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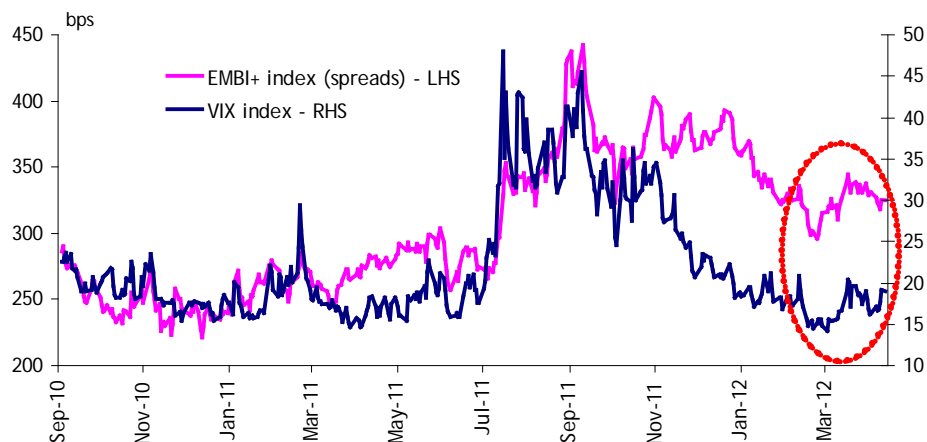
## Financial markets in the region trim part of their recent gains

- **Bulgaria:** Tapping the international markets after eleven years
- **Poland:** Economy still resilient, but exhibiting preliminary signs of slowdown
- **Romania:** No confidence vote brings unexpectedly down the Romanian government
- **Serbia:** A challenging domestic macroeconomic outlook
- **Turkey:** CBT maintains hawkish tone
- **Ukraine:** Growth slowed more than expected in Q1-2012
- **Albania:** Macroeconomic imbalance persist
- **FYROM:** 2011 fiscal deficit in line with the official target; revisions to 2012 official macro forecasts

### New Europe market strategy highlights

**Regional FX markets:** We favor entering **short €/TRY positions** at current levels around 2.29 with a stop loss at 2.31 and a target of 2.26 and **USD/TRY shorts** at 1.76 with an initial target of 1.74 ahead of the 1.72 level. Separately, we see limited room for a break of the **EUR/RSD 111-112** range, but we would not rule out entering a **small long EUR/RSD position** at current levels with a target of 113.50 and a stop loss below 110.00. We prefer to stay **sidelined on the Romanian leu** in view of lingering political uncertainty. **In the sovereign credit space,** we maintain our earlier **long Turkish 5-year CDS** recommendation that remains *in the money* and **long Hungarian 5-year CDS spread** position. We also keep our 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 **long Romanian 10-year CDS** and **buy the Romanian 6¾ February 2022 USD-denominated bond**. We also hold our previous call of going **long 5-year protection on Russia vs. shorting 5-year protection on Poland**. **In local rates markets** and we maintain our **long position in Polish 2/5 vanilla swaps**.

### Risk appetite waned in recent weeks on lingering euro area worries



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 |
| <b>Bulgaria</b>   | 0.2            | 1.7  | 1.0  | 3.0                    | 4.2  | 2.0  | -4.0                  | -2.1  | -1.4 |
| <b>Poland</b>     | 3.9            | 4.3  | 3.1  | 2.6                    | 4.3  | 3.5  | -7.8                  | -5.1  | -3.4 |
| <b>Romania</b>    | -1.3           | 2.5  | 1.0  | 6.1                    | 5.8  | 3.5  | -6.9                  | -4.4  | -3.0 |
| <b>Serbia</b>     | 1.0            | 1.6  | 0.5  | 6.8                    | 11.2 | 5.5  | -3.6                  | -4.6  | -4.3 |
| <b>Turkey</b>     | 9.2            | 8.5  | 3.0  | 8.6                    | 6.4  | 9.4  | -3.6                  | -1.4  | -1.3 |
| <b>Ukraine</b>    | 4.2            | 5.2  | 3.0  | 9.4                    | 8.0  | 5.5  | -6.5                  | -4.2  | -4.0 |
| <b>New Europe</b> | 5.3            | 5.7  | 2.7  | 6.4                    | 6.0  | 6.1  | -5.6                  | -5.8  | -2.6 |
| <b>Euro area</b>  | 1.8            | 1.5  | -0.3 | 1.6                    | 2.7  | 2.3  | -6.2                  | -4.1  | -3.5 |
| <b>USA</b>        | 3.0            | 1.7  | 2.0  | 1.6                    | 3.1  | 2.3  | -10.1                 | -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  |
| <b>Bulgaria</b>   | -1.0                   | 0.9  | 0.5  | currency board       |       |       | 1.96         | 1.96  | 1.96  |
| <b>Poland</b>     | -4.6                   | -4.1 | -4.0 | 3.50                 | 4.50  | 4.50  | 3.96         | 4.46  | 4.10  |
| <b>Romania</b>    | -4.5                   | -4.4 | -4.7 | 6.25                 | 6.00  | 5.00  | 4.28         | 4.32  | 4.40  |
| <b>Serbia</b>     | -7.2                   | -9.1 | -8.5 | 11.50                | 9.75  | 9.00  | 106.1        | 106.9 | 115.0 |
| <b>Turkey</b>     | -6.5                   | -9.9 | -8.0 | 6.50                 | 5.75  | 5.75  | 1.54         | 1.88  | 1.72  |
| <b>Ukraine</b>    | -2.1                   | -5.5 | -5.0 | 7.75                 | 7.75  | 7.50  | 7.96         | 7.99  | 8.10  |
| <b>New Europe</b> | -5.0                   | -6.6 | -5.8 | -                    | -     | -     | -            | -     | -     |
| <b>Euro area</b>  | -0.5                   | -0.3 | -0.1 | 1.00                 | 1.00  | 1.00  | 1.34         | 1.27  | 1.26  |
| <b>USA</b>        | -3.2                   | -3.1 | -2.9 | 0.250                | 0.250 | 0.250 | 0.75         | 0.79  | 0.79  |

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

## I. Overview

### **Economic activity in the region decelerated further in Q1-2012 on slowing external demand, deteriorating domestic sentiment and exceptionally bad weather conditions**

The slowdown in most regional economies continued in the first quarter of this year, driven, primarily, by slowing exports, and softening activity in the domestic manufacturing and retail trade sectors. To complicate things further, exceptionally unfavorable weather conditions, coupled with frequent power shortages put additional strain on regional economic activity during the first quarter of the year. The Southeastern Europe region appears to have been hit the most, arguably as a result of its close trade and financial links with a number of crisis-hit euro area periphery economies. In more detail:

**Industrial activity in Bulgaria has deteriorated sharply since last December, with output contracting by 3.5% yoy in Q1-2012** Furthermore, goods exports in the first two months of this year registered their first negative annual growth reading (-6.1% yoy) since 2009. Over the same period, imports expanded by 7.1% yoy.

The winter turned particularly harsh starting from February in **Romania**. Heavy snowfalls and low temperatures damaged infrastructure and causes serious disruptions in domestic output, industrial production and retail sales contracted by 1.4% and 2.5%, respectively over that month.

**The Serbian economy** recorded a very poor performance in Q4 2011. On a qoq seasonally adjusted basis, domestic output contracted by 0.3% in the fourth quarter of last year, after declining by 0.7% in Q3. This suggests that the economy has already entered recession, at least from a technical standpoint. Preliminary Central Bank estimate for the first quarter of this year showed a 1.5% yoy decline in real GDP, the first negative annual growth reading since Q1 2009.

On a more constructive note, the **Polish economy** is faring relatively better than its regional peers. Yet, recent readings in a range of higher-frequency macro indicators suggest a gradually softening in domestic economic activity. Among others, industrial output expanded by just 0.7% yoy in March, after growing by 4.6% yoy in February and by 9.1% yoy in January 2012. Furthermore, the headline PMI manufacturing index slowed to 49.2 in April from 50.1 in the prior month.

**Ukraine's real GDP growth** disappointed market expectations in Q1-2012, rising by a preliminary 1.8% yoy after expanding by 4.7% yoy in Q4-2011. Industrial production contracted by 1.1% yoy in March, bringing overall output growth to a feeble 0.8% yoy in Q1 vs. 7.1% yoy in 2011.

In Turkey, it appears that the recent slowdown in domestic economic activity has bottomed out in the first quarter of this year and we expect a gradual improvement from the second quarter onwards. Indicatively, the manufacturing purchasing Managers' Index (PMI) for Turkey hit a 5-month peak of 52.3 in April, bouncing above the boost-or-burst threshold of 50 for the first time in three months.

### **Heavy political noise weighs on regional economies**

In recent weeks, the region was hit by a new bout of political uncertainty. In a number of countries, either parliamentary elections were held according to schedule, or unpredictable political volatility erupted as weak government coalitions are struggling with the implementation largely unpopular fiscal austerity programs.

In **Serbia**, President Boris Tadic's resignation from his post paved the way for early presidential elections on May 6, the same day parliamentary and local elections took place. As no candidate won an outright majority, there will a run-off on May 20 between the incumbent President and the leader of Serbian Progressive Party (SNS) Tomislav Nikolic. In the parliamentary elections, the ruling Democratic Party (DS) came in the second place behind its main rival, the Serbian Progressive Party (SNS). The allocation of seats in the parliament rules out the possibility of a single party government, but negotiations can only begin after a new President is sworn in. The new coalition government, when formed, is expected to be confronted with significant challenges. Among others, they will need to present a revised budget and introduce spending cuts in order to bring the fiscal deficit within the targets agreed with the IMF. That appears to be a key prerequisite for unfreezing the present precautionary agreement.

**Romania's** government was toppled unexpectedly on April 27, two months after it took office, following a no confidence vote in Parliament. The new government, led by social democrats-PSD and headed by new Prime Minister Victor Ponta committed to continue implementing the fiscal and structural measures laid out in the present IMF-EU precautionary programme. Yet, after successful negotiations with the Fund, the new government has managed to revise the 2012 fiscal deficit target, to 2.2%-of-GDP, from 1.9%-of-GDP previously. That was in an effort to facilitate a restoration of public wages to levels prevailing before the 25% cut implemented in mid-2010. The Romanian election calendar remains heavy with local and parliamentary elections scheduled for June and late November, respectively.

The recent rift in the junior *Public Affairs* coalition partner threatened to destabilize the government coalition in **Czech Republic**. The break-up of the parliamentary group of *Public Affairs* led to dissolution of the coalition on 22 April. The government survived a no-confidence motion on April 27<sup>th</sup>, after

most of *Pulbic Affairs'* MPs decided to co-operate with the two major parties and voted against the motion.

### Regional monetary policy developments

**Romania:** Against a backdrop of benign inflation pressures, volatile capital inflows and increased domestic political uncertainty, the NBR paused on its monetary easing cycle in April. The Bank's communiqué signaled an increased focus on maintaining financial stability. Since the inception of its latest easing cycle in November 2011, the NBR has delivered four rate cuts (25bp each) bringing its policy rate to 5.25%, currently.

**Serbia:** Having been among the first central banks in the region to initiate its latest easing policy cycle, the NBS decided in its April meeting to hold on policy rates for a third consecutive month. The key rate currently stands at 9.50%. The recent rise in domestic political risks, worsening fiscal dynamics and the freezing of the IMF precautionary agreement were among the main reasons behind the Bank's *no-rate-change* decision. Increased uncertainties over the domestic inflation outlook, stemming from rising imported prices as a result of the dinar's weakening trend, higher post-election administered prices and the impact of the new agricultural season also weighted in the central bank's latest decision.

**Turkey:** At its April monetary policy committee meeting, Turkey's central bank (CBT) held interest rates unchanged in line with expectations. Accordingly, the key policy 1-week repo rate remained at a record low level of 5.75%, while the overnight borrowing and lending rates were kept at 5.00% and 11.50% respectively. In addition, the CBT also maintained the required reserve ratios (RRRs) for foreign currency and lira deposits at their earlier levels. Casting a relatively more hawkish tone, the Committee noted in its accompanying statement that it "will not tolerate temporary factors to have an adverse impact on the inflation outlook" and added that further monetary tightening may be instrumented in the forthcoming months in order to contain inflation pressures.

**Poland:** The key interest rate was kept unchanged at 4.50% at the latest (April) NBP policy meeting. Increased downside risks to the domestic growth environment coupled with easing inflation pressures make us believe that policy rates will remain unchanged for the remainder of the year.

**Ukraine:** A recent visible improvement in the domestic inflation outlook had 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.

### Financial markets shed part of Q1-2012 gains on lingering euro area worries

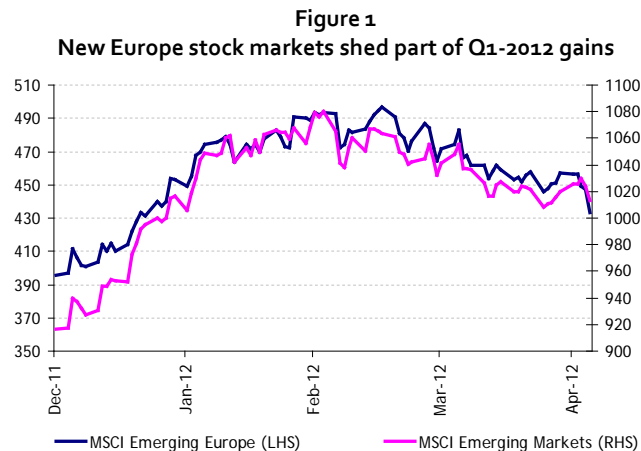
Emerging financial markets came under some pressure in recent weeks on resurfaced fears over the euro area outlook and waning investor optimism following a relatively good Q1 - 2012 earnings season and the ECB's latest (February 2012) 3-year long-term refinancing operations (LTROs). Meanwhile, escalating political tensions in several European countries weighed further on investors' sentiment. As a reminder, the Dutch government collapsed in late April amid disagreement over additional fiscal austerity measures, paving the way for early polls in September. A few days later, Romania's parliament unexpectedly toppled the previous government in a successful no confidence motion, increasing the likelihood that the next general election - currently scheduled for November 2012 - will be brought forward. The government of the Czech Republic came close to the brick of collapse a few weeks ago, after the departure of a junior coalition partner from the government. Separately, Greece held on May 6 general elections with preliminary results indicating a fragmented parliament and no single-party government tenure. On the same day, second round Presidential elections in France resulted in the defeat of outgoing President Nicolas Sarkozy. In Serbia, parliamentary as well as presidential elections were held on May 6. An inconclusive result on the former suggests that it may take up to three months for a government to emerge, while a run-off on the latter is due to be held on May 20.

As an indication of waning risk appetite, the VIX index, considered as a gauge of investor sentiment, rose to 19.16 in early May from 15.50 at the end of Q1, bouncing further above a multi-year low of 13.66 hit in mid-March. In a similar vein, the iTraxx Crossover index, which consists of 50 equally-weighted CDSs of the most liquid sub-investment grade European corporates, hovered around 150bps higher earlier in May from a 7-month trough just above 500bps touched on March 19. In addition, the spread of the JP Morgan Emerging Markets Bond Index Plus (EMBI+) stood at 324bps on May 4, some 5bps wider compared to its end-March levels and nearly 30bps higher from its March-19 multi-month lows.

Equity markets in New Europe fared worse than most major global indices over the last month or so, with its losses exacerbated by escalating political tensions in Europe and the ongoing euro area debt crisis. Indicatively, the **MSCI Emerging Europe Equity index** lost around 8% since the end of March, underperforming the broader **MSCI Emerging Markets Equity index** which shed 3% and the corresponding **MSCI World index** which fell by nearly 4% over the same period. Serbia's and Turkey's main indices were the region's main underperformers, posting losses to the tune of 6-7% each in early May compared to their end-March level. Increased political uncertainty in Serbia in the way to the May elections and growing worries over fiscal slippages and the ensuing freezing of the country's



precautionary Stand-By Arrangement with the IMF in April pushed the **BELEX15 index** in early May to its lowest level since end-January. In Turkey, central bank monetary tightening exacerbated downward pressures on **ISE 100**, which touched a 3-month trough of 58,047.71 on May 7.

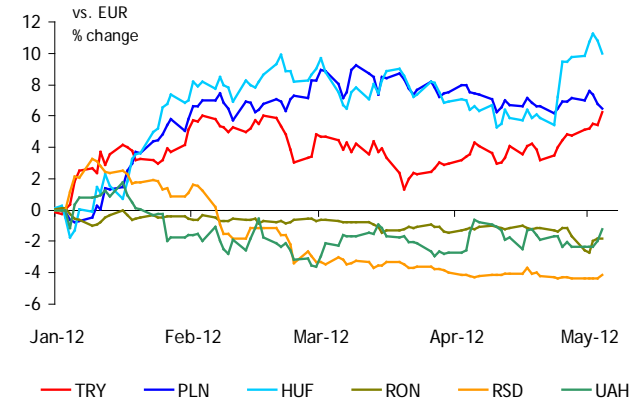


Source: Bloomberg, EFG Eurobank Research

**Regional currencies** have staged a mixed performance over the last month or so. The **Turkish lira** held on to most of its gains recorded since mid-April on further rate tightening by the CBT and its ongoing hawkish rhetoric. As a result, the **USD/TRY** hit a 1-½-month trough of 1.7490 in early May. Elsewhere, the **Hungarian forint** remains the region's best performer so far this year, receiving additional support lately from news that the European Union gave the country the green light to start negotiations with official lenders on a new financial aid package. The news was well received by financial markets as initial talks were brought to a standstill in late 2011 after the government passed in parliament legislation which was considered to be breaching such key EU rules as full central bank independence. Against this background, the **EUR/HUF** plunged to as low as 282.10 earlier in May, falling by nearly 6% from a 3-month high near 300 touched on April 23. On the other hand, the **Serbian dinar** and the **Romanian leu** remained under pressure on continuing central bank monetary policy easing, escalating political uncertainty in both countries and investor worries over the outlook of current stabilization programmes with international lenders. As a reminder, the IMF placed on hold Serbia's €1bn Stand-By Arrangement earlier this year on disagreement with the government over the 2012 budget targets, while the central bank has delivered a total of 300bps of monetary easing since mid-2011. Deteriorating risk sentiment after the French and Greek election results in early May also weighed. As a result, the **EUR/RSD** touched a new record peak just above 112 on May 7. Separately, **Romania's leu** came under significant pressure earlier this month, touching a record low of 4.4588/EUR on May 1, following the collapse of the previous government. In a move to alleviate increased depreciation

pressures, the central bank decided to stay put on policy rates after 100bps of cumulative rate cuts since last November.

**Figure 2**  
Regional currencies mixed in recent weeks  
(year-to-date returns)

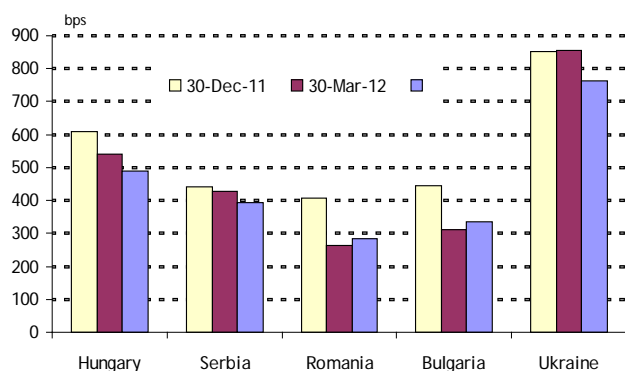


Source: Reuters, EFG Eurobank Research

In **local rates markets**, government bonds retained a firm tone over the last few weeks, with the long-end of the yield curve broadly outperforming. Hungary fared better than its regional peers following the positive news from the European Commission. As a result, the benchmark 3- and 10-year bond yields each plunged to levels below 8% in early May, having eased by ca 86bps and 106bps, respectively, since end-March. In Turkey, the yield of the 2-year government bond remained range-bound around 9.25-9.50% over the last month, largely shrugging off increased central bank monetary tightening. This compares with a 2-½-year high above 11.6% hit in early January. Meanwhile, the 10-year note slid to an 8-month in early May below the 9% level.

New Europe's **external debt markets** have mostly held onto year-to-date gains in recent weeks with better regional fundamentals continuing to lend support. Hungary and Ukraine, which had until recently underperformed their peers, led the weaners pack since late March. Indicatively, the **Hungarian 5-year CDS spread** narrowed to a 2-month trough near 495bps from a 3-month high of 603bps hit in late April. In view of the recent unexpected positive developments with the European Commission, further narrowing is possible, especially if the government moves closer to securing a financial aid deal with international lenders. However, widening risks remain, especially in the event that IMF/EU negotiations disappoint expectations. Elsewhere, Ukraine's 5-year CDS spreads eased to a 2-month trough near 760bps earlier in May some 100bps lower from a multi-month peak in mid-March.

**Figure 3**  
**External debt spreads hold onto this year's gains**



Source: Reuters, Bloomberg, EFG Eurobank Research

### Strategy - Emerging New Europe Markets

**Regional FX markets:** With the Central Bank of Turkey appearing determined to stick to its hawkish stance on inflation we maintain a constructive view on the lira. Additional monetary tightening is on the cards and a comparatively better domestic growth outlook vs. other EM peers remains a key support factor for the TRY. Against this background, we favor entering **short €/TRY positions** at current levels around 2.29 with a stop loss at 2.31 and a target of 2.26. We also favor **USD/TRY shorts** at 1.76 with an initial target of 1.74 ahead of the 1.72 level. **In our view, the short euro trade** is likely to outperform that against the USD, as rising euro area worries are likely to keep the single currency under pressure in the coming months. Regarding the Serbian dinar, lower policy rates in tandem with ongoing fiscal worries and political uncertainty ahead of the May 6 elections have kept the EUR/RSD rangebound within the 111-112 area in recent weeks. We see limited room for a break of that range, but we would not rule out entering a **small long EUR/RSD position** at current levels with a target of 113.50 and a stop loss below 110.00. We also prefer to stay **sidelined on the Romanian leu** in view of lingering political uncertainty, especially ahead of the November general elections and the June NBR policy meeting.

**In the sovereign credit space,** we maintain our earlier **long Turkish 5-year CDS** recommendation that remains *in the money* (entry level at 230bps, stop loss at the recent low of 210bps and target of 270bps). We reiterate that the recent rally in Turkey's 5-year CDS appears to have been overdone and a new rewidening trend appears possible from both a technical and a fundamental standpoint. We also maintain our **long Hungarian 5-year CDS spread** position (entry level at 545bps, stop loss at 490bps and target at 750bps). Although positive news from the European Commission stirred optimism about a new bailout agreement with official lenders, implementation risks still lie ahead.

Separately, we maintain our 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 55bps currently. We also keep our **long Romanian 10-year CDS and buy the Romanian 6¾ February 2022 USD-denominated bond** targeting a further narrowing of the basis from levels near 40bps now to 30bps. Finally, we also hold our previous call of going **long 5-year protection on Russia vs. shorting 5-year protection on Poland** at current levels near +10bps (target: -50bps), not far from our +15bps stop loss.

**In local rates markets,** we maintain our (in-the-money) **long position in Polish 2½ vanilla swaps** at current levels of -3bps, retaining our earlier target of +10bps with a stop loss at -7bps. That is on the basis that the Polish economy will likely outperform most of its regional peers this year on relatively healthier macro fundamentals.

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## II. New Europe – Country Analysis: Bulgaria

### Tapping the international markets after eleven years

- Near-term growth outlook of Bulgaria remained weak on headwinds from the Euroarea sovereign crisis and bad weather conditions: all short-term indicators were in the red in the first two months of 2012
- The government plans to issue Eurobonds after eleven years in May to address the redemption needs of January 2013

#### The government plans to issue Eurobonds at the end of May to address the redemption needs of January 2013

Bulgaria is about to tap the international markets after eleven years. The cabinet approved the issuance of five or seven year Eurobonds worth €950 mn. The issuance is geared to address the external debt redemption needs (1.8bn Leva-€835 mn) in January 2013. In principle, the budget law allows for the repayment of debt and the projected deficit to be financed through privatization receipts, short-term (up to three years) domestic market denominated securities and a Eurobond placement in the international market.

The decision comes at the right timing. The Ministry of Finance opted for this solution as market conditions are relatively favorable. The latter is illustrated in the EMBIG spreads of around 250bps. Having the second lowest public debt ratio in EU-27 (17% of GDP) and undershooting the fiscal targets (i.e. a deficit of 2.1% of GDP instead of a target of 2.5% in 2011) consistently signals government commitment to fiscal prudence. Moreover, Bulgaria never lost its investment grade credit rating status throughout the post-Lehman Brothers period. In addition, the issuance is going to repair the decline of the fiscal reserve, thus ensuring currency board stability. The fiscal reserve declined further by 25% yoy to BGN 3.8bn in February -below the BGN 4.5bn threshold stipulated in the Budget law.

#### Euroarea sovereign crisis and bad weather conditions weigh negatively on the growth outlook of Q1-2012

High frequency indicators suggest a weak performance in the first months of 2012. All major indicators were in recessionary territory. Bad weather conditions took their toll on economic activity as well:

| Bulgaria: Eurobank EFG Forecasts               |                |                |              |              |
|--|----------------|----------------|--------------|--------------|
|  | 2009           | 2010           | 2011         | 2012f        |
| <b>Real GDP (yoy%)</b>                         | -5.5           | 0.4            | 1.7          | 1.0          |
| Final Consumption                              | -7.3           | 0.5            | -0.3         | 0.8          |
| Gross Capital Formation (Fixed)                | -17.6          | -18.3          | -9.7         | 1.0          |
| Exports  | -11.2          | 14.7           | 12.8         | 2.0          |
| Imports  | -21.0          | 2.4            | 8.5          | 3.5          |
| <b>Inflation (yoy%)</b>                        |                |                |              |              |
| HICP (annual average)                          | 2.5            | 3.0            | 3.4          | 2.0          |
| HICP (end of period)                           | 1.6            | 4.4            | 2.0          | 1.8          |
| <b>Fiscal Accounts (%GDP) - Cash Basis</b>     |                |                |              |              |
| 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         |
| <b>Labor Statistics - National Definitions</b> |                |                |              |              |
| Unemployment Rate (registered, %)              | 9.1            | 9.2            | 10.4         | 10.0         |
| Wage Growth (total economy)                    | 11.8           | 6.4            | 9.1          | 3.5          |
| <b>External Accounts</b>                       |                |                |              |              |
| 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           | 14.1           | 14.9         | 15.0         |
| <b>Domestic Credit</b>                         | <b>2009</b>    | <b>2010</b>    | <b>Q3 11</b> | <b>Q4 11</b> |
| 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        |
| <b>Financial Markets</b>                       | <b>Current</b> | <b>3M</b>      | <b>6M</b>    | <b>12M</b>   |
| Policy Rate                                    |                | Currency Board |              |              |
| EUR/BGN  | 1.96           | 1.96           | 1.96         | 1.96         |

Source: National Sources, Eurostat, IMF, Eurobank Research

■ **Industrial Production:** The growth of industrial production has turned negative since December (-1.2% yoy). The downturn has accelerated sharply in February to -1.8% mom/-4.0% yoy. Apart from lower external demand, conjectural factors such as floods in the beginning of the month came into play.

■ **Industrial turnover:** The growth of industrial turnover has landed to single digits compared to 17.2% yoy in 2011. Industrial turnover advanced by 4.9% yoy in February vs. only 3.5% yoy in January. Once again, extreme winter conditions combined with an accident in one of the thermal power plants led to the suspension of electricity exports for a week.



- **Retail trade:** Retail sales in volume terms have been declining for eight months in a row. The contraction accelerated to -5.6% yoy in February, after a temporary improvement in December and January because of the Christmas holidays, at the same rate as in last October and November.
- **Business Sentiment:** Despite an improvement in March by 2.3pps, business confidence lies significantly below its last twelve month moving average
- **Exports:** Export activity registered its first negative annual growth rate in last January since 2009. Exports declined by 6.1% yoy in Jan-February, whereas imports expanded by 7.1% yoy in the same period.
- **Current account turned again red in the first two months:** Current account deficit came at 1% of GDP in Jan-Feb vs. a 0.9% surplus in 2011.

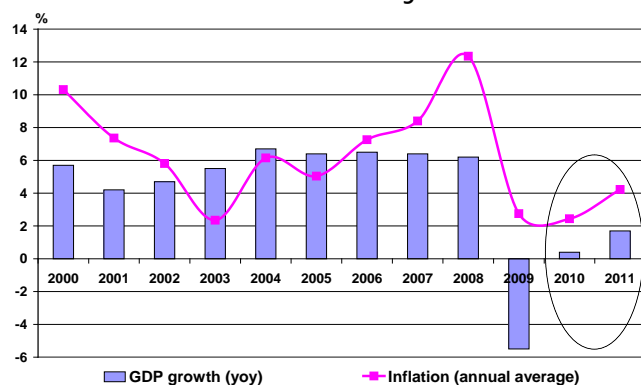
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### Full year growth outlook remains weak given the challenges exporters are going to face in 2012

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 of 2009. Looking ahead, we have downgraded our forecast for 2012 to 1% from 1.3% earlier. Our forecast is still built upon two assumptions. Firstly, it assumes that there will be another round of painful recession of domestic demand. Thus, the principal growth driver will switch to domestic demand from net exports given that a number of downside risks have started materializing for exporters. Secondly, it assumes a mild recession in Euroarea (our dedicated economists' forecast has been revised downwards to -0.3% 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.

**Figure 1**  
Output rebound in 2010-2011 has been lackluster after the recession in 2009



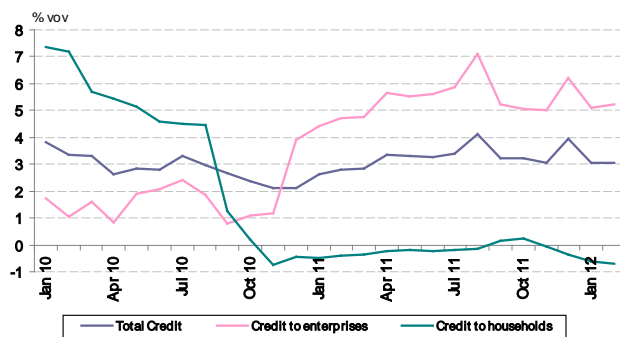
Source: National Statistics, Eurobank Research

**Focus: Latest developments in the Bulgarian banking sector**

**Credit conditions remain subdued in Q1:2012**

The pickup of credit activity in December 2011 (1.5%/4.1% mom/yoy) was only temporary, as credit growth decelerated during Q1:2012. On a yearly basis, private sector credit slowed to 3.1% yoy in February 2012, down from 3.9% yoy in the end of 2011 (Figure 1). The slowdown in credit growth came mainly as a result of the contraction in households lending (-0.1%/-0.7% mom/yoy in February 2012). The consumer lending stock has dropped by almost 1% since October 2011, due to the uncertainty about incomes and jobs as well as the negative sentiment stemming from high unemployment.

**Figure 1**  
**Private sector credit growth**

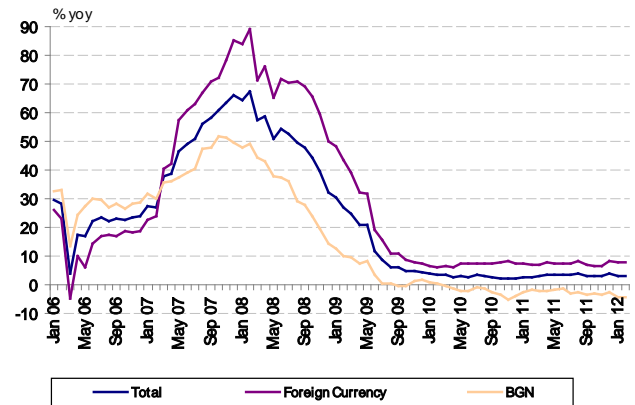


Source: Bulgarian National Bank, Eurobank Research

In contrast, corporate credit still supports total credit single-handedly and has been accelerating since September 2010. In February 2012, the corresponding figure stood at -0.13%/5.2% mom/yoy, little down from 1.6%/6.2% mom/yoy in the end of 2011. In terms of currency breakdown, credit in foreign currency has gained further share. It remained high in February 2012 (0.0%/8.0% mom/yoy) compared to November 2011 (0.7%/6.5% mom/yoy), whereas local currency credit further dropped by 0.5%/4.5% mom/yoy.

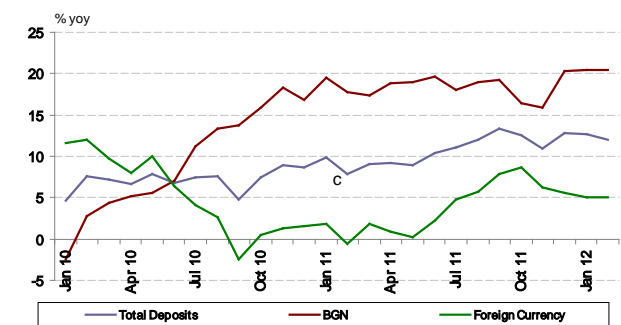
From a longer term perspective, credit growth has remained subdued since the Lehman Brothers collapse in September 2008, which brought an abrupt end in the lending boom in Bulgaria (Figure 2). Credit growth averaged 6.5% yoy in the period Q4:2008-Q1:2012, while between Q1:2004 and Q3:2008 the corresponding figure ran at 43% yoy (nominal terms). The correlation between GDP and credit growth has been positive between H1:2004 and H2:2008. On the other hand, from July 2009 onwards the correlation turned negative (about -0.6).

**Figure 2**  
**Total credit growth**



Source: Bulgarian National Bank, Eurobank Research

**Figure 3**  
**Local currency deposits**



Source: Bulgarian National Bank, Eurobank Research

**Deposit growth accelerated in Q1:2012 with local currency deposits as a major contributor**

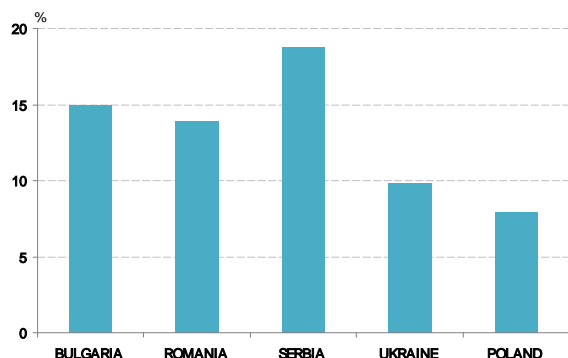
Deposit growth remained robust in Q1:2012. The figure remained unchanged at 0.0%/12.0% mom/yoy in February 2012, marginally down from 2.8%/12.8% mom/yoy in December 2011 (Figure 3). The locomotive for this are deposits in Leva, instead of foreign exchange. Local currency deposits represented 53.4% of total in February 2012, whereas the corresponding ratio in February 2011 stood at 49.9%. In addition, it is very encouraging that deposits in foreign currency were relatively stable (-1.0%/5.0% mom/yoy).

Breaking down the components of deposit dynamics, households' deposits increased by 14.1% yoy in February 2012, down from 14.4% yoy the previous month. Likewise, non financial corporations' deposits followed a similar trend, as the figure increased by 9.1% yoy, down from 10.3% yoy in January 2012. Note that in the long term, deposits have increased significantly by 32% since September 2008 cumulatively, as households and corporates have started to save more and pay back their debts.

### Although NPLs peaked in Q4:2011, the financial soundness of the banking sector remains overall healthy

Following the crisis of 2008/2009, NPLs increased rapidly across countries of Eastern Europe and reached high levels compared to those prior to the financial crisis. NPLs problems became more pronounced in those countries where the recession was particularly deep and where the pre-crisis credit boom had been more rapid. In Bulgaria, Non-Performing-Loans (loans overdue more than 90 days) to total loans ratio climbed to 14.93% at the end of 2011 compared to 11.9% in the end of 2010. The figure remained the second highest in December 2011 among those of New Europe's countries (Figure 4).

**Figure 4**  
**Non-Performing-Loans in New Europe (2011)**



Source: Central Banks, Eurobank Research

Bulgaria's banking system remains well-capitalized. Total capital adequacy ratio stood at 17.53% in Q4:2011, slightly lower than 17.75% in Q3:2011; Tier I capital adequacy ratio also remained high, at 15.74% at the end of 2011. Bulgaria's banking sector is still profitable. Although the profits were lower by almost 5% compared to Q4:2010, Bulgarian banks achieved a BGN 586mn (€299mn) net profit in Q4:2011. In addition, the ratio of liquid assets to total liabilities has improved. In December 2011, it stood at 25.57%, increased by almost 5% in comparison to last year's figure. The locomotive for this are both the modest lending growth and the healthy deposit expansion. As a result, the loans-to-deposits ratio dropped from 123.32% in November 2008, the highest level of the decade, to 101.8% in February 2012, the lowest level since Q1:2008.

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## II. New Europe – Country Analysis: Poland

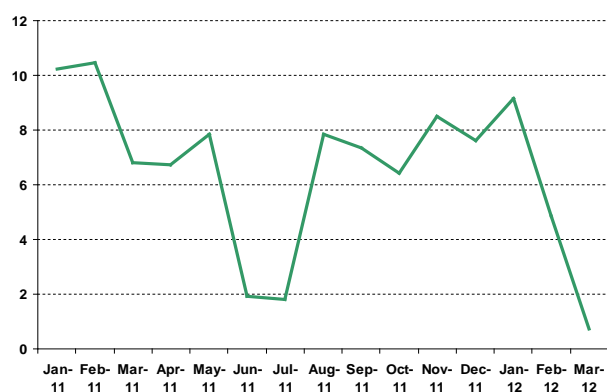
### Polish economy still resilient but exhibiting preliminary signs of slowdown

- Deeper than expected slowdown in industrial production; it expanded by just 0.7% yoy in March
- Inflation has started to ease; it stood at 3.9% yoy in March
- Key policy rate should remain unchanged on signs of economic slowdown coupled with inflation ease
- Both lending and deposits growth in positive territory

#### Polish economy shows the first signs of slowdown

Poland's resilience was confirmed by Q4-11 data, with the economy growing by 4.3% yoy. However, the more recent activity data have been disappointing. Industrial production expanded by an unexpectedly low rate of 0.7% yoy in March from 4.6% yoy recorded in February and 9.1% yoy in January. (Figure 1) What's more, PMI slowed to 49.2% in April from 50.1% in March.

**Figure 1**  
Deeper than expected slowdown in industrial production in the recent months



Source: National Bank of Poland, Eurobank Research

Household consumption also showed the first signs of slowdown; this was not surprising taking into account conditions in the labour market and the credit condition tightening. The labour market has deteriorated further with unemployment rising to 13.3% in March and employment slowing to 0.6% at the same month. Moreover, wage growth was subdued; it stood at just

| Poland: Eurobank EFG Forecasts          |                |             |              |              |
|---|----------------|-------------|--------------|--------------|
|   | 2009           | 2010        | 2011         | 2012f        |
| <b>Real GDP (% yoy)</b>                 | 1.6            | 3.9         | 4.3          | 3.1          |
| Private Consumption                     | 2.1            | 3.2         | 3.1          | 3.0          |
| Government Consumption                  | 2.1            | 4.3         | -0.8         | 0.5          |
| Gross Capital Formation                 | -11.5          | 9.3         | 10.0         | 7.0          |
| Exports                                 | -6.8           | 12.1        | 7.3          | 6.0          |
| Imports                                 | -12.4          | 13.9        | 5.9          | 5.8          |
| <b>Inflation (% yoy)</b>                |                |             |              |              |
| CPI (annual average)                    | 3.5            | 2.6         | 4.3          | 3.5          |
| CPI (end of period)                     | 3.5            | 3.1         | 4.6          | 3.2          |
| <b>Fiscal Accounts (% GDP)</b>          |                |             |              |              |
| General Government Balance              | -7.3           | -7.8        | -5.1         | -3.4         |
| Gross Public Debt (ESA95 definition)    | 50.9           | 54.9        | 55.0         | 54.9         |
| Gross Public Debt (national definition) | 49.9           | 52.8        | 53.5         | 53.5         |
| <b>Labor Statistics (%)</b>             |                |             |              |              |
| Unemployment Rate (% of labor force)    | 11.0           | 12.1        | 12.4         | 12.0         |
| Wage Growth (private sector - average)  | 5.2            | 4.2         | 5.2          | 4.5          |
| <b>External Accounts</b>                |                |             |              |              |
| Current Account (% GDP)                 | -3.9           | -4.6        | -4.3         | -4.0         |
| Net FDI (bn EUR)                        | 6.0            | 2.5         | 6.6          | 6.0          |
| FDI / Current Account (%)               | 76.9           | 40.6        | 65.0         | 60.0         |
| FX Reserves (bn EUR)                    | 55.2           | 70.0        | 60.0         | 74.8         |
| <b>Domestic Credit</b>                  | <b>2009</b>    | <b>2010</b> | <b>Q3 11</b> | <b>Q4 11</b> |
| 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        |
| <b>Financial Markets</b>                | <b>Current</b> | <b>3M</b>   | <b>6M</b>    | <b>12M</b>   |
| Policy Rate                             | 4.50           | 4.50        | 4.50         | 4.50         |
| EUR/PLN                                 | 4.16           | 4.10        | 4.20         | 4.10         |

Source: NBP, EcoWin, Bloomberg, Eurobank Research

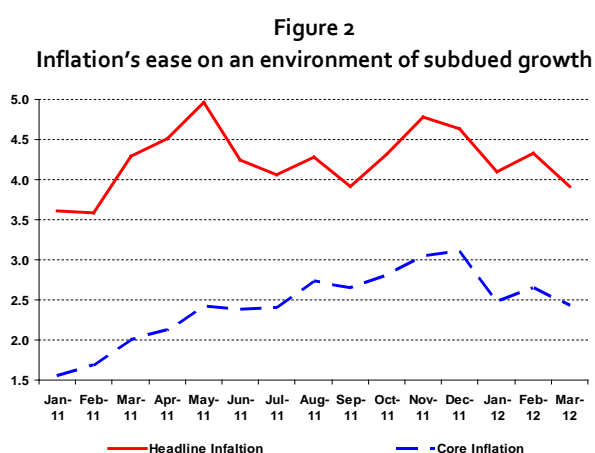
3.8% yoy in March. In addition, as a result of household incomes decline, retail sales slowed to 10.7% yoy in March. Although this figure looks impressive, it reflects mainly sales of investment goods related to Euro 2012 and the recent consumption boom.

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. However, the economy has started to show the first signs of slowdown as private consumption, which was the main engine of growth since

2010, has weakened and fiscal consolidation curbs domestic demand. We have pencilled a 3.1% yoy GDP growth in 2012 with risks to the downside should the Euro-zone economy fails to stabilise.

### Inflation has started to ease

Headline inflation slowed to 3.9% yoy in March from 4.3% yoy in February. This reading was the lowest in a year. Moreover, core inflation (measure which excludes food and energy prices) slowed to 2.4% yoy in March from 2.6% yoy in the prior month. (Figure 2)



Source: National Bank of Poland, Eurobank Research

We expect inflation to pick up a little in the coming months ahead of the Euro 2012 which the country co-hosts in June. However, this will likely be limited and temporary. Overall, we anticipate headline inflation to start converging slowly towards the target's upper limit (of 3.5% yoy) until the end of 2012 as price pressures should remain limited in an environment of subdued growth.

### Monetary policy on hold on signs of economic slowdown coupled with inflation ease

The National Bank of Poland (NBP), after having raised the key policy rate by 100bps between January and June last year, it has since remained on hold. Yet, MPC's (Monetary Policy Committee) rhetoric turned more hawkish than previously without ruling out interest rate hikes in the coming months. However, recent data suggest that downside risks to growth are more serious than previously anticipated. At the same time, inflation outlook has improved. In all, we foresee, in line with financial markets, the key policy rate to remain unchanged at 4.50% for the remainder of the year.

### Both credit and deposits are growing in annual terms

Total credit has decreased since last December; it contracted by 15% year-to-March, reflecting the credit conditions tightening. Yet, in March it grew by 0.7% mom and 12.2% yoy. Household credit contracted by 1.5% year-to-March while corporate lending remained flat during the same period. On the other hand, total deposits grew by 6.9% yoy in March. Consequently, loans to deposits ratio stood at 104.5% in March.

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## II. New Europe – Country Analysis: Romania

### No confidence vote unexpectedly brings down the Romanian government

- The Romanian government was toppled unexpectedly on April 27th by a 4 votes margin, two months after it took office, following a no confidence vote in Parliament
- The new government presented its programme in the parliament. Upon negotiations with IMF, the fiscal target of 2012 has been upwardly revised to 2.2% of GDP
- Recent high frequency data overstate the slowdown of the Romanian economy because of bad weather conditions so that the medium term growth outlook remains positive
- Financial stability concerns prompt Central Bank to maintain interest rates unchanged at 5.25%

#### Romanian government collapsed after an opposition motion of no confidence passed in parliament

The Romanian government was toppled unexpectedly on April 27th, two months after it took office, following a no confidence vote in Parliament. The motion passed with a majority of 235 MPs (4 more than required) from the opposition Social-Liberal Union and last minute defections from the ruling Democratic Liberal Party-PDL. Note that the Social-Liberal Union was formed by the national liberal party-PNL-and Romanian social democrats-PSD.

Political volatility had a negative impact on domestic financial markets. Initially, the EUR/RON pair traded in a volatile session at levels around 4.39 at the same day vs. 4.37 in late hours on April 26. The pressure from the political fall out had led leu to depreciate as much as 4.44. On May 7<sup>th</sup>, EUR/RON had reached 4.41, still above the threshold of 4.40. Year-to-date, the leu has depreciated by ca 2.1% against the euro on a cumulative basis.

Outgoing Prime Minister, Mihai-Razvan Ungureanu, was unable to fend off defections in the coalition that allowed his predecessor, Emil Boc, to survive 10 such motions in 2010-2011. Mr. Boc resigned in February 6, after violent protests broke out in Bucharest. Emil Boc's government introduced in July 2011 (and consequently implemented) a highly-unpopular fiscal austerity package, consisting of, among other measures: (i) a 25% cut in public-sector wages; (ii) a 5ppt VAT hike to 24%; and (iii) more than 100k lay-offs in the broader public sector.

| Romania: Eurobank EFG Forecasts           |                |             |              |              |
|---|----------------|-------------|--------------|--------------|
|   | 2009           | 2010        | 2011         | 2012f        |
| <b>Real GDP (yoy%)</b>                    | -6.6           | -1.6        | 2.5          | 1.0          |
| Real Domestic Demand                      | -12.0          | -1.5        | 2.8          | 0.7          |
| Consumption                               | -7.4           | -1.3        | 0.4          | -0.5         |
| Investment                                | -28.1          | -2.1        | 2.6          | 5.5          |
| Exports                                   | -6.4           | 14.0        | 11.7         | 5.0          |
| Imports                                   | -20.5          | 11.9        | 11.2         | 6.5          |
| <b>Inflation (yoy%)</b>                   |                |             |              |              |
| CPI (annual average)                      | 5.6            | 6.1         | 5.8          | 3.5          |
| CPI (end of period)                       | 4.9            | 8.0         | 3.1          | 3.4          |
| <b>Fiscal Accounts (%GDP, Cash Basis)</b> |                |             |              |              |
| General Government Balance                | -7.3           | -6.4        | -4.2         | -3.0         |
| Gross Public Debt                         | 30.0           | 37.3        | 39.5         | 41.0         |
| <b>Labor Statistics (annual avg,%)</b>    |                |             |              |              |
| Unemployment Rate (% of labor force)      | 7.8            | 7.0         | 5.1          | 6.5          |
| Wage Growth (total economy)               | 8.4            | 2.5         | 4.9          | 5.8          |
| <b>External Accounts</b>                  |                |             |              |              |
| Current Account (%GDP)                    | -4.2           | -4.4        | -4.3         | -4.7         |
| Net FDI (EUR bn)                          | 3.0            | 1.8         | 1.4          | 2.5          |
| FDI / Current Account (%)                 | 72.3           | 40.5        | 31.7         | 37.0         |
| FX Reserves (EUR bn)                      | 30.9           | 36.0        | 37.2         | 35.0         |
| <b>Domestic Credit (end of period)</b>    | <b>2009</b>    | <b>2010</b> | <b>Q3 11</b> | <b>Q4 11</b> |
| Total Credit (%GDP)                       | 50.2           | 52.7        | 52.3         | 50.6         |
| Credit to Enterprises (%GDP)              | 19.6           | 20.4        | 20.8         | 19.9         |
| Credit to Households (%GDP)               | 20.4           | 19.9        | 19.0         | 18.0         |
| FX Credit/Total Credit (% private)        | 60.1           | 63.0        | 63.6         | 63.4         |
| Private Sector Credit (yoy)               | 0.9            | 4.7         | 6.5          | 6.6          |
| Loans to Deposits (%)                     | 130.6          | 137.7       | 140.0        | 141.9        |
| <b>Financial Markets</b>                  | <b>Current</b> | <b>3M</b>   | <b>6M</b>    | <b>12M</b>   |
| Policy Rate                               | 5.25           | 5.25        | 5.00         | 5.00         |
| EUR/RON                                   | 4.40           | 4.40        | 4.45         | 4.45         |

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

Social and political pressures to restore public wages have been on the rise lately, especially since 2012 is an election year. President Basescu reiterated on April 25 that the government needs to reverse public wage cuts effectively from June. From his part, the outgoing Prime Minister promised recently that the

Cabinet would discuss the issue with the IMF during a regular review of the present programme.

The opposition Social-Liberal Union now holds the majority in Parliament. According to the Romanian constitution, President Basescu (who is in office since 2009 by the support of **PDL**) nominated a new Prime Minister who will need to gain parliamentary backing. The required procedure proved straight forward and swift, although the risk of political acrimony and a tense domestic political environment remains, at least for the short-term. Opposition leader, Victor Ponta (PSD), took the nomination as Prime Minister, as was widely expected, and presented a new cabinet. The new cabinet presented its programme in the parliament

**The new government presented its programme in the parliament. Upon negotiations with IMF, the fiscal target of 2012 has been upwardly revised from 1.9% to 2.2% of GDP**

Romania is currently running a €5bn two-year precautionary arrangement with the IMF and the EU, following expiration of an earlier regular Stand By arrangement in March 2011. The Romanian government has already completed successfully four reviews under the present programme without making any use of the designated funds so far. The fifth review of the current programme started on April 24 and was about to finish on May 7. The review was postponed until the formation of a new government.

Upon the formation of the new cabinet and further negotiation between the government and the IMF, an agreement was reached on the revision of the fiscal target of 2012. 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) in 2012. The budget deficit target (in cash terms) was increased from 1.9% to 2.2% of GDP in order to create room for public wages to rise. The public wages will be restored to the level before the 2010 cut (a measure that will cost 0.4% of GDP) and the health contributions (which were incorrectly calculated and amount to 0.1% of GDP) will be returned to pensioners. Nevertheless, the fiscal deficit target in ESA95 terms remained unchanged at 3% of GDP.

The budget execution data bring the fiscal deficit to 0.6% of GDP in Q1, in line with the full year target. The consolidated budget deficit reached RON 3.40bn in Q1. Consolidated budget revenues in January-March 2012 stood at RON 45.7bn, up by 9.9% yoy in nominal terms, while consolidated budget expenses stood at RON 49.1bn, up by 4.9% in nominal terms compared to a year earlier.

The new government under the leadership of the social democrats-**PSD and Prime Minister designate**, Mr. Victor Ponta, presented its programme in the parliament. The document reflects the government commitment and support for

the continuation of the IMF precautionary programme. On the other hand, the risk of fiscal slippage in view of the heavy election calendar in 2012 (local elections in June-parliamentary elections in December) is material. The rating agencies (Fitch and Moody's), have already warned about the risks of a downgrade in the long term credit rating if fiscal slippages are generated in the future.

**Romanian economy in much better shape now than in the pre-crisis period**

Having emerged from an earlier recession, the economy expanded by 2.5% in 2011, for the first time since 2008. Our GDP forecast in 2012 stood at 1% subject to downside risks due to the Euroarea sovereign crisis. Inflation declined to 3.1%YoY last December, a historical low, coming in well within the NBR's respective target range (3% +/- 1%YoY). At the same time, the current account deficit ended at 4.2% of GDP, far from the unsustainable pre crisis levels. Romania has made visible progress in fiscal consolidation in the last couple of years, managing to reduce the general government deficit (on a cash basis) from 7.3%-of-GDP in 2009 to 4.2%-of-GDP year amid a highly uncertain domestic economic environment.

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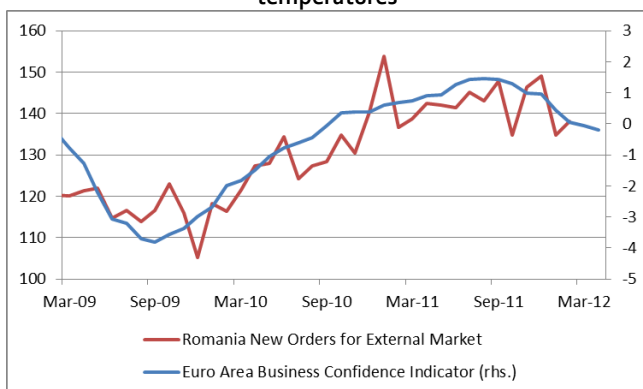
**Focus: Growth outlook: Bad weather leads to sharp slowdown of economic activity. However, medium term growth outlook remains positive**

The Romanian winter turned particularly harsh starting from February. Heavy snowfalls and snowstorms as well as low temperatures took their toll on infrastructure and significantly slowed down economic activity.

Industrial production, retail sales shrank 1.4% and 2.5% respectively while construction increased 1.6% due to civil engineering works. Subsequently, there is a material risk of the economy shrinking for a second consecutive quarter on a seasonally adjusted basis (also referred to as technical recession). However, we believe talks of a double-dip recession in Romania are premature. The contraction of economic activity came as a direct result of two consecutive exogenous shocks: the strong agricultural output in Q3.2011 created a negative base effect in Q4.2011, while the harsh winter conditions lead to a slowdown of activity in Q1.2012.

Aggregate industrial production shrank by 1.4% in February. However, the aggregate numbers also reflect a surge in the production of electricity and gas which increased by +14.9% compared with the previous month on seasonally adjusted data. Mining and quarrying recorded the sharpest decline -7.5% mom, while manufacturing shrank by 2.3% (Figure 1).

**Figure 1**  
**Electricity and gas output surged in February due to low temperatures**



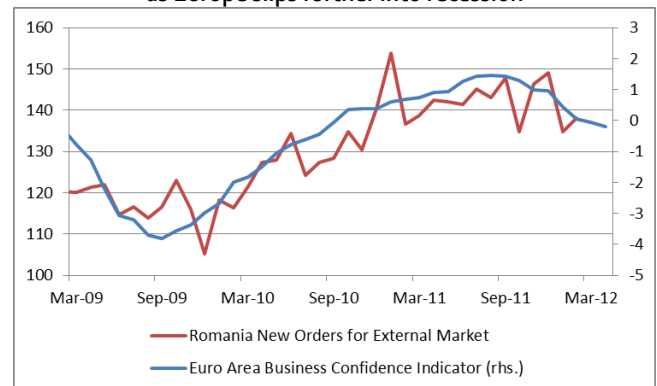
Index, 2005=100, seasonally adjusted data  
Data Source: Eurostat

Encouragingly, the dynamics of sentiment indicators have remained stable in spite of these adverse shocks. The confidence indicator for Romania's industrial sector – as measured by the European Commission Managers' surveys has been recovering since September 2011 and reached 49.4 points in April 2012, albeit remaining below the critical level of 50 points which points towards contraction of the sector. Similarly, production

expectations for the months ahead improved from 51.35 points in October 2011 to 55.9 points in April 2012.

However, the medium term outlook remains mildly contractionary as Europe's economy slips further into recession. The annual growth rate of new orders for the external market has been ebbing away since Q3.2011 and has now fallen to negative levels for the first time since January 2009: -1.3% in February (Figure 2).

**Figure 2**  
**The outlook for external new orders remains broadly negative as Europe slips further into recession**



Index, 2005=100, seasonally adjusted data, 6-month lagged data for BCI  
Data Source: Eurostat, European Commission

Construction of new residential buildings also shrank in the first two months of the year with a reading of -2.4% yoy in February, after having picked up quickly in the last quarter of 2011 (14.5% yoy in December). However, we believe this sharp slowdown has also been influenced by the harsh winter conditions. Business managers in the construction sector indicated that the role of weather as a deterrent of their activity has increased by 36% mom in February. Against this backdrop, we expect to observe a mild rebound of construction activity in the forthcoming months.

Retail sales appear to have been equally affected by the harsh winter. The sector contracted by 2.5% in February compared with to the previous month on a seasonally adjusted basis. Moreover, we have observed a sharp divide between sales of food, which increased by 3% mom, and non-food products, which shrank by 4.9% mom. This pattern was most likely formed by consumers stockpiling food ahead in anticipation of the snowfalls.

Similarly to industrial production, sentiment indicators have remained relatively stable. The intention to make major purchases increased by 1% mom in February, while the perceived financial situation of the representative household increased by 1.8% mom.

Cumulatively, we believe recent data overstate the slowdown of the Romanian economy and that the medium term growth outlook remains positive.

### Monetary policy: Inflation rate falls to historic lows, but concerns regarding financial stability prompt a pause of the NBR's policy relaxation

The adverse weather also had repercussion on the inflationary environment. Food prices increased by 1.2% mom in February, the sharpest rise in the past 12 months. Nevertheless, headline inflation declined to 2.6% in February and 2.4% in March on the back of a favorable statistical base effect.

Even though the March figure is the lowest inflation level ever recorded in Romania, it still marks a 0.4pp overshooting of the NBR's February inflation forecast (2% for the end of Q1.2012). However, CORE3 inflation has come in lower than the Bank's February forecast at 2.1% vs. 2%.

These dynamics show that underlying inflationary pressures remain low in spite of the higher than expected headline figure. Moreover, we estimate headline inflation will end the year within the NBR's target interval of 3%  $\pm$ 1pp even after accounting for adverse shocks.

While the inflationary environment remains broadly benign, financial volatility has grown in recent weeks. The no confidence vote and the formation of a new government have amplified the volatility of capital flows and subsequently the exchange rate.

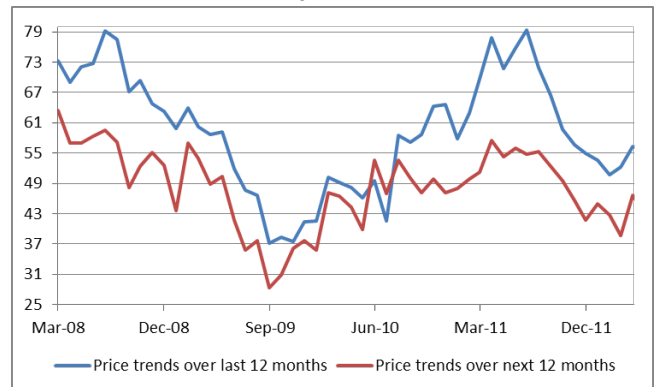
Against this backdrop, the NBR has decided to adopt a prudent position and paused its rate cutting cycle. The relaxation of monetary policy had begun in November 2011 and consisted of four consecutive rate cuts of 25bp each to 5.25%. The effect on interbank rates was further amplified by regular liquidity injections through REPO operations. Subsequently, the 3 Month ROBOR rate fell from 6.1% in November 2011 to 4.5% at the end of April 2012.

The NBR's stance on inflation remains dovish. However, the bank's communiqué signaled an increasing focus on maintaining financial stability. We believe the Central Bank has adopted a wait-and-see approach in order to avoid increasing the volatility of capital flows.

We believe this wait-and-see approach is also justified by recent changes of inflationary expectations. European Commission surveys show that perceived price trends over the last 12 months and expectations for the next 12 months have increased since the beginning of 2012 (Figure 3).

Should financial volatility recede and inflationary expectations stabilize, we believe there is a significant chance for the NBR to resume its rate cutting cycle as early as June.

**Figure 3**  
Inflationary expectations have increased since the beginning of 2012



Balance of positive answers

Data Source: European Commission

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## II. New Europe – Country Analysis: Serbia

### A challenging domestic macroeconomic outlook

- Presidential elections are going to be held together with parliamentary and local elections on May 6<sup>th</sup> ; Opinion polls bring the ruling Democratic Party (DS) in the second place against its main rival Serbian Progressive Party (SNS)
- Revised fourth quarter output performance disappoints: GDP growth came at -0.3% qoq /+0.4% yoy, down from 0.7% yoy in the third
- The Central Bank maintained interest rates unchanged at 9.5% in April for a third month in a row and mobilized the tool of required reserves on top of significant FX intervention to address local currency weakness

#### President Boris Tadic resignation from his post paves the way for Presidential elections on May 6<sup>th</sup>, at the same time with parliamentary and local elections

Presidential elections will be held together with parliamentary and local elections on May 6<sup>th</sup>. In an attempt to improve the electoral chances of the ruling Democratic Party (DS) in the forthcoming parliamentary elections, President Tadic stepped down on April 4<sup>th</sup>. The presidential term was officially scheduled to expire in February 2013, eight months from now. His main opponent, Mr Tomislav Nikolic, leader of the main opposition Serbian Progressive Party (SNS) is ahead in polls by a close margin of two percentage points. As no candidate is expected to win an outright majority in the first round, a second round will take place on May 20<sup>th</sup>. In case the incumbent pro European president is re-elected, this would be his third term in office. On the other hand, his main rival Mr Tomislav Nikolic, has differentiated himself significantly from the hard-line, anti-EU and pro-Russian position he supported in the elections of 2008, as part of the agenda of his former party (SRS-Serbian Radical Party).

#### The new coalition government will be confronted with significant challenges in the post-election landscape

On the parliamentary elections front, the Serbian Progressive Party (SNS) still leads the public opinion polls. However, after the approval of EU candidate status for Serbia on March 1<sup>st</sup>, the margin has slightly closed in favor of the ruling Democratic Party (DS) from around 7pps in late December to 5pps in late April. In any case, the probability of a single party government in

| Serbia: Eurobank EFG Forecasts           |                |             |              |              |
|--|----------------|-------------|--------------|--------------|
|  | 2009           | 2010        | 2011         | 2012f        |
| <b>Real GDP (yoy%)</b>                   | -3.5           | 1.0         | 1.7          | 0.5          |
| <b>Inflation (yoy%)</b>                  |                |             |              |              |
| CPI (annual average)                     | 8.1            | 6.2         | 11.2         | 5.5          |
| CPI (end of period)                      | 6.6            | 10.3        | 7.0          | 6.0          |
| <b>Fiscal Accounts (%GDP)</b>            |                |             |              |              |
| General Government Balance               | -4.5           | -4.6        | -4.8         | -4.4         |
| Gross Public Debt                        | 38.2           | 44.8        | 47.9         | 44.5         |
| <b>Labor Statistics (%)</b>              |                |             |              |              |
| Unemployment Rate (%of labor force, ILO) | 16.9           | 19.2        | 23.0         | 19.0         |
| Wage Growth ( <i>total economy</i> )     | -3.3           | 7.5         | 11.2         | 5.0          |
| <b>External Accounts</b>                 |                |             |              |              |
| Current Account (% GDP)                  | -7.2           | -7.6        | -9.1         | -8.5         |
| Net FDI (EUR bn)                         | 1.4            | 0.9         | 1.8          | 1.0          |
| FDI / Current Account (%)                | 65.9           | 41.3        | 61.6         | 75.0         |
| FX Reserves (EUR bn)                     | 10.6           | 10.0        | 12.1         | 10.5         |
| <b>Domestic Credit</b>                   | <b>2009</b>    | <b>2010</b> | <b>Q3 11</b> | <b>Q4 11</b> |
| 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        |
| <b>Financial Markets</b>                 | <b>Current</b> | <b>3M</b>   | <b>6M</b>    | <b>12M</b>   |
| Policy Rate                              | 9.50           | 9.00        | 9.00         | 9.00         |
| EUR/RSD                                  | 111.83         | 115.00      | 115.00       | 115.00       |

Source: National Sources, IMF, Eurobank Research & Forecasting

the new 250 seats parliament is practically non existent. The election law provides proportional representation and no party is expected to collect the required amount of votes to reach majority. The most probable scenario would be for a new pro-European government coalition to be formed under the leadership of Democratic Party (DS) and a number of smaller parties as was the outcome in the previous elections.



The new cabinet will be confronted with significant challenges in the post-election landscape. The new coalition government will have to present a revised budget and introduce spending cuts in order to bring the fiscal deficit again within the targets agreed with the IMF (4.25% of GDP fiscal deficit target for 2012, 1% for debt guarantees) before the freezing of the precautionary agreement.

**Disappointing fourth quarter performance pulls down the full year estimate in 2011 at 1.6%; Preliminary Central Bank estimate brings output contraction to -1.5% yoy in the first quarter of 2012**

The revised data of the last quarter confirmed that Serbian economy registered a very poor performance in Q4-2011. GDP growth slowed to 0.4% yoy in Q4, compared to 0.7% yoy in Q3. On a qoq seasonally adjusted basis, output contracted by 0.3% qoq in Q4 after contracting by 0.7% qoq in Q3. As a result, Serbia is in recession from a technical point of view. Despite the slowdown in the growth environment in the 2H-2012, the full year output growth came at 1.6% yoy in 2011 compared to 1% in 2010. The main growth driver was investment while both consumption and net exports had a negative contribution.

Looking ahead, we anticipate a negligible growth rate in 2012 at best, provided that the recession in Euroarea remains shallow. For that to occur, the negative output performance in the 1H should be offset by a more positive 2H. The prospects of 2012 are clouded with concerns stemming from the Euroarea sovereign crisis, with potential repercussions on both capital and trade flows. At the same time, Serbia is more sensitive than any other economy in SEE because the tool of fiscal policy is constrained.

High frequency indicators paint a very gloomy picture of the domestic economy in Q1 2012. All of them (industrial production, retail trade, and exports) are in recessionary territory. To make things worse, bad weather conditions augmented the industrial production contraction of the industrial sector. The preliminary Central Bank estimate for the first quarter GDP growth brings contraction to 1.5% yoy, the first annual contraction in a quarter after Q1 2009.

**The Central Bank maintained interest rates unchanged at 9.5% for a third time in a row in April. The mobilization of the required reserves ratio together with strong FX intervention deterred further local currency volatility**

On April 9th, the NBS left the key policy rate unchanged at 9.5% for a third month in a row. The move was widely expected by Bloomberg consensus (15 out of 23 analysts expected no rate change). In addition to increased fiscal risks and the freezing of the IMF precautionary agreement, the Central Bank cited uncertainties in the 2H inflation outlook. These stem from rising imported prices due to the Dinar depreciation trend, higher post-

election administered prices and the impact of the new agricultural season.

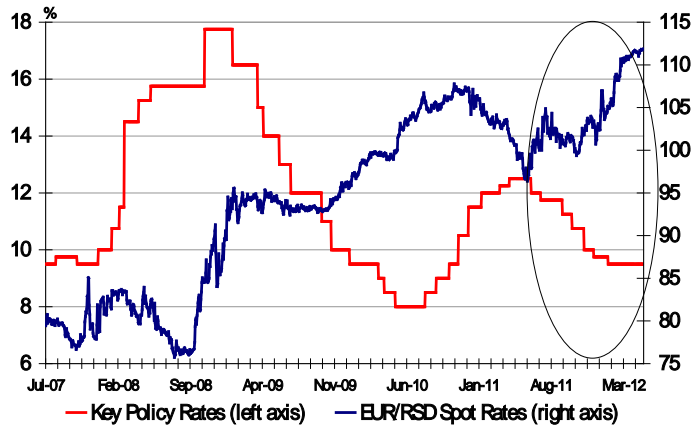
Inflation slowed even further to 3.2% yoy in March, down from 4.9% yoy in February and an average of 10.5% yoy in 2011 due to downward demand side pressures. The inflation reading lies within the crawling target range (4.4%+/-1.5%) of the Central Bank under the current inflation targeting regime. Inflation is expected to reach its trough during 2012 in April and then trend higher until year end, despite the growth outlook remaining weak, as a number of factors will come into play. First of all, the positive base effects from last year's food prices rally will phase out. Secondly, the new government is expected to hike administered prices (and most probably indirect taxes) in order to consolidate public finances. Last but not least, the impact of the new agricultural season on food prices- a large chunk of the consumer basket- is yet to be known. That said, we anticipate NBS to remain on hold until uncertainties in the political landscape and fiscal outlook clear out, even though the medium term inflation outlook remains relatively benign. In addition, the risks posed by the Euroarea sovereign crisis together with the depreciation pressures necessitate a more cautious approach.

More importantly, the Central Bank mobilized the tool of reserve requirements in order to release €300mn of FX liquidity in the market. On the one hand, it reduced the minimum reserves requirement in FX (by 1pps to 29% on maturities up to 2 years-by 3pps to 22% on maturities over 2 years). On the other hand, it increased the share of FX required reserves allocated in Dinars (to 20% for maturities up to 2 years-to 15% for maturities over 2 years).

For the time being, the decisive FX intervention of the Central Bank has led Dinar volatility to subside. The Dinar has stabilized little below 112/€ (at 111.85/€ on May 1<sup>st</sup> above the critical threshold of 110/€), for the first time in the post Milosevic era. The Central Bank has spent €708mn (half of it during April-May) since the beginning of 2012 in order to support the domestic currency. The risk of further depreciation looms even after the elections if challenges are not properly addressed. The macroeconomic outlook is full of challenges given the freezing of the IMF precautionary agreement, the political uncertainty stemming from the forthcoming parliamentary elections, and the growing imbalances in a recessionary environment. The current account deficit remained sizeable at 9.1% of GDP while gross external debt stood at 74.5% of GDP in 2011. Fiscal slippage ahead of the elections made the need for fiscal consolidation more evident. Public debt edged at 45.1% of GDP in 2011.

Figure 1

NBS kept interest rates unchanged at 9.5% for a third month in a row



Source: NBS, Bloomberg, Eurobank Research

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## II. New Europe – Country Analysis: Turkey

### CBT maintains hawkish tone

- Recent evidence suggests that economic slowdown may have bottomed out in Q1
- Pace of improvement in external imbalances picks up

#### Recent evidence suggests that economic slowdown may have bottomed out

After recording stellar real GDP growth of 8.5% in 2011, Turkey's economy appears to have slowed down sharply over the first three months of the year primarily on the back of unfavorable base effects. Ongoing monetary tightening from the Central Bank since late last year and the adverse external environment, which weighs on business and consumer sentiment, also add to the domestic economic deceleration. In response, labour market conditions have deteriorated over recent months, with the three-month rolling unemployment rate at 10.2% over the December-February period standing at its highest level in nearly a year.

Even so, a gradual recovery will likely be witnessed in Turkey's economy from Q2-2012 onwards as the impact of negative base effects over the first quarter of the year wanes, while the negative contribution of net exports weakens as consumption and investment growth is contained. The rebound is already being reflected in several macroeconomic indicators and expectations surveys. Indicatively, manufacturing confidence rose to an 11-month peak of 116 in April, standing above the 100-point threshold separating pessimism from optimism, and capacity utilization came in at 74.7 over the same month, returning to its highest level since January. In addition, the HSBC Manufacturing Purchasing Managers' Index (PMI) for Turkey rose to a 5-month peak of 52.3 in April from 49.6 in March, bouncing above the boost-or-burst threshold of 50 for the first time in three months. Industrial production which weakened sharply at the start of 2012 on the back of unfavorable weather conditions and rising global uncertainties will likely recover in the second quarter as the slowdown seemed to be exacerbated by temporary factors.

Under its medium-term programme, the government envisions real GDP growth of 4% this year, while the Economy and Industry Ministers left the door open for a 5% expansion, or even higher. These figures are above our 3% projection and further beyond the IMF's 2.3% forecast. In our view, growth headwinds in the face of tighter monetary conditions, the euro area's debt crisis and higher oil prices, especially due of the

#### Turkey: Eurobank EFG Forecasts

|                                     | 2009  | 2010           | 2011E        | 2012F        | 2013F        |
|-------------------------------------|-------|----------------|--------------|--------------|--------------|
| <b>Real GDP (yoy%)</b>              | -4.8  | 9.2            | 8.5          | 3.0          | 4.5          |
| Private Consumption                 | -2.3  | 6.7            | 7.7          | 1.0          | 1.5          |
| Govern. Consumption                 | 7.8   | 2.0            | 4.5          | 2.0          | 2.5          |
| Gross Capital Formation             | -19.0 | 30.5           | 18.3         | 5.0          | 7.5          |
| Exports                             | -5.0  | 3.4            | 6.5          | 5.5          | 6.5          |
| Imports                             | -14.3 | 20.7           | 10.6         | 1.2          | 3.5          |
| <b>Inflation (yoy%)</b>             |       |                |              |              |              |
| CPI (annual average)                | 6.3   | 8.6            | 6.4          | 9.4          | 6.7          |
| CPI (end of period)                 | 6.5   | 6.4            | 10.5         | 7.5          | 5.5          |
| <b>Fiscal Accounts (%GDP)</b>       |       |                |              |              |              |
| Central Government Balance          | -5.5  | -3.6           | -1.4         | -1.5         | -1.3         |
| Gross Public Debt                   | 45.4  | 42.5           | 40.0         | 38.0         | 36.0         |
| Primary Balance                     | 0.1   | 0.8            | 1.9          | 2.0          | 2.1          |
| <b>Labor Statistics (%)</b>         |       |                |              |              |              |
| Unemployment Rate (%of labor force) | 13.5  | 12.0           | 9.5          | 10.5         | 10.2         |
| <b>External Accounts</b>            |       |                |              |              |              |
| Current Account (% GDP)             | -2.3  | -6.5           | -9.9         | -8.0         | -7.5         |
| Net FDI (USDbn)                     | 6.9   | 7.3            | 13.4         | 12.5         | 13.5         |
| FDI / Current Account               | 46.9  | 12.0           | 17.4         | 19.0         | 22.0         |
| FX Reserves (USDbn)                 | 69.6  | 80.7           | 78.3         | 77.0         | 78.0         |
| <b>Domestic Credit</b>              |       | <b>Q2 11</b>   | <b>Q3 11</b> | <b>Q4 11</b> | <b>Q1 12</b> |
| Total Credit (%GDP)                 |       | 44.1           | 47.1         | 48.8         | 46.2         |
| Credit Private Sector (%GDP)        |       | 42.5           | 45.5         | 47.2         | 44.8         |
| FX Credit/Total Credit (%)          |       | 22.5           | 24.6         | 24.4         | 23.8         |
| Private Sector Credit (%yoy)        |       | 43.3           | 44.8         | 34.7         | 28.0         |
| Loans to Deposits                   |       | 93.8           | 96.1         | 96.9         | 98.6         |
| <b>Financial Markets</b>            |       | <b>Current</b> | <b>3M</b>    | <b>6M</b>    | <b>12M</b>   |
| Policy Rate (1-week repo)           |       | 5.75           | 5.75         | 5.75         | 5.75         |
| USD/TRY (where applicable)          |       | 1.76           | 1.75         | 1.73         | 1.70         |

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

turmoil in the Middle East, will likely hinder a further recovery this year.

#### CBT maintains hawkish tone

At its April monetary policy committee meeting, Turkey's central bank held interest rates unchanged in line with expectations. Accordingly, the key policy 1-week repo rate remained at a record low level of 5.75%, while the overnight borrowing and lending rates were kept at 5.00% and 11.50% (11.00% provided for primary dealers) respectively. The CBT also maintained required reserve ratios (RRRs) for foreign currency and lira deposits at their earlier levels. Casting a rather more hawkish tone, the Committee noted in its accompanying statement that it "will not tolerate temporary factors to have an adverse impact

on the inflation outlook” and added that further monetary tightening may be instrumented in the forthcoming months in order to contain inflation pressures.

Notably, annual CPI disappointed expectations coming in at a 3-½-year peak of 11.14% in April. The increase was primarily driven by unfavorable base effects and hikes in electricity and gas prices that came into effect last month. Importantly, broad based increases in all of the core indices suggest rising risks to inflation. At its latest inflation report, the Central Bank noted that the additional inflationary impact of hikes in electricity and gas tariffs in April and higher-than-earlier-expected oil prices would be offset by past and future monetary tightening and thus kept its projections for end 2012 and 2013 unchanged. The CBT anticipates inflation to ease towards 6.5% by end-December – below our upwardly revised 7.5% forecast - as domestic demand remains relatively contained. This means that if this forecast is vindicated the CBT will miss once gain its target for the year (at 5% for 2012-14). For end-2013, it envisions a further deceleration to 5.2%, reiterating that in the medium-term inflation will decline to near 5%.

As a reminder, the CBT introduced in October last year a policy corridor consisting of the overnight lending and the key policy, one week repo, rates. By reducing the average amounts provided through its cheap means of funding, the 1-week repo auctions (5.75%), it increases the average cost of liquidity offered and simultaneously achieves a flexible monetary policy strategy. With an ongoing improvement in the current account deficit (CAD) already underway, the CBT appears to have recently turned its focus back on inflation. The effective funding rate has been shifted to levels above 8% since late March from around 7.5% since mid-January and in three separate incidents (Figure 1) it was pushed above 10% (December, March and April) in order to contain rising price pressures.

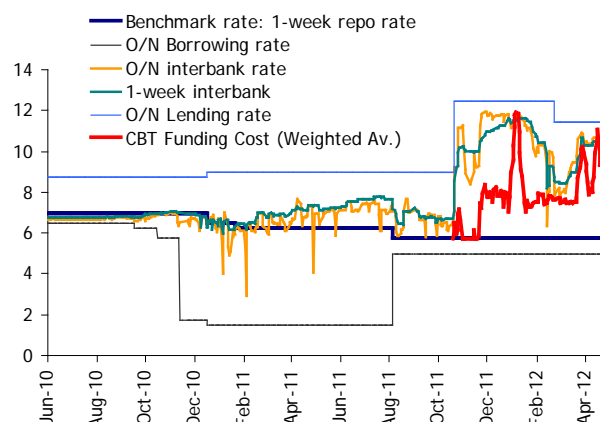
All in all, we anticipate the CBT to continue along its current monetary policy mix in the coming months, rendering additional bouts of increased monetary tightening in episodes of rising inflation risks and particularly in times of pronounced TRY weakness. These tightening periods are likely to be short in duration as the Bank will try to avoid exacerbating downside risks to the domestic economy, which is braced for a soft landing this year.

#### Pace of improvement in external imbalances picks up

The recent improvement in Turkey’s external imbalances appears to have picked up pace in February and March. In support of the aforementioned, March’s trade deficit narrowed by around 25% on an annual basis to \$7.35bn. Exports proved particularly resilient rising by 12.2%yoy to \$13.25bn, receiving assistance from the increased diversification of Turkish products towards non-EU countries and improved competitiveness due to

the lira’s depreciation against major currency peers since early 2011.

**Figure 1**  
**CBT renders significant tightening in three separate incidents since late 2011**



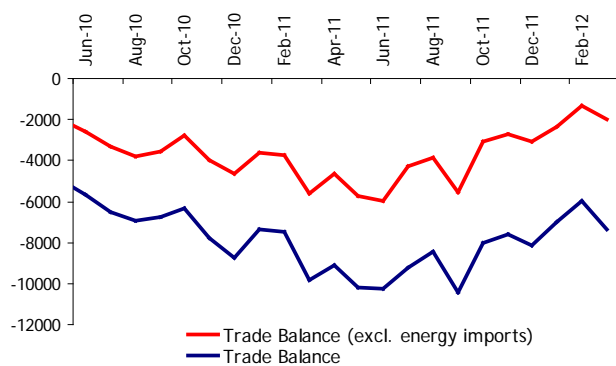
Source: National Statistics, CBT, Eurobank EFG Research

Exports towards non-EU countries and particularly the Middle East have marked notable increases in Q1-2012 offsetting a 1.5%yoy decline in exports directed to the EU27 region as a result of the deepening euro area debt crisis. Indicatively, exports towards Iraq (Turkey’s second largest trade partner currently after Germany) rose by 41%yoy over the first three months of the year, while those towards Egypt, Saudi Arabia and the USA recorded respective annual increases of 85%, 58% and 32% over the same period. Also supporting the narrowing of the trade balance in March, imports declined by 4.8%yoy to \$20.60bn in view of weakening domestic demand dynamics, with a more notable drop of 12.4%yoy registered when removing the energy imports item. It is worth noting that Turkey imports most of the energy it consumes, which as a result exerts widening pressures on the country’s trade and current account deficits.

As a consequence of the significant adjustment in March’s trade balance we anticipate the current account deficit, due to be released a few days later, to show a further improvement from February’s 16%yoy narrowing. In view of weaker domestic demand and ongoing exports’ geographical diversification the current account will likely continue to shrink in the months ahead. The government’s new incentive scheme announced in April, aimed at supporting the domestic industrial sector and containing the country’s elevated current account deficit, may also bear a positive impact. The plan which takes effect from January 2012, includes measures encouraging domestic investments, such as exemptions in custom duties and VAT as well as tax reductions for general, regional, large scale and strategic projects. Notwithstanding the aforementioned, the pace of improvement in the current account deficit may start slowing down in the coming months in view of higher oil prices and an expected pick up in domestic economic activity from Q2-2012 onwards.

Against this background we continue to anticipate a narrowing to 8%-of-GDP this year from 9.9% in 2011. However, in this area the shortfall remains at elevated levels and will continue to pose among Turkey's main macroeconomic vulnerabilities in the medium-term. S&P decided to revise Turkey's long-term foreign and local currency sovereign credit rating outlook to stable from positive in early May, citing weakening external demand and a deterioration in the terms of trade. At the same time, the agency affirmed the long- and short-term foreign currency sovereign credit ratings on Turkey at "BB/B" and its long- and short-term local currency ratings at "BBB-/A-3". In a similar tone, Moody's cast a warning message in March noting that the country's high external and internal imbalances could exert downward pressures on its credit ratings. However, the agency maintains its positive outlook on Turkey.

**Figure 2:**  
Energy imports exacerbate widening pressures on CAD (\$bn)



Source: National Statistics, Eurobank EFG Research

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## II. New Europe – Country Analysis: Ukraine

### Growth slowed more than expected in Q1-2012

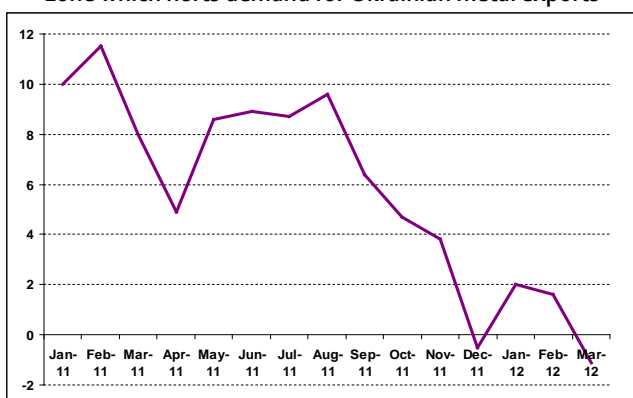
- Ukraine's economy has slowed sharply to 1.8% yoy in Q1-2012 driven by a slump in the industrial sector
- Industrial production contracted by 1.1% yoy in March after having grown by 7.1% yoy in 2011
- Inflation has remained low for the past few months, largely due to food prices decline in H2-11; it stood at 1.9% yoy in March
- Credit growth has decelerated while deposit growth has accelerated since the beginning of this year.

#### Real GDP growth in Q1-2012 stood below expectations

Growth of the Ukrainian economy slowed more significantly than expected to a very modest 1.8% yoy in Q1-2012, down from 4.7% yoy recorded in Q4-2011. This slowdown is mainly driven by a slump in the industrial sector. Industrial production contracted by 1.1% yoy in March and grew by a feeble 0.8% yoy in Q1-12 as a whole, after having grown by 7.1% yoy in 2011. (Figure 1) Industrial production's slowdown is largely attributed to weakened external demand on metals, particularly from the euro-zone and Russia, hitting Ukraine's steel industry. In addition to the slowdown in industry, agricultural production growth has slowed too on colder than usual weather condition in the first quarter.

Figure 1

Industrial production shrinks on slowing industry in the euro-zone which hurts demand for Ukrainian metal exports



Source: National Bank of Ukraine, Eurobank Research

| Ukraine: Eurobank EFG Forecasts      |                |             |              |              |
|--------------------------------------|----------------|-------------|--------------|--------------|
|                                      | 2009           | 2010        | 2011         | 2012f        |
| <b>Real GDP (% yoy)</b>              | -14.8          | 4.1         | 5.2          | 2.8          |
| Private Consumption                  | -1.5           | 2.2         | -1.6         | 4.0          |
| Government Consumption               | -2.4           | 4.0         | -2.2         | 1.0          |
| Gross Capital Formation              | -53.5          | 16.4        | 25.6         | 15.0         |
| Exports                              | -20.1          | 4.1         | 3.0          | 5.0          |
| Imports                              | -37.1          | 11.1        | 18.9         | 14.0         |
| <b>Inflation (% yoy)</b>             |                |             |              |              |
| CPI (annual average)                 | 16.0           | 9.4         | 8.0          | 5.5          |
| CPI (end of period)                  | 12.3           | 9.1         | 4.6          | 7.5          |
| <b>Fiscal Accounts (% GDP)</b>       |                |             |              |              |
| General Government Balance           | -8.7           | -6.5        | -4.2         | -4.0         |
| Gross Public Debt                    | 35.3           | 41.7        | 42.4         | 43.0         |
| <b>Labor Statistics (%)</b>          |                |             |              |              |
| Unemployment Rate (% of labor force) | 9.6            | 8.8         | 8.0          | 7.9          |
| Wage Growth (real - private sector)  | -9.8           | 6.7         | 10.7         | 12.5         |
| <b>External Accounts</b>             |                |             |              |              |
| Current Account (% GDP)              | -1.5           | -2.2        | -5.5         | -5.0         |
| Net FDI (bn USD)                     | 4.7            | 5.7         | 7.0          | 8.0          |
| FDI / Current Account (%)            | 268.7          | 190.8       | 77.9         | 65.0         |
| FX Reserves (bn USD)                 | 26.5           | 34.6        | 31.8         | 25.0         |
| <b>Domestic Credit</b>               | <b>2009</b>    | <b>2010</b> | <b>Q3 11</b> | <b>Q4 11</b> |
| 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        | 164.7        |
| <b>Financial Markets</b>             | <b>Current</b> | <b>3M</b>   | <b>6M</b>    | <b>12M</b>   |
| Policy Rate                          | 7.50           | 7.50        | 7.50         | 7.50         |
| USD/UAH                              | 8.04           | 8.10        | 8.20         | 8.10         |

Source: NBU, IMF, Bloomberg, Eurobank Research

By contrast, the consumer sector is holding up relatively well. Retail sales continue to grow by double digit figures supported by robust real wage growth and slowing inflation. Namely, retail sales grew by 12.6% yoy in March from 13.2% yoy in February. At the same time, real wage growth grew by 15.8% yoy in March down from 16.1% yoy in the prior month.

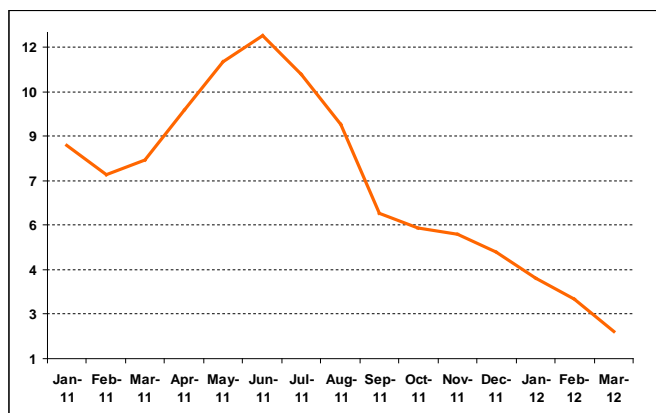
Admittedly, strong domestic consumption should compensate the lower performance of the industrial sector due to weaker export prospects. Downside risks to growth are also limited by the Euro 2012 football championship (co-hosted with Poland in June), which has increased investments. Moreover, the government is likely to increase spending ahead of parliamentary elections in October 2012. All in all, we anticipate economic growth to decelerate to 2.8% yoy in 2012 from 5.2% yoy recorded in 2011.

The outlook of 2012 is very uncertain; it will very much depend on whether or not Ukraine will manage to resume the IMF programme which has been on hold for a year as the government refuses to raise household natural gas costs 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. An IMF mission to Ukraine is scheduled for late May. Nevertheless, the parliament approved a supplementary budget rising total expenditure by \$4bn, the bulk of which is expected to be spent on various social programmes ahead of October's elections. This move demonstrates the prioritisation of inward political issues and does little to improve Ukraine's image in the international markets.

#### Inflation continues to slow

Consumer price inflation stood at 1.9% yoy in March, down from 3.0% yoy recorded in the prior month and an average of 8.0% yoy in 2011 as a whole. (Figure 2)

**Figure 2**  
Inflation has remained slow on food prices decline observed in H2-11



Source: National Bank of Ukraine, Eurobank Research

March data on inflation came out lower than expected. The 1.9% yoy reading is the lowest in the last nine years. Headline inflation's ease is attributed to food prices decline since the second semester of last year. However, we expect some inflation pressures to appear from price increases during the Euro 2012 championship and the possible rise in utility tariffs later this year,

should IMF loan resumes. Moreover, strong wage growth is expected to spur inflationary pressures. In all, we anticipate inflation to average at 5.5% yoy in 2012.

Lower inflation allowed the National Bank of Ukraine to cut its key policy rate by 25bps to 7.50% in late March, after having kept it unchanged since August 2010.

#### Total credit has decelerated while total deposits has accelerated since the beginning of this year

Total credit growth decelerated to 6.3% yoy in March from 8.1% yoy in February. This deceleration was once more attributed to household credit which contracted by 6.1% yoy in March while corporate lending accelerated by 10.7% yoy in the same month. On the other hand, total deposits grew by 14.5% yoy in March, from 15.5% yoy recorded in the prior month, driven both by corporates' and households' deposits (standing at 17.2% yoy and 12.4% yoy respectively). Consequently, the loans to deposits ratio dropped further to 157.5% in March 2012 from 169.7% recorded a year earlier. On a positive note, non-performing loans to total loans ratio stood at 10% in March, slightly down from 10.2% in February.

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## II. New Europe – Country Analysis: Albania

### Macroeconomic imbalance persist

The Albanian economy expanded by 3.8% yoy and 0.1% qoq in Q4-2011, according to the latest released data. Based on the quarterly GDP data, real growth in 2011 was 3.0% from 3.3% in 2010. Growth was supported mainly by external demand and a small fiscal stimulus. The IMF in its latest forecasts (April 2012) predicts a further deceleration of economic activity in 2012 to 0.5% and a pick up in 2013 to 1.7%. The Eurozone debt crisis and weak foreign demand are expected to hold the Albanian economy back.

Inflationary pressures remain contained. In March 2012 inflation was 1.0% yoy compared with 4.3% a year before, mainly due to stable food prices. Both the Bank of Albania (BoA) and the IMF expect low inflation rates in 2012, well in line with the BoA's medium-term target for 2%-4% annual inflation rate.

The government has set a target for the 2012 fiscal deficit to 3.0% of GDP from 3.5% in 2011. In the 1<sup>st</sup> quarter of 2012 the cash balance of the general government had a deficit of ALL - 11.5 bn, decreased by 2.5% compared to the same quarter in 2011. This though was almost three times higher than planned, since revenue were 5.0% less and expenditure 5.1% more than the budget's target for Q1-2012. It should be noted that there is little room for increasing public expenditure in 2012, since Gross Public Debt in 2011 was 58.8% of GDP, close to the 60% legal ceiling.

External imbalances remain strong. The current account (CA) deficit deteriorated in 2011 to 12.2% of GDP from 11.3% of GDP in 2010. The trade deficit increased by 13.8%, mainly because of increased fuel and electricity imports. This deterioration was only partially counterbalanced by small increases in the income and current transfers balances. The latter increased by 1.6% supported by remittances from expatriates (-0.3% yoy). Remittances were decreasing by -4.9% yoy in the first three quarters of 2011, but rebounded spectacularly in the 4<sup>th</sup> quarter increasing by 14.3% yoy. The CA deficit was financed mainly by FDI and an increase in deposits from non-residents. Net FDI decreased to 7.6% of GDP in 2011 from 8.8% of GDP in 2010. The future financing of the CA deficit is a risk, since FDI inflows may prove vulnerable to the deteriorating international economic and financial environment and non-residents deposits may reverse course, putting pressure to FX reserves.

| Albania: Economic data         |             |             |             |                |
|--------------------------------|-------------|-------------|-------------|----------------|
|                                | 2009        | 2010        | 2011        | 2012f          |
| <b>Real GDP (% yoy)</b>        | 3.6         | 3.3         | 3.0         | 0.5(IMF)       |
| <b>Inflation (% yoy)</b>       | <b>2009</b> | <b>2010</b> | <b>2011</b> | <b>2012f</b>   |
| CPI (annual average)           | 2.3         | 3.6         | 3.5         | 1.9(IMF)       |
| CPI (end of period)            | 3.7         | 3.4         | 1.7         | 3.1(IMF)       |
| <b>Fiscal Accounts (% GDP)</b> | <b>2009</b> | <b>2010</b> | <b>2011</b> | <b>2012f</b>   |
| General Government Balance     | -7.0        | -3.1        | -3.5        | -3.0(Gov)      |
| Gross Public Debt              | 59.8        | 58.2        | 58.8        | 59.6(Gov)      |
| Primary Balance                | -3.9        | 0.3         | -0.4        | 0.6(Gov)       |
| <b>Labor Statistics (%)</b>    |             |             |             |                |
| Unemployment Rate (%)          | 13.6        | 13.5        | 12.9        | 12.1(Gov)      |
| Wage Growth (State sector)     | 11.9        | 6.7         | -           | -              |
| <b>External Accounts</b>       |             |             |             |                |
| Current Account (% GDP)        | -15.2       | -11.3       | -12.2       | -13.2(IMF)     |
| Net FDI (bn EUR)               | 0.69        | 0.79        | 0.71        |                |
| FDI / Current Account (%)      | 55.3        | 84.5        | 67.1        |                |
| FX Reserves (bn EUR)           | 1.57        | 1.83        | 1.85        |                |
| <b>Domestic Credit</b>         | <b>2009</b> | <b>2010</b> | <b>2011</b> |                |
| 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        |                |
| <b>Financial Markets</b>       | <b>2009</b> | <b>2010</b> | <b>2011</b> | <b>Current</b> |
| Policy Rate (%)                | 5.25        | 5.0         | 4.75        | 4.25           |
| ALL/EUR (end of period)        | 137.1       | 138.5       | 138.3       | 140.1          |
| ALL/USD (end of period)        | 95.8        | 103.5       | 106.4       | 105.8          |

Source: BoA, INSTAT, IMF, Reuters

Credit expansion to the private sector was strong in the first quarter of 2012, registering a 9.0% yoy growth. Nonetheless, financial intermediation remains low, with total credit to the private sector reaching 38.4% of GDP in March 2012. Note that 65.4% of outstanding loans to the private sector are denominated in foreign currency. Deposits increased by 10.9% yoy in the 1<sup>st</sup> quarter of 2012. The loans to deposits ratio was just 62.2 in March 2012.

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

### 2011 fiscal deficit in line with the official target; revisions to 2012 official macro forecasts

FYROM's economy is expected to face serious challenges in 2012 and to slow down compared to 2011, when it registered a 3.0% real growth rate. The IMF in its latest forecasts (April 2012) has revised downwards its growth projections for 2012 to 2.0% from 2.5% previously. The Government in April also lowered its economic growth forecasts for 2012, from an unrealistic 4.5% to 2.5%. Foreign demand is expected to be weaker in 2012 due to the anticipated slowdown in the Eurozone, the country's main trading partner, and the effects of the Eurozone debt crisis. Domestic demand is also a risk due to unemployment remaining extremely high (31.8% in Q4-2011). Industrial production in the first quarter of 2012 contracted by 8.4% yoy. This was due to output declines in energy and export oriented industries. Recent ethnic tensions underlined non economic risks.

The National Bank of the Republic of Macedonia (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. Consumer prices rose by 2.2% yoy in April 2012, driven mainly by housing (including fuel and lighting), transport and communication services. The IMF expects inflation to slow down in 2012 to 2.0% (2011: 3.9%).

In 2011 the Central Government and Funds fiscal deficit was 2.55% of GDP, thus attaining the 2011 budget target. This is the second year in a row that the fiscal deficit target is met. The deficit was financed mainly from the standing two year Precautionary and Liquidity Line (PLL) agreement with the IMF. In April 2012 the government revised the 2012 budget on the back of the deepening debt crisis in the Eurozone and a more realistic GDP forecast. It kept the deficit target to 2.5% of the projected GDP (for a third year in a row) but expenditures and revenues were cut by 5.3% and 4.7% respectively. The PLL agreement with the IMF reduces financing risks, since available resources reach ca. 3.0% of projected GDP. In the first two months of 2012 the fiscal deficit reached -0.7% of projected GDP. Central government debt increased to 28.2% of GDP in 2011 (24.6% of GDP in 2010). IMF projections put it to 30.5% of GDP in 2012.

Credit expansion to the private sector was strong in March 2012, registering an 8.0% yoy growth. Note that 27.4% of outstanding loans to the private sector are denominated in foreign currency and a further 28.0% have an FX clause. Deposits grew by 9.5% yoy in March with 47.2% of deposits being denominated in

foreign currency. The loans to deposits ratio was a healthy 89.1% in March 2012. Doubtful and contested loans reached 9.7% of total loans in December 2011, increasing by 16.0% yoy.

| FYROM: Economic data                 |             |             |             |                |
|--------------------------------------|-------------|-------------|-------------|----------------|
|                                      | 2009        | 2010        | 2011        | 2012f          |
| <b>Real GDP (% yoy)</b>              | -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)       |
| <b>Inflation (% yoy)</b>             |             |             |             |                |
| 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)      |
| <b>Fiscal Accounts (% GDP)</b>       | <b>2009</b> | <b>2010</b> | <b>2011</b> | <b>2012f</b>   |
| Central Government and Funds Balance | -2.7        | -2.5        | -2.6        | -2.6 (IMF)     |
| Gross Central Government Debt        | 23.8        | 24.6        | 28.2        | 30.5 (IMF)     |
| <b>Labor Statistics (%)</b>          | <b>2009</b> | <b>2010</b> | <b>2011</b> | <b>2012f</b>   |
| Unemployment Rate (%)                | 32.2        | 32.1        | 31.8        | 31.2 (IMF)     |
| Wage Growth (Nominal gross, %)       | 9.4         | 1.0         | 1.2         |                |
| <b>External Accounts</b>             |             |             |             |                |
| Current Account (% GDP)              | -6.8        | -2.2        | -2.8        | -5.0 (IMF)     |
| Net FDI (bn EUR)                     | 0.14        | 0.16        | 0.30        |                |
| FDI / Current Account (%)            | 30.0        | 104.8       | 150.1       |                |
| FX Reserves (bn EUR)                 | 1.37        | 1.48        | 1.80        |                |
| <b>Domestic Credit</b>               | <b>2009</b> | <b>2010</b> | <b>2011</b> |                |
| 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        |                |
| <b>Financial Markets</b>             | <b>2009</b> | <b>2010</b> | <b>2011</b> | <b>Current</b> |
| Policy Rate                          | 8.5         | 4.1         | 4.0         | 4.0            |
| MKD/EUR                              | 61.46       | 61.40       | 61.49       | 61.48          |
| MKD/USD                              | 43.98       | 46.20       | 43.96       | 46.24          |

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

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