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Quarterly

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2Q 2011

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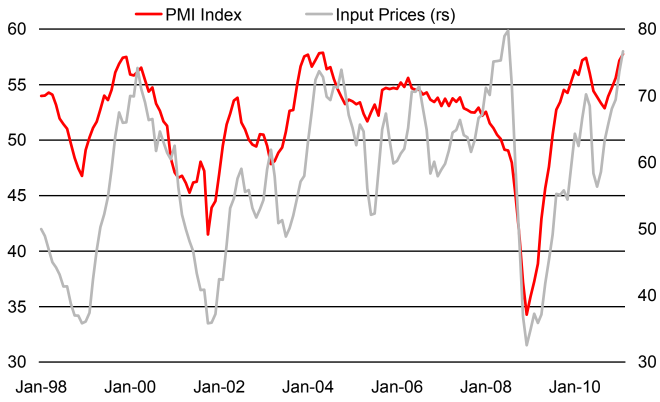
CEE: Holding its own against some gusty headwinds

In terms of dominant themes for CEE in the coming quarter we focus on two inter-related issues which we see as central to determining overall macro performance. The first is the ability of CIS and those countries that were forced towards IMF programmes to build on the renewal of capital inflows seen over recent months. The second is the ability of consumers and central banks in oil importing countries both in CEE and more globally to weather the most recent increase in food and oil prices at a time when labour markets remain weak. The outcome on both fronts will be determined at least as much by the global developments as it will domestic policy decisions in CEE.

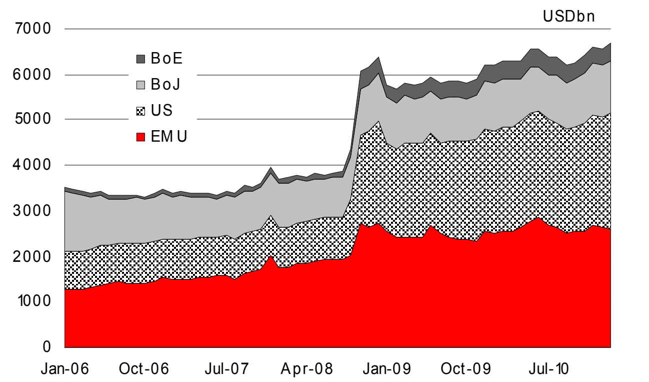
Our global backdrop is supportive of CEE in 2011…

As we enter 2Q, global growth dynamics remain supportive of CEE. Since the publication of our last quarterly we have increased our forecast for US and EMU GDP by 1.0pp and 0.3pp to 3.1% and 1.7% respectively. A weather-related impact reduced German 4Q GDP gains to 0.4% but we expect a rebound to 0.9% qoq in 1Q. The US posted a healthy 0.7% qoq in 4Q. Data released YTD for 2011 point to further gains ahead. The global manufacturing PMI is up 2.2 points since December to return to within a tenth of its highest on record. The global services PMI is up 1.8 points to 55.6, 2.9 points above its long term average.

Global manufacturing PMI is at close to an all time high but input prices have also moved sharply higher also



Central bank balance sheets remain large but additional liquidity likely to come to a halt in 3Q, with Japan acting as exception



Source: BoJ, BoE, ECB, Fed, Markit, UniCredit Research

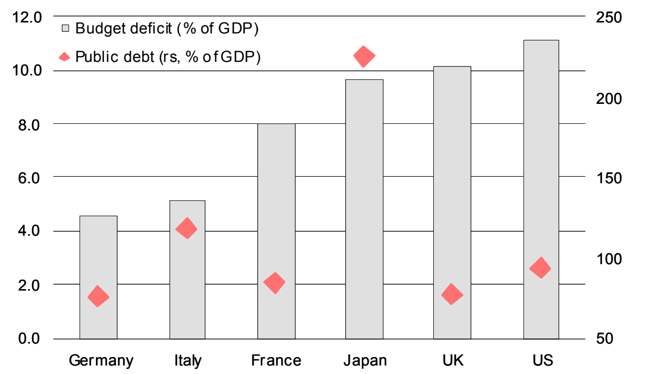
That said global headwinds have increased considerably and introduce downside risks to our forecasts:

Downside risks are made up of uncertainty in the Middle East and Japan, the ability of the global economy to withstand higher commodity prices and prospective monetary policy tightening

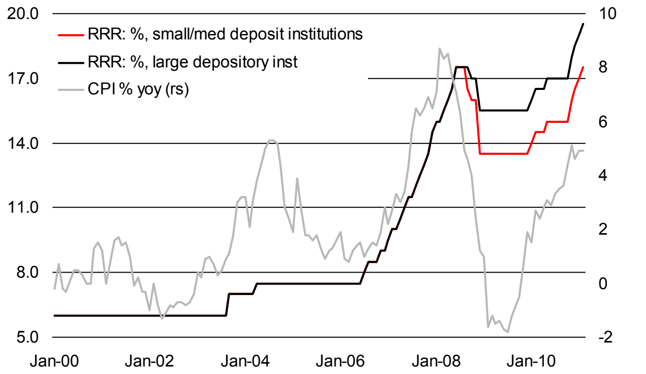
- Our primary concern is commodity prices. Central banks hold differing views on the implications of higher commodity prices. Oil is up USD 20 per barrel since the beginning of the year while global food prices, as measured by the CBR food price index are up 9.4% in USD terms YTD, 35.2% yoy. Gains in the global manufacturing PMI index have been matched by significant gains in input prices. The ECB appears determined to hike rates in April while the Fed's QE2 programme expires in June, though the Bank remains reluctant to hike rates. Higher commodity prices are as much an upside risk to inflation as they are a downside risk to growth. A mix of higher inflation and persistent double digit budget deficits in some developed countries is a looming risk for government and corporate borrowing costs. Within the developed world central banks continue to tighten monetary policy, with China having recently pushed through its third hike to reserve requirements this year, following 6 last year.

- Though more marginal, we also highlight uncertainty as to how events in Japan play out and continued EMU rumblings. In the positive scenario CEE should see some marginal benefits from Japan's rebuilding efforts. On EMU details on the enlargement of the EFSF and a framework for the ESM are being ironed out but the Greek government is struggling to put together another large package of consolidation measures, agreement on the re-structuring of Ireland's banking sector is proving politically difficult while the market continues to view the Bank of Spain's estimates for recapitalization of the cajas as unrealistic. Portugal limps from one bond auction to the next hoping to avoid external assistance.

Governments in the developed world continue to face a considerable challenge on fiscal consolidation (2010 data)



China battles higher inflation and credit extension with hikes in reserve requirements



Source: IMF, PBOC, UniCredit Research

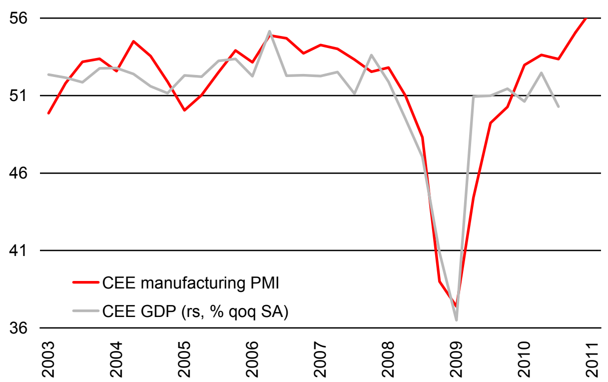
The region enjoys a continued recovery in economic activity as 2011 progresses

The region is on track to show GDP gains of almost 4% this year

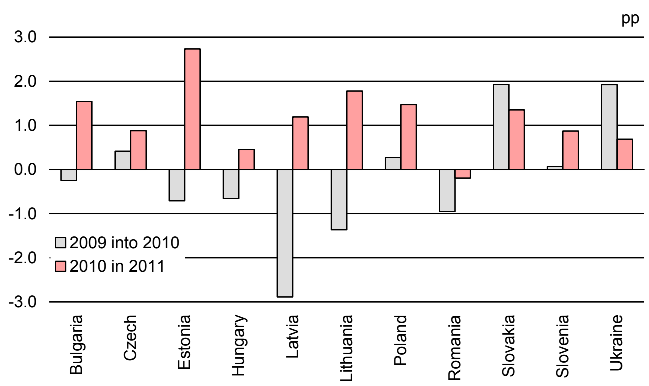
Just as is the case in the developed world, CEE is weathering this list of headwinds well. From the data released on 4Q GDP to date (Turkey and Russia are the most noticeable exceptions), all economies except for Latvia showed qoq gains. Romania and Croatia are the only two economies in the region where GDP growth in yoy terms in 4Q was negative. With the exception of Romania, all countries enjoy a positive carryover from GDP last year into this year. In the Baltics, Bulgaria, Poland and Slovakia, that carryover exceeds 1pp this year. We continue to expect GDP gains this year for CEE as a whole of almost 4%, with all countries in our group posting positive gains for the first time in 4 years. Data released to date for 2011 is supportive of this view. Over the first two months of the year we have seen a further 1.2 point increase in the manufacturing PMI index to 56.9, its highest on record, putting CEE on track for an acceleration, rather than deceleration in growth in 1Q11.

RECENT ECONOMIC ACTIVITY INDICATORS ARE POSITIVE

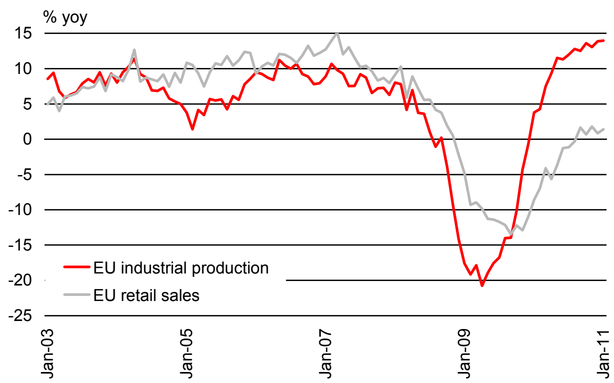
PMI data points to further gains ahead for GDP[1]



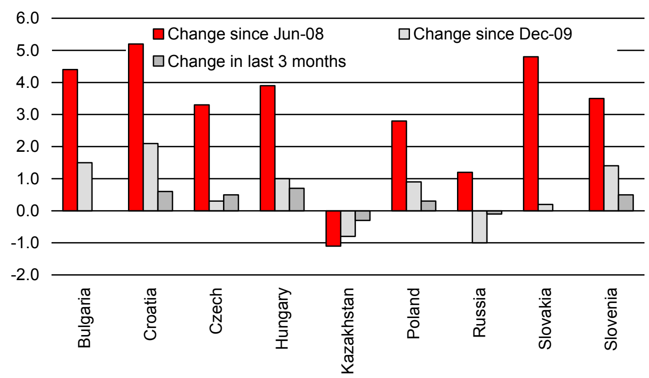
A positive carryover should aid GDP growth this year[2]



Within the EU countries the recovery is unbalanced and heavily reliant on industrial production[3]



Unemployment has only meaningfully turned in the CIS



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

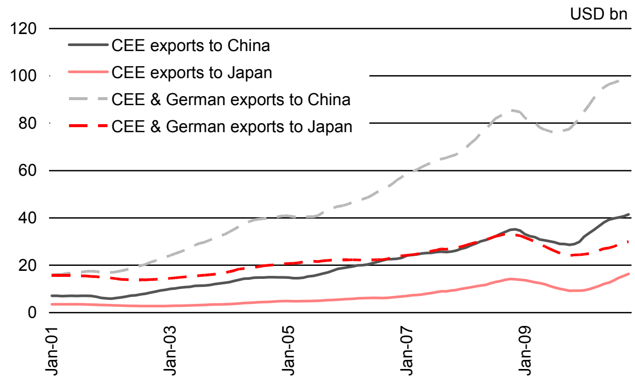
Trade and financial linkages with Japan are not a risk

In a benign scenario, the impact of events in Japan should be neutral to positive for economic activity in CEE. In terms of a potential decline in import demand from Japan, the impact on the region should be easing manageable. Over the 12 months to Oct-10, 1.5% of all CEE exports went to Japan. To the extent that parts of CEE export to Germany which then re-exports to Japan, once again the impact should be negligible. 1.2% of German exports went to Japan over the 12 months to Oct-10. While CEE may not benefit directly from an uptick in Japanese growth on the back of the re-building effort, CEE will benefit to the extent that China is involved in those efforts. CEE exports 2.5 times more goods to China than to Japan. CEE and Germany combined export 3.3 times more to China than it does to Japan. We would not exclude that the automobile industry in CEE may also benefit to the extent that there is a shortfall in production elsewhere. Hyundai-Kia and Toyota are present in Czech Republic, Toyota in Poland, Toyota, Honda and Hyundai-Kia in Turkey. Meanwhile direct financial linkages are weak. BIS data shows exposure of Japanese banks to CEE at a modest USD 20.9bn, of which USD 9.3bn is owed by Russian entities and USD 3.2bn by Turkish entities. To facilitate comparison, European banks were owed USD 1263bn by entities in CEE at the end of 3Q last year. Russia's borrowings from Japan represent 5% of total Russian borrowings from foreign banks, in Turkey's case 1.8% of total borrowings.

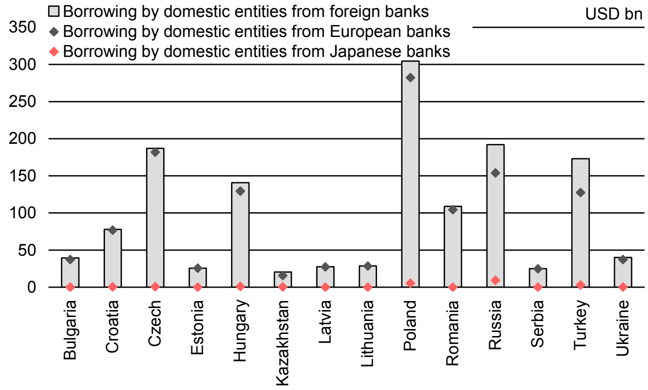
[1] Our CEE PMI refers to a simple average of the PMI manufacturing indices for Czech Republic, Hungary, Poland, Russia and Turkey
[2] Carryover refers to full year growth assuing
[3] Carryover refers to full year growth assuing

CEE IS NOT RELIANT ON EXPORTS TO OR CAPITAL FROM JAPAN

China is a much more important export destination for CEE than Japan



Reliance on Japanese capital is small and easily manageable



Source: Direction of Trade statistics, BIS, UniCredit Research

Higher commodity prices are more of a risk to growth in some countries than others in CEE

Higher commodity prices represent the primary shift in the macro environment. Their increase has different implications for different countries

Of most concern to us at this stage in terms of a continued recovery in economic activity are commodity price increases. To examine the impact of these on CEE, we must divide the region into two, namely oil importers and exporters.

- **Growth in CIS should benefit from the increase in global energy prices.** Partially counteracting this, Russia and Kazakhstan have suffered from higher food prices – 15.3% yoy and 13.6% yoy in February – but the recovery in domestic demand is much better anchored than elsewhere in the region and as such should be able to withstand this. At shown above Russia and Kazakhstan are the only two economies in the region to show a meaningful decline in unemployment since the crisis while Russia, Kazakhstan and Ukraine show the strongest real wage growth (in excess of 8% in all three cases) in the region currently. Of course Ukraine is not an energy exporter but it is a steel exporter, helping neutralize the impact of higher energy on its terms of trade. A much better harvest than elsewhere combined with controls on food prices has limited food price growth in Ukraine.

- **Among the energy importers, we believe that downside risks to growth are most contained in Turkey and to a lesser extent Poland.** Our concerns in Turkey and Poland are more contained in part because we have seen a more robust recovery in domestic demand, labour markets and credit to date. The most recent reading in Poland shows employment growth in excess of 4%, though real wage growth remains much below 1%. Latest data from Turkey showed it posting the largest real wage growth in the region following CIS. While every USD 10 increase in the price of a barrel of oil adds 0.4-0.5pp to C/A deficits, both countries to date have also shown an ability to import capital (though there are risks that that changes from here) to facilitate such a wider CA. deficit.

- **Among the smaller economies in the region, we are more concerned about the downside risks from higher commodity prices on economic activity.** The recovery is very much reliant on external demand with domestic demand lagging. Most recent data releases put growth in industrial production in the 'new' EU countries at an average 14.0% yoy, the 9th consecutive month of double digit gains (13.8% on a 3m/3m SA and annualized basis). In contrast retail sales posted a meager 1.4% yoy growth rate (1.5% on a 3m/3m SA and annualized basis). In many cases unemployment has yet to show clear signs of a peak while latest data showed a contraction in real wages in Lithuania, Romania and Croatia. Against these headwinds any downside surprises on external demand would translate into a more broadbased reduction in growth prospects, with domestic demand unable to fill the gap.

Central bank inflation targets are at risk, though core inflation is still contained

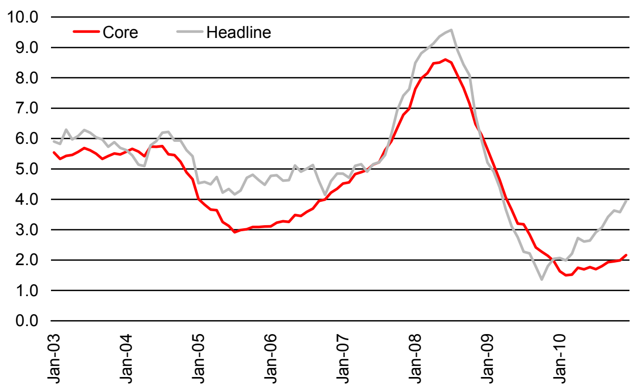
The most immediate impact from higher commodity prices is higher inflation, making central banks in the region increasingly uncomfortable

Higher oil and food prices mean that inflation targets for many central banks in the region currently are out of reach. At this stage Czech Republic and Turkey are the only countries in the region to post inflation below target. Hungary, Poland, Romania, Kazakhstan, Russia and Serbia have all seen inflation rise above target. In most of these cases the contribution from food and energy prices is currently significant enough to absorb central banks' full 'inflation allocation'. That said, at least to date core inflation pressures remain contained. As shown below, the gap between headline and core is larger now than it has been at any point in the past.

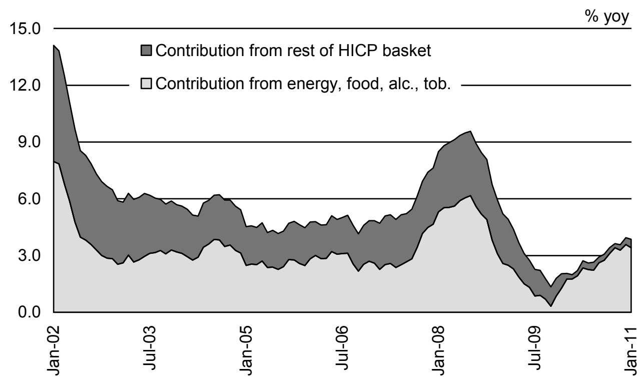
Central banks will remain well aware that all that is required from here to bring inflation down over a 12 month horizon is stabilization in food and oil prices and not a decline. Should harvests show an improvement on last year's poor performance, it would introduce downside pressure to food prices. Averaging latest data for the EU countries in our sample and Turkey, inflation stood at 3.9% yoy, up from 2.1% yoy 12 months ago. Food and energy accounts for 3.4pp of this 3.9%. Core inflation is more muted, with a record wide gap opening up between headline and core. Assuming energy and food prices were to remain unchanged from here while the contribution from the remainder of the inflation basket was constant, headline inflation on average across the new EU countries and Turkey would fall to 0.3% yoy 12 months from now. This uncertain commodity price outlook combined with manageable core inflation creates a dilemma for central banks.

COMMODITY PRICES DRIVE INFLATION AND POSE A DILEMMA FOR CENTRAL BANKS

Headline inflation under pressure but core much more contained



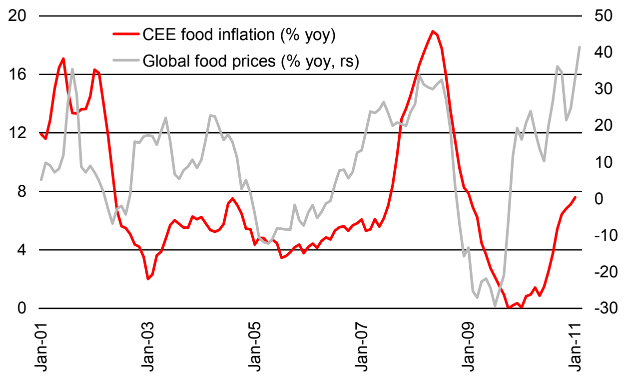
Inflation in the EU countries and Turkey – all about food and oil



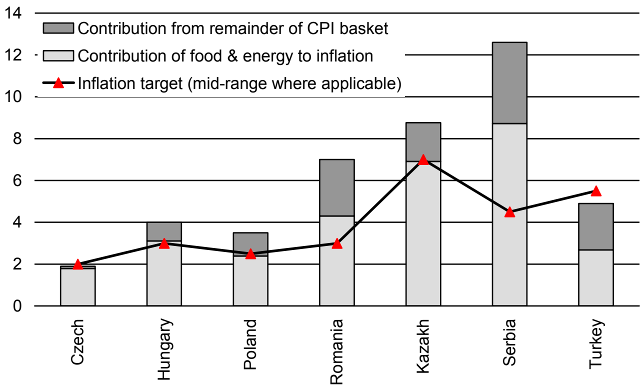
Source: Eurostat, Bloomberg, national statistical offices, UniCredit Research

COMMODITY PRICES DRIVE INFLATION AND POSE A DILEMMA FOR CENTRAL BANKS (CONT'D)

Global food prices point to further upside risks to inflation



For many central banks food and energy inflation soak up all of their inflation allowance, leaving no room for price increases elsewhere[4]



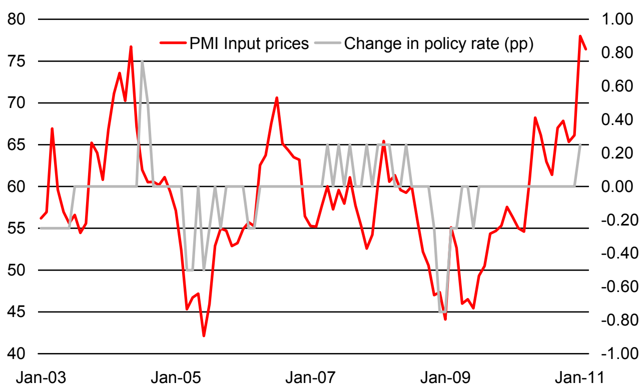
Source: Eurostat, Bloomberg, national statistical offices, UniCredit Research

In CIS monetary conditions need to be tightened further

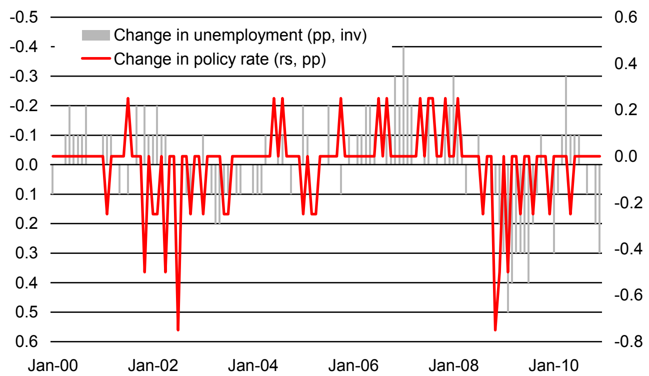
For central banks in CIS policy direction is weighted towards a continued tightening of monetary conditions. To date the CBR has been largely reliant on RUB gains to tighten monetary conditions. We expect some modest hikes ahead but RUB will remain the CBR's primary tool. In Kazakhstan, currency gains are more constrained by political pressure, at least ahead of April's election while the Governor Marchenko has already signalled scope to increase this year's inflation target (6%-8%). Even taking this into account, we see a need for the NBK to build on March's 50bp rate hike, as well as recent currency gains. Ultimately Ukraine should also follow suit, capturing IMF conditionality on a move towards inflation targeting and greater FX flexibility.

PRICE PRESSURES BUILD IN POLAND, CZECH CONTINUES TO WORRY ABOUT WEAK LABOUR MARKETS

In Poland, price pressures point to a rate hike



Inflation in the EU countries and Turkey – all about food and oil



Source: Eurostat, Bloomberg, national statistical offices, UniCredit Research

[4] For Czech, Hungary, Poland, Romania and Turkey, measurement is based on Eurostat HICP index and weights and based on January data.

In Turkey and Poland we see continued action to contain inflation pressures. Czech will lag

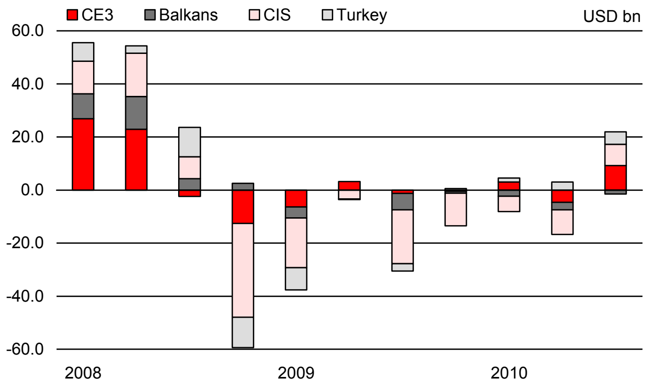
In Turkey and Poland we also see a case for a tightening of monetary conditions but this will come in different forms. The NBP favors gradual rate hikes which is hopes will translate into PLN gains, though to date it has been disappointed on PLN performance. With inflation to remain above target throughout this year, we expect at least 50bp in rate hikes ahead, which should over time translate into PLN gains. in turkey we expect the CBT to maintain its unorthodox monetary policy over the coming 1-2 quarters. The CBT's most recent reserve rate hike (a weighted average of 470bp to 14.4 percent) underlines their commitment to this strategy. From here we view their preferences as a static policy rate, a stable TRY, though it would not oppose modest depreciation from here and stable RRR, though some further increases cannot be excluded in the case of further upside surprises on credit growth over the course of 2Q. Looking further out towards year end, confirmation that the Fed will not add further to liquidity provision at a time when domestic inflation is likely to top the CBT's target should prompt some modest rate hikes. In Czech Republic a renewed downturn in domestic demand in 4Q conflicts with what will soon be a 50bp negative spread between the ECB's and CNB's policy rates and strong external demand. We expect some normalization in the policy rate ahead but this will be less aggressive than in Poland. **In Hungary, Romania and Serbia we see central banks as on hold from here for at least the next quarter.**

CEE finally rejoins the capital flows party

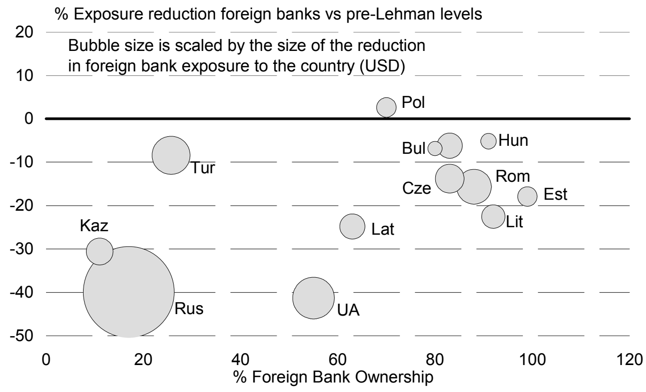
Many parts of CEE lagged the global recovery in capital flows…

In our last quarterly we highlighted, with the exception of Poland and Turkey, the extent to which the region as a whole has lagged other emerging market regions globally in terms of a renewal of capital inflows. From BIS data, developing Asia and LatAm saw foreign banks commit new capital to their region already over 2Q-3Q09 but 3Q10 represented the first quarter since the crisis when CEE as a whole saw a (very modest) renewal of inflows. Within the region Turkey and Poland bounced back quickly but CIS and the Balkans experienced outflows for much longer. Such a considerable outflow of capital from some parts of the region has undoubtedly acted as a drag on economic activity but has also translated into a significant improvement in positioning. For example foreign banks have reduced their exposure to Russian entities by 40% from their pre-crisis Lehman peak, 41% in Ukraine and 31% in Kazakhstan. Portfolio flows showed a similar trend, with Poland and Turkey accounting for 60% of all portfolio inflows between 2Q09 and 3Q10.

Foreign bank inflows into the region have finally begun to flow not just into Turkey and Poland but also to CIS



Even adjusting for 3Q inflows, CIS has seen a large clean-out in positioning



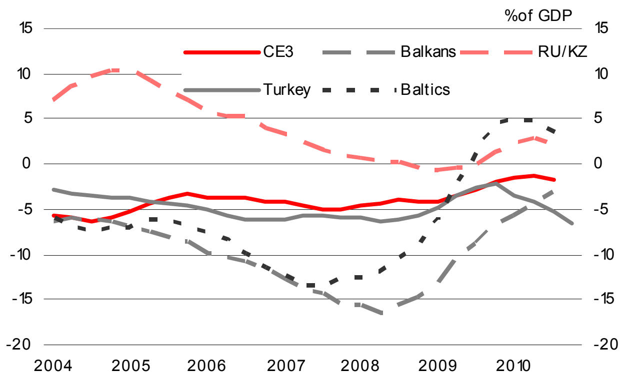
Source: BIS, national central banks, UniCredit Research

…but capital is now beginning to trickle down through the region on the back of improving fundamentals and supportive positioning

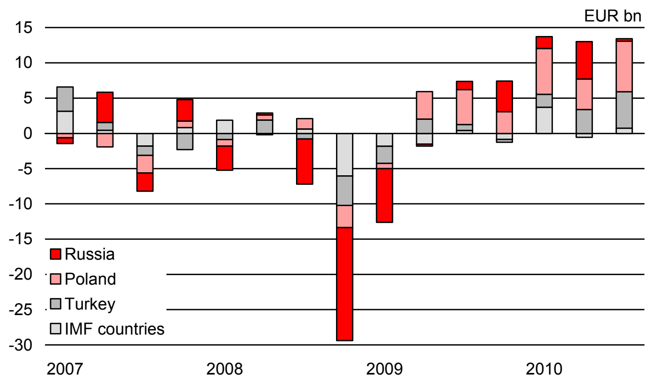
The laggards are now showing signs of catching up. We view this as a function of two drivers. First central banks in other EM regions globally have stepped up their battle against capital inflows. Second a number of countries in the region have shown an improvement in macro performance in part due to (IMF anchored) reforms, in part due to higher commodity prices (CIS). For example 3Q last year was the first quarter that we saw foreign banks increase exposure to Russian entities. Recent months have seen corporates from both Kazakhstan and Ukraine return to the market. Hungary has seen consistent inflows into its domestic fixed income market since Sep-10, a trend that has continued recently despite outflows from emerging market local currency funds. The authorities fiscal package and improved relations with the EC, IMF and NBH act as a support. Croatia and Lithuania has successfully executed Eurobond issues, while Latvia and Serbia may come to the market soon. Serbia has seen a significant pick up in capital inflows into its domestic fixed income market. At the time of writing, the outlook from here was less clear cut to the extent that the probability of the telecom privatization materializing has fallen due to a lack of bids while the government has yet to clearly indicate whether or not it will press ahead with another IMF programme once the current programme expires in 2Q.

Romania strikes us as particularly under-owned – net portfolio inflows since 2004 stand at only EUR 2bn, though this has been concentrated over recent quarters. The government's continued commitment to reform, as evidenced from its decision to enter a precautionary stand-by once the current arrangement rolls off in April, is encouraging. The IMF estimates that only marginal measures are required to bring next year's deficit in line with the 3% target while focus under the new programme on privatization of SOEs should generate capital inflows into the economy.

Turkey stands out in terms of deterioration of the C/A



Turkey and Poland has soaked up the majority of portfolio flows to the region since the crisis



Source: BIS, national central banks, UniCredit Research

Poland and Turkey have already seen more than their fair share of short term capital inflows

Poland and Turkey stand out as the two countries that are most vulnerable in terms of an outflow of capital in the event of deterioration in risk appetite globally. A shift in the nature of capital inflows at this stage would be preferable. The largest balance of payments financing item in Poland last year was inflows into government debt, both local and hard currency. This totaled EUR 15.6bn compared with a C/A deficit of EUR 11.6bn. Meanwhile Poland continues to disappoint in terms of fiscal performance. Last year's deficit neared 8% of GDP. Pressure from the European Commission to consolidate should prompt an improvement this year but the authorities will have to take extensive measures following 4Q's general election to meet next year's 3% target. In the meantime preferences among the domestic authorities remain for a continued inflow into government debt markets. Turkey has adopted a different strategy, though it is too early to take a firm view on its outcome. We estimate short term foreign inflows, largely in the form of portfolio and bank inflows, at USD 45bn last year, compared with a full year C/A deficit of USD 48.6bn. Both countries have seen a widening of C/A deficits, though this is much more pronounced in Turkey than Poland – in Turkey on a 3m/3m SA and annualized basis, the C/A deficit stands at 10.5% of GDP. With this in mind the CBT has been active is accumulating ammunition in the form of FX reserves, cutting interest rates to deter short term inflows and taking measures to ensure a greater handle on bank liquidity.

Monitoring downside risks closely

Cautiously bullish for 2Q

The combination of continued gains in economic activity and prospects for an improvement in capital inflows bode well for CEE for 2Q but the risks to our baseline since our last quarterly are more asymmetric and biased to the downside. The resilience of global economic activity to this increase in commodity prices is a concern. Any slowdown will have different implications for different parts of CEE, though ultimately all would suffer. For Turkey and Poland, the two oil importers that have enjoyed the strongest rebound in domestic demand, the most obvious risk channel is a decline in global risk appetite, translating into a reversal of capital inflows which in Poland's case could damage budget financing prospects. In the weaker oil importing countries, economic activity is likely to slump quicker than elsewhere, calling a halt to the tentative recovery in capital inflows and currency appreciation trends. To the extent that a slump in global economic activity would at some stage translate into a decline in commodity prices, CIS may not suffer initially but would ultimately suffer a correction in economic activity and capital flows. As Russia and to a lesser extent Kazakhstan have relied largely to date on currency gains to tighten monetary conditions, currency weakness could promptly set in.

To date CEE has help up well in the face of these headwinds. This has been reflects in recent ratings action. Latvia has been returned to investment grade by Fitch recently while Serbia was been upgraded one notch to BB. We see scope for Romania to follow. Turkey is in line for an upgrade, but probably more next year than this. Hungary's fiscal package, if implemented, may see the sovereign moved off negative outlook by year-end, though the banking sector remains a weak spot. There is little to no evidence in the data quarter to date to indicate a slowdown in economic activity but instead data point to stronger gains. Meanwhile central banks' gradual shift towards tighter monetary conditions for the most part seems a most sensible strategy. This leaves us with a cautiously upbeat tone heading into 2Q, albeit with a closer eye on higher frequency indicators to monitor the risks.

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CEEMEA FI/FX strategy: positioning should increasingly matter after disappointing 1Q

Top trade ideas:

1. **Long 2023/A HGB**
2. **Long ROMGB**
3. **Pay 5Y5Y PLN fwd on dips**
4. **Short PLN/HUF**
5. **Short EUR/RON**
6. **Short USD/KZT**
7. **Short USD/UAH**
8. **FX swap funded Turkish, Russian and Kazakh short term bond**
9. **Sell Ukraine (on spikes) Romania, Hungary 5Y CDS**
10. **Long Ukraine 2012 and 2013 Eurobonds**

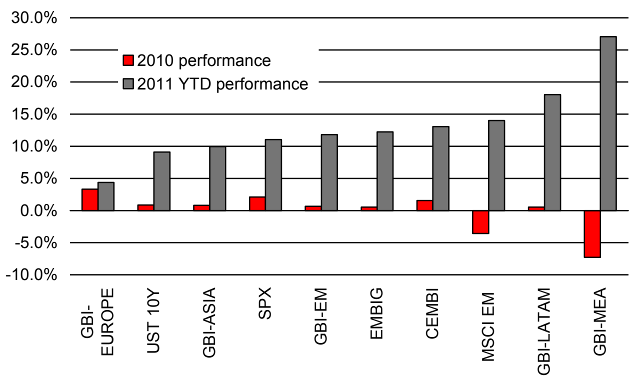
Evolving themes:
See risk reward is turning in favor of TRY but we are not there yet

- **EM markets closed a disappointing quarter following a stellar 2010 which is in our view driven by weak inflows into EM funds and headwinds from higher G3 yields. In this world we believe positioning could increasingly matter:** as fund flows turn less one way and G3 bond markets continue to create headwinds we believe market positioning should continue driving performance. To position on this theme we recommend short PLN/HUF, short EUR/RON and long ROMBGs.

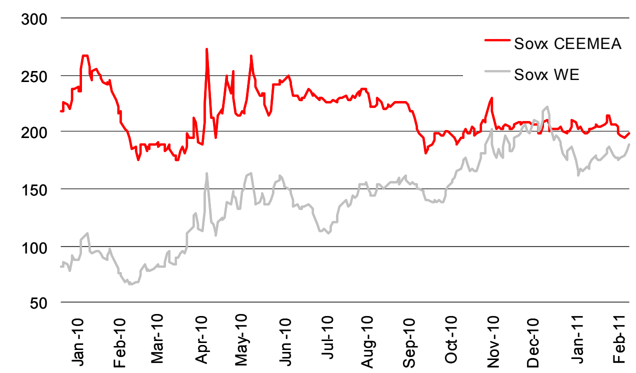
- **CEEMEA rates offer paying opportunity:** we see risk premium as relatively low on the long end of several CEEMEA local currency swap markets and we recommend paying 5Y5Y PLN IRS. Due to supportive supply-demand balance we still like long end HGB bonds. **In the sovereign credit universe** we see room for Romania and Hungary to tighten from here while see the Turkey/Russia trade as matured. We continue favor Ukraine credit. **In CEEMEA FX** we are looking to buy TRY as we think the CBT's ability to control liquidity is strong. We still like CIS FX but after the strong move observed in RUB we take profit and run longs in UAH and KZT. **Widening onshore and offshore rate spread in 1Q means we see FX swap funded short term LC papers in Turkey, Russia and Kazakhstan attractive.**

PRATICALLY ALL EM ASSETS CLASSES STOPPED OUTPERFORMING IN 1Q11

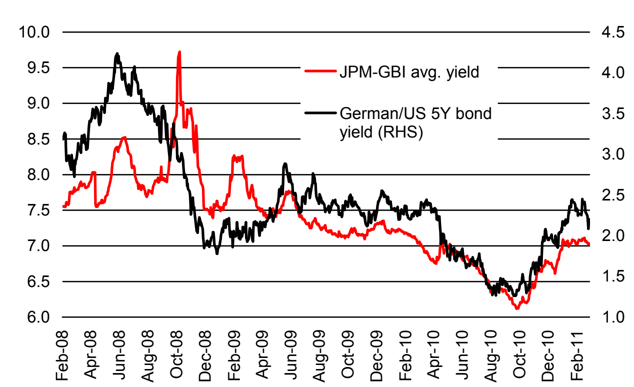
YTD EM performance has been poor compared to 2010



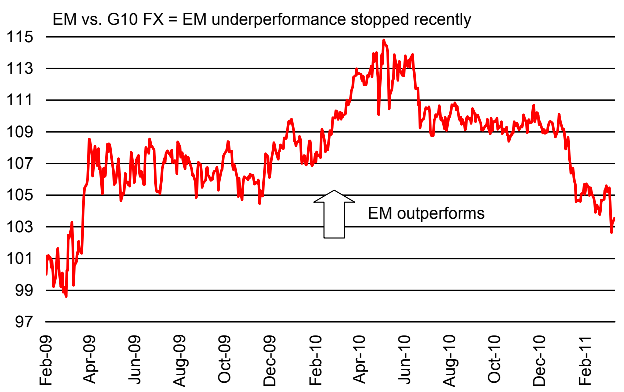
CEEMEA credit outperformance also stopped



EM yields stopped falling following G2 rates



EM FX started underperforming G10 FX



Source: EPFR, Bloomberg, JPM, UniCredit Research

Fund flows now less supportive for EM assets

Fund flows are now less supportive for EM markets particularly for equity funds

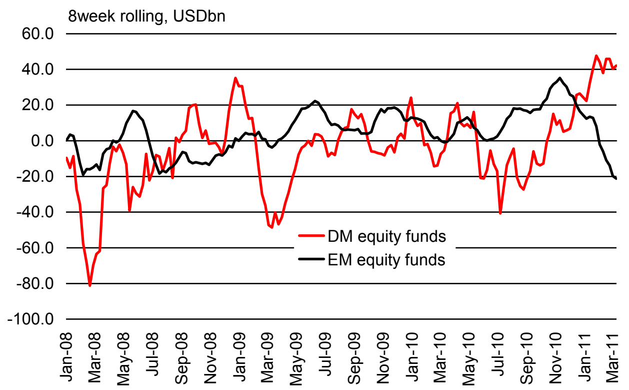
One of the big themes in equity markets YTD was the significant outflow from dedicated Emerging Markets (EM) funds and inflow into dedicated Developed Markets (DM) funds. YTD EM equity funds have seen a USD 16bn outflow vs. a USD 52.5bn inflow into DM equity funds (last year EM funds saw USD 84bn inflows vs. a USD 15bn outflow from DM funds). Although this trend slowed somewhat recently the flow backdrop had important implications on relative equity market performance. YTD EM equity markets underperformed DM equity markets by more than 7%, measured by the MSCI indices.

Bond flows were less supportive as well

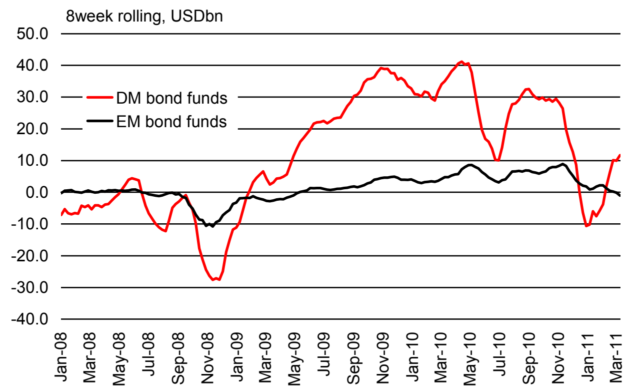
Recent data suggest that a similar pattern might be playing out with bond funds. Although YTD EM bond funds have seen an outflow of just USD 21mn, in the same period last year they had already received a USD 5.3bn inflow. Meanwhile, inflows into DM bond funds appear to be picking up again in the recent weeks. In terms of specific EM bond funds (based on currency focus), dedicated local currency bond funds seen the biggest outflow in March since autumn 2008 (still up USD 846mn YTD), while hard currency and blend currency EM bond funds have been struggling to attract inflows since the beginning of the year (YTD outflow USD 868mn). If outflows from local currency bond funds continue we believe it might have important implications on local currency bond markets.

FUND FLOW BACKDROP LOOKS MORE CHALLENGING THAN IN 2010

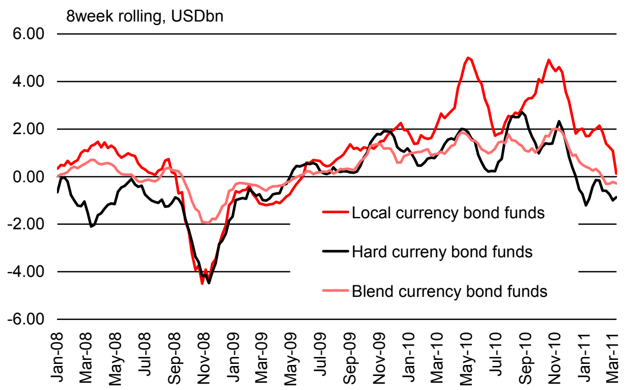
Significant EM equity outflows vs. DM inflows…



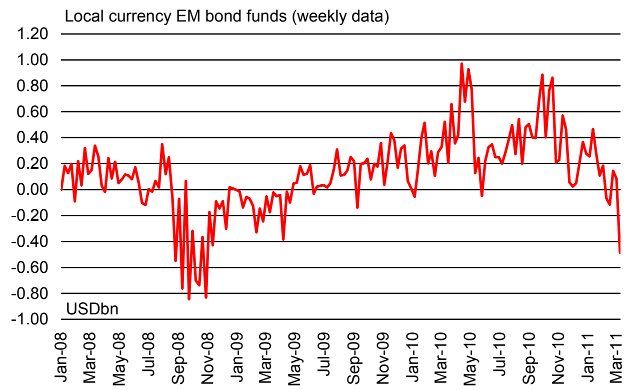
This pattern is now gradually appearing in bond funds



YTD most hard currency funds saw outflows but LC is also following



As weekly data shows big outflows from LC EM bond funds



Source: EPFR, Bloomberg, JPM, UniCredit Research

Less inflows and higher G3 yields do not bode well for EM markets but positioning could support some

LC duration recommendations

CZK	Short
HUF	Long
PLN	Neutral
RON	Long
TRY	Neutral
RUB	Short

Two way fund flows and rising G2 yields do not bode well for EM credit and rates as asset classes

In a world where fund flows are now less one way while G3 yields are heading north, we believe non-resident positioning will become an increasingly important driver of EM returns. When assessing to what extent EM bond fund flows and G3 yields impact credit spreads and local currency yields we calculated regressions between weekly changes between these variables (we used EMBIG and JPM-GBI average yields for the two submarkets) since Jan 2010. As can be seen in the charts below the models captured relatively well the dynamics year to date in the credit market but somewhat less so in the local currency rate market. The main finding of these calculations show that G3 yields entered with negative sign into the credit spread calculation which suggests that lower global yields are not necessarily good news for weekly developments in credit markets but fund flows did cushion the move last year.

Going forward we believe positioning could become an important driving factor of trading

In the local rate space, higher G3 yields are undoubtedly negative for local yields while the cushioning impact from EM flows was less important in 2010. Simply including our year end G3 rates forecast and calculating with only 50% of the 2010 flows would bring us to EMBIG spreads of around 350bp (up by 30bp) and JPM-GBI yield at 7.40% (up 40bp). **This suggests that the overall market trend could remain bearish in local currency rate and credit markets going forward broadly underlying our bearish view for the whole year.** Although the markets could remain bearish as an asset class we believe relative market positioning could become an increasingly important factor.

We estimate the POLGB market is heavily crowded followed by Turkey and Hungary

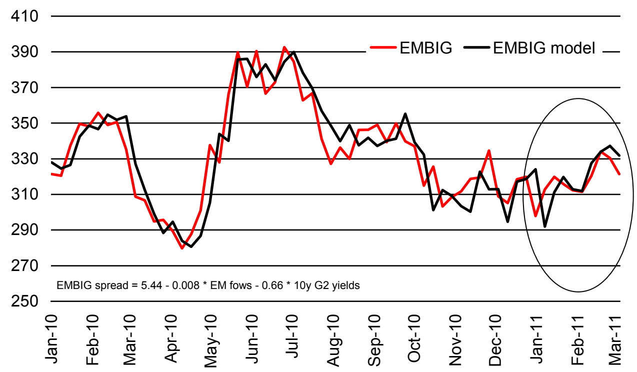
In EEMEA we estimate that the Polish and to a lesser extent the Turkish bond markets could see headwinds if EM bond funds continue to see outflows and positioning comes into focus. We estimated the relative positioning by comparing total inflows into EM local currency bond funds during the last 2 years versus actual changes in non-resident bond holdings in the specific countries. For country weights we used JPM-GBI weights. We assume that non-residents are neutrally positioned if the actual change in non-resident bond holdings matches the inflow into EM local currency bond funds (taking into account the country weight). Although this method could overestimate positioning given not only dedicated local currency EM bond funds invest into local currency bond markets but we believe it provides a fair assessment of positioning and their relative size. Using cumulative flows into EM local currency bond funds we estimate that non-residents are mostly O/W in POLGBs (by approximately USD 15bn), followed by TURKGB (by circa USD 5.5bn, we also note that non-resident TURKGB holdings went up by USD 1.7bn despite an outflow from EM funds). In the case of Hungary we estimate that non-residents are still about USD 0.5-1.0bn U/W despite the recent significant increase in HGB holdings. In the off-benchmark space we think Romania remains under-owned by non-resident investors both in equities and bonds. As we have highlighted in the economic section of this publication, portfolio inflows began to move into countries other than Turkey and Poland as the lagging countries started soaking up inflows.

In the smaller off benchmark local currency markets we believe ROMGBs offer value, while Serbian bills are also attractive but in the near term could see some headwinds

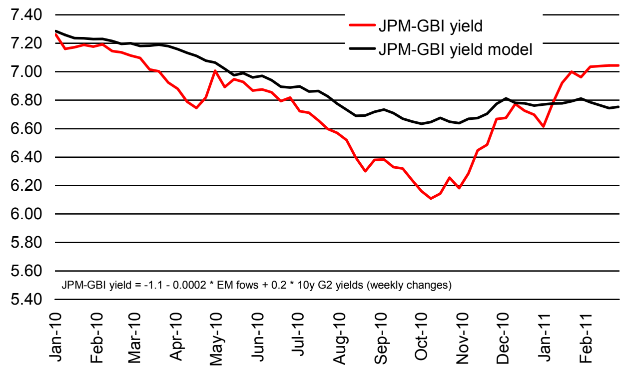
The trade implication of the above backdrop is to focus on less crowded smaller markets (Serbia, Romania) or to play the reverse of the positioning especially where the near term newsflow is also supportive. We remain short PLN/HUF (target 65.00) for now and favor less crowded local currency markets (Romania and Serbia). Although Serbia might see some headwinds in the near term due to the disappointing Telekom privatization newsflow we expect market focus to turn towards Romania. The RON is the best performing EM currency YTD with 4.1% appreciation but this is more of a catch up from the underperformance in 2010 (it was the second worst performing currency with only 5.2% appreciation in 2010). **We believe local currency ROMGBs are attractive at current levels.**

FUND FLOWS AND G3 YIELD DIRECTION IS UNLIKELY TO BE SUPPORTIVE OF CREDIT AND LOCAL CURRENCY RATES

EMBIG spread vs. model

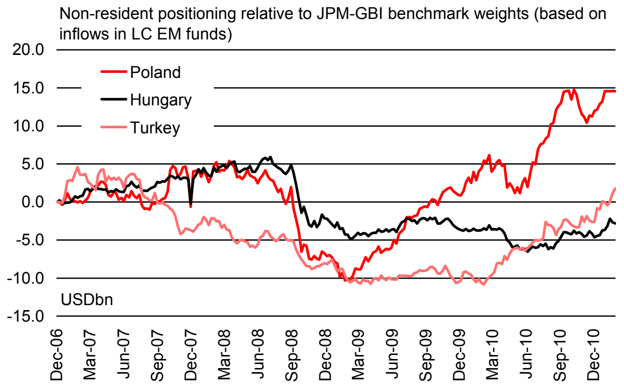


JPM-GBI yield developments vs. model

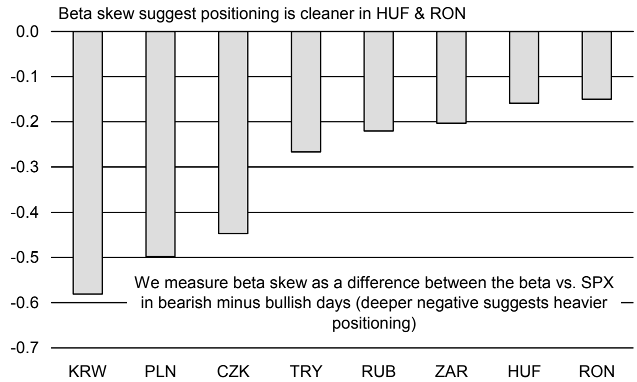


BIG DIFFERENCES IN THE REGION IN TERMS OF NON-RESIDENT POSITIONING

Significant O/W positions in Poland remain, Hungary still U/W



Beta skew suggests positioning is cleaner in Romania and Hungary



Source: JPM, EPFR, Bloomberg, UniCredit Research

Somee CEE swap rates offer good paying opportunity

JPM-GBI yields have moved 40bp higher in 1Q broadly mirroring the move observed in G3 yields. Using the above calculations we believe local bond markets could trade on a bearish trend in general. In this envrionment we believe some CEEMEA swap markets offer good paying opportunities from a global perspective. Looking at 5Y/10Y spreads in CEEMEA we actually see a number of local currency swap markets pricing too little risk premium compared to the fiscal, issuance and less supportive global environment going ahead.

Risk premium is relatively low in CEEMEA curve in general

One simple way to look at it is by just taking the difference between 10Y and 5Y rates. What we have found is that CEEMEA and in particular Poland and Hungary prices the lowest risk premium globally. In the case of Poland, the current level of 5Y10Y spread is especially striking given the well flagged fiscal risks. Accordingly, we would look to express the bearish view in the Polish rate market (switching from 5Y CDS buyer position). From a cost perspective we see paying the 5Y5Y PLN/EUR spread as a cheaper solution than paying 5Y CDS (positive roll-down of around 2bp per month vs. 14bp negative carry per month on a 5Y CDS payer position) while the two have correlated relatively well recently. The key risk to the trade is the potential jumbo flow from the MinFin. Accordingly, we are adding this position with an entry target level. We hence recommend paying 5Y5Y PLN rates with an entry target of 5.50% and take profit target of 6.25%.

We prefer paying 5Y5Y PLN

vs. Hungary where technicalities could keep risk premium low for longer

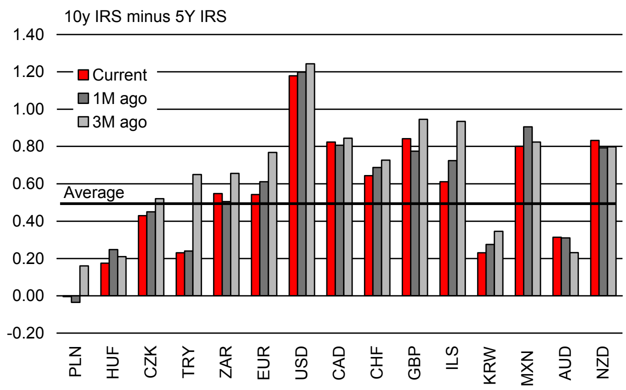
In the case of Hungary we refrain from paying rates outright as market technicalities will likely sustain the outperformance of local bonds (see Hungarian section) and this could keep the risk premium low on the long end of the curve for a while. As the supply demand balance primarily supports the bond market in Hungary we see some logic in hedging bond positions with swaps but we are not convinced about the timing yet and for the time being we are holding long 2023/A papers.

We are also paying RUB and TRY cross currency rates but versus local currency bonds

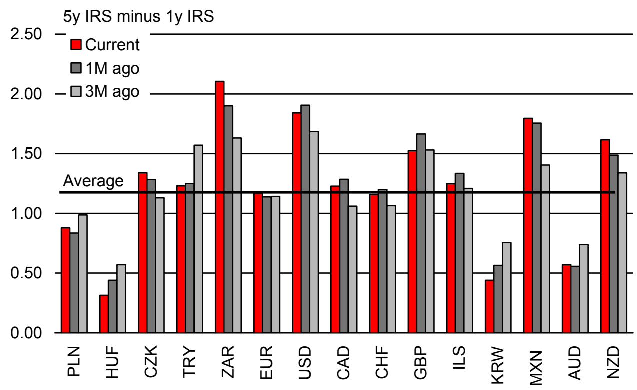
We also see the risk premium as relatively low as regards the Turkey and Russia curve but due to widening onshore and offshore rates we prefer to play these rate markets from that perspective and hence we would pay short end rates to fund local currency bond and t/bill exposures.

RISK PREMIUM IN POLISH LONG END AND HUNGARY SHORT END IS VERY LOW

Hungarian and Polish long end IRS look too flat



1Y/5Y looks too flat in Hungary



Source: JPM, Bloomberg, UniCredit Research

Sovereign credit market remains an unattractive asset class as a whole but residual opportunities remain

Sovx CEEMEA closed the quarter roughly flat

CEEMEA credit markets measured by the Sovx CEEMEA index closed the quarter roughly flat YTD but there have been number of interesting patterns playing out.

UCG credit real money portfolio allocation vs. benchmarks

CZK	M/W
BGN	M/W
HRK	U/W
HUF	O/W
KZT	M/W
LVL	M/W
LTL	O/W
PLN	U/W
TRY	M/W
RON	O/W
RUB	M/W
UAH	O/W

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

The Russia vs. Turkey credit trade has probably matured during the quarter but we are not sure about the timing of putting the reverse trade. The spread between the 5Y CDS tightened from plus 5bp to negative 30bp during the quarter amid increasing fears of an adverse impact on the current account balances from higher commodity prices. Looking at the oil vs. Russia/ Turkey CDS spread chart below we believe there is some more room to go in the near term but we feel this trade has ran its course already and we do not really see much value in chasing it.

Hungary and Romania should tighten further from here although the bigger part of the move is probably behind us. Although most of the move is already behind us in the credit universe we believe the credit spreads do not fully reflect the improved fundamental backdrop in Romania and potentially also in Hungary. Looking at CDS vs. rating we see scope for around another 20/50bp tightening of the 5Y segment in both names. We played this story via a seller on Romania since 8 Oct 2010 at 315bp and we are looking to take profit on dips below 250bp (current around 265bp). In Hungary we also played the tightening story via CDS seller and we see more room for n-t tightening but we see better opportunities in the local currency bond markets. Ratings wise we expect Romania to return to the investment grade in the second half of the year while we would probably see an outlook improvement in Hungary if the reforms are implemented in line with the plans.

We are constructive on Ukraine CDS and in the cash curve we favor short end versus long end

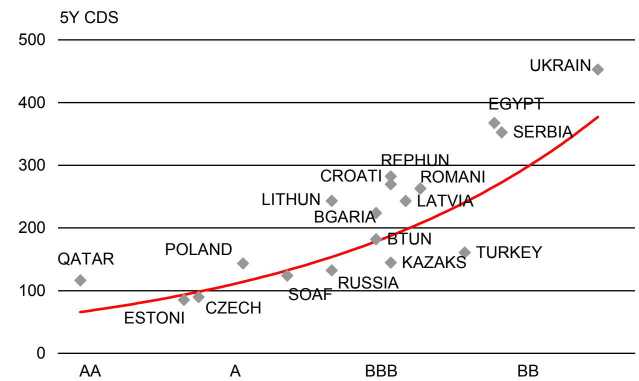
We remain constructive on Ukraine credit: We see reform momentum building in the coming weeks as authorities negotiate/implement the necessary reforms in order to facilitate the next IMF disbursement. Accordingly we would use spikes to sell 5Y Ukraine CDS with a potential to tighten to around 380/400bp during the quarter. After the USD 1.5bn Eurobond issue in February, we think it will take some time before the FinMin chooses to tap the market in order to avoid overcrowding (the size of the market has grown by 23% following the issue to USD 7.9bn). Given that the FinMin has an USD 2bn loan from VTB maturing in June, we would not rule out that an issue before or slightly after this could come out on the market, on the order of USD 1bn. In the cash market following the recent steepening of the CDS curve we favor short-dated Eurobonds (UKRAIN 2012, 2013) which have yet to catch up. Ratings wise we see scope for another 1-2 notches upgrade in line with the reform implementation progress.

We close our bearish Polish CDS trade and switch to local currency rate payer

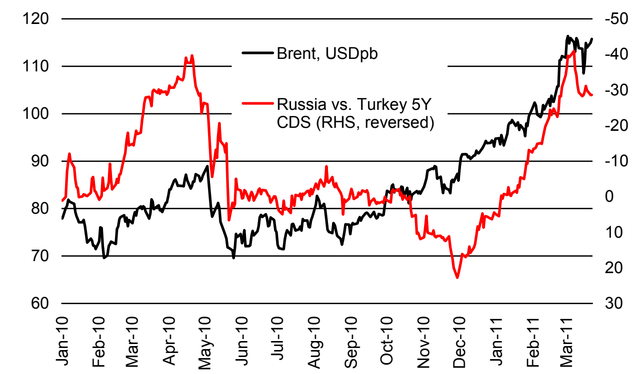
We remain cautious on Polish credit but due to the high cost of holding outright CDS payer positions we close our outright 5Y Polish CDS buyer (we entered at 140bp vs. current 144bp) and switching into local currency 5Y5Y PLN payer which is a much cheaper way to express bearish Polish fiscal outlook in our view.

EEMEA CREDIT MARKET OVERVIEW

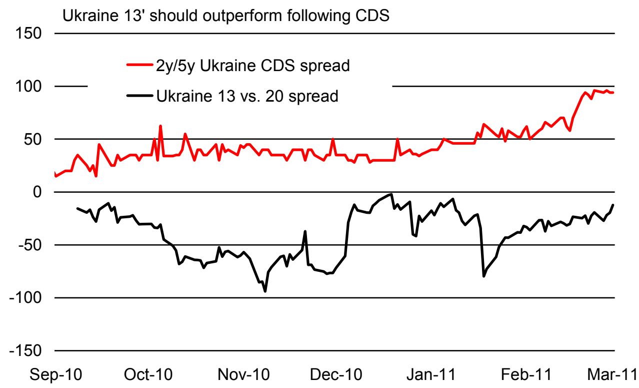
Hungary, Romania credit remains relatively cheap



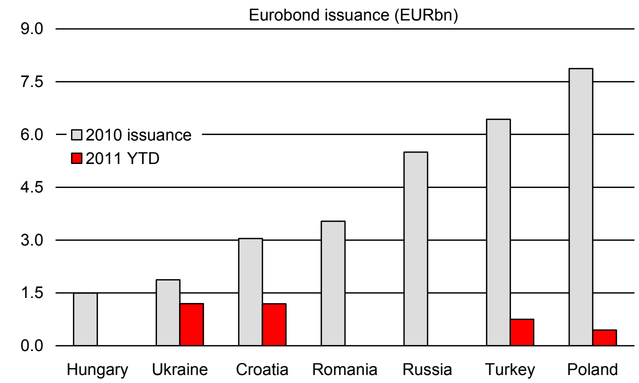
Russia vs. Turkey trade has probably matured in 1Q



Ukraine short end cash bonds should outperform following CDS



Eurobond issuance



Source: Bloomberg, UniCredit Research

FX should deliver positive returns

FX portfolio allocation recommendations

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

*Look to increase during the quarter

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

In 4Q10 we argued that amid tighter EM monetary policy versus still loose DM monetary policy and improved external balances should see FX delivering most of the returns with CZK and CIS currencies being the clear winners. Although EM FX as an asset class stopped outperforming G10 FX in 1Q11 CEEMEA currencies topped the EM FX league table and CZK & RUB were among the top 5 performers. Going forward we are monitoring a number of themes playing out in the EEMEA FX space.

We are looking to buy TRY as we believe the CBT is more able now to control TRY than it was in 2006

When is the right time to buy TRY? Although one might argue that the period running up to the 2006 TRY sell-off is similar to that in 2011, we believe there is a material difference in the CBT's ability to control the banking sector liquidity and hence to address short term flows and FX. The bank now provides around TRY 30bn liquidity to the banking sector (via short dated 1week repo operation) while back in 2006 it was taking around TRY 10bn liquidity off the sector. From a short term flow perspective we believe the current situation is much more manageable and if the CBT wants we think it has the ability to drive the currency stronger (by creating TRY shortage). With that in mind we believe the key indicator to watch apart from the actual CBT communication is the actual liquidity operations. This coupled with potentially higher inflation pressure implies that the argument for bullish TRY positions should increase in the coming months. Having said that we do not believe we are there yet and hence would wait for the liquidity operations to change but our point is that the risk of an uncontrolled further TRY depreciation from here is more limited now than it was in 2006.

We are taking profit on our long RUB position but remain long KZT and UAH

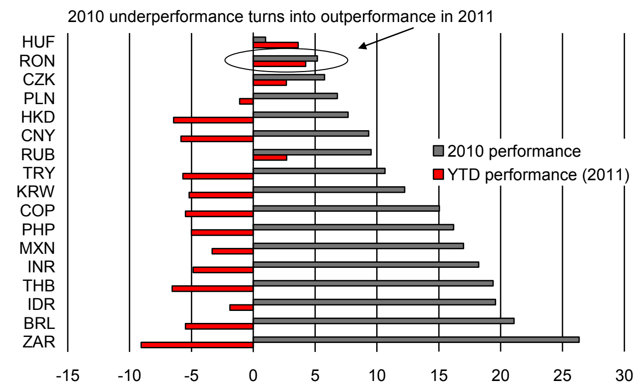
Has the RUB ran its course and outlook is now more balanced? we believe the long RUB story is now becoming a consensus trade and would prefer to express a bullish view via the other 2 CIS currencies (KZT, UAH). With RUB/KZT trading firmly above the 5.00 level we believe risk reward is better on longs in KZT and UAH. Also from here we might see the CBR rhetoric changing after the RUB has appreciated more than 6% YTD, from a valuation perspective the REER is at an all time high which might refocus market attention on the Dutch disease and potential negative implications on the non-commodity sector and despite all the CBR tightening YTD RUB liquidity is ample and cross currency interest rate swaps are about 5% below CPI. On a multi-month horizon we still expect the RUB to remain on an appreciation path but technically our bias is that the cross has probably run out of steam. Hence we are recommending taking profit on our long RUB/basket position.

We believe PLN could underperform in 2Q but in 2H policymaker effort should pick up, for the time being we remain short PLN/HUF

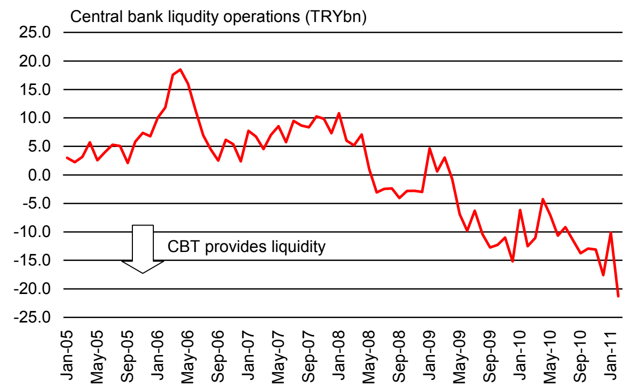
What is next for PLN after it failed to appreciate in 1Q11? The biggest disappointment YTD was undoubtedly the PLN which failed to appreciate despite both the MinFin and the NBP openly talking it up even mentioning specific levels that they intend to achieve. We believe the key motivation for Polish policymakers is public debt/GDP (reaching the 55%/GDP by the end of the year). According to our calculations using a relatively conservative nominal GDP growth and assuming that the pension reform will go ahead EUR/PLN will need to be around 3.80 by the end of the year. We believe the main reasons behind the lackluster performance is heavy positioning, market perception of NBP falling behind the curve and deteriorating current account balance. During the year the MinFin/NBP will however have the ability to step up efforts as Eurobond proceeds and EU flows can be channeled through the market (this in theory could mean around EUR 16bn flow in the market). As the main factors behind the currency underperformance is unlikely to disappear in the n-t we would use further spikes to add to PLN positions. This will unlikely occur in 2Q in our view. For the time being and also due to still supportive positioning and our constructive n-t view on the Hungarian fiscal situation we remain short PLN/HUF with a target of 65.00.

FX SHOULD CONTINUE DELIVERING RETURNS AMID BEARISH CREDIT AND RATE OUTLOOK

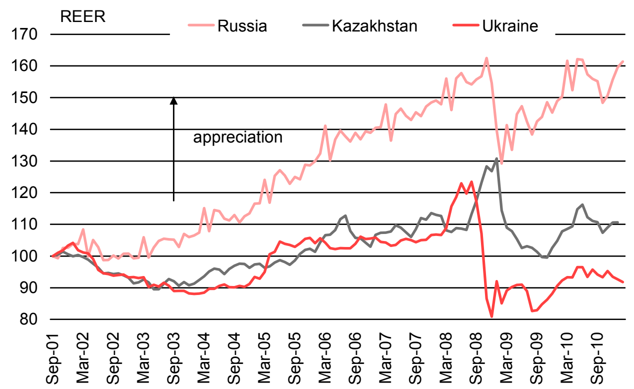
CEE FX tops EM league in 2011



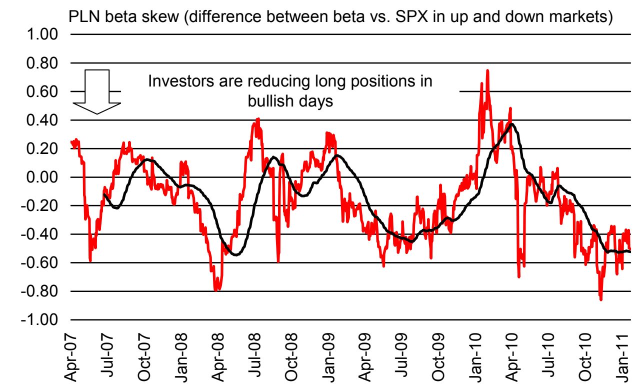
Turkish banking sector is more dependent on the CBT than in 2006



RUB valuation is getting a bit stretched vs. other CIS FX



Positioning is still against the PLN especially vs. HUF



Source: Bloomberg, UniCredit Research

Relative value possibilities

We believe onshore versus offshore trade could provide some carry potential during the year as the spreads have widened out in 1Q11

Apart from the above directional bets, we see a number of relative value possibilities opening up in 1Q which should provide ongoing carry opportunities in the next quarter.

Unorthodox monetary policy made FX swap funded Turkish t/bills attractive

Exploit widening difference between onshore and offshore rates: The non-standard monetary policy and/or increasing hedging activity of local corporates have led to a widening of onshore and offshore rate markets in some countries which makes FX swap hedged LC investments relatively attractive. **In the case of Turkey, after the CBT** cut the repo rate but increased the reserve requirements the spread between LC t-bills and cross currency swap rates widened again to around 200bp (on the 6Y maturity) and it is still around 100bp. We believe this has opened up an attractive opportunity to buy short dated local currency t-bills hedged with cross currency interest rate swaps.

We hence continue to see value in buying FX swap funded Turkish t-bills. We also note that non-residents increased TURKGB holdings during the sell-off but we believe most of this buying was hedged with cross currency swap rates and less outright buying. We would not buy non-hedged TURKGBs yet but in line with our evolving FX view we may change this view during the quarter.

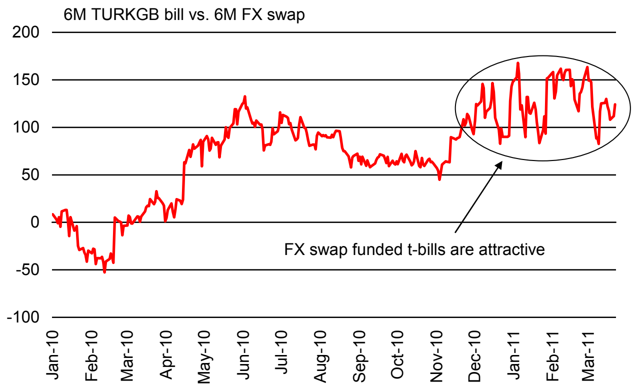
Onshore vs. offshore spreads also widened in Russian and Kazakhstan during the quarter

As regards Russia after the government issued the first Euro-clearable RUB denominated bond several corporate issuers followed and local issuance has also picked up. As corporates need funding in USD they are using RUB cross currency interest rate swaps to access the USD market. This plus excess RUB liquidity has pushed RUB basis swaps close to all time lows (3Y USD/ RUB basis swap is trading around negative 85bp). **We believe this backdrop similar to Turkey makes FX swap funded RUB bonds attractive.**

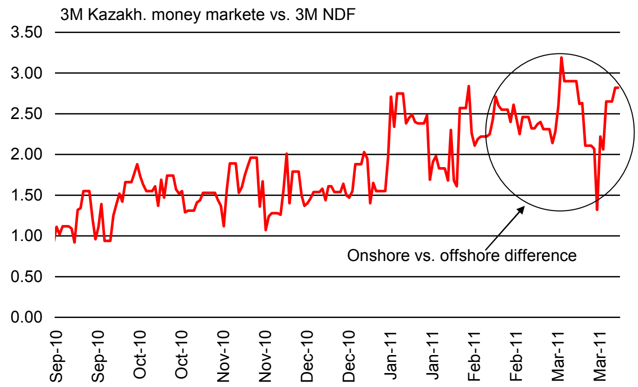
In the case of Kazakhstan, those investors that have access to the local market could achieve around 100/150bp positive carry by placing KZT depos and fund it via NDF positions. We believe this non directional trade has probably played an important role in keeping the USD/KZT at relatively high levels. We believe this remains an attractive opportunity for those investors who have access to the local market.

ONSHORE VS. OFFSHORE RATES DIVERGED OPENING ATTRACTIVE CARRY OPPORTUNITIES

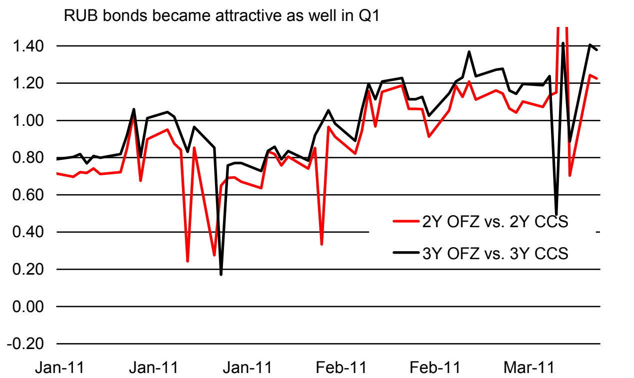
Turkish t-bills are cheap



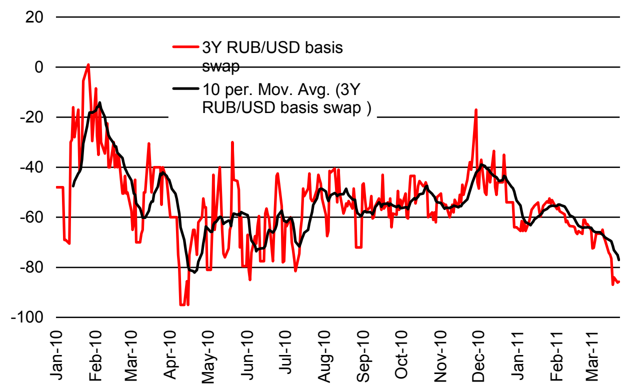
Access to the Kazakh money market could provide 200/300bp carry



RUB bonds are also attracive…



…as the basis is heading lower



Source: Bloomberg, UniCredit Research

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CEEMEA corporates: Stay bullish on Oil&Gas

Upside risks in commodities should boost credit metrics of CIS corporates

We see room for further moderate spread tightening in Emerging European corporate credits in the coming months, albeit volatility should remain high in the short-term as EEMEA credits remain vulnerable to a further flight to quality. Our constructive stance towards regional corporate credits is driven mainly by upside potential in commodity prices, which is a concomitant phenomenon of developments in the MENA region and the earthquake in Japan. Both events have the potential to push higher particularly energy prices– the uprising in the MENA region through an adverse supply effect, the earthquake in Japan through higher demand on the back of reconstruction needs as well as a global push towards traditional energy sources. The disruption in Japanese nuclear power generation and the turmoil in Libya are supportive for LNG demand in particular, thus for Gazprom's credit metrics. Moreover, the earthquake in Japan might lead to political calls for a wider use of conventional energy generation on a global scale. Russian and Kazakh oil&gas issuers should additionally benefit from the geographically safe distance of their oil&gas reserves from the MENA region. Moreover, the need to rebuild infrastructure after the earthquake in Japan should also boost demand for steel, particularly for long steel products (Evraz).

Rating momentum to turn positive

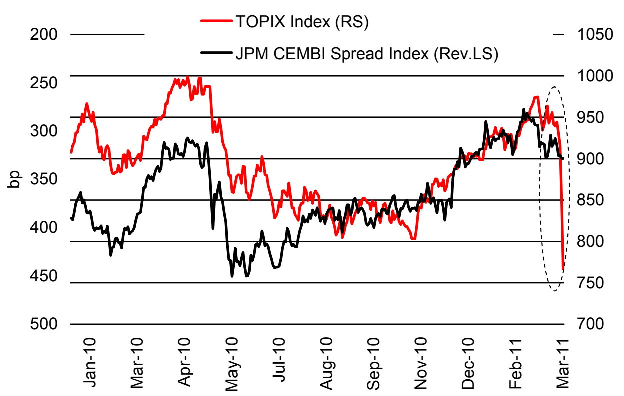
Improving credit fundamentals should pave to way for a more positive rating trend. During the current reporting season, earnings releases of major Eurobond issuers showed a substantial improvement in credit metrics, i.e. improved EBITDA generation, declining leverage as well as robust cash positions. In most cases, the latter ensures full coverage of 2011-2012 debt servicing. Although negative rating actions outweighed positive ones in January-February – mainly on the back of credit negative corporate policy actions, particularly M&A activity (VTB, BoM, VIP) and shareholder tensions (NorilskNickel) – improved credit metrics suggest that the latest upgrades of AlfaBank and Evraz by S&P to BB-s and B+s, respectively could be a harbinger of a more pronounced trend towards positive rating actions going forward.

Default rates to remain very low

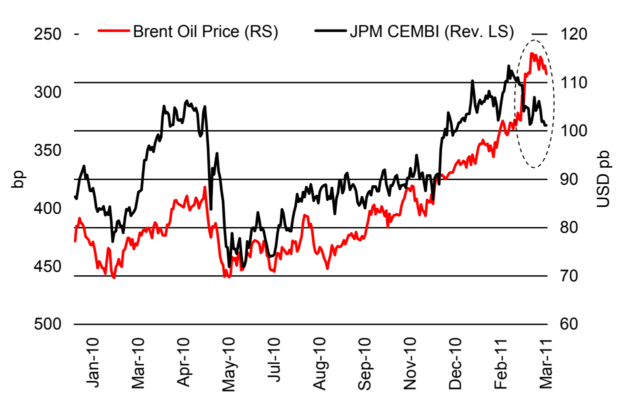
Fundamentals suggest that default rates will remain very low in Emerging European corporate credits. Czech Sazka was the sole credit event in the region this year, as the company failed to pay principal on its sinkable EUR 215mn 2021 Eurobond (insolvency proceedings will be opened in Prague on 21 April). However, we estimate this event to represent a mere 0.8% of outstanding euro-denominated Emerging European corporate credits, and expect default rates to remain at very low levels in the months ahead.

WHO WILL BE IN THE DIRVER'S SEAT AMONG EMERGING EUROPEAN CREDITS?

Emerging European corporate spreads vs. TOPIX



Emerging European corporate spreads vs. oil price



Source: Bloomberg, JPM, UniCredit Research

Technical factors still remain supportive

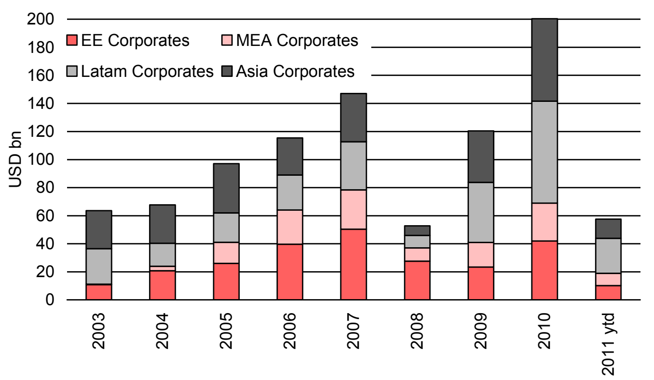
Supply risk remains contained, as funding requirements are moderate on the back of conservative capex plans and alternative funding sources through the RUB corporate bond market. As depicted in the left chart below, compared to volumes of LatAm and Asian issuers, which placed USD 25.1bn and USD 13.6bn in bonds YTD, primary Eurobond market activity of Emerging European corporate issuers has remained moderate YTD at USD 10.3bn (incl. the RUB 20bn RSHB Eurobond issue). Some 47% of the new issues were High Yield compared to 24% in the same period last year; this, in combination with the fact that the issues were well oversubscribed overall, suggests strong appetite for Emerging European credits. It is worth noting that newcomers were among the issuers on the Eurobond market, for example Novatek (Baa3s/BBB-n/BBB-n), and Oschadbank (B2s/--/Bs). While Eurobond market activity was rather moderate, issuance on the domestic bond market in Russia has been booming, with RUB 178bn in domestic corporate bonds being placed YTD vs. RUB 61.6bn in the same period of the prior year. Ample liquidity and expectations of further rate hikes by the CBR were the key drivers of RUB bond issuance.

Strategy: focus on Oil&Gas

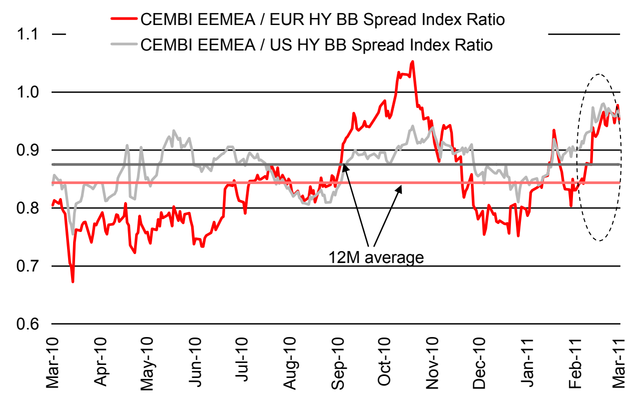
We think it would be premature to cut exposure to Emerging European corporate credits now. However, in the short term, it needs to be seen which forces will prevail in Emerging European credits: a further decline of risk appetite or the outlook of stronger commodity prices. Besides the expectations of improving credit metrics, the earthquake in Japan will lead to a revision of interest rate hike expectations by major central banks, which should support appetite for carry. Key risks to our constructive medium-term assessment of Emerging European corporate credits include significant M&A activity as well as dividend-payout risk. From a relative value perspective, Emerging European corporate credits look cheap vs. European and US High Yield credits; as the right chart below shows, following the recent hunt for yield, the ratio of the EEMEA CEMBI index and the European and US High Yield index trades at or close to the respective 12M high. As the earthquake in Japan and the turmoil in the MENA region will contribute to further tightness in the oil and gas market, we are constructive on the Oil&Gas sector, where we continue to see value in credit proxies for Oil&Gas prices, i.e. notably via GAZPRU, either on an outright basis (see table below) or on a relative value basis vs. Turkey and Polish 5Y CDS buyer positions (see EEMEA Credit Explorer). For the remaining EEMEA corporate credit universe, we keep our hold recommendations, and advise to use the current weakness to enter the market or to scale up existing positions.

EUROBOND SUPPLY REMAINS CONTAINED, WHILE EMERGING EUROPEAN CREDITS OFFER VALUE VS. HY CREDITS

Eurobond issuance



EEMEA vs. European and US High Yield credits



Source: Bloomberg, BondRadar, JPM, ML, UniCredit Research

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Corporate credit recommendations

Country	Rating, (Moody's/ S&P/Fitch)	Recommendation	Recommended paper	Price	YTM (%)	ASW (bp)	Comment
AGROK	B2p/Bs/--	Hold	EUR 12/16	108.6	7.93	522	Agrokor is currently rumored to have submitted a bid for a 23.3% stake in Slovenian food retailer Mercator. While such a transaction would weigh negatively on the company's financial profile, we take comfort from its improving operating performance as well as its proven commitment to ratings. Since it remains to be seen whether Agrokor will actually be successful in gaining a stake in the company, we keep our hold recommendation on the name.
GAZPRU	Baa1s/BBBs/BBBs	Overweight	USD 4/19 USD 8/37	125.2 109.4	5.37 6.53	270 245	Our overweight recommendation is based on the expected favorable development of the domestic price regime, the company's monopoly position in gas exports, the strong state support, as well as the massive asset base with large reserves. Furthermore, Gazprom benefits from higher oil and gas prices.
LUKOIL	Baa2s/BBB-s/BBB-s	Hold	USD 11/14	108.8	3.76	230	Our hold recommendation is based on the company's strong market position in Russia (No. 2) and its high degree of integration. Furthermore, the profile benefits from management's good relationship with the Russian government.
MOLHB	--/BB+s/BBB-s	Hold	EUR 4/17	98.3	6.21	308	Credit ratios of MOL have improved and the company benefits from the recovery in oil prices and improved downstream margins. We assume that current bond prices discount for all uncertainties, and keep our hold recommendation.
TNEFT	Baa1s/BBBs/BBBp	Marketweight	USD 3/14	106.6	3.32	215	We have a marketweight recommendation for the name, although its credit metrics might deteriorate in the future due to an ambitious capex program. However, we assume that this is offset by Transneft's monopoly position in crude oil transportation in Russia and the supportive regulatory framework, enabling very stable cash flows. In addition, the company's strategic importance for the Russian economy provides it with strong state support.
TMENRU	Baa2s/BBB-s/BBB-s	Hold	USD 3/18	115.0	5.28	269	We have changed our buy recommendation on TNK-BP to hold, due to a dispute between shareholders Alfagroup and BP regarding BP's new strategic alliance with Rosneft. Nevertheless, the group has a sound market position as one of the largest vertically integrated oil producers in Russia, its solid reserves and production base, and the high degree of operational and cost efficiency.
VIP	Ba2wn/BB+wn/--	Hold	USD 2/21	13.15	7.29	390	We have changed our sell recommendation for VIP bonds to hold, as the negative impact of the Weather Investments (Wind Telecoms) acquisition is already discounted in current spreads and approval of this transaction by VimpelCom's shareholder meeting is largely expected, despite Telenor's opposition to this acquisition.
MOBTEL	Ba2wn/BBn/BB+p	Hold	USD 6/20	113.0	6.71	367	We keep our hold recommendation on the MOBTEL bonds. In the absence of bigger acquisitions, we expect MTS' credit profile to continue to improve over the next 12 months. This assumption is priced in current bond spreads. After S&P recently affirmed MTS' BB rating and removed it from creditwatch, as the risk of technical default is no longer applicable to any of MTS' debt liabilities after receiving related consent waivers from its debtholders, also this potential risk seems limited and never caused significant spread pressure. However, S&P still has a negative outlook for MOBTEL bonds due to general corporate governance concerns.
TPSA	A3s/BBB+s/BBB+s	Marketweight	EUR 5/14	108.2	3.24	82	We changed our overweight recommendation for TPSA bonds to marketweight, as the spreads have strongly tightened since 12/2010. However, we continue to view the bonds as a means to improve the carry of a combined FT/TPSA investment. We expect a relatively stable credit profile development, despite an unfavorable market environment.
CEZCO	A2s/A-s/A-s	Marketweight	EUR 10/21	101.7	4.78	131	We keep our marketweight recommendation for the name, which is based on the company's dominant market position in the Czech Republic, its strong cash-flow generation and the highly competitive generation mix. Current spreads appear to discount for all uncertainties, and trade fair compared to peers.
ESTONE	A1s/As/As	Hold	EUR 11/20	95.91	5.0	155	We assign a hold recommendation to the name, which is based on strong support from the Estonian government and its dominant position in the Estonian energy market. In addition, the company's business profile also benefits from own full oil shale mining operations, reducing fuel price risk.
RSHB, BKMOSC, VTB, SBERRU, MDMBK		No recommendation					Coverage in transition.

Source: UniCredit Research

Emerging Europe Equities

2011 EM returns end-loaded; Russia over Turkey in 1H

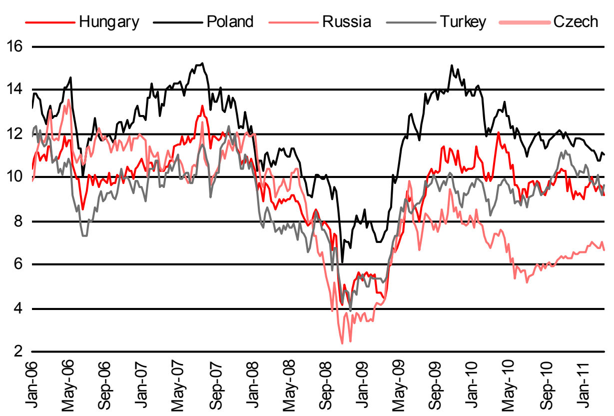
Summary

We expect positive returns for EM in 2011, driven by earnings growth, but we expect returns to be end-loaded. We haven't changed our underlying positive stance on the global economic recovery story for this year, but event risks have been rising this year and EM equity funds continue to see outflows. It may be well be later in the year before **(i)** a moderation of year-on-year growth of food and energy prices takes pressure off central banks; **(ii)** economic slowdown risks for Japan ease; **(iii)** political risks in the MENA region stabilise; **(iv)** emerging market equity fund redemptions from short-term investors in the asset class ease allowing inflows to re-start; **(v)** for clarity to emerge on plans for stressed sovereigns within the Euro zone periphery; and for markets transition through **(vi)** a first rate hike from the ECB as well as **(vii)** the end of quantitative easing in the US at the end of June.

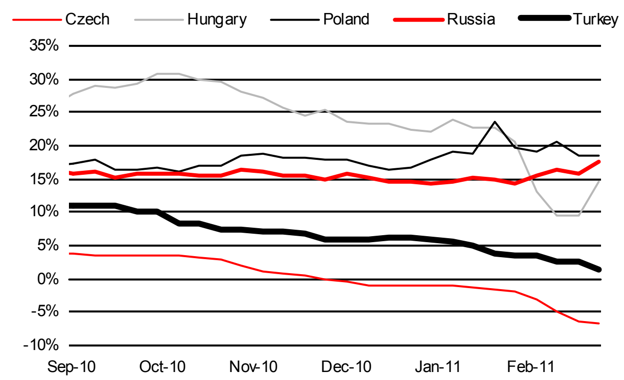
Our base case is that none of these is likely to derail our relatively upbeat view on the global economic recovery story for this year, but there is plenty of scope for bouts of risk aversion – our base case sees positive, but end-loaded returns in EM equities this year.

TURKEY HIT BY DE-RATING AND DOWNWARDS EARNINGS REVISIONS – HOW MUCH IS JUSTIFIED?

12m FWD PER – Russia still trading at a big discount



2011 EPS growth has been revised down in Turkey; Russia positive



Source: Thomson Datastream, I/B/E/S, MSCI Barra, Bloomberg, UniCredit Research

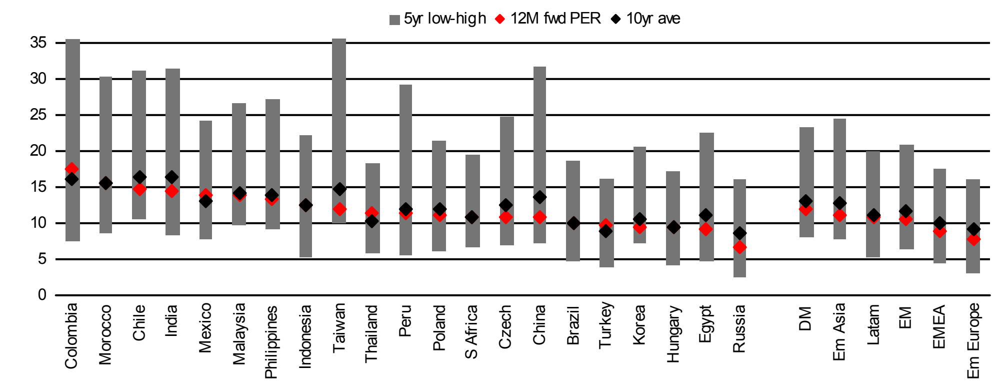
Emerging market equities are down 5% YTD, (6% off their peak) versus developed markets which are flat. Emerging market equities have now underperformed developed markets by 9% since the emerging markets relative performance peak. While there has been some pull-back in markets, recent risks (see above) have not caused a major pull-back.

This relatively lacklustre performance for emerging markets (at a period when earnings are growing strongly) has allowed the emerging markets 12m FWD PER to fall back from 11.7x to 10.5x, which is 10% below the five year average of 11.6x. The discount of emerging markets to developed markets on a 12m FWD PER basis has widened from 6% to 12%, which is now exactly in line with the five year average discount. We conclude that so long as rising input prices don't cause significant downgrading of emerging market earnings forecasts that the asset class is offering reasonable value at current levels.

Emerging Europe is up 6% year to date, the only emerging markets region to be in positive territory: all MSCI country indices in emerging Europe are in positive territory, with the exception of Turkey. Emerging Europe is currently trading on a 12m FWD PER of 7.8, significantly below the five year average of 9.1x, giving the region a 25% discount to global emerging markets, which is very slightly higher than the five year average of 23%.

On a 12m FWD PER basis (see graph), Russia on 6.8x, Turkey on 9.6x, Hungary on 9.3x and the Czech Republic on 10.7x are all trading at a discount to the emerging markets average on 10.5x; Poland is the only exception on 11.1x. Versus their five-year average 12m FWD PER ratio, Russia is trading with a 21% discount, the Czech Republic a 14% discount, Poland a 7% discount, Hungary a 2% discount, with Turkey the only exception, with a 7% premium.

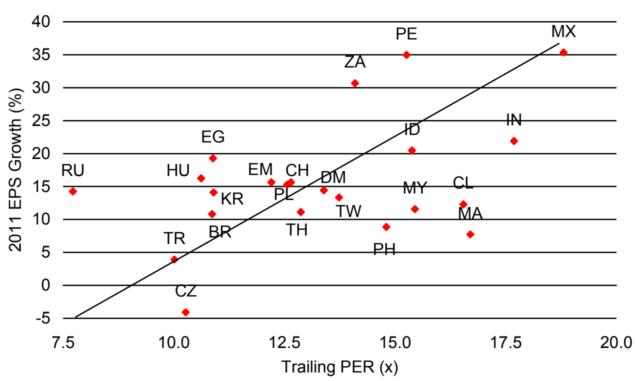
EM12M FWD PER VERSUS 10YR AVERAGE



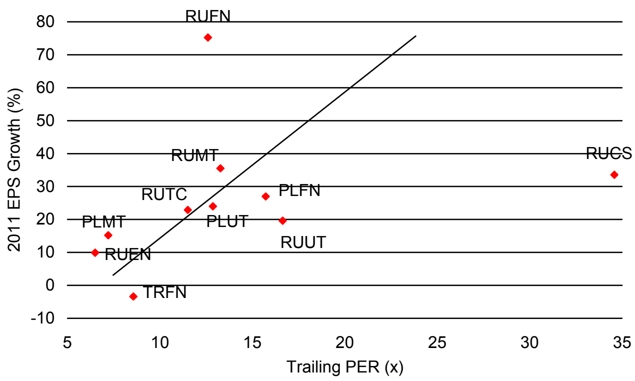
Source: Thomson Datastream, I/B/E/S, MSCI Barra, Bloomberg, UniCredit Research

VALUATION VERSUS GROWTH

EM country EPS growth v PER scatter



Emerging Europe key country sectors EPS growth v PER scatter



Source: Thomson Datastream, I/B/E/S, MSCI Barra, Bloomberg, UniCredit Research

Country allocation

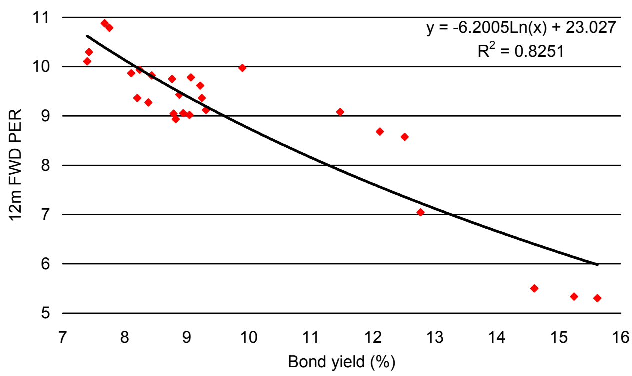
Turkey

The desire of the Central Bank of Turkey to slow down bank lending to 25% year on year in Turkey (via reserve rate requirements hikes) while weakening the currency (via interest rate cuts) has resulted in a 25% fall in MSCI Turkey (in USD terms). As a strong mid-term growth story, fuelled by demographics, regional growth and underleverage, is it time to go aggressively overweight Turkey?

RISING BOND YIELDS DIRECTLY IMPACT VALUATIONS IN TURKEY

Turkish benchmark local currency bond yield (%)

Turkey – Valuation driven by bond yields



Source: Thomson Datastream, I/B/E/S, MSCI Barra, Bloomberg, UniCredit Research

At this point, we believe Turkey is now pricing in a more cautious outlook which is healthy – but this outlook is probably justified. Driven by rising commodity prices, and despite currency weakness and central bank policy, our economists see the current account deficit increasing significantly this year, and a sharp pick up in inflation in the second half of the year. Such an outlook, we believe, is likely to keep the central bank very focused on slowing banks' loan growth, and could even push the bank in to an earlier than anticipated rate hiking cycle (which might actually be welcomed by the market).

While we no longer consider Turkish equities a sell, we can justify the market's fall by looking at the combination of three key factors – **(i) Earnings revisions.** 12m FWD earnings expectations for MSCI Turkey have come down by 8% since November; **(ii) The currency move.** The Turkish lira has fallen by 10% (and we believe the central bank not to be overly concerned about this fall); **(iii) Increased bond yields.** Benchmark bond yields have added 110 basis points in yield, rising from 7.65% in November (via a low of 6.90%) to 8.75% now, which should account for at least a one point reduction in the PER (the R^2 of Turkish equity valuations to bond yields is a very high 0.82 (see graph), compare with just 0.24 for Russia).

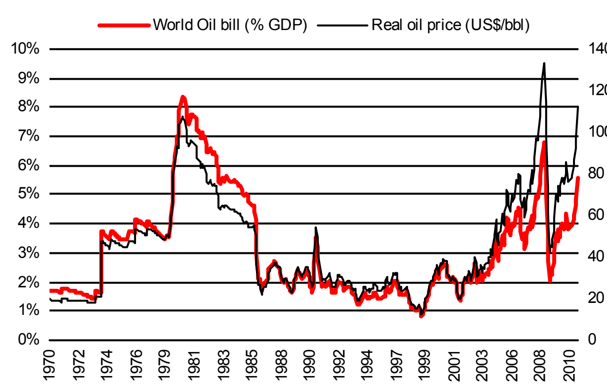
Putting these three factors together, ought to have resulted in a 24% USD fall in the market, calculated by combining the market's 12M FWD earnings downgrade, 10% currency weakness and 9% 12m FWD PER derating as yields have risen). Our inflation outlook suggests that bond yields could rise modestly from here by year end. Other factors we believe the market is assessing is Turkey's sustainable growth rate – given current account dynamics, this could be in the 4-5% range (rather than the 6-7% that some more bullish investors had assumed following 2010's strong rebound). Poor readings on the current account could also see delays in Turkey's promotion by rating agencies (perhaps into 2012). We see no huge rush to buy in Turkey, but at some point, heading in to the summer, we expect the market to become more attractive. Timing could be post-election, when bank lending has slowed, a new central bank governor will be in place, and bond market yields may start to be calmed by central bank rhetoric moving more in favor of rate hikes; at the same time, investors may start pricing in rebounding 2012 earnings.

Russia

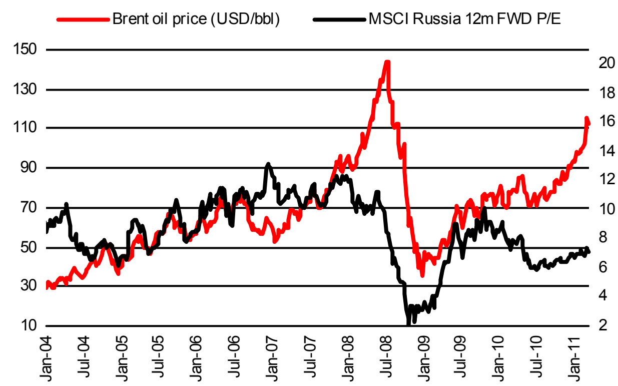
We are overweight Russia, though we suspect that market will not show straight line returns from here: several conversations with buy side managers have indicated investor fears that Russian equities could become 'boxed in' by high oil prices – i.e., if oil prices rise they could sow the seeds of another global slowdown and subsequently lower oil prices (and thus lower Russian equities) or oil prices could fall back (and thus lower Russian equities) if Japan results in a growth dip or Middle Eastern tensions dissipate. Indeed, we believe that the most positive scenario for Russia would actually be a very gradual appreciation of the oil price from USD 95-100/bbl upwards, rather than a sudden upwards move from current levels. **Mid-term implications of events in both Japan and the MENA region for energy prices** are important for Russia. We see the risk of further instability in the middle East as likely to lead to a mid-term premium in oil prices (supported by both greater propensity for increased budgetary expenditure by regional governments, as well as disruption risk). Combined with the potential for nuclear power projects either to be delayed or cancelled (or at the very least becoming more expensive as safety-systems and redundancy are boosted) this should be mid-term supportive to oil prices, though we don't rule out some temporary weakness in the event of a prolonged slowdown in Japan (particularly if the global supply chain is impacted).

NOT YET IN AN ENERGY CRISIS, RUSSIAN OIL PRICES HAVE TENDED TO DRIVE PER – SCOPE FOR CATCH UP

World Oil bill (ls) as a percentage of global GDP



Brent oil price (lhs) versus MSCI Russia 12m FWD PER (rs)



Source: Thomson Datastream, I/B/E/S, MSCI Barra, Bloomberg, IMF, US Labor Department, AP Dow Jones, BP, UniCredit Research

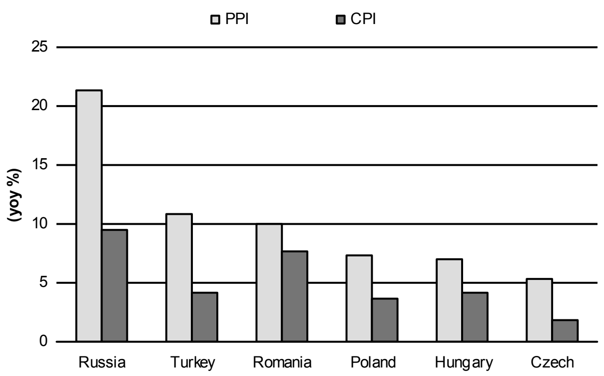
Sectors

UniCredit's commodities team assumes an elevated (but not spiking) average Brent price of USD 110/bbl in 2011F, and USD 105/bbl in 2012F. We believe that such a scenario is consistent with a gradual re-rating of Russian equities, giving scope for further upgrades to consensus earnings. In addition, the **PER of Russian equities has historically been highly correlated to the oil price** (see graph below) but has recently been lagging (see graph). This linkage instinctively makes sense (and may be why some bottom up analysts have historically underestimated the sensitivity of oil stocks to the oil price): the relationship held well during the previous bull market at least until the sub-prime crisis started impacting valuations. We expect that this PER-oil price linkage will catch up as: **(i)** investors gain confidence in the higher oil price (**the time value of oil**); **(ii)** strong oil prices boost **budgetary receipts**

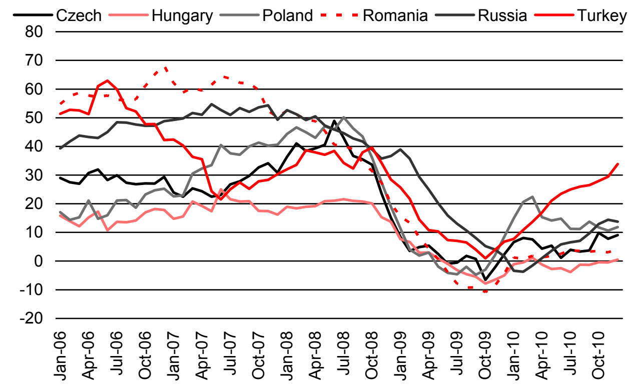
(Finance Minister Kudrin sees the budget balancing at USD 115/bbl) reducing crowding out effects from bond issuance and reducing the pressure on the government to sell equity stakes; **(iii)** the central bank allows further **appreciation of the currency** to keep a lid on inflation (surveys suggest that inflation is the number one fear among Russians) thus encouraging further equity-friendly flows in to an appreciating currency, and ultimately causing domestically focused stocks to outperform. We also see **(iv)** emerging **clarity of the likely Presidential candidate** in March 2012 as a positive trigger and **(v)** we also expect the Russian government to maintain its **market-friendly focus** on attracting inwards investment to Russia to survive the higher oil price environment: the recent downturn starkly demonstrated the need to upgrade the Russian economy, update the technological base and diversify the economy, a message which we believe has not been lost on the authorities.

TURKISH BANKS HAVE BEEN GROWING TOO FAST AND RISING BOND YIELDS DIRECTLY IMPACT VALUATIONS

PPI higher than CPI – margin pressure on processing companies



Turkey – Valuation driven by bond yields



Source: Thomson Datastream, I/B/E/S, MSCI Barra, Bloomberg, UniCredit Research

As far as sectors go, we have been highlighting that **rising input costs** this year could result in downwards pressure on the margins of companies where the business model involves processing (or selling) physical goods (see *Emerging Europe Strategy – A reasonable rate of return,* 21 January 2011). We include here materials stocks as well as consumer durables and consumer staples companies. We are already seeing early signs of this in selected corporate results, as well as PPI exceeding CPI across the region (see graph), which has the potential to feed through in to margin pressure. This continues to support our view that the environment at least in the first half of 2011 is likely to be more favorable to companies which have either **(i)** strong **pricing power** via commodity pricing, primarily oil and gas – or – **(ii)** companies selling services, media, financials and telecoms. Utilities could be another candidate, though in Russia, the state has indicated its willingness to cap tariff increases this year (2011-2 is the election period in Russia). Year-on-year input prices should start to moderate in 2H11, which could lead to a reversal of this sector preference.

Central Europe

The economic recovery which progressed during 2010 in the CE3 region, and began to take hold in SE Europe as well near the year-end, has set the stage for moderate equity-market gains during 2011 in the region. Interestingly, the wide performance gaps which opened up during 2010 between the region's markets have narrowed, as rallies in Hungary (before year-end) and in Romania (early in 2011) showed an investor response to signs of economic upturn in these lagging economies. At this point, Central European markets are no longer cheap, but after the latest correction they are not expensive, either, and are capable of responding to improving fundamentals as the year progresses (for the full year, we expect returns of about 15% for CE markets). Actual market performance will be influenced by several factors:

- **Valuations** – CE3 equities look reasonable on various valuation metrics we use in our analyses, but we could not argue that significant upside from the current levels exists. Stocks in Poland trade at 12MF P/E of 11.0x, Hungary at 9.2x and the Czech Republic at 10.5x (consensus IBES numbers for MSCI country indices). All these values are 6%-10% below long-term averages. Other measures, like BY/EY, DY or 12MF PER/GDP growth usually point to 5%-15% upside.

- **Earnings momentum** – remains solid in Poland and Hungary, where consensus expectations point to a little over 20% EPS growth in 2011. Poland is in fact the only market in the region, which has recently seen some upward earnings revisions. On the opposite side we find the Czech Republic, where analysts have been downgrading expectations over the last months and now expect small contraction in 2011 earnings.

- **Rate cycle:** Whereas inflation pressures have picked up in some parts of the region, turmoil in the Middle East and the earthquake effects in Japan may delay further tightening moves by central banks for now, due to global uncertainties. The mid-March decision to hold rates by the Polish central bank reflected this view. Ultimately rates will need to rise to more normal levels, but the slowing in this process means equities should remain in the "comfort zone" as far as monetary policy is concerned, at least until 4Q2011. Implications: This may limit upward pressure on CEE currencies, and should also be supportive of rate-sensitive sectors including banks and property. The currency effect may also help retailers.

- **Germany:** Surprising strength in Germany's industrial and export sectors has been a driving force for European recovery, and has boosted activity in Central Europe as well. Our outlook is for German growth to remain above-average at least into 2012, helping underpin GDP trends in most CE economies, and particularly Czech, Hungarian and Polish growth. Should Germany falter, this would undermine investor sentiment generally.

- **Austerity measures:** The pressure to rein in fiscal deficits has hindered economic recovery in Hungary, Bulgaria, Romania and Croatia in particular, with more moderate effects in Poland and Czech Republic. Another effect has been to weaken public support for the governments implementing the austerity, which has raised uncertainty in Romania, Bulgaria and Croatia, and to a lesser extent in Czech Republic, Hungary and Poland. Autumn elections in Poland will be a focus, but so far the government appears able to retain power.

- **Share overhang risk**: There is a substantial pipeline of potential share offerings in CE3 markets. In FY11 – possibly EUR 12bn, or 10%+ of existing free-float, concentrated in 2Q and just after the summer, mainly in Poland. Beyond that, the Hungarian government will transfer assets of private pension funds to the state in June, with later disposal on the market. In Romania, there are plans over the next 15 months to sell stakes worth EUR 750-900mn.

- **External shocks**: The turmoil in the Middle East and the recent natural disaster/nuclear contamination risks in Japan have come on top of the still-unresolved European debt crisis, making investors more risk-averse. While we maintain that each of these risk factors is more likely to find a solution that will not greatly impact global growth, the lack of clarity at present means the current shift to safe-haven investments (Swiss Franc, USD, JPY, sometimes gold) may be a recurring obstacle to CE equity performance, even as fundamentals locally remain little changed and relatively healthy.

Highlighted stock ideas

Russia/CIS

Alliance Oil (Buy, TP USD 25.30, upside 42%), due to its strong growth potential in the upstream segment, where production is forecast to rise 25% yoy in 2011, and the company's potential to benefit from the pending oil tax reform due to the advanced stage of the company's refinery upgrade project.

Dragon Oil (Buy, TP USD 10.60, upside 25%) has significant value due to its market-leading oil price leverage based on the lucrative PSA license terms, as well as potential for outperformance in production growth as the company's guidance appears to be too cautious on the back of 2010 underperformance.

Gazprom Neft (Buy, TP USD 6.82, upside 35%) in our view has strong rerating potential as the market reassesses the value of the non-consolidated subsidiaries and as the upstream assets transfer from Gazprom is finalized in 2Q-3Q of 2011.

MTS (Buy, TP USD 31.50, upside 52%) and **Vimpelcom (Buy, TP USD 21.10, upside 54%),** should narrow the 20% valuation gap with peers, aided by a strong rouble and impulses to revenue growth and margins from data uptake (from 3G rollout starting 4Q10).

OGK 4 (Buy, TP USD 0.14, upside 55%): the most efficient and profitable fossil fuel genco in Russia with strategically located assets and competitive cost of fuel.

Polymetal (Buy, TP USD 24.00, upside 32%) is our top pick of gold miners, with 2011E production growth of 37% vs. 11% for closest peer, Polyus Gold, while trading at a large 24% discount on 2011E EV/EBITDA to Polyus Gold.

RusHydro (Buy, TP USD 0.071, upside 50%): hydro generation is set to benefit the most from liberalization of electricity market. RusHydro is the most liquid company in the sector.

Sberbank (Buy, TP USD 4.40, upside 34%) is a proxy play on the Russian economy, but has the added positives of improving cost ratios and rising consumer loan demand. NPL dynamics should also improve the bottom line in coming quarters.

Sistema (Buy, TP USD 40.60, upside 54%) is our top pick as a combination of exposure to MTS, and to value creation in oils on Trebs and Titov license monetization and the crystallizing of the value of the 49% Russneft stake.

Turkey

Akcansa (Buy, TP TRY 8.50, upside 19%) – a positive price and demand outlook in domestic construction and cost reduction investments should benefit margins. Also, there are signs of rising demand from the Russian construction market. On 2011E EV/EBITDA, PER and EV/clinker ratios, Akcansa trades at discounts of 5%-16% to EM peers.

Akenerji (Buy, TP TRY 3.60, upside 14%) – Despite some downward revisions to forecasts due to changes in the electricity market and company financials, we believe potential asset sales are likely to keep the stock at a premium to the other local peers and less sensitive to downturns.

Halkbank (Buy, TP TRY 13.20, upside 8%) - our top pick in the sector: with a low L/D ratio (80%), a SME-dedicated loan book and further room for retail lending growth, Halkbank is likely to gain market share. Halkbank is trading at a moderate 2011E P/BV of 1.75x.

Is REIT (Buy, TP TRY 2.40, upside 36%) - trades at a 43% discount to its 2010 NAV vs. its 5Y historical average of 33% and a sector average of 12%. With its solid rental income and substantial projects on the agenda, the company should trade at a lower discount.

Turkish Airlines (Buy, TP TRY 8.30, upside 86%) - The expansion of its widebody fleet should help THYAO to gain market share in Europe-Asian and transatlantic traffic, thanks to the advantageous location of its hub and its cost efficient structure. The stock currently trades at a 13 % discount to European peers with similar growth and margin dynamics.

CE3 Equities

BRE Bank (Buy, TP PLN 350.00, upside 10%) - impressive earnings momentum through 2012 (near 40%) combined with solid dividend yield matching PL GB yield in 2012; reasonable valuation on 2012E multiples - P/E 11.5x, P/BV 1.5x.

Kernel (Buy, TP PLN 99.00, upside 24%) – positive m-t potential: **1)** planned conclusion of two M&A projects in Ukraine and Russia; **2)** attractive valuation (2011E P/E of 7.8x, 46% discount to peers); and **3)** strong earnings momentum 2011/12E average EPS growth of 35%.

PGNiG (Buy, TP PLN 4.25, upside 14%) – set to produce oil & gas at its Norwegian project from August, raising upstream share of EBIT from 35% to 45% by 2013, while EPS will be boosted by 66% in this period. Trades at 2012E P/E of 8.4x and EV/EBITDA of 5.0x.

TVN (Hold, TP: PLN 17.90, upside 15%) – fairly liquid play on rising consumer spending, leveraging its #1 share (35%) of TV ad market, which is expected to expand 9% in 2011. EBITDA CAGR of 25% through 2012, trades at 9.8x 2011E EV/EBITDA, below its 3Y average.

Romania

We focus on high-beta exposure in the financial sector, early beneficiaries of economic recovery (BRD) and possible regulatory changes (SIF 2). In the longer run, FP is Romania’s most attractive restructuring story.

BRD (Buy, 12M TP: RON 16.65, upside to TP 22%): proven resilience and capacity to outperform its domestic peers, and to to capitalize on its strengths (low NPL ratio vs. the sector, solid CAR, leading position in project financing); also has attractive relative valuation.

SIF 2 (Buy, 12M TP: RON 1.98, upside to TP 44%) is our top pick among the SIFs given its high liquidity and more proactive and investor-friendly investment strategy.

Fondul Proprietatea (Buy, 12M TP: RON 0.94, upside to TP 59%) remains the most attractive longer-term restructuring story, as it unlocks hidden value via listings of energy and infrastructure majority-state-owned companies in its portfolio.

EM CONSENSUS VALUATION TABLE

	PER (x)						EPS growth (%)					PBV (x)	ROE (%)	MSCI Wgt (%)
	2010	2011	2012	2013	Trailing	12M FWD	2009	2011	2012	2013	12M FWD	12M FWD	12M FWD	
Brazil	11.2	10.2	9.1	8.7	10.9	9.9	26.3	10.6	11.4	6.3	10.8	1.5	15.3	16.2
Chile	17.0	15.2	13.5	14.0	16.5	14.7	22.5	12.0	12.9	9.6	12.3	1.9	13.1	1.5
Colombia	21.9	18.0	15.9	27.6	20.8	17.4	45.6	21.7	13.4	17.4	19.3	2.0	11.6	0.8
Mexico	20.9	14.4	12.6	9.0	18.8	13.9	-10.0	45.6	14.2	39.0	35.4	1.2	8.5	4.6
Peru	17.1	11.5	10.6	11.0	15.3	11.3	27.6	47.9	8.8	-3.6	35.0	3.4	30.4	0.7
Em Latin America	**12.9**	**11.1**	**9.9**	**8.9**	**12.4**	**10.8**	**20.6**	**15.8**	**11.9**	**11.6**	**14.7**	**1.5**	**13.6**	**23.8**
China	12.9	11.2	9.6	9.4	12.4	10.7	31.9	15.3	16.0	11.3	15.6	1.8	16.7	17.5
India	17.3	14.2	12.0	9.9	17.2	14.1	21.0	21.9	18.2	5.6	21.9	2.4	16.6	7.1
Indonesia	16.0	13.1	11.2	9.4	15.2	12.6	15.2	21.9	16.9	18.1	20.5	3.2	25.2	2.3
Korea	11.4	10.0	8.8	8.2	11.0	9.6	46.9	14.4	13.4	6.2	14.1	1.4	14.1	13.7
Malaysia	16.5	14.6	13.1	11.8	15.6	14.0	32.3	13.4	11.6	10.6	11.6	2.1	15.0	2.9
Philippines	14.9	13.8	12.4	11.7	14.6	13.4	44.4	8.2	10.7	4.0	8.9	2.3	16.9	0.5
Taiwan	14.3	12.6	10.8	12.1	13.8	12.0	83.6	13.2	15.6	-4.1	13.3	1.8	15.0	11.2
Thailand	13.1	12.0	10.3	9.5	12.8	11.5	34.1	9.1	16.6	7.9	11.1	1.9	16.9	1.7
Em Asia	**13.3**	**11.6**	**10.0**	**9.3**	**12.9**	**11.2**	**41.5**	**15.2**	**15.2**	**6.7**	**15.2**	**1.8**	**15.7**	**56.9**
Czech Republic	10.1	10.8	10.4	10.3	10.3	10.7	-0.7	-6.8	4.6	0.1	-4.1	1.9	17.4	0.4
Hungary	11.2	9.8	8.1	7.1	10.8	9.3	7.4	14.6	20.6	13.5	16.2	1.2	12.5	0.4
Poland	13.4	11.3	10.5	10.4	12.8	11.1	30.3	18.6	7.2	1.5	15.3	1.5	13.3	1.7
Russia	8.2	7.0	6.5	5.9	7.9	6.8	33.7	17.7	6.1	9.0	14.3	1.0	14.4	7.3
Turkey	10.0	9.9	8.9	8.1	10.0	9.6	18.0	1.3	11.8	11.4	3.9	1.6	16.4	1.4
Em Europe	**9.2**	**8.0**	**7.4**	**6.8**	**8.8**	**7.8**	**28.7**	**14.9**	**7.3**	**8.3**	**12.6**	**1.1**	**14.4**	**11.2**
Egypt	11.2	9.6	7.9	6.7	10.9	9.1	18.6	18.3	21.7	15.0	19.3	1.4	15.1	0.4
Morocco	17.0	15.8	14.7	14.4	16.7	15.5	6.7	7.9	7.3	-0.1	7.7	4.8	30.8	0.2
South Africa	15.9	11.8	9.9	8.8	14.1	10.8	17.0	35.2	19.5	11.9	30.7	2.0	18.2	7.6
EMEA	**11.1**	**9.2**	**8.3**	**7.5**	**10.4**	**8.8**	**25.3**	**19.9**	**11.2**	**9.3**	**17.6**	**1.4**	**15.7**	**19.3**
EM	**12.6**	**10.9**	**9.5**	**8.7**	**12.2**	**10.5**	**32.3**	**16.4**	**13.5**	**8.7**	**15.7**	**1.6**	**15.2**	**100.0**
World	**14.2**	**12.3**	**10.9**	**10.0**	**13.6**	**11.9**	**40.0**	**15.2**	**13.3**	**8.6**	**14.4**	**1.6**	**13.5**	

Source: Thomson Datastream, I/B/E/S, MSCI Barra, Bloomberg, UniCredit Research

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Bulgaria (Baa3 positive/BBB stable/BBB- negative)*

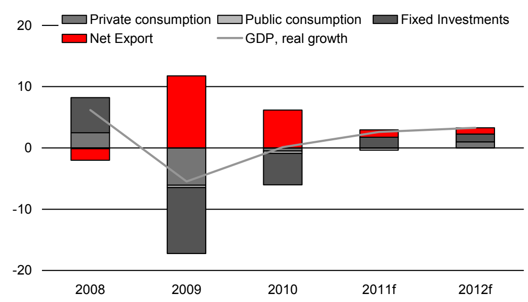
Outlook – The Bulgarian economic recovery gained momentum in 4Q10 on the back of solid exports and increased signs for stabilization of domestic demand. GFCF leveled off in 2010 and is seen expanding by a real 4.7% this year. However, after gaining traction in 4Q10, household spending is likely to loose momentum later this year, squeezed by sluggish labor market recovery and higher inflation. Meanwhile, higher food and energy prices are threatening to displace household sector recovery. This time, higher inflation is not only expected to curb real incomes but to push more households below the poverty line, as the average Bulgarian family spends half of its income on food and energy.

Author: Kristofor Pavlov, Chief Economist (UniCredit Bulbank)

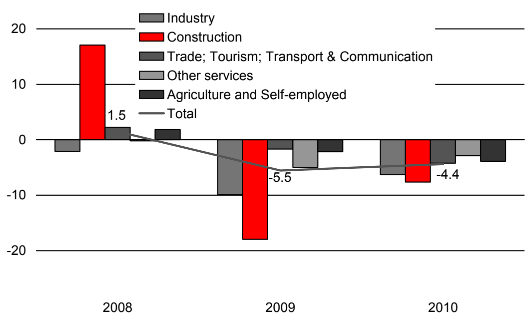
KEY DATES/EVENTS

- June - The government hopes to choose an investor for the privatization of major cigarette producer "Bulgartabak"
- June – Vote in Parliament on indexation of lowest pensions, provided that end-year fiscal deficit target is not at risk
- 13 May - Flash estimate of 1Q11 swda GDP figures

GDP GROWTH AND CONTRIBUTION TO GROWTH (%)



YOY CHANGE IN THE NUMBER OF EMPLOYED (%)



Source: National Statistical Institute, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2008	2009	2010E	2011F	2012F
GDP (EUR bn)	35.4	34.9	36.0	39.1	41.9
Population (mn)	7.6	7.6	7.5	7.5	7.5
GDP per capita (EUR)	4,658	4,618	4,783	5,208	5,610
Real economy yoy (%)					
GDP	6.2	-5.5	0.2	2.6	3.3
Private Consumption	3.0	-7.6	-0.6	0.0	1.3
Fixed Investment	21.9	-17.6	-16.5	4.7	4.9
Public Consumption	-1.5	-4.9	-5.0	-4.4	-0.3
Exports	3.0	-11.2	16.2	7.9	5.8
Imports	4.2	-21.0	4.5	5.3	3.8
Monthly wage, nominal (EUR)	279	311	331	357	380
Unemployment rate (%)	6.3	8.6	10.1	10.1	9.6
Fiscal accounts (% of GDP)					
Budget balance	3.0	-0.8	-3.9	-2.8	-2.5
Primary balance	3.7	0.0	-3.3	-2.0	-1.6
Public debt	15.5	15.5	16.7	17.3	21.4
External accounts					
Current account balance (EUR bn)	-8.2	-3.5	-0.4	-1.8	-2.4
Current account balance/GDP (%)	-23.1	-10.0	-1.0	-4.7	-5.8
Basic balance/GDP (%)	1.9	-1.9	-1.1	0.8	2.4
Net FDI (EUR bn)	6.2	3.4	1.5	2.0	1.9
Net FDI (% of GDP)	17.5	9.7	4.1	5.2	4.6
Gross foreign debt (EUR bn)	37.1	37.8	36.9	37.9	40.0
Gross foreign debt (% of GDP)	104.7	108.2	102.5	96.9	95.4
FX reserves (EUR bn)	12.7	12.9	13.0	13.3	14.3
Inflation/Monetary/FX					
CPI (pavg)	12.4	2.8	2.4	5.9	4.0
CPI (eop)	7.8	0.6	4.5	5.7	3.4
Central bank reference rate (eop)	4.07	0.23	0.20	0.42	0.98
USD/BGN(eop)	1.40	1.36	1.46	1.32	1.37
EUR/BGN (eop)	1.96	1.96	1.96	1.96	1.96
USD/BGN (pavg)	1.33	1.40	1.47	1.36	1.32
EUR/BGN (pavg)	1.96	1.96	1.96	1.96	1.96

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

Bulgaria: No easy fix for inflation woes

Low domestic demand holds back GDP growth

GDP growth accelerated to 2.1% qoq in 4Q10, bringing the Bulgarian economy 3.9% below where it was when the crisis started. For the whole 2010, GDP growth came in at 0.2%, a notch above our forecast. Another downward revision to the back data pushed 2009 GDP growth deeper into negative territory (to -5.5% yoy from -4.9% yoy). Exports, in 4Q10 posted their 6th consecutive qoq gain and are now 4.1% above its pre-crisis peak. GFCF was up 6.5% qoq but is still a hefty 34.3% lower when compared with its pre-crises print. Individual consumption was up 1.2% following 8th consecutive negative qoq prints, but is still 9.7% lower than its pre-crisis peak. All these point to an acceleration of Bulgarian recovery with some positive signs also related to the evolution of growth structure. Export remains the key growth engine, benefiting from the double digit upturn in productivity. GFCF has shown clear signs of stabilization last year and we expect it to contribute positively to growth in 2011, as foreign capital inflows benefit from anticipated progress in privatization and waning investors' concerns over the euro zone sovereign debt crises. However, after gaining traction in 4Q10, household spending is likely to lose momentum later this year, squeezed by slow labor market revival and higher inflation. A sluggish growth outlook for mature markets coupled with the strengthening of the euro will also weigh negatively on the pace of Bulgarian recovery. Deleveraging in some sectors, which entered the recession with fairly overstretched balance sheets, is not over, suggesting that there are still relevant economic imbalances to deal with. And finally, while fiscal squeezing that Bulgaria targets for 2011 is smaller when compared to those in the rest of the CEE region, it still puts one more drag on growth**.** Against this backdrop, we revised marginally downward our real GDP growth forecast for this and next year to 2.6% and 3.3%, from 2.8% and 3.5% initially.

The first qoq upturn in individual consumption, posted in 4Q10, remains in contrast with other data, most notably retail sales and sentiment indicators

Inflation threatens to displace weak domestic recovery as a primary source of concern for Bulgarian policy makers

Since the currency board introduction, price stability has been only rarely in the centre of economic policy debate in Bulgaria: but this time looks different. February's CPI hit the 5.2% yoy mark, a clear reminder that inflation problems are getting worse. The current spike in supply side inflationary pressure not only puts the ongoing recovery in jeopardy but also risks pushing more people below the poverty line, as those who spend the bulk of their income on necessities are still a significant part of the population. An average Bulgarian family spends a third of its income on food while another 15% goes on various items whose costs are closely linked to energy prices. Thus total costs on food and energy amounts to roughly half of income spent. But the poorest households are likely to suffer an even larger spending squeeze since only a small part of their incomes go beyond what necessities commands. There are also concerns about export competitiveness as Bulgaria uses 2.5x more energy per unit of GDP than the EU on average, but these are mitigated by the fact that inefficient use of energy is rather a household sector problem, as two-thirds of the total energy consumption goes there. Higher energy prices are estimated to have a sizeable effect on the external balance as well, though given where the C/A deficit was at the end of 2010 it looks set to remain below the levels seen as unsustainable in 2011. What's more, higher food and energy prices have stirred social discontent and have hit the popularity of the centre-right government of Boiko Borisov. Tens of thousand of people marched on the streets of the country's major cities chanting slogans against the price raises of the largest fuel wholesaler - Russian controlled LUKOIL, which also owns the only crude oil refinery in the Balkans. In response, the anti-monopoly watchdog launched a probe into an alleged cartel agreement in setting retail fuel prices. To offset the negative effect of high inflation, the FinMin admitted the chance for indexation of the lowest pensions, provided that fiscal revenues progress as planned during the first half of the current year. Given that weak household demand recovery and falling jobs are still the key economic hurdles Bulgaria needs to tackle, this policy response seems justified to us. Indeed, any measure to strengthen domestic currency is out of the cards due to the currency board. More fiscal tightening will hardly make economic sense either when, as today, price pressure are driven by problems with supply rather than overheating demand as in the years of the boom.

Unwelcomed redistribution of incomes will be the most harmful result of high inflation this time around

Apart from higher food and energy prices, core inflation is likely to remain subdued, as domestic demand recovery progresses only very slowly

Czech Republic (A1 stable/A positive/A+ positive)*

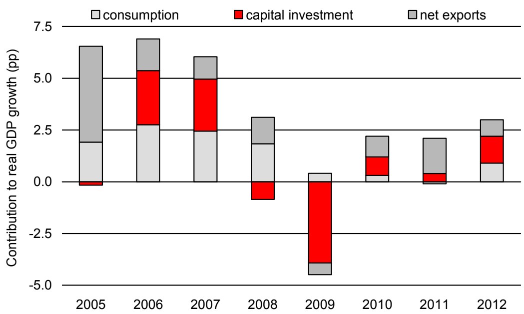
Outlook – Despite a disappointing 4Q performance, we have slightly increased our 2011 GDP forecast to 2.0% yoy. Fiscal policy will likely remain the main drag on domestic consumption leaving net exports the key driver. We project CPI to return to above the target and stay there after 2Q, a further jump is expected in Jan 2012 due to the VAT hike. We see the central bank gradually tolerating CZK appreciation and hiking rates by 75bp in line with the ECB. **Strategy** – Having taken profit on our bullish FX position in 1Q we now see the CNB as not in a rush to hike rates (due to subdued domestic demand) while it will tolerate gradual currency appreciation. Against this backdrop we see risk premium relatively elevated at the short end of the curve and we receive 1Y1Y CZK forwards.

Authors: Pavel Sobisek, Chief Economist (UniCredit Bank)/Patrik Rozumbersky, Economist (UniCredit Bank)

KEY DATES/EVENTS

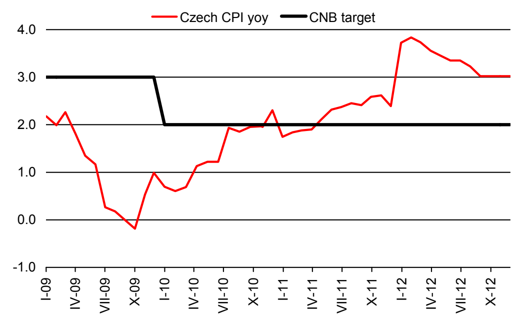
- CNB Board meetings – 24 March, 5 May
- Further details on pension and tax reform should come in late March, early April
- Details on healthcare funding due to increased expenses driven by a deal with doctors

NET EXPORTS SHOULD DRIVE GROWTH IN 2011



Source: CSO, UniCredit Research

CPI TO MOVE ABOVE CNB TARGET IN 2H11



Source: CNB, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2008	2009	2010E	2011F	2012F
GDP (EUR bn)	147.9	137.2	145.0	155.5	166.4
Population (mn)	10.4	10.5	10.5	10.6	10.6
GDP per capita (EUR)	14,181	13,081	13,792	14,740	15,727
Real economy yoy (%)					
GDP	2.5	-4.1	2.3	2.0	3.0
Private Consumption	3.6	-0.2	0.4	0.5	2.0
Fixed Investment	-1.5	-7.9	-4.6	2.0	4.0
Public Consumption	1.1	2.6	0.3	-1.5	-0.3
Exports	6.0	-10.8	18.0	14.6	10.0
Imports	4.7	-10.6	18.0	12.5	9.8
Monthly wage, nominal (EUR)	906	888	947	1,014	1,071
Unemployment rate (%)	5.5	8.1	9.0	8.5	7.7
Fiscal accounts (% of GDP)					
Budget balance	-2.1	-5.8	-4.8	-4.5	-3.5
Primary balance	-1.0	-4.6	-3.8	-3.3	-2.2
Public debt	30.0	35.3	39.1	42.6	43.8
External accounts					
Current account balance (EUR bn)	-0.9	-4.3	-5.5	-5.1	-6.8
Current account balance/GDP (%)	-0.6	-3.2	-3.8	-3.3	-4.1
Basic balance/GDP (%)	0.4	-2.1	-1.1	-0.7	-1.3
Net FDI (EUR bn)	1.5	1.4	3.8	3.9	4.6
Net FDI (% of GDP)	1.0	1.0	2.6	2.5	2.8
Gross foreign debt (EUR bn)	59.7	60.1	69.8	76.3	80.8
Gross foreign debt (% of GDP)	43.6	43.8	47.7	48.5	48.6
FX reserves (EUR bn)	26.6	28.9	31.7	34.5	36.5
Inflation/Monetary/FX					
CPI (pavg)	6.3	1.0	1.5	2.2	3.4
CPI (eop)	3.6	1.0	2.3	2.4	3.0
Central bank target	3.0	3.0	2.0	2.0	2.0
Central bank reference rate (eop)	2.25	1.00	0.75	1.50	3.00
3M money market rate (eop)	3.6	1.5	1.2	1.9	3.3
USD/CZK (eop)	19.21	18.39	18.69	16.22	16.78
EUR/CZK (eop)	26.80	26.35	25.02	24.00	24.00
USD/CZK (pavg)	16.97	18.96	19.06	16.84	16.22
EUR/CZK (pavg)	24.96	26.43	25.28	24.25	24.00

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

Reforms are finally starting to take shape

4Q GDP slowed on severe weather conditions

GDP growth slowed in 4Q10 to (adjusted) 0.3% qoq and 2.6% yoy, leaving the full-year reading at 2.2% – a notch below the flash estimate. The final quarter saw both private and government consumption contract moderately, while an inventory change and net exports were the key drivers on the demand side. From the production side, manufacturing stood overwhelmingly behind the expansion. The year-end slowdown in GDP was due more to severe weather conditions than to any lasting fundamental factor, in our view.

Economic activity looks strong at the beginning of the year

Indeed, the underlying trends suggest that the recovery is ongoing in early 2011. Manufacturing PMI surged to an all-time high in January and stayed close to it in February. On the hard data released so far this year, January industrial output hit 16.9% yoy, with new orders (advancing 19.2% yoy) unlikely to herald a slowdown for coming months. In the same vein, exports and imports expanded by around 30% yoy and new car registrations were 12% higher yoy in January. Even though we are still missing full evidence on retail consumption at the start of 2011, we expect GDP growth qoq to gather momentum in 1Q, also taking into account the year-end slowdown.

With domestic demand facing the impact of the cabinet's fiscal restraint, 2011 GDP growth should be chiefly driven by external demand

For FY11, we project a 2.0% expansion in GDP, up marginally on our former expectation of 1.8%. We foresee the cyclical recovery of domestic demand to continue but this is set to be curbed by government austerity measures. Household spending will take a hit from a 9% cut in wage costs in public administration as well as from a reduction of various welfare benefits, adding a mere 0.5%. Although capital spending will benefit from higher corporate spending appetite it will also suffer from a cut in the public budgets on infrastructure investment as well as the adverse effect of last year's boom of solar power investments. Consequently, GDP growth will largely be driven by net exports.

Inflation is set to return to above 2% and stay there since 2Q

The fading effect of indirect tax hikes from early 2010 pushed inflation below the CNB's 2% target at the beginning of this year, for the first time since last August. We expect, however, this correction to be temporary, with price pressures coming predominantly from the supply side lifting inflation back above 2% in 2Q. The oil price spike is the most pronounced, but not the only, factor behind the assumed pressure.

The first interest rate tightening is now approaching

The CNB left interest rates unchanged at a record low level in early February but three out of seven board members voted for 25bps tightening. Since then, both anti- and pro-inflation factors have appeared. The hawkish mood dissipated after 4Q GDP and CPI in both January and February came in below CNB expectations. In addition, one of the hawks left the CNB board recently. That said, the balance of risks seems to be gradually leaning to the pro-inflation direction. Apart from the supply-side price pressures, a noteworthy exogenous factor for the CNB is the ECB's intention to start tightening its policy as early as April. Our core scenario remains that the CNB will make the first step in 2Q, following the ECB with a slight delay. The relative lenience on the part of the CNB is set to be facilitated by the lack of demand driven signs of inflation. With two further ECB's hikes likely be copied by the CNB during 2011, the CNB repo rate is seen concluding the year at 1.50%.

Pension reform has been outlined with a voluntary opt-out. We find its parameters as very cautious

The center-right cabinet has outlined the basic parameters of its pension reforms. The plan, which is still to be finalized, will allow people to divert 3pp of the 28% social tax to a private fund from 2013 onwards. The diverted money will have to be matched by 2% coming from a person's net salary. The government estimates that the voluntary opt-out will trim the budget revenues by CZK 20bn a year (0.6% of GDP), which should be financed by a two-step VAT rise. In the first step taken in 2012, the lower VAT rate should go up to 14% from the current 10%. In the second step a year later, two existing VAT rates should merge at 17.5%.

We see the pension overhaul as very cautious, having only a moderate impact on inflation (which is set to rise by 1.2% in 2012) and a marginal impact on the propensity of households to spend from 2013. Arguably, the new pension pillar with such parameters will not help much to ease the state's burden to finance pensions in distant future.

Estonia (A1 stable/A stable/ A stable)*

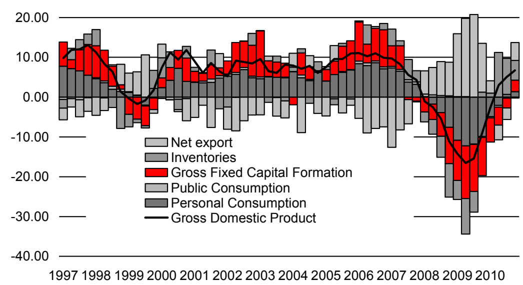
Outlook – We continue to upgrade our outlook for Estonia, following the recent elections. The poll results indicated a determination to continue with an austere budget policy, which has so far granted Estonia EMU membership. In the coming year we see inflation as the primary policy challenge for the central bank and government.

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

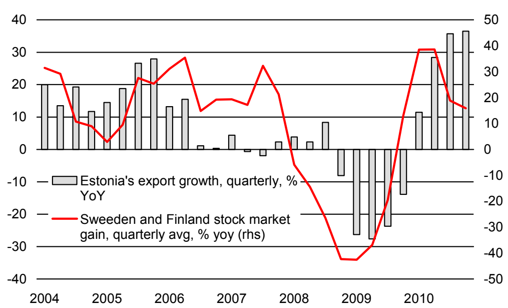
KEY DATES/EVENTS

- 2011, August-Spetember – Presidential elections
- 2011, May – Baltic states PMs' meeting in Estonia
- 2011, May – Submission of Stability report

NET EXPORTS AND INVENTORIES DRIVE GROWTH (YOY, %)



ESTONIA'S LINKS WITH NORDIC COUNTRIES



Source: Bloomberg, Statistics Estonia, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2008	2009	2010E	2011F	2012F
GDP (EUR bn)	16.1	13.9	14.5	15.7	16.9
Population (mn)	1.3	1.3	1.3	1.3	1.3
GDP per capita (EUR)	11,993	10,344	10,878	11,825	12,698
Real economy yoy (%)					
GDP	-5.1	-13.9	3.0	4.5	4.3
Private Consumption	-5.6	-18.8	-2.1	4.2	5.9
Fixed Investment	-15.0	-32.9	-9.6	16.5	14.1
Public Consumption	3.8	0.0	-2.0	1.7	1.7
Exports	0.4	-18.7	21.2	7.9	8.7
Imports	-7.0	-32.6	20.5	8.3	9.3
Monthly wage, nominal (EUR)	820	782	788	820	845
Unemployment rate (%)	5.5	13.8	16.8	11.0	7.5
Fiscal accounts (% of GDP)					
Budget balance	-2.8	-1.7	-0.8	-1.7	-2.3
Primary balance	2.6	1.4	0.4	1.3	1.9
Public debt	4.6	7.2	7.7	8.8	10.5
External accounts					
Current account balance (EUR bn)	-1.6	0.6	0.5	-0.2	-0.4
Current account balance/GDP (%)	-9.7	4.5	3.6	-1.3	-2.2
Basic balance/GDP (%)	-7.1	5.2	11.1	3.1	0.5
Net FDI (EUR bn)	0.4	0.1	0.9	0.5	0.5
Net FDI (% of GDP)	2.6	0.7	6.2	4.4	2.7
Gross foreign debt (EUR bn)	19.0	17.4	16.6	17.3	18.0
Gross foreign debt (% of GDP)	118.2	125.5	114.2	109.9	106.9
Inflation/Monetary/FX					
CPI (pavg)	10.4	-0.1	3.0	3.9	2.8
CPI (eop)	4.3	-0.8	3.9	2.7	2.8
Euribor 3M*	5.70	4.90	0.80	1.74	2.68
EUR/USD (eop)	1.40	1.43	1.34	1.48	1.43
EUR/USD (pavg)	1.47	1.39	1.33	1.44	1.48

*Euribor since 2010

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

Recovery on a firmer footing

Parliamentary elections outcome demonstrate broad support for the ruling government

March parliamentary election results came as no surprise, indicating strong support for the current economic policy. The government secured another four-year term in office. The ruling coalition, according to the preliminary results, won the majority with 56 seats in the 101-seat Parliament – 6 seats more than in the previous elections in 2007. We expect the government to continue with the current economic and fiscal policies. The election outcome demonstrated general public support for the government's program despite austere budget measures. According to the reports on the negotiations about the formation of the new government between two leading parties, the primary targets for the new cabinet will be the recovery of exports and a reduction in the tax burden. However, both parties are equally committed to pursue the current austere budget policy targeted at holding the budget deficit at the lowest level in the EU.

GDP continues to grow supported by industrial goods exports

GDP in 4Q11 grew 6.6% yoy in real terms – the fastest pace of all three Baltic States, but in absolute terms GDP still remains 15% below the peak of 4Q07. 2010 GDP growth increased to 3.1% with the greater portion of the growth coming from industrial production. In 4Q11 exports of goods and services grew 33.5%, while imports rose 30%.

Domestic demand is also recovering, although at a slower pace

There are also signs of reviving personal consumption. In December 2010 unemployment fell to 10% from 13.3% in December 2009, average wages in the same periods rose 3.9% in nominal terms. Household consumption increased in 4Q10 rose 3%, driven mainly by the increase in expenditures on household equipment and on transport. As a signal of an upcoming development, in 4Q10 gross fixed capital formation grew by 12% yoy. There are also anecdotal reports of the increasing investment activity in 1Q11 (Muuga port's EUR 200mn deal with a strategic Russian investor).

Inflation soars driven by food and energy prices

Inflation accelerated driven by world energy and food prices. In Jan 2011 HICP came in at 5% yoy. This is the third consecutive month when inflation breached the 5% level, having started off from 2-3% in mid-year. Food and energy have been the main inflation drivers – these inflation components simultaneously reached double-digit values by end 2010 and we see potential for their further increase on the back of the recent world developments. However, Estonia, being a net food exporter and the only country in the region in possession of oil shale reserves, which account for 90% of generated power, is potentially less exposed to negative effects of inflation driven by food and energy prices. On the negative side, Estonia has a record of inflation at +6%, and we can see current inflation readings approaching that number.

Fiscal policy remains extremely conservative

Public finances remain impressively prudent. Estonia's public debt is extremely low, standing at 9.5% of GDP in 2010, and its budget deficit for 2011 is expected to run at 1.6% of GDP, well within the limits set by the EMU. Due to the collapse in economic activity, current government expenditure rose from 28.5% of GDP in 2007 to 39.6% of GDP in 2009 but is now on a declining trend and should fall towards 35% of GDP by the end of next year. Public debt to GDP remains below 10% of GDP.

C/A may slide into deficit, challenging competitiveness

In line with a gradual recovery in domestic demand, Estonia's C/A remains in surplus but is narrowing (3.6% of GDP in 2010 v 4.5% of GDP in 2009). FDI has shown signs of acceleration and even though we expect the C/A to slip back into deficit this year and next, the basic balance should remain positive. On a longer term horizon, Estonia still has to demonstrate that it can keep inflation at a level close to the ECB target. To compensate for the loss of competitiveness that this implies, the authorities will have to continue to work towards further productivity gains.

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

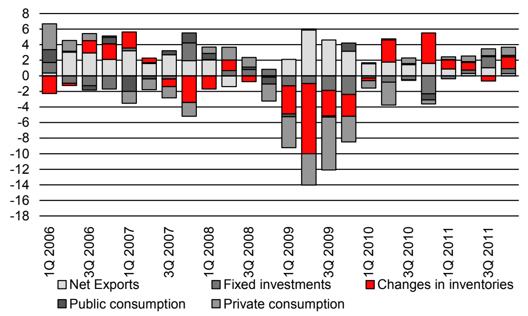
Outlook – We expect the fiscal newsflow to improve during 2Q as the government starts implementing the measures with mid April and July being key dates. Meanwhile growth is still healthy on the back of a supportive external and manufacturing cycle and we expect annual GDP growth to accelerate to 2% yoy. The supportive base effect should start pushing headline CPI lower which in theory allows the NBH to sound more dovish. The hawkish ECB however limits substantial cuts. **Strategy**– The supportive fiscal newsflow story and very strong supply/demand balance means we remain long HGBs (2023/A) and constructive on external markets. We also remain short PLN/HUF but would look to take profit during the first part of the quarter.

Author: Istvan Horvath (UniCredit Bank Hungary)/Gyula Toth, Head of EEMEA FI/FX Strategy (UniCredit Bank Vienna)

KEY DATES/EVENTS

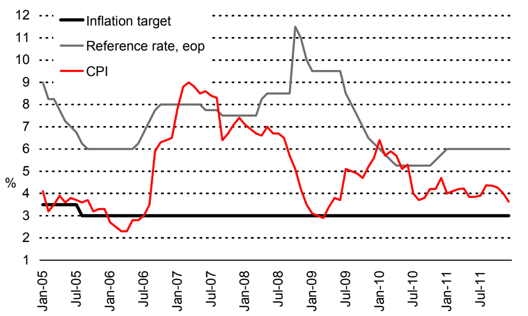
- First rate setting meeting of the new MPC (28March)
- 1Q Inflation report (30 March), 1Q Stability report (20 April)
- Publication of the new Convergence Program (mid April)

INVENTORIES REMAIN KEY DRIVER OF GROWTH(% YOY)



Source: CSO, UniCredit Research

CPI WILL UNLIKELY TO REACH TARGET IN 2011



Source: NBH; UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2008	2009	2010E	2011F	2012F
GDP (EUR bn)	106.5	92.9	98.9	103.8	113.0
Population (mn)	10.1	10.0	10.0	10.0	10.0
GDP per capita (EUR)	10,600	9,249	9,874	10,371	11,294
Real economy yoy (%)					
GDP	0.6	-6.3	1.2	2.8	3.5
Private Consumption	-0.6	-6.7	-1.9	1.4	2.3
Fixed Investment	0.4	-6.5	-5.2	2.9	2.9
Public Consumption	0.2	2.2	2.2	1.7	1.3
Exports	5.6	-9.1	14.0	9.5	14.6
Imports	5.7	-15.4	12.1	10.2	14.5
Monthly wage, nominal (EUR)	792	712	736	758	812
Unemployment rate (%)	7.8	9.8	11.1	10.7	8.3
Fiscal accounts (% of GDP)					
Budget balance	-3.4	-3.9	-3.0	-1.4	-2.0
Primary balance	0.6	0.3	0.1	-0.1	0.1
Public debt	72.3	78.4	78.9	68.3	77.0
External accounts					
Current account balance (EUR bn)	-7.8	-0.4	1.4	0.3	0.3
Current account balance/GDP (%)	-7.3	-0.5	1.6	0.3	0.6
Basic balance/GDP (%)	-2.5	1.1	3.7	4.1	4.5
Net FDI (EUR bn)	3.0	-0.2	0.5	2.4	2.6
Net FDI (% of GDP)	2.8	-0.2	0.5	2.3	2.3
Gross foreign debt (EUR bn)	123.5	135.8	130.4	127.5	121.4
Gross foreign debt (% of GDP)	122.3	141.2	133.4	121.5	107.5
FX reserves (EUR bn)	24.0	30.7	33.0	28.0	24.0
Inflation/Monetary/FX					
CPI (pavg)	6.1	4.2	4.9	4.1	3.4
CPI (eop)	3.5	5.6	4.7	3.6	3.1
Central bank target	3.0	3.0	3.0	3.0	3.0
Central bank reference rate (eop)	10.00	6.25	5.75	6.00	5.00
3M money market rate	8.8	8.7	5.5	6.0	5.8
USD/HUF (eop)	190.3	188.3	208.2	182.4	188.8
EUR/HUF (eop)	265.5	269.8	278.7	270.0	270.0
USD/HUF (pavg)	171.1	201.0	207.5	189.5	182.4
EUR/HUF (pavg)	251.7	280.3	275.3	272.9	270.0

Steps in the right direction, significant funding flexibility

The announced fiscal program is pointing in the right direction

The government announced a fiscal package that targets HUF 902bn savings (3%/GDP) by 2013 with more than 50% already realized in 2012. The sheer size of the package is larger than expected while it is focusing mostly on the expenditure side. The plan together with the cancellation of the government bond held by second pillar pension funds target a reduction in public sector debt to 66%/GDP from the current 80% while the budget deficit is expected to decline to 1.9% by 2014 from 2.9%/GDP in 2011. We believe the package is a step in the right direction to the extent that 4/5 of the measures are expenditure cuts. The key macro assumptions look realistic: GDP growth is expected at 3/3.5%, CPI is assumed at 3% (in line with the NBH medium term target) while according to our latest discussion with the EconMin interest rate expenditures are planned in line with the current yield curve. Against this backdrop we believe the fiscal newsflow could remain relatively positive in the coming 3 months with the first real assessment from the EU in mid April.

In terms of key events keep an eye on the submission of the convergence program in mid-April and July by when 2/3rd of the measures should be implemented

On the top of the positive fiscal newsflow we view the supply demand balance for government funding as strong for the rest of 2011. The pension reform means that the AKK does not have a net HUF funding need if it uses all pension assets. Although the 2011 financial plan calculates with only HUF 530bn income from the sale of pension assets the total value of non HGB assets in the portfolios is around HUF 1400bn (HUF 850bn in non-HUF denominated assets and HUF 550bn in non bond local assets). On the top of this, the plan calculated with HUF 585bn net LC issuance for 2011 but due to increased sizes YTD the AKK has already reached the target. Assuming the successful sale of HUF 530bn assets from the pension portfolios in 2H the AKK has a considerable amount of flexibility as the ongoing issuance is mostly pre-financing for 2012. On the external side the AKK also has flexibility. The plan envisaged EUR 4bn Eurobond issuance but in the event of serious markets pressure the HUF 850bn (EUR 3bn) non-HUF pension assets and EUR 2.8bn FX deposits at the NBH are available. Obviously from a longer term stability perspective the AKK is planning to go ahead with the full amount of issuance but the important point is a high level of flexibility in our view. **We also see considerable further buying potential from non-resident investors (despite an increase in their HGB holdings by EUR 1.5bn YTD).** We estimate that non-resident investors are still circa EUR 0.5-1.0bn underweight local currency HGBs (due to significant inflows into dedicated EM local currency bond funds and limited change in non-resident bond holdings last year, see chart). While pension funds and mutual funds are unlikely to buy more HUF bonds we see some further capacity from the banks side as lending remains limited while the sector as a whole still have excess liquidity of HUF 4000bn. Looking beyond 2011 the picture is less clear and depends on the actual usage of the pension assets and the implementation of the fiscal plan. But if the AKK manages to raise a sufficient buffer during the rest of the year we think the above outlined flexibility on the local side could be transferred to 2012. With all of this in mind, we see the potential for rating agencies to shift to a stable outlook by year end.

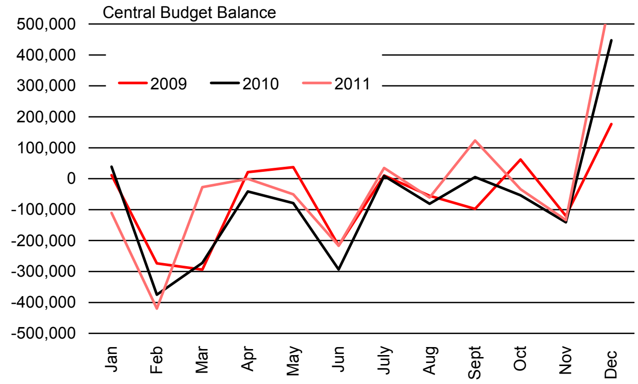
The AKK has considerable flexibility on the local and external side

Hungarian assets remain under owned creating a favorable supply/demand backdrop

The fiscal announcements point to the right direction

HUF bn	2012	2013	Cum.
Labour market	195	18	213
Transport system	45	15	60
Pensions	99	30	129
Drug subsidies	83	37	120
Education	12	26	38
Financial local governments	32	90	122
Total plan	**556**	**346**	**902**
Ex national debt reduction fund	**466**	**216**	**682**

Cash budget deficit (HUFthds) should stop growing from here till 4Q11 (2011 MinFin forecast)



Source: EconMin, UniCredit Research

On external funding the picture is more stable in 2011 than it was in 2010 but could deteriorate in 2012 onwards if the banking sector roll-over does not pick up

Due to a strong FDI pipeline (in the car industry), EU transfers and the positive current account we see the total external financing balance as manageable in 2011 (particularly versus 2008/10) while challenges could increase in 2012 again. The circa 2.5%/GDP committed FDI, balanced current account and circa 1.5%/GDP EU transfers means that banks can afford to run roll-over ratios of 90% (as was the case in 2010) without a significant negative impact on the overall external funding balance. The situation could however deteriorate significantly in 2012 if the FDI pipeline does not remain. The banking sector lost an average of EUR 237mn per month over the last 6 months of last year while the government repayment needs to the IMF and EU will increase to EUR 3.8bn (and to EUR 4.5bn in 2013) from only EUR 2bn in 2011. For the time being however we see the balance of risks around the HUF as relatively symmetrical with potential weakness only coming in 2012 onwards.

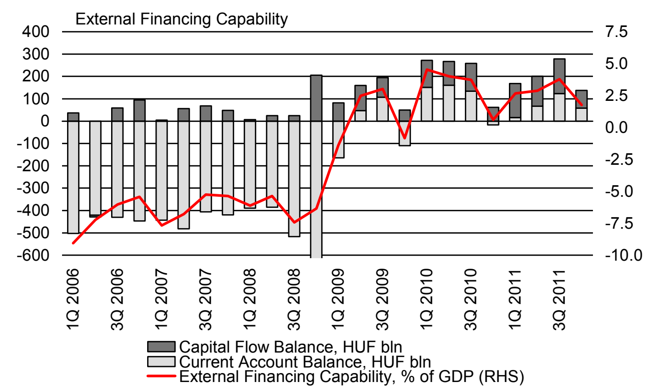
Growth should accelerate in 2011 driven by export and manufacturing

Meanwhile the near term growth outlook looks positive. GDP managed to post the fifth consecutive quarter of GDP gains in 4Q but at 0.2% qoq it was relatively modest (the full year growth was 1.2% yoy). The structure remains heavily tilted toward the manufacturing and exporting sector. Household consumption fell 0.5% qoq in 4Q reversing most of the 3Q gains while export remained strong at 2% qoq well above import growth 1.3% qoq. High frequency data suggest that the outlook for export and manufacturing remains strong: PMI in February reached the highest level since 1Q07 while the outlook for the German economy remains firm in the near term, industrial production is growth in double digit in qoq terms and short term dynamics also improved recently. We expect the inventory cycle to remain supportive in 1Q and 2Q this year. Overall we expect real GDP growth to increase to 2.8% yoy on the back of a further positive contribution from inventories, net export and minimal contribution from household consumption. In 2012 we see scope for further acceleration to 3/3.5% yoy which is still short of the growth rates reached before 2006 and the government is aiming for.

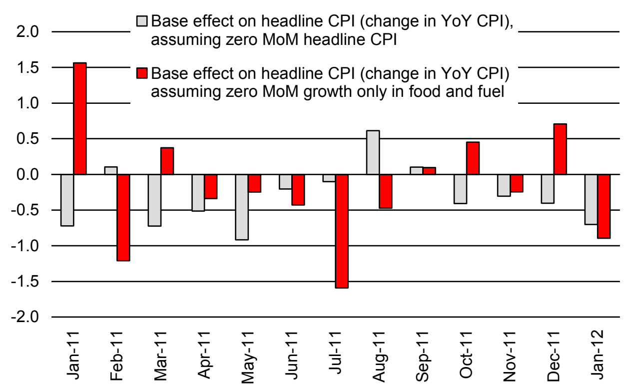
The new MPC will likely try to cut rates but our baseline assumes no change in the policy rate

In terms of monetary policy, the near term focus is on the replacement of the 4 external MPC members. Although the government and new MPC members may prefer to cut rates as soon as possible, we believe the NBH will maintain a wait and see approach for now and only in the case of a sustained decline in risk premium (stronger HUF and lower CDS) could trigger some moderate rate cut in the second half of the year. A more hawkish ECB and higher food and energy prices limit the room for maneuver however and hence we maintain our baseline scenario that the NBH will keep rates on hold till the end of the year. Purely from an inflation targeting perspective the room for looser monetary policy is also limited as we forecast headline CPI to remain above the 3% target.

External financing capability remains strong in 2011



Base effect on headline CPI is positive in the next 6M



Source: NBH, CSO, UniCredit Research

Strategy: supply demand balance supports bonds & credit

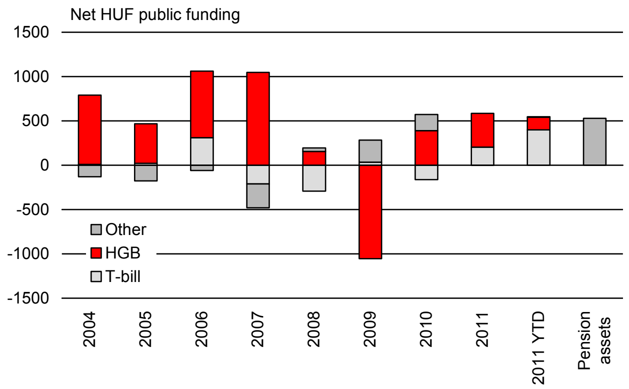
Buy 2023/A HGB with a target of 7%

Consider selling CDS

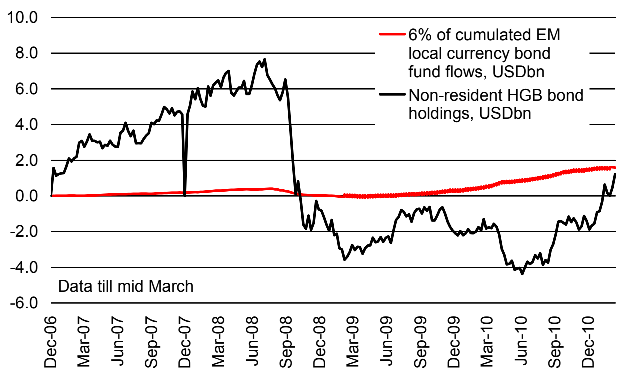
Look to take profit on short PLN/HUF during 1Q

Against the relatively constructive near term fiscal newsflow and very supportive supply demand balance we believe HGBs will continue to outperform in the second quarter and we would remain constructive on local currency government bonds. Valuation wise we see the long end as more attractive due to the relatively steep cash curve in historical terms (current 3Y/10Y HGB spread is around +60bp versus a negative 25bp 5Y average of this spread). We remain long 2023/A papers targeting another 50bp move lower. We would expect more volatility around the mid April convergence program announcement and the July implementation deadline. As the IRS curve is much flatter than the cash curve we would use swaps hedge the above bond view on a tactical basis. **The lack of meaningful external funding pressure (assuming a successful Eurobond issuance) for the next 12M means we expect external credit markets to outperform as well.** The cleanest trade would be selling short dated (1/2Y) CDS but due to liquidity considerations we would consider selling 5Y CDS with a target at 250bp. Although the balance of risk around the HUF is also supportive in the near term we think this could deteriorate probably earlier than the other classes and hence we would look to take profit on our short PLN/HUF positions. **Gyula Toth**

AKK has considerable flexibility on HUF issuance going forward



Non-resident bond holders are still U/W Hungarian bond market



Source: AKK, UniCredit Research

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2010E	2011F
Gross financing requirement	**25.2**	**24.1**
Budget deficit	3.2	2.5
Amortization of public debt	22.4	21.0
Domestic	21.1	16.9
External	1.3	4.1
Financing	25.2	24.1
Domestic borrowing	22.6	19.0
External borrowing	1.5	4.6
Bonds	1.5	4.0
IMF/EU	0.0	0.0
Other	0.0	0.6

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2010E	2011F	2012F
Gross financing requirement	29.6	37.2	33.3
C/A deficit	-1.4	-0.3	-0.3
Government/central bank	6.0	14.2	11.8
Amortization of medium to long term debt	1.8	5.1	5.9
Banks	3.4	7.4	4.4
Corporates	0.8	4.4	1.5
Short term debt amortization	25.0	23.3	21.8
Financing	30.1	40.0	35.4
FDI	0.0	2.4	2.6
Portfolio flows	-0.5	0.0	0.0
Borrowing	5.1	12.9	8.9
Government/central bank	2.0	4.0	4.4
Banks	2.6	5.6	3.3
Corporates	0.5	3.3	1.1
Short-term	23.7	22.5	21.5
EU transfers	1.8	2.2	2.5

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

Outlook – GDP contracted for a third consecutive year last year but is on track to show expansion this year and next. Domestic demand has shown signs of bottoming out while the C/A surplus is narrowing. The willingness of the government to take measures on the budget to date is impressive and the deficit should narrow this year but there is still some work to be done. Fitch's recent upgrade back into investment grade is testament to what the authorities have achieved to date.

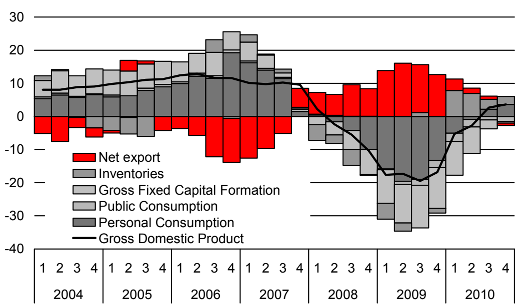
Strategy outlook – Lativa and Lithuania CDS are now trading hand in hand. As Lithuania has stronger credit metrics we would consider switching from Latvia at flat spread levels. Although issuance picked up in Lithuania we think Latvia may follow in 2H as the country prepares for repaying the IMF/EU package.

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

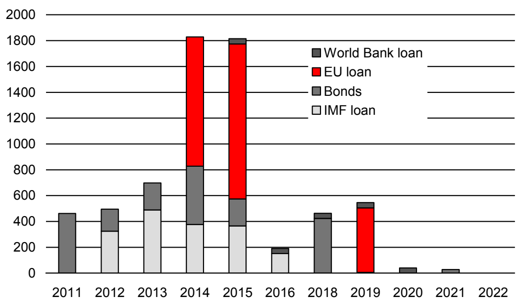
KEY DATES/EVENTS

- Mid-April: Fourth Review under IMF/EU Stand-By Arrangement
- May – Presidential elections
- May – Submission of Convergence report

DOMESTIC DEMAND DROVE CONTRACTION BUT SHOWS SIGNS OF BOTTOMING OUT (YOY, %)



LATVIA'S LOANS AND BONDS REPAYMENT SCHEDULE (MLN EUR)



Source: Blooomberg, Central Statistical Bureau of Latvia, UniCredit Research, IMF, European Comission

MACROECONOMIC DATA AND FORECASTS

	2008	2009	2010E	2011F	2012F
GDP (EUR bn)	22.9	18.5	18.0	19.4	20.7
Population (mn)	2.3	2.3	2.3	2.2	2.2
GDP per capita (EUR)	10,082	8,184	7,996	8,631	9,248
Real economy yoy (%)					
GDP	-4.1	-17.8	-0.5	3.8	3.5
Private Consumption	-5.6	-23.7	-0.2	3.0	2.1
Fixed Investment	-13.7	-36.1	-21.7	6.7	8.9
Public Consumption	1.8	-8.9	-11.1	-0.4	1.5
Exports	0.9	-13.3	10.5	11.1	8.7
Imports	-11.1	-32.9	7.1	12.0	9.9
Monthly wage, nominal (EUR)	678	651	629	656	680
Unemployment rate (%)	7.1	16.1	14.3	12.5	11.0
Fiscal accounts (% of GDP)					
Budget balance (incl. bank costs)	-7.5	-7.7	-11.7	-6.8	-2.3
Primary balance	-6.9	-6.2	-9.9	-4.7	0.0
Public debt	17.1	32.9	41.6	45.4	44.8
External accounts					
Current account balance (EUR bn)	-3.0	1.6	0.6	-0.3	-0.5
Current account balance/GDP (%)	-13.1	8.6	4.9	-1.4	-2.2
Basic balance/GDP (%)	-10.0	9.2	6.3	2.2	1.7
Net FDI (EUR bn)	0.7	0.1	0.2	0.7	0.8
Net FDI (% of GDP)	3.0	0.6	1.4	3.6	3.9
Gross foreign debt (EUR bn)	29.6	28.9	29.8	30.9	32.0
Gross foreign debt (% of GDP)	129.2	156.3	165.2	159.3	154.4
FX reserves (EUR bn)	5.8	5.2	6.9	7.4	7.9
Inflation/Monetary/FX					
CPI (pavg)	15.4	3.5	-1.1	3.7	3.2
CPI (eop)	13.6	-1.3	2.5	2.8	3.0
RIGIBOR 3M	6.00	4.00	3.50	3.75	3.75
USD/LVL (eop)	0.51	0.49	0.53	0.48	0.49
EUR/LVL (eop)	0.71	0.71	0.71	0.71	0.71
USD/LVL (pavg)	0.48	0.51	0.53	0.51	0.30
EUR/LVL (pavg)	0.71	0.71	0.71	0.71	0.71

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

Positioned for growth

Latvia is on track to post positive growth in 2011

Latvia was the only of the three Baltic economies to post a full year contraction in 2010 (-0.5%) but is showing signs of recovery and we expect full year growth this year of 3.8%. The decline in economic activity last year was generated largely by a further slump in gross fixed capital formation and public consumption. From a production perspective to GDP, industrial production is quickly gaining momentum, is rising at the pace comparable to the 2006-2007. Industrial output in 2010 was up by 13.9%. The exports in constant prices increased by 21.9%, although this run-up was mitigated by a steeper expansion of imports of almost 28%. So far the exports/imports have been growing at the pace outperforming other GDP components, in line with the similar trend in other Baltic countries.

Domestic demand still is slowly recovering

Domestic demand contracted through 1H-10 but showed gains in 2H-10. Monthly average gross wages in 2010 contracted by 3.5% but unemployment has peaked and is showing signs of decline - from 19.7% in 4Q09 it fell to 15.6% in 4Q10. Inflation in 2010 came in at the 2.5% constraining consumer purchasing power. Retail sales in constant prices in 2010 contracted by 2.2% compared to 2009, signaling still ongoing correction. By year end there were clear signs of improvement. Private consumption, having contracted by 6.2% yoy in 1Q10, managed to post gains of 5.2% yoy by 4Q10.

Major positive developments are coming come C/A balance readings

The turnaround in domestic demand is also visible in balance of payments dynamics. From a surplus of over 8% of GDP in 2009, the C/A surplus narrowed to almost below 5% of GDP last year. 4Q saw Latvia post its first quarterly C/A deficit since 4Q08. For this year we expect the C/A to post a very modest deficit, though this will be fully covered by FDI. Non-resident deposits, accounting for a large chunk of overall banking sector deposits, stopped declining by early 2010 and have since shown recovery.

Fiscal moves in the right direction but more remains to be done

The IMF is scheduled to return to Latvia in mid-April, later than the originally planned March because of some delays on the agreement on supplementary savings. Considerable progress has been made to date in pushing through politically difficult fiscal measures but more remains to be done. Last year's deficit, once banking sector costs are included, was in double digits while the programme targets a deficit of 2.3% of GDP by next year. Public debt to GDP is likely to edge higher this year but decline next year and remain well below the EU average.

Watch for re-engagement with the IMF and Eurobond issuance

The final review is scheduled for November and though much too early to confirm, we see the potential for Latvia to come to an agreement on a precautionary programme to follow up on the current stand-by arrangement. In the meantime we would not be surprised to see the sovereign access the Eurobond market. This would help towards repayment of IMF/EU loans next year as well as ease any crowding out pressure that may be present on the domestic market.

Ratings upgrades to re-affirm progress to date

Fitch recently upgraded Latvia by 1 notch to BBB- (positive outlook), bringing them back into investment grade territory. S&P has also moved Latvia's outlook from "stable" to "positive", though at BB+ it has still not returned to investment grade. Both upgrade press releases were referring to the improvement of the economic prospects and export growth as the basis for the revisions. Between mid-04 and mid-07 Fitch rated Latvia A-, underlining the scope for further upgrades ahead, though it is unlikely that Latvia returns to that sort of rating over the next 1-2 years. The key challenge from here is continued fiscal consolidation while expanding a competitive export base.

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

Outlook – We maintain a positive outlook on Lithuania, as the economy shows signs of a more broad based recovery. The government has focused on fiscal consolidation, but more remains to be done and we see the deficit returning to the 3% threshold set down in the Maastricht criteria most likely only in 2013. Soaring commodities prices should boost inflation and widen the C/A deficit but also act as a risk to the recovery in domestic demand.

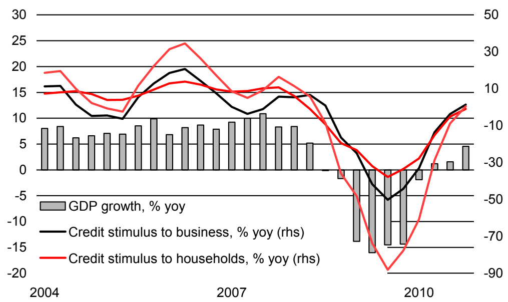
Strategy outlook – We believe that the positive rating outlook is still not reflected in Lithuanias credit spreads and would expect further compression in CDS and Eurobond spreads during the quarter.

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

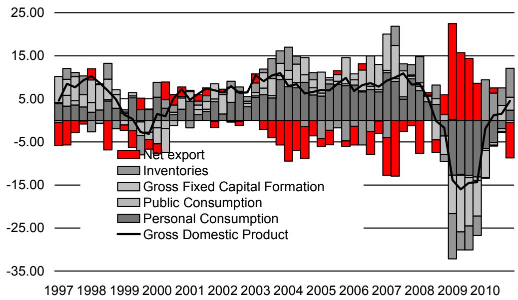
KEY DATES/EVENTS

- May-11 – Submission of Convergence report
- 2012 – Parliament elections

CREDIT EXTENSION INDICATES ACCELARATED RECOVERY



STRUCTURE OF GDP GROWTH IMPLIES STRONG CONTRIBUTION FROM INVENTORIES (YOY, %)



Source: Statistics Lithuania, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2008	2009	2010E	2011F	2012F
GDP (EUR bn)	32.3	26.5	27.4	29.2	30.7
Population (mn)	3.4	3.3	3.3	3.3	3.3
GDP per capita (EUR)	9,615	7,939	8,257	8,837	9,360
Real economy yoy (%)					
GDP	2.8	-14.7	1.3	3.7	3.0
Private Consumption	3.8	-17.7	-4.1	3.6	3.2
Fixed Investment	-6.9	-39.2	-0.3	4.4	5.3
Public Consumption	7.3	-1.9	-3.0	0.9	1.0
Exports	11.6	-12.7	16.3	9.8	9.7
Imports	10.3	-28.4	17.6	12.2	10.6
Monthly wage, nominal (EUR)	654	625	600	615	635
Unemployment rate (%)	4.8	9.5	14.5	10.0	7.5
Fiscal accounts (% of GDP)					
Budget balance	-2.6	-7.9	-6.5	-5.3	-4.0
Primary balance	-1.9	-6.7	-4.6	-3.1	-1.4
Public debt	15.6	29.5	35.0	38.2	40.3
External accounts					
Current account balance (EUR bn)	-4.2	1.1	0.3	-0.6	-0.9
Current account balance/GDP (%)	-13.1	4.3	1.6	-2.1	-3.0
Basic balance/GDP (%)	-9.5	4.1	4.3	0.5	0.6
Net FDI (EUR bn)	1.2	0.0	0.7	0.8	1.1
Net FDI (% of GDP)	3.6	-0.1	2.6	2.6	3.6
Gross foreign debt (EUR bn)	23.0	23.1	22.9	23.7	24.5
Gross foreign debt (% of GDP)	71.3	87.2	83.5	81.4	79.6
FX reserves (EUR bn)	4.6	4.5	4.9	5.2	5.5
Inflation/Monetary/FX					
CPI (pavg)	11.0	4.5	1.1	2.6	2.2
CPI (eop)	8.5	1.3	3.6	2.4	2.4
VILIBOR 3M	9.20	4.54	1.56	1.80	2.70
USD/LTL (eop)	2.55	2.37	2.61	2.33	2.41
EUR/LTL (eop)	3.45	3.45	3.45	3.45	3.45
USD/LTL (pavg)	2.35	2.48	2.60	2.40	2.33
EUR/LTL (pavg)	3.45	3.45	3.45	3.45	3.45

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

Slowly but surely pushing ahead

Economy continues to grow driven by exports

The Lithuanian economy continues to show gains in economic activity. 4Q10 saw GDP expand 1.8% qoq (4.6% yoy), bringing full year GDP to 1.3% in 2010. The GDP reading represents the fourth successive positive quarter of yoy figures, though GDP remains 13.4pp below its 3Q08 peak. Lithuania has benefitted from a recovery in Europe and Russia, with exports showing growth of circa 20% yoy each quarter since 2Q10. There are signs of a recovery in domestic demand, though at this stage it remains unbalanced and reliant on inventory accumulation. Private consumption has bottomed and in qoq terms growth averaged 0.7% per quarter over 2H10.

We expect the economy to expand further in 2011, although the pace of the growth may slow down

We expect Lithuania to post a continued recovery in economic activity this year and we forecast full year GDP growth in excess of 3%. The main driver behind the growth still being export and gross fixed capital formation, the latter we expect to rise after a sharp decline over the last 11 quarters. At the same time, the growth potential from inventory accumulation will soon be exhausted, as the inventories are about to reach the level close to the pre-crisis levels, both in absolute terms and relative to GDP. The C/A balance surplus in 2010 narrowed to 1.4% of GDP, decreasing by two-thirds compared to 2009. The formal capacity utilization remains below the pre-crisis levels, nevertheless we expect there still to be significant fixed capital investments due to economic restructuring and noteworthy efforts towards the renovation of industrial capabilities.

Credit, as well as foreign direct investments, is recovering in line with the overall economic expansion – FDI inflows into Lithuania in 3Q10 came in at the third highest in history, following up on four previous quarters of FDI outflows. On the other hand, domestic credit is recovering sluggishly. Credit returned to growth in 3Q after seven successive quarters of contraction. The tentative improvement in credit conditions is in line with the slowdown in foreign capital outflow from the banking sector.

Inflation is likely to peak, driven by oil and food prices

Primary risks at this stage remain soaring oil prices. The January HICP weakened 0.8% to 2.8% yoy compared to the same indicator for December. Although food inflation remained relatively unchanged in January compared to December at 5.1% yoy and energy HICP components fell from 19.74 to 12.81, we expect both groups to increase significantly in price over the next 3-6 months, particularly energy – to price in the latest oil price increase.

The government has worked hard on fiscal consolidation, but more remains to be done

To date the government's commitment to fiscal consolidation has been impressive but more remains to be done. From a budget deficit of 8.9% of GDP in 2009, last year's deficit was reduced to approximately 7.5% of GDP with a target for this year and next of 5.8% and 3% of GDP. At this stage there are some signs that reform fatigue has begun to set in and as things stand currently the government is not on track to meet this year's deficit target. Moreover some of the measures put in place during the crisis are scheduled to roll off at the end of next year, meaning that more also needs to be done to get to next year's 3% target. Encouragingly the government is required to put forward a supplementary budget if 1Q revenue targets are not met. Following a decent outcome for PM Kubilius at February's local election, the government should act on this over the next couple of months.

Lithuania is likely to increase debt offering in the international markets

Credit ratings are likely to be upgraded

Focusing on fiscal financing, Lithuania accessed Eurobond markets in March, selling USD 750mn – the first time that the sovereign has come to the market since September last year with a USD 750mn debt offering. Interest rates since the last issue have fallen. We do not rule out that the sovereign returns to the market once again this year given a EUR 1bn principal debt repayment in May 2012. **We expect Lithuania's sovereign rating to be upgraded by the end of this year** following a 2 notch downgrade by S&P and Fitch (3 by Moody's) since the onset of the crisis back in 2008.

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

Outlook – The economy continues to post robust GDP gains. Accompanied by an increase in inflationary pressures, even if largely due to food and oil, the NBP has begun to gradually hike rates. The NBP is no doubt disappointed by PLN losses and may take action later this year to help re-establish an appreciation trend. Lax fiscal policy remains our primary concern at this stage, though some government measures and EU pressure means that the deficit is at least heading in the right direction.

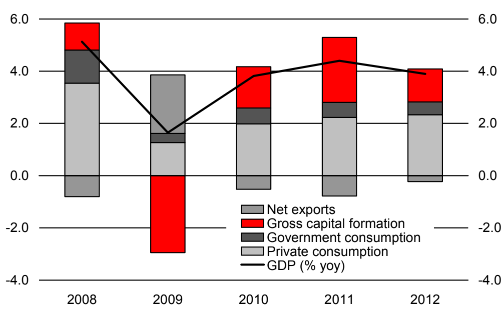
Strategy – We consider long dated IRS and CDS too low vs. fiscal risks. With the MinFin's jumbo flow still hanging over we would still wait before we pay the 5Y5Y PLN/EUR spread which benefits from a positive roll-down. In FX we think positioning continues to be against a meaningful PLN outperformance in the near term but this could turn into outperformance in 2H when the MinFin/NBP will become more serious about a stronger zloty. We stay short PLN/HUF for now.

Author: Marcin Mroviec, Chief Economist (Bank Pekao)

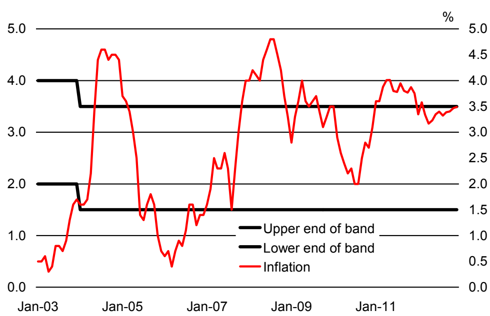
KEY DATES/EVENTS

- MPC decision-making meeting (5 April, 11 May, 8 June)
- Convergence report (May)
- Inflation report (June)
- Parliamentary election (6 Oct -4 Nov)

CONTRIBUTIONS TO YOY GDP (PP)



INFLATION HAS EDGED OUT OF TARGET BAND AND IS LIKELY TO REMAIN THERE FOR NOW



Source: GUS, NBP, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2008	2009	2010E	2011F	2012F
GDP (EUR bn)	362.0	310.6	350.0	382.1	419.6
Population (mn)	38.1	38.2	38.1	38.1	38.1
GDP per capita (EUR)	9,492	8,137	9,187	10,039	11,027
Real economy yoy (%)					
GDP	5.1	1.7	3.8	4.4	3.9
Private Consumption	5.7	2.1	3.1	3.6	3.8
Fixed Investment	9.6	-1.1	-0.1	9.8	5.4
Public Consumption	7.4	2.0	3.2	3.3	2.8
Exports	7.1	-6.8	12.1	9.8	9.1
Imports	8.0	-12.4	11.5	10.9	8.8
Monthly wage, nominal (EUR)	767	854	972	1,041	1,152
Unemployment rate (%)	9.8	11.0	12.3	10.8	9.8
Fiscal accounts (% of GDP)					
Budget balance	-3.6	-7.2	-7.9	-6.4	-4.3
Primary balance	-1.5	-4.6	-5.0	-2.6	-1.4
Public debt	47.2	50.7	53.8	54.5	55.9
External accounts					
Current account balance (EUR bn)	-17.4	-6.8	-11.6	-14.3	-16.5
Current account balance/GDP (%)	-4.8	-2.1	-3.3	-3.7	-4.0
Basic balance/GDP (%)	-2.0	1.0	-1.2	-1.1	-1.3
Net FDI (EUR bn)	10.1	10.0	7.5	10.0	11.0
Net FDI (% of GDP)	2.8	3.2	2.1	2.6	2.7
Gross foreign debt (EUR bn)	174	195	221	240	250
Gross foreign debt (% of GDP)	57.1	59.6	63.2	62.8	59.6
FX reserves (EUR bn)	44.1	55.2	70.0	85.0	97.0
Inflation/Monetary/FX					
CPI (pavg)	4.2	3.5	2.6	3.7	3.5
CPI (eop)	3.3	3.5	3.1	3.8	3.5
Central bank target	2.5	2.5	2.5	2.5	2.5
Central bank reference rate (eop)	5.00	3.50	3.50	4.25	4.50
3M Wibor	6.4	4.4	3.9	4.6	4.9
USD/PLN (eop)	2.97	2.86	2.96	2.64	2.66
EUR/PLN (eop)	4.15	4.10	3.96	3.90	3.80
USD/PLN (pavg)	2.39	3.10	3.01	2.78	2.64
EUR/PLN (pavg)	3.52	4.33	3.99	4.00	3.90

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

Solid growth but questionable fiscal policy

Poland to continue to post strong growth

We remain positive on the outlook for GDP growth this year, and maintain our forecast of 4.4%. The recently released data for 4Q10 confirmed acceleration of private consumption to 4.1% yoy (vs. 3.5% yoy in 3Q). For 2011 as a whole we assume private consumption growth of 3.6% yoy, something we believe is manageable even if we discount the fact that 4Q10 was artificially boosted by the frontrunning of January's VAT hike. Both wages and employment should be supportive. Regarding the number of employed people in the corporate sector, the January figure brought a very positive surprise with growth jumping to 3.8% from 2.4% in Dec 10. The domestic corporate sector employs more people (5.5mn) than it employed at the pre-crisis peak at end-2008 (5.4mn). Wage growth remains moderate (nominal growth of 5% yoy in Jan, against 3.6% yoy CPI inflation), but we expect acceleration to around 6% from 2Q onwards. Additionally structural change will take place in the labor market from May 2011 onwards as Germany and Austria opens its borders to workers from the new EU countries, reducing labor supply in Poland.

Public sector investment offers support, private sector investment should turn more positive

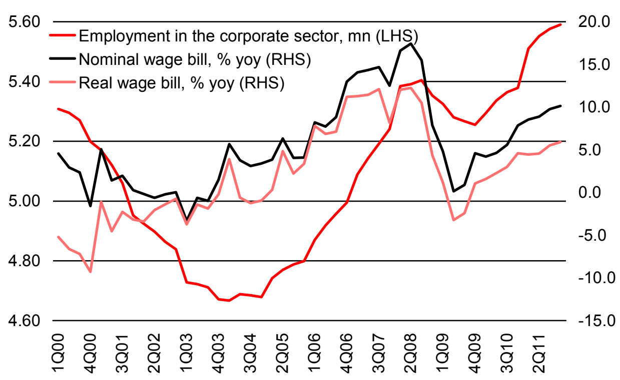
Investment trends diverge significantly between the public and private sector. Public investments will get an additional boost this year vs. the previous year. First there has been significant acceleration in the allocation of EU funds in 2010, and now almost all of the funds for 2007-2013 are allocated. Their actual spending will accelerate from here. Second some of the projects were ascribed to EURO2012 Football Championships that will be organized by Ukraine and Poland and as such face a tight deadline. Regarding private sector investment spending, there are signals that large companies will invest whereas mid-sized and small companies appear to be waiting for confirmation of the need for further investment. Nonetheless, private sector investments will be positive in the second half of the year bringing the composite growth in investments to close to 10%. Regarding 2012, the big question is if the private sector maintains a more pronounced investment phase. Given that public investments will be negative yoy in 2012, private investment will have to offset this to keep the total number positive.

Inflation has moved outside out the MPC's target band and is likely to remain there for the remainder of this year

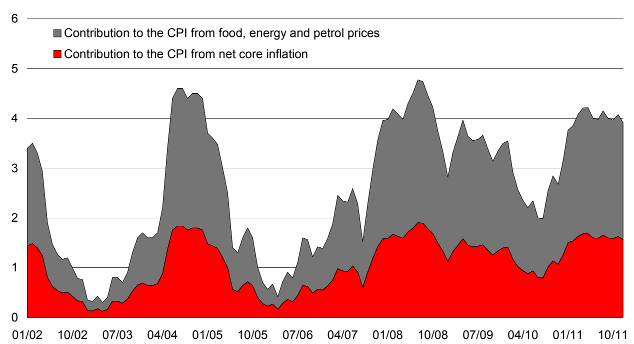
Strong growth is accompanied by rising inflationary pressures. From 3.1% in December, inflation in January and February rose to 3.6%, outside of the NBP's target band of 2.5% +/-1%. A combination of factors contributed to this including an increase in VAT from 22% to 23% from Jan, an increase of electricity prices and municipal prices and surprisingly strong growth in food prices. As a result CPI is likely to reach levels slightly above 4.0% around May, and then decline towards 3.8% in end-2011. This scenario assumes stabilization of food and energy prices in the second half of the year. Should they continue to increase, that would lessen the probability of CPI subsiding from the May high, esp. given that food prices constitute almost a quarter of domestic CPI basket.

STRONGER GROWTH, STRONGER LABOR MARKETS, HIGHER INFLATION

Labor market continues to recover



Food and energy are the primary drivers of inflation



Source: GUS, UniCredit Research

We see a maximum of 125bp in hikes this year

The MPC seems set on gradual rate hikes, dismissing inflation as due to factors that cannot be effectively countered with monetary policy. They also point out that CPI is likely to fall in the second half of the year due to food and energy price dynamics, though we see a risk of second-round effects and higher inflationary expectations. Our estimates point to net core inflation approaching the inflation target of 2.5% yoy at end-2011 while the NBP's recent inflation projection showed CPI above the MPC target during whole projection period (i.e. till 2013). At the current junction we assume two more 25bp hikes (April and most probably June, along with the next Inflation Projection release) after one hike already in January and the potential for further hikes (one, max two) in 2H11, should inflation continue to surprise on the upside and/or should wages growth accelerate.

The deficit should narrow gradually from here

Fiscal policy remains Poland's primary vulnerability at this stage. Last year's deficit stood at close to 8% of GDP – among the worst in the region despite solid GDP gains. 2011 should see improvement, in part because of some modest government efforts, in part because of pension sector 'reform', in part because of EU pressure to move towards Stability and Growth Pact criteria. Measures taken by the government include the above discussed VAT hike and a cap on discretionary government expenditure at inflation plus 1%. Aware of its sub-par fiscal performance, the sovereign has ensured a liquidity cushion via domestic and Eurobond issuance, as well as a pooling of liquidity resources available at various levels of government and SOEs.

Politics is a risk to consolidation – negative ratings action cannot be ruled out

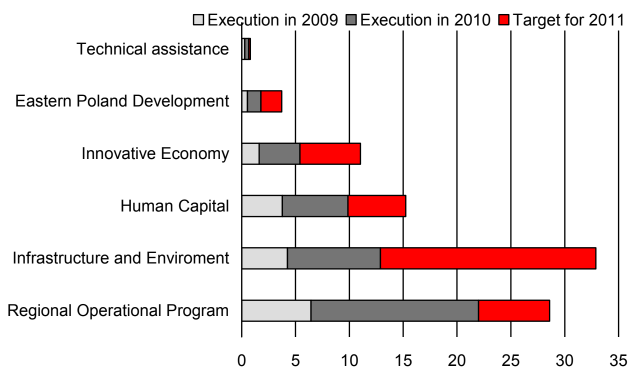
Politically the situation has become more complicated as the ruling Civic Platform (PO) is losing popularity and the vision of winning an absolute majority, something that seemed possible for the past couple of years, is now very difficult to envisage. The governing coalition following parliamentary elections in October will likely comprise 2-3 parties. Consensus on and implementation of fiscal reform may become more difficult as a result. Rating agencies appear to be paying increasing attention to fiscal dynamics – should the new government not act quickly, Poland could see a shift in its outlook to negative by year-end with the risk of a downgrade.

A bumpy ride for PLN

PLN remains a concern for both the Ministry of Finance and the NBP. Governor Belka was hoping that the recent rate hike, accompanied by NBP rhetoric, would have supported PLN. Meanwhile the government likely needs to see PLN sub-3.8/EUR by year-end to ensure no breach of the 55% of GDP debt threshold. Though unlikely to materialize in the near term, PLN should show gains over the course of 2011. If not, we would not rule out that the Ministry of Finance decides to divert EU funds and Eurobond proceeds from the NBP to the market in 2H11.

USE OF EU FUNDS HELPS GROWTH BUT ALSO CONTRIBUTES TO WEAKER FISCAL PERFORMANCE

Utilization of EU funds earmarked for 2007-13 and planned allocations



Foreigners increased their holdings of domestic bonds significantly

Source: European Commission, Ministry of Finance, UniCredit Research

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

Look to pay 5Y5Y PLN/EUR spread

Remain bearish credit and U/W sovereign cash

Keep neutral duration in POLGBs in the belly of the curve

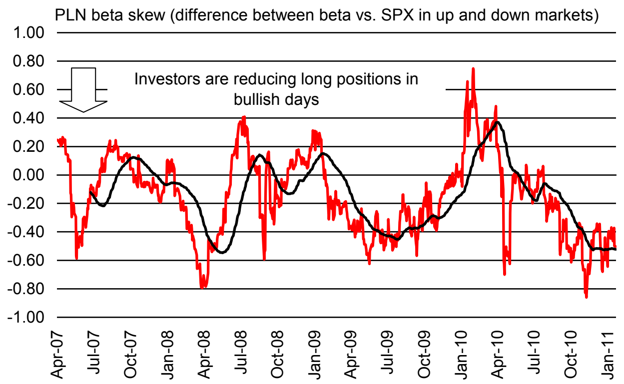
Although Poland's fiscal risks are well flagged we believe this is not priced in long dated IRS and CDS and hence we would look to express bearish view in these markets. From cost perspective we see paying 5Y5Y PLN/EUR spread as a cheaper solution than paying 5Y CDS (positive roll-down of around 2bp per month vs. 14bp negative carry per month on a 5Y CDS payer position) while the two has correlated relatively well recently. The key risk to trade is the potential jumbo flow from the MinFin and hence we wait for more clarity on this one before adding to the position. Although POLGBs look cheap from an ASW perspective we would keep a neutral duration as ASWs is distorted by the MinFin interference. As the belly of the curve tends to outperform in hiking cycles we keep neutral duration through this part of the curve.

Stay short PLN/HUF, look to take profit on meaningful EUR/PLN spikes

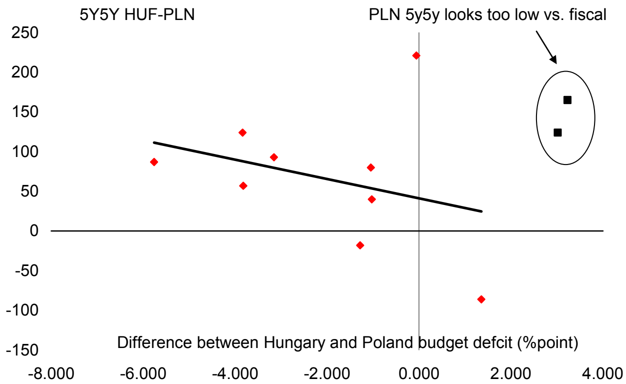
In FX we think positioning is still against a meaningful PLN outperformance in the near term (as seen in the chart below the beta vs. S&P is much higher in bearish days than in bullish days) while the NBP looks hesitant in terms of timing and size of rate hikes and against a hawkish ECB this could put them behind the curve. N-t underperfomance could turn into outperformance in 2H when the MinFin/NBP will become more serious about a stronger zloty. Accordingly we keep short PLN/HUF now but look to take profit and increase PLN allocation on meaningful EUR/PLN spikes.
Gyula Toth

POSITIONING IS AGAINST PLN OUTPERFORMANCE WHILE FISCAL RISKS ARE NOT PRICED IN IRS CURVE

Positioning is still against PLN



PLN fiscal risks are not priced in IRS markets



Source: UniCredit Research

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2010E	2011F	2012F
Gross financing requirement	**49.6**	**49.2**	**56.4**
Budget deficit	20.2	21.2	18.6
Amortisation of public debt	29.3	28.1	37.9
Domestic	27.1	26.5	34.1
Bonds	15.2	19.5	29.0
Bills	11.9	7.0	5.1
External	2.2	1.6	3.7
IMF/EU	0	0	0
Financing	**52.5**	**50.8**	**56.4**
Domestic borrowing	39.9	39.5	46.0
Bonds	34.0	33.2	37.3
Bills	5.9	6.3	8.7
External borrowing	12.6	11.3	10.3
Bonds	6.8	5.0	5.0
IMF/EU	0	0	0
Other (incl. privatization)	5.8	6.3	5.3

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2010E	2011F	2012F
Gross financing requirement	**85.9**	**83.4**	**84.6**
C/A deficit	11.6	14.3	16.5
Amortisation of medium to long term debt	23.5	16.3	15.2
Government/central bank	8.3	4.7	7.8
Banks	5.2	5.1	1.7
Corporates	9.9	6.4	5.6
Short term debt amortisation	50.8	52.9	53
Financing	**91.0**	**90.3**	**89.4**
FDI	7.5	10.0	11.0
Equity	4.4	4.5	4.7
Borrowing	86.1	82.1	80.1
Government/central bank	17.2	13.4	15.4
Banks	30.2	32.3	29.3
Corporates	38.7	36.3	35.4
EU transfers	6.7	7.4	7.3
Other	-13.7	-13.7	-13.7

Romania (Baa3 stable/BB+ stable/BB+ stable)*

Outlook – We expect the Romanian economy to return to positive growth in 2011 (1.7% yoy) which together with extended cooperation with the IMF/EU should ensure stable external and internal financing conditions. On the back of higher CPI and likely accelerating GDP the NBR is unlikely to cut rates in the current cycle but could tolerate some further currency appreciation.

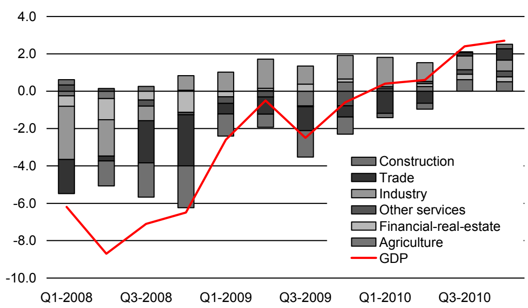
Strategy– We believe Romania could be one of the few countries globally which see rating upgrades during 2011 and hence we remain sellers of 5Y CDS. In the local bond market the light non-resident positioning coupled with appreciating currency means we see scope for lower yields on 3Y-5Y paper. Given weak domestic demand and the relatively solid external financing backdrop we believe the NBR would tolerate a gradual FX appreciation and recommend being short EUR/RON.

Author: Rozália Pál, Ph.D. Strategic Planning Expert (UniCredit Tiriac Bank)

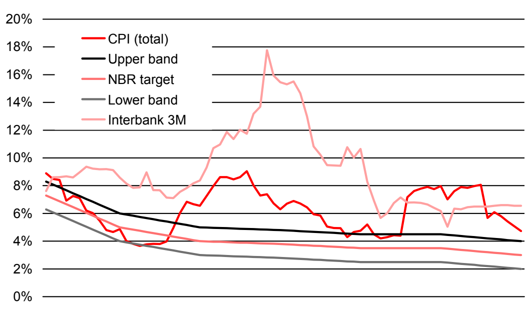
KEY DATES/EVENTS

- Central Bank Decision meetings on 31 March 2011, 3 May 2011 and 29 June 2011.
- Maturity of EUR 1.3bn 1Y T-bill on 29 July 2011 issued in EUR for local market.

2011 GDP GROWTH SHOULD TURN POSITIVE



CPI TO REMAIN ABOVE NBR TARGET



Source: NBR, Stat Office, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2008	2009	2010E	2011F	2012F
GDP (EUR bn)	136.9	115.9	122.0	130.1	145.4
Population (mn)	21.5	21.5	21.4	21.3	21.2
GDP per capita (EUR)	6,360	5,393	5,704	6,113	6,865
Real economy yoy (%)					
GDP	7.1	-7.1	-1.3	1.7	3.4
Private Consumption	8.4	-9.2	-2.0	1.6	4.7
Fixed Investment	19.3	-25.3	-13.1	6.5	5.5
Public Consumption	3.7	1.2	-3.2	-2.0	2.0
Exports	19.4	-5.5	13.1	11.0	8.5
Imports	17.5	-20.6	11.6	10.8	10.0
Monthly wage, nominal (EUR)	347	326	334	355	395
Unemployment rate (%)	4.0	6.3	7.6	6.5	6.0
Fiscal accounts (% of GDP)					
Budget balance	-4.9	-7.4	-6.5	-5.0	-4.5
Primary balance	-4.2	-6.2	-5.1	-3.7	-3.4
Public debt	20.0	27.8	35.5	38.1	39.7
External accounts					
Current account balance (EUR bn)	-16.2	-4.9	-5.2	-6.9	-8.1
Current account balance/GDP (%)	-11.8	-4.2	-4.2	-5.3	-5.6
Basic balance/GDP (%)	-5.0	-1.2	-2.1	-1.8	-1.1
Net FDI (EUR bn)	9.3	3.6	2.6	4.6	6.5
Net FDI (% of GDP)	6.8	3.1	2.1	3.5	4.5
Gross foreign debt (EUR bn)	51.8	65.8	72.0	77.9	85.3
Gross foreign debt (% of GDP)	37.8	56.8	59.0	59.9	0.0
FX reserves (EUR bn)	26.2	28.3	32.4	30.9	29.2
Inflation/Monetary/FX					
CPI (pavg)	7.9	5.6	6.1	6.6	3.7
CPI (eop)	6.3	4.7	8.0	4.7	3.5
Central bank target	3.8	3.5	3.5	3.0	3.0
Central bank reference rate (eop)	10.25	8.00	6.25	6.25	5.50
3M money market rate	13.0	11.7	6.7	6.4	5.9
USD/RON (eop)	2.89	2.95	3.20	2.84	2.83
EUR/RON(eop)	4.03	4.23	4.28	4.20	4.05
USD/RON (pavg)	2.50	3.04	3.17	2.99	2.79
EUR/RON (pavg)	3.68	4.24	4.21	4.30	4.13

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

Back to positive growth finally

We keep our call of 1.7% growth – depressed local demand counterbalanced by sustainable external demand

Romania will restart growing in 2011: We expect growth to return to the Romanian economy in 2011 and forecast 1.7% yoy growth after a 1.3% yoy contraction in 2010. On a quarterly basis the 4Q10 GDP showed a modest 0.1% qoq increase following a 0.7% qoq contraction. Private consumption however remained weak contracting 0.8% qoq following a 1% qoq contraction in the previous quarter. Much of the actual improvement is driven by inventory changes which added around 4pct to the annual GDP growth in 2010. Assuming inventories reach the pre-crisis level in the first half of 2011 we do not see much of a contribution to annual GDP growth. On the other hand we see exports remaining on a solid path (up by 5.8% qoq in 4Q) while domestic demand should also show some acceleration in 2H which together with solid export performance should push the annual GDP growth to around 1.7% yoy. Looking beyond 2011 we expect GDP growth to accelerate to around 3.4% yoy.

External financing is manageable with the new IMF agreement providing additional buffer

External financing balance looks firm despite relatively wide C/A. We see the 2010 current account gap (4.2%/GDP) to widen by around 1pct as domestic demand is accelerating but we see FDI coverage as relatively good compared to other CEE countries. In 2010 FDI covered about 50% of the current account which we expect to increase to around 60%. In terms of external funding needs (about EUR 33bn in 2011) we see the coverage being sufficient without further external assistance. Assuming unchanged public and banking sector roll-over ratios in 2011 (at 106% and 100%) we believe corporate roll-over ratios could remain below 100% (as was the case in 2010) while in the case of an abrupt deterioration in market conditions the new EUR 5bn (4%/GDP) precautionary stand by agreement with the IMF/EU would serve as a sufficient buffer.

While it also limits the potential fiscal overshoot

Moreover the ongoing presence of the IMF/EU should limit the potential deterioration of the fiscal accounts in the run up to the next general elections in 2012. Plus the positive results of the international presence was already evident while accelerating growth should help to achieve the fiscal gap narrowing to 5%/GDP in 2011 from 6.5%/GDP in 2010. In addition the debt dynamics should stabilize at around 35-38%/GDP which looks extremely low in international comparison.

Higher inflation means we no longer see the NBR cutting rates in 2H11

Higher inflation means we expect NBR to keep rates on hold until the end of 2011: We adjust upward our expectation for 2011 inflation to 4.7% yoy eop, above the CB target band of 3% +/-1%. The one-off jump due to the VAT increase (+5pps) as of July 2010 is expected to disappear from the yearly inflation pushing the headline number way below the current level. Nevertheless, increasing food and oil prices in the international markets will probably not allow the CPI to reach the NBR target. In line with the logic in the inflation targeting system we change our expectation of the monetary policy rate to be kept at the current level of 6.25% until the year-end. Moreover, given the changing inflationary outlook, the probability for an upward movement in interest rates cannot be ruled out particularly given a more hawkish external backdrop (ECB).

We are constructive on Romanian markets

Market outlook is constructive on all asset classes with potential rating upgrades serving as a key trigger: Against the above backdrop we believe Romania could be one of the few countries globally which sees rating upgrades during 2011 and we expect the rating moving back to investment grade potentially in the second half of the year. This in turn will likely support further compression of credit spreads and we remain sellers of 5Y CDS. In the local bond market although the interest rate dynamics from the NBR might not be as supportive as it was previously hoped, we believe the light non-resident positioning coupled with the appreciating currency means there is scope for lower yields on the 3Y-5Y segment of the curve. Given weak domestic demand and relatively solid external financing backdrop we believe the NBR would tolerate a gradual FX appreciation which would tighten monetary conditions and hence would remain short EUR/RON.

Slovakia (A1 stable/A+ stable/A+ stable)*

Outlook – The economy is expected to slow down this year on the back of the government's austerity package and the impact on income of higher energy and food prices that will constrain the recovery of household consumption. Exports and investment will be the key growth drivers. Despite some gyrations, the government remains relatively solid and committed to reforms. However, it is taking a sensitive approach to the socially vulnerable, which seems to be limiting the speed and depth of some reforms.

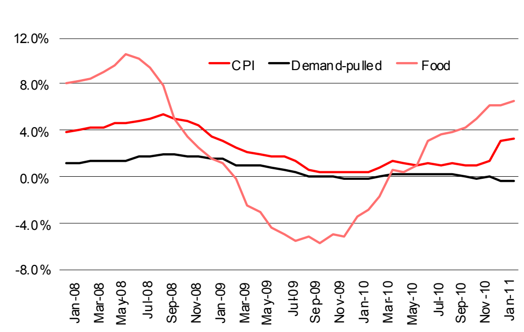
Strategy outlook – We expect improvement in the sovereign risk profile due to the fiscal consolidation program, which we consider to be credible. Accordingly we see scope for bond spreads to tighten during the year.

Author: Vladimír Zlacký, Chief Economist (UniCredit Bank)

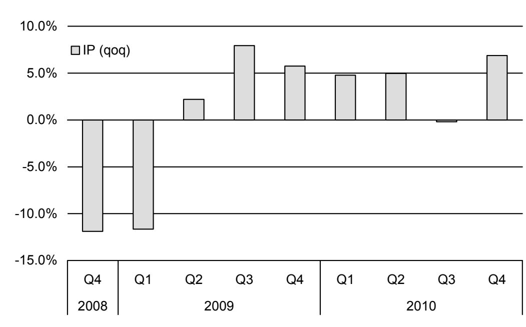
KEY DATES/EVENTS

- 8 April, 5 May and 8 June – Industrial production
- 13 April, 12 May and 13 June - CPI
- 13 May – flash GDP
- 8 June – GDP structure

INFLATION IS STARTING TO ACCELERATE, DRIVEN BY FOOD AND OIL PRICES



INDUSTRY IS A MAIN GROWTH DRIVER OF THE SLOVAK ECONOMY IN 2010



Source: Statistical Office SR, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2008	2009	2010E	2011F	2012F
GDP (EUR bn)	64.6	63.1	65.9	70.4	75.8
Population (mn)	5.4	5.4	5.4	5.4	5.4
GDP per capita (EUR)	11,928	11,670	12,207	13,036	14,031
Real economy yoy (%)					
GDP	5.8	-4.8	4.0	3.1	4.5
Private Consumption	6.1	0.2	-0.3	-0.2	2.9
Fixed Investment	1.0	-19.9	3.6	6.2	4.8
Public Consumption	6.1	5.6	0.1	-5.0	0.5
Exports	3.1	-15.9	16.4	6.2	7.9
Imports	3.1	-18.6	14.9	4.0	6.7
Monthly wage, nominal (EUR)	723	745	769	792	837
Unemployment rate (%)	9.6	12.1	14.4	14.0	13.1
Fiscal accounts (% of GDP)					
Budget balance	-2.1	-7.9	-7.8	-4.8	-3.5
Primary balance	-0.8	-6.5	-5.9	-2.8	-1.4
Public debt	27.8	35.4	42.3	44.4	44.7
External accounts					
Current account balance (EUR bn)	-4.4	-2.3	-2.2	-2.4	-2.7
Current account balance/GDP (%)	-6.6	-3.6	-3.3	-3.4	-3.5
Basic balance/GDP (%)	-1.7	-3.6	-3.7	-2.1	-1.5
Net FDI (EUR bn)	3.3	0.0	-0.3	0.9	1.5
Net FDI (% of GDP)	5.0	-0.1	-0.4	1.3	2.0
Gross foreign debt (EUR bn)	39.2	45.3	48.6	53.0	55.3
Gross foreign debt (% of GDP)	58.5	71.9	73.8	75.3	73.0
Inflation/Monetary/FX					
CPI (pavg)	4.6	1.6	1.0	3.6	3.7
CPI (eop)	4.4	0.5	1.3	4.0	3.4
Central bank reference rate (eop)	2.5	EUR	EUR	EUR	EUR
3M money market rate	3.9	EUR	EUR	EUR	EUR
EUR/USD (eop)	1.40	1.43	1.34	1.48	1.43
EUR/USD (pavg)	1.47	1.39	1.33	1.44	1.48

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

Austerity to bite – economy expected to slow down

The coalition government is losing MPs

The Slovak political scene has continued to see twists and turns during the last three months. A rebellious four member platform within the liberal SAS party called Ordinary People has complicated coalition politics on a number of issues. Furthermore, when its chairman Igor Matovič refused to vote with the coalition on the revision to the citizenship law, he was expelled from the SAS parliamentary club effectively leaving the coalition. The coalition majority has shrank to a 76 majority of a 150 member House since another MP left the coalition Christian Democratic Party (but declared allegiance to the coalition for now).

Highway construction on hold

The Slovak government has exposed itself to the opposition's criticism after its plan to re-allocate EU funds from the science, R&D and "society informatization" allotment into highway construction met with a rather cold reaction from Brussels. The EC suggested that Slovakia first uses its already allotted funds for infrastructure before it re-allocates its EU money. Road construction has been effectively put on hold after the elections since the new government has cancelled the pre-contracted PPP projects of the previous government and has not yet come up with a viable plan on how to finance the highways. The opposition has been gaining political points with the public by criticizing the current government for its un-ambitious plans and clumsy approach to building the local infrastructure. Indeed, the much needed road building programme would have boosted the ailing construction sector which was down 4.6% yoy in 2010; January construction data indicate no improvement.

Industry has been humming recently

Fortunately, the rest of the economy – primarily industry – has been enjoying a strong growth momentum recently. Using seasonally adjusted data, manufacturing increased its production in 4Q10 by 6.9% qoq – car, electronics, heavy machinery and pharma have been the key drivers. The January data imply another stellar month for the industry which grew by 17.1% yoy (0.9% mom, sa). Taking January data into account, the Slovak industry is already 5% above the pre-crisis level and the outlook for 1H11 is promising (mainly due to the continued boom in Germany). Strong exports should continue to underpin the growth outlook for 2011 together with investment recovery. A break down of 4Q10 GDP growth of 3.5% shows a strong contribution by these two expenditure categories. Investments were up 10.6% yoy and their contribution to growth was 2.8pps (inventories contribution was -0.5pps) Exports increased 14.3% outpacing import growth, which was 13.5% – net exports contribution to the growth was 1.7pps. Expenditure on government consumption contracted by 3.3% and its contribution to the growth was negative (-0.9pps). Finally, household consumption increased by 0.5% (contribution to growth of 0.3pps) after four consecutive quarters of negative growth. We predict 2011 growth to be 3.1% with exports and investment as the key growth drivers.

Investment picking up

Inflation on the rise – will curb household demand

As almost everywhere else, inflation in Slovakia has been rising recently. After increasing to 3.0% yoy in January on the back of a VAT increase and higher food and energy prices, February figures indicate further acceleration. February CPI came in at 3.3%, an uptick from January figures mostly due to higher food and fuel prices. Rising inflation together with our forecast for nominal wage growth – subdued at 2.9% yoy mainly due to the government cutting public sector pay – implies our prediction of a negative real wage growth this year. This combined with persisting high unemployment will keep any major recovery of household consumption on a leash in 2011.

Sovereign rating outlook

We do not expect a major change of sovereign rating in the next three months. Slovakia enjoys an A+ rating, but frequently outperforms Euroland countries with more a favorable rating on the markets. An ambitious fiscal consolidation program will further improve the risk profile. According to the recently approved strategy of country debt management 2011-2014, the government plans to finance most of its needs via benchmark issues (5,10 and 15Y) each worth at least EUR 3bn. Provided conditions of the markets allow it, the government would also like to issue a bond with long-term (20-30 year) maturity at some point.

Slovenia (Aa2 stable/ AA negative/AA stable)*

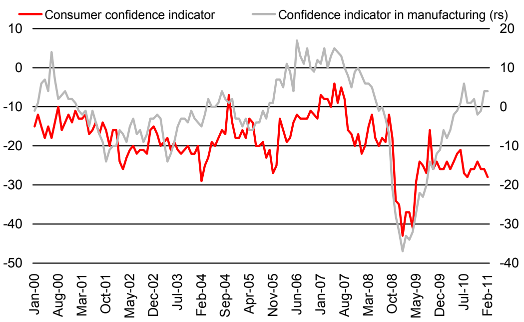
Outlook – A gradual recovery in the economy is under way in Slovenia with improving manufacturing sector confidence pointing to better export performance. Nonetheless, continued deteriorating price competitiveness indicators relative to main trading partners point to structural constraints for significantly faster growth.

Author: Goran Šaravanja, Chief Economist (Zagrebačka banka)

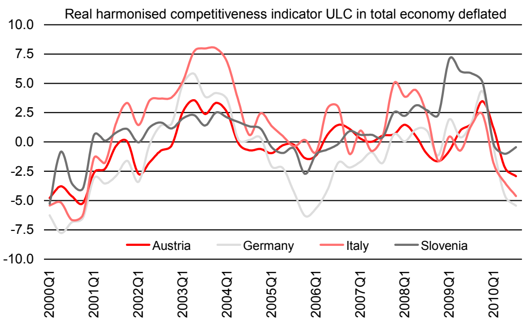
KEY DATES/EVENTS

- **May/June referendum on pension reform proposal**
- **31 May 1Q11 GDP**

CONFIDENCE IN MANUFACTURING IMPROVING



COMPETITIVENESS IMPROVING LESS THAN IN PEERS



Source: BIS, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2008	2009	2010E	2011F	2012F
GDP (EUR bn)	37	35	36	38	40
Population (mn)	2.0	2.0	2.0	2.1	2.1
GDP per capita (EUR)	18,468	17,345	17,608	18,390	19,391
Real economy yoy (%)					
GDP	3.7	-8.1	1.2	2.6	2.9
Private Consumption	3.5	-1.9	0.5	1.2	2.5
Fixed Investment	8.5	-21.6	-6.7	3.8	5.5
Public Consumption	6.2	3.0	0.8	0.0	0.5
Exports	3.3	-17.7	7.8	4.0	5.5
Imports	3.8	-19.7	6.6	4.9	6.0
Monthly wage, nominal (EUR)	1,391	1,439	1,495	1,535	1,592
Unemployment rate (%)	4.5	5.9	7.3	7.0	6.8
Fiscal accounts (% of GDP)					
Budget balance	-1.7	-5.5	-5.2	-4.7	-3.8
Primary balance	0.5	-4.7	-4.0	-3.2	-2.3
Public debt	22.6	35.9	39.9	42.8	44.3
External accounts					
Current account balance (EUR bn)	-2.5	-0.5	-0.4	-0.8	-1.4
Current account balance/GDP (%)	-6.7	-1.5	-1.2	-2.1	-3.5
Basic balance/GDP (%)	-5.7	-3.0	0.3	-0.1	-0.4
Net FDI (EUR bn)	0.4	-0.5	0.5	0.8	1.3
Net FDI (% of GDP)	1.0	-1.5	1.4	2.0	3.1
Gross foreign debt (EUR bn)	39.0	40.1	40.9	42.0	44.5
Gross foreign debt (% of GDP)	104.5	113.4	113.3	111.1	111.4
Inflation/Monetary/FX					
CPI (pavg)	5.7	0.9	1.8	2.2	2.8
CPI (eop)	2.1	1.8	1.9	3.1	2.7
Central bank reference rate (eop)	4.00	3.50	1.00	1.75	2.75
3M money market rate	3.9	3.8	0.8	1.5	2.3
EUR/USD (eop)	1.40	1.43	1.34	1.48	1.43
EUR/USD (pavg)	1.47	1.39	1.33	1.44	1.48

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

Gradual recovery taking shape

Economic recovery remains tentative

Manufacturing sector performing well. The economy grew 2.1% in 4Q10 and the trend qoq figures revealed growth of 0.6%. The economy expanded 1.2% in 2010 with net exports the main driver of economic activity on the back of the recovery in key euro zone trading partners, not least Germany, but in 2H10 a slowing of export growth was evident. Both household and government consumption rose over this period, yet increases in inventories linked to strong industrial production (up 8.0% yoy in 4Q10), which contributed 1.6pp to overall growth last year were a key component of growth. Sentiment indicators in manufacturing continue to recover, while consumer confidence continues to trend lower which is not too much of a surprise given unemployment rose from 5.9% in 2009 to 7.3% in 2010, deteriorating to 7.8% in 4Q10. Meanwhile, gross fixed capital formation remains in deep recession contracting 4.2% yoy in 4Q10 and 6.7% yoy for 2010 overall. This is in part a result of the deep, ongoing contraction in the construction industry, which was a major driver of growth prior to the global financial crisis.

Inflation surprisingly low in early 2011 given food and oil price dynamics

Inflation remains low, external imbalances narrowing: Consumer prices have risen 1.6% yoy in the first two months of the year. Food price inflation is more than double this rate however, core inflation has been negative since August 2010 according to our estimates. The current account deficit narrowed to 1.1% of GDP in 2010 from 1.5% in 2009. The slowing of export growth in 2H10 and pick up in imports as inventories rise and commodity prices increase contributed to this larger than expected current account deficit even as the income and transfers balances improved as expected. FDI inflows (at 1.5% of GDP) more than covered the current account deficit.

Forecasts largely unchanged but price competitiveness starting to become an issue

Forecasts largely unchanged. We maintain our growth (2.5%) and inflation forecast (2.4%) and look for a less pronounced increase in the current account deficit in 2011 (to only 1.6% of GDP). Nonetheless, the economy is not without its risks. Real gross wages rose 2.1% in real terms in 2010 even as unemployment rose. Slovenia's price competitiveness has deteriorated compared to other Euro zone and EU members whether measured by the GDP deflator or unit labor costs implying slower cost adjustments in the economy. A large share of exports to slow growing SEE also points to a deceleration in export growth in the medium term.

Government's plans to rein in budget deficit face referendum headwinds

Implementing reforms will take time. The government is planning to bring the fiscal deficit within the Maastricht criterion of 3% of GDP by 2013, but this will be a challenge especially as the constitutional court has decided pension reform which was passed last year can be put to a referendum. As a result implementation of the reforms will be further delayed until a referendum is held – a no vote would reverse them and put the whole issue back to square one. The 2010 consolidated government deficit came in at 5.2% of GDP, lower than we expected and our updated forecast for 2011 of 4.7% of GDP reflects the better starting point for 2011 as well as our assumptions of the net effects of delayed pension reform and obligations for the budget from capital increases in the banking sector. The government has adopted a fiscal rule which limits expenditure growth to the rate of potential output and created a fiscal council to oversee fiscal policy.

Pension reform will be the main policy topic in 2Q

Referendum defines n-t political debate. The constitutional court's decision ensures pension reform will be the main issue of debate in the run up to the referendum which is expected to be held in May or June.

Sovereign rating – referendum risk. Should the electorate reject pension reform at the referendum, the issue of a downgrade to the sovereign rating would become more interesting, because it would raise concerns about the pace of structural reform. Nonetheless, we would expect no change in the Slovenia's sovereign rating in the coming 12 months.

Bosnia Herzegovina (B2 stable/ B+ stable/not rated)*

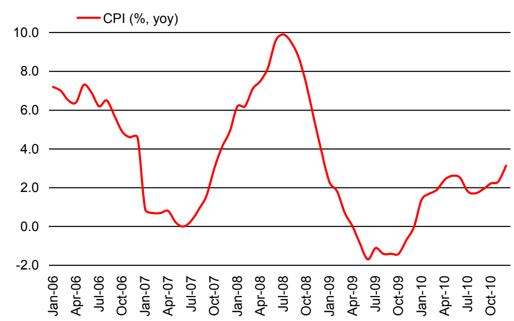
Outlook – Progress on fiscal policy, resuming implementation of the IMF agreement and the EU accession process will be largely determined by when the Council of Ministers (national government) is formed. External demand remains the clearest driver of economic growth, especially as inflationary pressures are building on the back of external influences.

Author: Goran Šaravanja, Chief Economist (Zagrebačka banka)

KEY DATES/EVENTS

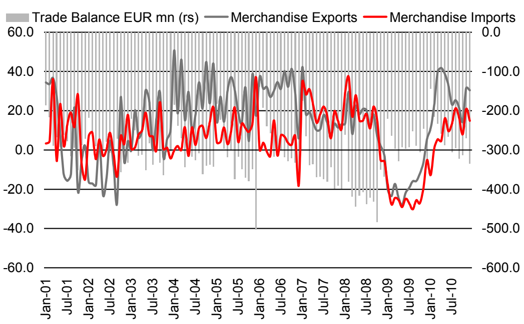
- **30 June 1Q10 Balance of Payments data**

CPI GOING UP



Source: UniCredit Research

MERCHANDISE EXPORTS STRONG, BUT IMPORTS ALSO PICKING UP



Source: CBBiH; UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2008	2009	2010E	2011F	2012F
GDP (EUR bn)	12.6	12.3	12.6	13.2	13.9
Population (mn)	3.9	3.8	3.8	3.8	3.8
GDP per capita (EUR)	3,283	3,194	3,280	3,444	3,619
Real economy yoy (%)					
GDP	5.4	-2.9	0.5	1.8	2.5
Monthly wage, nominal (EUR)	568	616	622	640	657
Unemployment rate (%)	40.3	41.5	43.0	42.5	41.8
Fiscal accounts (% of GDP)					
Budget balance	-4.0	-5.7	-4.5	-4.2	-3.7
Primary balance	-3.1	-5.1	-3.7	-2.8	-1.0
Public debt	30.8	35.4	39.0	41.3	43.0
External accounts					
Current account balance (EUR bn)	-1.8	-0.8	-0.9	-1.1	-1.3
Current account balance/GDP (%)	-14.4	-6.8	-6.9	-8.4	-9.2
Basic balance/GDP (%)	-9.4	-5.3	-7.2	-6.4	-5.6
Net FDI (EUR bn)	0.6	0.2	0.0	0.3	0.5
Net FDI (% of GDP)	5.0	1.5	-0.3	1.9	3.7
FX reserves (EUR bn)	3.2	3.2	3.3	3.4	3.5
Inflation/Monetary/FX					
CPI (pavg)	7.4	-0.4	2.2	3.2	2.6
CPI (eop)	3.2	0.0	3.1	3.6	2.7
3M money market rate	4.3	0.9	0.6	1.0	1.8
FX/USD (eop)	1.40	1.36	1.43	1.32	1.37
FX/EUR (eop)	1.96	1.96	1.96	1.96	1.96
FX/USD (pavg)	1.33	1.40	1.47	1.36	1.32
FX/EUR (pavg)	1.96	1.96	1.96	1.96	1.96

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

Inflation beginning to rise as recovery continues

Better industrial production figures reflect external demand

External demand still the main source of growth. Industrial production rose 1.6% yoy in 2010 and in January 2011 rose 17.5% with manufacturing rising 22.5% yoy. Although an encouraging figure, the January industrial production number also benefits from a very favorable base effect. We continue to expect an increase in industrial production this year to 2.7% yoy. Most of this production is driven by external demand. Labor market developments with very high registered unemployment continue to point to weak domestic demand. Furthermore, the ILO comparable unemployment rate rose from 24.1% in 2009 to 27.2% in 2010 and real gross wages fell 1.1% yoy deflated by CPI, according to our estimates.

Food prices beginning to feed through to inflation

External imbalances widening: After last year's 27.7% yoy increase in merchandise exports this year we expect a somewhat slower, but still noticeable, increase of 13% yoy. Export performance undoubtedly remains one of the bright spots of the economy. Nonetheless, with commodity prices rising, inputs into the production process will become more expensive, which will be reflected in higher merchandise imports. This effect was increasingly evident in 2H10 as well. As a result we forecast a widening of the current account deficit from an estimated 6.9% of GDP in 2010 to 8.4% in 2011.

Inflation and current account deficit forecasts increased

Inflation forecast revised up. Although the latest available inflation data at the time of writing was for December 2010, the data do show that food prices did start to rise in November and will be a major factor in determining inflation this year. We have increased our forecast from 2.1% to 3.2% for 2011. In the absence of almost any published data for 2011 we leave our GDP forecast unchanged at 1.8%, noting headwinds from expected interest rate hikes in the Euro zone on flexible rate loans in Bosnia Herzegovina.

Monetary policy loosened in February

Mandatory reserve requirement lowered. The Central Bank lowered the mandatory reserve requirement on deposits with maturity of less than 12 months from 14% to 10% with effect from 1 February 2011, thereby freeing up an additional BAM 300mn in liquidity. Nonetheless, banking sector deposits with the central bank remain well above minimum reserve requirements pointing to the effects of a rigid prudential framework for liquidity requirements in the Federation, as well as weak demand for credit more generally. Resolution of the current negotiations over the formation of executive governments at all levels would undoubtedly help reduce uncertainty and boost demand for loans from corporates in particular.

Post election negotiations continuing

Post election negotiations still under way. Forming a government in the Federation of BiH and at cantonal levels after the 3 October 2010 general elections has taken longer than expected. Despite progress since our last report, the process is not yet complete heading into 2Q11. Once the Council of Ministers (national level government) is formed a clearer focus on meeting the conditions of the current IMF agreement - which runs until July 2012 – will be possible. Also, governments could then finalize 2011 budgets, ending temporary budget financing conditions and facilitating policy implementation. Last but not least, progress on EU accession currently stalled, would finally be resumed.

No change in sovereign rating expected. Bosnia Herzegovina's sovereign outlook is stable and we expect no change in the country's credit rating in the next 12 months. While forming governments at all levels would be a definite plus, progress on resolving structural issues in the economy will take time.

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

Outlook – We continue to expect a gradual recovery of economic growth this year with risk perceptions likely to improve with the conclusion of EU accession talks and the holding of general elections later this year.

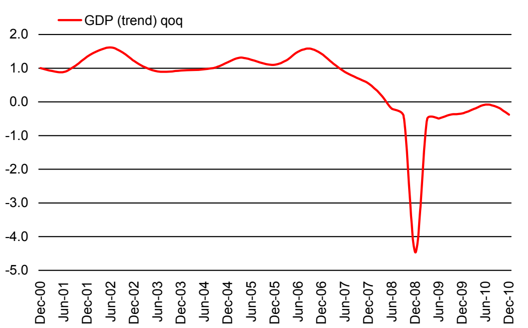
Strategy outlook – Although Croatian credit metrics look weak from a regional comparison perspective we think overall negative investor view regarding the Croatian macro story protects the market from positioning point of view. As the easiest way to express bearish view on Croatia is through credit markets we are looking to buy 5Y CDS on dips.

Author: Goran Šaravanja, Chief Economist (Zagrebačka banka)

KEY DATES/EVENTS

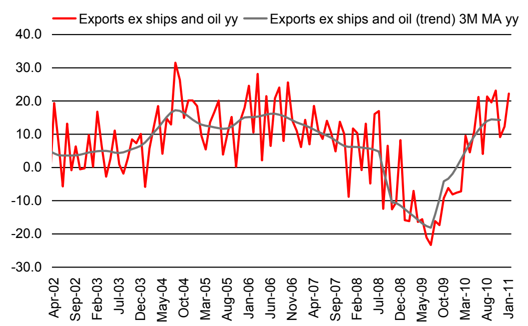
- **19 April:** Intergovernmental Conference on Croatia's succession to the EU. 3 further chapters of negotiations to be closed
- **May:** Interim report on Croatia's progress in implementing Chapter 23 (Justice and Fundamental Rights) of the Acquis Communautaire

EXPORTS SUPPORTIVE



Source:National Statistics Office, UniCredit Research

EXPORTS SUPPORTIVE



Source: National Statistics Office, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2008	2009	2010E	2011F	2012F
GDP (EUR bn)	47.4	45.4	45.6	46.8	49.7
Population (mn)	4,434.5	4,429.1	4,416.9	4,416.9	4,416.9
GDP per capita (EUR)	10,681	10,245	10,313	10,590	11,257
Real economy yoy (%)					
GDP	2.4	-5.8	-1.4	1.6	2.3
Private Consumption	0.8	-8.5	-0.8	1.1	2.5
Fixed Investment	8.2	-11.8	-11.0	3.5	6.5
Public Consumption	1.9	0.2	-1.2	1.0	0.0
Exports	1.7	-16.3	5.8	5.6	6.0
Imports	3.6	-20.7	-0.8	5.2	6.5
Monthly wage, nominal (EUR)	1,044	1,050	1,053	1,067	1,116
Unemployment rate (%)	8.4	9.4	12.0	11.8	10.9
Fiscal accounts (% of GDP)					
Budget balance	-1.4	-3.9	-6.5	-6.8	-5.2
Primary balance	0.5	-1.6	-2.6	-2.7	-2.6
Public debt*	42.3	50.4	57.0	61.6	63.9
External accounts					
Current account balance (EUR bn)	-4.3	-2.5	-1.1	-1.5	-1.9
Current account balance/GDP (%)	-9.2	-5.5	-2.5	-3.2	-3.8
Basic balance/GDP (%)	-2.3	-2.8	-0.3	-0.5	0.2
Net FDI (EUR bn)	3.2	1.2	0.8	1.3	2.0
Net FDI (% of GDP)	6.8	2.7	2.2	2.7	4.0
Gross foreign debt (EUR bn)	40.0	44.6	45.1	46.5	48.5
Gross foreign debt (% of GDP)	84.4	98.2	99.1	99.4	97.5
FX reserves (EUR bn)	9.1	10.4	10.7	10.5	11.5
Inflation/Monetary/FX					
CPI (pavg)	6.1	2.4	1.1	2.5	2.7
CPI (eop)	2.9	1.9	1.8	3.1	2.3
Central bank reference rate (eop)	6.00	6.00	6.00	6.00	6.00
3M money market rate	7.8	1.3	1.6	1.7	3.0
USD/HRK (eop)	5.29	5.09	5.39	5.01	5.12
EUR/HRK (eop)	7.37	7.30	7.38	7.41	7.32
USD/HRK (pavg)	4.91	5.26	5.49	5.13	4.93
EUR/HRK (pavg)	7.22	7.34	7.29	7.39	7.30

*(includes govt guarantees and development bank

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

May holds the key to timing on EU accession

Economic recovery remains tentative

Merchandise exports remain the bright spot. The flash estimate for 4Q10 GDP growth revealed a contraction in economic activity of 0.7% yoy – seasonally adjusted qoq data also point to a contraction. Data available to date for 2011 remain weak: industrial production contracted 6.7% yoy in January on a working day adjusted basis while retail sales in real terms rose 0.2% yoy. The one bright spot remains merchandise exports which rose 18.2% yoy in 2010 and 3.8% yoy in January – underlying exports (excluding ships and oil) rose 10% last year and over 20% yoy in January. Inflation remains low, rising 2.2% yoy in February, reflecting high unemployment and low real wage growth. Nonetheless higher food prices are beginning to feed through to the index.

Main economic forecasts unchanged

Forecasts point to a weak recovery. We stick to our 1.6% growth forecast for 2010 and marginally increase our average inflation forecast to 2.5% – food and energy prices will increase, but weak demand and a stable currency should limit inflationary pressures. The risk to our inflation forecast is to the upside. We also maintain our current account deficit forecast of 3.2% of GDP. Our view that the economy will only gradually recover has not changed. While our assumptions on EU growth are slightly improved and a loosening of local monetary policy will boost lending, both our higher oil price forecast and expectations of a cumulative 75bps hike by the ECB by the end of the year will impact negatively on the growth outlook.

Central bank loosens monetary policy to support growth

Central bank loosens monetary policy as indicators from the real sector point to weakness. On 8 March the central bank lowered the foreign assets to foreign liabilities ratio from 20% to 17%, releasing an estimated EUR 850mn in liquidity. The changes to monetary policy reflect concerns about the pace of economic recovery and seek to assist the recovery in credit growth to the private sector, which in 2010 rose only 3.6% yoy when excluding the impact on currency movements on the stock of credit according to central bank estimates.

We see a slightly higher budget deficit in 2011 as elections approach at year end

Fiscal policy: improved revenue growth in January. Tax revenues rose 1.6% yoy in January and social contributions rose by an even greater 2.1% yoy (despite an increase in the number of unemployed by over 80,000 compared to January 2010). This suggests to us a combination of more disciplined revenue collection, a price effect from oil imports and improving domestic demand. Yet given the government itself has increased its forecast of the fiscal deficit this year from 4.8% of GDP to 5.1% of GDP (our higher forecast includes an estimate for the shortfall of the Motorways Authority and the cost of the return of pensioner debt), it is evident that structural reforms to boost growth and efforts to reduce expenditures are required to lower the fiscal deficit.

Self-imposed goal of completing EU accession talks by 1H11

Government under pressure. Anti-government protests began in February while the latest opinion polls suggest the majority of the electorate would prefer an early election. From an economic policy perspective, earlier rather than later elections (i.e. towards the end of the constitutional deadline) would mean the new government would have enough time to put together a budget for 2012 during 4Q11. This would increase the likelihood of a restrictive and reform oriented budget. In terms of EU accession talks, May's Interim report on implementation of Chapter 23 (Justice and fundamental rights) will be key for assessing when this year accession talks will be completed.

No change to credit rating, for now

Sovereign credit rating outlook. Since our previous Quarterly S&P have lowered their long term sovereign rating one notch to BBB- with a negative outlook while Fitch in early March maintained their rating and outlook (BBB-, negative). From Fitch's comments it is evident that if after elections the government of the day does not embark on a policy of fiscal consolidation and structural reform to accelerate the long run sustainable rate of growth, a downgrade in the sovereign rating is likely.

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

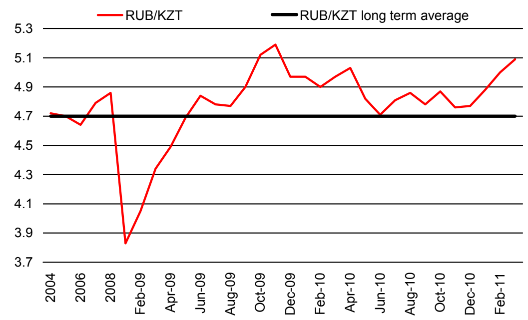
Outlook – With commodity exports equaling roughly one-third of GDP, Kazakhstan profits greatly from the high price environment. This will combine with massive government promoted infrastructure investment to keep growth at almost 7% this year and at 5%-6% long-term. Inflation above the central bank's 6%-8% implicit target corridor while real effective appreciation is moderate and the current account likely to be in surplus should prompt the central bank to allow faster KZT appreciation in 2011.**Strategy outlook** – Strong links to commodities provide ongoing support to the economy, with the KZT benefiting from this. The authorities moved to a managed float in March and keep the pace of the gains in check while further appreciation pressure is likely.

Author: Hans Holzhacker, Chief Economist (ATF Bank)

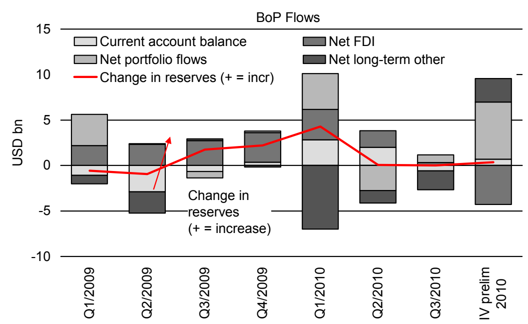
KEY DATES/EVENTS

- Early presidential election on 3 April 2011
- End of March: revision of the NBRKs inflation forecast
- Measures by the authorities to ease banks' poor asset quality problem – 2Q/3Q11

KZT ABOVE ITS LONG-TERM AVG VS. THE RUB



BOP FLOWS SUPPORTIVE



Source: NBK, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2008	2009	2010E	2011F	2012F
GDP (EUR bn)	89.8	77.3	109.9	126.6	142.6
Population (mn)	15.7	16.2	16.3	16.5	16.6
GDP per capita (EUR)	5,729	4,772	6,728	7,676	8,569
Real economy yoy (%)					
GDP	3.3	1.2	7.0	6.8	5.9
Private Consumption	3.8	-2.8	6.0	5.8	7.0
Fixed Investment	1.7	1.9	-1.8	10.5	10.1
Public Consumption	5.5	1.1	0.8	5.7	5.3
Exports	0.8	-6.2	10.0	7.0	3.8
Imports	-11.5	-15.9	2.0	16.0	10.5
Monthly wage, nominal (EUR)	343	329	397	434	491
Unemployment rate (%)	6.6	6.6	5.8	5.5	5.3
Fiscal accounts (% of GDP)					
Budget balance	1.2	-4.3	3.1	3.5	3.0
Primary balance	1.6	-3.9	3.5	4.6	4.2
Public debt	8.8	13.9	15.0	17.8	20.3
External accounts					
Current account balance (EUR bn)	4.7	-2.4	3.7	4.9	-0.8
Current account balance/GDP (%)	5.3	-3.2	3.4	3.8	-0.6
Basic balance/GDP (%)	16.3	8.5	10.1	9.1	3.3
Net FDI (EUR bn)	9.9	9.0	7.4	6.7	5.5
Net FDI (% of GDP)	11.0	11.7	6.7	5.3	3.9
Gross foreign debt (EUR bn)	79.9	75.5	89.2	90.1	93.6
Gross foreign debt (% of GDP)	88.9	97.7	81.2	71.2	65.7
FX reserves (EUR bn)	14.8	15.9	20.8	27.3	28.5
Inflation/Monetary/FX					
CPI (pavg)	17.2	7.3	7.1	9.4	7.4
CPI (eop)	9.5	6.2	7.8	9.8	7.1
Central bank target	7.0	7.0	7.0	7.0	7.0
Central bank reference rate (eop)	10.50	7.00	7.00	8.00	7.50
3M money market rate	8.9	9.6	2.0	4.9	8.4
USD/KZT (eop)	120.9	148.4	147.4	140.0	135.8
EUR/KZT (eop)	168.7	212.6	197.2	207.2	194.2
USD/KZT (pavg)	120.3	147.7	147.4	143.7	137.9
EUR/KZT (pavg)	177.0	205.9	195.5	206.9	204.1

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

Commodities, strong investment keep growth high

Decent growth in early 2011, particularly encouraging that investment has picked up

Real GDP growth has remained decent in early 2011. The StatAgency's "short-term indicator", which covers industries generating 67%-68% of GDP, was up 6.7% yoy in Jan-Feb 2011. Investment outlays increased 12.5% yoy in Jan-Feb after a decline by 0.5% yoy in 2010. Industrial production rose 5.6% yoy in Jan-Feb, somewhat less than the 10.0% in 2010 due to the fading out of the low base effect in manufacturing (it rose 18.4% in 2010) but also temporarily weak oil and petrochemical production. We see industrial production grow some 7% in 2011 as a whole and in 2012. In reaction to accelerating inflation, growth in constant price retail sales also eased a bit (to 10.6% yoy in Jan-Feb from 12.5% in 2010) after a very strong 4Q10. Employment at 8.1mn persons was up 0.5% yoy in February. Nominal monthly wages rose 16.2% yoy in January to KZT 77,464, real wages 7.5%, income per capita 17% yoy to KZT 41,122 (EUR 209), real income 8.2% yoy. In view of the prospects for commodity prices and the pick-up in investments, we upgrade our real GDP forecast to growth of 6.8% in 2011 and 5.9% in 2012 from 5.3% and 5.5% respectively. With Brent expected to average USD 110/barrel in 2011, we expect further support to the economy, given that the oil sector accounts for about 10% of the wage bill, 20% of corporate earnings and 55% of taxes in Kazakhstan.

We revise our real GDP growth forecast for 2011 to 6.8% from 5.9% in light of the high commodity price and the strong rebound in investment

In early March, the Republican Budget law was amended. Revenues in 2011 were revised to KZT 4,249.3bn (~20% of GDP), expenditures to KZT 4,945.1bn (~23% of GDP). The deficit remained unchanged at KZT 602.5bn or 2.8% of GDP (expenditures do not include net lending according to Kaz methodology, rev. and exp. do not add up to the deficit). Actual 2010 figures were KZT 3626.2bn (16.9% of GDP) for revenues, KZT 3861.0bn (17.9% of GDP) for expenditures, KZT 554.8bn (2.6% of GDP) for the deficit. The strong growth in revenues vs. 2010 results is due mainly to doubling the export duty on oil from USD 20 to USD 40 per ton and higher customs income. It seems achievable, if oil prices stay above USD 90 pb. Transfers from the Oil fund are set to 7.1% of GDP in 2011 vs. 6.7% in 2010. We expect the combined non-oil and oil budgets (the Oil fund) to reach a surplus of 3.5% of GDP in 2011, slightly up from 3.1% in 2010. More infra-structure oriented spending with significant multiplier effects will largely offset the negative growth effect of the tightening.

Some (oil+non-oil) fiscal tightening, but negative growth impact largely offset by high multipliers of infra-structure spending

Inflation on the rise, interbank interest rates and government paper yields nevertheless still very low despite policy rate hike

Inflation reached 8.8% yoy in Feb and food prices were up 13% yoy. On 9 March, the Central Bank hiked its 1W refinancing rate (at 7.00% since Sept 09) by 50bp in response. The NBK's inflation forecasts (an implicit target) stands at 6%-8%, but is likely to be revised. The rate hike has more a symbolic value; the impact on interest rates is weak: the 3M-Kazprime interbank rate remained below 2% p.a. in March due to banks' ample liquidity. Loans to companies have shown hesitating growth since late last year, but generally loan growth has remained subdued. With investment now becoming stronger, better news from the real estate market (+2.6% YTD in apartment prices, 7.8% yoy increase in sale-purchase transactions in February), and stepped up activities by the authorities to tackle bad debt, loan growth should recover to some extent this year, leading interbank rates to rise again.

Credit growth recovering hesitatingly, but some growth should take place in 2011

The central bank has resisted major KZT appreciation, but should allow more given inflation picks up and competitiveness is preserved as trading partner currencies appreciate too in real terms

The net international reserves of the NBK increased by USD 5.2bn during the first 2 months of 2011 to USD 32.9bn, the foreign assets of the Oil fund by USD 2.3bn to USD 32.9bn. The NBK intervened heavily to stem KZT appreciation and bought about USD 6bn in 1Q11. It drains the resulting KZT liquidity by selling short-term notes. Notwithstanding this we see inflation rising in yoy terms and breeching 9% in summer due to the base effect, even if it levels off mom. The high inflation should increase the NBK's appetite to let the KZT appreciate more freely, with our long-standing USD/KZT forecast remaining at 140 at eop 2011.

Early presidential elections instead of referendum favorable for Kazakhstan's reputation

On 3 April 2011, early presidential elections will be held. We have no doubt that Nursultan Nazarbayev will win. We believe that the decision not to extend his term to 2020 by referendum and hold early elections instead is positive for stability and international reputation.

Russia (Baa1stable/BBB stable/BBB positive)*

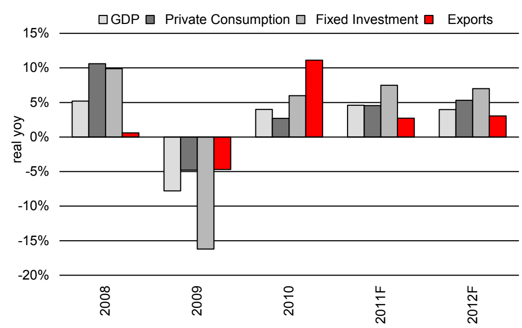
Outlook – Surging oil prices widen the current account surplus, narrow the budget deficit and boost corporate profits. The improvement, however, is likely to be largely limited to valuation gains for the RUB, as growing imports should prevent any meaningful acceleration of broader GDP. Additionally, inflation should also remain elevated, hindering the ongoing recovery in domestic demand but supporting further tightening by the Central Bank, including a cumulative 100bps rate hike by 2Q11 eop. **Strategy outlook** – We continue to like the RUB on commodity prices and anti-inflationary stance by the authorities. While the recent practice of local corporates of gaining access to USD funding through CCS ought to provide upward pressure on the short end of the curve while the long end remains well bid, translating into further flattening.

Author: Vladimir Osakovskiy, Ph.D., Head of Macroeconomic Analysis and Research (UniCredit Bank Russia)

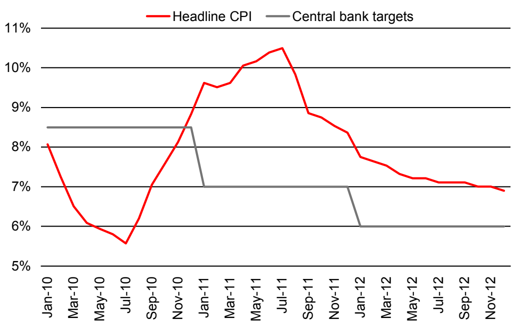
KEY DATES/EVENTS

- 5th-8th of each month – Monthly CPI
- 18th-22th of each month – Monthly indicators
- 7-Apr-11 1Q CA preliminary, 4Q10 CA
- 23-May-11 1Q GDP
- Last Fri of each month - CBR rate decision

DOMESTIC DEMAND SHOULD OVERTAKE EXPORTS AS KEY GROWTH DRIVER



INFLATION IS LIKELY TO REMAIN ABOVE OFFICIAL TARGETS



Source: Federal Statistical Service, CBR, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2008	2009	2010E	2011F	2012F
GDP (EUR bn)	1,132	871	1,102	1,334	1,403
Population (mn)	142	141	141	140	140
GDP per capita (EUR)	7,996	6,165	7,817	9,497	10,013
Real economy yoy (%)					
GDP	5.2	-7.8	4.0	4.6	3.9
Private Consumption	10.6	-4.8	2.7	4.5	5.3
Fixed Investment	9.9	-16.2	6.0	7.5	7.0
Public Consumption	3.4	-0.5	0.7	-0.1	-0.7
Exports	0.6	-4.7	11.1	2.7	3.0
Imports	14.8	-30.4	25.4	9.2	5.2
Monthly wage, nominal (EUR)	471	422	518	568	626
Unemployment rate (%)	6.3	8.3	7.4	7.0	6.5
Fiscal accounts (% of GDP)	4.9	-9.4	-5.3	-1.9	-2.6
Budget balance	4.9	-9.4	-5.3	-1.9	-2.6
Primary balance	5.5	-11.6	-6.8	-2.4	-4.0
Public debt	5.5	7.8	8.3	8.4	10.2
External accounts					
Current account balance (EUR bn)	77.7	35.7	55.9	92.1	41.0
Current account balance/GDP (%)	6.9	4.1	5.1	6.9	2.9
Basic balance/GDP (%)	8.0	3.5	4.2	5.9	2.8
Net FDI (EUR bn)	51.0	26.3	24.8	27.6	30.9
Net FDI (% of GDP)	4.5	3.0	2.3	2.1	2.2
Gross foreign debt (EUR bn)	341	330	356	310	328
Gross foreign debt (% of GDP)	35.6	34.7	33.6	23.4	23.8
FX reserves (EUR bn)	303	307	359	365	371
Inflation/Monetary/FX					
CPI (pavg)	14.1	11.7	6.9	9.5	7.2
CPI (eop)	13.3	8.8	8.8	8.4	6.9
Central bank target			8.5	7.0	6.0
Central bank reference rate (eop)	8.50	6.00	5.00	6.00	6.00
3M money market rate	22.00	7.50	4.02	5.90	5.90
USD/RUB (eop)	30.53	30.04	30.54	28.37	28.49
EUR/RUB (eop)	42.59	43.04	40.87	41.99	40.74
USD/RUB (pavg)	24.78	31.65	30.36	28.15	27.61
EUR/RUB (pavg)	36.46	44.13	40.27	40.54	40.86

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

Economics: Dreams might have come true

Forecast revision envisages all time record highs oil prices in 2011

A massive surge in commodities prices has put Russia into a supportive environment for an ongoing economic recovery. The upward revision to our oil price forecast from the previous USD 85/bbl to USD 110/bbl effectively puts the average annual price for 2011 at an all time high.

RUB is to remain strong in 2Q11

But should start to weaken in 3Q11-4Q11 on rising imports

RUB is set to be the main beneficiary of the increase in commodity prices. With record high oil prices the current account surplus is expected to more than double from our previous forecast to exceed EUR 92bn in 2011. We continue to view this surplus as the key driver of RUB strength and its expansion should give the RUB firmer support later in the year. Signs of a return of foreign capital flows add further support. BIS data for 3Q10 shows inflows from foreign banks for the first quarter in eight, following a 40% reduction in exposure by foreign banks to Russian entities relative to pre-crisis exposure We revise our exchange rate forecast to RUB 33.7/basket in 2011 avg, up from the previous RUB 34.6/basket. However, a major part of the expected impact should have an effect in 1H11, with most of improvements already priced in. Thus, we expect the RUB to stay close to the RUB 33/basket level throughout most of 2Q11, followed by weakening to about RUB 34.5/basket in 2011 eop, largely due to reversal of trade surplus gains on rising imports.

Investment should get a boost from corporate profits and low real interest rates

In the real economy, we see investment benefitting the most from the oil revenues spike. We expect robust growth of corporate profits, rising inflation having pushed real borrowing costs into negative territory, should also continue to support investment demand throughout most of 2011. However, we only reiterate our forecast of 7.5% investment growth for 2011 due to a massively disappointing start to the year. A 4.7% yoy drop in January after more than 10% yoy growth in late 2010 leaves little room for an upgrade.

High inflation should constrain consumer demand expansion

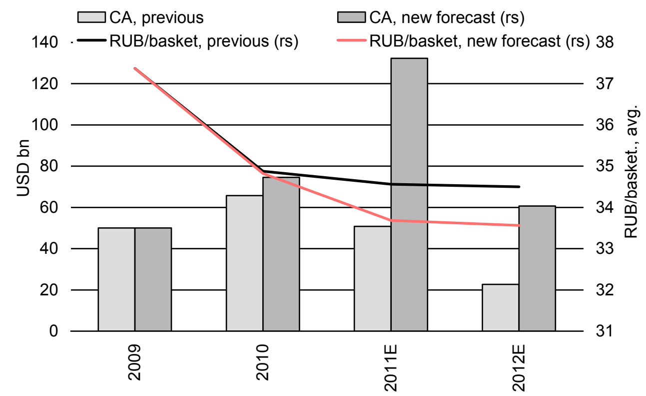
Consumer demand is likely to remain robust, posting expansion throughout 2011. Strong oil revenues and profits, as well as low real borrowing costs, should continue to support robust labor demand and meaningful wage and income gains. Neutralising this somewhat is inflation which should prevent its acceleration of consumer demand in 2011 to above our forecast of modest 4.5% growth.

Real GDP outlook is revised only marginally to 4.6% in 2011

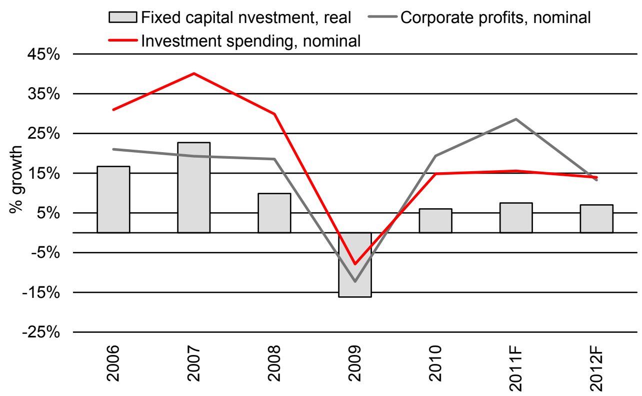
The importance of exports should fade further. Unlike inelastic oil exports, which are likely to expand more in nominal rather than in real terms, imports expansion is likely to be more real. We expect imports to rise by a strong 9.3% in 2011, vs. 2.7% export growth, which keeps our revised real GDP forecast at only slightly more optimistic 4.6% growth in 2011, despite record oil prices.

SPIKE IN OIL PRICES BECOMES THE KEY TREND OF THE QUARTER

Improving current account outlook boosts our RUB forecasts



Growing corporate profits should support investment



Source: CBR, Federal Statistical Service, UniCredit Research

Pre-election year raises spending, but oil revenues should nevertheless cut budget deficit

Headline fiscal performance should be flattered by higher oil prices and inflation. We admit that some spending increases are likely to be granted, such as the already announced indexations of public wages and pensions. However, we think that a major part of windfall oil revenues will be used to cut the budget deficit and partly might even be accumulated in the Reserve fund. Thus, we expect nominal spending of central government to rise by a modest 15% in 2011 to RUB 11.5 trn or some RUB 900bn above existing budget projections, which will be sufficient to sustain roughly flat public spending in real terms and push the deficit to a modest RUB 1trn or less than 2% of GDP.

Anti-inflationary efforts should gain in efficiency as CBR is more open to RUB gains

We also note that high oil prices should be supportive for a broad anti-inflationary policy. Though we admit that the pace and scale of RUB appreciation might force further FX interventions by the CBR. Historically these were the key driver of inflation in the country. With the recent widening of the RUB trading band and further efforts to induce greater flexibility of the exchange rate, we think that CBR is becoming increasingly open to further RUB appreciation, reducing the risks of pro-inflationary interventions.

Higher budget revenues allow for reversal of liquidity inflows from the budget

Inflation should start to slow in 2Q11, but is likely to remain high on average for the year

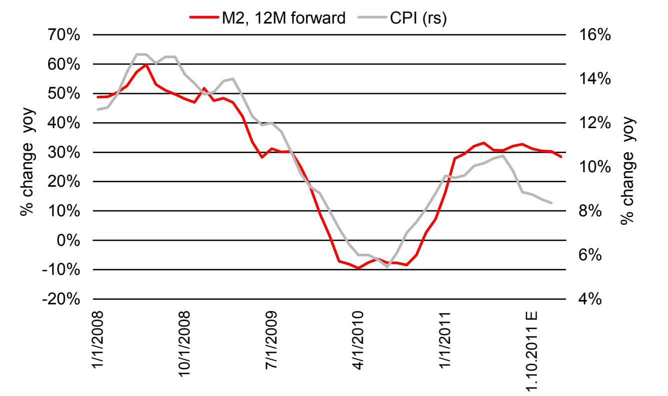
The improvement of fiscal balances allows reversal of liquidity inflows from the budget. Thus, with additional tax revenues the government is able to stop using the Reserve fund and intensify its efforts to develop domestic FI market by switching to domestic borrowings as the source of deficit financing. As a result, the budget is set to turn from a net provider to a net consumer of liquidity, which, we think, should be very constructive for the broader anti-inflationary efforts also paving the way for long term stability of money supply and prices. Overall, we reiterate our expectations that inflation should start to slow in the coming months to reach our 8.4% yoy forecast for 2011 eop, with technical low base effect and already accumulated price increase being the key reason behind our aggressive 9.5% inflation forecast for 2011 avg.

Tightening monetary policy should start to raise money market rates

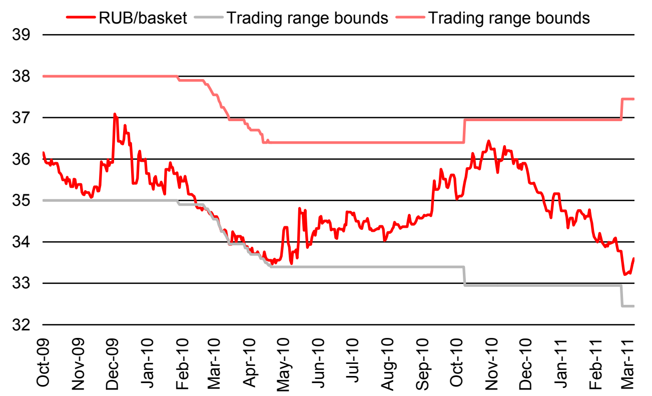
Lack of traditional liquidity inflows from FX interventions and from the budget should support growth of domestic interest rates, especially on the back of the likely recovery of loan demand from the real economy. Although we admit that liquidity remains excessive in early 2011, we think that such excess is mostly due to a spike of the Reserve fund use in December 2010, which is largely one-off in nature and should dissipate by summer. As a result, we think that money market rates are likely to finally de-couple from their floor set by the minimum CBR deposit rates and to start approaching the CBR liquidity provisioning rates of direct auction repo. We expect the benchmark 3M Mosprime to approach 6% by 2011 eop, up close to 2pp. from current levels.

INFLATION SHOULD START TO COOL IN MID-2011, AS INFLOWS OF FRESH LIQUIDITY SLOW

Accumulated money supply growth should keep inflation elevated throughout most of 2011



Swift widening of the RUB trading range reduces risks of major FX interventions



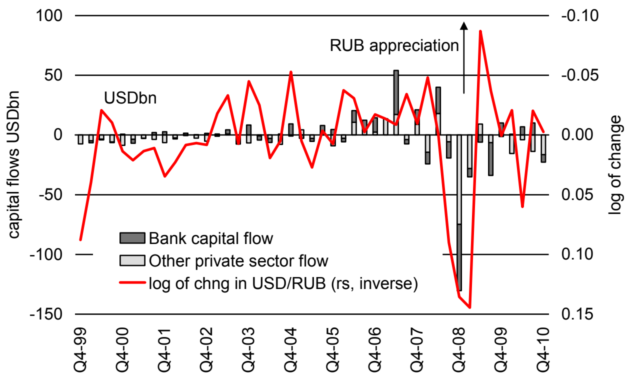
Source: CBR, Federal Statistical Service, UniCredit Research

Strategy: commodities and domestic reform supportive

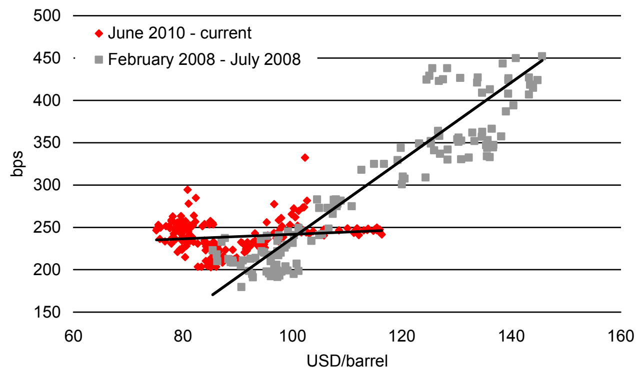
Commodity prices run the show

We **continue to like the RUB** on **1)** support from commodity prices **2)** tightening of monetary conditions by the CBR on an anti-inflationary stance **3)** FinMin changing fiscal stance, as additional oil revenues remove the need to use the Reserve fund, and hence make FinMin a net consumer of liquidity **4)** ongoing privatisation program. However, **given the heavy market positioning for a further RUB appreciation, and the already significant move, we prefer to take profit at current levels, but are looking to enter RUB long positions on spikes.** Going forward, capital flows ought to play a more important role, especially as flows into Russia have been lagging the regional recovery in 2010. By the same token the **high commodity prices are supportive for CDS premia**, with any further price shocks playing into seller positions, and helping to balance the budget deficit (reminiscent to comments by FinMin Kudrin saying that the budget is balanced with oil at USD 115). Current oil price dynamics are reminiscent of the first half of 2008 when the Urals price rose by USD 50 to USD 140 pb and CPI rose by 3.2pp from 11.9% leading to gradual refi rate hikes of 75bp. At the time, the combination of these factors led to a steepening of the CCS curve, however, this time we see limited space for a repeat of the trend, given that the CBR is letting most of the adjustment be done by RUB, while Russian corporates are using CCS to gain access to USD funding after issuing RUB bonds, which supports further flattening. **Dmitry Gourov**

Going forward capital flows will play a more important role



CCS 5Y-1Y spread vs. Oil price – not a repeat of 2008



Source: Bloomberg, CBR, UniCredit Research

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2010E	2011F	2012F
Gross financing requirement	**60.0**	**32.5**	**43.1**
Budget deficit	51.4	22.6	31.7
Amortisation of public debt	8.6	9.9	11.4
Domestic	8.6	9.9	11.4
Bonds	8.6	9.9	11.4
Bills	0	0	0
External	0	0	0
IMF/EU	0	0	0
Financing	**25.4**	**36.7**	**43.1**
Domestic borrowing	21.2	34.6	36.3
Bonds	21.2	34.6	36.3
Bills	0	0	0
External borrowing	4.1	2.1	6.8
Bonds	4.1	2.1	6.8
IMF/EU	0	0	0
Other	0	0	0

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2010E	2011F	2012F
Gross financing requirement	**22.4**	**-31.6**	**-10.8**
C/A deficit	-55.9	-92.1	-41.0
Amortisation of medium to long term debt	78.4	60.5	30.2
Government/central bank	2.1	3.0	1.9
Banks	24.2	21.8	5.4
Corporates	52.1	35.7	22.9
Financing	**105.0**	**97.5**	**112.3**
FDI	24.8	27.6	30.9
Equity	0	0	0
Borrowing	80.2	70.0	81.4
Government/central bank	4.0	2.1	6.8
Banks	34.9	25.0	27.6
Corporates	41.3	42.8	47.1

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

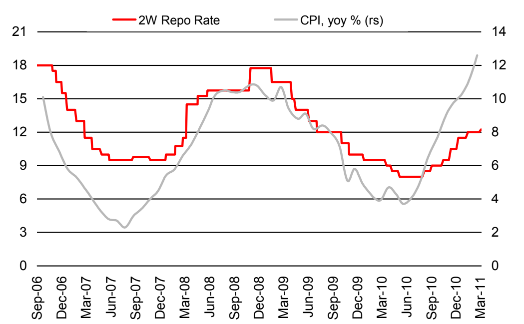
Outlook – Our growth outlook remains unchanged, with exports expected to continue playing a major role. Rising FDI inflows and a more stable currency this year are further positives for the economy. Even at this early stage in the year oil and food price dynamics from abroad suggest however that inflation will most likely exceed the central bank's year end target. **Strategy outlook** –Increased RSD issuance and for now solid external demand will continue to put pressure on yields as will the policy of managing the size of the issue – something that underpins our constructive stance for 1H11. We would be more careful in 2H11, given uncertainty over privatization revenues and the implications for the budget financing mix.

Author: Goran Šaravanja, Chief Economist (Zagrebačka banka)

KEY DATES/EVENTS

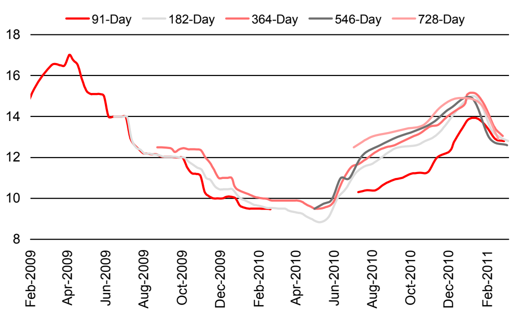
- **May 2011: Inflation Report by the NBS**
- **12 April – March CPI**
- **12 May – NBS Executive Board Meeting/April CPI**

INFLATIONARY PRESSURES RISING, BUT BASE EFFECT SUPPORTIVE IN 2H…



Source: NBS, UniCredit Research

FOREIGN DEMAND COMPRESSING THE YIELDS



Source: FinMin of Serbia, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2008	2009	2010E	2011F	2012F
GDP (EUR bn)	33.4	29.9	29.6	32.9	34.3
Population (mn)	7,350	7,307	7,277	7,247	7,222
GDP per capita (EUR)	4,545	4,099	4,072	4,543	4,752
Real economy yoy (%)					
GDP	5.5	-3.1	1.8	2.7	3.5
Monthly wage, nominal (EUR)	561	470	462	486	489
Unemployment rate (%)	13.7	16.1	20.0	19.5	18.8
Fiscal accounts (% of GDP)					
Budget balance	-2.6	-4.3	-4.5	-4.1	-3.7
Primary balance	-2.0	-3.5	-3.4	-2.7	-2.3
Public debt	26.3	32.9	41.0	41.7	44.6
External accounts					
Current account balance (EUR bn)	-7.1	-2.1	-2.1	-2.6	-2.8
Current account balance/GDP (%)	-21.1	-7.0	-7.0	-7.9	-8.1
Basic balance/GDP (%)	-15.7	-2.4	-4.1	-1.3	-2.3
Net FDI (EUR bn)	1.8	1.4	0.9	2.2	2.0
Net FDI (% of GDP)	5.5	4.6	2.9	6.7	5.8
Gross foreign debt (EUR bn)	21.8	22.8	23.8	25.0	27.0
Gross foreign debt (% of GDP)	65.3	76.1	80.3	75.9	78.7
FX reserves (EUR bn)	8.2	10.6	10.0	10.5	11.0
Inflation/Monetary/FX					
CPI (pavg)	11.7	8.4	6.3	10.9	6.7
CPI (eop)	8.6	6.6	10.5	8.9	6.2
Central bank target	10%±2	8%±2	6%±2	4.5%±1.5	4.0%±1.5
Central bank reference rate (eop)	17.75	9.50	11.50	10.50	8.50
3M money market rate	15.5	14.5	10.0	11.8	10.5
USD/RSD (eop)	64.34	67.11	79.30	74.32	78.32
EUR/RSD (eop)	89.78	96.17	106.13	110.00	112.00
USD/RSD (pavg)	55.40	67.45	77.73	72.92	75.00
EUR/RSD (pavg)	81.49	94.05	103.12	105.00	111.00

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

Inflation remains the main concern

Private consumption remains weak but production figures look better

Manufacturing sector performing well. GDP grew an estimated 1.8% in 2010. With both unemployment and inflation on the rise real incomes remain under pressure. Thus January's 4.9% yoy contraction in retail trade turnover in real terms is of little surprise. More positively, trend figures for industrial production, which have been more or less flat since 4Q09 have risen recently. We stick to our growth forecast of 2.7%, but note that rising EURIBOR rates (we see 75bp in hikes by the ECB this year) will feed through to floating rate loans.

Inflation will likely peak in April

Inflation rising: In an effort to manage the extent of public sector and pension increases to be granted in April, which depend on inflation in 1Q, the central bank succeeded in having the planned 10% increase in electricity prices delayed by one month to April. We expect inflation to peak slightly above 13% yoy in April, but do not see it in single digits before 4Q11. After last year's 23.8% yoy jump in merchandise exports, we expect a less robust growth of exports this year of 9.5%, while higher oil prices will push imports higher and as a result the current account deficit up towards 8.0% of GDP from 7.0% in 2010. The basic balance however will be much lower as we expect a more than doubling of FDI inflows to 6.7% of GDP – March saw the announcement of an EUR 900mn+ acquisition in the retail sector – even as the one bid received for 51% of Telekom Srbija on 21 March was well below the reserve price set out by the government, putting the whole privatization process in doubt.

Forecasts largely unchanged but price competitiveness starting to become an issue

EUR/RSD forecast lowered, inflation forecast raised. We have upped our year end inflation forecast to 8.9% yoy from 7.5% previously as a result of our new oil price forecast and expectation that the price agricultural products will remain elevated. At the same time, we have lowered our year-end EUR/RSD forecast from 117 to 110. Our forecast reflects the lower starting point for the EUR/RSD in 2011 and assumes the central bank's expectation of a 1.5% real appreciation of the currency, outlined in the February Inflation Report, is met. We see upside risk to the inflation outlook and the funding mix for the budget in the wake of uncertainty over the fate of the telecoms privatization as the main risks to the EUR/RSD, however, we also note should investor sentiment turn the hold to maturity nature of t-bills would limit non-residents' scope for exacerbating depreciation pressures. March's 25bp increase in the policy rate to 12.25% is also currency positive.

Pension reforms enacted, but further efforts to rein in the fiscal deficit will be needed

Budget deficit target looks on track – financing the more interesting aspect. In mid March the head of the tax office was quoted in the local press as suggesting tax revenues were RSD 4bn above forecast in Jan-Feb. With public sector unions seeking large pay increases, the IMF has advised providing a one-off payment at a cost to budget of up to RSD 10bn rather than increasing pay and pensions which would then feed through to recurring spending. Also, failure to privatize the telecoms company would lead to increased borrowing, bringing the 45% of GDP public debt limit into question. The March 8 18M t-bill auction saw a bid/cover ratio <1, yet a week later the 53W auction was well covered – all in all sentiment heading into 2Q11 is positive pointing to further yield compression. Beyond that we're not convinced of further yield compression given the first signs of falling headline inflation in the past have seen interest rates cuts which could lead to RSD adjustment and reduced non-resident demand for t-bills.

Government aiming for EU candidate country status by the end of 2011

Cabinet reshuffled in March. Parliament confirmed the reshuffled cabinet in mid-March with the government hoping to achieve EU candidate country status by October at which point elections could be called. While sentiment towards Serbia in the EU has improved in recent months, the issue of cooperation with The Hague Tribunal, which in the past has delayed accession progress, remains the main risk to these plans.

Sovereign upgrade. S&P upgraded Serbia's credit rating to BB from BB- with a stable outlook on 16 March citing improved policy implementation and political stability.

Turkey (Ba2 pos/ BB pos/BB+ pos)*

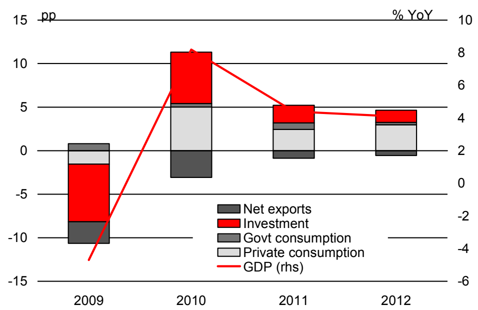
Outlook – As Turkey continues to post strong gains in economic activity, the CBT has shifted policy to address its concerns about an ever widening C/A deficit and rapid credit growth. Via hikes to reserve requirements, the CBT hopes to contain the amount and price of new credit extended while rate cuts should deter short term inflows. It hopes its latest 470bp RRR hike counteracts recent increase in oil pirces. Reate hikes over the next 1-2 quarters seem unlikely, though we expect some move by year end. **Strategy**– We believe the CBT's ability to control banking sector liquidity is much stronger than in 2006 and hence the probability of uncontrolled TRY weakness is more limited. We look to scale up TRY longs during the quarter. We continue see value in FX swap funded TURKGBs but look to go outright long once we jump on the FX wagon.

Author: Guldem Atabay, Economist (UniCredit Menkul Değerler A.Ş.),
Gillian Edgeworth, Chief EEMEA Economist (UniCredit Bank London)

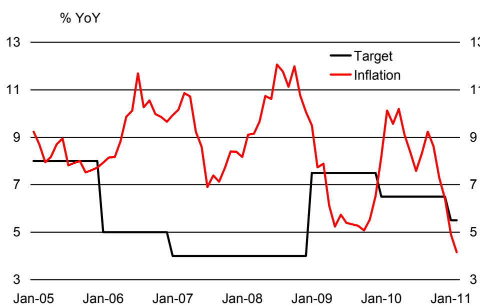
KEY DATES/EVENTS

- April: Appointment of new CBT governor
- 12 June: General election
- End April: Publication of next inflation report
- 23 April, 21 April, 25 May: CBT monetary policy decisions

A BROADBASED RECOVERY IN GDP



A POOR INFLATION TRACK RECORD TO DATE



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

MACROECONOMIC DATA AND FORECASTS

	2008	2009	2010E	2011F	2012F
GDP (EUR bn)	505.1	444.1	550.7	530.3	570.5
Population (mn)	71,517	72,561	73,613	74,681	75,763
GDP per capita (EUR)	7,062	6,120	7,481	7,101	7,530
Real economy yoy (%)					
GDP	0.7	-4.7	8.2	4.4	4.1
Private Consumption	0.5	-2.2	7.1	3.5	4.3
Fixed Investment	-8.2	-19.1	22.6	8.0	7.6
Public Consumption	1.7	7.8	3.5	6.9	2.5
Exports	2.7	-5.3	2.6	11.3	10.0
Imports	-4.2	-14.3	14.2	11.2	9.0
Monthly wage, nominal (EUR)	734	634	790	889	945
Unemployment rate (%)	11.0	14.0	11.9	11.5	11.3
Fiscal accounts (% of GDP)					
Budget balance	-1.8	-5.5	-3.6	-2.9	-2.4
Primary balance	3.5	0.1	0.9	0.4	1.1
Public debt	40.7	47.1	41.5	41.0	39.5
External accounts					
Current account balance (EUR bn)	-28.2	-10.0	-36.8	-41.1	-43.9
Current account balance/GDP (%)	-5.6	-2.3	-6.7	-7.8	-7.7
Basic balance/GDP (%)	-3.2	-1.3	-5.6	-6.5	-6.5
Net FDI (EUR bn)	12.3	4.1	6.1	6.4	6.8
Net FDI (% of GDP)	2.4	0.9	1.1	1.2	1.2
Gross foreign debt (EUR bn)	188.6	192.9	222.8	237.2	260.7
Gross foreign debt (% of GDP)	37.8	43.6	40.0	38.5	39.0
FX reserves (EUR bn)	50.2	49.3	53.3	54.6	52.7
Inflation/Monetary/FX					
CPI (pavg)	10.5	6.3	8.6	6.2	7.8
CPI (eop)	10.1	6.5	6.4	8.1	7.3
Central bank target	4.0	7.5	6.5	5.5	5.0
Central bank reference rate (eop)	15.00	6.50	6.50	7.75	7.75
3M money market rate	17.3	9.7	7.3	7.4	8.2
USD/TRY (eop)	1.54	1.49	1.54	1.60	1.63
EUR/TRY (eop)	2.15	2.14	2.07	2.37	2.33
USD/TRY (pavg)	1.30	1.55	1.51	1.60	1.62
EUR/TRY (pavg)	1.91	2.16	2.00	2.30	2.40

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

Battling quantitative easing with quantitative tightening

An ever widening C/A deficit and rapid credit growth saw the CBT push through a shift in strategy

The CBT's unorthodox monetary policy, introduced in 4Q last year, was designed to address some key concerns of the central banks.

1. The **rapid inflow of short term foreign capital,** which fuels an ever wider C/A deficit but has the potential to reverse quickly at some stage in the future for reasons outside of its control (e.g. some form of external shock), disrupting both economic activity and financial stability. A quick glance at the breakdown of foreign capital inflows over recent quarters reinforces their need for concern. Over the 12 months to November, foreigner inflows amounted to USD 44bn, with USD 40.6bn of this inflow short term in nature. On a seasonally adjusted and annualized basis, the current account deficit reached 10.5% of GDP over the 3 months to January, its widest on record and facilitated by such rapid inflows.
2. **Excessive private credit growth:** To the extent that this is at least partially facilitated by capital inflows into the economy, this is linked to the CBT's first concern. Last year saw private sector credit growth at in excess of 40% yoy.

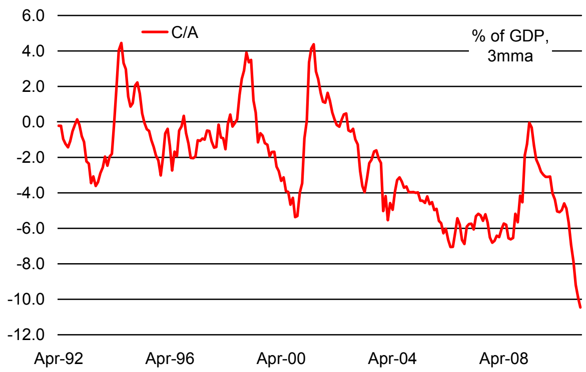
A shift away from a reliance on the policy rate to other instruments to control monetary policy

Since 4Q last year, the CBT has been active on a number of fronts. To control credit growth, reserve requirement ratios have been increased by a weighted average of 4.4pp. The CBT estimates that this should be sufficient to withdraw TRY 22.5bn from the market, equivalent to 5.8% of non-financial sector loans. Hikes in reserve requirements were concentrated on short term liabilities, while reserve requirements on longer term liabilities were cut to encourage an increase in the maturity of liabilities. To discourage short term flows, the CBT cut its overnight borrowing rate to 1.5% while hiking its lending rate to 9%. Of importance, the banking regulator BRSA has decreased loan to value ratios on residential mortgages and commercial property loans to 75% and 50% respectively. Meanwhile the CBT has accelerated its purchase of FX, YTD accumulating USD 2.6bn. Since the start of 2010, the CBT has accumulated USD 11.6bn via its FX purchases equivalent to 90% of the USD 13bn of inflows into domestic fixed income and equity markets over that period. These FX purchases facilitate an improvement in short term external debt and import coverage ratios but also provides the CBT with ammunition in the event of a sharp exit of capital at some point in the future.

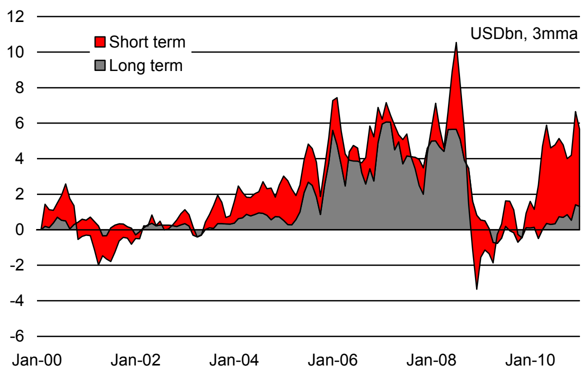
The external environment has changed significantly since the introduction of these policies.

CBT WANTS TO AVOID ABRUPT ADJUSTMENT IN EXTERNAL ACCOUNTS BY TACKLING THE ISSUE NOW RATHER THAN LATER

C/A deficit moves to record wide at rapid pace…



…financed by large amounts of short term capital inflows



Source: CBT, UniCredit Research

Since introduction of their unorthodox monetary policy, a series of external developments have moved against the CBT

1. At its early March meeting, the ECB signaled a rate hike in April but kept full allotment on its liquidity provision. The CBT views the rapid inflow of short term capital into Turkey as a reflection of the excessively loose monetary policy in the US, UK, Japan and EMU. This move by the ECB will ease its concerns, though only at the margin. More meaningful could be the conclusion of QE2 at the end of June.
2. Oil prices have increased well in excess of the USD 85 per barrel assumed in the 1Q inflation report. This extra USD 30 per barrel will add 1.5pp to the C/A deficit, as well as put upward pressure on inflation at a time when the CBT's latest inflation projection already showed no cushion in terms of meeting its target. The Bank forecast inflation at the end of this year at 5.1%, 0.4pp below its 5.5% target, and 5.9% next year, 0.8pp above its year-end target assuming oil at USD 85 and USD 90 pb in 2010 and 2011 respectively. In contrast with 4Q last year, the two inflation readings YTD have surprised on the upside.
3. There has been a large degree of uncertainty introduced into the outlook for the Middle East due to events in Egypt/Libya/Bahrain and elsewhere. These have the potential to generate both positives and negatives for Turkey in terms of trade and capital flows.

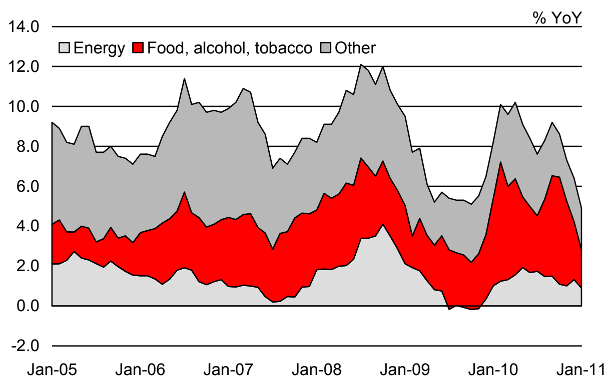
To address these changes in the external environment, the CBT pushed through an aggressive hike to RRR once again at its March meeting, hiking by a weighted average 470bp. Whether or not these policies will be effective, it remains to be seen. In terms of impact to date, the TRY basket has lost almost 88 percent since end-October, though it now seems to have found some form of temporary equilibrium. There has been a halt in inflows into the equity market though inflows into the domestic fixed income market continue. There have been some modest signs of an increase in the maturity of a variety of instruments and to date credit growth remains strong, though there are some tentative signs of improvement.

Further tightening ahead, though initially via reserve requirements rather than the policy rate

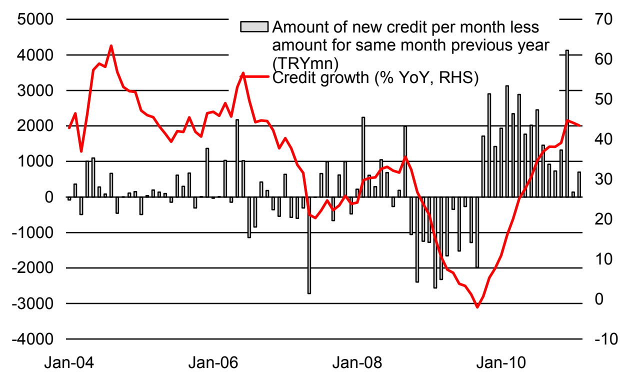
In an environment whereby the global economy manages to hold up in the face of recent events in Japan and the Middle East, the CBT will have to do more to tighten monetary policy. Over the next 3-6 months this should materialize in the form of further hikes to reserve requirements. To increase the chances of success of the current program, the government will also be required to further tighten fiscal policy – a move that would also contribute to a narrowing of the C/A deficit. Assuming that the Fed does not press ahead with QE3, rising inflation pressures will push the CBT towards rate hikes by the end of the year. From a longer term perspective this change in approach to monetary policy that we see in Turkey from a focus primarily on inflation to more of a joint focus on both inflation and financial stability is probably here to stay. For investors in search of a CBT that is fully committed to its 5% end-2012 inflation target, there will likely be disappointment. For investors in search of a central bank that has a higher probability of smoothing the potentially dangerous impact of rapid short term capital inflows on medium to long term growth prospects, the potential for positive surprise have probably increased over the past 3-4 months.

CREDIT IS MORE OF A CONCERN THAN INFLATION FOR THE CBT CURRENTLY

Contributions to inflation: Food and energy are key drivers



Credit growth remains elevated at this stage



Source: CBT, Eurostat, UniCredit Research

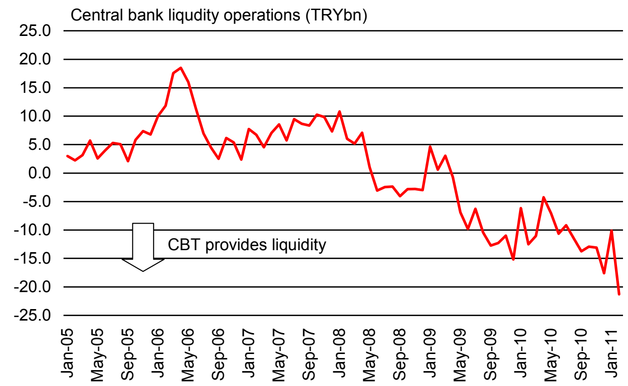
Strategy: look to increase long TRY positions during 2Q

Increase TRY allocation during the quarter

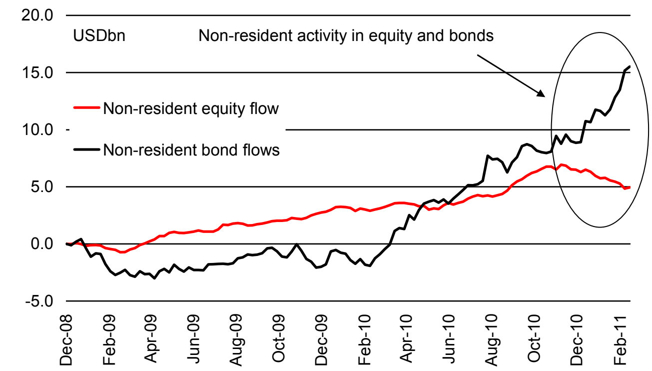
Increase TURKGB allocation in line with FX view

Although one might argue that the period running up to the 2006 TRY sell-off is similar to that of in 2011 we believe there is material difference in the CBT's ability to control the banking sector liquidity and hence to address short term flows and FX. The bank now provides around TRY 30bn liquidity and will probably need to provide more after the March RR hikewhilst back in 2006 it was taking around TRY 10bn liquidity off the sector. From a short term flow perspective we believe the current situation is much more manageable and if the CBT prefers they have the ab ility to drive the currency stronger (by creating TRY shortage). With that in mind we believe the key indicator to watch apart from the actual CBT communication is the actual liquidity operations. Although we can not rule out a further n-t move north in the TRY we do not think that the CBT's aim with the March RR hike was to facilitate a very strong n-t TRY appreciaiton and hence we are not in a scenario where the TRY regains all of the losses (circa 10%) it experienced since Nov 2010. On the other hand we believe this could gradually change in 2Q and we believe the risk reward will move in favor of long TRY. **Flows suggest that non-residents increased TURKGB holdings during the sell-of phase** but reduced equity holdings. We believe most of this TURKGB buying was hedged with cross currency swap rates (difference between 2Y benchmark and swap is still about 150bp) and less outright buying. We would not buy non-hedged TURKGBs yet but in line with our evolving FX view we consider to change this view during the quarter.

The banking sector is more dependent on CBT liquidity



Non-residents were buying TURKGB during the sell-off



Source: CBT, UniCredit Research

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2010E	2011F	2012F
Gross financing requirement	106.5	84.7	89.2
Budget deficit	**18.0**	**15.3**	**14.7**
Amortization of public debt	88.5	69.5	74.5
Domestic	81.0	61.4	65.9
Bonds	70.4	54.6	58.7
Bills	10.5	6.8	7.2
External	7.6	8.1	8.6
IMF/EU	1.0	1.0	1.0
Financing	88.5	69.5	74.5
Domestic borrowing	**72.3**	**54.1**	**55.9**
Bonds	63.6	47.1	49.8
Bills	8.7	7.0	6.2
External borrowing	6.8	5.7	6.4
Bonds	4.5	3.4	3.6
IMF/EU	**0.0**	**0.0**	**0.0**
Other	**2.3**	**2.3**	**2.7**

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2010E	2011F	2012F
Gross financing requirement	**55.5**	**63.5**	**65.5**
C/A deficit	36.8	41.1	43.9
Amortisation of medium to long term debt	21.7	22.4	21.6
Government/central bank	1.4	1.7	1.8
Banks	3.0	3.3	2.2
Corporates	17.3	17.4	17.6
Errors and omissions	-3.0	0.0	0.0
Financing	**57.0**	**63.5**	**65.4**
FDI	6.1	6.4	6.8
Equity	2.7	-0.5	2.5
Borrowing	41.5	53.5	54.1
Government/central bank	7.5	10.4	10.1
Banks	11.3	15.3	16.9
Corporates	22.6	27.8	27.0
Other (incl. reserve accumulation)	6.8	4.2	2.0

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

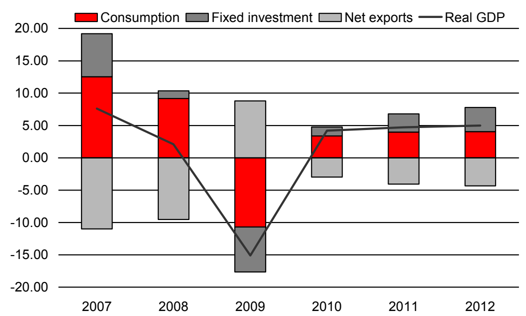
Outlook – Growth remains solid and close to potential as the economy is still being powered by the recovery for export products from EM markets and the CIS, while domestic demand is also recovering on wage growth, credit and investments ahead of EURO2012 preparations. The recent uptick in commodity prices is a risk to growth in our view, given the energy inefficiencies, but is partly offset by a comparable rise in steel and food price exports. **Strategy outlook** – As long as the current government remains reform oriented, and embarks upon a strategy of improving business conditions among other reforms, we continue to see further value in CDS premia tightening, we also like the short-dated Eurobonds on risk/return, and would enter NDF positions on spikes.

Author: Dmitry Gourov, Economist/Strategist (UniCredit Bank Vienna)

KEY DATES/EVENTS

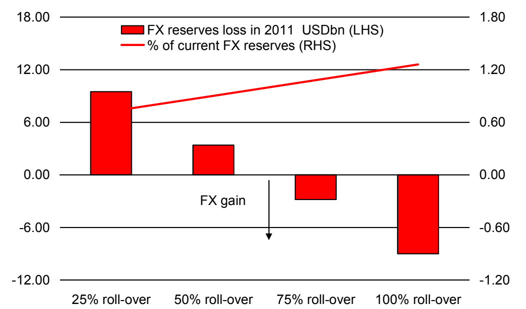
- The next IMF disbursement (Apr-May, USD 1.5bn)
- Association agreement with the EU (end 2011)
- UEFA EURO 2012 football cup (June 2012)

DEMAND LED GROWTH, BUT TRADE SUPPORTIVE



Source: State Committee Statistics of Ukraine. UniCredit Research

WHAT ROLLOVER RATIOS MEAN FOR FX RESERVES (EXCL IMF SUPPORT)?



Source: NBU; UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2008	2009	2010E	2011F	2012F
GDP (EUR bn)	123.4	81.4	105.9	119.3	144.7
Population (mn)	46.2	46.0	45.8	45.5	45.3
GDP per capita (EUR)	2,671	1,771	2,313	2,621	3,196
Real economy yoy (%)					
GDP	2.1	-15.1	4.2	4.7	5.0
Private Consumption	11.6	-14.2	4.5	5.2	5.0
Fixed Investment	4.2	-46.2	8.5	15.0	17.0
Public Consumption	-0.4	-8.8	1.5	0.7	0.9
Exports	6.7	-25.6	10.0	10.0	11.0
Imports	17.5	-38.6	13.0	14.0	14.0
Monthly wage, nominal (EUR)	235	170	213	229	278
Unemployment rate (%)	6.4	9.0	8.4	7.5	6.9
Fiscal accounts (% of GDP)					
Budget balance	-1.3	-11.3	-6.0	-3.5	-2.5
Primary balance	-2.6	-5.1	-3.7	-1.2	-0.4
Public debt	13.7	35.0	41.4	38.5	34.7
External accounts					
Current account balance (EUR bn)	-9.4	-1.2	-1.9	-3.4	-4.5
Current account balance/GDP (%)	-7.6	-1.5	-1.8	-2.8	-3.1
Basic balance/GDP (%)	-1.7	2.5	2.4	2.3	1.6
Net FDI (EUR bn)	7.3	3.2	4.3	6.1	7.0
Net FDI (% of GDP)	5.9	4.0	4.1	5.2	4.8
Gross foreign debt (EUR bn)	75.1	72.6	86.7	91.3	105.8
Gross foreign debt (% of GDP)	60.8	89.1	81.9	76.5	73.1
FX reserves (EUR bn)	19.9	18.5	25.8	31.5	36.6
Inflation/Monetary/FX					
CPI (pavg)	25.2	16.0	9.4	10.0	9.8
CPI (eop)	22.3	12.3	9.1	10.5	8.9
Central bank target	tentative target of 5% by 2014				
Central bank reference rate (eop)	12.00	10.25	7.75	8.50	8.00
3M money market rate	14.8	18.0	7.2	5.8	5.5
FX/USD (eop)	7.81	8.01	7.95	7.70	7.40
FX/EUR (eop)	10.90	11.48	10.89	11.40	10.58
FX/USD (pavg)	5.24	8.06	7.95	7.83	7.55
FX/EUR (pavg)	7.70	11.24	10.55	11.27	11.17

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

Economics: Keeping the momentum going

A robust recovery…

Economic recovery remains robust with preliminary estimates of 2010 GDP growth coming in at 4.2% yoy (exceeding the 3.7% yoy forecast from the government and our own forecast of 4% yoy). Early data for 2011 suggest that we will see a continuation of robust growth rates seen at year end, as manufacturing continues to perform well: up by 14.4% yoy in January (after an average rate of 10.7% yoy in 2010), with chemical production continuing to run high at 30.3% yoy and metallurgy at 13.3% yoy. We associate this with solid EM demand, but also a pick-up in activity in the broader CIS region. This robust external demand is growth supportive, although we see some drag on growth from the energy inefficiency in Ukraine and a higher base in 2010, hence we move our 2011 GDP forecast 0.3% lower to 4.7% yoy.

…supported by external demand…

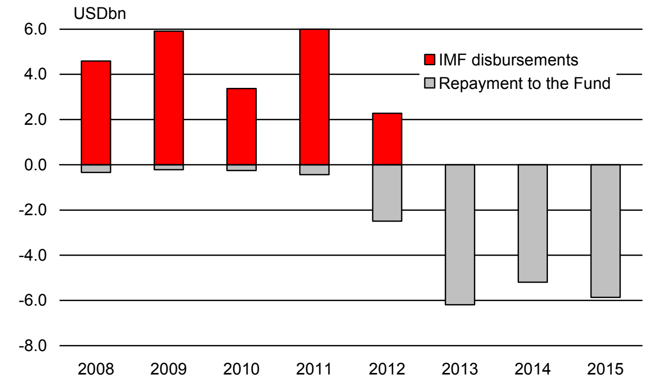
but domestic demand is picking up too

A supportive external environment provides a good momentum for robust growth in 1H11, especially as domestic sources of growth are picking up pace. The ongoing preparations for EURO2012 are starting to be seen on the fixed investment side, up 3.6% yoy in real terms in 3Q10 after eight quarters of negative growth. Meanwhile, there are encouraging signs coming from the consumption side since 2H10, with the volume of retail trade increasing to 11.1% yoy in Jan 2011 (after growth of 7.8% yoy in 2010 and a 20.6% yoy contraction in 2009). Part of the latter improvement is to a significant degree attributable to the pick-up of real wages, which have been growing by 10% since May-2010. A recovery in credit availability is also supportive with total bank lending up 3.1% yoy in January, while UAH consumer credit is also up 3.8% yoy in Jan-2011 after 21 months of contraction. The ongoing contraction in FX lending and NPL's at a high 30%-40% are still an obvious drag but this is set against a backdrop of favorable market conditions: banks are back on the market, issuing both in UAH and FX, and deposits have been growing for the past year.

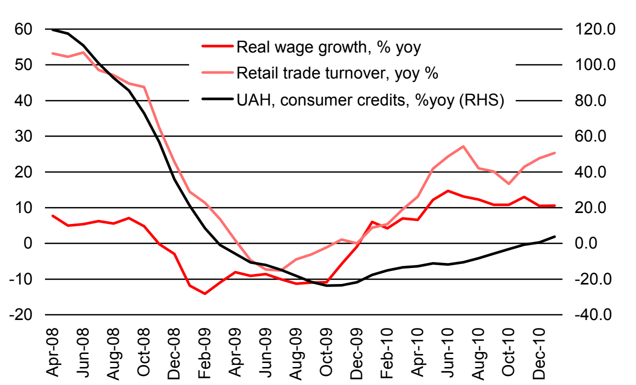
Government needs to do more work for the next IMF tranche – we see a 1-2month delay, from the original date of March

Ukraine is slowly implementing the reforms stipulated by the IMF, and in the end we see the USD 1.5bn being disbursed, with a 1-2 month delay as the government finalizes the reform (we have factored in the full USD 6bn drawdown from the IMF for 2011). Comments by deputy PM Tigipko suggest that the IMF decision is expected to be made in 'mid-April or so'. The key issue is pension reform which needs to be passed in parliament but hikes in gas and heating tariffs also need to be formalized. Instead of a 50% gas price hike from 15 April, the government is thinking of increasing household gas prices by 20% from 15 April and another 10% from 30 June, plus raising heating tariffs by 26% in April and 26% in Oct. Estimates show that delays in hikes will add an additional UAH 4bn to the budget deficit, which will need to be offset to keep the budget deficit at 3.5% for 2011. Other key measures that we are likely to see include: **1)** putting in place a more effective VAT refund process **2)** completing licensing procedures for the grain market under WTO rules **3)** finalizing UAH13bn bank recapitalization.

A heavy repayment schedule 2012 onwards



Credit and real wages starting to support retail growth



Source: IMF, Ukrstat, NBU, UniCredit Research

Higher oil prices counterbalanced by steel prices

The recovery in domestic demand is estimated to push the C/A further into deficit. On top of that we see the recent oil price rise adding another USD 4.7bn to the deficit, but given the close correlation of steel prices to oil, that will ease the shock as additional revenues of USD 2.6bn come from steel exports – bringing the 2011 C/A deficit to 2.8%/GDP (from 1.8% in 2010). In nominal terms the deficit is expected to double to USD 5bn. Positive FDI and portfolio flows will be sufficient to cover the short-fall, with FDI estimated at 5.2% of GDP. Privatization flows have the potential to pick up after the landmark Ukrtelecom deal that had been discussed in various years since the 1990s. The company was sold for USD 1.3bn, the biggest deal since 2005, when the Kryvy Rig steel mill was sold to Mittal. The anticipated sale of power distribution companies ought to bring in an additional USD 1bn in 2011.

and privatization picking up

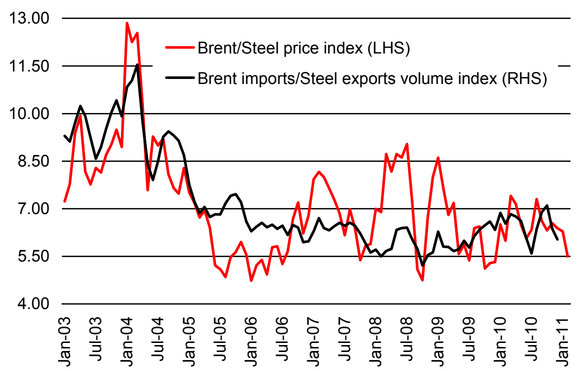
Gross external financing needs improving

In terms of external financing needs we expect a gradual decrease of the total gross external financing needs to 22.8% of GDP in 2011 and 18.2% of GDP in 2012 – a notable improvement from the 36.6% of GDP seen in 2009. The combination of moderating redemptions, lower capital flight and IMF/World Bank/EC/EBRD support should also help the ongoing build-up in FX reserves, leading to an additional USD 12bn being accumulated through-out 2011 (this assumes the full USD 6bn disbursement from the IMF). This would fit in line with the current NBU policy aimed at keeping UAH stable according to statements of NBU governor Arbuzov, and once conditions are ripe moving to more FX flexibility. Although still smoothing out large fluctuations (in effect keeping a heavily managed float), we expect the NBU to allow the UAH to be more driven by flows and C/A. As the financial system is more developed, the NBU is aiming to move towards an inflation target, with 5% being mooted by 2014.

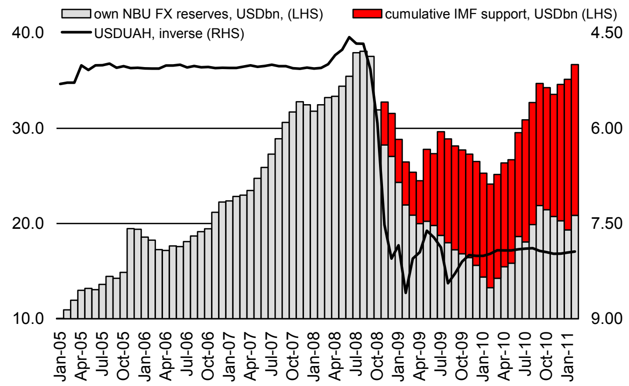
NBU increasing its anti-inflationary stance, next move would be to allow more FX gains

Anti-inflationary posturing by the CenBank and government is bearing fruit with CPI at the start of 2011 being a modest 8.2% yoy in January and 7.2% yoy in Feb (0.9% mom) – part of the story behind the decrease is some moderation in food prices dynamics (0.3% mom and 5.2% yoy in February), which is a result of the wheat export ban and price regulations on sensitive consumer items. The ban has been successful as it shielded Ukraine against the shock witnessed elsewhere (CBR food price index is up 30% since August). What does pose a greater worry is the pace of gains in the PPI which was at 4.8% mom in February coming to 21% yoy – with further commodity prices feed through laying the ground for transfer into CPI pressures in the coming months, although energy prices constitute a limited proportion of the CPI basket (pure fuel 1.6%, while the broad measure impacted by fuel is measured at 10.7%). The anticipated price hikes of gas and heating in 2011 ought to add 1% to average inflation and 2% to eop, bringing the December inflation to 10.5% yoy. To offset any future price pressures we believe the NBU ought to allow some nominal appreciation, a la Central Bank of Russia (CBR) – most likely from May onwards, on privatization flows and IMF disbursements.

Steel prices to compensate for some of the oil price shock



NBU FX reserves rising, even when one excludes IMF support



Source: NBU, Bloomberg, UniCredit Research

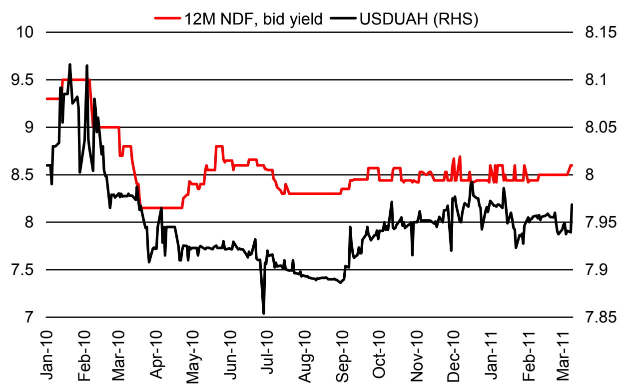
Strategy: go long on spikes

NDF market continues to price in depreciation, despite NBU FX accumulation/IMF programme and new NBU team aiming to keep UAH stable

We continue to see value in the UAH, and would recommend **entering fresh short USD/UAH positions on spikes (which are most likely to be related to IMF stipulated reforms)** given the nice carry the position provides and the solid fundamental support. By the same token any delay in the disbursement of the 2nd IMF tranche ought to bring CDS premia higher but we would use such spikes **to enter seller CDS positions** given that we see reform momentum building in the coming weeks as authorities negotiate/implement the necessary reforms. This should also continue to provide a favorable backdrop for further steepening/normalization of the curve i.e. 1Y-5Y CDS premia. After the USD 1.5bn Eurobond issue in February, we think it will take some time before the FinMin chooses to tap the market in order to avoid overcrowding (the size of the market has grown by 23% following the issue to USD 7.9bn). Given that the FinMin has an USD 2bn loan from VTB maturing in June, we would not rule out that an issue before or slightly after this could come out on the market, on the order of USD 1bn. We **favor short-dated Eurobonds (2013) from a risk/return perspective**, although a much better yield can be picked up on LC corporate bonds. **Dmitry Gourov**

Ukraine '13 should outperform following the CDS

NDF market continues to price in devaluation



Source: Bloomberg, UniCredit Research

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2010E	2011F	2012F
Gross financing requirement	**11.1**	**8.5**	**6.4**
Budget deficit	6.2	4.0	3.5
Amortization of public debt	4.9	4.5	2.9
Domestic	2.4	2.4	2.2
External	2.5	2.1	0.6
Financing	11.1	8.5	6.4
Domestic borrowing	5.1	6.2	4.5
External borrowing	5.9	2.3	1.9
Bonds	2.8	1.5	1.1
IFI	1.7	0.8	0.8
Other	1.5	0	0

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2010E	2011F	2012F
Gross financing requirement	29.7	26.4	27.3
C/A deficit	1.9	3.4	4.5
Government/central bank	2.5	2.1	0.6
Amortization of medium to long term debt	11.5	8.8	9.7
Banks	4.3	3.4	3.7
Corporates	7.1	5.4	5.9
Short term debt amortization	8.8	7.8	8.0
Financing	33.0	30.4	29.7
FDI	4.3	6.1	7.0
Portfolio flows	3.5	2.9	3.5
Borrowing	17.2	14.4	12.4
Government/central bank	2.8	1.5	1.1
IMF	2.6	4.1	1.6
Banks	2.9	2.4	2.8
- Corporates	8.9	6.4	7.0
Short-term	7.7	5.7	5.9
Other	0.3	1.2	0.8

Notes

Notes

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