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Supplier identification:
www.research.unicreditgroup.eu

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

For publication requests in Austria and CEE please refer to:

Bank Austria Identity & Communications Department
pub@unicreditgroup.at
+43 5 05 05 52826

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

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

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

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

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

Anna Kopetz, Economist, Baltics (UniCredit CAIB)
+43 5 05 05 82364, anna.kopetz@caib.unicreditgroup.eu

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

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

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

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

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

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

Gyula Toth, Economist/Strategist, EEMEA (UniCredit CAIB)
+43 5 05 05 82362, gyula.toth@caib.unicreditgroup.eu

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

Global backdrop: a mixed input for CEE

The global recovery unfolding broadly

The global recovery is unfolding broadly according to our expectations, as we outlined them in our year-ahead outlook three months ago. At the time we had flagged that there were upside risks to our US growth forecast, and indeed we have now revised it upwards to close to 3% for 2010, compared to a previous forecast of about 2%, reflecting encouraging signs of firming up in both private consumption and the housing market. Record-high productivity levels give reason to hope that we might see a more robust recovery in employment; for the time being, however, the labor market remains fragile, with the unemployment level hovering near 10%. The main obstacle to a more decisive recovery in employment seems to be the persisting uncertainty on the tax and regulatory environment. The US administration's medium term budget plans confirm that public finances will remain weak for some time, and we are beginning to see the first signs of weakening in investor appetite for USTs: swap spreads have turned negative, and demand has flagged in the face of larger issuance. Against this background, the risk of a meaningful rise in taxation cannot be easily dismissed. In addition, discussions continue on changes in financial sector regulation. This uncertainty seems to be having a negative impact on business sentiment, slowing down hiring and investment plans.

As we go forward, headline growth numbers in the US will suffer from the fading out of the fiscal stimulus plan. Fiscal stimulus added as much as 3 percentage points to growth in 2H09; its contribution will slow to about 1pp in 1H10, and will turn negative to the tune of 1pp in the second half of this year. The underlying momentum of private sector growth will continue to pick up, but headline figures will be dominated by the disappearing contribution of fiscal stimulus. Overall therefore, we still expect the US recovery to continue apace, and remain relatively optimistic.

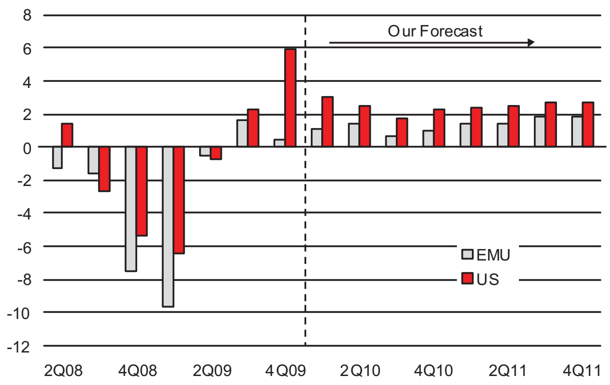
The Federal Reserve, for the time being, maintains a cautious assessment of the economic recovery, and at its March meeting confirmed that interest rates would be kept exceptionally low for an "extended period", coded language indicating about six months. We expect the first hike in the Fed funds rate to take place only in early 2011. We should note, however, that there are clearly diverging opinions within the FOMC, with some members increasingly uncomfortable with maintaining the current exceptionally supportive stance of monetary policy at a time when the recovery seems to be entrenched. In the meanwhile, the Fed is gradually beginning to phase out its liquidity support.

European recovery prospects are less buoyant

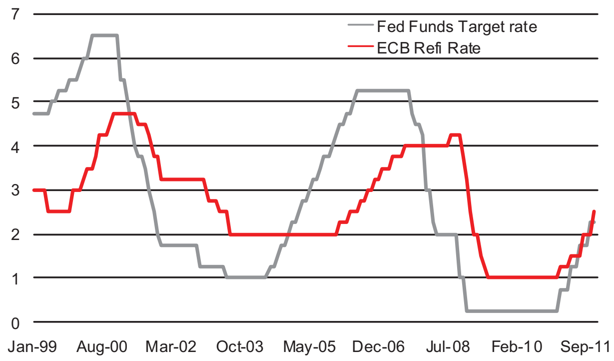
In Europe the recovery prospects remain lackluster, and we have kept unchanged our growth forecast for 2010 of just under 1%. Recent data have confirmed that exports remain the sole engine of the recovery, boosting manufacturing output. As the euro has weakened significantly since the beginning of the year, export performance is likely to remain robust in the months ahead. The data, however, also confirm that domestic demand continues to lag behind: the services PMI underperforms the manufacturing PMI by a clear margin. The normal unfolding of the Eurozone recovery would see exports kick start growth, followed by investment and finally consumption. This time, however, we remain skeptical on the prospects for both private consumption and investment. Eurozone non-financial corporates are burdened by a much higher debt level than in the past, and this will hinder investment and poses the risk of a credit squeeze as banks will see more indebted corporate as riskier borrowers. As far as consumption is concerned, the slow adjustment in the Eurozone labor market implies that unemployment is likely to keep rising throughout this year and into 2011, preventing private consumption from taking off.

US SET TO GROW FASTER THAN EMU BUT POLICY RATES REMAIN FLAT AND HIKES ONLY IN 2011

US to grow faster in the quarters ahead



Policy rates to remain flat in 2010



Source: UniCredit Research

European growth outlook significantly differs among countries

The growth outlook varies significantly across Eurozone countries, and these differences are likely to intensify as we go forward. At the positive extreme we have France and Germany with the strongest recovery prospects. Germany is riding the recovery in global trade thanks to the competitiveness of its manufacturing sector; whereas France benefits from a more balanced growth mix, with a more resilient domestic demand. On the other end of the spectrum, Greece and Spain remain mired in recession, and Italy seems set to register barely positive growth this year.

From the point of view of CEE, therefore, the Eurozone growth outlook contains mixed signals. On the one hand, the fact that Germany is outperforming should be encouraging news for countries like Czech, Hungary and Slovakia which have very strong trade links with Europe's locomotive. This, however, is tempered by the fact that Germany's growth is largely export-driven, and that the broader outlook for the Eurozone is much less buoyant. Overall, therefore, CEE countries which can count on a stronger domestic demand or on a somewhat more diversified export market should enjoy a relative advantage.

The Greek saga is not over

The Greek saga continues, and is likely to affect the European growth outlook as well as the outlook for financial markets in Europe and elsewhere. EU leaders have finally agreed to that the IMF should play a role in a potential support package, but also that no support will be given unless Greece has exhausted all remaining options. Greece has therefore come back to tap the markets, where it is indeed being able to place its bonds, but only at a high spread against bunds, and with visible signs of hesitation on the part of investors – indeed spreads have widened to new record in the days immediately following the Easter holidays. The medium term outlook for Greece remains uncertain: redemptions over the next four years will be significantly higher than in 2010, and combining fiscal austerity with robust growth is a formidable challenge, given a dramatic cumulated loss of competitiveness which cannot be offset via an exchange rate depreciation. We therefore see a very significant risk that market pressure and volatility will continue, resulting eventually in the negotiation of an IMF program, which should then allay concerns both on Greece itself and on the other peripheral countries which are seen as potentially at risk. Moreover, the protracted noise and uncertainty on Greece continues to steadily erode support for the EUR, and poses the risk of a further sudden depreciation of the common currency against the USD, should we see further and more convincing signs of a sustainable firming-up in the US recovery.

A two speed recovery in CEE

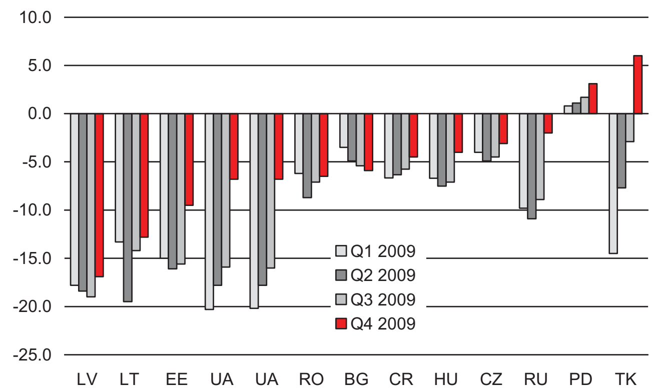
CEE: export driven recovery is under way…

The good news is that 4Q GDP headline data improved across the board in the region with Poland remaining in positive territory whilst Turkey delivered a strong positive surprise. The details are, however, more mixed as exports were the main driver of growth whilst domestic demand remained at depressed levels and actually slowed and surprised on the downside in many countries. Although this is a common in a normal recovery, we have concerns that growth data might start surprising on the downside in the coming quarters given: 1. the most recent high frequency data surprised slightly on the downside whilst our group is relatively cautious on the Eurozone growth, 2. similar to Western Europe we do not believe that domestic demand (particularly household demand) will rebound in the coming quarters due to rising unemployment and further downside surprises in recent retail sales data. This suggests that the EEMEA region as a whole is facing a two speed recovery (firmer exports and soft domestic demand). Looking at the exact stance in the business cycles we note that overall economic sentiment indicators have increased in all of the countries (apart from Bulgaria) but remain well below long term averages (chart 5). We also note that the picture in the consumer sector is not that clear with sentiment below long term average.

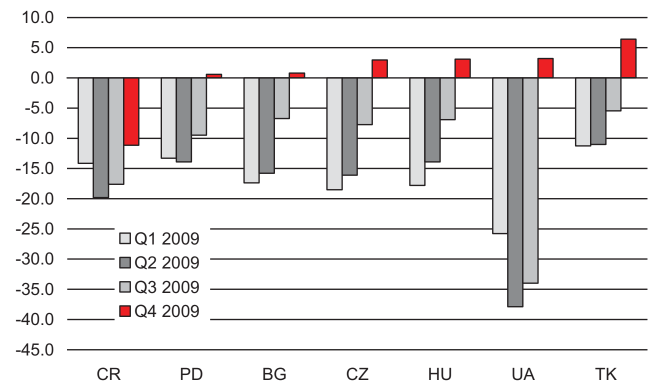
But we see scope for downside surprises in the coming quarters...

EXPORT-DRIVEN RECOVERY IS UNDER WAY

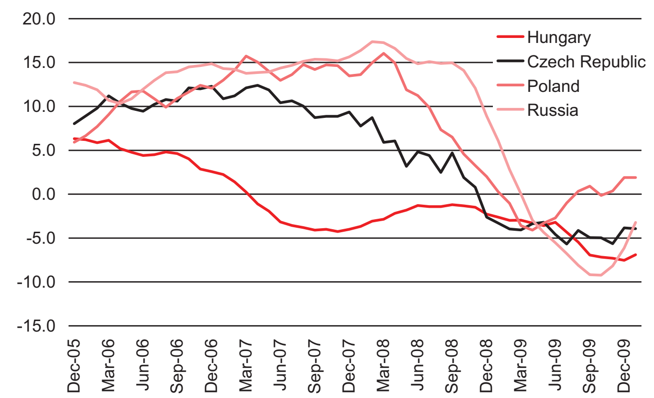
Turkish growth strongly outperforms (GDP growth yoy)



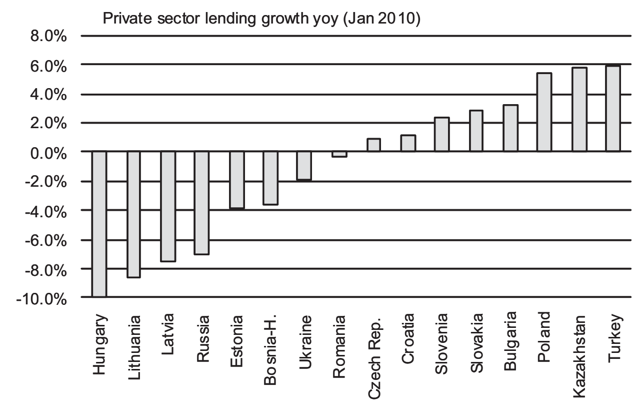
Exports improve across the board (export growth yoy)



Retail sales dynamic is still depressed (retail sales growth yoy)



Lending growth: wide differences in the region



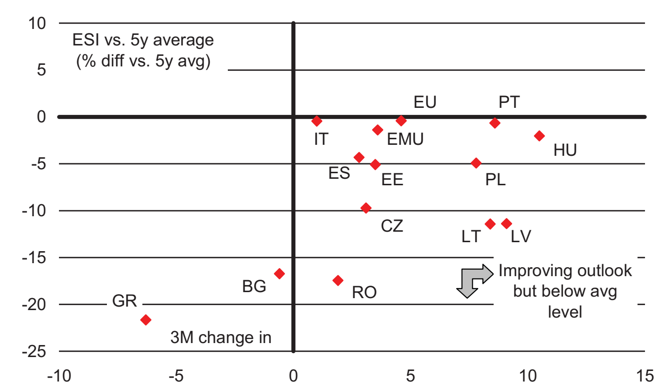
Source: Statistic offices, UniCredit CEE Strategic Analysis, UniCredit Research

Focus should shift to export competitiveness

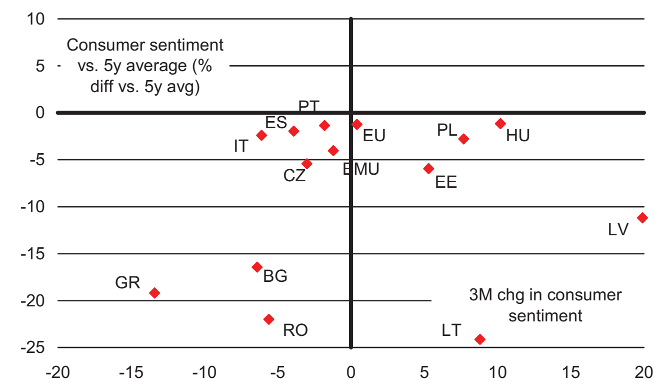
Looking at country by country we applied relatively small changes compared to the latest GDP forecasts: #1 We stick to our view that Turkish GDP will significantly outperform the region (4.5%) due to the relatively healthy banking sector, significant monetary easing during the crisis and a likely shift from public sector driven growth to investment, household demand. #2 We remain relatively unimpressed by the Polish GDP outlook (particularly in 2H 2010) and hence keep our GDP growth forecast at 2.6% slightly below cons. #3 We remain relatively bearish about the fixed exchange rate regime countries where we believe the adjustment will take its toll on 2010 GDP growth. Given we changed our FX call on these countries we also do not see a strong rebound in 2011. **Looking beyond 2011**, we project GDP to grow around 4% annually (which will exceed EMU growth by around 2.5pp) given the smaller need for fiscal adjustments, deleveraged banking sectors, still relatively cheap labor costs and overall scope for further real convergence. On the other hand, as the growth rate was clearly overheating before the crisis (Baltics particularly) some countries will likely not reach pre-crisis levels even in the medium term.

ECONOMIC SENTIMENT IMPROVES BUT REMAINS BELOW AVG – CONSUMER SENTIMENT IS MORE MIXED

Economic sentiment indicators



Consumer sentiment indicators



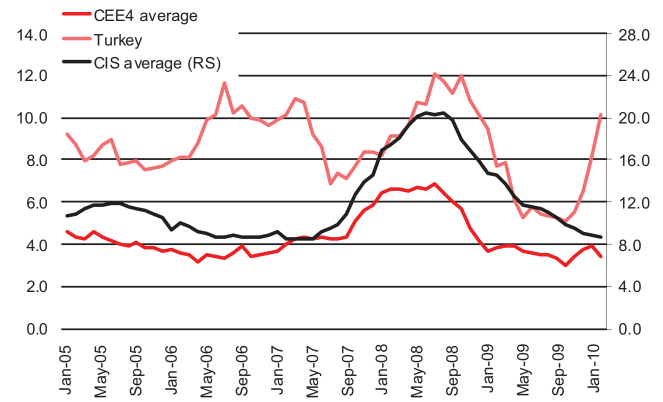
Source: European Commission, UniCredit Research

Inflation pressure remains limited

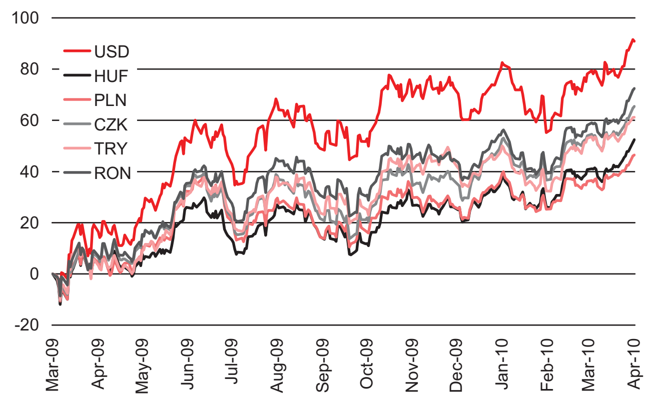
Headline inflation, apart from Turkey remained on a downward path across the region driven by relatively low G3 inflation prints, low capacity utilization and still depressed domestic demand. Looking ahead we believe only commodity prices (and in some cases regulatory price changes) represent upside risk to EEMEA inflation. Although oil prices are around 65% higher yoy in USD we note that the currency appreciations over the last year have offset some of the negative impact in local currency. That said, we believe some central banks might face an interesting dilemma. Namely on the one hand they do not want to tolerate too strong currencies but on the other hand firmer currencies (and monetary conditions) might help to offset the negative impact of higher commodity prices. We believe Turkey could be one of the clearest examples where the headline inflation increased significantly in 1Q (+300bp) partly on the back of adverse base effects. Looking ahead, we see the biggest inflationary risk in Turkey as the central bank tries to balance growth and inflation with keeping rates low for a longer period whilst we feel the upward cycle is the strongest in this country. Overall our inflation outlook is now more benign across the region and hence we expect further rate cuts in Hungary, Romania and Russia; we have postponed our rate hike expectations for the Czech Republic and Poland whilst we continue to expect only Turkey to enter into a more serious tightening cycle in 2010.

TURKISH INFLATION DECOUPLED FROM REGIONAL TRENDS

Regional inflation trends (yoy headline CPI)



Accumulated oil price changes in various local currencies



Source: National Statistic Office, Bloomberg, UniCredit Research

CEE public sector looks healthier than Western Europe in many aspects

During the last quarter the focus has firmly shifted to the health of public sector balances in Western Europe. During this period EEMEA markets remained relatively resilient and we believe this was due to their fiscal metrics. Looking at individual countries and various fiscal sustainability measures we find that EEMEA countries in many cases not only perform better than the Eurozone periphery countries but also better than the EU average.

#1 The cyclically adjusted primary balance is the best in Bulgaria and Hungary in 2010. Only Latvia can be found at the other extreme of the ranking with a 6%/GDP primary deficit.

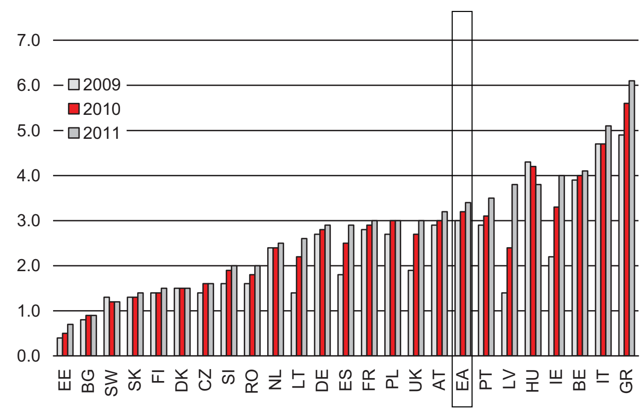
#2 In terms of public sector debt only Hungary is above the EU average whilst all other EEMEA countries are below the EU average.

#3 interest expenditures also look much better than the EU average and following the recent significant rally in local currency bond markets we would expect more improvement in this metric.

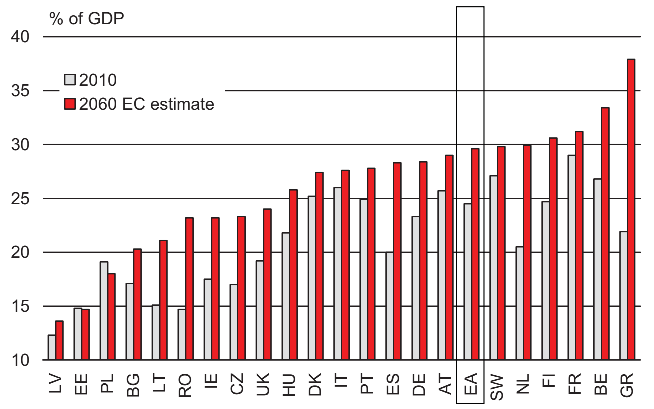
#4 Long term sustainability: The story becomes even more positive if one takes a look at the EU fiscal sustainability report which shows age related spending projections until 2060. On this ranking (obviously keeping the no policy change assumption in mind) Poland looks the only EU country which will not face age related spending increase over the next 50 years. All EMU periphery countries can be found on the end of the scale. Although this is definitely good news we note that Emerging Europe will not remain entirely isolated as fiscal corrections in the West will have a negative impact on their export outlook on a longer time horizon.

FISCAL BACKDROP IS DIVERGING SIGNIFICANTLY

Interest expenditure (% of GDP)



Age related public expenditure (% of GDP)



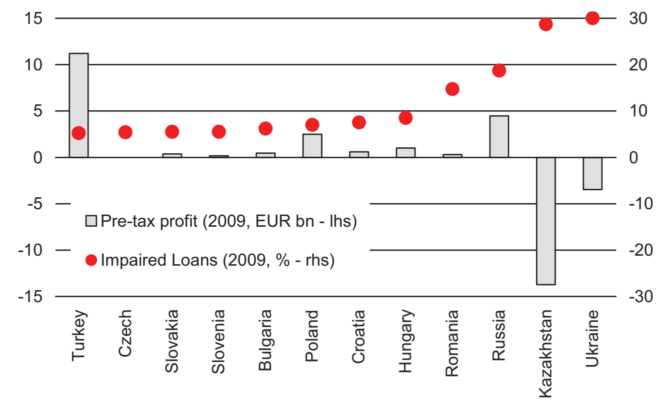
Source: European Commission autumn 2009 forecast, EC Sustainability Report

Banking sector held up much better than other EM banks in previous crisis

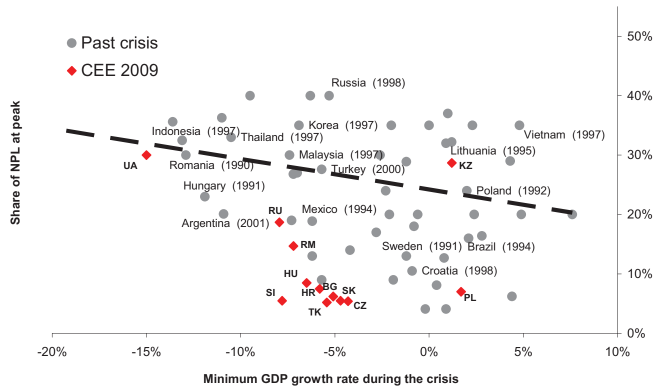
Banking sector: The CEE banking sector's vulnerabilities played a relevant role during the crisis. Despite the absence of toxic assets, most of the banking sectors in the region were exposed to high external funding needs, high "leverage" (i.e. elevated loans over deposits ratio), relevance of lending in foreign currency, credit quality issues. One year later, we can say the wall held: the various banking sectors emerged, not unscathed but functional. Only the banking sectors in the Baltics, Ukraine and Kazakhstan posted losses in 2009 (profitable in all the other countries). Impaired loans remain extremely high in Ukraine, Kazakhstan and Russia. For the other countries, impaired loans doubled or tripled in 2009 (more than tripled only in the Baltics, Romania, Ukraine, Kazakhstan) but remained under control, between 5% and 10% for most of the countries. As regards the top 7 groups operating in CEE (they control around one third of total assets in the banking sectors of Central Europe and South Eastern Europe, dominated by foreign banks, which control around 80% of total assets) only one posted losses at group level in 2009. Thus, these leading groups, despite more than EUR 25bn of provisions booked last year, are in a position to re-start lending activity in the region. In summary, the banking sector shouldn't be a brake for the CEE economies in the coming years.

THE HEALTH OF BANKING SECTORS IN CEE COUNTRIES: OVERALL HELD UP RELATIVELY WELL

CEE Banking sectors – Credit quality and profitability

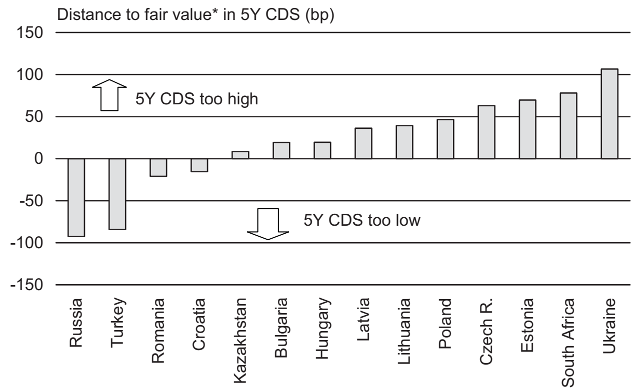


Credit quality – CEE held up well compared to previous crisis

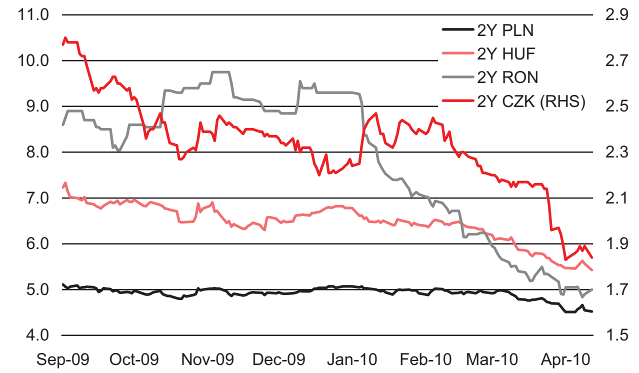


Source: UniCredit CEE Strategic Analysis, IMF

5Y CDS vs. fair value



2Y rates moved significantly lower in CEE recently



*We estimated fair values based on credit rating, GDP and current account as inputs and used 30 EM countries as a sample.

Source: UniCredit Research

Authors:

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

Gyula Toth, EEMEA Economist/Strategist (UniCredit CAIB)
+43 5 05 05 82362, gyula.toth@caib.unicreditgroup.eu

		Relevant Political Events/Main Achievements	Main Political issues to be faced
Central Europe	POLAND	Many members of Poland's political, financial and military élite died in a plane crash in Russia, near Smolensk, where they were going to commemorate the anniversary of Katyn massacre Election will be anticipated; the presidential role is now assumed by the speaker of the lower house of parliament, Komorowski (himself a candidate in the presidential elections, with a very good chance of winning)	Presidential elections and the transition following the air disaster The Central Bank governor Slawomir Skrzypek died and has to be replaced
	HUNGARY	Starting from the 5th IMF review, the authorities decided not to drawn the amounts made available by the Fund. Strong Fidesz victory (opposition) in the elections on April the 11th. Current governing party MSZP came second, followed by the radical right wing party Jobbik	
	CZECH REPUBLIC	In March, the junior coalition Green Party has withdrawn its support from the interim government of Prime Minister Fischer	General elections to be held on May 28-29. It is unlikely the government will be changed only weeks before May election, but current disagreements among the parties are likely to raise voters' apathy towards politics.
	SLOVAKIA	In March, the controversial "Patriotic Act" has been passed by parliament to strengthen patriotism among citizens. The Slovak Democratic and Christian Union-Democratic Party (SDKU-DS), has named Iveta Radicova, its deputy chair, to run the general election due next June.	A draft amendment to the Bankruptcy Law, which will harmonize Slovak legislation with EU law and increase transparency, has yet to be approved. General elections to be held in June.
Baltics	LATVIA	In March, the People's Party left the government coalition, but the Government will receive the support of Latvia's First Party/Latvia's Way (LPP/LC). In February and March the IMF, the EU and the WB approved the disbursement of the joint loan's third tranche.	Assuring the political stability until next elections (October). Respecting IMF conditions to allow the next tranches' disbursement
	LITHUANIA	The government lost its parliamentary majority on 16 March 2010 (70 seats, 1 short of a majority).	
South Eastern Europe	ROMANIA	In February, the country obtained the disbursement of the second and third tranches under the stand-by agreement with the IMF. The main opposition Social Democrat party ended the five-year leadership of Mircea Geoana, choosing instead Victor Ponta as its new leader.	IMF mission scheduled for late April. In May (or June) the Government will operate the first budget's revision.
	BULGARIA	The Parliament has not supported (March 31) the process of impeachment against President Parvanov proposed by the ruling party GERB.	The Government intends to introduce a package of economic measures to fight the economic crisis and reduce the fiscal deficit.
	BOSNIA-H.	In February the Bosnian Serb region passed a law that will make it easier to hold referendums on divisive issues.	Respecting IMF conditions to allow the next tranches' disbursement, following the EUR 138.4 mn tranche recently obtained
	SERBIA	In February a free-trade agreement between Serbia and the European Union came into force. In March the Central Bank Governor Jelasic resigned due to disagreement with Government's economic policy. The IMF allowed Serbia to withdraw the third tranche of EUR 350 million under the stand-by agreement.	To appoint a new Central Bank Governor. To speed up country's accession to the EU.
Other countries	TURKEY	In January the Constitutional Court overturned a law that transferred from military to civilian courts cases during peacetime in which army personnel were accused of crimes against national security. In February several former senior army and navy commanders have been arrested after an investigation into an alleged military plot in 2003. In March the Parliament passed a bill that shortens the waiting period between the announcement of a referendum on the actual poll from 120 days to 60 days.	Possible constitutional reform focused on banning political parties and on the judiciary. Tensions between the Government and the secular apparatus, in particular linked to the Ergenekon case.
	RUSSIA	Russian ruling party placed first, decreasing popular support, in all eight regional legislative elections (March).	Growing social discontent and possible tensions between President and PM.
	UKRAINE	Yanukovich has been elected as new President. In March the Tymoshenko's Government coalition collapsed. Ukraine's Parliament eased coalition creation rules. A new Government coalition and a new Cabinet, lead by the new PM Azarov, has been formed in March.	To appoint a new Central Bank Governor. To sign a new gas agreement with Russia. Respecting IMF conditions to allow the next tranches' disbursement

Source: UniCredit Political Studies

Bulgaria

Outlook

The upturn in exports and inventories has started, but the household sector will need more time to join the recovery process. What's more the recovery is fragile and depends on the strength of the resurgence of Bulgaria's key trading partners, risk appetite toward emerging markets and the pace of the implementation of domestic reforms, including progress in EU funds absorption. We have thus decided to stick to our existing projection, that the Bulgarian economy will remain in recession for the most part of 2010, and that prospects for a meaningful recovery look better in 2011 and thereafter.

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

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

MACROECONOMIC DATA AND FORECASTS

	2007	2008	2009	2010F	2011F
GDP (EUR bn)	28.9	34.1	33.9	34.4	36.0
Population (mn)	7.6	7.6	7.6	7.5	7.5
GDP per capita (EUR)	3,782	4,485	4,479	4,570	4,804
GDP (constant prices yoy %)	6.2	6.0	-5.0	-1.0	2.2
Private Consumption, real, yoy (%)	5.1	4.5	-6.2	-4.2	1.3
Fixed Investment, real, yoy (%)	21.7	20.4	-26.9	-9.8	5.6
Public Consumption, real, yoy (%)	3.4	-1.4	-5.7	-4.3	-1.3
Exports, real, yoy (%)	5.2	2.9	-9.8	4.8	4.3
Imports, real, yoy (%)	9.9	4.9	-22.3	-1.7	4.7
CPI (average, yoy %)	8.4	12.4	2.8	2.5	2.4
Central bank reference rate (LEONIA, avg)	4.56	4.07	0.23	0.40	1.32
Monthly wage, nominal (EUR)	220	279	302	301	313
Unemployment rate (%)	6.9	6.3	9.1	12.5	12.2
Budget balance (% of GDP)	3.5	3.0	-0.8	-3.1	-3.4
Current account balance (EUR bn)	-7.8	-8.2	-3.2	-2.2	-2.6
Current account balance (% of GDP)	-26.8	-24.0	-9.4	-6.4	-7.2
Net FDI (EUR bn)	8.8	6.2	3.3	2.5	2.2
FDI (% of GDP)	30.6	18.2	9.8	7.3	6.0
Gross foreign debt (EUR bn)	29.0	37.0	37.6	38.3	39.8
Gross foreign debt (% of GDP)	100.3	108.4	111.0	111.3	110.7
FX reserves (EUR bn)	11.9	12.7	12.9	13.6	14.9
(Cur.Acc-FDI)/GDP (%)	3.7	-5.8	0.3	0.9	-1.2
FX reserves/Gross foreign debt (%)	41.2	34.4	34.4	35.6	37.5
Exchange rate to USD eop	1.34	1.40	1.36	1.42	1.50
Exchange rate to EUR eop	1.96	1.96	1.96	1.96	1.96
Exchange rate to USD avg	1.43	1.33	1.40	1.41	1.47
Exchange rate to EUR avg	1.96	1.96	1.96	1.96	1.96

Source: UniCredit Research

STRENGTHS

- No stimulus phasing out will burden recovery dynamics
- Strong commitment to push structural reforms
- Untapped potential to boost growth by better use of EU aid

WEAKNESSES

- Large private sector external debt
- Slower adjustment dynamics due to fixed exchange rate
- Rebalancing of external position is not over

Economy is slowly getting back on its feet, but the headwinds remain

The risks for the recovery process have eased, but this will not necessarily translate into a sustained upswing

Economic newsflow has been more positive in early 2010, as clear signs of stabilization have emerged after the sharp output decline last year (GDP growth at -5% in 2009). The balance of payments data underlined what had been already obvious from the improvement in sentiment and activity indicators: recovery has started, led by export and inventories and is proceeding roughly at the same speed as in the rest of Emerging Europe.

But the news is not all positive; data releases for the household sector were pretty downbeat. While low inflation is helping to preserve real incomes, depressed retail sales combined with flagging confidence indicators suggest that households remain reluctant to spend.

A dismal job market and a crippled housing sector will keep a lid on household sector recovery

The latest labor market figures showed that job losses escalated in 4Q09 and even the manufacturing sector, where the recovery process has started, continued to shed jobs. More worryingly, labor market adjustment, which is instrumental for the economy's rebalancing under the currency board, has predominately taken the form of rising joblessness rather than a sharper slowdown in wages. This is a negative development, as it threatens to make the adjustment socially more painful, thus further eroding the flagging public support for reforms.

There are clear signs that stabilization of housing prices has started

The crippled housing market remains at the heart of Bulgaria's recession, with median home prices falling 30% from their peaks, and even more sharply in heavily affected second-tier regions. The drop has sapped a principal source of wealth for Bulgarian consumers whose spending had largely contributed to growth during the years of the economic boom. On the positive side, the fall in housing prices slackened to just 2% qoq in 4Q09, while 12 out of 28 regions reported positive qoq price changes, suggesting that house prices are stabilizing in a growing number of regions. Surprisingly, house prices on the coast, which was largely viewed as the most "overheated" location during the construction boom, continued to decline at a slower than the average market rate, which seems to highlight that the rebalancing in these particular areas will need more time to fully materialize.

Growth prospects are deemed bleak in 2010

Given the above, **we are still forecasting negative GDP growth in 2010,** as we think that Bulgarian households will need more time to join the recovery process. It would be too optimistic to believe that an upturn in exports and inventory alone would be strong enough to bring the economy out of the woods; hence Bulgaria is likely to remain in recession for the most part of 2010. Moreover, sustainable recovery goes much further than only the rate of growth; it only begins when companies and banks clean up their balance sheets and the economy starts to create new jobs again. In the medium-to-long run Bulgaria needs to press ahead with structural reforms to lay the foundation for sustainable growth, while in the short-run it needs to boost domestic liquidity and strengthen its reserves position to dampen any potential financial markets concerns on private sector capacity to rollover its external debt.

ERMII not so close

Opposite to many other emerging markets Bulgaria entered the recession with lower level of government debt and a good state of public finances. However, the unpleasant surprise is that the Bulgarian 2009 budget deficit was revised to 3.7% due to unaccounted procurement deals: this "hidden deficit" is forcing Bulgaria to scrap its bid to apply to join the ERMII mechanism this year. This is not a major threat, but it's obviously unpleasant and adds to the rather poor fiscal performance registered by Bulgaria in the first three months of the year. The scale of fiscal consolidation which Bulgaria needs to implement from 2011 onward looks smaller when compared with those due in other peers, but the government cannot rest on its laurels: we may expect VAT increase and more austerity measures being implemented in the moths ahead, as the government will be keen to avoid budget deficit widening again above 3% benchmark.

Czech Republic

Outlook – Although the economic recovery accelerated in 4Q we believe uncertainties about the key export markets, the lower-than-expected actual CPI, sluggish domestic demand and a firmer CZK means we expect the CNB to maintain a low policy rate. Further policy easing cannot be fully ruled out. We still forecast 2010 GDP growth at 1.6% around 0.7% above the EMU average.

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

Patrik Rozumbersky, Economist (UniCredit Bank)
+420 2 211 12506, patrik.rozumbersky@unicreditgroup.cz

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

MACROECONOMIC DATA AND FORECASTS

	2007	2008	2009	2010F	2011F
GDP (EUR bn)	127.3	147.9	137.2	145.7	156.4
Population (mn)	10.3	10.4	10.5	10.5	10.6
GDP per capita (EUR)	12,336	14,181	1,3074	13,846	14,814
GDP (constant prices yoy %)	6.1	2.5	-4.2	1.6	2.4
Private Consumption, real, yoy (%)	4.9	3.6	-0.2	-0.8	1.5
Fixed Investment, real, yoy (%)	10.8	-1.5	-8.3	-3.0	4.0
Public Consumption, real, yoy (%)	0.7	1.0	4.4	-0.5	0.0
Exports, real, yoy (%)	15.0	6.0	-10.2	10.8	8.9
Imports, real, yoy (%)	14.3	4.7	-10.2	9.7	8.6
CPI (average, yoy %)	2.8	6.3	1.0	1.3	2.0
Central bank reference rate	3.50	2.25	1.00	1.25	2.75
Monthly wage, nominal (EUR)	755	910	892	926	985
Unemployment rate (%)	6.6	5.5	8.1	9.5	9.3
Budget balance (% of GDP)	-0.7	-2.1	-6.6	-5.5	-5.0
Current account balance (EUR bn)	-4.1	-0.9	-1.4	0.0	-0.9
Current account balance (% of GDP)	-3.2	-0.6	-1.0	0.0	-0.6
Net FDI (EUR bn)	7.6	4.4	2.0	2.4	3.6
FDI (% of GDP)	6.0	3.0	1.4	1.6	2.3
Gross foreign debt (EUR bn)	51.6	57.8	54.0	59.4	63.7
Gross foreign debt (% of GDP)	38.9	42.2	39.4	40.0	40.2
FX reserves (EUR bn)	23.7	26.6	28.9	29.0	29.0
(Cur.Acc-FDI)/GDP (%)	2.8	2.4	0.4	1.6	1.7
FX reserves/Gross foreign debt (%)	45.9	46.0	53.4	48.8	45.5
Exchange rate to USD eop	18.19	19.21	18.39	18.12	19.08
Exchange rate to EUR eop	26.52	26.80	26.35	25.00	24.80
Exchange rate to USD avg	20.25	16.97	18.96	18.42	19.17
Exchange rate to EUR avg	27.75	24.96	26.43	25.60	25.50

Source: UniCredit Research

STRENGTHS

- External financing at comfortable levels
- Flexible monetary policy
- Low vulnerability of financial sector

WEAKNESSES

- Sharply weakening FDI inflow
- No quick end to private consumption contraction
- Left-wing parties likely to win general elections

Facing the headwinds of sluggish domestic demand

Net exports started to prop up GDP in 4Q, while negative contributions of capital formation and private spending became even more severe

The economic recovery accelerated in 4Q, with the decline in GDP moderating to -3.1% yoy from 3Q's -4.5% yoy. The demand structure of 4Q GDP has changed substantially from that of the previous three quarters. Net exports showed the biggest shift, with their contribution to GDP turning to positive 2.7%-points from negative 1.6%-points in 3Q as exports returned to yoy growth while imports continued to drop. Domestic consumption also added to 4Q GDP but only thanks to the ongoing robust public spending (+1.1%-points). Household consumption, on the other hand, extended its drop to -1.2% yoy from -0.5% in the previous three months. Both components of gross capital pushed GDP down by a record 6.7%-points. But while fixed capital formation has somewhat eased its decline from 3Q, the inventory rundown has intensified. Full-year seasonally adjusted GDP contracted 4.1% yoy last year after a 2.3% yoy expansion in 2008. With domestic demand still trending downwards, price growth remained pretty subdued at the start of this year. In fact, inflation dropped to 0.6% yoy in February from 1.0% yoy at the end of 2009 dragged down primarily by lower growth in utility prices. In addition, the impact of hikes in VAT and excise taxes from early this year, adding roughly 1.0%-point to yoy inflation, appeared lower than initially expected. The current account deficit remained well under control last year, widening moderately to 1.0% of GDP from 0.6% seen in 2008. However, the net inflow of FDI slowed to just 0.7% of GDP in 2009, failing to cover the current account gap for the first time since 2004. The risk for the country's external position arising from this imbalance is not imminent but the related trends need to be watched carefully.

A quick economic rebound is unlikely, dragged by bearish outlook for household and investment demand

Structural data related to the first month of this year have been far from impressive. Although industrial output remained on the recovery path in January, its growth momentum (5.3% yoy vs. -22.0% yoy in January 2009) looked rather disappointing. Depressingly, construction output as well as retail trade continued to contract dramatically in January, down 25.6% yoy and 5.0% yoy respectively. What's more, the prospects for a quick rebound in both sectors are not yet in sight. Hence, sticking to our prediction from three months ago, we believe that household spending and construction related investments will be the main drags on the economic recovery. We expect private spending to drop by 0.8% yoy this year on slowing household incomes and the unwillingness of the corporate sphere to hire new staff to boost employment. We estimate fixed capital formation to contract 3.0% yoy, rebounding from -8.3% yoy in 2009, with machinery and transport related investment standing behind the improvement. Therefore, this year's GDP growth, which we continue to expect at 1.6%, should mainly be driven by ongoing recovery of foreign demand translating into a jump in exports and inventory accumulation.

Pre-election populism of the leftist CSSD party, the likely winner of the May elections, threatens the fiscal restriction targets outlined by the current caretaker government

The austerity measures, introduced in this year's state budget by the interim government, seem to be paying dividends – at least in the tax area. Tax collection in the first two months of the year looks to be consistent with the budget plan. Nevertheless, the spending pledges of the largest left-wing party CSSD, which leads opinion polls in the run-up to the 28-29 May elections, have raised the likelihood of a looser fiscal policy in the coming years. For the time being, the finance minister of the interim government Janota, who will most likely prepare the first draft of the 2011 budget, does not want the fiscal gap to exceed 4.8% of GDP next year.

We expect the CNB to keep the repo rate at a record 1% longer than we thought previously and forecast just one 25bp hike before the year-end

Unlike three months ago, we now expect the CNB to keep the two-week repo rate flat at 1% by late 2010 and then to deliver just one 25bp interest rate hike before the year-end. The lower urgency to start policy tightening is seen coming from the lower-than-expected actual CPI, sluggish domestic demand and a firmer CZK. Moreover, given that two CNB board members were surprisingly in favor of a 25bp repo rate cut at the last meeting, we do not rule out additional policy easing. Further CZK strengthening in the months to come, which is however not part of our baseline scenario, would make this step even more likely. Although we have shifted our year-end EUR/CZK forecast to 25.0 from 26.0, we still believe CZK might come under temporary weakening pressure before the summer due to the elections.

Estonia

Outlook

After last year's full year contraction in real GDP of 14.1% yoy, we expect a further negative headline figure for this year. The recent newsflow on meeting the Maastricht criteria means that we are increasingly optimistic that Estonia will be invited to join the Eurozone at the beginning of 2011.

Author: Anna Kopetz, Economist (UniCredit CAIB)
+43 5 05 05 82364, anna.kopetz@caib.unicreditgroup.eu

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

MACROECONOMIC DATA AND FORECASTS

	2007	2008	2009	2010F	2011F
GDP (EUR bn)	15.6	16.1	13.3	12.8	13.5
Population (mn)	1.3	1.3	1.3	1.3	1.3
GDP per capita (EUR)	11,644	12,001	9,969	9,625	10,138
GDP (constant prices yoy %)	6.3	-3.5	-14.1	-1.3	3.4
Private Consumption, real, yoy (%)	7.9	-4.6	-18.4	-5.3	1.3
Fixed Investment, real, yoy (%)	4.8	-11.5	-29.8	-0.7	4.8
Public Consumption, real, yoy (%)	3.9	4.1	-0.5	-2.4	1.9
Exports, real, yoy (%)	0	-0.7	-11.2	1.5	3.6
Imports, real, yoy (%)	4.2	-8.7	-26.8	-1.2	2.4
CPI (average, yoy %)	6.6	10.4	-0.1	-0.3	1.7
Monthly wage, nominal (EUR)	725	819	781	758	735
Unemployment rate (%)	4.7	5.5	13.8	15.5	14.7
Budget balance (% of GDP)	2.7	-2.9	-2.8	-3.0	-3.0
Current account balance (EUR bn)	-2.8	-1.5	0.6	0.8	0.5
Current account balance (% of GDP)	-18.1	-9.4	4.7	6.2	3.6
Net FDI (EUR bn)	0.8	0.6	0.2	0.3	0.5
FDI (% of GDP)	5.3	3.7	1.1	2.3	4.0
Gross foreign debt (EUR bn)	17.2	19.1	17.4	15.7	15.6
Gross foreign debt (% of GDP)	112.4	118.5	130.7	122.2	115.3
FX reserves (EUR bn)	2.2	2.8	2.3	2.0	2.2
(Cur.Acc-FDI)/GDP (%)	-12.5	-5.7	5.9	8.5	7.6
FX reserves/Gross foreign debt (%)	13.0	14.7	13.2	12.8	14.1

Source: UniCredit Research

STRENGTHS

- Political determination to introduce the EUR in 2011
- Rapid unwinding external imbalances

WEAKNESSES

- Weak internal demand
- High FX leverage in domestic private sector

2011 Euro introduction seems increasingly likely

With 14.1% yoy contraction Estonia performed best compared to its Baltic peers

Compared to its Baltic neighbors, Estonia performed best with its economic activity contracting by 14.1% yoy in 2009. The lowest GDP data were recorded in 2Q09, when the economy contracted by 16.1% yoy; since then it has improved gradually to reach -9.5% yoy in 4Q. When looking at the seasonally adjusted data, the picture is more upbeat: 4Q09 saw an increase of 2.5% qoq (after 3Q's -0.5% qoq). Compared to last year, the largest decreases were registered in fixed capital formation (2009: -29.8% yoy), followed by private final consumption (2009: -18.4%yoy). Exports and imports fell sharply, with full-year data of -11.2% and -26.8% yoy, respectively. For this year, we expect a further contraction in real GDP, driven mainly by a slide in private final consumption, and pencil in a full-year GDP figure of -1.3% yoy. This figure is better than our last call and is due to a more positive view on exports and a less pessimistic outlook on fixed capital formation.

Sharp improvement in C/A

The full year 2009 C/A data came in at a surplus of 4.7% to GDP, which is considerably better than 2008's deficit of 9.4%. This is mainly attributable to a pronounced fall-off in imports, coupled with a less marked decline in exports. The net FDI figures registered low levels with the full year 2009 number amounting to just 25% of the data seen one year earlier. For this year, we expect exports to improve slowly, while we still see imports declining slightly. Accordingly, we pencil in a further improvement in the C/A balance to a 2010 full-year value of 6.2% to GDP. Moreover, a firm 'yes' from the European Commission on the question of the Euro-introduction in 2011 is likely to make Estonia more attractive for FDI (see below).

Deflation to continue, but outlook revised

Deflation, in place since May 2009, didn't pick up as much as previously thought: February's data even saw an almost balanced -0.1% yoy number. This, in addition to the planned tax increases in the first half of 2010, means that we have revised our CPI forecast for 2010. We still see an overall negative number but expect it to come in at a more modest -0.3% yoy (as opposed to our last call of -1.4% yoy).

Euro-introduction next year seems to be increasingly likely

The most important question at the moment for Estonia is whether it will get a green light to introduce the euro at the beginning of 2011. Preparations for the introduction of the currency are well under way, despite the fact that the decision is only expected in June. (The European Commission's recommendation is expected on 12 May, while a final decision by EU government-leaders should be made in June.)

From a fundamental view, **it looks like Estonia should pass all the entry-criteria:** even the budget figures that were released recently were supportive. The numbers published by the local statistics office amounted to a deficit of 1.7% to GDP in 2009, which was definitely better than what we had penciled in. However, it might be that it will see some upwards revision, if the EC has some doubts about specific items; we think, however, that the risk that these upwards revisions are likely to push Estonia above the 3% threshold is very low.

We would see any rejection of Estonia's euro-bid that is not based on economic reasons but on political grounds as a big negative with potentially important negative consequences. Recent comments by EU politicians, however, don't point in that direction: EC President Barroso said recently that "Estonia will be judged on the basis of its own performance". This means that we think it increasingly probable that Estonia will be the next country to introduce the euro with potentially positive implications for its FDI figures and its economic activity.

Hungary

Outlook

Growth is improving on the back of export and inventory rebuild while other domestic elements of growth continue to disappoint. We see no acceleration in domestic demand and as the EMU outlook is deteriorating, making us maintain our relatively bearish 2010-11 GDP forecast. We do not believe that the new government will significantly loosen fiscal policy and we now expect the policy rate to be cut to 5%. Against this backdrop we maintain our long held view that HUF will not be able to appreciate significantly from current levels during 2010.

Author: Gyula Toth, Economist/Strategist (UniCredit CAIB)
+43 5 05 05 82362, gyula.toth@caib.unicreditgroup.eu

	Moody's	S&P	Fitch
Long-term foreign currency credit rating	**BAA1 negative**	**BBB- stable**	**BBB negative**

MACROECONOMIC DATA AND FORECASTS

	2007	2008	2009	2010F	2011F
GDP (EUR bn)	101.1	105.5	93.1	100.6	107.7
Population (mn)	10.1	10.1	10.0	10.0	10.0
GDP per capita (EUR)	10,040	10,494	9,275	10,041	10,753
GDP (constant prices yoy %)	1.0	0.6	-6.3	-0.1	2.8
Private Consumption, real, yoy (%)	-1.6	-0.6	-6.7	-3.8	0.5
Fixed Investment, real, yoy (%)	1.6	0.4	-6.5	-2.8	5.5
Public Consumption, real, yoy (%)	-4.3	-0.3	1.0	0	0.1
Exports, real, yoy (%)	16.2	5.6	-9.1	6.5	10.0
Imports, real, yoy (%)	13.3	5.7	-15.4	5.0	9.0
CPI (average, yoy %)	8.0	6.1	4.2	4.2	2.3
Central bank reference rate	7.50	10.00	7.00	5.00	5.00
Monthly wage, nominal (EUR)	736	798	715	744	788
Unemployment rate (%)	7.3	7.8	9.8	11.5	11.0
Budget balance (% of GDP)	-5.0	-3.7	-3.9	-5.0	-4.0
Current account balance (EUR bn)	-6.6	-7.5	0.2	-1.0	-1.3
Current account balance (% of GDP)	-6.5	-7.1	0.2	-1.0	-1.2
Net FDI (EUR bn)	0.6	2.5	2.0	2.1	2.4
FDI (% of GDP)	0.6	2.3	2.1	2.0	2.2
Gross foreign debt (EUR bn)	98.8	122.8	130.5	150.9	140.1
Gross foreign debt (% of GDP)	97.8	116.4	140.1	150.0	130.0
FX reserves (EUR bn)	16.4	24.0	24.6	28.0	27.0
(Cur.Acc-FDI)/GDP (%)	-5.9	-4.8	2.3	1.0	1.0
FX reserves/Gross foreign debt (%)	16.6	19.6	18.8	18.6	19.3
Exchange rate to USD eop	173.30	190.27	188.26	192.03	203.85
Exchange rate to EUR eop	252.72	265.49	269.80	265.00	265.00
Exchange rate to USD avg	183.33	171.09	201.00	194.24	199.25
Exchange rate to EUR avg	251.31	251.66	280.28	270.00	265.00

Source: UniCredit Research

STRENGTHS

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

WEAKNESSES

- High public sector debt levels (above 80% in 2009)
- Uncertainties around the long term growth outlook
- High FX leverage in domestic private sector

Growth finally improves but domestic economy remains weak – monetary conditions to remain loose

Growth is finally improving but mostly on the back of export whilst domestic demand has weakened

Growth indicators are finally showing some signs of improvement but the details highlight that it is mostly driven from abroad with weak domestic demand actually surprising on the downside. The contraction of 4Q GDP improved to negative 4% from negative 7.1% yoy (negative 0.4% qoq seasonally adjusted from negative 1.2% qoq). The main contribution came from inventories (10% qoq) whilst the household contribution continued to fall by 1.4% qoq. Exports were up by 3.4% qoq whilst imports increased by 4.4% qoq. Higher frequency indicators show that the diverging domestic vs. external recovery trend continued in 1Q10. This coupled with increasing worries about Eurozone growth (our house forecasts a mere 0.9% yoy) means that we remain fairly bearish on GDP growth not only for 2010 (negative 0.6% yoy) but also for 2011 (only 2.4% yoy).

Recent inflation data was distorted by basket change and regulatory price adjustment

Inflation: Although the Jan-Feb CPI numbers brought a surprise in both directions, we believe that the main trend in the underlying dynamic is still downward. One of the potential risk factors is likely higher commodity prices which are exaggerated by the weaker EUR. In summary, we slightly increased our 2010 inflation projection (to 4.2% yoy) but left the 2011 forecast unchanged below the NBH 3% medium term target (at 2% yoy).

We forecast rates at 5% by the end of 2010…

Monetary policy: We believe the above described macro background creates room for 75-100bp monetary easing by year end (we also feel that the structure of the MPC is now generally more dovish than before following the expiry of two mandates). This relatively dovish call is supported by our global view where we do not expect a rate change from the ECB this year and we have just postponed our first rate hike call on the Fed. This call on the NBH interest rate outlook is about 25-50bp below consensus.

… but political changes will be important

Politics: The first round of the parliamentary election was held on 11 April. According to the final results the Fidesz has won a landslide victory receiving 52.7% support with its party lists. The current governing party MSZP came second with 19.3% followed by the radical right wing party Jobbik with 16.7% support. Only one more party (the liberal-green LMP) made into the parliament with 7.4% support. We believe the Fidesz has a fair chance to secure a two third majority in the second round (25 April). This is important as it makes much easier to for the Fidesz to implement structural reforms such as the number of local governments. The fiscal policy of the Fidesz looks pretty unclear but based on their previous comments they will probably try to increase the 2010 and 2011 budget deficit targets (3.8%/GDP and 2.8%/GDP). Fidesz claims that the true 2010 deficit is around 7.5% due to several one-off elements and underestimated revenues. As this change needs to be approved by the IMF/EU we expect a renegotiation of the existing program and most probably a new one as well. We expect only a moderate fiscal loosening for this year (to around 5%/GDP) whilst the 2011 number will also increase (to around 4.5%/GDP). The key longer term issue for the new government remains debt sustainability and growth. Although the recent substantial decline in long end interest rates (by around 100bp in 1Q) makes the job of the next government somewhat easier, Hungary will likely need to keep the primary balance in a small surplus (around 1%/GDP in the coming years in order to ensure declining public debt ratio). Looking at the recent developments in Greece we believe this criterion is becoming more important for the EU.

We still do not see EUR/HUF substantially below current levels

Rating might be upgraded in H2 2010

Due to the relatively weak growth outlook (and higher dependency on exports) we do not believe that the National Bank is interested in steering the EUR/HUF rate substantially below the current levels. Indeed EUR/HUF remained fairly stable during the last quarter due to dovish monetary policy. We forecast somewhat weaker HUF in the coming months compared to the current level and do not see it below 265 in the coming 12M. We believe that rating agencies will take a wait and see approach for now. As we do not believe that the fiscal outlook will deteriorate much we expect upgrades but most probably not earlier than in 4Q10.

Latvia

Outlook

It looks like the economy bottomed out in 3Q09 and has been improving slightly over the past few months. Meanwhile, the internal devaluation strategy has seen the real exchange rate depreciate, which has helped the export sector. We believe, however, that Latvia still has to go through some large economic readjustments and see the developments on the political front as a threat to stability in the short- to mid-term.

Author: Anna Kopetz, Economist (UniCredit CAIB)
+43 5 05 05 82364, anna.kopetz@caib.unicreditgroup.eu

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

MACROECONOMIC DATA AND FORECASTS

	2007	2008	2009	2010F	2011F
GDP (EUR bn)	21.0	23.2	18.8	16.4	14.6
Population (mn)	2.3	2.3	2.3	2.3	2.2
GDP per capita (EUR)	9,218	10,197	8,357	7,286	6,488
GDP (constant prices yoy %)	10.0	-4.6	-18.0	-2.5	5.5
Private Consumption, real, yoy (%)	14.8	-5.2	-22.4	-8.7	2.4
Fixed Investment, real, yoy (%)	7.5	-15.1	-37.7	22.9	3.6
Public Consumption, real, yoy (%)	3.7	1.5	-9.2	-11.6	-7.7
Exports, real, yoy (%)	10.0	-1.3	-13.9	0.8	10.5
Imports, real, yoy (%)	14.7	-13.6	-34.2	-2.6	2.3
CPI (average, yoy %)	10.1	15.5	3.6	-3.0	1.5
Central bank reference rate	6.00	6.00	4.00	4.00	3.00
Monthly wage, nominal (EUR)	565	682	655	535	453
Unemployment rate (%)	6.0	7.5	17.2	21.8	18.2
Budget balance (% of GDP)	-0.4	-4.0	-8.6	-8.6	-6.7
Current account balance (EUR bn)	-4.6	-3.0	1.8	1.4	1.0
Current account balance (% of GDP)	-23.8	-13.0	9.4	8.7	6.9
Net FDI (EUR bn)	1.4	0.7	0.1	0.2	0.4
FDI (% of GDP)	6.8	3.0	0.4	1.4	2.7
Gross foreign debt (EUR bn)	28.4	29.8	27.7	25.3	19.4
Gross foreign debt (% of GDP)	135.1	128.5	147.0	154.2	133.2
FX reserves (EUR bn)	3.8	3.5	4.8	2.3	2.5
(Cur.Acc-FDI)/GDP (%)	-14.9	-10.0	9.8	10.1	9.6
FX reserves/Gross foreign debt (%)	13.4	11.8	17.3	9.1	12.9

Source: UniCredit Research

STRENGTHS

- Significant IMF and EU balance of payments support
- Some improvements in fundamentals

WEAKNESSES

- Political instability
- Doubts about sustainability of the currency regime
- High FX leverage in domestic private sector

Fundamentals gradually improving – politics unstable

Economy bottomed out in 3Q09

It appears as if the economy bottomed out in 3Q last year, when real GDP contracted by 19% yoy; 4Q saw a slight improvement to -16.8% yoy, leading to a full year contraction of 18% yoy. The deep recession seen last year was broad-based, with fixed capital decreasing by 37.7% yoy, private final consumption falling by 22.3% yoy and exports and imports by 13.9% yoy and 34.2% yoy, respectively. For 2010 we stick to our forecast of negative growth of 2.5-4.0% yoy, driven by a further fall-off in internal demand and a rather suppressed recovery in exports. Some uncertainty is attached to the 2009 figures (as they are subject to updates by the statistics office, especially the GDP figure), which means that the months to come are very likely to see some narrowing in our 2010 headline GDP call.

C/A improving quickly

The C/A deficit saw an impressive unwinding over the past quarters – it improved from a 3 year average of -20% to GDP to a surplus of 9.4% to GDP in 2009. This was mainly due to the sharp fall-off in imports which was more pronounced than that of exports: the 2009 levels of merchandise exports and merchandise imports stood at 79% and 60% of the 2008 values, respectively. On the financing side, the largest flows were seen in the "other investment balance" – the outflows seen in the banking balance (i.e. local banks repaying their FX loans) were, however, almost offset by the inflows from the international loan to the general government balance. The overall picture shows an increase in reserve assets as well (by around LVL 650mn representing approximately 25% of early 2009-reserves). Net FDI were very modest in 2009, coming in at less than 10% of the 2008 values. We don't expect a major pick-up this year and pencil in a net FDI to GDP ratio of 1.4% for 2010.

Deflation expected for 2010, improvements in the real exchange rate

Deflation deepened over the past months reaching -4.2% yoy in Feb. We expect deflation to continue throughout 2010 and pencil in an average CPI figure of -3.0% yoy. Devaluation, coupled with falling wages, will definitely not help the already very depressed private consumption figures. The fall in prices, however, helps the readjustment of the real imbalances: the real exchange rate (CPI based, source BIS) depreciated smoothly over the last months, coming down by 8.5% since its peak in February 2009. Accordingly, Latvia has seen a continuous increase (with a small fall-back at the end of last year) of its export-share to the EU-15 (3M moving average) since the beginning 2009, despite remaining below trend.

Some improvements in fundamentals...

The steady increase in Latvia's export share (with EU-15), the depreciation in the real exchange rate, the observed pick up in recent export data and some modest improvement in monthly indicators (retail trade and industrial production), mean that the case for devaluation is becoming weaker. Nevertheless, we still see some risk, stemming mainly from politics. Having said that, it should be noted that even with improvements in the fundamentals in place, there is still room for arguing that a devaluation is sensible from an economic point of view (especially with the outlook of only a modest recovery in the Eurozone) .

but politics still unclear

Threat of a devaluation still on the horizon

Since the People's Party left the government, the political situation in Latvia has lacked clarity: PM Dombrovskis now heads a minority government that is unable to push decisions through parliament without the help of one of the opposition parties. In this regard the Latvia's First Party (LPP) granted in March 2010 its support to the minority government. However considering the possibility of additional disagreements among the political parties and/or the eventual LPP's withdraw of support Government's position remains weak, representing a major threat to the international loan agreement. According to the agreement, Latvia is not allowed to run a budget deficit of more than 8.5% to GDP in 2010. If the originally planned budget for 2010 were in place, this would probably present less of a problem – but with the reversal of the decision concerning the pension cuts by the Constitutional Court at the end of last year it looks to be very difficult to meet the 8.5% target without the implementation of further austerity measures. The challenge of implementing further austerity measures ahead of the general elections in October 2010 coupled with being a minority government with the support of an opposition party (at the time of writing) seems to be too big of an obstacle to overcome. Accordingly, we still see some risk of devaluation especially in the run-up to the elections.

Lithuania

Outlook

After the full-year contraction in economic activity of 15% yoy in 2009, we believe the recession has bottomed out. However, we still expect negative growth figures in GDP headline data this year. A big challenge is the reigning in of public finances – the plan of reducing the budget deficit to 3% within the next 3 years seems to be very ambitious to us, especially against the backdrop of a further GDP contraction this year and only a gradual economic recovery thereafter.

Author: Anna Kopetz, Economist (UniCredit CAIB)
+43 5 05 05 82364, anna.kopetz@caib.unicreditgroup.eu

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

MACROECONOMIC DATA AND FORECASTS

	2007	2008	2009	2010F	2011F
GDP (EUR bn)	28.4	32.2	26.7	25.9	27.1
Population (mn)	3.4	3.4	3.4	3.3	3.3
GDP per capita (EUR)	8,420	9,569	7,971	7,734	8,110
GDP (constant prices yoy %)	8.9	2.8	-15.0	-3.0	3.0
Private Consumption, real, yoy (%)	12.4	4.0	-17.0	-6.0	2.6
Fixed Investment, real, yoy (%)	20.8	-5.9	-39.0	-5.0	4.2
Public Consumption, real, yoy (%)	3.3	7.9	-2.1	-2.1	-1.9
Exports, real, yoy (%)	4.3	12.2	-15.3	-0.4	6.0
Imports, real, yoy (%)	11.6	10.5	-28.9	-3.7	4.4
CPI (average, yoy %)	5.7	11.0	4.5	-0.4	0.9
Monthly wage, nominal (EUR)	522	654	625	578	520
Unemployment rate (%)	4.3	5.8	13.5	16.6	16.3
Budget balance (% of GDP)	-1.2	-3.2	-9.1	-9.2	-7.4
Current account balance (EUR bn)	-4.1	-3.8	0.9	1.2	1.1
Current account balance (% of GDP)	-14.6	-11.9	3.2	4.5	3.9
Net FDI (EUR bn)	1.0	1.0	0.1	0.5	0.8
FDI (% of GDP)	3.6	3.2	0.3	1.9	3.1
Gross foreign debt (EUR bn)	20.5	23.0	24.5	24.7	25.0
Gross foreign debt (% of GDP)	72.3	71.6	91.6	95.6	92.3
FX reserves (EUR bn)	5.2	4.6	5.1	3.9	4.3
(Cur.Acc-FDI)/GDP (%)	-11.0	-8.8	3.5	6.4	7.0
FX reserves/Gross foreign debt (%)	25.3	20.0	20.8	15.8	17.2

Source: UniCredit Research

STRENGTHS

- Rapidly unwinding external imbalances
- Politicians' determination to reign in the public deficit
- More limited risk of currency parity adjustment

WEAKNESSES

- Sharp contraction in economic activity
- Widening fiscal deficit

Stabilizing at low levels

Sharp contraction in 2009, negative growth figures still to be expected…

The Lithuanian economy contracted by 15% yoy in 2009. The decline of 12.8% yoy seen in 4Q09 was already considerably better than the -19.5% seen in 2Q09, but still deeply in the red. The pattern of a broad-based decline in economic activity is very similar to that seen in Latvia and Estonia: very sharp falls in fixed capital formation (-39.0% yoy in 2009) and private final consumption (-17.0% yoy), as well as fall-offs in exports and imports, whereby the latter proved to be more pronounced than the former (-15.3% yoy and -28.9% yoy, respectively). The most recent figures show some stabilization, but the values are still very low (retail trade figure in February 2010 came in at -16.0% yoy, IP registered -4.8% yoy).

Lithuania's growth outlook is improving: we have revised our full year GDP forecast upwards. This optimism stems mainly from a more positive view on the development in export data. For the months to come, we expect a further contraction in economic activity and pencil in a full year real GDP figure of -3.0% yoy. The main drivers of this contraction will be a continuation of declining private consumption figures as well as very weak (namely slightly negative) real export figures. Another factor to weigh negatively on economic activity is the closure of the nuclear power plant Ignalina at the end of last year, which is likely to drive energy prices up (this is already evident in recently published CPI data).

External accounts moving into surplus

The recent sharp fall-off in imports is already reflected in the C/A data. The 2009 full-year figure came in at a surplus of 3.2% to GDP, better than we had expected and considerably up on 2008's C/A deficit of 11.9%. Given our view on the development of exports and imports, we expect the C/A surplus to improve this year by around 1pp and see some deterioration when domestic demand and imports pick up again in 2011. Net Foreign Direct Investment saw a sharp drop over the last year – Lithuania received one tenth of the FDI received in 2008, which represents the worst performance compared to Latvia and Estonia. For this year we expect some improvement, although we think that there might be some "crowding out" of FDI because of the very likely adoption of the euro in Estonia which might make Estonia more attractive for FDI than its Baltic peers.

In deflation since the beginning of 2010

At the beginning of 2010 Lithuania slipped into the deflationary zone: as seen in Latvia and Estonia, the sharp recession coupled with political measures has led to price cuts. Despite the fact that the electricity prices increased (as expected, because of the closure of the nuclear plant), the headline CPI figures since January have been in the red. We expect this development to continue and see some acceleration in the pace of falling prices in the months to come; approaching the end of the year, we pencil in some pick-up in price growth. Overall, we expect a full-year average CPI growth rate of -0.4% yoy after last year's full-year average of 4.5% yoy.

Ambitious budgetary consolidation plans

Lithuania's politicians are still committed to reigning in public finances: The budget deficit of 2009 (the final figures is expected to come in at -9.1% to GDP) is planned to be gradually whittled away over the coming years to finally amount to less than 3% to GDP in 2012. We are very skeptical about this objective and forecast an almost unchanged budget deficit for 2010 vis-a-vis 2009.

More limited risk of change in the currency-parity

A better global environment and improving conditions in the three Baltic States are easing the pressures on a possible adjustment in the currency parity over the short- to medium-term. To this, we should add that Lithuania still has the option to ask for international help if need be.

Poland

Outlook

We believe Polish GDP will continue to print strong numbers in 1Q and 2Q10 but this trend is expected to lose steam later in the year. Despite strong GDP numbers we believe the recovery at this stage is non-inflationary as conditions for domestic demand continue to deteriorate whilst monetary conditions (particularly the PLN) are tight. Consequently, our view on the NBP is fairly dovish. The political situation was overthrown with the tragic death of the President of Poland and many key policymakers (including the Governor of the Central Bank) in a plane accident on 10 April.

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

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

MACROECONOMIC DATA AND FORECASTS

	2007	2008	2009	2010F	2011F
GDP (EUR bn)	310.8	362.0	310.5	344.7	370.8
Population (mn)	38.1	38.1	38.2	38.1	38.1
GDP per capita (EUR)	8,154	9,492	8,134	9,050	9,743
GDP (constant prices yoy %)	6.8	4.9	1.7	2.6	2.7
Private Consumption, real, yoy (%)	4.9	5.9	2.3	2.1	2.5
Fixed Investment, real, yoy (%)	17.6	8.2	-0.3	-1.4	2.0
Public Consumption, real, yoy (%)	3.7	7.6	1.2	2.3	2.4
Exports, real, yoy (%)	9.1	7.2	-8.9	6.0	7.5
Imports, real, yoy (%)	13.7	8.2	-14.3	5.6	6.5
CPI (average, yoy %)	2.5	4.2	3.5	2.3	2.6
Central bank reference rate	5.00	5.00	3.50	3.75	4.25
Monthly wage, nominal (EUR)	762	820	834	889	909
Unemployment rate (%)	12.7	9.8	11.0	12.6	12.4
Budget balance (% of GDP)	-2.0	-3.6	-7.2	-7.1	-6.6
Current account balance (EUR bn)	-14.7	-18.3	-5.0	-6.9	-8.3
Current account balance (% of GDP)	-4.7	-5.1	-1.6	-2.0	-2.2
Net FDI (EUR bn)	17.2	10.0	8.4	10.0	10.0
FDI (% of GDP)	5.5	2.8	2.7	2.9	2.7
Gross foreign debt (EUR bn)	159.1	172.8	192.2	198.6	214.0
Gross foreign debt (% of GDP)	48.4	56.7	61.9	57.6	57.7
FX reserves (EUR bn)	44.7	44.1	55.2	61.4	68.4
(Cur.Acc-FDI)/GDP (%)	0.8	-2.3	1.1	0.9	0.5
FX reserves/Gross foreign debt (%)	28.1	25.5	28.7	30.9	32.0
Exchange rate to USD eop	2.47	2.97	2.86	3.04	3.08
Exchange rate to EUR eop	3.60	4.15	4.10	4.20	4.00
Exchange rate to USD avg	2.76	2.39	3.10	2.91	2.97
Exchange rate to EUR avg	3.78	3.52	4.33	4.05	3.95

Source: UniCredit Research

STRENGTHS

- The only EU country with positive GDP growth in 2009
- Sound corporate and banking sector
- EU funds offset decline in private sector investments

WEAKNESSES

- High budget deficits and accompanying borrowing needs
- Deteriorating labor market and weaker private consumption
- Lack of fiscal reforms in the next two years

Positive momentum to lose steam gradually

Key forecast changes and rationale

We maintain our basic scenario of strong GDP growth in the first half of the year, with a slight amendment due to the harsh weather conditions in most of 1Q – snow and ice hit construction work and, to some extent, retail sales and industrial output. This suggests that 2Q10 GDP growth will be marginally stronger than in 1Q (which we estimate at around 3.0% yoy). We had initially assumed 1Q would be the strongest quarter in terms of GDP growth in 2010. However, this does not change the big picture; in that we continue to expect 1H10 to be strong and 2H10 to show visible signs of growth losing momentum, as the labor market continues to deteriorate hurting private consumption and the strengthening zloty impairs the key engine of 2009 growth, net exports. On a positive note, it looks as if investments will be less negative than we previously thought (-3.3%) – now we project -1.4%. That revision is responsible for most of the revision of our 2010 GDP growth forecast, from 2.3% previously to 2.6% now.

In line with our expectations expressed three months ago, EUR/PLN managed to breach 4.00 – however, we reiterate our call that 2Q10 will likely see the zloty reversing its multi-month appreciation, as it will probably anticipate weaker growth momentum and more visible state budget problems in the second half of the year. In our core scenario CPI inflation is likely to fall until early Summer 2010, bottom slightly below 2.00% yoy and rebound towards 2.3% at YE 2010. This is one of the reasons why we are constructive on the POLGBs; the global deceleration of monetary aggregates creates a risk of a deflationary impulse, which will likely be another supportive factor for T-bonds.

Policy response

There have been several statements from the NBP President on the necessity to “start thinking about interest rate hikes”, based mostly on the NBP’s Inflationary Projection showing CPI above the upper end of the inflationary target (1.5%-3.5%) circa 2 years from now. This seems to be a lonely voice at this stage, given the expected fall in inflation, as well as the fact that even the NBP forecasts sub-potential GDP growth in the next three years. Our core scenario continues to expect just one rate hike this year, but a no-hikes scenario would not be a big surprise, especially if CPI turned out softer and/or zloty strengthened more than currently assumed.

The key medium- and long-term problem is the lack of adequate policy response to high deficits – 2010 will see a public sector deficit of around 7% of GDP, only slightly better than in the previous year, and the next 2 years will likely see deficits around 6% of GDP. Recently the EU, commenting on Poland’s Convergence Program, pointed out that public finance reforms are hardly ambitious, and – except for a strong growth scenario – insufficient to meet the Maastricht criteria in the next few years. Unfortunately, this problem is likely to continue, as presidential elections this year and parliamentary ones next year make politicians unwilling to propose any public finance reforms, as these would have to include tax hikes or spending cuts. Such high deficits add to the volatility of the domestic FX and FI markets – now that the mood is positive and markets expect strong GDP growth, and thus lower borrowing needs, yields are pushed lower and the zloty stronger. However, the situation may reverse in the second half of the year, turning the virtuous cycle into a vicious one, and we would become cautious on POLGBs and PLN as the year progresses.

Political outlook

The political situation was overthrown with the tragic death of the President of Poland and many key policymakers (including the Governor of the Central Bank) in a plane accident on April 10. The immediate impact on markets was muted, and the impact on the economy is hard to gauge at this stage – theoretically, it can negatively influence private consumption, as mediocre increase of disposable income could be additionally dampened by deterioration of social mood. However, it’s just a risk scenario at this stage. The tragedy accelerated the Presidential elections – which will be held at the end of June.

Romania

Outlook

Romania will exit recession in 2010 but will have to tackle the worsening social conditions that will drag on consumption while the investment recovery will probably shift to the second part of the year. Fiscal slippage remains one of the main country risks given the rigidity of social spending and depressed budget revenues. The IMF's review mission in late March remained optimistic, though.

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

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

MACROECONOMIC DATA AND FORECASTS

	2007	2008	2009	2010F	2011F
GDP (EUR bn)	123.7	136.9	115.9	126.0	139.2
Population (mn)	21.5	21.4	21.3	21.2	21.1
GDP per capita (EUR)	5,745	6,391	5,439	5,941	6,598
GDP (constant prices yoy %)	6.2	7.1	-7.1	0.4	3.5
Private Consumption, real, yoy (%)	9.8	8.4	-9.2	0.7	4.6
Fixed Investment, real, yoy (%)	29.0	19.3	-25.3	-0.2	5.0
Public Consumption, real, yoy (%)	7.6	3.7	1.2	2.0	2.7
Exports, real, yoy (%)	7.9	19.4	-5.5	4.8	7.0
Imports, real, yoy (%)	27.2	17.5	-20.6	5.2	9.5
CPI (average, yoy %)	4.8	7.9	5.6	4.0	3.9
Central bank reference rate	7.50	10.25	8.00	6.25	5.75
Monthly wage, nominal (EUR)	312	347	326	351	381
Unemployment rate (%)	4.3	4.0	6.3	8.5	7.0
Budget balance (% of GDP)	-2.3	-4.9	-7.4	-6.0	-5.0
Current account balance (EUR bn)	-16.7	-16.9	-5.1	-6.4	-8.0
Current account balance (% of GDP)	-13.5	-12.3	-4.4	-5.1	-5.7
Net FDI (EUR bn)	7.2	9.0	4.9	5.0	5.6
FDI (% of GDP)	5.8	6.6	4.2	4.0	4.0
Gross foreign debt (EUR bn)	38.7	51.4	64.2	72.1	77.9
Gross foreign debt (% of GDP)	31.3	37.6	55.4	57.2	56.0
FX reserves (EUR bn)	27.2	28.3	30.9	30.2	28.7
(Cur.Acc-FDI)/GDP (%)	-7.7	-5.7	-0.1	-1.1	-1.7
FX reserves/Gross foreign debt (%)	70.2	55.0	48.1	42.0	36.9
Exchange rate to USD eop	2.45	2.89	2.95	2.97	3.08
Exchange rate to EUR eop	3.58	4.03	4.23	4.10	4.00
Exchange rate to USD avg	2.43	2.50	3.04	2.96	3.05
Exchange rate to EUR avg	3.34	3.68	4.24	4.12	4.05

Source: UniCredit Research

STRENGTHS

- Significant IMF and EU balance of payments support
- Low public sector debt levels
- High roll-over rates of banks' external financing

WEAKNESSES

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

Public sector restructuring with IMF assistance

Romania's economy is set for a very slow recovery of 0.4% during 2010

GDP contracted by 7.1% in 2009 driven by the fall in private consumption (-9.2% yoy) and huge loss in investment (-25.3% yoy). On the positive side, inventories and exports entered positive territory in the third and fourth quarter. More encouraging is the rebound of industrial production, as industrial value added registered 4% yoy growth in the fourth quarter. In 2010 consumption will be affected by social pressures coming from both public and private restructuring (+0.7% yoy in 2010) while unfreezing of investment projects is expected to be shifted to the end of the year with depressed figures projected for the first quarter of 2010 (overall -0.2% yoy in 2010). Still, the outlook has improved due to lower financing costs (particularly in local currency). On the supply side, industrial production is expected to remain the main driver of the recovery boosted by external demand.

Disinflation trend to continue in 2010

Huge C/A correction amid good FDI coverage. Balanced external trade in 2010

The weak local demand will help the disinflation trend to continue during 2010. The Inflation rate is expected to enter the target band in 2010. The economy has been rebalanced with current account deficit declining to 4.4%/GDP largely covered by FDI (97% coverage). The sharp contraction has been driven by the narrowing trade deficit (-65% yoy) but helped also by current transfers less affected by the crisis (-31% yoy) and by a sharp reduction in outflows on the incomes balance (-42% yoy). We expect CA deficit with no major changes compared to the previous year but reversing its trend and slightly deepening towards 5% of GDP on the back of reaccelerating imports.

Monetary policy softening to continue in 2010

The NBR has cut its policy rates 150bp YTD while the interbank interest rate has been pushed below the key rate, amid persisting abundant liquidity on the inter-bank market. The monetary easing has been supported by RON appreciation and disinflation process. Due to the relatively limited inflation pressure, still negative output gap and likely ongoing appreciation pressure on the RON (due to C/A improvement) we expect the NBR to continue the easing cycle. Another MRR rate cut is also plausible during the year but is more likely in the second half of the year.

Budget deficit slippage remains the major risk for 2010 although with improved outlook for ample public sector restructuring

On the fiscal side, Romania ran a consolidated budget deficit of 1.08% of GDP in the first two months of 2010 while it aims to reduce the general government deficit from 7.4% of GDP in 2009 to 5.9% of GDP in 2010. In order to achieve this, further steps in adopting the wide-ranging structural reforms for reshaping the public sector need to be taken (unitary wage law, revised pension legislation and reorganization of state agencies). Separately, upon reviewing the government's convergence program 2009-2012, the EC concluded that Romania meets the conditions for assistance, but it needs further consolidation measures for 2011 and 2012. We see a significant risk of the budget deficit overshooting on social pressures but this may be offset to some extent by the strong anchoring ingredient of IMF assistance for current spending reduction and extensive public sector restructuring. Consequently, our expectation for the budget deficit is now close to the targeted level for this year with further rebalancing in the coming years.

Sovereign credit rating outlook still dependent on fiscal performance

Fiscal performance and external financing, conditional on the IMF/EU stand-by-agreement, **continues to be crucial for the credit outlook**. The IMF assistance and the strong balance of payment correction has brought stability to Romania as reflected by the Fitch and S&P rating outlook improvements to Stable from Negative in February and March 2010, respectively. Consequently, we believe the RON will be able to maintain its recent gains and we expect the EUR/RON to fluctuate around 4.10 supported by the improved balance of payment backdrop and relatively high rates. On the other hand given its potential negative consequence on the economic growth revival we would not rule out that the NBR might step in if EUR/RON significantly dips below the 4.10 level. Following the recent major rally in Romanian rates we believe the long end rates are now too low particularly on a regional basis.

Slovakia

Outlook

As industry roars ahead in Germany, Slovakia is likely to experience a stronger 1H10. While European growth is projected to slow down towards end-2010, Slovakia is likely to buck the trend due to the two factors: 1. The country attracted the production of a new car model and a new electronics producer and these EUR 500mn projects will be put to work in 2H10. 2. The government has decided to implement ambitious highway construction projects. The parliamentary elections in June 2010 will be the key event for the future policy agenda.

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

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

MACROECONOMIC DATA AND FORECASTS

	2007	2008	2009	2010F	2011F
GDP (EUR bn)	54.9	64.8	63.3	66.5	70.7
Population (mn)	5.4	5.4	5.4	5.4	5.4
GDP per capita (EUR)	10,165	11,968	11,722	12,311	13,095
GDP (constant prices yoy %)	10.6	6.2	-4.7	3.1	3.8
Private Consumption, real, yoy (%)	7.1	6.1	-0.4	-0.4	2.0
Fixed Investment, real, yoy (%)	9.1	1.8	-10.5	3.8	9.4
Public Consumption, real, yoy (%)	0.1	5.3	2.8	0.0	0.0
Exports, real, yoy (%)	14.3	3.2	-16.5	6.4	7.2
Imports, real, yoy (%)	9.2	3.1	-17.6	6.6	6.8
CPI (average, yoy %)	2.8	4.6	1.6	1.3	3.0
Central bank reference rate	4.25	2.50	1.00	1.00	2.50
Monthly wage, nominal (EUR)	669	723	745	761	799
Unemployment rate (%)	11.0	9.6	12.1	13.0	12.6
Budget balance (% of GDP)	-1.9	-2.3	-6.0	-5.7	-5.2
Current account balance (EUR bn)	-3.3	-4.2	-3.9	-3.1	-3.1
Current account balance (% of GDP)	-5.3	-6.5	-3.5	-3.7	-4.3
Net FDI (EUR bn)	2.7	1.7	1.2	1.8	0.9
FDI (% of GDP)	4.4	2.5	-0.3	1.5	1.3
Gross foreign debt (EUR bn)	32.4	35.9	45.4	52.4	58.9
Gross foreign debt (% of GDP)	59.0	55.4	71.6	78.8	83.2
(Cur.Acc-FDI)/GDP (%)	-1.1	-3.9	-4.4	-1.9	-3.0

Source: UniCredit Research

STRENGTHS

- Banking sector in good shape
- Some FDI interest due to euro adoption and tax system
- Euro adoption protected the country

WEAKNESSES

- Euro adoption does not allow currency depreciation to improve price competitiveness
- Very dependent on world trade as industry is the main engine of growth (autos, electronics, steel)
- A possible tax hike after the elections and a prolonged fiscal deficit

Watch out for upcoming elections

Slovak 2010 GDP forecasts

	previous	new
NBS	2.9	3.1
MinFin	1.9	2.8
UniCredit	**2.6**	**3.1**

Slovak 2011 GDP forecasts

	previous	new
NBS	4.2	4.3
MinFin	4.1	3.3
UniCredit	**3.8**	**3.8**

The Slovak economy continues to rebound more strongly than its neighbors after a deeper recession in 1H09. Due to base effects, 3% growth should be attainable this year even after penciling in a weaker 2H10. Unemployment stopped rising at the end of 2009, peaking at 13% and jumping 5.5% during the crisis, the biggest adjustment among the four Central European countries (Hungary, Czech Republic, Slovakia, Poland). Mirroring stronger German PMI and IFO data, the Slovak industry should see a strong 1H10 as new orders to stocks still remain high. As fiscal stimuli wear off (cash for clunkers scheme finishes this summer in most countries), industrial growth is likely to slow down. High unemployment, coupled with the lagged construction sector, will keep the rest of the economy in a pretty weak position. Consumption should fall and the real estate market will reach the bottom only this year.

Stronger 1H10 in industry is accompanied by weak domestic services and construction

It is worth noting that even during the crisis, the country managed to attract EUR 500mn projects into autos and electronics. They will gradually be put to work in 2H10. More specifically, a small-sized family car is to expand Volkswagen capacity by one third. What's even more important is that the new model will suit today's demand probably more than the present SUVs. Meanwhile, a new Taiwanese electronics plant, in addition to the expansion of existing Korean plants (Au Optronics and Samsung), will increase output.

Slovakia continues to enjoy zero real interest rates

In the run up to the elections the government is rushing to finalise chunky PPP projects (public and private partnership), amounting to more than EUR 5bn or more than 9% of GDP during the next 5 years. We therefore expect growth to continue to accelerate towards 4% in 2011. Inflation should remain low, but will rise from today's zero percent levels.

Government does not have a plan to consolidate the fiscal accounts, hopes for recovery to do the job

The public deficit reached 6% in 2009 (from 2.3% in 2008). However, we do not see any credible plans to tackle the fiscal deficit. As the crisis results in permanent (or almost permanent) loss of output, the government has failed to follow up with reforms. The deficit could be slightly lower in 2010 on paper but it is not expected to fall in reality if one takes into account PPP projects (which are outside the official figures).

Higher unemployment cuts into popularity premium of the coalition

Despite the worsening fiscal policy, financing conditions remain very good. Slovakia continues to enjoy zero real interest rates. Country risk – calculated as the 10Y bond spread – remains low and hovers around 100bp despite the Greek jitters and is tighter than would correspond to the country's rating.

Key parliamentary elections scheduled for June 2010

Parliamentary elections will be held in June. As almost 1/3 of voters show a preference for junior parties that could possibly miss the 5% minimum threshold to get into parliament, a broad mix of election outcomes is possible. The worsening financial conditions of households have cut into the government's popularity. The popularity of market-oriented opposition parties has edged up from 35% six months ago to 45% today.

SMER-headed government will likely opt for a higher deficit instead of hiking taxes

Despite this, the likely election outcome (60-70% probability) is a SMER government being mandated for another term. In this instance, there is no ambitious reform agenda in place either on the spending or revenue front. Hence, there is a danger of tax increases after the elections. We assume, however, that the government will opt for a higher deficit after implementing cosmetic changes to revenues (possibly through a hike in the flat tax from 19% to 20-21%, if any). The government will allow automatic stabilizers to do some fiscal consolidation, while the euro together with the low levels of public debt will provide some short-term leeway. The deficit is likely to stay high in the years ahead.

Slovenia

Outlook

The economy entered 2010 with less momentum, but improving sentiment indicators point to a healthier full year performance. We expect the budget deficit to remain high, but even though we forecast a rise in public debt to near 40% of GDP this year, access to international finance for the government is not a problem. External debt, at 115% of GDP in 2009, remains the main weakness and also a possible drag on future growth.

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

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

MACROECONOMIC DATA AND FORECASTS

	2007	2008	2009	2010F	2011F
GDP (EUR bn)	34.5	37.1	34.9	35.7	37.1
Population (mn)	2.0	2.0	2.0	2.1	2.1
GDP per capita (EUR)	17,169	18,366	17,105	17,400	17,994
GDP (constant prices yoy %)	6.8	3.5	-7.8	0.6	1.5
Private Consumption, real, yoy (%)	5.3	2.2	-2.6	-1.4	1.5
Fixed Investment, real, yoy (%)	11.9	6.6	-21.6	0	3.9
Public Consumption, real, yoy (%)	2.5	3.7	3.0	0	1.0
Exports, real, yoy (%)	13.8	3.4	-15.6	1.0	2.3
Imports, real, yoy (%)	15.7	3.8	-17.9	3.6	4.2
CPI (average, yoy %)	3.6	5.7	0.9	1.6	2.5
Central bank reference rate	4.00	2.50	1.00	1.00	2.50
Monthly wage, nominal (EUR)	1,284	1,391	1,439	1,470	1,505
Unemployment rate (%)	4.9	4.5	5.9	6.8	6.3
Budget balance (% of GDP)	0	-1.8	-5.6	-6.6	-6.5
Current account balance (EUR bn)	-1.5	-2.3	-0.3	-0.5	-0.9
Current account balance (% of GDP)	-4.2	-6.2	-1.0	-1.4	-2.4
Net FDI (EUR bn)	-0.3	0.4	-0.7	-0.2	0.1
FDI (% of GDP)	-0.8	1.0	-1.9	-0.6	0.3
Gross foreign debt (EUR bn)	34.8	39.0	40.1	42.5	45.5
Gross foreign debt (% of GDP)	100.7	105.1	115.0	119.1	122.7
(Cur.Acc-FDI)/GDP (%)	-5.0	-5.1	-2.9	-2.0	-2.1

Source: UniCredit Research

STRENGTHS

- Relatively low public debt levels
- Foreign debt essentially denominated in local currency
- Export orientation can lever off any Eurozone recovery

WEAKNESSES

- Highly leveraged banking sector
- Corporate sector relatively weak
- Lower price competitiveness

Economy enters 2010 with less momentum

Poor headline GDP numbers but underlying data point to a mild recovery in growth in 2010

Data for 4Q09 and early 2010 were fairly weak. In 4Q09 GDP fell 5.5% yoy, as the economy contracted 7.8% on average in 2009 (the sharpest drop among Eurozone countries), led by a 21.6% yoy drop in gross fixed capital expenditure. The economy did not noticeably improve in the final quarter of 2009, with the seasonally and working day adjusted data posting a 0.1% qoq expansion only. Industrial production figures for January 2010 revealed a contraction of 6.1% mom with only capital goods' production in positive territory. Confidence indicators are up (although well below average historical levels) with manufacturing and services leading the way, while consumer confidence has remained unchanged in the 6 months since October 2009. Meanwhile, construction sector confidence hit a record low in March 2010, suggesting investment will remain weak this year. Credit growth is also weak which will act as a constraint on the private sector.

Weak domestic demand keeps inflation low

The current account improved significantly in 2009: A net improvement of over EUR 1.4bn in the balance of goods and services was the main driver of a contraction in the current account deficit from 6.2% of GDP in 2008 to 1.0% in 2009. In January export growth was essentially flat, while imports of goods and services fell 2.7% yoy, reflecting both weak demand in key export markets and weak domestic demand. Inflationary pressures were muted in Slovenia with consumer prices averaging 1.4% yoy in Jan-Feb and we estimate core inflation remained in negative territory in this period.

GDP growth in 2010 seen at 0.6%

No change to our major forecasts. Overall, the Slovenian economy entered 2010 with less momentum. Nonetheless, sentiment indicators continue to point north for most sub-sectors which leaves us comfortable with our forecast of a mild recovery in GDP growth of 0.6% this year. Despite a 22.9% increase in minimum wages, we see private consumption in negative territory this year. Nonetheless, this increase represents another headwind for the private sector, in addition to weak credit growth and domestic demand in key export markets.

Fiscal stimulus drives widening of the budget deficit…

… but public debt still below 40% of GDP in 2010

Recession continues to impact fiscal accounts. The preliminary consolidated government figures point to a deficit of 5.6% of GDP (EUR 2.0bn) for last year and in January 2010 the central budget deficit amounted to EUR 220mn, compared to a surplus (of EUR 6mn) in January 2009. The European Commission has cautioned that the authorities' fiscal projections are too optimistic and we maintain our view that the budget deficit this year could exceed 6.5% of GDP. The recession has also highlighted the importance of pension reform, which is currently being discussed in Slovenia. Namely, in 2008 transfers from the general government budget to the pension fund rose 8.9% yoy to EUR 1.2bn and again by 11.9% yoy in 2009 to EUR 1.3bn.

Government squabbles remain a distraction

Squabbles risk distracting government. We do not see the recent resignation of the Minister of Agriculture, the Minister of Finance being under public scrutiny for non-policy issues and the recent debate over whether to hold a binding or non-binding referendum on the treaty agreed with Croatia over an ongoing dispute as issues which will threaten the government. Rather, we see this as increasing the risk of distracting the government from focusing on economic policy issues. Moreover, the recent decision taken by the Government to hold a binding referendum on the treaty agreed with Croatia over an ongoing dispute could risk, in case of negative response from the population, to put Pahor Government under pressure, since the PM has targeted the resolution of the border dispute as one of his top foreign policy goals.

Sovereign credit rating stable on low public debt

Slovenia's low public debt and EMU membership are a big plus for its sovereign credit rating. Even though we forecast a rise in public debt to near 40% of GDP this year, access to international finance for the government is not a problem. External debt, at 115% of GDP in 2009, remains the main weakness and also a drag on future growth.

Bosnia & Herzegovina

Outlook

Domestic demand remains subdued and the credit market is not showing any signs of a clear and fast recovery. The IMF program is on course after the politically difficult reductions in war veterans' benefits were enacted. However, investment activity might be delayed until after October's general elections, which will be the main event of the year and will raise the political noise over the coming months.

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

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

MACROECONOMIC DATA AND FORECASTS

	2007	2008	2009	2010F	2011F
GDP (EUR bn)	11.1	12.6	12.1	12.3	12.6
Population (mn)	3.8	3.9	3.9	3.9	3.9
GDP per capita (EUR)	2,876	3,282	3,153	3,186	3,281
GDP (constant prices yoy %)	6.8	5.4	-3.5	-1.0	0.8
CPI (average, yoy %)	1.5	7.4	-0.4	2.1	2.2
Monthly wage, nominal (EUR)	488	568	616	620	633
Unemployment rate (%)	44.0	40.3	41.5	42.5	42.0
Budget balance (% of GDP)	-0.1	-4.0	-5.2	-4.5	-4.2
Current account balance (EUR bn)	-1.2	-1.9	-0.9	-0.8	-0.8
Current account balance (% of GDP)	-10.4	-15.1	-7.6	-6.3	-6.5
Net FDI (EUR bn)	1.5	0.7	0.4	0.5	0.5
FDI (% of GDP)	13.5	5.7	2.9	4.2	4.0
FX reserves (EUR bn)	3.4	3.2	3.2	3.1	3.1
(Cur.Acc-FDI)/GDP (%)	3.1	-9.4	-4.7	-2.1	-2.4
Exchange rate to USD eop	1.34	1.40	1.36	1.42	1.50
Exchange rate to EUR eop	1.96	1.96	1.96	1.96	1.96
Exchange rate to USD avg	1.43	1.33	1.40	1.41	1.47
Exchange rate to EUR avg	1.96	1.96	1.96	1.96	1.96

Source: UniCredit Research

STRENGTHS

- Significant support from International financial institutions
- Currency Board arrangement reduces policy uncertainty
- Foreign-owned banks are well capitalized

WEAKNESSES

- Election year complicates the already intricate political scene
- Domestic demand is remains weak
- Exports concentrated in commodities and steel

Approval of IMF tranche funds a big boost

Domestic demand remains weak…

Domestic demand remains subdued, production activity is still weak and the credit market is not showing any clear signs of recovery. Industrial production fell 0.5% yoy in January, according to the Agency for Statistics of Bosnia and Herzegovina. Wage growth is slowing sharply and fell in real terms in both entities in Jan-Feb 2010, while unemployment rose last year to over 20% on an internationally comparable basis. In the first two months of the year merchandise exports rose 18.0% yoy to EUR 498.7mn while merchandise imports fell 5.8% yoy (after recording a contraction of 23.6% yoy in the same period in 2009). This last figure highlights the weakness of domestic demand at present. Thus while the current account deficit just about halved to 7.6% of GDP in 2009 we expect it to continue contracting to 6.3% of GDP this year. Credit growth in the first two months of this year is down 3% while non-performing loans have doubled to 5.5% in the past half year. At the same time, banks have EUR 1.4bn deposited with the central bank in excess of their mandatory reserve requirements. In summary, demand for credit remains weak in Bosnia-Herzegovina.

…inflation forecast raised on administered price rises

Compared to the previous quarter our view on the economy remains essentially unchanged. We continue to expect a contraction in GDP of 1% this year. Before the elections investment activity in the private sector is likely to remain weak. We have, however, increased our CPI forecast from an average 1.1% to 2.1% in 2010 and from 1.8% to 2.2% in 2011. The main reason for this is that in January 2010 tobacco excise taxes rose 16.2% mom, while telephone charges rose 7.4% mom and primary school education costs rose 8.6% mom. Evidently, these increases in regulated prices will feed through to the headline CPI, even though the underlying CPI data continues to point to weak domestic demand this year.

Structural reforms passed by parliament ensuring disbursement of IMF and World Bank money

The IMF approved a EUR 138.4mn disbursement to Bosnia Herzegovina in late March. The key to this decision was the passing of legislation in the Federation of BiH and Republika Srpska (RS) in late February reducing the benefits of war veterans. In addition, disbursement of the third tranche was conditional on the passing of laws improving the targeting of the benefits of other social groups and creating appropriate welfare programs. Evidently, the disbursements of these two tranches will ease the pressure on the fiscal positions of the Federation and Republika Srpska. In addition, the World Bank has approved a USD111mn loan (initially scheduled for December 2009).

Elections to be held in October which will lead to an increase in political noise in the coming quarters

With the **general elections in October already in focus**, comments by the Prime Minister of RS in recent months calling for a referendum on succession and in late March for possible talks on a “peaceful separation” have been condemned by the High Representative and other international community representatives. Ahead of the elections populist rhetoric will increase, but we would note that, given the dependence of the authorities on the IMF program, when push comes to shove, the authorities will eventually implement conditions set by the IMF and World Bank to gain access to financing. This attitude was seen with the politically very challenging reduction in war veterans’ benefits which took months to navigate through the legislative process but was finally approved. Nonetheless, constitutional and electoral law amendments could very easily be delayed until after October’s poll and progress on EU accession is likely to remain very slow.

No change to sovereign rating expected

S&P affirms Bosnia’s B+ (stable) credit rating in December. We expect no change to the country’s sovereign credit rating in the coming 12 months. This is especially the case now that the IMF in late March 2010 finally approved the second and third tranche disbursement of funds (following the standstill at the end of 2009). This removes the main source of uncertainty since it means unequivocally that the IMF program is on track. The level of reserves, essential for the maintenance of the currency board, remains at very comfortable levels (EUR 3.0bn in February 2010, representing over 5 months cover of imports of goods and services).

Croatia

Outlook

Although the trend in industrial production has been positive during 1Q10, the pace of expansion is too weak to suggest a sustained recovery. Budget revenues were weak during the first two months of the year, while the current account deficit continues to narrow and the currency remains stable. Croatia continues to move along the EU accession path and should be able to open all chapters of EU accession process this quarter.

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

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

MACROECONOMIC DATA AND FORECASTS

	2007	2008	2009	2010F	2011F
GDP (EUR bn)	42.8	47.4	45.4	45.5	47.4
Population (mn)	4.4	4.4	4.4	4.4	4.4
GDP per capita (EUR)	9,654	10,681	10,245	10,282	10,706
GDP (constant prices yoy %)	5.5	2.4	-5.8	-1.0	1.3
Private Consumption, real, yoy (%)	6.2	0.8	-8.5	-1.7	1.4
Fixed Investment, real, yoy (%)	6.5	8.2	-11.8	-4.5	1.9
Public Consumption, real, yoy (%)	3.4	1.9	0.2	0	1.0
Exports, real, yoy (%)	4.3	1.7	-16.3	-3.5	1.7
Imports, real, yoy (%)	6.5	3.6	-20.7	-6.0	2.7
CPI (average, yoy %)	2.9	6.1	2.4	1.5	2.4
Monthly wage, nominal (EUR)	961	1,044	1,050	1,058	1,086
Unemployment rate (%)	9.6	8.4	9.4	10.0	9.6
Budget balance (% of GDP)	-2.0	-1.4	-3.9	-4.9	-4.2
Current account balance (EUR bn)	-3.2	-4.4	-2.4	-2.0	-2.2
Current account balance (% of GDP)	-7.6	-9.2	-5.2	-4.4	-4.6
Net FDI (EUR bn)	3.5	3.2	1.0	1.3	2.2
FDI (% of GDP)	8.1	6.8	2.1	2.7	4.6
Gross foreign debt (EUR bn)	33.3	39.0	44.6	47.5	50.5
Gross foreign debt (% of GDP)	77.7	82.4	98.3	104.3	106.5
FX reserves (EUR bn)	9.3	9.1	10.0	10.5	11.5
(Cur.Acc-FDI)/GDP (%)	0.6	-2.4	-3.1	-1.7	0.1
FX reserves/Gross foreign debt (%)	28.0	23.4	22.4	22.1	22.8
Exchange rate to USD eop	5.03	5.29	5.09	5.36	5.68
Exchange rate to EUR eop	7.33	7.37	7.30	7.40	7.38
Exchange rate to USD avg	5.35	4.91	5.26	5.29	5.50
Exchange rate to EUR avg	7.34	7.22	7.34	7.35	7.32

Source: UniCredit Research

STRENGTHS

- EU accession in 2012 looks likelier
- Credible monetary policy response
- External imbalances adjusting quickly

WEAKNESSES

- Uncertainty over public sector borrowing requirement
- High FX leverage in household and private sector
- 2009 tax increases have adversely affected domestic demand

EU in sight but still no clear signals of a sustained recovery

No signs of a sustained recovery

Few signs of an upturn in 1Q 2010. The economy contracted 5.8% in 2009 (GDP was down 4.5% yoy in 4Q09) with private consumption down 8.5% yoy and investment spending contracting 11.8% yoy. Data released to date for 1Q10 offers few signs of an upturn. Although the trend in industrial production has been positive in early 2010, the pace of expansion is too weak to suggest a sustained recovery. Retail trade remains in deep negative territory falling 9.3% yoy in January while construction activity fell 18.4% yoy in real terms (and by 1.4% mom in sa terms). Inflationary pressures remain muted – in the two months since December 2009 consumer prices have risen 0.7%, but our calculations suggest core inflation is still falling.

GDP growth forecast remains -1.0%, inflation forecast lowered to 1.5% yoy

Inflation forecast revised down, fiscal deficit up. Despite the likelihood of higher electricity prices and our forecast of higher oil prices we see inflation averaging only 1.5% this year as the currency remains strong (moving in a very narrow range since June 2009) and domestic demand weak. We have revised our fiscal deficit up to 4.9% of GDP for three main reasons – 1. the central government budget figures for January and February 2010 paint a picture of deterioration; 2. the ongoing shipyard privatization initiative implies an, as yet, undefined cost to the government this year and 3. the government's decision to honor previous promises on subsidies to farmers this year and next will add at least HRK 300mn to the deficit this year.

Current account deficit to narrow further, EUR/HRK remains stable

The current account deficit is noticeably lower, but foreign debt is over 100% of GDP. The current account deficit in 2009 narrowed to around 5.2% of GDP from 9.2% a year earlier as imports of goods and services contracted EUR5.9bn (25%). In the first two months of this year the merchandise trade deficit narrowed by EUR200mn as imports, having fallen 27% in 2009, contracted a further 10.8%. Croatia's access to foreign markets will see foreign debt rise this year, but by a smaller amount than in 2009. We see foreign debt at around 104% of GDP at end 2010. As mentioned, the EUR/HRK was strong throughout the first quarter of 2010 with borrowing from corporates, the issuance of FX-linked t-bills in an otherwise less liquid market and a narrowing external deficit all contributing. Money market conditions remain extremely loose with Zibor rates near record lows. We maintain our view the central bank will not alter monetary policy settings as long as the currency remains stable.

Fiscal trends in early 2010 point to a budget rebalance

Budget revenues were down 0.5% in Jan-Feb 2010 while expenditures rose 6.4% yoy. The revenue side is not a surprise, while the increase in expenditures is greater than expected. The government continues to suggest a rebalancing is not required, but we are not convinced given the authorities have backed down in the face of protests from farmers, the cost to the budget of the ongoing shipyard privatization initiative remains unquantified and expenditure and revenue trends point to an overshooting of the deficit target. In 1Q10 the government issued two 10-year domestic bonds (HRK 3.5bn and EUR 350mn) and borrowed EUR 200mn from the World Bank.

All EU accession chapters should be opened in 2Q

Policy debate unfocussed despite looming tough choices. With the number of unemployed registered for social benefits in excess of 300,000 the economic policy debate remains in defensive mode with the focus on "saving jobs and anti-recession measures", yet the government is not exposed to much pressure to explain where growth will come from – the policy debate has yet to focus on how to enable the private sector to contribute. During 2Q the remaining EU accession chapters should be opened, which would boost the government. Nonetheless, tough decisions will have to be made to conclude EU accession talks this year.

EU talks and narrowing external imbalances positives for sovereign rating

No change to credit rating outlook is expected. We see no change in Croatia's sovereign rating during the coming months. Greater visibility on the potential closing date for EU accession talks should emerge once all chapters of *acquis communautaire* are opened during 2Q, which is a potential *plus*. But with foreign debt over 100% of GDP and the fiscal deficit widening we conclude no change is likely.

Kazakhstan

Outlook

A solid recovery began in 4Q09 and continued through 1Q10, helping us to decide in favor of a revision of our 2010 real GDP forecast from 2.5% to 3.5% – slow credit growth and lower quasi-fiscal spending will prevent an even faster growth for now. We see inflationary pressures returning in 2010 as consumer demand recovers, an additional factor to allow the KZT to appreciate slightly, as BoP inflows will remain favorable for FX.

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

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

MACROECONOMIC DATA AND FORECASTS

	2007	2008	2009	2010F	2011F
GDP (EUR bn)	76.1	89.8	77.3	90.1	113.5
Population (mn)	15.5	15.7	16.2	16.3	16.5
GDP per capita (EUR)	4,912	5,729	4,772	5,513	6,886
GDP (constant prices yoy %)	8.9	3.3	1.2	3.5	5.0
Private Consumption, real, yoy (%)	10.8	3.8	2.0	2.2	3.6
Fixed Investment, real, yoy (%)	17.3	1.7	-0.9	8.1	11.8
Public Consumption, real, yoy (%)	14.0	5.5	2.3	3.2	4.3
Exports, real, yoy (%)	9.0	1.8	-10.0	7.0	11.0
Imports, real, yoy (%)	25.5	-11.5	-17.0	6.0	14.0
CPI (average, yoy %)	10.8	17.2	7.3	7.7	7.5
Central bank reference rate	11.00	10.50	7.00	7.25	7.25
Monthly wage, nominal (EUR)	313	343	329	376	474
Unemployment rate (%)	7.6	6.6	6.6	6.2	6.1
Budget balance (% of GDP)	5.2	1.2	-4.3	-4.1	-2.0
Current account balance (EUR bn)	-6.0	4.7	-2.4	-2.6	-4.6
Current account balance (% of GDP)	-7.9	5.3	-3.2	-2.9	-4.0
Net FDI (EUR bn)	8.1	9.9	9.0	9.9	12.4
FDI (% of GDP)	10.7	11.0	11.7	11.0	10.9
Gross foreign debt (EUR bn)	65.8	77.3	77.5	74.9	75.4
Gross foreign debt (% of GDP)	86.5	86.0	100.2	83.1	66.4
FX reserves (EUR bn)	12.7	14.8	15.9	18.6	21.0
(Cur.Acc-FDI)/GDP (%)	2.8	16.3	8.5	8.1	6.9
FX reserves/Gross foreign debt (%)	19.3	19.1	20.5	24.8	27.8
Exchange rate to USD eop	120.68	120.88	148.36	135.00	135.00
Exchange rate to EUR eop	175.99	168.66	212.61	186.30	175.50
Exchange rate to USD avg	122.54	120.32	147.65	143.57	135.00
Exchange rate to EUR avg	167.99	176.98	205.89	199.56	179.55

Source: UniCredit Research

STRENGTHS

- Broad-based recovery since 4Q09
- Resilient FDI
- Ample foreign and fiscal reserves

WEAKNESSES

- Continued huge bank losses because of poor asset quality
- Slow credit growth
- Weak competitiveness of non-resource sectors as KZT appreciates

Back to growth

2009 GDP growth: +1.2%, with agriculture, telecoms and mining being the main drivers

Real GDP grew 1.2% yoy in 2009, up from -1.5% yoy in 1Q-3Q, according to StatAgency figures, on higher household consumption and sharply lower imports, even as gross fixed capital formation and exports had a negative impact on growth. The main drivers of growth by sector were agriculture (+13.8% yoy), telecoms (+8.3%) and mining (+6.1%). Financial intermediation (-10.6%), hotels-restaurants (-8.7%) and construction (-4.9%) fell sharply by contrast. While financial intermediation and hotels-restaurants continued to contract in 4Q, all other sectors started to see growth. There are unresolved data puzzles, e.g. 4Q09 growth alone amounts to 8.5% yoy, according to our estimates based on 1Q-3Q and full year StatAgency data. That a solid recovery began in 4Q09 and continued in 1Q10 seems nevertheless credible. Industrial output likely grew 11% yoy in 1Q, compared with 2.2% yoy in 2009. Recovery in constant price retail sales is even more pronounced: from -5.8% yoy in 2009 to an estimated +10.5% yoy in 1Q. We thus revise our 2010 real GDP forecast from 2.5% to 3.5%. Slow credit growth and lower quasi-fiscal spending will prevent even faster growth. We see a real GDP increase of 5% in 2011 thanks to strong demand for Kazakh fuels and metals and multiplier effects from large projects in road construction, power stations, oil and gas that started in 2010. Moreover, in the run-up to the 2012 presidential elections, social spending is likely to rise again late in 2011.

We upgrade our 2010 GDP forecast from 2.5% to 3.5%

Republican budget loosening, offset by lower quasi-fiscal spending

The 2010 Republican budget was amended slightly in March from its November version to account for recommendations President Nursultan Nazarbayev made in his annual speech to the nation, notably a 25% hike of civil servants' pay on 1 April and investments related to the "program of accelerated modernization and industrialization". Revenue was hiked by 9.8% to KZT 3378bn (18.8% of GDP by our estimates), spending by 10.2% to KZT 4182bn (23.3% of GDP) and the deficit from KZT 720bn to KZT 804bn (4.5% of GDP). This compares with an actual 3.2% of GDP deficit in 2009. We forecast a slight narrowing of the public deficit – Republican + local + Oil fund financed projects – from 4.3% of GDP in 2009 to 4.1% in 2010.

Banking system in the red, deep restructuring still ahead

The banking system made another loss of EUR 325mn in Jan-Feb 2010 (local accounting standards) due to poor asset quality after a total loss of EUR 13.8bn (18% of GDP) in 2009. With deep restructuring still ahead – though with improved prospects as Alliance and BTA reached (or almost reached) important agreements with creditors – credit growth will remain rather slow in 2010, although many banks now have sufficient liquidity.

Monetary easing a thing of the past

KZT to appreciate to perhaps 135 to the USD by year-end 2010

In 2009, the central bank cut its refinancing rate stepwise to 7% (by 350bp), citing disinflation. We see inflationary pressures returning in 2010 as consumer demand recovers and average custom rates increase as a consequence of the customs union with Russia and Belarus effective since 1 January 2010. The central bank widened its KZT/USD corridor from 150 +/-5 to 150 +15/-22.5 on 5 February 2010. Thanks to BoP inflows the KZT is and will remain under appreciation pressure.

FDI inflows more than sufficient to finance C/A deficit and debt repayments

FX reserves an impressive 15 month import cover

The C/A came in at a deficit of USD 3.4bn in 2009 (3.2% of GDP), compared with an USD 6.6bn surplus in 2008. We forecast an average 2010 oil price (Brent) of USD 85 per barrel, up 35% on 2009, but nevertheless expect a deficit of 2.9% of GDP because reaccelerating import growth and rebounding profits from FDI will offset higher export prices. Net inward FDI inflows remained at a robust USD 12.6bn in 2009, which is, however, 20% lower than in 2008. There is some concern that FDI will dry up a little, when Tengiz oilfield investments level off, but we expect FDI to finance the C/A deficits in 2010 and 2011. About USD 11bn in principal debt repayments falls due in 2010, however, roughly 50% of this is bank debt, largely to be restructured or refinanced and another USD 1.9bn is intra-company debt. Central bank reserves (at USD 27.6bn in Feb-2010) and foreign assets of the Oil fund (at USD 25.2bn) are sufficient to cover almost 15 months of imports.

Russia

Outlook

The flow of positive news has stalled in early 2010, as investment extended a sharp decline, on the back of a reversal of fiscal stimulus. The flipside of the general weakness is a deeper disinflation that ought to support further monetary easing at least in 2Q, but rates are set to reverse in 2H10 as RUB might start to weaken on further liquidity inflows from the budget.

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

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

MACROECONOMIC DATA AND FORECASTS

	2007	2008	2009	2010F	2011F
GDP (EUR bn)	945.2	1,139.8	884.6	1,137.2	1,269.2
Population (mn)	142.0	141.6	141.3	141.0	140.4
GDP per capita (EUR)	6,656	8,049	6,260	8,065	9,038
GDP (constant prices yoy %)	8.1	5.6	-7.9	3.4	5.0
Private Consumption, real, yoy (%)	13.6	11.5	-7.7	3.9	6.9
Fixed Investment, real, yoy (%)	21.1	9.1	-16.2	3.0	6.0
Public Consumption, real, yoy (%)	3.4	2.5	2.0	-2.0	-1.9
Exports, real, yoy (%)	6.4	0.2	-4.7	2.6	4.2
Imports, real, yoy (%)	26.6	17.7	-30.4	17.4	6.4
CPI (average, yoy %)	9.0	14.1	11.7	6.4	6.9
Central bank reference rate	6.05	9.17	6.00	5.50	5.75
Monthly wage, nominal (EUR)	386	471	420	492	562
Unemployment rate (%)	5.6	6.3	8.4	8.1	7.4
Budget balance (% of GDP)	6.0	4.8	-8.4	-5.7	-4.5
Current account balance (EUR bn)	57.4	69.8	33.9	61.1	50.2
Current account balance (% of GDP)	6.1	6.1	3.8	5.4	4.0
Net FDI (EUR bn)	38.3	28.7	21.3	25.5	30.6
FDI (% of GDP)	4.1	2.5	2.4	2.2	2.4
Gross foreign debt (EUR bn)	314.0	340.8	364.0	345.6	374.6
Gross foreign debt (% of GDP)	35.9	35.4	38.7	30.1	30.6
FX reserves (EUR bn)	326.4	302.9	287.5	309.9	306.5
(Cur.Acc-FDI)/GDP (%)	10.1	8.6	6.2	7.6	6.4
FX reserves/Gross foreign debt (%)	104.0	88.9	79.0	89.6	81.8
Exchange rate to USD eop	24.64	30.53	30.04	30.32	30.84
Exchange rate to EUR eop	35.93	42.59	43.04	41.84	40.09
Exchange rate to USD avg	25.55	24.78	31.65	29.17	30.09
Exchange rate to EUR avg	35.02	36.46	44.13	40.55	40.02

Source: UniCredit Research

STRENGTHS

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

WEAKNESSES

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

Recovery slows pace, but remains intact

Flow of positive news stalls in early 2010, as investment extends sharp decline

A steady flow of positive news on the economic recovery in Russia has stalled in early 2010 revealing the surprising weakness of key economic variables. Thus, investment declined by 8% yoy in 2M10, despite very strong base effects from 2009, which has considerably constrained the recovery of industrial output, cargo shipments and has also triggered a further drop in construction. Overall, the estimates by the Ministry of Economic Development highlighted that in February real GDP fell by 0.9% mom in seasonally-adjusted terms, which was the first contraction since June 2009.

Reversal of fiscal stimulus is seen as the key factor behind general weakness

We see the abrupt reversal of fiscal stimulus as the key reason for weaker investment demand and cut our forecast of investment growth to 3% in 2010. The government's fiscal efforts have become increasingly concentrated on the support of the general population, with substantial funds allocated to continued indexations of pensions and social transfers. At the same time, in 2010 the government has practically stabilized public spending in nominal terms for the first time in the entire modern economic history of Russia, which has triggered massive cuts in infrastructure spending. Such cuts in public investment act as a catalyst and seem to be behind the broader slowdown of investment and are likely to constrain the recovery of investment throughout 2010 at the very least.

Weakness of domestic demand intensifies disinflation, as weaker imports boost GDP outlook

On the plus side, weak domestic demand continues to tame inflationary pressures. Thus, we cut our projections of inflation by roughly 1% to 6.4% on average for 2010, noting that it could dip below 6% yoy during the summer on persistent high base effects. Lower inflation trigger our revision of private consumption growth by some 1pp. to 3.9%, which mainly improves broader real GDP growth outlook up to 3.4%. We note that strong low base effect of weak 1H09 should support robust 4%-5% yoy real GDP growth in 1H10, followed by a gradual easing to a more moderate 2.5% yoy in 2H10.

Faltering recovery and deeper disinflation support further monetary easing at least in 2Q

We continue to believe that intensified weakness of investment demand as well as deeper disinflation keep doors wide open for further monetary easing in the next few months. Although, several senior government and central bank officials have already suggested that the easing cycle is already over for now after the latest 25bps rate cut in late March, we believe that there is a room for at least one more 25bps rate cut in 2Q10. Coming on top of continued liquidity inflow from the federal budget deficit, we believe that such rate cuts could put further pressure on the entire yield curve driving the 3M Mosprime rate below 4% by summer. Nevertheless, the relatively high domestic rates as well as expectations of further RUB strength are set to boost capital inflows and provide support to the currency in 2Q10, possibly pushing the unit down to RUB33/basket level in 1H10 eop.

Rates to reverse decline in 2H10 as RUB might start to weaken on further liquidity inflows from the budget

However, we also expect that low domestic interest rates on top of continued inflow of fresh RUB liquidity from the budget should trigger a turnaround of the RUB rally in 2H10. Coming on top of a reversal of the disinflation trend due to the increasingly strong low base effect of 2H09, we think that such RUB weakness is likely to initiate the CBR's tightening cycle, with some 25-50bp in hikes by the end of the year. Nevertheless, we also continue to expect substantial weakening of the RUB in 2H10 and revise our FX forecasts only slightly to RUB 35.5/basket for 2010 eop, and RUB34.3/basket on average for the year.

Inventory build-up is the key domestic upside risk for the year

Among the possible upside risks to our GDP forecast we note the potential recovery of inventory build-up. Although, given the weakness of domestic demand and remaining uncertainty over economic recovery we view the likelihood of any major inventory growth as rather low, it could still trigger a stronger than expected rebound in real GDP growth, at least in 1H10. Apart from this, we also note the potential for stronger recovery of global economic growth, especially in China, which could trigger a more substantial rebound of demand for major Russian export commodities.

Serbia

Outlook

The currency has stabilized and the central bank looks set to cut interest rates further as weak domestic demand continues to characterize the economy. The IMF program remains an important anchor for Serbia's sovereign rating. Meanwhile the change of leadership at the central bank, following Governor Jelašić's resignation, ought not to change monetary policy, with EUR/RSD staying below 100.

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

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

MACROECONOMIC DATA AND FORECASTS

	2007	2008	2009	2010F	2011F
GDP (EUR bn)	28.8	33.4	30.5	30.3	32.0
Population (mn)	7.4	7.4	7.3	7.3	7.3
GDP per capita (EUR)	3,900	4,545	4,170	4,151	4,408
GDP (constant prices yoy %)	6.9	5.5	-3.0	-0.5	2.2
CPI (average, yoy %)	6.5	11.7	8.4	4.9	5.7
Central bank reference rate	10.00	17.75	9.50	7.50	7.00
Monthly wage, nominal (EUR)	484	561	470	465	482
Unemployment rate (%)	18.1	13.7	16.1	16.8	16.5
Budget balance (% of GDP)	-1.6	-2.0	-4.2	-4.0	-3.5
Current account balance (EUR bn)	-4.6	-5.8	-1.7	-2.1	-2.3
Current account balance (% of GDP)	-16.0	-17.3	-5.7	-6.9	-7.1
Net FDI (EUR bn)	1.8	1.8	1.4	1.8	2.3
FDI (% of GDP)	6.3	5.5	4.5	5.8	7.0
Gross foreign debt (EUR bn)	17.8	21.8	22.8	24.8	27.0
Gross foreign debt (% of GDP)	61.8	65.3	74.6	81.8	84.4
FX reserves (EUR bn)	9.6	8.2	10.6	11.8	11.5
(Cur.Acc-FDI)/GDP (%)	-9.7	-11.9	-1.2	-1.1	-0.1
FX reserves/Gross foreign debt (%)	54.2	37.4	46.5	47.7	42.6
Exchange rate to USD eop	54.03	64.34	67.11	72.46	78.46
Exchange rate to EUR eop	78.79	89.78	96.17	100.00	102.00
Exchange rate to USD avg	58.34	55.40	67.45	71.22	75.94
Exchange rate to EUR avg	79.98	81.49	94.05	99.00	101.00

Source: UniCredit Research

STRENGTHS

- IMF program a key policy anchor
- FDI to benefit from announcement of 40% sale of state-owned telecommunications company
- No sign of meaningful inflationary pressures this year

WEAKNESSES

- Domestic demand remains weak
- Recovery in industrial production centered on metals production
- High FX leverage in domestic private sector

More policy rate cuts and a stable EUR/RSD

Data available for 1Q 2010 point to continued weakness in domestic demand

Domestic demand remains weak. GDP contracted 3.0% in 2009, after falling 1.6% yoy in 4Q09. Industrial production rose 3.0% yoy in Jan-Feb 2010, partly the result of a strong base effect. However, much of this growth is concentrated in metals production. At the same time seasonally adjusted figures point to a decline in manufacturing and industrial production in February. Meanwhile, retail trade in real terms contracted 12% yoy in January. Consumer prices in February (3.9% yoy) came in below the central bank's target range reflecting weak domestic demand as much as the contribution of base effects. March inflation data will show a spike as electricity prices rose 11.5%, but this will not change the overall picture for 2010 in which we see a further moderation in inflationary pressures. External trade data for Jan-Feb 2010 showed a 13.3% yoy increase in merchandise exports (an increase of EUR 102mn to EUR 872mn), with 70% of this increase due to metals exports, while merchandise imports fell 5.3% yoy over this period to EUR1.65bn. Thus the picture in Serbia remains one of weak domestic demand.

We stick to our -0.5% GDP growth forecast

We expect the economy to continue to contract in 2010. While our GDP forecast for 2010 of -0.5% might appear to be significantly different from the official forecast of 1.5%, there isn't a meaningful difference in our opinion. Namely, by using fixed 2002 weights the authorities' figure invariably overstates GDP growth, something which the Economics Institute in Belgrade has pointed out. When the methodology is revised we expect historical growth rates to be lowered too. The official forecast of 1.5% in essence represents the statistical carry over from 2009 to 2010 meaning that no underlying growth in the economy is being assumed this year. Based on the patchy high frequency data for 1Q10, we keep our -0.5% GDP growth forecast unchanged. Despite expectations of a smaller merchandise trade deficit, we see a slight widening in the current account deficit this year to 6.9% of GDP since we do not expect a repeat of such a strong contribution to the bottom line from transfers as seen in 2009. The announcement in late March of plans to privatize 40% of the fixed line operator Telekom Srbije, should see resultant FDI inflows in 4Q10/1Q11 to cover most of this deficit.

NBS looks set to continue cutting policy rates as EUR/RSD has stabilized below 100

The IMF program remains an important anchor for Serbia's sovereign rating. While Governor Jelašić's resignation on 23 March came as a surprise, and will inevitably lead to questions about the credibility of monetary policy, we see no change in monetary policy. The EUR/RSD has depreciated about 7% since December 2009 to just below 100 and the NBS has intervened spending over EUR 625mn in 1Q10. The stock of outstanding NBS bills fell from RSD 152bn on 30 December 2009 to just RSD 107bn on 17 March 2010 (before ending 1Q 10 at RSD140bn). This leads us to conclude that the NBS looked to weaken the RSD deliberately. However, the movement in the EUR/RSD to 100 more than likely occurred more quickly than the Central Bank anticipated. Nonetheless, with over EUR 10.5bn in FX reserves and the latest IMF tranche of money approved in March, we don't see the EUR/RSD heading above 100, as the NBS has plenty of firepower to keep it there. Inflation will remain low given weak domestic demand (we see CPI averaging 4.9% in 2010 with year end at 6.2% yoy) providing scope for rate cuts in a stable EUR/RSD environment. Thus we maintain our forecast of another 100bp in rate cuts this year leading to a 2W repo rate of 7.50% at the end of 2010.

There is enough scope for policy makers to meet the 4.0% of GDP budget deficit target

Pensions and public sector salaries frozen in 2010. It is true that revenue trends in February (budget revenues down RSD 8.8bn compared to January) and March have been disappointing, but this only supports our slightly bearish GDP forecast. The budget deficit at 4% of GDP appears in sight and the government does have scope to cut investment spending if needed to meet the budget deficit target. The main aim of the policy is to reduce the share of public sector wages from 11.5% of GDP in 2010 to 8% in 2015 and the share of pensions from 13% of GDP to 10% in 2015. Last year's and this year's nominal freezes of public wages and pensions should go a long way to help meet this goal.

Turkey

Outlook

Recovery in industrial production is unequivocally underway and Turkey should outperform on the growth front relative to peers in the region. With inflation set to fall and promising budget data, the main risks stem from the political arena. A possible referendum on constitutional reforms could turn into a vote of confidence for the government.

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

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

MACROECONOMIC DATA AND FORECASTS

	2007	2008	2009	2010F	2011F
GDP (EUR bn)	473.2	499.5	442.7	500.7	573.7
Population (mn)	70.6	71.5	72.6	73.4	74.2
GDP per capita (EUR)	6,703	6,985	6,101	6,825	7,735
GDP (constant prices yoy %)	4.7	0.7	-4.7	4.5	4.5
Private Consumption, real, yoy (%)	4.6	0.5	-2.3	3.5	4.6
Fixed Investment, real, yoy (%)	5.4	-8.2	-19.2	7.0	7.0
Public Consumption, real, yoy (%)	6.5	1.7	7.8	3.0	4.1
Exports, real, yoy (%)	7.3	2.7	-5.4	5.4	5.8
Imports, real, yoy (%)	10.7	-4.2	-14.4	7.0	8.0
CPI (average, yoy %)	8.8	10.5	6.3	8.4	5.7
Central bank reference rate	15.75	15.00	6.50	7.75	8.25
Monthly wage, nominal (EUR)	907	943	770	720	795
Unemployment rate (%)	10.3	11.0	14.0	13.7	13.4
Budget balance (% of GDP)	-1.6	-1.8	-5.5	-4.8	-3.9
Current account balance (EUR bn)	-28.0	-28.2	-10.0	-19.1	-24.1
Current account balance (% of GDP)	-5.9	-5.6	-2.3	-3.8	-4.2
Net FDI (EUR bn)	16.1	12.3	4.1	7.1	9.0
FDI (% of GDP)	3.4	2.5	0.9	1.4	1.6
Gross foreign debt (EUR bn)	182.2	188.6	205.2	230.5	275.6
Gross foreign debt (% of GDP)	38.5	37.8	46.4	46.0	48.0
FX reserves (EUR bn)	48.4	50.2	48.6	52.9	59.2
(Cur.Acc-FDI)/GDP (%)	-2.5	-3.2	-1.3	-2.4	-2.6
FX reserves/Gross foreign debt (%)	26.6	26.6	23.7	23.0	21.5
Exchange rate to USD eop	1.17	1.54	1.49	1.51	1.53
Exchange rate to EUR eop	1.71	2.15	2.14	2.09	1.99
Exchange rate to USD avg	1.30	1.30	1.55	1.51	1.52
Exchange rate to EUR avg	1.79	1.91	2.16	2.09	2.03

Source: UniCredit Research

STRENGTHS

- Solid banking sector
- Growth potential
- Fiscal accounts under control

WEAKNESSES

- High public sector debt levels
- Political environment heating up, but stability currently not seeming to be at risk

Recovery in place, but politics heating up

IMF has ceased to be a necessity

The IMF saga is finally over (Turkey will not need a support package from the IMF). Turkey did suffer a contraction of 4.7% in 2009, but withstood the storm reasonably well particularly in relative terms. Budget dynamics deteriorated but not drastically, and they seem to be improving at the moment. Meanwhile, the current account deficit shrank significantly during and as a result of the contraction. The financial sector is in very good shape. Hence the IMF has ceased to be a necessity. The choice of doing without the Fund was mostly political with some possible conditional economic benefits also contributing to the decision.

Recovery is underway

Growth is on a healthier path. The industrial production growth figure for the second month of 2010 is 18.1% yoy. If one looks at mom IP growth figures adjusted for seasonal and calendar effects since April 2009 when the recovery seems to assert itself clearly, only 3 negative growth months are observed out of 11, and the absolute values of expansion beat those of contraction hands down. Thus an unequivocal recovery is underway, but its pace is still far from creating any inflationary pressure of its own and also far from pushing the Central Bank into a preemptive hike mode.

Annual inflation came down to single digit levels (9.6%) in March after having edged up to 10.1% in February on the back of rising food prices. There were some concerns at double digit levels leading to some deterioration in inflation expectations for all time horizons, but they all came down and provided a breather for the Central Bank. Administered price hikes are very instrumental in the high annual inflation figure as alcohol and tobacco related inflation stands at 43%, but the lion's share of the contribution to annual inflation belongs to the food category with a yoy inflation of 11.2%. Everyone knows that inflation will fall back again in the last quarter of the year and in the first quarter of 2011 due to favorable base effects, and that perception has kept interest rates fairly well under control and only partially responsive to inflation announcements. The repeatedly stated intention of the Central Bank to keep rates low as long as possible is widely bought (with only few exceptions). We continue to find merit in the CBT's current stance and rhetoric: a pre-emptive hike is not needed for now.

Budget data are promising

February central government budget data look promising as tax revenues displayed 16.9% yoy growth while that of non-interest expenditures remained relatively limited at 10.1%. Robust tax revenue growth is juxtaposed against slower expenditure growth which is great news if sustained. The Government is more likely than not to keep budget balances in check and maybe even go for a policy of beating the year end targets which were not set too aggressively in the first place.

Rate hikes only towards the end of the year

As regards monetary policy, there is hardly anything hawkish in the MPC communiqué released after the March meeting. The MPC also admitted that despite a drop to single digits in March, inflation would remain significantly above the target for some time. We stick to our "low for longer" view and expect the MPC to hike the policy rate by 125bp by end-2010.

Politics back at center stage: a referendum will turn into a vote of confidence for the Government

A package that entails 26 **constitutional amendments** formulated by the governing AKP was submitted to all political parties and the opposition is opting to reject it. The most controversial issue in the package seems to be the amendment to restructure the composition of the Constitutional Court and the Higher Council of Judges and Prosecutors (HSYK). The Venice Criteria pertaining to party closures are in the package as well, and the extraordinary authority assigned to the Chief Prosecutor for the Supreme Court in closure cases is curbed if not totally done away with. It will not be possible for the AKP to pass the package in parliament directly due to the two thirds majority requirement, but support from the Kurdish BDP group should be enough to take it to a referendum. A referendum will inevitably turn into a vote of confidence for the AKP and with roughly one year before general elections, strategies will be shaped mostly in regard to the referendum outcome by all political parties.

Ukraine

Outlook

With politics out of the way and a new government in place, focus is now on jump-starting reforms and accelerating growth. The renegotiation of the IMF package sets the tone for the right financial conditions – helping to drive the rally in Ukrainian assets as investors flock to make use of the opportunities for high yields. We remain cautiously optimistic on growth this year, and have pushed our 2010 GDP forecast up to 3% and see further UAH strengthening.

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

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

MACROECONOMIC DATA AND FORECASTS

	2007	2008	2009	2010F	2011F
GDP (EUR bn)	103.1	123.4	81.4	103.5	137.9
Population (mn)	46.6	46.4	46.1	45.8	45.5
GDP per capita (EUR)	2,210	2,661	1,766	2,261	3,029
GDP (constant prices yoy %)	7.6	2.1	-15.1	3.0	4.0
Private Consumption, real, yoy (%)	17.1	11.6	-14.2	0.5	3.0
Fixed Investment, real, yoy (%)	24.8	4.2	-46.2	8.0	14.0
Public Consumption, real, yoy (%)	2.8	-0.4	-8.8	1.5	0.7
Exports, real, yoy (%)	2.8	6.7	-25.6	10.0	9.0
Imports, real, yoy (%)	20.2	17.5	-38.6	8.0	10.0
CPI (average, yoy %)	12.8	25.2	16.0	11.0	10.4
Central bank reference rate	8.00	12.00	10.25	9.50	9.75
Monthly wage, nominal (EUR)	195	234	170	204	256
Unemployment rate (%)	6.4	6.4	10.5	9.4	8.2
Budget balance (% of GDP)	-1.4	-1.3	-11.3	-6.2	-3.9
Current account balance (EUR bn)	-4.1	-8.5	-1.4	0.1	-0.8
Current account balance (% of GDP)	-3.9	-6.9	-1.7	0.1	-0.6
Net FDI (EUR bn)	6.3	7.1	3.2	4.3	7.2
FDI (% of GDP)	6.1	5.8	3.9	4.2	5.2
Gross foreign debt (EUR bn)	56.7	72.9	72.6	80.2	90.6
Gross foreign debt (% of GDP)	55.0	59.0	89.1	77.5	65.7
FX reserves (EUR bn)	21.8	19.4	17.9	17.4	15.4
(Cur.Acc-FDI)/GDP (%)	2.2	-1.2	2.2	4.3	4.7
FX reserves/Gross foreign debt (%)	38.4	26.6	24.7	21.7	17.0
Exchange rate to USD eop	5.09	7.81	8.01	7.40	6.90
Exchange rate to EUR eop	7.42	10.90	11.48	10.21	8.97
Exchange rate to USD avg	5.05	5.24	8.06	7.71	7.15
Exchange rate to EUR avg	6.92	7.70	11.24	10.71	9.51

Source: UniCredit Research

STRENGTHS

- Ongoing political stabilization and streamlining of power
- Improving C/A balance, and improved export performance
- Significant NBU FX reserves

WEAKNESSES

- High NPL ratios
- Weak fiscal position and dire need for reform
- A rapidly ageing population

Growth as a factor of reform and confidence

With politics out of the way focus is on reform to accelerate growth…

With politics out of the way (at least for now – local elections are expected to take place in Nov-2010) and a new government in place, **focus is now on jump-starting reforms and accelerating growth**. The renegotiation of the IMF package sets the tone for the right financial conditions – the markets have factored in a quick end of April/start of May disbursal of the next IMF tranche, potentially reaching as much as USD 5bn (which would also open up an additional USD 2bn from the EC, WB and the EBRD) – helping to drive the rally in Ukrainian assets as investors flock to make use of the opportunities for high yields. The last political hurdle for the continuation of the rally is now removed – the Constitutional Court ruled that the current parliamentary coalition is legal.

…while a quicker restoration of favorable financial conditions prompt us to up our GDP growth forecast by 1% to 3% in 2010

We remain cautiously optimistic on growth this year, although arguably not as bullish as the government with its 3.7% GDP growth estimate, and have pushed our 2010 forecast up to 3% (a 1% point increase since our last forecast). The key rationale behind the move is a much quicker restoration of favorable financial conditions for the country on political stabilization (implying greater availability of funding at a cheaper rate). Moreover, we are now more confident about the gradual restoration of consumption – real wages have been positive in 2M10 and the UAH is also gradually strengthening – prompting us to move consumption growth to a marginal +0.5% yoy. We see bank recapitalization being implemented through 2010, something that will ultimately support domestic demand, and open up financing for the investment projects related to EURO2012. This, however, should not make policy makers complacent about the scope of necessary reforms.

Government has opportunity to implement long delayed reforms, with key focus on gas and pension reform

We believe that the new government has a unique opportunity to implement long-delayed reforms, and thereby lay the foundation for growth beyond the 1Y horizon (gas sector, pension, healthcare and tax administration – among others). For the remainder of 2010 policy makers will be constrained in their spending, given that the IMF has signaled it will not tolerate a budget deficit of more than 6%. Reform of Naftogaz and the gas sector will be a priority, and the Ukrainian government's negotiations for a lower gas price may pay-off, recent newsflow suggests potential for a reduction in the price to USD 205-210/bcm from the current USD 305/bcm. There should be more clarity on the latter when Russian President Dmitry Medvedev visits Kiev in May. The latter would also have a benign effect on inflation which is expected to hover around 10%-12% throughout the year, given that there are no demand pressures for now, although recent FX intervention is creating excess liquidity on the domestic market helping to push down money market rates to just around 7%-8% at the end of March from the 17%-18% seen at the end of December.

FX to remain a favorable opportunity throughout 2010, don't expect any swift moves, but rather a gradualist approach as NBU intervenes on the market

We continue to see a favorable situation maintaining itself on the FX market, especially as the REER index has likely eased back to 2000 levels, which implies potential for appreciation – deviation from the 10Y trend is some 13%, **suggesting that the UAH is cheap**. Other fundamental analysis too suggests that UAH looks good and is set to remain so on the back of: **a)** IMF inflows, **b)** on a C/A surplus – a result of higher steel prices and volumes, and subdued local demand, **c)** further opening up of bond markets (domestic T-Bills have seen a surge of foreign inflows in March), **d)** ongoing debt-restructuring and repatriation of Ukrainian money from offshore accounts to buy assets while they are cheap and **e)** the return of confidence on the domestic markets, whereby the population is converting FX savings back into UAH (the reverse was a major reason for UAH depreciation since Oct-2008). Therefore, we keep our end of year forecast at USD/UAH 7.4 (a view we have held since Jan-2009) and at 6.9 in 2011, this runs counter to the forward market where the 1Y USD/UAH trades at 8.4 ask and 2Y USD/UAH at 9.5 ask, although much better than what we saw 3M ago. Having said that, we would not expect any major moves, with NBU only allowing the USD/UAH to move lower gradually - in March the NBU bought some USD1.6 bn to limit appreciation pressures, allowing USD/UAH to move only 1% lower.

Notes

Notes

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Regulatory authority: "BaFin" – Bundesanstalt für Finanzdienstleistungsaufsicht, Lurgiallee 12, 60439 Frankfurt, Germany.

b) UniCredit Bank AG London Branch, Moor House, 120 London Wall, London EC2Y 5ET, United Kingdom.
Regulatory authority: "BaFin" – Bundesanstalt für Finanzdienstleistungsaufsicht, Lurgiallee 12, 60439 Frankfurt, Germany and subject to limited regulation by the Financial Services Authority (FSA), 25 The North Colonnade, Canary Wharf, London E14 5HS, United Kingdom. Details about the extent of our regulation by the Financial Services Authority are available from us on request.

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The UniCredit CAIB Group, consisting of
d) UniCredit CAIB AG, Julius-Tandler-Platz 3, 1090 Vienna, Austria
Regulatory authority: Finanzmarktaufsichtsbehörde (FMA), Praterstrasse 23, 1020 Vienna, Austria

e) UniCredit CAIB Securities UK Ltd., Moor House, 120 London Wall, London EC2Y 5ET, United Kingdom
Regulatory authority: Financial Services Authority (FSA), 25 The North Colonnade, Canary Wharf, London E14 5HS, United Kingdom

f) UniCredit Securities, Boulevard Ring Office Building, 17/1 Chistoprudni Boulevard, Moscow 101000, Russia
Regulatory authority: Federal Service on Financial Markets, 9 Leninsky prospekt, Moscow 119991, Russia

g) UniCredit Menkul Değerler A.Ş., Büyükdere Cad. No. 195, Büyükdere Plaza Kat. 5, 34394 Levent, Istanbul, Turkey
Regulatory authority: Sermaye Piyasası Kurulu – Capital Markets Board of Turkey, Eskişehir Yolu 8.Km No:156, 06530 Ankara, Turkey

h) UniCredit Bulbank, Sveta Nedelya Sq. 7, BG-1000 Sofia, Bulgaria
Regulatory authority: Financial Supervision Commission, 33 Shar Planina str.,1303 Sofia, Bulgaria

i) Zagrebačka banka, Paromlinska 2, HR-10000 Zagreb, Croatia
Regulatory authority: Croatian Agency for Supervision of Financial Services, Miramarska 24B, 10000 Zagreb, Croatia

j) UniCredit Bank, Na Príkope 858/20, CZ-11121 Prague, Czech Republic
Regulatory authority: CNB Czech National Bank, Na Příkopě 28, 115 03 Praha 1, Czech Republic

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

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

m) UniCredit Bank, Šancova 1/A, SK-813 33 Bratislava, Slovakia
Regulatory authority: National Bank of Slovakia, Stefanikovo nam. 10/19, 967 01 Kremnica, Slovakia

n) Yapi Kredi, Yapi Kredi Plaza D Blok, Levent, TR-80620 Istanbul, Turkey
Regulatory authority: Sermaye Piyasası Kurulu – Capital Markets Board of Turkey, Eskişehir Yolu 8.Km No:156, 06530 Ankara, Turkey

o) UniCredit Tiriac Bank, Ghetarilor Street 23-25, RO-014106 Bucharest 1,Romania
Regulatory authority: CNVM, Romanian National Securities Commission, Foişorului street, no.2, sector 3, Bucharest, Romania

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

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Banking network

UniCredit Group CEE banking network – Headquarters

Azerbaijan

Yapi Kredi Azerbaijan
G28 May Street,5
AZ-1014 Baku, Azerbaijan
Phone: +994 12 497 77 95
E-mail: yapikredi@yapikredi.com.az

The Baltics

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

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

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

Bosnia and Herzegovina

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

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

Bulgaria

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

Croatia

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

Czech Republic

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

Hungary

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

Kazakhstan

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

Kyrgyzstan

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

Macedonia

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

Montenegro

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

Poland

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

Romania

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

Russia

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

Serbia

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

Slovakia

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

Slovenia

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

Turkey

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

Ukraine

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

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

UniCredit Group CEE banking network – Corporate customers

Austrian contact

Bank Austria

Sonja Holland
Phone: +43 5 05 05 56344

Alexandra Kaufmann
Phone: +43 5 05 05 51054

E-mail: business_development@unicreditgroup.at

German contact

UniCredit Bank AG

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

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

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

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

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

Italian contact

UniCredit Corporate Banking

Stefano Coceancigh
Phone: +39 0422 654 006
E-mail: stefano.coceancigh@unicreditgroup.eu

International contact

Azerbaijan

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

Bosnia and Herzegovina

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

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

Bulgaria

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

Croatia

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

Czech Republic

Miroslav Hrabal
Phone: +420 2 2111 6271
E-mail: miroslav.hrabal@unicreditgroup.cz

Estonia

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

Hungary

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

Kazakhstan

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

Latvia

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

Lithuania

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

Macedonia

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

Montenegro

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

Poland

Tomasz Pelc
Phone: +48 22 524 6207
E-mail: tomasz.pelc@pekao.com.pl

Romania

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

Russia

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

Serbia

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

Slovakia

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

Slovenia

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

Turkey

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

Ukraine

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

UniCredit Research*

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

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

Economics & FI/FX Research

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

Economics & Commodity Research

Global Economics

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

European Economics

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

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

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

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

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

Dr. Loredana Federico
+39 02 8862-2209
loredana.federico@unicreditgroup.eu

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

Chiara Silvestre
chiara.silvestre@unicreditgroup.de

US Economics

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

Commodity Research

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

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

EEMEA Economics & FI/FX Strategy

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

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

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

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

Anna Kopetz, Economist, Baltics
+43 50505 823-64, anna.kopetz@caib.unicreditgroup.eu

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

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

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

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

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

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

Gyula Toth, Economist/Strategist, EEMEA
+43 50505 823-62, gyula.toth@caib.unicreditgroup.eu

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

Global FI/FX Strategy

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

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

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

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

Giuseppe Maraffino, FI Strategy
+39 02 8862-2027, giuseppe.maraffino@unicreditgroup.de

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

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

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

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

Publication Address

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

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www.research.unicreditgroup.eu

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