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Emerging Europe: touching down

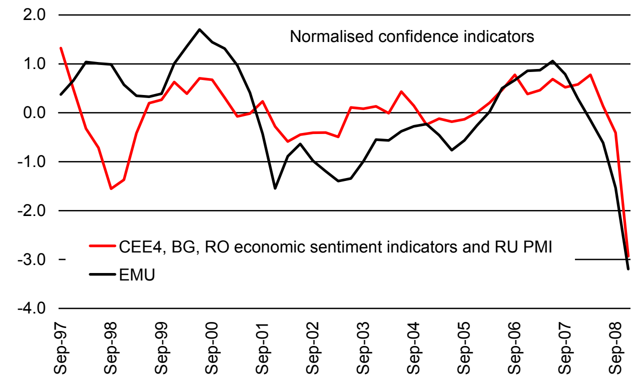
Emerging Europe's long-term real convergence story ran head first into the global slowdown in Q4/08, with the region's economic sentiment indicators deteriorating at a faster pace in Q4/08 than they did in Q4/98 following the Russian crisis. In contrast to 1998, however, the principal driver of Q4's/08 slowdown was a collapse in global demand.

Collapse in external demand hit CEE growth across the board in Q4/08

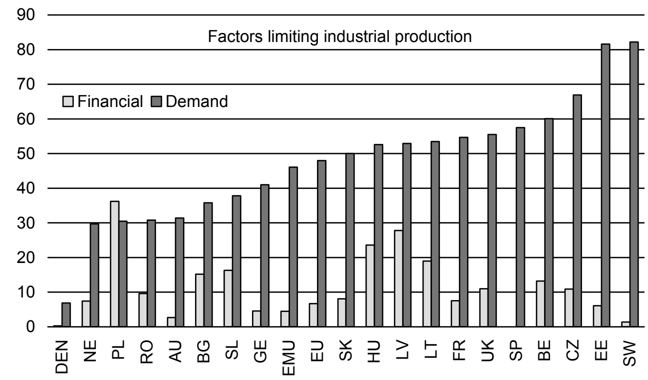
The extent to which weak demand is responsible for Emerging Europe's slowdown is clearly illustrated by the European Commission's January 2009 quarterly survey. Here, a lack of demand, rather than finance, was cited in all countries as by far the major constraint on production. The implication of the collapse in export demand is that all countries recorded a sharp slowdown in Q4/08, even if they had otherwise low macro vulnerability readings, such as the Czech Republic.

SENTIMENT HAS RAPIDLY DETERIORATED, BUT MAINLY ON A LACK OF DEMAND, RATHER THAN FINANCE

Sentiment indicators have deteriorated at a faster pace and to a deeper level than in 1998...



…but a lack of demand as opposed to finance is cited as the main limiting factor for industrial production in the EU27.



Source: European Commission, Markit, UniCredit Research

The GDP growth consensus has been slashed, but risks of further radical revisions lower are diminishing

Against the backdrop of a sharp deterioration in global and regional indicators, consensus forecasts for 2009 global, EMU and CEE GDP growth were cut significantly in the latter half of 2008, with the CEE 2009 consensus now at 0.6% from 5.7% in June 2008. We see some downside risk to the consensus and forecast CEE to contract 0.8% in 2009, though by the same token we do not expect to see a similar magnitude revision lower in the GDP consensus in the coming six months as in the previous six months. This also implies we expect the CEE-EMU growth differential to remain in positive territory: convergence is on the back burner but in some sense will still sustain, even in 2009.

Differentiation is set to increase…

Differentiation set to increase during 2009: Whereas Q4/08 was marked by an across the board export slowdown, the key story as 2009 progresses will likely be one of differentiation between countries. Specifically, some countries in the region arguably have faster recovery prospects than others.

Czech Republic, Poland and Turkey have good recovery prospects

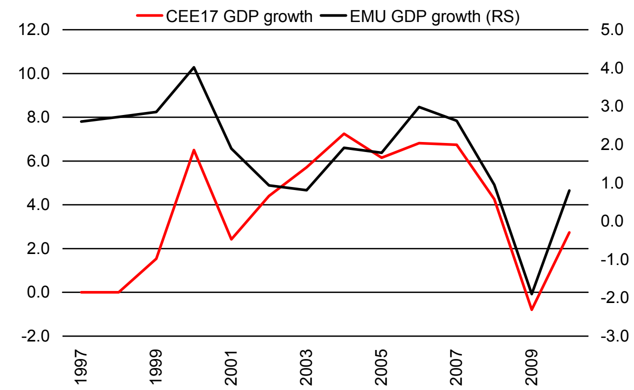
We see Emerging European medium-term recovery prospects as stronger in the Czech Republic, Poland and Turkey. These are countries where policymakers have the flexibility to significantly loosen monetary conditions and whose private sectors were to some extent less overstretched prior to the global slowdown. In short, as soon as EMU stabilizes these countries are set to rebound.

Recovery prospects are more challenging in countries where:

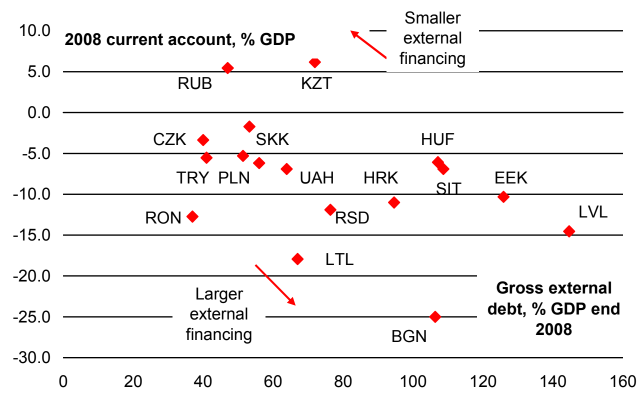
1. **Policymakers are constrained in their ability to loosen monetary conditions:** In some Emerging European countries this is potentially a function of fixed currency regimes, financial stability risks or political concerns over exchange rate weakness.

2. **External financing gaps are greater:** Put simply, lower Emerging Market capital inflows reduce the ability of countries to run wide external funding gaps (current account deficit and external debt redemptions). This in turn increases the probability that countries with wide external financing gaps will have restrained domestic demand growth for longer than other countries with fewer balance of payments constraints to growth. This will affect countries most which either previously had the largest current account deficits and, or, higher gross external debt levels (implying higher redemptions in any given year). See chart.

UNICREDIT CEE AND EMU GDP FORECASTS



2008 CURRENT ACCOUNT BALANCE VS. GROSS EXTERNAL DEBT, % GDP



* A simple average of the 2009 GDP consensus for Bulgaria, the Czech R., Hungary, Poland, Russia, Turkey, Ukraine.

Source: Consensus Economics, UniCredit Research

Comparisons with the Asian crisis are wide of the mark

It is clear that the outlook for Emerging Europe is challenging, with some countries likely to experience below potential growth for an extended period as overstretched balance sheets are effectively repaired. This is not the same thing as saying Emerging Europe is the "Asia of 1997", however. We see four key differences between Asia "then" and CEE "now":

Differences between "then" and "now"….

1. **FX reserves in relation to short-term debt are in general higher in Emerging Europe than in Asia (see chart).** Put differently, policymakers have a greater ability to plug financing gaps than some Asian central banks did.

2. **Foreign Direct Investment (FDI) as a percent of GDP is higher in most Emerging European countries now than in most Asian countries in 1996.** Therefore, Western European and other global firms are in CEE for the long-term, whilst countries in the region have a lower reliance on more volatile portfolio financing.

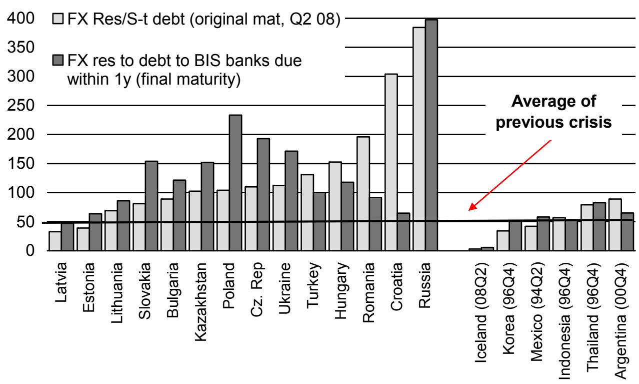
3. **The quality of banking regulation and enforcement of the regulation is arguably far better in CEE now than in pre-crisis Asia.** This is difficult to show in a quantitative comparison, though it is noteworthy that even today CEE scores higher in World Bank credit information and legal rights rankings than Asia (the series only go back to 2004, however, meaning they can't be compared to pre-crisis Asian levels). See chart.

4. **A significant number of Emerging European countries are members of the European Union.** Not only does this significantly strengthen the institutional and regulatory environment (and in our opinion reduces capital flight risk), but it also increases, we believe, the likelihood of significant external support if needed and makes it more likely that direct investors remain invested for the long-term.

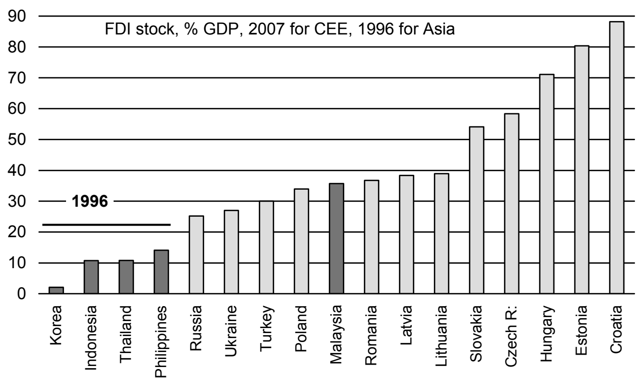
Additionally, the IMF has also proven its ability to rapidly provide balance of payments support when needed in the last 3 months. This, coupled with significant fiscal reserves in Bulgaria, Estonia, Kazakhstan and Russia, underlines the extent to which Emerging European policymakers have the ability to plug financing gaps in 2009.

Obviously, Emerging Europe remains vulnerable, especially given some countries still have meaningful challenges in 2009, both economically and politically, and bouts of contagion cannot be ruled out. The comparison above does, however, highlight some important differences between "Asia" and "CEE" and suggests that the stylized parallel should be taken with a pinch of salt, and with greater focus on the relative strengths and weaknesses of individual CEE countries.

FX RESERVES TO SHORT-TERM DEBT



FDI STOCKS, % GDP



Source: BIS, UNCTAD, UniCredit Research

What does recent extreme FX weakness tell us?

Emerging European currencies have weakened significantly since their strongest levels in July 2008 and have in many cases underperformed broader Emerging Market currencies (see chart). We attribute this to two main factors: **1.** Dovish Emerging European Central Banks and some tolerance towards weaker currencies (in some countries more than others). **2.** The region's wide external financing gap and associated market fears that the region is the next "Asia".

Will FX weakness continue?

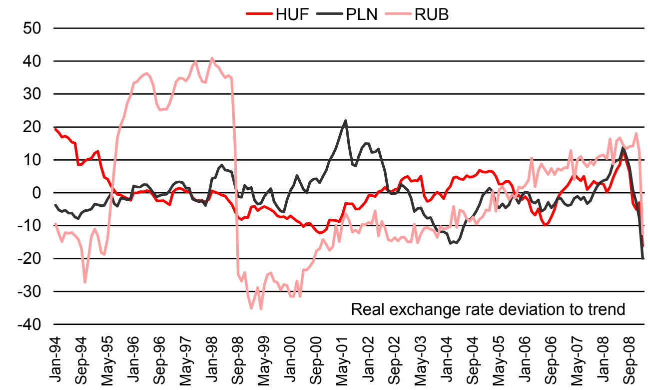
Looking ahead, to the extent that points 1. and 2. remain broadly in play in the near-term, we see a risk of further Emerging European currency depreciation in Q1/09. Depreciation is likely to continue to occur in both high and low macro vulnerability risk countries, with the latter a function of greater policymaker tolerance for weaker currencies to help support the growth outlook.

Greater differentiation to creep in during Q2

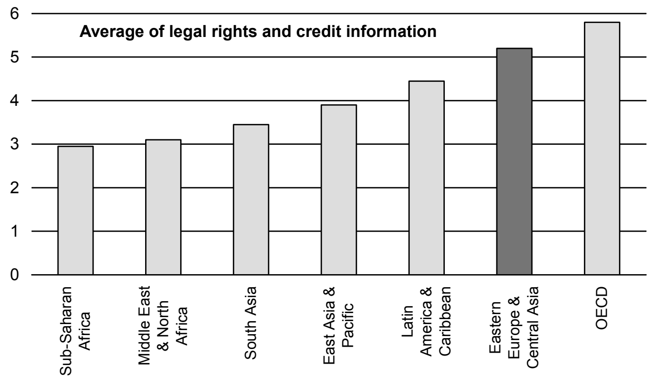
As with the growth outlook, we also expect to see greater differentiation occur in terms of currency performance as 2009 progresses too. Specifically, as growth indicators start to stabilize and the central bank policy outlook becomes more balanced, we would expect currencies in countries with lower macro vulnerabilities to turnaround, especially if they are at a significant deviation to their long-term real appreciation trend. In contrast, we would expect to see currencies in countries with weaker recovery prospects and greater financial stability concerns to underperform Q2+, with fixed exchange rate regimes also potentially receiving further tests.

CURRENCIES HAVE SIGNIFICANTLY DEPRECIATED; THOUGH NOW LOOK INCREASINGLY CHEAP TO FUNDAMENTALS…

Real HUF, PLN and RUB versus long-term real appreciation trend



CEE Financial Sector Infrastructure is strong…*



* An average of the World Bank Ease of Doing Business Indicators for Legal Rights and Credit Information.

Source: BIS, Bloomberg, World Bank, UniCredit Research

The region should not be treated as a homogenous block…

The outlook is challenging: External demand is weak, capital inflows are limited and some countries are constrained in their policy response to the radical deterioration in the near-term growth outlook. The region should not be treated as a homogenous block, however, with some countries having good recovery prospects for H2/2009. More broadly, "CEE-09" is not a carbon copy of "Asia-97". The region's banking sector is in better shape than in Asia, external support for the region is significant, whilst the extent of pre-97 Asian capital inflows was an order of magnitude higher than pre-09 CEE. Looking beyond 2009, the region's real and nominal convergence prospects remain solid in our view too. In short, the easy times are over, but the good prospects are not…

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Bulgaria

Outlook

Recent dataflow points to a sharp slowdown in economic activity which has led to a pronounced deterioration in the short-to-medium term outlook for the Bulgarian economy. We now forecast just 0.2% growth in 2009 and a moderate recovery to 2.0% growth in 2010. The flipside of the sharp slowdown in domestic demand and significantly lower energy prices is a significant improvement in the current account outlook, however.

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

MACROECONOMIC DATA AND FORECASTS

	2006	2007	2008e	2009f	2010f
GDP (EUR bn)	25.2	28.9	34.2	36.6	39.2
Population (mn)	7.7	7.6	7.6	7.6	7.5
GDP per capita (EUR)	3286	3782	4497	4845	5210
GDP (constant prices y-o-y %)	6.3	6.2	5.9	0.2	2.0
Private Consumption, real, y-o-y (%)	8.5	5.1	5.2	2.1	2.5
Fixed Investment, real, y-o-y (%)	14.7	21.7	16.4	-3.8	-1.8
Public Consumption, real, y-o-y (%)	-2.5	3.4	3.7	3.3	4.0
Exports, real, y-o-y (%)	8.7	5.2	2.5	-8.9	-2.0
Imports, real, y-o-y (%)	14.0	9.9	5.0	-6.0	-1.8
CPI (year end, y-o-y %)	6.5	12.5	7.8	6.0	4.5
Central bank reference rate	3.3	4.6	5.8	3.5	3.4
Unemployment rate (%)	9.1	6.9	6.3	10.0	9.5
Budget balance / GDP (%)	3.6	3.5	3.0	-2.5	-2.0
Current account balance (EUR bn)	-4.5	-6.3	-8.5	-5.1	-4.5
Current account balance / GDP (%)	-17.8	-21.8	-25.0	-14.0	-11.5
Net FDI (EUR bn)	6.0	6.5	5.0	3.3	2.9
FDI % GDP	23.8	22.6	14.6	9.0	7.5
Gross foreign debt (EUR bn)	20.6	28.9	36.3	36.8	39.2
Gross foreign debt (% of GDP)	81.7	99.8	106.3	100.5	99.9
FX reserves (EUR bn)	8.9	11.9	12.7	9.5	10.3
(Cur.Acc-FDI) / GDP (%)	6.0	0.7	-10.4	-5.0	-4.0
FX reserves / Gross foreign debt (%)	43.3	41.4	35.0	25.8	26.2
Exchange rate to USD eop	1.5	1.3	1.4	1.4	1.5
Exchange rate to EUR eop	2.0	2.0	2.0	2.0	2.0
Exchange rate to USD AVG	1.6	1.4	1.3	1.4	1.4
Exchange rate to EUR AVG	2.0	2.0	2.0	2.0	2.0

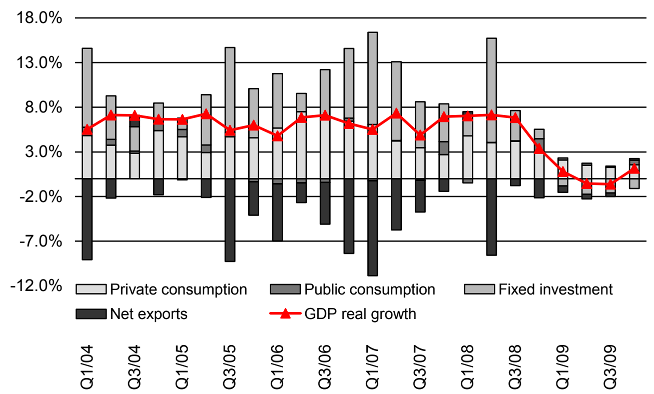
Source: UniCredit Research

Macro outlook

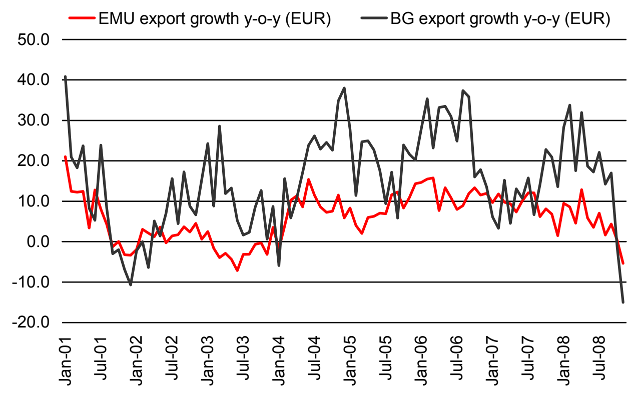
Outlook for Bulgarian economy has deteriorated rapidly

GDP grew by 7.1% in H1/2008 and slowed only marginally to 6.8% in Q3. In contrast, dataflow in Q4/08 indicates a sharp slowdown in economic activity, which has led to a pronounced deterioration in the short-to-medium term outlook for the Bulgarian economy. Weaker economic activity in export-oriented industries is behind the ongoing downturn. Regional exports are to a large extent correlated with the EMU export cycle, due to their importance as intermediary goods in the supply chain. Bulgarian exports are no exception, despite decoupling in 2007 attributable to the one-off drop in agricultural output which was hit by bad weather. Thus, cooling external demand caused Bulgarian export growth to fall into negative territory in October (-1.4% y-o-y), and particularly deep in November (-15.0% y-o-y). Output and sales in the key export-oriented industries fell across the board, while the most recent sentiment indicators – a forward-looking gauge of economic activity – posted their steepest decline since the start of transition.

GDP DOWN-UNDER FOR THE NEXT 4 QUARTERS



BULGARIAN EXPORT MARKET CLOSELY LINKED TO EMU



Source: ECB, National Statistics Institute, UniCredit Research estimates

Despite sharp economic downturn inflation will recede only marginally in 2009

Recent data releases show that appetite for consumption in the household sector has been losing strength on the back of: **1.** more difficult access to credit, **2.** negative wealth effect, and **3.** worsening economic outlook. Twelve month retail sales growth in Nov 2008 dropped to minus 1.2%, reaching its lowest level since the series began in 2000. The detailed index structure revealed that consumer durables posted the steepest decline among all categories of goods and services under observation.

Our central projection envisages a significant slowdown in GDP growth this year, reflecting weaker foreign capital inflows, lower export demand, and subdued real incomes growth. We expect the weakest quarterly GDP growth readings in Q2/Q3 this year, with recovery starting in early 2010. The exact timing and pace of the recovery process depends on the interplay between downside risk factors (the strength of capital inflows) and the expected stimulus from lower policy rates in the eurozone, the support to real income growth from lower inflation, and the scale of fiscal and monetary stimulus undertaken by local policy makers. Against this backdrop we have slashed our GDP growth projection for 2009 to 0.2%. We expect economic growth to strengthen to 2% in 2010 and to 3.1% in 2011, before returning to its full potential in 2012.

CPI slowed sharply to 7.8% y-o-y in Dec 2008. The index marked a steep decline since its peak in June when CPI climbed to (15.3%) its highest level in a decade. The outlook for inflation this year is shaped by two opposing groups of factors. On the downside, the ongoing economic downturn will result in pronounced demand-pull inflation easing. On the upside, higher administratively regulated prices and liberalization in a number of sectors will prevent CPI from dropping much below the end 2008 level. We see CPI receding marginally to 6% at the end of this year, while average annual inflation is estimated at 7%

Macro vulnerability indicators

External vulnerability increased at an alarming pace

The C/A gap widened by 39.2% y-o-y to EUR 7.5bn in Jan-Nov 2008, or 22% of the projected full-year GDP, vis-à-vis 19% of GDP one year ago. On the financing side, net FDI came in at EUR 4.8bn, or roughly 17% down vis-à-vis Jan-Nov 2007. Looking ahead, the combination of rapidly cooling domestic demand and lower energy prices will enable the current account gap to shrink to 14% of GDP in 2009. We see FDI, however, shrinking further in 2009 by one third vs. 2008. The strong profitability of local banks will allow them to continue to attract debt financing, though on a significantly smaller scale than in previous years. The global deleveraging process will take its toll on the private corporate sector's capacity to roll over its maturing obligations. This, in turn, will lead to a moderate depletion of central bank reserves in 2009 which, given the currency board, will keep the local supply of money very tight.

Policy response to the slowdown

The government should carefully calibrate its future interventions given the scale of existing vulnerabilities

Substantial fiscal buffers, accumulated during the boom years, gave a very strong starting position to the authorities to deal with the economic downturn. In the last 2M of 2008 the authorities injected a large fiscal stimulus into the economy, which was funded by fiscal revenue. On the monetary policy side, the Bulgarian National Bank (BNB) eased MRR, which increased liquidity in the banking system by BGN 1.6bn in the last 2M of 2008 and BGN 1.2bn in Jan 2009.

This year the BNB is considering easing regulatory requirements for classification and provisioning of loan exposures to help banks deal with the consequences of the economic downturn, while the budget plan envisages a 20% increase in public sector capital expenditures. It is too early to assess how successful the fiscal stimulus undertaken at the end of 2008 was, but the scale was truly impressive for the size of the economy.

The global crisis has strongly constrained capital inflows leading to tightening of conditions on the local credit market

The ongoing squeeze in foreign capital inflows combined with the rapidly worsening economic outlook has led to a significant credit tightening. Both the availability and price of domestic loans have seen sizeable corrections. Annual growth in outstanding loans to households and non-financial corporations slowed to 32% in Dec, from 50% in Aug, and 65% at the end of 2007. This mostly reflected a large scale reduction in the supply of new credit as newly granted loans in Oct and Nov dropped by 25% and 63% respectively on a y-o-y basis.

Official reserves dropped by 13.6% in Q4/08 and by another 4.6% in Jan 2009 focusing attention on external vulnerability. The months ahead promise to be equally testing given external funding conditions remain challenging. The government says that there is no need for a new deal with the IMF, but arguably external support would smooth the transition to a more restrained post credit bubble world.

Czech Republic

Outlook

GDP decelerated fast in Q4/08 and we forecast a contraction of 1.2% in 2009 against the backdrop of weak external demand and contracting investments. Given low macro vulnerabilities and a proactive policymaker response to the slowdown we nevertheless see recovery prospects as strong coming into 2010.

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

MACROECONOMIC DATA AND FORECASTS

	2006	2007	2008e	2009f	2010f
GDP (EUR bn)	113.5	127.2	148.3	137.1	154.2
Population (mn)	10.3	10.3	10.4	10.5	10.5
GDP per capita (EUR)	11053	12322	14230	13074	14618
GDP (constant prices y-o-y %)	6.8	6.0	2.9	-1.2	2.8
Private Consumption, real, y-o-y (%)	5.4	5.3	2.7	1.2	3.0
Fixed Investment, real, y-o-y (%)	6.5	6.7	4.4	-2.5	3.0
Public Consumption, real, y-o-y (%)	-0.7	0.4	1.2	1.2	1.0
Exports, real, y-o-y (%)	15.8	14.9	6.7	-4.2	6.8
Imports, real, y-o-y (%)	14.2	14.2	4.9	-2.8	6.9
CPI (year end, y-o-y %)	1.7	5.4	3.6	2.3	2.2
Central bank reference rate	2.5	3.5	2.3	1.0	2.5
Unemployment rate (%)	8.1	6.6	5.5	6.8	7.2
Budget balance / GDP (%)	-2.7	-1.0	-1.2	-2.9	-2.7
Current account balance (EUR bn)	-2.9	-2.3	-5.0	-4.0	-4.2
Current account balance / GDP (%)	-2.6	-1.8	-3.4	-2.9	-2.7
Net FDI (EUR bn)	4.4	6.7	7.0	4.7	9.2
FDI % GDP	3.8	5.2	4.7	3.4	6.0
Gross foreign debt (EUR bn)	43.4	50.9	55.8	60.6	67.8
Gross foreign debt (% of GDP)	37.1	38.2	40.0	42.4	43.2
FX reserves (EUR bn)	23.9	23.7	26.6	25.0	25.0
(Cur.Acc-FDI) / GDP (%)	1.3	3.5	1.4	0.5	3.2
FX reserves / Gross foreign debt (%)	55.1	46.6	47.6	41.3	36.8
Exchange rate to USD eop	20.9	18.2	19.2	18.7	19.6
Exchange rate to EUR eop	27.5	26.5	26.8	26.5	25.5
Exchange rate to USD AVG	22.6	20.2	17.0	20.0	19.1
Exchange rate to EUR AVG	28.3	27.8	25.0	27.6	26.0

Source: UniCredit Research

Growth slowing, but recovery prospects solid

Q3 GDP growth yet again driven by foreign demand

GDP growth continued at a decent clip in Q3/08 before slowing rapidly in Q4. In Q3, real GDP was still up a solid 4.2% y-o-y in working day adjusted terms, with foreign demand continuing to drive economic activity (net exports added 2.8%-points to GDP). On the domestic demand side, consumption slowed only marginally from Q2, with the ongoing deceleration of household spending to 2.5% y-o-y mitigated by a pick-up in government expenditures to 3.7% y-o-y. Fixed investments showed a 4.5% y-o-y advance in Q3, though a sharp drop in the rate of inventory accumulation reduced GDP growth by 1.6%-points.

Monthly data signal GDP may have contracted in Q4 already

Economic activity tumbled at the beginning of Q4 with both October and November industrial output contracting significantly in y-o-y terms and new manufacturing orders down 25%-30% and even retail sales showing a decline. Therefore, the figures signal that GDP may have contracted in Q4/08. The contraction would leave FY 2008 growth around 3% only, or just half of 2007's expansion.

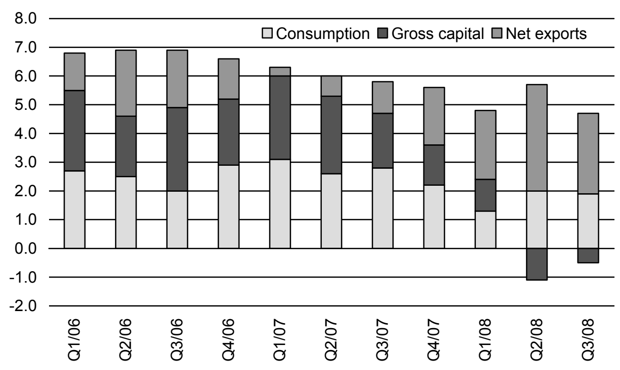
Given its close ties to the eurozone the economy has little chance of escaping recession this year

Looking at the start of 2009, the economic situation does not seem to have improved. Many corporations, mainly but not only from the automotive industry, have implemented temporary shutdowns or four-day working weeks. Loss of demand is feeding through into related sectors such as transportation and business services. Given the openness of the Czech economy with its exports accounting for 67% of nominal GDP, and taking into account the bleak global scenario, the country will unlikely avoid recession this year. We project the real drop in exports (-4.2% y-o-y) to outpace that of imports (-2.8% y-o-y), with the external component subtracting 1.6% from GDP growth. Also fixed investment is set to fall (by 2.5% y-o-y by our projection), with business spending on machinery and transport equipment seen down substantially. Private spending is expected to stay moderately in positive territory, however, with a 1.2% y-o-y gain with the sharp slowdown in inflation supporting real incomes. On balance, we see GDP contracting by 1.2% in 2009, the first negative reading since 1998. From a longer-term perspective, however, the Czech Republic's low macro vulnerability readings and policymakers' proactive policy response to the slowdown suggest that growth can bounce back fast in 2010.

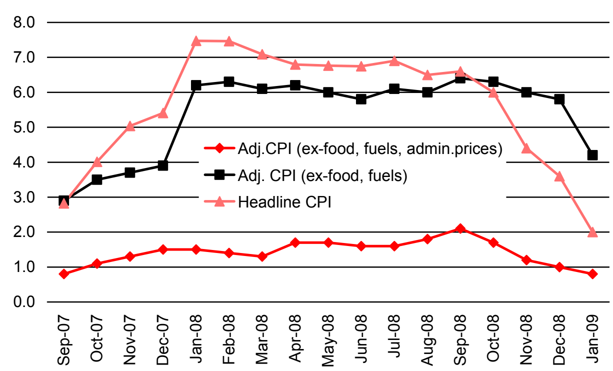
Inflation to continue retreating, with cooling activity and favourable base effect leading the way

In December inflation returned to the 2-4% band targeted by the CNB for 2009. A further drop in inflation to around 2% y-o-y is forecast for the beginning of this year. The main reason is that the impact of the introduction of healthcare fees and the effect of the VAT hike from 5% to 9% coming into force in January 2008 should drop out of the y-o-y comparison. Core inflation will also continue to decelerate driven by mounting spare capacity. On the other hand, the heavily-weighted housing segment is unlikely to push inflation down, as housing costs are set to rise by a similar rate as that seen a year ago. Looking further ahead, cooling economic activity should keep inflation down for the most of this year. We expect the bottom to be reached in Q3 at slightly above 1% y-o-y and average 2009 inflation to be 1.7% y-o-y.

GDP BREAKDOWN – CONTRIBUTION TO GDP GROWTH IN P.P.



CPI DEVELOPMENT AND ST OUTLOOK



Source: Czech Statistical Office, UniCredit Research

CZK on a roller-coaster ride

CZK sharp retreat to bring at least some respite to exporters

Over the last 18 months, the Czech koruna has been on a roller-coaster ride, which has lifted EUR/CZK volatility to a decade high. Following its almost 20% y-o-y gain versus EUR in mid-2008, CZK started to weaken late last year and ended 2008 1% weaker on a y-o-y basis. The first month of this year saw the koruna's losses versus the euro extending to more than 20% since mid-2008. With growth indicators set to remain weak in the coming months and monetary policy loose we see CZK remaining under pressure to weaken and factor in EUR/CZK at 29.0 by end Q1/09. We don't see this as a one-way blessing for the economy. While it is hoped to bring some alleviation to exporters' strains, the fact that some may have hedged this year's expected revenues at firmer CZK levels last year will dampen the revenue boost. Also, inflationary impacts of a weaker CZK cannot be ignored.

Balance of payments in good shape

Neither the size of the C/A gap nor the debt level threaten to alter the firm external position of the economy

Despite significant near-term growth risks, the Czech Republic continues to have some of the lowest macro vulnerabilities in the region. We expect the C/A deficit to have widened to 3.4% of GDP last year but the gap is set to be fully covered by net FDI inflows projected at 4.1% of GDP. Positively, the overall BoP picture is not expected to deteriorate much this year. Although the FDI as a % of GDP is set to shrink, we assume the same for the C/A where the projected decline in dividend outflows (on the back of lower corporate profitability) should outweigh a mild drop in foreign trade surplus. More broadly, external debt remains relatively low at an estimated 42.4% of GDP.

Policymakers are reacting proactively to the slowdown

Further rate cuts depend on CZK & economic activity

The bleak economic outlook and falling inflation (notwithstanding the January surprise on the upside) continue to provide arguments for looser monetary policy, whilst depreciating CZK urges caution. With the risk of CZK weakness extending in near term, we don't think that the CNB would continue cutting the repo rate without any break. That said, we believe that the exchange rate stabilization may open the door for a final 25bp rate cut to 1.50% in Q2.

On the fiscal policy side, the 2009 budget assumes a moderate 1.6% of GDP deficit which is, however, based on a high GDP growth assumption. The government will debate measures to tackle the economic crisis in the few weeks. Notwithstanding that, automatic stabilizers within public finance are set to stimulate fiscal policy without any extra measures taken. We predict the deficit will approach 3% of GDP in 2009.

Politics – Minority government to sustain

Despite its recent reshuffle, the government will find it increasingly difficult to proceed with further economic reforms

The long-awaited cabinet reshuffle, accomplished in January, is unlikely to alter the principle woe of the government coalition: its actual minority status in the Lower House. Key economic reforms such as pension and healthcare are set to stall whilst anti-crisis measures, if any, will face a complicated birth. In autumn at the latest, the opposition is likely to make another attempt to vote the government down.

Estonia

Outlook

Weak local indicators coupled with a fragile global environment set a difficult agenda for 2009, as retreating consumer demand and falling exports have already pushed the economy into a recession. FDI remained stable in 2008, but risks are to the downside in 2009 – while politicians deny the need for broader help from the international community. Either way the government is poised to make some unpopular decisions as tax collection has been falling.

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

MACROECONOMIC DATA AND FORECASTS

	2006	2007	2008e	2009f	2010f
GDP (EUR bn)	13.1	15.3	16.2	16.1	16.5
Population (mn)	1.3	1.3	1.3	1.3	1.3
GDP per capita (EUR)	9745	11379	12063	12022	12359
GDP (constant prices y-o-y %)	10.4	6.3	-2.4	-4.6	0.2
Private Consumption, real, y-o-y (%)	12.8	7.8	-4.2	-7.7	-2.2
Fixed Investment, real, y-o-y (%)	19.5	4.8	-4.2	-7.5	-0.3
Public Consumption, real, y-o-y (%)	1.8	3.9	4.8	-4.8	-0.5
Exports, real, y-o-y (%)	11.6	0.0	-1.4	-6.5	-2.9
Imports, real, y-o-y (%)	20.4	4.2	-8.1	-8.7	-4.1
CPI (year end, y-o-y %)	5.1	9.6	7.0	2.0	2.5
Unemployment rate (%)	5.9	4.7	4.9	6.2	7.3
Budget balance / GDP (%)	3.3	2.7	-1.9	-3.5	-2.9
Current account balance (EUR bn)	-2.2	-2.8	-1.7	-1.1	-0.5
Current account balance / GDP (%)	-16.7	-18.1	-10.3	-6.7	-3.0
Net FDI (EUR bn)	0.5	0.8	0.6	0.3	0.2
FDI % GDP	4.2	5.3	3.7	1.8	1.1
Gross foreign debt (EUR bn)	12.8	17.2	20.3	23.1	24.4
Gross foreign debt (% of GDP)	97.7	112.4	125.9	143.6	147.7
FX reserves (EUR bn)	2.1	2.2	2.8	2.0	1.7
(Cur.Acc-FDI) / GDP (%)	-12.5	-12.8	-6.6	-4.9	-2.0
FX reserves / Gross foreign debt (%)	16.6	13.0	13.5	8.7	7.0
Exchange rate to USD eop	11.9	10.7	11.2	11.0	12.0
Exchange rate to EUR eop	15.6	15.6	15.6	15.6	15.6
Exchange rate to USD AVG	12.5	11.4	10.6	11.3	11.5
Exchange rate to EUR AVG	15.6	15.6	15.6	15.6	15.6

Source: UniCredit Research

Macro outlook

Negative GDP growth data since Q2/08

The economy slipped into recession in Q2/08, GDP growth turned negative (at -1.1% y-o-y) and continued to fall in Q3/08 (-3.5% y-o-y) . The main driver behind the contraction was fading consumer demand – all but one retail sales release in 2008 registered negative growth or were close to zero. Moreover, Q4/08 saw a rapid fall in industrial production, with the December contraction reaching -20.7% y-o-y, adding more pain to the already poor sentiment after the 4.5% y-o-y drop in Q3/08.

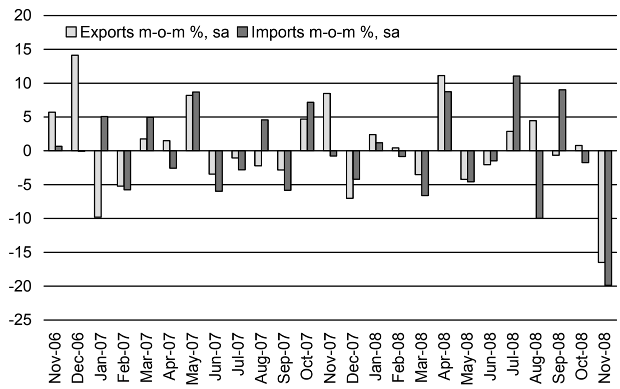
Recession to continue throughout 2009

Given the weak local indicators and a fragile global backdrop, 2009 is set to be a difficult year for Estonia. We expect further falls in private consumption, a drop in investment activity and a decrease in exports. On the back of this, we see Estonian GDP shrinking by 4.6% y-o-y in 2009, after a 2.4% fall in 2008.

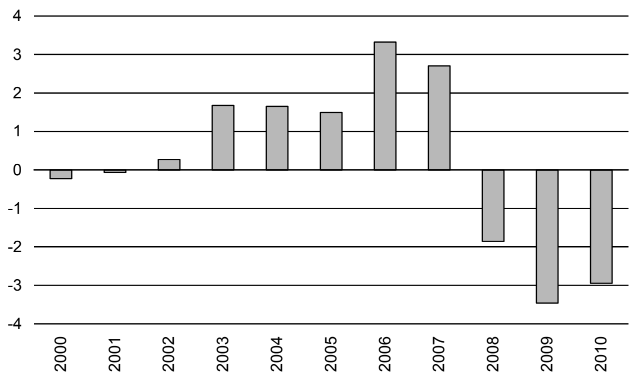
Inflation moving lower

After having peaked at 11.8% y-o-y in June, the inflation figure has moved lower coming in at 7.0% y-o-y in December. Core inflation has also been falling, coming in at a seasonal adjusted 0.4% m-o-m at the end of 2008, down from a 2008 average of 0.6%. We expect inflation to continue to move lower in 2009 on lower energy prices and a further slowdown in domestic demand. Our central forecast for 2009 is an average inflation rate of 2.7% y-o-y.

EXPORTS AND IMPORTS (SEAS. ADJ.) DROPPED SHARPLY



BUDGET BALANCE % GDP



Source: Statistical Office and Ministry of Finance, UniCredit Research estimates

Macro vulnerability indicators

Narrowing current account deficit

Given the soft import performance and the weakening export growth figures (the seasonal adjusted m-o-m data dropped sharply at the end of last year for exports as well as for imports – see chart above) the current account deficit fell to 12.0% of GDP by Q3/08 from 18.1% in 2007. We expect the overall 2008 balance to come in at 10.3% and forecast a further shrinking of the current account deficit to 6.7% in 2009, despite the weakening in export growth – linked to the fact that some 70% of Estonia's exports go to the EU. This trend is likely to continue in 2010 with a sharp narrowing of the deficit to 3% to GDP.

FDI has been quite stable in 2008 and is expected to come in only slightly lower in comparison to the 2007 levels. This is, however, set to change in 2009, as inflows are expected to decelerate sharply. Despite this, Estonian politicians have so far rejected the need to follow Latvia's path in asking the IMF or the broader international community for financial help.

Estonia's FX reserves have not seen as large a decrease as those of Latvia's in Oct/Nov 2008. However, it should be noted that the FX reserves peaked at EUR 3.3bn in October and have since been steadily decreasing. The reported EUR 2.8bn at the end of 2008 represented a 15% decrease from October's levels.

Policy response to macro outlook

First budget deficit in 2008 for several years

Given the weak economic activity, particularly expressed in the lower than planned tax collection figures, the Estonian central government ran a deficit for the first time in years. The deficit amounted to some 2% of GDP in 2008 and was met by state reserves (see chart on previous page).

The fact that Estonia managed to run budget surpluses in previous years gives the central government more room for manoeuvre in the current circumstances compared to its Baltic neighbours. However, the planned 2009 budget represents a major challenge to Estonian politicians, especially against the backdrop of a further worsening economy. The targeted deficit of below 2% of GDP in 2009 is also optimistic, since it is based on an expected GDP contraction of "only" 2.1-3.5% y-o-y. The more likely outcome, namely a deficit that exceeds 3%, is per se not a big risk, given – as mentioned above – the fiscal reserve.

Politics

No riots seen in Estonia so far

The three party coalition led by PM Andrus Ansip found it very difficult to find a consensus over the 2009 budget – with further alterations to the budget likely ahead, the decision making is set to become increasingly difficult. Nevertheless, we don't expect major instability or difficulties on the political front.

In contrast to Latvia and Lithuania, Estonia so far has not seen any social unrest or riots caused by unpopular political measures and the weak state of the economy. This might, however, change if the government has to make severe austerity amendments to the budget.

The unemployment rate has increased sharply over the last months of 2008 and reached 4.7% (according to the Estonian Labour Market Board). This is the highest figure for more than four years.

Hungary

Outlook

GDP is set to contract by 3.0% in 2009 with a significant fall off in domestic demand in the driver's seat. The policy response to the growth slowdown is also constrained by high external private sector FX leverage levels. On a brighter note, the significant IMF/EU balance of payments support meaningfully reduces external financing risks and increases policymaker scope to stabilize the currency at slightly weaker levels.

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	Moody's	S&P	Fitch
Long-term foreign currency credit rating	**A3 negative**	**BBB negative**	**BBB stable**

MACROECONOMIC DATA AND FORECASTS

	2006	2007	2008e	2009f	2010f
GDP (EUR bn)	90.0	101.1	105.8	92.4	103.4
Population (mn)	10.1	10.1	10.1	10.0	10.0
GDP per capita (EUR)	8932	10048	10530	9199	10322
GDP (constant prices y-o-y %)	4.1	1.1	0.7	-2.8	0.9
Private Consumption, real, y-o-y (%)	1.9	-1.8	0.3	-6.5	-1.1
Fixed Investment, real, y-o-y (%)	-6.2	1.5	-2.2	-1.2	4.1
Public Consumption, real, y-o-y (%)	5.8	-2.2	0.6	-3.6	0.0
Exports, real, y-o-y (%)	18.6	15.9	3.1	-7.8	6.1
Imports, real, y-o-y (%)	14.8	13.1	2.8	-11.0	4.7
CPI (year end, y-o-y %)	6.5	7.4	3.5	2.0	2.8
Central bank reference rate	8.0	7.5	10.0	7.0	6.5
Unemployment rate (%)	7.5	7.4	7.8	9.5	8.8
Budget balance / GDP (%)	-9.3	-4.9	-3.3	-2.9	-2.6
Current account balance (EUR bn)	-6.8	-6.5	-7.3	-2.7	-3.5
Current account balance / GDP (%)	-7.5	-6.4	-6.9	-2.9	-3.3
Net FDI (EUR bn)	0.5	0.7	2.1	1.1	1.2
FDI % GDP	0.6	0.7	2.0	1.1	1.1
Gross foreign debt (EUR bn)	83.3	100.4	115.0	115.0	112.1
Gross foreign debt (% of GDP)	92.5	99.3	108.7	124.5	108.4
FX reserves (EUR bn)	16.4	16.4	24.0	29.0	29.0
(Cur.Acc-FDI) / GDP (%)	-6.9	-5.7	-4.9	-1.8	-2.2
FX reserves / Gross foreign debt (%)	19.7	16.3	20.9	25.2	25.9
Exchange rate to USD eop	191.3	173.7	189.8	197.2	200.0
Exchange rate to EUR eop	252.3	253.4	264.8	280.0	260.0
Exchange rate to USD AVG	210.3	183.3	170.8	210.2	198.5
Exchange rate to EUR AVG	264.3	251.3	251.3	290.3	270.0

Source: UniCredit Research

Domestic demand set to be weak in 2009

Growth collapsed in Q4/08

GDP growth slowed significantly in Q3 to just 0.8% and we expect it to contract in Q4 by around 1.5% y-o-y, as industrial production growth was increasingly dragged down by the recession in the eurozone. Both export and industrial production posted double-digit declines in Nov-Dec.

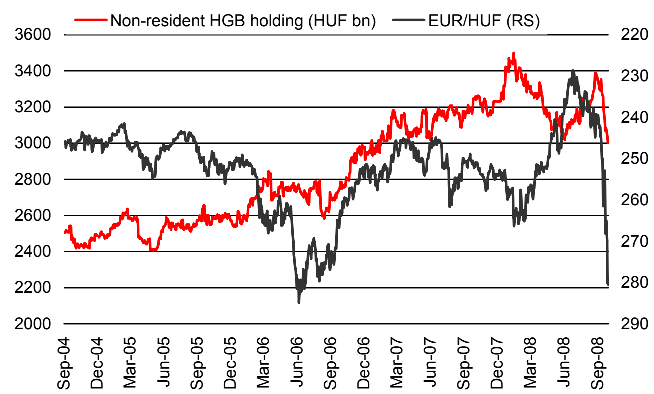
2009 is not looking better as household demand and investments are expected to free fall

In 2009 we expect GDP to contract by 2.9%. The decline will be driven by a slightly more than 6% y-o-y collapse in household demand and a 1.2% y-o-y contraction in fixed investments. The main driving force will be rapidly slowing wage growth (only 3.2% vs. 8.5% in 2008) and an expected contraction in credit for both the household and corporate sectors. The slowdown in wages is primarily fuelled by a sharp rise in unemployment and a cap on public sector wage growth. The credit contraction is mostly the result of the lack of new external financing and a switch to local currency funding and rates. Despite the already very weak figures we believe that the balance of risks is on the downside given a weaker currency may further impinge on household disposable income and another raft of fiscal measures might be announced to offset the effect of lower than expected inflation.

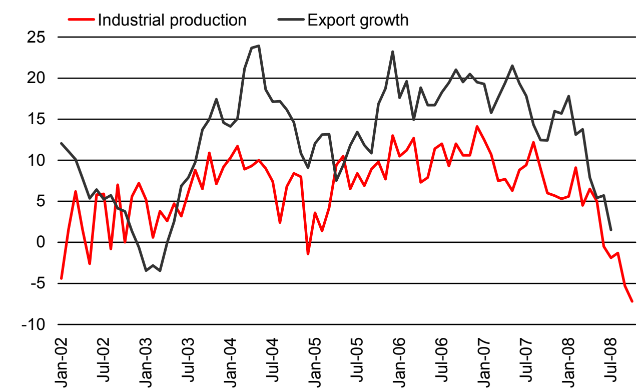
Meanwhile inflation will likely breach the NBH target in Q1/09 and will remain below that during the whole year

Inflation reached 3.5% y-o-y at the end of 2008 and we expect the inflation target (3%) to be breached in Q1/09 and to ease further to around 1% y-o-y by mid year before slightly accelerating to around 2% by the end of the year mostly on the back of higher EUR/HUF and adverse base effects. Core inflation was 30bp above the headline inflation at the end of December. Given the extremely poor outlook for domestic demand we do not see any meaningful inflation pressure and hence expect core inflation to follow the pattern of the headline figure. A potential hike in VAT rate represents some upside risk to this outlook.

NON-RESIDENT HOLDINGS OF BONDS V EUR/HUF



INDUSTRIAL PRODUCTION



Source: AKK, Bloomberg, Statistical Office

Private sector FX imbalances are a risk, but IMF & EU support is significant

Current account deficit is expected to improve on the back of falling imports and weaker HUF

Although the trade balance improved in 2008 to nearly zero from a significant 2.3% of GDP deficit, the income balance deteriorated and the external financing need remained relatively high at around 7% of GDP. The net result of the domestic demand slowdown in 2009, however, is that the trade balance and also the services balance will post a meaningful surplus pushing the current account deficit to around 4% of GDP in 2009. This will be attributable to imports falling even faster (9.3% y-o-y) than exports (around 6% y-o-y), given the lack of domestic demand and weaker HUF. FX reserves increased to EUR 24bn by the end of 2008 (22% of GDP from 16% a year earlier) boosted by the arrival of the first of three tranches from the IMF (circa EUR 5bn).

External financing has been largely addressed by the IMF led package

Hungary's external debt levels proved to be the major Achilles heel of the country. They moved well above 100% of GDP by the end of Q3/08, which was among the highest in EEMEA especially if ranking by using the Guidotti-Greenspan rule (which says short-term external debt should not exceed FX reserves) meaning that the financing of the external deficit could have been problematic if rollover ratios remained well below 100%. As a response the government secured a USD 25bn financing package from the IMF/WB and the EU. With this in place external financing in 2009 is secured even if rollover ratios were to come in at zero. Such a low rollover ratio is unlikely in our view, however, given the commitment of non-resident parent banks to their local operations and the confidence engendered by the IMF/EU support package.

HUF threatens to slow easing cycle

NBH has already reversed 2/3 of the Oct 300bp rate hike

Interest rates have been cut by a total 200bp since fiscal loosening started in November. This almost completely reverses the 300bp rate hike in October when the NBH had to support the HUF before securing the IMF agreement. Significantly falling inflation in the last 3M and the stabilizing FX rate provided the justification for the easing.

Meanwhile fiscal policy is going through a major cyclical adjusted tightening…

The fiscal deficit is expected to remain flat at around 2.9% of GDP, which in the current growth backdrop (around 5% below potential growth) represents a huge cyclical adjusted fiscal tightening. Even with the flat fiscal deficit assumption Hungary's public debt could spike well above 70% in 2009. Accordingly, we believe if growth deteriorates further the government will have to offset the revenue shortfalls with lower expenditures or higher tax rates. If the growth outlook deteriorates even further and the FX ratio of total public debt increases (as IMF proceeds are substituting local funding at the moment) we see a risk of more sovereign downgrades (the rating outlook is currently negative with Moody's and S&P).

…and the NBH cannot fully compensate for it given high private sector FX leverage

Accordingly local policymakers are in a very tight corner

Over the next 12M we expect the NBH to continue the gradual easing but given the high FX leverage in the private sector (62% of household loans denominated in FX) they cannot ignore EUR/HUF developments. Our bias is that the NBH will try to keep EUR/HUF in the 300-310 range, possibly through FX intervention and a temporary pause in the easing cycle (at the extreme hikes could even move back onto the radar screen). As 2009 progresses we expect EUR/HUF to stabilise – partly given the impact of increasingly cheap fundamental valuations on the trade balance – and for cuts to thereafter resume, pushing the NBH key rate down to 7% by the end of the year.

Politics

Government has secured the necessary support to pass the 2009 budget

The position of the Hungarian Socialist Party (MSZP) which theoretically runs a minority government has somewhat stabilized since the outbreak of the crisis in October 2008. Both the previous coalition partner (Free Democrats) and the smaller opposition party (Democratic Forum) supported the 2009 budget vote and showed a willingness to pass the amended budget (which will be presented in the coming weeks).

But the coming months look challenging as the economic downturn feeds into the public mood and the government may need to continue tightening

Over the next few months, however, the above "coalition" might be seriously tested as the economic downturn starts to be more widely felt by the population and the government could potentially face even more difficult decisions to keep the budget deficit on track. Another potential risk may arise from the forthcoming EU elections where the government is expected to lose by a very wide margin.

Latvia

Outlook

Demand is set to continue its fall, as a weak consumer, constrained by a tight labour market and limited credit availability, keeps his purse shut. However, the pronounced international support of USD 10bn and a responsive government – implementing a package of severe austerity measures – ought to give the economy its necessary dose of bitter medicine, and pave way for a future recovery. For now, riots and social unrest, paint difficult times ahead for Latvia's politicians, however.

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

MACROECONOMIC DATA AND FORECASTS

	2006	2007	2008e	2009f	2010f
GDP (EUR bn)	15.9	19.9	22.0	21.9	22.4
Population (mn)	2.3	2.3	2.3	2.3	2.3
GDP per capita (EUR)	6928	8705	9688	9727	9945
GDP (constant prices y-o-y %)	12.2	10.3	-2.9	-5.7	-1.9
Private Consumption, real, y-o-y (%)	21.2	13.9	-5.9	-5.2	-0.9
Fixed Investment, real, y-o-y (%)	16.4	8.4	-7.0	-8.8	-0.7
Public Consumption, real, y-o-y (%)	4.9	4.8	0.1	-8.0	-3.0
Exports, real, y-o-y (%)	6.5	11.1	-1.3	-6.6	-1.3
Imports, real, y-o-y (%)	19.4	15.0	-8.1	-4.9	-0.1
CPI (year end, y-o-y %)	6.8	14.1	10.9	3.6	3.9
Central bank reference rate	5.0	6.0	6.0	5.0	4.5
Unemployment rate (%)	6.8	6.0	5.3	8.0	8.8
Budget balance / GDP (%)	-0.2	0.1	-2.7	-5.1	-3.8
Current account balance (EUR bn)	-3.6	-4.6	-3.2	-1.7	-1.0
Current account balance / GDP (%)	-22.5	-23.8	-14.5	-7.8	-4.7
Net FDI (EUR bn)	1.2	1.4	1.1	0.6	0.5
FDI % GDP	7.5	7.2	5.2	2.9	2.0
Gross foreign debt (EUR bn)	18.1	26.8	31.8	34.8	37.5
Gross foreign debt (% of GDP)	114.0	135.1	144.6	158.6	167.4
FX reserves (EUR bn)	3.3	3.8	3.6	2.4	1.9
(Cur.Acc-FDI) / GDP (%)	-15.0	-15.8	-9.4	-4.9	-2.6
FX reserves / Gross foreign debt (%)	18.2	14.1	11.3	6.9	5.1
Exchange rate to USD eop	0.5	0.5	0.5	0.5	0.5
Exchange rate to EUR eop	0.7	0.7	0.7	0.7	0.7
Exchange rate to USD AVG	0.6	0.5	0.5	0.5	0.5
Exchange rate to EUR AVG	0.7	0.7	0.7	0.7	0.7

Source: UniCredit Research

Macro outlook

GDP contracted in the second half of 2008…

Latvia's economy is experiencing a hard landing: real GDP growth contracted by 4.6% y-o-y in Q3/08 and as recent growth indicators show is set to contract further. Retail sales data were heavily in the red (i.e. the last three releases showed double-digit contractions on a yearly basis, see chart). While industrial production data saw shrinking activity, with the November release recording a contraction of 13.9% y-o-y.

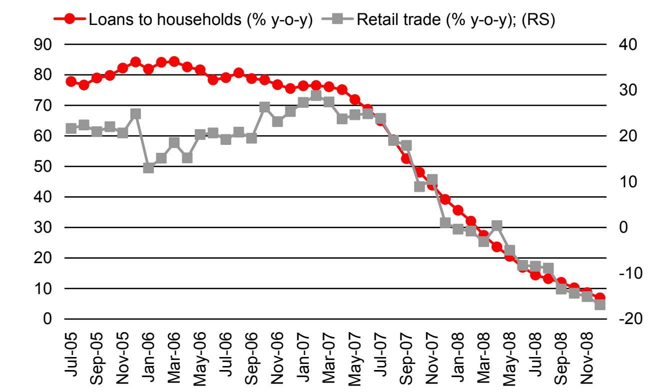
…and is set to contract further in 2009

We forecast a GDP contraction of 6% in 2009, as demand is expected to fall in all areas of the economy. In addition, to a weak consumer, who is constrained by a tight labour market and lack of credit availability, we forecast a contraction in investment, public consumption (revenue and hence government spending constraints due to slowdown) and exports in 2009 (exports to the EU account for approximately 75% of Latvia's total exports).

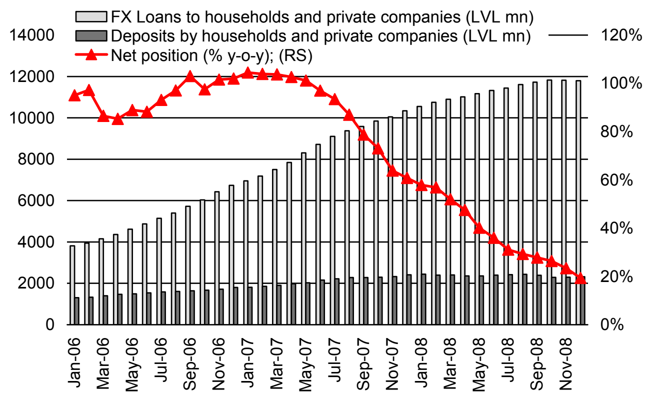
Inflation is coming down

Inflation, amounting to a 2008 average figure of 15.5% y-o-y, will continue to come down in 2009 on falling commodity and food prices pressure as well as further weakening domestic demand. Core inflation peaked in May at 13.7% y-o-y and decreased steadily since then to reach 10.7% at the end of last year. Given the economic contraction as well as the above mentioned external factors, we believe that average 2009 inflation is likely to fall to about 5.4% y-o-y.

RETAIL SALES AS WELL AS LOANS TO HOUSEHOLDS MOVED SHARPLY SOUTH



INTERNATIONAL RESERVES AND INTERVENTIONS BY THE CB



Source: Central Bank, Statistical Office, UniCredit Research

Macro vulnerability indicators

C/A deficit likely to drop sharply…

The expected fall in FDI and the still relatively wide current account deficit indicate that Latvia might face problems in funding its financing gap, especially as its FX reserves decreased considerably in October and November 2008 on interventions by the Central Bank (CB) to support the lat. FX reserves, however, picked up again in December, when the CB could stop intervening, given the good news of the international support package of USD 10bn. The financing gap, therefore, should be less of a worry for now. This, in turn, underpins our central scenario, that the Central Bank will succeed in keeping the LVL within the ±1% band to the euro – in place since 2005.

…but funding gap remains a risk

The private sector carries a large FX debt burden. It should be noted, however, that the y-o-y growth rate of private sector net FX indebtedness has moved lower steadily over 2008, in Jan 2008 the growth rate stood at 57.9% y-o-y while in Dec it had come down to 19.4% y-o-y (see chart above).

Austerity measures package adopted

Sharp fiscal contraction on its way

Responding to the fast deteriorating macroeconomic outlook and also in order to qualify for the international support package Latvia committed itself to a package of severe austerity measures at the end of last year. This package includes, alongside other measures, higher VAT and a 15% cut in public sector wages in 2009. As a result general government expenditure is planned to decrease by about 20% compared to last year. The country targets a deficit of 5% of GDP for 2009.

Given the expected further fall in economic activity, the targeted deficit of 5% of GDP in 2009 still looks a bit optimistic and the risk is that Latvia won't be able to meet this target. The fact, however, that the availability of funding is especially scarce at the moment means that the Latvian government does not have a lot of possibilities at hand to stretch the budget deficit a lot further. The logical result, namely a further cut in public expenditure if revenues come in sharply lower than expected, is likely to increase the already mounting social tensions.

Politics – difficult times ahead

Riots in January, call for early elections

After the riots seen in Latvia in mid January, which were the first riots of this kind since Latvia's independence in 1991, the four party coalition government led by PM Ivars Godmanis has come increasingly under pressure and the situation has evolved into – as some commentators already call it – a political crisis. The main request of the protesting and rioting people is the dissolution of parliament which is, in their eyes, the main culprit of the difficult economic situation Latvians are currently facing.

President Zatlers, the one who could start the process of dissolving the parliament, has so far refused to do so and offered a compromise instead: He wants PM Godmanis to reorganise the government in such a way as to include members of the opposition in its ranks. By doing so, he hopes that early elections can be avoided. At the same time, however, he also wants to have the constitution changed, so that it becomes easier to dissolve parliament if the public is not satisfied with its government.

Further tensions to be expected

It is, however, questionable if these measures can really prevent the public from calling for early elections, especially given the difficult times ahead (the tough fiscal policy measures, falling real wages and the likely sharp increase in the unemployment rate). According to the Welfare Minister, Iveta Purne, the unemployment rate could double to 14% from 7% at the end of 2008, which was already the highest for more than two and a half years. In a nutshell, this means further social unrest and difficult times ahead for Latvia's politicians.

Lithuania

Outlook

Positive dynamics for most of 2008 and a lesser degree of overheating in comparison to its Baltic peers, are still expected to give way to a recession in Lithuania. This will force a readjustment of growth, and a contraction of the current account deficit. While austerity measures set in place by the government ought to make this a painful, but hopefully short lived adjustment.

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	Moody's	S&P	Fitch
Long-term foreign currency credit rating	**A2 negative**	**BBB+ negative**	**A- negative**

MACROECONOMIC DATA AND FORECASTS

	2006	2007	2008e	2009f	2010f
GDP (EUR bn)	24.0	28.4	32.8	34.4	36.3
Population (mn)	3.4	3.4	3.4	3.4	3.3
GDP per capita (EUR)	7065	8420	9752	10240	10845
GDP (constant prices y-o-y %)	7.8	8.9	3.2	-4.7	-0.3
Private Consumption, real, y-o-y (%)	10.6	12.4	3.3	-5.0	-3.0
Fixed Investment, real, y-o-y (%)	19.4	20.8	-2.5	-4.8	-1.3
Public Consumption, real, y-o-y (%)	3.7	3.3	3.7	-7.0	1.5
Exports, real, y-o-y (%)	12.0	4.3	12.8	-4.6	-2.0
Imports, real, y-o-y (%)	13.7	11.6	9.9	-8.3	-4.1
CPI (year end, y-o-y %)	4.5	8.1	8.8	4.0	4.2
Unemployment rate (%)	5.6	4.3	5.5	7.1	8.4
Budget balance / GDP (%)	-0.4	-1.2	-1.8	-3.0	-1.6
Current account balance (EUR bn)	-2.6	-4.1	-3.9	-2.3	-1.4
Current account balance / GDP (%)	-10.6	-14.6	-11.9	-6.6	-3.9
Net FDI (EUR bn)	1.2	1.0	0.6	0.4	0.3
FDI % GDP	5.1	3.6	1.9	1.0	0.8
Gross foreign debt (EUR bn)	14.4	20.5	25.1	29.9	34.3
Gross foreign debt (% of GDP)	60.2	72.3	76.4	87.0	94.7
FX reserves (EUR bn)	4.4	5.2	4.5	3.8	3.6
(Cur.Acc-FDI) / GDP (%)	-5.6	-11.0	-10.0	-5.6	-3.2
FX reserves / Gross foreign debt (%)	30.5	25.3	17.9	12.7	10.5
Exchange rate to USD eop	2.6	2.4	2.5	2.4	2.7
Exchange rate to EUR eop	3.5	3.5	3.5	3.5	3.5
Exchange rate to USD AVG	2.7	2.5	2.3	2.5	2.5
Exchange rate to EUR AVG	3.5	3.5	3.5	3.5	3.5

Source: UniCredit Research

Macro outlook

Still strong GDP growth in H1/2008

Lithuania showed fewer signs of overheating compared to its two Baltic peers in recent years, though it is still set to follow them into a recession. The economy recorded an impressive average 6.1% y-o-y GDP growth rate in the first half of 2008 and an expansion of 2.9% y-o-y in Q3, but those figures are very likely to have been the last positive figures for quite some time: industrial production came in at -4.6% y-o-y in Q4/08, down from 2.5% y-o-y in Q3. A similar pattern can be seen in the retail figures: after a peak of 27.10% y-o-y in February, the indicator deteriorated sharply and plummeted to -11.7% in November.

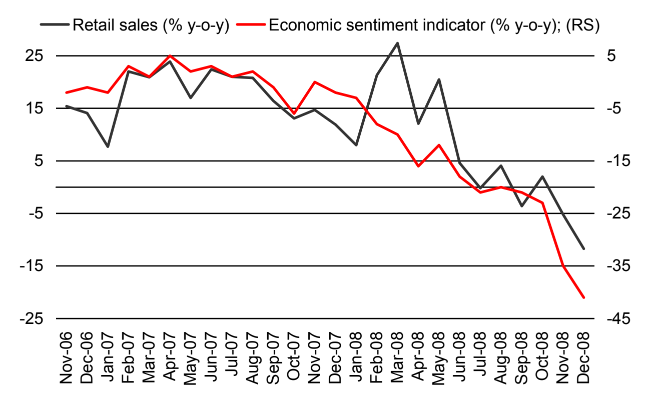
But contraction already under way

Despite the expected contraction in Q4/08 the previous positive dynamics will provide support and tally growth for 2008 to some 3.2% y-o-y. However, in 2009 a different dynamic is expected – the economy is set to contract by 4.7% y-o-y on weak domestic demand, falling exports and a drop in investment. The recession, already under way, is also reflected by the falling economic sentiment indicators, which have slipped to their lowest level in six years.

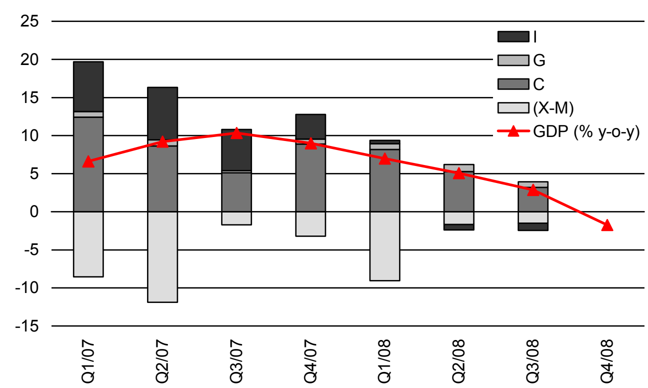
Inflation likely to decrease

Inflation moved down steadily over the second half of 2008, after peaking at 12.5% y-o-y in June. Falling energy and food prices contributed to an 8.5% y-o-y in December rate. Given the weakening domestic demand, as well as the low energy and food prices, we expect CPI to move lower over the course of 2009 to an average of 5% y-o-y. Having said that, it should be noted that temporary increases in the inflation rate will be on the agenda in 2009, given the increases in VAT and excise taxes put in place by the new government. Core inflation moved lower in 2008 as well, representing waning consumer demand: the end-of-period seasonal adjusted m-o-m figure was 0.3%, while the seasonal adjusted annual average figure amounted to 0.7% m-o-m.

ECONOMIC SENTIMENT INDICATOR IS PLUMMETING



GDP GROWTH TO EXPLORE NEGATIVE TERRITORY



Source: European Commission, Central Bank, Statistical Office, UniCredit Research

Macro vulnerability indicators

Exports as well as imports have already started moving lower

Export as well as import growth rates started to move lower in the second half of 2008. This means that the export growth rates came down to a (still strong) 3 month average of 22.5% y-o-y at the end of 2008 while it stood at 27.4% y-o-y at the beginning of the year. A similar, but more extreme, pattern could be observed in the import data, the 3 months average of the latest data available in 2008 amounted to 10.2% y-o-y from 31.5% y-o-y seen at the start of the year. The result, namely, a shrinking current account deficit is – not surprisingly – barely visible in the Q4/07-Q3/08 data; the current account deficit for this period came in at 14.5% to GDP, only slightly lower than the 2007 figure of 14.6%. Given, however, the marked fall in imports in Q4, we expect the current account deficit to register 12.5% in 2008.

C/A deficit to narrow sharply over 2009

For 2009, we expect the fall in imports (and also the decrease in export growth rate figures) to continue, on the back of this we pencil in a current account deficit of 6.7%. FDI decreased over the course of 2008 and is expected be about 70% of 2007's levels. We expect a similar declining trend in 2009.

International reserves amounted to LTL 15.8bn at the end of 2008, which is lower than end 2007's figure of LTL 18.2bn. Likely resulting from the events in Latvia, Lithuania's international reserves fell in November to the lowest level seen in more than one year, but picked up again in December.

Policy response to macro outlook

Increasing budget deficit

Most recent figures show that the economic downturn led to lower than expected tax receipts in 2008 which means that the budget deficit widened to 2.9% of GDP; the largest deficit since 2001.

The 2009 budget deficit is, however, set to be at least as large as this year's deficit, if not larger. This is despite the austerity measures set in place by the new government: In order to prevent Lithuania from having to turn to the international community for financial help, the new government decided on tough fiscal measures. These involve raising VAT, cutting public sector wages as well as increasing corporate taxes. The government said that it wanted to cut the government deficit to 2.1% in 2009, which is going to be a difficult task, given the expected decrease in economic activity and the sharp contraction Lithuania will probably face.

No changes in the exchange rate regime expected

As in the case for Latvia and Estonia, we don't expect any change in the current exchange rate regime, conditional, however, on the developments in Latvia (i.e. if Latvia's peg were to face severe problems or even a devaluation, Lithuania and Estonia would be affected as well).

Politics

New parliament faces headwind because of austerity measures

Lithuania elected a new parliament in October 2008, which took over at the end of last year. Andrius Kubilius is the new PM leading the centre-right coalition which faces increasing headwind as people are becoming increasingly unhappy with the economic policy in place and the anticipated austerity measures. As seen in Latvia, Lithuania experienced severe riots in the middle of January which had, however, less immediate political consequences.

As in Latvia, the future rise in unemployment and the further expected deterioration of the economic situation leads us to the conclusion that further riots are very likely to take place in the coming months as well. This is especially true, as Lithuanians are becoming increasingly worried about their jobs: a recent survey in a newspaper revealed that over 31% of the population are worried that they might lose their jobs in the near future.

Poland

Outlook: We look for growth to slow in 2009, but remain in positive territory on the back of consumer demand. A significant easing of monetary conditions by the central bank also supports end of year recovery prospects, though with the implication that the zloty has started the year on a very weak footing. We consider current zloty levels to be undervalued and expect to see some recovery in H2/2009 when growth starts to stabilize.

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

MACROECONOMIC DATA AND FORECASTS

	2006	2007	2008e	2009f	2010f
GDP (EUR bn)	272.1	310.8	361.7	301.4	358.8
Population (mn)	38.1	38.1	38.1	38.1	38.1
GDP per capita (EUR)	7137	8154	9491	7910	9420
GDP (constant prices y-o-y %)	6.2	6.7	4.9	1.2	2.8
Private Consumption, real, y-o-y (%)	5.0	5.0	5.0	2.9	4.0
Fixed Investment, real, y-o-y (%)	14.9	17.6	7.2	-4.1	-1.0
Public Consumption, real, y-o-y (%)	6.1	3.7	-0.8	2.7	2.5
Exports, real, y-o-y (%)	14.6	9.1	8.0	-3.4	9.2
Imports, real, y-o-y (%)	17.3	13.6	7.6	-3.9	7.6
CPI (year end, y-o-y %)	1.4	4.0	3.4	2.1	2.3
Central bank reference rate	4.0	5.0	5.0	3.3	4.0
Unemployment rate (%)	16.2	12.7	9.8	10.5	11.7
Budget balance / GDP (%)	-1.8	-2.0	-2.4	-3.3	-3.1
Current account balance (EUR bn)	-7.4	-14.6	-19.2	-15.6	-17.4
Current account balance / GDP (%)	-2.7	-4.7	-5.3	-5.2	-4.8
Net FDI (EUR bn)	15.7	16.7	11.4	7.2	10.0
FDI % GDP	5.7	5.4	3.1	2.4	2.8
Gross foreign debt (EUR bn)	128.9	158.4	185.9	195.2	218.6
Gross foreign debt (% of GDP)	46.6	48.3	51.4	64.8	60.9
FX reserves (EUR bn)	36.8	44.7	44.1	48.6	52.4
(Cur.Acc-FDI) / GDP (%)	3	1	-2	-3	-2
FX reserves / Gross foreign debt (%)	29	28	24	25	24
Exchange rate to USD eop	2.9	2.5	3.0	2.8	2.8
Exchange rate to EUR eop	3.8	3.6	4.1	4.0	3.7
Exchange rate to USD AVG	3.1	2.8	2.4	3.2	2.8
Exchange rate to EUR AVG	3.9	3.8	3.5	4.4	3.9

Source: UniCredit Research

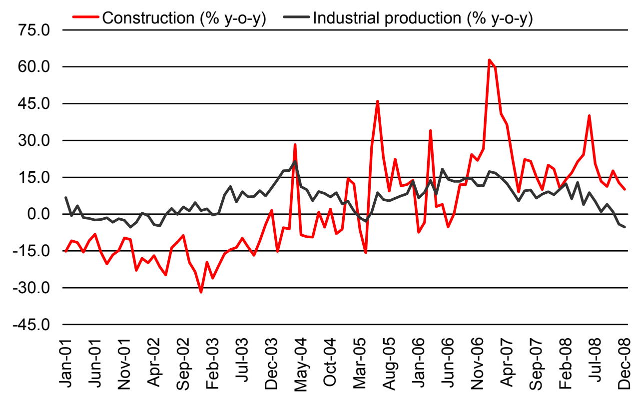
Growth to remain in positive territory

Consumption to support headline growth

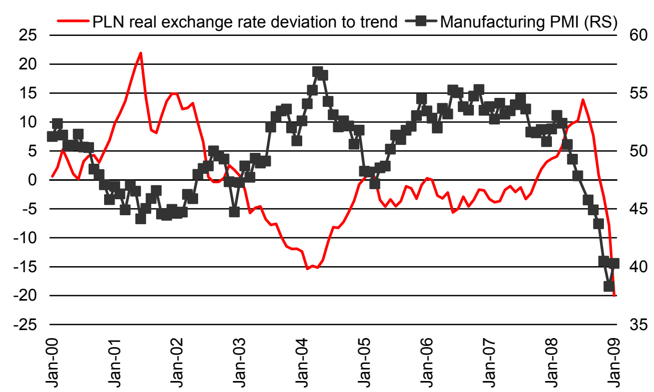
Growth slowed sharply in Q4/08, with a sharp deceleration in consumption, investment and exports pushing full year 2008 growth down to 4.8% from 6.7% in 2007. For 2009, we look for 1.2% GDP growth, with risks skewed to the downside. We forecast private consumption growth at 2.9%, lower than the circa 5% gains seen in 2006-8, but higher than most other countries in the region. We expect consumption to receive support from: **1.** January's cut in personal income tax thresholds (to 18%/32% from 19/30/40%, putting circa PLN 8bn in taxpayers' pockets), **2.** the almost 5% rise in pension and disability payments, **3.** still positive real wage growth. We look for investment to contract 4% in 2009. This assumes, however, that the Cabinet speeds up investment spending (totaling gross EUR 67bn in 2007-2013), which will offset a more pronounced fall in enterprise investment. The risk remains on the downside, as EU-co-financed spending also depends on meeting numerous bureaucratic standards, and usually takes time; therefore the Cabinet's determination to use this way of offsetting the global slowdown may not bear fruit in 2009.

The inflation picture has clearly improved in recent months, as significant declines of commodity and energy prices are pushing respective CPI/PPI items down, whilst the growth slowdown will push core inflation down too. We expect net core inflation (CPI ex food and energy) to decline from 2.8% y-o-y in Dec 2008 to below 1% by end-2009. CPI is expected to fall to 2.2% y-o-y at end 2009 (from 3.3% in Dec 2008). Positive developments are also seen in manufacturing prices – they were up by only 0.8% y-o-y in Dec 2008, and will likely stay below 1% for most of 2009, keeping PPI under control. All these will be clearly supportive for MPC rate cuts.

CONSTRUCTION AND INDUSTRIAL PRODUCTION SLOWED



REAL EXCHANGE RATE V PMI



Source: Eurostat, BIS, Markit, UniCredit Research

Macro vulnerability indicators

Current account deficit set to gradually shrink in 2009

The current account deficit, estimated at end-2008 at 5.3%, will likely slightly improve in 2009 to 4.9%, as the significantly weaker zloty will curb imports, which have already been hit by weaker domestic demand. Meanwhile, although the global slowdown will hit exporters the weaker currency is an offsetting positive. We also see some scope for FDI to hold up, to some extent, with the Polish agency for foreign investments estimating 2009 FDI at EUR 8-10bn (circa EUR 12bn in 2008); the relatively optimistic figure is based on projects already conducted, investment commitments made in previous years, as well as due to fresh projects. In this context it's worth mentioning the recent decision by Dell (computer company) to move its production facilities from Ireland (where it was one of the largest exporters) to Poland. Similar crisis-triggered changes in production locations may thus be supportive for domestic export performance.

Official reserve assets were little changed in 2008 (EUR 44.1bn in Dec) vs. 2007 (EUR 44.7bn), having previously continuously increased since 2003 (EUR 27.1bn). Short-term foreign currency debt (EUR 54.2bn in end-08) is expected to decline towards EUR 47bn next year. An important note is that it contains non-residents' deposits and short-term trade liabilities; as imports fall so will the trade debt. Another important note is that in Poland there are no short-term FX consumer loans (contrary to many regional peers), significantly lowering the risk of impact of FX fluctuations on the economy.

NBP seems happy with both lower interest rates and a weaker exchange rate

NBP rate to fall to 3.25% by end 2009

The MPC cut interest rates in Jan 2009 to 4.25% from 5.00% previously, further front loaded cuts are expected, with our baseline scenario of rates falling to 3.25% by year-end. Notably, the MPC has not seemed particularly concerned by the weak zloty so far, suggesting it is relatively relaxed with both an interest rate and currency driven loosening of monetary conditions. Ultimately, however, with the zloty now at fundamentally cheap levels, we do not expect January/February's pace of weakening to sustain through H1/2009, whilst once growth stabilizes in H2 we expect to see the zloty bounce back fast.

There have been no major fiscal changes, apart from lowering personal income tax thresholds from Jan 2008, to 18%/32% from previous 19%/30%/40%. However, this was decided two years ago, and hence had nothing to do with the current crisis. The basic approach of the government is to keep the budget deficit low, speed-up EU-funds utilization to enhance investment, and offer some guarantees for investment.

Feed through of NBP rate cuts muted

Borrowing costs are relatively high

Although NBP interest rates have fallen and will fall further, it is not clear that corporate borrowing costs will fall that much. The global risk premium for longer-dated financing increased (the NBP estimates this effect at around 300-350 bp between pre-crisis time and Oct 2008), and so did competition to attract domestic deposits (also circa 300 bp). This will push the cost of credit higher. Additionally, the net government borrowing needs of circa PLN 40bn (adjusting for weaker growth more likely in the order of PLN 60bn) pose a real threat of crowding-out. Therefore, in spite of lower short-term rates, the cost of new loans will likely increase. Gross government borrowing needs are around PLN 140bn, which is also relatively high against the current financial markets backdrop.

Politics

Government remains popular

Politics remains pretty quiet in Poland, as the ruling Civic Platform (PO) is seeing (poll) support of 40-55%, significantly above the support they got during recent elections (41.5% in autumn 2007). This is not so much due to the spectacular achievements of the current Cabinet, but mostly due to the weakness of the opposition parties. The high level of support will likely be challenged this year, as the economic slowdown is always a drag on popularity of those in power, and additionally the history of Polish politics teaches that usually around two years after elections the ruling party starts experiencing the onset of a sizeable loss of popularity. However, in the coming quarter the political situation will most probably remain stable, not exerting any sizeable negative impact on the markets. Meanwhile, although the government continues to favour 2012 EMU entry, tough market conditions and uncertainty about constitutional amendments suggest it may no longer try to join ERM2 in H1/2009.

Romania

Outlook

Economic growth is forecast to slow rapidly in 2009, against a tight global capital flow backdrop. The positive flipside of this, however, is a significant reduction in the current account deficit and a sharp improvement in the inflation outlook. Fiscal policy and further sovereign credit ratings downgrades remain risk factors, however, something which continues to warn of upside pressure on EUR/RON in 2009.

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

MACROECONOMIC DATA AND FORECASTS

	2006	2007	2008e	2009f	2010f
GDP (EUR bn)	97.8	121.4	136.9	125.6	143.1
Population (mn)	21.6	21.5	21.4	21.3	21.2
GDP per capita (EUR)	4529	5639	6391	5893	6747
GDP (constant prices y-o-y %)	7.9	6.0	8.0	0.6	2.0
Private Consumption, real, y-o-y (%)	11.4	10.2	11.1	0.2	3.3
Fixed Investment, real, y-o-y (%)	19.3	28.9	23.1	0.4	3.9
Public Consumption, real, y-o-y (%)	-9.9	7.4	5.0	1.0	4.8
Exports, real, y-o-y (%)	10.6	8.7	18.2	-8.0	3.8
Imports, real, y-o-y (%)	22.4	26.1	21.2	-6.7	6.5
CPI (year end, y-o-y %)	4.9	6.6	6.3	4.7	4.0
Central bank reference rate	8.8	7.5	10.3	8.5	7.0
Unemployment rate (%)	5.4	4.3	4.0	6.0	5.0
Budget balance / GDP (%)	-1.5	-2.3	-4.8	-5.0	-4.5
Current account balance (EUR bn)	-10.2	-16.7	-17.4	-12.3	-11.5
Current account balance / GDP (%)	-10.4	-13.7	-12.7	-9.8	-8.1
Net FDI (EUR bn)	8.7	7.2	9.6	4.5	4.7
FDI % GDP	8.9	5.9	7.0	3.6	3.3
Gross foreign debt (EUR bn)	31.4	38.5	50.6	56.9	65.4
Gross foreign debt (% of GDP)	32.2	31.7	36.9	45.3	45.7
FX reserves (EUR bn)	22.9	27.2	28.3	25.4	26.7
(Cur.Acc-FDI) / GDP (%)	-1.5	-7.8	-5.7	-6.2	-4.8
FX reserves / Gross foreign debt (%)	73.0	70.7	55.9	44.7	40.8
Exchange rate to USD eop	2.6	2.5	2.9	3.2	3.3
Exchange rate to EUR eop	3.4	3.6	4.0	4.5	4.3
Exchange rate to USD AVG	2.8	2.4	2.5	3.3	3.2
Exchange rate to EUR AVG	3.5	3.3	3.7	4.5	4.4

Source: UniCredit Research

The party is over

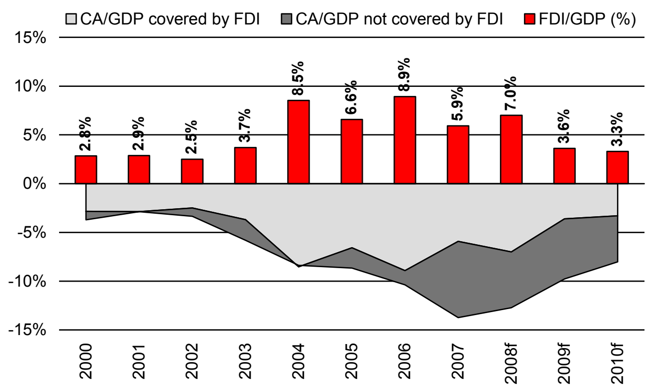
First clear signs of the real economy slowing surfaced in Q4

Despite robust economic growth of 8.9% y-o-y in the first three quarters of 2008, Romania's vulnerability and exposure to the global financial crisis became apparent in Q4 with the first clear signs of the real economy slowing that is anticipated to result in full-year 2008 growth of 8% y-o-y. The flipside to 2008's rapid growth is a more painful correction this year and we look for growth of only 0.6%. Adequate policy measures that guarantee the necessary funding of the real economy will help to soften the contraction.

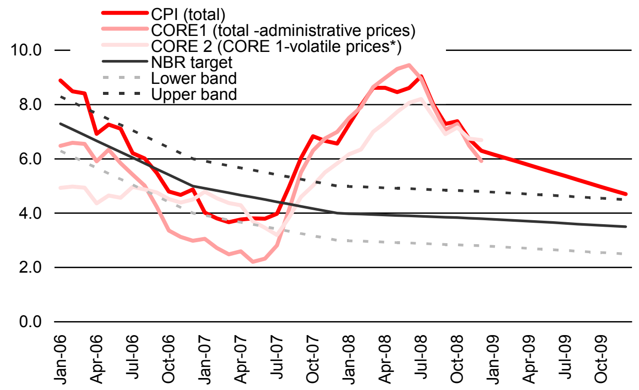
Inflation will likely stay above the NBR target band during 2009

After the 9% peak in inflation in July 2008, disinflation started to gain pace in H2/2008. The disinflation process is forecast to continue in 2009 with year-end inflation expected at 4.7% (still slightly above the upper band of the Central Bank target of 3.5% +/-1%) and core inflation very close to the headline inflation figure.

CURRENT ACCOUNT DEFICIT AND ITS COVERAGE BY FDI



HEADLINE INFLATION AND CORE INFLATION



* Excluding volatile prices

Source: BNR, UniCredit Research estimates

Current account to improve significantly, but financing gap a concern

Export growth to remain negative but the stronger import drop will bring the expected C/A correction

The Romanian C/A deficit showed the first signs of improvement in Q4 driven by strongly contracting imports. This allowed the full year 2008 current account deficit to "only" widen 5% on 2007 to reach EUR 17.4bn or 12.7% of GDP, down from its peak of 13.7% seen in 2007. The RON depreciation exerted a positive effect on the C/A deficit correction, mostly through rising import prices that put a brake on import-oriented consumption (-17% y-o-y drop in Nov), exports did, however, also fall into negative territory for the first time in five years in November (-9% y-o-y). In 2009 we forecast a further narrowing of the current account deficit to 9.8% with lower energy prices and weak domestic demand dragging down imports.

Coverage of the of external financing need still the major source of concern

Despite an improving current account deficit, the external financing gap will remain one of the major sources of concern given the tight global capital flow backdrop. With FDI coverage of the C/A deficit likely dropping to around 40% in 2009 there is a risk of FX reserves drain.

Interest rate easing complicated by fiscal policy and the exchange rate

Monetary policy bore the brunt of the tightening in 2008, though has started to loosen in 2009

The Romanian Central Bank initiated a tightening cycle in November 2007 and raised its key policy rate seven times from 7% to 10.25% in July 2008 in a bid to slow the rate of lending and limit the risks of the economy overheating. To this end, the Central Bank also introduced a new regulation effective as of last Oct aimed at putting a ceiling on the maximum level of household debt. This restriction has been recently removed for loans with high-quality real estate assets as collateral.

In response to the rapid deterioration in the growth outlook the NBR turned its policy stance around in 2009, however, and initiated its first cautious cut of 25bp in February 2009. We expect the pace of easing to remain very gradual, however, and forecast end 2009 NBR rates only 150bp lower at 8.50%. One reason for caution in monetary loosening is continued fiscal risks. Against the backdrop of elections, the budget deficit came in at 4.8% of GDP in 2008 (5.2% of GDP under ESA'95 standards). Furthermore, although the government targets a fiscal gap of 2% of GDP for 2009, there are risks of overshoot again in 2009. The budget is based on relatively optimistic GDP and budget revenue growth assumptions, whilst it is also unclear whether the government will manage to up social security contributions in the face of union opposition.

Politics

Majority government should ensure more stability

2009 is the Presidential election year

Following Q4/08 parliamentary elections, the DLP formed a coalition with its former main rival, the leftist SDP. This provides the government with a sound majority of above 70% in parliament. This majority should ensure more stability for the Romanian political scene. The consecutive resignations of two interior ministers from the PSD in a very short period is not a major issue at this stage, but it still creates uncertainty and worsens the performance of the new cabinet. Presidential elections are likely to be held in Romania this November. President Basescu might win a new mandate. However, the inefficient measures of the new cabinet formed by his party might also erode the President's popularity.

Slovakia

Outlook

Slovakia entered the eurozone on 1 January 2009, shielding markets from the reduction in capital flows, but creating additional downwards pressure on exports. EMU membership means interest rates are already negative in real terms, though any Slovak specific policy loosening now needs to come from fiscal policy. We look for 2009 growth to come in at 1.8%.

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

MACROECONOMIC DATA AND FORECASTS

	2006	2007	2008e	2009f	2010f
GDP (EUR bn)	44.5	54.8	65.3	70.6	75.3
Population (mn)	5.4	5.4	5.4	5.4	5.4
GDP per capita (EUR)	8260	10155	12086	13071	13953
GDP (constant prices y-o-y %)	8.5	10.4	6.7	1.8	3.3
Private Consumption, real, y-o-y (%)	5.8	7.0	6.0	2.5	3.3
Fixed Investment, real, y-o-y (%)	9.3	8.7	6.9	0.8	3.3
Public Consumption, real, y-o-y (%)	10.2	-1.3	4.1	5.5	5.0
Exports, real, y-o-y (%)	21.0	13.8	3.3	-5.5	4.0
Imports, real, y-o-y (%)	17.7	8.9	1.3	-5.1	4.4
CPI (year end, y-o-y %)	4.2	3.4	4.4	2.7	3.7
Central bank reference rate	4.8	4.3	2.5	1.0	1.5
Unemployment rate (%)	13.3	11.0	9.8	11.7	11.6
Budget balance / GDP (%)	-3.6	-2.2	-2.0	-2.7	-2.5
Current account balance (EUR bn)	-3.4	-2.9	-4.0	-4.0	-3.5
Current account balance / GDP (%)	-7.7	-5.3	-6.2	-5.7	-4.7
Net FDI (EUR bn)	3.7	2.4	1.8	1.6	2.1
FDI % GDP	8.4	4.4	2.8	2.3	2.8
Gross foreign debt (EUR bn)	24.4	30.2	38.0	40.1	43.2
Gross foreign debt (% of GDP)	50.9	54.7	56.0	56.8	57.3
(Cur.Acc-FDI) / GDP (%)	0.7	-1.0	-3.4	-3.4	-1.9
Exchange rate to USD eop	26.2	23.0	21.6	21.2	23.2
Exchange rate to EUR eop	34.6	33.6	30.1	30.1	30.1
Exchange rate to USD AVG	29.6	24.6	21.3	21.8	22.2
Exchange rate to EUR AVG	37.2	33.8	31.3	30.1	30.1

Source: UniCredit Research

Macro outlook

Q3/08 showed the last figure of high growth for Slovakia at 7% y-o-y

We expect Q4/08 growth at a mere 3% y-o-y

GDP growth slowed down in Q3/08 to 7.0% y-o-y with domestic demand the main growth driver. In contrast, the recession in Western Europe was reflected by a sharp brake being applied to both export and import dynamics. We look for a far more significant impact on growth in Q4/08 and beyond. We forecast growth to fall from 6.7% in 2008 to a mere 1.8% in 2009. Some pick-up of growth to 3.3% is expected in the election year of 2010, however, on the back of some recovery in demand for Slovak exports and a fiscal package.

Growth is expected to pick-up to 3.3% in 2010

In the mean time, unemployment should increase from 10% to almost 12% this year

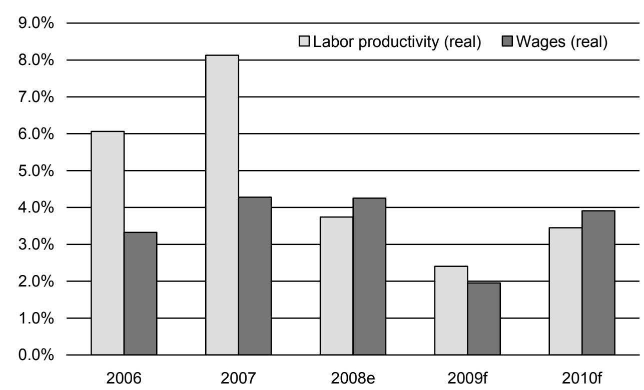
Industrial production and foreign trade figures showed that the impact of the recession in eurozone countries already hit the Slovak economy hard in November. Production in most cyclical industries such as autos, electronics or steel fell by more than 10% y-o-y. The slowdown of the economy relatively quickly affected the labour market. Unemployment started to increase as of September last year and should reach 11.7% on the back of exporters scaling down production. While the government plans a generous 8.7% pay rise in 2009 in the public sector with average inflation at 2.9%, the private sector could struggle to record much wage growth at all. This means that domestic demand will be weaker than previously expected and the growth of household consumption fall from 6% y-o-y last year to 2.5% growth this year.

With lower growth, inflation is expected to fall to below 3% level

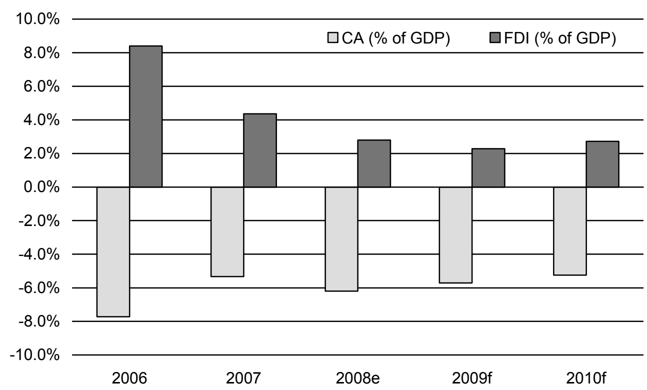
We expect that the recession in most EU countries will continue to impact manufacturing in 2009. Falling manufacturing will push exports 5% lower y-o-y for the first time in this decade. This will produce a negative drag on overall growth, pushing it below 2%. The government is, however, planning a 1% of GDP fiscal stimulus package for 2009, mainly financed by EU funds.

Y-o-y CPI decelerated 1% in Q4/08 to 4.4% on the back of lower food and fuel prices as well as lower demand pressures. With lower growth and the fixed currency, Slovak inflation should further fall below 3% by year-end as subdued demand will keep the prices of services in check.

LABOUR PRODUCTIVITY VS. WAGE GROWTH



CURRENT ACCOUNT AND FOREIGN DIRECT INVESTMENTS



Source: Statistical Office, Central Bank, UniCredit Research

EMU membership is supportive

Slovakia joined the eurozone as of January 2009

Current account deficit should fall only marginally to 5.7% of GDP as exports will struggle

Slovak public debt is relatively low at below 30% of GDP

The banking bailouts are not needed as the bad loans were absorbed by the government in 2001 before the privatisation of state banks

Slovakia effectively had a fixed currency regime in H2/2008 ahead of the full euro adoption as of January 2009. Therefore, the country did not face the same pressures on its currency as other countries in the region, resulting in a significant appreciation of its real exchange rate versus its key export competitors. The current account reached a deficit of 6.2% of GDP in Q3/08. The deficit was only partially covered by FDI inflow at 2.8% of GDP, at 42% coverage. As exports are hit by the recession in Slovak's main trading partners, the deficit will improve only marginally to 5.7% of GDP this year. Elections planned for 2010 will keep import dynamics high, resulting in the deficit only a notch below 5% of GDP despite some export revival. Slovakia's external debt reached EUR 36.9bn as of September last year, of which 51% was short-term debt. Its net external debt is 19.2% of GDP. The public debt is relatively low at 28.7% of GDP, increasing to just below 30% of GDP by 2010 as the banking sector is in good shape.

Policy response to macro outlook

Slovakia adopts eurozone interest rates of a mere 2% in January

Fiscal impulse is expected to be at 1% of GDP

We expect the government to miss its 2.1% of GDP fiscal target and instead pencil in a deficit of 2.7% of GDP

Having joined EMU, 1 January 2009, monetary policy is now driven by the ECB. This, leaves fiscal policy as the key local policy response to the growth slowdown. In reaction to the sharp growth slowdown, the government increased the planned public finance deficit from the targeted 1.7% to 2.1% of GDP in 2009. Adding EU funds on top of that, the fiscal impulse is expected at 1% of GDP for 2009. However, the authorities assume 4.6% growth and are likely to revise the growth figure down in February to around 2.5%. We do not expect the government to cut expenditures in line with the tax shortage and expect the fiscal deficit to be reach 2.7% of GDP instead. The government plans to cut the 2nd private pension pillar in H1/2009 to save on the "pension deficit" by encouraging older people to switch to the public pillar. So far, this has not been very successful and the deficit hence could be higher still.

2010 should see the continuation of missing the fiscal target as the elections should take place in summer. On the other hand, the bank bailouts are not needed as the government carved out bad loans not long ago in 2001 before privatisation of the state banks.

Politics

Coalition is stable as the senior coalition party enjoys over 40% popularity

General parliamentary elections are scheduled for summer 2010

The ruling leftist populist coalition has a stable majority in parliament. The reform-oriented opposition parties do not have a real impact on the political development of the country. Furthermore, the coalition is a one-man show as the main coalition party SMER enjoyed strong popularity support of over 40% in most of the recent polls. There are no key reforms on the agenda. The presidential election is scheduled for April 2009 (the president does not have executive powers). The much more important general parliamentary elections will take place in summer 2010 and so far it seems SMER will form the new government as well.

Slovenia

Outlook

Rapidly slowing growth is a result of EU demand for exports drying up. However, the government is in a strong fiscal position to help the economy – implementing a EUR 860mn package, which ought to help support jobs. While, lower oil and commodity prices should see the current account deficit narrow despite an evidently unfavourable environment for exports.

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

MACROECONOMIC DATA AND FORECASTS

	2006	2007	2008e	2009f	2010f
GDP (EUR bn)	30.5	33.5	36.8	37.5	39.3
Population (mn)	2.0	2.0	2.0	2.0	2.0
GDP per capita (EUR)	15167	16688	18310	18586	19497
GDP (constant prices y-o-y %)	5.7	6.1	3.9	0.5	2.5
Private Consumption, real, y-o-y (%)	4.0	3.1	3.1	0.5	3.5
Fixed Investment, real, y-o-y (%)	8.4	17.8	8.2	0.0	5.4
Public Consumption, real, y-o-y (%)	4.4	1.4	3.5	4.0	4.0
Exports, real, y-o-y (%)	12.3	13.0	5.2	2.5	6.0
Imports, real, y-o-y (%)	12.2	14.1	6.4	3.0	8.0
CPI (year end, y-o-y %)	2.8	5.6	2.1	2.8	3.6
Central bank reference rate	3.5	4.0	2.5	1.0	1.5
Unemployment rate (%)	6.0	4.9	5.1	5.2	5.6
Budget balance / GDP (%)	-1.2	-0.1	-0.2	-3.0	-2.5
Current account balance (EUR bn)	-0.8	-1.5	-2.2	-2.0	-1.7
Current account balance / GDP (%)	-2.5	-4.3	-6.1	-5.3	-4.4
Net FDI (EUR bn)	0.5	1.1	1.0	0.4	0.8
FDI % GDP	1.7	3.2	2.7	1.2	2.0
Gross foreign debt (EUR bn)	23.9	35.5	39.5	40.1	42.1
Gross foreign debt (% of GDP)	78.5	106.0	107.1	107.0	107.0
(Cur.Acc-FDI) / GDP (%)	-0.9	-1.1	-3.4	-4.1	-2.4
Exchange rate to USD eop	181.7	164.3	171.7	168.8	177.5
Exchange rate to EUR eop	239.6	239.6	239.6	239.6	239.6
Exchange rate to USD AVG	190.7	174.8	162.9	173.1	173.0
Exchange rate to EUR AVG	239.6	239.6	239.6	239.6	239.6

Source: UniCredit Research

Economy set to slow in 2009

Growth outlook deteriorating sharply…

Economy slowed sharply in Q4/08: although the Q3/08 GDP figures make impressive reading (headline growth 3.8% y-o-y) the data available to date for Q4/08 point to a sharp slowing in economic activity as the international environment weakens. Data on new orders in industry up until October 2008 show a sharp deterioration in October with total orders down 29.3% y-o-y in real terms with orders from abroad falling 27.9% y-o-y and domestic orders falling 35.9% y-o-y. Industrial production in November fell 12.0% y-o-y (work day adjusted) with inventories of finished industrial goods rising 7.9% y-o-y at the same time. With the growth outlook for the eurozone slowing rapidly and the government providing subsidies to industrial sector companies to shorten the working week from 40 to as low as 32 hours, industrial production is set to contract again in 2009, having already recorded a negative growth rate in 2008.

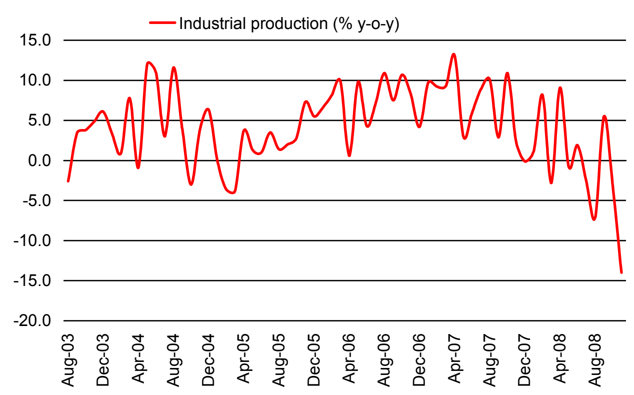
…risks to growth forecast skewed to the downside

While private consumption continued to hold up well in the first three quarters of 2008, rising 3.5% y-o-y over this period, the prospects going forward are evidently not as bright. Unemployment is set to increase from just over 4.0% in 2008 to over 5% this year and economic sentiment indicators strongly suggest consumption will slow this year. Only Bulgaria and Latvia recorded a greater deterioration in the European Commission's economic sentiment indicator in December (compared to November). At the same time over the previous 12 months Slovenia's economic sentiment indicator deteriorated the most. November 2008 saw a drop in the stock of mortgage and consumer credit of 0.9% compared to October. All in all, we expect the Slovenian economy to grow at a rate of 0.5% this year, down from an estimated 3.9% y-o-y in 2008.

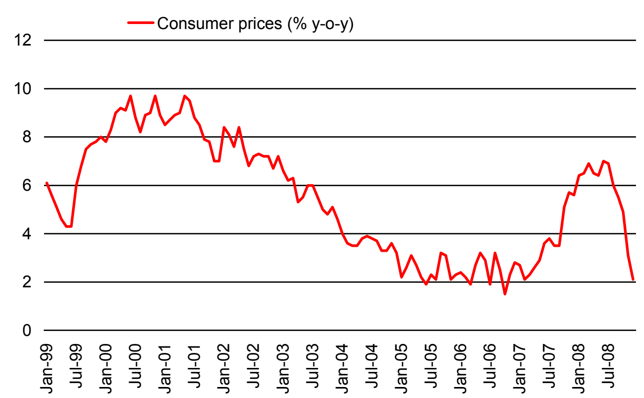
…credit growth to slow

Banking sector more reliant on external funds than CEE peers. One of the main risks associated with Slovenia is the relatively high reliance of the banking sector on foreign capital. At the same time the loans/deposit ratio in Slovenia was in excess of 150%, the highest in CEE. The obvious flipside of this is that Slovenia’s relatively high reliance on wholesale markets to fund banking sector lending suggests credit growth in 2009 will slow.

INDUSTRIAL PRODUCTION HEADS LOWER…



…AS DOES INFLATION



Source: Sors, Bloomberg, UniCredit Research estimates

Inflation to fall further

Inflation takes a back seat: Although inflation averaged 6.2% y-o-y in 2008 by December it had decelerated to 2.1% y-o-y. Heading into 2009 the combination of rapidly slowing domestic demand and lower commodity prices are the main factors driving inflationary dynamics. Although the Institute for Macroeconomic Analyses and Development, the government's forecaster, sees real wage growth exceeding productivity growth by 1.4%-points (largely as a result of public sector wage trends) we estimate that lower commodity prices and weakening domestic demand will lead to a sharp reduction in annual inflation from 6.2% y-o-y in 2008 to only 1.1% y-o-y this year.

Fiscal policy has ample room to manoeuvre

Ample scope for fiscal stimulus

Fiscal stimulus package approved by government: With public debt estimated at the end of 2008 at only 21.8% of GDP coupled with a track record of minimal fiscal deficits in previous years the authorities have room to manoeuvre in attempting to support economic growth in 2009. In December 2008 the government approved a EUR 806mn fiscal stimulus package (2% of GDP). The main measure of the government's package will be to subsidize a shorter working week from 40 to 36 hours in an effort to minimize job losses. These subsidies will be available for 6 months and could be extended for a further 12 months. Subsidies will be provided for research and development activities while the government will also alter tax administration procedures in an effort to reduce the overpayment (and later reimbursement) of tax payments for companies.

State-owned export bank to support local banks

In addition, the state-owned export bank (SID) which borrowed EUR 250mn in December 2008 to deposit into commercial banks in order to support lending growth will continue to borrow money in 2009 for this purpose. Taking into account the activities of the SID the fiscal stimulus planned by the authorities is estimated to amount to 3.5% of GDP.

Current account deficit to narrow slightly in 2009

Current account deficit to narrow

Lower oil and commodity prices should see the current account deficit narrow despite an evidently unfavourable environment for exports: Higher oil prices during the course of most of 2008 and faltering external demand towards the end of the year will see the current account deficit widen to over 6% of GDP in 2008. In the first 10 months of the 2008, petroleum products and related materials imports rose 82.4% y-o-y to EUR 1.95bn. With oil and other commodity prices falling Slovenia's terms of trade will improve in 2009, while slowing domestic demand will further limit the growth of imports. Export growth will also slow sharply given the deteriorating EU growth profile (70% of Slovenia's merchandise exports go to the EU). Slovenia has traditionally exported strongly to the countries of South East Europe (SEE), however, with that region also heavily affected by the global financial crisis the scope for compensating weaker export growth to the EU via SEE is minimal. In addition, the authorities estimate that Slovenia's obligations to the EU budget will increase by approximately EUR 450mn this year. Nonetheless, largely on the back of expected significantly lower oil imports this year we expect the current account deficit to narrow this year to EUR 2bn or 5.3% of GDP.

Politics

The government's fiscal stimulus package is unlikely to run into any difficulties. Bilateral relations with Croatia are, however, taking up plenty of space in the political arena since Slovenia blocked the opening of 11 chapters of Croatia's EU accession process in December because of unresolved border issues. There is consensus on the issue amongst parliamentary parties, however, the longer Slovenia maintains its position the greater the risk of European Union displeasure at this stance, which may complicate domestic political dynamics.

Bosnia & Herzegovina

Outlook

Growth will slow in 2009, along with the rest of the region, though the resumption of production at the Bosanski Brod oil refinery will potentially see industrial production rising over 20% y-o-y, contributing over 4%-points to growth. Additionally it will lower refined oil imports helping to close the current account deficit.

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

MACROECONOMIC DATA AND FORECASTS

	2006	2007	2008e	2009f	2010f
GDP (EUR bn)	9.8	11.1	12.5	13.3	14.1
Population (mn)	3.8	3.8	3.9	3.9	3.9
GDP per capita (EUR)	2543	2876	3253	3447	3652
GDP (constant prices y-o-y %)	6.9	6.8	5.8	2.5	3.0
CPI (year end, y-o-y %)	4.6	4.9	3.2	3.2	2.8
Unemployment rate (%)	44.5	44.0	40.3	42.0	41.5
Budget balance / GDP (%)	2.9	1.0	-0.5	-2.5	-3.0
Current account balance (EUR bn)	-0.8	-1.4	-2.0	-1.1	-1.2
Current account balance / GDP (%)	-7.8	-12.6	-15.8	-8.0	-8.2
Net FDI (EUR bn)	0.6	1.5	0.3	0.2	0.4
FDI % GDP	5.8	13.8	2.7	1.5	2.9
FX reserves (EUR bn)	2.8	3.4	3.1	2.6	2.9
(Cur.Acc-FDI) / GDP (%)	-2.0	1.2	-13.1	-6.5	-5.3
Exchange rate to USD eop	1.5	1.3	1.4	1.4	1.4
Exchange rate to EUR eop	2.0	2.0	2.0	2.0	2.0
Exchange rate to USD AVG	1.6	1.4	1.3	1.4	1.4
Exchange rate to EUR AVG	2.0	2.0	2.0	2.0	2.0

Source: UniCredit Research

Bosnia not immune to global slowdown

Growth outlook deteriorating…

Bosnia only reports annual GDP data so that knowledge that the economy expanded an estimated 6.8% in 2007 adds little value in the current climate. Nonetheless, Q4/08 economic data do point to slowing growth with merchandise trade data signaling faltering export and import growth. Strong merchandise export growth, which rose 15.8% y-o-y in the 10 months to October, slowed to 1.9% y-o-y in November and fell 4.1% y-o-y in December.

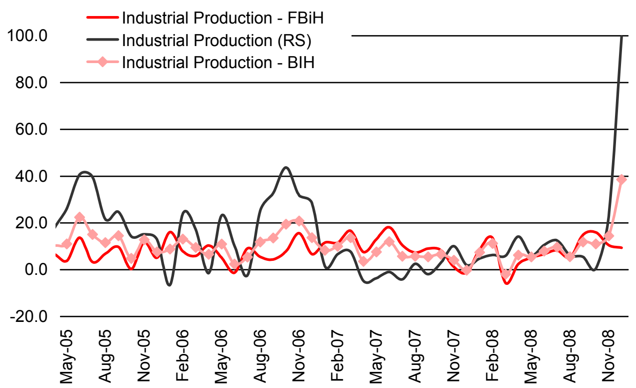
…but a quirk in industrial production should result in a positive growth rate…

The outlook for growth in 2009 is poor. We expect the economy to slow sharply from 5.8% last year to only 2.5% in 2009 although the impact of the opening of an oil refinery on industrial production may see growth surprise on the upside. Nonetheless, we envisage domestic demand slowing rapidly as credit growth slows. At the end of 2007 the loan/deposit ratio for the banking sector was 98.6% while at the end of November 2008 that ratio rose to 119.8% as deposits fell over EUR 400mn in October. With global financial market conditions remaining tight we do not expect such a gap between deposits and loans to be sustained in 2009. The other main driver of our forecast is the terms of trade effect (lower export prices) which will impact Bosnia's main exports, namely, aluminium, steel and metals.

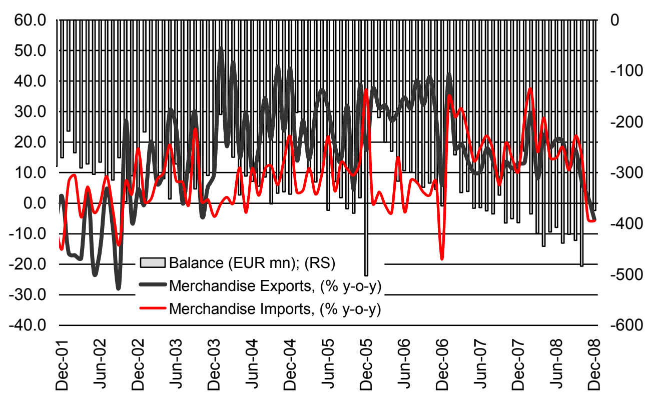
…inflation set to moderate

Consumer prices at the end of December fell to 3.2% y-o-y after having peaked at 9.9% y-o-y in July. We estimate core inflation fell to 2.7% y-o-y at the end of December. This year inflation should more than halve to an average 3.5% as domestic demand slows and the abolition of tariffs on 90% of goods from the beginning of this year impact on the price of imported goods.

INDUSTRIAL PRODUCTION



SLOWING IMPORT AND EXPORTS



Source: Federation Statistical Office, RS Statistical Office, Central Bank of BiH, UniCredit Research

Low external debt repayments, but internal liquidity an issue

Current account deficit to narrow in 2009

With credit growth expected to slow and the price of Bosnia's main exports – aluminium, steel and metals – falling we look for both imports and exports to contract in 2009, after an estimated widening of the current account deficit to 15.8% of GDP in 2008. Higher oil prices led to a 35% increase in petrol imports last year, while motor vehicle imports rose 18.2% to over EUR 600mn on robust credit growth in the first 10 months of 2008. In addition, the resumption of production at the Bosanski Brod oil refinery (see below) will lower Bosnia's oil import bill. **Overall, we see the current account deficit narrowing to 8%** of GDP this year with FDI inflows 1.5% of GDP, implying a financing gap of EUR 860mn, half last year's amount. Bosnia's foreign debt service obligations amount to approximately EUR 200mn, however, slowing growth and weakening entity and national level fiscal positions mean the domestic payment arrears are a risk.

Not much scope for monetary or fiscal policy to help deal with slower growth

Central bank can only lower mandatory reserve requirements to counter slowing growth...

Bosnian monetary policy is characterised by a currency board arrangement, which has been one of the most popular policies implemented by the international community. As such the central bank has little scope for loosening monetary policy beyond altering the mandatory reserve requirement rate (MRR). In October 2008 the central bank lowered this rate from 18% to 14%, freeing up BAM 727mn. Since 1 January 2009, the MRR on liabilities deposited with banks for over 12 months has been 10% (down from 14%). In combination with the October move the Central Bank thus released over BAM 1bn in liquidity to the banking sector in response to tighter financing conditions abroad and the fall in banking sector deposits in October (only a BAM 17mn increase in deposits occurred in November according Central Bank data). In the two months since the end of September 2008 FX reserves fell over EUR 300mn (8.9%).

Governments are revising their spending plans down in line with Fiscal Council decrees

Entity and national level governments are all facing more challenging times for conducting fiscal policy, with tax revenue growth stalling as economic growth slows. The Fiscal Council of BiH, formed last year to strengthen fiscal discipline, on 6 November ruled that expenditures could be increased up to 12% compared to 2008. In response governments at all levels revised/are revising their budgets to meet this target. At the national level, the lower house cut EUR 100mn of spending proposed by the presidency of BiH bringing the size of the budget back to EUR 700mn, while in Republika Srpska the government in late January announced a public sector wage freeze (and 10% cut in public sector salaries above BAM 2000) amongst the measures to free resources for a guarantee fund for exporters and a fund general assistance to the economy. In the Federation, where an election promise in 2006 to earmark 40% of public spending for social policy has created the most pressing requirement for reforms, the government is to prepare legislation to reform spending war veterans', disability and social welfare payments. Efforts to cut spending will reduce the risk of crowding out the private sector. Nonetheless, we still estimate a combined fiscal deficit of 2.5% of GDP this year.

Base effect kicks in as oil refinery resumes output

Oil refinery comes on line to supercharge industrial production

The investment by Russia's Njeftegazinkor into the Bosanski Brod oil refinery, which began operating at full capacity in November 2008 led to an increase in industrial output in Republika Srpska from 7.3% y-o-y in the first 10 months of 2008 to 16.3% y-o-y in the whole of 2008, with industrial production rising 99.6% y-o-y in December. For the whole of Bosnia industrial production rose from an estimated 7.4% y-o-y in the first 10 months of 2008 to 10.6% y-o-y in 2008. This year should see industrial production rising over 20% y-o-y, contributing over 4%-points to growth. In addition, the functioning of the new refinery will lower Bosnia's oil imports.

Croatia

Outlook

The growth outlook remains poor on the back of a weak international environment. While, monetary policy settings remain tight with strong currency policy still in place and double-digit interest rates in the interbank market – constraining credit growth. Fiscal policy has no room for countercyclical management and as tax revenues slow the private sector is exposed to the risk of crowding out by increased government borrowing.

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

MACROECONOMIC DATA AND FORECASTS

	2006	2007	2008e	2009f	2010f
GDP (EUR bn)	34.2	37.5	41.2	40.7	42.9
Population (mn)	4.4	4.4	4.4	4.4	4.4
GDP per capita (EUR)	7707	8453	9295	9181	9680
GDP (constant prices y-o-y %)	4.8	5.6	2.1	-1.6	1.6
Private Consumption, real, y-o-y (%)	3.5	6.2	1.7	-1.0	1.5
Fixed Investment, real, y-o-y (%)	10.9	6.5	7.5	-1.3	3.5
Public Consumption, real, y-o-y (%)	2.2	3.4	1.9	2.5	2.5
Exports, real, y-o-y (%)	6.9	5.7	2.8	-1.0	1.0
Imports, real, y-o-y (%)	7.3	5.8	6.1	-0.5	2.5
CPI (year end, y-o-y %)	2.0	5.8	3.6	3.8	2.7
Central bank reference rate	0	0	0	0	0
Unemployment rate (%)	11.2	9.6	8.9	9.8	9.6
Budget balance / GDP (%)	-3.0	-2.3	-1.6	-2.8	-3.2
Current account balance (EUR bn)	-2.7	-3.2	-4.5	-3.6	-3.4
Current account balance / GDP (%)	-7.9	-8.6	-11.0	-8.8	-7.8
Net FDI (EUR bn)	2.7	3.5	3.3	1.5	2.5
FDI % GDP	8.0	9.3	8.0	3.7	5.8
Gross foreign debt (EUR bn)	29.3	33.2	39.0	40.0	42.0
Gross foreign debt (% of GDP)	85.5	88.6	94.6	98.2	97.8
FX reserves (EUR bn)	8.7	9.3	9.7	8.7	9.2
(Cur.Acc-FDI) / GDP (%)	0.1	0.6	-3.0	-5.2	-2.0
FX reserves / Gross foreign debt (%)	29.8	28.0	24.9	21.8	21.9
Exchange rate to USD eop	5.6	5.0	5.3	5.2	5.7
Exchange rate to EUR eop	7.4	7.3	7.4	7.5	7.4
Exchange rate to USD AVG	5.8	5.4	4.9	5.3	5.4
Exchange rate to EUR AVG	7.3	7.3	7.2	7.4	7.4

Source: UniCredit Research

GDP growth – how low can it go?

Growth outlook deteriorating sharply…

GDP growth in Q3/08 was weaker than expected at a headline 1.6%. Adjusting for the contribution of inventories the growth rate was actually -0.2% y-o-y and seasonally adjusted data also support this view. In the final quarter of 2008 the economy likely contracted 0.7% y-o-y taking into account weak retail sales and industrial production data. Admittedly, November and December industrial production figures were "only" down 3.5% and 1.6% y-o-y respectively, but capital goods production fell 16.2% y-o-y in December and consumer durables production 17.9% y-o-y. Credit growth to the private sector and households has slowed while in December M1 money supply contracted 4.6% y-o-y.

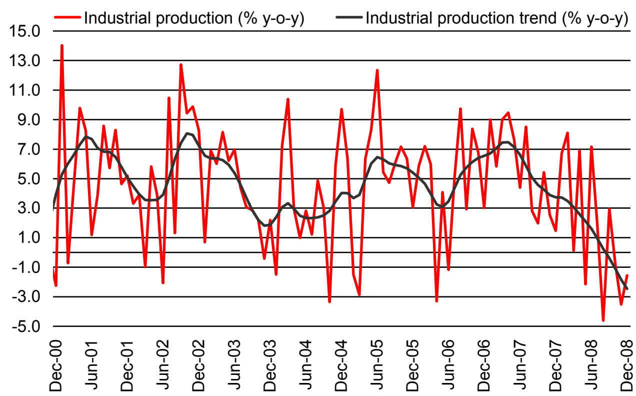
…risks to growth forecast remain skewed to the downside

The growth outlook remains poor given the deteriorating international economic environment. In addition, monetary policy conditions remain tight, constraining credit growth, while the expected increase in public sector borrowing as tax revenue growth underperforms risk crowding out private sector investment given limited access to international financial markets. As a result our growth forecast of -1.6% y-o-y remains exposed to downside risk.

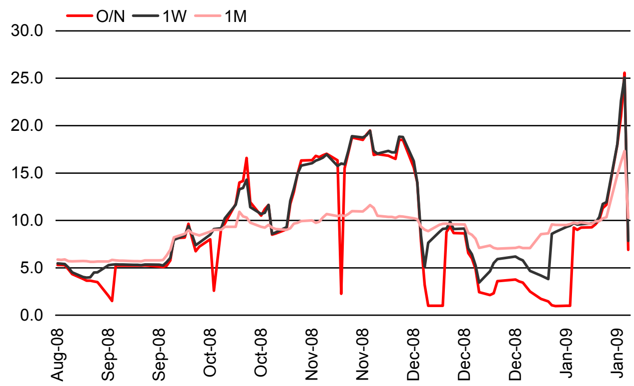
…headline inflation will rise in Q1/09, but on average be significantly lower compared to 2008

Collapsing oil prices and pre-Christmas discounts saw consumer prices moderate to 2.9% y-o-y in December. The 23.5% increase in gas prices, higher cigarette prices, the re-imposition of co-payments for public sector health services and 7% increase in fuel prices in mid-January will see consumer prices rise by approximately 1.0% m-o-m in January 2009. However, slowing domestic demand coupled with lower commodity prices this year will see a significant reduction in the average inflation rate to 2.8% y-o-y (from 6.1% in 2008), with headline figures close to 1.0% y-o-y in the summer. The reduction in core inflation accelerated in Q4/08 and is expected to fall further in 2009 on slowing domestic demand.

INDUSTRIAL PRODUCTION SLOWS…



…BUT POLICY CONDITIONS REMAIN VERY TIGHT



Source: CBS, Reuters, UniCredit Research estimates

Current account deficit to narrow, but external obligations remain high

Slowing domestic demand and lower commodity prices set to lower current account deficit…

This year we expect the current account deficit to narrow to 8.8% of GDP as import growth slows. For each month of Q4/08 data revealed y-o-y falls in merchandise imports. Over this same period, excluding exports of ships, merchandise exports also fell in y-o-y terms. With inventories in the industrial sector having increased 10.6% y-o-y in H2/2008 demand for intermediate goods should moderate. Combined with slowing domestic demand and falling commodity prices this will see import growth slow sharply. With the EU in recession the outlook for merchandise export growth is poor while the nature of the tourism season will, to a large extent, determine the size of the current account deficit.

…but high debt service obligations remain a source of vulnerability

In October 2008 gross foreign debt rose EUR 1.5bn to EUR 37.7bn partly as a result of exchange rate movements. However, the October figures showed short-term banking sector debt rising over EUR 600mn as deposit growth stagnated. We estimate year-end gross foreign debt figures of EUR 39 bn (94.4% of GDP). Our balance of payments forecasts imply a financing gap of EUR 2.1 bn (CAD-net FDI inflows), while the central bank estimates foreign debt repayment obligations of EUR 9.4 bn for the whole of 2009, of which EUR 2.5 bn is due during the current quarter.

Monetary & fiscal policy

Central bank to remain focused on maintaining exchange rate stability

Monetary conditions remain tight with money market rates in January at one point in excess of 25%, ahead of a Central Bank reverse repo auction. January saw the EUR/HRK head above 7.45 at one point on seasonal corporate demand for FX, before falling back to 7.40. Meanwhile, tax revenues began to falter in Q4/08 and there are indications that the first weeks of January also exhibited weakness in tax revenue growth.

The Central Bank has repeated on numerous occasions that it remains committed to maintaining currency stability after reverting to the more conventional policy of not announcing its preferred exchange rate corridor. The Central Bank loosened monetary policy conditions, by reducing the 28.5% foreign assets to liabilities ratio to 25%, to enable the domestic banking system to refinance the government's Q1/09 international debt obligations with a EUR 750mn syndicated loan. Nonetheless, it continues to strain HRK liquidity out of the system and shows no sign of changing policy, although obviously the question of how long it can continue to do so remains.

Slowing tax revenue growth continues to invite speculation over a budget rebalance

In December 2008 the government abandoned a balanced budget target for 2009 submitting to parliament a budget with a 0.9% of GDP deficit entailing a public sector borrowing requirement of approximately HRK 13bn. Slowing tax revenue growth (the Ministry of Finance stated in mid January that last year budget revenues grew 1.8% below forecast) is adding urgency to calls for spending cuts in a budget rebalance with the Banking and Employers' main bodies calling for the government to seek IMF assistance. The aim apart from freeing up some resources for assistance to the economy would be to reduce the public sector's borrowing requirement so as to free up funding sources for the private sector. Using the government's methodology (i.e. excluding the motorway authority, pension debt repayments and the development bank) we forecast a budget deficit of -2.8% of GDP on weaker tax revenue growth expectations.

Politics – Local elections, Slovenia, the budget…

May local elections in focus

Local elections will be held in May which will complicate the discussion of economic policy in the meantime since the government will want to avoid jeopardising its prospects with unpopular measures before then. At the same time, the opening of 11 chapters with the EU is being blocked by Slovenia over unresolved border issues. While this evidently brings into question the ability of the government to complete negotiations this year, should Slovenia maintain its stance, the government will be in a position to argue talks moved into 2010 because of factors out of their control.

Kazakhstan

Outlook

The slowdown started earlier in Kazakhstan than the rest of the region. Strong fiscal reserves nevertheless put the government in a relatively strong position to support the banking sector. We consider the NBK's 20% KZT devaluation in February a sensible move and look for the USD/KZT exchange rate to be held steady for the coming months, though would not rule out another move thereafter if oil prices moved south.

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

MACROECONOMIC DATA AND FORECASTS

	2006	2007	2008e	2009f	2010f
GDP (EUR bn)	64.5	76.1	89.5	78.6	85.4
Population (mn)	15.4	15.6	15.8	15.9	15.9
GDP per capita (EUR)	4191	4885	5682	4933	5359
GDP (constant prices y-o-y, %)	10.7	8.9	2.8	-1.3	4.0
Private Consumption, real, y-o-y (%)	12.6	10.8	-0.1	0.7	4.5
Fixed Investment, real, y-o-y (%)	29.7	17.3	5.2	-9.0	7.6
Public Consumption, real, y-o-y (%)	7.3	14.0	-4.2	4.3	4.3
Exports, real, y-o-y (%)	6.5	9.0	-1.0	-8.0	6.0
Imports, real, y-o-y (%)	12.1	25.5	-6.0	-2.6	9.3
CPI (year end, y-o-y, %)	8.4	18.8	9.5	12.6	7.5
Central bank reference rate	9.0	11.0	10.5	9.5	9.0
Unemployment rate (%)	7.8	7.6	6.7	7.5	7.9
Budget balance / GDP (%)	8.4	5.2	1.2	-6.4	-4.0
Current account balance (EUR bn)	-1.6	-5.4	5.5	-6.1	-3.8
Current account balance / GDP (%)	-2.5	-7.0	6.2	-7.7	-4.5
Net FDI (EUR bn)	5.0	7.4	6.4	3.1	5.8
FDI % GDP	7.8	9.8	7.1	4.0	6.8
Gross foreign debt (EUR bn)	56.2	65.7	64.4	60.7	63.4
Gross foreign debt (% of GDP)	87.1	86.3	72.0	77.3	74.3
FX reserves (EUR bn)	15.2	12.7	14.4	9.6	12.0
(Cur.Acc-FDI) / GDP (%)	5.3	2.7	13.3	-3.7	2.4
FX reserves / Gross foreign debt (%)	27.1	19.3	22.4	15.8	18.9
Exchange rate to USD eop	126.7	121.5	120.9	165.0	165.0
Exchange rate to EUR eop	167.1	177.2	168.6	234.3	214.5
Exchange rate to USD AVG	126.0	122.4	120.3	148.8	165.0
Exchange rate to EUR AVG	158.3	167.8	177.0	205.5	224.4

Source: UniCredit Research

Growth slowing, but fiscal easing will moderate the decline

Weak GDP, contracting industry, slowing retail trade

Growth negative: Statistical Agency data show real GDP growth of 3.9% y-o-y for Jan-Sep after 5.7% y-o-y for Jan-June, with private consumption flat and fixed capital formation growing below 4%. According to our estimates this means that real GDP growth turned negative in quarter on quarter seasonally adjusted terms in Q3/08, and it has probably remained negative since. Metallurgy, construction materials and engineering were particularly severely hit. We expect real GDP growth of some minus 1% in 2009. Growth should pick up somewhat in H2 thanks to a fledgling recovery in global demand for commodities. The real estate bubble will have been overcome to some extent. The strongest growth effect should however come from government programmes providing fiscal stimulus in the amount of 8-10% of GDP in nominal and still 4-5% of GDP in real terms. The execution of the government programmes has begun, but most of the money will reach the real economy only in H2.

Real GDP growth in 2009: -1.3%: some revival in H2

Inflation expected at 12.6% y-o-y by December 2009

Inflation substantially slowing: Inflation eased to 8.7% y-o-y in January from a peak of 20.1% in August, with food and transportation moderating the most. We expect y-o-y inflation to increase despite a statistical base effect, the impact of low commodity prices and weak demand because of hikes of utility prices, mainly related to electricity sector liberalisation in May-June and second round effects of the tenge devaluation.

2009 will see a current account deficit of almost 8% of GDP

The current account to turn negative: Thanks to high oil prices and weak domestic demand, the current account was USD 8.9bn in surplus in 2008, compared with a deficit of USD 7.3bn a year earlier, according to preliminary data. In Q1-Q3, exports surged 66% y-o-y in USD terms, while imports rose only 19% y-o-y. This was however achieved at 62% higher export prices, and 27% higher import prices. Under a scenario of moderately weak global commodity markets (oil prices recovering to USD 55-60 per barrel at end-2009) we expect a current account deficit of 7.6% of GDP for 2009 as both constant price export and import volumes contract.

FDI resilient in 2008, to some extent also in 2009

FDI inflows continued at a strong USD 7.8bn during Jan-Sep 2008, up from USD 6.1bn Jan-Sep 2007. Net inward flows of bank loans and deposits remained positive, at USD 3.9bn substantially below the USD 15.1bn of the year before, however. Net inward portfolio outflows amounted to USD 1bn, net outflows of resident capital (debt+equity) were little changed from 2007 at USD 14.3 bn. The difficult global environment, lower commodity prices, no new PSAs (production sharing agreements) and some pressure on the old ones due to increased "economic patriotism" will reduce FDI inflows in 2009. However, the extent of strategic non-resident interests in this commodity rich country should provide some resilience.

Reserves on the decline, but should stay above 2 month import cover

Reserves began to decline however in Q4 (from USD 21.9bn end-Sep to 19.4bn end Dec), and according to a central bank statement by further USD 2.7bn in January. We see them contracting to USD 13.7bn by the end of this year and the import cover to fall from 3.3 months at the end of 2008 to 2.2 months. With an expected current account deficit of USD 9bn and some USD 14bn in principal repayments coming due in 2009, the financing requirement adds up to some USD 25bn. This compares with USD 19.4bn in central bank reserves and USD 27.3bn of National Oil Fund assets as of 31 December 2008. We assume that the Oil fund will wind down its foreign assets by about USD 7-8bn in 2009 to prevent a larger decline in central bank reserves.

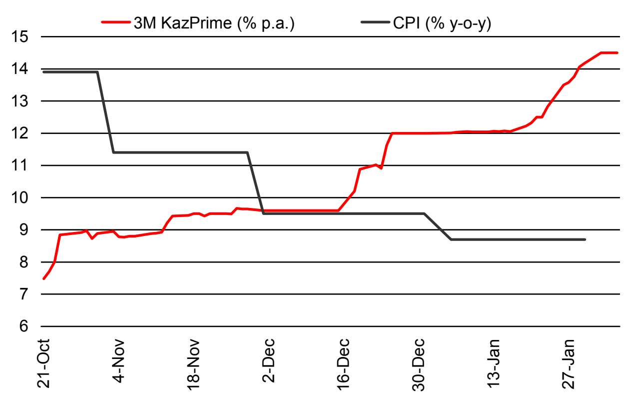
Budget deficit of 6.4% of GDP in 2009, after a surplus of 1.2% of GDP in 2008

Huge fiscal stimulus: The combined balance of the state budget and the Oil Fund will change from a surplus of 1.2% of GDP in 2008 to a deficit of 6.4% of GDP according to our estimates. Additionally a quasi-fiscal stimulus equivalent to 1.5% of GDP via government programmes will come in various forms financed from pension funds and other sources will apply. A part of the deficit widening is lower nominal revenue due to lower oil prices, even at constant prices the stimulus should amount to about 4-5% of GDP however.

The KazPrime sharply higher

Little scope for lower interest rates despite monetary easing: The central bank cut its 1 week refinancing rate from 10.5% to 10.0% as of 1 January 2009 and further to 9.5% as of 5 February. The minimum reserve requirement was lowered from 5% to 2% for liabilities vis-à-vis residents and from 7% to 3% for liabilities vis-à-vis non-residents on 18 November 2008 and is to decrease to 1.5% and 2.5% respectively on 3 March. The 3M KazPrime interbank rate nevertheless increased steadily from 7% in late September to 14.5% on 4 February 2009. Funding will remain scarce. We expect the KazPrime at 13% at the end of 2009, with some upward risk. Lending rates are also not likely to decline much due to high funding costs and risk re-pricing.

KAZPRIME INCREASED



KAZAKHSTAN'S 2009 ANTI-CRISIS MEASURES

	KZT bn	USD bn (1:120)	% of GDP
Tax measures	500	4.2	3.1
Financial sector stabilization	550	4.6	3.4
Housing / Real estate	615	5.1	3.8
SME Support	120	1.0	0.7
Agro-Industrial Komplex	120	1.0	0.7
Infra-Structure and other development projects	120	1.0	0.7
Sum of "crisis funds" for the economy in 2009	**2025**	**16.9**	**12.5**
To come from:			
The National Oil Fund	1207.5	10.1	7.5
The Republican Budget	585	4.9	3.6
Pension Funds and other sources	232.5	1.9	1.4

Source: NBK, Kaz government web page, UniCredit Research

Little stimulus from credit growth

Credit growth to remain weak: Outstanding loans were 5.5% higher in December 2008 than the year before compared with an increase of 51% in 2007. Banks' profit turned negative in Q4/08, leaving the aggregate pre-tax profit of the banking system 86% below the level of 2007, according to our calculations and local accounting standards. The government programmes make some credit growth likely in 2009, at modest rates however. Media report that the government via the National Welfare Fund will buy 78.14% of BTA, the largest bank by assets, because of a looming violation of prudent banking ratios. The government is reportedly also looking to buy 76% of shares of Alliance Bank, the fourth largest bank. At the same time the National Welfare Fund began to place large deposits with the major banks (Kazkommertsbank and Halyk received USD 1bn each). With roughly 11% of assets to be repaid by banks to non-residents in 2009, there is little scope. Further deteriorating credit quality will add to a conservative behaviour of banks.

Tenge devaluation to 150

Devaluation: On 4 February 2009, the NBK announced a devaluation with the USD/KZT set to 150 with a fluctuation band of circa +/- 5 KZT around this level. The NBK justified its move by a desire to maintain fx reserves and help competitiveness. This raises the question of whether the size of the move is sufficient. From a 3-12M perspective the jury is still out, given the size of the likely 2009 current account deficit and debt repayments. The RUB/KZT is still circa 14% below its 3y average even following the KZT devaluation. However, to the extent that the market is much shallower than e.g. Russia with a better ability for policymakers to influence the banking sector we expect that the NBK will be able to hold the 150 for now. On balance, we consider it as positive, although it will hurt economic subjects with debt in foreign and income in local currency and thus aggravate the bad loan problem.

Russia

Outlook

Russia has been hit by the collapse in commodity prices and the sharp turnaround in global capital flows. Taken together, they point to a 0.8% contraction of GDP growth in 2009 and pressure for the RUB to depreciate. With the RUB having already depreciated by more than 50% versus the USD we see the currency as increasingly fairly valued and even if a free float is forced by the market, we would ultimately see the unit rebounding.

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

MACROECONOMIC DATA AND FORECASTS

	2006	2007	2008e	2009f	2010f
GDP (EUR bn)	788.0	942.2	1127.6	842.7	967.5
Population (mn)	142.2	142.0	141.6	141.3	141.0
GDP per capita (EUR)	5542	6635	7963	5964	6862
GDP (constant prices y-o-y %)	6.7	8.1	5.6	-0.8	2.9
Private Consumption, real, y-o-y (%)	11.2	12.8	11.8	-0.1	6.2
Fixed Investment, real, y-o-y (%)	13.7	21.1	10.0	-10.0	0.0
Public Consumption, real, y-o-y (%)	2.5	5.0	6.2	3.6	0.8
Exports, real, y-o-y (%)	7.3	6.4	-7.8	-10.4	3.5
Imports, real, y-o-y (%)	21.9	27.3	7.0	-18.4	6.5
CPI (year end, y-o-y %)	9.0	11.9	13.3	8.8	9.2
Central bank reference rate	5.7	6.1	13.0	11.0	9.0
Unemployment rate (%)	6.7	6.1	6.5	9.0	7.5
Budget balance / GDP (%)	8.4	6.1	5.3	2.6	1.1
Current account balance (EUR bn)	75.2	57.1	64.4	12.2	11.0
Current account balance / GDP (%)	9.6	6.1	5.7	1.5	1.1
Net FDI (EUR bn)	22.9	38.3	44.0	27.0	33.9
FDI % GDP	2.9	4.1	3.9	3.2	3.5
Gross foreign debt (EUR bn)	234.7	314.0	372.9	344.9	367.9
Gross foreign debt (% of GDP)	31.4	35.9	33.5	41.2	36.3
FX reserves EUR bn)	230.2	325.4	303.6	240.8	258.7
(Cur.Acc-FDI) / GDP (%)	12.4	10.1	9.6	4.7	4.6
FX reserves / Gross foreign debt (%)	98.1	103.7	81.4	69.8	70.3
Exchange rate to USD eop	26.3	24.6	30.5	34.1	35.2
Exchange rate to EUR eop	34.7	35.9	42.6	48.4	45.8
Exchange rate to USD AVG	27.2	25.5	24.8	32.7	34.6
Exchange rate to EUR AVG	34.1	35.0	36.5	45.2	47.1

Source: UniCredit Research

Recession looms in 2009

GDP slows amid lower commodity prices and tight credit conditions

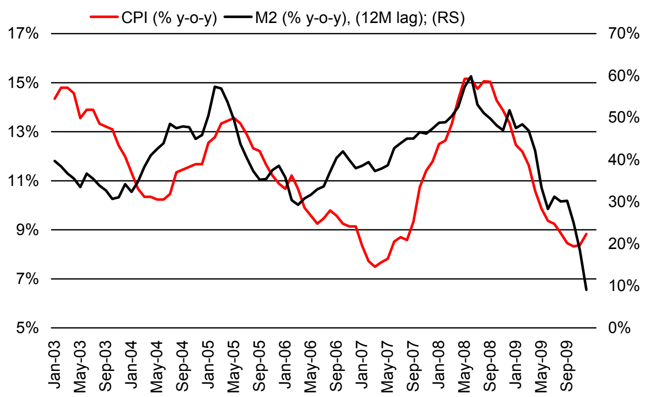
Russian GDP growth slowed from 8% in H1/2008 to just 6.2% y-o-y in Q3/08 and full year 2008 growth came in at 5.6%, indicating no more than 2% y-o-y growth in Q4/08. Against the backdrop of significantly lower commodity prices and tight credit conditions, investment growth slowed to just 3.9% y-o-y in November, down from over 16% y-o-y in H1/2008. Falling investment demand has already triggered significant 30%-50% production cuts in major steel and fertilizer producers, as well as widespread project closures. As a result, industrial output plunged 8.7% and 10.3% y-o-y in the last two months of the year, bringing about rising unemployment, a slowdown in real wages and a contraction in real disposable income growth.

Contraction in investment and weakness in consumer demand are to be counterbalanced by government spending

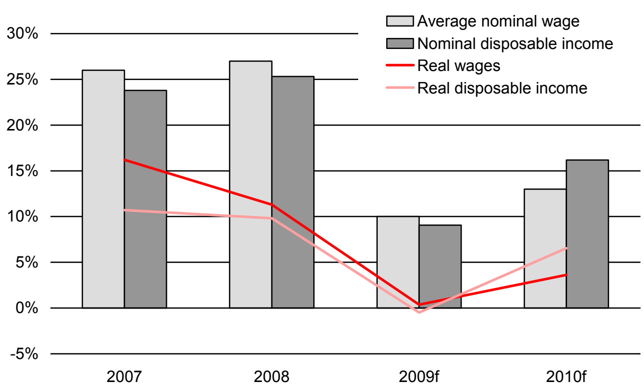
In 2009, we expect a broad-based economic deceleration to push the Russian economy into a 0.8% recession, with Q1/09 and Q2/09 likely to be the worst periods with contraction of some 3% y-o-y and 2.5% y-o-y, respectively. A major driver of the slowdown is likely to be a 10% real contraction in investment, as well as weakness in consumer demand. In the other direction, we see robust government spending, as well as an improvement in the net external balance (in constant price terms) providing some support to growth. One positive from slower growth will be slower inflation, which is expected to be affected by decelerating consumer demand growth and slowing money supply growth.

Growth could possibly come in above our forecast if global commodities demand surprised on the upside, which would bring about a boost to government revenues and spending, stabilize corporate profits and investment spending, as well as limit or even reverse capital flight. On the other hand, capital flight is a risk factor for growth.

HELPING M2 SLOWDOWN TO PUSH INFLATION INTO SINGLE DIGITS



SLOWING INCOMES SHOULD EASE CONSUMER DEMAND



Source: CBR, UniCredit Research estimates

Oil price collapse reverses capital flows

Q4/08 witnessed a sharp deterioration of balance of payments

Facing a continued collapse in oil prices alongside a still relatively strong rouble in Q4/08 Russia has had the sharpest deterioration of balance of payments in its history (the current account surplus shrunk USD 19bn q-o-q). This emphasized its continued dependence on commodities prices and questioned the appropriateness of the stable rouble policy. Both clearly provided a vivid illustration of the fact that even the largest reserves are not sufficient to reverse or even ease market trends.

Capital account deteriorated to USD130bn deficit in Q4/08

In these circumstances, the Central Bank has decided to smooth out the transition of the exchange rate to a new equilibrium level and prevent a currency run from the population and pledged its massive reserves to provide continued support to the rouble. However, the main outcome from such a policy was an even larger speculative run on the rouble, which caused the Russian capital account to deteriorate sharply to a nearly USD 130bn deficit in Q4/08 alone, an estimate rivaling total capital taken out of Russia during 10 years of reforms between 1994-2005 (USD 161bn).

As a result, the Central Bank spent some USD 140bn (nearly 25% of total) on interventions during the quarter, bringing total international reserves to USD 396bn in mid-January, down some USD 200bn since their peak in early August. Although the size of the reserves remains significant, it is important to keep in mind that circa USD 225bn back the sovereign wealth funds belonging to the government, rather than Central Bank. Admittedly, however, if the government finances its RUB budget needs with the fund the CBR would not lose FX. Either way, the pace of reserves losses points to an increasingly stretched ability of the monetary authorities to continue their existing managed exchange rate regime. Overall, all of these factors clearly indicate the increasing vulnerability of the current managed exchange rate regime (see below).

Anti-crisis response should ease pressures

Government adopts a massive anti-crisis package

In response to the rapidly deteriorating economic outlook and slowing growth, the Russian government has adopted a massive anti-crisis package. The package basically represents a broad easing in monetary as well as fiscal policy, including measures such as a massive reserve requirement cut, large-scale liquidity injection into the local banking system by the Central Bank, recapitalization of systemic banks from public funds, creation of a USD 50bn facility for refinancing external corporate debt, and considerable fiscal stimuli provided through profits tax cut, a direct budget spending hike, loan guarantees etc.

Given rouble devaluation concerns domestic interest rates range well above 20% for 3M interbank lending, and remain in double digits for O/N loans. We believe that any meaningful stabilization of domestic money markets will hinge upon an easing in market rouble devaluation expectations. Following a 55% devaluation of the RUB versus USD since July (slightly greater than other commodity currencies) we believe we are getting closer to equilibrium levels on the rouble, though risk of overshooting this level remains given ongoing resident and speculative demand for hard currency.

From the fiscal policy perspective, the government is likely to face the first federal budget deficit in many years, due to collapsing oil and gas revenues, as well as the announced tax cuts and anti-crisis spending. Although there has been some talk of the deficit hitting as high as 7% of GDP in 2009, our forecast is for a somewhat more restrained 2.6% of GDP, with the devaluation of the rouble supporting tax revenues. Even so, we expect government consumption to be one of the few positive contributors to demand growth in 2009.

Overall, the reduction in interest rates, stabilization of the exchange rate, as well as considerable fiscal stimulus should all eventually feed into the expected recovery of the real GDP growth starting in late 2009.

No political news so far, but tensions start to grow

Coming quarters to test political support behind the ruling elite

2008 marked the several important political changes, including transition of power during the elections, as well as an important amendment to the current constitution with an extension of the parliamentary and presidential term from four to five and six years, respectively. Following such important developments, no major political news is planned or expected for the next few quarters. However, the importance of political factors is likely to start to gain momentum in Russia over the coming quarters, as mounting economic problems brought about by falling real incomes and rising unemployment are likely to test true political support behind the ruling elite, as popular discontent is already on the rise.

Serbia

Outlook

The growth outlook has deteriorated in Serbia along with the rest of the region and we forecast 1.0% growth in 2009. The growth slowdown coupled with a large external financing gap has pushed RSD weaker, though the positive flipside of this is a more constructive export outlook. An IMF programme and some stabilization in the political environment also provide some grounds for optimism.

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

MACROECONOMIC DATA AND FORECASTS

	2006	2007	2008e	2009f	2010f
GDP (EUR bn)	24.3	29.1	33.2	30.8	34.0
Population (mn)	7.4	7.4	7.4	7.4	7.4
GDP per capita (EUR)	3278	3948	4513	4186	4620
GDP (constant prices y-o-y %)	5.6	7.1	5.5	1.0	3.5
CPI (year end, y-o-y %)	6.6	10.1	6.8	8.5	5.6
Central bank reference rate	14.0	10.0	17.8	20.0	17.5
Unemployment rate (%)	20.9	18.1	13.3	15.0	14.5
Budget balance / GDP (%)	1.5	1.3	-2.0	-3.0	-2.0
Current account balance (EUR bn)	-2.4	-3.9	-6.0	-4.5	-4.7
Current account balance / GDP (%)	-9.8	-13.2	-17.9	-14.7	-13.7
Net FDI (EUR bn)	3.4	1.6	2.1	0.9	2.0
FDI % GDP	14.0	5.5	6.2	2.9	6.0
Gross foreign debt (EUR bn)	14.9	17.8	22.3	24.8	28.0
Gross foreign debt (% of GDP)	61.3	61.0	67.0	80.3	82.4
FX reserves (EUR bn)	9.0	9.6	8.2	6.5	7.0
(Cur.Acc-FDI) / GDP (%)	4.2	-7.7	-11.8	-11.7	-7.7
FX reserves / Gross foreign debt (%)	60.6	54.2	36.6	26.3	25.0
Exchange rate to USD eop	60.5	54.0	64.3	71.8	70.0
Exchange rate to EUR eop	79.8	78.8	89.8	102.0	91.0
Exchange rate to USD AVG	67.2	58.3	55.4	69.8	71.0
Exchange rate to EUR AVG	84.4	80.0	81.5	96.5	96.5

Source: UniCredit Research

Growth slowing, but inflation remains high

Growth outlook deteriorating…

The Serbian economy continued to cool in the final quarter of 2008 with industrial production figures in both October and November recording a contraction in headline and seasonally adjusted terms. This is in part due to production cuts in response to souring international market conditions in industries such as steel. Merchandise trade figures also point to slowing growth. Imports, which rose in double-digit terms until September, rose only 7.4% y-o-y in October and fell 10.3% y-o-y in November. At the same time, exports fell 4.4% y-o-y in November, after also having risen in double-digit terms until October.

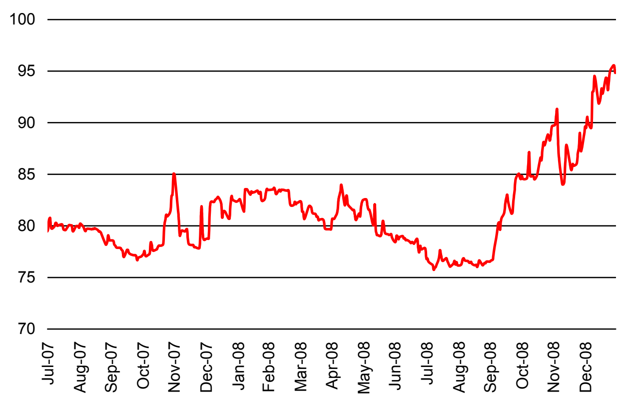
…but the government is putting together a EUR 1bn support package

We expect growth in 2009 to slow to 1% compared to 5.5% in 2008. While the government is putting together an economic support package (see below), Serbia's extensive external imbalances in the current global economic environment clearly suggest slower growth this year. On the plus side, the banking sector is highly capitalised and Serbia has a Stand-by Agreement in place with the IMF.

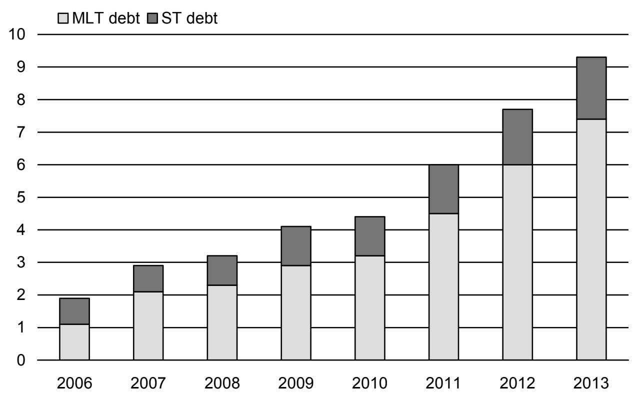
…inflation will remain high

The National Bank of Serbia has implemented a new inflation targeting regime as of 1 January 2009. It now targets headline CPI (as opposed to core inflation); 8% y-o-y in December. At the end of last year CPI came in at 8.6% y-o-y on lower food and oil prices and averaged 11.7% y-o-y. Core inflation was 10.1% y-o-y in December 2008. We see our 8.5% end-year CPI forecast exposed to upside risk given depreciation pressures and the potential for regulated prices to rise more than the 13% ceiling defined by the Central Bank as not endangering the CPI target.

EUR/RSD HEADS UP…



…AS EXTERNAL DEBT SERVICE REQUIREMENTS RISE



Source: NBS, Reuters, IMF, UniCredit Research estimates

High external financing requirement in 2009

Current account deficit to narrow in 2009…

Serbia's current account deficit widened last year by an estimated EUR 2bn to 18% of GDP under the influence of strong domestic demand and high oil prices during most of 2008. We expect the current account deficit to narrow this year to 14.5% of GDP. FDI inflows (6.2% of GDP) covered just over one third of the deficit. In December 2008 FX reserves fell EUR 893mn to EUR 8.1bn as the NBS intervened to ease the rise of the EUR/RSD. Up until 28 January the NBS intervened with an additional EUR 346.4mn to stem upward pressure on the EUR/RSD, which hit 97.5 on intra-day trading on 28 January. The payment of EUR 400mn by Gazprom for 51% of local oil company NIS on 2 February will help ease depreciation pressures in the n-t.

…but, external financing obligations remain extensive

We estimate that Serbia's gross foreign debt exceeded EUR 22bn approaching 67% of GDP at the end of last year. Serbia's external debt repayments this year amount to EUR 4.1bn, up approximately EUR 800mn on last year. At the same time we see the gap between the current account deficit and FDI inflows at approximately EUR 3.6bn implying a financing gap of EUR 7.7bn. As a result we see the potential for FX reserves to fall another EUR 1.7bn this year, although this will fall if the new FIAT factory in Kragujevac starts production later this year.

Government setting up support package while the NBS loosens policy

Commercial banks to help out on economic package…

…IMF agreement in place

The government is aiming for a budget deficit of 1.75% of GDP, but with growth slowing, it is exposed to the risk of lower than expected tax revenues. In late January it announced an RSD 100bn package to support corporate lending. Of that amount, RSD 40bn will come from international financial institutions while the government will provide RSD 7bn in subsidies to banks in a deal which will see them extend RSD 40bn in short-term loans at 5.5% and RSD 10-12bn in 3-5-year loans at 6.5%. Thus, the government hopes to fill the gap expected to be left by the reduction in cross-border lending this year. The government also has access to a EUR 402.5mn stand-by facility, which it will discuss drawing down in February.

…while NBS maintains loosening bias.

The National Bank of Serbia (NBS) has eased monetary policy settings and will maintain this bias. The stock of outstanding Central Bank bills has fallen from a high of RSD 248bn at the end of September 2008 to RSD 105bn in late January 2009, injecting RSD 143bn of liquidity into the market. We expect this stock to fall further over coming months. Over this same period the EUR/RSD rose approximately 25% to 95. The NBS has been intervening over this period to smooth the depreciation pressures. We expect more of the same in coming months with the NBS intervention aimed at avoiding excessive movements in the currency. As such we see the EUR/RSD heading higher on the back of corporate demand for FX to finance external obligations.

In late January the NBS lowered its 2W repo policy rate by 125bp to 16.50% and the central bank is planning to lower dinar reserve requirement rates too in a further effort to boost liquidity in the domestic market. We do not see any further cuts in the policy rate given the pressures the currency has been under in January.

Politics: these are more stable times

Economic situation focuses politicians' minds

In recent months the political situation in Serbia has become more stable. Although Kosovo remains a genuine political issue in Serbia, the EU's EULEX mission to Kosovo was deployed there last year without generating lasting difficulties for the government. Achieving full co-operation with The Hague Tribunal and thus removing the last political barrier to progress on EU accession continues to hinge on finding two remaining fugitives. Nonetheless, the Serbian government announced in January it was planning to submit its bid to join the EU in July this year. In short, as the effects of the global financial crisis have begun to feed through to Serbia, the political scene has become more stable.

Turkey

Outlook

Turkish growth slowed ahead of the region, already turning in a weak figure in Q3/08. This sets up 2009 for a 1% contraction in GDP, although the flipside of this will be a significant improvement in the external balance, alongside lower commodity prices. A proactive central bank monetary easing policy coupled with a sound banking sector sets up Turkey for a relatively rapid growth rebound coming into 2010.

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	Moody's	S&P	Fitch
Long-term foreign currency credit rating	**Ba3 stable**	**BB- negative**	**BB- stable**

MACROECONOMIC DATA AND FORECASTS

	2006	2007	2008e	2009f	2010f
GDP (EUR bn)	419.2	477.9	498.5	449.1	500.8
Population (mn)	70.4	70.6	70.8	71.0	71.2
GDP per capita (EUR)	5954	6769	7040	6326	7034
GDP (constant prices y-o-y %)	6.9	4.6	0.8	-1.0	3.4
Private Consumption, real, y-o-y (%)	4.6	4.1	1.1	-1.5	3.5
Fixed Investment, real, y-o-y (%)	13.3	5.5	-2.1	-6.0	2.8
Public Consumption, real, y-o-y (%)	8.4	6.5	4.5	5.0	5.0
Exports, real, y-o-y (%)	6.6	7.3	7.0	-10.0	7.3
Imports, real, y-o-y (%)	6.9	10.7	5.5	-12.0	7.0
CPI (year end, y-o-y %)	9.7	8.4	10.1	7.8	6.8
Central bank reference rate	17.5	15.8	15.0	11.0	10.0
Unemployment rate (%)	9.9	9.9	10.5	11.5	11.0
Budget balance / GDP (%)	-0.6	-1.6	-1.8	-1.6	-1.3
Current account balance (EUR bn)	-25.4	-28.0	-27.6	-12.8	-15.5
Current account balance / GDP (%)	-6.1	-5.9	-5.5	-2.8	-3.1
Net FDI (EUR bn)	16.1	16.1	11.3	8.9	11.0
FDI % GDP	3.8	3.4	2.3	2.0	2.2
Gross foreign debt (EUR bn)	156.2	168.1	204.2	224.6	244.6
Gross foreign debt (% of GDP)	38.3	33.8	41.0	50.0	48.8
FX reserves (EUR bn)	46.2	48.4	50.0	45.0	42.0
(Cur.Acc-FDI) / GDP (%)	-2.2	-2.5	-3.3	-0.9	-0.9
FX reserves / Gross foreign debt (%)	29.6	28.8	24.5	20.0	17.2
Exchange rate to USD eop	1.4	1.2	1.5	1.7	1.6
Exchange rate to EUR eop	1.9	1.7	2.1	2.4	2.1
Exchange rate to USD AVG	1.4	1.3	1.3	1.7	1.6
Exchange rate to EUR AVG	1.8	1.8	1.9	2.3	2.2

Source: UniCredit Research

Macro outlook

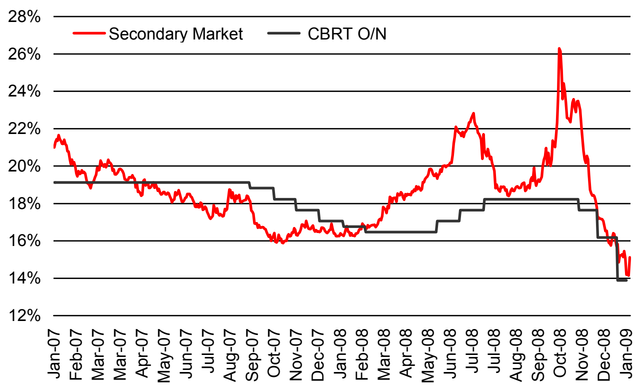
Q3/08 growth was already very disappointing…

Q3 growth came in below expectations at 0.5% and prospects for 2009 do not look very bright. On the expenditure side, the domestic demand contribution at minus 0.4%-point was in sharp contrast to the 1.5%-point contribution coming from external demand and not a promising outlook going forward. Private consumption growth at a negligible 0.4% was more than matched by a 10.0% reduction in private sector investment expenditure (a 2%-point drag on headline GDP), presenting a private sector expenditure outlook that is unprecedented in the post-2001 crisis period. Government expenditure has picked up in the meantime with public consumption expenditure contributing 0.7%-point and investment expenditure 0.8%-point to overall growth.

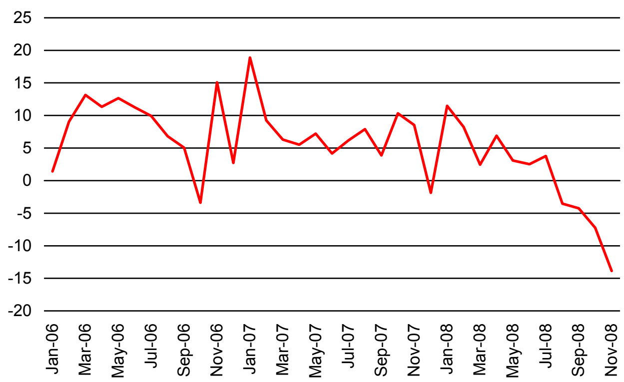
Our growth forecasts for Q4/08, 2008, and 2009 currently stand at minus 4.6%, 1.0%, and minus 1.0%, respectively. Following the local elections at the end of March, expect some fiscal tightening under the very probable IMF arrangement and thus an end to the positive contribution coming from public expenditure in recent quarters. The export channel will make its adverse impact felt more and more given the dismal global outlook and a heavier hit could be coming from the finance channel which is extremely important for banks' and non-bank corporates' external financing needs. Turkey's fate is closely linked to that of the global system and one advantage she has currently over some of her peers is the underleveraged consumer, the product-wise relatively unsophisticated financial system, and domestic absorption as the traditional driver of growth.

0.4% December CPI inflation culminated in a 10.1% annual inflation figure for 2008. There were virtually no signs of exchange rate pass-through and weak demand conditions seemed to be the dominating factor. Disinflation should continue uninterrupted for the first five months of the year due to both a lack of effective demand and the base effect from last year. The CBT's core CPI indices are also displaying downward trends across the board, and that should analogously continue uninterrupted for the first five months as well. The Central Bank revised down its 2009 inflation estimate to 6.8% from 7.5%, and it is quite possible that the target may be met barring any significant depreciation and a respective pass-through. The key risk remains, however, the exchange rate.

MARKET RATES CONVERGE



Y-O-Y INDUSTRIAL PRODUCTION GROWTH SLOWING FAST



Source: Statistics Office, Bloomberg

Macro vulnerability indicators

Current account deficit is improving fast

The current account deficit is on a steady decline for a number of reasons and the reduction should continue uninterrupted for some time to come with energy prices remaining low and the growth outlook and hence import demand continuing to be subdued. The end-2008 figure should be around USD 42bn, but the current outlook suggests that the 2009 figure could be around half that number barring any unexpected pick up in sentiment. There is little change in the financing quality and the non-debt financing of the current account deficit remains at 45%.

The external debt of the private sector (excluding the Central Bank) stands at USD 196bn and that of the public is slightly less than USD 80bn. External debt amortization is particularly challenging for 2009 at USD 64.9bn, according to Treasury data (as opposed to USD 12.7bn in 2008 and projection of USD 36.6bn in 2010).

The Central Bank has taken a proactive easing stance

Rate cuts have so far been significant

The Central Bank's aggressive rate cuts seems to have worked in the sense that benchmark rates have come down significantly and are below 15% at the moment. Considering the fact that benchmark rates were around 26% as recently as on 24 October 2008, the reduction is nothing but spectacular. It needs to be added that benchmark rates are literally divorced from the exchange rate as of late, and with limited non-resident money in the overnight market, further policy rate cuts should have a minimal impact on FX rates. With regard to the latest rate cuts which were perceived by most market agents as aggressive and/or risky and/or imprudent, the Monetary Policy Council downplayed the decline in oil prices, the reduction in the pass-through parameter, and the slowdown taking place globally and at home. What was most important in criticisms that followed was that no one disputed the relevance of these factors. The disagreement pertained to the strength of these factors but not to their existence. However, the Central Bank may have switched to a new paradigm taking advantage of the opportunity generated by the recent global crisis. The argument here is that disinflation efforts overwhelmingly based on appreciation of local currency are de facto fragile. Moreover, a higher exchange rate and a lower interest rate mix is presumably regarded as a superior initial start-up point for the new disinflation effort, and rate hikes if necessary would be less problematic and the level of the exchange rate rather than that of the interest rates could provide the motive for inflows. This may very well be the new mind frame that is adopted and if right, it should signal a few more front loaded cuts in the upcoming period.

Politics

The domestic political scene has been boiling for some time with the Ergenekon trial where those who are accused of plotting a coup against the elected AKP government are being put on trial one after another. Eleven so-called "waves" of raids and taking into custody by security forces involved high level generals, journalists, union leaders, academics, low rank soldiers, security forces personnel, etc. Trivialized for some time by some mainstream media, it should be no more as polls indicate that more than 60% of the public believes in the existence of Ergenekon. Confessions by the accused perpetrators are coming thick and fast regarding the para-military deeds of the last two decades and no-one seems to be surprised as "the deep state" had always been more than just a rumour for "Joe Public". AKP remains to be the only beneficiary of the Ergenekon case as the rest of the political system still chooses to remain relatively distant in case the trials end up with no clear convictions. It is very likely that such an ending is now out of the question, and the main opposition party CHP for that very same reason has openly declared itself as the attorney power for the accused. There seems to be no turning back; and with the EU's unconditional support for the process should continue uninterrupted and should ultimately serve the country's political stability in a major way.

Ukraine

Outlook

The unfolding global economic crisis – reflected by capital inflows drying up and demand for Ukrainian products slumping – has exposed the need for a period of painful macroeconomic adjustment. Moreover, unpredictable politics have dampened the initial confidence boost from the USD 16.4bn IMF package (which worked to add 50% to central bank FX reserves), leading to a sharp UAH depreciation and the associated risks for banks.

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	Moody's	S&P	Fitch
Long-term foreign currency credit rating	**B1 stable**	**B+ negative**	**B+ negative**

MACROECONOMIC DATA AND FORECASTS

	2006	2007	2008e	2009f	2010f
GDP (EUR bn)	84.8	103.1	117.8	89.4	110.0
Population (thd.)	46929.5	46646.0	46372.7	46101.0	45830.9
GDP per capita (EUR)	1808	2210	2541	1939	2400
GDP (constant prices y-o-y %)	7.1	7.6	2.1	-5.8	2.0
Private Consumption, real, y-o-y (%)	14.4	17.1	10.0	-10.6	2.8
Fixed Investment, real y-o-y (%)	18.7	24.8	7.0	-16.0	3.5
Public Consumption, real y-o-y (%)	4.8	2.8	2.0	2.3	1.9
Net Exports, real, % of GDP	-14.9	-24.0	-32.0	-25.7	-26.6
CPI (year end, y-o-y %)	11.6	16.6	22.3	15.0	10.5
Central bank reference rate	8.5	8.0	12.0	11.5	10.0
Unemployment rate (%)	6.8	6.9	6.2	9.5	7.5
Budget balance / GDP (%)	-0.7	-1.4	-1.3	-4.0	-2.0
Current account balance (EUR bn)	-1.3	-4.3	-8.1	-1.8	-0.9
Current account balance / GDP (%)	-1.5	-4.2	-6.9	-2.0	-0.8
Net FDI (EUR bn)	4.6	6.7	6.8	2.9	6.5
FDI % GDP	5.4	6.5	5.7	3.3	5.9
Gross foreign debt (EUR bn)	42.3	58.4	75.3	87.7	94.5
Gross foreign debt (% of GDP)	49.8	56.7	63.9	98.1	85.9
FX reserves (EUR bn)	16.6	21.8	22.0	10.5	8.0
(Cur.Acc-FDI) / GDP (%)	4	2	-1	1	5
FX reserves / Gross foreign debt (%)	39	37	29	12	8
Exchange rate to USD eop	5.0	5.1	7.8	8.1	7.4
Exchange rate to EUR eop	6.7	7.4	10.9	11.4	9.6
Exchange rate to USD AVG	5.0	5.0	5.2	8.2	7.7
Exchange rate to EUR AVG	6.3	6.9	7.7	11.3	10.5

Source: UniCredit Research

Macro outlook

Global crisis demands painful adjustment

The unfolding global economic crisis has exposed the need for a period of painful macroeconomic adjustment. So far, the country has been the hardest hit in the CIS region, as capital inflows have dried up and demand for Ukrainian products has slumped – creating difficulties in financing 2008's 7% of GDP current account deficit. In turn, the +60% UAH depreciation has increased the risks related to domestic FX debt, and pressured bank capitalisation.

As the economy falls into a sharp recession in Q4/08…

The contrast is sharp: robust GDP growth of +10% in August, gave way to a pronounced fall of -19% in December 2008, with construction and manufacturing being hit the hardest. While, the dramatic drop in global demand for such key Ukrainian export commodities as steel (45% of goods exports), fertilizers (10% of goods exports) as well as some machinery equipment (10% of goods exports) has also been translated into staggering falls in industrial production, marking record historical falls of 28.6% y-o-y in November and 26.6% in December. Whereas all industrial sectors contributed to the fall, sectors such as mining, transport and equipment manufacturing, as well as steel all fell by over 40% y-o-y.

…as industrial production stages historical falls

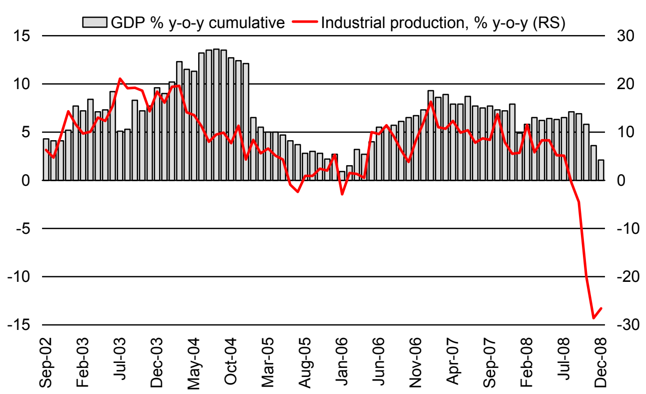
For 2008, the strong dynamics of 9M/2008 tallied growth to 2.1% for the full year. However in 2009 we are expecting a decline of at least 5.8%, with the crisis hitting the hardest at the start of the year (GDP contracting by 15% in Q1/09), and easing by year-end, as a global recovery starts to gain momentum, lifting the 2010 growth outlook to 2%. The adjustment will be painful for both households and corporates, as wage growth slows, availability of credit remains limited and servicing debt increases. However, as a recovery starts to gain momentum, the economy should quickly rebound, driven by rising investment ahead of the EURO 2012 preparations and improvements in competitiveness – a result of a flexible exchange regime.

Recovery will gain momentum as the global economy starts to emerge

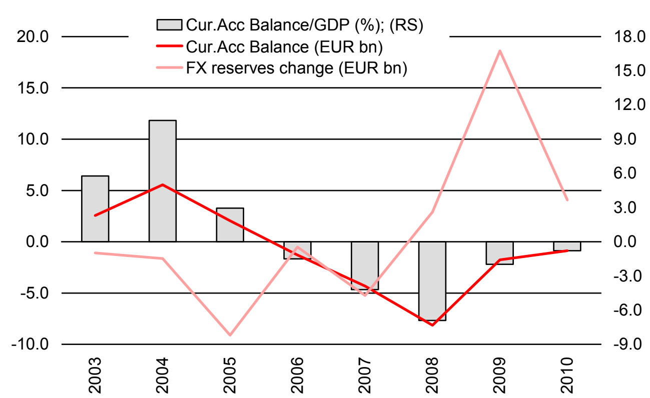
While inflationary pressures remain elevated, even as the rate ought to come down

Inflation started to come down in autumn 2008, after spiking at 31.1% in May, on the back of hikes in food prices (55% of the CPI basket) and higher energy costs (y-o-y CPI growth was 22.3% in December). In 2009, our baseline forecast assumes a further deceleration of inflation on the back of a demand shock. Moreover, according to the agreed IMF stand-by-programme, the government ought to push the rate down to 17%. However, UAH depreciation remains a risk to disinflation, while monetary financing of the budget deficit in an election year is another factor to watch.

INDUSTRIAL PRODUCTION PLUNGES



CURRENT ACCOUNT BALANCE SET TO IMPROVE



Source: Statistical Office, Central Bank, UniCredit Research

Macro vulnerability indicators

Debt rollover ratios to remain critical, amid capital flight and debt mismatch

The pressure from the reversal of capital inflows, has compounded pressure on the UAH – trading above 8 at the start of the year, up from just UAH 4.6/USD during summer 2008. Given the bleak state of affairs and an uncertain political environment, we also think that capital flight and pressure on the UAH might continue and even escalate in the near future fuelled by continued demand for FX from the general population, as well as companies and banks. Private FX debt repayments for 2009 are estimated at USD 29bn, and total financing needs at USD 46.5bn. Debt rollover ratios will be critical, in 2009, while Central Bank support/intervention on the FX market will continue to move the UAH, but with the limitation that no more than USD 24.1bn (including full IMF money) can be spent to keep to the terms of the IMF deal.

Credit risks are clearly present

The silver lining in the rapid UAH depreciation is that a significant moderation of imports on the back of a demand shock ought to help make the current account gap financeable – a 2% of GDP deficit (USD 2.4bn) in 2009. However, a weak UAH also poses significant risks for the financial sector: 50% of corporate loans and 60% of household debt are FX linked (most were taken at USD/UAH 5.05). The latter might also be compounded by rising fears of rapidly deteriorating credit quality of the country and corporate sector. Clearly with USD/UAH at a 50% deviation to the 1 year avg. debt servicing costs have significantly spiked.

Policy response to macro outlook

USD 16.4bn IMF backing an important support factor

The stand-by arrangement with the IMF for USD16.4bn (over the course of 2008-2010) has provided an important boost to confidence. However, the initial USD 4.5bn tranche, transferred in October was largely spent on supporting the UAH in Oct/Nov/Dec. Daily NBU interventions on the FX market are now critical to UAH stability. However, weak performance, underlines that IMF support alone is not necessarily sufficient to stabilize the situation. Strong and credible government policy is also needed to reassure the markets, and more importantly in the near-term to bolster local sentiment in order to reduce capital flight.

The government has penciled in a 3% budget deficit for 2009, but there are difficulties with budget execution, as revenues have rapidly fallen, leaving a gap in the pension fund. Some see a risk that the Central Bank may be forced to finance the budget expenditures this year, although the Central Bank is forbidden to do so directly – FinMin's domestic debt placements are to become more frequent, with bonds later transferred to the Central Bank balance sheet. There is some scope for optimism – UAH 44bn (USD 6bn) have been budgeted for recapitalization of the banking system this year. And a few banks have already been sold without state support (Nadra, Prominvest, National Credit, Ukrprombank, Rodovid). Moreover, the NBU has already provided support to banks via refinancing lines in Nov 2008-Jan 2009 worth a total UAH 84bn.

Politics

Politics remain noisy, chaotic and unpredictable

Noisy, chaotic, and unpredictable are just some of the by-words that go with Ukrainian politics. Deadlock remains a near-term concern in Ukraine, despite a last minute coalition agreement in the Rada, which spelled an end to speculation about parliamentary elections in December. More broadly, there is significant positioning taking place ahead of the early 2010 presidential election. The next President is likely to be either Yulia Tymoshenko or Victor Yanukovich. However a recent poll is suggesting that the balance of popularity is shifting, with Yanukovich enjoying a significant lead. Arguably, political stability will improve once the presidential elections are finally out of the way.

For your notes

For your notes

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