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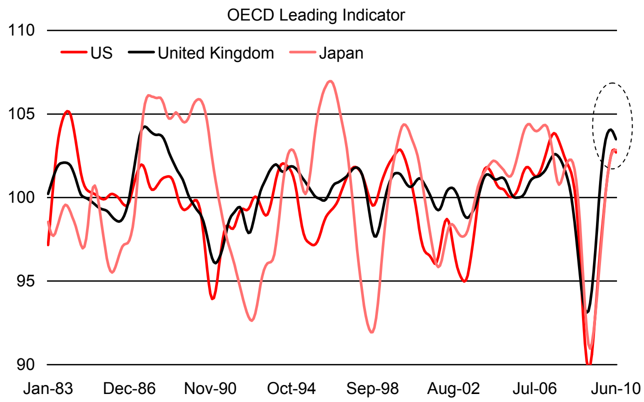
Global growth slowing, not stopping

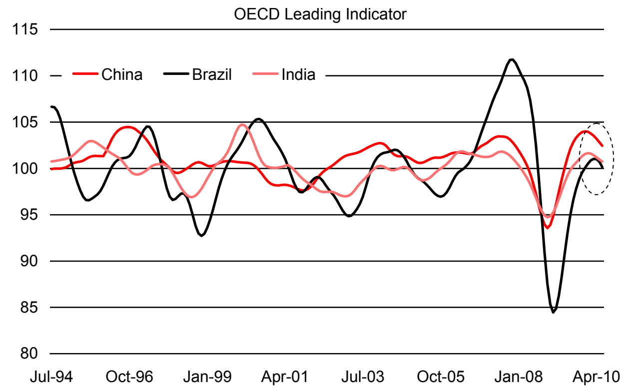
The global outlook continues to unfold in line with our view: the initial, most dynamic phase of the recovery is now losing momentum, and growth is decelerating in both advanced economies and emerging markets. In the major emerging economies, growth should remain robust; in the advanced economies, however, it is settling on a lackluster pace. This deceleration is normal and expected, as the impulse from fiscal stimulus and from the inventory cycle is fading out of the picture. The question, however, is how quickly private consumption and investment will be able to pick up the slack.

OECD LEADING INDICATORS, EM AND ADVANCED ECONOMIES

US, UK and Japan OECD leading indicator



Emerging Market OECD leading indicator

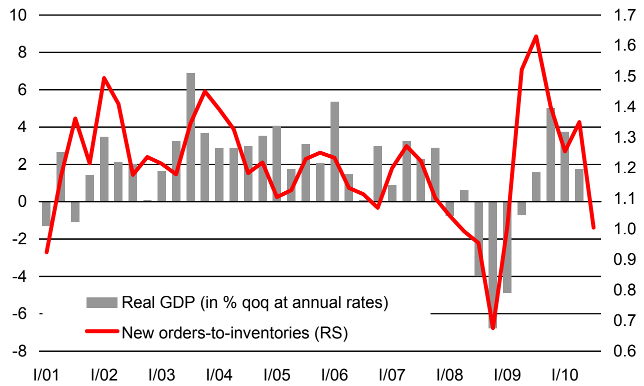


Source: OECD, UniCredit Research

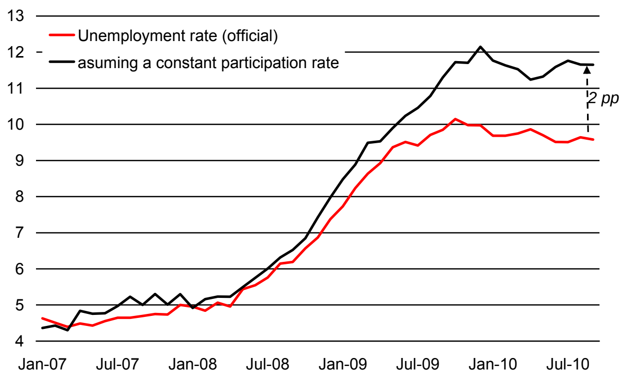
The question is most relevant in the US, where pessimism is still pervasive, and fears of a double-dip recession are becoming increasingly common. There is no doubt that the current US recovery is extremely anemic and disappointing by historical standards (see chart). The Achilles heel of the recovery is private consumption, held back by persistently high unemployment and a still-fragile labor market. The unemployment rate remains very high, at close to 10%, with long-term unemployment emerging as a significant economic and social problem; the pace of job creation remains weak, and the disappointing labor market performance undermines consumption. The corporate sector on the other hand enjoys good profitability and rude financial health, but uncertainty on taxes, regulation, and demand are restraining investment. Overall, we believe fears of a double-dip recession are exaggerated: the corporate sector is strong, the financial sector has recovered, and consumers are repairing their balance sheets at a fast pace. However, we need to recognize that growth over the next 2-3 years will be weak, and that the "bubbly" pre-crisis levels of activity and employment do not represent a realistic benchmark.

US RECOVERY AND UNEMPLOYMENT

Dynamic in manufacturing clearly pointing south



Plunging participation rate lowers unemployment rate

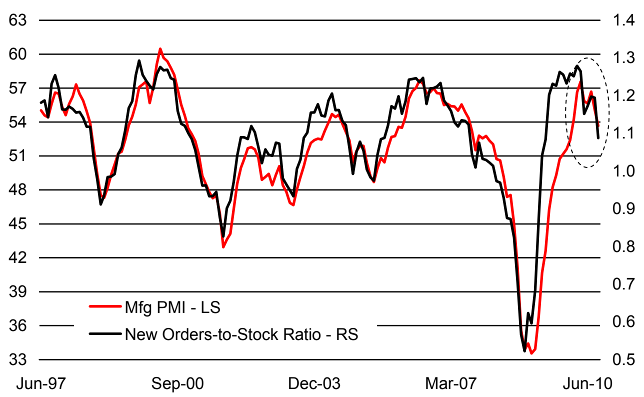


Source: UniCredit Research

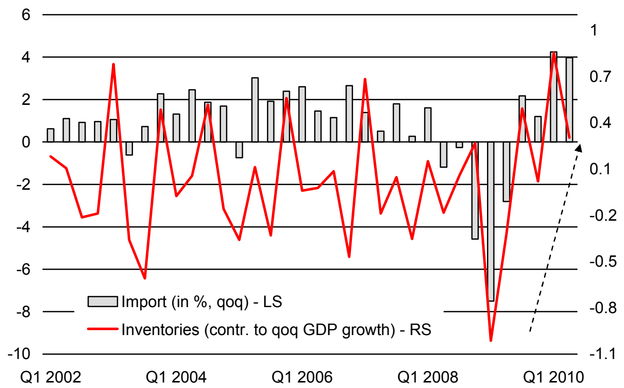
In Europe, after a stronger than expected 2Q10, growth is also losing momentum, as evidenced by PMIs and new order/inventory ratios. There are several reasons to expect that the deceleration will be gradual and not sharp, however. First, as export performance loses steam, imports will also decline, given the relatively high content of imported intermediate inputs in export production, and this will cushion the adverse impact on GDP. In addition, the strong performance in exports to date will continue to feed into stronger capital expenditure and employment for some time.

EUROZONE PMIS AND IMPORTS

Eurozone PMI



Inventory cycle is slowing

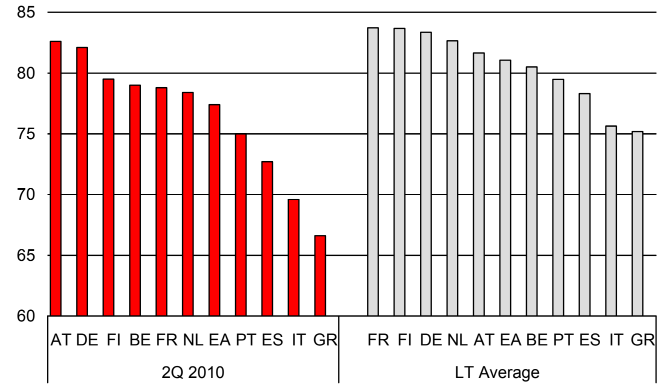


Source: UniCredit Research

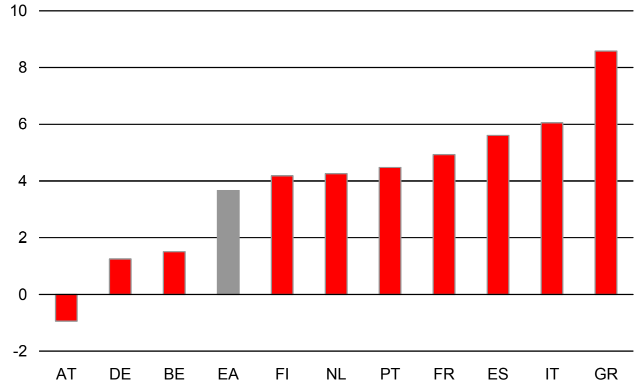
However, the main story in the Eurozone is the two-speed nature of the recovery, with an increasing divergence between stronger and weaker economies. This divergence appears largely structural, and threatens to remain a source of weakness and instability, as well as a significant policy challenge, for years to come. The divergence is obvious in the GDP growth rates, but also in the speed at which different countries have moved to close the capacity utilization gap: on the one hand, Austria has already closed the gap, with Germany and Belgium about to follow; on the other, most of the periphery still has a wide capacity utilization gap. This is further exacerbated by the fact that capacity utilization rates have consistently been lower in the periphery than at the core.

CAPACITY UTILIZATION

Capacity utilization ST and LT



Difference in long-term and current capacity utilization



Source: UniCredit Research

In itself, this divergence is not a problem for CEE countries, which are most closely correlated with the German industrial cycle – we expect German growth to remain robust. The risk however is that this divergence in performance might fuel continued volatility in financial and sovereign bond markets. Investors are still skeptical of Greece's chances of success, and concerns have now focused on Ireland, which is having to shoulder a gigantic cost to shore up its financial sector; Portugal is next in the list of concerns. While the European Financial Stabilization Fund is nearly operational and ready to be deployed in case of emergency, if we get to that stage it will not be without renewed bouts of instability.

On a pure relative value basis, heightened concern on peripheral Eurozone sovereign bonds should benefit CEE countries, given their much sounder fundamentals – as we have often pointed out in the past. However, to the extent that instability in sovereign bond markets undermines the Eurozone's financial sector (as banks are important holders of the bonds in question), it might have a negative spillover impact on CEE as well, given the predominant role played by Eurozone-based banks in CEE markets. A source of comfort is that the Eurozone's financial sector has also gotten stronger, as shown by steadily diminishing demand for ECB liquidity; significant problems remain in localized pockets of the banking system (Ireland, the German Landesbanken, and some Spanish Cajas), but systemic risks have greatly diminished.

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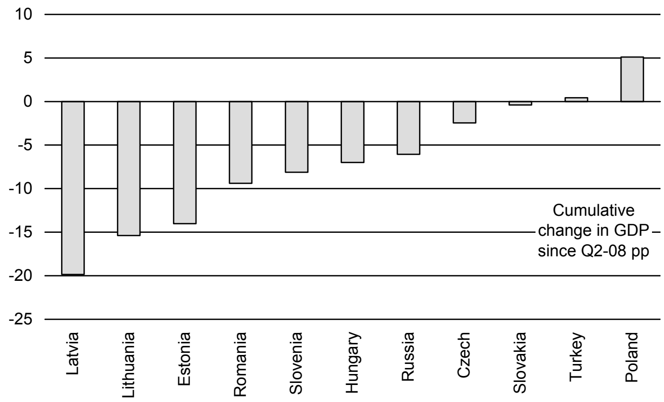
CEE: Continued, albeit bumpy, recovery ahead

3Q10 should prove another quarter of recovery

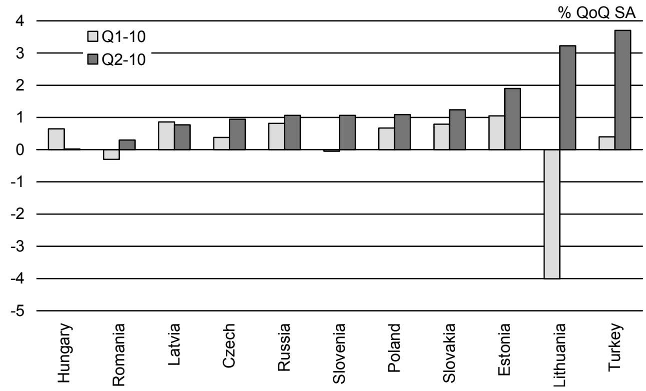
Since our last quarterly publication, the region has continued to show recovery, supported by strong external demand and an improving domestic demand environment. In the 11 countries where we have access to seasonally adjusted GDP data, 10 showed qoq gains in 2Q10. Turkey led the pack, gaining 3.7% qoq. Hungary represented the exception, with GDP flat qoq. In terms of a rebound in economic activity since the onset of the crisis, however, sharp divergences remain. Poland and Turkey are the only two countries in the region where GDP has recovered to in excess of its pre-crisis levels. Poland of course impressively escaped recession. In contrast, in Hungary and Romania, GDP remains 7-10pp below its pre-crisis levels, while in Latvia GDP remains almost 20pp below its pre-crisis levels.

A SHARP ADJUSTMENT IN EXTERNAL ACCOUNTS IN THE REGION

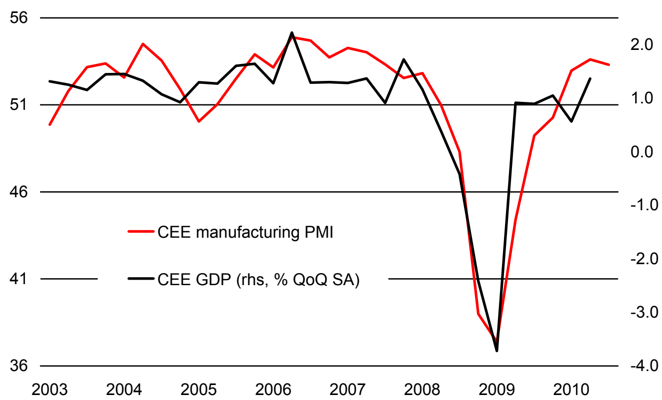
Strong divergence in recovery in economic activity since the crisis



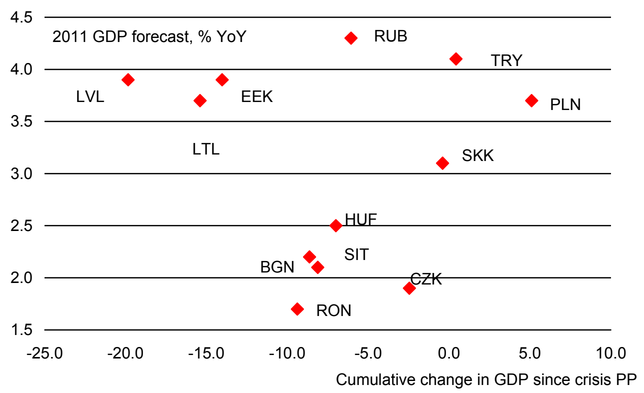
With the exception of Hungary, GDP in all countries showed gains in 2Q10



Manufacturing PMIs suggest that 3Q10 will show further GDP gains[1]



Next year a strong divergence across countries in terms of economic activity will remain



Source: National statistics offices, UniCredit Research

Industry and inventories have been central to recovery

To date industry and inventories have been key drivers of the recovery. Our CEE manufacturing PMI reached 53.6 in 2Q10, the highest level since 2Q07, and it eased only moderately to 53.3 in 3Q10. The cumulative impact of the change in inventories since the crisis is, as of 2Q10, positive in Czech, Estonia, Slovakia, and Romania, while it is broadly neutral in Turkey and Poland. Hungary and Russia on the other hand have yet to experience a boost from inventories – since 2Q08 changes in inventories have subtracted a cumulative 11.3pp and 6.1pp respectively from GDP.

[1] **Our CEE manufacturing PMI indicator is a simple average of the manufacturing PMIs for Czech, Hungary, Poland, Russia, and Turkey.**

Looking ahead, we expect a continued recovery, although on the whole the pace of gains is unlikely to accelerate much from here and in some cases will slow. Industry should continue to make a positive contribution, though less so than previously, as external growth slows. However, domestic demand should be more supportive in a number of cases, and not only due to inventories. From a regional contraction of 5.7% of GDP last year, we forecast real GDP gains of 3.6% this year and 3.8% next year.

Labor market dynamics turn more positive

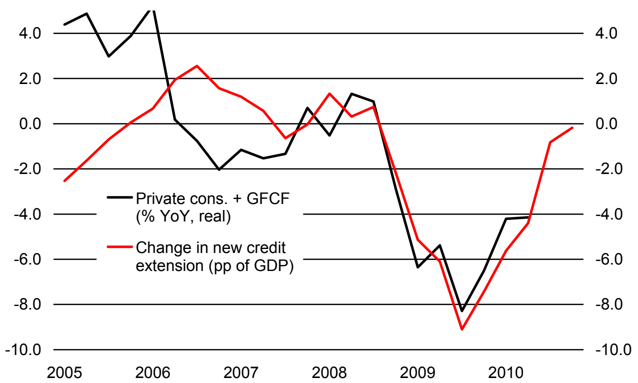
Labor markets have seen positive developments. Unemployment (SA) was unchanged in 2Q10 from 1Q10 at an average of 12.3% following seven quarters of increases. Unemployment fell in Czech, Estonia, Latvia, Poland, Romania, and Slovakia. In Russia, unemployment fell 0.9pp to 6.9% over the 12 months to August, while in Turkey unemployment is down 2.5pp to 10.5% over the 12 months to June.

Credit dynamics also support economic activity

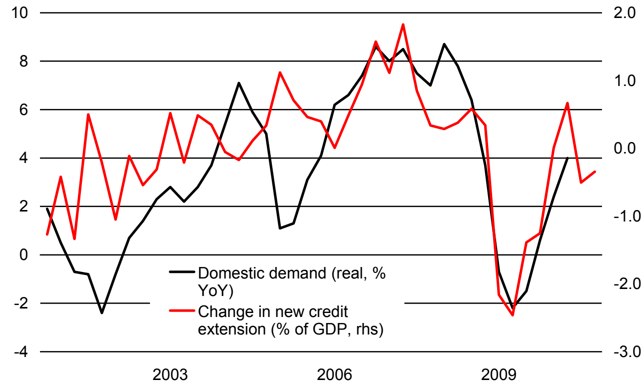
In terms of the impact of credit on economic activity, we look not at credit growth but rather the amount of new credit allocated to the economy in a certain period relative to the previous period, i.e. the change in the value of credit transactions in one period relative to the previous period[2]. Below we chart the change in new credit transactions as a % of GDP for Hungary, Poland, Russia, and Turkey.

CREDIT SHOULD SUPPORT DOMESTIC DEMAND (FURTHER) FROM HERE

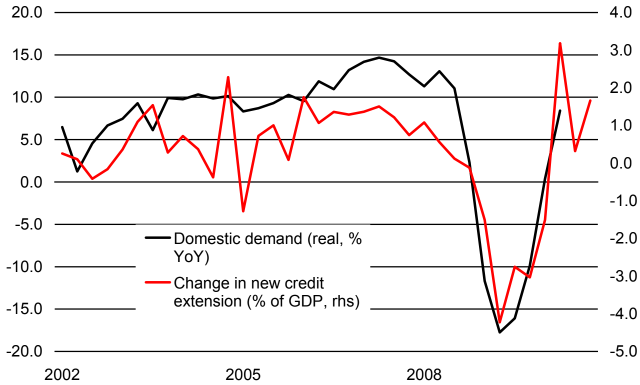
Hungary: Credit impact on domestic demand assuming new credit extension does not increase from average of past 4 quarters



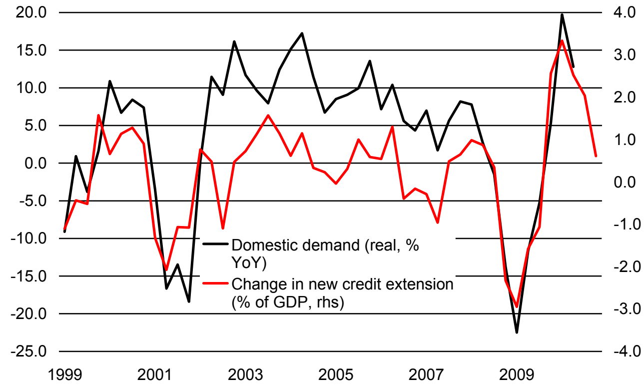
Poland: Credit impact on domestic demand assuming new credit extension does not increase from average of past 4 quarters



Russia: Credit impact on domestic demand assuming new credit extension does not increase from average of past 4 quarters



Turkey: Credit impact on domestic demand assuming new credit extension does not increase from average of past 4 quarters



Source: National statistics offices and central banks, UniCredit Research

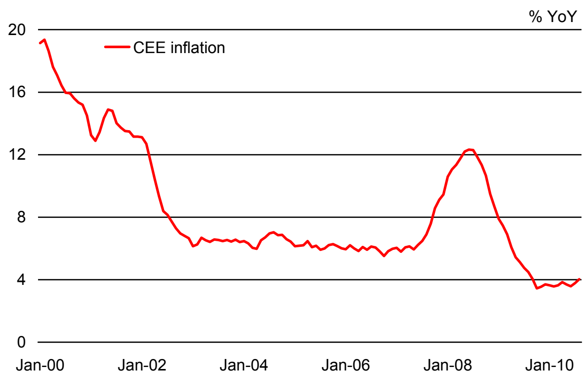
[2] **For further discussion please refer to Biggs, M., Mayer, T. & Pick, A., "Credit and economic recovery: Demystifying Phoenix Miracles", 2010.**

In the case of Hungary, the stock of credit continues to contract at this stage, but more importantly the pace of contraction is slowing. The change in the amount of new credit extended correlates well with the downturn in domestic demand over recent quarters. Looking ahead and assuming that the pace contraction in the stock of credit remains at its average over the past four quarters, domestic demand growth in yoy terms in Hungary should turn positive by 4Q10. In the event that new credit extension turns positive, domestic demand would benefit further.

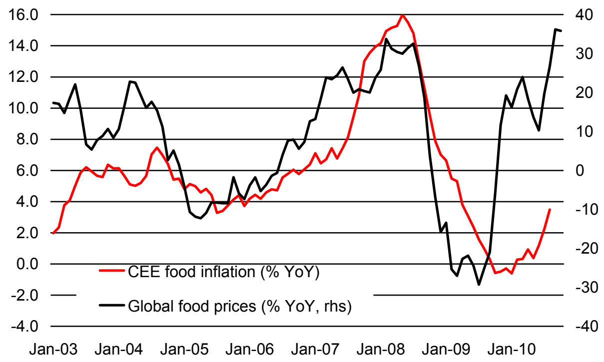
In Poland and Russia, our credit indicator suggests that domestic demand growth will remain positive over 2H10. Our credit impulse indicator shows a sharp slowdown in domestic demand growth in Turkey from a current unsustainable rate of 12.8% yoy. This assumes that credit extension does not exceed that from the past four quarters, as is the case with the other three countries presented. In the case of an upside surprise to this assumption, the slowdown would be less pronounced.

INFLATION IS SET TO RISE MORE IN SOME COUNTRIES THAN OTHERS

Inflation in the region has hit a record low



Food price inflation represents the most prominent risk



Source: National statistics offices and central banks, UniCredit Research

Headline inflation set to rise but central banks will take some comfort from well-behaved core inflation for now

Against this background of a continued recovery in economic activity, inflation pressures are on the rise, albeit from record-low rates. We forecast annual average inflation in the region next year at 6.6%, up from 5.8% this year. These pressures look set to manifest themselves in a few forms.

1. First and foremost, an increase in food prices across the region is already underway. This should be more pronounced in some countries than others. Drought and fire in Russia, weather-related declines in harvests in a series of other countries in the region (in particular Poland, Latvia, Lithuania, Slovakia, and the Czech Republic), and a spike in global food prices (the CRB food price index rose 31.7% yoy in September, its fastest pace of increase since July 2008) should translate into an acceleration in food price inflation from here. There are already signs of this in some countries, e.g. Serbia, Turkey, and Russia, despite measures by some governments to limit food exports to contain price increases.

2. Secondly, fiscal policy measures look set to contribute to inflation pressures in a number of countries next year. A VAT hike is planned in Poland for next year, which we estimate will add 0.7-0.8pp to CPI. Bulgaria plans an increase in excise taxes on fuel and tobacco, while Romania pushed through a 5pp VAT hike in July, pushing inflation outside of its target band (2.5%-4.5% for end-2010) to 7.6% in August. Ukraine has planned further increases in gas prices.

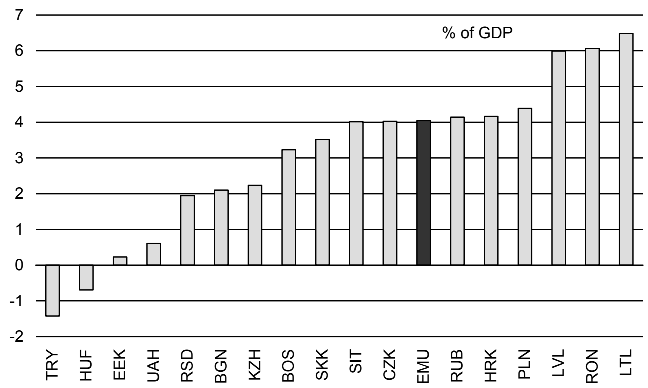
3. Lastly, currencies in the region have offered central banks little in terms of support. Nominal effective exchange rates in all countries except Czech, Russia and Turkey depreciated between end-2009 and end-August.

Fiscal consolidation is on track, though with some noticeable exceptions

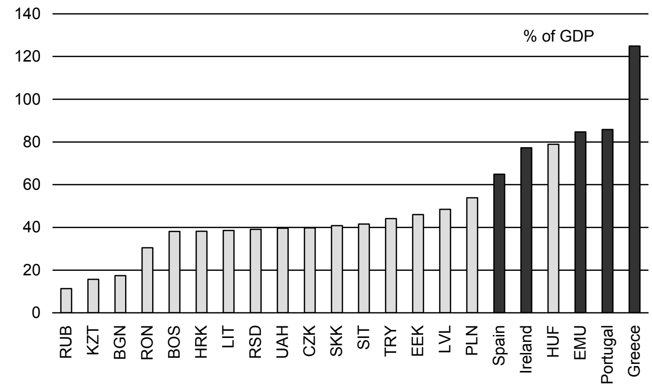
For the most part, fiscal consolidation in the region remains on track. We project an average budget deficit in the region next year of 4.5% of GDP compared with 5.4% last year and 7.0% in 2009. In many cases primary balances are in better shape than in EMU, while public debt to GDP ratios (with the exception of Hungary) compare favorably. Outperformers in the region remain Estonia (the only one of the new EU countries to avoid the excessive deficit procedure since joining the EU) and Bulgaria (the government targets a deficit of 2.5% of GDP after an expected outcome of 4.8% of GDP this year). The Czech government is targeting a deficit of 4.5% of GDP next year, down from 5.3% this year while in Slovakia the new government quickly approved a consolidation plan to cut the deficit by 2.8pp of GDP next year to 5.0%.

PUBLIC SECTOR BALANCE SHEETS SHAPE UP MUCH BETTER THAN IN EMU BUT THERE IS STILL WORK TO BE DONE

Adjustment in primary balance required to stabilize public debt to GDP at 2010 ratios



Public debt to GDP is much more contained in most cases than in EMU (2009)

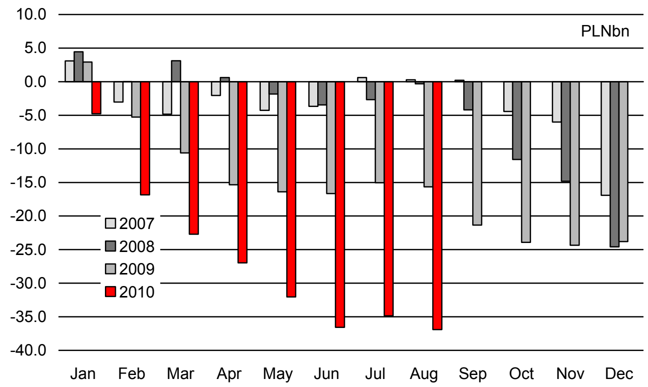


Source: IMF, UniCredit Research

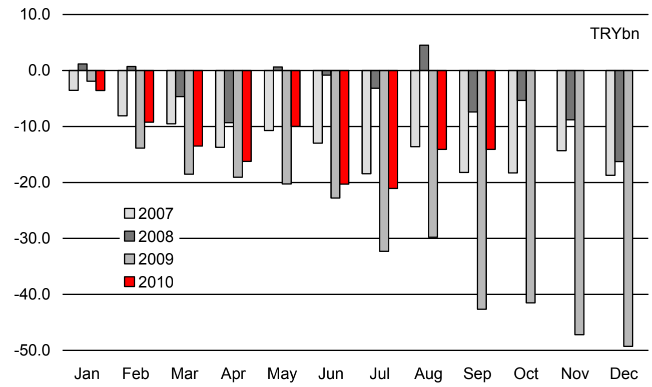
In terms of "IMF" countries, risks have increased in some cases over recent months although they remain manageable. Hungary is the most obvious example where Prime Minister Viktor Orban took a number of months after the general election to announce commitment to the 3% deficit target, and only then after persuasion from Brussels. The detail of the consolidation package, scheduled for announcement in mid-October, will be crucial. The NBH estimates that measures worth 1.1pp of GDP are required. In Romania, we are closely watching the outcome of this month's vote of confidence in the government. In the event that the government remains in place, we expect further progress with the IMF programme. A failed vote would significantly increase uncertainty on the future of the programme and no doubt further weigh on the currency and the ability of the government o finance itself on the market. From 8.1% of GDP last year, the Latvian government must lower the deficit to 6.5% of GDP next year, while Ukraine targets a deficit of 3.5% of GDP, 2pp of GDP tighter than this year. Expect plenty of news flow on the fiscal front over the course of 4Q10.

LACKLUSTER BUDGET PERFORMANCE IN POLAND CONTRASTS WITH IMPROVEMENT IN TURKEY

Significant deterioration in central government budget balance YTD in Poland despite gains in economic activity



Turkey budget performance improves



Source: IMF, UniCredit Research

Amongst the larger economies, performance is mixed. Turkey outperforms, Poland disappoints

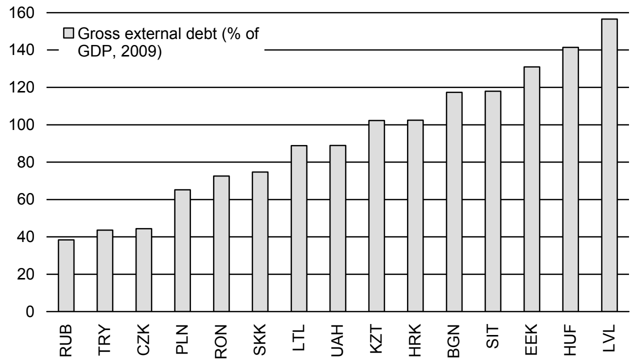
Amongst the larger economies, Turkey has outperformed while Poland has disappointed. Robust revenue growth in Turkey (19.0% yoy YTD) should be sufficient to narrow the deficit by more than 2pp this year to 3.2% of GDP. Performance is similar in Russia, where the budget deficit should narrow by almost 3pp of GDP this year to 5.7% of GDP, though rapid increases in expenditure over recent years leaves the underlying budget situation very vulnerable to a downturn in oil prices. In Poland the central government deficit over the eight months to August more than doubled in PLN terms, while Prime Minister Donald Tusk now admits that this year's deficit will be in the region of 7%-8% of GDP, largely unchanged from last year. Diligent pre-financing and strong foreign demand for bonds (since end-2008 foreign holdings of bonds have more than doubled to EUR 25.1bn) has supported the fixed income market to date, but such fiscal policy slippage risks EU wrath as well as a sharp decline in investor confidence at some stage. Note that since end-08 foreign holdings of Polish government bonds have more than doubled to in excess of EUR 25.1bn.

Some countries boast much more robust external balance sheets than others

In contrast with public sector balance sheets, external indebtness remains more of an issue in some countries in the region. Gross external debt, as a percentage of GDP, in Russia, Turkey, the Czech Republic, and Poland is the lowest in the region (although higher than in other EM regions). Gross external financing requirements in Poland and Turkey next year stand at 6.9% and 9.6% of GDP respectively, above some of their international peers (Mexico and Colombia, two countries that have arranged Flexible Credit Lines with the IMF, face requirements of 3.8% and 4.7% of GDP next year) but manageable and not significantly in excess of 2009 and 2010.

A STRONG DIVERGENCE IN EXTERNAL ACCOUNTS

Ranking EEMEA in terms of gross external debt



An overview of IMF programs in the region

	Date of arrangement	Expiration	Total amt. agreed	Undrawn balance	IMF credit outstanding under GRA
Bosn & Her	8-Jul-09	30-Jun-12	1.34	0.81	0.54
Hungary	6-Nov-08	5-Oct-10	16.1	4.4	11.7
Iceland	19-Nov-08	31-Aug-11	2.1	1.0	1.2
Latvia	23-Dec-08	22-Dec-11	2.3	1.0	1.4
Romania	4-May-09	3-May-11	17.2	3.6	13.6
Serbia	16-Jan-09	15-Apr-11	4.0	2.1	1.9
Ukraine	28-Jul-10	27-Dec-12	15.1	13.3	12.5

Source: National central banks, UniCredit Research

Gross financing requirements in some "IMF countries" are a concern

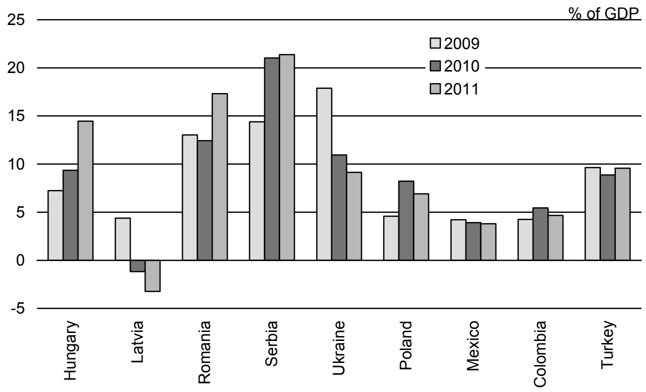
Those countries that were forced towards IMF programs as the crisis set in continue to face higher external financing requirements over the medium-to-long term however, reflecting higher levels of indebtedness. As shown below, Hungary, Romania, and Serbia, all face double-digit gross financing requirements next year. Latvia is in a better position, given that it now runs a C/A surplus more than sufficient to cover the amortization of medium-to-long term debt. Such large external financing requirements reflect not only a one-year phenomena but a multi year challenge, in part because of scheduled repayments to the IMF. Not surprisingly, it is in these countries where the recovery in economic activity is more lackluster with little sign of a return in capital flows. Repayment of such funds over the coming quarters will also stunt economic activity.

Taking this into account, rollover into some form of renewed IMF agreement in most cases would represent the smoothest transition once current programs expire. This does not necessarily mean drawing off further funds (some programs are in any case overfunded) but a move to a precautionary agreement, which would facilitate a re-negotiation of repayments if necessary. Romania's program is scheduled to expire in May next year, Serbia's in April. In Romania, Governor Mugur Isarescu has noted that Romania will not need further funding once the program expires but will continue co-operation with the Fund. In Latvia, the issue is less pressing given that the program concludes in December 2011, while the outcome of recent general elections bode well for continuity. Ukraine's program does not expire until end-2012.

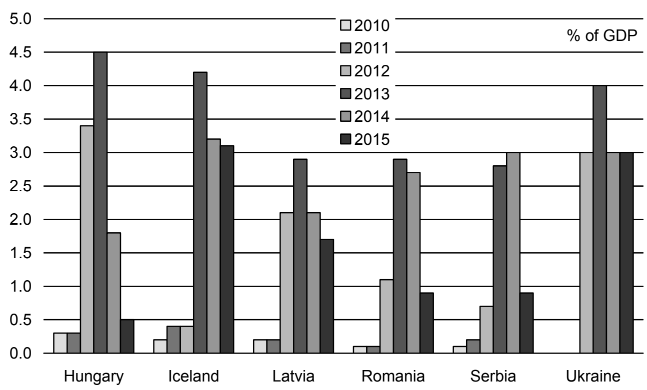
Hungary is of most concern to us over the medium term. Over the coming quarters, gross external financing requirements are contained and should be easily managed by the government. However, as we move into 2Q11 and beyond, the government begins to play a much larger role in the country's gross external financing requirement, which we estimate at an average of 2.8% of full year GDP per quarter between 2Q11 and 2Q13. This is due to the redemption of Eurobonds and, from 4Q11, repayment of EU and IMF loans. Recent news on the FDI front is positive, but it should neutralize only a small fraction of outflows related to IMF and EU payments.

SOME COUNTRIES IN THE REGION MAY SUFFER DUE TO LARGE EXTERNAL FINANCING REQUIREMENTS

Hefty gross external financing requirements in some cases



Scheduled repayments to IMF assuming full drawdown on programs



Source: IMF, NBH, UniCredit Research

There is no need to rush to hike rates

Against such contrasting backdrops for economic activity and indebtedness, we expect monetary policy and currency performance across the region to vary. With money market rates at close to record lows, in some countries (Czech, Poland, Russia, Turkey) it is a question of when, rather than if, rates will rise. That said, the case for any rapid rate increases is weak, particularly in an environment where emerging market central banks are concerned about the pace of currency gains, and we do not expect the ECB to hike rates until 4Q11.
In Poland the output gap argument is amongst the weakest in the region (given that there was no recession), inflation next year should rise due to the planned VAT hike and higher food prices, the currency is not offering the MPC any help in tightening monetary conditions currently, while fiscal policy is lax. A gradual "normalization" of policy rates beginning in 1Q11 looks likely. We also see rate hikes in Turkey from 1Q11. In Czech the CNB should very gradually bring the policy rate back towards what they consider as neutral over the course of 2011, although with fiscal tightening planned, the case for hikes is much less convincing than in Poland.

In other economies in the region the case for rate hikes on the basis of rising demand side inflation pressures – at least over the next 12 months – is less compelling. In Hungary, core inflation has been very well behaved over recent months, while in Romania the pass-through from the VAT hike to inflation has been more limited than expected. Serbia represents the exception on this front, having hiked rates 100bp since July to limit currency losses (even in the face of FX intervention) and inflation (though to some extent driven by food prices). In the case of much more extreme currency pressures, we would expect Hungary and Romania to shift to currency intervention as a first step and only then to rate hikes. In a scenario whereby these governments make progress on fiscal reform, further moderate rate cuts could come into play once again, potentially by year-end.

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CEE FI/FX Outlook: Navigating a bumpy road

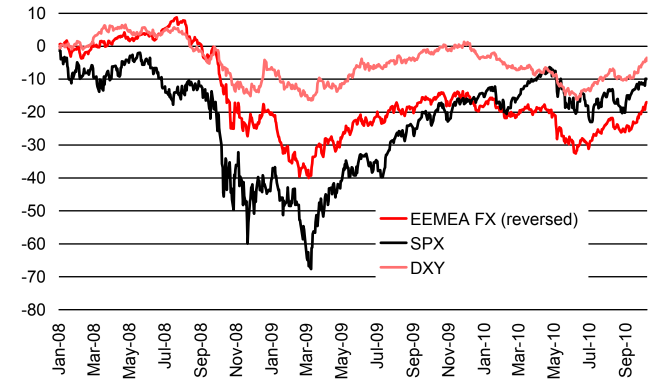
The prospects of QE2 created a golden combination for EEMEA FX and rates…

The global backdrop has been supportive for EEMEA markets. Driven by the increasing probability of further quantitative easing in the major economies, the golden combination of firmer equities (+10% SPX), and weaker USD (8% lower DXY) created a very favorable external backdrop for EEMEA FX markets, which closed the third quarter about 11% stronger vs. the greenback (chart 1). With the correlation between the USD and risky assets moving back to the highs of 4Q09, we believe the external backdrop remains exceptionally supportive for EM FX. Meanwhile, fully in line with the downward trend observed in the G3 rates, local currency EEMEA rates continued moving lower in the last couple of months (5y average rate declining by 25bp in 3Q10 and 160bp YTD). Whereas the above trends have been almost solely driven by global factors, the EEMEA sovereign credit markets continued to decouple from the ongoing deterioration in the Western European sovereign space. This is evidenced in the spread between the Sovx CEEMA and Western Europe indices, which tightened another 35bp in 3Q10 (90bp tightening YTD) hitting new lows (chart 4).

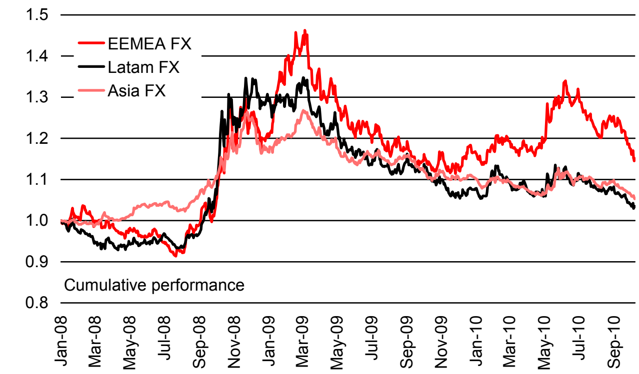
…while EEMEA credit continued to decouple form periphery problems

PERFORMANCE OVERVIEW AND KEY DRIVERS

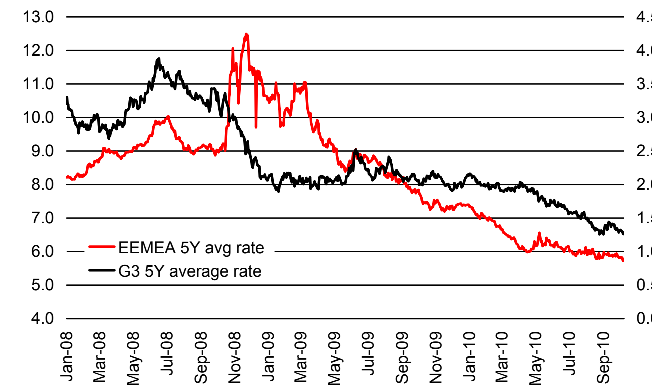
Firmer equities and weaker USD boosted EEMEA FX performance



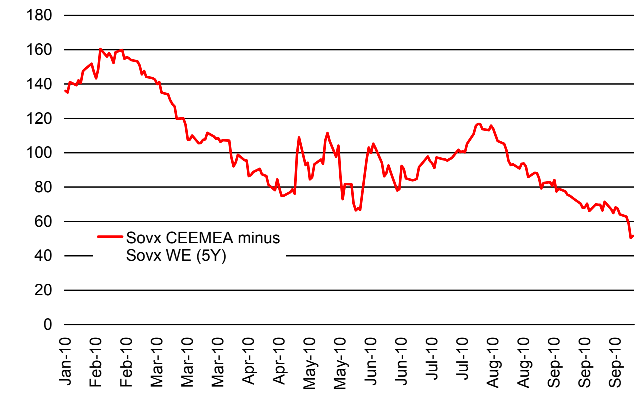
EEMEA FX started closing its performance gap vs. Asia & Latam



Local rates continued moving lower in tandem with G3 rates



CEEMEA credit significantly outperformed Western Europe



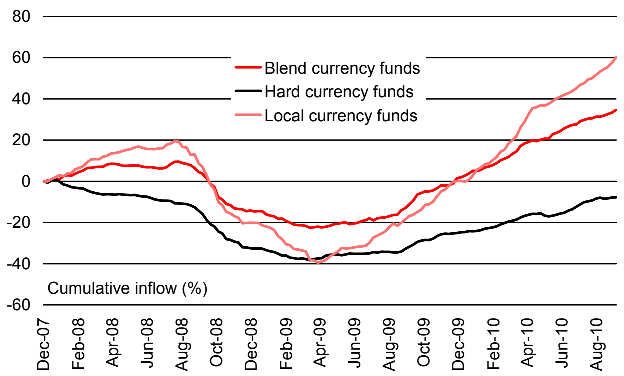
Source: Bloomberg, UniCredit Research

Local currency bond flows remains strong particularly in Turkey and Poland

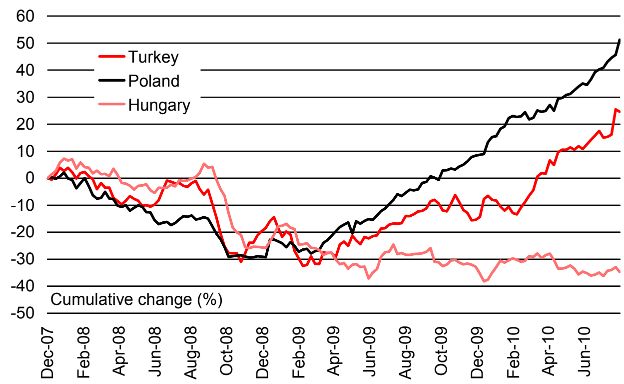
The fund flow backdrop has been exceptionally strong in 3Q10 and YTD. The supportive global backdrop saw strong inflows into EM funds. Dedicated EM bond funds continue to receive exceptional strong inflows. In Q4 these funds saw an inflow of USD 11bn, bringing the YTD inflow to USD 28bn. About 54% of the fresh inflow continues to go into dedicated local currency funds, but only about 28% into dedicate hard currency EM funds. In the EEMEA region, the Polish and the Turkish local currency bond markets saw the biggest inflow of foreign capital during 3Q10. Non-resident bond holding was up by 17% in Poland and by 14% in Turkey, bringing the YTD increase to 52% and 47% respectively. Meanwhile Hungary remained the major underperformer in the region as non-resident bond holding fell by 2% YTD.

FUND FLOWS AND NON-RESIDENT POSITIONING

EM bond funds (particularly local currency) saw strong inflows in 3Q10



Most of the inflow went into the Polish and Turkish bond markets



Source: National statistics offices and central banks, UniCredit Research

Appreciation pressure could arrive in EEMEA as well…

As the ECB resist joining the global renewed easing cycle this could be more profound for EUR referenced countries

How EEMEA FX will perform amid global currency wars? As global economic performance has broadly disappointed during the third quarter, policymaker focus has again shifted toward competitive devaluation and beggar-your-neighbor policies. Particularly in the G10 markets, some central banks were hinting at a new set of unconventional measures, whilst others (Japan) have already directly entered the market to weaken their own currencies. The excess liquidity created is obviously finding its way to emerging markets, where policy makers are not necessary happy seeing large amount of capital flows appreciating their currencies and inflating their local assets. As several currencies in the region (CE4) are referenced to the EUR, the key question for them is also how the ECB will react to the fact that similarly to 2H09, the EUR is again picking up disproportional appreciation pressure. But an increasing number of EM countries are turning toward unconventional measures in a move to stem their currency appreciation: Brazil, for instance, has increased the taxation on buying local currency bonds in a move to stem capital inflows. In EEMEA capital controls are not on the agenda yet (and would be additionally complicated in the EU member countries), but nevertheless we have already seen some actions to stem currency appreciation: the Turkish Central Bank increased the size of daily FX purchase auctions while the National Bank of Poland directly intervened a few months ago (at 3.80 EUR/PLN level).

PLN and TRY should appreciate as bond flows will start pushing currencies stronger amid stabilizing current account

Looking ahead, we believe the key question is who can afford such appreciation pressure? Based on the GDP growth outlook, the status of their output gap and level of currency undervaluation (based on REER), we believe the **best candidates are Poland, Turkey, and to lesser extent the Czech Republic**. Interestingly the Polish and the Turkish bond markets have seen extreme strong non-resident capital inflows YTD (non-resident bond holdings increased by about USD 20bn in these countries) and, taking this into account, the FX performance is not too spectacular. One explanation is that the current account balance started to deteriorate in both countries (in line with recovering economic activity). The good news here as these economies reach their pre-crisis performance is that we do not expect current account balances deteriorate much more in 2011 (Poland: 2.2%/GDP deficit in 2011, unchanged from 2010, Turkey: 5.2%/GDP vs. 5.0%/GDP in 2010). This suggests that if the bond flows are sustained in the coming months, this should increasingly translate into firmer currency performance. Given that FDI inflows are still relatively poor, we believe both policy-makers will need to attract further portfolio inflows, probably via tolerating firmer currencies.

KZT and UAH could see appreciation pressure too

But will higher policy rates hurt those bond inflows in 2011? We do not think so, as long as the central banks are not surprising significantly on the hawkish side, and if a higher policy rate reflects stronger economic performance. **In the non-correlated FX universe,** we believe the UAH and KZT still offer catch-up potential, given their improved balance of payments backdrop. Although the central banks in both intervened to stem currency appreciation, we believe these values could be unlocked at some point.

BOND INFLOWS HAVE BEEN OFFSET BY DETERIORATING CURRENT ACCOUNT IN POLAND AND TURKEY

Poland	Turkey

Source: National statistics offices and central banks, UniCredit Research

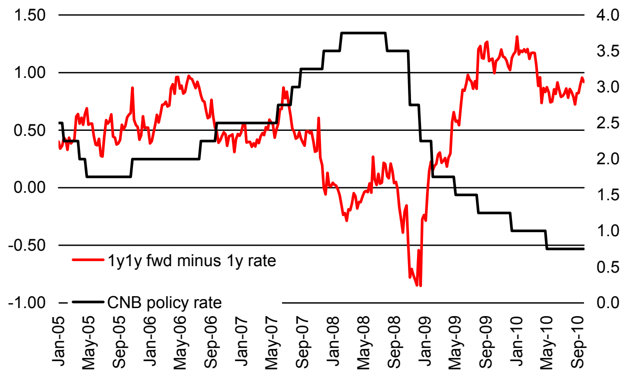
Yield curves in the countries where central banks may hike rates already price significant risk premium

Does it make sense to start positioning bearishly in the local rate markets in the current deflationary environment? As we stressed before, we do not expect any EEMEA central bank to surprise on the hawkish side over the remainder of the year, but given their relative growth difference, our economists expect the National Bank of Poland, the Central Bank of Turkey, and probably the Czech National Bank to start normalizing their rates in 1H11, probably in a very cautious fashion. From other countries, we see Romania and Hungary hiking rates only under extreme pressure on their currencies, as their underlying economic performance is still very weak. In fact, the inflation backdrop could warrant further rate cuts later in 2011. When it comes paying rates, we believe the key question is what is the market already pricing. Looking at the Czech Republic, for instance, the difference between the 1y1y forward and the 1y rate is currently around +100bp, which is almost two times higher than this spread was in 2005, the last time the CNB started hiking its rates. The situation is Poland is somewhat similar, although the spread has been shrinking lately (from around 100bp to around 75bp), bringing it roughly in line with the spreads we observed around the beginning of the last rate hiking period. The risk premium is the most elevated in case of **Turkey**. This backdrop suggests that in the countries where the probability of a rate hike in 1H11 is the highest, the markets are already positioned for higher rates. **Given that we do not think that the central banks will shock the markets with aggressive rate hikes,** we still see value in those local currency bond markets (at the shorter end of the yield curves), and we do not believe that the time is right to add bearish rates positions.

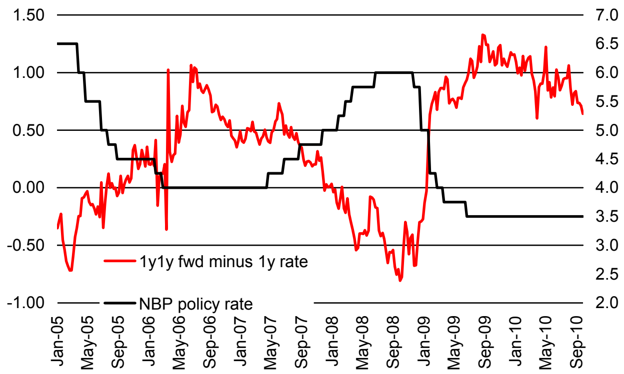
…hence local bond markets still offer value

POLICY RATES VS. YIELD CURVE SHAPES

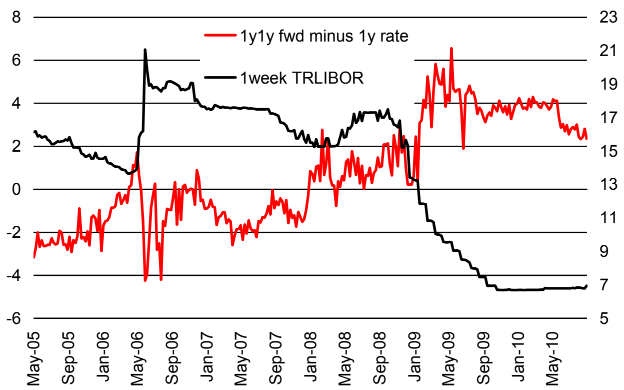
Czech Republic: risk premium looks elevated



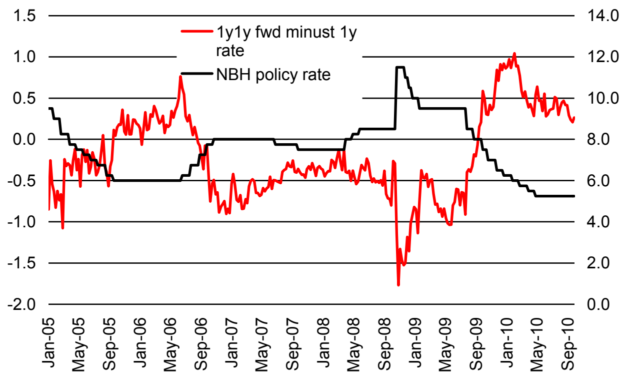
Poland: risk premium has been shrinking lately



Turkey: risk premium has been shrinking but still elevated



Hungary: risk premium is still relatively high



Source: National statistics offices and central banks, UniCredit Research

The convergence between East and West is largely behind us...

We remain constructive on a few individual countries

We believe that a large part of the value from the CEEMEA sovereign credit markets has already been exploited. Given that the fiscal backdrop is significantly better in these economies than in Western Europe, the Eastern European credit market has already significantly tightened compared to Western Europe (see chart), to YTD lows. That said, the market is already pricing the better fundamental backdrop, and hence we see little value in chasing this trend. On the other hand, we believe some individual countries that lagged the move in the Sovx CEEMEA still offer value: we believe that Romania with its IMF program being on track, and Ukraine, also with relatively good progress in the IMF program, still offer value. We would also put Hungary into this camp despite the lack of intention to have a new IMF program, but with relatively firm commitment to a low budget deficit. As the year progresses, we believe the motivation of Hungarian policymakers to sign up for a new program could increase.

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Sovereign credit rating outlook

Country	Rating, LT FC (Moody's/ S&P/Fitch)	Fiscal balance, % GDP, 2010 forecast	Gross external debt/GDP, 2010	Curr. account balance % GDP, 2010 forecast	FX reserves, % GDP, end 2010, forecast	2010 GDP forecast minus 5y average	Outlook	Rating Outlook
Bulgaria	Baa3p/BBBs/ BBB- n	-4.8	105.62	-3.0	35.01	-4.6	neutral	Rating outlook has stabilized on the back of re-established fiscal discipline and the commitment of the new government to uproot corruption and press ahead with structural measures.
Croatia	Baa3s/BBBn/ BBB-n	-6.5	100.84	-3.7	23.46	-3.7	mixed	We see risk of negative rating news flow in the coming 3M given that fiscal deficit overshooting might lead to higher financing requirements, while FX failed to provide a meaningful competitive gain.
Czech Republic	A1s/Ap/A+p	-5.2	44.76	-2.1	21.75	-1.5	neutral	We still see the Czech economy as one of the best placed within Europe to recover. We do not expect rating changes in the next months.
Estonia	A1s/As/As	-1.4	114.48	4.5	18.27	0.7	positive	The Eurozone entry in 2011 makes us **positive** on the rating outlook. Estonian rating was upgraded by 1 notch in June by S&P's and by 2 notches in Mid-July by Fitch. Further upgrades are on the cards.
Hungary	Baa1n/ BBB-n/BBBn	-3.9	136.81	0.8	31.99	0.4	negative	Following the break up in talks with the IMF we see the rating outlook deteriorating in the near term. Obviously new talks or the publication of a credible long term plan could stabilize the rating.
Kazakhstan	Baa2s/BBB-s/ BBB-s	-4.1	79.47	4.3	21.66	-0.4	positive	Thanks to a prudent fiscal balance, increasing FX reserves and high commodity prices and largely completed bank restructuring **ratings might be lifted by one notch** in the coming months.
Latvia	Baa3s/BBs/BB+s	-7.7	162.64	6.4	30.69	-2.9	Positive	The country is benefiting from a better external environment and the Estonian Euro accession path. Further improvements in the rating can be expected, partially reversing the downgrades of 2008-09. **Positive**
Lithuania	Baa1s/BBBs/ BBBs	-7.5	86.66	1.7	17.58	-1.6	Positive	All three rating agencies have now moved their outlooks from negative to stable on improving conditions. We believe, the economic outlook will continue to improve. **Positive**
Poland	A2s/A-s/A-s	-7.1	60.72	-2.3	22.35	-1.4	neutral	We see the ratings outlook as **neutral** for now, with the negatives of a growth slowdown and relatively high public debt being offset by a relatively low external financing gap in relation to the size of the economy. However, a large public deficit this year and next poses a medium term risk to the fiscal accounts, and ratings.
Romania	Baa3s/BB+s/ BB+s	-7.0	62.53	-6.3	25.89	-6.2	neutral	Given the IMF/EU package reduced tail risk for Romania and the government approved a significant austerity package we expect rating dynamics stabilizing in the near term. On the other hand implementation risk might offset this. **Neutral**
Russia	Baa1s/BBBs/BBBp	-6.0	30.62	4.5	27.64	-0.6	neutral	Stabilizing oil prices will likely have a stabilizing effect on Russia's rating in the coming 3M Following the recent change from "stable" to "positive" from Fitch, other agencies could follow. **Positive** in the medium term**.**
Serbia	-/BB-s/BB-n	-4.7	79.90	-7.8	33.29	-2.5	neutral	IMF package reduces tail risks, but the relatively wide external financing gap, coupled with an uncertain long-term growth outlook, means that we are cautious on the ratings outlook and would expect the government to do more.
Slovakia	A1s/ A+s/ A+s	-7.8	84.21	-2.1	0.00	-1.1	neutral	Eurozone membership is a stabilizing factor, though to the extent that this is reflected in the rating already, we are **neutral** on the outlook. If global manufacturing turns into a double dip, however, downside ratings risk would increase.
Slovenia	Aa2s/AAs/ AAs	-6.0	116.39	-1.0	1.64	-1.4	neutral	Eurozone membership is a key supportive factor for Slovenia's ratings, as are low public sector debt levels. We hence see ratings remaining on **hold**, despite high overall external debt levels.
Turkey	Ba2p/BBp/BB+s	-3.4	40.75	-4.9	10.41	3.8	positive	Moody's raised the outlook from stable to positive. We expect further improvements in the next twelve months especially as YTD fiscal performance has been surprisingly robust.
Ukraine	B2s/B+s/Bs	-6.0	73.12	0.0	23.46	2.6	positive	The renewal of a new 29-month USD15.2bnIMF stand-by agreement and anticipated reforms by the government, allowed us to change the view from neutral to positive (although we still think there are implementation risks present), while S&P upgrade ought to pave way for other agencies to follow especially if reform momentum holds up.

Source: UniCredit Research

Bulgaria

Outlook – After weak 1Q, growth stabilized in the 2Q and is expected to rebound in the 3Q. This reflects a stronger-than-expected export and inventory recovery in combination with improved absorption of EU funds. But while utilization of EU funds is set to improve looking forward, neither the current pace of export recovery nor inventory rebound looks sustainable. What's more, painful labor market adjustment is not yet over, meaning that GDP growth is likely to remain below potential for at least several more quarters, before we see household and particularly the debt burdened corporate sector ready to spend and invest more again.

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

MACROECONOMIC DATA AND FORECASTS

	2007	2008	2009	2010F	2011F
GDP (EUR bn)	30.8	35.4	35.0	35.6	37.2
Population (mn)	7.6	7.6	7.6	7.5	7.5
GDP per capita (EUR)	4,028	4,658	4,633	4,722	4,958
GDP (constant prices yoy %)	6.4	6.2	-4.9	-0.5	2.2
Private Consumption, real, yoy (%)	8.3	3.0	-4.0	-3.6	-0.7
Fixed Investment, real, yoy (%)	11.8	21.9	-29.0	-9.4	4.3
Public Consumption, real, yoy (%)	-1.6	-1.5	-4.9	-3.5	-1.3
Exports, real, yoy (%)	6.1	3.0	-10.3	8.2	4.8
Imports, real, yoy (%)	9.6	4.2	-21.5	-0.8	1.2
CPI (average, yoy %)	8.4	12.4	2.8	2.0	2.4
Central bank reference rate (LEONIA, avg)	4.56	4.07	0.23	0.18	0.25
Monthly wage, nominal (EUR)	220	279	302	314	321
Unemployment rate (%)	6.9	6.3	9.1	9.7	9.5
Budget balance (% of GDP, cash basis)	3.5	3.0	-0.8	-4.8	-3.5
Current account balance (EUR bn)	-7.8	-8.2	-3.5	-1.1	-0.7
Current account balance (% of GDP)	-25.2	-23.1	-9.9	-3.0	-2.0
Net FDI (EUR bn)	8.8	6.2	3.4	1.4	1.7
FDI (% of GDP)	28.7	17.5	9.6	3.9	4.6
Gross foreign debt (EUR bn)	29.0	37.1	37.7	37.6	38.2
Gross foreign debt (% of GDP)	94.3	104.7	107.6	105.6	102.5
FX reserves (EUR bn)	11.9	12.7	12.9	12.5	13.2
(Cur.Acc-FDI)/GDP (%)	3.5	-5.6	-0.3	0.9	2.6
FX reserves/Gross foreign debt (%)	41.1	34.3	34.3	33.1	34.7
Exchange rate to USD eop	1.34	1.40	1.36	1.37	1.34
Exchange rate to EUR eop	1.96	1.96	1.96	1.96	1.96
Exchange rate to USD avg	1.43	1.33	1.40	1.46	1.37
Exchange rate to EUR avg	1.96	1.96	1.96	1.96	1.96

Source: UniCredit Research

STRENGTHS

- Strong fiscal fundamentals
- Improved EU funds absorption
- Well capitalized banking sector

WEAKNESSES

- Elevated corporate sector debt
- Large exposure to Greek economic woes
- Limited policy space to respond to new adverse shocks

Bulgarian economy is slowly emerging from recession

Export and inventory recovery, on top of improved EU funds absorption helped economy to stabilize…

Driven by stronger-than-expected export and inventory recovery, Bulgarian output and employment demonstrated clear signs of stabilization in the 2Q. Improved EU funds absorption was also among the relevant factors which helped economy leveling off in the 2Q. We expect GDP to have gained momentum further in the 3Q10 as a number of evidence suggest that output in the agriculture, construction and tourism have experienced solid rebound. More specifically, wheat output at 3.8mn tons was above both last year level of 3.7mn tons and historical annual average of 3.4mn tons. Construction of roads has benefited from better EU funds absorption, while a moderate improvement of sales receipts in the tourism sector reflects rise in domestic and international tourists which has more than balanced the negative impact of lower prices. **Against this backdrop, we revised upward our GDP growth forecast for 2010 (from -1% to -0.5% yoy drop) and 2011 (from 1.8% to 2.2% yoy rise).** Growth next year is also set to draw support from the restart of some investment projects which were put on hold during the most testing moments of the crises.

But optimism behind growth is poised to fade away looking forward…

Labor market rebalancing seems not over…

However, there are several factors supporting our relatively downbeat view on the GDP growth for this and next year. For a start, external demand in some key trading partners of the country is expected to moderate, providing for weaker export growth from 4Q10 onwards. Initial boost from restocking is also likely to fade away because now shops and warehouses are fuller. Recent slide in unemployment rate, in our view, is short lived and will soon fade away. It reflects the traditional increase in jobs during summer in construction, agriculture and particularly in the tourism sector as well as more jobless workers dropping out of the labor force, as eligibility requirements for those receiving unemployment benefits has been tightened earlier this year. Painful adjustment of jobs in the non-tradable sectors, which most actively participated in the last investment and consumption boom, seems not over and will continue to weigh negatively on employment and income looking forward. Sentiment indicators likewise suggest that we have not reached yet the point when companies will be in a mood to add new jobs. The balance between hiring and firing intentions of managers in September was most severely negative in construction and trade, which is not surprising as these were among the most overheated sectors during the boom. But quite disappointingly, managers from the manufacturing sector, which by far has experienced the strongest upturn, do not indent to create new jobs either. Moreover, economic theory says that jobs will only increase when economic growth exceeds productivity growth. Given that productivity growth in Bulgaria has been historically at around 2.5% yoy we should not expect economy to start creating new jobs before this level is reached. But looking at consensus forecast this will not take place next year when real growth of slightly above 2% yoy is expected. This makes us skeptical on the chances to withes any sustainable rise in employment before the 2H11. Though housing market outlook has improved recently, it still characterizes with significant uncertainty and weaker prices might be hard to avoid next year, before we see prices rebalancing process coming to an end. And finally, credit conditions are likely to remain tight, as inflow of FDI has stabilized at lower levels when compared with the boom and NPL's in the bank's lending books are still elevated, which is likely to prevent rapid borrowing costs decline for at least several more quarters.

No aggressive fiscal squeezing will be needed next year…

Despite strong fiscal fundamentals, the fact that budget deficit is set to widen to 4.8% of GDP this year leaves little room for more easing looking forward. Budget deficit target for 2011 was set at 2.5% of GDP (on a cash basis), meaning that fiscal policy is about to shift from expansionary in 2010 to slightly contractionary in 2011. However, it is worth pointing out that in sharp contrast to most of its emerging market peers, Bulgaria does not need aggressive fiscal squeezing, which in turn helps to explains why we do not see fiscal consolidation plan, which authorities will start implementing from 2011 onward, as representing a setback for the economic recovery process.

Czech Republic

Outlook – 2H10 should be characterized by a follow-through from the recovery that we saw in 1H10, as domestic demand continues to overtake net exports as a driver of economic activity, although fiscal austerity and an increase in inflation should moderate the pace of recovery. With GDP gains set to remain below potential and the CZK continuing on its appreciation path, the case for rate hikes before 2Q11 remains weak.

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

MACROECONOMIC DATA AND FORECASTS

	2007	2008	2009	2010F	2011F
GDP (EUR bn)	127.3	147.9	137.2	144.8	155.7
Population (mn)	10.3	10.4	10.5	10.5	10.5
GDP per capita (EUR)	12,336	14,181	13,077	13,773	14,776
GDP (constant prices yoy %)	6.1	2.5	-4.1	2.0	1.9
Private Consumption, real, yoy (%)	4.9	3.6	-0.2	0.6	0.5
Fixed Investment, real, yoy (%)	10.8	-1.5	-9.2	1.6	0.4
Public Consumption, real, yoy (%)	0.7	1.0	4.2	0.4	-1.0
Exports, real, yoy (%)	15.0	6.0	-10.8	11.2	6.7
Imports, real, yoy (%)	14.3	4.7	-10.6	11.4	5.4
CPI (average, yoy %)	2.8	6.3	1.0	1.4	1.9
Central bank reference rate	3.50	2.25	1.00	0.75	1.50
Monthly wage, nominal (EUR)	755	906	888	947	1,005
Unemployment rate (%)	6.6	5.5	8.1	9.0	8.8
Budget balance (% of GDP)	-0.7	-2.7	-5.9	-5.2	-4.5
Current account balance (EUR bn)	-4.1	-0.9	-1.4	-3.0	-2.7
Current account balance (% of GDP)	-3.2	-0.6	-1.0	-2.1	-1.7
Net FDI (EUR bn)	7.6	4.4	2.0	4.7	5.3
FDI (% of GDP)	6.0	3.0	1.4	3.3	3.4
Gross foreign debt (EUR bn)	51.6	59.7	60.1	66.1	71.7
Gross foreign debt (% of GDP)	40.6	40.4	43.8	45.7	46.0
FX reserves (EUR bn)	23.7	26.6	28.9	31.5	33.5
(Cur.Acc-FDI)/GDP (%)	2.8	2.4	0.4	1.2	1.7
FX reserves/Gross foreign debt (%)	45.9	44.5	48.1	47.6	46.7
Exchange rate to USD eop	18.19	19.21	18.39	17.34	16.44
Exchange rate to EUR eop	26.52	26.80	26.35	24.80	24.00
Exchange rate to USD avg	20.25	16.97	18.96	18.86	17.13
Exchange rate to EUR avg	27.75	24.96	26.43	25.30	24.40

Source: UniCredit Research

STRENGTHS

- External financing at comfortable levels
- New government sticking to fiscal consolidation
- Low vulnerability of financial sector

WEAKNESSES

- Fiscal restrictions set to slow 2011 GDP growth
- Generous subsidy to solar power projects set to cause a sharp rise in electricity prices
- Foreign demand losing steam

Domestic demand back on stage

Domestic demand joined foreign trade as a growth driver in 2Q10

The economy gained further momentum in 2Q10, with GDP growth picking up to 2.4% yoy from 1.0% yoy in 1Q10. A qoq comparison confirmed the strong rebound as GDP surged by 0.9% in 2Q10 after a 0.4% rise in 1Q10. Domestic demand proved a key driver. A strong upward shift in inventories, adding 2.3pp to 2Q10's growth, led the acceleration from 1Q10, while net exports, the main growth pillar from previous periods, reduced its contribution to growth sharply from 2.2pp to 0.4pp. Private spending was the most striking element of the demand structure. Inconsistent with shrinking employment and slowing real wage dynamics, growth in household consumption strengthened from 0.1% yoy in 1Q10 to 0.8% yoy in 2Q10. The only component dragging on 2Q10 growth was fixed capital formation.

Revival in domestic demand failed to boost inflation but contributed to foreign trade deterioration

Importantly, the surprising upturn in private consumption failed to trigger any visible inflation pressures. Even though inflation jumped to 1.9% yoy in August from 1.2% in May, the acceleration proved driven purely by non-demand factors, such as a surge in food and alcoholic beverage prices and a hike in natural gas prices. However, a rebound in domestic demand translated into higher import dynamics, causing a shift in foreign trade developments. The yoy improvements observed during the first months of the year were reversed, with the YTD trade surplus even falling short of the level from the same period last year.

We expect the pace of GDP growth in 2Q to be maintained in 2H10, with domestic factors playing an increasing role

Data released over the summer suggest that overall demand held firm in 3Q10. Seasonally adjusted industrial production in July maintained its robust expansion from the previous months, and together with double-digit growth rates in new orders and improving confidence indicators, points to a sector set to avoid any marked downturn in the months to come. Similarly, retail sales remained in growth territory after a seasonal adjustment in July, leading us to believe that the worst is over for private consumption. Hence, we believe that GDP growth should maintain its pace of over 2% in 2H10. We also believe that growth factors should continue to shift toward domestic demand. Increasing business activity translating into higher fixed capital creation should play a stronger role. Moreover, we anticipate that investment growth in 2H10 should receive a boost from one-off new projects in solar power generation – an attractive business whose generous government subsidy is likely to end this year. On the negative side, higher imports of investment goods are set to affect foreign trade, which we expect to start subtracting from GDP growth in 3Q10. On household consumption, we do not expect 2Q10 dynamics to accelerate further through 2H10, as the effect of a more stable situation on the labor market should be offset by higher inflation (compared to 1H10), hitting the already slowing pace of disposable income. Whereas the improved outlook for private spending and investment supports an upward revision to our GDP growth forecast for this year, from the previous 1.8% to 2.0%, we expect these two components, by contrast, to grow less sharply next year, leading us revise our outlook for 2011 GDP growth from 2.2% down to 1.9%.

Inflation and CZK give few reasons to start tightening interest rates anytime soon

Subdued inflationary pressures have allowed the CNB to keep interest rates at a record-low level since the last cut in May, and there are few reasons at the moment to predict an early shift to a tightening bias. Inflation is widely expected to continue oscillating around 2%, the CNB's target, until at least end-2011, while the CZK, hitting a two-year high vs. the EUR recently, does not support the hawks. Hence, we stick to our view that the first hike will not be delivered before 2Q11.

Government kept its pledges and approved austere 2011 budget

In line with its conservative fiscal stance, the new center-right government has agreed to reduce the 2011 state budget deficit to CZK 135bn, from this year's CZK 163bn target. The bulk of measures consist of cuts to wages, welfare and operating spending, but some tax hikes are also in the pipeline. In general, the outlined pace of fiscal consolidation seems appropriate both in terms of the extent and timing. However, not to divert from this path, the purely "austere" 2011 budget should be followed by a "reform-shaped" budget for 2012.

Estonia

Outlook – The Estonian economy has started growing at a solid pace, but exports seem to be the main driver. With unemployment above 18%, domestic consumption-driven growth is unlikely to appear for at least the next several quarters. The country's strong fiscal position – the combination of public deficit and public debt ratios has no comparison among European countries – and Euro adoption (planned for January 2011) significantly reducing the risks arising from such high levels of external indebtedness.

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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

	2007	2008	2009	2010F	2011F
GDP (EUR bn)	15.6	16.1	13.7	14.2	15.0
Population (mn)	1.3	1.3	1.3	1.3	1.3
GDP per capita (EUR)	11,644	12,001	10,246	10,667	11,259
GDP (constant prices yoy %)	7.2	-3.6	-14.1	2.4	3.9
Private Consumption, real, yoy (%)	9.0	-4.7	-18.5	-0.4	3.0
Fixed Investment, real, yoy (%)	9.0	-12.1	-34.4	-9.0	5.5
Public Consumption, real, yoy (%)	3.7	4.1	-0.5	1.0	0.7
Exports, real, yoy (%)	0.0	-0.7	-11.2	16.8	9.1
Imports, real, yoy (%)	4.7	-8.7	-26.8	11.0	8.6
CPI (average, yoy %)	6.6	10.4	-0.1	2.2	2.4
Monthly wage, nominal (EUR)	725	819	781	832	843
Unemployment rate (%)	4.7	5.5	13.8	18.2	16.8
Budget balance (% of GDP)	2.6	-2.8	-1.7	-1.4	-2.1
Current account balance (EUR bn)	-2.8	-1.5	0.6	0.6	0.7
Current account balance (% of GDP)	-17.7	-9.4	4.6	4.5	4.9
Net FDI (EUR bn)	0.8	0.6	0.2	0.7	0.8
FDI (% of GDP)	5.2	3.7	1.1	5.1	5.2
Gross foreign debt (EUR bn)	17.4	19.0	17.4	17.2	16.8
Gross foreign debt (% of GDP)	111.0	118.5	126.7	120.6	112.4
FX reserves (EUR bn)	2.2	2.8	2.3	2.6	2.8
(Cur.Acc-FDI)/GDP (%)	-12.5	-5.7	5.7	9.6	10.1
FX reserves/Gross foreign debt (%)	12.9	14.7	13.2	15.2	16.7
Exchange rate to USD eop	10.73	11.21	10.92	10.94	10.72
Exchange rate to EUR eop	15.65	15.65	15.65	15.65	15.65
Exchange rate to USD avg	11.41	10.64	11.22	11.66	10.99
Exchange rate to EUR avg	15.65	15.65	15.65	15.65	15.65

Source: UniCredit Research

STRENGTHS

- Sound fiscal position
- Euro adoption in 2011
- Rapid unwinding of external imbalances

WEAKNESSES

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

Recovery and euro adoption, but unemployment to stay high

Euro adoption in January 2011

The Estonian economy is recovering from a sharp recession in 2009 and has started to grow at a solid pace (healthy 3.1% yoy GDP growth in 2Q10), driven by exports. Estonia's top trading partners – the Nordic countries and Russia – are rapidly strengthening, following the disproportionate impact of the crisis in 2008-2009. During the first half of 2010, the Estonian economy saw a strong rebound in manufacturing activity (+19.9% yoy in 2Q10), but the construction sector is still struggling (-7.7% yoy). Confidence indicators suggest that these trends should continue in the second part of the year. Euro adoption from 1 January 2011 – making Estonia the third of the ex-communist countries to join the common currency, after Slovenia (2007) and Slovakia (2009) – should be the main driver of economic trends in the country for the next few months: it should have some positive effects on consumers' and investors' confidence and spur trade flows. With Euro adoption in sight, the country could also enjoy a revival in foreign direct investment, although limited and not comparable with the past decade. **Unemployment is set to remain higher than 18% this year** (from 13.8% in 2009 and 5.5% in 2008), and this should weigh on domestic demand. Domestic consumption, more than 20% lower in real terms since the beginning of the crisis, looks unlikely to drive growth for several quarters.

Domestic demand remains extremely weak

All in all, during the last quarter, Estonia's economic performance signficantly improved while global risks increased only marginally. In this environment, we revised our growth forecast upward from 1.2% to 2.4% in 2010, and from 3.2% to 3.9% in 2011. We also revised our inflation forecast slightly upward, to 2.2% in 2010 and 2.4% in 2011 to take into account the price increases registered during the summer.

In the meantime, external imbalances were rapidly reduced, and the current account should be in surplus in 2010, for the second year in a row. The CA surplus – estimated at 4.5% of GDP in 2010 – was accompanied by a significant increase of foreign direct investment (EEK 10bn in 7M10, vs. only EEK 1.5bn last year). The outflow from banking institutions remains significant, but lower than one year ago.

Banking sector: NPLs under control

The banking sector, one epicenter of the crisis, is reducing its exposure in terms of external funding: the loan/deposit ratio is moving south, and lending activity is still subdued (-2.7% YTD in July, which is, however, a noticeably lower decline than that in the other Baltic states). Moreover, NPLs remain under control in Estonia, at 7.2% of gross loans in 2Q10 (while they have risen to around 20% in the other two Baltic states). At the same time, the Central Bank reduced the reserve requirement from 15% to 11% in September, with a further cut to 7% in November. In 2011, the reserve requirement will be 2% for liabilities with a maturity under two years, and 0% for liabilities with maturity over two years. The increase in liquidity becoming available should at least partially be used to reduce the banking sector's external debt.

Favorable fiscal position amidst huge consolidation efforts

The center-right government has continued to maintain a prudent fiscal policy during recent months to support the country's entrance into the Eurozone. **The virtuous combination of public deficit and public debt ratios has no comparison across European countries:** the deficit is set to remain below 1.5% of GDP this year, with the budget balanced in 2014, while the debt/GDP ratio is extremely low (below 10%). This is the effect of huge efforts in terms of fiscal consolidation: deficit-reducing measures reached almost 9% of GDP in 2009. Given the above, and following the rating upgrades by S&P and Fitch during the summer, we believe further upgrades are in the cards over the medium term, while the political landscape is not expected to deliver any surprises before the next parliamentary elections in March 2011. Estonian country risk (in terms of CDS) is substantially lower now than at the beginning of this year, and it is now more than half of the country risk of Eurozone members such as Italy and Spain.

Hungary

Outlook – Following a difficult start, the government is expected to present the main numbers of the 2011 budget by mid-October. Given the enormous pressure from the EU, we believe the government will have to show a 3%/GDP deficit target for next year. As the September decision indicates, the central bank's concerns have eased significantly, and we do not expect rates to change before late 2011. Despite the relatively tight fiscal and monetary policy, the near-term outlook appears generally favorable, driven by the supportive inventory cycle and the stabilizing credit cycle. However, Hungary's high external financing needs due to the lack of a new IMF program mean that medium-term concerns remain.

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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

	2007	2008	2009	2010F	2011F
GDP (EUR bn)	101.1	105.7	93.0	96.9	104.3
Population (mn)	10.1	10.1	10.0	10.0	10.0
GDP per capita (EUR)	10,044	10,517	9,264	9,672	10,419
GDP (constant prices yoy %)	1.0	0.6	-6.3	1.0	2.5
Private Consumption, real, yoy (%)	-1.6	-0.6	-6.7	-3.5	1.3
Fixed Investment, real, yoy (%)	1.6	0.4	-6.5	1.0	6.5
Public Consumption, real, yoy (%)	-4.3	-0.3	1.1	2.2	0.6
Exports, real, yoy (%)	16.2	5.6	-9.1	12.2	6.3
Imports, real, yoy (%)	13.3	5.7	-15.4	12.5	7.2
CPI (average, yoy %)	8.0	6.1	4.2	4.9	4.0
Central bank reference rate	7.50	10.00	6.25	5.25	5.25
Monthly wage, nominal (EUR)	738	792	712	732	756
Unemployment rate (%)	7.3	7.8	9.8	11.2	9.5
Budget balance (% of GDP)	-5.5	-3.4	-3.9	-3.9	-2.8
Current account balance (EUR bn)	-6.6	-7.5	0.1	0.8	-0.7
Current account balance (% of GDP)	-6.5	-7.1	0.1	0.8	-0.7
Net FDI (EUR bn)	4.0	4.9	1.2	4.6	5.9
FDI (% of GDP)	3.9	4.6	1.3	4.8	5.6
Gross foreign debt (EUR bn)	98.8	122.9	130.7	130.5	129.8
Gross foreign debt (% of GDP)	97.8	116.3	140.5	134.7	124.5
FX reserves (EUR bn)	16.4	24.0	30.7	31.0	28.0
(Cur.Acc-FDI)/GDP (%)	-2.6	-2.5	1.4	5.6	4.9
FX reserves/Gross foreign debt (%)	16.6	19.6	23.5	23.8	21.6
Exchange rate to USD eop	173.30	190.27	188.26	197.20	184.93
Exchange rate to EUR eop	252.72	265.49	269.80	282.00	270.00
Exchange rate to USD avg	183.33	171.09	201.00	206.91	191.10
Exchange rate to EUR avg	251.31	251.66	280.28	277.55	272.17

Source: UniCredit Research

STRENGTHS

- One of the most stable governments in the EU
- Relatively low budget deficit for the region

WEAKNESSES

- High public and private sector debt levels
- Uncertainties about the long-term growth outlook
- High FX leverage in the domestic private sector

Near-term outlook positive; medium-term concerns remain

All eyes on the 2011 budget to be presented in mid-October

Following a difficult start, the government is expected to present the main numbers of the 2011 budget by mid-October. Previous statements target a budget deficit of around 3% of GDP vs. 3.8% of GDP in 2010, which would bring Hungary – the only new EU country (joined in May 2004) to spend all its time under the excessive deficit procedure – out of EDP. Given the enormous pressure from the EU, we believe the government will have to show this number, though the devil, as always, will be in the details. The rating agencies are in a "wait-and-see" mode; all three have a negative outlook, with S&P and Fitch just one notch above investment grade. In our view, it is very unlikely that the government would adopt a new IMF program in the current market conditions.

Details still missing

The most important element we see on the revenue side is the financial sector tax, which is expected to bring about HUF 200bn per year (around 0.8% of GDP); however, this is collected in 2010 and thus cannot reduce the deficit in 2011. We do not expect major fiscal reforms to be announced in mid-October, mostly due to the lack of time. The government had hoped to take second pillar pension payments (1.5% of GDP) into account, but under the new EU ruling this cannot occur. Otherwise, it appears likely that the flat tax will be introduced within a three-year timeframe, rather than coming into full effect next year.

Underlying inflation pressure low; NBH could keep rates down longer

As was evident from this month's rate decision, the central bank's concerns eased significantly over the past month. The bank welcomed the government's announcement of a 3% deficit target and was no doubt relieved to see the EUR/HUF rate, and particularly the CHF/HUF rate, lower. Some inflation concerns remain, with the August projection showing inflation above the 3% target throughout the forecast horizon (until 4Q12); the sticky nature of wage growth is also disappointing. On a more positive note, the HUF has rallied from the 283.8/EUR used in the last inflation report, and core inflation is behaving well, holding at 1.0% for the past three months (measured as 3 month/3 month seasonally adjusted and annualized). Currently, we are not projecting further rate cuts in Hungary through end-2010, but would shift in that direction if the details of next year's budget show credible measures to achieve the 3% target. A lower CHF/HUF rate would also likely be necessary. We see rate hikes as a realistic option only in a scenario of extreme stress; accordingly, our base case assumes rates unchanged through end-2011.

Near-term growth outlook still positive

Although we believe fiscal policy will likely remain relatively tight and expect no more easing at this point, we see the near-term growth outlook as reasonably positive. Unlike many other countries in the region, Hungary's inventory cycle should support growth, with inventories subtracting a cumulative 6.1pp since the crisis began in 2Q08. We also note that as the pace of credit contraction eases, domestic demand should continue improving yoy in 4Q10 and 1Q11. Looking ahead, we are still concerned about the relatively significant external financing needs Hungary faces due to the lack of a new IMF program and the repayment requirements of the previous program (around 3.5%/GDP in 2011 and 2012). The external financing needs will likely keep the current account under control (close to balance), but this could limit longer-term growth to around 2% yoy.

HUF likely to remain weak; credit market could benefit disproportionately from a credible fiscal plan

We do not believe the HUF is ready for a sustainable rally from current levels, given the uncertainty surrounding the medium-term growth outlook. We therefore target the EUR/HUF rate at around 280 by end-2010E and project only a moderate gain to about 270 by end-2011E. The credit market has already priced in a fairly bearish outlook, so we believe the main beneficiary of a credible fiscal plan could be the external bond market.

Latvia

Outlook – The economy is showing signs of improvement, but fragilities remain. The so-called internal devaluation strategy – a substitute for the nominal devaluation strategy and based on an unprecedented wage adjustment – will continue to weigh on household spending. However, the possibility of tail scenarios (double dip, pressure on the currency peg) materializing has been substantially reduced. In terms of fiscal policy, the Latvian government remains committed to IMF targets (for a consolidated budget deficit at 3% in 2012), which make Euro adoption attainable by 2014.

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

MACROECONOMIC DATA AND FORECASTS

	2007	2008	2009	2010F	2011F
GDP (EUR bn)	21.1	23.0	18.5	18.0	18.9
Population (mn)	2.3	2.3	2.3	2.3	2.2
GDP per capita (EUR)	9,254	10,145	8,221	8,002	8,407
GDP (constant prices yoy %)	10.0	-4.6	-18.0	-0.9	3.9
Private Consumption, real, yoy (%)	14.8	-5.5	-22.4	-4.3	3.0
Fixed Investment, real, yoy (%)	7.5	-15.6	-37.7	-7.0	7.4
Public Consumption, real, yoy (%)	3.7	1.5	-9.2	-6.0	-1.7
Exports, real, yoy (%)	10.0	-1.3	-13.9	7.2	7.6
Imports, real, yoy (%)	14.7	-13.6	-34.2	-1.0	4.0
CPI (average, yoy %)	10.1	15.5	3.6	-1.4	1.4
Central bank reference rate	6.00	6.00	4.00	3.50	3.75
Monthly wage, nominal (EUR)	565	682	654	595	595
Unemployment rate (%)	6.0	7.5	17.2	15.1	14.1
Budget balance (% of GDP)	-0.3	-4.1	-9.0	-7.7	-5.6
Current account balance (EUR bn)	-4.6	-3.0	1.6	1.2	1.2
Current account balance (% of GDP)	-23.8	-13.0	9.6	6.4	6.2
Net FDI (EUR bn)	1.4	0.7	0.1	0.1	0.2
FDI (% of GDP)	6.7	3.0	0.6	0.3	1.0
Gross foreign debt (EUR bn)	28.4	29.8	27.2	29.2	28.3
Gross foreign debt (% of GDP)	134.6	129.2	147.0	162.2	150.1
FX reserves (EUR bn)	3.8	3.5	4.8	5.5	5.4
(Cur.Acc-FDI)/GDP (%)	-14.8	-10.0	9.3	6.7	7.2
FX reserves/Gross foreign debt (%)	13.4	11.8	17.6	18.9	19.1
Exchange rate to USD eop	0.48	0.50	0.49	0.49	0.48
Exchange rate to EUR eop	0.70	0.70	0.70	0.70	0.70
Exchange rate to USD avg	0.51	0.48	0.50	0.52	0.49
Exchange rate to EUR avg	0.70	0.70	0.70	0.70	0.70

Source: UniCredit Research

STRENGTHS

- Significant IMF and EU support
- Improvements in fundamentals
- Currency peg no longer under stress

WEAKNESSES

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

Stabilization achieved, growth in sight

Fragilities remain

The Latvian economy is showing signs of improvement, but fragilities remain. We expect it to contract by around 0.9% this year – slightly less than previously expected – and to expand by 3.9% in 2011, in line with our previous forecast. GDP registered a 2.1% yoy drop in 2Q10, following a 6% decline in 1Q10. Growth in the second quarter saw the 12th consecutive quarter of a negative contribution from gross fixed capital formation but a very relevant positive contribution from inventories (4.3pp). The so-called internal devaluation strategy – a substitute for the nominal devaluation strategy and based of an unprecedented wage adjustment – will continue to weigh on household spending. The cumulative output decline reached almost 25% during the crisis of 2008-2009, the highest in the world out of the 183 countries monitored by the IMF. We expect the country to reach previous GDP levels (in real terms) again only in 2016-2017. However, we also note that **the possibility of any tail scenarios (double dip, pressure on the currency peg) materializing is significantly reduced** as many risk factors are lower than before, and the external environment is notably better (including the stabilizing effect of Estonia's convergence toward the Eurozone).

External imbalances quickly corrected: we expect the current account balance to remain largely in surplus this year, even if it showed some deterioration during the first seven months of 2010. We forecast the CA surplus to remain above 6% this year and in 2011, while the dynamics of foreign direct investment look to remain extremely weak.

The 3% threshold to be reached in 2012

In terms of fiscal policy, the Latvian government remains committed to IMF targets for a consolidated budget deficit lower than 8.5% of GDP in 2010, lower than 6% in 2011, and 3% in 2012. The decline of tax revenues (-4.5%) over 7M10 was partially offset by a larger decline of expenditures (-11% yoy). However, further tax increases could be needed to keep the deficit within the targets. We believe that the targets agreed with the IMF can be achieved, and that Euro adoption – the best "exit strategy" available from the currency peg in our view – is attainable by 2014. At the same time, local interest rates continue to remain extremely low, with the market characterized by a large excess of lat liquidity; the 3M Rigibor dropped to around 0.5%.

The banking sector is not fully out of the woods

As for the banking sector, lending activity remains largely subdued. The amount of lending in the economy continues to fall: it is 13% lower since the beginning of the crisis and 5% lower YTD. At the same time, the downturn took its toll on credit quality: Non-performing loans (NPLs) deteriorated to 19% of the loan portfolio in 2Q10. We believe that credit quality problems are starting to level off gradually, with the peak in NPLs expected at 20%-22%: in this sense, a full banking crisis has been avoided.

We expect a further improvement in the Latvian rating

The improved economic situation and the strong external anchors provided by the EU and the IMF make us think that further rating improvements are likely in upcoming months. Fitch, which downgraded Latvia's rating at the end of 2008 and in April 2009, has raised its outlook from negative to stable in September 2010, as an example.

The recent parliamentary elections enhanced the support for the government

Following the general elections of 3 October, the center-right Unity Bloc, which makes up a large part of the previous ruling coalition, won over 30% of the vote. We believe this represents a positive signal for the government, especially if we take into account the potential negative effect on public consensus from the harsh austerity measures. Harmony Center (center-left) got more than 25% of the votes, with the Greens and Farmers Union collecting around 19%-20%. At the time of writing, Unity is discussing various coalition options. Unity and the Greens/Farmers now have a majority of 55 votes in the 100-seat parliament, but this total would increase to 63 if either the "Fatherlanders" or "For A Good Latvia" parties participate in the government coalition (both won 8 seats). The political environment following the elections should mean the continuation of previous policies and the commitment to the IMF program.

Lithuania

Outlook – Growth should continue to remain mainly export-driven for several quarters, amid high and still-increasing unemployment, which is creating a drag on domestic consumption. External and fiscal imbalances have been reduced, and risks are lower. However, the banking sector remains a weak spot, and it is still suffering from a sharp deterioration of credit quality. All in all, rating agencies could find ample room to increase ratings once fiscal consolidation becomes visible and a target for Euro adoption comes into sight.

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

MACROECONOMIC DATA AND FORECASTS

	2007	2008	2009	2010F	2011F
GDP (EUR bn)	28.4	32.2	26.7	27.1	28.5
Population (mn)	3.4	3.4	3.4	3.3	3.3
GDP per capita (EUR)	8,420	9,569	7,971	8,296	8,525
GDP (constant prices yoy %)	8.9	2.8	-15.0	0.9	3.7
Private Consumption, real, yoy (%)	12.1	3.6	-17.0	-6.8	2.7
Fixed Investment, real, yoy (%)	23.0	-6.5	-38.7	11.0	4.9
Public Consumption, real, yoy (%)	3.2	7.9	-2.3	-1.2	-2.3
Exports, real, yoy (%)	3.0	12.2	-15.5	22.5	10.3
Imports, real, yoy (%)	10.7	10.5	-29.3	15.0	7.3
CPI (average, yoy %)	5.7	11.0	4.5	1.0	1.9
Monthly wage, nominal (EUR)	522	654	625	609	611
Unemployment rate (%)	4.3	5.8	13.5	17.3	15.9
Budget balance (% of GDP)	-1.0	-3.3	-8.9	-7.5	-5.7
Current account balance (EUR bn)	-4.1	-3.8	1.0	-0.5	0.4
Current account balance (% of GDP)	-14.5	-11.9	3.8	1.7	1.7
Net FDI (EUR bn)	1.0	1.2	-0.1	0.0	0.6
FDI (% of GDP)	3.6	3.2	0.5	0.1	2.0
Gross foreign debt (EUR bn)	20.5	23.1	24.5	23.5	24.4
Gross foreign debt (% of GDP)	72.3	71.6	91.6	86.7	85.4
FX reserves (EUR bn)	5.3	4.6	4.6	4.8	4.8
(Cur.Acc-FDI)/GDP (%)	-11.0	-8.1	3.4	-1.7	3.3
FX reserves/Gross foreign debt (%)	25.7	19.8	18.9	20.3	19.6
Exchange rate to USD eop	2.37	2.47	2.41	2.41	2.36
Exchange rate to EUR eop	3.45	3.45	3.45	3.45	3.45
Exchange rate to USD avg	2.52	2.35	2.48	2.57	2.42
Exchange rate to EUR avg	3.45	3.45	3.45	3.45	3.45

Source: UniCredit Research

STRENGTHS

- Euro adoption perspectives
- Commitment to reign in the public deficit
- No risk for the currency peg

WEAKNESSES

- Consequences of the sharp contraction in economic activity
- Further austerity measures to be implemented
- High and increased unemployment

The worst is over, and risks are substantially lower

Recovery in place, but domestic demand still weak

The Lithuanian economy is enjoying a more favorable environment, and it is also benefiting from the stabilization of its Latvian neighbor and Estonia's path to Euro adoption. In 2Q10, Lithuanian GDP growth moved into positive territory on a yoy basis (+1.3% yoy from -2.8% in 1Q10) following six consecutive negative quarters. However, growth remains exclusively export-driven (exports grew 21% yoy in 2Q10): investment (-8.8% yoy in 2Q10 vs. -32% yoy in 1Q10) and consumption (-7.3% from -9.2%) are showing signs of improvement but remain a drag on growth. Household consumption in particular should remain a laggard. The 10.9% yoy increase in industrial production registered in August contrasts with the 2.1% yoy decline in retail sales. In our opinion, unemployment should continue to take a toll on domestic demand: **the unemployment rate, at around 4% in 2007, is still climbing, reaching 18.3%** in 2Q10 (from 15.6% in 4Q09). However, we expect a gradual reduction of the unemployment rate in coming quarters, together with improvements in economic activity.

Unemployment at extremely high level

In terms of price dynamics, **the deflationary risk seen during the first part of this year** (negative CPI inflation in the first three months) **did not materialize,** and inflation moved towards 2% (food prices are also playing a role). All in all, we revised upward both our growth and inflation forecasts, although both revisions were limited.

Further austerity measures in sight

The public sector deficit, following the sharp deterioration in 2009 when the deficit jumped from 3.3% of GDP to 8.9%, is moving towards a more sustainable path. Expenditures were reduced by more than revenues during 1H10. **The European Commission assessed the actions taken by Lithuania in response to the excessive deficit procedure (February 2010) as convincing** and coherent with the target of a deficit at 3% of GDP in 2012. The deficit should gradually improve starting this year, but further austerity measures could be necessary to achieve targets.

The current account moved into surplus in 2009 (+3.8% of GDP from an 11.9% deficit in 2008) **and this surplus should remain this year** (around 1.5%-2.0% of GDP), especially thanks to a good export performance. International reserves are at comfortable levels and increasing (+8.9% yoy in August).

NPLs moving towards 20%

The banking sector, however, remains the country's the weak spot, and it is still suffering a sharp deterioration of credit quality. The latest available information shows that the non-performing loans ratio surpassed 19% in 1Q10, almost doubling yoy. Credit activity is still in negative territory (-3.6% YTD and -11% since the beginning of the crisis) as in the other two Baltic countries, while the banking sector as a whole has not posted a quarter in the black (in terms of pre-tax profit) since the end of 2008. The deleveraging process could continue in the coming months.

Room for rating upgrades

We expect the rating agencies to gradually reverse the rating actions taken during the crisis (three downgrades from Moody's, two from S&P, three from Fitch in 2008-2009). The three agencies already moved the outlook on Lithuania's rating from negative to stable in the first part of this year and could find room to increase the rating once fiscal consolidation is visible and a euro adoption target is in sight.

Poland

Outlook – Poland remains one of the best-performing economies in the region. We expect the recovery to continue into next year, to a large extent supported by larger drawdowns of EU funds which should boost investment. More disappointingly, concerns about any related political costs have prevented the government from tackling Poland's wide budget deficit. We expect the MPC to leave rates on hold for the rest of this year, though the risks of a near-term rate hike have gathered pace.

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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

	2007	2008	2009	2010F	2011F
GDP (EUR bn)	310.8	362.0	310.7	351.3	379.4
Population (mn)	38.1	38.1	38.2	38.1	38.1
GDP per capita (EUR)	8,154	9,492	8,140	9,222	9,968
GDP (constant prices yoy %)	6.8	5.1	1.8	3.3	3.7
Private Consumption, real, yoy (%)	4.9	5.7	2.3	2.6	3.1
Fixed Investment, real, yoy (%)	17.6	9.6	-0.8	0.1	10.7
Public Consumption, real, yoy (%)	3.7	7.4	1.9	2.4	1.5
Exports, real, yoy (%)	9.1	7.1	-7.9	10.9	9.7
Imports, real, yoy (%)	13.7	8.0	-13.6	9.2	10.9
CPI (average, yoy %)	2.5	4.2	3.5	2.4	2.7
Central bank reference rate	5.00	5.00	3.50	3.50	4.00
Monthly wage, nominal (EUR)	762	820	834	858	929
Unemployment rate (%)	12.7	9.8	11.0	12.0	11.8
Budget balance (% of GDP)	-2.0	-3.6	-7.2	-7.1	-6.6
Current account balance (EUR bn)	-14.7	-18.3	-5.0	-7.9	-8.3
Current account balance (% of GDP)	-4.7	-5.1	-1.6	-2.3	-2.2
Net FDI (EUR bn)	17.2	10.0	8.3	10.0	10.0
FDI (% of GDP)	5.5	2.8	2.6	2.8	2.6
Gross foreign debt (EUR bn)	159.1	172.8	194.4	213.3	233.9
Gross foreign debt (% of GDP)	51.2	47.7	62.6	60.7	61.7
FX reserves (EUR bn)	44.7	44.1	55.2	78.5	98.6
(Cur.Acc-FDI)/GDP (%)	0.8	-2.3	1.0	0.6	0.4
FX reserves/Gross foreign debt (%)	28.1	25.5	28.4	36.8	42.2
Exchange rate to USD eop	2.47	2.97	2.86	2.87	2.67
Exchange rate to EUR eop	3.60	4.15	4.10	4.10	3.90
Exchange rate to USD avg	2.76	2.39	3.10	3.02	2.81
Exchange rate to EUR avg	3.78	3.52	4.33	4.05	4.00

Source: UniCredit Research

STRENGTHS

- Sound corporate and banking sector
- Acceleration of spending of EU funds (EUR 67bn total) in the next few years

WEAKNESSES

- High budget deficits and related borrowing needs
- Political reluctance to cut the budget deficit, reinforced by political cycle

Poland: EU funds to act as multi-year stimulus

We have raised our GDP forecasts due to stronger, EU-propelled investments

As we expected, GDP proved stronger in 2Q10 than 1Q10 (3.5% yoy vs. 3.0% yoy respectively). We continue to expect GDP gains to slow from 2Q10 but remain above 3.0% yoy, largely due to a robust investment environment. The recently released numbers show significant acceleration in EU-co-financed (mostly infrastructure) spending, and this should remain a significant stimulus for economic growth in the next few years. This year investments are likely to be flat as consequences of adverse weather conditions during most of 1Q are unlikely to be reversed in full, but next year we project investment growth of 8%-10% yoy as private sector investment remains largely unchanged from this year and public sector investment rises sharply due to the EURO 2012 European Football Championships. Due to this factor (and to a lesser extent a slightly better outlook on private consumption), we have raised our GDP forecasts to 3.3% for 2010 and 3.7% for 2011 (previously 2.6% and 2.8% yoy, respectively). The latter number assumes that the global economy is still muddling through the consequences of the crisis, i.e. that global growth is muted. Should it turn out to be stronger, there is a good chance that GDP gains will remain above 4.0%. From a multi-year perspective, it is important to note that already half of the circa PLN 260bn of EU funds have been allocated, while by the end of next year most of them will be allocated – and actually spent in the economy in the next few years. That means a very well-timed (though more by coincidence than by intention) medium-term stimulus for the economy, which at the same time will address one of the economy's weak spots, namely infrastructure (mostly highways and transportation).

Most of the EU funds should be allocated by end-2011; that would represent a significant, multi-year stimulus for the economy

We continue to expect EUR/PLN above 4.00 at year-end

We continue to expect the zloty to show moderate depreciation from now until year-end. We stick to our inflation scenario, forecasting year-end inflation at around 2.5%. In 2011 inflation is likely to accelerate towards 3.0-3.5% by year-end, with the range reflecting food- and fuel-related uncertainties.

Government failure to tackle the fiscal deficit has to date not proved problematic…

The government's response to widening budget deficits has fallen short of expectations. Note that budget deficits in 2009, 2010, and 2011 will be almost or in excess of twice the 3% target set down in Maastricht. The VAT hike (base rate going up by 1pp from Jan 2011, i.e. from 22% to 23%) is assumed to bring an additional PLN 5bn, but this is a small dent in a public sector deficit of more than PLN 100bn this year, and around PLN 85bn next year. The delay in the appropriate policy response can be attributed to upcoming Parliamentary elections (scheduled for Autumn 2011, but may be speeded up due to Poland's EU presidency in 2H11), and a general unwillingness to discuss reforms that translate into reduced social spending. However, there is a risk that investor patience with a lack of fiscal reform may translate into a nasty reaction in both the PLN and the domestic fixed income market over the next few quarters.

…though it increases the risk that the MPC will be forced to take action

Though increasingly a close call, we expect the NBP to keep interest rates on hold for the remainder of this year before gradually "normalizing" rates next year. At this stage it is a question of when rather if the MPC will hike rates. The PMIs have increased into 'rate hiking' territory, while inflation is also set to edge up towards the upper end of the NBP's target band from here. For now, however, wage growth remains low while the NBP will no doubt be concerned about the risk that any rate hikes cause rapid PLN gains. The key risk to our call is a sharp increase in the October inflation projection.

Romania

Outlook – July's fiscal austerity measures are likely take a toll on 2H10 growth numbers, while the inventory cycle has likely run out of steam in 2H10. Accordingly, GDP should continue to fall on an annual basis (-2.5% yoy) and underperform the region in 2011. Meanwhile Romania's C/A balance is deteriorating due to lower remittances and FDI coverage has weakened. Coupled with the challenging political consequences of the austerity package, this leaves us cautious on sovereign credit as well as the FX outlook.

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

MACROECONOMIC DATA AND FORECASTS

	2007	2008	2009	2010F	2011F
GDP (EUR bn)	123.7	136.9	115.9	118.5	123.6
Population (mn)	21.6	21.5	21.5	21.4	21.3
GDP per capita (EUR)	5,735	6,360	5,393	5,540	5,807
GDP (constant prices yoy %)	6.2	7.1	-7.1	-2.5	1.7
Private Consumption, real, yoy (%)	9.8	8.4	-9.2	-3.3	2.8
Fixed Investment, real, yoy (%)	29.0	19.3	-25.3	-5.2	6.2
Public Consumption, real, yoy (%)	7.6	3.7	1.2	-2.1	-2.0
Exports, real, yoy (%)	7.9	19.4	-5.5	13.7	6.0
Imports, real, yoy (%)	27.2	17.5	-20.6	14.2	9.5
CPI (average, yoy %)	4.8	7.9	5.6	5.9	5.5
Central bank reference rate	7.50	10.25	8.00	6.25	5.00
Monthly wage, nominal (EUR)	312	347	326	337	347
Unemployment rate (%)	4.3	4.0	6.3	8.5	8.0
Budget balance (% of GDP)	-2.3	-4.9	-7.4	-7.0	-5.0
Current account balance (EUR bn)	-16.7	-16.9	-5.1	-7.4	-7.9
Current account balance (% of GDP)	-13.5	-12.3	-4.4	-6.3	-6.4
Net FDI (EUR bn)	7.2	9.0	4.9	3.6	4.9
FDI (% of GDP)	5.8	6.6	4.2	3.0	4.0
Gross foreign debt (EUR bn)	38.7	51.8	65.6	74.1	79.4
Gross foreign debt (% of GDP)	31.3	37.8	56.6	62.5	64.3
FX reserves (EUR bn)	25.3	26.2	28.3	30.7	29.0
(Cur.Acc-FDI)/GDP (%)	-7.7	-5.7	-0.1	-3.3	-2.4
FX reserves/Gross foreign debt (%)	65.4	50.7	43.1	41.4	36.5
Exchange rate to USD eop	2.45	2.89	2.95	3.01	2.88
Exchange rate to EUR eop	3.58	4.03	4.23	4.30	4.20
Exchange rate to USD avg	2.43	2.50	3.04	3.15	3.02
Exchange rate to EUR avg	3.34	3.68	4.24	4.22	4.30

Source: UniCredit Research

STRENGTHS

- Significant IMF and EU balance of payments support
- Low public sector debt levels
- Stable C/A deficit

WEAKNESSES

- High public deficit with risk of overshooting
- High FX leverage in domestic private sector
- Deteriorating loan portfolio quality

Slide back into recession, hopefully just for the short term

Prolonged recession this year on the back of strongly contracting local demand

The Romanian economy contracted by 0.5% yoy in 2Q10, which was an improvement compared to the 2.6% yoy drop in 1Q10 (more encouragingly, seasonally adjusted qoq growth accelerated to 0.3% from a contraction of 0.3% in Q1). As expected, exports and inventories remained the main drivers of the improvement. Inventories offered a major surprise, adding about 4.8pp to overall growth. While we welcome the improvement, it also suggests that the inventory cycle is more or less over in Romania and should not boost growth in the coming period. More negatively, despite the good performance of exports (21.4% yoy and 2% qoq), the net export contribution turned negative due to the stronger import acceleration in 2Q10 (24.5% yoy and 4.9% qoq). Moreover, fixed investments surprised on the negative side with a strong drop of 9.5% yoy (-4.4% qoq) after a slight improvement in 1Q10 (+1.2% qoq). Looking ahead, we would not be surprised to see further a setback in growth in the coming quarter, due to the end of the inventory cycle and the still-depressed level of domestic demand. More encouragingly, we would expect some further support from export markets. Nevertheless we maintain our overall view that the Romanian economy will underperform the region in 2011 (only 1.7% growth compared to the regional average of 3.8%).

One-off jump in inflation driven by VAT hike, stalling the monetary easing cycle

A 5pp VAT increase as of July 2010 was the key development for inflation, leading to a one-off jump. As a result, inflation is likely exceed the target range, and we expect it to reach 7.3% yoy at year-end. The weak growth outlook means we do not see a significant risk of second-round impact, and hence we expect inflation to decelerate in 2H11 to around 4% yoy. Due to the jump in headline inflation, real rates turned negative. Nevertheless, policy rate hike amid persisting negative output gap would be more harming than helping. On top of some inflation uncertainty, we also believe that uncertainties regarding the social and political aspects of fiscal measures leave no room for loosening for now. Accordingly, we expect the monetary policy rate to be kept at the current level of 6.25% until year-end.

Balanced external trade in 2010 amid some deterioration of capital inflow through current transfers and FDI

The external deficit widened during 7M10 by 38.5% yoy, after the 65% yoy contraction last year. This was mainly driven by a 32% yoy fall in current transfers, which stood only at EUR 1.5bn against the EUR 2.3bn registered for the same period last year. The trade deficit contracted by 5.5% yoy. Finally, external financing has deteriorated markedly, with FDI dropping by 36% yoy, resulting in coverage of only 50.3% of the current account deficit (vs. 97% coverage during 2009). We expect a similar trend for the full year, and we forecast the C/A deficit at 6.3% of GDP in 2010.

2010 budget balance looks to be on target

On the fiscal side, Romania ran a consolidated budget deficit of 4.1% of GDP in the first eight months of 2010 vs. a target of 6.8% of GDP (according to the IMF quarterly review of the SBA in May 2010). VAT collections in August showed a significant improvement, increasing by 4.5% yoy in 8M10. A 25% reduction in the public sector wages cut personnel expenditures for 8M10 by 6.8% yoy. The biggest component on the expenditure side remains the social assistance, amounting to 36.3% of total public expenditure (9% of GDP). Nevertheless, Romania is currently trying to address part of the problems in social spending through passing of a new pension law that should index pensions to inflation instead of gross wages. Public investments dropped by 23.3% yoy this year. Overall, we expect the budget deficit to be close to the targeted level this year, with further rebalancing in upcoming years.

Neutral on sovereign outlook, RON is not ready for a sustainable rally

Fiscal performance and external financing, conditional on the IMF/EU stand-by-agreement, continues to be crucial for Romania's sovereign credit outlook. Due to relatively weak external balances and ongoing fiscal-related risks, we believe the RON is not yet ready for a sustainable recovery, and hence we expect EUR/RON at 4.30 by year-end.

Slovakia

Outlook – Ambitious fiscal consolidation is planned for 2011 to cut the budget deficit by 3pp to approximately 5% of GDP. The new right-wing government has agreed a series of revenue and expenditure measures. Inflation should accelerate, driven by higher taxes and energy prices, but wage growth should ease due to public wage cuts. This is likely to delay domestic demand recovery, leaving the economy reliant on external demand and the launch of new export-oriented production capacity in the automotive and consumer electronics sectors. Overall, we expect to see Slovakia secure its position among the EU growth leaders.

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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

	2007	2008	2009	2010F	2011F
GDP (EUR bn)	54.9	64.8	63.3	66.0	69.4
Population (mn)	5.4	5.4	5.4	5.4	5.4
GDP per capita (EUR)	10,165	11,966	11,722	12,217	12,845
GDP (constant prices yoy %)	10.6	6.2	-4.7	4.3	3.1
Private Consumption, real, yoy (%)	7.1	6.1	0.2	0.6	-0.2
Fixed Investment, real, yoy (%)	9.1	1.8	-10.5	2.4	2.2
Public Consumption, real, yoy (%)	0.1	5.3	2.8	2.0	-5.0
Exports, real, yoy (%)	14.3	3.2	-16.5	14.5	6.2
Imports, real, yoy (%)	9.2	3.1	-17.6	12.5	3.5
CPI (average, yoy %)	2.8	4.6	1.6	1.2	4.1
Central bank reference rate	4.25	2.50	EUR	EUR	EUR
Monthly wage, nominal (EUR)	669	723	745	770	792
Unemployment rate (%)	11.0	9.6	12.1	13.9	13.5
Budget balance (% of GDP)	-1.9	-2.3	-8.0	-7.8	-5.0
Current account balance (EUR bn)	-3.3	-4.2	-3.9	-3.1	0.0
Current account balance (% of GDP)	-5.3	-6.5	-3.2	-2.1	-1.9
Net FDI (EUR bn)	2.7	1.7	1.2	1.8	0.0
FDI (% of GDP)	3.8	3.3	-0.3	1.5	1.3
Gross foreign debt (EUR bn)	32.4	35.9	47.0	55.5	61.6
Gross foreign debt (% of GDP)	59.0	55.4	74.2	84.2	88.9
(Cur.Acc-FDI)/GDP (%)	-1.1	-3.9	-4.4	-1.9	0.0

Source: UniCredit Research

STRENGTHS

- New government likely reform-orientated
- Ongoing FDI interest due to euro adoption and tax system
- Banking sector in good shape

WEAKNESSES

- Limited policy tools to stimulate the economy
- Very dependent on the global trade cycle, with industry the main growth engine (autos, electronics, steel)
- Weak domestic demand

Fiscal tightening on horizon

With the new government in place, strong fiscal tightening is planned for next year

The new right-wing government of Prime Minister Iveta Radičová was formed in early July and basically repeats the "super-reform" government of 2002-2006. The first months saw some tension and potential conflicts between liberals (SaS) and conservatives (Christian Democrats), but the coalition was able to agree on the make-up of fiscal consolidation for the years ahead, following deterioration in public finances in the final months of the leftish government of Prime Minister Robert Fico. The deficit neared 8% of GDP in 1H10, mainly due to the lower-than-expected budget revenues. The coalition has since proposed a front-loaded consolidation plan to cut the deficit from a revised 7.8% of GDP in 2010 to 5% in 2011 and confirmed a target of 3% for 2013. Roughly half of next year's consolidation should come from revenue measures (raising VAT by 1pp, excise taxes on beer and tobacco, energy taxes, etc.) and half from cost-cutting in public administration. As expected, two of three large highway projects (PPPs) have been cancelled; the remaining project is already under way, as the contract was closed before the elections. Other infrastructure projects have not been halted, but the speed of construction should moderate. Instead of being structured as PPPs, the projects are to be supported by higher transfers from the state budget and redirected EU funds.

External demand remains the main driver of gains in economic activity

Domestic demand is still weak, but the labor market shows signs of improvement

The Slovak economy continues to rebound, benefiting from stronger external demand, although domestic demand remains weak. GDP growth accelerated in 2Q10 to 1.2% qoq, continuing to demonstrate some of the strongest growth in the EU (but 2% below pre-crisis levels). Construction showed signs of recovery this spring on the back of election spending, but this is unlikely to persist. Despite zero real interest rates, corporate loans are not growing, as production capacity has not been fully utilized. The growth of real wages accelerated to 2.4% yoy despite the slight acceleration of inflation, but higher household income is not yet reflected in consumption (the non-food component of retail sales is 20% below pre-crisis levels). Demand-pull inflation stabilized close to zero, with inflation driven only by supply factors (food and oil prices). The labor market is also showing signs of stabilization, with the most recent readings showing rising employment in manufacturing, although services continue to suffer.

External demand should boost economic activity in the coming quarters…

Assuming external demand continues to expand in 2H10 (as suggested by IFO and ZEW), in particular from Germany as the main buyer of Slovak exports, we have increased our 2010 GDP forecast from 3.5% to 4.3%. GDP should still be driven mainly by net exports, although a moderate recovery in domestic demand is possible, stimulated by labor market improvement. We expect annual inflation to accelerate, largely driven by food prices and base effects, with demand-pull inflation restrained.

…but overall economic activity is likely to moderate in 2011 due to fiscal restrictions as inflation moves higher

We look for slower gains in economic activity in 2011 and have cut our GDP forecast for next year from 3.5% to 3.1%. We expect fiscal tightening by the government to block any recovery in household consumption, and project real wages to decline for the first time in seven years, due to cuts in public sector wages and accelerating inflation related to tax hikes (we estimate tax changes adding 1pp to HICP). On the positive side, we expect the planned launch of new export-oriented production capacity in automotive (VW's new small-sized family car) and consumer electronics (AU Optronics' LCD panels) to support further export growth.

Credit metrics are roughly in line with the rating peer group, underlying the stable rating outlook

Despite the budget deficit deterioration over the past two years, Slovakia's key credit metrics are roughly in line with the average A-rating peer group, as reflected in the stable outlook of all agency ratings (A1, A+, A+). We expect the ratings to remain unchanged over the next 12M, with Eurozone membership still a stabilizing factor and the global manufacturing cycle the strongest downside risk. We believe this outlook is fairly priced by the credit markets, with credit default swaps trading at the second-lowest level in the CEEMEA region (5Y at around 80bp-90bp) and around 15bp below the rating peer average.

Slovenia

Outlook – We see scope for private consumption to support growth, although there are no imminent signs it will materialize quickly, resultantly in the near term exports should continue to play a key role. Inflation remains low, and external imbalances are narrowing. Given the protests seen against public sector wage policy in late September, it remains a point of interest in the coming months as to how much of its reform agenda the government manages to achieve.

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

MACROECONOMIC DATA AND FORECASTS

	2007	2008	2009	2010F	2011F
GDP (EUR bn)	34.6	37.3	35.4	36.5	38.3
Population (mn)	2.0	2.0	2.0	2.1	2.1
GDP per capita (EUR)	17,203	18,468	17,345	17,813	18,604
GDP (constant prices yoy %)	6.9	3.7	-8.1	1.2	2.1
Private Consumption, real, yoy (%)	6.6	3.5	-1.9	-0.1	1.2
Fixed Investment, real, yoy (%)	12.8	8.5	-21.6	-5.6	4.5
Public Consumption, real, yoy (%)	0.7	6.2	3.0	0.5	-0.5
Exports, real, yoy (%)	13.7	3.3	-17.7	7.6	4.2
Imports, real, yoy (%)	16.7	3.8	-19.7	6.7	5.0
CPI (average, yoy %)	3.6	5.7	0.9	2.0	2.9
Central bank reference rate	4.00	2.50	1.00	1.00	1.25
Monthly wage, nominal (EUR)	1,284	1,391	1,439	1,490	1,530
Unemployment rate (%)	4.9	4.5	5.9	6.8	6.3
Budget balance (% of GDP)	0.0	-1.7	-5.5	-6.0	-4.7
Current account balance (EUR bn)	-1.5	-2.5	-0.5	-0.4	-0.7
Current account balance (% of GDP)	-4.2	-6.7	-1.5	-1.0	-1.8
Net FDI (EUR bn)	-0.2	0.4	-0.5	0.3	0.4
FDI (% of GDP)	-0.6	1.0	-1.5	0.7	1.0
Gross foreign debt (EUR bn)	34.8	39.0	40.1	42.5	45.5
Gross foreign debt (% of GDP)	100.5	104.5	113.4	116.4	118.7
(Cur.Acc-FDI)/GDP,%	-4.8	-5.7	-3.0	-0.3	-0.7

Source: UniCredit Research

STRENGTHS

- Recovery in export growth
- Manufacturing activity picking up
- Government embarks on structural reform program

WEAKNESSES

- Private consumption remains weak
- Wage trends potentially exceed productivity gains

Exports still the key to growth

Industrial production and merchandise export data the main positives in Slovenia…

More signs of recovery have been visible recently. Apart from the 2.2% yoy increase in GDP in 2Q10 and the acceleration of growth in seasonally adjusted qoq terms of 1.1%, industrial production data also rebounded strongly during the quarter, and July data revealed an increase of 9.5% yoy with manufacturing production up 10.4% yoy. Unemployment in ILO-comparable terms in 2Q10 flattened out, remaining at 7.1%. Gross wages are up 4.0% yoy in January-July 2010, yet data on retail sales continues to point to weakness: in August, the retail sales index rose 0.8% yoy, but fell 1.6% yoy when excluding the fuel component. The mom trend also remains negative. Generally weak private consumption (down 0.3% in 1H10) is somewhat surprising given real wage growth and stronger retail lending trends. Undoubtedly, there is potential for private consumption to boost GDP growth, but there are no imminent signs it will materialize.

…while private consumption remains weak despite wage and growth and increased household lending

Inflation set to remain low, and the current account deficit to narrow further this year

Inflation remains low, and external imbalances are narrowing. Given relatively weak domestic demand, inflationary pressures remain minimal. In September, headline inflation rose 2.0% yoy. Indeed, our estimates suggest core inflation has been very close to zero in recent months and was actually negative in 1Q10. Slovenia's current account deficit continues to narrow, amounting to EUR 106mn in 7M10, a drop of 67.3% yoy. Exports of goods and services were up 10.2% yoy over this period, while imports of goods and services have accelerated since March 2010 as industrial production activity began to recover. As a result, the surplus in goods and services in 7M10 declined 16% yoy to EUR 314mn. Nonetheless, sizeable reductions in the income and transfers deficits drove the contraction in the current account deficit.

GDP growth forecast revised up

GDP forecast raised for 2010 and 2011. The main change in our forecasts is an upward revision in GDP growth for this year from 0.9% to 1.2% and for 2011 from 1.9% to 2.1% yoy. For 2010, the revision simply reflects the impact of data released to date, while for 2011 we expect a positive contribution from gross fixed capital investment for the first time since 2008. In addition, the regional outlook (Croatia, Bosnia, and Serbia) is improving, providing a boost to Slovenia's exporters, which are well established in the region. While the relatively high contribution of exports in the structure of GDP is a definite plus for Slovenia, we note that in the manufacturing sector gross wage growth in 7M10 amounted to 9.8% yoy – and this after an increase of 0.9% yoy in 2009 when labor productivity in industry fell 8.4% yoy. A repeat of this result in 2010 and beyond would represent a risk to Slovenia's export growth.

Government embarks on structural reform program…

Supplementary budget sees spending cuts and tax increases. The government has frozen public sector salaries and pensions, intending to save EUR 200mn this year, with a further EUR 390mn from delaying capital spending initiatives. We continue to expect a consolidated general government deficit of 6% of GDP this year, but expect it to fall below 5% in 2011 as tax revenue growth moderately recovers and the full year effects of spending measures feed through. In addition, the government is aiming to reform labor market practices, social welfare benefits and the pension system which in the medium to longer term will improve the stability of public finances and boost productivity growth.

…inviting protests

Protests against public sector wage policy. Late September saw public sector strikes in protest at the government's plans to reduce the public sector wage bill and other reforms. In our opinion this was an expected reaction from public sector unions, but not something which should endanger the government. The main point of interest in the coming months should be to see how much of its reform agenda the government manages to achieve.

Sovereign credit rating stable

No change in sovereign rating expected. Relatively low public debt, efforts to reduce the fiscal deficit and evidence of a recovery in export growth are the main reasons we see no change to Slovenia's sovereign rating in the next 12M.

Bosnia & Herzegovina

Outlook – Export growth remains strong as the country enters the usually lengthy period between elections and the formation of a new government. We do not see much scope for private consumption contributing more to economic growth in 2011- the focus will remain on external conditions in the region, which will become more supportive towards growth. The most important anchor we see for fiscal policy is the current IMF program, which remains in place until July 2012.

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

MACROECONOMIC DATA AND FORECASTS

	2007	2008	2009	2010F	2011F
GDP (EUR bn)	11.1	12.6	12.3	12.6	13.1
Population (mn)	3.8	3.9	3.8	3.8	3.8
GDP per capita (EUR)	2,876	3,281	3,193	3,278	3,403
GDP (constant prices yoy %)	6.8	5.4	-2.9	0.5	1.8
CPI (average, yoy %)	1.5	7.4	-0.4	2.2	2.0
Monthly wage, nominal (EUR)	488	568	616	622	635
Unemployment rate (%)	44.0	40.3	41.5	41.2	41.0
Budget balance (% of GDP)	-0.1	-4.0	-5.2	-4.5	-4.2
Current account balance (EUR bn)	-1.2	-1.9	-0.9	-0.8	-1.0
Current account balance (% of GDP)	-10.4	-15.1	-7.5	-6.5	-8.0
Net FDI (EUR bn)	1.5	0.7	0.4	0.3	0.5
FDI (% of GDP)	13.5	5.7	2.9	2.0	3.9
FX reserves (EUR bn)	3.4	3.2	3.2	3.2	3.1
(Cur.Acc-FDI)/GDP (%)	3.1	-9.4	-4.6	-4.5	-4.1
Exchange rate to USD eop	1.34	1.40	1.36	1.37	1.34
Exchange rate to EUR eop	1.96	1.96	1.96	1.96	1.96
Exchange rate to USD avg	1.43	1.33	1.40	1.46	1.37
Exchange rate to EUR avg	1.96	1.96	1.96	1.96	1.96

Source: UniCredit Research

STRENGTHS

- IMF program provides a credible policy anchor
- Strong export growth
- Lower external financing needs expected near term

WEAKNESSES

- Hiatus between election and government formation
- Challenges in meeting structural targets of IMF program
- Domestic demand remains weak

Exports the key for growth outlook

Exports continue to underpin the recovery in growth

Industrial production continues to accelerate. Manufacturing output at the national level rose 14.4% yoy in August, making it the main driver of the aggregate 7.1% yoy increase in industrial production. Production of intermediate and consumer durables increased the most in August (and for 8M10), with the higher activity reflected in merchandise trade data, where merchandise exports rose 28.8% yoy in 8M10. The marked pick-up in merchandise imports, concentrated in crude materials (up 60.1% yoy in 8M10) and mineral fuels and lubricants (up 40.7% yoy) in May points to a further rise in industrial production and exports. Domestic demand, however, remains weak. We estimate that real gross wages fell 1.0% yoy in 7M10. In addition, consumer price data for August revealed a headline inflation rate of only 1.7% yoy, and we estimate core inflation fell 0.2% yoy during the month. Nonetheless, the broadest monetary aggregate reported by the Central Bank, M2, rose 6.9% yoy in 7M10, foreshadowing improved growth prospects.

GDP forecast for 2011 revised upward; current account deficit expected to narrow to 6.5% of GDP

GDP and current account deficit forecasts increased. We maintain our 0.5% growth forecast for this year, but have raised our GDP forecast for 2011 from 1.2% yoy to 1.8% – we expect a brighter regional outlook in 2011 compared to this year, supporting export growth of roughly 10%. We do not see much scope for private consumption contributing more to economic growth next year (there is no real wage growth and still high unemployment – 27.2% in April 2010, according to preliminary data for Bosnia & Herzegovina's first ever ILO comparable labor force survey). However, we do note that commitments by the Federation government to honor arrears to war veterans and other benefit recipients should boost spending. The major change in our forecasts from the previous quarter is the current account deficit, which we now project at 6.5% of GDP for 2010 (previously 3.6%), driven by the strong rise in merchandise imports since May. Inflation should remain low: we forecast 2.2% for 2010, assuming a reversion to winter tariffs for energy in October, and we expect similar trends in 2011.

IMF agreement in place until July 2012

Federation budget now reflects reality. In September the Federation government submitted a supplementary budget including all commitments in respect of obligations to the pension fund, arrears owed to benefit recipients, and the like. In both the Federation and Republika Srpska fiscal policy require further attention to meet the stated goal of a 3% GDP deficit in 2011. Given our expectation that governments at the national and entity levels are unlikely to be in place before 1Q11, this goal could be challenging, especially since tax revenue growth amid weak domestic demand would not be supportive. The most important anchor we see for fiscal policy is the current IMF program, which expires in July 2012. We also expect EU funds and World Bank lending facilities to support budget financing needs.

4Q10 and beyond to be taken up forming new governments after 3 October's general elections

Elections out of the way – now comes the hard part. With elections out of the way, the focus moves to forming new governments. As in previous post-election periods, we expect the process to last for a number of months. We see policy coordination within the Federation and between the Federation and Republika Srpska as the main challenge, and believe the discussions on a new constitution, once the country's governments are formed, should be the best indicator of how this process is playing out. Meanwhile, the likely scrapping of visa requirements for travel to EU member states in 4Q10 would provide welcome, tangible evidence of progress on accession.

No change to sovereign rating expected

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

Croatia

Outlook – With the fall in GDP largely at an end, the question now is how strong the recovery might be. The main positive we see for 2011 is the expected completion of EU accession talks, which could generate the confidence needed to spur a new investment cycle. With the general election not due until early 2012, the probability of most meaningful reforms being delayed until 2012 has risen, with higher political risk in the near term likely to manifest itself in fiscal policy trends. For these reasons, and despite the progress on EU accession, we expect only a gradual recovery in growth in 2011.

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

MACROECONOMIC DATA AND FORECASTS

	2007	2008	2009	2010F	2011F
GDP (EUR bn)	42.8	47.4	45.4	45.6	47.1
Population (mn)	4.4	4.4	4.4	4.4	4.4
GDP per capita (EUR)	9,654	10,681	10,245	10,299	10,641
GDP (constant prices yoy %)	5.5	2.4	-5.8	-1.5	1.6
Private Consumption, real, yoy (%)	6.2	0.8	-8.5	-2.5	1.2
Fixed Investment, real, yoy (%)	6.5	8.2	-11.8	-6.6	3.5
Public Consumption, real, yoy (%)	3.4	1.9	0.2	-0.5	0.0
Exports, real, yoy (%)	4.3	1.7	-16.3	3.3	1.7
Imports, real, yoy (%)	6.5	3.6	-20.7	-1.3	1.4
CPI (average, yoy %)	2.9	6.1	2.4	1.0	2.5
Monthly wage, nominal (EUR)	961	1,044	1,050	1,058	1,072
Unemployment rate (%)	9.6	8.4	9.4	10.5	10.2
Budget balance (% of GDP)	-2.0	-1.4	-3.9	-6.5	-6.0
Current account balance (EUR bn)	-3.2	-4.3	-2.4	-1.7	-1.8
Current account balance (% of GDP)	-7.6	-9.2	-5.4	-3.7	-3.9
Net FDI (EUR bn)	3.5	3.2	1.0	1.4	1.8
FDI (% of GDP)	8.1	6.8	2.1	3.0	3.7
Gross foreign debt (EUR bn)	32.9	40.0	44.6	46.0	48.5
Gross foreign debt (% of GDP)	76.9	84.4	98.2	100.8	102.9
FX reserves (EUR bn)	9.3	9.1	10.0	10.7	11.5
(Cur.Acc-FDI)/GDP (%)	0.6	-2.3	-3.3	-0.7	-0.2
FX reserves/Gross foreign debt (%)	28.3	22.8	22.4	23.3	23.7
Exchange rate to USD eop	5.03	5.29	5.09	5.10	5.03
Exchange rate to EUR eop	7.33	7.37	7.30	7.30	7.35
Exchange rate to USD avg	5.35	4.91	5.26	5.42	5.14
Exchange rate to EUR avg	7.34	7.22	7.34	7.27	7.32

Source: UniCredit Research

STRENGTHS

- EU accession talks nearing completion
- External imbalances narrowing
- Currency stable

WEAKNESSES

- Influence of political cycle on reform agenda
- Widening fiscal deficit
- Domestic demand

Improving trends but extent of recovery uncertain

Fall in GDP largely over, extent of recovery still uncertain

Growth returns in 3Q10. After a contraction of 2.5% yoy in 1H10, high-frequency data point to a better 3Q10. Retail trade expanded by 0.7% yoy in real terms in July, the first increase in 24 months, and we expect a further rise in 4Q10, with the higher solidarity tax rate of 4% set to be abolished in late October. Anecdotal evidence from the tourist season points to a solid result, but industrial production remains negative (-0.7% yoy in working-day-adjusted terms in August), although in July and August the mom trend finally turned positive. Inflationary pressures are muted, with headline inflation at just 1.0% yoy in August. We believe the fall in GDP is largely over, noting that the extent of recovery remains uncertain at this point.

Inflation forecast lowered from 2.9% to 2.5%, other key forecasts for 2011 unchanged

Inflation forecast for 2011 lowered to 2.5%. Our main forecasts for 2010 are unchanged; for 2011 we project growth of 1.6%, inflation of 2.5% (previously 2.9%), and a current account deficit below 4% of GDP, all of which reflects underlying weak domestic demand. The main positive we see for 2011 is the expected completion of EU accession talks, which could generate the confidence needed to spur a new investment cycle. With the general election not due until early 2012, the probability of most meaningful reforms being delayed until 2012 has risen, with higher political risk in the near term likely to manifest itself in fiscal policy trends. For these reasons, and despite the progress on EU accession, we expect only a gradual recovery in growth in 2011.

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

Minimal foreign debt growth in 1H10. In 1H10 foreign debt rose just EUR 300mn, and we project gross external debt increasing by only 2.5pp GDP yoy to 100.8% as of end-2010. We expect the basic balance (current account net FDI) to narrow to -0.7% of GDP, which would augur well for near-term EUR/HRK stability; therefore, our monetary policy expectations are as before, and we expect no changes in the coming quarters to the current low money market rates.

Disappointing supplementary budget points to slower decline in fiscal deficit in 2011

Focus in 4Q on next year's budget. We expect 4Q10 to feature preparations for the 2011 budget. Public sector salaries and pensions are to be capped in 2011, with debate in 4Q10 over fiscal responsibility legislation assuming greater importance, especially if the discussions to exclude the public health institute (HZZO) from the 2011 fiscal accounts materialize (we estimate the 2010 cost of budget transfers to the HZZO at HRK 2.5bn). Revenue growth is currently poor, while the lack of reform initiatives in September's supplementary budget points to a slower reduction in the fiscal deficit in the forecast period; if the government embarks on a restrictive budget course following the elections, we would expect the deficit to narrow to 4.5% of GDP in 2012.

Weak government as election year approaches suggests near-term policy risks

Conventional wisdom suggests EU accession talks should be completed in 1H11, but... In 3Q10 the government raised expectations that it would hand down a restrictive supplementary budget, implementing many of the measures in its Economic Recovery Program. The timid supplementary budget and subsequent retraction of pension reform proposals in late September illustrated the government's weakness, following the success of the unions' referendum initiative, inspired by labor law amendments (see previous CEE Quarterly). The government faces politically challenging decisions in the coming months in competition policy (shipyards) and legal affairs areas, if EU accession talks are to be completed on schedule. While our baseline scenario envisages this, we believe the risk of this not occurring is not insignificant.

No change to credit rating

We expect no change to Croatia's credit rating. Successful completion of the EU accession talks would be a major plus for Croatia, but without measures to ensure a more sustainable medium-term fiscal position and an increase in private sector investment in the nearer term, we would not expect Croatia's credit rating to change.

Kazakhstan

Outlook – A sharp increase in net exports helped lift real GDP growth to 8.0% yoy in 1H10. Thanks to higher prices and volumes, exports grew impressive 71% yoy in USD terms, while imports remained unchanged. We increase our 2010 GDP forecast from 5% to 6.3%, reduce however our 2011 forecast from 6.0% to 4.5% because of the higher 2010 base, weaker global growth than previously assumed and some slow-down since mid-year in seasonally adjusted month on month growth in industrial production.

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

MACROECONOMIC DATA AND FORECASTS

	2007	2008	2009	2010F	2011F
GDP (EUR bn)	76.1	89.8	77.3	97.0	107.1
Population (mn)	15.5	15.7	16.2	16.3	16.5
GDP per capita (EUR)	4,912	5,729	4,772	5,933	6,492
GDP (constant prices yoy %)	8.9	3.3	1.2	6.3	4.5
Private Consumption, real, yoy (%)	10.8	3.8	-2.8	3.1	5.4
Fixed Investment, real, yoy (%)	17.3	1.7	1.9	0.8	6.3
Public Consumption, real, yoy (%)	14.0	5.5	1.1	2.4	3.1
Exports, real, yoy (%)	9.0	0.8	-6.2	12.0	5.0
Imports, real, yoy (%)	25.8	-11.5	-15.9	10.0	16.0
CPI (average, yoy %)	10.8	17.2	7.3	7.2	7.4
Central bank reference rate	11.00	10.50	7.00	7.25	7.25
Monthly wage, nominal (EUR)	313	343	329	396	437
Unemployment rate (%)	7.6	6.6	6.6	5.9	5.6
Budget balance (% of GDP)	5.2	1.2	-4.3	-4.1	-2.0
Current account balance (EUR bn)	-6.0	4.7	-2.4	4.1	-2.2
Current account balance (% of GDP)	-7.9	5.3	-3.2	4.3	-2.0
Net FDI (EUR bn)	8.1	9.9	9.0	9.7	8.8
FDI (% of GDP)	10.7	11.0	11.7	10.0	8.2
Gross foreign debt (EUR bn)	65.8	79.9	75.5	77.1	77.7
Gross foreign debt (% of GDP)	86.5	88.9	97.7	79.5	72.5
FX reserves (EUR bn)	12.7	14.8	15.9	21.0	23.4
(Cur.Acc+FDI)/GDP (%)	2.8	16.3	8.5	14.3	6.2
FX reserves/Gross foreign debt (%)	19.3	18.5	21.0	27.3	30.1
Exchange rate to USD eop	120.68	120.88	148.36	144.00	140.00
Exchange rate to EUR eop	175.99	168.66	212.61	205.92	204.40
Exchange rate to USD avg	122.54	120.32	147.65	146.73	142.00
Exchange rate to EUR avg	167.99	176.98	205.89	196.82	202.24

Source: UniCredit Research

STRENGTHS

- Strong rebound in manufacturing
- High increase in net exports
- Successful restructuring of foreign debt of BTA and Alliance

WEAKNESSES

- Solution for poor quality bank assets not in sight
- No credit growth yet, net interest income of banks declines
- Investment activity still subdued

Fast recovery in 2010, more moderate growth in 2011

GDP grew 8% yoy in 1H 2010

Strong rebound in manufacturing

We increase our 2010 GDP forecast from 5% to 6.3%, but reduce our 2011 forecast from 6.0% to 4.5%

Real GDP grew 8.0% yoy in 1H10, which translates into 8.8% yoy in 2Q10, according to our estimates, following 7.1% yoy growth in 1Q10. Constant price gross value added (GVA) increased 3.1% yoy in agriculture, 6.3% in mining, and 18.3% in manufacturing, but contracted 3.9% in construction and 6.4% in financial intermediation. Total services GVA grew 4.8%. Industrial output rose 10.9% yoy for 8M10, with mining up 5.8% and manufacturing 19.1%, while constant price retail sales increased 13.5% yoy. The strong performance of industry, the large foreign trade surplus, and substantial real income growth (4.6% yoy in 7M10) prompt us to once again upgrade our 2010 GDP forecast, from 5.0% yoy growth to 6.3%. However, we reduce our 2011 forecast from 6.0% to 4.5%, because of the higher 2010 base and global growth that may be lower than previously expected. Drivers are set to shift from net exports to domestic demand.

Inflation broadly within target despite drought

Inflation was 6.5% yoy in August, well within the central bank's 6%-8% target corridor. However, as a result of the drought in western Kazakhstan and in many grain-exporting countries (particularly Russia), and due to tariff hikes, December inflation might come in marginally above target. The reaction of the NBK, if any, is likely to be moderate.

Fiscal tightening, but high infrastructure spending should keep negative growth effect limited

We keep our broad fiscal deficit forecast, taking into account Oil Fund Spending on government sponsored programs, at 4.1% of GDP, 2% and 1% for 2010, 2011, 2012

Kazakhstan is preparing to phase in fiscal tightening. The Finance Ministry published some details of the draft budget for 2011-2013: revenues should amount to roughly 20% of GDP for all three years (we estimate revenues over 7M10 reached 18.6% of GDP). Transfers from the Oil Fund are to contribute 7.1% of GDP in 2011 vs. 8.5% this year. The growth in revenues would mainly come from a hike in the oil export duty from USD 20 to USD 40 per ton, and from higher customs income (Kazakhstan receives 7.33% of the proceeds of the Customs Union with Russia and Belarus). The personal income tax rate should change from the current 10%, to 15% and then 20%, although this remains under discussion. Spending on education and health receive particular mention. Spending under the government's "Accelerated industrialization and modernization" program should come to KZT 1,745bn (EUR 9.2bn) over the three years, with KZT 708bn going to road construction and KZT 586bn to agriculture. Thanks to the rather strong multiplier effects from infrastructure investment, fiscal tightening should not impact growth too much, in our opinion.

Declining interest income and higher investment should finally lift credit growth in 2011, despite low credit quality.

Loans to clients fell 2.5% YTD as of August. Portfolio quality has remained low and uncertainty about future regulation remains (regarding capital adequacy and consumer protection), which keeps banks risk-averse. They are using liquidity to repay foreign debt or state liquidity support and to purchase (rather low-yielding) securities. Sharply declining net interest income (by 57% yoy in Jan-July) should combine with some pick-up in investment to finally renew credit growth in late 2010 or early 2011. Some USD 11bn (8.5% of GDP) of foreign debt forgiveness for BTA and Alliance, finalized in August, should also help. There are also signs – albeit weak ones – of the real estate market beginning to revive: small increases in apartment prices and, since June, in the stock of mortgage loans.

Large CA surplus, continued strong FDI inflows

We revise our 2010 eop KZT forecast, but continue to believe in basic balance-driven appreciation.

Thanks to both higher prices and volumes, exports grew 71% yoy in USD terms in 1H10, while imports remained unchanged, according to preliminary balance of payments statistics. The low import readings are in part the result of the Customs Union, which favors production within Kazakhstan because of higher tariffs vis-à-vis third countries and a lower VAT rate than in Russia. The C/A had a USD 5.7bn surplus in 1H10 vs. a USD 3.5bn deficit a year earlier. Net inward FDI was USD 5.0bn in H1, 2.7% higher yoy. The KZT has stopped appreciating against the USD in June, although the NBK has not intervened. The NBK's net international reserves peaked at USD 28.8bn in April, declining to USD 26.4bn by August. One explanation for this is investment by the Oil Fund, whose foreign assets reached an all-time high of USD 28.4bn in August. Banks have also placed part of their excess liquidity abroad and stopped repatriating foreign assets. We revise our 2010 eop KZT/USD forecast of 139 to 144, but believe that appreciation pressures will reemerge in 2011 because a strongly positive basic balance (C/A+FDI).

Russia

Outlook – The worst droughts and wildfires in nearly a century have intensified adverse trends of slowing economic growth and rebounding inflation, as well as all but eliminating most upside risks of a stronger economic recovery in 2010. Rising inflation is also expected to undermine economic growth in 2011 and trigger a cumulative 150bps rate hike starting from 1Q11. Meanwhile, the RUB is likely to remain weak in 4Q10 on deteriorating fundamental support, whereas rates should start to recover on rising public borrowing.

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

MACROECONOMIC DATA AND FORECASTS

	2007	2008	2009	2010F	2011F
GDP (EUR bn)	945.2	1,136.7	877.9	1,138.2	1,232.6
Population (mn)	142.0	141.6	141.3	141.0	140.4
GDP per capita (EUR)	6,656	8,027	6,213	8,072	8,777
GDP (constant prices yoy %)	8.5	5.2	-7.9	3.4	4.2
Private Consumption, real, yoy (%)	14.3	10.8	-7.7	3.8	6.2
Fixed Investment, real, yoy (%)	22.7	9.9	-16.2	3.0	7.0
Public Consumption, real, yoy (%)	2.7	2.8	2.0	0.6	-3.0
Exports, real, yoy (%)	6.3	0.6	-4.7	1.1	1.7
Imports, real, yoy (%)	26.2	14.8	-30.4	19.6	5.1
CPI (average, yoy %)	9.0	14.1	11.7	6.7	9.0
Central bank reference rate	6.05	8.50	6.00	5.00	6.50
Monthly wage, nominal (EUR)	386	471	420	511	557
Unemployment rate (%)	5.6	6.3	8.4	7.9	7.3
Budget balance (% of GDP)	6.0	4.9	-8.6	-6.0	-5.1
Current account balance (EUR bn)	57.4	70.2	34.9	51.7	32.6
Current account balance (% of GDP)	6.1	6.2	4.0	4.5	2.6
Net FDI (EUR bn)	38.3	28.7	21.3	25.5	30.6
FDI (% of GDP)	4.1	2.5	2.4	2.2	2.5
Gross foreign debt (EUR bn)	314.0	340.8	329.8	333.0	314.7
Gross foreign debt (% of GDP)	33.2	30.0	37.6	29.3	25.5
FX reserves (EUR bn)	326.4	302.9	307.3	314.6	304.0
(Cur.Acc-FDI)/GDP (%)	10.1	8.7	6.4	6.8	5.1
FX reserves/Gross foreign debt (%)	104.0	88.9	93.2	94.5	96.6
Exchange rate to USD eop	24.64	30.53	30.04	29.74	29.00
Exchange rate to EUR eop	35.93	42.59	43.04	42.53	42.34
Exchange rate to USD avg	25.55	24.78	31.65	30.15	29.02
Exchange rate to EUR avg	35.02	36.46	44.13	40.44	41.33

Source: UniCredit Research

STRENGTHS

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

WEAKNESSES

- Dependence on commodities prices
- Structural inefficiencies, lack of domestic investment resources
- High NPL ratios

Drought dries up risks of stronger recovery

Adverse weather conditions intensify negative trends in the economy, limiting potential upside risks

Summer has added natural disasters to a list of factors constraining economic recovery. The worst droughts and wildfires in nearly a century triggered a drastic drop in domestic agricultural production, a strong rise of food prices, the introduction of an export ban on wheat, and ultimately seems to have undermined the recovery of both consumer and investment demand. However, we believe the impact of the weather only intensified an already existing trend of broader economic slowdown, rather than launch it, although it also eliminated most of the remaining upside risk for a robust economic recovery in 2010.

Inflation is likely to continue to accelerate well into 2011

We recently hiked our inflation outlook to 8.3% yoy for 2010 eop, and 8.2% yoy for 2011 eop, in order to reflect the impact of the drought. However, we reiterate our view that the weather only triggered the start of price increases, while the rising money supply – the growth of which accelerated to over 30% yoy in 2Q10 – remains the key fundamental driver of broader inflation. Moreover, we think that the delayed effect of the accumulated money supply increase, as well as a strengthening low base effect, should push inflation up to nearly 10% by next summer, and to 9% on average for 2011.

Adverse trends and speculative factors undermine the RUB in the short term…

…but deteriorating fundamentals should continue to keep RUB weak in 4Q10

The drought also supports our forecast of RUB 35.5/basket for 2010 eop, which we keep unchanged at the moment. In fact, the RUB recently dipped below our year-end forecasts on a combination of technical and speculative factors. Even though this sharp weakness is likely to be short-lived, we think that the currency is likely to remain weak in 4Q10, due to a continued deterioration of fundamental support. As a result of the wheat export ban and very modest 10% increase of food imports due to decline of domestic production, we estimate the Russian trade surplus for the remaining 4M of the year should shrink by about USD 6-8bn, or by 10%-15% at the very least. As a result, the current account surplus, which has already shrunk to less than USD 8.7bn – down from some USD 33.5bn in 1Q10 – could continue to narrow even further, even with stable oil prices.

Rising imports contribute to the general economic slowdown

No major upsides from revision of historical data

Rising imports and accelerating inflation also support our expectations for a further slowdown of economic growth in 2010. Therefore, we keep our conservative outlook for 3.4% real GDP growth in 2010 unchanged. According to government estimates, real GDP growth has already slowed to just 2.4% yoy in August, down from some 5.2% yoy in 2Q10. We reiterate that adverse weather has only intensified the slowdown due to the persistent weakness of investment demand, the rapid expansion of imports, the expected reversal of fiscal stimulus in late 2010, and a rapidly fading low base effect. We also note that Federal Statistics Service has revised 1Q10 data only marginally, 2.9% yoy growth to 3.1%, and kept its 2Q10 estimate unchanged at a rather modest 5.2% yoy, effectively eliminating the last major upside risk to our conservative growth outlook.

2011 outlook cut to 4.3% on rising inflation

We cut our real GDP outlook for 2011 to 4.3% yoy growth, down from the previous 5.0%, mostly because of the 2.3pp hike in our forecast for inflation, which should constrain the recovery of consumer demand and undermine the real growth of public spending (despite slightly more aggressive spending targets). However, we slightly increased our outlook for investment to a more optimistic 7%, due to restart of public infrastructure spending.

Rate are due to recover later in the year on expansion of public borrowing and rising inflation…

…but CBR rate hikes are due only in 1Q11

We reiterate our expectations for higher local interest rates due to rising fixed income supply and accelerating inflation. We expect the 3M Mosprime rate to creep above 4% by 2010 eop, and up to 6% as of 2011 eop, because of a planned massive expansion of public borrowing in 4Q10 and 2011. However, the weakening economic recovery might pressure rates in 4Q10. We note that the government has already cut its borrowing outlook for 4Q10 nearly 4X to just RUB 300bn, partly to prevent rate increases. We also expect the CBR to keep rates unchanged in 4Q10, despite rising inflation, in an attempt to aid recovery, but expect a 150bps cumulative hike in 2011, starting with 75bps in 1Q11.

Serbia

Outlook – Growth outlook is improving, with increasing signs of a recovery in domestic demand, especially from the anticipated wage hikes in the public sector. On the back of the latter we see upside risk to the inflation outlook due to domestic demand trends and the ongoing pass-through impact on inflation from the weak currency, to which the National Bank has reacted with tighter monetary policy. We continue to see the EUR/RSD rate exposed to upside risk, given the wider current account deficit (although 2011 privatization revenues should boost the central bank's FX reserves), rising foreign debt and foreign debt service obligations, and inflationary pressures.

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

MACROECONOMIC DATA AND FORECASTS

	2007	2008	2009	2010F	2011F
GDP (EUR bn)	28.8	33.4	30.5	30.0	29.4
Population (mn)	7.4	7.4	7.3	7.3	7.2
GDP per capita (EUR)	3,900	4,545	4,178	4,128	4,060
GDP (constant prices yoy %)	6.9	5.5	-3.0	1.5	2.7
CPI (average, yoy %)	6.5	11.7	8.4	5.8	7.2
Central bank reference rate	10.00	17.75	9.50	9.50	10.50
Monthly wage, nominal (EUR)	484	561	470	460	443
Unemployment rate (%)	18.1	13.7	16.1	20.0	18.8
Budget balance/GDP (%)	-1.6	-2.0	-4.2	-4.7	-4.0
Current account balance (EUR bn)	-4.6	-6.1	-1.7	-2.3	-2.7
Current account balance (% of GDP)	-16.0	-18.2	-5.7	-7.8	-9.2
Net FDI (EUR bn)	1.8	1.8	1.4	1.0	2.5
FDI (% of GDP)	6.3	5.5	4.5	3.3	8.5
Gross foreign debt (EUR bn)	17.8	21.8	22.8	24.0	26.0
Gross foreign debt (% of GDP)	61.8	65.3	74.6	79.9	88.4
FX reserves (EUR bn)	9.6	8.2	10.6	10.0	11.0
(Cur.Acc-FDI)/GDP (%)	-9.7	-12.8	-1.2	-4.4	-0.7
FX reserves/Gross foreign debt (%)	54.2	37.4	46.5	41.7	42.3
Exchange rate to USD eop	54.03	64.34	67.11	76.92	82.19
Exchange rate to EUR eop	78.79	89.78	96.17	110.00	120.00
Exchange rate to USD avg	58.34	55.40	67.45	76.41	80.75
Exchange rate to EUR avg	79.98	81.49	94.05	102.50	115.00

Source: UniCredit Research

STRENGTHS

- Merchandise exports picking up
- Industrial production accelerating
- Progress made on EU accession

WEAKNESSES

- Depreciating currency hangs over inflation forecast
- External imbalances in focus as domestic demand rises
- Lower FDI inflows drive higher basic balance deficit

External imbalances more important as domestic demand picks up

More and more signs of stronger domestic demand

Recovery continues. In 2Q10 the economy grew 2% yoy, with seasonally adjusted qoq data revealing a strong rise of 0.8%. Apart from the usual suspects, transport and communication, the main boost to growth came from industrial production and financial intermediation; the construction industry remains in deep recession. Data for 3Q10 also point to continuing recovery: industrial production in seasonally adjusted mom terms rose in July and August, retail sales were up 2.8% yoy in July in real terms, and real wages grew by 1.8% yoy in August. Subsidized loans to industry and, more recently, to households appear to be bearing fruit. Bottom line: there are increasing signs of a recovery in domestic demand.

With stronger growth comes the risk of wider external imbalances and higher inflation

Growth outlook improves, year-end inflation target in jeopardy. We have revised our growth forecast for the year to 1.5% on 1H10 GDP data and the high-frequency data available to date for 3Q10. We also expect stronger growth (2.7%) in 2011, but believe rising domestic demand (public sector salaries and pensions should rise by up to 6% in 2011) should be reflected in a larger current account deficit: 7.8% of GDP this year and 9.2% in 2011. We also see upside risk to the inflation outlook due to domestic demand trends and the ongoing pass-through impact on inflation from the weak currency. As a result, our year-end forecasts for consumer prices are now 8.3% yoy in 2010 and 6.4% in 2011.

Further rate hikes on the way

Tighter monetary policy in response to weaker currency. After increases of 100bp in August and September, we expect the National Bank of Serbia to raise interest rates once more in 2010 – by 50bp to 9.5%, as inflation trends higher towards the end of the year. We expect policy rates to peak at 11.5% in 2Q11 and, as inflationary pressures ease, to be cut to 10.5% by end-2011. We continue to see the EUR/RSD rate exposed to upside risk, given the wider current account deficit (although 2011 privatization revenues should boost the central bank's FX reserves), rising foreign debt and foreign debt service obligations, and inflationary pressures (this year and next we expect consumer prices to exceed the central bank's target range). Serbia's economy is strongly oriented towards the Eurozone, so we view a stable currency as a key to tempering inflationary pressures. The main argument in favor of the RSD is that rising yields on t-bills (we see a further increase of 85bp from current levels by end-2010 and a cumulative 200bp in 1Q11) should increasingly tempt inflows.

IMF program on target as fiscal responsibility legislation

Fiscal responsibility legislation in place of IMF program. In late September the IMF approved the fifth review of Serbia's current program, opening the way for a disbursement of EUR 366.5mn. The key fiscal policy event is the submission of fiscal responsibility legislation that assumes a medium-term general government deficit of 1% of GDP (IMF definition) and medium-term trend growth of 4%. Importantly, it builds in sensitivity to the cyclical deficit and sets a limit of 45% of GDP for public debt. The legislation is intended to improve the credibility of fiscal policy once the current IMF program ends in April 2011. With general elections due by May 2012, this is important legislation. We note that the poor demand for t-bills amid RSD weakness in recent months led the government in late September to borrow EUR 250mn to finance the budget gap.

EU to discuss candidate country status in October

Candidate country status application to be discussed on 26 October. In early September Serbian authorities managed at the eleventh hour to agree the text on a resolution submitted to the UN General Assembly on Kosovo with the EU and US. As a result, Serbia avoided the prospect of a freeze on EU accession, with the EU's decision on its application for candidate country status due on 26 October. A successful IMF program, progress on EU accession, and fiscal responsibility legislation point to a stable credit rating for Serbia, despite higher external liability risk as domestic demand picks up.

Turkey

Outlook – Growth performance remains solid and political risk is now mitigated, following the referendum in September – the AKP should be better positioned to maintain the single-party government structure after the general election in June 2011. In terms of growth, we believe Turkey will outperform its regional peers, and for more than one year. We expect the CBRT to start increasing rates at end-1Q11, right after inflation dips to around 5%.

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

MACROECONOMIC DATA AND FORECASTS

	2007	2008	2009	2010F	2011F
GDP (EUR bn)	473.2	499.5	442.7	552.0	598.2
Population (mn)	70.6	71.5	72.6	73.4	74.2
GDP per capita (EUR)	6,703	6,985	6,101	7,523	8,064
GDP (constant prices yoy %)	4.7	0.7	-4.7	7.0	4.1
Private Consumption, real, yoy (%)	4.6	0.5	-2.3	6.0	3.5
Fixed Investment, real, yoy (%)	5.4	-8.2	-19.2	16.0	9.0
Public Consumption, real, yoy (%)	6.5	1.7	7.8	3.5	3.0
Exports, real, yoy (%)	7.3	2.7	-5.4	8.0	4.0
Imports, real, yoy (%)	10.7	-4.2	-14.4	18.0	7.0
CPI (average, yoy %)	8.8	10.5	6.3	8.4	6.0
Central bank reference rate	15.75	15.00	6.50	7.00	8.25
Monthly wage, nominal (EUR)	711	734	634	762	871
Unemployment rate (%)	10.3	11.0	14.0	11.6	10.7
Budget balance (% of GDP)	-1.6	-1.8	-5.5	-3.4	-3.2
Current account balance (EUR bn)	-28.0	-28.2	-10.0	-26.9	-30.7
Current account balance (% of GDP)	-5.9	-5.6	-2.3	-4.9	-5.1
Net FDI (EUR bn)	16.1	12.3	4.1	6.0	7.3
FDI (% of GDP)	3.4	2.5	0.9	1.1	1.2
Gross foreign debt (EUR bn)	182.2	188.6	192.9	224.9	241.7
Gross foreign debt (% of GDP)	38.5	37.8	43.6	40.8	40.4
FX reserves (EUR bn)	48.4	50.2	49.3	57.5	56.6
(Cur.Acc-FDI)/GDP (%)	-2.5	-3.2	-1.3	-3.8	-3.9
FX reserves/Gross foreign debt (%)	26.6	26.6	25.6	25.6	23.4
Exchange rate to USD eop	1.17	1.54	1.49	1.43	1.41
Exchange rate to EUR eop	1.71	2.15	2.14	2.05	2.06
Exchange rate to USD avg	1.30	1.30	1.55	1.50	1.43
Exchange rate to EUR avg	1.79	1.91	2.16	2.01	2.04

Source: UniCredit Research

STRENGTHS

- Solid financial sector improving on the back of recovery
- Impressive fiscal performance
- Political risk mitigated following the September referendum

WEAKNESSES

- Reliance on external financing for growth purposes
- Rapid increases in the C/A deficit as the economy recovers
- EU convergence process stalled

Impressive growth, but momentum loss likely ahead

Solid growth and lower political risk

We used the title "Impressive growth performance amidst exaggerated political risk" for the Turkey section of the previous CEE Quarterly, and we seem to have had more of the same, with one important change: **political risk is no longer exaggerated, following the ruling AKP's hands-down victory** in the referendum on constitutional reform.

GDP growth in 2Q10 was stronger than expected at 10.3%, corresponding to a seasonally and calendar-effect adjusted qoq figure of 3.7%. The 32.1% yoy growth in private investment expenditures was surprisingly high but more than welcome, as that category had been a major depressant of growth since 2008. Private consumption growth of 6.2% was also robust.

We revise growth upward for 2010, downward for 2011

Our revised growth forecast for 2010 is 7%, but our change for next year is in the opposite direction (forecast cut to 4.1%. Betting on further normalization in global financial markets and enhanced opportunities for external financing in 2012, we expect growth to resume and move above 5%. Unemployment continues to fall: the unadjusted figure decreased by 0.5pp mom (2.5pp yoy) to 10.5% in June. We are encouraged to see unemployment falling steadily amid rising labor-force participation (finally reaching 50%).

Annual inflation stands at 8.3%, following the higher-than-expected 0.4% increase in August due almost entirely to food price hikes. The global food inflation threat appears to be quite real, with the Turkish case much more volatile than similar economies. The central bank has warned of a possible surge in unprocessed food prices in October, adding that it would likely be temporary. We expect year-end inflation to fall to 7.2%, followed by significant reductions in Jan-Feb 2011.

Food prices to have stronger effect in October

The CBRT has started implementing an exit policy, reversing some of the measures it took during the crisis, the latest being the increase in required TRY and FX ratios, which aim at reducing liquidity gradually. **We expect the CBRT to start increasing rates in late 1Q11,** just before the base effect stops supporting disinflation dynamics and right after inflation dips to around 5% (possibly 4%). Signaling too late could prove costly, just as signaling too early could create an environment that is precisely the opposite of what you want to prevent, i.e., one in which expectations of higher inflation are rejuvenated. The CBRT is already changing its tone on the monetary policy outlook, emphasizing risks more than before. The CBRT's latest move was widening the spread between the overnight rate and the one-week repo rate by 25bp, noting that further reductions in the borrowing rate are possible to widen the gap between the overnight borrowing and lending rates to reduce the overfunding to the market and leave less end-day excess liquidity.

Exit policy: higher rates in the cards

Highly favorable fiscal performance

Fiscal performance in 8M10 has been nothing short of spectacular, with the cumulative budget deficit at TRY 14.4bn and the primary surplus at TRY 20.9bn; year-end targets are TRY 50.2bn and TRY 6.6bn respectively. The government has created significant breathing room for itself on the fiscal front, thanks to the strong recovery and the ensuing revenue increase. The margin may be used somewhat going forward, but we would not expect it to be abused: fiscal slippage expectations circulated incessantly as the elections approached, but we believe they were totally unfounded. Moreover, the strong showing by the AKP in the referendum suggests that populist expenditures are not required to generate support for the party.

Another vote of confidence for the AKP

We see the referendum results on the constitutional reform package as the final seal of approval for the AKP government, the fight against which was turned into a plebiscite. Clearly, the AKP is the unequivocal winner of the referendum; the 58%-42% outcome points to a discernible spread between AKP supporters and rivals, and we believe the AKP can likely maintain the single-party government structure following the general election next June.

Ukraine

Outlook – Active preparations for EURO 2012 are stimulating construction and improvements in the dilapidated infrastructure, which in our view ought to be one of the key drivers of growth in the run-up to the games, with trickle-down effects on the rest of the economy. We expect to see growth at around 5% in 2011 and 2012, but also assume that the government will go ahead and push through much-needed fiscal and structural reforms, which should start a cycle of modernization.

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

MACROECONOMIC DATA AND FORECASTS

	2007	2008	2009	2010F	2011F
GDP (EUR bn)	103.1	123.4	81.4	105.8	125.9
Population (mn)	46.6	46.4	46.1	45.8	45.5
GDP per capita (EUR)	2,210	2,661	1,766	2,312	2,765
GDP (constant prices yoy %)	7.6	2.1	-15.1	3.5	5.0
Private Consumption, real, yoy (%)	17.1	11.6	-14.2	1.5	4.5
Fixed Investment, real, yoy (%)	24.8	4.2	-46.2	8.0	17.0
Public Consumption, real, yoy (%)	2.8	-0.4	-8.8	1.5	0.7
Exports, real, yoy (%)	2.8	6.7	-25.6	9.0	10.0
Imports, real, yoy (%)	20.2	17.5	-38.6	8.5	14.0
CPI (average, yoy %)	12.8	25.2	16.0	9.2	11.5
Central bank reference rate	8.00	12.00	10.25	8.25	9.25
Monthly wage, nominal (EUR)	195	234	170	208	242
Unemployment rate (%)	6.4	6.4	8.8	7.2	6.4
Budget balance (% of GDP)	-1.4	-1.3	-11.3	-6.0	-5.2
Current account balance (EUR bn)	-4.0	-8.8	-1.4	0.0	-0.7
Current account balance (% of GDP)	-3.9	-7.1	-1.7	0.0	-0.5
Net FDI (EUR bn)	6.3	7.3	3.2	4.2	6.4
FDI (% of GDP)	6.1	5.9	3.9	4.0	5.1
Gross foreign debt (EUR bn)	56.2	75.1	72.6	77.4	80.7
Gross foreign debt (% of GDP)	54.6	60.8	89.1	73.1	64.1
FX reserves (EUR bn)	21.6	19.9	17.9	24.8	27.4
(Cur.Acc-FDI)/GDP (%)	2.2	-1.2	2.2	4.0	4.5
FX reserves/Gross foreign debt (%)	38.4	26.6	24.7	32.1	34.0
Exchange rate to USD eop	5.09	7.81	8.01	7.65	7.25
Exchange rate to EUR eop	7.42	10.90	11.48	10.94	10.59
Exchange rate to USD avg	5.05	5.24	8.06	7.88	7.45
Exchange rate to EUR avg	6.92	7.70	11.24	10.57	10.61

Source: UniCredit Research

STRENGTHS

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

WEAKNESSES

- Slow fiscal consolidation
- Ageing population
- Divided society

Growth as a function of reform

Good growth in 2010 on base effects

Robust growth of close to 6% yoy in 1H10 is linked to significant base effects; the economy should slow to more moderate levels of growth in 2H10, bringing the 2010 tally to at least 3.5% yoy. Even as the industry-export side of the economy has benefited most from the recent improvements – industrial production is up by an average 10.7% yoy in 8M10 – we are starting to see domestic demand pick up: 8M retail sales were up 4.6% yoy, and real wages were up 12.3% yoy in August. Active preparations for EURO 2012 are stimulating construction and improvements in the dilapidated infrastructure, which in our view ought to be one of the key drivers of growth in the run-up to the games, with trickle-down effects on the rest of the economy. The mix of decent growth in trade partners and recovering domestic demand ought to keep growth at around 5% in 2011 and 2012 according to our estimates – to consistently achieve these higher rates of growth, we would need to see an increase in productivity (most likely through embracing new technologies). Thus, one of the key underlying assumptions behind our benign GDP forecast is that the government will go ahead and push through much-needed fiscal and structural reforms, something that was implied in the recent World Bank report, which should start a cycle of modernization.

EURO 2012 preparation stimulating the economy…

…but reform key to reaching long-term 5% growth

IMF program to keep government in a straitjacket

The 2011 budget has not yet been presented to the public, with the delay linked to ongoing discussions around the new tax law, which ought to be passed in the coming weeks – but comment suggest that the process may drag itself out to year-end. However, the fact that the new government has been able to gain trust from both the IMF (a new USD15bn stand-by agreement was signed over the summer months) and international investors (the September EUR 2bn Eurobond was 3X oversubscribed) diminishes our earlier worries about financing – something that has been reflected in declining CDS premia and falling rates on government borrowing. Meanwhile recent comments from the IMF sound reassuring, and we think the next USD 1.5bn tranche ought to be disbursed without too many surprises. According to the IMF program, the 2011 deficit should be no larger than 3.5% of GDP and include unpopular reforms. We believe the fact that the government needs the IMF should keep it in a straightjacket, and force to implement unpopular reforms, e.g. estimates suggest that at current gas prices, another 50% hike for the population would be needed to bring them to market levels (the IMF would want to see this happening from 1 April 2011).

Unpopular reforms to continue in 2011

Inflation remains in check but will accelerate in 2Q-4Q11

The inflation outlook is a worry for the coming quarters following the significantly higher September print, with yoy rates set to continue to rise. Real risks to inflation are, in our view, more present during 2Q-4Q11 when the implementation of reforms should begin and the low base effect from a benign 2010 starts to kick in, pushing inflation to 13%-15% yoy. We believe it will be important to keep inflationary expectations in check by that time, so a tighter monetary policy should result (we expect a 50bps hike from the NBU in 2010, and another 100bps in 2011). However, we also think that the NBU will in the end opt out to allow some nominal appreciation to counteract some of the inflationary pressures.

C/A broadly balanced, and covered by FDI inflows

The current account has been fairly balanced in 2010 on good demand for commodity exports (metals and chemicals) and weaker imports. However, the pick-up in economic activity should widen the deficit in the coming quarters; this should not be a problem given the robust FDI flows (our estimates: 4.3% of GDP in 2010, 4.9% in 2011 and 4.5% in 2012), which should fully cover the deficit. Moreover, the anticipated privatization of Ukrtelecom (worth some EUR 1.5bn) should be another large one-off supporting factor. The broadly balanced C/A implies that FX will be primarily influenced by local confidence and capital inflows. With inflows expected to remain good on reforms – something that will also boost local confidence – we would expect to see a marginally stronger UAH in the coming quarters. So far, however, the NBU has been reluctant to allow the UAH to strengthen, instead choosing to buy any excess FX on the market and sell when there is a deficit, keeping the USD/UAH in the 7.9-8.0 range throughout 2010.

Local confidence and capital inflows will drive the direction of the UAH

Notes

Notes

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