

SEE Quarterly II 2010


SEE AT A GLANCE

External Environment

As we have outlined in our previous CESEE Quarterly Q4 2009-Q1 2010 in early 2010, the global recovery is broadly unfolding. Hence, the bulk of recently released economic and sentiment indicators from the US and the EMU continued to improve and point to a solid inventory-led production rebound. With regard to the EMU, exports remain the sole engine of the recovery, boosting manufacturing output. As the euro has weakened significantly against the greenback since the beginning of the year, export performance is likely to enjoy further support from this side. The figures, however, also confirm that domestic demand continues to lag behind: The typical unfolding of the Eurozone recovery would see exports kick start growth, followed by investment and, in the end, consumption. This time, however, we remain cautious on the prospects for both private consumption and investment. With regard to consumption, unemployment is likely to keep rising throughout this year and into 2011, preventing private consumption from taking off. Nonetheless, the **recession in the eurozone has ended at mid-2009**. Similarly, as inflationary and disinflationary tendencies still seem to be balanced this year, monetary policy will remain expansive, although a certain tightening stance has been already taken place. Overall, we expect **moderate GDP growth at around 1.0% in the EMU**, while 2010 full-year (FY) growth figures should be higher in the US.

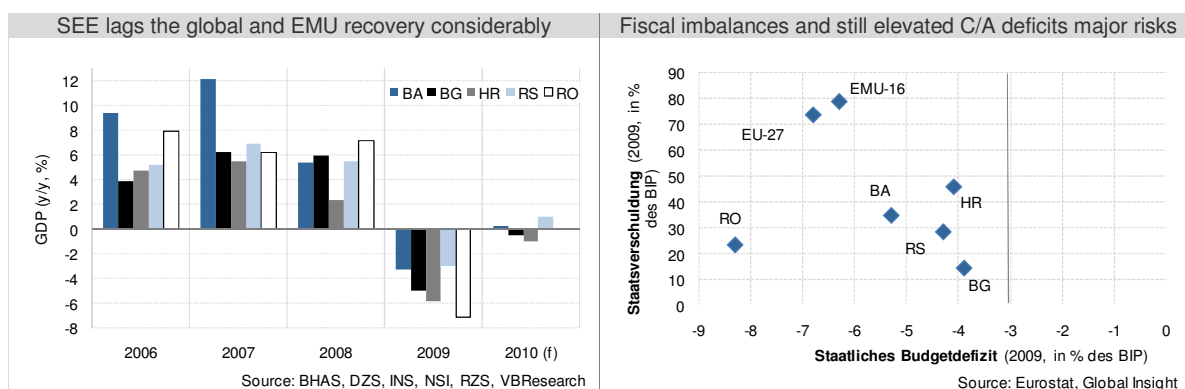
Economic Performance in SEE

The Eurozone growth outlook contains mixed signals for the Southern Eastern European (SEE) region. The fact that Germany is outperforming should be encouraging news for all SEE countries, which have strong trade links with Europe's leading economy. This, however, is tempered by the fact that other important trading partners, e. g. Italy, recover only gradually and, for the time being, SEE exports failed to participate in the recent global upswing. In addition, as SEE countries are suffering from deeply depressed domestic demand, an FDI-driven recovery in exports remains the white hope for SEE. Overall, we expect quarterly GDP growth dynamics to pick up only slowly in H2 2010. Fixed investment and private consumption are still deeply subdued, however, and should remain so this year. Thus, the region as a whole continues to lag behind the EMU recovery and is facing a **two speed recovery** (slowly firming exports and restrained domestic demand). In a low-growth environment, hence, export competitiveness will be further tested in 2010. Looking at individual countries, despite the positive statistical carry over from 2009 to 2010, **BG and HR are anticipated to mire in recession, while BA, RS and RO should more or less stagnate** this year.

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	<p>Note: Starting with this publication, our former "CESEE Quarterly" is published in two separate parts. This "SEE Quarterly" covers the southern eastern European region, while the CEE Quarterly" is dedicated to the CE4 (CZ, HU, PL, SK).</p>	

Going more into details, the underlying reasons for the slow pace of economic recovery is mainly due to the severe economic imbalances that built up during the boom years. Strong inflows of EU transfers and investment capital pushed trade and payments imbalances to alarming proportions, as private foreign borrowing was the key source of financing domestic demand. As the reliance on private consumption and the continued preference of consumers for imported goods is a cause of concern, **rebalancing of most SEE countries' growth model is crucial**. However, this takes time, especially with regard to the anticipated sluggish rebound of foreign direct investment (FDI), which slumped dramatically last year. The development on the FDI front has been seen in a number of economies in the region as subsidiaries of foreign firms have been repaying credits that had been extended by their parent companies to tide them over the rough times in 2009. Given the projected **lower contribution of FDI-driven investment to economic activity**, the adjustment of the economy is expected to involve a **shift to a more export-oriented growth pattern**, which would depend to a large extent on a recovery in external demand. To sum up, over the next two to three years none of the SEE economies should be able to regain the high pre-crisis growth rates.

Due to the tight trade links between advanced and emerging Europe, **main risks around our baseline scenario of a gradual and sluggish recovery seem to be broadly balanced**. On the upside, the pickup in global trade could prove stronger than anticipated and, thus, FDI inflows could revive faster than expected. On the downside, debt problems of some EMU countries weigh heavily on the outlook, especially in Serbia. Locally, bad loans could aggravate tensions in the financial sector with overhangs of FX-denominated debt creating vulnerabilities that could resonate across the continent through the integrated banking system.



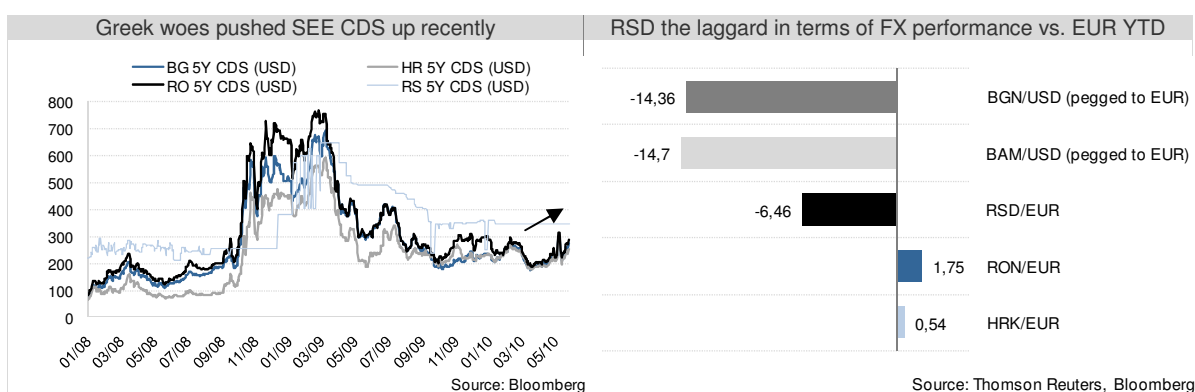
Particularly **high unemployment should further dampen wage and inflationary pressures** in the quarters ahead, although consumer prices are expected to rebound somewhat from their current, low levels. Slightly stronger currencies, negative output gaps and soft domestic demand will keep core inflation under control whilst headline inflation will be adversely affected by unfavorable base effects in commodity prices. Another "favourable" impact of the global downturn is the **extraordinary reduction of external imbalances**, reducing external vulnerabilities. Nevertheless, international financing support in BA, RO and RS had been essential to handle both external and internal financing needs when the financial crisis unfolded. From a country risk perspective, hence, internal imbalances are scrutinized with growing intensity, thereby adding to the still considerable external vulnerabilities.

Fiscal Performance

Public finances have been hit hard by the crisis but still look better than in many of the western European countries. Looking at individual countries we find that **SEE countries in many cases not only perform better than the Eurozone periphery countries**, but also better than the EU average. Nevertheless, mainly due to unusually strong responsiveness of public revenues to the decline in economic activity, fiscal imbalances surged across the board in 2009, with the exception of Hungary. **In 2010**, however, a certain **improvement is foreseen in the deficit ratio** as economic activity picks up, temporary measures come to an end and most country's need to comply on concrete criteria agreed with the international lending community. Overall, we believe that the generally low level of public sector debt make SEE public finances manageable.

Financial Markets

Until local yields took a beating in mid-May over mounting concerns on the Greek debt crisis, SEE domestic yield curves performed a downward movement year-to-date (YTD), which was in line with our expectations. After significant fears about Greece going bust have emerged, the market looked in anger at the EMU periphery and only some days later the whole euro-zone got into cross fire. To expect the SEE region to remain unaffected would be not more than wishful thinking. CDS, highly volatile in the course of this year, were pushed up considerably with BG's, RO's and HR's CDS moving synchronically since the beginning of this year. Looking ahead, following last year's period of sharply tightening sovereign bond spreads amid a favourable risk perception of the CEE/SEE region as a whole, we believe that local supply pressure and upside pressure on core market yields will keep SEE yield curves under pressure. Fiscal consolidation will be difficult enough, so **we do not expect significant spread tightening in the months ahead.**



As outlined above, before mounting concerns on the sustainability of the Greek bailout worsened global sentiment greatly, the Romanian leu gained considerably ground vs. the euro between Jan.-Apr. 2010. Investors' favourable perception of the region was the main driver behind appreciation dynamics, with the "investors' fear index" (S&P 500 implied volatility index) falling to levels last seen before the global crisis unfolded. Although we did expect RON gains against the euro in the medium term, the **pace of appreciation was somewhat surprising**. At the same time the Croatian kuna remained more or less stable, while the Serbian dinar followed a sharp depreciation trend in the course of this year.

Overall, we stick to our forecasts of a **stabilization of our SEE currencies against their current levels in the remainder of this year**. As soon as markets have calmed down – a crucial assumption of our baseline scenario – and fundamentals are coming into the limelight again, we are confident for SEE currencies to get on a moderate appreciation path. **In the short run, we expect the crisis around the EMU to overlap the slowly unfolding economic recovery on the local scene**. Pronounced deviations from the basically projected medium term appreciation path are in the pipeline. Apart from the external factors, political noise and uncertainties surrounding external and internal deficit financing issues are expected to be the main sources of risk for SEE currencies in the short to medium term. On a final note, we believe SEE central banks – still provided with substantial FX reserves – still not to tolerate too strong movements in the course of this year, in fact, in both directions.

CURRENCY	EUR exchange rate				3m Interbank rate (bps)				5y gv bond YTM (bps)				CDS (5y USD)	Base Rate
	26.05.10	31.12.09	Perf.10	Perf.09	26.05.10	31.12.09	Perf.10	Perf.09	26.05.10	31.12.09	Perf.10	Perf.09	26.05.10	26.05.2010
EUR					0,70%	0,70%	0	-219	1,52	2,42	-90	11		1,00
HRK	7,27	7,31	0,54%	0,76%	0,00%	3,25%	-325	-441	5,68				272	9,00
BGN	1,96	1,96	-	-	2,26%	2,81%	-55	-333	5,01	5,92	-91	85	285	0,18
RON	4,16	4,24	1,75%	-5,26%	6,71%	10,15%	-344	-374	7,74	10,75	-301	75	296	6,25
RSD	102,50	95,88	-6,46%	-6,68%	8,90%	10,84%	-194	-804	3,93				275,0	8,00

* Local Currency; RS: EUR Source: Thomson Reuters

BOSNIA and HERZEGOVINA

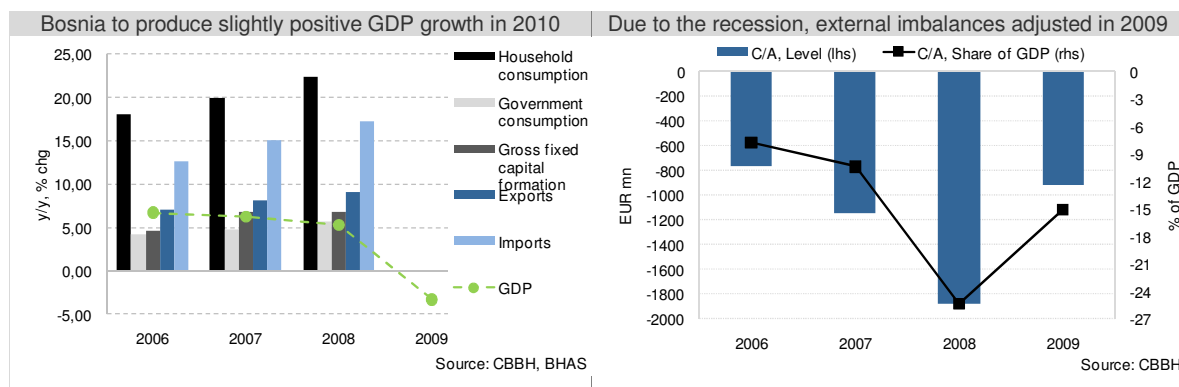
Long-term foreign currency credit rating (and outlook)

B2 (stable) (Moody's)	B+ (stable) (S&P)	Not rated (Fitch)
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Economic Growth Performance

According to the central bank of Bosnia and Herzegovina (CBBH), **2009 full-year (FY) GDP declined by -3.3%** against 2008. By SEE standards, this appears to be a quite modest decline. Industrial output fell -3.3% with -11.6% in the Bosniak-Croat Federation (FBiH) and +9.0% in the Republica Srpska (RS) thanks to the relaunch of the Bosanski Brod oil refinery in late-2008 (output increase of coke and refined petroleum products in 2009 at 498.6% !). Though detailed data are not available yet, retail trade and construction are also supposed to hurt GDP, as consumers and businesses were hit by the credit crunch. One factor that definitely positively influenced economic activity in 2009 was net exports, as imports fell faster than exports. Industrial output in March 2010 increased by 4.3% y/y, according to the local Agency for Statistics (BHAS). This result comes as a marked improvement from the annual contraction of -0.5% seen in both January and February. The latest data serve as confirmation of the **recently emerged strengthening trends in the economy**.

The GDP development during the next few quarters will of course be massively influenced by international business climate developments. Should the latter be favourable, any export expansion will be easier; citizens working abroad will earn more money and send more remittances, and more foreign capital will be inclined to enter the country. We believe, Bosnia to return to **slightly positive export-led growth in 2010**, partly supported by strengthening export demand from its European markets. Mainly due to further rising unemployment, however, **domestic demand is likely to remain relatively muted**, with little help for consumption from fiscal spending. Still, considerable uncertainty remains over the country's near-term economic future, as much will depend on the government's ability to rein in fiscal deficits and cooperate with the international financial community.



Despite the economy recovering gradually, the most severe problems of the economy will continue to persist: In the first two months of 2010 unemployment increased by more than 5% year-to date (YTD) with the internationally comparable **rate of registered unemployed persons staying at around 25%** (total number at 520,000). The numbers are of special concern, since less than 1/3 of the population is economically active at all in the sense of having or seeking a job. These dejecting circumstances are set to worsen further with the **unemployment rate rising by around 3 pps by the end of this year**. Still, the adverse effects of the global crisis have not peaked yet.

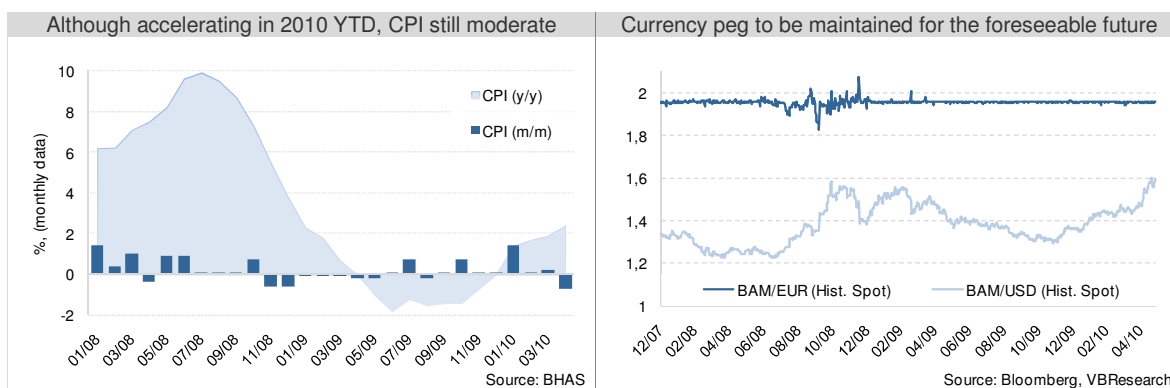
External Balance

The global recession forced a substantial correction of Bosnia's external deficits in 2009. Exports declined due to a collapse in domestic demand in key trading partners, while imports fell back thanks to declining commodity prices and more limited financing options for external deficits and debt. Hence, the foreign-trade deficit narrowed to EUR 3480 mn in 2009 (2008: EUR 4888 mn). While the shrinking trade deficit – limiting the country's external vulnerability considerably – was a welcome development, the sharp decline in exports is discouraging. Based on the narrowing trade gap, CBBH data suggest that the current-account (C/A) **deficit dropped to around -7.5% of GDP in 2009**. That compares with a figure of over -13% in the previous year.

Recent BHAS data show that exports in March 2010 soared by 37.1% y/y, the recent improving trend thus strengthening. Meanwhile, imports increased by a considerably lower rate of 5.2% y/y, after only returning to marginal annual growth in February. These developments point to the **continuation of a narrowing trade deficit** (Q1 2010 -22% y/y). Indeed, the drop in reconstruction aid and official transfers, combined with the strictures on foreign borrowing, will serve to constrain imports over the medium term. From 2010, the reduction of the external imbalances will be more gradual with VB Research projecting the **2010 C/A shortfall coming in at around -6.5% of GDP**.

Inflation and Monetary Policy

In 2009, FY inflation reached an average of **-0.4%** (2008: 7.4%). That occurred as global commodity prices were pushed downward and prices of transport and clothing decreased significantly. Those drops were balanced by steep increases in the alcohol and tobacco category mainly. On the back of further global commodity price increases BHAS data saw consumer prices gaining 1.9% y/y in March, following similar growth rates in Jan./Feb. Evidently, these increases in regulated prices will feed gradually through to the headline CPI and add to the ongoing pressure from commodity prices. **With average annual rates of about 2.5–3.5% we expect accelerated price dynamics in 2010**, even though domestic demand should remain weak this year.



Foreign Exchange Rate

The CBBH succeeded in maintaining monetary and exchange-rate stability, as well as relatively low, single digit inflation in recent years. The latter is partly due to the **stability of the currency, which has remained fixed against the euro at BAM 1.956 / EUR in 2009**. After the currency board has brought a substantial strengthening in 2002–08 against the greenback, **BAM/USD fell back in 2009 and 2010 YTD**. The appreciation of USD vs. EUR in recent months adds to this development. Moreover, the Bosnian K-mark has appreciated significantly against some of the other Western Balkan currencies in recent years, particularly that of Serbia, which is one of Bosnia's top trading partners. One of the biggest threats to currency stability in recent years were represented by large external deficits. Fortunately, Bosnia saw a sharp rise in FX reserves until 2007, helping to bolster the domestic unit. Until H1 2009 reserves fell back moderately, but rose back in subsequent months to an end-2009 level of USD 4.65 bn. Furthermore, the steep drop in imports raised the **import cover ratio back to more than six months in 2009** (4 months in 2008).

Despite some benefits outlined above, the absence of an independent monetary policy poses challenges. For one, Bosnia may have **difficulties maintaining export competitiveness** while using a currency over which it has no control. As a result, the country will have to rely on such measures as keeping fiscal deficits to a minimum. With the focus on fiscal policy, which to a large extent is also geared toward buttressing the credibility of the currency board, **we expect the peg to remain unchanged**. However, BAM may come under pressure if growth in external deficits resumes.

Fiscal Balance

The **IMF has approved the third tranche of EUR 138.4mn** to BiH in late March. The key to this decision was the passing of legislation in FBiH and RS in late February reducing the benefits of war

veterans. In addition, disbursement was conditional on the passing of laws improving the targeting of the benefits of other social groups and creating appropriate welfare programs. In addition, the World Bank has approved a USD 111 mn loan (initially scheduled for December 2009).

The 2009 fiscal deficit objective agreed with the IMF was exceeded and the fiscal outlook has worsened. Preliminary data indicate that, on account of revenue shortfalls and despite lower-than-programmed expenditures, the **2009 general government deficit reached -5.3% of GDP compared with the program target of -4.7 %**. Under unchanged policies, the fiscal deficit would reach 6% of GDP in 2010, thus putting fiscal sustainability at risk. Against this backdrop, the revised fiscal strategy accommodates a slightly higher deficit for 2010. **The fiscal balance has been revised to -4.5 % in 2010 from the original -4% of GDP**. According to the IMF, as soon as the authorities have come to agreement on measures necessary to advance the program objectives, the fourth tranche of support of about EUR 40 mn could be disbursed. This would bring the overall support from the IMF's 3-year, EUR 1.2 bn standby loan to approximately EUR 565 mn.

Evidently, the disbursements of the last tranche will ease the pressure on the fiscal positions in the course of 2010. The fact that **BiH will vote for new members of the parliaments and of the BiH presidency in October 2010**, poses the major threat to fiscal performance. Indeed, populist rhetoric will increase, but we would note that – given the dependence of the country on the IMF program – we expect the authorities to eventually implement IMF and World Bank conditions to gain access to financing. Failure to implement budget compromises could derail the IMF arrangement and bring about a financial collapse in the FBiH – which is in much worse fiscal shape than the RS.

Bosnia and Herzegovina: Macroeconomic Indicators and Key Forecasts							
	2006	2007	2008	2009	Latest		2010
Real GDP (% y/y)	9,3	12,1	5,3	-3,3	--	--	0,5
Private Consumption	4,5	8,3	7,7	--	--	--	--
Government Consumption	3,6	0,2	2,4	--	--	--	--
Gross Fixed Capital Formation	-9,4	27,5	4,2	--	--	--	--
Export (Goods and Services)	14,8	9,4	6,4	--	--	--	--
Import (Goods and Services)	-5,1	11,4	7,6	--	--	--	--
National Income							
Nominal GDP (BAM bn)	17,51	21,71	24,65	23,77	--	--	23,88
Nominal GDP (EUR bn)	8,95	11,10	12,60	12,15	--	--	12,21
GDP per capita (EUR)	2387	2846	3231	3115	--	--	--
Labour Market							
Unemployment Rate (%)	31,1	29,0	23,4	24,1	25,3	M02-10	27,5
Prices & Money							
CPI (% y/y)	6,1	1,5	7,4	0,1	1,9	M03-10	3,0
Broad Money, M2 (% y/y)	24,7	21,6	4,3	1,7	6,6	M03-10	--
Public Sector							
Fiscal balance (% of GDP)	2,0	-0,1	-4,0	-5,3	--	--	-4,8
Revenue (EUR bn)	4,63	5,24	5,75	5,60	--	--	--
Expenditure (EUR bn)	4,42	5,25	6,26	6,18	--	--	--
External Sector							
C/A Balance (EUR bn)	-0,77	-1,16	-1,91	-0,92	--	--	--
C/A Balance (% of GDP)	-8,6	-10,4	-15,1	-7,6	--	--	-6,5
Net Direct Invest. (EUR bn)	0,57	1,50	0,72	0,36	--	--	--
Debt Indicators							
General Govt. Debt (% of GDP)	24,0	29,7	27,7	35,5	--	--	--
Domestic (EUR bn)	0,07	1,27	1,34	1,64	--	--	--
External (EUR bn)	2,09	2,03	2,14	2,67	--	--	--
Total external Debt (% of GDP)	50,5	42,6	42,7	55,3	--	--	--
Total external Debt (EUR bn)	4,52	4,73	5,38	6,72	--	--	--
Financial Markets							
Policy Rate (%)	--	--	--	--	--	--	--
BAM/EUR (eop)	1,956	1,960	1,931	1,953	1,956	M05-10	1,956
BAM/EUR (avg)	1,958	1,958	1,955	1,956	--	--	--
BAM/USD (eop)	1,485	1,331	1,387	1,364	1,595	M05-10	--
BAM/USD (avg)	1,559	1,430	1,337	1,406	--	--	--

f: forecast, eop: end of period, avg: average, LCU: local currency unit

Source: Global Insight, Thomson Reuters, Bloomberg, BHAS, CBBH, VBRResearch

BULGARIA

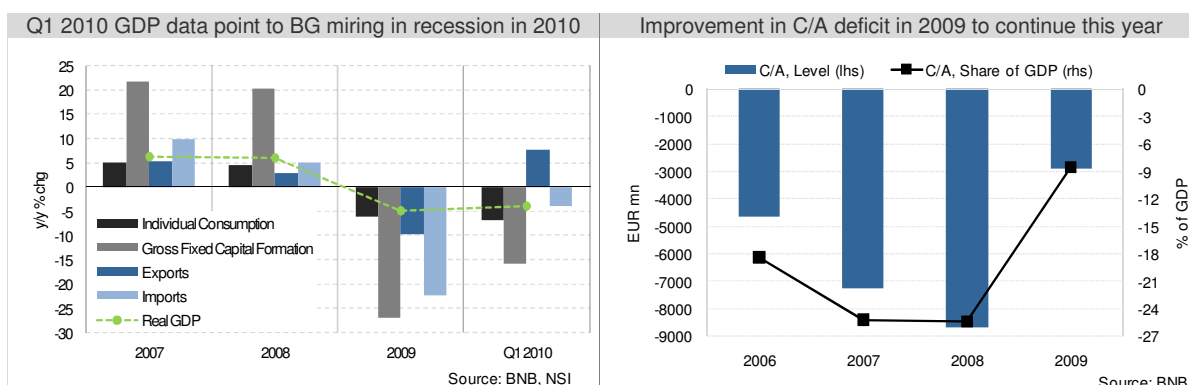
Long-term foreign currency credit rating (and outlook)

Baa3 (positive) (Moody's)	BBB (stable) (S&P)	BBB- (negative) (Fitch)
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Economic Growth Performance

The global economic downturn had a severe effect on the Bulgarian economy. In Q4 2009 the decline of real GDP was still accelerating to -5.9% y/y from -5.4% y/y in Q3, bringing **2009 a full-year (FY) slump in economic activity of -5%**. The contribution of domestic demand was deeply negative as all of its components contracted sharply. Gross fixed capital formation registered the highest decline, collapsing by -27% y/y. Tight credit market conditions, declining FDI inflows and lackluster economic prospects were the main factors behind the **negative dynamics of domestic demand**. Private and government consumption were lower as well, declining by -6% y/y and -5.5% y/y respectively. According to the National Statistics Institute's (NSI), the pace of contraction moderated for the first time since the crisis reached Bulgaria in H12009, with **GDP down by -4.0% y/y in Q1 2010**. Hence, the **economy remained in recession throughout Q1 2010** with exports – gradually picking up since Q4 2009 – and upturning inventories the only aggregates providing any favourable impetus to collective output (exports up by 7.6% y/y, after -9.8% in 2009 as a whole).

With credit to the domestic private sector limited, high unemployment constraining private consumption, and demand in the EU15 for Bulgarian exports still relatively muted, we expect the economy only to recover towards the end of 2010 with **FY GDP growth staying slightly negative in 2010**. In addition, considering the currency board in conjunction with the need to maintain an austere fiscal stance, **economic policy has only a very limited room to maneuver**. Rates of growth achieved in 2004–08, in excess of 6% p. a., will not be seen again within the medium term (m/t).



From a low in recent history of 5.8% reached in September 2008, registered unemployment surged month after month. The Ministry of Labour and Social Policy put the headline **rate of unemployment at 10.14% in March 2010, down modestly from 10.26% in February**. It should be noted that reflecting trends in seasonal jobs, unemployment rates typically rise in Bulgaria late in the year and further in the first quarter of the following year. Those favourable seasonal effects, however, should be eroded by the fact that unemployment typically lags the business cycle. Assuming further restructuring of enterprises, in particular the recently privatized large-scale state enterprises, **VB Research projects the unemployment rate to surge to above 12% by the end of this year**.

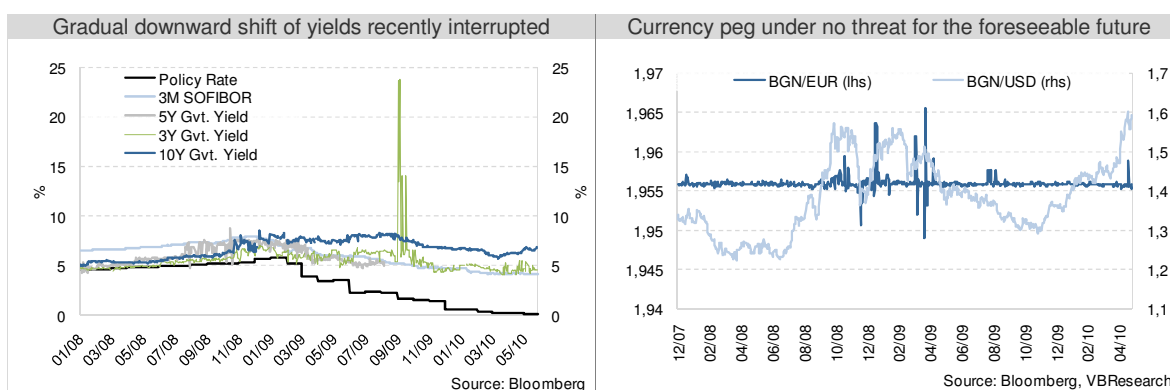
External Balance

At the same time the global recession brought about a welcome adjustment in some of the imbalances. The **current-account (C/A) deficit improved sharply from -25.5% in 2008 to -9.4% of GDP in 2009**. However, whereas in 2009 the decline of the C/A shortfall was driven by the fall in FDI inflows and imports decreasing faster than exports, in the medium term the correction is expected to be the result of exports picking up faster and earlier than imports. First signs fulfilling those expectations already emerged as the C/A deficit in Q1 2010 reached -1.4% of GDP (Q1 2009: -4.2% of GDP). Thus, the **external payments imbalance narrowed by EUR 942.6 mn in Q1 2010, or nearly two-thirds**. On the negative side, however, the balance of foreign direct investment (FDI) in Bulgaria during Q1 2010 actually represented an outflow of EUR 21.9 mn (vs.

EUR 926 mn inflow in Q1 2009). Incoming FDI had been playing an important role in minimizing the increase in net external debt due to the C/A gap, by providing alternative financing. As export performance should only gradually pick up in the remainder of 2010 with Western Europe and CESEE enjoying only a moderate recovery we project a **lower, but still substantial C/A deficit of around -6.0% of GDP in 2010**. However, it remains to be seen how sustainable these adjustments will be. Additionally, the country's gross external debt at above 110% of GDP remains high, but is mitigated by the fact that the C/A deficit has been fully financed through FDI in 2009.

Inflation and Monetary Policy

Apart from unwinding external imbalances, another favourable effect of the (global) recession is decelerating inflation. Contracting domestic demand in 2009 and significant excess capacity in early 2010 have completely knocked the wind out of the sails of Bulgarian inflation, together with relatively stable world-market prices of key imported commodities. Averaging 12.4% in 2008, **average consumer price inflation came in at 2.8% in 2009**. Nevertheless, according to recent NSI data prices picked up by 1.8% y/y (1.1% m/m) in April 2010, from 1.3% y/y in March. Inflation, however, should remain tame, with the chief sources of upward pressure on domestic prices being the higher cost of imported fuels and one-off phenomena such as the excise-tax increase. Moreover, still-muted domestic demand and substantial excess capacity will keep inflationary pressures modest in 2010, but thereafter, further adjustments to regulated prices will cause some acceleration. On balance, **we expect headline inflation to average only 2.4% in 2010**, while this forecast also assumes a normal harvest and no substantial further rebound in world-market prices of fuels or food.



Bulgaria intends to keep its currency board in place until it adopts the euro, despite the limitations this imposes on economic policy and on the ability to boost competitiveness via depreciation of the currency. With the exception of the setting the basic interest rate and reserve requirements, the Bulgarian National Bank (BNB) will continue to have little recourse to monetary policy in the years to come. For the best part of last year the policy rate – to which many other interest rates are keyed – dropped remarkably to only 0.39% as of 1 January 2010. Mainly over concerns that domestic credit to the non-financial private sector was not expanding sufficiently to support economic recovery, last year's trend continued with the **basic interest rate slashed to 0.18% in May 2010**.

Foreign Exchange Rate

Bulgaria had hoped to begin talks on entering the ERM II, but in light of a larger-than-anticipated 2009 fiscal deficit as well as the current concerns over possible contagion from Greece's fiscal and sovereign debt difficulties, the talks are being delayed. Even if inflation rates are kept sufficiently muted in the interim, **euro adoption is now unlikely to take place before 2015**. Under the currency board system, the **Bulgarian lev is pegged to the euro at a rate of 1.95583**. Moreover, in part because of the Greek debt crisis as well as stronger recovery in the US than in the EMU, the euro and lev depreciated vis-à-vis the greenback in January–May 2010. The real effective exchange rate of the lev was down -2.8% y/y at the end of Q1 2010. These losses are, however mitigated by the fact that the share of Bulgarian trade conducted with the Eurozone continues to rise. Looking ahead, Bulgaria's **FX reserves should be sufficient to maintain the peg without any realignment** in 2010/11. If a wide excess of C/A deficit over net FDI should develop FX reserves

could come under severe pressure. As a member of the EU, however, Bulgaria could expect support for its balance of payments from the EU as well as from multilateral financial institutions.

Fiscal Balance

Since the very ambitious target date of accessing the Eurozone by 2013 has become definitively unfeasible, the burden of macroeconomic stabilization remains solely shifted to the fiscal sphere. Due to unaccounted procurement deals the **budget deficit was revised to -3.7% of GDP in 2009, compared with -0.8% as initially reported**. Apart from these expenditures in question, following a surplus in 2008 the accumulation of last year's deficit was mainly due to the economic downturn, which has adversely affected the tax intensity of the economy.

To set the budget deficit on a declining path in 2010, the government adopted an anti-crisis and fiscal consolidation package. Under the no-policy-change assumption, the **general government deficit should reach less than -3% of GDP in 2010**, while government gross debt – though significantly increasing against 2009 – is set to remain at an outstandingly favourable level below 20% of GDP. Some of the budgetary components are, as usual, subject to uncertainties. On the expenditure side, social spending could exceed the funding allocated in the budget for 2010 in case of unexpectedly unfavourable labour-market developments. On the revenue side, Bulgaria could face a protracted period of significantly less tax-intensive growth composition, as the economy shifts to a more export-oriented pattern. However, the **risks to the budgetary projections are in our view mitigated by the relatively cautious growth assumptions of the authorities**.

Bulgaria: Macroeconomic Indicators and Key Forecasts							
	2006	2007	2008	2009	Latest	2010	
Real GDP (% y/y)	6,3	6,2	6,0	-5,1	-4,0	Q1-10	-0,5
Private Consumption	8,5	5,1	4,5	-6,2	-6,8	Q1-10	--
Government Consumption	-2,5	3,4	-1,4	-5,7	-2,4	Q1-10	--
Gross Fixed Capital Formation	14,7	21,7	20,2	-26,9	-15,8	Q1-10	--
Export (Goods and Services)	8,7	5,2	2,8	-14,4	7,6	Q1-10	--
Import (Goods and Services)	14,0	10,1	5,3	-22,3	-4,0	Q1-10	--
National Income							
Nominal GDP (BGN bn)	49,4	56,5	66,7	65,4	--	--	64,8
Nominal GDP (EUR bn)	25,2	28,9	34,1	33,4	--	--	33,3
GDP per capita (EUR)	3281	3780	4491	4439	--	--	--
Labour Market							
Unemployment Rate (%)	9,6	7,7	5,7	9,6	10,1	M03-10	12,2
Prices & Money							
CPI (% y/y)	7,3	8,4	12,3	2,8	1,8	M11-09	2,5
Broad Money, M2 (% y/y)	26,9	31,1	8,8	4,3	7,9	M03-10	--
Public Sector							
Fiscal balance (% of GDP)	3,6	3,5	3,0	-3,7	--	--	-1,3
Revenue (EUR bn)	10,2	12,3	14,0	13,4	--	--	--
Expenditure (EUR bn)	9,3	11,3	12,6	13,7	--	--	--
External Sector							
C/A Balance (EUR bn)	-4,67	-7,34	-8,58	-3,12	--	--	--
C/A Balance (% of GDP)	-18,5	-25,4	-25,2	-9,3	--	--	-6,2
Net Direct Invest. (EUR bn)	3,25	4,80	3,27	3,24	--	--	--
Debt Indicators							
General Govt. Debt (% of GDP)	21,4	17,2	12,2	13,3	--	--	--
Domestic (EUR bn)	1,51	1,64	1,57	1,87	--	--	--
External (EUR bn)	3,89	3,33	2,59	2,58	--	--	--
Total external Debt (% of GDP)	86,0	107,8	102,8	112,6	--	--	--
Total external Debt (EUR bn)	21,70	31,14	35,05	37,63	--	--	--
Financial Markets							
Policy Rate (%)	3,26	4,58	5,77	0,39	0,18	M05-10	--
BGN/EUR (eop)	1,956	1,960	1,931	1,962	--	--	1,956
BGN/EUR (avg)	1,958	1,958	1,956	1,955	--	--	--
BGN/USD (eop)	1,485	1,331	1,387	1,364	1,593	M05-10	--
BGN/USD (avg)	1,559	1,430	1,337	1,405	--	--	--

f: forecast, eop: end of period, avg: average, LCU: local currency unit

Source: Global Insight, Thomson Reuters, Bloomberg, NSI, BNB, VBRResearch

CROATIA

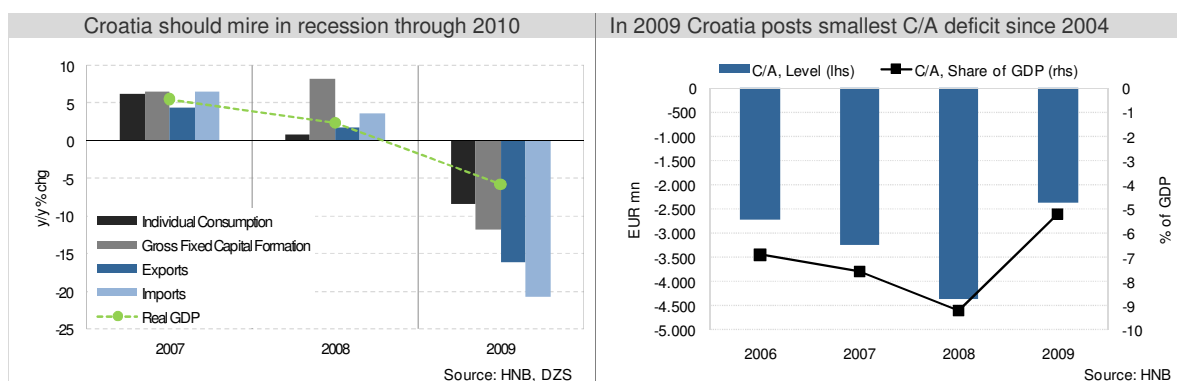
Long-term foreign currency credit rating (and outlook)

Baa3 (stable) (Moody's)	BBB (negative) (S&P)	BBB- (negative) (Fitch)
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Economic Growth Performance

The global crisis severely affected the Croatian economy, which went into a deep recession, wiping out previously strong growth rates (2004-2008: 4.3% on average). **Real GDP declined by -5.8% in 2009**, driven by strong fall in domestic demand. Private consumption declined by around -8.5% and total investment by -11.8%. As a result, domestic demand posted a huge negative contribution to GDP of around -8 pps, whereas net exports provided some compensation. Regarding the latter, losses in total exports (-16.2% y/y) were lower than the reduction in imports (-20.7% y/y). The sharp decline in imports was a direct result of the loss of export demand on the domestic economy.

Although the worst of the current recession seems to be over, **industrial production slipped in March -0.6% y/y, one of the weakest such performances in SEE**. This reflects ongoing real sector restructuring and deleveraging, as well as the fact that the industrial sector is encumbered with one of the region's most onerous tax burdens. A lack of access to credit, deteriorating labour conditions and first signs of an underperformance of domestic tourists should further weaken retail sales activity in 2010. Without a revival in industrial production and of export demand – most critically from Italy, Germany and Bosnia – **Croatian GDP is projected to stay in negative territory and post around -1% for 2010** as a whole, representing one of the weakest recoveries in Europe.



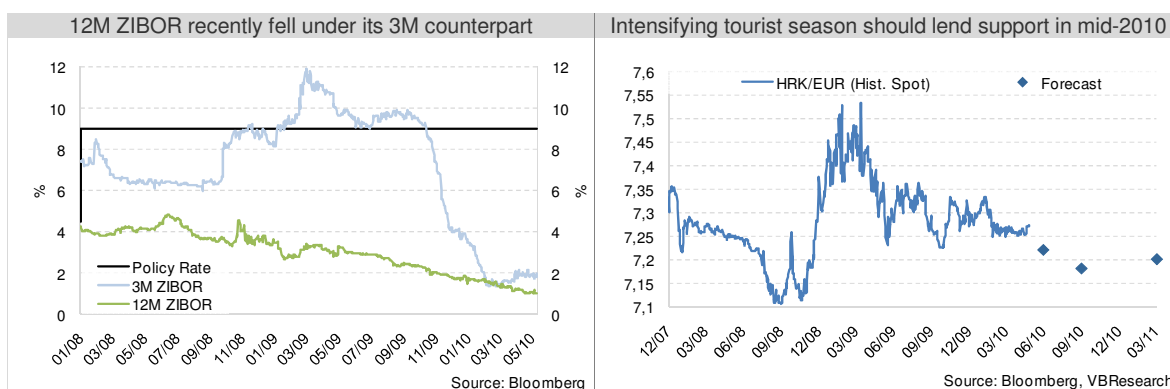
The slow turnaround in labour markets will weigh heavily on domestic consumption. In detail, Croatia's registered unemployment rate stood at 16.7% at 2009 (end of period, eop), some 3 pps higher than it had been at 2008 (eop). Before the **unemployment rate decreased to 17.9%** on the back of seasonal effects (tourist industry) in April, it seems to have peaked at 18.4% in the previous month, according to the Central Bureau of Statistics (DZS). Although the deceleration of employment losses has continued to ebb, it has done so extremely modestly. We believe this **very slow easing in job losses to continue** throughout the remainder of 2010. However, overall unemployment will remain extremely elevated, with the jobless rate averaging higher than it did in 2009.

External Balance

In 2009, Croatia posted a **current-account (C/A) deficit of EUR 2.361 bn, or -5.2% of GDP**, down by -46% compared to 2008. Although still large, the gap was nevertheless the smallest such deficit since 2004. The improvement of the external balance was largely a reflection of the sharp narrowing in the merchandise trade deficit, contracting by nearly 1/3 to EUR 7.398 bn. Despite the sharp adjustment, significant new borrowing was required, as inflows of non-debt-creating capital declined sharply vs. 2008 – mainly due to a sharp drop-off of FDI inflows (2009: EUR 1.875 bn vs. 2008: EUR 4.192 bn). To make up the financing gap, the country borrowed heavily, driving **external debt up from 76.2% in 2008 (eop) to 101.6% of GDP in 2009 (eop)**. In Q1 2010, the trend in the merchandise trade balance continued, underlining that domestic demand recovery is expected to be one of the weaker ones in Europe. As a result, the **2010 C/A is likely to continue to improve to -4.5% of GDP**, but remains dangerously high putting tremendous pressure on the country's ability to attract sufficient capital inflows to meet financing demands.

Inflation and Monetary Policy

The positive flipside of slowing credit expansion has kept inflation low over the course of 2009, with the average CPI dipping to just 2.4% in 2009. After hitting a record low of 1.1% as of September 2009, in the final months of the year inflation trended upwards, but largely only because of base effects (Dec.: 1.9% y/y). At the outset of 2010, these base effects shifted, allowing **inflation to retreat once again in Jan.-Apr. 2010, falling to just 0.6% as of April**. Goods retailers, in particular, have been forced to keep prices low in order to salvage whatever retail trade activity they could. With global commodity prices holding steady in H1 2010 and domestic demand still extremely depressed, inflationary pressures will remain subdued for the near future, although base effects may cause the annual rate to push up moderately, particularly in H2 2010. This **low inflation – likely averaging less than 2.0% in 2010** – assumes a stable kuna. Should the currency falter sometime during the year – as contagion from Greece spreads to countries with public financing problems like Croatia has – inflation could be significantly higher than our current baseline projection.



Typical monetary policy instruments such as **interest-rate changes are often circumvented by foreign-owned banks**, which borrow directly from their parent companies. The central bank (HNB) targets nominal exchange rate stability, due to the extremely high proportion of euro-denominated consumer loans. Thus, the bank has little scope to apply countercyclical measures, limiting its actions mostly to FX interventions and liquidity supply to banks. At the beginning of Feb. 2010, the **reserve requirement rate was reduced once again, to 13%** in an attempt to spur stagnating credit activity. In April, however, the HNB announced that it might not cut rates any further, blaming a failure of the government to follow their moves with appropriate fiscal and structural changes.

Foreign Exchange Rate

With the country's ability to maintain financial stability, the kuna stabilized in the course of 2009, buoyed by a better than expected tourist season. In fact, by the end of that tourist season, the kuna was threatening to push even higher if not for **HNB intervention in the FX markets**. Even as tourist demand fell off, the kuna remained strong, prompting the HNB to intervene in December to stem gains. HRK/EUR ended 2009 trading at 7.375 (Performance 2009 at +0.7%), but despite the slight appreciation, the kuna has not yet returned to its mid-2008 heights. By the end of Q1 2010, the unit appreciated modestly, rising to 7.267/euro and **remained steady in both April and May, even in the face of the deepening Greek crisis**. Borrowing from corporates, the issuance of FX-linked t-bills in an otherwise less liquid market and a narrowing external deficit were the main contributors.

While we expect the **kuna to remain strong and steady against the euro in the remainder of the year**, on a 3M horizon we see the exchange rate moving to the lower part of the band, preferred by the HNB (7.20-7.50). This should be due to the announced quasi-sovereign external borrowing and the unfolding tourist season in mid-2010. At the same time, in case of high appreciation pressures against the euro, the HNB could intervene, as premature currency strength could stall the nascent, export-led recovery. As the local currency is **fairly vulnerable to sudden swings in global sentiment the Greek crisis has exacerbated these risks**, as contagion could easily spread to Croatia, which struggles with an expansionary fiscal position. Moreover, depreciation pressures will be stronger than they have been for years in the latter part of 2010, as Croatian offi-

cials struggle to ensure that the country's **heavy external financing obligations** can continue to be met, the tourist season ends and the traditional winter depreciation pressures emerge.

Politics & Fiscal Balance

The global crisis brought Croatia's public finances under severe pressures, necessitating budgetary adjustments in 2009. A number of fiscal adjustment measures were taken to compensate for rapidly falling revenues. Finally, with **-4.1% of GDP the budget deficit exceeded the officially targeted level by 0.7 pps**. Hence, total public debt increased by 15.9% to 50.4% of GDP compared with the end of 2008, while new government bonds issued on the domestic market will have caused a further increase in Q1 2010. Overall, the forecast projects that the 2010 **fiscal deficit will stay close to the 2009 level**. The forecast is largely based on the budget framework adopted by the Croatian authorities. The latter foresees a lower deficit of -3.3% of GDP, however, it is grounded on more optimistic GDP growth projections (compared to our forecast).

The economic policy debate remains in defensive mode with the focus on saving jobs and antirecession measures. Thus, in mid-April, a **new recovery package was detailed that aims to stimulate economic growth**. Among the major points of the programme would be an overhaul to the tax system and major spending cuts, including a sharp reduction in the country's bloated civil service. At the same time, subsidies would be sharply reduced, to comply with EU demands, and the government would overhaul the pension system. Finally, the controversial "crisis" tax that was implemented mid-2009 would be repealed in November 2010. As we assume that during the remainder of Q2 2010 the remaining accession chapters should be opened, we think the Adriatic state's goal to become the EU member in 2012 could be at risk unless accession negotiations finish this year.

Croatia: Macroeconomic Indicators and Key Forecasts							
	2006	2007	2008	2009	Latest		2010
Real GDP (% y/y)	4,7	5,5	2,4	-5,8	--	--	-1,0
Private Consumption	3,5	6,2	0,8	-8,5	--	--	--
Government Consumption	2,2	3,4	1,9	0,2	--	--	--
Gross Fixed Capital Formation	10,9	6,5	8,2	-11,8	--	--	--
Export (Goods and Services)	6,5	4,3	1,7	-16,2	--	--	--
Import (Goods and Services)	7,4	6,5	3,6	-20,7	--	--	--
National Income							
Nominal GDP (HRK bn)	286,34	314,22	342,16	333,06	--	--	329,73
Nominal GDP (EUR bn)	39,09	42,82	47,35	45,33	--	--	44,88
GDP per capita (EUR)	8822	9671	10707	10263	--	--	--
Labour Market							
Unemployment Rate (%)	16,9	15,1	13,4	16,7	17,9	M04-10	18,0
Prices & Money							
CPI (% y/y)	3,2	2,9	6,1	2,4	0,6	M04-10	1,8
Broad Money, M2 (% y/y)	27,8	19,7	16,4	7,5	4,2	M03-10	--
Public Sector							
Fiscal balance (% of GDP)	-2,6	-2,0	-1,8	-4,1	--	--	-4,0
Revenue (EUR bn)	15,33	17,26	18,66	17,62	--	--	--
Expenditure (EUR bn)	15,95	17,68	19,05	19,49	--	--	--
External Sector							
C/A Balance (EUR bn)	-2,72	-3,24	-4,37	-2,36	--	--	--
C/A Balance (% of GDP)	-6,9	-7,6	-9,2	-5,2	--	--	-4,3
Net Direct Invest. (EUR bn)	2,56	3,49	3,22	0,96	--	--	--
Debt Indicators							
General Govt. Debt (% of GDP)	37,4	35,6	27,8	34,1	--	--	--
Domestic (EUR bn)	8,65	9,44	9,12	9,97	--	--	--
External (EUR bn)	5,95	5,81	4,04	5,47	--	--	--
Total external Debt (% of GDP)	78,6	82,6	76,2	101,6	--	--	--
Total external Debt (EUR bn)	30,72	35,35	36,09	46,06	--	--	--
Financial Markets							
Policy Rate (%)	4,50	9,00	9,00	9,00	--	--	9,00
HRK/EUR (eop)	7,347	7,339	7,175	7,300	7,255	M05-10	7,250
HRK/EUR (avg)	7,332	7,347	7,219	7,337	--	--	--
HRK/USD (eop)	5,578	4,985	5,156	5,094	--	--	--
HRK/USD (avg)	5,838	5,365	4,935	5,288	--	--	--

f: forecast, eop: end of period, avg: average, LCU: local currency unit

Source: Global Insight, Thomson Reuters, Bloomberg, DZS, HNB, VBRResearch

ROMANIA

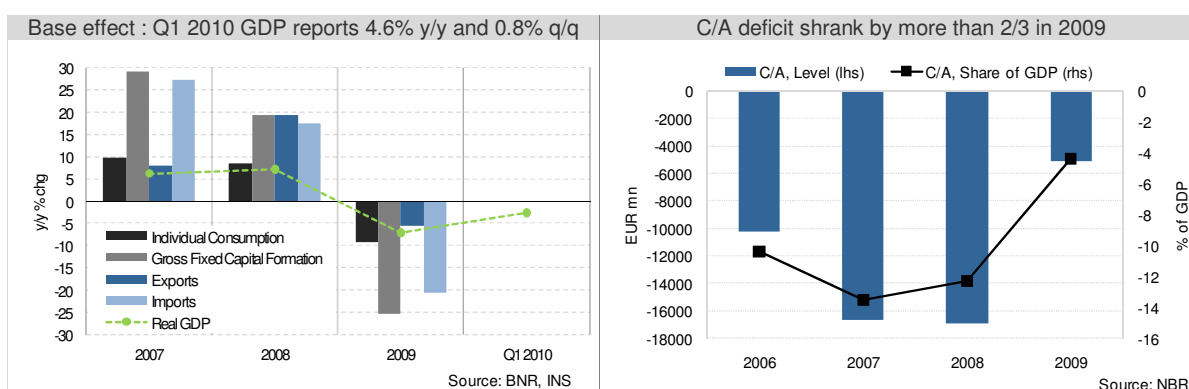
Long-term foreign currency credit rating (and outlook)

Baa3 (stable) (Moody's)	BB+ (stable) (S&P)	BB+ (stable) (Fitch)
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Economic Growth Performance

The Romanian economy has suffered a severe contraction last year: GDP slumped by -7.1% as compared to 2008 with nominal GDP standing at RON 491.27 bn (EUR 116.19 bn). **In Q1 2010, the economy still mired in recession as GDP dropped by -2.6% y/y (-0.3% q/q)**. Construction and retail trade remained the most affected economic sectors as aggregate demand remained low, while industrial production increased mainly due to the rise of external demand. In detail, industrial production rose by 4.4% in Q1 2010, while construction works dropped by -19.5% vs. the same period last year. Main drivers behind the dramatic drop of the latter were plunging residential and non-residential buildings (-43.4% and -29.7%).

We anticipate that the Romanian **economy should continue to contract in 2010 by around -1 % y/y**, due to the delay in reforming and reducing public sector expenses as well as the unexpected sluggish EMU recovery. As domestic demand is anticipated to remain deeply depressive (private sector loans and deposits still depressed in March), **an export-led recovery remains the white hope** for Romania's economy. Good signs underlining our expectations emerged recently with the overall value of new orders in industry surging by 18.9 % in the first quarter of 2010 vs. the same timeframe last year.



In April 2010, the unemployment rate reached 8.07%, dropping by 0.29 pps vs. March, but higher by 2.37 pps against April 2009. The slight downward trend of unemployment could be owed to seasonal factors and the recent growth in birth rate. The government promised to reduce the number of employees in the public sector by the end of the year, therefore the **unemployment rate might resume the rising pace in the next months, ending the year in the 8.5-9.0 % zone**.

External Balance

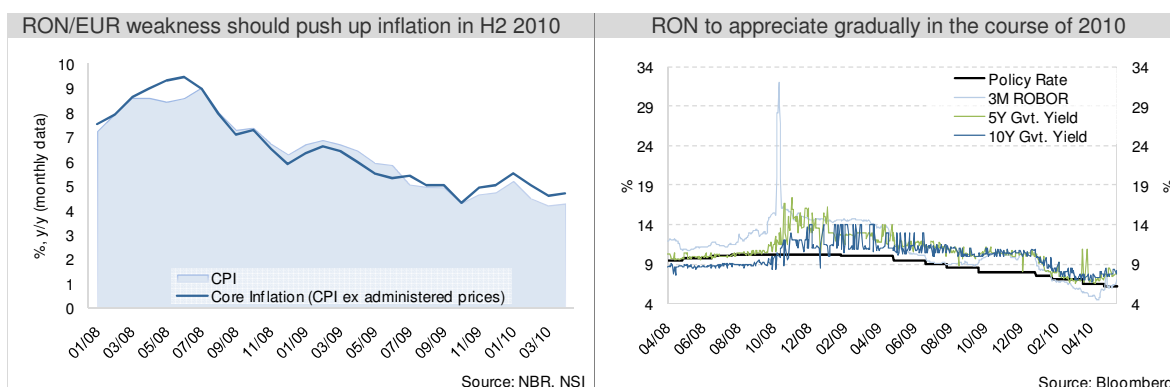
Following an extraordinary adjustment in the course of last year, the **current account (C/A) deficit rose to EUR 1,506 mn, up by 65.5% y/y in Q1 2010**, largely due to a low base and a steep fall in current transfers. The foreign trade deficit continued to decelerate in March, although the pace of contraction has decelerated (-24.4%) vs. the previous months. This is due to a slower increase in imports than in exports. In the same timeframe, the balance of services continued to deteriorate, recording a shortfall of EUR 273 mn vs. a deficit of EUR 64 mn in March 2009 as all services had a negative contribution. The current transfers, mostly **remittances from Romanians working abroad, plunged by -62.8%** in the observed period, to EUR 454 mn. In March the income gap remained the same as compared to the same period in 2009, reaching EUR 518 mn. With regard to the financing side, **FDIs amounted to EUR 754 mn in Q1 2010, falling by -48.9%** as compared to the same period last year. Thus, FDIs covered only 50.1% of the C/A gap. On a final note, net foreign direct investments stood at EUR 288 mn, while 86.2% of total FDIs were equity stakes.

Looking ahead, we see the **C/A shortfall to preserve its historically low, but still elevated levels of around 5.5-6.0% of GDP in 2010**, as both consumption and the local currency are likely to remain weak, discouraging a substantial rebound in imports.

Inflation and Monetary Policy

Headline inflation followed a downward trend in Q1 2010, dropping to 4.20% in March vs. 5.20% in January on the back of hikes in tobacco excise duties at the beginning of the year. **In April headline inflation posted a slight increase reaching 4.28%**, mainly due to the depreciation of the local currency and price increases at medicines and fuels. Against this background, especially the unexpected hikes in excise duties prompted the National Bank of Romania (NBR) to revise upwards the year-end inflation forecast to 3.70% from the previous 3.5%. Nonetheless, the NBR maintained unchanged its inflation targets at 3.5% for 2010 and at 3.0% for 2011. We are a bit more pessimistic than the NBR, as **we estimate that headline inflation would reach at around 4.0% at end-2010**, due to the unfavourable developments in the RON/EUR rate in recent weeks.

The NBR continued to relax monetary conditions. With inflationary pressures easing and investors' mood towards Romania improving until CEE assets took a heavy beating over mounting concerns on the European sovereign debt crisis in early-May, the key rate was slashed by 50 bps for three times in a row. Starting the year at 8.0 %, hence, the policy rate reached 6.5% in April. Since the latest domestic and international uncertainties required a more prudent monetary policy approach, the central bank has reduced the **pace of monetary easing to 25 bps at the monetary policy meeting in May, sending the base rate to 6.25%**. As central bankers admitted to have **less space for future rate reductions**, the monetary policy stance in Romania is aimed to maintain price stability, but, still, also to boost lending to the non-governmental sector. Thus, we believe that the NBR is likely to further slacken monetary reins, cutting the **key rate by another 75 bps to 5.5% until the end of 2010**. The pace, however, is anticipated to be lower (25 bps moves) than previously, as inflation proves to be quite resilient.



In May, the interest rate to the credit facility of the NBR Lombard rate decreased to 10.25 %, while the deposit facility rate has been lowered to 2.25 %, as the NBR kept a 4 pps spread around the monetary policy rate. Since the beginning of the year, the NBR has kept **unchanged the ratios of mandatory reserve requirements at 15% for RON and 25% for FX liabilities**. The ongoing monetary easing in recent months as well as the improving liquidity conditions in the banking system triggered a downward trend of interest rates. This is true for both various segments of the financial markets and the interest rates applied by credit institutions to non-bank customers.

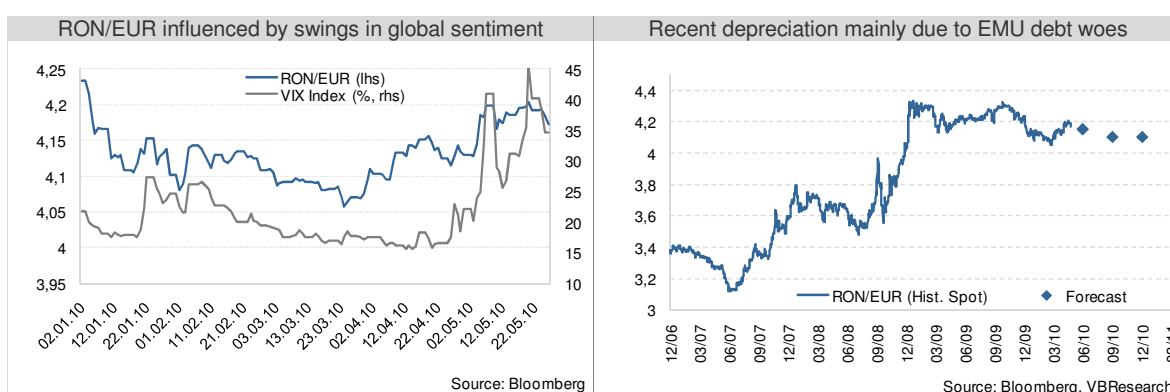
Yield Curve & foreign Exchange Rate

Since the beginning of the year, the **liquidity conditions have improved substantially in the Romanian money market**, due to the increase of the monetary base following the disbursement of the EC and IMF loan tranches, as well as the relaxation of minimum reserve requirements. Therefore, interbank interest rates positioned on a downward path dropping even below the key rate as credit demand from clients was weak and the amounts borrowed by the Finance Ministry gradually decreased in comparison to last year.

During January-April, the Ministry of Public Finance borrowed from the **local primary market RON 17.3 bn (EUR 4.2 bn)**, although it initially announced auctions for state securities worth RON 15.5 bn. Given the substantial improvement in money market liquidity conditions and lower financing

needs of the authorities, yields of state securities positioned on a downward path, easing down from 9% on average in January to an average of 6.5 % as of April.

In the first three months of 2010, the **Romanian leu positioned on a gradual appreciation path from its 4.23 level at end-2009 to a 15-month high at RON/EUR 4.05 on March 24, 2010**. The main driver behind this appreciation dynamics was a greatly improving sentiment towards the Central Eastern and Southern Eastern European region as a whole. Global sentiment can impressively be illustrated by the S&P 500 implied volatility index, aka VIX Index, which is regarded the investors' fear index. However, on the back of sharply deteriorating sentiment, which was triggered by sovereign debt issues of Greece and the EMU respectively, the strengthening trend of the leu reversed in April. Those pressures have been exacerbated by **unfavorable macroeconomic data from the local scene and Romania's hardly improving fiscal outlook**. Against this background, the Romanian unit tested the RON/EUR 4.2 threshold in early-May, which hardly held on with support from NBP interventions in the FX market. Regarding the latter, the NBR's foreign exchange reserves reached EUR 32.4 bn in April, increasing by EUR 350 mn as compared to March 2010, providing sufficient means of defending the local currency.



The monetary easing bias of the central bank puts continued downward pressure on the leu. In addition, **Romania's lagged exit from the current recession is likely to weigh further on the outlook**. On the other hand, more favourable growth perspectives in the medium term, the end of monetary loosening and the anticipated stabilization of the C/A deficit should be supportive for the domestic currency as the year progresses. Furthermore, we anticipate the IMF program to remain well on track, despite the recently intensifying social protests against the fiscal austerity measures. Hence, one major risk to our forecast stems from the political scene, especially with regard to the government's stamina in pushing through those unpopular measures. Overall, we expect the leu to quote **more or less unchanged around 4.2/euro in the remainder of H1 2010**, before appreciating slightly in H2 2010 again. As always, a favourable level of risk appetite is an inevitable assumption to our forecast with the European sovereign debt crisis currently in focus – posing substantial contagion risk to countries with deep fiscal gaps like Romania has.

Politics & Fiscal Balance

As recently implemented government measures had only a limited impact in reducing public expenditures, the public budget deficit was higher than expected: In March 2010, the general consolidated budget posted a deficit of RON 8.22 bn (EUR 2 bn, or -1.53% of GDP). Total revenues decreased by -1.4%, while total expenses dropped by only -0.5%. After the last review of the IMF and the EC, the **budget deficit target was revised upwards to -6.8% of GDP from the previous -5.9%**. Accordingly, the country's public debt reached around EUR 37.7 bn, or 28.77% of GDP – an increase by 4.7% vs. December-2009. Due to the continuous widening of the fiscal deficit in the past two years **Romania's debt service reached EUR 13.4 bn last year, as compared to EUR 3.38 bn in 2008**. The Ministry of Public Finance expects the debt service to decelerate to EUR 10.3 bn in 2010, as the state treasury switched to longer term borrowings.

At the end of April 2010, IMF, EC and World Bank experts visited Romania to assess the compliance with the targets set under the multilateral financing agreement. Due to the delay in implementing structural reforms, the government has finally chosen to **adjust the public sector and to**

diminish the social bill, as the private sector has already adjusted sharply. In particular, the Romanian government has committed to reduce public expenses with cuts in public sector salaries by -25% – effective from June 2010 – and to diminish the number of public employees by the end of 2010. Furthermore, the government intends to cut pensions and unemployment aid by -15% each. The Romanian president admitted that these measures are painful, but represented the alternative from tax hikes, which would have deepened the economic recession. According to IMF the budget deficit would have reached -9.1% of GDP in 2010 in absence of these measures.

For the time being, Romania has already received EUR 9.34 bn from the IMF, EUR 2.5 bn from the EC and EUR 300 mn from the World Bank. If Romania manages to reduce public expenses, respects its commitment to the financing agreement, it will receive the **fifth IMF tranche worth EUR 850 mn at the end of June**, while in July the third EC tranche of EUR 1.15 bn and the second EUR 300 mn tranche from the WB should follow.

Romania: Macroeconomic Indicators and Key Forecasts							
	2006	2007	2008	2009	Latest	2010	
Real GDP (% y/y)	7,9	6,2	7,1	-7,1	-2,6	Q01-10	-1,0
Private Consumption	11,4	11,6	8,4	-10,8	--	--	--
Government Consumption	-9,9	8,5	3,9	1,2	--	--	--
Gross Fixed Capital Formation	19,3	28,9	19,0	-25,4	--	--	--
Export (Goods and Services)	9,2	8,1	18,1	-5,5	--	--	--
Import (Goods and Services)	22,5	27,3	17,3	-23,0	--	--	--
National Income							
Nominal GDP (RON bn)	344,54	404,71	509,48	509,82	--	--	--
Nominal GDP (EUR bn)	97,77	121,32	138,18	120,28	--	--	--
GDP per capita (EUR)	4539	5654	6470	5655	--	--	--
Labour Market							
Unemployment Rate (%)	5,2	4,0	4,4	6,0	8,1	M04-10	9,0
Prices & Money							
CPI (% y/y)	6,6	4,8	7,8	5,6	4,3	M04-10	4,0
Broad Money, M2 (% y/y)	31,4	41,5	6,3	-5,9	12,8	M03-10	--
Public Sector							
Fiscal balance (% of GDP)	-1,5	-3,1	-4,9	-7,4	--	--	-7,0
Revenue (EUR bn)	25,17	33,08	37,32	28,41	--	--	--
Expenditure (EUR bn)	26,99	36,37	42,53	34,40	--	--	--
External Sector							
C/A Balance (EUR bn)	-9,99	-16,72	-16,95	-5,23	--	--	--
C/A Balance (% of GDP)	-10,2	-13,8	-12,3	-4,3	--	--	-5,8
Net Direct Invest. (EUR bn)	9,42	7,45	8,82	4,71	--	--	--
Debt Indicators							
General Govt. Debt (% of GDP)	38,5	40,2	35,2	42,5	--	--	--
Domestic (EUR bn)	17,97	24,45	27,05	29,48	--	--	--
External (EUR bn)	19,66	24,31	21,60	21,61	--	--	--
Total external Debt (% of GDP)	33,4	52,1	50,3	65,9	--	--	--
Total external Debt (EUR bn)	32,61	63,24	69,44	79,22	--	--	--
Financial Markets							
Policy Rate (% eop)	8,75	7,50	10,25	8,00	6,25	M05-10	5,50
RON/EUR (eop)	3,382	3,608	3,985	4,232	4,171	M05-10	4,100
RON/EUR (avg)	3,525	3,334	3,683	4,240	--	--	--
RON/USD (eop)	5,838	5,365	4,935	5,288	--	--	--
RON/USD (avg)	2001Q3	2001Q4	2002Q1	2002Q2	--	--	--

f: forecast, eop: end of period, avg: average, LCU: local currency unit

Source: Global Insight, Thomson Reuters, Bloomberg, INS, NBR, VBRResearch

SERBIA

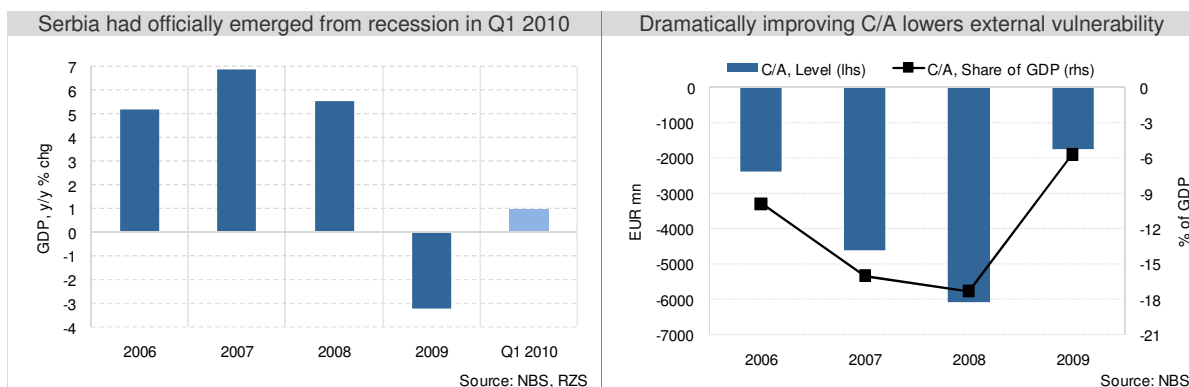
Long-term foreign currency credit rating (and outlook)

Not Rated (Moody's)	BB- (stable) (S&P)	BB- (negative) (Fitch)
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Economic Growth Performance

With the global financial crisis spilling over rapidly to Serbia in late-2008, according to the local statistical office (RZS) **GDP fell -3.0% in 2009** against 2008 with the negative quarterly y/y-growth-dynamics easing gradually (Q4 2009: -1.6% y/y). Mainly plunging domestic demand caused the recession with its components falling by -25% (investment) and -3% y/y (consumption). Net exports, however, are estimated to have positively contributed as imports dropped more dramatically than exports. Plummeting industrial output (-12.1% y/y), pulled by poor results in manufacturing and the key basic metals category, harmed export performance. Releasing its first ever flash estimate of quarterly GDP according to the RZS **Serbia had officially emerged from recession (1% y/y in Q1 2010)**. This is consistent with the latest data, indicating that industrial output increased and the trade figures point to a continued recovery (exports up 14.9%, imports down -4.8% y/y).

Looking ahead, domestic demand is expected to remain flat in 2010, reflecting the combined impacts of declining real incomes and employment, as well as tight credit conditions. Against this backdrop, we envisage **modest positive growth at above 1.0% for 2010**. Note, our projection essentially represents the statistical carry over, meaning that **no underlying growth in the economy is being assumed**. Furthermore, this growth scenario is predicated on an ongoing global recovery, as well as strong fiscal adjustment efforts in compliance with the IMF. Finally, an ongoing rebalancing of Serbia's growth model is crucial, with the tradable sectors emerging as a viable growth engine. Still, **potential spillover risks from Greece** are at hand: While Serbia's trade links are small and Greek bank subsidiaries account for around 15% of Serbia's banking assets, the exposure of their parent banks in direct cross-border lending to Serbian corporates raises concerns.



Unemployment – already high before the global downturn – increased to over 17% by the end of 2009, according to ILO standards. The main reason for the rise was sharply contracting employment, particularly in the recession-hit manufacturing and construction sectors. While some positive effects should come from the economic recovery in 2010, we assume this level to persist by the end 2010, as economic restructuring is going on with government ministers have stated public sector employment will be cut by 10,000-14,000 in 2010 in an effort to meet IMF fiscal targets. Only bringing in more FDI and cutting back on the grey economy will help reduce jobless rates.

External Balance

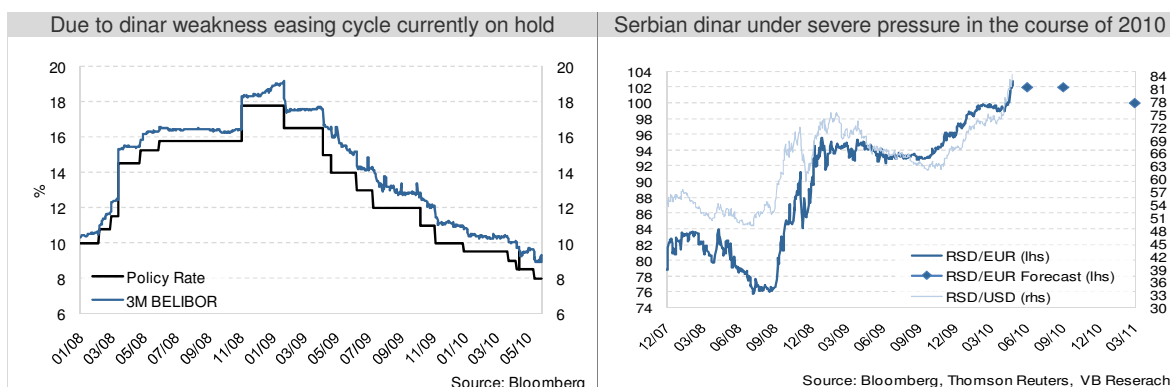
With plummeting exports and a more pronounced plunge in imports the foreign trade gap narrowed to EUR -4.76 bn in 2009. An even more dramatic improvement was revealed by C/A figures with the **gap accounting for EUR -1.74 bn, or -5.7% of GDP** (-17% in 2008). On the financing side, net FDI reached only EUR 1.37 bn (2008: EUR 1.82 bn). Portfolio investment, at a negative EUR -55 mn for the year, still spoke of a lack of investor appetite for Serbian assets. **In Q1 2010, the narrowing trend continued** with the cumulative C/A deficit falling by around -25% y/y.

Looking ahead, as exports are likely to strengthen gradually in H2 2010 – additionally supported by the currently weak RSD/EUR exchange rate – and domestic demand likely to remain subdued, the

merchandise trade deficit is set to narrow further. Nevertheless, this effect should be overcompensated, since we do not expect a repeat of such a strong contribution to the bottom line from transfers as seen in 2009. Thus, the 2010 **C/A gap is likely to widen significantly to around 7% of GDP**. The announcement in late March of plans to privatize 40% of the fixed line operator Telekom Srbije, should see resultant FDI inflows in Q4 2010/Q1 2011 to cover most of this deficit.

Inflation and Monetary Policy

The National Bank of Serbia (NBS) met its 2009 end-year core inflation target of between 6% and 10%, with the full-year (FY) **consumer price index coming in at 8.4%**. The sharp drop in global commodity prices and constrained domestic demand has worked to lower inflationary pressure, while the hike in regulated prices and the weakening failed to have a negative influence on the downward trend (yet). The slowdown in y/y-inflation continued in Q1 2010, mainly in response to the persistently low aggregate demand. **Prices in April 2010, however, increased by 4.3% y/y**. Serbia's inflation targeting is likely to be complicated by rising inflationary expectations, regulated price increases, an upturn in global commodity prices and the currently heavy depreciation pressures on the dinar. **Overall, we expect price growth to be kept under control during 2010.**



After six years at the helm of the central bank, **NBS governor Radovan Jelasic resigned in late March**. Until a successor is appointed – the ruling coalition proposed Dejan Soskic – he will perform his duties. Nonetheless, the NBS decided to further ease monetary policy and slashed the 2w repo rate between March and May by 50 bps on a monthly basis, bringing monetary easing to 150 bps year-to-date (YTD). The massive easing – this was the eleventh cut since the beginning of 2009 – now totals 975 bps with the **base rate reaching another historical low at 8%**. Recent slackening of monetary reins was mainly triggered by concerns on Serbia's still-sluggish economy. As long as headline inflation remains within the NBS target range, a policy of **gradual monetary loosening is possible to be continued in H2 2010**. A stabilization of the dinar vis-à-vis the euro – hitting one all-time-low after another in recent weeks – is a crucial prerequisite for that.

In order to stimulate growth in deposits, foreign borrowings and lending, the Monetary Board of the NBS also **lowered both local (LCY) and foreign currency (FCY) mandatory reserve rates (MRR)**. Effective as of 18 March 2010, the LCY MRR was lowered from 10% to 5%, while the FCY MRR was cut from 40% to 25%. The new FYR MRR will be phased in gradually in the course of 2010. The NBS initially raised the dinar share from 20 to 40% in Dec. 2008 to support the local currency, but reduced it then gradually as part of benefits offered under the Vienna agreement.

Foreign Exchange Rate

The dinar-euro rate remained stable without FX interventions throughout most of 2009. In December 2009, however, depreciation pressures re-emerged. In line with its stated FX intervention strategy, **the NBS was further forced to spend considerable sums of FX reserves in early 2010** in an attempt to curb the stubborn depreciation trend. The dinar fall was caused by supply-side pressures, prompted when the government converted EUR 500 mn of EU and IMF loans to deliver payments to budget recipients. This has been exacerbated by ongoing demand for imported energy, strong corporate demand to repay maturing cross-border credits and ongoing monetary easing.

Then, fuelled by Jelasic's resignation in late-March, RSD even broke the sacrosanct 100/EUR threshold. **By the end of May the unit was even pushed above 102/euro, a new all-time-low (-6.74% YTD)**, as pressures on the local currency failed to abate. Continued central bank interventions during April and May and a no-change decision at the last NBS meeting in mid-May were obviously not sufficient to alleviate the unfavourable sentiment towards the Serbian unit.

Regarding domestic factors, we assume that monetary policy gets more cautious and the government's fiscal approach is adjusted in line with IMF recommendations. In addition, the dinar's path also will depend partly on the **sentiment towards CEE and the Balkans**. Based on our baseline scenario, especially with regard to the anticipated easing of concerns on the European sovereign debt crisis, we now believe that the **dinar will stabilize against the euro during the months to come**. An unexpected sharp widening of the C/A deficit, delays in privatization and low FDI, as well as possible contagion from the EMU debt crisis argue for some risks of further RSD depreciation. Nonetheless, with sufficient FX reserves, including the latest IMF tranche, the **NBS has plenty of firepower** to keep it slightly above RSD/EUR 100 and restore confidence in the domestic currency.

Fiscal Balance

Serbia's government budget deficit rose sharply in 2009 because of higher-than-expected revenue shortfalls. The **budget deficit stood at -4.3% of estimated GDP, allowing Serbia to meet the fiscal restrictions imposed by the IMF**, demanding fiscal deficits not to exceed -4.5% of GDP. In Q1 2010 the general government deficit reached RSD 20.4 bn as the pace of expenses was not followed by still, declining revenues (due to tumbling corporate income tax revenues). Although the deficit doubled on a y/y basis, it represents just 20% of the official deficit for 2010. In line with the USD 4-bn loan deal with the IMF, Serbia is **targeting a budget deficit of -4.75% of GDP** in 2010. Nevertheless, this would require the introduction of wide-ranging spending cuts totalling around RSD 100 bn dinar. With the IMF threatening to withhold the remaining EUR 1.5 bn, the government is under intense pressure to meet the requirements. On the other hand, wage and pension freezes have created considerably social tensions. Against this background, the **government sought a softening of the criteria after Serbia seemingly left recession** (previous target 4.0% of GDP).

Serbia: Macroeconomic Indicators and Key Forecasts							
	2006	2007	2008	2009	Latest	2010 (f)	
Real GDP (% y/y)	5,2	6,9	5,5	-3,0	1,0	Q1-10	1,0
Private Consumption	4,5	3,0	11,9	-7,0	--	--	--
Government Consumption	5,3	12,8	13,5	-12,0	--	--	--
Gross Fixed Capital Formation	15,7	19,9	-8,0	-4,9	--	--	--
Export (Goods and Services)	16,1	3,2	-1,8	-12,3	--	--	--
Import (Goods and Services)	11,4	11,1	4,6	-20,7	--	--	--
National Income							
Nominal GDP (RSD bn)	2,042,05	2,273,70	2,790,90	2,956,03	--	--	--
Nominal GDP (EUR bn)	24,01	26,02	30,06	30,74	--	--	--
GDP per capita (EUR)	3273	3851	4647	4283	--	--	--
Labour Market							
Unemployment Rate (%)	--	--	13,70	17,20	--	--	17,30
Prices & Money							
CPI (% y/y)	11,7	6,5	16,3	9,2	4,3	M04-10	7,5
Broad Money, M2 (% y/y)	42,9	47,3	-0,9	-3,9	1,2	M03-10	--
Public Sector							
Fiscal balance (% of GDP)	-1,5	-2,0	-2,4	-4,3	--	--	-5,0
Revenue (EUR bn)	10,31	12,53	14,02	12,16	--	--	--
Expenditure (EUR bn)	10,68	13,09	14,86	13,50	--	--	--
External Sector							
C/A Balance (EUR bn)	-2,38	-4,63	-5,96	-1,80	--	--	--
C/A Balance (% of GDP)	-9,8	-16,3	-17,4	-5,7	--	--	-5,5
Net Direct Invest. (EUR bn)	3,40	1,84	1,86	1,02	--	--	--
Debt Indicators							
General Govt. Debt (% of GDP)	39,1	35,6	29,4	28,7	--	--	--
Domestic (EUR bn)	3,60	3,38	3,38	2,79	--	--	--
External (EUR bn)	5,79	5,89	5,45	6,04	--	--	--
Total external Debt (% of GDP)	61,2	70,1	66,9	77,2	--	--	--
Total external Debt (EUR bn)	14,69	18,24	20,11	22,63	--	--	--
Financial Markets							
Policy Rate (% eop)	15,35	14,00	17,75	9,50	8,00	M05-10	7,50
RSD/EUR (eop)	78,99	79,09	87,54	96,13	102,50	M05-10	101,0
RSD/EUR (avg)	84,27	80,04	81,67	94,23	--	--	--
RSD/USD (eop)	59,98	53,73	62,90	67,84	--	--	--
RSD/USD (avg)	67,10	58,44	55,83	68,03	--	--	--

e: estimate, f: forecast, eop: end of period, avg: average

Source: Global Insight, Thomson Reuters, Bloomberg, RZS, NBS, VBRResearch

Imprint

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Austria

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Cut-Off date for the present issue: May 26, 2010

Data Source (if not directly specified): Bloomberg, Thomson Reuters

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