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NEW EUROPE ECONOMICS & STRATEGY

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Regional markets retreat from recent highs as EMU debt crisis deepens

Bulgaria: Economic recovery underway, driven mainly by higher exports. GDP growth seen accelerating further in 2011 on improving domestic demand dynamics

Poland: Central Bank leaves key interest rates unchanged; raises reserve requirements on PLN and foreign currency deposits

Romania: Government survives no-confidence vote for the second time in four months; Political landscape to remain challenging in the period ahead

Serbia: NBS raised its key policy rate by a further 100 bps to 10.50%, in a move to address rising inflation risks and depreciation pressures on the dinar; Increased price pressures in the domestic economy suggest Central Bank may miss year-end inflation target

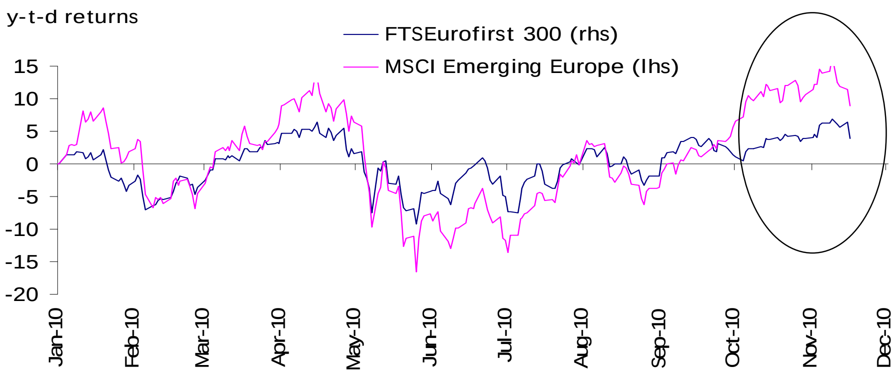
Turkey: Recent data suggests pace of economic recovery is slowing down in H2; full-year GDP growth still likely to outperform growth in New Europe peer-economies, expected to be as high as 7.5%

Ukraine: Constitutional Court overturned a number of restraints on Presidential powers introduced during the Orange Revolution in late 2004 and moved to strengthen the authorities of the President

New Europe market strategy highlights

We maintain our call that the Turkish lira and the Polish zloty will remain among the outperformers in the region on comparatively stronger economic fundamentals and relative monetary policy expectations. In local rates markets, it appears increasingly likely that in many cases that the recent rally has run out of steam. In Turkey, payer positions in 1Y1Y forward may provide value on incipient inflation risks in view of a strong economic recovery and the risk of fiscal slippage ahead of the July 2011 general elections. We stay sidelined in Hungary and Romania as fiscal uncertainty and political jitters bode ill for local rates in both countries in the coming months. We like receiving the 10-year POLGB-Bund spread at current levels around 250bps and favour long positions at the Ukrainian 4.95% October 2015 government bond in the area of 520 over ASWs. We continue to believe that external debt markets in New Europe remain expensive at current levels and highly susceptible to negative external developments.

Emerging Europe stocks outperforming developed EU peers on superior growth prospects, resilience to EMU debt crisis



Source: Bloomberg

Introductory Comment

Dear reader,

A number of countries in New Europe have already released their flash GDP estimates for Q3:2010, among them Bulgaria, Romania, Ukraine and Serbia. With the exception of Romania, the remaining countries published positive GDP growth readings, confirming our earlier view that the recovery in the region continues despite the deepening fiscal crisis in euro area.

For most economies in the region, the recovery has so far been primarily by higher net exports. However, we expect a more balanced pattern of economic growth in the coming quarters, in view of gradually improving domestic demand dynamics. Yet, economic recovery in New Europe remains uneven, with Turkey and Poland leading the rest of the pack, Serbia and Ukraine rebounding modestly and Bulgaria and Romania lagging behind.

The upside inflation risks we flagged in our earlier New Europe Economics & Strategy Monthly issues, have started to materialize in some regional countries. Supply side factors such as higher food prices stemming from a poor agricultural season, excise tax hikes and elevated world commodity prices have lately pushed CPI readings higher. However, the majority of central banks in New Europe are expected to stay put on policy rates, at least until H2-2011

Earlier this month we traveled to Sofia, Bulgaria where we hold a number of meetings with high level government officials. In this report, you can read the excerpts from our latest Trip Notes report on Bulgaria, published earlier this month. In our view, the country's sold fiscal position lays the foundations for a stronger economic rebound next year. Our main conclusion is that the Currency Board Arrangement remains sound and sustainable while the apparent elimination of the earlier lev-overvaluation provides an overwhelming case for maintaining the present FX regime until euro area entry

In Romania, the coalition government has survived another vote of no confidence in less than four months. However, the implementation of an aggressive fiscal consolidation program (25% cut in public wages and a 5pps VAT rate hike last July) continues to weigh on domestic demand, bringing real GDP growth down to -2.5% yoy in Q3 from -0.5% yoy in the prior quarter.

Serbia continues to exhibit convincing signs of economic recovery. An upwardly revised Q2 GDP growth estimate and the flash Q3 GDP report signal that the domestic economic recovery is gaining traction. However, soaring price pressures threaten to overshoot the Central Bank's inflation target. To complicate things further, increased depreciation pressure on the local currency apparently leaves no other option to the monetary authorities but to increase policy rates further in the period ahead. We see room for additional rate tightening of 50-100bps by the end of 2010 (key policy rate currently at to 10.50%).

In Ukraine, following a catastrophic recession last year, a recent stabilization in the domestic economic and political environment is contributing to a gradual improvement in the macroeconomic outlook.

Poland, the only EU economy which escaped recession in 2009, continued to perform solidly in Q3. As result, the Polish Central Bank kept in early November its policy rate unchanged at 3.50% for 16th month in a row and raised reserve requirements by 50bps, in a move broadly interpreted a signal of future monetary policy tightening.

Recent data suggests a relative deceleration in the pace of economic recovery in Turkey in H2. Yet, full-year GDP growth is still expected to outperform growth in New Europe peer-economies, turning out to be as high as 7.5%. More importantly, the recovery is characterized by relatively low inflation pressures despite the temporary rally in food prices.

Financial markets in New Europe have lately derived support from new monetary-policy easing moves in a number of industrialized economies and increased foreign portfolio inflows to regional asset and currency markets. A flurry of strong corporate earnings in Q3 has also favored global sentiment lately, helping to ease global economic recovery worries. Nevertheless, the rally came into a halt over the last few sessions on escalating concerns about the EMU sovereign debt crisis.

As a result, local rates markets came under some pressure recently, with nominal yields bouncing from multi-month lows touched in October. In a similar vein, local currencies eased slightly from recent multi-month highs recorded in the wake of the Fed's decision to extend its QE programme.

The Polish zloty and the Turkish lira remain the main outperformers year-to-date on superior macroeconomic fundamentals compared to the rest of the region. External debt markets also firmed since late September, assisted by allaying fears over the sustainability of the global economic recovery. As a result, five-year CDS spreads in the region remain near recent lows hit in early November on improved risk sentiment and expected rating upgrades.

Prof. Gikas A. Hardouvelis
Chief Economist & Director of Research

Summary of key macroeconomic indicators

Realizations and forecasts

	Real GDP (yoy)			Consumer Prices (p.a.)			Fiscal Balance (%GDP)		
	2009	2010	2011	2009	2010f	2011f	2009	2010f	2011f
Bulgaria	-5.0	0.0	2.5	2.5	3.1	2.7	-4.7	-3.8	-2.8
Poland	1.8	3.4	3.5	3.5	2.5	2.8	-7.1	-8.0	-7.0
Romania	-7.1	-2.0	1.5	5.6	6.5	4.5	-8.3	-7.8	-6.4
Serbia	-3.0	1.5	3.0	8.2	6.5	6.0	-4.2	-4.8	-4.0
Turkey	-4.7	7.5	5.0	6.3	8.8	7.2	-5.5	-3.8	-2.7
Ukraine	-15.1	4.0	4.2	15.9	10.2	11.0	-8.7	-6.5	-5.0
New Europe	-4.3	4.1	3.9	6.5	6.3	5.7	-6.6	-5.9	-4.7
Euro area	-4.1	1.7	1.5	0.3	1.5	1.6	-6.3	-6.8	-6.0
USA	-2.4	2.7	2.4	-0.3	1.6	1.1	-12.9	-11.1	-9.9

Foreign exchange and policy interest rates

Realizations and forecasts

	Current Account (%GDP)			Policy Rate (e.o.p.)			FX* (e.o.p.)		
	2009	2010	2011	current	2010f	2011f	current	2010f	2011f
Bulgaria	-9.4	-3.5	-7.0	currency board			1.96	1.96	1.96
Poland	-1.6	-3.1	-3.2	3.50	3.50	4.00	3.96	3.90	3.75
Romania	-4.4	-5.5	-6.0	6.25	6.25	6.50	4.29	4.33	4.25
Serbia	-5.7	-8.5	-9.5	10.50	11.50	9.50	106.7	110.0	115.0
Turkey	-2.2	-5.4	-5.5	7.00	7.00	8.50	1.46	1.40	1.30
Ukraine	-1.5	0.1	-1.0	7.75	7.75	7.75	7.95	7.80	7.90
New Europe	-2.6	-4.1	-4.6	-	-	-	-	-	-
Euro area	-0.6	0.0	0.2	1.00	1.00	1.25	1.34	1.38	1.35
USA	-2.9	-3.3	-3.4	0.125	0.125	0.125	0.70	0.72	0.74

Source: National statistics, IMF, EC, Eurobank Research forecast vs. EUR (TRY and UAH vs. USD

I. Overview

New Europe economies on a two-speed recovery path

Most recent data confirms that emerging market economies in New Europe remain on a recovery mode, as a rebound in major trade partners continues to support export growth. However, domestic demand dynamics remain weak in a number of regional economies, with increased emphasis on fiscal austerity weighing on the outlook of consumption and investments. For economies closely linked to euro area periphery markets, spill over risks from the ongoing debt-crisis continue to haunt investors. Along these lines, the recovery in New Europe continues on a two-speed mode. Turkey remains the frontrunner, having posted double-digit GDP growth in H1. The rebound was initially driven by favourable base effects and bouncing inventories. However, as the latter's impact gradually fades, domestic consumption and investments are increasingly providing support, assisted by accelerating domestic credit. Poland is also exhibiting strengthening domestic demand dynamics, having registered average GDP growth of 3.3%yoy in the first six months of the year. In spite of the strong rebound in both countries, it is worth highlighting that the recovery in domestic labour market conditions is proving relatively slow. On the other hand, Romania continues to pose as the primary laggard in the region, expected to be the only EU27 economy - apart from Greece - to remain in recession this year, weighed down by a string of aggressive fiscal austerity measures that came into effect earlier this year. In fact, third quarter GDP data confirmed a deepening of the economic recession, with real growth contracting by 2.5%yoy after a 0.5%yoy decline in Q2. Meanwhile, economic activity in Hungary accelerated to 1.6%yoy in July-September from 1.0%yoy a quarter earlier. In Bulgaria, real GDP growth bounced into a positive reading on a quarter-on-quarter basis in Q2 and on an annual basis in Q3, signalling that the domestic economy is gradually emerging out from recession.

Underlying inflation pressures remain benign, but risks linger due to higher food prices, improving output gaps

Underlying inflation pressures in New Europe remain benign as domestic demand dynamics in most regional economies remain benign. Against this background, the impact of fiscal austerity measures on inflation is likely to prove temporary in the coming months. The same applies to higher food prices which have lately boosted by adverse weather conditions. We reiterate that current price pressures are cost-push rather than demand-pull and as such, they should moderate gradually going forward. Meanwhile, we consider the risks of second round effects rather limited at this point as output gaps remain negative. However, as the latter narrow gradually, inflation risks may become more apparent towards the end of next year.

Most central banks in the region to stay put on rates in the coming several months

In view of the aforementioned factors, we anticipate that most central banks in New Europe will stay put on rates over the coming several months. Hasty monetary tightening is likely to deal another blow to ailing domestic demand, while increased interest rate differentials relative major trade partner economies would risk accelerate capital inflows, pushing regional currencies higher and taking a toll on exports. In that respect, the FOMC's decision in early November to extend its QE programme has added to expectations that enhanced global liquidity conditions will stir a new round of appreciation pressures on emerging market assets and currencies. This provides additional support to our long-held view that most central banks in the region are unlikely to incept their monetary tightening cycles earlier than next year. Even in Poland, where expectations for imminent rate hikes have been on the rise lately we do not anticipate the Central Bank to embark on monetary tightening before Q1 2011. Romania and Hungary, which halted their monetary easing cycles earlier this year so as to contain price pressures stemming from higher excise and VAT tax rates, are likely to stand pat on rates for some time. Meanwhile, Turkey's central bank is not expected to deliver its first rate hike before Q4 2011, as clearly indicted in the CBRT's October inflation report. On the flipside, Serbia's central bank last raised its key policy rate in October in view of increased inflation pressures and a weakening dinar (which is currently at all-time lows vs. the euro).

Fiscal consolidation remains a key challenge for most economies in the region

In view of the lingering debt crisis in the euro area periphery and last year's significant deterioration in the fiscal positions of many countries in New Europe, a key challenge for governments remains fiscal consolidation ahead. Most countries in the region have already scrapped earlier support measures and have undertaken unpopular steps in order to push their ballooning budget deficits lower. Along these lines, concerns about fiscal and political stability ahead are on the rise. In Romania, the government survived a new no-confidence motion in parliament as recently as in October. In Serbia, trade unions are opposing an IMF-backed pension law, while in Hungary new taxes and a pension reform bill have stirred public discontent and raised concerns about the long-term sustainability of public finances. In these lines, the upcoming endorsements of 2011 budget drafts in regional parliaments will be closely monitored by market participants over the coming weeks.

Regional stock markets off recent multi-year highs amid escalating EMU periphery worries

Financial markets in New Europe extended their rally into early November following an extension of the FOMC's quantitative easing programme and a flurry of strong corporate earnings results. Allayed global economic worries also boosted sentiment towards the region, which is expected to significantly outpace growth in developed peer economies. However, the rally came into a halt over the last few sessions, in view of the recent escalation in EMU sovereign debt crisis. At the market close of November 15, the benchmark MSCI Emerging Market equities index was around 3.7% higher compared to its late-September levels, remaining not far off a 29-month peak of 1,159.98 hit earlier this month. The corresponding Emerging Europe sub-index, which had been a laggard in recent months, outperformed its peers to post gains in excess of 5% over the last month or so, having recoiled slightly from a 26-month high of 539.24 hit on November 9. Year-to-November-15, the said index is up ca 11%, outpacing a 6% ascent in the World MSCI, but still lagging behind gains of ca 13% recorded in corresponding benchmark index of emerging equities. In the New Europe region, Ukraine's PFTSI index remains the major outperformer, having recorded gains to the tune of ca 41% since the beginning of the year. Turkey's XU100 is the runner up having registered a year-to-date jump in excess of 30%.

Local government bond yields edging higher

Local bond markets in New Europe have remained broadly supported in recent months against a background of low inflation and scaled-back monetary tightening expectations by central banks in the region. However, fiscal uncertainty and increased political jitters in a number of economies have lately pushed government bond yields higher from lows recorded earlier this year. In Poland, increased expectations for rate hikes in the imminent future on the back of recent hawkish statements by a number of NBP officials also had an impact. As a result, the Polish benchmark 2- and 10-year government bond yields rose by ca 40-50bps each in early November, touching respective 5- and 3-month highs of 4.947% and 5.77%. In Hungary, 3- and 10-year benchmark bond yields rose by ca 60bps each to 6.8% and 7.2%, respectively from multi-month lows achieved in mid-October. Elsewhere, Turkey's April 25, 2012 benchmark bond hovered around levels of 7.95%, from an all-time low of 7.70% recorded a few weeks earlier, as headline CPI accelerated more than expected in recent months.

Regional currencies retreat for recent highs on EMU debt concerns

Local currencies came under pressure in recent sessions on escalating EMU fiscal concerns. Yet, most remain close to multi-month highs achieved earlier this month, supported by improving macro fundamentals, increased capital inflows and the FOMC's decision to renew its QE programme. It does not come as a major surprise that the Turkish lira and the Polish zloty have been among the outperformers so far this year, in view of their superior underlying macroeconomic fundamentals. Notably, the recent surge in capital inflows to Turkey pushed the TRY to a 2-year peak in early November, prompting aggressive action by the CBRT in the form of a higher reserve requirement on lira deposits and a 400bps cut in the Central Bank's overnight borrowing rate. Following these developments, the USD/TRY bounced to a 1-½-month peak 1.4534 on November 16, from a 2-year trough of 1.3830 touched two weeks earlier. Separately, the Polish zloty eased by ca 2% to hit a 2-week low against the euro after touching a near 7-month peak of 3.8715/EUR earlier this month. In spite of recent pressures on both currencies, there is little to suggest that either has embarked on a sustainable downtrend. In Turkey, the rebound of the domestic economy is expected to be the most dynamic in the region, while political and policy-related uncertainties have eased significantly recently, as the government has so far displayed staunch commitment to fiscal prudence. In Poland, the zloty is likely to remain supported by expectations that the NBP will be among the first CBs in the region to incept its monetary tightening cycle in view of strengthening domestic demand dynamics. On the flipside, Romania's leu remains not too far from a 3-½-month low of 4.3240/EUR hit in late October as ongoing political uncertainty and a weak growth outlook continue to weigh on investor sentiment. Elsewhere, the Serbian dinar stands close to a lifetime low near 108/EUR touched on October 28. The currency remains the region's major underperformer having slid by more than 10% year-to-date. Its weakness has been widely attributed to increased corporate demand for hard currency and a lack of capital inflows. The central bank has intervened several times in the FX markets so far this year and also raised its key policy rate three times since August to stop the unit from depreciating any further.

External debt spreads remain compressed on improved risk sentiment, expected rating upgrades

New Europe external debt spreads in the CDS space have tightened further since late September, reflecting easing investor worries over the sustainability of the world economy. 5-year CDS spreads in Turkey, Bulgaria and Romania have shrunk by ca 20% over the last month or so, with the former's touching 3-½-year lows near 115ps on November 4. Note that Moody's raised in early October Turkey's credit rating outlook to positive from stable citing strengthened economic and fiscal resilience. Meanwhile, Poland's 5-year CDS spread rose by more than 20bps in mid-November from a 6-month low of 110bps earlier that month. Hungary is a primary laggard in region, with its CDS spreads narrowing just 4% to 312bps since late September, amid lingering worries over the country's long-term fiscal position. Moody's warned in September that the country's credit ratings could be downgraded if a credible fiscal plan is not presented by the government on time. On its part, S&P affirmed its ratings on Hungary in early November but maintained its negative outlook amid concerns about deteriorating government finances. Elsewhere, Ukraine's 5-year CDS spreads remain close to a low of 487 hit in mid-October after Moody's raised the country's credit rating outlook to stable from negative, citing improving external liquidity conditions after the government sealed a $15bn deal with the IMF and successfully launched Eurobond issue in September.

Strategy

In spite of lingering euro area debt jitters, the economic revival in New Europe and FOMC's second quantitative easing programme bode well for regional asset markets in the coming months. The prospect of an economic rebound in tandem with benign inflation pressures also favors investor sentiment towards the region. Local currencies remain near recent highs and we continue to see further appreciation potential in the coming months. We maintain our call that the Turkish lira and the Polish zloty are likely to remain among the outperformers on comparably stronger economic fundamentals and (eventually) increasing interest rate differentials vs. the rest of the region. In our view, the Romania leu will continue lagging its regional peers in the near future as the domestic economy is expected to be among the very few in Europe to post a negative GDP growth this year, while the prospect of monetary tightening by the NBR is still relatively distant. Lingering political jitters and fiscal consolidation concerns are also likely to continue capping the leu's upside potential.

In the local rates markets, it appears increasingly likely that in many cases that the recent rally has run out of steam. In Turkey, payer positions in 1Y1Y forward may provide value on incipient inflation risks in view of a strong economic recovery and the risk of fiscal slippage ahead of the July 2011 general elections. We stay sidelined in Hungary and Romania as fiscal uncertainty and political jitters bode ill for local rates in both countries in the coming months. We like receiving the 10-year POLGB-Bund spread at current levels around 250bps and favour long positions at the Ukrainian 4.95% October 2015 government bond in the area of 520 over ASWs.

We continue to believe that external debt in New Europe at current levels remains quite expensive and highly susceptible to negative external developments related to e.g. the lingering sovereign debt crisis in the euro area and the pace of the global economic recovery ahead.

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II. New Europe – Country Analysis: **Bulgaria**

Currency Board remains sound and sustainable

- Economic recovery underway, driven mainly by higher exports. GDP growth seen accelerating further in 2011 on improving domestic demand dynamics
- The government remains firmly committed to swift euro adoption; Conditions for ERM-II entry application may become more favorable by the end of next year, provided that the government will stick to the announced fiscal target for 2011
- Bulgaria needs to accelerate structural reforms in the pension system, health care and education sectors in order to ensure medium-term sustainability of its public finances
- The silver lining of the economic recession is the rapid absorption of earlier macroeconomic imbalances. The latter can lay the foundation of a more balance growth environment medium-term
- Credit conditions remain tight despite the adequate capitalization and sufficient liquidity of the banking system. The deleveraging process in the household sector appears to be reaching a trough, yet vulnerabilities in the corporate sector remain
- Bulgaria's Currency Board Arrangement remains sound and sustainable, with foreign exchange reserves providing strong coverage of the monetary base and broader monetary aggregates.
- The apparent elimination of an earlier lev-overvaluation provides an overwhelming case for maintaining the present FX regime until euro adoption

Earlier this month, we traveled to Sofia where we met with high-level officials from the BNB, the Finance Ministry, and the IMF as well as market participants from the domestic financial sector. The present note attempts to offer our readers a cohesive overview of current conditions in the domestic economy and markets and the outlook ahead. In addition, it provides an update on issues related to the sustainability of the Currency Board Arrangement (CBA) as well as the opportunities and challenges facing Bulgaria in its road towards euro adoption.

Economy is slowly emerging from recession, driven primarily by higher exports

The domestic macro outlook has brightened since our last visit to Sofia in December 2009. Having seen the worst of the recession in Q4:2009, the Bulgarian economy is recovering slowly, with the pace of contraction in real GDP growth easing to 1.4% yoy in Q2:2010, from 3.6% yoy in the prior quarter. On a quarter-to-quarter (seasonally adjusted) basis, domestic output grew by 0.5% in Q2, after declining by 0.5% in the first quarter. Notably, the majority of our discussants forecasted another positive q-o-q reading in Q3 and thus, a termination of the domestic recession, at least from a technical standpoint.

The pattern of recent economic recovery largely repeated itself in Q2:2010, with domestic demand falling behind. The pace of contraction in private consumption appears to have slowed to - 4% yoy from -6.8% yoy in Q1. Government spending was also particularly weak (-19.2% yoy in Q2) affected by the government's fiscal consolidation program. Furthermore, investment recorded a steep decline of -12.2% compared to -15.8% yoy in the prior quarter and -24.9% in the year 2009 as a whole. On a more positive note, the contribution of net exports to overall GDP growth turned even more positive in Q2, compared to the first quarter of 2010, mainly reflecting higher exports.

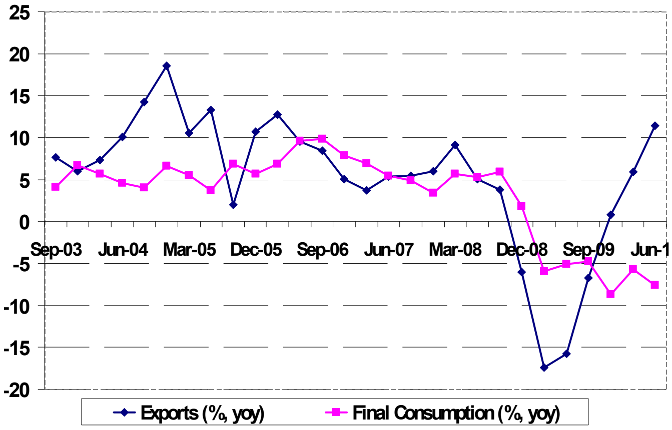
The latter recorded an astonishing growth of 12.4% yoy in Q2, after rising by 7.6% yoy in Q1. At the same time, imports stayed flat on yearly basis in Q2 vs. -2.6% yoy in Q1.

Bulgaria: Eurobank EFG Forecasts

	2008	2009	2010f	2011f
Real GDP (yoy%)	6.0	-5.0	0.0	2.5
Final Consumption	6.0	-5.0	-4.0	2.0
Gross Capital Formation *(Fixed)*	20.4	-26.9	-6.5	2.5
Exports	2.9	-9.8	13.0	5.0
Imports	4.9	-22.3	2.5	4.0
Inflation (yoy%)				
HICP (annual average)	12.0	2.5	3.1	2.7
HICP (end of period)	7.2	1.6	4.2	3.0
Fiscal Accounts (%GDP) - *EU Methodology*				
General Government Balance	1.7	-4.7	-3.8	-2.8
Gross Public Debt	13.7	14.7	18.6	21.7
Primary Balance	3.9	0.0	-2.0	-1.5
Labor Statistics - *National Definitions*				
Unemployment Rate (% of labor force)	6.3	7.6	9.0	8.0
Wage Growth *(total economy)*	26.5	8.5	4.5	2.5
External Accounts				
Current Account (% GDP)	-25.4	-9.4	-2.5	-5.5
Net FDI (EUR bn)	6.2	3.3	1.2	2.0
FDI / Current Account (%)	75.8	103.6	135.0	100.0
FX Reserves (EUR bn)	12.7	12.9	12.5	11.5
Domestic Credit	**2008**	**2009**	**Q1 10**	**Q2 10**
Total Credit (%GDP)	75.2	79.2	78.9	79.2
Credit to Enterprises (%GDP)	47.8	49.4	49.2	49.4
Credit to Households (%GDP)	26.0	28.2	28.1	28.1
FX Credit/Total Credit (%)	57.2	58.6	59.5	60.1
Private Sector Credit (yoy)	32.3	4.5	3.3	2.8
Loans to Deposits (%)	119.3	120.5	116.3	114.3
Financial Markets	**Current**	**3M**	**6M**	**12M**
Policy Rate		Currency Board		
EUR/BGN	1.96	1.96	1.96	1.96

Source: National Sources, Eurostat, IMF, Eurobank Research

Figure 1
Final consumption remained weak in Q2



Source: National Statistics, Eurobank Research

For the time being, the continued slump in domestic demand is outweighing the recovery in net exports. For the year 2010 as a whole, domestic demand is not anticipated to have a positive contribution to overall GDP growth, given the former's steep pace of contraction in H1. Yet, the contribution of domestic demand is expected to gradually become less negative in the coming quarters, which, along with a continuing positive contribution from next exports, should see annual real GDP growth turning positive in the second half of the year, starting from Q4:2010.

Growth expected to pick up in 2011 on improved domestic demand dynamics and sustained exports recovery

The domestic macro outlook for 2011 and beyond was a focal point in our discussions with government and industry officials. There was unanimous agreement among our contacts that next year should see both a significantly faster and a more balance economic growth trajectory, though there were diverging views over the magnitude of the expected recovery.

We also anticipate an acceleration of the pace of domestic economic recovery next year, with the contribution of domestic demand turning positive and that of next exports lessening somewhat relative to the current year, mainly as a result of higher imports growth. Our baseline forecast for Bulgaria's GDP growth in 2011 lies at 2.5% yoy, with risks being broadly balanced. Among the upside risks to the domestic growth environment, we rank high the utilization of EU structural funds and the country's sound fiscal position. A faster utilization of EU funds could provide a significant boost to domestic investment over the next several years, especially in an environment of more difficult conditions in world credit markets and reduced FDI inflows. The Bulgarian government has recently demonstrated significant progress regarding the absorption and efficient utilization of EU funds, with the respective absorption rate climbed to around 8% in September 2010 compared to less than 1% a year earlier. According to one of our contacts, the continuation of such improved performance could add between 1.0 and 1.5pps to annual GDP growth over the coming few years.

Most importantly, the relatively solid fiscal position lays the foundations for a stronger economic rebound next year, while, at the same time, allows for greater predictability with respect to the government's policies on wages and pensions. In addition to the aforementioned, recent readings in a range of higher-frequency macro indicators and improving consumer and business surveys signal stabilizing conditions in the domestic economy and lay the foundations of a more pronounced economic recovery in 2011. On the other hand, there is a number of downside risks to our GDP forecasts. Among others, these include the impact of a potential growth slowdown in main trade-partner economies that could not be offset by increased exports to new markets. Bulgarian exports have diversified geographically in recent years with a growing volume now being destined to Middle East and Turkey. Yet, the risk of slower exports growth in 2011 is not minimal, if only on the back of unfavorable base effects. Last but not least, stagnant credit growth could prevent a more sustained recovery in domestic demand dynamics next year.

Achievement of the fiscal target in 2010 considered more or less a done deal

In our meetings with officials at the Central Bank and the Ministry of Finance, we had the opportunity to discuss the latest fiscal developments and the budget outlook for 2011. The broad picture is that Bulgaria still enjoys a comfortable fiscal position, as measured by standard sustainability metrics and in comparison with other countries in the broader region. First of all, the fiscal deficit in Bulgaria remains one of the lowest in EU-27. Even after accounting for a number of revisions to past fiscal data as a result of the hidden procurement annexes discovered last March, the 2010 budget deficit is projected to reach 4.8%-of-GDP on a cash basis and 3.8%of-GDP in ESA-95 terms. Moreover, gross public debt is expected to reach 18.6% of-GDP this year, comparing to 84.7% in EU-16 and 79.6%-of-GDP in EU-27. The respective figure stands significantly below the Maastricht Treaty's 60% threshold, remaining the second lowest in EU-27 after Estonia.

The revision of this year's fiscal target in July (to 4.8%-of-GDP, from 0.7%-of-GDP envisioned initially) brought the respective deficit projection closer to current economic reality. The revised budget forecasts total revenues to reach BGN 15.2 bn this year i.e., 11% yoy (or 2.9%-of-GDP) lower relative to the initial target. On the expenditures side, total budget outlays this year are now seen amounting to BGN 18.9 bn or 5.7% yoy higher than the initial target. The budget execution data for the first eight months have demonstrated that the achievement of the fiscal target of 2010 is more or less a done deal. In fact, higher tax revenue during the remainder of the year could even facilitate an outperformance of the fiscal deficit target in 2010. There are a number of potential reasons for such a favorable development, including: a) an improved tax collection mechanisms, b) recovering domestic demand 3) higher than forecast domestic inflation boosting nominal tax revenues.

According to preliminary data, the fiscal deficit reached BGN 1.5 bn year-to-September or 2.1% of projected 2010 GDP, remaining steady relative to the January-August period. Importantly, the negative trend in revenues collection has started to reverse, though total revenues were still declining on an annual basis in the first eight months of the year, albeit at a slower pace than in early 2010. (Total revenue down 9.8% yoy in January-August vs. -13.6% yoy in 1H). Among other categories, VAT revenues jumped strongly in recent months, currently standing not far from their pre-crisis levels. Specifically, they reached around 61.9% of the full-year budget plan in August against only 43.1% in June. In addition, the implementation of additional belt-tightening measures since last March has resulted in total expenditures declining by 1.2% yoy year-to-August vs. -0.5% yoy in 1H.
Our discussions with BNB and finance ministry officials focused on two

additional issues. The first one relates to the financing of this year's fiscal deficit. The revised budget foresees that financing will come from both the fiscal reserve account and domestic resources, with domestic debt issuance forecasted to reach BGN 2.0 bn by the end of 2010 against BGN 1.2 bn planned initially.

The government made use of its fiscal reserve account to finance the fiscal deficit in 1H: 2010. (In fact it had started drawing down the fiscal reserve account for budget-financing purposes since July 2009, when deficits started to emerge). As a result, the fiscal reserve declined to BGN 6.0 bn in June 2010, from BGN 7.6 bn in December 2009. According tour discussants, the use of the fiscal reserve to finance the fiscal deficit was terminated in June 2010, with the contingency reserve climbing to BGN 6.7 bn in September. That said, the Ministry of Finance resorted to domestic financing sources in more recent months, issuing in September some €234mn in 15-year EUR-denominated bonds at 6.45%. The aforementioned issue was extremely successful, being oversubscribed by five times, relative to the initially intended issue size (€45 mn).

Successful execution of 2011 budget seen as key prerequisite for reapplying to ERM-II mechanism

Another important issue we delved into during our recent Sofia meetings was the attainability of the 2011 fiscal targets. The new budget foresees the fiscal deficit to decline to 2.5% of GDP on a cash basis, based on a 3.6% GDP growth assumption for 2011. That would be the combined result of expenditures staying flat in nominal terms and total revenues growing by 5.2% yoy. Most of our discussants argued that next year's fiscal target remains within reach. Yet, some of them expressed certain reservations regarding the official forecast for GDP growth next year. We do share these concerns. However, we note that the final deficit will depend not only on the headline GDP outcome, but also on the composition of growth next year. Naturally, that is because a shift towards a more domestic-demand oriented growth environment has, by definition, higher tax content (because of the VAT).

The government has stated that it does not intend to change the present VAT or the corporate and personal income tax rates next year. However, it has announced its intention to raise excise taxes on some goods. In addition, it intends to increase the social security contribution rates, most probably by 3pps, taking back the prior year's reduction. The government has a number of options to finance the 2011 budget deficit with domestic and external resources, but it has not made clear yet the precise financing mix it intends to use. Among the options is the issuance of Eurobonds in international markets worth €1.0-1.2bn.

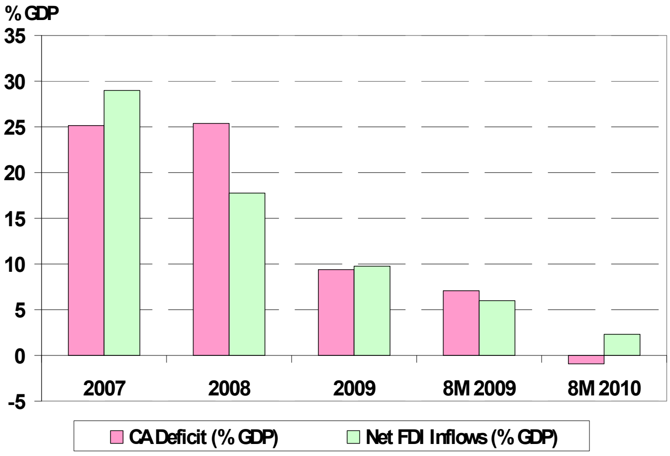
There are two important implications with respect to the achievement of the fiscal target in 2011. The revelation of the hidden annexes in public contracts last March had a negative impact on the image of the country, but not a devastating effect on the credibility of its fiscal statistics. Yet, the breach of the 3%-of-GDP deficit threshold was enough to defer the ERM -II application and put the country in the adventures of the excessive deficit procedure. For that reason, it is imperative that the fiscal target of 2011 is achieved. From our discussions with the authorities and a number of high-level industry officials we concluded that the government remains committed to swift euro adoption as soon as domestic and external macroeconomic and political conditions allow. As such, an official application for ERM-II entry could materialize as early as in 2012, especially if the government manages to meet next year's fiscal target.

Last but not least, the government needs to ensure successful execution of its fiscal consolidation program in order to strengthen medium-term sustainability of public finances. An important element in that process is the acceleration of the structural reforms in the pension system, health care and education sectors. The current solid fiscal position offers domestic authorities a valuable time window to implement these reforms in a gradual and orderly manner. For that reason, structural reforms in those areas should not to lose momentum ahead of next year's Presidential elections

The silver lining of the recent recession is the quick absorption of earlier macroeconomic imbalances

One of the side effects of the recent recession in Bulgaria is the quick retreat of earlier macroeconomic imbalances. In particular, the decline in the current account deficit has exceeded by far earlier analyst expectations. According to the latest data, the current account swung into surplus in August for a third month in a row. As a result, it recorded a surplus of €323 mn in January-August, which represented 0.9% of the projected full year GDP vs. a deficit of 7.3% of GDP in the first eight months of 2009 (Figure 2).

Figure 2
Current account swung into surplus in Jan-August 2010



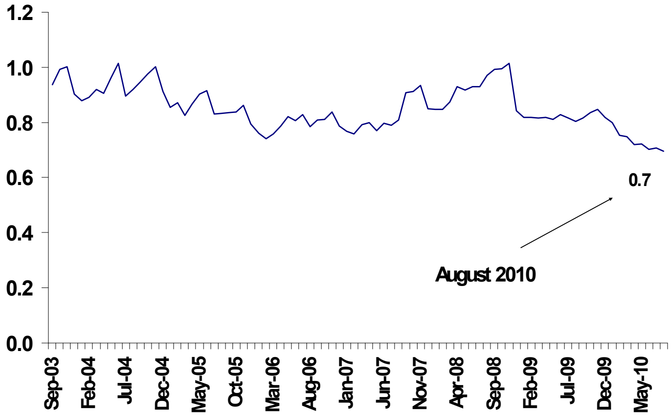
Source: BNB, Eurobank Research

This improvement reflects mainly a smaller trade gap (down 4.8ppts of GDP year-on-year in January-Aug 2010 at 3.7% of GDP), owing to a strong recovery in exports (+32.2% yoy over that period). In August only, exports were growing at the astonishing rate of 47.6% yoy against a decline of 25.5% in August 2009. Imports grew by 7.2% yoy over the same period, having recorded negative annual growth until April. Exports to non EU-markets expanded more rapidly, benefiting mainly by the rebound in the Turkish economy. Besides a lower trade gap, other elements have also contributed to the current account improvement year-to-August. Although revenues from tourism and transportation from foreign visitors remained flat compared to last year, net services recorded a surplus increased by 45.5% yoy thanks to less transportation and tourism services used by domestic residents. In addition, the incomes deficit came out much lower than a year earlier (down 20.2% in January-August), as foreign-owned companies paid out less dividends to mother companies abroad. Moreover, net current transfers recorded a higher surplus (+69% yoy), thanks to increased EU funds inflows.

From the funding side, the capital and financial account recorded a deficit of €695mn in the first eight months of this year. The most important component, net FDI inflows, remained sharply lower (down 60.5% vs. a year earlier), amounting to €835 mn. The sectors affected the most were real estate and financial intermediation.

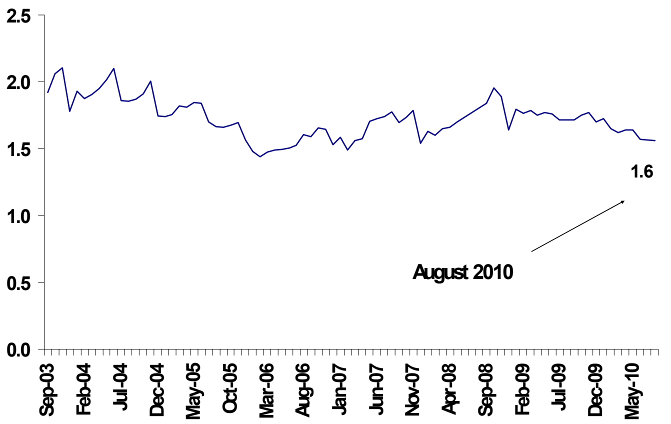
However, the FDI-to-current account coverage improved to 237% year-to-August, from 82% in the corresponding period last year. Elsewhere, net portfolio investments remained negative (-€483mm vs. -€567mn in January-August 2009), while the negative net balance of €1083 mn of other investment reflects the repayment of foreign debt obligations by the banking and corporate sectors. Overall, the private sector's gross external debt registered a small decline to 93.6% of GDP in August compared to 96% in late 2009.

Figure 3
Coverage of local currency denominated portion



of M2 by FX reserves (1xtimes)

Figure 4:



Money base coverage by FX reserves (1Xtimes)

Source: BNB, Eurobank Research

The rapid improvement of current account deficit entails significant policy implications. Once considered the major vulnerability of the Bulgarian economy, the unwinding of the external imbalance has so far proceeded in an orderly, yet painful, fashion. That is because, given the high export content of Bulgarian imports, the decline in the current account deficit has so far been primarily driven by a sharp fall in FDI inflows. The latter implies, in turn, that the balance-of-payments improvement can prove sustainable in absence of significant structural deficiencies. Secondly, it creates a new economic environment and a set of new challenges.

The Bulgarian economy has been a major beneficiary of capital flows in the broader region in the past, which served as the main engine of domestic growth. Driven by convergence prospects, the Bulgarian economy received 27.1 bn Euros in FDI inflows during 2004-2008. The majority of those inflows were channeled to non-tradable sectors. The most representative sector was the real estate market which flourished in the booming years. Given that capital inflows are highly unlikely to reach their pre-crisis levels, the pattern of growth will have to switch to a more balanced between domestic and external demand mix.

Currency Board Arrangement remains strong and sustainable

Bulgaria's currency board arrangement (CBA) remains strong and sustainable, with foreign exchange reserves continuing to provide ample coverage of the money base (ca 160% in August 2010 i.e., not far from pre-Lehman levels).

FX reserves also currently cover a significant part of the country's (Lev-denominated part of) M2 and also continue to provide strong coverage of broad money, which is presently among the highest in the emerging markets universe (~ 50% vs. 35% average). In addition to fulfilling these technical requirements, there is also overwhelming political support to, as well as a strong social and cultural component in the CBA.

From a more structural medium-term perspective, it appears that the sharp inflation decline and a significant improvement of macroeconomic imbalances in recent months have eliminated the earlier lev overvaluation, provides an overwhelming case for maintaining the present FX regime until euro adoption.

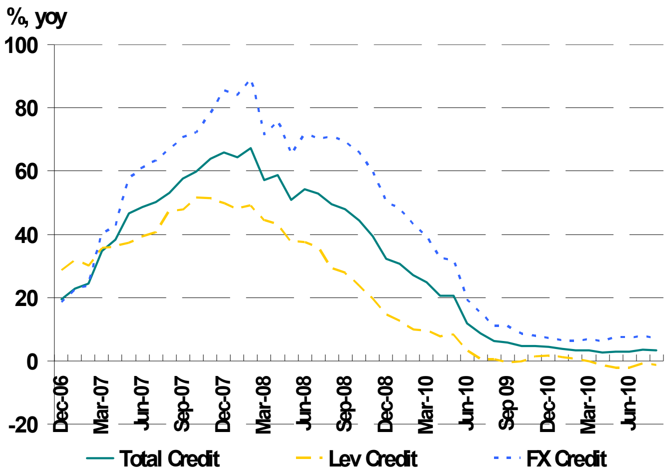
Credit conditions in the domestic market remain tight; growth of NPLs have started to moderate

The Lehman Brothers collapse in September 2008 brought an abrupt end to the lending boom in Bulgaria, with the Central Bank's measures to boost domestic liquidity and encourage lending (e.g. cuts in minimum reserve requirements) having so far only partial success. Credit growth to the non government sector landed to a single digit of 4.5% yoy at the end of 2009 compared to 47.9% yoy a year earlier. Ever since, credit creation remained stagnant, growing cumulatively by just 0.5% yoy in January-August 2010.

The continued tightness of domestic credit conditions stems, primarily, from the demand side. Credit growth is not constrained so much by the lack of adequate supply on credit by domestic banks, despite the still relatively high loans-to deposits ratio (113.9% in August 2010). It is the lack of demand that is severely constraining new lending. Households and corporates have started to save more and repay their debts.
For that reason, deposits have recorded a strong bounce since the beginning of the year, growing cumulatively by 5.5% yoy in January-August.

The process of deleveraging in the household sector seems to have been approaching a trough lately. Credit to households has retreated slightly in January-August, by -0.1% yoy cumulatively. The insignificant decline is owed to two opposite trends within the consumer segment.
Housing mortgage loans grew by 2.1% yoy, while consumer lending decreased by 2.2% yoy cumulatively over that period. Furthermore, credit to corporates registered negligible growth of 0.2% yoy year-to-August.

Figure 5
Credit activity remains stagnant



Source: BNB, Eurobank Research

Overall, it appears that the domestic banking sector has fared pretty well during the economic downturn. Part of the resilience to the global credit crunch and, more recently, to the euro area sovereign debt crisis can be attributed to its geographically diverse ownership structure, which is a crucial difference relative to the Baltics region. In addition, domestic banks have been very successful in renegotiating loan agreement with existing clients.

The NPLs ratio has risen relatively modestly compared to the rest of the region so far, reaching 9.5% in June 2010 compared to 5.2% in September 2009. Yet taking into account that NPLs is a lagging indicator of economic activity, the corresponding ratio may rise a little further in the coming months. However, the growth rate of NPLs has started to moderate, which predisposes for a peak in the ratio in the coming months.

Moreover, the local banking sector carries strong capital buffers. Those are reinforced by those large foreign-own subsidiaries who have committed to maintain their overall exposure in the country to at the levels recorded in last May. In contrast to 1997, where a banking crisis turned into an economic crisis, the solid domestic banking system now appears to be an anchor of stability in the Bulgarian economy.

In terms of capitalization, the banking sector scores relatively high in the region. The capital adequacy stood at 17.3% in H1 against 14.3% before the onset of the crisis in September 2008 which provides enough comfort against rising NPLs and optimism for the banks to extend new lending when economic conditions improve.

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II. New Europe – Country Analysis: **Poland**

Central Bank leaves key interest rates unchanged; raises reserve requirements on PLN and foreign currency deposits

- Most recent readings in a range of higher-frequency indicators suggest domestic economy continued to perform solidly in Q3; we stick to our 3.4% GDP growth forecast for 2010
- October inflation jumps to 2.8% yoy form 2.5% yoy, mainly due to higher food prices; core inflation remains stable at 1.2% yoy for a third consecutive month in September
- NBP kept the policy rate unchanged at 3.5% for 16th month in a row and raised reserve requirements (by 0.5pts to 3.50%). Move broadly interpreted a signal of future monetary policy tightening
- Fitch signals downgrade risk if Polish government fails to take convincing measures aiming to promote a substantial reduction in the budget deficit by 2012
- Domestic credit growth returns to positive territory, as banks appear more willing to lend and demand for credit revives, especially in mortgage lending

IMF revised upwards Polish GDP growth forecasts

Real GDP growth accelerated to 3.3% yoy in the first half of 2010, from 0.8% yoy in the same period a year earlier, led by higher inventories and improving domestic demand dynamics. All signs suggest that the domestic economy performed solidly in Q3 and we stick to our 3.4% GDP growth forecast for the full-year. The latter coincides with the IMF's (recently revised) growth projection for 2010. In late October, the Fund revised its GDP growth forecasts for the Polish economy to 3.4% yoy and 3.7% yoy in 2010 and 2011 respectively, from 3.1% yoy and 3.5% yoy expected in July.

Looking ahead, strong employment growth is expected to continue supporting consumption, with sizeable inflows of EU structural funds (up to €67bn available over the 2010-2012 period), providing a strong boost to domestic investment. What's more, public sector investment will remain supported ahead of the 2012 European Football Championships. Looking at the more recent readings in a range of higher-frequency indicators, retail sales (in volume terms) surprised to on the upside in September, rising by 8.6% yoy against a market consensus forecast of 6.9% yoy and a 6.6% yoy reading in the prior month, signalling that the recovery in domestic demand is gaining pace. Elsewhere, industrial production growth slowed to 11.8% yoy in September from 13.6% yoy in August, but still expanded by 12% yoy in the third quarter as a whole. With respect to labour market developments, employment growth was slightly higher in September, coming in at 1.8% yoy, from 1.6% yoy in the prior month. Nevertheless, employment is not rising fast enough to fully absorb new entrants to the country's labour force. This may help to explain why wage growth still remains relatively subdued (3.7% yoy in September vs. 4.2% yoy in August).

In the latest Inflation report, the National Bank of Poland revised its real GDP growth forecasts to 3.5% yoy and 4.3% yoy in 2010 and 2011 respectively (from 3.2% yoy and 4.6% yoy estimated in June's Inflation Report). Downside risks to the Polish economic outlook come in the face of the country's deteriorated fiscal position. That may lead to further fiscal austerity measures that could weigh on Poland's economic performance.

Poland: Eurobank EFG Forecasts

	2008	2009	2010f	2011f
Real GDP (% yoy)	5,0	1.8	3.4	3.5
Private Consumption	5.8	2.3	2.8	3,0
Government Consumption	7.4	1.9	2.4	2,0
Gross Capital Formation	6.4	-13.8	1.6	9,0
Exports	7.3	-7.8	12.5	10.2
Imports	8.4	-13.5	13.4	10.4
Inflation (% yoy)				
CPI (annual average)	4.2	3.5	2.5	2.8
CPI (end of period)	3.3	3.5	2.7	2.8
Fiscal Accounts (% GDP)				
General Government Balance	-3.7	-7.1	-8	-7,0
Gross Public Debt	47.2	51,0	55,0	57,0
Labor Statistics (%)				
Unemployment Rate (% of labor force)	9.8	11	11.5	11,0
Wage Growth *(private sector - average)*	NA	4.2	3.3	3.5
External Accounts				
Current Account (% GDP)	-5,0	-1.6	-3,0	-3.2
Net FDI (bn EUR)	8,0	6.1	9.5	10.5
FDI / Current Account	43.7	122.2	90	90
FX Reserves (bn EUR)	40.6	54.8	72	68
Domestic Credit	**2008**	**2009**	**Q1-10**	**Q2-10**
Total Credit (% GDP)	50.9	53.1	52.2	54.4
Credit to Enterprises (% GDP)	17.6	16.1	15.7	15.8
Credit to Households (% GDP)	29.7	31.6	31.6	33.6
FX Credit/Total Credit (%)	32.6	30.2	29.3	31.8
Private Sector Credit (% yoy)	38.1	7.2	1.2	7.2
Loans to Deposits (%)	106	102.6	100.6	103.2
Financial Markets	**Current**	**3M**	**6M**	**12M**
Policy Rate	3.5	3.5	3.75	4,00
EUR/PLN	3.97	3.9	4,00	3.9

Source: NBP, EcoWin, Bloomberg, Eurobank Research

Fitch signals downgrade risks to Polish credit ratings amid heightened fiscal problems

In late October, Fitch rating agency said that it may downgrade Poland if the government fails to implement a substantial and sustainable reduction in the budget deficit by 2012. Furthermore, the IMF forecasted that the Polish fiscal deficit will rise further to about 8% of GDP in 2010, mainly as a result of lower than projected corporate and personal income tax revenues. According to the Fund, the fiscal consolidation effort in 2011 will need additional measures including, among others: a) a broadening of the tax base for income taxes and social security contributions, b) a rationalization of social transfers and benefits to weaker social groups and c) tighter pension indexation. In our view, these measures would send a strong signal to the markets regarding the commitment of domestic authorities to fiscal sustainability, while preserving the economy's growth momentum. Yet, a delay in the appropriate policy response appears to be likely due to the upcoming Parliamentary elections scheduled for autumn 2011. Note, however, that the elections may be brought forward due to Poland EU presidency in the second semester of 2011.

Poland continues receiving strong capital inflows, mainly in the form of inward portfolio investments

The current account deficit narrowed to €1.13bn in August 2010 from €1.52bn in the previous month and €251mn in August 2009. Trade deficit deteriorated further to €789mn in August from €606mn in July due to decelerating exports growth. We expect the current account deficit to widen further in the coming months, with the full-year gap coming in at ca 3% of GDP in 2010, from 1.6% of GDP in 2009.

From the funding side, portfolio inflows in July-August amounted to €5.7bn, out of which €5.3bn were invested in domestic debt securities. On a 12-month-rolling basis, portfolio investment reached €21.3bn in August 2010, compared to €1.9bn over the same period a year earlier. On the other hand, foreign direct investment (FDI) remained almost stable compared to the same period a year earlier, with the corresponding 12-month-rolling figure reaching €9.1bn in August 2010 vs. €9.4bn a year earlier. At the same time, Poland is building up foreign reserves. The latter stood at €72.4mn in September 2010 compared to ca €57mn in the beginning of the year.

In its last Financial Stability Report (October 2010), the IMF highlighted that Poland currently receives the largest capital inflows relative to the size of its domestic economy compared to other emerging market economies. While this represents a vote of confidence in the Polish economy by international investors it also involves the risk of inflating domestic asset bubbles that could exacerbate external financing volatilities. This is especially relevant for Poland, given the recent surge in inward portfolio investment, which is generally more susceptible to reversal that FDI investment.

October inflation's jump owed to higher food prices

Headline CPI jumped to 2.8% yoy in October, from 2.5% yoy in September and 2.0% yoy in August, slightly below consensus expectations for a 2.9% yoy increase. On a monthly basis, inflation rose by 0.5% mom in October, following a 0.6% mom increase in the prior month. The surge in October and September inflation is largely attributed to higher food prices (~25% share in the CPI basket). Food prices rose by 4.8% yoy (1.0% mom) in October up from 4.3% yoy (1.8% mom) in September and 2.3% yoy (-1.4% mom) in August. The spike in food inflation is the result of unfavourable agricultural conditions, owing to the floods in spring and summer 2010. It is worth noting that core inflation, the measure which excludes food and energy prices, remained stable in September at 1.2% yoy for a third month in a row. However, strengthening demand conditions, coupled with a 1ppts increase in VAT rates from January 2011 pose upside risks to domestic inflation in the coming months. Taking into account recent inflation developments, the National bank of Poland in its October Inflation Report raised its annual average CPI forecast for 2011 from 2.7% yoy to 3.0% yoy, but kept its 2010 inflation projection unchanged at 2.5% yoy (Table 1). In a similar vein, in late October the IMF revised its GDP and inflation forecast for Poland. The Fund now expects Polish inflation rising to 2.7% yoy in 2011 (from 2.5% yoy expected in July), on the back of improving domestic labour market conditions (Table 2). We expect headline inflation to average 2.5% yoy this year, before accelerating to around 2.8% yoy in 2011.

Table 1
IMF's updated forecasts

	July 2010		October 2010	
	2010	2011	2010	2011
GDP	3.1	3.5	3.4	3.7
CPI	2.5	2.5	2.4	2.7

Source: IMF

Table 2
NBP's updated forecasts

	June 2010		October 2010	
	2010	2011	2010	2011
GDP	3.2	4.6	3.5	4.3
CPI	2.5	2.7	2.5	3.0

Source: NBP's Inflation Report June 2010, October 2010.

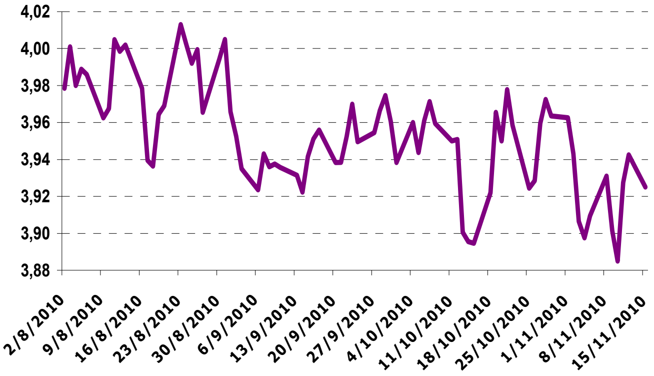
NBP keeps policy rates unchanged at 3.50%, for 16th month in a row

NBP decided in its October MPC meeting to keep its policy rate unchanged at 3.50% for 16th month in a row and, instead, raised reserve requirements on (PLN and FX deposits) by 0.5ppts to 3.50% effective on 31 December 2010. The move was interpreted by markets as a signal of future policy tightening, while avoiding for the time being attracting additional foreign portfolio inflows. The latter would risk triggering a new round of currency appreciation with adverse consequences for competitiveness and exports growth. The MPC further justified its decision by pointing to rapid industrial production growth, gradually easing credit condition, steadily rising capacity utilisation and an improving labour market. In addition, the accompanied policy statement read that domestic price and wage pressures remain contained. We stick to our forecast for a gradual NBP rate tightening trajectory in the months ahead, with the first 25bps hike being delivered in Q1-2011 and the key policy rate expected to be raised to 4.00% by end of 2011, from 3.50%, currently.

Zloty seems broadly stable in for the rest of the year

We expect the zloty to remain relatively stable in the remainder of the year, mostly ranging within the 3.90-4.00 area. Deputy Finance Minister, Ludwik Kotecki, stated recently that he expected the zloty to continue hovering in a stable range in the following months, taking no clear direction. Kotecki added that a zloty level close to 4.00 against the euro is beneficial for Poland's economy as it is not inflationary, not too strong for exporters and not too weak for importers. (Figure 1)

Figure 1
EUR/PLN exchange rate



Source: Reuters, Eurobank Research.

Positive credit growth almost entirely driven by lending to households

Polish credit conditions has improved recently. Credit growth is driven largely by lending to households, while corporate loans continue to decline.

Monthly growth of total credit returned to a positive territory in August, rising by 2.2% mom, following a 1.3% mom contraction in July. This brought year-to-August total credit growth to 5.9%. Private sector credit grew by 9.2% yoy in August after slowing to just 1.2% yoy earlier this year (March 2010). According to NBP's latest monetary survey (October 2010) domestic banks are becoming more willing to lend and, at the same time, demand for credit is reviving, especially in mortgage lending. Namely, household credit grew by 3.3% mom in August and by 10.6% year-to-August. At the same period, mortgage lending rose by 3.3% mom in August and by 13.5% since the beginning of the year. On the contrary, corporate loans declined by 0.3% year-to-August, even though, they rose by 0.4% mom in August. In annual terms, loans to corporates continued their downward trend, yet with a smaller scale of decline (-2.5% yoy in August compared to -9.0% yoy recorded in March 2010).

What's more worrisome is the rise in the share of foreign currency loans; FX denominated loans to total loans ratio reached 31.9% in August compared to already high level of 30.9% at the beginning of this year. Total deposits grew by 1.2% mom in August and by 5.3% year-to-August. The Loans to Deposits ratio stood at 103.3% in August compared to 102.6% in the beginning of this year.

Non-Performing Loans (NPL) to total loans ratio showed some signs of stabilization and remained stable at 8.3% for second consecutive month in August. Yet, in absolute figures NPLs rose by 16.8% since the beginning of this year, with household, mortgages and corporates NPLs increasing by 29.3%, 35.4% and 4.6% respectively. Moreover, zloty denominated NPLs rose by 41.9% since the beginning of this year while Swiss Franc denominated NPLs grew by 28.8% at the same period.

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II. New Europe – Country Analysis: **Romania**

Government coalition survives new no-confidence vote

- Government survives no-confidence vote for the second time in four months; Political landscape to remain challenging in the period ahead
- Real GDP contraction accelerated to -2.5% yoy in Q3, from -0.5% in the prior quarter on the back of the tough fiscal consolidation measures introduced last summer
- Central Bank maintains interest rates unchanged at 6.25%, in line with market expectations; adopts ambitious inflation targets for 2012 and beyond

GDP contraction deepened in Q3

According to the flash Q3 GDP report released on November 12, real output on an seasonal unadjusted basis declined by 2.5% yoy, following a 0.5% yoy contraction in the prior quarter. On a seasonally adjusted basis, GDP declined by -0.7% qoq, after recording marginally positive growth (+0.3% qoq) in Q2. Year-to-September, real GDP contracted by -1.9% yoy on an unadjusted basis and by -2.3% yoy on a seasonally adjusted basis.

The deepening of the domestic recession in the third quarter of the year did not come as a major surprise. According to a poll conducted by the Romanian Financial-Banking Analysts' Association (AAFBR) ahead of the release of the flash Q3 GDP report, the pace of economic contraction was expected to reach 0.7% qoq and 2.3% yoy respectively. The flash estimate was in line with our expectations as well. In the August 2010 issue of our New Europe Economics & Strategy Monthly we highlighted that the improvement in GDP growth recorded in Q2 was likely to prove temporary.

Although a breakdown of the Q3 GDP figures is not yet available, it is quite obvious to us that the government's tough austerity package introduced last summer was the major culprit of the deepening recession. The austerity package included, among other measures, sizeable cuts in public sector wages and a steep hike in the main VAT rate. The new austerity measures, put into effect on July 1, appear to have had a pronounced impact on domestic demand, which remains the weak link of the Romanian economy. The five percentage points VAT rate hike (from 19% to 24%) is eroding the purchasing power of domestic households, while a 25% reduction in public sector wages and a 20% cut in public spending on goods and services is putting additional pressure on disposable incomes. The latter, in turn, has been already reflected in a 4.3% yoy decline in the volume of retail sales in Q3, with even steeper drops being recorded in such vital sectors as food sales (-8% yoy).

Consequently, private consumption is expected to remain a negative contributor to overall GDP growth in 2010, while investment spending is unlikely to provide any support, in view of the continuing recession in the all-important construction sector (construction index down by 14.3% yoy in Q3). The only encouraging signs come from the industrial sector, which continues to contribute positively to overall GDP growth. Industrial production growth slowed to 4.8% yoy in Q3, from 6.8% in the prior quarter, but it is still in a positive territory, continuing to derive support from higher external demand. Exports of goods grew by 18.6% yoy in January-September, helping to pull domestic manufacturing out of recession.

Romania: Eurobank EFG Forecasts

	2008	2009	2010f	2011f
Real GDP (yoy%)	7.3	-7.1	-2.0	1.5
Private Consumption	9.5	-10.5	-2.5	1.0
Govern. Consumption	7.1	0.8	-2.0	-1.0
Gross Capital Formation	16.2	-25.3	-10.0	2.5
Exports	8.7	-5.5	20.0	10.0
Imports	7.8	-20.6	15.0	8.5
Inflation (yoy%)				
CPI (annual average)	7.9	5.6	6.5	4.5
CPI (end of period)	6.3	4.7	8.0	4.0
Fiscal Accounts (%GDP)				
General Government Balance (ESA 95)	-5.4	-8.3	-7.8	-6.4
Gross Public Debt (ESA 95)	13.3	23.7	35.5	41.9
Labor Statistics (annual avg,%)				
Unemployment Rate (% of labor force)	4.0	6.3	9.0	7.5
Wage Growth (total economy)	23.6	8.4	5.5	6.5
External Accounts				
Current Account (%GDP)	-11.6	-4.4	-5.5	-6.0
Net FDI (EUR bn)	9.5	4.8	4.5	5.0
FDI / Current Account (%)	57.6	94.3	65.0	61.5
FX Reserves (EUR bn)	26.2	28.3	31.5	35.0
Domestic Credit *(end of period)*	**2008**	**2009**	**Q1 10**	**Q2 10**
Total Credit (%GDP)	42.7	50.2	50.5	53.3
Credit to Enterprises (%GDP)	18.8	19.6	19.7	20.9
Credit to Households (%GDP)	19.7	20.4	19.9	21.1
FX Credit/Total Credit (%, private)	53.1	60.1	60.4	61.6
Private Sector Credit (yoy)	33.7	0.9	-1.6	6.4
Loans to Deposits (%)	131.9	130.6	126.5	136.6
Financial Markets	**Current**	**3M**	**6M**	**12M**
Policy Rate	6.25	6.25	6.25	6.50
EUR/RON	4.29	4.33	4.35	4.30

Source: National Sources, Eurostat, IMF, Eurobank Research

Overall, we still anticipate GDP growth to contract by 2% yoy in 2010. Our forecast is slightly better than market consensus (e.g. Romanian Financial-Banking Analysts' Association expects a 2.2% contraction this year). On its part, the IMF now forecasts a 2% yoy decline in real output this year against a 0.5% yoy contraction expected in early August.

No confidence vote fails to bring down government coalition for the second time in four months

The government coalition survived on October 27th a no confidence vote for the second time in four months. The motion was initiated by the leftist main opposition parties, the Social-Democrat Party (PSD) and the National Liberal Party (PNL), in an attempt to boycott the IMF-agreed austerity fiscal package. Specifically, 219 parliament members voted for the motion, compared to 236 (50%+1 of all members of parliament) required to bring down the government. There were no votes in favor of the government, as the parliament members of the ruling party decided to abstain from voting in order to avoid defections.

In our August 2010 New Europe Economics& Strategy Monthly issue we warned that the rejection of the June 2010 no-confidence vote did not necessarily mean a more stable domestic political environment going forward . Recent opinion polls suggest that a new general election would see the major opposition party, SDP, being able to gain the first position, with a good chance to form a new coalition government. As such, the polls give a strong incentive to the opposition parties to attempt to overthrow the ruling coalition. The current government, who relies on independent and ethnic minority MPs for a very thin parliamentary majority of 4 seats, is likely to continue facing problems in parliament.

Furthermore, recent developments related to a new proposed education law led to frictions among the government coalition partners. The constitutional court ruled against a government initiative to speed up the approval of the law, after it was debated in the Senate. The attempt to challenge the educational legislation touches upon a very sensitive issue: the education of ethnic minorities in the country. The UDMR party, which represents the ethnic Hungarians, considers this law important as it increases minorities' rights in education. The party leader has already made it clear that UDMR's participation in the coalition is conditioned upon the progress made in issues related to minorities' rights. The latter was a clear hint that the UDMR might exit the ruling coalition if the new education law is not passed in its original form. In an attempt to rebut worries over political instability, the Prime Minister Emil Boc has recently stated that the government may continue to pursue on an accelerated legislative-approval process despite the Constitutional Court ruling.

On the other hand, the ruling party PDL has no incentive to resort to early parliamentary election at this point. In such case, according to the polls, PDL could lose most of its seats in an early parliamentary election given the implemented unpopular policies. In addition, the UDMR party has in reality no real option to form another government coalition with the rest of the opposition parties (PSD and PNL), under the current circumstances. The UDMR minority party could promote its agenda on ethnic minority education reforms only under the current government coalition.

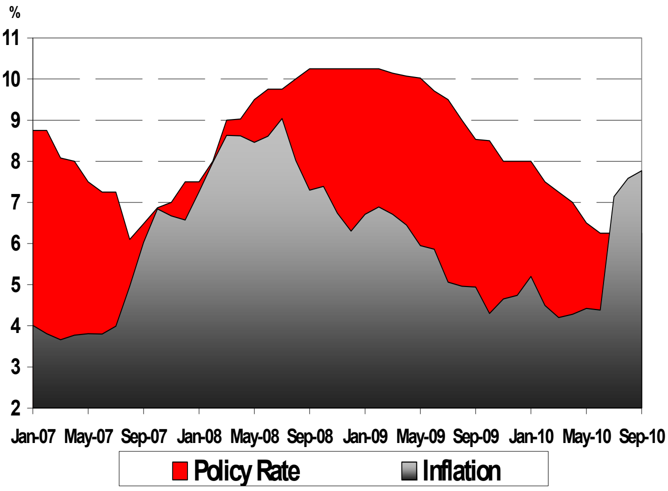
All in, there is still a non-immaterial probability that the domestic political landscape will remain challenging in the coming months. In conclusion, the chance that current government will not be able to end its term in late 2012 is still significant, yet lower than before. However, the risk of increased social unrest is still looming. Labor unions haven't given up on their effort to annul the government fiscal consolidation program, preparing new demonstrations in the coming months. Thus, renewed political instability may inhibit the government's ability to implement its fiscal consolidation program. If such risks materialize, then RON and RON denominated assets may come under further pressure in the period ahead.

Central Bank maintains key policy rate and minimum reserve requirements unchanged;

The Central Bank decided on November 2nd, to keep its key policy rate and the associated deposit facility rate unchanged at 6.25% and 2.25%, respectively. They also decided to maintain the minimum reserves requirement at 15% for RON and 25% for FX. Furthermore, the NBR Board left this year's formal inflation target unchanged at 3.5 +/-1 percent, but revised upwards its year-end CPI forecast, to 8.2% yoy from 7.8% yoy previously. According to the NBR Governor, Mr. Mugur Isarescu, the main risks to the domestic inflation outlook stem from administrated and food prices and uncertainty surrounding the implementation of the government's fiscal reform. At the same time, the Board decided to maintain its inflation target for next year, while adopting a new one for the period 2013 onwards. More specifically, the 2012 target was kept unchanged at 3 ±1 percent, while from 2013, a flat multi-annual inflation target of 2.5 ±1 percent was adopted.

After cutting interest rates by 175bps since the beginning of 2010, the NBR was forced to terminate its easing policy cycle last June to address rising inflation risks stemming from a steep hike in main VAT rates. Ever since, interest rates remain on hold and will most probably stay unchanged for the remainder the current year. The Central Bank's current strategy attempts to strike a balance between two opposite forces: the negative output gap on the one hand and the recent inflation spike and renewed pressures on the RON due to heightened political instability on the other. On the inflation front, note that the VAT hike and higher food prices boosted domestic inflation to 7.9% in October compared to 4.38% in June yoy. The surge in inflation brought real interest rates to a negative territory (ca -150bps, currently), which, naturally, makes RON assets even less appealing (Figure 1). Higher food prices (+5.5% yoy /+0.8% mom in October) were the main driver behind inflation in the last couple of months. Floods in mid summer have damaged agricultural production while commodity price rallies in international markets increased imported food prices. In addition, the impact on inflation from the first round effects from the VAT hike makes things only worse.

Figure 1
Inflation spike brings real interest rates into negative territory



Source: NBR, Eurobank Research

Longer-term bond yields may trend higher in the foreseeable future
The higher risk premia on domestic assets investors are currently requiring are also reflected in Romanian bond yield levels. Investors started demanding since late spring higher yields for longer maturities as a consequence of the uncertainties with respect to the political situation, the implementation of the fiscal consolidation program and the ongoing recession in 2010.

However, the government refused to pay yields higher than 7% for all medium and long term maturities since last May. As such, the

Ministry of Finance strategy was to reject all bids above 7% in all the auctions since the beginning of the year. To fill in the respective gaps, the ministry resorted to issuing short-term T-bills (up to 6M) in the same period, taking advantage of ample interbank liquidity. That strategy had two negative side effects. Firstly, it resulted in long-maturities issues remained undersubscribed and secondly it skewed the maturing profile of public debt towards short-term maturities. Thus, at the end of August, the Ministry of Finance had secured less than half of the amount required to cover its financing needs for 2010. However, pressing re-financing needs compelled the Ministry of Finance to abandon in November its previous strategy of capping the offered yield at 7.00%. As a result, the Ministry of Finance finally accepted to pay yields higher than the latter level in a 3-year bonds tender on November 4 (RON0.1bn sold at an average rate of 7.1%). In addition, the Ministry paid a yield of 7.3% at a 12-month T-bills tender on November 8, selling some RON1.1bn.

The government will eventually need to speed up its issuance program (including an €1.5bn Euro denominated issue) in the coming two months given that resorting to financial markets is currently the only option available for covering its borrowing requirement. The next IMF/EU loan tranches will be utilized for Balance of Payments support, and thus they will be used to boost FX reserves. That would lead to a relatively heavy supply calendar in the period ahead and, most probably, to even higher bond yields demanded by domestic and international investors in the coming government debt auctions.

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Special Focus

Romania's political environment: Recent developments and challenges ahead

Domestic political parties appear unwilling to break away from their populist agendas

Domestic politics are currently dominated by three political parties: the Democrat-Liberal Party (PDL) – currently ruling with support from ethnic minorities and a breakaway group from PSD – the Social-Democrat Party (PSD) and the National Liberal Party (PNL), the latter two forming the Parliamentary opposition. All three parties have a long history of alliances, government spells, and populist agendas.

The recession that hit Romania in late 2008, the ensuing confidence and liquidity problems and the IMF agreement signed in March 2009 exposed the local political class to the imminence of reforms aimed at balancing public finances and addressing long-standing structural imbalances. So far, progress on such reforms appears to have been rather limited.

Having said that, the current PDL-led government has managed to address some of the country's fiscal problems by a) imposing a more transparent system of determining wages for public workers starting January 1st 2010, b) cutting the public wage bill by 25% starting July 1st 2010, and c) enforcing laws aiming to curtail below-the-line public spending i.e., expenditures not included in the budget plan. The latter measures will come into full effect in 2011.

Meanwhile, an attempt to slash the deficit of the social security system (amounting to ca €4bn at the end of Q3 and accounting for almost three quarters of the entire budget deficit) by cutting pensions by 15% was strongly opposed by PSD and PNL and was eventually struck down by the Constitutional Court. This led to a 5 pp VAT hike to 24% effective from July 1st that helped attain the budget deficit targets set jointly with the IMF.

A new pension law was sent back to the Parliament after accusations of fraud prevented its initial passing in the Chamber of Deputies. The latter has effectively postponed two key measures aimed at boosting budget receipts. Namely: a) increasing the retirement age to 65 years regardless of gender and b) adding state employees from the army, police, secret services and the judicial system to the ranks of regular budget contributors.

However, a number of needed reforms have not been addressed properly. Among them:

- increasing labour market flexibility: pressure from labour unions and a lack of long term vision have left Romania among a handful of European countries that did not allow for variable working hours in order to avoid layoffs;
- cutting red tape: a earlier implemented reform managed to cut their total number of taxes from 491 to 302 in 2009, but fell short of a full overhaul of the fiscal system;
- diminishing the waste of public funds: budget expenditure on goods & services and public transfers increased in the first three quarters of 2010 by 1.3%yoy and 12.8%yoy, respectively, despite a stated attempt to cut public spending. Meanwhile, capital expenditure (comprising mainly public investment) has been crowded out, falling 28.6% year-to-September.

Moreover, increased pressure by various social groups and the local media appear to have recently soured the government's appetite for reforms. Adding pressure, the opposition proposed a series of populist measures, which included among others, increasing the pension point and the minimum wage (both triggering an eventual pension hike), decreasing retirement age, and cutting the VAT for basic food items. The latter has been mistakenly passed by the Chamber of Deputies, highlighting the confusion and alarming economic dilettantism of MPs. The President will probably refuse to pass the law, thus giving Parliament a chance to right the wrong.

Also for populist purposes, the current opposition has vilified the IMF agreement. Yet, no future Romanian government could afford to back out of the agreement (or not extend the current arrangement). The reason has less to do with liquidity (since NBR reserves were 32.6 billion euro at the end of September 2010) and more with sovereign risk assessments and their effect on financing costs and foreign investment flows.

Unstable alliances

The thin majority enjoyed by PDL and its allies has brought the legislative power to a near standstill, with all major laws being contested at the Constitutional Court or threatened with non-confidence votes. The Parliamentary elections of 2008 left PDL and PSD on equal footing in terms of MPs, with PNL being the third largest party.

PDL and PNL governed together as an alliance between December 2004 and March 2007, when PNL formed a minority Government with the official backing of the minorities and the silent support of PSD. Ever since, the tensions between PDL and PNL have been high and the possibility of a new alliance has been vehemently denied by PNL, despite arduous courting from PDL.

PDL and PSD formed in December 2008 a super-coalition that enjoyed a 70%-plus majority, but it collapsed before presidential elections were held in November 2009.

Any alliance involving PSD and one of the other two major parties could be destabilized by the Social-Democrats' plan to scrap the flat tax and revert to progressive tax levels. PDL and PNL have introduced the flat tax at the beginning of 2005 and both claim to be its staunch defenders.

Ideological or political chasm will not disappear smoothly, so stable governments are unlikely to form during the present legislature. At the same time, the uninominal voting system is an important deterrent of early elections because of unpredictable outcomes.

Going forward

The non-confidence vote faced by Emil Boc's Government on October 27, 2010 failed as expected. The markets priced in this outcome as early as October 22, when the leu began to strengthen against the euro. During the voting, party lines were not broken as PDL and the minorities refused to cast any votes. 219 MPs voted to oust the Government, 17 short of the needed number. This non-confidence vote failed by a larger margin than the last attempt in June, when the opposition lacked only 8 MPs to topple the Cabinet. The true reason of the repeated unsuccessful attempts at bringing down the Government is that PSD and PNL cannot harmonize their economic programs without alienating their base. This should not deter further non-confidence motions if the Government structure will not change in 2011.

In chronological order, the Government will most likely attempt to:

- pass a new education law, with limited impact on sovereign risk;
- meet the budget deficit target for 2010: after the wage cuts and the VAT hike, the 6.8% of GDP target looks feasible. Nevertheless, mounting arrears are a big caveat and we expect a breach of the IMF agreement regarding unpaid dues to the private sector. The Council of Foreign Investors (CFI) has asked the Government to come up with a list of arrears to be financed by banks in order to improve the liquidity of private sector firms that have to receive money from public authorities. So far, the Government has not reacted to a proposition that looks easy to implement and could be beneficial for the functioning of the economy;
- sign a new agreement with the IMF: a precautionary agreement could be signed in early 2011, but before March, when the current arrangement expires. The new agreement will probably require further reforms. The IMF delegation has already pointed out some priorities: bettering the absorption of EU funds, improving the efficiency of publicly owned companies through privatization (while tapping investor money from abroad), making public-private partnerships functional and increasing the flexibility of the labour market.

Potential impact on economic variables

The Romanian currency is likely to weaken before the signing of a new IMF agreement. Since both resistance to further reforms and IMF requirements could strengthen, negotiations could go less smoothly than predicted. We expect, however, a precautionary agreement to be in place by March 2011, thus relieving some of the upward pressure on the exchange rate. A sharp appreciation of the leu is out of the question since the weak leu is helping exports.

Interbank interest rates are likely to stay below 7% for maturities up to 3 months, while the longer end of the curve could remain flat around 7.2%. Abundant short term liquidity could help the Ministry of Finance cap its yield at 7%, provided no additional political turmoil.

Real GDP is likely to fall between 2% and 3% in 2010. A potential recovery could be postponed to H2 2011 if further fiscal tightening measures will be enforced in 2011 (the likeliest are freezing wages for public employees and taxing pensions). We expect real GDP dynamics for 2011 in the -1% - +1% range. Even a small recovery would feel close to a recession for the weakened private sector. A consumption-led recovery looks unlikely because of pricy loans, weak currency and consumer pessimism. Both the IMF mission and the NBR have spoken against boosting consumption for fear of a re-widening trade deficit. At the same time, the robust performance of exports (+17.6% after eight months using FOB data) is not enough to drive the GDP into the black, since exports account for only 30% of GDP.

Potential risks

A change of the Government before a precautionary agreement with the IMF is arranged could affect markets by increasing uncertainty. As mentioned before, it is likely that any Government would eventually yield to the pressure of maintaining a close collaboration with the IMF, but a delayed signing (especially beyond March 2011, when the current agreement expires) would push up the exchange rate and interest rates. The MoF would probably have to pay more than 7% when borrowing from the private sector and the leu could test again the 2010 high of 4.4 RON/EUR.

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II. New Europe – Country Analysis: **Serbia**

Soaring inflation threatens to overshoot Central Bank's year-end target

- NBS raised its key policy rate by a further 100 bps to 10.50%, in a move to address rising inflation risks and depreciation pressures on the dinar
- Increased price pressures in the domestic economy suggest Central Bank may miss year-end inflation target
- Upward revision to Q2 GDP growth estimate signals economic recovery is gaining traction
- Serbia takes an important step towards EU integration

NBS hikes key policy rate for the fourth month in a row to arrest dinar depreciation, heightened inflation pressures

On November 11th, NBS raised its key policy rate by 100 bps to 10.50%. This was the fourth rate hike since the Central Bank terminated its policy easing cycle in early August. In a statement released after the policy meeting, the Central Bank cited once again the inflationary impact of higher agricultural product prices as a result of a poor domestic wheat crop and the Russian export ban. In addition, there was an explicit reference to the dinar depreciation and its potential implications for the domestic inflation outlook.

The new NBS rate hike hardly came as a surprise to us. The announcement of the September CPI reading (+1.3%/+7.7% mom/yoy) made it apparent that domestic inflation pressures continue to intensify. This renders doubtful the achievement on the year-end target at the first place. However, the most important factor that weighed on the NBS's policy decision was the rapid pace of dinar depreciation in recent months as well as the recent rise in sovereign risk premia. Since September 2009, the dinar has come under significant depreciation pressure that intensified in the summer months despite repeated central bank interventions in the FX market. When the dinar reached a new historic low at 107.04/€ on August 2, the Central Bank was apparently forced to hike interest rates.
The domestic currency temporarily recouped some of its earlier losses before starting to re-weaken again, reaching 105.6/€ on September 6. This prompted the Central Bank to intervene again. After remaining broadly flat at levels around 105/€ for a short period of time, the dinar started to depreciate again. On October 28th, it reached 108.05/€, a new historical low.

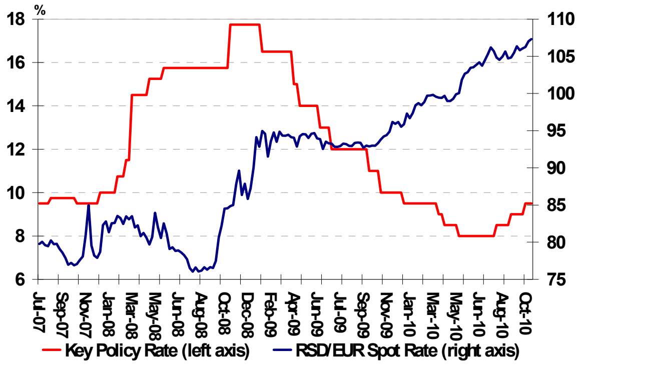
Dinar traded at 107.08/€ on November 11th, right after the announcement of the latest hike (Figure 1). Officially, the Central Bank does not have an explicit exchange rate target. Yet, it has spent some €2.2bn (i.e., more than the IMF funding received so far ~ €1.5 bn) so far this year in an attempt to smooth excessive currency volatility and prevent a faster pace or dinar depreciation. The latter has turned out to be a double-edged sword for the Serbian economy, complicating things further for the Central Bank. On the one hand, it helps to boost export competitiveness and thus, growth. Note that the fragile economic recovery has so far been mainly driven by higher exports (+14.5% yoy in Jan-Aug 2010). On the other hand, it increases inflationary pressures because of a high pass-through (estimated at 0.2-0.3ppts in the current quarter and ca 0.6ppts over the next 12 months). Furthermore, dinar depreciation hurts the ability of unhedged borrowers to service their debts thus increasing the probability of NPLs rising further in the period ahead (NPLs ratio at 17.5% in Q2).

Serbia: Eurobank EFG Forecasts

	2008	2009	2010f	2011f
Real GDP (yoy%)	5.5	-3.0	1.5	3.0
Inflation (yoy%)				
CPI (annual average)	12.5	8.2	6.5	4.8
CPI (end of period)	8.6	6.6	9.5	4.5
Fiscal Accounts (%GDP)				
General Government Balance	-2.6	-4.2	-4.8	-4.0
Gross Public Debt	25.6	31.3	37.0	41.0
Labor Statistics (%)				
Unemployment Rate (%of labor force, ILO)	14.7	16.1	18.5	16.5
Wage Growth *(total economy)*	17.9	4.1	4.8	6.7
External Accounts				
Current Account (% GDP)	-17.1	-5.7	-8.5	-9.0
Net FDI (EUR bn)	1.8	1.4	1.5	2.0
FDI / Current Account (%)	30.0	78.7	55.0	70.0
FX Reserves (EUR bn)	8.2	10.6	11.3	10.2
Domestic Credit	**2008**	**2009**	**Q1 10**	**Q2 10**
Total Credit (%GDP)	41.0	48.7	51.2	56.1
Credit to Enterprises (%GDP)	25.8	29.4	30.8	32.9
Credit to Households (%GDP)	14.0	14.7	15.3	16.4
Private Sector Credit (yoy)	34.9	14.3	12.9	23.1
Loans to Deposits (%)	125.1	127.0	133.2	138.7
Financial Markets	**Current**	**3M**	**6M**	**12M**
Policy Rate	10.50	11.50	10.50	9.50
EUR/RSD	107.10	110.00	110.00	115.00

Source: National Sources, IMF, Eurobank Research & Forecasting

Figure 1
Dinar depreciation continues despite higher policy rates and central bank interventions



Source: Bloomberg, Eurobank Research

Inflation en route to overshoot year-end target; NBS expected to hike rates again in December

Headline CPI rose further in September, moving closer to the upper side of the Central Bank's target band (6%+/-2%). Consumer price inflation came in at 7.7% yoy in September, up from 6.7% yoy in the prior month and 4.8% yoy in January 2010. This brought the annual average inflation to 5% yoy year-to-September, compared to 8.9% yoy over the same period a year earlier. Strong pressures are already apparent in the regulated as well as the market-driven segments of consumer prices. Since August, food prices are a positive contributor to inflation because of the poor domestic crop and the rally in soft commodity prices. Their impact on headline inflation is magnified by their significant weight in the CPI basket (~37.8%). Food prices rose by 2% mom/6.2% yoy in September vs. 3.6% mom/4.4 yoy in August.

The second biggest monthly increase came from the categories of education (+12% yoy/+1.8% mom) and restaurants& hotels (+8.5% yoy/+1.7% mom), with the alcoholic beverages & tobacco category registering an equally big increase (+14.4% yoy/+1.3 mom). Regulated prices also inched up in September, reaching 10.3% yoy compared to 10.0% yoy in August. On the other hand, transportation prices, which have been a key driver of domestic inflation in the previous months, eased further to 10.3% yoy in September from a peak of 11.4% yoy in May.

The September CPI reading was still within the official target band (4-8%) for 2010, but the Central Bank anticipates the spike in food prices to continue in the following months. The latter coupled with the lagged pass through effects of the dinar depreciation (imported prices account for ca 1/3rd of the CPI basket) as well as elevated inflation expectations are expected to push consumer prices to levels above 8% yoy in October and, most probably, to double digit growth by the end of 2010. The first indication in this direction is reflected in the evolution of two leading indicators: the retail price index (RPI) and the cost of living index. Retail prices and the cost of living accelerated to 9.9% yoy and 8.6% yoy respectively.

In our view, the aforementioned developments will have two important consequences:

First and foremost, it appears that the NBS has not much choice but to hike policy rates further (we expect at least a further 50-100bps of rate hikes by the end of this year). In addition, the Central Bank is currently in discussions with the government on the possibility of deploying measures aiming to stabilize domestic food prices.

Secondly, the latest CPI readings suggest that the inflation target will likely be missed this year, for the first time since the introduction of inflation targeting regime in August 2006. What is even more worrying, it appears that the Central Bank may also find it difficult to meet the official inflation target for next year (4.5% +/- 1.5%). In fact, the attainability of next year's inflation target has already stirred intense public debate domestically. Local media reported that the IMF has allegedly encouraged the Central Bank to change the current inflation targets in order to make them more attainable. IMF rebutted those reports as "erroneous", supporting the current inflation targeting framework.

Short-term dinar outlook remains bearish

In our recent New Europe Economics & Strategy Monthly issues we expressed a strong bearish view on the dinar, emphasizing that attaining currency stability will prove a contentious and critical task for the domestic authorities in coming months. Looking ahead, we continue to see limited scope for a meaningful recovery in the local currency in the foreseeable future, continuing to anticipate a move towards 110/€ by year end. There are a number of reasons supporting the latter view:

- In principle, it was the NBS that first embraced the notion of the transition of the Serbian economy from a domestic demand-driven to an exports-oriented model of development. In our view, this entails implications for the FX policy, on the basis that the exports-driven growth model the NBS envisages may not be compatible with a sustainably strong dinar. In addition, the recently-released government strategy document titled "Serbian post-crises economic growth and development model 2011-2020", incorporated as one of its key underlying assumptions that the dinar would continue to depreciate by about 2 percent per annum until 2015. This implies that a weaker currency is considered as a key element in the country's post-crisis development strategy.
- Low export competitiveness compared to other peers: According to the IMF, Serbia's wage levels relative to labor productivity seem in line with most transition peers. However, they significantly exceed those of key regional competitors, including Bulgaria and Slovakia
- Inflation volatility: Given the traumatic experiences of hyper inflation and bank defaults of the nineties, the level of confidence in the domestic currency as a store of value is low. This is reflected in the high Euroization level in the economy. FX deposits have a lion's share in total deposits (FX deposits currently comprise ca 72% of total deposits). The present inflation volatility only hampers the de-Euroization strategy of the government.
- In addition, capital inflows remain weak. Net FDI inflows, one of the most important sources of BoP financing, decreased by 42.2% yoy year-to-August 2010, covering just 34.2% of the corresponding current account deficit. There is still a large stock of state-owned enterprises to be privatized in order to attract more FDI inflows in Serbia. However, market conditions are such that there is little prospect of a strong recovery in FDI or other capital inflows in the foreseeable future. Note here that the government plans to sell a 40% stake in the Telekom Serbia through an international tender. When this finally takes place, most probably in the beginning of 2011, it is going to boost FX reserves in a one-off sales transaction, offering some valuable ammunition to the Central Bank
- The switch to monetary policy tightening has not so far had limited success in containing depreciation pressures on the dinar. That is because it appears that the CB is still behind the curve in its fight against inflation.
- Last but not least, the ongoing sovereign crisis in the Euro area complicates things further. The fiscal crisis exerted downward pressure on all regional currencies, particularly those tied to the euro.

On the other hand, financial markets seem to have so far ignored the positive news flow of economic data:

- Improving macroeconomic environment: The Serbian economy has exited recession, recording positive real GDP growth in H1 2010. The revised Q2 data showed that economic recovery is gaining ground. GDP grew by 2% yoy in Q2, outperforming the initial flash estimate of 1.6%. This comes on top of +0.6% yoy growth in Q1, bringing the GDP growth performance in H1 at 1.2% yoy.
- Government is on track with the IMF program. The implementation has been smooth so far, being currently at the stage of the fifth review. All the quantitative targets for end June were met, including

that of the fiscal deficit. In fact, the authorities withdrew only €56 mn of the latest loan tranche (€383 mn in late August), bringing the overall disbursements at €1.5bn out of a total financial package of €2.9bn. The sixth review will most probably be completed by end of November, with one more left for next February.

- What is more important, the government is successfully implementing the required structural reforms. The government is at the final stage of completing or has already implemented most of the politically-sensitive structural reforms including, among others, the pension system reform and the downsizing of the central government sector personnel by 10%. In that respect, the Serbian government is complying with IMF program requirements more effectively than other governments who run similar programs in the New Europe region.

Serbia takes important step towards EU accession

On October 25, EU foreign ministers agreed to ask the European Commission for an opinion on launching entry talks with Serbia. More specifically, foreign ministers asked the Commission to prepare a formal assessment on Serbia's EU entry application. A positive appraisal by the European Commission is a prerequisite for formally launching accession negotiations. However, the foreign ministers statement stressed that further progress towards EU membership would largely depend on the degree of co-operation with the International Criminal Tribunal for the former Yugoslavia (ICTY).

Relations with EU have improved considerably in recent months. Serbia filed for EU candidate status last December. The unblocking of the interim trade agreement, the first contractual agreement between Serbia and the European Union, has brought immediate benefits to Serbian exporters, given that more than half of the country's exports are destined to EU markets. Furthermore, the EU decided last June to unblock the ratification process of the Stabilization and Association Agreement (SAA). Last but not least, the EU visa liberalization for the first time since the 1990s has enhanced convergence expectations, by allowing Serbs to reclaim travel freedoms abolished, following the collapse of the Former Yugoslavia.

There is no doubt that this is an important decision for the country and the region as a whole. For a region still fractured in ethnic disputes, the vision of EU membership in principle anchors longer-term political and macroeconomic policy expectations in the broader region. Moreover, it acts as a disciplinary devise and encourages structural reforms. In addition, it has a positive impact on the perceived risk premium of the country. Thus, it ceteris paribus helps to reduce sovereign borrowing costs and creates a friendlier environment for foreign investments. Last but not least, Serbia has already received € 2bn of financial aid related to EU accession since 2000.

A number of EU members have lately shown a clear political will to speed up Serbia's accession process, in spite of Netherlands's pending objections. The decision of the group of EU foreign ministers comes in the wake of a recent (inherently negative for Serbia) decision by the International Court of Justice on Kosovo's declaration of independence. On 22 July, the Court of ruled that Kosovo had not violated the international law by declaring independence in 2008.

The decision of the foreign ministers group represents a small, yet still essential and symbolic step towards Serbia's EU accession. However, there is still considerable distance to be covered before actual negotiations on EU membership begin. Serbia needs to tackle a number of important issues in several key areas, including, among others, the rule of law, judicial reform, a consolidation a market economy institutions and regional co-operation. Putting effort in these areas will require significant time, political will and hard work.

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II. New Europe – Country Analysis: **Turkey**

2011 budget draft and new medium-term economic programme seen minimizing fiscal risks ahead July general election

- Recent data suggests pace of economic recovery is slowing down in H2; full-year GDP growth still likely to outperform growth in New Europe peer-economies, expected to be as high as 7.5%.

- Consumer price inflation rises further in October; falling core indices signal benign underlying pressures

- Turkey's Central Bank keeps its key policy rate stable, cuts overnight borrowing rate in a move to improve interbank liquidity and discourage speculative inflows

Real GDP growth to slide into a single-digit territory in H2

After recording annual growth rates in excess of 10% in the first two quarters of the year, real GDP is expected to register single-digit growth in H2. Notably, the strong bounce in inventories following last year's recession is gradually phasing out (positive contribution to real GDP growth down to 1.2ppts in Q2, from 7.6ppts in the first quarter). Also, the sizeable base effects supporting the pace of economic recovery during the first half of this year are bound to wage going forward, considering that GDP growth bounced to 6% yoy in Q4 2009 after contracting by ca 11% yoy in January-June 2009. Furthermore, slower growth in main trade partner economies in tandem with stabilizing domestic demand will probably prohibit any significant improvement in net exports' contribution to overall economic activity in the period ahead. Net exports subtracted 1.6ppts from real GDP in Q2, as exports of goods and services rose by 12%yoy and imports registered a 17.8%yoy jump over that period.

Recent data confirm a slower recovery in H2....

Recent readings in a range of higher-frequency indicators appear to support the aforementioned views. Among them, industrial production growth slowed to 10%yoy in Q3, after rising by 15.4% in the first half of the year, pointing to an ongoing, yet decelerating pace of improvement in the sector.

With respect to labor market developments, the 3-month average annual rate of unemployment (11.4% in Q3) remains at elevated levels, albeit standing lower by ca 5ppts comparing to a lifetime peak recorded in February 2009. According to Turkish Exporters' Assembly (TIM), exports growth decelerated to 8.8% yoy in October, from 10.5% yoy in the prior month and average growth of 12.45% yoy in the first nine months.

Meanwhile, in spite of an 11.3%yoy jump in September the number of foreign visitors to Turkey rose by 2.9%yoy in Q3 after a 9.3%yoy jump in H1, pushing tourist arrivals ca 6%yoy higher over the first nine months of the year. Also, revenues declined by 10%yoy in Q3 after a 7.4% gain in Q2. In part, all-inclusive packages may be responsible for lower revenues as they are becoming increasingly popular, curbing foreigners' spending in the country. On a more positive note, adding to recent evidence that the economic recovery is strong and sustainable, automotive production rose by 31%yoy in October, pushing the January-October rate of growth to 28%yoy. Capacity utilization, considered to be a leading indicator of both manufacturing activity and GDP growth, jumped to a 2-year high of 75.3%, halting consecutive declines in August and September. With respect to domestic consumption dynamics, the consumer confidence index hit a 2-½-year high of 90.4pts in September, halting a two-month falling streak. Meanwhile, while credit activity remains on an uptrend in recent months. The latter is actually becoming a headache for the Central Bank, on the basis that fast credit growth is exacerbating the divergence between domestic and external demand, fuelling a widening in the current account balance and risking to instigate inflation pressures anew.

Turkey: Eurobank EFG Forecasts

	2008	2009E	2010F	2011F
Real GDP (yoy%)	0.7	-4.7	7.5	5.0
Private Consumption	-0.3	-2.3	4.5	5.0
Govern. Consumption	1.7	7.8	5.0	3.0
Gross Capital Formation	-6.2	-19.2	16.0	10.0
Exports	2.7	-5.4	6.0	8.0
Imports	-4.1	-14.4	18.0	10.5
Inflation (yoy%)				
CPI (annual average)	10.4	6.3	8.8	7.2
CPI (end of period)	10.1	6.5	8.0	6.7
Fiscal Accounts (%GDP)				
Central Government Balance	-1.8	-5.5	-3.8	-2.7
Gross Public Debt	39.5	45.4	42.5	41.5
Primary Balance	3.5	0.1	1.0	1.5
Labor Statistics (%)				
Unemployment Rate (%of labor force)	13.6	13.5	12.0	11.0
External Accounts				
Current Account (% GDP)	-5.7	-2.2	-5.4	-5.5
Net FDI (USD)	15.8	6.1	7.5	9.0
FDI / Current Account	37.5	43.5	19.0	22.0
FX Reserves (USDbn)	71.0	69.0	80.0	90.0
Domestic Credit	**2008**	**Q4 09**	**Q1 10**	**Q2 10**
Total Credit (%GDP)	31.1	34.8	33.4	37.4
Credit Private Sector (%GDP)	29.7	32.9	31.6	35.5
FX Credit/Total Credit (%)	13.2	14.9	16.9	18.7
Private Sector Credit (%yoy)	22.9	11.3	22.8	34.0
Loans to Deposits	82.4	78.7	79.9	82.1
Financial Markets	**Current**	**3M**	**6M**	**12M**
Policy Rate	7.00	7.00	7.00	7.50
USD/TRY (where applicable)	1.46	1.40	1.35	1.30

Source: National Sources, Eurostat, IMF, Eurobank Research & Forecasting

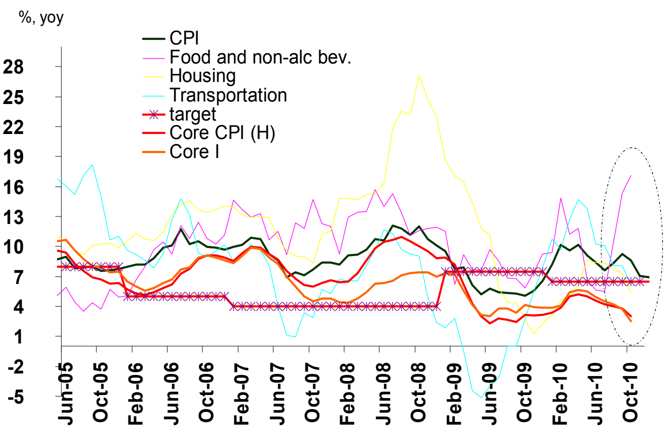
...but economy still braced to outperform regional peers in 2010, recording GDP growth as high as 7.5%

Notwithstanding the aforementioned, we expect Turkey to outperform its peers and register a 7.5%yoy growth reading this year (consensus: +7.0%yoy). Real GDP grew at an annual pace of 11.0% in the first half of the year, with strong rebound witnessed in domestic consumption and investment. Exports have also recovered. However, the net contribution of the external sector is increasingly negative as imports' growth is far outpacing that of exports on the back of a sharp rise in domestic demand. Allayed concerns about the domestic political landscape are likely to further support sentiment towards Turkey, and thus boost investment. For 2011, we continue to anticipate a GDP growth slowdown to 5.0%, on back of base effects and an increasingly negative contribution from net exports.

Consumer price inflation rises further in October; subdued core CPI readings suggest benign underlying pressures

Headline CPI again surprised to the upside in October. The index rose by 1.83%mom, outpacing an expected gain of 1.43%mom. Eight out of the twelve CPI components moved higher, with a 4.52%mom jump in food products and alcoholic beverages adding 1.23ppts to the October headline reading. Meanwhile, clothing and footwear prices jumped 7.63%mom due to seasonal factors, contributing 0.55ppts to October's CPI print. On a more encouraging note, headline CPI slowed to 8.62% on an annual basis from a 6-month peak of 9.24%yoy recorded in the prior month, mainly reflecting favorable base effects stemming from the reversal of economic stimulus measures in October 2009. What's more, seven of the nine core CPI indices eased on an annual basis in October, suggesting that underlying inflation pressures remain subdued. Notably, the "H" and "I" indices, closely monitored by the CBRT, decelerated further, touching new historic lows of 3.02% and 2.50% respectively. Elsewhere, producer prices rose by 1.21%mom, exceeding the market's median forecast of +0.50%mom and bringing the annual rate of increase in the index to 9.92%, from 8.91%yoy a month earlier. Not surprisingly, agriculture prices were among the main upward PPI drivers in October.

Figure 1
Inflation bounces in October on rising food prices



Source: National Statistics

Recent inflation spike likely to prove temporary

Looking ahead, we expect a reversal of the uptrend in headline inflation and broadly concur with the CBRT's view that the recent CPI spike will likely to prove temporary, as it has been mainly being driven by cost-push rather than demand-pull factors. We believe that food price inflation will decelerate gradually in the coming months, thanks to improved weather conditions and a better harvest. In addition, favorable base effects are also likely to assist the disinflation process going forward. Furthermore, inflation expectations remain relatively subdued. Along these lines, we see the risk of second-round effects as relatively limited and expect headline CPI to ease towards 8%yoy by the end of this year. The latter forecast stands above our earlier year-end CPI projection of 7.1%yoy, as food prices proved stickier than expected. Note here that the CBRT anticipates inflation to ease to 7.5% by year-end, effectively acknowledging that this year's target of 6.5%yoy will most likely be missed. Further ahead, the disinflation trend is likely to continue through to Q1 2011. However, a slight pick up thereafter is possible in view of potential fiscal slippages ahead of July's parliamentary elections and a narrowing output gap. Potential upside in oil prices is also another factor that may instigate inflation pressures anew. However, this may be in part alleviated by a stronger lira. For December 2011, we maintain our earlier CPI forecast of slightly lower than 7.0%yoy, which stands above the CBRT's 5.5%yoy target for next year.

CBRT maintains CPI forecasts broadly in line with the previous inflation report.

At its updated inflation report released in October, Turkey's central bank kept its CPI forecasts for the 2010-2012 period broadly in line with these envisaged a quarter earlier. The CBRT noted that assuming that policy rates are maintained constant at their current levels in the coming months with limited hikes starting in the last quarter of next year, inflation is expected (with a 70% probability) to come in at 7.5% at the end of 2010 as envisioned in the previous report. Although the bank revised upwards its end-2010 food inflation forecast to 10.5%yoy from 7.5% previously, it predicted that higher food prices will be offset by a faster than earlier anticipated non-food disinflation. The bank marginally raised its year-end CPI projections for 2011 and 2012 to 5.4% from 5.3% and 5.1% from 5.0%, respectively. A stronger than previously expected recovery was the main culprit for the upward revision. It was however nearly-fully cushioned by a softer than earlier anticipated core-inflation trajectory.

Turkey's Central Bank keeps its key policy rate stable, cuts its overnight borrowing rate…

Turkey's Central Bank kept its key policy rate, the 1-week repo rate, stable at 7.00% at its MPC meeting on November 11, in line with market expectations. The committee also left the overnight lending rate unchanged at 8.75%. However, in a rather unexpected move, the Bank cut the overnight borrowing rate by a much larger that expected 400bps to 1.75%. The latter is considered to be part of CBRT's exit strategy measures and effectively increases further the spread between the overnight borrowing rate and the 1-week repo rate. In a similar move, the Bank also cut the Late Liquidity Window Borrowing Rate to zero from 1.75% previously.

…to facilitate interbank lending and discourage speculative portfolio inflows

CBRT's latest policy moves aim to support liquidity conditions in the interbank market, since domestic commercial banks will now be discouraged from lending their excess liquidity to the CBRT and, in turn, be encouraged to trade with each other. This is effectively expected to compress further short-term interbank rates and deter "hot money" portfolio inflows. The latter appear to have exacerbated the lira's recent uptrend, which along with buoyant domestic credit expansion is aggravating the external imbalance and contributing to a widening of the current account deficit. In the policy statement accompanying the November MPC meeting, the CBRT explicitly noted such concerns. The rest of the statement was broadly similar to that issued at the October policy meting. The MPC repeated that "economic activity continues to recover" and that it will take a long time before industrial capacity utilization returns to pre-crisis levels. Furthermore, although employment conditions continue to improve, the rate of unemployment remains at elevated levels. The Committee reaffirmed its earlier view that inflation will remain on a downtrend in the period ahead and that core inflation is expected to remain consistent with the medium-term targets. The statement also repeated that "it would be necessary to maintain policy rates at current levels for some time, and to keep them at low levels for a long period". The MPC signaled anew that it plans to continue gradually implementing the remaining measures as envisaged in its exit strategy programme.

Additional exit-strategy measures unfolded

The Central Bank has taken a number of steps in recent months as part of its exit strategy measures, aimed at reversing accommodative policies employed during the global financial crisis. Besides the measures decided at the November policy meeting, the Bank has a) changed in May its key policy rate from the overnight borrowing rate to the 1-week repo rate, b) cut its overnight borrowing rate by a cumulative 75bps in September-October, c) canceled its 3-month repo auctions last month and recently tightened reserve requirements. In fact, a day after the November 11 MPC, the Bank announced an increase in reserve requirements on TRY deposits by 50bps to 6%, which it estimates will dry up some TRY 2.1bn ($1.5bn) from the FX market. The move was the second so far this year, after the CBRT raised as of October 1 its reserve requirement on commercial banks to 11% from 10% for FX and to 5.5% from 5.0% for TRY deposits.

CBRT unlikely to hike policy rates before Q4 2011.

To conclude, CBRT's latest moves suggest that the Bank remains confident on the disinflation process but worries about rapid domestic credit expansion and the recent surge in speculative capital inflows. We expect the Bank to continue unfolding the remaining measures envisaged in its exit strategy programme published in April, with further increases in the reserve requirements ratios likely to be delivered in the following months. The CBRT has already signaled that additional moves are on the cards if credit activity shoots up further. We maintain our earlier view that the CBRT will stay put on policy rates in the coming months and incept its monetary policy tightening cycle not earlier than in Q4 2011 - as noted in the latest Inflation Report, released in October. A premature rate hike in an environment of still benign underlying price pressures would risk exacerbate the lira's uptrend and attract additional speculative inflows.

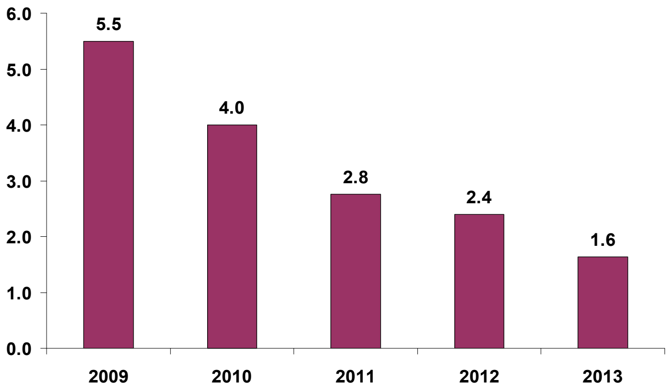
2011 budget draft and new Medium-Term Programme sooth fiscal concerns ahead of next year's election

The government unveiled in mid-October its 2011 draft budget, which was broadly in line with the 2011-2013 medium-term economic plan (MTP) announced a few days earlier. According to the new plan, real GDP growth is seen slowing from 6.8%yoy in 2010 to 4.5%yoy in 2011, with annual rates of 5.0% and 5.5% expected in 2012 and 2013, respectively. The central government budget deficit is envisaged at 4.0%-of-GDP this year vs. 4.9%-of-GPD projected previously, below the shortfall of 5.5%-of-GDP realized in 2009. A further improvement is anticipated in the following three years, with the central government deficit expected to shrink to 2.8%-of-GDP in 2011, 2.4% in 2012 and 1.6% in 2013. End-2010 inflation is envisaged at 7.5%yoy and is expected to ease gradually towards 4.9%yoy by 2013. Meanwhile, the current account deficit is anticipated to stabilize a tad above 5%-of-GDP levels, from last year's 2.2%-of-GDP multi-year trough.

Fiscal improvements likely to continue in the period ahead

In all, the MTP's targets and assumptions echoed realistic, helping to allay market concerns raised after the government removed a much-awaited fiscal reform from its near-term agenda. What remains to be seen however, is commitment to the announced fiscal targets, especially as the July 2011 general election risks to temporarily dent fiscal consolidation efforts. That said, with last September's constitutional referendum revealing strong public support to the government, the risk of significant fiscal slippage in the coming months is relatively low, in our view.

Figure 2
Budget deficit % GDP (central government)



Source: Medium-Term Programme (2011-2013), State Planning Organization

The budget deficit is likely to exhibit a substantial improvement this year, largely assisted by spending discipline and higher tax revenues, which were boosted by a strong economic rebound. In fact, the consolidated government deficit dropped by nearly 50%yoy to TRY 21.3bn in the first nine months of the year, which, according to our calculations, stands at around 1.9%-of-projected-GDP, well below a deficit of 4.3%-of-GDP registered over the same period a year earlier. As such, we expect the central government deficit to slightly outperform the 4.0%-of-GDP shortfall envisioned in the new MTP as well as last year's 5.5% realization. It is also worth mentioning that the primary budget surplus jumped 283%yoy, to TRY 18bn over the January-September period, while the domestic debt roll-over ratio is expected to ease to 93.7% for the whole of 2010 from an earlier forecast of 99.5%.

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II. New Europe – Country Analysis: **Ukraine**

IMF programme on track

- The Constitutional Court overturned a number of restraints on Presidential powers introduced during the Orange Revolution in late 2004 and moved to strengthen the authorities of the President
- IMF upgrades its macroeconomic outlook for Ukraine
- Inflation risks on the rise due to higher food prices, increases in utility tariffs
- Significant rise of FDI inflows supports current account balance
- Increasing signs of stabilisation in the domestic banking sector; high level of NPLs remains a concern

Constitutional Court removes restrains on presidential power

In early October, Ukraine's Constitutional Court overturned a number of restraints on Presidential powers introduced during the Orange Revolution in late 2004 and moved to strengthen the authorities of the President. Moreover, the Court ordered lawmakers to restore a 1996 constitutional law, under which the President appoints the Prime Minister and the Cabinet. In short, the Constitutional Court abolished the political reform of 2004 and returned a near-absolute power to the President. As authoritarian the new regime may seem, it may provide an anchor of domestic political stability to the country in the present trajectory.

On the fiscal side, the government has not yet unveiled the 2011 budget due to delays related to ongoing discussions over a new tax law. However, Prime Minister, Mykola Azarov, assured recently that the new budget will receive parliamentary approval by December 10, 2010.

Meanwhile, the October 31[th] local elections, served as a political test of economic reforms. The PoR party of the current President, Victor Yanukovych, and its allies consolidated power in key regions, keeping the influence of opposition parties quite limited. The PoR received 36.2% of the vote, while candidates of the party of opposition leader and former Prime Minister, Yulia Tymoshenko, received 13.1%. The local elections outcome is broadly in line with what President Yanukovych achieved in the Presidential elections nine months ago and seems to have strengthened his standing nationwide.

IMF upgrades Ukraine's economic outlook

Following his visit to Ukraine in early October, IMF Managing Director, Dominique Strauss-Kahn, said he is satisfied with the country's performance so far in complying with the requirements of the existing Stand-By Arrangement. He also expressed confidence over a successful completion of the first program review (November 3-15), which would allow the release of a new loan tranche worth $1.5bn. What's more, the IMF staff upgraded its projection for Ukraine's 2011 GDP growth to 4.5% yoy, from 4.3% yoy seen back in July. The discrepancy between the new and old forecasts for 2011 inflation is much wider; with CPI now seen averaging 10.8% yoy next year vs. from 9.7% yoy projected earlier.

Table 1
IMF upgrades its July projections on 2011 GDP and inflation

	2010		2011	
	July 2010	October 10	July 2010	October 10
GDP	3.7%	3.7%	4.3%	4.5%
CPI	12%	9.8%	9.7%	10.8%

Source: IMF

Ukraine: Eurobank EFG Forecasts				
	2008	2009	2010f	2011f
Real GDP (% yoy)	2.3	-15.1	4,0	4.2
Private Consumption	9.5	-12.1	2.5	3.5
Government Consumption	0.4	1.8	1,0	1.5
Gross Capital Formation	32.6	-48.4	4,0	8,0
Exports	5.1	-23.6	12,0	12.5
Imports	18.4	-36.8	11,0	13,0
Inflation (% yoy)				
CPI (annual average)	25.2	15.9	10.2	11,0
CPI (end of period)	22.3	12.3	11,0	10.5
Fiscal Accounts (% GDP)				
General Government Balance	-3.2	-8.7	-6.5	-5,0
Gross Public Debt	19.5	34.6	39.5	41.5
Labor Statistics (%)				
Unemployment Rate (% of labor force)	6.5	9.4	9,0	8.5
Wage Growth *(real - private sector)*	6.3	-10.3	7,0	5,0
External Accounts				
Current Account (% GDP)	-7,0	-1.5	0.1	-1,0
Net FDI (bn USD)	9.9	4.7	6,0	7,0
FDI / Current Account	77.6	34,0	100,0	90,0
FX Reserves (bn USD)	31.9	26.5	35,0	36,0
Domestic Credit	**2007**	**2008**	**2009**	**Q2 10**
Total Credit (% GDP)	59.5	77.3	79.1	70.8
Credit to Enterprises (% GDP)	36.9	46.7	50.5	46.6
Credit to Households (% GDP)	22.9	29.5	26.4	22.3
FX Credit/Total Credit (%)	49.5	59,0	50.8	18.5
Private Sector Credit (% yoy)	74.5	58.5	-3.1	1.4
Loans to Deposits	150.4	234,0	215.9	192.2
Financial Markets	**Current**	**3M**	**6M**	**12M**
Policy Rate	7.75	7.75	7.75	7.75
USD/UAH	7.85	7.8	7.9	7.9

Source: NBU, IMF, Bloomberg, Eurobank Research

Moody's upgrades Ukraine's outlook to stable

Following recent upgrades by Fitch and S&P, rating agency Moody's also upgraded its outlook on Ukraine's sovereign ratings (currently at B2) to stable form negative, encouraged by the country's improved external liquidity position as a result of the new IMF programme and the successful issuance of $2bn of Eurobonds in September.

Economy grew by a revised 5.9% yoy in Q2, from 4.9% yoy in the prior quarter

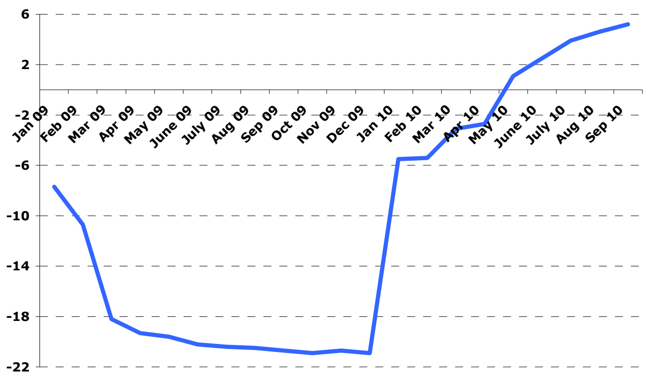
According to Ukraine's State Statistics Committee, gross domestic product grew by a revised 5.9% yoy in Q2, which compares with an initially reported reading of 6.0% yoy. A sectoral breakdown of the GDP

report suggests that growth was mainly driven by higher industrial output (manufacturing production rose by 14.7% yoy in Q2-10 against 12.4% yoy in the prior quarter).
On the demand side, household consumption grew by 5.1% yoy (3.7% qoq) in Q2-10 from 0.5% yoy in Q1-10, implying improved consumer confidence and household purchasing power. What's more, gross capital formation grew by 51.1% yoy in Q2-10, compared to 32% yoy growth in Q1-10 and a contraction of 48% yoy in the prior year. Exports grew by 14.9% yoy in Q2-10 from 7.0% yoy in Q1-10 and against 23.6% yoy decline in 2009. Imports grew by 24.9% yoy in Q2-10 from 2.4% yoy in Q1-10 and against 36.8% yoy fall in 2009. For the year as a whole, we anticipate GDP growth to accelerate to +4.0% yoy, following a 15.1% yoy contraction in 2009.

With respect to higher-frequency indicators of domestic economic activity, industrial production accelerated to 10.5% yoy (2.9% mom) in September, following growth of 9.2% yoy in the prior month. September's data signal a recovery following a temporary slowdown during the summer months (industrial production growth averaged 8.2% yoy in the June-August period) and suggests increased resilience to shifts in external demand. In our view, domestic producers remain well positioned to withstand a certain period of sluggish economic growth in major industrialised economies, among other reasons because more that 60% of Ukraine exports are destined to fast-growing emerging market economies.

Retail sales (in volume terms) picked-up further in September; they accelerated to 5.2% yoy, from 4.6% yoy in August. This was the fifth consecutive month of positive sales growth after 17 months of contraction (retail sales tumbled 18.3% yoy in 2009). (Figure 1)

Figure 1
Retail sales rebounding



Source: National Statistics, Eurobank Research

Inflation risks on the rise due to higher food prices

Domestic inflation accelerated to 10.5% yoy (+2.9% mom) in September, from 8.3% yoy (+1.2% mom) in the prior month. The rise is largely owed to a poor summer grain harvest that has boosted domestic food prices. Note that food has an unusually large weight in the CPI basket (around 50 percent). Food prices grew by 13.2% yoy in September, following an 8.8% yoy increase in the previous month. What's more, a 50% hike in the price of natural gas for households, effective from August 1st, contributed to the September CPI increase, as utilities comprise over 10% of the consumer basket. Yet, inflationary pressures could also stem from further increases in utility tariffs, such as heating and hot-water, fully related to the rise in gas price. We anticipate inflation to rise further in the last quarter of the year, averaging around 10.2% yoy in the year 2010 as a whole. Given an additional 50% hike in gas tariffs scheduled for April 2011, we expect inflation to accelerate further in 2011, averaging around 11.0% yoy.
In a move to address increased inflation risks in the domestic economy, the National Bank of Ukraine has raised its overnight refinancing rate by 75bps since early October.

Significant rise in FDI inflows

In August 2010, the overall balance of the current and the capital & financial accounts ended up with small surplus of $30mn, which compares with a surplus of $743mn recorded in the prior month. For the first eight month of 2010 the corresponding surplus amounted to $5.2bn compared to a $10.8bn deficit in the same period a year earlier. Yet, in August the current account recorded the highest monthly deficit since the beginning of the year ($563mn vs. a deficit of $223mn in July).
On a more positive note, since last April the capital and financial account has been in surplus. In August it reached $593mn which was largely due to the increase of FDI inflows; they amounted to $654mn compared to $283mn recorded in July. The construction sector was the main recipient of FDI, mainly thanks to preparations ahead of the EURO 2012 soccer championship. Year-to-August, net FDI inflows amounted to $3.1bn, up 20.9% compared to the same period a year earlier. What's more, some 24% of FDI inflows were channelled to the domestic banking sector. We anticipate the full-year 2010 current account to be slightly positive, at levels around 0.1% of GDP.

The IMF tranche of $1.9bn received in August increased reserve assets to $32.7bn. The international reserves grew further by 6.1% mom in September to $34.7bn largely due to Ukraine's $2bn Eurobond successful issuance.

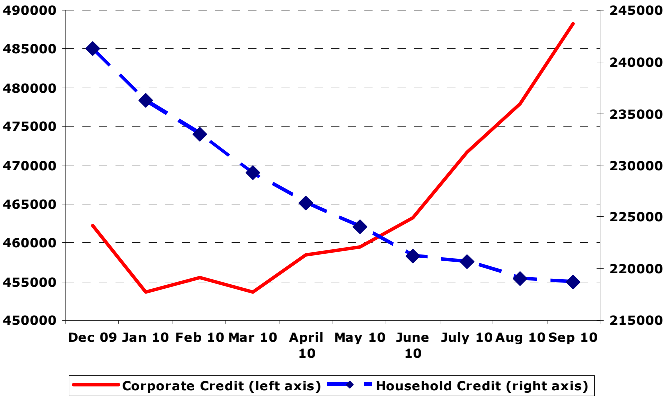
Hryvnia boosted by increased capital inflows

The recent improvement in the country's external position continues to support the hryvnia. Domestic political stability, the recent resumption of the IMF programme (since late July 2010) and improving investor sentiment towards domestic asset markets have also contributed to currency appreciation.
In an attempt to prevent a further significant currency appreciation that could weigh on exports and also increase the economy's susceptibility to easily reversible capital flows, the Ukrainian government said in early October that capital controls could be imposed if such inflows become more speculative in nature. The Ukrainian banking system remains fragile and maybe unable to effectively intermediate capital inflows. In addition, the inability to fully sterilize inflows could increase inflationary pressures.
Since the beginning of August (when the IMF programme was brought back on track) the hryvnia has depreciated by 0.8% versus USD but since the beginning of the year the hryvnia has appreciated by 0.5%; currently the exchange rate vs. USD stands at 7.892 compared to 8.00 at the beginning of this year. Overall, we anticipate the hryvnia to remain relatively stable in the coming months at levels around 7.85-7.95 vs. USD.

Latest credit developments

Conditional in the Ukrainian banking sector have lately shown increased signs of stabilisation. Private sector credit grew by 3.7% year-to-September.
This was largely due to the growth of corporate loans, which have risen by 5.6% in the first nine months of the year. On the other hand, household credit dropped by 9.4% over the same period, with a more significant drop recorded in mortgage loans (-13.5% year-to-September) (Figure 2).

Figure 2
Diverging trends in domestic credit dynamics



Source: National Bank of Ukraine, Eurobank Research

Meanwhile, private sector deposits increased 3.4% mom in September, equally supported by household and corporate deposits (up by 2.9% mom and 4% mom, respectively). Private sector deposits grew by 20.8% year-to-September. Deposits in national currency outperformed, recording growth of 35.7% year-to-September.

The Loans to Deposits ratio decreased further in September, reaching 183.3% compared to 215.9% in December 2009. Yet, a lingering risk to the domestic banking system is the continuing rise in Non Performing Loans (NPLs). Even according to National Central Bank's (less strict) definition, NPLs to total loans ratio stood at 11.9% in September 2010 compared to 9.7% in December 2009. (According to the IMF's definition, NPLs reached 41.6% in March 2010 from 40.2% in December 2009). More worrisome, NPLs grew by 23.7% year-to-September.

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