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Regional Scenario

Regional outlook 2008–2009

	Real GDP		Inflation eop.		Interest rate eop.			Exchange rate eop.			Current account/ GDP		Fiscal Balance/ GDP	
	2008	2009	2008	2009	2007	2008	2009	2007	2008	2009	2008	2009	2008	2009
Central Europe														
Czech Rep.	4.0	4.5	5.0	2.8	3.50	3.75	4.00	26.6	25.7	25.5	–3.4	–3.1	–2.3	–2.9
Hungary	2.4	2.9	4.9	3.5	7.50	7.50	6.50	253	254	252	–4.4	–4.2	–4.0	–3.2
Poland	5.2	4.4	4.2	2.2	5.00	6.25	5.00	3.58	3.45	3.53	–4.5	–5.2	–2.6	–2.5
Slovakia	6.9	6.0	4.0	4.2	4.25	3.50	ECB	33.6	32.3	EURO	–3.7	–2.9	–2.0	–1.7
Slovenia	4.1	4.0	4.8	2.8	ECB	ECB	ECB	EURO	EURO	EURO	–4.7	–4.8	–1.0	–1.2
Baltics & SEE														
Estonia	2.6	3.2	7.3	6.0	7.2	5.7	5.1	15.65	15.65	15.65	–13.9	–13.9	–0.5	0.0
Latvia	4.7	3.0	10.5	7.0	6.0	5.5	5.0	0.703	0.703	0.703	–17.0	–14.0	0.2	0.2
Lithuania	6.5	5.3	8.2	5.9	7.2	4.2	3.5	3.45	3.45	3.45	–11.9	–11.2	–1.2	–0.9
Bosnia–H.	6.0	5.5	5.0	3.2	–	–	–	1.96	1.96	1.96	–13.8	–13.4	1.9	1.3
Bulgaria	5.6	4.8	7.7	5.2	4.68	5.25	5.50	1.96	1.96	1.96	–20.2	–17.5	3.5	1.7
Croatia	4.3	4.2	5.0	2.8	6.7	6.5	6.5	7.33	7.28	7.28	–9.0	–8.7	–2.6	–2.8
Romania	5.5	5.0	5.8	4.0	7.5	10.0	9.0	3.61	3.58	3.66	–14.2	–13.5	–3.0	–2.9
Serbia	5.0	5.5	10.0	6.7	10.0	17.5	13.0	79.2	82.0	82.5	–14.8	–13.9	–0.6	–0.9
Other Countries														
Kazakhstan	4.5	6.3	10.2	9.0	12.35	8.50	7.50	177.2	170.8	163.4	–1.9	–1.3	–1.0	–1.0
Russia	7.0	6.2	12.5	10.0	5.65	6.00	5.90	35.9	33.3	32.9	5.2	4.3	7.5	7.2
Turkey	4.2	5.0	7.8	5.3	15.75	14.75	13.00	1.71	1.96	2.02	–5.8	–6.0	–1.8	–1.4
Ukraine	5.4	4.6	17.1	9.0	8.0	10.3	6.3	7.42	7.07	6.82	–6.8	–7.4	–1.0	–3.0

Source: UniCredit Group CEE Research Network.

Clouds remain at the international level ...

The turbulence on the financial markets is showing only mild signs of abating and more evidence has emerged that the US economy is strongly slowing down, with mounting pressures on consumers. Indeed, financially overstretched US households are suffering from declining housing wealth, tightening financial conditions and increasing consumer prices. The combined effect of the monetary and fiscal stimulus will provide some relief in the second half of the year. It is clear, however, that this rebound will be short-lived and growth will slow again thereafter, with a likelihood that we will see a protracted period of growth with rates well below potential.

In the Eurozone, the first signs of deceleration are materialising, with April industrial confidence declining in all of the three largest countries (IFO was rising in Q1). While it seems likely that consumer spending will prove resilient and prevent a huge drop in the pace of growth, this will not be able to counterbalance the decline in external demand (also due to euro appreciation) and investment (in the euro area, corporates are more financially exposed than consumers and will be hit harder by the financial turmoil). Finally, but likely only towards the end of 2008, the ECB will cut rates slightly, acknowledging that the growth slowdown will progressively alleviate inflationary pressures coming from commodities (food included); no particular relief will arrive in 2009 and a growth rate of around 1.5 % will likely prevail in both years. In this context, the USD will likely recover somewhat on the back of better

news on the economy in 2008 H2 and thereafter, but only to a limited extent, closing 2008 at around 1.40.

The main risks pertain to the interrelation between the financial strains and the real economy: a pronounced slowdown in the real economy in fact will heighten uncertainty on the financial markets and balance sheet problems for financial institutions, rendering the recovery slower and more problematic.

... but CEE is still able to live up to the challenge

We continue to recognise two main contagion channels for the CEE – namely a tightening of credit conditions, associated with a tightening of capital inflows and the expected lower Eurozone growth. We also believe that international investors' risk aversion may strongly aggravate domestic weaknesses in some countries. International investors are quite nervous and increasingly selective. They actually seem to be searching for signs of potential crisis to play against them and in such a context large current account deficits, poor economic data or political tensions can be even more dangerous.

Still, we believe the region remains in a position to face up to the challenges. We continue to forecast relatively strong economic performance, with growth at 5.6 % in 2008, versus 6.7 % in 2007, and our previous estimate for 2008 of 5.7 %.

Central European countries in a good shape

We keep our yoy growth forecast of 4.7 % in Central Europe, down from 6.0 % in 2007. Despite expected lower Eurozone demand, competitiveness remains good, and we generally see a positive contribution of net exports to growth. On top of that, both investment and consumption, despite moderating, remain supportive. Slovakia, which is ready for Euro adoption in January 2009, will register dynamic 6.9 % growth in 2008 and 6.0 % expansion of GDP in 2009, smoothly driven by both domestic and internal demand. The automotive industry and the electrical and optical equipment sector continue to be the key drivers on the production side, as competitiveness continues to be supported by improving labour market conditions, combined with wage growth still remaining well below productivity growth. We expect a moderate but positive contribution of net exports to growth in the Czech Republic as well, combined with strong positive investment growth overshadowed by a combination of weaker stock-building and especially faltering private consumption, as a consequence of the new tax reform. Overall, growth should settle at around 4 % this year, recovering to some 4.5 % in 2009–2010. In Poland, we forecast 5.2 % growth in 2008, decelerating to some 4.4 % in 2009. The economy is increasingly facing pressures from rising capacity constraints, with higher inflation, higher interest rates and stronger currency weighing on consumption and, to some extent, export performance. Growth should settle around 4 % in both 2008 and 2009 in Slovenia, with some slowing in exports as a consequence of increasingly slack European demand and some moderation in consumption, together with the impact of high inflation, as the Slovenian CPI features the highest growth among all euro area members.

It should be noted that markets are pricing in quite favourable developments in Central Europe. The Slovak, Czech and Polish currencies are all on an appreciation trend, while the 5Y CDS spread stands at 30, 44 and 39 bps respectively. With inflationary pressures high all over the region, due to a large extent to rising international food prices, monetary policies have been rather tight in all the countries. We do not expect further tightening in the Czech Republic, while in Slovakia the Central Bank should start following the ECB interest rates decisions since confirmation of euro adoption. In Poland, we see potential for further two 25bp hikes in rates by the middle of 2008. We also discern some upside risk, amid uncertainty about energy and food prices at the world level.

Hungary remains the tricky country in Central Europe, and is still reaping the consequences of the fiscal correction plan in terms of growth at least. The results in terms of stabilisation in 2007 were better than expected, at the cost of a much slower recovery, while inflationary pressures, combined with political tensions and volatile and selective international capital markets forced the central bank to hike rates by 50 bps at the end of March and by another 25 bps at the end of April, bringing the key rate to 8.25 %. Still a quite tight monetary policy stance is likely in the next few months. We are again revising our growth forecasts from 2.8 % to 2.4 % in 2008, assuming moderate cuts in rates only at the end of the year to 7.5 %. The country is the most sensitive in Central Europe to deterioration in the global environment, as proved by the strong increase in the 5Y CDS spread, which stood at 116 bps in April.

Repricing of risk at the international level triggers a correction of existing imbalances in South Eastern Europe and the Baltics

We forecast some deceleration in growth rates in SEE and the Baltic countries, from 6.8 % in 2007 to 5.3 % in 2008, compared with our previous forecast of 5.7 % for 2008. These are all small, open economies, which have been financing their growth in recent years from external funding, resulting in large current account deficits and widening external debt. Global repricing of risk has hit the region particularly hard, leading to substantial increases in the cost of external funding. We expect the new global environment to bring some cooling, through lower capital inflows or higher cost of external funding, which will also translate into tighter domestic credit conditions, given the local banking system dependency on foreign funding.

Marked deceleration in economic growth already materialising in Estonia and is likely in Latvia and, to a milder extent, in Lithuania

A pronounced slowdown in growth is materialising in the Baltics, following the clear overheating of some of these economies. Reduced capital inflows, a turnaround in the real estate sector, high inflation and interest rates and reduced lending activities in Estonia have already led to a contraction in growth from 6.4 % in Q3 2007 to 4.8 % in Q4 2007 and we expect further deceleration. We forecast growth at around 2.6 % in 2008, with a recovery starting only from 2010. A very similar pattern is expected in Latvia, where short-term economic indicators for the first months of 2008 already point to some slowdown. We forecast growth at 4.7 % this year, declining to 3.0 % in 2009. A turnaround in the real estate segment is materialising, as the number of transactions and prices in the capital city have dropped by almost 18 % in 2007. Skyrocketing inflation and decelerating lending activities are curbing consumption and reduced capital inflows are putting a cap on investment growth. In Lithuania, a more moderate deceleration, to 6.5 % this year and 5.3 % in 2009, is expected, thanks to the rather more balanced macroeconomic background. One aspect worthy of note is that in the current global context, international financial markets are negative on the three Baltic countries and local currency markets are pricing in some devaluation risk. With markets being too shallow for a successful speculative attack, we believe, however, that the necessary readjustment of existing economic imbalances will more likely come from the ongoing economic downturn.

SEE countries still on track for smooth correction of imbalances

After expanding by more than 6 % in the past several years, we expect a slowdown in Bulgaria to some 5.6 % in 2008 and 4.8 % in 2009. Higher cost of capital and increased risk aversion will bring deceleration in both foreign capital inflows and investments, especially in the holiday home segment. The reduced availability of international funding and increased borrowing costs will make it more difficult to satisfy the large external financing requirements. With a high current account deficit and rising inflationary pressures, international markets are starting to question the long-term sustainability of the currency board. In our view, however, macroeconomic policies are very coordinated, focused on some moderate cooling, to prevent overly strong real appreciation, and on increasing flexibility to enhance the economy's efficiency and competitiveness. In-

ternational repricing of risk might even be supportive, by indirectly leading to more forceful tightening of monetary conditions.

Some cooling in terms of growth is materialising in Croatia, as a result of the ongoing financial crisis and, probably even more relevant, due to domestic measures implemented to curb lending growth. While Q1 2008 will remain strong, sagging credit activity, combined with high inflation and worsening outlook for the Eurozone economy should lead to roughly 4.3 % performance for the full year and 4.2 % in 2009, with a rebound in 2010, thanks to the EU effect. It is interesting to note that despite the 5Y CDS being at 82 bps, Croatia is still relatively attractive for foreign capital, as proved by the strong appreciation pressures faced by the kuna, even in combination with a high current account deficit and wide external debt.

There was also positive news from Bosnia-Herzegovina, as an agreement on the reform of the police system has finally been reached, which was a precondition for signing the Stabilisation and Association Agreement with the EU. The country is facing the same challenges as other neighbouring economies, with strong growth fuelling a widening current account gap, which likewise is associated with strong imports of machinery and equipment.

Political tensions are in the spotlight in Serbia and may severely affect economic performance in 2008. Following the tensions in recent months, the 5Y CDS is at around 295 and one of the highest in the region. While a victory in the May 11 parliamentary elections by pro-EU parties centred around the Democratic Party of President Tadic would be welcomed by the EU and investors, the political environment is likely to remain messy. Amid rising inflation and strong investor risk aversion, the Central Bank has been forced to hike rates by 525 bps since the beginning of the year, while passing technical measures which force banks to increase holdings in local currency, to keep the dinar stable. We forecast further 225 bps in rate hikes by the end of the year, and believe that the stability of the exchange rate can only be preserved if the political noise calms down. So far, there is clear evidence that investment is being delayed, while consumption growth and credit remain strong. Overall, we expect growth to decelerate to 5.0 % in 2008, from 7.5 % in 2007, versus our previous forecast of 6.0 % for 2008.

International investors sentiment on Romania has deteriorated substantially over recent months, as proved by the 5Y CDS spread which now stands at around 147 bps. Increasing risk aversion has led to a reversal in capital inflows and rapid depreciation of the currency (17 % since August last year), also triggering a highly restrictive monetary policy (250 bps in hikes since October 2007). While growth should settle at around 5.5 % this year and 5.0 % in 2009, the country is clearly paying the cost of its long-term vulnerabilities. We also expect some cooling in lending growth, as banks face an increase in their cost of funding and in the cost of risk.

Tough political agenda in Turkey again at the worst possible moment, preventing a full recovery in growth

The Turkish economy slowed down significantly in 2007, which was a very eventful year, dominated by both local elections and global uncertainties. While the Central Bank was ready again to start an easing cycle

to support consumption and investment growth, a new challenge has materialised in relation to the possible court decision to ban the governing party as unconstitutional. With the 5Y CDS spread at around 241 bps, the lira starting to depreciate quickly and inflation continuing to rise, the Central Bank had to start playing the card of higher nominal rates, to avoid excessive capital outflows and excessive strong depreciation of the currency, at the cost of economic growth. We now forecast growth at 4.2 % in 2008, slightly recovering to 5.0 % in 2009. We expect the Central Bank to maintain a relatively tight monetary policy stance, allowing some moderate cuts in rates only if international sentiment on the country stabilises. We continue to expect lots of political noise and tensions, which will be reflected in market volatility.

Russia is the bright spot – strong enough to exceed all expectations despite all the ongoing challenges

The repricing of risk at the international level since July has hit Russia, as both banks and medium and large Russian companies relied heavily on external funding in recent years. Limited access to international markets and the increase in the cost of funding led to some moderate credit tightening. This tightening mainly materialised as a contraction in yoy growth in retail lending, matched by an acceleration in corporate lending growth – all in the context of increasing spreads applied by banks to their clients. Still, the economy continues to perform very well. Strong consumption and investment remain the key drivers, prompting us to revise our growth forecasts upward from 6.7 % to 7.0 % in 2008. The major threat for the country is still rising inflation. In the current high inflation/low liquidity environment the Central Bank clearly faces the challenge of tightening while providing sufficient liquidity, making monetary policy a fairly sophisticated task.

In Ukraine, high inflation and some tightening of monetary policy will slow GDP slightly more than we originally expected in 2008 and 2009. We now see real GDP growth at 5.4 % in 2008 and 4.6 % in 2009, with inflation peaking at 22 % and 10 %, respectively. Later, some fiscal loosening in view of the 2010 Presidential elections and preparation for the 2012 European Football Championship should allow for a rebound.

Serious concerns for Kazakhstan in the short term, with medium- to long-term potential preserved (hopefully)

Kazakhstan is an example that economic overheating can lead to a bursting bubble. Stalled credit growth and double-digit inflation on the back of soaring food prices will reduce real GDP growth to perhaps 4.5 % this year. The good news is that reduced domestic demand as global commodity prices remain high will sharply reduce the current account deficit again in 2008 to probably 2 % of GDP. This makes a substantial tenge devaluation very unlikely. A strong increase in net exports will mitigate the decline in GDP growth although both private consumption and investment will turn out rather weak. Credit quality will show a significant deterioration this year as the economy slows, the residential construction bubble has burst and monetary conditions have tightened. We still do not expect a crisis of the banking system as a whole, but competition has increased and some redistribution of economic power among the large banks will occur. Continued strong global demand for commodities should combine with an easing of the tensions in the banking sector globally and locally to re-ignite GDP growth in 2009 and 2010 to some 6–7 %.

Country	Latest Political Event/Main Achievements	Main issues to be faced
BOSNIA-HERZEGOVINA	<ul style="list-style-type: none"> In February 2008 the Bosnian Parliament reappointed Prime Minister Spiric's Government nearly four months after his resignation. In April 2008, after more than three years of talks, the Parliament has approved the police reforms demanded by the European Union in order to sign the Stabilisation and Association Agreement (SAA). 	<ul style="list-style-type: none"> The Serb Democratic Party, the main opposition Bosnian Serb Party, has called for a referendum on the independence of the Srpska Republic from the Bosnia-Herzegovina Federation, citing Kosovo as precedent. SAA signing in the next weeks
BULGARIA	<ul style="list-style-type: none"> The Government won the fourth and fifth confidence vote (February and April 2008) filed by the opposition that claimed it had failed to fight corruption and had closed ties with the organized crime. In April the Minister of Interior Petkov resigned due to EU pressure on failure of Bulgaria's authorities to fight organized crime. 	<ul style="list-style-type: none"> To speed-up reforms in the five areas subject to Monitoring Regime by the EU, especially against the widespread corruption and organized crime. Strong popular disaffection and discontent over the Country's political life. Possible risks of defection by the second ruling partner NMS-II (National Movement for Simeon II).
CROATIA	<ul style="list-style-type: none"> The party of ethnic Serbs decided to stay in the coalition despite Government's recognition of Kosovo. The Government temporarily suspended its control of the Fishing and Ecology Protected Zone in order to speed up its accession to the EU. In April 2008, the EU decided to open another two (energy and transport sectors) of the 35 policy chapters. NATO decided to invite Croatia to join the Organization. 	<ul style="list-style-type: none"> To speed-up the reforms necessary to meet EU accession criteria. Croatia has yet opened negotiations on only 18 chapters. The most contentious issues, such as agriculture and state support to the shipbuilding industry, have been left to last Protests by the Serbs minority in Croatia after the Country recognized Kosovo's independence.
CZECH REPUBLIC	<ul style="list-style-type: none"> In February 2008 outgoing President Klaus has been reelected in a third parliamentary round vote for a further five year-term. 	<ul style="list-style-type: none"> The weak coalition Government has to face a strong left-wing opposition, especially to approve the needed reforms (pension system, further healthcare reform, the vote on stationing a US missile defense radar system).
HUNGARY	<ul style="list-style-type: none"> More than 80 % voted in favour of abolishing healthcare and tuition fees in a referendum held on 9 March 2008. The outcome is a clear victory for the opposition FIDESZ party and a symbolic setback for the reforms advocated by the Government. The junior Government coalition partner, the Liberals (SZDSZ), after PM's decision to remove the Health Minister (SZDSZ), decided to withdraw from the coalition leaving the Socialist party to govern in a minority Government. 	<ul style="list-style-type: none"> PM Ferenc Gyurcsany, now leading a minority Government, lacks the backing of both the public and his own party to continue his reform agenda. The PM announced that the planned tax reform is unlikely to take place in the medium term.
LITHUANIA	<ul style="list-style-type: none"> PM Kirkilas survived a no-confidence vote, which followed criticism of the Government's policies on the energy sector and education. 	<ul style="list-style-type: none"> Parliamentary elections are scheduled for autumn 2008. To face corruption. The last scandal involved the speaker of Parliament, Viktoras Muntianas, who resigned on April 1st following a bribery allegation. To consolidate country's energy sector.
POLAND	<ul style="list-style-type: none"> In April 2008, both houses of the Polish Parliament ratified the Lisbon Treaty, with a clause that allows the country to opt out of the European Union Charter of Fundamental Rights. The Government is improving Country's relations with EU and in particular with Germany and Russia. 	<ul style="list-style-type: none"> The Government decided to withdraw Poland's 900 troops from Iraq by the end of 2008. To push ahead with privatization, tax cut and deregulation.
ROMANIA	<ul style="list-style-type: none"> In April 2008 Romania's Prime Minister Tariceanu nominated Comanescu as new Foreign Minister. The appointment, confirmed by President Basescu, ended tensions between President and PM around this appointment. 	<ul style="list-style-type: none"> Government fragility (hampered by the continuous tensions between President Basescu and PM Tariceanu) until the next Parliamentary elections (to be held in November 2008) Several strikes due to low wages.
RUSSIA	<ul style="list-style-type: none"> D. Medvedev won the presidential elections, held on March 2, with over 70 % of votes. In April 2008 the bill limiting foreign investments in "strategic" branches of the economy has been approved by the Parliament. Putin became Chairman of the Governing Party "United Russia". EU decided to extend the current agreement with Russia to 2008. 	<ul style="list-style-type: none"> On May 8, 2008 Medvedev will take office as Russian President and Putin will become Prime Minister. They will have to assure the Country political stability and continuity, sharing the power. International discontent after President Putin called to establish official links with the two separatist Georgian regions (Abkhazia and South Ossetia).
SERBIA	<ul style="list-style-type: none"> On February 17, Kosovo declared its independence. On March 8, 2008 Serbian PM Kostunica resigned amid political contrasts, over Kosovo issue with the Democratic Party. The President dissolved the Parliament and called early elections. 	<ul style="list-style-type: none"> Local and political election to be held on May 11. Risk that the Country could abandon its pursuit of European Union membership, especially in case of Radical Party's victory in the next elections. International community's opposition to Serbian decision to hold political and local elections also in Kosovo.
SLOVAKIA	<ul style="list-style-type: none"> On April 10, Slovakia's Parliament ratified the EU reform Treaty, after a long filibustering by some opposition parties. Slovakia met the inflation criterion for euro adoption. 	<ul style="list-style-type: none"> EU asked for a more severe fiscal policy
SLOVENIA	<ul style="list-style-type: none"> Government decided not to sell 49.1 % of Telekom Slovenije one of the main privatization, partly due to internal coalition divisions. 	<ul style="list-style-type: none"> To speed-up the privatization process. Parliamentary elections in October 2008
TURKEY	<ul style="list-style-type: none"> On April 18, the Parliament approved a social security reform, raising the retirement age to 65 while decreasing some pensions. The Government submitted to Parliament a long delayed measure to reform art. 301 of the Penal Code. 	<ul style="list-style-type: none"> To face political uncertainty and slowdown of political reforms, due to Constitutional Court's decision to accept to hear Chief Prosecutor's case requesting to ban the ruling AK Party for anti-secular activities. To fulfill the conditions in the area of "company law" and "intellectual property law" in order to speed up the EU's accession. Possible introduction of legal amendments that would rewrite criteria for shutting political parties.
UKRAINE	<ul style="list-style-type: none"> Ukrainian Parliament ratified the Country's accession to WTO. Ukraine and Russia reached an agreement over gas prices, but not all questions are finally settled and new disagreements can evolve. EU agreed to extend the 2005-2007 Action Plan for 2008. 	<ul style="list-style-type: none"> Increasing tensions between President Yushchenko and PM Tymoshenko. To sign a new Partnership and Cooperation Agreement with the EU, including the creation of a deeper free trade area. Nato decided to reconsider Ukraine's membership in December.

Source: UniCredit Group – Political Studies – Institutional & International Affairs

Bulgaria



Outlook

After expanding by more than 6 % over the past several years, we expect economic growth to slow to 5.6 % this year and to further decelerate to 4.8 % in 2009. Vulnerabilities arising from financing domestic demand with international funding will start weighing on Bulgaria's GDP growth, in the context of a new gloomier international scenario. Higher cost of capital and more pronounced risk aversion will bring some deceleration in both foreign capital inflows and investments, especially in the holiday home segment. Overall, the reduced availability of international funding and increased borrowing costs will make it more challenging for the country to satisfy its large external financing requirements. On the positive side, our baseline macroeconomic scenario envisages the CA deficit and inflation decreasing toward more sustainable levels over the medium term.

MOODY'S LT FC RATING
Baa3/Positive

S&P'S LT FC RATING
BBB+/Stable

FITCH LT FC RATING
BBB/Negative

SPREAD AVG (APR) 104
EMBI+ Spread on Euro Curve

Macroeconomic data and forecasts

	2006	2007	2008f	2009f	2010f
Nominal GDP (EUR bn)	25.2	28.9	33.2	36.7	40.4
Per capita GDP (EUR)	3,286	3,782	4,364	4,851	5,368
Real GDP, yoy (%)	6.3	6.2	5.6	4.8	5.3
Inflation (CPI), yoy, eop. (%)	6.5	12.5	7.7	5.2	4.2
Inflation (CPI), yoy, avg. (%)	7.3	8.4	9.2	5.8	4.8
Unemployment rate, eop. (%)	9.1	6.9	6.7	6.7	6.4
Exchange rate BGN/EUR, eop./avg.	1.96	1.96	1.96	1.96	1.96
LEONIA, avg. of Dec	3.43	4.68	5.25	5.50	4.70
LEONIA, avg. of the year	2.79	4.03	5.05	5.50	5.10
Current account balance/GDP (%)	-17.8	-21.5	-20.2	-17.5	-14.4
FDI/GDP (%)	23.6	21.1	14.5	11.0	13.5
Budget balance/GDP (%)	3.6	3.7	3.5	1.7	1.6
General government debt/GDP (%)	24.7	19.8	16.6	14.5	13.5
Total external debt/GDP (%)	80.7	97.3	103.0	107.0	113.5

Sources: Central Bank, Statistical Office, UniCredit Bulbank Economic Research Unit, UniCredit Group CEE Research Network.

Main topics

- Despite slowing private consumption, economic growth accelerated in Q4 2007 thanks to buoyant investment, solid government spending and moderate export recovery. However, the structure of economic growth remains overly reliant on externally financed investment, suggesting that the global financial crisis may negatively impact foreign capital inflows, investment, and eventually GDP growth going forward.
- The inflation outlook remains uncertain as demand driven inflationary pressure has increased recently. Nevertheless, we see 2008 year-end inflation easing moderately in reflection of waning domes-

tic demand in combination with normalisation of output levels in the agriculture sector and a favourable base effect.

- Improving merchandise trade and the income balance have alleviated some pressure on the CA balance. We are cautiously optimistic for the CA outlook in 2008 and beyond. Building new production capacities and export recovery of raw agriculture products and processed foods will be at the heart of strengthening in exports. At the same time, slowing domestic demand and more benign primary energy prices, anticipated in our global scenario, should constrain import growth.

Some slowing in GDP growth is on the cards

Buoyant investment and government spending pushed up GDP growth in Q4 2007

2006 GDP was revised upward from 6.1 % to 6.3 %. The strong performance in Q4 2007 pushed full-year GDP growth to 6.2 %, just in line with our forecast and above consensus projections. The 6.9 % yoy increase observed in the last quarter came on the heels of disappointing 4.9 % real growth in Q3, when unfavourable climatic conditions triggered a sizeable one-off contraction in agricultural output. Simple calculations show that if the plunge in agriculture output had not taken place, economic growth would have reached an all-time record high of 8.5 % in 2007. Manufacturing (15.4 %), construction (16.9 %), and electricity, gas and water supply sectors (17.2 %) were at the forefront of economic expansion. Star performers in the services sector were tourism (11.8 %) and financial intermediation, where more than 60 % credit growth boosted GVA growth to all time record of 34.0 % yoy.

On the demand side, economic growth was propelled by the quick accumulation of physical capital. Investment, including changes in reserves of unfinished production, reached 37 % of GDP – its highest level since the start of transition. Approximately 21 % of total investment was channelled into the booming real estate and vertically integrated construction sector. At the same time, consumption expenditures in the household sector posted its weakest quarterly growth rate in more than five years, rising by meagre 3.4 % yoy in Q4 2007, despite a favourable combination of improving job creation as well as rapid retail credit and wage growth. The strong economic performance in Q4 2007 also drew support from the recovery in export growth and the traditional boost of government expenditures in November and December, when the public sector almost doubles the size of its monthly disbursements to utilise the budget surplus above those targeted for the end of the fiscal year.

Economic growth is still expected to remain solid in H1 2008

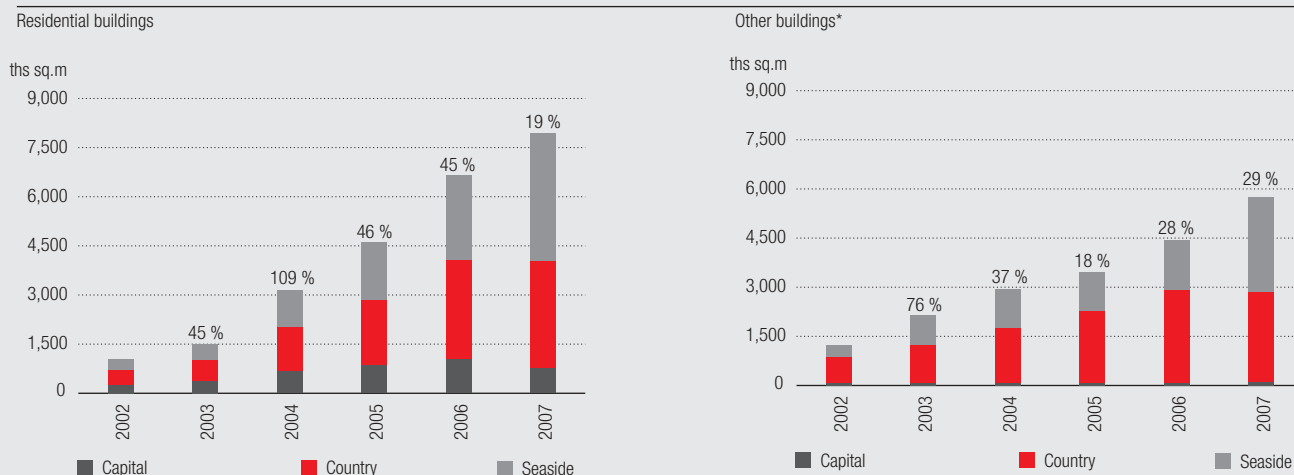
Favourable economic data in early 2008 suggests that rapid GDP growth will be sustained in the first half of the year. Output and sales growth in

industry remains one of the strongest among all EU member countries, especially in manufacturing of metals, electrical appliances, and machinery and equipment sectors where the construction of new production capacities was particularly strong in recent years. Moreover, the rapid expansion of money supply and credit aggregates continues to support household consumption and investment in the corporate sector. Despite tighter borrowing conditions and rising risk aversion amongst international lenders, the inflow of international funds is still strong. There are very isolated cases of companies reducing the scale of their projects or rescheduling their initial investment plans, due to difficulties in accessing capital. The most visible example is probably the projects that relied entirely on the local stock exchange, where IPO activity is close to zero, due to the lack of clarity as to whether the negative correction in prices is over. The upturn in the retail sales dynamics, which was first noticed in December last year, was reconfirmed in January and strengthened further in February, although it seems partially attributable to the shift in the methodology of observations in the national statistics. All these factors, on balance, points to a significant resilience of economic activity in the beginning of the year which will bring GDP growth in H1 2008 to around 6.25 % yoy. However, the structure of GDP growth remains excessively reliant on externally funded investment, thus fuelling concerns about the impact that the global financial crisis is going to have on investment and economic growth. Excessive wage growth undermines competitiveness, while the rapid accumulation of physical capital in the economy still fails to translate into sizeable productivity gains. Unemployment has dropped sharply, but this also suggests that labour shortages will increasingly limit GDP growth prospects going forward. If left unchecked, double-digit inflation threatens to depress consumption expenditures in the household sector, while also negatively affecting sentiment in the real economy. Similarly disturbing is the impact of unabated inflation on the wage bargaining process, which already comes at a complicated moment as export growth is likely to slacken, reflecting the knock-on effect which the global financial crisis is going to have on economic growth in Bulgaria's key trading partners. International investors grew more risk averse and already started to internalise higher cost of risk in their projects in Bulgaria. At the same time, there are growing indications that Bulgaria's hol-

Short-term indicators

	Mar-07	Apr-07	May-07	Jun-07	Jul-07	Aug-07	Sept-07	Oct-07	Nov-07	Dec-07	Jan-08	Feb-08	Mar-08
Real GDP, yoy (%)	5.5	—	—	7.3	—	—	4.9	—	—	6.9	—	—	—
Industrial production, yoy (%)	9	11.7	7	7.7	14.3	8.4	8.9	11.3	7.4	5	8.2	5.2	—
Inflation (CPI), yoy (%)	4.1	4.2	4.3	5.6	8.4	12.0	13.1	12.4	12.6	12.5	12.5	13.2	14.2
Unemployment (%)	8.92	8.38	7.82	7.42	7.25	7	6.78	6.73	6.62	6.91	7.38	7.26	6.79
Exchange rate, EUR, eop.	1.96	1.96	1.96	1.96	1.96	1.96	1.96	1.96	1.96	1.96	1.96	1.96	1.96
LEONIA, avg.	3.68	3.81	3.84	4.01	4.10	4.09	4.24	4.26	4.58	4.68	4.75	4.83	4.85
Export, (EUR) yoy (%)	15.1	3.2	11.7	9.8	15.8	6.6	14.2	22.8	20.8	13.6	28.3	33.1	—
Import, (EUR) yoy (%)	16.8	15.7	17.4	22.0	20.5	8.4	23.3	21.7	27.2	9.2	18.6	31.2	—
Trade balance, EUR mn	-521.9	-525.0	-601.3	-558.2	-603.3	-584.7	-607.1	-707.2	-793.5	-801.7	-610.8	-596.0	—
Current account, EUR mn	-461.5	-551.7	-460.5	-299.4	-250.9	-255	-514.3	-691.3	-728.7	-894.2	-697.8	-594.3	—

Sources: Central Bank, Statistical Office, UniCredit Bulbank Economic Research Unit.

Building permit dynamic by region (total floor space in thousands square meters, yoy % growth rates)

Source: National Statistical office. *) Other buildings include hotels, restaurants, retail, office, school, hospitals and manufacturing buildings.

Today home real estate market segment is gradually losing its allure for foreign individual investors. Local real estate brokers signal that buyers from UK and Ireland are roughly one-fifth of those seen a year ago, and this drop is only partially offset by a surge of interest originating from other locations, such as Russia and Greece. The latter is likely to impact the size of incoming FDI as the relative share of international funds channelled into the real estate, and vertically integrated construction and tourism sectors, was almost half of the total in the last two years. It appears that credit growth is also set to moderate as banks find it more challenging to expand their external borrowing and have to rely exclusively on domestic savings, where growth is unlikely to exceed 28 % in 2008. On the other hand, we expect slowing investment in the private sector to be partially compensated by an increase in the investment spending of the central government and municipalities, provided that the EU lift its ban on financial aid for Bulgaria. Against this backdrop and given the vulnerabilities arising from financing domestic growth with international funds, we think that the global financial crisis will start to weigh on Bulgaria's GDP growth performance in H2 2008 and particularly in 2009. Overall, our scenario is now assuming GDP growth to slow to 5.6 % in 2008 and 4.8 % in 2009.

The inflation outlook remains uncertain

Consumer prices continued to advance to record-setting highs, accelerating to 14.2 % yoy in March from 13.2 % yoy in February. The reference index HICP, used as the main gauge for euro adoption, increased to 13.2 % yoy in March from 12.2 % yoy one month earlier. Twelve-month food prices maintained their upward trend in March to reach 24.0 %, against 21.1 % in December 2007. Thus, almost two-thirds of the cumulative consumer price inflation in Bulgaria largely reflects global supply side shocks related to food and primary energy prices. Natural gas prices increased by 9.87 % in January and there are plans for an identical adjustment in April, which is expected to be accompanied by 15 % growth in central heating and surge in water supply prices of roughly similar proportions. Likewise, harmonisation of excise rates spurred cigarettes and alcoholic beverages prices in March by 2.3 % mom. However, the causes of Bulgaria's inflation are more broadly based and on top of the aforementioned factors, they al-

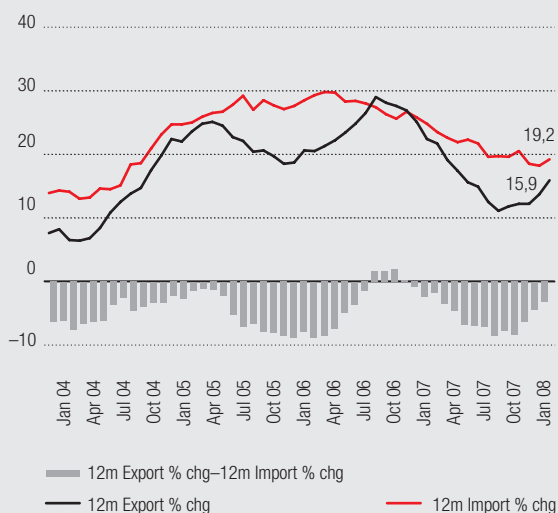
so include excessive wage growth, rapid credit expansion, labour market tightening, and lack of sufficient reforms aimed at boosting competition. Nevertheless, we see year-end inflation slowing to 7.7 % in 2008 and further to 5.2 % in 2009. Easing of inflationary pressure will draw support from moderation in wages, credit and investment growth, and particularly from the normalisation of output levels in the agriculture sector. The disinflationary process will, furthermore, mirror the high base year effect which should start materialising in H2 2008. We think that the uncertainty surrounding the medium-term inflation outlook remains pronounced, in the face of general elections next year which will make it more difficult for the government to bind wage growth to productivity. In the context of a lack of reforms needed to expand the role of the free market and competition in the state dominated energy and railway transportation sectors, administratively regulated prices will likewise remain a source of inflationary pressure in the period of the forecast. On the other hand, the start of reforms in the education and possibly in the health care sector clearly represents a very positive development. It should be noted though, that we are still far from the point when these reforms will feed into lower health care and education services prices for end customers.

Improving merchandise trade and income balance is alleviating pressure on the CA gap

The CA deficit widened by 16.2 % yoy to reach EUR 1.291 bn in the first two months of the year, as compared to revised EUR 1.112 bn in 2007. The CA gap edged up only marginally to 2.9 % of full-year projected GDP in 2008, against 2.8 % a year ago. Imports rose by 31.2 % yoy in February, speeding up from 18.6 % in January. Exports increased at an even faster pace of 33.0 % yoy in February and 28.3 % in January, but the trade balance in the first two months of the year nevertheless deteriorated by 14.6 %, in reflection of the higher import base effect. The balance on services and current transfers also reported moderate deterioration, which however was largely offset by an increase on the income balance, as compensation of employees surged by 27 % yoy. FDI edged up 15.3 % reaching EUR 0.432 bn, compared to EUR 0.375 bn in the first two months of 2007, but providing only roughly 31 % coverage of the gap.

Merchandise Export and Import

12-Month moving average growth rate, in %



We are cautiously optimistic for the CA outlook in 2008 and going forward. We think performance in early 2008 is broadly in line with our baseline scenario, which envisages the twelve-month CA gap peaking in H1 2008, but then starting to ease gradually thereafter. Together with the broadly anticipated recovery in exports of raw agriculture outputs and processed foods, the construction of new production capacities should translate into some modest strengthening in export growth. At the same time, slowing domestic demand and more benign primary energy prices in the second half of 2008 should constrain import growth. Aside from the factors mentioned already, the CA balance (including the capital account) will draw support from a possible increase in the volume of EU aid, which however is conditional on Bulgaria's progress in fighting corruption and organised crime. Thus, on balance, we see the CA deficit easing marginally to 20.2 % of GDP in 2008, and further to 17.5 % next year. Despite sizeable tensions on the global financial markets, the combination of high profit margins and low asset values in Bulgaria will continue to make the country attractive for foreign capital inflows. Nevertheless, FDI is estimated to slow down to around 14.5 % of projected full-year GDP in 2008 and 11.0 % in 2009, also causing some deterioration in the financing structure of the large CA mismatch.

Bulgarian government will soon turn into a net lender to the rest of the world

At the end of February, general government debt decreased to EUR 5.1 bn or 16.1 % of the 2008 full-year GDP forecast. At the same time, the fiscal reserve reached EUR 3.8 bn pushed by the hefty surpluses in the consolidated fiscal programme in 2007 and in early 2008. Later in March, the ministry of finance paid EUR 266.9 mn and USD 12.8 mn to the World Bank to clear accumulated interest and principal on six loan exposures ahead of schedule. The operation was in line with authorities' strategy of keeping a roughly balanced ratio between floating and fixed interest rate liabilities and reducing exchange rate mismatches between the government reserve and debt accounts. The fiscal reserve already covers some 80 % of public debt and Bulgarian government may soon become a net creditor to the rest of the world provided that a tight fiscal policy is sustained, privatisation of state shipping company Navibulgar is completed, and the final cash payment arrangement of Iraq debt is received as scheduled.

Brussels temporarily blocked EU aid for Bulgaria under the pre-accession programmes

In March the European Commission suspended disbursement of financing on already approved projects under all pre-accession programmes. The authorities in Brussels explained this action in relation to general weaknesses in EU fund management as well as suspicions about corruption in the work of local executive authorities. In response, the Bulgarian government undertook a series of examinations that found additional irregularities and led to the dismissal of local heads of executive agencies responsible for the administration of the PHARE programme and the Road Agency director, who among other things runs ISPA projects for the rehabilitation and modernisation of transport infrastructure. EU authorities signalled, that if already identified problems remain unattended, financing under operational programmes could also be frozen. Earlier in February the European Commission presented the interim report on progress of Bulgaria in reforming the judiciary system and fighting organised crime and corruption. Substantial improvements were noticed in enacting new legislation that removes ambiguity regarding the independence of the judiciary system as well as adoption of new judicial system act and new penal and administrative procedure code. But the country's performance in fighting organised crime and high level corruption was once more described as unsatisfactory. A more detailed report, due to be released in June, will be crucial for EU to decide on possible activation of safeguard clauses and further limitation of EU aid in case Bulgarian authorities persist with their soft approach against corruption and organised crime.

Event	Date	Reading
Balance of payments	15 May	The size of CA deficit remains the most closely watched macroeconomic indicator.
GDP Q1 2008	19 June	Solid growth momentum behind investments and export strengthening are likely to keep GDP growth robust in Q1 2008.
Report of European Commission to the European Parliament and the Council on Bulgaria's progress on accompanying measures following Accession.	End of July 2008	Reading Conclusions of the report will highlight possible response of EU in case Bulgaria's performance in fighting organized crime and corruption is assessed as unsatisfactory.

Czech Republic



Outlook

So far, the Czech Republic has been largely unaffected by the global economic slowdown. Although export performance is not likely to remain completely immune, we believe in a positive, albeit minor, contribution by net exports to this year's growth. On the domestic demand side, we expect the ongoing strong growth in fixed investment to be overshadowed by a combination of weaker stock-building and faltering private consumption, leading to deceleration of 2008 GDP growth to 4 % yoy from last year's rate of 6.5 % yoy. Despite some gradual softening, inflation is expected to remain well above the CNB's 3 % target for the whole of this year. Although our baseline scenario continues to forecast no further interest rate hike by year-end, the additional monetary tightening is still on the cards. Public budgets will hardly maintain the trend of a gap reduction from the past years as extra spending will be required for co-financing of EU programmes.

MOODY'S LT FC RATING
A1/Positive

S&P'S LT FC RATING
A/Stable

FITCH LT FC RATING
A+/Stable

SPREAD AVG (APR) 37
EMBI+ Spread on Euro Curve

Macroeconomic data and forecasts

	2006	2007	2008f	2009f	2010f
Nominal GDP (EUR bn)	114	128	152	163	176
Per capita GDP (EUR)	11,110	12,410	14,630	15,550	16,670
Real GDP, yoy (%)	6.4	6.5	4.0	4.5	4.5
Inflation (CPI), yoy, Dec. (%)	1.7	5.4	5.0	2.8	2.7
Inflation (CPI), yoy, avg. (%)	2.5	2.8	6.7	3.2	2.7
Unemployment rate (%)	8.1	6.6	5.7	5.5	5.5
Exchange rate CZK/EUR, Dec. avg.	27.50	26.62	25.70	25.50	25.50
Exchange rate CZK/EUR, avg.	28.34	27.76	25.40	25.60	25.50
2-week repo rate, eop.	2.50	3.50	3.75	4.00	4.00
2-week repo rate, avg. of the year	2.17	2.88	3.73	3.90	4.00
1M Pribor, Dec. avg.	2.52	3.98	3.85	4.05	4.05
1M Pribor, annual avg.	2.22	2.96	3.80	3.95	4.05
Current account balance/GDP (%)	-3.1	-2.5	-3.4	-3.1	-3.1
FDI/GDP (%)	4.2	5.2	4.9	6.0	4.5
Public debt/GDP (%) (ESA 95)	29.4	28.7	28.7	28.0	28.8
Budget balance/GDP (%) (ESA 95)	-2.7	-1.6	-2.3	-2.9	-2.7
Total external debt/GDP (%)	36.9	37.9	38.2	38.4	38.6

Sources: Czech National Bank, Czech Statistical Office, Labour and Social Affairs Ministry, Ministry of Finance, UniCredit Group CEE Research Network.

Main topics

- 2007 GDP growth held steady above a 6 % yoy rate for the third year in a row. Q4 GDP expanded by 6.6 % yoy, picking up slightly from the 6.3 % yoy rate in Q3, as slowdown in domestic demand was overshadowed by improving foreign trade. Final consumption showed only a minor deceleration from Q3, but with faltering household spending offset by extra government expenditures.
- Following a 25-bp hike in February and a cumulative 100-bp increase last year, the CNB voted 6-1 for stable rates in March, with one vote in favour of an additional quarter-point tightening. With both pro- and anti-inflationary risks remaining huge, the Bank

seemed to adopt a wait-and-see approach. Inflation appears to have peaked, but concerns about spiralling inflation remain.

- Ongoing CZK appreciation appeared the chief argument for not raising rates in March. CZK enjoys the status of a safe-haven currency and kept benefiting from global uncertainty. Although its sharp appreciation has had no visible drag on the economy yet, negative implications threaten to emerge later. These concerns led the CNB and FinMin to conclude a deal which would take some pressure off the crown by shifting all public sector FX operations outside the foreign exchange market.

Growth moderate, with inflation risks persisting

Net exports as the main growth driver in Q4

Q4 GDP growth reached 6.6 % yoy, lagging behind the flash estimate of 6.9 %, but beating our forecast of 6.2 %. Combined with moderate revisions of previous quarters, this brought full-year 2007 growth to 6.5 % yoy, up a notch from the 2006 expansion. Remarkably, the economy expanded at an above 6 % growth rate for the eleventh consecutive quarter. Positively, all major components on the demand side contributed to growth in 2007, with the structure in Q4 becoming even more balanced as growth drivers shifted in part from household spending to net exports. The contribution rate of the final consumption component to growth in Q4 (2.7 pp), however, failed to drop from the previous quarter, with the slack in household spending almost fully taken up by a surge in public sector expenditures. Whereas private spending apparently started feeling the pinch of accelerating inflation, public expenditures were boosted by two one-off impacts: unusually high spending on road infrastructure and increased activity by health insurance companies preceding the implementation of medical fees at the start of 2008. The statistical office estimated that excluding these impacts, Q4 GDP would have risen by 6.0 % yoy. Gross capital formation lost some momentum in Q4, with soaring investment growth overshadowed by a sharp drop in stock accumulation. On the other hand, export growth slowed much less from the previous quarter than that of import, raising the contribution of net exports to growth to 2.1 pp from 0.7 pp in Q3. On the supply side, growth continued to be pulled by the manufacturing industry which added 2.7 pp to the overall expansion.

2008 growth will mainly be hit by slowdown in private spending

The sectoral data published so far this year suggest that the economic slowdown was less pronounced at the beginning of 2008 than we forecast three months ago. Basically, no impact from weaker growth abroad has been observed in the industry and export figures. Therefore, we have revised up our forecast for Q1 GDP growth to 4.7 % yoy from previous rate of 4.1 %, with the drop from the Q4 rate (6.6 % yoy) attributed primarily to faltering private consumption and a lower pace of stock-building. Moreover, the purchasing power of households

seems solely affected by the inflation spike as their spending in nominal terms appears to maintain its former momentum. Restrictive reform measures coming into force at the start of this year seem counterbalanced by ongoing robust growth in wages and decreasing unemployment. In addition, the parliament approved an extra mid-year hike in pensions, which should also partly compensate for the elevated inflation. In the real terms, however, we still predict household spending growth to shrink to 3.5 % yoy for the whole of this year from 5.6 % yoy in 2007. On the other hand, we expect both net exports and fixed investment to maintain their contribution to GDP growth from last year. Therefore, the predicted slowdown in gross capital formation to 4.0 % yoy from 9.2 % yoy (2007) should only come from the inventory side. We keep our forecast of a 4 % yoy GDP growth rate for 2008.

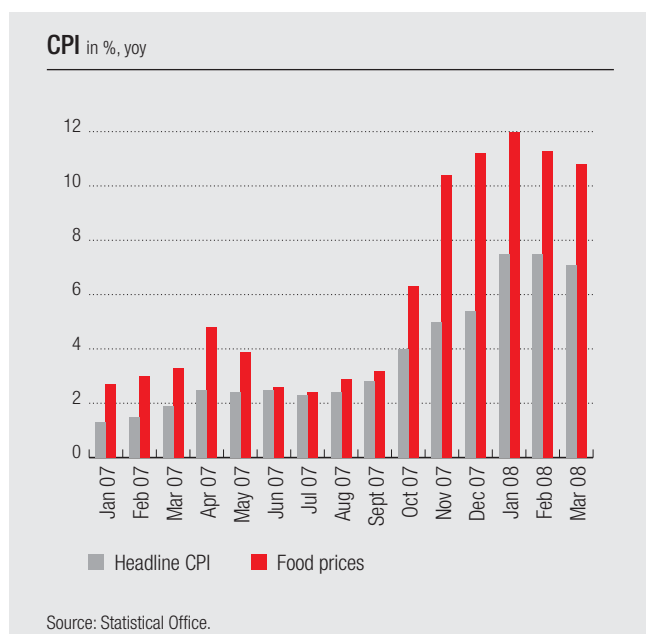
Industrial production surprised on the upside

The first two months of this year saw surprisingly robust performance in the industrial sector. Production jumped 9.1 % yoy in January and 11.3 % yoy in February, picking up sharply from 6.1 % yoy in last year's final quarter. Growth was based on the three traditional pillars: car production, manufacturing of electrical and optical equipment, and production of machinery, which altogether contributed more than three-quarters to the output gain in the first two months of 2008. On the other hand, in addition to the long-standing recession in the textile industry, food processing has also failed to come out of contraction territory. Production of food seems to be suffering from the steep growth in food prices, which has apparently shifted consumers' preferences to cheaper products. Wage growth acceleration in industrial companies was also remarkable, with nominal wages posting double-digit year-on-year increases in both January and February. This surge can partly be explained by a tax-driven shift in bonuses to the beginning of this year, but potential other reasons should be closely watched by the CNB. Ongoing strong employment growth (+2.5 % yoy in Feb) appeared as another positive feature of the economy's key sector. Despite of signs of continued strength of industry, two negative trends seem to be emerging. The first one relates to industrial sales growth which lagged behind growth in production in January, for the first time

Short-term indicators

	Mar-07	Apr-07	May-07	Jun-07	Jul-07	Aug-07	Sept-07	Oct-07	Nov-07	Dec-07	Jan-08	Feb-08	Mar-08
Real GDP, yoy (%)	6.5	—	—	6.5	—	—	6.3	—	—	6.6	—	—	—
Industrial production, yoy (%)	10.6	14.3	7.0	6.8	11.8	6.4	1.7	8.5	6.7	3.1	9.1	11.3	—
Inflation (CPI), yoy (%)	1.9	2.5	2.4	2.5	2.3	2.4	2.8	4.0	5.0	5.4	7.5	7.5	7.1
Unemployment rate (%)	7.3	6.8	6.4	6.3	6.4	6.4	6.2	5.8	5.6	6.0	6.1	5.9	5.6
Exchange rate/EUR, eop.	28.00	28.13	28.33	28.72	28.04	27.73	27.61	26.97	26.26	26.62	26.07	25.22	25.34
1M Pribor, avg.	2.54	2.54	2.61	2.81	2.90	3.07	3.33	3.35	3.43	3.98	3.70	3.81	3.87
Export, (EUR) yoy (%)	19.0	24.3	13.2	14.9	22.7	17.8	15.4	19.4	17.5	9.6	18.7	24.0	—
Import, (EUR) yoy (%)	15.2	20.0	11.7	15.1	21.2	17.7	12.4	17.3	13.9	9.3	17.9	24.0	—
Trade Balance, EUR mn	551	166	189	285	−58	−40	491	318	467	−126	469	562	—
Current account, EUR mn	509	−510	−582	−181	−454	−1,054	−19	−526	148	−855	185	464	—

Sources: Czech National Bank, Czech Statistical Office, Labour and Social Affairs Ministry, UniCredit Bank Economic Research.



since August 2006. The fact that the situation was repeated again in February may signal that the backlog of inventories has started increasing. The second unfavourable trend is related to weaker orders from abroad. February was the third month in a row which saw a yoy drop in foreign orders at current prices. In this respect, expectations of brisk industrial growth going forward appear to be unjustified. We expect the pace of production to drop to around a half of its recent levels in the course of this year.

Monetary policy tightening secured by the firming CZK

March CPI showed the first monthly drop (−0.1 % mom) since last September, as a moderate increase in housing rents and a seasonal rise in prices of clothing were more than offset by declines in prices of food, alcoholic beverages and holidays. In year-on-year terms, inflation fell more than expected, receding to 7.1 % in March from a nine-year high of 7.5 % in the previous two months, chiefly due to the weaker growth in cigarette and food prices. The first retreat in yoy price growth since July 2007 points to the beginning of the long-awaited downside correction. Nevertheless, cigarette prices will be gradually absorbing January's excise tax hikes in the coming months, slowing this trend somewhat. In Q4, however, we expect inflation to fade more quickly as a result of the base effect and to stand at around 5 % yoy at the year-end.

The CNB held the benchmark two-week repo rate unchanged at 3.75 % in March, following a 25-bp hike in February. Holding rates steady was advocated by six board members, with one member voting for 25-bp tightening. In the meeting's minutes, the bank reported that the inflation risks were significant in both directions: a strong CZK and the prospect of a steeper reduction of euro area growth on the anti-inflation side, while most of recent data from the domestic economy and potential cost-side shocks were assessed as pro-inflationary risks. On balance, the CNB stressed the importance of upcoming data which could somewhat brighten the picture. The Bank's statement on March inflation showed that the outcome was just 0.2 percentage points above its forecast (shrinking from 0.6 pp in February). The narrowing

of the gap appeared consistent with CNB's view that the price spike was temporary and that inflation would return back towards 3 % target at the start of next year. Overall, there seems to be no strong argument on either side at the moment that would call for a change in monetary policy. Our baseline scenario still forecasts no interest rate change in the months ahead, even though we see a hike more likely than a cut as the next policy step.

The continued strength of CZK has been the main argument for the CNB not to extend the rate tightening cycle. After consolidating as high as EUR/CZK 25.65 in late March on the CNB's no-change verdict, the crown firmed back to the stronger side of EUR/CZK 25.0 in early April. Ongoing flows from the beleaguered USD and hedging activities of local exporters served as key factors boosting the domestic currency. In mid-April, the crown briefly shot up to EUR/CZK 23.0 in overnight trading, breaking the previous all-time high at EUR/CZK 24.83, seen in early March. However, the move proved short-lived and was caused by low liquidity and automatic stop-loss orders, with EUR/CZK rebounding back to 24.7 the next day. Robust CZK appreciation, amounting to more than 10 % versus the euro on a yoy basis, made the CNB call for an update of a six-year old agreement with the FinMin on stemming the crown's advance. The authorities agreed to divert foreign currency income from the FX market by introducing the following measures related to public sector operations: freezing of privatisation revenues on a special CNB account, hedging of the flows from potential Eurobond issues and converting expected subsidies from EU funds into the CNB's reserves. We suppose, however, that even though these measures could play an important psychological role, future currency movements will continue to be primarily driven by market forces. Looking ahead, we still believe that CZK will slide back to levels which will be more justified by economic fundamentals once global risk aversion eases. Nevertheless, we now expect the correction to be milder than we had forecast earlier since: 1) normalisation on global markets may take longer, 2) exporters' hedging operations may put a cap on any attempts to drive EUR/CZK substantially higher. We predict the crown easing to EUR/CZK 25.7 (against previous EUR/CZK 26.5) by year-end.

Trade balance keeps improving, despite CZK strength and weaker growth abroad

Much like the figures from industry, foreign trade data from earlier this year also revealed the resilience of the Czech economy to flagging growth in the Eurozone. The trade balance surpluses in both January and February surprised on the upside and again exceeded the levels from the same months of 2007. The trend of yoy improvement was thus extended to more than a year. It is quite amazing that we have seen no trade deterioration yet, considering the slowdown in the developed European countries, huge CZK gains and commodity prices climbing to new record highs. In fact, oil and natural gas imports in February jumped by roughly 1/3 and 1/4, respectively, compared to a year ago, resulting in a widening of deficit in mineral fuels by CZK 3.0 bn. However, this was more than counterbalanced by a growing surplus in trade with cars and machinery (by CZK 5.2 bn yoy in February). Apparently, export capabilities have been primarily supported by soaring car production. Moreover, shipments to the key two destinations – Germany and Slovakia – did not abate. Importantly, Jan–Feb trade figures fit in well with our assumption of ongoing improvement in the full-year balance.

The 2007 current account deficit was revised down to 2.5 % from the original figure of 3.0 % of GDP, underscoring the strong external finance position of the domestic economy. The overall balance of payments picture remained positive at the start of 2008 as well, providing justification for further CZK gains. The cumulative current account balance for the first two months of this year featured a surplus of CZK 16.6 bn, double the surplus reached in the corresponding period of the previous year. The trade and services balances came in positive at CZK 27.5 bn and CZK 8.6 bn in January and February, respectively, while the income balance gap stood at CZK 26.0 bn. Current transfers showed a moderate cumulative surplus of CZK 1.7 bn, boosted by inflows of EU funds. The trade balance and current transfers proved to have the biggest impact on the year-on-year increase in the CA surplus, with both improving by around CZK 5 bn. Going forward, however, we maintain a cautious outlook for this year's CA development. We remain sceptical about further improvement in the services balance as well as the balance of income, which has yet to suffer from dividend outflows following the robust corporate profits posted last year. Our forecast of a 2008 CA deficit amounting to 3.4 % of GDP will, however, hardly set off any alarm bells. On the financial account, Jan-Feb gross FDI inflow remained firm, totalling CZK 32.8 bn. By contrast, portfolio and other capital balances saw net outflows, bringing the total financial account to a net negative sum of CZK 8.8 bn in Jan-Feb. Nonetheless, this year's FDI-to-GDP ratio is not expected to differ much from that of last year as the government's plan to restart the privatisation process should boost the figure only in 2009.

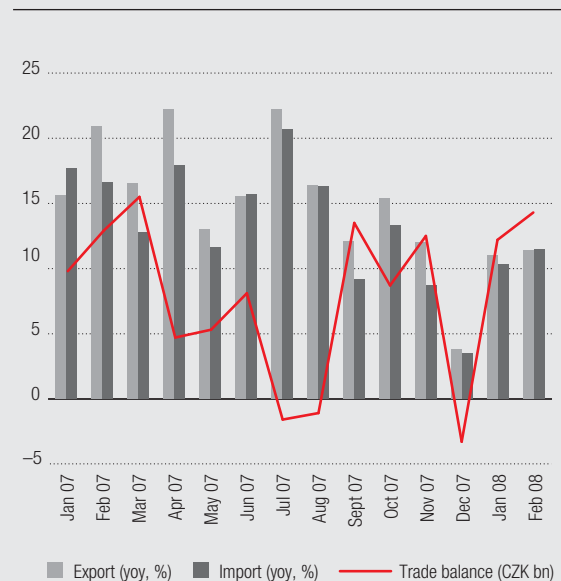
Two extra spending factors behind state budget deterioration

The state budget showed a deficit of CZK 13.4 bn at the end of March, a negative shift from last year's Q1 surplus of CZK 11.3 bn. Total revenues were up 11.6 % yoy pulled mainly by non-tax and capital income (+39 % yoy). Tax and fee revenues rose 5.7 % yoy, led by corporate taxes. State budget expenditures exploded by 22.9 % yoy in Q1 due to two specific reasons: 1) an advance subsidy payment in the education chapter, 2) one-off capital spending on road infrastructure. Considering these two extra spending factors, the underlying picture suggests no dramatic deterioration, if any, in state finances. According to FinMin, an extra August pension hike, which is estimated to raise this year's budget expenditures by CZK 6.6 bn, should be fully covered from pension insurance contributions flowing into the state's pay-as-you-go system because of faster nominal wage growth. Consequently, we see little risk of overshooting the government's full-year 2008 deficit target of CZK 70.8 bn.

Rosy picture of public budgets seems unsustainable

The overall public sector deficit (under ESA-95 rules) narrowed sharply to 1.6 % of GDP last year from 2.7 % in 2006, a larger drop than the previous FinMin estimate (1.9 % of GDP in 2007). In nominal terms, the deficit shrank by roughly CZK 30 bn to CZK 56 bn, thanks mainly to a CZK 23.3 bn rise in the surplus of local budgets and a CZK

Foreign trade in CZK terms



Source: Statistical Office.

5.6 bn improvement in the balance of health insurers. A further increase of the budget reserve, which accumulates the unspent funds, also had a positive effect on the ESA-95 deficit level last year. More importantly, however, the deficit of central government institutions showed little improvement from the previous year despite the booming economy. In this respect, it would be premature to regard Czech public finances as healthy and stabilised. Already this year, we expect the deficit to rise again as we do not believe the local government finances can maintain the positive bias from 2007. Moreover, the growing need to co-finance EU programmes may require the budget reserve to be gradually dissolved, resulting in a rise in spending under the ESA-95 methodology. Additional pressure on the central budget part of public finances may come in 2009 when the economic slowdown projected for this year takes its toll on income tax collection. We expect the public finance deficit to widen to 2.3 % of GDP this year and further to 2.9 % in 2009.

In respect of the euro, Prime Minister Topolánek recently reiterated that fiscal, pension and health sector reforms must come before euro adoption, and that his government was in no hurry to enter the euro area. Hence, we still consider 2013 the first possible entry date.

Event	Date	Reading
MPC meeting	May 7, June 26	MPC decision will show how it balances inflation risks with economic slowdown

Estonia



Outlook

Faster-than-expected cooling amidst rising inflation and a difficult external environment are increasing the risk that the landing of the Estonian economy might be rougher than was originally thought. The bursting of the real estate bubble and sharply lower credit growth will combine with cuts in government expenditures to slow real GDP growth to some 2–4 % this year and the next. We nevertheless still believe that the authorities and the banking system have sufficient resolve and means to keep the adjustment process fairly smooth. Lower than potential output growth over the next two years will cause price and wage increases to slow down along with enterprise restructuring. Subsequently, probably by 2010, the economy should rebound. By then, higher exports thanks to renewed strong global demand and an easing of credit conditions due to renewed capital inflows and to lower inflation should also support growth.

MOODY'S LT FC RATING
A1/Positive

S&P'S LT FC RATING
A/Negative

FITCH LT FC RATING
A/Negative

SPREAD AVG (APR) N.A.
EMBI+ Spread on Euro Curve

Macroeconomic data and forecasts

	2006	2007	2008f	2009f	2010f
Nominal GDP (EUR bn)	13.2	15.5	17.4	19.0	21.3
Per capita GDP (EUR)	9,841	11,585	13,016	14,210	15,931
Real GDP, yoy (%)	11.2	7.1	2.6	3.2	6.3
Inflation (CPI), yoy, eop. (%)	5.1	9.6	7.3	6.0	4.2
Inflation (CPI), yoy, avg. (%)	4.4	6.6	10.0	6.2	4.9
Unemployment rate LFS (%)	5.9	5.3	5.4	5.3	4.0
Exchange rate EEK/EUR, avg./eop.	15.65	15.65	15.65	15.65	15.65
Interest rate eop. (3m Talibor)	3.85	7.20	5.70	5.10	4.70
Interest rate avg. (3m Talibor)	3.16	4.84	6.45	5.40	4.90
Current account balance/GDP (%)	–15.5	–17.4	–13.9	–13.9	–13.5
FDI/GDP (%)	10.1	11.7	9.0	9.1	9.4
Budget balance/GDP (%)	3.6	3.2	–0.5	0.0	1.5
Public debt/GDP (%)	4.0	2.9	3.0	2.9	2.0
Total external debt/GDP (%) ¹	96.4	110.3	111.0	112.7	112.0

Sources: Ministry of Finance of Estonia, Bank of Estonia, Statistics Estonia, UniCredit Group CEE Research Network.

1) More than one-half is trade credit.

Main topics

- The economic sentiment indicator computed by the Estonian Institute of Economic Research averaged –2.4 points in Q1 2008, compared with 23.3 points in Q1 2007. This is the worst figure since early 2000. Consumer confidence showed the lowest reading, followed by construction companies. Industrial companies were slightly more optimistic, but also at values not seen since late 2004.
- Consumer prices increased by 10.9 % yoy in March, mainly due to rising food prices, (+14.5 % yoy), district heating energy, heating materials and motor fuels. Regulated prices changed by 19.8 % yoy, non-regulated prices by 8.5 %.
- Credit growth slowed to 32 % yoy in February 2008 compared with 48 % yoy in July 2007 before the onset of the global liquidity crisis. In the first two months of 2008 the loan stock increased by 2.7 %, significantly below the 4.7 % in the same period of 2007.
- 12-month forwards indicated an exchange rate of 15.8 in April, pointing to the risk of a collapse of the currency board. The figure is lower though than the 16.0 seen at the end of 2007. The deviation from the actual exchange rate is not very high and we believe that the currency board can be defended by the authorities, given the interest of the main players to maintain an orderly environment.

Adjustment under way

Further cooling

Real GDP growth continued to slow. It amounted to 4.8 % yoy in Q4 2007, down from 6.4 % yoy in Q3. Domestic absorption growth fell to 5.5 % yoy from 7.2 % in Q3 as growth in private consumption slowed to 3.3 % yoy. Gross fixed capital formation exceeded the previous year's level by 5.6 %. Exports of goods and services contracted by 0.2 % yoy, imports by 0.7 % yoy. Trade and real estate contributed most to the cooling. The value added generated by "real estate, renting and business activities" slowed to 0.6 % yoy at constant prices in Q4 2007, VA growth in trade was at -1.6 % yoy even negative. The situation in the real estate sector has dramatically changed. The number of completed housing units likely still increased in Q4 2007, but 32 % less purchase-sale contracts were notarised and their value fell by 44 %. The average sq.m. price in Tallinn fell from a high of EUR 1,868 in Q3 2007 to EUR 1,693 in Q4.

Industrial output points to a further weakening in the coming months. Total industrial output grew by 3.9 % yoy in January–February 2008, but the manufacture of intermediate goods fell by 3.2 % yoy, and that of durable consumer goods by 3.1 %. Retail sales grew a meagre 1.2 % yoy in January–February.

Double digit inflation

A hike in excise duties, and high global food and fuel prices lifted inflation to over 11 % yoy in the first two months of 2008. At 10.9 % yoy it was only slightly lower in March. Producer price increases exceeded 8 % yoy in January and February, prices of food products 20 %. Inflation will likely slow later this year as the impact of the tax increase fades and food prices grow less fast. However, it is unlikely that inflation will fall to below 7 % yoy by December. Given the situation on global commodity and especially food markets, even higher readings cannot be excluded. The high inflation rate will take its toll on real income growth. Real wage growth is showing initial signs of a slowdown. Deflated by consumer prices, wage growth slowed to 10.3 % yoy in Q4 from 14.4 % in Q1 2007.

Foreign trade gap narrowing on weaker imports

Import growth declined from 30 % yoy in 2006 in euro terms to 6 % yoy in 2007 according to customs statistics. Imports of fuel declined by 9 % following disputes with Russia. Imports of machinery and transport equipment fell by 1 % yoy due to a relocation of production and trading companies. Growth in exports also slowed significantly in 2007, to only 4 % yoy from 24 % yoy in 2006. The main factors were again exports of fuels which fell by 21 %, and exports of machinery and transport equipment which declined by 3.5 %. The current account deficit widened from 15.5 % of GDP in 2006 to 17.4 % of GDP in 2007, but has narrowed since the fourth quarter.

Substantial slowdown in credit growth

The banking sector has begun to significantly scale down lending as

cross-border capital inflows to financial intermediaries decreased. According to balance of payments data, inflows to credit institutions fell from EUR 1,034 mn in Q2 2007 to EUR 939 mn in Q3 and further to EUR 706 mn in Q4 2007. The first two months of 2008 saw outflows. They were in part offset by the unwinding of assets held by Estonian banks abroad, but this is not a long-term option.

In the context of high dependency on foreign borrowing the tightening of credit terms is passed on to the domestic level. Banks face higher funding costs despite widespread foreign ownership. Growth in corporate loans fell to 29 % yoy by February 2008 from 61 % at the beginning of 2007. The most pronounced decrease in the growth rate was observed in "real estate, renting and business activities", from 86 % yoy at the beginning of 2007 to 26 % yoy at year-end. Growth in retail loans fell from 62 % yoy in January 2007 to 30 % yoy by February 2008. Average kroon lending rates for companies rose from 5.6 % in January 2007 to 7.2 % by February 2008. The average rates on kroon deposits increased over the same period from 3.6 % for companies and 3.2 % for retail customers to 5.2 % and 4.8 %, respectively. The quality of banks' lending portfolios has deteriorated. Loans past due or with unpaid interest have increased from 2.8 % of the loan portfolio at the end of 2006 to 5.3 % by February 2008. Given that the economy is adjusting and credit growth continues to slow, the quality of loans is likely to worsen further.

Fiscal tightening on the agenda

There are growing signs that the government will not be able to meet the 2008 budget targets. On April 3, the Finance Ministry released a forecast according to which the deficit of the general government will reach 1.1 % of GDP in 2008 if no action is taken, the result of a short-fall of tax revenues, especially from value added and social security tax. This compares with a 2008 surplus target of 1.3 % of GDP and an actual 2007 surplus of 2.8 % of GDP. The Finance Ministry proposed that ministries draft by April 17 measures to slash 7–9 % off their budgets. The board of the Estonian ruling coalition agreed that the government would draft a supplementary budget.

What type of landing?

According to the central bank's April "Economic policy Statement", which lowered the 2008 real GDP growth forecast to 2 %, "the long-awaited economic adjustment is underway in Estonia, but it is no longer as smooth as expected due to the less favourable external environment". We agree. Scarcer foreign funding combined with cuts in government spending and high inflation and interest rates is an unfavourable mixture. We nevertheless still assume that the economy will return back on track in a fairly organised manner. The authorities seem to be aware of the problems and decided to address them. The years of very high growth are however over for the next couple of years.

Event	Date	Reading
Budget amendment	Autumn 2008	Lower than budgeted revenues might force the government to cut expenditures

Hungary



Outlook

The 5.5 % general government deficit in 2007, compared to the planned figure of 6.8 %, proves that the Hungarian stabilisation programme is achieving results. As economic growth is failing to recover, however, the general understanding is that the measures might also have overshoot the target, freezing up the economy. Hungary is thus facing the new challenges arising from volatile, risk-averse international capital markets in a context of improved fiscal balance, but with very low growth. Inflation remains high, while technical and global factors have prompted deterioration in the money market interest level and in yields on government securities. The increased debt service burden is likely to wipe out the modest leeway intended for a tax reform. The March 9 referendum on healthcare reform has forced the government to rethink its economic policy. The Socialist-Liberal coalition dissolved, and the Socialist party is preparing itself for minority government.

MOODY'S LT FC RATING
A2/Stable

S&P'S LT FC RATING
BBB+/Negative

FITCH LT FC RATING
BBB+/Stable

SPREAD AVG (APR) 99
EMBI+ Spread on Euro Curve

Macroeconomic data and forecasts

	2006	2007	2008f	2009f	2010f
Nominal GDP (EUR bn)	89.9	101.0	104.9	112.5	121.5
Per capita GDP (EUR)	8,920	10,040	10,440	11,210	12,130
Real GDP, yoy (%)	3.9	1.3	2.4	2.9	4.0
Inflation (CPI), yoy, eop. (%)	6.5	7.4	4.9	3.5	2.9
Inflation (CPI), yoy, avg. (%)	3.9	8.0	6.0	3.6	3.1
Unemployment rate (%)	7.5	7.3	7.3	7.2	7.0
Exchange rate HUF/EUR, eop.	252.3	253.4	254.0	252.0	252.0
Exchange rate HUF/EUR, avg.	264.3	251.3	257.8	255.0	253.0
2-week repo rate, eop.	8.00	7.50	7.50	6.50	5.25
1M Babor, eop.	8.09	7.51	7.55	6.55	5.30
1M Babor, avg.	6.80	7.18	7.90	6.85	5.80
Current account balance/GDP (%)	-6.1	-5.0	-4.4	-4.2	-3.8
FDI/GDP (%)	6.0	4.0	3.1	3.8	4.1
Budget balance/GDP (%)	-9.2	-5.5	-4.0	-3.2	-2.9
Public debt/GDP (%)	65.6	66.0	64.0	63.3	61.9
Total external debt/GDP (%)	86.5	97.3	94.5	93.4	90.8

Source: NBH, Statistical Office, Ministry of Finance, UniCredit Group CEE Research Network.

Main topics

- Economic recovery is slower than previously expected. Due to delayed acceleration in retail consumption, we now forecast a growth rate of 2.4 % in 2008, down from the previous estimate of 2.8 %. Some upside development in private and public sector investments might lead capital formation to increase by 6.8 % yoy.
- Flat domestic consumption and a reduction of the budget deficit to 4 % may improve the country's external balances and domestic financing.
- The disinflation path is much more gradual than previously expected, as a consequence of the unfavourable international environment.
- The National Bank is responding to the development of inflation with monetary rigour, but the steps so far have also taken into account the increased risk aversion on the money and capital markets. This may fade in the coming months with economic fundamentals stabilising and inflation decelerating or may become more severe on the back of uncertainty in the political environment, the lack of room for manoeuvre of a minority government and, in particular, uncertainty about the continuity of the budget reform.

Recovery slower than expected and political tensions add further volatility risk

Bottoming-out period lasts longer than expected

Following quarterly deceleration since Q3 2006, economic growth slowed in 2007 from 3.9 % in the previous year to a meagre 1.3 %, as a result of implementing a painful stabilisation programme, which was started in 2006 in order to pave the way for Hungary's EMU membership by 2013 as the latest. By Q4 2007, year-on-year growth had shrivelled to 0.8 % from 3.7 % in the same period of 2006 and 2.7 % at the beginning of 2007. A decisive cause for the downturn was registered in the fields of private and public consumption. A decrease in real net wages as well as in social transfers led private consumption to decline (–2.1 % yoy in 2007). Restrained expenditures of the government implied a drop in the final consumption of the public sector (–3.2 % yoy) and triggered a sharp decrease (–22.7 % yoy) in public investment as well. As the value of capital expenditures implemented by the state accounted for almost 15 % of total national investment in 2006, such a strong contraction could hardly be compensated by the healthy 4.6 % yoy expansion in the fixed capital formation of the private sector. Slacker demand for construction was among the main reasons for public investment deceleration, as 81 % of state investments are implemented in the field of construction, and at a national level the volume of construction-type investment contracted by 6.8 %. Overall, the volume rise in gross capital formation reached 6.1 % comparing to 2006 as a result of the large-scale accumulation in inventories.

The only area that provided actual contribution to GDP growth was the country's net export performance, which improved constantly throughout the year thanks to growing exports and less dynamic increases in import, which were curbed by weak domestic demand. The vast majority of export growth was related to the standard front-runners in the manufacturing branches such as the machinery, electronics, automotive and chemical industry, and the manufacturing of non-metallic and metallic items. By the end of 2007, net exports in real terms registered an increase of 43 % yoy. This could have been higher if agriculture had not closed 2007 with a negative result due to severe weather condi-

tions. In real terms, value added in agriculture was down 13.3 % on 2006, but because of the 25 % price increase, nominal added value was up 7.4 %.

Weak demand delays recovery

2008 should be the turning point in the Hungarian economic trend. Successful external performance is being supported by relatively solid growth in the real economy. Driven by export sales, industrial growth picked up to 13.2 % yoy in February, a record-setting figure for growth since March 2006. With export growth accelerating close to 20 % yoy and imports expanding at 15.8 %, the external trade balance improved by 167 % yoy in February and closed with a surplus of HUF 22.1 bn against the HUF 12.9 bn deficit a year ago. Exports will continue to be the main engine behind economic growth for 2008 as a whole, even though some deceleration in net exports may still occur during the coming months in line with the foreseen weakening in demand abroad.

We expect further momentum in economic growth to come from investments, as the sufficiently strong private sector investment sentiment is unlikely to fade, while the contraction in capital expenditure by the public sector will presumably come to an end. Moreover, within the framework of EU and state development funding, construction companies can count on HUF 1,500 bn worth of orders between the summer of 2008 and the end of 2009. If only 10 % of these projects are completed by the end of this year, total volume of capital expenditure may grow by 6.8 % yoy.

We do not foresee a quick rebound in private consumption, however, as growth in real wages will remain very moderate. With an annual growth rate of 0.3 %, final consumption of households will remain close to stagnation in 2008. We envision a further 4 % yoy decline in public consumption as the government will continue to pursue a restrictive fiscal policy in order to achieve the goals set in the Convergence Programme.

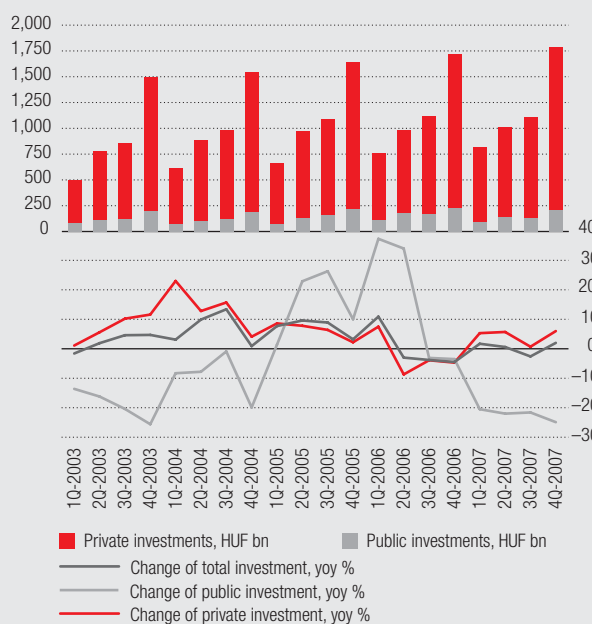
Short-term indicators

	Mar-07	Apr-07	May-07	Jun-07	Jul-07	Aug-07	Sept-07	Oct-07	Nov-07	Dec-07	Jan-08	Feb-08	Mar-08
GDP real growth, yoy (%)	2.7	–	–	1.2	–	–	0.9	–	–	0.8	–	–	–
Industrial production, yoy (%)	5.2	10.5	3.8	9.0	12.0	9.6	6.5	8.6	5.7	5.3	6.1	13.2	–
Inflation (CPI), yoy (%)	9.0	8.8	8.5	8.6	8.4	8.3	6.4	6.7	7.1	7.4	7.1	6.9	6.7
Unemployment rate (%)	7.5	7.5	7.3	7.0	7.0	7.2	7.2	7.3	7.5	7.7	8.1	8.0	–
Exchange rate HUF/EUR, eop.	247.8	246.4	250.4	245.9	250.7	254.1	250.8	251.1	253.4	253.4	259.5	262.2	259.4
1M Buber, avg.	8.06	8.01	8.00	7.96	7.74	7.78	7.70	7.50	7.50	7.51	7.50	7.62	7.78
Export, (EUR) yoy (%)	14.1	19.1	13.5	19.3	23.9	19.6	13.0	17.4	8.1	6.4	16.4	17.5	–
Import, (EUR) yoy (%)	6.1	16.6	9.2	14.0	17.2	15.1	7.3	13.5	5.5	7.1	12.9	13.6	–
Trade balance, EUR mn	–151.7	–307.1	–286.7	–150.0	–281.0	–480.8	–245.3	–197.8	–137.2	–307.4	–70.5	78.8	–
Current account, EUR mn ¹	–1,111.0	–	–	–2,626.0	–	–	–3,947.0	–	–	–5,060.0	–	–	–

Source: NBH, Statistical Office, Ministry of Finance, UniCredit Group CEE Research Network.

1) cumulative.

Development of investments by sectors



Source: Central Statistical Office, UniCredit Bank Hungary.

Overall, we expect GDP growth to reach an average rate of 2.4 % yoy in 2008, lower than the previous estimate of 2.8 %. Stronger acceleration in economic activity might be expected from 2009, as private consumption will start to revive. The most significant acceleration, however, is expected to come about in 2010, as global demand should start to re-stabilise. All in all, the Hungarian economy is expected to expand by 2.9 % in 2009 and 4 % in 2010.

Public finances remain under tight control

The 2007 budget deficit reached 5.5 % of GDP, which was well better than expected, marking an improvement of 3.7 % against the 2006 deficit of 9.2 %. The central budget realised HUF 600 bn (EUR 2.4 bn) in revenues over the plan, although two-thirds thereof was already used, also over the plan, for the absorption of losses by public institutions in a difficult situation due to the austerity measures. The deficit target of 4 % set for 2008 seems achievable. The most critical item is the social security fund, but there was already some surplus in this fund last year. Jump-starting the overly-chilled economy, however, calls for a reduction of tax burdens in order to improve the country's international competitiveness. Employers' forums and independent experts expect a significant cut in government expenses, equal to at least 4 % of the GDP, partially done through a cutback in public administration, but even more in social expenditures. As a matter of fact, Hungary spends about 60 % of the budget on social benefits, and this is closely related to an unhealthy employment structure and a lax pension system.

Within the framework of the healthcare reform, the outcome of the March 9 referendum scuttled the government's measures. Four-fifths of the voters plainly refused to contribute to medical treatment and daily hospital care, paying a modest fee of slightly more than EUR 1 on

a case-by-case basis. They also refused the introduction of tuition fees payable by students in university education – free until now – during the years of their studies.

The referendum undermined the coalition government's political support. At present, support for the opposition is far stronger and this, by any means, implies narrow limits for the government's capacity to propose and implement further budgetary reforms. The Socialist party, which is expected to form a minority government, will reformulate its reform steps and the economic policy connected therewith. Still, until the upcoming elections in spring 2010, there is only extremely limited leeway for any kind of comprehensive reform policy. However, there are attempts to reshape the Act on Regional Healthcare Funds, approved in connection with the healthcare reform, to avoid the involvement of private capital in the system, a point strongly attacked by the opposition and the general public. Another referendum will most probably be held on this issue this autumn.

For the time being, the Socialist government is resolutely standing up for the continuation of the general government's reform and reduction of the budgetary deficit, in line with its commitment in the Convergence Program approved in 2006 by the EU Commission. The Program foresees the budgetary deficit dropping below 3 % by 2009 and, in principle, not allowing a softening of the reform process for the sake of recovering political popularity and election spending in connection with the 2010 elections. Up to now, the budgetary policy of the Socialist government has qualified as credible in the eyes of foreign investors, and data for the first half of 2008 also confirm that the 4 % plan can be achieved. However, from the point of view of budget reform and tax reform, being shaped jointly with the employers, some very unfavourable news is that the surplus revenues of about EUR 1 billion this year are not available even for a modest tax reduction, because the financing of state debt and current budget deficit will eat up most of this surplus, as a consequence of soaring market interest rates.

Inflation to decelerate only slowly

With the surprisingly strong 8 % surge of average prices in 2007 now past, many analysts had anticipated that the high base effect would bring a relatively significant deceleration in CPI from January 2008 on. On the contrary, it seems that the delayed pass-through effect of higher agricultural prices to food prices and the steep rise in household energy prices kept the CPI from declining very much. In March, headline yoy inflation was still at 6.7 %, down slightly on February's rate of 6.9 % and January's figure of 7.1 %. Moreover, in February core inflation even accelerated, rising from 5.2 % yoy in January to 5.3 % yoy and remaining at the same level in March. As forthcoming month-on-month indices are expected to ease just slightly, headline inflation will decrease very slowly during the rest of 2008. We expect CPI yoy growth to be around 6 % until September, and then decline to 4.9 % by the end of the year.

Central bank takes a tightening stance – no cuts earlier than the end of the year

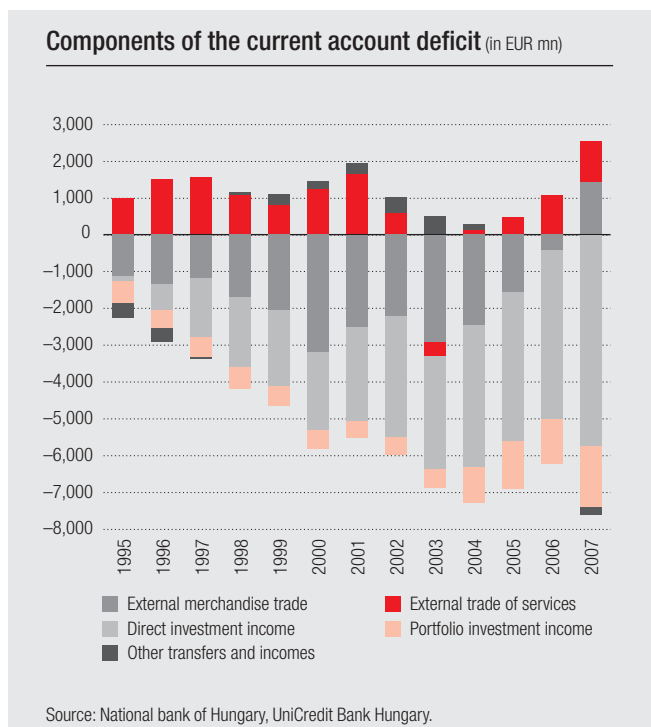
With effect from April 1, 2008, the National Bank of Hungary increased its base rate to 8.0 %, from 7.5 % which had been in effect since last September. This rate hike was preceded by several months, during

which investors on the financial market were expecting a move towards a tighter monetary policy in response to the unfavourable inflation data. But the Monetary Council, attributing the stubbornly high price levels primarily to exogenous factors, and also considering the significant decrease in real wages and real earnings dampening demand pressure, avoided tightening its monetary policy in the first few months of the year. At the end of March, however, the Monetary Council was compelled to concede to market pressure, as a consequence of a lack of demand in the Hungarian government bond market.

It is well-known that the risk premium for Hungary jumped strongly as a result of the global credit crunch in the summer of 2007, but this level in itself did not represent a threat to the base rate of 7.5 %. As in several other emerging regions, international investment demand backed off from the Hungarian government securities market, and as a consequence the government securities stock held by non-residents declined by about 400 million early this year. This is, however, a minor drop in volume as compared to their holdings of EUR 12–14 billion. The main trigger behind the freeze-up on the government bond market was indeed a new regulation on Hungarian pension funds, come into force in the beginning of 2008, as a consequence of which pensions funds started to restructure their portfolios. According to this regulation, the ratio of equities, which was previously limited to 10 %, could now be increased to 40 %. On this basis, they dumped a portion of their government securities holdings onto the market and, due to the lack of investor demand, they managed to freeze the Hungarian bond market. Yields soared by 100-150bp, remaining without buyers, even at those prices. The upsurge in yields forced commercial banks to sell, realising losses, due to bond supply rising to enormous levels on the market. The increase in yields pushed up the prices of auctions also to the upper ceiling – the financing of the Treasury jumped to the band of 8.5–9.0 % p.a. Interbank interest rates (in an expectation of a major increase in central bank rates) followed the yield curve of government securities – breaking away from the NBH base rate. On April 28, the central bank decided to further tighten monetary policy by increasing the key rates to 8.25 %, in order to curb inflationary pressures. Though further rate increase can not be ruled out in the next months, with economic fundamentals stabilising and inflation decelerating, the central bank should be able to cut the rate back to 7.5 % at least by the end of the year.

External financing fundamentals improve firmly

Hungary's current account deficit narrowed by 7.1 % yoy to EUR 5.1 bn in 2007, but the decline was more moderate than previously expected. Quite a considerable part of the improvement in trade gap was offset by the increase of repatriated profit related to FDI, the nominal value of which rose by EUR 1.15 bn to EUR 5.72 bn (+25 % yoy), basically due to impressive export expansion of multinational corporations. This means that while companies in foreign ownership improve the trade gap, the excess profit they generate from growing exports deteriorates the final amount of the CA balance. As a conclusion, we expect



just a slight yoy improvement in the CA deficit in the future. The amount of net inward FDI reached EUR 4 bn (4 % of the GDP) in 2007, EUR 1.4 bn less than in 2006, as the sale of Budapest Airport to the Hochtief by the former owner BAA for EUR 1.8 bn was financed basically from loan taken from banks abroad. The transaction not only deteriorated FDI statistics but increased Hungary's external indebtedness. The net flow of portfolio investments also turned negative, corresponding to 5.28 % of GDP. Nonetheless, Hungary's net foreign financing requirement narrowed to 7.4 % of GDP from 8.6 % in 2006 as a consequence of improving external trade performance and shrinking borrowing requirement of the government.

Event	Date	Reading
Budget 2009	Q4 2008	It is important to see whether even a minority government is able to go on with the necessary reforms

Latvia



Outlook

After peaking in H2 2007, we expect a clear economic slowdown in Latvia this year, with growth anticipated to bottom out in 2009. Since July 2007, the international repricing of risk has hit the country, as reflected by the strong increase in credit default swap spreads. Given the strong reliance of the country on international capital flows to finance the huge current account balance, the increase in the cost of risk is leading to deceleration. This is already clear in the banking sector, where credit growth has more than halved since April–May. Risks of a much broader correction remain skewed on the upside with tight fiscal policy and a proactive central bank approach essential to support a smooth adjustment process and prevent major risks of over-reaction.

MOODY'S LT FC RATING
A2/Stable

S&P'S LT FC RATING
BBB+/Negative

FITCH LT FC RATING
BBB+/Negative

SPREAD AVG (APR) N. A.
EMBI+ Spread on Euro Curve

Macroeconomic data and forecasts

	2006	2007	2008f	2009f	2010f
Nominal GDP (EUR bn)	16.0	20.0	24.0	26.7	29.8
Per capita GDP (EUR)	6,990	8,760	10,590	11,820	13,250
Real GDP, yoy (%)	11.9	10.2	4.7	3.0	5.7
Inflation (CPI), yoy, Dec. (%)	6.8	14.1	10.5	7.0	4.5
Inflation (CPI), yoy, avg. (%)	6.5	10.1	14.5	8.0	5.8
Unemployment rate avg. (%)	6.8	6.0	6.2	6.5	6.3
Exchange rate LVL/EUR, eop./avg.	0.703	0.703	0.703	0.703	0.703
Refi rate, eop.	5.00	6.00	5.50	5.00	5.00
Interest rate (3M Rigibor), Dec	4.20	10.75	5.60	5.10	5.05
Interest rate (3M Rigibor), avg.	4.37	8.66	6.35	5.40	5.05
Current account balance/GDP (%)	-22.3	-22.8	-17.0	-14.0	-12.0
FDI/GDP (%)	8.3	7.9	6.7	6.6	5.2
Budget balance/GDP (%) ^{1 2}	-0.2	0.0	0.2	0.2	0.5
Public debt/GDP (%)	10.6	9.7	7.7	7.0	6.3
Total external debt/GDP (%)	113.1	133.3	127.9	125.3	114.3

Source: Bank of Latvia, Central Statistical Bureau of Latvia, UniCredit Group CEE Research Network.

Note: 1) Net lending/borrowing under Excessive Deficit Procedure; 2) ESA95.

Main topics

- Real GDP growth eased to a revised rate of 8.0 % yoy in Q4 2007 from almost 11.0 % in Q3, on the back of weaker consumption and a cool-down on the real estate market. Compared to the past months, we now expect a more marked correction in the economy, in the context of a highly unsupportive global context, with GDP growth to slow to 4.7 % for the whole year.
- Inflation remains a serious problem for the Latvian economy after having peaked at its highest level in 11 years, at 16.8 % in March

as prices for food, heating and clothing rose. However, decelerating economic growth and weaker consumption growth should bring some moderation in the dynamic of prices especially in H2, with inflation to reach 10.5 % at the end of the year.

- Despite some tentative signs of weakening pressure, the global repricing of risk further highlights the risks in terms of the sustainability of external imbalances.

Economy clearly loosing momentum

Further significant cooling is on the cards

The Latvian economy is showing the first signs of cooling off. Real GDP growth eased to a revised rate of 8.0 % yoy in Q4 2007, down from almost 11.0 % in Q3, on the back of sagging consumption and a cooler real estate market. The risks of a faster correction of the current macroeconomic imbalances have clearly risen in the last 6 to 7 months, as is also reflected by Fitch's Ratings downgrade of the country's outlook to 'negative' at the end of last January, and rising credit default swaps spreads (to almost 170 bps from 138 bps at the beginning of the year).

More marked deceleration is on the cards in light of the first data available for 2008. Retail sales rose only by a marginal 1 % yoy in February, after the fall posted at the beginning of the year, mainly on the back of waning growth in sales of food, beverages and tobacco, while industrial production dropped for the third month in a row, falling by -0.4 %. Skyrocketing inflation is clearly contributing to eroding consumers' buying power, resulting in weaker economic growth. So far, the anti-inflationary measures introduced by the government last summer have been quite unproductive, with the only consequence being a negative impact on the real estate market. The number of transactions in the property market dropped by almost 18 % in 2007, with prices for flats in the capital city falling by a similar amount after having peaked in April at over EUR 1,700. In turn, the slowdown of the real estate sector negatively influences consumption, via a wealth effect, and investment.

An important contribution to the ongoing stabilisation in the pace of economic growth is also coming from tighter lending requirements by banks affected by the ongoing increase in the cost of funding, in the context of high dependency from foreign financing. After having almost halved throughout 2007, growth in domestic credit further slowed in the first two months of 2008 to reach a seven-year low of 29 %. A further slowdown is anticipated in the months to come with loans growth expected to reach around 21 % at the end of this year.

Compared to the past months, we now forecast a more marked correction in the economy already starting from Q1 2008, with GDP growth to slow to 4.7 % for the whole year. Growth is expected to bottom out in Q4 2009 and to reaccelerate only starting from 2010. Risks, however, continue to be skewed on the downside with a much faster correction in the economy, which might bring renewed pressures on the lat. In that context, possible adjustments in the pegging cannot be ruled out, even if speculative attacks against the currency are still very difficult to launch as the market is too shallow. After the weakening trend observed in the first half of 2007, pressures on the lat gradually abated

towards the end of the year. Money market rates have also returned to more normal level, with 3M Rigibor dropping from almost 13 % in October to 6 % in the recent weeks.

Inflation out of control

Latvian CPI inflation topped out at its highest level in more than 11 years, reaching 16.8 % in March from 16.7 % in February. Fast rising food prices, up 21 % on a yearly basis, together with higher prices for tobacco and alcohol, water, housing, gas and electricity were behind the upward trend in inflation observed since beginning of the year. In the months to come, sagging domestic demand and consumption growth are expected to foster some improvement in the inflation outlook, especially starting from this summer, with CPI inflation expected to gradually slow to 10.5 % at the end of the year. Still, as inflation is currently also a world story related to food price developments, risks again remain on the upside.

Tighter fiscal policy remains crucial

Following some tightening in the fiscal performance through the year and extra revenues supported by a strong dynamic of the economy, the general government balance ended 2007 with a marginal deficit of -0.04 % as a percentage of GDP (by the ESA95 standards). The government is putting a lot of efforts into improving budget performance, planning a larger surplus in the following years to fight inflation and help reduce current imbalances. At the same time, some measures such as the elimination of the down-payment requirement on mortgages (currently set at 10 %) are currently under discussion in order to support a smooth correction in the economy and avoid any abrupt reduction in lending. Concerns about a possible over-reaction remain also on the central bank side resulting from the recently announced lowering of mandatory reserves for commercial banks.

Pressures on the CA deficit to lower, but the gap remains large

The pace of expansion in the Latvian economy is gradually loosing ground as confirmed by recently released data on the current account deficit which reflected a significant deceleration by -9 % yoy to reach a cumulated LVL 425 mn (EUR 0.6 bn) in January-February, on the back of slack domestic demand. Inflows of FDI remain strong after having peaked at almost 8 % in 2007, although they still provide only modest coverage of the gap. Sluggish consumption and still good export performance are expected to support some improvement in terms of a further reduction in the CA deficit through the year to reach 17.0 % of GDP in 2008 from 22.8 % registered in 2007. Financing the gap in the current global environment is, however, increasingly difficult.

Event	Date	Reading
GDP growth, CPI and CA balance	–	Rising imbalances might trigger further pressures on the lat requiring forceful intervention by CB

Lithuania



Outlook

With economic growth in the EU countries decelerating and the repricing of risk at the international level having effects on country spreads and interbank rates, the global liquidity crisis is affecting the Lithuanian economy via both the real and the financial channel. The expected slowdown in growth will neither be sudden nor dramatic, and it will have some positive effects in offsetting economic overheating. External imbalance will improve, amidst lower import growth, with the key challenge in terms of funding related to international banks' attitude towards the country. CPI inflation will remain high this year and drop off only gradually, meaning that EUR adoption in 2010 is now quite unrealistic.

MOODY'S LT FC RATING
A2/Stable

S&P'S LT FC RATING
A-/Negative

FITCH LT FC RATING
A/Negative

SPREAD AVG (APR) 82
EMBI+ Spread on Euro Curve

Macroeconomic data and forecasts

	2006	2007	2008f	2009f	2010f
Nominal GDP (EUR bn)	23.7	28.0	33.0	37.2	41.4
Per capita GDP (EUR)	6,990	8,330	9,840	11,130	12,410
Real GDP, yoy (%)	7.7	8.8	6.5	5.3	5.6
Inflation (CPI), yoy, Dec. (%)	4.5	8.1	8.2	5.9	4.7
Inflation (CPI), yoy, avg. (%)	3.8	5.7	10.7	7.1	5.3
Unemployment rate, LFS (%)	5.6	4.3	4.7	5.1	5.0
Exchange rate LTL/EUR, eop./avg.	3.45	3.45	3.45	3.45	3.45
Interest rate eop. (3m Vilibor)	3.72	7.19	4.22	3.55	3.80
Interest rate avg. (3m Vilibor)	3.11	5.21	5.20	3.89	3.68
Current account balance/GDP (%)	-10.8	-13.7	-11.9	-11.2	-9.8
FDI/GDP (%)	6.1	5.0	4.6	4.5	5.2
Budget balance/GDP (%)	-0.5	-1.3	-1.2	-0.9	-0.7
Public debt/GDP (%)	18.2	17.4	17.3	17.3	17.2

Sources: Ministry of Finance of the Republic of Lithuania, Lietuvos Bankas, Statistics Lithuania, Eurostat, UniCredit Group CEE Research Network.

Main topics

- Preliminary data show a relevant GDP slowdown in Q1, with growth reaching 6.4% year on year. Some signs of slowdown, mostly in investment activities, become already apparent since Q4 2007, despite leading indicators point for a continuation of a relatively sustained growth path in the first part of 2008
- Global turbulence in the financial market is influencing Lithuanian assets, leading to higher bond spreads (i.e. higher country risk) and higher interbank rates.
- Inflation has not stopped accelerating and hit 11.3 % yoy in March. Cumulated inflation since the end of 2007 is already close to 4 %.
- The current account deficit surged to 13.7 % of GDP in 2007. It is mainly financed by foreign bank credit, and this will remain a source of vulnerability. Erosion of official reserves continued in recent months, and they are now down 14 % on the level registered at the end of 2007.

Ready for the long-awaited slowdown

Further risks from the external environment

The global liquidity crisis is having an impact on the Lithuanian economy, as markets revise their perception of Lithuanian risk in view of domestic vulnerabilities related to clear signs of economic “overheating” (strong growth with significant external imbalances and rising inflation), the stagnating housing market, and inflexibilities in terms of adjustment due to the currency board. Spreads on 10-year international bonds – an indication of the markets’ perception of country risk – eased in April to 110 bp, down from the highs in March (almost 130 bp), but are still well higher than last year, when they were ranging at around 60 bp. The 1-year forward rates on the currency are not very far off from exchange rate parity (less than 1 %), indicating a negligible risk of depreciation. Despite being less relevant compared to end-2007, liquidity tensions have once again pushed the 3M Vilnibor over 5 %, up from 4.80 % in March.

Growth waning

Domestic demand weakened and economic growth slowed down during the last quarter of 2007, when the GDP grew by 8 %, down from 10.9 % in Q3. The deceleration was mainly driven by the sharp slowdown of investments, which grew by 8.4 % yoy in Q4. The preliminary GDP growth data for the first quarter of this year shows a further deceleration, to 6.4 %. While the three Baltic countries are in different economic phases, it is clear that all of them are suffering from domestic and international weaknesses. A marked slowdown is already on the cards in Estonia and most probably will come in Latvia, and those two countries account for 20 % of Lithuanian exports.

Leading indicators in Lithuania do, however, point to a continuation of a relatively sustained growth path in the first half of 2008. The most recent data for industrial production and retail sales showed growth rates higher than 10 % and 20 % respectively, and export performance was also strong. Moreover, new car sales are growing fast. Lending growth to the private sector is decelerating, but remains higher than 40 % in yoy terms.

Inflation rising

Inflation is one of the major sources of concern for Lithuania and in general for the Baltic economies. The year-on-year March inflation rate reached 11.3 %, with food and commodity prices among the major drivers. Eurozone inflation is also accelerating (now at 3.6 %), but the gap between the two inflation rates, in Eurozone and Lithuania, has never been so wide. This wide gap is a problem for the country’s competitiveness (on the supply side) and will have negative effects on the purchasing power of consumers (on the demand side). The Producer Price Index, which can be considered an early indicator of inflation, is now higher than 20 %, despite some slowdown in March with respect to February. Inflation will remain high during the months ahead and will probably peak this year. Our inflation forecasts for the coming years imply that euro introduction in 2010 (as previously planned) is no longer a realistic target.

Fiscal accounts worsening

The general government deficit was higher than expected in 2007, and the government also slightly missed the revenue target in the first months of 2008.

The government aims to improve the budget and turn around the current deficit into a surplus, but this objective appears to be a tall order during an election year, with general elections scheduled for the autumn of this year. Despite the rapid growth in the Lithuanian economy, the policy response of the authorities is rather mild, as has also been underlined by the EU Commission. Some correction is expected only in 2009 and 2010. Public debt fell to 17.4 % of GDP last year (from 18.2 % in 2006), below the target set in the convergence programme.

Current account gap expected to ease

The current account deficit surged to 13.7 % on average in 2007 (EUR 3.8 bn), up from 10.9 % in 2006 (EUR 2.5 bn). However during the last quarter of 2007 the deficit eased to 12 %, and the most recent foreign trade data (with exports booming during the first two months of 2008) appear to support further improvement in the external position.

Nonetheless, financing the current account deficit will be challenging, given its current structure: foreign direct investments covered less than 40 % of the current account deficit in 2007 (5 % of GDP), and foreign banks’ financing represented more than 12 % of GDP in 2007 (up from 8.6 % in 2006). Even if this credit is mostly associated to intra-company funding from the large Nordic banks to local subsidiaries, we believe that in the context of tighter credit standards at the international level, some tightening might be expected, which would then translate in a tightening of domestic credit in the country. In the meantime, erosion of official reserves is becoming apparent: in March official reserves declined for the fifth month in a row and are now around EUR 4.5 bn, 14 % lower than year-end, but still amounting to 3 months of import coverage.

In the coming years, we expect a modest reduction in the current account deficit. Export activity will be tempered by lower EU demand (representing 65 % of Lithuanian exports), although exports of petroleum products will rebound thanks to the Mazeikiu refinery. Lower imports will contribute to the reduction of the external gap.

Soft landing still possible?

All in all, given the external and domestic conditions, we expect a rather clear slowdown to materialise. We forecast GDP slowing to 6.5 % in 2008 and to around 5.5 % in 2009 and 2010. Per capita GDP is expected to be close to EUR 12,400 in three years’ time. Still, this is probably not the kind of hard landing that we will see in the other Baltic countries.

Event	Date	Reading
GDP Q1	May 29	Cooling down of growth should be confirmed

Poland



Outlook

The Polish economy continues to perform quite strongly, with some moderation from the peaks seen in recent years, but remaining relatively resilient to the new global environment. Growth decelerated slightly in Q4 2007 and we expect this trend to continue over the medium term, due to the higher interest rate environment and deterioration in net exports. Nonetheless, we continue to forecast a 5.2 % rate of growth for 2008. Despite the turbulence in global financial markets and high volatility on the Polish equity market, the zloty has appreciated rapidly. Inflation remains high, and we expect it to peak at around 5 % in the middle of this year. The Monetary Policy Council (MPC) has raised the interest rate by 75 bp since the beginning of 2008 and some additional hikes are possible. The government has presented a new convergence programme that foresees the structural public finance balance to be cut to 1 % of GDP in 2010, while the Ministry of Finance declared 2012 as the most probable date for euro adoption.

MOODY'S LT FC RATING
A2/Stable

S&P'S LT FC RATING
A-/Positive

FITCH LT FC RATING
A-/Stable

SPREAD AVG (APR) 69
EMBI+ Spread on Euro Curve

Macroeconomic data and forecasts

	2006	2007	2008f	2009f	2010f
Nominal GDP (EUR bn)	272.2	308.4	370.4	390.7	413.7
Per capita GDP (EUR)	7,140	8,090	9,740	10,270	10,870
Real GDP, yoy (%)	6.2	6.6	5.2	4.4	4.7
Inflation (CPI), yoy, Dec. (%)	1.4	4.0	4.2	2.2	2.4
Inflation (CPI), yoy, avg. (%)	1.0	2.5	4.6	2.6	2.3
Unemployment rate (%)	16.2	12.7	10.4	9.0	7.9
Exchange rate PLN/EUR, eop.	3.83	3.58	3.45	3.53	3.50
Exchange rate PLN/EUR, avg.	3.90	3.78	3.44	3.48	3.52
Interest rate (reference), Dec.	4.00	5.00	6.25	5.00	4.75
Interest rate (WIBOR-3M), Dec.	4.20	5.67	6.33	4.98	4.89
Interest rate (WIBOR-3M), ann. avg.	4.21	4.74	6.28	5.64	4.90
Current account balance/GDP (%)	-3.2	-3.7	-4.5	-5.2	-4.8
FDI/GDP (%)	5.5	4.2	3.5	3.6	4.0
Budget balance/GDP (%) (ESA95) ¹	-1.8	-2.0	-2.6	-2.5	-2.3
Public debt/GDP (%) (ESA95) ¹	42.5	45.2	44.3	44.5	44.3
Total external debt/GDP (%)	46.5	48.0	52.0	52.4	52.7

Sources: Central Bank, Central Statistical Office, Bank Pekao Research Division – UniCredit Group CEE Research Network.

1) Pension funds are calculated as part of the public sector up to 2006 and from 2007 related costs are fully included.

Main topics

- GDP growth in Q4 2007 was 6.3 % yoy, with fixed investment as the main driver. Net exports deteriorated slightly, while private consumption increased by only 3.7 %, which is much less than the 9 % rise in real wages. Employment and average wages in the business sector accelerated again at the beginning of 2008, signalling that the consumption boom is still ahead of the economy.
- Despite the repricing of risk at the international level and volatility in global markets, zloty appreciation accelerated further in March and April, as the euro rate fell to 3.4 zloty. Some further strengthening of the zloty is still possible.
- After increasing rapidly throughout Q4 2007, with a rise from 1.5 % in August 2007 to 4.2 % in February 2008, inflation decelerated to 4.1 % in March. We expect that the Monetary Policy Council (MPC) will stop monetary policy tightening in the middle of the year at 6.25 %. But if world food and energy prices continue to increase, the MPC will raise the interest rate by 25 bp or even 50 bp in H2 2008.
- The central budget balance recorded a surplus of PLN 3.1 bn in March, heralding a better-than-planned result for 2008 as a whole.

Resilient to the new global environment – increasing inflation, but growth remains strong and the zloty appreciates

Growth dynamics is stable in the beginning of 2008

In Q4 2007, growth stood at 6.3 % yoy, down 0.2 p.p. from Q3. Fixed investments remain the most important driver, with a very strong 16.4 % yoy increase. Private consumption on the other hand decelerated, falling from 5.2 % to 3.7 % yoy, which was quite a strange development considering the strong increase in household incomes and the 12.2 % real growth in retail sales. Net exports which usually fall in Q4 improved, from –2.89 % of GDP in Q2 and –2.46 % of GDP in Q3, to –1.85 %. Industrial output accelerated to 8.5 % yoy in Q1 2008, after slight deceleration in November and December 2007. Bank lending grew at the still very high pace of 29.5 % in year-on-year terms, despite higher interest rates in Q1 2008, signalling that demand for credit remains robust. We expect GDP growth at above 6 % in Q1.

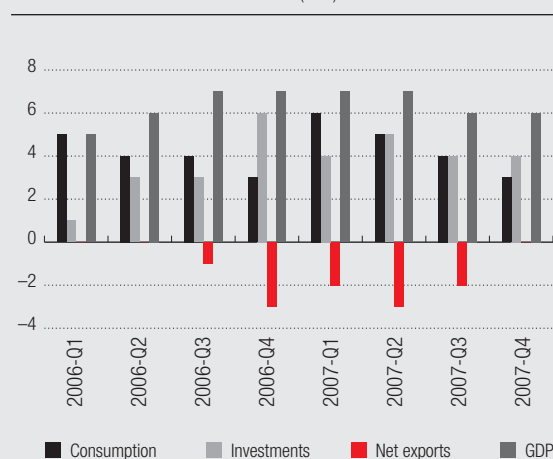
Production capacity constraints limit further growth, with full recovery from 2010

We expect some more deceleration in growth in the quarters ahead, as the Polish economy will feel the pinch of production capacity limits more and more. The impact of higher-than-expected inflation, higher interest rates and strong zloty appreciation will also be gradually felt. Gloomy prospects for EU growth will play a role as well. All in all, we maintain our forecast of 5.2 % GDP growth for 2008 as a whole and 4.4 % in 2009. Similarly, we expect a reversal of this trend in 2010 as strong current investment will eventually alleviate the production capacity constraints. In 2010, growth will be also supported by a lower central bank interest rate, the expected recovery of the world economy, tax cuts as well as other business environment reforms and the acceleration of privatisation announced by the government. The main risk to growth is possible further acceleration of food and energy prices especially, which would force the MPC to tighten monetary policy much more than in our current base scenario.

Reversal in the emigration trend

Emigrants are coming back to Poland as wages in the Polish economy

Contribution to GDP Growth (in %)



Source: Central Statistical office, Bank Pekao – MRO.

have increased strongly, while the rapid appreciation of the zloty and weaker growth in Western Europe have made foreign jobs much less attractive. This reversal of emigration may relieve tensions in the Polish labour market. Employment growth in the private sector accelerated again in Q1 2008 to 6 % yoy, while average wage rose 11.4 %. After a seasonal increase in January to 11.7 % the official unemployment rate fell again to 11.1 % in March. The acceleration of average wages in the private sector was a partly one-off effect of some delay in extra-payments which usually were paid at the end of the year. Additionally, the new government turned out to be strong enough to withstand labour union pressures for additional wage growth in the public sector. Therefore, we still expect some deceleration in average wage growth in the coming quarters to around 8 % in nominal terms at the end of 2008, which will lower real wages growth in H2 2008. Taking into account still strong output and domestic demand growth, these wage increases are

Short-term indicators

	Mar-07	Apr-07	May-07	Jun-07	Jul-07	Aug-07	Sept-07	Oct-07	Nov-07	Dec-07	Jan-08	Feb-08	Mar-08
Real GDP, yoy (%)	7.3	—	—	6.5	—	—	6.5	—	—	6.3	—	—	—
Industrial production, yoy (%)	11.3	12.6	8.1	5.6	10.4	8.9	5.4	10.8	8.5	6.4	10.7	15.0	0.9
Inflation (CPI), yoy (%)	2.5	2.3	2.3	2.6	2.3	1.5	2.3	3.0	3.6	4.0	4.0	4.2	4.1
Unemployment rate (%)	14.3	13.6	12.9	12.3	12.1	11.9	11.6	11.3	11.2	11.4	11.7	11.5	11.1
Exchange Rate/EUR, eop.	3.87	3.79	3.82	3.76	3.79	3.82	3.78	3.63	3.63	3.58	3.63	3.52	3.53
3M Wobor, avg.	4.22	4.32	4.44	4.52	4.78	4.91	5.09	5.13	5.36	5.67	5.64	5.74	6.02
Export, (EUR) yoy (%)	13.4	16.1	11.6	10.7	17.0	14.9	8.2	13.6	13.1	8.6	21.9	28.7	—
Import, (EUR) yoy (%)	20.8	25.4	13.7	20.8	23.3	13.4	13.7	17.7	15.4	15.3	18.8	32.3	—
Trade balance, EUR mn	–1,076	–949	–957	–1,123	–1,299	–472	–917	–858	–785	–1,294	–644	–933	—
Current account, EUR mn	–818	–687	–1,246	–1,506	–1,252	–576	–546	–1,158	–95	–1,976	–1,105	–1,324	—

Sources: Central Bank, Central Statistical Office.

not very dangerous for corporate profitability, but may constitute one of the main reasons behind the increasing inflation pressure.

Inflation will accelerate again in the months ahead, and then taper off by year-end

After reaching 4 % yoy in December, inflation stood at the same level in January (partly due to the adoption of the new CPI basket, which lowers inflation figures by 0.1–0.2 percentage points). It then jumped to a peak of 4.2 % in February and subsequently eased to 4.1 % in March. The contribution of food and fuel prices to inflation decreased as year-on-year food price inflation fell from 8.2 % in December 2007 to 7 % in March and the rate of increase in fuel prices fell from 18.1 % to 10.1 %. Nevertheless, electricity and natural gas prices accelerated, as well as some service prices. A further rise in gas and electricity prices was already announced for April and May as well. We expect that inflation will reach around 5 % in the middle of 2007 and then gradually decrease to 4.2 % in December. But there are serious upside risks due to the danger of further increases in world energy and food prices.

Monetary policy tightening to continue

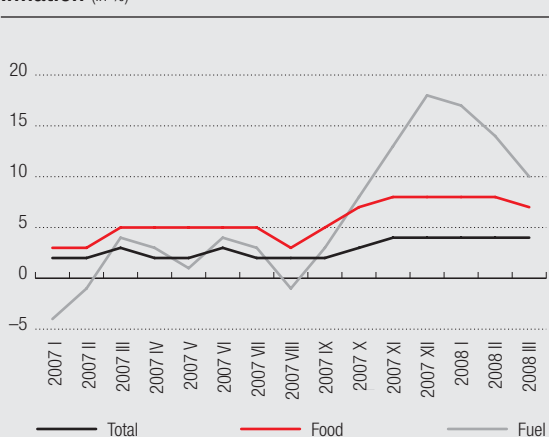
The MPC has been dominated by hawks in recent months, so monetary policy tightening gathered pace at the beginning of this year. The reference rate was raised three times by 25bp in Q1. The zloty reacted very strongly, appreciating from December to the middle of April and gaining more than 5 %. Probably this will prompt the MPC to wait one or two months for another hike, but this may not be the final move in this cycle of interest rates increases. The main MPC concern is wage growth, and hence the latest acceleration of this indicator had to make the MPC nervous. Additionally, the energy sector supervisory authority just approved a substantial hike in gas and electricity prices, to be introduced in April and May, impacting inflation again. Another danger comes from the accommodating monetary policy stance of the US Fed, which could easily lead to a further increase in world energy prices. So far, zloty appreciation has partly offset inflationary pressures stemming from higher global inflation. Nonetheless, the MPC is aware that the recent zloty appreciation can be only a short-term effect of the increas-

ing spread between Polish and foreign interest rates and thus understands that it cannot take this as a foundation for its strategies to achieve a sustainable reduction in inflation. While the strong zloty may foster disinflation, over the long run it will only be effective if it is supported by a substantial drop in domestic demand. In such an environment, we expect the MPC to continue to tighten and forecast two 25-bp interest rate rises in the middle of 2008 to 6.25 %. On the other hand, a stronger interest rate increase may result in greater exchange rate volatility, because over the short run it will result in stronger appreciation but over the medium term it will work against the external balance of the Polish economy. We recognise some upside risk in the interest rate scenario in H2 2008, arising from uncertainty about world energy and food price developments going forward.

Despite zloty appreciation, exports have accelerated, but less than imports

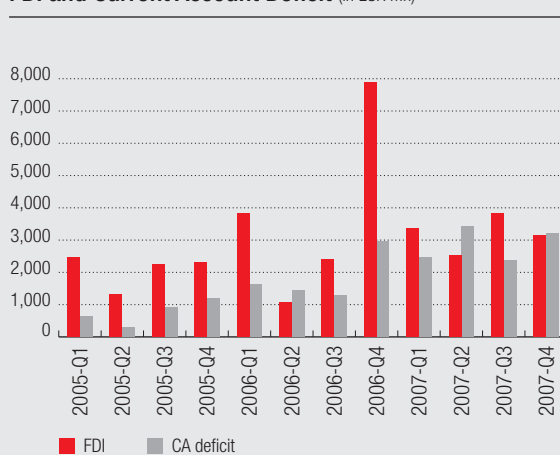
From September 2007 to the middle of April, the zloty appreciated more than 10 % in reaction to the increasing interest rate spread and the still very brisk growth of the Polish economy. Despite this, exports remained above 20 % yoy in January and 28 % in February. This can be explained by the increasing role of foreign investors in the Polish export sector, which are relatively less sensitive to increasing wage costs, and to the absorption effect caused by soaring domestic demand. Imports, however, which grew at a slightly lower rate than exports in January, jumped to almost 32 % yoy in February. In part, this was because of a strong increase in cars purchased with cash withdrawn from mutual funds in January, after equity prices fell. Therefore, this spike in imports may only be a temporary phenomenon. However, there is a clear trend towards gradual deterioration in the trade balance. This should not influence exchange rates in the next few months because of strong FDI inflows (which however were almost 15 % lower in euro terms in 2007 than in 2006), inflows of EU funds and remittances of emigrants which in 2007 were estimated at above EUR 5.8 bn. The increasing interest rate spread will also prompt an increase in portfolio investments. This is why we have revised down our December 2008 forecast of the euro exchange rate to 3.45 zloty. In 2009, however, the increasing current account deficit will exert some pressure on

Inflation (in %)



Source: NBP, Bank Pekao – MRO.

FDI and Current Account Deficit (in EUR mn)



Source: NBP, Bank Pekao – MRO.

the zloty. We also expect some more weakening of FDI inflows than previously estimated, because of the global slowdown. Increasing foreign debt presents an additional risk. In 2007, foreign debt increased by EUR 14.1 bn. In 2008, we expect an even stronger rise, because the banking sector will be looking for external finance as households have shifted to FX mortgage loans again after the interest rate spread widened. We expect zloty depreciation to EUR/PLN 3.53 by the end of 2009. Only in 2010 will the zloty appreciate again, as increasing production capacity will support export growth and the lower interest rate spread will render foreign financing less attractive.

Government's convergence programme is ambitious, but it is still not clear how to achieve it

Due to strong growth, the budget registered a surplus of PLN 3.1 bn in Q1 2008, boosting the chances that the 2008 budget balance will once again be much better than planned. The government has just published a new convergence programme that incorporates a structural public sector deficit of 1 % of GDP for 2010. Nevertheless, it is still unclear what measures will be adopted to achieve this goal. The government repeated the promise of tax cuts in 2009, 2010 or 2011, but still is not revealing what cuts in expenditures will be made. One can be almost sure that any government attempt to cut social spending will be blocked by presidential veto, with the early retirement law being the

only possible exception. The current law, which assures early retirement for wide groups of workers, will expire at the end of this year. This means that if a new law, which narrows early retirement to smaller number of professions, is blocked by president, all workers would lose this right. One can therefore expect that the president will be forced to approve new regulations. Other savings are feasible only by cutting government administration costs, which cannot generate a significant result. So the success of the government's plan for fiscal adjustment depends mainly on economic growth, which must be above 5 % in the next two years to reconcile tax cuts with budget deficit cuts.

Ministry of Finance suggests euro adoption is possible in 2012

This declaration should be treated more as a forecast, rather than a strong commitment. The government announced at the very beginning of its term that convergence criteria should be met as quickly as possible, because the criteria are good for the economy regardless of whether the euro is adopted or not. The Ministry of Finance recently repeated that the economy should be well prepared before joining the euro area, and that the current turmoil on global financial market has to be over before Poland enters ERM-II. At any rate, the first possible date is 2012 but it may be delayed by one or two years.

Event	Date	Reading
Next ECB decisions	May, June 2008	If the ECB leaves euro interest rates unchanged the danger of excessively strong zloty appreciation over the short term will decrease and disinflation measures will be better distributed between the credit channel and the exchange rate channel.
Budget for 2009	November 2008	This will show to what extent the government is able to pursue their convergence plan.

Romania



Outlook

Very favourable performance in the construction and services sectors more than offset the damage to the drought-stricken agricultural sector last year, spurring GDP growth to 6 %. We leave our projection for 2008 GDP growth at 5.5 %, in light of waning consumer demand and some cooling in investment activity triggered by the global turmoil as well as further tightening in monetary conditions. We anticipate some slight improvement in the current macro imbalances starting from H2. Still, the lowering coverage of the external gap by FDI in the context of increasing international risk aversion and volatility of capital flows is a cause for concern.

MOODY'S LT FC RATING
Baa3/Stable

S&P'S LT FC RATING
BBB-/Negative

FITCH LT FC RATING
BBB-/Negative

SPREAD AVG (APR) 128
EMBI+ Spread on Euro Curve

Macroeconomic data and forecasts

	2006	2007	2008f	2009f	2010f
Nominal GDP (EUR bn)	97.8	121.4	135.5	157.5	178.2
Per capita GDP (EUR)	4,530	5,640	6,320	7,390	8,400
Real GDP, yoy (%)	7.9	6.0	5.5	5.0	4.7
Inflation (CPI), yoy, eop. (%)	4.9	6.6	5.8	4.0	3.7
Inflation (CPI), yoy, avg. (%)	6.6	4.8	7.4	4.6	3.8
Unemployment rate, avg. (%)	5.4	4.3	4.2	4.2	4.1
Exchange rate RON/EUR, eop.	3.38	3.61	3.58	3.66	3.69
Exchange rate RON/EUR, avg.	3.52	3.33	3.60	3.62	3.67
Policy rate (Dec) ¹	8.75	7.50	10.00	9.00	7.75
1M ROBOR Dec	8.54	8.12	10.42	9.50	8.20
1M ROBOR avg.	8.73	7.85	10.02	9.84	8.85
Current account balance/GDP (%)	-10.4	-13.9	-14.2	-13.5	-12.8
FDI/GDP (%)	9.3	5.8	4.5	3.9	3.5
Consolidated government budget balance/GDP (%)	-1.6	-2.3	-3.0	-2.9	-2.7
Public debt/GDP (%) (ESA 95)	17.4	18.6	17.2	16.2	15.4
Total external debt/GDP (%) ²	29.3	30.3	32.5	33.0	33.6

Source: Central Bank, Central Statistical Office, UniCredit Tiriac Bank Macroeconomic Research, UniCredit Group CEE Research Network.

Note: 1) CB policy rate is the interest rate applied on 2W (1M till 31 July 2007) commercial bank deposits kept at NBR; 2) Figures exclude short-term external debt.

Main topics

- Economic growth is likely to remain solid at 5.5 % in 2008, backed by lively investment and consumption, despite the tighter credit conditions and some negative impact on household purchasing power due to higher inflation and recent RON depreciation.
- After having peaked at 8.6 % in Q1 2008, inflation is set to decelerate to 5.8 % at the end of 2008, helped by the lower base effect of the higher inflation recorded in H2 2007. Still, higher inflationary pressures originating from strong wage increases and rapid credit growth, combined with a rather unfavourable international environ-

ment might justify further tightening in the monetary stance (by an overall 50 basis points).

- Excess demand, in the context of trade liberalisation and the abolition of custom duties following EU entry, resulted in a sharp deterioration of CA deficit last year, which rose to 13.9 % of GDP. Despite some marginal increase anticipated for this year, the expected cooling in the pace of economic expansion will support tempering of pressures on the external gap.

The new international scenario clearly unveils the costs of Romanian domestic disequilibria

The challenges of an election year

2008 is an election year in Romania with both local and parliamentary elections expected to take place, for the first time with a uninominal voting system. Local elections will take place in June, with the first ballot held on June 1, followed by the second round on June 15. The major political parties are preparing to launch their candidates for the Bucharest City Hall, with President Basescu's newly formed Democratic Liberal Party (DLP) believed to stand the strongest chance of winning the seat. The DLP was formed in December 2007 when the president's Democratic Party (DP) merged with Liberal Democratic Party (LDP), a breakaway group of the ruling National Liberal Party (NLP).

As for the parliamentary elections, the government has not yet decided the date. We expect the elections to be held in the early autumn (in the case of early elections) or in any case by the end of the legislative period in November.

Due to the current political fragmentation, alliances among political parties will be necessary to form a majority government. The Prime Minister's ruling party NLP is looking for new partners for the upcoming elections. However, not many options are left to them, given the strong political disputes recently. In December 2006, the Conservative Party (CP) decided to quit the ruling coalition, followed by the dissolution of the ruling D.A. Alliance in April last year, when the DP joined also the opposition. According to the NLP's representatives, the possibility of joining forces with the leftist SDP cannot be ruled out. Such a move, however, would strongly contradict the centre-right orientation of the party, still representing most probably the only chance it has of becoming a strong competitor for the reinforced President's party. The newly formed DLP, the most popular party so far, announced its intention to stand alone in the first ballot, being very confident of its own forces.

A healthy political environment focused on the prosecution of structural reforms, improvements in the absorption of EU funds and proper management of public spending would be essential in order to minimise the

country's vulnerability amidst the recent deterioration in investor confidence. In the current environment, the last thing Romania needs is political noise further adding to international investors' risk perception.

Record growth in construction and trade services boosted economic performance last year

Real GDP growth decelerated in 2007 to 6.0 % yoy from 7.9 % yoy registered in 2006, and the result was thus slightly above our expectations. The Romanian economy has been driven by strong construction activity (up by 33.6 % yoy) and service sectors, such as trade, transport and communication (+10.8 % yoy), which more than offset the damage wrought in the drought-stricken agricultural sector (-16.9 %).

Private consumption remained robust, up 10.2 % yoy, with only a moderate slowdown compared to 11.4 % registered a year before. The fast pace of household consumption continued to be fuelled by strong wage growth, falling unemployment and easier availability of credit. Growth was also backed by a record-setting rise in investments (28.9 % yoy), mainly oriented towards new construction (31.5 % yoy in 2007), but also accompanied by strong investment in equipment that accelerated to 32.1 % yoy in Q4 from 19 % yoy in Q1 2007.

Despite the better export performance in Q4, net exports deteriorated strongly last year on the back of a 26.1 % year-on-year increase in imports. This surge in imports was stimulated by RON appreciation in H1 2007 and the abolition of custom duties following EU accession.

Slowdown in GDP growth is on the cards

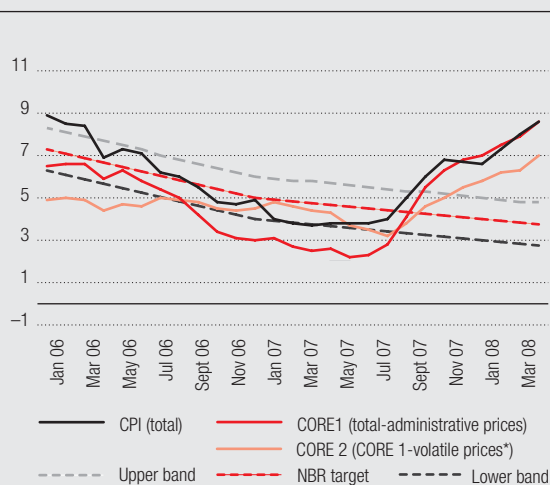
The widening foreign trade deficit and rapid credit growth are serious concerns in the context of increasing risk aversion at the international level. The rating agencies Standard & Poor's and Fitch acted accordingly, changing Romania's outlook from stable to negative, while the market is pricing Romania amongst the most risky countries, driving some widening in credit default spreads, rapid depreciation of RON and falling stock market prices. According to the latest Fitch Ratings

Short-term indicators

	Mar-07	Apr-07	May-07	Jun-07	Jul-07	Aug-07	Sept-07	Oct-07	Nov-07	Dec-07	Jan-08	Feb-08	Mar-08
Real GDP, yoy (%)	6.1	—	—	5.9	—	—	5.8	—	—	6.0	—	—	—
Industrial production, yoy (%)	9.0	1.4	6.8	5.4	6.3	4.3	6.1	3.6	3.9	-0.1	5.6	4.4	—
Inflation (CPI), yoy (%)	3.66	3.77	3.81	3.80	3.99	4.96	6.03	6.84	6.67	6.57	7.26	7.97	8.63
Unemployment rate (%)	4.8	4.5	4.1	4.0	3.8	3.9	3.9	4.1	4.2	4.1	4.3	4.3	—
Exchange rate/EUR, eop.	3.35	3.33	3.27	3.13	3.16	3.27	3.36	3.34	3.50	3.61	3.70	3.73	3.73
1M interbank rate, avg. (%)	8.47	8.29	9.06	7.78	7.25	6.99	7.18	7.65	7.97	8.12	8.61	10.24	10.55
Export (FOB), yoy (%)	12.4	16.9	7.1	9.8	18.8	8.6	12.6	24.8	12.1	15.1	18.4	20.3	—
Import (CIF), yoy (%)	29.0	30.2	23.0	23.3	28.6	20.3	23.4	29.3	22.4	6.5	12.0	14.2	—
Trade Balance, EUR mn	-1,616	-1,644	-1,873	-1,789	-1,800	-1,806	-1,690	-2,203	-2,223	-2,072	-1,410	-1,460	—
Current account, EUR mn ^{1 2}	-3,429	-4,826	-6,280	-7,648	-8,713	-9,889	-11,212	-12,966	-14,928	-16,872	-1,135	-2,193	—

Sources: Central Bank, Central Statistical Office; Note: 1) Cumulated to end of the period; 2) Reinvested profit included.

CPI inflation and its main contributors (in %, yoy)



Source: Central Statistical Office, Central Bank.

report on banking system risk, the macro-prudential indicators (MPI) position Romania in the highest risk group (MPI3). We expect the higher risk scenario to reflect in some cap in terms of growth.

We continue to see investment as a driver, although some moderation is expected in the pace of its growth. Construction activities will indeed drop off, as the cost of funding is increasing, while demand from abroad and for speculative investment is likely to cool. Still, construction will remain among the best performing sectors in the economy, backed by large unsatisfied demand for high-quality accommodation.

Consumption growth will be negatively affected by high inflation and the higher costs of credit, in the context of strong monetary tightening. The negative contribution of net exports is projected to decline, driven by sagging domestic demand for imported products, also due to the recent RON depreciation, on the one hand and improved export capacity on the other hand. Overall, we expect GDP growth to slow down this year to 5.5 %.

Inflation peaked in Q1 2008, slightly above expectations

The annual inflation rate has remained on an upward path since August 2007, reaching 8.6 % in March 2008. The 4.6 percentage point increase in the annual growth rate of consumer prices as against August 2007 was mainly due to exogenous supply-side shocks from food prices. Moreover, the rapid depreciation of the RON (around 17 %) since August of last year has been feeding into both prices of imported products and services such as telecommunications, which are directly indexed to foreign currency. Non-food prices also went up significantly, mainly driven by hikes of fuel prices on the international market. The contribution of administrated prices to the inflation rate declined relatively, with the only price adjustment implemented in gas prices in February 2008, up by 8.5 %.

CORE-2 inflation (which excludes administrated and volatile prices) accelerated to 7.0 % yoy in March, signalling that demand-induced pres-

ures are still high. Excess demand has been underpinned by rapid wage growth (20.5 % yoy increase in average net wages observed in February) and strong credit expansion (up 66.6 % yoy in February). The brisk expansion of public spending in the last two months of 2007 also significantly contributed to persistent excess demand and consequently to the upward trend in prices.

The disinflation process is expected to regain pace starting from the second half of 2008. Despite this projected deceleration, for the second year in a row we expect year-end inflation to remain significantly above the CB target band (3.8 +/- 1 %), ending 2008 at 5.8 %.

Risks remain in any case skewed on the upside mainly on the back of still fast growth in wages and higher public spending anticipated in the run-up to the elections. The dynamics of consumer prices might also be influenced by stronger and longer effects of negative exogenous shocks on food and fuel prices on the international markets. Further upward adjustments in regulated end-user prices of electricity and natural gas may contribute to further pressures on price growth. Moreover, while currency depreciation provides a helping hand in reversing external imbalances, it threatens the inflation outlook due to a significant pass-through into rising domestic prices.

Further tightening in monetary policy needed to reduce current imbalances

The less favourable inflation outlook along with the international repricing of risk and consequently reduced capital inflows and a fast depreciating RON prompted the CB to tighten the lending conditions in domestic currency by raising the monetary policy rate by a cumulative 250 bps since October 2007 and applying some prudential measures for foreign currency denominated credits to un-hedged borrowers.

Given the persistence of inflationary pressures, further tightening in monetary conditions cannot be ruled out. Overall, we expect a further 50-bp increase in the policy rate to be implemented within first half of the year.

Disinflation expected in the second part of the year accompanied by a possible stabilisation of the exchange rate might reinforce the firm monetary conditions and put an end to the tightening cycle.

Risks for a loosening fiscal stance on the upside

The Romanian government's fiscal balance at the end of 2007 was a deficit of 2.3 % of GDP, which was better than previously estimated. Revenues accounted for 31.4 % of GDP as compared to 31.2 % in 2006, while expenditures reached 33.7 % of GDP up from 32.7 % registered in 2006.

For 2008, a 2.7 % fiscal deficit (around 3.2 % based on ESA95) is initially planned, with significant increases in social spending. As a response to the EC critics, the government signed an emergency ordinance in the first week of March endorsing the first budget revision for this year. The deficit target of the general government budget has been reduced to 2.3 % of GDP, with a cut of around EUR 1.1 bn from the initial budget but also a surge in the Reserve Funds with an additional RON 500 mn (around 0.1 % of GDP), mainly for the elections organ-

ised this year. However, the Ministry of Finance announced that in the second revision of the budget, planned for June, some funds, such as those for transport and defence ministries would be increased. Consequently, we keep our projections for the 2008 fiscal deficit at around 3.0 % of GDP, as we see low chances of more coherent action aiming at expenditure cuts.

CA deficit set to stabilise this year

Last year, the Romanian CA deficit reached EUR 16.9 bn on the back of a widening trade gap to EUR 17.6 bn. While remittances of Romanians working abroad covered around 28 % of the trade gap (EUR 4.9 bn), the income component of CA expanded further on the negative side by 36 % yoy, totalling more than EUR 4.4 bn. This category is mainly represented by the repatriation of profits. Overall, the CA deficit reached 13.9 % of GDP last year compared to slightly more than 10 % in 2006.

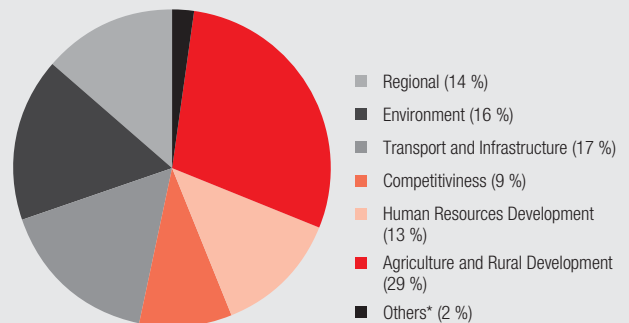
Despite some anticipated stabilisation in the CA deficit to around 14.2 % of GDP this year, due to decelerating demand for imported goods and improving export performance, the lower financing of the external gap by FDI is a source of concern over the short-to-medium term. In the context of a deteriorated international environment the risks of an abrupt slowdown in capital inflows are heightened. We still believe however Romania will continue to remain an appealing destination, with FDI expected to stabilise around EUR 6.1 bn in the next three years.

Post-accession EU funds expected to accelerate the progress of structural reforms

Despite the timid progress achieved in 2007, 2008 is expected to be the first fully operational year for the accessibility to the post-accession structural and cohesions funds provided by the EU (around EUR 30 bn planned for 2007–2013).

In 2007, Romania benefited from EUR 2 bn of EU funds (1.7 % of GDP), but managed to use only EUR 0.4 bn, reaching an absorption rate of 21.7 %, half that of countries like Czech Republic, Poland, Hungary and Slovakia after their first year of EU accession. The funds allocated for agriculture and rural development had the lowest absorption rate (only 1 %), running merely EUR 10 mn from the EUR 740 mn dis-

The European Funds Allocation for Romania



* Others include The European Fischery Fund, Technical Assistance and Administrative Capacity Fund

Source: The Ministry of Economy and Finance.

tributed for 2007. The funds not used in 2007 will be equally distributed to the years 2008–2013. The structural and cohesion funds including those for regional development, reached an absorption rate of 32.7 % (EUR 420 mn).

In 2008, out of the EUR 2.9 bn in European funds, the largest amounts are earmarked for agriculture and rural development (EUR 1.02 bn). An additional EUR 0.86 bn and EUR 0.64 bn have been allocated for regional development and the cohesion fund in 2008.

As part of the cohesion fund, a new project called “Economic Competitiveness Operational” has been launched with the objective reducing the average productivity gap of Romania relative to EU. EUR 2.5 bn (out of which EUR 195 mn in 2008) is planned to be invested in new equipment, plants, buildings and IT software. Funds will be also allocated to supporting the elaboration of business plans, feasibility studies, management and marketing strategies. Its first Axis, allocated exclusively for SMEs development (EUR 0.8 bn), became operational already at the beginning of April this year.

Event	Date	Reading
Local elections	1 June, 15 June	The local elections will be held for the first time in an uninominal system
CB Board Meeting	6 May 2008, 26 June 2008	Further tightening (by an overall 50 bps) might be necessary to reduce current imbalances

Slovakia



Outlook

Strong and sound economic growth is expected to continue – driven both by domestic and external demand. The steady improvement on the labor market should continue. However, the gradual depletion of the qualified labor force could lead to excessive wage growth in the mid-term horizon. The external position is expected to further improve and remain well balanced. The adoption of the euro in January 2009 is in sight, but European institutions will look at the sustainability of Maastricht criteria, mainly in regard to inflation. Demand pressures are expected to stay under control. Inflation is nonetheless likely to accelerate, driven by external cost factors and one-off effects of the adoption of the euro. Monetary policy is expected to follow the ECB's decisions on interest rates since confirmation of the adoption of the euro. The stronger koruna and a more restrictive fiscal policy could help to keep inflation at reasonable levels in the short term.

MOODY'S LT FC RATING
A1/Stable

S&P'S LT FC RATING
A/Positive

FITCH LT FC RATING
A/Positive

SPREAD AVG (APR) 42
EMBI+ Spread on Euro Curve

Macroeconomic data and forecasts

	2006	2007	2008f	2009f	2010f
Nominal GDP (EUR bn)	45	55	63	69	75
Per capita GDP (EUR)	8,260	10,160	11,680	12,870	13,980
Real GDP, yoy (%)	8.5	10.4	6.9	6.0	5.7
Inflation (CPI), yoy, eop. (%)	4.2	3.4	4.0	4.2	3.5
Inflation (CPI), yoy, avg. (%)	4.5	2.8	4.3	4.4	3.7
Unemployment rate (avg.) (%)	10.4	8.4	7.4	7.0	6.8
Exchange rate SKK/EUR, eop.	34.57	33.60	32.30	EUR	EUR
Exchange rate SKK/EUR, avg.	37.25	33.78	32.52	EUR	EUR
2-week repo rate (Dec)	4.75	4.25	3.50	ECB	ECB
1M Interest rate (Dec BRIBOR – mid)	4.71	4.09	3.43	ECB	ECB
1M Interest rate (avg. BRIBOR – mid)	3.99	4.14	3.90	ECB	ECB
Current account balance/GDP (%)	-7.0	-5.3	-3.7	-2.9	-2.5
FDI/GDP (%)	7.5	3.8	4.0	3.7	3.3
Budget balance/GDP (%)	-3.6	-2.2	-2.0	-1.7	-0.8
Public debt/GDP (%)	30.4	29.4	29.2	28.5	27.1
Total external debt/GDP (%)	50.9	54.7	53.4	52.3	51.7

Source: National bank of Slovakia, Statistical Office of SR, National Labor Office, UniCredit Bank Macroeconomics & Market Analyses.

Main topics

- GDP was surprisingly strong, reaching a record level in Q4 – it is still favourable, driven by both domestic and external demand.
- The labour market reflected strong economic growth – employment continued to rise, unemployment reached a historical low.
- Wage growth remains robust. Despite some acceleration in Q4 2007, it is still far behind growth in labour productivity.
- Slovakia is again closer to adopting the euro in January 2009, nominally fulfilling all the Maastricht criteria – European institutions will appraise their sustainability.
- Inflation accelerated, pushed up by food and oil prices as in other EU countries – showing no signs of growing demand pressures.
- However, retail sales significantly accelerated in the first few months of the year, sending clearly hawkish signals to monetary policy.
- Monetary policy is expected to follow the ECB's interest rate policy since July – after final confirmation on the adoption of the euro.
- A necessary tightening of monetary policy could result in a stronger conversion rate, which is supported also by politicians to keep inflation at reasonable levels – we still expect the conversion rate to be at 32.3 SKK/EUR.
- A reasonable tightening of fiscal policy will probably continue in the coming years to prevent possible overheating.

Strong economic growth with euro on horizon

GDP growth surprised in Q4

GDP grew by 14.3 % yoy at constant prices in Q3, its strongest growth ever and the highest growth among all EU countries. In 2007, GDP growth thus averaged 10.4 % (the second highest in EU).

Despite record GDP growth, the growth structure remained relatively sound, driven both by domestic and external demand. Nevertheless, GDP growth was more significantly boosted by domestic demand (contribution of 8.0 p.p.) in the last quarter. It was positively influenced mainly by forward buying of cigarettes (according to our estimates with a positive impact of 2 p.p.) and by investment growth in the economy, while household consumption and government spending recorded a moderate loss of momentum in annual growth. Despite overall brisk growth in domestic demand, there are no signs that this has increased the demand-driven inflationary pressure. The results of a comparison of nominal and real economic growth were more surprising than the growth structure in Q4. For the first time ever, real economic growth exceeded nominal growth. This means that the aggregate price deflator was negative, signalling a year-on-year fall in prices. A closer look shows that the price deflator was pushed down mainly by price developments in foreign trade.

2008–2010 – Sound growth to continue

Even if GDP growth will probably not reach the record levels of the last 2 years, strong growth should also continue in the upcoming period. We expect GDP to slow to 6.9 % yoy in 2008 (also reflecting a base effect). The growth should still be fairly evenly balanced between domestic and external demand. On the supply side, the automotive and electrical equipment sectors are likely to remain the engines of growth, still benefiting from the gradual increase in production capacity.

Our outlook for 2009–2010 remains unchanged, with GDP forecast to grow by 6.0 % yoy in 2009 and 5.7 % in 2010. GDP growth is likely to be driven by domestic demand in both of these years, with elections in 2010 further supporting this trend. An expected easing of monetary conditions in the eurozone and consequently also in Slovakia in this year and the next should also stimulate domestic demand – household consumption as well as investments.

Industrial production maintains its strong performance

Industrial production (IPI) maintained its relatively strong performance, with annual growth averaging 10.0 % in the first two months of the year. Production growth was followed by even higher industrial sales (18.2 % yoy in the same period).

Industrial production is driven mainly by dynamic growth of manufacturing (10.7 % yoy). However, after a recession in electricity, gas and water supply last year, the sector recovered in the first two months of 2008, recording 5.3 % yoy growth. Surprisingly, mining and quarrying also continued to enjoy moderate annual growth (2.0 % yoy). Despite our negative outlook for the sector in the medium term, growth should continue for the most part of this year, supported by the re-opening of the lignite mine in Čary, postponing the closure of some inefficient coal mines, and by the expected construction boom (positively influenced segment of non-energy materials).

The dynamic growth of manufacturing is still driven by the automotive boom. The second pillar of the economy – electrical equipment – recorded, surprisingly, a significant loss of momentum at the beginning of the year, adversely affected by the post-Christmas effect in consumer electronics, and, most of all, by a sharp decline in the non-consumer segment. The textile, leather and glass industries (faced by strong international competition and a strong koruna), and the timber industry (due to a base effect) remain in long-term recession.

We expect industrial production to maintain its relatively strong momentum in terms of yoy growth also in 2008, despite an expected moderate slowdown. Despite currently weaker results, we expect the electrical industry to rebound again during the year and gradually assume a leading position (in terms of growth) after the automotive industry.

Construction has recovered

Construction output emerged from a period of stagnation and grew by 13.8 % yoy in the first two months of the year. The revival of construction output was supported mainly by large enterprises (over 20 em-

Short-term indicators

	Mar-07	Apr-07	May-07	Jun-07	Jul-07	Aug-07	Sept-07	Oct-07	Nov-07	Dec-07	Jan-08	Feb-08	Mar-08
Real GDP, yoy (%)	8.3	–	–	9.3	–	–	9.4	–	–	14.3	–	–	–
Industrial production, yoy (%)	12.9	15.0	16.7	10.9	17.3	4.9	12.0	12.7	13.2	6.5	8.5	11.5	–
Inflation (CPI), yoy (%)	2.7	2.7	2.3	2.5	2.3	2.3	2.8	3.3	3.1	3.4	3.8	4.0	4.2
Unemployment rate (%)	8.9	8.5	8.3	8.3	8.3	8.2	8.3	7.9	7.8	8.0	8.1	7.8	7.6
Exchange rate/EUR, eop.	33.38	33.67	34.08	33.83	33.54	33.74	33.87	33.36	33.38	33.60	33.67	32.80	32.61
1M BRIBOR mid, avg. (%)	4.22	3.65	3.99	4.12	4.14	4.14	4.16	4.14	4.14	4.09	4.13	4.08	4.07
Export (FOB), yoy (%)	30.8	39.5	31.0	21.0	31.4	15.2	19.6	23.6	24.7	14.9	19.2	29.7	–
Import (FOB), yoy (%)	27.5	27.1	26.9	22.0	31.3	17.2	8.5	18.8	20.0	14.4	19.7	21.1	–
Trade Balance, EUR mn	–42	22	–95	–134	–47	–173	108	22	–139	–347	215	250	–
Current account, EUR mn	–119	–9	–378	–576	–555	–140	–108	–439	–423	–308	–9	–	–

Source: National Bank of Slovakia (NBS), Statistical Office of SR, National Labour Office, UniCredit Bank Macroeconomics & Market Analyses.

ployees); we originally expected the downturn of “large construction” to end in the summer months.

The start-up of new projects, as well as a lower comparison basis in H2, could keep the annual growth of construction output at double-digit levels during most of the year. In the following years, the growth of the construction industry could also be significantly supported by infrastructure development that was underpinned by PPP projects. The higher volume of financing for infrastructure development emerged as one of the reasons for the slower reduction of the deficit in public finances also in the current proposal for the budget of public administration for the years 2009–2011.

Economic growth is still able to generate new workplaces. Employment according to ESA 95 methodology (domestic criteria) grew by 2.3 % yoy (by 49.5 ths people annually) in Q4 to 2,205 ths employees. Furthermore, another 177.2 ths people (corresponding to 7.5 % of all employed persons) are working abroad. However, the outflow of the labour force is gradually slowing down, with annual growth of 12.1 % in Q4 (though the increase is only 1.1 % compared to Q1 2007). We do not expect any significant increase in the number of emigrants in upcoming years, while the number of those employed abroad could start to gradually decline along with the growth of job opportunities in Slovakia or with potentially higher pressure on the growth of wages.

Unemployment falls to historical low

Growing employment resulted in a significant decline of unemployment, which reached a new historical low of 7.59 % as of March (by Labour Office statistics); this is 1.30 p.p. lower than in the same period of last year. The seasonally adjusted unemployment rate (UniCredit Bank calculation) dropped to 7.39 %. We expect the unemployment rate to continue to fall to 6.8 % in 2010. The natural unemployment rate could be (based on our estimate) close to the level of 5–6 % in Slovakia. This means that unemployment is gradually approaching its potential. Taking into account also the not very favourable structure of unemployment with a high share of unskilled long-term unemployed, the momentum of the decline in unemployment should significantly slow down in upcoming years. At the same time, the growing economy should still require new qualified employees. However, the above-mentioned labour market constraints will most likely lead to a shortage of labour in the medium term and consequently also to higher wage pressures, increased spending on training new employees, and probably also to an import of labour from “cheaper” countries outside the EU.

Wage growth under control

The average monthly wage reached SKK 22,925 (EUR 686) in Q4, representing annual growth of 8.0 %. This means that real wages grew by 4.5 % yoy, which was again far behind real labour productivity growth of 11.7 %. Real labour productivity has been growing faster than real wages already for 8 consecutive quarters. Wage developments have remained relatively sound and should not create inflationary pressures.

The slight acceleration of wage growth in the last quarter was driven by the public sector, agriculture and transportation and communication. Wages grew the slowest in manufacturing and in the hotels and restaurants sector.

Despite higher inflation, we expect real wage growth to slightly accelerate in upcoming years. As mentioned above, the lack of a qualified labour force in some regions and professions should create increasing wage pressures. Furthermore, elections in 2010 could stimulate wage growth in the public sector. We expect real wage growth to average 5.1 % in 2008–2010.

Excessive growth of retail sales

Retail sales significantly accelerated at the beginning of the year, reaching average annual growth of 16.1 % at constant prices. Thus, despite accelerating inflation, demand from the population is growing. With regard to the structure of the growth of retail sales (mainly driven by electronic goods, furniture, clothes etc.), it is possible that the growing demand will be reflected in inflation only to a limited degree. Nevertheless, retail sales sent clearly hawkish signals to monetary policy. Since the NBS does not have too much manoeuvring room in regard to the interest component of monetary conditions, a partial tightening of monetary conditions could be achieved only by a strengthening of the koruna. Thus, retail sales could be put on the list of arguments in favour of a stronger conversion rate upon the adoption of the euro.

Food prices boosted inflation

Inflation (CPI – national methodology) continued to accelerate, reaching 4.2 % yoy as of March. Inflation was driven by prices for food, fuel and healthcare, as well as regulated prices for energy – i.e. mainly by external factors, while demand-driven inflation (measured by prices for market services excluding imputed rentals – UniCredit Bank estimate) has stabilised close to 3.0 %. Inflation is thus so far sending mainly neutral signals to monetary policy.

Slovakia meets Maastricht inflation criterion...

Despite the acceleration in the rate of inflation over the last few months, Slovakia easily fulfilled the Maastricht inflation criterion. Average annual inflation in the last 12 months pursuant to harmonised Eurostat methodology reached 2.22 % as of March. The benchmark of three countries with the lowest inflation in the EU was 1.72 % in the same period, which means that the Maastricht inflation criterion reached 3.22 %. Slovakia is thus fulfilling this criterion with 1.00 p.p. to spare.

... but the main question remains sustainability

The fulfilment of the Maastricht criterion with such ease is mainly due to a low inflation rate in the last year. Therefore, there is some doubt about the sustainability of the criterion. While the inflation momentum offers a little less cause for optimism, it is still sufficient. If we take a look only at the last month (not at the 12M average as in the criteria calculation), Slovakia is still meeting the criterion, although the gap is shrinking to 0.36 p.p. (3.62 % vs. 3.98 %) – this means that at least until March, Slovakia did not show signs of excessive inflationary growth (compared to other EU countries). Taking into account the generally higher sensitivity of converging countries to external cost factors such as food and energy prices (due to their higher share in the consumer basket), the initial one-off shock from fixing the conversion rate to the euro (rounding off effect, significantly lower FX pass-through) and administrative increase of excise taxes on tobacco (in both 2008 and 2009), it is likely that Slovakia's inflation will be slightly above the Maastricht criterion in 2009–2010. As the above mentioned factors

are external (influencing also inflation in other EU countries) or one-off factors, we believe that Slovakia is achieving a sustainable price performance in line with Maastricht requirements.

Koruna at new historical high

The koruna started the new year with relatively volatile trading at relatively weaker levels, reflecting the turbulence on global financial markets, moving within a range of 33.2–34.1 SKK/EUR. The regional mood improved at the end of January, but market rumours about the adoption of the euro and mainly about the future conversion rate still contributed to relatively high volatility of the koruna and an appreciation of the currency. Consequently, the koruna was supported by record GDP figures in the middle of February and mainly by statements of politicians (prime minister, minister of finance) and some NBS Board members at the end of month, who advocated a stronger conversion rate to keep inflation at a reasonable level in the upcoming years. The koruna started to appreciate heavily and reached a new historical high, slightly above 32.2 SKK/EUR. The koruna's sharp upward trend lasted only a short time, stopped by the verbal intervention of the NBS governor (focusing on doubts about exporters' performance in case of a strong koruna). When the governor subsequently softened his tone and denied that the NBS would intervene, the koruna returned to stronger levels.

Stronger conversion rate more likely

One of the last unknowns in the euro process is the conversion rate. The current central parity is at 35.4424 SKK/EUR. However, we see room for a further revaluation, most likely in May. There are several factors which support a stronger conversion rate. A stronger rate could be helpful in maintaining a reasonable inflation level. Lower inflation is also of political significance, especially with approaching elections in 2010, and therefore it also has the support of politicians. Furthermore, some leading indicators such as retail sales are starting to send slightly hawkish signals to monetary policy. Taking into account the expected easing of interest rates in the eurozone, just stronger FX rate should lead to a necessary tightening of monetary conditions, at least partially. Therefore, we expect the conversion rate to be set close to the current spot, and we maintain our previous forecast of 32.3 SKK/EUR.

Monetary conditions expected to be more relaxed

The central bank did not change key interest rates in Q1. The last change (cut by 25 bps.) took place in April last year.

The country is close to a final decision on EMU entry, which is generally expected to be positive. Current local key interest rates are 25 bps

above the ECB rate. We expect that the Slovak central bank will harmonise the key interest rate with that of the ECB at the first meeting after a final decision on the adoption of the euro, and consequently will follow the rate decisions of the ECB. This means that until the end of the year the key interest rate in Slovakia should decline by 75 bps to 3.5 % p.a., and in 2009 by an additional 50 bps to 3.0 % p.a.

Decreasing public finance deficit

Based on official information of the Statistical Office, public finances ran a deficit of 2.16 % of GDP in 2007 – this is well below Maastricht criteria of 3.0 %.

The state budget (as a key component of public finances) continued to develop favourably also at the beginning of the year, reaching a surplus of SKK 3.4 bn as of March. The positive development of the state budget this year, contrary to previous years, is not attributable mainly to the higher-than-planned collection of taxes, but rather to savings on the expenditure side of the budget. We expect that in the next few months there could still be a slightly weaker collection of taxes due to lower revenues from tobacco duties. However, in the second half of the year, the collection of taxes should stabilise again. If the state succeeds in maintaining the discipline also on the expenditure side of the budget, the year-end deficit of the public finances could again be considerably below the budgeted level. The current development of the state budget can significantly also help Slovakia in discussions regarding sustainability of the fulfilment of the Maastricht criterion of public finances.

Foreign trade with record surplus

The better export performance of Slovak companies helped to further improve Slovakia's foreign trade (FT) at the beginning of the year. FT thus reached a record surplus of SKK 15.5 bn in Jan.–Feb. We therefore revised our forecast for this year: FT is expected to run a surplus of SKK 9.0 bn instead of the previously expected deficit of SKK 5.0 bn. We nonetheless revised the CA deficit downward to 3.7 % of GDP this year (instead of 3.0 %), largely because the outflow of dividends is likely to be higher than previously expected.

Euro almost in place

We see some 90 % probability of Slovakia adopting the euro in January 2009. As Slovakia nominally fulfilled all Maastricht criteria, the main doubts (and de facto only doubts) are over the sustainability of the inflation criteria.

Event	Date	Reading
GDP and its structure	May 15, June 3	Some leading indicators such as retail sales and foreign trade indicate that Q1 growth could be higher than expected
EMU entry decision	Beginning of July	If Slovakia's entry into the eurozone should be politically rejected (10 % probability), the country will face a short-term shock (according to our expectations 1–2 years) with a depreciation of the koruna (above 34.0 SKK/EUR), increasing interest rates, higher inflation and slightly lower GDP growth, most likely followed also by lower inflows of FDI, higher CA deficit and by a more relaxed fiscal policy (due to scheduled elections and the absence of any constraints).
Setting of conversion rate	Beginning of July	Stronger conversion rate could be helpful in maintaining a reasonable level of inflation

Slovenia



Outlook

Given its EU/EMU membership, the Slovenian economy is not exposed to major risks over the short to medium term, even if the global outlook were to worsen further. Nonetheless, the country's economic growth will feel the pinch of the global and Eurozone slowdown (as the Eurozone accounts for 70% of Slovenian exports). The global environment will also have some effects on domestic consumption, and sentiment indicators already show some deterioration as well as in retail sales. Hence, after peaking in 2007, we expect growth to remain between 4% and 4.5% during the next three years. Inflation is rising and will remain a source of concern. But hand in hand with slacker domestic demand, inflation is expected to fall gradually in H2 2008. The gap to Eurozone inflation, however, will only decline gradually. The October general elections will only create some modest pressure on fiscal accounts, which remain solid. The debt/GDP ratio may drop further.

MOODY'S LT FC RATING
Aa2/Positive

S&P'S LT FC RATING
AA/Stable

FITCH LT FC RATING
AA/Stable

SPREAD AVG (APR) N. A.
EMBI+ Spread on Euro Curve

Macroeconomic data and forecasts

	2006	2007	2008f	2009f	2010f
Nominal GDP (EUR bn)	30.5	33.5	37.2	40.1	43.0
Per capita GDP (EUR)	15,170	16,690	18,470	19,910	21,310
Real GDP, yoy (%)	5.7	6.1	4.1	4.0	4.4
Inflation (CPI) yoy, eop. (%)	2.8	5.6	4.8	2.8	2.6
Inflation (CPI) yoy, avg. (%)	2.5	3.6	6.4	3.8	2.7
Unemployment rate, avg. (%)	6.0	4.9	5.0	4.8	4.7
Exchange rate SIT/EUR, eop./avg.	239.6	EUR	EUR	EUR	EUR
Interest rate (3M interbank rate, eop.)	3.57	4.78	3.52	3.07	3.35
Interest rate (3M interbank rate, avg.)	3.44	4.14	3.78	3.13	3.18
Current account balance/GDP (%)	-2.5	-4.8	-4.7	-4.8	-4.9
FDI/GDP (%)	1.7	3.0	2.8	2.8	3.9
Budget balance/GDP (%)	-1.2	-0.1	-1.0	-1.2	-1.2
Public debt/GDP (%)	27.2	24.1	23.6	23.4	23.3

Source: Bank of Slovenia, SORS, UniCredit Group CEE Research Network.

Main topics

- In 2007, economic growth remained strong, rising to 6.1 % – the highest growth rate since Slovenia gained independence – from 5.7 % in 2006. Economic growth then started to decelerate, however, in Q4 2007.
- Inflationary pressures intensified on the back of higher food and energy prices. Since February 2007, inflation has been steadily accelerating. It was close to 2 % at the beginning of 2007, and is now moving towards 7 %. Slovenia now has the highest inflation rate among the Eurozone countries.
- The general government deficit was almost balanced in 2007 (at 0.1 % of GDP), while public debt declined to 24.1 %.
- In 2007, the current account deficit doubled to 4.8 % of GDP, with FDI inflows relatively high, reaching 3 % of GDP. The main source of financing continued to be borrowing from parent banks abroad (around 5 % of GDP in net terms). The net position in terms of FDI and portfolio flows (inflows minus outflows) is increasingly negative, due to growing investments of Slovenians abroad.

Resilient to the international risk repricing, but growth is slowing

Slower growth ahead, but risks under control

Given its EU/EMU membership and relatively solid macroeconomic fundamentals, Slovenia has been only marginally affected by the repricing of risk at the international level. In addition, the general elections which will be held in the autumn (October 2008) present no risk to the economic policy outlook. The Slovenian stock exchange has posted losses (–26 % in the year to date) but, in spite of the uncertainty characterising the global environment and other CEE countries, Slovenian country risk, measured in terms of sovereign spread, remains low, with spreads now hovering at 40–45 bps on ten-year bonds. Via the trade channel, however, economic growth will feel the effects of the expected slowdown in the Eurozone, which accounts for 70 % of Slovenian exports. The global environment is also having some effects on domestic consumption, with sentiment indicators already weakening.

In 2007, economic growth remained strong, rising to 6.1 % – the highest growth rate since Slovenia gained independence – from 5.7 % in 2006. However, in Q4 2007 economic growth decelerated to 4.7 %, slipping from 6.4 % in Q3 and thus confirming the anticipated slowing trend that gradually materialised during the course of last year, following a peak in Q1. Almost all GDP components saw a significant slowdown, with gross fixed capital formation being the most strongly hit: after acting as a driver for domestic demand in the first three quarters of the year (22 % yoy growth), in Q4 2007 it rose only 7.6 %. The contribution of external trade to GDP was finally positive in Q4, after two quarters of negative performance.

In the meantime, the average unemployment rate in 2007 reached 4.9 % of the labour force, down from 6.0 % in the previous year, despite some upsurge in the last quarter of 2007 (4.7 %, up from 4.5 % in Q3). More recent data provide some clues about the positive evolution of economic activity, which is still relatively strong. Indeed, industrial production grew by 7.5 % yoy in February (4.5 % mom), thanks to the performance of the manufacturing sector and despite weak construction activity. The expansion of credit is still very significant: since last July, year-on-year credit growth has remained well above 30 %, primarily driven by loans to non-financial corporations (35 % yoy in February). On the other hand, sentiment indicators have fallen significantly in recent months, but did improve slightly in March. The retail trade index in March was very weak (0.3 % year on year and –4.2 % month on month). In 2008 and 20'09, we expect the impact of the global slowdown to drag growth down to around 4 % on average.

Inflation still accelerating

Since February 2007 inflation has been persistently accelerating. It was close to 2 % at the beginning of 2007, but is now moving towards 7 %. Indeed, CPI inflation rose 1.3 % in March compared to February

and reached 6.9 % in year-on-year terms, driven mostly by clothing and energy costs. This is the highest inflation rate in the last 16 years in the entire euro area. For this reason the European Commission has continued to stress the need for structural reforms in Slovenia, especially regarding labour and product markets.

Considering that the rise in international prices of raw materials and fuel is not set to slow significantly over the short term, and given the lack of competition in some sectors, risks on the inflation front are still quite acute. But together with the slowdown in domestic demand, a gradual fall in inflation is expected towards the second half of the year. The gap with Eurozone inflation will decline only gradually.

Fiscal accounts almost balanced

On the fiscal front, improvements in the area of public finances last year were better than expected. The general government deficit in 2007 was estimated at only EUR 24 million, equivalent to 0.1 % of GDP. Consolidated public debt is at EUR 8 bn or 24.1 % of GDP, thanks to the general government surpluses in the last two quarters of 2007. This is mainly due to the slower dynamics of expenditure increases in comparison with the trend in revenues. Despite the good results recently, the prospects of economic slowdown and the October parliamentary elections (moreover Slovenia currently holds the six-month rotating presidency of the EU) will create only moderate pressure on fiscal accounts, increasing the budget deficit, which we forecast to be around 1 % of GDP in 2008. Public debt remains low, at 24.1 % of GDP at the end of last year and 23.6 % in 2008.

Current account deficit doubled in 2007

In 2007, the current account deficit rose to 4.8 % of GDP (EUR 1.6 bn), again the highest value since independence, and twice the size of the gap of 2006. Deterioration of the merchandise trade deficit pushed the trade gap higher than 5 % of GDP, whereas exports of services remains strong (net service exports contributed to offsetting 60 % of the gap in the balance of goods).

FDI inflows were relatively robust in 2007, at around 3 % of GDP. The main source of financing for the growing CA deficit, however, is increased borrowing from parent banks abroad (around 5 % of GDP in net terms): this represents a source of risk, given the current global context and the ongoing credit squeeze. One should also consider that the net position in terms of FDI and portfolio flows is increasingly negative, due to growing investments of Slovenian companies abroad. Gross foreign debt at the end of February 2008 amounted to EUR 35.7 bn. Over EUR 4 bn of this amount is inter-company lending. The increase in foreign debt of EUR 1.6 bn since the end of 2007 is mainly due to a EUR 1 bn government bond issued early this year.

Event	Date	Reading
CPI	30 May	Slovenian CPI is set to remain the highest inflation rate amongst Eurozone countries
Q1 GDP growth	5 June	A further slowdown is expected

Croatia



Outlook

With international economic conditions no longer benign as a result of the ongoing financial crisis and amid domestic measures to curb lending growth, the Croatian economy, unsurprisingly, is beginning to cool. Whether or not inflation has peaked for the year is unlikely to be answered until the third quarter, even though the outlook in this respect is definitely exposed to upside risk. At the same time, given high oil prices, the current account deficit is likely to widen this year, while FDI inflows as a percentage of GDP should drop off compared to last year. Croatia's accession negotiations with the EU have accelerated recently, but the authorities in Zagreb will be required to meet the preconditions for opening the remaining chapters if the joint goal of completing accession talks by the end of 2009 is to be achieved.

MOODY'S LT FC RATING
Baa3/Positive

S&P'S LT FC RATING
BBB/Stable

FITCH LT FC RATING
BBB-/Stable

SPREAD AVG (APR) 112
EMBI+ Spread on Euro Curve

Macroeconomic data and forecasts

	2006	2007	2008f	2009f	2010f
Nominal GDP (EUR bn)	34.2	37.5	41.8	45.4	48.9
Per capita GDP (EUR)	7,710	8,450	9,420	10,230	11,030
Real GDP, yoy (%)	4.8	5.6	4.3	4.2	4.7
Inflation (CPI), yoy, Dec. (%)	2.0	5.8	5.0	2.8	2.5
Inflation (CPI) yoy, avg. (%)	3.2	2.9	6.2	3.7	2.7
Unemployment rate, avg. (%)	11.2	9.4	8.9	8.5	8.2
Exchange rate HRK/EUR, eop.	7.35	7.33	7.28	7.28	7.25
Exchange rate HRK/EUR, avg.	7.32	7.34	7.27	7.23	7.20
1w Zibor, avg. of Dec.	3.84	6.70	6.50	6.50	4.90
1w Zibor, avg. of the year	3.28	5.50	5.75	5.00	4.50
Current account balance/GDP (%)	-7.9	-8.6	-9.0	-8.7	-8.2
FDI/GDP (%)	8.0	9.7	6.2	6.7	7.2
Budget balance/GDP (%)	-3.0	-2.3	-2.6	-2.8	-2.8
Public debt/GDP (%)	41.0	38.9	37.4	37.3	37.5
Total external debt/GDP (%)	85.5	87.8	87.3	86.9	86.6

Sources: CNB, CSB, Zagrebacka Banka Research – New Europe Research Network.

Main topics

- The final quarter of 2007 saw growth slow down more than expected to 3.7 % yoy. As a result, the annual rate of growth in 2007 was 5.6 %. The data released so far for 2008 suggest that growth in Q1 was fairly robust despite a high base effect.
- Still, with credit growth slowing both in nominal terms and particularly in real terms and the value of the stock market having fallen 32.8 % since the beginning of the year, domestic demand will not be as supportive of growth this year.
- At the same time, growth in merchandise goods' exports in Q4 2007 slowed to 4.1 % yoy while imports of merchandise goods rose 12 % yoy. The current account deficit widened to 8.6 % of GDP last year.
- Having risen sharply at the end of 2007, consumer prices remained elevated. Nonetheless, headline CPI fell in each month of Q1 2008 from a high of 6.2 % yoy in January to 5.7 % yoy in March.
- Parliament passed the 2008 budget in late March which aims for no fiscal consolidation compared to 2007. Thus, the target deficit for this year remains the same at 2.3 % of GDP. Given the maintenance of public sector expenditure trends, the Croatian National Bank is unlikely to ease the monetary policy settings.

Moderation in growth will materialise during 2008

Growth set to moderate further

In Q4 2007 economic growth slowed more than expected to 3.7 % yoy, as all components of domestic demand lost pace. For example, private consumption recorded its lowest rate of growth in 2007 at 5.0 % yoy in Q4, while investment activity rose only 4.0 % yoy.

Even so, the slowdown in domestic demand towards the end of last year was not much of a surprise. What did surprise was the sharp deceleration in export growth, which according to the national accounts rose only 2.1 % in Q4 2007. This was largely the result of weaker merchandise export growth in November and December 2007.

Looking at the data released on Q1 2008 to date, the picture is somewhat rosier. Industrial production rose 4.7 % yoy in Q1, and after weak performance in January retail sales rose over 7.0 % yoy in real terms in February. The construction activity index in February rose 12.8 % yoy, partly as a result of favourable weather conditions.

Labour market data based on the International Labour Organisation methodology show a reduction in the unemployment rate to 8.4 % in Q3 2007. The employment rate rose in that quarter rose to 45.4 %, reflecting the robust growth seen in the economy prior to Q4 2007 and therefore increasing the exposure to the risk of worsening as economic growth wanes.

On the other hand, credit growth to households and enterprises continues to slow. Since July of last year, following yet another tightening of monetary policy conditions by the central bank, credit growth has been slowing. In February 2007 the rate of credit growth to enterprises and households rose 13.7 % yoy, down from 22.2 % yoy in June 2007. In real terms, credit growth is sharply lower. In 2007, credit growth in real terms was 18.3 % yoy, while in the first two months of 2008 a combination of slowing nominal credit growth and higher inflation has seen credit growth in real terms amount to only 7.6 % yoy. As 2008 progresses this moderation in credit growth will become more of a drag on economic growth. While growth in Q1 2008 will be relatively strong,

slower credit expansion, higher inflation and a worsening outlook for the Eurozone economy going forward mean that we still think the Croatian economic growth will be higher than 4 % (namely 4.3 % and 4.2 % in 2008 and 2009, respectively), even if we see our forecast for this year exposed to some downside risk.

Has inflation peaked for the year?

In Q1 2008 consumer prices rose an average of 5.9 % yoy. Consumer prices rose most strongly in January, partly as a result of administered price hikes by some local governments. February and March have seen a slight fall in headline inflation to 5.8 % yoy and 5.7 % yoy, respectively. Indeed, were there not moral suasion by the government, which negotiated a reduction in food prices by the retail industry in February, the headline figures would have been higher. It remains to be seen how long the reductions in profit margins agreed in February will remain in place.

At the same time, core inflation (which excludes volatile components such as food and oil as well as regulated prices) has remained largely unchanged at 5.3 % yoy in January and 5.0 % yoy in February (and we estimate 5.0 % yoy for March). In other words, while increases in the price of food and oil (10.8 % yoy and 9.9 % yoy in Q1 2008, respectively) have undoubtedly influenced headline inflation, other prices have also risen more sharply in recent months.

Given the rise in inflation in recent months it comes as no surprise that unions have begun to demand higher wages. The focus in particular, is on increasing the minimum wage. In the industrial sector real gross wages advanced 2.7 % last year, while labour productivity was up 5.2 % over this period.

During April, the state-owned electricity company announced that it would be seeking a double-digit increase in electricity prices once full liberalisation for the enterprise sector occurred. While there is no guarantee that an increase will be granted, September 2005 was the last time electricity prices rose – by 5.5 %.

Short-term indicators

	Mar-07	Apr-07	May-07	Jun-07	Jul-07	Aug-07	Sept-07	Oct-07	Nov-07	Dec-07	Jan-08	Feb-08	Mar-08
Real GDP, yoy (%)	7.0	—	—	6.6	—	—	5.1	—	—	3.7	—	—	—
Industrial production, yoy (%)	9.0	9.4	7.7	4.4	8.5	2.8	2.1	5.5	2.5	1.4	6.7	8.1	—
Inflation (CPI), yoy (%)	1.8	2.3	2.2	2.0	2.1	2.6	3.9	4.3	4.6	5.8	6.2	5.8	5.7
Unemployment rate (%)	11.2	—	—	9.1	—	—	8.4	—	—	—	—	—	—
Exchange rate, kuna/EUR, eop.	7.38	7.37	7.31	7.30	7.30	7.32	7.28	7.35	7.31	7.33	7.25	7.28	7.26
1W Zibor, avg.	4.0	4.4	4.7	5.6	7.2	4.5	5.6	7.7	8.3	6.7	7.5	5.4	4.2
Export, (FOB) yoy (%)	-6.6	24.3	9.5	19.5	24.6	7.9	7.4	13.0	12.6	-10.9	19.6	7.7	—
Import, (CIF) yoy (%)	6.8	16.4	15.6	1.3	17.7	5.9	6.6	14.0	12.7	6.0	27.4	13.0	—
Trade Balance, EUR mn	-907	-867	-972	-784	-833	-809	-760	-918	-859	-762	-821	-878	—
Current account, EUR mn	-2,021	—	—	-1,381	—	—	2,087	—	—	-1,892	—	—	—

Sources: Official statistics (CNS, CBS), Zagrebacka Banka Research.

Food and oil price dynamics are another evident source of upside risk to the inflation outlook, while the continued strengthening of the currency and slowing domestic demand point in the other direction. On balance, even though there has been a slight moderation in consumer prices in Q1 2008, we see the risks to inflation as being on the upside. On average, inflation in 2008 will be higher than 6 % (5.5 % yoy as of December 2008), double the level registered in 2007.

External imbalances remain high

Data released at the end of March showed that the current account deficit rose to 8.6 % of GDP in 2007 (EUR 3.2 bn). A moderation in exports of goods and services to 6.3 % yoy materialised in Q4 2007, while imports of goods and services picked up 11.7 % yoy at the same time and was the main reason behind the 25 % yoy increase in the Q4 2007 current account deficit.

While we definitely expect domestic demand to taper off, oil and food price dynamics, as well as indications of profit repatriation by foreign investors, will increase this year. This leads us to expect a slight widening of the current account deficit to 9.0 % of GDP for the whole 2008.

Indeed, merchandise trade data for January and February illustrate the impact of oil price rises on the merchandise trade balance. Over this period oil imports rose 32.8 % yoy, adding EUR 100 mn to the merchandise trade deficit alone. Merchandise imports grew 19.5 % yoy over this period, while merchandise export growth was a respectable 13.2 % yoy. As a result, the merchandise trade balance rose 25.6 % yoy to EUR 1.7 bn. We see this outcome as consistent with expectations of relatively strong growth in Q1, but as the year progresses we expect moderation in non-oil imports.

Given expectations of a widening current account deficit and the increased cost of borrowing in international markets, the main issue is how this external imbalance will be financed. While last year saw a record inflow of foreign direct investment of EUR 3.6 bn (9.7 % of GDP), which more than covered the current account deficit, it is difficult to see this feat being repeated again this year. To begin with, a large part of last year's FDI inflows were the result of capital increases by foreign owned banks as well the earnings they retained. With most banks' capital adequacy ratios well above the statutory limit of 10 %, the contribution of banking sector capital increases will not be as great this year. In 2006 and 2007, the combined inflows of FDI and long-term net credit inflows covered between 190 % and 200 % of the current account deficit. The second half of last year in particular saw companies borrow an increasing amount abroad as credit conditions tightened domestically. Net credit inflows associated with corporate borrowing in H2 2007 rose 68.7 % yoy to EUR 2.3 bn. Although the growth in long-term net credit attributable to the corporate sector in H2 2007 likely continued in Q1 2008, net long-term credit inflows should moderate further this year, as the cost of refinancing have risen and banks continue to reduce their exposure abroad. Hence, we expect coverage of the current account deficit by FDI and long-term credit inflows to be lower than the 190 % recorded last year.

No figures for foreign debt in 2008 have been released to date. Gross foreign debt at the end of 2007 did, however, amount to EUR 32.9 bn

or 87.8 % of GDP. This year the combination of high nominal GDP growth (due to inflation) and our expectation that borrowing abroad will fall off in line with slower growth leads us to expect that gross foreign debt as a percentage of GDP will decline slightly to 87.3 % by the end of the year.

The EUR/HRK exchange rate is exposed to appreciation pressures indicating that capital inflow remains significant. Since the beginning of February, the EUR/HRK has remained within a very narrow band of 7.25–7.30, with the market unwilling to test the central bank's resolve. Namely, governor Rohatinski made clear in a meeting in early February with the government and the banks that he would not like to see the EUR/HRK go below 7.25. The resumption of regular reverse repo auctions at around the same time has improved money market liquidity and seen money market rates stabilise and the appreciation pressures registered in mid-late January have eased. While the onset of the peak tourist season in the summer will see appreciation pressures on the currency return, in the interim, assuming no changes to monetary policy, more of the same in terms of currency stability and stable money market rates looks to be on the cards.

We do not expect the central bank to ease monetary policy in the coming months. The monthly statistical indicators released to date for 2008 indicate relatively strong growth, high inflation, and a rising current account deficit whereas FDI inflows are set to fall compared to 2007. While the argument that increased financing costs abroad have tightened credit conditions for the HNB is not without merit, on balance we do not expect the central bank to alter monetary policy settings in the near term.

No change in fiscal policy

At the time of writing the final figures for the 2007 budget were not available. Nonetheless, when presenting the 2008 budget to parliament in March, the government did state that it expected a deficit of 2.3 % of GDP last year compared to the 3.0 % it originally budgeted. The economic cycle thus worked in the government's favour last year, which is no surprise given the robust economic growth registered in 2007.

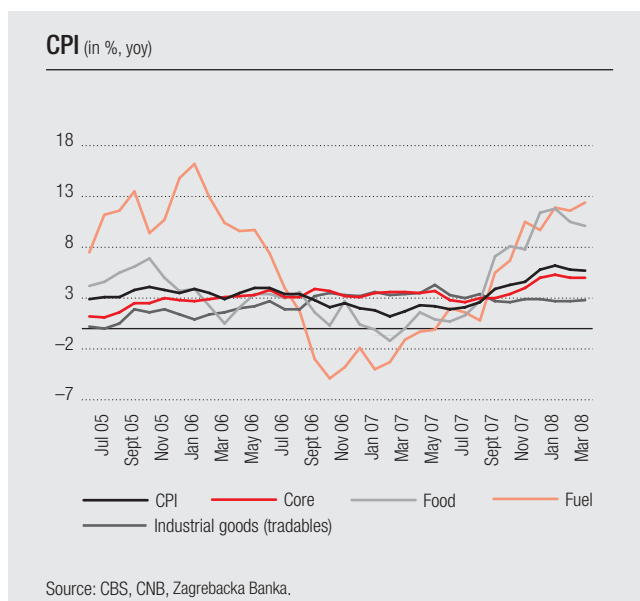
This year's budget, which aims for exactly the same budget deficit of 2.3 % of GDP, is hardly ambitious, locking in promises made last year on social welfare policy and including a 6 % increase in public sector salaries. Admittedly, last year saw the return of pensioner debt amount to HRK 3.5 bn while this year the amount to be spent will be roughly HRK 850 mn. Since the government does not include the repayment of pensioner debt into its definition of the deficit, that de facto contraction in spending is not evident in the headline budget deficit figures.

While there are no figures available yet for the 2008 budget, as mentioned, the evidence from Q1 2008 and the first weeks of April is that tax revenue growth appears in line or even above initial expectations. Namely, Treasury bill issuance has been in line (with minor variations) with plans. The Ministry of Finance in mid-April announced it was postponing the issuance of its Eurobond (EUR 750 mn was planned) until the current turbulence in the financial markets subsides. Increased issuance of Treasury bills and a bridging loan, agreed in March, would

cover financing needs in the meantime. That is not to say the budget is not exposed to risk. Indeed, with public spending and entitlements rising, the budget is more than ever exposed to the vagaries of the economic cycle. Also, large, one-off sources of revenue (sale of the government's remaining 18 % stake in pharma company Pliva in 2006 or the IPO of Croatia Telecom last year) are not evident this year, and we expect the slowdown in growth over the course of this year to be reflected in sagging tax revenues. The government is likely to slow some infrastructure investment and higher inflation will be conducive to tax revenue growth, but we still expect a slightly higher deficit this year, at 2.6 % of GDP (on the government's basis of calculation) since we expect flagging growth for the remainder of the year.

Meanwhile, press reports and statements from government officials on plans to provide another bail out next year of shipyards within the context of restructuring and EU accession also raise questions about the ability of the government to achieve a balanced budget by 2010.

EU accession talks resumed, deadlines loom – The suspension by Croatia of its ecological and no fishing zone in January saw, as EU Enlargement Commissioner Rehn noted in Brussels in April, the process “resume with renewed dynamism”. Croatia has now opened more than half of the chapters of the Acquis Communautaire. Yet if the government's goal and the desire of the European Parliament to complete accession talks by 2009 is to be met, the coming few months will have to see progress made on meeting all of the criteria for opening the re-



maining chapters. In the sphere of economic policy the major challenge is in the competition policy arena, where the status of the shipyards is the most evident outstanding issue. Early April was also important for Croatia since it received an invitation together with Albania to join the NATO alliance.

Event	Date	Reading
Q1 Balance of Payments	30 June	Will provide a first indication of the main trends in the external accounts for this year.

Turkey



Outlook

Politics stole the scene once again when the Chief Prosecutor of the High Court of Appeals came up with an indictment against the ruling AKP on March 14, demanding closure of the party and that its leading figures be banned from politics for five years. In the current international environment, characterised by strong investor risk aversion and volatile capital inflows, Turkish political tensions represent a clear source of risk and play a role in undermining the prospects for the economy. With the aim of fighting higher inflation, but also with a view to capital inflows, the Central Bank will have to pause with interest rate cuts, which will slow economic growth. Still, given relatively sound macroeconomic fundamentals, the outlook is not gloomy.

MOODY'S LT FC RATING
Ba3/Stable

S&P'S LT FC RATING
BB-/Negative

FITCH LT FC RATING
BB-/Stable

SPREAD AVG (APR) 227
EMBI+ Spread on Euro Curve

Macroeconomic data and forecasts

	2006	2007	2008f	2009f	2010f
Nominal GDP (EUR bn)	419.2	479.5	506.7	552.8	596.8
Per capita GDP (EUR)	5,950	6,790	7,160	7,790	8,380
Real GDP, yoy (%)	6.9	4.5	4.2	5.0	5.5
Inflation (CPI), yoy, eop. (%)	9.7	8.4	7.8	5.3	4.5
Inflation (CPI), yoy, avg. (%)	9.6	8.8	9.4	6.6	4.9
Unemployment rate (%)	9.9	9.9	9.6	9.3	9.0
Exchange rate TRY/EUR, eop.	1.860	1.714	1.959	2.021	2.063
Exchange rate TRY/EUR, avg.	1.809	1.786	1.927	1.990	2.042
Reference rate (O/N, simple), eop.	17.50	15.75	14.75	13.00	11.50
Reference rate, compound yearly avg. (%)	16.9	18.8	16.5	14.9	13.0
Current account balance/GDP (%)	-6.1	-5.7	-5.8	-6.0	-6.3
FDI/GDP (%)	3.8	3.3	2.1	1.8	1.9
Budget balance/GDP (%)	-0.6	-1.6	-1.8	-1.4	-1.4
Primary surplus/GDP(%)	5.4	4.1	3.9	3.9	3.9
Public debt/GDP (%)	48.1	41.3	39.5	37.8	36.8

Source: Central Bank, Turkish Statistical Institution, Yapi Kredi Strategic Planning and Research, UniCredit Group CEE Research Network.

Main topics

- Chief Prosecutor of the High Court of Appeals applied to the Constitutional Court demanding that the ruling AKP be closed and its prominent figures be banned from political party membership. That has led Turkey into a period of uncertainty in the political and economic sphere.
- 2007 growth of 4.5 % was below expectations and deceleration is evident. Growth in private investment expenditures was dismal as of the end of 2007, and the prospects are not promising if domestic political and global risk perceptions do not improve.
- Inflation has advanced to levels around 9 %, due to higher food and oil prices, and disinflation will be a tough job. The Central Bank nevertheless toughened up its tone and it is now more hawkish on the policy rate.
- In contrast to the considerable slowdown in domestic demand in 2007, exports and imports exhibited very strong growth. The current account deficit ended 2007 at 5.7 % of GDP, down from 6.1 % in previous year. The deficit would have been around 5.3 % had oil prices remained at 2006 levels.

Political uncertainty again at the centre of attention

A difficult environment, locally and internationally

The Chief Prosecutor of the High Court of Appeals applied to the Constitutional Court demanding that the ruling AKP be closed and its prominent figures be banned from political party membership. This has led Turkey into a period of uncertainty that the country has been trying to shake off since the July 2007 elections. The anti-AKP establishment can not afford to lose another battle after the failed e-coup in April in 2007 and the following landslide election victory by the AKP and the election of Abdullah Gul as president, but we do not think that a decision in favour of shutting down the AKP should be taken as a given.

On the economic front, some consequences are already visible. The Turkish lira is one of the worst performing currencies in the emerging markets realm, and the ISE-100 is similarly one of the worst performing stock markets, with the benchmark rate close to 19 % levels. Moreover, on April 4, S&P lowered its rating outlook from stable to negative, given the tensions in the political and global arena.

Balance of payments statistics indicate a widening current account deficit and worsening financing dynamics. The deterioration in the sheer size of the deficit is solely from energy prices, but that is little consolation as we are looking at a substantial financing need nevertheless. What has been most worrisome in the last few months is the deterioration in financing quality: the non-debt creating financing ratio (on a 12-month rolling basis) is down to 50.8 % in February from 78.6 % in September 2007, and the steady decline is quite eye-catching. A more severe financing capability reduction could be in the picture, if the political crisis proves to be protracted and a market friendly solution does not appear to be in sight.

Still, in a global environment of significant jitters, Turkey's performance is unparalleled in the country's recent history. The deterioration in macro indicators is still well within manageable bounds, and the AKP seems keen to ramp up the pace of reforms to enhance the support it is receiving from the outside world. Inflation has advanced to high levels and disinflation will be a challenge, but that is a global theme and the difficulties faced are mostly of an international nature. Steady dete-

rioration in inflation expectations, which rose by 1 percentage point from March to April, is one particularly striking aspect and the Central Bank is sounding more hawkish about this deterioration for the first time. It will not refrain from hiking rates if a severe outflow takes place.

Relevant GDP revisions

In March the updated GDP series was announced. The methodology used to calculate GDP was changed significantly: the previous series used to be calculated according to the UN System of National Accounting (SNA 68), whereas the new series uses the European System of Accounts (ESA-95) instead. The scope of the economic activities included in GDP calculations increased. Housing stock was revised, some technical coefficients used in sectoral calculations were updated, the informal economy's contribution to GDP was revised and some daily wage activities were included. Recently emerging sectors (such as Internet service providers, leasing agencies, participation banks, pension funds, non-profit financial intermediaries, and free trade areas) are included in the calculations. The extent of the revision was at the higher end of the expectations, and the new GDP series are much higher. For 2006, GDP at current prices increased to USD 526 bn from USD 400 bn, representing a 31.6 % increase.

Growth deceleration is evident

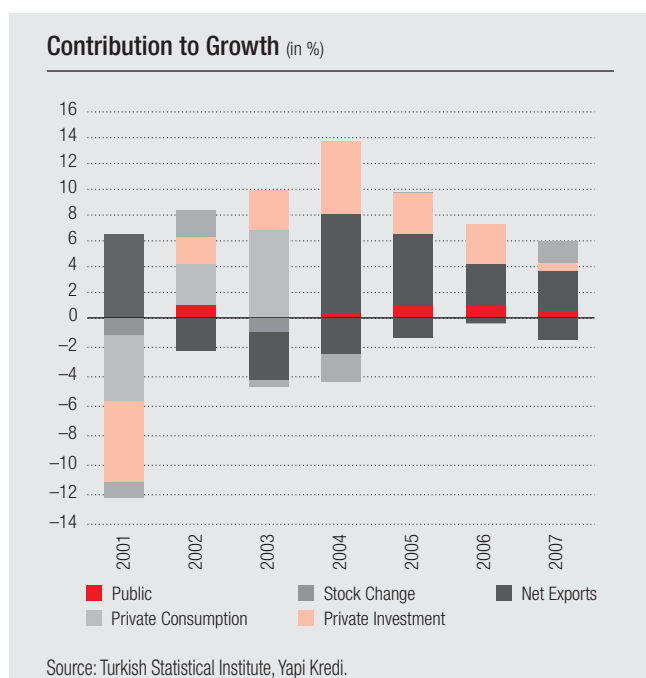
The 3.4 % GDP growth in Q4 2007 was well below market expectations (consensus was around 4.8 %), bringing overall growth to 4.5 % in 2007. Nominal GDP reached USD 655 bn in 2007 (with per capita at USD 9,282). Problems mostly centre on private investment expenditures which grew with at a dismal rate of 2.7 % in 2007, the second lowest figure in the post-2001 period and significantly below the 2006 figure of 15.0 %. Net exports' contribution remained negative, and the rate of growth of imports, at 11.1 % yoy, was almost twice the rate of growth of exports at 6.7 %.

On the production side, the most salient figure is the contraction in agriculture, at 7.3 % in 2007 and a -0.7 percentage points contribution. The decline in manufacturing sector growth is also evident: after four years of robust growth with an average rate over 9 %, the rate was just

Short-term indicators

	Mar-07	Apr-07	May-07	Jun-07	Jul-07	Aug-07	Sept-07	Oct-07	Nov-07	Dec-07	Jan-08	Feb-08	Mar-08
Real GDP, yoy (%)	7.6	—	—	4.0	—	—	3.4	—	—	3.4	—	—	—
Industrial production, yoy (%)	3.7	2.8	5.9	2.9	4.5	6.3	2.5	8.4	8.1	-1.0	11.4	7.5	—
Inflation (CPI), yoy (%)	10.86	10.72	9.23	8.60	6.90	7.39	7.12	7.70	8.40	8.39	8.17	9.10	9.15
Unemployment rate (%)	10.4	9.8	8.9	8.8	8.8	9.2	9.3	9.7	10.1	10.6	11.3	—	—
Exchange rate/EUR, eop.	1.847	1.861	1.779	1.767	1.756	1.774	1.717	1.701	1.738	1.714	1.744	1.819	2.074
Reference rate O/N, comp. avg.	19.1	19.1	19.1	19.1	19.1	19.1	18.9	18.5	17.9	17.3	16.9	16.6	16.5
Export (FOB), yoy (%)	9.6	16.7	23.1	8.2	13.8	15.0	4.1	23.2	11.4	0.1	39.9	25.7	—
Import (FOB), yoy (%)	3.3	1.3	8.6	5.9	17.1	10.7	6.7	22.5	13.2	12.4	36.0	22.7	—
Trade Balance, EUR mn	-2,327	-2,512	-3,118	-2,894	-3,574	-3,355	-2,904	-3,001	-2,568	-3,323	-3,109	-2,317	—
Current account, EUR mn	-2,279	-2,398	-2,642	-2,324	-2,068	-1,187	-1,636	-2,274	-2,213	-3,485	-2,710	-2,500	—

Source: The Central Bank, Turkish Statistical Institution, Yapi Kredi Strategic Planning and Research.



5.4 % in 2007. The slowdown in the construction sector is also eye-opening after brisk growth rates since 2002: the sector peaked with 2006 growth at 18.5 % whereas in 2007 growth was just by 5.0 %.

Our expectation for 2008 GDP growth is 4.2 %, which is worse than the rate realised in 2007. In addition to the problems exported from the European and US markets, private expenditure and especially private investments, the flagship of growth for some years now, do not yet signal any recovery and we do not see significant improvements given the relatively high inflation/interest rate scenario. Increasing political risks also support the slowing trend.

Optimists' last fort: robust industrial production

Amidst all these gloomy figures, the only promising news came from the industrial production side: after 5 % growth in Q4 2007, year-on-year growth in January and February reached 11.4 % and 7.5 %, respectively. Although we expect a lower figure for March, the first quarter growth rate seems to have exceeded 7.5 %. Motor vehicle production is particularly important, with 40.8 % growth in the first two months of 2008.

Inflation moves away from the year-end target

Inflation numbers for the month of March came out higher than expected, with CPI at 0.96 %. As a result, year-on-year inflation increased to 9.15 % as of March. The main culprit behind this high inflation rate has been food price inflation, in respect of which the cumulative figure for the first three months stood at 8.5 %, the highest by far going back to first quarter of 2003. Clothing and footwear inflation compensated slightly for this rise, posting a decline of 15.0 %, but that was far from enough due to the weighting of food being more than three times that of clothing and footwear.

All of the eight special indices registered year-on-year increases as a result of widespread price increases; this deterioration may prove to be

temporary as we see no demand side pressures in inflation figures. Another point is the continued disinflation on the rental for housing chapter which has registered steadily declining annual rates since February 2007, and has come down to 14.7 % from 19.9 % exactly a year ago. We have not turned bearish on inflation dynamics in the absence of any demand pull pressures, but the numbers are clear and the year-end inflation target is arguably much less credible now than it was few months ago. Therefore, we revise our year-end inflation forecast up to 7.8 % yoy.

CBRT to stay put over the next term

The CBRT left benchmark interest rates on hold in April. This is the second time in a row that the Central Bank has held its key rate steady. The relatively hawkish tone of the recent remarks indicates that the CBRT will maintain a cautious stance in the coming period.

CBRT surveys point to continuously deteriorating inflation expectations and even the move in the last month alone is quite striking. The latest bi-weekly survey, the first for the month of April, indicates severe deterioration in year-end, 12-m-ahead, and 24-m-ahead inflation expectations. The year-end expectation deterioration of 1.01 percentage point in just one month is particularly striking. The crucial question now is the reaction of the CBRT to this worsening picture in terms of inflation expectations.

Economists are divided between those who think that holding rates steady is the prudent choice and those who believe a hike in rates is called for. Our contention is that in this period of serious positive carry on the fixed income side (16.5 % O/N compounded vs. 18.9 % benchmark rate), a hike would have a limited impact on market rates in the first phase. It would however have the potential of further exacerbating inflation expectations for all future periods considered, as agents would interpret the hike as the CBRT's reduced confidence in its own targets and increased likelihood of the target being missed unless borrowing and lending costs are raised, even under suppressed demand conditions. That basically is adverse signalling and should be avoided until some aggregate demand pressure is experienced or at least contemplated. We also believe that the CBRT will maintain a reserved stance for the purpose of containing both the direct inflation impact and the indirect "outflow – depreciation – pass-through – inflation" channel. To sum up, we think that the Bank will pause for an extended period.

Robust growth in foreign trade continued

In contrast to the considerable slowdown in domestic demand in 2007, exports and imports exhibited very strong growth, at 25 % and 22 %, respectively. These figures are inflated by the surging international commodity prices and the strength of the euro against the dollar, while rate of increases in terms of quantity were also significant. More precisely, of the 25 % growth increase in exports, 11 percentage points stem from increase in quantity, whereas of the 22 % growth of imports, 13 percentage points stem from quantity increases, both of which do not yet point at a slowdown.

Interestingly, in contrast to the slowdown in domestic consumption and investment, imports of consumption and investment goods accelerated

in the second half of 2007. This might have been prompted by the realisation of postponed demand after the elections, along with improved expectations and strong local currency in H2 2007. In the first two months of 2008, there has been no change in the underlying trends, with exports and imports exhibiting even more extraordinary growth (with 52 % and 47 %, respectively). Nevertheless, signs of slowing in foreign trade can be observed from March onwards, following the re-adjustment of the exchange rate and more uncertainties in the global and local political environment to come.

The current account deficit ended 2007 at USD 37.4 billion, corresponding to 5.7 % of the new GDP figure, down from 6.1 % in previous year. It is worth noting that the 12 % increase in average oil prices in 2007 alone led to about a USD 3.3 billion increase in the current account deficit. The deficit would have been around 5.3 % had oil prices remained at 2006 levels.

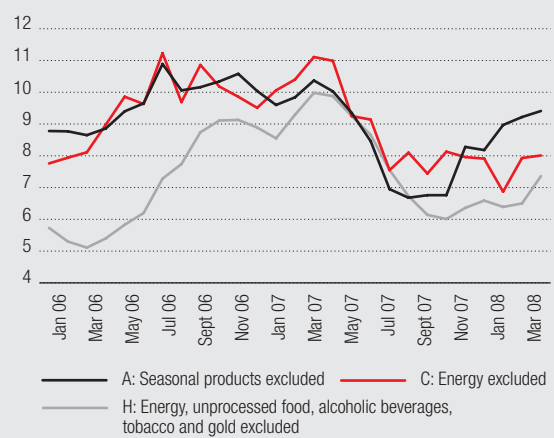
In 2008, 19 % export growth and 18 % import growth is expected. Sagging GDP growth is expected to limit import growth, while at the same time high international prices are expected to counterbalance this impact. Consequently, we project the current account deficit at USD 43 billion, stabilising around 5.8 % of GDP.

Corporate sector borrowing at full strength

In 2007, FDI inflows reached USD 22 billion, USD 3 billion of which stemmed from non-residents' purchases of real estate. In the first two months of 2008, the pace of FDI inflows dropped off, falling to USD 1.6 billion. However, there were major sales in February such as tobacco producing Tekel and Migros (a retail chain store). Assuming that the proceeds of those sales along with the proceeds from Petkim's sale last year in November are realised in 2008, we can already estimate an FDI inflow of USD 5.5 billion so far. In the rest of the year, we expect inflows from FDI to reach USD 16 billion (including real estate purchases), despite the local and global uncertainties ahead. We do not expect a sudden stop in FDI as investors are focused on the medium term, and the impact could be realised later after 2008, if the recession in the world economy turns out to be deeper and longer than expected.

In 2007, total net capital inflows amounted to USD 48 billion, USD 28.5 billion of which originated from corporate sector's loan borrowing. The corporate sector continued to borrow heavily from abroad in the first two months of 2008, as well, already obtaining USD 5.3 billion of credits (net). The adversities in the global economic environment do not seem to have affected the corporate sector's borrowing capabilities yet. Increasing corporate sector debt is one issue of concern, however, as it has surged tremendously in the last three years. The private sector's foreign debt stock in total foreign debt was 40 % in 2004, before it rising to 64 % at the end of 2007. In other terms, Turkey's foreign

Core inflation (Special CPI Indicators, yoy, %)



Source: Turkish Statistical Institute.

debt jumped USD 42 billion in one year, USD 40 billion of which is due to the private sector. This increases the vulnerability of the corporate sector in the event of exchange rate shocks.

Increase in budget expenditures is contained

Following last year's loosening in expenditures, the Central Administration Budget started the year in relatively good shape. In the first three months, tax proceeds were quite robust, while the increases in expenditures were contained to a great extent. However, because of last year's Telekom privatisation receipts, non-tax revenues remained significantly below the level recorded in Q1 2007.

However, the dismal figure in non-interest expenditure this year is due to Turk Telekom privatisation proceeds in the amount of TRY 5.84 accruing in March 2007. Consequently, total revenues contracted 6 % in real terms, standing at around 23 % of the year-end target.

On the other hand, a 14 % nominal decline in interest expenditures in Q1 2008 contained total expenditures. In addition, a deliberate effort is observed to limit non-interest expenditures, specifically, in personnel expenditures, purchases of goods and services (including health expenditures) and investments.

The primary surplus was 32 % lower (in real terms). Concerns regarding the viability of the Central Administration Budget targets for the rest of the year can be cited as the possibility of loosening expenditures due to approaching municipal elections and slowing tax revenues due to the weaker economy. Nevertheless, data in the first quarter do not support those concerns.

Event	Date	Reading
MPC decision on interest rates	May 15	Central Bank is expected to keep policy rates unchanged for an extended period.
National Income Figures	June 30	1Q 2008 growth figures will be announced. Slowdown in domestic demand is expected to continue

Bosnia and Herzegovina



Outlook

All of the data released to date point to 2008 being another year of solid economic growth. Imports of machinery and equipment are rising, pointing to stronger investment activity and also suggesting that industrial production could well accelerate further. Credit growth remains robust and motor vehicle imports are on the rise. Unsurprisingly, inflation will remain pronounced this year while the evidence to date of strong domestic demand points to a larger current account deficit at a time when FDI inflows are likely to fall, given the slow progress in the privatisation agenda. While the budget position remains solid for the near term, there are clouds gathering in the sphere of fiscal policy. In domestic politics, the focus will move from signing the Stabilisation and Association Agreement (SAA) to constitutional reform and taking the next step on the long road to eventual EU accession.

MOODY'S LT FC RATING
B2/Stable

S&P'S LT FC RATING
Not rated

FITCH LT FC RATING
Not rated

SPREAD AVG (APR) N. A.
EMBI+ Spread on Euro Curve

Macroeconomic data and forecasts

	2006	2007	2008f	2009f	2010f
Nominal GDP (EUR bn)	9.8	10.6	11.9	13.0	14.0
Per capita GDP (EUR)	2,540	2,750	3,090	3,380	3,640
Real GDP, yoy (%)	6.2	6.7	6.0	5.5	5.0
Inflation (CPI), yoy, eop. (%)	4.6	4.9	5.0	3.2	2.5
Inflation (CPI), yoy, avg. (%)	6.1	1.5	6.5	3.8	2.8
Unemployment rate, avg. (%)	44.5	44.0	39.5	38.7	38.0
Exchange rate BAM/EUR, eop./avg.	1.96	1.96	1.96	1.96	1.96
Current account balance/GDP (%)	-8.4	-13.3	-13.8	-13.4	-13.1
FDI/GDP (%)	5.8	14.0	5.4	5.9	5.8
Budget balance/GDP (%)	2.9	2.3	1.9	1.3	0.8
Public debt/GDP (%) ¹	21.3	18.9	17.2	16.1	15.5
Total external debt/GDP (%)	57.1	58.4	59.7	61.2	63.1

Source: CBBH, BiH Agency for Statistics, Federal Office of Statistics, RS Institute of Statistics, UniCredit Group CEE Research Network;

¹) External public debt

Main topics

- Bosnia's politicians finally managed to pass the relevant legislation in April 2008 to commence the process of police reform which opens the way for the country to sign a Stabilisation and Association Agreement (SAA) with the EU.
- Data released to date for 2008 point to strong domestic demand, supporting our view that growth will remain robust in 2008.
- Inflation was over 6.0 % yoy in Q1 2008 and is likely to remain above this level for most of this year. We increase our forecast from 6.0 % yoy to 6.5 % yoy as a result for the whole 2008.
- Although strong domestic demand points to solid tax revenue growth, there is renewed uncertainty over contingent liabilities, since the state-level frozen foreign exchange savings bonds were not issued by the 31 March 2008 deadline.
- The privatisation of Aluminij Mostar and Telekom BiH has been on the agenda for a while, but in recent months there has been no progress on either initiative to suggest they will be realised this year. This would see FDI inflows sharply lower this year compared to 2007.

Police reform deal first step on long road to EU accession

Police reform agreed

After a number of years of acrimonious debate and the brokering of a compromise proposal by the High Representative, Bosnia's two houses of parliament finally passed the police reform legislation which will enable the country to sign a Stabilisation and Association Agreement (SAA) with the EU. For policing powers to be fully transferred from the entity to the state level, constitutional changes will be necessary, and they will take a while to negotiate. The other political question with economic implications is the issuance of frozen foreign exchange savings bonds by Republika Srpska in February, which has thrown into disarray the initial plan to issue these bonds at the state level (see section on fiscal policy).

Strong growth in Q1 2008

All of the data released to date for 2008 point to relatively strong growth. Industrial production is up 5.0 % yoy in Q1 2008 in the Federation with mining (up 10.8 % yoy) and the production of energy (up 8.4 % yoy) the main drivers. Manufacturing activity in the Federation rose only 2.6 % yoy over this period. Data for the first two months of the year in Republika Srpska (RS) paint a similar picture with overall growth in industrial production of 5.6 % yoy, but manufacturing down 0.5 % yoy, while mining activity was up 24.3 % yoy and energy production up 15.5 % yoy.

State level data suggest that unemployment is falling. Moreover, wage growth is accelerating. Gross wages rose 9.7 % yoy in 2007 in nominal terms, having risen from BAM 909 in January 2007 to BAM 1007 (EUR 515) at the end of last year. Meanwhile, credit growth remains robust despite higher mandatory reserve requirements in place since 1 January 2008. Thus, credit growth to households was up almost 30 % yoy in Jan-Feb 2008 while credit growth to private sector enterprises was up 31.5 % yoy over this period. We continue to expect GDP growth of around 6.0 % in 2008, only slightly lower than in 2007.

Rising inflation

Inflation was 6.2 % yoy in both January and February according to state level statistical office data. Entity level statistical office data point to slightly higher inflation in March. In RS the inflation rate was 6.7 % yoy in March, while in the Federation it amounted to 7.4 % yoy. Food prices were up over 11 % in Q1 2008 while the increase in electricity prices mandated by regulators in both entities at the beginning of the year has also been a feature of consumer price index figures this year. Perhaps the most worrying factor in the inflation outlook is evidence that wage increases have accelerated further in early 2008. Namely, data from the Agency for Statistics of BiH show that gross wages rose 10 % yoy in January and then accelerated by over 16 % yoy in February. While no data on productivity is available for the BiH economy, it is difficult to see these increases being in line with productivity growth. With oil prices high and global food prices also heading higher in com-

bination with strong domestic demand and rising wages, our inflation forecast of 6.5 % yoy in 2008 remains exposed to upside risk.

High external imbalances

Given these trends, it is no surprise that the merchandise trade deficit in Q1 2008 has widened 38.7 % yoy to BAM 2.1 bn. While oil imports are up 47.3 % yoy on higher prices, imports of other categories of goods also reflect healthy domestic demand. For example, imports of machinery and equipment have risen 36.6 % yoy suggesting rising investment activity, related in part to motorway construction and even the construction of additional electricity generation capacity. At the same time, imports of motor vehicles rose in Q1 2008 by 42.2 % yoy while imports of manufactured final goods were also up 24.9 % yoy, pointing to strong consumption spending. Last year, the current account deficit rose to 13.3 % of GDP (BAM 2.7 bn) and this year with the current trends we see the deficit widening slightly to 13.8 % of GDP and then easing only very modestly. The more relevant issue is that FDI inflows are unlikely to be anywhere near as high as last year's level of 14.0 % of GDP. While last year the sales of 66 % of Telekom Srpske to Serbian investors drove FDI inflows to almost EUR 1.5 bn, the ongoing sagas related to the privatisation of aluminium producer Aluminij Mostar and the privatisation of the Federation's Telekom BiH suggest that FDI inflows will be sharply lower in 2008. All in all, this year the current account gap will remain high (13.8 % of GDP), while FDI will be significantly lower than last year (5.4 % of GDP), hence creating more difficulties, especially given the current international environment, in the external financing.

Question marks over fiscal policy

The sale of Telekom Srpske is the main reason that public finances in Republika Srpska are stronger than in the Federation, even though the consolidated fiscal position is in surplus. In February, contrary to legislation which states that frozen foreign exchange savings bonds were to be issued by 31 March 2008 at the state level, Republika Srpska issued its own BAM 209 mn bonds, which it may well buy back at a politically convenient moment with some of the funds received from 2007 privatisation proceeds. In April, the IMF stated that it was concerned about the fiscal standing in the Muslim-Croat Federation of BiH, partly since the non-issuance of the aforementioned state-level bond for frozen foreign exchange deposits opens up the possibility of legal challenges by creditors. In addition, the Federation budget is burdened by a legislative requirement to allocate 40 % of budget spending to war veterans, demobilised soldiers and other vulnerable groups. Masked though they may be by strong growth at the moment, the risks to Bosnia's fiscal position have risen to a certain extent in Q1 2008. However, given the aforementioned growth scenario, we do not forecast any deterioration in the budget balance ratio over GDP.

Event	Date	Reading
Signing of SAA	Spring	Definitely important, but by no means a sign of a normalisation in relations between BiH's main political parties and constituent nations.

Kazakhstan



Outlook

Stalled credit growth and double-digit inflation on the back of soaring food prices will reduce real GDP growth to perhaps 4.5 % this year. The good news is that the combination of lower domestic demand growth and high global commodity prices will lead to a sharp re-narrowing of the current account deficit in 2008, probably to 2 % of GDP. This makes substantial devaluation of the tenge very unlikely. A strong increase in net exports will mitigate the decline in GDP growth. Credit quality will show significant deterioration this year as the economy slows, the residential construction bubble has burst and monetary conditions have tightened. We still do not expect a crisis in the banking system as whole, but competition has intensified and some redistribution of economic power among the large banks will occur. Continued strong global demand for commodities should combine with an easing of tensions in the banking sector globally and locally to re-ignite GDP growth in 2009 and 2010 again to some 6–7 %.

MOODY'S LT FC RATING
Baa2/Stable

S&P'S LT FC RATING
BBB–/Negative

FITCH LT FC RATING
BBB/Negative

SPREAD AVG (APR) N. A.
EMBI+ Spread on USD Curve

Macroeconomic data and forecasts

	2006	2007	2008f	2009f	2010f
Nominal GDP (EUR bn)	64.5	75.9	93.7	122.2	154.3
Per capita GDP (EUR)	4,190	4,870	5,950	7,670	9,680
Real GDP, yoy (%)	10.6	8.5	4.5	6.3	7.7
Inflation (CPI), yoy, Dec (%)	8.4	18.8	10.2	9.0	6.7
Inflation (CPI), yoy, avg. (%)	8.6	10.8	16.3	9.4	7.7
Unemployment rate (%)	7.8	7.6	6.7	6.6	6.4
Exchange rate/EUR, eop.	167.1	177.2	170.8	163.4	156.0
Exchange rate/EUR, avg.	158.3	167.8	173.2	165.5	159.1
Exchange rate/USD eop.	127.0	120.3	122.0	121.0	120.0
1-W repo rate, Dec.	9.0	11.0	11.0	9.5	9.0
KazPrime 3M (Dec)	5.50	12.35	8.50	7.50	7.00
Current Account balance/GDP (%)	–2.4	–6.9	–1.9	–1.3	–3.6
FDI/GDP (%)	7.7	9.9	6.8	5.8	6.2
Budget balance/GDP (%) ¹	0.7	–0.8	–1.0	–1.0	1.0
Public Debt/GDP (%)	12.0	7.7	9.0	9.7	8.0

1) Consolidated budget according to Kazakh methodology, including the oil fund.

Sources: NBK, Kazakh Statistical Agency, KASE, UniCredit Group CEE Research Network.

Main topics

- Real GDP growth slowed further to 5.3 % yoy in Q1 2008, dropping from 5.6 % yoy in Q4 2007 and 8.5 % in 2007 as a whole.
- Money incomes rose by only 2.8 % yoy in January–February in real terms compared with an average of 17.8 % in 2007.
- Food prices were up 27.1 % in March 2008 on the year before. Overall inflation stood at 18.7 % yoy.
- State budget revenues increased by 26.3 % yoy in Q1 2008, below plan however, mainly because of lower-than-projected revenues from import duties. The budget remained nevertheless in surplus, as expenditures were also 89 % below target.
- Between August 2007 and February 2008, after the global liquidity crisis began, outstanding retail loans increased by a mere 0.9 %, with corporate loans edging up just 2.9 %. Credit quality has significantly deteriorated.
- Exports increased at a remarkable rate of 62 % yoy in USD terms in January–February, while import growth slowed to 11 % yoy due to slack domestic demand.
- Perception of Kazakh risk improved a bit last month. CDS spreads declined slightly, from a peak of 287 bp on 17 March 2008 to 234 bp on April 21.

Inflation and weak credit growth curb domestic demand

Oil diplomacy

At a plenary meeting on March 26, the lower house of the Kazakh parliament gave its go-ahead for ratification of the Baku-Tbilisi-Ceyhan pipeline agreement with Azerbaijan. The pipeline circumvents Russia via Georgia and Turkey. Under the agreement, Kazakh oil will be transported to Baku by tankers through the Caspian Sea. Kazakhstan will continue to rely mainly on Russian export routes, but the move fits into President Nazarbayev's "multi-vector" foreign policy.

Growth cools markedly

Real GDP growth slowed further to 5.3 % yoy in Q1 2008 from 5.6 % yoy in Q4 2007 and 8.5 % in 2007 as a whole. We estimate that in seasonally adjusted qoq terms, this means almost zero growth. Industrial production increased by 3.7 % yoy in Q1 2008, easing back from 4.5 % in 2007 as whole, but up from 2.9 % yoy in Q4. The acceleration was brought about by mining, which increased by 6.8 % yoy driven by exports. The output of manufacturing decreased in contrast by 1.2 % yoy as the food, textile and construction materials industries all fell.

High inflation is taking a toll on income growth. Money incomes rose by 2.8 % yoy in January-February in real terms, with real wages moving 0.5 % higher. This compares with average rates of 17.8 % and 17.3 %, respectively, in 2007. Growth in retail trade slowed to 4.3 % yoy in Q1 as a result, down from 10.0 % yoy in 2007. Investment did surprisingly well in early 2008. Outlays in fixed assets rose by 16 % yoy thanks to robust increases in agriculture, communal services and financial intermediation. Construction output grew by 8.5 % yoy in Q1. Such brisk growth is not likely to last, however, as shrinking cement production already indicates.

Food prices soar

Via booming exports, the high global food prices are also affecting domestic prices. Kazakh food prices were 27.1 % higher in March 2008 than in the year before. Headline inflation rose to 18.7 % yoy, from an average of 10.8 % in 2007. There is room for some hope: the increase in Q1 2008 was 2.5 %, slightly below the 2.6 % recorded for Q1 2007. This is in part the result of political pressures not to raise prices on certain important commodities however. With agricultural producer prices 42.5 % higher in March than one year before, price increases for consumers will remain on the agenda. On April 15, the government decided to ban wheat (but not flour) exports until September 1, 2008, that is until the new harvesting campaign. Actions taken by the authorities will likely combine with weakened income growth to slow – at least official – inflation to only some 10 % yoy by December 2008.

Current account deficit to narrow again

After widening from 2.3 % of GDP in 2006 to 6.9 % of GDP in 2007, the current account deficit is set to narrow again substantially thanks

to high export prices and weak import volumes. Exports increased by 62 % yoy in USD terms in January–February, while import growth slowed to 11 % yoy. Export prices were 48.4 % higher than the year before (in January). Import prices rose by 15.8 % yoy, which leaves imports almost unchanged yoy in volume terms, taking the 4.5 % appreciation of the tenge against the USD into account. We expect the current account deficit to narrow to as much as 1.9 % of GDP in 2008.

No major devaluation

Foreign exchange reserves declined by USD 5.0 bn to USD 17.4 bn in H2 2007 because of sharply lower inflows of cross-border loans and because of reflows of net inward portfolio investment of USD 2.7 bn. FDI remained by contrast strong, with inflows amounting to USD 6.0 bn in H2 2007 more than double USD 2.7 bn seen in H2 2006. In Q1 2008, international reserves bounced back again, reaching USD 19.8 bn as of 15 April 2008. The National Oil Fund has an additional USD 23.4 bn in foreign assets. With the heavy repayment burden of about USD 12 bn in 2008 for the banking sector alone, a renewed decline must be expected later this year. The reserves should suffice, however, to protect the tenge from any strong devaluation.

Credit growth stalled

Since September 2007, credit growth has almost faded. Outstanding retail loans increased by 0.9 % between August 2007 and February 2008, corporate loans by 2.9 %. This compares with 46.1 % and 37.2 %, respectively, between August 2006 and February 2007. Total loans increased by 2.2 %. Deposit growth slowed from 31.6 % to 4.0 % over the same period, with retail deposits growing just 1.5 %. One reason for the weak credit growth is a lack of funding from abroad. Bank debt was at USD 45.9 bn as of 31 December 2007 almost unchanged from June 2007, after surging in the years before: at the end of 2004, it amounted to only USD 7.7 bn. The monetary survey shows that bank liabilities vis-à-vis non-residents even fell slightly from the end of 2007 through March 2008. A second reason for the meagre credit growth is the deterioration in credit quality. Based on data provided by the banking supervision, Fitch estimates that the proportion of doubtful and loss loans remained almost unchanged during Q3 2007 at around 2 %, but rose to 3.1 % at end-2007 and further to 4.0 % at the end of February 2008. According to Kazakh methodology, impaired loans in the construction industry jumped from 2.6 % in June 2007 to 7.5 % as of 31 January 2008.

Lower credit demand from clients, a lower propensity of banks to extend loans because of quality concerns, combined with refinancing by the authorities to reduce interbank rates somewhat again despite the weak funding base. The 3-month "KazPrime" increased from 5.5 % at the beginning of 2007 to a high of 12.5 % on 8 January, but fell again to about 9 % by late April.

Event	Date	Reading
Rating actions	2008	Major rating agencies might put Kazakhstan under review because of the more difficult situation in the banking system

Russia



Outlook

The new Russian President and Government will begin their work in May 2008. Political continuity and also continuity in economic policies are almost certain. Debates are however intensifying as to how the large fiscal surplus should be used, and it remains to be seen what stance the new Putin government will adopt. Despite the international credit crisis and slower global growth, the Russian economy performed very well in the first quarter of 2008. Industrial output showed significant growth driven by expanding domestic demand and strong investments. We revise our GDP growth forecast for 2008 slightly upward from 6.7 % to 7.0 %. The major threat for the economy remain strong price pressures. In the current high-inflation/low-liquidity environment, the central bank has to tighten and provide sufficient liquidity at the same time, making monetary policy a fairly sophisticated task.

MOODY'S LT FC RATING
Baa2/Stable

S&P'S LT FC RATING
BBB+/Stable

FITCH LT FC RATING
BBB+/Stable

SPREAD AVG (APR) 171
EMBI+ Spread on USD Curve

Macroeconomic data and forecasts

	2006	2007	2008f	2009f	2010f
Nominal GDP (EUR bn)	785	942	1,147	1,401	1,613
Per capita GDP (EUR)	5,520	6,640	8,100	9,920	11,440
Real GDP, yoy (%)	6.7	8.1	7.0	6.2	5.3
Inflation (CPI), yoy, eop. (%)	9.0	11.9	12.5	10.0	8.0
Inflation (CPI), yoy, avg. (%)	9.7	9.0	13.5	10.8	8.6
Unemployment rate (%)	6.7	6.1	5.6	5.1	4.9
Exchange rate RUB/EUR, eop.	34.7	35.9	33.3	32.9	32.4
Exchange rate RUB/EUR, avg.	34.1	35.0	34.6	33.1	32.7
Exchange rate RUB/USD, eop.	26.3	24.6	23.8	24.4	24.9
Exchange rate RUB/USD, avg.	27.1	25.6	24.2	24.1	24.7
Interest rate (2W interbank rate), eop.	5.92	5.65	6.00	5.90	5.50
Interest rate (2W interbank rate), avg.	4.18	5.17	5.50	5.00	4.80
Current account balance/GDP (%)	9.6	6.1	5.2	4.3	1.5
FDI/GDP (%)	2.9	4.1	3.6	3.7	3.8
Budget balance/GDP (%)	8.4	8.0	7.5	7.2	6.0
Public debt/GDP (%)	8.2	6.9	6.2	5.9	5.5
Total external debt/GDP (%)	31.4	35.7	37.0	37.7	38.0

Sources: Rosstat, UniCredit Group New Europe Research Network.

Main topics

- The Ministry for Economic Development and Trade estimates GDP growth to have amounted to about 7.4 % yoy in early 2008.
- Retail sales increased by 17 % yoy in February 2008, driven by strong real disposable income growth.
- Investment in fixed assets grew by a record high rate of 21.2 % yoy in February.
- The strong increase in global oil prices since the beginning of the year has underpinned Russia's export growth. In USD terms, exports grew by an impressive 58 % yoy in January.
- Inflation accelerated to 13.3 % yoy in March 2007. The government and the central bank changed their inflation target for December 2008 from 8 % to 9.5–10 %.
- The global liquidity crisis has had little impact on loan growth so far. The growth rate of outstanding loans amounted to 55.8 % yoy in February 2008, even up from the 50.7 % yoy recorded in July 2007, when the crisis began.
- Russia's international reserves reached the record high level of USD 507 bln as of April 1, 2008.

Fast growth despite international slowdown

Smooth transfer of power

Mr. Putin's eight-year presidency comes to an end on May 7, when his successor and protégé Mr. Dmitry Medvedev will be sworn in as Russia's new President. On April 15, 2008, President Putin became the leader of the United Russia party, the largest party in the Russian Duma. In early May 2008, after he steps down as President, he is to be appointed Russia's new Prime-Minister.

This is the first time in Russian history when the political power will be transferred as a result of a popular vote. Besides, it will be the first time when a political leader, commanding an overwhelming public support, will voluntarily give up his office in accordance with the requirements of the constitution. This makes this event ground-breaking for establishing new political traditions in Russia. Mr. Putin will be one of the most powerful Russian prime ministers since the fall of the USSR in 1991. Mr. Medvedev vowed to continue the political and economic course that has emerged in recent years.

Stability versus modernisation

Rising inflationary pressures and growing financial resources available to the government have intensified debates about the government's economic policy priorities. This became publicly apparent in polemics between Prime Minister Zubkov and Finance Minister Kudrin at a session of the Finance Ministry board in April 2008. Mr. Kudrin objected to spending budget revenues from oil in excess of the budget expenditure targets and insisted on curbing expenditure growth to not more than 9–10 % yoy in real terms in 2008 and to not more than 4–5 % in subsequent years (expenditures grew around 16 % in real terms in the last couple of years). Prime Minister Zubkov countered that the government policy should not restrict demand, but on the contrary stimulates supply by increasing infrastructure investment.

De facto, the government's economic priority has been to maintain macroeconomic stability so far. However, ample financial resources from strongly increasing budget revenues and the bulging Stabilisation Fund became the basis for a growing influence of those who favour a

much more active role of the state in modernising the Russian economy. 2007 marked a new stage in the shift towards more activism by the state with this end. This manifested itself in a real explosion in drafting of all sorts of long-term development plans by government agencies, in establishing a number of state-controlled corporations financed by the government, and in increased spending of budget funds on infrastructure projects.

Opponents of these policies point to signs of overheating such as rising inflation and surging labour costs. It remains to be seen how this key macroeconomic issue will be handled by the new government chaired by Mr. Putin.

Despite fears of a global slowdown, the Russian economy has continued to grow fast

Despite the protracted global credit crisis, the Russian economy performed strongly in Q1 2008. The deceleration in the USA seems to have had little impact on global oil consumption. Energy prices have remained high and this provides a beneficial external environment for Russia.

According to Ministry for Economic Development and Trade estimates, real GDP grew by 7.4 % yoy in January 2008, and similarly strongly in February and March. Key drivers of this growth remained strong investment and household consumption. Growth in fixed investment by companies reached 19.0 % yoy in January, according to Rosstat, and 21.2 % in February. The record high level of investments is a result of both replacement and expansion of fixed assets. Investment growth is expected to remain high in 2008, at about 16 % yoy.

Real disposable incomes were up on the previous year by 10.6 % in February 2008. Average monthly wages grew, totalling USD 631 or EUR 418 in February. They vary however widely across industries. The highest monthly wages and salaries are paid in finance (USD 1,739), oil production (USD 1,317), and transportation (USD 1,128). The lowest wages are traditionally observed in agriculture (USD 269) and educa-

Short-term indicators

	Mar-07	Apr-07	May-07	Jun-07	Jul-07	Aug-07	Sept-07	Oct-07	Nov-07	Dec-07	Jan-08	Feb-08	Mar-08
GDP real growth, yoy (%)	7.4	—	—	8.1	—	—	7.3	—	—	9.5	—	—	—
Industrial production, yoy (%)	7.9	4.6	6.7	10.9	7.8	3.8	3.0	6.1	4.7	6.5	4.5	7.5	6.5
Inflation (CPI), yoy (%)	7.3	7.6	7.8	8.5	8.7	8.6	9.3	10.8	11.4	11.8	12.6	12.7	13.3
Unemployment rate (%)	6.8	6.4	6.0	5.9	5.8	5.7	5.8	5.9	5.9	6.1	5.8	6.6	—
Exchange rate RUB/EUR, eop.	34.7	35.1	34.8	34.7	34.9	35.0	35.3	35.6	36.0	35.9	36.2	36.4	37.1
2W interbank rate(%), avg.	5.3	4.5	4.0	4.0	3.9	5.1	6.9	7.0	7.0	5.6	4.1	5.2	5.6
Export (FOB), yoy (%)	−0.4	4.5	5.59	0.84	6.27	3.12	6.34	23.69	23.85	17.15	38.67	—	—
Import (FOB), yoy (%)	24.4	31.8	28.92	19.77	30.48	29.01	17.81	22.24	21.50	13.27	18.29	—	—
Trade balance, EUR mn ¹	22.3	30.5	40.0	46.4	54.0	62.1	70.1	79.1	88.3	97.6	12.3	—	—
Current account, EUR mn ¹	17.2	—	—	29.0	—	—	38.9	—	—	52.3	—	—	—

Source: ROSSTAT, Reuters, UniCredit Group CEE Research Network; 1) cumulative.

tion (USD 388). We project real disposable income to grow 10.5 % yoy in 2008, little changed from the 10.4 % yoy of 2007.

Industrial output grew 6.2 % yoy in Q1 2008 according to Rosstat. The best performing sector has become manufacturing with 7.7 % yoy growth in January–February 2008, followed by “water, gas and energy” (growth of 7.4 %). “Mining and quarrying” expanded by only 1.4 %. Extraction of oil even contracted by 0.2 % yoy in Q1, dropping by 1.7 % in March.

Growth in manufacturing was broad-based, with virtually all industries and sub-industries showing strong increases. The worst performing industries in January–February 2008 were the manufacturing of electrical and optical equipment, which declined by 4.7 % yoy mainly due to a drop of 28.9 % in the output of TV sets (because of a high base in 2007) and the manufacturing of wood and wood product with a decline of 7.4 %.

Supported by strong investment, construction also continued to expand at a very fast pace: In January–February, construction output increased by 30.2 % yoy. The value of construction work amounted RUB 416.7 bn (USD 17.3 bn). A future stimulus for construction will result from the federal programme for airport reconstruction, which envisages capital investment of about USD 2.2 bn in 2008–2009. The programme will involve 68 airports all over the country already this year.

The strong growth in disposable incomes is fuelling a continuing retail trade boom. Sales expanded by 16.3 % yoy in January–February, according to Rosstat. Sales of non-food goods increased by 22.7 % yoy, while sales of foodstuffs were up 8.7 % yoy. We forecast retail sales to grow 15 % this year, 14 % yoy in 2009 and 12 % yoy in 2010.

High revenues, increased budget surplus

The share of the federal budget in the total economy has become considerably larger in 2008 compared to a year ago. According to initial estimates, federal budget revenues totalled 26.2 % of GDP (RUB 1,322 bn), in January–February, whereas they amounted to just 21.3 % of GDP in the same period of 2007. Because of the transition from monthly to quarterly payments of VAT, these figures exclude VAT revenues. If properly adjusted, revenues for January–February 2008 were 8 percentage points of GDP higher than in 2007. The most important factor behind this extraordinary growth was the high oil prices and the resulting higher-than-planned export custom duties (totaling RUB 509.4 bn as of March 1, 2008).

Federal budget expenditures 2008 totalled 18.1 % of GDP in January–February (vs. 12.9 % in 2007). The increase in expenditures is explained by larger transfers to the regional budgets (which account for 40 % of federal budget expenditures), higher outlays on national defence, social policies and the national economy. The federal budget surplus totalled 8.2 % of GDP in January–February 2008 (vs. 8.4 % in 2007).

On February 1, 2008, Russia's Stabilisation Fund was transformed into two separate funds: the Reserve Fund and the National Welfare fund. The resources of the Reserve Fund, the purpose of which is to cover

federal budget deficits in case they occur, totalled USD 130.5 bn as of April 1, 2008.

The resources of the National Welfare Fund amounted to USD 33 bn as of April 1, 2008. The purpose of this fund is to cover the deficit of the Russian Pension Fund and to co-finance voluntary pension contributions. The currency structure of both funds remains the same: 45 % of their assets are in USD-denominated instruments, 45 % in EUR-denominated ones, and the remaining 10 % is in GBP. The financial assets of both National Welfare and Reserve funds are split as follows: 80 % in foreign government bonds, 15 % in international government agencies and central banks bonds, 5 % in international financial organisation bonds.

CPI will exceed target

High inflation remains a major worry. Despite a number of measures taken by the government to curb inflation, the CPI continued to increase rapidly across the board in Q1 2008. The measures include government-sponsored agreements with retailers on temporary price freezes on some key foodstuffs, increasing customs duties for exports of foodstuffs and decreasing them on imports of foodstuffs. Yet, international oil prices since the beginning of 2008 drove up Russia's export proceeds. These strong inflows added to strong growth in money supply (M2 was 56 % higher in March 2008 than in March 2007) and became one of the contributors to CPI growth during Q1 2008.

The CPI increased by 4.8 % during Q1 2008 compared with 3.4 % during Q1 2007 (in yoy terms, CPI growth amounted to 13.3 % in March). The drivers have remained the same as in late 2007: prices for food and services. Food prices increased 5.7 % in Q1 2008 (vs. 2.6 % a year ago) due to soaring prices for grain, dairy products and fruits and vegetables. Prices for services increased 7.5 % in Q1 2008 (vs. 8.0 % a year ago), primarily because of double-digit growth in housing and utility prices. Prices for non-food products increased 2.0 % in Q1 2008 (vs. 1.4 % a year ago).

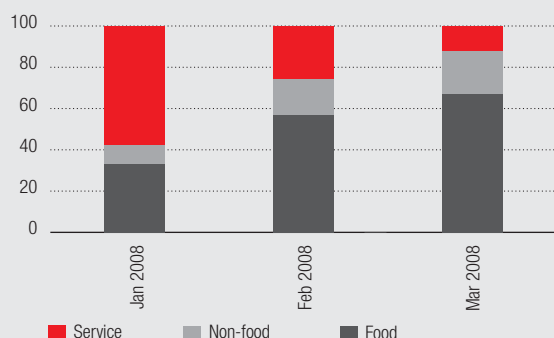
The authorities have already changed their original inflation target for December 2008 from 8 % to 9.5–10 % yoy. We expect inflation of at least 12.5 % for December of this year, given the current macroeconomic conditions.

Monetary policy: conflicting targets, increasingly mainstream

In 2008, the authorities have to pursue conflicting targets. On the one hand, they have to provide the Russian banking system with sufficient liquidity. On the other hand, the CBR has to counter inflation by controlling the growth of money supply. From mid 2007 on, after the global liquidity crisis had begun, the situation on the interbank has tightened. The 2-week MosPrime rate, which can be taken as an indicator, increased from around 4 % p.a., where it stood until mid-July 2007 to between 6 %–8 % until mid-December 2007.

Since late 2007 the CBR has expanded its credit to the banking system by intensified reverse repo operations with banks. On April 17, 2008, the Finance Ministry started auctions for depositing RUB 300 bn of free funds of the federal budget to commercial banks (for one-

CPI components contribution (%)



Source: Rosstat, UniCredit Group New Europe Research Network.

month periods). The minimal rate set in the first auction was 7.25 % p. a. This has helped reducing the 2W-MosPrime rates to between 4 %–6 % in 2008. The 6 month rate, which reflects more strongly inflation expectations, fell significantly less however. It stood at 7.4 % in late April, only slightly below the peak of 7.6 % in March and still above 7.3 %, the highest rates seen in 2007.

The global liquidity crisis and high interbank rates have had little impact on loan growth so far. The growth rate of outstanding loans amounted to 55.8 % yoy in February 2008, even up from the 50.7 % yoy recorded in July 2007. The reason is the higher demand from companies because the conditions on the bond and equity markets have deteriorated leading them to look for commercial bank financing. Corporate loan growth accelerated to 53.4 % yoy in February from 46.2 % yoy in July. Retail loan growth decelerated by contrast from 66.9 % in July to 56.8 % in February. The slow down began however already before the liquidity crisis: In June 2006, the growth rate stood at 89.6 % yoy.

To counter inflation, the CBR increased its refinancing rate in February 2008 along with all other rates at which it provides credits to banks by 25 basis points to 10.25 % and increased the minimum reserve ratio for various types of deposits by between 0.5 and 1 percentage points. In April, the CBR raised the refinancing rate further to 10.50 %. The CBR forecasts that these measures will decrease the growth of M2 money supply from 48 % in 2007 to 30–35 % in 2008. The actual growth rate amounted to 42.2 % yoy in March. With some slow down in the growth of retail deposits already visible, at least the upper CBR's forecasts appears achievable. This will hardly suffice however, to bring inflation down to target. In real terms, in-

terest rates will very likely remain negative this year. Monetary tightening will remain moderate.

In future, negative real interest rates should disappear as a normal feature of the Russian financial market. Analysing the more long-term perspectives, one must conclude that monetary policy has now entered a period of fundamental change. Until recently, almost all the growth in money supply came from CBR's purchases of foreign exchange. But in 2007, Russia's current account surplus decreased to USD 78 bn (from USD 94 bn in 2006) under the impact of much faster growth of imports compared to exports, and this trend is set to continue. Furthermore, in 2007, the current account surplus was very close to the increase of the volume of Russia's Stabilisation fund. This means that in absence of private capital inflows the growth of money supply would have been close to zero. Therefore, the long-term trend of the Russia's money supply policy is that it will be based increasingly on refinancing of the Russian banking system by the Bank of Russia and will increasingly depend on the CBR's interest rate policy. The Russian monetary policy is thus on the way to become more and more similar to the global mainstream both in terms of instruments and procedures.

Russia's international reserves rose, despite lower capital inflows

The international financial crisis has had some impact on net private capital flows. According to the CBR, the outflow of net private capital from Russia reached USD 22.8 bn in Q1 2008, compared to a USD 13.5 bn net private capital inflow in 2007. Mr. Ulyukae, deputy chairman of the CBR, noted in his last testimony that the central bank is decreasing its forecast for net capital inflows to USD 25–30 bn this year, in view of the current macroeconomic situation.

The capital outflow did not however prevent a strong increase in Russia's international reserves. As a result of booming exports, Russia's foreign exchange reserves grew by 6.5 % during Q1 and reached USD 507 bn as of April 1, 2008. Russia has the third highest international reserves after China and Japan.

Continued strong global demand for commodities and the weakening of the USD pushed oil prices to new highs. As a result, Russia's exports in January 2008 reached USD 34 bn (58 % growth yoy), according to Rosstat, while imports amounted USD 15 bn, up 35 % yoy. The appreciation of the rouble against the USD by 4.4 % since beginning of 2008 will continue to drive import growth. We expect Russia's foreign trade surplus to decrease to 8.2 % of GDP (vs. 10.2 % in 2007), and the current account balance to narrow to 5.2 % of GDP in 2008 (vs. 6.1 % in 2007). This is still high enough however to ensure growth in international reserves even in periods of weak capital inflows.

Event	Date	Reading
Inflation data	June 2008	The agreement to freeze prices on certain socially significant foodstuffs expired on 30 April 2008. Inflation data for May will reveal how strong price pressures really are.

Serbia



Outlook

While a victory in the 11 May parliamentary elections for pro-EU parties centred around the Democratic Party (DS) of president Tadic would be welcomed by the EU and investors, and now that Serbia has signed a Stabilisation and Association Agreement (SAA) with the EU, the political environment in Serbia is likely to remain messy nevertheless. Inflationary pressures are rising and while recent central bank measures have seen the RSD strengthen, political noise will be important in determining whether the currency remains strong. There is evidence that investment activity is being delayed until after the elections, while wages, credit and retail sales data all point to strong consumption spending. While government spending is rising, we see economic growth slowing this year. The current account deficit is likely to narrow this year, but question marks over FDI inflows point to increasing foreign indebtedness, in a moment in which international risk aversion is extremely high.

MOODY'S LT FC RATING
Not rated

S&P'S LT FC RATING
BB-/Negative

FITCH LT FC RATING
BB-/Stable

SPREAD AVG (JAN) N. A.
EMBI+ Spread on Euro Curve

Macroeconomic data and forecasts

	2006	2007	2008f	2009f	2010f
Nominal GDP (EUR bn)	24.6	29.4	33.7	37.7	42.2
Per capita GDP (EUR)	3,310	3,970	4,560	5,120	5,730
Real GDP, yoy (%)	5.7	7.5	5.0	5.5	6.2
Inflation (CPI), yoy, eop. (%)	6.6	10.1	10.0	6.7	5.4
Inflation (CPI), yoy, avg. (%)	12.7	6.8	11.1	7.5	6.3
Unemployment rate (%)	20.9	19.0	18.7	18.3	18.0
Exchange rate RSD/EUR, eop.	79.0	79.2	82.0	82.5	83.0
Exchange rate RSD/EUR, avg.	84.1	80.1	81.5	82.3	82.8
2W repo rate, eop.	14.0	10.0	17.0	13.0	10.0
Current account balance/GDP (%)	-12.9	-17.1	-14.8	-13.9	-13.0
FDI/GDP (%)	13.8	5.5	5.2	5.8	5.9
Budget balance/GDP (%)	1.5	1.3	-0.6	-0.9	-1.2
Public debt/GDP (%)	34.1	28.4	23.3	22.0	21.0
Total external debt/GDP (%)	63.6	65.1	66.5	67.6	67.5

Source: NBS, Statistical Office of the Republic of Serbia, UniCredit Group New Europe Research Network.

Main topics

- Parliamentary elections on 11 May will be important in determining the pace at which Serbia pursues EU accession. At present, the polls are evenly split between anti-EU accession parties and pro-EU accession parties, although the EU's decision to offer a Stabilisation and Association Agreement (SAA) to Serbia on 29 April may influence the final outcome.
- Privatisation tenders have been delayed and some previously agreed investment deals have fallen through, hinting that investment activity will provide less of a boost to economic growth this year.
- Nonetheless, credit activity, public sector wage increases and retail sales data all point to increasing private consumption, which has contributed to stronger inflationary pressures and seen the inflation rate approach 12 % yoy in March.
- Given monetary tightening and evidence of postponements in investment activity, we see the current account deficit narrowing to 14.8 % of GDP, but foreign debt rising to 66.5 % of GDP as FDI inflows cover only 5.2 % of the current account deficit.

Political uncertainty, rising inflation and delayed investments

Political uncertainty remains high

Serbia faces an important parliamentary election on 11 May after the government fell in the aftermath of Kosovo's declaration of independence. Kosovo's declaration of independence. Opinion polls released before the EU offered Serbia an SAA on 29 April suggest a close election. Parties not prepared to join the EU until it states categorically Kosovo is a part of Serbia are marginally ahead of parties prepared to join the EU in accordance with the conditions of the SAA. Were the Radical Party (SRS) to form the core of the next government, EU accession talks would not progress because they have openly stated they are not willing to co-operate with The Hague War Crimes Tribunal. The EU (and investors) would welcome a government based around the Democratic Party (DS) and soon offer to sign an SAA with Serbia. With the Serbian electorate evenly divided, we expect a close result, and would not at all be surprised if the formation of a new government took a number of months, similar to what happened after the January 2007 election. After the January 2007 election. Before the EU commences the process of ratifying the SAA, Serbia must establish full cooperation with the ICTY. With the electorate evenly divided, this suggests Serbia's path to EU membership will remain lengthy.

Growth still strong, but slowing

Economic growth slowed in each of the four quarters of last year, amounting to 6.9 % yoy in Q4 2007 and 7.5 % yoy in 2007 as a whole. Although no national accounts data for Q1 2008 will become available at the end of June, there is anecdotal evidence that investment projects are being delayed by the election campaign. The commencement of a motorway construction project has been delayed by political infighting, the previously approved privatisation of a mine in eastern Serbia has fallen through while the gas pipeline and NIS privatisation deal with Russia await ratification by the Serbian parliament. Industrial production data, although up 8 % yoy in January–February 2008 in seasonally adjusted terms point to a slight moderation. We expect the GDP growth to substantially slow to 5 %, in 2008.

At the same time, indicators on private consumption suggest no immediate slowing. Credit growth data for January 2008 shows an increase in activity in real terms for households of 38.3 % yoy and 28.2 % yoy for enterprises. Wage growth remains pronounced with aggregate gross wages in Q1 2008 rising 5.2 % yoy in real terms. However, public sector wage increases. Unsurprisingly, data for the year to date (January–February) on retail sales also reflect solid growth of 12.9 % yoy in real terms, despite an unfavourable base effect

Inflation continues to rise

Amidst robust consumption spending, loosening fiscal policy (public sector wage and social welfare spending increases) and high food and

oil prices, it is no surprise that both headline and core inflation have continued to rise in 2008. In March, the most widely quoted Retail Price Index was up 11.8 % yoy, while core inflation rose to 7.0 % yoy, above the central bank's target range of 3–6 %. In response to the increase in inflationary pressures and weakness in the RSD (driven by the political situation), the National Bank of Serbia (NBS) has continued to tighten monetary policy. In mid-March it surprised the market by raising the 2W repo rate by 300bp to 14.5 % and in late March it announced that from 17 May 10 % of mandatory foreign exchange reserves would have to be deposited in RSD. This last announcement saw the RSD strengthen from 84 to 80.5 against the euro as banks' demand for RSD increased. Concerns that oil and food price dynamics as well as inflationary expectations may not settle down any time soon have led the NBS to reiterate that it is prepared to tighten monetary conditions further in an effort to achieve its core inflation target by the end of the year. In addition, the 20 % up-front deposit on RSD unsecured loans is being removed, while the deposit of FX unsecured loans is being increased in an effort to make the local currency more attractive. With much saving, credit and pricing activity in the Serbian economy very sensitive to movements in the EUR/RSD, and exchange rate stability is a more powerful factor than local currency interest rates in controlling inflation. And an improved political situation would do much to remove lingering pressure on the RSD.

A lower current account deficit?

The current account deficit in 2007 widened to over EUR 5 bn, or 17.1 % of GDP. Data for the first two months of the year show a deficit of EUR 650 mn. While higher oil prices and robust consumption argue in favour of a widening deficit, we believe the delays in privatisation deals and investment activity will, in the end, limit the current account deficit to approximately EUR 5 bn this year. Given strong nominal GDP growth, we therefore expect the current account deficit to narrow to 14.8 % of GDP this year. The main issue however, will be the coverage of the deficit by FDI inflows. Although the balance of payments data show inflows of over EUR 500 mn in January–February, the first instalment of the RTB Bor mine complex privatisation will be returned to the investor after the deal fell through. Likewise the commencement of investment in the South Stream oil and gas pipeline will not begin until after the elections when the parliament is expected to ratify the deal signed earlier this year with Gazprom. While the banking sector will contribute to FDI inflow with retained earnings and more than likely further capital increases, we expect the political uncertainty currently enveloping Serbia to translate to FDI inflows of approximately 5.2 % of GDP, similar to last year. Nonetheless, a second year of below average FDI inflows would see foreign indebtedness increase from 65.1 % at the end of 2007 to 66.5 % of GDP at the end of this year.

Event	Date	Reading
Early Parliamentary Elections	11 May	We expect a close result with the risk the new government may take quite a while to form, the country's EU accession process will remain long and difficult.

Ukraine



Outlook

High inflation and some tightening of economic policy will slow GDP slightly more in 2008 and 2009 than we originally assumed. We now expect real GDP growth of 5.4 % yoy in 2008 and 4.6 % in 2009, with inflation averaging 22 % and 10 %, respectively. In 2010, a rebound in economic growth to 5.6 % yoy should take place, with inflation easing to some 8 % and the economy receiving some stimulus from fiscal loosening in late 2009 in the run-up to the 2010 presidential elections and from preparation for the 2012 European football championship. WTO accession on 16 May 2008 will support steel exports. The current account deficit is nevertheless set to widen to about 8 % of GDP until 2010. Credit expansion has remained strong up to now, but tighter monetary conditions will eventually force banks to scale back their business plans. The debate on a new constitution may lead Ukraine from a presidential-parliamentarian to an unambiguously parliamentary republic, not without political turbulences however.

MOODY'S LT FC RATING
B1/Positive

S&P'S LT FC RATING
BB-/Negative

FITCH LT FC RATING
BB-/Positive

SPREAD AVG (APR) 309
EMBI+ Spread on USD Curve

Macroeconomic data and forecasts

	2006	2007	2008f	2009f	2010f
Nominal GDP (EUR bn)	84.8	102.6	128.3	160.2	194.5
Per capita GDP (EUR)	1,810	2,200	2,780	3,490	4,270
Real GDP, yoy (%)	7.1	7.6	5.4	4.6	5.6
Inflation (CPI), yoy, Dec. (%)	11.6	16.6	17.1	9.0	7.5
Inflation (CPI), yoy, avg. (%)	9.1	12.8	22.0	10.0	8.2
Unemployment rate (%)	6.8	6.9	6.2	6.0	6.0
Exchange rate UAH/EUR, eop.	6.65	7.42	7.07	6.82	6.37
Exchange rate UAH/EUR, avg.	6.34	6.92	7.22	6.88	6.60
Exchange rate UAH/USD, eop.	5.05	5.05	5.05	5.05	4.90
Current account balance/GDP (%)	-1.5	-4.2	-6.8	-7.4	-8.2
FDI/GDP (%)	5.4	6.6	5.7	4.8	4.8
Budget balance/GDP (%)	-0.7	-1.3	-1.0	-3.0	-3.0
Public debt/GDP (%)	15.0	16.5	18.0	22.2	25.0
Total external debt/GDP (%)	49.8	56.9	53.6	51.9	51.9

Sources: Ukrainian central bank, UkrStat, UniCredit Group New Europe Research Network.

Main topics

- Real GDP expanded 6.0 % yoy in Q1 2008 according to preliminary Ukrstat estimates.
- Industrial output increased by 7.8 % yoy in Q1, compared with an average of 10.2 % in 2007. Construction output increased by 1.7 % yoy, significantly down from 15.6 % in 2007.
- Inflation accelerated to 26.2 % yoy in March. Food prices grew 42.5 % yoy.
- To counter inflation, the central bank increased its overnight interest rate from 14.5 % to 15 % for loans secured by state bonds as of 21 April 2008, and from 15.0 % to 16 %, for unsecured loans in addition to earlier tightening measures.
- It hiked the discount rate to 12 % from 10 % as of April 30.
- Despite the global liquidity crisis, credit growth remained strong in Q1. The loan stock increased by 12.7 % during Q1 2008 compared to 11.4 % during Q1 2007. The value of outstanding loans exceed previous year's figure by 76 % yoy as of 31 March.
- Interbank rates have drastically increased on the back of high hryvnia demand. The KievPrime overnight rate rose to almost 30 % in late April, and the 3-month rate moved to 18 %. The central bank abstained for some time from purchasing foreign exchange, allowing the hryvnia to appreciate to 4.9 to the USD, although the official rate has remained at 5.05.

Hot inflation, hot politics

Towards a parliamentary republic?

The political situation has remained tense in Ukraine. Prime Minister Yulia Tymoshenko and the president's secretariat and also President Victor Yushchenko himself are engaged in sharp disputes with each other on an almost daily basis. More and more the constitution is moving into the centre of conflict. A blueprint for a new constitution submitted by a working group established last year by a decree of the head of state, envisions the preservation of presidential authority. The president would reportedly lose influence over the economy and would not have the first say in appointing the foreign minister, the defence minister or in proposing the prime minister candidate, but would retain control over the strategic issues of foreign policy and national security. President Yushchenko wanted to have the new constitution adopted by a referendum. The constitutional court, however, ruled that a new constitution cannot be adopted by a referendum unless parliament amends the existing constitution to provide for such a possibility. The parliament thus cannot be circumvented.

Prime Minister Yulia Tymoshenko now favours a parliamentary republic, transferring power over the executive unambiguously to the government. Passing changes to the constitution requires a two-thirds majority of votes in parliament, which means that Tymoshenko will have to ally with the opposition Party of Regions. The price BYUT would have to pay to the "Regions" is not yet clear, but an agreement appears not unlikely, given the strong voter support for the "Yulia Tymoshenko Block" and the slim chances for "Party of Regions" leader Victor Yanukovich to win the 2010 presidential elections. Such an agreement would very likely mean the collapse of the orange coalition. In the short run, political turmoil would deepen, rendering coherent economic policies even more difficult. In the long run, however, a two-party system might evolve, making Ukraine look more similar to the rest of Europe.

Real GDP up 6 % in Q1

Real GDP grew by 6.0 % yoy in Q1 2008 according to preliminary Ukrstat estimates. Value added in trade grew fastest, followed by manufacturing and "transport, storage and communication". Construction value added fell 1 % yoy, after strong growth last year. For 2007, GDP growth was revised from 7.3 % to 7.6 %.

Inflation a key issue

Inflation has become a central issue in recent months, affecting broad ranges of the population. Inflation accelerated to 26.2 % yoy in March, with food prices skyrocketing to 42.5 % yoy. And there is more fuel for inflation: in a move to improve the finances of the state energy firm Naftogaz, the government issued a recommendation for the national energy regulator to hike gas prices both for households and for district heating companies.

Monetary tightening

To counter inflation, the central bank (NBU) increased its overnight interest rate from 14.5 % to 15 % for loans secured by state bonds as of 21 April 2008, and from 15.0 % to 16 %, for unsecured loans in addition to earlier tightening measures. It hiked the discount rate to 12 % from 10 % as of April 30. On the other hand, the NBU decided to ease refinancing requirements by accepting commercial banks' own shares as collateral, but warned that it would refuse to refinance banks exhibiting excessive credit portfolio growth. The rate hikes come in a situation where interbank rates are already very high. The O/N KievPrime rose to almost 30 % (the 3M rate to 18 %) by late April as major, mostly foreign-owned, retail banks started to feel a UAH deficit. There was little moderation in credit growth during Q1 2008: The loan stock increased by 12.7 % ytd compared with 11.4 % ytd during Q1 2007, leaving the March yoy figure at 76 %. Flight from the USD due to revaluation rumours (and actual hryvnia appreciation at cash points and the interbank market) further increased hryvnia demand while the central bank abstained from buying foreign exchange, probably testing possible reactions to a more flexible hryvnia FX rate, which has now been under discussion for some time. Ultimately the significantly tighter monetary conditions will force banks to scale back their business plans.

Fiscal restraint

Budget revenues showed even stronger growth than expenditures in early 2008, resulting in a state budget surplus. In order to tighten fiscal policy, government expenditures might be cut however later this year. First Vice Prime Minister Olexandr Turchynov said that one "cannot avoid considering correction of macroindices which are to be corrected together with adoption of amendments to the budget". Such a move is politically not easy of course. We believe that fiscal tightening will in the end not take place by expenditure cuts, but by higher nominal revenues while expenditures will not be fully adjusted to higher inflation. The fiscal deficit will probably widen substantially in 2009, in the run-up to the presidential elections of 2010 and as GDP and price growth slows.

Strong exports, stronger imports

With steel prices up more than 20 % in Q1 2008, the external environment has remained favourable for Ukraine's exports. Exports of ferrous metals, accounting for more than one-third of total exports, increased by 18 % yoy on a USD basis. Most importantly, exports of machinery and of means of transportation increased by 39 % yoy and 60 % yoy respectively and together now account for 17 % of total exports. High imports will nevertheless substantially widen the current account deficit this year, probably to almost 7 % of GDP, even though slower growth should bring some relief in late 2008.

Event	Date	Reading
WTO accession	May 16	On April 16 2008, Ukraine sent a note to the WTO, informing about the ratification of the protocol on joining the organisation. Ukraine should become a full member 30 days later.

Annex

Country Ratings – foreign currency long term debt

		Current Rating	Upgrade from	On (date)	Outlook	Date
Bosnia & Herzegovina	Moody's	B2	B3	17-May-06	Stable	24-May-06
	S&P	—	—	—	—	—
	Fitch	—	—	—	—	—
Bulgaria	Moody's	Baa3	Ba1	01-Mar-06	Positive	23-Feb-07
	S&P	BBB+	BBB	26-Oct-06	Stable	26-Nov-07
	Fitch	BBB	BBB—	17-Aug-05	Negative	31-Jan-08
Croatia	Moody's	Baa3	—	—	Positive	18-Jul-07
	S&P	BBB	BBB—	22-Dec-04	Stable	11-Jul-07
	Fitch	BBB—	BB+	28-Jun-01	Stable	28-Aug-07
Czech Republic	Moody's	A1	Baa1	12-Nov-02	Positive	24-May-06
	S&P	A	A—	02-Oct-07	Stable	02-Oct-07
	Fitch	A+	A	04-Mar-08	Stable	04-Mar-08
Estonia	Moody's	A1	Baa1	12-Nov-02	Stable	12-Sep-07
	S&P	A	A—	17-Nov-04	Negative	21-Jan-08
	Fitch	A	A—	07-Jul-04	Negative	31-Jan-08
Hungary	Moody's	A2	A1	22-Dec-06	Stable	22-Dec-06
	S&P	BBB+	A—	15-Jun-06	Negative	14-Mar-08
	Fitch	BBB+	A—	06-Dec-05	Stable	05-Nov-07
Kazakhstan	Moody's	Baa2	—	—	Stable	09-Jun-06
	S&P	BBB—	BBB	08-Oct-07	Negative	29-Apr-08
	Fitch	BBB	BBB—	20-Dec-05	Negative	17-Dec-07
Latvia	Moody's	A2	Baa2	12-Nov-02	Stable	12-Sep-07
	S&P	BBB+	A—	17-May-07	Negative	21-Jan-08
	Fitch	BBB+	A—	17-Aug-07	Negative	31-Jan-08
Lithuania	Moody's	A2	A3	12-Sep-06	Stable	12-Sep-06
	S&P	A—	A	30-Jan-08	Negative	30-Jan-08
	Fitch	A	A—	23-Oct-06	Negative	07-Dec-07
Macedonia	Moody's	—	—	—	—	—
	S&P	—	—	—	Stable	08-May-06
	Fitch	BB+	—	02-Dec-05	Positive	14-Aug-07
Poland	Moody's	A2	Baa1	12-Nov-02	Stable	24-May-06
	S&P	A—	BBB+	29-Mar-07	Positive	21-Feb-08
	Fitch	A—	BBB+	18-Jan-07	Stable	18-Jan-07
Romania	Moody's	Baa3	Ba1	06-Oct-06	Stable	06-Oct-06
	S&P	BBB—	BB+	06-Sep-05	Negative	05-Nov-07
	Fitch	BBB	BBB—	31-Aug-06	Negative	31-Jan-08
Russia	Moody's	Baa2	Baa3	25-Oct-05	Stable	24-May-06
	S&P	BBB+	BBB	04-Sep-06	Positive	11-Mar-08
	Fitch	BBB+	BBB	25-Jul-06	Stable	16-Aug-07
Serbia	Moody's	—	—	—	—	—
	S&P	BB—	B+	18-Jul-05	Negative	11-Mar-08
	Fitch	BB—	—	19-May-05	Stable	02-Aug-07
Slovakia	Moody's	A1	A2	17-Oct-06	Stable	17-Oct-06
	S&P	A	A—	19-Dec-05	Positive	03-Mar-08
	Fitch	A	A—	11-Oct-05	Positive	23-Jul-07
Slovenia	Moody's	Aa2	Aa3	26-Jul-06	Positive	29-Jul-06
	S&P	AA	AA—	16-May-06	Stable	02-Mar-07
	Fitch	AA	AA—	12-Jul-06	Stable	16-Oct-07
Turkey	Moody's	Ba3	B1	14-Dec-05	Stable	24-May-06
	S&P	BB—	B+	17-Aug-04	Negative	03-Apr-08
	Fitch	BB—	B+	13-Jan-05	Stable	12-Dec-07
Ukraine	Moody's	B1	B2	10-Nov-03	Positive	10-Nov-06
	S&P	BB—	B+	11-May-05	Negative	02-Aug-07
	Fitch	BB—	B+	21-Jan-05	Positive	25-Oct-06
Ratings' movements since the beginning of 2008:						
		downgrade	upgrade			
Source: Moody's, S&P's and Fitch's.						

Country ceiling ratings scale

	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17
Moody's	Aaa	Aa1	Aa2	Aa3	A1	A2	A3	Baa1	Baa2	Baa3	Ba1	Ba2	Ba3	B1	B2	B3	Caa1
S&P's	AAA	AA+	AA	AA–	A+	A	A–	BBB+	BBB	BBB–	BB+	BB	BB–	B+	B	B–	CCC+
Fitch's	AAA	AA+	AA	AA–	A+	A	A–	BBB+	BBB	BBB–	BB+	BB	BB–	B+	B	B–	CCC+

Credit Default Swaps (USD, bp)

	quarterly – eop.				Latest	Latest YTD
	Q2 2007	Q3 2007	Q4 2007	Q1 2008	30-Apr-08	% change
Bulgaria	14	30	72	181	125	73.8 %
Croatia	15	30	66	131	80	22.0 %
Czech R.	6	7	16	42	44	172.3 %
Hungary	19	32	49	176	114	134.7 %
Kazakhstan	39	113	203	282	229	12.6 %
Latvia	10	10	138	156	167	21.1 %
Poland	9	14	24	73	37	56.7 %
Romania	18	41	82	204	144	75.2 %
Russia	43	71	88	148	103	17.0 %
Serbia	106	157	227	250	259	14.3 %
Slovakia	6	7	17	54	25	53.0 %
Turkey	146	164	167	309	242	44.3 %
Ukraine	135	193	242	299	275	13.7 %

Source: Bloomberg.

Money market interest rates, avg.

	Apr-07	Feb-08	Mar-08	Apr-08	Apr-07/Apr-08 difference
Bulgaria – 1M Interbank mid	3.81	6.35	6.37	6.42	2.61
Croatia – 1M Zibor mid	4.48	7.39	5.75	5.36	0.89
Czech Rep – 1M Pribor mid	2.44	3.70	3.77	3.79	1.35
Estonia – 3M Talibor	4.18	6.00	5.78	5.73	1.55
Hungary – 1M Interbank	8.01	7.62	7.77	8.05	0.04
Kazakhstan – 1M Kibor	4.92	9.25	8.44	7.72	2.80
Latvia – 3M Rigibor	6.79	6.48	5.50	4.97	-1.82
Poland – 1M Wibor mid	4.24	5.52	5.82	6.10	1.87
Poland – 3M Wibor mid	4.32	5.73	6.02	6.29	1.98
Romania – 1M Bubor mid	6.99	9.24	9.99	11.38	4.40
Russia – 3M Interbank	5.61	6.43	7.35	7.17	1.56
Slovakia – 1M Bribor mid	3.43	3.94	3.93	4.23	0.35
Slovakia – 3M Bribor mid	3.65	3.98	4.00	4.28	0.22
Turkey – 1M Interbank	17.74	15.64	15.75	15.58	-2.16

Source: Bloomberg.

Exchange rates – ECB methodology

	Regime	Target	Exchange rate vs EUR – quarterly eop.				Latest	Latest YTD
			Q2 2007	Q3 2007	Q4 2007	Q1 2008	30-Apr-08	% change
Bulgaria	Currency Board	EUR	1.96	1.96	1.96	1.96	1.96	0.0 %
Croatia	Managed Float	Informal peg to EUR	7.30	7.27	7.33	7.27	7.27	-0.8 %
Czech Rep.	Managed Float	Inflation	28.76	27.53	26.52	25.23	25.22	-4.9 %
Estonia	Currency Board	ERM II: central parity at 15.6466 EEK to 1 EUR, +/-15 %	15.647	15.647	15.647	15.647	15.647	0.0 %
Hungary	Managed Float	Central parity at 282.36 to 1 EUR, +/-15 %	246.71	250.98	253.04	260.65	253.27	0.1 %
Kazakhstan	Free Float	Inflation	163.71	171.38	177.17	190.22	188.79	6.6 %
Latvia	Currency Board	ERMII: central parity at 0.702804 to 1 EUR, +/-15 %	0.696	0.705	0.697	0.698	0.699	0.2 %
Lithuania	Currency Board	ERM II: central parity at 3.4528 to 1 EUR, +/-15 %	3.45	3.45	3.45	3.45	3.45	0.0 %
Poland	Free Float	Inflation	3.77	3.77	3.60	3.52	3.46	-4.1 %
Romania	Managed Float	Inflation (1 new RON=10,000 ROL)	3.12	3.34	3.58	3.73	3.68	2.9 %
Russia	Managed Float	Control floating, inflation band	34.86	35.45	35.94	37.09	36.83	2.5 %
Serbia	Managed Float	Inflation	78.87	79.31	78.80	82.43	80.80	2.6 %
Slovakia	Managed Float	ERMII: central parity at 35.4424 to 1 EUR, +/-15 %	33.61	33.89	33.62	32.50	32.24	-4.1 %
Ukraine	Free Float	USD de facto	6.80	7.17	7.36	7.89	7.56	2.7 %
Turkey	Free Float	Inflation	1.78	1.72	1.71	2.11	2.00	17.0 %

Source: Bloomberg.

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