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Emerging Europe: Relief, not euphoria

- **On the back of the healthier than anticipated rebound in global growth we have marginally raised our broad CEE17 growth forecast to 1.4% (by 0.3pp) in 2010. The modest size of the revision signals that we feel more confident about the economic recovery in EME, but certainly not euphoric, as headwinds at both the global and local level will limit the pace of recovery going forward.**

- **The global economy** is rebounding faster than anticipated, driven by a robust recovery in global trade. Germany has also surprised on the upside, and the rapid improvement in the euro zone should quickly transmit to CEE. The more open economies (Czech Republic, Hungary, Slovakia) are best positioned, but Poland for now remains the outperformer.

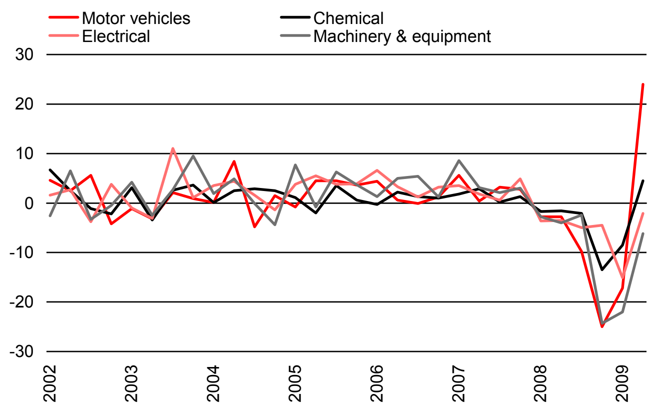
- **CEE vulnerabilities** have shifted from external to fiscal balances, as the growth contraction has narrowed C/A gaps and widened fiscal deficits, including in Poland and Turkey. Hungary and to some extent Romania are bucking this trend, with a prudent fiscal stance in the context of IMF-supported programs. Political ramifications of these adjustments have, however, been evidenced by the recent collapse of the Romanian government.

- **Key macro forecast highlights**: **1.** Although Poland is outperforming at the moment we believe this reflects the late cycle nature of its economy, and expect this to turn into underperformance in 2010-2011. We hence increased our 2009 GDP forecast but slightly reduced 2011, **2.** We expect the Turkish economy to significantly outperform the region in 2010 and see GDP growing at 3.2%, **3.** Despite the recent surge in oil prices we expect the Russian economy to only grow by 1.3% in 2010 due to weak domestic demand, **4.** We expect Hungary, the Baltic Countries, Bulgaria, Croatia and Serbia to remain in recession in 2010.

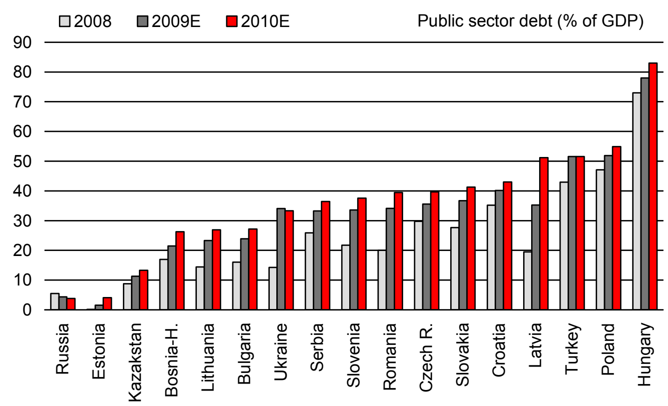
- **FI/FX market outlook**: We expect the likely appreciation pressure on CEE currencies to translate into sustained low levels of short-end rates and we see scope for ongoing under-performance of CEE FX vs. other asset classes. As such we only expect the PLN to meaning-fully appreciate by the end of the year given undervaluation and expected privatization flows.

IMPROVEMENT IN GLOBAL TRADE IS POSITIVE BUT VULNERABILITIES SHIFTED FROM THE EXTERNAL TO THE FISCAL SIDE

Global trade driving the recovery (German foreign new orders)



CEE vulnerabilities shifting from the external to the fiscal side



Source: UniCredit Research

Global recovery underway, with strong short-term momentum

The global economy is currently enjoying a robust and broad-based rebound, but momentum will weaken in 2010

The recent round of 2Q GDP releases has confirmed that the global economy has rebounded sooner and faster than markets had been anticipating. The evidence in terms of hard data suggests that this recovery is genuine, and in coming months will probably continue to look V-shaped, fueling market optimism. In the euro zone, economic activity contracted a mere 0.2% on a quarterly basis, much less than expected, thanks to upside surprises in France and in Germany, where quarterly growth has already returned to positive territory. In the US, 2Q GDP showed a 0.7% annualized contraction, while the UK was the only developed economy to disappoint, showing a 0.8% qoq decline. In Asia, the main emerging economies grew by an average annualized rate of more than 10%, and even sluggish Japan rebounded by a solid 0.9% qoq. The resilience of Latin America, especially Brazil, has also surprised on the upside.

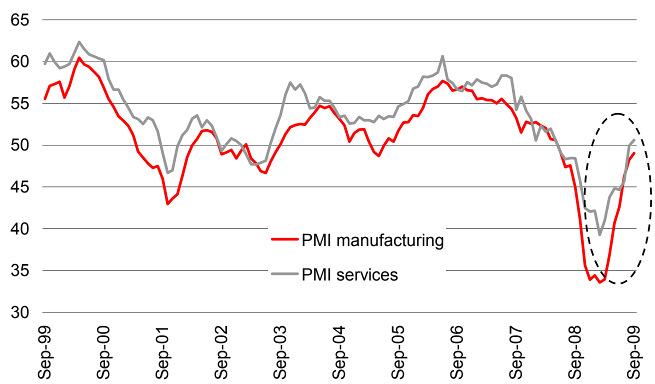
While policy stimulus has played a key role, it is global trade that has become the main engine of the recovery: the acceleration in economic activity has started most decisively in Asia, and its robust pace has helped turn net exports into an important contributor to growth – together of course with the ongoing contraction in imports.

The positive momentum of data surprises is likely to continue until the end of the year and possibly into early 2010, pushed by three main drivers: 1. global trade will continue to provide support; **2.** the inventory cycle is only now kicking in with gusto, and will start showing up in the GDP growth data beginning in 3Q (inventories subtracted as much as 0.7pp from euro zone growth in 1Q and 2Q); and **3.** already enacted policy stimulus will continue to come on line and propel the economy.

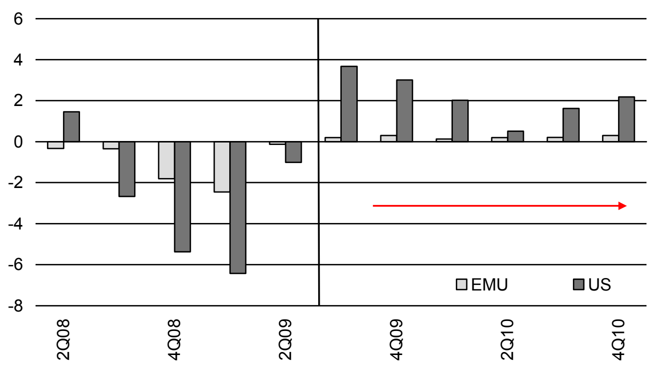
However, growth momentum is fated to fade into 2010 especially in the developed economies. Even though supportive policies will remain in place, policymakers will not provide fresh stimulus as the economy improves, and the policy impulse will therefore abate. Private sector demand should take up the baton, but both investment and consumption face important headwinds: **1.** consumption will be held back by rising unemployment; and **2.** investment will be restrained by historically low levels of capacity utilization and the already high levels of leverage by corporates.

HEALTHY RECOVERY IN THE EURO ZONE UNDER WAY BUT WE EXPECT ANOTHER SLOWDOWN IN 2Q10

Healthy recovery in the euro zone



Recovery underway, but momentum will weaken in 2010



Source: Markit, UniCredit Research

CEE to benefit from global recovery, but concerns persist on fiscal imbalances and lending

The faster pick-up in the euro zone will gradually support a recovery in CEE activity

The sharp pick-up in euro zone sentiment indicators is already reflected in better CEE business sentiment – CEE should benefit very soon from the strong German recovery. This will primarily support countries with more open economies (Czech Republic, Hungary, Slovakia). Besides net exports, a further contribution to growth should come from a turnaround in the inventory cycle: the sharp recession registered throughout the region in 1Q and 2Q included an unprecedented rapid downward adjustment in inventories – which now bodes well for near-term recovery prospects. **Poland remains the outperformer in terms of growth.** The country has successfully avoided recession, and is poised for growth of 1.5% this year, as private consumption has remained resilient in the face of rising unemployment. This outperformance, however, in part reflects a late-cycle phenomenon: we expect investment and consumption to struggle, restraining the acceleration of growth to rates well below potential in 2010-11.

Sentiment indicators failed to improve in the service sector, however, which suggest that domestic demand is set to remain weak in the coming quarters:

1. CEE retail sales correlate highly with credit, and hence household demand will remain weak where the banking sector relied heavily on external financing, and is currently reducing its loan to deposit ratios by moderating lending. The winners here are Turkey and Poland, where loan to deposit ratios are below 100%; and which are therefore less vulnerable to deleveraging in the banking sector.

2. Investment will remain extremely soft given that significant spare capacity gives firms leeway to increase production and delay new investment until they have greater confidence in the recovery.

This implies that after a deep recession, the structure of CEE growth is changing in favor of net exports. This has already helped to drive a fast and significant reduction in external current account imbalances, which were the region's Achille's Heel – external financing risks are therefore declining quickly. Turkey, where the adjustment has been helped significantly by lower energy prices, is a case in point: we project the C/A deficit to narrow to 1.5% this year from nearly 6% last year.

In some countries, however, fiscal imbalances are becoming a concern. In Kazakhstan and Russia falling commodity prices and lower revenues are pushing deficits wider – although the low level of total public sector debt (Russia: 4.4% of GDP estimated for end of 2009) (Kazakhstan: 11.3% of GDP estimated for end of 2009) is a supportive factor. Within CEE, Hungary is the strong performer on this front: in the context of its IMF program, it is running a tight fiscal policy to balance the fact that it has the highest debt ratio in the region (79% of GDP estimated for end of 2009). In contrast, fiscal deficits are widening rapidly in Poland and Turkey**.**

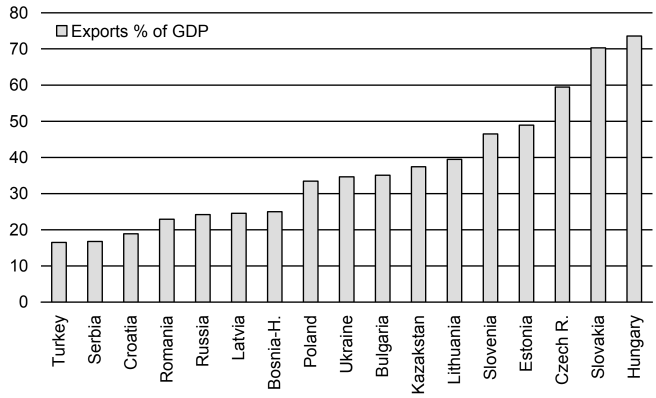
Just as in the euro zone, there is concern that a contraction in lending could hamper the recovery in the EEMEA region. In the euro zone, this concern has been clearly articulated by the ECB: the worry is that as non-performing loans rise due to the recession, their adverse impact on banks' balance sheets will trigger another round of deleveraging via a contraction in lending. Given the strong inter-relation between the banking system in the euro zone and in EEMEA, this credit squeeze would then most likely manifest itself across the whole European region. This concern needs to be taken seriously, as some lending markets have already come under stress, notably in Romania.

However, conditions in the banking sector are improving: 1. banks' profitability has increased recently, with support coming also from the recovery in asset prices, which has led the IMF to lower its estimate of total financial sector losses; **2.** the improvement in the growth outlook reduces the downside risks to the NPL forecasts; and **3.** some banks have already begun to strengthen their capital positions, thereby putting themselves on a stronger footing to sustain credit growth. Within the euro zone, there are some encouraging signs of ongoing normalization in financial markets, including a much reduced demand for liquidity at the ECB's Long Term Refinancing Operation on 29 September.

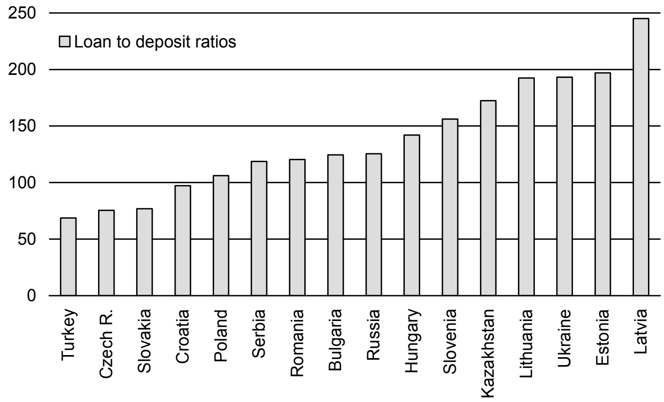
Bottomline: the growth outlook for the EEMEA region has improved – even though the region remains in a more vulnerable position than Emerging Asia and Latin America – and vulnerabilities have now shifted from the external to the fiscal side. With the recovery getting underway, rate cutting cycles are coming to an end: Turkey, Hungary and Russia are the only countries where we expect further rate cuts before year-end. It is too early, however, to start betting on a turn in the monetary policy cycle. With growth outlooks still uncertain and more dependent on exports, and hence competitiveness, central banks will remain wary of fuelling currency strength and will maintain a dovish bias for longer than markets expect. Even in the cases of the Czech Republic and Poland, where central banks have signaled the end of the easing cycles, markets are in our view too aggressive in pricing future hikes (see below).

MORE OPEN ECONOMIES SET TO BENEFIT THE MOST BUT LENDING WILL REMAIN SOFT IN SOME COUNTRIES

More open economies set to capitalize on recovery in global trade…



Lower banking sector leverage = lower risk to lending levels



Source: Fitch, UniCredit Research

FI/FX market strategy

Following a stellar second quarter when EEMEA/USD was up by 13.5%, EEMEA FX started to decouple from other asset classes in 3Q09. Our EEMEA/USD basket closed only 3.8% higher vs. a near 15% jump in SPX and the average 100bp spread tightening in their own 5y sovereign CDS. The divergence is even bigger when measured vs. the EUR given the general USD weakness observed in the last quarter. Moreover EEMEA FX has also underperformed the local rates market. This decoupling trend is even more spectacular considering the significant improvements in the region's current account balances during the third quarter. We attribute these developments to the following two factors:

1. **As domestic demand is still very weak and net exports have taken the lead in GDP growth central banks have become less tolerant toward stronger currencies** particularly given painful competitiveness gains at the end of last year. This is evidenced by ongoing rate cuts in Turkey (150bp in 3Q), the restart of the easing cycle in Hungary (200bp in 3Q vs. no change in 2Q) and the 150bp rate cuts together with increased intervention efforts by the Central Bank of Russia. The strength of this factor is also evidenced by the fact that the two best performing currencies in the CEE region were PLN and CZK where CenBanks hinted that they are finished with rate cuts (for now) and yield curves started pricing rate hikes (forward rate agreements indicate around 80bp rate hikes from both central banks over the next 12M).

2. **Non-resident holding data suggest that non-resident real money positioning is still relatively light in the local markets.** This indicates that the rally in local markets was mostly driven by local participants. For instance the non-resident ownership of HGBs has failed to increase since the end of July, non-resident ownership of TURKGBs was up by 8% but a significant part of this was driven by valuation effects. And finally we believe that inflows into dedicated euro zone convergence funds have not been remarkable in the last quarter.

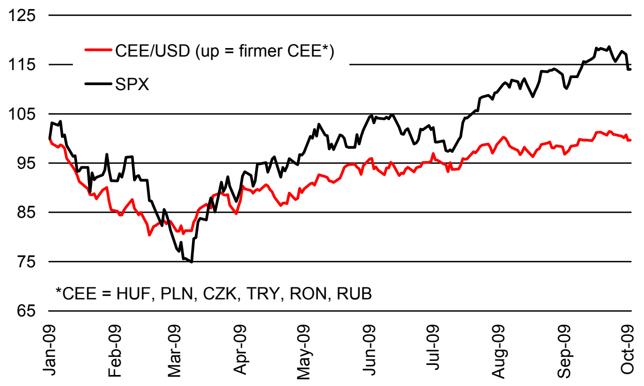
Looking ahead we expect the external balance improvement to put further appreciation pressure on FX, which CenBanks will continue to resist. On top of a temporary inventory driven deterioration we expect CEE current accounts to continue delivering positive surprises as household demand is still very weak (lower wages, soft lending growth) vs. a somewhat improved outlook for exports. We believe that the associated FX appreciation pressure is still unwelcome and CenBanks will continue to resist it with low rates and interventions. Against this backdrop although both Poland and the Czech Republic signaled the end of their easing cycles we think that no imminent rate hikes are on their agenda. On the other hand, we expect Hungary (further 50bp by year end), Turkey (at least further 50bp by year end) and Russia (further 100bp by year end) to continue the easing cycle in the next quarter. We believe this trend will continue to support the short end of the yield curves and we are particularly positive about Russia (as CBR tries to draw a line under the basket), Czech Republic and Poland (where the curves are pricing rate hikes). Additionally we see scope for further downside in TRY and HUF short end.

While external financing risks have been broadly addressed, focus will remain on fiscal policies with associated pressure on the long end of the curves. This can be best assessed, in our view, through ASW spread developments and on the shape of the yield curves. According to our estimates, although the level of Polish and Czech long end yields are relatively high, only the Turkish yield curve includes a fair amount of risk premium while the other curves have steepened on the back of falling short ends and steeper EUR yield curve. We think that risk premium vs. fiscal risks will continue to hang over the long ends of the curves vs. the short ends in Poland, the Czech Republic and potentially in Russia in the coming quarter.

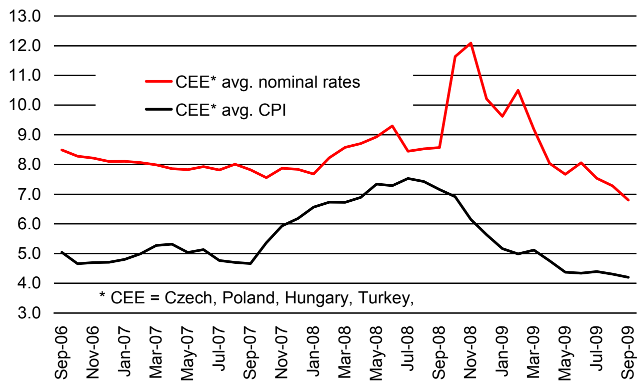
Bottom line: Overall, we expect that the likely appreciation pressure on CEE currencies will translate into a sustained low level of short end rates and we see scope for ongoing under-performance of CEE FX vs. other asset classes. As such, we only expect the PLN to meaningfully appreciate by the end of the year given undervaluation and expected privatization flows. In the bond markets we expect the long ends to continue underperforming short ends where the curve does not price sufficient fiscal related risk premium (Poland, Czech Republic and Russia).

CEE FX DECOUPLED FROM IMPROVING RISK APPETITE

CEE FX decouples from SPX in 3Q…



as CEE CenBanks accelerated rate cuts



Source: UniCredit Research

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Bulgaria

Outlook

We expect the downturn to deepen in 3Q09 but see some scope for an inventory driven recovery after this period. Given the limited ability of local policymakers to loosen fiscal and monetary policy we believe that the worst is not over yet for Bulgaria and we expect GDP to contract in 2010 by 2.5%, which appears to be in line with the recent IMF forecast but circa 2% below market consensus.

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

MACROECONOMIC DATA AND FORECASTS

	2007	2008	2009E	2010E	2011E
GDP (EUR bn)	28.9	34.1	32.9	31.8	32.9
Population (mn)	7.6	7.6	7.6	7.5	7.5
GDP per capita (EUR)	3,782	4,485	4,341	4,225	4,396
GDP (constant prices yoy %)	6.2	6.0	-6.3	-2.5	2.0
Private Consumption, real, yoy (%)	5.1	4.5	-7.5	-5.3	-2.1
Fixed Investment, real, yoy (%)	21.7	20.4	-22.4	-15.7	-5.0
Public Consumption, real, yoy (%)	3.4	-1.4	-1.2	2.0	1.5
Exports, real, yoy (%)	5.2	2.9	-15.8	-3.8	5.0
Imports, real, yoy (%)	9.9	4.9	-23.4	-11.2	-2.8
CPI (average, yoy %)	8.4	12.4	2.6	-0.6	1.5
Central bank reference rate	4.58	5.77	2.15	3.30	4.80
Monthly wage, nominal (EUR)	220	268	252	237	234
Unemployment rate (%)	6.9	6.3	9.5	12.9	13.5
Budget balance/GDP (%)	3.5	3.0	-0.3	-1.8	-1.8
Current account balance (EUR bn)	-7.3	-8.6	-4.1	-2.9	-2.3
Current account balance/GDP (%)	-25.1	-25.3	-12.4	-9.1	-6.9
Net FDI (EUR bn)	8.3	5.7	2.7	2.1	2.1
FDI % GDP	28.7	16.7	8.3	6.5	6.5
Gross foreign debt (EUR bn)	29.0	36.7	35.6	34.9	35.3
Gross foreign debt (% of GDP)	100.2	107.7	108.5	109.8	107.1
FX reserves (EUR bn)	11.9	12.7	11.2	10.0	10.1
(Cur.Acc-FDI)/GDP (%)	3.5	-8.6	-4.1	-2.6	-0.4
FX reserves/Gross foreign debt (%)	41.2	34.6	31.4	28.6	28.7
Exchange rate to USD eop	1.34	1.40	1.33	1.32	1.42
Exchange rate to EUR eop	1.96	1.96	1.96	1.96	1.96
Exchange rate to USD AVG	1.43	1.33	1.39	1.30	1.38
Exchange rate to EUR AVG	1.96	1.96	1.96	1.96	1.96

Source: UniCredit Research

STRENGTHS

- Strong commitment of the new administration to cut corruption and press ahead with other structural measures
- Significant potential to support growth by improving EU funds absorption

WEAKNESSES

- Large private sector funding gap
- Lack of exchange rate flexibility
- Limited room for fiscal and monetary policy expansion

Recovery is around the corner, but the worst is not over

Economy will hit the bottom in 2H09, as recession in industrial sector spills over into services sectors

GDP continued to contract to 4.9% yoy in 2Q09 from 3.5% yoy in 1Q09, with gross fixed investments and private consumption being the main drags. Activity indicators reported positive mom readings in July and August, but remain close to the -20% mark on a yoy basis. Retail sales dipped to fresh lows, as the downturn stimulated a move from consumption and borrowing towards savings and debt consolidation. Forward-looking indicators are not far from their lowest levels ever; signaling the worst is not over and output contraction is likely to have sharpened in 3Q09. Rebalancing of the labor market advanced at an encouraging pace in 1Q09 but lost momentum in 2Q09, partly due to the lack of effort to scale back jobs and wages in the public sector ahead of the general election in June. In August, CPI receded to just 1.3% yoy from 11.2% yoy one year ago, after headline inflation posted negative mom readings in the last four consecutive months. In 2Q09, housing prices lost 9.7% of their value qoq and were 24.2% down from their peak in 3Q08. Credit growth has come to a near-halt, as banks are under pressure to cutback external borrowing and growth of domestically attracted deposits lost momentum to just 0.9% yoy in August. On the positive side, the unwinding of the C/A gap has progressed at a faster than expected pace causing a pronounced improvement in the external position of the country.

Stronger than expected external balance improvement is under way

Rising job losses, falling housing prices and anemic credit growth will take their toll on consumer spending

We expect output in the manufacturing sector to stabilize in 1H10, as inventories start to be rebuilt and the growth prospects in the euro zone are less bleak, in our view. Despite the signs that manufacturing may turn the corner soon, there are several second-round-crisis effects which are now hitting the economy. The combination of rising job losses, falling housing prices and anemic credit growth will keep GDP growth negative next year. We expect the recession to be technically over at the end of 2010 or in early 2011, but at the same time the origins of the downturn does not augur for a strong rebound. In our view, self-sustainable recovery will not be possible without a normalization of lending growth and stabilization of the housing market. In addition, more time will be needed to steer the economy towards a more sustainable growth pattern, shifting production resources from overheated domestic-demand-oriented sectors to higher-value-added export driven industries.

Bumpy and protracted recovery lies ahead…

Despite difficult environment the new government seems to have restored fiscal discipline

The anti-crisis measures implemented by the previous government were too-short-term and lacked the focus to match the severity of the downturn. Following the general elections we have seen a pronounced shift toward more prudent policies. The new administration adopted a more decisive stance against corruption, which remains the Achilles heel of the economy, and embarked on aggressive cost cutting as it became clear that the lack of fiscal policy adjustment during the first seven months of the year could lead to a huge budget deficit in 2009. The authorities are now committed to downsizing public administration, bringing wage growth in line with productivity, linking pension growth to budget performance and shifting the financing of public investments at the expense of higher EU funds absorption and external borrowing. To help the recession-battered private sector the government will speed up VAT refunds, cut the social security contribution rate, reduce the number of license regimes and streamline the public procurement process.

Strong reform agenda reduces the pain from the downturn and helps bring end to recession

The policy approach seems to be the right one. Given the limited room for fiscal and monetary policy expansion under the fixed exchange rate regime, attention has shifted toward pressing ahead with the structural measures needed to improve competitiveness in the medium-to-long term, while at the same time boosting the absorption of EU aid which should provide the necessary stimulus for domestic demand in the short-run.

We see low risk of a sovereign ratings downgrade

The combination of re-established fiscal discipline and the strong commitment of the new administration to cutback corruption and press ahead with structural measures is a big plus for Bulgaria's sovereign ratings. In addition, in contrast to other emerging markets with pegged currencies, Bulgaria has better reserves metrics and exhibits less painful economic adjustment dynamics.

Czech Republic

Outlook

We have increased our 2010 GDP forecast to 1.4%, due to a somewhat better export outlook and an expected rebuild of inventories, domestic demand is to remain weak, however. Against this backdrop we do not think that the CNB will tolerate a much stronger CZK and only expect a 25bp rate hike at the end-2010 while forecast EUR/CZK at 26.00 in both years.

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

MACROECONOMIC DATA AND FORECASTS

	2007	2008	2009E	2010E	2011E
GDP (EUR bn)	127.3	148.1	137.7	144.3	155.2
Population (mn)	10.3	10.4	10.5	10.5	10.6
GDP per capita (EUR)	12,336	14,198	13,127	13,683	14,642
GDP (constant prices yoy %)	6.1	2.7	-4.2	1.4	3.5
Private Consumption, real, yoy (%)	4.9	3.4	1.1	-0.6	3.0
Fixed Investment, real, yoy (%)	10.8	-1.1	-8.0	-2.5	4.0
Public Consumption, real, yoy (%)	0.7	1.6	2.6	0	2.0
Exports, real, yoy (%)	15.0	6.6	-10.2	6.0	9.0
Imports, real, yoy (%)	14.3	5.0	-10.0	5.9	8.5
CPI (average, yoy %)	2.8	6.3	1.1	2.2	2.1
Central bank reference rate	3.50	2.25	1.25	1.50	3.25
Monthly wage, nominal (EUR)	755	910	879	907	971
Unemployment rate (%)	6.6	5.5	8.1	9.6	9.4
Budget balance/GDP (%)	-0.6	-1.5	-7.0	-5.0	-4.6
Current account balance (EUR bn)	-4.1	-4.6	-2.0	-3.1	-4.1
Current account balance/GDP (%)	-3.2	-3.1	-1.5	-2.1	-2.7
Net FDI (EUR bn)	7.6	7.3	4.0	4.2	5.5
FDI % GDP	6.0	4.9	2.9	2.9	3.5
Gross foreign debt (EUR bn)	51.6	57.8	64.2	67.3	74.0
Gross foreign debt (% of GDP)	38.9	42.1	45.8	46.6	46.7
FX reserves (EUR bn)	23.7	26.6	28.0	29.0	29.0
(Cur.Acc-FDI)/GDP (%)	2.8	1.9	1.4	0.8	0.9
FX reserves/Gross foreign debt (%)	45.9	46.0	43.6	43.1	39.2
Exchange rate to USD eop	18.19	19.21	17.69	17.57	18.12
Exchange rate to EUR eop	26.52	26.80	26.00	26.00	25.00
Exchange rate to USD AVG	20.25	16.97	18.79	17.22	17.96
Exchange rate to EUR AVG	27.75	24.96	26.50	26.00	25.50

Source: UniCredit Research

STRENGTHS

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

WEAKNESSES

- Austerity package to hit private consumption
- End of car subsidies in W. Europe to drag on auto industry
- Interim government lacking political mandate

GDP growth: exports and inventories to drive recovery

2Q GDP structure barely changed from 1Q, with inventories remaining the most depressing component

GDP grew by a mere 0.1% qoq in 2Q, ending 6 months of recession, but its yoy contraction still gained momentum to 5.5% from 1Q's 4.5%. The deepening of yoy decline resulted almost solely from a sharp reduction of inventories which wiped off 4.4pp from 2Q GDP. Retaining a similar dynamic to 1Q, fixed capital formation was down 7.2% yoy while private consumption rose 1.6% yoy, which implies that households have redirected their spending from investment to consumer goods. Finally, net exports continued to improve on the previous quarters, although their contribution to GDP was still negative (-0.7pp). The trend of falling inflation has remained intact with headline CPI dropping to a mere but still positive 0.2% yoy in August. Prices of food and transportation costs have been particularly compressed but both with the signs of bottoming out. Importantly, the country's external position has kept firm despite sharply slowing net FDI inflow. This is thanks to improving foreign trade and shrinking outflow of dividends which have brightened the picture on the C/A front.

Net exports and inventories to drive the economic rebound from 2H09

We believe the recession in yoy terms peaked in 2Q. Even though the first month of 3Q brought little signs of a rebound in the activity data, leading indicators combined with a favorable base effect paint a somewhat rosier picture for August onwards. We expect the upturn in GDP to be led by a rally in stock-building and a better export performance. That said, fixed capital formation is projected to remain depressed and the positive growth in private consumption should gradually evaporate. On balance, we have made few changes to the outlook for the GDP dynamic in 2H09, but a weaker than expected outcome in 1H has led us to revise the full-2009 GDP forecast down to -4.2% from -3.2%. By contrast, we have lifted the GDP growth forecast for 2010 from 0.7% to 1.4% in reaction to improved prospects for Germany (could be even higher without the austerity package). Hence, foreign demand is set to become the engine of GDP growth, propping up both exports and inventories, while domestic capital and household spending will hardly make any contribution to the recovery.

Austerity package to prevent public sector deficit from bursting

Our GDP and public sector deficit forecasts take into account the government austerity package recently approved by parliament. We estimate that the underlying fiscal restriction will slash next year's public sector deficit to 5% of GDP from 7% of GDP if there is no policy change scenario. Unlike its negative impact on GDP growth worth roughly 0.8pp in 2010, the package implies a stronger expansion for 2011, with our prediction for 3.5% GDP growth looking appropriate.

Risk of a November rate cut increasing, our baseline remains unchanged rates until end 2010

Although the August interest rate cut was not repeated in September, the recent appreciation pressure on CZK and dovish comments from the CNB suggests that the risk of a November rate cut is increasing. From a broader perspective our baseline scenario, however, remains that no more rate cuts will arrive in this cycle as inflation is approaching its bottom and economic activity is apparently behind the turning point. Given a parliamentary "yes" to a bolder fiscal restriction, we assume that the CNB will put off the start of a tightening cycle until late 2010. Importantly, planned hikes in VAT and excise taxes, which are supposed to add around 1%- point to the headline inflation next year, should not influence the CNB's decision making. We expect the repo rate at 1.50% at end-2010.

Period with the interim government in power extended after an early election plan scrapped

Political uncertainty increased sharply after the Constitutional Court scrapped a law allowing an early election to be held on 9-10 Oct. The chance of an election taking place before the year-end were then killed by the leftist parties, leaving the responsibility for the preparation of the 2010 budget to the interim government of PM Fischer. The austerity package supported by both main left and right-wing parties has given Fischer's cabinet wide political backing and has raised the likelihood it will stay on until the end of regular term in May 2010.

CZK will lack extra fundamental support to resume the firming trend next year

CZK has extended its rally against the euro by another 3% over the last three months taking little notice of the increasing tension on the political scene. However, we doubt that CZK will be able to keep these gains, forecasting its retreat to EUR/CZK 26.0 which is viewed as the level more consistent with CZK's long-term trend.

Estonia

Outlook

Estonia's economy has contracted very sharply since the credit crunch and, as a result, we continue to believe that plans to introduce the euro as early as in 2011 are very ambitious and are unlikely to happen. Nevertheless, we will keep a close eye on fiscal developments, which are also expected to influence the ratings outlook.

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

MACROECONOMIC DATA AND FORECASTS

	2007	2008	2009E	2010E	2011E
GDP (EUR bn)	15.6	16.1	13.1	11.5	10.4
Population (mn)	1.3	1.3	1.3	1.3	1.3
GDP per capita (EUR)	11,644	12,001	9,813	8,584	7,815
GDP (constant prices yoy %)	6.3	-3.5	-15.3	-3.8	5.1
Private Consumption, real, yoy (%)	7.9	-4.6	-16.2	-5.2	2.3
Fixed Investment, real, yoy (%)	4.8	-11.5	-29.2	-3.2	1.2
Public Consumption, real, yoy (%)	3.9	4.1	-4.7	-4.1	0.6
Exports, real, yoy (%)	0	-0.7	-12.3	-1.8	4.3
Imports, real, yoy (%)	4.2	-8.7	-23.9	-2.6	0.5
CPI (average, yoy %)	6.6	10.4	-0.1	-1.4	1.7
Monthly wage, nominal (EUR)	725	819	776	709	584
Unemployment rate (%)	4.7	5.5	13.5	15.4	15.1
Budget balance/GDP (%)	2.7	-2.9	-4.0	-4.4	-4.7
Current account balance (EUR bn)	-2.8	-1.5	0.1	0.2	0.4
Current account balance/GDP (%)	-18.1	-9.4	1.0	1.9	3.8
Net FDI (EUR bn)	0.8	0.6	0.1	0.2	0.2
FDI % GDP	5.3	3.7	0.6	1.5	2.0
Gross foreign debt (EUR bn)	17.2	19.1	16.5	15.8	14.1
Gross foreign debt (% of GDP)	112.4	118.5	125.6	138.3	135.7
FX reserves (EUR bn)	2.2	2.8	2.3	2.0	2.2
(Cur.Acc-FDI)/GDP (%)	-12.5	-5.7	1.6	3.3	5.7
FX reserves/Gross foreign debt (%)	13.0	14.7	14.0	12.6	15.6

Source: UniCredit Research

STRENGTHS

- Political determination to introduce the EUR
- Rapidly unwinding external imbalances
- Significant spare capacity

WEAKNESSES

- Difficulties to meet the 3% budget deficit criterion
- High FX leverage in domestic private sector
- Risk of contagion in case of Lat devaluation

Is the euro in sight?

Accelerated deterioration of economic activity in 2Q09

The contraction in economic activity that started in 1Q08 continued at an accelerated pace in 2Q09: GDP growth data came in at a negative 16.1% yoy, after 1Q's -15.0% yoy. Private consumption continued to move lower (2Q: -20.3% yoy from -17.3% in 1Q), as did fixed investment (2Q: -38.8% yoy; 1Q: -27.3%). Exports improved somewhat but remained still deeply in the red (2Q: -11.1% yoy; 1Q: -16.5%); imports fell further and registered -30.9% yoy in 2Q (1Q: -27.4% yoy). The sharper than expected fall-off in most of the indicators has prompted us to revise our full-year 2009 growth forecast to -15.3% yoy.

But foreign trade data improving

A closer look at the foreign trade data shows some upward movement and represents a flicker of hope, although the most recent figures somewhat muddy the picture: after some improvement in 2Q (exports at -13.2% yoy in June from -30.0% in May and imports at -29.3% yoy in June from -41.2% in May), the figures deteriorated again in July. Our calculations of the seasonally adjusted 3-month moving average show a more upbeat picture, however: after 7 months of negative mom figures, exports registered 3.1% mom growth in July – the second consecutive month of positive growth. Imports show a similar pattern with the seasonally adjusted 3-month moving average now at a positive 3.6% mom after one year of negative releases.

The development in exports and imports helped to improve the C/A – the rolling C/A to GDP ratio (3Q08-2Q09) stands – after the downwards revision of the 1Q data – at -2.2%; we expect a further improvement in the C/A to 1% to GDP in 2009.

Deflation is set to continue

Estonia slipped into deflation in May; the August CPI reading was -0.9% yoy, considerably down from August 2008 when CPI registered 11% yoy. We expect deflation to continue in the remainder of this year and pencil in an average of -0.1% yoy for the full year 2009.

The government is sticking to its euro-introduction plan in 2011

Despite the sharp contraction in economic activity, the government is sticking to its plan of introducing the euro as soon as possible – in Estonia's case this means in 2011. Controlling the public finances and achieving the allowed 3% to GDP budget deficit this year represents a big challenge, but Estonian politicians seem to be firmly determined to trim the deficit down to the required level.

But spill over effects from a Latvian devaluation may have unexpected consequences

At the moment it is very difficult to say whether they will reach their target, namely the 3% budget deficit this year or not – negotiations about next year's budget as well as further amendments to this year's are still ongoing, however, we continue to believe that Estonia will not reach the 3% budget deficit this year, given the sharp economic contraction, accompanied by falling tax revenues and increasing unemployment-payments. It is possible that the euro in Estonia might even be a bit further away: we stick to our view of a more than 50% probability of a devaluation of the lat over the course of the next year – this however could also have serious implications for Estonia given the high FX indebtedness of the private sector. As we said in the last CEE Quarterly, any change in Latvia's currency regime will most likely also lead to a change in the Estonian one.

Credit rating outlook depends on this years budget

S&P cut Estonia's long-term credit rating to A- with a negative outlook in August. This was not surprising, given that S&P's rating was previously two notches above Fitch's. Very important for the sovereign credit rating outlook is evidently the development of this year's budget. This was also said explicitly by S&P – should Estonia manage to keep its budget deficit below 3% in 2009, its creditworthiness will improve. As said above, this is not our baseline scenario, though.

Hungary

Outlook

The significant inventory adjustment that occurred in the first two quarters bodes well for the near term recovery outlook and we expect qoq GDP to improve sharply in the coming quarters. However, very soft domestic demand outlook means that we still do not see significant growth beyond the inventory rebuild. Accordingly, we keep our 2010 GDP forecast in negative territory (at -0.6%). Meanwhile, we believe that the NBH will try to resist the potential FX appreciation pressure which might come from the current account and improved risk appetite and still prefer EUR/HUF in the range of 265-285. Accordingly we see n-t downside risk to rates.

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

MACROECONOMIC DATA AND FORECASTS

	2007	2008	2009E	2010E	2011E
GDP (EUR bn)	101.4	105.8	90.3	96.3	102.9
Population (mn)	10.1	10.1	10.0	10.0	10.0
GDP per capita (EUR)	10,072	10,526	8,997	9,612	10,267
GDP (constant prices yoy %)	1.2	0.6	-6.1	-0.6	2.4
Private Consumption, real, yoy (%)	-1.4	0.1	-7.2	-3.8	0.1
Fixed Investment, real, yoy (%)	1.8	-2.6	-5.8	5.0	6.0
Public Consumption, real, yoy (%)	-4.5	-1.9	-1.6	-1.2	0
Exports, real, yoy (%)	16.4	4.8	-11.0	4.9	6.0
Imports, real, yoy (%)	13.4	4.7	-16.0	4.5	7.0
CPI (average, yoy %)	8.0	6.1	4.2	3.1	1.9
Central bank reference rate	7.50	10.00	7.00	6.00	5.50
Monthly wage, nominal (EUR)	736	799	703	744	788
Unemployment rate (%)	7.3	7.8	9.9	10.5	9.5
Budget balance/GDP (%)	-4.9	-3.4	-3.9	-4.5	-4.0
Current account balance (EUR bn)	-6.6	-8.9	-1.7	-1.8	-2.1
Current account balance/GDP (%)	-6.5	-8.4	-1.9	-1.9	-2.0
Net FDI (EUR bn)	0.8	3.6	1.4	1.5	1.7
FDI % GDP	0.8	3.4	1.6	1.6	1.7
Gross foreign debt (EUR bn)	99.5	121.8	114.8	126.3	133.7
Gross foreign debt (% of GDP)	98.1	115.1	127.1	131.1	130.0
FX reserves (EUR bn)	16.4	24.0	32.0	29.0	28.0
(Cur.Acc-FDI)/GDP (%)	-5.7	-5.0	-0.3	-0.3	-0.3
FX reserves/Gross foreign debt (%)	16.5	19.7	27.9	23.0	20.9
Exchange rate to USD eop	173.30	190.27	190.48	179.05	192.03
Exchange rate to EUR eop	252.72	265.49	280.00	265.00	265.00
Exchange rate to USD AVG	183.33	171.09	200.71	178.81	186.62
Exchange rate to EUR AVG	251.31	251.66	283.00	270.00	265.00

Source: UniCredit Research

STRENGTHS

- Significant IMF and EU balance of payments support
- Strong influence on fiscal policy by IMF/EU

WEAKNESSES

- High public sector debt levels
- Still wide external financing gap
- High FX leverage in domestic private sector

Near term outlook improves, NBH to resist HUF appreciation

Huge decline in inventories bodes well for n-t recovery prospects, but household demand will remain soft while investment will translate into higher imports in 2010

2Q GDP contracted by 7.5% driven by a huge inventory decline (42% yoy contraction vs. 22% in the first quarter). Other domestic demand elements have, however, improved compared to the first quarter: household consumption was down by 4.7% yoy after a 5.9% yoy decline, fixed capital formation declined by just 3.3% yoy after a 6.9% yoy contraction recorded in 1Q. As a result the net export jumped to 8.6% from only 3.4% in the first quarter. For the near term recovery prospects we believe that the huge inventory decline is good news as companies will start rebuilding inventories in the coming two quarters on better export markets. Accordingly, we are looking for a relatively significant jump in the qoq seasonally adjusted GDP figures probably moving into positive territory in 3Q and 4Q. Looking further ahead we think that the initial inventory rebuild boost will die down in 1Q-2Q next year leaving the yoy GDP figures just in negative territory. Our multi-quarter bearishness is driven by the poor household demand outlook (we expect a contraction of 3.8% yoy in 2010) due to extremely soft lending activity, lower wages and higher unemployment. Although fixed investments will receive a boost from investment in the car industry we believe this will lead to higher imports as well. Overall, we believe that the headline GDP will remain soft in 2010 and expect a contraction of 0.6% yoy..

Retailers unable to pass on tax changes to consumers – underlining the weakness of the domestic economy

We see significant risk of inflation undershooting the target by the end of 2010

CPI data delivered positive surprises in the third quarter but at the same time underlined the weakness of domestic demand. The July-August figures showed that retailers were able to pass on only around one-third of the VAT and excise tax hikes to final consumers. Accordingly inflation spiked at a much lower level than was originally thought and we revised our year end CPI forecast to 5.2% yoy from 6.5% yoy. Looking ahead we think that poor domestic demand and the appreciating currency, despite adverse base effects in commodity prices, will bring headline inflation below the 3% central bank target in 3Q10. By the end of the year we see a significant risk of CPI target undershooting and expect CPI of just 1.8% yoy.

Fiscal policy: 2009 looks to be on track but the 2010 target will likely be renegotiated

Although the IMF/EU agreed earlier to increase the budget deficit target to 3.9%/GDP, with this number Hungary still has the lowest deficit in the whole region. This has come into the spotlight after major fiscal deteriorations were observed in Hungary's neighboring countries. Although we do not see risks around the 2009 target (given high level of reserves built in) the poor domestic demand outlook and a very likely change in the government will lead to the renegotiation of the 2010 target (currently at 3.8%/GDP), in our view.

NBH preferred range appears to be EUR/HUF 265-285

Slight divergence between SPX and EUR/HUF already reflects the dovish CenBank backdrop

On the back of encouraging CPI releases and stabilizing risk premium (lower EUR/HUF and nearly 200bp CDS spread tightening) the NBH restarted the easing cycle in July and cut rates by 100bp which was followed by two more 50bp rate cuts. Although the NBH officially does not have an FX target based on the comments by various MPC members we think that the preferred range is around 265-285. That said we believe the key question for the next quarter will be how the NBH stops/slows the likely FX appreciation pressure coming from the radically improved current account and risk appetite backdrop (2Q already saw a decent surplus at EUR 476mn). The slight divergence between SPX and EUR/HUF in the last 2 months suggests that the dovish central bank might have already played a role. Accordingly we look for at least another 50bp rate cut until end-2009 followed by another 100bp in 2010.

Political noise eases as most parties are interested in status quo

The political noise has declined significantly in the last couple of months as most of the political parties seem to be satisfied with the status quo (i.e. no early elections). The opposition remains happy that the Socialist are doing the painful fiscal cuts.

Rating likely to be kept on hold in the coming quarter

Although risk perception and fiscal policy has improved (particularly in light of the deterioration elsewhere) we still do not believe that rating agencies will raise the rating in the coming quarter. The recent S&P outlook change is encouraging however.

Latvia

Outlook

GDP is set to remain weak in 2009, with only export and import figures showing some recent improvement, albeit from very low (negative) numbers. Despite the higher deficit targets policymakers still find it extremely difficult to implement measures, negotiated with the international lenders, with more budget cuts necessary to meet the conditions. As the story progresses, we continue to see risk of increasing pressure to change the FX parity.

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

MACROECONOMIC DATA AND FORECASTS

	2007	2008	2009E	2010E	2011E
GDP (EUR bn)	21.0	23.1	19.8	16.7	14.9
Population (mn)	2.3	2.3	2.3	2.3	2.2
GDP per capita (EUR)	9,218	10,177	8,775	7,434	6,653
GDP (constant prices yoy %)	10.0	-4.6	-16.3	-5.4	6.0
Private Consumption, real, yoy (%)	14.8	-10.6	-21.7	-6.7	1.8
Fixed Investment, real, yoy (%)	7.5	-12.7	-32.0	-6.7	2.6
Public Consumption, real, yoy (%)	3.7	1.5	-11.4	-9.6	-3.1
Exports, real, yoy (%)	10.0	-1.3	-16.9	0.7	10.5
Imports, real, yoy (%)	14.7	-13.6	-32.3	-3.7	0.2
CPI (average, yoy %)	10.1	15.5	3.4	-2.7	1.5
Central bank reference rate	6.00	6.00	3.50	4.50	3.00
Monthly wage, nominal (EUR)	565	682	636	520	441
Unemployment rate (%)	6.0	7.5	16.8	19.5	17.2
Budget balance/GDP (%)	-0.4	-4.0	-8.1	-8.6	-5.8
Current account balance (EUR bn)	-4.6	-3.0	1.0	1.1	1.0
Current account balance/GDP (%)	-23.8	-13.0	5.0	6.6	6.8
Net FDI (EUR bn)	1.4	0.7	0.2	0.3	0.4
FDI % GDP	6.8	3.0	1.1	2.0	2.6
Gross foreign debt (EUR bn)	28.4	29.6	28.3	25.9	20.1
Gross foreign debt (% of GDP)	135.1	128.2	143.2	155.0	134.6
FX reserves (EUR bn)	3.8	3.5	2.9	1.9	2.5
(Cur.Acc-FDI)/GDP (%)	-14.9	-10.0	6.1	8.6	9.4
FX reserves/Gross foreign debt (%)	13.4	11.8	10.2	7.3	12.4

Source: UniCredit Research

STRENGTHS

- Significant IMF and EU balance of payments support
- Rapidly unwinding external imbalances
- Improving external environment

WEAKNESSES

- Political instability
- Difficulties in implementing IMF/EU negotiated measures
- High FX leverage in domestic private sector

Where is the light at the end of the tunnel?

On a yoy basis all GDP subcategories moved lower in 2Q compared to 1Q

Economic activity in the first six months of 2009 was weaker than expected, declining by an average of 18.3% yoy. The fall was broad-based: in 2Q fixed investment declined by 38% yoy, private consumption by 23% and exports and imports were down 18% and 39% yoy respectively. Compared to the decline in 1Q (on an annual basis) all categories moved lower; our calculations of the seasonally adjusted data support this finding – only exports and imports showed a somewhat different pattern: seasonally adjusted real exports declined by 3.9% qoq in 2Q (significantly better than 1Q's -13.6%) and imports were down 12.6% qoq (from 1Q's -13.6%).

Exports and imports still in the red, but improving

The stronger decline in imports than in exports, as well as some improvement in the data, can also be seen from the monthly C/A figures – our calculations of the seasonally adjusted 3 month moving average of exports stood at -0.7% mom in July (up from its trough of -6.8% mom in January), imports registered -2.2% mom, showing a steady improvement from -11.2% mom at the beginning of this year. This development helped to further improve the C/A, the 3Q08 to 2Q09 C/A deficit to GDP now stands at -2.2% (last quarter it stood at -9.1%) and we expect it to further improve to reach well above 2% in 2009. As expected, net FDI performed poorly over the first 7 months of 2009, registering only 10% of net FDI over the same period last year.

Inflation continued on its downwards path

Inflation moved sharply lower over the first half of 2009, coming in at 1.8% yoy in August which is well below the 15.7% seen in August 2008. We expect inflation to register negative growth rates in 4Q this year and pencil in an average inflation rate of 3.4% yoy for 2009. According to our calculations, the development of seasonally adjusted negative core inflation, first registered in February 2009, continued over the past few months – this is in line with the so-called "real devaluation strategy" pursued by Latvia's politicians.

The stronger than initially assumed fall-off in fixed investment, in particular, led us to revise our full year GDP forecast to -16.3% yoy from -15.0%; this is still slightly higher than the consensus and official Latvian forecast because of our more optimistic stance on the positive contribution of the fall-off in imports to overall GDP data. Nevertheless, we don't rule out the risk that a further downwards revision in our GDP forecast might be needed.

Loan agreement revised to reflect the economic reality

The deeper than expected recession meant that international lenders had to revise the terms of the loan agreement – Latvia is now allowed to run a 10% to GDP budget deficit this year, an 8.5% deficit next year and a 6% deficit in 2011 (ESA 95 terms).

But risk of a devaluation remain elevated, with 50% probability over the next 15 months

We expect this year's deficit to come in below the 10% target, but see problems for next year. Our main concern in this respect is politics: the political situation has again become very difficult over the last few weeks; the issue of the 2010 budget has been discussed emotionally – one climax was when the People's Party, the largest party in the Saeima, dismissed a member who had voted in favor of a real estate tax, a tax whose planned introduction the People's Party itself signed in the Letter of Intent with the IMF in late July. Politicians also committed themselves in the Letter of Intent with the IMF and in the Memorandum of Understanding with the EU to improve the 2010 budget deficit by LVL 500mn, something they have – so far – been unable to realize. It seems that parties are already positioning themselves for the election campaign (parliamentary elections are scheduled for fall next year); and the "D-word" is not a taboo any more – A. Skele, former PM and member of the People's Party only recently re-emphasized its view that the lat should be devalued. Given those developments and the still gloomy macroeconomic situation (see also analysis in the last CEE Quarterly), we stick to our view of a more than 50% probability of a devaluation over the next 15 months.

Lithuania

Outlook

The ongoing recession is proving to be deep and sharp, with very weak 2Q09 GDP figures prompting us to revise our 2009 GDP forecast to -17.0% yoy. Despite a second round of amendments to the budget, politicians expect the deficit to come in at 8-9% of GDP this year, and a similar number is expected in 2010, which in the end may force the authorities to ask for external financial help.

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

MACROECONOMIC DATA AND FORECASTS

	2007	2008	2009E	2010E	2011E
GDP (EUR bn)	28.4	32.3	27.9	24.4	21.9
Population (mn)	3.4	3.4	3.4	3.3	3.3
GDP per capita (EUR)	8,420	9,595	8,318	7,292	6,542
GDP (constant prices yoy %)	8.9	3.0	-17.0	-7.0	4.4
Private Consumption, real, yoy (%)	12.4	5.0	-20.1	-6.0	2.6
Fixed Investment, real, yoy (%)	20.8	-5.5	-35.9	-6.8	2.6
Public Consumption, real, yoy (%)	3.3	4.3	-7.1	-10.3	-3.2
Exports, real, yoy (%)	4.3	11.3	-27.4	-5.4	6.1
Imports, real, yoy (%)	11.6	10.0	-34.5	-5.3	1.2
CPI (average, yoy %)	5.7	11.0	4.4	-0.7	1.1
Monthly wage, nominal (EUR)	522	654	593	510	390
Unemployment rate (%)	4.3	5.8	15.4	18.1	18.2
Budget balance/GDP (%)	-1.2	-3.2	-7.9	-8.0	-5.3
Current account balance (EUR bn)	-4.1	-3.8	0.2	0.6	0.9
Current account balance/GDP (%)	-14.6	-11.9	0.7	2.4	3.9
Net FDI (EUR bn)	1.0	1.0	0.4	0.6	0.8
FDI % GDP	3.6	3.1	1.3	2.3	3.5
Gross foreign debt (EUR bn)	20.5	23.0	27.8	26.0	23.5
Gross foreign debt (% of GDP)	72.3	71.4	99.7	106.6	107.5
FX reserves (EUR bn)	5.2	4.6	4.1	3.9	4.3
(Cur.Acc-FDI)/GDP (%)	-11.0	-8.7	2.0	4.7	7.4
FX reserves/Gross foreign debt (%)	25.3	20.0	14.7	15.0	18.3

Source: UniCredit Research

STRENGTHS

- Rapidly unwinding external imbalances
- Politicians' determination to reign in public deficit
- Low and falling inflation

WEAKNESSES

- Sharp contraction in economic activity
- Widening fiscal deficit
- Potential spill-over effects from Latvia in case of a devaluation

A lot to worry about…

Broad-based contraction ongoing

Lithuania's economy performed worst of all the three Baltic States in 2Q09 with GDP falling by -20.2% yoy. The fall was broad-based: private consumption moved lower by 19.3% yoy in 2Q (1Q: -15.7%); fixed investment registered -39.8% yoy (1Q: -37.6%) and real exports and imports were down by 23.3% yoy and 35.3% yoy, respectively (from -12.7% and -33.5% in 1Q). The very sharp fall in 2Q GDP data led us to revise our full-year 2009 GDP forecast to -17.0% yoy. This means that we expect the recession in Lithuania to be the sharpest in the Baltics; a very negative development indeed, especially as Lithuania had seemed initially to be better prepared to sail through the crisis and only started to register negative growth rates in 4Q08 (as opposed e.g. to Estonia that has been seeing shrinking GDP for the past 18 months).

Looking at the monthly foreign trade data, however, gives some reason for optimism: in July the 3 month moving average of seasonally adjusted exports stood at its highest level (which is still low but at least positive at 1.1% mom) in almost a year and has been steadily rising over the last few months from its lowest point of -8% mom in March. Imports show a somewhat similar pattern: the 3 month moving average of seasonally adjusted imports is now at -0.1% mom, up from -14.0% mom in February and at its highest value since August 2008.

C/A continues to improve on the back of a stronger fall in imports

The C/A came in nearly balanced in the first half of this year with a surplus of LTL14mn; the rolling C/A to GDP ratio now stands at -3% (3Q08-2Q09); we expect a further improvement in the C/A (given the stronger fall in imports than in exports) and pencil in a full-year C/A surplus of GDP of 0.7%.

Inflation moving lower, but VAT hike will put a floor under it

Headline inflation has been falling steadily over the course of this year and reached 2.6% in August. Our calculations of the seasonally adjusted core inflation show negative growth rates since the end of 1Q09 – we expect seasonally adjusted core inflation to stay low over the remainder of this year and expect an average headline inflation of 4.4% yoy. It should be noted, however, that another VAT hike (by 2% to 21%) in place since the beginning of September will somewhat slow the downwards movement of inflation in the coming months.

Amendments to the budget implemented, now the focus is on the Sodra

The strong contraction in economic activity means that the government's plan to keep the budget deficit below 5% to GDP this year looks increasingly like wishful thinking and has consequently been given up. After a second round of amendments to the 2009 budget deficit during the summer, politicians still expect a deficit of almost double the original 5%. This means that another round of amendments – although previously ruled out by politicians – seems to be in the cards, although no decision has been made on this topic yet. The focus of the recent discussions is on the "State Social Insurance Fund" (Sodra), responsible for benefit payments; given the sharp rise in unemployment (Eurostat recorded 16.7% in July, up from 7.2% one year ago) Sodra faces mounting financial difficulties, a problem the government started to address recently.

Budget deficits are set to remain large in 2009 and 2010…

The ongoing discussions about next year's budget hint at a deficit in 2010 nearly as large as or even larger than this year's deficit – nothing to fuel any optimism about an early introduction of the euro. In fact, we repeat our opinion that any change in the Latvian currency regime would also very likely be the trigger for a devaluation of the Lita.

…which in the end may force the authorities to ask for external financial help

Lithuania has so far avoided turning to the international community for financial help to weather the current crisis; at the moment it is sticking to its strategy of coping with it on its own; we don't rule out, however, the possibility of Lithuania asking for financial help, especially if public finances deteriorate even more sharply.

Poland

Outlook

Although Poland is outperforming at the moment we believe this partly reflects the late cycle nature of its economy, and expect this to turn into a moderate underperformance in 2011. We have therefore increased our 2009 GDP forecast to 1.4% but reduced 2011 to 2.6%. Accordingly, we expect rates to remain low and expect only one 25bp rate hike across the whole forecast horizon. Fiscal risks increase but public sector debt ceiling should limit further deterioration.

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

MACROECONOMIC DATA AND FORECASTS

	2007	2008	2009E	2010E	2011E
GDP (EUR bn)	311.2	361.7	304.5	353.0	367.6
Population (mn)	38.1	38.1	38.1	38.1	38.1
GDP per capita (EUR)	8,163	9,491	7,991	9,267	9,659
GDP (constant prices yoy %)	6.8	4.9	1.4	1.8	2.6
Private Consumption, real, yoy (%)	4.9	5.4	2.1	2.1	1.9
Fixed Investment, real, yoy (%)	17.6	8.1	-4.8	-3.6	2.0
Public Consumption, real, yoy (%)	3.7	7.6	3.1	2.5	2.4
Exports, real, yoy (%)	9.1	7.2	-2.9	7.5	9.0
Imports, real, yoy (%)	13.7	8.2	-6.4	6.7	6.5
CPI (average, yoy %)	2.5	4.2	3.7	2.8	2.8
Central bank reference rate	5.00	5.00	3.50	3.75	3.75
Monthly wage, nominal (EUR)	762	905	765	873	880
Unemployment rate (%)	12.7	9.8	11.2	12.5	13.1
Budget balance/GDP (%)	-2.0	-3.9	-5.9	-7.0	-3.9
Current account balance (EUR bn)	-14.6	-19.6	-3.4	-6.4	-10.5
Current account balance/GDP (%)	-4.7	-5.5	-1.1	-1.8	-2.7
Net FDI (EUR bn)	16.7	11.0	5.0	6.5	8.0
FDI % GDP	5.4	3.0	1.6	1.9	2.1
Gross foreign debt (EUR bn)	158.4	171.8	192.2	198.6	214.0
Gross foreign debt (% of GDP)	48.5	56.0	58.1	56.3	59.0
FX reserves (EUR bn)	44.7	44.1	55.6	61.4	68.4
(Cur.Acc-FDI)/GDP (%)	0.7	-2.4	0.5	0	-0.7
FX reserves/Gross foreign debt (%)	28.2	25.7	28.9	30.9	32.0
Exchange rate to USD eop	2.47	2.97	2.72	2.64	2.90
Exchange rate to EUR eop	3.60	4.15	4.00	3.90	4.00
Exchange rate to USD AVG	2.76	2.39	3.09	2.58	2.78
Exchange rate to EUR AVG	3.78	3.52	4.35	3.90	3.95

Source: UniCredit Research

STRENGTHS

- The only EU country with positive GDP growth in 1Q-2Q
- Significant improvement in foreign trade balance

WEAKNESSES

- Sharp rise in public deficit and borrowing needs
- Lack of fiscal reforms in the next two years due to political calendar

Poland to remain in pole position but may underperform later

Poland outperforms near-term

As signaled in the previous quarterly, we revised out GDP forecast for this year from -0.5% to 1.4%. The data for 2Q (0.9% growth) turned out to be even better than in 1Q (0.8%), and in the coming quarters we expect even better data. The main drivers remain net exports on the positive side, decline of inventories on the negative, and an orderly decline of private consumption as a stabilizing factor. As we expect positive surprises from the economy in the coming months (already partly seen in leading indicators, both domestic and European), we remain relatively constructive on the PLN.

But after mid 2010 Poland might underperform as late cycle story materializes

Looking further ahead (second half of 2010 and particularly 2011) we are less optimistic regarding growth prospects. Poland is to a large extent a “late cycle story”: currently it is still taking advantage of positive “inertia” from the previous “boom” period. But, as the next “bust” cycle kicks in with the labor market continuing to deteriorate (drag on domestic consumption), the PLN likely to strengthen mid-term (i.e. no support from net exports) and the economy is less exposed to the Western European recovery than other CEE countries Poland is likely to see a dip in growth. Accordingly, we believe it is probable that 2011 will see GDP growth in Poland below regional average, similar to what was seen back in 2002.

The weakening of the PLN continues to have positive impact on the current account, and hence we revised our forecasts to 1.1% C/A deficit in 2009 vs. circa 3% previously.

We do not expect rate hikes before 2H10

Monetary policy remains stable as inflation stays above the upper range of the MPC inflation target (1.5-3.5% yoy) thus blocking possible rate cuts. On the other hand, the still fragile recovery makes it very unlikely that rates could be hiked this year. We continue to believe there will be no MPC rate changes until year-end, especially as the current Council is finishing its term. Inflation will likely exceed the upper range of the target in the coming months, but with the economy far below potential output, rate hikes may be discussed no sooner than in 2Q10.

Fiscal policy remains a risk as govt pushes its ambitious privatization plan

The fiscal situation remains tense (with the public sector deficit likely to approach 6% of GDP this year and 7% in 2010, compared to 3.9% in the previous year), but under control. What worries financial markets is the size of next year’s net borrowing needs (PLN 82bn, vs. PLN 52bn this year), particularly because if the ambitious privatization plan (circa PLN 37bn in 2009 and 2010) is not fulfilled, the borrowing needs will be higher. However, for this year almost 90% of borrowing needs will be met by end-September, and so supply pressure should ease somewhat in the coming months. Growth is unlikely to be supported with any new government programs, as the Cabinet is striving not to exceed the 55% debt/GDP threshold next year, as that would necessitate significant spending cuts, according to the Public Finance Act. The major government policy line is to save as much as possible in administrative (and other) costs, and this approach is set to stay in force, in our view.

Political outlook remains stable in the near term

Politically the situation remains very stable, with the ruling Civic Platform (PO) attracting a steady 50% of popular support, which to a large extent is a function of weakness of the opposition parties. On the other hand, the political calendar (presidential elections next year and parliamentary ones in 2011) creates a deadlock regarding much needed fiscal reform – such reform would have to mean social spending cuts, which is not a particularly good theme to win elections on.

Rating outlook stable for now

Rating agencies are signaling no change in credit outlook, but no public finance reform after the presidential elections might prompt them to consider revisions of the outlook.

Romania

Outlook

Romania's economy is set to contract sharply this year by -7.5% yoy. Meanwhile, financial constraints stemming from higher interest rates and the deteriorating wealth effect will exert an important drag on both consumption and investment making recovery very slow during 2010. Even with the new budget deficit target settled at 7.3% of GDP, we see further risk of fiscal slippage due to increased political risks following the collapse of the coalition government. We expect the IMF/EU to take a wait and see approach in the near term.

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

MACROECONOMIC DATA AND FORECASTS

	2007	2008	2009E	2010E	2011E
GDP (EUR bn)	123.7	136.9	117.4	122.3	138.2
Population (mn)	21.5	21.4	21.3	21.2	21.1
GDP per capita (EUR)	5,745	6,391	5,506	5,766	6,548
GDP (constant prices yoy %)	6.2	7.1	-7.5	0.4	3.5
Private Consumption, real, yoy (%)	9.8	8.4	-11.9	0.6	4.6
Fixed Investment, real, yoy (%)	29.0	19.3	-16.0	1.0	5.0
Public Consumption, real, yoy (%)	7.6	3.7	0.4	2.0	2.7
Exports, real, yoy (%)	7.9	19.4	-17.4	4.0	7.0
Imports, real, yoy (%)	27.2	17.5	-28.0	8.5	11.0
CPI (average, yoy %)	4.8	7.9	5.7	3.9	3.8
Central bank reference rate	7.50	10.25	8.00	6.50	5.75
Gross Monthly wage, nominal (EUR)	312	348	323	345	390
Unemployment rate (%)	4.3	4.0	7.0	7.6	7.0
Budget balance/GDP (%)	-2.3	-4.8	-7.3	-6.0	-5.0
Current account balance (EUR bn)	-16.7	-16.9	-7.0	-7.7	-9.3
Current account balance/GDP (%)	-13.5	-12.3	-6.0	-6.3	-6.7
Net FDI (EUR bn)	7.2	9.0	4.6	4.8	5.5
FDI % GDP	5.8	6.6	3.9	3.9	4.0
Gross foreign debt (EUR bn)	38.7	50.8	62.6	71.4	77.8
Gross foreign debt (% of GDP)	31.3	37.1	53.3	58.4	56.3
International reserves (EUR bn)	27.2	28.3	29.3	26.3	23.7
(Cur.Acc-FDI)/GDP (%)	-7.7	-5.7	-2.1	-2.4	-2.7
Int. reserves/Gross foreign debt (%)	70.2	55.6	46.8	36.9	30.5
Exchange rate to USD eop	2.45	2.89	2.93	2.84	2.90
Exchange rate to EUR eop	3.58	4.03	4.30	4.20	4.00
Exchange rate to USD AVG	2.43	2.50	3.00	2.85	2.89
Exchange rate to EUR AVG	3.34	3.68	4.24	4.30	4.10

Source: UniCredit Research

STRENGTHS

- Significant IMF and EU balance of payments support
- Low public sector debt
- EU convergence with long-term growth potential

WEAKNESSES

- High public deficit with risk of overshooting
- High FX leverage in domestic private sector
- Political risk resulted from inter-coalition tensions

Painful but necessary corrections on the way

Romania's economy is set to contract by -7.5% yoy followed by very slow recovery during 2010

The recession deepened in 2Q, with an 8.7 % yoy contraction compared with the 6.2% drop in 1Q (although seasonally adjusted growth improved to -1.1% qoq in 2Q from the -4.6% qoq in 1Q). Looking forward, two opposing forces will be at work: On the one hand, exports will drive a further improvement in industrial production, as reflected by the leading sentiment indicators. Moreover, the inventory cycle is now turning, and will also help to boost industrial output. On the other hand domestic demand will remain weak, with further contraction in consumer spending and depressed investment levels. Consumption is being hampered by accelerating unemployment, frozen real wages, and negative wealth effects, while financial constraints and higher interest rates will be the main obstacle to investment. On balance therefore we expect a 7.5% contraction this year and a very slow recovery in 2010, with full-year growth of only 0.4%. One positive side effect of the weak growth dynamics is that the disinflation trend is set to continue, and we have therefore lowered our year-end inflation forecast to 4.6% yoy. The CB's target band of 3.5% +/-1% hence looks much more realistic. Another positive side effect of the recession is that the C/A deficit has been contracting sharply by 74% yoy in the first 7M of 2009 to EUR 2.7bn, driven by the narrowing trade deficit (-69% yoy) but helped also by current transfers, less affected by the crisis (-27% yoy) and by a sharp reduction in outflows on the income balance (-49% yoy). We expect this improvement to continue, and forecast the CA deficit to halve to 6% of GDP this year.

Disinflation remains a feature

The positive flipside of the coin: huge C/A correction for 2009

Further monetary policy softening expected

The Central Bank managed to keep inter-bank rates close to its policy rate through open-market operations in the second quarter, allowing policy rate cuts to pass through to the real economy (115bp interest rate drop of loans denominated in local currency in July from its peak of 18.15% reached in March 2009). As interest rates are still high and lending activity is nearly frozen, while disinflation continues, the CB cut a further 50bp at its September meeting. We now expect the bank to adopt a cautious monetary stance to support the local currency, holding the key rate at 8% till year-end.

Mounting budget deficit for 2009 brings first steps for ample public sector restructuring

On the fiscal side, the 8M public deficit reached 4.4% of GDP, triggered by a sharp plunge of revenues and the rigidity of social expenditures. A ray of light came from the IMF/EC aid package, as a EUR 1.5bn EU loan and half of the IMF's EUR 1.85bn second tranche has been authorized to be used for the budget deficit, softening financing pressures. The government has committed, with the help of international assistance, to restructure the pensions system and public sector salaries. For this year, an out-of-the-box measure has been announced to help contain the public sector wage bill: public employees will take 10 unpaid leave days, which will reduce personnel expenditure by 15.5% per month. In the longer term, the public sector payroll will be reduced from 9.6% of GDP to 6% by 2015. The measure involves a significant reduction of public sector employees by 326,000 persons, or 25% of the total, by 2015 out of which 150,000 next year. Even with the new budget deficit target settled at 7.3% of GDP, we see further risk of fiscal slippage due to increased political risks after the collapse of the coalition government.

Political noise increased sharply after the collapse of the coalition government

On 1 October the PSD resigned from the governing coalition after President Basescu approved the dismissal of the PSD Interior Minister. The PDL will govern during the interim period (even if a no confidence vote is passed by parliament), until the presidential elections. It will be followed either by **1.** a PDL minority government or **2.** a new government resulting from early elections. From a fiscal policy and ratings perspective obviously the lack of an effective government represents a significant risk. In the near term we expect the international institutions (IMF/EU) to take a wait and see approach and only see risk of a delay to the payment in December but do not expect a complete collapse of the program. On November 22 the first ballot of the presidential election will be held, followed by a second round on December 6.

Slovakia

Outlook

Stronger demand from Germany should have a positive impact on Slovakian GDP growth and we expect a 2.1% growth rate in 2010. A relatively healthy banking sector coupled with still firm public sector wage growth mean that we are not too pessimistic about household demand in 2010. Due to the deteriorating public sector balance we do not envisage credit upgrades in the period.

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

MACROECONOMIC DATA AND FORECASTS

	2007	2008	2009E	2010E	2011E
GDP (EUR bn)	54.9	64.9	63.4	65.9	69.9
Population (mn)	5.4	5.4	5.4	5.4	5.4
GDP per capita (EUR)	10,158	11,988	11,730	12,201	1,2941
GDP (constant prices yoy %)	10.4	6.4	-5.4	2.1	3.5
Private Consumption, real, yoy (%)	7.1	6.1	-0.7	1.7	2.0
Fixed Investment, real, yoy (%)	8.7	6.8	-8.6	-1.4	8.2
Public Consumption, real, yoy (%)	-1.3	4.3	4.5	3.5	1.0
Exports, real, yoy (%)	13.8	3.2	-17.5	4.0	7.0
Imports, real, yoy (%)	8.9	3.3	-16.8	4.0	6.3
CPI (average, yoy %)	2.8	4.6	1.7	1.7	3.5
Central bank reference rate	4.25	2.50	EUR	EUR	EUR
Monthly wage, nominal (EUR)	669	723	738	765	803
Unemployment rate (%)	11.0	9.6	12.7	13.6	12.6
Budget balance/GDP (%)	-1.9	-2.2	-5.9	-5.8	-5.3
Current account balance (EUR bn)	-3.3	-4.2	-3.9	-3.1	0
Current account balance/GDP (%)	-5.4	-6.5	-4.6	-5.0	-4.2
Net FDI (EUR bn)	2.7	1.7	1.2	1.8	0
FDI % GDP	4.4	2.5	1.8	2.7	2.2
Gross foreign debt (EUR bn)	32.4	35.9	35.4	39.6	45.4
Gross foreign debt (% of GDP)	59.0	55.3	55.8	60.1	65.0
(Cur.Acc-FDI)/GDP (%)	-1.1	-3.9	-4.4	-1.9	0
Exchange rate to EUR AVG	33.78	31.29	30.13 = 1 EUR	EUR	EUR

Source: UniCredit Research

STRENGTHS

- Banking sector in good shape
- Some FDI interest due to euro adoption
- Euro adoption prevents short-term currency volatility

WEAKNESSES

- Euro adoption does not allow currency depreciation to improve price competitiveness
- Very dependent on world trade as industry the main engine of growth (autos, electronics, steel)
- No reform agenda, booming deficit even without the need to help banks

Coming out of recession, slowly

"W" scenario is a real risk for Slovak industry for 1H10

1Q09 turned out to be very poor for the Slovak economy, reaching the bottom after a 10% qoq collapse (on seasonally and one-offs adjusted data). 2Q was a small improvement with 1% qoq growth, putting 1H09 annual decline at 5.5% yoy. We expect a continual qoq recovery based on stronger demand from Germany in 2H09. Manufacturing should take a lead as recovery gets under way. Some appreciation of the neighboring currencies will put some pressure off Slovak services. Both the Slovak Finance Ministry and the central bank adjusted their forecasts closer to ours and the uncertainty about 2009 growth is now much smaller. As expected, the NBS hiked its unemployment forecast while the Finance Ministry now assumes more helpful external demand. We do not change our view of a 5.4% recession for 2009.

Domestic demand continues to get support from public wage growth, with average real wage growth below 1% in both this and next year. Inflation benefits from the disinflation in the euro zone. NLB unemployment has increased by 5% since the beginning of the crisis and the recent dynamics suggest that the figures are finally stabilizing. However, we do not expect them to decline in the short-term.

If the "W" scenario hits Germany in 1H10, Slovakia will feel an immediate impact. Therefore, we do not yet assume a strong recovery in 2010. True, we up our 2010 forecast to 2.1% based on agreed PPP highway construction projects. However, most of the growth expected in 2010 is technical due to the low base effect (i.e. on 0% qoq throughout 2010, headline growth should approach 2%). We continue to argue that as corporates face pressures to increase price competitiveness, the shift of production from old EU to Slovakia should persist.

Slovakia continues to enjoy low ECB rates

Slovakia continues to enjoy ECB low interest rates. The 10Y spread has narrowed to 140bp as risk aversion has abated slightly.

Government lets the cyclical forces boost the fiscal deficit, no strong measures expected in elections' year 2010

Public debt rises from 30% to 40% of GDP

The fiscal deficit mirrors the dramatic collapse of Slovak growth with no savings measures taken this year and very limited ones next year. Despite no need to re-capitalize the local banks, the fiscal deficit is expected to reach 6% of GDP this year, falling to 5.8% of GDP next year (5.5% of GDP penciled in the state budget proposal). The scheduled parliamentary elections in June 2010 will prevent the government taking real "belt-tightening" measures and the uncertainty about growth still remains. The government will not push the economy via tax cuts, but instead focuses on maintaining the purchasing power of public employees and highway construction via PPP schemes (outside fiscal numbers). Most of the savings are planned for after the elections, with Maastricht's 3% target to be reached in 2012. The public debt thus increases from below 30% levels in 2008 to 40% in 2010. There remains a medium-threat of tax hikes for 2011-2012.

Higher unemployment cuts into popularity premium of the coalition

The state budget for 2010 and the appointment of the central bank governor will be the last action of this government coalition. As the unemployment rises, the popularity of the coalition has fallen from 60% to 50% while the opposition's has risen from 30% to 40%. In our view, the ruling populist SMER party is the likely winner of the elections but now it is less clear whether a similar populist coalition will continue after the elections.

Slovak ratings put on hold due to high fiscal deficit

Due to high fiscal deficit, the rating agencies changed the positive outlook to stable. Lower public debt level and euro adoption buy Slovakia some leniency with rating agencies.

Slovenia

Outlook

The improving outlook in Slovenia's main trading partners mean that we expect a small positive growth rate in 2010 (0.5%). On the other hand, we are now more bearish on domestic demand and have cut our private consumption forecast to neg. 0.4% from 0.2%. Low level of public sector debt will "protect" the rating despite the widening budget deficit.

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

MACROECONOMIC DATA AND FORECASTS

	2007	2008	2009E	2010E	2011E
GDP (EUR bn)	34.5	37.1	34.5	35.5	36.9
Population (mn)	2.0	2.0	2.0	2.1	2.1
GDP per capita (EUR)	17,169	18,366	16,913	17,333	17,914
GDP (constant prices yoy %)	6.8	3.5	-8.0	0.5	1.4
Private Consumption, real, yoy (%)	5.3	2.2	-1.9	-0.4	1.5
Fixed Investment, real, yoy (%)	11.9	6.6	-20.4	1.0	3.9
Public Consumption, real, yoy (%)	2.5	3.7	3.0	1.0	1.0
Exports, real, yoy (%)	13.8	3.4	-21.0	-7.9	1.1
Imports, real, yoy (%)	15.7	3.8	-20.0	-7.9	2.2
CPI (average, yoy %)	3.6	5.7	1.0	2.5	2.5
Central bank reference rate	4.00	2.50	1.00	1.00	2.50
Monthly wage, nominal (EUR)	1,284	1,391	1,413	1,441	1,498
Unemployment rate (%)	4.9	4.5	5.8	6.2	5.5
Budget balance/GDP (%)	-0.1	-0.2	-5.8	-4.9	-3.7
Current account balance (EUR bn)	-1.5	-2.3	0.2	-0.5	-0.6
Current account balance/GDP (%)	-4.2	-6.2	0.6	-1.5	-1.7
Net FDI (EUR bn)	-0.3	0.4	-0.6	-0.2	0.1
FDI % GDP	-0.8	1.0	-1.7	-0.6	0.3
Gross foreign debt (EUR bn)	34.8	39.0	41.8	43.5	45.5
Gross foreign debt (% of GDP)	100.7	105.1	121.0	122.4	123.3
(Cur.Acc-FDI)/GDP (%)	-5.0	-5.1	-1.2	-2.0	-1.4
Exchange rate to EUR AVG	239.64 = 1 EUR	EUR	EUR	EUR	EUR

Source: UniCredit Research

STRENGTHS

- Low public debt levels
- Foreign debt essentially denominated in local currency
- Early in electoral cycle

WEAKNESSES

- Sharp reduction in access to capital for companies
- High loan/deposit ratio of the banking sector
- Export oriented economy dependent on EU recovery

Fiscal stimulus yet to feed through to economic growth

Massive drop in investment spending behind downward revision in growth forecast

Economy slows sharply in 1H09. In 2Q09 GDP contracted 9.3% yoy with investment activity falling 27.3% yoy while private consumption contracted 2.6% yoy (after a surprisingly robust +0.1% yoy in 1Q09). That said seasonally adjusted qoq data pointed to a 0.7% expansion in GDP during 2Q. At the same time, new orders in the industrial sector (which accounts for approximately one quarter of the economy) declined by 0.2% qoq in 2Q. Moreover, domestic new orders continued to fall, by another 10.4% qoq in 2Q, while orders from abroad rose 1.8% over this period. The data paint a picture of a continuing decline in domestic investment activity in the near-term, as do the latest indicators on private consumption. Seasonally adjusted retail sales in real terms fell 0.2% in August compared to July. Meanwhile in September consumer confidence in seasonally adjusted terms picked up markedly to -18 and the overall confidence indicator improved to -17 from -20 in August. Going forward, the rise in unemployment will further constrain private consumption – in 2Q09 the unemployment rate rose to 5.6% from 5.4% in the previous quarter.

Weaker domestic demand has translated into a healthier current account with 7M09 posting a surplus of EUR 59.4mn, as the goods and services balance swung into a surplus of EUR 600mn in this period compared to a deficit of EUR 486mn in the corresponding period of 2008. Imports of goods and services are down 28% yoy, while exports have contracted 21.7% yoy over this period.

Inflation takes a back seat: Given the extent of the fall in domestic demand (11.2% yoy in 1H09) it is of little surprise that inflation too has plummeted, averaging 0.9% yoy in January-August and is unlikely to rise much further in the remainder of the year. Food and energy price dynamics have supported this trend, however, the compression in prices of tradable goods and market services point to the effects of much weaker domestic demand. We also estimate core inflation to have been negative since May 2009 in yoy terms. Increases in regulated prices, tobacco and alcohol are providing most of the upward pressure on the CPI index this year.

We lower our growth forecast to -8.0% this year. While we expect the economy to post growth of 0.5% in 2010, given the export orientation of the economy, the extent of any recovery will largely depend on a return to growth in Slovenia's major trading partners. We also expect a better take up in the government's EUR 1.2bn loan guarantee program once procedural issues are resolved and the government agrees to take on more risk (in the first two months only EUR 250mn in guarantees were sought). While we look for a surplus of 0.6% of GDP in the current account this year, we expect a deficit in 2010 of 1.5% of GDP as imports pick up. The outlook until the end of 2010 points to low inflation in Slovenia driven by weak domestic demand and the strong euro.

Fiscal stimulus drives widening of the budget deficit

Budget deficit rises as expenditures increase. In 1H09 the consolidated budget deficit amounted to EUR 1.1bn (3.2% of GDP). Tax revenues have been falling in 2009, while expenditures are on the rise, all in all, we see the budget deficit growing to 5.8% of GDP this year. In September, the government issued its third Eurobond for 2009, worth EUR 1.5bn, bringing total issuance to EUR 4bn this year. We see public debt rising to 33.5% of GDP by the end of this year. **However, Slovenia's low public debt is a big plus for its sovereign credit rating.** Even though we forecast a rise in public debt, access to international finance for the government is not a problem.

Sovereign credit rating stable on low public debt

Policy debate continues

The pension reform debate, the potential for further strikes in companies finding themselves in financial difficulties and the ongoing debate over what exactly Slovenia's PM agreed to with his Croatian counterpart in relation to an outstanding border dispute are likely to be the main political issues for the government in the coming months.

Bosnia & Herzegovina

Outlook

Bosnia's recession is set to continue, as domestic demand remains weak, on the back of tighter fiscal policy, rising unemployment and minimal credit, while the contribution of net exports will not be enough to pull headline GDP into positive territory – we expect a fall of 1% in 2010. Given the strong international support we deem the currency board arrangement to be safe.

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

MACROECONOMIC DATA AND FORECASTS

	2007	2008	2009E	2010E	2011E
GDP (EUR bn)	11.1	12.6	12.3	12.5	12.9
Population (mn)	3.8	3.9	3.9	3.9	3.9
GDP per capita (EUR)	2,876	3,282	3,189	3,238	3,335
GDP (constant prices yoy %)	6.8	5.4	-3.0	-1.0	0.8
CPI (average, yoy %)	1.5	7.4	0.2	2.6	2.2
Monthly wage, nominal (EUR)	488	568	597	613	625
Unemployment rate (%)	44.0	40.3	42.0	44.0	43.5
Budget balance/GDP (%)	-0.1	-4.0	-4.7	-4.0	-3.0
Current account balance (EUR bn)	-1.2	-1.9	-1.0	-0.9	-1.0
Current account balance/GDP (%)	-10.4	-14.9	-8.3	-7.0	-7.5
Net FDI (EUR bn)	1.5	0.7	0.2	0.4	0.5
FDI % GDP	13.8	5.5	1.7	3.3	4.0
FX reserves (EUR bn)	3.4	3.2	2.9	3.0	3.1
(Cur.Acc-FDI)/GDP (%)	3.4	-9.4	-6.7	-3.7	-3.5
Exchange rate to USD eop	1.34	1.40	1.33	1.32	1.42
Exchange rate to EUR eop	1.96	1.96	1.96	1.96	1.96
Exchange rate to USD AVG	1.43	1.33	1.39	1.30	1.38
Exchange rate to EUR AVG	1.96	1.96	1.96	1.96	1.96

Source: UniCredit Research

STRENGTHS

- Significant IMF and EU balance of payments support
- Currency Board arrangement reduces policy uncertainty
- Foreign-owned banks supporting subsidiaries

WEAKNESSES

- Fractured political environment
- Wide external financing gap
- Commodities and steel are the main exports

IMF support key to maintaining stability

Domestic demand is clearly slowing…

Domestic demand remains subdued, with credit growth to the private sector in July still below end-2008 levels. Although gross wages rose 11.4% yoy in the first 7 months of the year, the unemployment rate is rising too (41.8% in July) and with cuts in social welfare and public sector salaries in the coming months, the outlook for private consumption remains weak. This has been confirmed by merchandise import data, which in 8M09 recorded a fall of 26.1% yoy. The current account deficit halved in 1H09 to EUR 436mn on a sharply lower merchandise trade deficit, while transfers were only down EUR 50mn over this period. Inflationary pressures remain minimal with August CPI moderating 0.2% mom and the headline inflation rate -0.1% in the first 8 months of the year. This is in line with a weak domestic demand environment.

…inflation and current account deficit forecasts lowered

Our GDP forecast remains unchanged at -3% and -1% for 2009 and 2010 respectively. Tighter fiscal policy, rising unemployment and minimal credit growth will act as a brake on growth, while the contribution of net exports will not be enough to record a positive rate of growth next year. We see inflation at only 0.2% yoy this year and even then consider it exposed to downside risk and see it rising to only 2.6% yoy in 2010. Given the sharp fall in imports and signs that transfers from abroad are holding up well, we see the current account deficit narrowing sharply from 14.9% of GDP to 8.3% of GDP by year end. We see a slight recovery in exports next year leading to a further reduction in the deficit, to 7.0% of GDP.

Focus shifts to implementation as the IMF prepares for its first review of the stand-by agreement in November

Supplementary budgets passed at all levels. The entities and state level governments have passed amended budgets with the focus now shifting to the implementation of various measures agreed with the IMF. This year reductions in public sector wages are expected to yield savings of over EUR 100mn, with three-quarters of the savings in the Federation where the fiscal situation is most pressing. Reductions in transfers and other recurring spending is expected to result in a further EUR 200mn in savings, while increases in tobacco, fuel and alcohol excises earlier this year should generate over EUR 80mn in revenues. The full year effects of these measures are intended to contribute to a reduction in the consolidated general government deficit by 0.7pp to 4.0% of GDP. By the end of this year the Federation government will, together with the World Bank, draft reforms of its benefits system, which by the end of the current stand-by agreement is intended to ensure the sustainability of public finances.

No recent changes to monetary policy settings. With the focus on reform issues and fiscal policy, which to a large extent are also geared toward buttressing the credibility of the currency board arrangement, we expect no changes to policy settings in the coming months.

Fractious political environment persists

Political climate deteriorating. In recent weeks Bosnia's High Representative and numerous foreign diplomats have stated that the political climate is deteriorating with the appointment of key state agency positions unresolved and reforms associated with the Stabilisation and Association Agreement moribund. In such an environment there are evident risks that economic policy initiatives may also be affected. While we do not discount this possibility, given the importance of the current IMF program to the maintenance of macroeconomic stability in Bosnia Herzegovina and thus the prospects of politicians at the upcoming general elections in October 2010, we nonetheless expect more progress on economic policy issues compared to other policy areas.

No change to sovereign rating expected

IMF deal and commencement of repayment of Brady bonds point to no change in sovereign credit ratings. In June 2010 Bosnia will commence servicing its EUR 223.2mn Series B Bond London Club obligations after exceeding GDP per capita targets. This, together with the IMF deal, leads us to expect no change in the country's sovereign rating.

Croatia

Outlook

Due to ongoing weakness in household demand and higher VAT we expect GDP to contract by 1.5% in 2010. Meanwhile external imbalances continue to adjust quickly mostly at the price of contracting domestic economy. We consider the end of Slovenia's blockade of over 10 chapters of Croatia's EU negotiations, which resumed in full on 2 October, to be a big medium term positive for the credit rating and for the FX outlook.

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

MACROECONOMIC DATA AND FORECASTS

	2007	2008	2009E	2010E	2011E
GDP (EUR bn)	42.8	47.4	44.9	45.9	48.0
Population (mn)	4.4	4.4	4.4	4.4	4.4
GDP per capita (EUR)	9,654	10,681	10,120	10,345	10,834
GDP (constant prices yoy %)	5.5	2.4	-6.2	-1.5	1.2
Private Consumption, real, yoy (%)	6.2	0.8	-7.6	-2.5	1.2
Fixed Investment, real, yoy (%)	6.5	8.2	-9.6	-5.2	1.0
Public Consumption, real, yoy (%)	3.4	1.9	1.8	0.0	1.0
Exports, real, yoy (%)	4.3	1.7	-15.9	-7.5	1.5
Imports, real, yoy (%)	6.5	3.6	-18.8	-8.5	2.2
CPI (average, yoy %)	2.9	6.1	3.0	3.3	3.1
Monthly wage, nominal (EUR)	961	1,044	1,027	1,053	1,092
Unemployment rate (%)	9.6	8.4	10.0	11.0	9.8
Budget balance/GDP (%)	-2.0	-0.8	-3.9	-3.5	-3.0
Current account balance (EUR bn)	-3.2	-4.4	-2.0	-1.7	-1.4
Current account balance/GDP (%)	-7.6	-9.3	-4.5	-3.6	-2.8
Net FDI (EUR bn)	3.5	3.2	1.5	1.7	2.0
FDI % GDP	8.1	6.8	3.3	3.7	4.2
Gross foreign debt (EUR bn)	33.3	39.0	42.0	44.0	47.0
Gross foreign debt (% of GDP)	77.7	82.4	93.6	95.9	97.8
FX reserves (EUR bn)	9.3	9.1	9.3	9.0	9.0
(Cur.Acc-FDI)/GDP (%)	0.6	-2.5	-1.2	0.1	1.4
FX reserves/Gross foreign debt (%)	28.0	23.4	22.1	20.5	19.1
Exchange rate to USD eop	5.03	5.29	5.10	5.07	5.36
Exchange rate to EUR eop	7.33	7.37	7.50	7.50	7.40
Exchange rate to USD AVG	5.35	4.91	5.23	4.87	5.15
Exchange rate to EUR AVG	7.34	7.22	7.38	7.35	7.32

Source: UniCredit Research

STRENGTHS

- EU accession will likely accelerate
- Well capitalized banking sector
- External imbalances adjusting quickly

WEAKNESSES

- Domestic demand to remain weak
- Uncertainty over 2010 public sector borrowing requirement
- High FX leverage in household and private sector

Resumption of EU talks a big plus in uncertain times

Sharp contraction in domestic demand in 1H with high frequency data pointing to more of the same in 3Q

2Q GDP contracts 6.3% yoy, but bottom is near. Private consumption fell 9.4% yoy in 2Q09 and investment spending contracted 12.7% yoy. Seasonally adjusted data suggest no n-t recovery in investment (down 2.4% qoq) and while private consumption fell only 0.1% qoq tax increases in 2H will have a negative impact. Nonetheless, seasonally adjusted qoq GDP data do suggest the economy has reached its low point in this cycle. Industrial production for 3Q so far suggests a bottoming out, although retail sales turnover is still moribund, down 16.3% in 7M09 and seasonally adjusted data suggest the contraction in retail trade has not yet reached its nadir. There is little support coming from the labor market, as employment in 8M09 has contracted by 26K and credit growth to the private sector at the end of August was only 3.6% yoy, with deleveraging in the household sector.

No recovery in output growth before 2H10, but inflation will remain stable …

Growth forecast revised down to -6.2%, inflation to 3.0% yoy. As of August 2009, Croatian consumers are faced with a higher tax burden (solidarity tax – due to expire at end 2010 – and a 1pp increase in VAT) and rising unemployment. At the same time, the private sector remains under strain with payment arrears in the economy a major source of headwinds. These are the main reasons we forecast a drop in GDP of 1.5% in 2010. Uncertainty over the extent of the public sector borrowing requirement in the remainder of the year and in 2010 also remains an issue. Inflationary pressures subsided over the summer and on base effects we anticipate a headline CPI figure of 3.8% yoy in December. On the back of full year effect of the VAT increase next year we forecast inflation at 3.3% in 2010.

… and external imbalances will continue to narrow, although external debt service remains high

External imbalances are continuing to shrink, with the merchandise trade deficit in the first 8 months of the year narrowing by over EUR 2.5bn, while tourism revenues are likely to fall by up to EUR 1bn. Thus we see the current account more than halving to 4.5% of GDP this year, with the trend continuing in 2010 on account of weak domestic demand. In addition, we estimate foreign debt service in 2010 at EUR 12.8bn will be approximately EUR 1bn lower than this year. We see monetary policy conditions broadly unchanged in the remainder of 2009.

Government aiming for a nominal freeze in spending in 2010…

…not yet exactly clear how this will be achieved

Macro-fiscal projections aim for spending freeze in nominal terms. The government is looking to lower consolidated general government expenditures in 2010 by 2.5% in real terms. Given indexation clauses in public sector employment contracts, the HRK 600mn bill for compensating "new" pensioners, a rising interest rate bill and the potential cost to the government (in the form of assuming obligations from a part of guarantees provided) of shipyard privatization this will be a challenge. This is especially so given senior government officials have declared 87% of expenditures as fixed meaning the 2010 budget will contain no reform initiatives bringing into question medium term projections of a fall in the budget deficit toward 1.4% of GDP in 2012. Even though we see revenue forecasts of +1.7% yoy in 2010 as prudent, the budget remains exposed to revenue risks on the weak growth outlook. We see the budget deficit narrowing next year from 3.9% of GDP in 2009 to 3.5% of GDP, with the risks to the upside. In 1H09 the consolidated general government spending deficit was HRK 8.1bn, with expenditures up 7.6% yoy and revenues down 8.1% yoy.

End of Slovenia's blockade of EU talks an evident plus as domestic issues keep up the pressure on the government

In September Slovenia agreed to end its blockade of over 10 chapters of Croatia's EU negotiations, which resumed in full on 2 October. The government has been under pressure in recent months with scandals in state-owned enterprises receiving plenty of media attention. However, the head of a key coalition partner, the Peasant's Party, stated in late September that his party would only leave the government if the privatization of the electricity company became policy, so the government looks safe for now.

EU talks and narrowing external imbalances positives for sovereign rating

End of Slovenia's blockade on EU accession talks and narrowing external imbalances a positive for sovereign rating. Similarly, despite upside risks, the EUR/HRK should remain stable throughout 2010 averaging 7.35.

Kazakhstan

Outlook

Recovery in industrial output paves the way for better immediate prospects, but as consumption remains sluggish and reduced quasi-fiscal spending of the oil fund and tighter banking regulation kicks in, 2010 growth is set to be a little lower than anticipated at 2.5%. However, infrastructure projects ought to feed through with large positive multiplier effects supporting growth. But until the banking sector restructuring is out of the way, credit growth will remain subdued.

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

MACROECONOMIC DATA AND FORECASTS

	2007	2008	2009E	2010E	2011E
GDP (EUR bn)	76.1	89.8	71.5	74.7	91.6
Population (mn)	15.5	15.7	15.8	16.0	16.1
GDP per capita (EUR)	4,912	5,729	4,515	4,676	5,685
GDP (constant prices yoy %)	8.9	3.3	-1.6	2.5	5.0
Private Consumption, real, yoy (%)	10.8	3.8	-2.8	0.5	4.3
Fixed Investment, real, yoy (%)	17.3	1.7	-11.2	7.5	10.8
Public Consumption, real, yoy (%)	14.0	5.5	-3.4	4.6	3.4
Exports, real, yoy (%)	9.0	1.8	-7.0	6.5	11.0
Imports, real, yoy (%)	25.5	-11.5	-9.0	6.0	15.0
CPI (average, yoy %)	10.8	17.2	7.5	7.3	7.0
Central bank reference rate	11.00	10.50	7.00	7.50	8.00
Monthly wage, nominal (EUR)	313	343	320	320	382
Unemployment rate (%)	7.6	6.6	6.8	7.0	6.5
Budget balance/GDP (%)	5.2	1.2	-9.9	-4.0	0
Current account balance (EUR bn)	-5.4	4.7	-6.3	-2.9	-2.4
Current account balance/GDP (%)	-7.0	5.3	-8.8	-3.8	-2.6
Net FDI (EUR bn)	7.4	9.9	8.2	9.3	11.7
FDI % GDP	9.8	11.0	11.4	12.5	12.7
Gross foreign debt (EUR bn)	65.8	77.3	77.8	73.2	71.2
Gross foreign debt (% of GDP)	86.5	86.0	108.8	98.0	77.8
FX reserves (EUR bn)	12.7	14.8	11.7	12.6	15.6
(Cur.Acc-FDI)/GDP (%)	2.7	16.3	2.7	8.7	10.1
FX reserves/Gross foreign debt (%)	19.3	19.1	15.0	17.2	21.9
Exchange rate to USD eop	120.68	120.88	150.00	150.00	150.00
Exchange rate to EUR eop	175.99	168.66	220.50	222.00	207.00
Exchange rate to USD AVG	122.54	120.32	147.72	150.00	150.00
Exchange rate to EUR AVG	167.98	176.98	208.28	226.50	213.00

Source: UniCredit Research

STRENGTHS

- Fiscal support in 2009, structural policies support in 2010
- Export-driven recovery in industrial output
- Resilient FDI

WEAKNESSES

- Further contraction in consumption in July/August
- 2 of 4 major banks in default on foreign debt
- Sharp deterioration in bank asset quality

Industry leads recovery, banking reform key

Consumer sentiment and income growth make us believe in less than 3% contraction in private consumption in 2009

Recovery in industrial output paves the way for better immediate prospects – industrial output rose 2.3% yoy in August and 1.8% yoy in July, up from -0.7% yoy in 2Q and -4.8% in 1Q. Moreover, employment programs and reduced inward migration have helped stabilize unemployment, which rose just 0.1% in August (at 6.4%) compared to a year ago. However, a sharp fall in constant price retail trade turnover (17.8% yoy in August, 17.2% July, 13.1% 2Q, 3.5% 1Q) contrasts with improved consumer sentiment (+5pp to +7% in August) and 3.2% yoy real wage increases in Jan-July. We have also been witnessing a more severe downturn on market-places rather than shops which to us is an indicator of a delay in recovery of the informal economy. While, net repayments of retail loans have also contributed to weak consumption.

We improve our 2009 real GDP forecast from -2.3% to -1.6%

However, the 2Q09 GDP figure came in slightly higher than we had expected, with our estimates showing a fall of 2.3% yoy and a seasonally adjusted (not annualized) fall of 0.9% qoq, after -2.2% yoy and -1.0% qoqsa in 1Q. More favorable developments on the industry side, as well as a slightly higher than expected GDP figure, have prompted us to improve our 2009 forecast, clipping a 2.3% contraction to one of 1.6%.

The driver for the upgrade on the demand side is net exports, as consumption and investment will remain weak in 2009. We have reduced our forecast for 2010 from 3% to 2.5% as we see an end to the quasi-fiscal spending of the oil fund and tighter bank regulation kicking in. We keep our relatively bullish 5% GDP growth forecast for 2011, which is based on expectations of strong demand for Kazakh fuels and metals, particularly from Asia. As bank restructuring is completed and large infra-structure projects start to materialize (as early as 2010) this ought to have major positive multiplier effects.

We now expect a C/A deficit of USD 8.8bn or 8.8% of GDP for 2009, somewhat smaller than the 9.4% of GDP we were afraid of before.

The C/A swung into a USD 3.7bn deficit in 1H09, from a USD 3.8bn surplus in 1H08, as exports decreased 51% yoy in USD terms, and imports by 23% yoy. However FDI inflows have remained robust at USD 5.3bn in 1H (only 13% lower yoy), and we expect them to easily finance the C/A deficit. USD 20bn in central bank FX reserves and another USD 23bn as part of the oil fund, should enable the tenge to stay in the corridor of 150(+-5)/USD.

The refinancing rate will likely remain unchanged until year-end

Continued disinflation left CPI growth at 6.0% yoy, 0.4% mom (0.4% momsa) in September. We believe this to be close to a low and see some potential for an increase on the back of a recovery and hikes in regulated prices. The central bank has maintained its easing bias, cutting the refinancing rate by 50bp to 7% (300bp below January) at the start of September.

Fiscal policy will become more restrictive in 2010, and more oriented towards infrastructure projects, supporting public-private partnership.

The government's budget draft foresees a deficit of 4.1% of GDP for 2010. However, more important is the fact that the authorities have made clear that oil fund spending will be more restrictive in 2010 (in 2009, the oil fund replaced foreign assets with domestic bonds of the Samruk-Kazyna state holding, which in turn subsidized the economy). Taking this into account, we expect a deficit of 10% of GDP, where about KZT 720bn (EUR 3.4bn, 4.8% of GDP) of Samruk-Kazyna money is being distributed for bank stabilization, housing and SME support.

With 2 of the formerly largest 4 banks by assets in default on foreign debt and far-reaching regulations plans, a strong impact will come from banking reform

With 2 of the formerly 4 largest banks by assets in default on foreign debt and far-reaching regulations plans, a strong impact will come from banking reform. Preliminary discussions include proposals to tighten regulations for capital adequacy, foreign funding, and possibly imposing a loan-deposit ratio. It will be crucial to do this in an anti-cyclical way in order not to dry up funding too much. The formerly largest bank, BTA, now 75.1% state-owned, was due to conclude a foreign debt restructuring agreement with creditors by 18 Sept, but the deadline has been extended. BTA had offered 4 net present-value-equivalent options resulting in an 82.25% haircut, but could not agree with creditors on the amount of provisions and other issues. Bank restructuring will last well into 2010 making credit growth more difficult.

Russia

Outlook

Immediate recovery prospects look better, but domestic demand remains sluggish on a deteriorating labor market and squeezed credit, implying limited upside potential with growth set at 1.3% for 2010. The positive flipside of the slowdown is a healthy balance of payments and a subdued inflationary environment, which allows for the continuation of aggressive monetary easing and a weaker ruble.

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

MACROECONOMIC DATA AND FORECASTS

	2007	2008	2009E	2010E	2011E
GDP (EUR bn)	945.2	1,139.8	881.4	967.3	1157.6
Population (mn)	142.0	142.0	141.9	141.8	141.8
GDP per capita (EUR)	6,656	8,026	6,211	6,821	8,166
GDP (constant prices yoy %)	8.1	5.6	-7.4	1.3	4.1
Private Consumption, real, yoy (%)	13.6	11.5	-10.8	3.1	8.3
Fixed Investment, real, yoy (%)	21.1	9.1	-14.2	2.0	4.0
Public Consumption, real, yoy (%)	3.4	2.5	4.6	1.9	1.8
Exports, real, yoy (%)	6.4	0.2	-10.3	5.0	6.3
Imports, real, yoy (%)	26.6	17.7	-20.6	12.1	14.0
CPI (average, yoy %)	9.0	14.1	11.8	7.9	8.4
Central bank reference rate	6.05	9.17	6.50	5.75	5.25
Monthly wage, nominal (EUR)	386	471	402	411	486
Unemployment rate (%)	5.6	6.3	8.8	8.6	7.5
Budget balance/GDP (%)	6.0	4.8	-7.5	-5.5	-4.4
Current account balance (EUR bn)	55.6	68.0	42.6	58.6	71.8
Current account balance/GDP (%)	5.9	6.0	4.8	6.1	6.2
Net FDI (EUR bn)	38.3	28.7	21.3	25.5	30.6
FDI % GDP	4.1	2.5	2.4	2.6	2.6
Gross foreign debt (EUR bn)	314.0	365.5	273.1	264.2	271.0
Gross foreign debt (% of GDP)	35.9	42.2	31.4	25.5	22.5
FX reserves (EUR bn)	326.4	302.9	298.0	335.5	404.7
(Cur.Acc-FDI)/GDP (%)	9.9	8.5	7.2	8.7	8.8
FX reserves/Gross foreign debt (%)	104.0	82.9	109.1	127.0	149.3
Exchange rate to USD eop	24.64	30.53	32.60	31.66	32.45
Exchange rate to EUR eop	35.93	42.59	47.92	46.86	44.78
Exchange rate to USD AVG	25.55	24.78	32.84	31.72	32.17
Exchange rate to EUR AVG	35.02	36.46	46.30	47.90	45.68

Source: UniCredit Research

STRENGTHS

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

WEAKNESSES

- Dependence on commodities prices
- Lack of domestic investment resources
- Rising NPL ratios

No V-shape in sight

The recent optimism in equity markets and PMI gains ground in some macro data

Recent optimism about a swift economic recovery is showing up in some of the headline numbers. Thus, investment demand looks to have stabilized at around a 19% yoy decline, pulling off from the 23.1% yoy drop in May. Part of this is based on resilient export demand from China, which has fed through into industrial output and cargo shipments, potentially signaling that the worst phase of the crisis is over. We expect further improvements in the coming months as base effects kick in, falling interest rates feed through and capital flows stabilize. While a reversal of the inventory run-down and a resulting rebuilding of stocks together with a fiscal stimulus is also expected to be supportive. As a result, we see real GDP growth recovering to -4% yoy in 4Q09, from -10.9% in 2Q09.

Real GDP is set to recover to a 4% yoy dip by 4Q09, up from -10.9% yoy drop in 2Q09

Domestic demand continues to deteriorate…

Domestic consumer demand, on the other hand, continues to deteriorate. Unemployment reached an 8-year high in seasonally-adjusted terms in August at 8.1% of the labor force. The weakness, in its turn is triggering a continuation of the contraction in real wages and disposable incomes, pushing retail sales deeper into the red – close to a 10% yoy decline in August.

…but consumer weakness supports a healthy balance of payments and subdues inflation

The deep contraction demand has helped Russia to maintain a healthy balance of payments profile, triggered by a sharp decline in imports. Preliminary estimates put the current account surplus at USD 15bn in 3Q09, as the 41.8% yoy drop in imports helped to offset 46.1% yoy decline in exports and rising profit repatriation. Additionally, weakness in consumer demand on top of the contracting money supply has finally started to undermine inflationary pressures, with inflation slowing to fresh 2-year low of 10.7% yoy in September. We expect inflation to continue to fall, and reach single digits by year-end, and then stay in that range in the future as authorities switch to an inflation targeting regime.

Weakness of domestic demand should prevent rapid economic recovery in 2010

Deterioration of the labor market and weak consumer demand is likely to continue to put pressure on economic growth until at least early 2010. Moreover, it is likely that an additional drag will come from the local banking system that is expected to continue to struggle with its NPL problem for another couple of quarters. As a result, we do not expect a rapid economic recovery in 2010, notwithstanding the strong base effect at the beginning of the year, and change our real GDP growth outlook only slightly to 1.3% growth next year (up from 0.8% growth we had penciled in earlier on).

Fiscal stimulus is set to reverse in 2010, put pressure on the economy

The other factor, which should limit a quick rebound, is the abrupt end to the fiscal stimulus in 2010, which the government approved in its latest reading of the federal budget. Thus, according to the latest draft, total budget spending is set to stabilize at 2009 levels in nominal terms in 2010, or close to RUB 9,700bn, implying an effective contraction in real terms. Moreover, the major policy goal for the government seems to be the reduction of the federal budget deficit, rather than economic stimulus. This is perfectly understandable, given that 2010 deficit is planned at some RUB3000bn (close to 7% of GDP according to official estimates), implying that there is a limit placed on positive surprises from the fiscal side.

Monetary policy to retake the lead in policy response, pressuring RUB in the meantime

Overall, the focus of the policy response to the crisis is likely to gradually shift back to the monetary policy. Thus, we believe that the continued disinflationary pressure could help the CBR maintain its monetary easing through further rate cuts and potentially some quantitative easing in support of the local banking system. As a result, we continue to expect further devaluation pressure on the RUB, and reiterate our RUB 39.5/basket forecast for eop 2009 and RUB 38.5/basket eop in 2010.

Serbia

Outlook

Tentative signs are that the economy is bottoming out, but the climb back up is expected to be gradual with most of the fiscal adjustment taking place in 2010 – something that will limit the upswing and keep growth at -0.7 in 2010. The immediate focus, however, has now shifted to fiscal policy as the IMF has tied the second and third tranches of the stand-by agreement to fiscal consolidation.

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

MACROECONOMIC DATA AND FORECASTS

	2007	2008	2009E	2010E	2011E
GDP (EUR bn)	29.5	34.0	30.6	31.3	32.8
Population (mn)	7.4	7.4	7.4	7.4	7.4
GDP per capita (EUR)	4,002	4,614	4,151	4,254	4,455
GDP (constant prices yoy %)	7.1	5.4	-4.8	-0.7	1.3
CPI (average, yoy %)	6.5	11.7	8.6	7.0	6.1
Central bank reference rate	10.00	17.75	11.00	10.00	10.00
Monthly wage, nominal (EUR)	484	561	480	496	515
Unemployment rate (%)	18.1	18.0	18.5	19.0	18.2
Budget balance/GDP (%)	-1.5	-2.0	-4.5	-4.0	-3.5
Current account balance (EUR bn)	-4.6	-4.7	-2.3	-2.0	-2.4
Current account balance/GDP (%)	-15.6	-13.9	-7.5	-6.2	-7.2
Net FDI (EUR bn)	1.8	1.8	1.1	1.2	1.4
FDI % GDP	6.2	5.4	3.5	3.7	4.3
Gross foreign debt (EUR bn)	17.8	21.8	22.8	24.8	27.0
Gross foreign debt (% of GDP)	60.2	64.2	74.5	79.0	82.3
FX reserves (EUR bn)	9.6	8.2	9.0	9.0	9.2
(Cur.Acc-FDI)/GDP (%)	-9.4	-8.4	-4.0	-2.5	-2.9
FX reserves/Gross foreign debt (%)	54.2	37.4	39.6	36.4	34.1
Exchange rate to USD eop	54.03	64.34	64.63	67.57	72.46
Exchange rate to EUR eop	78.79	89.78	95.00	100.00	100.00
Exchange rate to USD AVG	58.34	55.40	66.67	64.57	70.42
Exchange rate to EUR AVG	79.98	81.49	94.00	97.50	100.00

Source: UniCredit Research

STRENGTHS

- Significant IMF balance of payments support
- Weaker currency helping adjustment process
- Current account deficit narrowing sharply

WEAKNESSES

- Persistent inflationary pressure
- Wide external financing gap
- High FX leverage in domestic private sector

Focus shifts to 2010 budget plans

GDP fell 4.1% yoy in 1H09, the current account deficit narrowed sharply, but inflationary pressures remain

Current account deficit continues to narrow rapidly. There are tentative signs the Serbian economy is bottoming out. Industrial production on a seasonally adjusted basis rose in August in mom terms (after being flat in June and July), while announcements from steel producers that they plan to resume production during the remainder of the year will see industrial production recover somewhat from the 16.2% contraction recorded in January-August, at the same time retail sales have contracted by 9%. With credit growth slowing (the stock of household credit in June 2009 was marginally below the end 2008 stock in EUR terms) and the likelihood of further job losses, the outlook for domestic demand remains subdued. The upshot of all of this is that the current account deficit has narrowed sharply, contracting over 70% to just over EUR 1bn in the first seven months of 2009. Imports of goods and services were down 28.4% yoy over this period while exports fell 20% yoy. In August CPI moderated to 8% yoy in part because of seasonally lower food prices.

GDP forecast cut from -2.5% to -4.8% in 2009, NBS CPI target in jeopardy

In 2010 we expect the economy to contract further. The IMF has sanctioned a delay in fiscal adjustment to next year. Thus the negative impact on growth from the fiscal adjustment has also been delayed until 2010. In addition, we do not see significant scope for stronger credit growth next year. Household consumption will not be a driver of growth in 2010. Even though exports will recover from this year's trough, so will imports associated with the production process. We see the current account narrowing to 7.5% of GDP this year from over 13% in 2008. Weak domestic demand in 2010 will see the current account deficit contract slightly to an estimated 6.2% of GDP next year.

We do not believe the NBS will be able to continue cutting rates for much longer

The National Bank of Serbia policy rate stands at 11%. We do not expect any further cuts in the policy rate this year. The IMF has advised caution on cutting rates too quickly since the inflation outlook is exposed to upside risk. We see inflation at 9.2% at year end. In addition, if a mooted increase in VAT finds its way into the 2010 budget scope for further cuts will also be limited. The lower current account deficit, increased FX reserves (higher SDR allocation plus stand-by agreement funding) which rose to EUR 9.6bn at the end of August, an increase of EUR 1.4bn on December 2008 will help the NBS maintain currency stability. Nonetheless, any potential delays in the payment of second tranche money from the IMF would be negative for sentiment despite the announcement of a USD1bn loan from Russia to the Serbian government in early October.

Further spending cuts/tax rises needed to achieve IMF deficit target

IMF approves widening of the budget deficit target from 3% to 4.5% of GDP in 2009. However, second and third tranche payments from the stand-by agreement are contingent upon the fiscal deficit in 2010 not exceeding 3.5% of GDP (although the government is hoping to be able to negotiate a 4% target in 2010). Consolidated budget revenues in Jan-July 2009 were 2.3% yoy lower, while expenditures rose 4.7% yoy. Interest payments were up 18.4% yoy in 1H09, while spending on pensions was up 22.2% yoy at the same time. By the end of September the stock of outstanding T-bills rose to almost EUR 900mn (from zero).

Arguing for reforms will not be easy

Will the government be able to implement flagged public sector employment cuts? Various government ministers have stated public sector employment will be cut by 10,000-14,000 in 2010 in an effort to meet IMF fiscal targets. Interest payments will rise next year. Public opinion is unlikely to take kindly to any reductions in entitlements. That will make for an interesting autumn and winter, however, as senior government ministers have noted repeatedly, without IMF assistance the outlook for the economy is dire.

IMF agreement supports sovereign rating

IMF agreement should preclude ratings cut. Even though the second tranche of IMF funds may be delayed due to missed fiscal policy targets, we do not see Serbia's sovereign credit rating being cut n-t. Underlying our assumption for the EUR/RSD of 95 at year end 2009 is our expectation that the government will do enough on the 2010 budget to ensure at worst a minimal delay in the disbursement of IMF funds.

Turkey

Outlook

We continue to expect the Turkish economy to significantly outperform the region in 2010 and see GDP growing at 3.2% vs. 1.4% CEE average. This will be primarily driven by the drastically eased monetary conditions (lower rates, weaker FX), very supportive base effect and somewhat looser fiscal position. Meanwhile, we expect the CBT to keep on surprising on the dovish side with further rate cuts in the coming months and only expect a mild tightening cycle in 2H10.

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

MACROECONOMIC DATA AND FORECASTS

	2007	2008	2009E	2010E	2011E
GDP (EUR bn)	472.1	498.3	435.7	443.4	534.6
Population (mn)	70.6	71.5	71.9	72.7	73.5
GDP per capita (EUR)	6,688	6,968	6,060	6,099	7,274
GDP (constant prices yoy %)	4.6	0.9	-5.2	3.2	4.5
Private Consumption, real, yoy (%)	4.6	0.8	-3.0	3.2	4.6
Fixed Investment, real, yoy (%)	5.4	-7.1	-22.0	6.0	7.0
Public Consumption, real, yoy (%)	6.5	1.9	5.0	3.0	4.1
Exports, real, yoy (%)	7.3	2.3	-9.0	5.4	5.8
Imports, real, yoy (%)	10.7	-3.8	-21.5	7.0	8.0
CPI (average, yoy %)	8.8	10.5	6.0	5.4	5.1
Central bank reference rate	15.75	15.00	6.75	7.50	8.00
Monthly wage, nominal (EUR)	907	943	750	705	775
Unemployment rate (%)	9.9	11.0	14.8	14.5	14.0
Budget balance/GDP (%)	-1.6	-1.8	-6.3	-4.8	-3.9
Current account balance (EUR bn)	-28.0	-28.3	-7.2	-11.9	-17.6
Current account balance/GDP (%)	-5.9	-5.7	-1.6	-2.7	-3.3
Net FDI (EUR bn)	16.1	12.3	5.8	6.6	8.4
FDI % GDP	3.4	2.5	1.3	1.5	1.6
Gross foreign debt (EUR bn)	182.1	188.8	204.9	214.7	257.5
Gross foreign debt (% of GDP)	38.6	37.9	47.0	48.4	48.2
FX reserves (EUR bn)	48.4	50.2	48.3	49.3	55.8
(Cur.Acc-FDI)/GDP (%)	-2.5	-3.2	-0.3	-1.2	-1.7
FX reserves/Gross foreign debt (%)	26.6	26.6	23.6	23.0	21.7
Exchange rate to USD eop	1.17	1.54	1.60	1.56	1.50
Exchange rate to EUR eop	1.71	2.15	2.35	2.31	2.07
Exchange rate to USD AVG	1.30	1.30	1.57	1.58	1.53
Exchange rate to EUR AVG	1.79	1.91	2.21	2.39	2.17

Source: UniCredit Research

STRENGTHS

- Healthy banking sector with stellar capital adequacy
- Strong disinflation trend continuing with no threat in the upcoming period, significant monetary easing

WEAKNESSES

- Uncertain government support for an IMF agreement
- Outlook for fixed investments still relatively poor

Recovery yes, but pace still uncertain

GDP contraction is likely to end in 4Q and even maybe in 3Q, but the pace of recovery is still quite uncertain at the moment

GDP contracted by 7.0% in 2Q, with the qualitative aspects of the growth figure looking identical to those in 1Q. Seasonally adjusted, qoq growth seems strong, but whether this amounts to a sustainable recovery is the big question at the moment. We would cautiously tend to side with those who have a skeptical approach towards a strong recovery argument if only for lack of data reasons. We maintain our forecast of minus 5.2% for 2009. We also keep our growth forecasts of 3.2% and 4.5%, respectively for 2010 and 2011.

August inflation came in at minus 0.3% bringing the yoy rate further down to 5.33%, which is extremely low for the month of Ramadan from a historical perspective. Almost all core indices (6 out of 8) improved compared to July and the CBRT's favorite Index I also came down. Services inflation continues to be benign, which is the best inflation news we have heard for some time. In line with these developments, we revised down our 2009 inflation forecast to 5.2% and slightly revised up the 2010 inflation forecast to 5.3%. We maintain our forecast of 4.5% for 2011.

In July 2009, the foreign trade deficit dropped by 65.3% to USD 2.2bn and the services surplus rose by 7.2% to USD 2.9mn. As a result, the current account deficit narrowed by 79.4% yoy to USD 6.6bn during the first nine months. The financial account recorded a net capital outflow of USD 375mn in January-July 2009, in contrast to a net inflow of USD 34.2bn in the same period a year ago. FDI performance was also disappointing at USD 5bn to date, which has fallen by more than half compared to the same period last year. Our CA/GDP forecasts now stand at -1.6%, -2.7% and -3.3% respectively for 2009, 2010 and 2011.

The government has finally released the much awaited Medium Term Economic Plan (MTEP) with more feasible and consistent projections than that of previous plans. The most important reform area in public administration seems to be the implementation of the "fiscal rule" as of 2011. Overall the Plan suggests that the government is keen to move forward with the IMF negotiations. However, we continue to believe that the government would rather get IMF consent to the plan than sign an official stand-by with the Fund.

The Central Bank is likely to surprise the market with cuts that exceed market expectations in 2009 and initiate a mild tightening cycle in 4Q10

We anticipate that the CBRT will cut interest rates at least 50bp by the end of the year, and possibly more. We rest this argument on two lines of reasoning: **1.** The CBRT sees the recovery rate to be slower than the markets, and is thus keen to cut rates more boldly than the market thinks it will. **2.** The Bank would like to avoid moving into double-digit policy rates and would hate to see the same for bond rates. The environment is as safe as it could be for bold cuts due to the extraordinary sluggishness of the economy. And if this creates some depreciation impact on the exchange rate, it may even be better as the expected deprecation component of nominal rates will naturally be reduced with depreciation virtually taking place. Lower rates will thus be more easily justifiable. When the Bank feels the need to start hiking rates, it would like to have as low an initial point as possible in order to have the largest hiking margin going forward.

The Democratic Initiative with its Kurdish and Armenian components has stirred some controversy in the country but we believe this to be a constructive turbulence

The AKP's Kurdish, or, as some AKP members prefer to call it, democratic initiative is serving as a tomography of the political environment in the country. The initiative is prudent, bold, courageous, and last but not the least belated, i.e. mistimed by the AKP. The AKP has started the initiative and is thus behind it, but it will definitely be tested, or better put it will continue to be tested. We have already seen some oscillatory behavior from some AKP officials especially in the aftermath of the Chief of Staff's comments following the CHP and the MHP joint complaint that due reaction expected from "the alert forces" was still missing. The initiative, which indeed has a less pronounced Armenian component as well, has the full support of the EU and the US it seems, and that is also why it created some negative sentiment among the xenophobic portion of the society.

Ukraine

Outlook

Stabilization on export pick-up is becoming more evident. Favorable base effects are starting to kick in, with growth prospects for 2010 improving to 1.7% (plus upside potential exists). However, fiscal deterioration remains a worry as the government is reluctant to implement meaningful reform, resulting in uncertainty around the continuation of the IMF program. The upcoming January elections also pose risks to stability.

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

MACROECONOMIC DATA AND FORECASTS

	2007	2008	2009E	2010E	2011E
GDP (EUR bn)	103.1	123.4	81.7	92.6	126.7
Population (mn)	46.6	46.4	46.1	45.8	45.5
GDP per capita (EUR)	2,210	2,661	1,773	2,022	2,783
GDP (constant prices yoy %)	7.6	2.1	-13.5	1.7	3.3
Private Consumption, real, yoy (%)	17.1	11.6	-13.0	-1.0	2.5
Fixed Investment, real, yoy (%)	24.8	4.2	-50.0	5.0	10.0
Public Consumption, real, yoy (%)	2.8	-0.4	0.1	0.9	0.7
Exports, real, yoy (%)	2.8	6.7	-23.0	7.0	11.0
Imports, real, yoy (%)	20.2	17.5	-40.0	6.0	11.0
CPI (average, yoy %)	12.8	25.2	16.3	11.4	9.6
Central bank reference rate	8.00	12.00	10.00	9.50	9.75
Monthly wage, nominal (EUR)	195	234	167	181	231
Unemployment rate (%)	6.4	6.4	11.3	10.5	8.2
Budget balance/GDP (%)	-1.4	-1.3	-7.9	-4.9	-2.7
Current account balance (EUR bn)	-4.1	-8.5	0.1	1.1	-0.6
Current account balance/GDP (%)	-3.9	-6.9	0.1	1.2	-0.5
Net FDI (EUR bn)	6.3	7.1	2.0	4.1	6.8
FDI % GDP	6.1	5.8	2.5	4.4	5.3
Gross foreign debt (EUR bn)	56.7	74.0	66.0	67.3	77.0
Gross foreign debt (% of GDP)	55.0	60.0	80.8	72.7	60.8
FX reserves (EUR bn)	21.8	19.4	10.1	10.5	14.5
(Cur.Acc-FDI)/GDP (%)	2.2	-1.2	2.6	5.6	4.9
FX reserves/Gross foreign debt (%)	38.4	26.2	15.4	15.6	18.8
Exchange rate to USD eop	5.09	7.81	8.10	7.40	6.90
Exchange rate to EUR eop	7.42	10.90	11.91	10.95	9.52
Exchange rate to USD AVG	5.05	5.24	8.06	7.75	7.15
Exchange rate to EUR AVG	6.92	7.70	11.37	11.70	10.15

Source: UniCredit Research

STRENGTHS

- Rapidly improving C/A balance
- Significant NBU FX reserves
- Significant spare capacity

WEAKNESSES

- Rising NPL ratios
- Upcoming presidential elections
- Fiscal deterioration and lack of reform

Shifting into the right gear

Signs of stabilisation, as exports start to pick up…

Ukraine's economy has been showing signs of stabilisation in recent months, with August industrial production, at -23.3% yoy, recording the lowest drop since October 2008. Much of the recent advance stems from key export industries, which are responding to the pick-up in demand and slight increase in prices (metallurgy exports posted a 19.6% mom rise while agricultural exports grew 15.1% mom in August). At the same time, the UAH devaluation still limits domestic consumers, as real wages continue to decline by 10%, although the dip in retail trade (in constant prices) has bottomed out at -20% for the past 3M. On a 6-9M horizon we expect the recovery to be led by a) favorable base effects and b) better exports on improved global performance. This has led us to raise our outlook for 2010 growth prospects to +1.7% from +0.5% (in addition upside potential exists for a more robust pick-up on the back of a global recovery, albeit a full-fledged recovery is not likely until domestic demand recovers, which we reckon will be the story in 2011).

…but recovery to be based on favorable base effects and improved global performance

Authorities testing IMF patience

Non-compliance of authorities with a number of key IMF conditions complicates prospects for the 4th IMF tranche worth USD 3.8bn scheduled for 15 November. It is probable that IMF officials are disappointed with the progress of reforms (failure to comply with the promise to hike gas prices by 20% for the population, delays in recapitalisation of banks, a 5%-7% gap between the official and market exchange rate). Although the IMF has shown a lot of flexibility in dealing with Ukraine, it could be the case that the next tranche is not disbursed and the program will need to be re-negotiated after the electoral cycle is over.

while fiscal deterioration remains a worry

Fiscal performance remains closely linked to reforms stipulated by the IMF, the reform of Naftogaz alone would save the government 1% of GDP in 2010, helping to come closer to the 4%/GDP deficit the Fund has set as a condition. And by becoming involved in the current Naftogaz Eurobond restructuring the government is shooting itself in the foot – it plans to issues Eurobonds worth some USD 2bn in 2010. The market will demand a premium for the restructuring from the sovereign as well as from the corporates that will decide to tap the Eurobond market, although we suspect that may only open up in 2H10.

External financing needs mitigated by high debt-roll over ratios and C/A improvement, but local confidence is still key

In the meantime, the NBU will continue to spend some of its USD 28bn of FX reserves to support the UAH. One important point, which arguably reduces the need for large external financing is that debt-rollover ratios have remained fairly robust at 76% in 8M09, while the C/A is looking more balanced, and with gas imports for winter storage out of the way we expect a surplus in 4Q09. But keeping local confidence in the system remains key.

Elections pose risks to stability, although once out of the way accelerated reforms are likely

The start of the election campaign will complicate matters in the coming months, with risk particularly high in the weeks just before the elections (17 Jan) and straight after once a winner is announced (potential for dispute and conflict between ruling elites). The result is difficult to predict, although a faster economic recovery would benefit PM Tymoshenko. A continued political stand-off after the election would have a negative effect on the economy (strikes, people running for the safety of the USD, banks no longer lending, non-payments rising). However, in the aftermath of the elections we are also likely to see accelerated reforms in governance, a more pragmatic foreign policy and more political unity.

FX likely to remain volatile, but macro improvements a major support factor

We attribute the recent USD/UAH weakening and CDS volatility to the ongoing political and economic instability fuelled by depreciation expectations and large debt repayments (35% of this year's total fell due in Aug-Sept). However, we think that improvements in the C/A, high-debt roll-over ratios, and a better growth performance ought to support the UAH into the year end. Major risks to the forecast, however, are related to the political situation and confidence of the population. While risk of further monetisation of the budget both this year and next too poses risks to our USD/UAH 7.4 at the end of 2010.

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