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CEE: Working through the collateral damage

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- The combination of stronger external demand, lower interest rates, lower inflation which should help boost consumer purchasing power, upside risks from credit and the potential for a modest bounce from inventories supports a gradual recovery in GDP growth across the region over the course of 2013.
- But the collateral damage from the EMU crisis and a broader global slowdown has been significant and will take time to work through. We expect more positive data to begin to filter through only towards end-Q1 and into Q2 next year. Industry and external demand in particular are crucial and will have to lead the way in any recovery. Only once this is convincing will a recovery in domestic demand become realistic.
- In the face of a slowdown in activity this year, the most predominant theme across CEE and emerging markets more broadly was the influx of foreign portfolio capital but looking ahead proper management of these flows is crucial. Some countries have left themselves vulnerable to the extent that FX reserve accumulation has not kept pace. Moreover a normalisation of G7 yields, even if this is to occur gradually, risks feeding into higher external financing costs for CEE, putting some countries in the region at a disadvantage to their global EM peers.
- This has occurred at a time when domestic policy decisions have taken different directions across the region. Efforts in the Baltics, Bulgaria, Czech, Poland and Romania to secure public debt sustainability are impressive. Russia and Turkey have fallen short in terms of reducing macro vulnerabilities but lower debt ratios provide a cushion. Croatia, Hungary, Serbia, Slovenia and Ukraine represent the laggards.
- The 2008/09 crisis prompted a downgrade of potential growth across the region due to developments within the region. 2012 has brought another downgrade, albeit smaller, but this time mostly due to factors outside of the region's control. Looking forward most of the region remains in a strong position to take advantage of a recovery in EMU and more globally but this cannot be taken for granted. Domestic policies will play an increasing role in differentiating economies.

2013 will be a better growth year for CEE than 2012…

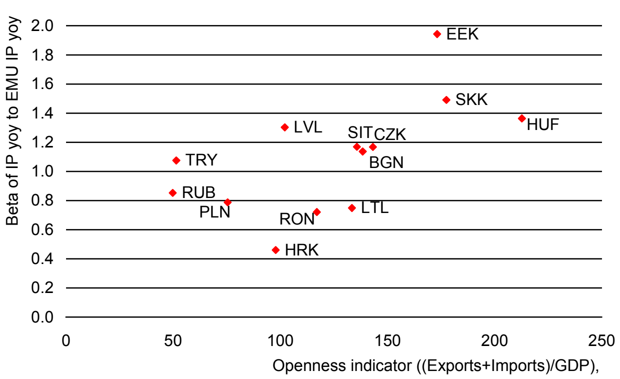
Industry should provide more support to growth in 2013

2013 should see a gradual recovery in economic activity in the region following a weak 2012. We forecast GDP growth at 2.5% in 2012, unchanged from our last quarterly but still representing the slowest pace of growth in 3 years. We now see GDP growth in 2013 at 2.9% (previously 3.1%), before rising to 3.4% in 2014. A number of factors favour such a recovery:

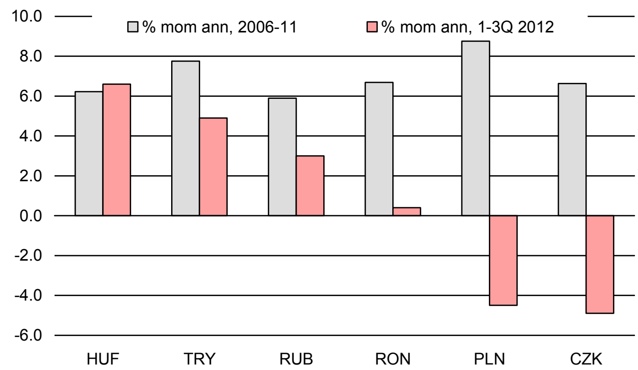
1. Stronger external demand should support industry and exports across the region amidst a recovery in China and easing uncertainties on the US fiscal cliff, both of which help Germany where the non bank corporate sector sits on substantial cash balances. China's manufacturing PMI clawed its way back above 50 in November for the first time since Jun-11 while we expect the fiscal cliff to be addressed by year-end, removing uncertainties on that front as we enter 2013. This should support industry and exports in CEE, particularly in those closest to EMU, following an exceptionally weak 2012.

INDUSTRY HAD A WEAK 2012 AS IT RELIES ON THE REST OF THE WORLD

EMU IP slowdown = CEE IP slowdown



Industry performance YTD



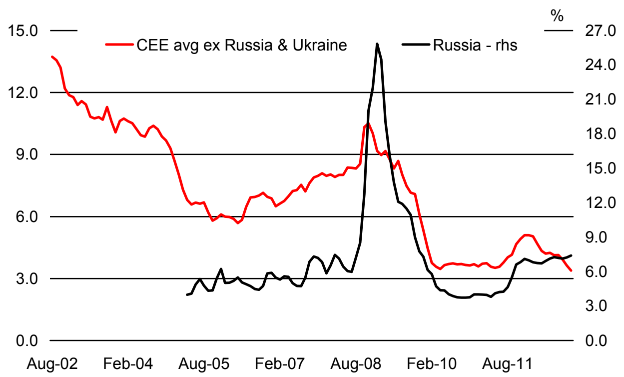
Source: Eurostat, national statistics offices, UniCredit Research

Favourable financial conditions bode well…

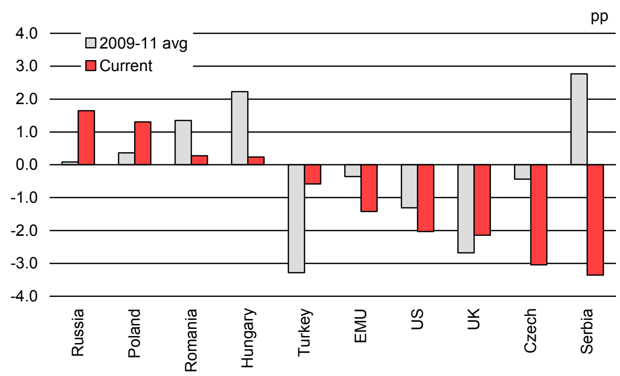
2. Unlike the beginning of 2012, we enter 2013 with much less financial stress and easier monetary policy in most countries in the region. This should over time feed into an improved growth performance. This time last year both Poland and Turkey were intervening to defend their currencies from further depreciation while Turkey, Hungary, Poland, Russia and Serbia hiked rates either late last year or over the course of this year. But this year even some of the weakest macro stories in CEE (with the exception of Ukraine) have enjoyed currency stability in H2 2012 while interest rates have already fallen and in some cases will continue to do so. We do not foresee a tightening of interest rates in any country, with the exception of Serbia, next year. Money market rates across many countries in the region have returned to their historical lows once again.

INTEREST RATES IN NOMINAL, AND OFTEN TIMES REAL, TERMS ARE ACCOMMODATIVE

Interest rates (3 month) back at their lows across most of CEE



Real interest rates vary across the region



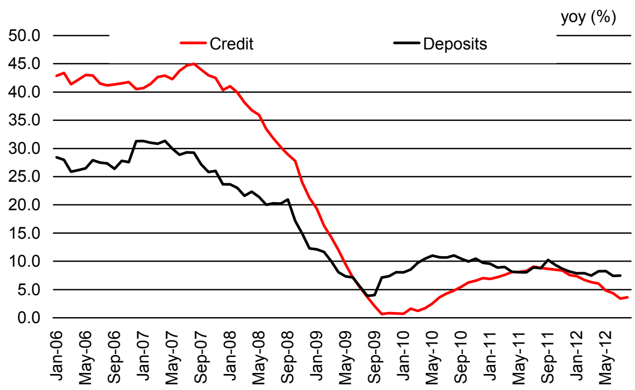
Source: Bloomberg, national central banks, UniCredit Research

…while lower inflation should boost purchasing power

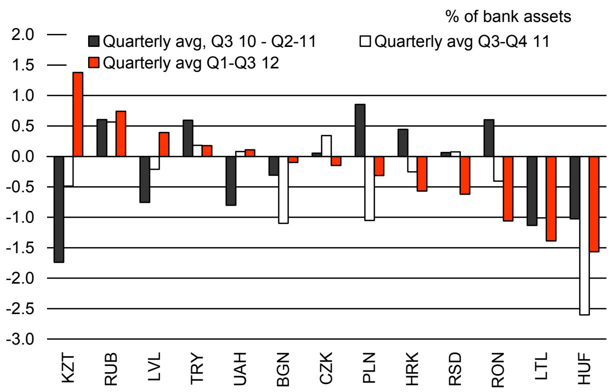
3. The better than expected inflation prints that we have seen across the region over the past 2-3 months mark a downward trend in inflation in many inflation targeting economies in the region (e.g. Czech, Poland, Turkey) that should remain over the coming quarters. This follows an extended period of above target inflation in a number of countries, capturing currency volatility, rising energy and at times food prices. But currencies have been stable across the region over recent quarters, as have oil prices. Food price inflation is likely to edge higher but is manageable. This not only supports lower rates for longer but also should help boost real consumer purchasing power.

CREDIT TRENDS MAY NOT IMPROVE RAPIDLY BUT SHOULD ALSO NOT DETERIORATE SIGNIFICANTLY FROM HERE

Most of the region has adjusted to financing credit growth from deposit growth



Differentiated foreign flows to banking sectors across the region



Source: National central banks, UniCredit Research

The risks from credit to domestic demand are weighted to the upside…

4. The risks to domestic demand from credit growth are weighted to the upside across the region for 2013 as a whole, with the exception of Russia and to a much lesser extent Turkey[1]. For many countries in CEE, credit trends dragged on domestic demand in 2013 as they were impacted by a slowdown in deposit growth and declining foreign funding. But for those countries where banking sectors are predominantly foreign owned, we do not expect an increase in the pace of deleveraging from here, though trends are significantly differentiated across the region (e.g. Hungary suffers much more than Poland). Meanwhile banking sectors have adjusted to funding credit growth via (relatively low) deposit growth. Russia may prove the exception in 2013 to the extent that credit growth is already high and while we expect the banking sector to increase its reliance on foreign funding, maintaining even the current pace of credit growth will remain a challenge.

…while there is some limited potential for a boost to GDP from inventories

5. Though not as large as was the case in 2008/09, Slovenia, Czech, Romania, Poland, Turkey and Hungary has all seen a run-down in inventories in the past four quarters, opening some space for a bounce.

…but the collateral damage from the EMU crisis has been significant

Expect better data to filter through only towards end-Q1/Q2 2013

But the collateral damage from a combination of the EMU crisis and a broader global slowdown has been significant and will take time to work through. We expect more positive data to begin to filter through only towards end-Q1 and into Q2 next year. This is in line with our German and EMU forecast, showing a bottom in the cycle this quarter, followed by the resumption of positive growth rates in Q1 (0.5%) and Q2 (0.2%) respectively.

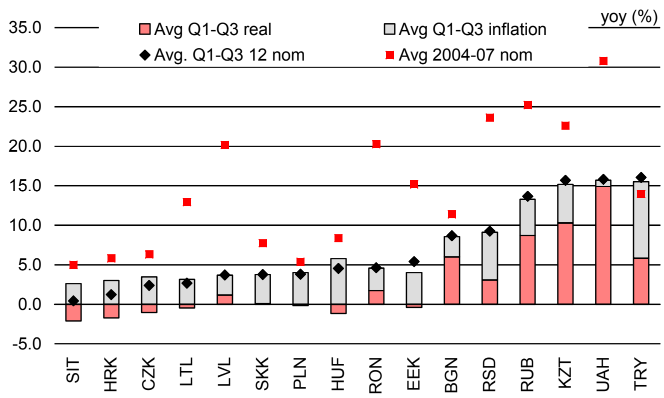
Industry and external demand will have to lead the way…

Industry and external demand in particular are crucial and will have to lead the way in any recovery. As 2011 drew to a close, industry was the primary crutch for growth across the region, in part because some economies never saw a real bounce in domestic demand (Hungary, Czech, Croatia) post 2008 and in part because those that did were already in the process of seeing domestic demand growth slow (Turkey, Poland). But 2012 proved an exceptionally weak year for industry. At the time of writing, we had October data to hand and once again that showed little signs of improvement. Once the support from industry was removed, it was inevitable that domestic demand faltered further.

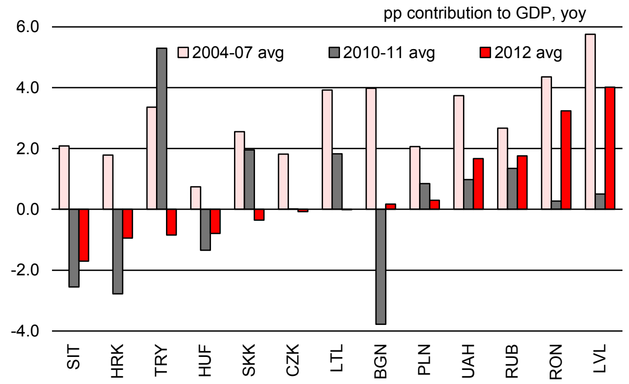
[1] For a more detailed discussion, please refer to our CEE Navigator publication from 22nd October, "CEE credit and growth shocks: A turning point".

EXPECT DOMESTIC DEMAND TO RECOVER MORE GRADUALLY

Wage growth is low, dragging on consumption



Only in a few countries have we seen a convincing recovery in investment



Source: National statistics offices, UniCredit Research

…followed by domestic demand

Only once the recovery in external demand is convincing will a recovery in domestic demand become realistic. We enter 2013 with nominal wage growth across the region well below its pre-crisis average and often times further eroded by inflation. Unemployment has begun to edge upwards in a number of countries. Meanwhile with the exception of a few countries, investment growth has either ground to a halt or turned negative. Russia, Romania (H1-12) and Latvia are the exceptions on this front.

Fiscal policy has played a differentiating role to the extent that for the first time countries such as Turkey have been able to avoid pro-cyclical policies. Fiscal policy has also supported activity in Russia. Poland and Czech plan a slower pace of consolidation ahead but have not actively used policy to support activity. Other weaker performing economies continue to face tighter policies ahead, e.g. Croatia, Hungary, Slovenia.

Liquidity, liquidity, liquidity

2012 was all about foreign portfolio flows supporting asset prices…

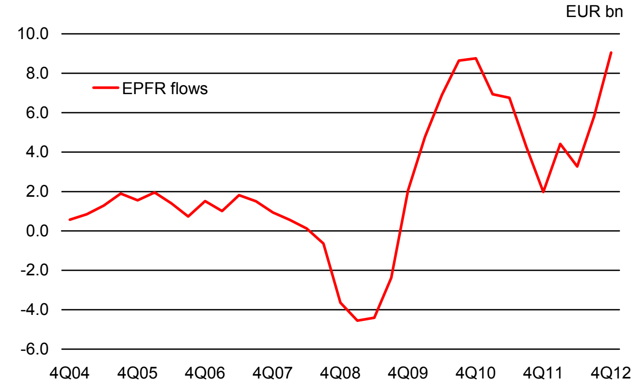
In the face of this slowdown in economic activity, the most predominant theme across CEE and emerging markets more broadly in 2012 was the influx of foreign liquidity via portfolio flows, acting as a crucial source of relatively cheap funding for public and private sectors and as a substitute for weak FDI and bank flows. Part of these inflows are structural in nature, reflecting a shift in asset allocation from developed to developing markets. But part is cyclical, in search of yield in the face of record amounts of G7 central bank liquidity.

…but these flows require management

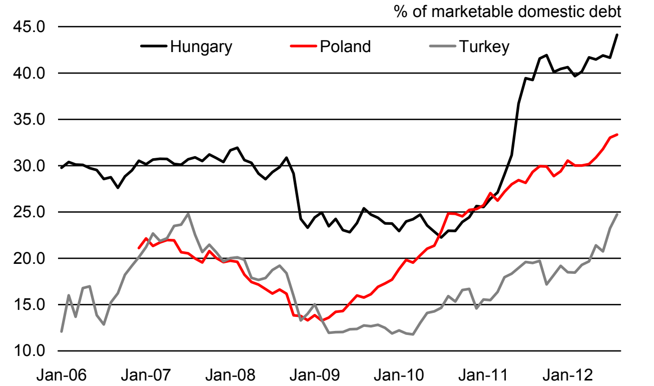
Looking ahead proper management of these flows is crucial. While in the absence of these flows, financing constraints across the region would undoubtedly have been much more negative for growth, these flows have fostered vulnerabilities. For example foreign holdings of domestic government debt are at all time highs across a number of countries in the region.

RECORD PORTFOLIO FLOWS TO THE REGION

2012 represented the strongest year for portfolio flows to emerging markets in history…



…with CEE enjoying its fair share (foreign holdings of domestic debt)



Source: National statistical agencies, DOTs, UniCredit Research

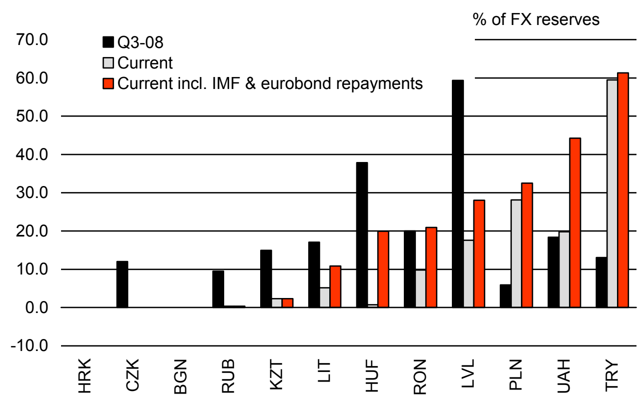
We construct an indicator to gauge vulnerabilities to short term capital flows

To gauge in more depth relative external vulnerabilities across the region, we construct our own indicator focusing on a combination of short term inflows to capture the shift in the composition of capital to the region since 2009 and upcoming external government redemptions to the market and IMF/EU. The methodology is as follows:

- We sum portfolio inflows and short term external borrowing between Q1-08 and Q3-08 and calculate the percentage of these inflows that reversed between Q4-08 and Q2-09, as well as sovereign redemptions coming due, all as a percent of FX reserves;
- We repeat the exercise but this time summing inflows to the 6 quarters to 2Q12. We assume the same portion of outflows as in late-08/early-09, then add IMF/EU and sovereign Eurobond redemptions.

GAUGING EXTERNAL VULNERABILITIES TO SHORT TERM CAPITAL FLOWS

FX reserve coverage ratios



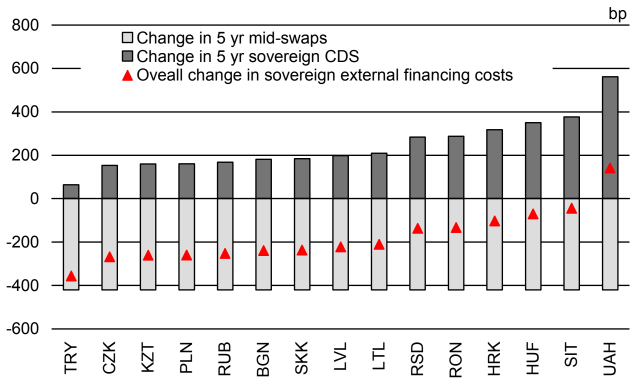
Source: National central banks, UniCredit Research

Ukraine and Turkey emerge as vulnerable to a withdrawal of short term capital, Croatia, Czech, Russia and Kazakhstan are in much more comfortable positions

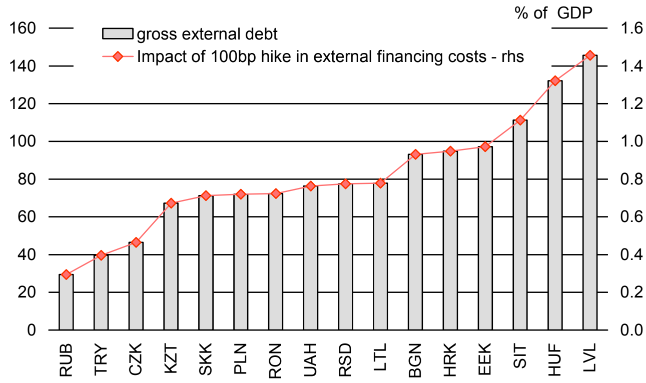
By this metric, Croatia, Czech, Bulgaria, Russia and Kazakhstan are at very limited risk of currency pressure over the coming quarters. Vulnerabilities in Romania are unchanged while they have improved in Hungary. In other words, should Hungary see the same portion of portfolio outflows as in end-08/early-09 and pay down all external redemptions from FX reserves in 2013, FX reserves would decline by just 20%[2]. But Poland, Ukraine and Turkey emerge as considerably more vulnerable. Should the NBP in Poland wish to cover outflows in full in this scenario, it would require a decline in reserves equivalent to over 30% of the total, compared with less than 10% in 2008. This is because FX reserve accumulated have failed to keep pace with short term inflows, though we do not take account of Poland's USD 30bn FCL from the IMF. Turkey and Ukraine are bottom of the pack.

BEWARE OF RISING EXTERNAL FINANCING COSTS

Change in external financing costs, as proxied by 5 yr sovereign CDS, 2007 compared with Q4-12 average



Should gross external debt costs increase, some countries will feel the pinch



Source: Bloomberg, national central banks, UniCredit Research

Next year is more likely to be about the beginning of a gradual increase in overall external financing costs

Of course a withdrawal of funding is a particularly negative scenario but what does seem possible is that a number of countries will have to reckon with higher external funding costs ahead, generated by higher yields in G7. This is a process which is likely to materialize gradually in the face of a continued recovery in activity in the US and China, followed by Germany, over the course of 2013. Examining the change in external financing costs in CEE since 2007, as proxied by 5 year sovereign CDS over mid-swaps, all countries have seen an increase in their own sovereign risk premium, which in turn carries implications for their banks and non-financial corporates. This stands even post the rally that we have seen this year, though there is differentiation. The increase in Turkey has been smallest while in Croatia, Hungary, Slovenia and Ukraine it has been much more pronounced. But this has been more than neutralized by lower rates in EMU and the US to date.

Those countries with lower external debt to GDP are in a much better position to carry this burden

Should we see higher yields in G7 pass-through in full to financing costs in CEE, the region as a whole will prove more vulnerable than other EM regions due to its higher stock of external debt. But once again it is important to differentiate. In Russia, Turkey and Czech Republic, a 100bp increase in the cost of external funding would imply a widening in the incomes deficits in the C/A of less than 0.5% of GDP. In contrast in Hungary and Slovenia it would narrow C/A surpluses by over 1.0pp of GDP.

[2]Please note that in Hungary recent net short term inflows are reduced significantly by foreign bank deleveraging while if only portfolio flows are included, Hungary would suffer larger outflows under this metric.

Differing domestic vulnerabilities

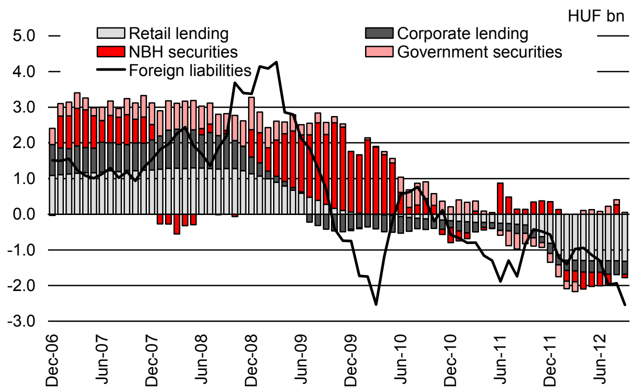
The currency board countries, plus Czech, Poland, Romania and Kazakhstan stand out as having pushed ahead with reform-orientated policies in the face of plentiful inflows of cheap capital

It is against this backdrop of a gradual recovery in growth combined with the potential for somewhat higher external financing costs that we expect more differentiation across sovereign credits over the course of the coming quarters. While the overall size of portfolio inflows risks moral hazard, some economies continue to perform impressively. Romania is the only country in the region to consistently maintain a programme with the IMF amidst commendable budget performance. Though fiscal performance is at risk of slippage in Poland and Czech next year, the authorities have put in place over the past 3 years a series of consolidation measures to protect public debt to GDP while banking sectors have emerged solid. Fiscal performance in the currency board countries, namely Bulgaria, Latvia and Lithuania, also require mentioning while Kazakhstan's balance sheets incorporate a large cushion to protect against a decline in commodity prices, even if the authorities have addressed banking sector shortfalls much too gradually.

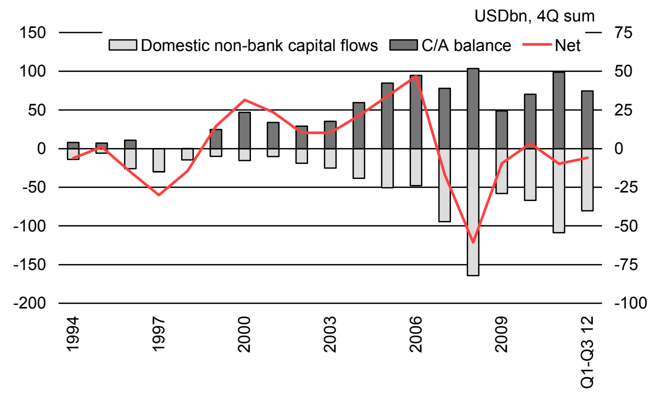
Russia and Turkey fall in between the leaders and laggards

Russia and Turkey fall in between the leaders and laggards. From a capital flows perspective, both have seen an increase in vulnerabilities but low public and external debt ratios continue to provide a cushion. In Turkey this takes the form of increased banking sector reliance on foreign capital flows, pushing its net foreign asset position to -10.8% of GDP from -1.4% of GDP at end-09, financed by portfolio capital to some extent. Meanwhile co-ordination across the government, central bank and financial regulator is lacking on macro management. In Russia there has been a structural shift in domestic capital outflows, reflecting in part higher oil prices but also greater political uncertainty and a weak investment climate. At 5.8pp of GDP over Q1-Q3 this year, this sort of capital outflow represents a structural growth impediment.

Hungary: Banks run down exposures across the board



Russia: Locals withdraw more and more capital



Source: NBH, CBR, UniCredit Research

Even if done involuntarily, Croatia and Slovenia will come under more pressure to push through reforms in 2013…

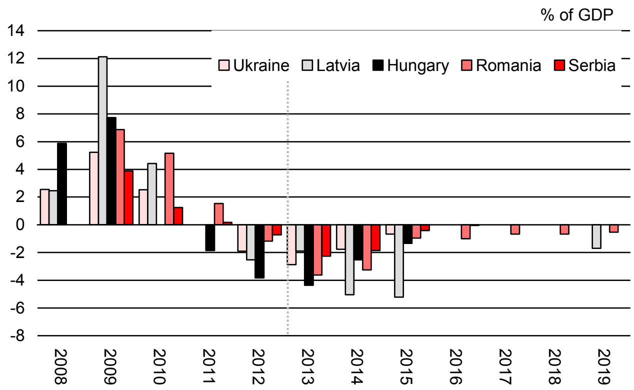
But it is Ukraine, Hungary, Slovenia, Serbia and Croatia that fall into the laggards camp. The good news is that in Slovenia and Croatia, should the authorities not succeed in pushing through the necessary measures themselves, the coming 1-2 quarters will in any case see the introduction of external anchors. A halt to the government's plan for a bad bank in Slovenia will likely see the introduction of a Troika programme. In Croatia the government has performed poorly in terms of expenditure and broader public sector reform but will face pressure from EU to do so upon entry mid next year.

…while Hungary, Serbia and Ukraine drag their feet

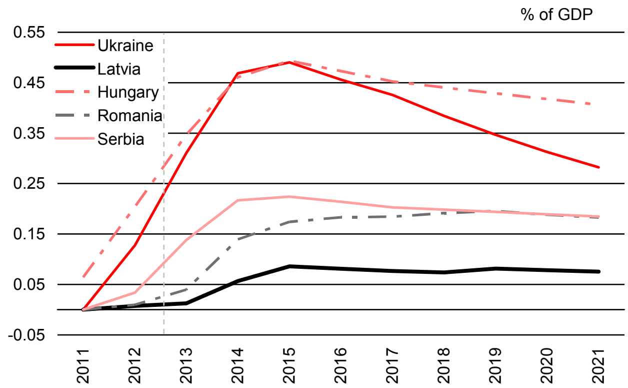
It is not a coincidence that the remaining three of this group of five were forced to enter IMF programmes upon the onset of the crisis in 2008 but have since discarded cooperation. Over the past 12 months access to external capital, either via domestic or external markets or Russia, has helped to sustain a sub-optimal policy mix for longer. At this stage, Ukraine's shortfall requires addressing most urgently, given the combination of a halt in GDP growth, a decline in steel prices, declining FX reserves and a large gross external financing requirement. In Hungary the pressure is much less significant at this stage, though 2012 has been a year littered with policies that damage the banking sector, avoid necessary adjustment in the size of the public sector and harm the investment environment. Serbia also drags its heels in terms of implementing the necessary central bank and fiscal measures to secure another programme. As shown below, Hungary and Ukraine face sizeable IMF/EU redemptions, as well as the largest upside risks in terms of refinancing costs in the external market.

IMF REPAYMENTS RAISE FINANCING REQUIREMENTS AS WELL AS INTEREST RATE BILLS

Disbursements and repayments to the IMF



Estimating the impact of rolling over IMF loans in hard currency markets[3]



Source: IMF, Bloomberg, UniCredit Research

Don't take convergence for granted

2012 has forced another assessment of CEE potential growth…

The 2008/09 crisis prompted a downgrade of potential growth across the region as foreign investors re-assessed their willingness to invest, particularly at the low lending rates that they had in the past. 2011/12 has prompted another round of revisions, this time because of a combination of funding and growth constraints that foreign investors faced domestically, particularly in developed Europe.

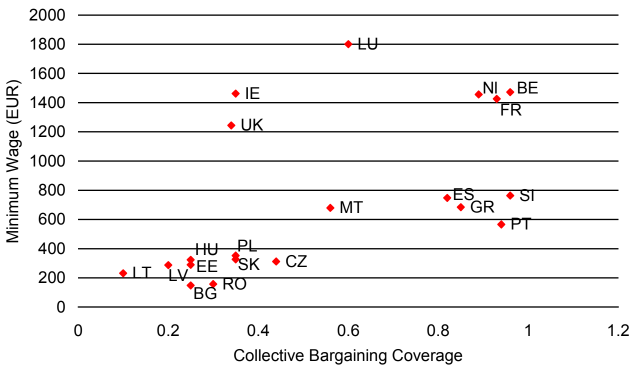
…but CEE still has considerable potential to outperform EMU

At least when we examine labour flexibility and costs in the newer EU countries, the case for a recovery in foreign inflows to real economies in the region, supporting overall growth prospects looking forward, remains strong. With the exception of Slovenia, minimum wages are competitive while metrics such as trade union coverage or wage bargaining powers suggest that labour market flexibility acts as much less of a constraint than in EMU. But growth in many countries in the region is as much, if not more, a demand rather than a supply issue at this stage. This is captured in the most recent FDI trends, showing a decline once again following only a very modest recovery post 2008.

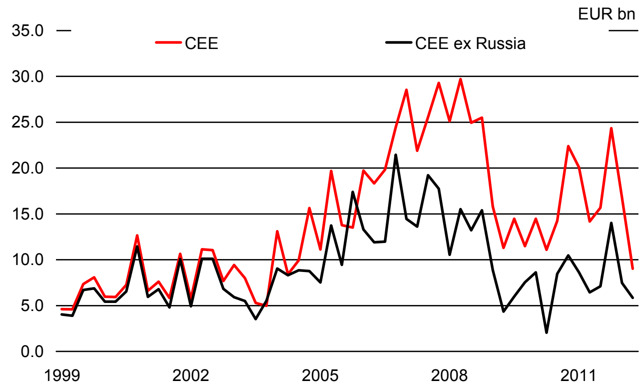
[3] We assume that all repayments are rolled via eurobond issuance in hard currency at a rate equivalent to this year's average in 5 year CDS space while the IMF's lending rate is unchanged from here.

CEE GROWTH REQUIRES EXTERNAL DEMAND

Newer EU countries benefit from low minimum wages and flexible labour markets…



…but a more convincing recovery in global growth is required before FDI picks up once again

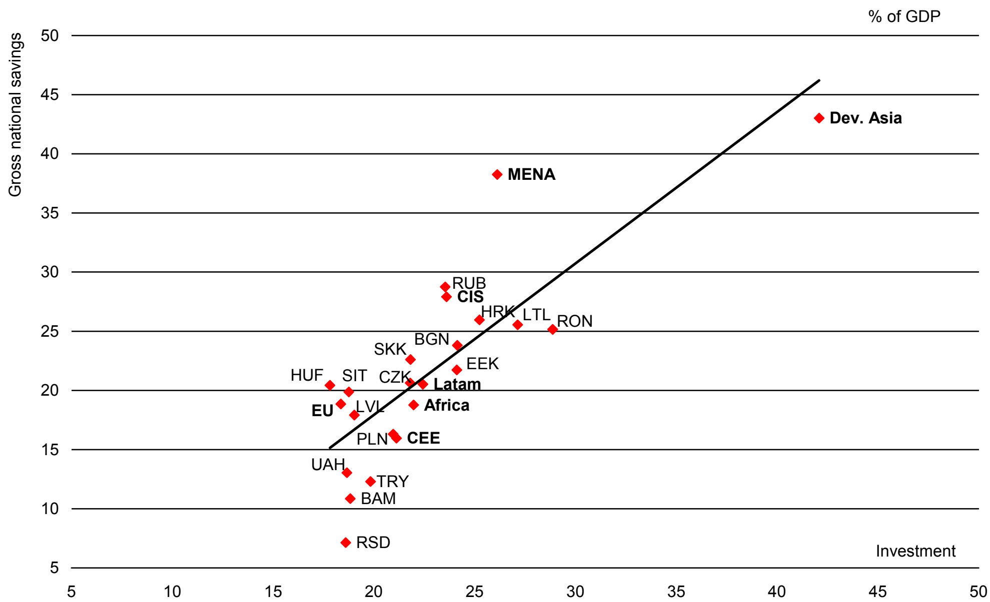


Source: Eurostat, national central banks, UniCredit Research

Differentiating on domestic policies

But CEE cannot take growth for granted, even in a stronger external environment. Ill-advised domestic policies have shown clear evidence of impacting overall wellbeing. For example, in Hungary real private consumption has fallen to levels last seen in Q3-02, in Croatia in Q1-05. Charting savings versus investment, CEE ex-CIS significantly underperforms all other EM regions which ultimately risks constraining growth. With this in mind, domestic policy makers' initiatives to keep potential growth on track are essential. Those that act in the opposite direction are increasingly at risk of a more persistent downturn.

SAVINGS V INVESTMENT: CEE DOES NOT COMPARE WITH OTHER EM REGIONS (2012)



Source: IMF, UniCredit Research

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Countries

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

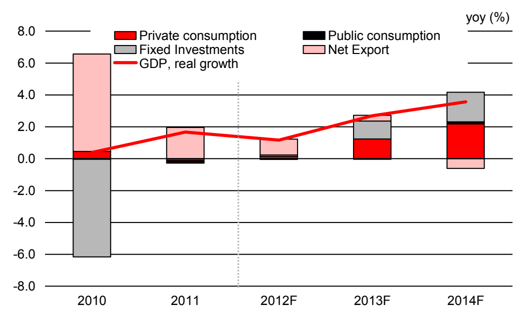
Outlook – The Bulgarian economy is on course to enjoy faster growth next year, as headwinds that held it back are gradually easing. Slowly but surely, households are starting to spend more and save less after household debt fell to its lowest level since 2007. House prices are stabilizing after falling more than 40% from their 2008 highs. Capital flows have reversed trend and are now shifting to a steady inflow after last year's outflows, which were driven by external deleveraging pressure. Improved absorption of EU funds has slowly but steadily boosted capital spending. The fiscal stance is planned to become more growth supportive next year, also strengthening disposable incomes and consumption more generally. All these, above all seem to reflect the prudent fiscal policy, pursued by the Bulgarian authorities which has helped to reduce many pf the macroeconomic imbalances and structural dislocations that had been standing in the way of the recovery process.

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

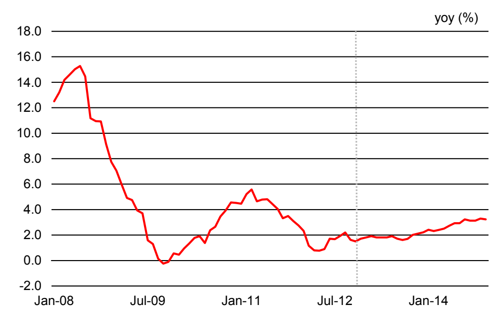
KEY DATES/EVENTS

- 15 Jan – redemption of Eurobond (EUR 818mn)
- 27 Jan – referendum on the future of nuclear power in Bulgaria
- Mid-Feb – Flash estimate of 4Q12 & FY12 GDP figures

GDP GROWTH AND CONTRIBUTION TO GROWTH



INFLATION (CPI) YOY



Source: NSI, BNB, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2010	2011	2012E	2013F	2014F
GDP (EUR bn)	36.1	38.5	39.8	41.6	43.9
Population (mn)	7.5	7.3	7.3	7.2	7.2
GDP per capita (EUR)	4804	5252	5470	5734	6100
Real economy yoy (%)					
GDP	0.4	1.7	0.6	1.7	2.8
Private Consumption	0.6	-0.2	2.6	3.1	3.4
Fixed Investment	-18.3	-9.7	-1.2	2.1	5.0
Public Consumption	-0.5	-4.9	-0.6	1.6	-0.3
Exports	14.7	12.8	2.1	2.4	3.4
Imports	2.4	8.5	4.0	4.0	4.2
Monthly wage, nominal (EUR)	331	362	391	420	454
Unemployment rate (%)	11.3	11.8	12.7	12.5	11.7
Fiscal accounts (% of GDP)					
Budget balance	-3.9	-2.1	-0.9	-1.3	-0.9
Primary balance	-3.3	-1.4	-0.1	-0.4	-0.1
Public debt	16.7	17.0	19.8	18.9	22.9
External accounts					
Current account balance (EUR bn)	-0.4	0.2	-0.6	-1.0	-1.5
Current account balance/GDP (%)	-1.0	0.4	-1.4	-2.5	-3.5
Basic balance/GDP (%)	-1.1	0.4	3.4	1.7	4.2
Net FDI (EUR bn)	0.7	1.4	1.5	1.7	1.9
Net FDI (% of GDP)	1.8	3.5	3.7	4.1	4.4
Gross foreign debt (EUR bn)	37.1	35.4	35.3	34.8	35.7
Gross foreign debt (% of GDP)	102.8	91.9	88.6	83.7	81.2
FX reserves (EUR bn)	13.0	13.3	14.7	15.4	17.3
Inflation/Monetary/FX					
CPI (pavg)	2.4	4.2	3.0	2.6	2.9
CPI (eop)	4.5	2.8	4.3	2.5	3.3
Central bank reference rate (eop)	0.2	0.2	0	0.1	0.5
USD/BGN (eop)	1.47	1.51	1.50	1.45	1.40
EUR/BGN (eop)	1.96	1.96	1.96	1.96	1.96
USD/BGN (pavg)	1.48	1.41	1.52	1.48	1.42
EUR/BGN (pavg)	1.96	1.96	1.96	1.96	1.96

Source: UniCredit Research

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

Economy is on course to enjoy faster growth next year

With net exports dragging on GDP, individual consumption has picked up the slack so far in 2012

Bulgaria's economic performance has continued to improve, albeit slowly, over the three months since our most recent quarterly publication. The improvement was centered on the household sector, where individual consumption has posted a positive qoq print in five out of the last six quarters. The 3Q12 reading (up 0.5% qoq and 3.0% yoy) was even more impressive as it came against the backdrop of the strongest qoq gain in more than a decade posted in the previous quarter. This seems to suggest that, slowly but surely, households are starting to spend more and save less, after putting off purchases and channeling an increased share of their disposable income reducing debt for a prolonged period of time. But while demand conditions in the household sector have started to change for the better, exports slowed down in 3Q12 (0.0% qoq compared with a 1.0% average qoq gain in the last four quarters prior to that), as growth momentum remained weak in many of the country's key trading partners. GFCF (up 0.4% qoq and 1.0% yoy), on the other side, showed more signs of stabilization after posting its first positive yoy print since 4Q08. GDP growth in 3Q12 remained at 0.5% for a third consecutive quarter. **We marginally revise our GDP growth projection upward to 0.6% this year and 1.7% next year (from 0.5% and 1.5%, respectively).** Despite the minor fine-tuning of our growth forecast, there has been no change in our fundamental view, which remains one of a gradual recovery, led by individual consumption and, to a lesser extent, by investments and exports. The growth trajectory should be better because practically all headwinds that have weighed on the recovery in 2012 should abate going into 2013. Individual consumption should draw support from the planned increase in pensions and minimum wage, ongoing house-price stabilization, reduced household debt and lower inflation. Corporate sector deleveraging should peter out, as both the rise in foreign inflows and the drop in resident outflows should help the price and availability of credit for the real economy to improve. In the second half of 2013, the gradually accelerating recovery in household spending, along with the ongoing improvement in financial market conditions, is likely to boost private sector capital spending. The growth-supportive fiscal policy stance expected next year (after Bulgaria became the first EU member state to exit the excessive deficit procedure and with the fiscal consolidation process having advanced markedly) should remove another drag on growth that has been weighing on the recovery since 2009. At the same time, the external drag is expected to abate further since global trade is likely to gain momentum gradually, as the euro area emerges from recession.

We see real GDP growth accelerating to 1.7% next year (from 0.6% in 2012), with domestic demand taking the driving seat

Many of the headwinds that Bulgarian economy faced in 2012 ease

CPI inflation, after falling from 4.8% in June 2011 to 1.6% in June 2012, accelerated over four consecutive months to 4.4% in October. The recent spike in CPI inflation mostly reflects an increase in electricity prices in June, in order to cover the costs associated with the boom in solar and wind power plants that have been switched to the electricity transmission grid and a larger-than-expected seasonally-driven increase in food prices. Inflationary expectations remain well entrenched, but the 2.4pp positive gap between PPI and CPI in October seems to suggest that there must be some pass-through effect waiting to materialize in the months to come.

Inflationary pressure is set to remain well contained over the entire forecast horizon

CPI inflation is likely to remain little changed toward the end of this year, and to ease moderately early next year, when the new lower import prices of natural gas agreed with Gazprom in November 2012 are scheduled to feed through into lower central heating prices (the regulator already indicated that the price drop would be in the range of 5-10% for the different regions in the country). As the economy is set to operate below its full potential at least for another two more years, the inflation risks in the short-to-medium run are virtually non-existent. We expect yearly CPI inflation to remain around 3% until early summer 2013, before gradually receding to 2.5% in end-2013. In terms of annual averages, we see CPI inflation at 3.0% in 2012 and 2.6% in 2013, before rising modestly again to 2.9% in 2014.

BOP trends demonstrated a broad-based improvement in the course of 3Q12

The CA surplus shrunk to 0.5% of GDP between January and September 2012, from 2.5% in 2011, as stronger services, income and current transfer balances failed to fully offset the worsening in the merchandise trade balance**.** A closer look at the details reveals that roughly two thirds of the merchandise trade balance deterioration reflects trade losses caused by the higher energy import prices, while the remaining third appears to be attributable to the modest improvement in domestic demand conditions. A shift away from crisis-hit Europe towards the more dynamic Middle East and Asian markets, on the other hand, has helped exports to report modest positive growth (2.5% yoy) in 9M12.

The shift to a smaller c/a surplus was accompanied by a marked increase in net foreign capital inflows

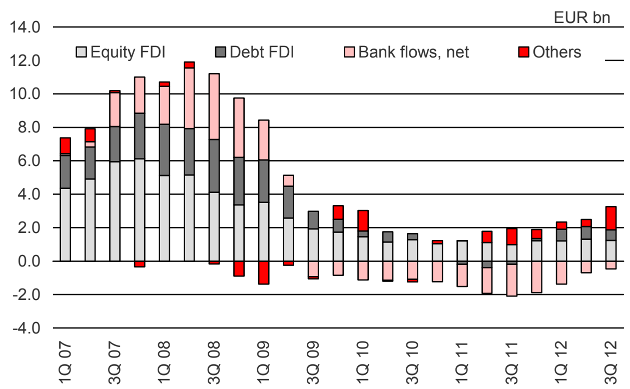
Capital outflows channeled through the banking sector have slowed markedly

Capital flows have gradually reversed their trend and are now shifting to a steady inflow after last year's outflow driven by external deleveraging. The financial account shifted to a surplus equivalent of 3% of GDP in the first nine months of 2012, from a 2.4% deficit a year ago, after practically all its components improved significantly. FDI inflows almost doubled to 2.4% of GDP, from 1.3% in 2011, as the debt FDI component reversed its flow in 2012. Portfolio investments, on the other hand, shifted from a small outflow in 1H12 to a marked inflow later in the year, after Bulgaria successfully placed EUR 950mn of 5Y bonds on the sovereign debt market in July. Banks continued to make net repayments abroad, but on a substantially smaller scale than before. Capital outflows channeled through the banking sector lost momentum, falling to just 0.9% of GDP between January and September 2012, from a hefty 4.6% outflow one year earlier. The latter seems attributable above all to the significant improvement in the banking sector's external position, where the net external liabilities to total liabilities ratio eased to just -3.4% in October 2012, from an already very solid -4.3% a year ago and -17.3% at its peak in November 2008. Both the rise in foreign inflows and the drop in resident outflows reflected improved market sentiment, which helped boost risk appetite, after the ECB's announcement of the establishment of the OMT facility in September. Looking ahead to the rest of this year and later into the next year, we expect capital flow improvement to continue, albeit at a somewhat slower pace. Thus, we see the yearly rise in the central banks' FX reserves (which under fixed exchange rates leads money supply changes) accelerating to 4.9% in 2012 and to 6.3% in 2013 (stripped from the one-off effects associated with the refinancing of the EUR 818mn euro-denominated bonds maturing in January 2013), as compared with the less solid 2.9% rise posted in 2011.

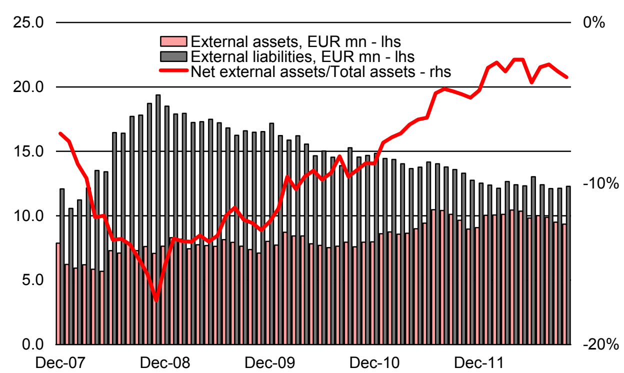
As Bulgaria continued to pursue prudent fiscal policy, risk premia (based on 5Y USD-denominated CDS) has fallen to levels not seen since mid-2008

After reducing the budget deficit to 2.1% of GDP in 2011, Bulgaria was the first country to exit the excessive deficit procedure. Fiscal metrics have continued to improve this year and the fiscal deficit is now on track to narrow to 0.9% of GDP. This would be better than the government had planned (2012 deficit target was set at 1.3% of GDP) and would imply a sizeable underlying fiscal tightening of 1.2% of GDP. Next year, the government plans to pause its fiscal consolidation efforts (budget will target a 1.35% of GDP deficit).

Capital flows, 12M MA



Banking sector external position (EUR mn)



Source: BNB, UniCredit Research

Strategy: More rallies ahead for GBs

All bond redemptions for 2012 have already been covered

The strong fiscal position of the sovereign and limited debt supply, will continue to support Bulgarian GBs. 2013 will be off to a dynamic start for the budget as EUR 930mn (or 49% of the FY government financing requirements) have to be settled in January – a maturing EUR 818mn global bond, interest payments on external and domestic debt and a EUR 25mn domestic note all fall due in January. Preemptive issuance on the hard-currency market in July 2012 has provided the needed funds for these payments, allowing for strengthening of the already very healthy fiscal position of the sovereign. Domestic bond redemptions in 2013 have been kept at a minimum (only 3.8% of the current debt stock is due next year) in compliance with external debt dynamics, leaving the fiscal deficit as the main gap that has to be filled next year. In light of the election year, fiscal consolidation has been given a breather and the shortfall is forecast at 1.3% of GDP – marginally higher, compared to the 2012 estimate of 0.9%. The upcoming parliamentary election will also command debt issuance policy during the year – we see a repetition of the 2012 calendar, albeit for different reasons (to avoid political noise close to the July vote) when 48% of GB supply was concentrated in 1Q.

Increased liquidity in the financial sector to drive GB yields to new lows

In light of the above, we believe yields on GBs will have even more room for tightening in 1Q13. We see this as the result of two factors. First, capital flow reversal in the economy has taken the form of significantly reduced banking outflows as a result of the substantial improvement in the net external position of the sector. Thus, with deposit growth dynamics set to slow only marginally in 2013 and demand for new credit set to pick up only slightly, liquidity in the financial industry is likely to increase from already elevated levels. And second, cash inflows into the financial sector resulting from the amortization of domestic and external debt are estimated to total BGN 1.857bn over the course of 2013, amounting to 155% of GB supply, as specified in the 2013 Budget law. High seasonality in these flows suggests that BGN 1.614bn of these will fall in 1Q, which will be met by only BGN 0.6bn of GB supply (270%) according to our front-loaded issuance scenario. This implies that rising liquidity in the financial sector, on top of an overall improvement in the external risk environment, will drive sovereign debt yields to new lows.

GOVERNMENT GROSS FINANCING REQUIREMENTS

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

GROSS EXTERNAL FINANCING REQUIREMENTS

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

Source: BNB, MF, UniCredit Research

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

Outlook – From recession in 2012, Czech Republic should move towards a gradual recovery in economic activity in 2013, supported by improving external demand and an upturn in the inventory cycle. Private consumption is set to remain a drag. Having no more space for monetary policy easing, the CNB may seek to weaken the currency with market intervention. The public sector is set to post a deficit just above 3% of GDP, leaving fiscal policy broadly neutral.

Strategy outlook – Risks in H1-13 are weighted towards a gradually higher EUR/CZK.

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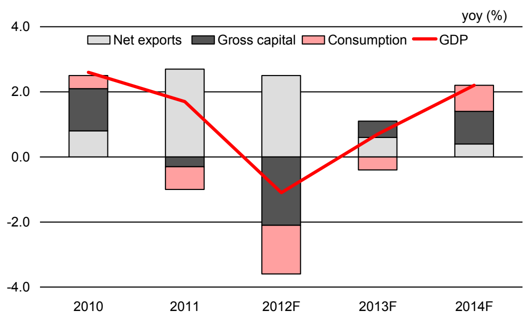
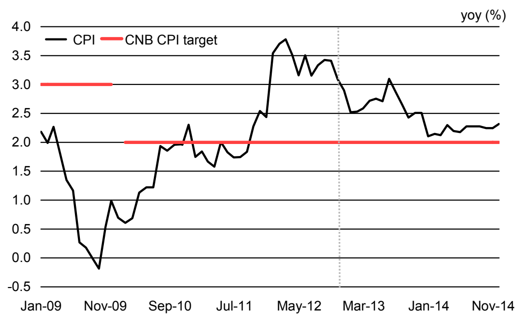
KEY DATES/EVENTS

- 2nd half of December – State budget draft final reading
- Feb 6 – CNB policy meeting and inflation report
- Mar 28 – CNB policy meeting
- Jan 2, Feb 4, Mar 1 – Manufacturing PMI

INVENTORY CYCLE TO SUPPORT GDP IN 2013 AFTER STRONG 2012 ADJUSTMENT



CPI IS HEADING LOWER BUT NOT BELOW TARGET



Source: CZSO, CNB, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2010	2011	2012F	2013F	2014F
GDP (EUR bn)	149.2	154.8	152.2	155.3	166.1
Population (mn)	10.5	10.5	10.5	10.5	10.5
GDP per capita (EUR)	14,185	14,746	14,481	14,746	15,759
Real economy yoy (%)					
GDP	2.6	1.7	-1.1	0.7	2.2
Private Consumption	0.5	-0.6	-2.8	-0.5	1.5
Fixed Investment	0	-0.9	-3.0	-3.0	3.0
Public Consumption	0.6	-1.7	-0.6	-1.0	0.5
Exports	16.0	11.1	4.3	6.0	8.5
Imports	15.7	7.5	1.3	6.2	9.4
Monthly wage, nominal (EUR)	944	994	993	1,007	1,067
Unemployment rate (%)	9.0	8.6	8.6	9.3	9.0
Fiscal accounts (% of GDP)					
Budget balance	-4.8	-3.3	-4.7	-3.4	-3.0
Primary balance	-3.5	-1.9	-3.3	-1.9	-1.5
Public debt	37.8	40.8	45.5	47.5	48.4
External accounts					
Current account balance (EUR bn)	-5.8	-4.4	-1.6	-0.7	0
Current account balance/GDP (%)	-3.9	-2.9	-1.1	-0.5	0
Basic balance/GDP (%)	-0.8	-0.4	2.6	2.9	3.5
Net FDI (EUR bn)	4.6	3.9	5.6	5.3	5.8
Net FDI (% of GDP)	3.1	2.5	3.6	3.4	3.5
Gross foreign debt (EUR bn)	70.5	72.6	76.4	81.4	89.8
Gross foreign debt (% of GDP)	47.3	46.9	50.2	52.4	53.0
FX reserves (EUR bn)	31.8	31.1	32.0	32.0	32.0
Inflation/Monetary/FX					
CPI (pavg)	1.5	1.9	3.4	2.7	2.2
CPI (eop)	2.3	2.4	3.0	2.5	2.3
Central bank target	2.0	2.0	2.0	2.0	2.0
Central bank reference rate (eop)	0.75	0.75	0.05	0.05	1.00
3M money market rate	1.09	0.97	0.75	0.30	0.75
USD/CZK (eop)	18.8	19.4	19.5	18.7	17.5
EUR/CZK (eop)	25.1	25.8	25.4	25.3	24.5
USD/CZK (pavg)	19.1	17.6	19.4	19.1	18.6
EUR/CZK (pavg)	25.3	24.6	25.2	25.5	24.9

Source: UniCredit Research

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

2013: From shallow recession to shallow recovery

Recession extended into 3Q 2012 due to weak domestic demand

3Q represented the fourth consecutive quarter of recession as the economy contracted -0.3% qoq sa (-1.5% yoy). Though detailed figures are not available, household consumption was reported to decline further, while a drop in investments into real estate, machinery and transport equipment also subtracted from GDP. Net foreign trade continued to make a positive contribution. The decline in value added was driven by construction and manufacturing.

Private spending has suffered from depressed consumer sentiment, declining real wages and rising unemployment

The protracted weakness in household spending in 3Q was a reflection of very low consumer confidence, which was even more depressed than at its lowest point during the 2008-2009 economic crisis. This reflects a combination of factors, including government tax hikes and the lingering financial crisis abroad. Moreover, it is now taking its toll on unemployment, which was up 0.6 p.p. yoy in October, while it had been flat yoy at the end of 2Q. Real wage growth dealt another blow to private spending in 3Q, posting a 1.8% yoy drop. Highlighting the contraction in domestic demand, public consumption suffered from the government's determination to keep the fiscal deficit close to 3% of GDP, while public investment was hit by the low utilization of EU funds. The fall in private investment reinforced declining industrial production and slowing import growth.

Leading indicators do not point to an upturn of GDP in 4Q

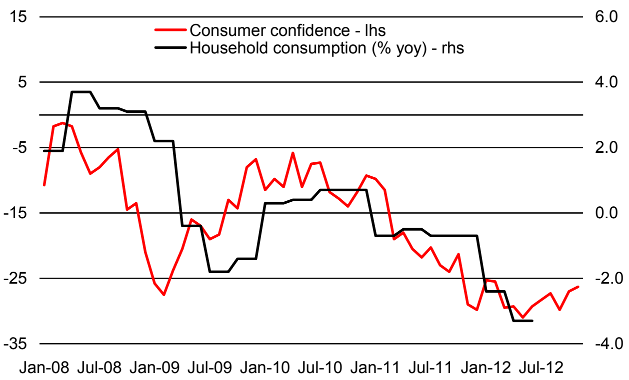
Judging from leading indicators, 4Q does not seem to be fundamentally better than 3Q. The manufacturing PMI and the CZSO's industrial confidence index fell to a 3-year low lately, though November saw a small bounce in the former indicator. Industrial orders in current prices dropped yoy in August and September, with both foreign and domestic orders posting a decline. On the other hand, consumer confidence showed a moderate improvement for the second consecutive month in November, providing hope that household consumption could have bottomed out in 3Q. On balance, we do not count on an upturn of GDP in 4Q. Together with a lower than expected 3Q and potential for downward revision to 1H data, we revise full-2012 GDP to -1.1% (previously -0.9%).

The recovery next year will be milder than envisaged earlier but solid fundamentals will allow GDP to return to its potential in roughly a 2-year horizon

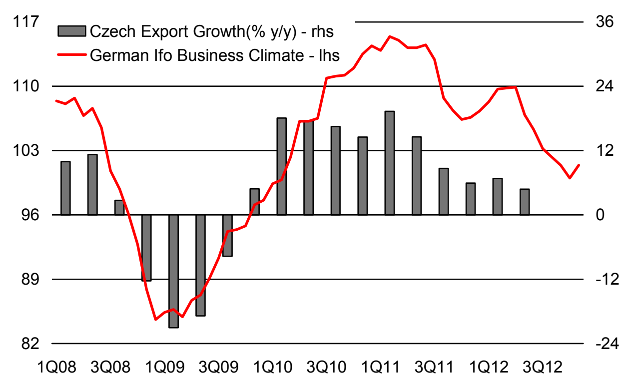
A moderate recovery in external demand, a boost from inventories and a halt to the contraction in household consumption are expected to be major drivers of a GDP upturn next year. Compared to our previous estimate, however, we reduced our growth forecast by half to 0.7%, unconvinced that private spending and investment will post full-year gains. Looking further ahead, we believe that solid fundamentals will allow the economy to return to its potential growth, which we estimate at around 2.5%, already at the turn of 2014-2015. The economy will benefit from stability of its financial system, solid external balance indicators, credible monetary policy and progress in fiscal consolidation through 2010-2013 which should prevent fiscal tightening from 2014 onwards.

EXTERNAL DEMAND, THOUGH WEAK, REMAINS SUPERIOR TO DOMESTIC DEMAND

Uptick in consumer confidence too small to revive consumption



Exports to continue growing, tentative acceleration from 1Q13



Source: CZSO, UniCredit Research

CPI holds above the CNB's target due to factors not relevant for monetary policy

Inflation stood at 3.4% yoy in October, in the middle of the 3.1%-3.8% interval it has been holding since the start of this year. The principal reason for headline inflation exceeding the CNB's 2% target remains the VAT hike in January. Monetary policy relevant inflation, which excludes changes in VAT and other indirect taxes, was just 2.1% yoy in October, down from its peak at 2.7% in March. Looking ahead a new pattern may arise in inflation, as declining fuel prices and a higher base from late last year are supposed to push headline inflation below 3% yoy at year end. In January, inflation is set to get a boost from hikes in both VAT rates by 1 p.p. We estimate that this effect will add 0.9 p.p. to CPI, which could however be less than this year's impact. Hence, the yoy rate of inflation might drop further below 3% for the whole of 2013. CZK and food prices are seen as major upside risk factors for inflation.

Basic balance has substantially improved thanks to combination of lower C/A deficit and stronger FDI inflows

External stability of the economy has substantially firmed this year. The foreign trade surplus (in the BoP methodology) almost doubled to CZK 136.3bn during January-September from a year earlier as import growth slowed faster than export growth. Together with a lower incomes deficit, the current account deficit narrowed by 68% yoy to CZK 28.9bn (just 1% of estimated GDP) over Q1-Q3. On the financial account, net FDI more than doubled to CZK 96.6bn (3.4% of GDP). Hence, the basic balance is set to post surplus in 2012, the first in full-year terms since 2007.

Subdued economic activity will slow but not derail fiscal consolidation

Poor economic performance is taking its toll on the state budget revenues. We expect a CZK 25bn shortfall in tax income compared to the full-2012 approved budget. That said, expenditures may also end up below the budget owing to various restrictions on current spending as well as delays in infrastructure projects. The ESA-95 deficit will anyway largely exceed the original plan at 3% of GDP, reaching our estimate 4.7% of GDP. However, 1.5 pp of this will stem from the effect of CZK 59bn church restitutions which is irrelevant for this year's cash or debt position of the government. For 2013, the public sector deficit is drafted at 2.9% of GDP, leaving fiscal policy only marginally restrictive. We see nevertheless the risk of the deficit skewed slightly to the upside as the public administration speeds up projects co-financed from EU funds. Looking further ahead, the government has just approved a slower the pace of fiscal consolidation, targetting deficits of 2.7% and 2.4% of GDP, respectively, for 2014 and 2015. This comes as a second change in the fiscal trajectory in less than a year. Originally, the trajectory was heading towards entire balance to be reached by 2016. Our takeaway is that while the new deficits don't look enormous, combined with low GDP growth they may keep pushing public debt towards 50% of GDP in case of a moderate slippage, possibly triggering corrective measures under the new Fiscal Responsibility Law to be enacted in 2013.

Risk of CNB interventions will likely influence EUR/CZK rate also through 1H13

CNB projections for budget deficits look substantially different. The structural deficit is forecast to move down to 1.4% of GDP, halving yoy. Such a move explains much of the commitment of CNB to keep easing monetary conditions even after its policy rate has reached a technical zero. Since two months ago, the option of fx interventions to weaken CZK in 1H13 has been repeatedly mentioned by CNB representatives. Whether interventions will actually be implemented as a policy tool depends above all on the CNB's fiscal assumptions in the next inflation report to be published early February. Anyway, the option has already been driving EUR/CZK higher and is likely to influence the cross over the most of 1H13. For that reason we have shifted our average EUR/CZK forecast for 2013 to 25.50, up by 1.2% from estimated average of 2012.

Short-term interest rates are set to remain stable at their all-time lows in 2Q13

Meanwhile, interest rate policy has in practice been deactivated. The CNB assumes a decline in 3M PRIBOR in its model to 0.2% from a current 0.5% but acknowledges that this is unlikely to happen, as the repo rate would have to go further down by additional 30-40bp from its current level of 0.05%. While short-term rate cuts are technically hardly conceivable, hikes are not expected either, at least until 2014. Hence, 2013 is set to be the year of stable short-term rates at their all-time lows. As for longer rates (CZK IRS and CZGB yields), these will likely move in line with their EMU peers (EUR IRS and bund yields).

Strategy: Comfortable financing, focus on CZK

Stable demand and supply conditions are envisaged for state debt financing

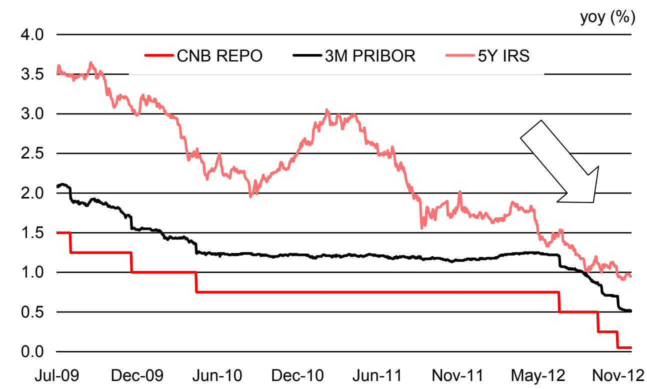
State financing is unlikely to be problematic in 2013. Borrowing needs amount to CZK 228bn, of which CZK 100bn relates to net debt issuance, similar to 2012. Instrument-wise, local bond issuance is scheduled at CZK 146bn, with an additional CZK 30bn reserved for retail bonds. A Eurobond issue should fill the gap but given a high CZK 140bn cash reserve, the state has the option to avoid such issuance in 2013. Within the maturity structure of local bonds to be issued, shorter fixed-coupon tenors are expected to prevail. Local demand for bonds is expected to remain stable as well. It is supposed to bring more household savings under pension fund management, but increments are set to be very gradual and not only targeting CZK bonds.

From a policy maker perspective, focus has shifted from the policy rate to the currency in order to protect against downward pressure on inflation. Over recent months, the CNB's strategy of verbally intervening against CZK has been successful. Taking the next step, namely active FX intervention, requires more evidence of a persistent slowdown in activity over the course of at least Q1 2013.

INTEREST RATES AT ALL-TIME LOW, FOCUS ON CZK

Increased reliance on CZK as policy tool

Interest rates probably hit bottom, CNB repo at technical zero



Source: Bloomberg, CNB, UniCredit Research

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2011	2012F	2013F
Gross financing requirement	**10.4**	**9.7**	**8.9**
Budget deficit	6.1	4.2	3.9
Amortisation of public debt	10.9	12.1	11.5
Domestic	10.9	12.0	11.5
Bonds	4.3	5.4	4.9
Bills	6.6	6.6	6.6
External	0	0.1	0
IMF/EU	0	0	0
Financing	**10.4**	**9.7**	**8.9**
Domestic borrowing	10.2	7.3	8.2
Bonds	8.2	7.3	8.2
Bills	2.0	0	0
External borrowing	0.2	2.4	0.7
Bonds	0	2.2	0.5
IMF/EU	0	0	0
Other	0.2	0.2	0.2

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2012F	2013F	2014F
Gross financing requirement	**7.03**	**3.44**	**7.93**
Banks	0.60	0.59	0.80
Government and central bank	1.89	0.93	3.18
Other sectors	4.54	1.93	3.85
Financing	**7.03**	**3.44**	**7.93**
Banks	0.57	0.80	2.21
Government and central bank	2.75	0.02	0.02
Multilateral institutions	0.19	0.47	0.70
Companies	2.32	0.79	1.03
Other	1.20	1.36	3.96

Source: CNB, MinFin, UniCredit Research

Estonia (AA- stable / A+ stable)*

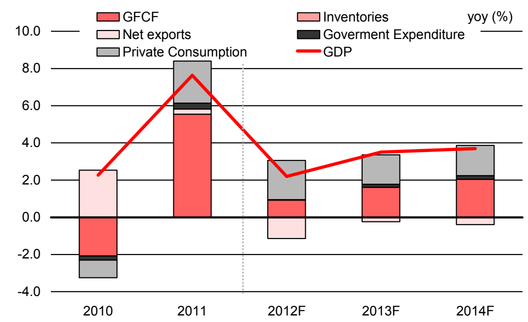
Outlook – According to the preliminary data, 3Q GDP growth accelerated to 3.4% yoy (+1.7% qoq sa). Given the latest numbers, we revise our FY12 forecast to 2.8%. In October, industrial production remained flat yoy, thus showing some relative signs of improvement compared to mid-year. We see some stagnation in the industrial production in the remainder of 2012 and 1H13, but it should start peaking up from there. Meanwhile, retail sales continued to show sound growth, increasing another 5.0% yoy in October, and we expect this dynamic to be carried forward. The draft 2013 budget, submitted to parliament, sees the deficit at 0.7% assuming growth at 3%, below our own forecast.

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

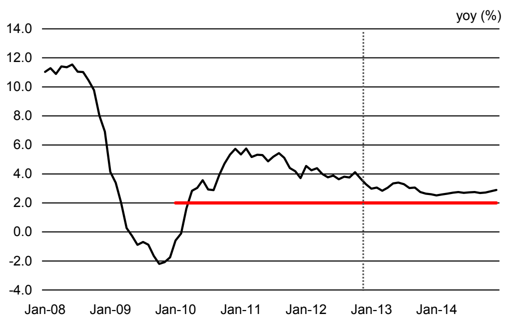
KEY DATES/EVENTS

- 10 Dec, 11 Feb – 2Q GDP (prelim/final)
- 30 Jan, 28 Feb, 29 Mar– Industrial production
- 31 Jan, 27 Feb, 28 Mar – Retail trade

CONSUMPTION TO SUPPORT GROWTH



INFLATION TO DECELERATE



Source: Statistics Estonia, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2010	2011	2012F	2013F	2014F
GDP (EUR bn)	14.5	16.4	17.5	18.6	19.8
Population (mn)	1.3	1.3	1.3	1.3	1.3
GDP per capita (EUR)	10,871	12,311	13,124	13,996	14,898
Real economy yoy (%)					
GDP	3.1	7.6	2.8	3.5	3.7
Private Consumption	-2.1	6.6	4.2	3.1	3.2
Fixed Investment	-9.6	26.8	3.7	6.5	8.0
Public Consumption	-2.0	1.6	0.1	0.9	1.1
Exports	21.2	24.8	5.5	8.5	10.2
Imports	20.5	27.3	7.2	9.3	11.2
Monthly wage, nominal (EUR)	788	820	890	910	930
Unemployment rate (%)	16.8	11.6	9.5	7.9	6.8
Fiscal accounts (% of GDP)					
Budget balance	-0.8	0.3	0	0.5	0
Primary balance	-0.8	0.2	0	0.5	0
Public debt	7.7	6.5	6.1	5.2	4.9
External accounts					
Current account balance (EUR bn)	0.5	0.5	0.1	-0.1	-0.3
Current account balance/GDP (%)	3.6	3.0	0.8	-0.6	-1.4
Basic balance/GDP (%)	11.0	12.8	3.0	0.4	0
Net FDI (EUR bn)	0.9	1.2	0.5	0.2	0.3
Net FDI (% of GDP)	7.4	9.8	2.2	1.0	1.4
Gross foreign debt (EUR bn)	16.6	15.7	15.0	14.0	13.8
Gross foreign debt (% of GDP)	114.2	95.6	85.9	75.2	69.6
FX reserves (EUR bn)	2.6	2.3	2.5	2.5	2.5
Inflation/Monetary/FX					
CPI (pavg)	3.0	5.0	3.7	3.0	2.7
CPI (eop)	3.9	3.7	3.2	2.6	2.9
3M money market rate	0.80	EUR	EUR	EUR	EUR
USD/EEK (eop)	11.7	EUR	EUR	EUR	EUR
EUR/EEK (eop)	15.6	EUR	EUR	EUR	EUR
USD/EEK (pavg)	11.8	EUR	EUR	EUR	EUR
EUR/EEK (pavg)	15.6	EUR	EUR	EUR	EUR

Source: UniCredit Research

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

Soft landing in sight

GDP growth is accelerating

According to the preliminary data, 3Q GDP growth accelerated to 3.4% yoy (+1.7% qoq sa) from 2.2% yoy (+0.5% qoq sa) recorded in 2Q, exceeding both consensus and our own forecast (2.0% yoy and 2.2% yoy, respectively). According to the Statistics Estonia press release, "economic activities in the domestic market mainly contributed to the GDP growth", confirming our view of domestic demand as the main driver of economic expansion. Construction, information and communication services were the main contributors to economic growth in 3Q, while the manufacturing input was negative. Given the latest numbers, we revise our FY12 forecast up to 2.8% from the September's 2.2%.

IP and retail trade data show mixed performance

In October, industrial production remained flat yoy, thus showing some relative signs of improvement compared to mid-year, when it posted three consecutive months of yoy decline from July to August (according to Statistics Estonia, the main reason for this series of negative numbers was the decrease in energy and mining production because of "the growth of imports due to low-priced electricity from Nordic countries"). We see IP remaining flat until at least year-end due to negative external factors. Meanwhile, retail sales continued to show sound growth, increasing another 5.0% yoy in October, thus staying in the range 5.0-7.0% for the fifth consecutive month. The impressive dynamic in retail sales going forward will be further supported by the positive labor market dynamics. Gross wages in 3Q increased by another 5.7% yoy, accelerating from 5.0% posted in 2Q. Of some concern to us is inflation peaking in October at 4.0% yoy from 3.7%, but we attribute this only to temporary one-off adjustments of energy prices.

C/A shows positive developments

The 3Q C/A, according to monthly flash estimates, moved into positive territory, posting an EUR 80mn surplus (approx. 0.4% of estimated FY12 GDP), bringing the cumulative 9M C/A deficit to 0.7% of expected FY12 GDP. The goods and services trade surplus continued to grow from the start of the year, reaching EUR 279mn. In yoy terms, that however translates into a 29% contraction of the trade surplus. This is mostly the result of growing imports (yoy terms +11.1% in 3Q vs. only 7.8% yoy for exports). The income balance stayed in the red at a negative EUR 220mn, widening by one third yoy. Current transfers weakened, contracting threefold from the level posted a year ago to only a EUR 21mn surplus. The capital account remained virtually unchanged with EUR 149mn positive number. FDI posted a disappointing result, contracting nearly six-fold yoy, but still remaining in positive territory at EUR 125mn. Portfolio investments moved into the red with an EUR 220mn deficit. Financial derivatives only marginally affected the final result with EUR 13mn print, only marginally changing yoy. Other investments however positively surprised, as the deficit on this item contracted by 18x yoy to only EUR 88mn, representing a halt of the foreign bank deleveraging process registered through 2010-2011.

The draft 2013 budget sees the deficit at 0.7% in 2013 and GDP growth at around 3.0%

The draft 2013 budget, submitted to parliament, sees the deficit at 0.7% in 2013. The main features of the 2013 budget are the scheduled increase by 4.4% of public sector wages and family allowances by 5%, which looks quite a motivated move given the austerity measures introduced in 2009-2011. Growth in 2013 is forecasted at around 3.0%, which is also in line with the numbers published by the European Commission in its Autumn forecast. Revenue for the 2013 state budget is anticipated at EUR 7.5bn and expenditure at EUR 7.7bn. These numbers, however, reflect a change in budget accounting methods (listing transferrable taxes and payments totalling approx. EUR 1.0bn on the state budget). Adjusted for this, the 2013 figures represent a. 4.6% increase in revenues vs. a 4.3% decrease in expenditures to 2012 budgeted figures.

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

Outlook – The Hungarian government continues to rely on makeshift fiscal packages to drive the deficit below 3% of GDP. This goal has been met at the cost of undermining growth: GDP will fall in 2012 and stagnate next year. Structural reforms are needed to stabilize the deficit and reduce the tax burden on businesses, but are unlikely before March 2014 elections because of political costs. Hence, we don't expect an IMF agreement unless markets force the government to ask for help. Meanwhile, Hungary is expected to profit from good investor appetite and issue FX bonds in early 2013, while relying mostly on HUF borrowing next year.

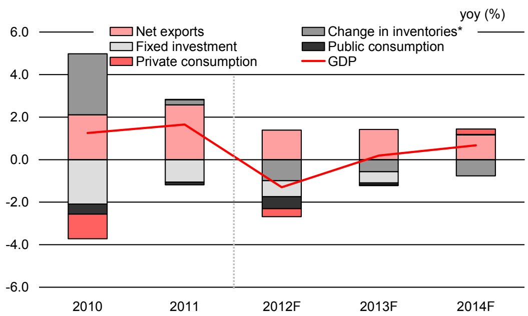
Strategy – The likely subordination of the central bank to the government will allow the former to intervene in the secondary market. The news is positive for yields, but HUF negative, due to increased money supply and limited FX reserves.

Author: Dan Bucsa, Economist (UniCredit Bank London)

KEY DATES/EVENTS

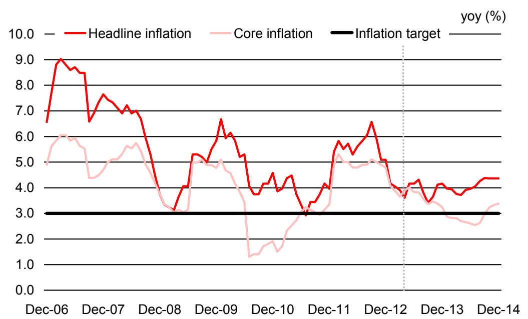
- NBH rate meetings: 29 Jan, 12 Feb, 26 Feb, 12 Mar
- Q4 GDP data: 14 Feb
- 3 Mar: Appointment of new NBH governor
- 27 Mar: Appointment of new NBH deputy governor

GDP DRIVERS



*Adjusted for statistical error

HEADLINE AND CORE INFLATION VS. TARGET



Source: CSO, NBH, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2010	2011	2012F	2013F	2014F
GDP (EUR bn)	97.2	100.5	99.7	106.4	107.1
Population (mn)	10.02	10.01	10.00	10.00	10.00
GDP per capita (EUR)	9,696	10,045	9,973	10,642	10,717
Real economy yoy (%)					
GDP	1.3	1.6	-1.3	0.2	0.7
Private Consumption	-2.7	0.2	-2.7	-0.5	0
Fixed Investment	-9.7	-5.5	-0.7	-0.1	0.5
Public Consumption	1.1	-2.4	-6.8	-3.0	0.1
Exports	14.3	8.4	-0.6	1.1	4.4
Imports	12.8	6.3	0.8	2.3	4.9
Monthly wage, nominal (EUR)	736	763	765	806	798
Unemployment rate (%)	11.1	11.0	11.2	10.8	9.9
Fiscal accounts (% of GDP)					
Budget balance	-4.2	4.3	-2.7	-2.8	-3.4
Primary balance	-0.7	-2.7	1.2	1.1	0.5
Public debt	82.2	81.6	78.0	77.1	77.2
External accounts					
Current account balance (EUR bn)	1.2	0.9	0.9	1.7	1.6
Current account balance/GDP (%)	1.2	0.9	0.9	1.6	1.5
Basic balance/GDP (%)	3.0	3.2	2.7	3.7	4.1
Net FDI (EUR bn)	3.0	1.5	2.1	2.2	2.5
Net FDI (% of GDP)	3.1	1.5	2.2	2.1	2.3
Gross foreign debt (EUR bn)	138.2	131.7	133.6	123.2	118.8
Gross foreign debt (% of GDP)	142.3	130.9	134.0	115.8	110.9
FX reserves (EUR bn)	32.3	35.1	27.4	26.8	25.1
Inflation/Monetary/FX					
CPI (pavg)	4.9	3.9	5.7	4.0	4.1
CPI (eop)	4.7	4.1	5.2	4.2	4.4
Central bank target	3.0	3.0	3.0	3.0	3.0
Central bank reference rate (eop)	5.75	7.00	5.75	5.00	6.00
3M money market rate	5.85	7.24	5.75	5.00	6.15
USD/HUF (eop)	208	240	184	152	225
EUR/HUF (eop)	278	311	280	290	300
USD/HUF (pavg)	208	201	186	169	226
EUR/HUF (pavg)	275	279	288	282	293

Source: UniCredit Research

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

Reliant on foreign capital, despite strive for independence

Hungary remains dependent on foreign capital…

Looking at the evolution of the Hungarian economy over the past two years, it is ironic how the government's strive for economic independence left growth and financial stability more reliant on foreign capital than ever before. Over the next two years, growth could come only from stronger external demand and foreign direct investment and only if foreign investors continue to pile up on the largest share of outstanding sovereign debt in CEE.

…despite the government's strive to reduce public debt and the budget deficit…

The government focuses on reducing the public debt stock, the debt to GDP ratio shrinking to 78% of GDP in September 2012 from 81.6% in 2010, but the pace is slowed by poor growth. In this environment, authorities chose to cut debt through unconventional measures (like the planned haircut of 20% on loans granted by local banks to municipalities) and to squeeze the budget deficit below 3% of GDP for the first time since 2000. Because the government tends to overestimate growth and tax receipts, additional tax packages had to be implemented without prior notice. There were six such packages for 2012 and already three for 2013, reducing the projected deficit for 2013 by 1.5% of GDP, but increasing the tax burden in particular on the service sector. Telecom companies and banks were the preferred target. There are two caveats to the government's approach to reducing deficits: it is not sustainable in the medium term and it undermines growth.

…using makeshift tax packages…

The budget deficit adjustment is not sustainable without structural reforms, but no major improvements are expected before elections in 2014. The EC predicts that the budget deficit will climb to 3.5% of GDP in 2014. Authorities are reluctant to increase the tax burden on households and small and medium companies, due to general elections to be held in March 2014. Hence, the Government remains prisoner to makeshift measures aimed at patching gaps in public finances. The IMF has suggested a list of reforms, including reducing the public wage bill, reducing losses at transport companies and reforming local administration.

…while undermining growth over the medium term…

Focusing taxation on companies led to a slump in investment (-5.2%yoy in 9M12). The decision to spare consumers and SMEs from shouldering part of the fiscal adjustment backfired, as administrative wage hikes were eaten up by inflation and retail sales fell 1.5% yoy in 9M12. The economy contracted 1.4%yoy between January and September and could improve only marginally to -1.2% for the whole year. Moving forward, we expect GDP to bottom out mid-2013, with only a mild recovery after that. Hence, we forecast stagnation next year (+0.2% expected growth) and below-potential growth in 2014 (+0.8% yoy) supported by a pickup in foreign demand and a widening of the trade surplus. Both private consumption and fixed investment are expected to decline next year by 0.5% and 2.9% respectively and to contribute a combined 0.1pp to growth in 2014 as financing dries out amid the ongoing bank deleveraging process.

…and alienating the IMF

With low willingness to implement meaningful reforms, we don't expect an IMF agreement before the 2014 general elections. After dragging for a year, negotiations between Hungary and the IMF have been halted. The only event that could bring about a new IMF loan is a sharp deterioration in market sentiment because Hungary is the CEE country most dependent on foreign financing.

Good appetite has helped Hungary to issue local debt…

Public financing will continue to rely on the local market, taking advantage of good risk appetite for emerging market assets and abundant local liquidity, while net FX needs will mostly be covered from NBH FX reserves. The debt management agency AKK has been very successful in meeting Hungary's financing needs in 2012, despite the country's junk rating. Foreign investors increased their holdings of HGBs to 47% of outstanding volume in November, while average demand at local auctions has been 2.5x in 2012. The debt management agency believes there is scope for paying yields above the current average of 5% if markets demand them, since they are fully covered by inflation, running above 6% currently.

…but a return to foreign markets is expected next year

The AKK could tap foreign investors in early 2013 to take advantage of good appetite for CEE assets and to reduce the pressure on the local debt market. FX outflows (maturing FX bonds and IMF repayments) exceed annual reserve inflows both in 2013 (EUR 5.0bn) and 2014 (EUR 5.7bn). Examining liquidity buffers, the government can access easily reserves exceeding the equivalent of EUR 9.0bn, out of which a third is in FX. On top of these resources, the AKK can access more than EUR 1bn through repos done with local banks. Banks own abundant liquidity, with outstanding two-week bills issued by the central bank at HUF 4.0tn (EUR 14.1bn) on 28 November. Lastly the government plans to focus on retail clients who own 10% of local debt. The AKK launched in November a 3Y bond linked to euro area inflation and sold over EUR 100mn in just ten days (half of the amount it planned to sell in a year).

The banking sector will remain in the red, hit by high taxation and poor economic outlook

The government forces the banking sector to delever, undermining growth. The banking sector is subject to a bank tax levied as a percent of total adjusted assets, but will also have to pay a financial transaction tax from January 2013. On top of these taxes, the government could force banks to take a 20% haircut on HUF 612.1bn of municipal debt, inflicting additional losses of approximately EUR 0.4bn (0.4 of GDP). The early repayment schemes for FX mortgage loans was scheduled to expire in December 2012, but is being extended. In these conditions, Hungarian banks will probably face a fourth consecutive year of losses in 2013. Former major sources of revenues have dried out, with the loan stock falling by a third over the past four years and sovereign exposure down 7% between August 2010 (peak) and September 2012. Because new loan origination stalls, the NPL ratio has risen above 16% in June 2012. In this environment, foreign banks recapitalised Hungarian subsidiaries with EUR 2.0bn over the past 15 months, keeping the solvency ratio of the system above 14%. The NBH expects the loan to deposit ratio to decline to 110% this year and 100% by the end of 2013, with the loan portfolio shrinking also in 2014.

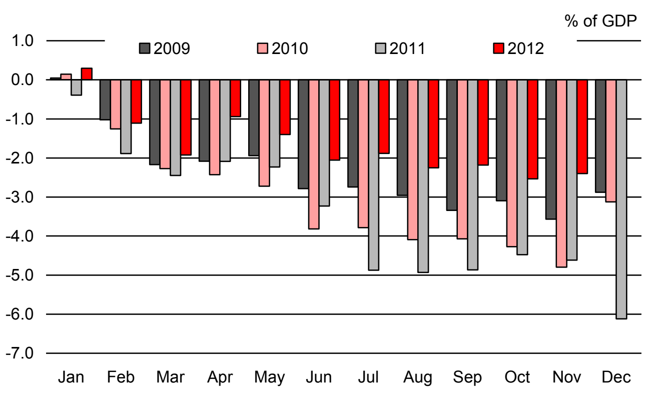
Despite inflation remaining above target until late 2014…

The inflation rate will remain above target over the next couple of years, with tax shocks and volatile price patterns distorting inflation expectations. Headline inflation could end 2012 at 5.2% due to higher food prices and effects from tax increases and the NBH expects inflation to return close to target by mid-2014 (our forecast is more pessimistic, with end-year inflation at 4.2% in 2013 and 4.4% in 2014).

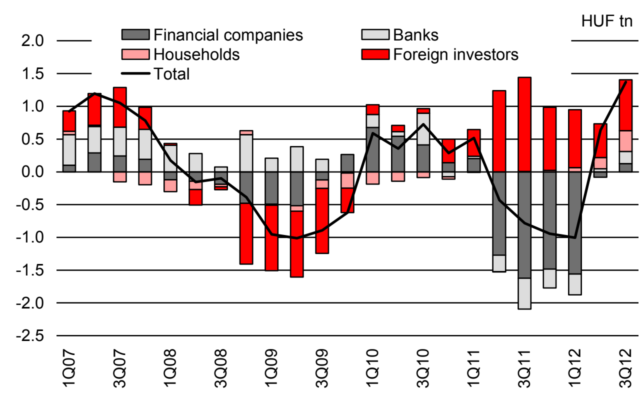
… we expect four more policy rate cuts in 2013

In this high inflationary environment, the NBH is expected to cut the monetary policy rate to 5% in 2013, hoping to spur growth. The MPC is dominated by four non-executive dovish members. The executive members of the MPC will be replaced in March 2012 and the NBH is expected to fall completely under the sway of the government. Low interest rates are not sustainable amid high inflation and the NBH is expected to hike again in 2014, if markets don't force them to tighten as early as 2013.

THE BUDGET DEFICIT HAS FALLEN IN 2012 AT THE COST OF SQUEEZING GROWTH



NET PURCHASES OF GOVERNMENT DEBT BY SECTOR (12M CUMULATED)



Source: KSH, AKK, NBH, UniCredit Research

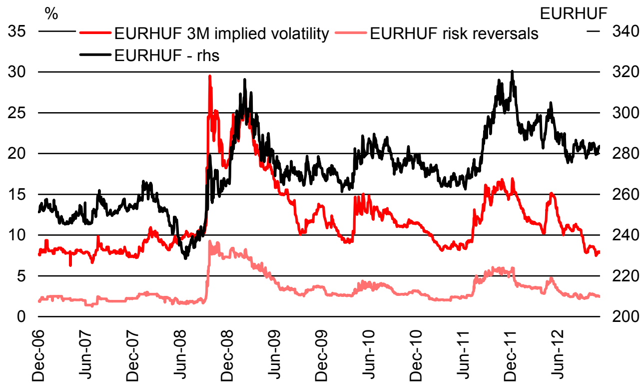
Strategy: Scope for HUF underperformance

Bearish on HUF once the central bank will lose its independence in March 2013

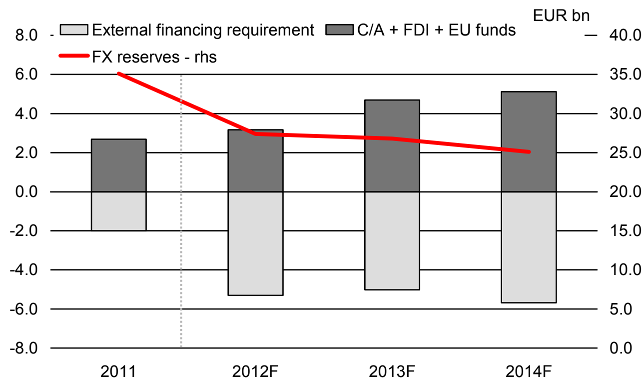
We are tactically bearish HUF given its weak growth performance, vulnerabilities associated with such large foreign ownership of domestic debt and upcoming changes at the central bank which will see it fall under the sway of the government as of March. The government plans to allow the NBH to purchase sovereign debt in the secondary market to use limited FX reserves for FX debt repayments. The first piece of news is positive for HUF yields and is likely to limit volatility. The second is HUF negative.

With implied volatilities at five year lows and EUR/HUF below 285, we believe that EUR/HUF currently doesn't price in the change in policies. Hence, we look for HUF depreciation above 290 HUF/EUR once the changes an the NBH take place.

The market doesn't price in the recent bearish news for the HUF



Absent FX issuance, reserves will fall, limiting scope for intervention



Source: Bloomberg, UniCredit Research

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2012F	2013F	2014F
Gross financing requirement	**17.0**	**19.0**	**20.1**
Budget deficit	2.7	3.0	3.6
Amortization of public debt	14.3	16.0	16.4
Domestic	9.0	11.0	10.7
Bonds	3.4	5.7	5.0
Bills	5.5	5.3	5.8
External	5.3	5.0	5.7
IMF/EU	2.3	4.5	0.7
Financing	**18.0**	**19.0**	**20.1**
Domestic borrowing	13.8	14.4	17.1
Bonds	8.5	8.6	10.2
Bills	5.3	5.8	6.8
External borrowing	0	2.5	3
Bonds	0	2.5	3.0
IMF/EU	0	0	0
Pension funds	4.2	2.1	0.0

Source: AKK, IMF, NBH, UniCredit Research

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2012F	2013F	2014F
Gross financing requirement	**29.5**	**31.3**	**33.1**
C/A deficit	-0.9	-1.6	-1.5
Amortisation of medium to long term debt	6.7	11.9	14.9
Government/central bank	3.9	7.0	9.0
Banks	2.0	3.6	3.9
Corporates	0.9	1.3	2.0
Amortisation of short term debt	23.7	21.0	19.7
Government/central bank	8.5	6.6	5.9
Banks	10.9	10.4	10.2
Corporates	4.3	4.0	3.6
Financing	**36.1**	**31.3**	**33.1**
FDI	0.9	1.3	1.3
Equity	4.0	2.3	1.5
Long-term borrowing	1.1	5.6	7.8
Government/central bank	0	1.5	2.6
IMF	0	0	0
Banks	0.4	2.9	3.3
Corporates	0.7	1.2	1.9
Short-term borrowing	21.0	19.7	18.6
Government/central bank	6.6	5.9	5.3
Banks	10.4	10.2	10.0
Corporates	4.0	3.6	3.2
EU transfers	1.4	1.8	2.3
Change in FX reserves (reduction(+)/increase(-))	7.7	0.6	1.6

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

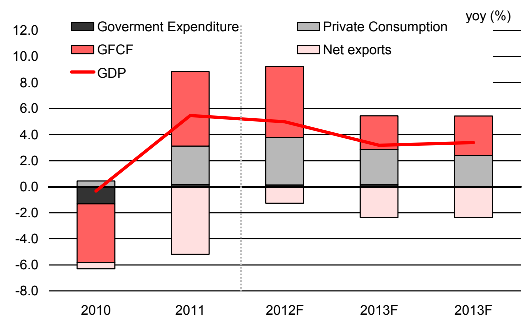
Outlook – 3Q GDP growth accelerated to 5.2% yoy (+1.7% qoq sa), and the current figure brings 1Q-3Q growth to 5.7% yoy. Given the latest GDP reading and other high-frequency data available to date, we revise our forecast for FY12 up to 5.0% from 4.7%. However, retail sales and IP continue to show signs of slowdown. The main challenge for Latvia going forward will be EMU entry, with the authorities targeting January 2014. The EC should assess the country in May/June of next year. Inflation is the primary hurdle, though we also see some positive developments on this front. S&P upgraded Latvia's rating to BBB from BBB- in the first half of November. A successful eurozone application could lead to a further rating upgrade by one or two notches.

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

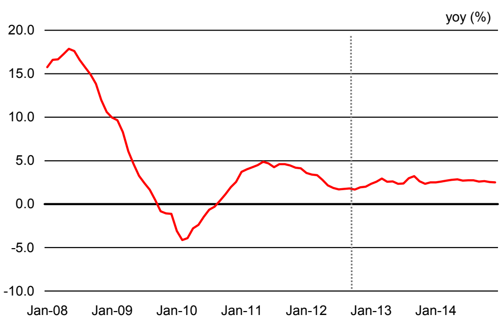
KEY DATES/EVENTS

- Dec – Parliament's voting on 213 budget
- 11 Feb, 11 Mar – 4Q GDP (prelim., final)
- 03 Jan, 04 Feb, 06 Mar– Industrial production

CONSUMPTION TO DRIVE GROWTH



INFLATION TO STABILIZE



Source: Central Statistical Bureau of Latvia, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2010	2011	2012F	2013F	2014F
GDP (EUR bn)	18.0	19.7	21.1	22.3	23.7
Population (mn)	2.3	2.2	2.2	2.2	2.2
GDP per capita (EUR)	7,989	8,753	9,422	9,945	10,550
Real economy yoy (%)					
GDP	-0.3	5.5	5.0	3.2	3.4
Private Consumption	0.4	4.4	5.4	4.0	3.5
Fixed Investment	-21.7	24.6	11.9	8.5	10.6
Public Consumption	-9.7	1.3	1.0	1.1	0.1
Exports	11.5	12.6	14.0	11.5	9.0
Imports	11.5	20.7	14.0	13.2	10.7
Monthly wage, nominal (EUR)	629	663	679	697	625
Unemployment rate (%)	14.3	12.7	11.3	10.9	10.7
Fiscal accounts (% of GDP)					
Budget balance (incl. bank costs)	-7.8	-4.0	-2.6	-2.5	-2.5
Primary balance	-9.9	-1.9	-1.8	-1.6	-1.1
Public debt	44.7	44.9	44.4	44.5	44.5
External accounts					
Current account balance (EUR bn)	0.6	-0.1	-0.2	-0.2	-0.3
Current account balance/GDP (%)	3.6	-0.6	-0.9	-1.0	-1.2
Basic balance/GDP (%)	5.0	5.0	2.2	1.4	1.2
Net FDI (EUR bn)	0.2	1.1	0.6	0.8	0.9
Net FDI (% of GDP)	1.4	5.6	3.1	2.4	2.4
Gross foreign debt (EUR bn)	29.8	30.9	31.7	33.2	34.7
Gross foreign debt (% of GDP)	165.3	157.1	150.0	148.5	146.3
FX reserves (EUR bn)	6.9	7.4	7.5	7.3	7.4
Inflation/Monetary/FX					
CPI (pavg)	2.5	4.4	2.3	2.5	2.6
CPI (eop)	-1.1	4.2	1.7	2.5	2.6
3M money market rate	1.90	1.03	0.25	0.75	1.00
USD/LVL (eop)	0.53	0.53	0.54	0.52	0.50
EUR/LVL (eop)	0.70	0.70	0.70	0.70	0.70
USD/LVL (pavg)	0.53	0.50	0.54	0.53	0.52
EUR/LVL (pavg)	0.70	0.70	0.70	0.70	0.70

Source: UniCredit Research

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

Preparing for euro accession

GDP growth accelerated again

3Q GDP growth accelerated to 5.2% yoy (+1.7% qoq sa), from 5.0% yoy posted in 2Q. The current figure brings 1Q-3Q growth to 5.7% yoy. The robust 5%+ rate of growth was in line with high frequency data published so far. The 3Q result is a consequence of two ongoing developments in Latvia's economy. Firstly, it's growing reliance on internal sources of growth (mostly personal consumption), as personal consumption and GFCF jointly contributed 4.1pp to the final growth figure. Secondly, there is an increasing input from net exports to growth, mostly driven by the increasing share of Russia and the Nordics as its main export destinations, combined with decreasing imports. Together, these two factors result in some decoupling of growth in Latvia from the overall eurozone. Given the strong 3Q GDP reading and the high-frequency data available to date, we revise our forecast for FY12 up to 5.0% from 4.7%.

Retail sales and IP continue to show signs of an approaching slowdown

However, there are still some signs of an approaching slowdown. Industrial production growth in September decelerated to 3.1% yoy (-2.8% mom sa), which is the slowest rate of growth since the end of 2010. In mom sa terms, the current number is comparable to the -2.6% mom sa reading posted in December 2011. September weakness in IP had little effect on the 3Q GDP reading – partially thanks to the strong result posted by IP in July and August (8.1% and 5.3% yoy, respectively). However, the current weak mom sa reading may signal a further deceleration of IP growth going into 4Q. Retail trade in October also shows similar dynamics. Despite a very sound result at 9.2% yoy wda, in mom sa terms the deceleration is quite pronounced (-1.4% mom). We take the current high frequency numbers as a signal of an approaching slowdown to a more sustainable and gradual pace of growth in 2013 from the current elevated figures.

C/A shows mixed developments

The September C/A moved into positive territory, posting a LVL 27.9mn surplus (approx. 0.2% of estimated FY12 GDP), bringing the cumulative 9M C/A deficit to 1.5% of expected FY12 GDP. Overall, the C/A numbers available to date look positive, reconfirming two trends of the current economic cycle: continuing growth of exports and the inflow of FDI.

The main challenge for Latvia going forward will be EMU entry

The main challenge for Latvia going forward will be EMU entry, with the authorities targeting entry in January 2014. The EC should assess the country in May/June of next year. Latvia's primary challenge at the moment is inflation, both in terms of getting this in line with the target and convincing European authorities that this easing inflation pressure is sustainable. The authorities have also cut taxes this year, which flattered the inflation data, but the actions are likely to be taken into account by the EC and ECB. A positive assessment for Latvia would undoubtedly be a positive, both for the country itself and broader EU integration momentum, but at this stage it is a close call.

Inflation seems to be the main hurdle

So far, Inflation continued to improve in 3Q. According to the data for October, inflation slowed to 1.6% yoy, bringing inflation for the first 10 months of the year to only 2.4% yoy. We reiterate our view on inflation for FY12 at 2.3%. Whether this will be enough to achieve the goal remains an open question which will strongly depend on the inflation performance in the EU as a whole. In the last several months, the threshold showed some descending dynamics as well. On the fiscal side, on the other hand, the situation is sound. For this year, our expectation for the budget deficit stands at 2.5% of GDP, as planned by the government, though the risks are skewed towards outperformance. November's revised forecasts from the EC see this year's deficit at 1.7% of GDP.

S&P upgraded Latvia's rating to BBB

S&P upgraded Latvia's rating to BBB from BBB- in the first half of November, while also posting a positive outlook. According to S&P, a successful eurozone application could lead to a further rating upgrade by one or two notches. On the back of the upgrade, Latvia sold USD 1.25bn of 7Y Eurobonds at 2.889% in December, covering borrowing needs for 2013.

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

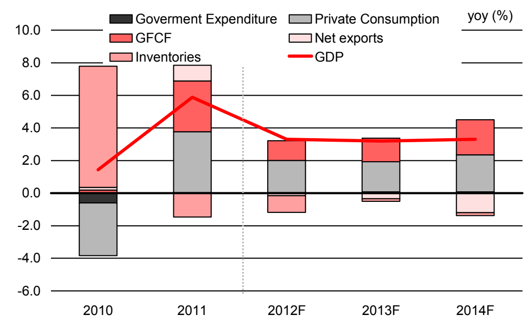
Outlook – Lithuania's 3Q GDP increased by 4.4% yoy (1.3% sa qoq) from 2.1% yoy in 2Q (0.6% sa qoq). On the back of a continuing significant contribution from net exports and the latest strong GDP result, we revise our FY12 forecast to 3.3%. Both retail trade and industrial production showed an improving performance in the first month of 4Q versus 3Q. Industrial production in October grew 14.4% yoy (10.2% yoy wda). Elections brought changes to the political landscape, but not to economic policy. Algirdas Butkevicius, the next PM, mentioned 2015 as the most likely EMU accession year.

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

KEY DATES/EVENTS

- Dec– Voting on the 2013 budget
- 30 Jan, 28 Feb - 4Q GDP (prelim., final)
- 21 Jan, 21 Feb, 21 Mar – Industrial production

CONSUMPTION TO SUPPORT GROWTH



INFLATION TO SLOW DOWN

Source: Statistics Lithuania, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2010	2011	2012F	2013F	2014F
GDP (EUR bn)	27.4	30.2	32.2	34.1	36.2
Population (mn)	3.3	3.3	3.3	3.3	3.3
GDP per capita (EUR)	8,257	9,161	9,803	10,400	11,033
Real economy yoy (%)					
GDP	1.2	5.9	3.3	3.2	3.3
Private Consumption	-4.1	4.7	3.0	3.0	3.7
Fixed Investment	-0.3	17.1	6.0	7.0	10.0
Public Consumption	-3.0	0.9	0.2	0.5	0.5
Exports	16.3	13.7	7.0	8.4	9.5
Imports	17.6	12.7	7.4	9.0	11.1
Monthly wage, nominal (EUR)	600	615	638	647	664
Unemployment rate (%)	14.5	11.7	10.0	9.0	7.8
Fiscal accounts (% of GDP)					
Budget balance	-7.5	-4.2	-3.1	-2.5	-2.5
Primary balance	-4.6	-3.1	-1.1	-0.5	-0.7
Public debt	35.0	35.9	36.9	37.3	37.6
External accounts					
Current account balance (EUR bn)	0.3	-0.5	-0.9	-0.7	-0.7
Current account balance/GDP (%)	1.6	-1.7	-2.9	-2.0	-1.9
Basic balance/GDP (%)	4.3	1.3	-1.7	0.5	1.2
Net FDI (EUR bn)	0.7	0.9	0.4	0.9	1.1
Net FDI (% of GDP)	2.6	3.0	1.2	2.5	3.1
Gross foreign debt (EUR bn)	24.1	24.8	25.4	25.9	25.0
Gross foreign debt (% of GDP)	87.8	82.1	79.1	76.0	69.1
FX reserves (EUR bn)	4.9	5.2	5.5	5.2	5.1
Inflation/Monetary/FX					
CPI (pavg)	1.1	4.1	3.0	2.8	2.7
CPI (eop)	3.6	3.4	3.2	2.5	2.8
3M money market rate	1.56	1.77	0.75	1.00	1.05
USD/LTL (eop)	2.60	2.60	2.66	2.56	2.47
EUR/LTL (eop)	3.45	3.45	3.45	3.45	3.45
USD/LTL (pavg)	2.60	2.47	2.66	2.59	2.58
EUR/LTL (pavg)	3.45	3.45	3.45	3.45	3.45

Source: UniCredit Research

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

Accelerating again, but slowdown on the horizon

Economy peaked again

Lithuania's 3Q GDP increased by 4.4% yoy (1.3% sa qoq) from 2.1% yoy in 2Q (0.6% sa qoq). In qoq terms, the current reading is the highest rate of growth since 2Q11 and brings economic growth for the first three quarters of 2012 to 3.4% yoy. Looking at the structure of the economic expansion in 3Q, we see that the biggest contribution came from net exports (2.6pp). Personal consumption added another 1.9pp. All other components (including GFCF) had a less pronounced effect the final reading, with public consumption contributing 0.1pp and GFCF taking 0.8pp from 3Q GDP. The continuing significant contribution from net exports (mostly supported by the growth of exports) and from the latest strong GDP result have led us to revise upward our FY12 forecast to 3.3% from 3.0%.

Retail sales and industrial production are continuing to improve…

Both retail trade and industrial production showed an improving performance in the first month of 4Q. Retail trade increased by 4.9% yoy in October (+0.8% mom sa), from only 0.7% yoy in September. 3Q12 recorded an average of 3.0% yoy retail trade growth. Industrial production in the first month of 4Q posted a very impressive result of 14.4% yoy (10.2% yoy wda) but remains somewhat volatile.

…while inflation slows

Inflation slowed to 3.1% yoy (0.2% mom) in October from September's 3.4% yoy. The yoy reading is the lowest since July of this year. Looking at the components' breakdown, the good news is the deceleration of heating, electricity and gas price growth, which fell sharply to 3.1% yoy from 4.8% yoy in September. Especially positive here is that this deceleration occurred in the middle of the heating season. Food and beverage inflation remained roughly in line with that of September, rising by only 0.1pp to 3.0% yoy. In our view, the combination of these two factors may have a positive effect on personal consumption.

Export/import dynamic is sound

The 9M cumulative C/A deficit came to 1.3% of FY12 GDP, as September's C/A deficit came in at LTL 475mn (approx. -0.4% of the estimated FYGDP). In yoy terms, the September deficit significantly increased from a marginal LTL 15mn surplus posted a year ago. Overall, the September results look fairly neutral to us. The positive (albeit expected) news is the sound performance of exports vs. imports and continuing inflow of FDIs. Looking at the September C/A structure, the goods and services trade deficit combined narrowed by 12.5% yoy to LTL 225mn, driven by faster yoy growth of exports (13.7% yoy) vs. imports (12.8% yoy). The financial account posted some positive developments as FDI remained effectively unchanged yoy, staying at LTL 683mn, and portfolio investments in September stayed in positive territory, but decreased by 45.2% yoy to LTL 324mn.

Elections brought changes to the political landscape, but not to economic policy

Following general elections held in Lithuania on 14 and 28 October, President Grybauskaite agreed to name Algirdas Butkevicius as the next Prime Minister. As a reminder, the Social Democrats party, led by Butkevicius, won the greatest number of seats in the newly-elected parliament (38 of 141). Following the elections, a coalition agreement was signed between Social Democrats, Labor party (29 seats) and Order and Justice (11 seats) and Electoral Action of Poles in Lithuania (8 seats) – all were formerly in the opposition. Despite the political noise around the nomination, we see few risks for fiscal or economic policies going forward. After the elections, Algirdas Butkevicius already reconfirmed his adherence to the 3% of GDP deficit policy, and mentioned 2015 as the most likely EMU accession year. The first real test for these statements will be voting on the new 2013 budget, which is one of the first laws to be approved by the newly-elected parliament. The current 2013 budget draft was prepared by the departing cabinet of Andrius Kubilius, with the budget deficit at 2.5% of GDP and a forecast of 3% economic growth in 2013. To date, the fiscal situation remains well managed and under control, so we revise our end of year deficit to under 3.0%. And we see few risks to the 2013 deficit forecast of 2.5% to GDP.

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

Outlook – We have revised down our GDP growth expectations for this year and next to 2.1% and 1.7%. Softer GDP numbers plus declines in gas and electricity prices in January 2013 will push down the inflation path, prompting the MPC to cut rates further. After a 25bp cut in November and December, we expect another 50bp of easing in 1Q13 (ie 100bp in the cycle). The biggest worry for 2013, apart from the uncertain GDP path, will be the situation in public finances.

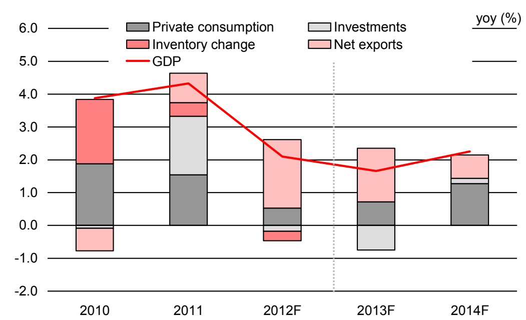
Strategy outlook – We see limited potential for POLGB and for the zloty to rally in the context of a worsening fiscal outlook and weaker Bunds. The curve is likely to steepen. EUR-PLN will likely stay in a 4.05-4.25 range in the coming months.

Author: Marcin Mrowiec, Chief Economist (Bank Pekao)

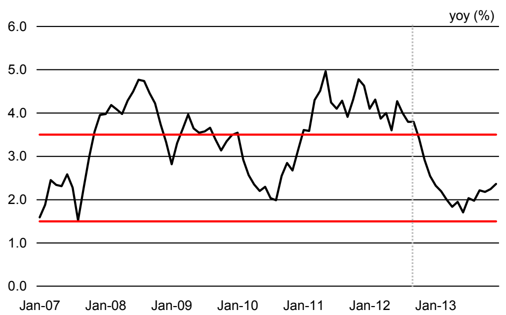
KEY DATES/EVENTS

- MPC decision-making meetings –
  8-9 January, 5-6 February, 5-6 March
- 4Q GDP – end-February
- The NBP releases update to inflation projection – March

NET EXPORTS – KEY DRIVER OF GROWTH IN 2013



CPI TO FALL SIGNIFICANTLY IN 2013



Source: NBP, GUS, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2010	2011	2012F	2013F	2014F
GDP (EUR bn)	354.6	369.7	380.5	393.3	418.0
Population (mn)	38.2	38.1	38.1	38.1	38.0
GDP per capita (EUR)	9,283	9,709	9,995	10,336	10,990
Real economy yoy (%)					
GDP	3.9	4.3	2.1	1.7	2.3
Private Consumption	3.2	2.6	0.9	1.2	2.1
Fixed Investment	-0.4	9.0	-0.9	-3.8	0.8
Public Consumption	4.1	-1.7	-0.6	0.3	0.6
Exports	12.1	7.7	0.6	0.8	3.1
Imports	13.9	5.4	-1.5	-0.8	2.4
Monthly wage, nominal (EUR)	860	875	889	922	981
Unemployment rate (%)	12.1	12.4	12.8	13.5	13.2
Fiscal accounts (% of GDP)					
Budget balance	-7.9	-5.0	-3.5	-3.8	-3.0
Primary balance	-0.7	0.7	1.0	0.8	0.0
Public debt	54.8	56.4	56.2	57.9	57.8
External accounts					
Current account balance (EUR bn)	-18.1	-18.0	-12.1	-10.2	-12.6
Current account balance/GDP (%)	-5.1	-4.9	-3.2	-2.6	-3.0
Basic balance/GDP (%)	-2.2	-1.2	-1.9	-0.2	-0.5
Net FDI (EUR bn)	10.5	13.6	5.0	9.5	10.7
Net FDI (% of GDP)	3.0	3.7	1.3	2.4	2.6
Gross foreign debt (EUR bn)	236.0	251.0	260.1	271.7	293.9
Gross foreign debt (% of GDP)	66.6	67.9	68.4	69.1	70.3
FX reserves (EUR bn)	70.0	75.7	77.6	75.8	78.9
Inflation/Monetary/FX					
CPI (pavg)	2.6	4.3	3.7	2.2	2.4
CPI (eop)	3.1	4.6	2.5	2.6	2.5
Central bank target	2.5+/- 1%	2.5+/- 1%	2.5+/- 1%	2.5+/- 1%	2.5+/- 1%
Central bank reference rate (eop)	3.50	4.50	4.25	3.75	3.75
3M money market rate	3.94	4.54	4.92	3.75	3.80
USD/PLN (eop)	2.98	3.32	3.22	3.05	2.94
EUR/PLN (eop)	3.96	4.42	4.18	4.12	4.12
USD/PLN (pavg)	3.01	2.94	3.23	3.13	3.06
EUR/PLN (pavg)	3.99	4.12	4.19	4.18	4.10

Source: NBP, GUS, UniCredit Research

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

Economy to bottom in Q1 2013

We have revised our GDP forecast for 2012 to 2.1% from 2.6% and for 2013 to 1.7% from 2.2% – the economy should bottom out in 1Q13

We have revised our 2012 GDP forecast down to 2.1% from 2.6% and for 2013 down to 1.7% from 2.2%. One key reason for the revision comes from recent revisions to past GDP data, which showed that private consumption in relatively "good times" (2011, with GDP at 4.3%, as well as in early 2012) was on average growing 0.5pp slower than GUS had previously reported. Private consumption will be under even greater pressure (esp. in 1H13), due to the deterioration in the labor market. At the same time, the aggregates that were set to weaken in 2013 (like public investments and public consumption) were revised up for 2011 and 1H12, thus creating an even higher statistical base for the future. Another reason for our revision was the recent real-economy data releases, as these numbers surprised to the downside. The good news is that it is likely that economy will bottom out sometime in 4Q12-1Q13, and should accelerate afterwards, in line with improving situation in the eurozone.

However, one should keep in mind serious headwinds that will make this rebound very gradual. First, the inflow of EU funds will slow down, thus negatively affecting public investment. According to government estimates, public investments added 0.7pp to GDP growth on average in 2005-2011, whereas in 2012 and 2013 the contribution will be a negative 0.6pp and 0.7pp respectively. The private sector is declaring a low propensity to invest and hence we expect a 3.8% yoy reduction in investment in 2013, after -0.9% yoy in 2012. Private consumption is expected to rebound gradually (1.2% yoy expected for 2013, after 0.9% in 2012), as even if the economy rebounds more strongly than currently anticipated, it will take a few quarters before this feeds through into higher wages and employment, and finally into consumption. Once GDP bottoms out in 1Q13 at around 0.8% yoy, we expect it to gradually accelerate to 2.3% yoy in 4Q13.

It seems that GDP growth in the next 2-3 years will not exceed potential growth, estimated at 2.8-2.9% by the NBP

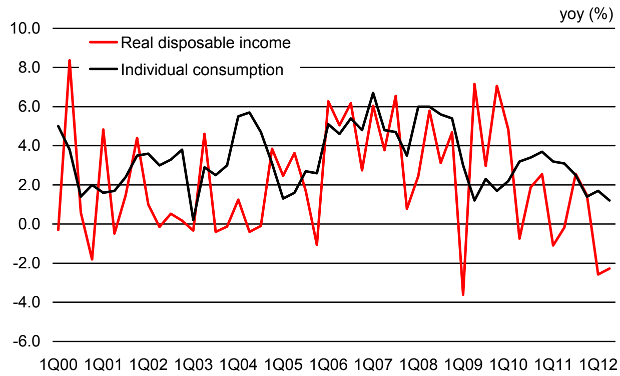
Looking further into the future, it seems that in the next 2-3 years economic growth will not exceed potential growth, estimated at 2.8-2.9% by the NBP. Whereas the fundamental situation of the country remains solid (government actively working to consolidate public finances; one of the best-capitalized and best-regulated banking systems in Europe; relatively flexible labor market, which will be additionally strengthened with the freeing up of many regulated professions soon), the decrease in the inflow of EU money and a stagnant labor market will keep consumption and investment growth rather muted.

CPI inflation will fall to 2.5% by end-2012, and bottom out around mid-2013

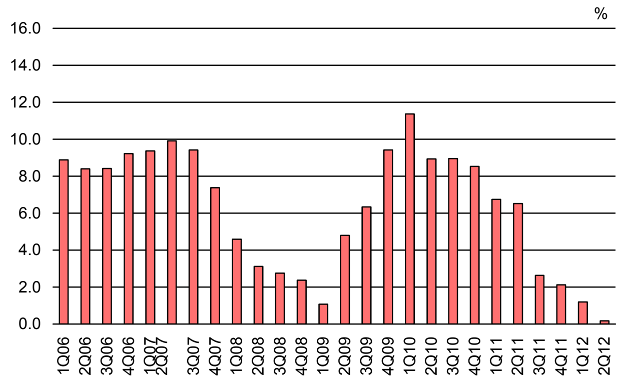
Focussing on CPI, inflation is likely to decline to 2.5% yoy by end-2012 and continue to fall until June 2013, when we expect it to bottom out at around 1.7% yoy. It will likely stay around 2% in the following few months, before rebounding towards the inflation target (2.5%) by end-2013. This follows an extended period of above target inflation – in the 58 months since end-07, inflation has been on target for only 6.

PRIVATE CONSUMPTION WILL STAY UNDER PRESSURE FROM WEAK LABOR MARKET AND LOW SAVINGS RATE

Weaker labour markets translate into negative real disposable income growth and weaker consumption growth



Household saving rate is close to zero – building buffers going forward means consumption will remain sluggish



Source: NBP, StatOffice, UniCredit Research

The NBP started a rate-cutting cycle in November, and we expect it to deliver 50bp of cuts this year, followed by another 50bp in 1Q13

The MPC initiated a rate-cutting cycle in November 2012 – we expect a total of 100bp of cuts in this cycle. 2012 has been rather problematic for the MPC, as CPI inflation stood above the upper end of the MPC's inflation "tolerance zone" (1.5-3.5%) for most of the year, whereas GDP was sending clear signals of a slowdown. Worries about inflation were strong enough to trigger a rate hike in May, which was "erased" only in November. Going forward, the situation seems clearer, as CPI inflation will likely stay in the MPC's target zone for most of (or the whole of) 2013, and – according to NBP projections – GDP growth is set to remain below potential growth not only in 2013, but in 2014 as well. The risks to this scenario are the following. The global economic rebound may push commodity prices high in a relatively short time, hitting into inflation, and thus limiting room for rate cuts. Another risk is an outflow by foreign investors from the POLGB market (they now hold more than PLN 180bn), e.g. triggered by fiscal worries. That could weaken the zloty significantly, and thus loosen the MCI, without further rate cuts.

The state's budget deficit figure is likely to exceed the official plan of PLN 35.6bn by close to PLN 20bn due to weaker growth, and as tax revenue forecasts seem overestimated

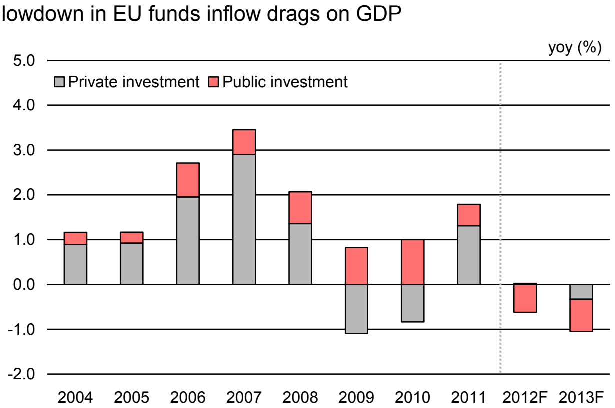
The official 2013 budget deficit is likely to be higher than expected, due to weaker growth and too much optimism in tax revenue forecasts. The official budget deficit forecast for 2013 is PLN 35.6bn, but our estimates show it may be almost PLN 20bn higher, due to two key reasons. Firstly, the forecast was built on the assumption of 2.2% GDP growth, which now seems overly optimistic and even prime minister Donald Tusk admitted that it is likely that growth will be weaker next year. Secondly, and more importantly, the cabinet was too optimistic with regard to tax revenue, assuming growth in most items in spite of the fact that 2013 economic growth will be weaker than in 2012, and it will have a less favorable structure from the point of view of tax revenue (weaker domestic absorption and strong exports (with zero-VAT)). VAT revenue has already been overestimated for 2012 (the cabinet assumed 9.3% yoy growth, whereas the actual figure is likely to be around -2% yoy), and for 2013, 4% growth is assumed, whereas we would assume a decline of around 3%. VAT is the single most important item, both for 2012 and for 2013, but growth of other tax revenue also seems to have been overestimated for 2013. After adjusting the figures, in our view the tax revenue may be lower by close to PLN 20bn next year. That would mean a deficit of around 3.5% of GDP in 2013, close to this year's 3.6%. It should be noted, though, that the cabinet implemented all the fiscal consolidation measures it announced – the shortfall comes on the back of weaker growth and a less favorable structure of this growth. Nonetheless, this will necessitate higher T-bond issuance (although by a smaller amount than revenue shortfall; the Cabinet will likely find some savings) next year to meet borrowing needs.

C/A deficit is going to decline below 3% GDP in 2013

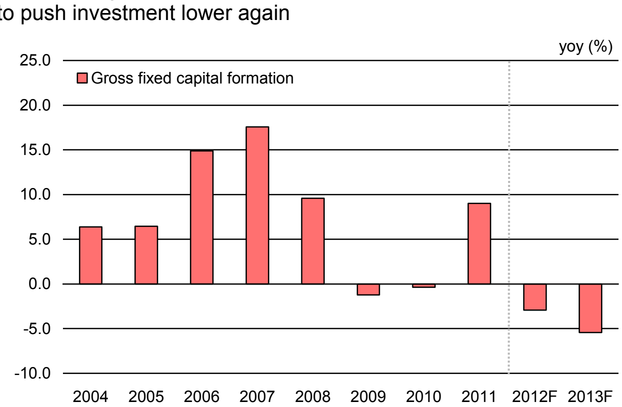
Regarding the 2013 BOP, we expect some rebound in exports in 2H13 (on the back of EU recovery), which will also slightly increase imports (inputs for exports' production). The stronger increase of exports than imports should translate into further narrowing of trade balance (to circa EUR 3.3bn from 4.4bn in 2012) and also narrowing of C/A gap (from 3.2% GDP in 2012 to 2.6% in 2013).

INVESTMENTS WILL SEE THEIR STRONGEST DECLINE IN A DECADE NEXT YEAR

Slowdown in EU funds inflow drags on GDP



Deteriorating public investments and weak private investments to push investment lower again



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

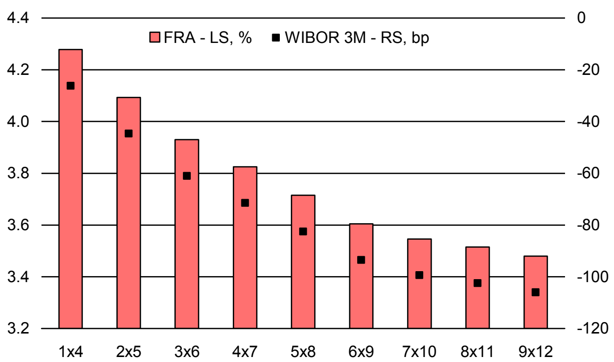
Strategy: Limited upside in local markets

In 2013 we expect moderate upward pressure on bond yields amid a lower growth environment, weaker fiscal performance and weaker bunds

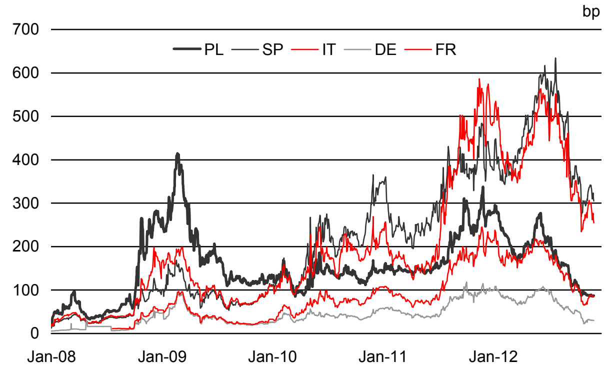
Taking into account the short-term story (possible lack of auctions in December, window dressing, etc.), we do not exclude that bonds continue their rally into year end but over a longer horizon, we see a risk of correction and yields closer to 4.50% at the longer end of the curve in the context of a less comfortable fiscal situation and the potential for upward pressure on bunds. Short-term paper may suffer from disappointment regarding the overall size of the rate cutting cycle but changes should be limited due to excess liquidity in the local banking sector and shortening duration by investors. As a consequence, the curve may be steeper by some 10-20bp at the end of 1Q13. In FX we see little further upside for the zloty in the near term in the face of rate cuts and the potential for a slowdown of inflows into POLGBs. We expect range-trading in the 4.05-4.25 range over the next couple of months.

EXPECTATIONS OF RATE CUTS AND GOOD PERCEPTION OF POLAND BROUGHT T-BOND YIELDS TO RECORD LOWS; NOT MUCH ROOM FOR FURTHER YIELD DECLINES

The market is pricing in more than 100bp cuts in the next 9M



Poland CDS spreads (5Y, bp) are now trading at par with France, and below Italy and Spain



Source: MinFin, NBP, UniCredit Research

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2012F	2013F	2014F
Gross financing requirement	**42.9**	**37.5**	**37.7**
Budget deficit	14.3	14.8	12.4
Amortization of public debt	28.6	22.7	25.3
Domestic	24.6	19.0	21.2
Bonds	21.7	17.5	18.3
Bills	2.9	1.5	2.9
External	4.0	3.7	4.0
IMF/EU	0.0	0.0	0.0
Financing	**42.9**	**37.5**	**37.7**
Domestic borrowing	35.1	29.5	28.6
Bonds	32.2	26.4	27.8
Bills	2.3	4.3	1.7
Other	0.6	-1.2	-0.9
External borrowing	7.8	8.0	9.1
Bonds	5.1	5.3	6.5
IMF/EU	0.0	0.0	0.0
Other	2.7	2.7	2.6

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2012F	2013F	2014F
Gross financing requirement	**104.0**	**98.5**	**104.3**
C/A deficit	12.1	10.2	12.6
Amortization of medium to long term debt	17.5	14.0	14.5
Government/central bank	4.0	3.7	4.0
Banks	7.2	6.0	6.0
Corporates	6.3	4.3	4.5
Short term debt amortization	74.4	74.3	77.2
Financing	**104.0**	**98.5**	**104.3**
FDI	5.0	6.5	7.5
Equity	2.3	3.0	3.5
Borrowing	99.3	96.7	101.3
Government/central bank	7.8	8.0	9.1
Banks	37.0	36.5	38.4
Corporates	54.6	52.1	53.7
EU transfers	9.0	8.0	7.0
Other	-11.6	-15.7	-15.0

Source: NBP, MinFin, UniCredit Research

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

Outlook – GDP will stagnate in 2012 and grow below 2% over the next two years. Structural reforms are needed to accelerate growth, but political will is waning. We hope for further pressure from the IMF, since a third agreement could come only after fulfilling further provisions from the second loan deal (privatisations and reducing public sector slack). A strong fiscal adjustment story, Romania needs to show consistency in policy implementation and refrain from renewed political quarrelling if it wants to profit from risk appetite.

Strategy – 2013 should be the year of RON sovereign bonds. With attractive entry prices (that could be enhanced by political noise in December 2012), a low share of foreign investors and strong anchors from a new IMF agreement and inclusion in local debt indices, RON debt should rally in 2013, reducing the liquidity premium it currently pays over other CEE bonds.

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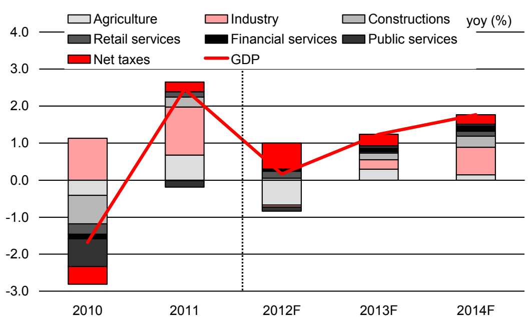
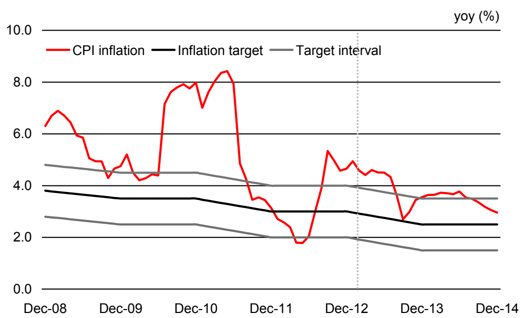
KEY DATES/EVENTS

- Jan 7th, Feb 5th – NBR rate decisions
- Jan 7th – IMF review
- Mar 2013: 4Q GDP
- Mar 2013: second IMF agreement ends

GDP GROWTH RECOVERS GRADUALLY



INFLATION TO MODERATE IN 2013



Source: NBR, CSO, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2010	2011	2012F	2013F	2014F
GDP (EUR bn)	124.1	136.5	135.9	140.1	144.4
Population (mn)	21.50	21.40	21.40	21.40	21.40
GDP per capita (EUR)	5,774	6,379	6,349	6,546	6,750
Real economy yoy (%)					
GDP	-1.7	2.5	0.2	1.3	1.8
Private Consumption	-2.0	0.7	-0.2	0.5	1.3
Fixed Investment	-13.1	6.4	2.8	3.8	5.4
Public Consumption	-3.2	-3.5	-0.5	0.1	0.4
Exports	13.1	9.9	-0.6	2.7	5.2
Imports	11.6	10.5	-0.2	2.8	3.6
Monthly wage, nominal (EUR)	334	346	344	350	359
Unemployment rate (%)	7.3	7.4	7.3	7.2	7.0
Fiscal accounts (% of GDP)					
Budget balance	-6.8	-5.2	-3.0	-3.0	-3.0
Primary balance	-5.3	-3.7	-1.6	-1.6	-1.6
Public debt	30.5	33.3	34.5	35.5	36.0
External accounts					
Current account balance (EUR bn)	-5.5	-6.0	-5.0	-4.9	-4.3
Current account balance/GDP (%)	-4.4	-4.4	-3.7	-3.5	-3.0
Basic balance/GDP (%)	-4.2	-3.9	-2.8	-2.3	-1.0
Net FDI (EUR bn)	2.2	1.8	1.5	2.0	2.6
Net FDI (% of GDP)	1.8	1.3	1.1	1.4	1.8
Gross foreign debt (EUR bn)	92.5	98.4	100.4	101.2	104.6
Gross foreign debt (% of GDP)	74.5	72.1	73.9	72.2	72.4
Fx reserves (EUR bn)	32.4	33.2	31.4	27.9	26.9
Inflation/Monetary/FX					
CPI (pavg)	6.1	5.8	3.3	4.0	3.5
CPI (eop)	8.0	3.1	4.6	3.6	3.0
Central bank target	3.5	3.0	3.0	2.5	2.5
Central bank reference rate (eop)	6.25	6.00	5.25	5.25	5.00
3M money market rate	6.25	6.30	6.00	5.40	5.25
USD/RON (eop)	3.20	3.34	3.50	3.47	3.32
EUR/RON (eop)	4.28	4.32	4.55	4.68	4.65
USD/RON (pavg)	3.18	3.05	3.47	3.46	3.41
EUR/RON (pavg)	4.21	4.24	4.46	4.58	4.69

Source: UniCredit Research

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

Further reforms needed for growth and fiscal stability

Agriculture and public investment sent GDP growth back in the red in 3Q12

After three years of successful fiscal adjustment, growth remains Romania's biggest challenge. But with domestic demand hit by austerity, a poor harvest and faltering exports amid weak economic activity in the EU, the country faces stagnation over the coming quarters. GDP contracted by 0.6% yoy in 3Q12 (-0.5% qoq) after drought hit wheat and maize crops and the government stopped infrastructure projects for lack of funding, causing investment to decline after growing 2.6% yoy in 1H12. Going forward, we expect a 0.1% yoy growth rate in 4Q12 driven by public consumption and rising inventories, bringing the annual growth rate to just 0.2%. On the supply side, the bad agriculture year spurs retail sales (up 3.6% yoy in 3Q12), but industry will not contribute to growth because of weakening activity in Germany.

Absent structural reforms, GDP growth will remain below 2%

GDP growth could pick up gradually in 2013 and 2014 to 1.3% and 1.8% respectively, in line with a slow recovery of economic activity in the euro area. Faster growth will depend on further structural reforms and better EU fund absorption. The former could aim at reducing public sector slack (while leaving more funds available for public investment) and increasing the participation of the labour force. The latter could offset poor foreign direct investment. Absent such measures, GDP (without agriculture) cannot grow faster than 2% yoy.

The trade deficit prevents the C/A deficit from narrowing faster…

The current account deficit shrank to 3.6% of GDP at the end of September from 4.4% of GDP at the beginning of the year, but the improvement relies on a narrower income balance deficit, on larger transfers to the government and service balance surplus for a combined reduction of EUR 1.0bn. Despite a weaker RON in 2012, the goods trade balance hovers at EUR 7.0bn FOB-FOB (EUR 10.0bn FOB-CIF) due to inelastic imports of energy and food, coupled with a high content of imports for Romanian exports.

…while coverage with FDI and EU funds remains the weakest in the region

Romania continues to be one of the weakest fund flow stories in CEE. FDI and capital account flows cover the smallest share of the current account among new EU members, leaving a gap of approximately 1.7% of GDP to be financed from more volatile inflows, such as portfolio investment. The latter turned to EUR 2.0bn outflows during this summer's political crisis and the 10M12 flows amounted to just EUR 1.0bn (0.7% of GDP). The dependence on volatile inflows could be reduced if Romania were to absorb more European funds. At less than 10% of fund allocation, Romania lags all other countries in CEE in terms of absorption of structural and cohesion funds and the country could try emulating Poland and the Baltics who have managed to attract 45%-60% of allocated funds. During the next financial programming period 2014-2020, the country risks receiving fewer funds than its size and needs would entail because European authorities want to punish underperformers.

Fiscal austerity helped reduce the budget deficit below 3% of GDP…

Romania's budget deficit will fall in 2012 below 3% of GDP (based on accruals, ESA 95 methodology) and the country will exit the Excessive Deficit Procedure (EDP). On cash basis, the deficit has been flat at 1.2% of GDP between July and October but local authorities have accumulated arrears following local elections in June.

…but further reforms are needed to ensure consolidation…

Further fiscal consolidation in 2013 will necessitate additional reforms in order to meet the deficit target of 2.2% of GDP (too tight a target given the current economic weakness throughout Europe). The Romanian authorities intend to implement a list of reforms with help from the IMF and the World Bank (WB): improving tax collection, simplifying tax payment procedures, better monitoring the tax duties of wealthy individuals, prioritising capital expenditure though multi-annual investment plans and further reducing the losses of state-owned enterprises. The first and last two items on the list have been permanently on the priority list of Romanian governments, with limited results. There are a number of risks to next year's budget. GDP growth could fall short of the government's 2% assumption while the wage bill will rise to 7-7.1% of GDP as wages are returned to June 2010 levels. EU fund disbursements will restart gradually after a negative audit in 2012. Lastly there is likely to be pressure from local administration for higher expenditure. Even if Romania fails to meet the 2.2% deficit target, a gap below 3% of GDP in 2013 will be a positive result. The structural deficit could fall next year below 1% of GDP, approaching the 0.7% medium-term target.

…and to secure a third IMF agreement

Although all parliamentary parties are committed to the IMF agreement, privatisations and public sector reforms have dragged over the past year. Romanian authorities would like to sign a third agreement when the current one expires in March 2013, but the IMF would like to see more results before that happens.

The NBR will focus on FX rather than interest rates…

The small amount and volatile nature of FX fund flows are likely to weigh on the RON in 2013. In this environment, the monetary policy will probably focus on the exchange rate, rather than interest rates. Although inflation was at 4.6% in November and will miss the 3% target this year, the National Bank of Romania (NBR) is unlikely to hike in 2013. The inflationary shock is caused by a temporary spike in food prices and the central bank believes it should not squeeze other categories of prices with tighter monetary policy for lack of structural reforms in agriculture and trade. Moreover, the central bank sees inflation returning to the target interval by the end of next year and fears moving against the easing trend in CEE. With limited scope for direct interventions, the NBR has used the supply of liquidity in order to fight depreciation. Since 8 October, one-week repos have been capped at a third of demand, while additional liquidity was provided through bilateral operations. The results are a 1.5% RON appreciation between mid-September and end-November and 3M money market rates above 6%.

… at the cost of hitting again bank results

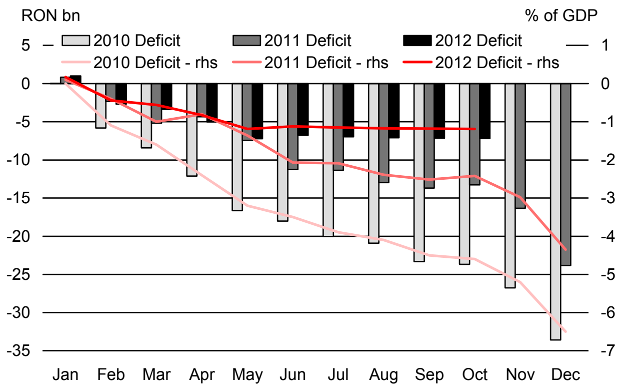
The banking system remains in the red, with the NBR expecting a slow recovery. EUR lending has been capped through a series of regulations aimed at reducing FX risk for unhedged borrowers, while RON lending remains expensive due to the high cost of funds and increasing NPLs (17.3% in September, with further increases expected). Slow deleveraging continues with the foreign liabilities of the banking system declining by EUR 1.5bn between September 2011 and September 2012. The real growth rate of lending turned negative during the autumn, with demand declining as economic prospects worsened.

MinFin to focus on diversifying the investor base for RON issuance

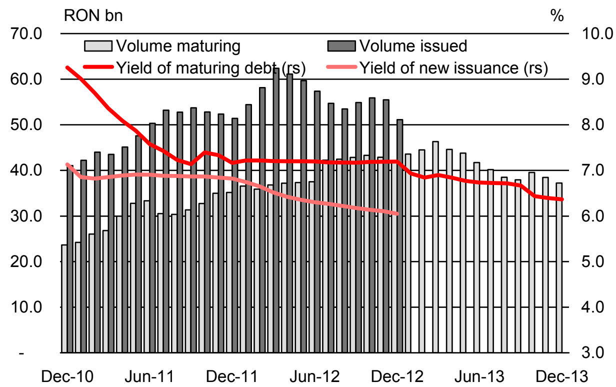
The MinFin has had its best year on international markets, selling EUR 2.25bn and USD 2.25bn of debt. The MinFin focuses now on local issuance, extending maturities and increasing liquidity to benchmark size for 2Y, 3Y and 5Y bonds, while accepting to pay higher yields (the spread between the average accepted yield and that of all bids has fallen below 20bp for 2 and 3Y from more than 1.5pp earlier this year). Hence, foreign interest in RON bonds has risen, fuelled by the inclusion in the Barclays local bond index from 31 March 2013 and advanced negotiations with JP Morgan. Foreign investors owned just 5.4% of RON marketable debt at the end of September, while the share for FX debt issued locally was 24.9%. During 2013, the MinFin plans to issue the equivalent of EUR 2.25bn in Eurobonds and found demand for 7-10Y debt in EUR and for 10-30Y debt in USD.

THE IMPROVED BUDGET EXECUTION REDUCES FUTURE FINANCING NEEDS, ALLEVIATING THE PRESSURE ON YIELDS

YTD cash budget deficit at 1.2% of GDP between June and October



Debt repayments peak in 2013.There is scope for higher RON yields



Source: MinFin, NBR, UniCredit Research

RON bonds – the potential of a rally

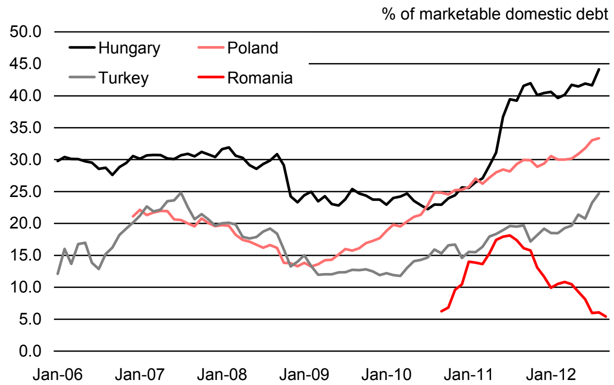
We're expecting RON bonds to rally in 2013 based on inclusion in local debt indices and IMF anchor…

Romania's local bond market has been an underperformer among regional peers. Foreign investors own 45% of Hungary's local debt, 30% of Poland's, and only 5.4% of Romania's. RON sovereign bonds pay a liquidity premium over HUF bonds, while ASW spreads for comparable FX bonds were 55 to 90 bp in favour of the RON at the beginning of December. We suppose JP Morgan will follow Barclay's and include RON bonds in local bond indices in 2013. The MinFin increased liquidity on 2Y, 3Y, 5Y and 15Y, allowing yields to rise 20bp since mid-October.

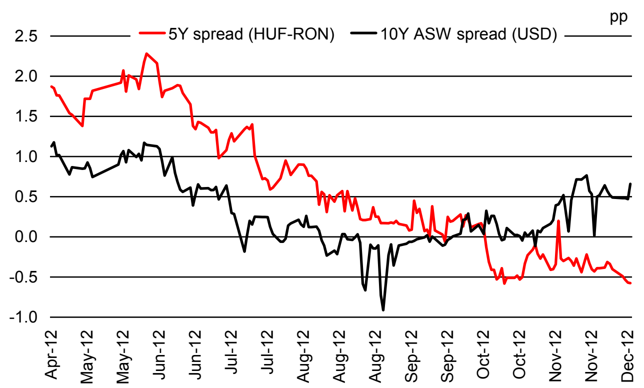
…but only after Romania gets a new government

The only threat to a rally in 2013 is political noise. While general elections are expected to yield the same governing coalition (the Social Liberal Union will probably have more than 50% of MPs), the president could prolong uncertainty by denying Victor Ponta another stint as PM (thus offering a more attractive entry price for a long RON bond position). Even if this scenario materialises, we expect a government to form and a new IMF agreement to be signed after the current one expires in March, providing further support to RON yields. Subsequently, we expect the 5Y RON yield to rally at least 60bp, closing the negative spread vs. HUF 5Y yield.

Foreign investors have been avoiding RON bonds



Hungary vs Romania bond spreads. RON debt is underperforming



Source: Bloomberg, UniCredit Research

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2012F	2013F	2014F
Gross financing requirement	**13.7**	**15.5**	**15.3**
Budget deficit	3.1	3.1	3.2
Amortisation of public debt	10.5	11.5	11.2
Domestic	9.8	11.5	11.2
Bonds	2.3	4.4	4.2
Bills	7.5	7.1	7.0
External	0.7	0	0
IMF/EU	0.1	0.9	1.0
Financing	**16.6**	**15.5**	**15.3**
Domestic borrowing	11.6	13.3	12.8
Bonds	6.0	5.3	5.2
Bills	5.6	7.9	7.7
External borrowing	5.0	2.3	2.5
Bonds	4.0	2.3	2.5
IMF/EU/WB	1.0	0	0
Other	0	0	0

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2012F	2013F	2014F
Gross financing requirement	**38.7**	**38.5**	**37.3**
C/A deficit	5.0	4.9	4.3
Amortisation of medium to long term debt	22.8	21.1	21.0
Government/central bank	2.0	1.0	1.0
Banks	7.5	6.3	6.0
Corporates	13.3	13.8	14.0
Amortisation of short term debt	10.9	12.5	12.0
Government/central bank	3.5	5.0	4.5
Banks	2.5	2.6	1.9
Corporates	4.9	4.9	5.6
Financing	**37.7**	**38.5**	**37.3**
FDI	1.5	2.0	2.6
Equity	-0.8	1.2	1.0
Borrowing	34.0	29.7	29.6
Government/central bank	6.5	3.5	3.5
Banks	9.0	8.4	7.5
Corporates	18.5	17.8	18.6
EU Funds	1.2	1.7	2.8
NBR FX reserve change	1.8	3.9	1.3

Source: IMF, NBR, Unicredit Research

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

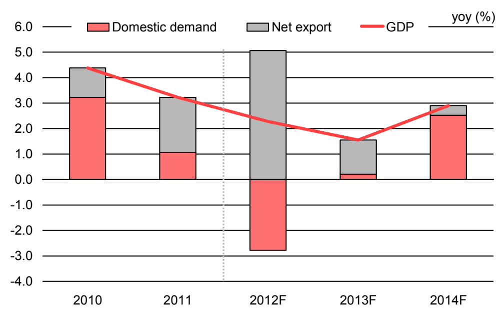
Outlook – Slovakia has outperformed many other countries in the region in terms of GDP this year but expect a gradual slowdown ahead as the positive car industry boost fades and domestic demand remains weak. Parliament has approved a new less flexible labour code which poses a risk to unemployment in a slowing economy. The state budget to be approved in coming days targets a 3%/GDP deficit in 2013, with some risks from growth projections. Consolidation measures are revenue rather than expenditure focussed. A record high trade surplus is expected to shrink only as domestic demand recovers (2014), The CA should thus remain in moderate surplus.

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

KEY DATES/EVENTS

- 11 Jan, 8 Feb, 11 Mar – Industrial production
- 14 Jan , 13 Feb, 13 Mar - CPI
- 14 Feb – flash GDP
- 6 Mar – 4Q GDP and its structure

NET EXPORT AS A MAIN GROWTH DRIVER OF SLOVAK ECONOMY



INFLATION ACCELARATING DRIVEN BY FOOD

Source: Statistical Office SR, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2010	2011	2012F	2013F	2014F
GDP (EUR bn)	65.9	69.1	71.7	73.8	77.1
Population (mn)	5.4	5.4	5.4	5.4	5.4
GDP per capita (EUR)	12,128	12,725	13,205	13,592	14,191
Real economy yoy (%)					
GDP	4.4	3.2	2.3	1.6	2.9
Private Consumption	-0.8	-0.5	-0.2	-0.4	0.8
Fixed Investment	6.5	14.2	-2.1	2.1	3.0
Public Consumption	1.0	-4.3	-1.1	-1.5	0.0
Exports	16.0	12.7	8.0	4.0	5.9
Imports	14.9	10.1	2.7	2.9	6.4
Monthly wage, nominal (EUR)	769	786	805	830	859
Unemployment rate (%)	14.4	13.5	14.0	14.5	14.1
Fiscal accounts (% of GDP)					
Budget balance	-7.7	-4.8	-4.6	-2.9	-2.5
Primary balance	-6.9	-3.6	-2.9	-0.6	0.1
Public debt	41.1	43.3	50.9	52.3	52.6
External accounts					
Current account balance (EUR bn)	-2.5	-1.4	0.4	0.6	0.4
Current account balance/GDP (%)	-3.7	-2.1	0.5	0.8	0.5
Basic balance/GDP (%)	-2.2	-0.8	1.8	2.0	1.7
Net FDI (EUR bn)	1.3	1.5	1.2	0.7	1.2
Net FDI (% of GDP)	2.0	2.2	1.7	0.9	1.5
Gross foreign debt (EUR bn)	49.7	52.9	55.5	57.6	60.2
Gross foreign debt (% of GDP)	75.4	76.6	77.4	78.0	78.2
FX reserves (EUR bn)	EUR	EUR	EUR	EUR	EUR
Inflation/Monetary/FX					
CPI (pavg)	1.0	3.9	3.7	3.0	3.1
CPI (eop)	1.3	4.4	3.6	2.8	3.4
Central bank target	EUR	EUR	EUR	EUR	EUR
Central bank reference rate (eop)	EUR	EUR	EUR	EUR	EUR
3M money market rate	EUR	EUR	EUR	EUR	EUR
EUR/USD (pavg)	EUR	EUR	EUR	EUR	EUR
EUR/USD (pavg)	EUR	EUR	EUR	EUR	EUR

Source: UniCredit Research

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

Cars braking, economy to slow down

Fiscal consolidation measures mostly revenues-based

One of the most discussed topics in recent months in Slovakia was public finances and related austerity measures. The left-wing government led by Robert Fico has committed to decrease the budget deficit to 2.9% of GDP by the end of 2013 in line with the excessive deficit procedure. This rather ambitious goal is based on the GDP growth of 2.5% in 2012 and 2.1% in 2013 and assumes the planned deficit of 4.6% of GDP for 2012 is met. The budget counts upon proposed austerity measures, some of which have already been approved – increase of corporate and personal income tax, increase of social security contributions for self-employed, special levy for regulated sectors, extension of bank levy on retail deposits (effective September 2012), increase of excise duty on tobacco and administrative fees.

The recent measures also include shifting some pension contributions from the second to the first pillar, generating additional revenue for the budget in coming years but also increasing government pension obligations in the future. Although the government committed to freeze budget spending, most of measures focus on the revenue side. The government set aside a reserve of EUR 313 million to cover the risk of lower than expected GDP growth due to the persisting uncertainty. Since Fico's social democratic SMER party have majority in the parliament and the opposition is weak, we expect the budget for 2013 to be approved by the parliament without any political tension.

Debt brake to be activated already this year, coalition considers changes in constitutional law

While Slovakia's public debt ratio is still relatively moderate, it is expected to exceed 50% of GDP in 2012 which is the first threshold of the local debt brake. The increase is partially caused by the recent issue of extra debt to cover future needs, taking advantage of current favourable financial markets. The Minister of Finance is proposing a change to the Fiscal Responsibility Law (constitutional law – support of opposition parties needed) for the pre-financing amount to be excluded from the debt break assessment base. The opposition parties are open to discuss and support such changes in debt brake.

New Labour Code strengthening protection of employees and trade unions

The Slovak parliament has recently approved amendments to the Labour Code (effective January 2013) which aim at strengthening protection of employees and trade unions. The new Labour Code is less liberal as it reduces workplace flexibility by changing a possibility for employers to sign successive employment contacts for a definite period and increases firing costs by reintroduction of concurrency of full notice period and severance pay. These amendments may create tensions for employers who expect a drop in sales to lay off part of their permanent employees in advance, resulting in further increase of unemployment in 4Q. To combat the high unemployment especially among young people (Slovakia has one of the highest youth-unemployment rates in the EU), the Labour Ministry introduced a programme to create jobs for young people by providing subsidies from EU funds.

Economy continues to growth

The economy continued a dynamic growth in 3Q 12 with 0.6% qoq and 2.2% yoy. We expect GDP growth to be still driven mostly by net exports (stimulated by autos) while the domestic demand remains weak. Industrial production showed double-digit growth in 3Q 12 (16.1% yoy), clearly driven by automotive (75.6% yoy due to extra production coming on line from KIA and Volkswagen), while ex-auto manufacturing declined. The slow-down of euro-zone economies reflected on weaker performance of the export oriented sectors except of automotive in 3Q. Growing automotive and weak domestic demand contributed to extension of foreign trade surplus (4.3% of GDP). FT surplus is expected to shrink only with recovery of domestic demand, probably not sooner as in 2014.

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

External demand is expected to be main driver of the growth also in 2013, while domestic demand should be inhibited by fiscal consolidation. We expect 2012 GDP growth at 2.3% yoy (showing small qoq contraction in 4Q), decelerating to 1.6% yoy in 2013 (carry over effect for 2013 expected to be only 0.2% vs. 1.0% in 2012). Growth should remain jobless and in combination with the less flexible labour code could keep the unemployment rate at relatively high levels. Real wages are expected to decline further in 2012 and stabilize in 2013, postponing a recovery of household consumption to 2014.

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

Outlook – The Slovenian economy slid further into recession in 3Q12 after posting its second consecutive quarter of contraction. Against this backdrop, we have lowered our FY12 GDP growth forecasts to -2.2% yoy, and to -1.3% yoy for 2013. On the fiscal side, we expect the budget deficit to narrow to 4.1% of GDP this year, followed by a widening to 6.5% of GDP in 2013 due to bank recapitalization costs. Of key concern remains the referendum vote over the Bank Stability Law, expected to take place early next quarter. Should the referendum pass, we see the government failing to raise the required EUR 4bn worth of funding required from the banking sector from the market, eventually forcing it to seek funding from the troika.

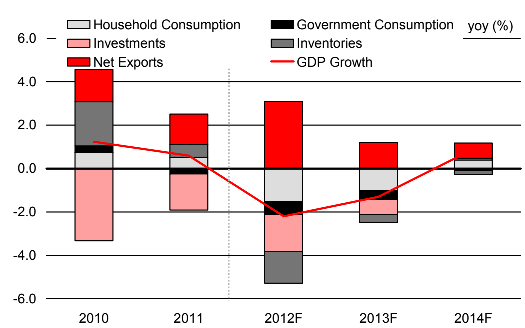
Strategy outlook – We have a bias to enter a long bond position but wait for more clarity/ market nervousness surrounding the referendum

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

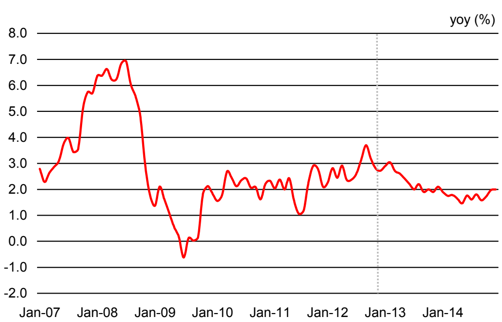
KEY DATES/EVENTS

- 23 Dec – Deadline for the collection of signatures for the referendum on the Banking Stability Law
- 28 Dec, 28-1 Jan, 25-1 Feb, 25-29 Mar – Consumer Price Index
- 28 Dec, 28-1 Jan, 25-1 Feb, 25-29 Mar – Retail Trade
- 7-11 Jan, 11-15 Feb, 11-15 Mar – Industrial Production
- Jan-Feb – Possible referendum vote

ECONOMY BACK IN RECESSION



CPI TO REMAIN BELOW EU AVERAGE



Source: IMF, MinFin, Eurostat, Unicredit Research

MACROECONOMIC DATA AND FORECASTS

	2010	2011	2012F	2013F	2014F
GDP (EUR bn)	35.6	36.2	35.7	35.6	36.3
Population (mn)	2.0	2.1	2.1	2.1	2.1
GDP per capita (EUR)	17,381	17,628	17,438	17,389	17,711
Real economy yoy (%)					
GDP	1.2	0.6	-2.2	-1.3	0.9
Private Consumption	1.3	0.9	-2.7	-1.8	0.7
Fixed Investment	-13.8	-8.1	-9.1	-4.0	0.5
Public Consumption	1.5	-1.2	-3.0	-2.1	-0.4
Exports	10.1	7.0	1.5	3.2	5.2
Imports	7.9	5.2	-2.8	1.8	4.8
Monthly wage, nominal (EUR)	1,495	1,525	1,531	1,546	1,564
Unemployment rate (%)	7.3	8.2	8.5	9.1	9.5
Fiscal accounts (% of GDP)					
Budget balance	-5.8	-6.4	-4.1	-6.5	-3.7
Primary balance	-4.2	-4.5	-1.8	-3.9	-0.9
Public debt	38.6	46.9	51.5	69.4	71.8
External accounts					
Current account balance (EUR bn)	-0.2	0.0	0.4	0.6	0.5
Current account balance/GDP (%)	-0.6	0.0	1.1	1.7	1.5
Basic balance/GDP (%)	0.6	1.8	2.5	2.9	2.5
Net FDI (EUR bn)	0.4	0.6	0.5	0.4	0.4
Net FDI (% of GDP)	1.2	1.8	1.4	1.2	1.0
Gross foreign debt (EUR bn)	40.7	40.2	41.8	42.6	44.0
Gross foreign debt (% of GDP)	114.4	111.2	116.9	119.6	121.1
Inflation/Monetary/FX					
HICP (pavg)	2.1	2.1	2.8	2.3	1.7
HICP (eop)	2.2	2.1	2.7	2.1	2.0
EURIBOR 3M	1.02	1.42	0.19	0.65	1.10
EUR/USD (pavg)	EUR	EUR	EUR	EUR	EUR
EUR/USD (pavg)	EUR	EUR	EUR	EUR	EUR

Source: Unicredit Research

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

All eyes on the referendum

GDP contraction in 3Q12 stood at a worrying 3.3% yoy…

The Slovenian economy slid further into recession in 3Q12 after posting its second consecutive quarter of contraction. The reading, which stood at -3.3% yoy, places the Jan-Sep contraction at -2.2% yoy. All components of domestic demand contributed to the decline, led unsurprisingly by the ongoing retrenchment in gross fixed capital formation (-20.4% yoy). The fall in September in real wages (-4.4% yoy) and decline in consumer confidence also affected private consumption which dropped by 3% yoy. Public expenditure contracted by 3.1% yoy on account of June's supplementary budget cuts. On the other hand, net trade remained positive, this time as a result of a stronger reduction of import demand.

…leading us to reduce our GDP growth estimates for the forecast horizon

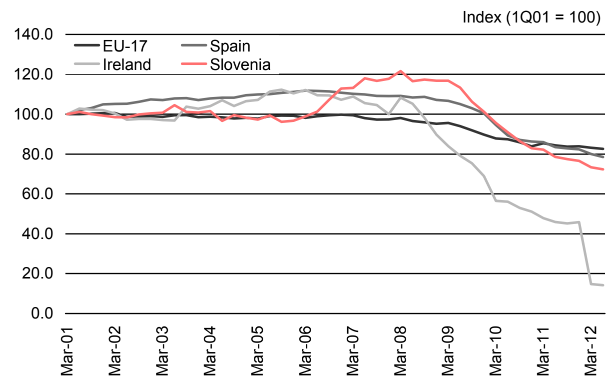
Against this backdrop, we have lowered our FY12 GDP growth forecast to -2.2% yoy. The figure is broadly in line with market expectations and assumes further weakening of domestic demand. This downward trend is expected to continue well into 2013, although the positive contributions on the side of net external demand should limit the fall of GDP to -1.3% yoy next year. Overall, we see gross fixed capital formation remaining at low levels, as credit constraints and increased deleveraging at home will continue to cap investment potential. The prospects for the construction industry also remains subdued, as both building activity and construction permits continue to decline yoy. That said, we do not see a substantial contraction in construction activity going forward as most of the adjustment can be said to have already taken place. Note that since its peak in 2008, growth in this sector has dropped by as much as 2.1pp of GDP, lowering its weight in the economy to 5.2% of GDP (vs. 5.4% in the EMU, 9.3% Spain and 2.8% in Ireland). As for domestic consumption expenditure, it will still remain suppressed on account of further fiscal tightening measures and worsening labor market prospects. All in all, we see potential growth in the economy as lower than in pre-crisis years as the economy continues to face lower FDI inflows (21.3% reduction vis-à-vis 2011), increasing financing costs (benchmark 10-year note at 5.3%) and prolonged competitiveness losses (21% nominal increase in ULCs since EU-accession). Gradual recovery in trend growth will therefore remain sluggish, reaching between 2-2.4% of GDP by 2017.

HICP inflation expected at 2.8% yoy for 2012, 0.3pp higher than the euro-average

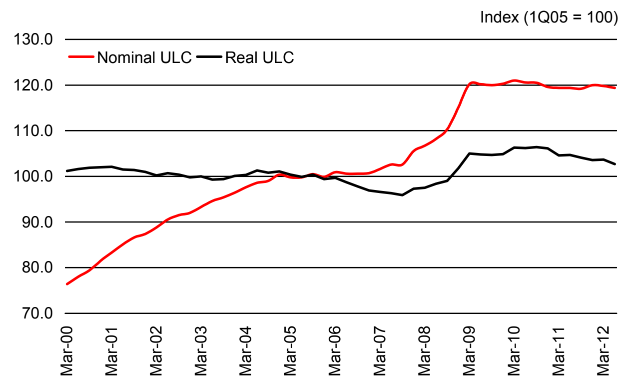
Inflation down in November, current account surplus by year-end. HICP inflation stood at 2.8% yoy in November, down from 3.2% yoy in October, due mostly to declining prices in communication services (-3.4% yoy). This should bring the annual average close to 2.8% yoy, somewhat higher than the 2.5% inflation expected for the euro-area. Suppressed domestic demand and declining commodity prices in 2013 will continue pushing average inflation down, expected at a peak of 2.3% yoy. The current account however is set for a small surplus this year, following positive trade balance data in the first two months of 3Q12 and the EUR 344.9mn (2.8% of GDP) surplus recorded in 2Q12. In particular, the C/A surplus should stabilize at 1.1% of GDP by year-end, followed by a mild increase to 1.7% in 2013.

WEAKENED COMPETITIVENESS AND INVESTMENT ACTIVITY TO WEIGH NEGATIVELY ON GROWTH

Construction activity to remain subdued despite adjustment



Increase in ULCs has deteriorated Slovenian competitiveness…



Source: NBS, MinFin, UniCredit Research

Budget deficit set to widen to 6.5% of GDP in 2013 due to direct capital injections into banks

Banking sector recapitalizations to complicate fiscal consolidation. June's supplementary budget aims to cap the deficit this year at 3.5% of GDP, though we expect it to narrow to just 4.1% of GDP after the pronounced decline in GDP and persistent increase of interest expenditures. Deficit reduction in the 2013 budget is concentrated in increased indirect tax revenues, aimed at overcoming the 1pp. fall in the corporate income tax rate. Expenditures however are set to rise, as the additional measures remain insufficient to offset the increase in use of EU funds. Adding the planned EUR 1bncapital injection into banks, our deficit forecast for 2013 increases to 6.5% of GDP, reverting thereafter to 3.7% of GDP by end-2014. Public debt would thus continue its upward path, reaching a peak of 70% of GDP next year after incorporating the EUR 4bn worth of loans to be transferred to the bad bank.

Pension expenditures in Slovenia among the highest in the euro-area; labor market still inflexible

To guarantee long-term fiscal sustainability, the government is pushing ahead with pension and labor market reforms. In regard to pension reform, the recently approved legislation aims at increasing the eligible age for pensions to 65 years for both men and women, as well as extending the period for assessing pensions from the 18 most favorable years to 24. Similarly, it establishes a more stimulating policy of bonuses for later retirement as well as greater flexibility for partial retirement. In all, these should cap the spiraling-upward trend in pension expenditures, currently among the highest in the EU. As for the labor market reform, the modifications to the two draft acts aim at capping the high wage bill in the public sector, together with breaking the strong degree of inflexibility and duality in the labor market.

System-wide capital adequacy levels currently at minimums…

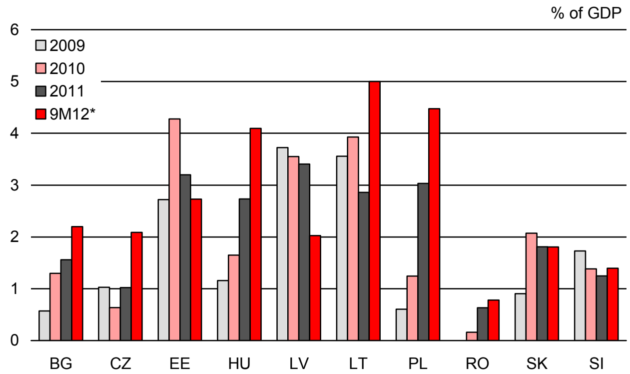
Soaring NPLs and eroded capital ratios have pushed Slovenian banks to their knees. Following rapid credit growth in the lead-up to 4Q08, lending to the economy has ground to a halt, triggering a rapid surge in banks' NPLs (12.1% as of February 2012). In turn, this has weakened system-wide capital adequacy levels, forcing Slovenia's largest bank, Nova Ljubljanska Banka (NLB), to seek two capital injections since 2011 totaling EUR 622mn. Capital levels for NKBM and Abanka Vippa also remain at minimums, a concern that has forced the government to announce direct capital injections into these banks of up to EUR 1bn, alongside the creation of a bad bank designed to absorb up to EUR 4bn in assets.

…making it more necessary to recapitalize the banking sector and approve the Banking Stability Law

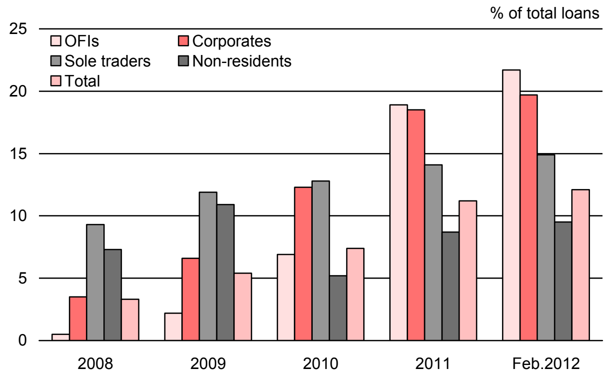
Referendum approval of the Banking Stability Law remains crucial. Following the validation of signatures filled by the KNG syndicate on October 30, the trade union is in need of collecting 40,0000 signatures by December 23 in order for the referendum to take place. Unless the Constitutional Court rules otherwise, we expect the final vote over the creation of the 'bad bank' to occur in January, time during which the government should seek alternative bank restructuring options as a preemption of a potential 'no vote'. This would entail injecting capital directly into banks, which is likely to prove less efficient as well as discouraging for international investors. To the extent that the government is highly unlikely to be able to raise this extra EUR 4bn in the market, a fully-fledged troika package would have to follow.

PUBLIC EXPENDITURE TO INCREASE NEXT YEAR AS A RESULT OF BANK RECAPS AND INCREASED USE OF EU FUNDS

Absorption of EU funds to increase in 2013



Corporate bankruptcies behind NPL hike



Source: NBS, MinFin, UniCredit Research

Financing secured until 2Q13

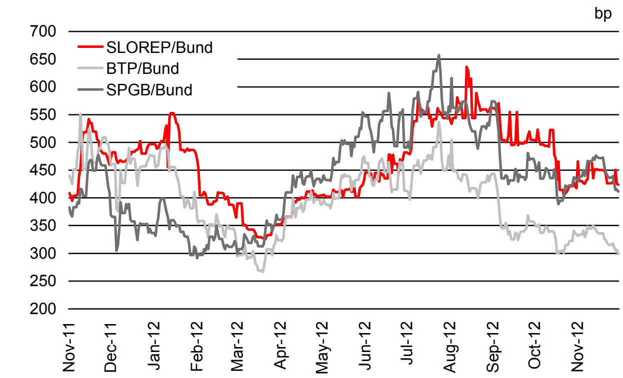
We have a bias to enter a long bond position but wait for more clarity/market nervousness surrounding the referendum

Financing needs for next year will come close to EUR 4bn, assuming that the referendum is not successful. These are made up of the budget deficit, bank recapitalization costs and T-bill rollovers. The recent USD 2.25bn Eurobond issue should buy the government sufficient time to end Q1 but beyond that the sovereign will either need to return to the external market or access Troika funding. In the more negative macro scenario whereby the government's bank recapitalization plan is not successful, funding needs increase significantly but will most likely be covered by the Troika rather than official issuance.

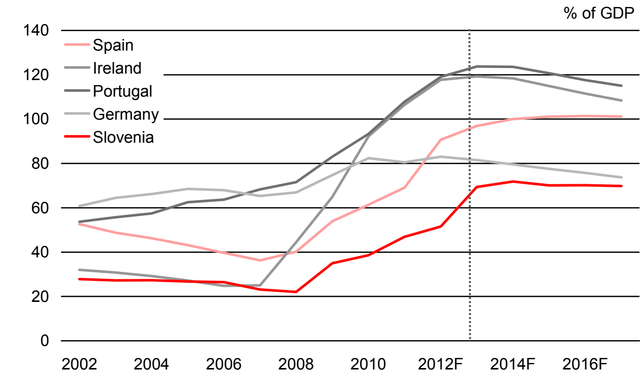
At this stage we are monitoring the situation, with a bias in favour of initiating a long bond position, either on the back of a cheapening of bonds in the lead up to the referendum or more clarity on its outcome. The combination of Slovenia's manageable financing needs in absolute terms, including a much narrower budget deficit than other periphery economies, the guarantee of an ESM backstop and Slovenia's low debt levels favour this.

ON A RELATIVE BASIS, THERE IS VALUE IN SLOVENIA

Slovenian 10Y yield spreads to increase in 1Q13



Slovenia's debt-to-GDP ratio still compares well to EU peers



Source: NBS, IMF, Bloomberg, UniCredit Research

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2011	2012F	2013F	2014F
Gross financing requirement	**3.5**	**3.5**	**4.1**	**4.4**
Budget deficit	2.3	1.5	2.3	1.3
Amortization of public debt	1.2	2.0	1.8	3.1
Domestic	0.7	2.0	1.8	3.1
Bonds	0.6	1.2	0.2	1.9
Bills	0.1	0.9	1.6	1.2
External	0.5	0	0	0
IMF/EU	0	0	0	0
Financing	**4.0**	**3.3**	**4.2**	**4.4**
Domestic borrowing	4.0	1.6	2.2	3.4
Bonds	3.0	0	1.0	2.6
Bills	1.0	1.6	1.2	0.8
External borrowing	0	1.7	2.0	1.0
Bonds	0	1.7	2.0	1.0
IMF/EU	0	0	0	0
Other	0	0	0	0

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2011	2012F	2013F	2014F
Gross financing requirement	**11.6**	**9.6**	**8.8**	**9.8**
C/A deficit	0	-0.4	-0.6	-0.5
Amortisation of medium to long term debt	5.3	4.4	3.7	4.2
Government	0.5	0	0	0
Central Bank	0	0	0	1.0
Banks	3.5	3.1	2.3	2.0
Corporates	1.3	1.3	1.3	1.2
Amortisation of short term debt	6.3	5.6	5.7	6.1
Government	0	0	0	0
Banks	2.2	1.2	1.3	1.3
Corporates	4.1	4.4	4.4	4.8
Financing	**9.6**	**12.2**	**11.7**	**8.7**
FDI	0.6	0.5	0.4	0.4
Short-term borrowing	5.6	5.7	6.1	5.0
Government	0	0	0	0
Central Bank	0	0	0	0
Banks	1.2	1.3	1.3	1.3.
Corporates	4.4	4.4	4.8	5.0
Medium to long-term borrowing	2.9	5.4	4.3	2.5
Government	0	1.7	2.0	1.0
Central Bank	1.1	2.2	0.5	-0.5
Banks	0.6	0.2	0.5	0.7
Corporates	1.2	1.3	1.3	1.3
EU Funds	0.5	0.6	0.8	0.8

Source: MinFin, NBS, UniCredit Research

Bosnia Herzegovina (B3 stable / B stable)*

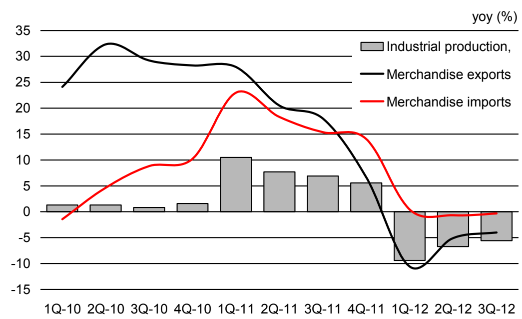
Outlook – Our GDP growth forecast remains unchanged both for 2012 and 2013 at -0.9% yoy and 0.8% yoy, respectively. The SBA with the IMF (SDR 338.2mn) should contribute to financial stability but fiscal consolidation measures constrain public consumption, even though planned public investments should provide some support in 2013. Compliance with SBA requirements will be crucial in keeping the sovereign rating stable. November's government shuffle at the state level and agreement among 6 ruling parties should help focus attention again on the reform process, as the slow pace of reforms pushed expectations for submission of a credible application for EU candidate status towards 2013.

Author: Hrvoje Dolenec, Chief Economist (Zagrebačka banka)

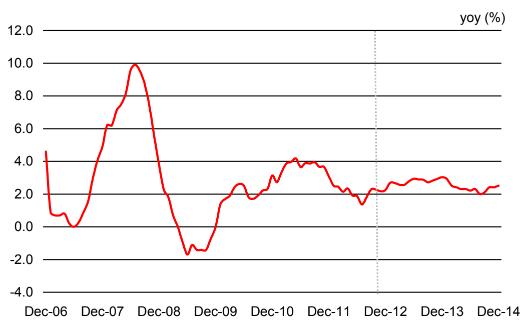
KEY DATES/EVENTS

- 25 January Wages and Unemployment
- 25 February CPI and Industrial production
- March 2013 External Government Debt 2012
- March/April 2013 Balance of payments 2012

MERCHANDISE EXPORTS UNDER PRESSURE



CPI EXPECTED TO MODERATE



Source: IMF, MinFin, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2010	2011	2012F	2013F	2014F
GDP (EUR bn)	12.6	13.0	13.2	13.7	14.2
Population (mn)	3.8	3.8	3.8	3.8	3.8
GDP per capita (EUR)	3,271	3,392	3,435	3,561	3,699
Real economy yoy (%)					
GDP	0.7	1.3	-0.9	0.8	1.5
Monthly wage, nominal (EUR)	622	650	663	676	692
Unemployment rate (%)	42.9	43.3	44.1	43.9	43.6
Fiscal accounts (% of GDP)					
Budget balance	-2.5	-1.3	-2.5	-2.2	-1.3
Primary balance	-1.9	-0.5	-1.8	-1.3	-0.3
Public debt	37.4	39.7	42.1	40.4	38.9
External accounts					
Current account balance (EUR bn)	-0.7	-1.2	-1.3	-1.3	-1.3
Current account balance/GDP (%)	-5.7	-9.6	-9.6	-9.7	-9.1
Basic balance/GDP (%)	-4.2	-7.5	-6.5	-6.3	-5.5
Net FDI (EUR bn)	0.2	0.3	0.4	0.5	0.5
Net FDI (% of GDP)	1.5	2.1	3.1	3.4	3.6
Gross foreign debt (EUR bn)	6.6	6.7	6.9	7.2	7.4
Gross foreign debt (% of GDP)	52.8	51.6	52.2	52.6	52.4
FX reserves (EUR bn)	3.3	3.3	3.3	3.3	3.3
Inflation/Monetary/FX					
CPI (pavg)	2.2	3.7	2.1	2.8	2.4
CPI (eop)	3.1	3.1	2.3	3.0	2.5
3M money market rate	0.57	1.18	0.33	0.23	0.60
USD/BAM (eop)	1.47	1.47	1.50	1.45	1.40
EUR/BAM (eop)	1.96	1.96	1.96	1.96	1.96
USD/BAM (pavg)	1.47	1.40	1.50	1.47	1.46
EUR/BAM (pavg)	1.96	1.96	1.96	1.96	1.96

Source: UniCredit Research

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

A fragile recovery ahead

We continue to see real GDP growth at -0.9% and 0.8% yoy in 2012 and 2013

GDP forecast left unchanged both for 2012 and 2013 at -0.9% yoy and 0.8% yoy. Economic trends continue to develop in line with our expectations, as domestic weaknesses and slower demand from the EU and neighboring countries affect activity. In the first nine months, the decline in industrial production was 5.6% yoy, lead by a decrease in manufacturing industry, mining sector and energy production, while the nine-month decline of 4% indicates a negative trend in exports in 2012. The modest GDP growth outlook for 2013 is a result of the combined impact of gloomy growth outlook for the region's main trading partners and sluggish domestic demand. Consolidation efforts should slightly affect public consumption, even though investments in energy projects, highways and border infrastructure could boost activity in 2013.

SBA brought stability, but also stronger fiscal discipline

Fiscal policy and inflation outlook: As soon as the IMF stand-by arrangement was approved (SDR 338.2mn) in September, the first tranche was disbursed worth SDR 50.7mn (some EUR 60mn) and partly used for repayment of a due obligation from the previous SBA in October. A recent review by IMF staff and positive assessment should result in the December 2 tranche disbursement of the same amount, which will be also partly used for meeting the January repayment (SDR 22.8mn or some EUR 27mn). In order to strengthen the sustainability of public finances, the government in Republika Srpska has committed to freeze wages for public administration employees. The government in the Federation BH planned savings both through restraining additional staff expenses and through lower social transfers and budget allocations to local governments. Given all the proposed measures, the consolidated budget deficit should be lower in 2013 (2.2% of GDP). Considering exposure to external shocks, the IMF requested a gradual elimination of the primary deficit by the end of 2015 and cutting the public debt to 31% of GDP by 2017. Such a requirement has led us to rethink public debt forecasts, as it should push public debt to decline as measured by a % of GDP in 2013. Combined effects of low short-term interest rates in the eurozone and insufficient domestic demand for loans resulted in larger bank deposits with the CB BiH. FX reserves therefore recorded a strong recovery in 3Q (6.9% qoq), building up resilience towards cyclical movements in FX demand throughout next year. Given the recent developments, we slightly changed our inflation forecasts to 2.1% yoy for 2012 (from 2.0% yoy) and to 2.9% yoy for 2013 (from 2.8% yoy). After summer disinflationary readings mostly generated by food prices, in September the CPI recorded a stronger monthly increase, returning to a somewhat faster pace of inflation. Expectations for 2013 remain almost unchanged and we see moderate inflation, mostly driven by food prices and administered prices in the final quarter.

As modest pressure on consumer prices emerged in autumn, inflation should mildly increase and spillover to 2013

C/A deficit forecasts are revised for post 2012 amid methodological changes, but balance will only improve upon stronger external demand

Current account outlook: As the historical series has been revised in accordance with new methodology, we also adjust our C/A deficit forecast for 2012 to 9.6% of GDP, while for 2013 it should remain at 9.7%. Implementation of a new methodology initiated an increase in trade deficit statistics as merchandise which is only being processed in country without change of ownership is excluded from trade statistics, while the positive contribution of such processing operations to the service account is declining. The key driver for the C/A deficit is the fact that imports stand at almost double exports, with large contributions from foods and raw materials to imports. Therefore, despite the expected faster growth of exports, the C/A deficit should not change significantly in 2013. As data on FDI now includes loans of foreign owners provided directly to the domestic non-financial sector, we expect FDI to grow, but as a share of GDP should remain restrained at a maximum of 3 to 4% of GDP.

As the focus should return to the pace of reforms, submission of a credible application to achieve EU candidate status moves towards 2013

Rating and the EU candidate status outlook. After Moody's raised its outlook in July, compliance with the SBA requirements should be crucial for keeping a sovereign rating stable in the following period. The November re-composition of the government at the state level and the agreement among 6 ruling parties should contribute to speedier reforms. Taking into account all previous delays in the reform process, submission of a credible application for EU candidate status should now be expected in 2013.

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

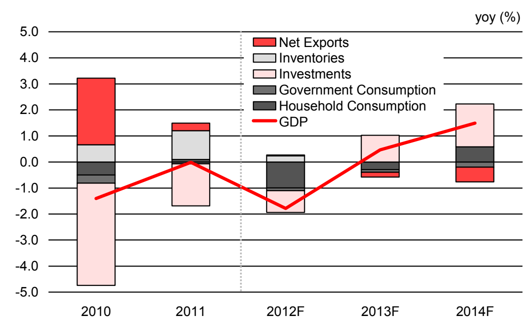
Outlook – We continue to expect GDP growth at -1.8% and 0.5% in 2012 and 2013, respectively, as negative trends dominate in all sectors of the economy, with the exception of tourism. Necessary reforms for strengthening the competitive position of the Croatian economy have not been introduced while the 2013 budget provides further disappointment on this front, undermining the potential long-term economic growth. However, we continue to see EU accession as an accelerator for reform implementation, privatization activities and, combined with the access to financial resources from EU funds, a strengthening of investment activities.

Author: Hrvoje Dolenec, Chief Economist (Zagrebačka banka)

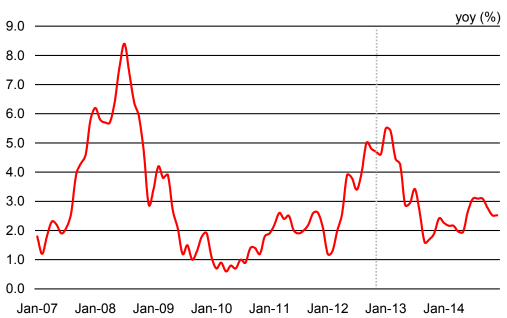
KEY DATES/EVENTS

- 20 Dec – 3Q GDP (detailed data)
- 21 Dec – 3Q Labour force data (first results)
- 31 Dec – 3Q BoP and Foreign debt
- 31 Jan – Foreign trade from 2012
- 31 Jan – Tourism from 2012 (first results)

GDP GROWTH



INFLATION OUTLOOK



Source: CNB, MinFin, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2010	2011	2012F	2013F	2014F
GDP (EUR bn)	44.9	44.9	44.9	46.7	48.8
Population (mn)	4.4	4.4	4.4	4.4	4.4
GDP per capita (EUR)	10,158	10,205	10,231	10,663	11,164
Real economy yoy (%)					
GDP	-1.4	0.0	-1.8	0.5	1.5
Private Consumption	-0.9	0.2	-1.7	-0.5	1.0
Fixed Investment	-11.3	-7.2	-4.0	5.0	7.7
Public Consumption	-0.8	-0.2	-0.5	-0.5	-1.0
Exports	5.2	2.0	-1.0	1.7	3.0
Imports	-1.4	1.2	-1.0	2.0	4.0
Monthly wage, nominal (EUR)	1,054	1,049	1,040	1,053	1,084
Unemployment rate (%)	11.8	13.5	15.2	15.5	14.5
Fiscal accounts (% of GDP)					
Budget balance	-4.9	-4.9	-4.0	-4.0	-3.8
Primary balance	-3.0	-2.6	-1.6	-1.3	-1.0
Public debt	42.1	49.5	54.3	56.3	57.9
External accounts					
Current account balance (EUR bn)	-0.5	-0.4	-0.4	-0.8	-1.0
Current account balance/GDP (%)	-1.1	-1.0	-0.9	-1.6	-2.0
Basic balance/GDP (%)	-0.2	1.3	0.3	0.3	0.7
Net FDI (EUR bn)	0.4	1.0	0.6	0.9	1.3
Net FDI (% of GDP)	0.9	2.3	1.2	1.9	2.7
Gross foreign debt (EUR bn)	46.5	45.7	46.5	48.5	50.5
Gross foreign debt (% of GDP)	103.6	101.8	103.5	103.8	103.5
FX reserves (EUR bn)	10.7	11.2	11.8	12.4	12.9
Inflation/Monetary/FX					
CPI (pavg)	1.1	2.3	3.4	3.2	2.5
CPI (eop)	1.8	2.1	4.6	2.4	2.5
Central bank target	n.a.	n.a.	n.a.	n.a.	n.a.
Central bank reference rate (eop)	6.00	6.00	-	-	3.00
1W money market rate	1.18	1.28	1.50	1.75	2.50
USD/HRK (eop)	5.55	5.66	5.85	5.59	5.36
EUR/HRK (eop)	7.39	7.53	7.60	7.55	7.50
USD/HRK (pavg)	5.49	5.31	5.81	5.64	5.60
EUR/HRK (pavg)	7.29	7.43	7.55	7.53	7.50

Source: UniCredit Research

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

Sustainable long term growth calls for reforms

Stronger results in tourism sector in 3Q failed to offset unfavourable trends in other sectors

GDP decline continued into the second half of 2012. Improved developments in the tourism sector were recorded in 3Q. However, this has not spilled over to other sectors with real GDP falling 1.9% yoy in 3Q. This once again calls for reforms to build foundations for a sustainable economic recovery. The list of necessary reforms comprises public administration (both central and regional/local government), labour market, reforms in education and health sector, pension reform and tax reform. Reform process should include restructuring of public companies and local utility companies too. Taking into account both the lack of reforms and deteriorated outlook for the Eurozone, we attach some additional downside risks to our 2013 growth outlook, kept at 0.5% yoy. While EU accession could create opportunity to restore investment activities, supported by access to increased EU funding, the risk of such a scenario has to be highlighted. We continue to see EU accession as an accelerator for reform implementation and privatization activities. Without reforms and meaningful efforts to attract (foreign) investment, in particular in export-oriented industries, the long term growth potential will remain significantly lower than in the pre-crisis period (2-3% rather than 4-4.5%).

Lack of reforms increases downside risks for 2013, while EU accession continues to be seen as an accelerator for implementation of reforms, privatization activities and investment climate recovery

Fiscal outlook: One of the key factors for economic outlook remains rational fiscal policy, which should have led to a decline in the budget deficit and government expenditures (as a share of GDP) to more sustainable levels. However, this year's fiscal consolidation plan has lost momentum. As a result, the government proposed a series of budget amendments. Failing to follow the plan aimed at reducing expenditure, the fiscal responsibility law provisions have not been met (expenditures decreased by only 0.6 pp of estimated GDP rather than the requested 1 pp). Therefore, with such a backdrop, the 2013 budget proposal was in the limelight. But, as opposed to the mid-term strategy released in July, the general government deficit target has been increased while the primary surplus, as a required precondition for public debt consolidation, is not planned for the following three year period. Furthermore, the budget proposal fails to address required reforms which should reduce the fiscal burden and improve the competitiveness of the economy in the medium term. Investment expenditures are planned through so called extra budgetary users and public companies. The acceleration in the overall privatization process is based on the sale of government stakes in two financial companies (HPB-Croatian Postal Bank and Croatia osiguranje – the largest Croatian insurance company), missing the strategy for the rest of the stakes in state portfolio. Finally, the budget proposal is not aligned with the provisions of the fiscal responsibility law and does not bring cuts in expenditures. Such proposal is linked to the risks both on the revenues and expenditure side. The budget is also based on the very optimistic growth assumption of 1.8% yoy.

The 2013 budget proposal fails to reflect required reforms, while fiscal consolidation through a lower deficit and overall expenditure cuts is not continued

Current account outlook: This year's surplus on the services balance of the current account should be sufficient to neutralize the existing trade deficit as improved physical indicators should translate into better financial results in the tourism sector. However, the shortage recorded on the income account, partly neutralized by the current transfers' surplus, should still weigh on the current account deficit. The capital account balance reveals historically weak FDI inflows (only EUR 154 mn in 1H), which is another indicator of the low attractiveness for international investors. With the investment climate unchanged, we do not see any improvements in direct investments in the current year, or an extraordinary inflow in 2013. However, the lack of FDI inflow is alleviated by capital inflow from the repatriation of Croatian FDIs abroad as well as by portfolio and other investment net inflows (EUR 1.5 bn all together).

Maintaining investment grade rating for Croatia should remain important policy target

Rating outlook: Fitch reversed its outlook to negative again, responding to 2013 government budget proposal, while Moody's confirmed its negative outlook for the sovereign rating. Both agencies point to the slow pace of reforms. Maintaining an investment grade rating for Croatia remains an important policy target considering government funding requirements and plausible access to funding sources to support the desired investment activity revival.

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

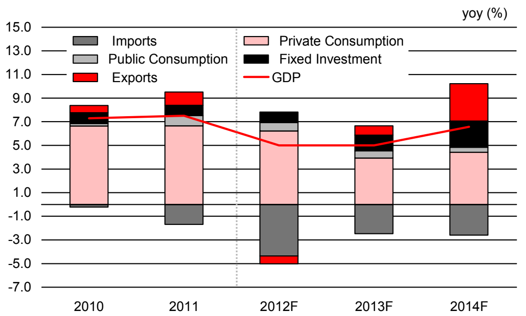
Outlook – Real GDP growth slowed to 5.2% yoy in Jan-Sep 2012 from 7.5% yoy in 2011 due to weak performance in mining and metals and lower output in agriculture than last year. Growth in services held up well, but we foresee some deceleration too, given that income growth has slowed and finances of companies have deteriorated. We keep our 5.0% real GDP forecast for 2012, but reduce slightly our forecast for 2013 to 5.0% from 5.2% and to 6.6% from 6.9% in 2014. There will be little growth stimuli from monetary policy and from the Republican budget in 2013-15, but ongoing road and power station construction along with increasing oil extraction at Kashagan from late 2014 on should re-accelerate GDP growth then. Off-budget spending from the National Oil Fund, the Tengiz "future growth project" and Expo 2017 related investment should help as well. We see the KZT only slightly depreciate, but the forecast risk has increased.

Author: Hans Holzhacker, Chief Economist (ATF Bank)

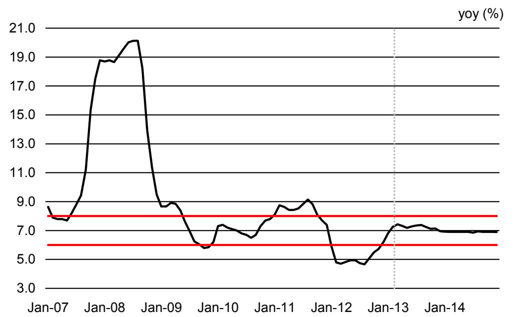
KEY DATES/EVENTS

- 1H13 – BTA's second foreign debt restructuring
- Early 2013 – Launch of Kashagan's oil production, but we assume only on a small scale
- Late 2013 – WTO entry

CONTRIBUTION OF CONSUMPTION TO DECREASE, OF INVESTMENT TO INCREASE



INFLATION TO RISE TO TARGET



Source: ASRK, NBRK, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2010	2011	2012F	2013F	2014F
GDP (EUR bn)	111.5	133.9	155.7	161.0	172.7
Population (mn)	16.4	16.6	16.7	16.9	17.0
GDP per capita (EUR)	6,781	8,072	9,299	9,535	10,133
Real economy yoy (%)					
GDP	7.3	7.5	5.0	5.0	6.6
Private Consumption	10.9	11.0	10.3	6.5	7.3
Fixed Investment	3.8	3.6	3.7	5.5	9.1
Public Consumption	2.7	11.3	9.0	7.9	5.7
Exports	1.9	3.5	-2.1	2.5	9.9
Imports	0.9	6.9	17.8	10.1	10.6
Monthly wage, nominal (EUR)	397	441	534	570	616
Unemployment rate (%)	5.8	5.4	5.3	5.2	5.1
Fiscal accounts (% of GDP)					
Budget balance	3.0	6.1	5.5	5.5	6.1
Primary balance	3.5	6.8	6.3	6.4	7.1
Public debt	14.8	12.4	13.1	14.6	15.9
External accounts					
Current account balance (EUR bn)	3.3	10.1	7.7	5.4	6.8
Current account balance/GDP (%)	2.9	7.6	5.0	3.3	3.9
Basic balance/GDP (%)	9.5	14.5	11.1	8.3	9.2
Net FDI (EUR bn)	7.4	9.3	9.6	7.9	9.1
Net FDI (% of GDP)	6.6	6.9	6.2	4.9	5.2
Gross foreign debt (EUR bn)	86.9	92.7	104.2	105.7	108.1
Gross foreign debt (% of GDP)	77.9	69.2	66.9	65.6	62.6
FX reserves (EUR bn)	20.8	22.2	23.6	23.2	24.4
Inflation/Monetary/FX					
CPI (pavg)	7.1	8.3	5.2	7.2	6.9
CPI (eop)	7.8	7.4	6.2	6.9	6.9
Central bank target	7.0	7.0	7.0	7.0	7.0
Central bank reference rate (eop)	7.00	7.50	5.50	5.50	6.50
3M money market rate	2.03	1.79	2.58	5.04	5.67
USD/KZT (eop)	147	144	150	151	152
EUR/KZT (eop)	195	192	196	204	212
USD/KZT (pavg)	148	146	147	149	155
EUR/KZT (pavg)	196	204	192	199	208

Source: UniCredit Research

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

Growth slows, re-acceleration in 2014 and beyond

Real GDP growth slowed to 4.3% yoy in 3Q12

Kazakhstan has not escaped the global slowdown, with growth in real GDP slowing to 5.2% yoy in Jan-Sep 2012 from 5.6% in 1H 11, according to preliminary data. The 5.6% yoy in Jan-Sep translates into 4.6% yoy in 3Q alone (+1.3% qoq sa), according to our estimates, vs 5.6% (+1.4% qoq sa) in 2Q. Real value added fell 8.4% yoy in agriculture in Jan-Sep after 6.0% yoy in 1H, growth in real value added of industry slowed to 0.5% yoy from 2.1% yoy in 1H, whereas growth in construction slightly recovered to 2.3% yoy from 0.5%. Growth in services decreased only moderately to 8.8% yoy from 9.0%.

StatAgency data indicate that nominal GDP fell yoy in 3Q

Growth in nominal GDP slowed significantly more than growth in real GDP. Nominal GDP fell 0.9% yoy in 3Q12, according to our calculation. The GDP-deflator was up only 3.1% yoy in Jan-Sep, vs 8.7% in 1H (and 17.8% in 2011), leaving it to decline by 5.3% yoy in 3Q. In services (50% of GDP) the deflator rose only 4.4% yoy in Jan-Sep vs 13.6% in 1H. We are a bit puzzled how to explain this. Trade in commodities may play a role. The trade deflator was fell to -0.9% yoy in Jan-Sep from +13.6% yoy in 1H 2012.

Mining and metals have likely kept industry flat in 2012

Incomes growth has moderated, prompting consumption growth also to ease

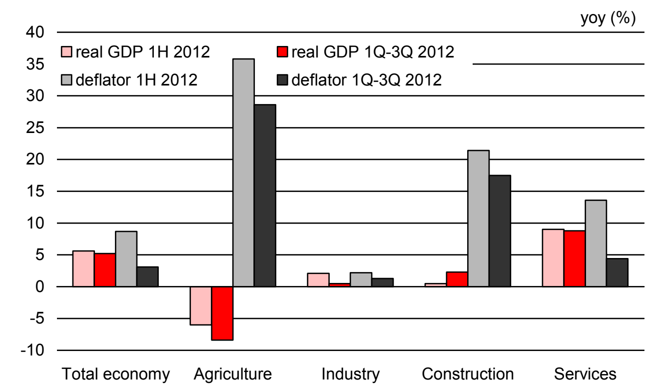
The slowdown is evident in industry while also feeding through to the consumer. Industrial output increased a mere 0.4% yoy in Jan-Oct 2012 and decreased 1.6% yoy in 3Q. Mining output was flat yoy in Jan-Oct, oil extraction decreased 1.8% yoy. Manufacturing grew 0.5% yoy as the output of ferrous metals (17% of manufacturing) slumped 10% yoy. Consumption-driven industries such as food, apparel, furniture did relatively well, but growth in constant price retail sales has finally also begun to slow (slightly), to 12.5% yoy in October from 13.5% yoy in 3Q. Real wage growth moderated to 3.4% yoy in September from 7.2% yoy in August. Per capita income increase 2.3% yoy in real terms in September, significantly less than the 4.2% yoy of August.

Investments grew in manufacturing and the power industry, but continued to fall in mining

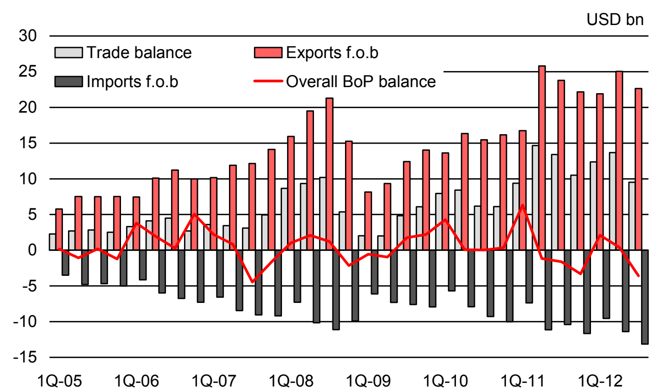
Investment has remained weak. Constant price investment outlays rose 2.9% yoy in Jan-Oct 2012, marginally up from 2.4% in 2011. Investment in manufacturing (11% of the total) was up 31% yoy, in the power industry (8%) up 26% yoy, but investment in mining (31%) fell another 7.5% yoy after 10% in 2011. The weakness in mining investment is reflected in the financing structure of the investments: financing from own sources increased to 54.3% of the outlays in Jan-Oct 2012 from 48.7% a year earlier, by loans to 11.6% from 10.8%, by the budget to 19.7% from 18.1%, whereas the contribution of foreign investment (given substantial foreign ownership in mining) decreased to 14.4% from 22.2%.

THIRD QUARTER 2012 DATA INDICATE A SLOWDOWN IN GROWTH AND A WEAKER BOP

Lower real GDP growth, sharply lower increase in the deflator



The trade surplus narrowed by USD 3.9bn yoy in 3Q 12.



Source: ASRK, NBRK, UniCredit Research

Profits of large and medium companies fell substantially

Finances of companies have begun to deteriorate. Profits rose by 56% yoy and 37% yoy, respectively, in transportation and in telecoms in Jan-October 2012. However, the overall profit of large and medium enterprises was 22% lower than a year earlier as profits in mining fell 9% and turned negative in "scientific and technical activities", which includes geological exploration. Profits grew well below inflation in manufacturing (at 1.5% yoy) and in trade (at 3.1%).

The banking system might spread the weakness in mining to other sectors of the economy

Growth in corporate deposits has slowed significantly

Interbank rates have begun to rise, lending rates might follow

The deteriorating corporate finances, particularly in mining, slowed the growth in corporate deposits, which via reduced bank liquidity threatens to spread the weakness in mining to other sectors. Overall client deposits grew 5.4% yoy, with retail deposits 21.6% higher yoy in October, but corporate deposits up only 2.4% yoy. Growth in broad money (M3) accelerated to 8.8% yoy in October from 7.1% yoy in September, remained however well below the 15% growth rates seen in early 2012. Cash outside the NBRK rose by 12.4% yoy, but the money base shrank by 7.6% because banks withdraw reserves held with the central bank. Outstanding bank loans were 13.9% higher in October than the year before (corporate + 11.6% yoy, retail lending +20.1% yoy). The 3M-KazPrime stood at still moderate 4.0% at end-November, but trends upward. Given benign inflation of 5.6% (in November vs a 6-8% target), less severe than feared food price increases, and slowing economic growth, we do not longer expect the NBRK to hike any time soon its 1W refinancing rate (currently at 5.5%). However, a cut is also unlikely: some price hikes (e.g. gasoline) have been delayed and represent a risk to future inflation. Average interest rates on KZT loans to legal persons fell stepwise from 15% at end-2009 to about 11% at end-2011 but have discontinued decreasing since. With liquidity becoming scarcer and the cleansing of banks' and companies' balance sheets remaining slow - although 3 major banks (Halyk, Kazkom, BTA) have set up SPVs now to deal with real estate loans and the Problem Asset Fund has become operative – interest rates might rise again. Lending growth should remain moderate in 2013 and probably also 2014.

Budget expenditures set to rise only modestly in 2013 and 2014

Focus is now rather on structural reforms than on growth incentives from the budget after several years of hikes in civil servant wages and social spending. The "Republican budget for 2013-2015" signed into law by President Nursultan Nazarbayev on 26 November 2012 sets the Republican budget deficit to 2.1% of GDP for 2013 (probably little changed from the actual 2012 outcome), 1.8% of GDP for 2014 and 1.5% of GDP in 2015. The transfer from the National Oil Fund to the budget is to remain unchanged in 2013 from 2012 at KZT 1,380bn, then reduced again to KZT 1,188bn in 2014 and in 2015. We forecast a combined State Budget (Republican=Local) and the Oil Fund surplus of 5.5% of GDP for both 2012 and 2013 with both production and the average oil price little changed from 2012 (Brent to go from USD 111pb to USD112 pb). The budget law projects the Republican budget expenditures, with social spending being the largest part, to increase modestly by 3.0% yoy in 2013, 4.3% in 2014 and 10.2% in 2015. At the same time, the moratorium on subsoil licenses shall be revoked, administration reform shall continue, the "Peoples IPO" has been launched, the corporate governance of the state-holding Samruk-Kazyna shall be streamlined, and industrial relations and the cooperation with the trade unions be put on a new footing.

We reduce our GDP forecast for 2013 and 2014 a bit, but see Kazakhstan's long-term potential intact

We slightly lower our real GDP growth forecast from 5.2% to 5.0% for 2013 and from 6.9% to 6.6% for 2014, but continue to see growth potential of 6-7% in 2015 and beyond. While there will be little growth push from monetary policy and the budget, ongoing road (Western-China Western-Europe corridor) and power station construction (Balkhash), financed in part from abroad, including from IFIs, the modernization of the railroads and refineries, along with increasing oil extraction should accelerate GDP growth once again, but probably not before late 2014. Though first production at Kashagan will very likely begin in early 2013, large commercial volumes will probably not be reached before 2015, projections of the Ministry of Trade and Development show. Kashagan issues remain complicated: ConocoPhillips has informed the authorities of its intentions to sell its 8.4% stake to ONGC Videsh of India. Kazakhstan (and the other stakeholders) has a preemptive right to buy the stake. A decision is expected in H1 2013. With the support of 103 countries Astana was selected as the host city of the EXPO-2017. The Tengiz oil field "Future growth project" with USD 20bn in planned investments over the next 6 years should help to recover investment growth from 2014 on and should significantly increase Kazakhstan's growth potential after 2018.

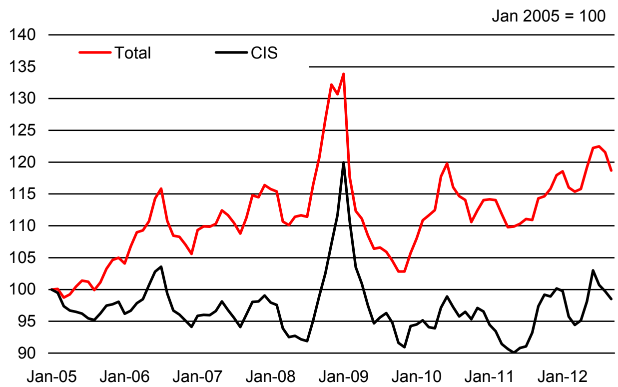
Strategy: How much will the KZT depreciate?

We keep our forecast of only moderate KZT weakening, but the downside (weakening) risk has increased

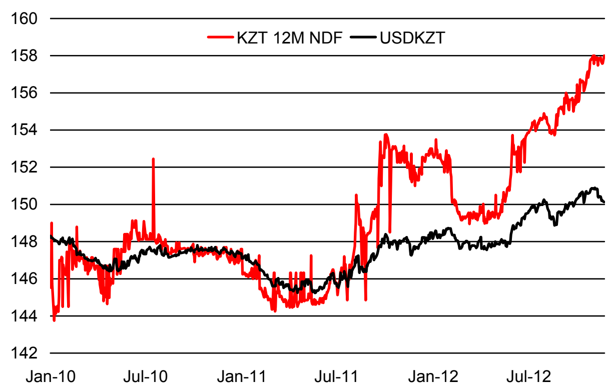
Kazakhstan's CA surplus came in at USD 1.5bn in 3Q 12, according to preliminary data, substantially below the USD 4.3bn in 3Q 11. FDI almost halved to USD 2.2bn from USD 4.0bn (both to be blamed on mining), while portfolio investment abroad (the Oil Fund) increased to USD 3.2bn from USD 1.4bn. The overall BoP was by USD 3.6bn in deficit in 3Q as a result. The foreign assets of the Oil fund rose to an all-time high of USD 56.9bn in October, but the net international reserves of the central bank fell to USD 28.5bn from a peak of USD 34.8bn in February 2012. We foresee a narrowing of the CA surplus to 3.3% of GDP in 2013 from 5.0% in 2012 as import growth continues to outpace export growth. The NBRK obviously intervened in support of the KZT in September and October, which nevertheless depreciated 2.9% between 1 September and 5 November from 146.46 to 150.84 to the USD, then recovering slightly. We believe that the NBRK has enough reserves and is willing to allow only a very moderate depreciation of the KZT. However, the KZT appreciated by 4.1% to the RUB from 5.06 to 4.86 from 1 Sep to 30 Nov, raising the real effective fx-rate vis-à-vis the CIS countries to levels not seen since late 2008. This limits the incentive for the central bank to spend more money in support of the KZT. We see the basic balance to remain in surplus in 2013 and 2014 at about 9% of GDP and therefore keep our forecast of 151 KZT to the USD for eop 2013 and 151.5 for 2014 and still believe that the 12M NDFs exaggerate. A lot will depend on the further movement of the RUB, however. The forecast risk has increased.

REAL EFFECTIVE FX-RATE AND NDFS INDICATE MODERATE DEPRECIATION

The real effective fx-rate vis-à-vis CIS is rather strong



12 M NDFs imply significant KZT weakening



Source: NBRK, Bloomberg, UniCredit Research

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2011	2012F	2013F	2014F
Gross financing requirement	**4.2**	**5.0**	**5.0**	**4.8**
Budget deficit*	2.8	4.1	3.9	3.6
Amortisation of public debt	1.3	0.9	1.1	1.2
Financing	**4.2**	**5.0**	**5.0**	**4.8**
Borrowing**	3.8	4.5	5.5	5.3
Other	0.3	0.5	-0.5	-0.4

*Republican budget
**Of this, less than one-third external, we estimate

Source: MinFin, NBRK, UniCredit Research

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2011	2012F	2013F	2014F
Gross financing requirement	**-1.2**	**1.4**	**1.9**	**-0.3**
C/A deficit	-10.1	-7.7	-5.4	-6.8
Amortisation (loans)	8.9	8.3	7.3	6.5
Government/central bank	0.1	0.1	0.2	0.6
Banks	2.9	1.2	1.6	1.4
Corporates	6.0	7.1	5.4	4.6
Financing	**-1.2**	**1.4**	**1.9**	**-0.3**
FDI (non-resident net)	9.3	9.6	7.9	9.1
Equity	0	0.1	0.1	0.1
Borrowing (loans)	9.4	10.7	9.1	8.6
Government/central bank	0.6	0.2	0.4	0.4
Banks	1.4	0.3	1.1	1.1
Corporates	7.4	10.3	7.6	7.1
Other (resident FDI, portfolio, lending, reserves)	-19.9	-19.0	-15.2	-18.1

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

Outlook – The Russian economy enters 2013 experiencing a slowdown in GDP growth, though less prounced than elsewhere. We have some concerns that cyclical as well as structural factors play a role. Increased political instability is feeding through to persistent domestic capital outflows while an increased cost of funding and regulatory requirements are weighing on the banking sector. Russia also struggles to grow in the face of stable rather than rising oil prices. The positive within this environment is the CBR's continued shift to a much more flexible RUB.

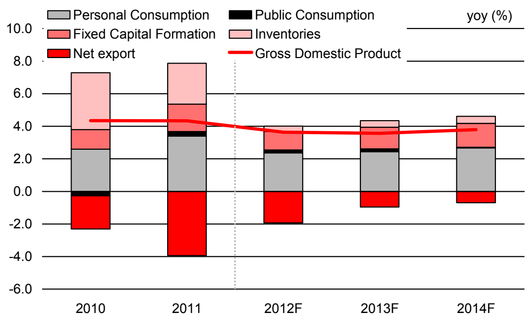
Strategy outlook – Despite a bearish longer term RUB outlook, the combination of favourable Q1 seasonality, euroclearability of OFZs and the potential for increased foreign issuance by the banking sector should support both the currency and OFZs in Q1.

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

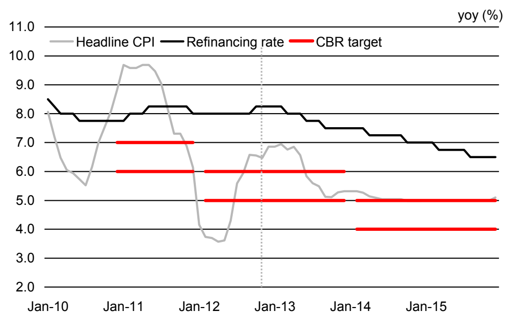
KEY DATES/EVENTS

- 18-22 of each month – Monthly indicators
- 1st half of every month – CBR decision on rates
- January 2013 liberalisation of OFZ market

DOMESTIC DEMAND DRIVES THE ECONOMY



INFLATION INCREASE KEEPS PRESSURE ON INTEREST RATES



Source: Bank of Russia, Federal Statistics Service, Unicredit Research

MACROECONOMIC DATA AND FORECASTS

	2010	2011	2012F	2013F	2014F
GDP (EUR bn)	1,102	1,336	1,527	1,692	1,774
Population (mn)	142.9	143.1	142.9	142.7	142.5
GDP per capita (EUR)	7,714	9,336	10,689	11,857	12,454
Real economy yoy (%)					
GDP	4.3	4.3	3.6	3.6	3.8
Private Consumption	5.1	4.8	4.6	4.7	5.1
Fixed Investment	6.2	5.2	5.3	6.0	6.5
Public Consumption	0.7	-0.1	1.0	1.0	0.2
Exports	11.1	2.2	2.5	2.5	2.1
Imports	25.4	7.5	11.8	7.0	5.3
Monthly wage, nominal (EUR)	518	580	675	704	765
Unemployment rate (%)	7.5	6.6	5.8	5.7	5.7
Fiscal accounts (% of GDP)					
Budget balance	-6.6	0.8	0	-1.0	-0.5
Primary balance	-5.8	1.3	0.2	-0.7	-0.2
Public debt	8.3	9.8	10.2	11.2	12.0
External accounts					
Current account balance (EUR bn)	55.9	79.5	68.3	27.8	8.2
Current account balance/GDP (%)	5.1	6.0	4.5	1.6	0.5
Basic balance/GDP (%)	4.7	5.3	4.3	2.4	1.3
Net FDI (EUR bn)	-9.8	-11.8	-12.7	-1.1	12.4
Net FDI (% of GDP)	-0.9	-1.2	-0.8	-0.1	0.7
Gross foreign debt (EUR bn)	356.3	424.3	474.3	506.0	530.5
Gross foreign debt (% of GDP)	34.7	31.9	31.1	29.9	29.9
FX reserves (EUR bn)	358.2	384.7	397.0	378.7	353.6
Inflation/Monetary/FX					
CPI (pavg)	6.9	8.6	5.1	6.0	5.1
CPI (eop)	8.8	6.1	6.9	5.3	5.0
Central bank target	8.5	8.0	8.25	7.5	7.0
Central bank reference rate (eop)	5.0	5.25	5.75	5.25	5.00
3M money market rate	4	6.6	7.1	6.5	5.75
USD/RUB (eop)	30.54	32.20	30.60	31.99	32.26
EUR/RUB (eop)	40.82	41.67	39.78	43.19	45.16
USD/RUB (pavg)	30.28	29.39	31.09	30.61	31.24
EUR/RUB (pavg)	40.36	40.87	39.90	40.53	43.00

Source: UniCredit Research

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

Challenges ahead

Economic activity has slowed as 2012 has progressed…

The Russian economy enters 2013 experiencing a slowdown in GDP growth, though less pronounced than elsewhere in the region. From 4.9% yoy in Q1-12, GDP slowed to 2.9% yoy in Q3. Temporary factors such as high base effects and agriculture are at play – having experienced a bumper 2011 harvest, some payback in 2012 was inevitable. But there are also more concerning signs of a slowdown elsewhere. By October, industry growth had slowed to 1.8% yoy. Data on rail cargo loading for the first 11 months of 2012 posted growth of only 3%, below expectations. Growth slowed to 1.7% yoy in November while representatives of OAO “RZhD” (42% of total cargo turnover in Russia) expect negative figures in December.

…in part because of political uncertainty and persistent domestic capital outflows…

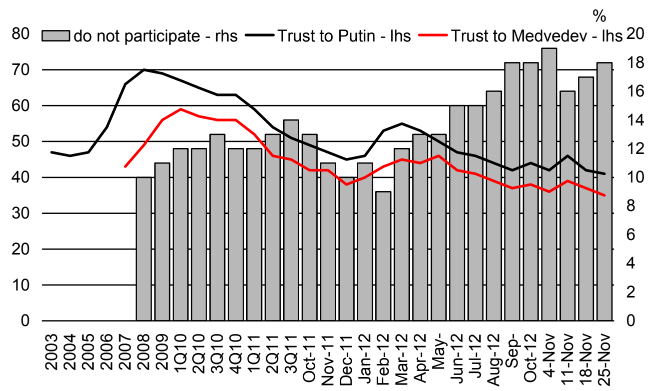
We have some concerns that cyclical as well as structural factors play a role. In terms of politics, there are no critical elections expected in Russia in the next five years (State Duma end-2017 and Presidential early 2018) but instability within the government still surprised us in H2-12. In autumn, 2 out of 26 ministers were dismissed. Although the changes seem to be positive (indicating a move towards higher efficiency and responsibility, less corruption, etc.), in previous years there were only a few changes at this level. Recent polls show trust in President Putin and PM Medvede at multi-year lows. Simultaneously domestic capital outflows have remained persistent post the Presidential election. YTD capital outflows from the non-bank domestic economy stand at USD80.5bn, spread pretty evenly over the first three quarters, compared with a C/A deficit for the same period of USD74.6bn and domestic capital outflows of USD67bn for Q1-Q3 11. In Q3 these outflows stood at USD30bn, compared with USD19.1bn in Q3-11. In part this reflects a recycling of C/A savings but in part also likely captures the impact of increased political uncertainty over the past 12 months.

…in part because of more expensive credit…

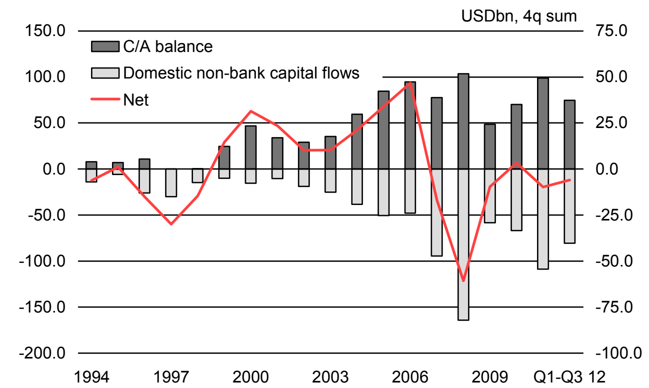
Secondly 2012 has also been notable for the CBR's prioritisation of inflation but this comes with short term costs in terms of the price of money and bank regulation. The structural liquidity deficit in the banking sector is filled via repo operations (whose volume exceeded USD 63bn or 5.7% of banking sector liabilities) but at increasing costs for banks. For instance, the 3-month money market rate in 2011 was on average 4.97% but in 2012 it rose by 210bp to 7.06%. Other indicative rates behave similarly (e.g. maximum deposit rates in banks with the highest retail deposit market share grew by 131bp). In terms of the regulatory environment, it becomes tougher for banks – new initiatives in capital adequacy measures officially cost banks 0.7pp of capital (while independent estimates range from 1.5-2.1pp), pushing capital adequacy ratios to 13.2%. In 1H13, the CBR will introduce additional tightening for excessively risky uncovered retail lending, which will also constrain Russia’s growth.

CONDITIONS FOR GROWTH: GENERALLY WORSENED

Trust to the political system is at historical lows..



…while domestic capital outflows are persistent



Source: FOM, Bloomberg, CBR, UniCredit Research

…and in part because the oil price has stabilised rather than increased

Thirdly Russia's public sector and external balance sheets are such that current oil prices are no longer sufficient to generate growth – for this, consistent oil price increases are required. 2012 represents the first year in three that oil prices have not increased. Meanwhile the oil price at which the C/A and budget balances has reached USD 87pb and USD 109pb respectively, up from USD 48pb and USD 53.5pb in 2007. Combined with limits to physical amounts of raw materials extraction, constant real exports and the risk of reduction over the medium term introduce risks.

Russia's flexible exchange rate has the potential to act as a powerful adjustment mechanism…

The positive within this environment is the CBR's continued shift to a much more flexible RUB. The bi-currency basket (might range between 31.65-38.65 RUB) changes its value automatically once interventions exceed USD 450mn (less than 0.1% of total FX reserves). In 2012, this “degree of freedom” changed only once, but we do not rule out a situation of another change in the last days of the year – as was the case in 2011. Presumably, in the coming 2-3 years, the range will exceed RUB 10, which effectively means that the RUB is indeed a freely floating currency. Moreover we see a strong CBR preference in favour of RUB weakening rather than strengthening, in particular as an adjustment mechanism to protect against a decline in oil prices. Note than when oil prices slipped over May-June by 25%, the RUB declined more than 15% which allowed the government to avoid the loss of revenues for the federal budget: inflow were stable at RUB 1.0 trillion per month. We expect in 2013 two periods: in 1H RUB will be stronger than now on the back of OFZ liberalization and seasonal factors. Yet in H2-13 a gradual RUB depreciation trend will start due to oil prices and absence of new local investment themes. Thus the annual average exchange rate to basket will not change to 2012 at 35.10, while 2013 eop we see RUB/EUR at 43.19 and RUB/USD at 31.99. Later on we expect 4% depreciation per year.

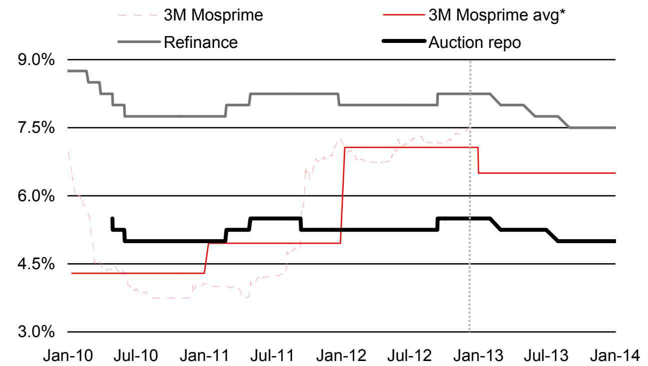
From a structural perspective, the newly accepted budget rule (spending cannot exceed revenues more than by 1% of GDP, while revenues are calculated as a function of the past long-term average oil price) also helps protect public finances. Assuming an oil price (Urals) at USD 91 per barrel authorities plan to receive RUB 12 866bn (which is 0.7% below FY2012), later on this figure will grow at 9.7% p.a. to reach RUB 15.6 trillion in 2015. Spending in 2013 will exceed revenues by 0.8% of GDP, to 2015 this will be decreased to almost null (0.01%), although we expect slightly less stringent figures (by 0.2pp) as our projections of economic growth are less optimistic.

…and the CBR will pay more attention to economic growth in 2013

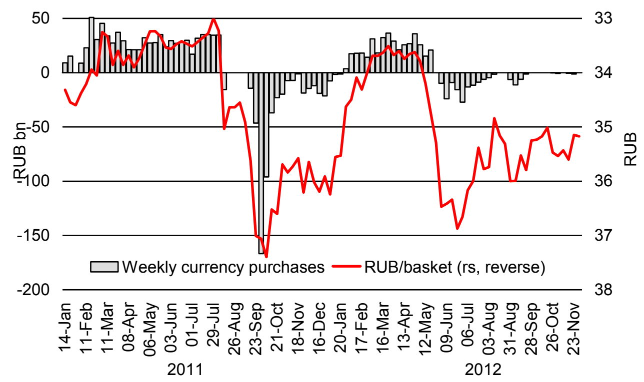
A slowdown in economic growth and lower inflationary pressure will make monetary policy in 2013 more accommodative. The CBR’s decision to hike interest rates in September was most likely a one-off fine tuning to offset a 25bp loosening in late 2011. That said, we expect that before the end of Q1-13, the CBR will start a prolonged gradual policy of cutting interest rates. It will not be more rapid than 25bp in a quarter – to ensure that inflationary processes and expectations are under control. We see the refinancing rate decreasing to 7.5% in 2013 (but still above zero in real terms). However, the environment for local banks will stay tight as a high degree of dependency on the CBR in terms of liquidity increases the vulnerability of banking business to changes in regulations.

CBR POLICY

More accommodative monetary policy will bring lower market rates...



…while CBR will prevent RUB from appreciating



Source: Bloomberg, CBR, UniCredit Research

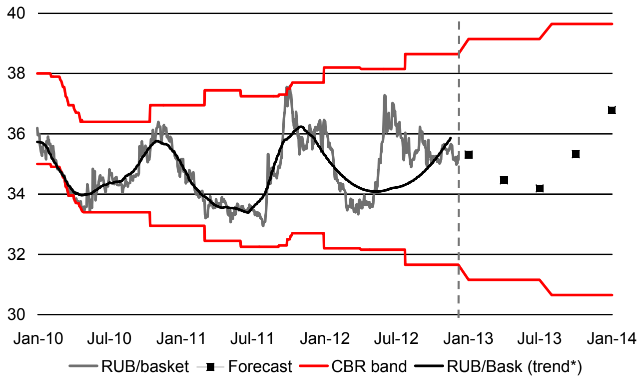
Strategy: A favoured local markets trade for Q1

Both RUB and OFZs should perform well in Q1

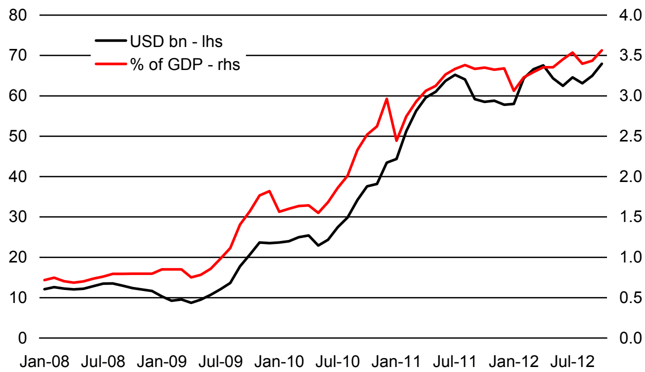
Despite a bearish longer term RUB outlook, the combination of favourable Q1 seasonality, euroclearability of OFZs and the potential for increased foreign issuance by the banking sector in the face of a stable oil price should support both the currency and OFZs over the first 2-3 months of the year. Q1 tends to be Russia's largest C/A surplus quarter of the year and while the expectation of euroclearability has already seen yields rally significantly, we continue to expect inflows in the new year. With banking sector liquidity tight and the banking sector running a positive net foreign asset position, it makes sense that the trend of domestic bank borrowing offshore (USD18.1bn over Q1-Q3 12, triple the same period in 2011) continues to accelerate and provide an additional source of capital inflow.

RUSSIA LOCAL MARKETS REPRESENT A FAVOURED TRADE FOR Q1

FX seasonality supports RUB in Q1



The stock of OFZs on the rise as foreigners begin to enter market



*for 2010-2011 – 3 month moving average shifted by 45 days, for 2012 – statistical model

Source: Bloomberg, CBR, UniCredit Research

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2012F	2013F	2014F
Gross financing requirement	**36.1**	**58.4**	**53.2**
Budget deficit	0.0	16.9	8.9
Amortisation of public debt	16.5	18.5	21.1
Domestic	14.8	16.8	19.7
Bonds	14.8	16.8	19.7
Bills	-	-	-
External	1.8	1.6	1.4
IMF/EU	-	-	-
Sovereign Fund	19.6	23.1	23.2
Financing	**40.7**	**50.1**	**47.8**
Domestic borrowing	35.5	45.1	43.2
Bonds	35.5	45.1	43.2
Bills	-	-	-
External borrowing	5.1	5.0	4.7
Bonds	5.1	5.0	4.7
Other	-	-	-

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2012F	2013F	2014F
Gross financing requirement	**-9.0**	**30.5**	**51.7**
C/A deficit	-68.3	-27.8	-8.2
Amortisation of medium to long term debt	47.6	50.4	55.2
Government/central bank	1.8	1.6	1.4
Banks	17.20	19.00	21.00
Corporates	28.60	29.80	32.80
Errors and omissions	11.73	7.84	4.65
Financing	**-9.0**	**30.5**	**51.7**
FDI	-12.7	-1.1	12.4
Equity	-	-	-
Borrowing	64.1	69.6	73.0
Government/central bank	5.1	5.0	4.7
Banks	23.0	24.7	24.0
Corporates	36.0	39.9	44.3
Other	-	-	-
Domestic investments abroad	-72.6	-19.7	-8.6
Official reserves change / other	12.2	-18.3	-25.1

Source: MinFin, CBR, Unicredit Research

Serbia (BB- negative / BB- negative)*

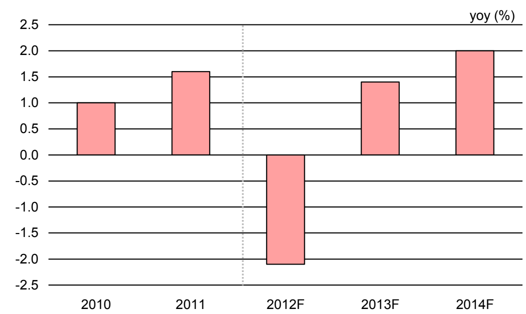
Outlook – The Serbian economy contracted by 2.2% yoy in 3Q12, bringing Jan-Sept growth to -1.8% yoy. Going forward, we see GDP this year contracting by a sharp 2.1% yoy, followed thereafter by a slow net export-led recovery. Against this backdrop and growing interest expenditures, we see the budget deficit for next year narrowing to just 4.5% of GDP, which should place public debt close to 60% of GDP. On the monetary front, we expect moderate cuts from mid year, mainly as a response to growing inflationary pressures, though we do not rule out further FX or liquidity interventions by the NBS to support the RSD in the forecast period.

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

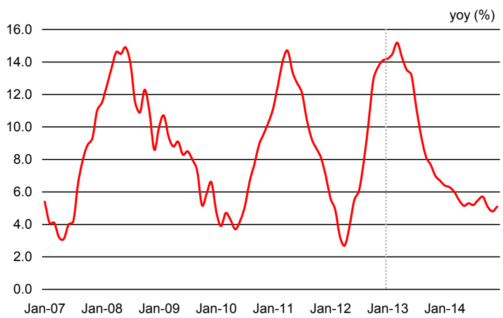
KEY DATES/EVENTS

- 12 Dec, 11 Jan, 12-13 Feb, 12-13 Mar – Consumer Price Index
- 14 Dec, 10 Jan, 7 Feb, 7 Mar – NBS rate decisions
- 28 Dec, 29 Mar: 3Q12 GDP (final), 4Q12 GDP (final)
- 28 Dec, 31 Jan, 28 Feb, 29 Mar – Industrial Production
- 28 Dec, 31 Jan, 28 Feb, 29 Mar – Retail Trade

GDP GROWTH RESUMING IN 2013



INFLATION SET TO PEAK IN 1Q13



Source: NBS, MinFin, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2010	2011	2012F	2013F	2014F
GDP (EUR bn)	28.0	31.1	28.9	31.6	32.8
Population (mn)	7.5	7.6	7.6	7.6	7.6
GDP per capita (EUR)	3,730	4,116	3,810	4,151	4,314
Real economy yoy (%)					
GDP	1.0	1.6	-2.1	1.4	2.0
Monthly wage, nominal (EUR)	461	518	504	525	544
Unemployment rate (%)	19.2	23.0	26.4	26.5	25.7
Fiscal accounts (% of GDP)					
Budget balance	-4.7	-5.0	-6.7	-4.5	-3.5
Primary balance	-3.5	-3.6	-5.0	-3.0	10.7
Public debt	43.5	46.5	58.6	59.8	62.5
External accounts					
Current account balance (EUR bn)	-2.1	-2.8	-3.5	-3.2	-3.8
Current account balance/GDP (%)	-7.4	-8.9	-12.2	-10.1	-11.6
Basic balance/GDP (%)	-4.4	-3.0	-10.8	-6.8	-7.0
Net FDI (EUR bn)	0.9	1.8	0.4	1.0	1.5
Net FDI (% of GDP)	3.1	5.9	1.4	3.3	4.6
Gross foreign debt (EUR bn)	23.8	24.1	25.2	26.3	27.7
Gross foreign debt (% of GDP)	85.0	77.5	87.2	83.3	84.4
FX reserves (EUR bn)	11.7	12.9	10.3	10.8	11.3
Inflation/Monetary/FX					
CPI (pavg)	6.8	11.2	7.6	11.3	5.5
CPI (eop)	10.3	7.0	14.1	6.7	5.1
Central bank target	6%±2%	4.5%±1.5%	4.0%±1.5%	4.0%±1.5%	4.0%±1.5%
Central bank reference rate (eop)	11.50	9.75	10.95	10.00	9.50
BELIBOR 3M	10.72	12.88	11.62	12.35	11.80
USD/RSD (eop)	79.2	80.8	85.7	85.0	85.9
EUR/RSD (eop)	105	104	114	119	122
USD/RSD (pavg)	77.7	73.3	87.8	88.2	87.5
EUR/RSD (pavg)	103	101	113	116	120

Source: UniCredit Research

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

Recession deeper than expected

GDP growth forecast for FY12 is reduced to -2.1% after weaker-than-expected contributions from private consumption and net external trade

Economy to contract in 2012, growth to resume in 2013. Following two consecutive quarters of contraction, the Serbian economy fell by a further 2.2% yoy in 3Q12 (preliminary), bringing the Jan-Sept cumulative growth reading to -1.8% yoy. During this period, both private and net export demand contributed negatively to growth, with agricultural output adding the most to this decline on the back of this year's poor harvest. Going forward, we see GDP this year contracting by a sharp 2.1% yoy, followed thereafter by a slow net export-led recovery. Nonetheless, domestic demand for 2013 will remain subdued, particularly on the public expenditure side, due to added fiscal consolidation needs. Private consumption will also remain suppressed due to declining real wages and the full effect of October's hike in indirect taxes. Gloomy labor market prospects and higher inflation expectations will further add to this fall, although the pace of the drop should ease by end-2013 as inflation pressures ease. That said, we see investment expenditure catching-up, especially on the FDI side, as evidenced by Fiat's growing car production plans and RWE's recently announced EUR 2.2bn investment in energy. On this front, the USD 1bn Russian investment in railways and the USD 1.8bn Chinese loan for the development of new roads are also a positive.

Deficit target of -3.6% for 2013 is overly ambitious

Fiscal consolidation remains a challenge. Public finances deteriorated considerably in 1H12 after a pre-election surge in expenditures. In response, a supplementary budget was introduced early in September, aimed at capping the deficit for 2012 at 6.7% of GDP. On the revenue side, measures included a two percent hike on both the VAT and corporate income tax rates to 20% and 12%, respectively, as well as further increases in excise duties and personal income taxes. On the expenditure side however, the package fell short of capping expenses, as the savings resulting from lower wage and pension indexations were more than offset by the increase in subsidies and employee outlays. For 2013, the government has set itself a deficit target of 3.6% of GDP, which in our view seems rather ambitious. Since end-2008, the sovereign's interest bill has tripled and there is no reason to believe that this will peak in the near future. Moreover, growth in the economy will remain low, casting some doubts on the revenue-enhancing potential of next year's budget. With this in mind, we see the budget deficit falling to 4.5% of GDP next year, setting public debt at close to 60% of GDP.

Inflation set to peak in 1Q13 as the next agricultural season resumes

Inflation rising, RSD stabilized. Inflation in Serbia continued to accelerate in October to 12.9% yoy, mainly on account of persistent pressures from food and administered prices. The reading, which was well above the NBS's target, is expected to continue spiraling upwards, peaking in 1Q13 as the next agricultural season resumes. Consequently, we expect the NBS to continue tightening rates over the next quarter, potentially reaching 11.5-11.75% by 2Q13. In addition, we remain confident the NBS will continue guaranteeing RSD stability, as this remains essential for financial stability (as most loans are FX denominated) and public debt sustainability (as over 80% of public debt is in FX). Since June, the NBS has stuck to this goal by drawing off its FX reserves (YTD EUR 1.4bn) and soaking up liquidity, allowing the RSD to stabilize at 112-114/EUR. Going forward, we do not rule out further interventions of this kind to moderate RSD volatility, including additional increases to reserve requirements.

Further assurances on central bank legislation and fiscal consolidation are needed to secure IMF funding

IMF deal uncertain, EU-membership negotiations halted After its 'mini mission' in September, the Fund returned to Serbia in November to follow up on the details of next year's budget. In their concluding statement, the IMF finds the measures as insufficient to meet the full fiscal adjustment required for 2013, suggesting that negotiations for a three-year precautionary loan could be well postponed until next Spring. This however, does not mean a financing issue for the government, as its financing needs for 1H13 have been already secured via its November USD 700mn Eurobond issuance and a USD 1bn loan from Russia. In contrast, the European Commission refused in October to give a starting date for EU-accession negotiations, after the observance of the postponement of Belgrade-Priština talks and their lack of implementation of already reached agreements. Although we expect talks to resume next year, we nonetheless believe these will remain difficult, as they will require, among other commitments, an agreement over Kosovo's final status.

Turkey (Ba1 positive / BB stable /BBB- stable)*

Outlook – Turkey's impressive soft landing in 2012 can be attributed to a combination of the CBT's control over bank liquidity and short end rates, impressive export performance (even if its sustainability is uncertain) and fiscal flexibility. From here growth should improve as the impact of the credit slowdown has fed through to domestic demand, the central bank has and is likely to continue to lower interest rates while Turkey will also benefit from a recovery in external demand. The primary risk factor remains Turkey's shortage of FX reserves, in particular in light of the sharp increase in short term capital inflows since 2009.

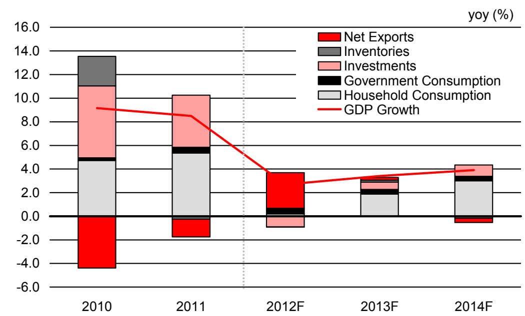
Strategy– Within a risk-hungry environment, Turkey boasts a stable currency, lower but still high carry and on a relative basis a decent growth story. In this environment, TRY remains a convincing carry trade in the near term.

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

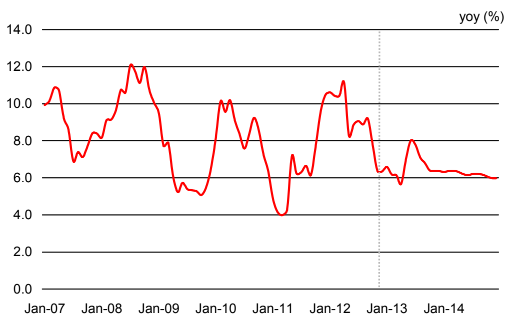
KEY DATES/EVENTS

- Rate decisions: 18 Dec,
- CPI, PPI: First working day of every month
- Q4 GDP: Early March

DOMESTIC DEMAND SLUMPS, LEAVING THE BURDEN ON NET EXPORTS



INFLATION TO EASE ONLY GRADUALLY BUT REMAIN OUT OF TARGET



Source: TurkStat, CBT, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2010	2011	2012F	2013F	2014F
GDP (EUR bn)	552.4	558.7	628.4	697.2	753.0
Population (mn)	73.0	74.0	74.9	75.8	76.7
GDP per capita (EUR)	7,567	7,555	8,392	9,196	9,816
Real economy yoy (%)					
GDP	9.2	8.5	2.7	3.4	3.9
Private Consumption	6.7	7.8	0.3	2.8	4.5
Fixed Investment	30.5	18.5	-3.5	2.5	4.0
Public Consumption	2.0	4.5	4.5	3.8	3.6
Exports	3.4	6.4	14.0	6.8	4.9
Imports	20.7	10.9	1.0	5.5	5.9
Monthly wage, nominal (EUR)	796	783	906	1,031	1,147
Unemployment rate (%)	11.9	9.8	9.2	9.7	9.7
Fiscal accounts (% of GDP)					
Budget balance	-2.7	-0.3	-2.1	-3.0	-2.5
Primary balance	1.0	2.3	0.7	-0.3	0.0
Public debt	42.4	39.6	36.9	36.2	35.1
External accounts					
Current account balance (EUR bn)	-35.2	-55.5	-41.6	-45.1	-44.7
Current account balance/GDP (%)	-6.4	-9.9	-6.6	-6.5	-5.9
Basic balance/GDP (%)	-5.3	-8.2	-5.2	-5.1	-4.6
Net FDI (EUR bn)	5.7	9.6	8.9	9.4	10.0
Net FDI (% of GDP)	1.0	1.7	1.4	1.4	1.3
Gross foreign debt (EUR bn)	218.7	237.8	263.0	293.8	323.2
Gross foreign debt (% of GDP)	39.6	42.6	41.8	42.1	42.9
FX reserves (EUR bn)	59.2	59.4	76.9	81.0	80.1
Inflation/Monetary/FX					
CPI (pavg)	8.6	6.5	9.0	6.7	6.2
CPI (eop)	6.4	10.4	6.4	6.4	6.0
Central bank target	7.5	6.5	5.5	5.0	5.0
Central bank reference rate (eop)	6.50	5.75	5.75	5.75	6.50
3M money market rate	11.56	11.00	5.75	6.00	6.75
USD/TRY (eop)	1.52	1.85	1.77	1.70	1.71
EUR/TRY (eop)	2.02	2.46	2.30	2.30	2.39
USD/TRY (pavg)	1.51	1.67	1.78	1.72	1.75
EUR/TRY (pavg)	2.00	2.34	2.31	2.30	2.35

Source: UniCredit Research

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

From the soft landing challenge to the recovery challenge

The combination of ample global liquidity, diversification of exports and external financing and Turkey's ability to avoid pro-cyclical fiscal policy has allowed it to engineer a soft landing

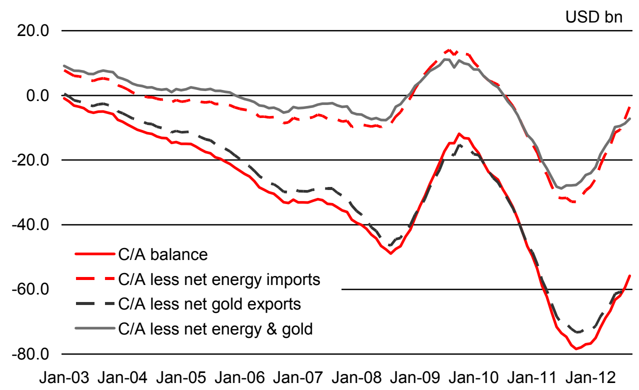
Turkey's success in engineering a soft landing in 2012 can be attributed to the following:

- The structure of the CBT's balance sheet allowed it to soak up a considerable amount of TRY to stabilise the currency as we entered 2012. This, combined with ample global liquidity, triggered in part by the ECB's LTROs and followed up by Draghi's OMT plan, ensured a solid bid for high yielding assets, including the Turkish sovereign and for the first time increased issuance of domestic bank debt in FX, helping finance the C/A deficit at record low interest rates. Fitch's shift to investment grade, combined with expectations of a similar move by Moody's in the coming quarters has also helped;
- In the face of a sharp slowdown in external demand, Turkey has managed to grow exports and help compensate for the slump in domestic demand more so than elsewhere in the region. The sustainability of this growth is questionable but this does not take from the fact that the recovery has materialised. Of the USD 20bn of improvement in the C/A deficit over the first 9 months of the year, USD 11.5bn (USD 10.4bn)was due to increased gross (net) gold exports;
- For the first time in its recent history, Turkey has been able to employ counter-cyclical fiscal policy in the face of an external slowdown in growth, facilitated by a solid balance sheet and, as discussed above, ample financing. Over the first 10 months of the year, real expenditure and revenue growth reached 8.2% yoy (-0.5% yoy for the same period in 2011) and 3.2% yoy (9.7% yoy for the same period in 2011) respectively. From here the government's focus is on improving GDP growth ahead of local and presidential elections in 2014. The government's medium term plan, published in October, put GDP growth in 2013, 2014 and 2015 at 4%, 5% and 5% respectively. While these forecasts appear optimistic to us, there are reasons to expect an acceleration in growth from here. Firstly the impact of the slowdown in credit growth should, to a large extent, have already been captured by domestic demand. The change in new credit extension, rather than credit growth, correlates well with domestic demand in Turkey. Assuming that credit growth settles at approximately 15% yoy, the downside risks to new credit extension from domestic demand are limited. Secondly, facilitated by slowing GDP growth, easing inflation and ample foreign capital inflows, the CBT has been able to lower interest rates significantly. For example the cost of funding it provides to the banking sector has fallen from 8.9% in January to 5.7% in November;

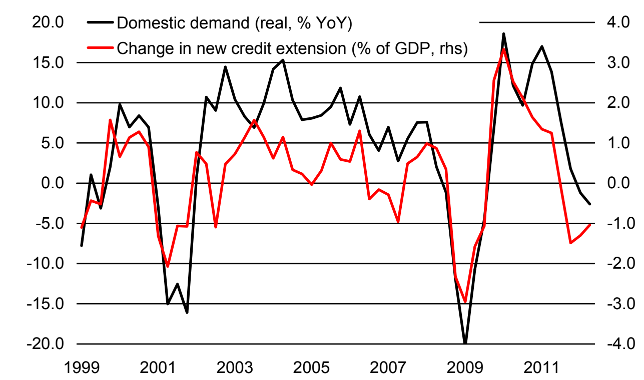
GDP growth should gradually accelerate in 2013

EXTERNAL DEMAND FILLED SOME OF THE GAP CREATED BY DOMESTIC DEMAND

The C/A balance, energy and gold



The impact of slowing credit growth has fed through to domestic demand (assumes credit growth at 15% yoy)



Source: Turkstat, CBT, UniCredit Research

- While Turkey has been successful in diversifying its exports, this has been largely gold-related and others areas of exports have suffered from the global slowdown, much as elsewhere in the region. We expect 2013 to show a gradual improvement on this front.

Despite improvement, the CBT's inflation target remains difficult because of a lack of coordination across domestic institutions and what is considered an excessive growth sacrifice

From a structural perspective, however, the CBT has once again had to compromise on its 5% inflation target, as well as facilitate a wider than desired C/A deficit for longer to avoid a sharper contraction in economic activity. Upon the launch of its unorthodox monetary policy in late 2010, the CBT openly targeted "5*5*5", namely a 5% C/A deficit combined with 5% GDP growth and 5% inflation. This rapidly proved unrealistic and while the CBT's ability to engineer a soft landing in 2012 is impressive, it seems to have settled with inflation above target for longer, a C/A deficit which settles at close to 7% of GDP for some time while growth recovers towards but not necessarily convincingly to 5%.

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

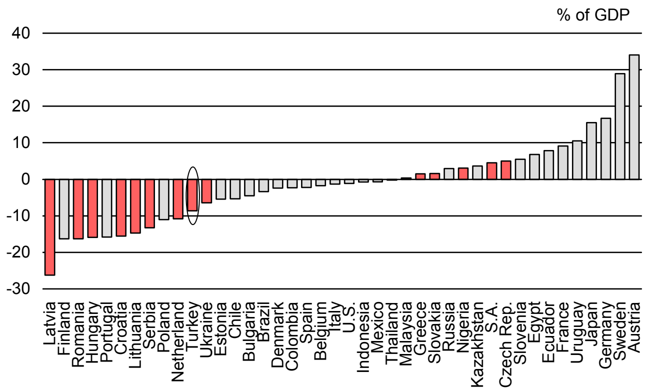
But concerns on renewed currency volatility combined with a still wide C/A deficit position prevent the CBT from accumulating much needed FX reserves, despite an increasing shortfall. This is only likely to change if the TRY basket meaningfully breaks 2.0. Via its reserve option coefficient framework, the CBT has been successful in growing FX reserves from USD 78.5bn at the end of last year to USD 100bn by end-November. The CBT argues that in the case of TRY depreciation pressure, the banks will exchange TRY at the CBT for this FX, stabilizing if not significantly increasing domestic interest rates and stabilizing the currency. Problematic within this is that the CBT's overall ammunition relative to short term inflows or the increase in bank external liabilities over recent years has weakened. As shown below, by EM standards the Turkish banking system now runs one of the widest negative net foreign asset positions, though unlike much of the rest of CEE this is not financed by mother banks but to some extent by increased Eurobond issuance.

Prospects of investment grade amidst increased political uncertainty

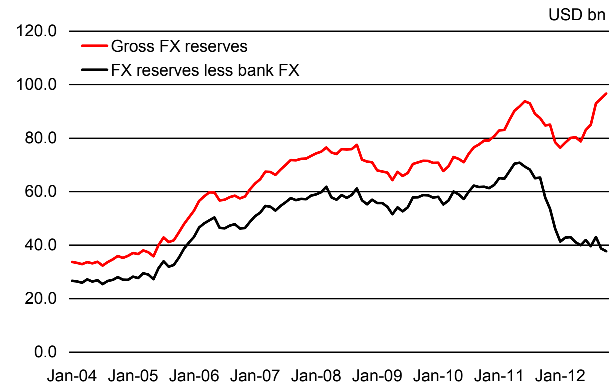
A key anchor for Turkey, amidst these increased external vulnerabilities, is the prospect of another investment grade rating over the course of next year, following Fitch's move in November. From a foreign investment flow perspective, this should help to re-inforce the structural nature of at least some of the decline in interest rates that we have seen in Turkey since the 2008 crisis as well as improve prospects for more medium to long term foreign investment. The more negative backdrop to this is the rising geopolitical tensions across the Middle East which at this stage are having limited knock on impacts on Turkey but pose an increasing tail risk.

RISKS IN NEED OF MANAGEMENT

The banking sector's net foreign asset position v international peers



FX reserves are stable but banking liabilities have increased



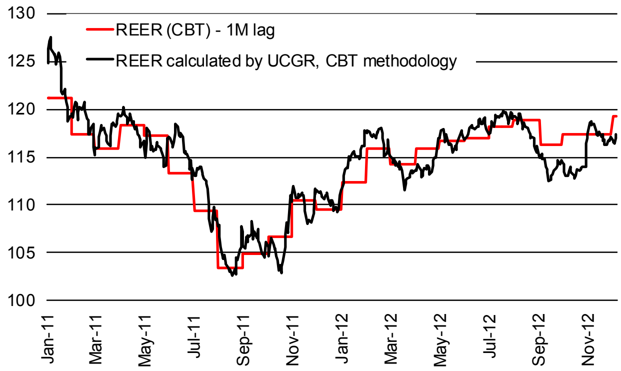
Source: CBT, Turkstat, UniCredit Research

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

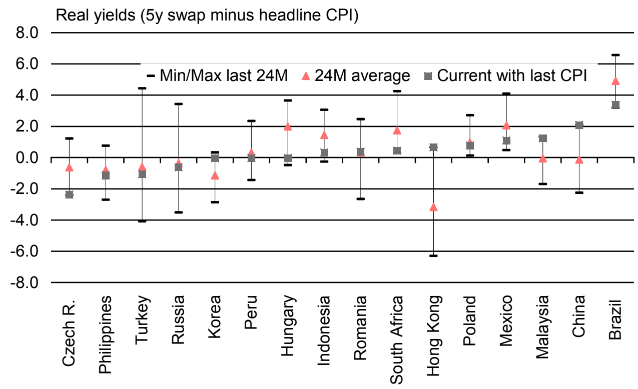
Long TRY as the CBT continues to favour low currency volatility

Within a risk-hungry environment, Turkey boasts a stable currency, lower but still high carry and on a relative basis a decent growth story. The prospects of another investment grade rating for TRY and overall capital flows must be balanced against a C/A deficit which by global standards remains large and hefty gross external financing requirements. But Governor Bacsi has drawn clear battle lines on TRY, signaling that in the near term any meaningful break of the TRY basket below 2.0 will be met by central bank action. 2013 should see a maximum of 2-3% gains. In other words the CBT is willing to re-introduce increased currency volatility, assuming favourable external markets, only very gradually. With that in mind, TRY remains a convincing carry trade as we enter 2013, with a bias to sell USD on any backups towards the top the basket's 2.0-2.1 range.

Turkey: CBT says REER is capped at 120 this year, 2-3% nominal gains next year



Real rates are low, suggesting most rate cuts are now done



Source: CBT, Treasury, Bloomberg, UniCredit Research

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2011	2012F	2013F	2014F
Gross financing requirement	**62.9**	**73.7**	**82.8**	**88.3**
Budget deficit	1.5	13.2	20.9	18.8
Amortisation of public debt	61.4	60.5	61.9	69.5
Domestic	53.9	53.7	58.0	62
Bonds	48.0	52	56.0	60
Bills	6.0	1.7	2.0	2.0
External	7.4	6.8	3.8	7.5
Financing	**61.5**	**66.4**	**88.0**	**88.3**
Domestic borrowing	54.8	49.3	71.5	72.1
Bonds	50.6	68.8	69.5	70.1
Bills	4.20	2.0	2.0	2.0
External borrowing	6.7	5.1	5.9	5.8
Bonds	6.7	4.7	5.5	5.4
IMF/WB	0	0.4	0.4	0.4
Other	0	11.9	10.6	10.3

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2011	2012F	2013F	2014F
Gross financing requirement	**145.5**	**136.0**	**147.3**	**154.9**
C/A deficit	62.0	42.4	43.7	44.1
Amortisation of medium to long term debt	30.9	31.8	31.1	32.7
Government/central bank	4.6	3.7	2.7	2.1
Banks	5.6	8.1	8.2	8.8
Corporates	20.7	20.1	20.2	21.8
Errors and omissions	-9.6	-5.1	0	0
Financing	**148.4**	**112.1**	**147.3**	**154.9**
FDI	14.7	17.5	16.8	18.1
Equity (private, net)	17.7	24.5	18.0	14.1
Borrowing Medium to Long term	38.1	31.4	31.9	33.9
Government/central bank	4.0	2.1	1.6	1.2
Banks	10.0	7.2	8.2	8.8
Corporates	24.2	22.0	22.2	23.9
Other (incl. reserve accumulation)	9.1	-28.5	0.9	2.9

Source: CBT, Treasury, Bloomberg, UniCredit Research

Ukraine (B3 negative / B negative / B stable)*

Outlook – Ukraine enters 2013 with an economy that has come to a standstill, a hefty twin deficits problem, scheduled IMF repayments and FX reserves which are low and continue to decline, putting UAH under pressure. The outcome of the parliamentary elections in November has slowed the authorities' willingness to address their twin deficits while discussion on FX depreciation persists. Ukraine may be able to go it alone for a multi month period but remains vulnerable to any exclusion from external markets and may ultimately have to choose between the IMF and Russia.

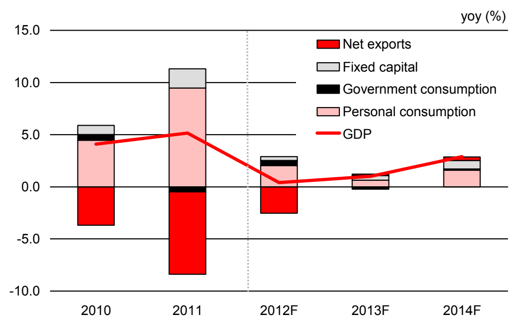
Strategy outlook – We expect any near term UAH depreciation to be minimal. Even in a scenario where the authorities are successful in meddling through, strong external risk appetite will be met with persistent issuance, providing plenty of entry opportunities.

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

KEY DATES/EVENTS

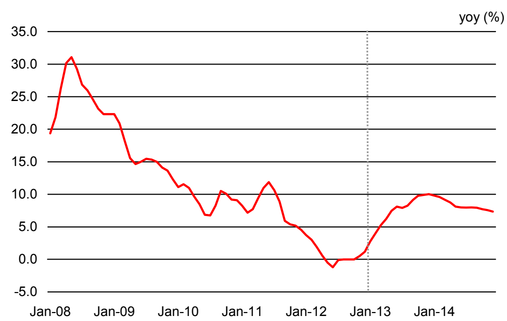
- Mid-January: Scheduled IMF visit
- 5-10th of each month: FX reserve data
- 15-18th of each month: Industrial production data

GDP GROWTH SLOWING SHARPLY



Source: Ukraine State Committee Statistics, UniCredit Research

INFLATION AT RECORD LOW BUT SET TO RISE



Source: Ukraine State Committee Statistics, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2010	2011	2012F	2013F	2014F
GDP (EUR bn)	102.6	118.4	126.7	126.4	128.6
Population (mn)	45.8	45.5	45.3	45.1	44.9
GDP per capita (EUR)	2,241	2,603	2,796	2,804	2,864
Real economy yoy (%)					
GDP	4.1	5.2	0.4	1.0	2.9
Private Consumption	7.0	15.0	3.2	1.0	2.5
Fixed Investment	4.9	10.1	2.0	2.5	4.5
Public Consumption	2.7	-2.4	2.5	-1.1	0.6
Exports	4.5	2.2	-3.5	4.5	6.5
Imports	11.1	16.8	1.4	4.0	5.5
Monthly wage, nominal (EUR)	213	237	281	284	308
Unemployment rate (%)	8.4	8.2	8.0	8.3	8.3
Fiscal accounts (% of GDP)					
Budget balance	-5.7	-2.7	-5.7	-4.8	-4.2
Primary balance	-4.1	-0.8	-3.5	-2.5	-1.8
Public debt	40.1	36.5	41.9	45.3	44.8
External accounts					
Current account balance (EUR bn)	-2.3	-6.9	-9.8	-7.5	-7.2
Current account balance/GDP (%)	-2.2	-5.8	-7.7	-5.9	-5.6
Basic balance/GDP (%)	2.0	-1.3	-4.0	-2.0	-1.7
Net FDI (EUR bn)	4.3	5.4	4.7	5.0	5.0
Net FDI (% of GDP)	4.2	4.5	3.7	3.9	3.9
Gross foreign debt (EUR bn)	88.2	95.5	99.1	104.1	97.4
Gross foreign debt (% of GDP)	86.0	80.6	78.2	82.3	75.7
FX reserves (EUR bn)	25.1	23.3	16.9	16.0	17.5
Inflation/Monetary/FX					
CPI (pavg)	9.4	8.0	0.8	7.4	9.3
CPI (eop)	9.1	4.6	1.2	10.0	8.5
Central bank target	tentative target of 5% by 2014				
Central bank reference rate (eop)	7.22	5.80	5.50	6.00	6.00
USD/UAH (eop)	7.97	8.04	8.20	9.02	9.29
EUR/UAH (eop)	10.6	10.4	10.7	12.2	13.0
USD/UAH (pavg)	7.95	7.94	8.12	8.61	9.16
EUR/UAH (pavg)	10.5	11.1	10.5	11.4	12.6

Source: UniCredit Research

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

Avoiding difficult decisions

Battling a contraction in GDP, a hefty twin deficits problem, scheduled IMF repayments and declining FX reserves

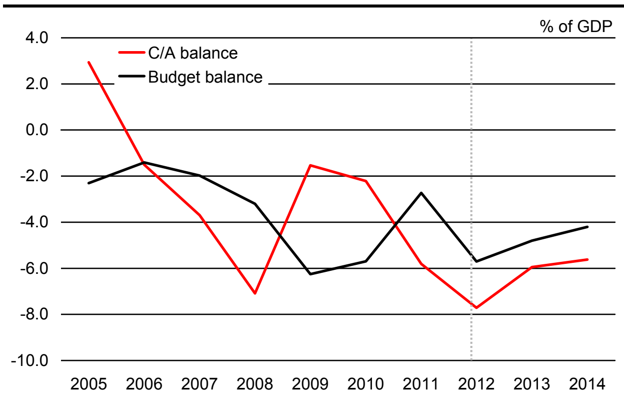
Ukraine enters 2013 with an economy that has come to a standstill, a hefty twin deficits problem, scheduled IMF repayments and FX reserves which are low and continue to decline, putting UAH under pressure:

- By Q3 GDP growth fell 1.3% YoY and for the year as a whole Ukraine will post GDP gains of less than 1%. This reflects the combination of a terms of trade shock, a poor year for agriculture, a credit crunch and tight monetary conditions. 2012 saw steel prices fall over 30%, pushing the growth of metal exports into negative territory. The authorities have protected against a sharp increase in gas prices by collapsing volumes. Meanwhile credit growth has ground to a halt amidst a slowdown in deposit growth and persistent outflows of foreign bank funding. 3m Kievprime has traded above 20% since July;
- Ukraine's C/A deficit looks set to finish the year at approximately 8% of GDP, 2pp of GDP wider than in 2011, while the budget deficit has also widened significantly in the face of a slowdown in economic activity and populist fiscal policy ahead of November's parliamentary elections;
- FX reserves continue their decline, due to a combination of IMF repayments, gas imports and currency defence. At USD23.4bn in November, FX reserves have fallen by 14% or USD 3.9bn since September, USD7.0bn since end-11. FX reserve coverage of imports had fallen to less than 4 months of imports and 80% of short term external debt by Q2;
- In the face of such a decline in FX reserves, Ukraine's gross external financing requirement remains large. Though low rollover ratios on foreign bank debt have long been the norm (2012 YTD 0.65, 2011 0.4), non-bank financial corporate rollover ratios remain above one while Ukraine also boasts high FDI inflows. But the sovereign's external financing requirement, at EUR4bn next year, is problematic. To help with budget financing, central bank holdings of government debt are also on the increase.

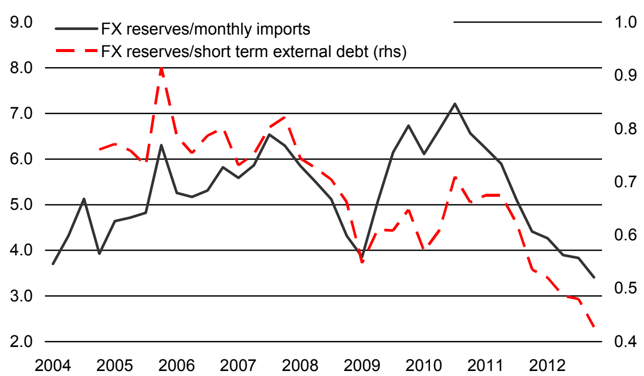
Expect the authorities to react over the course of Q1

The outcome of parliamentary elections in November has slowed the authorities' willingness to address their twin deficits. President Yanukovich's Party of Regions, though still holding a majority with the help of the Communists, did not poll as well as was widely expected. There is a clear window for much needed reform – presidential elections are not scheduled until 2015 – but the authorities are likely to react only over the course of Q1. While the FX reserve loss over the past couple of months is large, locals do not appear to be transferring UAH deposits into USD in size but instead placing all new deposits in FX. December also tends to see increased UAH demand from locals for the holiday season.

TWIN DEFICITS AT RECORD WIDES



FX RESERVES ARE LOW BY ALL METRICS



Source: IMF, NBU, national statistics office, UniCredit Research

There is focus on the extent to which UAH will be used as an adjustment mechanism

A crucial question hanging over the authorities is the viability of this current fixed FX regime. The deterioration in the BoP points to a need for UAH weakening while the combination of a move towards increased flexibility in some trading partner economies (e.g. Russia) and persistent terms of trade shocks (via both exports and imports) over recent years points to a need to use FX as an adjustment mechanism against external shocks. In the past FX depreciations have been considered politically even more expensive than gas price hikes. As a result the authorities are reluctant. This year has seen a muted attempt to faciliate some more flexibility but looking ahead the authorities need to choose between an acceleration in this strategy or a continuation of tight monetary policy, upon which they will be forced to layer fiscal consolidation next year. Any sort of gradual shift towards a more flexible exchange rate will be difficult but the longer the authorities leave this, the more complicated it will become.

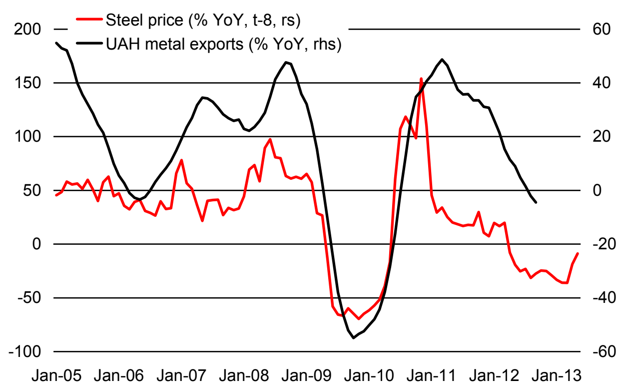
Ukraine may be able to go it alone for some months to come…

Can Ukraine go it alone? It is possible for a multi month period but an unviable strategy over a multi-quarter period. Much depends on the pace of FX reserve loss over the first couple of months of the year but the Ukrainian authorities have done a good job of buying time this year by rolling over loans with Russia, limiting gas imports and issuing in USD. Another 1-2 hard currency issues, would buy the authorities a further 3-4 months. Combining this with a gradual weakening of UAH would add further credence to such a strategy. Should market access evaporate however, this strategy would quickly become unrealistic.

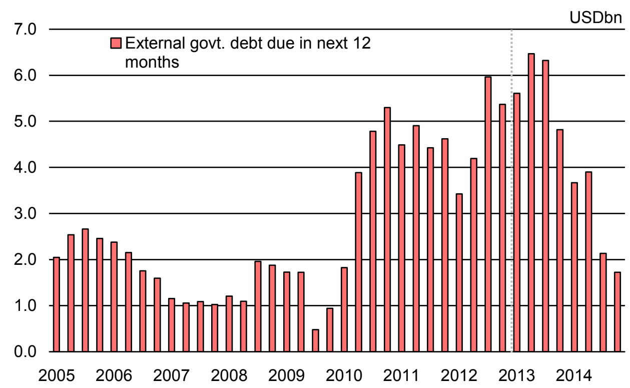
…but large funding needs ultimately risk forcing it towards external help

As a result a more reliable source of hard currency funding is likely to be needed at some stage, even if we are unconvinced of the authorities' willingness to agree to this pre-emptively. The IMF is an option, and politically more palatable than in Hungary, but this will require agreement on gas price hikes and currency flexibility. In case there was any doubt on the Fund's flexibility on gas price hikes, their recent paper quells these. They point to the current policy as weighing on government finances, sustaining energy over-consumption, dampening investment in delivery systems and undermining incentives for domestic production. Even in a scenario whereby Ukraine agrees to a new IMF deal, most if not all IMF funding will be used to roll monies borrowed under the previous programmes, implying that market access will still be necessary. A planned mission for December has been delayed and is now scheduled for the second half of January. Russia also an option for funding. This is nothing more than a political decision and would most likely require Ukraine to agree to membership of the customs union, representing a further step away from the EU. Ukraine's gas contract with Russia will also be under discussion. Though our baseline is an IMF deal ahead of a Russia deal, much will depend on the terms of any deal that Russia is willing to make available.

LOWER STEEL PRICES HAVE WEIGHED ON EXPORTS



THE SOVEREIGN'S EXTERNAL REDEMPTION PROFILE REMAINS CHALLENGING



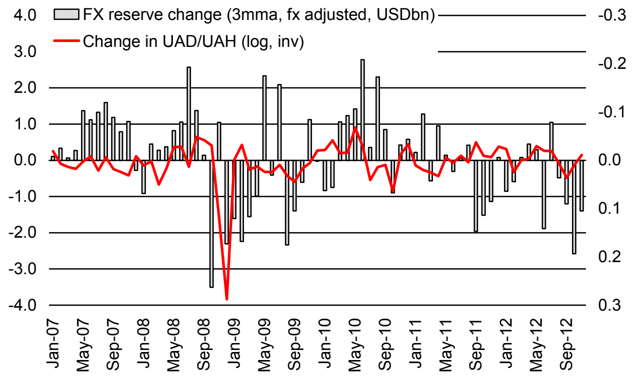
Source: MinFin, NBU, State Treasury, UniCredit Research

Ukraine: Wait and see

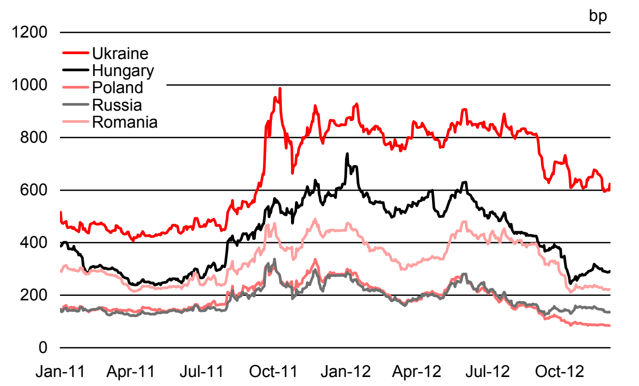
No need to rush

Ukrainian asset prices have held up well in the face of domestic macro pressure, supported by a risk-on external environment. Any currency move in UAH in the coming months will at best be a resumption of the authorities' strategy of gradual depreciation. Any larger move will require a resumption of large FX reserve loss post Xmas. But even in a scenario where the authorities are successful in muddling through, strong external risk appetite will be met with persistent issuance, providing plenty of entry opportunities.

FX RESERVE PRESSURE IS LARGE BUT NOT UNKNOWN IN UKRAINE



UKRAINE IN A LEAGUE OF ITS OWN BUT HOLDING WELL IN FACE OF DOMESTIC PRESSURE (5YR CDS)



Source: Bloomberg, NBU, UniCredit Research

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2012F	2013F	2014F
Gross financing requirement	**15.8**	**20.4**	**20.3**
Budget deficit (excl Nafto)	4.7	3.5	2.8
Amortisation of public debt	11.1	16.8	17.5
Domestic	6.7	11.9	13.1
Short term	0.9	5.0	5.5
Medium to long term	5.8	6.9	7.6
External	4.4	4.9	4.4
of which IMF	2.5	4.1	2.7
Financing	**15.8**	**20.4**	**20.3**
Domestic borrowing	11.5	13.8	15.1
of which NBU	2.5	1.0	0
Short term	5.0	5.5	6
Medium to long term	6.5	8.3	9.1
External borrowing	3.8	5.5	5.0
Bonds	3.8	4.0	5
IMF	0	1.5	0
Other	0.5	1.1	0.2

Source: MinFin, NBU, UniCredit Research

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2012F	2013F	2014F
Gross financing requirement	**60.3**	**55.6**	**54.0**
C/A deficit	9.8	7.5	7.2
Medium to long term amortisation	17.7	18.4	17.0
Banks	5.6	4.4	3.6
Corporates	7.7	9.0	9.0
Government/central bank	4.4	4.9	4.4
Short term debt amortisation	25.5	24.8	24.8
Banks	4.5	4.2	4.2
Corporates	19.5	19.0	19.0
Government/central bank	1.6	1.6	1.6
Other (incl. intercompany lending, capital flight	7.3	5.0	5.0
Financing	**60.3**	**55.3**	**54.0**
FDI	4.7	5.0	5.0
Portfolio flows	0.5	0.5	0.5
Medium to long term borrowing	21.1	22.7	22.5
Banks	3.3	2.2	2.5
Corporates	13.0	14.0	14.0
Government/central bank	4.8	6.5	6
Short term borrowing	24.8	24.8	24.8
Banks	4.2	4.2	4.2
Corporates	19.0	19.0	19.0
Government/central bank	1.6	1.6	1.6
Other	2.2	0.4	1.2
Change in reserves	7.0	2.0	0

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