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Division of Research & Forecasting

Director: Gikas Hardouvelis
ghardouvelis@eurobank.gr

Coordinator:

Ioannis Gkionis
Research Economist
igkionis@eurobank.gr

Other contributing authors:

Panagiota Chioti
Junior Economic Analyst
pchioti@eurobank.gr

Stella Kanellopoulou
Research Economist
skanellopoulou@eurobank.gr

http://www.eurobank.gr/research

Commentary

The year 2008 marks a major turning point for the economies of New Europe as several factors will place them under significant stress. We highlight the worldwide financial crisis and its negative impact on real growth across the globe, the increased uncertainty and the higher risk premia demanded by international investors for channelling financial and real capital into emerging economies and, finally, the upswing in energy and commodity prices that have fed into higher global inflation.

Countries like Bulgaria, Romania, Serbia and Turkey face a bigger challenge, as the global impact on their economies is larger. This is partly due to a fragile domestic political environment and partly to macroeconomic imbalances. A crash or an immediate hard landing in any of those countries is rather unlikely. However, a significant moderation in economic activity, coupled with a reduction in credit growth, is quite probable. In Romania and Serbia, the large current account deficits, combined with the diminishing coverage from outside financing via FDI, heighten the worries of a future hard landing. Poland and Ukraine on the other hand, seem more capable of escaping a slowdown. Poland can weather the storm based on robust domestic demand that would offset any weaker external demand. Ukraine, despite its high political uncertainty and inflation, continues to reap the benefits of higher commodity prices on its exports and to enjoy a robust consumption growth due to the ongoing credit boom.

The rise in inflation is a common characteristic across the countries of New Europe. Inflation has gone up to 14.2% in Bulgaria, 8.6% in Romania, 9.2% in Turkey, 14.3% in Serbia and 26.2% in Ukraine. Most of the increase in inflation has occurred in the non-core component, which is, nevertheless, important for local welfare as food prices carry a significant weight in the consumption basket. Moreover, there are increased signs that higher commodity and energy prices are gradually passing through to core inflation, especially in Romania and Turkey. Inflation threatens real disposable incomes and has a direct effect on the growth of private consumption. Should inflation persist, we expect it to more or less stay close to its current levels throughout 2008.

Current real interest rates are relatively low in Romania, Serbia and Poland, and even lower -negative- in Bulgaria and Ukraine, suggesting an overly expansionary monetary policy. In Romania, such a policy was recently translated into a depreciation of the domestic currency and a belated attempt by the monetary authorities to raise nominal interest rates. In Bulgaria, which has a currency board, the expansionary monetary policy has fed into higher credit growth and increased market worries that the currency board may break prior to joining EMU.

With the exception of Bulgaria, the countries of New Europe run fiscal deficits. Fiscal authorities are under pressure to accommodate high wage demands by various groups who suffer from higher inflation and aspire to converge quickly to the living standards of Western Europe. Striking a balance between demands for better incomes and the need to grow in a sustainable manner, all within an environment of international turbulence, poses a significant challenge to local governments.

All in all, growth is set to slow down to more sustainable levels in the countries of New Europe. Yet, the region's convergence story is still alive, acting as an anchor to market expectations and policy decisions.

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

1. Bulgaria

- **Bulgaria grew by a robust 6.2% yoy in 2007 against 6.3% in 2006. Growth is set to decelerate marginally in 2008 as a result of the ongoing international financial markets turbulence and the unfavorable external environment.**

- **Investments, the main driver, are maintained at double digit growth rates, reaching 37% of GDP.**

- **The suspension of EU pre-accession assistance programs puts the government on the spot to demonstrate more tangible results in the fight against organized crime and high level corruption, while the whole issue adds more fuel to the political debate.**

- **The risk for a fiscal side slide is limited. There is a broad political consensus that fiscal surplus should be maintained as an anchor on the road to Euro area membership.**

- **The hefty increase in the current account deficit to 21.4% of GDP against 15.6% in 2006 raises serious concerns among analysts for its financing. Net FDI inflows coverage though is maintained at relatively high levels.**

- **The country's indebtness grows even further. Heavy private sector borrowing drives gross external debt to 97% of GDP in 2007.**

- **Inflation is maintained at double digit levels-14.2% yoy in March- driven by surging food and oil prices. Surging credit growth and the rise in disposable income from the reduction in the tax rate add to demand side pressures as well.**

- **The increase in the minimum reserve requirements from 8% to 12% had no impact on credit growth during 2007. Credit growth accelerated rapidly by 65.9% yoy in 2007, against 23.9% yoy in 2006.**

- **Credit growth is expected to decelerate in 2008, a reflection of the higher borrowing costs and tighter credit conditions. In that direction, credit growth moderated to 57.2% yoy in March 2008.**

- **The banking sector's profitability profits increased by 42% yoy to a historical high. ROA increased to 2.4% and ROE went up to 23.8%.**

1.1 Current Economic Developments

Outlook 2007-2008

Bulgaria has managed to weather relatively well the international financial crisis up to now. Economic growth has maintained robust in 2007. Surging capital inflows and rapidly expanding credit growth finance an investment boom in Bulgaria. In turn, the current account deficit balloons to extraordinary levels. In time of uncertainty and worldwide credit squeeze, financing such a huge current account deficit makes the economy more vulnerable. Demand side pressures from higher nominal wages coupled with the increased food and energy prices push inflation to double digit territory. Higher inflation, the only Maastricht criterion Bulgaria does not fulfill, implies that Euro area membership becomes more distant.

In this context, the government policy reactions are constrained. Monetary policy is bound by the currency board arrangement. Administrative restrictive measures to contain credit growth had no impact. On the positive side, the fiscal surplus helps to avoid further fiscal stimulus in the economy that would add to the macroeconomic imbalances.

Economic growth is set to decelerate marginally in 2008. Nevertheless, GDP growth is expected to maintain a solid 5.5%. The ongoing international financial markets turbulence is going to weigh negatively on investment. Credit growth will moderate to more sustainable levels. The deceleration reflects higher borrowing costs and tighter credit conditions. In turn this will have a moderate negative impact on consumption and investments. Additionally, the unfavorable external environment as it mirrored in the weak Euro area growth performance and higher commodity prices will deduct some more percentage points from net exports (Table).

Table

Bulgaria	2006	2007	2008
Real GDP growth	6,3	6,2	5,5
Inflation (annual average)	7,4	7,6	9,7
Current account balance (% of GDP)	-15,6	-21,4	-21,9

Source: IMF

Political Environment

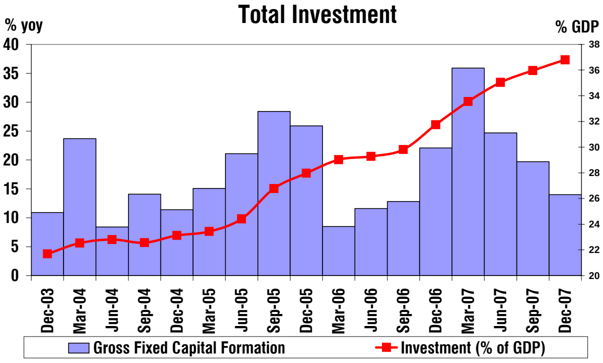
The political landscape has changed since the formation of a new right wing party, Citizens for European Development of Bulgaria (CEDB). The ruling three party government coalition loses ground on popularity, which already was recorded twice in elections results. The CEDB has managed to win two elections in a row in 2007: Elections for the European parliament and local elections. More importantly, CEDB has managed to propel defects from the right-wing National Movement for Stability and Progress (NMSP) or formerly the Simeon II National Movement, which participates in the three-party coalition. Should the rest of the remaining 35 MPs withdraw their support from the government coalition then early parliamentary elections, originally scheduled in 2009, cannot be avoided. The government coalition just survived its fifth vote of no confidence tabled by the Opposition. The subsequent cabinet reshuffling will only gain some time before voices for an early parliamentary election become stronger again.

The government is at odds with the European Commission. The second post-accession benchmarking report criticized the lack of progress on visible results in the fight against organized crime and high-level corruption. The report update expected in July, provided that the assessment does not change, may impose sanctions on Bulgaria. Moreover, Bulgarian authorities have been heavily criticized for the poor management and lax control of EU funds, which resulted in suspension of the pre-accession assistance programs (PHARE, ISPA, and SAPPARD). The suspension of funding puts the government on the spot to demonstrate more tangible results, while the whole issue adds more fuel to the political debate.

Growth performance

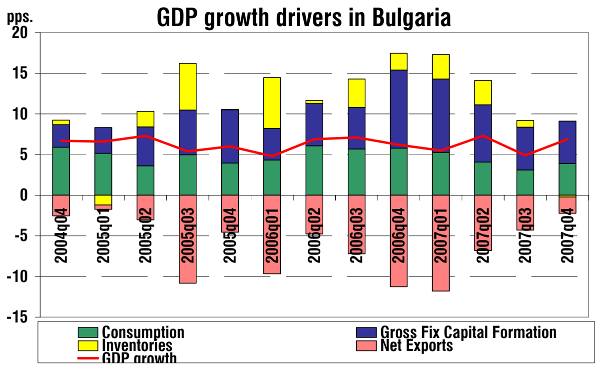
The Bulgarian economy demonstrated solid performance in 2007. GDP grew by 6.2% yoy against 6.3% yoy in 2006. GDP growth in Bulgaria is investment-led. Gross fixed capital formation accelerated to 21.7% yoy in 2007, against 14.7% yoy in 2006. As a result, total investment reached 37% of GDP in 2007 compared to only 24% some years ago. This represents an increase of more than ten percentage points of GDP in less than two years (Figure 1.1).

Figure 1.1



Final consumption lost momentum in 2007, despite strong wage increases and robust employment growth. It decelerated to 4.9% yoy in 2007 against 7.3% yoy in 2006. Higher inflation eroded households purchasing and resulted in deterioration of expectation for their financial situation, which was translated in lower demand for durables. On the other hand, the external sector made a less negative contribution in 2007. Real exports grew by 5.2% yoy, against a double imports growth rate of 9.9% yoy in 2007. The weak exports performance can be partially explained by the change in the methodology in (Figure 1.2).

Figure 1.2



From the supply side, the agricultural sector posted a sharp contraction by 30% yoy. Poor performance in the agricultural sector was counterbalanced by the strong activity in services and industry. Industry expanded strongly by 14% yoy and services by 7.5% yoy. The macroeconomic data (retail and industrial sales) coming out strengthen that the economy is not expected to experience a hard landing, but will display a solid performance in 2008 as well.

Public Finances

Fiscal measures over-performed in 2007. Some fiscal loosening which was expected, took place in the year-end. Some extra spending on infrastructure and cutting down on social contributions pushed down the budget surplus. The budget surplus ended at 3.8% of GDP, which is significantly higher than the 2% IMF-agreed target.

The budget draft of 2008 provides for a 3% surplus, which is expected to be achieved, if not overshoot. There is a broad political consensus over the fiscal policy as an anchor to Euro area membership. The introduction of a flat personal income tax of 10%, the lowest in the European Union, makes it look more challenging. Nevertheless, the results of the implementation of flat tax on corporate profit have shown that the revenues increase surpassed any expectations. Similarly, if we take into account the robust wage growth taking place and the social contributions reduction, tax revenues both direct and indirect will equally outperform.

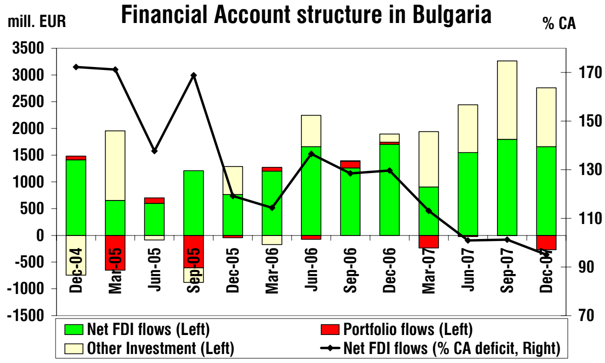
Balance of Payments Developments

The latest balance of payments developments have exceeded every single forecast. The trade deficit deteriorated in a less rapid speed to

25.5% of GDP, against 22.2% in 2006. In our last issue of New Europe Quarterly Economic review we described that the deterioration of the trade deficit comes as a result of the robust investment activity. The simultaneous shrinkage of the current transfers and income surplus though brought the current account deficit at a record high at 21.5% of GDP in 2007, compared to 15.6% of GDP in 2006. The trend continued in the first two months of 2008, where the current account reached 3.9% of the forecasted GDP.

On the financing side, the Net FDI inflows still dominate the financial account. Net FDI flows stood at 21% of GDP in 2007, covering more than 90% of the current account deficit. As long as the attractiveness of real estate and financial sector investments is high, FDI inflows will continue to be abundant. A sudden stop in investment inflows due to the liquidity crisis worldwide or a fall in returns would dry up the balance of payment off funds and cause a major disruption in current account financing (Figure 1.3).

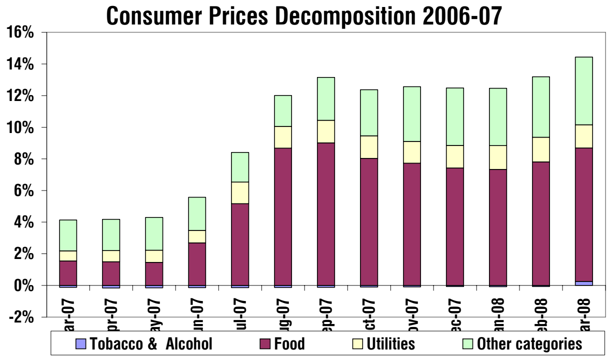
Figure 1.3



Inflation Dynamics

Inflation in Bulgaria is maintained at double digit territory. Consumer prices are the highest in the European Union. Inflation in Bulgaria soared to 14.2% yoy in March, compared to 4.1% yoy a year ago. The summer drought on agricultural production resulted in food prices skyrocketing, turning Bulgaria into a net food importer. Food prices accelerated to 24% yoy in March, from only 4.4% yoy just before last summer. The relatively bigger weight of food prices on the CPI basket -35% of the total basket-magnified the result (Figure 1.4). Headline HICP follows a similar trend. In addition, demand side pressures are making their appearance more evident. Core inflation has picked up in response to higher labor costs. As a result, it would be safe to conclude that the disinflation trend wouldn't resume again before the second half of 2008.

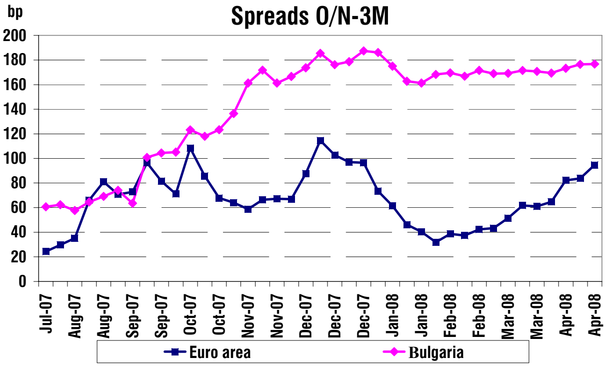
Figure 1.4



The way to ERM II mechanism, a two year period before Euro adoption, is not going to be clear cut. The latest consumer price developments make the inflation hurdle look even harder for Bulgaria to overcome on the way to Euro area. A hypothetical postponement of the Euro area accession target could result in challenging the currency board.

In the run up to 2008, the international financial markets turbulence was mirrored in Bulgarian assets as well. The growing financial markets concern pushed the sovereign spreads to widen and the credit default swaps to pick up (Figures 1.5-1.6). Nevertheless, spreads widened to a less extent than in other emerging markets. In addition, the spreads between short-term interbank rates in Lev and the Euro have widened. Higher spreads reflect both market worries over the currency board arrangement as a result of the skyrocketing current account deficit and higher inflation but also tighter liquidity conditions in the Bulgarian money markets. At this point, markets still demand higher, but less than they used to in the end of 2007, risk premiums.

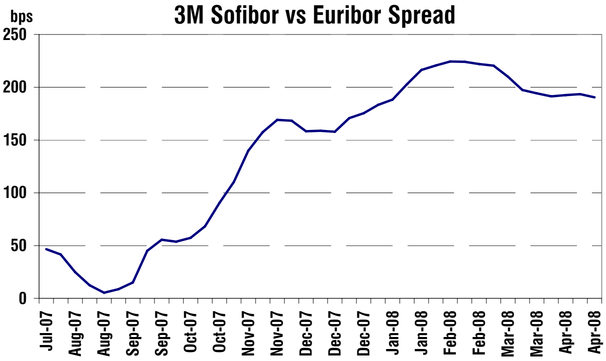
Figure 1.5



1.2 Banking Developments

Bulgaria's banking sector recorded robust growth in 2007. Total assets grew by 40% yoy, compared to 28.4% yoy in 2006. Total assets as a percentage of GDP stood at 104.6% in 2007, as opposed to 86% in 2006. Credit growth in Bulgaria is one of the fastest in Emerging Europe. The Central Bank increased the minimum reserve requirement from 8% to 12%. Nevertheless, it was proved to be ineffective as there wasn't any credit growth decrease during 2007. The first data coming out in 2008 show a moderation in credit expansion.

Figure 1.6



Consolidation in the Bulgaria's banking sector continued in 2007. Acquisitions and mergers brought the number of banks from 32 to 29 in 2006-2007. The consolidation cycle in 2007 ended with the merger of DZI Bank and Bulgarian Post Bank with Eurobank EFG Bulgaria in November 2007. Still, the banking system is considered quite concentrated. The market share of the five largest banks in terms of banking sector assets was 56.5% in 2007. Foreign banks play a key role in banking system, as they possessed 85% of total banking assets in 2007.

Credit Developments

The new restrictive measures, which came into effect on last September, had no impact on credit activity in Bulgaria during 2007. Namely, total credit growth accelerated rapidly by 65.9% yoy in Q4

2007, against 23.9% yoy a year earlier. Credit activity peaked at 67.4% yoy in February 2008, but decelerated to 57.2% yoy in March. Total credit stood at 66.9% of GDP in 2007, up from 46.4% in 2006. The main component of total credit portfolio in 2007 was credit to enterprises, which was 64% of the whole portfolio (Figure 1.7).

Total credit in foreign currency skyrocketed by 85.4% yoy in Q4 2007, against 18.6% yoy a year earlier. Moreover, credit in domestic currency accelerated by 49.8% yoy as of December 2007, compared to 28.7% yoy in December 2006. FX Loans accounted for 51% of total loans in 2007, compared to 45% a year earlier. In addition, EUR denominated loans represented 95% of total FX loans (Figure 1.8).

Credit to households continued on the upward trend during 2007. Household credit growth increased by 58.8% yoy in Q4 2007, as opposed to 32.1% yoy in Q4 2006. The increase of net wage growth and the tightening labor market were the main drivers behind this development. Moreover, FX-household credit rose by 78.5% yoy in Q4 2007, compared to 74.1% yoy a year earlier. Consumer loans accounted for the vast majority of household credit with a percentage of 55%. Consumer loans increased by 52.2% yoy in Q4 2007, compared to only 12% yoy a year earlier. The rising trend of consumer loans continued in 2008 and reached 53.9% yoy in February 2008, only to step down to 50.2% in March. Mortgages are the second growth engine in housing lending. However, mortgages decreased to 67.4% yoy as of December 2007, in comparison with 73.4% yoy a year earlier (Figure 1.9).

Credit growth to enterprises accelerated by 67.5% in Q4 2007, compared to 19.4% yoy in Q4 2006. The repatriation of corporate loans and the robust economic and investment activity were the main reasons behind this development. As a result, FX denominated corporate credit growth amounted to 87.1% yoy in Q4 2007, against 12.2% yoy a year earlier.

The corporate sector resorts to external borrowing heavily, in order to overcome the restrictive measures by Bulgarian National Bank. Private sector denominated debt inched up to 33.8% in 2007 against 28.7% in 2006. Additionally, intercompany lending is another financing means used. Thus, intercompany lending stood at 33.2%

Figure 1.7

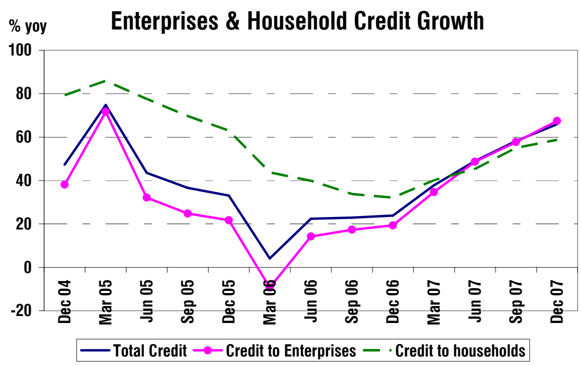


Figure 1.8

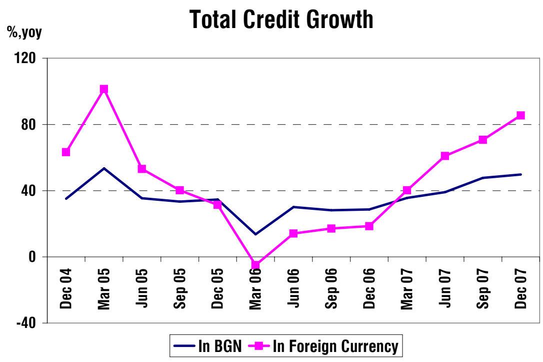
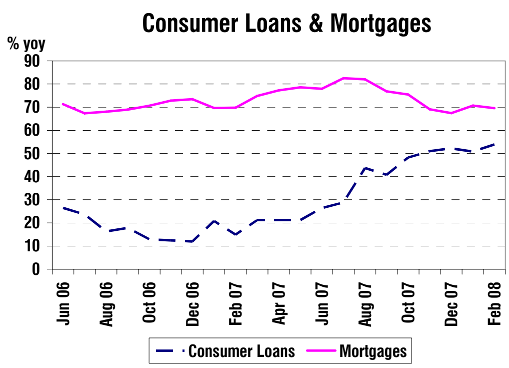
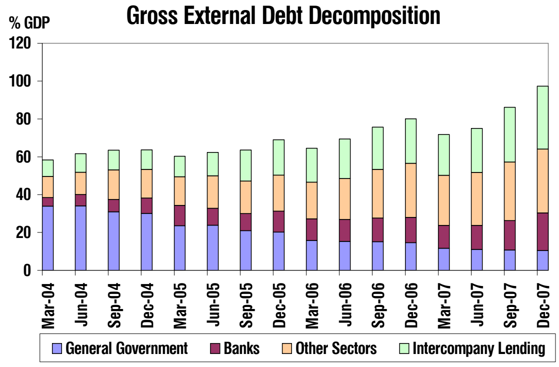


Figure 1.9



of GDP in 2007, against 23.5% in 2006 (Figure 1.10). The picture would be incomplete if we did not take into account leasing. Leasing is used as the main alternative credit channel for the circumvention of restrictive measures. More specifically, the value of outstanding leasing contracts grew by 83% yoy in 2007, compared to 80.8% yoy in 2006. As a result, leasing stood at 6% of GDP at end-2007, against 4% at end-2006.

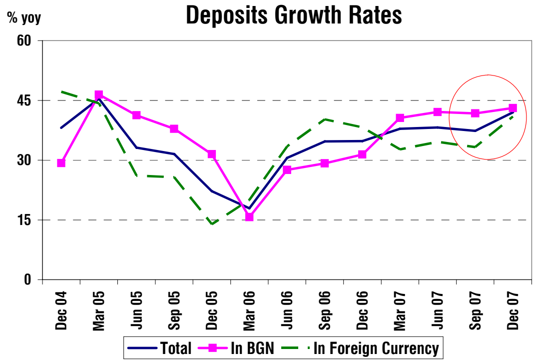
Figure 1.10



Deposits Developments

Liquidity risk in the banking sector has increased. The loan to deposit ratio reached 96.5% in 2007, compared to 82.6% in 2006. The FX loan to deposit ratio aggravated to 97.5% in 2007, as opposed to 74.1% a year earlier. Credit expansion in foreign currency outweighed that of deposits significantly. Total deposits increased by 42% yoy in Q4 2007, against 34.8% yoy in Q4 2006. Specifically, deposits in local currency increased by 43.1% yoy in Q4 2007, against 31.4% yoy a year earlier. The main contributors of this development were the increases in wages and the increases in company profitability. In addition, deposits in foreign currency went up by 41% yoy at year-end 2007, compared to 38.3% yoy at year-end 2006 (Figure 1.11).

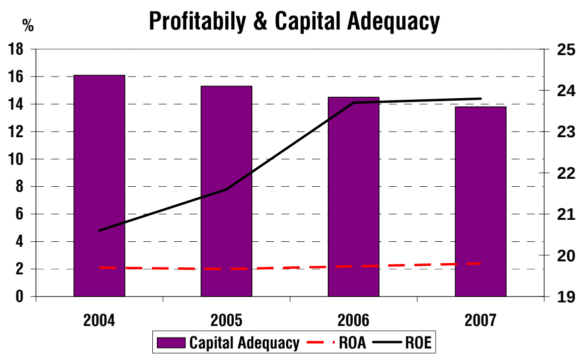
Figure 1.11



Banking sector's profitability and Capital Adequacy

The Bulgarian banking sector's profitability reached an impressive level in 2007. In particular, profits increased by 42% yoy to BGN 1144 mln, a ten-year historic high. The significant rebound of profits leads to an increase of Return on Assets and Return on Equity indicators. Hence, ROA increased to 2.4%, compared to 2.2% a year earlier. Furthermore, ROE went up to 23.8% in 2007, against 23.7% in 2006.

Figure 1.12



The Capital Adequacy ratio continued to be well above the EU requirement of 8%. The Capital Adequacy of the system recorded a decline from 14.5% in Q4 2006 to 13.8% in Q4 2007. This decline is due to the rapid increase of credit activity. However, the Bulgarian banking sector has managed to preserve solvency and liquidity so as to cover risks. The Capital Adequacy ratio is projected to further decline and reaches the EU requirement level (Figure 1.12).

Bulgaria: MacroEconomic Indicators	2003	2004	2005	2006	2007	Q4 2006	Q4 2007
Output and expenditure							
GDP	4.5	5.6	6.3	6.3	6.2	6.2	6.9
Final Consumption	5.9	5.4	5.4	6.5	4.9	7.3	4.5
Gross fixed capital formation	13.9	12.0	22.6	17.2	23.6	22.1	14.0
Exports of goods and services	8.0	13.1	9.1	9.1	5.4	5.0	6.0
Imports of goods and services	15.3	14.1	13.0	15.4	10.2	14.0	5.7
Industrial production	14.1	15.9	6.7	6.1	9.2	3.5	8.4
Labour Market							
Employment	5.5	3.1	2.0	4.3	4.6	4.3	4.6
Unemployment (in per cent of labor force)	13.7	12.0	10.1	9.0	6.9	8.4	6.1
Prices							
Consumer prices (annual average)	2.3	6.1	5.0	7.3	8.4	6.1	12.5
Producer prices (annual average)	4.9	5.9	6.9	9.2	8.6	8.2	11.9
Average monthly wage in economy	6.2	6.0	8.0	11.0	20.6	11.5	23.2
Government sector							
General government balance (National Definition)	0.0	1.7	3.1	3.5	3.8	3.5	3.8
General government debt	48.1	40.1	31.3	24.7	20.0	24.7	20.0
Monetary and Financial Indicators							
M3	16.6	22.5	27.3	21.4	29.2	26.5	30.0
Total Credit	55.4	47.3	33.1	23.9	65.9	23.9	65.9
Base interest rate	2.68	2.61	2.04	2.69	3.93	3.10	4.36
Exchange rate BGN/USD	1.50	1.40	1.57	1.55	1.40	1.51	1.35
Exchange rate BGN/EUR	1.95	1.95	1.95	1.95	1.95	1.95	1.95
Real Effective Exhange Rate (Index)	140.1	141.9	141.5	146.9	161.9	146.9	161.9
International Position							
Current account balance	-5,5	-6,6	-12,0	-15,6	-21,5	-15,7	-21,5
Trade balance	-13,7	-15,1	-20,2	-22,2	-25,5	-22,2	-25,5
Foreign direct investment, net	10.5	12.9	15.3	17.9	20.5	17.9	20.5
External debt (National Definition)	60.1	64.2	69.0	80.1	97.0	80.1	97.0
Memorandum items							
Population (end-year, thousand)	7801	7761	7719	7679	7641	-	-
GDP (in mrd of EUR)	17.77	19.88	21.88	25.10	28.70	-	-
GDP per capita (in EUR)	2277.9	2561.5	2834.6	3268.7	3756.1	-	-

Source: National Statistics, BNB, European Commission, IMF Statistics

Bulgaria: Banking Indicators	2004	2005	2006	2007
Percentage of GDP (%)				
Assets	65.1	78.3	86.0	104.6
Total Credit	36.1	43.8	46.4	66.9
Total Credit in FX	17.3	20.8	21.0	33.9
Credit to Enterprises	26.1	29.0	29.6	43.0
Credit to Enterprises in FX	16.5	18.7	18.0	29.2
Credit to Households	9.9	14.7	16.6	23.0
Credit to Household in FX	0.8	2.0	3.0	4.7
Mortgages	2.6	4.8	7.2	10.4
Deposits	51.0	60.6	56.1	70.0
Deposits in FX	23.1	24.0	28.4	35.1
Percentage Change (%, yoy)				
Assets	43.8	31.8	28.4	40.0
Total Credit	47.3	33.1	23.9	65.9
Total Credit in FX	63.2	31.4	18.6	84.0
Credit to Enterprises	38.1	21.7	19.4	46,4
Credit to Enterprises in FX	59.3	24.2	12.2	87.1
Credit to Households	79.3	63.0	32.1	58.8
Credit to Household in FX	241.5	185.1	74.1	78.5
Mortgages	147.0	101.2	73.4	67.4
Deposits	43.7	30.1	34.8	42.0
Deposits in FX	47.2	13.9	38.3	41.0
Percent (%)				
Capital Adequacy Ratio	16.1	15.3	14.5	13.8
Capital to Assets	11.0	10.5	–	–
NPLs to Total Loans	2.0	2.2	2.2	–
Provisions to NPLs	48.5	45.3	–	–
Return on Assets	2.1	2.0	2.2	2.4
Return on Equity	20.6	21.6	23.7	23.8

Sources: BNB, IMF

2. Romania

- **Romanian assets come under pressure because of the global credit squeeze. Stock market declined by 22.5% since the beginning of the year. RON depreciated by 16.2% since mid summer.**

- **Uncertainty about macroeconomic stability in Romania has increased. Economic growth slowed to 6% yoy in 2007 against 7.9% yoy in 2006. It is set to decelerate further in 2008-2009.**

- **The fragile political environment ahead of the elections forces the minority government to continue its expansive consumption oriented fiscal policy. Romania risks losing its borderline investment grade.**

- **The European Commission has expressed concern that the fiscal policy followed poses a risk to the convergence process. If fiscal policies remain unchanged, the European Commission forecasts the budget deficit to widen to 3.7% of GDP in 2009.**

- **The current account deficit widened further to 13.9% of GDP while the net FDI inflows coverage dropped significantly to 42.5% in 2007.**

- **Inflation is spiralling upwards on higher food prices and energy costs, forcing the Central Bank to hike interest rates aggressively by a total of 275 basis points since last October to 9.75%.**

- **Financial intermediation in Romania, although official data underestimate it, is still comparatively low for its level of economic development. Total assets stood at 65.8% of GDP in 2007 against 51.2% in 2006.**

- **The liquidity risk is added to the list of potential threats to the banking system. The loans to deposits ratio reached 114.8% in 2007, as opposed to 95.8% a year earlier.**

- **The NPLs ratio recorded a significant acceleration since July 2007, due to local currency depreciation. NPLs as a proportion of total loans stood at 7.8% in December 2007, up from 5.5% in December 2006**

2.1 Current Economic Developments

Outlook 2007-2008

If there is any country in New Europe who has felt the impact of the global markets squeeze, this is Romania. In the second half of 2007, as well as in the first months of 2008, the world wide credit squeeze increased risk aversion for emerging market assets. As a result, RON assets came under significant pressure. The domestic currency depreciated by 16.2% since mid summer -0.4% in Jan-April 2008 (Figure 2.1). The stock market declined more compared to other Emerging markets too (Figure 2.2). It declined by 25.3% at the same period -22.5% in Jan-April.

The pressure on Romanian assets is not totally unjustified. The macroeconomic stability in Romania is threatened, while the turbulent political situation is not helpful either. There are visible signs of overheating in the economy. GDP grows above potential. The current account widens in double digit levels. Unemployment hovers at historical low levels, loose fiscal policy feeds nominal wages race, while the economy clearly lacks investment in infrastructure. The aggregate supply does not expand quickly enough to accommodate strong demand. On the other hand there is lack of adequate response from supply side politics.

Economic growth prospects are still positive for Romania in 2008. We expect though that growth would start decelerate moderately in 2008, with a higher probability to see a bigger slowdown in 2009. Strong consumption driven by significant sustained credit and wage growth still support GDP growth. Investment is expected to continue displaying double digit growth rates, driven primarily by construction. High investment returns still attract investors. However, there are a number of setbacks which will start making their influence more apparent from 2008. We expect to see the negative impact of rising interest rates and tightening of credit conditions worldwide. In addition, rising food and oil prices feed inflationary expectations. In turn, this will have a negative impact on domestic demand. After the elections in late 2008, we would expect to see also some fiscal policy tightening that would also had a negative effect on growth in the short-term (Table).

Table

Romania	2006	2007	2008
Real GDP growth	7,9	6,0	5,4
Inflation (annual average)	6,6	4,8	7,0
Current account balance (% of GDP)	-10,4	-13,9	-14,5

Source: IMF

Figure 2.1

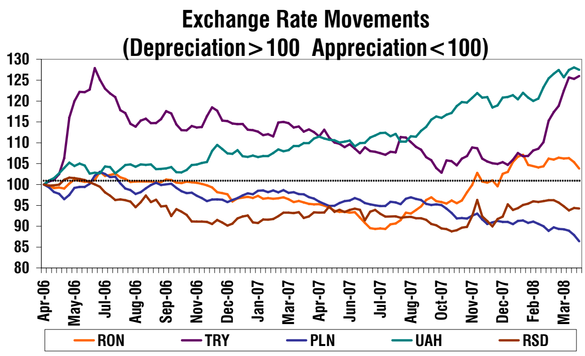
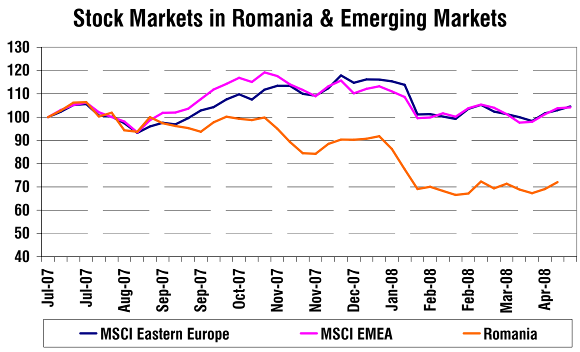


Figure 2.2



Political Environment

This is an election year for Romania. Local elections are going to take place in June. Parliamentary elections are scheduled for November. The minority government comprising of NLP and HDUR (the smaller government coalition partner) relies on the support from the socialist SDP (former communist) party – to continue running. The European Parliament elections confirmed that the major opposition party-DLP is heading the polls. The Democratic Liberal party-(DLP) came out of the merger between DP, which broke away from the governing NLP, and LDP, and is supporting President Basescu.

The political situation is liquid. Political volatility persists but less than in the previous year. The focus now is turned to the potential coalitions that may emerge out of the parliamentary elections in November. The mobility in the cabinets of the parties maintains a high liquid political situation. In conclusion, parties' antagonism dominates the political scene. As a result, it puts required structural reforms second in priority. In addition, it results in competition in populist politics. In turn, this is transformed into fiscal policy being more expansive.

An indication that structural reforms donot advance is the recent European Commission report update. It is very critical of the lack of sufficient progress recorded in the areas of judicial reforms. This is not the first time European Commission is critical. The European Commission has not imposed any sanctions on Romania. Nevertheless, if the problems persist it would be safe to conclude that restrictions could be imposed on access to EU funds.

Growth performance

Economic activity decelerated in 2007. Domestic demand gained further ground as private consumption remained robust and investment gained momentum. The contribution of net exports became more negative as imports soared and exports decelerated due to RON appreciation especially in the first half.

GDP growth reached 6% yoy in 2007 down from 7.9% yoy in 2006. GDP growth ended in a positive note to 6.6% yoy in the last quarter, after slowing down to 5.7% yoy in mid-year. Private consumption was the main driver in GDP growth. It contributed ten percentage points, an equal robust performance as in 2006. Nevertheless, private consumption is losing ground lately. Heightened inflation expectations, monetary policy tightening and the RON depreciation, weigh negatively on the households' balance sheets.

Investment gained momentum driven by construction. Gross fixed capital formation grew by an impressive 28.9% yoy against 19.3% in 2006. The investment side contributed 11 pps, up from 7.7 pps. Exports decelerated to 8.7% yoy in 2007 from 10.6% yoy in 2006. On the other hand, imports grew by 26.1% yoy against 22.4% yoy in 2006.Net exports contributed fifteen percentage points against ten in 2006 (Figure 2.3).

From the sectorial point of view, agriculture had a very negative contribution. Agriculture slumped by 16.9% yoy in 2007. The poor performance of agriculture was counterbalanced by construction which grows at rates over 30%. Construction output grew by 33.6% yoy in 2007, the highest in EU-27. Construction contributed 2.4 pps, more than one third in the GDP growth rate in 2007. All segments (engineering, residential and non-residential) displayed double-digit strong performance (Figure 2.4).

Figure 2.3

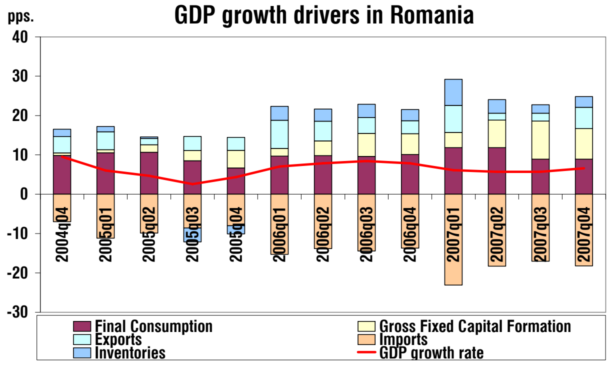
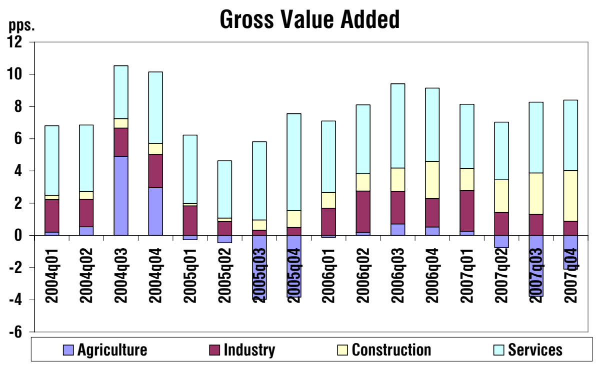


Figure 2.4



Public Finance

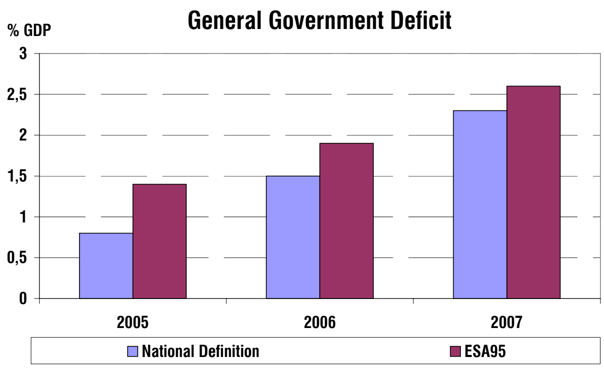
The fiscal policy followed in Romania calls for more thorough investigation and certainly deserves a more critical stance. The minority government follows a pro-cyclical, inconsistent and overly expansionary fiscal policy, which contradicts monetary policy and endangers macroeconomic stability. At this stage of macroeconomic development, the government should target a budget surplus instead of a budget deficit. Instead the government follows a more relaxed fiscal path which edges the European Commission rules.

The bulk of spending is directed towards consumption. Substantial increases in public wages and pensions feed domestic demand which in turns boosts inflation and the current account deficit. The increase in consumer spending is done at the expense of containing capital expenditures. The funds not absorbed in capital investment projects are redirected to consumption purposes. This further complicates the situation as the so much needed infrastructure is neglected.

Public wages are found to be raised by 30% ex-post in 2007, while the new budget calls for a further 12% increase on average in 2008. One of the implications for public wage increases is that they are giving also the tone for the anticipated increases in the private sector. Moreover, public expenditures for pensions soared by 30% yoy in November. A planned hike by 7.4% next year is going to weigh even more negatively, especially if bringing it forward in 2008 materializes.

The fiscal policy is not credible. The budget target is revised multiple times throughout the year, so that the year end result is not predictable. In 2006, the budget targets were revised several times so that the year end result came up to 2.2% of GDP. In 2007, the government targeted a budget deficit of 2.8% of GDP, which if measured in ESA95 terms, exceeded the 3% European Commission limit. The budget deficit ended at 2.3%, which is an equivalent of 2.5% in ESA95 terms (Figure 2.5). In 2008, the government targets a deficit of 2.3%, better than the initially targeted 2.75% but subject to uncertainty.

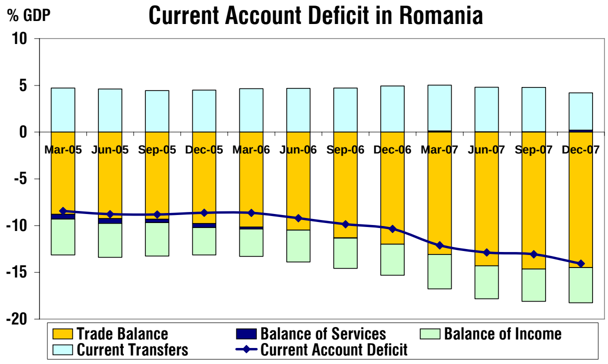
Figure 2.5



The European Council assessment of the Romania’s convergence program diagnosed visible overheating symptoms, while criticized the official growth forecasts as too optimistic. The followed fiscal policy is not in line to contain the growing external imbalances and inflationary pressures. The convergence process is at risk. The Council recommended that Romania tighten fiscal policy with appropriate wage policy and further structural reforms. Lastly, the Council recommended for Romania to improve the expenditure composition.

Balance of Payments

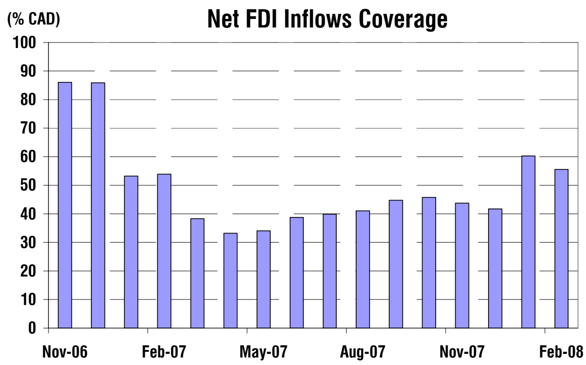
Figure 2.6



The current account deficit skyrocketed to 13.9% of GDP in 2007 compared to 10.4% in 2006. The sustained boom in credit growth compounded by the expansive fiscal policy is boosting domestic demand which drives imports growth. Total Imports surged by 25% yoy against exports growing by 14% yoy. On the positive side, the current account has a strong investment component. Indeed, consumer goods hold a small share in total imports -approximately 15%. In addition, imports of transport equipment and machinery soared by 35.3% yoy comprising 38.1% of total imports in 2007. Overall, the trade deficit deteriorated to 14.9% of GDP in 2007, compared to 12.1% in 2006 (Figure 2.6).

In the first two months of 2008, exports growth outpaced that of imports. Although, it is still early to diagnose a trend, energy related exports are favored by high oil prices while machinery exports continued their robust performance. Imports decelerate as a result of the change in methodology in the first part of the year, due to EU accession.

Figure 2.7



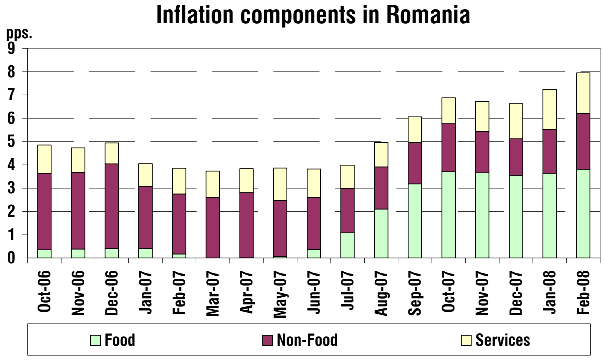
When it comes to financing, the quality of financing has declined significantly. The net FDI inflows coverage of the current account deficit came up to 42.5% in 2007, compared 90% for 2006. The net FDI inflows have slowed significantly, as privatization revenues peaked last year. FDI figures were exceptionally high in 2006, because of the one off inflow coming from the privatization of BCR (3.75 bn Euros). However, if this transaction is not taken into account, FDI inflows in 2007 are higher. Further on, net FDI inflows coverage improved to 55.5% in the first two months of 2008 (Figure 2.7).

Inflation Dynamics

Inflation followed an upward spiral trend in the last quarter of 2007. Inflation ended at 6.6% yoy in December clearly above the Central Bank 4% (+/-1%) target. The rally also continued in the first months of 2008. Consumer prices accelerated further to 8.6% in March, on rising gas prices, which is likely to be the peak for the year.

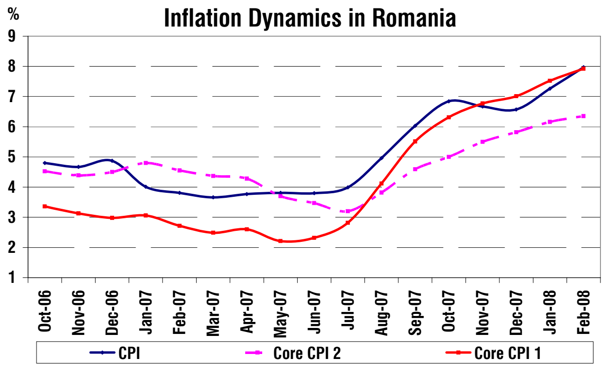
The rise in consumer prices is attributed not only is not only the result of the food prices supply shock. Demand side pressures contribute as well. The evolution of prices for non-food items and services verifies that (Figure 2.8). In addition, all core measures follow an upward trend after July. Core 2 CPI (without administered and volatile prices) hiked to 6.3% yoy in February compared to a low 3.2% yoy in July (Figure 2.9).

Figure 2.8



The nominal wages acceleration inflates domestic demand which supply bottlenecks cannot satisfy thus feeding into inflation. The rapid credit growth leverages the effect increasing inflation expectations even more. Nominal wages rose by 22.7% yoy on average in 2007. Even though inflation spiked in the last quarter, real wages accelerated to a significantly high 17.9% yoy. In the end, the depreciation of the RON in H2-2007 against the Euro weighs equally negatively in the inflation (especially services inflation) because of the high degree of pass through.

Figure 2.9



On the positive side, there is increased awareness of the overheating problem by the monetary authorities. For that reason, the Central Bank adopted a more restrictive monetary stance, in order to contain rising inflation. Monetary authorities hiked interest rates by 275 basis points (225 bps year to date) to 9.75% since last October. Tighter monetary conditions support the carry trade appeal for the domestic currency and provide a shield against currency weakening.

The macroeconomic data coming out support the view that further monetary policy is coming. Wages growth stays on a robust trend and is unlikely to cool off until elections. High public spending in order to accommodate wage demands will add to inflationary pressures. The PPI-producer price index is on an upward trend-15.6% yoy in March against 5-7% before year-end. The evolution of PPI prices predisposes that inflationary pressures will remain strong as increased costs will be passed on to consumers. All in all, it would be safe to conclude that the inflation target will be overshot by at least by one percentage point that Central Bank forecasts and not before the electoral cycle ends in Romania.

2.2 Banking Developments

The Romanian banking sector experienced another year of rapid growth in 2007. Total assets grew by 51.8% yoy, compared to 34.7% yoy in 2006. The Euro area convergence story anchors expectations over future developments. The large market size and the high growth potential provide a significant incentive for foreign banks to enter and expand their operations. Total assets stood at 65.8% of GDP in 2007 against 51.2% in 2006. Financial intermediation, although official data underestimate it, is still comparatively low for its level of economic development.

There are 41 banks in Romania, of which 36 are foreign ownership and only 5 are domestic ones (two state-owned and three domestic privately owned). Foreign ownership accounted for 87.2% of total assets in 2007, marginally higher from 85.1% in 2006. The market concentration is not expected to change unless the government proceeds with the privatization of CEC, which lingers since 2006.

The Romanian banks operate in an environment of high although declining spreads, tighter monetary policy and high reserve requirements. The partial abolition of credit restrictions after European Union accession and the robust economic growth are classified in the factors supporting their business expansion. The restrictive stance of the Central Bank induces commercial banks to transfer part of their corporate lending activities overseas. In addition, higher domestic interest rates turn borrowers to lending in foreign currency. Foreign currency lending stands at more than 50% of total lending. On the downside, the currency mismatch highlights the foreign exchange risk issue in the banking sector.

Credit Developments

Credit expansion in Romania is exceptionally high, which results in Romania catching up with a relatively high speed. Total credit growth accelerated to 64.5% yoy in Q4 2007, as opposed to 52% yoy in Q4 2006. In a restrictive monetary policy environment, total credit growth probably peaked in January-February 2008. In real terms, total credit is not accelerating. Total credit stood at 39% of GDP in 2007, up from 28% in 2006.

More analytically, FX-denominated loans are driving credit expansion. Higher domestic interest rates, a reflection of the tighter monetary policy implemented, provides incentives to resort to cheaper borrowing through FX-lending. FX lending skyrocketed to 84% yoy in December 2007, up from 33.7% yoy a year earlier. In response, the Central Bank imposed higher levels for the foreign currency credit provisions in order to minimize the foreign exchange risk. Hence, the commercial banks stored more money so as to cover these risks. FX lending outgrows domestic currency lending since July when RON started to depreciate. That is the reason behind the domestic currency credit growth rate landing to 39.2% yoy in Q4 2007, down from 79.5% in Q4 2006. FX-lending as a percentage of GDP stood at 19.9% or an equivalent of 51% of total lending (Figure 2.9).

The household segment of the market expands very rapidly. Romanians borrow heavily against their future incomes motivated by the high wage growth. Household credit represents 17.7% of GDP in 2007 against 11.5% last year. Borrowing takes place in FX currency, in less expensive rates than the domestic ones but carries significant foreign exchange risk (Figure 2.10). As a result, FX credit doubled to 134.4% yoy in 2007, up from 71.8% yoy in 2006. The opposite trend takes place for domestic denominated credit growth, which halved to 45.4% yoy, compared to 93.2% yoy in 2006 (Figure 2.11).

Consumer loans accounted for the vast majority of credit channeled to households -77.1% of household credit. Consumer loans have exhausted their dynamic growth. Mortgages are going to be the next growth engine in household lending. Housing demand leads construction to be the highest within the EU countries in 2007. Mortgages grew by 76.8% yoy in 2007, compared to 53% yoy in 2006. Foreign currency mortgages are the most popular. Nearly 90% of total mortgages are FX denominated.

Corporate lending growth remained broadly unchanged in 2007. Corporate lending increased by 46.4% yoy, up from 43% yoy in 2006. Corporations, like consumers, preferred cheaper FX lending, undertaking significant FX risk. Corporate lending growth in RON

Figure 2.9

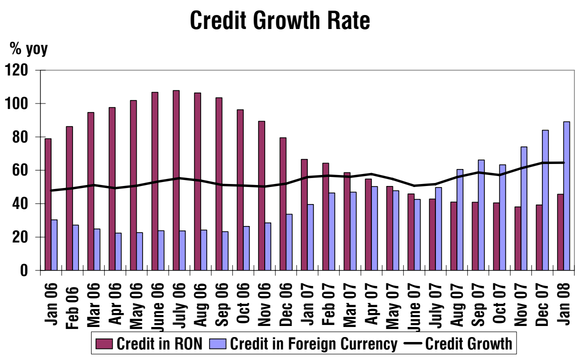


Figure 2.10

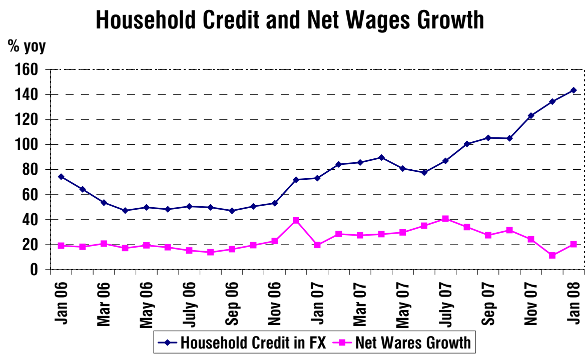
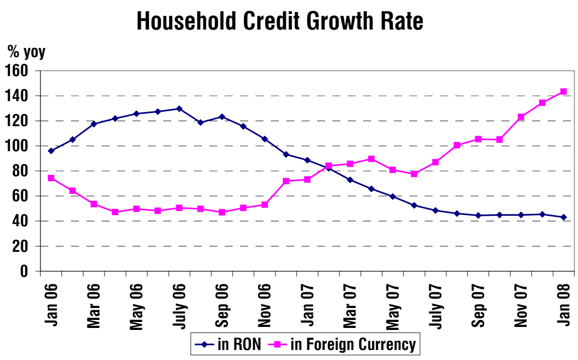


Figure 2.11



had a significant decrease to 35.8% yoy in 2007, against 66.6% yoy a year earlier. FX corporate lending grew by 56.3% yoy in 2007, compared to 26.4% yoy in 2006.

There are two issues we need to highlight in the case of Romania as in the case of Bulgaria. The first one is about external borrowing as an alternative financing way corporations resort to, so that the credit restrictions are circumvented. As a result, external debt in Romania stood at 46.8% in Q4 2007, up from 34.5% in Q1 2006 (Figure 2.12).

Leasing is another field we should turn our attention to. Not regulated until recently, the leasing market grows rapidly. Enterprises resort to leasing as an alternative financing source. More analytically, the total value of outstanding leasing contracts grew by 53% yoy at the end of 2007. Leasing contracts now represent 4% of GDP in 2007, up from 3.6% in 2006. New companies such as OTP, Cyprus or Impuls Leasing are entering the market. According to the industry association projections, the leasing market will grow at a lower rate of 20%-25% yoy in 2008, reaching 6 bn EUR (Figure 2.13).

Figure 2.12

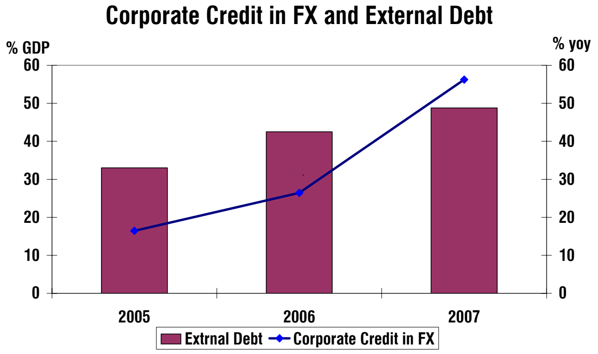
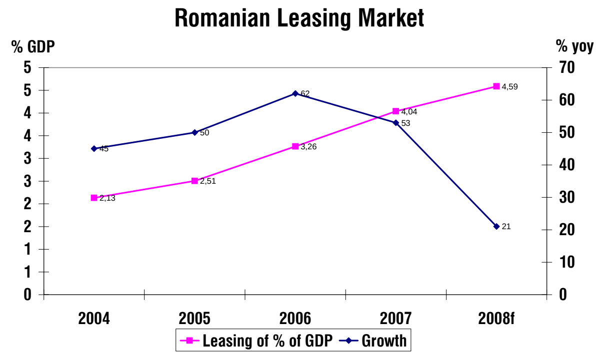


Figure 2.13



Deposits Developments

The liquidity risk is added to the list of potential threats to the banking system. The loans to deposits ratio reached 114.8% in 2007, as opposed to 95.8% a year earlier. The loans to deposits ratio is one of the highest ratios in the countries of New Europe. The ratio deterioration reveals that credit expansion becomes highly dependant on external financing. For that reason, the FX loans to deposits ratio worsened to 194.3% in 2007, against 140.4% in 2006.

Total deposits grow at levels below those of credit expansion. Total deposits grew by 33.9% yoy in December 2007, up from 28.9% yoy a year earlier. Higher interest rates were not enough to stimulate domestic savings growth rate. On the other hand, the recent RON depreciation trend lifted foreign currency deposits to 32.9% yoy, up from 20.4% yoy in 2006. Sectorial wise, household deposits are the most dynamic segment. The rapid real wage growth fuels dramatic increases in household deposits. The deposits growth rate reached 52.7% yoy, up from 28.9% yoy in 2006. Corporate deposits growth decelerated to 17.8% yoy in 2007, down from 30.9% yoy in 2006 (Figure 2.14).

Banking sector's profitability and Capital Adequacy

Our expectations for deceleration in the banking sector profitability were confirmed. Net profits increased by 32% yoy to EUR 825mn in 2007. The net profits increase does not keep up with the credit expansion growth. Hence, ROA declined to 1.1% in 2007, compared to 1.3% in 2006. In addition, ROE remained almost unchanged at 10.4% in 2007, up from 10.2% in 2006. The first five banks in terms of market share earn 90% of the reported net profits.

We see a potential risk to the downside from NPLs. The NPLs ratio recorded a significant acceleration since July 2007. This condition is attributed to an upward trend of FX denominated loans, due to devaluation of the local currency. Thus, NPLs as a proportion of total loans stood at 7.8% in December 2007, up from 5.5% in December 2006 (Figure 2.15). The NPLs ratio in Romania is the second highest in the countries of New Europe, standing behind only that of Ukraine.

The Capital Adequacy ratio decreased to 12.7% in late-2007, down from 18.1% a year earlier. The decrease is a natural consequence of the rapid credit expansion. The Capital Adequacy ratio is expected to decline further, as credit expansion continues unabated, but well above the 8% threshold.

Figure 2.14

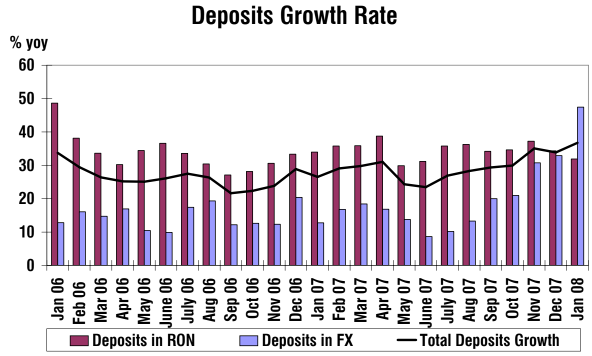
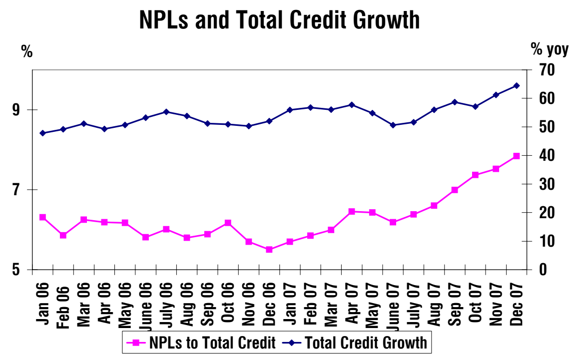


Figure 2.15



Romania: Macroeconomic Indicators	2003	2004	2005	2006	2007	Q4 2006	Q4 2007
Output and expenditure							
GDP	5.2	8.2	4.4	7.7	6.0	7.9	6.6
Private consumption	8.2	12.6	9.5	12.4	10.4	12.4	9.2
Public consumption	7.1	5.0	13.2	2.7	7.9	2.8	6.0
Gross fixed capital formation	8.2	11.4	11.1	15.3	28.0	21.3	28.0
Exports of goods and services	8.7	14.1	8.1	10.7	8.8	9.3	14.9
Imports of goods and services	15.7	22.6	16.6	22.7	26.1	24.9	28.6
Industrial production (cumulative)	3.9	4.2	3.4	6.0	6.2	7.3	5.6
Labour Market							
Employment (% change)	0.3	0.8	2.6	1.3	2.8	1.3	2.8
Unemployment (in per cent of labor force)	7.6	6.8	5.8	5.4	4.3	5.1	4.1
Prices							
Consumer prices (annual average)	15.3	11.9	9.0	6.6	4.8	4.8	6.7
Producer prices (annual average)	19.6	19.1	10.6	11.6	8.1	11.1	9.3
Average monthly wage in economy	25.4	22.5	23.7	16.8	21.0	21.5	20.8
Government sector							
General government balance (National Definition)	-2.2	-1.2	-0.8	-1,9	-2,6	-1,9	-2,6
General government debt	21.5	18.8	15.9	12.4	12.5	12.4	12.5
Monetary and Financial Indicators							
M2	23.3	39.9	17.0	27.9	28.1	25.0	32.8
Total Credit	49.2	32.5	43.7	52.0	64.5	52.0	64.5
Reference rate	18.9	20.2	9.7	8.45	7.50	8.75	7.50
Exchange rate RON/USD (end-period)	3,31	2.91	2.91	2.81	2.43	2.69	2.37
Exchange rate RON/EUR (end-period)	3.75	4.04	3.61	3.51	3.33	3.47	3.44
Real Effective Exhange Rate (Index)	99.1	101.6	119.9	128.9	139.1	132.0	139.1
International Position							
Current account balance	-5,5	-8,4	-8,6	-10,4	-14,5	-10,4	-14,5
Trade balance	-7,6	-8,7	-9,8	-12,1	-14,9	-12,1	-14,9
Foreign direct investment, net	3.2	8.6	6.5	9.6	6.0	9.6	6.0
External debt	34.7	35.1	33.0	42.5	48.8	42.5	48.8
Memorandum items							
Population (end-year, thousand)	21734	21673	21624	21591	21526	-	-
GDP (in Mrd of EUR)	52.6	60.8	79.6	97.1	118.1	-	-
GDP per capita (in EUR)	2420.2	2805.3	3681.1	4497.2	5486.4	-	-

Source: National Statistics, NBR, European Commission, IMF Statistics

Romania: Banking Indicators				
	2004	2005	2006	2007
Percentage of GDP (%)				
Assets	37.1	45.2	51.2	65.8
Total Credit	17.8	21.9	28.0	39.0
Total Credit in FX	10.3	11.4	12.8	19.9
Credit to Enterprises	10.6	12.1	14.6	18.0
Credit to Enterprises in FX	7.1	7.1	7.6	10.0
Credit to Households	4.8	7.4	11.5	17.7
Credit to Household in FX	2.2	3.3	4.7	9.4
Deposits	23.1	26.0	28.2	31.9
Deposits in FX	13.6	17.0	9.1	10.2
Percentage Change (%, yoy)				
Assets	48.0	42.5	34.7	51.8
Total Credit	32.5	43.7	52.0	64.5
Total Credit in FX	–	29.1	33.7	84.0
Credit to Enterprises	29.2	32.5	43.0	46.4
Credit to Enterprises in FX	–	16.5	26.4	56.3
Credit to Households	58.3	80.0	83.8	82.1
Credit to Household in FX	–	72.8	71.8	134.4
Deposits	41.5	31.5	28.9	33.9
Deposits in FX	–	46.3	20.4	32.9
Percent (%)				
Capital Adequacy Ratio	20.6	21.1	18.1	12.7
Capital to Assets	8.9	9.2	8.6	–
NPLs to Total Loans	6.9	6.1	5.5	7.8
Provisions to NPLs	45.6	45.6	–	–
Return on Assets	2.0	1.6	1.3	1.1
Return on Equity	15.6	12.7	10.2	10.4

Sources: NBR, IMF

3. Serbia

- **Early parliamentary elections are scheduled for May, following the collapse of the short-lived government coalition. The elections outcome will determine the country's EU-membership prospects.**

- **GDP grew by 7.5% yoy in 2007, despite a draught-induced contraction in agricultural output, the restrictions imposed on credit growth and the inflation spike. GDP growth is projected to decelerate to 6% yoy in 2008.**

- **The current account deficit skyrocketed to 16.1% of GDP in 2007, with FDI coverage declining to an alarming rate of just 50%. The lack of sufficient Greenfield inflows and the postponement of the privatization program raise a red flag with respect to the sustainability of current account financing.**

- **On the fiscal side, the spending cuts envisioned in the 2008 draft budget appear to be insufficient to help address rising macroeconomic imbalances.**

- **Consumer prices have reached double-digit rates, boosted by second round effects from higher food and oil prices. CPI stood at 14.3% yoy in March 2008, up from 4.2%in the same month a year earlier, while core inflation is already above this year's 3-6% targeted band. Aggressive monetary policy tightening by the NBS (500 bps of rate hikes delivered since December 2007) has so far been insufficient to contain inflationary pressures.**

- **The Serbian banking sector recorded strong growth by 31.9% yoy in 2007, which is underestimated by official data as the prudential measures had an impact on banking sector strategy.**

- **The implementation of NBS restrictive measures in late 2007 had been limited in curbing credit expansion to households. New measures will be in place in 2008.**

- **The banking system has maintained a sound level of liquidity as it continued to attract significant deposits from households. At the same time, profitability decreased marginally on less net interest income.**

3.1 Current Economic Developments

Outlook 2007-2008

Serbia has entered its seventh year of transition after the Milosevic era. Early parliamentary elections have been called following the collapse of a short-lived government coalition. There's a lot more at stake in these elections than just political stability. Serbia is going through a period, which is more or less likely to determine the country's path towards European Union membership. Current political uncertainty is also jeopardizing economic stability, causing stress in local financial markets and the currency (Figure 3.1). This phenomenon is compounded by the international financial turbulence, scaring away would-be investors.

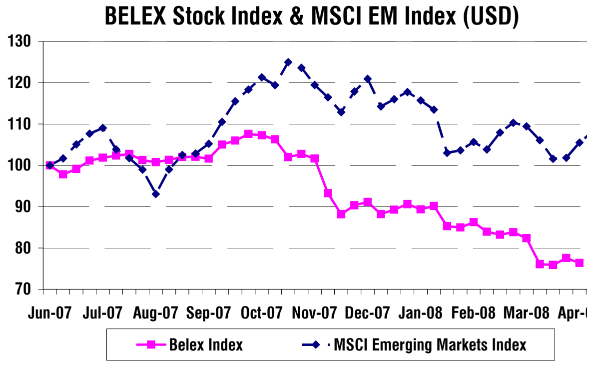
Table

Serbia	2006	2007	2008
Real GDP growth	5,7	7,5	6,0
Inflation (annual average)	12,8	6,5	7,2
Current account balance (% of GDP)	-11,5	-16,1	-16,5

Source: IMF

On the macroeconomic front, GDP growth rate is projected to decelerate to 6% yoy in 2008 (Table). The deceleration in economic activity reflects a more restrictive monetary policy stance, mounting political uncertainty and the higher borrowing costs due to the global credit squeeze.

Figure 3.1



Political Environment

The unilateral declaration of Kosovo independence spurred waves of political instability in Serbia. Just after the latest Presidential elections resulted in a new term for incumbent pro European President Tadic, the independence declaration shattered the fragmented government coalition. The subsequent dramatic events stressed the political differences among the coalition partners over the Kosovo issue. Prime Minister Kostunica has already indicated that he would be against Serbia's EU accession bid unless the bloc rejects Kosovo's independence. President Tadic and his allies don't share this view and believe that those issues ought to be separated.

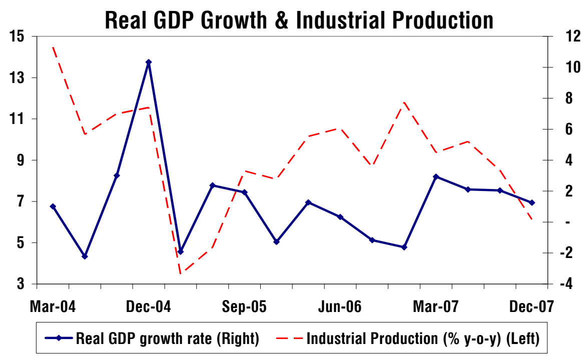
The signing of an interim political agreement instead of the Stabilization and Association agreement with the European Union triggered the government's collapse. The government stayed in office only ten months, during which no significant progress was recorded with regard to structural reforms. Early parliamentary elections will take place in May, together with the local elections.

Recent opinion polls indicated that there is a significant probability that a government coalition of Nationalists-DS party and allies might emerge out of the elections. In that case, the EU convergence story becomes highly questionable, which makes us wonder what the alternative way forward is. Note here that the economy is highly dependent on EU inflows (both investment and pre-accession funds) to finance the current account deficits and most export revenues come from EU countries. A protracted delay in the formation of a new government formation, like the one experienced in early 2007, could weigh further on local markets.

Growth performance

Economic activity accelerated last year, with the most recent official data showing real GDP growth of 7.5% yoy in 2007 against 5.7% yoy in 2006. This was the highest reading in the post-Milosevic era. The pick up in growth reflects mainly an overly expansive fiscal policy stance and the unprecedented credit expansion. Industrial production decelerated to 3.3% yoy in 2007 against 5.7% yoy in 2006 (Figure 3.2).

Figure 3.2



Three sectors were almost exclusively responsible for last year's GDP growth. Transportation and communication contributed 2.7pps, financial intermediation1.3pps, and wholesale& retail trade 1.9pps. The summer drought had a significant negative impact on agriculture, whose contribution to overall GDP growth was minus 1pps. On the spending side, private consumption was the main driver of GDP growth in 2007, accelerating to 6.6% yoy, from 4.4% yoy in 2006, supported by a 30% yoy rise in public-sector wages. Another key driver was investment. Investment spending as a percentage of GDP increased to 19.3% in 2007 from 17.9% in 2006.

Public Finances

In our view, the implemented fiscal policy undermines medium-term macroeconomic stability, as successive elections have resulted in significant fiscal loosening. Public wages have increased strongly last year, pushing up private-sector labor costs via a demonstration effect. The most recent official data (national methodology) shows a budget surplus of 1.5% of GDP in 2007, against a surplus of 1.4% in 2006. On a similar note, the consolidated government budget ended last year with a minor surplus of 0.4% of GDP. This result is attributed to the stellar performance of budgetary revenue, itself a reflection of robust economic activity, one-off Telekom licenses revenues and NIP under-spending. However, if the fiscal result is adjusted for privatization revenues and debt repayments, then the budget accounts portray an entirely different story. IMF calculations bring the 2007 deficit to around 2% of GDP. Fiscal policy for 2008 envisages public-spending cut backs aiming to attain a budget deficit target of 0.5% of GDP. We see overshooting risks to this target, however, we believe that it is sufficient enough to help correct growing macroeconomic imbalances.

Balance of Payments

Recent trends in the balance of payments send out a worrying signal. The current account deficit skyrocketed to 16.1% of GDP in 2007, from 11.5% in 2006. The trade balance as a percentage of GDP deteriorated marginally to 20.5%. A significant decline in current transfers was mainly responsible for the deterioration in the current account deficit last year, though one should note that the transfers account is usually subject to significant and frequent data revisions (Figure 3.3).

A worrying trend in last year's balance of payments statistics was that imports growth outpaced that of exports as a result of vibrant domestic demand. In USD terms, imports grew by 36.9% yoy, while exports grew by 34.6% yoy in 2007. The ban on exports of cereals had an adverse impact on overall exports growth last year, which was not counterbalanced by strong commodities exports.

On the financing side, FDI inflows registered a significant decline in 2007 after peaking at €4bn in 2006 (Figure 3.4). The outlook for further privatizations in 2008 is problematic given the elections taking place in May and the subsequent time likely to be required for the

Figure 3.3

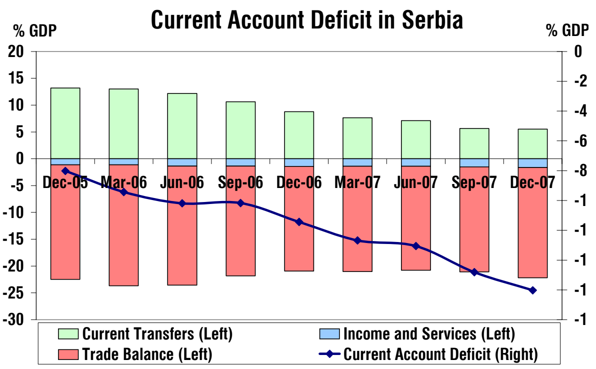
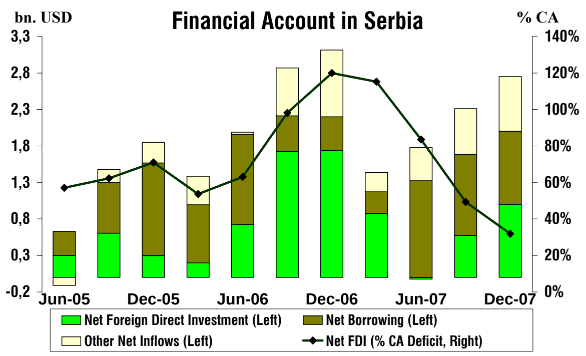


Figure 3.4

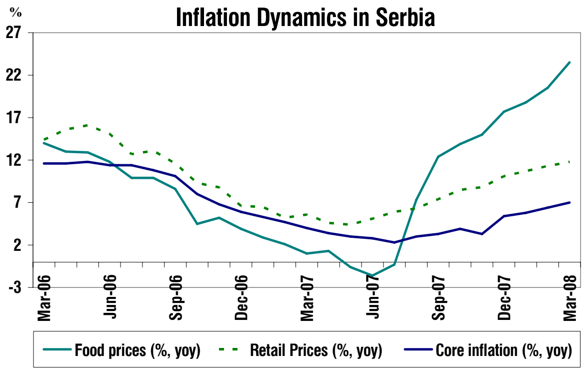


formation of a new government. Privatization revenues are likely to amount to less than €1 bn this year, i.e., much less than required for the financing the adequate current account deficit. The prospects of attracting Greenfield investment to compensate for the difference are not encouraging either. Unless political turbulence ceases, there are risks of a significant worsening in balance-of-payments dynamics this year.

Inflation Dynamics

Inflation followed an upward spiral in the last quarter of 2007, fuelled by elevated food and energy prices. Consumer prices growth reached 14.3% yoy in March against 4.2% in the same month a year earlier. Core inflation, the measure targeted by the central bank came in at 5.4% yoy in December i.e., inside the CB´s 4-6% inflation target, compared to 5.8% yoy in December 2006. Nevertheless, its average monthly growth rate accelerated to 0.8% yoy in Q4-2007 and 0.5% yoy in Q1-2008. Core inflation has exceeded the upper boundary of this year's 3-6% target zone in both February and March 2008, coming in at 6.5% and 7.0% yoy, respectively (Figure 3.5).

Figure 3.5



In response to the rising inflationary pressures, the National Bank was forced to increase interest rates by 500 basis points since December. Real interest rates currently stand at ca 2 percentage points, a level not high enough to compensate for rising inflation risks and lingering political uncertainty. As a result, further monetary policy tightening is on the cards in the months ahead in order to address the forthcoming headwinds.

3.2 Banking developments

The banking sector in Serbia recorded a year of strong expansion in 2007. Total assets growth remained strong, albeit at a slower level. Total assets increased by 31.7% yoy, against 39.4% yoy in 2006. Strong banking sector expansion is a reflection of the rapid catch-up of the country compared to other regional peers, although a late comer. This trend is reinforced by the economic activity pick up in 2007. Total assets as a percentage of GDP now stand at 67.4% against 59.9% in 2006.

The official data neglect to capture the full expansion of the banking sector. There is an explanation for that. The prudential measures that were adopted in 2006 had an impact on the banking sector strategy. High mandatory reserve requirements pushed the banking industry to adopt strategies to circumvent them. Banks transferred some of their corporate sector portfolios to off-balance sheets. High reserve requirements prompted foreign-owned local chapters to channel credit directly to corporations from parent banks abroad. In addition, most banks engaged on capital increases in an attempt to counterbalance the effects of the prudential measures and finance their operations.

The authorities' decision to impose restrictions on credit expansion to households marked banking sector developments in 2007. Further restrictions are in place from the beginning of 2008. The monetary authorities imposed restrictions in order to tame credit expansion as it was thought to feed inflationary pressures and to boost the widening current account deficit. The impact on household lending is yet to be seen. The first data coming out from the NBS show that the impact has been limited. The picture is distorted by the Dinar depreciation in the last quarter.

Banking sector consolidation continued during 2007. The concentration is still moderate. The five banks with the largest balance sheet total accounted for 44.1% of total assets as of Q3-2007. The number of banks dropped to 36 from 37 at end-2006, while is projected to reach 33 in 2008. The merger between Vojvodanska Banka and National Bank of Greece is expected to be followed by the merge of Panonska Banka into Banca Intesa and Continental Banka into LHB Banka. After the political landscape clears out, privatization plans for the remaining state-owned financial sector assets (five state owned banks) are going to come out the fridge. The outgoing government had declared that Komercialna Banka was not to be sold in the short term.

Credit Developments

Total credit grew by 39.2% yoy in Q4-2007, up from 16.7 % yoy in Q4 2006. Total credit followed an increasing growth pattern throughout 2007. The implementation of NBS restrictive measures in late 2007 had only partial success in curbing credit growth. Credit expansion maintained the high speed rates, almost double the growth rate recorded in 2006. The credit growth peaked in November only to decelerate slightly in December to 39.2% yoy. The impact from the adoption of restrictive policies is expected to be fully seen during 2008.

Credit to households was the main engine behind credit expansion. The growth rate was maintained above 50% yoy throughout the year. Mortgage and consumer credit were the most dynamic segments, replacing cash loans. Credit to households peaked in November when the growth reached 58% yoy, only to step down marginally to 50.4% yoy at the end of 2007 after the implementation of the prudential restrictive measures, against 54.2% yoy in 2006 (Figure 3.6).

The depreciation trend of the Dinar (approximately 10% in November) blurs the picture as the vast majority of consumer lending is FX indexed or FX denominated. Credit to households accounted for 37% total lending portfolio at the end of 2007 as opposed to 33% in 2006 (Figure 3.7).

Credit to enterprises rebounded in 2007 compared to 2006. Enterprises credit growth rate reached 34.5% yoy in Q4 2007 as opposed to 3.5% yoy a year earlier. The acceleration in corporate credit growth was the result of higher demand for financing investments. The picture would be incomplete if we didn't take into account corporate sector external borrowing. Corporate sector external debt almost doubled in 2007. Corporate sector external debt stood at 26.4% of GDP at year end against 19% in 2006 (Figure 3.8).

Summing up, credit penetration, as it is measured by total credit as a percentage of GDP, was still low compared to other regional peers. Total credit stood at 33.2% of GDP in 2007 against 28% in 2006.

Deposits Developments

The banking system has maintained a sound level of liquidity. The percentage of loans funded by deposits remained almost the same, even though loans accelerated. This is because, the banking system

Figure 3.6

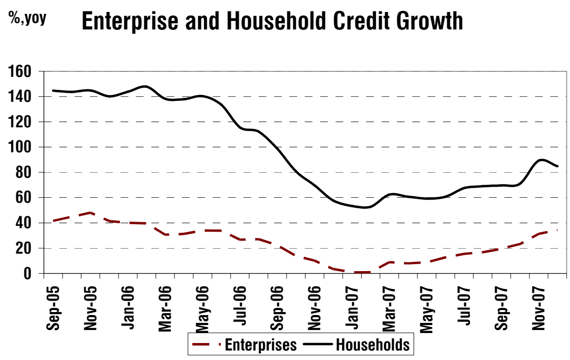


Figure 3.7

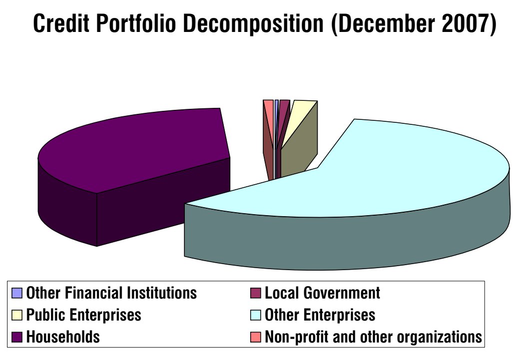
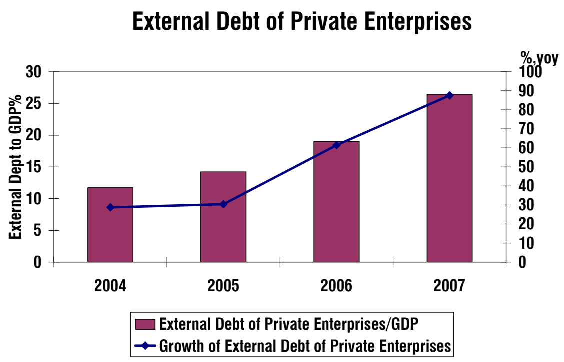


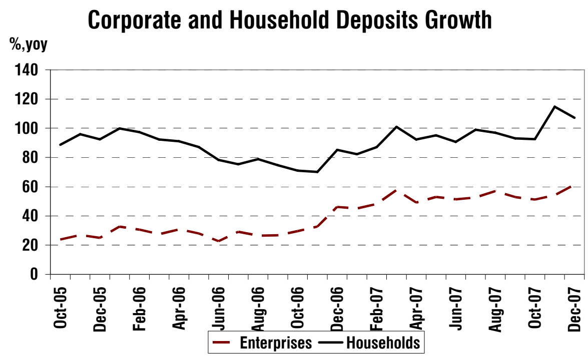
Figure 3.8



continued to attract significant deposits. Total deposits increased by 46.9% yoy in 2007, up from 39.6% yoy a year earlier.

Higher living standards and the recovering consumer confidence in the banking system resulted in household deposits increase by 45.9% yoy in Q4 2007. On the other hand, private enterprises deposits recorded an important increase of 61.3% yoy in Q4 2007 (Figure 3.9). The economic pick up has improved enterprises liquidity, while external borrowing amplifies their foreign currency deposits.

Figure 3.9



The tendency of foreign currency deposits' share to total deposits going down was confirmed. The share of foreign currency deposits to total deposits was 62.8% in Q4 2007, down from 66.4% in Q3 2007, but the share of deposits in RSD to total deposits increased in 37.2%, up from 33.6% in Q3 2007. This is a reflection of the effectiveness of the measures taken by the Central Bank to reduce the Euroization in the economy. On the other hand, Euroization is still very high in the households' balance sheets-90% of total deposits are foreign currency denominated.

Banking sector's profitability and Capital Adequacy

Despite the world financial crisis, it is important to note that Serbian banking sector has managed to preserve solvency and liquidity. Banking system's capital adequacy reached 24.8% yoy in Q3 2007, up from 24.7% yoy at the end of 2006, but down from 25.9% yoy in Q2 2007.

Profitability in banking sector of Serbia decreased marginally in Q3 2007 compared to Q2 2007. More especially, in Q3 2007 the pre-tax profit of RSD of Serbian banking sector was 15.6 billion, as opposed to 16.5 billion in Q3-2006. According to National Bank of Serbia, most of the banks recorded profit, except for eleven ones, which had loss in Q3 2007, in comparison with eight in Q2 2007. The reduction of net interest income was the main reason behind these negative results. As a result, ROA and ROE reached 1.61% and 8.23% respectively, compared to 1.7% and 9.7% a year earlier.

Serbia: MacroEconomic Indicators	2003	2004	2005	2006	2007	Q4 2006	Q4 2007
Output and expenditure							
GDP	2.5	8.4	6.2	5.7	7.5	4.8	6.9
Industrial production	-3.0	7.9	0.3	5.7	3.3	7.7	0.2
Labour Market							
Unemployment (official data)	26.1	23.9	25.3	26.6	24.3	-	-
Prices							
Retail Price Index (annual average)	11.8	9.9	17.3	12.8	6.5	8.2	9.1
Producer prices (annual average)	4.6	9.6	14.1	13.4	5.9	8.4	8.5
Government sector							
RS budget (Deficit/Surplus) balance (National Definition)	-1.4	-0.1	1.5	1.4	1.5	1.4	1.5
General government debt	67.9	53.7	46.2	38.8	30.5	38.8	30.5
Monetary and Financial Indicators							
M3	29.1	31.2	39.1	37.4	41.1	33.8	44.0
Total Credit	32.9	46.6	52.1	16.7	39.2	16.7	39.2
Exchange rate CSD/USD (end-period)	57.41	58.38	66.92	67.19	58.34	61.65	54.34
Exchange rate CSD/EUR (end-period)	65.15	72.73	83.06	84.29	79.9	79.42	78.72
Real Effective Exhange Rate (Index)	101.9	98.9	101.6	116.5	110.1	116.5	110.1
International Position							
Current account balance	-7.2	-11,9	-8,1	-12,6	-15,9	-12,6	-15,9
Trade balance	-21.2	-28,8	-21,5	-21,8	-20,5	-21,8	-20,5
Foreign direct investment, net	6.7	4.0	5.7	14.8	5.0	14.8	5.0
Gross External Debt	66.7	57.5	58.7	61.7	61.1	6.17	61.1
Memorandum items							
Population (middle-year)	7480591	7463157	7440769	7411569	7397651	-	-
GDP (in Mil of EUR)	17922.1	19673.0	21235.5	25316.8	31340.8	-	-
GDP per capita (in EUR)	2395.8	2636.0	2853.9	3415.8	4236.6	-	-

Source: National Statistics, NBS , European Commission, IMF Statistics

*REER:end of previous year=100

Serbia: Banking Indicators	2004	2005	2006	2007
Percentage of GDP (%)				
Assets	43.0	52.2	59.9	67.4
Total Credit	23.4	29.1	28.0	33.2
Credit to Enterprises	17.3	20.1	18.0	19.6
Credit to Households	4.6	7.5	8.9	12.3
Deposits	19.0	22.8	26.1	32.7
Percentage Change (%, yoy)				
Assets	36.1	48.7	39.4	31.7
Total Credit	46.6	52.1	16.7	39.2
Credit to Enterprises	33.8	41.5	3.5	34.6
Credit to Households	126.2	98.7	54.2	50.2
Deposits	36.0	46.7	39.6	46.9
Percent (%)				
Capital Adequacy Ratio	27.9	26.0	24.7	27.9
Capital to Assets	18.8	16.2	15.6	–
NPLs to Total Loans			11.7	10.4*
Share of risky loans to total loans	23.3	23.2	21.4	–
Provisions to NPLs	58.9	47.8	–	–
Return on Assets	-1.0	0.9	1.7	1,7
Return on Equity	-5.3	5.9	9.7	8.5

Sources: NBS, IMF
* as of June 2007

4. Poland

- **Real GDP growth accelerated to 6.5% yoy in 2007 against 6.2% yoy in 2006 on buoyant investment activity. Economic growth remains resilient in 2008, nevertheless at a slower pace.**

- **The newly emerged investor-friendly coalition government offers good prospects for political stability. However, it cannot override the presidential veto power.**

- **Inflationary pressures stemming from tight labour market and higher energy and food prices led consumer prices to rise by 4.1% yoy in March 2008, well above the central bank's 2.5% (±1%) inflation target for a fifth consecutive month.**

- **Wage increases above labour productivity undermine competitiveness, pushing up unit labour costs.**

- **Monetary authorities hiked interest rates to 5.75% in March, a total of 75bps since last December in an attempt to curb inflation pressures.**

- **Zloty is the best-performing currency in Central & Eastern Europe. So far, this has had little effect on exports competitiveness.**

- **Poland met, for the first time, both fiscal Maastricht criteria since it joined the EU in 2004. Stronger than expected economic growth and a lower than planed public spending boost public finances.**

- **The current account deficit widened to 3.7% of GDP in 2007. Net FDI inflows coverage is maintained at high level (90.8%), though it declined below 100% for the first time since 2003.**

- **Credit volumes in Poland remain unaffected by the international financial markets crisis. Total credit grew by 29.2% yoy in 2007 against 24.1% in 2006.**

- **The banking sector profitability is not expected to be as strong in 2008 as in previous years. Polish banks are challenged by increased funding, expansion and operating costs.**

4.2 Current Economic Developments

Outlook 2007-2008

The newly emerged government offers good prospects for political stability in the short term. In the medium term, it's investor-friendly policy orientation provides guarantees that investments will remain robust. Economic growth was strong in 2006-2007; GDP growth rates exceeded 6%. However, GDP growth started slowing in the last quarter of 2007 and this trend should continue in 2008. Nevertheless, it still remains at high levels, especially if one takes into account the global economic slowdown. Vivid domestic demand shields the Polish economy from the negative impact of the weak international environment. Consumption and investment are likely to remain robust in 2008. EU funds inflows will provide additional boost. Consequently, this makes us believe that GDP growth will exceed comfortably 5% with an upside potential, in contrast to IMF recent forecasts (Table).

Table

Poland	2006	2007	2008
Real GDP growth	6,2	6,5	4,9
Inflation (annual average)	1,0	2,5	4,1
Current account balance (% of GDP)	-3,2	-3,7	-5,0

Source: IMF

Tight labour markets place an upward pressure on wages. Inflationary pressures from the labour market along with higher energy and food prices result in consumer prices rising well above the central bank's inflation target. Consumer prices averaged 2.5% in 2007 against 1% in 2006. In spite of the slightly softer inflation reading in March, consumer prices are set to rise further during 2008. In an attempt to curb inflation, the Central Bank purses monetary policy tightening, that is not expected to bring inflation in line with the Maastricht criterion before 2009. In the meantime, higher interest rates result in zloty sharply appreciating. However, the strong zloty has not yet affected Polish exports performance.

Poland does not meet the inflation criterion any more. In contrast Poland met for the first time in 2007 both fiscal Maastricht criteria since it joined the EU in 2004. Stronger than anticipated economic growth provides a positive boost to public finances. The budget deficit came below target in 2007 and is expected to be below target in 2008 too. As a result, the General Government deficit stood below the 3% of GDP limit. At the same time, the General Government debt stood at 46.8% GDP way below the 60% limit.

Political environment

Last October's national elections led to the formation of a PO-PSL coalition government. The coalition government enjoys a parliamentary majority which does not surpass the 60% threshhold so as to override a Presidential veto. This implies a potential source of political risk, especially in the light of the Prime Minister and PO leader presidential ambitions. Moreover, the coalition government is caught between conflicting goals, with respect to the implemented fiscal policy. On one side, the Prime Minister desires to court popularity ahead of the 2010 presidential election; hence he needs to deliver on his promises for pubic-sector wage hikes and tax reforms during last October's electoral campaign. On the other side, the rest of PO, by contrast, is eager to push for a pro liberal agenda, boost Polish competitiveness and get the country into shape for entry in the Euro area.

The dispute over the parliamentary ratification of EU's Lisbon reform treaty has dominated political developments over the past month. The major opposition party PiS, failed to block the ratification –which requires a two-thirds majority- when the government threatened for a referendum on the treaty. Finally the Lisbon treaty was approved by parliament in early April.

On the international scene, the PO-PSL government is trying to rebuild its sharply deteriorated relations with Germany due to the confrontational approach adopted by the previous government. In addition, the coalition government has tried to drive a harder bargain regarding the US interceptor missiles on Polish territory.

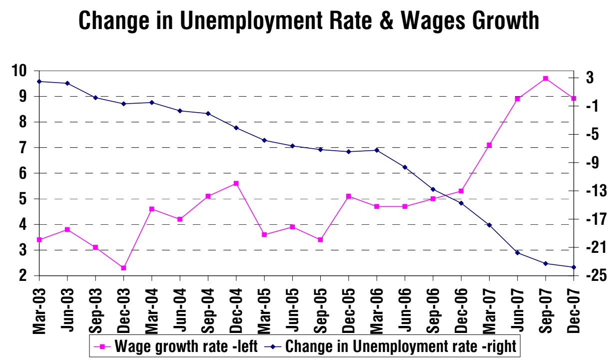
Growth performance

Poland's real GDP growth amounted to 6.1% yoy in Q4, marginally lower than 6.4% in both Q2 and Q3, bringing overall growth to 6.5% in 2007. Domestic demand was weaker in Q4 than the previous quarters. The improvement though in the net exports position largely offset the effects of slower domestic demand growth, on GDP growth rate, in the last quarter of 2007.

Investment continued to be the main driver growing by 16.4% yoy. Private consumption decelerated to 3.7% yoy, against 4.7% yoy in Q4 2006, compared to 5.1% yoy in Q3 2007. The previously large gap between exports and imports growth rates almost disappeared in the fourth quarter. Imports slowed down to 8.2% yoy in the last quarter of 2007 against 17.5% yoy a year ago. At the same time, exports grew by 8.2% yoy against 10.1% yoy.

Monthly indicators for the first quarter suggest that economic growth maintained its rapid pace. Industrial production accelerated to 12.6% yoy in February. Moreover, construction growth remains strong with an increase of 15.9% yoy in February 2008.

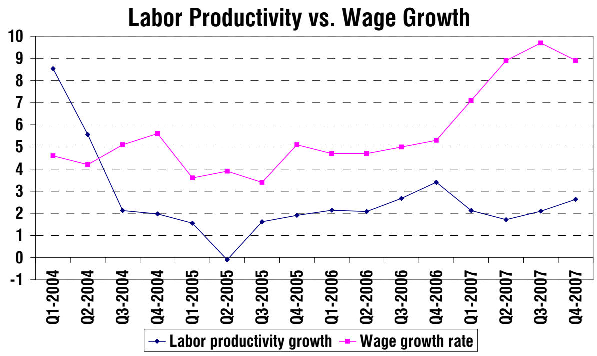
Figure 4.1



Labour market developments

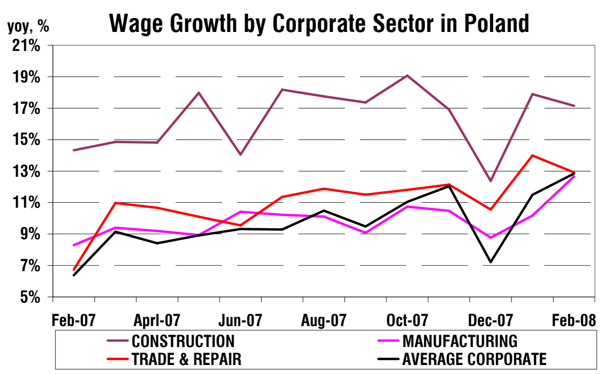
Strong economic growth translates into an improvement in the labour market. Unemployment dropped to the lowest levels since Poland joined the EU. The unemployment rate fell to 11.3% in Q4 2007 against 14.8% in Q4 2006 (Figure 4.1). Strong employment growth reveals labour market shortages. Employment growth stood at 4.2% yoy at the same time.

Figure 4.2



Tight labour markets place an upward pressure on wages. More precisely, average monthly wages accelerated to 8.9% yoy in Q4 2007, versus 5.3% yoy in Q4 2006. On the downside, average annual wages grow faster than labour productivity (Figure 4.2). As a result, unit labour costs increase and thus enterprise sector competitiveness is expected to suffer in the near term. The robust wage growth is expected to continue due to the favourable macroeconomic environment. In more detail, the reading on February's corporate wages was 12.8% yoy against 6.38% yoy in February 2007. This is highest for nearly 8 years, reflecting an increase in all corporate sectors.

Figure 4.3



A larger increase was observed in the construction sector with 17.15% yoy while in manufacturing it was 12.66% yoy and in trade & repair at 12.92% yoy (Figure 4.3). The above increase in the corporate sector wages becomes more significant if we take into account the employed persons by sectors. For instance, manufacturing accounts for 42% of the corporate sector employees (Figure 4.4).

Figure 4.4

Public Finances

Stronger than expected economic growth coupled with a lower than planned level of public spending benefit public finances. High nominal growth led to stronger tax receipts. Slow progress in implementing EU supported investment projects results in a lower than planned level of public spending. As a result, the state budget deficit came at PLN 16.9bn in 2007, or just 56.4% of the target set. Moreover, the data released for Q1 2008 showed a budget surplus of PLN 3.1bn compared to a full-year target of PLN 27.1bn deficit. In Q1 2008 revenues reached 23.4% of the full-year plan while public spending was at 20.3% of the full-year target. The budget deficit is expected to be below PLN 24bn in 2008.

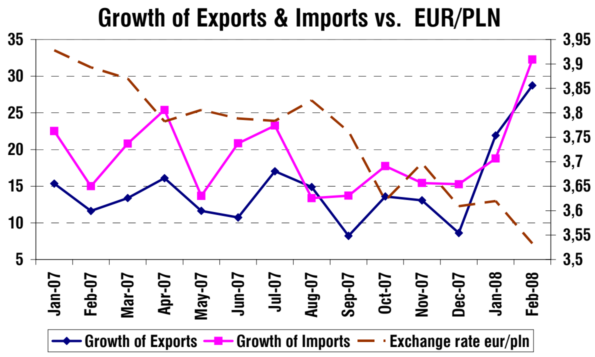
Poland met for the first time, both fiscal Maastricht criteria since it joined the EU (i.e. a deficit of less than 3% of GDP and a public debt of less than 60% of GDP). The achievement is attributed to the strong economic growth rather than public expenditure reform. Public expenditure reform is under debate for a long time in Poland.

The new government also pledged to consolidate public finances. The consolidation plan entails liquidation of some state agencies and funds. The move could save the state about PLN 10bn (0.9% of GDP from 2007) within 2-3 years. In the meantime, the government has taken decisions that will raise expenditures in 2008. The additional expenditures (wage increases, retirement and disability pension valorisation) are geared towards consumption and will cost PLN 11.7 bn or 1% of GDP in 2008.

Balance of Payments Developments

The current account deficit widened to the highest level since 2000 in Q4-2007. The current account deficit jumped to 3.8% of GDP versus 3.2% in Q4 2006. In the first two months of 2008 the current account deficit widened further to 4%. On the other hand, exports continue to grow rapidly and slightly outpacing imports growth (Figure 4.5). This suggests that the strong zloty has not yet affected Polish exports.

Figure 4.5

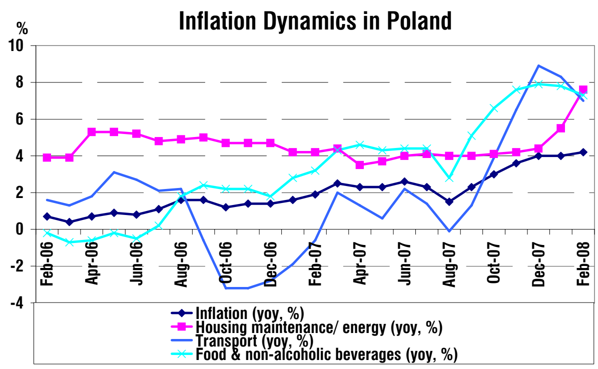


Total FDI inflows reached in 2007 12.8bn EUR against a record high of 15.2bn in 2006. The net FDI inflows covered 90.8% of current account deficit in 2007. Although it is a high level of coverage, compared to other countries of New Europe, it is the first time since 2003 that the current account deficit is not totally financed by net FDI inflows. The major sectors that attract FDI in Poland are manufacturing (23.7% of total inflows) and services (65%). Almost half of services category represented real estate inflows. Moreover, the 90% of FDI inflows are coming from EU and only a 2.7% from USA.

Inflation dynamics

Strong economic growth above potential has been accompanied with high inflationary pressures. Consumer prices accelerated sharply in the last quarter of 2007. Inflation rallied from 2.3% yoy in September to 4.0% yoy in December and further to 4.1% in March (Figure 4.6). Inflation would have been higher if it had not been for the downward revision since the beginning of 2008. January's inflation was revised down to 4.0% yoy from earlier reports of 4.3% yoy. This downside surprise was driven by changes to the CPI basket, shifting more weight from food towards services. It's worth mentioning the increase in weights of the restaurants and hotels component, indicating the better economic situation of households over the last year.

Figure 4.6

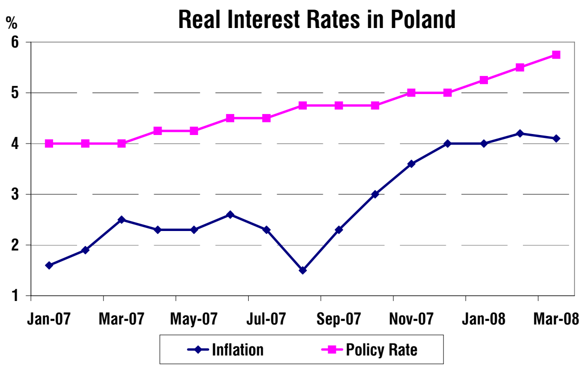


Supply side factors such as higher oil and food prices drive inflation up. Inflationary pressures stem not only from supply side. Inflationary pressures from the labour market gradually increase as lower unemployment, along with migration, leads to faster wage growth. For that reason, net inflation (the core measure which excludes food and transportation fuel) stood a 2.7% yoy in March against only 1.7% yoy at year end.

On the positive side, lower import prices are easing inflationary pressures. Slightly softer inflation reading in March may indicate that the strong zloty counteracts some of the increase in oil and food prices.

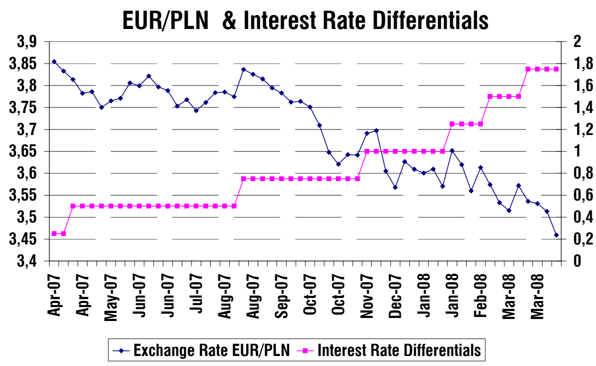
The Central Bank raised the reference interest rate further to 5.75% in March. It's the third 25bps rise, a total of 75bps, since last December. Consumer prices flucutated above the upper tolerance range limit (the NCB's inflation target is 2.5%±1%) since last November. This leaves the Central Bank with little choice but to hike interest rates aggressively, in an attempt to curb inflationary pressures, as real interest rates have been actually on the decline since last August (Figure 4.7).

Figure 4.7



At the same period, the strong appreciation trend of the Zloty begun. (Figure 4.8). In mid April the Zloty had appreciated by 6.5% against EUR since last November. Zloty is the best-performing currency in Central & Eastern Europe at this point. The appreciation against US dollar is even greater (13.8% since last November). The Zloty is expected to continue strengthening against the Euro due to strong Polish economy fundamentals and expectations of further rate hikes.

Figure 4.8



4.3 Banking Developments

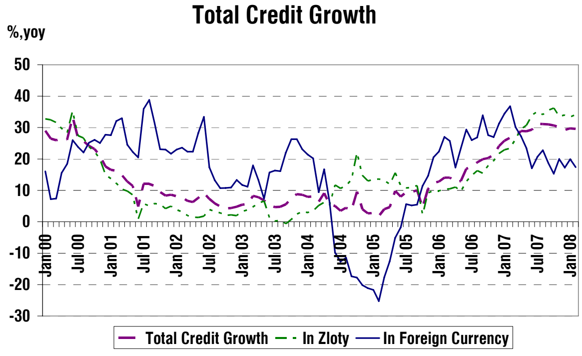
At first sight, the Polish banking sector displayed strong dynamics in 2007. The banking sector benefited from the strong economic performance of the Polish economy during 2007. Both assets and profitability growth reveal the picture of a dynamic expanding industry in which new entrants show up. The banking sector assets grew by 17.6% yoy to PLN 801 bn. The banking sector assets to GDP reached 68.9% against 64.3% in 2006. Financial intermediation still has a long way to converge to the average Europe Union levels. Strong economic growth, rising disposable per capita incomes will eventually translate into higher demand for financial services. There is already an active market for financial services including investment funds, brokerage firms etc. On a consolidated basis, financial sector assets grew by 18.1% yoy in 2007, compared to 12.8% yoy a year earlier. Moreover, total assets stood at 78.8% of GDP in 2007, compared to 73.8% in 2006, which is a record high level.

Nevertheless, the outbreak of the financial crisis since last summer has imposed dramatic changes on the international environment. Polish banks operate under the positive influence of the macroeconomic environment but on the other hand they have to face the harsh reality imposed by the international financial turbulence. In addition they have to deal with increasing interest rates and credit conditions tightening. More analytically, the reference rate has risen to 5.75% as of March 2008 from 4% at the beginning of the previous year and it is expected to increase further to 6.5% approximately during 2008. The monetary policy tightening is expected to put further pressure on margins and thus profitability.

The financial crisis has raised a number of issues which are going to dominate the agenda in 2008. So far, we have witnessed relatively modest increases in credit default swap and bond spreads, but no major slowdown in credit volumes. On the negative side, the cost of capital for a financial institution through money market refinancing in Poland has increased by around 100 bps since August. The increased wholesale cost of funding turns the attention to attracting deposits.

Polish banking institutions face not only increased funding costs. Their expansion strategy requires strong investments in personnel and networks, which in turn increases operating and sunk costs. Intense competition squeezes margins as well. The poor stock performance has a negative impact on revenues from commissions and investment funds. Consequently, it comes to us as natural to expect that banking sector profitability isnot going to be as robust as in previous years.

Figure 4.9



Credit Developments

Credit volumes in Poland have not been affected by the financial markets crisis. Credit expansion remained robust throughout the last months of 2007 and the first months in 2008. Total credit grew by 29.2% yoy in 2007 against 24.1% yoy in 2006 (Figure 4.9). Credit in Zloty reached 34% yoy up from 21.7% yoy. FX denominated credit slumped to 17.2% yoy compared to 31.3% yoy a year earlier. The decline reflects the strong appreciation trend of Zloty during this period.

Credit penetration stands at a very moderate level compared to the Euro area levels. Total Credit reached 38.8% of GDP in 2007 compared to 33.1% in 2006. On average credit volumes are expected to decelerate modestly in 2008. During this year, the impact of monetary policy tightening and the credit conditions tightening is expected to be seen.

The consumer segment leads credit expansion in Poland. Household credit accounts for more than half of the banking sector portfolio (Figure 4.10). Credit to households grew by 38.4% yoy in 2007, the highest growth since 2000 (Figure 4.11). Even after this increase, household credit now represents 21.8% of GDP. The household indebtness is still comparatively quite low for the level of GDP per capita in European Union. The strong demand for consumer loans reflects household demand for durable goods, which in turn is translated in robust private consumption growth rates. The improvement in household financial conditions is depicted at the decline in unemployment and real wages growing at 6% yoy on average in 2007.

Mortgage loans expand rapidly as demand for housing is strong. Mortgages outstanding value grew by 50.6% yoy in 2007. Newly granted mortgages increased by 7% yoy. Soaring real estate property prices have led average newly granted loan value to increase by 12.3% yoy in the same period Mortgage sales have started easing in late 2007-early 2008, albeit from high levels. Increased lending costs as a result of the interest rate hikes and the tightening of credit conditions have an impact on mortgages growth. In addition, Zloty appreciation and higher domestic interest rates prompted lenders to convert loans in Zloty to Swiss Franc. As a result, mortgages in domestic currency seem to decelerate driving down mortgages overall (Figure 4.12).

The corporate segment of the market rebounded in 2007. Credit to corporates grew by 23% yoy as opposed to 14.5% yoy in 2006 (Figure 4.13). Increased demand for investments drive credit to private enterprises up to 27.8% yoy. On the public sector side, public

Figure 4.10

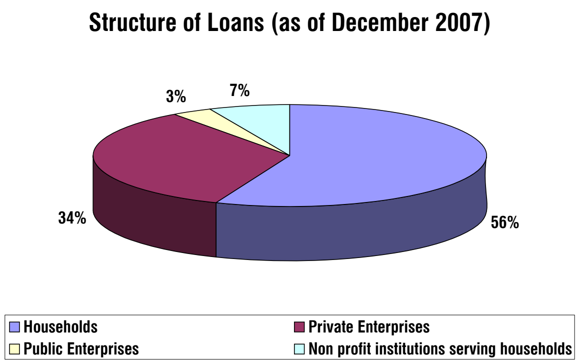


Figure 4.11

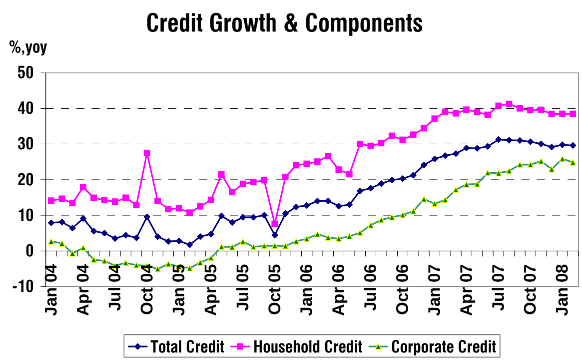
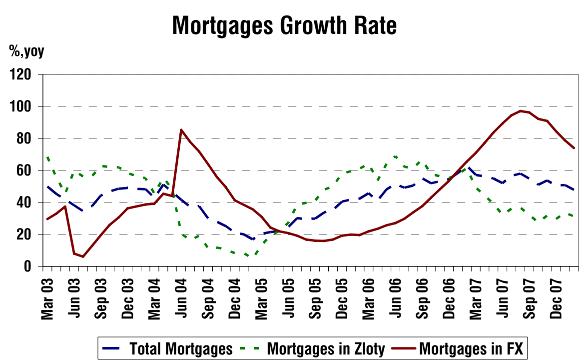


Figure 4.12



corporations lending decreased by 12% yoy.

Deposit Developments

During the late months, we have witnessed two opposite trends in deposits growth. Household deposits growth rebounded while corporate deposits declined significantly. The recent poor stock market performance and the rising interest rates have made bank deposits attractive to households again. Household deposits growth rate reached 10% yoy in Q4-2007, up from 8.6% yoy a year earlier. Deposits in zloty were the main contributor in household deposits-89.1% of total household deposits.

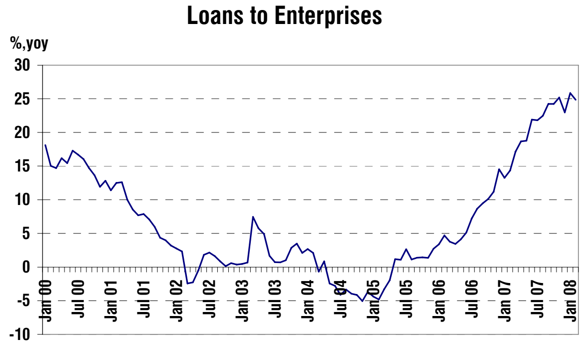
On the other hand, enterprise deposits, decreased to 14.3% yoy in Q4 2007, against 26.4% yoy a year earlier. Enterprises make extensive use of their own funds for their booming investment needs. Tighter credit conditions from the sub-prime crisis and rising interest rate costs urge companies to use their own available funding sources first.

Summing up, total deposits stabilized to 13.8% yoy in 2007, down from 14.3% in 2006. Nevertheless, deposits growth cannot compensate for the rapid credit expansion. The channeling of deposits to the stock market together with the dynamic credit expansion has made deposits scarcer than before. Hence, the loan to deposit ratio deteriorated significantly from 85.9% in 2006 to 97.5% in 2007. For that reason, the liquidity risk has become the number one challenge the banking sector faces.

Banking Sector's Profitability and Capital Adequacy

The financial performance of the banking sector was remarkable in 2007. Net profit increased by 28.5% to PLN 125 bn in 2007. Most of the profit came from traditional banking activities. Namely, increased net interest income contributed 60% and commissions 30% in total net profit. Profitability indicators recorded an upward trend in 2007. Return on Assets (ROA) increased to 1.7% in 2007, up from 1.6% in 2006. In addition, Return on Equity (ROE) went up to 25.1% in 2007, against 22.5% a year earlier. At the same time, the banking sector

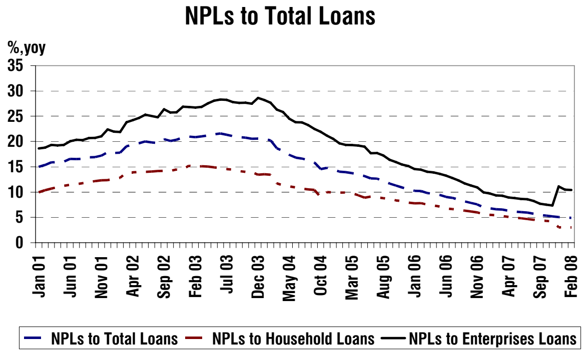
Figure 4.13



maintained very sound credit standards. Compared to 20% in 2002-2003, non-performing loans reached new record lows. NPLs stood at 5.07% in 2007 against 7.01% in 2006 (Figure 4.14).

Capital adequacy declined for a third year in a row, but it is still maintained well above the 8% threshold. The Capital Adequacy Ratio declined to 11.9%, down from 13.2% in 2006. The Basel II requirements implementation will lower capital adequacy ratios even more as the financial institutions will have to adjust to new liquidity regulations. Additionally, the robust credit growth entails additional challenges, if it is not accompanied with capital increases. Overall, we would expect the capital adequacy ratio to drop further. The Financial Supervision Commission, the banking sector regulator, recommended that banks use their retained profits to boost capital adequacy. Most banks though chose not to follow the informal recommendation and continued their dividend policy.

Figure 4.14



Poland: MacroEconomic Indicators	2003	2004	2005	2006	2007	Q4 2006	Q4 2007
Output and expenditure							
GDP	3.8	5.4	3.6	6.2	6.5	6.6	6.1
Private consumption	2.0	4.3	2.0	4.8	5.2	4.7	3.7
Public consumption	4.9	3.2	5.2	5.8	0.7	4.5	0.1
Gross fixed capital formation	-0.1	5.9	5.4	14.9	20.4	16.6	16.4
Exports of goods and services	14.0	14.3	7.8	15.0	8.5	10.1	8.2
Imports of goods and services	9.3	15.6	4.6	17.6	12.6	17.5	8.2
Industrial production	8.8	12.7	4.1	12.0	9.6	10.9	8.6
Labour Market							
Employment	-1.1	0.9	2.3	3.5	4.3	3.6	4.2
Unemployment (in per cent of labor force)	19.9	19.5	18.2	16.2	12.7	14.8	11.3
Prices							
Consumer prices (annual average)	0.8	3.5	2.1	1.0	2.5	1.3	3.5
Producer prices (annual average)	2.6	7.0	0.7	2.3	2.3	2.8	2.3
Average monthly wage in economy	3.2	4.9	4.0	4.9	8.7	5.3	8.9
Government sector							
General government balance (ESA95)	-4.7	-3.9	-2.5	-3,9	-3,0	-3,9	-3,0
General gross government debt (ESA95)	43.9	41.8	41.9	47.8	46.8	47.8	46.8
Indicators							
M3	2.4	7.6	13.2	12.7	15.8	14.5	13.6
Total Credit	8.6	2.7	12.4	24.2	29.2	24.2	29.2
Exchange rate Zloty/USD (end-period)	3.89	3.62	3.24	3.08	2.74	2.93	2.47
Exchange rate Zloty/EUR (end-period)	4.44	4.51	4.01	3.89	3.77	3.83	3.60
Real Effective Exhange Rate (Index)	96.32	96.22	107.47	109.84	114.1	111.21	119.0
International Position							
Current account balance	-2.1	-4.2	-1,6	-3,2	-3,7	-3,2	-3,7
Trade balance	-2.6	-2.2	-0.9	-2,0	-2,8	-2,0	-2,8
Foreign direct investment, net	2.0	4.7	2.3	3.0	3.8	3.0	3.8
Memorandum items							
Population (end-year, thousand)	38195	38180	38161	38129	38108	-	-
GDP (in Mrd of EUR)	191.6	204.2	244.4	271.5	304.9	-	-
GDP per capita (in EUR)	5016.4	5348.3	6404.4	7120.6	8000.9	-	-

Source: National Statistics, NBP, European Commission, IMF Statistics, Bloomberg

Poland: Banking Indicators	2004	2005	2006	2007
Percentage of GDP (%)				
Assets	68.4	70.2	73.8	78.8
Total Credit	27.2	28.7	33.1	38.8
Total Credit in FX	6.3	7.2	8.7	9.3
Credit to Enterprises	12.6	12.1	12.9	14.4
Credit to Enterprises in FX	3.1	2.8	2.9	2.7
Credit to Households	11.9	13.9	17.3	21.8
Credit to Household in FX	2.9	4.0	5.5	6.2
Mortgages	4.0	5.3	7.7	10.5
Deposits	34.9	36.3	38.5	39.9
Deposits in FX	5.0	5.4	5.7	4.8
Percentage Change (%, yoy)				
Assets	4.4	9.0	12.8	18.1
Total Credit	2.7	12.3	24.1	29.2
Total Credit in FX	-21,1	20.6	31.3	17.2
Credit to Enterprises	-3.7	2.6	14.5	23.0
Credit to Enterprises in FX	-27,7	-2,4	9.5	5.5
Credit to Households	11.7	24.0	34.5	38.4
Credit to Household in FX	-9,2	48.4	47.1	25.6
Mortgages	21.1	40.5	54.6	50.6
Deposits	6.4	10.4	14.3	13.8
Deposits in FX	-5,5	15.9	11.9	-6,3
Percent (%)				
Capital Adequacy Ratio	15.4	14.5	13.2	11.9
Capital to Assets	8.0	7.8	–	–
NPLs to Total Loans	14.9	11.0	7.0	5.1
Provisions to NPLs	61.3	61.6	–	–
Return on Assets	1.4	1.6	1.6	1.7
Return on Equity	16.7	19.9	22.5	25.1

Sources: NBP, IMF

5. Ukraine

- **Tensions between the weak government coalition partners, the President and the Prime Minister, appear heightened. The probability of a new election is non trivial. Ratified WTO membership is expected to provide a positive catalyst to economic growth.**

- **Ukraine was the top growth performer in New Europe in 2007. GDP grew by 7.6% yoy on the back of surging domestic demand and a favorable external environment which boosts exports. GDP growth is forecasted to slow to 5.6% in 2008.**

- **The fiscal outlook in 2008 is more uncertain, given that it would be more difficult to repeat last years' revenue performance, while expenditure is expected to increase.**

- **The current account deficit increased to 3.7% of GDP in 2007 due to rising imported gas prices and is financed by surging capital inflows, both FDI and portfolio investments.**

- **Inflation soared to 26.2% yoy in March, the highest level since 2000. Food prices, which carry a significant weight in the consumption basket, are the main driver behind the inflation rally.**

- **The Central Bank has hiked interest rates to 12% and allowed Hryvnya to fluctuate on a wider fluctuation band against USD in an attempt to contain inflation. If inflation news gets worse, we expect a further widening of the band.**

- **Credit boom, financed through external borrowing continues in Ukraine despite the global credit squeeze. Total credit grew by 74.1% yoy and total credit as a percentage of GDP reached 60.3% in 2007.**

- **Liquidity risk is a major threat to the banking system. The Loans to Deposits ratio widened to152.6% in 2007 against 133.1% in 2006.**

- **Measures implemented to contain dollarization in Ukraine had partial success. Dollarization in deposits declined modestly in Q4-2007.**

5.1 Current Economic Developments

Outlook 2007-2008

The Ukrainian economy demonstrated a strong economic performance in 2007 despite the ongoing political turbulence. The foundations for strong growth performance lie in the expansionary fiscal and monetary policies and a favorable external environment for Ukrainian steel exports. Surging capital inflows and the ongoing credit boom have leveraged this effect.

In the last couple of years Ukraine faced up to the supply shock of continuously rising imported gas prices, which puts pressure on production costs and widens the current account deficit. Industry will face another challenging year as gas prices will grow further by 38% in 2008, but will capitalize on their investments in energy saving technologies. In addition, it will reap the benefits of the rising steel prices and ratified WTO membership. On the other hand, the international financial market crisis has resulted in higher interest rate spreads for Ukraine, higher than the emerging markets average (Figure 5.1).

Economic developments in 2008 are expected to reflect roughly the above facts. GDP growth is expected to decelerate moderately as domestic demand will be negatively affected from soaring inflation and as credit expansion is expected to cool down on higher borrowing costs (Table). The most obvious risk comes from the political side. The political landscape remains fragile even after the elections.

Political Environment

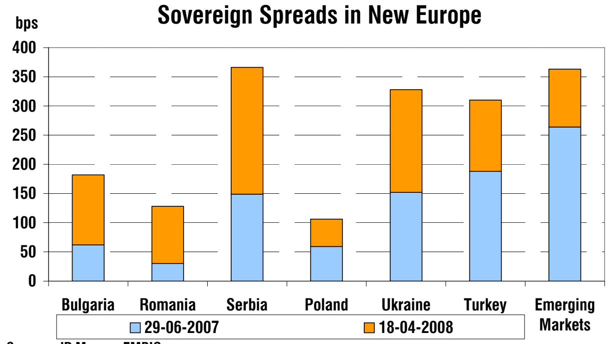
It took three months for a government to form in Ukraine after the early parliamentary elections in late September. Prime Minister Julia Tymoshenko leads a weak government coalition with a marginal majority in parliament. Policymaking though has not improved. Tension between the main coalition partners has started to emerge out of political ambition. From allies in the Orange revolution in 2004, and coalition partners in the current government, Prime Minister

Table

Ukraine	2006	2007	2008
Real GDP growth	7,1	7,3	5,6
Inflation (annual average)	9,0	12,8	21,9
Current account balance (% of GDP)	-1,5	-4,2	-7,6

Source: IMF

Figure 5.1



Source : JP Morgan EMBIG

Tymoshenko and now most probably future rivals in the next presidential elections. Politicians act with a horizon until the Presidential elections. Tymoshenko's campaign to massively pay out failed Soviet-era bank deposits can be explained through that prism.

The showdown between the President and the Prime Minister dominates local politics. At this time, they appear to be sharply divided over Ukraine's future constitutional amendments and the way they must be approved. In addition, Yushchenko also suspended the government's privatization plan. The developments underscore the fragile political environment. The main question is whether this will lead to new elections.

Relations with Russia are going to be once again a key theme in 2008. The Ukrainian government signed a new deal with Gazprom in which gas prices hiked for the third time in the last years-38% in 2008. Nevertheless, Gazprom retained middleman Swiss-registered RosUkrEnergo, an importer that Tymoshenko attempted to eliminate from the market.

Russia strongly opposes NATO membership of Ukraine, which is not fully supported within political parties either. More tension is to come, as the group of outstanding issues is going to be diversified. WTO membership was ratified in the Ukrainian parliament after a long time. Ukraine pledges to become a member of the working group for assessing Russia's application to WTO.

Figure 5.2

Growth performance

Economic activity remained equally robust in 2007. GDP grew by a revised 7.6% yoy in 2007. Ukraine was the top growth performer in New Europe in 2007. Buoyant private consumption and investment maintained economic growth vibrant (Figure 5.2). Industrial production accelerated to 10.2% yoy in 2007 against 6.2% yoy in 2006. The ongoing credit boom and the electoral cycle support strong growth in real households' disposable incomes by 12.8% yoy.

In turn, private consumption was boosted by 15.1% yoy in the first nine months of 2007 against 12.5% yoy in 2006. Investment in energy saving technology and the production capacity upgrade drives gross fixed capital formation up by 22% yoy at the same period compared to 19% in 2006. Strong construction activity reinforces the positive trend-15.8% yoy expansion in 2007. Net Exports are negative. The external favorable environment for steel products drives exports' rebound to 3.1% yoy. Nevertheless, the hike in imported gas prices and the domestic demand doubled imports growth to 15% against 6.5% in 2007.

The first data released from the supply side point to a slight deceleration in 2008. GDP growth slowed to 6.0% in the first quarter. The services sector continues to be the main driver. Trade expanded by 14.7% yoy, an indication of the robust private consumption growth, which is underpinned by the generous budget outlays to pensioners and compensation for frozen deposits in post-Soviet era. Manufacturing grows by 9% as benign external conditions keep exports' demand alive. The drop in construction activity by 1% is only temporary, a trend which is expected to be reversed in the forthcoming months.

Public Finance

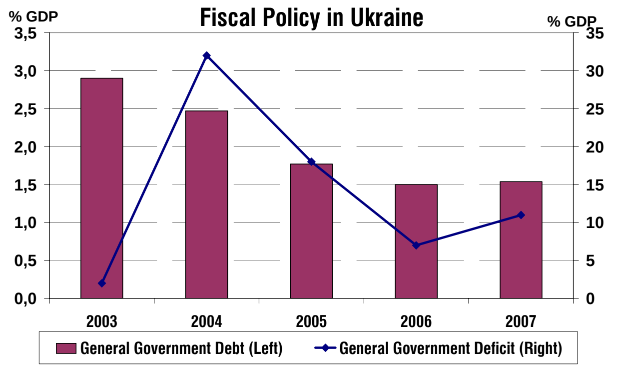
Inflation tax benefits the performance of fiscal indicators, but puts more strain on macroeconomic stability. Faster than expected nominal GDP growth and the increase in income tax rate result in revenues over performing by 8%. Buoyant revenue growth and low public debt figures allow politicians to increase public spending too. Public expenditure geared to consumer spending soars, which reflects the rapid electoral cycle.

Consolidated government revenues increased by 28% yoy. Income tax was the most dynamic component. The increase in the tax rate by 2 pps coupled with robust wage increases resulted in personal income tax (PIT) growing by 52.6% yoy. In addition, higher corporate profitability allowed corporate income tax (CIT) to increase by 35%. VAT revenues were only 17.8% higher than in 2006. VAT underperformance is explained because of the partial restoration of free economic zones and fiscal relaxation due to the elections. On the other hand, consolidated public expenditures rise fast too. Public wage spending increased on average by 26%. Pension spending explodes too. It is estimated that pension spending has increased by 258% since 2004.

The contribution of local budget surpluses saved the consolidated government performance from derailing. The consolidated government deficit came at approximately 6 bn UAH, an equivalent 0.8% of GDP, which was much less than the initial forecast of 3.2% deficit (Figure 5.3).

Fiscal policy in 2008 is expected to be more expansionary. The state budget envisages fiscal loosening to 2.1% of GDP in 2008, from 1.1% in 2007. But the risk of a higher consolidated government deficit is much higher. The government expects that the performance of tax revenues would repeat itself in 2008. This scenario has a lower chance to materialize if GDP growth were to slow down. On the negative side, the privatization program is not expected to fully materialize because of the political antagonism between the President and the Prime Minister. In turn, this will increase the financing requirements and servicing costs. Further spending increase for wages and pensions is envisaged. Government spending for pensions is projected to increase by 40% in 2008. In addition, average real wages are expected to grow by 18.7% yoy. Compensation for Soviet-era frozen deposits could leverage government expenditures further. The official provision accounts for 8 billion UAH or 1% of GDP, but it is expected to adjust higher pending on the privatization revenues performance.

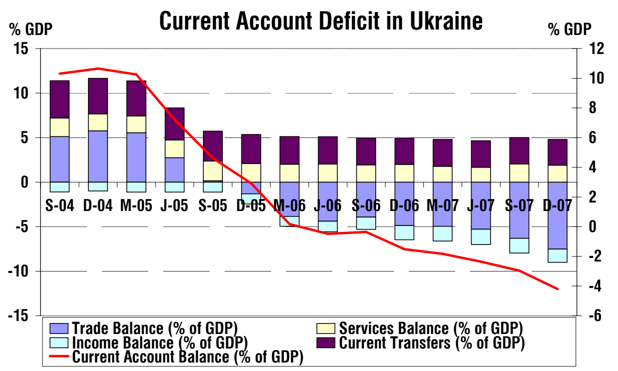
Figure 5.3



Balance of Payments

The deterioration in the current account deficit reflects the adverse developments in the terms of trade. The hikes in gas prices put more strain on the imports side, which is only partially offset by higher steel export prices. As a result, the trade balance deteriorated to 7.5% of GDP against 4.9% in 2006. Moreover, the current account deficit widened to 3.7% of GDP in 2007 compared to 1.5% in 2006 (Figure 5.4).

Figure 5.4

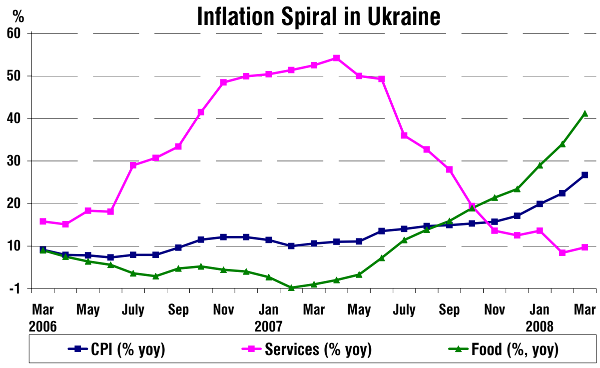


Nevertheless, current account financing does not constitute a major problem. Strong acquisition activity in the banking sector attracted significant capital inflows. Thus, Net FDI inflows amounted to 7.1% of GDP compared to 5.4% in 2006. Ukraine has also attracted significant portfolio inflows as the stock market has been one of the top performers among emerging markets.

Inflation Dynamics

Inflation followed an upward spiral in the last quarter of 2007. Consumer prices soared to 16.6% in 2007 against 12.8% in 2006. Inflation reached 26.2% in March, which is the highest level since 2000. Just as the impact from the gas price hikes in 2006 had started to recede, food prices started to rally. The drought had a significant negative impact on agricultural products supply. Agricultural production, particularly cereals, decreased significantly on the back of rising fuel prices and bio-fuel production needs. Food prices carry significant weight-60% of the consumption basket. Thus food prices rally contribute the most to the inflation spiral since last summer. The government has attempted to restrain inflation with administrative measures, such as price controls and export restrictions (Figure 5.5).

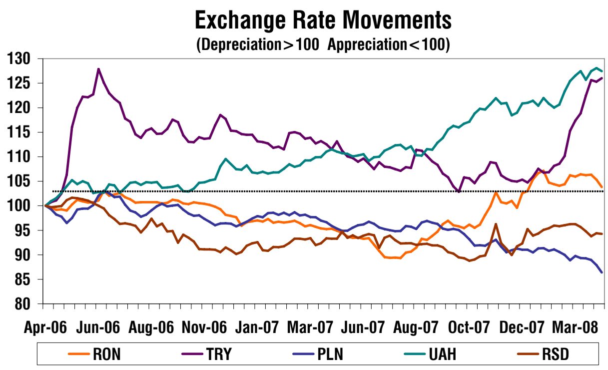
Figure 5.5



In addition, higher gas and fuel prices weigh more negatively on inflation outlook. The full pass through of higher energy prices to industry drives production costs high. For that reason, the PPI index grew by 23.2% in 2007. Households have not felt the higher energy prices as public utility hikes and administered prices adjustments were avoided. Nevertheless, producers are passing the increases to consumers, thus feeding inflation further. Wage increases are just making the situation worse. If plans to adjust gas prices for consumers materialize, then risks from inflation will be on the downside.

Higher inflation has prompted the Central Bank to adopt a more restrictive policy stance. It has introduced reserve requirements on banking sector capital inflows from overseas. In addition, it increased interest rates by 400 basis points to 12% since the beginning of 2008. Real interest rates are still negative. The monetary policy tightening is so far inadequate, given the high dolarization level in the economy and the supply-side nature of inflation. More aggressive monetary policy tightening is to come. The currency peg to the dollar was successful in bringing down inflation in the 90s in Ukraine. But this is not the case any more. Voices to abandon the exchange rate of Hryvnya against the US dollar have become louder. The Central Bank has signaled that it will allow Hryvnya more flexibility without abandoning the peg. The local currency was allowed to fluctuate on a wider band from 5-5.05 UAH/USD to 4.95-5.25 UAH/USD. If inflation were to become worse, a band widening cannot be ruled out. Hryvnya has depreciated against EUR, in the last two years more than any currency in New Europe (Figure 5.6).

Figure 5.6



5.2 Banking Developments

The Ukrainian banking sector continued to grow very fast during 2007. The lasting domestic political crisis and the international financial markets turbulence in the last months of 2007 had limited impact. Total assets increased by 76% yoy in 2007, as opposed to 59% yoy a year earlier. The lasting credit boom has contributed to the robust growth rates in the economy. Financial intermediation grows quickly as well. Total assets stood at 83% of GDP in 2007, against 67% in 2006.

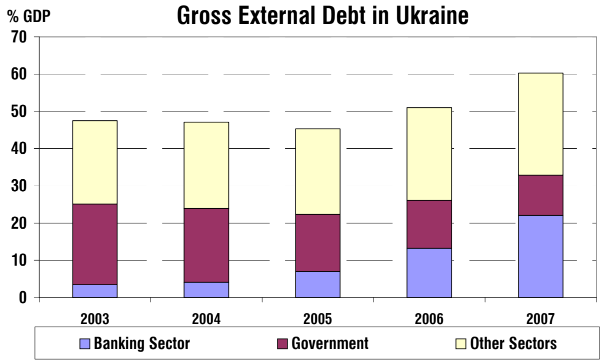
The Central Bank has adopted drastic measures in order to tame credit expansion in late 2007. Firstly, the NBU has tightened reserve requirements on foreign capital from abroad since December 2007. Foreign borrowing is subject to a 4-5% reserve requirement .Moreover, the NBU has tightened the capital adequacy norms for commercial banks, classifying more precisely risky assets. The implementation of these measures aimed to contain the credit expansion and to make it more difficult for the domestic banking system to borrow from abroad.

Banks used external borrowing in a significant degree to finance their loan expansion in the last years. Banks took advantage of the favorable international markets conditions to access cheap capital. Nevertheless, the global financial turmoil has not prevented banks from resorting to long-term external loans. The gross external debt which corresponds to the banking sector rose to 22% of GDP in

2007 compared to only 4% in 2004 (Figure 5.7). Tighter credit conditions worldwide, would induce the banking sector to restrain from external borrowing and focus on domestic currency lending.

The ongoing credit booms as well as the attractive net interest rate margins provide an important incentive for new foreign entrants in the Ukrainian banking system. There were 196 banks until the end of 2007, much more than any other country in New Europe. 44 of them were foreign banks, possessing a 35% share of total assets. The concentration in Ukrainian banking system was still relatively low. Ten banks with the largest market shares accounted for 51.2% of total assets in 2007. The number of mergers and acquisitions was impressive during 2007 and continued to be at start-2008 creating a more competitive environment. Alpha Bank, the last entrant, purchased the 90% stake of Astra Bank as of end-February 2008.

Figure 5.7



Credit Developments

Credit expansion fluctuated at very impressive levels during 2007. Total credit grew by 74.1% yoy in Q4 2007, against 71% yoy in Q4 2006. According to preliminary data by NBU, total credit growth maintained its robust growth at 76.2% yoy in the first quarter of 2008, down from 73.1% in Q1 2007. Total credit stood at 60.3% of GDP in 2007, up from 45.6% in 2006 (Figure 5.8).

More analytically, FX credit continued to be the main drive behind total credit growth, albeit a lower pace. FX-credit increased by 75.4% yoy in Q4 2007, down from 95.4% yoy a year earlier. On the other hand, credit in Hryvnya accelerated to 72.7% yoy in Q4 2007, against 52.3% yoy in Q4 2006. The gap between the credit growth in Hryvnya and that of credit in foreign currency was almost closed in December 2007 (Figure 5.9).

FX credit as a percentage of total credit stood at 49.9% in 2007 compared to 49.5% in 2006. The level was almost unchanged, revealing that measures to contain dollarization had no impact on credit.

Figure 5.8

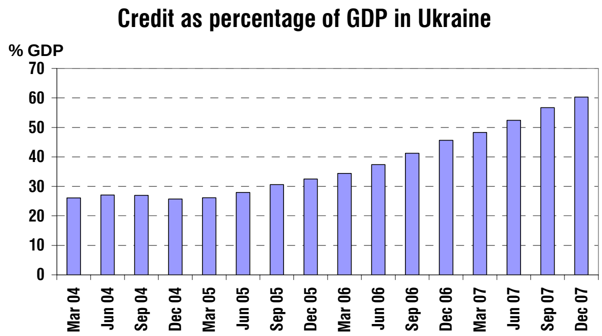
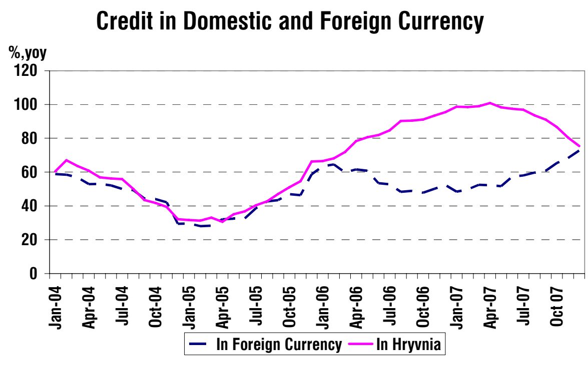


Figure 5.9



Credit to households maintained its strong expansion albeit a lower pace. Thus, household loans increased by 95.6% yoy in Q4 2007, as opposed to 130% yoy a year earlier. Household credit as a percentage of GDP stood at 22.6% in Q4 2007, against 15.1% in Q4 2006. Households are exposed to significant exchange rate risk. FX-Household credit continued to increase with high pace at 98.7% yoy at end-2007, compared to 152.1% yoy at end-2006.

Corporate credit accelerated in 2007. The corporate credit growth rate reached 62.3% yoy in Q4 2007, against 51.3% yoy a year earlier. FX- credit to enterprises decelerated to 58% yoy in Q4 2007, down from 67.4% yoy a year earlier. The Ukrainian corporate sector is very profitable and the fact that Ukrainian enterprises have started to borrow in Hryvnya reduces FX risks.

The leasing sector has started to expand rapidly in Ukraine as well. The outstanding value of leasing agreements grew by 5.3 times, to USD 3792 bn. in 2007, against USD 716 mln a year earlier. Leasing as a percentage of GDP stood at 2.6% in 2007, compared to 0.63% in 2006. The leasing market is projected to grow further in the coming years.

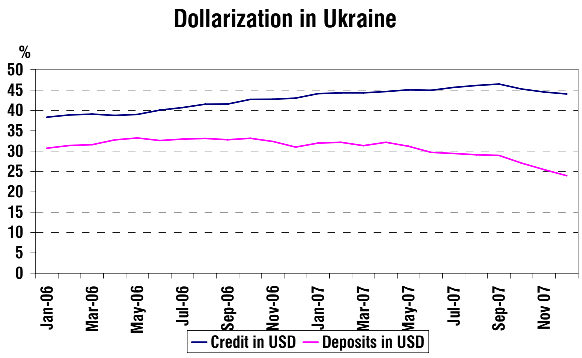
Deposits Developments

The global financial crisis has highlighted the liquidity risk as one of the major threats to the banking system in Ukraine. The loans to deposits ratio reached 152.6% in 2007, as opposed to 133.1% in 2006. The loans to deposits ratio is the highest ratio in the countries of New Europe. The FX loans to deposits ratio worsened to 237.2% in 2007, against 173.1% in 2006.

Total deposits remarked a robust expansion. Total deposits grew by 51.8% yoy in Q4 2007, against 38.8% yoy in Q4 2006. The main contributor of this growth was deposits growth in Hryvnya, which reached 66.5% yoy in Q4 2007 compared to 30.8% in Q4 2006. Higher interest rates, and the drastic measures by NBU against borrowing in USD were the main engines of this acceleration. Thus, deposits in foreign currency reduced markedly to 28.1% yoy in 2007, from 54% yoy a year earlier. We can observe a decline in dollarization of deposits, with the proportion of FX deposits to total deposits declining to 32.1% in 2007, against 38.1% in 2006 (Figure 5.10).

Household deposits increased rapidly from 45.6% yoy in Q4 2006 to 53.6% yoy in Q4 2007. FX deposits growth decelerated by 32.5% yoy in Q4 2007, against 57.5% yoy a year earlier. On the contrast, a significant increase is observed to deposits growth in Hryvnya. The fierce competition between the banks and the increase in interest rates are some of the factors which leaded the increase in household deposits. Corporate deposits growth increased by 45.7% yoy at end-2007, compared to 28.7% yoy a year earlier. FX enterprises deposits growth rate reduced to 18.1% yoy inQ4 2007, against 43.5% yoy in The fact that companies used more FX-denominated loans than FX deposits implied the increased foreign exchange risk.

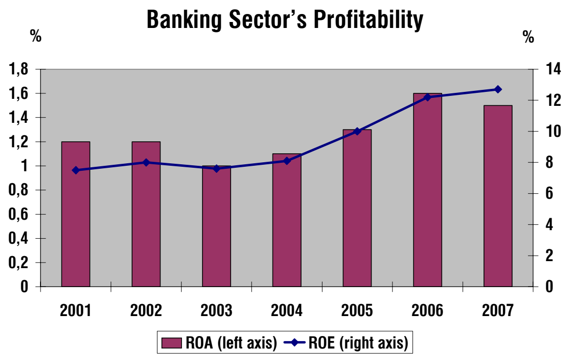
Figure 5.10



Banking sector's profitability and Capital Adequacy

Profitability in Ukrainian banking sector remained in satisfactory level during 2007. The banking profits increased by 54% yoy in 2007 to USD 1.41 bn, against 91% yoy a year earlier. Thus, Return on Assets (ROA) stood at 1.5% at end-2007, compared to 1.6% at end-2006. Moreover, Return on Equity reached 12.7% in 2007, up from 12.2% in 2006. This slight decrease of ROA is attributed to the remarkable increase of total assets, which grew by 76% yoy this period (Figure 5.11).

Figure 5.11



Intense competition especially between foreign players has started to have an impact on pricing. Interest rate spreads have started to decline in Ukraine. Namely, the spread between credit and deposits interest rates declined to 4.9% in December 2007, down from 5.9% a year earlier. Interest rate spreads are still considered to be high, but going on forward we expect the decline is expected to be reflected on profitability too.

The Capital Adequacy Ratio decreased to 13.9% in late-2007, down from 14.2% a year earlier. This decrease is attributed to the rapid credit expansion, despite the banks capital increase and the tighter capital adequacy norms for commercial banks by NBU.

Ukraine: Macroeconomic Indicators	2003	2004	2005	2006	2007	Q4 2006	Q4 2007
Output and expenditure							
GDP	9.6	12.3	3.0	6.8	7.6	9.5	7.4
Final Consumption	9.8	10.2	15.3	12.5	13.4	7.4	14.5
Gross Fixed Capital Formation	27.9	4.9	18.6	19.0	22.2	28.0	25.1
Exports of goods and services	10.3	16.6	-11,9	-5,1	3.3	1.0	5.6
Imports of goods and services	16.3	10.9	6.5	6.6	19.5	6.4	27.2
Industrial production	15.2	12.1	3.2	5.9	10.2	8.0	9.0
Labour Market							
Unemployment (in per cent of labor force)	3.6	3.5	3.2	2.8	-	8.2	-
Prices							
Consumer prices (annual average)	5.2	9.0	13.5	11.0	13.0	11.0	16.0
Produce Prices (annual average)	7.6	20.4	16.7	9.0	19.0	14.0	21.0
Average monthly wage in economy	23.0	27.7	36.5	29.0	29.7	24.0	33.6
Government sector							
Consolidated Budget Deficit	0.2	3.2	1.8	0.7	3.3	0.7	3.3
General government debt	29.1	24.7	18.4	15.2	14.9	13.1	14.9
Monetary and Financial							
M2	46.9	32.8	53.9	38.0	43.0	35.0	49.0
Total Credit	61.4	30.6	61.9	71.0	74.1	71.0	74.1
Exchange rate UAH/USD (end-period)	5.35	5.32	5.09	5.03	5.02	5.03	5.04
Exchange rate UAH/EUR (end-period)	6.03	6.62	6.34	6.32	6.89	6.49	7.30
Real Effective Exhange Rate (Index)	95.29	96.13	105.89	110.73	112.2	113.1	113.3
International Position							
Current account balance	5.8	10.6	2.9	-1.5	-4,2	-1,5	-4,2
Trade balance	1.0	5.8	-1,3	-4,9	-7,5	-4,9	-7,5
Foreign direct investment, net	2.8	2.6	8.7	5.4	6,5	5.4	6,5
Gross External debt	47.7	47.2	44.7	50.8	-	50.8	-
Memorandum items							
Population (end-year, thousand)	-	-	46924.8	46607.4	46749.2	-	-
GDP (in millions of EUR)	-	-	70338.6	84804.0	102737.2	-	-
GDP per capita (in EUR)	-	-	1499.0	1819.5	2197.6	-	-

Source: National Statistics, NBU, European Commission, IMF Statistics

Ukraine: Banking Indicators	2004	2005	2006	2007
Percentage of GDP (%)				
Total Credit	25.7	33.8	45.6	60.3
Total Credit in FX	10.8	14.1	22.3	30.1
Credit to Enterprises	20.7	25.0	29.5	36.8
Credit to Enterprises in FX	8.3	9.4	12.7	15.4
Credit to Households	4.3	8.4	15.1	22.6
Credit to Household in FX	2.5	4.6	9.4	14.4
Deposits	24.0	31.3	33.9	39.5
Deposits in FX	8.8	10.3	12.9	12.7
Percentage Change (%, yoy)				
Total Credit	30.6	61.9	71.0	74.1
Total Credit in FX	32.2	66.3	95.4	75.4
Credit to Enterprises	24.7	48.2	51.3	62.3
Credit to Enterprises in FX	24.8	44.1	67.4	58.0
Credit to Households	63.1	121.0	130.0	95.6
Credit to Household in FX	62.7	138.8	152.1	98.7
Deposits	35.2	60.0	38.8	51.8
Deposits in FX	54.3	50.8	54.0	28.1
Percent (%)				
Capital Adequacy Ratio	16.8	15.0	14.2	13.9
Capital to Assets	13.1	11.5	12.1	–
NPLs to Total Loans	30.0	19.6	17.8	–
Provisions to NPLs	21.1	25.0	23.1	–
Return on Assets	1.1	1.3	1.6	1.5
Return on Equity	8.1	10.0	12.2	12.7

Sources: NBU, IMF

6. Turkey

- **The lawsuit filed by the Chief State prosecutor to close down the ruling party threatens to throw the country into a new round of political instability. In early April, Standard and Poor's revised its outlook on Turkey's sovereign ratings to negative from stable, citing rising risks on the domestic political front and the global environment.**

- **A 32% upward revision to GDP data does not alter the picture of a slowing down economy. Real GDP growth decelerated to 4.5% yoy in 2007, from a revised 6.9% yoy in 2006 and no significant bounce is expected this year as domestic demand dynamics remain weak and the external sector is likely to exert a higher negative contribution.**

- **The current account deficit declined to 5.7% of revised GDP in 2007, from 6.1% in 2006 as a result of weaker domestic demand. The financing of this year's current account deficit will likely be a more challenging proposition, given tighter credit conditions.**

- **Investors reduce their exposure to emerging market assets as a result of the ongoing turbulence in the financial markets worldwide. The TRY has slid by ca 15% against EUR and Turkey's main stock-market index, XU100, has lost around 22% since the beginning of 2008.**

- **The medium term fiscal framework foresees a cut in the primary surplus target to 3.5% of revised GNP from 4.2%. Renewed fiscal loosening will weigh further on the country's inflation outlook.**

- **Inflation has recently made a dynamic comeback. Supply-side influences such as higher food and energy prices boosted consumer prices to 9.6% yoy in April. Second-round effects are likely to prevent a material CPI deceleration in coming months, deterring the Central Bank from further monetary-policy easing.**

- **Credit expansion stabilized at 30% yoy in the late months of 2007, down from 46.1% yoy in 2006. Mortgages are expected to pick up this year as consumer loans growth moderates.**

- **Liquidity risk in the domestic banking sector has increased recently. The loans to deposits ratio in local currency currently stands at 91.3%, whereas that in FX currency at 57.5%**

Outlook 2007-2008

The economy slowed down in 2007 as a result of past monetary tightening and increased political uncertainty stemming from the electoral cycle. The shift to aggressive monetary-policy easing since last September (225bps of cumulative CBT rate cuts delivered thus far) is likely to provide some boost to GDP growth going forward, but downside risks have increased lately as a result of a more challenging external environment and heightened political instability domestically. Net exports are likely to exert a higher negative contribution to overall GDP growth this year, while tighter credit conditions on consumption and investment will likely weigh on domestic demand (Table).

Structural reforms and fiscal consolidation in recent years have resulted in the Turkish economy developing more resilience to external shocks. However, high dependency on foreign capital inflows for the financing of the external deficit means persistent vulnerability to sudden shifts in global investor sentiment. In this respect, it is encouraging to see the government attempting lately to engage in a new form of agreement with the IMF, aiming to provide additional flexibility with regard to government spending on infrastructure and, at the same time, maintain a powerful anchor for macroeconomic and structural reforms.

Table

Turkey	2006	2007	2008
Real GDP growth	6,9	4,5	4,0
Inflation (annual average)	9,6	8,8	7,5
Current account balance (% of GDP)	-6,1	-5,7	-6,7

Source: IMF

Political Environment

Hopes that tensions on the political side would subside after the 2007 parliamentary election have been rebutted. The government's decision to go ahead with easing the ban on women wearing headscarves at Turkish universities, with the co-operation of the right-wing MHP party, has prompted a powerful reaction from pro-secularist institutions. The lawsuit filed by the Chief State prosecutor to outlaw the ruling AKP party threatens to throw the country into a new round of political instability.

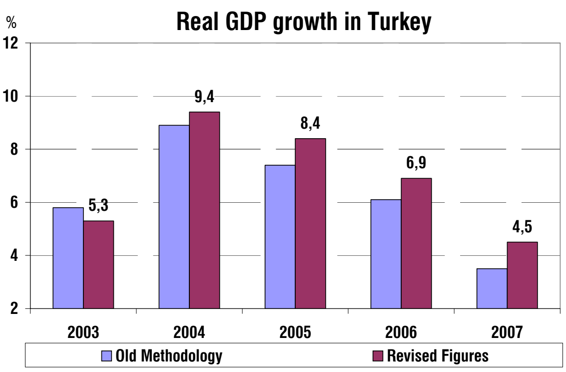
Responding to the challenge, the government has recently signaled its intention to bring forward certain constitutional amendments, aiming to make the dissolution of a political party more difficult to instigate. To gain parliamentary approval of the aforementioned amendments, however, the government would again need the co-operation of the right-wing opposition party. In case that parliamentary approval is not attained, a new referendum will be needed to ratify the amendments. In the worst scale scenario, new elections might be called upon with the participation of the current accused politicians probably in a new political formation. In our view, a wide-spread political crisis will finally be averted, since the AKP party continues to enjoy strong public support and there are pressures from the industrialist group on opposing parties to reach a compromise.

In conclusion, it will not take anything less than three months in terms of time to pass before this case clears out. The repercussions can be direct and indirect. Rising political tensions may exert additional downward pressure on domestic financial markets and the Lira, and also cause further delays in much needed, EU-backed structural reforms. On the latter issue, note that the latest outbreak of domestic political tensions has reportedly led to a significant watering-down of the recently-passed Social Security reform.

Growth performance

The recent upward revision to GDP data led to a significant improvement in such key ratios as the fiscal and current account deficits to GDP, but, in reality, it has not altered the picture of a slowing-down economy. Last year, the economy is thought to have expanded at a pace of just 4.5% yoy, compared to a revised 6.9% yoy in 2006 (Figure 6.1). The figure marks the lowest growth rate since the financial crisis in 2001. The slowdown in the economic activity was attributed to the lagged-effects of past monetary-policy tightening as well as a drought-induced contraction in agricultural output. The agricultural sector shrunk by 7.3% yoy in 2007, slashing ca 0.65 pps of GDP growth. On the other hand, construction sector's output, one of the main growth engines in recent years, grew by only 5% yoy last year.

Figure 6.1

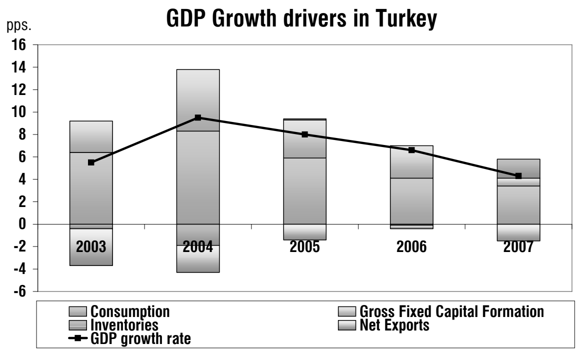


Consumption was the main driver of GDP growth last year, though it recorded one of the weakest growth reading in recent years. Final consumption decelerated from 5.1% yoy in 2006 to 4.4% yoy in 2007. Private consumption was flat in 2007 but posted significant fluctuations. Indicators such as automobile and white goods sales signal that private consumption regained some of its lost momentum in the third and the fourth quarter on the back of rising consumer credit growth.

In line with the aforementioned trends, gross fixed capital formation growth eased to 3.3% yoy in 2007 from 13.3% yoy in the prior year, with its contribution to overall GDP growth declining to around 0.7ppts, from 2.9ppts in 2006. If the change in inventories *(1.7ppts)* is also taking into account, then the respective contribution rises to 2.4ppts against 2.8ppts in 2006. At the breakdown, private-sector investment (+2.7% yoy) decelerated significantly in 2007, while, on a more positive note, public investment jumped to 7.6%.

Net exports continued to weigh negatively on growth in 2007. Exports grew by 6.7% yoy against 6.6% yoy in 2006. On the other hand, imports gained momentum, growing by 11.1% in 2007, from 6.9% yoy. The 2007 import bill was fuelled by consumption goods imports, which rose considerably in the second half of the year, as a result of reviving domestic demand and the stronger TRY. As a result, external sector deducted approximately 1.5ppts from GDP growth in 2007, compared to only 0.3ppts in 2006 (Figure 6.2).

Figure 6.2



Public Finances

The recent revisions to GDP statistics *did* improve some key ratios of fiscal performance but have not actually altered the county's underline fiscal situation. In 2007, the central government primary surplus and budget deficit were more or less in line with the targets set by the Ministry of Finance. The primary surplus ended at 4% of revised GNP, a slight deviation from the 4.1% (or 5.7% of the old GNP) official target. On a more positive note, the central government budget deficit was lower than expected at 1.6% of revised GNP against a target of approximately 2% of revised GNP. The annual growth of tax revenues from goods and services decelerated to 7% last year, from 12.6% and 21.2% in 2006 and 2005 respectively, while non-tax revenues outperformed due to an advance payment related to Turk Telekom's privatization. On the spending side, although current expenditures rose significantly last year (+17% yoy), as a result of the strong rise in personnel expenses, the ensuing decline in interest costs resulted in total expenditures coming in below total appropriations. A more accurate picture of last year's fiscal performance is portrayed, when the IMF-defined measures are taken into account. Specifically, the consolidated government sector (CGS) recorded a primary surplus of 3.5% of revised GNP (4.7% of old GNP), a figure higher than an earlier official forecast but significantly lower the initial target of 5% (6.5% of old GNP) envisioned in the 2007 budget.

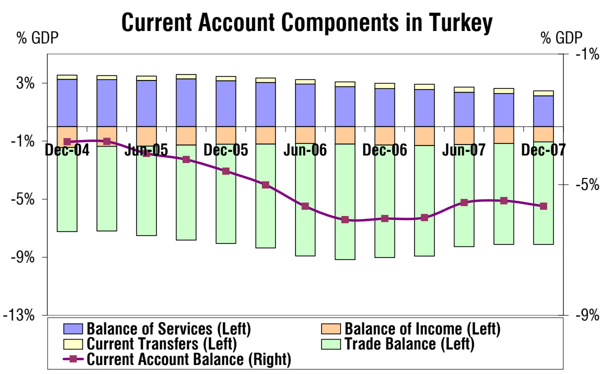
The government was expected to adopt a more restrictive fiscal stance this year. Instead, the government chose to maintain the same loose fiscal stance. The target for the primary surplus for the broader consolidated government sector was scaled back to 3.5% from 4.2% of revised GNP (or an equivalent 5.5% of old GNP which represents 1 pps GDP of fiscal loosening already).

In view of the above developments, the following two conclusions can be readily drawn: i. fiscal policy will likely add more to inflation than to growth, a fact which has been underestimated. As a result, the Central Bank would be more inclined to be hawkish ii. fiscal-policy implementation will depend on the results of the state owned enterprises (accounting for approximately 0.5% of old GNP) as well as implementation of the social security reform and this year's ambitious privatization program. The fiscal results announced for the first two months provide an encouraging message in that directions as tax revenues over performed budgetary targets. Nevertheless more data will be needed to arrive at conclusions.

Balance of Payment Developments

The current account deficit remains one of the most important medium-term vulnerabilities. It edged down to ca 5.7% of revised GDP in 2007, from slightly above 6.0% in 2006. The main driver of the slight improvement was a lower trade deficit (7.1% of GNP vs. 7.8% of GDP in 2006) as a result of the weaker domestic demand (Figure 6.3). Exports grew by 23% yoy last year, assisted by the

Figure 6.3



strong performance in the motor vehicles and machinery equipment sectors. Imports grew by 20% yoy in 2007 reflecting, among other influences, a higher import-bill for oil and the continued exports dependency on intermediate goods. Consumption and capital goods growth regained momentum in the second half of 2007.

Turkey is highly dependant on capital inflows, though, in recent years, the dependency on portfolio flows has decreased with the slack being taking up by FDI (approximately US$ 20bn each year in 2006-2007). At the end of 2007, net FDI inflows represented 3% of the revised GDP and covered around 52% of last year's current account gap. The financing of the current account deficit becomes more difficult in 2008. For the coverage to remain at the same level this year, it would require more than 20 bn. USD worth of FDI inflows. Thus, it is imperative for the government to advance the privatization program. Given the tightening liquidity conditions worldwide, and the anticipated decline of capital inflows to emerging markets it is not clear whether this target is achievable.

Inflation Dynamics

Inflation has made a dynamic come back lately, with consumer prices rallying since last September (CPI: 9.7%yoy in April 08 vs. 7.1% yoy in September 07). The Central Bank attributes the re-acceleration of inflation mainly to supply-side factors. The main driver behind the upswing since September is food, commodity prices hikes and administrative prices adjustments. To better monitor such influences, the Central Bank has added a new core measure in the group of inflation indicators it monitors (e.g., G and H indices) (Figure 6.4). The new measure, which excludes (processed and unprocessed) food and energy prices, stood very close to the 4% target of the central bank in the period examined (Figure 6.5).

Looking ahead, the inflation outlook is not quite rosy. The main risk comes from second-round influences, pass-through effects from the recent weakening of the Lira as well as rising pipeline pressures (PPI inflation currently at 14.6% yoy, against 4.4% yoy last autumn) (Figure 6.6). The Central Bank revised already its inflation forecast to 9.3% yoy in 2008 against 5.5% yoy three months ago. In our view,

Figure 6.4

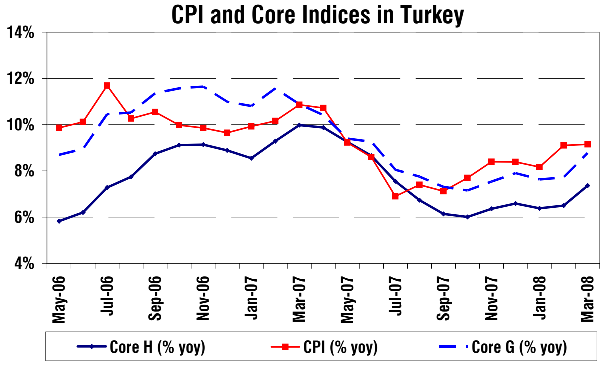


Figure 6.5

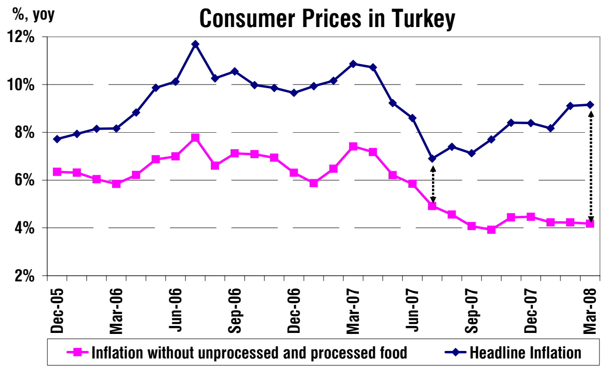
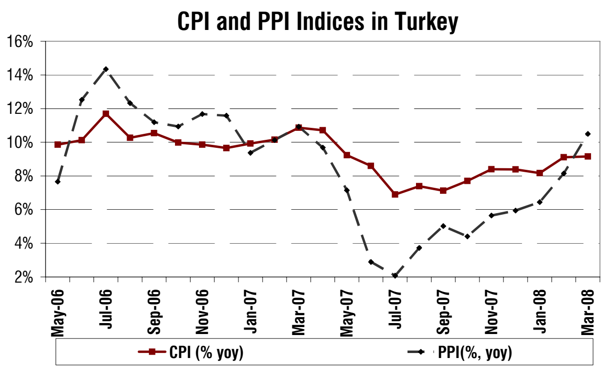


Figure 6.6

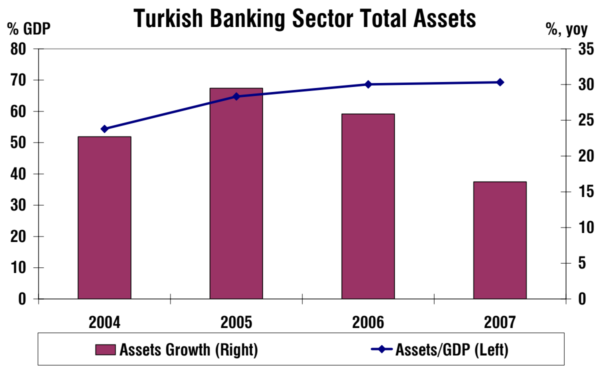


there is no room for further monetary policy easing in the period ahead in view of strengthening inflation pressures and increased current account financing needs in a fragile international economic environment.

6.2 Banking Developments

The Turkish banking sector displayed solid performance in 2007 despite the global financial market turmoil and increased domestic political noise due to the double elections. Total banking sector assets increased by 16.4% yoy in 2007, compared to 22.8% yoy a year earlier. Financial intermediation is relatively low compared to EU-27 levels. Total assets stood at 91.5% of GDP at the end of 2007, an equivalent of 69.5% according to the revised GDP figures, versus over 300% of GDP in EU-27 (Figure 6.7).

Figure 6.7



The long-term prospects of the domestic financial sector remain positive but short-term downside risks have increased lately. Although the sector has no direct exposure to the US subprime market, there is an indirect negative impact via increased funding costs for domestic banks. The limited dependence on external financing compared to other emerging market peers provides a cushion against adverse external developments, but increased competition for market share will likely continue to pressurize NIM margins. On the positive side, further monetary policy easing will contribute to further credit expansion and provide for a positive boost in their operations.

The privatization of state owned banks Halkbank and Vakifbank is going to be a key issue in 2008. Although the privatization plans have not been crystallized, the most probable scenario seems to be that Halkbank will be privatized through the sale of a 75% stake to a strategic partner, after the IPO placement of 25% last year. Halkbank ranks 7th in terms of assets, and 6th in terms of deposits. According to officials from Central Bank, the privatization process of Halkbank is expected to be completed by mid-2008.

Credit Developments

Credit expansion stabilized at 30% yoy in the late months of 2007, down from 46.1% yoy in 2006. The trend followed a steadily accelerating pace after reaching a five-year low in June. In turn, total credit stood at 45% of GDP, which comes down to 34.2% with revised GDP figures, compared to just 39.7% in 2006. The credit growth deceleration trend is anticipated to come to an end, as the monetary policy easing cycle continues. According to preliminary data, total credit increased by 1.7% as of mid January.

Consumer credit was the main driver behind credit expansion last year. Consumer loans, increased by 37.5% yoy in December 2007, down from 51.8% yoy a year earlier but up from 29.7% yoy in June 2007. Consumer lending in foreign currency is restricted, so that exchange rate volatility has no impact on consumer credit growth. Mortgages grew by 38.8% yoy in 2007, compared to 88.4% in 2006. Rising domestic housing needs and low mortgage penetration (3.9% of revised GDP in December 2007) are expected to continue support mortgage credit growth in the quarters and years ahead.

Lending to enterprises recorded a moderate growth pace last year compared to lending to households. Corporate credit grew by 27.2% yoy in Q4 2007, down from 44.2% yoy in November 2006. According to “Banks loans tendency survey”, banks do not expect a serious change in demand for corporate loans and thus business lending growth rate is expected to follow a similar pace in the forthcoming months.

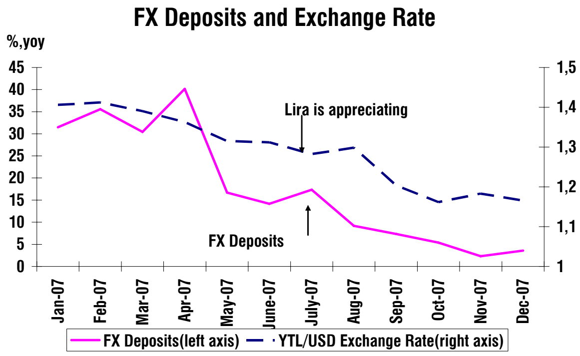
Deposit Developments

Liquidity risk in the domestic banking sector has increased lately. The loan to deposit ratio now stands at 80.1% compared to 71.2% in 2006. At first sight, it looks like there is enough funding to support credit expansion. Nevertheless, there is a huge difference in the ratios when it is decomposed to local and FX currency. The loan to deposit ratio in local currency stands at 91.3%, whereas that in FX currency stands at 57.5%.

Total deposits increased moderately by 16% in 2007, not keeping up with credit expansion. Local currency deposits recorded a growth at 23.4% yoy in 2007. On the other hand, the TRY appreciation trend slashed the FX deposit growth rate to 3.6% yoy in 2007, against 30.2% yoy in 2006 (Figure 6.8).

Funding has become a crucial issue worldwide for banks given the global liquidity crunch. Borrowing is a relatively small fraction of the Turkish banking sector liabilities. Given the increased costs of raising external financing, the banking sector will need to rely more on the deposit side to finance its expansion. As a result, attracting more deposits into the banking system becomes a key issue in 2008.

Figure 6.8

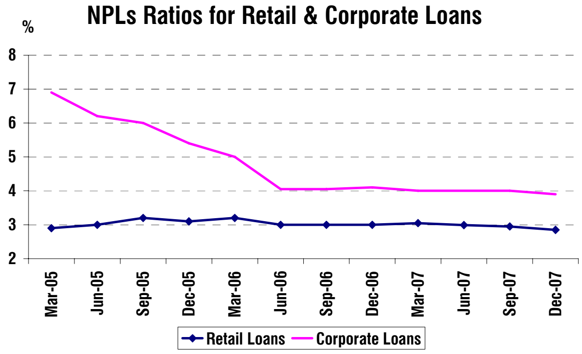


Banking Sector's Profitability and Capital Adequacy

The net profit, return on assets and return on equity of the banking sector as a whole increased in 2007. Net profit grew by 31.3% yoy in 2007, as opposed to 90.5% yoy in 2006. The rise in banks' profitability was primarily driven by the net interest income, which rose by 20.8% yoy. ROA improved to 3.4% in 2007, up from 3.3% in 2006. Finally, ROE reached 24.9% in December 2007, against 21% a year earlier.

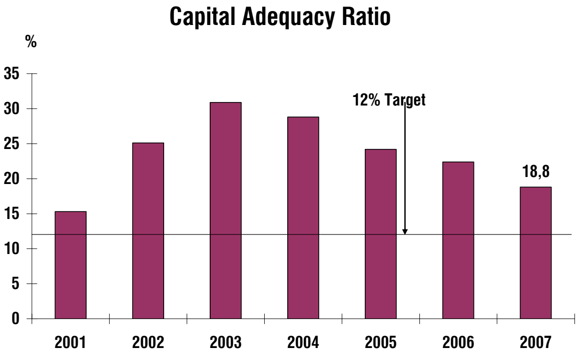
The NPLs ratio remained broadly steady in 2007. It stood at 3.5% at the end of last year against 3.8% at the end of 2006. The explanation behind this development is that loans growth has outpaced NPLs. From a sectorial perspective, NPLs ratio for corporate loans stands well above that of consumer loans (Figure 6.9). All in all, the Central Bank believes that credit risk is still limited, as stress tests indicate that the banking system can sustain a sharp increase in NPLs ratio.

Figure 6.9



The Capital Adequacy Ratio stood at 18.8% in late 2007, compared to 22.4% in late 2006. The ratio stands well above the 8% requirement and the target ratio of 12% (Figure 6.10). The ratio is expected to continue its declining trend as the banking sector asset mix shifts to loans. Loans enjoy higher profit margins from their large risk-free government securities portfolios.

Figure 6.10



Turkey: MacroEconomic Indicators	2003	2004	2005	2006	2007	Q4 2006	Q4 2007
Output and expenditure							
GNP	5.9	9.9	7.6	4.6	-	5.0	-
GDP	5.3	9.4	8.4	6.9	4.5	5.7	3.4
Private consumption	9.2	10.2	7.5	4.6	3.8	0.9	1.9
Public consumption	-2,6	6.5	2.5	8.4	2.8	2.0	1.6
Gross fixed capital formation	14.2	28.4	17.4	13.3	3.4	8.2	7.2
Exports of goods and services	6.9	11.2	7.9	6.6	6.7	7.9	2.5
Imports of goods and services	23.5	20.8	12.2	6.9	11.1	1.6	15.7
Industrial production (in nominal terms)	8.7	9.8	5.4	5.8	5.4	5.9	5.1
Labour Market							
Employment	-0,8	2,0	1,7	-0,4	-3,6	-3,2	-1,7
Unemployment (in per cent of labor force)	10.5	10.3	10.2	9.9	9.9	9.6	10.1
Prices							
Consumer prices (annual average)	21.6	8.6	8.2	9.6	8.8	9.8	8.2
Producer prices (annual average)	22.7	14.6	5.9	9.3	6.3	11.4	5.3
Average monthly wage in industry	23.0	13.4	12.2	11.5	9.5	12.1	9.9
Government sector							
Central Government Budget overall balance	-11,2	7.1	-2,2	0.1	-0,7	0.1	-0,7
Consolidated Public Sector Overall balance	-9,1	-4,6	-0,3	-0,4	-0,5	-0,4	-0,5
Net public sector debt	70.3	64.0	55.3	44.8	40.9	44.8	40.9
Monetary and Financial Indicators							
M3	32.3	39.5	31.2	32.2	17.7	21.1	21.4
Total Credit	35.2	50.6	54.2	46.1	30.4	46.1	30.4
Reference rate	26.0	18.0	13.5	17.5	15.75	17.5	15.75
Exchange rate YTL/USD (end-period)	1.49	1.42	1.34	1.42	1.17	1.42	1.17
Exchange rate YTL/EUR (end-period)	1.69	1.77	1.67	1.86	1.70	1.86	1.70
Real Effective Exhange Rate(Index)(1995=100)	140.6	143.2	171.4	160.1	190.3	160.1	190.3
International Position							
Current account balance	-2,5	-3,7	-4,6	-6,0	-5,7	-6,0	-5,7
Trade balance	-4,4	-5,8	-6,8	-7,8	-7,1	-7,8	-7,1
Foreign direct investment, net	0,4	0,5	1,9	3,6	3,0	3,6	3,0
Memorandum items							
Population (end-year, thousand)	70712	71789	72065	72974	70586	-	-
GDP (in Mrd of EUR)	257.1	305.0	408.0	407.5	470.1	-	-
GDP per capita (in EUR)	3635.9	4248.6	5661.6	5584.2	6660.0	-	-

Source: National Statistics, CBRT, European Commission, IMF Statistics

Turkey: Banking Indicators

	2004	2005	2006	2007
Percentage of Revised GDP (%)				
Assets	54.9	62.7	65.9	69.5
Total Credit	17.4	23.1	28.9	34.2
Total Credit in FX	–	6.6	7.4	8.2
Credit to Enterprises	14.2	18.9	22.7	26.1
Credit to Households	4.7	7.0	9.1	11.4
Credit to Household in FX	–	0.0	0.0	0.0
Mortgages	–	1.9	3.1	3.9
Deposits	34.2	37.5	40.6	42.7
Deposits in FX	–	13.6	15.2	14.3
Percentage Change (%, yoy)				
Assets	22.7	29.5	22.8	16.4
Total Credit	50.6	54.2	46.1	30.4
Total Credit in FX	–	–	31.0	22.8
Credit to Enterprises	54.5	53.9	40.1	27.2
Credit to Households	106.0	76.7	51.8	37.5
Credit to Household in FX	–	–	17.3	73.1
Mortgages	–	–	88.4	38.8
Deposits	23.0	27.2	26.5	16.0
Deposits in FX	–	–	30.2	3.6
Percent (%)				
Capital Adequacy Ratio	28.8	24.2	22.4	18.8
Capital to Assets	15.0	13.5	–	–
NPLs to Total Loans	6.0	4.8	3.8	3.5
Provisions to NPLs	88.1	89.8	90.7	88.3
Return on Assets	2.3	2.7	3.3	3.4
Return on Equity	16.4	11.8	21.0	24.9

Sources: CBRT, IMF

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