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Macroeconomic Scenario

Regional outlook 2008–2009														
	Real GDP		Inflation		Interest rate			Exchange rate			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	3.2	5.3	2.8	3.50	3.50	3.50	26.6	25.7	25.0	-3.4	-2.7	-2.3	-2.9
Hungary	2.5	3.3	5.3	3.0	7.50	8.50	7.00	253.4	245.0	243.0	-4.4	-4.1	-3.6	-3.2
Poland	5.2	4.2	4.0	3.3	5.00	6.00	5.50	3.58	3.42	3.47	-5.4	-5.6	-2.5	-2.3
Slovakia	7.5	6.0	3.6	4.4	4.25	4.25	ECB	33.6	30.1	EUR	-4.6	-4.0	-2.0	-1.7
Slovenia	5.1	4.0	6.4	4.6	ECB	ECB	ECB	EUR	EUR	EUR	-5.1	-5.0	-0.3	-0.3
Baltics & SEE														
Estonia	-1.2	1.7	8.0	6.0	7.2	6.3	5.2	15.65	15.65	15.65	-11.1	-11.9	-1.2	-1.0
Latvia	0.5	0.4	11.0	6.5	6.0	6.0	5.5	0.70	0.70	0.70	-14.5	-12.8	-0.9	0.1
Lithuania	4.7	3.8	9.9	6.2	7.2	5.6	4.7	3.45	3.45	3.45	-11.9	-11.2	-0.9	-0.9
Bosnia-H.	5.8	4.8	6.5	3.4	4.8	4.6	3.9	1.96	1.96	1.96	-15.3	-13.6	-0.5	-1.8
Bulgaria	6.3	4.2	10.3	8.0	4.7	5.5	5.9	1.96	1.96	1.96	-23.5	-20.2	3.5	3.0
Croatia	3.7	3.2	5.1	3.9	6.7	5.8	5.5	7.33	7.28	7.25	-10.3	-8.9	-1.4	-1.7
Romania	8.0	4.8	6.2	4.8	7.50	10.25	9.50	3.61	3.60	3.70	-13.5	-13.0	-3.2	-3.0
Serbia	7.0	5.3	9.5	7.7	10.0	15.8	13.5	79.2	76.0	75.0	-17.0	-13.6	-2.0	-3.0
EU Candidates and other Countries														
Kazakhstan	3.8	4.2	11.7	8.6	12.35	7.00	7.50	177.2	174.0	167.0	3.5	-0.8	-1.1	-1.1
Russia	7.4	6.0	13.0	11.7	6.82	8.00	7.40	35.9	36.2	35.1	7.5	4.6	6.5	3.0
Turkey	4.2	4.6	11.0	7.8	15.75	16.75	15.75	1.71	1.81	1.88	-6.5	-6.7	-1.6	-1.4
Ukraine	6.3	4.2	20.3	10.8	8.0	8.3	6.8	7.42	7.18	7.02	-7.2	-8.9	-1.4	-3.0

Source: UniCredit Group CEE Research Network.

Global financial and economic weakness testing CEE

One year after the beginning of the international financial turmoil, high uncertainty and volatility persist at the global level, with no signs of abating. The US economy continues to perform poorly and signs of a slowdown are now materialising also in the eurozone. Strong inflation and declining employment are taking their toll on households' spending, while a low level of construction activity – likely to persist for the whole forecasting period – will reflect the weakening capital formation until mid-2009, which will in turn slow down investment. With a large share of CEE exports being directed towards the eurozone which is experiencing declining growth, the situation is anything but favourable for CEE.

The financial sector crisis is deepening, moving from the US to the UK and to Western Europe. Stock markets have been dropping for weeks, liquidity is becoming an issue for the financial industry, while risk aversion is increasing sharply. Such a scenario is clearly unresponsive for emerging markets and for CEE.

The repricing of CEE market risk has clearly intensified in line with global trends. The 5Y CDS spread, though being a quite illiquid measure in some of the countries, is peaking, and strongly penalising those countries which show macroeconomic imbalances (see chart 1). The CDS spread for Ukraine is now trading at more than 700 bps, while the spread more than doubled in the last month in Kazakhstan, Russia and

Latvia (now at 430, 254 and 330, respectively). Risk pricing, although already high, also increased in South Eastern European countries (CDS spreads are currently above 200 bps in Romania, Bulgaria and Serbia) and Turkey, where CDS spreads are now close to 300 bps. While Central European countries have also been affected by a surge in CDS spreads in the last month, they continue to enjoy a relatively lower risk perception than other countries in the region and – with the exception of Hungary – their CDS spreads are far below 100 bps.

Going on declining world growth will reflect the high uncertainty, volatility and strong risk aversion characterising international markets, with a negative effect on international capital flows.

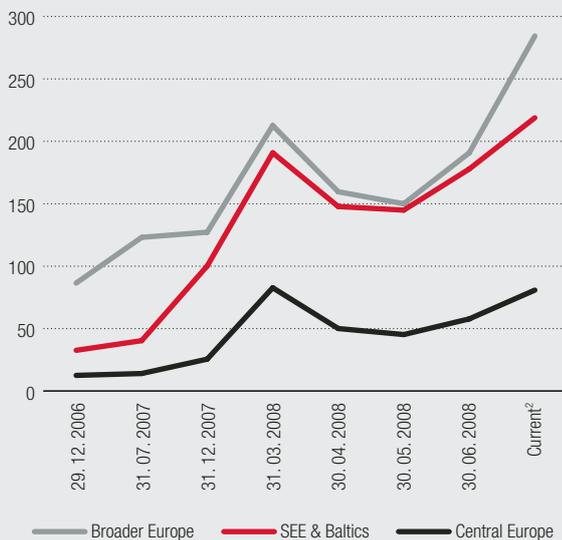
Growth to decelerate from 5.8 % in 2008 to 4.9 % in 2009

While growth has so far remained quite strong throughout the CEE region, the gloomy international outlook will take its toll in 2009. High vulnerability and cost of risk combined with lower demand in the eurozone will lead to a slowing of GDP growth from 5.8 % in 2008 to 4.9 % in 2009, with some recovery in 2010 (5.2 %).

High dependency on capital inflows and cost of risk the main contagion channel for CEE ...

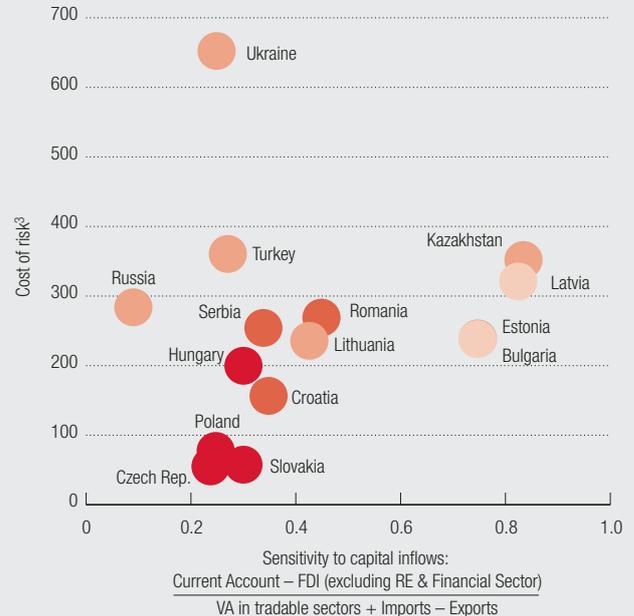
We identify the high dependency on capital inflows and cost of risk as the main contagion channel for CEE. Most of the CEE countries are run-

Chart 1
Clear repricing of risks (5Y USD CDS Spread¹)



Note: 1) Excluding Slovenia, Bosnia, Estonia and Lithuania. 2) Latest data: 29/09/2008. 3) Cost of Risk is calculated as CDS of the country as of 29/09/2008.
Source: Bloomberg, local CBs, UniCredit Group CEE Research Network

Chart 2
High dependency on capital inflows



ning wide current account deficits; an indication that the economy is unable to generate enough domestic savings. Economic growth has been financed by “importing” external funds – in the form of FDIs or public or private debt. The banking sector has played a role, with strong lending growth – one of the main drivers of the retail and investment boom – being largely financed from abroad. The re-pricing of risk at the international level has led to an increase in the cost of such external financing, meaning a general tightening of monetary and credit conditions. Such tightening can be moderate, leading to some cooling of economic activity, or more abrupt, meaning a strong correction in terms of growth.

Countries with greater dependency on foreign funding and facing a higher cost of risk are more exposed to a correction. It is interesting to note in Chart 2 that Kazakhstan, Latvia and Estonia, the 3 countries in the region which are already experiencing a strong credit and monetary tightening, are those which emerged as more sensitive using our indicator. Bulgaria, Romania and Lithuania follow. The most recent international sell off suggests the relevance of a contagion channel for CEE.

... adding to lower demand from the eurozone

Lower demand from the eurozone will negatively influence CEE export performance as the European Union absorbs roughly 60 % of exports from Central and South Eastern Europe and somewhat more than 40 % of exports from the CIS countries. Central European economies are even more exposed as they have developed a strong trade specialisation within the EU in highly cyclical sectors like the

automotive industry and the electrical and optical equipment. However, the production optimisation strategies of international companies could be interpreted as a possible stabiliser effect. It is true that European corporations are constraining investments at the global level, including those in CEE – meaning a stabilisation in the wave of delocalisation of production projects and lower FDIs in the region. In an effort to maximise efficiency, international and global companies will nonetheless try to fully profit from their past delocalisation choices, thus scaling down production in more mature/higher cost countries rather than in the CEE region. This might provide some support for CEE production activities, despite the decline in demand in world markets.

Growth in Central Europe to slow to 4.0 % in 2009, mainly driven by lower demand from the eurozone

Lower demand from the eurozone and slower consumption and investment activities are the main factors responsible for the slowdown in growth in Central Europe (Poland, Hungary, the Czech Republic, Slovakia and Slovenia). We forecast growth to decline from 4.7 % yoy in 2008 to 4.0 % in 2009. Only Hungary will record some acceleration, after the weak performance recorded so far in the wake of the implementation of the austerity package in late 2006. The region seems to be relatively less sensitive to potential shocks. Slovenia is already a member of the eurozone, while Slovakia will adopt the new currency on January 2009. In a surprise move, Poland has recently announced its intention to seek early adoption of the euro (targeting 2011/2012 as a possible date), and preparation has clearly accelerated.

Correction in real estate and tightening of capital inflows behind the strong cooling in the Baltics. South Eastern Europe also vulnerable

A reversal in the real estate market and a tightening of capital inflows are behind the abrupt correction currently experienced in the Baltics. Following a decade of excessively rapid growth, driven by strong consumption and investment and a boom in the real estate market, the situation started to stabilise at the beginning of 2008. The real estate market has experienced a sharp downturn in both Latvia and Estonia, while the banking sector, which was relying highly on external funding, has reacted to the general increase in the cost of risk, substantially contracting lending growth. The resulting monetary and credit tightening has led to a marked contraction in economic activity. Estonia and Latvia are already in recession. Lithuania, which has a more developed industrial base, is slowing down more gradually, but also traditionally lags behind the cycle of the other two Baltic countries.

With high current account imbalances, strong dependency of growth from international capital inflows (with a large share of FDI being directed towards the real estate or the financial sector) and strong inflationary pressures, SEE countries (Bulgaria, Romania, Croatia, Serbia and Bosnia and Herzegovina) face similar challenges. We price in a slowdown in growth in SEE, from 6.8 % in 2008 to 4.5 % 2009. The real estate market is showing signs of a correction, especially in some overheated sub-segments (i.e. the tourism sector in Bulgaria or the residential and commercial property market in Bucharest, Romania). Investment is also slowing down, while growth in consumption is impeded by a deterioration in the financial position of households and tightening access to the credit market. We nonetheless see a smoother slowdown taking place in the region compared to the Baltic states. Signs of economic overheating are much less clear in SEE than they were in the Baltics. Moreover, the economic structure in SEE is much more diversified, with a higher share in economic activity of tradable rather than non-tradable sectors.

Higher international risk aversion and cost of risk are clearly affecting growth and risk prospects also in the Broader Europe countries, with Russia no longer representing an exception

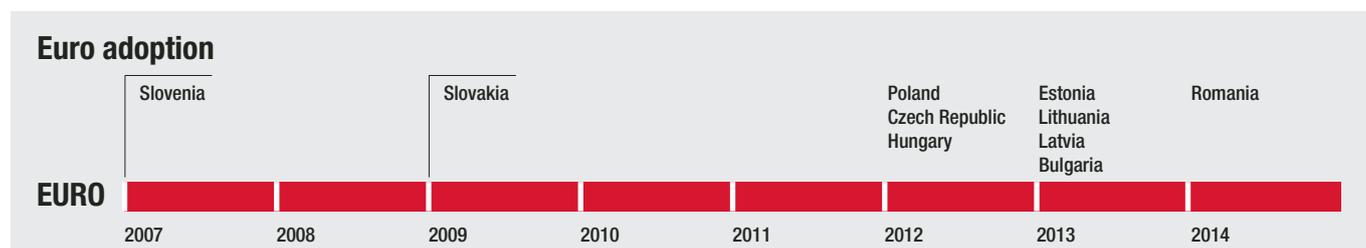
While oil prices have been stabilising, the Russian economy has revealed imbalances related to its lack of diversification and to the dependency of some sectors on capital inflows. In the last months, the global financial turmoil (more than the Russia-Georgia conflict) caused large capital outflows, resulting in a stock market slump and liquidity shortages in the interbank market. While the strong position of the large state-owned banks and the resolve of the authorities to tackle the problems – made possible by huge international and fiscal reserves – prevented a major systemic crisis, we reinforce our view that this situ-

ation will result in some additional concentration in Russia's banking sector. Moreover, lower capital inflows resulting in tighter credit conditions will combine with still high but lower oil prices to reduce investment appetite and income growth. As a consequence, real GDP growth will likely slow to 6.0 % in 2009 from 7.4 % in 2008.

Dependency on international capital inflows and a persistently high cost of risk represent a challenge for Ukraine. While clearly being illiquid, the 5Y CDS spread is now settling at more than 700 bps, the highest in the overall CEE region and among the highest in the emerging markets. Such a high cost of risk is already leading to a tightening of credit and monetary conditions. The real estate market is showing the first signs of overheating, though still limited to a few sub-segments. Political instability predominates, with the collapse of the Orange coalition. In addition, Ukraine continues to be highly dependent on the development of steel prices, which tend to slow down somewhat, while the fight with Russia which wants to further increase gas prices is still unresolved. Overall, we keep as a baseline scenario a decline in growth from 6.3 % in 2008 to 4.2 % in 2009, mostly due to a slowdown in consumption and investment activity.

In Kazakhstan, scarce cross-border capital inflows due to the global liquidity crisis very much constrain credit growth. This combines with the burst of the residential construction bubble and lower oil price to limit real GDP growth to probably only 3.8 % this year and 4.2 % in 2009. Inflation will nevertheless average 17.6 % this year and perhaps 9.5 % in 2009. Loan growth has become very weak and will accelerate only slightly also in 2009. Credit quality has deteriorated but the Kazakh authorities are working to establish a distressed assets fund to ring-fence potential risks. Oil prices have peaked in 2008 and will now be lower for some time. The revival of the Kazakh economy nevertheless has to come from the oil and gas industry which accounts for 70 % of exports. Much will depend on the situation of global financial markets however, and thus on the environment for the Kazakhstani banks to roll over their cross-border debt and renew lending.

In Turkey, amidst the stress exported from the European and US markets and weak private expenditure (especially private investments, the flagship of growth for some years), growth was very weak in Q2 2008 (1.9 % yoy). However, the growth environment can now benefit from the absence of political risks (during the summer the Constitutional Court ruling on AKP avoided a major political impasse), which will have positive effects on consumer and business confidence. We forecast growth in Turkey, supported by some easing by the central bank, to gradually accelerate in 2009 and 2010. Turkey nevertheless remains extremely vulnerable to international investor sentiment, with risks being mostly on the downside.



Country	Latest Political Event/Main Achievements	Main issues to be faced
BOSNIA-HERZEGOVINA	<ul style="list-style-type: none"> In September the Bosnian Serb authority decided to withdraw its backing for the law establishing the joint power transmission operator, Elektroprivreda BiH, and form its own company instead. 	<ul style="list-style-type: none"> The European Commission warned that the Bosnian Serb authority's decision over the country transmission power may represent a step back in the context of the SAA. Local elections on October 5, 2008.
BULGARIA	<ul style="list-style-type: none"> The Government won the sixth confidence-vote filed by the opposition that claimed it had failed to prevent the misuse of the European subsidies. In July the EU Commission decided to freeze USD 500m of European funds due to the Government's poor use of the funds and to the Government's poor results in the fight against corruption and organized crime. After Bulgarian farmers' protests, Bulgaria and the EU have agreed on an action plan to pay back farmers hit by EU's decision to freeze agricultural subsidy. 	<ul style="list-style-type: none"> To speed-up reforms in the five areas subject to the European Monitoring Regime. Strong popular disaffection and discontent over the Country's political life. Support for the opposition party rose while Government's popularity continued to fall.
CROATIA	<ul style="list-style-type: none"> In July the Parliament has approved the bill regulating the capital market. The country has opened the negotiation with EU on a new chapter, free circulation of goods, and has provisionally closed the supplementary chapter on enterprise and industrial policy. The Government has presented a plan for the reorganization of the shipbuilding sector through privatisation. 	<ul style="list-style-type: none"> To speed-up the reforms necessary to meet EU accession criteria. Croatia has yet opened negotiations on 21 chapters. The most contentious issues, such as agriculture and state support to the shipbuilding industry, have been left to last.
CZECH REPUBLIC	<ul style="list-style-type: none"> The country signed an agreement with the US on basing a powerful radar system in the Czech Republic. In September two deputies for the ruling party defected, reducing the Government's parliamentary seats to 98 out of 200. 	<ul style="list-style-type: none"> After the defection of two deputies, the Government coalition lacks a reliable parliamentary majority ahead of parliamentary votes on the 2009 budget, a US missile defence radar, the EU's Lisbon Treaty, the next Czech EU's Presidency. Tension with Russia due to Czech agreement with the US.
HUNGARY	<ul style="list-style-type: none"> In September the Liberal party rejected the Government's tax cut plan. In September the Government survived a no confidence-vote. Both the ruling Socialists and their former coalition partner, the liberal SZDSZ, opposed to dissolving parliament. 	<ul style="list-style-type: none"> The Government will need Liberal's support for the parliamentary approval of the 2009 budget law and tax plan.
POLAND	<ul style="list-style-type: none"> PM declared that Poland plans to join the euro zone in 2011. After tensions with the EU Commission Poland submitted the new shipyards plan to the European Commission. In August the Government agreed to host a U.S. missile shield after Washington accepted Polish demands for enhanced military cooperation. 	<ul style="list-style-type: none"> Strong tensions with Russia over Georgia conflict and the US missile shield. The Government decided to withdraw Poland's 900 troops from Iraq by the end of 2008. To ratify the EU Lisbon Treaty. To face EU Commission's answer over the shipyards restructuring plan.
ROMANIA	<ul style="list-style-type: none"> In July EU Commission criticized the country for the persistent corruption and shortcomings in the judicial reform. No sanctions were inflicted. The Minister of Labour has been suspended due to corruption accusations against him. 	<ul style="list-style-type: none"> Parliamentary elections to be held in November 2008. Current PM Tariceanu announced he will be again National Liberal Party's candidate.
RUSSIA	<ul style="list-style-type: none"> Conflict with Georgia. The country has recognized Abkhazia and South Ossetia's independence. The country decided to increase defense spending to USD 50 billion. In Sep. Russia and EU signed a pact on 200 European observers' deployment in Georgia. In Sep. President Medvedev announced several measures designed to shore up Russia's faltering stock markets and banking sector. 	<ul style="list-style-type: none"> To face the economic consequences of the international financial turmoil and of the Georgia's conflict. Strong tensions in Russia's foreign relations after the conflict with Georgia. Tensions with EU over Russian troops' pull out from Georgia. Tensions with Ukraine.
SERBIA	<ul style="list-style-type: none"> In July the Parliament approved a new Western-leaning Government. In Sep. Parliament ratified the energy agreement with Russia and the Stabilization and Association Agreement (ASA) with the EU. 	<ul style="list-style-type: none"> Netherlands' decision to block the ASA until Belgrade has demonstrated full co-operation with the International Criminal Tribunal for the former Yugoslavia. Facing the Kosovo independence's consequences.
SLOVAKIA	<ul style="list-style-type: none"> In September a latest Government reshuffle took place. New Environment and Agriculture Ministers were appointed. 	
SLOVENIA	<ul style="list-style-type: none"> On Sep. 21 political elections were held. The Social Democrats, previous opposition party, won 43 seats in the 90-seat parliament along with their allies. 	<ul style="list-style-type: none"> New Government (probably an SD-Zares-LDS-DeSUS coalition) to be formed in the next weeks.
TURKEY	<ul style="list-style-type: none"> In Aug. the Constitutional Court ruled against closing the governing AK Party but decided to impose partial financial penalties on the party. In Aug. a top prosecutor announced an indictment against 86 people suspected of involvement in a coup plot against Turkey's government. Improvement of the relations with Armenia. 	<ul style="list-style-type: none"> To speed up the reform process. To strengthen the relations with EU. To balance its relations with the US and with Russia especially after the Russia-Georgia conflict.
UKRAINE	<ul style="list-style-type: none"> After the parliamentary approval of a law decreasing presidential powers and the PM Tymoshenko's cautious reactions to the Russian attack to Georgia, the President's party left the governing coalition. 	<ul style="list-style-type: none"> Increasing tensions between President Yushchenko and PM Tymoshenko. Increasing Government instability, President Yushchenko could dissolve Parliament and call new elections.

Source: UniCredit Group – Political Studies

Bulgaria



Outlook

In H1 2008 the pace of economic expansion accelerated to its highest rate since the start of the transition, with unemployment and real income growth posting results never seen before in the last decade. The build-up of large macroeconomic imbalances in the context of a rapid deterioration of external conditions points, however, to enhanced risks. It should be noted that since 2006, 50 % of economic growth was attributable to only 3 sectors: real estate, construction and the financial industry. With the global financial crisis adding pressure to costs and the availability of external liquidity, we forecast a deceleration in capital inflows, with those three sectors being particularly affected. Our central scenario envisages GDP growth bottoming out at 4.2 % in 2009, and stabilising closer to its potential in 2010 and in 2011. On the positive side, the slowing economy will help to drive the current account gap and inflation towards more sustainable levels in the medium term.

MOODY'S LT FC RATING
Baa3/Stable

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

FITCH LT FC RATING
BBB/Negative

SPREAD AVG (SEP) 162
EMBI+ Spread on Euro Curve

Macroeconomic data and forecasts

	2006	2007	2008f	2009f	2010f
Nominal GDP (EUR bn)	25.2	28.9	34.5	39.1	43.7
Per capita GDP (EUR)	3,290	3,780	4,540	5,160	5,810
Real GDP, yoy (%)	6.3	6.2	6.3	4.2	4.5
Inflation (CPI), yoy, eop. (%)	6.5	12.5	10.3	8.0	6.5
Inflation (CPI), yoy, avg. (%)	7.3	8.4	13.0	9.1	7.4
Unemployment rate, eop. (%)	9.1	6.9	6.7	7.0	7.2
Exchange rate BGN/EUR, eop./avg.	1.96	1.96	1.96	1.96	1.96
ON Sofibor, eop. (%)	3.4	4.7	5.5	5.9	4.5
ON Sofibor, avg. of the year (%)	2.8	4.0	5.2	5.7	4.9
Current account balance/GDP (%)	-17.8	-21.8	-23.5	-20.2	-16.5
FDI/GDP (%)	23.8	22.6	15.5	10.0	11.0
Budget balance/GDP (%)	3.6	3.5	3.5	3.0	2.5
General government debt/GDP (%)	24.7	19.8	15.0	13.0	12.0
Total external debt/GDP (%)	81.7	99.8	103.0	108.0	111.0

Sources: Central bank, Statistical office, UniCredit Bulbank Economic Research Unit, UniCredit Group CEE Research Network.

Main topics

- In Q2 2008 Bulgaria reported the third strongest rate of economic growth in the EU. The rising cost of risk and lower capital inflows will, however, lead to a deceleration in growth going forward. The cooling economy will help growth to stabilize closer to its potential and large macroeconomic asymmetries to adjust in an orderly manner.
- On the back of mostly technical factors, CPI posted a steep fall in August. Nevertheless, excessive domestic demand and wage growth continue to pose upside risks for price stability.
- The fiscal surplus reached 6.5 % of the anticipated full year GDP in Jan–July 2008, which fostered plans for spending all savings in excess of the initial 3 % end-year target. We think that given the leading role which fiscal policy has in stabilising the economy, in the context of lack of national monetary policy Bulgarian policymakers should save as much as possible of the fiscal windfall in 2008.

Economic growth to slow – and this is very good news

Despite testing global conditions, real GDP increased by 7.1 % yoy in Q2 2008.

In Q2 2008, Bulgaria reported the third strongest economic growth rate of all EU countries. Output growth surprised on the upside and was marginally above growth in Q1 2008 (7.0 % yoy). Growth was repeatedly pushed by domestic demand, and particularly by GFCF and stock-building which expanded by erratic rates of 29 % and 50 % respectively. Concurrently, export growth (5.1 %) was less than half of import growth, which quickened to 13.7 % yoy, mostly on the back of rising energy prices. Imbalances in the growth pattern are thus quite clear.

Going forward, we think Bulgaria will experience a marked correction.

On top of lower export growth, we expect some deceleration in both consumption and investment. The country is a small and open economy that relies heavily on imports of international savings to finance its booming domestic demand. Growth is overreliant on just three economic sectors: real estate, construction and financial intermediation, which have contributed more than half of total economic growth since 2006. So far output expansion in these three sectors has been predominantly financed with large FDI inflows. However, the breakdown of data for H1 2008 showed that FDI in the construction and real estate sector decreased significantly, by 24 % and 37 % respectively. The cooling holiday home segment and the withdrawal of large institutional investors – that are selling assets and cancelling projects in early phases of implementation in an effort to raise cash and cut back their exposure to the local real estate market – will further dampen foreign capital inflows going forward. FDI channelled into the financial intermediation sector (basically loans from parent companies to local subsidiary banks) are still reporting positive growth, rising by 26 %, though one should note that in 2007 much stronger growth of 134 % was recorded. Going forward, the combination of growing risk aversion, difficult access to international liquidity and rising costs of borrowing will make it more challenging for local banks to attract funds, which should result in credit tightening. Such a tightening of credit conditions should help correct macroeconomic asymmetries arising from the excessive

growth in domestic demand. So far, however, monetary conditions are still quite loose. Real interest rates on bank lending are close to zero despite the recent fall in inflation and the upward correction in interest rates on newly extended loans by roughly 1 % when compared with the same period one year earlier. The price of banks' external borrowing is trending upwards, reflected in rising spreads between BGN and EUR denominated money market rates and the elevated spread above the risk-free benchmark on credit default swaps. Nevertheless, domestic banks increased external borrowings significantly, which allowed them to sustain the pace of credit growth a notch below 50 % yoy at the end of August. There are only limited signs of a tightening of credit standards, particularly as regards loans for the overheating holiday homes market. At the same time, access to parent company funding might in some cases prevent the full pricing in of the most recent higher premiums, thus delaying credit conditions tightening.

We revised downward our GDP growth projection for next year, with our central scenario now assuming growth will moderate to 4.2 % in 2009 and stabilise around 4.5 % in 2010. We think that a moderation of growth is good news for the Bulgarian economy. The build-up of excessive macroeconomic imbalances during the booming years combined with a dry-up of external liquidity has substantially increased the risk of a crisis. Therefore, the slowing domestic demand will be instrumental to prevent a disorderly adjustment of economic asymmetries with painful implications for growth, jobs and wealth accumulation.

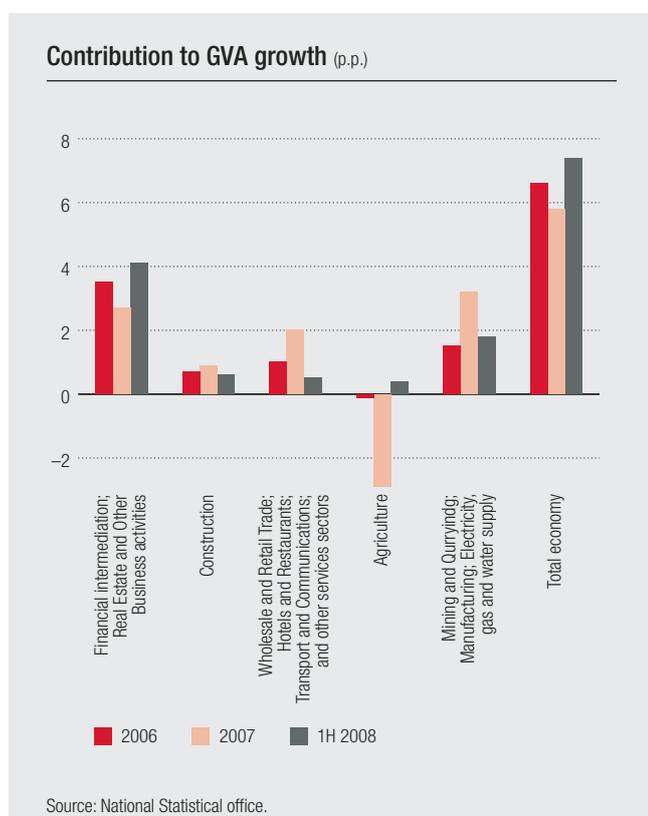
Is fiscal surplus target of 3 % of GDP sufficient to stabilise booming economy?

The surplus in the consolidated fiscal programme reached BGN 4.2 bn in the first 7 months of 2008, which is equivalent to 6.5 % of the estimated full-year GDP. The authorities attributed the surplus to improving tax collection and delayed spending, but poor macroeconomic projections underlying the preparation of the budget plan are also among the relevant explanations. Nevertheless, spending is expected to rise significantly in the remaining months of the year as the government seems ready to spend the surplus above the 3 % year-end

Short-term indicators

	Aug-07	Sep-07	Oct-07	Nov-07	Dec-07	Jan-08	Feb-08	Mar-08	Apr-08	May-08	Jun-08	Jul-08	Aug-08
Real GDP, yoy (%)	–	4.9	–	–	6.9	–	–	7.0	–	–	7.1	–	–
Industrial production, yoy (%)	8.4	8.9	11.3	7.4	5.0	8.2	5.4	–1.1	8.9	6.6	4.2	3.3	–
Inflation (CPI), yoy (%)	12.0	13.1	12.4	12.6	12.5	12.5	13.2	14.2	14.6	15.0	15.3	14.5	11.2
Unemployment (%)	7.00	6.78	6.73	6.62	6.91	7.38	7.26	6.79	6.51	6.19	5.97	5.96	–
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.	4.15	4.29	4.32	4.65	4.75	4.85	4.96	4.98	5.00	5.06	5.16	5.32	5.35
Export, (EUR) yoy (%)	6.6	14.1	22.8	20.9	13.6	28.2	33.8	17.5	32.0	18.7	17.2	15.3	–
Import, (EUR) yoy (%)	8.7	23.1	21.9	27.7	9.9	19.2	31.9	16.1	39.0	26.3	34.3	25.5	–
Trade balance, EUR mn	–589.3	–604.9	–709.8	–800.7	–813.2	–613.7	–600.5	–583.3	–770.2	–813.2	–926.1	–883.2	–
Current account, EUR mn	–265.3	–541.8	–710	–752.4	–940.7	–769.7	–635.6	–507.6	–750.9	–698.9	–769.5	–424.0	–

Sources: Central bank, Statistical office, UniCredit Bulbank Economic Research Unit.



fiscal target. Ahead of the general elections scheduled for mid-2009 the three parties of the ruling coalition have already agreed to divide spending between investment and social payments. This move, however, will fuel the already excessive inflation and CA gap even further, escalating the risk of a sharp economic downturn. We think that given the leading role which fiscal policy has in stabilising the economy, in the context of lack of national monetary policy Bulgarian policy-makers should save as much as possible of the fiscal windfall in 2008.

Excessive domestic demand and strong wage growth remain a risk for price stability.

Prices fell sharply in August to 11.2 % as the steep increase in food costs one year earlier dropped out of the consumer price index. In addition, falling food prices drew support from the bumper wheat crop which reached its highest level in 14 years. Clothing and footwear prices as well as transportation costs eased marginally on a mom basis. Twelve month headline HICP retreated to 11.8 %, while core HICP (excluding energy, food, alcohol and tobacco prices) increased moderately to 11.4 % in August. Producer price inflation in the domestic manufacturing sector inched up to 15.4 % in July, thus moving above the growth in consumer prices for the first time in thirteen months. Recent confidence surveys paint a mixed picture. While business managers in the construction and wholesale and retail trade sectors expect a moderate increase in output prices, inflationary expectations in the manufacturing and services sectors eased somewhat. However, these results were in sharp contrast to inflationary expectations in the household sector, where the worst quarterly reading ever was recorded in the survey conducted in July.

We think that the recent sharp drops in oil prices suggest certain moderation in external pressure, provided that these declines are sustained. Nevertheless, the prospects for international commodity price developments remain uncertain. Their levels are still above those seen in 2007 and tight market conditions continue to pose risks for price stability on the upside. Fuelled by loose monetary conditions, excessive growth in domestic demand continues to pull prices up. Moreover, the global shocks to oil and food prices have apparently begun to trigger second-round inflationary effects, as the size of nominal wage indexation looks increasingly driven by past inflation developments. Double-digit increases in wage costs are a clear sign of a knock-on inflation effect and are threatening to spark a vicious cycle of wage and price hikes, unless Bulgaria abandons its soft approach to excessive wage expansion. During Q2 2008, average wages in the economy climbed by 24 % yoy with the growth momentum being strongest in the booming real estate and financial intermediation sectors. Tight conditions on the local labour market were further highlighted by the drop in the number of job seekers, as unemployment fell to its lowest level since the start of transition, and by well-pronounced shortages of skilled labourers in several industries. Elevated inflationary expectations in the household sector seem particularly hard to contain, posing a risk for a sharp correction of consumption expenditure, which represents roughly two-thirds of total GDP in the economy.

At the same time, local gas monopoly Bulgargas is confronted with the reluctance of regulators to pass on rising wholesale gas prices – resulting from the renegotiated contract with Russia – to retail customers. Thus Bulgargas keeps on subsidising its end-prices for local customers with receipts from gas transit to neighbouring countries. On top of that, the record crude oil prices that we witnessed in June and July will only be reflected in higher costs of gas imported from Russia in Q4 2008 and Q1 2009 due to a time lag embedded in the price-setting formula in the supply contracts with Gazprom. The local electricity distribution companies face very similar challenges, albeit for different reasons. Apparently, the most recent retail electricity price increases failed to cover the full cost of upgrading the retail distribution network. In response to this, the electricity distribution companies decided to appeal regulator's decision in court, and to downsize planned investments, but as pointed out several times, this cannot last forever.

We think that the balance of risks for inflation remains skewed on the upside. The main uncertainty is related to the likely degree of persistence in demand-pull inflation and how large the slowdown in output growth should be to offset this persistence. Likewise, the risks for wage-push inflation are well pronounced, while inflation expectations in the household sector remain dangerously elevated. Our central scenario envisages that pay pressure and credit growth will decrease only gradually in 2009 and thereafter. At the same time, the squandered spending in the public sector ahead of the general elections will continue to exercise upward pressure on price levels. Against this background we do not expect the forecasted easing in output growth in the last months of 2008 and in 2009 to have much impact on inflation in the short run. On balance, these will keep inflation in double-digits to the end of 2008, while only marginal easing to 8.0 % should be expected towards the end of 2009.

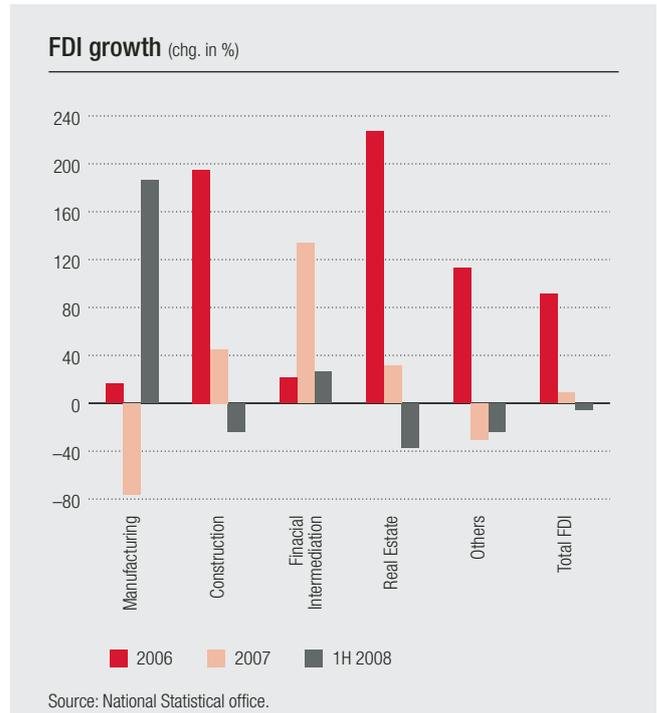
Deterioration of external balances – rising risk of disorderly adjustment of economic asymmetries

The current account (CA) gap widened by 47.3 % yoy to EUR 4.6 bn in Jan-July or 13.2 % of the projected full-year GDP, as compared with 10.7 % in the same period one year ago. In July, import growth (25.5 %) outpaced export growth (15.3 %) for the fourth month in a row, driving the trade gap for the first seven months of the year upwards by 37.1 % yoy. Both the services and the income balance deteriorated slightly, which was partially compensated by an improvement in net transfers, as receipts coming from the EU budget increased somewhat. On the financing side, net FDI came in at EUR 2.4 bn, or roughly 25 % below the level in the first 7 months of the previous year. The slowing pace of net FDI was more than balanced by the massive 77 % yoy surge in debt financing to EUR 3.7 bn as compared with EUR 2.1 bn a year ago. Roughly one third of the international savings channelled into the Bulgarian economy was attributable to the activities of local commercial banks. The overall balance of payments ended up in positive territory adding approximately EUR 1.7 bn to the official reserves, which reached an amount equivalent to 5.7 months of the country's goods imports. However, the ratio of net FDI to the CA fell to 52 % from 104 % one year ago as sustainable sources of financing lost momentum in the context of deteriorating external conditions. On a positive note, the composition of FDI in H1 2008 shifted in favour of larger relevance of tradable goods sectors, while FDI channelled into real estate and construction fell by 40.4 % and 24.1 % respectively.

The drop in energy prices, if sustained, will provide some relief to CA developments in the coming months. Likewise, the CA balance will draw support from the bumper grain crop which will allow some 1.5 to 2 mn tons of wheat to be exported in 2008 and in the early months of 2009. However, erratic domestic demand growth will keep on fuelling pressure on imports, driving the CA towards a deficit estimated at 23.5 % of full-year GDP. Against the backdrop of unfolding global financial turmoil, the slowing inflow of international savings will add to the vulnerability of the country's external position. Nevertheless, we think that Bulgaria will escape a fully-fledged crisis and the moderation of economic growth will allow the CA gap to decrease towards a more sustainable level in the medium term (16.5 % in 2010 and 13.5 % in 2011 relative to GDP). In a recent move, Moody's downgraded Bulgaria's ratings outlook from positive to stable on the back of concerns that a drying-up of global liquidity will make it more challenging for the country to satisfy its huge financing needs.

Bulgaria needs to do more to revamp its judiciary system

In July the European Commission reiterated its criticism of Bulgaria's failure to make satisfactory progress in fighting corruption, organised crime and revamping its judiciary system. In light of evidence regarding the lack of accountability and transparency in public procurements the



Commission suspended EUR 496 million in funds and barred two national agencies from administering EU taxpayers' money. Bulgarian authorities now have their last chance to save funding from the three pre-accession programs PHARE (still with EUR 250 million to be granted), ISPA (EUR 150 million to be granted) and SAPARD (EUR 115 million to be granted) provided they implement the agreed reforms, including new laws on lobbying and party financing and a revamp of the penal code. On the other hand, if by the end of November the country fails to demonstrate sufficient progress in the areas identified as problematic, the funds will be permanently cancelled and the suspended amounts could rise considerably as several operational programs are also at risk. Nevertheless, the government survived a no-confidence vote in parliament tabled by the opposition over the lost funds. The suspended European funds combined with last year's drought and rising input prices has driven farmers and milk producers to protest, demanding the urgent allocation of some EUR 30 million in subsidies to be paid by the state budget as compensation. As this is treated as state aid, the European Commission did not permit the Bulgarian government to make the payment. It agreed to one-off aid totalling EUR 10,000 per milk producer, but only for fully-renovated farms producing a high quality of end product. In a recent development, the Council of EU ministers acknowledged the recent efforts of the Bulgarian authorities, but underlined that fair, independent and well-resourced administrative and judicial systems are still needed in order to allow EU policies to function properly.

Event	Date	Reading
Preliminary draft of the Consolidated Government Budget for 2009	10 November 2008	Particularly important, as it will help to judge to what extent the approaching general elections will impact on the fiscal policy stance.
GDP growth	15 December 2008	Economic growth is expected to remain strong in Q3 2008 but to slow down thereafter.

Czech Republic



Outlook

The prospect of more significant growth deterioration in the eurozone and the prolonged strength of the koruna are now expected to weigh on more heavily domestic economic growth next year than previously believed. In addition to looming problems on the external demand side, fixed investment, which is facing a cyclical slowdown, and weaker household spending are set to take their toll on domestic demand. Inflation is projected to quickly drop towards the Czech National Bank's (CNB) 3 % inflation target by early next year and hold around this level through all of 2009. We believe that an easing of monetary conditions will be secured through depreciation of the CZK rather than with additional interest rate cuts. Our pessimism concerning the koruna is based on the assumption that it will come under selling pressure once the global risk appetite restores and concern over domestic economic data comes back into focus.

MOODY'S LT FC RATING
A1/Positive

S&P'S LT FC RATING
A/Stable

FITCH LT FC RATING
A+/Stable

SPREAD AVG (SEP) 62
EMBI+ Spread on Euro Curve

Macroeconomic data and forecasts

	2006	2007	2008f	2009f	2010f
Nominal GDP (EUR bn)	113	128	152	159	175
Per capita GDP (EUR)	11,050	12,390	14,550	15,160	16,550
Real GDP, yoy (%)	6.8	6.6	4.0	3.2	4.0
Inflation (CPI), yoy, Dec. (%)	1.7	5.4	5.3	2.8	2.8
Inflation (CPI), yoy, avg. (%)	2.5	2.8	6.6	3.1	2.8
Unemployment rate (%)	8.1	6.6	5.4	6.0	6.0
Exchange rate CZK/EUR, eop.	27.50	26.62	25.70	25.00	24.50
Exchange rate CZK/EUR, avg.	28.34	27.76	24.90	25.30	24.70
2-week repo rate, Dec. avg.	2.50	3.50	3.50	3.50	4.00
2-week repo rate, avg. of the year	2.17	2.88	3.62	3.50	3.75
1M Pribor, Dec. avg.	2.52	3.98	3.60	3.60	4.05
1M Pribor, annual avg.	2.22	2.96	3.74	3.60	3.80
Current account balance/GDP (%)	-2.6	-1.8	-3.4	-2.7	-2.7
FDI/GDP (%)	3.8	5.2	4.6	6.2	4.2
Budget balance/GDP (%) (ESA 95)	-2.7	-1.6	-2.3	-2.9	-2.7
Public debt/GDP (%) (ESA 95)	29.4	28.7	28.7	28.0	28.3
Total external debt/GDP (%)	37.1	38.0	39.2	39.9	40.1

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

Main topics

- GDP growth continued to ease, reaching 4.5 % yoy (seasonally unadjusted) in Q2, down from 5.3 % yoy in Q1. With household consumption posting a surprising increase and foreign trade making one of the biggest contributions to growth in the country's history, a significant inventory pullback was the main factor behind the deceleration of economic growth in Q2.
- The inflation path has finally started heading downwards, with declining food and fuel prices leading the way. The prospect of price growth quickly returning to the CNB's inflation target by early next year prompted the bank to loosen monetary policy in August. The benchmark two-week repo rate was cut by 25 bp to 3.50 %.
- The trend of depreciation in the CZK has recently been interrupted by a rally by the Polish zloty after Poland announced its intention to swiftly enter the EMU. In addition, renewed worries about the health of the global financial sector have caused a renewed flight to safety instruments, including the safe-haven koruna.
- The trade balance continued to improve as declining imports, hit by slowing domestic demand, managed to overshadow struggling export activity, which was depressed by a strong CZK and decreasing growth in the eurozone.

No relief for economic growth on the horizon

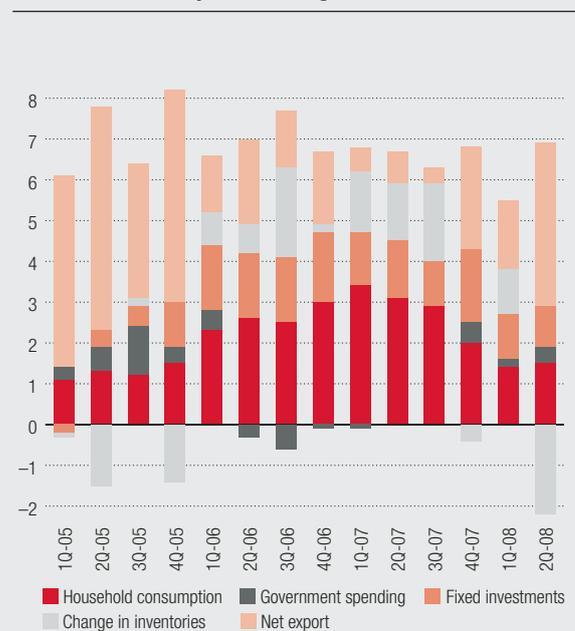
Growth in Q2 depressed by inventory pullback

GDP growth in Q2 underscored the weakening trend in the economy, which is being increasingly affected by faltering demand in the eurozone, the impact of the strong CZK and elevated domestic inflation. Unadjusted growth slowed to 4.5 % yoy in Q2 from the upwardly revised figure of 5.3 % yoy in Q1. Similarly, the seasonally adjusted figure marked a deceleration to 4.6 % yoy in Q2 from 5.4 % yoy in Q1. While headline growth was in line with market expectations, its subcomponents brought two major surprises. First, household consumption growth picked up again, increasing to 3.4 % yoy from 2.7 % yoy in the previous quarter. Given the poor growth of disposable income, savings and loans must have played a role in the financing of private spending. Second, a substantial slowdown in the building of inventory, which detracted 2.2 % from GDP growth, may have resulted from a reduction of output and from the lower volume of purchases of input materials as a result of declining orders. Fixed capital formation growth still held up well, increasing by 4.1 % yoy, albeit decelerating somewhat from the previous quarter. Construction investment and machinery and equipment investment were the most significant growth factors. Net exports, which added 4.0 % to overall growth, proved to be the main driver of the expansion. While exports maintained their robust pace from previous quarters, imports decreased, reflecting the signs of cooling domestic demand.

More weakness yet to come

The impact of the rapid appreciation of the CZK earlier this year and the prospect of marked growth deterioration in the eurozone will likely take a more significant toll on the Czech economy in the second half of this year and in 2009 than we previously expected. Private spending is set to weaken further, notwithstanding its rally in Q2, which we regard as short-lived. A negligible pickup in household consumption to 2.8 % yoy next year from an estimated 2.6 % yoy this year is consistent with our assumption of sluggish real income growth in 2009. In addition, the inventory rundown seen in Q2 highlights the risk of a faster drop in investment activity and lower growth in exports in the coming quarters. Therefore, we expect fixed investment growth to slow to 3.5 % yoy this year and further to 2.5 % yoy in 2009. Furthermore, the contribution of

Contribution to adjusted GDP growth (p.p.)



Note: Statistical discrepancies are not taken into account in the chart.
Source: Statistical Office

foreign trade to overall growth will likely drop substantially next year due to weakness in Europe's core economies. The anticipated deceleration of GDP growth to around 3.0 % yoy in the second half of the year should knock GDP growth for all of 2008 down to 4 % yoy. We project that economic growth will remain subdued at 3.2 % yoy in 2009.

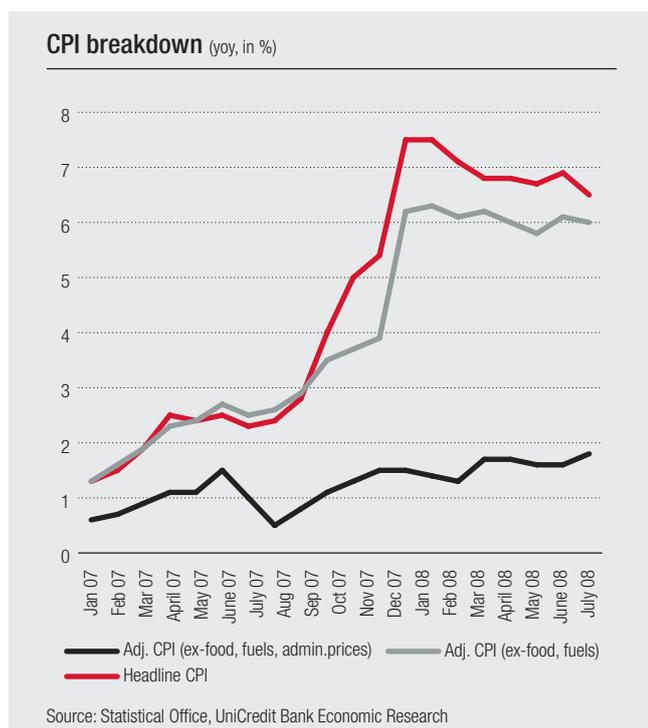
Industry starts to feel the pinch

The economic slowdown looks consistent with the intensifying problems among industrial producers. Following June's mild 3.4 % yoy increase, output picked up to 6.7 % yoy in July, but this was only because July had three more working days than the base month. After

Short-term indicators

	Aug-07	Sep-07	Oct-07	Nov-07	Dec-07	Jan-08	Feb-08	Mar-08	Apr-08	May-08	Jun-08	Jul-08	Aug-08
Real GDP, yoy (%)	—	6.4	—	—	6.6	—	—	5.3	—	—	4.5	—	—
Industrial production, yoy (%)	7.2	2.3	9.8	8.9	6.0	8.3	11.6	-2.1	12.0	3.1	3.4	6.7	—
Inflation (CPI), yoy (%)	2.4	2.8	4.0	5.0	5.4	7.5	7.5	7.1	6.8	6.8	6.7	6.9	6.5
Unemployment rate (%)	6.4	6.2	5.8	5.6	6.0	6.1	5.9	5.6	5.2	5.0	5.0	5.3	5.3
Exchange rate/EUR, eop.	27.73	27.61	26.97	26.26	26.62	26.07	25.22	25.34	25.21	25.09	23.90	23.95	24.74
1M Pribor, avg.	3.07	3.33	3.35	3.43	3.98	3.70	3.81	3.87	3.89	3.86	3.87	3.85	3.65
Export, (EUR) yoy (%)	18.1	15.8	20.1	18.1	10.4	19.6	24.9	6.7	27.4	14.1	20.3	24.2	—
Import, (EUR) yoy (%)	17.5	12.8	18.3	14.6	9.8	19.3	25.8	10.2	26.5	11.1	17.3	19.3	—
Trade Balance, EUR mn	-6	497	298	469	-106	460	539	290	286	401	631	308	—
Current account, EUR mn	-949	55	-460	240	-746	474	460	191	-366	-438	-1681	-13	—

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



seasonal adjustment and working day adjustment, growth was just 1.6 % yoy. In addition to traditionally weak sectors such as the textile and leather industries, the wood and food processing sectors have consistently been in negative territory in each of the last three months. Furthermore, the pillars of Czech industry in the recent past – automobile and plastics manufacturing – also came under pressure and no longer displayed double-digit growth rates. Declining orders and a substantial slowdown in employment growth underscore the sector's downtrend. Employment growth decelerated to 0.6 % yoy in July, down from 1.1 % yoy in June, while the yoy index of new orders at current prices has been hovering around the zero level for the past several months now. The separate PMI index showed that industrial activity fell deeply into negative territory in August, indicating that the worst for the industry is yet to come. Thus, we expect output to grow by only 4 % yoy both this year and next after expanding by 9.0 % yoy in 2007.

Easing of monetary conditions assumed to be secured by CZK depreciation

Inflation slipped to 6.5 % yoy in August, the lowest rate so far this year, from 6.9 % yoy in July, further retreating from the nine-year peak of 7.5 % yoy hit at the start of this year. In August alone, prices dipped 0.1 % as a seasonal drop in food prices and a continued decline in fuel prices overshadowed the opposite movements of package holiday costs and cigarette prices. While the increase in tobacco prices induced by an excise tax change in January has been unexpectedly small so far, the effects of the strong CZK on consumer prices have been concentrated to clothing. In the next two months, we expect yoy inflation to stay at around the level seen in August since the natural easing of price growth will likely be counterbalanced by administrative increases related to gas and tobacco prices. A sharp drop in inflation is forecast for the last two months of the year and for January 2009, with a favourable base effect

leading the way. Over the next year, we expect sluggish economic activity to keep yoy price growth close to the CNB's 3 % inflation target.

A similar scenario, which assumes that inflation will return to a level somewhere around the target in early 2009, proved to be behind the CNB's monetary policy reversal at its August meeting. The bank unanimously agreed to cut its benchmark rate by 25 bp to 3.50 %, loosening policy for the first time since April 2005. Alternative proposals for leaving interest rates steady and for cutting them by a more aggressive 50 bp were also on the table, but the bank did not vote on them in the end. A new macroeconomic prognosis of the central bank's monetary section was also discussed by CNB board members. The outlook for GDP growth for this year and next was cut compared to the previous forecast, while the inflation and interest rate forecasts were pushed forward on the monetary policy horizon. Although the forecast for the 3M Pribor was raised as compared to the prior projection, it was still consistent with the scenario of one or two additional quarter percentage point cuts of the repo rate by the end of the year. This means that the outlook for macroeconomic indicators for 2009 corresponds to more or less stable rates in the course of next year. The strong CZK and, recently, the correction of commodity prices were seen as anti-inflation risks, whereas the major pro-inflation risk was higher-than-expected wage growth. Our outlook for future interest rate development seems slightly more hawkish than the CNB's projection suggests. We do not rule out yet another 25 bp rate cut in November providing that the CZK stays strong and major central banks come up with emergency cuts in the wake of the financial crisis. However, we still believe that the easing of monetary conditions is more likely to proceed through exchange rates, meaning that no more interest rate cuts will be needed. In addition, a cut in the CNB's inflation target from the current level of 3 % to 2 % from 2010 will put central bankers on the alert starting late this year. Overall, we do not expect to see significant policy changes until the end of 2009.

After hitting an all-time high of 22.925 per euro in late July, the CZK reversed course and started depreciating as the economy weakened and the CNB became the first central bank in the region to loosen monetary policy. The dollar's recent rally against the euro, sparked by growing concerns over European economic growth, also contributed to the CZK/EUR correction. Nevertheless, after shedding almost 9 % of its value against the single currency in just one-and-a-half months, the CZK got a strong boost in early September from neighbouring Poland, whose government announced its ambitions to bring the country into the EMU as early as 2012. In addition, global risk aversion has increased once again, allowing the safe-haven koruna to retain its latest gains. However, we believe that it will not be long before investor confidence in higher-yielding assets is restored, causing the CZK to resume its course of depreciation in Q4. Concerns over the deterioration of domestic economic data should also come back into focus. Consequently, we are not very optimistic about the a significant rally by the koruna next year, with the expected average CZK/EUR exchange rate in 2009 even exceeding this year's estimated level.

Falling imports behind impressive trade balance data

So far the trade balance has shown surprising resilience to the strong CZK, weak demand in Europe and high commodity prices. The monthly

trade surplus came in at CZK 7.2 bn in July after a CZK 15.3 bn surplus in June, with the cumulative balance of these two months exceeding the corresponding 2007 level by an astounding CZK 13.6 bn. However, a detailed look at the data reveals that the picture is far from rosy. It appears that the improvement came primarily from weakening imports rather than from rallying export activity. In fact, the export performance has weakened and even an exceptionally strong working day effect in July did little to boost it. Exports grew by just 3.2 % yoy (versus the 2.5 % yoy increase in June), driven by shipments of computers and telecommunications equipment, while imports were down 0.9 % yoy despite a hefty 27.0 % yoy increase in fuel imports. A robust decline of machinery imports, a typical sign of fading domestic investment activity, seems to be the primary factor behind the decrease in imports over the past few months. The full-year surplus is set to increase further from last year's record level, although the surge in the CZK and slow growth abroad may drag exports more visibly later this year.

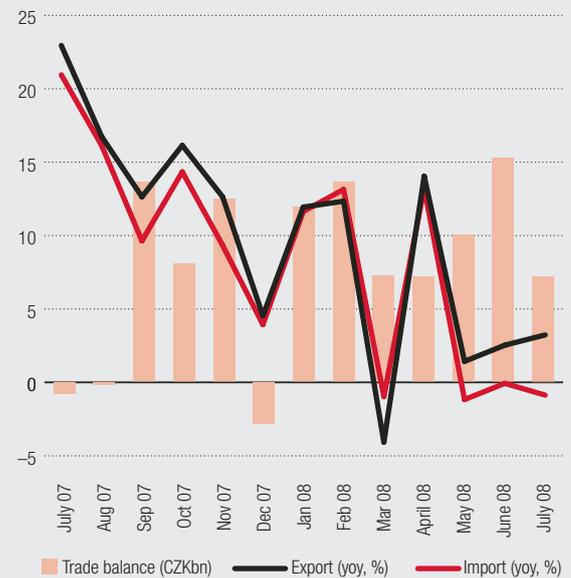
Current account increasingly suffering from profit repatriation

While our previous report pointed to a yoy improvement of the current account in the first months of this year, the latest data combined with the CSU's revision of the time series unveiled a less optimistic picture. The current account deficit in the period from January to July amounted to CZK 32.5 bn, up significantly from a CZK 11.9 bn gap a year ago. The deterioration came solely from a huge CZK 64.0 bn yoy increase in the income balance deficit, as the trade and services balances as well as current transfers posted improvements. In fact, the outflow of profits seems to be developing roughly in line with our forecast and the only reason for our revision of the 2008 C/A/GDP estimate to -3.4 % from the previous level -3.7 % is the better-than-expected foreign trade development. In 2009, we expect the current account deficit to narrow to 2.7 % of GDP since decreased corporate profitability will likely put a cap on the income balance gap, while the planned start of production in the Hyundai automobile plant will provide a boost to foreign trade. Importantly, the year-to-date financial account surplus (CZK 34.3 bn), which slightly surpassed the current account gap, underlines the country's firm external financing position. In additional positive news, the FDI inflow appears to be maintaining momentum and is up slightly from a year ago in the period from January to July.

Outlook for budget deficit based on unrealistic GDP growth forecasts

The government has approved a draft of the 2009 central state budget with a GFS-based deficit of CZK 38.1 bn, down from an approved CZK 71.3 bn deficit this year. The total public sector gap, which also includes regional budgets, health insurance and other funds, is projected at 1.6 % of GDP in 2009 under the ESA-95 rules, compared to 1.5 % this year. However, we do not believe the government will be able to meet its fiscal targets both this year and next since they seem to be

Foreign trade in CZK terms



Source: Statistical Office

based on overly optimistic assumptions about GDP growth (4.6 % this year and 4.8 % in 2009). It remains to be seen whether Minister of Finance Kalousek sticks to his promise and cuts the overall spending plan in order to meet the deficit target once the effects of the economic deterioration become clear at the end of this year.

Pressure on government to set the date for euro adoption intensifies

The surge of the CZK, which peaked at 19 % yoy appreciation against the euro in July, has forced Czech business leaders to step up pressure on the government to set a target date for the adoption of the euro. According to a recently published survey, almost 30 % of the companies polled have to cut jobs and consider moving some operations abroad due to the strength of the koruna. Industry representatives have pointed out that setting a date for EMU entry would increase planning certainty for companies and decrease interest in koruna speculation. The prime minister and leader of the right-wing party ODS, Mirek Topolanek, has resisted these calls, reiterating the view that the country first needs to synchronise its economic cycle with the eurozone and complete key fiscal and pension reforms. We are sceptical about the belief held by some representatives of the corporate sphere that the government will at least come up with a working date for the adoption of the euro by the end of this year. However, a lot will depend on the ODS congress held in late 2008, where Topolanek is set to advocate his position as chairman of the party.

Event	Date	Reading
MPC meeting	Nov 6	The CZK/EUR exchange rate and the extent of the economic slowdown will likely have the biggest impact on CNB's decision.
Budget 2009	Nov-Dec	The parliamentary voting on the budget and accompanying amendments will indicate whether the government coalition will hold together.

Estonia



Outlook

Estonia is following Denmark as the second EU country to slide into a recession, and it is the first in CEE. Real GDP growth was negative in Q2, and weak private consumption, high interest rates and high lending rates will likely result in a 1.2 % decline in real GDP in 2008 as a whole. Relatively weak growth in the EU as domestic demand only slowly recovers will leave real GDP growth only slightly positive also in 2009. Credit growth has decelerated substantially, with economic cooling and higher refinancing and rollover costs increasingly making credit quality an issue. The good news is that the narrowing current account deficit – as domestic demand weakens even more than external demand – will help to sustain the kroon's peg to the euro. Adjustments, including enterprise restructuring and slower wage growth, will provide the preconditions for a reacceleration of growth. There is a chance that Estonia will not only be the first to enter recession but also the first to emerge from it.

MOODY'S LT FC RATING
A1/Stable

S&P'S LT FC RATING
A/Negative

FITCH LT FC RATING
A-/Negative

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

Macroeconomic data and forecasts

	2006	2007	2008f	2009f	2010f
Nominal GDP (EUR bn)	13.1	15.3	16.5	18.0	19.7
Per capita GDP (EUR)	9,750	11,380	12,300	13,460	14,790
Real GDP, yoy (%)	10.4	6.3	-1.2	1.7	4.3
Inflation (CPI), yoy, eop. (%)	5.1	9.6	8.0	6.0	4.2
Inflation (CPI), yoy, avg. (%)	4.4	6.6	10.5	6.4	4.9
Unemployment rate LFS (%)	5.9	4.7	5.4	5.6	5.1
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	6.27	5.20	4.80
Interest rate avg. (3m Talibor)	3.16	4.84	6.44	5.74	5.00
Current account balance/GDP (%)	-16.7	-18.1	-11.1	-11.9	-12.8
FDI/GDP (%)	10.9	12.8	7.3	7.5	7.8
Budget balance/GDP (%)	3.3	3.0	-1.2	-1.0	1.5
Public debt/GDP (%)	4.0	3.0	4.0	4.7	3.5
Total external debt/GDP (%) ¹	97.4	112.3	115.1	116.2	118.3

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

- After only a marginal growth of 0.2 % yoy in Q1 2008, real GDP fell by 1.1 % yoy in Q2 as private consumption declined by 2.0 % and fixed investment fell by 2.5 %.
- Consumer prices increased by 11.0 % yoy in August. Inflation reached its peak at 11.4 % yoy in June.
- Credit growth slowed by almost two-thirds. Loan growth fell to 7.5 % between the end of 2007 and the end of July 2008, down from 20.7 % during the same period a year earlier.
- Credit quality is deteriorating. The ratio of overdue loans (principal or interest) in the total loan stock almost doubled to 6.2 % as of 31 July, up from 3.2 % in July 2007.
- With imports even weaker than exports, the current account deficit is shrinking. It narrowed to EUR 1,153 mn in Jan–Jul 2008, down from EUR 1,611 mn a year earlier. Imports decreased by 2.1 % yoy in euro terms, while exports increased by 6.0 %.

First in (a recession), first out?

Output and demand decline

Real GDP contracted by 1.1 % yoy in Q2 2008 after a marginal growth of 0.2 % yoy in Q1 (according to preliminary estimates by Statistics Estonia, made for the first time after switching to the so-called chain-linking methodology, which uses the previous year's prices instead of a fixed base price for deflating). Real GDP decreased by 0.8 % qoq seasonally and working day adjusted in Q2.

Domestic demand fell by 2.8 % yoy in Q2. Private consumption decreased by 2.0 %, mainly due to the reduction in expenditures on transportation and clothing and the deceleration in the growth of spending on food. Fixed capital formation decreased by 2.5 %, mainly because of lower investment by households and the financial sector. Investment by the manufacturing sector was almost flat; only government investment in construction continued to grow. General government expenditures increased by 4.6 %.

The decrease in foreign trade accelerated, partly reflecting the strained relations with Russia. Exports of goods and services decreased by 4.9 % yoy in Q2, and imports by 8.2 %. Exports of goods alone decreased by 3.2 %, primarily due to lower exports of refined petroleum products (Russia blocked oil deliveries, citing technical problems). In contrast, exports of basic metals and electrical machinery (electrical motors and appliances) increased. Exports of services fell by 8.9 % primarily due to the decrease in exports of services for railway cargo. The decrease in imports of goods was influenced mainly by the decrease in imports of refined petroleum products and of motor vehicles.

The decline in industrial output of 0.3 % yoy in Q1 accelerated to 4.7 % in Q2 and then to 5.2 % (working day adjusted) in July. Retail sales declined by 0.5 % yoy in Q1, and by 3.0 % in Q2 and in July. Growth in average gross monthly wages eased from 19.5 % yoy in Q1 to 15.2 % yoy in Q2. The real estate market continued to shrink. According to Statistics Estonia, 9,800 purchase-sale transactions were notarised in Q2 2008, almost a third less than in Q2 2007.

With domestic demand contracting even more than we expected and the external environment providing little support, we have reduced our forecast for real GDP growth in 2008 further to -1.2 % (from 0.1 % in CEE Quarterly 3/2008).

Budget balance slightly negative in 2008 and 2009

Tax inflows amounted to EEK 46.8 bn in the period from January to August, 63.7 % of the target for this year. This is marginally below the 63.9 % in August 2007. We now expect a general government deficit of 1.2 % of GDP in 2008. The postponement of earlier planned tax cuts and hikes in excise taxes or VAT on some goods is likely to be offset by weak revenues because of the sluggish economy. Therefore, the budget balance should also be slightly negative in 2009.

Inflation peaked in June

Inflation eased to 11.0 % yoy in August from its peak of 11.4 % yoy in June. Regulated prices increased by 23.5 % and non-regulated prices by 7.2 %, down from 8.5 % yoy in June. We still expect the base effect combined with the recession and easing global price pressures to slow inflation to 8.0 % by December. Average annual inflation will likely amount to 10.5 % in 2008. For 2009 we expect inflation of 6.4 %.

Credit growth down, lending rates up

Loan growth fell to 7.5 % between the end of 2007 and the end of July 2008, down from 20.7 % during the same period a year earlier. Deposits increased by 5.9 % during the period from January to July 2008, compared with 10.6 % from January to July 2007. In yoy terms, loan growth amounted to 28.7 % and deposit growth to 9.0 % in July 2008, significantly less than the 11.1 % yoy July inflation rate. Corporate loans increased by 7.1 % and retail loans by 8.3 % during the period from January to July. Corporate deposits fell by 7.5 % during the same period, compared with an increase of 4.2 % a year earlier. Retail deposit growth was more resilient and only fell from 14.0 % to 12.9 %.

Credit quality increasingly an issue

In line with the changes in the economy, the share of overdue loans has significantly increased. The ratio of overdue loans (principal or interest) in the total loan stock almost doubled to 6.2 % as of 31 July, up from 3.2 % in July 2007, with loans that are more than 60 days overdue increasing from 0.4 % to 1.4 %. Within the latter, overdue company loans increased from 0.1 % to 0.8 %, most significantly among real estate companies, and overdue retail loans from 0.3 % to 0.6 %. The number of companies defaulting on payments grew 42 % yoy to 3,163 in H1, according to a survey by Krediidinfo covering 52,000 enterprises. The number of companies experiencing financial problems grew the most in construction. According to the survey, smaller companies are having more problems with meeting their commitments.

Lower current account deficit helps increase reserves despite weaker capital inflows

Estonia's current account deficit narrowed to EUR 1,153 mn in Jan–Jul 2008, down from EUR 1,611 mn a year earlier. Imports were 2.1 % lower in euro terms, while exports increased by 6.0 %.

At a total of EUR 945 mn, net inward direct investment was 21 % lower than the previous year. Portfolio investment recovered from an outflow of EUR 226 mn the year before to an inflow of EUR 180 mn, but has certainly dropped since July. "Other investment" inflows fell by two-thirds, from EUR 2,497 mn in Jan–Jul 2007 to EUR 834 mn in Jan–Jul 2008, mostly due to lower inflows to the banking sector. Thanks to the smaller current account deficit and reduced capital outflows, reserves nevertheless increased by EUR 495 mn, only about 10 % less than the EUR 549 mn the year before.

Event	Date	Reading
Preliminary Q3 GDP	13 Nov. 2008	Will give some clues as to how deep Estonia's recession actually is.

Hungary



Outlook

The unpredictable outcome of the ever-deepening crisis on the global financial markets coupled with the fragile domestic political situation makes prospects rather uncertain. Except for rising risk premiums on financial assets denominated in HUF and volatile movements in the HUF/EUR exchange rate and portfolio investments, Hungary has so far managed to withstand the immediate effects of the sporadic waves of money market shocks. The indirect consequences of such a crisis may hamper the recent recovery by weakening demand in Hungary's main European trading partners, with negative consequences on net export developments. In addition to this, the unstable political scene with the minority government makes the outlined fiscal policy uncertain. Still, we continue to foresee an improvement in GDP growth in 2009.

MOODY'S LT FC RATING
A2/Stable

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

FITCH LT FC RATING
BBB+/Stable

SPREAD AVG (SEP) 121
EMBI+ Spread on Euro Curve

Macroeconomic data and forecasts

	2006	2007	2008f	2009f	2010f
Nominal GDP (EUR bn)	90.0	101.1	111.3	122.0	131.7
Per capita GDP (EUR)	8,940	10,040	11,070	12,150	13,140
Real GDP, yoy (%)	3.9	1.3	2.5	3.3	4.0
Inflation (CPI), yoy, eop. (%)	6.5	7.4	5.3	3.0	2.7
Inflation (CPI), yoy, avg. (%)	3.9	8.0	6.4	3.3	2.9
Unemployment rate (%)	7.5	7.3	7.7	7.4	7.2
Exchange rate HUF/EUR, eop.	252.3	253.4	245.0	243.0	237.0
Exchange rate HUF/EUR, avg.	264.3	251.3	247.0	240.0	238.0
2-week repo rate, eop.	8.00	7.50	8.50	7.00	6.00
1M Bubor, eop.	8.09	7.51	8.45	7.07	6.08
1M Bubor, avg.	6.80	7.18	8.30	7.60	6.55
Current account balance/GDP (%)	-6.0	-5.0	-4.4	-4.1	-3.7
FDI/GDP (%)	6.0	4.0	3.6	3.8	4.0
Budget balance/GDP (%)	-9.2	-5.5	-3.6	-3.2	-3.0
Public debt/GDP (%)	65.6	66.0	64.0	63.3	61.9
Total external debt/GDP (%)	86.4	97.7	93.0	91.6	89.0

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

Main topics

- The ongoing recovery of growth will remain fragile amidst weakening external demand in the main EU trading partners. The GDP may grow by 2.5 % in 2008 and by 3.3 % in 2009, though with regard to the unfolding global financial crisis, a less than 3 % increase cannot be ruled out for next year either.
- Export dynamics, so far the sole engine of growth, are set to weaken. Domestic demand is not yet robust enough to offset this, and any acceleration of consumption would inevitably have an impact on imports, exacerbating the external trade and the CA balance.
- The decline in public consumption should stop, while private investments should remain solid.
- The budget balance is set to improve beyond expectations and may finally close at 3.6 %, well below the 4 % target approved in the Convergence Program for 2008. The inflation path is set to descend from August 2008 on, and is expected to end up around 3 % by the end of 2009. The NBH, however, should remain prudent and keep interest rates on hold till year-end 2008.

Economic growth recovers, despite uncertainties on international markets

Domestic demand improves, external performance deteriorates

Since early autumn 2006 when Hungary set forth the stabilisation program as part of the Convergence Program to become eligible for euro adoption, economic growth has accelerated in consecutive quarters only in 2008 Q2. GDP rose by 2.0 % yoy bringing the cumulative annual H1 growth to 1.9 %. Even though the upsurge was expected earlier and the rate was still quite humble compared to those of other CEE countries, this growth was free from hefty financial imbalances which, prior to the stabilisation program, generally prevailed as a side-effect of expansion.

No sooner, however, had the economy started to recover than clouds begun to accumulate and made prospects formerly deemed secure uncertain, especially in relation to net exports, which so far had proven to be the sole engine of the recovery. Favourable developments in external trade in 2008 Q1 subsided in Q2 owing to the deceleration in economic growth of major EU partner countries, the moderate recovery in private consumption that regularly nudges imports up, and the strengthening HUF against the EUR.

The HUF/EUR exchange rate climbed from 266 in early March to as high as 235 by the end of June, thus partially swallowing up the labour productivity gain achieved by manufacturing over the period. The 1.2 % increase in private consumption could not really compensate the manufacturing industry for the drop in export sales, therefore manufacturing output posted a minor decrease by June-July. Besides the weakening demand from abroad, some multinational firms relocated part or all of their production abroad, thus exerting additional pressure on industrial output. The flat trend of new orders not only curtailed industrial growth but also hit manufacturing investments, the performance of which, however, improved slightly on the previous quarter (investments decreased by 2.4 % yoy in Q2, following a decline of 9.8 % in Q1). As other industries experienced increases in capital for-

mation, except for business & personal type services and mining, the total volume of investments carried out in the private sector grew by 4 % yoy following a decrease of 0.8 % in Q1. By contrast, communal investments contracted further by 28.8 % in Q2 (after a 22 % decline in Q1), mainly due to a negative development in construction. Disappointing investments in the public sector caused the total volume of fixed capital formation nationwide to shrink by 2.1 % yoy, after a 4.8 % drop in Q1. However, apart from investments, public consumption reversed its decline in Q2 and grew by 0.5 % yoy.

The unemployment rate decreasing to 7.5 % in July, the improving employment conditions together with the gradual increase in real net wages stimulated private consumption, as mentioned above, to 1.2 % yoy in Q2 following the 1.1 % drop in the previous quarter. However, retail sales volumes continued to be weak, recording a 1.8 % shortfall in July, and in the field of household investments, dwelling-related expenditures have stagnated and the number of completed new flats declined by 15 % in H1.

On the output side of GDP, the construction industry still suffers from a heavy shortfall in government orders and from weak household demand. The sector reported a 12 % decline yoy in Q2 and the relentlessly shrinking stock of orders predict the recession will last for at least another half-year. Breaking with traditions, agriculture turned out to be the most dynamic sector in Q2 thanks to the exceptionally good harvest. Service industries are still ailing due to a lack of proper consumer demand.

Fundamentals support recovery, net export performance is at risk

The ongoing recovery depends on how the economic performance of Hungary's main trading partners unfolds. However, the stock of orders in manufacturing has been on the rise since March. The investment activity of private enterprises started growing again after one episode

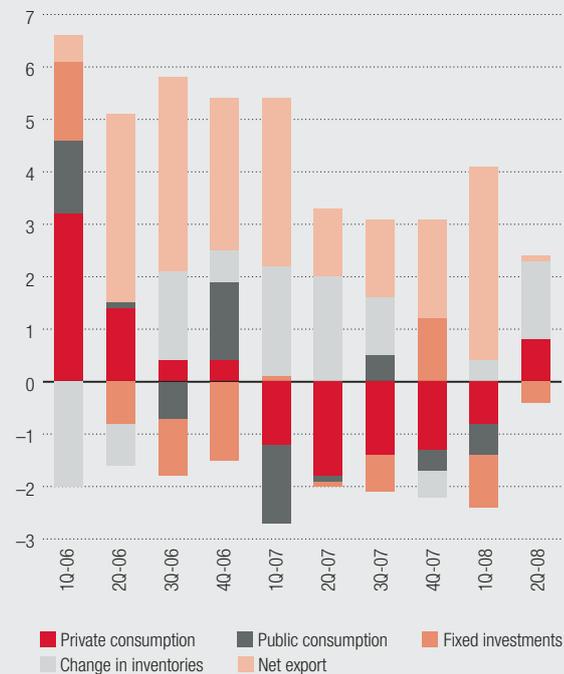
Short-term indicators

	Aug-07	Sep-07	Oct-07	Nov-07	Dec-07	Jan-08	Feb-08	Mar-08	Apr-08	May-08	Jun-08	Jul-08	Aug-08
GDP real growth, yoy (%)	–	0.9	–	–	0.8	–	–	1.7	–	–	2.0	–	–
Industrial production, yoy (%)	9.6	6.5	8.6	5.7	5.3	6.4	13.0	1.9	11.8	2.2	–0.3	0.6	–
Inflation (CPI), yoy (%)	8.3	6.4	6.7	7.1	7.4	7.1	6.9	6.7	6.6	7.0	6.7	6.7	6.5
Unemployment rate (%)	7.2	7.2	7.3	7.5	7.7	8.1	8.0	8.0	7.7	7.7	7.6	7.5	–
Exchange rate HUF/EUR, eop.	254.1	250.8	251.1	253.4	253.4	259.5	262.2	259.4	253.4	240.8	237.0	231.2	238.2
1M Buber, avg.	7.78	7.70	7.50	7.50	7.51	7.50	7.62	7.78	8.05	8.37	8.59	8.50	8.50
Export, (EUR) yoy (%)	19.6	13.0	17.4	8.1	6.4	19.8	19.6	6.1	22.2	6.4	7.8	8.2	–
Import, (EUR) yoy (%)	15.1	7.3	13.5	5.5	7.1	16.4	16.1	4.8	17.9	5.1	8.8	10.2	–
Trade balance, EUR mn	–457.3	–214.7	–111.1	9.1	–119.8	–87.7	143.2	229.2	64.1	27.5	89.8	–238.7	–
Current account, EUR mn ¹	–	–5,090	–	–	–6,510	–	–	–1,647	–	–	–3,485	–	–

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

1) cumulative.

Contribution of growth components to GDP growth (p.p.)



Source: CSO

of marginal contraction in Q1 due to a high base effect, and private consumption will probably keep on rising along with stronger purchasing power. In line with these findings, a further acceleration of GDP growth is expected for the rest of 2008. Exports are also predicted to regain part of their earlier thrust given the abundant grain harvest, the excess of which generally ends up abroad. For the whole of 2008 the actual final consumption of households should easily reach 0.9 % yoy, and net exports may rise by even 50 % with 12.6 % growth for exports and 11.4 % higher imports. As the decline in communal investments is forecast to level off or possibly even halt in the next two quarters, gross fixed capital formation together with stockpiling should grow by around 3.7 % in 2008 as a whole. On the production side, the added value of agriculture, even according to a moderate scenario, may expand by at least 25 % yoy, providing a significant boost to GDP growth in the form of net export growth. The manufacturing industry is likely to experience somewhat weaker growth than previously expected but even so there is a good chance for it to develop by an annual rate of 5.6 %. The service sector will probably make moderate progress along with rebounding domestic demand, and is forecast to generate 1 % GDP growth yoy. The construction industry could be the sole business area that will record another annual decline of around 6.4 %. Provided there is no sudden and dramatic deterioration in global economic conditions, the Hungarian economy will gear up to 2.5 % yoy growth in 2008 as against 1.3 % in 2007.

2009 and 2010 are supposed to bring a further acceleration in growth on the back of steadily enlarging private consumption and a modest increase in public consumption. The investment performance of the private sector is expected to remain brisk, while instead of holding back

the nationwide development of fixed capital formation, as happened during 2007 and 2008, the state, the local governments and households are set to increase their investment activity in the next two years. Along with thriving consumption and investments, imports will inevitably start growing, leading to a fall in the net export surplus. As a result, domestic demand may gradually take the place of net exports as the principal engine of economic growth. Overall, we expect GDP growth to reach 3.3 % yoy in 2009 and to accelerate further to 4.0 % in 2010.

Inflation declines, monetary easing as yet uncertain

Sitting at 6.5 %, twelve-month headline inflation is still high, though it has been falling slowly since May from a peak of 7 %. As always happens in late summer, food prices were down by 18.6 % yoy because of the drop in the prices of seasonal food items (potatoes, fresh vegetables and fruits). While food prices moderated, the 9.9 % yoy increase in regulated gas prices in July, effective from August, was the key driver behind the rise in household energy and motor fuel prices by 1.9 % yoy, and thus annual CPI came in at 6.5 %. As the prices of other items in the consumer basket either fell or remained flat, without the regulated price rise yoy inflation would have declined to around 6.2 %. Encouraging progress, however, has been recorded in producer and agriculture prices. The mom indices of agriculture report a significant decline since June, while producer prices on a monthly basis started to ease even in April. A stronger HUF also favours the ongoing descent in consumer inflation, which would then continue for the rest of the year. As the National Bank considers the accomplishment of the 3 % inflationary target by 2010 as its overriding priority, and the majority of members in the Monetary Council are not impressed at the current declining trend in headline inflation, no sudden ease in the monetary cycle is expected to take place in the next few months. What comes afterward depends also on how the forint develops against the euro.

Deficit target overshoot, newly published tax package

In the first eight months, the general government positions were basically on schedule, as the deficit totalled HUF 672.5 bn (2.4 percent of GDP) excluding local governments, while the latest projection of the Ministry of Finance for the given period was HUF 675.5 bn. The general government had a deficit of HUF 91.2 bn in August 2008, slightly lower than the latest related projection (HUF 94.1 bn). Both public revenue and expenditure figures were somewhat lower than expected. The central government produced a deficit of HUF 94.6 bn, while social security funds and extra budgetary funds achieved surpluses of HUF 0.3 bn and HUF 3.1 bn respectively. Based on this recent development, the Ministry of Finance changed the year-end projection and now the government deficit is expected to reach 3.8 % of GDP at the end of 2008 from the previous 5.0 %.

To improve the international competitiveness of the country, a fundamental reform of the tax system along with some cutbacks in social expenditures are needed. However, the main reform measures such as the renewal of the healthcare or education systems have already been stalled by resistance from the population, and the minority government has also had to soften its budgetary reform steps due to the extremely strong support of the opposition party Fidesz. The mere survival of the Socialist government now depends on the approval of the 2009 budget.

On 27 August, Hungary's Prime Minister published a package of proposals called an „agreement“, concerning the reorganisation of the tax system, which included substantial tax reductions. The HUF 1000-1200 bn worth of cutbacks would be distributed evenly over the next 3-4 years, essentially meaning HUF 300 bn (1 percent of GDP) per year. The original proposal consists of three main areas, the widening of the 18 % bracket of personal income tax, a decrease in the corporate tax burden by cutting employers' social security contributions, and deleting the 4 % special tax for high-earning taxpayers, known as the „solidarity tax“. To compensate, corporate income tax would increase to 18 % from the current 16 %, while VAT rates would stay unchanged, and no expenditure cuts are proposed. The entire proposal was based on the whitening of the economy and on a more efficient collection of taxes, assuming that lower taxes and tougher controls will provide better incentives for tax payments to be an adequate resource, and offset the revenue shortfall. Stricter control would also include compulsory bank transfers instead of cash, particularly for wages and higher-value purchases.

After the publication of the afore-mentioned proposal, several changes have been made concerning the details of the 2009 tax package. Some additional tax increases have also been enclosed to the official tax bill of the government, such as the new tax on company cars for instance, or the so-called Robin Hood tax which means 8 percent more

tax on companies' profits. On the other hand, as a result of the fine-tuning process and the reconciliations with representative platforms of different business communities, some restrictions have disappeared from the adjusted tax proposal of the government as well.

It is still questionable whether the structure of this package will be able to provide answers to the deep weaknesses of the Hungarian economy regarding low labour participation or tax avoidance, without any tightening of social benefits.

CA deficit on the rise again

The current account deficit in Q2 deteriorated on a quarterly basis from EUR 1.6 bn in Q1 to EUR 1.8 bn, though yoy the deficit narrowed by EUR 131 mn. Net exports posted an increased surplus yoy (+222 %) on the external trade of goods, and an 11 % decrease in the surplus of services. Along with the higher risk premium on HUF-denominated assets and the higher base rate, the deficit from income transfers related to debt servicing rose by 60 % yoy to EUR 784 mn. The balance of income transfers arising from profit gains due to FDI were down again by 16 % yoy following the 4 % drop in Q1. For the rest of 2008 a modest improvement should evolve in the wake of an anticipated increase in the foreign trade surplus of services, and a slightly lower amount of repatriated profit from FDI.

Event	Date	Reading
Budget 2009	2008 Q4	It is important to see whether the minority government can pursue the necessary reforms

Latvia



Outlook

The Latvian economy continues to weaken as a result of falling real estate prices, a dip in consumer spending and more expensive credit. The outlook remains gloomy with preliminary information for Q3 indicating that the economy may have further contracted, entering into a phase of stagflation expected to last over a year. The scope of the slowdown has also taken the government by surprise and threatens to create a budget deficit this year and next year. The rapid cooling of the economy is expected to bring some improvement in the inflationary outlook and a narrowing of external imbalances driven by weakening domestic demand and consumption growth. Overall, the economy remains vulnerable to a financial crisis, although we still consider the risk of such a scenario materialising to be relatively low. The current rapid cooling – if it does not turn out to be deeper and prolonged – could indeed result in a reversal of the trend, opening the door for a gradual recovery in the economy.

MOODY'S LT FC RATING
A2/Negative

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

FITCH LT FC RATING
BBB/Negative

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

Macroeconomic data and forecasts

	2006	2007	2008f	2009f	2010f
Nominal GDP (EUR bn)	15.9	19.9	23.0	24.9	27.2
Per capita GDP (EUR)	6,930	8,710	10,130	11,020	12,070
Real GDP, yoy (%)	12.2	10.3	0.5	0.4	3.6
Inflation (CPI), yoy, Dec. (%)	6.8	14.1	11.0	6.5	4.5
Inflation (CPI), yoy, avg. (%)	6.5	10.1	15.4	7.5	5.5
Unemployment rate avg. (%)	6.8	6.0	6.2	6.4	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	6.00	5.50	5.00
Interest rate (3M Rigibor), Dec	4.20	10.75	6.12	5.60	5.10
Interest rate (3M Rigibor), avg.	4.37	8.66	6.50	5.75	5.25
Current account balance/GDP (%)	-22.5	-22.9	-14.5	-12.8	-12.0
FDI/GDP (%)	8.3	8.0	5.3	4.6	4.5
Budget balance/GDP (%) ^{1 2}	-0.2	-0.04	-0.86	0.08	0.34
Public debt/GDP (%)	10.7	9.7	9.8	9.7	9.7
Total external debt/GDP (%)	114.0	134.2	121.5	115.9	111.4

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

- The economic outlook in Latvia has further deteriorated during the first half of 2008. In Q2 2008 real GDP growth decreased to a revised 0.1 % yoy, down from 3.3 % in the previous three months, after soaring inflation drastically reduced consumer spending and real estate prices fell. The combination of slower consumer spending and a reduction in capital inflows are anticipated to cause a further contraction in the pace of the economy, with GDP growth projected to slow to 0.5 % for the whole year.
- After reaching its peak in May at 17.9 % yoy, CPI inflation is gradually decreasing and will continue to fall as the economy slows, reaching 11.0 % by year-end. Although the inflationary outlook has improved slightly, the risk that the country may be heading toward a period of stagflation remains high.
- External imbalances are expected to improve further as a result of decreasing domestic demand, which will cut import growth, and a stronger performance in the export sector. The current account (CA) deficit is projected to narrow to around 14.5 % of GDP this year and -12.8 % in 2009.

On the brink of ‘stagflation’

Winds of recession

The Latvian economy continues to weaken as a result of falling real estate prices, a dip in consumer spending and more expensive credit. In Q2, real GDP increased by a revised 0.1 % yoy – the slowest pace since 1995 – as accelerating inflation and tighter lending conditions led to a fall in retail sales and a decrease in manufacturing. Private consumption decreased by 5.0 % in Q2, after a marginal increase of 2.3 % in the previous three months. The fall in investment activity was even more significant, as investments decreased by almost 7 % yoy after a 5.1 % yoy increase in Q1.

The outlook looks rather gloomy with preliminary information for Q3 indicating that the economy may have further contracted, opening the door for a phase of stagflation that may last for more than a year. Recently, Moody’s downgraded its outlook to negative for Latvia as a result of stalled economic growth and tightened liquidity access. Fitch followed the same path and recently cut its rating by one notch to BBB as a response to continuous deterioration of the financial environment. In July, retail sales fell by an annual 8.0 % (unadjusted), after decreasing by almost 9.0 % in June, mainly due to falling sales for food products affected by tightening lending conditions and lower consumer purchasing power. The correction in the real estate market continues with very few signs of stabilisation thus far.

Overall, the economy remains vulnerable to a financial crisis, although we still believe that such a scenario is highly unlikely. In this context, the risk of devaluation also remains low provided that a much deeper and prolonged correction of the economy does not take place.

Down from the peak

After reaching its peak in May, CPI inflation has been falling, supported by the rapid cooling of the economy and decreasing pressure on food and oil prices. Latvia’s inflation rate fell to 15.7 % yoy in August, the lowest level in seven months, and may be poised to further decrease in the coming months as the economy slows, reaching 11 % at the end of this year and 6.5 % in 2009.

On September 11, Latvia’s central bank left its refinancing rate unchanged and cut its mandatory reserve requirement to provide banks with liquidity as lending slows. The central bank’s effort is mainly targeted at preventing overreactions in the economy and stimulating the financial sector in order to attract long-term funding. So far, the Lat-

vian central bank has reduced the reserve ratio for bank liabilities with a maturity of more than two years three times, cutting it from 8 % to 6 %.

Fiscal tightening needed to avoid budget deficit

Lowering domestic demand, rapid wage growth and a cooling real estate market are forcing the government to cut spending in order to prevent the budget from slipping into a deficit. The Latvian government recently announced it is targeting a balanced budget, although the risk of falling into a deficit is relatively high given the anticipated impact of lower economic growth on the planned fiscal revenues. In July, the revenues in the general government’s consolidated budget grew by a mere 1.8 % yoy, while expenditures surged by 26.0 % (these figures have increased by 15.8 % and 24.6 % respectively since the beginning of the year).

The speed of the economic slowdown has clearly taken the government by surprise, forcing it to announce drastic measures to cut public spending, such as the freezing of public wages and closing of three special assignment ministries. The fast expansion in wages – which were up by more than 25 % in the first half of the year – represents the main cause for concern as it may contribute to the further erosion of the country’s competitiveness and put pressure on public spending. In this context, the European Bank for Reconstruction and Development has recently emphasised the need to promote further structural changes to the economy and boost competitiveness by improving the business environment and targeting higher investments to increase productivity.

External imbalances to narrow as economy slows

In July, Latvia’s external imbalance showed further signs of deceleration, with the current account posting a deficit of LVL 209 mn (EUR 0.3 bn), down by almost 45 % yoy thanks to cooling domestic demand resulting from the ongoing tightening in lending conditions. The country’s CA deficit, which was the widest in the EU last year at 23 % of GDP, is anticipated to narrow further as the economy slows, reaching a projected 14.5 % of GDP in 2008 and 12.8 % in 2009. As far as the financing of the gap is concerned, capital inflows have weakened since March of this year, with FDI decreasing by almost 50 % in July compared to one year earlier, mainly due to lowering equity capital investment. The inflows connected to intra-company loans remain robust, although they are decelerating and are expected to deteriorate considerably in the coming months.

Event	Date	Reading
GDP and CA	–	Further cooling in the economy and lowering of external imbalances might help to reduce pressures on the FX market.

Lithuania



Outlook

The only Baltic country still showing respectful growth, Lithuania, is set for a further slow-down. The imbalances are very similar to those previously felt by Estonia and Latvia: wide current account deficits, strong dependency on capital inflows and a weakening real estate market, although Lithuania had a less overheated economy compared to the other two and can benefit from a slightly more diversified economic structure (with a higher share of industry and agriculture). However, given its slightly delayed economic cycle a slowdown is expected. The corporate sector is already showing signs of weakening. Weaker demand will, however, improve the current account deficit and dampen inflationary pressures. The latter seem to have peaked during the summer. Parliamentary elections will be held on 12 October; the outcome is far from guaranteed, but the political environment is not a major source of risk for the country.

MOODY'S LT FC RATING
A2/Stable

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

FITCH LT FC RATING
A-/Negative

SPREAD AVG (SEP) 115
EMBI+ Spread on Euro Curve

Macroeconomic data and forecasts

	2006	2007	2008f	2009f	2010f
Nominal GDP (EUR bn)	23.7	28.0	32.6	36.6	40.2
Per capita GDP (EUR)	6,989	8,303	9,700	10,912	12,026
Real GDP, yoy (%)	7.7	8.8	4.7	3.8	4.2
Inflation (CPI), yoy, Dec. (%)	4.5	8.1	9.9	6.2	4.7
Inflation (CPI), yoy, avg. (%)	3.7	5.7	11.3	8.1	5.5
Unemployment rate, LFS (%)	5.6	4.3	5.3	5.8	6.0
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	5.62	4.69	4.51
Interest rate avg. (3m Vilibor)	3.11	5.21	6.23	5.16	4.60
Current account balance/GDP (%)	-10.8	-13.7	-11.9	-11.2	-9.8
FDI/GDP (%)	6.1	5.0	3.9	4.1	4.8
Budget balance/GDP (%)	-0.5	-1.2	-0.9	-0.9	-0.7
Public debt/GDP (%)	18.2	17.3	17.6	18.0	18.3

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

Main topics

- In the second quarter economic growth slowed to 5.2 %: it is the slowest pace in more than six years but still respectable, visibly higher than in the other Baltic States.
- Elections will be held in mid October. A government coalition is a possible outcome. Moreover a referendum has been called for the same day to delay the closure of the nuclear plant at Ignalina which, according to the EU accession deal, is supposed to happen in 2009.
- Inflation, as in numerous countries in the CEE region, peaked during the summer and started decreasing in August (-0.2 % from July).
- During the last three months there has been a substantial improvement in the current account. Current account financing in the first part of the year was again realised mainly through cross-border bank loans.
- Fitch lowered the country ceiling to A- from A (outlook was kept negative)

Further slowdown imminent following Estonia and Latvia

Elections in sight

The country's next parliamentary election is scheduled for 12 October 2008. Currently, around 55 % of the seats in the Lithuanian parliament are controlled by the three main parties, the Labour Party, Homeland Union and the Social Democrats (the latter is the party of Prime Minister Kirkilas). Since it is expected that none of the running parties will obtain a clear majority, the next government will probably be based on a coalition. The President recently called for a "grand coalition" between Homeland Union and the Social Democrats to prevent other parties from taking power. The results of the most recent polls show that the opposition Homeland Union will achieve the best result, followed by the Labour party and the Social Democrats. However, a large share of the electorate is still undecided. Simultaneously with the elections, a referendum (consultative, no legal impact) has been called to delay the closure of the aging nuclear plant at Ignalina (which meets around 70 % of the country's energy needs). The second unit of the plant was supposed to close in 2009 according to the EU accession deal. The Lithuanian authorities are persuading the EU Commission to extend this deadline till 2012.

Much difference to the other Baltic States?

In Q2 2008 economic growth slowed to 5.2 %, the slowest pace in more than six years. Both household consumption (+7.3 % from +11.1 % in the previous quarter) and corporate investments (-0.9 % from +24 %) contributed to the slowdown. On the supply side, agriculture and industry growth even accelerated in Q2, but growth in construction halved.

Recent data on Lithuanian industrial production gives cause for concern (-3.3 % in August) while retail sales were rather weak (+4.4 % in July). The housing market is clearly weakening further, while consumer and business confidence has also dipped in recent months; finally, corporate activity is slowing fast: the mentioned drop in investment in Q2 was eye-catching and corporate deposits are showing visible signs of weakness (-10 % in the year to date in August, a possible indication of a severe reduction in corporate liquidity). On the other hand, no slowdown in credit growth – one of the main potential transmission channels of the external shock – is yet apparent: loans to the system are still running at +32 % yoy in July (+14 % in year-to-date terms).

All in all, the economic environment is much better than in the other Baltic States (Q2 GDP growth in Latvia was 0.2 % and -1.1 % in Estonia), but this does not mean the Lithuanian economy will not experience a severe slowdown in the coming quarters (it is too early to speak about a possible recession).

The Lithuanian economy will partially follow negative trends in the coming quarters, for various internal and external reasons such as external imbalances and inflationary concerns, the contagion effect (both

via trade and financial links), connections of banking sectors in the different Baltic countries, etc. In the meantime Fitch lowered the country ceiling to A- from A (Outlook has kept negative).

The global environment is not supportive either and it is a source of further tension on the Lithuanian market. In September the spread on 10y Lithuanian international bonds surged to 130bps, reaching the highs of March and more than doubling from last year. The Vilibor is moving up again, albeit very slowly.

Hence, in line with our global scenario (growth in the USA and the Eurozone expected to be weaker in 2009 than in 2008), Lithuania will experience a further slowdown in 2009 while the recovery in 2010 will be very mild. Even assuming the second unit in the Ignalina nuclear power is not closed in the next two years, we forecast that GDP growth will drop to 3.8 % in 2009 and 4.2 % in 2010.

Inflation peak has been reached

Lithuanian inflation slowed for the second consecutive month in August (+12 % from +12.2 % in July and 12.5 % in June), still, it remains more than three times higher than in the Eurozone. Moreover, the law regarding the automatic indexation of the minimum wage and of social payments, which was initially vetoed by the President, passed its second reading on 15 July. It is clear that inflation will remain the major challenge with regard to euro adoption, which is expected to happen no earlier than 4–5 years time.

In the meantime, Lithuanian budget revenues were slower than forecasted in the first eight months of the year, due to the more sluggish economic growth which has reduced tax collection. This could push the deficit above the Government target.

Improving external accounts

During the last three months the current account deficit showed a significant improvement thanks to weaker domestic demand. The deficit, 14.5 % of GDP in the first half of 2008, fell slightly with respect to the same period of 2007, but current account financing will remain challenging in the current global environment. In the first seven months of 2008 foreign direct investments displayed a 36 % decrease and ended up covering less than 15 % of the current account deficit. Cross-border bank loans again constituted the lion's share (covering 61.5 % of the deficit), increasing further in recent months. Our projections see the current account deficit gradually improving next year, in line with the envisaged continuation of the slowdown in domestic demand. However, lower imports will be counterbalanced, at least partially, with lower external demand (i.e. weakening exports) if one considers the difficulties in the EU and in Estonia and Latvia (the latter two absorb almost 20 % of Lithuanian exports).

Event	Date	Reading
Parliamentary elections	12 October	Not a major source of risk for the country; a coalition government is expected

Poland



Outlook

The economy expanded strongly in 2008 H1 by posting annual growth of 5.9%. Domestic demand stayed the main driver. However, recent macroeconomic data confirm that economic growth is gradually decelerating, in line with our expectations. We stand by our forecast of 5.2% GDP growth yoy this year and 4.2% in 2009. In July/August the inflation rate peaked this year at 4.8% yoy. We expect the CPI to decline in the coming months due to the strong zloty, lower crude oil prices and the high statistical base. The downward trend of inflation should continue in 2009. The MPC maintains its cautious stance, even suggesting the possibility of some further tightening in monetary policy, if this is needed to fulfil the Maastricht inflation criterion. However, we believe that the gradual inflation decrease and the weaker economic performance in 2008 H2 will instead force the MPC to keep interest rates unchanged in the coming months, while we reconfirm our forecast for a monetary easing of 50 bps later in 2009.

MOODY'S LT FC RATING
A2/Stable

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

FITCH LT FC RATING
A-/Stable

SPREAD AVG (SEP) 89
EMBI+ Spread on Euro Curve

Macroeconomic data and forecasts

	2006	2007	2008f	2009f	2010f
Nominal GDP (EUR bn)	272.1	308.7	372.7	398.4	424.9
Per capita GDP (EUR)	7,140	8,100	9,800	10,470	11,160
Real GDP, yoy (%)	6.2	6.6	5.2	4.2	4.4
Inflation (CPI), yoy, Dec. (%)	1.4	4.0	4.0	3.3	2.4
Inflation (CPI), yoy, avg. (%)	1.0	2.5	4.4	3.5	2.9
Unemployment rate (%)	16.2	12.7	9.5	8.8	8.1
Exchange rate PLN/EUR, eop.	3.83	3.58	3.42	3.47	3.43
Exchange rate PLN/EUR, avg.	3.90	3.78	3.42	3.44	3.45
Interest rate (reference), Dec.	4.00	5.00	6.00	5.50	4.75
Interest rate (WIBOR-3M), Dec.	4.20	5.67	6.30	5.80	4.89
Interest rate (WIBOR-3M), ann. avg.	4.21	4.74	6.33	5.75	4.90
Current account balance/GDP (%)	-2.7	-3.7	-5.4	-5.6	-4.4
FDI/GDP (%)	5.5	4.4	3.2	3.3	4.0
Budget balance/GDP (%) (ESA95) ¹	-1.8	-1.8	-2.5	-2.3	-2.3
Public debt/GDP (%) (ESA95) ¹	42.5	45.2	44.2	44.0	43.6
Total external debt/GDP (%)	46.6	48.3	52.0	52.0	52.3

Sources: Central Bank, Central Statistical Office, Bank Pekao Market Analyses and Forecasting, UniCredit 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 2008 Q2 remained strong reaching 5.8% yoy, mainly driven by robust consumption and investment. We are cautious about development next year. We expect growth to decelerate due to the unfavourable changes in the external environment and some weakening of investment activity.
- Poland's PM surprised the market with the announcement of a target for euro adoption as early as 2011. The market reacted strongly to this news with curve and currency rallies. The zloty is relatively strong despite uncertainty on the global market. At the same time, the convergence story still dominates the fixed income market and

it will exert a significant influence on the long end of the curve in the forthcoming months. Market volatility is still very high. Any signals of global market stabilisation in the long term could support further zloty appreciation.

- Inflation peaked this year in August at 4.8% yoy. However, after excluding food and energy prices the new net core inflation index increased by 2.7% yoy, exceeding the NBP's CPI target (which is 2.5% yoy). Taking into account the strong zloty and lower oil prices, we expect inflation to decline towards 4% yoy in December 2008 and further to 3.3% yoy in December 2009.

Government and Monetary Policy Council to face new challenge – euro adoption

Strong growth to moderate in coming quarters

GDP growth in 2008 Q2 remained strong, surging by 5.8 % yoy vs. 6.1 % yoy in 2008 Q1 and 6.5 % yoy in 2007 Q2. Domestic demand stayed the main driver of the Polish economy and contributed 6.1 % to GDP growth in 2008 Q2. This came from a robust increase in private consumption (up by 5.6 % yoy), supported by fixed investments (up by 15.2 % yoy). Such strong consumer demand was consistent with retail sales data, booming by 15.6 % on average in 2008 Q2 and confirmed that consumption is still bolstered by double-digit wage and loan growth. On the other hand, public consumption dynamics were in negative territory as a result of the very low absorption of European Union funds.

The biggest surprise, however, came from international trade which subtracted 0.6 pp from GDP growth. The downturn in the euro zone, Poland's main export market, resulted in exports slowing to 7.4 % yoy in 2008 Q2 from 13.4 % in 2008 Q1. This was accompanied by imports weakening to 8.2 % yoy in 2008 Q2 from 13.7 % yoy in the previous quarter. Recent macroeconomic data points anew to an economic slowdown in 2008 H2. Industrial production surprised on the downside not only in July, but also in August, falling by 3.7 % yoy, its lowest level since the beginning of 2005. Moreover, the manufacturing PMI index continued to decline in August, for the fifth consecutive month. As such, we expect GDP to grow by 5.2 % yoy this year. This is still a highly respectable performance compared with other CEE countries. However, we remain cautious about development next year, expecting GDP growth at 4.2 % yoy due to the unfavourable changes in the external environment and the expected weakening of investment activity.

Monetary Policy Council nearing the end of tightening cycle

As expected, the Monetary Policy Council (MPC) left interest rates unchanged at its September meeting, maintaining the hawkish tone of its

communiqué. The statement released after the September meeting reiterated as risk factors the same issues as mentioned in the previous one. The MPC still expects economic growth to decline in the coming quarters and the unfavourable correlation between wage and labour productivity growth to continue. The MPC also pointed out that „persistently high inflation creates a risk of inflation expectations remaining elevated, and consequently feeds the risk of second-round effects“. Thus the MPC still suggests further interest rate hikes are possible in the coming months to bring inflation rate back down to the target in the medium term. However, the overall tone of the statement and its medium-term implication for monetary policy seem to be somewhat milder. The council strongly intimated that „a more comprehensive assessment of the inflation outlook will be possible after analysing data released in the near future and the October projection of inflation and GDP“. In our opinion the MPC will keep its restrictive bias for as long as possible due to euro adoption considerations. Such a tightening approach, combined with a rather moderate pass-through of energy prices to other consumer prices, however, should lead to a more benign inflation trend than that presented in the recent inflation report. All told, we believe the MPC might not actually need to increase rates in 2008, while we maintain our view that some monetary policy easing may start in 2009 H2.

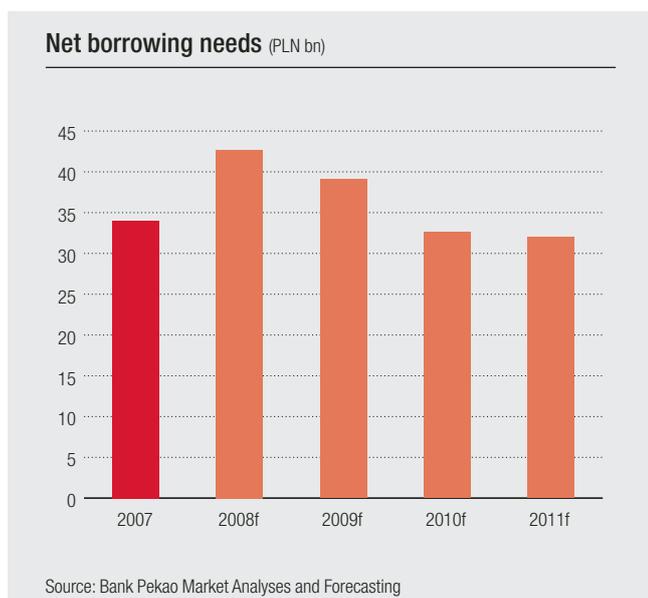
2009 budget draft in line with updated convergence program

Poland's government approved the 2009 budget draft, setting the budget deficit at PLN 18.2 bn. The government also cut this year's deficit to PLN 22.9 bn from the PLN 27.1 bn assumed in the 2008 budget bill. According to the official statement, revenues next year are expected to total PLN 303.5 bn (up by 15.5 % from this year's forecast value), while budget spending is to amount to PLN 321.7 (up by 12.6 %). It is worth noting that both estimates do not account for EU co-financing. On the revenues side, the government expects tax revenues to increase by 9.4 % vs. 11.6 % predicted for 2008, mainly due to lower

Short-term indicators

	Aug-07	Sep-07	Oct-07	Nov-07	Dec-07	Jan-08	Feb-08	Mar-08	Apr-08	May-08	Jun-08	Jul-08	Aug-08
Real GDP, yoy (%)	–	6.5	–	–	6.4	–	–	6.1	–	–	5.2	–	–
Industrial production, yoy (%)	8.9	5.4	10.8	8.5	6.4	10.7	15.0	1.0	15.1	2.4	7.3	5.9	–3.7
Inflation (CPI), yoy (%)	1.5	2.3	3.0	3.6	4.0	4.0	4.2	4.1	4.0	4.4	4.6	4.8	4.8
Unemployment rate (%)	11.9	11.6	11.3	11.2	11.4	11.7	11.5	11.1	10.5	10.0	9.6	9.4	9.3
Exchange Rate/EUR, eop.	3.82	3.78	3.63	3.63	3.58	3.63	3.52	3.53	3.46	3.38	3.35	3.20	3.35
3M Wibor, avg.	4.91	5.09	5.13	5.36	5.67	5.64	5.73	6.02	6.29	6.41	6.58	6.62	6.52
Export, (EUR) yoy (%)	14.9	8.2	13.5	13.1	8.7	23.2	30.2	12.0	33.9	12.0	16.1	22.7	–
Import, (EUR) yoy (%)	13.4	13.7	17.7	15.4	15.4	18.7	32.5	13.9	31.8	14.2	20.2	22.4	–
Trade balance, EUR mn	–472	–917	–859	–783	–1,645	–535	–840	–1,402	–1,075	–1,280	–1,706	–1,563	–
Current account, EUR mn	–576	–546	–1,183	–67	–2,061	–962	–1,347	–1,738	–1,455	–1,673	–2,292	–1,222	–

Sources: Central Bank, Central Statistical Office, Bank Pekao Market Analyses and Forecasting



PIT (Personal Income Tax) rates. The draft introduces a change in Poland's tax system, which will be simplified to two tax brackets of 18 and 32 percent, with the vast majority of Poles set to pay the lower rate. This adjustment of the system is likely to cost the budget around PLN 8 bn in personal income tax revenues. As regards spending, the government assumes lower expenditure on pensions and social insurance, which may be related both to new legislation aiming to reduce the number of early retirements and to steady improvements on the labour market. The approved 2009 budget draft is consistent with the updated convergence program, assuming a reduction in the general government deficit to 2 % of GDP in 2009. Despite an optimistic revenue and spending outlook, we do not see any particular risk to realising the budget. However, we reckon the budget deficit relative to GDP will be 2.3 % next year.

Turning to budget financing, the government assumes net borrowing will decrease to PLN 39.1 bn from the PLN 42.7 bn estimated for 2008. In particular, domestic financing will amount to PLN 32.3 bn vs. PLN 34 bn this year. The main contribution to domestic financing will come from selling Treasury Securities (TS). It is worth noting the change in the domestic financing structure. The Ministry of Finance is returning to the strategy of increasing the average duration of TS. The Ministry plans to decrease T-bill debt in 2009 by PLN 4.6 bn (vs. growth of PLN 22 bn this year), while the net issuance of marketable T-bonds will increase by PLN 35.2 bn (vs. the PLN 10.6 bn increase expected this year), of which the net issuance of fixed T-bonds will increase by PLN 30.1 bn (vs. PLN 5.8 bn this year). In our opinion, the main risk factor comes from privatisation revenues assumed at PLN 12 bn next year. Net inflows to the state budget are projected at PLN 6.76 bn. These assumptions are optimistic taking into account the uncertain situation on the Warsaw Stock Exchange. Fund managers expect an improvement in the equity market over the next 12 months or at least a stabilisation. However, it is not sure whether this situation will translate into increased interest in the Treasury offer of companies.

Euro adoption in 2012 more realistic after PM declaration

Poland's PM surprisingly declared, for the first time since the Civic Platform (PO) won the parliamentary elections, that the government's goal is to adopt the euro in 2011. After the meeting between the government and the MPC, a statement was issued saying that 2011 would be the year when Poland should receive all agreements needed to join the euro zone, with the euro being adopted from January 2012. The exact schedule will be published in October. In our opinion, the most important concept is the new strong commitment of the authorities for EMU convergence, rather than the exact date itself. The news about EMU accession positively influenced the foreign exchange market. The PLN/EUR dropped from 3.48 to 3.38 on 10 September and after a rebound to 3.43 (the day after) it fell sharply to 3.33. Afterwards, the PLN/EUR started to move in a range between 3.30 and 3.38 with high volatility. We expect the convergence process to positively weigh on investors' sentiment vis-à-vis Poland in the forthcoming years too.

We believe 2011 is very tough target, as PM Tusk himself also admitted, and maintain our basic scenario that the most likely and earliest date for entering the euro zone is the beginning of 2012. One should not forget, however, that even if Poland does meet all the Maastricht criteria (meaning the actions of the Government and the NBP would be successful), the institutional EU framework is based on a specific time calendar that could limit Polish aspirations and postpone the euro adoption by several months.

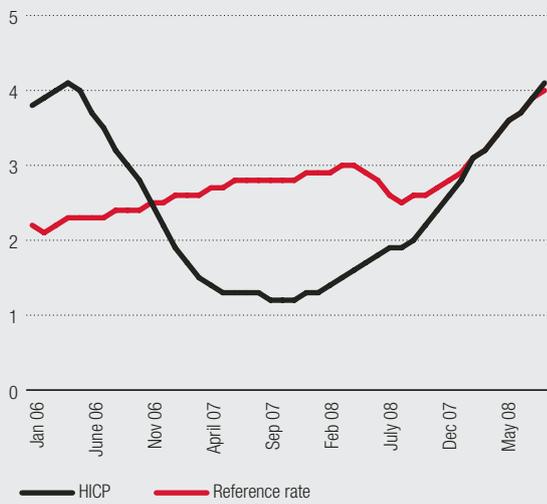
Before joining EMU, Poland has to meet the Maastricht criteria. The fiscal convergence criteria (a general government deficit below 3 % of GDP and a public sector deficit below 60 % of GDP) have already been met. In our opinion, the fiscal convergence path presented by the government earlier this year seems to be quite realistic. Price convergence (with the reference value of the 12-month average HICP rate plus 1.5pp) is a question mark. The rising Polish inflation rate has caught up with the eurozone reference rate (4.1 % vs. 4.0 % respectively in August), however, if inflation in Poland rises faster than the EU average, this criterion will be missed. Thus fulfilling the inflation criterion will be the most difficult of the Maastricht criteria, though recent inflation developments (lower growth in food and energy prices and also the fall in crude oil prices) reveal that it might only be a temporary threat. Nevertheless, the HICP data for Poland as well as other EU countries will be closely monitored in the coming months.

ERM-2 entry likely in 6 months

Some concerns have arisen over the exchange rate stability criterion, as before joining the euro zone, Poland has to join ERM-2 and the PLN/EUR exchange rate must remain within the fluctuation band for at least two years. Minimising this time has been the objective of all EMU convergence countries. We expect Poland to enter the ERM-2 system in the next six months, most likely at the beginning of 2009, taking into account the deputy minister's statement that Poland is technically ready to enter the ERM-2 mechanism and a referendum on accepting the European currency is unnecessary.

Apart from fulfilling the Maastricht convergence criteria, Poland also needs to change the Constitution internally in order to adopt the eu-

Poland and Maastricht inflation criterion (%)



Source: Central Statistical office, Bank Pekao Market Analyses and Forecasting

ro. This requires a two-thirds majority in parliament, and so some of the opposition parties would have to support the change. There is no clear stance from the largest opposition party Law and Justice (PiS)

and uncertainty will prevail in the short run. We believe, however, that the next three years will be enough to ensure legislative consistency between Polish and EU law, and therefore this legal risk poses less of a problem than risks of delays in Maastricht criteria convergence.

Current account gap widens

The increasing deficit in the current account is stoking fears among investors. The 12 month-cumulative CA deficit amounted to EUR 15.1 bn at the end of July vs. EUR 10.7 bn in the same period of 2007. The higher deficit resulted from a deterioration in the trade balance – exports increased by 17.2 % at the end of July, while imports accelerated by 19.1 %. Considering the global economic downturn we expect that exports will decrease gradually in 2008 H2. Therefore we expect the current account deficit to reach 5.4 % of GDP in 2008 and widen further to 5.6 % of GDP in 2009. The deteriorating relationship between FDI inflows and the CA deficit is worthy of note. At the end of July the 12-month cumulative FDI accounted for 84 % of the gap, while in the same period of 2007 it was 161 %. This trend potentially implies greater reliance on short-term portfolio capital in financing the deficit, which might increase the risk of zloty depreciation in the coming quarters. Therefore, we remain cautious about future expectations on zloty strengthening, despite the declaration about joining EMU. Based on this declaration we have scaled back our PLN/EUR forecast to 3.42 (down from 3.44 previously) for the end of this year.

Event	Date	Reading
Euro adoption schedule	October 2008	It will reveal the government's and the central bank's efforts regarding euro adoption, and especially about joining ERM-2
NBP inflation projection	October 2008	Many MPC members will wait for this document before deciding on medium-term monetary policy
Budget for 2009	November 2008	This will show to what extent the government is able to pursue its convergence plan

Romania



Outlook

Although a high degree of uncertainty and volatility persist at the global level, Romania's economy continues to show good resilience to the crisis, supported by prospects of a good harvest which will help keep GDP above the potential level. Some cooling of the growth rate is however anticipated as from Q4 this year, mainly on the back of lower private consumption and a slowdown of construction activity. The weaker performance of local capital markets is expected to continue at least in the short-term, together with continuously high volatility of FX markets. The risk of a moderate decline of capital inflows remains high despite the good track record in FDI, supported also by a couple of privatisation deals. Under these conditions, a well-balanced macro policy mix remains crucial to supporting a smooth reduction of current disequilibria.

MOODY'S LT FC RATING
Baa3/Stable

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

FITCH LT FC RATING
BBB/Negative

SPREAD AVG (SEP) 228
EMBI+ Spread on Euro Curve

Macroeconomic data and forecasts

	2006	2007	2008f	2009f	2010f
Nominal GDP (EUR bn)	97.8	121.4	136.6	157.2	175.5
Per capita GDP (EUR)	4,530	5,640	6,380	7,370	8,270
Real GDP, yoy (%)	7.9	6.0	8.0	4.8	4.7
Inflation (CPI), yoy, eop. (%)	4.9	6.6	6.2	4.8	4.0
Inflation (CPI), yoy, avg. (%)	6.6	4.8	7.7	5.2	4.5
Unemployment rate, avg. (%)	5.4	4.3	4.0	4.0	4.1
Exchange rate RON/EUR, eop.	3.38	3.61	3.60	3.70	3.77
Exchange rate RON/EUR, avg.	3.52	3.33	3.62	3.65	3.73
Policy rate (Dec) ¹	8.75	7.50	10.25	9.50	8.00
1M ROBOR Dec	8.54	8.12	12.50	11.75	9.70
1M ROBOR avg.	8.73	7.85	11.75	12.10	10.70
Current account balance/GDP (%)	-10.4	-14.0	-13.5	-13.0	-12.5
FDI/GDP (%)	8.9	5.9	6.0	4.5	3.8
Consolidated government budget balance/GDP (%)	-1.5	-2.3	-3.2	-3.0	-3.0
Public debt/GDP (%) (ESA 95)	17.4	18.8	17.8	16.9	16.1
Total external debt/GDP (%) ²	29.2	31.7	37.1	37.4	38.2

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

- Romanian GDP expanded by a real 9.3 % yoy in Q2 2008 above market consensus. The good agricultural harvest in Q3 is expected to positively influence the performance of the economy, with some signs of a slowdown of growth more visible as from the last quarter of this year. Overall, growth is projected to peak at 8.0 % in 2008, with a more marked slowdown next year to 4.8 %.
- Following the peak of 9 % yoy, reached in July, August brought a monthly deflation and 1 % drop in the annual inflation rate driven by decreasing volatile food prices and declining oil prices on the inter-

national market. Inflation is set to slow to 6.2 % until the end of the year.

- Pressures on the external gap seemed to ease further in the first seven months of 2008, with the momentum of exports still outperforming that of imports. Given the observed moderation of the deficit and higher than initially expected GDP growth, the Romanian current account deficit is expected to slightly improve compared to last year, resulting in a full year gap of 13.5 % of GDP.

Cooling of economic growth likely

2008 election campaign launched

The government has finally set the date for parliamentary elections for November 30, 2008. The elections will be held for the first time in a uninominal system in 469 regional units, each of them represented in the Romanian Parliament by one person. The ballot will have only one voting round and in the electoral units where none of the candidates get a majority of votes, the proportional system will be applied.

As the parliamentary elections are drawing closer, some parties have announced their strategy for the most important political event of the year. President Basescu's new Democratic – Liberal Party (DLP), resulting from the merger of the Democratic Party with the Liberal Democratic Party, appointed Theodor Stolojan as its candidate for the position of prime minister. Meanwhile, the leftist Social Democratic Party (SDP) confirmed its alliance with the Conservative Party (CP). The minority ruling party NLP, which comes third in the electors' preference after the DLP and SDP according to the last poll, announced its partnership with the central Christian-Democratic National Peasants' Party (CDNPP).

According to the last Monitoring Report released in July, the European Commission acknowledged that the institutions which are most vital for a functioning judicial system are in place in Romania, but the foundation on which they rest is still fragile and decisions on high-level corruption are highly politicised. In addition, the EU considers the efforts of the DNA (National Anti-corruption Directorate) to be ineffective in respect of its preventive function as most of the high-level corruption cases have been delayed or have not been launched. No real progress has been made in the ten key cases involving former ministers, partly due to the Parliament, which has blocked the investigation, or due to the High Court of Cassation or Justice which overturned previous decisions.

After the EC report was issued, the Parliament took action and approved the request of the DNA (National Anti-corruption Directorate) to start investigations against two politicians, the former economy minister

Codrut Seres and the current labour minister Paul Pacuraru, although it had previously rejected a similar demand concerning two other politicians, former prime minister Adrian Nastase and former transportation minister Miron Mitrea.

As was recently also stressed by Fitch, creating the conditions for a healthy and more stable political environment with a focus on the implementation of structural reforms, institutional and infrastructural development remain essential in order to guarantee the country's long-term growth.

Good agricultural harvest to support economic growth this year

In Q2, Romania's real GDP growth further accelerated to 9.3 % yoy from 8.2 % in the previous three months on the back of still lively consumption and booming investments. Despite the buoyant growth, the soundness of its structure and its long-term sustainability remain questionable. The strong lending growth in H1 (61 % yoy) has significantly boosted retail trade and construction activity. Moreover, consumption has been supported by the fast growth of wages (up by 24 % yoy in Jan-July). On the other hand, the financial position of private households became gradually more strained on the back of higher interest rates, depreciated currency and soaring inflation. Overall, private consumption increased by 12.2 % yoy in Q2, following the record high of 14.3 % yoy in Q1.

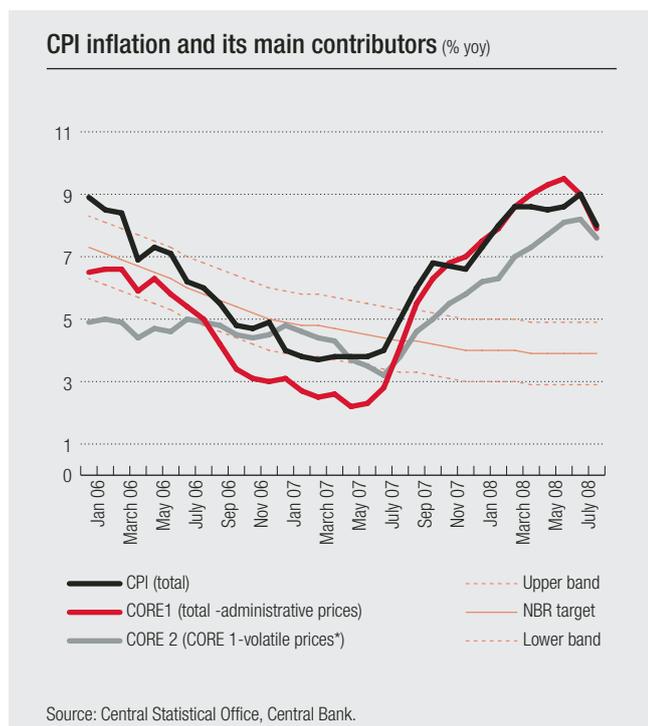
The strong rise in investments has also continued in Q2, driven mainly by new construction projects (34.8 %yoy), while investments in equipment slowed to 23.8 % yoy.

This development is also underlined by higher-than-expected inflows of FDI in H1, peaking at EUR 4.8 bn. M&A activity in Romania increased more than threefold to EUR 5.3 bn, mainly due to an increase in the value per deal. Manufacturing continues to be the most dynamic sector followed by real estate, wholesale and transportation. Statistical data show a well-balanced structure of investment by sector. In H1, the

Short-term indicators

	Aug-07	Sep-07	Oct-07	Nov-07	Dec-07	Jan-08	Feb-08	Mar-08	Apr-08	May-08	Jun-08	Jul-08	Aug-08
Real GDP, yoy (%) ¹		5.8	–	–	6.0	–	–	8.2	–	–	9.3	–	–
Industrial production, yoy (%)	–	6.1	3.6	3.9	–0.1	5.6	4.4	5.7	11.1	4.2	5.9	3.0	–
Inflation (CPI), yoy (%)	4.3	6.03	6.84	6.67	6.57	7.26	7.97	8.63	8.62	8.46	8.61	9.04	8.02
Unemployment rate (%)	4.96	3.9	4.1	4.2	4.1	4.3	4.3	4.2	3.9	3.8	3.8	3.8	–
Exchange rate/EUR, eop.	3.90	3.36	3.34	3.50	3.61	3.70	3.73	3.73	3.68	3.62	3.65	3.54	3.53
1M interbank rate, avg. (%)	3.27	7.18	7.65	7.97	8.12	8.61	10.24	10.55	12.04	11.05	11.47	11.46	12.42
Export (FOB), yoy (%)	6.99	12.7	24.9	12.2	15.6	19.8	22.2	2.9	24.4	20.2	21.1	20.8	–
Import (CIF), yoy (%)	8.7	23.7	29.5	23.2	7.9	12.9	16.7	10.7	26.0	9.4	17.5	14.2	–
Trade Balance, EUR mn	20.4	–1,696	–2,208	–2,255	–2,119	–1,413	–1,511	–1,992	–2,104	–1,783	–2,013	–1,887	–
Current account, EUR mn ^{1 2}	–1809	–11,192	–12,974	–14,976	–16,950	–1,064	–2,143	–3,374	–4,857	–6,335	–7,946	–9,401	–

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



fast growing construction sector absorbed 20 % of total investments in the economy; the bulk of investment was allocated to productive areas such as industry (36.3 %) and trade (28.3 %). Investment in agriculture contracted slightly compared to Q1, accounting for 4.8 % of total Romanian investments.

Some slowing of construction activity is however expected through the rest of the year, as also reflected by the recent stagnation in the momentum of prices for new housing and real estate transactions especially in the capital city. This is also reflected in the strong rise of the construction work index, which eased slightly to 29.2 % in July compared to the average 33 % yoy registered in H1 2008. Moreover, the number of new building permits issued showed a monthly decline in the last couple of months.

For the remaining part of the year, brisk growth is still expected, reinforced by the anticipated good agricultural output in Q3. However, some slowdown of growth might occur already as from Q4, mainly through an easing of consumption and construction activity, which supports our forecast for growth of 8.0 % for the whole year.

Disinflation to resume

Faster than expected GDP growth resulted in still strong aggregate demand pressures on prices, with a growing risk of a dangerous wage-prices spiral. The average growth of net wages further accelerated compared to last year, while the promised increase in the minimum statutory wage by a total of 20 % to RON 600 (EUR 160) contributed to greater pressure on mid-term inflation.

The relevance of excess demand pressure on prices is clearly reflected in the recent developments of CORE2 inflation (excluding administrative and volatile prices), which was down from its peak of 8.2 % in July

to 7.6 % yoy in August, mainly on the back of falling oil prices on the international market and a slight appreciation of the local currency. The disinflation process is however anticipated to gather momentum in the last part of the year, pointing to a year-end forecast of 6.2 %. We nonetheless see the chances for the central bank to meet its target of 3.5 % next year diminishing, with CPI inflation expected to remain above 4 % in the next two years.

Easing of monetary policy cycle only from the middle of next year

On July 31st, Romania's central bank decided to raise the key policy rate for the seventh time since last November to 10.25 % from 10 % on the grounds of rising concern for the fast credit growth and the growing risk of an overheating of the economy. To this end, the central bank has also introduced a new regulation aimed at capping the maximum level of indebtedness based on some stress testing.

Given the better than initially expected short-term inflation outlook, we do not see space for a further increase in the policy rate, with the easing cycle not anticipated to start before the middle of next year.

Risks for slacker fiscal performance driven by populist decisions

The growth rate of budget revenues slowed from the sharp rise registered at the beginning of the year to 36 % in the first seven months of 2008, to reach 20.3 % of GDP. This was mainly due to the disappearance of the base effect from lower VAT revenue at the beginning of last year. At the same time, expenditures surged by 44 % yoy to 20.9 % of GDP in the first seven months of 2008. As a result, the general government budget reached a deficit of 0.64 % of GDP, down from 1.18 % of GDP in H1 2008. The strongest contribution to the deficit came from the state budget, which expanded to 1.2 % of GDP (down from the peak of 1.7 % of GDP recorded in H1). On the other hand, the social security budget still managed to record a positive input, remaining in surplus, although its value diminished by 42 % compared to the same period of last year.

Although the government made an effort to promote a more prudent fiscal policy, the temptation to win more voters proved to be stronger. Consequently, the government decided to increase the benchmark index for calculating individual pensions by 20 % to RON 697.5 as of November earlier than originally planned. The benchmark index was already increased in November 2007 by 35 % and by another 7.5 % in January 2008. It will be further raised next January to complete the promised reform of the pension system aimed at bringing the average pension to 45 % of the average gross wage from the level of 35.5 % in November 2007.

Moreover, the government, trade unions and employers' associations signed an agreement on an increase of the gross monthly minimum wage from the current level of RON 500 to RON 540 as of October 1st, and on further raising it to the level of RON 600 on January 1st, 2009. Taking into account all these factors and a possible easing of fiscal policy in view of the forthcoming elections, risks for a widening of the budget deficit this year remain skewed on the upside, pointing to a deficit of 3.2 % for the whole of 2008.

External deficit slightly improving

The foreign trade gap (FOB/FOB) continued to widen although at a slower rate, surging by 7 % yoy in Jan-July, with export growth still outperforming the growth of imports. Inflows of foreign remittances slowed to 1 % yoy for the first seven months compared to the same period of last year due to worsening economic conditions in several EU countries, especially in Spain. The loss of jobs as a result of the slowdown in construction activity in these countries may therefore have a negative impact on the inflows of foreign currency that Romania is counting on this year. The strong slowdown of remittances and the deterioration of the income balance already resulted in a further widening of the current account gap by 12 % yoy in the first seven months of 2008, to EUR 9.4 bn.

Over the same period, FDI provided 61 % coverage of the current account gap. Equity holdings and reinvested profits accounted for 55 % of a total EUR 5.8 bn, while the rest of the capital inflows came in the form of inter-company loans. Based on statistical data from the Trade Register, the subscribed capital of foreign investors reached EUR 3 bn. This is more than double the EUR 1.3 bn recorded for the same period of last year.

The better than initially expected FDI attractiveness of the country despite the current deterioration of the global financial environment supports our view that the trade balance will improve in the next couple of years through an increase of the country's export capacity.

Still, Romania's pronounced reliance on external savings needs to be monitored, especially in the context of the rising cost of risk and higher exchange rate volatility.

Deficiencies in the allocation of EU funds

Despite its ambitious infrastructural plans, Romania's government continued to show a poor ability to administrate the EUR 5.8 bn funds allocated for the period 2007-2013. The improvement of the country's road network through an additional 160 km of motorways and repair work on 800 km of trunk roads and 1,300 km of secondary roads have been planned for completion by 2015. However, within less than 2 years of the launching the project, the government managed to realise less than 10 % of this ambitious project. Meanwhile, Romania announced the construction of a second bridge over the Danube that will link Romania with Bulgaria. The project will be made in cooperation with Bulgaria and will be financed with the pre-accession funds SAPARD and ISPA. Although 2010 has been set as the official deadline for the completion of the project, the Romanian government has just started organising the tender procedure to select the companies that will build the bridge. Other ambitious projects include Romania's involvement in the construction of the first high speed railways that will connect Constanta with Budapest, which is expected to be completed before 2015.

Nevertheless, some positive signals came from the great interest shown in the secondary roads rehabilitation programme, which is part of the Regional Operational Programme. The value of the submitted applications exceeds by 50 % the total amount available for the period 2007-2013. On the operational side, after receiving the first transfer of the EUR 1bn for the payment of the accepted structural projects, Romania is preparing the next audit reports necessary to receive further transfers, expected to be due at the end of the year.

Event	Date	Reading
Parliamentary election	Nov 30, 2008	Elections will be held for the first time in a uninominal system
CB Board Meeting	30 Oct 2008, 06 Jan 2009	We expect the policy rate to be kept on hold

Slovakia



Outlook

Strong economic growth is expected to continue, driven mainly by domestic demand. The global financial crises and slowing Eurozone economies are expected to have a limited impact. Continual improvement on the labour market should persist. However, a gradual exhausting of qualified labour could lead to excessive wage growth over a mid-term horizon and create additional inflationary pressure. Inflation should accelerate in 2009, pulled up by the one-off effect of the euro adoption and the continual price convergence of services. However, it should remain under control. The monetary stance is expected to follow the ECB in the rest of the year (until euro adoption). Fiscal policy should improve further, but we see increasing risks regarding the upcoming elections and relaxation of the tightening stance after euro adoption. The external position is expected to improve further backed by rising foreign trade.

MOODY'S LT FC RATING
A1/Positive

S&P'S LT FC RATING
A/Positive

FITCH LT FC RATING
A+/Stable

SPREAD AVG (SEP) 61
EMBI+ Spread on Euro Curve

Macroeconomic data and forecasts

	2006	2007	2008f	2009f	2010f
Nominal GDP (EUR bn)	44.6	54.8	66.0	74.9	81.2
Per capita GDP (EUR)	8,260	10,150	12,220	13,870	15,050
Real GDP, yoy (%)	8.5	10.4	7.5	6.0	5.6
Inflation (CPI), yoy, eop. (%)	4.2	3.4	3.6	4.4	3.5
Inflation (CPI), yoy, avg. (%)	4.5	2.8	4.2	4.1	3.7
Unemployment rate (avg.) (%)	10.4	8.4	7.4	7.0	6.8
Exchange rate SKK/EUR, eop.	34.57	33.60	30.13	EUR	EUR
Exchange rate SKK/EUR, avg.	37.25	33.78	31.24	EUR	EUR
2-week repo rate (Dec)	4.75	4.25	4.25	ECB	ECB
1M Interest rate (Dec BRIBOR – mid)	4.71	4.09	4.31	ECB	ECB
1M Interest rate (avg. BRIBOR – mid)	3.99	4.14	4.14	ECB	ECB
Current account balance/GDP (%)	-7.0	-5.3	-4.6	-4.0	-3.6
FDI/GDP (%)	7.5	3.8	3.7	3.7	3.3
Budget balance/GDP (%)	-3.6	-2.2	-2.0	-1.7	-0.8
Public debt/GDP (%)	30.4	29.4	28.8	27.8	26.5
Total external debt/GDP (%)	50.9	54.7	51.0	49.8	49.2

Source: National bank of Slovakia, Statistical Office of SR, National Labour Office, UniCredit Bank Market Research & Strategy.

Main topics

- GDP growth was in line with expectations in Q2, still clearly driven by domestic demand – mainly investments and government spending.
- Record employment growth was observed in the labour market. The strong koruna as well as increasing wages contributed to reversing the trend of labour moving abroad.
- Wage growth has slightly exceeded labour productivity growth for the second quarter in a row; however, inflation still remains under control, pulled up by cost and one-off factors. Demand-pulled inflation shows no signs of increasing demand pressures.
- The European institutions approved the adoption of the euro in Slovakia from January 2009. Koruna trading has calmed down and the koruna is currently moving in a close range of 30.250–30.400 SKK/EUR, gradually appreciating to the level of the conversion rate of 30.1260 SKK/EUR.
- The monetary stance is expected to follow ECB rate decisions, while the key interest rates are already balanced.
- A reasonable tightening of fiscal conditions should continue in the coming years to prevent the economy from overheating, however, there are some signs of a potential loosening stemming from the approaching elections in 2010.

Sound economic growth waiting for euro adoption

GDP growth still clearly driven by domestic demand

As expected, GDP growth slowed down slightly in Q2, to 7.6 % yoy from 8.7 % in the previous quarter. Despite that, Slovakia is still one of the EU countries with the quickest economic growth (behind Romania).

GDP was again clearly driven by domestic demand, while net exports remained at the level of last year. Despite this, however, the structure of GDP was healthier than in Q1. Contrary to Q1, investments and government spending (mostly driven by healthcare spending) pushed domestic demand up, while household consumption, as expected, calmed down and returned to reasonable growth of 5.7 % yoy. The higher investment activity could create a good basis for maintaining GDP growth dynamics in the coming years too. In Q2, however, it exerted further pressure on imports and despite the dynamic exporting, net exports did not succeed in contributing to GDP growth as much as was expected.

On the supply side, GDP growth was again driven mainly by manufacturing (especially by the increasing production capacities in the automotive and electrical industry).

2009-2010 – Dynamic growth in GDP should persist

Taking into account the enduring global financial crisis as well as the expected slowdown of Eurozone economies we decided to revise our GDP forecast slightly for the coming years, expecting a gradual decline in investment activity as well as slowing growth in foreign trade – with the latter, however, exerting no impact on GDP growth. We also reconsidered the effect of the increase in tobacco duty (which significantly influenced the figures in Q4 last year). As the increase in taxes was postponed from January to February 2009, the effect will most likely be distributed over 2 quarters – Q4 2008 and Q1 2009. Therefore, we now forecast GDP growth of 7.5 % yoy (from its previous 7.7 %), and anticipate a slowdown to 6.0 % in 2009 and then to 5.6 % yoy in 2010.

Despite the downward revision of GDP growth, Slovakia should still be one of the quickest growing economies in the EU. Economic expansion

will be driven mainly by domestic demand, which will also be supported by the approaching elections in 2010. However, a positive contribution to growth should also be recorded by net external demand, as we think that the slowing economic trends in most of the Eurozone economies (as the main trade partners of Slovakia) will be counterbalanced by the beneficial position of Slovakia as a production base of many EU companies (because production costs are still relatively lower).

Supply side of the economy still putting in healthy performance

Industrial production (IP) growth decelerated in Q2. However, with average yearly growth of 6.0 % in Jan–July 2008 it still remains lively. Furthermore, IP growth is still accompanied by double-digit annual growth in industrial sales (11.9 % yoy in the first seven months of the year).

IP is driven mainly by manufacturing growth followed by electricity, gas and water supply. On the other hand, mining and quarrying recorded a steep drop, mainly in the segment of energy materials mining, while the quarrying of non-energy materials is still producing dynamic development, pulled up mainly by the construction boom.

The growth in manufacturing is driven mainly by the automotive and electrical industry. However, the chemical industry has also showed a significant revival and double-digit year-on-year growth in the last few months. The strengthening of the koruna could be mentioned as the most important factor leading to a significant decline of production in the textile, leather and glass industries.

We still expect overall industrial production to maintain the relatively high dynamics of year-on-year growth (at 5–10 %) in H2 2008. The automotive and electrical equipment industry should stay the main drivers of future growth.

Construction booming, but with growing risks

Construction output continued to display dynamic growth, recording an average yearly rate of 11.0 % in Jan–Jul. 2008. It was driven both by

Short-term indicators

	Aug-07	Sep-07	Oct-07	Nov-07	Dec-07	Jan-08	Feb-08	Mar-08	Apr-08	May-08	Jun-08	Jul-08	Aug-08
Real GDP, yoy (%)	–	9.4	–	–	14.3	–	–	8.7	–	–	7.6	–	–
Industrial production, yoy (%)	4.8	12.1	12.6	12.3	6.3	8.6	11.8	1.6	9.8	3.1	6.2	1.8	–
Inflation (CPI), yoy (%)	2.3	2.8	3.3	3.1	3.4	3.8	4.0	4.2	4.3	4.6	4.6	4.8	5.0
Unemployment rate (%)	8.2	8.3	7.9	7.8	8.0	8.1	7.8	7.6	7.4	7.4	7.4	7.5	7.4
Exchange rate/EUR, eop.	33.74	33.87	33.36	33.38	33.60	33.67	32.80	32.61	32.24	30.24	30.31	30.39	30.31
1M BRIBOR mid, avg. (%)	4.14	4.16	4.14	4.14	4.09	4.13	4.08	4.07	4.09	4.12	4.12	4.06	4.13
Export (FOB), yoy (%)	15.2	19.6	23.6	24.7	14.9	18.6	28.8	10.0	26.0	12.7	24.7	18.2	–
Import (FOB), yoy (%)	17.2	8.5	18.8	20.0	14.4	24.4	28.1	10.3	32.9	7.3	20.7	20.6	–
Trade Balance, EUR mn	–173	108	22	–139	–347	58	5	–57	–199	92	–25	–138	–
Current account, EUR mn	–140	–108	–439	–423	–308	–33	127	–296	–484	–340	–484	–	–

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

new construction and repairs, mainly in the segment of buildings, while the segment of civil engineering surprisingly stagnated or slightly decreased.

We expect the construction boom to continue in H2 backed by new real-estate projects as well as the expected recovery of investment activity in the economy, but also supported by the lower base effect from last year. However, the enduring global financial crisis will be one of the main threats to the construction sector in Slovakia as well. We can already see some signs of the credit squeeze in the real estate segment, as developers are financing their activities through their own resources (a significant decline in real estate deposits was recorded in recent months).

Despite increasing risks in the building segment, construction output should maintain its relatively dynamic growth in the coming years, driven by a new boom in the civil engineering segment supported by Public Private Partnership (PPP) and EU funds.

Employment continues to show record growth...

Economic growth is still able to generate new jobs. Employment under ESA 95 methodology (domestic rules) accelerated to 2.9 % (+63,100 people annually) in Q2, the highest growth since 1995 (when the time series started). There were, therefore, about 2,227,000 employees in the domestic economy.

Workers beginning to return from abroad

Strong growth in employment under the national methodology was observed in Q2 (reaching 2.9 % yoy), while there was also a reversal of the trend in people leaving to work in foreign countries (-8,500 yoy or -4.9 % yoy). We identify two main factors in this change of trend – the heavily appreciating koruna, backed by the depreciating British pound, and the increasing demand for qualified labour in the domestic economy, which pushed up pressure on wages.

Unemployment at historical low

Growing employment resulted in a significant decline of unemployment. However, as expected, the yearly decline in unemployment has slowed. The jobless rate based on Labour office statistics declined to a new historical low of 7.36 % in August, 0.83 pp lower than in the same period of the previous year. We expect the unemployment rate to continue falling to 6.8 % in 2010. This could be close to the natural level of unemployment, which (by our estimate) is around 5–6 % in Slovakia in the mid to long term. As the growing economy will require new and qualified labour, Slovakia could face labour market problems over a mid-term horizon, potentially leading to excessive wage growth or the importing of labour from “cheaper” non-EU countries.

Wage growth remains dynamic

The average gross monthly wage reached SKK 21,459 (EUR 683) in Q2, recording annual growth of 9.5 %. This means real wage growth was 4.8 % yoy and thus exceeded real labour productivity growth of 4.6 % yoy (for the second quarter in a row). Despite this, we do not consider wage growth to be unhealthy. We think there is still a cushion for future wage growth as labour productivity has exceeded wage growth for several quarters.

The growth in wages was driven mainly by healthcare services (up 14.1 % yoy) followed by mining, quarrying and real estate and other business services (up by 13.2 %). Real wages increased in all economic branches except for financial intermediation, hotels & restaurants and transportation & communication.

Retail sales return to normal trend

After exhibiting record growth at the beginning of 2008 (driven mainly by long-term consumption goods), retail sales slowed down in Q2. Nevertheless, retail sales growth remained lively at 9.5 % yoy in Jan-July 2008. The stabilisation of retail sales growth at 6–7 % in recent months could indicate healthier GDP growth (with reasonable household consumption) in Q3.

Inflation continues to accelerate...

Inflation (CPI growth – national methodology) accelerated again in recent months, hitting a 2-year maximum in August (5.0 % yoy). However, the drivers of inflation changed in the summer months. As expected, the pressure coming from food and oil prices has relaxed and both these items recorded a monthly decline in prices as well as a gradual deceleration of annual growth dynamics. On the other hand, inflation was negatively influenced by one-off effects in July-August, such as the unexpected increase in office materials (increasing overall yearly inflation by 0.1 pp in July) and imputed rentals (increasing overall yearly inflation by 0.3 pp in August).

Demand-pulled inflation (measured by prices of market services excluding imputed rentals – UniCredit Bank estimate) speeded up only slightly to 3.6 % yoy in August – which, however, is still far behind average price growth.

Slovakia safely fulfilled the Maastricht inflation criterion after the evaluation period too, although the gap has gradually been narrowing. Despite the current acceleration, Slovakia is still able to keep its inflation relatively under control and close to the EU average under the harmonised methodology. Despite this we still expect that Slovakia will follow the example of Slovenia and Cyprus. Therefore, after adopting the euro, inflation will exceed the Maastricht level, although not as dramatically as in the case of Slovenia.

... but inflation should not surge after euro adoption

Inflation should be pulled up by the increase in tobacco prices (due to hike in the duty on tobacco) in September-October 2008. On the other hand, the gradual deceleration in annual growth of food and partially also fuel prices should continue in the autumn too (driven by base effects). Furthermore, the massive strengthening of the koruna in the spring months could soften price growth, especially of consumer goods, in H2. Therefore, we reckon inflation already peaked in August. Since the regulatory office refused the gas price hike proposal (which was already included in our previous scenario), we decided to revise the year-end inflation forecast from 4.3 % to 3.6 % yoy. However, SPP (gas company) has in the meantime delivered a new proposal to the regulatory office (for a 20 % gas price hike). In our opinion, this second one will most likely be refused again, or postponed to the beginning of next year. However, if the regulatory office does approve it, this could increase yearly inflation by 0.9 pp (in a worst-case scenario).

2009 will be the first year of the euro in Slovakia. Most likely, similarly to other countries, Slovak inflation will thus have to suffer the “costs” of euro adoption – due to the rounding effect (estimated to be 0.2–0.3 pp) or the missing FX pass-through. However, we do not expect significant pressure to come from price convergence after adopting the euro, while the prices of durables and semi-durable goods are already almost at the level of the EU average. Some pressure may be visible in service prices, but we think this is more a question of the economy catching up than of the euro adoption. Thus we expect average inflation to accelerate to 4.1 % in 2009, before slowing down to 3.7 % in 2010. Over a mid-term horizon, inflation could stabilise at 3.0–3.5 %, reflecting the increasing pressure on service prices stemming from increasing living standards and price convergence, as service prices were only 46.2 % of the EU average in 2007.

Done deal – koruna market already dead

As expected, the approval process for adopting the euro was successfully completed at the beginning of July (8th) with the final approval of the European Council of Ministers of Economy and Finance. The conversion rate was set at the level of the actual central parity – 30.1260 SKK/€. As most of the market was expecting the conversion rate to be set at that level, the koruna remained stable. At the same time, it most definitely stepped out of the V4 region and ignored all the sudden movements of the other regional currencies, reflecting only daily trading volatility and interest rate spread changes (against the Eurozone). The koruna has thus been moving in a tight range of 30.250–30.400 SKK/EUR since the second parity revaluation at the end of May.

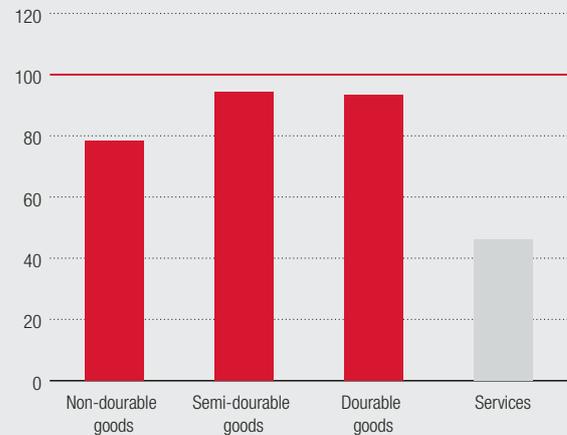
Monetary policy in hands of ECB

The Central Bank did not change its key interest rates in H1, which remain at 4.25 %. The economy is sending neutral or slightly hawkish signals towards monetary policy. However, as the euro adoption was confirmed and the economy is urgently calling for a change in monetary conditions, we reckon the NBS will follow the ECB's rate decisions. The Eurozone and Slovak key interest rates are now balanced. However, convergence is expected to continue in interbank rates, as the Slovak interest rate curve is still 35-75 bps below the Eurozone's (the Slovak market, contrary to the Eurozone one, has a liquidity surplus).

State budget still under control

The state budget recorded a surplus of SKK 5.1 bn as of end-August, which is SKK 4.7 bn better than in the same period of 2007. Contrary to previous years this positive budget development is not driven by the higher-than-planned collection of taxes, but rather by savings on the expenditure side of the budget. The status of expenditure is one of the lowest since 1998, reaching only 55.7 % of the yearly plan (as of August). However, we have to note that the main part of spending takes place in the last month of the year.

Comparative price levels of goods and services in Slovakia compared to EU average (EU = 100)



Source: Eurostat, UniCredit Bank Slovakia Market Research & Strategy

Revenues ended August at 62.2 % of the yearly plan and fell behind the pro rata target. While corporate taxes have again exceeded expectations, the main fallout was recorded in VAT and excise taxes, chiefly as a result of tobacco stockpiling at the end of 2007. As the increase in the duty on tobacco has also been approved for next year, we expect a recovery in the collection of those taxes in H2, which could stabilise revenues. If the state succeeds in maintaining discipline on the expenditure side of the budget, the year-end public finance deficit could probably come in below the budgeted level of 2.3 % of GDP again.

No improvement in foreign trade

The foreign trade result surprised on the downside in H1. The cumulative foreign trade (FT) deficit reached SKK 8.3 bn as of July, which is SKK 4.5 bn higher than in the same period last year. There are several factors behind the weaker FT results. The most important are the Eurozone slowdown and the increasing investment activity or preparations for new production activities, mainly in the automotive and electrical eq. industry. We still expect an improvement in foreign trade in H2, driven by better export performance and decreasing pressure on the import side. Overall, foreign trade is expected to be balanced this year.

The current account (CA) deficit was in line with our expectations in H1. Worse FT results in recent months were compensated by the lower outflow of dividends, but we expect the CA to be revised in the coming months (as it was in previous years). The anticipated improvement of FT in H2 and stable repatriations of profit could keep the CA at the level of our previous scenario, i.e. 4.6 % of GDP in 2008.

Event	Date	Reading
Wage growth	4 Dec	Continued wage growth in excess of labour productivity growth could create pressures for fiscal tightening. As this is unlikely considering the upcoming elections (2010), it could create unwished demand-pulled inflation pressure
State budget 2009–2011 proposal	3 Nov, 1 Dec	Possible relaxation of fiscal stance after euro adoption, supported by approaching elections in 2010

Slovenia



Outlook

The global outlook has worsened in recent months, and this will take its toll on the Slovenian economy very soon, despite the positive performance during the first part of the year. Growth in 2009 will not be higher than 4 %. The Slovenian economy will only gradually see an acceleration of growth in 2010, in line with our expectations for the other EU countries (two-thirds of Slovenian exports go to EU countries). Inflation rates have started to improve. However, inflation is much higher than in the other EMU countries, and disinflation will only be gradual. The elections held on 21 September resulted in the victory of Pahor's Social Democratic Party, immediately followed by the party led by the outgoing prime minister, Jansa. The Social Democrats will form a coalition government, but they will have to make an agreement with the Pensioners' Party (which now has its foot in the door of the political arena) to achieve an absolute majority and form a government.

MOODY'S LT FC RATING
Aa2/Positive

S&P'S LT FC RATING
AA/Stable

FITCH LT FC RATING
AA/Stable

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

Macroeconomic data and forecasts

	2006	2007	2008f	2009f	2010f
Nominal GDP (EUR bn)	30.5	33.5	37.6	41.2	44.9
Per capita GDP (EUR)	15,170	16,690	18,680	20,470	22,240
Real GDP, yoy (%)	5.7	6.1	5.1	4.0	4.4
Inflation (CPI) yoy, eop. (%)	2.8	5.6	6.4	4.6	3.9
Inflation (CPI) yoy, avg. (%)	2.5	3.6	6.6	5.5	4.3
Unemployment rate, avg. (%)	6.0	4.9	5.0	5.0	4.8
Exchange rate SIT/EUR, eop./avg.	239.6	EUR	EUR	EUR	EUR
Reference rate (ECB)	3.75	4.00	4.25	3.75	3.75
Interest rate (3M interbank rate, eop.)	3.57	4.85	4.90	4.15	3.95
Interest rate (3M interbank rate, avg.)	3.44	4.28	4.80	4.39	4.02
Current account balance/GDP (%)	-2.8	-4.9	-5.1	-5.0	-4.9
FDI/GDP (%)	1.7	3.2	2.7	2.4	3.1
Budget balance/GDP (%)	-1.2	-0.1	-0.3	-0.3	-0.3
Public debt/GDP (%)	27.2	24.1	24.0	23.8	23.7

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

Main topics

- In the parliamentary elections held on 21 September, the opposition Social Democratic Party (led by Borut Pahor) won the majority of votes and will probably be able to form a coalition government. However, the balance of power is now in the hands of the Pensioners' Party, which won the seven seats that are necessary for Pahor's coalition to attain the parliamentary majority.
- Growth in the second quarter was better than expected (+5.5 %) thanks to an increase in consumption and some recovery in net exports. However, industrial production is already showing clear signs of weakness, and the international scenario is also not supportive.
- The inflation rate dropped to 6 % in August following the highs in June, when it reached its highest level since 1992. It is still the highest rate among the fifteen countries in the eurozone.
- The current account deficit widened in the first part of the year, with the main source of financing remaining bank loans from abroad.

Growth is still resilient; the political landscape is changing

A new coalition following September elections

In the parliamentary elections held on 21 September, the Social Democrats, led by Borut Pahor, won most of the votes, immediately followed by Jansa's Slovenian Democratic Party, which was the major party in the outgoing four-year centre-right administration. Pahor's party (in favour of a stronger welfare system) tripled the percentages it obtained four years ago. According to preliminary data, the Social Democrats and their allies, the Liberals and the Liberal-Democrats, now control 43 of the 90 seats in the Slovenian parliament (hence three seats less than necessary for an absolute majority). The balance of power is now in the hands of the Pensioners' Party (previously in Jansa's coalition), which won the seven seats that are necessary for Pahor's coalition to attain the parliamentary majority. Talks with the Pensioners' Party will not be easy and will take time.

Growth set to decelerate

The global outlook has worsened further in recent months, but the effects on the Slovenian economy are not yet fully visible. Slovenian GDP growth in Q2 was 5.5 %, showing marginal acceleration compared to the previous quarter (Q1 was +5.4 % yoy). The main drivers of growth have been an increase in domestic consumption and an improvement in the external balance, resulting from both a marginal increase in exports and a decline in imports. Investment growth, however, dropped from 17.3 % in Q1 to 10.9 % in Q2. On the supply side, the contribution to GDP by the manufacturing sector more than doubled in comparison to the first quarter of 2008, while the contribution by the construction industry decreased by half.

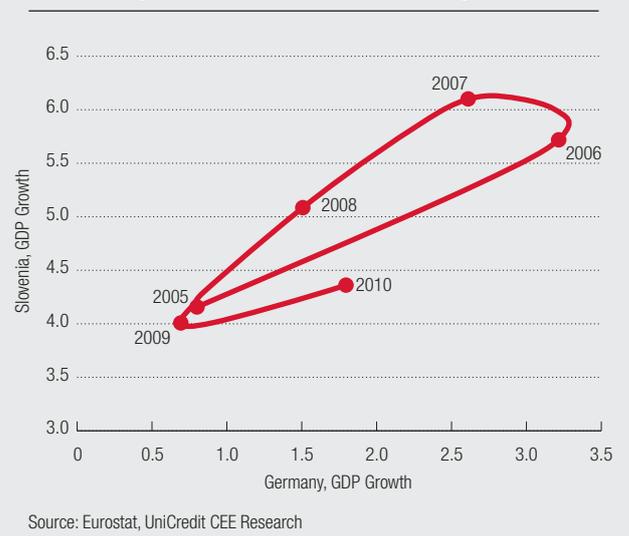
More recent data indicate a worsening of economic conditions: Industrial production fell in July (-4.6 % yoy, the largest decrease in the last five years), suggesting that the economy will slow down very soon; however, high growth in retail sales and positive employment data are both signs that the slowdown is not likely to be dramatic.

We forecast that real GDP growth will be lower in the remaining quarters of 2008 and will settle at around 4 % in 2009. The recovery in 2010 will be mild, following the pattern of German recovery (see chart), considering the fact that two-thirds of Slovenian exports are destined for EU member states and 30 % of them go to Germany.

Falling inflation rates

The inflation rate dropped more than expected in August, when it was at 6 % yoy as a result of decreasing pressure on food and energy prices (-1.8 % and -4.2 %, respectively, in comparison to the previous month). This was the lowest rate this year, but it is still the highest

Economic growth in Slovenia and Germany



among the fifteen countries in the eurozone. We expect inflationary pressure to fade away only over the next few years, again in the wake of the other EU member states.

In the meantime, during the first half of 2008 the government accumulated a fiscal surplus, outperforming the result achieved in the same period of 2007, when a deficit occurred. The performance can be attributed to a 13 % increase in revenues, mainly driven by non-tax revenues, while expenditures were up by only 8.6 %.

Worsening external imbalances

The current account deficit remained high in the first half of the year: It more than doubled in comparison to the same period in 2007. Foreign direct investments in Slovenia increased significantly (+56.8 %); however, bank loans from abroad, which increased by 61 %, are still the major contributor when it comes to financing the current account deficit (contributing double the amount they did last year). We should bear in mind the fact that Slovenian corporations financed around a quarter of their credit needs through cross-border loans in 2007. We expect that the current account deficit will not ease significantly in the next two years, given the anticipated demand for imports. The current account deficit will be financed to a higher degree by portfolio inflows (because of future privatisations via IPOs), while the growth of bank loans will decelerate as a result of the credit squeeze at the international level.

Event	Date	Reading
Q3 GDP growth	11 Dec.	We expect some slowdown following the strong performance in Q1 and Q2.

Croatia



Outlook

The Croatian economy looks set to continue slowing during 2008 and 2009: industrial production and retail sales are already weak, credit growth is sluggish (given the 12% nominal administrative limit imposed by regulators) and the international environment is not supportive either. At the same time, inflation appears, as expected, to have peaked in July and should end the year slightly higher than 5.0% yoy. The recent drop in oil prices is a key factor behind this scenario. In the meantime, however, the current account deficit should widen to approximately 10% of GDP this year as the impact of higher oil prices in H1 2008 and a widening income deficit on profit repatriation and higher interest payments feed through. Hence, there is no prospect of looser monetary policy settings in the near term. Nonetheless combined FDI and medium and long-term credit inflows will comfortably cover the current account balance. Thus, the kuna will remain exposed to appreciation pressures.

MOODY'S LT FC RATING
Baa3/Positive

S&P'S LT FC RATING
BBB/Stable

FITCH LT FC RATING
BBB-/Stable

SPREAD AVG (SEP) 138
EMBI+ Spread on Euro Curve

Macroeconomic data and forecasts

	2006	2007	2008f	2009f	2010f
Nominal GDP (EUR bn)	34.2	37.5	41.8	45.0	48.3
Per capita GDP (EUR)	7,710	8,450	9,410	10,140	10,900
Real GDP, yoy (%)	4.8	5.8	3.7	3.2	4.0
Inflation (CPI), yoy, Dec. (%)	2.0	5.8	5.1	3.9	2.7
Inflation (CPI) yoy, avg. (%)	3.2	2.9	6.5	4.1	3.0
Unemployment rate, avg. (%)	11.2	9.6	9.1	8.7	8.4
Exchange rate HRK/EUR, eop.	7.35	7.33	7.28	7.25	7.25
Exchange rate HRK/EUR, avg.	7.32	7.34	7.26	7.23	7.20
1w Zibor, avg. of Dec.	3.84	6.69	5.80	5.50	5.35
1w Zibor, avg. of the year	3.28	5.49	5.10	5.25	5.15
Current account balance/GDP (%)	-7.9	-8.6	-10.3	-8.9	-8.0
FDI/GDP (%)	8.0	9.6	8.4	7.3	7.7
Budget balance/GDP (%) ¹	-3.0	-2.3	-1.4	-1.7	-1.9
Public debt/GDP (%)	41.0	38.9	37.4	37.3	37.5
Total external debt/GDP (%)	85.5	88.6	89.1	89.4	89.4

Sources: CNB, CBS, Zagrebacka Banka Research – CEE Research Network; 1) ESA 95 from 2008.

Main topics

- Consumer prices peaked at 8.4 % yoy in July and look set to moderate to 5.1 % yoy by December as the impacts of lower oil prices, efforts to coerce retailers into lower margins and a high base effect combine.
- While retail sales, credit growth and industrial production data suggest slowing domestic demand, construction data points the other way. All told we reckon domestic demand will moderate and forecast a growth rate in 2008 of 3.7 % yoy.
- Higher oil prices and a higher income deficit will see the current account deficit rise to over 10 % of GDP this year. Nonetheless, the currency will remain exposed to appreciation pressures since FDI and credit inflows will remain high and comfortably cover the deficit.
- Tax revenue growth remained strong in H1 2008; with economic growth slowing, however, the prospect of the government balancing the budget without enacting some painful reforms looks optimistic. Croatia's economic imbalances expose it to greater risks as the international economic environment deteriorates and investor sentiment focuses more closely on economic fundamentals.

Current account deficit to come into focus as headline inflation moderates

Most indicators point to slowing growth

Second quarter growth slowed to 3.4 % yoy, with private consumption slowing to 2.2 % yoy. At the same time government consumption rose 3.2 % yoy. Domestic demand contributed 6.5 % to growth in Q2 2008 on strong investment activity, however, rising imports saw the contribution of net exports to GDP of -3.2 %. Growth in H1 2008 was thus 3.8 % yoy. On balance the data released for the beginning of Q3 point to a further decline in growth. Retail sales data points to softening consumer spending. In July, retail sales actually fell 0.1 % yoy. At the same time, data from the central bank showed that consumer overdraft debt rose 17.5 % yoy at the end of June 2008. Up until July, new car registrations were up 12.5 % yoy, but in August there was a sharp drop of over 40 % yoy in new car registrations. Even though there is a strong negative seasonal effect associated with new car sales in August, the drop this year was larger than expected.

Another indicator of headwinds for private consumption is the slowdown in credit activity in real terms (given the 12 % administrative limit on nominal credit growth). In real terms the rate of growth is only 5.4 % yoy. This compares to a growth rate in real terms of 18.1 % yoy in the corresponding period last year. In addition, by mid-September assets under management were down almost 50 % since the beginning of the year, which will also impact adversely on private consumption.

Investment spending in Q2 2008 rose a robust 12.6 % yoy, supported by consistently strong construction activity. The index of construction activity expanded 13.9 % yoy in Q2 2008 after having increased 10.2 % in Q1. Industrial production rose 1.8 % yoy in July and fell 4.6 % yoy in August. In the first 8 months of this year industrial production expanded 2.8 % yoy. The August result was influenced by a large working day effect, however, even adjusting for this the data still points to a moderation in industrial production activity. At the same time, the inventory of finished industrial goods rose sharply in July and August (8.1 % yoy the most recent reading). This points to weaker domestic and external demand.

Construction remains the one sector which throughout 2008 has been consistently strong. In July construction activity showed renewed strength, rising 15.0 % yoy. The number of new apartments completed in H1 2008 was up 60.3 % yoy. There were also 4.8 % more new apartments under construction in H1 2008 compared to the corresponding period last year. Nonetheless, there is increasing anecdotal evidence of more challenging times ahead for the construction industry. There are more and more completed but unsold apartments than before, while the number of construction permits issued for buildings in the first seven months of this year was down 17.2 % yoy. While employment growth and construction activity point one way, wage growth, industrial production and retail sales data suggest slowing domestic demand, prompting us to lower our growth forecast for 2008 to 3.7 %, while for 2009 we forecast 3.2 % yoy as the external economic environment worsens.

External imbalances widen

Higher oil prices over the course of H1 2008 have played an important role in the widening of Croatia's goods trade deficit. In the first 8 months of this year the goods trade deficit has risen 18.0 % to EUR 7.7 bn. Growth in goods imports over this period was 13.7 % to EUR 12.4 bn while oil imports rose 39.3 % to EUR 1.6 bn. The fall in oil prices since August will see the growth of the oil import bill slow, which in turn will restrain the rise of the goods trading deficit. Imports excluding oil have been declining all year and in the seven months to July rose 10.7 % yoy to EUR 10.8 bn.

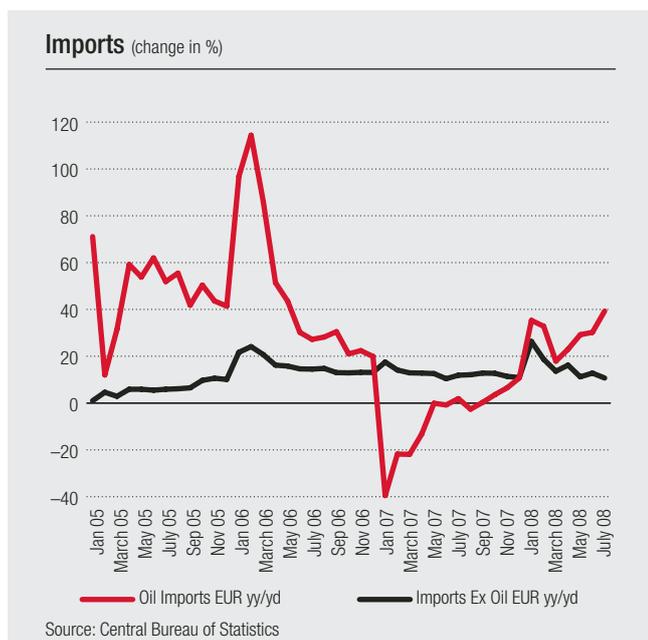
Goods exports were up 8.6 % yoy in the first seven months of this year but the tougher international economic environment is showing signs of impacting on export growth.

Balance of payments data for Q2 2008 revealed a current account deficit of EUR 1.8 bn (up 31.5 % yoy), which meant that for the 12 months to June 2008 the current account deficit amounted to EUR 4.17 bn, or 10.0 % of GDP. Higher oil prices were a major driver of the

Short-term indicators

	Aug-07	Sep-07	Oct-07	Nov-07	Dec-07	Jan-08	Feb-08	Mar-08	Apr-08	May-08	Jun-08	Jul-08	Aug-08
Real GDP, yoy (%)	-	5.1	-	-	3.7	-	-	4.3	-	-	3.4	-	-
Industrial production, yoy (%)	2.8	2.1	5.5	2.5	1.4	6.7	8.1	0.2	6.9	-2.1	7.2	1.8	-4.6
Inflation (CPI), yoy (%)	2.6	3.9	4.3	4.6	5.8	6.2	5.8	5.7	5.7	6.4	7.6	8.4	7.4
Unemployment rate (%)	-	8.4	-	-	9.7	-	-	10.0	-	-	-	-	-
Exchange rate, HRK/EUR, eop.	7.32	7.28	7.35	7.31	7.33	7.25	7.28	7.26	7.26	7.25	7.25	7.22	7.16
1W Zibor, avg.	4.5	5.6	7.7	8.3	6.7	7.5	5.4	4.3	4.1	4.6	4.1	5.0	4.9
Export, (FOB) yoy (%)	7.9	7.4	13.0	12.6	-10.9	19.7	9.5	-2.0	10.7	9.4	3.3	11.8	-
Import, (CIF) yoy (%)	5.9	6.6	14.0	12.7	6.0	27.4	13.7	4.0	22.9	3.3	22.1	12.1	-
Trade Balance, EUR mn	-809	-760	-918	-859	-762	-820	-876	-987	-1.153	-957	-1.102	-937	-
Current account, EUR mn	-	2.073	-	-	-1.910	-	-	-2.523	-	-	-1.809	-	-

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



widening in the current account deficit. Q2 service exports were up 15.5 % yoy to EUR2.55 bn reflecting a solid tourist pre-season, suggesting another successful peak season in Q3.

Given the tightening of global financial conditions and the income deficit of the current account rose to EUR 791 mn during the second quarter. 3Q merchandise trade data so far suggests the goods deficit will eat into the surplus generated by tourism, so that while falling oil prices will help in 4Q to limit the current account deficit, for full year 2008 we expect the current account deficit to increase to 10.3 % of GDP.

On the financing side, net foreign direct investment inflows in the first half of the year were EUR 1.8 bn. With MOL's bid for an increased stake in local oil and gas company INA set to be completed in mid-October, FDI inflows in 2008 will cover the vast majority of the current account deficit.

Foreign debt data is available for the first seven months of the year. Over this time, foreign debt increased from EUR 2.2 bn to EUR 35.4 bn. Compared to the end of 2007, total short-term debt has risen EUR 0.9 bn, most of which is the result of short-term borrowing by enterprises; at the same time, long-term borrowing by the banking sector has fallen by an equivalent amount. Enterprises have increased borrowing by almost EUR 2.2 bn in the first seven months of the year, while the stock of government long-term foreign debt was down EUR 500 mn over the period. The summer months usually see a seasonal lull in foreign debt accumulation, but we nonetheless forecast an increase in the foreign debt stock of EUR 4 bn to EUR 37.2 bn by the end of 2008, implying that as a percentage of GDP foreign debt stock will rise to 89.1 %.

Inflation begins to moderate

As expected, consumer price inflation peaked in July at 8.4 % yoy while in August it was 7.4 % yoy. The fall in oil prices, which commenced in August, was one of the main factors behind the moderating

inflation rate. In addition, the government has again resorted to moral persuasion in an effort to lower food prices in September, which could be reflected, in the short term at least, in lower inflation.

Core inflation data from the Central Bank for June revealed a jump from 5.6 % yoy in May to 6.5 % yoy with the price of services being the main driver, having increased 2.3 % mom. Our calculations for July and August suggest a slight moderation in the core inflation rate toward 6.0 % yoy. Core inflation was essentially stable throughout 2008 at around 5.0 % yoy until the June increase.

By the end of 2008 we expect the headline inflation rate to moderate to 5.1 % yoy. The base effect (inflationary pressures became more apparent from August 2007), lower oil prices and efforts by the government to coerce retailers into lowering margins will all work in that direction. At the same time, there are a number of risks to the inflation outlook.

So far, wage developments on aggregate have been constructive. Labour productivity in the industrial sector rose 5.3 % in the first seven months of the year while real gross wages increased by only 0.9 % yoy (in H1 2008). Nonetheless, with wage growth having largely been subdued over the past year, there is a risk that this may not continue to be the case. The second risk is regulated prices, specifically gas prices. Government ministers have hinted that gas prices will not rise this year. However, gas prices have not increased in a number of years, and domestic gas prices will eventually have to reflect global trends. All in all, we see inflation averaging at 6.5 % in 2008 and moderating to 4.1 % in 2009.

Tight monetary policy will remain in place

Irrespective of the latest turbulence in the international financial markets, monetary policy in Croatia will remain tight. Indeed, on 22 September the central bank rejected all bids at its reverse repo auction. On 25 September the HNB announced cash in bank vaults would no longer counts towards maintaining reserve requirements from 9 October. This means banks will have to cover the HRK 2.6 bn shortfall caused by this decision in the market, which has pushed the 1 week Zibor rate towards 8.50 % at the end of September.

In the meantime, the EUR/HRK has been at record lows around 7.10 during September, mainly as a result of MOL's bid for an increased stake in local oil and gas company INA. Once the transaction is completed in mid-October we expect to see the EUR/HRK head back over 7.20, however, the HNB's announcement it would use FX interventions around the time of the transaction could limit upside potential for the EUR/HRK.

In H1 2008 the government's fiscal position continued to benefit from solid revenue growth, with tax revenues rising 11.3 % yoy for the consolidated general government. Income and profit taxes rose 15.4 % yoy over this period, reflecting the increase in employment as well solid profit growth recorded last year by the private sector, while VAT revenues were up 13.3 % yoy.

On the expenditure side, current spending in H1 2008 was up 10.2 % yoy. The public sector wage bill was up 8.6 % yoy and interest pay-

ments rose by a moderate 7.5 % yoy. Subsidies however, increased by a staggering 22.8 % yoy (well before any decision on how to handle shipyards in the face of EU pressure for reform) and social welfare spending rose 8.1 %. Our assessment of the fiscal position is unchanged: the budget deficit remains low for now, but is undoubtedly exposed to the risk of deterioration as revenue growth slows in response to moderating economic growth. An acceleration of reform initiatives would enable the government to lower expenditures, while also facilitating the achievement of EU accession requirements. At the same time the Central Bank is in a position to ease monetary policy settings substantially if required to bolster growth.

EU accession talks: encouragement from Brussels

In mid-September EU Enlargement Commissioner Rehn and EU Commission President Barroso both stated Croatia could complete negotia-

tions on EU accession talks during 2009. Apart from providing encouragement to policymakers, government and opposition politicians to argue the virtues of reform initiatives, such support firms up investor sentiment towards Croatia, just as the latest phase of the international financial sector's difficulties takes hold. Yet as 2009 approaches, chapters, including the most difficult ones, will have to be opened on a regular basis to avoid disappointment.

Although Croatia's economy is not as exposed to the risk of a hard landing as some other Central Eastern European economies, its imbalances in the current international environment do mean it is more at risk than before. In such an environment, the consistent implementation of reforms, which carry the bonus of completing the technical aspects of EU accession next year, appears the ideal course for maintaining investor confidence.

Event	Date	Reading
Opening of remaining acquis communautaire chapters	2H 2008	If Croatia succeeds this will be a very important step to ensuring it completes the technical phase of EU accession talks during 2009

Turkey



Outlook

The non-closure decision of the Constitutional Court regarding the AKP case was a big relief for the markets. However, the positive mood prevailed only for a couple of weeks before the markets fell victim to the global crisis. The slowdown in economic growth became more visible in the second quarter, mostly due to the sluggish domestic demand. The second half of the year will probably not be so different from the first half as regards growth performance. However, declining commodity prices, weak domestic demand and a stable currency are expected to limit price increases. The financing of the current account deficit is another hot topic on the agenda, as the share of non-debt financing is coming down, though not at an alarming rate.

MOODY'S LT FC RATING
Ba3/Stable

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

FITCH LT FC RATING
BB-/Stable

SPREAD AVG (SEP) 232
EMBI+ Spread on Euro Curve

Macroeconomic data and forecasts

	2006	2007	2008f	2009f	2010f
Nominal GDP (EUR bn)	419.2	477.9	531.1	607.2	662.8
Per capita GDP (EUR)	5,950	6,770	7,500	8,550	9,310
Real GDP, yoy (%)	6.9	4.6	4.2	4.6	5.5
Inflation (CPI), yoy, eop. (%)	9.7	8.4	11.0	7.8	6.8
Inflation (CPI), yoy, avg. (%)	9.6	8.8	10.5	9.0	7.3
Unemployment rate (%)	9.9	9.9	10.5	10.0	9.5
Exchange rate TRY/EUR, eop.	1.860	1.714	1.813	1.877	1.950
Exchange rate TRY/EUR, avg.	1.809	1.786	1.851	1.845	1.913
Reference rate (O/N, simple), eop.	17.50	15.75	16.75	15.75	14.25
Reference rate, compound yearly avg. (%)	16.93	18.81	17.52	17.64	16.18
Current account balance/GDP (%)	-6.1	-5.8	-6.5	-6.7	-6.8
FDI/GDP (%)	3.8	3.4	1.5	1.6	1.7
Budget balance/GDP (%)	-0.6	-1.6	-1.6	-1.4	-1.3
Primary surplus/GDP(%)	5.4	4.1	4.1	3.7	3.0
Public debt/GDP (%)	48.2	41.6	37.5	35.0	32.6

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

Main topics

- The possible impacts of developments in global financial markets are being watched carefully. Although there are no imminent problems at the moment, the developments are making market players quite nervous, as is the case all around the world.
- 2008 Q2 GDP growth slowed down to 1.9 %, the lowest since 2002 Q1. Industrial production figures indicate that the third quarter will not be overly different from the previous one.
- The increase in annual inflation stopped in August thanks to the fall in commodity prices and the strong YTL. Annual inflation is now expected to head downwards.

Political risks subside but global risks mount: challenging year and more to come

Political and economic outlook

Politics barely sleeps here and what has been taking place following the no-closure/no-ban ruling of the Constitutional Court is a clear testimony to that. Brawls may look miniscule when compared to what was at stake during the closure case, but they are not that trivial either. The (in)famous Ergenekon case (indictment about those who plotted to overthrow the Government and lay the foundations for military intervention, a vulgar but quite precise description of the case in hand) lingers on, the Prime Minister has taken on the media mogul of the country or the other way around, and President Gul paid a visit to Armenia which caused some controversy in the country again, giving us yet another snapshot of the sharp division among political entities. There was either a full endorsement of the trip or vehement objections to it. The AKP and the Kurdish ethnic party DTP supported it while the main opposition parties CHP and MHP refused to contemplate such a trip and categorically rejected it. The masses however, had a much less divisive attitude towards the rapprochement targeting Armenia and signalled to us once again that change does take place in Turkey at a pace that bewilders certain politicians.

Q2 GDP growth came in disappointing at 1.9 %, and amidst all the lingering global uncertainty it did not attract the attention it deserved. Aside from the low level itself, there seems to be a downward trend in growth particularly visible after 2007 Q2. A total of ten quarters within which only two display superior performances in comparison to the previous year may be suggestive of something more than a cyclical component, i.e. a secular component as well.

Inflationary dynamics should not deteriorate any more, barring any oil price shocks beyond what we have seen so far. Electricity price hikes the latest of which came in the second week of September will impact on October inflation and in the vicinity of 0.2 to 0.3 percentage points. Year-end inflation should come in at around 11 % and much depends on the course of the exchange rate and oil prices.

The Central Bank is most likely to keep policy rates unchanged at 16.75 % and the much rumoured rate cuts will only materialise if the global financial system displays true signs of stability and inflationary dynamics worldwide remain contained.

The absence of any significant political risk and the ruling out of any fiscal loosening as local elections approach next spring are mandatory for staying afloat in a still uncertain global environment. The fiscal performance so far has been quite assuring and that is most welcome. We do not assign any significant probability to any sudden subversive fiscal irresponsibility manoeuvring and remain fairly confident on that front.

Turkey's relative performance in the EM realm will also largely depend on the availability of financing and the state of her external balances. The non-energy current account balance has not been deteriorating but actually improving somewhat as of late, though oil prices have been a killer. With the significant easing in oil prices from nearly USD 150 per barrel to roughly USD 100 these days, Turkey's vulnerability is unequivocally lower, but that brings only relative relief. Her MSCI and currency performances in the aftermath of the closure decision indicate that Turkey has once again coupled with the EM world and that is consolation for the moment with all parties waiting to see how the financial crisis will unwind and impact on the global economic scene.

Growth puts on brakes in second quarter

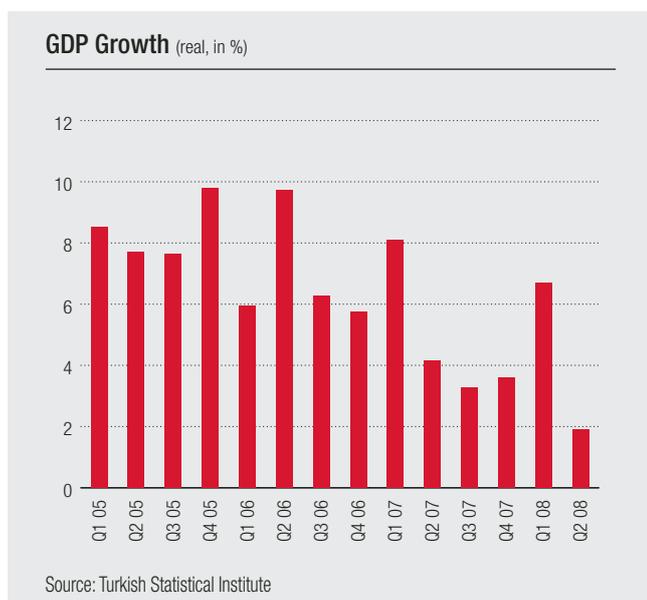
2008 Q2 GDP growth slowed down with a figure of 1.9 %, the lowest since 2002 Q1. Turkey's economy, having slowed down to 4.5 % in 2007, surprisingly registered robust growth in 2008 Q1, with GDP growth of 6.9 %. However, with the second quarter performance, the probability of not reaching 4 % year-end growth has risen significantly.

On the expenditure front, public expenditure growth was negative in 2008 Q2, while private expenditure slowed down substantially. Domestic demand was unequivocally hurt by the worsening sentiment due to

Short-term indicators

	Sept-07	Oct-07	Nov-07	Dec-07	Jan-08	Feb-08	Mar-08	Apr-08	May-08	Jun-08	July-08	Aug-08	Sep-08
Real GDP, yoy (%)	3.3	–	–	3.6	–	–	6.7	–	–	1.9	–	–	–
Industrial production, yoy (%)	2.5	8.4	8.1	–1.0	11.4	7.5	2.5	6.3	2.4	0.8	3.4	–	–
Inflation (CPI), yoy (%)	7.1	7.7	8.4	8.4	8.2	9.1	9.3	9.7	10.7	10.6	12.1	11.8	–
Unemployment rate (%)	9.3	9.7	10.1	10.6	11.3	11.6	10.7	9.6	8.9	–	–	–	–
Exchange rate/EUR, eop.	1.717	1.701	1.738	1.714	1.744	1.819	2.074	2.009	1.880	1.934	1.814	1.740	–
Reference rate O/N, comp. avg.	18.9	18.5	17.9	17.3	16.9	16.6	16.5	16.5	16.8	17.4	17.9	18.2	18.2
Export (FOB), yoy (%)	4.2	23.3	11.5	0.2	39.8	26.5	8.6	14.4	15.2	10.5	20.4	–	–
Import (FOB), yoy (%)	6.5	22.5	13.2	12.3	36.0	23.3	9.8	17.9	14.0	19.0	18.7	–	–
Trade Balance, EUR mn	–2,886	–2,997	–2,565	–3,303	–3,114	–2,312	–2,637	–3,180	–3,449	–4,057	–4,108	–	–
Current account, EUR mn	–1,647	–2,268	–2,216	–3,536	–2,767	–2,585	–2,689	–3,170	–3,025	–3,595	–3,544	–	–

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



a myriad of well-known reasons. More specifically, private consumption which grew by 2.8 % lost steam big time and contributed a dismal 1.95 percentage points to overall growth. The change in stocks and net exports contributed nearly 0.4 percentage points each, and the positive contribution by net exports was welcome, but it cannot be relied on going forward given the adverse newsflow regarding the EU and Russia, Turkey's largest export zones by far.

Public investment and public consumption contracted in 2008 Q2 by 16.8 % and 3.7 % respectively. The negative contribution of public expenditure will undoubtedly have positive implications on the budget performance, on inflation and on avoiding crowding-out effects, but growth repercussions in the midst of an overall deceleration should also be closely followed.

On the production side, agriculture in particular and industry slumped with -3.1 % and 2.8 % growth respectively. Agriculture, after a disastrous 2007, was expected to make a positive contribution. The "Agricultural Production Forecasts" recently published by Turkstat, which projected an increase for 2008, still support our expectation of a positive contribution through the year, despite the dismal second quarter growth. The services sector was not spared a slowdown either, posting growth of 2.1 %. The construction sector almost stopped altogether with 0.9 % growth in this period.

Although we can expect better performances from agriculture on the production side and a limited recovery in private expenditures due to the mitigation of political risks, it will be a challenge to reach 4 % year-end growth. Looking forward, economic performance in 2009 is expected to be slightly better than in 2008, but still relatively weak, with expected GDP growth of 4.6 %. A moderate recovery in private expenditures is expected to lead to economic growth, assuming that the global turmoil will be contained and people will start to realise their postponed consumption and investment decisions. However, one should not expect a rapid recovery, as the repercussions of the global turmoil will certainly continue through into 2009.

Deceleration in industrial production continues in third quarter

In July, industrial production (IP) increased by 3.4 % yoy, higher than the gloomy market expectation. But this should not be interpreted as an optimistic signal about the future. This "3.4 %" loses its charm, considering that July 2008 has one working day more than July 2007. After we adjust the working days, we end up with yoy IP growth for July of nearly 0 %. Hence, this month's performance signals a general economic slowdown and suggests that last months' poor performances were not just coincidence.

The growth deceleration seemed to be mostly across the board and not dominated by some key and particularly badly performing sectors. As for contributions to the 3.4 % figure, Motor Vehicles, Basic Metal, Electrical Machinery and Food lead with contributions of 1.58, 0.73, 0.66, and 0.44 percentage points respectively. The underperformers were Textiles – as usual – and the brightest sector in the second half of 2007 and the early quarters of 2008 – Chemicals – with negative contributions of 1.15 and 0.70 percentage points respectively.

Inflation surprisingly slows in August

In August the consumer price index (CPI) decreased by 0.24 bringing yoy inflation to 11.77 %. The groups of Clothing and Footwear and Transport pulled headline inflation down, while – on account of natural gas price hikes – housing expenditure contained its decline. Although the headline rate was lower than the market expectation and the CBRT signalled immediately that it could start rate cuts earlier than planned, special CPI indices, excluding energy, food, tobacco and gold – CBRT favourites – continued to increase. In this context it is too early to celebrate the change in underlying trends and expect a rate cut from the CBRT, especially given that global turmoil has intensified and reached a rattling rate as of September.

Recent hikes in inflation before August were, to a large extent, driven by high commodity prices – especially oil – and the supply side shocks due to the drought, whereas the reverse trend in the very same factors along with depressed domestic demand are expected to be the factors behind disinflation in the upcoming period. Oil prices retreated from 140 dollars per barrel to below 100 dollars, accompanied by a similar decline in prices of other commodities. However, the recent escalating tensions in the global economy and its reflection in the local financial markets of increasing FX rates might postpone disinflation thanks to the pass-through effect. In addition, electricity price hikes will also put pressure on inflation in the near term.

Altogether we expect CPI to reach 11 % at the end of 2008 and decelerate moderately to 7.8 % at the end of 2009. The pace stability is restored to the global economy and the rate of decline in commodity prices will determine the extent of the reduction in inflation.

CBRT continues to keep rates on hold in September

Following three consecutive rate hikes from 15.25 % to 16.75 % in May-July period, the CBRT has kept rates on hold since August. Earlier in September, immediately after the benign inflation figures, the announcement implying that a rate cut policy option was on the table was quite surprising, and in contrast to this, we maintained our expectation that the CBRT

would not move in September due to ongoing problems in international credit markets and the global economy. We expect no rate cut or hike until the end of the year. The rate cut cycle may start after relative stability returns to the global economy, together with stagnant domestic demand and a continuation of the favourable outlook in food and oil prices.

Deceleration in economic activity not helping to contain current account deficit

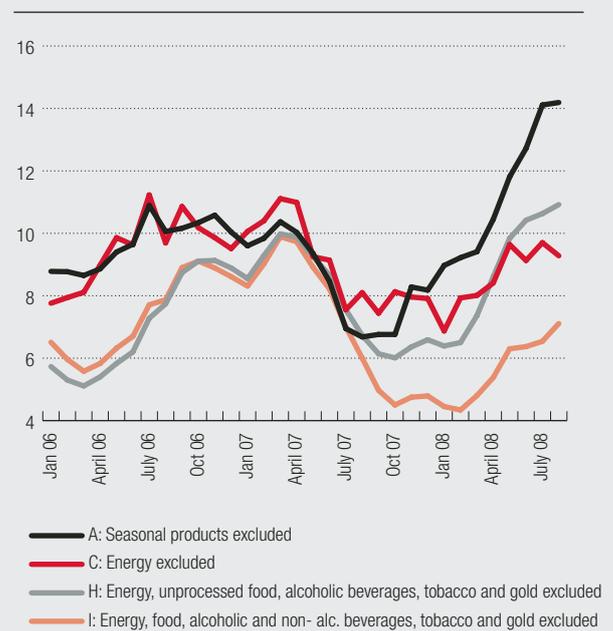
With the USD 4.1 billion current account deficit in July, the 12-month cumulative deficit reached USD 47.1 billion, not reflecting any deceleration yet, despite the weakening of domestic demand. Traits of the slow-down could be found in weakening import volumes since February. Breaking foreign trade figures down into price and volume effects shows us the extent of the surge in international commodity prices and decelerating economic activity. Growth in imports has been recorded at 3.5 % in the March-July period, much weaker than the overall 2007 volume growth. By contrast, import prices posted 29 % growth in this period as a result of soaring oil and metal prices. Volume growth in exports in March-July, on the other hand, was recorded at 8 % yoy, reflecting a moderate deviation from last years' growth trend. However, export price growth in this period has been much higher at 24 %, explaining most of the total export growth.

Starting from August, commodity prices have bounced back somewhat, which imply a possible deceleration of the price effect in the rest of the year. Moreover, the weak domestic demand is also expected to curb import growth. Even taking these factors into account we forecast 32 % growth in both imports and exports in 2008 as a whole, and the current account deficit to reach USD 52.4 billion, corresponding to 6.5 % of projected GDP. This is due to the fact that the decline in commodity prices has only been partial and its impact will become more tangible in 2009. This may help to stabilise the current account deficit to GDP ratio at around 6.5 % in the next two years.

Despite difficult global environment in 2008, financing of the current account deficit not creating many problems so far

Cumulative capital inflows amounted to USD 33.9 billion in the first seven months of 2008, surpassing last year's value by USD 3.4 billion, positive news considering the adversities created by the global financial crisis and local political debacles. However, details of the financing components reflect some weaknesses which we often noted previously. Two usual suspects stand out again. The first is the continuous decline in the ratio of non-debt creating financing (defined as the sum of foreign direct investments, equity sales and inflows through net errors and omissions) to the current account deficit, which fell to 35 % (cumulative, yoy) as of July. This is the lowest value registered since May 2003. FDI inflows and inflows to local securities markets continue to be weak. Gross FDI inflows amounting to USD 9.4 billion remained 40 % below last year's figure in the same period. We might see stronger FDI inflows and portfolio investment in the coming period along with the return of

Core Inflation (Special CPI-Indicators, yoy, in %)



Source: Turkish Statistical Institute

relative stability to the global economy and the easing of local political tensions, but that is by no means a safe bet yet.

Secondly, increasing reliance on corporate sector borrowing in foreign financing is continuing with the corporate sector's net borrowing reaching USD 23.7 billion in the first seven months, corresponding to 70 % of net capital inflows. The banking sector's net borrowing in the form of loans remained limited to USD 4.9 billion in this period.

Successful budget performance in the first eight months

The Central Administration Budget recorded a primary surplus of YTL 41 billion and a budget surplus of YTL 4.6 billion in January-August. The outlook for the budget seems quite bright, with the year-end primary surplus having already been surpassed and the budget balance recording a significant surplus. Revenues have been robust so far, where 72 % of the year-end targets were already achieved in the first eight months. In a slowing economy, tax proceeds seem not to have stagnated, which may be attributed to better tax collection. Non-tax revenues remained rather stagnant owing to the slowdown in privatisation this year.

On the expenditures side, an effort has been made to control non-interest expenditures, which contracted by 3 % in real terms in the first eight months. Specifically, this took its toll on transfers to social security institutions and agricultural transfers which contracted by 13 % and 9 % in real terms. Hence, budget realisations seem to be in line with the year-end targets for now.

Event	Date	Reading
Monetary Policy Committee Meeting	22 October	Central Bank is expected to keep policy rates on hold until the end of the year.

Bosnia and Herzegovina



Outlook

With international financial market conditions more difficult, the economy in Bosnia and Herzegovina is being exposed to more risk given its high current account deficit and dependency on capital flows from abroad. While credit growth has been robust this year at close to 30 % so far, next year it will slow appreciably (deposit growth is weak already). As oil prices have come down significantly since the summer, coupled with signs of respite in food price developments, inflation will moderate in the remainder of 2008. Since we expect domestic demand pressures to slow as well and this year's public sector wage increases are unlikely to be repeated, we reckon inflation will continue to moderate next year. At the same time the current account deficit is expected to narrow. If privatisation revenues remain elusive, FDI inflows will cover only a minor part of the current account deficit.

MOODY'S LT FC RATING
B2/Stable

S&P'S LT FC RATING
Not rated

FITCH LT FC RATING
Not rated

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

Macroeconomic data and forecasts

	2006	2007	2008f	2009f	2010f
Nominal GDP (EUR bn)	9.8	11.1	12.6	13.8	14.9
Per capita GDP (EUR)	2,540	2,880	3,270	3,570	3,860
Real GDP, yoy (%)	6.9	6.8	5.8	4.8	5.4
Inflation (CPI), yoy, eop. (%)	4.6	4.9	6.5	3.4	2.8
Inflation (CPI), yoy, avg. (%)	6.1	1.5	7.9	4.5	3.0
Unemployment rate, avg. (%)	44.5	42.9	39.0	38.5	38.0
Exchange rate BAM/EUR, eop./avg.	1.96	1.96	1.96	1.96	1.96
Current account balance/GDP (%)	-8.4	-12.7	-15.3	-13.6	-12.5
FDI/GDP (%)	5.8	13.4	5.1	5.6	5.5
Budget balance/GDP (%) ¹	2.9	1.0	-0.5	-1.8	-3.0
Public debt/GDP (%) ²	21.3	18.0	16.8	16.7	16.5

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

1) For 2006: not including local government and road authorities. 2) External public debt.

Main topics

- Industrial production and construction activity data both point to solid domestic demand in Bosnia and Herzegovina this year. In addition, gross wage growth of 7.5 % in real terms in the first 7 months of this year gives a further boost to domestic demand.
- Inflationary pressures marginally subsided in August with the headline consumer price index coming in at 9.5 % yoy, down from 9.9 % yoy in July. Core inflation rose only modestly in August compared to July. Falling oil prices and signs of moderation in food prices should see the headline inflation rate slow to 6.5 % yoy by the end of 2008.
- Although credit growth has been close to 30 % in the first 7 months of this year, deposit growth is lagging behind as the Federation government's deposits fall and private sector deposits exhibit only marginal growth. Given that tight financial market conditions internationally imply higher financing costs for the banking sector, this should see credit growth slow appreciably next year.
- Higher oil prices in H1 2008 contributed approximately one third of the increase in the goods trade deficit until August 2008, and are the main reason we forecast a current account deficit of 15.3 % of GDP this year.

Growth strong for now, but a moderation looks increasingly likely

Political tensions prevail

Tensions between Bosnia and Herzegovina remain evident with Republika Srpska (RS) deciding on 11 September to withdraw from the state power transmitter. Given lengthy negotiations over reforms before conditions were met for the EU to ratify the Stabilisation and Association Agreement earlier this year, this decision suggests discussions on amendments to the constitution (which are also a part of the EU accession process) will be complicated and protracted. It is therefore of little surprise that EU enlargement commissioner Rehn commented in Brussels, on 17 September, that the country's hopes of eventually joining the EU were being held back by divisions amongst Bosnia's leaders.

Economic activity remains resilient

In both entities industrial production activity accelerated over the summer months. In the Federation industrial production in the first 8 months of the year was up 5.4 % yoy, with manufacturing generating the lion's share of registered growth. In Republika Srpska (RS) industrial production rose by 8.4 % yoy in the 8 months to August, however, the structure of that growth was different. In RS mining activity rose 20.8 % yoy while manufacturing activity was up by a mere 2.6 % yoy. Construction activity remained strong in both entities, but especially in the Federation (41 % in the first seven months of this year versus 12.4 % in RS).

Wage growth has been pronounced all year in Bosnia Herzegovina with the main reason being the public sector. For the whole of BiH in July, gross wage growth was just under 10% yoy in real terms, with growth rates of over 30 % yoy in the health sector, over 20 % yoy in the education sector and over 10 % yoy in the public administration and electricity and gas supply sectors.

Credit growth remains strong in 2008, rising 29 % yoy in July. Yet it is difficult to see how credit growth will be able to remain as robust heading into 2009. On the deposits side, private sector company deposits rose only 0.6 % between July and the end of 2007, while household deposits were up 9.6 %. With international financial market conditions tightening and there being little scope for an increase in deposits, credit growth looks set to slow in BiH. The challenging outlook for fiscal policy (especially in the Federation) and our expectation of slower credit growth in 2009 are the main reasons we forecast a moderation in the rate of GDP growth to 4.8 % next year.

Decelerating inflation

The August consumer price index data for BiH showed a welcome decline in inflationary pressures with the headline inflation rate falling to 9.5 % yoy from 9.9 % in July. This was the first fall in the yoy inflation rate since June 2007. Food prices fell in comparison to July by 0.4 %, fuel prices by 2.1 % and the latter will drop further given movements in world markets in coming months. We estimate that core inflation rose only marginally to 2.9 % yoy in August compared to 2.8 % in July. Even though wage policies have contributed to inflationary pressures this year and product market inefficiencies are working in the same direction, the fall in oil prices in world markets and our expectations of slower credit growth and domestic demand next year lead us to expect consumer prices will average 4.5 % next year (compared to 7.9 % in 2008).

Rising external imbalances

With oil prices having almost doubled in the first part of the year it is no surprise that oil imports in the first 8 months of 2008 have contributed over one third of the increase in the goods trade deficit, on the basis of data from the BiH statistical office (+25.7 % yoy). Goods import growth was 21.8 % yoy over this period, while corresponding export growth was 16.7 %, resulting in export revenue of EUR 2.3 bn in January–August 2008. Almost half of the increase in goods exports is the result of aluminium, steel and electricity exports, a by-product of the country's narrow production base. We maintain our view that the current account deficit in BiH will be over 15 % of GDP this year. Announced investments by foreigners into the electricity generation sector may commence this year and therefore boost FDI inflows; however, should the privatisation of Aliminij Mostar and/or Telekom BiH not take place this year (the most likely outcome), FDI inflows in 2008 will be significantly lower than in 2007.

In mid-September, ratings agency Moody's reaffirmed Bosnia's B2 government bond rating with a stable outlook, noting that the largely foreign-owned banking sector should shield the country from the prospect of excessive financial stress. The country's foreign exchange reserves at the end of July 2008 amounted to EUR 3.4 bn, covering 4.5 months of imports. Meanwhile, at the end of June Bosnia's gross public foreign debt stood at EUR 1.98 bn, which represents a fall of EUR 41 mn compared to the end of 2007.

Kazakhstan



Outlook

Scarce cross-border capital inflows due to the global liquidity crisis significantly constrain credit growth. This combines with the bursting of the residential construction bubble and lower oil price to limit real GDP growth to probably only 3.8 % this year and 4.2 % in 2009. Loan growth has become very weak and will accelerate only slightly also in 2009. Credit quality has deteriorated but the Kazakh authorities are working to establish a distressed assets fund to ring-fence potential risks. Oil prices have peaked in 2008 and will now be lower for some time. The revival of the Kazakh economy has nevertheless to come from the oil and gas industry which accounts for 70 % of exports. To some extent lower prices will be compensated by higher production. The country's wealth will thus shift further to the oil-rich regions in the West. Much will depend on the situation in international banking, however, and thus on the environment for the Kazakhstani banks to roll over their cross-border debt and renew lending.

MOODY'S LT FC RATING
Baa2/Stable

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

FITCH LT FC RATING
BBB/Negative

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

Macroeconomic data and forecasts

	2006	2007	2008f	2009f	2010f
Nominal GDP (EUR bn)	64.5	76.1	91.4	117.0	144.0
Per capita GDP (EUR)	4,191	4,885	5,800	7,342	9,043
Real GDP, yoy (%)	10.7	8.7	3.8	4.2	6.1
Inflation (CPI), yoy, Dec (%)	8.4	18.8	11.7	8.6	6.3
Inflation (CPI), yoy, avg. (%)	8.6	10.8	17.6	9.5	7.2
Unemployment rate (%)	7.8	7.6	6.8	6.7	6.0
Exchange rate/EUR, eop.	167.1	177.2	174.0	167.0	164.7
Exchange rate/EUR, avg.	158.3	167.8	180.8	170.2	166.8
Exchange rate/USD eop.	127.0	120.3	120.0	121.0	122.0
1-W repo rate, Dec.	9.0	11.0	10.5	9.5	9.0
KazPrime 3M (Dec)	5.50	12.35	7.00	7.50	7.50
Current Account balance/GDP (%)	-2.4	-6.9	3.5	-0.8	-3.5
FDI/GDP (%)	7.7	9.9	6.4	5.8	6.4
Budget balance/GDP (%) ¹	0.7	-0.8	-1.1	-1.1	1.0
Public Debt/GDP (%)	12.0	7.7	9.0	9.7	8.0

1) Including the oil fund.

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

Main topics

- Real GDP growth slowed to a revised 5.4 % yoy in H1 2008 from 8.7 % in 2007, due to weak domestic demand.
- Inflation still stood at 20.1 % yoy in August, little changed from June and July.
- Loan growth amounted to a mere 1.5 % from the beginning of 2008 through end-July 2008, compared with 42.0 % during the same period in 2007.
- The share of bad and doubtful loans in the total loan portfolio of Kazakhstani banks increased to 3.2 % as of 1 September 2008 from 1.9 % at the beginning of the year.
- High commodity prices allowed exports to grow 60.7 % yoy in USD terms in H1 2008. Imports grew only 15.5 %.

Hopes on oil and the end of the global banking crisis

Growth has severely slowed since Q2

According to preliminary data, real GDP growth declined from 6.1 % yoy in Q1 to 5.4 % yoy in H1. This would imply a slowing to 4.8 % yoy in Q2 according to our estimations or growth of only 0.1 % qoq in seasonally adjusted terms. Industrial output increased by 3.3 % yoy in Jan-July (5.0 % in 2007 as a whole). This was attributable only to a 5.8 % increase in mining and a 9.4 % increase in the generation and distribution of electricity, gas and water. Manufacturing declined by 0.9 % yoy. Retail sales grew by a meagre 2.6 % yoy in Jan-July 2008. We are therefore reducing our real GDP forecast for 2008 further from 4.6 % yoy to 3.8 % yoy. For 2009 we now expect 4.2 % instead of 6.1 %.

Inflation stubbornly high

Despite the weakening growth, inflation has remained high, driven by what could be called "export competition", i.e. high prices abroad, prompting companies to sell their goods there. The CPI increase still amounted to 20.1 % yoy in August, little changed from June and July. Food prices were as much as 30.1 % yoy higher in August than the year before and this year's grain harvest is not very supportive. We still expect the statistical base effect to combine with the weaker economic growth and tight monetary conditions to reduce inflation to 11.7 % by December, but we see some upward risk.

Very weak credit growth

Lack of foreign financing and the bursting of the residential construction bubble have resulted in subdued credit growth. Loan growth amounted to only 1.5 % from the beginning of 2008 through end-July 2008, compared with 42.0 % during the same period in 2007. Corporate loans grew 4.6 % while retail loans even fell by 4.2 %. Deposits grew by 20.3 % thanks to relatively strong corporate deposits, in part probably promoted by the authorities. Growth in retail deposits weakened to 4.3 % Jan-July ytd from 43.7 % the year before.

Towards a "Stress Fund"

A reduced opportunity to roll over loans becoming due combines with the slowing of the economy to significantly worsen banks' loan portfolios. Kazakhstani banks had a total of KZT 467.2 bn (EUR 2.3 bn) or 3.2% of the total loan portfolio in bad and doubtful (of the category 5 according to the Kazakh classification) loans on their books as of 1 September 2008, compared with KZT 249.0 bn or 1.9 % of the loan portfolio at the beginning of the year. To protect the banking system, the authorities plan to set up a USD 6 bn distressed asset fund to have a strong defence line against arising problems. The fund would issue securities as part of the plan. The budget is to contribute USD 1 bn and USD 5 bn are to come from the market.

Oil transfers help budget

Revenues of the state budget, which comprises the central and local

governments but not the oil fund, increased by 26.2 % yoy in Jan-August 2008, with expenditures up 30.5 %. Tax revenues increased by only 19.7 % (in Jan-July). The shortfall was covered by higher transfers from the Oil Fund. We expect a slight widening of the consolidated budget of the republic, the local administrations and the oil fund to 1.1 % of GDP in 2008 from 0.8 % of GDP in 2007, with a similar magnitude in 2009. Much depends however on the amounts the state will need to protect the banking sector.

The new tax code

The new tax code now under discussion for some time is intended to reduce the tax burden for the business outside mining and to streamline tax collection. Thus, corporate profit tax is to be reduced from the current 30 % to 20 % from 2009 and 15 % from 2011. Its estimation will be based on international accounting standards. The VAT rate will be further reduced from 13 % to 12 % in 2009, with an automatic return system, and the unified social payments tax will be transformed from the current regressive 13-5 % scale to a flat rate of 11 %. Individual income tax will be kept at a flat 10 %. The resulting losses for the budget will be offset by a new Natural Resources Mining Tax (NDPI) based on world prices, and a so-called "extraprofit" tax with the intention of siphoning off monopoly rents. The burden for the large oil and mining companies will rise. The parliament will probably pass the new code on 8 October 2008.

Soaring foreign trade surplus in H1

High commodity prices allowed Kazakhstan to achieve a record trade surplus of almost USD 18 bn in H1 2008, compared with USD 7 bn in H1 2007. Exports amounted to USD 35.0 bn, 60.7 % more than the year before in USD terms. Imports totalled USD 17.1 bn, a 15.5 % yoy growth. More than 72 % of exports were mineral products, 15 % metals, 5 % food and agricultural products and 3 % chemicals. With commodity prices on the decline, the magnitude of the trade surplus in H1 is unlikely to be repeated. Unless commodity prices not more than halve, foreign trade should however play a positive role for growth also in late 2008 and in 2009.

Some regional aspects

Growth in Kazakhstan has slowed, but there are substantial regional differences. Whereas industrial output growth for the entire republic totalled 3.3 % yoy in Jan-July 2008, the figure for the oil rich Atyrau province was 19.8 %, for the real estate bubble-ridden cities Astana and Almaty 84.6 % and 89.8 %, respectively, and for industrial Karaganda 95.1 %. Thanks to the oil, wealth is likely to shift further to the West. Already now in Atyrau the average wage amounts to KZT 117.3 thousand per month (in June), more than the about KZT 90 thousand in Astana and Almaty, and three times the KZT 39 thousand in Shambylska province.

Event	Date	Reading
The new tax code	Oct. 08	Final details will be known after the parliament will decide on the code in early October

Russia



Outlook

The global financial turmoil caused large capital outflows from Russia in recent months, resulting in a stock market slump and liquidity shortages on the Russian interbank market. There will be some concentration processes taking place in the Russian banking system. However, thanks to the strong position of the large state-owned banks and the resolve of the authorities to tackle the problems – made possible by huge international and fiscal reserves – no systemic crisis will occur. Lower capital inflows resulting in tighter credit conditions will however combine with still high but lower oil prices to reduce investment appetite and income growth. As a consequence, real GDP growth will likely slow to 6.0% in 2009 from 7.4% in 2008.

MOODY'S LT FC RATING
Baa1/Positive

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

FITCH LT FC RATING
BBB+/Stable

SPREAD AVG (SEP) 267
EMBI+ Spread on USD Curve

Macroeconomic data and forecasts

	2006	2007	2008f	2009f	2010f
Nominal GDP (EUR bn)	785	942	1,147	1,392	1,614
Per capita GDP (EUR)	5,520	6,640	8,100	9,850	11,450
Real GDP, yoy (%)	6.7	8.1	7.4	6.0	5.5
Inflation (CPI), yoy, eop. (%)	9.0	11.9	13.0	11.7	8.6
Inflation (CPI), yoy, avg. (%)	9.7	9.0	14.0	12.6	9.3
Unemployment rate (%)	6.7	6.1	5.6	5.1	4.9
Exchange rate RUB/EUR, eop.	34.7	35.9	36.2	35.1	34.3
Exchange rate RUB/EUR, avg.	34.1	35.0	36.5	35.7	34.7
Exchange rate RUB/USD, eop.	26.3	24.6	25.0	25.4	25.3
Exchange rate RUB/USD, avg.	27.1	25.6	24.3	25.2	25.4
Interest rate (3M Mos Prime), eop.	5.9	6.0	8.0	7.4	7.0
Interest rate (3M Mos Prime), avg.	5.1	5.3	7.5	7.2	6.6
Current account balance/GDP (%)	9.6	6.1	7.5	4.6	2.3
FDI/GDP (%)	2.9	4.1	3.7	3.7	3.9
Budget balance/GDP (%)	8.4	6.1	6.5	3.0	1.5
Public debt/GDP (%)	8.2	6.6	5.9	5.6	5.4
Total external debt/GDP (%)	31.4	35.9	35.0	36.0	36.0

Sources: Rosstat, UniCredit Group New Europe Research Network.

Main topics

- GDP grew by 8.0% in H1 2008 as Russia remained relatively resilient vis-à-vis the global turmoil in early 2008.
- Investment outlays growth decreased however to 7.9% yoy in August from 19.2% (avg.) in Jan-May.
- Reserve Fund assets increased by 14% ytd and totaled USD 142.6 bn as of September 1, 2008.
- Following the international crisis, the RTS and MICEX stock market indices lost 38.5% and 36.5%, respectively since August 21. The RUB depreciated by 4.5% and by 0.7% against the USD and EUR respectively. The 3M MosPrime Interbank rate rose sharply from 7.56% to 9.42%
- The CBR significantly reduced obligatory reserve ratios, REPO and Lombard rates to fight the lack of liquidity in the banking system.

No drama, only some deceleration and some concentration in banking

High growth, but some deceleration in Q2

According to Rosstat, real GDP grew 7.5 % yoy in Q2 2008 and amounted to RUB 19,113 bn (EUR 512 bn). The main contributors were construction with growth of 18.7 % yoy, retail trade with 11.7 % yoy, and transport and communications with 9.4 % yoy, while manufacturing grew below the average rate at 5.6 % yoy. The slowdown in capital outlays (14.9 % yoy in Q2 versus 20.2 % yoy in Q1) became the most important factor limiting GDP growth in the second quarter of 2008. In Q1 GDP growth still amounted to 8.5 % yoy, the 7.5 % yoy in Q2 indicated a significant slowdown in seasonally adjusted qoq terms.

Slowing investment main risk

The main threat to economic growth is that investment will slow further due to higher lending rates and increased aversion to risk. Taking into account the deterioration of global conditions, we have lowered our forecast for real GDP growth from 7.5 % to 7.4 % yoy for 2008 and from 6.6 % to 6.0 % yoy in 2009.

According to Rosstat, growth in companies' investment outlays almost halved from 15.3 % yoy in May to as little as 7.9 % yoy in August. Industrial output also shows some signs of slowing. It grew only 5.3 % yoy in the first eight months of 2008 compared with 7.1 % yoy in the same period of 2007. However, after a disappointing 0.9 % yoy in June, industrial output growth accelerated again to 4.7 % in August.

Manufacturing has remained the main driver of industrial growth, with a 7.6 % yoy growth in Jan-Aug 2008. Fast growth continued in the manufacture of food, beverages and tobacco (production of meat +12.8 % yoy, beverages +11.6 % yoy, tobacco products +7.4 % yoy), manufacture of textiles and leather products, manufacture of machinery and transport equipment (tractors +89.5 % yoy, turbines +36.7, cars +19 % yoy).

The construction industry significantly contributed to industrial growth in January-August. While the number of completed new housing units

slowed from +34 % yoy in Jan-Aug 2007 to +5.2 % yoy in Jan-Aug 2008, industrial construction boomed at +18.2 % yoy during the first seven months of 2008. This in turn accelerated the manufacturing of complementary products (+8.3 % yoy growth in manufacturing of plastic products, ceramic products +7.6 % yoy, bricks +7.2 % yoy in Jan-July 2008). The strong momentum of construction reflects the still strong growth in capital outlays in early 2008, which has since leveled off, however. We expect the growth of the construction industry to moderate as the real estate boom – taking place in particular in Moscow and St. Petersburg – comes to a halt.

Oil prices will be lower in 2009 than the excessive high ones in 2008, but also a decrease in the price of Urals oil to perhaps USD 80-85/bbl in 2009 should not hurt the Russian economy drastically. This would still be above the USD 70/bbl oil price assumed in the budget of the Russian Federation. Oil extraction costs in Russia range from USD 3/bbl to USD 12/bbl – depending on the location of the field. Extraction of natural gas grew by 1.2 % in January-July 2008. Further gas price increases will support Russian exports of commodities. However, the decline of oil prices will slow income growth of the large oil companies and in second-round effects also of related companies and private persons with some dampening effects on investment and consumption.

Although we do not expect a sharp downturn, we foresee some slowdown of growth in 2009. Bottlenecks in the supply of some production factors, mainly in some building materials and qualified labour, and therefore continued significant price pressures in some areas, combined with a reduced investment appetite are the main reason. We therefore adjusted our forecast for industrial output growth from 6.5 % to 5.7 % yoy for 2008, and from 6.6 % yoy to 5.5 % yoy for 2009.

Growth in services has remained very strong. The contribution of the service sector to economic growth accounted for 5.8 percentage

Short-term indicators

	Aug-07	Sep-07	Oct-07	Nov-07	Dec-07	Jan-08	Feb-08	Mar-08	Apr-08	May-08	Jun-08	Jul-08	Aug-08
GDP real growth, yoy (%)	–	7.3	–	–	9.5	–	–	8.5	–	–	7.5	–	–
Industrial production, yoy (%)	3.7	2.9	6.1	4.7	6.5	4.5	7.5	6.5	9.2	6.7	0.9	3.2	4.7
Inflation (CPI), yoy (%)	8.6	9.3	10.8	11.4	13.1	12.6	12.7	13.3	14.3	15.1	15.1	14.7	15.0
Unemployment rate (%)	5.7	5.8	5.9	5.9	6.1	5.8	6.6	6.4	6.6	6.4	6.2	5.3	–
Exchange rate RUB/EUR, eop.	35.0	35.3	35.6	36.0	35.9	36.2	36.4	37.1	36.9	36.8	36.9	36.5	36.2
3M interbank rate (%), avg.	5.5	7.0	7.6	7.2	6.8	5.9	6.5	7.5	7.1	6.5	6.1	6.0	7.2
Export (FOB), yoy (%)	3.12	6.34	23.69	23.85	17.15	41.09	29.01	24.98	25.66	22.71	40.39	39.7	–
Import (FOB), yoy (%)	29.01	17.81	22.24	21.50	13.27	17.38	28.14	15.02	30.25	20.1	18.1	28.8	–
Trade balance, EUR mn ¹	62.1	70.1	79.1	88.3	97.6	12.8	22.4	32.9	42.7	54.6	66.7	–	–
Current account, EUR mn ¹	–	38.9	–	–	52.3	–	–	23.9	–	–	44.1	–	–

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

points in Q2 2008. Retail sales, financial intermediation, transportation and telecom continued to drive the sector's development. With some slowing in industry and in income growth, some loss of momentum will also be seen in the services sector.

Private consumption relatively robust

Retail sales grew 15.2 % yoy in January-July – real disposable wages increased by 13.4 % yoy in January-August – and transportation and telecom 9.4 % yoy. In financial intermediation growth of 9.8 % yoy was achieved in Q2 2008. We expect households in Russia to remain highly consumption-oriented also in 2009. With real disposable wage growth of an anticipated 10 % yoy in 2009, we believe retail sales growth will slow slightly from 15 % yoy in 2008 to 13.5 % yoy in 2009. Private consumption growth should weaken from a possible 11 % in 2008 to 9.3 % in 2009.

Inflation still relatively high

Although CPI growth slowed on a mom basis in June–August 2008, the yoy inflation figures do not look very optimistic. According to Rosstat, consumer prices expanded 15.0 % yoy in August compared with 14.7 % yoy in July. The main contributor to the mom slowdown was a drop in food prices. During the summer months of 2008 fruit and vegetables dropped by 16.9 %, which is noticeably more than the 4.1 % in June-August 2007. The contribution share of food products in CPI growth decreased from 60 % in May to 8 % in July and even switched to zero in August 2008. With growth in broad money also slowing, in part because of the tightening measures taken by the government and the CBR, some easing of the price pressures is to be expected for the rest of the year. Money (M2) growth slowed from 48.4 % yoy in January 2008 to 30.2 % yoy in August or to only +9.5 % ytd as of September 1, 2008 compared with +24 % during the first eight months of 2007. On the other hand, there have been bottlenecks in the supply of some goods, which keep prices at persistently high levels. We keep our inflation forecast for December 2008 at 13 % yoy but raise our forecast for December 2009 and 2010 to 11.7 % yoy and 8.6 % yoy.

National Welfare and Reserve Funds: future changes

Fueled by high revenues from foreign trade, the Russian Reserve Fund received significant funding during the first 9 months of 2008. According to the Ministry of Finance, the assets of the Reserve Fund totaled USD 142.6 bn (+14 % since the beginning of the year), while the assets of the National Welfare Fund's amount equaled USD 31.9 bn and lost 0.2 % (in USD terms) due to the appreciation of the euro against the US dollar.

The Finance Ministry suggests a new approach to managing both sovereign funds in its budget strategy for 2008–2023. The CBR should no longer manage the National Welfare Fund as from next year and it is planned to invest about 40–50 % of the Fund's total assets in the stock market and 30 % in corporate bonds. One of the most important aspects of the new budget strategy is that the target share of the Reserve Fund is set to fall from 10 % to 6 % of GDP since 2010. By contrast, the National Welfare Fund will receive higher funding from the government's revenues from oil exports. A part of the National Welfare Fund's assets is to be invested in a reform of the pension system.

High budget surplus thanks to strong export proceeds

Federal budget revenues continued to grow strongly, fueled by both exports and taxes, and equaled RUB 4, 510 bn (EUR 124.4 bn) by August 2008. According to preliminary information from the Federal Treasury, budget revenues amounted to 24.1 % of GDP in Jan-Aug, which is 1.7 percentage points higher than in the same period of 2007. High global commodity prices had a strong impact. On the one hand, oil prices still remained high, and on the other, Russia has increased the volume of natural gas production for export purposes. Effective as of August 1, 2008 the Finance Ministry raised custom duties on oil exports from USD 398.1/bbl to USD 495.5/bbl. The non-tax income of the Russian Federal budget (of which customs duties on oil exports constitute the biggest part) in the first eight months of 2008 accounted for 10.1 % of GDP, the rest for 14 % of GDP. The main contributor to the impressive increase in tax receipts remained the value added tax, equaling 6.7 % of GDP. Revenues from the tax on natural resource extraction amounted to 3.4 % of GDP and corporate income tax to 1.9 % of GDP.

Federal budget expenditures amounted to RUB 4 101.6 (EUR 113.1 bn) or 15.4 % of GDP in the first eight months of 2008, which is 0.3 percentage points lower than in the same period of 2007. Traditionally, most of the budget expenditures (almost 6 % of GDP) are generated by interbudget transfers from Federal to regional and local levels of the budgetary system. The second most important recipient of expenditures (2.18 % of GDP) was the national defence system.

According to the three-year budget plan of the Finance Ministry, the federal budget surplus should amount to approximately RUB 2 000 bn (or 4.8 % of GDP) in 2008 and narrow to about RUB 1 400 bn (or 2.8 % of GDP) in 2009 because of slower growth of export revenues and rising budget expenditures.

Current account surplus expected to narrow next year

The current account surplus totaled USD 69.4 bn (8.6 % of GDP) in January-June 2008 compared to USD 36.6 bn a year ago. This significant widening was due to an increase in exports from USD 59.9 bn in Jan-June 2007 to USD 104.8 bn, this year helped by soaring oil prices.

We estimate the substantial capital outflows in Aug-Sep due to the global financial crisis and the Caucasus conflict to have amounted to USD 15–20 bn.

Russian international reserves grew 25 % during the period from January 1 to August 8, 2008 and accounted for USD 597.5bn. This growth was driven by the increase of revenues from oil exports along with an appreciation of that portion of the reserves which is denominated in euros. The CBR's monetary interventions, aimed at supporting the domestic currency, have had a direct impact on the volume of international reserves during last two months. According to the Bank of Russia's statistics, the volume of monetary reserves decreased by 6.3 % from USD 597.5 bn to USD 559.4 bn as of September 19. Taking into account an expected slowing of Russia's export revenue and a further depreciation of the US dollar, we have revised downward the annual forecast for currency reserves from USD 650 to USD 614 bn in 2008 and from USD 793 bn to USD 776 bn in 2009.

The financial turmoil

After showing itself to be resilient in H1, Russia also began to be affected by the international banking and stock market crisis more severely in H2. The Caucasus conflict generated additional uncertainty and also had a negative impact on capital flows and Russia's attractiveness for portfolio investors. This resulted in a decline of the RTS and MICEX (48 % and 44.5 %, respectively) stock indices since May 30 and a shortage of liquidity in the banking system.

In response, the government has supported the banking sector and also the corporate sector with additional investments and liquidity.

The financial turmoil on Russian markets can be divided into three stages: the first one lasted for seven months, from the beginning of 2008 to August 8, when Russian financial markets were correcting in line with other major emerging market indices by a smooth downtrend. During this period the RTS index dropped from 2297 points to 1843, or by 19.8 %.

The second stage began with the Caucasus conflict, when the money and stock markets reacted nervously to the crisis. However, the stock market did not fall substantially until August 20. The RTS lost only 0.5 % and the RUB depreciated only 4.2 % against the US dollar and 1.3 % against the euro. But money market rates began to rise due to the lack of liquidity.

The third and most serious stage started on August 21 and lasted until September 18. The RTS and MICEX indices lost 38.5 % and 36.5 % respectively, falling to a three-year low. The Russian ruble depreciated by 4.5 % and by 0.7 % against the US dollar and the euro respectively. The 3M MosPrime Interbank rate rose sharply from 7.56 % to 9.42 %. Capital outflows amounted probably to about USD 10–15 bn during this stage due to a massive outflow of foreign portfolio investment, an excessive reaction to the bankruptcy of Lehman Brothers. National portfolio investors joined a wave of panic sell-offs, pushing the stock market further down as the banking sector began to experience a substantial liquidity shortage.

In response, the CBR has temporarily changed its policy from fighting inflation to providing the banking sector with additional liquidity. The CBR lowered the obligatory reserve ratios for different types of deposits effective as of October 1, 2008 leaving the refinancing rate unchanged. The minimum requirement for deposits by non-residents in any currency was reduced to 4.5 % from 8.5 % and the ratio for deposits from private individuals was lowered to 1.5 % from 5.5 %, for other deposits to 2 % from 6 %. This will likely free extra liquidity in the amount of RUB 300 bn.

In addition, the Finance Ministry placed more than RUB 600 bn with commercial banks during Aug-Sep 2008 to support the sector with liquidity. To the three largest Russian banks – Sberbank, VTB and Gazprombank – the Finance Ministry offered to allocate RUB 1,123 bn of federal budget funds to enable them to provide funding to smaller banks. Another important support measure for the economy is the decision to reduce the oil export duty from USD 486/tonne to USD 372 /tonne as from October 1, 2008. The state-run Housing Reform Fund was allowed to place RUB 180 bn in deposits with commercial banks. The decision to increase its share in key domestic companies (such as Rosneft, Gazprom, VTB, Alrosa) by buying the stocks in the open market became another measure taken by the government to fight the effects of the global capital crisis. The authorities are ready to implement this measure if there should be any further significant drop in the Russian stock market. For this purpose the government is ready to spend RUB 500 bn from the federal budget, dividing the whole fund into two equal injections of RUB 250 bn. The first RUB 250 bn could be used immediately while the other part will remain the hedge tool for future periods.

The effect of active anti-crisis measures is already visible. The Russian stock market began to recover (the RTS index increased by 20.1 % after falling sharply in the middle of September). Interbank rates have begun to fall (the 3M MosPrime rate is back to 8.9 % from a record high 9.4 % as of September 15). However, as is also globally the case, some turbulence is probably still to be expected.

Despite the current turmoil we expect the Russian banking sector as a whole to remain stable. Russia has accumulated sufficient resources during the period of high commodity prices and strong growth to overcome the crisis. The exposure of the Russian banking system to equities is small and amounts to only 1.1 % of total bank assets. The currently difficult situation could even stimulate the creation of a more balanced financial system which is less dependent on financing from abroad. We expect far-reaching changes in the Russian banking sector. The number of banks (mainly small and medium-sized institutions) could decrease significantly. We also anticipate a large number of M&A deals (the most recent transaction is Onexim's acquisition of a 50 % stake in Renaissance Capital Bank for USD 500 mn). The large state-owned banks and some foreign banks will be the main beneficiaries after the crisis is over.

What makes the prospects less gloomy despite the global and domestic turbulences is that the Russian economy can rely on a safety net thanks to the funds accumulated in the Reserve Fund, huge international reserves while the government's foreign debt is relatively low.

Serbia



Outlook

With the Radicals having split in the parliament after 17 members formed a new parliamentary grouping led by former deputy leader Nikolic, the prospects for political stability in Serbia have improved. This increases the likelihood of advancing co-operation with The Hague Tribunal and of Serbia achieving candidate country status in 2009. Meanwhile, worsening international financial market conditions are exposing the Serbian economy, which is characterised by a large current account deficit, a looser fiscal policy after a one-off 10 % pension increase and still strong credit growth, increased risk and slower growth anticipated for 2009. We expect inflation will continue to moderate into 2009 as food and oil prices play a more constructive role. At the same time, we look to the central bank to stem the appreciation pressures on the currency which we believe will remain supported by the extensive privatisation pipeline in 2009 and beyond.

MOODY'S LT FC RATING
Not rated

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

FITCH LT FC RATING
BB-/Stable

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

Macroeconomic data and forecasts

	2006	2007	2008f	2009f	2010f
Nominal GDP (EUR bn)	24.3	29.1	34.6	41.8	47.8
Per capita GDP (EUR)	3,270	3,940	4,690	5,680	6,490
Real GDP, yoy (%)	5.6	7.1	7.0	5.3	5.6
Inflation (CPI), yoy, eop. (%)	6.6	10.1	9.5	7.7	5.4
Inflation (CPI), yoy, avg. (%)	12.7	6.8	11.2	8.7	6.3
Unemployment rate (%)	20.9	18.1	18.0	17.5	17.0
Exchange rate RSD/EUR, eop.	79.0	79.2	76.0	75.0	73.0
Exchange rate RSD/EUR, avg.	84.1	80.1	80.0	75.5	74.0
2W repo rate, eop.	14.00	10.00	15.75	13.50	10.00
Current account balance/GDP (%)	-9.8	-13.2	-17.0	-13.6	-11.1
FDI/GDP (%)	14.0	5.5	6.7	7.1	7.1
Budget balance/GDP (%)	1.5	1.3	-2.0	-3.0	-2.0
Public debt/GDP (%)	34.1	28.4	23.3	22.0	22.0
Total external debt/GDP (%)	61.3	61.0	56.5	53.2	50.6

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

Main topics

- During September the prospects for political stability improved with the Radical party splitting and 17 members forming their own parliamentary grouping. The government will be in a position to pursue its legislative agenda with more certainty now.
- In Q2 2008 GDP growth slowed to 6.2 % yoy. Industrial production, construction activity and retail sales data have all trended lower in recent months.
- Headline inflation has come down over the summer months as oil and food price dynamics became more constructive. Nonetheless, core inflation remains elevated, which in turn provides less scope for the National Bank of Serbia to lower interest rates.
- The one-off 10 % increase in pensions granted by the government on 29 August (and to come into effect in November) has loosened fiscal policy and should add over 1 % of GDP to recurrent spending in the full year.
- The current account deficit continues to widen, rising 68.3 % yoy in July to USD 5.6 bn on the back of higher oil imports and generally strong domestic demand.
- At the same time FDI inflows were solid at USD 2.4 bn. Privatisation revenues are expected to be greater in 2009 and 2010, which will support solid medium-term FDI inflows.

EU candidate country status likely in 2009

New government strengthened

During September the Radical Party split after it emerged deputy leader Nikolic had been in discussions with President Tadic and indeed voted for the ratification of the Stabilisation and Association Agreement (SAA) with the EU. In the end he formed a new parliamentary grouping with 16 other disaffected Radicals, thereby strengthening the hand of the government and President Tadic. This improves the likelihood of Serbia finding the remaining two Hague Tribunal fugitives, which would open the way for the EU to ratify the SAA with Serbia and give the country candidate country status next year. In this regard, on 15 September the Netherlands again blocked the implementation of the interim agreement with Serbia until full co-operation with the Hague Tribunal is established. The EU is set to issue its annual report on Serbia's progress toward EU membership in October.

Moderating domestic demand

Economic growth slowed in Q2 2008 to 6.2 % yoy after having increased 8.4 % in Q1. Thus in H1 economic growth was 7.3 %. Industrial production slowed slightly during Q2 2008 and in the first seven months of the year recorded a growth rate of 4.2 % yoy, which was rather evenly distributed amongst manufacturing (+4.3 % yoy), mining (+3.9 % yoy) and electricity, gas and water supply (+4.6 % yoy). At the same time, seasonally adjusted data points to near-term softness in industrial production, with seasonally adjusted manufacturing activity down 0.8 % mom in July.

Construction activity during Q2 expanded 10.3 % yoy, slightly up compared to Q1, which is due in part to seasonal factors. For H1 2008 construction activity was up 9.7 % yoy.

Retail sales slowed during Q2. After having begun the year strongly, retail sales growth in real terms fell to 5.9 % yoy in the first seven months of the year, in part because of higher inflation, even though credit growth remains robust and wage growth has been strong.

Indeed, in real terms in July gross wages rose 6.7 % yoy while average net wages in the same month exceeded EUR 400, representing a nominal increase of 15.9 % yoy. Overall, after an exceptionally strong Q1 2008, we expect that the contribution of domestic demand to growth during Q2 was lower. Data available to date for Q3 suggests this trend is continuing.

Headline inflation dips, core inflation remains high ...

Although the headline inflation rate moderated to 9.9 % yoy in September (the EU's harmonised index of consumer prices, which the central bank will use from next year as the basis for its core inflation tar-

get, rose 11.5 % yoy in September), core inflationary pressures remain marked. In August the core inflation rate was 10.4 % yoy, National Bank of Serbia governor Jelasic admitted that the bank's target of 3–6 % for this year was not attainable.

By the end of the year we expect core inflation to fall to 9.3 % yoy while the headline inflation rate should moderate to 9.5 % yoy with more constructive oil and food price dynamics.

With fiscal policy having become more expansionary after the one-off 10 % increase in pensions to come into effect in November (an election promise) which will add over 1 % of GDP to recurrent spending, we do not see too much scope for the NBS to loosen monetary policy. We therefore expect the 2W repo rate to remain unchanged at 15.75 % this year even though our expectation of a moderation in the inflation rate in the final quarter of the year may be used as a pretext to ease monetary policy (and a reduction for the bank in sterilisation costs). At the same time the intervention in the currency market on 5 August sent a fairly clear message to market participants that the central bank does not want to see the RSD appreciate too quickly. Part of the reason is that high oil prices in H1 2008 and strong domestic demand have led to a significant widening of the current account deficit so far this year.

...as the current account deficit widens

In the first 7 months of the year the current account deficit has risen 68.3 % yoy to USD 5.6 bn. With domestic demand likely only to moderate slightly this year we reckon the current account deficit will total 17 % of GDP this year. Although there have been FDI inflows of almost EUR 1.7 bn in Jan-July 2008, the vast majority of privatisation revenues will be realised in 2009 and 2010, suggesting solid FDI inflows in the medium term. Nonetheless, given current financial market conditions those revenues may well be lower than what could have been expected in previous years. Capital account data shows an increase in medium and long-term credit of USD 4.5 bn in the first 7 months of the year.

At the end of July, gross foreign debt rose to EUR 19.1 bn, which represents an increase of EUR 1.3 bn since the beginning of the year. At the end of August gross foreign exchange reserves stood at EUR 9.5 bn, which translates into import coverage of approximately 6 months, which is rather comfortable. Nonetheless, given the persistently strong credit growth, a large current account deficit and loosening fiscal policy at a time of intense international financial market conditions the Serbian economy is exposed to increased risk.

Event	Date	Reading
2009 Budget	November/ December	After the government granted a one-off 10 % increase in pensions following an election promise, both the central bank and investors will be looking towards indications of a more restrictive budget next year.

Ukraine



Outlook

Growth has remained very strong. This was supported by high global demand for steel and by ample capital inflows from abroad despite the global liquidity crisis. Continued very high growth accompanied by a further drastic widening of the current account deficit while capital inflows dry up is not sustainable however. We assume that GDP growth will significantly slow in 2009 and the authorities will also need to make big efforts to keep the hryvnia within the recently announced corridor for 2009. Credit growth has already begun to slow and the slowdown will accelerate as the economy cools and credit quality deteriorates. The political uncertainty, likely to last for some time, additionally contributes to raising financing costs as the risk aversion of investors has substantially increased. We expect some acceleration of economic growth in late 2009. By then it should be supported by renewed construction activity, in part related to the Euro 2012, and a rather loose fiscal stance in the run-up to the 2010 presidential elections.

MOODY'S LT FC RATING
B1/Positive

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

FITCH LT FC RATING
BB-/Negative

SPREAD AVG (SEP) 635
EMBI+ Spread on USD Curve

Macroeconomic data and forecasts

	2006	2007	2008f	2009f	2010f
Nominal GDP (EUR bn)	84.8	102.6	136.2	170.7	196.7
Per capita GDP (EUR)	1,810	2,200	2,950	3,720	4,320
Real GDP, yoy (%)	7.1	7.6	6.3	4.2	5.1
Inflation (CPI), yoy, Dec. (%)	11.6	16.6	20.3	10.8	7.3
Inflation (CPI), yoy, avg. (%)	9.1	12.8	24.9	12.4	8.2
Unemployment rate (%)	6.8	6.9	6.2	6.0	6.0
Exchange rate UAH/EUR, eop.	6.65	7.42	7.18	7.02	6.89
Exchange rate UAH/EUR, avg.	6.34	6.92	7.44	7.10	7.10
Exchange rate UAH/USD, eop.	5.05	5.05	4.95	5.09	5.10
Current account balance/GDP (%)	-1.5	-4.2	-7.2	-8.9	-10.4
FDI/GDP (%)	5.4	6.6	5.9	3.8	5.5
Budget balance/GDP (%)	-0.7	-1.1	-1.4	-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	51.9	48.9	51.0

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

Main topics

- Real GDP expanded by 7.1 % yoy in Jan-Aug 2008 according to preliminary Ukrstat estimates. Industrial output was by 6.3 % higher in Jan-Aug than the year before, retail sales 25.6 %
- Inflation peaked at 31.1 % yoy in May 2008. It eased to 26.0 % yoy in August. We assume it will fall to some 20 % in December of this year thanks to a good harvest.
- Import growth of 57.4 % yoy in USD terms more than tripled the current account deficit from a year earlier to USD 7.7 bn in Jan-Jul despite an increase in exports by 46.0 % yoy.
- Despite the global banking crisis, net FDI inflows increased 32.1 % yoy to USD 6.9 bn in Jan-Jul, long and medium borrowing was at USD 8.9 bn 33.6 % higher than the year before. More than half of FDI and other inflows went to the banking sector.
- Spreads on 5Y CDS averaged more than 500 bps in the first half of September compared with about 130 bps in June 2007, before the global banking crisis began.
- The second quarter of 2008 marks the beginning of a slow-down in credit growth. Loan growth eased to average 2.5 % mom in April-July, from 4.8 % the same period a year earlier, with growth in corporate loans declining to 2.4 % from 4.0 % and in retail loans to 2.7 % from 6.6 %.

High capital inflows delayed slowing but are unsustainable

The orange coalition broke

On Wednesday, 3 September 2008, Ukrainian President Viktor Yushchenko's party (NUNS) pulled out of the ruling coalition amid a government dispute over presidential powers and the Georgia-Russia conflict. The main trigger for the break-up was that the Yulia Tymoshenko Block (BYUT) and former Prime Minister Victor Yanukovich's Party of the Regions cooperated in adopting a law which strips the president of his veto on prime ministerial candidates and facilitated the impeaching the president. Yushchenko also accused Prime Minister Yulia Tymoshenko of "treason and political corruption" in failing to back the president in his support for Georgia and condemnation of Russia in the recent conflict over South Ossetia. Ukraine is always good for last minute solutions of conflicts, but early parliamentary elections or a temporary BYUT-Regions coalition with the purpose of gaining positions for early elections a bit later have become likely now. The most important immediate economic impact of the ongoing political woes is a further rise in refinancing costs because of the higher risk perception by foreign investors. The more long-term consequences – on privatisation, the restructuring of the utilities, monetary policy – will depend on the relative power between BYUT and the Regions and on the stability of a new government. Neither BYUT nor the Regions however want to fundamentally depart from the course towards the EU (Nato might be a different thing) or have a serious conflict with Russia.

Growth still very high

Real GDP grew by 7.1 % yoy in Jan-August 2008, according to preliminary UkrStat estimates, with agriculture soaring 24.4 % yoy and trade and transportation being the other main drivers. Value added in construction, education and health fell. Real disposable income grew by 13.7 % yoy in Jan-Jul despite high inflation, real wages by 9.0 %, retail sales increased 25.6 % yoy in real terms in Jan-August.

Budget: draft law for 2009 rather optimistic

The surplus of the consolidated budget of the central government and the local authorities equalled 1.5 % of GDP in H1 2008, slightly below the 1.7 % of last year. We believe that revenues will increase slightly less than expenditures because of the cooling economy, resulting in a widening of the consolidated budget deficit to 1.4 % of GDP this year from 1.1 % of GDP in 2007. On 13 September 2008, the government approved and sent to the parliament its draft for the 2009 budget law. It foresees revenues of the state budget of UAH 288.1 bn, and expenditures of UAH 305.5 bn, resulting in a deficit of 1.4 % of GDP. The revenues of the consolidated budget are projected at UAH 372.5 bn against UAH 280.1 bn planned for 2008, an increase of 33 %. This is based on the assumption of 6 % real GDP growth and of 9.5 % yoy inflation in December. The consolidated budget is to be balanced, an unlikely event given that lower than assumed growth will limit revenues

while social spending will substantially increase. We expect the deficit of the consolidated budget to widen to 3 % of GDP in 2009.

Credit growth slowing

To rein in inflation and control credit risk, the central bank (NBU) has applied several tightening measures including a gradual increase of the minimum regulatory capital to EUR 10 mn by 1 January 2012, which could affect small banks. The NBU raised the average weighted interest rate of its refinancing operations step-by-step from 14.6 % in January to 15.3 % by April and then further to 15.9 % by August. Reserve requirements for banks on loans (up to 6 months) from non-residents increased from 4 % to 20 % as of July. On the other hand, the NBU is now accepting shares of banks' owners as security when refinancing banks. Loan growth eased to average 2.5 % mom in April–July, from 4.8 % the same period a year earlier, with growth in corporate loans declining to 2.4 % from 4.0 % and in retail loans to 2.7 % from 6.6 %.

Where is the hryvnia going?

The NBU radically changed its FX policy on 21 May 2008 and revalued the official exchange by 4.1 % to 4.85 per 1 USD after having kept it at 5.05–5.06 for a long time. On 4 July 2008, the NBU announced a parity of 4.85 to the USD, with a fluctuation band of +/-4 %. On 15 September, the policy guidelines for 2009 were adopted and the corridor set at 4.85 +/-5 %.

CA deficit tripled, capital inflows soared

Ukraine's current account deficit more than tripled in H1 2008 from a year earlier, to USD 6.8 bn from USD 2.0 bn. The deficit widened further to USD 7.7 bn in Jan–Jul. Exports increased by 46.6 % yoy in USD terms in Jan–Jul and imports by 57.4 %. Ongoing high capital inflows despite the global banking crisis nevertheless allowed foreign exchange reserves to increase by USD 4.7 bn during Jan–Jul. Net FDI inflows increased 32.1 % yoy to USD 6.9 bn, long and medium borrowing was at USD 8.9 bn 33.6 % higher than the year before. More than half of the FDI and other inflows went to the banking sector. Neither the widening of the CA deficit at such a pace nor capital inflows of such a magnitude are sustainable. About one-half of the growth in exports was attributable to metal exports; this is not very likely to continue at such magnitudes given the slowing of the global economy. Ukraine can also not remain unaffected by the global liquidity crisis and the global credit tightening. Record high CDS spreads (peaking at 653 bps for 5Y on 18 September 2008 compared with 189 bps on 18 September 2007) have increased costs for cross-border refinancing. We assume that abating foreign financing will have a major negative impact on growth and that the hryvnia will come under pressure in 2009 at the latest and the authorities will need to make a strong effort to preserve the aforementioned corridor.

Event	Date	Reading
New government	Any time	Will give at least some indication where Ukraine's economic policy and structural reforms are heading to.

Annex

Country Ratings – foreign currency long term debt						
		Current Rating	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	Stable	26-Sep-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	03-Oct-08	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	Negative	25-Sep-08
	S&P	BBB+	A–	17-May-07	Negative	21-Jan-08
	Fitch	BBB	BBB+	03-Oct-08	Negative	03-Oct-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	03-Oct-08	Negative	03-Oct-08
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	Baa1	Baa2	16-Jul-08	Positive	16-Jul-08
	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	Positive	30-Jul-08
	S&P	A	A–	19-Dec-05	Positive	03-Mar-08
	Fitch	A+	A	08-Jul-08	Stable	8-Jul-08
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	B+	BB–	12-Jun-08	Stable	12-Jun-08
	Fitch	BB–	B+	21-Jan-05	Negative	25-Sep-08

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+

5-Y Credit Default Swaps (USD, bp)

	Q4 2007	quarterly – eop.			Q3 2008	Latest 1-Oct-08	Latest YTD % change
		Q1 2008	Q2 2008	Q3 2008			
Bulgaria	72	180	159	225	225	212,4 %	
Croatia	66	133	95	138	138	110,1 %	
Czech R.	16	42	28	62	62	281,6 %	
Hungary	49	176	134	166	166	243,0 %	
Kazakhstan	203	282	222	435	435	114,0 %	
Latvia	138	156	167	330	330	140,0 %	
Poland	24	74	51	74	74	213,4 %	
Romania	82	203	193	260	260	217,1 %	
Russia	88	148	108	261	261	196,6 %	
Serbia	221	250	246	255	255	15,4 %	
Slovakia	17	54	30	60	60	263,6 %	
Turkey	167	310	309	297	297	77,5 %	
Ukraine	242	299	378	718	718	196,9 %	

Source: Bloomberg.

Money market interest rates, avg.

	Sep-07	Jul-08	Aug-08	Sep-08	Sep-08/Sep-07 difference
Bulgaria – 1M Interbank mid	4.92	6.74	6.79	6.80	1.88
Croatia – 1M Zibor mid	5.90	5.48	5.58	6.24	0.34
Czech. Rep – 1M Pribor mid	3.33	3.85	3.65	3.67	0.34
Estonia – 3M Talibor	4.92	6.00	6.00	5.98	1.07
Hungary – 1M Interbank	7.70	8.50	8.54	8.59	0.89
Kazakhstan – 1M Kibor	7.88	6.56	6.04	6.27	-1.61
Latvia – 3M Rigibor	8.73	5.42	5.48	5.40	-3.32
Poland – 1M Wibor mid	4.96	6.27	6.25	6.31	1.35
Poland – 3M Wibor mid	5.09	6.62	6.52	6.56	1.47
Romania – 1M Bubor mid	6.26	10.95	11.86	12.71	6.45
Russia – 3M Interbank	6.95	6.23	7.22	8.65	1.70
Slovakia – 1M Bribor mid	4.30	4.20	4.27	4.20	-0.11
Slovakia – 3M Bribor mid	4.32	4.33	4.31	4.25	-0.07
Turkey – 1M Interbank	17.48	17.46	17.44	17.70	0.22

Source: Bloomberg.

Exchange rates – ECB methodology

	Regime	Target	Exchange rate vs EUR – quarterly eop.				Latest 01-Oct-08	Latest YTD % change
			Q4 2007	Q1 2008	Q2 2008	Q3 2008		
Bulgaria	Currency Board	EUR	1.96	1.96	1.96	1.96	1.96	0.0 %
Croatia	Managed Float	Informal peg to EUR	7.33	7.27	7.24	7.11	7.1034	-3.1 %
Czech. Rep.	Managed Float	Inflation	26.55	25.24	23.88	24.50	24.59	-7.4 %
Estonia	Currency Board	ERM II: central parity a 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 %	252.86	260.65	235.38	242.15	242.3	-4.2 %
Kazakhstan	Free Float	Inflation	177.17	190.22	189.38	171.96	171.96	-2.9 %
Latvia	Currency Board	ERM II: central parity at 0.702804 to 1 EUR, +/-15 %	0.697	0.698	0.705	0.708	0.708	1.6 %
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	3.60	3.52	3.35	3.40	3.38	-5.9 %
Romania	Managed Float	Inflation (1 new RON = 10.000 ROL)	3.58	3.73	3.65	3.75	3.74	4.6 %
Russia	Managed Float	Control floating, inflation band	35.89	37.09	36.94	36.14	36.22	0.9 %
Serbia	Managed Float	Inflation	78.80	82.43	78.51	76.84	76.76	-2.6 %
Slovakia	Managed Float	ERM II: central parity at 30.1260	33.61	32.50	30.22	30.30	30.30	-9.8 %
Ukraine	Free Float	USD de facto	7.36	7.89	7.19	7.15	7.18	-2.5 %
Turkey	Free Float	Inflation	1.72	2.09	1.94	1.79	1.79	4.5 %

Source: Bloomberg.

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