception of corruption) and possibly reform the education sector (ex-FinMin Miklos is rumored to be interested).

There could be two complications. First, new PM Radicova is a relatively inexperienced politician (although she was the Labor Minister in 2005-06). Second, the government will face a huge opposition party SMER in Parliament - SMER alone will have 80% of the seats of the new government 4-party MPs.

Stronger 2010 in industry will push the growth to 3.5%

Domestic demand continues to be weak

Real estate construction suffers

Meanwhile the Slovak economy continues to benefit from the strong world trade, posting the highest qoq growth in 1Q10 inside the EU. Since German IFO and ZEW suggests that Slovakia's main trading partner should continue to buy Slovak exports well into the year-end, we up our 2010 forecast from 3.1% to 3.5% (this continues to be an above consensus growth). A weaker euro helps. The growth slowdown should come only in 2011 as fiscal tightening hits the eurozone. The new Slovak government will introduce a tighter fiscal policy as well, probably stopping 2 out of 3 huge highway PPP (public-private partnership) projects. This prompts us to revise lower our 2011 growth from 3.8% to 3.5% (a below consensus growth at present). The output gap should not close before 2013.

PPP projects for highways might be downsized from 3 to 1

There are conflicting signs about employment development, but we expect the situation to stabilize in 2Q10. Domestic demand continues to be weak, retail sales and real estate construction has been hit as a consequence.

Slovakia continues to enjoy zero real interest rates

Slovakia continues to enjoy zero real interest rates, but corporate loans are not growing as the capacities are not fully utilized. We have not seen much value in long-end bonds due to benchmark bunds as well as the risk premium. The 10Y spread increased to 140bp ahead of the elections. We will decide whether to revise our view after seeing the new government's program. The euro, together with the relatively low levels of public debt, provides some short-term leeway, but fiscal accounts need to be addressed. Not least because the domestic banks have heavy balance sheets of bonds and the local private sector is not producing enough savings to buy the new issues.

Slovenia

Outlook – The Slovenian growth pattern in the first quarter of the year was quite disappointing and the recession deepened, but recent data on the manufacturing sector and exports point to a slightly stronger recovery this year (with still weak household demand). We hence marginally increased our GDP forecast for 2010 and 2011. During the summer the government will introduce a supplementary budget in which it plans to increase excise taxes and cut spending: this will not allow for any significant recovery stemming from domestic demand.

Author:
Goran Šaravanja, Chief Economist (Zagrebačka banka)
+385 1 6006 678, goran.saravanja@unicreditgroup.zaba.hr

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

MACROECONOMIC DATA AND FORECASTS

	2007	2008	2009	2010F	2011F
GDP (EUR bn)	34.5	37.1	34.9	35.9	37.6
Population (mn)	2.0	2.0	2.0	2.1	2.1
GDP per capita (EUR)	17,169	18,366	17,105	17,515	18,262
GDP (constant prices yoy %)	6.8	3.5	-7.8	0.9	1.9
Private Consumption, real, yoy (%)	5.3	2.2	-2.6	0	1.5
Fixed Investment, real, yoy (%)	11.9	6.6	-21.6	-7.2	3.9
Public Consumption, real, yoy (%)	2.5	3.7	3.0	1.4	1.0
Exports, real, yoy (%)	13.8	3.4	-15.6	4.4	4.0
Imports, real, yoy (%)	15.7	3.8	-17.9	4.2	5.0
CPI (average, yoy %)	3.6	5.7	0.9	2.0	2.9
Central bank reference rate	4.00	2.50	1.00	1.00	1.25
Monthly wage, nominal (EUR)	1,284	1,391	1,439	1,480	1,515
Unemployment rate (%)	4.9	4.5	5.9	6.8	6.3
Budget balance (% of GDP)	0	-1.7	-5.5	-6.0	-5.7
Current account balance (EUR bn)	-1.5	-2.3	-0.3	-0.3	-0.6
Current account balance (% of GDP)	-4.2	-6.2	-1.0	-0.7	-1.6
Net FDI (EUR bn)	-0.3	0.4	-0.7	-0.2	0.1
FDI (% of GDP)	-0.8	1.0	-1.9	-0.6	0.3
Gross foreign debt (EUR bn)	34.8	39.0	40.1	42.5	45.5
Gross foreign debt (% of GDP)	100.7	105.1	115.0	118.4	120.9
(Cur.Acc-FDI)/GDP,%	-5.0	-5.1	-2.9	-1.3	-1.3

Source: UniCredit Research

STRENGTHS

- Relatively low public debt levels (less than 40%)
- Foreign debt essentially denominated in local currency
- Export orientation can lever off any Eurozone recovery

WEAKNESSES

- Highly leveraged banking sector
- Still very weak construction sector
- Lower price competitiveness

A mixed bag of signals still point to slightly stronger growth

Recession deepened in 1Q but signs of recovery are visible

The growth pattern in the first quarter of the year was quite disappointing and the recession deepened. 1Q10 GDP data were weaker than expected: the headline figure was -1.2% yoy and the seasonally adjusted qoq data actually revealed a stronger deceleration of -0.5%, (compared to -0.3% in 4Q09). However, industrial production data for April rose 9.7% yoy and the mom trend data also indicate a recovery has commenced. Indeed, the sentiment indicator for the industrial sector in May 2010 was at its highest since the collapse of Lehman Brothers in September 2008. In addition, seasonally adjusted new orders in the industrial sector rose 1.1% qoq in 1Q10. Meanwhile, the construction sector remains mired in deep recession, contracting 14.7% yoy in 1Q10. Private consumption is also muted, with retail sales volumes falling, unemployment up to 7.1% in 1Q10 and wage growth slowing (up 2.2% yoy in real terms in Jan-April).

Core inflation turning positive

Inflation is up slightly, while external imbalances are narrowing. The balance of payments data for 1Q10 reveal an increase in exports of goods and services of 5.2% yoy in 1Q10. We see the current account deficit narrowing to just 0.7% of GDP. Inflation remains low but the trend is definitely up – our calculations suggest that core inflation turned positive in April for the first time in 12 months. In May consumer prices rose 2.1% yoy.

Higher GDP growth and inflation forecast…

We increase our GDP forecast to 0.9%, and our inflation forecast to 2.0%. Although 1Q10 GDP data in isolation would suggest otherwise, we increase our growth forecast to 0.9% from 0.6% this year. The combination of a favorable base effect and signs of a pick up in industrial production (export-driven) are the main reasons for this change in our forecast. We expect private consumption will remain weak this year, in part due to spending cuts and tax rises in the upcoming supplementary budget. On the inflation front, the government is set to increase excise taxes on electricity, gas and cigarettes in August and we therefore increase our average CPI forecast for the year to 2.0%.

…even though the announced austerity measures look set to dampen domestic demand further

The government is planning some austerity measures, including both spending cuts and tax increases. The central government budget recorded a deficit of EUR 1.24bn in the first five months of the year as tax revenue growth remained sluggish. This summer the government will introduce a supplementary budget in which it plans to increase excise taxes and cut spending. This will impact adversely on domestic demand. In our opinion, however, the key issues for the economy remain structural in nature. Many Slovenian exporters are in relatively low value added sectors, which leaves them more exposed to global competition and the banking sector is still suffering the effects of the global financial crisis. The government's intention to increase the retirement age to 65 (from 58 presently) and efforts to improve the efficiency of the labor market will also need to be followed through in order to maintain the generally prudent fiscal settings of the previous two decades.

Government in a stronger position after the referendum

Post-referendum the government can concentrate on economic policy. In early June Slovenia narrowly voted to accept the resolution mechanism agreed with Croatia over the long-running border dispute, boosting the government and allowing it to concentrate on economic policy issues, such as labor market and pension reforms.

Sovereign credit rating stable on low public debt

We do not expect any change in the sovereign rating during the coming months. Although Slovenia has structural issues to deal with in order to accelerate economic growth, post-referendum the government is in a stronger position, while compared to most Eurozone members the country's fiscal settings are favorable.

Bosnia & Herzegovina

Outlook

The economic trends are painting a picture of two economies – one in which export growth is booming and one in which domestic demand remains very weak. There is little doubt that the economy has turned the corner, however, the recovery appears to remain concentrated in a small number of industries. We have revised up our GDP forecast for the Bosnian economy to +0.5% in 2010 (from -1%). With lower external financing needs, FX reserves stable and the IMF agreement in place, macro risks are clearly moderating.

Author: Goran Šaravanja, Chief Economist (Zagrebačka banka)
+385 1 6006 678, goran.saravanja@unicreditgroup.zaba.hr

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

MACROECONOMIC DATA AND FORECASTS

	2007	2008	2009	2010F	2011F
GDP (EUR bn)	11.1	12.6	12.1	12.5	12.9
Population (mn)	3.8	3.9	3.9	3.9	3.9
GDP per capita (EUR)	2,876	3,282	3,153	3,239	3,349
GDP (constant prices yoy %)	6.8	5.4	-3.5	0.5	1.2
CPI (average, yoy %)	1.5	7.4	-0.4	2.3	2.2
Monthly wage, nominal (EUR)	488	568	616	624	638
Unemployment rate (%)	44.0	40.3	41.5	41.2	41.0
Budget balance (% of GDP)	-0.1	-4.0	-5.2	-4.5	-4.2
Current account balance (EUR bn)	-1.2	-1.9	-0.9	-0.5	-0.5
Current account balance (% of GDP)	-10.4	-15.1	-7.6	-3.6	-3.8
Net FDI (EUR bn)	1.5	0.7	0.4	0.4	0.5
FDI (% of GDP)	13.5	5.7	2.9	3.3	4.0
FX reserves (EUR bn)	3.4	3.2	3.2	3.1	3.1
(Cur.Acc-FDI)/GDP (%)	3.1	-9.4	-4.7	-0.4	0.1
Exchange rate to USD eop	1.34	1.40	1.36	1.60	1.58
Exchange rate to EUR eop	1.96	1.96	1.96	1.96	1.96
Exchange rate to USD avg	1.43	1.33	1.40	1.55	1.62
Exchange rate to EUR avg	1.96	1.96	1.96	1.96	1.96

Source: UniCredit Research

STRENGTHS

- IMF program provides a credible policy anchor
- Current account deficit narrowing sharply on higher exports
- Lower external financing needs expected near term

WEAKNESSES

- Election year complicates political scene
- Challenges in meeting structural targets of IMF program
- Domestic demand remains weak

A tale of two economies

The economy has turned the corner, but the recovery appears to be concentrated in a few sectors

Industrial production is picking up. In many ways the economic data for Bosnia Herzegovina to date this year paint a picture of two economies – one in which export growth is booming due to activity in a handful of sectors and one in which domestic demand remains very weak. In both the Federation and in Republika Srpska (RS) industrial production data show a pick up. In the Federation manufacturing activity has rebounded even faster (by 4.7% yoy in Jan-April) as textile, chemicals, metals and furniture production has increased sharply; in RS mining activity and metals production have been the main drivers of a 7.3% yoy increase in industrial production over this period. This activity has been reflected in merchandise trade data which revealed a 29.5% yoy increase in exports over this period. Household demand is weaker, but improving: retail trade data is marginally positive in real terms in the Federation (up 0.4% yoy in Jan-April) and up 3% yoy in RS over the same period. Yet, with import growth flat, loans to the household sector in April down 5.6% yoy and up only 1% yoy to enterprises, domestic demand will remain weak. In addition, gross wages have fallen in real terms by over 1% yoy in 1Q10. In the absence of administered price rises at the start of the year, inflation would be close to zero for the second year in a row. Although there is little doubt that the economy has turned the corner, the recovery currently appears to be concentrated in just a handful of private sector employers in a small number of industries.

GDP forecast revised up to 0.5% in 2010

We have revised up our GDP forecast for the Bosnian economy and expect a lower current account deficit. On the back of an almost 30% yoy rise in merchandise exports and no change in imports in the first four months of the year, in conjunction with somewhat better industrial production data, we have revised our growth forecast to 0.5% from -1.0% for this year. The remainder of 2010 will undoubtedly see the continuation of a sharp recovery in merchandise exports, which is also the reason why we have revised our forecast of the current account deficit from 6.3% of GDP to 3.6% of GDP. In 2011 and 2012 we do not see exports growing as quickly: indeed, a large part of this year's recovery only reflects a pick up in external demand from 2009's extremely depressed levels. More importantly, we see the basic balance (the current account deficit minus FDI) in 2010-12 as slightly positive, even though we do not see FDI inflows returning to pre-crisis levels. This implies lower external financing needs going forward. The conclusion is that macroeconomic risks are moderating in Bosnia Herzegovina. This is one of the reasons we maintain our view that the currency board arrangement is solid.

Despite progress key structural reforms are yet to be locked in…

IMF delays approval of the EUR 38mn disbursement. In May the IMF mission concluded that, based on 1Q 2010 data, the authorities had met their quantitative targets. However, in terms of structural benchmarks, the government is enjoying less success, especially in the Federation. As a result the IMF mission postponed a decision on whether to recommend the disbursement of the third EUR 38mn tranche to Bosnia Herzegovina. The measures the Federation government has to meet include #1 accelerating audits of eligibility for social welfare payments, #2 completing the reform of privileged pensions and #3 making sure that the agreed wage bill allocation for 2010 is not exceeded.

…as the general election on 3 October moves into focus

General elections in October are the main event of the year. Efforts to lock in reforms of the pension system and welfare eligibility will be challenging at the current point in the political cycle, as general elections will be held soon (on 3 October this year).

No change to sovereign rating expected

Sovereign rating expected to remain stable. With FX reserves stable, the country's external imbalances narrowing and the IMF agreement in place (despite unsurprising delays in implementation), we see no change to the credit rating in the next 12 months.

Croatia

Outlook

The recovery in Croatia appears to be taking longer to materialize than in other countries in CEE. In the near term a recovery in investment spending is unlikely given low capacity utilization; household demand remains very weak. We are revising down our GDP growth forecast to -1.5% this year (from the previous forecast of -1%). We also expect lower inflation, averaging only 1% this year. The fiscal deficit continues to widen and we expect the consolidated general government budget deficit to reach 5.9% of GDP.

Author: Goran Šaravanja, Chief Economist (Zagrebačka banka)
+385 1 6006 678, goran.saravanja@unicreditgroup.zaba.hr

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

MACROECONOMIC DATA AND FORECASTS

	2007	2008	2009	2010F	2011F
GDP (EUR bn)	42.8	47.4	45.4	45.6	47.3
Population (mn)	4.4	4.4	4.4	4.4	4.4
GDP per capita (EUR)	9,654	10,681	10,245	10,306	10,681
GDP (constant prices yoy %)	5.5	2.4	-5.8	-1.5	1.6
Private Consumption, real, yoy (%)	6.2	0.8	-8.5	-1.6	1.4
Fixed Investment, real, yoy (%)	6.5	8.2	-11.8	-5.1	2.1
Public Consumption, real, yoy (%)	3.4	1.9	0.2	0.4	1.0
Exports, real, yoy (%)	4.3	1.7	-16.3	0	1.7
Imports, real, yoy (%)	6.5	3.6	-20.7	-2.7	2.7
CPI (average, yoy %)	2.9	6.1	2.4	1.0	2.9
Monthly wage, nominal (EUR)	961	1,044	1,050	1,071	1,086
Unemployment rate (%)	9.6	8.4	9.4	10.0	9.6
Budget balance (% of GDP)	-2.0	-1.4	-3.9	-5.9	-4.9
Current account balance (EUR bn)	-3.2	-4.4	-2.4	-1.5	-1.7
Current account balance (% of GDP)	-7.6	-9.2	-5.2	-3.4	-3.5
Net FDI (EUR bn)	3.5	3.2	1.0	1.0	2.2
FDI (% of GDP)	8.1	6.8	2.1	2.2	4.7
Gross foreign debt (EUR bn)	33.3	39.0	44.6	47.5	50.5
Gross foreign debt (% of GDP)	77.7	82.4	98.3	104.1	106.7
FX reserves (EUR bn)	9.3	9.1	10.0	10.5	11.5
(Cur.Acc-FDI)/GDP (%)	0.6	-2.4	-3.1	-1.2	1.1
FX reserves/Gross foreign debt (%)	28.0	23.4	22.4	22.1	22.8
Exchange rate to USD eop	5.03	5.29	5.09	5.98	5.93
Exchange rate to EUR eop	7.33	7.37	7.30	7.30	7.35
Exchange rate to USD avg	5.35	4.91	5.26	5.76	6.05
Exchange rate to EUR avg	7.34	7.22	7.34	7.26	7.32

Source: UniCredit Research

STRENGTHS

- Stable currency
- External imbalances narrowing
- EU accession path

WEAKNESSES

- Widening fiscal deficit
- Slower recovery compared to others in CEE
- External indebtedness

Stuck in neutral?

No signs of a sustained recovery as domestic demand remains weak

The Croatian economy continued to contract in the first quarter of the year. The 2.5% yoy contraction in economic activity in 1Q10 was worse than expected. Data for 2Q10 to date offer little joy, pointing to yet another quarter of negative growth. Industrial production fell 6.6% yoy on a working day adjusted basis in April (and 1.9% mom seasonally adjusted). Merchandise exports rose 5.2% yoy in January-April and merchandise imports continued to contract (by 9% yoy) over this period. Household demand is even weaker: retail sales contracted over 8% yoy in real terms in April; at the same time gross wages in 1Q10 contracted in real terms by 1.8% yoy. Inflationary pressures remain minimal with headline consumer prices rising only 0.8% yoy in May.

Growth and inflation forecasts revised down

We revised down our GDP and inflation forecasts. As mentioned above, the Croatian economy continues to be characterized by weak domestic demand. In the near term a recovery in investment spending is unlikely given low capacity utilization. A net reduction in the income tax burden of HRK1bn in the full year (to come into effect on 1 July along with the abolition of the 2% solidarity tax on net income between HRK 3000-6000) will only impact on growth in 2011 since the 4% solidarity tax introduced last year will only be abolished in November this year. Although we see net exports contributing to growth this year, a pick up in industrial production is yet to materialize. We forecast the economy contracting 1.5% this year (previous forecast: -1%). We see inflation averaging only 1% this year as the strong currency and delays in increasing administered prices combine to keep inflation low.

Current account deficit to narrow further to 3.9% of GDP, EUR/HRK remains stable

The current account deficit is lower, but foreign debt is moving over 100% of GDP. With the merchandise trade deficit down by EUR 575mn in January-April, largely due to another 9% drop in imports (after a 26% yoy drop in the same period of 2009), the current account deficit looks set to narrow even more than previously forecast. Our new forecast of a deficit of 3.4% of GDP also reflects an expectation that tourism revenues will increase 5% this year. The EUR/HRK remains exposed to downward pressure despite continued extremely loose money market conditions. With the basic balance (current account minus FDI) narrowing to -1.2% of GDP this year, as imports continue to contract and borrowing by state-owned and private sector companies continues, we expect the EUR/HRK to rise to 7.30 at year end.

Fiscal trends in early 2010 point to a budget rebalance

The fiscal deficit continues to widen. By May the central government budget deficit exceeded HRK 7bn and, with revenue growth still below expectations and contingent liabilities representing a constant threat to expenditure dynamics, we revise our consolidated general government budget deficit forecast to 5.9% of GDP. The risk remains squarely to the upside.

Economic policy debate yet to develop fully

Referendum initiative on proposed labor law amendments puts the government in a tight spot. In mid-April the government announced a market-oriented economic recovery program. However, the government's inability (in negotiations which pre-date the economic recovery program) to bring around public sector unions to forfeit Christmas bonuses and other add-ons, saw it propose amending two clauses of the labor law to essentially limit the time expired collective agreements remain valid as well as opening up the possibility of collective agreements being torn up more easily. The unions responded by embarking on collecting 450,000 signatures within two weeks in early June to force a referendum on the issue. This has morphed into a general expression of displeasure towards the political class. After the likely referendum the government will have to do a much better job arguing its position to ensure support for its reform initiatives.

No rating changes expected

No change to credit rating is expected in the coming months. Late June/early July should see Croatia open the remaining 3 chapters of its EU accession process. We do not see the sovereign rating changing in the next twelve months.

Kazakhstan

Outlook – Robust growth in commodity exports is helping the Kazakh economy to propel ahead, with H1 2010 growth estimated some 8% yoy. Exports grew a staggering 69% yoy in USD terms in Jan-April vs a decline of 9% for imports, with both the C/A and trade balance going into surplus. The NBK had to intervene heavily to moderate the effect on the KZT. We now forecast the KZT to appreciate to 139 eop 2010, a bit less than before because of tight opposition to more FX flexibility.

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

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

MACROECONOMIC DATA AND FORECASTS

	2007	2008	2009	2010F	2011F
GDP (EUR bn)	76.1	89.8	77.3	101.9	128.7
Population (mn)	15.5	15.7	16.2	16.3	16.5
GDP per capita (EUR)	4,912	5,729	4,772	6,235	7,803
GDP (constant prices yoy %)	8.9	3.3	1.2	5.0	6.0
Private Consumption, real, yoy (%)	10.8	3.8	-2.8	2.0	4.2
Fixed Investment, real, yoy (%)	17.3	1.7	1.9	7.7	13.2
Public Consumption, real, yoy (%)	14.0	5.5	1.1	5.1	4.7
Exports, real, yoy (%)	9.0	1.8	-6.2	7.0	11.0
Imports, real, yoy (%)	25.5	-11.5	-15.9	6.0	14.0
CPI (average, yoy %)	10.8	17.2	7.3	7.6	7.0
Central bank reference rate	11.00	10.50	7.00	7.25	7.25
Monthly wage, nominal (EUR)	313	343	329	404	498
Unemployment rate (%)	7.6	6.6	6.6	6.0	5.7
Budget balance (% of GDP)	5.2	1.2	-4.3	-4.1	-2.0
Current account balance (EUR bn)	-6.0	4.7	-2.4	2.9	-5.2
Current account balance (% of GDP)	-7.9	5.3	-3.2	2.8	-4.1
Net FDI (EUR bn)	8.1	9.9	9.0	8.8	9.0
FDI (% of GDP)	10.7	11.0	11.7	8.6	7.0
Gross foreign debt (EUR bn)	65.8	77.3	75.5	71.8	76.2
Gross foreign debt (% of GDP)	86.5	86.0	97.7	70.5	59.2
FX reserves (EUR bn)	12.7	14.8	15.9	21.1	23.5
(Cur.Acc-FDI)/GDP (%)	2.8	16.3	8.5	11.5	2.9
FX reserves/Gross foreign debt (%)	19.3	19.1	21.0	29.3	30.8
Exchange rate to USD eop	120.68	120.88	148.36	139.00	135.00
Exchange rate to EUR eop	175.99	168.66	212.61	169.58	167.40
Exchange rate to USD avg	122.54	120.32	147.65	144.88	137.00
Exchange rate to EUR avg	167.99	176.98	205.89	182.55	165.77

Source: UniCredit Research

STRENGTHS

- Strong export recovery
- Successful restructuring of BTA and Alliance foreign debt
- Solid government finances and fx-reserves

WEAKNESSES

- Bank asset quality still very poor
- Slow credit growth
- Investment recovery oil related, not very broad-based yet

First half of 2010 sees growth of almost 8%

1Q GDP growth: +7.1%, 2Q above 8%

GDP grew 7.1% yoy in 1Q10, and probably more than 8% yoy in 2Q10, after 1.2% in FY 2009. The 7.1% is lower in both yoy and qoq sa terms than the, somewhat questionable, 8.4% that result from comparing StatAgency 1Q-3Q and full year 2009 data, according to our calculations. The acceleration in industrial output growth from 9.6% yoy in 4Q09 to 11.6% yoy in 1Q10 and more than 12% yoy in 2Q10 leaves little doubt that a strong recovery is underway. Constant price retail sales increased 0.3% yoy in 4Q09, 10.8% yoy in 1Q10 and more than 15% yoy in 2Q. Mom sa growth in industrial output has been slightly slower in 2Q than in 1Q – reflecting weaker growth in global demand - but has remained positive.

Growth driven by exports and a recovery in investment

Early 2010 saw a very strong export recovery. Investment and consumption also contributed to growth. Growth was held up thanks to the oil & gas sector (20.7% of GDP in 2009, 13.9% of which is mining) during the crisis period. The oil & gas sector grew 9.6% yoy in real terms in 2009 whereas non-oil GDP declined by 1.8%. This year, manufacturing also looks strong. Whereas mining grew 7.8% yoy in 1Q, manufacturing increased by 18.7%. Growth in 2009 was attributable to public consumption (+1.1%) and sharply contracting imports of goods and services (-15.9%). Exports also declined, but at 6.2% substantially less than imports. Private consumption fell 2.8%. There was, however, a rebound in fixed investment in 2H – in part oil related and in part due to the power sector - which brought the full year figure to +1.9% and likely continued in 2010. **Given the strong 5 month, we revise our 2010 GDP forecast**, from 3.5% to 5%, while slow credit growth and a more adverse global environment prevent us from penciling in an even higher prognosis.

We upgrade our 2010 GDP forecast from 3.5% to 5%

Inflation up to now within target, monetary tightening might come this fall.

Inflation was 7.0% yoy in May, in the center of the central bank's 6-8% target corridor. However, the consumer price index increased 4.2% between end-2009 and May 2010 driven by food prices and hikes in tariffs, somewhat more than the 3.5% during the same period of 2009. December inflation could come in slightly above target. The NBK will probably not change policy rates or minimal reserve requirements before commercial bank restructuring has been completed this fall and the inflation picture has become clearer, but will continue to drain liquidity through open market operations.

Loan growth still very weak, but should accelerate in 2H as banks have few debt repayments and have made some progress in bad loan work-out

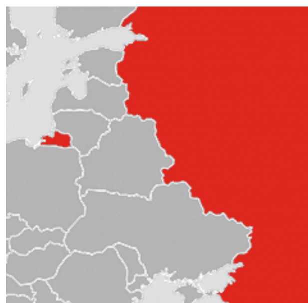
Loans to residents fell 0.3% from December through April 2010. The main obstacle for faster loan growth has been the banks' risk aversion and the need to repay cross-border liabilities. Substantially lower repayments on banks' cross-border debt should combine with higher money demand and progress in work out of bad loans to finally renew credit growth in 2H. Banks have to repay foreign debt (principal) of USD 1.8bn in 2010, according to NBK estimates based on 31 Dec 2009 data, which do not take into account banks' foreign debt restructuring that provides options with 3 year grace periods. This compares to a decrease in banks' cross-border debt by USD 9.1bn to USD 30.1bn in 2009.

Rebounding exports and substantial terms of trade gains push 1Q C/A balance into a large surplus

Exports grew a staggering 69% yoy in USD terms in Jan-April vs a decline of 9% for imports, according to customs statistics. The C/A balance came in at a surplus of USD 2.97bn in 1Q (11.5% of 1Q GDP) according to preliminary NBK estimates, compared with a deficit of USD 1.15bn (5.1% of 1Q GDP) a year earlier. The foreign trade balance reached a surplus of USD 8.1bn in 1Q10. Before, such figures were seen only in 1Q-3Q 2008, when oil prices were extremely high. Net inward FDI amounted to USD 2.95bn in 1Q (up 16% yoy). **The NBK had to intervene heavily** to moderate the effect on the KZT and bought roughly USD 9bnsince the announcement in November 2009 that the fx-corridor would be widened, of which about USD 5bn in the first 5 months of 2010. We still believe that the NBK will deviate from its current *de-facto* crawling peg policy which – continued along current lines – would result in about 142 KZT per USD by year-end. We now forecast the KZT to appreciate to 139 eop 2010, a bit less than before given strong opposition to more FX flexibility.

KZT to appreciate

Russia



Outlook - Weak 1Q10 real GDP, coming on top of a very strong low base effect, supports our cautious 2010 outlook. Public spending is expected to slip marginally in nominal terms: this will be the first ever persistent nominal decline in spending in Russian economic history and the first decline in real terms since 2001. Meanwhile, local market rates have reached our targets for 2Q10 and we continue to expect them to bottom out in the coming months; we also revise our RUB outlook to reflect changes in our EURUSD forecasts.

Author:
Vladimir Osakovskiy, Ph.D., Head of Macroeconomic Analysis and Research (UniCredit Bank Russia)
+7 495 258 7258 ext. 7558, vladimir.osakovskiy@unicreditgroup.ru

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

MACROECONOMIC DATA AND FORECASTS

	2007	2008	2009	2010F	2011F
GDP (EUR bn)	945.2	1139.8	884.6	1162.5	1327.6
Population (mn)	142.0	141.6	141.3	141.0	140.4
GDP per capita (EUR)	6,656	8,049	6,260	8,244	9,454
GDP (constant prices yoy %)	8.1	5.6	-7.9	3.4	5.0
Private Consumption, real, yoy (%)	13.6	11.5	-7.7	4.1	7.1
Fixed Investment, real, yoy (%)	21.1	9.1	-16.2	3.0	6.0
Public Consumption, real, yoy (%)	3.4	2.5	2.0	-2.1	-2.2
Exports, real, yoy (%)	6.4	0.2	-4.7	2.6	4.2
Imports, real, yoy (%)	26.6	17.7	-30.4	18.0	6.2
CPI (average, yoy %)	9.0	14.1	11.7	6.2	6.7
Central bank reference rate	6.05	9.17	6.00	5.50	5.75
Monthly wage, nominal (EUR)	386	471	420	512	594
Unemployment rate (%)	5.6	6.3	8.4	8.1	7.4
Budget balance (% of GDP)	6.0	4.8	-8.4	-5.4	-4.1
Current account balance (EUR bn)	57.4	70.2	34.9	64.1	50.9
Current account balance (% of GDP)	6.1	6.2	3.9	5.5	3.8
Net FDI (EUR bn)	38.3	28.7	21.3	25.5	30.6
FDI (% of GDP)	4.1	2.5	2.4	2.2	2.3
Gross foreign debt (EUR bn)	314.0	340.8	364.0	391.0	392.7
Gross foreign debt (% of GDP)	35.9	35.4	36.4	33.2	31.1
FX reserves (EUR bn)	326.4	302.9	307.3	381.6	385.0
(Cur.Acc-FDI)/GDP (%)	10.1	8.7	6.4	7.7	6.1
FX reserves/Gross foreign debt (%)	104.0	88.9	84.4	97.6	98.0
Exchange rate to USD eop	24.64	30.53	30.04	32.30	31.59
Exchange rate to EUR eop	35.93	42.59	43.04	39.41	39.17
Exchange rate to USD avg	25.55	24.78	31.65	30.65	31.68
Exchange rate to EUR avg	35.02	36.46	44.13	38.62	38.33

Source: UniCredit Research

STRENGTHS

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

WEAKNESSES

- Dependence on commodities prices
- Structural inefficiencies, lack of domestic investment funds
- High NPLs ratios

Weak 1Q10 reaffirms our cautious 2010 outlook

1Q10 real GDP supports our weak 3.4% forecast for 2010

1Q10 growth remained weak, real GDP came in at 2.9% yoy, which was well below even the most pessimistic forecasts. We note that such a weak reading came on top of very strong low base effect of a 9.4% yoy drop in 1Q09, highlighting the weakness of domestic demand, which is likely to continue to constrain Russian economic recovery in 2010. Therefore, we keep our 3.4% yoy forecast for 2010 unchanged.

Growth in 2Q10 is likely to be robust on base effects, intensified recovery

We expect 2Q10 real GDP growth to accelerate to a healthy 5.8% yoy. The economy is set to receive robust support from a stronger low base effect of a 10.8% yoy drop in 2Q09 as well as from the ongoing genuine recovery of domestic demand. The latter is partially attributable to government efforts, namely due to the success of the local version of the cash-for-clunkers scheme, which appears to have boosted economic activity throughout the entire value added chain all the way down to the iron ore mining.

Recovery is likely to slow in 2H10

The recovery is likely to cool down in 2H10 as the economy is set to feel the full effect of reversing fiscal support as well as a further recovery of imports. Thus, after rising 17% yoy in 5M10, in the remaining 7 months of the year according to the approved and the recently amended budget, public spending is expected to slip marginally in nominal terms. This will be the first ever persistent nominal decline in spending in Russian economic history and the first decline in real terms since 2001. Meanwhile, imports in April accelerated to above 29% yoy, even though the base effect is anticipated to peak in August-September. On the other hand, the potential of export expansion appears limited due to economic weakness in the Eurozone – the largest Russian trading partner – as a result of fiscal consolidations across an increasingly large number of countries and debt problems.

Consumer recovery is underway…

Which will make it the key factor behind strong 2011 growth

Consumer demand shows further signs of recovery, bringing inflationary pressures back to life. In 2010, real wages, disposable incomes and retail sales all settled in the positive growth territory in yoy terms, thereby affirming our view of domestic consumption as the key factor supporting broader economic growth this year, which is set to pull off more robust growth in 2011. On the other hand, seasonally-adjusted inflation seems to have finally bottomed out over the past few months due to increasingly robust demand. With M2 expanding in yoy terms for 7th consecutive month and accelerating to 33.2% yoy by May, we think that headline inflation is also on its way to bottom out at around 5.4% yoy in August-September and to accelerate back to 6.6% yoy by the end of the year.

Consumer rebound to bring inflation back to life, supporting rate hikes in 2H10

The reversal of the disinflation trend is expected to stop and turn around the monetary easing cycle by the Central Bank. After 2 rate cuts in 2Q10, which pushed the refinancing rate to a fresh all time low of 7.75%, in the latest policy statement as of 31 May, the CBR said that the current level of interest rates is likely to remain in place over the next few months, which, we think, marks the end of the easing cycle. With the headline and seasonally-adjusted inflation expected to rebound, we reiterate our forecast of CBR initiating a tightening cycle in 2H10 with some 25-50bp hikes by the end of the year.

Interest rates have reached our targets for 1H10 and are set to stay low in 3Q10

Rates are due to recover later in the year

Market rates have reached our targets for 2Q10, with the 3M Mosprime rate dipping below 4% for the first time since early 2007, on continued inflow of liquidity from the budget deficit. We expect further inflow of fresh liquidity from the budget to keep pressure on local rates in 3Q10 and undermine RUB later in the year. Therefore, we keep our FX forecast unchanged at RUB 35.5/basket in 2010 eop and only adjust our cross-rate forecasts vs. USD and EUR in order to reflect changes in our EURUSD forecast. However, we also reiterate our forecast of local interest rates rising around 4.8% by the end of the year, along with the expected rate hikes by the CBR, recovery of USD rates and the upcoming launch of domestic sovereign borrowing programs by the government.

Serbia

Outlook

Signs of export induced recovery are present, as industrial production is increasing, although consumption still remains subdued, and renewed weakness in the currency is of little help bringing about a tighter monetary policy as a response. Meanwhile, reforms to the pension system and a rationalization of the number of employed in the public sector are the conditions Serbia has to meet to qualify for the next IMF tranche of EUR 380mn.

Author: Goran Šaravanja, Chief Economist (Zagrebačka banka)
+385 1 6006 678, goran.saravanja@unicreditgroup.zaba.hr

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

MACROECONOMIC DATA AND FORECASTS

	2007	2008	2009	2010F	2011F
GDP (EUR bn)	28.8	33.4	30.5	29.4	29.1
Population (mn)	7.4	7.4	7.3	7.3	7.3
GDP per capita (EUR)	3,900	4,545	4,170	4,036	4,006
GDP (constant prices yoy %)	6.9	5.5	-3.0	0	2.2
CPI (average, yoy %)	6.5	11.7	8.4	5.1	6.3
Central bank reference rate	10.00	17.75	9.50	8.00	8.00
Monthly wage, nominal (EUR)	484	561	470	449	436
Unemployment rate (%)	18.1	13.7	16.1	17.0	16.5
Budget balance/GDP (%)	-1.6	-2.0	-4.2	-5.1	-4.0
Current account balance (EUR bn)	-4.6	-5.8	-1.7	-2.0	-2.3
Current account balance (% of GDP)	-16.0	-17.3	-5.7	-6.7	-7.8
Net FDI (EUR bn)	1.8	1.8	1.4	1.3	2.3
FDI (% of GDP)	6.3	5.5	4.5	4.2	7.7
Gross foreign debt (EUR bn)	17.8	21.8	22.8	24.8	27.0
Gross foreign debt (% of GDP)	61.8	65.3	74.6	84.1	92.8
FX reserves (EUR bn)	9.6	8.2	10.6	10.0	9.7
(Cur.Acc-FDI)/GDP (%)	-9.7	-11.9	-1.2	-2.5	-0.1
FX reserves/Gross foreign debt (%)	54.2	37.4	46.5	40.4	35.9
Exchange rate to USD eop	54.03	64.34	67.11	90.16	92.74
Exchange rate to EUR eop	78.79	89.78	96.17	110.00	115.00
Exchange rate to USD avg	58.34	55.40	67.45	81.35	92.98
Exchange rate to EUR avg	79.98	81.49	94.05	102.50	112.50

Source: UniCredit Research

STRENGTHS

- Merchandise exports pick up
- Acceleration of industrial production
- EU to commence ratification of Stabilization and Association Agreement

WEAKNESSES

- Depreciating currency hangs over inflation forecast
- Recovery remains weak, centered on a few sectors
- Lower FDI inflows drive higher basic balance deficit

Exports pick up as capacity utilization increases

Industrial production and merchandise exports pick up…

Signs of recovery as industrial production picks up. Industrial production rose sharply in April (11.3% yoy) and the seasonally adjusted mom figures also point to a recovery. With production capacities in the steel sector likely to be utilized in full in the remainder of the year, industrial production is set to rise further. The recovery in industrial production is also reflected in the merchandise trade figures, which reveal an 18% increase in January-April with steel, metal, chemical and agricultural exports the main contributors. At the same time, private consumption remains weak with retail sales volumes in real terms contracting 8.8% yoy in 1Q10. Wage growth is also weak, falling in EUR terms and rising only 1.5% yoy in inflation adjusted local currency terms. Although inflation was a record low 3.7% yoy in May, the risk of the central bank's end of year target of 6% being overshot remains, especially as the currency is depreciating.

… leading us to revise our growth forecast up to 0% from -0.5%

Growth outlook improves, current account deficit to widen. Although domestic demand remains weak, positive trends in industrial production and merchandise exports have led us to revise our growth forecast up from -0.5% to 0.0% for this year. The government's policy of subsidizing cash loans of up to EUR 3000 per person by the beginning of June has seen over EUR 80mn in credit extended for this purpose, while one-off assistance of RSD 6.5bn (roughly EUR 60mn) to public sector workers and pensioners should also stoke private consumption. Base effects in 4Q10 will see export growth slow and a slight increase in imports, in addition to lower transfers from abroad, are the main reasons we forecast a slightly higher current account deficit of 6.7% of GDP this year, despite the January-April balance of payments data suggesting a further contraction. We have also upped our inflation forecast for the end of the year to 7.0% yoy – this is still within the central bank's target range of 4%-8%. Nonetheless, we note rising core inflation, up 0.9% mom in May 2010, the highest monthly increase since April 2009 according to our estimates.

Comments from NBS in June point to higher EUR/RSD

Tighter monetary policy in response to weaker currency. Money market rates in Belgrade rose in June as the cumulative effect of over EUR 1.1bn in FX interventions to smooth the depreciation of the RSD fed through to tighter RSD liquidity. Comments by central bank officials that while the EUR/RSD remains below 110 inflation targets are not in question risks pushing the EUR/RSD to that level relatively quickly. With foreign debt data showing enterprises continuing to reduce FX exposure, FDI inflows down 50% yoy in Jan-April and the primary balance thus likely to double to 2.5% of GDP this year depreciation pressures on the RSD will remain. We expect that the NBS will not be lowering its policy rate below 8% given the risks of pass through of the weaker currency onto inflation but we also do not look for rate hikes given the authorities' attempts to stimulate local currency lending. We also expect continued FX interventions, noting that the authorities have agreed with the IMF to use up to EUR 2.5bn to defend the currency if necessary.

IMF sanctions higher fiscal deficit target

Widening fiscal deficit. Sluggish domestic demand has impacted on revenue growth. In response the IMF has sanctioned an increased fiscal deficit target of 4.8% of GDP (up from 4%). Reforms to the pension system (inflation based semi annual public sector wage and pension indexation) and a rationalization of the number of employed in the public sector are the conditions Serbia has to meet to qualify for the next IMF tranche of EUR 380mn. At the same time the Treasury is set to commence issuing 2-year t-bills at the beginning of July. Our expectation is for yields on the 12, 18 and 24 month tenures to be exposed to upward pressure over the coming quarter on continued depreciation risks and rising headline inflation.

Sovereign credit rating to remain stable

Commencement of Stabilization and Association Ratification Process a plus for Serbia's sovereign rating. The EU's decision in mid-June to recommend to member states the commencement of the ratification process as well as Serbia's ability to achieve goals set out in the current extended agreement with the IMF remain the main reasons we see no change in the country's sovereign rating in the coming 12M.

Turkey

Outlook

A robust economic recovery is underway in 2010 prompting us to revise our 2010 and 2011 growth to more than +5% yoy. And inflation seems to have moderated for the moment, coming back down to single digits. However, we still stick to our "low for longer view" and expect the MPC to hike the policy rate by 125bp at the end of 2010 at the earliest. Meanwhile, the fiscal performance so far is very supportive.

Author: Cevdet Akcay, Ph.D., Chief Economist (Yapi Kredi)
+90 212 319 8430, cevdet.akcay@yapikredi.com.tr

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

MACROECONOMIC DATA AND FORECASTS

	2007	2008	2009	2010F	2011F
GDP (EUR bn)	473.2	499.5	442.7	565.9	668.4
Population (mn)	70.6	71.5	72.6	73.4	74.2
GDP per capita (EUR)	6,703	6,985	6,101	7,712	9,011
GDP (constant prices yoy %)	4.7	0.7	-4.7	5.6	5.2
Private Consumption, real, yoy (%)	4.6	0.5	-2.3	3.5	4.6
Fixed Investment, real, yoy (%)	5.4	-8.2	-19.2	7.0	7.0
Public Consumption, real, yoy (%)	6.5	1.7	7.8	3.0	4.1
Exports, real, yoy (%)	7.3	2.7	-5.4	5.4	5.8
Imports, real, yoy (%)	10.7	-4.2	-14.4	7.0	8.0
CPI (average, yoy %)	8.8	10.5	6.3	9.2	6.8
Central bank reference rate	15.75	15.00	6.50	7.75	8.25
Monthly wage, nominal (EUR)	711	734	634	762	871
Unemployment rate (%)	10.3	11.0	14.0	13.7	13.4
Budget balance (% of GDP)	-1.6	-1.8	-5.5	-3.7	-3.0
Current account balance (EUR bn)	-28.0	-28.2	-10.0	-25.4	-31.4
Current account balance (% of GDP)	-5.9	-5.6	-2.3	-4.5	-4.7
Net FDI (EUR bn)	16.1	12.3	4.1	7.9	13.2
FDI (% of GDP)	3.4	2.5	0.9	1.4	2.0
Gross foreign debt (EUR bn)	182.2	188.6	195.0	226.3	257.3
Gross foreign debt (% of GDP)	38.5	37.8	44.1	40.0	38.5
FX reserves (EUR bn)	48.4	50.2	49.3	59.8	62.1
(Cur.Acc-FDI)/GDP (%)	-2.5	-3.2	-1.3	-3.1	-2.7
FX reserves/Gross foreign debt (%)	26.6	26.6	25.3	26.4	24.1
Exchange rate to USD eop	1.17	1.54	1.49	1.57	1.53
Exchange rate to EUR eop	1.71	2.15	2.14	1.92	1.90
Exchange rate to USD avg	1.30	1.30	1.55	1.54	1.53
Exchange rate to EUR avg	1.79	1.91	2.16	1.94	1.85

Source: UniCredit Research

STRENGTHS

- Strong fiscal performance
- High growth potential

WEAKNESSES

- Constitutional Reform still at center stage
- Stalled EU convergence process

Impressive growth amidst exaggerated political risk

GDP in 1Q10 expected at around 11.5% yoy

Signs of economic recovery appear almost on a daily basis and the strong bounce back effect expectation has led to widespread upward growth forecast revisions. IP growth in 1Q10 stands at 17.2% yoy unadjusted, at 17.9% yoy adjusted for effective working days, and at 2.55% qoq adjusted for seasonality and for effective days. April IP growth was also good at 17.0%, 17.0%, and 0.68%, respectively. Our GDP forecast for 1Q10 is 11.5%, and the risk may very well be on the upside. Consequently, the unemployment rate is also falling at a steady basis in seasonally adjusted terms, from 14.9% in April 2009 to 12.6% in March 2010.

Inflation down to single digit level

Inflation is down to single digit levels at 9.1% in annual terms in May and is likely to remain in that territory for the foreseeable future. The most important contribution of the latest minus 0.36% May inflation figure proved to be inflation expectations and we saw a discernibly lower end-of-year market forecast in the most recent CBT survey (50bp), and also lower 12M and 24M inflation expectations. Depending on the choice of core metrics, you can end up with fairly upbeat predictions and promising prospects of attaining levels in the vicinity of the target (6.5% for 2010 and 5.5% for 2011), but headline is the target and may remain fairly elusive as we have seen many times in the past.

Very good fiscal performance during the first part of the year

Fiscal performance in the first five months of the year has been truly stellar and this has become especially clear in the aftermath of the announcement of May central government figures. The year end budget deficit target is TRY 50.2bn. At the end of the first five months it was a mere TRY 10.0bn. Similarly, the first five months' cumulative primary surplus was TRY 14.2bn versus a year-end target of TRY 6.6bn. Fiscal slippage expectations due to upcoming elections, we believe, are totally unfounded. Fiscal performance so far is supportive of our core scenario, Parliament is likely to pass the fiscal reform soon and will be instrumental in the 2011 budget preparations in early fall. Meanwhile, you have a Government which expects an upgraded investment status sooner than markets expect it.

We still expect +125 bps towards year end, but the tone is increasingly dovish

We do not envisage any hawkish remarks in MPC communiqués for some more months and they will most likely stick to their rhetoric of a gradual recovery in domestic demand which arguably is nowhere close to the extent to threaten its decision to keep the policy rate at low levels for an extended time period. We still stick to our "low for longer view" and expect the MPC to hike the policy rate by 125bp at the end of 2010 at the earliest, presumably in two increments of 75bp and 50bp. It is also quite likely that the Bank will not raise rates in 2010 but will start hiking midway into the first quarter of 2011 when inflation heads south due to strong base effects. The rate decision on 17 June and its tone is considerably more dovish than the previous ones, supported by weak external demand conditions and falling unprocessed food and energy prices.

Constitutional Reform Package at center stage

On 8 June, the Constitutional Court held the first hearing of the CHP appeal to have the Constitutional Reform Package declared null and void on the basis of procedural misconduct and violation of the "unalterable" items of the existing Constitution. The Court may #1 reject the CHP petition, #2 pass it while dropping the most controversial three or four amendments, or #3 accept the petition either on grounds of procedural errors or on the basis of a breach of the spirit of the Constitution. The last of these possible rulings is likely to create the greatest havoc in domestic politics and it could force the AKP to reconsider an early election. We assign the lowest probability to this and the highest to a rejection of the petition with some amendments being dropped, effectively castrating the reform package.

Ukraine

Outlook

Exports and base effects have helped the economy to growth by +5% in 1H10, however, we see the momentum fading in the coming quarters, as reforms have been slow. One of the positive factors however, is the potential towards acceleration of EURO2012 infrastructure projects in the coming quarters, which could give an additional boost to growth. Lack of an IMF program, implies that the NBU needs to build a greater FX cushion, and will continue to intervene on the FX market keeping the UAH stable in the coming months.

Author: Dmitry Gourov, Economist (UniCredit CAIB)
+43 50505 82364, dmitry.gourov@caib.unicreditgroup.eu

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

MACROECONOMIC DATA AND FORECASTS

	2007	2008	2009	2010F	2011F
GDP (EUR bn)	103.1	123.4	81.4	114.6	156.9
Population (mn)	46.6	46.4	46.1	45.8	45.5
GDP per capita (EUR)	2,210	2,661	1,766	2,504	3,447
GDP (constant prices yoy %)	7.6	2.1	-15.1	3.0	4.0
Private Consumption, real, yoy (%)	17.1	11.6	-14.2	0.5	3.0
Fixed Investment, real, yoy (%)	24.8	4.2	-46.2	8.0	14.0
Public Consumption, real, yoy (%)	2.8	-0.4	-8.8	1.5	0.7
Exports, real, yoy (%)	2.8	6.7	-25.6	10.0	9.0
Imports, real, yoy (%)	20.2	17.5	-38.6	8.0	10.0
CPI (average, yoy %)	12.8	25.2	16.0	9.6	11.5
Central bank reference rate	8.00	12.00	10.25	9.50	9.75
Monthly wage, nominal (EUR)	195	234	170	223	286
Unemployment rate (%)	6.4	6.4	8.8	7.2	6.4
Budget balance (% of GDP)	-1.4	-1.3	-11.3	-6.1	-3.8
Current account balance (EUR bn)	-4.0	-8.8	-1.4	0.2	-0.8
Current account balance (% of GDP)	-3.9	-7.1	-1.7	0.1	-0.5
Net FDI (EUR bn)	6.3	7.3	3.2	4.9	7.5
FDI (% of GDP)	6.1	5.9	3.9	4.3	4.8
Gross foreign debt (EUR bn)	56.2	75.1	72.6	90.7	95.0
Gross foreign debt (% of GDP)	54.6	60.8	89.1	79.1	60.5
FX reserves (EUR bn)	21.6	19.9	17.9	21.1	16.1
(Cur.Acc-FDI)/GDP (%)	2.2	-1.2	2.2	4.4	4.3
FX reserves/Gross foreign debt (%)	38.4	26.6	24.7	23.3	17.0
Exchange rate to USD eop	5.09	7.81	8.01	7.40	6.90
Exchange rate to EUR eop	7.42	10.90	11.48	9.03	8.56
Exchange rate to USD avg	5.05	5.24	8.06	7.83	7.15
Exchange rate to EUR avg	6.92	7.70	11.24	9.87	8.65

Source: UniCredit Research

STRENGTHS

- Improving C/A balance, and better export performance
- Significant NBU FX reserves
- Significant spare capacity

WEAKNESSES

- Lack of reform and fiscal consolidation
- Upcoming local elections
- Divided society

First local elections, then reforms

Immediate growth driven by exports

Immediate growth prospects continue to be driven by exports and base effects (with Ukraine witnessing 4.8% yoy growth – one of the fastest rates in the CEE region in 1Q10). In the coming quarters acceleration of EURO2012 infrastructure projects may give an additional boost to growth, however, financing still remains an issue. A more robust recovery of private consumption and investment continues to be limited by low credit activity (as the banking system as a whole continues to deleverage) and high interest rates. Although unemployment has started to fall sharply, according to official statistics, real wages have been growing by an average 6% since the start of 2010, which is starting to feed gradually into the still sluggish retail trade dynamics (YTD +1.1%) – but it will take another 3 to 4 quarters before we see a more sustainable consumption rate. We see GDP growth reaching its long-term potential of 5% by 2012, however at the same time are concerned that lack of reform will bring this potential down to 3%, which represents a key risk to our already below consensus forecast.

But reform key to reaching long-term 5% growth potential

In the run-up to the local election, we see little interest in reform

During the summer months we see little interest in the country towards implementing painful reforms (tariff hikes, pension reform) as we approach regional elections, which are most likely to be set for October 2010 (when the Party of the Regions hopes to further consolidate its hold on power at local level). We believe that in the run up to the elections the government is set to maintain the status quo, despite the economy benefiting from the export-led recovery. The recent USD 2bn loan from Russia, postpones the need for an IMF program, which will likely include upfront reform conditions and tough negotiations this time. By this token a resumption of the program may be feasible after the elections in Nov-Dec 2010, unless there is a change in direction towards quicker reform in the meantime.

USD 2bn loan from Russia eases immediate financing needs

FX intervention is building a buffer of stability

In such an environment the Central Bank is set to continue building an FX buffer and keeping the USD/UAH rate stable at 7.91, further intervening on the FX market (the NBU bought some USD 3.3bn on the market in Mar-May 2010), amid ongoing capital inflows. We expect this to continue well into the year-end when some potential appreciation may be allowed – this is based on C/A remaining in surplus and FDI inflows remaining robust (4.3% of GDP in 2010). The main risk to the benign FX outlook may come from lax fiscal policy that could in the end push for monetization and lead to local confidence deterioration.

But with NBU still the chief financier of the government, but money not spilling through on the market so far

In the current environment the National Bank continues to be the chief financier of the government, buying 60% of the T-Bills issued in February onwards (UAH 11bn), whereas non-residents bumped up their exposure by UAH 2.6bn, bringing their total exposure to UAH 3.1bn (3% of the total issues outstanding). However, the government is now aiming to diversify its sources of financing with a Eurobond worth USD 1.3bn planned in the coming months and a USD 2bn loan from Russia agreed upon. In principle this has reduced the funding need for the summer months. But the optimism that markets have placed in the new government still needs to be confirmed - yields on T-Bills came down from 20%-25% in February to the current 11%-15%, while these are set to rise on the upcoming issuance of VAT bonds worth UAH 20bn.

So far this year inflation has trended downwards and we have nudged our average forecast lower to 9.6% amid lack of domestic demand, but M0 and M3 have started to grow, which is a sign that economic recovery is underway, but also a risk that any abrupt monetization could lead to acceleration in the inflation rate as favorable base effects disappear from Sept onwards. By the same token producer prices have continued to grow by double digits – signaling a lack of competition and the need for further liberalization by the government.

Notes

Notes

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Regulatory authority: CNB Czech National Bank, Na Příkopě 28, 115 03 Praha 1, Czech Republic

j) Bank Pekao, ul. Grzybowska 53/57, PL-00-950 Warsaw, Poland
Regulatory authority: Polish Financial Supervision Authority, Plac Powstańców Warszawy 1, 00-950 Warsaw, Poland

k) UniCredit Bank, Prechistenskaya emb. 9, RF-19034 Moscow, Russia
Regulatory authority: Federal Service on Financial Markets, 9 Leninsky prospekt, Moscow 119991, Russia

l) UniCredit Bank, Šancova 1/A, SK-813 33 Bratislava, Slovakia
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n) UniCredit Tiriac Bank, Ghetarilor Street 23-25, RO-014106 Bucharest 1,Romania
Regulatory authority: CNVM, Romanian National Securities Commission, Foişorului street, no.2, sector 3, Bucharest, Romania

o) ATFBank, 100 Furmanov Str., KZ-050000 Almaty, Kazakhstan
Agency of the Republic of Kazakhstan on the state regulation and supervision of financial market and financial organisations, 050000, Almaty, 67 Aiteke Bi str., Kazakhstan

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Banking network

UniCredit Group CEE banking network – Headquarters

Azerbaijan

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

The Baltics

UniCredit Bank Estonia Branch
Liivalaia Street 13/15,
EST-10118 Tallinn
Phone: +372 66 88 300
www.unicreditbank.ee

UniCredit Bank Lithuania Branch
Vilniaus Gatve 35/3,
LT-01119 Vilnius
Phone: +370 5 2745 300
www.unicreditbank.lt

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

Bosnia and Herzegovina

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

UniCredit Bank Banja Luka
Marije Bursac 7,
BH-78000 Banja Luka
Phone: +387 51 243 295
E-mail: info-bl@unicreditgroup.ba
www.unicreditbank-bl.ba

Bulgaria

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

Croatia

Zagrebačka banka
Paromlinska 2,
HR-10000 Zagreb
Phone: +385 1 6305 250
www.zaba.hr

Czech Republic

UniCredit Bank
Na Príkope 858/20
CZ-11121 Prague
Phone: +420 221 112 111
E-mail: info@unicreditgroup.cz
www.unicreditbank.cz

Hungary

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

Kazakhstan

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

Kyrgyzstan

ATFBank Kyrgyzstan
493, Zhibek Zholu Ave.
KG-720070 Bishkek
Phone: +7 312 67 00 47
E-mail: bank@atfbank.kg
www.atfbank.kg

Macedonia

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

Montenegro

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

Poland

Bank Pekao
ul. Grzybowska 53/57,
PL-00-950 Warsaw
Phone: +48 42 6838 232
www.pekao.com.pl

Romania

UniCredit Tiriac Bank
Ghetarilor Street 23-25,
RO-014106 Bucharest 1,
Phone: +40 21 200 2000
E-Mail: office@unicredittiriac.ro
www.unicredit-tiriac.ro

Russia

UniCredit Bank
Prechistenskaya emb. 9,
RF-19034 Moscow
Phone: +7 495 258 7200
www.unicreditbank.ru

Serbia

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

Slovakia

UniCredit Bank
Šancova 1/A,
SK-813 33 Bratislava
Phone: +42 1 44 547 6870
www.unicreditbank.sk

Slovenia

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

Turkey

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

Ukraine

UniCredit Bank
14, D. Galitsky St.,
UA-43016 Lutsk
Phone: +380 332 776210
www.unicredit.com.ua

Ukrsotsbank
29 Kovpak Street,
UA-03150 Kiev
Phone: +380 44 230 3203
E-mail: info@ukrsotsbank.com
www.usb.com.ua

UniCredit Group CEE banking network – Corporate customers

Austrian contact

Bank Austria

Sonja Holland
Phone: +43 50505 56344

Alexandra Kaufmann
Phone: +43 50505 51054

E-mail: business_development@unicreditgroup.at

German contact

UniCredit Bank AG

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

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

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

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

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

Italian contact

UniCredit Corporate Banking

Patrizia Conte
Phone: +39 0422 654 001
E-mail: CBBM.IMD.UCCorporate.it@unicreditgroup.eu

International contact

Azerbaijan

Yusuf Sevinc
Phone: +994 12 497 7095
E-mail: yusuf.sevinc@yapikredi.com.az

Bosnia and Herzegovina

UniCredit Bank
Ilvana Dugalija
Phone: +387 33 562 755
E-mail: ilvana.dugalija@unicreditgroup.ba

UniCredit Bank Banja Luka
Kristina Grozdanic
Phone: +387 51 243 295
E-mail: kristina.grozdanic@unicreditgroup.ba

Bulgaria

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

Croatia

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

Czech Republic

Miroslav Hrabal
Phone: +420 2 2121 6271
E-mail: miroslav.hrabal@unicreditgroup.cz

Estonia

Kaarel Ots
Phone: +372 66 88 358
E-mail: kaarel.ots@unicreditgroup.ee

Hungary

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

Kazakhstan

Ralitza Serbezova
Phone: +7 727 258 3000 1914
E-mail: serbezova@atfbank.kz

Latvia

Inga Cernova
Phone: +371 67085 569
E-mail: inga.cernova@unicreditgroup.lv

Lithuania

Joana Kucinskaite
Phone: +370 5 2745 353
E-mail: joana.kucinskaite@unicreditgroup.lt

Macedonia

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

Montenegro

Milan Djordjevic
Phone: +382 81 667 740
E-mail: milan.djordjevic@unicreditbank.rs

Poland

Piotr Kolodziej
Phone: +48 22 524 6201
E-mail: piotr.kolodziej@pekao.com.pl

Romania

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

Russia

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

Serbia

Ana Rakic
Phone: +381 11 3204 531
E-mail: ana.rakic@unicreditbank.rs

Slovakia

Katarina Hajnikova
Phone: +421 2 4950 4004
E-mail: katarina.hajnikova@unicreditgroup.sk

Slovenia

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

Turkey

Kristina Mestric
Phone: +90 212 339 7119
E-mail: kristina.mestric@yapikredi.com.tr

Ukraine

Nicola Longo-Dente
Phone: +38 044 5290583
E-mail: nicola.longodente@ukrsotsbank.com

UniCredit Research*

Thorsten Weinelt, CFA
Global Head of Research & Chief Strategist
+49 89 378-15110
thorsten.weinelt@unicreditgroup.de

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

Economics & FI/FX Research

Marco Annunziata, Ph.D., Chief Economist
+44 20 7826-1770
marco.annunziata@unicreditgroup.eu

Economics & Commodity Research

Global Economics

Dr. Davide Stroppa, Global Economist
+39 02 8862-2890
davide.stroppa@unicreditgroup.de

European Economics

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

Marco Valli, Chief Italian Economist
+39 02 8862-8688
marco.valli@unicreditgroup.de

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

Tullia Bucco
+39 02 8862-2079
tullia.bucco@unicreditgroup.de

Chiara Corsa
+39 02 8862-2209
chiara.corsa@unicreditgroup.de

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

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

Chiara Silvestre
chiara.silvestre@unicreditgroup.de

US Economics

Dr. Harm Bandholz, CFA
+1 212 672 5957
harm.bandholz@us.unicreditgroup.eu

Commodity Research

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

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

EEMEA Economics & FI/FX Strategy

Gyula Toth, Head of EEMEA FI/FX Strategy
+43 50505 823-62, gyula.toth@caib.unicreditgroup.eu

Cevdet Akcay, Ph.D., Chief Economist, Turkey
+90 212 319-8430, cevdet.akcay@yapikredi.com.tr

Matteo Ferrazzi, Economist, EEMEA
+39 02 8862-8600, matteo.ferrazzi@unicreditgroup.eu

Dmitry Gourov, Economist, EEMEA
+43 50505 823-64, dmitry.gourov@caib.unicreditgroup.eu

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

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

Vladimir Osakovsky, Ph.D., Head of Strategy and Research, Russia
+7 495 258-7258 ext.7558, vladimir.osakovskiy@unicreditgroup.ru

Rozália Pál, Ph.D., Chief Economist, Romania
+40 21 203-2376, rozalia.pal@unicredit.ro

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

Goran Šaravanja, Chief Economist, Croatia
+385 1 6006-678, goran.saravanja@unicreditgroup.zaba.hr

Pavel Sobisek, Chief Economist, Czech Republic
+420 2 211-12504, pavel.sobisek@unicreditgroup.cz

Jan Toth, Chief Economist, Slovakia
+421 2 4950-2267, jan.toth@unicreditgroup.sk

Global FI/FX Strategy

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

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

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

Dr. Stephan Maier, FX Strategy
+39 02 8862-8604, stephan.maier@unicreditgroup.eu

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

Roberto Mialich, FX Strategy
+39 02 8862-0658, roberto.mialich@unicreditgroup.de

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

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

Publication Address

UniCredit Research
Corporate & Investment Banking
UniCredit Bank AG
Arabellastrasse 12
D-81925 Munich
Tel. +49 89 378-18927
Fax +49 89 378-18352

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Internet
www.research.unicreditgroup.eu

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