Eurobank Research

Eurobank EFG

New Europe Economic Review

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August 2009

Division of Research & Forecasting

Director: Gikas Hardouvelis
ghardouvelis@eurobank.gr

Coordinator:

Ioannis Gkionis
Research Economist
igkionis@eurobank.gr

Other contributing authors:

Stella Kanellopoulou, Ph.D.
Research Economist
skanellopoulou@eurobank.gr

Spyridoula Drakopoulou
Junior Economic Analyst
v-sdrakopoulou@eurobank.gr

The Coordinator wishes to thank **Mr. Nikolaos Solomitros** for his significant contribution in this issue

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Main Themes

- A deeper than originally expected recession in the countries of New Europe is forecasted to continue into 2010 at a less drastic pace
- Credit expansion has slowed to a standstill and NPLs are rising
- Strong support by the IMF proved critical in containing the worst excesses of the earlier crisis
- And now leading indicators are showing that the worst is over
- Credit default swap rates are coming down as the market fear subsides and risk premia are stabilizing
- As expected, current account imbalances are shrinking and fiscal deficits are rising
- Intervention rates by the monetary authorities are declining thanks also to a declining rate of inflation
- A strategy of quick entry into EMU by those countries that had earlier adopted it as their main policy anchor is no longer as easy as it used to appear before the financial crisis

Real GDP

	2008	2009f	2010f
Bulgaria	6.0	-6.3	-2.0
Poland	4.9	0.5	1.5
Romania	7.1	-6.5	-1.5
Serbia	5.4	-5.5	-1.0
Turkey	1.1	-5.5	1.0
Ukraine	2.1	-12.0	0.0

Inflation (Annual Average)

	2008	2009f	2010f
Bulgaria	12.4	4.5	2.8
Poland	4.2	3.2	2.5
Romania	7.9	5.8	3.8
Serbia	10.7	8.5	7.0
Turkey	10.4	6.0	6.5
Ukraine	24.6	16.5	13.5

Current Account (%GDP)

	2008	2009f	2010f
Bulgaria	-25.3	-12.0	-10.0
Poland	-5.4	-3.0	-3.5
Romania	-12.3	-6.0	-5.0
Serbia	-17.8	-13.0	-11.5
Turkey	-5.6	-1.5	-2.5
Ukraine	-7.2	-0.5	-1.0

1. Bulgaria

Support for Currency Board remains strong yet markets worry of an eventual devaluation of the Lev

- **Economic contraction deepens across all sectors, with GDP expected to decline by -6% in 2009 and another -2% in 2010**
- **Inflation sharply down to 2.6% yoy in June, making easier to achieve the relevant Maastricht criterion for EMU entry**
- **The newly elected government offers political support to the currency board but contagion risks from the Baltic States increase concerns of possible Lev devaluation**
- **Devaluation worries continue to dominate the market thanks to the accumulation of a large overvaluation of the Lev, a vanishing budget surplus and a decline in the financing of the current account by capital inflows**
- **A devaluation would impose significant costs on households and corporations, whose FX debt exposure accounts for 43.5% of GDP, derailing further the economy, plus it may reignite domestic inflation should the recession end in 2011**
- **The government has enough cushion to be able to maintain the currency board intact, and has already indicated its willingness to restrict fiscal policy, yet its expressed desire to expedite its EMU entrance may eventually lead it to devalue the lev and irrevocably lock it to the euro at a more competitive rate**
- **The central bank launched measures to facilitate weakening credit activity and reduce uncertainty in the interbank market**
- **NPLs remain manageable, as they have are at 3.7% of total loans at the end of May versus 2.4% a year earlier**

Ioannis Gkionis & Spyridoula Drakopoulou

Bulgaria	2008	2009f	2010f
Real GDP growth	6.0	-6.3	-2.0
Inflation (annual average)	12.4	4.5	2.8
Current account balance (% of GDP)	-25.3	-12.0	-10.0

Source: Eurostat, IMF, NBB, National Statistics, Eurobank Research

Economic Outlook

Bulgaria is undergoing a sharp and painful economic adjustment. The marked decline of capital inflows and credit growth has led the economy to slide in a deep recession. The massive countercyclical measures initiated by the outgoing government helped to offset some of the downturn. Indeed, output has declined less in Q1 2009 than in other economies of the region. Yet, fiscal stimulus cannot be limitless as the currency board requires prudent fiscal policy. In addition, monetary policy is constrained by the currency board, in contrast to other countries with flexible exchange rates. This leaves no choice but for adjustment to come through a contraction in domestic demand. The severity of global financial crisis and the accumulation of significant macroeconomic imbalances during the good times will require a more sizeable adjustment in the case of Bulgaria. Thus, contraction will turn out deeper than expected. EFG Eurobank anticipates Bulgaria's economy to contract by 5% in 2009 and by a further 2% in 2010. On the positive side of this bleak economic outlook, the current account deficit is expected to halve to 12%. Inflation is set to improve further towards 2.5% yoy by year end underpinned by weak domestic demand remains weak and food prices trend.

The focus of attention of global markets shifts to the sustainability of the currency board. The newly elected government offered political support to the currency board as a policy anchor until Eurozone entry. Nevertheless contagion risks from a probable break up in the currency boards of the Baltic States increase market concerns of possible Lev devaluation. In the case of such event, it would entail significant economic costs for both corporates and households who are heavily lveraged in FX. The prudent policies of the past provide enough cushions for the incoming government to maintain the currency board. The technical requirements of the currency board are still comfortably met[1]. On the other hand, the currency board has incurred a large overvaluation on the Lev. Given the announced intention for Bulgaria to enter ERM II currency mechanism, the incoming government may eventually be forced to devalue the local currency to a more competitive rate on the run up to Eurozone entry.

Political Environment- Public Finances

The parliamentary elections results mirrored the success of the party of the Mayor of Sofia in earlier polls. The recently formed right wing GERB party won the parliamentary elections held in July. The party won almost 40% of the vote, winning 116 seats, 5 seats less than the absolute majority of 121. Nevertheless, it managed to form a minority government with the parliamentary support of the nationalist party "Attaka", which won 9.4% of the vote and 21 seats.

The Blue Coalition, a coalition of two minor right wing parties, won 6.76% of the vote and 15 seats. The "Order, Law and Justice" party, who was the last one to pass the threshold of 4%, won 10 seats. The outgoing government coalition partners registered significant electoral losses. The BSP Socialists managed to gather only 18%, a little higher than their ally, the ethnic Turkish MRF which gathered 15% of the vote. The third coalition partner NMSP, formerly the "Simeon II National Movement", fell short of the threshold.

The new government is going to be confronted with the issues of fighting corruption more efficiently and improving relations with EU on funds absorption. The incoming government officials have assigned top economic policy priorities Eurozone entry and tackling the economic downturn. For that reason, it has been announced that Bulgaria will apply for ERM II in November. Although high in the pre-election agenda, incoming government officials have now signaled that a new IMF agreement may no longer be a top priority, as the world markets sentiment improves.

Despite the significant fiscal policy loosening, the budget was still in surplus in Jan-May. The anti-crisis measures, initiated by the outgoing government ahead of the elections, brought the expenditures up by 24.1% yoy in Jan-May. On the other hand,

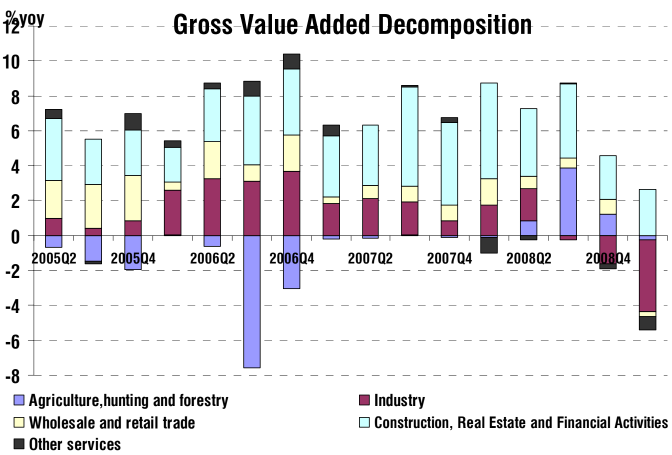
[1] For a more detailed analysis on the sustainability of the currency board please see "Hardouvelis and Monokrousos, Is Bulgaria's Currency Board sustainable?" Economy& Markets, July 2009

tax revenues were down by 10% compared to last year. Yet, the budget was still in surplus. It recorded a surplus of 0.8% of projected GDP little lower than the 1% year end fiscal target which was already revised from 3% in the beginning of the year. If nothing is changed, the general government will record a deficit. It would still be the lowest fiscal deficit in EU-27. Fiscal discipline is essential for maintaining sound the currency board. For that reason, the incoming government officials have committed to revise the budget, implementing such spending cuts to bring back the budget back to balance.

Growth performance

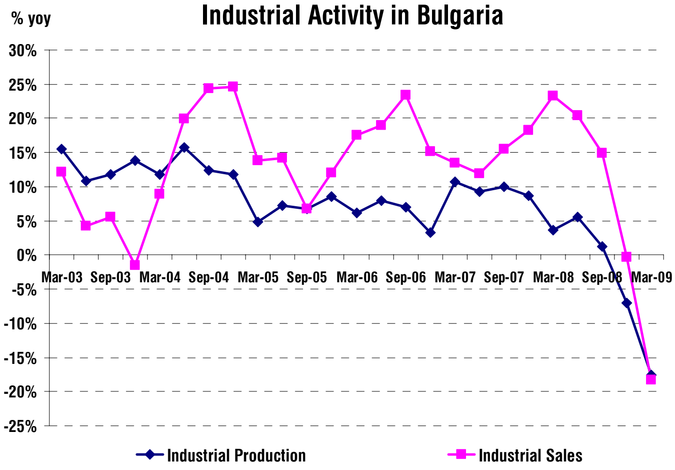
The economy registered two consecutive quarters of decline. On a seasonally adjusted basis, GDP declined by 5% qoq in Q1, on top of 1.5% qoq in Q4. Hence, the economy entered a technical recession. GDP declined by 3.5% yoy in Q1, for the first negative performance since the 1998 crisis. Domestic demand contracted by 10% yoy. The contraction was spread across all demand components. Final consumption dropped by 5.4%, Gross Fixed Capital Formation by 15% yoy. The domestic demand collapse was partially offset by the external sector positive contribution. The 21.1% yoy drop in imports than offsets the 17.4% yoy decline in exports. From a sectorial point of view, the industry took most of the hit contracting by 12.4%, then agriculture by 4.8%. Services were on a decelerating trend, still growing though by 2.5% yoy. (Figure 2)

Figure 2



All high frequency indicators deteriorate further which suggests that the contraction will deepen in Q2. Retail sales plummeted by 15.2% yoy in May, accelerating from 10.8% in April and 8.6% yoy on average in Q1. Industrial production contracted by 22.2% in May, a steeper decline than 20.2% in April and 17.6% in Q1. Construction output is on a free fall, declining by 14.5% yoy in May, on top of 8.9% yoy in April and 4.3% yoy in March. (Figure 3)

Figure 3

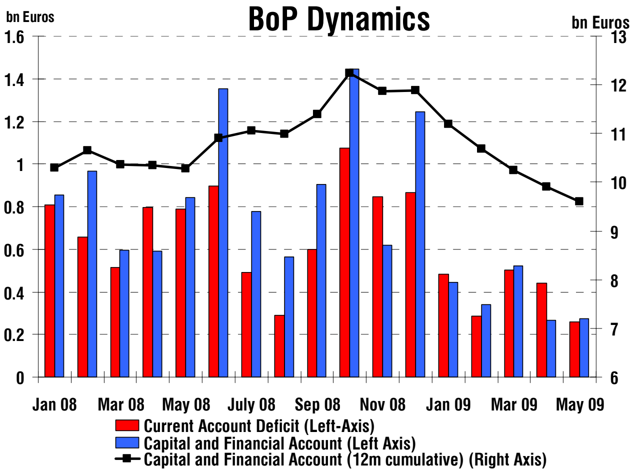


Balance of Payments

The current account deficit is shrinking rapidly. It stood at 20.4% of GDP in May against 25.3% in 2008.The sharp contraction in the trade balance is the main driver behind this improvement. The drying up of capital inflows has resulted in imports contracting by 33.3% in the first five month period. The weak Euro area demand for Bulgarian exports pushed them down by 30.3% during the same period. As a result, the trade deficit came down to 21.6% in May. The services surplus improved further to 3.1% of GDP. The improvement in the Income deficit was largely offset by the net current transfers decline.

On the financing side, capital inflows dried up even faster than the current account improvement. The capital inflows were effectively down by 82.7% yoy in Jan-May compared to the same period last year. The most important component, net FDI inflows reached 1.1 bn Euros, which represents a 44.6% yoy decline. Nevertheless, they still covered 57% of the current account deficit, an almost equal percentage compared to last year as the current account deficit shrinks fast. (Figure 4)

Figure 4



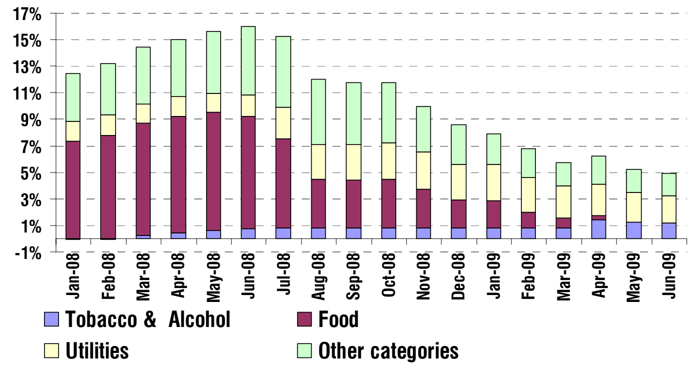
External vulnerability indicators continue to show a sustainable position, despite their deterioration since the end of 2008. External debt has remained relatively flat at 107% of GDP in May compared to Dec 2008. Short term debt, as a percentage of total external debt, has climbed to 39% compared to 30% a year ago. FX reserves declined both as a result of the Central Bank's decision to cut minimum reserve requirements and some capital outflows in the beginning of 2009. International reserves now stand at 11.8bn in May (34.6% of GDP) against 14.7bn in Sept 2008. In turn, the international reserves coverage of short term debt came down to 89% in May 2009 from 130% in late 2007.

Inflation-Monetary Policy

Inflation has registered a sharp decline since the end of last year. Consumer prices eased to 3.7% in June compared to 7.8% in December. Weak domestic demand coupled with lower food and energy prices have eased inflationary pressures. Lower food inflation is the most important contributor to the disinflation trend. Food inflation decelerated sharply to single digits in late 2008, turning into -0.1% yoy deflation in June, against a peak 24.2% yoy last year. Transport and communication prices were on a negative territory as well. The excise duties imposed on tobacco products had a minimum impact on overall inflation. Utilities continued to rise above inflation, yet the scheduled decrease in gas prices is going to put them on a downward trend in the 2H. Provided there is no unfavorable developments in food prices, consumer prices will ease further to 2.5-3% by year-end as economic contraction deepens. The risks to the inflation outlook come from a poor agricultural production which may reverse the negative food inflation trend. (Figure 5)

Figure 5

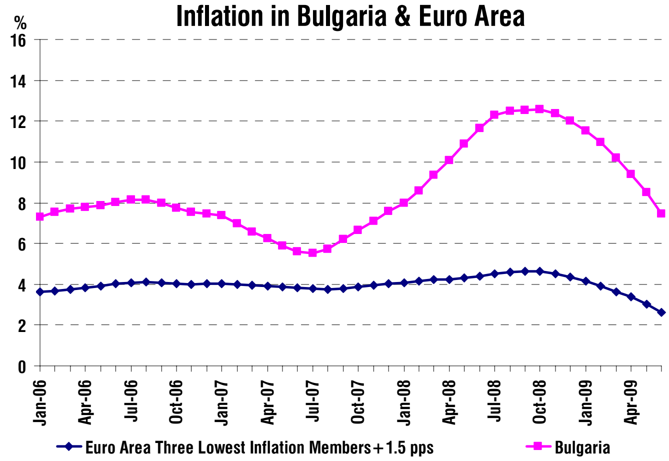
Consumer Prices in Bulgaria 2007-09



Meeting the inflation criterion was the main obstacle to enter EMU. The HICP (Harmonized consumer prices) performance will be utilized to assess if Bulgaria fulfills the criterion. HICP which carries a lower food prices weight registered a steeper decline. On that basis, it came down to 2.6% in June, making it easier for Bulgaria to achieve the relevant criterion. (Figure 6)

Figure 6

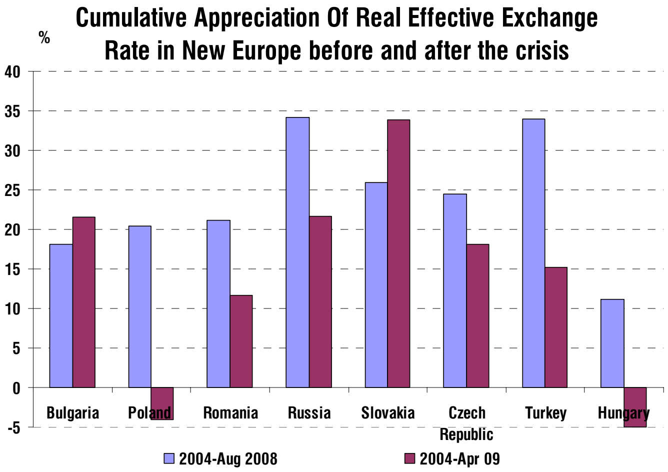
Inflation in Bulgaria & Euro Area



The currency board, which served as a policy anchor to stabilize the economy in the late nineties, comes increasingly on the epicenter. Contagion risks from a probable break up in the currency boards of the Baltic States, especially the Latvian

FX peg, increase market concerns of possible Lev devaluation. The incoming government has expressed its support for the currency board until Eurozone entry. The currency board enjoys strong public and constitutional support. In addition, the incoming government has signaled that it would stick to prudent fiscal policy. Last but not least it is supported by significant yet declining FX reserves which meet the technical requirements of the currency board. On the other hand, the currency has accumulated a large real effective exchange terms overvaluation on the domestic currency. The currency board constrains the exchange rate from becoming more competitive, in contrast to other countries with flexible exchange rates. (Figure 7)

Figure 7



The incoming government has announced its intention to apply for ERM II mechanism in the coming November. Thus, the government may eventually be forced to devalue the local currency to a more competitive rate on the run up to Eurozone entry. A potential devaluation would entail significant economic costs for both corporates and households who are heavily leveraged in FX.

Banking Developments

Since the outburst of the financial crisis commercial banks are constraining credit growth and sifting their focus towards attracting deposits. Both profitability and asset growth in the banking sector have been deteriorating throughout 2009 and are expected to continue this trend for the whole year. NPLs are increasing without, though, reaching worrying levels yet.

Banking sector's assets grew by 13% yoy in May, the slowest rate recorded during the last 3 years. Assets slowed down due to decreasing funding of the subsidiaries from their parent banks as well as to credit expansion deceleration. However the nominal value of assets still remains higher as a percentage of GDP.

The central bank has taken a number of measures since the outburst of the crisis. In 2008, it lowered minimum reserve requirements on all attracted funds from 12% to 10% and annulled reserve requirements on foreign and state deposits. Additionally, the government guarantees interbank loans for a period of one year. Moreover, under the amendment on Ordinance 21, 50% of the eligible institution's cash holdings including cash held as ATM stocks will be considered reserve assets. The measure intends to boost credit growth, ensure the required reserve requirements and reduce uncertainty in the interbank cash market.

The main issue seems to be, though, the sustainability of the currency board arrangement. Foreign exchange reserves seem to secure the stability of the currency board exchange rate regime and weaken the possibility of a depreciation of the currency. The currency board does not allow the central bank to act as a lender of last resort and does not give the central bank the right to use the financial policies to stimulate the economy. This is limiting the available options the county may have to tackle the crisis and support the financial sector.

Credit Developments

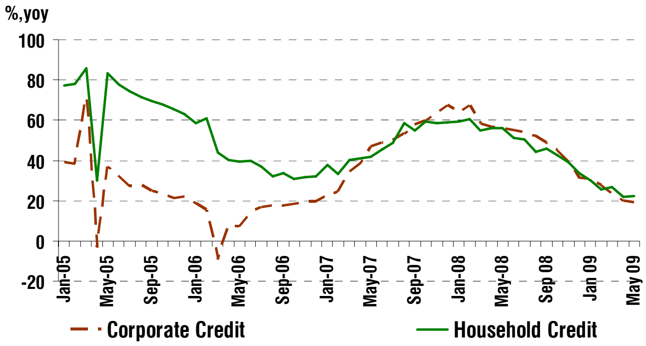
Bulgarian banks have shifted policies towards constraining credit activity growth. Total loans have seen a contraction in May compared to a month before, triggered by the decline in loans to credit institutions and the corporate sector. Yet, they still remain a lot higher than a year earlier.

Loans to non-financial institutions grew by 20.7% yoy in May compared to 30.6% in the beginning of 2009. Credit to households grew by 22.1% in May compared to 30.1% in January and 50.3% a year earlier.

Consumer credit, which is more vulnerable to volatilities in the domestic economy, decelerated to 19.1% versus 30.6% in the corresponding period. However, the Bulgarian Development Bank has established a program to provide incentives to banks to extend loans to SMEs. According to the program, BDB will grant 500 mn leva to small and medium enterprises through commercial banks. (Figure 8)

Figure 8

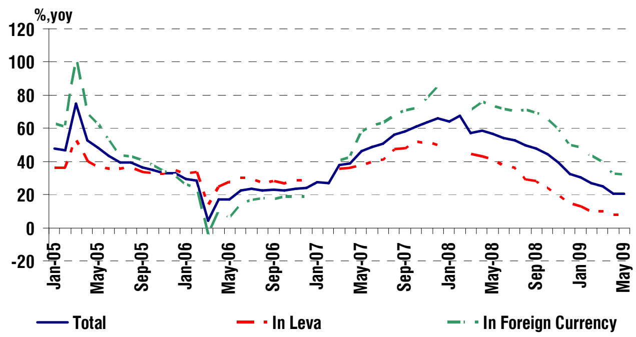
Corporate & Household Credit Growth



Credit in foreign currency, euros in particular, accounts for 55% of total credit. The currency board arrangement and the fixed exchange rate have boosted consumer confidence as far as lending in this foreign currency is concerned. As far as growth rates are concerned, credit in other currencies than local or euro continued to grow rapidly. In fact, credit in foreign currency other that euro increased by 111% in May. (Figure 9)

Figure 9

Total Credit Growth



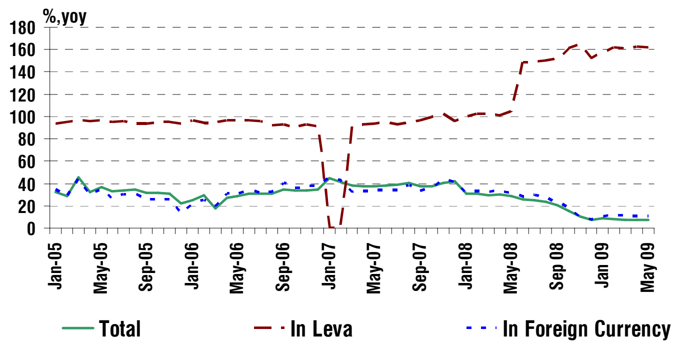
Deposit Developments

The banking sector is shifting its focus to attracting funds from the domestic banking system as international markets are affected by the credit crunch. A number of new deposit products that promise high returns are now available to consumers. The discrepancy between loans and deposits interest rates has increased substantially. Deposits growth has been decelerating substantially during the past few months. The volume of deposits has dropped, even in absolute terms, in January, February and May, while marking an increase, albeit small, in March and April. This decline is mainly driven by the decrease in deposits in local currency.

Deposits grew by 7.2% yoy in May in contrast to 9.1% in January. Deposits in local currency, which marked the steeper decrease, grew marginally by 0.9% in May compared to 7.7% yoy in the beginning of the year. Finally, deposits in FX expanded by 12.8% yoy, slightly up from 11.2% five months earlier. In nominal terms, deposits in local currency are decreasing whereas deposits in EUR are increasing. Depositors show that they prefer to save their money in EUR as a result of worries regarding the sustainability of the currency board. (Figure10)

Figure 10

Deposit Growth

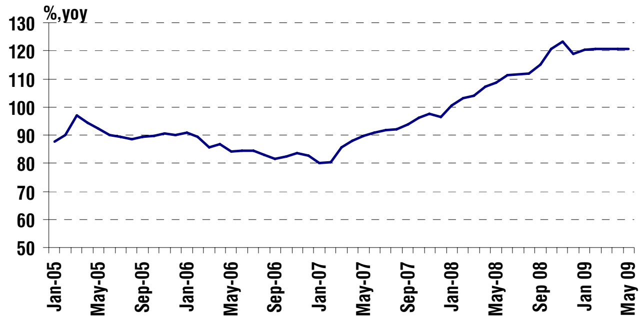


Given that the credit deceleration is accompanied by a slowdown in deposits, loan to deposit ratio has remained at the same levels throughout 2009. The ratio stood at 120.7% in May. However, the trend is not the same for loan to deposit ratio in local currency and FX. The first marked an increase to

161.6% in May compared to 157.5% in January while the latter decreased to 93% from 97.3% in the corresponding period. (Figure 11)

Figure 11

Loan to Deposit Ratio



According to the new amendment to the Deposit Insurance Act, clients of bankrupted financial institutions will have their deposits restored within 20 days instead of 45, as was previously the case. Deposit insurance guarantee remains at 100.000 BGN after increasing from 40.000.

Banking Sector's Profitability and Capital Adequacy

Profitability is wearing thin since the beginning of the year due to tightening credit activity, deceleration of interest rate margins, as well as banks' focus on stability and solvency. Capital adequacy ratio stood at 16.5% in Q1 2009 versus 14.5% a year earlier and 14.9% at the end of 2008. Profits amounted to 402bn BGN as of May 2009 compared to 588bn BGN one year earlier. A further deceleration of profitability is expected as interest rate margins decline. Banks are offering even double digit deposit rates in order to attract liquidity. At the same time, banks try to offer attractive credit products.

Non performing loans have been on the rise since the beginning of the year. NPLs accelerated to 3.7% in May up, from 3.3% one month earlier and 2.4% a year earlier. As a whole, their share still remains at manageable levels. Corporate bankruptcies are expected to exert pressure as troubled or classified assets include credit to companies with no overdue payments but with deteriorating performance.

In February the central bank adopted amendments to Ordinance 8 regarding the evaluation and classification of banks' risk exposures and the allocation of provisions to cover credit risk. The ordinance introduces a minimum threshold of BGN 100.000 above which a risk exposure or a pool of risk exposures shall be evaluated and classified individually. This amendment aims at easing credit institutions in negotiating credit conditions. As a result of this amendment, classified and overdue exposures, as well as provisions, are rising. The level of provisions seems healthy as they accounted for 145% of loss loans in March.

Bulgaria: MacroEconomic Indicators							
	2004	2005	2006	2007	2008	Q1 2008	Q1 2009
Output and expenditure							
GDP	6.6	6.2	6.3	6.2	6.0	7.0	3.5
Final Consumption	5.4	5.3	7.3	4.9	3.9	4.7	5.6
Gross fixed capital formation	13.5	23.3	14.7	21.7	20.4	15.5	-15.4
Exports of goods and services	12.7	8.5	8.7	5.2	2.9	9.2	-17.4
Imports of goods and services	14.5	13.1	14.0	9.9	4.9	5.8	-21.1
Industrial production	15.9	6.7	6.1	9.2	1.1	4.2	-18.1
Labour Market							
Employment	3.1	2.0	4.3	4.6	3.3	4.9	-0.8
Unemployment (in per cent of labor force)	12.7	11.5	9.6	7.8	6.3	7.1	6.7
Prices							
Consumer prices (annual average)	6.2	5.0	7.3	8.4	12.4	13.3	6.0
Producer prices (annual average)	5.5	7.3	8.7	8.0	13.3	14.1	0.6
Average monthly wage in economy	6.0	9.5	9.5	20.6	22.7	24.4	16.2
Government sector							
General government balance (National Definition)	1.7	3.1	3.5	3.5	3.0	-	0.8
General government debt	40.1	31.3	24.6	19.8	16.1	-	15.9
Monetary and Financial Indicators							
M3	22.5	27.3	21.4	29.2	21.8	29.9	7.4
Total Credit	47.3	33.1	23.9	65.9	32.3	57.2	24.9
Reference Rate (Base interest rate)	2.61	2.04	2.69	3.93	5.12	4.75	4.2
Exchange rate USD/BGN (end of period)	1.43	1.65	1.48	1.34	1.39	1.24	1.47
Exchange rate EUR/BGN (end of period)	1.95	1.95	1.95	1.95	1.95	1.95	1.95
Real Effective Exhange Rate (Index)	141.7	141.5	148.9	161.9	173.7	-	176.6
International Position							
Current account balance	-6.6	-12.4	-17.8	-21.8	-25.3	-24.7	-22.6
Trade balance	-14.9	-20.2	-22.0	-25.3	-25.7	-24.8	-23.3
Foreign direct investment. net	12.9	15.5	24.3	23.2	17.3	29.9	16.4
External debt (National Definition)	63.8	70.9	81.9	100.2	107.7	-	107.5
Memorandum items							
Population (end-year. thousand)	7761	7719	7699	7699	7699,0	-	-
GDP (in mrd of EUR)	19.88	21.88	25.24	28.90	34.12	-	-
GDP per capita (in EUR)	2561.50	2834.60	3278.30	3753.70	4431.7	-	-

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

**The indicators, for the calculation of which external debt data are used, are published with external debt for the reporting*

Bulgaria: Banking Indicators							
	2004	2005	2006	2007	2008	Q1 2008	Q1 2009
Percentage of GDP (%)							
Assets	65.1	78.3	86.0	104.6	105.2	101.3	103.4
Total Credit	36.1	43.8	46.4	66.9	75.7	68.8	75.3
Total Credit in FX	17.3	20.8	21.0	33.9	43.4	35.7	43.5
Credit to Enterprises	26.1	29.0	29.6	43.0	48.2	44.2	47.9
Credit to Enterprises in FX	16.5	18.7	18.0	29.2	35.5	30.8	35.6
Credit to Households	9.9	14.7	16.6	23.0	26.3	23.6	26.3
Credit to Household in FX	0.8	2.0	3.0	4.7	7.8	4.9	7.9
Mortgages	2.6	4.8	7.2	10.4	12.5	10.8	12.7
Deposits	51.0	60.6	56.1	70.0	63.6	66.1	62.4
Deposits in FX	23.1	24.0	28.4	35.1	32.0	33.7	32.7
Percentage Change (%, yoy)							
Assets	43.8	31.8	28.4	40.0	17.7	33.6	16.4
Total Credit	47.3	33.1	23.9	65.9	32.3	57.2	24.9
Total Credit in FX	63.2	31.4	18.6	85.4	49.7	71.3	39.2
Credit to Enterprises	38.1	21.7	19.4	67.5	31.2	58.2	23.5
Credit to Enterprises in FX	59.3	24.2	12.2	87.1	42.2	75.8	32.0
Credit to Households	79.3	63.0	32.1	58.8	33.8	55.0	26.9
Credit to Household in FX	241.5	185.1	74.1	78.5	96.6	67.6	84.5
Mortgages	147.0	101.2	73.4	67.4	40.2	61.2	34.1
Deposits	43.7	30.1	34.8	42.0	7.5	29.4	7.7
Deposits in FX	47.2	13.9	38.3	41.0	7.6	32.2	10.8
Percent (%)							
Capital Adequacy Ratio	16.1	15.2	14.5	13.8	14.9	14.5	16.5
Capital to Assets	11.0	10.5	10.4	10.5	11.4	10.9	12.4
NPLs to Total Loans	2.0	2.2	2.2	2.1	2.4	2.1	-
Provisions to NPLs	48.5	45.3	47.6	–	87.0	-	-
Return on Assets	2.1	2.1	2.2	2.4	2.1	2.5	1.6
Return on Equity	20.6	22.1	24.4	23.9	22.7	24.3	13.3

Sources: BNB, IMF

2. Poland

Faring better than its regional peers but not immune

- **Polish GDP growth slows down but remains positive in Q1-09 (0.8% yoy) while labour market conditions deteriorate as real wage growth turns negative and unemployment reaches double-digit levels**
- **Inflation gradually drops, allowing for some monetary policy easing, yet the inflation gap with the three best performing states in EU rises, putting in to question a quick EMU entrance**
- **An upward revision in the budget deficit target for 2009 to 27.2bn PLN from the original 18.2bn PLN also worsens the probability of a quick EMU entrance, while the EU initiates the excessive deficit procedure in May**
- **Credit growth, on a monthly basis, slows down to almost zero, while NPLs rise significantly to 6.1% in June from 4.3% in December**
- **Pressures on the zloty continue but the IMF comes to the rescue in early May with an approved $20.58bn Flexible Credit Line facility**
- **Despite the worsening economy, the governing party wins a sweeping victory in the European elections in June.**

Stella Kanellopoulou

Poland	2008	2009f	2010f
Real GDP growth	4.9	-0.5	1.5
Inflation (annual average)	4.2	3.2	2.5
Current account balance (% of GDP)	-5.4	-3.0	-3.5

Source: NBP, National Statistics, Eurobank Research

Economic Outlook

The financial turmoil hit Poland abruptly in late 2008. Following the onset of the global economic and financial crisis, Poland experienced - as most of its peers - a significant depreciation of its currency and a freezing up of its domestic interbank market. Yet, Poland is still faring better than its neighbours in Central Eastern Europe, being the only economy in the region to have recorded positive GDP growth in Q1-09 (+0.8% yoy).

Several factors have contributed to this outstanding resilience: Poland entered the crisis with smaller internal and external imbalances. Its economy is less dependent on exports (40% of GDP) and less leveraged. The country has a relatively low debt burden, with bank obligations amounting to just 75% of GDP (compared to 300% of GDP in Germany). Moreover, Poland features a relatively moderate level of public debt with a fiscal deficit of 3.9% of GDP in 2008, compared to the double-digit fiscal deficits of its regional peers.

Net exports and consumer spending were the main drives of growth in Q1-09. Consumers' demand has been consistently strong. This resilience is reflected in the retail sales readings, which have still recorded positive growth (0.9% in June compared to 1.1% in May and 1.3% in January). The resilience of consumer demand is partly due to the reduction of social contributions, a decrease in personal income tax for families, a generous indexation of pensions and a provision of social benefits. However, domestic demand growth is more likely to contract as private investment retrenches, consumption weakens, unemployment rises, credit growth recedes and wage growth fades. In particular, the deterioration in the labour market is rather alarming as suggested by the negative real wage growth reading in June.

Political Environment – Public Finances

The economic slowdown has not dented the popularity of the Prime Minister, Donald Tusk. The outcome of the European Parliament elections (Civic Platform Party -PO- won a 44% of the vote) was a good indicator of the governing party's popularity despite the grim economic data. The European elections were perceived as a triumph for the PO party, in view of the country's upcoming presidential election in 2010. A couple of days before the elections, Poles celebrated the 20th anniversary of the semi-free elections in June 1989, which signalled the end of Communism. Be that as it may, the fate of the country's shipbuilding industry cast a shadow over the anniversary. According to a recent European Commission's decision, Poland is obligated to restructure its shipbuilding industry. The restructuring is expected to reduce its productive capacity and thus result in substantial job losses.

The government has been pushing hard for Poland to join the Eurozone in 2012. Such a development would guarantee added insulation against the global financial crisis. Nevertheless, views over the optimal timetable for euro-adoption do vary. If Poland is to join the monetary union in 2012 the government will not be allowed the latitude to delay sizable cuts in public spending or avoid substantial tax hikes until a domestic economic recovery is firmly on track. Moreover, there is a risk of a downward spiral: higher taxes and spending cuts undermine GDP growth, and thus depress budget revenues, leading to an underperformance of the government's fiscal deficit target. Subsequently, the government is forced to further increase taxes and cut spending in an effort to meet the deficit target.

According to comments put forward in late June by the EU's Economic and Monetary Affairs Commissioner, Joaquin Almunia, Poland should first achieve the Maastricht fiscal-deficit criterion by 2012 and then proceed to adopt the euro at the start of 2014. This suggestion is in accordance with the Monetary Policy Council's opinion that ERM-II should only be joined when the prospects of fulfilling all Maastricht criteria are bright. In view of these developments, the increased uncertainty over Poland's euro adoption timetable results in market disappointment and pressures on the zloty.

Poland's fiscal financing needs have lately become a major source of concern. Notwithstanding earlier expectations of the government's 2008 fiscal deficit target overshooting, the final outcome (3.9% of GDP) came as a negative surprise. As a result, the European Commission initiated in May the Excessive Deficit Procedure for Poland. The higher than expected 2008 general government deficit reflects the results of the reforms undertaken on the expenditure side, particularly in the area of social protection. Namely, i) the reduction of social contributions (which slashed budget revenues by approximately 2% of GDP in 2007-2008) ii) the increase in personal income tax relief for families iii) the generous indexation of pensions and iv) social benefits. The government's latest forecasts submitted to the EU Commission imply a further widening of the budget deficit to 4.6% of GDP in 2009. The government implemented several structural reforms which will likely weigh negatively on the 2009 budget outcome. The personal income tax reform is estimated to cut the 2009 revenues by 0.5% of GDP. In addition, the rise in public investment and the reduction of the tax burden for businesses are expected to increase overall public spending. On the other hand, early retirement pensions were replaced with the less-costly bridge-pensions which will contribute to both higher labour participation and lower public expenditure. Taking all the above into consideration, our forecasts suggest that the 2009 budget deficit will be as high as 5.5% of GDP.

As a result of high budget deficits and an ever lukewarm privatisation process, gross public debt is expected to increase to over 50% of GDP in 2009, with risks skewed to the downside regarding the 2010 general government gross debt. This seems likely to exceed the Maastricht criterion threshold of 60% of GDP. Yet, the high exchange rate volatility and the ensuing valuation effects of the foreign denominated part of the debt stock imply a considerable uncertainty over the above projections.

The government's robust performance in the European Parliament elections strengthened its confidence and led to the announcement of the revised deficit target for 2009, just a few days after the electoral success. The state deficit target increased by almost 50% to 27.2bn PLN compared to the 18.2bn PLN target set initially. This revision is largely attributed to lower than originally expected budget revenues. The latter are estimated to drop by 30bn PLN, a fact explained largely by a tax collection rate way below the target. The curtailed budget revenues betray an unanticipated deterioration of Polish economic activity.

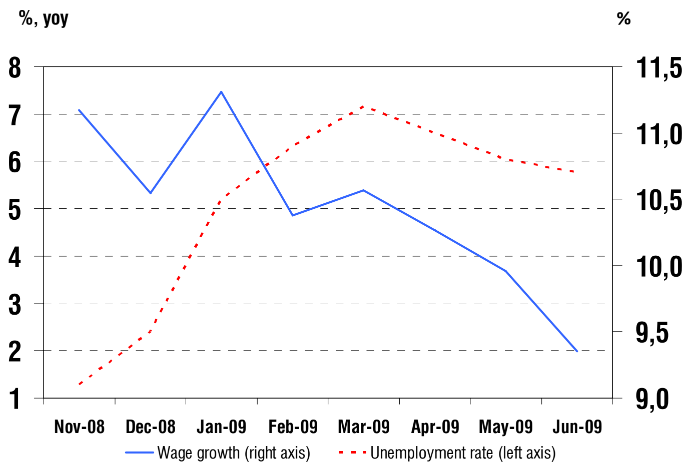
Growth Performance

Poland with its GDP growing by 0.4% qoq in Q1-09 (following a flat quarterly GDP growth in Q4-08) is one of the few countries in Europe not to have entered recession, as the technical requirement of two successive quarters of negative growth has not yet been fulfilled. Indeed, Poland was one of the very few EU countries to post a positive real GDP growth in Q1-09. It stood at 0.8% yoy down from 2.9% yoy in Q4-08. Domestic demand was a negative driver slashing 1.0ppt from Q1-09 GDP growth. This was mainly attributed to a large drop in inventories. On the other hand, net exports contribution to growth turned positive jumping to +1.8ppts as imports contracted more sharply than exports. The latter fell by 14.6% yoy in Q1-09 whereas imports dropped by 17.6% yoy over the same period.

Fixed investment grew by 1.2% yoy in Q1-09, compared to its double-digit growth in Q1-08. Consumer spending proved to be remarkably resilient, expanding by 3.3% yoy in the first quarter. Consumers' demand is reflected in retail sales readings, which although decelerating, still stood at positive territory of 0.9% in June. This resilience of consumer demand reveals a number of factors which had an effect on household's income levels: namely, the reduction in social security contributions and the cut in personal income tax. However, real wage growth turned decisively negative in June, a development which is likely to weigh on private consumption in the following quarters. Another disturbing fact is the double-digit figure of the unemployment rate observed since the beginning of the year. There are though some encouraging signs as the unemployment rate has eased to 10.7% in June after having peaked at 11.2% in March. (Figure 1)

Figure 1

Wage Growth & Unemployment Rate in Poland

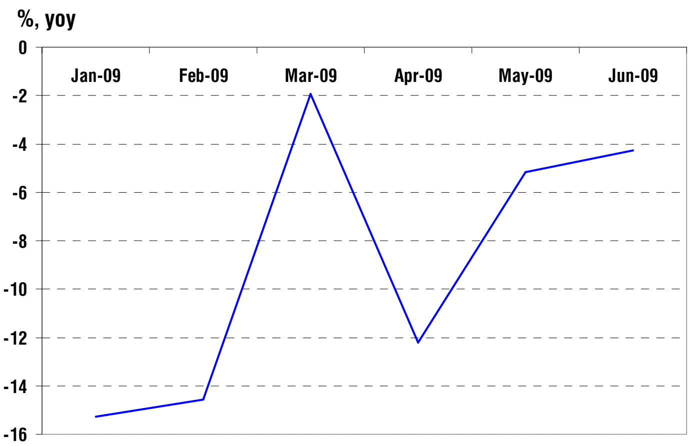


Source: EFG Research, National Statistics

The Polish industrial production fell by 10.6% yoy in Q1-09 but the pace of contraction was restrained in the last couple of months and stood at 4.3% yoy in June. (Figure 2) Poland's output gap slowdown has been considerably less acute in comparison to its regional peers. Furthermore, the country's industrial production displayed some signs of subsiding as indicated by the latest PMI data.

Figure 2

Industrial Production Growth in Poland



Source: EFG Research, National Statistics

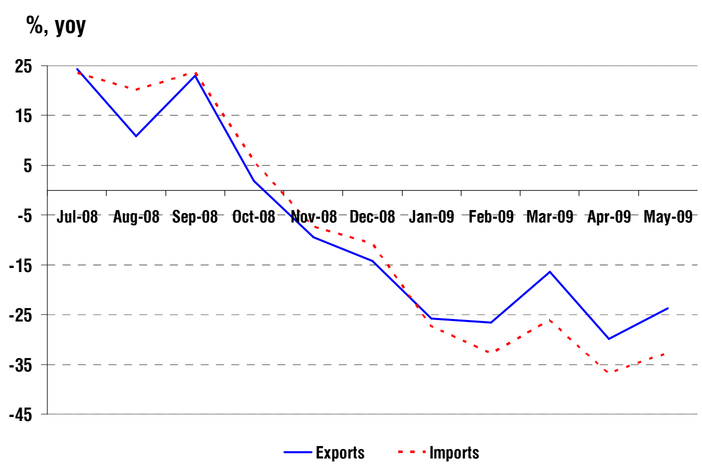
We are now projecting a mild recession in 2009 with a 0.5% yoy real GDP contraction. Looking further ahead, we expect a slow recovery in 2010. Real GDP growth is expected to turn slightly negative over the coming two quarters, since a further deterioration in the labour market will aggravate domestic demand, the main drive of Polish growth. However, risks to this forecast are tilted to the upside.

Balance of Payments

The current account balance has adjusted faster than expected. It has turned to a small surplus, since February. During the first quarter it stood at a €342mn surplus which narrowed further to €207mn in May. Since the beginning of the year the current account balance recorded a surplus of €696mn compared to a deficit of €8091mn year-to-May a year earlier. This current account trend was driven by an improvement in the trade balance as imports dropped substantially. Since February the deceleration of import growth outpaced that of exports. Imports dropped by 32.8% yoy in May while exports decreased by 23.8% yoy the said period. The sharp drop in imports reflects an equally sharp drop in domestic demand indicating a deterioration of the private consumption levels. The exports' decline by 4% mom from April to May reveals a European demand that is still weak. (Figure 3)

Figure 3

Exports – Imports Growth in Poland

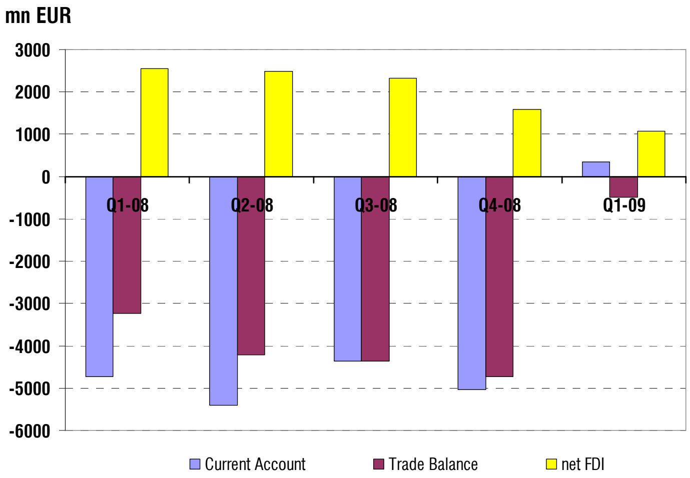


Source: EFG Research, NBP, National Statistics

Net FDI inflows stood at €1478mn in January-May. On a 12mth rolling basis, net FDI inflows cover ratio of the current account deficit increased to 51% in May 2009 compared to the 45% coverage for the year 2008. (Figure 4)

Figure 4

Current Account Balance and FDI in Poland



Source: EFG Research, NBP, National Statistics

Overall, in the following months we expect a further adjustment in the Polish current account balance with the 2009 deficit falling to 3.0% of GDP from 5.4% of GDP in 2008. The current account should improve as exports will most probably rebound faster than imports due to the weaker zloty (which actually improved Polish competitiveness) and the European economic recovery. Moreover, private consumption is expected to contract in the coming quarters aggravating domestic demand. The drop of domestic demand will constrain import growth.

In May, the IMF approved a one-year precautionary arrangement under its new Flexible Credit Line (FCL) facility amounting to $20.58bn; FCL is more flexible than a Stand-By-Agreement and is only available to economies with strong fundamentals. The Polish authorities opted for this facility to help preserve market access and guard against downside macroeconomic risks.

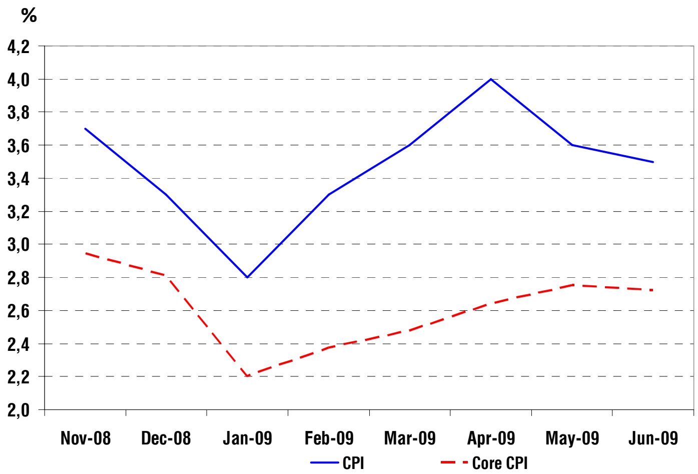
Polish external financing needs for 2009 also invite attention. According to the National Bank of Poland (NBP) statistics, both short-term debt and maturing long-term debts total in €64bn (more than half of this amount is due to parent bank/companies). However, these repayments' needs are matched by official reserves if the NBP's reserves holdings of €47.6bn (as of end June) are added to the $20.5bn IMF's FCL.

Inflation – Monetary Policy

Following a rise observed in the first months of 2009, Poland's CPI slowed in May to 3.6% yoy and dropped further to 3.5% yoy in June, reaching the upper limit for deviations from the NBP inflation target. The elevated level of 2009 inflation data was largely attributed to the lagged effects of previously effected increases in regulated prices and rising unprocessed food prices. A telling indication of this view is the data regarding the core inflation measure which remained stable – but relatively high - at 2.7% yoy in June. (Figure 5) In addition, a factor conducive to higher inflation was the strong depreciation of the zloty in the second half of 2008 and at the beginning of 2009. However, with market sentiment stabilising the FX pass-through should fade.

Figure 5

Inflation measures in Poland



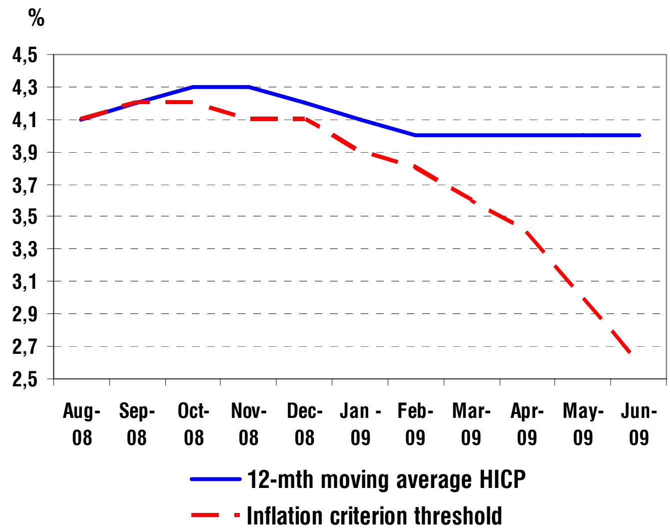
Source: EFG Research, National Statistics

In addition, a factor conducive to higher inflation was the strong depreciation of the zloty in the second half of 2008 and at the beginning of 2009. However, with market sentiment stabilising the FX pass-through should fade.

Reflecting these developments, the difference between the 12-month moving average HICP inflation in Poland and the reference value for the price stability criterion of the Maastricht Treaty has increased to 1.4ppts in June from 0.2ppts in January 2009. This increase -observed since March- might have been driven by the depreciation of the zloty exchange rate and the smaller scale of economic slowdown in Poland compared to other countries in the EU. The HICP inflation should be monitored if Poland is to enter the Euro-area, since the country has first to meet the Maastricht inflation criterion. (Figure 6)

Figure 6

Poland's HICP deviation from Maastricht criterion



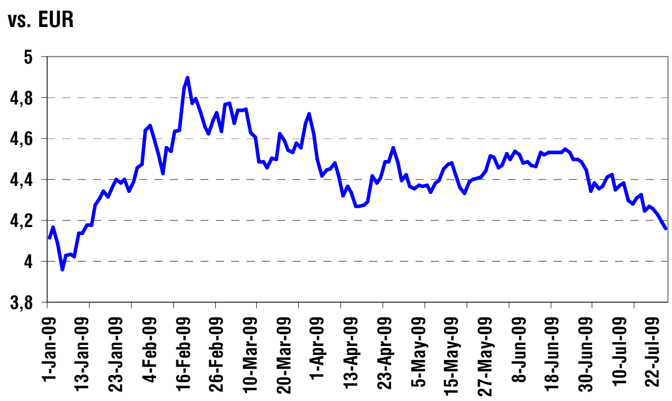
Source: EFG Research, Eurostat, National Statistics
Note: Maastricht inflation criterion: No more than 1.5% higher than the average of the three best performing (lowest inflation) member states of the EU.

We expect Poland's average annual inflation rate to fall to 3.0% yoy in 2009 and drop further to 2.5% in 2010. There are a number of factors supporting a further deceleration of domestic inflation in the period ahead. Namely, the slowdown of domestic demand should result in curbing inflationary pressures. Yet another crucial disinflation factor is the zloty strengthening, which should also abate inflation.

The zloty's stabilization in the past few months is encouraging. The earlier this year currency's fluctuations were mainly attributed to regional factors in the Central Eastern Europe, as the macroeconomic situation in some countries had worsened considerably since the end of 2008. With the gradual improvement of sentiment in the global financial markets, zloty's depreciation trend has eased. (Figure 7)

Figure 7

Zloty's Exchange Rate vs. the Euro



Source: EFG Research, Reuters

The slightly lower than expected inflation reading in June combined with the current account surplus and the deceleration in wage growth allow some monetary policy easing. However, in the near term we expect the Monetary Policy Council (MPC) to keep rates unchanged over summer months (at 3.50%) since it focuses on providing liquidity. We forecast one more interest rate cut later in the current year. This will take rates at 3.25% by year-end with risks to the downside as private consumption is expected to drop significantly in the coming quarters.

Banking developments

Poland's banking system remains relatively well capitalized without any serious solvency problems posing an immediate threat of a systemic banking crisis. However, as GDP growth is slowing and the unemployment rate is rising, credit risks are following suit, but are expected to be manageable. Meanwhile, the strong depreciation of the Polish currency earlier this year has had a negative impact on the balance sheets of households indebted in foreign currencies.

The authorities launched a credit boosting plan with a view to easing lending restrictions, offering loan guarantees and encouraging bank recapitalization. In particular, the NBP lowered the required reserve rate by 0.5 percentage point to 3.0% (from 3.5%), as of the 30th of June 2009. This reduction should increase liquidity by approximately 3bn PLN and should be conducive to increasing bank lending. The Monetary Policy Council will most likely lower the obligatory reserve ratio further by 50bps over the summer months and possibly by another 50bps later this year.

In addition, the NBP, in an effort to increase domestic liquidity, has arranged for dollar, Swiss franc, and euro swaps with foreign central banks. More precisely, the swap arrangement between the NBP and the Swiss National Bank (SNB) was further extended till the end of October. Under this arrangement, the SNB will provide the NBP with Swiss francs against euro, while the NBP will provide Swiss francs to its counterparties against Polish zloty.

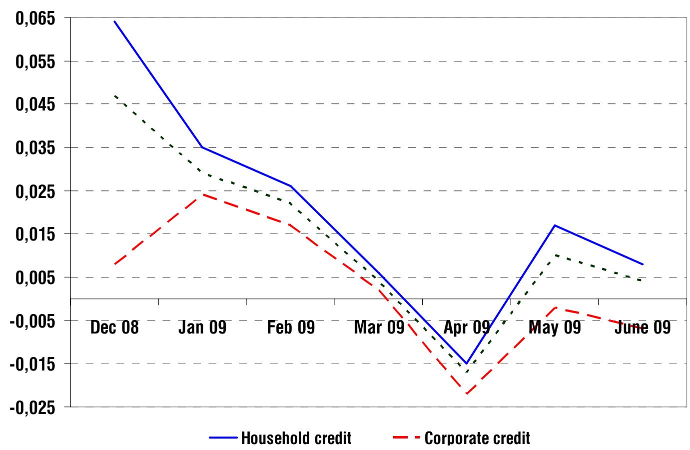
The Financial Supervision authority approved the mergers of Fortis Bank Polska with Dominent Bank and of Noble Bank with Getin Bank. The completion of mergers is due for the end of July.

Credit developments

The Polish banking system state of affairs is challenging. We still observe positive credit growth dynamics, in contrast to what is happening in regional peer-economies, where credit growth has turned to negative territory. The total outstanding private-sector credit grew cumulatively by 5.2% in January-June 2009 (zloty's depreciation accounted for half of this increase - approximately 2.8 ppts). There is a 32.2bn PLN rise observed in credit since the end of December. However, the pace of credit growth has slowed down in the last couple of months with the total growth standing at 0.4% mom in June. Although household credit is still growing (albeit at a decelerating pace) the corporate credit has turned negative since April. It declined by 0.2% mon in May and dropped further by 0.7% mom in June. (Figure 8) This actually reflects the unsettling financial situation of Polish enterprises as well as banks' caution for excessive lending in view of the increasing non-performing loans ratio.

Figure 8

Month on Month Credit Growth in Poland



Source: EFG Research, National Bank of Poland (NBP)

A case of concern with regards to the Polish banking system is the large share of household and corporate loans denominated in foreign currency (FX). The 33.7% of total private-sector loans outstanding were indexed in FX, in June. In particular, 40.3% of total household loans and 25.6% of total corporate loans were denominated in FX in the first semester of the year. The strong depreciation of the zloty since the end of 2008 might negatively affect these loans.

Furthermore, a large share of mortgage loans is indebted in FX; 67.8% in June. This is rather worrying as mortgage loans amounted to 33% of total credit and 54.2% of household loans, in June.

Deposit developments

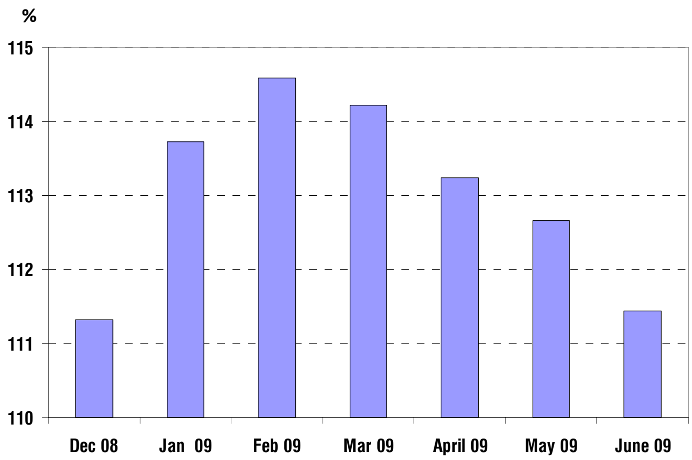
Polish banks in an effort to strengthen their balance sheets offered high rates of deposits – close to 9%. Total deposits increased by 4.8% in the first semester of 2009. There was a 28.3bn PLN rise in deposits since the end of December.

Loan to Deposit ratio has exceeded 100% since H1-08. The ratio growth accelerated after the onset of the current financial crisis last October. Having peaked at 114.6% in March, the loan to

Deposit ratio started to decline and stood at 111.4% in June. (Figure 9)

Figure 9

Loan to Deposit Ratio in Poland



Source: EFG Research, NBP

Banking Sector Profitability and Capital Adequacy

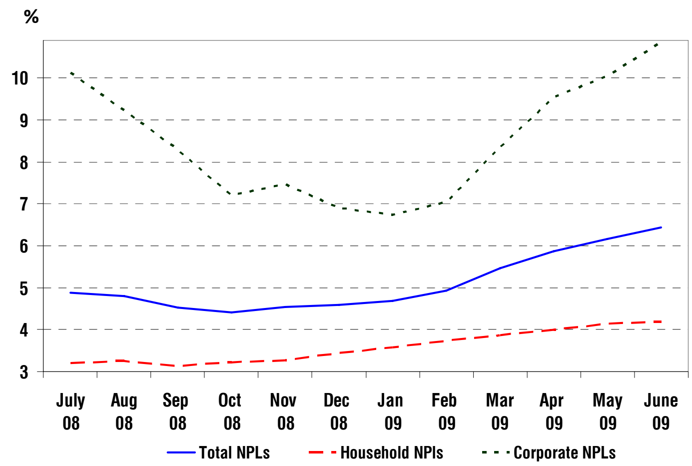
In the 2008, banks reported a record high of 14bn PLN in profits. This came about despite a poor quarterly performance in Q4-08 following the collapse of Lehman Brothers in September. This year's profits are more likely to be considerably lower. A telling indication is the first quarter profits, which reached 2bn PLN compared to last year's 4bn PLN for the same period. The main drag to profits growth came from the FX income component which had a significantly negative contribution to bank profits. Furthermore, Return on Equity (ROE) fell sharply to 10.7% in Q1-09 compared to 21.2% in the last quarter of 2008.

However, the Polish banking sector remains well capitalized with a Capital Adequacy ratio of 11.2% in March - the same reading as in Q4-08.

The most worrisome data regarding the banking system emerge from the rise of the Non-Performing-Loans (NPLs) ratio. They kept rising since last November and they have been substantially accelerating since March. The NPLs reached the alarming figure of 6.1% of total loans in June. The most worrying development is observed in corporate sector NPLs, which climbed to a double digit 10.5% the aforementioned period. (Figure 10)

Figure 10

Non- Performing Loans Ratio in Poland



Source: EFG Research, NBP
Note: NPLs monthly data

Poland: MacroEconomic Indicators	2003	2004	2005	2006	2007	2008	Q1 2008	Q1 2009
Output and expenditure				(Percentage Change in Real Terms)				
GDP	3.9	5.3	3.6	6.2	6.6	4.9	6.1	0.8
Private consumption	2.2	4.8	2.1	5.0	5.0	5.4	5.6	3.3
Public consumption	4.9	3.2	5.2	6.1	3.7	7.6	5.1	6.1
Gross fixed capital formation	-0.1	6.4	6.5	14.9	17.6	9.6	15.7	1.2
Exports of goods and services	14.0	14.3	7.8	15.0	9.2	7.4	10.4	-14.6
Imports of goods and services	9.6	16.3	4.7	17.6	13.7	8.5	13.2	-17.6
Industrial production	8.8	12.7	4.1	12.0	5.2	2.7	8.3	-10.6
Labour Market								
Employment	-1.0	0.9	2.3	3.6	4.3	3.7	4.6	1.5
Unemployment (in per cent of labor force)	19.9	19.5	18.2	16.2	12.7	9.8	11.2	10.9
Prices				(Percentage Change)				
Consumer prices (annual average)	0.8	3.5	2.1	1.0	2.5	4.2	4.1	3.2
Producer prices (annual average)	2.6	7.0	0.7	2.3	1.9	2.3	2.6	4.9
Average monthly wage in economy	3.2	4.9	4.0	4.9	8.7	9.6	10.1	6.8
Government sector				(In Per Cent of GDP)				
General government balance (ESA95)	-6.3	-5.7	-4.3	-3.9	-1.9	-3.9	-	-
General gross government debt (ESA95)	43.9	41.8	41.9	47.8	46.8	47.1	-	-
Monetary and Financial Indicators				(Percentage Change)				
M3	2.4	7.6	13.2	12.7	15.8	16.0	13.4	17.7
Total Credit	8.6	2.7	12.4	24.2	29.2	37.1	30.0	35.1
				(End of Period)				
Reference Rate	5.25	6.50	4.50	4.00	5.00	5.00	5.75	3.5
Exchange rate Zloty/USD (end-period)	3.74	3.00	3.26	2.90	2.46	3.0	2.22	3.48
Exchange rate Zloty/EUR (end-period)	4.72	4.07	3.85	3.82	3.60	4.1	3.51	4.62
Real Effective Exhange Rate (Index)	96.32	96.22	107.47	109.85	114.14	130.23	122.95	94.0
International Position				(In Per Cent of GDP)				
Current account balance	-2.1	-4.0	-1.2	-2.7	-4.7	-5.4	-5.0	-4.2
Trade balance	-2.7	-2.2	-0.9	-2.0	-3.7	-4.6	-4.1	-4.0
Foreign direct investment. net	2.0	4.7	2.3	3.0	3.6	2.5	3.5	2.2
External Debt	47.6	42.0	44.1	46.6	50.8	47.7	52.1	48.0
Memorandum items				(Denominations as Indicated)				
Population (end-year. thousand)	38195	38180	38161	38132	38116	38108.0	-	-
GDP (in Mrd of EUR)	191.6	204.2	244.4	272.1	310.6	360.6	-	-
GDP per capita (in EUR)	5016.4	5348.3	6404.4	7120.6	8000.9	9462.6	-	-

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

Poland: Banking Indicators							
	2004	2005	2006	2007	2008	Q1 08	Q1 09
Percentage of GDP (%)							
Assets	68.4	70.2	73.8	78.8	92.2	80.9	96.4
Total Credit	27.2	28.7	33.1	38.8	48.7	40.2	50.8
Total Credit in FX	6.3	7.2	8.7	9.3	16.1	9.9	18.0
Credit to Enterprises	12.6	12.1	12.9	14.4	17.0	15.0	17.5
Credit to Enterprises in FX	3.1	2.8	2.9	2.7	4.1	2.8	4.7
Credit to Households	11.9	13.9	17.3	21.7	28.9	22.7	30.5
Credit to Household in FX	2.9	4.0	5.5	6.2	11.7	6.9	13.0
Mortgages	4.0	5.3	7.7	10.4	15.6	11.1	16.9
Deposits	34.9	36.3	38.5	39.7	43.8	40.2	44.0
Deposits in FX	5.0	5.4	5.7	4.8	4.2	4.5	4.4
Percentage Change (%, yoy)							
Assets	4.4	9.0	12.8	17.0	29.1	20.7	27.6
Total Credit	2.7	12.3	24.1	29.2	37.1	29.6	35.1
Total Credit in FX	-21.1	20.6	31.3	17.2	89.3	21.0	94.5
Credit to Enterprises	-3.7	2.6	14.5	23.0	28.8	24.8	25.4
Credit to Enterprises in FX	-27.7	-2.4	9.5	5.5	64.3	3.0	83.6
Credit to Households	11.7	24.0	34.5	38.4	45.0	37.9	44.1
Credit to Household in FX	-9.2	48.4	47.1	25.6	104.6	33.4	102.1
Mortgages	21.1	40.5	54.6	50.6	62.5	48.9	62.4
Deposits	6.4	10.4	14.3	13.8	20.0	14.5	18.5
Deposits in FX	-5.5	15.9	11.9	-6.3	-3.7	-11.3	5.7
Percent (%)							
Capital Adequacy Ratio	15.5	14.5	13.2	12.1	11.2	11.1	11.2
Capital to Assets	8.0	7.8	7.5	7.8	7.2	7.6	7.5
NPLs to Total Loans	-	7.7	5.6	4.1	3.5	4.7	5.2
Provisions to NPLs	61.3	61.6	57.8	–	-	-	-
Return on Assets	1.4	1.6	1.8	1.7	1.6	1.6	-
Return on Equity	17.2	20.6	22.5	22.5	21.2	26.2	10.7

Sources: NBP, IMF

3. Romania

Economy still in a vulnerable position

- GDP is expected to contract by -6.5% in 2009 and by an additional -1.5% in 2010
- Inflation eases to 5.9% in June and leaves room for more bold interest rate cuts
- The Current account deficit is expected to halve to 6% of GDP in 2009 and as a consequence, its FDI coverage is expected to improve
- The 20bn IMF led support package stabilizes domestic financial markets and revives investor confidence
- A revised and stricter IMF stand-by arrangement agreement will govern the distribution of the second tranche, as the budget deficit overshot its target of 4.6% and macro figures turned out worse than originally estimated
- Lending conditions are becoming increasingly tighter despite the central bank's concrete measures to boost credit growth and liquidity
- The parent banks of the nine biggest banks operating in Romania met in Vienna to declare their commitment of maintaining their overall exposure to the country and of increasing the capital of their subsidiaries, if needed
- NPLs are on the rise, at 14.5% in 2009 Q1 compared to 9% a year earlier

Ioannis Gkionis & Spyridoula Drakopoulou

Romania			
	2008	2009f	2010f
Real GDP growth	7.1	-6.5	-1.5
Inflation (annual average)	7.9	5.8	3.8
Current account balance (% of GDP)	-12.3	-6.0	-5.0

Source: Eurostat, IMF, NBR, National Statistics, Eurobank Research

Economic Outlook

After four years of booming, the Romanian economy is undergoing a dramatic economic adjustment. The accumulation of large imbalances during the booming times exposed the Romanian economy to several risks which materialized by the international crisis. The sharp external demand contraction in combination with the shrinking capital inflows has placed the economy under stress. Less available external financing has impacted domestic credit growth as well. Despite the efforts of the Central Bank to revive lending and boost liquidity, banks have stopped lending. On top, poor weather conditions have a negative impact on output and this is likely to impact negatively on inflation once again too.

The IMF led loan support package provided some relief in the markets helping to avoid a mass scale crisis. Yet, Romanian assets could still prove vulnerable to potential contagion risks stemming from the Baltics region. IMF support may not prevent though the Romanian economy from contracting deeper than initially thought. The initial IMF forecast of a contraction of -4% in 2009, under which the loan was granted, may turn out to be optimistic. All macro figures diverge from the baseline scenario, stipulated in the Stand-By arrangement agreement. As a result, a revision on all macroeconomic variables before the disbursement of the second tranche of money should be expected. This is most probably going to happen without the agreement breaking down.

On the positive side, the long term commitment of foreign investors in Romania is reaffirmed by the recent foreign banks agreement in Vienna. The agreement amongst the nine largest foreign banks operating in Romania calls to maintain their presence and keep supporting their subsidiaries through capital increases.

Political Environment- Public Finances

The elections for Euro-parliament revealed some of the discontent of the electorate for the ruling coalition. Both coalition government parties, the Socialist Democratic (SDP) and the Democratic Liberal Party (DLP), received less percentage of the vote compared to the parliamentary elections in November. All eyes are turned on the Presidential race. The two main contestants are the incumbent President Basescu (DLP) and Mr. Geoana (SDP).

Tensions between the two coalition partners have already begun to arise ahead of Presidential elections later on this year. The DLP holds the posts of the Prime Minister and the Ministry of Finance. The budget allocations for the ministries are decided by the Ministry of Finance. The cabinet members from SDP are frustrated by the budget allocations, which are decided by the Ministry of Finance who comes from DLP. The race between the two Presidential candidates will certainly undermine the coalition government. The political landscape is expected to change in case the PSD nominee wins the Presidency.

The authorities have secured a €19.5 bn. financial support package by the IMF, the EU, the EIB and the EBRD. The package will be utilized to increase the FX reserves as well as to finance the budget deficit. The package was granted among others, under the condition of meeting a general government deficit of 4.6% of GDP in 2009 (local accounting standards-cash deficit), which is equivalent to 5.1% of GDP in EU methodology.

The fiscal performance in Jan-May remains in line with the IMF target. The budget deficit came out at 2.2% of the projected GDP in line with the ceiling of 2.73% for the 1H. Revenues decline by 4.7% comes as a result of the economic contraction. Although the government committed to contain current expenditures, those increased leading to a surge in spending by 14.3%. Nevertheless, the deeper than expected contraction, the pensions' increase and the government announced intention to continue financing some infrastructure projects will push the general government deficit above the target. The higher than expected budget outcome necessitates either a significant upward adjustment to the target or a significant fiscal tightening in 2H.

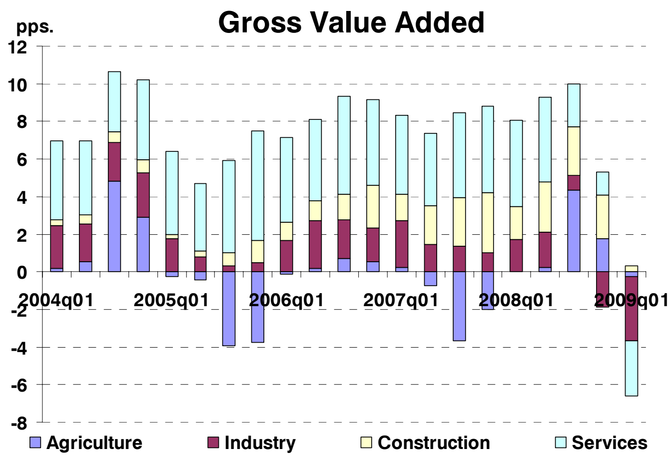
The government finds it already difficult to address the increasing public financing needs. The limited financing options force the government to resort to issue short-term T-Bills to finance the budget deficit. Ahead of the first disbursement of multilateral organizations' funds, the Treasury has been obliged to issue 21 bn RON in the 1H against 8.9 bn for 2008. The consequences are two fold: The price for short-term funds is costly and liquidity is drained off the market. The poor fiscal performance has prompted the EU to initiate the excessive deficit procedure against Romania. On the positive side, the government will be required to bring the deficit down gradually. In conclusion, public debt is forecasted to rise sharply above 30% in 2010.

Growth performance

The economy is in a technical recession. Real GDP contracted by 4.6% qoq on a seasonal adjustment basis in Q1-2009, after declining by 2.8% qoq in Q4-2008. On an annual basis, real GDP declined by 6.2% in Q1. The end of the credit boom had a strong negative impact on consumer demand. Government's consumption expansion by 4% was not able to prevent total consumption from shrinking by 9.1% yoy, as private consumption fell by 10.5% yoy. Exports shrunk by 20.8% against a decline in imports of 33.3%. The depletion of inventories led gross capital formation to decline by 36.7% yoy.

From the sectorial point of view, industry took a bad hit, as it shrunk by 11.1%. In addition, agriculture declined by 10.9% after a very good harvest last year. The services and the construction sector data surprised in a positive way. Services contracted by only 4% and the construction sector slowed down but still expanded by 4.7% yoy. Construction was the only sector with a positive contribution to GDP among other sectors. (Figure 1)

Figure 1



The high frequency data released in Q2 surprised to the downside, illustrating that the economy is in deep contraction mode. After some minor improvement in March, industrial production declined by 10% in May resuming its declining trend. Construction output is on a free fall, down by 13.9% in April. To make things worse, retail sales contracted by 10% in May as well, after holding up relatively well in Q1. Deterioration is expected to continue because the private sector cuts down on personnel as the economic downturn intensifies. Official unemployment has begun to rise from its recent historic lows, climbing to 5.8% in June. In conclusion, we anticipate that the recession is going to be deeper than initially forecasted. For that reason, we have revised our GDP forecast to -6.5% in 2009. (Figures 2,3,4)

Figure 2

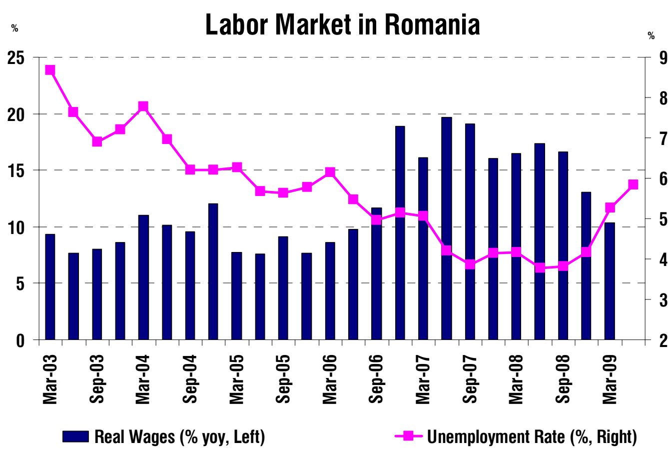


Figure 3

Industrial Production-Retail Sales

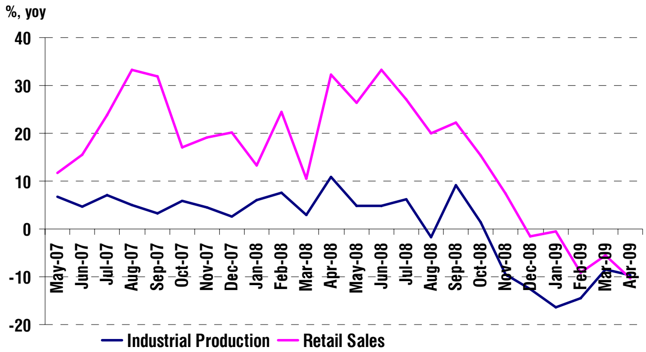


Figure 5

Current Account Deficit in Romania

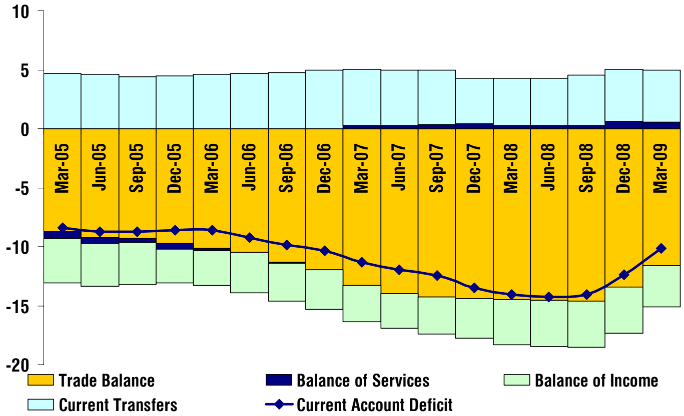
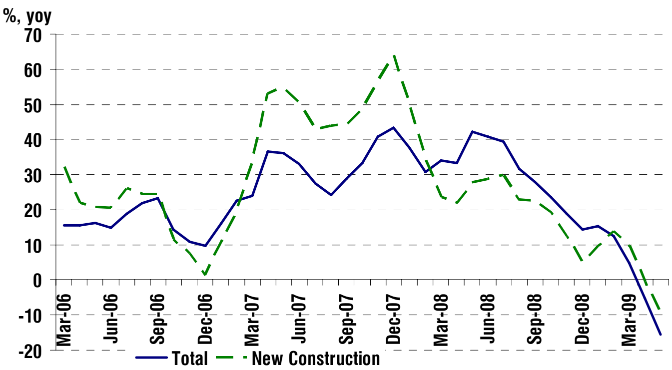


Figure 4

Construction, 3-Month M.A.



Balance of Payments

Current account adjustment is gaining momentum as economic activity contracts. The current account has shrunk by 79% yoy in the five months of 2009. The current account deficit declined to 8.6% of GDP against 12.1% of GDP in late 2008. The main driver behind this adjustment is the 65.9% decline of trade deficit. The domestic demand contraction causes imports to fall. The Euro area weakness, the main destination of Romanian exports, affects exports. The income deficit is improving as fewer profits from FDI investments are repatriated back in home countries. The level of remittances remained relatively high so that current transfers have narrowed only marginally by 10%. All in, given the speed of adjustment, the current account deficit is expected to land to 6% by year end. (Figure 5)

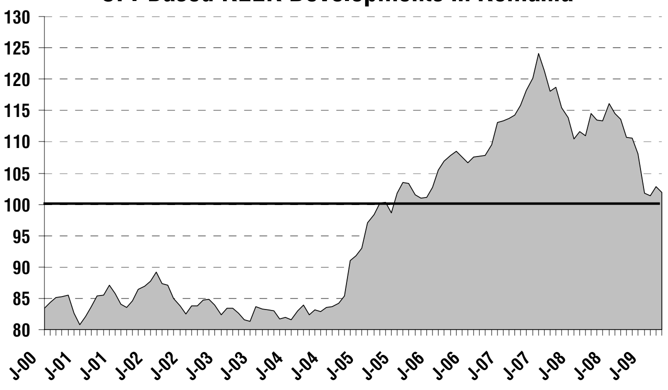
On the positive side, FDI keeps flowing in the domestic market, even though a 42% yoy decrease was registered in Jan-May. FDI inflows amounted to 2.5 bn Euros compared to 4.2 bn at the same period last year. Nevertheless, they still fully cover the smaller current account shortfall, compared to 60% coverage over the same period a year ago.

The RON has stabilized after its depreciation recorded in Q1. The revival of risk appetite in the world markets combined with the IMF-led support package has helped the domestic currency trade at 4.2 RON/€.

The risks for the RON seem contained given the determination of the Central Bank to prevent any significant depreciation. Central Bank position is reinforced by its strengthened FX reserves. In addition, the Real Effective Exchange Rate has declined since the last summer by 25%, so that overvaluation has been corrected. RON should be considered to be trading more closely to fair value than a year ago. (Figure 6)

Figure 6

CPI-Based REER Developments in Romania

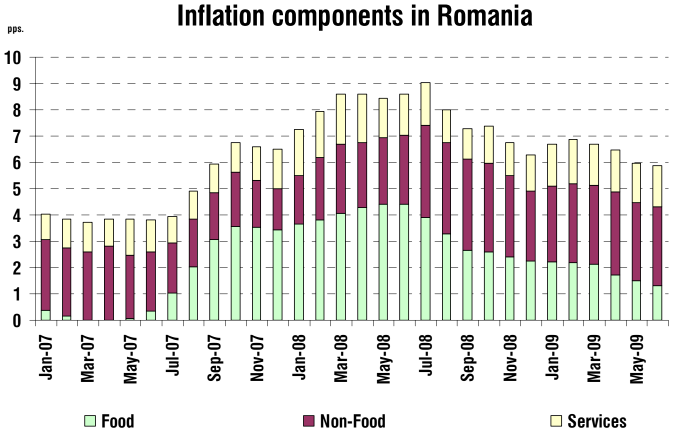


Inflation-Monetary Policy

Consumer prices started to trend downwards more visibly in Q2. Inflation moderated to 5.9% in June after peaking at 6.9% in February. The currency depreciation pressures maintained inflation at relatively higher levels in Q1 due to the high degree of pass-through. The main factor behind the disinflation trend is the declining food prices. Food prices inflation has halved from 6% to 3.5% in June. Non-food items and Services remain on average and above average inflation. (Figure 7)

Figure 7

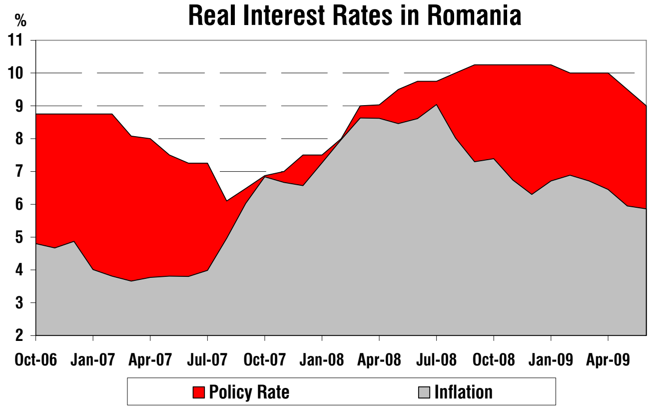
Inflation components in Romania



The Central Bank has not followed the rest of monetary authorities in the region in aggressive monetary easing. The high pass through degree of currency devaluation maintained inflationary pressures high in Q1. In addition, the high degree of FX leverage of corporates and households is one more reason for the central bank to be cautious. The central bank is obliged to maintain real interest rates at relatively high levels, in order to avoid any further currency weakening that would increase their debt burden. (Figure 8) The stabilization of the RON after March, in line with the rest of the global markets, allowed the Central Banks to increase the pace of easing. As a result, interest rates were cut by a total of 100 bps to 8.5% as of early August since the beginning of the year although recessionary pressures have been intense.

Figure 8

Real Interest Rates in Romania



We expect inflation to further decelerate to 5% by the end the year little above the upper 4.5% bound of the central bank target. Thus, the annual average inflation would be around 5.5% in 2009. The main preconditions for that to happen would be that RON remains stable and food prices trend is still favorable. Another contentious issue would be the implementation of the IMF agreement. This is closely tied with the fiscal discipline envisaged in the agreement, as we have already described. The implementation of the agreement with respect to the release of the second tranche of money would encourage the central bank to cut interest rates further up to 8%.

Banking Developments

The crisis has left its mark on the banking sector. Profitability displays a downward trend since the beginning of 2009. New lending activity is constrained and, therefore, growth rates are plummeting. Only the government sector is extending its lending and is supporting growth rate. Deposits are hovering around the same levels during the past few months. Despite, the credit growth deceleration, loan to deposit ratio is still at very high levels. Loan to deposit ratio in foreign currency has soared to high levels, increasing in that way the banks dependence on foreign financing.

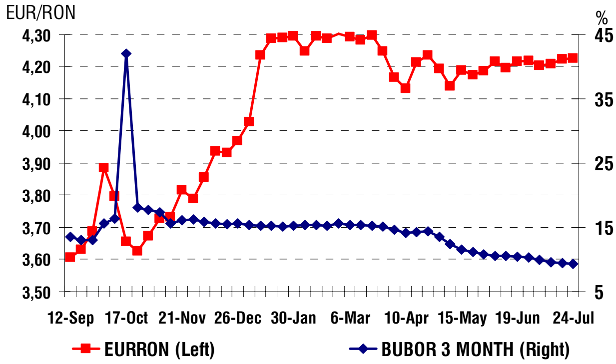
Since September 2008, the central bank has reversed its main target regarding credit growth. Until then, the NBR was taking measures to contain credit expansion, especially in foreign currency. Since September, though, the central bank is focusing on facilitating credit lending and constraining the increase of NPLs.

Indeed, the central bank lowered its policy rate and the minimum reserve ratio both for local and foreign exchange denominated loans, has amended rules for interbank interest rates and has made use of lending facility, FX swaps and repo transactions. These measures target boosting liquidity in the financial sector and facilitating new credit activity as well as giving incentives for longer-term financing of the banking sector. On the downside, the measures regarding the minimum reserve requirements will draw back the increase of foreign exchange reserves. However, after the IMF agreement Romania has boosted its reserves. Finally, as far as NPLs are concerned, banks should be flexible in the repayment of the debt of their costumers, especially for household loans denominated in foreign currency.

According to the IMF Stand-by Arrangement, the Romanian government should take measures to strengthen the banking sector. Maintaining strong capitalization, improving the capacity to respond in a timely and effective fashion in the event of bank distress, ensuring confidence in the banking system, improving supervision and regulation and promoting measures that facilitate debt restructuring are the main areas of focus. Following the finalization of the agreement, the local currency has shown signs of stabilization, without, however, returning to its September levels. (Figure 9)

Figure 9

FX & Money Market Rates in Romania



The Romanian banking sector is dominated by foreign banks as they own almost 90% of total banks' assets. Securing the support of their parent banks was of great importance. During their meeting in Vienna, the 9 biggest banks in Romania committed to maintain their overall exposure to the country, as well as, increase the capital of their subsidiaries in case it is needed. This move helped restore confidence in the sector, as there were worries regarding the possibility of a withdrawal of investments from the country.

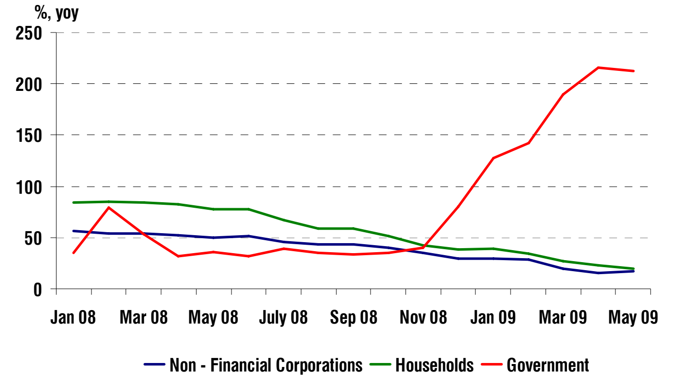
Credit Developments

Credit growth to the private sector has been severely hit and has plummeted to low levels compared to the beginning of the year. In fact, total credit grew by 27.3% yoy in May compared to 59.6% a year earlier. Non government credit has marked a steeper deceleration, to 11.2% yoy in June and 18.9% in April from 63.4% in June 2008. Credit in absolute terms seems to have increased mom in April by 405 mn RON. However, if we take into account the appreciation and stabilization of the currency, credit stock is decreasing by 634 mn RON. In May, total credit declined, even in absolute terms.

Government credit, contrary to credit in the private sector, doubled in May compared to a year before. Government credit, which accounted for 14% of total credit in May, is therefore the sector that still supports credit growth rate through the increased issuing of treasury bills. Credit growth for both non financial and household sector has dropped significantly since the beginning of the year. In fact, credit to non financial corporations grew by 13.3% in June compared to 30% in January, while credit to households decelerated to 14.6% from 38.9% in the correspondent period. Credit as a percentage of GDP has risen to 30.3% in Q1 2009, slightly up from 30.1% a quarter earlier. (Figure 10)

Figure 10

Loans to Private & Government Sector



The Romanian economy and especially households have funded themselves, to a large extent, in foreign currency. Total credit in FX accounted for 50.4% of total lending in May, while the contribution of FX lending in household sector stood at 60.2%. Mortgage sector has attracted the biggest share of FX loans as they account for 92%. The good news is, though, that the local currency shows signs of recovery and stabilization since April.

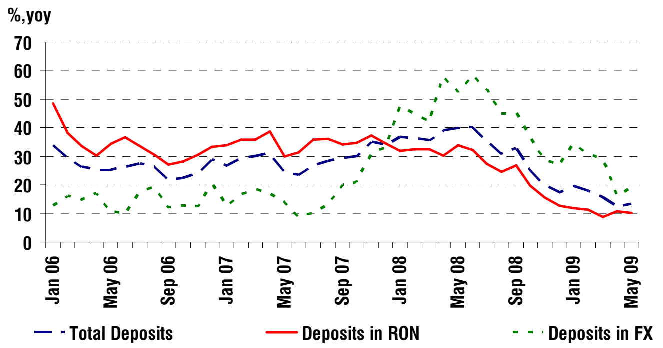
The Central Bank is putting into force measures to facilitate lending and avoid the possibility of a further deceleration of credit growth. Indeed, the NBR has lowered the policy rate to 8.5% in August from 10.25% at the beginning of the year. Moreover, the Central Bank decided to lower, starting from May, the minimum reserve ratio on FX denominated liabilities with residual maturities of over two years to 0% from 40% previously. In addition, the NBR announced two more measures: to cut the minimum reserve requirement ratio on leu and FX denominated liabilities with residual maturities of up to two years to 15% and 30% from 18% and 40% respectively. Finally, according to a new regulation, the NBR has simplified mortgage lending rules.

Deposit Developments

Deposit growth has marked a moderate decline since the beginning of the year. Deposits grew by 12.3% yoy in June against 19.4% in the beginning of the year. This decline is, mainly, attributed to the sharp decline in deposits in foreign currency whose growth rate decelerated to 17.3% in June against 34.3% in January. In terms of deposit penetration, deposits remained at the same level in Q1 compared to the previous quarter. (Figure 11)

Figure 11

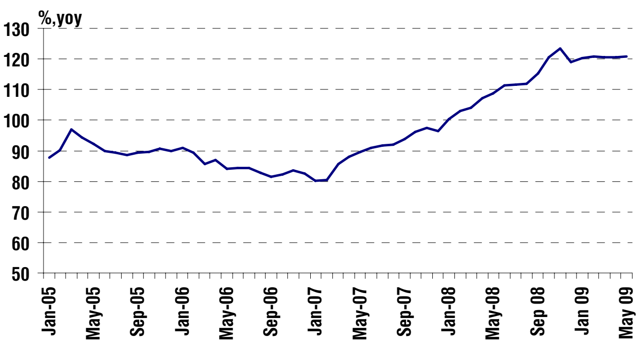
Total Deposit Growth



Given that the decline in deposit growth was more moderate than that of credit, loan to deposit ratio slightly improved and came down to 125.3% in June from 133.9% in January. In terms of local currency, the ratio stands well below unity but in terms of foreign currency, credit is double the deposit figure and came up to 208.1% in June. This ratio is one of the highest in the region and represents a potential risk to the viability of the financial system. (Figure 12)

Figure 12

Loan to Deposit Ratio

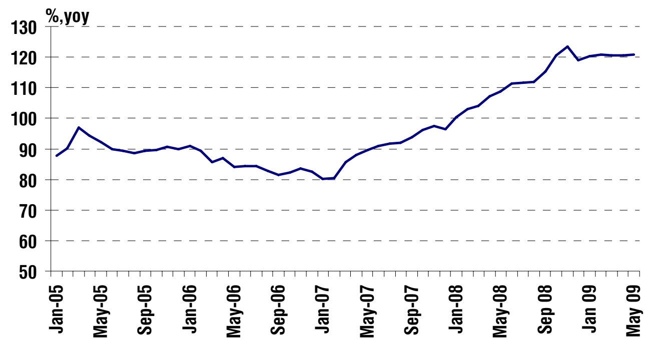


Banking Sector's Profitability and Capital Adequacy

Banking sector's profitability has been deteriorating throughout 2009. ROE and ROA ratios switched to negative territories in Q1. In fact, ROE fell to -2.9% while ROA to -0.3% compared to 1.5% and 16.5% in Q1 2008. (Figure 13)

Figure 13

Loan to Deposit Ratio



Capital Adequacy ratio remains above the EU requirement at 12% at the end of March. Among the measures that should be taken according to the IMF Stand-by Arrangement are the increase in capital adequacy ratio to 10% compared to the previous 8% and the adoption of the International Financial Reporting Standards (IFRS). These measures target the improvement of the supervision and regulation framework as well as the promotion of the stability and efficiency of the financial system.

The quality of banks assets has deteriorated substantially, increasing in that way the stock of provisions. NPLs have risen to 15.3% in April compared to 8.9% a year before. The significance of moderation of the rising NPLs has, also, been part of the Stand-by Arrangement which points out the need to take some measures for the easing of the debt servicing by borrowers during the crisis. Provisions have, also, increased dramatically and came up to 10.6 bn RON in April. In percent of total loans, provisions increased to 4.6% in April up from 3.8% in January and 2.2% a year ago. However, according to the new regulation approved at the end of March, commercial banks may reduce provisions for overdue loans of over 90 days with up to 25% of the collaterals. This measure will increase the funds that banks hold.

Romania: Macroeconomic Indicators	2003	2004	2005	2006	2007	2008	Q1 2008	Q1 2009
Output and expenditure	*(Percentage Change in Real Terms)*							
GDP	5.2	8.5	4.2	7.9	6.0	7.1	8.2	-6.2
Private consumption	8.4	14.6	9.9	12.4	11.0	9.3	14.3	-10.5
Public consumption	8.5	-9.3	11.8	-11.5	7.6	3.7	5.8	4.0
Gross fixed capital formation	8.3	12.8	9.4	11.6	9.8	19.3	33.2	-0.3
Exports of goods and services	8.4	13.9	7.7	10.6	8.7	19.4	25.3	-19.6
Imports of goods and services	16.0	22.1	16.0	22.4	26.1	17.5	35.1	-31.4
Industrial production (cumulative)	-0.8	2.7	-3.1	9.2	10.4	5.1	6.1	-13.0
Labour Market								
Employment (% change)	0.3	0.8	2.6	1.3	2.8	1.8	2.3	-1.8
Unemployment (in per cent of labor force)	7.6	6.8	5.8	5.4	4.3	4.0	4.2	5.3
Prices	*(Percentage Change)*							
Consumer prices (annual average)	15.3	11.9	9.0	6.6	4.8	7.9	8.0	6.8
Producer prices (annual average)	19.6	19.1	10.6	11.6	8.1	15.4	14.2	5.7
Average monthly wage in economy	25.4	22.5	23.7	16.8	21.0	23.0	22.8	16.7
Government sector	*(In Per Cent of GDP)*							
General government balance (National Definition)	-1.5	-1.2	-1.2	-2.2	-2.5	-5,4	-	-
General government debt	21.5	18.7	15.8	12.4	12.7	13.6	-	-
Monetary and Financial Indicators	*(Percentage Change)*							
M2	23.3	39.9	17.0	27.9	28.1	31.8	36.9	17.3
Total Credit	49.2	32.5	43.7	52.0	64.5	36.5	65.5	32.7
	(End of Period)							
Reference rate	18.90	20.20	9.70	8.45	7.50	10.25	9.50	10.0
Exchange rate USD/RON (end-period)	3.25	2.89	3.11	2.57	2.47	2.88	2.36	3.19
Exchange rate EUR/RON (end-period)	4.10	3.93	3.68	3.37	3.60	4.03	3.72	4.23
Real Effective Exhange Rate (Index)	82.6	84.7	100.0	107.6	117.3	112.3	111.0	102.0
International Position	*(In Per Cent of GDP)*							
Current account balance	-5.5	-8.4	-8.6	-10.4	-13.9	-12.3	-14.1	-12.3
Trade balance	-7.6	-8.7	-9.8	-12.0	-14.8	-13.4	-14.5	-11.6
Foreign direct investment. net	3.2	8.6	6.5	9.6	6.3	6.5	5.3	6.5
External debt	34.7	35.1	33.0	42.3	48.4	53.4	48.1	53.2
Memorandum items	*(Denominations as Indicated)*							
Population (end-year. thousand)	21742	21685	21634	21588	21523	21504	–	–
GDP (in Mrd of EUR)	52.6	61.1	79.82	97.7	123.8	136.8	–	–
GDP per capita (in EUR)	2405.3	2812.7	3690.0	4541.7	5639.3	6361.6	–	–

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

Romania: Banking Indicators							
	2004	2005	2006	2007	2008	Q1 08	Q1 09
Percentage of GDP (%)							
Assets	37.1	45.2	51.2	65.8	67.4	67.4	70.6
Total Credit	17.8	21.9	28.0	39.0	42.7	41.4	45.5
Total Credit in FX	10.3	11.4	12.8	19.9	22.7	21.4	23.5
Credit to Enterprises	10.6	12.1	14.6	18.0	18.8	18.9	19.1
Credit to Enterprises in FX	7.1	7.1	7.6	10.0	11.1	10.5	11.0
Credit to Households	4.8	7.4	11.5	17.7	19.7	18.9	19.9
Credit to Household in FX	2.2	3.3	4.7	9.4	11.6	10.4	12.0
Deposits	23.1	26.0	28.2	31.9	30.1	31.6	30.3
Deposits in FX	13.6	17.0	9.1	10.2	10.4	10.5	11.2
Percentage Change (%, yoy)							
Assets	48.0	42.5	34.7	51.8	27.6	39.4	26.3
Total Credit	32.5	43.7	52.0	64.5	36.5	65.5	32.7
Total Credit in FX	–	29.1	33.7	84.0	42.2	88.8	32.1
Credit to Enterprises	29.2	32.5	43.0	46.4	29.7	53.9	19.9
Credit to Enterprises in FX	–	16.5	26.4	56.3	39.1	62.5	31.9
Credit to Households	58.3	80.0	83.8	82.1	38.7	84.1	27.1
Credit to Household in FX	–	72.8	71.8	134.4	53.6	140.3	39.2
Deposits	41.5	31.5	28.9	33.9	17.4	35.5	15.4
Deposits in FX	–	46.3	20.4	32.9	27.1	42.1	28.7
Percent (%)							
Capital Adequacy Ratio	20.6	21.1	18.1	13.8	12.3	13.0	12.0
Capital to Assets	8.9	9.2	8.6	7.3	7.0	7.2	6.0
NPLs to Total Loans	7.2	7.6	7.4	9.0	12.3	9.0	14.5
Provisions to NPLs	14.2	10.7	13.4	20.0	24.7	22.1	27.5
Return on Assets	2.1	1.6	1.3	1.0	1.7	1.5	-0.3
Return on Equity	17.0	12.7	10.2	9.4	18.1	16.5	-2.9

Sources: NBR, IMF

4. Serbia

Contraction deeper than expected

- The 4bn USD regular stand by agreement, with IMF on top of the 0.5bn USD precautionary agreement together with financial assistance from international organizations, should be enough to address the heavier than expected financing requirements
- The Dinar has stabilized at 93-95 against the Euro in the last three months, sovereign bond spreads have declined by 700 bps from their all time highs, the stock market has rebounded by 61.5% in line with other global markets: the financial markets discount that the worst is already behind us
- The poor fiscal performance suggests that the consolidated government deficit will turn out at 4.5% of GDP, much higher than the 3% revised target set in the IMF agreement
- The global economic crisis hits Serbia more severely than expected. GDP growth is expected to shrink by 5% in 2009, while -1% growth should be expected in 2010
- The current account deficit is expected to shrink to 13% of GDP by year end against 17.8% in 2008.
- The gradual easing of consumer prices allowed the Central Bank to cut interest rates by 575 bps to 12%: The current food prices declining trend and financial markets upbeat mood would allow the Central Bank to cut interest rates further to 10% by year end
- Credit growth has decelerated to 29.1% yoy in May compared to 34% in January while total deposits grew by 7.6% in May versus 7.4% in January
- The NBS has taken a number of measures to increase Dinar liquidity in the sector and increase the funds that are available to the SMEs
- In an effort to boost confidence, the 27 banks that will participate in the Financial Sector Support Program commit to maintain their December 2008 level of exposure in the national economy and maintain bank capital adequacy and liquidity ratios at the levels prescribed

Ioannis Gkionis, Spyridoula Drakopoulou

Serbia	2008	2009f	2010f
Real GDP growth	5.4	-5.5	-1.0
Inflation (annual average)	10.7	8.5	7.0
Current account balance (% of GDP)	-17.8	-13.0	-11.5

Source: IMF, NBS, National Statistics, Eurobank Research

Economic Outlook

The world economic crisis hits the Serbian economy hard, more than initially expected. Serbia could not escape a recession in the New Europe universe, as it shares many characteristics in common with other economies in the region. The global economic crisis has significantly reduced capital inflows coming in the economy. The sudden stop in capital inflows has a dramatic impact on consumption and investment. The low trade openness partially offsets the negative impact of the international crisis, but will also constrain future recovery as well. That is why we revised our forecast of GDP growth in Serbia for 2009 and 2010 to -5% and -1% respectively. Accordingly, the capital inflows dry up is leading to a significant correction in the high current account deficit to 13% of GDP against 17.8% in 2008.

Yet, the external financing needs of the economy are still high. Serbia was one of the first countries to turn to IMF and other international organizations to secure financial support. By and large, the amounts will ensure adequate financing in the next two years. On the other hand, the challenges of the implementation in terms of fiscal consolidation are enormous. In fact, it threatens to put the economy deeper into recession, given the size of the public sector. On a more positive note, long term investors maintain their exposure in the country. In an effort to boost investors' confidence in the domestic economy, the major foreign banks have committed to maintain their presence in Serbia and to roll over their debt.

Political Environment- Public Finances

The municipal elections held for the city of Belgrade in June confirmed two trends in local politics. Firstly, the popularity of the ruling Democratic Party (DS), the major party in the government coalition, is on a downward trend. Second, a new force is emerging on the opposition side. The new party was created after the main opposition party-the Serbian Radicals was split. The former parliamentary leader of the Radicals, Nikolic, broke away to form the Serbian Progressive Party. The new party, which holds more moderate views than its predecessor, is consolidating support from the electorate and now stands very close in polls with the ruling Democratic Party. This will impair the ability of the government to formulate the austerity policies required by IMF.

Despite government efforts, there is no progress on the process of integration with European Union. There is no visible progress on the implementation of the Stabilization and Association Agreement. Nevertheless the EU made a step towards Western Balkans, partially abolishing visa restrictions for Serbian citizens for the first time since the nineties.

On the fiscal front, the performance recorded in Jan-May does not allow for any optimism. Revenues were already lagging by 6% behind the revised April target, which was based on the assumption of -2% contraction in 2009. The budget deficit in nominal terms was already twice as much .The worse than anticipated GDP growth is expected to be reflected on revenues and expenditures. As a result, the consolidated government deficit is expected to surpass 4.5% of GDP in 2009, a failure to achieve the condition of a 3% of GDP target stipulated in the IMF loan agreement. That said, the government claims that a revision in the target would be acceptable on that basis. On the negative side, that is not an argument IMF necessarily may accept. There are two implications as a result of that. First, the government may be obliged to have further spending cuts or new taxes imposed. In that case, recession would even deepen. Second, if there is going to be any delay in the release of the next tranche of the IMF loan that would hurt investors' sentiment toward Serbian assets.

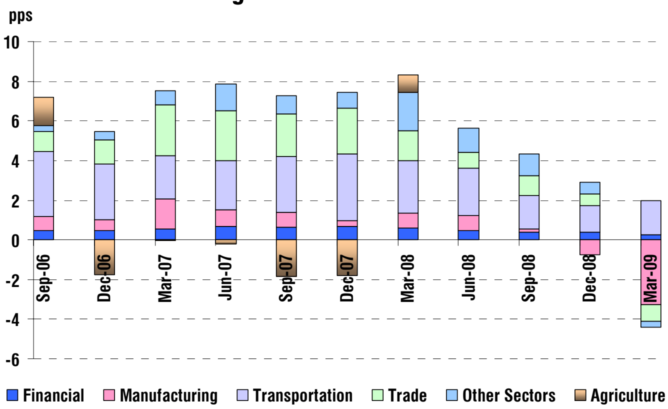
Growth performance

GDP contracted by 3.5% yoy in Q1-2009, against 2.8% yoy in Q4. This represents a slower contraction than what high frequency indicators suggested. The Central Bank anticipated a contraction by 5.8% yoy. Manufacturing was the most hit sector of the economy. It plummeted by 30.9% yoy in Q1, making a negative contribution of 3.3 pps to the growth rate. Wholesale and retail trade contracted by 7.8% yoy, having the second most negative contribution of 0.8 pps. Construction and real estate was down by 5.2%, amounting to a negative contribution of 0.4pps.

Transportation and communication maintained positive growth rates. Nevertheless they decelerated visibly to 16.9%, down from 22.9%. Those sectors made a positive contribution of 1.7pps. Financial intermediation had a positive contribution of 0.3pps growing by 2.5% yoy against 5.3% yoy last year. (Figure 1)

Figure 1

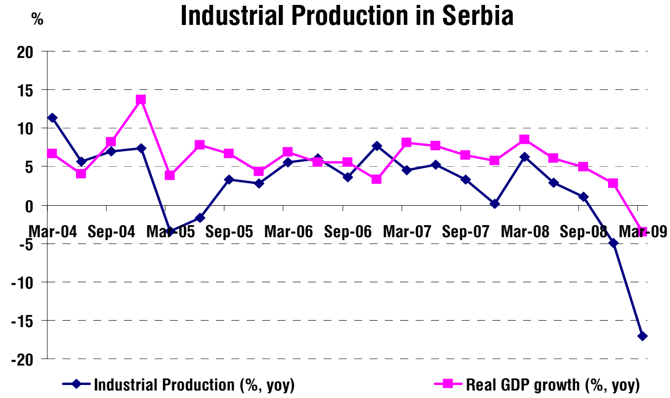
GDP growth drivers in Serbia



High frequency indicators suggest that the deterioration has not stopped. Industrial production plunged by 18.3% in May, which brings the overall performance, since the beginning of the year, to 18.1% yoy. The retail sales contraction gained momentum in May at -8%, although the data are not fully comparable given that last year in May there was a significant public wages increase. (Figure 2)

Figure 2

Industrial Production in Serbia



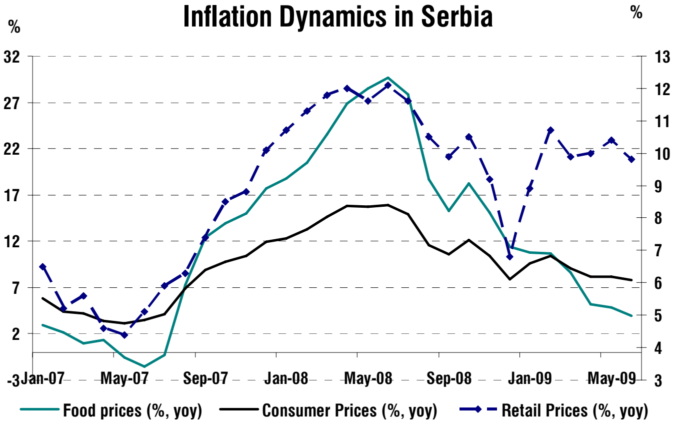
Inflation-Monetary Policy

Inflation has started to come down, after the upward course recorded in Q1. The stabilization of the domestic currency allowed consumer prices to start declining gradually. Effectively, consumer prices eased to 7.8% in June, against 9.6% in Dec. Accordingly, HICP stood at 8.3% yoy in June. Retail prices inflation maintained at relatively high levels at 9.8%, proving out to be stickier. Food prices were on a strong declining trend, at single digit levels-5.1% yoy in June. Transport prices posted an anemic increase-3.6% yoy benefiting from lower oil prices and weaker demand, significantly lower than last year.

In our view, the contractionary impact of weak domestic demand will broadly offset any upward regulated prices adjustment. That said, the main risks to the disinflation process would be any renewed pressures on the Dinar, inflationary pressures induced by the poor agricultural crop this year and a rise in VAT taxes in order to increase revenue collection.

In essence, the inflation is expected to remain within the required but at the upper bound of the 6-10% band. For that reason, we expect the Central Bank to adopt a more “wait and see” approach in the forthcoming months, but nevertheless maintain its easing monetary policy stance. Interest rates were aggressively cut by a cumulative of 575 bps since the beginning of the year, to 12%. (Figure 3)

Figure 3



Banking Developments

During the last quarter of 2008 and the first of 2009 the NBS advocated measures to combat the financial crisis. Due to the steep depreciation of the currency, the national bank raised mandatory reserve requirements to 40% compared to 20% previously. Moreover, in its effort to support the Dinar, NBS annulled mandatory reserves in foreign currency loans and spent a considerable amount of foreign exchange reserves. However, these measures did not have the desirable outcome. The Dinar has stabilized but it still ranges around its peak levels.

Therefore, the central bank lowered, in two consecutive moves, mandatory reserve requirements to 30%. The measure, that will be applicable as of July, will increase dinar liquidity in the sector. In order to lower banks' exposure to exchange rate risk, the NBS lowered foreign exchange risk indicator (bank foreign exchange assets to liabilities) from 20% to 10%. Key policy rate has been reduced by 575 basis points so as to boost credit activity which shows signs of moderation. Another measure introduced by the central bank was the abolishment of the gross household lending to share capital ratio which was standing at 200%.

In Q1 2009, foreign direct investments in the financial sector stood at EUR 40.8 mn, down from EUR 76.7mn in Q4 2008 and EUR 501.5 mn a year earlier. In order to boost investors' confidence, the parent institutions of the ten largest foreign owned banks met in March in Vienna. They committed to retain their overall exposure in the country and agreed to provide further capital boosts in case it is needed.

The Financial Sector Support Program (FSSP) will give access to banks that express their interest to participate to a number of facilities. Namely, new liquidity sources will be available to them, they will be able to include in their capital subordinated liabilities up to 75% of their core capital. What is more, in calculation of arrears on loans whose repayment terms were rescheduled under the framework defined, and for the purposes of their classification requirements, banks will be permitted to apply the subsequently agreed maturity date, as well as to raise FX risk ratio from 10% to 20% of their capital. NBS has greenlit 27banks out of 31 that expressed interest in participating in the program.

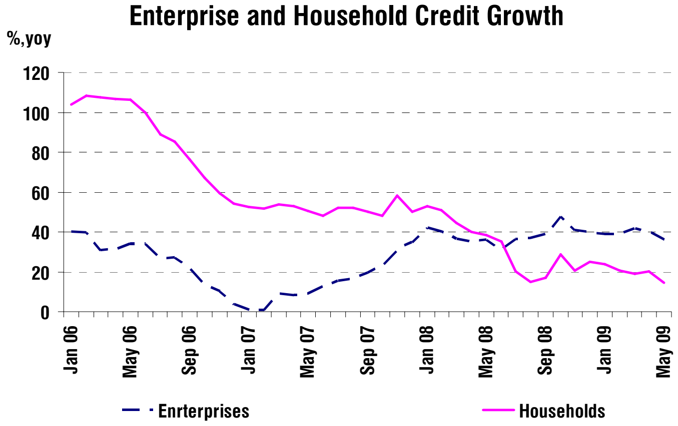
In order to gain access to these facilities, though, banks should commit to maintain their December 2008 level of exposure in the national economy, maintain bank capital adequacy and liquidity ratios at the levels prescribed. Finally, banks will commit to enable borrowers convert their foreign currency loans and foreign currency clause-indexed loans into dinar loans and provide for rescheduled loan repayment terms under the framework defined.

Credit Developments

Credit growth has decelerated, though, at a lower pace compared to the rest of the New Europe countries. In fact, credit grew by 29.1% yoy in May compared to 34% in the beginning of the year and 36% a year earlier. Household credit growth marked the steepest decline to 14.4% yoy in May compared to 23.8% in January. On the other hand, corporate credit expanded by 37.4% yoy in May versus 39% in January. (Figure 4)

Figure 4

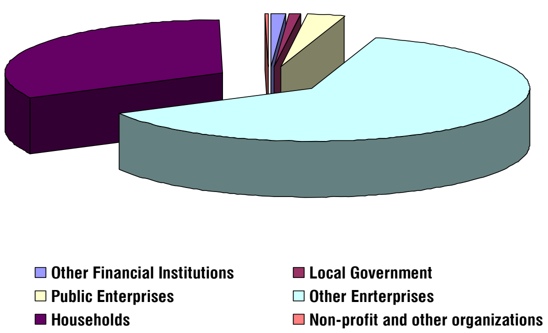
Enterprise and Household Credit Growth



Corporate loans are the driver behind credit growth as they account for 65% of total loans as of May. In a move to support lending to SMEs, Serbian banks will extend to local companies soft loans worth RSD162bn, more than the RSD122bn that was initially agreed. Moreover, in order to encourage more credit activity, there will be no upper limit on the amount of credit granted to entrepreneurs and small companies. Finally the NBS has annulled reserve requirements on fresh borrowing from abroad so as to increase liquidity in the sector, lower the cost of foreign re-financing and support the Dinar. (Figure 5)

Figure 5

Credit Portofolio Decomposition (May 2009)



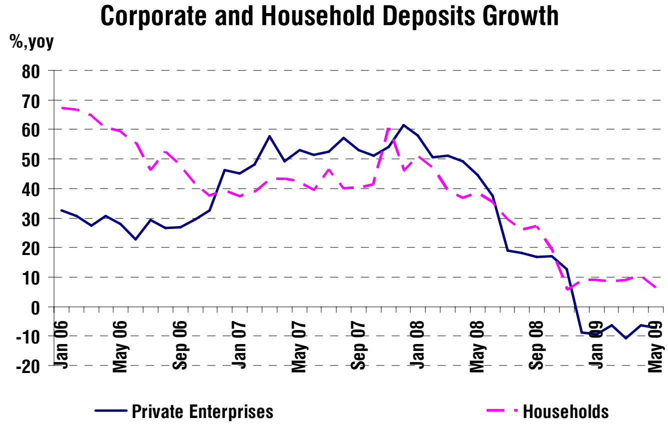
Deposit Developments

In the end of 2008, the number of deposits in absolute terms marked a slight decrease. However, in 2009 deposits are constantly increasing but their growth does not seem to follow a trend. Deposit growth increased in February and April but decreased in January, March and April. In fact, deposits grew by 7.6% yoy in May versus 10.5% a month earlier and 7.4% in January.

Deposits in FX remain the main driver of growth as they accounted for 68% of total deposits in May. Household deposits in FX account for 92% of total household deposits. Households' preference in keeping FX deposits can be partly explained by the high share of EUR-indexed household loans. Deposits from enterprises and especially private enterprises have been marking negative growth since December. Enterprise deposits contracted by 4.1% yoy in May versus -8.4% in January, while private enterprise deposits contracted by 7.2% yoy in May compared to 9.3%contraction in January. (Figure 6)

Figure 6

Corporate and Household Deposits Growth

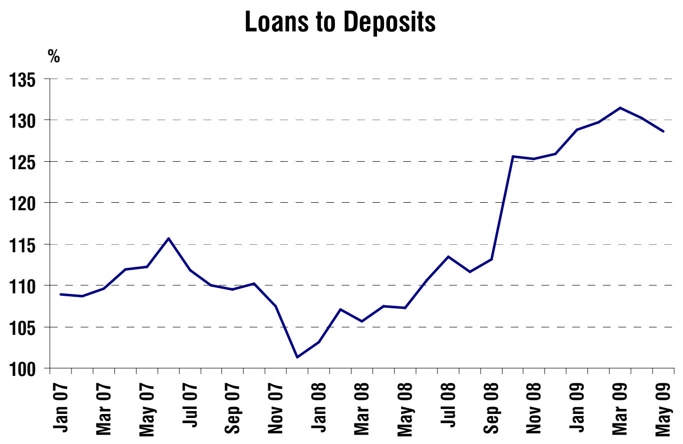


The NBS, in order to boost deposits growth, has introduced a number of measures. In order to boost consumers' confidence in the banking sector the NBS raised maximum guarantee deposits from EUR 3.000 to 50.000. This amendment insures almost every saver as only 1% of them own deposits over EUR 50.000. Moreover, the NBS gave one more incentive to depositors by annulling the tax on the interest rates earned on dinar savings accounts.

Confidence in the sector is being restored. Household FX savings are increasing in 2009 after their drop in 2008. What is more, according to the national bank, the share of longer-term deposits to total deposits is on the rise. In fact, one-year deposits increased to 30.3% of total household deposits, the share of savings of over one year reached 15% while demand deposits dropped to 26.5% in June.

Loans to deposits ratio stands at 128.6% in May after peaking at 131.5% in March. The ratio has been increasing since September 2008 due to the decrease in deposits in the end of 2008 as well as the fact that loans are increasing more rapidly than deposits. (Figure 7)

Figure 7

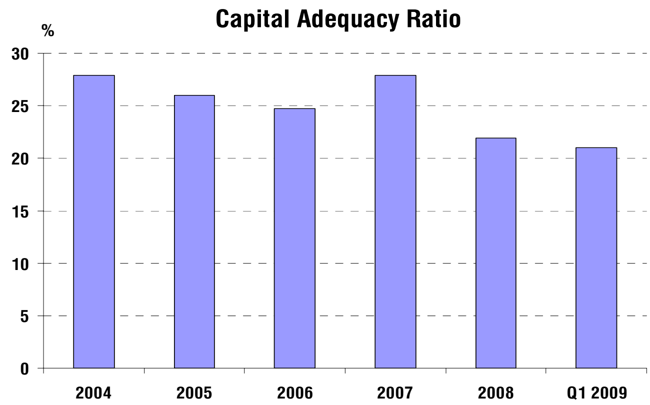


Banking Sector's Profitability and Capital Adequacy

Profitability indicators marked a slight decrease in late 2008. Indeed, ROA decelerated to 2.1% in Q4 down from 2.7% in Q3, while ROE decreased to 9.3% from 12%. Net interest margin increased to 7.8% in Q4 versus 7.5% in Q3. The increase of the net interest margin, which continues in 2009, has alerted the NBS. The national bank believes that banks should reexamine interest rate hikes in disbursed loans and assess the possibility of lowering the interest rates they charge on loans.

Capital adequacy ratio stood at 21% at the end of March. The figure has slightly decreased from 21.9% in the end of 2008; however it still remains at high levels, much higher than the 12% EU requirement. NPLs stood at 5.8% in Q4 of 2008, improving slightly from 6% in Q3. NPLs are expected to deteriorate within 2009. As far as provisions are concerned, banks are urged to reexamine their provisions as the NBS has ascertained that some loan contracts contain provisions that are in breach of good business practice principles. (Figure 8)

Figure 8



Serbia: MacroEconomic Indicators	2003	2004	2005	2006	2007	2008	Q1 2008	Q1 2009
Output and expenditure	*(Percentage Change in Real Terms)*							
GDP	2.5	8.4	6.2	5.7	7.5	5.4	8.5	-
Industrial production	-3.0	7.9	0.3	5.7	3.3	1.3	6.3	-17.0
Labour Market								
Unemployment (official data)	26.1	23.9	25.3	26.6	24.0	22.0	22.9	22.8
Prices	*(Percentage Change)*							
Retail Price Index (annual average)	11.8	9.9	17.3	12.8	6.5	10.7	11.3	9.8
Producer prices (annual average)	4.6	9.6	14.1	13.4	5.9	12.4	11.8	4.9
Government sector	*(In Per Cent of GDP)*							
RS budget (Deficit/Surplus) balance (National Definition)	-2.6	-0.3	0.3	-1.9	-1.7	-	-0.1	-
General government debt	69.9	55.4	48.0	41.6	33.7	25.7	29.8	-
Monetary and Financial Indicators	*(Percentage Change)*							
M3	29.1	31.2	39.1	37.4	41.1	29.6	46.4	7.7
Total Credit	32.9	46.6	52.1	16.7	39.2	35.0	38.6	33.9
	(End of Period)							
Reference Rate (Key Policy Rate- 2w repo)	-	-	-	14.00	10.00	17.75	14.50	16.50
Exchange rate CSD/USD (end-period)	54.64	57.94	72.22	59.98	53.73	62.9	52.13	71.59
Exchange rate CSD/EUR (end-period)	68.31	78.89	85.50	79.00	79.24	88.6	82.31	94.78
Real Effective Exhange Rate (Index)	101.90	98.90	101.60	116.50	110.10	95.1	99.5	95.6
International Position	*(In Per Cent of GDP)*							
Current account balance	-9.5	-11.9	-8.0	-12.0	-15.9	-17.8	-5.3	-5.5
Trade balance	-23.8	-28.7	-21.2	-20.5	-21.9	-7.7	-7.6	-7.3
Foreign direct investment. net	6.5	3.9	5.7	14.4	5.3	5.6	2.2	1.6
Gross External Debt	68.7	59.3	61.0	66.2	65.8	62.9	66.3	60.3
Memorandum items	*(Denominations as Indicated)*							
Population (mn, middle-year)	7481	7463	7441	7412	7382	7382	–	–
GDP (in Mil of EUR)	17922.1	19673.0	21235.5	25316.8	31340.8	33649.6	–	–
GDP per capita (in EUR)	2395.8	2636.0	2853.9	3415.8	4236.6	4558.3	–	–

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

**REER:end of previous year=100*

Serbia: Banking Indicators	2004	2005	2006	2007	Q3 2008	Q4 2008
	Percentage of GDP (%)					
Assets	43.0	52.2	62.4	73.8	71.1	70.8
Total Credit	23.4	29.1	28.0	36.4	40.9	45.3
Credit to Enterprises	17.3	20.1	18.0	22.3	25.2	26.1
Credit to Households	4.6	7.5	8.9	13.4	12.9	14.1
Deposits	19.0	22.8	26.1	35.9	34.6	32.7
	Percentage Change (%, yoy)					
Assets	36.1	48.7	39.4	31.7	19.6	14.7
Total Credit	46.6	52.1	16.7	39.2	31.2	35.2
Credit to Enterprises	33.8	41.5	38.5	33.3	37.5	40.1
Credit to Households	126.2	98.7	54.2	50.2	16.9	25.0
Deposits	36.0	46.7	39.6	46.9	27.0	8.7
	Percent (%)					
Capital Adequacy Ratio	27.9	26.0	24.7	27.9	23.3	21.9
Capital to Assets	19.5	16.2	18.5	21.0	24.4	23.6
NPLs to Total Loans	-	-	-	5.1	6.0	5.8
Return on Assets	-1.0	1.1	1.7	1.7	2.7	2.1
Return on Equity	-5.3	6.6	9.7	8.5	12.0	9.3

Sources: NBS, IMF

5. Turkey

Deep recession in 2009, modest recovery in 2010

- The GDP contraction is expected to reach -5.5% in 2009 with a modest - yet higher than the regional average, rebound at 1.5% in 2010
- The central government budget deficit is expected to exceed significantly the 5% of GDP target in 2009 and the absence of a medium term fiscal framework elevates the risk of derailing, further necessitating a new IMF stand-by arrangement that would address external financing needs, bolster investor confidence and shield TRY assets from a possible retrenchment of global markets
- Lower oil and food prices drive the CPI increase to a 40-year low of 5.7% yoy in June with inflation pressures expected to remain subdued throughout 2009, undershooting the 7.5% target of the central bank
- CBT intervention rates are projected to decline to 8% by year end while sovereign credit risk spreads have improved considerably
- The significant improvement in the oil balance and weakened domestic demand have improved the current account deficit, which is projected to reach 1.5% of GDP by year end
- Banking sector NPLs edged up to 4.8% in May from 3.7% in December, yet Q1 financial results were surprisingly good in an environment of plummeting credit growth that reached 10.5% yoy in May against 34.9% a year ago

Ioannis Gkionis, Spyridoula Drakopoulou

Turkey			
	2008	2009f	2010f
Real GDP growth	1.1	-5.5	1.0
Inflation (annual average)	10.4	6.0	6.5
Current account balance (% of GDP)	-5.6	-1.5	-2.5

Source: IMF, CBRT, National Statistics, Eurobank Research

Economic Outlook

GDP growth was already on a downward trend before the global economic crisis broke out. World output and trade contraction since the last months in 2008 had a dramatic impact on Turkey's domestic economy. The GDP losses registered in Q4-2008 and Q1-2009 are among the worst in the emerging economies universe and comparable only to those of the Baltics. Our forecast stands at -5.5% GDP in 2009, while we expect only a modest recovery in 2010 at 1.5%, in line with the scenario of a global recovery by then. However, the recession leads to a significant current account deficit improvement which is shrinking rapidly towards 1.5%. The rising output gap brings down domestic inflation towards 5.5%, well below targets, allowing for the Central Bank to maintain its easing bias.

An unsuccessful outcome in the negotiations for a new IMF regular stand by agreement is the main downside risk in our forecast. The shrinking of the current account deficit provides some comfort regarding the size of the external financing needs. Yet, it doesn't make the net funding gap disappear. The improvement in sovereign indicators suggests that financial markets have already discounted a new IMF agreement. Hence, the reemergence of global risk aversion could be catastrophic for Turkish denominated assets in the absence of cover provided by a new IMF agreement.

The second risk comes from fiscal indiscipline that would endanger economic revival. The deteriorating fiscal performance is a source of concern. The deep economic contraction may ultimately result in fiscal derailing. The lack of a medium term fiscal framework undermines government credibility, which doesnot help in bringing interest rates further down. The third risk comes from the political noise that may arise from a new collision between the AKP government and the military. Such a collision may hamper policymaking in a crucial period.

On the positive side, the domestic banking sector is solid. Key prudential indicators of capital adequacy and liquidity suggest a lower exposure to credit related contagion risks relatively to other New Europe peers. The domestic households are long in FX, while the domestic credit penetration remains one of the lowest in the region.

Political Environment-Public Finance

The cabinet reshuffle in early May attempted to reverse political losses after the local elections. The cabinet reshuffle has revived hopes for EU related reforms. All economy-related ministers have been replaced in an attempt to improve government productivity and to address more efficiently the challenges posed by the global recession. Mr. Babacan previous term as an economy minister gives him a strong support from the business community.

On the other hand, political noise may arise again. A new round of confrontation between the military and the ruling government party is looming. The latter may push for political reforms that might contain the constitutional role of the military in the society. The relations between the ruling Islamist party AKP and the military could worsen again, which could hurt investment sentiment towards Turkish assets.

The surge in spending ahead of the March local elections and the recession had a negative impact on public finances. The central government budget deficit has registered a ten times increase in Jan-May - to 20.7 bn from 2.1 bn a year ago. Total revenues appear to have increased by only 2.2% yoy, hit by the 5.5% tax revenues decline. At the same time, the government stimulus measures and higher interest expenses pushed expenditures up by 24.3% yoy. The pace of spending growth has decelerated somewhat after the local elections. This will not prevent the budget deficit from widening above the revised target of 50 bn despite the initiatives on the fiscal front. In conclusion, the primary surplus will dwindle from 3.5% to 1% of GDP. In turn, the central government budget deficit is forecasted to exceed 6% of GDP against only 1.8% in 2008.

There are two implications from the fiscal policy loosening. The rise in the public debt, for the first time since years, will increase the required debt rollover ratio, and at the same time lead to a crowding out of private sector resources. Secondly, the weak fiscal performance will unavoidably lead to a large fiscal adjustment in the future, which underlines the need for a medium term fiscal framework. Anchoring fiscal policy has been one of the conflicting issues between the IMF and the government. If long-term interest rates are to come down, the quality and commitment to fiscal discipline has to increase.

Growth Performance

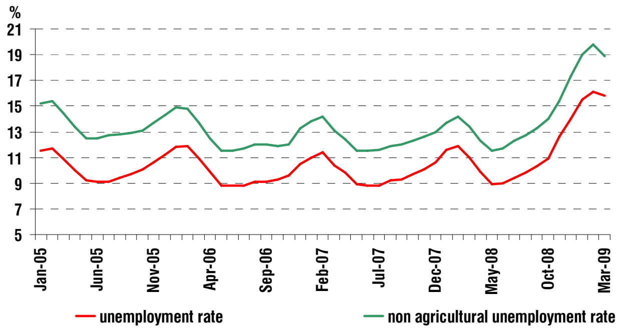
The economy has entered a deep recession since Q4-2008 for the first time since the 2001 crisis. It contracted by 13.8% yoy in Q1-2009, double than the 6.2% rate of contraction in Q4-2008. This contraction intensified both in private consumption and investment. Private consumption registered a 7.2% yoy decrease while gross fixed capital formation dived by an unprecedented 29.7% yoy. The economy is mainly hit through the trade channel. Exports fell by 11.3%, a steeper contraction than the 8.2% in Q4.

Nevertheless, the net exports were still a positive contributor to GDP growth, because imports shrunk by 31.9% yoy. The deeper than expected contraction prompts us to revise our forecast for GDP growth in 2009 from -4.5% to -5.5%, with only a modest recovery of 1.0% in 2010.

The impact of the current recession on employment is dramatic. Employees are laid off from firms in response to weak domestic demand and falling exports. The official unemployment rate has registered a significant increase to 15.8% in February-April 2009 from 11% a year before. Analysts' estimates including unregistered economy bring the total unemployment rate above 20%. (Figure 1)

Figure 1

Unemployment Rate



On the positive side, survey indicators readings suggest that the pace of deterioration has slowed down. The tax incentives introduced by the government to address the weak economic activity have provided a boost to both sentiment and economic activity. Confidence indicators show some signs of turning.

The PMI survey indicator has climbed over the threshold of 50 in May, the limit between expansion and contraction. Capacity utilization has improved to 70.4%, but stands still below the 80% pre crisis level. Yet, this improvement is not reflected at the industrial production indicators. (Figure 2)

Figure 2

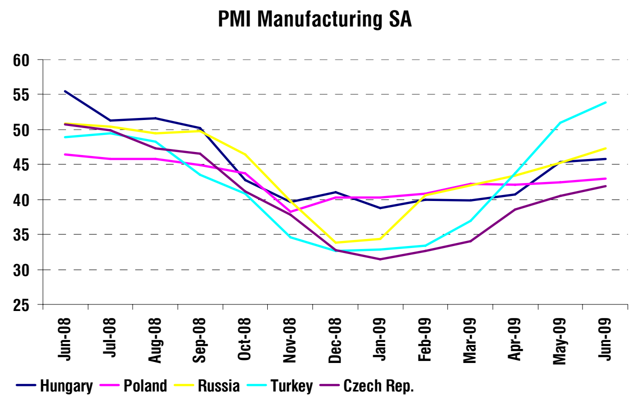
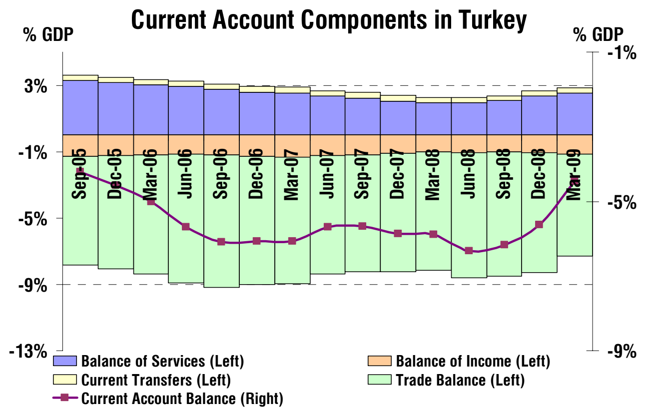


Figure 3



Balance of Payments

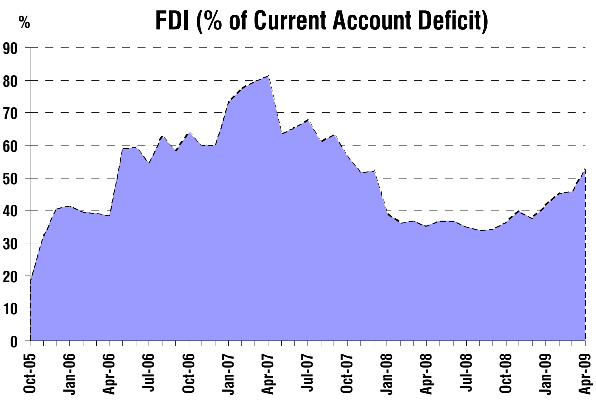
The current account deficit narrowed from 6.3% in Q3-2008 to 5.6% in 2008. Since the beginning of the year, current account deficit improvement has gained further momentum. It improved further to 3.9% in April well on course for 1.5% by year-end which is our forecast.

The main reason for this improvement is the declining trade deficit. The sharp contraction in domestic demand is pushing down imports. Nominal imports and exports decreased by 42% and 27.9% yoy respectively. Lower oil and commodities is the main driver behind the shrinking trade balance.

The non-oil current account balance has improved as energy represents 20% of total imports. The services balance was 10% up in Jan-May as tourism revenues remain relatively resilient-a fact that has also lowered the current account deficit. (Figure 3)

On the financing side, the balance of payments has recorded a 3.2 bn USD outflow in the first four months in contrast to a 17 bn USD net inflow last year. This was the result of net outflows in portfolio investment and other investment components. Portfolio investment is the most hurt due to the crisis. Losses were partially reversed after March from inflows in the domestic stock market. Other investment recorded a net outflow of 7.2 bn USD due to the private sector continued deleveraging. In addition net FDI inflows reached 2.5 bn USD against 4.2 bn. USD, a 38% decline. (Figure 4)

Figure 4



Nevertheless, the Net FDI inflows coverage of the current account deficit has improved because of the shrinking current account. Finally, Net errors and omissions totaled 17.6bn USD in the last six months. These unregistered capital inflows represent repatriated savings coming into the financial sector from abroad as a result of last December's tax amnesty bill.

Concerns for the high external financing needs are waning. Sovereign credit risk and domestic market indicators have improved. The domestic currency has appreciated by 6% after having weakened by 35% between Sep2008-March2009. The 5Y-credit default swap spreads declined to 251 bps. Turkey was perceived to have high external financing needs at the beginning of the year. Ever since, corporations had been relatively successful in rolling over corporate debt. In addition, a smaller current account deficit is more easily financed. This partly alleviated financing concerns and removed the pressures the government for an imminent new IMF agreement deal which no longer was the main scenario. We have long argued that the new agreement would serve as an anchor for the Turkish economy and help bolster investors' confidence.

Inflation Outlook-Monetary Policy

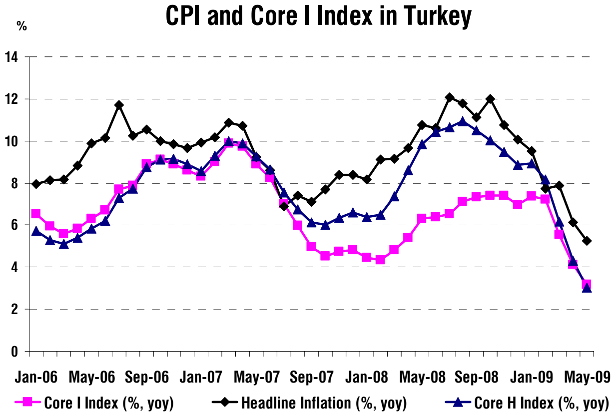
The slump of oil prices and weakened demand allowed for rapid inflation deceleration since the beginning of the year. Inflation has dropped from it's peak of 12% last October to 5.7% in June, a little higher than the 40 year low recorded in May. Core inflation is on a free fall an illustration of how weak domestic demand is. Core measures H and I stood at 2.3% yoy and 2.98% yoy respectively, one-third compared to last year. Inflation is expected to remain subdued on average throughout the rest of the year. Our year-end forecast for inflation stands at 5.5%, clearly undershooting the 7.5% target. The main upward risk to our forecast comes from the volatility in the oil prices. The impact of the depreciation pass through effect seems to be less strong than in the past and outweighed by anemic domestic demand. In addition, some of the tax cuts abolishment may put further upward pressure on inflation.

The sharp consumer prices decline has allowed the Central Bank to frontload its monetary policy easing. Interest rates were reduced by a cumulative 850 bps since the beginning of the monetary easing cycle, which brought the main policy rate to 8.25% in late July. The benign inflation in the 2H will allow the Central Bank to maintain its monetary policy easing bias. Depending on the magnitude of weakness in output data, we expect interest rates to decline further to 7.5% by year end.

On the other hand, we argue that further monetary easing within the single digit area is more complicated given that the global economic conditions are still fragile. In the case of a retrenchment in global markets sentiment, the domestic currency would be more susceptible to strong depreciation pressures. Although TRY trades steadily in the last months, there is still no IMF program agreement in place to shield the currency against investors risk aversion. In addition, the risk of a political turmoil cannot be ruled out in the next coming months. (Figure 5)

Figure 5

CPI and Core I Index in Turkey



Banking Developments

The banking sector has performed relatively well during the first five months of 2009. The announcement of banks' profits for Q1 2009 was a pleasant surprise, exceeding analysts' expectations. As a result, the banking sector has outperformed the market by more than 10%, as ISE 30 grew by 42.3% and the ISE Bank Index grew by 57.7% since the beginning of the year.

The banking system is more resilient after its restructuring following the 2001 crisis. Capital adequacy and capital-to-asset ratios remain at high levels, one of the highest in the region. Households in Turkey are better positioned than those of other countries as their FX indebtness ratios are relatively low. Moreover, the regulator is closely and effectively monitoring the progress made in the banking sector. In order to further promote supervision purposes, new measures regarding companies' FX lending were announced by the Turkish Economy Minister.

On the other hand, due to banks' unwillingness to lend, new credit activity is still restrained and credit growth rates are plummeting. This unwillingness is mainly attributed to a limited capacity to borrow from abroad, as well as worries regarding increasing NPLs and the sustainability of low interest rates.

NPLs and especially credit-card NPLs constitute the major vulnerability of the Turkish banking system. Starting from September 2008, non-performing loans have raised to 4.8% in May, deteriorating in that way loans' quality. In order to decelerate their growth, in the mid of June measures were announced with the aim of facilitating terms of repaying credit card debts. Another issue that has attracted a lot of attention is the depreciation of the local currency and its impact on the repayment of foreign currency denominated debts.

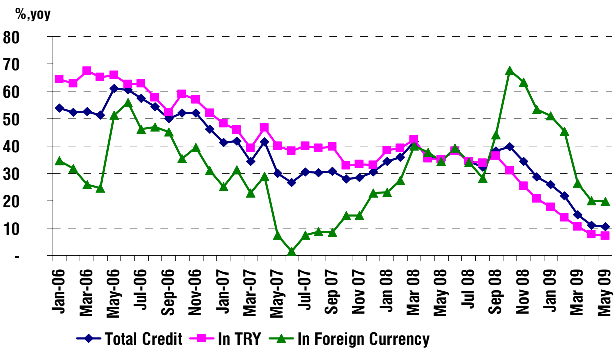
Credit Developments

Credit growth continued its decelerating trend, reaching its lowest level within the last three years. Lower interest rates and increased liquidity in the banking sector do not seem to help towards a credit growth rebound. The Central bank has cut interest rates to 8.25% in July compared to 15% at the beginning of the year. However, total credit grew by 10.5% yoy in May down from 34.9% a year before. Since March, credit in foreign currency is declining both in terms of growth and in absolute terms. In May, credit in FX accounted for 27.6% of total credit and grew by 19.7%, after peaking at 67.6% in October. All evidence shows that a return to last year's credit growth rates is not expected to come any time soon.

The Central Bank of Turkey introduced measures that ease restrictions on local banks' foreign currency lending. In fact, companies are now allowed to borrow in FX even if their revenues are in local currency. In this way companies will cease seeking FX loans from banks abroad, reducing in that way the sector's external debt. Another positive outcome of this new amendment is that since banks will not borrow FX from abroad, FX deposits will also stay in the domestic banking system, raising FX reserves of the country. Moreover, a new amendment regarding the banning of FX-indexed consumer loans came into force. This will shield households from developing negative FX positions. (Figure 6)

Figure 6

Credit Expansion

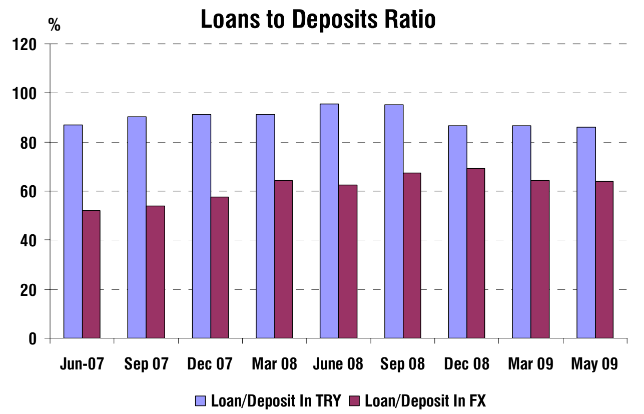


Consumer loans remain the main driver behind credit expansion, as they account for 32.7% of total loans. The downward trend described above is witnessed in every type of lending: consumer (11.4%in April coming down from 23.3% in December), mortgage (7.8% from 19.8%) and credit card loans (15.3% from 25.4%). As far as household loans in foreign currency are concerned, they remain at extremely low levels, leaving households exposed only to a small extend to exchange rate risk. Although credit expansion is decelerating, credit penetration continues to grow, although, marginally. Credit as a percentage of GDP stood at 38.4% in March slightly down from 38.7% three months before.

Deposit Developments

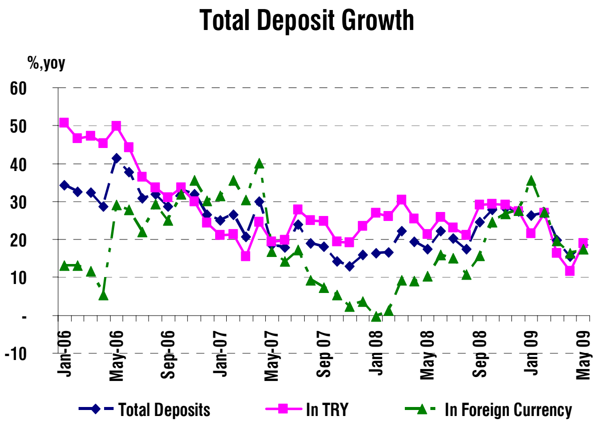
Deposits growth has remarkably slowed down as deposits grew by 18.5% in May versus 27.4% at the end of 2008, marking a small rebound from a 15.5% growth rate registered in April. The good news is, though, that the drop in the deposits growth rate is in line with the decline in credit growth. Indeed, loans to deposits ratio still stands well below unity. At the end of May, the ratio stood at 78.5% down from 80.8% at the end of 2008. (Figure 7)

Figure 7



Deposits in local currency still account for the biggest share of deposits (66.1% of total deposits as of May). (Figure 8)

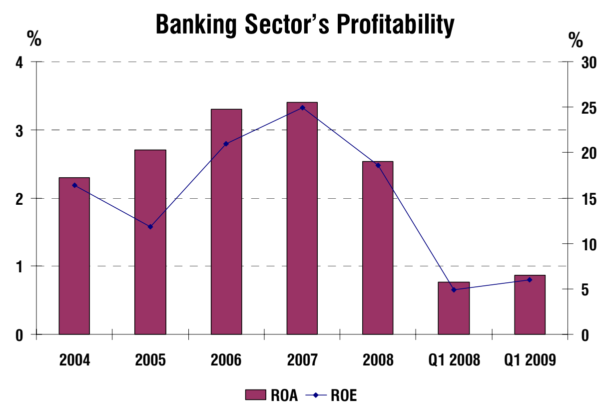
Figure 8



Banking Sector's Profitability and Capital Adequacy

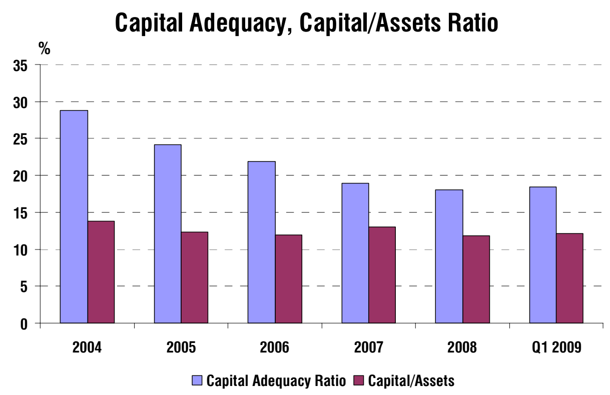
The banking system appears sound and capable of weathering the storm, strengthened by the structural reforms that were undertaken since the 2001 crisis. Banking sector's profits amounted to 9.1 billion TRY in May up from 7 billion TRY a year before. What is more, ROA and ROE ratios seem stronger in May 2009 versus the corresponding figures in 2008. ROA increased to 1.5% in May compared to 1.4% a year ago, whereas, ROE grew to 10.5% from 9.7% in the correspondent period. (Figure 9)

Figure 9



Besides, the banking system remains well capitalized as both capital adequacy and FX liquidity adequacy ratios remain well above the legal limit. In fact, the banking system's capital adequacy ratio stood at 19.3% in May up from 18% at the end of 2008. (Figure 10)

Figure 10



The quality of loans has shown the first signs of deterioration. NPLs have been on the rise during the past few months and have peaked in May. NPLs to total loans soared to 4.8% in May, up from 3.7% in December, while credit card NPLs climbed to 10.1% from 6.9% respectively.

In order to constrain NPLs growth new measures were introduced. According to the new amendments, overdue amounts will be restructured and repaid with lower interest rates and annual fees will also decline. This is in line with the decision that the CBRT announced in the mid of June regarding the reduction in the maximum interest rate that can be charged on the banks' receivables.

However, the Turkish Parliament has approved amendments that regulate the minimum monthly payment as a percentage of total debt and oblige banks to offer their clients 6-month, 12-month, 24-month and 36-month payment programs to pay off their credit card debts. Provisions to NPLs ratio marked a slight increase in May, after two consecutive months of decline and stands at 79.6%. (Figure 11, 12)

Figure 11

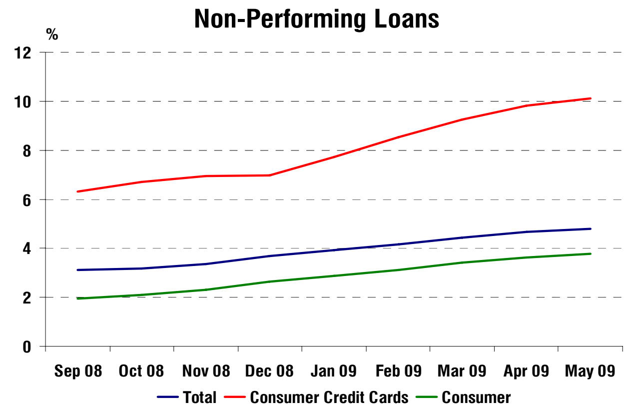
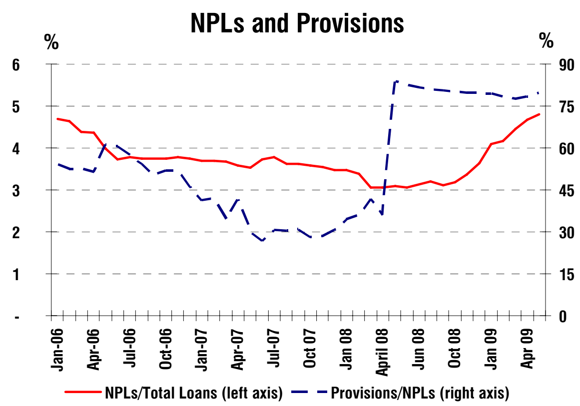


Figure 12



Net FX position of the banking system has switched to positive territories since March 2009 with FX assets exceeding FX liabilities. However, the corresponding figure for the non-financial corporation sector remains negative. Although it had been widening until the end of 2008 it shows signs of improvement in Q1 2009. (Figure 13,14)

Figure 13

Net FX Position of Non Financial Corporates

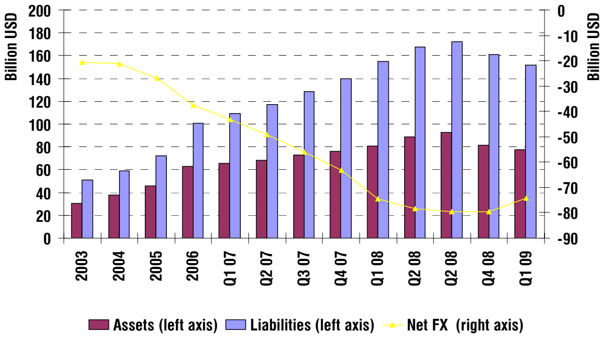
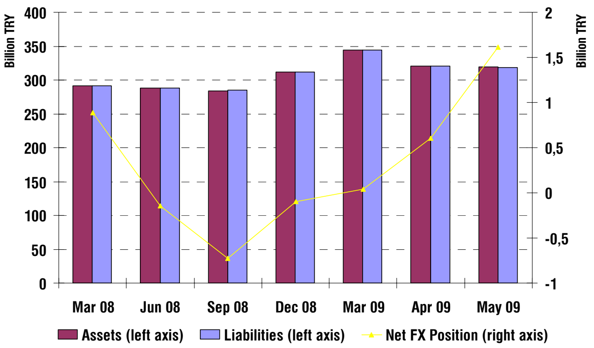


Figure 14

Net FX Position



Turkey: MacroEconomic Indicators	2003	2004	2005	2006	2007	2008	Q1 2008	Q1 2009
Output and expenditure			(Percentage Change in Real Terms)					
GDP	5.3	9.4	8.4	6.9	4.7	1.1	7.3	-13.8
Private consumption	9.2	10.2	7.5	4.6	3.9	0.2	5.9	-9.2
Public consumption	-2.6	6.0	2.5	8.4	6.5	1.8	5.0	5.7
Gross fixed capital formation	14.2	28.4	17.4	13.3	5.5	-4.6	9.6	-29.7
Exports of goods and services	6.9	11.2	7.9	6.6	7.3	2.6	13.3	-11.3
Imports of goods and services	23.5	20.8	12.2	6.9	10.7	-3.1	14.9	-31.9
Industrial production (in nominal terms)	8.7	9.8	5.4	7.8	6.9	-0.9	7.3	-22.0
Labour Market								
Employment	-0.8	2.0	1.7	-0.4	-3.6	1.7	-1.0	-0.4
Unemployment (in per cent of labor force)	10.5	10.3	10.2	9.9	9.9	10.7	11.9	15.8
Prices				(Percentage Change)				
Consumer prices (annual average)	21.6	8.6	8.2	9.6	8.8	10.4	8.8	8.4
Producer prices (annual average)	22.7	14.6	5.9	9.3	6.3	12.7	8.4	5.9
Average monthly wage in industry	23.0	13.4	12.2	11.5	-	9.5	8.8	-
Government sector				(In Per Cent of GDP)				
Primary balance(National Definition)	4.1	4.7	5.5	5,5	4,1	3.5	1.1	-0.1
Central Government Budget balance (National Definition)	-8.8	-5.4	-1.5	-0.5	-1.6	-1.3	-0.5	-2.0
General Government debt (ESA95)	67.4	59.2	52.3	46.1	39.4	39.5	-	42.2
Monetary and Financial Indicators				(Percentage Change)				
M3	32.3	39.5	31.2	32.2	17.7	24.1	24.8	22.6
Total Credit	35.2	50.6	54.2	46.1	30.4	28.6	41.6	14.7
				(End of Period)				
Reference rate (Overnight- Borrowing)	26.00	18.00	13.50	17.50	15.75	15.00	15.25	10.50
Exchange rate YTL/USD (end-period)	1.40	1.34	1.35	1.41	1.16	1.54	1.33	1.66
Exchange rate YTL/EUR (end-period)	1.76	1.83	1.59	1.86	1.70	2.15	2.09	2.20
Real Effective Exhange Rate(Index)(1995=100)	140.60	143.20	171.40	160.10	190.30	168.50	176.0	159.4
International Position				(In Per Cent of GDP)				
Current account balance	-2.5	-3.7	-4.6	-6.0	-5.7	-5.6	-5.9	-4.5
Trade balance	-4.4	-5.8	-6.8	-7.8	-7.1	-7.2	-7.2	-6.1
Foreign direct investment. net	0.4	0.5	1.9	3.6	3.0	2.1	2.2	2.0
Memorandum items				(Denominations as Indicated)				
Population (end-year. thousand)	70712	71789	72065	72974	70586	71386	–	–
GDP (in Mrd of EUR)	268.3	314.6	386.9	419.2	472.0	498.4	–	–
GDP per capita (in EUR)	3635.9	4248.6	5661.6	5584.2	6660.0	6981.8	–	–

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

Turkey: Banking Indicators							
	2004	2005	2006	2007	2008	Q1 08	Q1 09
Percentage of Revised GDP (%)							
Assets	54.9	62.7	65.9	69.5	76.7	71.3	79.0
Total Credit	17.4	23.1	28.9	34.2	38.5	35.9	38.4
Total Credit in FX	–	6.6	7.4	8.2	11.0	9.7	11.4
Credit to Enterprises	14.2	18.9	22.7	26.1	28.2	26.7	27.8
Credit to Households	4.7	7.0	9.1	11.4	12.3	11.4	12.1
Credit to Household in FX	–	0.0	0.0	0.0	0.0	0.0	0.0
Mortgages	–	1.9	3.1	3.9	4.1	4.0	4.1
Deposits	34.2	37.5	40.6	42.7	47.6	43.8	49.0
Deposits in FX	–	13.6	15.2	14.3	15.9	15.1	17.8
Percentage Change (%, yoy)							
Assets	22.7	29.5	22.8	16.4	26.0	23.0	19.0
Total Credit	50.6	54.2	46.1	30.4	28.6	41.6	14.7
Total Credit in FX	–	–	31.0	22.8	53.4	39.9	26.5
Credit to Enterprises	54.5	53.9	40.1	27.2	23.4	34.5	10.4
Credit to Households	106.0	76.7	51.8	37.5	23.3	40.4	13.8
Credit to Household in FX	–	–	17.3	73.1	4.6	27.7	15.0
Mortgages	–	–	88.4	38.8	19.8	44.4	10.0
Deposits	23.0	27.2	26.5	16.0	27.4	22.2	19.8
Deposits in FX	–	–	30.2	3.6	27.5	9.2	19.7
Percent (%)							
Capital Adequacy Ratio	28.8	23.7	21.9	18.9	18.0	17.2	18.5
Capital to Assets	14.4	12.9	11.3	13.0	11.8	11.9	11.2
NPLs to Total Loans	6.0	4.8	3.8	3.5	3.7	3.1	4.4
Provisions to NPLs	88.1	89.8	90.7	86.7	79.8	85.7	77.8
Return on Assets	2.3	2.7	3.3	3.4	2.5	0.8	0.9
Return on Equity	16.4	12.1	21.0	24.8	18.7	4.9	6.0

Sources: CBRT, IMF

6. Ukraine

Political Instability adds to sharp contraction

- **Sharp GDP contraction by 20.3% yoy in the first quarter with industrial production declining by 31.2% in the first semester**
- **Domestic political instability with upcoming presidential elections in January 2010 to exert further pressure**
- **IMF Stand-By-Agreement loan of $16.4bn has been set on track with second and third tranches of total $5.9bn already disbursed in May and late July, respectively**
- **Disquieting fiscal situation attributed to poor performance of budget revenues and excessive Naftogaz financing needs necessitate a revision in the IMF's agreement loan to allow Ukraine's government to run 6% of GDP budget deficit– from 4% of GDP agreed earlier**
- **After having risen to as high as 5304 bps in early March the Credit Default Swaps stood at 1526 bps in late July, suggesting that fears over country's default have eased**
- **Vague signs of an impending banking system stabilization stems from the reversal of household deposits withdrawal coupled with the launch of banking sector recapitalization**
- **Alarming Non Performing Loans ratio; they skyrocketed to 24% of total loans in Q1-09 from 14.5% in Q3-08.**

Stella Kanellopoulou

Ukraine	2008	2009f	2010f
Real GDP growth	2.1	-12.0	0.0
Inflation (annual average)	24.6	16.5	13.5
Current account balance (% of GDP)	-7.2	-0.5	-1.0

Source: NBU, National Statistics, Eurobank Research

Economic Outlook

The financial and economic crisis has delivered a hard blow to Ukraine's economy. This is largely the result of the country's heavy dependence on exports and external financing. The Ukrainian economy has contracted sharply (by more than 20% yoy in Q1-09), adjusting to negative terms of trade developments and the reversal of capital inflows. The impact of the crisis has been accentuated by the domestic political instability and the constant absence of much needed political coordination to address the economic crisis. The incessant political turbulence threatened Ukraine's adherence to the IMF program, earlier this year.

While inflation pressures have subsided lately and the drain of bank deposits has started to reverse, the fiscal imbalances remain the major source of Ukraine's vulnerability. The IMF agreed on a revision to this year's general government budget deficit target to 6% of GDP compared to 4% agreed earlier. The disquieting fiscal situation originates from the poor performance of budget revenues (as the economic downturn was more pronounced than expected) and the large financing needs of Naftogaz. This unsettling budget situation suggests the possibility of further rises in excise duties. Presidential elections scheduled for January 2010 also give cause for further inflationary risks.

On the positive side, the larger contraction contributes to a rapid improvement in the current account balance. Since the time that the IMF Stand-By-Agreement (SBA) loan has been broadly set on track, there has been a slight stabilisation of the exchange rate. Furthermore, CDS spreads have dropped significantly although still remain at quite high levels.

Political Environment - Public Finances

The political conflict between the Prime Minister, Yulia Tymoshenko, and the President, Viktor Yushchenko, threatened Ukraine's adherence to the IMF program, earlier this year. Eventually, both the President and the Prime Minister signed the first review under the Stand-By-Agreement with the IMF in early April 2009, thereby temporarily ending the impasse. This ongoing power struggle has resulted to a constant lack of much needed political coordination to address the economic crisis. In addition, the leading opposition party (headed by a pro-Russian leader, Viktor Yanukovych) prevented parliamentary efforts to pass important legislation, in May. Thus, the ongoing feud amongst major political players creates a counterproductive atmosphere in Ukraine's political scene. Quite illustrative in this respect is the failure to reach a consensus on the date of the next presidential election. After the collapse of the negotiations between Yulia Tymoshenko and Viktor Yanukovich, to form a coalition which would allow the parliament to elect the next president, Ukraine's parliament set a new date (January 17th 2010) for the next presidential elections. The Prime Minister, the incumbent President and the head of the leading opposition party are all candidates. Domestic political stability will likely remain elusive in the following quarters on the back of the presidential elections. Moreover, the sustained political turbulence is already taking its toll on the economic performance – with the focus shifting from economic needs to political issues.

Relations with Russia are expected to remain tense until the presidential elections. Additional tension stems from the gas deal. Specifically, given Ukraine's financial troubles, the country's ability to pay for Russian gas on a monthly basis has been seriously threatened. On the positive side of the issue, the Ukrainian government managed to strike an agreement with Russia in May. Under this agreement, Ukraine will not be penalised for the amount of imported gas not consumed in 2009. On the negative side, the European Commission decided (in late June) not to provide any financial aid that would ensure the flow of Russian gas to Europe next winter.

The state of affairs in fiscal policy causes greater concern. In February, the IMF delayed the release of the second tranche of the Stand-by-Agreement loan to Ukraine on the grounds of fears pertaining to fiscal policy. In light of the sharper than expected decline in economic activity, the IMF finally agreed - in April - in allowing the Ukrainian government to run a budget deficit of 4% of GDP in 2009, instead of a balanced budget initially agreed (in November 2008). The authorities committed themselves to implementing far-reaching structural reforms, including pension and tax reforms by the end of 2009. The most important measure implemented by the government had to do with the increase of pension contribution by private entrepreneurs. As of May the contributions to the State Pension Fund (SPF) have been raised by 4% and a further 7% increase is scheduled for December. Although this measure is estimated to provide an amount of 1.9bn UAH additional revenues to the SPF, there is a downside risk attached to it, particularly with respect to small businesses whose financial situation is becoming increasingly precarious in view of the ongoing crisis. Another measure approved by the government involved the rise of electricity and gas tariffs for those parts of the population consuming more. However, increases in domestic gas prices which would support Naftogaz but could have a negative impact on the financial state of households have been ruled out by the government ahead of the January 2010 presidential election.

Ukraine's disquieting fiscal situation originates from the poor performance of budget revenues. Expenditure commitments have been maintained but revenues have slumped, exposing underlying structural imbalances in the pension system and the energy sector. Specifically, the budget revenues from capital operations reached only half of the planned amount in 2008. This reflects the economic recession as well as the limited interest of investors in purchasing assets.

Under the July IMF revision of the SBA loan, the forecast for the budget deficit was widened, from 4% of GDP to 6% in 2009 (which also includes the Naftogaz deficit that is estimated at 2.6% of GDP). The budget deficit rises to 10% of GDP if bank recapitalization spending is added. The projection reflects the poor economic state of Ukraine. Under such conditions providing the state budget with necessary revenues to cover all planed expenditures (the majority of which represent social expenditures generated by the economic crisis) becomes a rather difficult task.

Growth Performance

The Ukrainian economy has contracted sharply in the first quarter of the year. Real GDP growth dropped by 20.3% yoy in Q1-09 with fixed investments falling by 48.7% yoy while private consumption declined by 11.6% yoy. Net exports contribution to growth turned positive. Real exports fell by 15.9% yoy while the imports contacted sharply by 35.6% yoy on the back of the decline in domestic demand and the real exchange rate depreciation. Industrial production - which accounts for ca 1/3 of domestic GDP - dropped by 31.2% over the first semester of 2009. The collapse in industrial production is attributed to a declining export demand (affecting steel exports mainly) coupled with a drop in consumer's demand thus far supported by ample credit availability. A telling indication of the drain in domestic demand is the alarmingly negative figure of retail sales. Over the first semester, retail sales fell by 14.8% contrasted to the 20.5% expansion displayed in the last quarter of 2008. The pace of retail sales decline continues to accelerate suggesting that the Ukrainian economy has still not shown any signs of subsiding.

We are now pencilling in a full year GDP contraction of more than 12% yoy. This deep contraction is generated by the ongoing deterioration of external and domestic demand. Exports will likely keep falling (world trade is forecasted to contract by 8.2% over 2009 as a whole) and private consumption will decline further due to the drop in real wages; the drying up of credit; and the hryvnia depreciation.

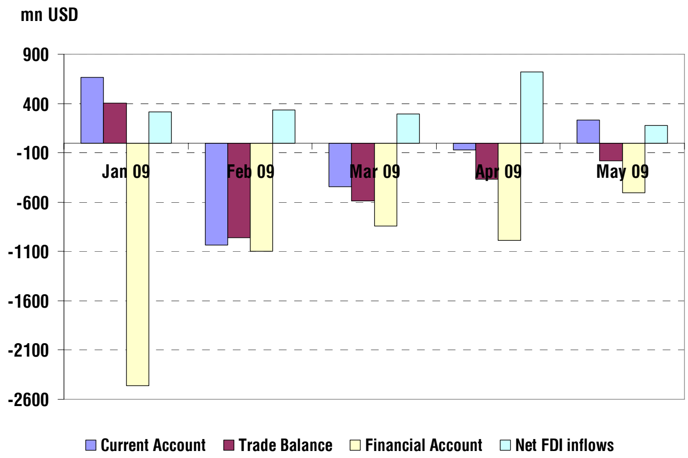
Balance of Payments

The current account recorded a surplus amounting to $230mn in May compared to a $70mn deficit in April. Since the beginning of the year the current account displayed a deficit of $660mn compared to a deficit of $6456mn January-to-May a year earlier. (Figure 1) The sharp adjustment was mostly driven by a shrinking trade deficit; in the course of the first 5 months it stood at less than a quarter of last year's performance ($1692mn deficit in Jan-May 2009 compared to $8321mn deficit in Jan-May 2008). Although both exports and imports shrank considerably owing to the fall in domestic and external demand, the lagged impact of the hryvnia devaluation in late 2008 allowed some space for the trade balance improvement, over the first five months of this year. Moreover, the rich harvest of 2008 coupled with a growth in global food prices supported food exports. Namely, exports fell by 43.7% yoy in the first five months while imports decreased by 52.4%yoy over the said period. Steel exports shrank sharply with their share of total exports falling to 32% from the usual 42% in recent years. (Figure 1)

The financial account switched to a deficit of $5.9bn in the period January-May. The overall loans and bonds balance displayed net outflows of $3.7bn in January-May in contrast to last year's $6bn net inflows. The financial account registered large outflows of short-term capital in the first quarter of this year. This actually represents the conversion of the hryvnia into foreign exchange cash. The roll-over ratio, which was 84.5% in Q1-09, declined to 80% in May. A further drop is expected over the remainder of the year owing to an increase in the amount of maturing debt. (Figure 1) Furthermore, the net FDI inflows fell to $179mn in May - the lowest reading since September 2005. In January-May period net FDI inflows declined by 57.5% yoy. They amounted to $1.8bn contrasted to last year's $4.3bn. (Figure 1)

Figure 1

Current Account Balance Components and FDI in Ukraine



Source: EFG Research, NBU, National Statistics

For the year 2009 as a whole, the current account balance is expected to narrow sharply as a result of reduced import demand and stand at a small deficit of 0.5% of GDP -from a 2008 deficit of 7.2% of GDP. Thanks to the $2.8bn injection provided by the second IMF tranche, Ukraine's international reserves increased by $2.6bn in May, reaching $27.8bn.

In early July, the IMF mission reached staff-level agreement with the Ukrainian authorities with regard to the third tranche of $3.3bn which was released later that month. However, the IMF mission revised its 2009 GDP growth forecast for Ukraine to 14% contraction from -8% seen previously.

The decision of the IMF to continue the SBA loan program to Ukraine affected the country's risk assessment. Perceived sovereign default risk remains elevated as measured by spreads on Credit Default Swaps (CDSs). After having risen to as high as 5304bps in early March the CDS stood at 1526 (July 29th). Nevertheless, CDS spreads suggest that risk aversion towards Ukraine is still very high. (Figure 2)

Figure 2

Ukraine's 5-year Credit Default Swaps

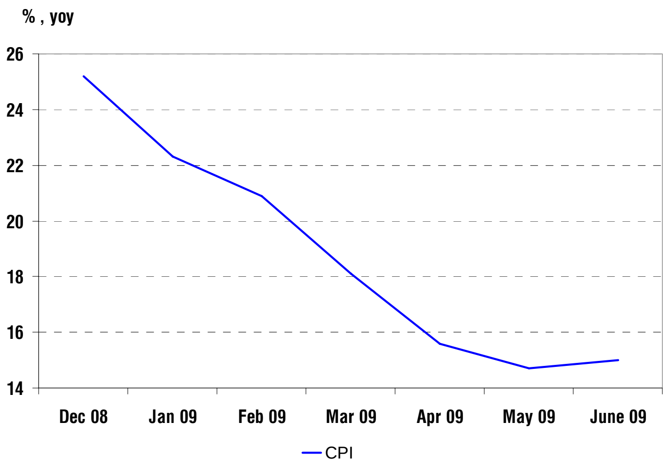
Source: EFG Research, Bloomberg

Inflation - Monetary Policy

Signs of abating domestic inflation pressures have been evident since February. Inflation has declined from 22.3% yoy in January to 15.0% yoy in June, despite the gradual depreciation of the hryvnia since October 2008. Disinflation has been driven by several factors: developments in oil and food prices; the widening output gap; and the sharp decline in domestic demand. Actually, inflation fared better than expected with the CPI standing at 14.7% yoy in May. This declining trend has been reversed in June, as higher excise duties and the IMF requirements to adjust public utility tariffs fuelled higher inflation rates. Specifically, prices of alcohol and tobacco increased by 9.5% mom (and by 40% yoy) whereas the cost of hot water and heating rose by 6.8% mom. (Figure 3)

Figure 3

Inflation dynamics in Ukraine



Source: EFG Research, NBU, National Statistics

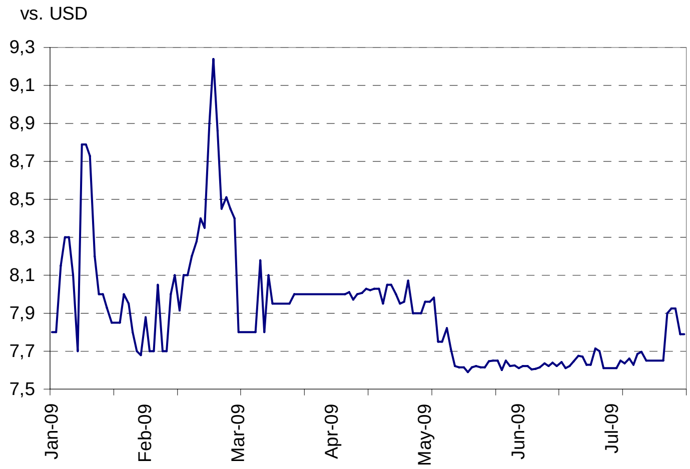
The unsettling budget situation suggests the possibility of further rises in excise duties. Moreover, potential spending increases in view of the presidential election in January may also pose inflationary risks. At the same time, the considerably weaker exchange rate has caused the cost of imported goods to rise whereas gas import costs hiked substantially and will probably increase further. In view of these developments, we expect the inflation to ease to an annual average of 16.5% yoy in 2009 compared to 24.6% yoy annual average in 2008.

The recent inflation slowdown, the stabilisation of the exchange rate and improvements in deposit dynamics, allowed the National Bank of Ukraine (NBU) to cut the key policy rate by 100bps to 11.00%, in June. However, the probability of a further easing in monetary policy is slight in 2009. The NBU will have to restrain money supply growth in view of the IMF restrictions and the probable increase in social expenditures ahead of the upcoming presidential election.

Since its peak in late February, the hryvnia has strengthened against the UD dollar thanks to the disbursement of the 2nd and 3rd tranche of the IMF SBA loan which helped to ease concerns over Ukraine's external financing requirements. The USD/UAH exchange rate stood at at the time of writing (July 29th). (Figure 4)

Figure 4

Hryvnia's Exchange Rate against the US Dollar



Source : EFG Research, Reuters

Banking developments

The largest risk for the Ukrainian economy stems from the banking sector. Intensive lending through FX loans (55% of total loans, in May 2009); increasing Loan-to-Deposit ratio (228%); significant rise of Non-Performing-Loans (24% of total loans in Q1-09); rising capital adequacy ratio (16.5% in Q1-09) and negative credit growth are the main factors creating a rather unstable banking environment in Ukraine.

The banking system has been under significant strain since last autumn and the key priority is to restore confidence. After being granted the second tranche of $2.8bn of the SBA (Stand-By-Agreement) loan with the IMF, local authorities have implemented a comprehensive framework for the recapitalization and restructuring of the banking sector. At the beginning of June, the government announced the list of seven banks due for recapitalisation through state funds. As of early 2009 these banks accounted for almost 17% of total deposits and for over 10% of total assets in the domestic banking sector. The state will acquire 75% to 99% of each bank's shares, ensuring full control over the recapitalised banks. The government has already spent $1.23bn (9.4bn UAH) to bail out 3 banks (Ukrhazbank, Kyiv Bank, Rodovic

Bank) and estimates the recapitalisation needs for all 7 banks to amount at 20bn UAH.

The continuing fragility of the domestic economy and the banking system led Fitch rating Services to downgrade further Ukraine's sovereign credit rating, by two notches to CCC+ in late February 2009. Moreover, Moody's downgraded Ukraine's foreign and local currency government bond ratings to B2 (from B1) in mid-May, citing a deteriorating macroeconomic situation and uncertainty over capital controls.

The National Bank of Ukraine (NBU) has undertaken several policy measures to stabilise the banking system. In line with IMF recommendations, the NBU lifted the moratorium on pre-term withdrawals of deposits, in May. This measure was imposed in October 2008 to prevent a further bank-run by panicked depositors. In June, the NBU tightened the terms of commercial banks' refinancing. Namely, the NBU shortened the maximum maturity of stabilisation credits to banks from 360 to 90 days and limited the volume of such credits to 50% of each bank's regulatory capital. In an effort to discourage deposit dollarization, the NBU raised reserve requirements for foreign currency time deposits from 3% to 4% and for foreign currency current accounts from 5% to 7%.

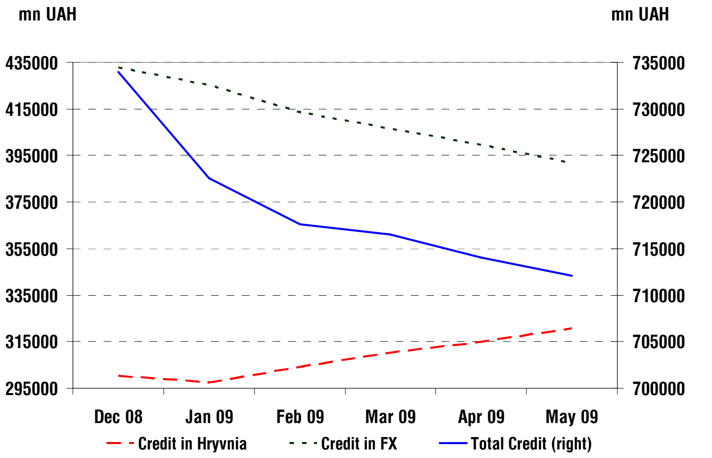
The banking system has recently started to display vague signs of a tentative stabilization. The continuing drain of household deposits stopped in April 2009 and there was a slight increase in May. What's more, Western European banks have begun to provide their subsidiaries in Ukraine with much-needed capital. FDI inflows into the banking system are a telling indication of this trend: they reached $360mn in April compared to $200mn in Q1-09. However, NPL and capital adequacy ratios have been rising alarmingly during the first quarter of the year. Moreover, the large share of loans denominated in foreign currency exerts extra pressures on the system since an additional capital injection will be required in the event of hryvnia depreciating further.

Credit developments

The situation remains rather fragile in the domestic banking sector. Total assets dropped by 7.3% year-to-May 2009. Furthermore, there has been a 21.9bn UAH decrease in total outstanding credit since December 2008, when the total credit growth turned negative. However, the pace of the drop eased in the last couple of months. In May 2009, total credit dropped by 0.2% mom compared to a 1.6% mom fall in January 2009. (Figure 5) It is worth noting that loans denominated in domestic currency are still growing; they grew by 6.8% between December 2008 and May 2009. Yet, this growth is partly due to the appreciation of the hryvnia (by 1.9%) during the aforementioned period.

Figure 5

Total Bank Credit Outstanding to the Private Sector in Ukraine

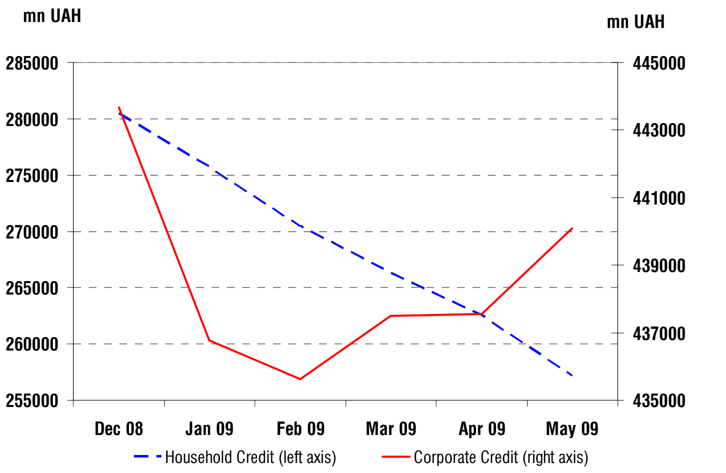


Source: EFG Research, NBU, National Statistics

The main drive behind the negative credit growth is household loans. In May, household credit dropped by 2% mom compared to a 0.6% mom increase in credit growth in the corporate sector. (Figure 6)

Figure 6

Household – Corporate Credit in Ukraine

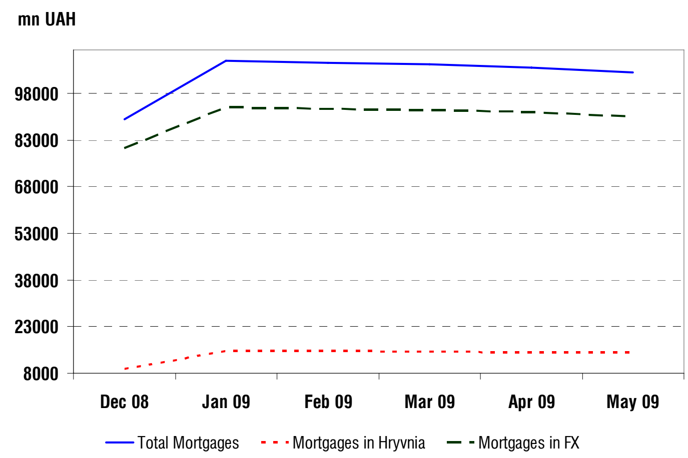


Source : EFG Research, NBU, National Statistics

Mortgages dropped by 3.2% since the beginning of this year. Their pace of fall accelerated in the last couple of months; mortgages fell by 1.4% mom in May. (Figure 7)

Figure 7

Total Mortgage Credit Outstanding in Ukraine



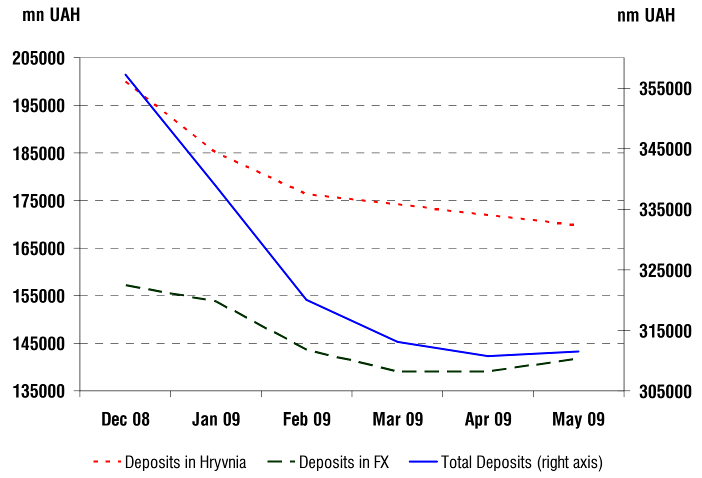
Source: EFG Research, NBU, National Statistics

Deposit developments

Between the beginning of October 2008 and the end of April 2009 a total of 28.9bn UAH in deposits were withdrawn. However, since April there has been a slowdown in deposit withdrawals whereas a slight increase was recorded in May 2009. Total deposits grew by 0.25% mom in May compared to a 5.1% mom fall in January. The drain was more substantial in deposits denominated in domestic currency. Actually, deposits denominated in hryvnia are still falling but the pace of drop has eased since May, when it stood at -1.2% mom compared to -7.5% mom in January. (Figure 8)

Figure 8

Total Deposits in Ukraine

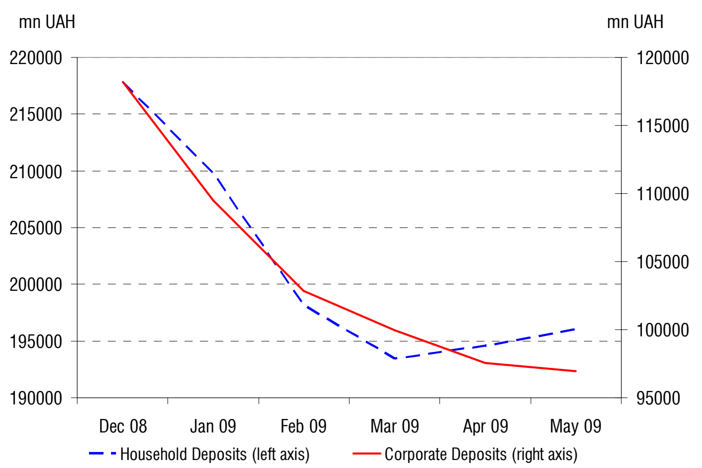


Source: EFG Research, NBU, National Statistics

The main contribution to deposits' withdrawal originates in the corporate sector. Corporate deposits fell by 18% since the beginning of this year, while household deposits drop stood at 10% during the same period. (Figure 9)

Figure 9

Household & Corporate Deposits in Ukraine

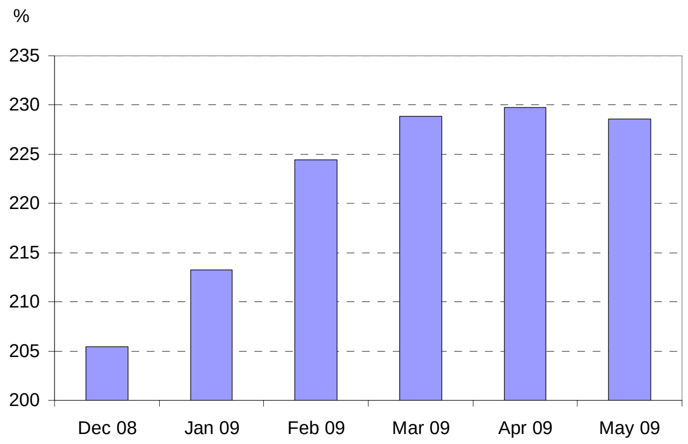


Source: EFG Research, NBU, National Statistics

An indicative aspect of the liquidity strain on the banking system is the ongoing increase of the Loan to Deposit ratio. After having reached the alarming figure of 200% at the beginning of this year, Loan to Deposit ratio continued growing significantly and stood at 228% in May 2009. (Figure 10) There are no signs of a potential reversal of this trend as the negative credit growth outpaces the small deposit inflows.

Figure 10

Loan to Deposit Ratio in Ukraine



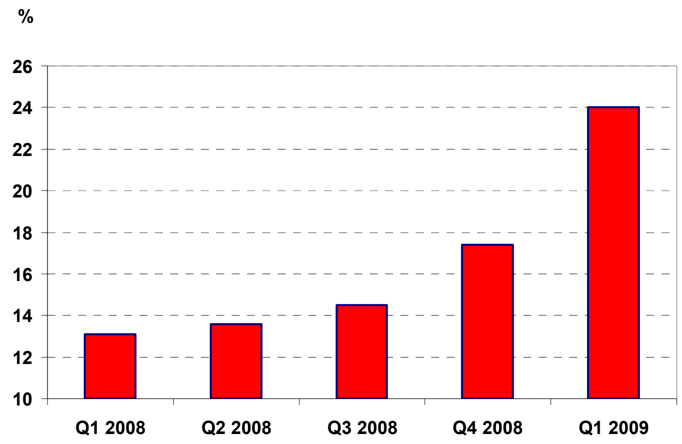
Source: EFG Research, NBU, National Statistcs

Banking Sector Profitability and Capital Adequacy

The most worrisome data with regard to the banking system is the steep rise of Non-Performing-Loans (NPLs) ratio. It skyrocketed to 24% of total loans in Q1-09 from 17.4% in Q4-08 and 14.5% in Q3-08. This rising trend of the NPLs ratio is a compelling evidence of the continuing deep contraction in real economic activity and reflects the deterioration of the banking assets' quality. (Figure 11)

Figure 11

Non-Performing Loans Ratio



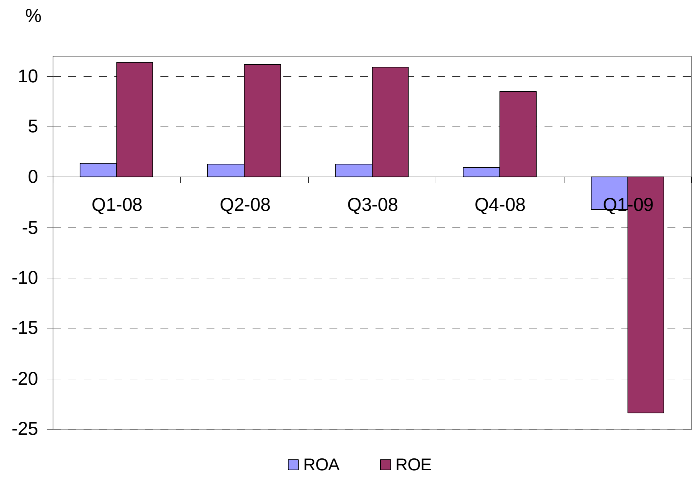
Source: EFG Research, IMF

Note: NPLs quarterly data

Furthermore, the banking sector profitability has also been hit: Return on Assets (ROA) and Return on Equity (ROE) turned negative in Q1-09, after several quarters of rather positive performance. ROA stood at -3.2% in Q1-09 and ROE fell sharply to -23.4% in Q1-09 compared to 8.5% in Q4-08. **(Figure 12)**

Figure 12

Return On Assets & Return On Equity

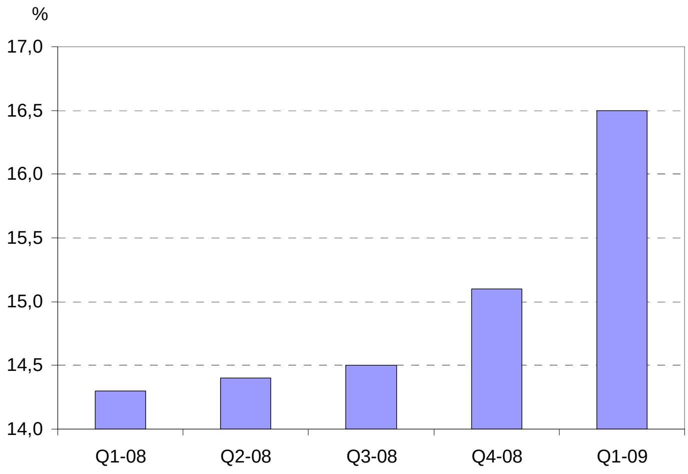


Source : EFG Research, NBU, National Statistcs

In addition, a discouraging sign regarding Ukraine's banking system stability is the important increase in Capital Adequacy ratio: it rose by more than 1 unit in the last quarter and stood at 16.5% in Q1-09 compared to 15.1% in Q4-08. (Figure 13)

Figure 13

Capital Adequacy Ratio



Source: EFG Research, NBU, National Statistcs

Ukraine: Macroeconomic Indicators

	2003	2004	2005	2006	2007	2008	Q1 2008	Q1 2009
Output and expenditure	*(Percentage Change in Real Terms)*							
GDP	9.6	12.3	3.0	6.8	7.4	2.1	6.3	-20.3
Final Consumption	9.8	10.2	15.3	12.5	13.4	9.9	17.0	-8.6
Gross Fixed Capital Formation	27.9	4.9	18.6	19.0	22.2	7.6	13.7	-
Exports of goods and services	10.3	16.6	-11.9	-5.1	3.3	5.1	4.4	-15.9
Imports of goods and services	16.3	10.9	6.5	6.6	19.5	18.4	23.8	-35.6
Industrial production	15.2	12.1	3.2	5.9	10.2	-2.5	7.7	-32.0
Labour Market								
Unemployment (in per cent of labor force)	9.1	8.6	7.2	6.8	6.4	6.4	7.1	9.5
Prices	*(Percentage Change)*							
Consumer prices (annual average)	5.2	9.1	13.6	9.1	12.8	24.6	20.8	20.4
Produce Prices (annual average)	7.7	20.3	16.7	9.5	19.5	35.5	26.9	-42.5
Average monthly wage in economy	23.0	27.7	36.5	29.4	29.7	33.7	39.4	7.2
Government sector	*(In Per Cent of GDP)*							
Consolidated Budget Deficit	0.2	3.2	1.8	0.7	1.1	1.3	0.6	-
General government debt	29.1	24.7	18.4	15.2	12.5	13.8	9.5	13.9
Monetary and Financial Indicators	*(Percentage Change)*							
M2	48.2	45.2	38.6	38.4	43.1	43.7	52.1	19.1
Total Credit	61.4	30.6	61.9	71.0	74.1	72.0	76.2	49.0
	(End of Period)							
Reference Rate (Discount Rate)	7.00	9.00	9.50	8.50	8.00	12.00	10.00	11.00
Exchange rate UAH/USD (end-period)	5.33	5.30	5.04	5.04	5.04	5.04	4.99	8.0
Exchange rate UAH/EUR (end-period)	6.72	7.21	5.95	6.65	7.37	11.06	7.89	10.88
Real Effective Exhange Rate (Index)	92.77	90.72	100.00	104.84	116.30	116.19	111.38	98.90
International Position	*(In Per Cent of GDP)*							
Current account balance	5.8	10.7	2.9	-1.5	-3.7	-7.2	-5.5	-5.9
Trade balance	1.0	5.8	-1.3	-4.8	-7.5	-9.2	-8.8	-7.9
Foreign direct investment. net	2.8	2.6	8.7	5.3	6.5	5.2	6.5	4.9
Gross External debt	47.5	47.2	45.9	50.6	56.0	55.9	57.7	58.9
Memorandum items	*(Denominations as Indicated)*							
Population (end-year. million)	–	–	46924.8	46607.4	46749.2	45847.0	–	–
GDP (in millions of EUR)	–	–	70338.6	84804.0	102737.2	125606.2	–	–
GDP per capita (in EUR)	–	–	1499.0	1819.5	2197.6	2739.6	–	–

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

Ukraine: Banking Indicators							
	2004	2005	2006	2007	2008	Q1 08	Q1 09
Percentage of GDP (%)							
Total Credit	25.7	33.8	45.6	59.9	77.3	62.6	75.8
Total Credit in FX	10.8	14.1	22.3	29.9	45.6	31.0	43.0
Credit to Enterprises	20.7	25.0	29.5	36.5	46.7	37.8	46.3
Credit to Enterprises in FX	8.3	9.4	12.7	15.3	24.1	16.1	22.3
Credit to Households	4.3	8.4	15.1	22.5	29.5	23.9	28.2
Credit to Household in FX	2.5	4.6	9.4	14.3	21.2	14.6	20.4
Deposits	24.0	31.3	33.9	39.2	37.6	39.2	33.1
Deposits in FX	8.8	10.3	12.9	12.6	16.5	13.0	14.7
Percentage Change (%, yoy)							
Total Credit	30.6	61.9	71.0	74.1	72.0	76.2	49.0
Total Credit in FX	32.2	66.3	95.4	75.4	103.1	71.3	70.8
Credit to Enterprises	24.7	48.2	51.3	62.3	70.3	64.4	50.6
Credit to Enterprises in FX	24.8	44.1	67.4	58.0	109.3	59.7	71.0
Credit to Households	63.1	121.0	130.0	95.6	74.9	96.8	45.1
Credit to Household in FX	62.7	138.8	152.1	98.7	97.8	85.8	70.9
Deposits	35.2	60.0	38.8	51.8	27.7	54.3	4.0
Deposits in FX	54.3	50.8	54.0	28.1	75.0	31.8	39.3
Percent (%)							
Capital Adequacy Ratio	16.8	15.0	14.2	13.9	15.1	14.3	16.5
Capital to Assets	13.7	11.9	12.5	11.6	12.9	12.1	13.4
NPLs to Total Loans	30.0	19.6	17.8	13.2	17.4	13.1	24.0
Provisions to NPLs	21.1	25.0	23.1	26.3	29.6	26.7	29.3
Return on Assets	1.1	1.3	1.6	1.5	1.0	1.4	-3.2
Return on Equity	8.4	10.4	13.5	12.7	8.5	11.4	-23.4

Sources: NBU, IMF

Country Ratings - foreing currency long term debt

		Current		From		(date)	Outlook	Date
	Moody's	B2		B3		17-May-06	Stable	24-May-06
	S&P	B+		-		22 -Dec 08	Stable	22-Dec-08
Bosnia & Herzegovina	Fitch	-		-		-	-	-
	Moody's	Baa3		Ba1		01-Mar-06	Stable	25-Sep-08
	S&P	BBB		BBB+		30-Oct-08	Negative	30-Oct-08
Bulgaria	Fitch	BBB-		BBB		10-Nov-08	Negative	30-Apr-09
	Moody's	Baa3		-		27-Jan-07	Stable	17-Apr-09
	S&P	BBB		BBB-		22-Dec-04	Negative	16-Mar-09
Croatia	Fitch	BBB-		BB+		28-Jun-01	Negative	21-May-09
	Moody's	A1				12-Nov-02	Stable	8-Dec-08
	S&P	A		Baa1		02-Oct-07	Stable	02-Oct-07
Czech Republic	Fitch	A+		A-	A	04-Mar-08	Stable	04-Mar-08
	Moody's	Aa1				24-May-06	Negative	23-Apr-09
	S&P	A		A1	A-	17-Nov-04	Negative	21-Apr-09
Estonia	Fitch	BBB+		A-		08-Apr-09	Negative	08-Apr-09
	Moody's			A3		31-Mar-09	Negative	7-Nov-08
	S&P	Baa1		BBB		30-Mar-09	Negative	17-Nov-08
Hungary	Fitch	BBB-	BBB	BBB+		10-Nov-08	Negative	02-Mar-09
	Moody's	Baa1		A2		12-May-09	Negative	12-May-09
	S&P	BBB-		BBB		08-Oct-07	Stable	08-May-09
Kazakhstan	Fitch	BBB-		BBB		28-Nov-08	Negative	17-Dec-07
	Moody's	Baa3		Baa1		23-Apr-09	Negative	23-Apr-09
	S&P	BB+		BBB-		22-Feb-09	Negative	24-Feb-09
Latvia	Fitch	BB+		BBB-		8-Apr-09	Negative	08-Apr-09
	Moody's			A2		23-Apr-09	Negative	23-Apr-09
	S&P	A3	BBB	BBB+		24-Mar-09	Negative	23-Apr-09
Lithuania	Fitch	BBB		BBB		08-Apr-09	Negative	08-Apr-09
	Moody's			-		-	-	-
	S&P	-	BB	BBB-		30-Apr-09	Negative	30-Apr-09
FYROM	Fitch	BB+		-		02-Dec-05	Negative	21-May-09
	Moody's	A2		Baa1		12-Nov-02	Stable	24-May-06
	S&P	A-		BBB+		29-Mar-07	Stable	27-Oct-08
Poland	Fitch	A-		BBB+		18-Jan-07	Stable	10-Nov-08
	Moody's	Baa3		Ba1		06-Oct-06	Stable	06-Oct-06
	S&P	BB+		BBB-		27-Oct-08	Negative	27-Oct-08
Romania	Fitch	BB+		BBB		10-Nov-08	Negative	10-Nov-08
	Moody's	Baa1		Baa2		16-Jul-08	Stable	12-Dec-08
	S&P	BBB		BBB+		8-Dec-08	Negative	08-Dec-08
Russia	Fitch	BBB		BBB+		2-Apr-09	Negative	02-Apr-09
	Moody's	-		-		-	-	-
	S&P	BB-		-		18-Jul-05	Negative	11-Mar-08
Serbia	Fitch	BB-		-		19-May-05	Negative	23-Dec-08
	Moody's	A1		A2		17-Oct-06	Stable	27-Mar-09
	S&P	A+		A		27-Nov-08	Stable	27-Nov-08
Slovakia	Fitch	A+		A		08-Jul-08	Stable	08-Jul-08
	Moody's	Aa2		Aa3		26-Jul-06	Stable	31-Mar-09
	S&P	AA		AA-		16-May-06	Stable	02-Mar-07
Slovenia	Fitch	AA		AA-		12-Jul-06	Stable	16-Oct-07
	Moody's	Ba3		B1		14-Dec-05	Stable	24-May-06
	S&P	BB-		B+		17-Aug-04	Negative	13-Nov-08
Turkey	Fitch	BB-		B+		13-Jan-05	Stable	12-Dec-07
	Moody's	B2		B1		12-May-09	Negative	12-May-09
	S&P	CCC+		B		25-Feb-09	Negative	25-Feb-09
Ukraine	Fitch	B		B+		12-Feb-09	Negative	12-Feb-09

Exchange Rates-EURO

	Quarterly-eop.					Latest	Latest YTD				
	Q2 2008	Q3 2008	Q4 2008	Q1 2009	Q2 2009	30-Ιουλ-09	% change	Max	Date	Min	Date
Bulgaria	1,96	1,96	1,96	1,96	1,96	1,96	-0,05	1,95	29/10/2008	1,97	23/4/2009
Poland	3,35	3,40	4,15	4,64	4,45	4,16	0,28	3,20	25/7/2008	4,90	17/2/2009
Romania	3,65	3,75	4,03	4,23	4,21	4,21	4,43	3,48	6/8/2008	4,34	22/1/2009
Turkey	1,94	1,79	2,15	2,21	2,16	2,08	-3,26	1,73	1/9/2008	2,34	19/3/2009
Ukraine	7,19	7,15	10,92	10,67	10,90	11,28	3,32	6,67	10/9/2008	12,97	18/12/2008
Serbia	78,51	76,84	89,79	95,29	93,78	93,88	4,56	75,79	6/8/2008	96,70	27/1/2009
Croatia	7,24	7,11	7,37	7,44	7,27	7,36	-0,14	7,07	19/11/2008	7,54	13/4/2009
Czech R.	23,88	24,50	26,85	27,36	25,95	25,58	-4,72	22,97	21/7/2008	29,57	17/2/2009
Hungary	235,38	242,15	265,62	308,08	272,31	268,08	0,93	228,49	21/7/2008	316,41	5/3/2009
Kazakhstan	190,25	168,96	168,90	199,96	211,10	212,20	25,64	149,73	20/11/2008	215,23	2/6/2009
Latvia	0,70	0,71	0,71	0,71	0,70	0,70	-0,83	0,70	16/4/2008	0,71	2/3/2009
Russia	36,94	36,14	42,66	44,99	43,76	44,33	3,92	34,15	27/10/2008	46,90	3/2/2009
Slovakia	30,22	30,30	30,07	30,13	30,13	30,13	0,20	30,07	31/12/2008	32,50	2/4/2008

Exchange Rates-USD

	Quarterly-eop.					Latest	Latest YTD				
	Q2 2008	Q3 2008	Q4 2008	Q1 2009	Q2 2009	30-Jul-09	% change	Max	Date	Min	Date
Bulgaria	1,24	1,39	1,41	1,47	1,39	1,39	-1,17	1,22	22/4/2008	1,57	28/10/2008
Poland	2,13	2,41	2,97	3,50	3,17	2,96	-0,47	2,03	18/7/2008	3,90	17/2/2009
Romania	2,32	2,66	2,88	3,19	3,00	2,99	3,69	2,22	22/4/2008	3,43	2/3/2009
Turkey	1,23	1,27	1,54	1,67	1,54	1,48	-4,01	1,15	15/1/2008	1,81	9/3/2009
Ukraine	4,57	5,08	8,05	8,05	7,77	8,02	-0,41	4,51	1/7/2008	9,29	24/2/2009
Serbia	49,83	54,52	64,26	71,67	66,86	66,69	3,78	49,00	4/8/2008	75,54	18/2/2009
Croatia	4,59	5,05	5,28	5,62	5,18	5,23	-0,88	4,53	21/7/2008	5,96	17/2/2009
Czech R.	15,16	17,38	19,22	20,65	18,49	18,18	-5,41	14,43	21/7/2008	23,49	20/11/2008
Hungary	149,41	171,82	190,10	232,52	194,10	190,49	0,21	143,50	21/7/2008	252,45	5/3/2009
Kazakhstan	120,77	119,90	120,88	150,91	150,43	150,78	24,74	119,48	15/9/2008	152,98	15/7/2009
Latvia	0,45	0,50	0,51	232,52	0,50	0,50	-1,58	0,44	22/4/2008	0,57	20/11/2008
Russia	23,44	25,64	29,40	33,95	31,15	31,51	7,17	23,16	14/7/2008	36,37	19/12/2008
Slovakia	19,18	21,54	21,57	22,73	21,47	21,41	-0,77	19,04	14/7/2008	24,38	27/10/2008

Money market interest rates-3 Month

	Quarterly-eop.					Latest	Latest YTD		
	Q2 2008	Q3 2008	Q4 2008	Q1 2009	Q2 2009	30-Jul-09	% change	Max	Date
Bulgaria	7,1	7,4	7,6	6,2	5,8	5,5	-27,2	8,0	27/11/2008
Poland	6,6	6,5	5,8	4,1	4,3	4,1	-29,6	6,8	24/10/2008
Romania	11,8	13,4	14,7	14,0	10,0	9,2	-37,6	32,1	20/10/2008
Turkey	18,1	17,5	17,0	11,4	10,0	8,7	-49,1	21,1	30/10/2008
Croatia	6,4	8,3	8,2	11,1	9,1	9,5	16,2	11,9	2/3/2009
Czech R.	4,2	4,0	3,6	2,4	2,1	2,1	-42,4	4,5	31/10/2008
Hungary	8,8	8,7	10	9,8	9,7	8,5	-15,1	12,4	27/10/2008
Kazakhstan	7,6	7,4	11,0	12,6	8,5	8,88	-19,3	18,8	4/2/2009
Latvia	5,4	6,2	8,9	8,5	14,4	10,4	16,6	17,2	26/6/2009
Russia	5,7	8,7	18,7	14,2	12,1	11,3	-39,5	22,1	26/1/2009
Slovakia	4,4	4,3	3,0	-	-	-	-	4,4	7/7/2008

Stock Markets					
				Performance	
Country	Closing Price 30-Jul-09	Highest Level of 52 Weeks	Lowest Level of 52 Weeks	Since Q2 (%)	Since January (%)
Poland	35.175,59	42.416,36	21.274,28	14,62	24,16
Romania	3.986,85	6.380,76	1.887,14	16,05	33,62
Ukraine	421,93	655,91	199,12	2,64	39,75
Serbia	571,36	1.503,99	354,39	0,18	4,66
Bulgaria	351,42	1.037,91	259,95	-1,34	-2,27
Turkey	42.182,11	43.259,37	21.228,27	13,25	56,20
Czech R.	1.030,20	1.478,20	628,50	14,59	18,40
Russia	1.001,30	1.966,68	498,20	2,39	59,74
Hungary	17.122,10	22.511,25	9.461,29	11,00	33,57
Slovakia	294,99	464,29	291,60	-11,20	-17,87
Croatia	1.849,56	3.651,90	1.262,58	1,52	4,37
Estonia	292,77	568,44	244,99	-2,60	2,75
Latvia	256,96	514,75	203,16	5,60	-5,15

5-Y Credit Default Swaps (USD,bp)							
	quarterly-eop.					Latest	Latest YTD
	Q2 2008	Q3 2008	Q4 2008	Q1 2009	Q2 2009	30-Jul-09	% change
Romania	194,3	263,3	670	525,8	398	282	-58,0
Turkey	310,5	296,2	430,6	407,2	264	214	-50,4
Bulgaria	163	229,2	523,4	521	404	279	-46,7
Poland	51,5	76,6	266	296	172	139	-47,6
Ukraine	380,3	738,3	3411,5	4037,1	1786	1583	-53,6
Croatia	97,5	143,3	460	431,5	256	246	-46,6
Czech R.	-279	66,5	177,5	223,5	114	97	-45,4
Hungary	134,5	169,3	442,6	540,1	360	270	-39,1
Kazakhstan	224,8	445,5	711,3	1033,7	513	404	-43,2
Latvia	-	344	860,5	917,5	748	678	-21,2
Russia	109,2	258,9	766,5	503,38	344	279	-63,6
Slovakia	31	63	170	129,7	88	77,17	-54,6

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