# CEE

## Quarterly

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# 1Q 2015

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# Contents



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# CEE in 2015: an endurance race

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- 25 years after communism fell, CEE is a diverse region, boasting some of the strongest and some of the weakest emerging markets. Differences in CEE will only become starker in 2015, with reform frontrunners growing and laggards in recession. A far-from-impressive recovery in the eurozone and weak global trade leave domestic demand as a more important growth driver. As a result, policy differentiation in the aftermath of the financial crisis defines the scope for current growth-conducive actions.
- As much as macroeconomic adjustment is needed, it will only come where external financing will dry up. Otherwise, yield-chasing investors will continue to pour money into countries that are happier to pay higher yields than to reform.
- Central Europe and the Baltics stand out in CEE, with a broad-based recovery, improving fiscal metrics and solid external financing capacities. Despite potential fluctuations in risk appetite, the Central European rally could continue in 2015. Dovish central banks will echo the ECB and pursue lax monetary policies that pave the way for a further spread narrowing vs. the eurozone core.
- The Balkans are struggling under the weight of missed opportunities. Serbia and Croatia have been postponing reforms to the point where they need IMF and EU monitoring. But as long as both countries retain access to foreign financing, the pace of adjustment will be underwhelming. Slovenia addressed its banking sector woes and Bulgaria will follow suit, but both countries need further reforms to accelerate growth.
- Turkey aborted the adjustment of economic imbalances in mid-2014. Domestic demand growth will accelerate for as long as the current account deficit can be easily financed. Low oil prices, rapidly falling inflation and investor reticence to purchase Russian assets will support Turkish domestic demand in the short term.
- Russia will struggle to avoid recession in 2015. Financial sanctions and falling oil prices are leading to currency depreciation and tighter liquidity conditions that will squeeze credit growth and reduce domestic demand. Adverse terms of trade across the commodity spectrum will limit the impact of net exports on GDP growth.
- Ukraine is unlikely to finance the external debt due after 2015 unless the IMF and other international creditors step in with significantly more money. Even so, the country will probably have to reschedule the debt due in 2016 and 2017. Before that, it will have to prove that it faces a liquidity, rather than a solvency problem. Thus, the country needs to stabilize GDP and reach a deal with breakaway Eastern regions.

## CEE: limited stimulus from global exports…

**CEE faces a growth slowdown in 2015…**

2015 finds CEE countries in need of a stronger external stimulus. In stark contrast with the beginning of 2014, net exports are currently a drag, rather than a driver of growth for most CEE countries. At a time when imports accelerated amid stronger domestic demand, exports slowed due to three main factors: a far-from-impressive recovery in the eurozone, weak demand from other emerging markets (EM) and conflicts in Ukraine and the Middle East.

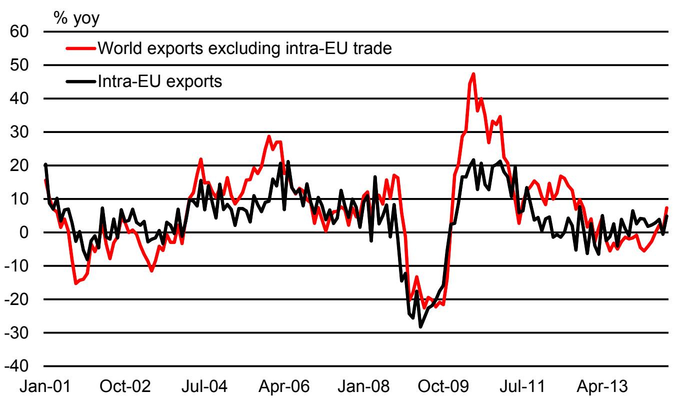
**…amid a timid recovery in global export growth**

The same constraints will prevent global exports from accelerating meaningfully above 3-4% yoy in 2015 and 2016. Even if demand outside the EU will recover amid stronger growth in the US, slower Chinese growth and financing challenges in other large EMs could cap world demand. As a result, export orders could continue to outperform domestic orders in EM and in the eurozone, as they did since the beginning of 2013. In this environment, the quest for export growth in CEE often translates into winning market share at the expense of competitors.

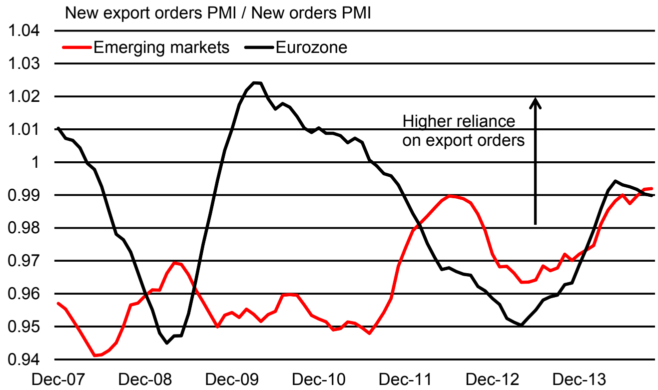
In a low-export growth environment, price competitiveness will be an issue. In the short term, euro depreciation against the dollar should provide support to CEE exports outside the EU. If this is not enough, CEE countries with flexible exchange rates could weaken their currencies by pursuing laxer monetary policies. In the longer term, CEE economies will have to switch to higher value-added manufacturing. With limited available FDI, EU funds remain the big differentiation factor between newer EU members and other EM.

### THE GLOBAL SEARCH FOR EXPORT DRIVERS

For the past two years, the EU was the main driver for global exports




Despite weakness, external demand outperforms domestic demand




Source: World Bank, Markit, UniCredit Research

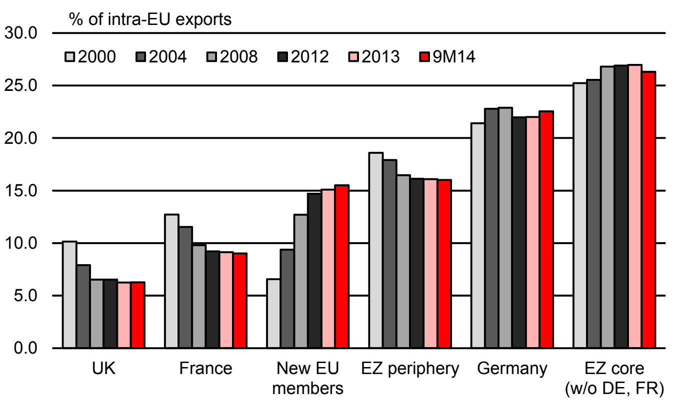
**CEE increased market share in intra-EU exports…**

### …amid a slow recovery in eurozone demand…

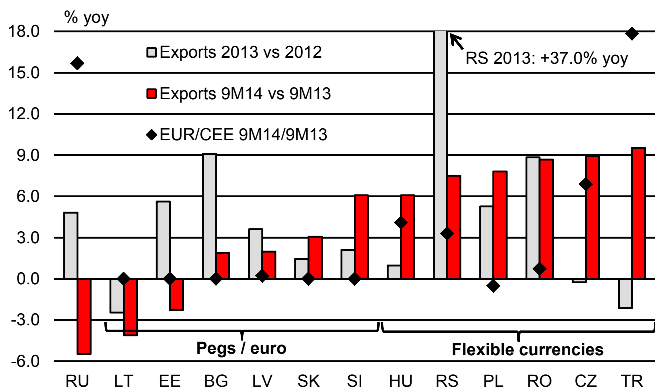
For most CEE countries, external demand is a larger problem than competitiveness, both inside and outside the EU. So far, CEE found it easier to increase its market share in the EU, rather than expanding in new markets. This is true especially for new EU members, which gained market share in intra-EU exports since joining the union at the expense of the periphery, France and the UK. In 2015, low production costs, more flexible labour markets, proximity and lower taxation could help new EU members surpass the eurozone periphery in the share of exports to the EU.

### CEE CONTINUES TO EXPAND MARKET SHARE IN INTRA-EU TRADE

CEE countries are increasing their share in EU exports…




…with currency depreciation helping competitiveness




Source: IMF, BIS, UniCredit Research

**…but faces the risk of weak domestic demand in the eurozone…**

However, CEE exports to the EU will struggle to grow by more than 5% yoy in 2015. A timid eurozone recovery is on the cards for 2015, but weak corporate fundamentals will delay the turnaround in domestic demand in France and Italy. Since mid-2014, eurozone sentiment indicators dipped as sanctions against Russia became stricter. Capital expenditure fell, while most large eurozone economies reported a reduction in capacity utilisation in 4Q14[1]. The exception is Germany, which also reports expected capacity constraints, alongside Austria.

**…with currency depreciation a way of boosting competitiveness**

Facing weak domestic demand, the eurozone will need further currency depreciation unless global exports rebound. Lower oil prices and a weaker currency could help eurozone growth pick up gradually to 1.0% in 2015 and 1.7% in 2016 after an anticlimactic end to 2014.

**German growth expectations are insufficient to provide a large boost to CEE exports**

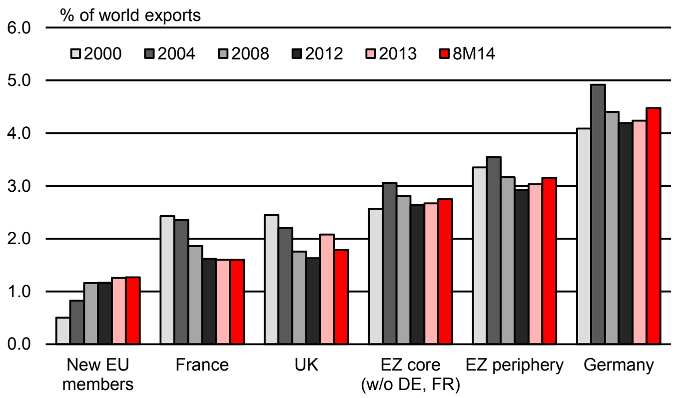
It is the US and Germany that CEE countries pin their hopes on, with the latter consolidating its position as the main trading partner and bellwether for future economic development. We expect a further growth pick-up in the US[2], but for CEE the impact will be limited and mostly indirect, via demand from Germany. Despite a gradual acceleration in quarterly growth, we expect the German economy to slow down to 1.2% yoy in 2015 from 1.5% yoy in 2014 due to a weak 2H14. Growth could re-accelerate to 2.0% yoy in 2016.

### …and limited scope for expanding exports outside the EU

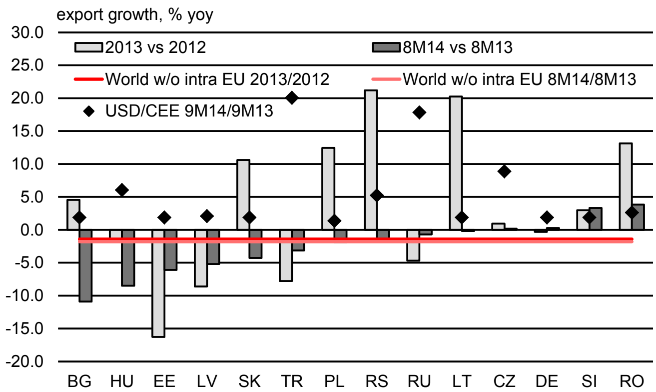
Export diversification outside the EU is encumbered by weak demand in large EM. Potential reasons why EM turned from the main driver of global exports in 2011-12 to the main drag since 4Q13 are the end of the commodity cycle, slower Chinese growth and an adjustment in current account deficits that cannot be financed by large capital inflows once QE3 ended in the US. Conflicts in Ukraine and the Middle East add to the grim demand picture, but failed to cap a fall in commodity prices that results from excess supply. This, in turn, will force domestic demand to contract in commodity exporting countries.

**…BUT OUTSIDE THE EU, THE SCOPE FOR EXPORT GROWTH IS LIMITED**

EU countries have a strong competitive position at global level…




…but demand is weak and currency depreciation offers little help




Source: IMF, BIS, UniCredit Research

[1] According to the business and consumer surveys of the European Commission.
[2] To 3.0% yoy in 2015 from 2.3% yoy in 2014. For 2016, we expect growth to moderate to 2.6% yoy.

## Risks stem from Europe's growth and political uncertainties...

**External risks stem from growth uncertainties in the eurozone economy…**

If the eurozone recovery fails to gather speed in 2015, CEE could use currency depreciation to cushion export share. Some CEE countries used this option in 2014. But weaker CEE currencies bode ill for eurozone countries where labour costs adjusted insufficiently since the financial crisis (e.g., Italy and France). The migration of manufacturing from the eurozone to the eastern fringe of the EU could continue, slowing the reduction in unemployment in the eurozone, especially for younger and lower-skilled workers.

**…and politics…**

Besides the weak eurozone recovery, a potential rise in populism in Europe could lead to unstable governments. Greek presidential elections scheduled for December 2014 could pose such a threat. Our baseline scenario is that the parliament will avoid early elections, but risks of a populist, anti-reform government are significant[3]. In this case, risk appetite and growth would be affected throughout the eurozone, but the currency union's existence is less threatened than a couple of years ago.

**…and the frozen conflict in Ukraine that should not escalate…**

**…as well as the frozen conflict in Ukraine…**

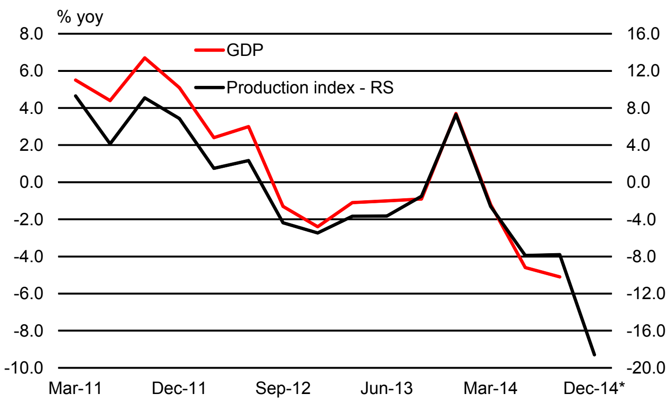
We do not expect an escalation in the Russian – Ukrainian conflict in 2015. Before that occurs, Europe could add to sanctions before the end of 2014 if there is no progress in negotiations and fighting in Eastern Ukraine continues. While uncertainty remains very high, we believe that both parties recognize that they have more to gain from negotiations. Ukraine's solvency, economic stability and, in the end, its very existence are at stake. In 2015, Russia's sanction- and oil price-driven economic recession will test the resilience of authorities, companies and the population.

**…that will be hopefully contained through negotiations…**

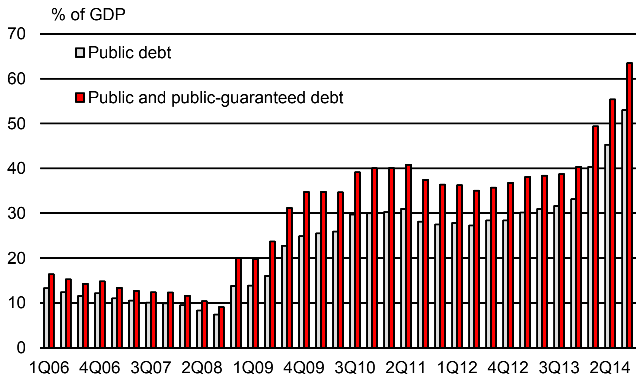
Ukraine's economic meltdown exceeded the IMF's grimmest expectations amid a sharper recession and a deeper fall in FX reserves. The production index computed by the central bank suggested a further acceleration of the recession in 4Q14. Given the negative carryover and the Donbas' isolation from the rest of the economy, the economic contraction could extend to 2015 amid a worsening financing story. In these circumstances, the sustainability of Ukraine's public debt is questionable. FX debt repayments and Naftogaz' deficits will sap into FX reserves, threatening a complete depletion by 2017 unless international creditors step in with additional financing. New IMF money, however, would require tougher reforms. Yet reducing external vulnerabilities by pursuing a more aggressive reform program would undermine the government's support and could lead to a breakup of the young coalition.

**UKRAINE NEEDS AN AGREEMENT WITH RUSSIA TO STABILISE ITS ECONOMY**

The Donbas conflict is accelerating the recession…




…leading to the sharp worsening of public debt metrics




*Production data available only for October at the time of writing

Source: NBU, statistical office, UniCredit Research

[3] For details, please see "2015: Better growth, tighter spreads & a weaker euro", published on 9 December 2014.

### …if Ukraine hopes for an orderly debt rescheduling…

**…so that Ukraine can have a chance to reschedule the debt due in 2016 and 2017…**

In addition, Ukraine could try to reschedule its foreign bonds due in 2016 (USD 2.3bn) and 2017 (USD 3.3bn), thus postponing bond payments until 2020 (there are no redemptions in 2018 and 2019). As argued in the Ukrainian section, the country would need to fulfill several conditions before negotiating with creditors, the most important being the stabilization of public debt and the containment of the Donbas conflict.

**…at the cost of giving more autonomy to the Donbas…**

A comprehensive deal with the breakaways people's republics of Donetsk and Luhansk (and implicitly with Russia) would require concessions from Ukraine, but will set the stage for gradual economic recovery. The persistence of a frozen conflict would not exclude economic ties between the Donbas and the rest of Ukraine. While the Donbas could remain de facto a part of Ukraine, the reintegration of Crimea would be much harder to achieve.

### …and if Russia wants to limit economic damages…

**…and giving up its NATO aspirations**

**For Russia, the main risks are recession in the short term…**

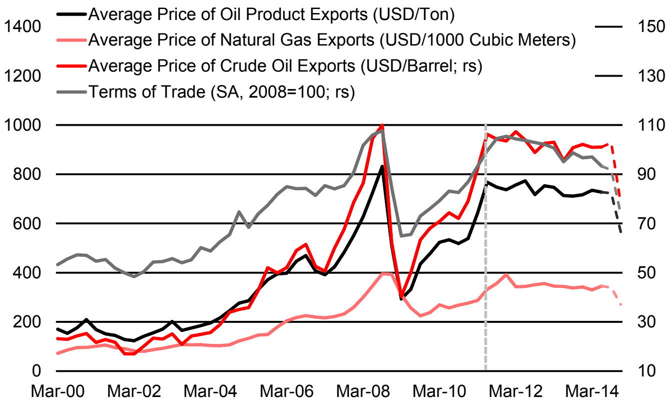
With the Ukrainian conflict, Russia achieved one of its initial goals, namely keeping Ukraine outside NATO. However, this geopolitical victory comes at great economic cost. Russia is risking recession in the short term followed by a protracted period of low potential growth amid financial sanctions. Debt repayments could lead to the crowding out of investment for Russian companies, while lending could slow down sharply amid tighter monetary conditions.

**…and low potential growth in the future**

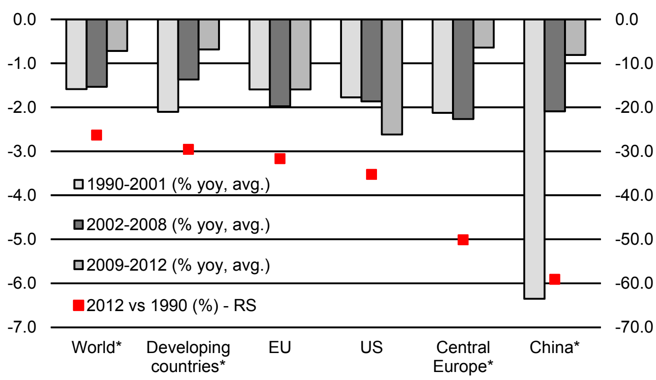
In the long run, Russia's energy exports are threatened by the global economy's falling energy intensity. A larger share of services in GDP and the move away from heavy industry into higher-value manufacturing in EM are the main reasons for the global reduction in energy consumption per unit of GDP. These trends are weakening Russia's bargaining power.

**RUSSIA'S TERMS OF TRADE ARE WORSENING AMID FALLING DEMAND FOR COMMODITIES**

Russia's terms of trade have worsened for the past four years…




…while the energy intensity of the world economy keeps on falling




*2011 instead of 2012

Source: NBU, statistical office, UniCredit Research

**Commercial sanctions could be lifted in 2015…**

One of the most important questions in CEE is whether sanctions on Russia will be maintained or increased further. To answer that, trade and financial sanctions probably need to be looked at separately. Commercial sanctions against Russia could be lifted first, with the EU struggling to achieve a consensus among its 28 members. Austria, Italy, Finland and Hungary are the likeliest to veto an extension of trade sanctions, but European dependency on Russian gas could soften the position of other states as well. If the EU starts backtracking on some of the trade sanctions, Russia could relax food import bans in return.

**…but financial sanctions could last longer…**

In contrast, financial sanctions will probably be maintained as long as the US does not see a satisfactory solution to the Ukrainian crisis. Due to US's prominence in world finance, European banks – most of them global players – will have to abide by these rules and refrain from providing financing to Russian firms and banks. It was the lack of access to bank funding for more than 30 days that led affect financing conditions for Russian banks the most and fuelled the rapid depreciation of the ruble. The Central Bank of Russia can easily cover the FX financing gap for banks, but a return to foreign money markets remains distant.

### … and preserve its investment grade

**…threatening Russia's investment grade rating…**

Russia's FX reserves are probably enough to cover several years of debt repayments. But a protracted absence from debt markets will threaten the country's investment grade rating either due to selective debt repayments by companies or due to a rapid depletion of FX reserves. RUB depreciation can slow down reserve depletion, but risks adversely impacting financial stability via negative wealth and balance sheet effects for FX borrowers.

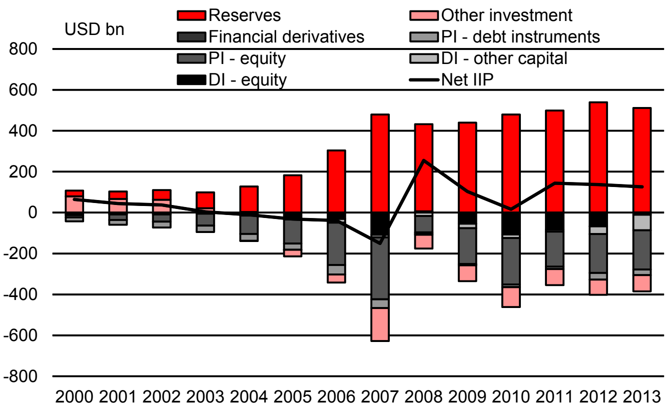
**…despite better risk metrics than for similarly-rated countries**

That said, a downgrade to sub-investment is difficult to justify for a country that enjoys a positive net international investment position. Besides huge FX reserves, debt metrics are significantly better than in the BBB- universe:

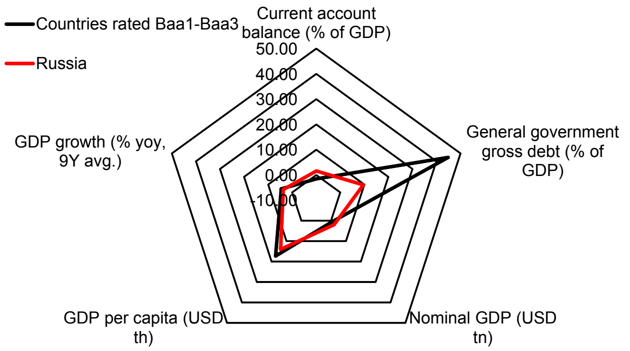
- External debt remains below 40% of GDP, with short-term external debt less than 5% of GDP. Depreciation and lack of access to foreign borrowing will offset each other in the evolution of debt metrics.
- Public debt hovers at 10% of GDP and could decline amid limited access to new borrowing.

**RUSSIA'S INVESTMENT-GRADE RATING RELIES ON MORE THAN JUST FX RESERVES**

FX reserves ensure a positive net international investment position…




…while Russia looks better than the low investment grade space




Source: National statistics offices, Moody's, UniCredit Research

### So far, Ukraine, Russia and the Middle East had limited effects on CEE trade

**The Ukrainian conflict had limited direct impact via external trade…**

So far, conflicts in Ukraine and the Middle East had limited trade implications in CEE: trade balances with Ukraine and Turkey worsened in 2014 compared to 2013, but those with Russia and the Middle East improved[4], despite falling exports. The net effect was a slight improvement in the CEE's trade balance.

While seasonal energy imports from Russia could widen CEE's trade deficit in the short term, a strong deterioration remains unlikely.

[4] In 9M14, CEE's trade deficit with Russia fell by EUR 2.5bn vs. 9M13 (excluding Ukraine). The trade surplus with the Middle East improved by EUR 0.6bn, while the one with Ukraine declined by EUR 1.9bn. The trade surplus with Turkey deteriorated by EUR 1.1bn. The aggregate effect was an improvement of EUR 0.1bn.

Most CEE countries have their gas storage capacities full to the brim, in fear of the conflict between Russia and Ukraine spilling over to gas deliveries. As a result, most CEE countries will be able to cover at least two winter months of gas consumption out of reserves (more than one month in case of a very harsh winter) and will need lower imports from Russia than in past years. This is very important, since almost three quarters of the gas imported by new EU member states comes from Russia. For the eurozone, the figure is less than a quarter.

At the same time, Russia cannot afford to forego exports to Europe, which remain difficult to replace: the two large contracts signed with China will amount to approximately 60% of annual gas exports to Europe only in 2018. Adding deteriorating terms of trade across all commodity exports, Russia needs to maintain export volumes. Otherwise, a fall in export revenues combined with limited access to foreign financing would lead to a faster depletion of FX reserves, jeopardizing the country's investment grade rating.

**…but could have a larger indirect impact via the eurozone, especially Germany**

The Ukrainian conflict poses a greater threat to CEE via its impact on eurozone (and especially German) expectations than directly. One reason could be the direct impact via trade. German exports to Russia contracted by 15.9% yoy in 9M14, more than twice as fast as CEE deliveries to Russia (-7.1% yoy). Another potential reason is Germany's privileged status among energy importers and fears of potential bottlenecks in supply and/or price changes. Among European countries, Germany is the largest recipient of Russian gas (more than 40 billion cubic metres per year). Moreover, only the UK and the Netherlands (both energy producers) pay lower prices for Russian gas than Germany.

**The Turkish recovery should offset potential trade losses from Middle East tensions**

The negative effects of the Middle East conflict are yet to arise, with CEE exports (excluding Turkey) up in 9M14. Going forward, lower oil prices are the largest risk to demand from the Middle East, with Romania, Poland and Bulgaria more vulnerable among CEE countries. Exports to Turkey are expected to recover in 2015 after falling in 1H14 amid a correction in Turkish domestic demand. The two main reasons are stronger Turkish imports (resulting from accelerating credit growth and made possible by cheap oil) and, to a lesser extent, exports to Russia being redirected via Turkey in order to eschew sanctions.

## Domestic demand: past reforms are a differentiating factor

**Domestic demand is weak outside the EU…**

In 2015, CEE will need robust domestic demand growth in case exports disappoint, but not all countries enjoy this cushion. Recession in Ukraine, Serbia and Croatia will be difficult to overcome amid weak fundamentals and a failure to tackle fiscal issues. In Russia, consumption and investment cannot weather low commodity prices and a dearth of external financing.

**…but strong in new EU member states…**

In newer EU member states, growth resilience will rely on consumption and investment drivers at work already in 2014, namely low inflation, solid labour market dynamics and accommodative monetary policies. This growth-supportive cocktail is the result of past reforms and post-Lehman adjustments that were not mirrored in other CEE countries.

### …via historically-low inflation in newer EU member states…

**…due to low inflation…**

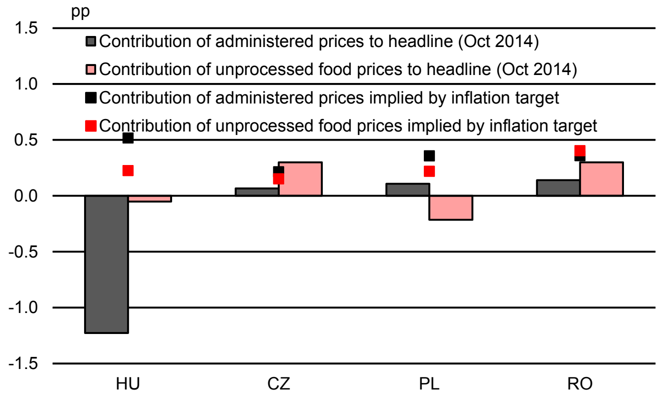
First, inflation remains low amid stronger competition in the retail sector, lower downward price rigidity and a barrage of supply-side disinflationary shocks that will continue to cushion purchasing power in 2015[5]. While food and administered prices will provide for negative base effects in 2015, their inflationary impact will be mitigated to a large extent by falling oil prices, with the bulk of the impact expected in 2015 due to a delayed pass-through[6].

[5]The CEE Navigator – *Monetary policy in Central Europe: the case for a long-term dovish bias* published on 27 October offers a more in-depth analysis of disinflationary factors in CEE.
[6]The pass-through from oil prices to inflation is the fastest in Poland (less than a month) and longer in other countries (one month and a half in Romania).

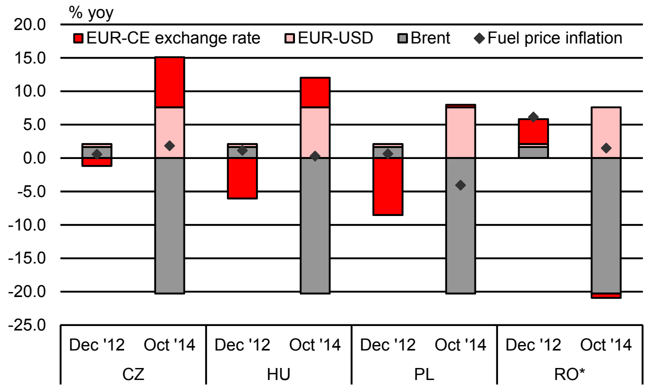
As a result, inflation could remain below 1% in Poland and Hungary for most of 2015 and could fail to reach targets in the Czech Republic and Romania until the end of the year. If oil prices stabilise mid-2015, inflation will rebound stronger in 2H15, with Hungary standing out.

### HIGHER FOOD AND ADMINISTERED PRICE INFLATION WILL BE PARTLY OFFSET BY FALLING FUEL PRICES

Food and administered price inflation will rebound in 2015…




…but fuel prices could decline significantly from here




*Excluding excise duty on fuels

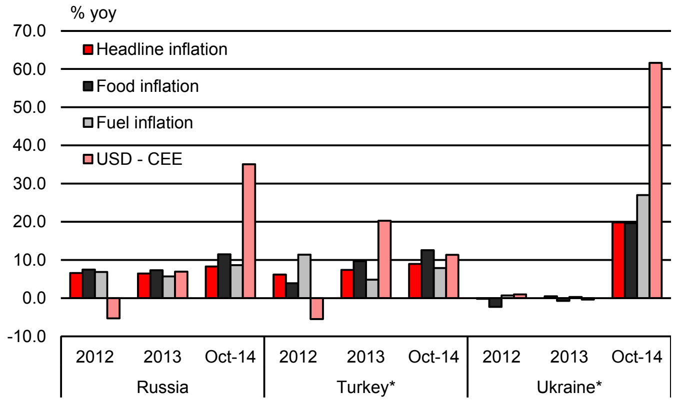
Source: Eurostat, national central banks, UniCredit Research

**…compared with high and rising inflation in Russia and Ukraine…**

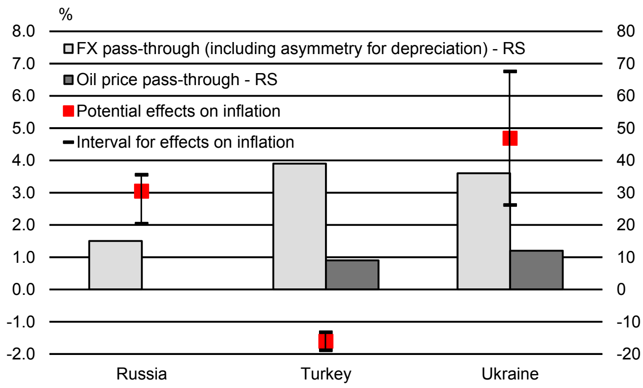
Outside the EU, the inflation story is markedly different due to larger FX pass-through and a series of shocks and rigidities that will keep inflation above targets in 2015. Sanctions in Russia, lower fund flows to Turkey and a sharp macroeconomic adjustment in Ukraine took their toll on currencies in 2014. In Turkey, a poor harvest added to consumer price inflation. However, depreciation is less of an immediate risk in Turkey, while Russian and Ukrainian currencies continue to fall amid plummeting oil prices and a shortage of external financing, respectively.

### INFLATION IS FAR FROM PEAKING IN RUSSIA AND UKRAINE

Supply-side shocks are prominent in keeping inflation high in Russia, Turkey and Ukraine…




…with Russia and Ukraine facing the risk of a significant FX pass-through from here (assuming the current level of USD crosses)




*Utility, energy and fuel prices, rather than only fuel prices

Source: National statistics offices, central banks, UniCredit Research

**…and high and falling inflation in Turkey**

Turkish headline inflation is expected to decline by more than 3pp in 1H15 due to base effects, before rebounding towards 7%yoy by the end of the year due to pressure on core inflation from stronger domestic demand and lower base effects. Given the delayed pass-through, Russian inflation will probably peak above 10% yoy in 2Q15 as long as the RUB does not depreciate in 2015.

Inflation is expected to fall towards 7% yoy by year-end due to base effects and weak domestic demand. In Ukraine, persistent financing woes could weigh on the currency over the next couple of years. Lower food, fuel and core prices can mitigate only part of the high FX pass-through and inflation is likely to exceed 25% yoy in 1H15.

### …improving labour market conditions…

**Labour market improvements boost growth in new EU member states…**

Second, labour market improvements in most newer EU member states should help the real wage bill grow faster than 3% yoy in 2015, with a slight slowdown in 2016. Businesses and consumers expect employment and real wage growth in 2015. With the exception of Estonia and Slovakia, businesses do not anticipate a slowdown in hiring[7]. At the same time, companies plan to increase wages, the main reasons being increased labour productivity, improved financial performance and a deficit of qualified employees[8]. If 1Q15 finds businesses as optimistic as they were at the end of 2014, then real wage growth should remain in excess of 2%, enough to ensure the resilience of private consumption.

**…leading to a deterioration in ULCs…**

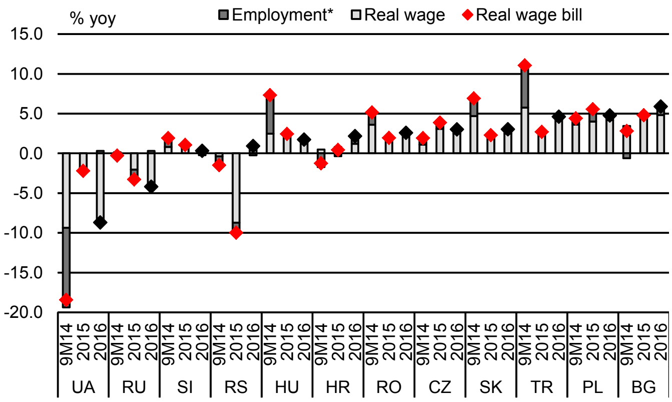
The main danger to consumption comes from slower wage growth amid weak inflation expectations and volatile new orders. Employers could also address falling productivity by capping labour costs, reversing part of the competitiveness loss that affected most newer EU members in 2013 and 2014. If wage growth continues to outpace productivity in 2015, currency depreciation can mitigate part of the problem. A weaker EUR vs. the USD is an advantage for new EU members and Balkan countries.

**…but from a much better position than in Turkey, Russia and Ukraine**

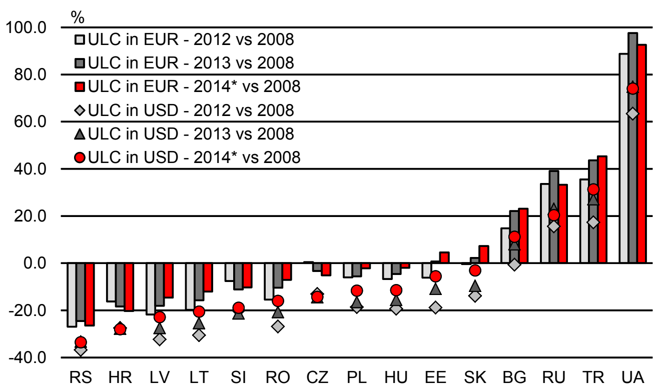
Among CEE countries outside the EU, only Turkey enjoys solid employment and real wage growth, but this comes at the cost of rising unit labour costs, with little change expected in 2015. Inflation could sap real wage growth in Russia and Ukraine next year and probably in 2016, but this will offset only a fraction of the competitiveness loss since the financial crisis.

**WAGE GROWTH IS SUPPORTING DOMESTIC DEMAND IN MOST COUNTRIES**

Both wages and employment will support consumption…




…while EUR depreciation offsets part of the deterioration in ULCs




*Assuming constant participation rates.

Source: CBT, IMF, Eurostat, UniCredit Research

[7] According to November 2014 data from the European Commission's business survey and to November PMIs.
[8] According to KPMG's *Pulse of Economy 2014*.

### …and growth-conducive monetary conditions…

**Easy monetary policy in Central Europe and the Baltics…**

**…will help local currency lending to rebound…**

Third, a combination of low inflation and significant growth risks led to overly dovish central banks in Central Europe. The bias will remain in place in 2015, keeping real monetary conditions at their most accommodative level on record. This will foster the rebound in new lending, driven by local currency loans. Part of the positive impact on domestic demand is mitigated by ongoing deleveraging from FX borrowers, with Romania, Hungary and Serbia standing out. Dealing with the FX debt overhang will take time. In Romania, the outstanding FX loan volume will decline as banks finally take NPLs off their balance sheets and borrowing costs for FX and local currency mortgage loans are comparable. Losing patience, Hungary decided to convert foreign currency mortgage loans into forint in 1Q15. It also granted a haircut of more than 20% in the process by charging banks penalties due to FX bid/ask spreads and interest changes. While a small boost to consumption is on the cards, such radical measures will only weaken the banking system, postponing the lending recovery.

**…while the deleveraging will continue on FX lending**

Despite loan to deposit ratios approaching (or falling below) one, the pace of deleveraging on FX debt only accelerated in 2014. The trend will probably continue as European banks reduce exposure to local subsidiaries amid more stringent capital requirements. But the road to self-funded banking systems means that lending growth will be capped by deposit growth, unless banks hold sizeable liquidity surpluses. From this point of view, the Czech Republic, Poland and Slovakia are in the best position to reignite lending, boasting excess liquidity of more than 16%, 8% and 5% of GDP, respectively. Unlike in the eurozone, capital positions are solid in CEE and limit potential loan growth only in Ukraine[9].

**Credit impulses will be positive in new EU member states…**

Due to improving local currency lending, the credit impulse will be positive at the turn of the year in most newer EU countries, although it needs to accelerate further to provide a boost to domestic demand throughout 2015. Credit standards are being relaxed across the region, with demand picking up for both households and firms. The main risk to the credit recovery remains weak external demand and a potential reassessment of investment needs.

**…but negative in Russia, Ukraine and Turkey…**

**…turning growth-supportive for the latter in 2H15.**

Outside the EU, demand for credit is recovering in Turkey and falling in Russia, Ukraine and Serbia. After a strong adjustment to credit growth in 1H14, lending reaccelerated in Turkey to growth rates last seen at the beginning of the year, despite interest rates being more than 0.5pp higher. If the central bank cuts rates in 1H15 amid strong disinflation, cheaper credit will only accelerate lending, threatening a re-widening of the C/A deficit before year-end. Even so, the credit impulse will turn positive only in 2H15 due to the strong deceleration from 1H14. The central bank would like to ease monetary conditions without reheating the economy, but its measures are unlikely to have significant effects[10]. With elections scheduled for June 2015, the government will welcome faster growth in domestic demand.

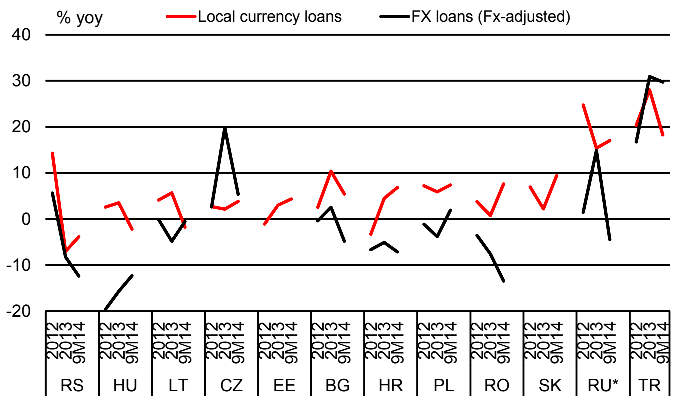
**No credit recovery in sight for Russia, Ukraine or Serbia**

In Russia and Ukraine, credit will come to a halt in 2015 amid a lack of foreign financing and tighter monetary conditions. With financial stability threatened by currency depreciation, the credit impulse will prove a massive drag on domestic demand. In Serbia, the private sector will probably have to deleverage further amid the ongoing recession.

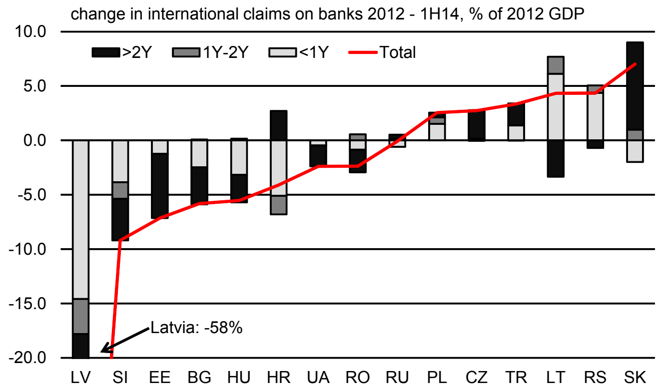
[9] Capital is not the only issue in the very fragmented Ukrainian banking system. Large NPL volumes, rising interest rates and UAH depreciation will take a toll on lenders and borrowers, rendering a credit recovery unlikely in 2015 or 2016.
[10] The CBRT started paying interest on minimum reserve requirements, paying more to banks with lower leverage ratios.

**LOCAL CURRENCY LENDING IS ACCELERATING, FX LENDING CONTINUES TO DECLINE**

Credit recovers in local currency, while the FX component is falling…




…as foreign banks adjust their exposure to CEE subsidiaries




*8M14 instead of 9M14

Source: CEE central banks, BIS, UniCredit Research

### …that will smooth the slowdown in investment…

**Investments are expected to slow down in 2015…**

Investments have been the main GDP growth driver in newer EU member states in 2014, providing for a strong carry-over into 2015 for domestic demand. Looking forward, the assessment of capacity utilisation and of constraints points to growing private investment in 2015, albeit at a slower pace. The slowdown has two main reasons.

**…due to external demand growth…**

First, foreign demand is not growing sufficiently fast to require an acceleration in capital spending. A good start to 2014 in Europe boosted private investment, while the recovery of domestic demand fuelled budget revenues and public infrastructure works. Yet investments lost momentum in 2H14 as both fiscal and export drivers weakened. However, if export demand were to pick up, private investment could reaccelerate promptly, since an increasing backlog and hiring intentions suggest diminishing slack.

**…and temporarily weaker EU funds flows**

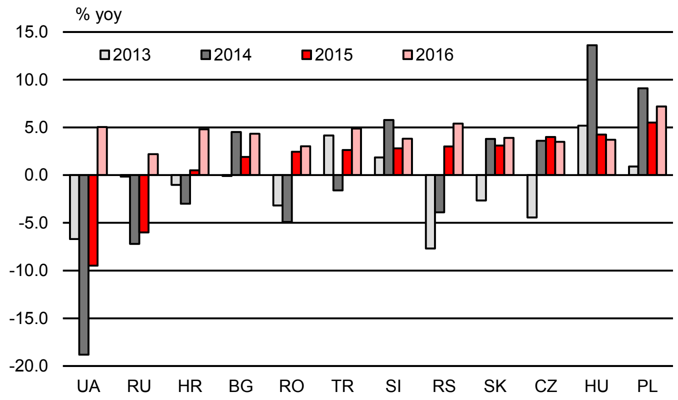
Second, new EU-funded projects under the 2014-20 programming period will take a while to develop and inflows could slow temporarily in 2015. In comparison, EU fund inflows were higher in 2014 than in previous years as projects funded between 2007 and 2013 reached their final stages. Laggards in EU fund absorption like Romania and Slovakia will continue to receive funding from 2007-13 until the end of 2015, but the latter asked for an additional one-year extension to 2016 and was backed by several CEE countries.

**Selective investment in Russia will aggravate the Dutch disease**

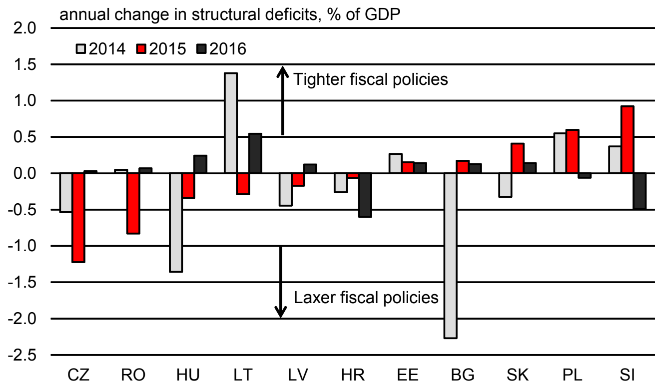
Outside the EU, fixed investment are expected to grow only in Turkey, helped by new lending and an emphasis on public infrastructure works. In Russia, capital expenditure will be crowded out by external debt repayments and lack of access to foreign capital markets. Alternative funding sources such as China will not suffice and the government faces the risk of having to draw down reserves so that planned capacity expansion in the oil and gas sector continues as planned. On a longer term, Russia faces the risk of aggravating its Dutch disease problem as it focuses further on economic sectors that can increase revenues at the fastest pace. Thus, a needed diversification away from commodity exports is unlikely in the medium term, with a direct impact on Russia's potential growth.

**STRONG DIFFERENTIATION IN INVESTMENT OUTLOOK**

Investment could slow in most countries in 2015, but not uniformly…




…as some countries will benefit from supportive fiscal impulses




Source: Eurostat, AMECO, UniCredit Research

**…with the help of fiscal impulses in some countries…**

**Several countries have scope for a positive fiscal impulse…**

Finally, heterogeneity among CEE countries extends to fiscal outlooks amid different political and economic cycle phases. In 2015, the fiscal impulse will turn growth-supportive in the Czech Republic and Romania, where governments have scope to increase expenditures after a thrifty 2014. In Hungary, the European Commission sees scope for further fiscal expansion without deficits exceeding the 3% of GDP threshold. In Croatia, the supportive fiscal impulse assumes that budget deficits will exceed 5% of GDP until 2016, meaning that the country faces the risk of penalties under the excessive deficit procedure.

The strongest tightening is expected in 2015 in Slovenia and Poland, where deficits should fall below 3% of GDP. However, better-than-expected budget revenues in Poland could push the deficit below the EC threshold already in 2014, limiting the painful fiscal adjustment in 2015. In Bulgaria, profligate spending in the first part of 2014 and expenses from the dismantling of bankrupt bank CCOB will require belt-tightening in 2015. While the EC expects the unadjusted budget deficit to remain above 3% of GDP until 2016, the good fiscal record of GERB governments could ensure a faster fiscal adjustment.

**…the exceptions being countries that postpone reforms due to available external funding…**

**…like Serbia and Croatia**

Outside the EU, access to foreign financing will delay meaningful reforms. Serbia needs to reduce the budget deficit from 7.8% of GDP in 2014 (including contingent liabilities). This is unlikely to happen in 2015 and the public debt to GDP ratio could climb above 80% in 2015, while the government could struggle to refinance debt later in the year. Despite a precautionary IMF agreement, the incentive for painful reforms is low as long as deficits can be financed. This is valid in Croatia's case as well and, to a smaller extent, in Turkey's. While the size of budget deficits has not been an issue since the financial crisis, the structure of public spending has deteriorated in Turkey, with three quarters of expenditure accounted for by wages, social security transfers, good and services and current transfers.

**Ukraine failed to adjust despite financing constraints**

Reforms are most needed (and long overdue) in Ukraine, where large subsidies for the energy sector and loss-making industrial producers render budget deficits unsustainable in the current environment. Despite the critical situation, reforms under the IMF agreement (including gas price hikes) failed to stabilise public finances, with the budget deficit expected at 6%of GDP in 2014 and above 4% of GDP in 2015 and 2016.

**…and the support of low oil prices (but not in Russia)**

Falling oil prices have several positive effects on CEE economies via lower inflation, improving trade balances with energy products and a boost to domestic demand due to gains in consumer purchasing power.

A gradual pass-through from cheaper oil to consumer price inflation will involve direct effects (via fuel and energy prices) and indirect effects through downward pressure on all price categories amid falling production costs. The estimated effects on headline inflation range between -0.2pp and -0.8pp in 2015.

The effect on trade balances is already evident for countries that are more dependent on fuel and energy imports. The impact on consumption (and maybe investment) will take a while to materialise, but a recent sharp improvement in consumer expectations suggests a noticeable improvement in purchasing power due to lower fuel costs. We estimate the effects on inflation and GDP growth of oil prices falling from USD 100/bbl to USD 75/bbl on average in 2015, with the results reported below. The overall effect on 2015 GDP growth ranges between 0.2pp in Romania (where the dependency on energy and fuel imports is the lowest among CEE countries) to 1.0pp in Ukraine. For inflation, the effect is proportional to the weight of energy and fuel prices in CPI (where Hungary stands out) and the pass-through from oil prices on local prices (Poland having the largest and fastest pass-through from falling prices). For 2016, oil prices were kept constant for the purpose of this exercise, although our macroeconomic forecasts assume a gradual rebound in oil prices.

For Russia, the decline in oil prices has the opposite effects. The weaker ruble will push inflation above 10% yoy in 2015 via currency depreciation, while the economy will enter recession due to falling consumption and investment.

**ESTIMATED EFFECTS OF LOWER OIL PRICES ON GDP GROWTH AND INFLATION**

| Pp change to annual growth | GDP | | | | Inflation | | | |
|---|---|---|---|---|---|---|---|---|
| | 2015 | | 2016 | | 2015 | | 2016 | |
| | Baseline | Range | Baseline | Range | Baseline | Range | Baseline | Range |
| Czech | 0.4 | 0.2 to 0.5 | 0.1 | 0.0 to 0.2 | -0.2 | -0.4 to -0.1 | -0.1 | -0.2 to 0.0 |
| Hungary | 0.5 | 0.2 to 0.7 | 0.2 | 0.0 to 0.4 | -0.5 | -0.7 to -0.3 | -0.2 | -0.3 to 0.0 |
| Poland | 0.4 | 0.2 to 0.5 | 0.2 | 0.0 to 0.3 | -0.4 | -0.5 to -0.3 | 0.0 | -0.1 to 0.0 |
| Romania | 0.2 | 0.0 to 0.4 | 0.1 | 0.0 to 0.2 | -0.2 | -0.3 to -0.1 | 0.0 | -0.1 to 0.0 |
| Russia | -1.1 | -1.4 to -0.6 | -0.2 | -0.3 to -0.1 | 0.6 | 0.2 to 1.0 | 0.1 | 0 to 0.3 |
| Turkey | 0.6 | 0.4 to 0.8 | 0.3 | 0.1 to 0.4 | -0.9 | -1.2 to -0.5 | -0.3 | -0.5 to -0.1 |
| Ukraine | 1.0 | 0.8 to 1.1 | 0.4 | 0.1 to 0.5 | -1.2 | -1.8 to -0.6 | -0.4 | -0.6 to -0.2 |

Source: UniCredit Research

## The scope for monetary easing is defined by inflation trends

**A dovish bias in Central Europe will result in rate cuts…**

Faced with slower or no growth in 2015, CEE central banks will try to ease monetary conditions, but the scope for action depends on macroeconomic risks and imbalances.

Central Europe stands out again, as it enjoys laxer monetary policies than the rest of CEE. In 2014, inflation surprises left real monetary conditions restrictive in Romania and Poland, neutral in the Czech Republic and accommodative in Hungary. With inflation forecasts showing a very gradual return to targets, it comes as no surprise that all central banks retain a dovish bias. This could be reinforced in the short term by deflationary pressures from lower oil prices and throughout 2015 by a dovish ECB.

Yet the scope for rate cuts is limited. The National Bank of Romania will probably lower the key rate to 2.50% on 7 January, but cuts below the inflation target are unlikely.

**…and additional easing measures**

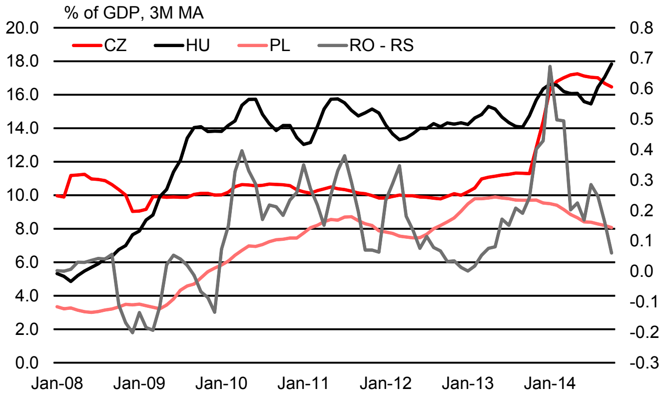
The surprisingly hawkish Polish MPC could probably deliver another cut towards the end of 1Q15, but not sooner. A dovish majority would need proof that inflation and growth are falling short of expectations and could act only after 2015 data start arriving. The Czech National Bank finds itself at the zero lower bound. The Hungarian Monetary Council probably knows that further cuts will not help flatten the yield curve or boost lending.

Besides a gradual rebound in inflation, easing alternatives are available:

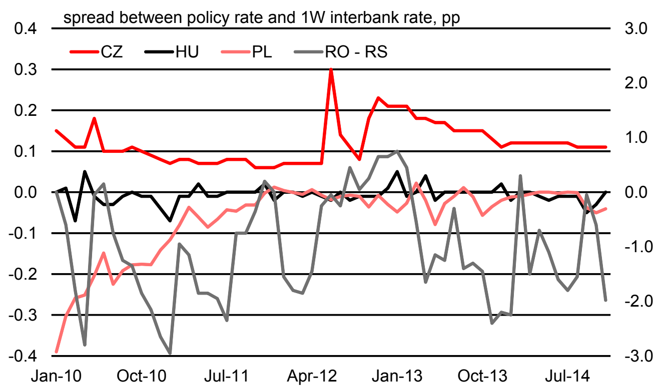
1. The National Bank of Romania is expected to cut minimum reserve requirements to keep market interest rates below the monetary policy rate;
2. The Czech National Bank could intervene verbally to weaken the currency temporarily or, ultimately, could increase the FX floor if inflation and growth risks escalate;
3. The National Bank of Hungary could stoke currency depreciation to foster external competitiveness. In addition, the imaginative NBH could come up with new liquidity facilities like the Funding for Growth Scheme and discount interest rate swaps used in 2013 and 2014 to lower longer-term interest rates.

**EXCESS LIQUIDITY IS BOOSTING LAX MONETARY CONDITIONS IN CENTRAL EUROPE**

Excess liquidity persists in Central Europe…




…pushing interbank rates below policy rates (exception: Czech)




Source: central banks, UniCredit Research

**Outside the EU, monetary policy has limited scope for action**

Outside Central Europe, the room for maneuver is much smaller. The Central Bank of Russia needs oil prices to stabilise before the ruble stops depreciating and inflation peaks. Only after that (i.e., in 2Q15 at the earliest) can the CBR start cutting rates. If tensions in Ukraine subside and investors return to buying Russian assets, the CBR could favour limited appreciation and a replenishing of reserves.

In Ukraine, the National Bank will probably struggle with limited FX reserves and continued pressure on the currency in 2015 and 2016. In view of high inflation via supply shocks and the monetization of budget deficits, rate cuts seem unlikely in 1H15.

**The CBRT risks cutting too much too soon**

In Turkey, disinflation will pave the way for rate cuts in 1H15, but the CBRT risks easing too much too soon due to political pressure. If falling inflation leads to higher capital inflows, the central bank could use the opportunity to replenish its very low net reserves. Otherwise, the CBRT will fail to protect the currency if depreciation pressures return towards the end of 2015 amid a wider C/A deficit.

The National Bank of Serbia will probably resume rate cuts in the aftermath of the new IMF agreement. Low inflation and economic recession warrant lower rates, but euroization and the reliance on volatile capital inflows to finance the C/A deficit will limit the scope for cuts. Hence, real interest rates could remain the highest among CEE countries in 2015.

### …and by currency support from capital flows

**Large basic balance surpluses in newer EU member states…**

Despite a rebound in domestic demand and imports, newer EU member states manage to run current account surpluses or cover external shortfalls through FDI and EU fund inflows. The resulting extended basic balances are wide enough to offset bank deleveraging in countries like Hungary, Slovenia, Bulgaria, Romania and Croatia.

The strong currency support will remain in place in 2015, despite a potential slowdown in EU fund inflows in countries like Poland and Hungary. Slower bank deleveraging would reinforce this. Thus, new EU member states stand out in the EM universe as being less vulnerable to changes in global risk appetite.

**…an ongoing dependence on portfolio financing in Turkey and Serbia…**

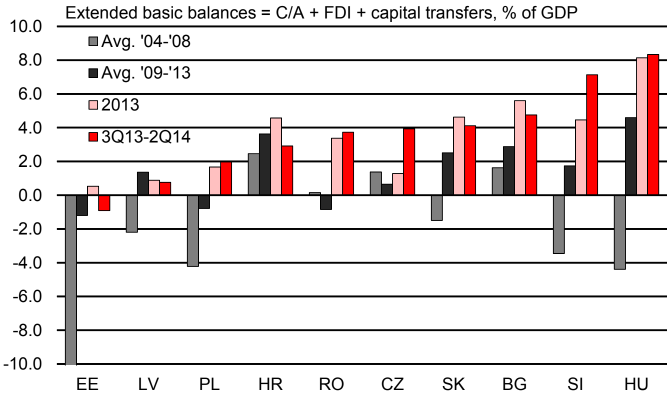
The picture is different outside of the EU, where countries like Turkey and Serbia continue to finance approximately 40% and 60% of their respective C/A deficits via portfolio inflows. High yields helped both countries in 2014, but the task will become more difficult in 2015. Catering mostly to USD-based investors, Turkey and Serbia could be hit by episodes of risk aversion if USD rates start normalising.

**…and limited access to foreign funding in Russia and Ukraine**

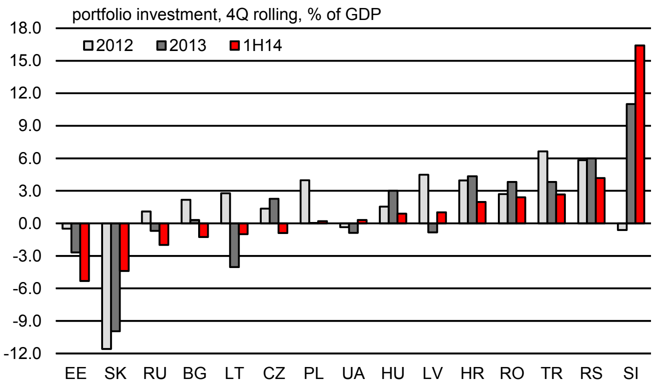
Russia and Ukraine face capital outflows and reserve depletion, albeit from very different starting positions. Russia can survive more than a year outside international debt markets at the cost of depleting reserves and sacrificing investment. Ukraine will need external help, as noted above.

**VARYING CURRENCY SUPPORT**

Extended basic balances support Central European currencies




…but other countries still rely on volatile portfolio investment




Source: Eurostat, central banks, UniCredit Research

# CEE Strategy: A more polarized landscape

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- For EM Fixed Income, we enter 2015 with yields in most regions near historical lows against a backdrop of a rebounding US economy in contrast to sluggish growth and low inflation in the eurozone. Rising expectations of Fed rate hikes will be balanced with additional ECB easing measures, if warranted, creating two-way pressure on yields.
- After significant tightening over 2014, we expect EM Fixed Income to continue to be well supported into the first half of 1Q15. However, a significant rally beyond this will require a further catalyst as we expect growth and inflation to start to pick up across the region. The action of the ECB will likely be crucial. If more accommodation is required and comes in the form of sovereign QE this will likely drive CEE yields significantly lower.
- Oil price remains a key factor influencing the path of inflation in Europe. Within CEE, it creates more differentiation in inflation and performance between markets, particularly in Russia and Turkey where the impact is more divergent. However among CE3, the pass-through is more convergent as the weaker oil price create a dovish bias across the region.
- In local markets, balancing rising growth and inflation expectations against the scope for rate cuts and potential ECB QE, we favor being overweight Romania against marketweight in Poland and Hungary. In Romania, we see the easing cycle lasting longer and we prefer long-dated ROMGB 23s. In Poland and Hungary, we favor longer-dated tenors but see rising growth and inflation toward the end of 1Q15 in Poland and forint depreciation in Hungary putting upward pressure on yields – although if ECB QE materializes, we then expect yields to fall considerably lower. We recommend being overweight Turkey as base effects and oil prices point to a significant deceleration in inflation in 1H15. We favor the belly of the curve and would look to initiate a 2s5s steepener if inflation falls faster than expectations in anticipation of a rate cut by the CBRT. In Russia, we recommend being underweight local bonds. As inflation is set to rise further pressure on the RUB is likely, and with low demand for bonds we see little room for improvement until the oil price stabilizes.
- On balance, we see lower risk and more value in hard currency bonds. The long end in Poland, Hungary and Romania remain attractive, with yields in the USD bonds typically higher than the local currency debt. We see value in the BGARIA EUR 24s with some stability returning to the market, and we prefer CROATIA USD 20s against SERBIA USD 20s on the balance of reform risk. In Turkey, we prefer local currency bonds, while in Russia we see the RUSSIA USD 23s as a safer alternative to local currency bonds.

## A strong last quarter ahead of 2015

**Solid EM local debt performance but USD strength remains a headwind**

We look ahead to 2015 after another positive quarter in both hard and local currency bonds, albeit with more differentiation within CEE. Bond returns were again outpaced by US equities, but hard currency bonds continue to outperform local currency bonds when currency effects are taken into consideration. Since 3Q14, most global EM local currency markets have continued to bull flatten, but the strength of the USD continues to hamper returns.

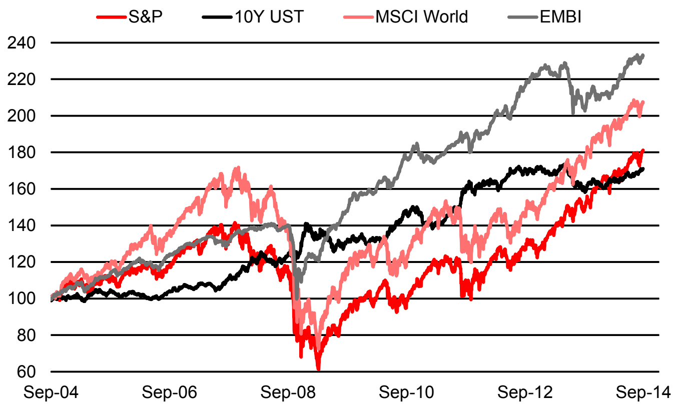
**CEE local market (excl. Russia) outperformed LatAm and Asia…**

**…as local currency spreads against 10Y Bunds tighten close to historic lows**

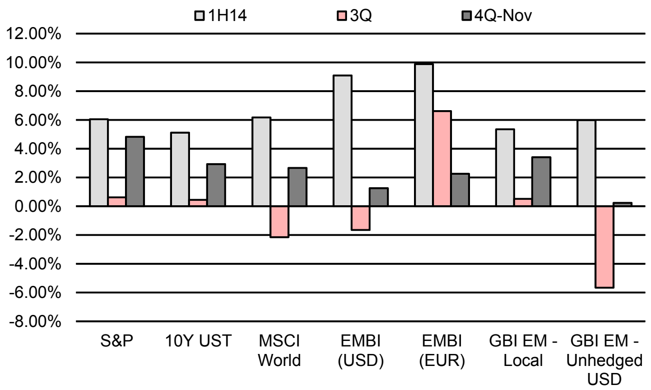
With the exception of Russia, CEE local currency bond markets outperformed LatAm and Asia, as yield curves continued to tighten close to historic lows. 10Y spreads across Central Europe against Bunds continue to decline, with the average CEE local bond curve having rallied 37bp since 3Q14. Excluding Russia, Ukraine and Bulgaria, CEE hard currency curves in USD and EUR rallied on average 22bp and 17bp, respectively.

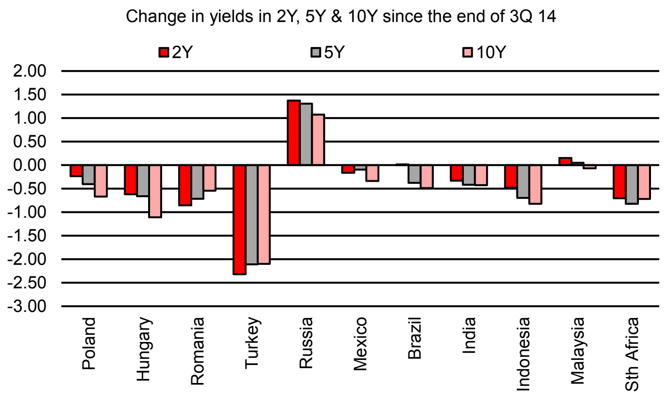
## EM DEBT MARKET PERFORMANCE IN A GLOBAL CONTEXT

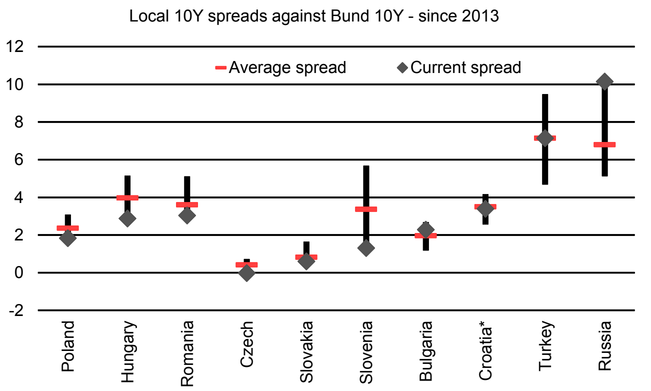
**Asset returns**




**YTD returns**




*7Y instead of 10Y

Source: Bloomberg, UniCredit Research

**Flows into local currency bonds have stabilized…**

**…while continued USD strength is driving inflows to hard currency bonds**

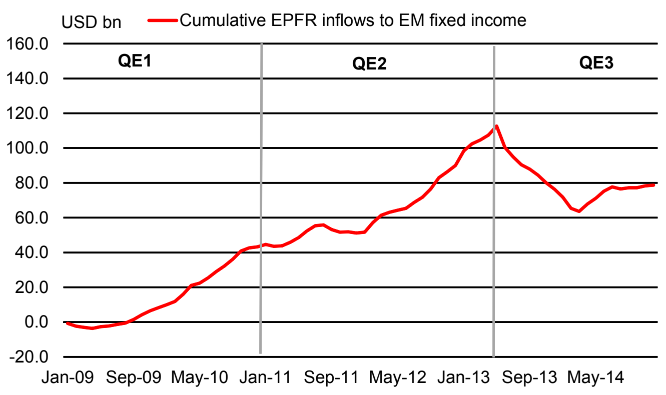
Inflows to EM have picked up over the last quarter, as the risk environment and bond performance improved. Aggregate flows to EM as measured by the EPFR data have returned to December 2013 levels, although still over 40% lower than the highs reached in May 2013. Despite a better performance, inflows into local currency bonds have failed to recover from the selloff in 1Q14. The strong USD since 2Q14 has hampered overall returns and idiosyncratic EM issues have impaired risk appetite. Hard currency bond flows have fared better, recovering to close to the highest level reached in 2014, but are still only 57% of the peak reached in May 2013.

**Foreign holders increased positions in Hungary, and Turkey over 4Q14 but…**

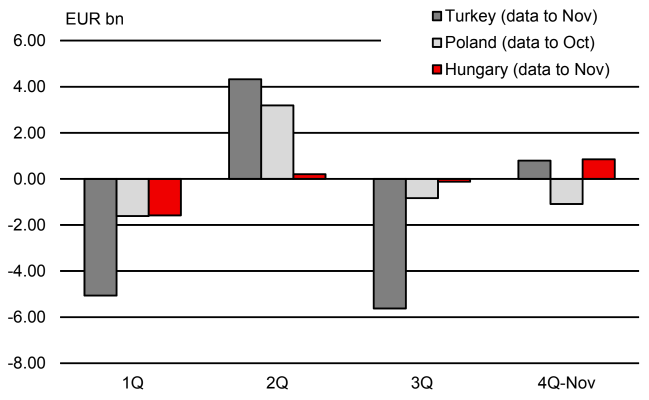
**…Russian bond outflows are likely to continue.**

Plateauing flows into aggregate EM local currency bonds following the end of the Fed QE program in October 2014 have failed to highlight the changing appetite within CEE. Since 3Q14, a steady increase in foreign holdings in Hungary has seen long end bonds (predominately owned by foreigners) in HGBs rally on average 90bp. It was a similar trend in Poland over September, but profit-taking in October by US-based investors stemmed the inflows. Foreigners returned in size to Turkey, resulting in the TURKGB curve tightening 183bp, while in Russia the severe weakness in the OFZ market saw foreign holdings drop RUB 35bn in 3Q14, and we fear this trend has continued into the end of 4Q14.

**GLOBAL EM PORTFOLIO FLOWS PLATEAUING...**




**FOREIGN INFLOWS INTO TURKEY AND HUNGARY IN 4Q14**




Source: Bloomberg, EPFR, Ministries of Finance, UniCredit Research

## 1Q15: Continuation of the rally likely hinges on ECB QE

**Expect CEE bonds to be well supported into 2015.**

We expect CEE bonds to continue to be well supported into the first months of 2015, but a significant rally beyond 1Q15 will require a further catalyst.

**Growth in the US should exceed growth in Europe,…**

**…causing front end UST to widen but this may not result in CEE yields widening…**

**…as they have become more correlated to Bund yields.**

The growth paths of the US and eurozone continue to diverge. Very strong NFP numbers confirm the reduction of slack in the labor market, which will likely drive up inflation. We expect the Fed to hike rates in June 2015, with the OIS curve currently pricing in a hike for 3Q15. In contrast, eurozone growth remains sluggish and a material reduction in growth and inflation forecasts by the ECB indicates further stimulus may be needed, possibly taking the form of sovereign QE. On balance, further USD strength in the lead-up to a potential US rate hike seems inevitable and, all else equal, we expect some pressure on front end bonds. In the 5Y-10Y tenor however, the beta and correlation of CEE yields to US rates has been declining while increasing against Bunds, indicating that curves in CEE will be much more driven by the action of the ECB in coming months than by the Fed.

**The bond rally may start to stagnate without a further catalyst…**

**…ECB sovereign QE could be this catalyst, and…**

**…if implemented would likely result in an extension of rally**

We expect that toward the end of 1Q15 the CEE bond rally may stagnate. Inflation and growth are likely to pick up in 2Q15, with the exception of Turkey, which could halt the rally without an additional catalyst. ECB sovereign QE, if implemented, could be this catalyst. In the US experience, when the Fed purchased USD 2.3tn of UST in 2009-14, EM 10Y yields tightened on average more than 100bp. In a scenario of ECB QE, we would expect yields to fall another leg lower, particularly in economies with strong fundamentals like Poland and Romania and in those with high real yields like Hungary and Bulgaria. We think that the likelihood of QE relies mainly on the path of the 5Y5Y inflation swap. If growth indicators improve helped by a weaker euro, and core inflation remains stable, then QE may be avoided. However, if these factors do not hold and/or there is a significant ‘exogenous driven’ euro appreciation putting downward pressure on the 5Y5Y inflation swap, then QE may be unavoidable. In this scenario, we expect the CEE bond rally to continue.

**Oil prices will continue to drive divergence in inflation in the region …**

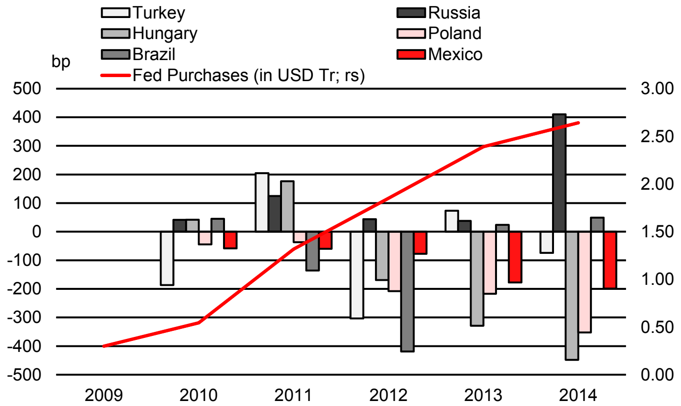
**…and we expect CEE bond performance to be increasing subject to QE headline risk**

Oil prices will continue to create a divergence in bond performance across CEE, having exact opposite impacts on inflation in Russia and Turkey, and differing pass-through rates in the rest of CEE. In the event oil prices continue to fall, the downward pressure on Turkish inflation and the RUB will see TURKGBs outperform OFZs. In Central Europe, the direction on inflation is the same, with declining oil prices impacting Hungary and Poland to a greater degree than Romania and Czech Republic, likely making bond returns more differentiated.

We think that two-way price action of oil into 1Q15 combined with the possibility of ECB QE leaves CEE in an environment where the likelihood of an extension of the bond rally is much more binary and increasingly subject to headline risk – both positive and negative.

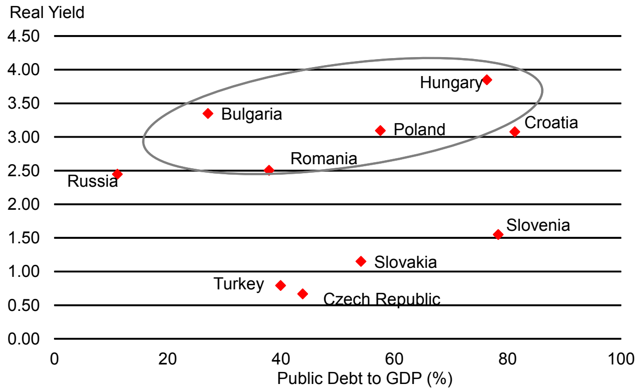
**CHANGE IN EM 2Y YIELDS OVER PERIOD OF US QE**

Cumulative drop in EM 2Y yields over US QE




**REAL YIELDS AGAINST PUBLIC DEBT TO GDP**

Real 10Y yield using 1Q15 forecast inflation against debt to GDP




Source: Bloomberg, national statistical offices, UniCredit Research

## Hard currency: lower risk than local currency debt

**We believe hard currency bonds are better value than local currency bonds...**

With the CEE bond rally at the crossroads, weighing up the surge in short-term US yields amid increasing short positioning, and another bout of USD strength and a dovish ECB, we think hard currency debt across CEE offers better value on both a Z-spread and risk perspective – particularly for USD-based investors.

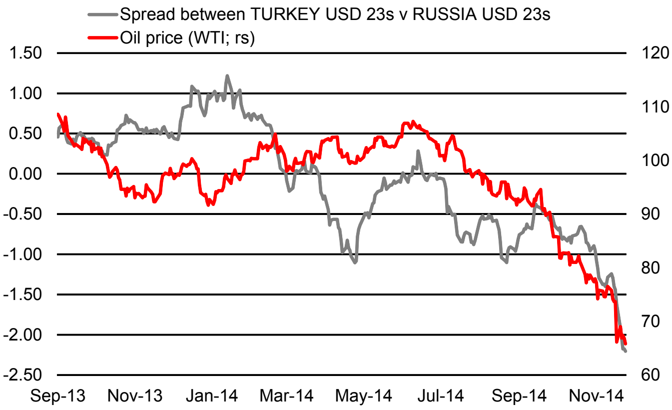
**…in Russia we think hard currency bonds will continue to outperform local currency bonds, and…**

With significant risks remaining in Russia, and a flat local yield curve making FX hedging costly, we prefer to be positioned in hard rather than local currency debt. We think the hard currency RUSSIA USD 22s and 23s are the best value from a Z-spread perspective. The rally in hard currency debt in Turkey driven by the drop in oil prices and appreciation in the lira has resulted in a 220bp spread between Turkey and Russia hard currency USD 23s. A widening of 176bp since the end of 3Q14.

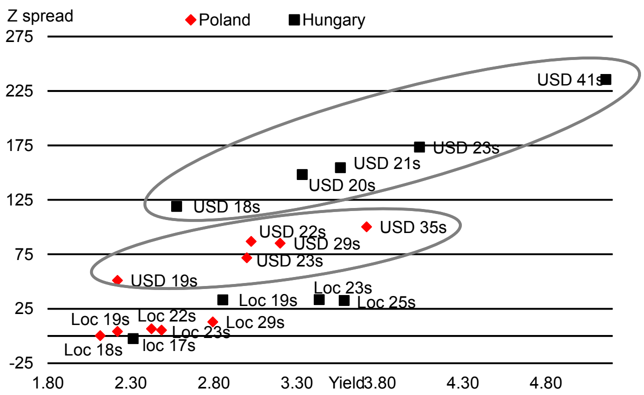
**…in Poland and Hungary, hard currency bonds are favored in longer-dated tenors.**

In Poland and Hungary, we recommend that investors switch to USD hard currency bonds in long-dated tenors. A combination of better yields and Z spreads compared to local bonds and of expected rising inflation beyond 1Q15 makes hard currency bonds, in our opinion, better value. In Hungary, with no FX issuance expected in 2015 and the goal to reduce the external debt ratio, we like being overweight the REPHUN USD 41s and REPHUN USD 23s. In Poland, we recommend an overweight position in POLAND USD 22s and POLAND USD 24, both yielding 50bp more than equivalent local bonds.

**IMPACT OF OIL PRICE ON RUSSIA V TURKEY USD 23 SPREAD..**




**VALUE IN USD BONDS IN POLAND AND HUNGARY**




Source: Bloomberg, UniCredit Research

**We prefer overweight ROMANI USD 44, and ROMANI USD 24s against POLAND USD 24s….**

In Romania, a small 2015 budget deficit and lower gross financing needs in 2015 (9% of GDP) amid a very low inflationary environment are likely to be bond positive. We recommend an overweight position in ROMANI USD 44s, which still offer good value along with the ROMANI EUR 24s. We also like being overweight ROMANI USD 24s against POLAND USD 24s as we expect Romania will ease monetary policy more than Poland. Both curves are pricing in 25bp policy rate cuts into 1Q15, but Romania should remain more accommodative for longer via minimum reserve cuts. In the absence of ECB QE, stable Polish GDP growth and stronger PMIs could see inflation rebound from 2Q15 reducing the inflation differential between Romania and Poland by 0.8pp and leading to Romanian bonds outperforming Poland's.

**…and like being overweight BGARIA EUR 24s versus LATVIA EUR 24s**

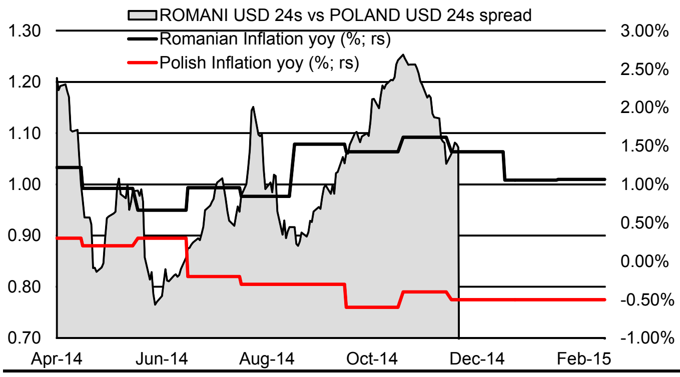
Despite macroeconomic imbalances, we like being overweight in Bulgaria EUR 24s against Latvia EUR 24s. With some emerging evidence of political stability and the underlying banking sector returning to profitability (net of the troubles at COCB), combined with recent strong auctions, we think bad news is behind us. Inflation is set to decelerate in Bulgaria and we think spreads between BGARIA EUR 24s and LATVIA EUR 24s should gradually return to pre-3Q14 levels.

**We think hard currency Croatia bonds will outperform Serbia's**

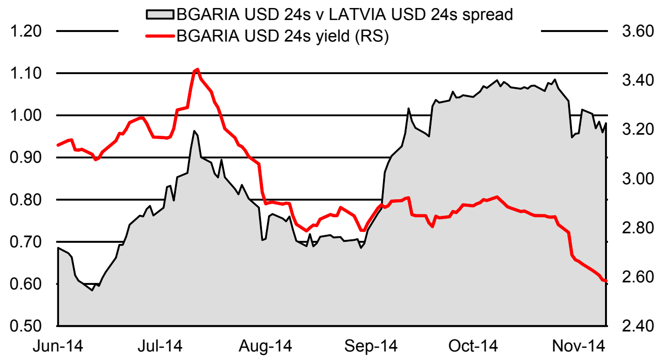
In the Balkans, balancing risks and reform progress, Croatia offers better prospects than Serbia. We like being overweight CROATIA USD 20s against SERBIA USD 20s. Croatia is further along the reform path and has access to EU funds, making it less risky than Serbia. After a significant bond rally into the IMF agreement, we think Serbia is at risk of political inertia in the face of an aggressive reform agenda, which we don't think is fully reflected in the current spread.

**RELATIVE VALUE ACROSS CEE**

ROMANI 24s v POLAND 24s spread and forecast inflation




Spread between BGARIA USD 24s v LATVIA USD 24s




Source: Bloomberg, national statistical office, UniCredit Research

## Local markets: Bond rally at the crossroads

**Greater convergence in inflation paths in CE3, while…**

**…oil prices are causing divergence in Russian and Turkish yields.**

We expect that 1Q15 will be the start of greater convergence in the path of inflation in CE3 due to the impacts of oil prices, Bund yields and growth. Downward pressure on inflation into 1Q14 should see further easing in Romania and Poland, with Hungary more dependent on the path of the ECB. Beyond 1Q15, inflation is likely to pick up more sharply in Hungary and we expect it will converge with Romania at the end of 2015 at levels below inflation targets. In Russia and Turkey, we think inflation continues to be driven by oil price moves. With the exception of Russia, we expect bond yield remain well supported into 1Q15, but inflation and growth paths are likely to become more differentiated towards the end of the quarter, creating more opportunities for relative value trades.

**Issuance set to be low in 2015 as budget deficits fall…**

**…and bond auction demand is likely to outstrip supply**

In most CEE countries, we expect issuance to be low in 2015, with most auctions likely to take place in 1H15 as yields reach historic lows. Poland, Romania, Czech Republic and Slovenia have completed their issuance targets for 2014 and have pre-funded for 2015 -16. This combined with declining 2015 budget deficits in the case of Poland, Romania, Slovenia and Bulgaria will likely limit supply. As a result, we expect demand to outstrip supply in 1Q15, fuelling the downward trend in average accepted yields, and keeping CEE bond auctions well bid. The exception is Russia, where a series of cancelled and low demand OFZ auctions means that it will probably fail to meet its issuance target for 2015. At the same time, reserves remain large. In Turkey, a widening deficit and USD 12.2bn of bond redemptions likely increases net issuance in 2015.

**We recommend being market-weight POLGBs and HGBs…**

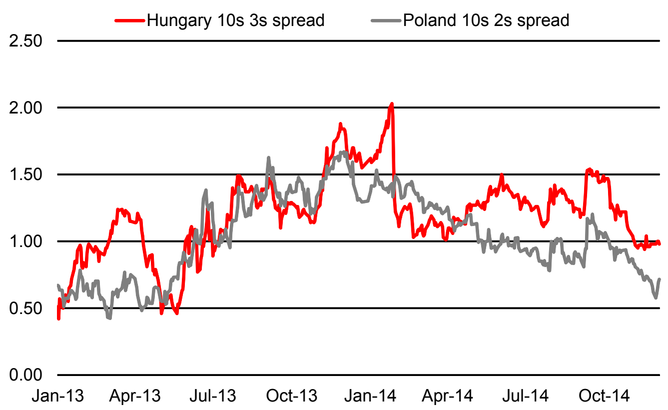
**…balancing rising inflation expectations and the chance of ECB QE...**

In Central Europe, balancing two-way risks to inflation and growth, we recommend being marketweight in Poland and Hungary, but would change our recommendation to overweight in the event of ECB sovereign QE. Scope for further easing in Poland is likely, but upward pressure to inflation beyond 1Q15 likely limits significant curve tightening without a further rally in Bunds. In Hungary, we expect rates to remain on hold despite downside risks to inflation, as base effects and excise taxes will push inflation upwards until the end of 2015. We favor the longer end in POLGBs and the 6-8Y points on the HGB curve into 1Q15. After significant bull flattening, 2s10s spreads in Poland and 3s10s spreads in Hungary are at very tight levels, and in the absence of ECB QE, we would look to initiate a steepener trade in both.

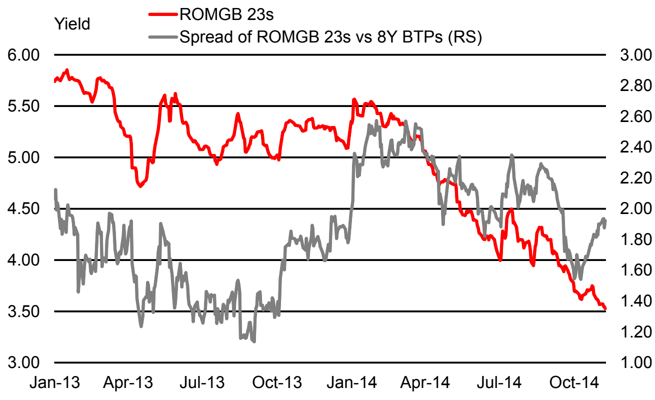
**…and recommend being overweight ROMGB.**

We also recommend an overweight allocation to ROMGBs amid more monetary easing and lower debt levels. We favor ROMGB 23s which are the most attractive from a liquidity, Z-spread and yield perspective.

**FLAT YIELD CURVE IN HUNGARY AND POLAND…**




**…ROMBG YIELDS REMAIN ATTRACTIVE**




Source: Bloomberg, UniCredit Research

**We recommend being overweight TURKGBs…**

**...in the anticipation of a significant drop in inflation**

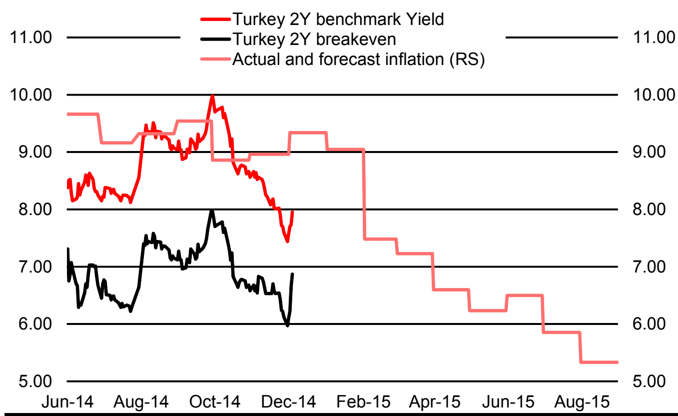
We recommend being overweight in TURKGBs. Despite Turkey's vulnerability to geopolitical risks, oil price appreciation and risk sentiment, we expect to see an improvement in the current account deficit in 1H15, as cheaper oil mitigates the impact of stronger domestic demand. A significant drop in inflation in 1H15 should provide further bond support as long as the CBRT does not frontload rate cuts. At current yields, we expect to see real yields turn positive in early 1Q15. We think most value is in the belly of the curve, in particular the TURKGB 20s. In a steep decline in inflation, we expect the CBRT will cut rates. If we start to see inflation falling faster than market expectations, we would initiate a 2s5s steepener in anticipation of a rate cut.

**We remain negative on Russia on high inflation and low oil prices…**

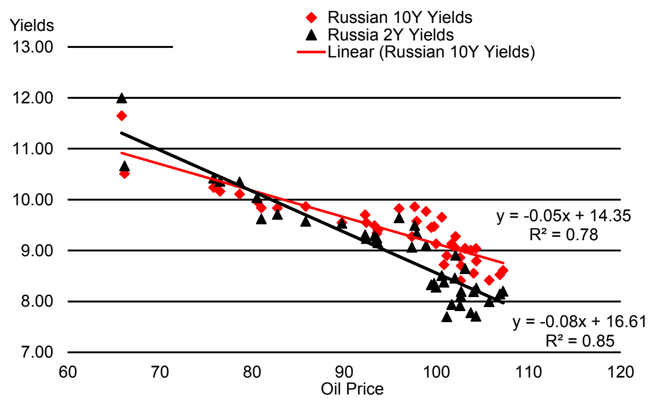
**…but see benefit in a 2Y 5Y flattener.**

In Russia, the economic situation remains precarious and we recommend an underweight allocation to local currency bonds. Auction demand remains weak, suggesting little appetite for OFZs, and with inflation expected to increase in 1Q15 we expect pressure to remain on local bonds. We also think that, until the oil price stabilizes, the RUB will continue to depreciate, putting pressure on the front end of the local curve. This combined with the move to a free-floating exchange rate increases the probability of CBR rate hikes which would see the curve bear flatten and possibly invert. With inflation expected to rise above 10% in 1Q15, we are expecting 200 – 300bp of rate hikes ahead, making a 2s5s flattener attractive.

**INFLATION PATH FOR TURKEY**




**WEEKLY OIL PRICES AND RUSSIA 2Y AND 10Y YIELDS**




Source: Bloomberg, UniCredit Research

# CEE Fixed Income Trade recommendations

### OPEN TRADES – LEVELS IN BASIS POINTS

| Date Initiated | Trade | Entry level | Target | Stop loss | Current level | P&L | Comment |
|---|---|---|---|---|---|---|---|
| 09 Oct | Rec 10Y Poland vs. Pay 10Y Hungary | 103 | 175 | 50 | 76 | -27 | Low inflation in Poland into 2015 will likely see NBP ease rates further. In contrast, rates should remain on hold for most of 2015 in Hungary as base effects and excise tax mean inflation will pick up beyond 1Q15. |
| 22 Oct | Long BGARIA EUR 24s vs. LATVIA EUR 24s | 104 | 84 | 118 | 98 | 6 | We think bonds were oversold in Bulgaria on the election and banking crisis. The formation of the government should provide a better chance of solving the banking issues in light of plans to join the EU. |
| 23 Oct | Long TURKGB 23s vs. TURKGB 18s | 31 | 10 | 60 | 30 | 1 | With the prospect of falling inflation from a number of base effects and the CBRT desire to have a flat yield curve, we expected that demand would increase in longer-dated tenors as investors extended duration. |
| 29 Oct | Long ROMANI EUR 24s vs. POLAND EUR 24s | 134 | 94 | 150 | 109 | 25 | With a lack of investment slowing down growth, we expect Romania to remain in an easing cycle longer than Poland which should see growth pick up beyond 1Q15, putting upward pressure on inflation. |
| 20 Nov | Long ROMGB 23s vs. HGB 23s | 17 | -35 | 40 | -11 | 28 | Spreads between the two trading are close to the highs and Romania is expected to remain in an easing cycle while inflation is likely to pick up markedly in Hungary beyond 1Q15. |
| 14 Nov | Long Turkey EUR 20 vs. BTP EUR 20s | 134 | 100 | 160 | 119 | 15 | Falling inflation in Turkey from base effects, namely lower food, transport, along with a stronger lira and lower oil prices should reduce inflation significantly in 1H15. |
| 14 Nov | Long Hungary EUR 20 vs. BTP EUR 20s | 97 | 80 | 115 | 80 | 17 | With positive carry of 97bp and Hungary set to reduce FX bonds in 2015 to 30% of debt, we expect support for bonds to continue into 2015. |
| | | | | Total | | 68 | |

Source: Bloomberg, Unicredit Research

### CLOSED TRADES – LEVELS IN BASIS POINTS

| Date Initiated | Trade | Entry level | Target | Stop loss | P&L | Comment |
|---|---|---|---|---|---|---|
| 11 Aug | Long POLGB 10Y vs. short Bund 10Y | 241 | 200 | 261 | 41 | The strong harvest and sanctions in Russia forced food prices down and lowered inflation, prompting rate cuts. Given the higher beta in Poland, we expect yields to tighten faster than in Germany. |
| 09 Sep | Long 1Y Turkey vs. short Russia 1Y | 46 | 4 | 80 | -23 | We expected Turkey to cut rates, which it did, but it also cut the size of the repo facility, which caused front-end yields to spike and hence hit our stop loss level. The spread is now at -329bp. |
| 09 Oct | Long POLGB 23s | 265 | 245 | 280 | 20 | Declining inflation in 2H14 was likely to keep the NBP in an easing cycle and as yields collapsed in Europe, more support from EU investors given attractive fundamentals in Poland kept rates supported. |
| 09 Oct | Long POLAND USD 22 | 325 | 300 | 340 | 25 | Expected continued easing by NBP, but looking to guard against USD strength and bonds were trading at attractive Z-spreads to local bonds. |
| 16 Oct | Russia 2s 5s bear flattener | 94 | 60 | 106 | -12 | With spreads trading toward the top of the range, we expected the CBR to hike rates in light of increasing inflation and RUB depreciation - which it did, 150bp on 31 Oct, but not before 5Y yields spiked hitting the stop . |
| 16 Oct | Long SERBIA USD 21s vs. CROATIA USD 21s | 41 | 20 | 47 | 20 | With the spread trading at the upper end of the range, we expect the market in Serbia to rally as the IMF agreement became more certain. |
| 29 Oct | Long ROMGB 19s vs. short POLGB 19s | 91 | 65 | 110 | 26 | With a lack of investment slowing growth, we expect Romania to remain in an easing cycle longer than Poland, which should see growth pick up beyond 1Q15, putting upward pressure on inflation. |
| 14 Nov | Long ROMANI EUR 19 vs. BTP EUR 19s | 68 | 50 | 85 | 18 | A yield enhancement trade, with 68bp of carry, we expect that, with bond issuance in Romania completed for 2015 and further easing expected, demand remains strong. |
| | | | | **Total** | **115** | |
| | | | | **Overall total** | **179bp** | |

Source: Bloomberg, Unicredit Research

# CEEMEA FX: caught amid crosswinds

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CEEMEA currencies will be caught in the crosswinds of a number of themes heading into 2015. We identify four main themes: **(1)** the plunge in energy prices, **(2)** rising expectations of further unconventional ECB easing, **(3)** higher US yields as the Fed moves to tighten policy and **(4)** weaker external demand for CEE exports.

In the following pages, we look at each of these drivers in the context of CEEMEA currencies.

**Key takeaways:**

- **Theme 1 – Falling energy prices**: TRY and HUF will benefit, though ZAR will lag behind. PLN, RON score neutral. RUB stays under pressure.
- **Theme 2 – ECB easing**: RON, CZK and, to a lesser extent, HUF may face upward pressure from lower EUR real yields should the ECB move to sovereign QE. PLN could join in too.
- **Theme 3 – Higher US yields in H2:** We think ZAR followed by TRY will be vulnerable to higher US yields. In contrast, PLN and HUF will hold up well.
- **Theme 4 – Weaker external demand:** Demand from DM economies for CEE exports is a crucial driver of currency performance. Very weak global demand suggests we shouldn't be braced for meaningful downside in EUR/CEE, especially for EUR/PLN.

## Setting the scene: How CEEMEA FX stacks up to EM peers

**CEE currencies are among the most undervalued in EM FX…**

We think that most currencies in CEE will continue to remain range-bound for much of 2015. While valuation and easier ECB monetary policy argue for stronger local units, a large dependence on eurozone growth via exports and authorities' preference for weaker exchange rates will ensure EUR/CEE remains anchored.

**…but there may be a good reason as to why they may remain so for some time yet**

Comparing movements in current account balances relative to real effective exchange rates, a number of CEE currencies should have already been stronger by now. PLN, HUF and CZK all have seen current account balances improve since 2009, yet all three appear to be at relatively weaker levels (chart 1). We suspect that central banks in the region could well become more activist (than is already the case) in keeping local currencies weaker. Taken together, we think EUR/CEE for the most part will remain range-bound.

Indeed, global trade has remained anemic, with import volumes from advanced economies rising at a subdued pace. This will have important ramifications for CEE currencies which are reliant on external demand. This will be the case even for currencies having good FX fundamentals like PLN. We show why we think PLN could remain subdued against EUR and USD, even though it will remain a regional outperformer (see theme #4).

As we will show, HUF looks appealing on a number of metrics; not only is it still relatively undervalued, but the currency also benefits quite nicely from the sharp fall in energy prices (see theme #1), has a lower vulnerability to higher US yields (see theme #3). However, the authorities' preference for a weak currency could weigh on the HUF.

Looking at the USD-bloc CEEMEA currencies, while both TRY and ZAR will remain vulnerable against USD, we are beginning to warm up more to TRY on a relative value basis. Not only does it benefit the most from the sharp fall in energy prices (see theme #1), but the currency has also seen some improvement in its current account imbalance as well as improvement in real yields (see theme #3). This is not the case for ZAR. We like TRYZAR higher.

Finally, we think it is too soon to call the bottom in RUB. The massive negative terms of trade shock and emerging signs of locals moving out of the currency are red flags.

On the other hand, the strong international investment position, ample reserves, very high real yields and good balances should serve the RUB well in an environment of rising US yields. We point out that of the major EM currencies, only in BRL is as much depreciation being priced in from current levels (chart 2). Accordingly, looking at relative value opportunities in RUB/BRL may be appealing as an efficient way to position for further RUB weakness.

**CEEMEA FX: VALUATION AND PRICING RELATIVE TO EM FX PEERS**

Chart 1: CEE looks undervalued among EM currencies

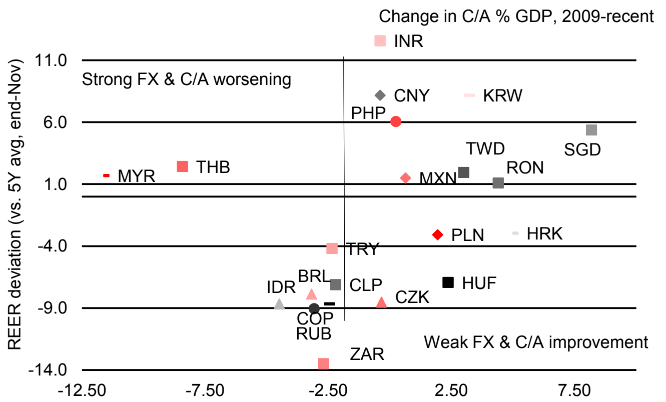
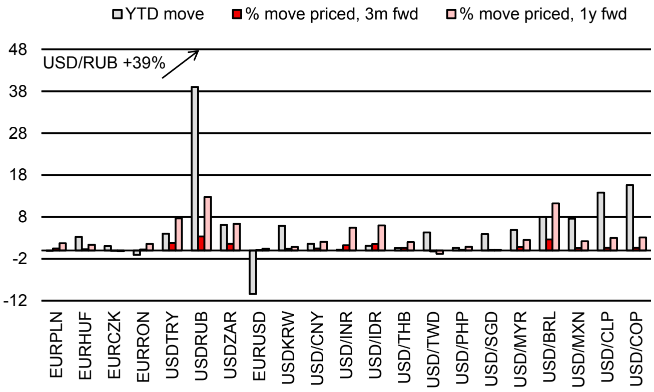



Chart 2: EM FX: What are forwards pricing in?




Source: Bloomberg, Haver, UniCredit Research

## Theme #1: Falling energy prices

**Assessing winners from energy price decline…**

In order to assess the winners and losers from the fall in energy prices, we compute the energy trade balance[11] as a percentage of GDP as well as the correlation of the crude oil price to local inflation figures[12] (chart 1). Currencies towards the left of the chart are those countries that are likely to see a greater benefit through an improving trade balance from falling energy prices, those on the right hand side will lose out the most. Currencies to the top of the chart could see strong downside risks to inflation, while those toward the bottom may not.

**TRY and HUF to benefit the most, ZAR should lag behind**

TRY, HUF and ZAR should all benefit in theory, given their sizeable energy trade deficit as a proportion of GDP. Note that while investors tend to focus on TRY and ZAR, HUF actually possesses the most sizeable energy trade deficit relative to GDP and should be well supported in regard to this driver. At the same time, large base effects from past administered price cuts will offset the impact of cheaper oil on inflation. ZAR benefits as well, but may lag given a structurally weak current account position via weakening external demand for commodities. In contrast, both RON and PLN score as neutral as far as this driver is concerned.

TRY will benefit a lot on a three to six month view with inflation likely to improve and move closer to the inflation target. Not only is the correlation between inflation and energy prices high, but it is also persistent[13], implying improvements will be seen through Q1. Our economists forecast that inflation will fall sharply from 9.05% yoy in December 2014 down to under 6% by June, owing to base effects and lower food and FX pass-through.

[11] We use mineral fuels and lubricants sub-category by commodity for export and import data for all countries to attempt to include all types of energy.
[12] We calculate 20-period correlations between CPI yoy data and annual growth of Brent crude prices (local currency terms), monthly data.
[13] In the case of Turkey, contemporaneous oil-CPI yoy correlation was high, but peaked at a five-month lag at 66%.

Chart 2 shows that inflation break-even levels are still relatively elevated compared to Brent crude prices, meaning scope for real rates to increase and support the TRY in the months ahead. However, any sign of the CBRT rushing to cut rates will likely compromise the pace of TRY gains.

In contrast, for ZAR the correlation of CPI to energy prices is weaker, with a lag length of only two months, implying that the impact of falling energy prices will be short-lived. This is not positive for a currency of a country where inflation remains above target. For HUF as well, inflation is even less responsive to falling energy prices, which suggests less downside inflation risk, and hence a lower risk that the central bank turn dovish. However, for a currency where inflation is below target, at the margin this should be a currency positive should the authorities refrain from easing policy further.

**CEEMEA FX AND THE FALL IN ENERGY PRICES**

Chart 3: Energy trade balance/GDP vs. Inflation sensitivity to energy

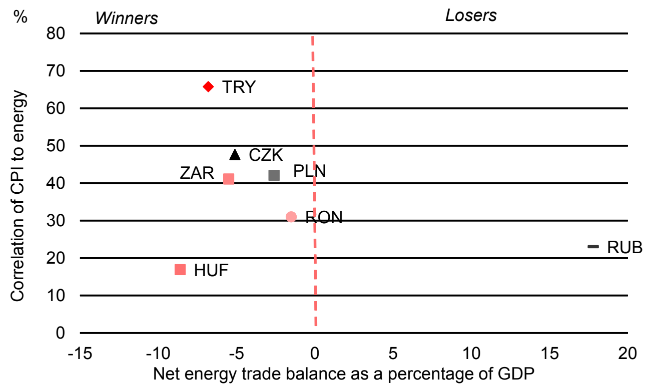
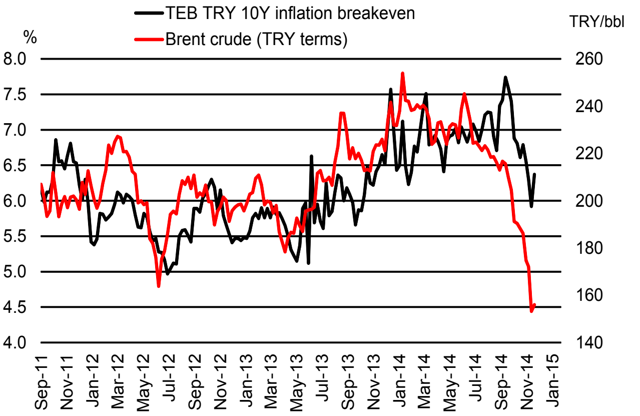



Chart 4: TRY: Crude oil vs. 10Y breakeven inflation




Source: Bloomberg, Haver, Department of Trade and Industry, South Africa, Turk Ekonomi Bankasi AS (TEB), UniCredit Research

## Theme #2: Unconventional ECB easing

**Assessing sensitivity of CEEMEA currencies to potential ECB QE…**

The big question for 2015 is if the ECB expands its balance sheet further, and resorts to sovereign QE in the same way the Federal Reserve and Bank of Japan have done after both central banks reached the zero bound in nominal policy rates. As outlined by ECB President Draghi in a recent speech, sovereign QE works through many different channels by influencing the behavior of lenders, borrowers and investors, but a key catalyst is a decline in real yields.

**…via sensitivity to EUR real yields**

Chart 1 plots the correlation of several CEEMEA currencies as well as EUR/USD with both real as well as nominal yield differentials[14]. While EUR/USD has shared a strong positive correlation with both nominal and yield differentials, in CEEMEA both the USD-bloc (RUB, TRY and ZAR) and EUR-bloc (PLN, HUF, CZK and RON) actually share a negative correlation, if any. Hence, while contracting real spreads may be bearish for EUR/USD, it is far from clear the same applies to crosses like EUR/PLN and EUR/HUF.

It is plausible that either **(a)** real rate differentials aren't as big a driver for CEE currencies and/or **(b)** authorities keep currencies weaker than real interest rate differentials would suggest. Either way, there is no compelling evidence to suggest that EUR/CEE move drastically lower even if the ECB succeeds in lowering EUR real yields to further negative territory using sovereign QE.

[14] We use monthly 2Y swap rates and headline CPI calculating real yields as the difference of the two. We use 12-month rolling correlations and then average over the entire sample.

Recognizing the limitations of using economic data released with a lag, we repeat the exercise using higher frequency data on implied EUR real yields[15]. We find that EUR/CEE pairs were positively correlated to market-implied EUR real rates to varying degrees. The link is weak for the entire period since 2009, though sensitivity of EUR/RON, EUR/CZK and, to a lesser extent, EUR/HUF was stronger over the past year. Meanwhile, EUR/PLN – like EUR/USD – had a decent positive link in 2013, though year to date the link has been weak.

**CEEMEA FX: SENSITIVITY TO REAL EUR RATES**

Chart 5: No clear link between real rate spreads & EUR/CEE

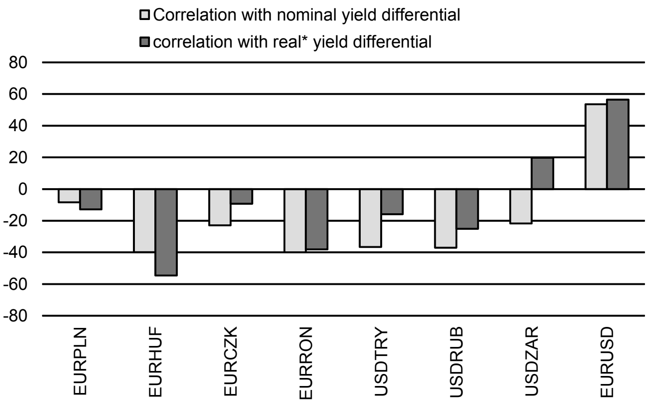
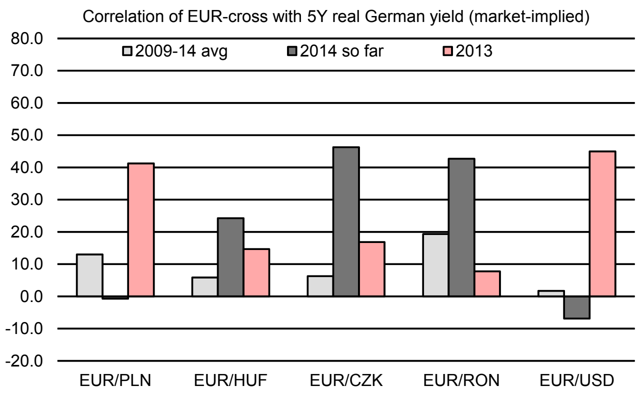



Chart 6: Sensitivity to market-implied EUR real rates




*Please see footnote 15 for methodology

Source: Bloomberg, UniCredit Research

## Theme #3: Higher US yields

**ZAR is the most vulnerable CEEMEA currency to higher US yields…**

Upward pressure on US yields should resurface in the second half of 2015 with our US economists forecasting the Federal Reserve hiking interest rates by 25bp in 2Q, 3Q and 4Q. As a result, US yields should move higher and we look for the US 10Y to back up to just under 3.00% by the end of 2015, at similar levels seen at the end of 2013. When US rates rise and EM-US rates tighten, countries' running current account deficits which are reliant on portfolio investment become vulnerable to a sudden stop.

**TRY trails behind, but should hold in much better than ZAR**

Like in 2013, both TRY and ZAR still suffer from current account deficits (-5.05% GDP and -6.2% GDP, respectively), though both countries now have slightly positive real rates (32bp and 75bp, respectively). Chart 1 shows how both metrics have changed for CEEMEA currencies over the past year.

As can be seen, of the two vulnerable currencies, TRY scores a little better having seen a larger positive change in both the current account position as well as the real rate compared to twelve months ago. As we have highlighted under theme #1, Turkish inflation is likely to fall fast (and real rates rise). In contrast, the real rate advantage in South Africa may not improve as fast.

We think it is also instructive to look at what foreign investors have been doing. Here, we focus on US investors as, back during the "taper tantrum", much of the losses on FX could be explained by how much investors had increased their exposure to the market in question (chart 1). Part of the losses in FX perhaps had to do with foreign investors (US investors in this example) hedging their existing asset holdings (buying USD, selling local currency) as local currencies began coming under pressure.

[15] We use German (bobl) 5Y yields and associated inflation-linked breakevens as a market-based proxy for EUR real yields.

Fast forward to today and, despite the "taper tantrum", US investors have actually increased further their asset holdings in TRY and ZAR (31% and 22%, respectively, between January and September). Accordingly, both will likely suffer the most on any sharp back up in US yields. In stark contrast, PLN and HUF have lower vulnerability; asset holdings have increased only modestly (4-5%).

**TRACKING VULNERABILITY TO HIGHER US YIELDS**

Chart 7: C/A balances and 2Y real rates: Now vs. 12 months ago

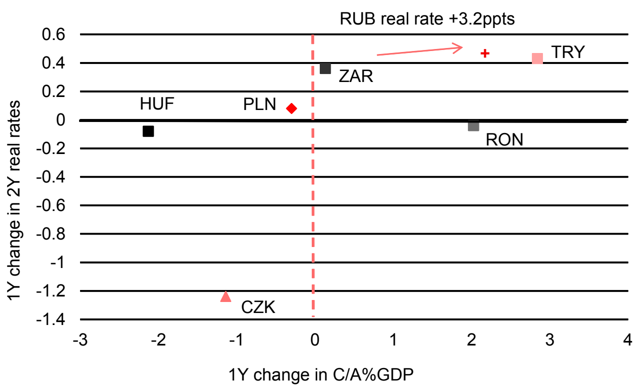
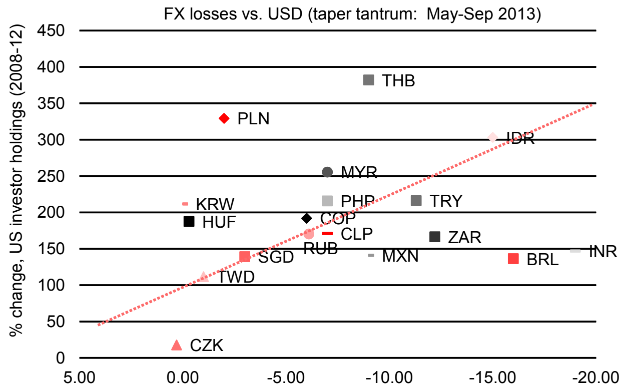



Chart 8: EM FX "taper tantrum" losses linked to US investor exposure




Source: Haver, Bloomberg, US Department of the Treasury, UniCredit Research

## Theme #4: Weaker external demand

**Assessing implications of weak external demand…**

Very weak global demand for EM exports suggests that we shouldn't be braced for meaningful downside in EUR/CEE beyond what has already been seen. Demand from DM economies for CEE exports is a crucial driver of currency performance and external demand appears depressed. Accordingly, while currencies like PLN with quality FX fundamentals may outperform within the region, it can still remain softer against both EUR and USD.

**Why even a regional outperformer like PLN could stay weaker vs. EUR**

Chart 9 plots each CEE country's exports to GDP[16] (x-axis) alongside the sensitivity of the real effective exchange rate[17] to advanced economy import volume growth[18]. CZK and HUF on the extreme right hand side have the largest share of gross exports in GDP, followed by RON and PLN. RUB, ZAR and TRY have a lower share of gross exports in GDP. However, when it comes to the sensitivity of the exchange rate to external demand trends, PLN stands out by far at 76%[19]. Despite having a much higher degree of trade openness in the economy, HUF and CZK have a much lower sensitivity historically to trends in external demand. Accordingly, even though Poland may be the regional bell-weather boasting strong domestic demand, low inflation, strong broad basic balance and a well-developed financial markets, it is not clear that this in itself will be enough to ensure appreciation of the currency. Stronger external demand appears to be a key input for PLN appreciation. This is particularly the case if weak external demand and low inflation mean central banks in the region turn more intolerant of stronger currencies, as our economists flag.

[16] We use GDP data for the year 2013.
[17] We look at correlation between the BIS REER yoy and advanced economy import volume growth yoy for the post financial crisis period (2009 onwards).
[18] We use the advanced economy import volumes as a proxy for the strength of external demand, but using Eurozone import volumes do not change the results.
[19] Even using monthly data since 1995, PLN still has the highest correlation at 41% followed by RON at 32%. HUF is much lower at 9%.

We find it plausible that a combination of stronger domestic demand and potentially weaker external demand (which Poland could face) could see PLN stay on the weak side against EUR. Chart 10 plots EUR/PLN versus the differential between Polish and German industrial production growth. Whenever domestic demand has outpaced external demand (German IP a proxy here), EUR/PLN has tended to be higher, and vice-versa. Hence, on weaker external demand, we wouldn't expect any lasting downside in EUR/CEE, notwithstanding temporary declines should investors begin to price in sovereign QE from the ECB.

**TRACKING VULNERABILITY TO WEAKER EXTERNAL DEMAND**

Chart 9: Export dependency vs. FX sensitivity to external demand

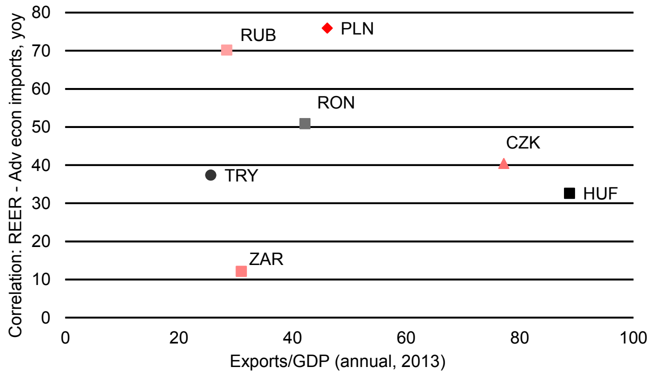
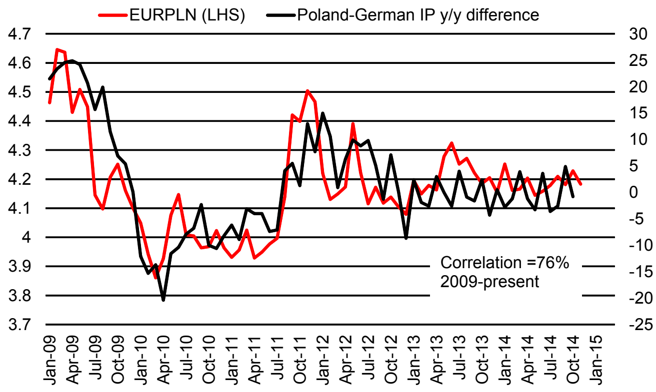



Chart 10: EURPLN vs. Poland minus Germany IP y/y




Source: Haver, Bloomberg, US Department of the Treasury, UniCredit Research

# Countries

# Bulgaria (Baa2 stable/BBB- stable/BBB- stable)*

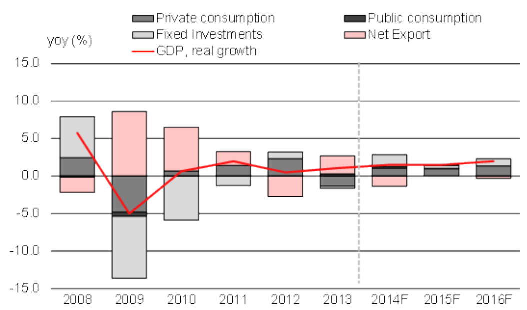
**Outlook** – The negative impact that political instability, frozen EU funds and June's bank crisis had on the pace of the Bulgarian economic recovery was compensated for by a pronounced shift towards a more growth supportive fiscal policy, which helped real GDP growth to strengthen marginally to 1.5% this year, from 1.1% in 2013. Next year, we expect GDP to defy gravity and to rise by another 1.5% in real terms. In a low-export growth environment in combination with limited room for more expansionary fiscal policy, we expect that improved absorption of EU funds and some support for private consumption, via lower energy prices and a declining savings rate, will be the main growth drivers. Importantly, acceleration of some long-postponed structural measures is also in the cards next year.

**Author: Kristofor Pavlov, Chief Economist (UniCredit Bulbank)**

### KEY DATES/EVENTS

- Mid-Feb: GDP flash estimate 4Q14 and FY14
- Mid-Feb: Number of employees 4Q14 and FY14
- End-1Q15: EUR 2.2bn new Eurobond issue

### GDP GROWTH WILL REMAIN SUBDUED




### DEFLATION TO CONTINUE ON CRUDE OIL DYNAMICS


Source: NSI, BNB, MoF, UniCredit Research

### MACROECONOMIC DATA AND FORECASTS

| | 2012 | 2013 | 2014F | 2015F | 2016F |
|---|---|---|---|---|---|
| GDP (EUR bn) | 40.9 | 41.0 | 41.1 | 41.5 | 42.6 |
| Population (mn) | 7.3 | 7.2 | 7.2 | 7.2 | 7.1 |
| GDP per capita (EUR) | 5,618 | 5,665 | 5,704 | 5,798 | 5,989 |
| **Real economy yoy (%)** | | | | | |
| GDP | 0.5 | 1.1 | 1.5 | 1.5 | 2.0 |
| Private Consumption | 3.2 | -1.8 | 1.5 | 1.4 | 1.9 |
| Fixed Investment | 4.2 | -0.1 | 4.5 | 1.9 | 4.3 |
| Public Consumption | 0.5 | 3.6 | 2.7 | 0.6 | -0.3 |
| Exports | 0.1 | 9.2 | 0.9 | 1.5 | 3.0 |
| Imports | 4.5 | 4.9 | 3.0 | 1.3 | 3.3 |
| Monthly wage, nominal (EUR) | 374 | 413 | 419 | 432 | 450 |
| Unemployment rate, avg (%) | 12.3 | 12.9 | 11.6 | 11.3 | 10.4 |
| **Fiscal accounts (% of GDP)** | | | | | |
| Budget balance | -0.4 | -1.8 | -3.6 | -3.1 | -2.9 |
| Primary balance | 0.3 | -0.9 | -2.7 | -2.2 | -1.9 |
| Public debt | 17.6 | 17.9 | 27.1 | 28.0 | 30.0 |
| **External accounts** | | | | | |
| Current account balance (EUR bn) | -0.5 | 0.9 | 1.0 | 1.2 | 0 |
| Current account balance/GDP (%) | -1.1 | 2.1 | 2.4 | 2.8 | 0.1 |
| Basic balance/GDP (%) | 1.0 | 4.5 | 4.7 | 5.1 | 3.1 |
| Net FDI (EUR bn) | 0.9 | 1.0 | 0.9 | 1.0 | 1.3 |
| Net FDI (% of GDP) | 2.1 | 2.4 | 2.3 | 2.3 | 3.0 |
| Gross foreign debt (EUR bn) | 37.7 | 37.3 | 37.7 | 36.9 | 36.9 |
| Gross foreign debt (% of GDP) | 92.2 | 91.0 | 91.8 | 88.9 | 86.6 |
| FX reserves (EUR bn) | 15.6 | 14.4 | 16.2 | 17.7 | 18.9 |
| **Inflation/Monetary/FX** | | | | | |
| CPI (pavg) | 3.0 | 0.9 | -1.4 | -0.5 | 0.7 |
| CPI (eop) | 4.2 | -1.6 | -0.7 | -0.3 | 1.0 |
| Central bank reference rate (eop) | 0.04 | 0.07 | 0.02 | 0.02 | 0.03 |
| USD/BGN (eop) | 1.48 | 1.42 | 1.60 | 1.70 | 1.66 |
| EUR/BGN (eop) | 1.96 | 1.96 | 1.96 | 1.96 | 1.96 |
| USD/BGN (pavg) | 1.52 | 1.47 | 1.48 | 1.67 | 1.68 |
| EUR/BGN (pavg) | 1.96 | 1.96 | 1.96 | 1.96 | 1.96 |

Source: Unicredit Research

* Long-term foreign currency credit rating provided by Moody's, S&P and Fitch respectively

## Unchanged growth trajectory, despite lack of fiscal stimuli

**Ongoing growth support from negative price dynamics…**

**…on top of gradually decreasing savings rate…**

**…while brighter exports and improved EU funds absorption are also in the cards**

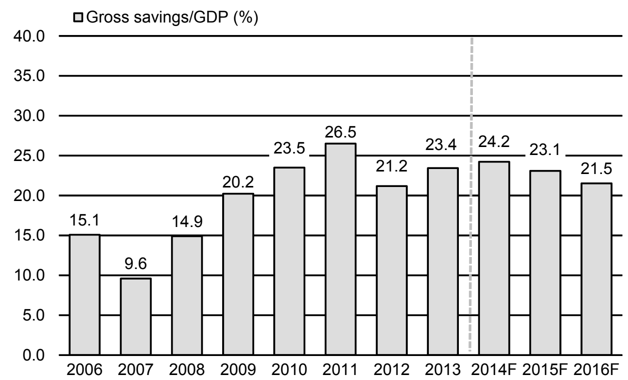
We expect real GDP growth of 1.5% in both this and next year, which marks a marginal correction from our previous projection for 1.3% and 1.6% growth in 2014 and 2015, respectively. Timid export recovery, improved absorption of EU funds and some support for private consumption, via lower energy prices and a declining savings rate (see lhs chart below), will be the main drivers. Also a solid performance of investment goods and of consumer durables manufacturing bodes well for growth momentum looking ahead. All these should be enough to offset credit growth deceleration and lack of positive fiscal impulses next year, as the impact of June's crisis slowly filters through the banking sector, while room for fiscal stimulus is now smaller, especially if authorities want to avoid the launch of an excessive deficit procedure, after the budget deficit is likely to expand to 3.6% of GDP this year.

**Domestic demand will remain the main growth driver next year, but its contribution to growth will weaken as solid fiscal impulse in 2014 will give way to growth neutral fiscal stance in 2015**

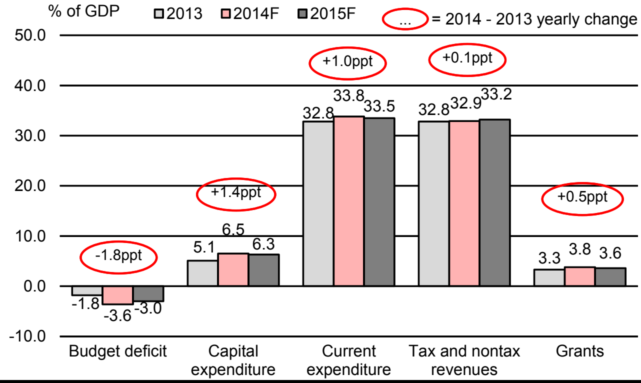
Similar to 2014, fiscal policy will play a crucial role for growth in 2015. But while this year brought a pronounced shift to a more growth supportive fiscal stance (as the cyclically adjusted primary balance deteriorated by 2.3% of GDP in 2014, reaching a magnitude only comparable in size with the 3.4% plunge posted at the start of the global crisis in 2009), which mostly took the form of a solid 1.4pp of GDP surge in public investments (to 6.5% in 2014, from 5.1% in 2013 and 4.5% on average in 2009-12), we expect next year's fiscal policy to remain growth neutral. This is because the budget deficit target was set at 3% of GDP in 2015, from 3.6% in 2014, as authorities want to avoid an excessive deficit procedure that may prove harmful for Bulgaria's plans to tap sovereign debt markets in 1H15. There is a positive aspect in the fact that the bulk of the deficit narrowing next year is planned to materialize via lower compensation of government employees and improved tax collection, while only a tiny part will come from lower public investments (see rhs chart below). Using fiscal multipliers as calculated by D. Muir and A. Weber (2013)[20], we estimate that the negative impact on next year's growth coming from slightly lower public investments and a cut in compensation of government employees envisaged in the new budget will be fully offset by the permanent positive impulse for growth that the large upward shift in public investment has already produced in 2014. The good news here is not only that the government has abandoned plans for aggressive fiscal consolidation, which given still elevated unemployment and broadly based deflationary pressure threatens to push the economy into a new recession, but also that policy makers want to cut the deficit in a way which is least detrimental for growth and does not hinder a recovery in employment in the short run.

There are growing signs that Bulgarian authorities will press ahead with some long-postponed structural reforms. For example, the new right-wing coalition government seems resolved to implement some of the unpopular measures needed to balance the pension system, and to improve the efficient use of public resources in the healthcare and education sectors.

Savings rate is seen trending downward next year…




Fiscal policy will be growth neutral next year…




Source: BNB, NSI, MoF, UniCredit Research

[20] Muir, D. and A. Weber (2013), *Fiscal Multipliers in Bulgaria: Low But Still Relevant*, IMF Working Paper 13/49

**Acceleration of structural reforms will be positive for growth in the medium-to-long run…**

**…but in the short run the impact would be more mixed: positive, as expectation should improve, thus also boosting growth, but also negative, as some job cuts in public administration are planned**

There are ambitious plans to cut public funding to the swollen security sector and to address quasi fiscal deficits in the energy sector, including via renegotiation of the most expensive long-term contracts for the purchase of electricity from solar and wind power plants as well as from the coal firing utilities in the Maritsa East basin. Importantly, authorities are keen to design and implement a working mechanism for investment of EU funds in projects aimed at improving homes' energy efficiency. Above all, consensus around some long-contested corrective measures, focused on preventing corruption and boosting the independence of judges, is taking shape. All these, with some delay, should be positive for growth dynamics toward the end of next year via the expectations channel. But while these structural measures are more than welcome, as they should boost capacity of the economy to produce more goods and services in the medium-to-long run, it would be safe to assume that they will be also accompanied by some pain in the short run, and therefore will act as a drag on household demand recovery for most of next year.

**Exports are forecast to make a slightly stronger positive contribution to growth next year, when compared with 2014**

In our forecast, exports are also among the components with a stronger upside potential and one that helps explain why the GDP growth momentum of the Bulgarian economy is expected to defy gravity next year. This is because all forecasts, including our global scenario for the eurozone, indicate that demand-side conditions for Bulgarian exports are likely to see some marginal improvement next year, although it remains clear that more time will be needed before the geopolitical shock triggered by the Russian incursion in Ukraine begins to fade.

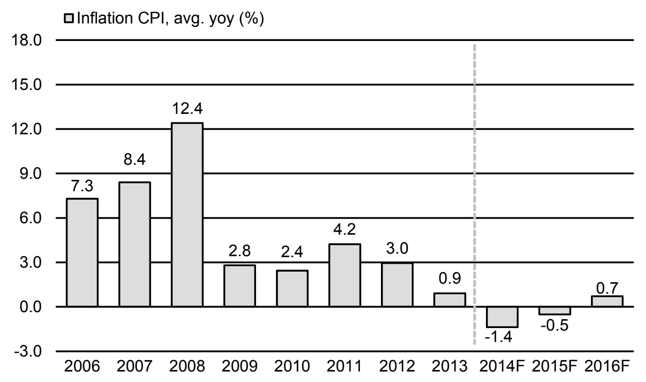
**If lower crude oil prices this year are not reversed in the course of 2015, a significant wealth transfer from oil producing to oil consuming countries will follow, with Bulgaria also being among those to benefit**

Low inflation is here to stay and is set to further stimulate GDP growth next year (we see eop and avg CPI in 2015 at -0.3% and -0.5%), although not to the extent that it did in 2014, when eop and avg CPI are likely to plunge to -0.7% and -1.4% (see lhs chart below). We estimate that if crude oil prices fall in line with our global scenario (more precisely to a 2015 avg of USD 75p/b, from USD 100p/b in 2014), only the first round effect will knock down 0.40 pp and 0.05 pp of the avg and eop CPI next year. As energy accounts for 13% of consumer spending while energy intensive sectors, such as manufacturing of metals and chemical products, have roughly 30% share of manufacturing output, lower oil prices will also impact GDP via the trade balance and domestic demand channels. Given country's high dependency on energy imports, lower crude oil prices are also set to narrow the trade deficit by EUR 400 mn or 1% of GDP, which should help the CA to end 2015 with a positive balance (2.8% of GDP) for a third year in a row.

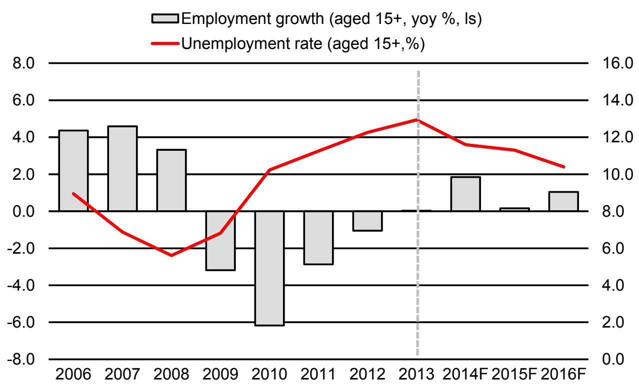
**Labor market on the mend**

Tentative labor market recovery seen in 2014 will carry over into 2015. But the pace of the unemployment rate improvement is set to lose momentum due to job cuts in the public sector, which are planned as part of the fiscal consolidation and structural reform efforts.

Slightly lower deflationary pressure is forecast for next year…




Though slowly, the unemployment rate is trending downward…




Source: NSI, UniCredit Research

## Strategy: Issuance returns to a more predictable, higher trajectory

**Government debt supply will increase as a result of the pro-growth budget stance and rebuilding of fiscal buffers**

We expect the MinFin to return to a more predictable government debt supply strategy as the need to cope with one-off factors slowly abates over the course of 2015 and 2016. Naturally, debt-managing efforts will follow fiscal dynamics and make a pronounced shift to a more expansionary issuance policy in line with what we view as a more growth-supportive budget position. This will see the gross general government debt level rise gradually to around 32-33% of GDP in 2019, where we expect it to stabilize for an extended period of time. This, in tandem with attempts to rebuild the liquidity buffer and operate with higher fiscal reserves, will leave the sovereign with a more active issuance calendar next year, which would be predominately focused on the external market in order to reduce crowding-out of domestic investors.

**A return to the Eurobond market is expected in early 2015…**

We expect the MinFin to frontload its funding efforts next year with considerable emphasis on tapping the Eurobond market as early as possible, probably at the turn of 1Q. The paper is estimated at EUR 2.2bn (or 5.3% of GDP) needed to roll over extraordinary short-term funding received in end-November and early-December, a 6M external syndicated bank loan for EUR 1.3bn and 9M and 12M bills on the domestic market for a combined EUR 0.8bn.

**…as domestic issuance remains more limited**

Debt management efforts of the sovereign in 2015 also include smoothening out and extending the domestic market curve and downsizing bill issuance which surged in 2014 due to extraordinary events. Selling of ST paper will slowly return to a more normal path, where the instrument is used to provide liquidity at the start of the year, and above all to smoothen bumps in the budget cycle. External bond issuance will be also preferred as the sovereign is struggling to construct a uniform yield curve on the Eurobond market.

**Growth-neutral fiscal consolidation and progress on the structural reform front will keep funding costs in check**

Despite this uptick in supply, we see more downward potential in yields on top of the marked shift in the domestic curve, which materialized since mid-November, with tightening of between 35 and 100bp already achieved. GB prices will be supported by a gradual fiscal consolidation effort that doesn't place an excessive burden on growth. Stabilization of fiscal fundamentals at healthy levels, despite the one-time worsening in 2014, would also draw support from progress in structural reforms aimed at addressing quasi fiscal deficits in the state funded pension system and energy sector.

**Author: Nikola Georgiev, Economist (UniCredit Bulbank)**

**GOVERNMENT GROSS FINANCING REQUIREMENTS**

| EUR bn | 2014F | 2015F | 2016F |
|---|---|---|---|
| **Gross financing requirement** | **3.5** | **7.2** | **2.7** |
| Budget deficit | 1.5 | 1.3 | 1.2 |
| Amortization of public debt | 1.8 | 5.7 | 1.3 |
| Domestic | 1.8 | 1.4 | 1.3 |
| Bonds | 0.4 | 0.1 | 0.6 |
| Bills | 1.4 | 1.4 | 0.8 |
| External | 0 | 4.3 | 0 |
| IMF/EU/Other | 0.2 | 0.2 | 0.2 |
| **Financing** | **3.7** | **4.9** | **2.6** |
| Domestic borrowing | 2.8 | 1.4 | 1.4 |
| Bonds | 0.6 | 0.5 | 0.8 |
| Bills | 2.2 | 0.9 | 0.6 |
| External borrowing | 3.2 | 2.7 | 1.1 |
| Bonds | 2.8 | 2.2 | 1.0 |
| IMF/EU/Other | 0.4 | 0.5 | 0.1 |
| Privatization | 0 | 0 | 0 |
| Fiscal reserves change (- = increase) | -2.3 | 0.8 | 0.1 |

**GROSS EXTERNAL FINANCING REQUIREMENTS**

| EUR bn | 2014F | 2015F | 2016F |
|---|---|---|---|
| **Gross financing requirement** | **13.4** | **17.2** | **13.2** |
| C/A deficit | -1.0 | -1.2 | 0 |
| Amortisation of medium to long term debt | 4.8 | 8.7 | 4.2 |
| Government/central bank | 0.2 | 4.5 | 0.2 |
| Banks | 0.8 | 0.6 | 0.5 |
| Corporates | 3.9 | 3.7 | 3.6 |
| Short term debt amortization | 9.5 | 9.6 | 9.0 |
| **Financing** | **13.4** | **17.2** | **13.2** |
| FDI | 0.9 | 1.0 | 1.3 |
| Portfolio flows | 2.1 | 0.7 | 0.9 |
| Borrowing | 7.2 | 6.9 | 5.0 |
| Government/central bank | 3.2 | 2.7 | 1.1 |
| Banks | 0.3 | 0.5 | 0.4 |
| Corporates | 3.7 | 3.7 | 3.6 |
| Short-term | 9.6 | 9.0 | 8.2 |
| EU transfers | 1.2 | 1.1 | 1.2 |
| Other | -5.8 | 0 | -2.1 |
| Change in FX reserves (- = increase) | -1.8 | -1.5 | -1.2 |

Source: BNB, MoF, UniCredit Research

# Croatia (Ba1 negative/BB stable/BB stable)*

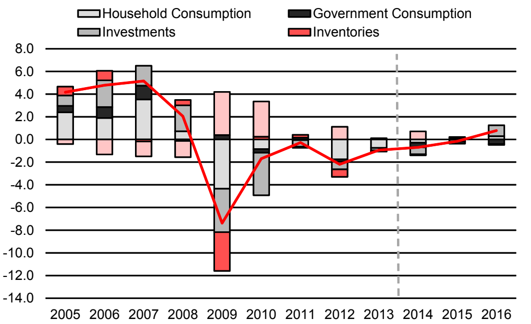
**Outlook –** We expect the recession to continue in 2015 (-0.2% yoy) after an upward revised contraction of 0.7% yoy in 2014 (from -1% yoy in 2013). The investment recovery is very much dependent on public investments, where we do not see solid signs of a marked acceleration during 2015. The impact of external demand is weakening, due to weaker-than-expected eurozone growth. The EDP 2014 targets have not been met, while the 2015 budget proposal does not guarantee a significant improvement. The fiscal performance will continue to weigh on the economic environment, putting pressure on funding conditions and the country's risk premium.

**Author: Hrvoje Dolenec, Chief Economist (Zagrebačka banka)**

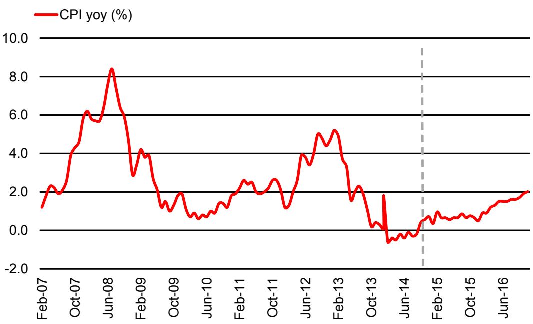
## KEY DATES/EVENTS

- Dec/Jan: Presidential elections
- 9 February: Foreign trade FY14
- 27 February: GDP flash estimate 4Q & FY14
- 10 March: GDP estimate 4Q&FY14
- 31 March: BoP 4Q & FY14
- March/April: In-depth review within MIP

## GDP GROWTH




## INFLATION OUTLOOK




Source: IMF, MinFin, Eurostat, UniCredit Research

## MACROECONOMIC DATA AND FORECASTS

| | 2012 | 2013 | 2014F | 2015F | 2016F |
|---|---|---|---|---|---|
| GDP (EUR bn) | 44.0 | 43.6 | 43.0 | 43.1 | 44.3 |
| Population (mn) | 4.3 | 4.3 | 4.2 | 4.2 | 4.2 |
| GDP per capita (EUR) | 10,302 | 10,240 | 10,117 | 10,179 | 10,478 |
| **Real economy yoy (%)** | | | | | |
| GDP | -2.2 | -0.9 | -0.7 | -0.2 | 0.8 |
| Private Consumption | -3.0 | -1.3 | -0.5 | -0.3 | 0.5 |
| Fixed Investment | -3.3 | -1.0 | -3.0 | 0.5 | 4.8 |
| Public Consumption | -1.0 | 0.5 | -2.0 | -1.0 | -2.0 |
| Exports | -0.1 | 3.0 | 4.7 | 2.9 | 3.7 |
| Imports | -3.0 | 3.2 | 3.0 | 2.7 | 4.0 |
| Monthly wage, nominal (EUR) | 1,048 | 1,048 | 1,042 | 1,048 | 1,073 |
| Unemployment rate (%) | 15.8 | 17.2 | 17.5 | 17.8 | 17.0 |
| **Fiscal accounts (% of GDP)** | | | | | |
| Budget balance | -5.6 | -5.2 | -5.9 | -5.3 | -4.6 |
| Primary balance | -3.0 | -2.0 | -2.3 | -1.7 | -0.6 |
| Public debt | 64.5 | 75.7 | 81.3 | 85.5 | 88.2 |
| **External accounts** | | | | | |
| Current account balance (EUR bn) | -0.1 | 0.4 | 0.5 | 0.3 | 0.2 |
| Current account balance/GDP (%) | -0.2 | 0.9 | 1.1 | 0.7 | 0.3 |
| Basic balance/GDP (%) | 2.3 | 2.4 | 2.7 | 2.8 | 2.8 |
| Net FDI (EUR bn) | 1.1 | 0.7 | 0.6 | 0.9 | 1.1 |
| Net FDI (% of GDP) | 2.5 | 1.5 | 1.5 | 2.0 | 2.4 |
| Gross foreign debt (EUR bn) | 45.3 | 45.9 | 46.1 | 47.6 | 49.5 |
| Gross foreign debt (% of GDP) | 103.0 | 105.3 | 107.4 | 110.4 | 111.8 |
| FX reserves (EUR bn) | 11.2 | 12.9 | 13.3 | 14.0 | 14.8 |
| **Inflation/Monetary/FX** | | | | | |
| CPI (pavg) | 3.4 | 2.2 | 0 | 0.7 | 1.5 |
| CPI (eop) | 4.7 | 0.3 | 0.7 | 0.5 | 2.0 |
| 1W money market rate | 1,4 | 0,7 | 0,6 | 0,7 | 0,9 |
| USD/HRK (eop) | 5,73 | 5,55 | 6,29 | 6,65 | 6,44 |
| EUR/HRK (eop) | 7,55 | 7,64 | 7,67 | 7,65 | 7,60 |
| USD/HRK (pavg) | 5,85 | 5,71 | 5,73 | 6,42 | 6,56 |
| EUR/HRK (pavg) | 7,52 | 7,57 | 7,63 | 7,64 | 7,61 |

Source: UniCredit Research

*Long-term foreign currency credit rating provided by Moody's, S&P and Fitch, respectively

## Lack of domestic impetus to recovery

**GDP decline expected to extend to 2015 in the absence of sustainable growth drivers**

**GDP to decline further in 2015.** Without hard solid evidence of public investment growth, while private investments remain on hold, we see a mild GDP contraction during 2015 of -0.2% as our baseline scenario. Investment environment is not improving with indications of changes in the tax environment. As the government enters the last year of its mandate, uncertainty is still high: there is no clear reform agenda, nor a plan for fiscal adjustment, both leading to an unstable tax and regulatory environment. A slower GDP decline in 3Q14 due to a big contribution of exports of both goods and services made us revise the projection for FY 2014 to -0.7% yoy. Slow but steady growth in tourism, with its main contribution to GDP in 3Q when the majority of tourist arrivals and stays (roughly ⅔) are recorded, was accompanied by still solid merchandise export growth. Industrial production rose mildly, but together with October data points to a break of a five-year long decline in this sector, with a strong contribution of manufacturing. Retail sales improved with the tourism season, but still indicating stagnation on an annual basis. Data releases reveal that investments declined notably, while construction is plunging. Personal consumption remains weak, with households focused on deleveraging, while public consumption has to remain restrained with the government finances operating under the constraints set by the excessive deficit procedure.

**Domestic investment environment still affected by uncertainty created by changes in tax and regulatory environment**

**Budget supplement acknowledged underperformance in revenues in 2014…**

**Fiscal outlook:** Since mid-October, the authorities proposed a budget amendment for 2014 and a budget draft for 2015. The former acknowledged the fiscal gaps during 2014. It resulted in a widening of the projected general government deficit on a cash basis to 5.0% of GDP (0.5pp off the target for 2014) or 5.9% of GDP on ESA2010 methodology. This is significantly larger than the EDP requirements (4.6% under ESA95) and could trigger penalties from the European Commission.

**… while the 2015 budget plan acknowledges a breach of the EDP target…**

The 2015 budget draft targets a deficit of 3.8% of GDP, larger than the EDP target of 3.5%. However, we identify some risks to it. On the revenues side, projecting real GDP growth of 0.5% yoy (nominal 1.9% yoy) seems to be exaggerated, in contrast to our growth view and the historic performance. The budget proposal contains a few measures that can create an additional shortage in revenues with doubtful mitigation measures. Namely, it will introduce changes in personal income tax, lowering the drag on income, and measures to ease the pressure on small entrepreneurs by relaxing VAT collection. Both measures are business friendly, but they will impact revenues. On the expenditure side, it looks like wage bill plans (but without public administration reform behind them), interest expenditures and pension disbursement are underestimated. We roughly estimate the combined effect in an additional gap of 0.8% of GDP. In addition, the second phase of pillar II to pillar I pension transfers of HRK 2.2bn (0.7% of GDP) will not be eligible for ESA2010 calculation.

The 2015 budget draft fell short of delivering expected policy guidelines ahead of new parliamentary elections. These were not clearly stated. In search for more transparency in budgetary operations, previously non-displayed revenues and expenditures of some users are now included in the budget. Moreover, Croatian Health Insurance Fund, an important segment, is presented separately, but with some of its items still recognized in the budget. However, historic data were not revealed to allow an appropriate analysis.

**… at a time when public debt exceeded 80% of GDP…**

Public debt breached the 80% of GDP threshold in 2014 due to a wider deficit and the inclusion of motorway operators' debt. The government will repay a EUR 750mn external bond in January and is expected to tap international markets later in 1Q15 with bond issuance of up to EUR 1.75bn, a figure penciled in the government financing plan for FY15. The government's current cash position allows such an approach. Most of the sizeable remaining redemptions and funding requirements throughout 2015 are linked to the domestic market.

**… weighing on rating assessments and requiring more reforms**

**Credit rating outlook:** Lack of reforms and sustainability of public debt will weigh on the credit rating outlook and country risk premium in the medium term. Thus, stronger cooperation with the European Commission within the EDP mechanism seems more necessary than before, with potential potentially of an IMF agreement gradually easing.

# Czech Republic (A1 stable/ AA- stable/A+ stable)*

**Outlook** – Cyclical factors are helping the Czech economy to overcome external weakness. Solid domestic consumer and investment appetite together with moderate fiscal easing should suffice in 2015 for a pace of GDP growth comparable with 2014. Monetary conditions are seen staying neutral.

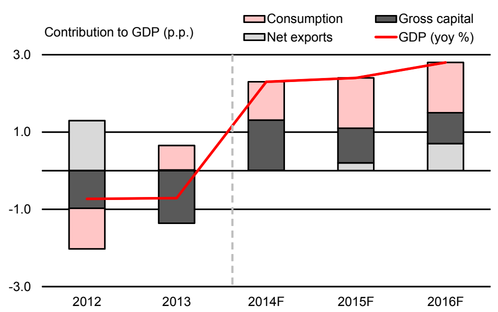
**Strategy outlook** – CZGB yields are seen tracing those of German Bunds at their depressed levels. Coupled with the CNB's policy that will fight any meaningful CZK appreciation, this leaves limited opportunities for multi-currency investors.

**Authors: Pavel Sobisek, Chief Economist (UniCredit Bank)**
**Patrik Rozumbersky, Economist (UniCredit bank)**

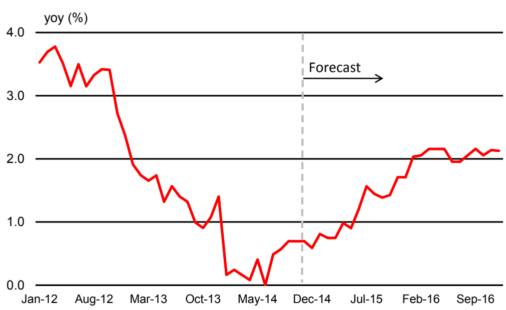
### KEY DATES/EVENTS

- CNB policy meetings – 17 Dec
- Manufacturing PMI – 2 Jan, 2 Feb, 2 Mar
- Flash 4Q GDP – 13 Feb

### GDP IN 2015: PRIVATE CONSUMPTION TO ACCELERATE, NET EXPORTS TO IMPROVE




### CPI WILL TAKE LONGER TO GET TO CNB GOAL




Source: CZSO, Unicredit Research

### MACROECONOMIC DATA AND FORECASTS

| | 2012 | 2013 | 2014F | 2015F | 2016F |
|---|---|---|---|---|---|
| GDP (EUR bn) | 161.0 | 157.3 | 155.6 | 162.6 | 172.7 |
| Population (mn) | 10.5 | 10.5 | 10.5 | 10.5 | 10.5 |
| GDP per capita (EUR) | 15,321 | 14,968 | 14,790 | 15,453 | 16,407 |
| **Real economy yoy (%)** | | | | | |
| GDP | -0.7 | -0.7 | 2.3 | 2.4 | 2.8 |
| Private Consumption | -1.7 | 0.4 | 1.5 | 2.3 | 2.3 |
| Fixed Investment | -2.8 | -4.4 | 3.6 | 4.0 | 3.5 |
| Public Consumption | -1.0 | 2.3 | 1.3 | 1.0 | 1.0 |
| Exports | 4.3 | 0.3 | 7.4 | 4.2 | 7.0 |
| Imports | 2.6 | 0.3 | 8.3 | 4.3 | 6.7 |
| Monthly wage, nominal (EUR) | 997 | 966 | 935 | 967 | 1,017 |
| Unemployment rate (%) | 6.8 | 7.7 | 7.7 | 7.0 | 6.5 |
| **Fiscal accounts (% of GDP)** | | | | | |
| Budget balance | -4.0 | -1.3 | -1.7 | -2.5 | -2.5 |
| Primary balance | -2.5 | 0 | -0.4 | -1.2 | -1.2 |
| Public debt | 45.5 | 45.7 | 43.8 | 44.4 | 44.9 |
| **External accounts** | | | | | |
| Current account balance (EUR bn) | -2.5 | -2.2 | -0.9 | -0.8 | -0.9 |
| Current account balance/GDP (%) | -1.6 | -1.4 | -0.6 | -0.5 | -0.5 |
| Basic balance/GDP (%) | 1.4 | -0.6 | 2.9 | 2.9 | 2.9 |
| Net FDI (EUR bn) | 4.8 | 1.3 | 5.4 | 5.4 | 5.9 |
| Net FDI (% of GDP) | 3.0 | 0.8 | 3.5 | 3.3 | 3.4 |
| Gross foreign debt (EUR bn) | 96.8 | 98.8 | 106.5 | 116.4 | 130.2 |
| Gross foreign debt (% of GDP) | 60.1 | 62.8 | 68.4 | 71.6 | 75.4 |
| FX reserves (EUR bn) | 34.0 | 40.8 | 44.0 | 44.2 | 44.5 |
| **Inflation/Monetary/FX** | | | | | |
| CPI (pavg) | 3.3 | 1.4 | 0.4 | 1.2 | 2.1 |
| CPI (eop) | 2.4 | 1.4 | 0.6 | 1.7 | 2.1 |
| Central bank target | 2.0 | 2.0 | 2.0 | 2.0 | 2.0 |
| Central bank reference rate (eop) | 0.05 | 0.05 | 0.05 | 0.05 | 0.25 |
| 3M money market rate | 1.00 | 0.46 | 0.35 | 0.34 | 0.40 |
| USD/CZK (eop) | 19.06 | 19.89 | 22.70 | 23.90 | 22.50 |
| EUR/CZK (eop) | 25.14 | 27.43 | 27.70 | 27.50 | 26.50 |
| USD/CZK (pavg) | 19.58 | 19.57 | 20.70 | 23.40 | 23.40 |
| EUR/CZK (pavg) | 25.14 | 25.97 | 27.56 | 27.60 | 27.20 |

Source: UniCredit Research

*Long-term foreign currency credit rating provided by Moody's, S&P and Fitch, respectively

## Relying on cyclical factors

**Solid domestic consumer and investment appetite will bolster the economy in 2015**

**Cyclical factors are helping the Czech economy to overcome external weakness and keep the real convergence process on track.** Unless the external outlook deteriorates beyond what is currently perceived, solid domestic consumer and investment appetite together with moderate fiscal easing should suffice in 2015 for a pace of GDP growth comparable with 2014. That said, we also count on increasing support from external demand from 2H15 onwards.

**3Q GDP growth was driven largely by domestic demand**

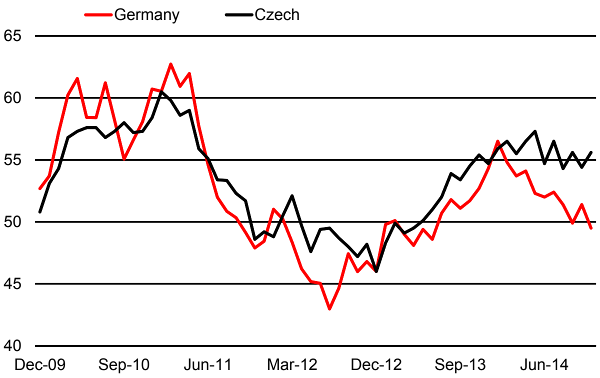
**Neither pace nor structure of GDP growth changed meaningfully in 3Q14.** Rising in all its components, domestic demand added to GDP growth yoy 2.6 p.p. while net exports subtracted 0.2 p.p. Real exports moderated to 6.1% yoy, which was nevertheless still well above global trade expansion of an annual 3%. Also encouragingly, foreign demand currently fares much better in nominal terms than real data would suggest. This can be deduced from terms of trade improvements in 3Q14, driven largely by better price competitiveness in car manufacturing. From 4Q14 onwards, the terms of trade will be additionally helped by declining oil prices. We hence predict nominal GDP to expand a solid 5% for full-2014. The same factor is set to keep adding to nominal GDP growth also in early 2015.

**Short-term signals from industry as well as construction are positive**

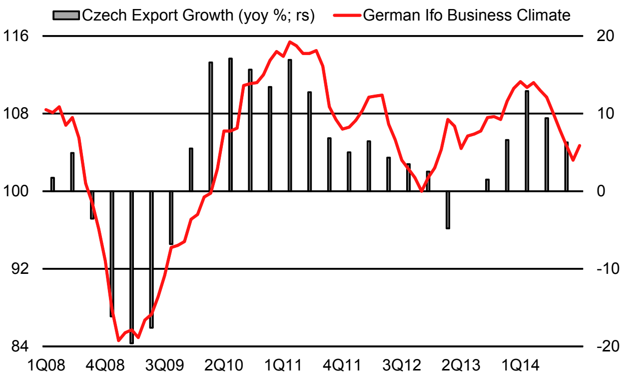
**Despite a weaker external environment, short-term indicators in the economy do not imply much upcoming stress. In industry,** 3Q14 output growth at 4.0% yoy was moderately weaker than in 2Q but well above that in the eurozone. Importantly, new orders managed to keep the double-digit growth rate, in a large part driven domestically. Coupled with November's manufacturing PMI at 55.6, this suggests that the positive momentum in industry should continue into early 2015 . Looking further into 2015, much will depend on the sustainability of the current boom in the automotive sector. There, we have less doubt about the supply side which will continue to benefit from the ongoing investments of all major producers. As to the demand side, we find the situation more uncertain. What may nevertheless help (and not only the car sector) would be a pick-up of the eurozone's GDP growth, penciled in for 2H15. Also promising for industrial output as well as entire GDP is the recovery of the domestic construction sector, the signs of which have been in place for some time but which we expect to become broader-based in 2015. In addition, an increased number of FDI projects are set to boost production capacity in industry.

**INDUSTRIAL OUTPUT AND EXPORTS REMAIN RESILIENT AMID MIXED SIGNALS**

Manufacturing PMIs foresees stable growth for Czech industry; widening gap versus German PMI sounds warning about medium term




If the latest upturn in German Ifo business confidence is confirmed, Czech export growth should bottom out in 4Q14




Sources: CZSO, UniCredit Research

**Private consumption may benefit in 2015 from higher wage growth and lower unemployment rate**

**The outlook for private consumption remains positive**. Consumer confidence in November hit a seven-year high, with households showing less concerns than before about unemployment and price rises. As to the former, the downward trend has still been moderate but probably has further to go as vacancies hit a six-year high. Nominal wage growth is expected to pick up in 2015, reflecting a more generous approach in the public sector and firmer fundamentals of many private entities.

**Lower fuel prices are set to delay the envisaged pick-up of inflation until mid-2015**

**Average inflation is projected to rise slightly in 2015**, but the pace of reflation will be slow due to falling oil prices. Already now, inflation growth seems to have come to a standstill, with the annual CPI growth stagnating at 0.7% yoy in October. The effect of CZK depreciation has petered out, while demand pressure on inflation remain subdued. Therefore, in the next couple of months, inflation will likely continue to lack momentum. The impact of a sharp decline in global oil prices on local fuel prices has largely been tamed by a surge of distributors' margins so far. Hence, with the expected normalization of the margins and taking into account the our oil price scenario, fuel prices themselves could subtract as much as 0.2 p.p. from inflation in the next months. Combined with the impact of the abolishment of healthcare fees, this should offset the low base from early 2014[21], keeping headline inflation below 1% yoy at least until 2Q15. A gradual acceleration of inflation from mid-2015 on is likely to reflect reviving domestic and external price pressures, including, perhaps, a recovery of oil prices.

**Moderate fiscal easing will materialize in 2015**

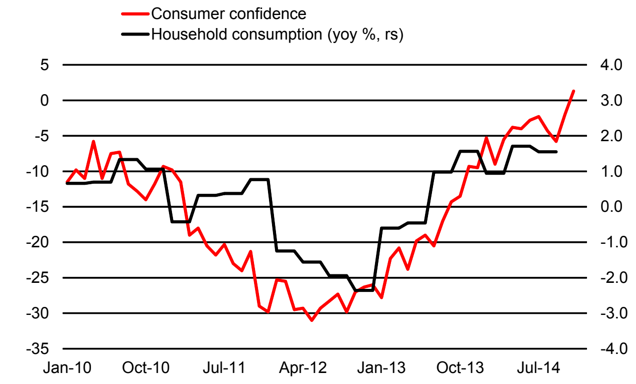
**Fiscal policy could ease moderately in 2015** after being broadly neutral in 2013 and 2014. We assume a deficit widening towards CZK 100bn in 2015 amid higher public expenditure that will include social transfers but also infrastructure investments. Unlike in previous years when funds were allocated but not fully drawn down, we expect that funds allocated for that purpose will be spent in 2015.

**Monetary conditions are set to stay neutral, policy fine-tuning will be achieved via the timing of the exit from FX interventions**

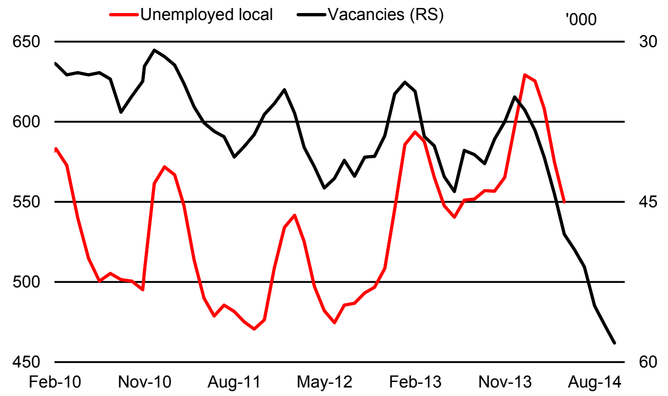
**The CNB has aligned its previous above-consensus GDP and CPI forecasts with the prevailing view on the market.** While both revisions suggest the need for easier monetary policy, the actual EUR/CZK rate at 27.6, above the 27.0 intervention trigger level, acts in the opposite way. The shift of the FX trigger level upwards apparently remains in the CNB's arsenal in the case of a sharp deterioration of economic prospects. This is, however, not part of our or consensus scenarios.

**PRIVATE CONSUMPTION WILL BENEFIT FROM SENTIMENT AND LABOR MARKET TRENDS AMID GROWING WAGES**

A seven-year high in consumer confidence bodes well for private spending




The number of jobless still remains elevated but the surge of vacancies points to a structural change on the labor market




Source: CZSO, UniCredit Research

[21] Base effects refer mainly to a steep fall in electricity prices.at the beginning of 2014. In 2015, the base effect will be offset by oil prices.

With interest rates set to remain at the current zero level until an exit from the intervention policy will have been accomplished in 2016, monetary conditions are most likely to stay neutral over the whole of 2015. The policy fine-tuning may nevertheless be implemented via communication about an appropriate FX intervention exit date in 2016. Given that we expect the date at around mid-2016, clear signals are unlikely to appear before end of 2015.

**Mid-cycle growth in 2016 could trigger more inflationary)**

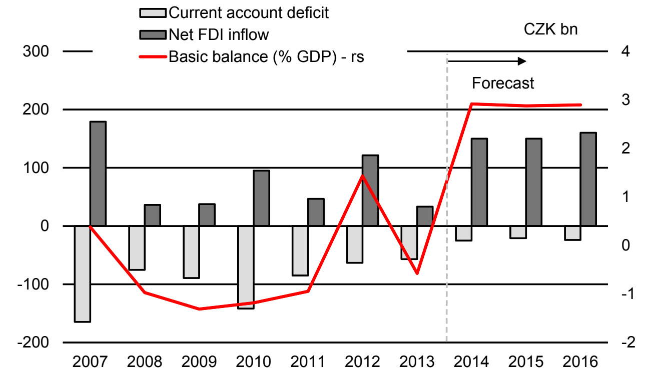
**For 2016, we assume that the economy will enter a later stage of the economic cycle**. The external environment is expected to improve slightly, with Czech real convergence to European standards continuing. Inflationary pressures could rise moderately, triggering a tightening of monetary conditions, while fiscal policy may swing from accommodating to neutral. The upbeat picture may obviously be marred by tail risks of various origins; we are nevertheless in general more worried about risks coming from abroad than domestic ones.

## Strategy: limited opportunities for multi-currency investors

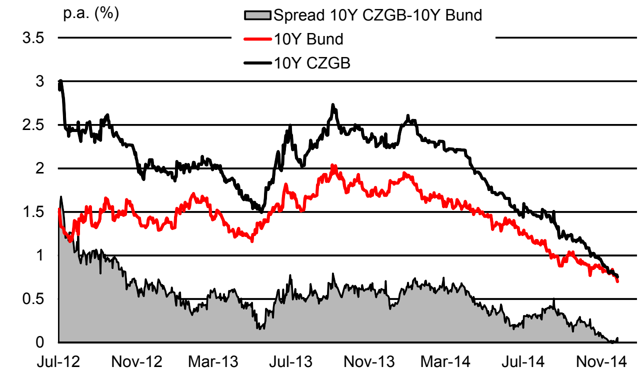
**Borrowing needs of the state may moderately rise in 2015 against the backdrop of a higher deficit**

We expect borrowing needs to increase somewhat in 2015 from 2014 for two reasons. The first is the envisaged rise of the central government deficit by CZK 20bn. The second is that the cash reserves cannot be used to reduce issuance in 2015, as it was the case in 2013 and 2014. That said, we see no strong reasons for a correction in government bond yields. Instead, yields will only trace those of German Bunds at their depressed levels. Coupled with the CNB's policy that will fight any meaningful CZK appreciation, this leaves limited opportunities for multi-currency investors.

A longer-term basic balance improvement owes to higher FDI and lower C/A deficits




Limited issuance of CZGB has contributed not only to all-time low yields but to entire closing of the 10Y spread with German Bunds.




### GOVERNMENT GROSS FINANCING REQUIREMENTS

| EUR bn | 2013 | 2014F | 2015F |
|---|---|---|---|
| **Gross financing requirement** | **15.0** | **10.8** | **13.4** |
| Budget deficit | 3.1 | 3.1 | 3.6 |
| Amortisation of public debt | 11.8 | 7.7 | 9.8 |
| Bonds | 4.5 | 3.2 | 5.3 |
| EIB loans | 0.1 | 0.1 | 0.1 |
| Bills | 7.3 | 4.4 | 4.4 |
| **Financing** | **15.0** | **10.8** | **13.4** |
| Domestic borrowing | 11.7 | 10.8 | 11.4 |
| Bonds | 7.1 | 6.4 | 7.1 |
| Bills | 4.6 | 4.4 | 4.4 |
| External borrowing | 0.2 | 0 | 2.0 |
| Bonds | 0 | 0 | 2.0 |
| EIB/IMF | 0.2 | 0 | 0 |
| Change in cash reserve | 3.1 | -2.8 | 0 |

### GROSS EXTERNAL FINANCING REQUIREMENTS

| EUR bn | 2014F | 2015F | 2016F |
|---|---|---|---|
| **Gross financing requirement** | **48.7** | **48.1** | **51.0** |
| C/A deficit | 0.9 | 0.8 | 0.9 |
| Amortisation of MT-LT debt | 7.0 | 6.3 | 9.1 |
| Banks | 0.8 | 0.5 | 1.0 |
| Government and central bank | 1.6 | 1.3 | 2.8 |
| Other sectors | 4.6 | 4.6 | 5.4 |
| Amortisation of ST debt | 40.7 | 41.0 | 41.0 |
| **Financing** | **48.7** | **48.1** | **51.0** |
| FDI | 5.4 | 5.4 | 5.9 |
| Borrowing | 41.8 | 40.9 | 43.1 |
| Banks | 18.9 | 19.5 | 19.5 |
| Government and central bank | 2.5 | 2.3 | 3.8 |
| Multinational institutions | 20.4 | 19.1 | 19.8 |
| Companies | 1.5 | 1.8 | 2.1 |
| EU transfers and other | 8.8 | 6.1 | 5.5 |

Sources: CZSO, MoF, UniCredit Research

# Hungary (Ba1 stable/BB stable/BB+ stable)*

**Outlook** – Growth is expected to slow to 2.3% yoy in 2015, with a slight pick-up to 2.5% yoy in 2016. Fixed investment could decelerate, crowded out by government purchases of private companies in banking, energy and utilities. Improving external debt metrics and a large basic balance surplus will support Hungarian asset prices and could set the stage for a return to investment grade. Authorities could retain their preference for a weaker HUF.

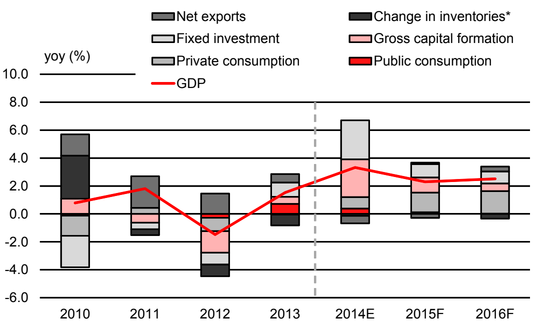
**Strategy** – We recommend being market-weight in HGBs, preferring the belly. Lower financing needs, dovish NBH and ECB will help bonds in 2015, with higher inflation and currency depreciation the largest risks for local bonds. We prefer USD REPHUNs due to better valuation and to their better resilience to potential increases in UST yields.

**Author: Dan Bucşa, Economist (UniCredit Bank London)**

**KEY DATES/EVENTS**

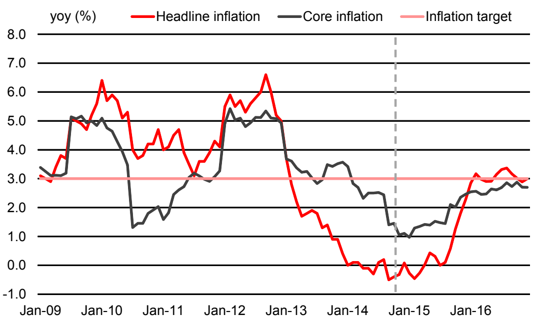
- 13 Feb: 4Q14 GDP (flash estimate)
- 16 Dec, 27 Jan, 24 Feb, 24 Mar: NBH rate meetings
- 1Q: FX mortgage loan conversion into HUF

**GDP DRIVERS**




* adjusted for statistical error

**HEADLINE INFLATION VS. TARGET**




Source: CSO, NBH, UniCredit Research

**MACROECONOMIC DATA AND FORECASTS**

| | 2012 | 2013 | 2014F | 2015F | 2016F |
|---|---|---|---|---|---|
| GDP (EUR bn) | 97.6 | 100.5 | 103.1 | 105.7 | 109.9 |
| Population (mn) | 9.9 | 9.9 | 9.9 | 9.8 | 9.8 |
| GDP per capita (EUR) | 9,832 | 10,141 | 10,437 | 10,728 | 11,190 |
| **Real economy yoy (%)** | | | | | |
| GDP | -1.7 | 1.5 | 3.3 | 2.3 | 2.5 |
| Private Consumption | -1.9 | -0.1 | 1.7 | 2.9 | 3.3 |
| Fixed Investment | -3.8 | 5.2 | 13.6 | 4.2 | 3.7 |
| Public Consumption | 0.0 | 3.3 | 1.7 | 0.6 | 0.1 |
| Exports | 2.0 | 5.9 | 7.8 | 5.8 | 6.3 |
| Imports | 0.1 | 5.9 | 9.3 | 6.7 | 6.6 |
| Monthly wage, nominal (EUR) | 771 | 776 | 767 | 773 | 777 |
| Unemployment rate (%) | 10.9 | 9.7 | 7.9 | 7.7 | 7.7 |
| **Fiscal accounts (% of GDP)** | | | | | |
| Budget balance | -1.9 | -2.2 | -2.9 | -2.9 | -2.9 |
| Primary balance | 1.8 | 1.3 | 0.0 | 0.2 | 0.2 |
| Public debt | 79.9 | 77.3 | 76.3 | 77.7 | 78.5 |
| **External accounts** | | | | | |
| Current account balance (EUR bn) | 0.8 | 3.0 | 3.1 | 2.4 | 2.4 |
| Current account balance/GDP (%) | 0.8 | 3.0 | 3.0 | 2.3 | 2.1 |
| Basic balance/GDP (%) | 2.4 | 3.4 | 2.1 | 1.9 | 3.0 |
| Net FDI (EUR bn) | 0.0 | 0.4 | -0.9 | -0.4 | 0.9 |
| Net FDI (% of GDP) | 1.5 | 0.4 | -0.9 | -0.4 | 0.8 |
| Gross foreign debt (EUR bn) | 124.8 | 117.9 | 116.1 | 109.9 | 108.4 |
| Gross foreign debt (% of GDP) | 127.9 | 117.3 | 112.6 | 104.0 | 98.7 |
| FX reserves (EUR bn) | 33.9 | 34.4 | 35.2 | 30.9 | 31.8 |
| **Inflation/Monetary/FX** | | | | | |
| CPI (pavg) | 5.7 | 1.6 | 0.0 | 0.4 | 3.0 |
| CPI (eop) | 5.0 | 0.4 | 0.1 | 2.3 | 3.0 |
| Central bank target | 3.0 | 3.0 | 3.0 | 3.0 | 3.0 |
| Central bank reference rate (eop) | 5.75 | 3.00 | 2.10 | 2.10 | 2.10 |
| 3M money market rate (avg) | 6.99 | 4.31 | 2.41 | 2.20 | 2.34 |
| HUF/USD (eop) | 220.93 | 215.67 | 252.46 | 273.91 | 271.19 |
| HUF/EUR (eop) | 291.29 | 296.91 | 308.00 | 315.00 | 320.00 |
| HUF/USD (pavg) | 225.10 | 223.70 | 232.44 | 264.99 | 273.80 |
| HUF/EUR (pavg) | 289.34 | 297.01 | 308.52 | 312.88 | 318.17 |

Source: Unicredit Research

* Long-term foreign currency credit rating provided by Moody's, S&P and Fitch respectively

## Putting the break on growth

**Growth is set to slow down to % yoy in 2015…**

2015 should be the year when Hungary capitalises on macroeconomic improvements and sets the stage for a return to investment grade. However, the 2014 economic rebound is not sustainable and we expect growth to slow to 2.3% yoy in 2015 from 3.3% yoy in 2014, rebounding to 2.5% yoy in 2016. The main reasons are sluggish demand from Europe and moderate domestic demand growth amid poor lending and government interventionism.

**…amid subdued demand from the eurozone…**

Subdued demand growth in the eurozone and in emerging markets could slow export growth to 5.8% yoy in 2015 and 6.3% yoy in 2016 from 7.8% yoy in 2014. Hungary's dependence on European demand increased in 9M14, 80% of exports being shipped to the EU. Cars, machinery and other manufacturing goods registered the largest increases. Without additional production capacities in the pipeline, exports will probably slow from here, while imports could pick up amid stronger demand. Even so, the trade surplus could remain above 6% of GDP.

**…weak lending…**

While new HUF lending will rebound further, the overall loan volume will decline as existing FX borrowers continue to delever. Faster retail credit growth is unlikely after the conversion of FX mortgage and mortgage-backed loans into HUF, an opinion echoed recently by central bank officials. Even after accounting for bank repayments for "unfair" loan provisions, CHF borrowers who took out a loan between 2000 and 2008 face negative equity of approximately 7% of the loan value (assuming an initial downpayment of 20%). The gap closes for EUR loans, but the volume is almost seven times smaller than for CHF mortgage loans. Meanwhile, corporate lending has limited appeal despite cheaper funding. This is evident in the net take-up of the funding for growth scheme, which shrank to HUF 151.8bn (0.5% of GDP) in 10M14 from HUF 657bn (2.2% of GDP) in 2013.

**…and less public investment…**

In 2015 and 2016, fiscal policies will be less growth-conducive amid budget deficits capped at 3% of GDP. Government expenditure could shift to a larger extent from fixed investment, the main growth driver in 2014, to purchasing private companies. The targeted sectors are banking, utility, energy, and, more recently, retail[22]. Adding the ongoing focus on public employment schemes, the fiscal space left for public investment is limited.

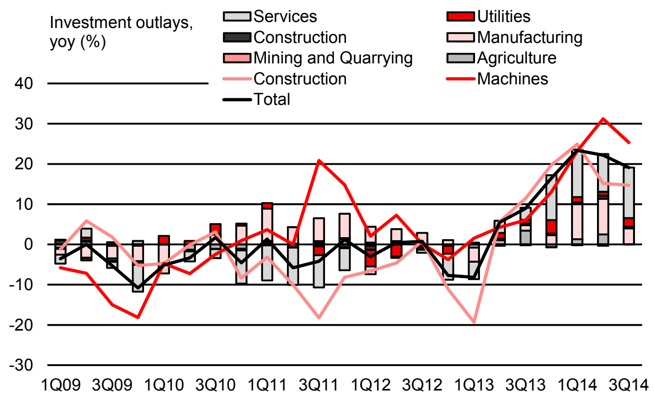
**…but more private company purchases**

**Private investment in need for other drivers than FGS and EU funds**

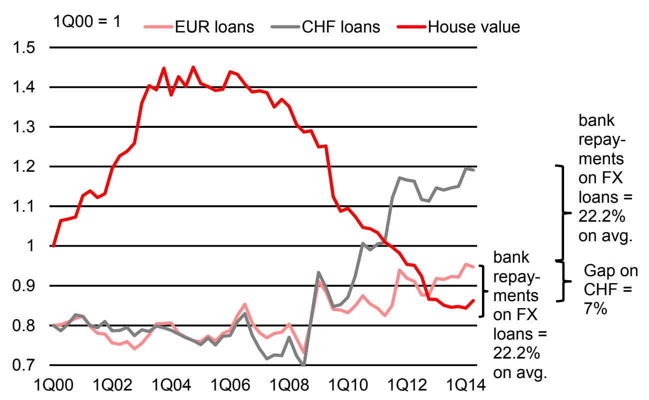
Meanwhile, private investment will need another driver like the FGS to maintain the current growth rate. In 2013 and 2014, annual EU fund inflows in excess of 3% of GDP offset scarce FDI, but they could fall in 2015, before projects financed under the 2014-20 programming period gain traction. As a result, the growth of fixed investment could slow to 4.2% yoy in 2015 and 3.7% yoy in 2016 from 13.6% yoy in 2014.

**DOMESTIC DEMAND EXPECTED TO SLOW FROM HERE**

Investment growth will slow down faster after peaking in 1Q14




CHF borrowers still face negative equity after the loan conversion




Source: NBH, NSO, FHB, UniCredit Research

[22] New regulation could push some retail chains out of the market by increasing taxes, limiting opening hours and setting high profitability thresholds until 2018.

**Investors likely to focus on debt correction, rather than growth…**

Investors are expected to focus on improvements in flow and stock imbalances, ignoring interventionism. Public debt will decline marginally as a percent of GDP, but external debt could fall below 110% of GDP after the loan conversion. This increases the chances of upgrades to investment grade, needed to open European markets to Hungary. Yet the country is unlikely to receive two such upgrades before 2016. Meanwhile, the threat of re-entering the excessive deficit procedure persists due to slow government deleveraging.

**…and lax liquidity conditions**

Monetary policy will remain accommodative, with the central bank likely to push for further liquidity-providing facilities along the lines of the FGS and the discount IRS to flatten the curve. We believe that further rate cuts are unwarranted at the moment for four main reasons. **1.** Inflation will probably remain negative for most of 1H15, but could rise to 2.3% yoy by the end of 2015, turning the real base rate negative. **2.** The NBH's cost with the two-week deposits will fall sharply in 2015 and will be offset by gradual HUF depreciation. This way, liquidity drainage will not have a fiscal cost. **3.** Rate cuts failed to transfer to longer-term bond yields, where foreign investors own the majority of bonds. More easing is unlikely to flatten the curve. **4.** Lending is not rebounding and the reason is demand, rather than borrowing costs.

**Further rate cuts are warranted only if the ECB does QE**

**No hikes expected before 2016**

The NBH could cut again if the ECB does QE and the additional liquidity starts putting pressure on EUR-HUF. Meanwhile, the central bank has no incentive to tighten. With expectations of ECB hikes pushed beyond 2016, rate hikes would be needed only if the potential rate normalization in the US will encumber the government's financing program. However, the central bank can manage liquidity to help the government borrow and prevent yields from rising before resorting to rate hikes. Excess liquidity will persist in the market even after the conversion of FX loans and will be replenished from net loan repayments[23].

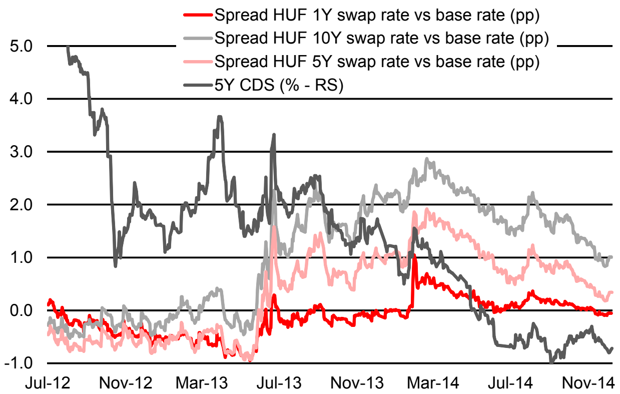
**The HUF could depreciate again, despite supportive fundamentals…**

**…but the debt to GDP ratio will remain year-end anchor**

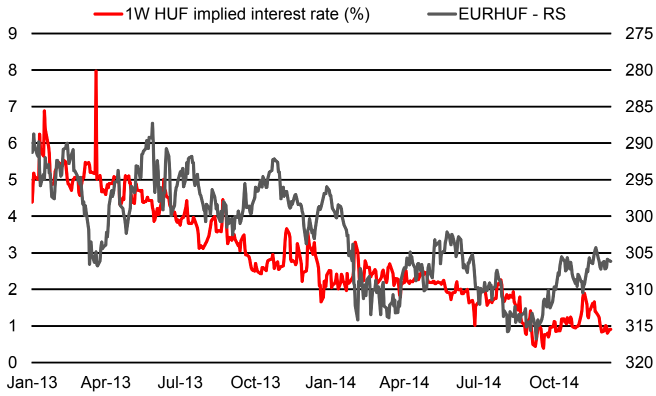
The HUF will probably weaken again in 2015, despite supportive fundamentals. The large C/A surplus and strong EU funds will remain in place, while the conversion of FX mortgage loans into HUF is expected to be currency neutral. Moreover, the currency basis could narrow due to the decline of FX assets in the banking sector, providing another boost to the HUF. Despite this, the government already hinted at currency depreciation in 2015 to mitigate the impact of rising unit labour costs on competitiveness. With negligible carry costs, the HUF could start depreciating from the beginning of 2015. Potential triggers could be new liquidity facilities that would push effective interest rates even lower. We expect EUR-HUF at 315 before the end of 1Q15. At the end of 2015, the FX rate will have to allow for a reduction of the public debt to GDP ratio. But with a shrinking FX portion of debt, the pain threshold is moving higher.

**MONETARY EASING DOES NOT REQUIRE FURTHER RATE CUTS**

Most of the spread tightening since April is due to risk appetite




Despite strong fundamentals, low rates fuel HUF depreciation




Source: National Statistics Office, AKK, NBH, Bloomberg, UniCredit Research

[23] If the loan to deposit ratio declines to 100%, this would add 1.1% of GDP to excess liquidity.

## Strategy: Marketweight on balanced risks

**Foreign holdings of HGB returned to 1Q14 levels…**

**…and the HGB rally faces headwinds.**

**Expected HUF weakness and rising inflation could put pressure on the curve…**

High real 10Y yields have supported bonds and non-resident holdings of HBGs have returned to January and June 2014 levels. Bond auctions have been well supported and since the end of 3Q14, long end bonds have tightened on average by 87bp. Despite this, we think there are some headwinds on the horizon. HUF weakness in 1Q15 will likely put upward pressure on the front end of the curve, followed by rising inflation that will seep into real yields in 2H15. More supportively, though, gross financing needs will fall to approximately EUR 14 bn in 2015 from EUR 24 bn in 2014 amid a refinancing of the IMF/EC loan through longer-term bonds and a stabilization of budget deficits. Additionally if the ECB begins sovereign QE, the NBH may be forced to ease. A flatter yield curve in the euro area could extend the HGB rally.

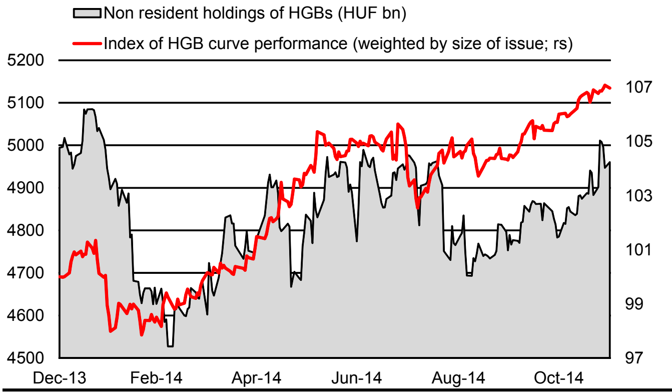
**…mitigated by lower issuance in 2015 and chance of ECB QE.**

**We recommend being market weight in HGB, preferring the belly of the curve…**

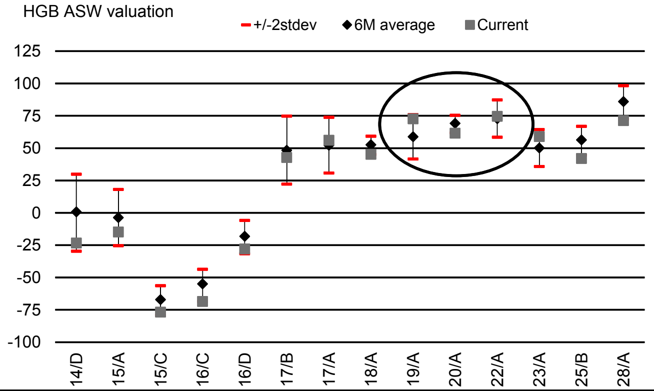
**…but we see more value and less risk in the USD hard currency bonds**

Balancing rising inflation in Hungary, a more hawkish Fed and chances of ECB QE, we recommend investors be market weight in Hungary. We favour the belly of the HGB curve, with the 20s and 22s the most attractive points on a Z-spread and asset swap spread basis. We prefer however USD REPHUNs to HGBs due to higher yields and Z-spreads. REPHUNs should be more insulated from Fed rates hikes but still benefit, albeit to a lesser degree than HGBs, from potential ECB QE. In addition, the lack of FX issuance in 2015 and the aim to reduce FX debt below 30% of total debt should provide support to hard currency bonds. We prefer the REPHUN USD 41 on the USD curve and the REPHUN EUR 20 on the EUR curve.

Bond performance is flattening with nonresident holdings falling…




..with the belly of the curve looking attractive




Source: AKK, Bloomberg, UniCredit Research

### GOVERNMENT GROSS FINANCING REQUIREMENTS

| EUR bn | 2014F | 2015F | 2016F |
|---|---|---|---|
| **Gross financing requirement** | **25.1** | **20.7** | **25.4** |
| Budget deficit | 3.0 | 3.1 | 3.2 |
| Amortization of public debt | 22.1 | 17.6 | 22.2 |
| Domestic | 10.9 | 9.5 | 11.0 |
| Bonds | 2.7 | 2.3 | 4.3 |
| Bills | 8.2 | 7.2 | 6.7 |
| Other | 6.0 | 5.8 | 5.8 |
| External | 5.2 | 2.3 | 5.4 |
| IMF/EU and other loans | 2.7 | 0.2 | 2.2 |
| Bonds | 2.5 | 2.1 | 3.2 |
| **Financing** | **25.1** | **20.7** | **25.4** |
| Domestic borrowing | 18.3 | 17.5 | 20.4 |
| Bonds | 11.0 | 10.8 | 13.3 |
| Bills | 7.2 | 6.7 | 7.1 |
| External borrowing | 4.9 | 2.5 | 5.0 |
| Bonds | 2.2 | 0 | 2.5 |
| Other | 2.7 | 2.5 | 2.5 |
| Pension funds | 2.0 | 0.7 | 0 |
| Government reserves | -2.0 | 0 | 0 |

Source: AKK, IMF, NBH, UniCredit Research

### GROSS EXTERNAL FINANCING REQUIREMENTS

| EUR bn | 2014F | 2015F | 2016F |
|---|---|---|---|
| **Gross financing requirement** | **25.1** | **19.3** | **16.6** |
| C/A deficit(+)/ surplus(-) | -3.0 | -2.3 | -2.1 |
| Amortisation of medium to long term debt | 11.4 | 6.0 | 10.7 |
| Government/central bank | 6.9 | 2.5 | 6.6 |
| Banks | 2.2 | 1.3 | 1.7 |
| Corporates | 2.4 | 2.2 | 2.4 |
| Amortisation of short term debt | 16.7 | 15.6 | 8.0 |
| Government/central bank | 4.2 | 3.4 | 2.0 |
| Banks | 7.9 | 7.5 | 1.5 |
| Corporates | 4.6 | 4.7 | 4.5 |
| **Financing** | **25.1** | **19.3** | **16.6** |
| FDI | -0.9 | -0.4 | 0.8 |
| Equity | -1.0 | -1.0 | -0.8 |
| Long-term borrowing | 8.6 | 5.5 | 8.1 |
| Government/central bank | 4.4 | 3.0 | 5.5 |
| Banks | 1.9 | 0.5 | 0.4 |
| Corporates | 2.3 | 2.0 | 2.2 |
| Short-term borrowing | 15.6 | 8.0 | 6.2 |
| Government/central bank | 3.4 | 2.0 | 1.2 |
| Banks | 7.5 | 1.5 | 0.8 |
| Corporates | 4.7 | 4.5 | 4.2 |
| EU transfers | 3.7 | 2.8 | 3.2 |
| Change in FX reserves (reduction(+)/increase(-)) | -0.9 | 4.4 | -0.9 |

# Poland (A2 stable/A- stable/A- stable)*

**Outlook** – Economic growth is expected to remain flat at 3.3% yoy in 2014 and 2015, with consumption playing a more prominent role among growth drivers and investment slowing down slightly. Inflation could rise slowly towards 1% by the end of 2015 and remain there throughout 2016. Even so, the NBP is expected to deliver just one cut due to robust domestic demand growth and very low deflation fears. The fiscal improvement should allow for a reduction in the budget deficit below 3% of GDP, despite more spending in election year 2015

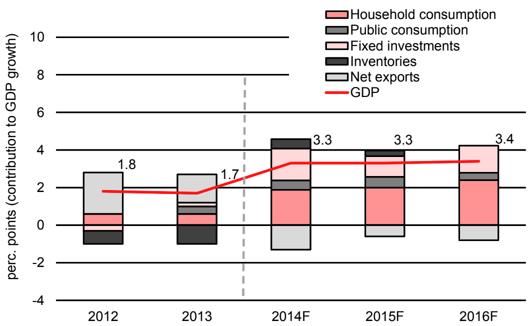
**Strategy** – POLGBs remain well supported by deflation and chance of ECB QE. However, in 2015 inflation will rebound and could push yields higher. PLN remains supported by fundamentals, but is vulnerable to risks from the Ukraine conflict and eurozone's economic performance. Modest appreciation is on the cards, assuming a stable external environment and falling EUR-USD.

**Author: Marcin Mrowiec, Chief Economist (Bank Pekao)**

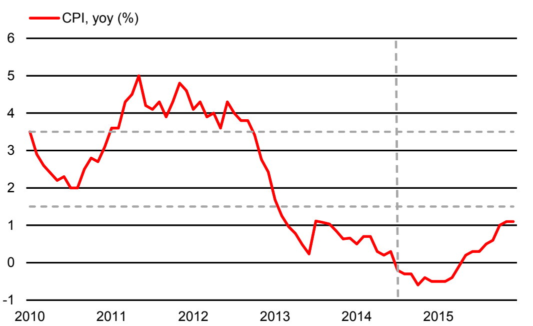
### KEY DATES/EVENTS

- MPC decision-making meetings 13-14 Jan, 4-5 Feb, 4-5 Mar
- NBP releases update to Inflation Projection: early March
- Presidential elections – May 2015

### GDP COMPONENTS




### HEADLINE INFLATION VS. TARGET




Source: StatOffice, NBP, UniCredit Research

### MACROECONOMIC DATA AND FORECASTS

| | 2012 | 2013 | 2014F | 2015F | 2016F |
|---|---|---|---|---|---|
| GDP (EUR bn) | 386.1 | 395.7 | 411.1 | 429.8 | 450.2 |
| Population (mn) | 38.1 | 38.1 | 38.0 | 38.0 | 38.0 |
| GDP per capita (EUR) | 10,143 | 10,399 | 10,809 | 11,306 | 11,851 |
| **Real economy yoy (%)** | | | | | |
| GDP | 1.8 | 1.7 | 3.3 | 3.3 | 3.4 |
| Private Consumption | 1.0 | 1.1 | 3.0 | 3.3 | 4.0 |
| Fixed Investment | -1.5 | 0.9 | 9.1 | 5.5 | 7.2 |
| Public Consumption | 0.2 | 2.1 | 2.7 | 3.2 | 2.1 |
| Exports | 4.3 | 5.0 | 4.8 | 5.4 | 6.5 |
| Imports | -0.6 | 1.8 | 7.9 | 6.9 | 8.2 |
| Monthly wage, nominal (EUR) | 891 | 911 | 952 | 1,007 | 1,053 |
| Unemployment rate (%) | 12.8 | 13.5 | 12.4 | 11.1 | 10.6 |
| **Fiscal accounts (% of GDP)** | | | | | |
| Budget balance | -3.7 | -4.0 | -3.2 | -2.7 | -2.5 |
| Primary balance | -1.1 | -1.5 | -1.1 | -0.7 | -0.4 |
| Public debt | 54.4 | 55.7 | 48.7 | 49.5 | 50.0 |
| **External accounts** | | | | | |
| Current account balance (EUR bn) | -13.7 | -5.2 | -5.6 | -7.4 | -8.8 |
| Current account balance/GDP (%) | -3.5 | -1.3 | -1.4 | -1.7 | -1.9 |
| Basic balance/GDP (%) | -2.1 | -1.3 | 1.3 | 1.1 | 0.9 |
| Net FDI (EUR bn) | 5.6 | 0.1 | 11.0 | 12.0 | 13.0 |
| Net FDI (% of GDP) | 1.4 | 0.0 | 2.7 | 2.8 | 2.9 |
| Gross foreign debt (EUR bn) | 278.0 | 277.5 | 306.1 | 293.0 | 292.4 |
| Gross foreign debt (% of GDP) | 72.0 | 70.1 | 74.4 | 68.2 | 64.9 |
| Fx reserves (EUR bn) | 82.6 | 77.1 | 91.5 | 107.7 | 115.3 |
| **Inflation/Monetary/FX** | | | | | |
| CPI (pavg) | 3.7 | 0.9 | 0.0 | 0.3 | 1.8 |
| CPI (eop) | 2.4 | 0.7 | -0.5 | 1.1 | 2.4 |
| Central bank target | 2.5±1pp | 2.5±1pp | 2.5±1pp | 2.5±1pp | 2.5±1 |
| Central bank reference rate (eop) | 4.25 | 2.50 | 2.00 | 1.75 | 2.25 |
| 3M money market rate | 4.91 | 3.02 | 2.53 | 2.10 | 2.20 |
| USD/PLN (eop) | 3.10 | 3.01 | 3.40 | 3.58 | 3.47 |
| EUR/PLN (eop) | 4.09 | 4.15 | 4.15 | 4.12 | 4.10 |
| USD/PLN (pavg) | 3.26 | 3.16 | 3.16 | 3.50 | 3.50 |
| EUR/PLN (pavg) | 4.19 | 4.20 | 4.17 | 4.10 | 4.10 |

Source: UniCredit Research

*Long-term foreign currency credit rating provided by Moody's, S&P and Fitch respectively

## Growth supported by robust domestic demand and EU funds

**GDP growth in 2015 is expected to be 3.3%, same as in 2014**

**We expect GDP to grow by 3.3% in 2015, at the same pace as in 2014**, but the composition of growth will change slightly. Private consumption is expected to accelerate to 3.3% yoy in 2015 from 3.0% yoy in 2014 amid robust growth in the real wage bill. Fixed investments surprised at around 9.1% yoy in 2014, but are expected to slow down a bit to 5.5% yoy, even though the private sector will benefit from fresh EU money. Exports could rise slightly stronger in 2015 (5.4% yoy vs. 4.8% in 2014) amid improving demand from Europe, whereas imports will slow down a bit (6.2% yoy in 2015 vs. 7.4% yoy in 2014). Net exports are expected to stay negative, albeit less so in 2015 (-0.4pp contribution) than in 2014 (-1.4pp). Even so, the external situation remains the key risk.

**Solid performance of the labor market is supportive for domestic demand**

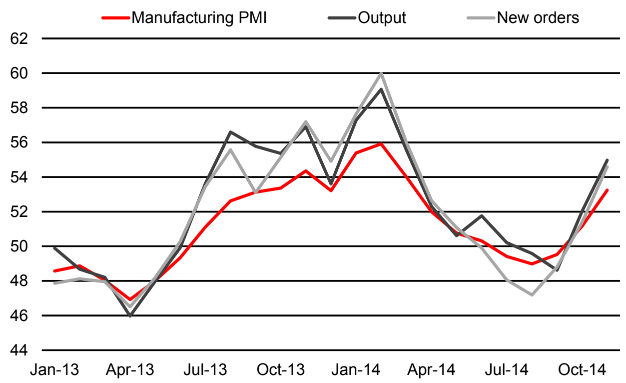
**The situation on the domestic labor market has been recovering throughout 2014, and should continue to improve in 2015**. Job creation is visible predominantly in the manufacturing sector amid considerable support from foreign demand, especially in 1H14. At the same time, growth of the average wage in the corporate sector remained stable in the range of 3.5-4.0% yoy. We expect that in 2015 employment growth will accelerate to1.2% yoy from 0.6% in 2014, with a larger impact of services and trade on job creation and no significant wage pressure (growth of the average wage at 4.0% vs. 3.8% in 2014). This will translate into a faster growth rate of the real wage bill ( 4.9% vs. 4.4% in 2014), which will be a crucial supportive factor for domestic consumption.

**CPI is to stay negative till October, then rebound to 0.4% yoy at end-December and around 1.5% yoy in mid-2015**

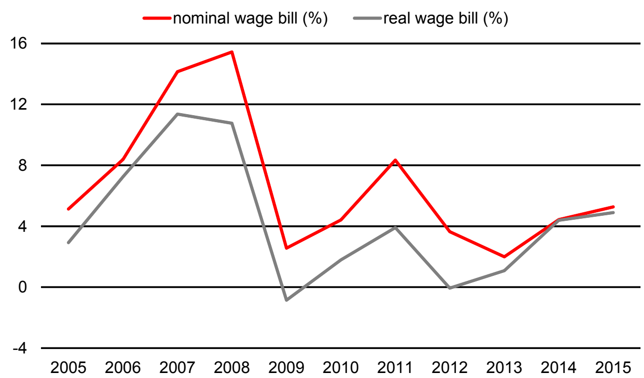
**CPI inflation could remain negative until April 2015, exceeding 1% yoy only in 4Q15 and then flattening in 2015 (year-end forecast at 1.1% yoy).** The inflationary picture remains very benign, with food, transportation, clothes and shoes and "other" being the only major price categories out of 12 with negative annual changes, mostly due to temporary supply-side shocks. Food deflation is the consequence of good harvests combined with the Russian import embargo. Transportation prices declined due to lower crude oil prices, while prices for clothes and shoes have fallen for most of the past 12 years. Going forward, the probability of a Japanese-style deflationary spiral is extremely low, especially when taking into account that both wages and employment keep growing. Net core inflation never went negative in 2014 (expected at 0.7% in December 2014) and is not expected to turn negative at any point during 2015 (year-end forecast at 1.3%).

**PMI REBOUNDED NICELY IN RECENT MONTHS, AND ROBUST WAGE BILL GROWTH WILL SUPPORT DOMESTIC DEMAND**

PMI has seen nice rebound recently




Robust wage bill growth will support domestic consumption




Source: StatOffice, UniCredit Research

**In our baseline scenario, we assume one 25bp rate cut in March 2015**

**The Monetary Policy Council may deliver one more 25bp cut in early 2015.** The comments from the MPC are very mixed. However, as negative CPI is mostly the effect of low food and energy prices, the focus of the Council is on the outlook for growth and on the risks of a deflationary spiral in the real economy. As the real wage bill is increasing at a healthy pace (almost 5% in real terms expected in 2015), the risks of deflationary "second round effects" are small. Given the high statistical base from early 2014, the risk is that the pace of economic growth may weaken in early 2015, and that's why we pencil in one more rate cut in 1Q15 (25bp) in our baseline scenario. However, if growth is robust, the Council may decide keep interest rates on hold. Even though the risk of deflation is low, the MPC faces a credibility issue due to inflation remaining below target until the forecast horizon. Combined with negative output gaps until 2016, this would suggest possibility of further monetary easing, should growth outlook surprise to the downside.

**Execution of 2014 state budget is proceeding very well, with deficit reaching only 60% of the plan in the first ten months of 2014. Poland is likely to exit EDP in 2016**

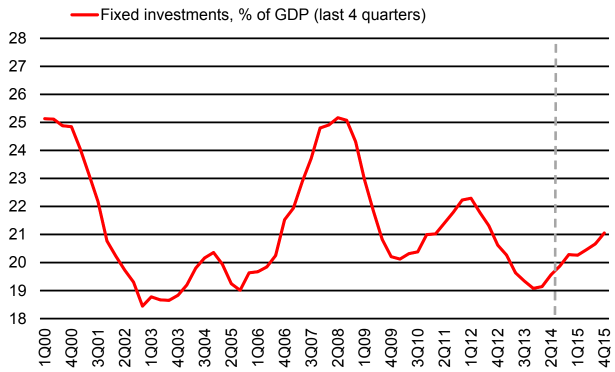
**The execution of the 2014 state budget is proceeding very well and Poland is on track to correct the excessive deficit in 2015.** In the first ten months of 2014, the deficit (cash basis) amounted to PLN 27.2bn, i.e. 57.3% of the annual target of PLN 47.5bn. In line with our expectations, budget revenues in 2014 are likely to be at least PLN 10bn higher than assumed in the budget act, mostly due to buoyant VAT collection. In 2014, the deficit may amount to PLN 30bn, i.e. well below the plan. In 2015, the government set the deficit limit at PLN 46.1bn and, given the fact that it is an election year, we expect the deficit to reach the limit or be very close to it. Net borrowing needs are expected to rise to PLN 54.0bn in 2015 from the PLN 43.bn estimated for 2014. Nevertheless, the general government deficit (ESA2010) is seen at 3.2% of GDP in 2014 and 2.7% of GDP in 2015, as the pension system overhaul reduced some "below the line" expenditures of the state budget and boosted Social Security Fund revenues. We expect Poland to exit the excessive deficit procedure in 2016.

**Poland will see both Presidential and Parliamentary elections in 2015. These could bring a reshuffle of the governing coalition, as the opposition won recent local elections**

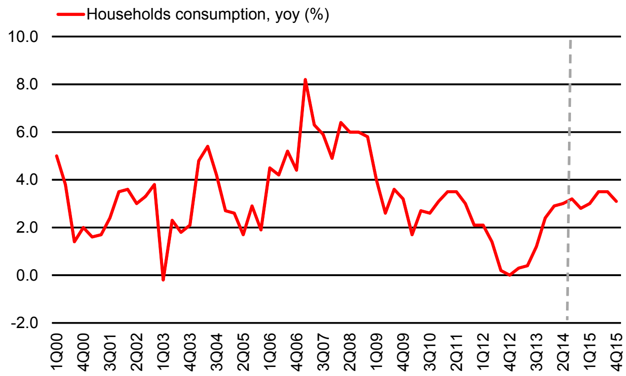
**The year 2015 will see both Parliamentary and Presidential elections in Poland**. This will be an important event, as the opposition fared very well in recent local elections, and has good chances of winning the Parliamentary elections. From an investment point of view, the political situation (and possible coalition reshuffle) will be closely watched, but should not be a problem, as both domestic as well as international investors are much more immune to political noise than they were five or ten years ago. One issue that needs to be resolved in the meantime involves the irregularities during the recent local elections – the number of invalid votes as well as the number of protests sent to the courts was also high. The courts will resolve the protests, but if they don't do it in convincing way, there could be more tension during the elections in 2015.

**DOMESTIC ECONOMY WILL BE SUPPORTED BOTH BY INCREASING FOREIGN TRADE AS WELL AS BY DOMESTIC CONSUMPTION**

Investments should continue to rise, boosted by EU funds




Consumption is also expected to improve, thanks to robust labor market




Source: StatOffice, UniCredit Research

## POLGB yields stable, further rally possible on ECB QE

**Domestic factors in favor of zloty strengthening vs. the EUR**

**Local yield curve are supported by deflation and possibility of ECB QE, …**

**…but as growth firms and CPI rebounds, we expect yields to rise in 2H15**

The zloty remains well supported by fundamentals, but on the other hand remains vulnerable to possible negative impulses both from the conflict between Russia and Ukraine and from risks to eurozone's economic performance. Assuming a stable external environment, we forecast a gradual strengthening of the zloty vs. EUR (towards 4.10 in end-2015). POLGBs are still well supported on the back of further rate cut expectations in 1Q15 and potential QE in the eurozone. While the risk of improving macro outlook and flat NBP rates may affect T-bonds, deflation and moderate debt supply following significant pre funding in 2014 should limit the negative effects. Beyond 2Q15 we think there is a risk of curve widening due to better economic performance and CPI returning closer to the target band.

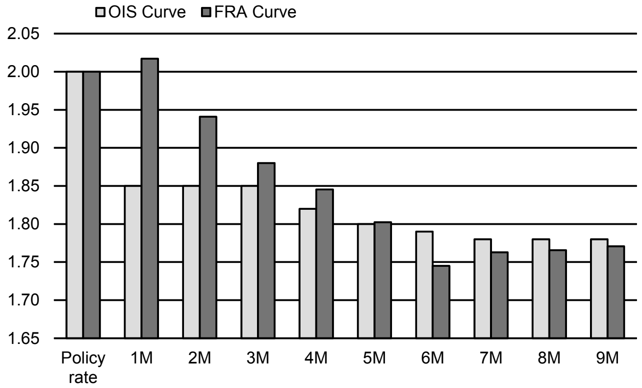
**We recommend investors be marketweight POLGBs…**

**…balancing the chance of easing and QE against growth.**

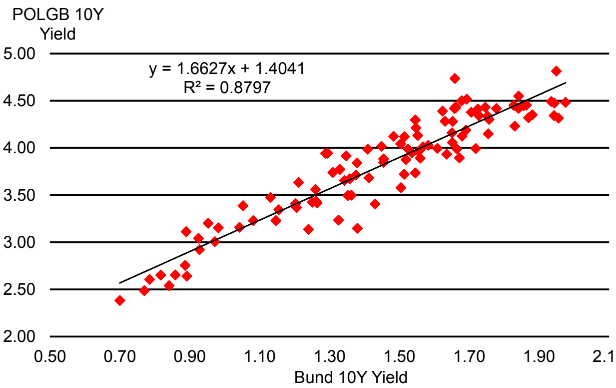
**We see value in long end POLGB but prefer the hard currency USD bonds**

We recommend that investors be market weight in POLGBs. While we may get additional support from further easing, we believe that most of the rally has finished, unless the ECB starts sovereign QE. If the ECB does QE, we expect the curve to bull flatten. The significant inflow of eurozone investors into local bonds over 3Q14 could continue if Bund yields collapse further. In this scenario the long end could test 2.00-2.20%. On the local curve we see most value in the POLGB 22s and 25s but we favour the USD hard-currency curves and think the POLAND USD 22 and USD 24 offer much better value both on a yield and a Z-spread basis.

FRAs priced in one further rate cut




Poland local 10Y yield correlation with Bund 10Y yield




Source: Finance Ministry, NBP, UniCredit Research

**GOVERNMENT GROSS FINANCING REQUIREMENTS**

| EUR bn | 2014F | 2015F | 2016F |
|---|---|---|---|
| **Gross financing requirement** | **26.6** | **33.3** | **34.7** |
| Budget deficit | 8.5 | 11.0 | 11.0 |
| Amortization of public debt | 18.1 | 22.3 | 23.8 |
| Domestic | 15.1 | 19.2 | 20.6 |
| Bonds | 15.1 | 19.2 | 20.6 |
| Bills | 0 | 0 | 0 |
| External | 3.0 | 3.1 | 3.2 |
| IMF/EU/IFIs | 0 | 0 | 0 |
| **Financing** | **26.6** | **33.3** | **34.7** |
| Domestic borrowing | 21.1 | 27.6 | 30.3 |
| Bonds | 23.7 | 28.4 | 31.6 |
| Bills | 0 | 0 | 0 |
| Other | -2.5 | -0.8 | -1.2 |
| External borrowing | 5.5 | 5.7 | 4.4 |
| Bonds | 3.4 | 4.0 | 4.4 |
| IMF/EU/WB | 0 | 0.2 | 0 |
| Other | 2.1 | 1.4 | 0 |

**GROSS EXTERNAL FINANCING REQUIREMENTS**

| EUR bn | 2014F | 2015F | 2016F |
|---|---|---|---|
| **Gross financing requirement** | **74.1** | **76.5** | **71.6** |
| C/A deficit | 5.6 | 7.4 | 9.0 |
| Amortization of medium to long term debt | 16.8 | 14.1 | 12.7 |
| Government/central bank | 3.0 | 3.1 | 3.2 |
| Banks | 6.4 | 4.1 | 3.5 |
| Corporates | 7.3 | 6.9 | 6.0 |
| Amortization of short term debt | 51.8 | 55.0 | 50.0 |
| **Financing** | **74.1** | **76.5** | **71.6** |
| FDI | 7.0 | 7.5 | 4.5 |
| Equity | 1.0 | 1.5 | 1.5 |
| Borrowing | 64.5 | 60.0 | 56.4 |
| Government/central bank | 5.5 | 5.7 | 4.4 |
| Banks | 18.8 | 19.4 | 16.0 |
| Corporates | 40.3 | 35.0 | 36.0 |
| EU transfers | 11.8 | 12.0 | 15.0 |
| Other | -10.3 | -4.5 | -5.8 |

Source: CSOP, NBP, Ministry of Finance, IMF, Unicredit Research

# Romania (Baa3 stable/BBB- stable/BBB- stable)*

**Outlook** – Growth could fall slightly to 2.5% in 2015 from 2.7% yoy in 2014 and recover to 3% yoy in 2016, with domestic demand outpacing net exports amid improving RON lending and a positive fiscal impulse. Further growth acceleration needs a reassessment of fiscal policies. We expect a completion of the final IMF stand-by agreement in autumn 2015. We expect EUR-RON to trade range-bound as FDI and EU fund inflows will probably cover the C/A deficit and bank deleveraging.

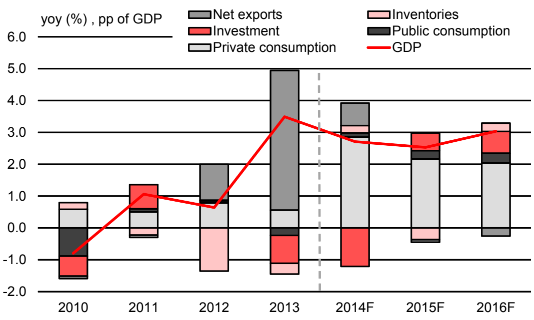
**Strategy** – We recommend keeping an overweight position in ROMGBs with further easing ahead and lower issuance in 2015 (ROMGB and ROMANI combined). We favour the long end in ROMGBs and in ROMANI USD, both outright and in relative value trades against regional peers.

**Authors: Dan Bucşa, Economist (UniCredit Bank London)**
**Cătălina Molnar, Chief Economist (UniCredit Ţiriac Bank)**

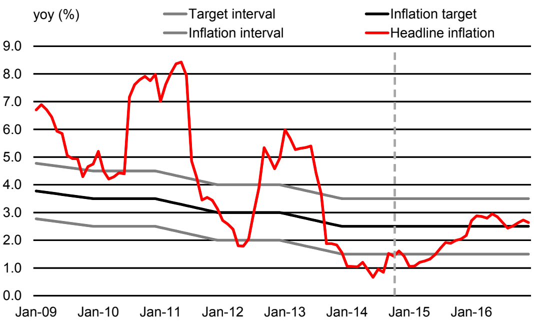
### KEY DATES/EVENTS

- 7 Jan, 4 Feb: NBR rate decisions
- Jan: IMF review under the SBA
- 13 Feb, 6 Dec: 4Q GDP (flash estimates, structure)

### GDP COMPONENTS




### INFLATION OUTLOOK




Source UniCredit Research, NBR, Statistical Office

### MACROECONOMIC DATA AND FORECASTS

| | 2012 | 2013 | 2014F | 2015F | 2016F |
|---|---|---|---|---|---|
| GDP (EUR bn) | 133.9 | 144.7 | 151.3 | 158.7 | 170.9 |
| Population (mn) | 20.1 | 20.0 | 19.9 | 19.9 | 19.8 |
| GDP per capita (EUR) | 6,663 | 7,226 | 7,585 | 7,983 | 8,619 |
| **Real economy yoy (%)** | | | | | |
| GDP | 0.6 | 3.5 | 2.7 | 2.5 | 3.0 |
| Private Consumption | 1.7 | 0.5 | 3.8 | 3.3 | 3.1 |
| Fixed Investment | 0.1 | -3.2 | -4.9 | 2.5 | 3.0 |
| Public Consumption | -5.6 | -1.2 | 5.0 | 1.8 | 2.2 |
| Exports | 1.0 | 21.4 | 6.6 | 4.5 | 5.4 |
| Imports | -1.8 | 8.5 | 4.8 | 4.6 | 5.9 |
| Monthly wage, nominal (EUR) | 479 | 507 | 529 | 548 | 574 |
| Unemployment rate (%) | 6.9 | 7.0 | 7.0 | 6.9 | 6.7 |
| **Fiscal accounts (% of GDP)** | | | | | |
| Budget balance | -2.9 | -2.3 | -1.6 | -2.1 | -1.6 |
| Primary balance | -1.1 | -0.6 | -0.1 | -0.6 | -0.2 |
| Public debt | 37.3 | 37.8 | 39.7 | 37.8 | 37.0 |
| **External accounts** | | | | | |
| Current account balance (EUR bn) | -6.1 | -1.2 | -1.5 | -1.7 | -2.5 |
| Current account balance/GDP (%) | -4.5 | -0.8 | -1.0 | -1.1 | -1.4 |
| Basic balance/GDP (%) | -6.3 | -2.8 | 0.3 | 0.2 | -0.1 |
| Net FDI (EUR bn) | -2.4 | -2.9 | 2.0 | 2.0 | 2.2 |
| Net FDI (% of GDP) | -1.8 | -2.0 | 1.3 | 1.3 | 1.3 |
| Gross foreign debt (EUR bn) | 100.9 | 98.1 | 95.3 | 92.3 | 92.2 |
| Gross foreign debt (% of GDP) | 75.3 | 67.8 | 63.0 | 58.2 | 53.9 |
| FX reserves (EUR bn) | 31.2 | 32.5 | 31.5 | 31.6 | 31.6 |
| **Inflation/Monetary/FX** | | | | | |
| CPI (pavg) | 3.3 | 4.0 | 1.2 | 1.6 | 2.7 |
| CPI (eop) | 5.0 | 1.6 | 1.4 | 2.2 | 2.6 |
| Central bank target | 3.0 | 2.5 | 2.5 | 2.5 | 2.5 |
| Central bank reference rate (eop) | 5.25 | 4.00 | 2.75 | 2.50 | 2.50 |
| 3M money market rate | 5.22 | 4.05 | 2.15 | 1.43 | 1.93 |
| USD/RON (eop) | 3.36 | 3.26 | 3.65 | 3.83 | 3.71 |
| EUR//RON (eop) | 4.43 | 4.48 | 4.45 | 4.40 | 4.38 |
| USD/RON (pavg) | 3.47 | 3.33 | 3.36 | 3.82 | 3.72 |
| EUR/RON (pavg) | 4.46 | 4.42 | 4.44 | 4.42 | 4.39 |

Source: Unicredit Research

* Long-term foreign currency credit rating provided by Moody's, S&P and Fitch respectively

## Looking for a sustainable growth story

**A volatile political landscape before 2016 elections will affect reforms.**

Romania is entering 2015 facing a potential reshuffle of the political landscape before general elections in autumn 2016. Until then, we expect little progress in reforms regardless of the outcome (if the current centre-left government remains in power or if a new centre-right-coalition will form around the supporters of newly-elected President Klaus Iohannis).

**Fiscal policies need to improve…**

**…to boost public investment…**

Ad-hoc fiscal policies remain Romania's main growth challenge. With budget deficits firmly below 3% of GDP, the quality and amount of public investment need to improve to accelerate potential growth. Public investment and co-financing for EU funded projects plummeted by more than 10% yoy in 10M14, highlighting deficiencies in public procurement procedures, pressure from the judicial system as well as the government's short term focus on social security and public consumption expenditure. The government is trying to address some of these issues, for example by drawing up a master plan for 2014-30 infrastructure projects and streamlining the public procurement system in the construction sector.

**…and help conclude the IMF agreement in autumn 2015**

Romania agreed with the IMF on a budget deficit of 1.8% of GDP in 2015 (cash), but we pencil in a shortfall of 2.1% of GDP (accruals). This sets the stage for the completion of the third stand-by agreement in autumn 2015 despite key unaddressed issues, such as reducing the losses at state-owned enterprises in transportation and improving tax collection.

**Growth expected at 2.5% yoy in 2015 and 3.0% yoy in 2016…**

**…driven by consumption…**

Growth is expected to slow to 2.5% yoy in 2015 from 2.7% yoy in 2014, despite a good carryover from 2014[24], and accelerate to 3% yoy in 2016. The main drivers will be private consumption and investment. We expect consumption to slow to 3.3% yoy in 2015 from 3.8% yoy in 2014 amid a downward convergence of wage growth to productivity dynamics.

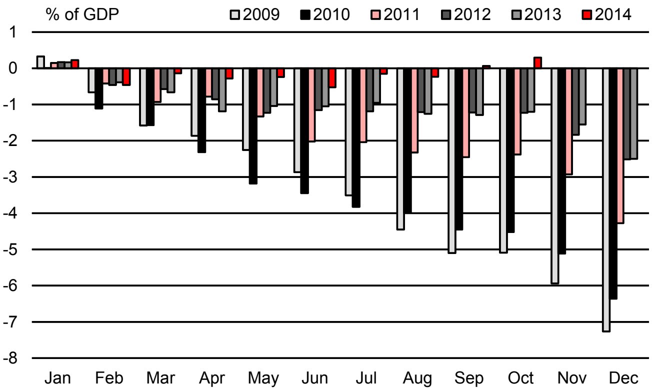
**…and a small rebound in investments…**

**…but net exports could be a drag on growth**

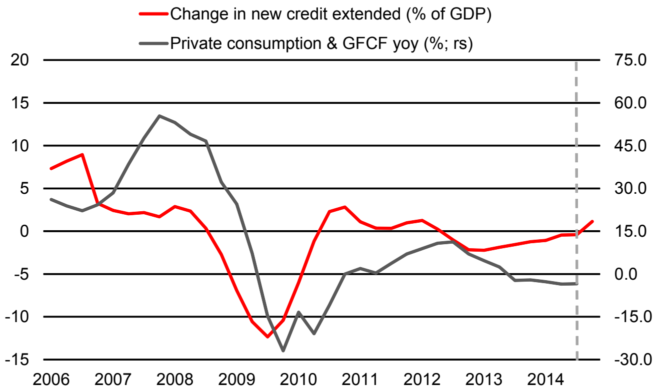
EU fund absorption and poor investment in 2014 could accelerate investment growth to 2.5% yoy in 2015. After EU fund inflows exceeded EUR 3.5bn in 2014, a larger amount could arrive in 2015, as Romania will receive the last of the EU funds from the 2007-2013 programming period. In 2016, though, EU fund inflows could fall because of poor planning for the 2014-20 programming period, rejected repeatedly by the EC. Imports will probably outpace exports, with the latter expected to decelerate to 4.5% yoy in 2015 in the absence of new big manufacturing projects. The positive base effects from increasing car production are over, while those from electronics could last for a couple of quarters.

**POSITIVE FISCAL AND CREDIT IMPULSES WILL SUPPORT DOMESTIC DEMAND IN 2015**

A positive fiscal impulse in 2015 could follow 2014's fiscal austerity




The credit impulse could turn positive as the loan decline slows




Source: Ministry of Finance, National Bank of Romania, NIS, UniCredit Research

[24] Following a move to ESA 2010 methodology, quarterly growth improved in 2Q14 and 3Q14. But a large part of the upturn is explained by statistical discrepancies.

**Inflation to remain below target for most of 2015…**

**…triggering another rate cut to 2.50% and MRR cuts**

Lower oil prices could keep headline inflation below target for most of 2015. Thus, the NBR is expected to cut once more on 7 January and stop at the target level (2.5%). Yet this does not mean an end to the easing cycle, since the NBR could reduce RON minimum reserve requirements to 6% (or below) from 10% currently. Depreciation would be a solution to ease real monetary conditions further, but the large stock of FX loans remains a concern.

**The rebound in RON lending will continue…**

**…while banks could continue cleaning up their balance sheets**

RON lending is expected to accelerate further in 2015, offsetting some of the decline in FX loans and resulting in a positive credit impulse to domestic demand. Comparable interest rates for RON and FX mortgage lending could boost the refinancing of FX debt, but past losses from collateral value and RON depreciation are slowing the process. As a result, FX loans fell to 56.8% of private sector loans in September 2014, but remain too large to allow the central bank a looser grip on the currency. Banks reduced their NPL ratio by 5pp in five months to 15.3% in September 2014 (less than 10% on EBA methodology), due to NPL write-offs (RON 5.4bn) and sales (RON 6bn). The subsequent system-wide loss in 2014 can be covered out of strong capital positions (the solvency ratio was 17.06% in September).

**Romanian bonds could remain attractive in 2015…**

**…due to low financing needs…**

**…a change in investor structure…**

**…and a large fiscal buffer**

A combination of lax monetary conditions, low financing needs and limited reliance on foreign investors makes Romanian bonds attractive in 2015. Gross financing needs will fall in 2015 to less than 9% of GDP, with net issuance of 1.5-2% of GDP covered mostly by domestic investors. A reduced dependency on foreign capital coincides with a rotation of new investors from the US to the eurozone, Asia and central banks, increasing the scope for a further bond rally, despite yields being at all-time lows. Most of new foreign investments in ROMGBs benchmark against more dovish central banks than the Fed. In case of market stress, the MinFin can tap its sizeable reserves, which cover more than four months of gross financing.

**The C/A deficit will remain low…**

**…and will be covered by FDI and EU funds…**

**…while large portfolio outflows are unlikely**

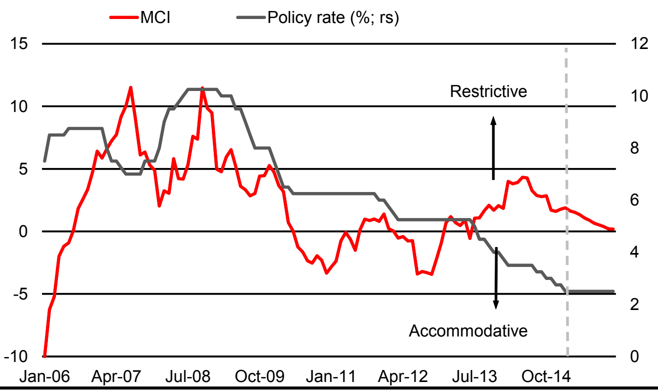
We expect the C/A deficit at 1.1% of GDP in 2015 and 1.4% of GDP in 2016 due to improving service exports and lower capital repatriation at multinational companies. While the C/A gap will be covered by FDI and EU fund inflows, banks will probably continue to bleed some EUR 1bn per year until foreign liabilities fall to regional levels as a proportion of bank financing. At the same time, the potential for more portfolio inflows remains intact: the foreign ownership of ROMGBs was below 20% in September, failing to pick up despite good risk appetite. This means that investors do not hold significant overweight positions in ROMGBs. Low spreads and a gradual exit of US investors will probably keep that proportion stable.

**We expect the RON to trade in a tight range**

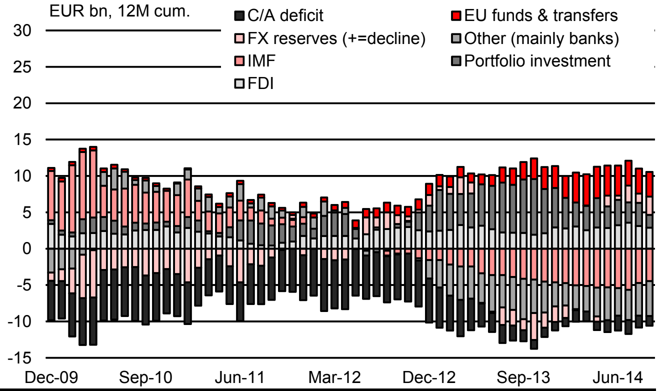
In this environment, the RON faces mild appreciation pressures, but the NBR will counter them by intervening whenever EUR-RON falls out of the 4.40-4.50 preferred range. RON appreciation could harm external competitiveness, while the negative impact on FX borrowers from potential RON depreciation would outweigh terms of trade improvements for exporters.

**MONETARY EASING CAN CONTINUE AMID BOP SUPPORT FOR THE RON**

Further easing needed for accommodative real monetary conditions




IMF and bank outflows cap the C/A deficit




Source: MinFin, NIS, NBR, UniCredit Research

## Long-end ROMGBs and ROMANI in USD remain attractive

**We recommend staying overweight in ROMGBs with further easing ahead..**

**…and lower issuance in 2015**

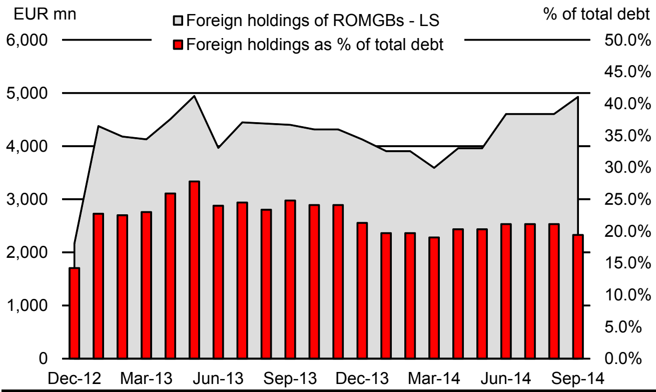
We recommend an overweight allocation to the long end of the ROMGB curve, as low inflationary conditions should prompt the NBR to cut rates and reduce the minimum reserve requirement. Issuance for 2015 is likely to be low following reduced funding needs and the prefunding already completed for 2015. Bond issuance remains well supported with long end auctions issued at historically tight spreads and foreign holdings of ROMGB reaching the highest amount since 2Q13. As a percentage of total debt, foreign ownership has dropped, suggesting foreigners are not overweight. Despite significant tightening in 2014, ROMGB and ROMANI could rally further if the ECB moves ahead with QE.

**We favour the long end in ROMGBs and in ROMANI USD...**

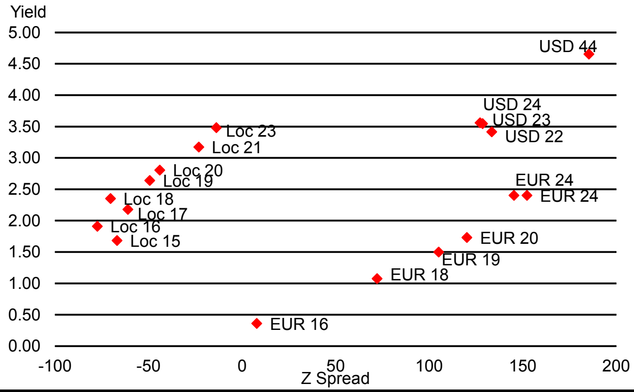
**…both outright and in relative value trades against regional peers**

For long-only investors, we recommend longer-dated ROMGBs, particularly the ROMGB 23s, which are attractive from a yield and Z-spread perspective. For USD-based investors, we recommend hedging the currency. On the hard currency curve, we favor the ROMANI USD 44s which offers an attractive yield and should benefit in the event of further USD strength and ECB QE. On the EUR curve, we favor the recently-issued ROMANI EUR 24s. The easing cycle in Romania could be longer than in other regional countries, so we still advocate being long ROMGB 23s vs. HGB 23s, long ROMANI USD 24s vs POLAND USD 24s and long ROMANI EUR 23s vs. POLAND EUR 23s.

Foreign holdings increased in value, but dropped as % of total debt




The long end of the ROMGB and ROMANI curves looks attractive




Source: NBR, MinFin, Bloomberg, UniCredit Research

**GOVERNMENT GROSS FINANCING REQUIREMENTS**

| EUR bn | 2014F | 2015F | 2016F |
|---|---|---|---|
| **Gross financing requirement** | **13.2** | **13.1** | **13.1** |
| Budget deficit | 3.1 | 3.3 | 2.8 |
| Amortisation of public debt | 10.1 | 9.8 | 10.3 |
| Domestic | 8.9 | 6.9 | 8.6 |
| Bonds | 6.3 | 4.2 | 6.3 |
| Bills | 2.2 | 2.4 | 2.0 |
| Loans | 0.4 | 0.3 | 0.3 |
| External | 1.2 | 2.9 | 1.7 |
| Bonds and loans | 0.2 | 1.2 | 1.7 |
| IMF/EU/IFIs | 1.0 | 1.7 | 0 |
| **Financing** | **13.2** | **13.1** | **13.1** |
| Domestic borrowing | 9.3 | 10.3 | 11.1 |
| Bonds | 6.6 | 7.9 | 9.3 |
| Bills | 2.4 | 2.0 | 1.5 |
| Loans | 0.4 | 0.4 | 0.3 |
| External borrowing | 4.9 | 2.8 | 2.0 |
| Bonds | 4.3 | 2.7 | 2.0 |
| IMF/EU/WB | 0.6 | 0.1 | 0 |
| Other | 0 | 0 | 0 |
| Fiscal reserves (- = increase) | -1.0 | 0 | 0 |

**GROSS EXTERNAL FINANCING REQUIREMENTS**

| EUR bn | 2014F | 2015F | 2016F |
|---|---|---|---|
| **Gross financing requirement** | **41.1** | **37.7** | **34.8** |
| C/A deficit | 1.5 | 1.7 | 2.5 |
| Amortisation of medium to long term debt | 17.9 | 16.8 | 13.7 |
| Government/central bank | 5.2 | 4.7 | 2.7 |
| Banks | 5.9 | 5.4 | 5.0 |
| Corporates | 6.8 | 6.7 | 6.0 |
| Amortisation of short term debt | 19.2 | 18.1 | 17.1 |
| Government/central bank | 0.3 | 0.3 | 0.2 |
| Banks | 4.8 | 3.2 | 2.5 |
| Corporates | 14.2 | 14.6 | 14.4 |
| Other | 2.5 | 1.1 | 1.5 |
| **Financing** | **41.1** | **37.7** | **34.8** |
| FDI | 2.0 | 2.0 | 2.2 |
| Equity | 0.3 | 0.1 | 0.1 |
| Borrowing | 34.3 | 31.9 | 30.7 |
| Government/central bank | 6.2 | 4.4 | 3.9 |
| Banks | 8.1 | 7.5 | 7.0 |
| Corporates | 20.0 | 20.0 | 19.8 |
| EU Funds - capital transfers | 3.5 | 3.7 | 1.9 |
| Change in FX reserves (reduction(+)/increase(-)) | 1.0 | 0 | 0 |

Source: NBR, MinFin, UniCredit Research

# Slovakia (A2 stable/ A positive/A+ stable)*

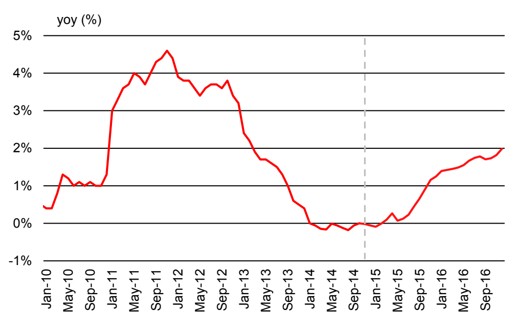
**Outlook** – Economic growth is expected to continue, driven mainly by recovering domestic demand supported by low inflation, an improving labor market and approaching elections. Inflation should remain anchored close to zero due to declining energy prices, free railway passes for students and pensioners and the absence of demand-pull inflation. The foreign trade surplus should narrow due to accelerating imports but will still remain a key driver of the CA surplus. The debt brake was unblocked by new methodology, unfreezing expenditures for the next few years.

**Author: Ľubomír Koršňák, Chief Economist (UniCredit Bank Czech Republic and Slovakia)**

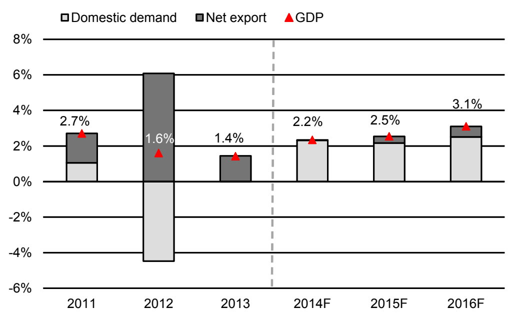
### KEY DATES/EVENTS

- 12 Jan, 10 Feb, 10 Mar – Industrial production
- 14 Jan, 13 Feb, 12 Mar – CPI
- 13 Feb – flash GDP
- 6 Mar – GDP and its structure

### INFLATION TO REMAIN SUBDUED




### GDP DRIVEN BY RECOVERING DOMESTIC DEMAND




Source: Statistical Office SR, UniCredit Research

### MACROECONOMIC DATA AND FORECASTS

| | 2012 | 2013 | 2014F | 2015F | 2016F |
|---|---|---|---|---|---|
| GDP (EUR bn) | 72.2 | 73.6 | 75.1 | 77.0 | 79.8 |
| Population (mn) | 5.4 | 5.4 | 5.4 | 5.4 | 5.4 |
| GDP per capita (EUR) | 13,349 | 13,594 | 13,874 | 14,220 | 14,737 |
| **Real economy yoy (%)** | | | | | |
| GDP | 1.6 | 1.4 | 2.3 | 2.5 | 3.1 |
| Private Consumption | -0.5 | -0.8 | 2.3 | 2.2 | 2.5 |
| Fixed Investment | -9.3 | -2.7 | 3.8 | 3.1 | 3.9 |
| Public Consumption | -2.0 | 2.4 | 3.5 | 1.2 | 1.0 |
| Exports | 9.3 | 5.2 | 4.3 | 5.4 | 6.1 |
| Imports | 2.6 | 3.8 | 4.6 | 5.4 | 5.9 |
| Monthly wage, nominal (EUR) | 805 | 824 | 859 | 875 | 901 |
| Unemployment rate (%) | 14.0 | 14.2 | 13.4 | 13.2 | 12.7 |
| **Fiscal accounts (% of GDP)** | | | | | |
| Budget balance | -4.2 | -2.6 | -2.9 | -2.5 | -1.5 |
| Primary balance | -2.7 | -0.8 | -1.3 | -0.9 | 0.2 |
| Public debt | 52.1 | 54.6 | 54.1 | 55.0 | 54.6 |
| **External accounts** | | | | | |
| Current account balance (EUR bn) | 1.6 | 1.5 | 1.4 | 0.9 | 0.9 |
| Current account balance/GDP (%) | 2.3 | 2.1 | 1.8 | 1.2 | 1.1 |
| Basic balance/GDP (%) | 4.2 | 3.5 | 3.3 | 2.7 | 2.6 |
| Net FDI (EUR bn) | 2.2 | 0.4 | 0.6 | 1.2 | 1.5 |
| Net FDI (% of GDP) | 3.0 | 0.6 | 0.8 | 1.5 | 1.9 |
| Gross foreign debt (EUR bn) | 53.8 | 59.7 | 64.4 | 68.0 | 71.1 |
| Gross foreign debt (% of GDP) | 74.5 | 81.1 | 85.8 | 88.4 | 89.1 |
| **Inflation/Monetary/FX** | | | | | |
| CPI (pavg) | 3.6 | 1.4 | -0.1 | 0.4 | 1.6 |
| CPI (eop) | 3.2 | 0.4 | -0.1 | 1.2 | 2.0 |
| Central bank reference rate (eop) | EUR | EUR | EUR | EUR | EUR |
| 3M money market rate | EUR | EUR | EUR | EUR | EUR |
| EUR/USD (eop) | EUR | EUR | EUR | EUR | EUR |
| EUR/EUR (pavg) | EUR | EUR | EUR | EUR | EUR |

Source: UniCredit Research

* Long-term foreign currency credit rating provided by Moody's, S&P and Fitch respectively

## Economy boosted by recovering domestic demand

**Economic growth expected to be driven mainly by domestic demand**

A gradual recovery of the Slovakian economy is on the cards, with GDP growth projected to reach 2.3% in 2014, 2.5% in 2015 and accelerating to 3.0% in 2016. The main driver will be domestic demand, boosted by low inflation and approaching general elections, while a significant pickup in net exports is not likely due to accelerating imports. Before an improvement next year, we expect a slight economic slow-down in 4Q14 due to weaker external demand and a worsening of local consumer confidence. The Slovakian economy has been delivering stable growth at 0.6% qoq sa for the fourth quarter in a row, slowing down from 2.6% to 2.4% yoy. 3Q14 figures surprised as weak monthly data from industry and construction suggested that the expansion would slow down. Industrial growth decelerated more significantly in the summer months due to a decline in key sectors – automotive and consumer electronics, driven also by decreasing demand for new cars in Russia, which was only partially offset by rising European new car sales. Construction continue to suffer due to supply-side issues (top players' debt rescheduling spreading to the sector).

**Falling gas imports supported the trade surplus**

We expect the foreign trade surplus to shrink from 6.4% to 5.7% GDP in 2015, but to remain an important driver of the CA surplus. In 2014, the foreign trade surplus improved mainly due to declining gas imports in the last few months, while exports stagnated. Once gas imports will normalize, imports are expected to increase again, driven by stronger domestic demand.

**Labor market improvements will boost household spending**

The labor market continues to improve amid economic growth; however, rising uncertainty and a temporary dip in activity are expected to have a negative impact on employment in the coming months, making local companies cautious in hiring new workers. Employment growth is thus expected to decelerate, while the decline of unemployment below the 13% level will be slow. As some wage negotiations tend to be backward looking in terms of inflation, real wage growth accelerated significantly in 2014, heavily supporting household consumption. If wage negotiations benchmark to zero inflation in 2014, wage growth will slow down next year, reaccelerating slightly in 2016, in the run-up to general elections.

**Low inflation to persist for a few years**

Inflation is expected to remain close to 0% yoy in the coming months, as base effects and free railway tickets for student and pensioners granted by the government should cancel each other.. The low-inflation environment is expected to persist in coming years. Supply-side factors (oil prices, regulated gas prices etc.) will keep inflation subdued in 2015, while we expect a moderate rebound of demand-pull inflation only at the end of next year.

**The debt brake was unblocked…**

**…leading to a likely rise in budget spending**

Due to the new ESA2010 methodology, public debt declined to 54.6% GDP, below the debt brake trigger requiring an expenditure freeze. However, the government budget proposal sent to Parliament was still relatively restrictive, suggesting the public finance deficit to be 1.98% of GDP in 2015. The number took into account the previous estimate for the debt level and needed to be in line with the debt brake. Nevertheless, it is likely that Parliament will approve some adjustments, increasing the public finance deficit to 2.5% of GDP. Meanwhile, the risks of exceeding the 3% of GDP deficit level this year have increased, but public debt is expected to remain below 55% GDP as the Debt Agency will minimize cash reserves by bond buy-backs (of bonds with maturity in January 2015). The likelihood of breaking the 55% threshold will increase again in 2015, but the data will be released only after the 2016 general elections and thus will not require immediate actions, since a new government can enjoy a 2-year holiday from the debt brake.

**Social Democrats dominate, right-wing opposition fragmented**

2015 will be a pre-election year with general elections scheduled for spring 2016. Any unpopular measures will be most likely postponed. Polls suggest that the ruling Social Democrats will keep their leading position, while the right-wing opposition is fragmented with several parties just on the edge of the 5% threshold needed to enter Parliament. Recent municipal elections confirmed the balance of power – Social Democrats and independent candidates (unlike municipal elections, only parties can run in general elections) won the most seats.

# Slovenia (Baa1 stable/A- negative/BBB+ stable)*

**Outlook –** Following a strong pick-up in 2014, the Slovenian economy is expected to slow down to 1.8% in 2015 due to weaker domestic demand. Net exports will also slowdown, but are still expected to add 0.9pp to GDP growth. On the banking front, no additional state funding will be required for Slovenia's three largest domestic banks, as retained profits remain sufficient for now to cover potential capital shortfalls. Even so, we expect public expenditures to remain high and at risk of widening the budget deficit above target. On a more positive note, the privatization process is advancing as planned which should help build credibility on the new government and stabilise Slovenia's public debt trend.

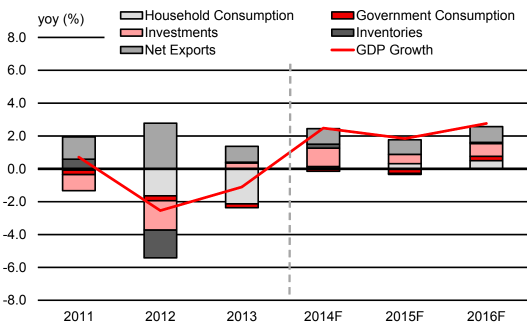
**Strategy –** We see scope for a short term rally amid low inflation, declining issuance needs and stronger auction support. However with a pick-up in growth beyond 1Q15, we think the chance of a significant further rally will largely depend on how accommodative the ECB is and how much Bunds yields tighten.

**Author: Carlos Ortiz, Economist (UniCredit Bank London)**

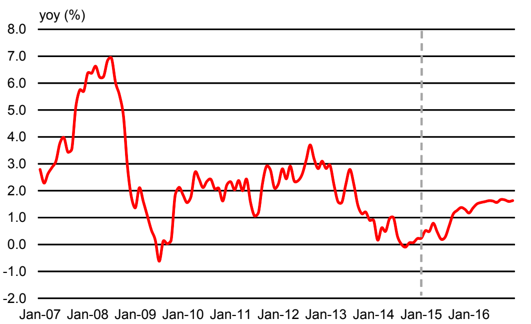
**KEY DATES/EVENTS**

- 11 Dec, 11-12 Jan – Policy rate decision
- 12 Dec, 9 Jan, 13 Feb – Consumer Price Index
- 30 Dec, 30 Jan, 27 Feb – Industrial output
- 30 Dec, 30 Jan, 27 Feb – Trade balance

**DOMESTIC DEMAND TO CATCH-UP IN 2015**




**INFLATION TO EASE IN 1H15, BUT REMAINS OUTSIDE OF TARGET**




Source: NBS, MinFin, UniCredit Research

**MACROECONOMIC DATA AND FORECASTS**

| | 2012 | 2013 | 2014F | 2015F | 2016F |
|---|---|---|---|---|---|
| GDP (EUR bn) | 36.0 | 36.1 | 37.4 | 38.2 | 39.5 |
| Population (mn) | 2.1 | 2.1 | 2.1 | 2.1 | 2.1 |
| GDP per capita (EUR) | 17,517 | 17,550 | 18,115 | 18,473 | 19,086 |
| **Real economy yoy (%)** | | | | | |
| GDP | -2.6 | -1.0 | 2.5 | 1.8 | 2.8 |
| Private Consumption | -3.0 | -3.9 | 0.3 | 0.6 | 1.0 |
| Fixed Investment | -8.9 | 1.9 | 5.8 | 2.8 | 3.8 |
| Public Consumption | -1.5 | -1.1 | -0.8 | -1.4 | 1.4 |
| Exports | 0.3 | 2.6 | 5.5 | 5.3 | 6.0 |
| Imports | -3.9 | 1.4 | 4.6 | 4.5 | 5.3 |
| Monthly wage, nominal (EUR) | 1,526 | 1,523 | 1,539 | 1,554 | 1,562 |
| Unemployment rate (%) | 8.9 | 10.1 | 10.0 | 9.6 | 9.1 |
| **Fiscal accounts (% of GDP)** | | | | | |
| Budget balance | -3.7 | -14.5 | -4.6 | -3.3 | -2.8 |
| Primary balance | -1.7 | -12.0 | -1.4 | -0.1 | 0.8 |
| Public debt | 53.4 | 70.4 | 78.3 | 81.3 | 80.7 |
| **External accounts** | | | | | |
| Current account balance (EUR bn) | 1.0 | 2.1 | 1.9 | 2.1 | 2.4 |
| Current account balance/GDP (%) | 2.8 | 5.8 | 5.0 | 5.5 | 6.0 |
| Basic balance/GDP (%) | 3.3 | 4.2 | 8.4 | 10.0 | 8.4 |
| Net FDI (EUR bn) | 0.2 | -0.6 | 1.3 | 1.7 | 1.0 |
| Net FDI (% of GDP) | 0.5 | -1.7 | 3.5 | 4.5 | 2.4 |
| Gross foreign debt (EUR bn) | 41.3 | 39.9 | 41.5 | 43.5 | 43.5 |
| Gross foreign debt (% of GDP) | 114.6 | 110.5 | 111.0 | 113.8 | 109.9 |
| **Inflation/Monetary/FX** | | | | | |
| CPI (pavg) | 2.8 | 1.9 | 0.4 | 0.7 | 1.5 |
| CPI (eop) | 3.1 | 1.1 | 0.2 | 1.3 | 1.6 |
| EURIBOR 3M | EUR | EUR | EUR | EUR | EUR |
| EUR/USD (eop) | EUR | EUR | EUR | EUR | EUR |
| EUR/USD (pavg) | EUR | EUR | EUR | EUR | EUR |

Source: UniCredit Research

*Long-term foreign currency credit rating provided by Moody's, S&P and Fitch respectively

## Turning the corner

**GDP in 3Q14 increased by an impressive 3.2% yoy, driven by domestic demand…**

**The Slovenian economy is set for a strong recovery this year**, driven by net exports and robust infrastructure investment. In 3Q14, GDP accelerated by an impressive 3.2% yoy (from 2.9% yoy in 2Q14), representing the strongest growth performance since 1Q08. Growth was broad-based, and led by domestic demand which added 1.8pp to headline growth. Component-wise, the strongest contribution was fixed investments, after accelerating by 7.2% yoy and adding 1.3pp to GDP. Domestic consumption decelerated from 2Q14, but still managed to add 0.4pp on the back of rising household expenditures (up 0.8% yoy). In part, this is explained by the recovery of consumer confidence in 3Q14, which also translated into stronger retail sales during the summer (+ 5.1% yoy, sa). As expected, government consumption flattened due to the elections, but is expected to weaken from 4Q14 on the back of austerity. In contrast, net exports increased a further 16.7% yoy, driven by exports (+ 6.8% yoy), adding an additional 1.6pp to headline GDP growth.

**…forcing us to revise our FY14 GDP growth estimate by 0.9pp to 2.5% yoy**

**We expect the economy to grow by 2.5% this year and by 1.8% yoy in 2015**. In contrast to SEE peers, growth this year should be broad-based and strongly supported by domestic demand. Next year, however, we see growth slowing down to 1.8% yoy, owing predominantly to base effects and weakened domestic demand. On this front, we expect the planned cuts in the 2015 budget to reduce public expenditures by 0.8% yoy, and subtract close to 0.2pp from FY15 growth. The planned hikes to excise taxes and cuts in wages will also constrain household expenditures (+0.6 yoy), while the slowdown in EU-funded infrastructure projects will take its toll on investments (down to 2.8% yoy). The contribution from net exports will decrease, albeit slightly, namely on the back of weak German and Italian growth. Trade sanctions with Russia will also play a role, albeit less pronounced, since so far the net export impact has been small (-0.1pp of GDP in 9M14)

**Inflation will remain tame and below the EU average for the forecast horizon**

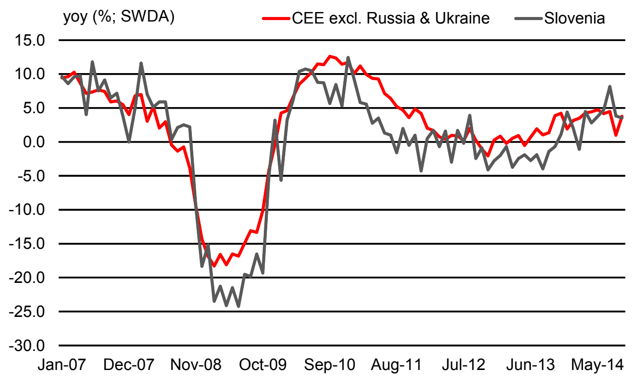
**Inflation remains weak but is expected to accelerate in 1H15**. In November, harmonized CPI inflation fell by 0.1% mom, bringing the annual reading to a meager 0.07% yoy. For year-end, we expect inflation at 0.2% yoy, but it should accelerate in 1Q15 on the back of rising food prices and the planned January hikes to financial transaction fees. Even so, it will remain tame (FY15 avg: 0.7% yoy) and below the EU average throughout the entire forecast horizon.

**The C/A surplus is expected to increase from 2015 due to a stronger trade balance**

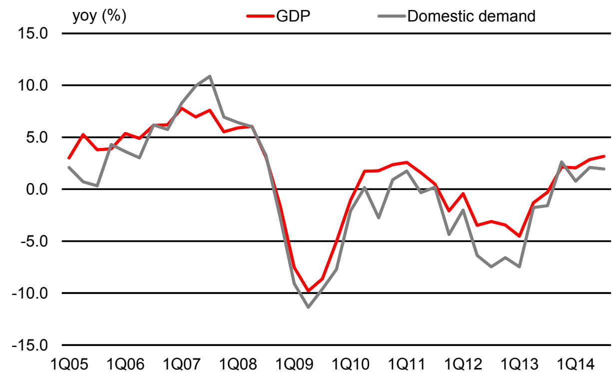
**The C/A surplus will ease to 5% of GDP in 2014,** driven by a wider income deficit. In 9M14, the C/A surplus fell by 2.8% yoy to EUR 1.6bn. The widening was driven entirely by the income deficit (up 37% yoy to EUR 0.6bn) as foreign-owned companies started to repatriate profits abroad due to the improved macro outlook. Against this backdrop, we estimate the C/A surplus this year will fall to EUR 1.9bn (or 5% of GDP). Looking ahead, we expect the C/A to be supported by wider trade surpluses which should put it at 6% of GDP by end-2016.

**ECONOMIC RECOVERY HAS BEEN BROAD-BASED BUT LED BY DOMESTIC DEMAND**

IP remained relatively robust in 9M14 …




…helping domestic demand and GDP to rebound to three-year highs




Source: MinFin, Haver, UniCredit Research

**Domestic banks' capital ratios remain adequate but are still affected by high corporate NPLs**

**The domestic banking system will not require additional state funding**, according to the ECB/EBA's asset quality review (AQR) and stress test results released on 26 October. Only under the adverse scenario would NLB and NKBM fail the stress tests, albeit by a small margin, and be required to raise EUR 34mn (NLB) and EUR 31mn (NKBM) to meet the Tier 1 capital hurdle of 5.5%. Nevertheless, both banks have pledged to cover these potential capital shortfalls from their retained profits, totaling a combined EUR 105mn in 9M14. This means no additional state recapitalizations will follow for both banks, which are planned to be privatized by 2015 (NKBM) and 2017 (NLB). The restructuring of Abanka was also completed last October, and should be followed by its merger with Banka Celje in 2016, provided the restructuring plan of this smaller bank is approved by the EC in the coming months.

**We expect the budget deficit this year to widen versus target…**

**The budget performance this year has been poor,** forcing the government to adopt a revised budget at end-October. Between Jan-Oct, the state budget deficit totaled EUR 1.1bn, surpassing the government's initial full-year target (EUR 1bn). The slippage was driven by higher interest (+9.2% YTD) and capital (+ 40% YTD) expenditures, forcing the MinFin to lift the annual deficit to EUR 1.2bn (or 3.2% of GDP). Even so, we find this revision optimistic, and we expect the budget deficit to widen further to EUR 1.7bn (or 4.6% of GDP) once bank recapitalization costs are included. This should lift public debt to 78% of GDP this year, double that in 2010.

**…while the 2015 budget risks being insufficient to bring the deficit down to 2.8% of GDP**

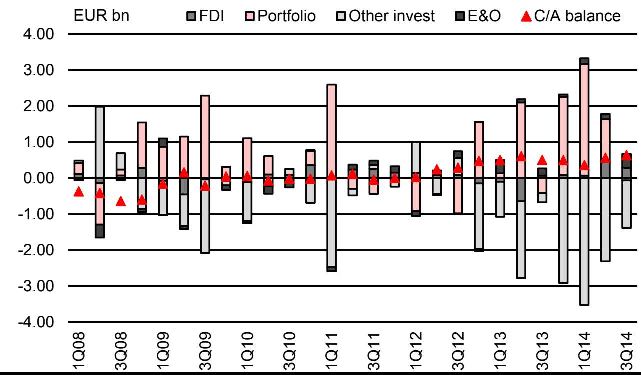
**We view the 2015 budget bill as a step in the right direction but implementation risks remain high**. The approved fiscal consolidation package aims to raise savings by EUR 0.7bn (or 2% of GDP) next year, via both expenditure cuts (EUR 0.6bn) and revenue-enhancing measures (EUR 0.1bn)[25]. Net-net, we welcome the measures but still see some risk of being watered down (i.e. overhaul of public procurement). What's more, the budget bill does not address high welfare spending, while the repayment of Yugoslav-era foreign deposits risks increasing contingent payments meaningfully (ca. EUR 0.5bn). Keeping this in mind, we doubt the EDP objective will be attained next year (FY15: 3.2% yoy), unless additional expenditure cuts are introduced in January in line with EC recommendations.

**The sale of NKBM expected by year-end; Telekom Slovenia in 1Q15**

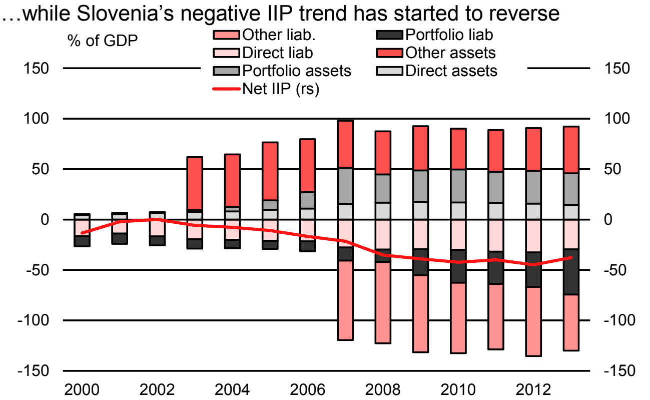
**The privatization process is advancing as planned.** On top of the sale of Aerodrom Ljubljana in September, binding bids have already been submitted for NKBM, Žito and Telekom Slovenia, which are planned to be sold by 1Q15. More importantly, the government has voiced its predisposition to enlarge the 15-company privatization list presented May 2013, though it is still uncertain that will be done given the opposition of its two coalition partners (SD and DeSUS). In our view, Slovenia's SOE sector remains oversized and needs deep restructuring, as otherwise it risks putting Slovenia's debt on an unsustainable path.

**EXTERNAL IMBALANCES ARE NOT SEVERE**

Capital inflows remain strong….




…while Slovenia's negative IIP trend has started to reverse




Source: MinFin, Haver, UniCredit Research

[25] On the expenditure front, main measures include the overhaul of public procurement, cuts to the public sector wage bill of 3%, and a reduction of municipalities' expenditures. On the revenue front, measures include the preservation of the highest income tax bracket for top earners (EUR +16mn), an increase in the levy on financial and insurance services (EUR +30mn), improvement of the tax collection system (EUR +24mn) and hike to excise taxes on unhealthy food and drinks (EUR +8mn).

## Strategy: Further rally needs additional stimulus

**Bond environment is positive in the short term…**

**…2014 financing targets have been met amid pre-funding for 2015 and 2016**

**Expect a resumption of bond auctions in 2015**

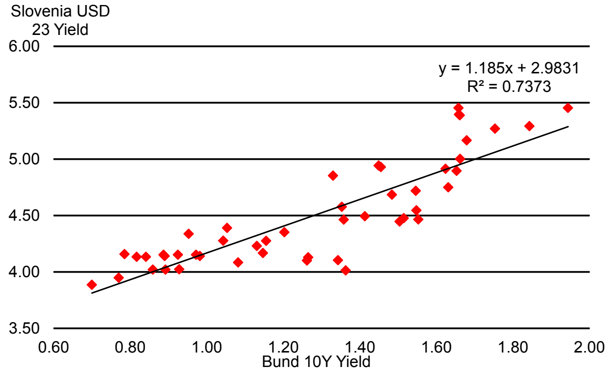
Inflation remains very low and is likely to decline into the early months of 1Q15. We think this, combined with a stable majority government, keeps the environment positive for bonds in the short term despite high public debt levels. The budget deficit has declined and financing targets for 2014 have been completed alongside with EUR 2.7bn of pre-financing for 2015 and 2016. The strong issuance this year has come mainly from the placement of 5Y and 7Y USD bonds and a new 7Y euro bond raising collectively EUR 3.7bn. This means the EUR 3.2bn of debt maturing in 2015 should be comfortably covered. In 2015, we expect the MinFin to resume bond auctions, looking to hold 4 – 5 auctions by tapping existing issues and possibly looking to issue in USD and extending duration to a 10Y or 15Y bond.

**Bonds have rallied but with inflation headwinds ahead…**

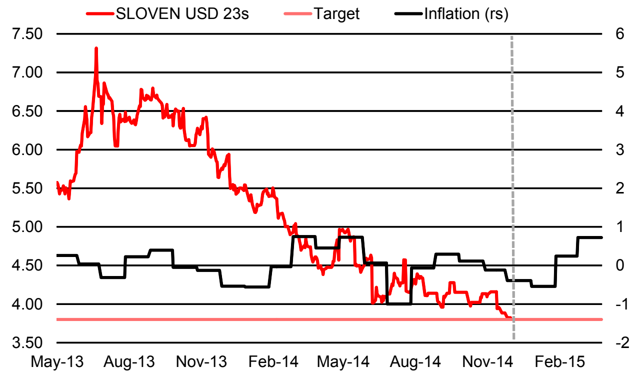
**…additional stimulus will be require to prevent yields from plateauing**

The yield curve has tightened significantly since the end of 1Q14, particularly in the belly of the curve. We think that, with the upward path of inflation beyond 1Q15, any additional tightening will likely be driven by easing measures from the ECB and the degree to which Bunds continue to tighten. Without this, we expect yields to plateau. We recommended being long the SLOVEN USD 23 last July, and we lowered our target yield from 400bp to 380bp in 3Q14.

In event of ECB QE, bonds should rally further….




Without QE, inflation path suggests yield plateau




Source: Bloomberg, UniCredit Research

### GOVERNMENT GROSS FINANCING REQUIREMENTS

| EUR bn | 2014F | 2015F | 2016F |
|---|---|---|---|
| **Gross financing requirement** | **5.5** | **3.5** | **5.0** |
| Budget deficit | 1.7 | 1.2 | 1.1 |
| Amortization of public debt | 3.8 | 2.3 | 3.9 |
| Domestic | 3.8 | 2.3 | 2.4 |
| Bonds | 1.9 | 1.1 | 1.3 |
| Bills | 1.9 | 1.2 | 1.1 |
| External | 0 | 0 | 1.5 |
| IMF | 0 | 0 | 0 |
| **Financing** | **5.5** | **3.5** | **5.0** |
| Domestic borrowing | 4.6 | 3.5 | 2.9 |
| Bonds | 3.0 | 2.0 | 1.5 |
| Bills | 1.6 | 1.5 | 1.4 |
| External borrowing | 2.7 | 1.5 | 1.0 |
| Bonds | 2.7 | 1.5 | 1.0 |
| IMF/EU | 0 | 0 | 0 |
| Other | 0 | 0 | 0 |
| Change in cash reserves (+ = decline) | -1.7 | -1.5 | 1.1 |

Source: MinFin, UniCredit Research

### GROSS EXTERNAL FINANCING REQUIREMENTS

| EUR bn | 2014F | 2015F | 2016F |
|---|---|---|---|
| **Gross financing requirement** | **7.7** | **6.0** | **6.8** |
| C/A deficit | -1.9 | -2.1 | -2.4 |
| Amortization of medium to long-term debt | 3.3 | 3.2 | 4.5 |
| Government | 0 | 0 | 1.5 |
| Central Bank | 0 | 0 | 0 |
| Banks | 1.7 | 1.6 | 1.5 |
| Corporates | 1.7 | 1.6 | 1.5 |
| Amortization of short-term debt | 6.2 | 4.9 | 4.7 |
| Government | 0 | 0.1 | 0.1 |
| Central Bank | 1.1 | 0 | 0 |
| Banks | 0.8 | 0.6 | 0.4 |
| Corporates | 4.3 | 4.2 | 4.2 |
| **Financing** | **7.7** | **6.0** | **6.8** |
| FDI | 1.3 | 1.7 | 1.0 |
| Medium to long-term borrowing | 3.3 | 2.1 | 1.9 |
| Government | 2.7 | 1.5 | 1.0 |
| Central Bank | 0 | 0 | 0 |
| Banks | 0.3 | 0.3 | 0.5 |
| Corporates | 0.3 | 0.3 | 0.5 |
| Short-term borrowing | 2.3 | 1.3 | 2.6 |
| Government | 0 | 0 | 0 |
| Central Bank | 1.1 | 0 | 0 |
| Banks | 0.3 | 0.3 | 0.6 |
| Corporates | 0.9 | 1.0 | 2.0 |
| EU Funds | 0.8 | 0.9 | 1.3 |

# Bosnia and Herzegovina (B3 stable/B stable/not rated)*

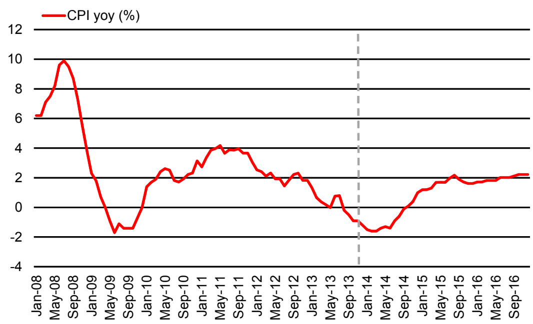
**Outlook** – Economic activity began to recover gradually after a significant contraction in 2Q following widespread floods, but we keep our view of no GDP growth this year. We also keep our forecast of 2% GDP growth in 2015. General elections for members of the Presidency of Bosnia and Herzegovina, the assembly of both entities and all cantons of the Federation took place in October. The election of Members of the Parliamentary Assembly of Bosnia and Herzegovina and of executive bodies at all levels should be finalized by the end of 2014. As of early December, the IMF staff mission is pursuing the delayed 8th review under the Stand-By Arrangement. The new authorities are expected to resume the implementation of the program.

**Author: Hrvoje Dolenec, Chief Economist (Zagrebačka banka)**

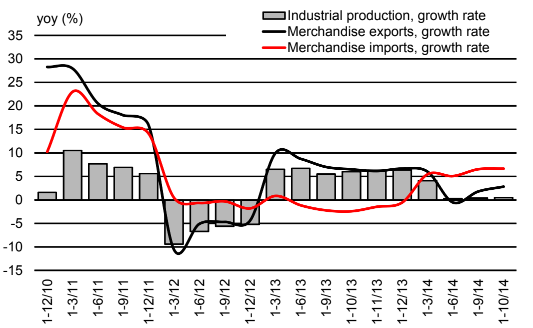
### KEY DATES/EVENTS

- 20 Jan: CPI December 2014
- 20 Jan: Foreign trade FY14
- 25 Jan: Industrial Production FY14
- 27 Mar: Balance of payments FY14
- Mar: 10th review of SBA

### DEFLATION PERIOD LEFT BEHIND




### MERCHANDISE EXPORTS: DEFICIT TO WIDEN AGAIN




Source: IMF, Ministry of FInance, Eurostat, UniCredit Research

### MACROECONOMIC DATA AND FORECASTS

| | 2012 | 2013 | 2014F | 2015F | 2016F |
|---|---|---|---|---|---|
| GDP (EUR bn) | 13.2 | 13.4 | 13.3 | 13.8 | 14.6 |
| Population (mn) | 3.8 | 3.8 | 3.8 | 3.8 | 3.8 |
| GDP per capita (EUR) | 3,430 | 3,504 | 3,478 | 3,608 | 3,811 |
| **Real economy yoy (%)** | | | | | |
| GDP | -1.2 | 2.1 | 0 | 2.0 | 3.5 |
| Monthly wage, nominal (EUR) | 660 | 661 | 662 | 678 | 697 |
| Unemployment rate (%) | 44.1 | 44.6 | 44.0 | 43.9 | 43.7 |
| **Fiscal accounts (% of GDP)** | | | | | |
| Budget balance | -1.9 | -2.3 | -4.0 | -3.3 | -2.1 |
| Primary balance | -1.2 | -1.4 | -3.0 | -2.4 | -1.1 |
| Public debt | 39.7 | 42.5 | 45.3 | 44.6 | 42.8 |
| **External accounts** | | | | | |
| Current account balance (EUR bn) | -1.2 | -0.7 | -1.1 | -1.2 | -1.2 |
| Current account balance/GDP (%) | -9.3 | -5.5 | -8.1 | -8.4 | -8.1 |
| Basic balance/GDP (%) | -7.2 | -3.5 | -4.6 | -4.4 | -3.9 |
| Net FDI (EUR bn) | 0.3 | 0.3 | 0.5 | 0.6 | 0.6 |
| Net FDI (% of GDP) | 2.1 | 1.9 | 3.5 | 4.1 | 4.2 |
| Gross foreign debt (EUR bn) | 6.9 | 7.0 | 7.4 | 7.7 | 8.1 |
| Gross foreign debt (% of GDP) | 52.3 | 52.0 | 55.3 | 55.6 | 55.3 |
| FX reserves (EUR bn) | 3.3 | 3.6 | 3.7 | 3.7 | 3.8 |
| **Inflation/Monetary/FX** | | | | | |
| CPI (pavg) | 2.1 | -0.1 | -0.8 | 1.6 | 2.0 |
| CPI (eop) | 1.8 | -1.2 | 1.0 | 1.6 | 2.2 |
| 1M money market rate | 0.33 | 0.12 | 0.15 | 0.15 | 0.50 |
| USD/ BAM (eop) | 1.48 | 1.42 | 1.60 | 1.70 | 1.66 |
| EUR/BAM (eop) | 1.96 | 1.96 | 1.96 | 1.96 | 1.96 |
| USD/ BAM (pavg) | 1.52 | 1.47 | 1.47 | 1.64 | 1.69 |
| EUR/ BAM (pavg) | 1.96 | 1.96 | 1.96 | 1.96 | 1.96 |

Source: UniCredit Research

* Long-term foreign currency credit rating provided by Moody's, S&P and Fitch respectively

## Modest recovery following events in May continues

**GDP fell by 1.2% in 2Q yoy primarily due to negative effects of the natural disaster in May**

**GDP growth could reach 2% yoy in 2015**, despite potential difficulties with delays in the formation of a new authority line-up following the general elections in October. The main driver of growth should be the reconstruction of buildings and infrastructure damaged by floods and landslides in 2014. In addition, the carryover from 2014 is positive. There was a gradual recovery of economic activity after the 2Q14 contraction, primarily following the catastrophic floods and landslides in May. The first estimate of 2Q14 GDP indicated a decline of 1.2% yoy. According to seasonally adjusted data, a decreasing trend of GDP was recorded for the first two quarters of the year at the rate of -0.2% and -0.5% qoq, respectively. The largest decline in gross value added in 2Q was recorded in mining (-16.2%), agriculture and forestry (-10.8%), real estate (-9.6%), electricity production (-8.8%), and hotels and catering (-5.4%), while among the most significant sectors of the economy only construction achieved considerable growth (+7.8%). During the summer and autumn months, an expected recovery in economic activity has begun, partly owing to reconstruction. However, the recovery is does not look strong enough to achieve growth on an annual basis, and therefore we keep our previous forecasts of zero GDP growth in 2014. The cumulative growth of industrial production in the first ten months reached only 0.5% yoy, with energy production (a significant part of industrial production) falling by 6.7% yoy. The construction sector achieved a cumulative growth of 6.9% yoy in 1Q-3Q, largely due to the intensive construction of new sections of the Corridor Vc motorway. In the same period, the number of tourist nights fell by 7.1%.

**Foreign trade deficit is widening in 2014 due to the slowdown in exports, ,while import growth is accelerating**

**Domestic demand is improving, as seen in the wider trade deficit, higher inflation and employment.** The trade gap widened in January-October due to both the relatively slow growth in exports and increasing growth of imports. Exports of goods reached EUR 3.7 billion, increasing by only 2.8% yoy, while imports reached EUR 6.9 billion, rising 6.6% yoy. The foreign trade deficit, therefore, reached EUR 3.2 billion, an increase of 11.4% yoy. We expect the C/A deficit at 8.1% of GDP in 2014, while the slower recovery in EMU will mean a further widening in 2015. Inflation turned positive in October (+0.1% yoy), after declining for 14 consecutive months. The uptick was due mainly to higher administered prices for electricity, gas, fuels, alcoholic beverages and tobacco, but demand pressure is evident in other price categories (such as clothing and footwear), where monthly inflation was positive. Employment is picking up, rising by 3.1% yoy in September. At the same time, the registered unemployment rate declined by 1.3pp. The average gross salary increased by 1.1% yoy in 1Q-3Q in real terms as negative inflation offset the nominal wage decrease of -0.1%yoy.

**The fiscal picture is not improving, despite higher indirect tax revenues**

**The fiscal picture is not improving.** Following the floods, expenditure increased by 1.7% of GDP , offsetting better revenues. Indirect tax revenue rose by approximately 5.5% yoy in the first eleven months of 2014 despite weaker domestic demand since May. We ascribe better revenues mainly to more efficient collection which was targeted within SBA. At the same time, there are indications that direct tax revenues in both entities declined in the same period. This particularly applies to revenues from profit tax, income tax and social contributions..

**8th review of SBA currently underway, delayed due to general elections**

**We expect post-election negotiations with the IMF to be successful.** The IMF returned in December to Bosnia for the eighth review under the Stand-By Arrangement**.** Upon the completion of the review, the disbursement of the next tranche can be expected under the extended SBA, now amounting to 330% of the quota or EUR 620mn. So far, some EUR 475mn or 250% of the quota was disbursed, supporting the budget and SBA criteria compliance.

# Russia (Baa2 negative/BBB- negative/BBB negative)*

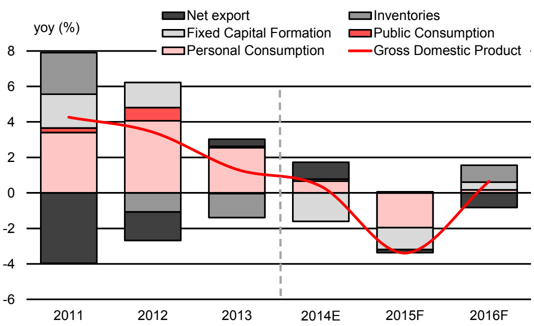
**Outlook** – The Russian economy will probably fall into recession in 2015. Consumption is expected to contract amid falling real wages and credit, while investment could be crowded out by debt repayments. RUB depreciation has cushioned the budget so far, but increases risks to financial stability and inflation. The CBR is expected to hike by 200-300bp in the coming months. A stabilization in oil prices would help stop the RUB decline and would slow down recession. Meanwhile, we prefer FX bonds to the local curve, where relative value trades are a less risky option than outright bond positions.

**Authors: Artem Arkhipov, Head of Macroeconomic Analysis and Research (UniCredit Bank Russia), Anna Bogdyukevich, Economist (UniCredit Bank Russia), CFA**

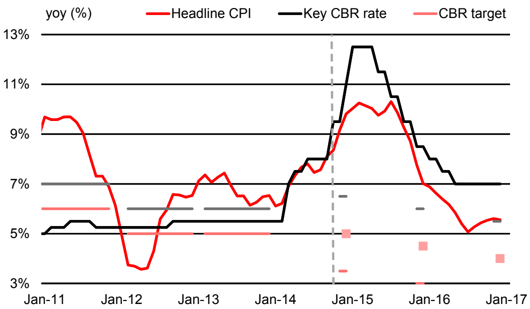
### KEY DATES/EVENTS

- 18 Dec – Putin's annual press-conference
- 30 Jan – MPC meeting
- 18-23 of every month – short-term statistical overview

### DOMESTIC DEMAND WEAKENS




### INFLATION ABOVE TARGET FOR NOW




Source: Federal Statistical Service, CBR, UniCredit Research

### MACROECONOMIC DATA AND FORECASTS

| | 2012 | 2013 | 2014F | 2015F | 2016F |
|---|---|---|---|---|---|
| GDP (EUR bn) | 1,556 | 1,573 | 1,429 | 1,282 | 1,443 |
| Population (mn) | 143.0 | 143.3 | 143.7 | 143.6 | 143.5 |
| GDP per capita (EUR) | 10,882 | 10,974 | 9,943 | 8,925 | 10,057 |
| **Real economy yoy (%)** | | | | | |
| GDP | 3.4 | 1.3 | 0.4 | -3.4 | 0.6 |
| Private Consumption | 7.9 | 4.7 | 1.2 | -3.5 | 0.3 |
| Fixed Investment | 6.4 | -0.1 | -7.2 | -6.0 | 2.2 |
| Public Consumption | 4.6 | 0.5 | 0 | 0.1 | 0 |
| Exports | 1.4 | 4.2 | -1.0 | -3.5 | 0 |
| Imports | 8.8 | 3.7 | -5.1 | -4.0 | 3.5 |
| Monthly wage, nominal (EUR) | 675 | 696 | 623 | 557 | 616 |
| Unemployment rate (%) | 5.3 | 5.4 | 5.6 | 6.8 | 6.5 |
| **Fiscal accounts (% of GDP)** | | | | | |
| Budget balance | 0 | -0.5 | 0.8 | 0.3 | -0.4 |
| Primary balance | 0.2 | -0.1 | 1.2 | 0.8 | 0.1 |
| Public debt | 10.2 | 11.7 | 15.7 | 15.9 | 16.9 |
| **External accounts** | | | | | |
| Current account balance (EUR bn) | 63.2 | 24.8 | 38.2 | 12.8 | 7.1 |
| Current account balance/GDP (%) | 4.1 | 1.6 | 2.7 | 1.0 | 0.5 |
| Basic balance/GDP (%) | 3.5 | 1.6 | 3.6 | 1.0 | 0.5 |
| Net FDI (EUR bn) | 1.4 | -11.7 | -20.0 | -4.3 | 10.7 |
| Net FDI (% of GDP) | 0.1 | -0.7 | -1.4 | -0.3 | 0.7 |
| Gross foreign debt (EUR bn) | 485.1 | 546.7 | 528.4 | 508.9 | 493.9 |
| Gross foreign debt (% of GDP) | 31.2 | 34.8 | 37.0 | 39.7 | 34.2 |
| FX reserves (EUR bn) | 407.3 | 377.4 | 343.3 | 353.8 | 344.8 |
| **Inflation/Monetary/FX** | | | | | |
| CPI (pavg) | 5.1 | 6.8 | 7.7 | 9.4 | 5.8 |
| CPI (eop) | 6.6 | 6.5 | 9.8 | 7.0 | 5.6 |
| Central bank target | 5 - 6 | 5 - 6 | 5.00 | 4.50 | 4.00 |
| Central bank reference rate (eop) | 5.50 | 5.50 | 11.00 | 8.50 | 7.00 |
| 3M money market rate | 7.45 | 7.08 | 12.30 | 9.75 | 8.00 |
| USD/RUB (eop) | 31.07 | 32.73 | 54.40 | 48.78 | 47.93 |
| EUR/RUB (eop) | 39.92 | 44.97 | 66.37 | 56.10 | 56.56 |
| USD/RUB (pavg) | 30.37 | 31.85 | 38.14 | 50.30 | 48.44 |
| EUR/RUB (pavg) | 40.23 | 42.41 | 50.46 | 59.47 | 56.24 |

Source: UniCredit Research

*Long-term foreign currency credit rating provided by Moody's, S&P and Fitch respectively

## Resilience tests

**Russia will fall into recession in 2015…**

The Russian economy will probably fall into recession in 2015 as several rounds of sanctions added to underlying economic weakness to exhaust the limited growth potential stemming mainly from domestic demand. While commercial sanctions could be gradually lifted already from 2015, financial sanctions could remain in place for a longer time. The latter bit harder than economic ones in 2014, leading to a 63% plunge in the RUB value, a 200-300bp increase in Eurobond yields and the loss of a third of the USD value of the stock market.

**…as sanction take their toll…**

We expect GDP to fall by 3.2% yoy in 2015 – under our baseline scenario of oil prices averaging USD 75/bbl – after growing by 0.4% yoy in 2014, when the economy proved more resilient than expected. Capital investment fell by 2.5% yoy in 10M14, but industrial production and retail sales rose by 1.7% yoy and 2.2% yoy respectively. Yet past growth drivers are expected to weigh on economic activity in 2015.

**…on purchasing power and consumption…**

**…and net exports…**

First, household consumption could shrink by 3.5% yoy in 2015 after cooling down in 2H14. A pick-up in 1H14 was caused by the population bringing forward purchases of durables in anticipation of rising prices. But since March 2014, purchasing power has come under pressure. The real wage bill fell in 3Q14 for the first time since 4Q09 amid tumbling real wages and flat employment. Second, a further contraction in import volumes will not be able to offset export weakness to the same extent as in 2014, when it kept GDP growth afloat.

**…reinforcing the shock from lower oil prices…**

**…despite RUB depreciation**

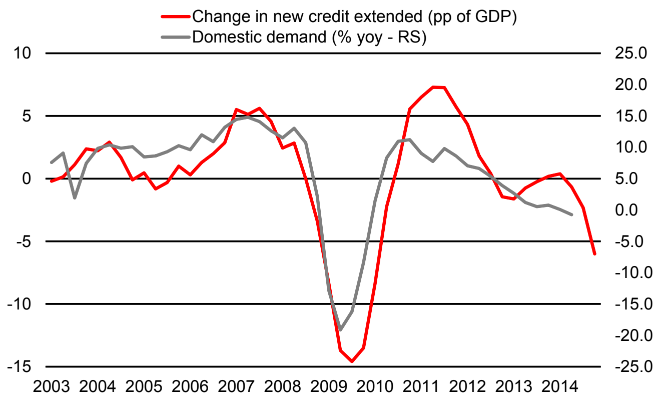
Finally, the 36% drop in the oil price between late June and early December has yet to pass through completely to real and nominal indicators. RUB depreciation is acting as an embedded stabilizer for the state budget, which recorded a surplus of 1.9% of GDP in 10M14. At the same time, it creates a negative wealth effect via higher prices and FX debt stock that weighs on consumption and savings. As a result, investment could be crowded out amid forced deleveraging in the private sector due to lack of access to international debt markets.

**We expect the RUB to stabilise if oil prices stop from falling…**

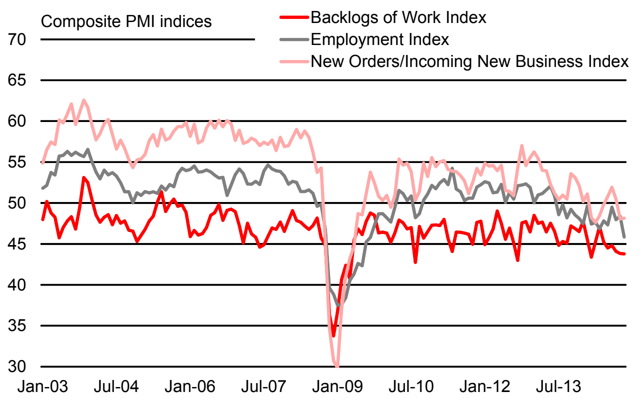
Looking through market volatility, the RUB will be anchored in the short term by oil prices and budget constraint, since oil and gas revenues contribute more than 50% to the overall budget revenues. Assuming that the oil price will not fall below USD 65/bbl and will rebound towards USD 80/bbl by the end of 2015, the budget would balance at USD-RUB 54, up from USD-RUB 35.5 in 2014. Sharper depreciation to cover regional budget shortfalls would endanger financial stability. Thus, the government will probably draw down emergency reserves to cover additional financing requirements, including infrastructure programs.

**DOMESTIC DEMAND IS EXPECTED TO PUSH THE ECONOMY INTO RECESSION**

The slowdown in credit will be negative for domestic demand…




…the economy facing the sharpest downturn since 2009




Source: Rosstat, CBR, UniCredit Research

**…but the longer-term outlook hinges on the length and scope of sanctions.**

Longer term, the RUB outlook will be shaped by the length and scope of sanctions. Balance of payments risks seem contained in the near future. On the one hand, flexible imports stabilised the C/A surplus despite worsening terms of trade. On the other hand, capital outflow is likely to continue as companies have to redeem almost USD 120bn in 2015 and USD 50bn in 1H16. Low debt rollover rates will sap into liquidity and could require state support.

**A draw-down of reserves could mitigate part of the growth shocks…**

**…but could undermine sovereign rating**

The Reserve and National Wellbeing funds amount to roughly USD 170bn, but the latter has been rather actively utilized in providing guarantees and credit lines for large-scale projects. Thus, the question of sustainability may arise if the oil price stays low for an extended period of time (through 2016-17). A rapid depletion of reserves amid debt repayments could trigger the loss of Russia's sovereign investment grade, despite supportive external and public debt metrics. This would only reinforce capital outflows and would extend economic recession. Limited access to foreign financing would also act against Russia's intention to diversify away from the production of commodities to other manufacturing branches. The reason for that lies in the capacity of the oil and gas sectors to deliver more revenues in a shorter period of time.

**Inflation is expected to peak close to 10% yoy in 1H15…**

Higher inflation will weigh on the economy throughout 2015. Supply-side shocks stemming from sharp RUB depreciation and higher food prices due to import barriers are expected to push the headline figure to 9.8% yoy by end-2014 and above 10% yoy in 1H15. Weak domestic demand, a negative credit impulse and an expected slowdown in ruble depreciation could push inflation down to 7.0% yoy by end-2015.

**…but meanwhile the CBR could deliver 200-300bp in additional hikes…**

**…while renewed FX interventions are unlikely to stop depreciation**

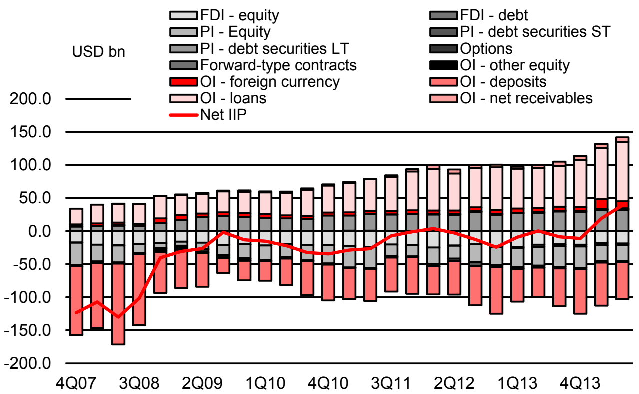
The market adjusted its inflation expectations, pricing in more than 300bp in rate hikes as of early December. This put pressure on the CBR to deliver 200-300bp in rate hikes over the next months in order to add credibility to its inflation targeting commitment. The CBR completed the transition towards a freely-floating exchange rate regime in November 2014, focusing on preserving FX reserves. Before that, the CBR sold almost USD 30bn in October, and year-to-date, FX reserves declined by USD 80bn. Faster RUB depreciation in early December, however, prompted renewed interventions, undermining the central bank's credibility. The CBR can use FX repos to stabilise the currency, but auctions were poorly bid mid-November due to unattractive costs and/or the absence of a large USD liquidity deficit.

**Financial stability could become an issue amid RUB weakness**

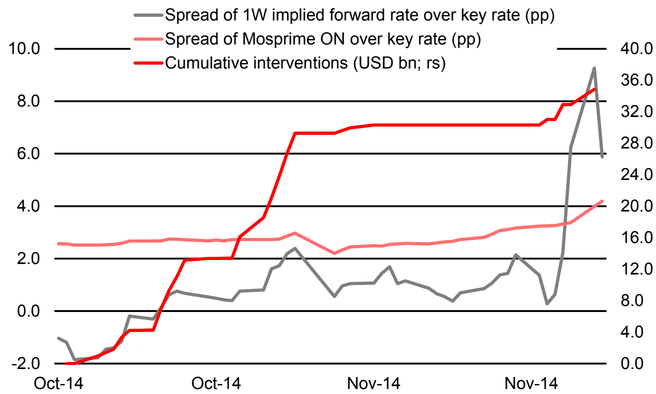
The banking sector's resilience has not been tested yet. A flight from RUB to FX deposits failed to materialise and would prove very costly now. At the same time, NPLs could rise amid RUB depreciation, putting pressure on capital metrics. The CBR announced that 10% of banks did not meet capital requirements in December 2014. The percent could grow further.

**FX INTERVENTIONS HAVE A NEGATIVE IMPACT ON THE ECONOMY**

FX interventions could deteriorate the net investment position…




...while tightening monetary conditions




Source: Rosstat, CBR, UniCredit Research

## Strategy: Difficult environment to continue into 1Q15

**We recommend an underweight allocation to Russia local bonds as structural challenges remain**

**Falling oil prices could put pressure on RUB but…**

**…rising inflation will likely prompt the CBR to hike rates causing the curve to bear flatten**

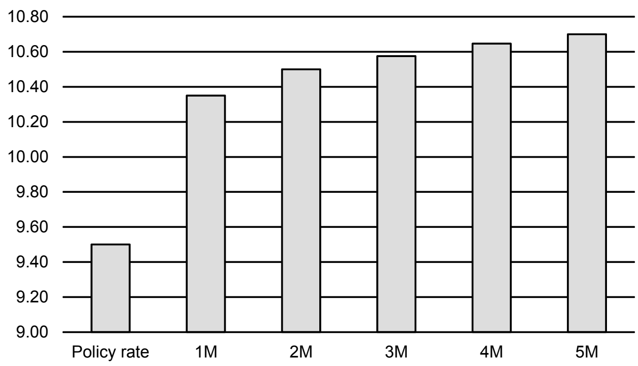
**The local curve remains vulnerable and...**

**…we see less risk in USD hard currency bonds and relative value curve trades**

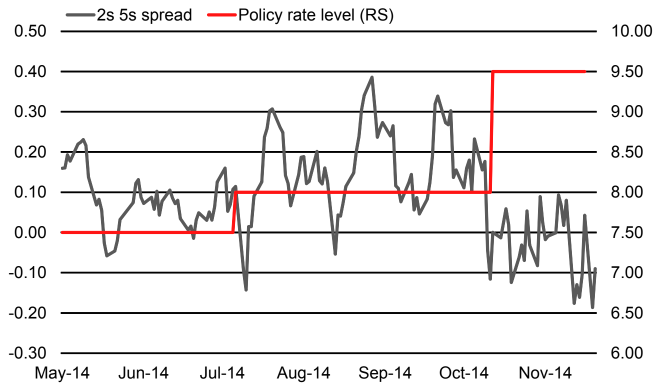
We recommend an underweight allocation to Russian local currency bonds as the significant structural growth challenges remain and the terms of trade continue to deteriorate. Despite the aggressive sell off in RUB we think further pressure could result if oil continues to decline. However, with inflation moving to 9.1% yoy in November, there is a higher probability that the CBR will hike rates at the next meeting to stabilize the currency. The Ruonia curve is pricing a 100bp hike at the December 2015 meeting which should see the curve bear-flatten. Foreign holdings have fallen from their peak in 2Q15 and demand for local bonds has declined with the majority of bond auctions since the end of 3Q14 cancelled. When bonds were sold, issuance fell short of plan and yields were in double digits, a trend likely to continue into 1Q15.

The local OFZ curve is very flat making currency hedging expensive while the front end continues to be vulnerable to hikes. We think the belly of the local curve is more attractive than the wings but prefer the USD hard currency bonds. While not immune from geopolitical and economic risks, hard currency bonds are less impacted by rate hikes and RUB declines. The bonds are also more attractive on a Z-spread basis. The RUSSIA USD 22s and 23s offer the best value on the USD hard currency curve. Relative value trades are the least risky option in the local curve. We think there is value in a 2s5s flattener ahead of expected rate hikes.

OIS curve is pricing in rate hikes ahead




Spread between 23s and 17s should flatten in event of a rate hike




Source: Bloomberg; UniCredit Research

**GOVERNMENT GROSS FINANCING REQUIREMENTS**

| EUR bn | 2014F | 2015F | 2016F |
|---|---|---|---|
| **Gross financing requirement** | **5.4** | **14.2** | **21.9** |
| Budget deficit | -11.4 | -3.8 | 5.6 |
| Amortisation of public debt | 16.0 | 16.5 | 15.0 |
| Domestic | 15.2 | 14.7 | 15.0 |
| Bonds | 15.2 | 14.7 | 15.0 |
| Bills | n.a. | n.a. | n.a. |
| External | 0.8 | 1.9 | n.a. |
| Sovereign Fund | 0.8 | 1.5 | 0.3 |
| **Financing** | **5.4** | **14.2** | **21.9** |
| Domestic borrowing | 5.0 | 13.7 | 13.7 |
| Bonds | 5.0 | 13.7 | 13.7 |
| Bills | n.a. | n.a. | n.a. |
| External borrowing | n.a. | n.a. | 5.0 |
| Bonds | n.a. | n.a. | 5.0 |
| Other | 0.4 | 0.5 | 2.2 |

**GROSS EXTERNAL FINANCING REQUIREMENTS**

| EUR bn | 2014F | 2015F | 2016F |
|---|---|---|---|
| **Gross financing requirement** | **61.1** | **98.9** | **80.7** |
| C/A deficit | -38.2 | -12.8 | -7.1 |
| Amortisation of debt | 93.8 | 107.9 | 80.9 |
| Government/central bank | 0.8 | 1.9 | 1.9 |
| Banks | 28.0 | 38.0 | 30.5 |
| Corporates | 65.0 | 68.0 | 48.5 |
| Errors and omissions | 5.4 | 3.8 | 6.9 |
| **Financing** | **61.1** | **98.9** | **80.7** |
| FDI | -20.0 | -4.3 | 10.7 |
| Equity | 0 | 0 | 0 |
| Borrowing | 39.8 | 51.6 | 65.7 |
| Government/central bank | 0 | 0 | 5.0 |
| Banks | 10.5 | 15.8 | 22.5 |
| Corporates | 29.3 | 35.8 | 38.2 |
| Domestic investments abroad | 75.4 | 41.1 | 13.2 |
| Official reserves change/other | -34.1 | 10.5 | -9.0 |

Source: Rosstat, CBR, Unicredit Research

# Serbia (B1 stable/BB- negative/B+ stable)*

**Outlook –** The Serbian economy is expected to contract by 0.7% yoy in 2015, driven by weak domestic demand and sluggish trade activity. Domestic consumption will weaken further due to the budgeted cuts to public expenditures, while net trade activity is expected to accelerate only from 2H15. We view the low inflation environment supportive of further rate cuts in 1Q15, with scope for a minimum of 125bp in rate cuts by end-2015. The signing of the IMF deal is encouraging as it will provide Serbia with a much-needed fiscal anchor, but public debt will remain excessively high and not expected to stabilise until 2018.

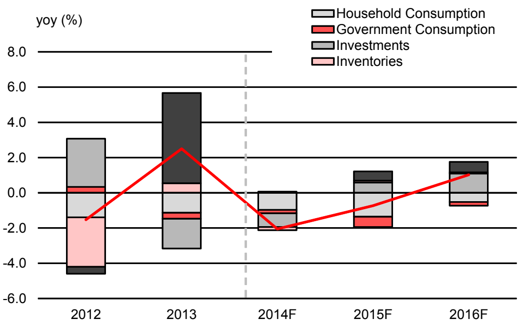
**Strategy –** Bonds have rallied into the IMF agreement but weaker bond auctions and widening yields post the agreement suggest the bulk of the rally may be over. We are expecting the MinFin to issue a Eurobond in 1Q 15 which should cover a large part of 2015 financing needs. We think the reform process is at risk of political inertia and think that compared to Croatia, Serbian paper is overvalued.

**Author: Carlos Ortiz, Economist (UniCredit Bank London)**

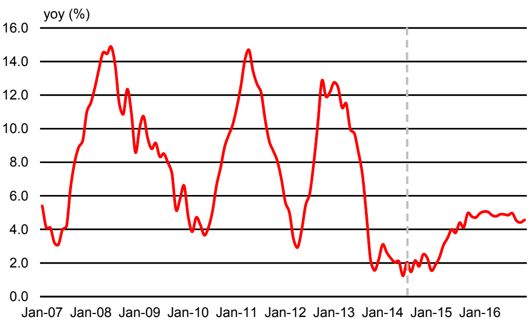
### KEY DATES/EVENTS

- 11 Dec, 11-12 Jan – Policy rate decision
- 12 Dec, 9 Jan, 13 Feb – Consumer Price Index
- 30 Dec, 30 Jan, 27 Feb – Industrial output
- 30 Dec, 30 Jan, 27 Feb – Trade balance

### DOMESTIC DEMAND TO CATCH-UP IN 2015




### INFLATION TO EASE IN 1H15, BUT REMAINS OUT OF TARGET




Source: NBS, MinFin, UniCredit Research

### MACROECONOMIC DATA AND FORECASTS

| | 2012 | 2013 | 2014F | 2015F | 2016F |
|---|---|---|---|---|---|
| GDP (EUR bn) | 31.7 | 34.3 | 33.1 | 32.1 | 32.2 |
| Population (mn) | 7.2 | 7.2 | 7.2 | 7.2 | 7.2 |
| GDP per capita (EUR) | 4,401 | 4,785 | 4,599 | 4,454 | 4,477 |
| **Real economy yoy (%)** | | | | | |
| GDP | -1.5 | 2.5 | -2.1 | -0.7 | 1.0 |
| Private Consumption | -1.8 | -1.5 | -1.3 | -1.8 | -0.7 |
| Fixed Investment | 14.4 | -7.7 | -3.9 | 3.0 | 5.4 |
| Public Consumption | 1.7 | -1.7 | -1.0 | -3.0 | -1.1 |
| Exports | 1.8 | 16.6 | 3.5 | 4.2 | 5.4 |
| Imports | 1.9 | 2.0 | 2.5 | 2.3 | 3.2 |
| Monthly wage, nominal (EUR) | 508 | 537 | 529 | 465 | 463 |
| Unemployment rate (%) | 23.9 | 22.1 | 20.7 | 21.8 | 22.0 |
| **Fiscal accounts (% of GDP)** | | | | | |
| Budget balance* | -6.6 | -5.0 | -5.6 | -4.6 | -4.3 |
| Primary balance | -4.5 | -2.4 | -2.2 | -0.4 | 0.7 |
| Public debt | 60.2 | 63.8 | 75.5 | 84.8 | 91.3 |
| **External accounts** | | | | | |
| Current account balance (EUR bn) | -3.6 | -2.1 | -2.2 | -1.8 | -1.6 |
| Current account balance/GDP (%) | -11.5 | -6.1 | -6.7 | -5.7 | -4.9 |
| Basic balance/GDP (%) | -9.4 | -2.5 | -2.6 | -1.0 | 0.2 |
| Net FDI (EUR bn) | 0.7 | 1.2 | 1.3 | 1.5 | 1.6 |
| Net FDI (% of GDP) | 2.1 | 3.6 | 4.0 | 4.7 | 5.0 |
| Gross foreign debt (EUR bn) | 25.6 | 25.8 | 26.0 | 27.5 | 28.8 |
| Gross foreign debt (% of GDP) | 80.9 | 75.2 | 78.5 | 85.7 | 89.4 |
| FX reserves (EUR bn) | 12.0 | 12.1 | 10.5 | 11.2 | 10.8 |
| **Inflation/Monetary/FX** | | | | | |
| CPI (pavg) | 7.3 | 7.9 | 2.1 | 3.6 | 4.8 |
| CPI (eop) | 12.2 | 2.2 | 2.3 | 4.7 | 4.6 |
| Central bank target | 4.0±1.5% | 4.0±1.5% | 4.0±1.5% | 4.0±1.5% | 4.0±1.5% |
| Central bank reference rate (eop) | 11.25 | 9.50 | 8.00 | 6.75 | 6.50 |
| 3M money market rate (Dec avg) | 11.64 | 10.15 | 8.24 | 7.45 | 7.65 |
| USD/RSD (eop) | 113.13 | 113.09 | 117.18 | 127.34 | 134.54 |
| EUR/RSD (eop) | 86.18 | 83.13 | 98.85 | 109.77 | 114.02 |
| USD/RSD (pavg) | 87.96 | 85.16 | 88.46 | 105.98 | 112.15 |
| EUR/RSD (pavg) | 113.72 | 114.64 | 120.60 | 127.34 | 134.54 |

Source: UniCredit Research

*Long-term foreign currency credit rating provided by Moody's, S&P and Fitch respectively

## Put to the Test

**3Q14 GDP contracted further due to shrinking private investments and exports**

**The Serbian economy is expected to remain in recession in 2015, hindered by May floods and a weaker global trade environment**. Preliminary GDP data from 3Q14 showed GDP contract by 3.6% yoy, down from a negative 1.3% in 2Q14. This placed the GDP drop in 9M14 at -1.8% yoy, the lowest level since September 2012. The drop in activity was driven by shrinking industrial production (down 14.3% yoy in 3Q14), which continued to be negatively affected by May floods, particularly in the gas & electricity (-38%) and mining sectors (-28.3%). But manufacturing activity also remained weak (-5.8% yoy), owing to the halt in production of Fiat cars during the collective annual vacation in August and the overhaul in the Pančevo refinery. The above impacted domestic demand notably, particularly among private fixed investment which fell 7.6% yoy in 3Q14 (or 5% yoy s.a). Government (-1.6% yoy) and private (-1.2% yoy) consumption also contracted in 3Q14, but their negative contribution was offset by the increase in inventories of a number of agricultural products. In contrast, net exports subtracted a whopping 4.8pp from headline GDP growth amidst falling exports (-5.9% yoy) and rising (energy-driven) imports (1.9%)

**The contribution from net exports will flatten this year…**

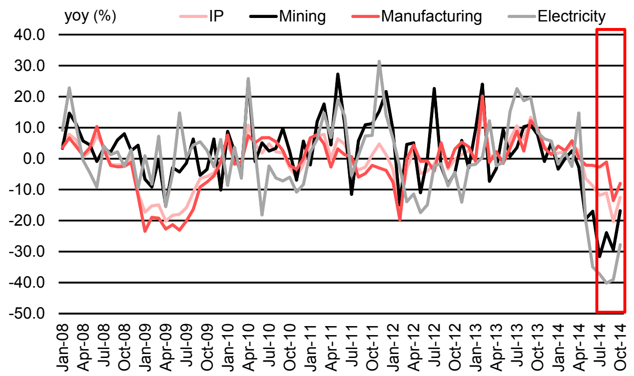
**Against this backdrop, we expect the economy to contract by 2.1% this year and by 0.7% in 2015**. The drop in FY14 GDP will be exclusively attributed to weaker domestic demand, as the contribution from net exports is expected to flatten. Next year, we should see some rebalancing, but domestic demand will keep the economy in recession on the back of austerity measures. On this front, private consumption is expected to contract by 1.8% yoy and subtract close to 1.4pp from GDP growth, driven primarily by the budgeted cuts to public sector wages and pensions. The restructuring of SOEs and the continuation of the partial government employment freeze will weigh further on consumption, and this is expected to lift the unemployment rate to 21.8%. At the same time, public expenditure growth is expected to remain negative throughout the forecast horizon. In contrast, we should see investments pick up due to reconstruction activity in the flood-hit areas, but downside risks remain, particularly if credit conditions for firms continue to tighten. As for net exports, we do not expect a strong rebound due to the slow recovery of main European trading partners, but overall they should add an average of 0.5pp of GDP per annum until 2016.

**….and widen the C/A deficit to 6.7% of GDP**

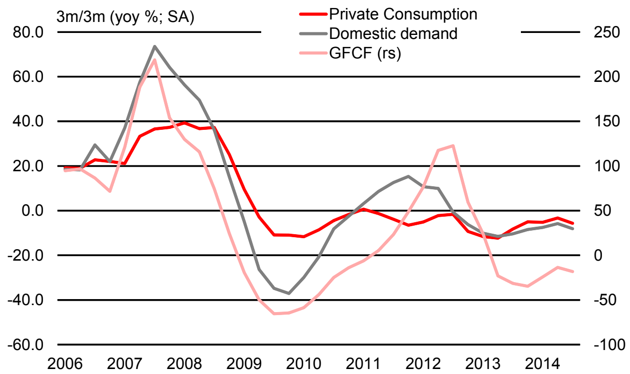
**The C/A deficit is set to widen this year but is expected to recover as soon as global trade recovers in 1H15**. In 3Q14, the C/A deficit widened by 33.5% yoy to EUR 0.5bn, bringing the Jan-Sept deficit to EUR 1.5bn. This widening was primarily driven by the deterioration of the trade deficit, up 43.9% yoy to EUR 0.9bn, but also by the fall of remittance inflows, down 3.6% yoy to EUR 0.7bn. Provided this trend is maintained, and energy imports continue to rise in 4Q14 (+3.3% yoy in 3Q14), we estimate the C/ A deficit this year to widen to EUR 2.2bn (or 6.7% of GDP). That said, it should narrow from next year on as trade recovers, and eventually reach 5% of GDP by the 2016.

**RECESSION IN 2014 DRIVEN ENTIRELY BY DOMESTIC DEMAND …**

Despite the uptick in October, IP will remain weak…




…and weigh negatively on domestic consumption and investment




Source: Markit, MinFin, Haver, UniCredit Research

**Food and administered prices will drive the acceleration of inflation in 1H15**

**Inflation remains tame and is expected to reach the NBS target band of 4±1.5% only by 2Q15.** In October, inflation decelerated to 1.8% yoy (from 2.1% in September), constituting the eighth consecutive month in which it remained below the NBS's target range. The drop was driven primarily by the deceleration in food prices (down 1.4% mom; +0.5% yoy) but these are expected to accelerate from here due to base effects. The two hikes to gas prices since October will nonetheless have a limited impact on headline inflation given their small share in the consumer basket (0.66%). Consequently, we expect inflation to reach the NBS's target band only by April next year, when the government is expected to introduce an excise duty on electricity prices (ca. 10%). Disinflationary factors will also come into play, namely from weak domestic demand, which should help keep inflation stable around target until end-2016.

**We expect a minimum of 125bp in rate cuts by end-2015**

**The low inflation environment should open the door for further rate cuts in 1Q15,** provided EM risk appetite remains supportive. In November, the NBS cut the policy rate by 50bp to 8%, after four consecutive months of being kept unchanged. The move came earlier than expected and was accompanied by a decrease in FX reserve requirement ratios. In our view, this measure risks proving counter-effective as it could trigger a steeper contraction of FX lending by banks, given their ongoing deleveraging strategy on FX assets. Instead, the cost of credit should cheapen, since Serbia continues to have one of the largest real rates in the region at a time when the economy is facing a deep recession. Thus, we expect the NBS to continue the easing cycle in 1Q15, with scope for a minimum of 125bp by end-2015.

**NPLs remain large but can be fully covered by provisions**

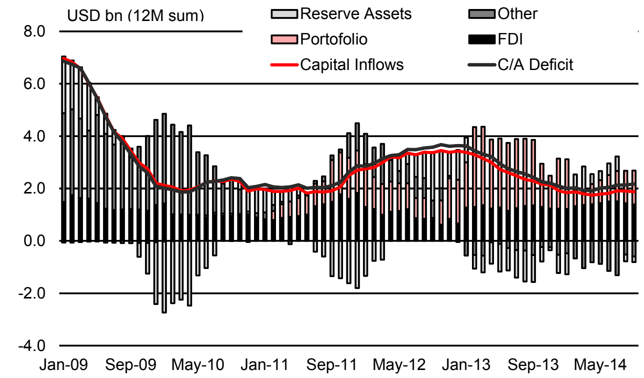
**The weakness in RSD and in domestic demand is expected to raise banks' NPLs further,** but potential losses are fully covered by regulatory provisions. As of August, total NPLs stood at 22.8% and were centered around companies in the manufacturing, trade and construction sectors (27.1%). With RSD weakness in sight (2015F at 127/EUR), we expect NPLs to increase further but will remain manageable. On this note, regulatory (111%) and IFRS (54%) provisions cover half of NPLs, while capital buffers remain relatively strong (CAR at 20.4% at end-August) and above minimum regulatory requirements (12%).

**The restructuring of Serbia's SOEs remains essential to make the government's medium-term fiscal plan viable**

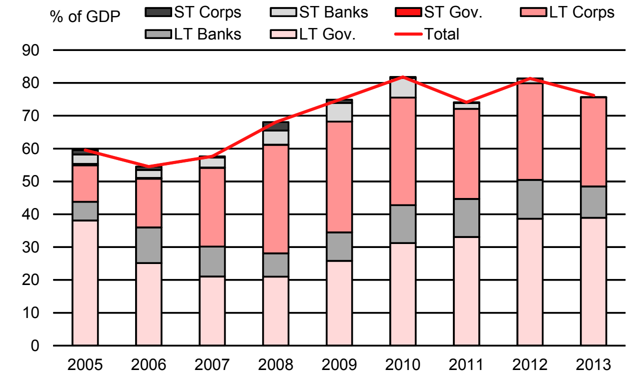
**We welcome the IMF deal as it will provide Serbia with a much-needed fiscal anchor.** On 20 November, Serbia reached an agreement with the IMF over a three-year precautionary program worth EUR 1bn. The program will enter into force on 1 January 2015, with the first quarterly review scheduled for mid-May. Overall, the program targets savings of EUR 1.3-1.5bn over the next three years in order to bring the budget deficit down to 3% of GDP by 2017. The 2015 budget will be presented to Parliament in mid-December and is expected to include most measures adopted in the 2014 revised budget. Overall, we expect the consolidated deficit this year to widen to 5.6% of GDP (or 8.2% of GDP if below-the-line-items are included), and ease to 4.6% of GDP in 2015 provided contingent payments are reduced as planned and consolidated revenues remain stable. This should put public debt at 84% of GDP by end-2105, double that in 2010.

**EXTERNAL IMABALANCES HAVE CORRECTED, BUT REMAIN LARGE**

Serbia remains highly dependent on portfolio capital…




…weighing against the sovereign's high stock of external debt




Source: MinFin Haver, NBS, UniCredit Research

## Strategy: Bulk of the rally is likely over

**Bonds tightened significantly in run-up to the IMF deal but have not maintained this trend**

**We expect the MinFin will issue a EUR 1-2bn Eurobond in 1Q15**

USD denominated bonds tightened significantly in the lead up to the IMF deal but have now widened. Recently, local bond and bill auctions have been weak compared to before the IMF agreement, suggesting that the rally may be over. Nevertheless, given current low yields, we expect the MinFin to come to the market in 1Q15 and issue a long dated EUR 1-2bn Eurobond, which should cover a large part of the financing target for 2015.

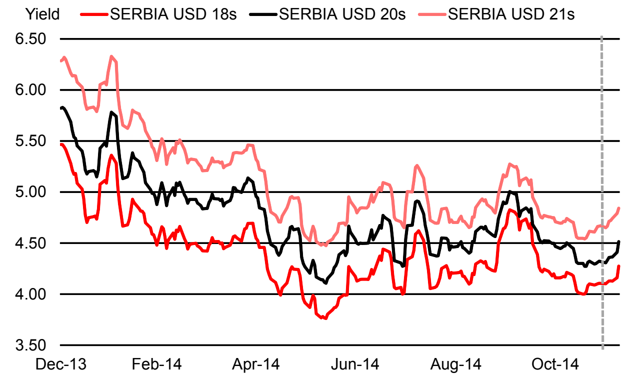
**The reform process could be at risk of political inertia, and…**

**...as such we think that Serbian bonds should not trade inside Croatian bonds**

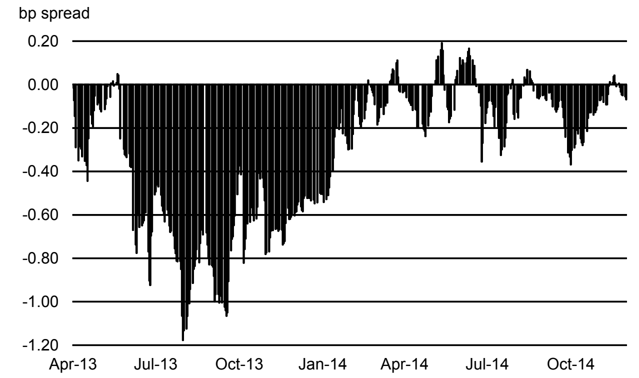
We could see further tightening in bonds if the IMF agreed-on reforms are implemented swiftly but we have some concerns regarding the breadth and complexity of the task. We worry that the process may be hampered by political inertia in individual ministries, resulting in the plan falling behind schedule. Given this risk, we think that Serbian bonds should not trade inside Croatian paper. Croatia is further along the reform process, has access to EU funds and benefits from ECB liquidity. We recommend going long CROATI USD 20s against a short SERBIA USD 20s, expecting the spread to widen at least 40bp.

**WE THINK THAT THE USD CURVE IS REACHING A FLOOR**

Rally appears to be ending, widening after IMF deal in November…




Spread between CROATIA USD 20 and SERBIA USD 20




Source: Bloomberg, UniCredit Research

**GOVERNMENT GROSS FINANCING REQUIREMENTS**

| EUR bn | 2014F | 2015F | 2016F |
|---|---|---|---|
| **Gross financing requirement** | **5.9** | **5.8** | **5.0** |
| Budget deficit | 2.7 | 2.2 | 1.8 |
| Amortization of public debt | 3.3 | 3.4 | 3.2 |
| Domestic | 2.2 | 2.8 | 2.7 |
| Bonds | 0.3 | 1.7 | 1.8 |
| Bills | 1.9 | 1.1 | 0.9 |
| External | 1.1 | 0.6 | 0.6 |
| IMF | 0.6 | 0.1 | 0 |
| **Financing** | **5.9** | **5.8** | **5.0** |
| Domestic borrowing | 3.7 | 3.7 | 4.0 |
| Bonds | 2.4 | 2.4 | 2.5 |
| Bills | 1.4 | 1.3 | 1.5 |
| External borrowing | 1.3 | 2.1 | 1.9 |
| Bonds | 0 | 0.7 | 0.9 |
| IMF/EU | 0.5 | 0.4 | 0.1 |
| Other | 0.8 | 0.9 | 0.9 |
| Change in cash reserves (+ = decline) | 0.9 | 0 | -0.9 |

**GROSS EXTERNAL FINANCING REQUIREMENTS**

| EUR bn | 2014F | 2015F | 2016F |
|---|---|---|---|
| **Gross financing requirement** | **5.8** | **5.6** | **5.2** |
| C/A deficit | 2.2 | 1.8 | 1.6 |
| Amortization of medium to long term debt | 3.3 | 3.7 | 3.6 |
| Government/Central Bank | 1.1 | 0.6 | 0.6 |
| IMF | 0.6 | 0.1 | 0 |
| Other | 0.5 | 0.5 | 0.5 |
| Banks | 0.3 | 0.6 | 0.6 |
| Corporates | 0.9 | 1.9 | 1.9 |
| Amortization of short term debt | 0.2 | 0.1 | 0 |
| Government/Central Bank | 0 | 0 | 0 |
| Banks | 0.2 | 0.1 | 0 |
| Corporates | 0 | 0 | 0 |
| **Financing** | **5.8** | **5.6** | **5.2** |
| FDI | 1.2 | 1.3 | 1.5 |
| Equity | 0 | 0 | 0 |
| Borrowing | 3.7 | 4.5 | 4.2 |
| Government/Central Bank | 1.3 | 2.1 | 1.9 |
| IMF | 0.5 | 0.4 | 0.1 |
| Bonds | 0 | 0.7 | 0.9 |
| Other | 0.8 | 0.9 | 0.9 |
| Banks | 1.1 | 0.6 | 0.6 |
| Corporates | 1.3 | 1.8 | 1.7 |
| Change in FX reserves (+ = decline) | 0.9 | -0.2 | -0.5 |

Source: NBS, MinFin, UniCredit Research

# Turkey (Baa3 negative/BB+ negative/BBB- negative)*

**Outlook –** In 2015, a better outlook for growth and inflation needs to be balanced against the risk of recurring external vulnerabilities. We expect growth in Turkey to improve to 3.4% yoy in 2015 and 4.2% yoy in 2016 from 2.9% yoy in 2014. Better credit growth is expected to boost investment and private consumption, with pre-election spending adding to the mix. Falling oil prices will probably mitigate the effect of stronger domestic demand on the CAD in 1H15, while falling inflation could boost capital inflows and real wages. The CBRT is expected to cut rates, but an aggressive easing cycle could jeopardise the rollover of short term foreign financing, which continues to grow fast, especially for banks.

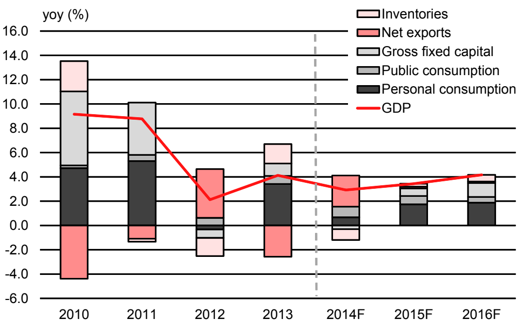
**Strategy –** Falling inflation is expected to support TURKGBs and the TRY in 1H15 and we prefer the 5Y part of the curve. In case the CBRT cuts are too aggressive, we favour a 2s5s steepener. In external debt, we prefer TURKEY USD 20s and TURKEY USD 40s.

**Author: Carlos Ortiz, Economist (UniCredit Bank London)**

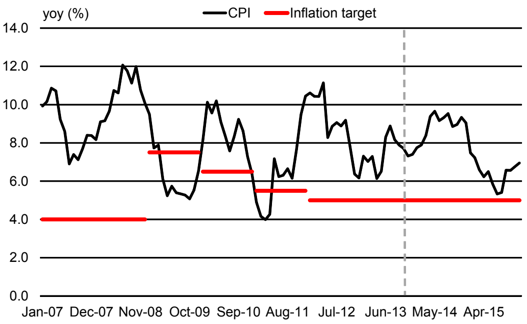
### KEY DATES/EVENTS

- 24 Dec, 17 Jan – Policy rate decision
- 31 Dec, 25 Jan – Trade balance
- 2 Jan, 2 Feb, 2 Mar – Manufacturing PMI
- 13 June 2015 – General elections

### DOMESTIC DEMAND TO CATCH-UP IN 2015




### INFLATION TO EASE IN 1H15, BUT REMAINS OUTSIDE OF TARGET




Source: Turkstat, CBRT, UniCredit Research

### MACROECONOMIC DATA AND FORECASTS

| | 2012 | 2013 | 2014F | 2015F | 2016F |
|---|---|---|---|---|---|
| GDP (EUR bn) | 614.9 | 617.8 | 604 | 753 | 812 |
| Population (mn) | 74.9 | 76.5 | 77.3 | 78.2 | 79.0 |
| GDP per capita (EUR) | 8,211 | 8,077 | 7,814 | 9,632 | 10,282 |
| **Real economy yoy (%)** | | | | | |
| GDP | 2.1 | 4.1 | 2.9 | 3.4 | 4.2 |
| Private Consumption | -0.5 | 5.1 | 1.0 | 2.6 | 2.9 |
| Fixed Investment | -2.7 | 4.2 | -1.2 | 2.6 | 4.9 |
| Public Consumption | 6.1 | 6.2 | 8.0 | 6.0 | 4.0 |
| Exports | 16.3 | -0.3 | 8.1 | 5.1 | 6.0 |
| Imports | -0.4 | 9.0 | -1.5 | 4.5 | 5.5 |
| Monthly wage, nominal (EUR) | 919 | 961 | 955 | 1,208 | 1,301 |
| Unemployment rate (%) | 8.4 | 9.1 | 9.6 | 9.5 | 9.5 |
| **Fiscal accounts (% of GDP)** | | | | | |
| Budget balance | -2.0 | -1.2 | -1.9 | -2.1 | -1.5 |
| Primary balance | 1.4 | 2.0 | 1.1 | 0.9 | 1.6 |
| Public debt | 37.6 | 37.4 | 40.0 | 41.9 | 41.7 |
| **External accounts** | | | | | |
| Current account balance (EUR bn) | -37.7 | -49.0 | -29.4 | -33.4 | -45.2 |
| Current account balance/GDP (%) | -6.1 | -7.9 | -4.9 | -4.4 | -5.6 |
| Basic balance/GDP (%) | -3.9 | -5.9 | -2.4 | -2.1 | -3.2 |
| Net FDI (EUR bn) | 13.5 | 12.4 | 14.9 | 17.6 | 19.3 |
| Net FDI (% of GDP) | 2.2 | 2.0 | 2.5 | 2.3 | 2.4 |
| Gross foreign debt (EUR bn) | 256.7 | 282.3 | 282.6 | 282.6 | 283.4 |
| Gross foreign debt (% of GDP) | 41.8 | 45.7 | 46.8 | 37.5 | 34.9 |
| FX reserves (EUR bn) | 75.7 | 80.4 | 79.2 | 78.7 | 78.5 |
| **Inflation/Monetary/FX** | | | | | |
| CPI (pavg) | 8.9 | 7.5 | 8.94 | 6.46 | 7.08 |
| CPI (eop) | 6.2 | 7.4 | 9.05 | 6.95 | 6.27 |
| Central bank target | 5.0 | 5.0 | 5.0 | 5.0 | 5.0 |
| Central bank reference rate (eop) | 5.50 | 4.50 | 8.25 | 7.25 | 7.00 |
| 3M money market rate (Dec avg) | 5.8 | 9.1 | 9.70 | 8.50 | 8.30 |
| USD/TRY (eop) | 1.79 | 2.07 | 2.24 | 2.25 | 2.30 |
| EUR/TRY (eop) | 2.35 | 2.83 | 2.73 | 2.59 | 2.71 |
| USD/TRY (pavg) | 1.80 | 1.91 | 2.18 | 2.17 | 2.28 |
| EUR/TRY (pavg) | 2.32 | 2.53 | 2.90 | 2.56 | 2.65 |

Source: UniCredit Research

*Long-term foreign currency credit rating provided by Moody's, S&P and Fitch respectively

## Better growth, same risks

**We expect growth at 3.4% yoy in 2015…**

**In 2015, a better outlook for growth and inflation needs to be balanced against the risk of recurring external vulnerabilities.** The Turkish economy is set for a domestic demand-driven rebound that is announced by accelerating credit growth and improving business sentiment. We expect growth at 3.4% yoy in 2015 and 4.2% yoy in 2016, after 2.9% yoy in 2014. Private consumption could accelerate to 2.6% yoy in 2015 vs. 1% yoy in 2014, in parallel with a rebound in fixed investment (2.6% yoy in 2015 vs. -1.2% yoy). The premises of stronger domestic demand lie in improving data in 2H14.

**…driven by accelerating credit growth and domestic demand**

**Credit growth is expected to accelerate further**, after reversing completely the slowdown from January – June 2014 to grow by 23.5% (13w/13w avg. annualized) at end-November. Commercial loans outperformed, increasing by approximately 25%. Even so, the credit impulse to domestic demand will remain negative until 2H15 due to the strong deceleration in 1H14. Backing loan demand, the manufacturing PMI rose to a nine-month high in November due to strong employment and increasing capacity utilisation, although industrial production has lagged this improvement (+2.4% yoy in October). The big risk to the recovery in the corporate sector is the Turkish companies' large open FX positions (ca. 22% of GDP), which makes their cash flows and new investments highly vulnerable to FX volatility.

**The contribution from net exports will flatten next year due to Iraq and a slower EMU…**

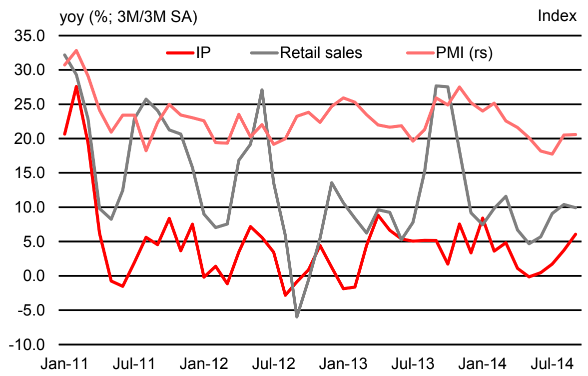
**The recovery of private consumption could be more sluggish** amid a slowdown in real wage growth below 6% yoy in 3Q14, but disinflation should boost real revenues in 1H15. In addition, general elections scheduled for June 2016 are expected to support confidence, public and private spending. In contrast, we expect the contribution from net exports to flatten next year, as trade will remain constrained by a weak EMU recovery and the fighting in Iraq. Turkey failed to capitalize on sanctions between the EU and Russia, with exports to the latter falling by 13.3% yoy in 3Q14, but food and manufacturing exports could fare better in 2015.

**…but this should not prevent the C/A deficit adjusting further in 2015**

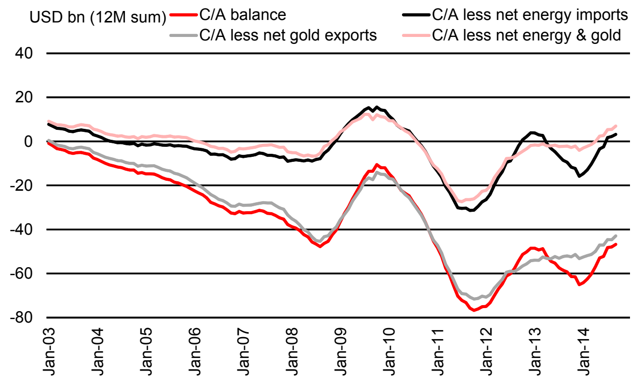
**Falling oil prices could reduce the 2015 C/A deficit below 5% of GDP** for the first time in five years. This improvement also captures a delayed reaction to the domestic demand adjustment from 2014, for which we expect a CAD of USD 41bn or 5.1% of GDP. In 9M14, the C/A deficit narrowed by 37.2% yoy to USD 30.8bn (or 4.1% of GDP), driven primarily by the trade balance (down 18.5% yoy). The adjustment continued in 4Q14, albeit at a slower pace(imports fell by 1.5% yoy in October). A resurgent domestic demand will probably offset lower energy prices in 2H15 and 2016, leading to an expected re-widening of the CAD to 5.8% of GDP in 2016, driven by a larger trade deficit, both due to an expected recovery in oil prices and higher non-energy imports.

**DOMESTIC DEMAND TO REBOUND IN 2015, ALBEIT MODERATELY…**

Despite the uptick, industrial and retail activity remain weak




Lower oil prices will help reduce the C/A deficit to pre-crisis levels




Source: Markit, CBRT, Haver, UniCredit Research

**Turkey's funding remains highly vulnerable to changes in EM risk sentiment**

**The C/A financing will continue to rely excessively on short term flows.** A falling C/A deficit was easier to cover in 2014, but the structure of financing was still dominated by portfolio capital and short-term bank flows (ca. 42% of total in 9M14). As a result, the banks' short term external debt rose to 18.4% of GDP by mid-2014, jumping 5pp in just 2 years and exceeding the aggregate short term external debt of all other sectors by USD 20bn. Since May 2014, fund inflows into local bonds exceeded USD 5bn, reversing the outflows from the first five months of the year, but this was not reflected in reserve accumulation at the central bank, whose net reserves remain below USD 30bn. This leaves Turkey increasingly vulnerable to changes in EM risk sentiment, particularly if the Fed adopts a more hawkish tone over the course of 1H15.

**We expect the CBRT to resume rate cuts in 1Q15, delivering at least 100bp by mid-2015**

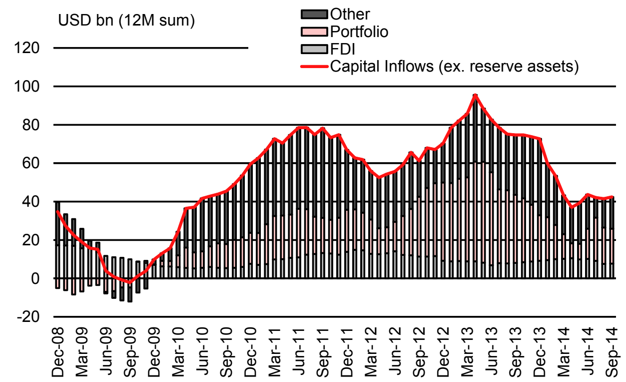
**On a more positive note, inflation will ease in 1H15,opening the door for further rate cuts.** Base effects from lower food and FX pass-through, as well as falling oil prices could push headline inflation down by more than 3pp by the summer of 2015 from an expected 9.0% yoy at the of 2014. In 2H15, though, inflation could rebound to 7% yoy amid stronger domestic demand and fewer positive supply-side shocks. Neither inflation expectations, nor the CBRT's inflation projections (8.9% in 2015 and 6.1% in 2016) reflect potential disinflation, but we expect a fast adjustment to both in early 2015. As a result, the CBRT is expected to resume rate cuts in 1Q15, delivering at least 100bp by mid-2015 and easing liquidity conditions in the process. A reduction of the O/N lending rate cannot be excluded either, but it is likely to come at a later stage, since it currently provides the CBRT with ample flexibility to react to sudden changes in global market conditions. The main risk is that the CBRT cuts more or faster-than-expected amid political pressure, thus threatening TRY stability.

**A tighter fiscal stance will be required to bring the primary surplus to 2% of GDP by 2017**

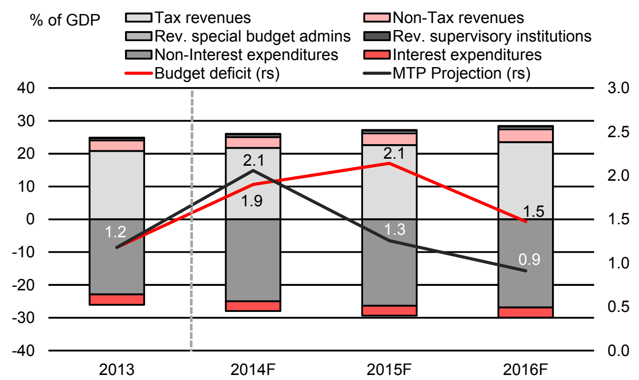
**Despite general elections next year, the expected budget deficit widening will be limited** (to 2.1% of GDP from 1.9% of GDP in 2014). Budget performance has deteriorated in 2014 amid local and presidential elections. Between January and September, total primary expenditures had risen by 12.7% yoy to TRY 317bn. Moreover, the structure of expenditure deteriorated, with capital transfers being the only expenditure items that did not increase. Strong tax revenues (up 7.9% YTD in 9M14) partly offset higher spending. In 2014, almost half of the fall in the primary balance (to 1.1% of GDP from 2.0% of GDP a year ago) was covered by lower interest expenditure (down 0.4pp to 1.8% of GDP). But a normalization of rates in the US could add to interest costs in 2015 and 2016. With the general elections just around the corner, we expect the government to push on fiscal to stimulate activity (i.e. non-interest expenditures up 1.4pp of GDP) and lift the deficit 0.9pp above the target of 1.3% of GDP. More than a reduction of the deficit level, Turkey needs to reform the structure of public spending to avoid a gradual widening of budget gaps. Meanwhile, public debt is expected to stabilise around 42% of GDP in 2015 and 2016.

**FUNDING ANF FISCAL IMBALANCES REMAIN MANAGEABLE, FOR NOW…**

Turkey remains over reliant on portfolio capital




Primary expenditures cuts are required to meet MTP objectives




Source: Haver, MinFin, CBRT, UniCredit Research

## Strategy: Falling inflation likely supportive for TURKGBs

**We recommend overweight in TURKGB despite risks**

**Falling inflation should be positive for TURKGBs in 1Q15**

We recommend being overweight in TURKGBs. Despite potential risks from slowing growth, geopolitical conflicts and C/A widening, inflation should fall sharply in H1 2015. Base effects from food and transport which added 2.7pp to inflation in 1H14 will come off, while TRY appreciation, falling oil prices and combined USD 1.3bn of foreign inflows since Q3 2014, should give support. Provided oil prices and the TRY basket are stable and Russian sanctions remain in place we expect bonds to be well supported into 1Q15.

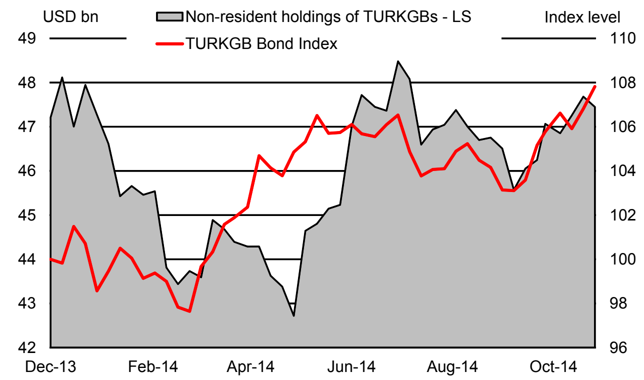
**Long only investors should move to the belly of the curve**

**If inflation falls by more than the market expects….**

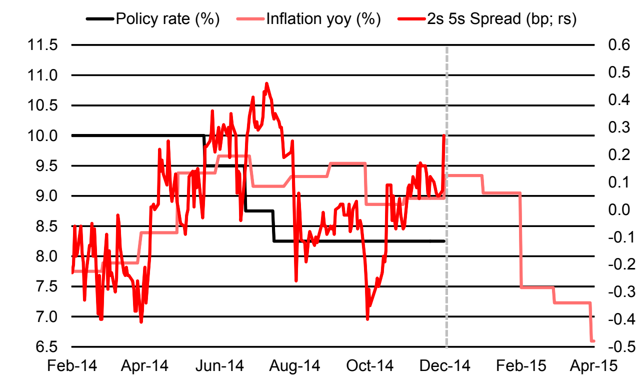
**…..we expect rate cuts and would initiate a 2s 5s steepener**

For long only investors, we recommend moving duration to the 5Y area on the curve, which is attractive from both a yield and Z-spread perspective. As inflation falls, the likelihood of a rate cut increases. We are expecting inflation at 6.6% by Q1 2015 vs. market estimates of 7.40%, and think that a cut of under 50bp should be positive for the bond curve. If inflation drops more significantly shorter term we would look to initiate a 2s5s steepener in anticipation of a rate cut. On the hard currency curves, we favor the TURKEY USD 22 and also the longer dated TURKEY USD 40.

Foreign inflows continue to support TURKGBs




If inflation drops significantly – initiate a short term 2s 5s steepener




Source: Bloomberg, UniCredit Research

**GOVERNMENT GROSS FINANCING REQUIREMENTS**

| EUR bn | 2014F | 2015F | 2016F |
|---|---|---|---|
| **Gross financing requirement** | **70.2** | **82.6** | **79.6** |
| Budget deficit | 11.5 | 16.1 | 12.0 |
| Amortisation of public debt | 58.7 | 66.5 | 67.6 |
| Domestic | 42.8 | 47.9 | 47.9 |
| Bonds | 42.8 | 47.9 | 47.9 |
| Bills | 0 | 0 | 0 |
| External | 15.9 | 18.5 | 19.7 |
| **Financing** | **70.2** | **82.6** | **79.6** |
| Domestic borrowing | 49.3 | 52.9 | 47.9 |
| Bonds | 49.3 | 52.9 | 46.9 |
| Bills | 0 | 0 | 1 |
| External borrowing | 15.6 | 18.6 | 18.9 |
| Other | 10.0 | 10.3 | 8.8 |
| Change in cash reserves(+ = decline) | -4.6 | 0.7 | 3.9 |

**GROSS EXTERNAL FINANCING REQUIREMENTS**

| EUR bn | 2014F | 2015F | 2016F |
|---|---|---|---|
| **Gross financing requirement** | **149.0** | **164.9** | **168.4** |
| C/A deficit | 29.4 | 33.4 | 45.2 |
| Amortisation of medium to long term debt | 25.9 | 23.8 | 22.2 |
| Government/central bank | 2.0 | 2.1 | 2.2 |
| Banks | 12.1 | 9.2 | 8.2 |
| Corporates | 11.9 | 12.5 | 11.8 |
| Short term debt | 97.4 | 110.9 | 103.6 |
| Government/central bank | 13.9 | 16.4 | 17.5 |
| Banks | 57.2 | 65.3 | 58.5 |
| Corporates | 26.3 | 29.2 | 27.5 |
| Errors & omissions | -3.8 | -3.3 | -2.6 |
| **Financing** | **149.0** | **164.9** | **168.4** |
| FDI | 14.9 | 17.6 | 19.3 |
| Portfolio | 15.1 | 17.0 | 21.5 |
| Borrowing medium to long term | 32.1 | 26.9 | 27.4 |
| Government/central bank | 1.0 | 1.3 | 1.7 |
| Banks | 11.7 | 9.2 | 8.2 |
| Corporates | 19.4 | 16.4 | 17.5 |
| Short term borrowing | 98.4 | 102.2 | 109.2 |
| Government/central bank | 14.6 | 17.3 | 17.2 |
| Banks | 58.0 | 57.7 | 61.9 |
| Corporates | 25.9 | 27.2 | 30.1 |
| Other | -7.5 | -4.2 | -3.0 |
| Reserve accumulation | -3.9 | 5.5 | -6.0 |

Source: CBRT, Turkstat, UniCredit Research

# Ukraine (Caa3 negative/CCC stable/CCC negative)*

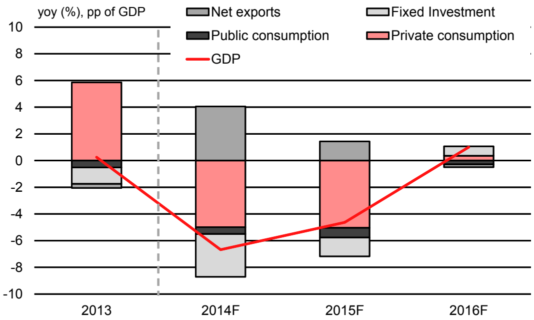
**Outlook** – Ukraine is facing a tough period ahead. The deepening recession is accentuating macroeconomic imbalances and the country will require further financial assistance in the form of additional loans from international lenders – mainly the IMF and the EU – and, potentially, a rescheduling of debt due in 2016 and 2017. The situation in financial markets is deteriorating rapidly amid deposit flight, sharp UAH depreciation and rising NPLs. The recession is expected to accelerate in 4Q14, with the economy needing a stabilization of the Donbas conflict in order to bottom out. A permanent truce in the Donbas would set the stage for stabilizing the economy, but will require concessions from Ukraine.

**Author: Dan Bucșa, Economist (UniCredit Bank London)**

### KEY DATES/EVENTS

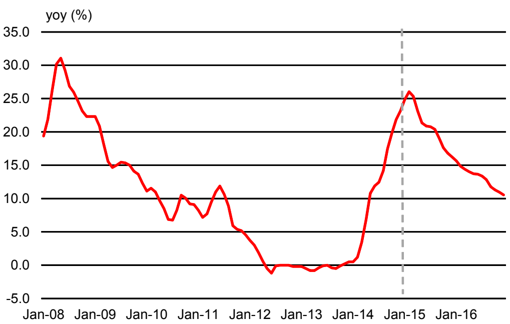
- 5-10th of each month: FX reserve data
- 15-18th of each month: Industrial production data
- Jan-Feb 2015: 3rd and 4th IMF tranches expected
- 20 Dec 2015: USD 3bn bond form Russia due

### GDP GROWTH COULD RESUME ONLY IN 2016




Source: State Statistics Service of Ukraine, UniCredit Research

### INFLATION EXPECTED TO PEAK IN 1H15




Source:State Statistics Service of Ukraine; UniCredit Research

### MACROECONOMIC DATA AND FORECASTS

| | 2012 | 2013F | 2014F | 2015F | 2016F |
|---|---|---|---|---|---|
| GDP (EUR bn) | 135.8 | 133.8 | 98.5 | 92.1 | 101.2 |
| Population (mn) | 45.5 | 45.4 | 45.3 | 45.2 | 45.0 |
| GDP per capita (EUR) | 2984 | 2947 | 2174 | 2038 | 2249 |
| **Real economy yoy (%)** | | | | | |
| GDP | 0.3 | 0.2 | -6.7 | -4.6 | 1.0 |
| Private Consumption | 9.1 | 7.8 | -6.2 | -6.2 | 0.4 |
| Fixed Investment | 2.8 | -6.7 | -18.8 | -9.5 | 5.0 |
| Public Consumption | 4.6 | -2.8 | -2.8 | -3.8 | -1.5 |
| Exports | -7.2 | -9.3 | -6.4 | -1.3 | 1.9 |
| Imports | 1.8 | -6.2 | -9.5 | -2.3 | 6.0 |
| Monthly wage, nominal (EUR) | 292 | 315 | 212 | 188 | 199 |
| Unemployment rate (%) | 7.8 | 7.5 | 8.6 | 9.0 | 8.7 |
| **Fiscal accounts (% of GDP)** | | | | | |
| Budget balance | -4.3 | -4.8 | -6.0 | -4.8 | -4.2 |
| Primary balance | -2.4 | -2.4 | -2.6 | -0.6 | 0 |
| Public debt | 37.4 | 40.9 | 62.0 | 76.2 | 93.0 |
| **External accounts** | | | | | |
| Current account balance (EUR bn) | -11.1 | -12.4 | -4.7 | -3.3 | -3.3 |
| Current account balance/GDP (%) | -8.2 | -9.3 | -4.8 | -3.6 | -3.2 |
| Basic balance/GDP (%) | -4.1 | -7.0 | -5.8 | -3.9 | -1.2 |
| Net FDI (EUR bn) | 5.6 | 3.1 | -1.0 | -0.3 | 2.0 |
| Net FDI (% of GDP) | 4.1 | 2.3 | -1.0 | -0.4 | 2.0 |
| Gross foreign debt (EUR bn) | 102.4 | 107.0 | 107.0 | 124.5 | 134.0 |
| Gross foreign debt (% of GDP) | 75.4 | 79.9 | 108.6 | 135.1 | 132.4 |
| FX reserves (EUR bn) | 17.2 | 14.1 | 5.8 | 5.1 | 5.9 |
| **Inflation/Monetary/FX** | | | | | |
| CPI (pavg) | 0.6 | -0.3 | 12.0 | 20.8 | 13.0 |
| CPI (eop) | -0.2 | 0.5 | 23.2 | 16.3 | 10.6 |
| Central bank target | tentative target of 5% by 2014 | | | | |
| Central bank reference rate (eop) | 7.50 | 6.50 | 14.00 | 11.50 | 10.00 |
| 3M money market rate (Dec avg) | 6.5 | 9.0 | 14.0 | 14.0 | 11.0 |
| USD/UAH (eop) | 8.07 | 8.24 | 16.00 | 17.00 | 18.00 |
| EUR/UAH (eop) | 10.62 | 11.33 | 19.52 | 19.55 | 21.24 |
| USD/UAH (pavg) | 8.08 | 8.15 | 11.89 | 16.48 | 17.41 |
| EUR/UAH (pavg) | 10.39 | 10.83 | 15.72 | 19.45 | 20.22 |

Source: UniCredit Research

*Long-term foreign currency credit rating provided by Moody's, S&P and Fitch respectively

## A daunting task ahead

**Ukraine is facing a worsening macroeconomic outlook…**

**…and larger financing needs**

Ukraine has never faced a more difficult period than 2015-2016 since gaining independence in 1991. The attempt at stabilising the country amid the poor track record in public policies and the recent conflict with Russia looks more of a daunting task as time goes by. With macroeconomic imbalances widening due to the recession, the country needs more money from international creditors and, potentially, a rescheduling of debt due in 2016 and 2017.

**Debt repayments are frontloaded in 2015-17**

Ukraine's marketable debt redemptions are frontloaded. Almost three quarters of its FX bonds (domestic and external) are due by the end of 2017. Financing needs amount to USD 13.6bn in 2015 and USD 11.2bn in 2016 when including only FX bond redemptions, IMF repayments and current account deficits, of which Naftogaz requirements are estimated under a very optimistic scenario[26]. We assume that the C/A net of gas imports will register a surplus in both 2015 and 2016, despite higher imports of energy and coal if the conflict in Donbas continues. A full closing of C/A gaps is unlikely due to adverse terms of trade. Food, minerals and metals account for more than 70% of exports with both demand and prices declining.

**The financing gap exceeds USD 14bn under optimistic assumptions…**

**…with the IMF and the EU the likeliest funding sources**

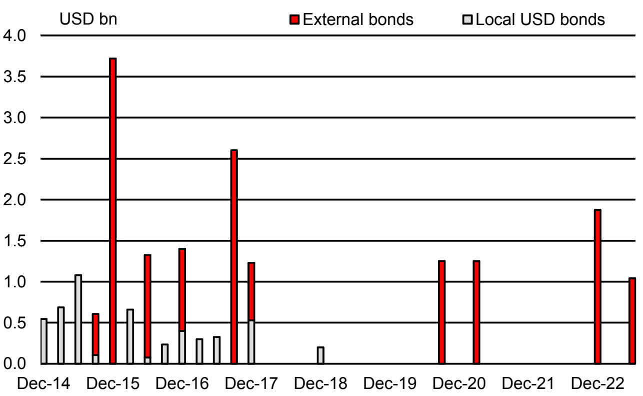
Even based on optimistic assumptions, Ukraine needs more than USD 26.0bn in additional financing to avoid a complete depletion of reserves by 2017. This could come via an increase in international support and perhaps a rescheduling of FX marketable debt due in 2016 and 2017. Additional money from the IMF would require a tougher reform program. The current one was designed to limit the pain inflicted on the private sector and make long-term adjustment more palatable. A sharper downturn, however, will probably lead to wider budget deficits than expected by the IMF in 2014 (6.0% vs. 5.8% of GDP), 2015 (4.8% vs. 3.9% of GDP) and 2016 (4.2% vs. 2.7% of GDP). The trade-off between bolder reforms and political stability is especially important in Ukraine, where the adjustment has been repeatedly aborted in the past under public pressure. An additional source of potential financing is the EU, which pledged EUR 11bn between 2014 and 2020, with more than EUR 1.5bn disbursed in 2014.

**A rescheduling of external bonds due in 2016 and 2017 is an option**

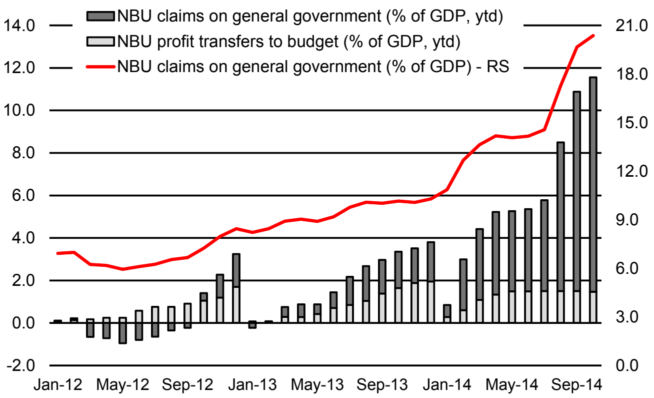
External bond redemptions amount to USD 5.6bn in 2016 and 2017, with domestically-issued FX bonds totaling USD 2.6bn. It is unclear if Ukraine will repay the latter in FX. In order to avoid a rapid depletion of reserves, Ukraine will probably try to reduce local financing needs via money creation and depreciation. The NBU increased its claims on the government above 20% of GDP (and 69% of marketable debt) by October 2014.

**DEBT FRONTLOADING AND DEBT MONETISATION**

Ukraine's external bond repayments are front-loaded




The NBU is financing a large share of the budget deficit




Source: NBU, national statistics office, UniCredit Research

[26]We assume that gas purchases fall to USD 6bn in 2015 (more than 15% lower than in 2014) and rebound to USD 7.5bn in 2016. Imports from Gazprom are considered at a price of USD 378/ 1000 cubic metres. We also assume that price hikes for domestic consumers will offset UAH depreciation, so that Naftogaz' fiscal costs do not increase due to depreciation.

**Ukraine needs to constrain debt growth if it seeks a rescheduling**

Before asking for a maturity extension, Ukraine will need to prove that it has a liquidity rather than a solvency problem, i.e., in the medium term it can constrain public debt, which exceeded 60% of GDP[27] (including public guarantees) and could reach 90% by 2016 amid recession and UAH depreciation. Inflation and depreciation reinforce each other, with monetary expansion also contributing. We expect inflation to peak at above 25% yoy before returning towards 16% yoy by end-2015. This scenario assumes gradual, but limited UAH depreciation.

**A rapid deterioration in financial conditions…**

In the very short term, financial markets are a concern. The rapid deposit flight (-14.2% ytd in October 2014 for UAH and -11.8% ytd for FX-adjusted FX loans) led to controls on withdrawals of UAH and FX, thus reducing, but not stopping, outflows. As a result, the central bank was financing in October 2014 8.8% of banks' assets through "stabilization loans". Adding to worries, FX depreciation is expected to send the NPL ratio well above 30%. This comes amid a capital shortage estimated at UAH 66bn (USD 4.2bn) for the largest 35 banks[28].

**…will fuel an acceleration of the recession**

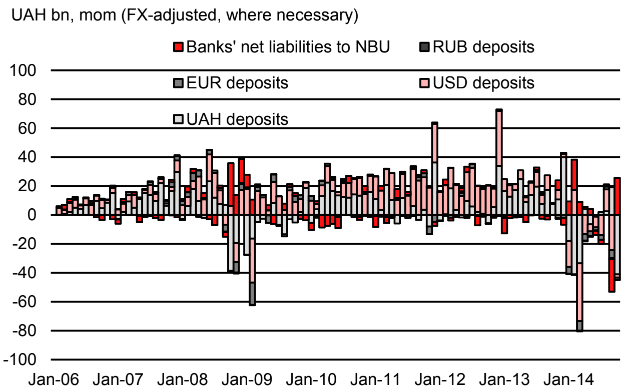
Under these circumstances, recession will probably continue in 2015. The GDP fall accelerated in 4Q14. The apparent GDP resilience in 3Q14 was due to registering more agricultural output in September, rather than in October, as was the case in 2013. High frequency data suggest a sharp correction in other sectors, especially construction and mining, the latter affected by the conflict in Donetsk and Luhansk. Supply shortages (especially energy and raw materials) will probably squeeze output in manufacturing in 2015. An improvement cannot be expected if financing constraints worsen. We pencil in a turnaround in activity in 2H15, assuming that financing concerns will ease by mid-2015 and trade with Donbas will resume.

**Ukraine needs a stabilization of the conflict in the Donbas**

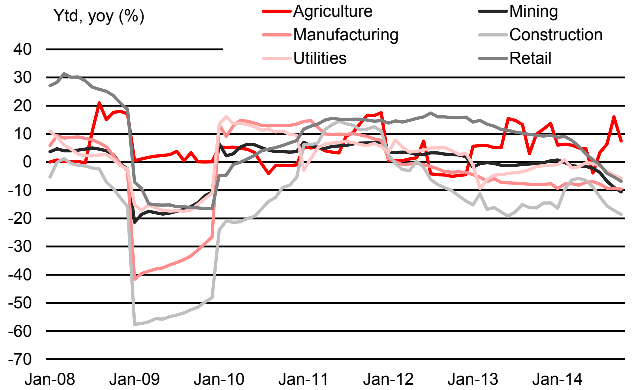
While we expect a frozen conflict in Donbas, Ukraine's recovery requires an agreement with the breakaway republics of Donetsk and Luhansk and, implicitly, with Russia. A comprehensive deal would entail concessions from Ukraine. Larger autonomy for the Donbas could "restart" ties with the rest of Ukraine's economy[29] and could set the stage for a long-term gas contract that would reduce Russia's influence on Ukrainian politics[30]. A long-term truce in the East would help business and consumer confidence recover, lifting consumption and investment in 2016, albeit from a very low base. While the Donbas could remain de facto a part of Ukraine, the reintegration of Crimea will be much harder to achieve.

**THE ECONOMIC DOWNTURN IS ACCELERATING**

The run on deposits continues despite controls on withdrawals




Activity is contracting in all sectors with the exception of agriculture




Source: NBU, Bloomberg, UniCredit Research

[27] Russia declared that it will not call the USD 3.0bn bond due in December 2015, despite the debt to GDP ratio exceeding the 60% threshold.
[28] UAH 20.5bn for foreign-owned banks, UAH 23.0bn for private local banks and UAH 12.5bn for three state-owned banks, the latter likely recapitalized by the NBU.
[29] The Donbas accounted before the crisis for approximately 16% of Ukraine's GDP and for 27% of Ukrainian exports.
[30] The gas price is also important. Under a deal reached on 30 October 2014, Ukraine would pay 50% more than under the 2010 import agreement, a price that could imply long-term losses at Naftogaz.

## Notes

## Notes

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