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NEW EUROPE ECONOMICS & STRATEGY

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Eurobank EFG

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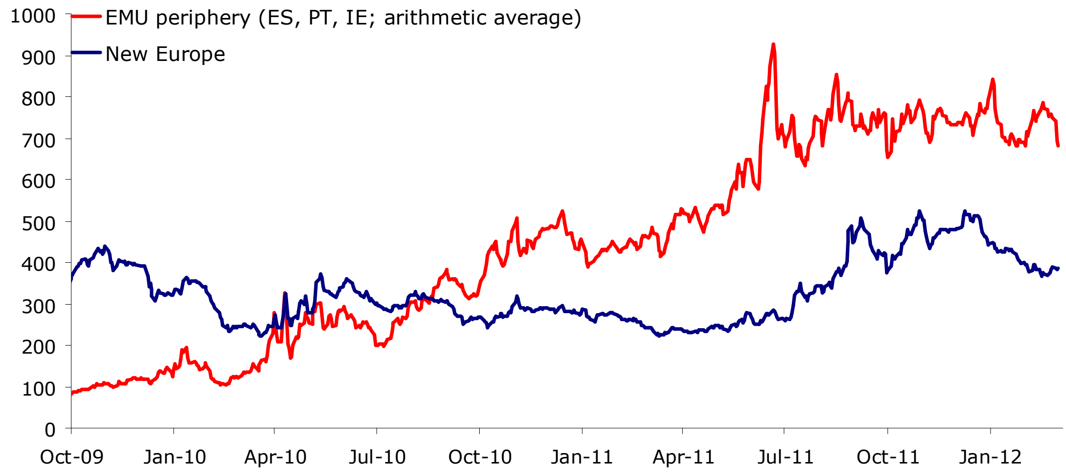
Financial markets enter consolidation phase after strong start in Q1

- **Bulgaria:** Weak domestic demand performance in Q4-2012
- **Poland:** Remains the star performer in Central Europe
- **Romania:** A challenging year lies ahead following visible progress in macroeconomic stabilization and structural reforms in recent months
- **Serbia:** Mounting fiscal risks ahead of parliamentary elections
- **Turkey:** Economic slowdown already evident; modest rebound expected in H2
- **Ukraine:** Uncertain outlook ahead of election period
- **Albania:** Growth to decelerate in 2012 despite monetary stimulus
- **FYROM:** Strong growth expected in 2012 but external financing risks remain

New Europe market strategy highlights

Regional FX markets: We recommend **short USD/TRY positions** with an initial target of 1.7700, in the way to 1.7600 and a stop loss at 1.7950. We also like **short positions against the TRY basket** at levels near 2.070, targeting 2.050 ahead of 2.030 (expected over the coming 2-3 months), with a stop loss at 2.1050. **In the sovereign credit space**, we believe that a re-widening of the Turkish 5-year CDS trend is possible from both a technical and fundamental standpoint. We would enter long at current levels near 230bps, with a stop loss at the recent low of 210bps and a target of 270bps. We also favor going long the Hungarian 5-year CDS spread (entry level at 545bps, stop loss at 490bps and target at 750bps). Separately, we maintain out earlier (near risk-free) basis trade of going long 5-year protection on Turkey with a long position in the Turkish USD-denominated 7½% February 2017 bond and we also keep our long Romanian 10-year CDS and buy the Romanian 6 ¾ February 2022 USD-denominated bond. 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 maintain our (in-the-money) position in Polish 2/5 vanilla swaps.

NE external debt spreads continue to outperform euro area periphery peers



Sources: Bloomberg, 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	1.7	1.3	3.0	4.2	2.0	-4.0	-2.1	-1.4
Poland	3.9	4.3	3.3	2.6	4.3	3.5	-7.8	-5.6	-3.6
Romania	-1.3	2.5	1.0	6.1	5.8	3.5	-6.9	-4.4	-3.0
Serbia	1.0	1.6	0.5	6.8	11.2	5.5	-3.6	-4.6	-4.3
Turkey	9.2	8.5	3.0	8.6	6.4	8.0	-3.6	-1.4	-1.3
Ukraine	4.2	5.2	3.0	9.4	8.0	6.5	-6.5	-4.2	-4.0
New Europe	5.3	5.7	2.7	6.4	6.0	5.7	-5.6	-3.4	-2.6
Euro area	1.9	1.4	0.0	1.6	2.7	2.3	-6.2	-4.3	-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	-1.0	0.9	0.5	currency board			1.96	1.96	1.96
Poland	-4.6	-4.1	-4.0	3.50	4.50	4.50	3.96	4.46	4.10
Romania	-4.5	-4.4	-4.7	6.25	6.00	5.00	4.28	4.32	4.40
Serbia	-7.2	-9.1	-8.5	11.50	9.75	9.50	106.1	106.9	115.0
Turkey	-6.5	-9.9	-8.0	6.50	5.75	5.75	1.54	1.88	1.70
Ukraine	-2.1	-5.5	-5.0	7.75	7.75	7.50	7.96	7.99	8.10
New Europe	-5.0	-6.6	-5.8	-	-	-	-	-	-
Euro area	-0.5	-0.3	-0.1	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

Q4 2011 data shows deceleration in most economies in the region

GDP data for the last quarter of 2011 were broadly in line with market consensus forecasts and, in some cases, slightly better than anticipated. Yet, the readings confirmed that economic activity in New Europe has embarked on deceleration path, following reasonably strong output growth in the first half of last year.

In **Bulgaria**, real GDP growth came in at 1.6% yoy in Q4, unchanged from a quarter earlier, but down from 2.2%yoy and 3.2%yoy in Q2 and Q1 2011, respectively. Output growth in **Romania** slowed down to 1.9% yoy in the fourth quarter, from 4.4% yoy in Q3. In **Serbia**, Q4 growth edged a bit higher, to 0.8% yoy from 0.5% yoy in Q3, yet undergoing a notable deceleration relative to the first half of the year (Q1-2011: +3.7% yoy; Q2-2011: 2.5% yoy). In other regional economies, the slowdown was less pronounced, thanks to country-specific circumstances. In **Poland**, growth remained resilient at 4.3% yoy in Q4 vs. 4.2% yoy in Q3 compared to 4.6% yoy in Q2 and 4.5% yoy in Q1. In **Turkey**, economic activity slowed sharply to 5.2% yoy in Q4, from an average of 9.7% yoy over the first nine months of the year. After recording in Q3-2011 the highest annual rate of change since 2008 (+6.6% yoy), Ukrainian real output growth eased to 4.6% yoy in the fourth quarter of last year.

In terms of growth drivers, domestic demand across the region was weaker on an annual basis in Q4-2011. Despite the seasonal boost due to the Christmas holiday and support from positive real wages, domestic consumers and businesses have consolidated their balance sheets further, in an effort to deal with tighter lending conditions, rising unemployment and ongoing fiscal consolidation. Fearing a new domestic economic slowdown due to worsening conditions in main trade-partner economies and the lingering euro area sovereign debt crisis, many firms in the region expressed their intension to postpone their earlier capital investment plans.

As we noted already, the degree of economic slowdown reflected in the Q4 GDP data varied significantly across countries, in the region. Nevertheless, net export performance in most economies in the region was overall satisfactory and, in many cases, more resilient than expected, with still soft consumption dynamics providing a partial offset.

2012 macro outlook is clouded by significant uncertainties

Overall, most economies in New Europe recorded reasonably strong output growth last year, recovering from the economic downturn post the Lehman debacle Looking ahead, deteriorating domestic conditions in main trade-partner economies and the lingering euro area debt crisis (despite the recent improvement in a number of periphery markets) is pausing as a major threat to the region's growth prospects this year, especially given the latter's high exposure to the euro area via trade and finance channels. On the other hand, the improvement in market sentiment after the provision of ECB liquidity through LTROs has provided ground for optimism, helping to partially alleviate deleveraging concerns in the European banking sector.

More specifically,

A worsening external environment and continuing fiscal austerity will likely depressed domestic economic activity in **Bulgaria** and **Romania**, though we expect overall GDP growth in both economies to remain in a slightly positive territory. Pre-election fiscal slippage will also conspire with a worsening external environment to also propagate broadly stagnant growth in the **Serbian** economy**.** On the other hand, **Poland** is expected to outperform again its Central Europe peers this year, thanks to its relatively closed economy and reasonably strong domestic demand dynamics. In **Ukraine** growth is expected to decelerate this year, with the domestic economy remaining vulnerable to sudden swings in the global investor sentiment. **Turkey**, last year's star performer, is expected to register a sharp slowdown in economic activity to ca 3.0% in 2012 after an 8.5% expansion in 2011.

Despite increasing risks and high uncertainties stemming from the deepening Euroarea sovereign crisis, our baseline scenario is still for a positive GDP growth trajectory this year for most economies in New Europe. It is very important to note that this view is expected to materialize under the assumptions of a mild recession in the euro area over the first six months and the absence of significant unforeseen external shocks. Although conditions and sensitivity to the sovereign crisis may defer across regional economies, overall growth is expected to be much slower than in 2011 and to remain well below potential.

Impact of euro area sovereign crisis becomes more pronounced

The impact of the protracted euro area sovereign debt crisis is already evident, primarily through the trade and finance channels. These spillover effects have been more pronounced in Central Europe, primarily in the economies of Hungary, Slovakia, and Czech Republic. Elsewhere:

Bulgaria's industrial output contraction deepened to -3.1% yoy in January, from -1.2% yoy in the prior month, while in the first month of this year exports registered its first negative growth reading (-10.2% yoy) for the first time since October 2009.

In Poland, some initial signs of a slowdown are already visible in the latest PMI manufacturing and labor market data.

Nevertheless, retail sales remain robust, growing by 13.7% yoy in February.

Romania's industrial production came in at 1.2% yoy in January 2012 compared to a +11.8% yoy recorded in the same month a year earlier, reflecting softer export orders and lower anticipated manufacturing activity in the future.

In Turkey, industrial production growth declined on an annual basis in January (-1.3%yoy sa) for the first time since September 2009. Moreover, the February PMI data showed a contraction in domestic manufacturing activity for the first time in six months and automotive sales have been on a steep downtrend so far this year (-32%yoy in January & February).

In Ukraine, industrial production, which accounts for nearly a quarter of the domestic economic output, has decelerated from average growth of 7.0% yoy last year to 2.0% yoy in January and 1.6% yoy in February, driven by deteriorating conditions in the domestic manufacturing sector. On a more positive note, retail sales continue registering double-digit growth supported by higher real wages and slowing inflation.

Central Bank Watch

Most Central Banks in the region remained on hold in the past month, with the exception of the National Bank of Ukraine and the National Bank of Romania.

Romania: With February CPI coming in at a record low of 2.6% yoy (i.e, within the Central Bank's 3.0%+/-1% target range) and with GDP growth braced for a slowdown this year, the NBR reduced its key policy rate by another 25bps to a record low of 5.25%. (Since last November the NBR has delivered 100bps of cumulative rate cuts).

Poland: the NBP kept the key interest rate unchanged at 4.50% in March as was widely expected. Yet, the MPC's rhetoric turned more hawkish than previously, with the committee not ruling out higher policy interest rates in the coming months.

Serbia: The National Bank of Serbia, among the first in the region to cut policy rates, remained on hold in March. Increased fiscal risks and the recent dreadlock over the precautionary agreement weighted decisively on the NBS decision. The move was widely expected by financial markets The NBS has cut the key policy rate (2-week repo rate) by a total 300 basis points in the last nine months to 9.50% currently.

Turkey: At its latest monetary policy meeting in March the CBT held its policy interest rates stable, in line with market expectations. In detail, the overnight lending rate remained at 11.50% and the key policy rate, the 1-week repo rate, at 5.75%. In addition, the overnight borrowing rate was also kept at 5.00%, as were the interest rates on borrowing facilities provided for primary dealers (11.00%). The borrowing (0.00%) and lending (14.50%) late liquidity window interest rates were also kept stable.

Ukraine: Slower inflation allowed the NBU to cut its key policy interest rate by 25bps to 7.50% in late March, after having kept it unchanged since August 2010. In addition, the NBU eased rules for mandatory reserve requirements, allowing banks to keep only 60% compared to 100% of the mandatory reserves in the NBU's special account. Moreover, the NBU in January and February cut the overnight refinancing interest rates by a cumulative 50bps.

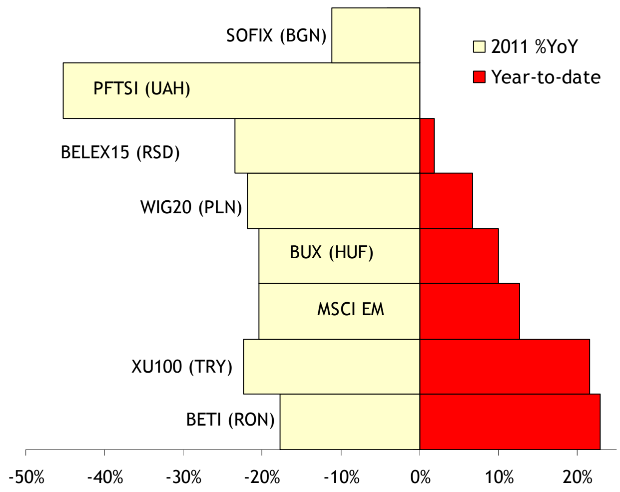
Financial markets consolidate near early 2012 highs as rally runs out of steam

Equity markets in New Europe rallied strongly over the first three months of the year, with the ECB's 3-year long-term refinancing operations (LTROs) in December and February providing significant support to investor sentiment. Growing global growth optimism and overall accommodative central bank policies worldwide have also favoured. Indicatively, the VIX index, considered as an indicator of investor risk appetite, slid to 13.66 points in mid-March, its lowest level since June 2007. In a similar vein, the iTraxx Crossover index, which consists of 50 equally-weighted CDSs of the most liquid sub-investment grade European corporates, eased on March 19 to as far as a 7-month trough just above 500bps.

Notwithstanding the aforementioned improvement, the market rally has run out of steam in the last few weeks as the impact of the ECB's liquidity-injection operations appears to be gradually ebbing. Against this background, most indices in the region are consolidating near recent multi-month highs hit earlier this year. The **MSCI Emerging Europe Equity index** hovered around levels of 472 in late March, remaining within distance from an eight-month high near 500 points hit in mid-March. On a regional level, Turkey's **ISE 100** and Romania's **BETI** have led the rally so far this year, registering gains in excess of 20%, each, in Q1-2012.

With major central banks around the globe expected to maintain ultra-accommodative policies for the foreseeable future, the rally in regional stock markets may have further to run. However, renewed concerns about the euro area debt crisis may exert downward pressures. Fiscal worries have recently been on the rise in Spain and ensuing spillover risks are escalating in Italy, while the possibility of Portugal eventually requiring a second bailout package remains on the cards. Geopolitical risks, such as ongoing tensions in the Middle East and a heavy elections calendar in New Europe are to be closely monitored. Note that Serbia (May), Ukraine (October) and Romania (local elections in June and general probably in late November) are holding national elections later this year.

Figure 1
New Europe stock markets posted hefty gains in Q1-2012

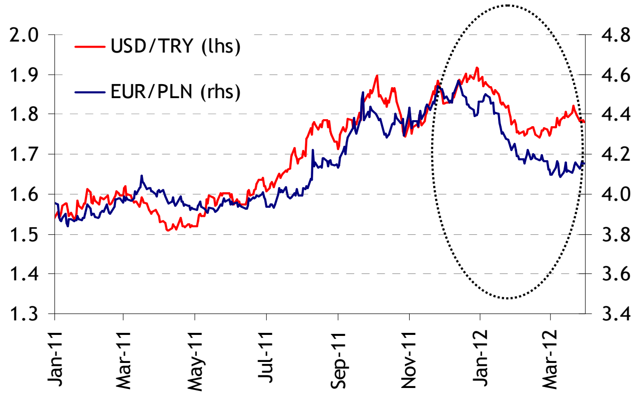


Source: Reuters, EFG Eurobank

In a similar vein, **regional currencies** remained in March near multi-month peaks recorded earlier this year. Among the notable exceptions were the **Serbian dinar** and the **Romanian leu**. The former has come under significant pressure since late last year amid increased corporate demand for hard currency and growing concerns about the country's fiscal position after the IMF placed on hold a €1bn Stand-By Arrangement earlier this year on disagreement with the government over the 2012 budget targets. A total of 300bps of monetary easing instrumented since mid-2011 did not bode well for the Serbian currency either. As a result, the EUR/RSD touched a new record low, just below 112, in late March, in spite of central bank interventions since the beginning of the year worth around €415mn. Separately, **Romania's leu** remains near a 21-month low of 4.3880 against the euro weighed down by eroding domestic-foreign interest rate differentials after the central bank slashed by 25bps its key policy rate to 5.25% for the fourth consecutive time in March.

In line with the performance in other asset classes, the rally witnessed recently in New Europe **local rates markets** appears to have run out of steam. However, support remains in the face of the FOMC's pledge to maintain interest rates around their current near-zero levels and the ECB's LTROs. Turkey remains the primary outperformer year-to-date, with gains being concentrated in the short-end of the yield curve. Indicatively, the 2-year benchmark stood around levels of 9.50% at the end of March. This compares with a near 2-½-year high above 11.6% hit in early January.

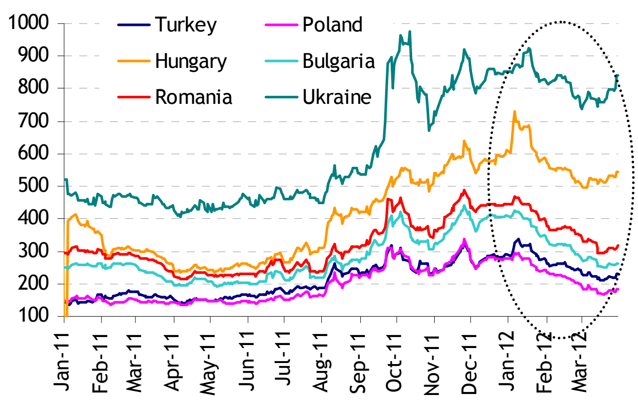
Figure 2
Major regional currencies consolidate near multi-month highs



Source: Reuters, EFG Eurobank

New Europe's **external debt markets** have rallied strongly so far this year in view of improving global liquidity conditions and hopes that the worst of the euro area sovereign debt crisis is already behind. Better regional fundamentals and global growth optimism also favor. Hungary and Ukraine have lagged their peers as worries linger over whether the former's government will eventually secure a bailout deal with international lenders and the latter will unfreeze the current $15bn Stand-By Arrangement that was brought to a standstill in early 2011. Indicatively, the **Hungarian 5-year CDS spread** rose to a 1-½-month peak of 560bps in late March, some 70bps wider compared to a multi-month low hit a few weeks earlier. Although the recent rally in the region's external debt markets may currently look somewhat overdone and with a consolidation period to possibly follow, ultra-accommodative policies from central banks worldwide will likely continue to support sentiment towards the region's external debt markets. On the other hand, risks lie primarily in the face of ongoing tensions in the Middle East and potential renewed euro area debt crisis jitters.

Figure 3
External debt spreads rallied strongly in recent weeks



Source: Reuters, Bloomberg, EFG Eurobank

Strategy - Emerging New Europe Markets

Regional FX markets: The main driver of the Turkish lira’s improved performance in recent sessions has been the CBT’s decision to tighten liquidity conditions in early March and to adopt a more hawkish tone at its latest MPC meeting. Against this background - and in view of the significant narrowing in the current account deficit in February - some further lira appreciation is likely in the short term. We recommend **short USD/TRY positions** with an initial target of 1.7700, in the way to 1.7600 and a stop loss at 1.7950. We also like **short positions against the TRY basket** at levels near 2.070, targeting 2.050 ahead of 2.030 (expected over the coming 2-3 months), with a stop loss at 2.1050. Elsewhere, we prefer to stay **sidelined on the EUR/RSD** in the coming weeks, as we have entered a pre-election period (general elections are due in May) and the pair currently stands near record lows.

In the sovereign credit space, our earlier long Turkish 5-year CDS recommendation (entry level: 250bps) hit the 220bps stop loss in early March. However, we believe that a re-widening trend is possible from both a technical and fundamental standpoint. The recent rally appears to have been overdone and at current levels near 230bps Turkey’s credit default spreads seem too tight compared to those of similar credit-rated peers. This outperformance is primarily due to the country’s cheap macro-hedge status and negative basis opportunities as CDS trade tighter relative to bonds. Against this background we would enter long positions at current levels with a stop loss at the recent low of 210bps and a target of 270bps. Risks to this position lie in the face of a potential credit rating upgrade in the imminent future.

We also favor going long the Hungarian 5-year CDS spread (entry level at 545bps, stop loss at 490bps and target at 750bps) as we believe that the recent sharp narrowing will likely reverse amid lingering uncertainty surrounding a potential new bailout deal with international lenders.

Separately, we maintain out earlier (near risk-free) basis trade of going long 5-year protection on Turkey with a long position in the Turkish USD-denominated 7½% February 2017 bond, targeting a tightening towards 30bps from levels slightly below 70bps currently. A risk-off scenario until mid-May could favor this position. In a similar vein, we also keep our long Romanian 10-year CDS and buy the Romanian 6 ¾ February 2022 USD-denominated bond targeting a narrowing of the basis from levels near 70bps now to 30bps. We also maintain our previous call of going long 5-year protection on Russia vs. shorting 5-year protection on Poland at current levels near -5bps (target: -50bps) but we revise our stop loss to +15bps from +30bps earlier.

In local rates markets, we maintain our (in-the-money) position in Polish 2/5 vanilla swaps at current levels of -+5bps, retaining our earlier target of +10bps and moving our stop loss to entry level -7bps as we continue to expect the Polish economy to fare better than regional peers this year on comparably healthier fundamentals.

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

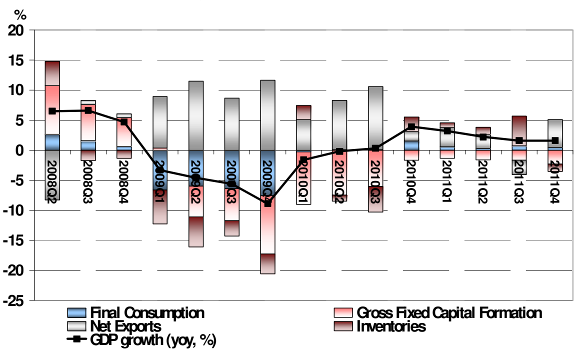
Weak domestic demand performance in Q4 -2012

- Output fails to impress in Q4: GDP grew by 1.6% yoy, a growth rate same as in Q3, on robust net exports dynamics, subdued private consumption and negative investments
- The fiscal target for 2012 is demanding, yet within reach: The government targets a decline of the cash based general government deficit to 1.35%, down from 2.1% in 2011
- Market focus shifts on the external debt redemption needs in January 2013; The sale of a stake in the state-owned electricity company (BEH) could minimize the amount required from markets

GDP growth remained weak in the fourth quarter on significant negative contribution from the investments side

GDP growth failed to impress in the last quarter of the year. On a yearly basis, real GDP grew by 1.6% yoy, the same growth rate as in Q3. On a quarter on quarter seasonally adjusted basis, GDP growth inched higher at 0.4% qoq, up from 0.3% qoq in Q3. The positive news of the reading is the robust positive dynamics of net exports. Exports expanded by 12.6% yoy in Q4, up from 5.4% yoy in Q3, despite an adverse EU-27 growth environment. Part of this strength is explained by the diversification of the exports portfolio towards non-EU markets (exports to non-EU markets climbed up to approximately 40% of total in 2011). In contrast, imports slowed down to a 4.5% yoy growth in Q4 vs. 9.0% yoy in Q3. Thus, the net exports contribution to growth turned to +4.7 pps in Q4 in Q4 vs. -3.3pps in Q3.

Figure 1
Net exports had a positive contribution in Q4 in an adverse EU growth environment



Source: National Statistics, Eurobank Research

Bulgaria: Eurobank EFG Forecasts	2009	2010	2011	2012f
Real GDP (yoy%)	-5.5	0.4	1.7	1.3
Final Consumption	-7.3	0.5	-0.3	1.0
Gross Capital Formation *(Fixed)*	-17.6	-18.3	-9.7	2.0
Exports	-11.2	14.7	12.8	2.0
Imports	-21.0	2.4	8.5	3.5
Inflation (yoy%)				
HICP (annual average)	2.5	3.0	3.4	2.0
HICP (end of period)	1.6	4.4	2.1	1.8
Fiscal Accounts (%GDP) - *Cash Basis*				
General Government Balance	-0.9	-4.0	-2.1	-1.4
Gross Public Debt	15.6	16.7	17.0	18.3
Primary Balance	-0.2	-3.3	-1.4	-0.5
Labor Statistics - *National Definitions*				
Unemployment Rate (registered, %)	9.1	9.2	10.4	10.0
Wage Growth *(total economy)*	11.8	6.4	9.1	3.5
External Accounts				
Current Account (% GDP)	-8.9	-1.0	0.9	0.5
Net FDI (EUR bn)	2.4	1.2	1.3	1.5
FDI / Current Account (%)	78.2	321.6	Na	Na
FX Reserves (EUR bn)	12.9	12.9	13.3	15.0
Domestic Credit	**2009**	**2010**	**Q3 11**	**Q4 11**
Total Credit (%GDP)	79.2	76.4	72.7	74.5
Credit to Enterprises (%GDP)	49.4	48.2	46.7	48.0
Credit to Households (%GDP)	28.2	26.4	24.6	24.6
FX Credit/Total Credit (%)	58.6	61.3	63.3	63.7
Private Sector Credit (yoy)	4.5	2.1	3.2	3.9
Loans to Deposits (%)	120.0	112.9	105.6	104.0
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

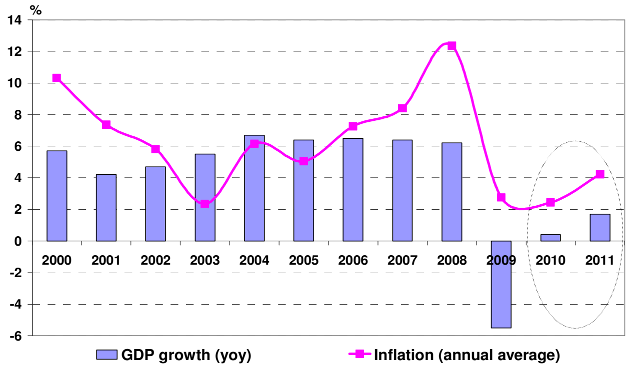
In addition, private consumption, the largest component of GDP, further stabilized to +0.3% qoq/+1% yoy, compared to +0.4% qoq/+1.2% yoy in the prior quarter. Private consumption received support primarily from positive real wages despite weak labor market demand. Unemployment stood at 11.4% in Q4-2011, the highest level in 2009-2011. Average annual inflation declined to 2.5% yoy in Q4 and nominal wages increased by 8.7% yoy in Q4. The largest wage increases can be traced in highly specialized sectors or high seasonal demand which drive the overall labor cost higher (eg. Informatics-science, agriculture) More importantly, declining food and energy prices- the biggest spending items of their budgets- allowed households to take a breath.

On the other hand, investment activity was once again in red, dragging down growth performance. Despite optimism arising from higher EU funds absorption this year, the contraction of investments deepened to -9.7% yoy in Q4 vs. -7.4% yoy in Q3. Thus, investments subtracted 3.5pps from growth in Q4 vs. adding +3.3pps in Q3. Including the last reading of Q4, investments were negative for a twelfth quarter in a row. As a result investments as a percentage of GDP have dropped to 23% in 2011 against a record high at 37% in 2008. The post-crisis drop in investments is largely explained by the decline of FDI inflows (from 9 bn. Euros in 2007 to 1.3bn Euros). In addition, firms have expressed their retrenchment plans postponing capital investments in fear of a new round of recession induced by the Euroarea sovereign crisis. From a sectorial point of view, the real estate sector has yet to give positive boost- the construction index was down by 13% on average in 2011. Yet, investments edged towards zero on a quarterly basis (only -0.1% qoq) for the first time in the post-Lehman period (2009-2011), creating expectations of bottoming out.

Near-term growth outlook remains weak given the challenges exporters are going to face in 2012

Overall, the full year growth performance in 2011 came at 1.7% yoy, up from 0.6% yoy in 2010. In any case, it disappoints expectations of a quick recovery from the recession in 2009. On the other hand, Bulgaria fares relatively well compared to the EU-27 average, even if growing at a slower speed than in the pre-crisis period. As an illustration, GDP growth in Q4-2011 (+0.4% qoq/+1.6% yoy) was stronger than the EU-27 average (-0.3% qoq/+0.9% yoy) for a fifth consecutive quarter. From that point of view, growth in Bulgaria was the third highest on a quarterly and the seventh highest on a yearly basis in EU-27.

Figure 2
Output rebound in 2010-2011 has been lackluster after the recession in 2009



Source: National Statistics, Eurobank Research

Looking ahead, our forecast for 2012 -1.3%- is based upon two assumptions. Firstly, it assumes that the principal growth driver will switch to domestic demand from net exports given that a number of downside risks will materialize for exporters. Secondly, it assumes a mild recession in Euroarea (our dedicated economists' forecast stands currently at 0% in 2012) with no major deleveraging banking sector spillovers in Bulgaria. While the global environment does not bode well, the Euroarea sovereign crisis is the most imminent threat to Bulgaria. Bulgaria is highly dependent on EU, not only in terms of trade and capital flows, but also through banking system interlinkages. In the worst case scenario, an external shock from a prolonged EU debt crisis or a disruption in capital flows could push Bulgaria again in deep recession.

Fiscal consolidation will continue in 2012, a pre-election year for Bulgaria amid difficult external financing environment conditions

The budget of 2012 envisages a further decline of the consolidated government deficit (on a cash basis) from 2.1% of GDP in 2011 to 1.35%. The revenues target is set at 28.7bn Leva (35.2% of projected GDP) against a realization of 25.3bn Leva (33.7% of GDP) in 2011. On the expenditures side, the target is set at 28.9 bn Leva (36.5% of projected GDP) compared to a realization of 26.9bn Leva (35.8% of GDP) in 2011.

In our view, the fiscal target is ambitious and demanding, yet within reach. Our concerns are skewed towards the revenue side instead of the expenditures side given the high uncertainties in the growth outlook. The initial macroeconomic assumptions of the budget (Nominal GDP growth: 6.5%, Real GDP growth 2.9%, average HICP: 3.2% in 2012) already deviate significantly from consensus forecasts. The latter may lead to a revision of revenues forecasts to more conservative levels. In addition, the budget makes no provisions for additional revenue raising measures (the increase in excise taxes on fuels will increase total revenues by only 230 mn Leva). The rest of the increase ought to come from improved collection in VAT tax (assuming that the VAT rate of 20% remains unchanged) and higher receipts from income taxes (the 10% flat tax regime is the most competitive tax rate in Europe at the moment).

On the other hand, there is room to ensure that the fiscal target is attained through further containment of expenditures. From that point of view, the authorities' past record of successful fiscal consolidation creates optimism for the attainment of the target. The fiscal target of 2011 was undershot by a wide margin (2.1% against an original target of 2.5% on a cash basis). The main expenditures items- nominal public wages and pensions- are projected to remain flat in 2012-for a third year in a row. In addition, it is also very positive to note that authorities have pushed for structural reforms in both the broader government sector and the pension system that would help in the fiscal consolidation effort. The gradual increase in the retirement age starting from January 2012 and the introduction of stricter service requirements in order to restrict access to early retirement will cap social expenditure. Moreover, the restructuring initiatives of state-owned enterprises in public transportation will add more savings. Last but not least, although not warranted, any underperformance of capital expenditures (projected to expand by 44% to reach 6.5% of forecasted GDP in 2012) would result in huge savings on the expenditures side as past experience has shown.

The focus of the market has shifted on the external debt redemption needs in January 2013. The fiscal reserve fell below the 4.5bn Leva threshold in January 2012

The difficult external financing environment has shifted market focus on the external debt redemption needs (1.8bn Leva) in January 2013. The Ministry of Finance has not specified the exact mix of sources (domestic-international market or a combination of both) it intends to use for the redemption needs. One of the options suggested in order to reduce the amount required from the markets is to use privatization proceeds. In that direction, the proceeds from selling a 20% stake in the Bulgarian Energy Holding (BEH) have been calculated to bring in 1 bn Leva.

In any case, the decline of the fiscal reserve below the stipulated threshold in January necessitates its repair soon in order to maintain currency board stability. The fiscal reserve fell by 25.6% yoy to BGN 4.03bn-below the BGN 4.5bn threshold stipulated in the Budget law in January. The steep decrease can be explained as the result of one-off payments, not only on debt, but also for the financing of agricultural subsidies, which will be only partially refunded by EU funds later in the year.

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

Remains the star performer in Central Europe

- Growth of the Polish GDP accelerated in Q4-11 to 4.3% yoy, outperforming the rest of Central Europe's economies, on increased investments and strong exports, both of which helped to offset weaker private consumption growth
- Headline inflation remains elevated on higher energy and food prices
- The NBP kept the key policy rate unchanged at 4.50% and held more hawkish rhetoric
- Tighter lending conditions cause a decline in lending activity

Polish economy showed strong resilience to external slowdown

Poland has managed to achieve certain isolation from the Euro-zone economic crisis thanks to solid domestic demand and relatively low export dependency (Polish exports to the Euro-zone accounts for only 15% of GDP compared to over 30% of GDP elsewhere in Central Europe). The Polish economy's resilience was confirmed by Q4 2011 data, which showed an acceleration of economic activity, in contrast to the trend in the rest of Central Europe. More precisely, in Q4-11 the GDP grew by 1.1% qoq vs. 1.0% in Q3-11 and in annual terms it grew by 4.3% yoy compared to 4.2% yoy in Q3-11. The economy got a boost from increased investments, higher public sector capital spending in particular. Public investment benefited from EU funds to improve infrastructure and modernize production. Moreover, construction and fixed investments are also supported by preparations ahead of the Euro 2012 football championship which will take place in June. In more detail, investment growth stood at 1.4% qoq (8.4% yoy) in Q4-11 from 1.2% qoq (9.7% yoy) recorded in Q3-11. On the other hand, private consumption has slowed and is no longer the main driver of growth. It expanded by 0.3% qoq (2.0% yoy) in Q4-11 from 0.5% qoq (3.0% yoy) in Q3-11 and 0.9% qoq (3.6% yoy) in Q2-11. Taking into account the deterioration in the labor market (unemployment rose to 13.3% in January and employment slowed at 0.9% the same month) and the tighter financial conditions, which are also encouraging savings, it is unlikely that private consumption will regain momentum in the coming months. However, recent retail sales remain still robust; they reached 14.3% yoy in January, which is a bit puzzling.

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	3.1	3.0
Government Consumption	2.1	4.3	0.7	0.5
Gross Capital Formation	-11.5	9.3	10.6	7.0
Exports	-6.8	12.1	7.3	6.0
Imports	-12.4	13.9	6.0	5.8
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	-3.6
Gross Public Debt (ESA95 definition)	50.9	54.9	55.0	54.9
Gross Piblic Debt (national definition)	49.9	52.8	53.5	53.5
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	4.5
External Accounts				
Current Account (% GDP)	-3.9	-4.6	-4.1	-4.0
Net FDI (bn EUR)	6.0	2.5	5.8	6.0
FDI / Current Account (%)	75.9	40.8	65.2	60.0
FX Reserves (bn EUR)	55.2	70.0	75.7	74.8
Domestic Credit	**2009**	**2010**	**Q3 11**	**Q4 11**
Total Credit (% GDP)	53.1	55.4	58.7	59.0
Credit to Enterprises (% GDP)	16.1	15.2	16.3	16.6
Credit to Households (% GDP)	31.6	34.2	35.9	35.5
FX Credit/Total Credit (%)	30.2	30.8	32.5	32.5
Private Sector Credit (% yoy)	7.2	8.9	14.3	13.5
Loans to Deposits (%)	102.6	102.4	106.5	105.2
Financial Markets	**Current**	**3M**	**6M**	**12M**
Policy Rate	4.50	4.50	4.00	4.00
EUR/PLN	4.10	4.10	4.20	4.10

Source: NBP, EcoWin, Bloomberg, Eurobank Research

The other supportive factor to Q4-11 GDP growth was the boost of exports, probably thanks to zloty weakening. Exports expanded by 3.3% qoq (8.0% yoy) in Q4-11 from 0.4% qoq (7.7% yoy) in Q3-11 with some sectors (notably vehicle production) continuing to grow at a fast pace despite the deteriorating external environment. Meanwhile, imports accelerated at a slower pace compared to exports, growing by 2.1% qoq (5.3% yoy) in Q4-11 from 1.0% qoq (5.2% yoy) in Q3-11. Accordingly, net exports contribution to Q4-11 GDP growth stood at 0.9% from 1.0% in Q3-11. We expect Polish exports to continue to benefit from the weaker zloty, whereas slowing private consumption is expected to dampen imports growth.

Overall, we expect Poland to continue to outperform the rest of Central Europe, driven by investment growth ahead of Euro 2012 football championship and EU funds on infrastructure. Yet, the economy will slow this year as private consumption, which was the main engine of growth since 2010, has weakened and fiscal consolidation should curb domestic demand. Some signs of slowdown are already visible in the weakening PMI prints, declines in employment and rising unemployment. We have penciled a 3.3% yoy GDP growth in 2012 with risks to the downside should the Euro-zone economy fails to stabilize.

The 2011 c/a deficit narrowed and was financed by private sources with FDI having the largest bulk

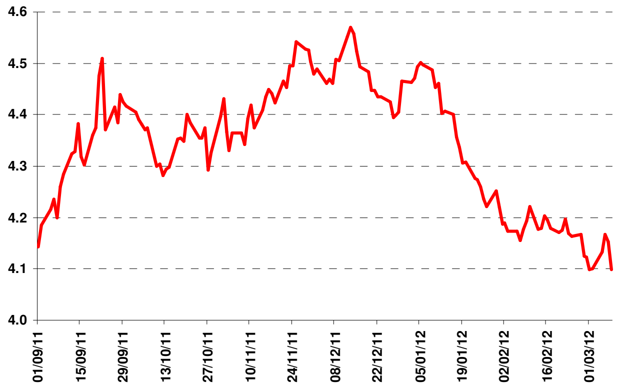
In 2011 the current account (c/a) deficit narrowed to 4.1% of GDP, compared to 4.6% of GDP in 2010. Equally importantly, the 2011 c/a financing came from private sources, with FDI having the largest bulk, in contrast to 2010 when funding came mainly from portfolio and bank flows. However, sustained investment demand and high commodity prices put pressure on the trade balance, while the high presence of foreign investors in the local capital market and high stock of FDI deteriorated further the income account deficit in 2011. A worrisome feature is the persistently very large number for the "Net errors and omissions" component, which is equal to 42% of the current account deficit in 2011. This year, we expect the same trends to weigh on current account, with c/a deficit remaining roughly unchanged at 4.0% of GDP in 2012 and it will continue to be financed from private sources and partly by capital transfers from the EU.

Zloty's appreciation helps ease inflationary pressures

Admittedly, the economy showed strong resilience to external slowdown. The main channel of influence from the Euro-zone crisis has been through zloty weakness. The domestic currency depreciated by ca 8% the last four months of 2011. But, as the risk sentiment in the global markets improved, this trend reversed; the zloty has appreciated by ca 8% since the beginning of 2012 (Figure 1). What's more, the long-term liquidity support from the ECB is expected to be supportive for zloty stabilization.

A stronger zloty should ease inflationary pressures. Yet, the persistently high commodity prices, energy inflation in particular, might lead to a pick-up in headline inflation. This is reflected in February's inflation data where CPI stood at 4.3% yoy (0.4% mom) from 4.1% yoy (0.7% mom) recorded in the prior month, driven by higher energy and food prices. This inflation print, although again above the upper limit of 3.5% of NBP's (National Bank of Poland) target, it is lower than most of 2011 readings thanks to favorable base effects following the 1% VAT hike in January 2011. We expect headline inflation to start converging slowly towards the target's upper limit until the end of 2012 as price pressures should remain limited in an environment of subdued growth.

Figure 1
Zloty's exposure to changes in risk sentiment



Source: National Statistics, Eurobank Research

Monetary policy became more hawkish on still robust economic activity and elevated inflation

The NBP kept in its March meeting the key interest rate unchanged at 4.50% as was widely expected. Yet, MPC's (Monetary Policy Committee) rhetoric turned more hawkish than previously without ruling out interest rate hikes in the coming months. However, the more benign inflation outlook, on the back of a stronger zloty and a less robust growth, should reduce the immediate risk of rate hikes. We expect the MPC to remain generally hawkish and try to manage expectations throughout 2012. However, we do not anticipate MPC to actually hike rates unless the outlook for inflation does not point to a return towards the target or economic activity shows strong positive signs. In all, we foresee, in line with financial markets, the key policy rate to remain unchanged at 4.50% for the reminder of the year.

Lending activity declined

For a second month in a row we observe a total credit decrease (-0.7% mom in January) driven by household lending contraction by -1.6% mom. This is the result of tighter lending conditions stemming from new regulations and high liquidity. On the other hand, total deposits declined also in January by -1.2% mom. However, in annual terms both credit and deposits are growing, by 14.4% yoy and by 11.1% yoy respectively.

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

A challenging year lies ahead following visible progress in macroeconomic stabilization and structural reforms in recent month

- After rising by 2.5% in 2011, real output growth is bound to slowdown this year, mainly reflecting weaker net exports and negative base effects from agriculture. Domestic demand is expected to take the lead as the primary driver of growth this year
- Inflation has declined to historically lows and is expected to ease further in the months ahead
- The current account is expected to widen marginally this year on improved domestic demand and weaker growth in main trade-partner economies Market concerns shift to the sources of balance-of-payments financing;

Economic growth overview: domestic demand buoys the recovery

Upon the liberalization of the capital account in 2005, Romania experienced a four years of rapid economic convergence. GDP grew at an average rate of 6.2% during this period and as financial deepening and increased income expectations fuelled a domestic demand boom. Private consumption increased a cumulated 25% in real terms from 2005 to 2008, while imports and investment expanded 45% and 68% respectively.

However, the economy also accumulated rising imbalances – particularly twin deficits i.e., a widening budget shortfall feeding back into the current account deficit, which reached record high levels near 14%-of-GDP in 2008. Once capital inflows dried up after the collapse of Lehman Brothers in autumn 2008, the domestic growth paradigm started to unravel.

Output declined in real terms by 7.1% in 2009, and a further 1.3% in 2010. The overall growth dynamic was the net result of two opposing dynamics. Exports recovered rather rapidly, growing by 37% from the end of 2008 to the end of 2011. However, domestic demand experienced a slump in 2009 and 2010, prolonging the recession over the period. Moreover, domestic demand underwent significant structural changes which will make the recovery slow and gradual.

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	0.7	0.7
Govern. Consumption	1.2	-3.2	-3.4	-0.5
Gross Capital Formation	-21.7	7.8	6.3	5.5
Exports	-5.0	14.3	9.9	5.0
Imports	-21.4	12.4	10.5	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	3.4
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)	6.9	7.3	7.0	6.5
Wage Growth (total economy)	8.4	2.5	5.3	5.8
External Accounts				
Current Account (%GDP)	-4.2	-4.5	-4.4	-4.7
Net FDI (EUR bn)	3.6	2.2	1.9	2.5
FDI / Current Account (%)	72.3	45.5	33.7	37.0
FX Reserves (EUR bn)	30.9	36.0	33.2	35.0
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	5.25	5.25	5.00	5.00
EUR/RON	4.37	4.35	4.40	4.40

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

During this period, Romania applied for a Romania applied for a two-year multi-lateral lending program, co-financed by the IMF (€12.95 billion in the form of a regular Stand By arrangement) and the European Commission (€5bn). The program aimed to

**This is an excerpt from our recent macroeconomic outlook publication on the Romanian economy* improve the fiscal sustainability of the Romanian economy. A second precautionary agreement was signed in 2011.

2011 marked the return to positive growth for the economy. Exports increased 9.9% (in real terms) during the year, while domestic demand increased 9.9% in the year, while domestic demand expanded 1.4%. Aggregate growth remained relatively tepid in the first two quarters of the year, but experienced a spur in Q3. Agriculture was the main driver of the acceleration, but domestic demand also picked up over that period. Quarterly growth in construction turned positive for the first time since 2009 (2.7% qoq) while retail sales rose as well (0.4% qoq). However, the boost from agriculture was only temporary, with quarter-on-quarter real GDP shrinking by 0.2% in Q4.

The pace of domestic economic recovery is bound to slow down in 2012. Both the IMF and the European Commission are forecasting a mild contraction of the euro area economy, boding ill for Romanian exports this year. Domestic demand is subsequently expected to buoy the recovery. Furthermore, growth may be boosted by an improved absorption of EU structural and cohesion funds.

Inflation falls to record lows and it is likely to descend further in the coming months

Romanian consumer prices have experienced high volatility throughout the past 2 years. Inflation jumped in the second half of 2010 due to an increase in VAT by 5 ppts (from 19% to 24%). Inflationary pressures continued to accentuate in the first half of last year, primarily driven by higher food prices, (+11.3%yoy in May 2011).

However, an exceptional agricultural harvest helped reverse this trend starting from May. Furthermore, food prices remained very low throughout the remainder of the year. Disinflation also accelerated after the elimination of the base effect from the VAT rate hike in the summer of 2010.

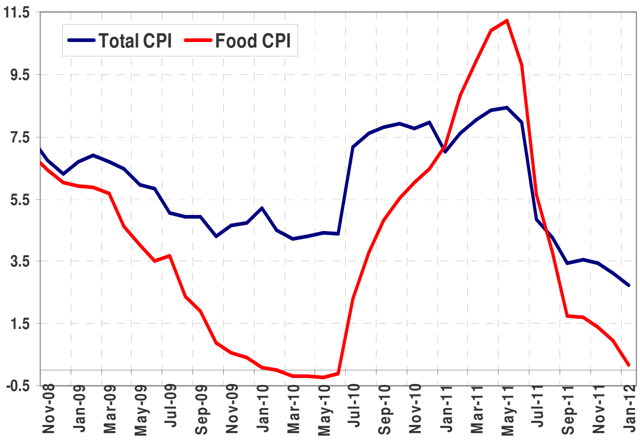
These factors helped drive inflation to 3.14% at the end of the year, within the Central Bank's target of 3% ±1pp. The disinflationary bias is expected to remain dominant throughout the first quarter of the year due to a favorable base effect. Subsequently, headline inflation may descend as low as 2.2% by the end of March. We expect consumer prices to rise mildly after this point, but remain within the Central Bank's targeted inflation interval of 3% ±1pp. Our current forecast sees consumer prices rising 3.4% yoy by the end of 2012. We believe the main risks for inflation stem from international oil prices as well as expansionary fiscal policy during the election year.

As the inflation environment improved, the NBR has started adjusting its monetary policy. The Bank cut the reference rate in November for the first time in 18 months. The easing cycle was continued with two consecutive rate cuts of 25bp each, driving the policy rate to 5.5% at the end of February. The Bank has since indicated that inflation risks remain skewed to the downside due to a persisting negative output gap and a muted recovery of bank lending. Against this backdrop, the NBR decided to continue the relaxation of monetary policy by operating a 25bp cut to its reference rate on March 29th. The Bank also announced it would maintain the current levels of Minimum Reserve Requirements while continuing to adequately manage interbank liquidity.

The decision was broadly expected by market participants as real the rate of interest (measured as the difference between the inflation rate and the Central Bank's reference rate) remains relatively high by regional standards. Even though the bad weather slowed the disinflationary process, CORE3 inflation still remained lower than the NBR's February forecast. For the time being, we maintain our forecast of a further 25bp cut by the end of the year. However, we believe the Bank may adopt a more hawkish tone as the inflationary outlook shows signs of deterioration.

Starting from January, we have argued that oil prices posed the main risk for inflation. These risks are now starting to materialize as Brent Oil prices have hovered above the 120$/barril level for the past month (above the NBR's baseline forecast) and are not expected to recede in the near future. The Government's intention to increase public wage during the election may exert further upside pressures on consumer prices.

Figure 1
Consumer prices have fallen rapidly due to an exceptionally good harvest and the elimination of the base effect from the VAT rate hike in mid-2010



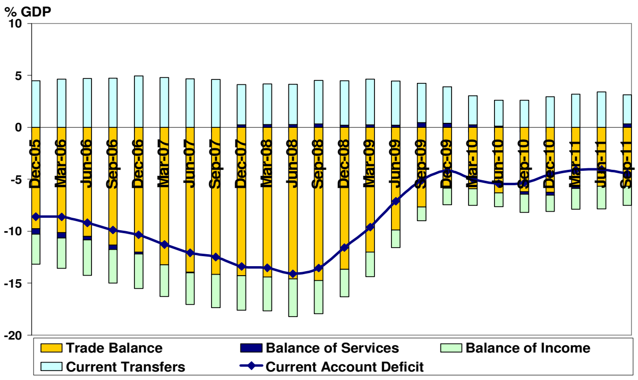
Source: National Institute of Statistics

Current account dynamics stabilized further in 2011, with focus shifting to BoP financing

The external accounts stabilized further in 2011, with the current account deficit widening by just 3%yoy, reaching €5.7bn. As a percentage of GDP, the current account shortfall registered a marginal decline to 4.4% from 4.5% in 2010. The main driver behind the current account stabilization was again the concomitant improvement in the trade deficit from 6.2% of GDP in 2010 to 5.7% of GDP in 2011. More specifically, exports increased by 20.5% yoy (vs. 28.5% yoy in 2010), while imports expanded +16.7% yoy (vs. 25.1% yoy in 2010). The services surplus remained almost flat at 0.3% of GDP in 2011. The income deficit deteriorated further by 0.2pps to 1.8% of GDP, reflecting higher repatriated profits and increased debt service payments. The surplus of current transfers declined by 0.1pps to 2.8% of GDP, reflecting two opposite dynamics: improved EU funds absorption and lower remittances by Romanian immigrants abroad. (Figure 2)

The minor correction recorded in the past year adds further to the three year-long period of adjustment, which begun in September 2008, when the current account deficit reached unsustainable levels. Overall, after reaching a peak of €16.7bn in 2007 (13.7% of GDP) the corresponding deficit declined to €4.7bn in 2009 (4.2% of GDP), before inching up to €5.5 bn (4.5% of GDP) in 2010. Gross external debt climbed to €98.6bn in 2011 compared to €92.4bn in 2010. As a percentage of GDP, gross external debt edged higher at 77.5%-of-GDP in 2011, compared to 75.4%-of-GDP in 2010 and 47.1%-of-GDP in 2007.

Figure 2
The improvement in the current account position has been driven by a declining trade deficit



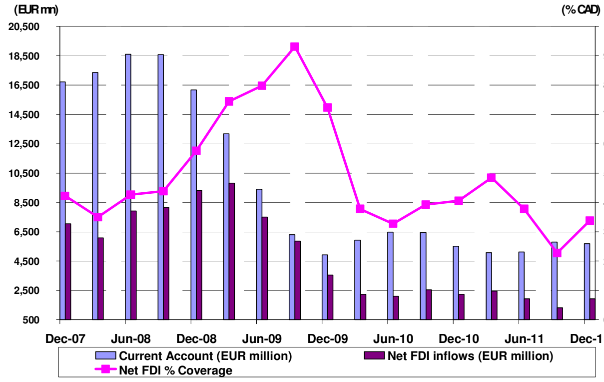
Source: NBR, Eurobank Research

Debt creating flows have taken the lead as the primary source of in current account financing in 2011

On the financing side, Romania has been no exception from the regional pattern of capital inflows drying up in the aftermath of the international financial crisis. The most important component during the boom times, net FDI inflows lost significant ground. Net FDI inflows declined from an all time high at €9.6bn in 2008 to €2.2bn in 2010 and to €1.9bn last year. In 2011 net FDI inflows covered only 33.8% of the corresponding current account deficit against 40.5% in the prior year and 72.3% in 2009 (Figure 3).

Portfolio inflows, climbed to €2.1bn in 2011, from €875mn in the prior year. Their relative share in the financial account surplus has increased from 3% in 2007-2008 to 16% in 2010 and to 43% in 2011. The rise can be broadly attributed to increased public debt issuance. Last but not least, net other capital investments-which comprises of new and rolled-over loans to the government and private sector-has come down to €1.89bn last year, from €5.83bn in 2010 as the government didn't make any use of IMF funding in 2011.

Figure 3
The coverage of the current account by FDI inflows has declined significantly since 2008



Source: Eurobank EFG Research, NBR

Moderate widening in the current account is expected in 2012 on improved domestic demand prospects, weakening conditions in main trade-partner economies

Our baseline macroeconomic scenario entails a moderate widening of the current account shortfall this year Balance of payments developments in 2012 will likely be characterized by three major trends, (under the assumption of no abrupt currency movements).

The first is the realized depth of expected recession in the euro area, by far the major trade partner of Romania. The Romanian economy is particular sensitive in that respect, given that EU-27 absorbed as much as 70% of total Romanian exports in 2011. Secondly, the magnitude of domestic demand rebound in 2012. Under our baseline macroeconomic scenario, domestic demand is likely to take the lead over next exports as the primary GDP growth driver this year. That is going to be reflected directly on imported consumer goods (around 20%) and indirectly on imported intermediate goods (around 50%) used as inputs in the manufacturing process. The two aforementioned trends will likely lead to widening pressure on the trade deficit.

Third, the rate of EU funds absorption. In principle, EU funds boost current transfers which traditionally offset some of the trade deficit. The outgoing government has promised to step up EU funds absorption by at least EUR 6bn (~5ppts-of-GDP) in each of the coming four years. However, EU funds are channeled to infrastructure projects which necessitate even more imports of raw materials and capital equipment. At the same time, the public investment program targets spending equivalent of 6.5% of GDP that will have a strong positive impact on investments but also a negative impact on the balance of payments.

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

Mounting fiscal risks ahead of parliamentary elections

- The risk of fiscal slippage ahead of the parliamentary elections-to be held on May 6th-and the freezing of the IMF precautionary agreement make domestic financial markets shaky: The Dinar crossed the 110/€ threshold for the first time in the post-Milosevic era
- Fiscal consolidation measures will be required in order to bring the fiscal deficit again within the target of 4.25% of GDP in 2012
- In the light of increased fiscal risks and Dinar depreciation pressures, NBS maintained the key policy rate unchanged at 9.5%

Consolidation measures will be required after the parliamentary elections in May in order to bring the fiscal deficit again within the target of 4.25% of GDP in 2012

The consolidated fiscal deficit came at 4.7% of GDP in 2011, slightly above the revised 4.6% target. However, the fiscal deficit is bound to exceed 5% in 2012 if no consolidation measures are taken. In addition, public debt came at 45.1% of GDP in 2011 according to the latest Ministry of Finance estimate (which is based upon an optimistic-and yet not official GDP forecast on the denominator), above the 45% threshold stipulated in the fiscal rule. As a result, the government is inclined to adopt additional fiscal austerity measures, which is very difficult just ahead of the elections. That means that the new coalition government-the probability of a single party government is almost non-existent-will have to present a revised budget and introduce spending cuts in order to bring the fiscal deficit again within the targets agreed (4.25% of GDP fiscal deficit target for 2012, 1% for debt guarantees).

Increased fiscal risks put the precautionary IMF agreement on hold until at least the parliamentary elections

The increased fiscal risks ahead of the parliamentary elections led IMF to freeze the two year precautionary agreement (effective since Aug 31st 2011). IMF challenges the outgoing government commitment on the targets of the precautionary agreement framework. The dispute between the outgoing government and the IMF is rooted in the assumptions behind government spending in the budget of 2012. According to IMF estimates, the extra spending commitments on infrastructure projects and debt issuance guarantees may add at least an extra 2% of GDP on the deficit and public debt of 2012.

Serbia: Eurobank EFG Forecasts

	2009	2010	2011	2012f
Real GDP (yoy%)	-3.5	1.0	1.6	0.5
Inflation (yoy%)				
CPI (annual average)	8.1	6.2	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	38.2	44.8	45.1	44.5
Labor Statistics (%)				
Unemployment Rate (%of labor force, ILO)	16.9	19.2	23.0	19.0
Wage Growth *(total economy, net)*	-3.5	7.5	11.2	5.0
External Accounts				
Current Account (% GDP)	-7.2	-7.2	-9.1	-8.5
Net FDI (EUR bn)	1.4	0.9	1.5	1.0
FDI / Current Account (%)	65.9	41.3	61.5	75.0
FX Reserves (EUR bn)	10.6	10.0	12.1	10.5
Domestic Credit	**2009**	**2010**	**Q3 11**	**Q4 11**
Total Credit (%GDP)	51.8	61.6	59.0	59.8
Credit to Enterprises (%GDP)	29.7	34.4	32.8	33.6
Credit to Households (%GDP)	17.3	19.1	18.2	18.2
Private Sector Credit (yoy)	14.3	26.2	6.7	5.9
Loans to Deposits (%)	126.9	144.3	143.9	141.9
Financial Markets	**Current**	**3M**	**6M**	**12M**
Policy Rate	9.50	9.50	9.50	9.50
EUR/RSD	111.35	115.00	115.00	115.00

Source: National Sources, IMF, Eurobank Research & Forecasting

In our view, the risk of an interruption of the precautionary agreement is limited. 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.

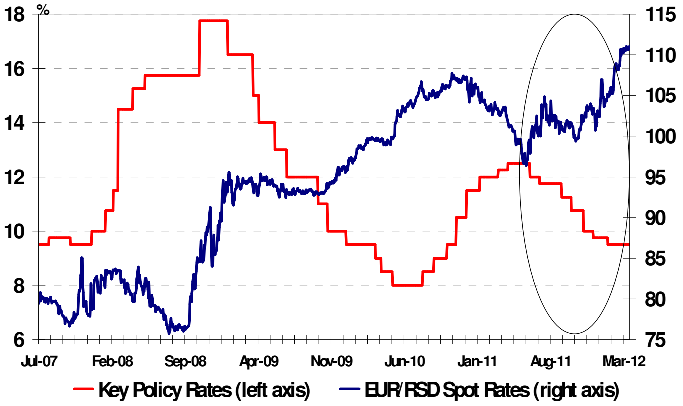
In the light of increased fiscal risks and Dinar depreciation pressures, NBS maintained the key policy rate unchanged at 9.5%

On Martch 8th, the NBS left the key policy rate unchanged at 9.5% for a second month in a row. The move was widely expected by Bloomberg consensus (11 out of 23 analysts expected no rate change). The NBS has cut the key policy rate (2-week repo rate) over the last nine months by total 300 basis points to its current level. The increased fiscal risks and the freezing of the precautionary agreement weighted decisively on the NBS decision. Looking ahead, we anticipate NBS to remain on hold until uncertainties in the political landscape and fiscal outlook clear out.

In principle, the weak growth outlook and the benign medium term inflation forecast advocate for further monetary easing:

- The growth outlook has been weaker in the 2H-2011. GDP growth slowed down to 0.5% yoy in Q3 and 0.8% yoy in Q4 against to 3.7% yoy in Q1 and 2.5% yoy in Q2. The growth outlook in 2012 is blurred by the high exposure of Serbia to the Euroarea sovereign crisis both in terms of the banking sector and trade flows. Net exports are not expected to score very well in a difficult year for Euroarea, which makes the economy more prone to the risk of a recession in 2012. On the positive side, the Serbian banking sector has the highest capital adequacy ratio in Europe (20% in 2010) which minimizes the need for additional capital injections.
- Inflation slowed even further to 4.9% yoy in February compared to 7% yoy in last December on weak demand side pressures. The inflation reading lies, within the crawling target range (4.4%+/-1.5%) of the Central Bank under the current inflation targeting regime compared to an average of 10.5% yoy in 2011.

Figure 1
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: Eurobank Research, Bloomberg

On the other hand, the risk of further depreciation pressures is very high, given that Serbia is on an official pre-election period. The fear of fiscal slippage ahead of the parliamentary elections and the freezing of the IMF precautionary agreement make domestic financial markets shaky. Dinar crossed the critical threshold of 110/€ (110.19/€ on Feb24th), only to stabilize at 111.15/€ on March 22nd, for the first time in the post Milosevic era. The Central Bank is very well equipped with reserves amounting to €11.1bn (34.5% of GDP or 429% of M1 at end Feb-12) to intervene. Those interventions (€420 mn in Jan-March) signal that further weakness is not welcome at this point.

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

Economic slowdown already evident; modest rebound expected in H2

- CBT turns more hawkish
- Current account deficit adjustment continues, but shortfall still too large

Domestic economy slows sharply in Q4-2011

Following an impressive expansion of 9.7%yoy over the first nine months of 2011, Turkey's domestic economic activity began to lose pace. Real GDP growth slowed sharply in Q4-2011coming in at 5.2%yoy from 8.4%yoy a quarter earlier, bringing the full-year print to 8.5%. The main drivers of the slowdown are Central Bank monetary tightening, introduced last October, and lingering global uncertainties, which primarily lie in the face of the euro area's debt crisis and weigh on investor and consumer sentiment as well as on global trade. In view of the aforementioned, households' consumption eased to 3.4%yoy over the October-December period from 9.2%yoy in 9M-2011 and government expenditure declined by 4.3%yoy after growing by 8.8%yoy over the fist nine months of the year. Meanwhile, investment growth nearly stagnated (+2.4%yoy) following a 25.1%yoy jump in January-September. On the other hand, imports' growth slowed down sharply as a result of weakening domestic demand dynamics. At the exports side, although the euro area is Turkey's main trading partner, an increased diversification of exports towards non-EU countries has partially offset the impact of the debt crisis on the trade balance. The lira's sharp depreciation in H2-2011 also appears to have helped. In fact, the contribution of net exports to growth turned positive in Q3-2011 for the first time since late 2009, with the impact becoming more pronounced in Q4.

Economic slowdown to continue in the first half of the year; modest rebound likely in H2

Most recent macroeconomic and sentiment indicators confirm that the slowdown in domestic economic activity in H1-2012 is already underway. Indicatively, industrial production growth declined on an annual basis in January (-1.3%yoy sa) for the first time since September 2009, February's PMI revealed contraction in manufacturing activity for the first time in six months and automotive sales have been on a steep downtrend so far this year (-32%yoy in January & February). Meanwhile, consumer credit eased to the Central Bank's (CBT) target of 25%yoy in mid-March from a multi-year high near 40%yoy in mid-2011. Labour market conditions also continue to worsen with the rate of 3-month rolling unemployment hitting an eight month high of 9.8% in November-January and marking its highest level in eight months.

Nevertheless, we anticipate real GDP growth to regain momentum in the second half of the year, driven by a mild recovery in the euro area and the gradual fade out of unfavorable base effects. Further reductions in the CBT's upper interest rate corridor limit may also offer some support to weakening domestic demand dynamics. Along these lines, we continue to expect a 3.0% economic expansion, which will however be highly dependent on global developments and particularly the evolution of the debt crisis in the euro area.

Turkey: Eurobank EFG Forecasts

	2009	2010E	2011F	2012F
Real GDP (yoy%)	-4.8	9.2	8.5	3.0
Private Consumption	-2.3	6.7	7.7	1.0
Govern. Consumption	7.8	2.0	4.5	2.0
Gross Capital Formation	-19.0	30.5	18.3	5.0
Exports	-5.0	3.4	6.5	5.5
Imports	-14.3	20.7	10.6	1.2
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	-9.9	-8.0
Net FDI (USD)	6.9	7.3	13.4	10.0
FDI / Current Account	46.9	12.0	17.4	15.0
FX Reserves (USDbn)	69.0	79.0	85.0	85.0
Domestic Credit	**Q1 11**	**Q2 11**	**Q3 11**	**Q4 11**
Total Credit (%GDP)	39.8	44.1	47.1	48.8
Credit Private Sector (%GDP)	38.2	42.5	45.5	47.3
FX Credit/Total Credit (%)	22.2	22.5	24.6	24.4
Private Sector Credit (%yoy)	44.8	43.3	44.9	34.7
Loans to Deposits	89.5	93.8	96.1	96.3
Financial Markets	**Current**	**3M**	**6M**	**12M**
Policy Rate (1-week repo)	5.75	5.75	5.75	5.75
USD/TRY (where applicable)	1.78	1.77	1.75	1.70

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

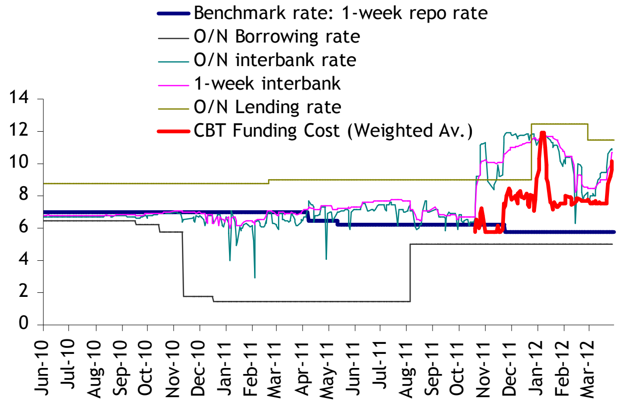
CBT turns more hawkish

As a reminder, since last October, the CBT has been utilizing an interest rate policy corridor effectively consisting of the overnight lending and the key policy, one week repo, rates. In this fashion, it has achieved a flexible monetary policy strategy, having greater room in controlling the amount of tightening provided. *For further details on the CBT's policy mix please see our previous New Europe Economics & Strategy report at* http://www.eurobank.gr/Uploads/Reports/1JANUARY%20FEBRUARY%202012.pdf. The bank has tightened monetary conditions significantly since late last year (Graph 1) in order to reign over a sharp depreciation of the lira, which fanned inflation concerns, and contain widening pressures on the already elevated current account deficit. The flexibility of its policy allows for swifter movements in the bank's average funding interest rate and this way alleviates a potential aggravation of the slowdown in domestic economic activity.

At its latest monetary policy meeting in March, the CBT held all its interest rates stable, in line with market expectations. In detail, the overnight lending rate remained at 11.50% and the key policy rate, the 1-week repo rate, at 5.75%. In addition, the overnight borrowing rate was also kept at 5.00%, as were the interest rates on borrowing facilities provided for primary dealers (11.00%) and the borrowing (0.00%) and lending (14.50%) late liquidity window interest rates. Signaling potentially tighter liquidity conditions for the coming weeks, the CBT reduced the amounts to be provided through its daily repo funding auctions to TRY 1-6bn from TRY3-7bn before and also cut the upper limit of the 1-month repo auctions to TRY5bn from TRY6bn. However, partly offsetting the tightening impact of the latter, it increased to 20% from 10% the percentage of TRY reserve requirements and slashed to zero from 10% before the amount of FX reserve requirements that may be held in gold, estimated to generate TRY6.1bn of additional liquidity into the FX markets. Importantly, the bank adopted a rather more hawkish tone compared to February's meeting when it unexpectedly narrowed its interest rate policy corridor by cutting by 100bps the overnight lending rate. As stated in the accompanying statement, the CBT is closely monitoring inflation developments and "additional monetary tightening will be repeated, when necessary".

Against this background, speculation about monetary policy easing that erupted after February's meeting proved premature. In support of the aforementioned, February's CPI came in at 10.45%yoy, remaining not far off a 3-year peak of 10.61% touched a month earlier and well above the CBT's 5.0% year-end target and 6.5%yoy forecast. Moreover, risks to inflation, such as higher food and oil prices and the renewed lira weakening since the CBT's February meeting leave little room for further cuts in the upper limit of the policy corridor in the imminent future.

Figure 1
CBT tightens monetary conditions anew

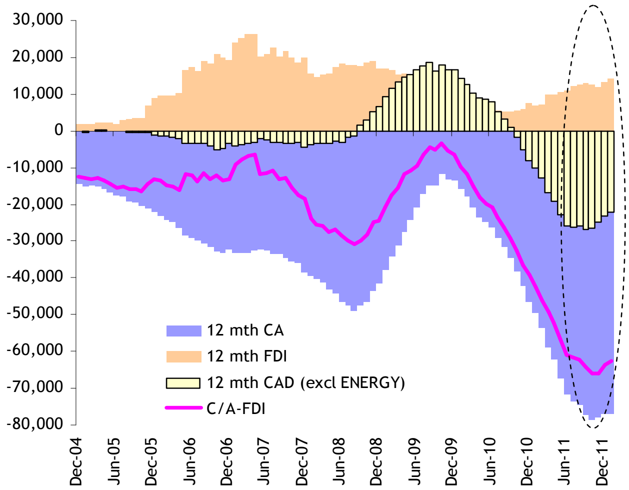


Source: Central Bank, Bloomberg, EFG Istanbul Equities, EFG Eurobank Research

Current account deficit adjustment continues, but shortfall still too large

The recent adjustment witnessed in Turkey's current account deficit (CAD) since H2-2011 continued early this year, receiving support from weakening domestic demand and improved competitiveness in view of the lira's sharp depreciation over recent months. In addition, increased diversification of exports towards non-EU countries has partially offset the impact of the euro area's debt crisis on the trade balance. Note that Turkey's largest trade partner is Germany with a share of around 10% of total exports, while exports to Iraq, USA and Russia corresponded to 7.3%, 4.4% and 4.1% respectively in January. However, the pace of improvement appears to have moderated in January, possibly due to higher oil prices. The CBT estimates that a $10 rise in oil per barrel increases the CAD by $4.5bn. As a result, the shortfall remained flat on an annual basis at $5.998bn. Separately, the 12-month rolling CAD widened 55%yoy to $77.132bn or 9.9% of GDP. This compares with an increase of 211%yoy over the same month a year earlier, while subtracting the energy component the deficit amounted to $22.1bn (ca 3% of GDP according to our estimates). As the Turkish economy is poised for a sharp slowdown this year we expect the ongoing adjustment in the current account gap to continue ahead, albeit at a potentially slower pace compared to recent months in view of high oil prices. Along these lines we maintain our full-year 2012 forecast of 8%-of-GDP. In spite of the already evident, and ensuing, improvement, Turkey's current account deficit remains at elevated levels with its financing being highly dependent on volatile portfolio inflows. As such, it is one of Turkey's key macroeconomic vulnerabilities. On a rather reassuring note, the recent improvement in global sentiment so far this year, will likely continue to support capital inflows towards the country.

Figure 2
Current account adjustment continues



Source: CBT, National Statistics, EFG Eurobank

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

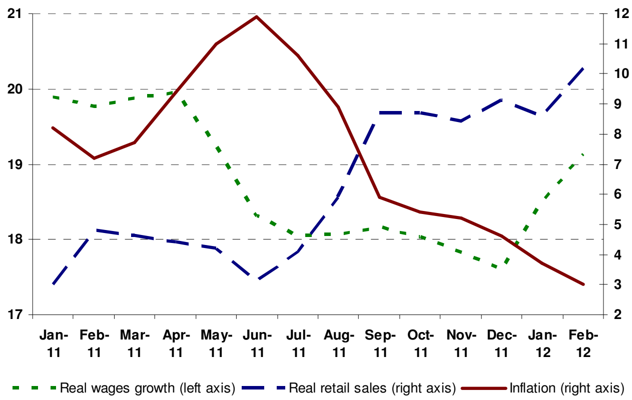
Uncertain outlook ahead of election period

- GDP growth has exceeded expectations accelerating by 5.2% yoy in 2011, yet recent industrial production data suggest deceleration in the near term
- Inflation slowed further at a 9-year low of 3.0% yoy in February
- Monetary policy easing with key policy interest rate cut to 7.50% after being unchanged for more than a year and a half
- Total credit has been in a downward trend since last November.

Growth has been driven by strong performance of consumption supported by slowing inflation

Ukraine's GDP growth has exceeded expectations accelerating to 5.2% yoy in 2011 from 4.1% yoy in 2010. Growth has been driven by strong performance of consumption. Retail sales grew by double digit figures the whole year supported by robust real wage growth and slowing inflation in the second semester of the year. (Figure 1)

Figure 1
Strong retail sales supported by robust real wage growth and slowing inflation



Source: National Bank of Ukraine, Eurobank Research

However, the momentum has begun to slow as the economy is seeing the first signs of deceleration. Industrial production, which accounts for a quarter of the economic output, has decelerated from average growth of 7.0% last year to 2.0% yoy in January and 1.6% yoy in February, driven by a sharp decline in manufacturing output. Yet, downside risks to growth are contained up to the Euro 2012 football championship which has increased

Ukraine: Eurobank EFG Forecasts	2009	2010	2011f	2012f
Real GDP (% yoy)	-14.8	4.2	5.2	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	6.5
CPI (end of period)	12.3	9.1	4.6	7.5
Fiscal Accounts (% GDP)				
General Government Balance	-8.7	-6.5	-4.2	-4.0
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	10.7	10.0
External Accounts				
Current Account (% GDP)	-1.5	-2.2	-5.5	-5.0
Net FDI (bn USD)	4.7	5.8	6.9	6.5
FDI / Current Account	268.7	190.8	78.0	60.0
FX Reserves (bn USD)	26.5	34.6	31.8	25.0
Domestic Credit	**2009**	**2010**	**Q3 11**	**Q4 11**
Total Credit (% GDP)	79.1	66.9	62.7	61.0
Credit to Enterprises (% GDP)	50.5	45.8	44.6	43.8
Credit to Households (% GDP)	26.4	19.1	16.2	15.3
FX Credit/Total Credit (%)	50.8	46.0	42.1	40.3
Private Sector Credit (% yoy)	-3.1	0.4	5.4	8.5
Loans to Deposits	215.9	175.9	169.0	163.1
Financial Markets	**Current**	**3M**	**6M**	**12M**
Policy Rate	7.50	7.50	7.50	7.50
USD/UAH	8.02	8.10	8.20	8.10

Source: NBU, IMF, Bloomberg, Eurobank Research

investments. In all, we anticipate GDP growth to fall to 3.0% yoy in 2012.

The outlook of 2012 is very uncertain; it will depend crucially on whether or not Ukraine will be able to secure an additional discount from Russia on the natural gas import price. Should this materialise, Ukraine will probably manage to resume the IMF programme which has been on hold for a year as the government refuses to raise household natural-gas costs, ahead of parliamentary election in October 2012, to narrow the budget deficit. 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. Furthermore, in mid-March the government announced that it wants to restructure $3bn of IMF debt (related to the 2008 IMF programme to Ukraine) due this year. This request is unlikely to be approved by the IMF but it does demonstrate the extent of financial pressures, as well as the prioritisation of inward political issues.

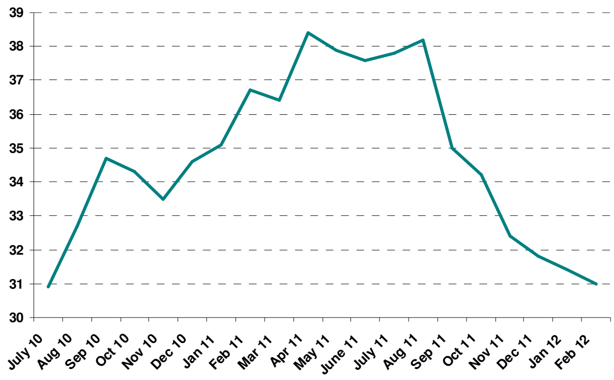
Current account deficit widened in 2011 on increasing oil prices which weigh on the gas import bill

The current account (c/a) deficit widened to 5.5% of GDP in 2011 from 2.2% of GDP in 2010 driven mainly by gas imports which prices are contractually tied to global oil prices. The recent rise of oil prices will likely push gas imports further, but seasonal factors should alleviate pressures. What's more, investments and tourist inflow related to the Euro 2012 football championship (which will take place in June-July 2012) will likely compensate for some of the loss. In all, we believe that this year the current account deficit will likely range at 5.0% of GDP. FDI will likely cover a large part of the c/a deficit but will not be sufficient to finance it in total. Therefore, we expect NBU reserves to continue to decline.

International reserves have diminished recently to stem hryvnia's devaluation

According to the National Bank of Ukraine (NBU), in the period September-December 2011 it spent about $6.4bn of its gross international reserves since their peak of $38.2bn in August 2011 to defend the exchange rate as Ukraine is dependent on borrowing from abroad to fund its imports and finance its debt. In late July 2010, when Ukraine agreed on the IMF lending, the FX reserves amounted at $30.9bn. At the beginning of 2011, they reached $34.6bn, they peaked at $38.2bn in August, due to large capital inflows, and at the end of the year they collapsed to $31.8bn. In late February 2012, FX reserves stood at $31bn i.e. at the level of July 2010. (Figure 2)

Figure 2
Ukraine's FX reserves has diminished since September 2011 to defend hryvnia's devaluation



Source: National Bank of Ukraine, Eurobank Research

In the context of higher risk aversion in capital markets and the absence of an IMF deal which would ensure Ukraine's financing needs, we anticipate pressures on the domestic currency to intensify in the coming months. Ahead of parliamentary election in October 2012, the authorities will likely continue to prevent the currency's devaluation since it is viewed as politically costly. Consequently, Ukraine's international reserves will probably diminish further in 2012 to back up the currency.

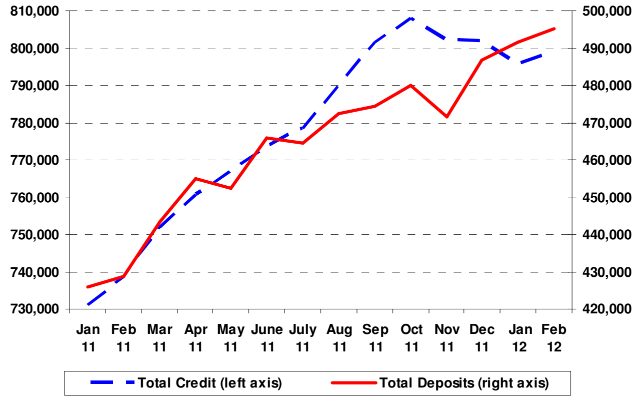
Last year's monetary tightening followed by monetary easing to support economic activity and lending

In 2011, intensified depreciation pressures on the hryvnia have led NBU to absorb domestic liquidity, via open market operations. This has translated into a significant tightening of lending standards and pushed up both deposit and lending rates. But, tighter liquidity has constrained banks' ability to lend to the government or to the private sector. Therefore, since last December, in an effort to maintain enough short-term monetary liquidity and prevent any risks in the day-to-day operations of the banks, the NBU has eased rules for mandatory reserve requirements, allowing banks to keep only 70% of the mandatory reserves in the NBU's special account (instead of 100% previously applied). From end March onwards, mandatory reserve requirements will fall to 60%. Moreover, the NBU in late January and in mid-February cut the overnight refinancing interest rates by a cumulative 50bps in order to provide support to the domestic economy. More precisely, the NBU cut the overnight rate on unsecured loans ultimately to 10.75% from 11.25% initially and the rate on loans under collateral of government T-bills to 8.75% from 9.25%. Note that the NBU had held the overnight refinancing rates unchanged since October 2010. In late March, slower inflation has allowed the NBU to cut its key policy interest rate by 25bps to 7.50% after having kept it unchanged since August 2010. This additional stimulus should support economic activity and lending. Admittedly, the authorities believe that the evolution of domestic demand dynamics in the period ahead will crucially depend on the availability of credit.

Total credit has started to decrease while deposits remained in an upward trend

In 2011, the total credit grew by 9.4% yoy driven by corporate lending, which increased by 14.9% yoy. Household credit was a drag to credit growth as it contracted by 4% yoy, with mortgages lending decreasing by 15.5% yoy. Since November 2011, total credit has started decreasing, a trend that was continued the first two months of 2012. Nevertheless, total credit growth in yoy terms remains in positive territory; it stood at 8.1% yoy in February 2012. On the other hand, total deposits grew by 16.9% yoy in 2011 driven both by corporates' and households' deposits. Since the beginning of 2012 the same trend has continued with household deposits standing at 12.8% yoy in February 2012 while corporates' deposits stood at 21.2% yoy at the same period. (Figure 3)

Figure 3
Total credit has started decreasing while total deposits has kept increasing



Source: National Bank of Ukraine, Eurobank Research

Consequently, loans to deposits (L/D) ratio dropped further to 161.4% in February 2012 from 172.3% recorded in February 2011 and 216.5% in February 2010. Although L/D ratio is still high, is close to pre-crisis levels and constitutes a considerable improvement from the peak of 226% in April 2009.

On a positive note, FX denominated loans have decreased, yet remaining at a high level; they stood at 40.5% of total loans in February 2012 from 46% in the beginning of 2011. A bit worrisome is the increase of Non-Performing-Loans (NPLs) by 3% in the first two months of 2012, although they had decreased by 6.5% in 2011. The NPLs ratio to total loans stood at 10.2% in February 2012 compared to 11.5% in the beginning of 2011.

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

Growth to decelerate in 2012 despite the monetary stimulus

The relatively closed Albanian economy weathered the international crisis really well thanks to an accommodating monetary policy and a fiscal stimulus in 2008 – 2009. The economy is now slowing down. It expanded by 2.6% yoy and 1.8% qoq in Q3-2011, with transport, trade and industry being the main drivers. The IMF estimates real growth of 2.5% in 2011 (3.9% in 2010) and projects further deceleration to 1.5% in 2012.

Monetary policy remains supportive. The Bank of Albania cut the key policy rate (1 week repo rate) by 25 bps to a historic low of 4.25% in March 2012. This became possible thanks to reduced inflationary pressures in the second half of 2011 (2011 inflation 3.5% yoy). In February 2012 inflation was 0.6% yoy, the lowest reading since January 2007. The BoA expects low inflation rates in 2012, well in line with its medium-term target for 2%-4% annual inflation rate.

Fiscal policy will be less supportive in the next two years. Increasing public debt constrains budgetary flexibility. The room for further fiscal stimulus is limited since public debt is close to the 60% legal ceiling (59.4% of GDP in 2011 according to IMF estimates). The government has set a ceiling for the budget deficit to 3% of GDP for 2012 - 2014. The 2011 budget deficit was ALL 45.7 bn or 3.5% of GDP.

Albania is less integrated into the international market than the rest of the SEE economies. External imbalances remain strong. The current account deficit in the first 3 quarters of 2011 deteriorated in comparison to the same period of 2010, from 7.4% of GDP to 8.8% of GDP. The trade deficit increased by 5.7% yoy, but most importantly, the current transfers surplus decreased by -8.6% yoy on the back of lower remittances from expatriates (-8.6% yoy). Remittances continued in their downward trend (12.1% of GDP in 2007 and 7.6% in 2010). This decline is both natural due to changing demographic and social conditions and a result of the worsening economic situation in Italy and Greece (according to IMF almost 60% of remittances come from Greece and 30% from Italy).

Credit expansion to the private sector was strong in January 2012, registering a 9.9% yoy growth. Note that 65.8% of outstanding loans to the private sector are denominated in foreign currency. Financial intermediation remains low. Total credit to the private sector has reached 39.6% of GDP in 2011 (30% of GDP in 2007). The loans to deposits ratio was just 61.9 in January 2012. NPLs increased to 18.9% of classified loans in December 2011 (13.6% in Dec 2011).

Risks are high due to an adverse external environment and exposure to euro area periphery. The political environment is less stable than in other SEE economies and EU candidate status remains illusive since necessary political and economic reforms are blocked by the lack of a consensus among major political powers.

Albania: Economic data				
	2009	**2010**	**2011f**	**2012f**
Real GDP (% yoy)	3.3	3.9	2.5(IMF)	1.5(IMF)
Inflation (% yoy)	**2009**	**2010**	**2011**	**2012f**
CPI (annual average)	2.3	3.6	3.5	3.5(IMF)
CPI (end of period)	3.7	3.4	1.7	2.9(IMF)
Fiscal Accounts (% GDP)	**2009**	**2010**	**2011f**	**2012f**
General Government Balance	-7.4	-3.7	-3.5	-3.0(Gov)
Gross Public Debt	59.8	58.2	59.4(IMF)	59.2(IMF)
Primary Balance	-4.3	-0.4	-0.4(IMF)	-1.0(IMF)
Labor Statistics (%)				
Unemployment Rate (%)	13.1	12.5	11.5(IMF)	11.0(IMF)
Wage Growth *(State sector)*	11.9	6.7	-	-
External Accounts				
Current Account (% GDP)	-15.1	-11.5	-10.9(IMF)	-9.8(IMF)
Net FDI (bn EUR)	0.72	0.84		
FDI / Current Account (%)	54.8	80.8		
FX Reserves (bn EUR)	1.57	1.83	1.81(11/11)	
Domestic Credit	**2009**	**2010**	**2011**	
Total Credit (% GDP)	38.3	38.9	41.0	
Credit to Enterprises (% GDP)	23.9	25.4	27.6	
Credit to Households (% GDP)	12.8	12.0	11.3	
FX Credit/Total Credit (%)	68.1	67.5	65.2	
Private Sector Credit (% yoy)	11.7	10.6	10.4	
Loans to Deposits (%)	63.9	66.5	61.5	
Financial Markets	**2009**	**2010**	**2011**	**Current**
Policy Rate (%)	5.25	5.0	4.75	4.25
ALL/EUR	137.1	138.5	138.3	139.8
ALL/USD	95.8	103.5	106.4	104.7

Source: BoA, INSTAT, IMF, Reuters

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II. New Europe – Country Analysis: **FYR of Macedonia**

Strong growth expected in 2012 but external financing risks remain

FYROM's economy expanded by 3.0% yoy in 2011 (2010: 1.8% yoy), continuing its recovery from the 2008 recession. The recovery has been supported by an accommodating monetary policy, prudent fiscal policies, elevated external demand and a rebound in domestic demand. The main drivers of growth in 2011 were investments (+22.7% yoy) and private consumption (+3.7% yoy), while government consumption declined by 5.5% yoy. On the other hand, the trade deficit widened by 20% yoy due to imports growing faster than exports. The IMF projects real growth of 3.7% in 2012. Despite the recovery, unemployment remains extremely high (31.2% in Q3-2011). Risks lie in the exposure to the euro area periphery and possible pressures on the fiscal and external accounts.

Monetary policy remains supportive. The National Bank of the Republic of Macedonia (NBRM) has held the key policy rate to 4.0% since December 2011, a historic low. The NBRM continues its exchange rate targeting strategy (de facto peg against the euro); the exchange rate of the denar against the euro remained stable close to 61.5 MKD/EUR. Average inflation in 2011 was 3.9% yoy compared to 1.6% yoy in 2010. Consumer prices rose by 2.9% yoy in February 2012, driven mainly by higher energy prices and housing. The IMF expects inflation to slow down in 2012 to 2.0%.

Fiscal policy remains sound and succeeds in striking a balance between supporting growth and maintaining a low fiscal deficit and public debt. Financing risks remain high though due to an unstable external environment. The standing two year Precautionary and Liquidity Line (PLL) agreement with the IMF provides cover against a deterioration of the external environment. Remaining available credit under the PLL amounts to ca. € 243 mn (3.3% of GDP). Central government deficit in November 2011 was 2.3% of GDP. The full year deficit target for 2011 was 2.5% of GDP, the same as in 2010. The 2012 budget is optimistic, assuming real GDP growth of 4.5% yoy and envisaging a deficit of 2.5% of GDP. More importantly, it includes a 29% increase in capital spending. Central government debt increased to 26.3% of GDP in November 2011. IMF projections put it to 28.2% of GDP in 2012.

FYROM's economy is small but open with total trade (exports plus imports) reaching 132% of GDP in 2011. The current account (CA) deficit widened to 2.7% of GDP in 2011 (2010: -2.2% of GDP) on the back of higher domestic demand and fuel prices. The trade deficit increased by 11.7% yoy with exports increasing by 25% yoy and imports by 21% yoy. Net current transfers increased by 9.2% yoy. The CA deficit is covered by FDI inflows which increased by 90.8% yoy reaching 4.2% of GDP in 2011. Gross external debt reached 63.2% of GDP in Q3-2011 increasing by 16% yoy. Official foreign currency reserves reached € 1.8 bn in February 2012, increasing by 19.8% yoy.

Credit expansion to the private sector was strong in February 2012, registering a 8.2% yoy growth. Note that 27.5% of outstanding loans to the private sector are denominated in foreign currency and a further 28.4% have an FX clause. Total credit to the private sector has reached 46.3% of GDP in February 2011. Deposits grew by 8.4% yoy in February with 49% of deposits being denominated in foreign currency. The loans to deposits ratio was a healthy 86.2% in February 2012. Capital adequacy of the banking system remains strong with the Tier I capital ratio reaching 14% in Q3-2011.

FYROM: Economic data				
	2009	**2010**	**2011**	**2012f**
Real GDP (% yoy)	-0.9	1.8	3.0	2.5 (EU)
Final Consumption	0.8	1.4	1.8	1.2 (EU)
Gross Capital Formation	-1.5	-6.3	22.7	6.7 (EU)
Exports	-16.2	23.4	11.3	6.0 (EU)
Imports	-15.0	11.6	14.1	4,9 (EU)
Inflation (% yoy)				
CPI (annual average)	-0.8	1.6	3.9	2.0 (IMF)
CPI (end of period)	-1.6	3.0	2.8	2.0 (IMF)
Fiscal Accounts (% GDP)	**2009**	**2010**	**2011f**	**2012f**
Central Government Balance	-2.7	-2.5	-2.5 (IMF)	-2.2 (IMF)
Gross Central Government Debt	23.8	24.6	26.3 (IMF)	28.2 (IMF)
Labor Statistics (%)	**2009**	**2010**	**2011**	**2012f**
Unemployment Rate (%)	32.2	32.0	31.3 e	30.0 (EU)
Wage Growth *(Nominal gross, %)*	9.4	1.0	1.2	
External Accounts				
Current Account (% GDP)	-6.8	-2.2	-2.7	
Net FDI (bn EUR)	0.14	0.16	0.30	0.40 (IMF)
FDI / Current Account (%)	30.0	104.8	150.1	
FX Reserves (bn EUR)	1.37	1.48	1.80	2.36 (IMF)
Domestic Credit	**2009**	**2010**	**2011**	
Total Credit (% GDP)	44.8	46.4	48.5	
Credit to Enterprises (% GDP)	25.8	26.9	27.8	
Credit to Households (% GDP)	17.5	17.7	18.2	
FX Credit/Total Credit (%)	22.8	27.1	30.2	
Private Sector Credit (% yoy)	4.2	1.7	5.1	
Loans to Deposits (%)	88.2	84.4	86.6	
Financial Markets				
Policy Rate	8.5	4.1	4.0	
MKD/EUR	61.46	61.40	61.49	
MKD/USD	43.98	46.20	43.96	

Source: NBRM, SSO, IMF, European Commission, Reuters

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