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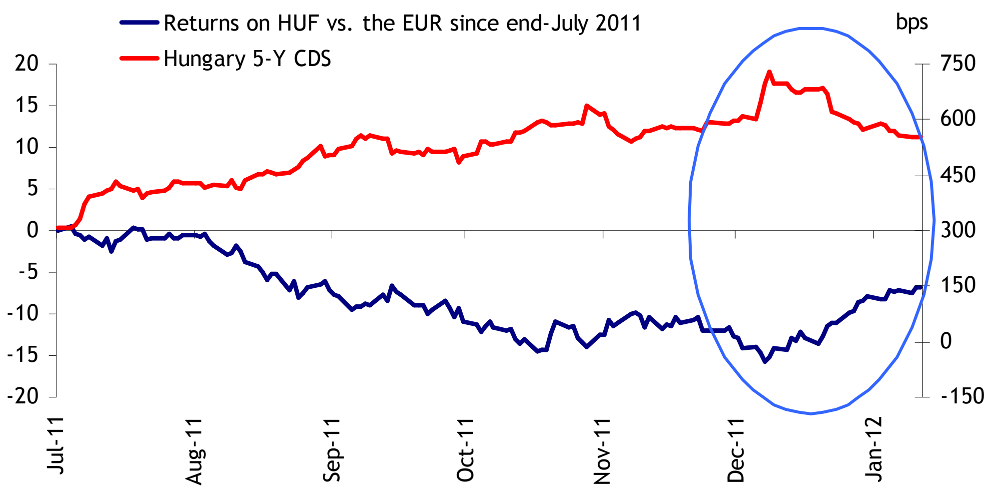
2012: A challenging year for the region

- **Bulgaria:** Outperformance of last year's fiscal target
- **Poland:** 2011 GDP growth above expectations
- **Romania:** Visible progress in fiscal consolidation, but significant challenges lie ahead
- **Serbia:** IMF postpones first review of precautionary agreement
- **Turkey:** Economic slowdown underway
- **Ukraine:** Worsening growth outlook increases susceptibility to external shocks, sudden shifts in global investor sentiment

New Europe market strategy highlights

Regional FX markets: At this stage, we prefer to stay broadly sidelined in regional currencies, as the early 2012 rally may soon run out of steam and lingering uncertainties over developments in the euro area may see regional FX markets coming under renewed pressure. **In the sovereign credit space**, we maintain our earlier long Turkish 5-year CDS recommendation. Constructing a near risk-free *basis* trade to take advantage of spread differentials, we favor going long 5-year protection on Turkey in parallel with a long position in the Turkish USD-denominated 5½% February 2017 bond. In a similar vein, we propose going long Romania's 10-year CDS at levels near 420bps and buy the Romanian 6³/₄ February 2022 USD-denominated bond at a cash price of 99.85 and z-spread at 500bps. We also maintain our previous call of going long 5-year protection on Russia vs. shorting 5-year protection on Poland. **In local rates markets**, we presently favour entering steepener positions in Polish 2/5 cross currency swaps at current levels of -7bps, targeting +10bps and assigning a stop loss at -20bps. That is on the view that the Polish economy may fare better than regional peers this year on comparably healthier fundamentals.

Concerns grow over Hungary's fiscal position, domestic financial stability



Source: Reuters, Eurobank EFG Research

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Summary of key macroeconomic indicators

Realizations and forecasts

	Real GDP (yoy)			Consumer Prices (p.a.)			Fiscal Balance (%GDP)		
	2010	2011	2012	2010	2011	2012	2010	2011	2012
Bulgaria	0.2	2.1	1.5	3.0	4.2	2.0	-4.0	-2.0	-1.4
Poland	3.9	4.3	3.3	2.6	4.3	3.5	-7.8	-5.6	-4.0
Romania	-1.3	2.5	1.0	6.1	5.8	3.5	-6.9	-4.4	-3.0
Serbia	1.0	1.9	1.5	6.8	11.2	5.5	-3.6	-4.6	-4.3
Turkey	9.0	8.2	3.0	8.6	6.4	8.0	-3.6	-1.4	-1.3
Ukraine	4.2	4.8	3.0	9.4	8.0	8.5	-6.5	-4.2	-3.0
New Europe	5.2	5.6	2.8	6.4	6.0	5.9	-5.6	-3.4	-2.6
Euro area	1.9	1.5	0.0	1.6	2.7	1.9	-6.2	-4.5	-3.5
USA	3.0	1.7	2.0	1.6	3.1	2.3	-10.5	-10.0	-8.5

	Current Account (%GDP)			Policy Rate (e.o.p.)			FX* (e.o.p.)		
	2010	2011	2012	2010	2011	2012	2010	2011	2012
Bulgaria	-1.3	2.5	0.5	currency board			1.96	1.96	1.96
Poland	-4.6	-4.8	-4.0	3.50	4.50	4.00	3.96	4.46	4.10
Romania	-4.3	-3.5	-5.0	6.25	6.00	5.00	4.28	4.32	4.40
Serbia	-7.2	-7.5	-8.5	11.50	9.75	9.00	106.1	106.9	110.0
Turkey	-6.5	-9.5	-8.0	6.50	5.75	5.75	1.54	1.88	1.70
Ukraine	-2.1	-5.3	-4.8	7.75	7.75	7.75	7.96	7.99	8.10
New Europe	-5.6	-3.4	-2.6	-	-	-	-	-	-
Euro area	-0.5	-0.6	-0.4	1.00	1.00	1.00	1.34	1.27	1.25
USA	-3.2	-3.1	-2.9	0.250	0.250	0.250	0.75	0.79	0.80

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

I. Overview

2012: A challenging year for the region

The onset of 2012 finds New Europe confronted with significant challenges and uncertainties. These have a common denominator: the Eurozone sovereign debt crisis. The crisis is affecting the region through a number of important channels. High exposure to euro area economies via the channels of trade and capital flows as well as inter financial market linkages cast the region vulnerable to downside shifts. Last but not least, the ongoing deleveraging process of the EU banking sector translates into measurable domestic macro prudential risks. In response, talks of a potential co-ordination of all stakeholders (official sector-regulators and private sector) in the form of a new Vienna type initiative are already underway.

Despite increasing risks and high uncertainties, our baseline scenario is still for a positive GDP growth trajectory this year for most economies in the region. This view is expected to materialize under the assumptions of a mild recession in the euro area and the absence of significant unforeseen external shocks. In any case, growth is expected to be slower than in the past year and to remain well below potential in most New Europe economies. Although conditions may defer across regional economies, the overall trend will likely be for growth to be primarily driven by subdued domestic demand and, to a lesser extent, by weaker net exports dynamics.

Region better positioned now than in 2008 to withstand external shocks

In our view, 2012 will likely prove to be a bifurcation year. Without any doubt, the first months will be a testing period of adjustment for most New Europe economies. Yet, the sensitivity of individual economies to the lingering euro area sovereign debt crisis will, no doubt, depend on the degree of dependence on external financing as well as other country-specific idiosyncratic characteristics.

As an overall assessment, we believe that by no means 2012 and 2008 are the same. Most countries in New Europe have done their homework in terms of economic policy over the past three years. First of all, their macroeconomic fundamentals are now much stronger than in the period following the Lehman debacle in September 2008. Massive pre-crisis macro imbalances have been absorbed, much-needed fiscal consolidation programs have been implemented and fiscal metrics in most regional economies are now much healthier compared to Western peers.

At the same time, a number of countries are running with relative success IMF-led programs. These programs have equipped respective authorities with significant FX reserves ammunition and have guided them in the implementation of important structural reform programs. All in all, the aforementioned developments place the region in a better position than in 2008 to withstand a worsening external environment.

Increasing evidence of economic slowdown

After recording broadly strong GDP growth readings in the third quarter of last year, most economies in New Europe appear to have embarked on a decelerating path, mainly as a result of a worsening external environment and the lingering debt crisis in the euro area. Regional PMI data for January confirm the weakening trend in manufacturing activity, with even the region's outperformers failing to escape unscathed. Only in Poland there are some signs of a broad based pick-up in domestic activity, with the country's latest PMI survey (January 2012) recording a rise in the headline index to 52.2 from a 2-year low of 48.8 reached last December.

Prospects remain favorable for the Polish economy with real GDP growth anticipated to come in at 3.3% this year (Eurobank Research forecast) after a +4.3% realization in 2011. Turkey, last year's star performer, is expected to register a sharp slowdown in economic activity to 2.4-3.0% in 2012 after an estimated expansion of around 8.0% last year. Ukraine's export-driven economy grew by 5.1% yoy in 2011 outpacing earlier analyst expectations. Yet domestic GDP growth is expected to decelerate this year on the back of lower external demand and increased funding pressures.

Economic growth in other economies in the region is likely to broadly stagnate this year as demand from abroad weakens. In addition, domestic demand dynamics will likely remain subdued as ongoing fiscal consolidation, weaker capital inflows and tightened lending conditions will continue to weigh on the outlook of private consumption and investments. Unfavorable base effects stemming from a broadly strong growth performance in the first three quarters of last year, renewed depreciating pressures on domestic currencies and risks of deleveraging by euro area parent banks constitute additional headwinds to the region's growth outlook in 2012.

Softening domestic economic activity, easing inflation pressures support case for looser monetary policies ahead

As we noted in our previous *New Europe Economics & Strategy* issue (December 2011), monetary policy is currently the primary tool for supporting domestic economic activity, given the ongoing fiscal consolidation in the region. Supporting the case for further monetary policy easing ahead, inflation pressures have recently subsided, domestic demand dynamics are weakening and the impact of past hikes in regulated price will wane going forward. The potential for further declines in oil prices from the peaks recorded last year may also favor. More importantly, the recent recuperation witnessed in regional currencies – if sustained – is likely to provide additional room for lower policy rates ahead.

Acknowledging rising risks to the domestic growth outlook several central banks in New Europe have already embarked on a monetary easing cycle. The National Bank of Serbia was among the first in the region to cut policy rates, being encouraged by the domestic disinflation process (Serbian CPI slid to a 1-½-year trough of 7.0% in December). Since the inception of its latest monetary easing cycle in June 2011, the Central Bank has delivered 300bps of cumulative rate cuts, bringing its key two-week repo rate to 9.50%.

With domestic inflation hitting a record low of 3.14% in December and GDP growth braced for a slowdown in the period ahead, the National Bank of Romania (NBR) lower its key policy rate by 75bps cumulatively since November to a record low of 5.50%, currently. Even the Central Bank of Ukraine, which had held fire since October 2010, slashed its overnight interest rates by 25bps in late January in order to provide support to the slowing domestic economy. The Central Bank cut the overnight rate on unsecured loans to 11.00% from 11.25%, the rate on loans under collateral of government T-bills to 9.00% from 9.25% and maintained its key discount rate stable at 7.75%.

Poland's Central Bank has kept interest rates unchanged at 4.50% since June as inflation remains stubbornly above its 2.5%+/-1% target. However, the market's median forecast is for some further monetary easing in H2:2012 as inflation pressures gradually ebb. On the other hand the Central Banks of Turkey and Hungary have retained their tightening bias as the depreciation of their domestic currencies last year aggravated inflation pressures in the former and fanned financial stability risks in the latter.

Although weak domestic demand dynamics may argue for lower rates ahead, the Central Bank of Hungary (MNB) hiked its key policy rate by a total of 100bps to 7.00% in two separate tightening moves in November and December last year. The move arguably aimed to support the forint and contain risks stemming from high domestic FX lending. Encouraged by the forint's recent recovery, the Bank held its horses in January, disappointing market participants who expected another interest rate increase.

Separately, the Central Bank of Turkey has maintained its monetary tightening bias since late October, continuing along a broadly unorthodox policy mix that has been in place since late 2010. With increasing evidence suggesting that the CBT's tightening policy moves are bearing fruit we expect that the Central Bank to continue along these lines for the greater part of the current year.

Hungary macroeconomic outlook 2012: Brief Assessment

Hungary's macroeconomic prospects have deteriorated significantly in recent months. The debt crisis in the euro area is taking a toll on the country's exports-oriented economy, while fiscal and monetary tightening ahead is anticipated to keep domestic demand subdued. In addition, high public sector debt levels (currently, the highest in Central and Eastern Europe at ca 80%-of-GDP) and considerable household leverage in FX loans are stirring worries over Hungary's fiscal and financial stability position going forward. This holds especially as the forint eased to record low levels against major currency peers in recent months. Note that 65% of total household loans are FX-denominated, particularly in CHF, Exacerbating these concerns were the unconventional policies the Fidez-led government has been pursuing since coming into power in mid-2010. Among them, was the decision to bring to an abrupt end an existing €20bn financial aid package agreed with official lenders in 2008. Another was the adoption of legislation enforcing the transfer of mandatory private pension fund assets into the state system, aiming to plug budget holes and avoid tough fiscal austerity measures.

According to financial markets regulator, PSZAF, some $16.1bn worth of assets were transferred to the state's coffers from mandatory private pension funds mid-last year. However, the move, which effectively overturned a reform endorsed in the late 90s, was heavily criticized on the basis that it constitutes a re-nationalization of the pension system. Its one-off impact is not expected to provide any structural adjustment to the budget or offer a sustainable improvement in the country's fiscal position longer-term.

In support of the aforementioned, the European Commission projects Hungary's 2011 budget balance to run a surplus of 3.6%-of-GDP thanks to the pensions' one-off transfer. However, a swing back into a deficit near 3%-of-GDP is anticipated in 2012, even after taking into account the austerity measures adopted recently.

Last year's actual deterioration in government finances is more clearly reflected in the Commission's structural budget forecasts, which envision a 5%-of-GDP deficit in 2011 following a 3.8%-of-GDP shortfall a year earlier. . It is worth noting that in its latest assessment of five EU countries under the Excessive Deficit Procedure (EDP), the European Commission judged that Hungary was the only country failing to implement sufficient fiscal consolidation. As a result the Comission decided to extend Hungary's EDP procedure (in place since 2004) for an additional period

Increased tax levies on domestic banks and an early FX mortgage repayment scheme, which essentially allows indebted households to repay their loans at favorable rates at the expense of banks, stirred additional controversy. Moreover, the government pushed trough parliament earlier this year legislation that was considered of breaching European Union rules and undermining the independence of, among others, the central bank and the judiciary. In response, the European Commission launched legal action against Hungary.

In view of the aforementioned, investor confidence towards Hungarian assets has waned recently. Hungary recently lost its investment grade from all three major credit rating agencies. Moreover, government bond yields soared to multi year highs earlier this year, external debt spreads widened significantly in the last six months and the forint hit a record low in early 2012.

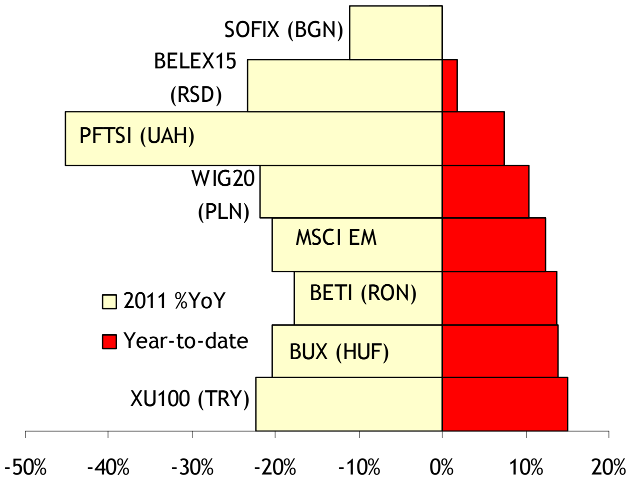
Financial markets in the region start the year on firm footing

After suffering double digit losses in 2011, **equity markets in New Europe** rallied over the first month of this year as global risk appetite improved, thanks to global central bank liquidity support and optimism that the US and German economies will fare better than initially expected. Optimism about a finalization of the Greek debt swap deal also favored, although the euro area sovereign debt crisis remains in the epicenter of market attention.

The **MSCI Emerging Europe Equity index**, which lost more than 25% last year, stood more than 20% firmer on February 7 from its levels at the end of 2011. At a regional level, all major market indices stood in a positive territory in early February, with most having recorded monthly gains in excess of 10%. Turkey's main stock index **ISE 100,** which touched its lowest level in 1-½-years in mid-August, staged a strong rebound in the first few weeks of this year (+18%) leading the region's gains. Hungary's **BUX** and Romania's **BETI** followed suit (+15% each). Poland's **WIG20** also posted double-digit gains (+10%) over the first month of the year, while Ukraine's **PFTS** and Serbia's **BELEX15** lagged behind with respective gains of ca 8% and 6%. Bulgaria's **SOFIX**, which fared much better compared to its regional peers in 2011, was the exception to stand in a marginally negative territory at the beginning of February.

Regional currencies, which came under considerable pressure late last year, received in early 2012 significant support from a notable improvement in global risk sentiment. Notably, the **Turkish lira** staged a 7% rally in the first few weeks of 2012, bouncing to a near 3-month high of 1.74/USD in early February. Its gains were facilitated by the new measures adopted by the central bank to support the domestic currency, a tighter monetary policy outlook in the period ahead and a further improvement in the current account deficit. The currency posed as last year's major underperformer in the region having plummeted to record lows of 1.9230/USD in December against a backdrop of increased market skepticism over the Central Bank's policy deliberations, high external imbalances and an unfavorable global environment.

New Europe indices recovered part of last year's losses in January

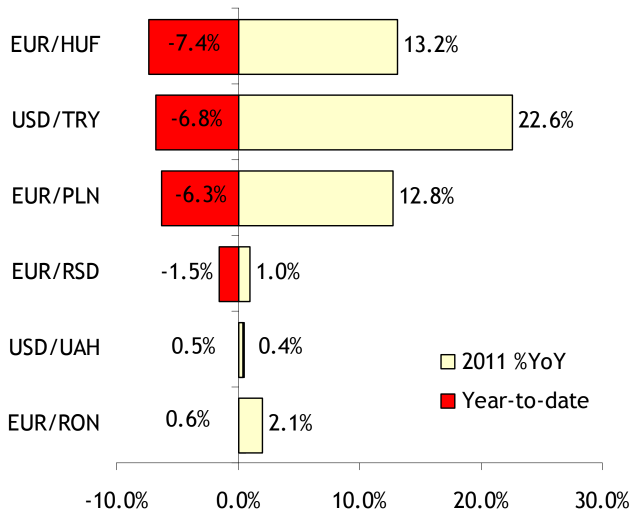


Source: Reuters, EFG Eurobank

Elsewhere, the **Polish zloty** strengthened by around 6% against the euro since the beginning of this year, after depreciating by ca 11% in 2011. The **Hungarian forint**, which touched a record low of 324.10/EUR in early January reversed course to stage a 12% rebound thereafter. In view of the forint's steep depreciation trend in recent months, Hungary's central bank (MNB) resorted to monetary tightening late last year in order to support the ailing currency. It delivered a 50bps rate hike in each of the MPC's meetings in November and December. However, the MNB's decision to hold its fire and disappoint expectations for a third consecutive policy rate increase proved to have a limited impact on the unit.

Among the laggards so far this year are the **Ukrainian hryvnia** and the **Romanian leu**. The latter touched a 1-½-month trough near 10.6/EUR in late January. Against the US dollar – to which the UAH is loosely pegged at around 8/USD - the currency weakened earlier this year towards a 2-year trough of 8.06. The frozen IMF deal and heightened risk aversion were among the main factors of the UAH's latest underperformance. As a result, speculation has been on the rise lately that the central bank may opt to adjust its peg bounds in order to alleviate depletion pressures on hard currency reserves. The **Romanian leu** remains little changed so far this year, following 75bps of cumulative rate cuts since last November in three separate central bank moves aimed at supporting the domestic economy.

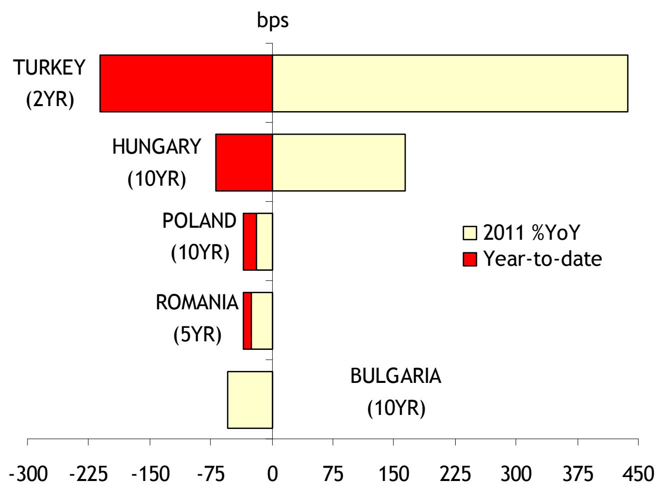
Regional FX markets start the year on a front footing



Source: Reuters, EFG Eurobank

In the **local rates markets,** yields of government bonds eased significantly in recent weeks thanks to improving risk sentiment. Turkey and Hungary are leading the gains so far in 2012, following a broadly disappointing performance for the greater part of last year. In Turkey, the rally has primarily been concentrated in the short-end of the yield curve, with the 2-year benchmark standing nearly 240bps lower in early February compared to a near 2-½-year high above 11% hit earlier in the year. In Hungary, the long-end of the yield curve fared better, with the 10-year government bond yield sliding ca 60bps in early 2012 towards a 1-½-month trough near 9%.

Local rates markets gain ground on improved risk appetite, monetary policy easing expectations ahead



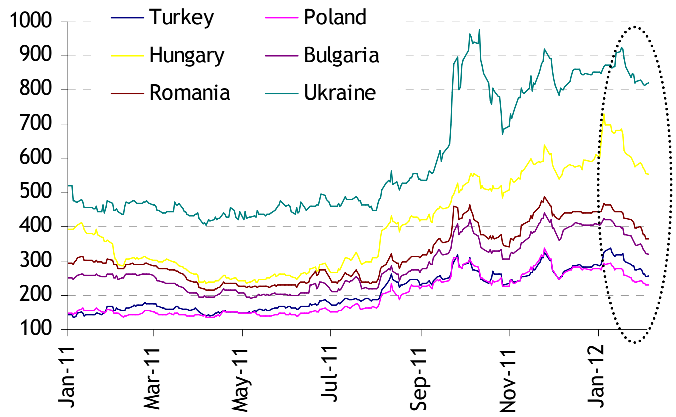
Source: Reuters, Bloomberg, EFG Eurobank

In a similar vein, **external debt spreads** over the last month or so. Indicatively, the **Hungarian 5-year CDS spread** narrowed by nearly 200bps in late January after hitting a 3-year peak of 754bps earlier that month, thanks to improving risk appetite and optimism that a new IMF deal will eventually be sealed.

In **Ukraine**, which largely underperformed its peers last year, concerns about the country's ability to service its public debt and external financing requirements have escalated recently. That is especially as the government has so far failed to produce a breakthrough in negotiations with the IMF for a resumption of the $15bn Stand-By Arrangement that was brought to a standstill in early 2011. Against this background, **Ukrainian 5-year CDS spreads** stood around 815bps in early February, little changed compared to their end-2011 levels.

In Turkey, external debt markets have rallied over the last three weeks as the current account deficit appears to have embarked on a slow but gradual adjustment and risk sentiment towards the region has improved. In response, **Turkish 5-year CDS spreads** hovered around levels of 263bps on February 2, having narrowed by around 85bps after hitting a 3-year high earlier this year. Meanwhile, **Bulgaria's 5-year CDS spreads** stood at around 320bps in early February, some 125bps narrower from a 2-½-year peak of 445bps touched last November.

External debt spreads narrow from recent peaks in early 2012



Source: Reuters, Bloomberg, EFG Eurobank

Strategy - Emerging New Europe Markets

Regional FX markets: Our recommended trade of shorting the TRY-basket hit the suggested target of 2.10 in mid-January. Moreover, in late December we collected profits on our short **EUR/RON trade** targeting levels around 4.28, while our long **€/RSD** position hit our suggested stop-loss level of 105.0. At this stage, we prefer to stay broadly sidelined in regional currencies, as the early 2012 rally may soon run out of steam and lingering uncertainties over developments in the euro area may see regional FX markets coming under renewed pressure.

In the sovereign credit space, we maintain our earlier long Turkish 5-year CDS recommendation (entry level: 250bps and stop loss near the October 27 low of 220bps). At current levels near 300bps we favor taking profits on half of our position and maintain the rest of the trade targeting higher levels between 325-350bps. Constructing a near risk-free *basis* trade to take advantage of spread differentials, we favor going long 5-year protection on Turkey (current level near 265bps) in parallel with a long position in the Turkish USD-denominated 5½% February 2017 bond (z-spread at 333bps currently and cash price of 102.75). The current spread stands at around 70bps and we target a tightening towards 30bps.

In a similar vein, we propose going long Romania's 10-year CDS at levels near 420bps and buy the Romanian 6¾ February 2022 USD-denominated bond at a cash price of 99.85 and z-spread at 500bps. The latter trade targets a narrowing of the basis from levels of 80bps to 30bps. Alternatively, the more liquid Romanian 5-year CDS at levels of 385bps could be utilized with entry at 115bps and target of 60bps. With Polish 5-year CDS spreads currently around 15bps wider compared to those of Russia, we maintain our previous call of going long 5-year protection on Russia vs. shorting 5-year protection on Poland (target: -50bps; stop-loss at +30bps).

In local rates markets, we closed half of our previous short-term steepener position in Turkish 2/10s cross currency swaps at the -180bps stop loss hit in early January. Later in the same month, we took a 50bps profit on the rest of the trade, when our suggested target of -100bps was hit. In view of the recent rally in short-end of the yield curve, we prefer to stay side-lined on this asset class. However, we presently favour entering steepener positions in Polish 2/5 cross currency swaps at current levels of -7bps, targeting +10bps and assigning a stop loss at -20bps. That is on the view that the Polish economy may fare better than regional peers this year on comparably healthier fundamentals.

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

Outperformance of 2011 fiscal deficit target

- Strong budget execution in first 11 month of 2011 signals outperformance of full-year deficit target
- Worsening external environment, uncertainties over the euro area debt crisis continue to weigh on the domestic economy
- Short term indicators predispose for a soft GDP reading in Q4:2011

Strong budget execution in first 11 month of 2011 signals outperformance of full-year deficit target

The latest budget execution data reveals that the full-year deficit target for 2011 is likely to be outperformed. The year-to-November general government deficit (cash basis) declined by 43.8% yoy to BGN 1.05bn or 1.4%-of-projected GDP. This compares with a 2.6%-of-GDP deficit realization in the same period a year earlier. Budget revenues improved in the first eleven months of 2011, albeit remaining below their pre-crisis levels. Total proceeds expanded by 6% yoy, to BGN 22.6 bn assisted by improved tax collections and higher domestic inflation in the first half of the year. However, they still lagged behind a corresponding full-year budget target of BGN 25.8 bn. As a percentage of projected GDP, total revenues reached 29.4%, marginally down from 30.3% in the same period a year earlier. Direct tax revenues outperformed, rising by 9.4% yoy despite weak labor market conditions and anemic domestic demand. Separately, the increase in the VAT rate in tourist services and improved tax collections boosted indirect taxes by 9.2% yoy. In a similar vein, social security contributions rose by 10.9% yoy in January-November, while non-tax revenues declined by 1.1% yoy over the same period.

On the expenditure side, total budget outlays in the first eleven months of 2011 grew by 2% yoy to BGN 23bn, remaining well below the corresponding full-year budget target of BGN 27bn. As a percentage of projected GDP, total expenditures reached 29.9%, down from 30.3% in the same period a year earlier. The most important components of budgetary expenditure, *i.e.,* public wages and pensions, remained broadly flat in nominal terms for a second year in a row, while in ppt-of-GDP terms they declined to 4.7% and 13.4%, respectively from 5.2% and 14.3% in the first eleven months of 2010. The observed restraint in budgetary expenditure was decisively facilitated by the under execution of the public investment program. Only 66.9% of

Bulgaria: Eurobank EFG Forecasts				
	2009	2010	2011f	2012f
Real GDP (yoy%)	-5.5	0.2	2.1	1.5
Final Consumption	-7.3	-1.1	1.2	1.0
Gross Capital Formation *(Fixed)*	-17.6	-16.5	1.0	2.0
Exports	-11.2	16.2	10.0	2.0
Imports	-21.0	4.5	7.5	3.5
Inflation (yoy%)				
HICP (annual average)	2.5	3.0	4.2	2.0
HICP (end of period)	1.6	4.4	2.8	1.8
Fiscal Accounts (%GDP) - *Cash Basis*				
General Government Balance	-0.9	-4.0	-2.0	-1.4
Gross Public Debt	15.6	16.7	17.5	18.3
Primary Balance	-0.2	-3.3	-1.0	-0.5
Labor Statistics - *National Definitions*				
Unemployment Rate (registered, %)	9.1	9.2	10.5	10.0
Wage Growth *(total economy)*	11.8	6.3	5.5	3.5
External Accounts				
Current Account (% GDP)	-8.9	-1.3	2.5	0.5
Net FDI (EUR bn)	2.4	1.8	0.9	1.5
FDI / Current Account (%)	78.2	374.0	Na	Na
FX Reserves (EUR bn)	12.9	14.1	13.5	15.0
Domestic Credit	**2009**	**2010**	**Q2 11**	**Q3 11**
Total Credit (%GDP)	79.2	76.4	73.8	72.7
Credit to Enterprises (%GDP)	49.4	48.2	46.8	46.7
Credit to Households (%GDP)	28.2	26.4	25.1	24.6
FX Credit/Total Credit (%)	58.6	61.3	62.1	63.3
Private Sector Credit (yoy)	4.5	2.1	3.3	3.2
Loans to Deposits (%)	120.5	112.9	108.2	105.6
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

targeted full-year capital expenditure had materialized until November (BGN 2.48bn vs. BGN 3.6bn planned in the budget).In ppt-of- Source: National GDP terms, public investment expenditure in the 11 months to November 2011 amounted to 3.3%-of-GDP compared to 3.7%-of-GDP in the same period a year earlier.

According to the Ministry of Finance, the full-year general government deficit in ESA terms is estimated to have outperformed the initial budget target of 2.5%-of-GDP, declining to 2%-of-GDP, from 3.1%-of-GDP in 2010. This impressive fiscal performance does not come as a major surprise to us. In a number of earlier research pieces (*see e.g. Eurobank EFG Research Trip Notes, October 2011 and March 2011)* we expressed our optimism about the attainability of the 2011 fiscal target, even without the adoption of additional consolidation measures. This is particularly encouraging development, as the government has accomplished to resist pressures for increased spending ahead of the November 2011 presidential and municipal elections. All in all, the latest budget execution data reinforce our long-held views about the soundness of Bulgaria's fiscal position. Bulgaria's full-year deficit compares favorably with the corresponding EU-27 average for 2011 (~4.7%-of-GDP as per the European Commission's Autumn 2011 Forecasts). Furthermore, the country's public debt is estimated to have reached ca 16%-of-GDP at the end of 2011, the second lowest ratio in the EU in 2011 behind Estonia.

As regards external sector developments, the country has managed to shift from a hefty current account deficit of 25%-of-GDP in 2007 to an unprecedented surplus of 2.5%-of-GDP in 2011. In conclusion, the Bulgarian economy is coping relatively well with the challenges stemming from the lingering euro area sovereign debt crisis. This sends a positive signal to the markets in a year where the government is considering tapping the international capital markets in a effort to keep borrowing costs as low as possible.

Higher-frequency data point to weakening growth dynamics since Q4:2011

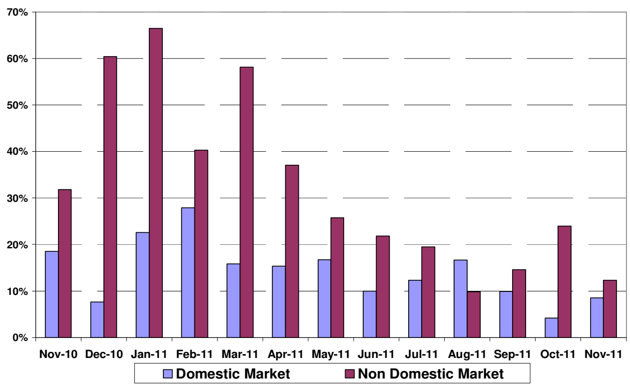
The latest signals from a range of high-frequency indicators of domestic economic activity are not particularly encouraging. Yet, domestic market data continue to significantly underperform external sector indicators. Specifically,

- **Industrial production** remains in a decelerating trend, coming in at -0.4% mom/ 0.6% yoy in November, down from +0.3% mom/+2.5% yoy in the prior month and +1% mom/+1.4% yoy in September (all in seasonally adjusted terms).
- **The pace of contraction in retail sales** deepened to -5.3% yoy in November, from -5.2% yoy in October, -3.0% yoy in September, and -0.8% yoy in June.
- After a brief seasonal improvement in the summer months, the **unemployment** rate climbed again to double digit levels in late 2011, coming in at 10.4% in December, from 10% in November and 9.4% in September.
- Growth of **household credit** remains subdued, growing by a modest 0.2% year-to-November 2011.

On a more positive note, recent external-sector indicators held up relatively well, despite deteriorating conditions in major trade partner economies:

- **Manufacturing new orders** recorded in November their second lowest reading for the year, coming in at +9% yoy vs. +7.4% yoy in October. This compares with **EU-27** averages of -1.2% yoy in November and +2.6% yoy in October. Note that manufacturing new orders in Bulgaria grew by 23.1% yoy in July (+7.2% yoy in EU-27).
- The signs of deceleration in **exports** continued in the last months of 2011. Yet, exports were up by an impressive 30.6% yoy in Jan-Nov 2011, albeit down from 41.1% yoy in Jan-June. Part of this strength is explained by the diversification of Bulgarian exports towards non-EU markets. Exports to non-EU markets expand more rapidly and now represent approximately 40% of total exports. In contrast, imports decelerated to 20.4% yoy in Jan-Nov 2011, down from 23.1% in Jan-June.
- The **industrial sector turnover** received more support by the external sector than by the domestic market in Q4. Industrial sales were up by 9.9% yoy in November and 10.8% yoy in October. Industrial sales to the non-domestic market were holding up, expanding by 12.3% yoy in November and 24% yoy in October. In contrast, industrial sales to the domestic market have decelerated to 8.5% yoy in November and 4.2% yoy in October. More specifically, industrial sales to the manufacturing sector of the domestic market collapsed to 0.5% yoy in November compared to 1.2% yoy in October and 10% yoy in July. (Figure 1)

Figure 1
Industrial sales to the domestic market decelerated faster than those to the non-domestic markets in Q4



Source: Eurobank Research, National Statistics

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

2011 GDP growth above expectations

- Polish GDP grew by 4.3% yoy in 2011, its fastest pace in three years, on the back of strong investment activity and buoyant exports
- IMF reaffirmes Poland's continued qualification to access FCL
- CPI down slightly in November, but still well above the NBP target
- MPC will likely keep policy rate unchanged at 4.50% at the February policy meeting. We continue to see room for additional policy easing later in the year
- Robust growth in bank credit and deposits continues

Full-year GDP growth at 4.3% in 2011, above market expectations

Polish real GDP growth accelerated to 4.3% in 2011, from 3.9% in the prior year. This was the fastest pace of expansion in three years, coming on the back of strong private investment and buoyed exports. Fixed-investment grew by 8.7% in 2011, following a mild contraction (-0.2% yoy) in the prior year. A weaker zloty- down by 13.1% against the euro in 2011- kept exports growing, even as the euro area's debt crisis damped demand in Poland's most important exports markets, including Germany. The economy appears to have kicked off this year on solid footing, with some earlier worries about of a significant deceleration in domestic economic activity not having been substantiated yet. Indicatively, the Polish PMI manufacturing index rose to 52.2 in January from 48.8 in December, outpacing the 49.9 market consensus forecast. A PMI reading above 50 indicates expansion in the manufacturing sector and a reading below that level indicated contraction. More precisely, Polish manufacturing grew in January for the first time in three months, with a weaker zloty boosting new export orders.(Figure 1)

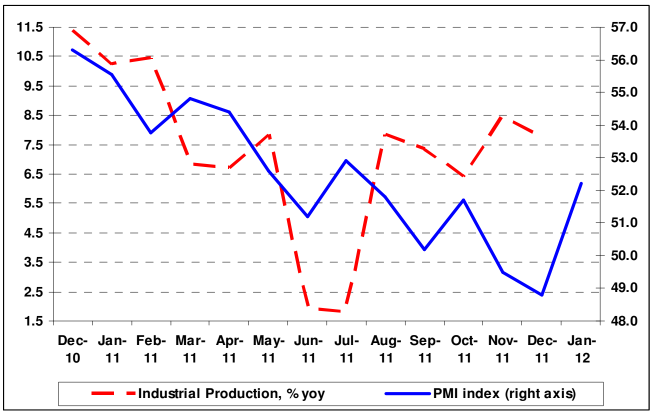
On a less positive note, the gradual worsening in labour market conditions (unemployment rate up to 12.5% in December from 12.1% in the prior month) and stabilising wage growth (+4.4% yoy in December, down from a 5.8% yoy peak reached last June) will likely translate into a slowdown of consumption spending in the coming months. The planned fiscal tightening is expected to curtail consumption growth as well.

Poland: Eurobank EFG Forecasts				
	2009	2010	2011f	2012f
Real GDP (% yoy)	1.6	3.9	4.3	3.3
Private Consumption	2.1	3.2	3.5	3.0
Government Consumption	2.1	4.3	0.7	0.5
Gross Capital Formation	-11.5	9.3	6.5	4.5
Exports	-6.8	12.1	5.1	6.0
Imports	-12.4	13.9	6.1	6.3
Inflation (% yoy)				
CPI (annual average)	3.5	2.6	4.3	3.5
CPI (end of period)	3.5	3.1	4.6	3.2
Fiscal Accounts (% GDP)				
General Government Balance	-7.3	-7.8	-5.6	-4.0
Gross Public Debt (ESA95 definition)	50.9	54.9	55.0	55.1
Gross Piblic Debt (national definition)	49.9	52.8	53.5	54.0
Labor Statistics (%)				
Unemployment Rate (% of labor force)	11.9	12.4	12.5	12.0
Wage Growth *(private sector - average)*	4.2	3.6	4.9	4.3
External Accounts				
Current Account (% GDP)	-3.9	-4.6	-4.8	-4.0
Net FDI (bn EUR)	6.0	2.5	8.0	9.0
FDI / Current Account (%)	75.9	41.6	75.0	70.0
FX Reserves (bn EUR)	55.2	70.0	75.7	72.0
Domestic Credit	**2009**	**2010**	**Q2 11**	**Q3 11**
Total Credit (% GDP)	53.1	55.4	56.3	58.7
Credit to Enterprises (% GDP)	16.1	15.2	15.8	16.3
Credit to Households (% GDP)	31.6	34.2	34.5	35.9
FX Credit/Total Credit (%)	30.2	30.8	30.6	32.5
Private Sector Credit (% yoy)	7.2	8.9	9	14.3
Loans to Deposits (%)	102.6	102.4	104.6	106.5
Financial Markets	**Current**	**3M**	**6M**	**12M**
Policy Rate	4.50	4.50	4.25	4.00
EUR/PLN	4.19	4.20	4.10	4.10

Source: NBP, EcoWin, Bloomberg, Eurobank Research

All in all, we anticipate the Polish economy to decelerate to 3.3% yoy in 2012 as a result of slower consumption growth and ebbing investment activity in the second half of this year. The latter will most probably peak ahead of the European football championship in June 2012, and start to decline thereafter as public expenditure on infrastructure levels off. Yet, the anticipated decline in domestic demand may be partly offset by a positive net exports contribution to GDP growth due to weaker zloty.

Figure 1
PMI index signals expansion in Polish manufacturing sector in January 2011



Source: National Bank of Poland, Eurobank Research

Note that Poland's main trade partner is Germany, which is likely to avoid recession in 2012. In addition, the Polish government is currently implementing a credible fiscal consolidation strategy that should help to rebalance growth and lead to a more sustainable trajectory in the medium term.

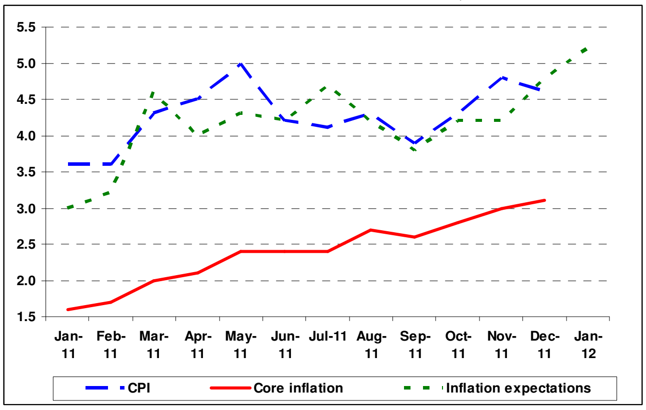
IMF extends Flexible Credit Line for Poland

The IMF reaffirmed Poland's continued qualification to access Flexible Credit Line (FCL) resources. The FCL arrangement for Poland was approved a year ago in the face of heightened external risks. Polish authorities have indicated that they intend to continue treating the arrangement as precautionary. This is a strong positive factor for the outlook of the Polish economy, especially in view of the lingering euro area debt crisis.[1]

Headline CPI decelerates slightly; core inflation and inflation expectations on the rise

Headline CPI decelerated at 4.6% yoy in December from 4.8% yoy in November, remained though above the upper boundary of the Central Bank's 2.5% +/-1% target. (Figure 2) Moreover, core inflation (measure which excludes energy and food prices) came in at 3.1% yoy in December from 3.0% yoy in the prior month, remaining at relatively elevated levels. Even more worrisome, the average inflation rate expected by individuals over the coming 12 months stood in January at 5.2%.

Figure 2
Inflation above NBP's target in 2011 on higher commodity prices and the weaker zloty



Source: National Bank of Poland, Eurobank

The significant rise of Polish CPI last year was mainly driven by higher food and energy prices, with the weaker zloty providing an additional boost to imported inflation. We expect these inflation drivers to ease in 2012. Base effect from the January 2011 VAT hikes will also fade. Overall, the unwinding of the last year's commodity price shock coupled with a slowdown in growth and a weaker labour market should gradually ease domestic inflationary pressures. We expect Polish inflation to average 3.5% yoy in 2012 vs. 4.3% yoy in 2011.

MPC likely to stay put on rates at February policy meeting

The National Bank of Poland (NBP) will likely keep its key interest rate unchanged at 4.50% at its February policy meeting as earlier worries about a more significant domestic economic slowdown have failed to materialise and inflation remains above the target. Yet we continue to see room for up to 50bps of cumulative rate easing until the end of the year as inflationary pressures will start fading in the coming months and major Central Banks (including the ECB) will likely remain in a highly expansionary mode. Supportive to the latter view is recent appreciation of the zloty against the euro of (by 6.5% ytd). Note that the domestic currency has devalued by 13.1% against the euro in 2011.

Robust growth in both bank deposits and credit

Conditions in the the Polish banking system remain sound. Even though ca. 70% of domestic banking assets are foreign owned, reliance on parent funding remains limited – net foreign liabilities account for 12% of assets. Moreover, up to now,

[1] The criteria for an FCL arrangement are the following: a sustainable external position; a capital account position dominated by private flows; a track record of access to international capital markets at favourable terms; a reserve position that is relatively comfortable when the FCL is requested on a precautionary basis; and sound public finances, including a sustainable public debt position.
The criteria also includes low and stable inflation, in the context of a sound monetary and exchange rate policy framework; no bank solvency problems that pose systemic threats to banking system stability; effective financial sector supervision; and data integrity and transparency.

problems of parent banks have not had any significant impact on the domestic market.

Total credit continues to accelerate; it grew by 15.1% year-to-November and by 2.9% mom in November from 0.1% mom in October. Total loans are driven both by household and corporate lending. Household credit grew by 12.8% year-to-November and by 2.2% mom in November; mortgages in particular recorded a robust growth rate of 18.5% year-to-November. Corporate credit increased by 7.1% year-to-November and by 3.7% mom in November. However, we anticipate demand for credit from the corporate sector to slow down in 2012 due to a less favourable macro environment. At the same time, slower growth of household incomes will also dampen household credit in 2012.

Total deposits grew by 10.5% year-to-November with household deposits increasing by 9.8% yoy and corporate deposits by 7.1% yoy over the same period. The Loans to Deposits ratio stood at 105.9% in November from 111% in October. Some banks may focus on deposits collection this year in an attempt to reduce their dependence on parent funding; thus deposits may continue to accelerate.

On a less positive note, Non Performing Loans (NPLs) increased again in November, following a small deceleration in the prior month; they grew by 8.7% year-to-November with household NPLs increasing by 15.9% over the same period. More worrisome, mortgages NPLs rose by 48.8% year-to-November as more that 57% of total mortgages are denominated in FX and zloty has depreciated significantly since September 2011. NPLs ratio to total loans stood at 7.9% in November from 7.7% in October.

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

Visible progress in fiscal consolidation, but significant challenges lie ahead

- Emil Boc steps down; designated successor Mihai Razvan Ungureanu to form new cabinet
- Central Bank lowers key interest rate by 25bps to 5.5% in line with consensus expectations. We expect another 25bps rate cut in early March
- Attainment of current year's fiscal target requires tough austerity measures to remain in place ahead of December 2012 elections

Emil Boc steps down; designated successor Mihai Razvan Ungureanu to form new cabinet

On February 7, Prime Minister Emil Boc submitted his resignation to President Traian Basescu, following weeks of nationwide street protests and riots against the government's austerity measures. President Basescu nominated Mihai Razvan Ungureanu as the new Prime Minister, with the latter expected to form a new cabinet within ten days. Note that the next parliamentary election is scheduled for December 2012.

The eruption of domestic political tensions has increased investor uncertainty over the outlook of the Romanian economy, but this is unlikely to last for long, in our view To a certain extent, increased investor uncertainty has already been reflected in the local stock market. However, the domestic currency exhibited relative stability (~4.35/€ at the time of the writing), while sovereign credit maintained their declining trend (5Y-CDS spread at ca 372bps at the time of the writing down from 450bps in mid January).

In our view, recent domestic political developments are unlikely to lead to a full-blown political crisis that could endanger the existing (precautionary) IMF facility for Romania. As a result, we do not expect a major deviation from the basic parameters of the program by domestic authorities. In essence, the new government is expected to derive support from the same coalition partners as the outgoing one (PDL, Ethnic Hungarians and Independent MPs). Yet, waning support in the polls for the ruling PDL party necessitated a bold reshuffle ahead of the next national election. According to the latest poll, support for PDL has dropped to only 18% compared to 33% of the vote in the 2008 elections.

Romania: Eurobank EFG Forecasts

	2009	2010	2011f	2012f
Real GDP (yoy%)	-6.6	-1.6	2.5	1.0
Private Consumption	-10.6	-1.5	0.9	0.7
Govern. Consumption	1.2	-3.2	-2.5	-0.5
Gross Capital Formation	-21.7	7.8	5.0	5.5
Exports	-5.0	14.3	12.0	5.0
Imports	-21.4	12.4	9.5	6.5
Inflation (yoy%)				
CPI (annual average)	5.6	6.1	5.8	3.5
CPI (end of period)	4.8	8.0	3.1	3.8
Fiscal Accounts (%GDP, Cash Basis)				
General Government Balance	-9.0	-6.9	-4.4	-3.0
Gross Public Debt	30.0	37.8	40.1	41.0
Labor Statistics (annual avg,%)				
Unemployment Rate (% of labor force)	7.8	6.9	7.0	6.5
Wage Growth (total economy)	8.4	2.5	1.4	4.5
External Accounts				
Current Account (%GDP)	-4.2	-4.3	-3.5	-5.0
Net FDI (EUR bn)	3.6	2.2	1.5	2.5
FDI / Current Account (%)	72.3	45.5	30.0	37.0
FX Reserves (EUR bn)	30.9	36.0	33.1	45.0
Domestic Credit *(end of period)*	**2009**	**2010**	**Q2 11**	**Q3 11**
Total Credit (%GDP)	50.2	52.7	52.7	52.3
Credit to Enterprises (%GDP)	19.6	20.4	20.5	20.8
Credit to Households (%GDP)	20.4	19.9	19.1	19.0
FX Credit/Total Credit (%, private)	60.1	63.0	62.9	63.6
Private Sector Credit (yoy)	0.9	4.7	1.3	6.5
Loans to Deposits (%)	130.6	137.7	134.9	140.0
Financial Markets	**Current**	**3M**	**6M**	**12M**
Policy Rate	5.50	5.25	5.00	5.00
EUR/RON	4.35	4.35	4.40	4.40

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

Visible fiscal consolidation progress in 2011

According to the latest budget execution data, the full-year consolidated budget deficit declined by 29% yoy in 2011, reaching RON 23.8bn. As a percentage of GDP, the consolidated budget deficit narrowed to 4.35%, from 6.5% a year earlier. Total revenue was up by 7.6% yoy whereas total expenditure grew by just 1.5% yoy over the same period. Total revenue reached RON 181bn (33.1%-of-GDP), slightly outperforming the corresponding budget target (RON 179.2bn). Notwithstanding the recessionary conditions in the domestic retail sector, VAT collections and excise taxes increased by 22.1% yoy and 10.4% yoy, respectively.

Furthermore, income tax receipts and social contributions grew by 4.1% yoy despite weak labor market conditions.

On the spending side, total, expenditure reached RON 205.4bn, not far away from the original target of RON 203.2 bn. Payroll expenses decreased by 10.6% yoy as a result of aggressive fiscal consolidation measures taken in June 2010 (25% cut in public wages) and the freeze in of public wages thereafter. As a percent of GDP, the overall bill for public wages came down to 7% in 2011, from 8.3% in 2010.

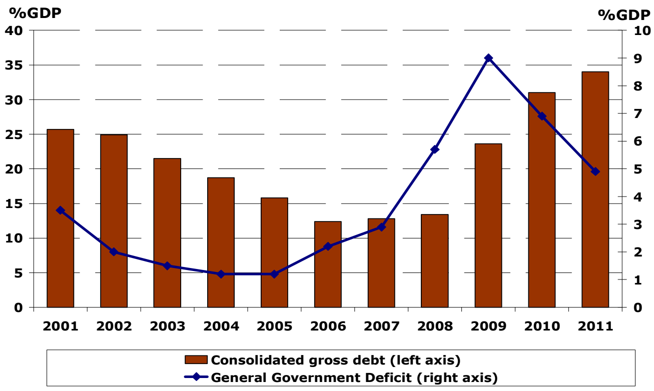
On a more positive note, capital expenditure and co-financing for European projects expanded by 18.6% yoy in 2011. In ppt-of-GDP terms, capital expenditure rose to 4.2% in 2011, from 3.8% in 2010. In addition, the rise in government outlays for goods & services was contained at 7.5% yoy, little above the average inflation, in an effort to contain current spending. Social protection costs (ca one-third of total budget expenditure), remained almost unchanged (-0.9% yoy), reflecting broadly flat pension payments vs. the same period a year earlier. In contrast, the cost of servicing public debt increased notably (+22.1% yoy) as public debt (national methodology) climbed slightly above 40%-of-GDP at the end of 2011 from 37.8%-of-GDP at the end in 2010

Attainment of current year's fiscal target requires tough austerity measures to remain in place ahead of December 2012 elections.

The execution of the 2011 budget was broadly in line with the requirements of the IMF precautionary agreement. In fact, the fiscal deficit in cash terms marginally undershot the 4.4%-of-GDP official target. The outgoing Romanian government delivered strong fiscal consolidation in an admittedly challenging domestic economic environment. Importantly, this was not achieved at the expense of cutting down on capital expenditures. The budget execution over the last couple of years put particular emphasis on changing the structure adjustment, favoring reductions in *current* rather than *capital* spending in order to achieve the fiscal targets.

Looking ahead, the fiscal performance to date sends a positive signal to markets and allows optimism over the attainability of the future fiscal targets envisioned in the present precautionary IMF programme. Overall, domestic authorities have accomplished to reduce the general government deficit on a cash basis from 7.3%-of-GDP in 2009 to 4.35%-of-GDP year in a highly uncertain domestic economic environment. The adjustment was even more impressive in ESA-95 accounting terms, with the government deficit having declined by 4ppt-of-GDP since 2009 to 5%-of-GDP last year.

Figure 1
Government reduced ESA-95 fiscal deficit by 4ppts-of-GDP in 2009-2011



Source: Eurostat, Eurobank Research

The fiscal target for 2012 is deemed to be challenging and ambitious. The outgoing coalition government had targeted a general government deficit of 1.9% of GDP on a cash basis (2.1% including IMF approved off-budget expenditures). However, the short-term domestic fiscal outlook is clouded with significant uncertainties and risks. First, it is important to note that authorities have already done significant work in containing budgetary expenditure by implementing politically-sensitive measures (e.g. more than 100k lay-offs in the broader public sector, public wage cuts etc). However, the risk of fiscal slippage may increase as we get closer to the date of the next parliamentary election (December 2012).

Secondly, there are risks related to the domestic growth outlook. The budget is built upon a forecast range for GDP growth between1.8%-2.3%. Even if headline GDP turn out to be in line with the budget forecasts, the realized growth mix (balance between domestic and external demand) will be a key determinant of the evolution of a range of budget revenue categories (e.g. VAT revenue).

Third, the level of arrears is another important source of concern. The problem of arrears to the private sector (contractors, suppliers etc) has been a focal point in all previous assessments of the multilateral lending program. Although the outgoing government has made significant progress last year in reducing outstanding debts to various suppliers, it did not manage to completely eradicate them. It is worth noting that the respective performance criterion was met in Q3-2011 for the first time since the inception of the IMF programme (precautionary and regular Stand By Arrangement).

Apparently, the government has done a lot of work both on an institutional and managerial level to contain arrears. As a result, it has minimized the level of arrears in central government and the health sector (the approximate level stood below 0.2% of GDP in Q3). In contrast, the level of arrears was such a significant problem within State-Owned Enterprises that could endanger the long-term fiscal sustainability. From that point of view, the data captured in the general government may not provide a complete and accurate picture. It is important to note that Eurostat had initially expressed its reservations on the impact of some public enterprises on the government deficit in April 2011. However, those reservations were withdrawn at a later stage. In the latest assessment of the IMF program issued in January 2012, the approximate number stood at 3.4% of GDP in Q3-2011 for the state owned enterprises monitored.

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Focus: Benign inflation environment allows Central Bank to ease monetary conditions

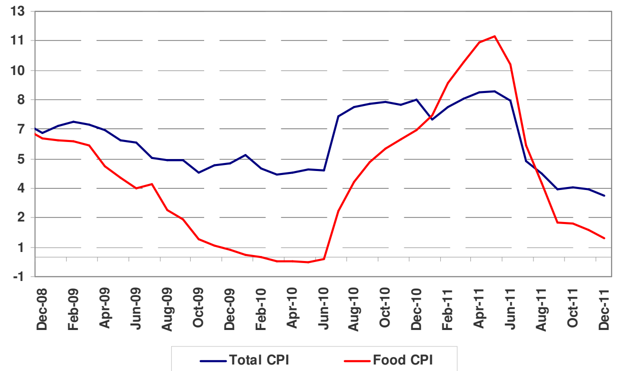
Inflation falls to record lows; disinflation to continue in the short term

Domestic consumer prices experienced high volatility throughout the past 2 years. Inflation jumped in the second half of 2010 due to a 5ppts increase in VAT rates, which is estimated to have added some 2.5ppts to headline CPI..

Inflationary pressures continued to accentuate in the first quarter of last year, mainly on the back of higher domestic food prices (+11.24% yoy in May 2011). However, an exceptional agricultural harvest helped reverse this trend, with the ensuing disinflation process deriving additional support from fading base effects stemming from the VAT hike in 2010. As a result, headline CPI eased to 4.25% yoy in August 2011 from a peak of 8.43% yoy recorded in May 2011. .

Food price inflation remained at low levels throughout the 4th quarter of last year, helping to drive headline CPI to 3.14% in December 2011. i.e., well within the Central Bank's target corridor of of 3% ±1ppts. This achievement looks even more impressive if one considers that domestic heating prices rose a cumulated by 20ppts from October to December.

Figure 1
Consumer prices have been falling rapidly due to an exceptional harvest and the elimination of the base effect from 2010's VAT hike



Source: National Institute of Statistics

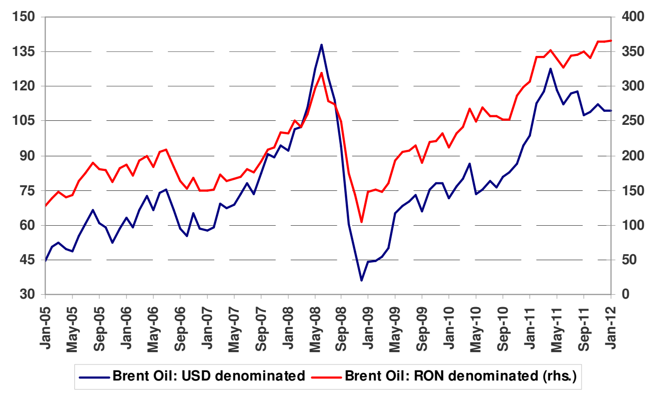
We expect domestic disinflation to continue in the first quarter of this year, assisted by weak demand-side pressures and favorable base effects stemming from to the sharp spike in food prices during the first half of 2011. Our forecast is for a headline CPI reading of 2% yoy in March 2012.

NBR's current projections are for a mild increase in domestic price pressures from that point onwards, with headline CPI seen finishing the year at 3.2% yoy, i.e., slightly above the 3% upper boundary of the Central Bank's target range. In our opinion, risks surrounding the domestic inflation outlook are slightly more skewed to the upside and, as a result, we currently have a CPI forecast of 3.4% for the end of this year.

In our view, the major upside risk to this year's inflation outlook stems from the evolution of world oil prices, especially in view of lingering geopolitical tensions in the MENA region. Tensions between Iran and the Western World have been running particularly high after the International Atomic Energy Agency's November report identified "strong indicators of possible weapon development". Subsequently, both the US and the EU have imposed economic sanctions against the country and urged other Asian countries to diversify their oil import sources. Direct impact on Romania, however, is going to be minimal as oil imports from the Arab country stood at a mere €1mn in the first 11 months of 2011. In addition, social unrest in Iraq and Nigeria as well as the slow recovery of Libyan oil production raise further risks regarding the increments in oil supply. As a conclusion, we expect oil prices to ease only marginally in spite of slowing global demand.

Other potential risks to Romania's inflation outlook this year include further adjustments in administered prices as well as domestic wage dynamics.

Figure 2
Oil prices denominated in RON have been rising since January 2009 and have exceeded the peak of 2008



Source: Thomson Reuters, National Bank of Romania

NBR policy outlook: Some additional room for monetary easing this year

Romania's Central Bank maintained its key reference rate steady at 6.25% for 16 consecutive months since May 2010. This was in spite of rising headline inflation as a result of the VAT rate hike which temporarily pushed inflation outside the NBR target range.

The NBR has started to gradually ease its monetary policy since last November to take account of easing domestic inflation pressures. The Bank lowered its key reference rate in November by 25bp. The move was followed by consecutive rate cuts in January and February (cumulatively 50bp), driving the policy rate to 5.50%.

The Banks' latest policy statement read that inflation risks are likely to remain skewed to the downside for the foreseeable future, thanks to a persisting negative output gap and the muted recovery of domestic credit.

Against this backdrop, we expect the NBR to lower its key policy rate one more time this quarter, with a further 25bp rate cut being delivered by the end of the year.

2012 domestic growth outlook

In the period leading to the economic crisis of 2008, Romania's GDP grew at an impressive average rate of 6.2%. The rapid expansion of financial intermediation, combined with increasing income expectations have fuelled a domestic demand boom, leading to a rapid increase in imports, consumption and investment.

However, the main implication of booming domestic demand conditions was rising internal and external imbalances in the form of sizeable twin deficits (budget deficit feeding back into the current account deficit). In a move to ease external financing concerns following the Lehman Brothers debacle, Romania secured in May 2009 a €20bn support package, financed by the IMF and the European Commission. (Upon its completion, the support program was eventually replaced by a €3.5bn. precautionary arrangement). In line with the conditionality laid out in the IMF/EU support package, the government enacted a series of structural reforms aiming to boost medium-term growth and correct earlier macroeconomic imbalances.

The recovery in the global economy in2009 facilitated a swift recovery in Romanian exports. Yet domestic demand continued to contract for some time, prompting negative GDP growth readings in 2009 and 2010. Following a tepid rebound in the first two quarters of 2011, the domestic economy experienced a growth spur in Q3, primarily due to an exceptional harvest. Crucially, domestic demand dynamics improved markedly in Q3-2011, with quarterly growth turning positive in construction for the first time in the last two years (+2.7% q-o-q) and retail sales rising as well (+0.4% q-o-q). The industrial sector also proved quite resilient (+3.2% q-o-q) helped by domestic orders.

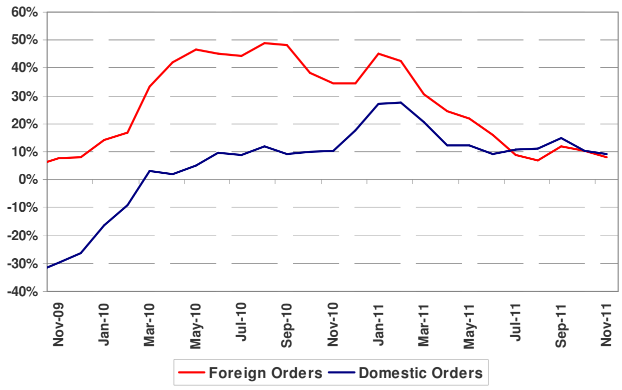
We estimate these trends to have broadly continued in the fourth quarter of last year, with full-year GDP growth in 2011 now projected at 2.6%. Yet, we expect the pace of economic recovery to slow down this year.

External trade will likely be adversely affected by worsening demand conditions in main trade partner economies. (The IMF has recently revised its 2012 growth forecast for the euro zone to -0.5% from +0.5% expected in September 2011).

In spite of the external environment deteriorating, manufacturing has remained relatively stable in the past three months. The sector expanded by an average +4.2% from September to November. We believe this dynamic have been helped by the resilience of domestic orders.

Since the beginning of the crisis, the growth rate of foreign orders has consistently outpaced that of domestic orders. However, the difference between these two components has been gradually shrinking since the beginning of 2011 and has actually reversed since August. While we expect domestic orders to continue buoying the sector throughout the year, we must note that this component will not be sufficient to support a pickup in the sector.

Figure 3
Foreign orders for manufacturing have been deteriorating for the past three quarters and are now outpaced by domestic ones



Source: Eurostat

We expect GDP growth in 2012 to be mainly driven by domestic demand. Specifically, we forecast an expansion of +3% for the construction sector and +1.9% for retail trade. Subsequently, we expect the economy to expand this year by around +1%. Downside risks for domestic demand in 2012 stem from a slowdown of private sector lending as well as an intensification of labor market pressures. However, a better absorption of structural and cohesion funds may provide a positive impulse to growth.

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

IMF postponed the first review of the precautionary agreement on concerns about the endorsed budget of 2012

- Inflation came down to 7% yoy in December, little above the NBS target range (4.5% +/-1.5%) in a very volatile year
- Weaker growth outlook and low supply side inflationary pressures keep Central Bank on an easing mode amidst financial markets turbulence. Central Bank cut interest rates by 25bps to 9.5%, bringing the overall cuts to 300 bps since the inception of the easing cycle;
- The IMF Executive Board meeting to consider the first review under the precautionary program has been postponed as the 2012 budget approved by parliament deviates from the program parameters. In our view, the probability of a collapse of the precautionary agreement is very limited

Inflationary pressures receded in December for the eighth month in a row. Inflation declined to 7%, but it is still exceeding the target band of the Central Bank (4.5 +/-1.5%) in a very volatile year

Inflation registered last December the highest negative month on month reading since July 2009. Consumer prices scaled down to -0.9% mom/+7.0% yoy in December vs. +0.9% mom/+8.1% yoy in November. The categories with the highest increase on a yearly basis were alcohol and beverages (0% mom/+11.1% yoy), housing, water utilities and gas (-0.1% mom /+9.6% yoy) and transportation (0% mom /+9.4% yoy). Food prices, the main driver behind inflation in the past months, decelerated to -2% mom/+6.4% yoy in December, down from +1.2% mom/+8.8% yoy in November against a peak of +5.3% mom/+22.9% yoy in last March.

The December reading is the lowest in 2011, a very volatile year as long as inflation is concerned. Average inflation climbed to 11.2% in 2011, compared to 6.2% in 2010. Having rallied in the last quarter of 2010, inflation peaked at 14.7% yoy in April 2011. The inflation rally was predominantly driven by supply-side factors related primarily to domestic food and world energy prices. The food prices shock was exacerbated by the high weight of food-37.8%- in the consumption basket. High oil prices worldwide stemming from the geopolitical tensions in the Middle East (tensions peaked in Q1-2011) made things only

Serbia: Eurobank EFG Forecasts				
	2009	**2010**	**2011f**	**2012f**
Real GDP (yoy%)	-3.5	1.0	1.9	1.5
Inflation (yoy%)				
CPI (annual average)	8.6	6.8	11.2	5.5
CPI (end of period)	6.6	10.3	7.0	6.0
Fiscal Accounts (%GDP)				
General Government Balance	-3.3	-3.6	-4.6	-4.3
Gross Public Debt	34.8	42.9	44.8	44.4
Labor Statistics (%)				
Unemployment Rate (%of labor force, ILO)	16.9	20	20.0	19.0
Wage Growth *(total economy)*	-3.5	7.5	8.3	5.0
External Accounts				
Current Account (% GDP)	-7.2	-7.2	-7.5	-8.5
Net FDI (EUR bn)	1.4	0.9	1.7	1.0
FDI / Current Account (%)	78.7	39.9	65.0	75.0
FX Reserves (EUR bn)	10.6	10.0	12.1	10.5
Domestic Credit	**2009**	**2010**	**Q2 11**	**Q3 11**
Total Credit (%GDP)	51.8	61.6	59.5	59.0
Credit to Enterprises (%GDP)	29.7	34.4	33.3	32.8
Credit to Households (%GDP)	17.3	19.1	18.4	18.2
Private Sector Credit (yoy)	14.3	26.5	11.0	6.7
Loans to Deposits (%)	127.0	144.6	148.8	143.9
Financial Markets	**Current**	**3M**	**6M**	**12M**
Policy Rate	9.50	9.00	8.50	9.00
EUR/RSD	105.99	106.00	110.00	110.00

Source: National Sources, IMF, Eurobank Research & Forecasting

worse. The implementation of administered prices hikes in gas and electricity prices contributed as well.

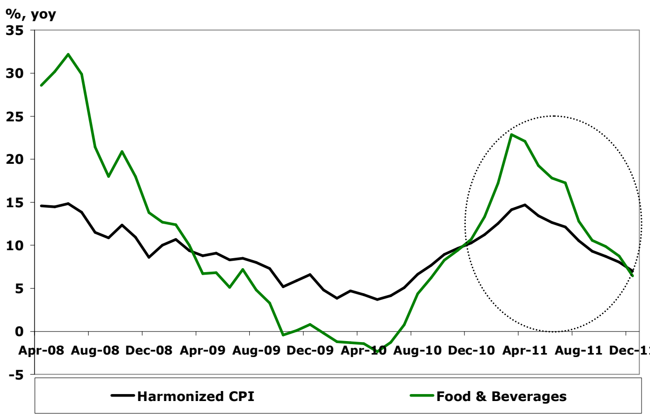
The absence of large second round effects from food prices led to inflation stabilization in following months. Inflation started gradually to retreat more visibly to the targeted band in the 2H.

The positive impact of the new agricultural season, in effect from July, coupled with the favorable base effects from the absorption of the price shock resulted in a sharp decline of food prices. On top of that, low domestic demand pressures (retail sector in recession) contributed positively to the downward inflation trajectory.

The view that the inflation rally was the result of a short-lived supply side shock was supported in all our previous issues of New Europe Economics & Strategy. An illustration of the above is that core inflation (CPI without food-energy-tax-alcohol) never surpassed the upper bound of the Central Bank targeted band. In turn, the December reading stood close to the year end Central Bank target (4.5 +/-1.5%) and below its earlier inflation report projection.

Figure 1

Inflation retreated close to the Central Bank target in December in a very volatile year



Source: NBS, Eurobank Research

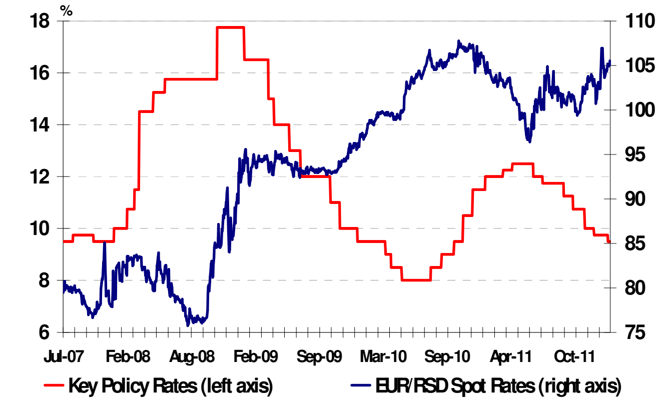
NBS cut rates further by 25bps in January. Since the inception of its easing cycle in early June the Central Bank, has cut rates by a cumulative 300bps from 12.5% to 9.5%.

On January 12, the NBS lowered its key policy rate by a further 25 bps to 9.5%. This was the fifth rate cut since June 7th, when NBS initiated its latest monetary policy easing cycle. This is in line with the results of the Bloomberg survey conducted ahead of the last policy meeting. According to the survey, the majority of participants (13 out of 23) expected a 25bps cut; seven expected rates to remain unchanged, two forecasted a 50 bps rate cut and one anticipated a rate increase.

In the statement released, the Central Bank reaffirmed the downward trend of inflation. More importantly, NBS repeated its previous forecast that inflation will probably undershoot the target tolerance band in Q1 (4.4%+/-1.5%). However, the Central Bank stressed that the latter may prove short-lived as a number of temporary factors will come into effect in Q1, pushing inflation to unsustainably low levels.

Figure 2

Since the inception of its easing cycle in early June the Central Bank cut rates by a cumulative 300bps from 12.5% to 9.5%



Source: NBS, Eurobank Research

More specifically, the Central Bank referred to favorable base effects from previously high food prices, the impact of temporary administrative caps on staple foods' profit margins during that period and the one-off effect of methodological changes in the calculation of fruit and vegetable prices. In turn, this will result in inflation bouncing back in Q2 (4.2+/-1.5%) and eventually stabilizing around the target band in Q3 (4.1% +/-1.5%).

Looking ahead, the Central Bank conditioned future rate actions on the materialization of risks stemming mainly from the Euroarea sovereign crisis, domestic fiscal policy and their impact on inflation. In that direction, there are a number of inter-related issues that will weigh in the future rates decision in our view:

- **Euroarea sovereign crisis**: The spillovers of the ongoing Euroarea sovereign crisis will most probably weigh negatively on capital inflows and trade flows. On the one hand, it will be hard for Serbia to repeat its previous year performance in terms of FDI and portfolio inflows in such a difficult external environment. On the other hand, the negative impact on the domestic growth outlook, mainly through the net exports channel, will be an incentive for the Central Bank to maintain an easing bias.
- **Dinar:** The fluctuations of the Dinar are not only a reflection of the country's risk premium but also have an indirect impact on inflation through imported materials. The Central Bank has estimated the pass through effect at 0.2-0.3 in the current quarter and 0.6 in the next 12 months.
- **Domestic fiscal policy**: As a rule of thumb, it is less likely to maintain fiscal discipline in an election year. Parliamentary elections are scheduled to take place in early May, the most probable date being May 6th. Lifting government spending restraints ahead of the elections could result in an inflation spike.
- **Inflation trajectory**: in the absence of a new supply side shock (potentially from energy prices, given the high

tensions in the Persian gulf), consumer prices will be easier to maintain on a downward trend, thus allowing more flexibility to the Central Bank

- **Credit conditions**: Credit dynamics have slowed significantly after the end of the state loan subsidies program. The rate cuts aimed in making lending in domestic currency more attractive, in line with the Central Bank dinarisation strategy. However, the results of stimulating domestic currency lending have been far from impressive.

In conclusion, we still hold the view that the Central Bank will maintain its easing bias in 1H-2012. During that period, provided no negative surprises occur on the inflation front, we still see room for additional 75-100 bps rate cuts from current levels. We anticipate that the level around 8.5% will be the bottom of the easing cycle. Thereafter, the Central Bank will be inclined to remain on hold for some time and even engage in tightening, depending on the outcome of the uncertainties described above.

The IMF Executive Board meeting to consider the first review under the precautionary program has been postponed as the 2012 budget approved by parliament deviates from the program parameters

On January 19th, the IMF representative office in Serbia announced that the first review under the precautionary agreement-originally scheduled for December 23rd-was postponed. The rationale behind the decision to postpone is rooted in the 2012 budget framework. According to the IMF, the 2012 budget, which has been endorsed by the parliament, does not comply with the requirements of the program. More specifically, the issuance of public debt and guarantees and the projected implementation of investment projects are in excess of what would be consistent with the targets of the program for deficit and debt.

In principle, Serbia runs a precautionary agreement with the IMF since Aug 31st 2011, which succeeded the expired Stand-by Arrangement. Fiscal policies were in the epicenter of contentious negotiations between the government and the mission during the drafting of the agreement. The finalized agreement entailed the adoption of a revised budget deficit target of 4.25% of GDP in 2012-down from 4.5% in 2011-and in line with the fiscal rule to achieve a public debt to GDP ratio below the threshold of 45%. In addition, the government ought to introduce measures amounting to 0.75% of GDP, primarily on the revenue side but also to cap current expenditure. The parliamentary endorsement of the budget 2012-which was provided in late December-under these parameters was a prerequisite for the approval of the first review of the precautionary agreement.

However, the IMF assessed that the endorsed budget contains some investment projects which could jeopardize the budget targets. Those investment projects (e.g. the Aleksinac-Novi Pazar gas pipeline) are either directly funded by the budget or the government has provided indirect state guarantees. Bearing in mind that the public debt to GDP ratio had already reached €15bn or 44.8% of the projected GDP in last November and the grim growth outlook ahead, the probability of debt breaching the 45% limit (set by the IMF induced fiscal responsibility law) is quite high. When that happens, the government is obliged by the law to submit a supplementary budget with additional fiscal tightening in order to ensure that debt ratio is brought back below the threshold. The timing is equally pressing given that parliamentary elections are only few months away.

In our view, the risk of an interruption of the precautionary agreement is limited. First of all, Serbian authorities have shown their commitment towards fulfilling the conditionalities of the previous regular Stand-by Arrangement. The precautionary agreement serves as a cushion in case of a new global downturn and reduces the sovereign risk premium of the country. That said, the outgoing government made limited use of the IMF funds under the regular SBA and has never made use of the funds in the precautionary agreement. On the other hand, the postponement sends a negative signal to the markets in a critical period. Serbia intends to issue short and long term debt worth RSD 304bn on the domestic market and also place RSD 104.4bn in Eurobonds most probably in Q4-2012.

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

Economic slowdown underway

- CBT keeps interest rates stable, maintains tightening bias
- Recent macroeconomic data suggest that overheating pressures are slowly ebbing
- 2011 inflation target missed, but last year's fiscal goal outperformed

Economic slowdown underway

Turkey's economy grew by 9.6%yoy in the first nine months of 2011, primarily thanks to strong domestic demand. However, recent readings in a range of real activity and sentiment indicators suggest that a slowdown is already underway. Important drivers behind the latter development include tightened monetary and fiscal policies as well as worsening conditions in main trade partner economies. Since late 2010 the Central Bank of Turkey has endorsed a number of (broadly unconventional) policy measures aiming to contain rapid domestic credit expansion and short-term capital inflows. More recently, the Bank resorted to monetary tightening in order to alleviate rising inflationary pressures. Slowing domestic lending growth is expected to weigh on private consumption and investments in the period ahead, while a mild recession in the euro area – one of Turkey's main export partners – will likely take a toll on exports. The deceleration in annual GDP growth may be more evident in H1:2012 as a result of unfavorable base effects due to double-digit output gains recorded in the same period a year earlier. Conditional on a more convincing policy response to the euro area debt crisis by EU authorities in the period ahead, a mild recovery in domestic economic activity may be witnessed in the latter half of this year. Against this backdrop, we estimate that Turkish GDP decelerated to 4.5%yoy in Q4:2011, bringing the corresponding full-year reading to 8.2%yoy.. For this year, we have a 3.0% GDP growth forecast, acknowledging that the balance of risks to the domestic economic outlook remains skewed to the downside.

Unconventional monetary policy mix to remain in place for some time

The lira's sharp depreciation last year aggravated domestic inflation pressures, forcing the Central Bank to resort to monetary tightening. Continuing along its earlier unconventional policy path, the CBT hiked in October 2011 its overnight lending rate by 350bps to 12.50%. Separately, it held the overnight borrowing rate stable at 5.00%. The key one-week repo rate was also kept unchanged at a record low of 5.75%.

Turkey: Eurobank EFG Forecasts

	2009	2010E	2011F	2012F
Real GDP (yoy%)	-4.8	9.0	8.2	3.0
Private Consumption	-2.3	6.7	8.5	1.0
Govern. Consumption	7.8	2.0	10.0	3.0
Gross Capital Formation	-19.0	29.9	20.0	5.0
Exports	-5.0	3.4	5.0	5.2
Imports	-14.3	20.7	15.0	0.5
Inflation (yoy%)				
CPI (annual average)	6.3	8.6	6.4	8.0
CPI (end of period)	6.5	6.4	9.7	6.5
Fiscal Accounts (%GDP)				
Central Government Balance	-5.5	-3.6	-1.4	-1.3
Gross Public Debt	45.4	42.5	40.0	38.0
Primary Balance	0.1	0.8	1.9	2.0
Labor Statistics (%)				
Unemployment Rate (%of labor force)	13.5	12.0	9.5	10.5
External Accounts				
Current Account (% GDP)	-2.3	-6.5	-9.5	-8.0
Net FDI (USD)	6.9	7.3	15.0	10.0
FDI / Current Account	46.9	12.0	20.0	15.0
FX Reserves (USDbn)	69.0	79.0	85.0	85.0
Domestic Credit	**Q4 10**	**Q1 11**	**Q2 11**	**Q3 11**
Total Credit (%GDP)	43.0	40.3	44.6	47.6
Credit Private Sector (%GDP)	40.9	38.6	43.0	46.0
FX Credit/Total Credit (%)	21.0	22.2	22.5	24.6
Private Sector Credit (%yoy)	44.0	44.8	43.3	44.9
Loans to Deposits	85.7	89.5	93.8	96.1
Financial Markets	**Current**	**3M**	**6M**	**12M**
Policy Rate (1-week repo)	5.75	5.75	5.75	5.75
USD/TRY (where applicable)	1.75	1.77	1.75	1.70

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

Policy rates have remained unchanged since then, but the CBT announced in December that it would start holding 1-month repo auctions as well. Along these lines, the Central Bank presently extends liquidity to markets primarily through its one-week (5.75%) and one-month repo (10.50%) auctions as well as through its overnight lending facility (12.50%). As a result, the funding costs in the interbank market remain bounded within a corridor of the lowest and highest rates. When the CBT opts to tighten monetary conditions it will lower the amounts available through the one-week repo and provide the rest of liquidity necessary through the other two more expensive options. If it aims for the opposite it will offer most of the funding required through the cheaper one-week repo tenders.

Effectively, the aforementioned policy shifts the average cost of interbank funding to the direction desired (Graph 1). Moreover, it seems that lending conditions have tightened significantly since last October. Indicatively, in early January, when the amount of effective monetary tightening reached a maximum under the current policy strategy, the CBT's weighted average cost of funds stood just below 12.00%, which translates into more than 600bps of tightening since October. Since then, the average rate has stabilized at around 7.50%, which still points to a considerable amount of monetary tightening beyond the key 1-week repo rate of 5.75%. The current policy mix permits significant monetary flexibility, allowing the CBT to deviate from its past strategy of considering changes in the 1-week repo rate only once a month.

The decision to employ a policy corridor appears to have initially confused some market participants, but the CBT's strategy has lately become more transparent and better communicated to the markets. In all, we anticipate the CBT to maintain its hawkish bias and its rather unconventional policy mix for most, if not for all, of 2012. In view of lingering upside risks to inflation a rate hike in the overnight lending rate can not be ruled out, at present. However, we assign a rather limited probability for such a move as the domestic economy is braced for a soft landing this year and the Central Bank's current strategy has already provided substantial monetary tightening as well as policy flexibility.

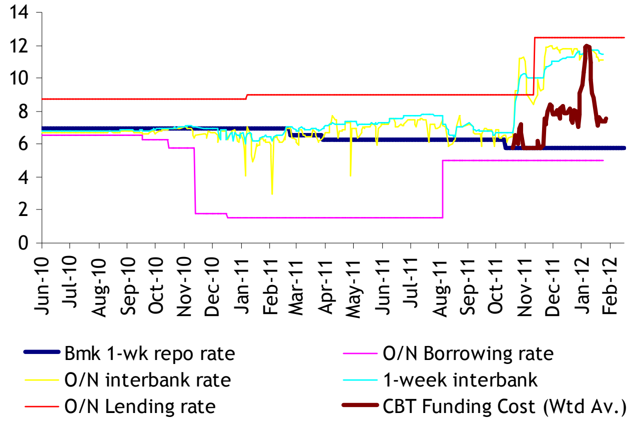
CBT keeps interest rates stable, maintains tightening bias

At its MPC meeting In January, Turkey's central bank (CBT) kept interest rates stable, maintaining its tightening bias. In a rather unexpected move, the Central Bank announced it would replace its regular daily FX auctions with intraday tenders (to be held when necessary), with an upper limit of $500mn. The announcement did not have any significant impact on the lira's main exchange rates.

Separately, at its January meeting the CBT also announced it would increase the quantity offered through its 1-month repo auctions to TRY20bn for the January 27-February 12 period from a maximum total funding amount of TRY12bn set in December when the bank introduced repo auctions of such tenure. The CBT also raised the maximum amount provided at each tender to TRY5bn from TRY3bn previously. The increased 1-month repo auction amounts suggest limited monetary tightening as the CBT appears to be in favor of increasing its lending capacities through the more expensive 1-month repo tenders. In return, banks are offered a longer lending maturity and lower shorter-term risks.

In the policy statement accompanying the January MPC meeting, the CBT expressed confidence over its current policy mix, noting that a rebalancing between domestic and external demand is underway and that the adjustment in the current account will continue in the period ahead. The Committee also acknowledged that inflation (+10.6%yoy in January) would remain at high levels in the short-term but highlighted that the monetary tightening delivered since October should limit second-round pressures and accelerate disinflation, particularly in Q4, 2012.

Figure 1
Substantial monetary tightening delivered since October 2011



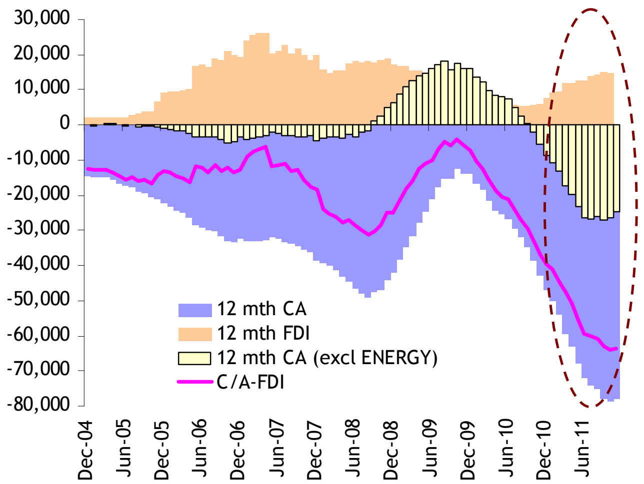
Source: Central Bank, Bloomberg, EFG Istanbul Equities, EFG Eurobank Research

Recent macroeconomic data suggest overheating pressures are slowly ebbing

According to the most recent macroeconomic data there is increasing evidence that the CBT's unconventional policy mix appears to be bearing fruit. Notably, November's current account deficit (CAD) shrunk for the first time in two years. The 12-month trailing deficit eased to $77.8bn in November (ca 10%-of-projected GDP) from a record peak of $78.6bn in the prior month, marking an improvement for the first time in 26 months. Excluding energy imports, the adjustment was more evident with the 12-M tralling CAD shrinking to $24.7bn, its lowest level in 6 months. The main factor behind the recent adjustment in the current account deficit is a narrowing trade shortfall and strong tourism revenues.

In spite of the recent signs of improvement, the current account shortfall remains a key vulnerability for the Turkish economy. Its adjustment has further to run and the high reliance on short-term capital inflows for its financing deems the country susceptible to sudden swings in global risk appetite.

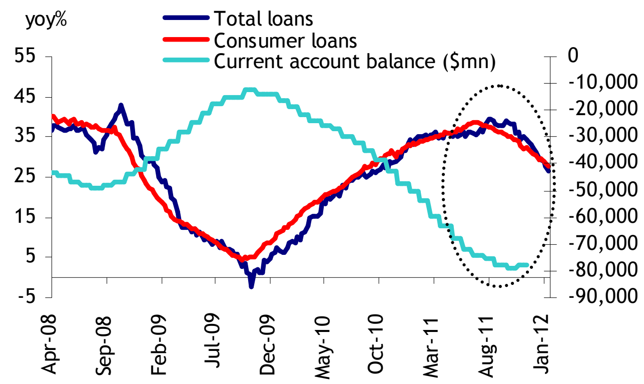
Figure 2
Current account adjustment underway



Source: CBT, National Statistics, EFG Eurobank

In another indication of slowing domestic demand dynamics, Banking Regulation and Supervision Agency (BDDK) data showed that the growth of total bank lending to the domestic economy slowed to ca 26%yoy in the last week of January (Graph 3). This compares with a multi-year high of 39.33%yoy in August 2011. Similarly, growth of consumer loans also decelerated that week to 27.8%yoy from a 2-year high of 38.7% in July, sliding further towards the CBT's 25% target.

Figure 3
Impact of CBT's measures more evident



Source: CBT, BDDK, EFG Eurobank Research

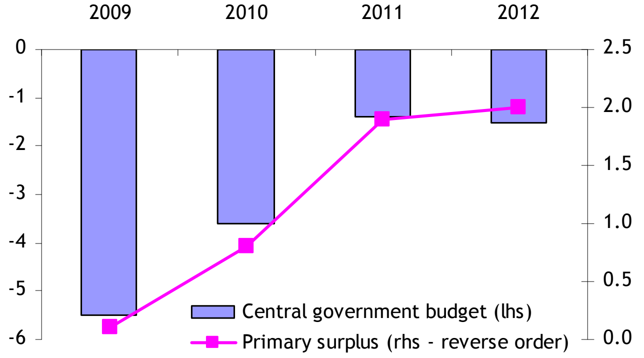
2011 inflation target missed…

Consumer price inflation breached last year the CBT's 5.5% target for end-2011 coming in at 10.45%yoy in December and outpacing the Central Bank's year-end forecast of 8.3%. Continuing along its upside trend, inflation outpaced expectations and came in at 10.61%yoy in January. The latest annual reading remained in double digit territory for the second month running; it was the highest in three years and more than double the 5.0% CBT end-2012 target. The recent increase primarily stemmed from higher food prices, the lira's pass through and administrative price hikes. In a similar vein, core inflation I index (excl. food, energy, alcohol, tobacco, gold) picked up pace in January with the annual rate hitting a near 5-year peak of 8.42%yoy. Against this backdrop inflation will likely remain elevated in the coming months. Our baseline scenario for year-end is that annual CPI will ease below 7.0% yoy, primarily thanks to weakening domestic demand and tightened monetary and fiscal conditions. Our forecast is broadly in line with the CBT's which in its latest inflation report released in late January revised upwards its inflation projection for end-2012 to 6.5% from 5.2% earlier. Upside risks to our forecast lie in the face of second round effects and higher wage growth.

… but 2011 fiscal goal outperformed

With regards to Turkey's fiscal performance in 2011, Turkish Finance Minister Mehmet Simsek said earlier in January that the state budget ran a TRY17.44bn (~$9.69bn) deficit, equivalent to 1.4%-of-GDP. This marks a near 60%yoy narrowing compared to the prior year when the government's budget gap stood at 3.6%-of-GDP. Last year's realization also outperformed the target of 1.7%-of-GDP and was primarily boosted by higher tax revenues. The Finance Minister added that the improvement would have been higher in the absence of infrastructure expenditure of TRY11.1bn realized after the Van earthquake. Adding to the positive tone, the primary surplus, which excludes interest payments on government debt, tripled to TRY24.77bn last year. The government passed in parliament in late December this year's budget, which envisages a central government deficit of TRY21.1bn or 1.5%-of-GDP. Expenditure is planned to amount to TRY350.9bn, while revenues are envisioned at TRY329.8bn and the primary surplus is seen at TRY29.2bn (around 2%-of-GDP). However, pro-cyclical factors that boosted last year's revenue collection are unlikely to favor in 2012. In addition, in view of growing global headwinds, the 4% growth forecast assumed in the Medium Term Programme for 2012-2014 is overly optimistic, which adds to upside risks to the 1.5%-of-GDP deficit target. Even so, the government has reiterated several times in recent months its commitment to fiscal discipline. In late October, it endorsed measures - e.g. tax hikes on vehicles, tobacco and alcohol - aiming to generate additional revenues of TRY5.5bn and to contain widening pressures on the current account deficit. It has also left the door open for further tax measures depending on global developments.

Figure 4
Fiscal performance improves



Source: National statistics, Ministry of Finance, MTP 2012-2014, Eurobank EFG Research

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

Worsening growth outlook increases susceptibility to external shocks, sudden shifts in global investor sentiment

- Negotiations to unfreeze IMF programme continue
- Domestic disinflation process accelerates on lower food prices
- NBU cuts key overnight refinancing rates by 25bps
- Corporate lending continues to drive domestic credit recovery

Worsening growth outlook increases susceptibility to external shocks, sudden shifts in global investor sentiment

GDP accelerated to 6.6% yoy in Q3-11, largely due to a good harvest which saw agricultural output recording a double-digit increase. However, growth prospects appear to have deteriorated during fourth quarter of last quarter, affected mainly by slower external demand. This apparently affected domestic industrial production, with output growth *contracting* by 0.5% yoy in December, following a notable deceleration to +3.8% yoy in the prior month. A worsened external growth and lingering instability in international markets are rendering Ukraine increasingly vulnerable to sudden swings in global investor sentiment. That is, especially in view of the country's lingering external imbalances and its significant dependence on commodities exports. On a more positive note, increased private consumption and investments ahead of EURO 2012 (European Football Championship) may partly counterbalance the dampening impact of weaker exports on domestic GDP growth in 2012. Yet, the evolution of domestic demand dynamics in the period ahead will crucially depend on the availability of credit. On that account, a prompt resumption of the IMF programme could help a great deal towards securing significant financing to cover external imbalances, stabilise expectations and reduce external funding costs. All in all, we anticipate GDP growth to fall to 3.0% yoy in 2012 from projected 4.8% yoy in 2011.

Negotiations with the IMF continue

Many meetings between Ukrainian officials and IMF representatives took place in recent weeks to discuss a resumption of the IMF programme. As a reminder, the IMF approved a 29-month Stand-By-Arrangement for Ukraine on Juy 29, 2010, with the country having already received two tranches

Ukraine: Eurobank EFG Forecasts	2009	2010	2011f	2012f
Real GDP (% yoy)	-14.8	4.2	4.8	3.0
Private Consumption	-14.9	7.0	9.9	6.5
Government Consumption	-2.4	2.7	0.4	1.0
Gross Capital Formation	-53.5	15.4	22.5	15.0
Exports	-22.0	4.5	6.2	5.0
Imports	-38.9	11.1	12.0	10.0
Inflation (% yoy)				
CPI (annual average)	16.0	9.4	8.0	8.5
CPI (end of period)	12.3	9.1	4.6	7.5
Fiscal Accounts (% GDP)				
General Government Balance	-8.7	-6.5	-4.2	-3.0
Gross Public Debt	35.3	41.7	42.4	43.0
Labor Statistics (%)				
Unemployment Rate (% of labor force)	9.6	8.8	8.0	7.9
Wage Growth *(real - private sector)*	-9.9	6.7	13.2	10.0
External Accounts				
Current Account (% GDP)	-1.5	-2.1	-5.3	-4.8
Net FDI (bn USD)	4.7	5.8	5.9	6.0
FDI / Current Account	268.7	190.8	65.0	60.0
FX Reserves (bn USD)	26.5	34.6	31.2	30.0
Domestic Credit	**2009**	**2010**	**Q2 11**	**Q3 11**
Total Credit (% GDP)	79.1	66.9	64.7	62.7
Credit to Enterprises (% GDP)	50.5	45.8	45.5	44.6
Credit to Households (% GDP)	26.4	19.1	17.4	16.2
FX Credit/Total Credit (%)	50.8	46.0	44.4	42.1
Private Sector Credit (% yoy)	-3.1	0.4	5.2	5.4
Loans to Deposits	215.9	175.9	166.0	169.0
Financial Markets	**Current**	**3M**	**6M**	**12M**
Policy Rate	7.75	7.75	7.75	7.75
USD/UAH	7.98	8.00	7.99	8.10

Source: NBU, IMF, Bloomberg, Eurobank Research

amounting to $3.4bn. The third tranche scheduled for March 2011 has been delayed as the Cabinet failed to meet a key programme conditionality calling for an increase in domestic gas prices rise and radical pension system reforms. The remaining available funds under the present SBA amount at $11.7bn (ca. 9.5% of GDP). As of the time of writing this report, no specific agreement has been reached for a renewal of the Stand-By-Arrangement. The key stumbling block remains the issue of raising household gas tariffs. The official position of Ukrainian government on the latter issue is that it can offset the losses made as a result of applied gas subsidies by implementing budget cuts in other areas. A potential gas deal with Russia would help to break the impasse in IMF-Ukraine negotiations as a significant discount in imported gas prices could potential alleviate the need for a sizable increase in household consumption tariffs. However, if Ukraine's external accounts deteriorate further and pressures on the hryvnia mount, domestic authorities will have little choice but to agree on unpopular measures, such as household utility tariffs, even though 2012 is an election year - Ukrainian parliamentary election are scheduled for October this year.

Current account widens slightly on large increase in income deficit

The current account deficit widened slightly in November, reaching $1.6bn from $1.5bn a month earlier. The slight deterioration was mainly on the back of a strongly negative income balance as a result of increase dividend payments abroad (-$677mn vs. -$189mn in October), which are likely to prove one-off. On a more positive note, the merchandise trade deficit narrowed in November to $1.2bn from $1.5bn in the prior month, but this was solely the result of an upsurge in agricultural exports. On the other hand, metals and machinery exports continue to decelerate.

The Capital and Financial Account turned positive to $746mn in November, after recording a deficit of $93mn in October. At the same time, FDI kept on tapering, hitting a two-year low of $148mn. Year-to November 2011, FDI reached $5.8bn compared to $5.6bn in the same period a year earlier.

While the current account deficit continued to widen in H2-2011, external financing has become more challenging. The cumulative current account deficit reached $8.7bn in Jan-Nov 2011, recording a $6.6bn increase from the same period a year earlier. Export growth slowed due to weaker external demand and softer commodity prices, but the adjustment of imports has lagged. Higher risk aversion in capital markets has increased external borrowing costs and reduced availability of financing sources for both the public and private sectors. All in all, we anticipate the 2011 current account gap to close to 5.3% of GDP.

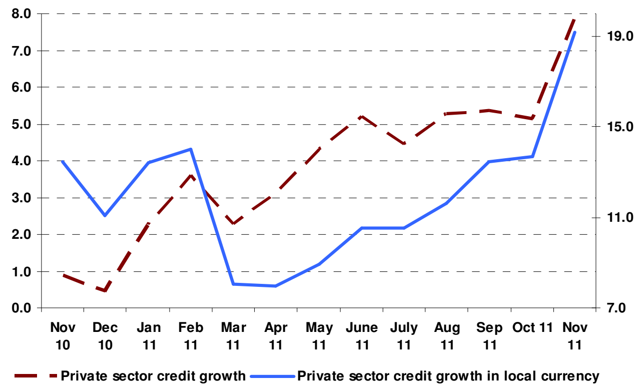
Inflation decelerates further on lower food prices

Consumer prices in Ukraine fell to 3.7% yoy in January from 4.6% yoy in December and its peak of 11.9% yoy in June 2011. The deceleration of January CPI was, once again, mainly attributed to lower food prices. The latter decelerated to 0.6% yoy in January from 1.7% yoy in the prior month. On the other hand, transport (18.3% yoy) and utilities (10.0% yoy) remain the main drivers of domestic inflation, mostly as a result of high fuel costs. We expect average inflation to increase to 8.5% yoy in 2012 from 8.0% yoy in the prior year, main as a result of higher utility tariffs.

Corporate lending continues to drive the credit recovery

Total credit growth decelerated to 9.1% yoy in November from 10.2% yoy in the prior month. This was attributed to household lending, which contracted by 4.6% yoy, while corporate loans accelerated to 15.0% yoy. Corporate lending continued to drive the credit recovery in 2011 supported by favourable export conditions in the first semester. Moreover, since last March there has been a recovery in private sector lending denominated in local currency, as economic stabilization and strong growth in real wages supported consumption. (Figure 1)

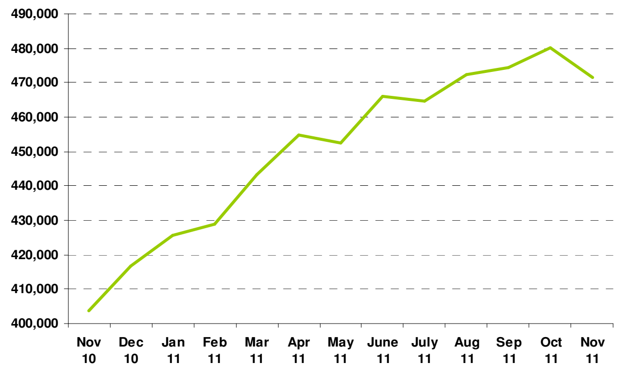
Figure 1
Recovery in local currency private sector lending supported by strong real wages growth



Source: National Bank of Ukraine, Eurobank Research

Total deposits decelerated in November to 16.8% yoy from 18.8% yoy recorded in the prior month, the growth standing at 13.2% year-to-November. Deposits growth was quite healthy in 2011 on the back of stabilizing domestic economic conditions and improving household confidence. (Figure 2)

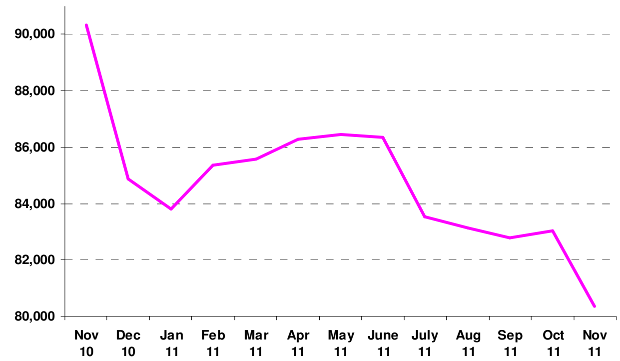
Figure 2
Healthy deposits growth in 2011 on the back of improving household confidence, stabilizing domestic economic conditions



Source: National bank of Ukraine, Eurobank Research

Non-Performing-Loans (NPLs) keep decelerating; in November 2011 they decreased by 3.2% mom and by 5.3% year-to-November. (Figure 3) Accordingly, the NPLs to total loans ratio stood at 10.0% in November from 11.5% at the beginning of 2011.

Figure 3
NPLs: significant deceleration in H2-2011



Source: National Bank of Ukraine, Eurobank Research

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