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Division of Research & Forecasting

Director: Gikas Hardouvelis
ghardouvelis@eurobank.gr

Coordinator:

Ioannis Gkionis
Research Economist
igkionis@eurobank.gr

Other contributing authors:

Panagiota Chioti
Junior Economic Analyst
pchioti@eurobank.gr

Stella Kanellopoulou
Research Economist
skanellopoulou@eurobank.gr

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Commentary

Gone is the era of great moderation. The worldwide unprecedented rapid expansion in output with low inflation of the last seven years is history. The party is over and 2009 promises to be a gloomy year. The rapid worsening of the financial crisis following the collapse of Lehman Brothers in September has accelerated the global slowdown. International institutions like the IMF, the OECD or the European Commission can no longer keep up with the onslaught of negative news and keep revising their official forecasts downward. Rating agencies woke up to the underlying risks and are busy downgrading the vulnerable countries. The slowdown affects everyone, the developed world, BRICs, oil producing countries, developing countries. No one seems able to avoid the slowdown, not even countries that in the past followed prudent policies with fiscal and current account surpluses, as they would be hard pressed to find willing buyers for their exports.

The countries of New Europe do not represent an exception to the general gloomy outlook for 2009. In the past decade they accomplished a remarkable convergence in living standards with Western Europe, yet now they may take a break from those fast growth rates. Our analysis shows that even in the good scenario of a relatively quick end to the financial crisis, output growth will be slashed in half. Some countries will not avoid an outright recession. Ukraine is about to enter it. Other countries are at a high risk of negative growth. Yet, numbers may be misleading. The slowdown is so sharp that even positive growth will feel like a recession.

Precise predictions are tenuous at the moment since the crisis is far from over. Yet the risks are clear: First, there is the risk of a rapid slowdown in credit expansion. Foreign banks have a large presence in New Europe and many of those banks are going through a process of rapid deleveraging in their home countries. The scarcity in global liquidity and global capital affects many parent banks, prohibiting them from transferring liquidity to New Europe, especially to the countries with loans that exceed deposits. Thus, credit expansion in New Europe is expected to be based on domestic means, i.e. on domestic deposit expansion.

This implies a supply-induced lower credit expansion, which will have a large negative impact on economic activity. Yet, the impact is not expected to be as large as the one we already witnessed in the Baltic States, when foreign banks stopped lending back in 2007. The elasticity of nominal GDP to credit growth is about one third relative to the elasticity in the Baltic States thanks to a later start in credit expansion and a more diversified base of sources and uses of funds.

A second risk arises from the large FX exposure of firms and households. The rapid depreciation in some of the currencies of new Europe can easily create problems in firm and household debt servicing and increase the size of non performing loans. The depreciation can also increase the amount of private and public foreign debt, exposing the countries to future servicing outflows. Depreciations can also prolong the persistence of earlier inflation. Of course, depreciations can also make exchange rate more competitive and improve the current account deficits. Another benefit is the avoidance of the harsh scenario of speculative attacks and devaluations.

A third risk is that of a sudden stop in capital inflows. Real estate FDI is declining fast, bank capital infusion as well, whereas new green field investments are very questionable. The countries of New Europe run high current account deficits and have large exposures in foreign debt. If capital from abroad dries up, it may generate a large domestic recession. Markets are already aware of this risk, driving the interest rates of credit default swaps a lot higher for those countries that have higher such exposures.

The first quarter of 2009 is expected to be difficult for NE economies as the international financial crisis begins to bite through a highest cost of capital and lower than expected exports. Locally, there is a dramatic change of sentiment for the worse. Investors and policy makers have begun worrying about a serious economic slowdown. The earlier worries about their overheated economies are long gone. Labor market bottlenecks, record low unemployment rates and impressive real wage increases are items of the past. As domestic demand becomes weaker, imports are expected to slow and the current account deficits to shrink.

Inflation is no longer in the radar screen of policy makers and a policy of reducing interest rates in order to support growth steals the lime light. Some countries like Poland and Turkey seem to have surprised the markets by cutting their intervention rates, yet similar “surprises” are likely to follow. Most governments also follow a relatively loose fiscal policy. Governments only have a few weapons to combat the crisis at their disposal. In that respect, they can turn to the IMF and ECB as lenders of last resort.

In some countries landing will be softer than in others. **Bulgaria's** monetary policy is tied by a currency board, which has resulted in a severe overvaluation of its exchange rate and to some degree, a very large current account deficit. The question of a possible break in the currency board is always in the minds of market participants, as it is in the case of the Baltic countries. Yet, Bulgaria's prudent fiscal policy will hopefully allow the government to engineer a soft landing. In addition, its diversified foreign owned banking system has not overstretched its funding capacity, which minimizes the probability of a sudden stop in the supply of credit. **Romania's** overheated economy would have already slowed down had it not received the strong boost of the agricultural rebound. The twin deficits in Romania put the economy at a highly vulnerable position and if monetary policy were relaxed, a possible depreciation might then turn FX risk into credit risk. Credit expansion will decelerate sharply leading to a correction in real estate prices.

Serbia, a latecomer as an investment destination, does not share the EU shield. Even though it has vast untapped sources of growth, it will not escape a soft landing in 2009. Policymakers have secured an IMF loan while the earlier restrictive measures on credit expansion provide a cushion of stability today. **Poland**, one of the first countries of New Europe to join the EU, is in a relatively better position. A stable self-funded economy with a healthy credit rating, doesn't face challenges of the same magnitude other counties do.

Turkey is undergoing significant pressures because of its high external financing requirements and the weak global demand. An agreement with the IMF seems to be on track and would boost foreign investors' confidence. Turkish households are not exposed to FX debt, making it easier for the lira to depreciate and make Turkish products more competitive internationally. **Ukraine** is the second country after Hungary to receive an IMF loan. The collapse of steel prices, the drying up of capital inflows, the increase in geopolitical risk, the ongoing domestic political clash and a few other factors suggest that the economy will go through a severe recession in 2009.

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

Real GDP			
	2007	2008e	2009f
Bulgaria	6.2	6.5	2.0
Poland	6.6	5.0	2.8
Romania	6.0	8.5	2.7
Serbia	7.1	6.5	3.0
Turkey	4.6	2.5	1.0
Ukraine	7.3	3.5	-5.0
Inflation			
	2007	2008e	2009f
Bulgaria	7.6	12.5	6.9
Poland	2.5	4.2	3.0
Romania	4.8	7.9	5.6
Serbia	6.4	13.0	8.0
Turkey	8.8	10.3	9.2
Ukraine	12.8	25.5	19.5
Current Account (%GDP)			
	2007	2008e	2009f
Bulgaria	-21.4	-22.0	-16.0
Poland	-4.5	-5.0	-3.5
Romania	-13.9	-13.5	-12.5
Serbia	-13.6	-18.5	-16.0
Turkey	-5.8	-6.0	-3.0
Ukraine	-4.2	-7.0	-5.0

1. Bulgaria

Sharp economic adjustment ahead

- **The marked correction in the real estate and financial services sectors will push the Bulgarian economy towards a sharp economic slowdown, if not a hard landing, in 2009**
- **Concerns have shifted from inflation to growth: Weak domestic demand and declining energy prices will push inflation further down to 5% next year**
- **The country's healthy fiscal condition allows the government a greater flexibility to buffer the consequences of the worsening global economic environment, as it has already decided to increase infrastructure spending and to support lending to SMEs**
- **The Central Bank reduced the minimum reserve requirements from 12% to 10% in order to increase the liquidity of the banking sector.**
- **Significantly less FDI inflows and slower income growth will force in the current account deficit to shrink from its 25% of GDP peak in 1H-2008 towards 16% in 2009.**
- **Credit growth is about to drop drastically from the current 50% levels yoy as liquidity constraints bind, external financing becomes overly costly and lending standards tighten.**
- **Standard and Poors downgraded the sovereign credit rating of Bulgaria by one notch to BBB**
- **The huge external financing requirements in a global environment of tight liquidity have pushed CDS to record high levels.**
- **The high FX-denominated leverage of households and corporates provide strong disincentives for Bulgarian authorities to abandon the currency board voluntarily in the medium term**
- **The diverse foreign ownership provides some comfort that a Baltic-style credit crunch will be avoided**
- **The strong capital base provides some optimism that the banking sector can address the inevitable rise of NPLs**

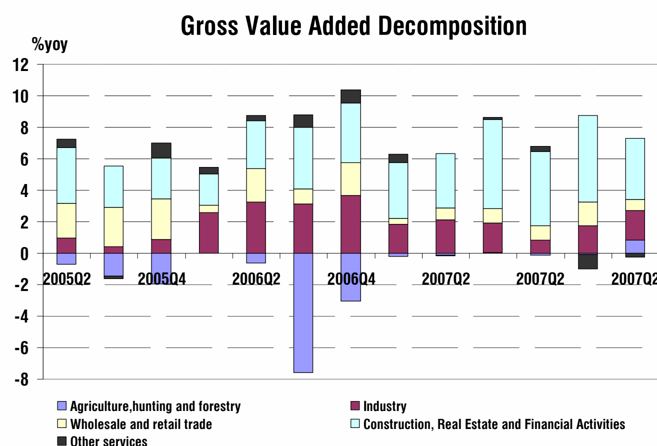
Outlook

Bulgaria has been a major beneficiary of the favorable world economic environment in recent years. Surging capital inflows and rapidly expanding credit growth helped Bulgaria achieve a spectacular average GDP growth performance of 6.3% in 2005-2008. The trend is about to reverse leaving no option to the economy but to adjust sharply.

The deepening of the international financial crisis from mid September onwards will not leave the Bulgarian economy unaffected. Growth relies heavily on real estate and financial services sectors in Bulgaria. The deepening financial crisis touches particularly upon those two sectors. (Figure 1)

Figure 1

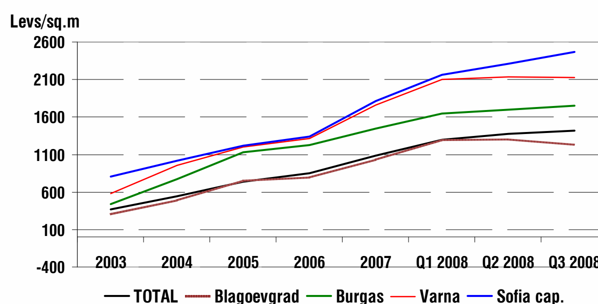
Gross Value Added Decomposition



Higher external financing costs lead the banks to cut down on credit, which, in turn, weighs negatively on investment and further on consumption. An illustrative example of this is that real estate prices in Bulgaria have already started to moderate if not decline in some cases. (Figure 2)

Figure 2

Average Annual Market Prices of Dwellings



The question is whether will be a hard or soft landing. The chances are that this will be a soft landing rather than a hard landing. The

worsening global economic environment finds the country is in a healthy fiscal position with a relatively strong banking sector. Nevertheless, the tighter liquidity conditions and the growing investors risk aversion worldwide are expected to impact negatively capital inflows. In addition, exports demand from the main trade partner Euro Area is expected to be weak too. This will not only have a negative impact on growth which we now forecast to land at 2% but at the same time raises the probability of an abrupt adjustment in the balance of payments. As a result, the current account deficit will shrink to 16% of GDP in 2009. The huge external financing requirements in an era of repricing risk in emerging markets and scarcity of funds led Standard and Poors to downgrade Bulgaria sovereign ratio by one notch to BBB. Yet, the sovereign rating is still above investment grade. (Table)

Table

Bulgaria	2007	2008	2009
Real GDP growth	6.2	6.5	2.0
Inflation (annual average)	7.6	12.5	6.9
Current account balance (% of GDP)	-21.4	-22.0	-16.0

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

Political environment

The country enters the pre-election period. There are 10 months left for the general parliamentary elections in Bulgaria. The outgoing three party coalition government comprised by the ruling Bulgarian Socialist Party (BSP) and its two minor coalition partners, is under severe criticism for the EU pre-accession funds freeze. For that reason, the Opposition initiated a vote of no confidence but with out success. Pressure is mounting but early election would be avoided, as all three coalition partners enjoy very low popularity. The new right-wing party CEDB is expected to capitalize the electoral losses, but at this moment it is unclear whether it could have a parliamentary majority.

Bulgarian authorities were heavily criticized for the poor management and lax control over EU funds in the second post-accession benchmarking report in the past July. As a result, the pre-accession programs (PHARE, ISPA, and SAPPARD) were suspended and the paying agencies accreditation was revoked. In response, the government drafted an Action Plan but effectively some deadlines passed and no results have been seen. For that reason, the European Commission side reports that the response on the government side is considered not to be adequate, so that funds will probably be lost.

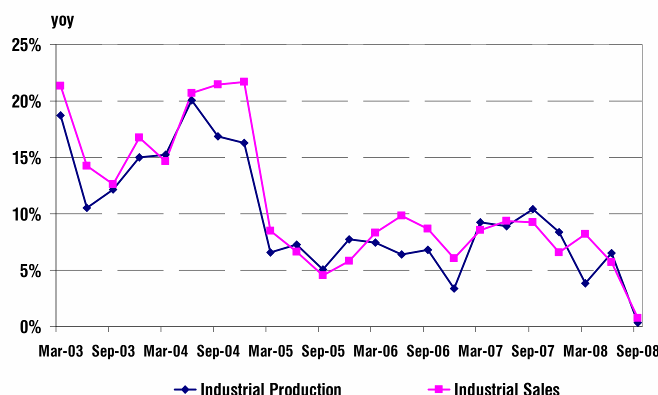
Growth performance

GDP growth proved out to be stronger than initially reported in Q3 thanks to the stellar performance of agriculture (44.3% yoy). The revised GDP growth in Q3 at 6.8% brought the year to date performance at 7% in 2008. Domestic demand components held up surprisingly well. Consumption increased by 5.4% yoy helped by strong real wage and the lagged effects of robust credit growth. Gross fixed capital formation soared by 22.3% yoy underpinned by significant, yet decreasing, FDI inflows especially in the real estate sector. Exports growth showed some weakness slowing to 3.8%. At the same time, imports growth halved at 4.2%.

Nevertheless, the performance recorded in Q3 is not illustrative of what will follow. Slowdown in Q4 is already evidenced in higher frequency indicators. Industrial production has shrunk by 0.1% yoy in Q3-2008 (further by 1.9% in October). In addition, industrial sales recorded a steep slowdown from 5.7% in Q2 to 0.5% yoy and further contracted by 1.6% in October as well. (Figure 3)

Figure 3

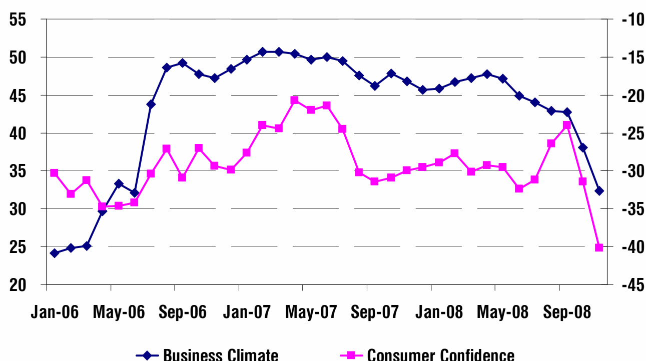
Industrial Activity in Bulgaria



The business and consumer sentiment plunge in September-October confirms that we are ahead of a significant economic activity slowdown. (Figure 4)

Figure 4

Confidence Indicators in Bulgaria



Public Finance

Bulgaria is the only country in the region that runs a fiscal surplus. In fact, the government raised the targeted surplus to 3.5% of GDP instead of 3% for 2008, motivated by the higher than expected revenues. The general government surplus reached 7.6% of the projected GDP in Jan-Oct. Large spending skewed to the end of the year will bring it back to the level of 3.5%. Half of the supplementary spending will be directed towards government consumption purposes and the rest to infrastructure investment.

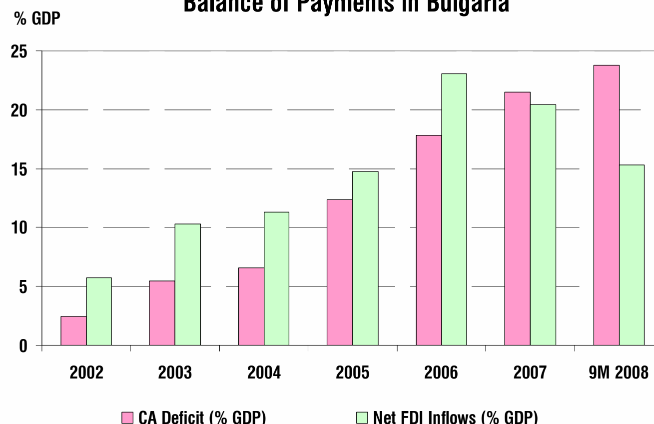
Although some of it is expected to diminish out of the lower revenues collection, the surplus will act as a buffer against economic slowdown headwinds next year. The government has built some flexibility around it in the budget of 2009. The surplus could be reduced down to 1% depending on the how harsh the economic condition will turn out to be. Infrastructure spending will increase by 20%, so that capital investment will reach up to 7% of GDP. A 20% pension increase is scheduled to boost next year social spending too. On top of that, the state run Bulgarian Development Bank will receive a capital injection of 500 million Lev (0.8% of 2009 nominal GDP) to extend loans for SMEs.

Balance of Payments

The current account deficit has started to moderate. At Q3 it stood at an annualized basis at 24.1% of GDP. The main culprit, the trade deficit has skyrocketed to 26.7% of GDP. We have long argued that the current account deficit is FDI inflows driven. FDI inflows suck in more imports which balloons the trade deficit. The FDI inflows decline will result in the current account shrinking. The Bulgarian government has slashed its projection for FDI inflows in 2009. It now projects that FDI inflows will amount to 5.3 bn Euros in 2009 against 6.5 bn Euros. The process has already started as net FDI inflows declined by 15% in Jan-Oct 2008. As a result, the Net FDI inflows coverage of the current account has declined, but stood at a relatively comfortable 67.3% in the first ten months of 2008. (Figure 5)

Figure 5

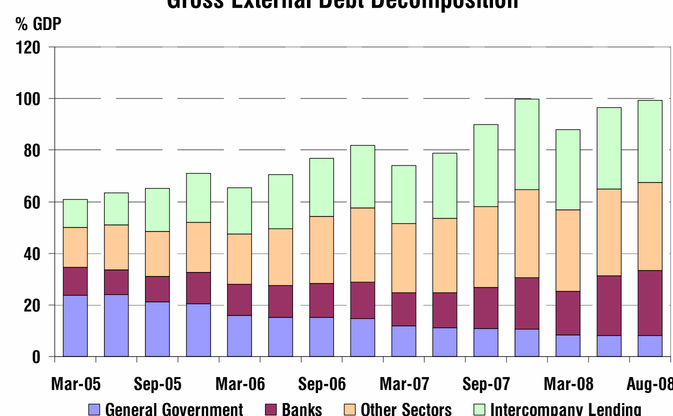
Balance of Payments in Bulgaria



The shortfall has been covered by debt inflows so that external debt climbed at 104.6% of GDP in Q3, mainly driven by the banking sector foreign borrowing. (Figure 6)

Figure 6

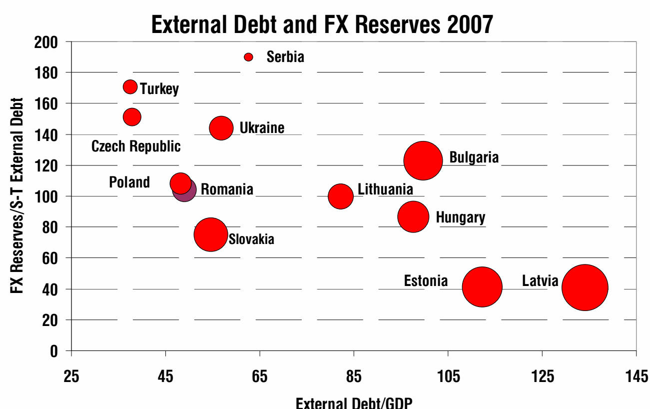
Gross External Debt Decomposition



It is noteworthy to mention that debt is becoming more skewed to short-term. Short term debt as a percentage of total external debt has climbed to 39% in October compared to 30% a year ago. The decision of the Central Bank to reduce the minimum reserve requirements of the banking sector pushed down reserves by 9.2% in October. Nevertheless, reserves still covered 110.5% of the short-

term debt down from 132% a year ago. This is favorably compared to the Baltics. (Figure 7)

Figure 7

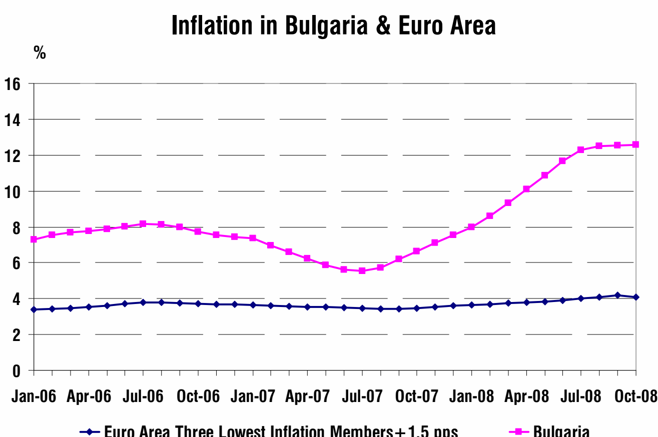


Inflation- Monetary Policy

The disinflation process resumed in Q3, as it was widely expected. After peaking at 15.3%, consumer prices started to ease helped by the deceleration trend in energy prices. Food prices started to contribute to the disinflation trend in November pushing down consumer prices to 9.1%. Thus, inflation entered a single digit area for the first time since July 2007. Despite a 24% gas prices increase, the year end inflation is expected to further ease to 8%.

The HICP (Harmonized consumer prices) registered a steeper decline as food prices carry less weight in the consumer basket. Despite the sharp drop of HICP to 8.8% yoy in November against 11.2% in October, inflation in Bulgaria is still the highest in EU-27. That said inflation has to drop significantly in order to fulfill the Maastricht inflation criterion, the main obstacle to EMU. (Figure 8)

Figure 8



Part of this distance is to be covered in 2009. Inflation is expected to drop further as domestic demand is expected to be much weaker. In that direction, the next year budget is built upon a 4.5% HICP year end (6.7% annual average)

Banking Developments

The spreading of the global financial crisis over to Europe found the Bulgarian banking sector in a very good shape. Total assets increased by 28.9% yoy in October 2008 against 35.3% a year ago just before the re-emergence of credit jitters. Total assets as a percentage of GDP stood at 107.7% in the Q3-2008, up from 95.8% a year earlier. Bulgaria enjoys the highest level of financial intermediation among the countries of the New Europe region. The banking sector is better capitalized compared to the average European standards. The capital to assets ratio stands well above 11% compared to 4-8% in most European countries.

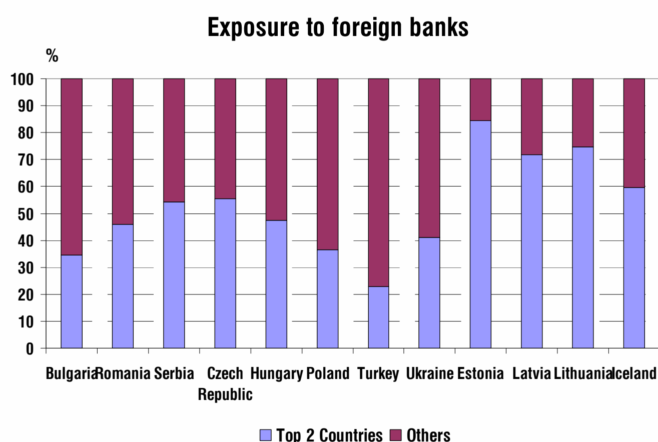
The legacy of 1996-1997, during which Bulgaria went through its worst banking crisis, prompted the government to respond immediately. The government ensured deposits in order to avoid an emerging bank run. In addition, it committed to address the liquidity problem of any bank. In that direction, the Central Bank reduced the minimum reserve requirements to inject liquidity in the banking system.

In any case, the ongoing financial crisis brings the Bulgarian banking sector ahead of significant challenges. The issue of access to financing becomes a first priority, although the loans to deposits ratio is modestly over 100%. The abundance of capital inflows has secured a very dynamic credit expansion in recent years. External financing has become overly scarce and expensive, which has turned the banks attention to attracting deposits. Secondly, concerns over a potential deterioration in the asset quality have emerged. The rapid credit growth in the recent years has raised the probability that NPLs could jump up in a sharply slowing down domestic economic environment.

Third, a lot will depend on the guidelines set by the foreign parents of Bulgarian banks. Until recently foreign-ownership was considered to be an advantage. Foreign ownership has provided advanced technology and know-how advantage while it has improved the

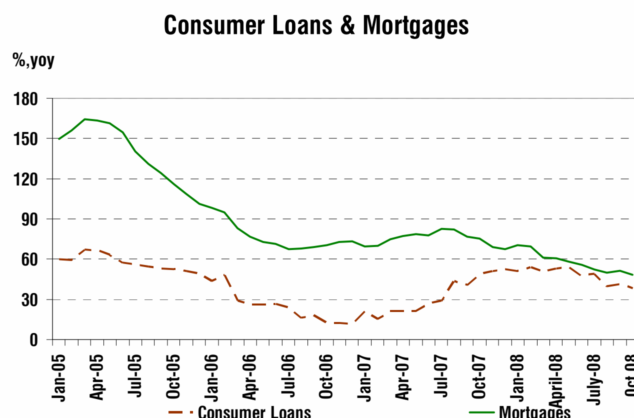
profitability. The global credit crisis hit on some of the foreign parents of Bulgarian banks has turned into a disadvantage. In contrast with the Baltics, the Bulgarian banking system has a diversified foreign-owned base, which minimizes the probability of a sudden stop in credit, but will not avert a tightening of lending conditions. (Figure 9)

Figure 9



Household credit growth has moderated. Credit to households grew by 42.8% yoy as of October, compared to 59.4% yoy a year earlier. Consumer loans went up by 38.1% yoy in October 2008, compared to 48.2% yoy a year earlier. Higher interest rates for mortgages had a negative impact on mortgages Mortgage loans growth decreased to 48.5% yoy in October 2008, against 75.4% yoy a year earlier. (Figure 11)

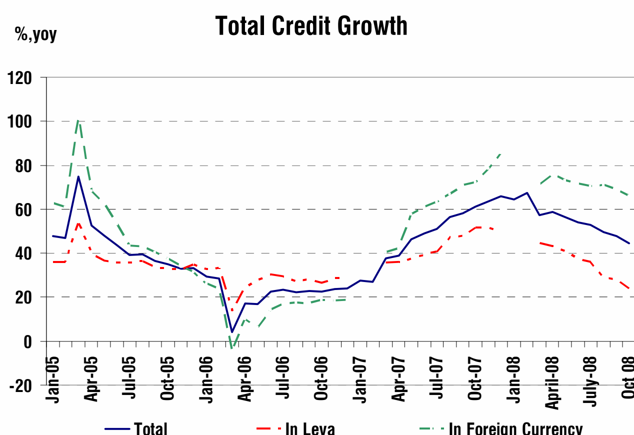
Figure 11



Credit Developments

Credit expansion in Bulgaria was strong in the first ten months of 2008. Total credit grew by 44.5% yoy in October 2008, down from 61.1% yoy in October 2007 and 65.9% yoy in 2007. Credit in FX is the main engine of credit expansion. FX-credit growth increased to 65.8% yoy in October 2008, up from 72.2% yoy a year earlier. In contrast, credit in local currency stepped down to 23.9% yoy in October 2008, compared to 51.7% yoy a year earlier. Total credit has reached 75.8% of GDP in Q3 2008, against 60.9% a year earlier. (Figure 10)

Figure 10



Credit to enterprises followed a proportional trend to that of households. Enterprise credit growth moderated to 45% yoy in October 2008, as opposed to 59.7% yoy a year earlier. In more detail, there is a shift towards FX lending. FX lending grew by 59.6% yoy in October 2008, compared to 70.1% yoy a year earlier. In contrast, enterprise lending in local currency decreased to 19.2% yoy in October 2008, compared to 51% yoy a year earlier.

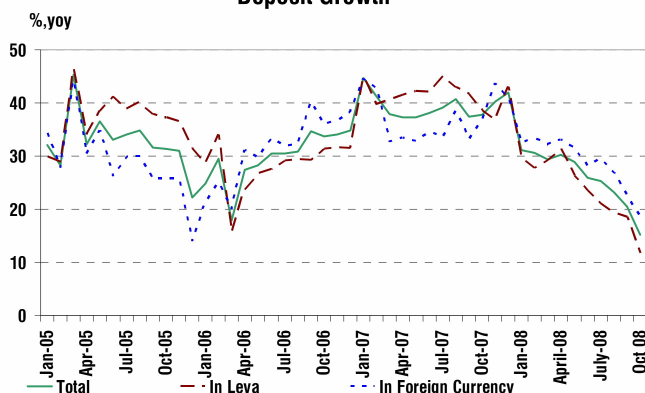
Deposit Developments

In an attempt to prevent a general bank run the government passed legislation to increase deposit guarantee (the level was increased up to 50,000 Euros which is relatively high for Bulgarian standards). In addition, the Central Bank of Bulgaria amended the minimum reserve requirements ordinance in order to increase liquidity in the banking system. The Central Bank will consider half of the cash banks hold in their vaults as reserve assets, i.e. satisfying the reserve requirement.

Even before the deepening of the financial crisis, the liquidity constraints had become apparent. The loan to deposit ratio climbed over the 100% threshold. Thus, the ratio reached 120.7% in October

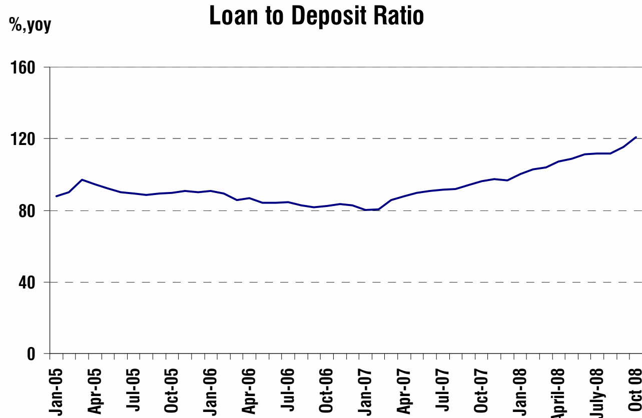
2008, compared to 92.2% a year earlier. For that reason, banks in Bulgaria have turned their attention to attracting deposits in the system. Competition among banks has increased who now offer higher interest rates to attract more deposits. (Figure 12)

Figure 12



There are two visible trends with respect to deposits in the first eight months. First of all, deposit growth slowed down. Total deposits growth dropped to 15.2% yoy in August 2008, compared to 37.7% a year earlier. Secondly, there is a shift towards FX deposits. FX deposits growth seems to be less affected negatively than that in local currency. FX deposits growth decreased to 18.6% yoy as of October 2008, as opposed to 36.8% yoy a year earlier. In addition, deposits growth in domestic currency grew to 11.7% yoy as of October 2008, down from 38.7% yoy a year earlier. (Figure 13)

Figure 13



Banking Sector's Profitability and Capital Adequacy

The Bulgarian banking sector is profitable. Its profitability level reached impressive profitability level in the first nine months of 2008. Total profit amounted to BGN 994 million, 33.6% higher than that a year earlier. ROA increased to 2.4% in Q3, compared to 2.2% a year earlier. Furthermore, ROE stood at 24.3% in 1H 2008, against 23.3% in 1H 2007.

The Bulgarian banks appear to be well capitalized which insulates them from the financial crisis. The Capital Adequacy ratio stood at 14.55% at the end of the second quarter, compared to 13.8% in December 2007. In addition, the Tier 1 capital ratio stood well above 11%, compared to 4-8% in the rest of EU. Furthermore, if projected profits are retained instead of given out as dividends according to the Central Bank recommendations, the ratio could climb even higher.

Bulgaria: MacroEconomic Indicators								
	2003	2004	2005	2006	2007	Q2 2007	Q2 2008	Q3 2008
Output and expenditure	*(Percentage Change in Real Terms)*							
GDP	5.0	6.6	6.2	6.3	6.2	7.3	7.1	6.8
Final Consumption	5.9	5.4	5.3	7.3	4.9	5.0	4.8	5.4
Gross fixed capital formation	13.9	13.5	23.3	14.7	21.7	24.7	28.6	22.3
Exports of goods and services	10.7	12.7	8.5	8.7	5.2	5.3	5.1	3.8
Imports of goods and services	16.4	14.5	13.1	14.0	9.9	11.1	13.7	4.2
Industrial production	14.1	15.9	6.7	6.1	9.2	8.9	6.6	-0.1
Labour Market								
Employment	3.5	3.1	2.0	4.3	4.6	3.6	3.7	3.1
Unemployment (in per cent of labor force)	14,3	12,7	11,5	9,6	7,8	7,9	6,2	5.9
Prices	*(Percentage Change)*							
Consumer prices (annual average)	2.4	6.2	5.0	7.3	8.4	4.7	15.0	12.2
Producer prices (annual average)	4.9	6.0	6.9	9.2	8.6	6.6	13.9	14.1
Average monthly wage in economy	6.2	6.0	9.5	9.5	20.6	19.6	24.2	22.6
Government sector	*(In Per Cent of GDP)*							
General government balance (National Definition)	0.0	1.7	3.1	3.5	3.5	3.2	5.7	7.5
General government debt	48.1	40.1	31.3	24.6	19.8	21.6	15.6	15.9
Monetary and Financial Indicators	*(Percentage Change)*							
M3	16.6	22.5	27.3	21.4	29.2	28.5	26.6	21.4
Total Credit	55.4	47.3	33.1	23.9	65.9	49.0	54.1	47.9
	(End of Period)							
Reference Rate (Base interest rate)	2.68	2.61	2.04	2.69	3.93	3.78	4.91	5.18
Exchange rate USD/BGN (end of period)	1.55	1.43	1.65	1.48	1.34	1.44	1.24	1.38
Exchange rate EUR/BGN (end of period)	1.95	1.95	1.95	1.95	1.95	1.95	1.95	1.95
Real Effective Exhange Rate (Index)	140.0	141.7	141.5	148.9	161.9	148.9	165.9	168.1
International Position	*(In Per Cent of GDP)*							
Current account balance	-5.5	-6.6	-12.4	-17.8	-21.8	-19.9	-24.2	-24.1
Trade balance	-13.7	-14.9	-20.2	-22.0	-25.3	-24.4	-26.8	-26.7
Foreign direct investment, net	10.6	12.9	15.5	24.3	23.2	22.6	22.1	20.97
External debt (National Definition)	60.1	63.8	70.9	81.7	99.8	78.9	96.1*	104.6
Memorandum items	*(Denominations as Indicated)*							
Population (end-year, thousand)	7801	7761	7719	7699	7699	–	–	-
GDP (in mrd of EUR)	17.77	19.88	21.88	25.24	28.90	–	–	-
GDP per capita (in EUR)	2277.90	2561.50	2834.60	3278.30	3753.70	–	–	-

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 repor*

Bulgaria: Banking Indicators						
	2004	2005	2006	2007	Q2 2007	Q2 2008
Percentage of GDP (%)						
Assets	65.1	78.3	86.0	104.6	90.9	106.9
Total Credit	36.1	43.8	46.4	66.9	56.8	73.9
Total Credit in FX	17.3	20.8	21.0	33.9	27.7	40.2
Credit to Enterprises	26.1	29.0	29.6	43.0	36.4	47.6
Credit to Enterprises in FX	16.5	18.7	18.0	29.2	23.3	34.0
Credit to Households	9.9	14.7	16.6	23.0	19.7	25.1
Credit to Household in FX	0.8	2.0	3.0	4.7	4.0	6.2
Mortgages	2.6	4.8	7.2	10.4	8.9	11.6
Deposits	51.0	60.6	56.1	70.0	62.5	66.4
Deposits in FX	23.1	24.0	28.4	35.1	31.7	34.3
Percentage Change (%, yoy)						
Assets	43.8	31.8	28.4	40.0	31.2	39.2
Total Credit	47.3	33.1	23.9	65.9	49.0	54.1
Total Credit in FX	63.2	31.4	18.6	84.0	60.9	71.7
Credit to Enterprises	38.1	21.7	19.4	46,4	48.7	54.9
Credit to Enterprises in FX	59.3	24.2	12.2	87.1	53.8	73.0
Credit to Households	79.3	63.0	32.1	58.8	45.3	51.1
Credit to Household in FX	241.5	185.1	74.1	78.5	89.4	84.9
Mortgages	147.0	101.2	73.4	67.4	78.0	55.6
Deposits	43.7	30.1	34.8	42.0	38.2	25.9
Deposits in FX	47.2	13.9	38.3	41.0	34.6	28.2
Percent (%)						
Capital Adequacy Ratio	16.1	15.2	14.5	13.8	14.4	14.6
Capital to Assets	11.0	10.5	10.4	10.5	10.5	10.6
NPLs to Total Loans	2.0	2.2	2.2	2.2	2.2	-
Provisions to NPLs	48.5	45.3	47.6	–	-	-
Return on Assets	2.1	2.1	2.2	2.4	2.2	2.4
Return on Equity	20.6	22.1	24.4	23.8	23.3	24.3

Sources: BNB, IMF

2. Poland

Financial crisis hammers the zloty

- **Polish-US missile agreement, spurred by the Russian-Georgian crisis, creates renewed tensions with Russia**
- **A sharp drop in industrial production in November coupled with a significant weakening of investment growth and a gradual deceleration of private consumption suggest a GDP growth deceleration to 2.9% yoy in 2009**
- **Since October, Poland does not fulfil the Maastricht criterion on inflation. The November's headline inflation reading stood at 3.7% yoy and expected to slow down to 3% on average in 2009**
- **The challenge facing the Monetary Policy Council (MPC) is that of slowing economic growth combined with zloty depreciation**
- **From October to late December, the zloty dropped by more than 21% against the euro and, at the time of writing, reached 4.11/€**
- **The MPC decreased the reference interest rate by 75bps to 5% at the end of December and further rate cuts are expected in 2009**
- **The government has introduced a €24.3bn stimulus package to boost investment**
- **In order to raise market confidence and ease the strains in the money markets, National Bank of Poland established a temporary EUR/CHF swap agreement with the Swiss National Bank and agreed a €10bn facility with the European Central Bank**
- **The government announced its intention to speed up entry into the Euro area in 2012.**

Outlook

The outbreak of the crisis in Georgia spurred the negotiations over the Polish-US missile agreement. The US base of 10 interceptor missiles in Poland brought about renewed tensions with Russia. Hence, since late August Poland is facing a geopolitical risk.

The escalation of the crisis in October 2008 and its spread to Central and Eastern Europe had a significant impact on the Polish financial markets. However, Poland appears to be in a much better shape than most of its CEE peers to weather the global financial crisis. This is attributed to the country's comparatively lower dependency on external financing, its strong fiscal position, as well as the improving inflation outlook. Nevertheless, the enormous volatility in the region's currency market had markedly affected the zloty, as investors found it very hard to exit some markets, such as the Baltic states and Romania, but they could still get prices in the Polish markets. In our view, it is likely that the zloty will remain under pressure as long as investors' sentiment toward the CEE markets remains negative.

The Polish authorities have taken several measures to raise market confidence and ease the strains in the money markets. Namely, the NBP established a temporary EUR/CHF swap agreement to provide the CHF liquidity needed in the Polish interbank market. Moreover, it agreed a €10bn facility with the European Central Bank to secure EUR liquidity for the Swiss francs. Additionally, in late November the government has introduced a €24.3bn stimulus package in an effort to boost investment.

The challenge now facing the Monetary Policy Council is that of slowing economic growth combined with zloty depreciation. Real GDP growth in Q3-08 stood at 4.8% yoy, but the outlook has deteriorated in recent months suggesting that the real growth rate for 2009 will not exceed 3.0% yoy.

A serious danger facing Poland is that of further zloty depreciation. Banks in the country may have limited foreign currency exposure but households have borrowed heavily in foreign currencies, especially in Swiss franc. (Table)

Table

Poland	2007	2008	2009
Real GDP growth	6.6	5.0	2.8
Inflation (annual average)	2.5	4.2	3.0
Current account balance (% of GDP)	-4.5	-5.0	-3.5

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

Political Environment

The US-Polish missile deal was spurred by the Russian-Georgian crisis. Negotiations over the installation of an antiballistic system in Poland have been going on for at least 18 months dating back to the

former government. Under the proposed agreement, the US was to base 10 interceptor missiles in Poland. The defence shield is designed to neutralize ballistic missiles targeted at the US or Europe. The outbreak of the Georgian crisis has acted as a catalyst persuading both parties to strike a final deal. In exchange for Polish consent to the US plan, Poland will be provided with a permanent Patriot battery - which will nonetheless remain under US command – and it will be accompanied by a bilateral defence agreement.

Tension between the President and the Prime Minister persists, notwithstanding their recent agreement over the missile defence system. President Kaczynski is sceptical about the euro-adoption timetable. Prime Minister Tusk argued that Eurozone membership will help to protect Poland from destabilising financial shocks. In late October, the government published its “road map” setting out measures that are necessary to be taken in the first half of 2009 if Poland is to adopt the euro in 2012. However, in order to adopt the euro, the Polish constitution has to change. As the government does not have the needed majority, it announced that, if necessary, it will schedule a referendum on euro-adoption. If taken, the referendum will, most likely, be held in June 2009.

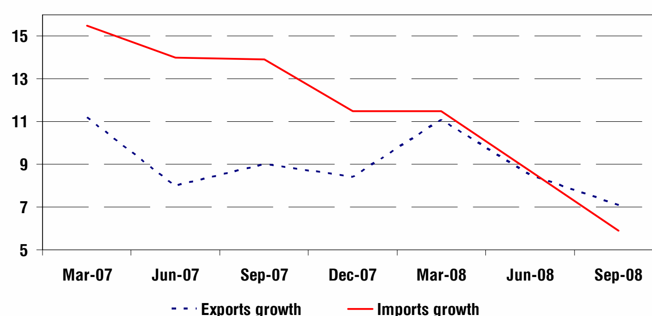
Growth Performance

In the third quarter of 2008, GDP grew by 4.8% yoy, beating the consensus for 4.6%. However, the relatively strong headline GDP figure masks some worrying underlying developments. In particular, fixed investment growth collapsed from 15.2% yoy in Q2 to just 3.5% yoy in Q3. This is mainly attributed to weaker construction growth, which fell to 11% yoy from 17.8% yoy in Q2. But business investment also appears to have fallen sharply as tougher credit conditions and turmoil in the global economy start to weigh on Polish firms. On the positive side, private consumption -the main driver of Polish growth- slowed slightly to 5.1% in the third quarter. Private consumption growth is likely to hold up better than investment growth on the back of rising real wages and tax cuts. Nonetheless, consumers are facing tighter lending conditions and they are still being squeezed by the lagged effects of rate hikes earlier this year. Thus, real incomes are likely to come under pressure despite a drop in inflation. As a result, household consumption is widely anticipated to slow sharply in 2009.

Net exports made a positive contribution to GDP for the first time in well over two years. However, this was due to a sharp drop in import growth. (Figure 1)

Figure 1

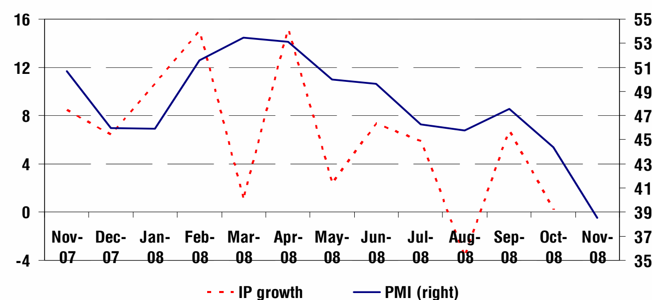
Exports-Imports growth



According to November data, Polish industrial production growth experienced a sharp contraction by 8.9% yoy, compared to 0.1% yoy in October. The decline was broad-based. Considering also the recent sharp drop in the manufacturing PMI, the industrial production slowdown reflects a further substantial weakening in the sector over the coming quarters. (Figure 2)

Figure 2

Industrial Production growth



Public Finances

According to EU Membership Convergence Program, Poland had to comply with the Maastricht criterion, which calls for a low fiscal deficit (under 3% of GDP). Poland has fulfilled this criterion and is no longer subjected to the EU excessive deficit procedure since July. Still, a series of decisive fiscal challenges remain to be tackled by the Polish policy makers. These challenges include the government’s commitment to reduce personal income taxes in 2009; an increase in public sector wages; social healthcare and early retirement reforms; the farmers’ pension system; a sufficient progress in infrastructure projects; privatisation of state-owned

companies; enhanced EU-funds absorption and the minimisation of bureaucracy.

Rather optimistically, the Ministry of Finance set a target for the budget deficit in the area of 18.2bn PLN for 2009 (this corresponds to 2/3 of the target deficit expected in the 2008 budget and to 2.1% of GDP). The 2009 budget was sent to the parliament for approval in late September. Although the outlook has changed since then, the government has not revised the 2009 budget so far. This budget was prepared on the assumptions that GDP growth will be 5% in 2009 and that CPI will increase by 2.9%. This low inflation assumption keeps expenditure for wages at lower than planned levels, while revenue collection increases in line with the –higher– actual inflation rate. Definitely, the former assumption on economic activity is overly optimistic under current circumstances. A revision of the GDP growth rate to 3% in 2009 will reduce significantly the tax revenues. Thus, it seems rather improbable that the projected general government deficit of 2.1% of GDP for 2009 will be met. The EU Council recommendation to Poland was to introduce specific measures which would restrict spending. Hence, the Polish government will be able to meet its commitment to bring down the structural deficit to 1% of GDP by 2011.

Box 1: EU-funds and privatisation program

EU-funds are expected to reach the amount of 70bn €in 2007-2013 and the government anticipates the absorption rate to exceed 70%. Despite high aspirations, EU-fund receipts, in the first semester of 2008, comprised less than 1/4 of the planned total for the whole year. An ambitious privatisation program has been inaugurated by the ministry of Treasury with an implementation schedule spanning the years 2008-2011. Revenues from the proposed privatisation scheme are expected to exceed 20bn PLN. Contrary to such expectations, only 10% of the yearly assets target was sold in the first semester of this year. A major factor contributing to the slowing down of the privatisation tempo has been the domestic stock market's poor performance. Stock market experienced a 40% fall since the beginning of 2008. This development has been seen as an inauspicious precursor to privatisations and discouraged other government plans to float companies which had earlier been earmarked for privatisation.

Balance of payments

The current account deficit has widened since the end of 2007, when it stood at 4.5% of GDP. In the three quarters of 2008, the overall current account deficit increased to 14227mn EUR compared to 8287mn EUR in the same period for 2007. In Q3-08 the current account deficit stood at 5.1% of GDP but as growth is expected to slowdown, we foresee a current account deficit for the whole 2008 not to exceed the level of 5% of GDP and to fall further at 3.5% of GDP in 2009. October's data suggest that the deficit widening is driven by a steady increase of trade deficit and a decelerating income deficit.

Parallel to the current account deficit widening, an inward FDI slowdown combined with a sharp growth in outward FDI has been observed the first semester of this year. This may result to an overall fall in the net FDI inflows cover ratio of the current account deficit for the year 2008. During the first ten months of 2008 the net FDI inflows covered only the 42.6% of the current account deficit, compared to 96.7% coverage at the same period in 2007.

Box 2: Polish exports structure

Despite fears of a negative impact on Polish exports generated from this year's strong zloty appreciation, a growth of 9.8% in exports value in PLN was observed in the first semester of 2008. The volume of exports also grew by 11.8%, in the first semester of 2008. At first sight, the increase of Polish exports seems incongruous with the strengthening of zloty, the rising unit labor costs and the significant economic activity deterioration attested for most of Poland's trade partners (especially Germany). This seemingly contradictory situation can be explained taking into consideration the structure of Polish exports. These latter originate mainly from foreign owned companies and are heavily attributed to intra-corporate trade. This type of trade is not strongly affected by exchange rate fluctuations since parent companies hedge themselves against currency risks. Positive export performance is further reinforced by the fact that -according to a NBP survey- 44% of exporting companies reduced their profit margins in an effort to remain competitive.

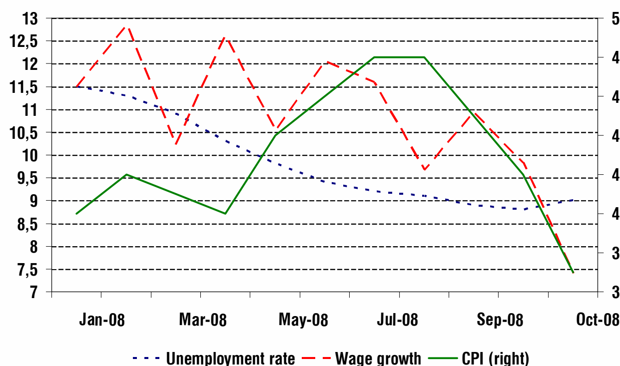
Inflation – Monetary Policy

Since October, Poland does not fulfil the Maastricht criterion on inflation. Measured by the EU's harmonised index, Polish inflation stood at 4.3% in November. This figure is greater than this month's maximum allowed of 4.1%. However, the November's headline inflation reading stood at 3.7% yoy after having peaked at 4.8% yoy in August. A worrying fact is that despite the drop in headline inflation, the core inflation is still slightly rising. The increase in regulated prices scheduled for January 2009 will also affect inflation. Low EU carbon dioxide emissions limits for 2008-2012 will result to a further rise in energy prices and will have an additional impact on inflation. Nevertheless, due to the deteriorating economic environment, inflation is expected to slow further to 3% on average in 2009.

The slowdown in the Polish economy is also beginning to affect the labour market. Growth in average corporate wages stood at 7.4% in November, compared to 10.9% yoy in September reading. For the first time since the beginning of 2008, the unemployment rate has slightly accelerated. It stood at 9.1% in November from 8.8% in October. (Figure 3)

Figure 3

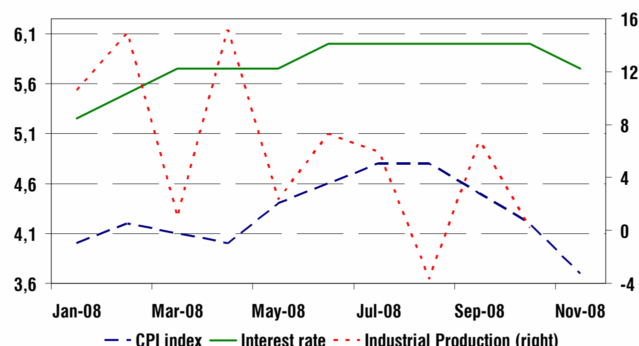
Wages - Inflation - Unemployment



The challenge facing the MPC is that of slowing economic growth combined with zloty depreciation. The November data of an 8.9% yoy drop on industrial production undoubtedly reflected a substantial economic growth slowdown. Thus, the December's MPC decision to cut interest rate was widely anticipated. However, the scale of the cut by 75bps came as a surprise. It was not expected the National Bank of Poland (NBP) to ease its monetary policy very aggressively because of the latest weakening of the zloty. Recent interest rate cuts in Hungary and Czech Republic, combined with the European Central Bank monetary policy easing, led the NBP to set the reference rate to 5%. Nevertheless, hawkish MPC members were concerned about the rise in core inflation despite the drop in headline inflation measure. But the growth outlook has deteriorated to such extent that inflation is no longer the major concern. The upshot is that further rate cuts are likely. We foresee rates to fall even below 4% during the current monetary easing cycle. (Figure 4)

Figure 4

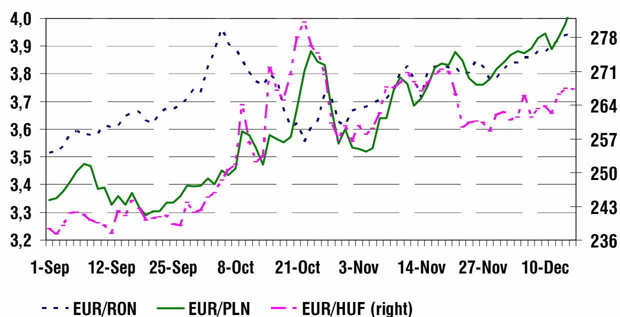
Inflation - Interest rate - Production



The escalation of the crisis in October and its spread to Central Eastern Europe (CEE) had a significant impact on the Polish financial markets and led to the zloty depreciation. In fact, the zloty has been one of the worst performing currencies in the CEE. Polish markets are affected by nervous sentiment concerning the region. There is a serious lack of liquidity in the other CEE currencies, i.e. investors are trying to exit the CEE currencies but the only currency liquid enough to exit (to short) is the zloty. Another reason for zloty devaluation may be that other currencies have benefited from an agreement with the IMF (like the Hungarian forint). In addition, the NBP has not intervened to support the zloty (as in the case of Romanian leva). In our view, it is likely that the zloty will remain under pressure as long as investors' sentiment toward the CEE markets remains negative. (Figure 5)

Figure 5

Exchange rates in CEE

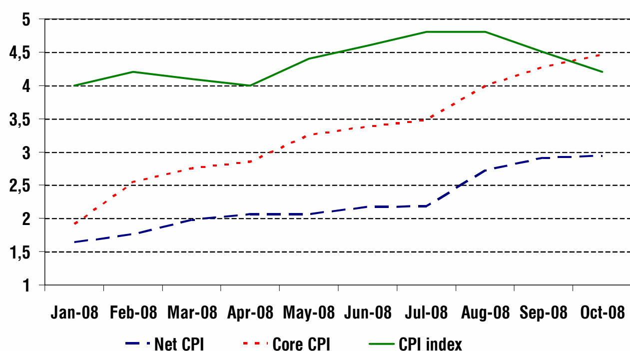


Box 3: New core inflation measure

Hikes in gas and electricity regulated prices in late April, have clearly been affecting inflation readings since May. This forced NBP to introduce a new core inflation measure which excludes food and energy prices – the previous one excluded only food and fuel prices. Through its new measure, NBP hopes to achieve more tangible results in exercising monetary policy. According to the former measure, November's core inflation is 4.7% yoy (vs. 2.8% yoy in April), whereas with the new measure, net inflation stands at 2.9% yoy for the same period (vs. 2.1% yoy in April). However, headline inflation dropped to 3.7% yoy in November. (Figure 6)

Figure 6

Measures of Inflation



Banking Developments

According to the Financial Supervision Commission (KNF), the Polish banking sector is as yet not facing any liquidity problems. Nevertheless, banks are finding it increasingly difficult to borrow money, especially in CHF, suffering from the collapse of interbank trust. In order to boost confidence, the NBP has expanded the range of monetary policy instruments it uses. This so-called "Confidence Pact" includes foreign exchange swap (FX swap) transaction in EUR and USD, as of October 17. The NBP signed to the same effect an agreement with the Swiss National Bank (SNB), establishing a temporary EUR/CHF swap arrangement. This agreement implemented on the 17th of November and will remain in force at least until January 2009. It is expected to provide the CHF liquidity needed in the Polish interbank market. In order to secure EUR liquidity for the Swiss francs, the NBP agreed a €10bn facility with the European Central Bank. This is intended to be an aid and it does not necessarily constitute an indication of forthcoming stresses in the balance of payments (as is the case of Hungary). Further measures aimed at bolstering financial stability are in the pipeline. A draft law concerning state treasury guarantees for financial institutions has already been approved. Such guarantees are envisaged to reach 50% of the outstanding debt and will apply only to safe and strong banks. In addition, the scope of 100% guarantee for individual bank deposits has been increased to EUR 50.000.

The current adverse international economic and financial environment has started to take its toll on the Polish economy. The enormous volatility in the region's currency market (particularly in Hungary) has markedly affected the zloty. During the past two months the earlier rising trend has been reversed. In view of this development Standard & Poor's Ratings Services have revised their outlook on the long-term foreign currency sovereign credit rating on Poland. The present outlook has been downgraded from positive to stable.

On the positive side, credit growth in Poland has never reached such high levels that would require the sale of complicated financial instruments. The prevalent traditional model of banking, which does not include investment banks, turned out to be in favor of the country's economy. Poland has been spared the effects of issuing risky securities. Furthermore, credit growth has lagged behind that of other CEE countries, reducing susceptibility to the global credit crunch.

A serious danger facing the Polish banking sector is that of further zloty depreciation. At Q3-08, 25% of total banking loans were denominated in FX. Even though this percentage can be regarded as

low when compared to regional standards, there is a growing share of mortgage loans denominated in FX (they stood at 59% of total mortgages in Q3-08). Banks in Poland may have limited foreign currency exposure, but households have borrowed heavily in foreign currencies, especially in Swiss franc. Therefore, the Polish banking system has swapped its foreign exchange risk for credit risk through the unhedged foreign exchange risk assumed by its domestic non-bank private sector. The NBP does not have the resources to refinance foreign currency exposure of the domestic private sector. Hence, if the zloty depreciation continues, it will cause both refinancing (liquidity risk) and solvency risks.

Another source of concern is the cross-border exposures of international banks active in Poland. The overall foreign ownership of the Polish banking sector stands at 66%. About 24% of Poland's exposure to Western European reporting banks is owed to Italian banks and 21% to German banks. These facts create new channels of contagion.

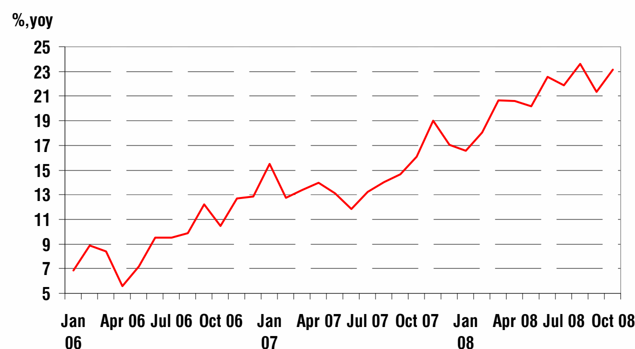
However, Polish banks are well capitalized, with the Capital-to-Assets ratio reaching 7.2 in Q3-08. Banks in Poland are not as dependent on foreign financing as is the case with countries in the region. Credit expansion in mainly financed by domestic deposits. All in all, the Polish banking sector has remained sound in the first three quarters of 2008 with high profitability levels.

In view of the increasing uncertainty related to the future economic situation, Polish banks tightened the standards for granting loans. The most severe tightening measures are recorded in long-term credit destined for large corporations. Regarding mortgage loans, the banks further raised their loan spreads, increased non-interest loan costs and lowered the maximum loan-to-value ratio. As for consumer credit, there has been a significant rise in loan commissions in both regular and riskier loans.

Poland is the 6th largest EU market in terms of population but the 2nd smallest in terms of banking assets penetration to GDP. This is a clear indication of the massive Polish banking sector potential. Total assets to GDP ratio reached the level of 87.9% in Q3-08 from 83.8% in Q2-08. In October total assets stood at 1098.5bn PLN increased by 23.2% yoy. (Figure 7)

Figure 7

Growth in Total Assets

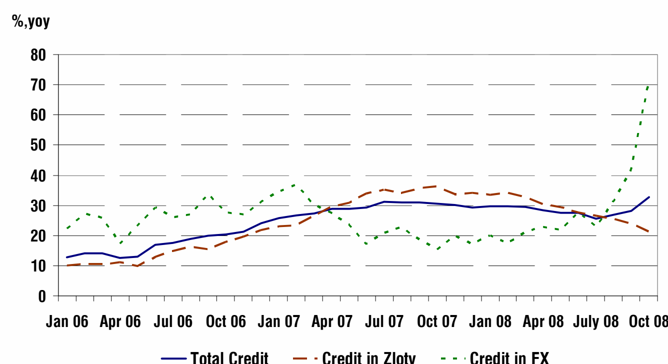


Credit developments

Total credit growth stood at 32.8% yoy in October compared to 26.9% yoy in Q3-08. This acceleration comes from loans denominated in FX (71% yoy growth in October compared to 32.1% yoy growth in Q3-08), while total loans denominated in zloty decelerated (21.2% yoy growth in October compared to 25.2% yoy growth in Q3-08). This twofold trend in loans reflects the impact of zloty's strong appreciation between January and September 2008. The increasing share of loans indexed in FX exposes unhedged borrowers to FX risk in addition to the cost born already from the zloty's depreciation since October. (Figure 8)

Figure 8

Growth in Total Credit



Corporate loans grew by 26.5% yoy in October following a 24.3% yoy growth in Q3-08. The growth of demand for corporate loans is related to the increasing financing needs for enterprises' fixed investment, inventories and working capital. The rapid wage growth is a further contributing factor, as the enterprises need to invest more in an attempt to compensate for increasing labor costs.

Mortgage loans are the main driving force behind credit growth as they amount to approximately 52% of retail loans and their penetration level to GDP reached 14.2% in Q3-08 compared to 11.6% in Q2-08. In October a growth of 55.2% yoy was recorded against 36.6% yoy in Q3-08. Changes in the structure of household expenditure and an increase in household income were the prime causes behind growing demand for housing loans. Evidence suggests a fairly resilient mortgage market with a particularly strong growth in FX mortgages. Housing loans denominated in FX grew by 88.4% yoy in October compared to 44% yoy in Q3-08. The renewed popularity of CHF mortgage loans among Polish borrowers is driven by a rising interest rate differential with PLN rates. This came about following interest rate increases and further expectations of zloty strengthening. From a borrower's point of view, the 2.5-3% interest rate difference compensates for the additional costs of the bid-ask FX spread charged by banks and provides additional opportunities to bet on appreciating PLN. Banks charge 2-3 times higher spreads in CHF loans as the lower reference rate gives them enhanced pricing power while they generate additional FX income on the bid-ask spread. (Figure 9, 10)

Figure 9

Components of Credit growth

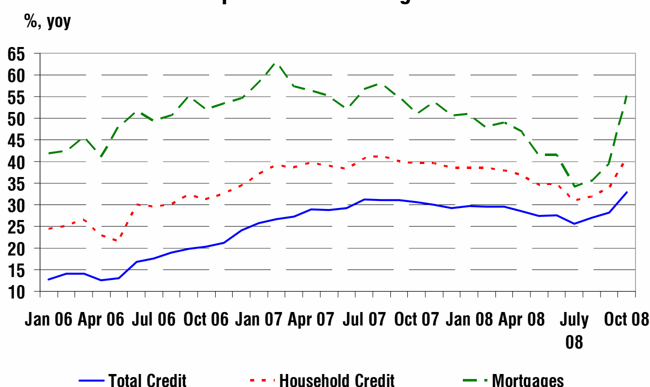
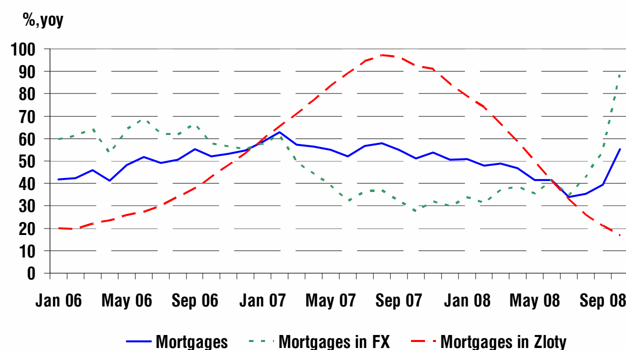


Figure 10

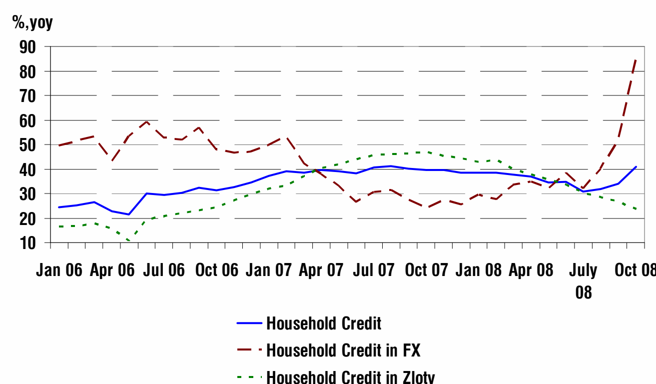
Mortgage Growth



Credit to households represented 27.3% of GDP in Q3-08 compared to 24.1% in Q2-08. An improvement in the financial standing of households and an increase in financing needs for the purchases of durable goods are two of the prime reasons behind household loans growth. Consumer loans grew by 40.9% yoy in October against 32.2% yoy in Q3-08. Although, according to October data, 63% of consumer loans are denominated in zloty, a stronger growth in FX indexed household loans was observed, they grew by 84.3% yoy. This trend may have been fuelled by the strong zloty's appreciation recorded in July. A disquieting conclusion comes from a survey reporting that the number of individuals spending more than they earn has increased by 1/5 during the past three months. Households strive to improve their living standards and are prepared to stretch their balance sheet positions. Over 20% of Poles spend 55% of their income to meet their loan obligations. In case zloty undergoes further depreciation, many Poles will find themselves under great strain to pay off their bank liabilities and debts. (Figure 11)

Figure 11

Household Credit Growth



Deposit Developments

Total deposits grew by 17.7% yoy in October compared to 18.6% yoy in Q3-08. This downward trend is fuelled by household deposits which grew by 22% yoy in October against 23.3% yoy in Q3-08. In addition, corporate deposits have decelerated, from 5.8% yoy in Q3-08 to 3.8% yoy in October. The Loan-to-Deposit ratio stood at 111.2% in October compared to 103.2% in Q3-08. Nonetheless, the Polish banking sector remains well capitalized with a Capital Adequacy Ratio of 10-13%. (Figure 12, 13)

Figure 12

Total Deposits Growth

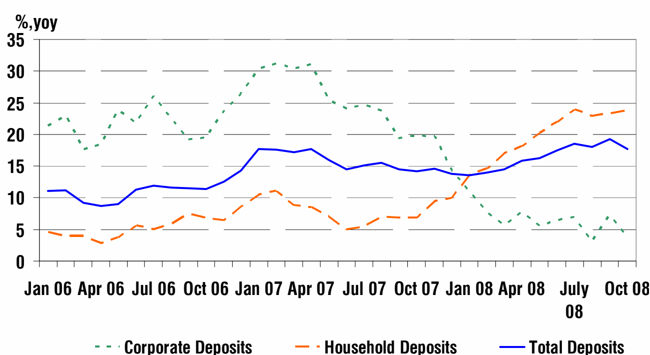
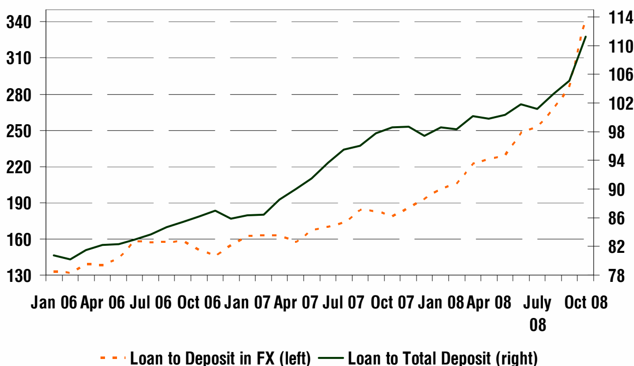


Figure 13

Loan to Deposits Ratio



Banking Sector's Profitability and Capital Adequacy

The Polish banks net earnings increased by 20.7% during the first nine months of 2008 in relation to the first three quarters of 2007. Their net earnings reached 12.7bn PLN.

Banks profits in the third quarter were largely generated by net interest income which contributed with 60%, fee revenue with 23%, while FX income with 12.5%. It should be noted that interest revenues grew by 54.5% in Q3-08 while FX income increased by 78.7% in the third quarter. The return on equity ratio (ROE) in Poland's banking sector fell to 26% in Q3-08 compared to 26.8% in H1-08. However, it is still at high level which explains why many foreign players consider Poland as one of Europe's most promising markets.

The Capital Adequacy Ratio dropped to 11% in Q3-08 – still above the 8% threshold- compared to 12.1% in Q4-07. This decrease is largely attributed to incorporation of operational risk in Basel II implementation since the beginning of 2008.

Poland: MacroEconomic Indicators								
	2003	2004	2005	2006	2007	Q2 2007	Q2 2008	Q3 2008
Output and expenditure	*(Percentage Change in Real Terms)*							
GDP	3.9	5.3	3.6	6.2	6.6	6.5	5.8	4.8
Private consumption	2.2	4.8	2.1	5.0	5.0	4.9	5.6	5.1
Public consumption	4.9	3.2	5.2	6.1	5.8	6.4	-1.2	0.0
Gross fixed capital formation	-0.1	6.4	6.5	15.6	20.4	19.0	15.2	3.5
Exports of goods and services	14.0	14.3	7.8	15.0	8.5	7.2	7.4	7.1
Imports of goods and services	9.6	16.3	4.7	17.6	12.4	13.6	8.2	5.9
Industrial production	8.8	12.7	4.1	12.0	9.6	8.7	8.2	3.1
Labour Market								
Employment	-1.0	0.9	2.3	3.6	4.3	4.8	3.5	-
Unemployment (in per cent of labor force)	19.9	19.5	18.2	16.2	12.7	12.9	9,8	9.1
Prices	*(Percentage Change)*							
Consumer prices (annual average)	0.8	3.5	2.1	1.0	2.5	2.4	4.3	4.7
Producer prices (annual average)	2.6	7.0	0.7	2.3	2.3	2.0	2.5	2.1
Average monthly wage in economy	3.2	4.9	4.0	4.9	8.7	8.9	11.6	9.8
Government sector	*(In Per Cent of GDP)*							
General government balance (ESA95)	-4.7	-3.9	-2.5	-3.9	-3.0	–	–	-
General gross government debt (ESA95)	43.9	41.8	41.9	47.8	46.8	–	–	-
Monetary and Financial Indicators	*(Percentage Change)*							
M3	2.4	7.6	13.2	12.7	15.8	16.2	15.5	16.9
Total Credit	8.6	2.7	12.4	24.2	29.2	29.3	27.6	28.2
	(End of Period)							
Reference Rate	5.25	6.50	4.50	4.00	5.00	4.50	6.00	5.75
Exchange rate Zloty/USD (end-period)	3.74	3.00	3.26	2.90	2.46	2.78	2.12	2.40
Exchange rate Zloty/EUR (end-period)	4.72	4.07	3.85	3.82	3.60	3.76	3.35	3.39
Real Effective Exhange Rate (Index)	96.32	96.22	107.47	109.85	114.14	113.85	130.37	131.70
International Position	*(In Per Cent of GDP)*							
Current account balance	-2.1	-4.0	-1.2	-2.7	-4.7	-3.9	-4.9	-5.0
Trade balance	-2.7	-2.2	-0.9	-2.0	-3.7	-3.1	-4.0	-4.1
Foreign direct investment. net	2.0	4.7	2.3	3.0	3.6	3.4	3.3	2.8
Memorandum items	*(Denominations as Indicated)*							
Population (end-year. thousand)	38195	38180	38161	38129	38108	–	–	-
GDP (in Mrd of EUR)	191.6	204.2	244.4	271.5	304.9	–	–	-
GDP per capita (in EUR)	5016.4	5348.3	6404.4	7120.6	8000.9	–	–	-

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

Poland: Banking Indicators						
	2004	2005	2006	2007	Q2 2007	Q2 2008
Percentage of GDP (%)						
Assets	68.4	70.2	73.8	78.8	74.6	83.2
Total Credit	27.2	28.7	33.1	38.8	36.2	42.4
Total Credit in FX	6.3	7.2	8.7	9.3	8.9	10.3
Credit to Enterprises	12.6	12.1	12.9	14.4	13.9	15.8
Credit to Enterprises in FX	3.1	2.8	2.9	2.7	2.7	2.7
Credit to Households	11.9	13.9	17.3	21.8	19.5	24.1
Credit to Household in FX	2.9	4.0	5.5	6.2	5.8	7.3
Mortgages	4.0	5.3	7.7	10.5	9.0	11.6
Deposits	34.9	36.3	38.5	39.9	38.6	42.0
Deposits in FX	5.0	5.4	5.7	4.8	5.2	4.1
Percentage Change (%, yoy)						
Assets	4.4	9.0	12.8	18.1	11.8	22.6
Total Credit	2.7	12.3	24.1	29.2	29.3	27.6
Total Credit in FX	-21.1	20.6	31.3	17.2	17.1	27.8
Credit to Enterprises	-3.7	2.6	14.5	23.0	21.9	24.2
Credit to Enterprises in FX	-27.7	-2.4	9.5	5.5	2.1	12.9
Credit to Households	11.7	24.0	34.5	38.4	38.2	34.9
Credit to Household in FX	-9.2	48.4	47.1	25.6	26.4	38.4
Mortgages	21.1	40.5	54.6	50.6	52.1	41.5
Deposits	6.4	10.4	14.3	13.8	14.5	17.5
Deposits in FX	-5.5	15.9	11.9	-6.3	9.1	-12.4
Percent (%)						
Capital Adequacy Ratio	15.5	14.5	13.2	12.1	12.4	10.9
Capital to Assets	8.0	7.8	7.5	7.8	7.6	7.4
NPLs to Total Loans	14.4	11.0	7.0	5.1	6.1	4.6
Provisions to NPLs	61.3	61.6	57.8	–	–	–
Return on Assets	1.4	1.6	1.8	1.7	1.0	1.0
Return on Equity	17.2	20.6	22.5	22.5	27.5	27.3

Sources: NBP, IMF

2. Romania

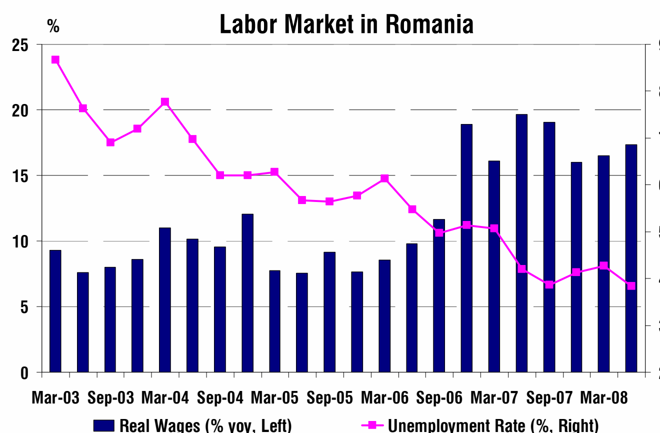
Economy in a highly vulnerable position

- **Economic activity will slow significantly in 2009 on weaker investment outlays, lower capital inflows and an unfavorable external environment**
- **The twin deficits put the economy at a highly vulnerable position: the current account deficit is set to remain at the high level of 13.5% of GDP and the public spending increase ahead of the parliamentary elections in November will result in Romania breaching the 3% EU limit in 2008**
- **Positive base effects and a good agricultural production helped inflation to ease to 6.5% at the end of 2008, while weak domestic demand will push it further downwards in 2009**
- **The sovereign rating downgrade of the Romanian economy to below investment grade by two out of the three main rating agencies (Standard and Poors and Fitch) will increase the cost of external financing for both the private sector and the government**
- **The Central bank is expected to maintain interest rates at 10.25% until Q1-2009 because of (a) high uncertainty stemming from the financial crisis and (b) downside risks to the disinflation process persist**
- **The RON is expected to remain under significant depreciation pressure driven by international investors risk aversion but the high FX risk prompts the Central Bank to use FX reserves to intervene in case of an abrupt fall**
- **Credit expansion will decelerate sharply as banks reduce lending rates in line with the increased external financing costs, tighten lending standards.**
- **The Central bank reduced the minimum reserve requirement in RON in an attempt to address the banking sector appetite for liquidity**
- **The predominantly foreign-owned banking sector will be confronted with significant challenges as the asset quality is expected to deteriorate and parent bank financing will be scaled back**

Outlook

The Romanian economy showed signs of strong resilience in 2008. It expanded by 9.1% in the first nine months, above potential GDP growth. GDP growth is expected to average at 8.5% in 2008. Yet, it is hard to imagine how Romania will escape a GDP growth landing in 2009. Domestic demand has already started to slow in H2-2008. If it hadn't been for the strong rebound of agricultural sector that would have been reflected in the GDP growth rates. From a long term perspective, this is not necessarily bad. EFG Research sees GDP growth to decelerate at 2.7% in 2009 on weaker domestic demand. In the short term though, credit growth deceleration as a result of the tightening of credit conditions and more costly external financing will result in consumer appetite slowdown. Some fiscal tightening after the elections is expected to put a break on public spending. In addition, investment will show some signs of cooling off especially in the construction sector as a result of costlier financing and weaker external demand. For that reason, we expect that unemployment will start to rise again from the historically low levels while real wage growth should slow down because of the weaker economic activity. (Figure 1) (Table)

Figure 1



Table

Romania	2007	2008	2009
Real GDP growth	6.0	8.5	2.7
Inflation (annual average)	4.8	7.9	5.6
Current account balance (% of GDP)	-13.9	-13.5	-12.9

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

Political Environment

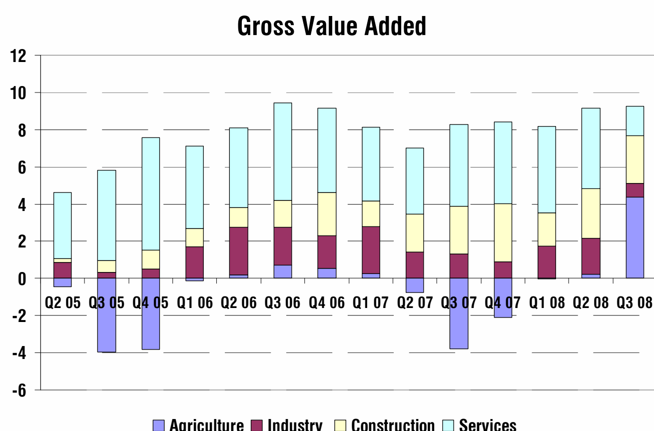
People's disappointment from politics led to a strikingly low turn-out in the parliamentary elections that took place on the 30th of November (40%). The elections, failed to form a government as no party won an absolute majority. The Democratic- Liberal Party (DLP) secured 115 seats in the 313-member lower house whereas the ex-communist Social Democrat Party (SDP) 114, marking a significant recovery compared to the previous elections outcome. The ruling National Liberal Party (NLP) came in third position with 65 seats. The new government, an unexpected government coalition between two politically opposite wings DLP (centre-right) and PSD (centre-left) is going to face significant challenges in the economy particularly with respect to fiscal policy. The incoming government will be forced to halt the overly expansionary fiscal policy in a year where this would be mostly needed. There is also a need to start pushing the reform agenda again. The latest European Commission report was very critical of the lack of sufficient progress in judicial reforms. If this trend continues, the probability of EU sanctions increases. As in the case of Bulgaria, restrictions could be imposed on access to EU funds.

Growth performance

Real GDP expanded at 9.1% yoy in Q3-2008 against 5.7% yoy in Q3-2007. Domestic demand was buoyant underpinned by continued strong consumption and investment figures. From the supply side, the agricultural output rebound gave a strong boost to GDP growth. Agriculture contributed 4.3 pps to GDP growth in Q3 2008. Total consumption maintained its momentum at 14.6% yoy in Q3-2008 driven by strong real wages growth and credit expansion. (Figure 2)

Figure 2

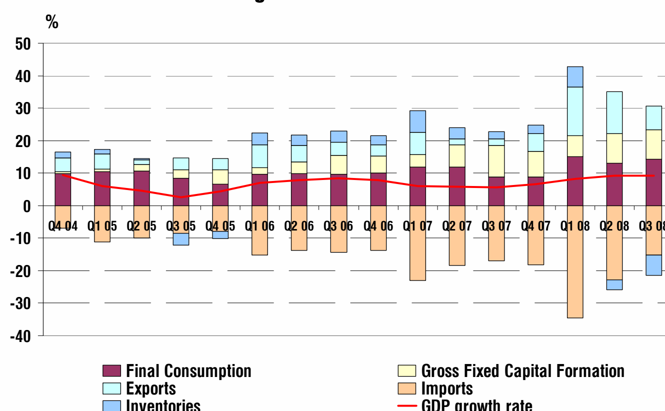
Gross Value Added



The ongoing construction boom led gross capital formation higher by 24% yoy in Q3-2008. Net exports contribution became less negative as exports recovered to 17.4% yoy in Q3-2008 against 4.8% yoy in Q3-2007. Imports growth decreased to 18.7% yoy in Q3-2008 compared to 24.7% yoy in Q3-2007. (Figure 3)

Figure 3

GDP growth drivers in Romania



Public Finance

The expanding government deficit is a major vulnerability of the Romanian economy. The outgoing government followed a pro cyclical fiscal policy which added to the overheating of the economy. In fact, the government increased public spending as it was expected in an election year, motivated by the higher nominal GDP increase in 2008. For that reason, the outgoing government brought forward to November the 20% pension increase scheduled for January 2009.

The approval of a 50% wage increase for teachers spurred similar demands in the public sector unions. The envisaged fiscal loosening resulted in Romania downgrade to sub investment grade. The government announced a public spending freeze in an attempt to boost market sentiment. This case is illustrative of the political struggle ahead of the elections. Bowing to pressures from unions and rival parties, the government recalled their earlier pre-electoral decision for a public spending freeze in 2009. More recently, in an attempt to pre-empt political and legal moves to raise teachers' salaries by 50%, the government agreed to increase teachers' wages by an average of 10% in 2009.

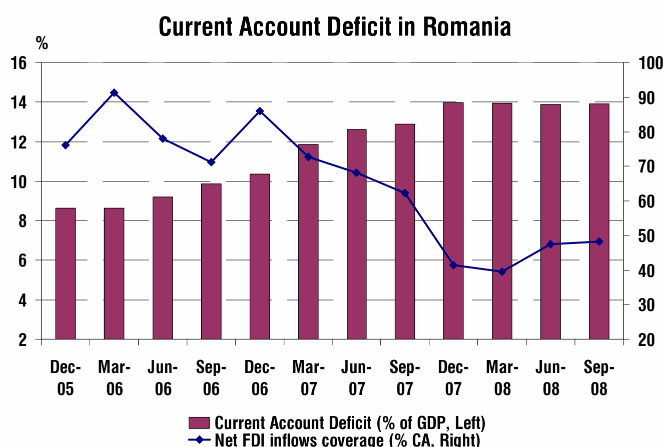
The increase in spending has made the probability of Romania breaching the 3% EU limit in 2008, almost a certainty.

In fact, the European Commission forecasts in the Autumn Forecasts that the general government deficit will reach 3.4% of GDP in 2008 and further widen to 4.1% in 2009.The consolidated government deficit reached 1.4% of projected GDP in Jan-Sep. This outcome is unfavorably compared to a 0.2% surplus at the same period last year. Although the released data are not compatible with ESA95 terms, it gives us a pretty good idea of further fiscal loosening. The path followed so far shows that the official 2.3% of GDP budget deficit target is unrealistic in any case.

Balance of Payments

The current account deficit shows signs of stabilization. It continues to expand, but at a slower pace than before. The pace of deterioration slowed down to 14.7% in the first nine months against 65.6% last year. Nevertheless, the current account deficit as a percentage of GDP remains large. It stood at 13.9% of GDP in Q3-2008 up from 12.9% in Q3-2008, but unchanged from the end of 2007. The trade balance dynamics improvement and the higher than expected nominal GDP growth were the main causes behind this development. Exports increased by 18%, faster than imports which grew by 15% in the first nine months. (Figure 4)

Figure 4



The RON depreciation last year kicked in, having a positive impact. In addition, higher fuel prices boosted "mineral" exports products. Imports growth has decelerated. Apart from a weaker RON, the change in imports methodology, and EU entry in 2007 can explain the weaker imports growth. In turn, the trade deficit has improved marginally to 14.3% of GDP in Q3-2008 against 14.5% in 2007.

The current account deficit is expected to remain large, but improve towards 13.5%, and certainly not exceed the 14% of GDP threshold by year end. Slowdown in exports is more or less unavoidable as the Euro area slowdown will unfold. On the other hand, demand from markets outside Euro area mainly Russia, Ukraine and Turkey who have boosted exports recovery are expected to slow down significantly as well. In addition relatively strong domestic demand will maintain imports growth robust. The current transfers' surplus is expected to decrease will not help offset the current account deficit. In addition, the increasing income deficit will have a negative impact on the current account deficit as a result of the profits repatriation.

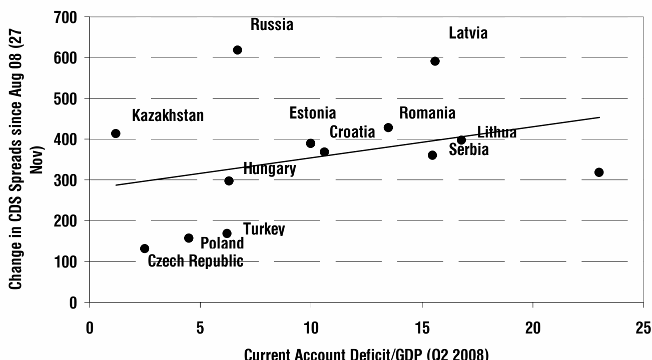
In terms of financing, there is small improvement in quality of financing, but external borrowing surges too. Romania is still an appealing destination for FDI inflows. Net FDI inflows reached 7.2 bn EUR in the first nine months of 2008. For that reason, the FDI coverage of the current account deficit has improved at 57.6% at the same period against 41.8% by 2007 year end.

On the other hand, the country indebtness increases rapidly. External borrowing reached 51% of GDP in June 2008 against only 39% in 2005. In absolute values this is two times higher than the level in 2005. More than two thirds of this debt is medium and long term denominated. The trend continued unabated so that medium and long term external debt increased by 42% yoy in Q3-2008. The debt inflows increased driven by private sector borrowing.

In contrast, government external public debt stood at only 7.7% of GDP. The deepening of the financial crisis has already increased the cost of financing. This is portrayed in the 5Y-CDS market. On top of that, the rating agencies downgrade to sub-investment grade will create an additional challenge for both the government and the private sector to borrow. (Figure 5)

Figure 5

CDS- Current Account Deficit/GDP

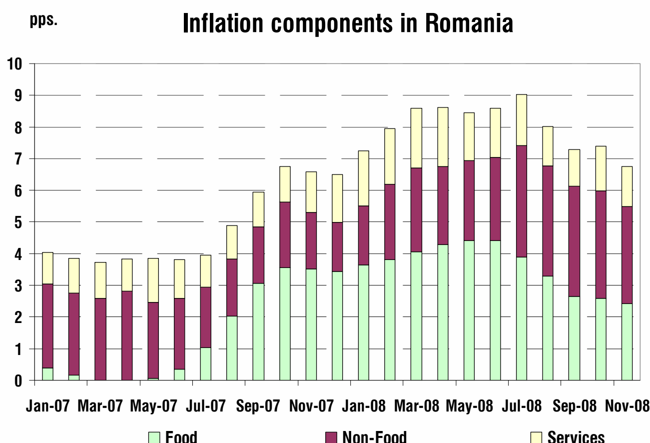


Inflation -Monetary Policy

Inflation came in at 6.7% in November down from 7.4% in October. The stronger than expected impact of the RON depreciation during the first half of October was the main reason behind the spike from 7.3% in September. The high degree of pass through in services weighs significantly on inflation. Notwithstanding the exchange rate, the evolution of inflation will be subject to any adjustment of administered energy prices. Moreover, the evolution of non-food prices and services proved that inflation had been rising not only on supply but also on demand side factors. The lax fiscal policies inflated domestic demand. (Figure 6)

Figure 6

Inflation components in Romania



Higher food prices after the poor agricultural performance last year were the main driver behind the inflation rally throughout 2008. The relatively big weight of food prices in the consumer basket-the highest in EU 27 (37.5%)-magnified that effect. The good news is that the share of food prices in the consumer basket should halve next year. The positive base effects and a good crop will push inflation towards 6.5% in 2008 after the 9% peak in July. The downward trend expected to continue throughout 2009 underpinned by weak domestic demand.

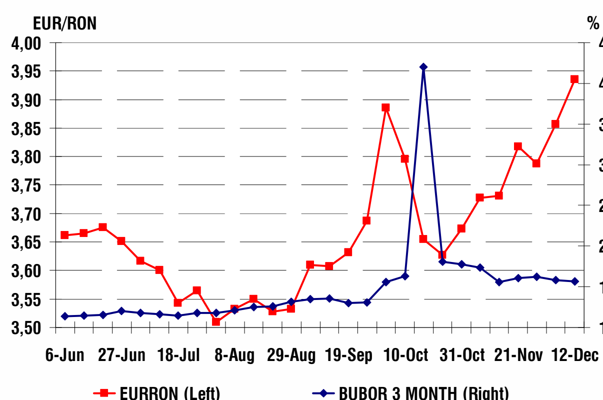
Interest rates were already hiked by a cumulative of 325 bps since last year to 10.25%. The Central Bank has communicated to the markets that monetary policy will remain tight. To that end, the inflation decline will result in monetary policy becoming more restrictive. In our view, monetary policy relaxing is highly unlikely before the first months in 2009. The inflation target band (2.8-4.8%) will be missed once more in 2008. In that direction, the Central Bank has revised their year end forecast at 6.7% for 2008 and at 4.5% for 2009 already. More importantly, the world financial crisis deterioration and the uncertainty with respect from its duration, compels policymakers to adopt a more cautious approach with respect to interest rates cuts.

Banking Developments

The banking sector in Romania demonstrated a relatively steady growth trend in the 9M-2008 despite the global credit crisis. Total assets grew by 35.7% yoy in September 2008, compared to 52.6% yoy a year earlier. The global credit crunch has had a limited impact so far on the banking sector. Nevertheless the risks have increased. Banks have to operate in a challenging new domestic and international environment. The banking sector has to overcome the constraints posed by the international financial crisis and the domestic environment. Money market rates soared during the recent crisis while RON came under severe pressure. (Figure 7)

Figure 7

FX & Money Market Rates in Romania



First of all, liquidity is a top issue for the banking sector. Romania ranks very high among the countries of New Europe in terms of liquidity risk. The loans to deposits ratio is the second highest in New Europe. Banks had to deal with a shortage of domestic deposits, especially in FX, but at the same time appetite for credit was strong. As a result, the domestic banking sector had to rely heavily on external funding to finance the credit expansion. Foreign banks subsidiaries control 90% of the total assets in Romania. Credit expansion has been based on domestic banks getting financing from their parent companies or the international financial markets. If the parent banks face liquidity shortages or annul their expansion plans, the impact would be significant. This turns our attention to the risk of an abrupt stop in lending, given the global credit squeeze.

Second, credit expansion has started to show signs of moderation. This reflects the increased external funding costs rather than lower appetite for credit. The monetary policy tightening had limited impact on credit growth so far. In fact, it induced consumers to turn to FX borrowing, in order to take advantage of the lower interest rates, at the expense of incurring FX risk in their balance sheets. In addition, minimum reserve requirements for local and foreign currency liabilities stood very high at 20% and 40% respectively. As a result, the Central Bank imposed new restrictions on lending to households.

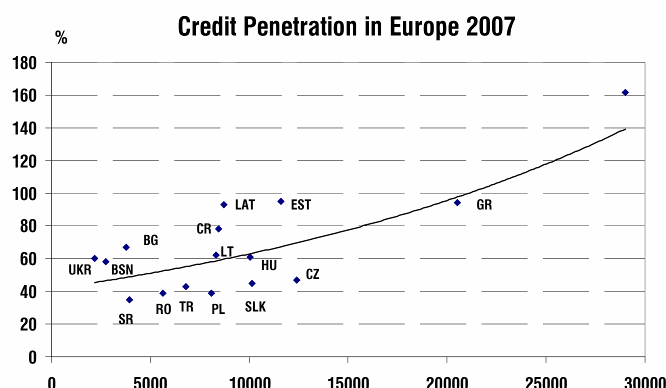
The restrictions aim to put a ceiling at the indebtness of individuals based on the demonstrated repayment capacity of borrowers. The regulations target the circumvention strategies of banks and any further credit expansion at the expense of significant credit quality deterioration. The adoption of the restriction measures will have a negative impact on credit growth. According to the NBR's expectations, the household component of the credit growth rate will decline significantly (10-12 pps) until the end of the year.

Although credit expansion has been strong in recent years, credit penetration in Romania recorded an upward trend, but it continued to be relatively low. Thus, total credit as a percentage of GDP stood at 43.5% in Q3 2008, up from 36.3% in Q3 2007. (Figure 8)

Equally, financial intermediation is still low in Romania. Total assets as a percentage of GDP stood at 67.7% in Q2 2008. This figure is the second lowest among New Europe countries-only Ukraine's ratio stands at lower levels.

Figure 8

Credit Penetration in Europe 2007

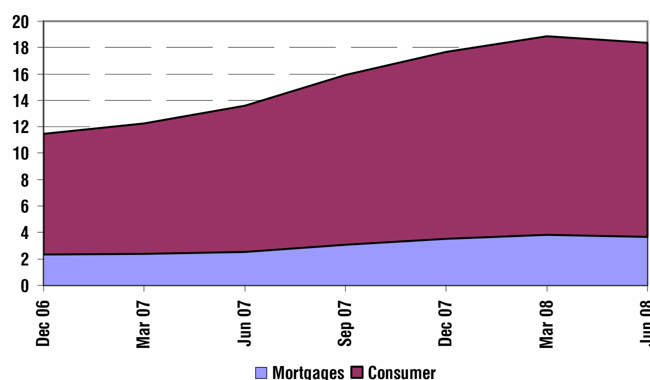


Credit Developments

Credit expansion showed signs of visible moderation in the first nine months. Total credit increased by 49.4% yoy in Q3 2008, as opposed to 56.7% yoy a year earlier. After reaching a peak at 66.6% yoy in February, credit growth started to moderate. Credit growth slipped to 49.4% yoy in September. FX-denominated loans are still the main driver of credit expansion. Higher RON interest rates induce consumers and corporates to borrow in FX. FX lending growth remained very strong at 63.9% yoy in Sep 2008, against 66.2% yoy a year earlier. Credit growth in RON slowed further to 36.2% yoy in Sep 2008, as opposed to 40.9% yoy in Sep 2007. (Figure 9)

Figure 9

Household Credit Decomposition (%GDP)

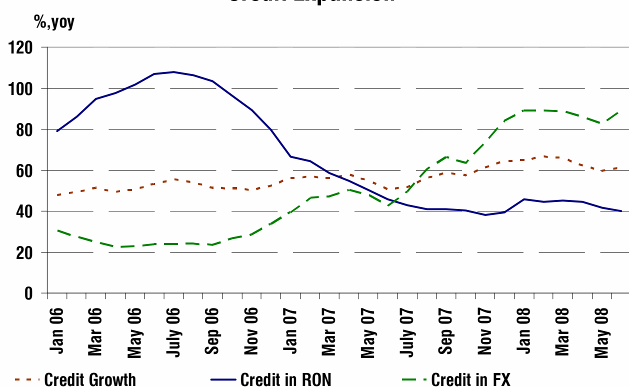


Households' credit growth slowed to 58.8% yoy in September 2008, compared to 68.9% yoy a year earlier, but stepped down to 67.1%

in July. The vast majority of this credit stock is consumer loans. (Figure 10) Mortgage growth is significant (64.3% yoy in September) because mortgage penetration is still very low. The increase in domestic interest rates had a negative influence on household credit growth in local currency. Thus, credit to households in RON increased by 32.3% yoy in Q3, down from 44.6% yoy a year earlier. Household credit in FX reached 86.7% yoy, against 105.2% yoy a year earlier.

Figure 10

Credit Expansion



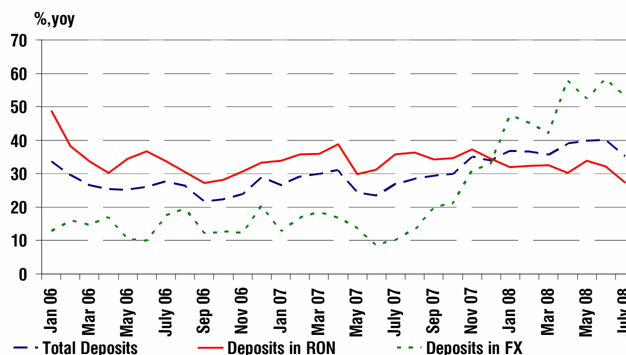
Corporate credit growth recorded a trend proportional to that of households. Credit to enterprises increased by 43% yoy in Q3, unchanged from one year ago. Nevertheless corporates turn to FX borrowing incurring significant exchange rate risk. FX corporate lending grew by 47.3% yoy in Sep 2008, compared to 45.7% yoy in Sep 2007. Credit to enterprises in RON decreased to 38.1% yoy, as opposed to 39.9% in June 2007.

Deposits Developments

The market has become highly competitive for deposits. Banks have turned their attention to attracting more deposits because of the difficulties in the international financial markets. Total deposits accelerated by 32.6% yoy in H1 2008, compared to 29.4% yoy in H1 2007. Deposit growth in FX, which grew by 45.2% yoy in Sep 2008, against 20% yoy in Sep 2007. Deposit growth in RON remained stable at 27% yoy in Q3 compared to 31.2% yoy a year earlier. (Figure 11)

Figure 11

Total Deposit Growth



Household deposits growth remained relatively stable overall at 38.5% yoy in Q3, against 49.1% yoy a year earlier. Household shifted deposits towards FX. Household deposit growth in RON decreased to 33.4% yoy in September 2008, compared to 52% in June 2007. In contrast, household deposits in FX doubled to 45.1% yoy in Q3, as opposed to 20% yoy a year earlier. Corporate deposits growth started to accelerate since June 2007. It increased to 27.6% yoy in Sep 2008, compared to 10.6% yoy last year. Corporate deposits in FX increased by 38.8% yoy in Q3, as opposed to -2.2% yoy a year earlier.

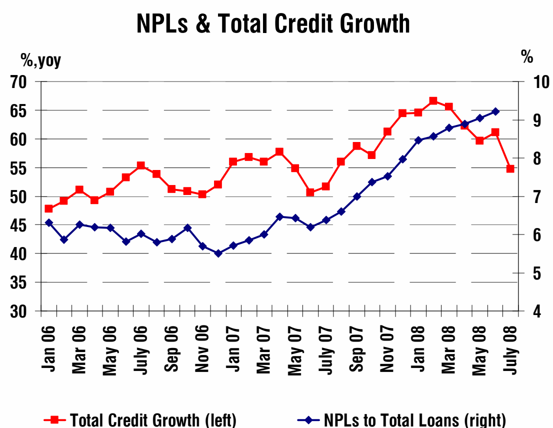
Total deposit growth didn't manage to keep up with total credit growth. Thus, the loan to deposit ratio reached 133.5% in June 2008, compared to 117.7% a year earlier. This ratio was one of the highest in the region in 1H 2008. The loan to deposit ratio in FX stood at 217.8% in Sep 2008, as opposed to 192.8% in Sep 2007.

Banking Sector's Profitability and Capital Adequacy

The Romanian banking sector recorded a significant profitability growth in 1H-2008. The main players reported over 40% yoy increase in profits. Thus, Return on Assets (ROA) increased to 1.6% in H1 2008, against 1% at end-2007. Return on Equity (ROE) reached 16% in H1 2008, compared to 9.4% at end-2007.

In our view, non performing loans (NPLs) represent a significant potential risk to financial stability in Romania. This is exacerbated by RON volatility. The NPLs ratio is on an upward trend since June 2007. It jumped to 9.2% in June 2008, compared to 6.2% a year earlier. (Figure 12)

Figure 12



The Romanian banking sector is characterized as well-capitalized. The Capital Adequacy Ratio (CAR) is well above the 8% EU-requirement. Hence, the CAR stood at 12.8% in June 2008, as opposed to 13.8% at end-2007. The Central Bank is not concerned that this is a negative development, but attributed this development to the rapid credit expansion.

Romania: Macroeconomic Indicators	2003	2004	2005	2006	2007	Q2 2007	Q2 2008	Q3 2008
Output and expenditure	*(Percentage Change in Real Terms)*							
GDP	5.2	8.5	4.2	7.9	6.0	5.7	9.3	9.1
Private consumption	8.4	14.6	9.9	12.4	11.0	11.5	12.2	14.6
Public consumption	7.7	-4.9	8.5	-3.1	5.6	10.2	4.1	4.9
Gross fixed capital formation	8.6	11.1	12.7	19.3	28.9	28.4	30.0	24.3
Exports of goods and services	8.4	13.9	7.7	10.6	8.7	3.5	26.9	17.4
Imports of goods and services	16.0	22.1	16.0	22.4	26.1	22.7	24.4	18.7
Industrial production (cumulative)	3.9	4.2	3.4	6.0	6.2	6.3	6.5	5.2
Labour Market								
Employment (% change)	0.3	0.8	2.6	1.3	2.8	2.8	2.0	1.8
Unemployment (in per cent of labor force)	7.6	6.8	5.8	5.4	4.3	4.2	3.8	3.8
Prices	*(Percentage Change)*							
Consumer prices (annual average)	15.3	11.9	9.0	6.6	4.8	3.8	8.6	8.1
Producer prices (annual average)	19.6	19.1	10.6	11.6	8.1	7.5	17.2	19.7
Average monthly wage in economy	25.4	22.5	23.7	16.8	21.0	22.1	24.2	24.8
Government sector	*(In Per Cent of GDP)*							
General government balance (National Definition)	-1.5	-1.2	-1.2	-2.2	-2.5	-0.7	-1.0	-1.4
General government debt	21.5	18.8	15.8	12.4	13.0	–	–	-
Monetary and Financial Indicators	*(Percentage Change)*							
M2	23.3	39.9	17.0	27.9	28.1	24.8	39.3	32.0
Total Credit	49.2	32.5	43.7	52.0	64.5	50.7	61.2	50.7
	(End of Period)							
Reference rate	18.90	20.20	9.70	8.45	7.50	7.25	9.75	10.25
Exchange rate USD/RON (end-period)	3.25	2.89	3.11	2.57	2.47	2.30	2.31	2.66
Exchange rate EUR/RON (end-period)	4.10	3.93	3.68	3.37	3.60	3.11	3.64	3.75
Real Effective Exhange Rate (Index)	99.08	101.60	119.83	128.90	140.52	141.52	136.26	144.70
International Position	*(In Per Cent of GDP)*							
Current account balance	-5.5	-8.4	-8.6	-10.4	-13.9	-12.6	-13.9	-13.9
Trade balance	-7.6	-8.7	-9.8	-12.0	-14.8	-14.3	-14.6	-14.4
Foreign direct investment. net	3.2	8.6	6.5	9.6	6.3	9.2	6.7	6.4
External debt	34.7	35.1	33.0	42.3	48.4	45.4	51.3	53.0
Memorandum items	*(Denominations as Indicated)*							
Population (end-year. thousand)	21742	21685	21634	21588	21523	–	–	-
GDP (in Mrd of EUR)	52.29	60.99	79.82	98.04	121.37	–	–	-
GDP per capita (in EUR)	2405.3	2812.7	3690.0	4541.7	5639.3	–	–	-

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

Romania: Banking Indicators						
	2004	2005	2006	2007	Q2 2007	Q2 2008
Percentage of GDP (%)						
Assets	37.1	45.2	51.2	65.8	58.9	66.8
Total Credit	17.8	21.9	28.0	39.0	32.6	42.6
Total Credit in FX	10.3	11.4	12.8	19.9	14.4	22.1
Credit to Enterprises	10.6	12.1	14.6	18.0	15.9	19.6
Credit to Enterprises in FX	7.1	7.1	7.6	10.0	8.0	10.5
Credit to Households	4.8	7.4	11.5	17.7	13.6	19.6
Credit to Household in FX	2.2	3.3	4.7	9.4	5.9	11.0
Deposits	23.1	26.0	28.2	31.9	27.8	31.7
Deposits in FX	13.6	17.0	9.1	10.2	8.4	10.8
Percentage Change (%, yoy)						
Assets	48.0	42.5	34.7	51.8	44.7	39.9
Total Credit	32.5	43.7	52.0	64.5	50.7	61.2
Total Credit in FX	–	29.1	33.7	84.0	42.6	89.3
Credit to Enterprises	29.2	32.5	43.0	46.4	38.9	51.8
Credit to Enterprises in FX	–	16.5	26.4	56.3	33.5	62.8
Credit to Households	58.3	80.0	83.8	82.1	62.4	77.4
Credit to Household in FX	–	72.8	71.8	134.4	77.6	131.5
Deposits	41.5	31.5	28.9	33.9	23.5	40.1
Deposits in FX	–	46.3	20.4	32.9	8.7	58.4
Percent (%)						
Capital Adequacy Ratio	20.6	21.1	18.1	13.8	15.0	12.8
Capital to Assets	8.9	9.2	8.6	7.3	8.2	7.0
NPLs to Total Loans	7.2	7.6	7.4	9.0	7.2	9.4
Provisions to NPLs	14.2	10.7	13.4	20.0	17.5	22.1
Return on Assets	2.1	1.6	1.3	1.0	1.5	1.6
Return on Equity	17.0	12.7	10.2	9.4	12.3	16.0

Sources: NBR, IMF

4. Serbia

Incurred problems amid financial crisis

- **A new pro-EU Serbian government has better prospects for political stability but fares significant challenges amid the deepening financial crisis.**
- **The Dinar lost 20% of its value in Aug-Nov, the stock market index plummeted to the lowest levels in its history and economic activity will halve to a 3% growth in 2009**
- **The dramatically depreciating Dinar maintains inflation stubbornly high at 12.3% in October, forcing the Central Bank to raise interest rates further to 17.75%, the highest nominal rates in New Europe**
- **The heavy external financing requirement in an era when capital inflows are more scarce and access to financing becomes more expensive, exacerbating the Serbian economy's major vulnerability: the current account deficit ballooned from 13.6% in 2007 to 18.5% in 2008**
- **Serbia has secured an IMF $516m precautionary stand by loan in an attempt to bolster investors' confidence in the economy under the condition to reduce the fiscal deficit to 1.5% of GDP in 2009**
- **The Central Bank has undertaken a number of initiatives to increase liquidity, confidence and reduce external financing costs in the banking sector**
- **The low indebtness level, strong liquidity and hefty capital base provide the required buffers for the Serbian banking sector to weather the current financial crisis.**

Outlook

The initial impact of the global financial crisis was limited, which led investors to believe that Serbia could escape the consequences of the global financial crisis unscathed. Just after the political concerns subsided after the formation of a pro European government, the deepening financial crisis spilled over to the emerging markets. The focus now shifts from internal politics to the real economy. The key question is how resilient is the Serbian economy.

The country doesn't have an EU or EMU shield, which makes it more vulnerable to investors sentiment shift. In addition, Serbia found itself in a relatively vulnerable position with a ballooning current account deficit, which raises a lot of concerns for its financing. The abrupt investors shift is very likely to slow capital inflows and subsequently cool off economic activity. While the banking sector has enough capital and liquidity buffers to weather the storm, a significant deceleration in credit growth is expected. Even though Serbia still has untapped sources of growth, it will not escape a soft landing in 2009. Eurobank Research sees GDP growth at 3% down from 6.5% in 2008. (Table)

Table

Serbia	2007	2008	2009
Real GDP growth	7.1	6.5	3.0
Inflation (annual average)	6.4	13.0	8.0
Current account balance (% of GDP)	-13.6	-18.5	-16.0

Source: IMF, NBS, National Statistics, Eurobank Research

The incoming government is confronted with incurred problems, which will require strong policies commitment and political will to deal with. The structural unemployment is high. The previous political instability has left the privatizations program behind which will be very hard to push in a very weak international environment. The EU accession process is at a standstill. Although the incoming government has shown visible progress, the Stabilization and Association agreement (SAA) is still frozen from the EU side.

Political Environment

A pro European coalition government coalition took office in Belgrade after the general elections held in May. The "For a European Serbia" ZES coalition which consists of the Democratic Party (DS) and its technocrat-led G17 plus ally, won the elections but didn't manage to have a parliamentary majority. The Socialist Party (SPS), the former President Milosevic party, joint forces with two other minor parties winning enough seats in the parliament to give either one of the two major contestants a majority. SPS agreed surprisingly to partner with the pro European coalition, rather than its traditional ally, the nationalistic Serbian Radical Party (SRS).

In our view, the government coalition stands a better chance to last more than its predecessor. SPS seems to have conceded in a number of hot, potential coalition breakup issues such as the co-operation with ICTY or the Stabilization and Association Agreement

with the EU. In addition, it would be to one interest, especially for the SPS, to have new election. On the other hand, it would be difficult to manage such a diverse government coalition, given that the different agendas some of the parties share.

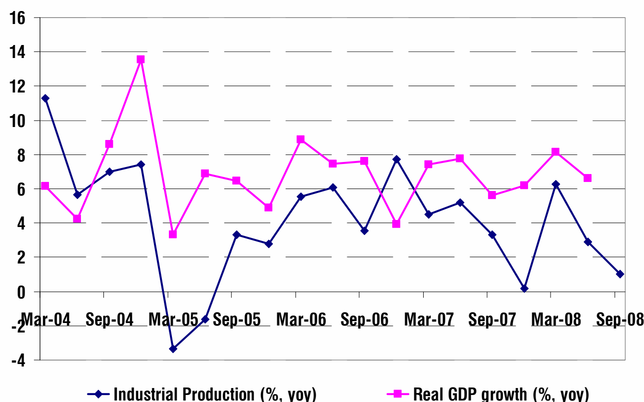
The arrest of the former Bosnian Serb Karadzic leader gave new impetus to the relations with the European Union, but also disproved any concerns that this would be a contentious issue for the government coalition. Yet the new government will have to strike a deal sooner or later on Kosovo issue, as it might remain the only outstanding obstacle on the way to EU membership in the future.

Growth performance

GDP growth averaged 7.3% yoy in the 1H-2008 against 7.8% in the 1H-2007. This spectacular performance gradually fades away. The high frequency data show that economic activity was slowing down in Q3, just before the financial crisis deepened. Retail sales slowed down to 2.3% in Q3 against 24.4% in Q3-2007. Industrial production landed to 1% in Q3-2008 against 3.3% in Q3-2007. (Figure 1)

Figure 1

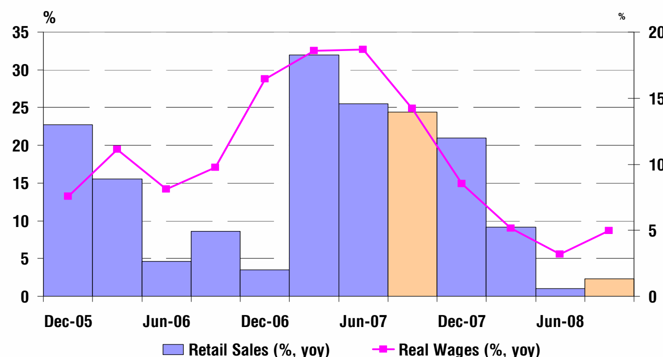
Industrial Production in Serbia



The outbreak of the crisis showed that economic activity weakened further in Q4. Industrial production contracted by 3.4% in October only, bringing the year to date performance at 2.4%, almost half than 4.2% recorded last year. (Figure 2)

Figure 2

Private Consumption & Real Wages in Serbia



The Government expects GDP growth to slow sharply at 3.5% at most in 2009. To address the consequences of the deepening crisis, the government introduced a stimulus package of 1.2 bn. Euros in the 2009 budget. Some 476m will be channeled towards the country's infrastructure, half of which will be invested through the National Investment Plan. Around 600m will be allocated to state guarantees for credits that banks will channel to the economy.

Public Finances

The new coalition government followed the same pro cyclical fiscal policy of its predecessor, just before it turned to IMF to secure a precautionary loan agreement. The Ministry of Finance accommodated the coalition politicians' demands in order for them to meet their pre-election promises. One of the conditions for the coalition to be formed was a generous pension increase of 10%, which will count on top of the 7% regular indexation increase in October.

Eventually, the consolidated government deficit will now stand close to 3% of GDP against 1.7% initially planned with the risks lying to the downside. Nevertheless, the incoming government has undertaken the commitment with the IMF to reduce the deficit to 1.5% of GDP in 2009. Notwithstanding the inflation pressures on the economy, the budget will face important financing challenges in the 2H. Privatization revenues, the main source of financing the budget deficits in recent years are lagging behind schedule.

Fiscal loosening becomes more evident in the data released, which are now compatible with IMF standards. The state budget recorded a deficit of RSD 17.5 bn. or 0.6% of GDP in Jan-Oct 2008, against a

revised target of 1.6% of GDP. Although tax revenues benefit from the high nominal growth, non tax revenues lag behind as a result of the weak privatization revenues. Tax revenues have increased by 18.6% yoy as all revenues components (VAT PIT, corporate income) maintain dynamic growth. On the expenditure side, election related spending surged at the expense of capital expenditures. The capital expenditures had only reached 60% of the revised plan in October, as the capital expenditures program (NIP) was under executed. Current expenses have increased by 25%, reaching 81.8% of the revised plan. The increase in expenses is driven by wages and pension increases. Personnel costs were up by 23.5%, expenses for goods and services up by 42.6%, subsidies by 33%, grants and transfers were up by 22.3%. For that reason, payments to employees have already reached 83.6% of the revised plan and funds for social assistance stood at 95.3% accordingly.

Balance of Payments

The balance of payments data (BoP) are in the process of revision in order to meet IMF standards. The BoP change in methodology decreases the current account deficit by 3-4 pps of GDP. According to the central bank, specific items (for example a portion of estimated remittances) have been transferred from the financial to the current account. As a result, the current account deficit appears lower while the financial account is reduced by almost the same amount.

The change in methodology doesn't change the picture. According to the revised data, the current account widened by 62.6% yoy further to USD 7 bn in the 9M-2008. In our calculations, the current account deficit stood at 16.5% of GDP against 13.6% in 2007. The trade deficit climbed further to 23.4% of GDP against 21.7% at the end of 2007. Imports surging by 39.8% yoy outpaced exports which rose by 37.7% yoy in the 9M-2008.

The balance on income starts to weigh negatively on the current account deficit. The deficit has reached 2.2% of GDP in 1H-2008 as a result of rising interest payments for the external debt. Current transfers, who offset a large part of the trade deficit, reached 9.4% of GDP down from 10.4% at year end. (Figure 3,4)

Figure3

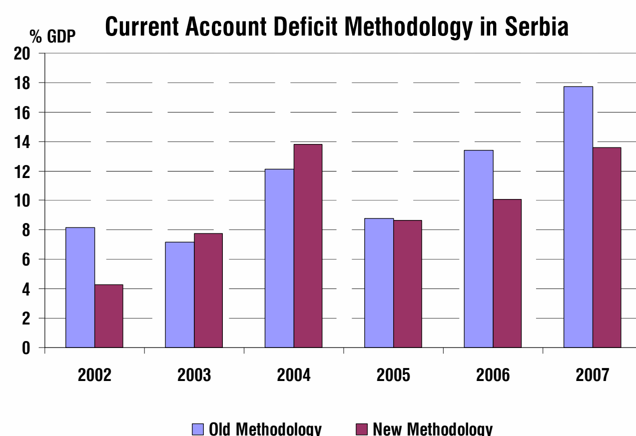
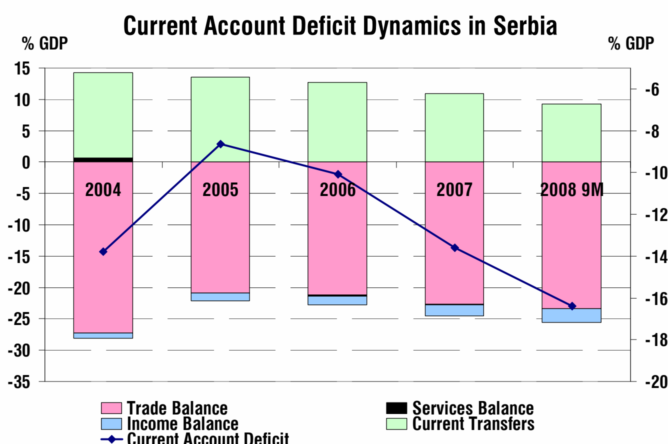


Figure 4



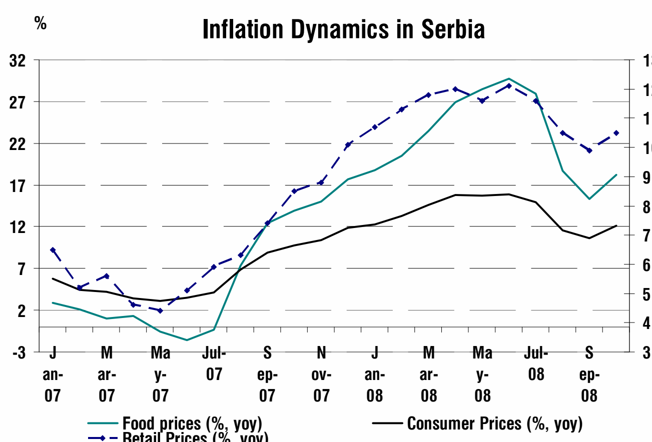
On the financing side, the balance of payments developments reflect the increasing reliance on external borrowing. Net FDI inflows in the country appear increased by three times in the 1H-2008. On a closer look, if adjusted for the capital outflow of 0.8 bn, then FDI inflow has gone up by 21% yoy which is an encouraging sign given the fact that limited privatization has taken place. Net FDI inflows covered 34.8% of the current account deficit in the 9M-2008 against 32.5% in 9M-2007.

Inflation- Monetary Policy

Inflation remains stubbornly high at 12.2% in October reversing the downward trend recorded in Q3. The recent deceleration in food and energy prices has been translated in a temporary deceleration in the consumer prices, which led inflation at 10.9% in September year end. The deepening financial crisis resulted in Dinar depreciation by 13% against the EUR and by 24% against the USD. In turn, this was

translated into a spike in inflation spike instantaneously. Lack of competition in some oligopolistic industries exacerbated the impact. On top of this, the sharp gas prices increase (3.6% mom increase) weighed negatively as well. There are two factors that put the disinflationary process further at risk. Firstly, there is a need for further administered prices upward adjustment. Second, the continued loose fiscal and income policies feed inflation. The 10% pensions hike on top of the regular increase effective from October will not have only fiscal implications but feed inflationary pressures as well. (Figure 5)

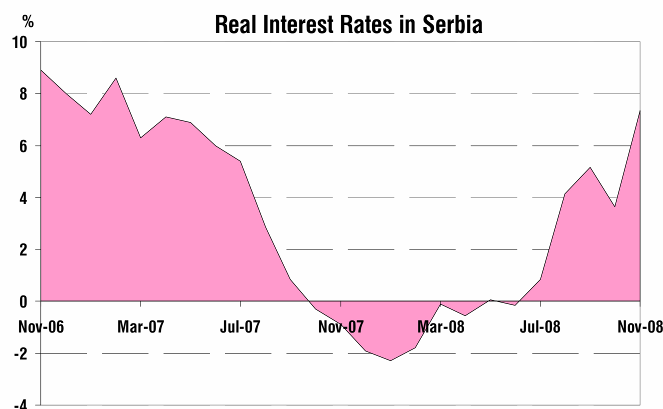
Figure 5



The view that core inflation could come down to the desired levels (3-6%) by the end of the year proved to be overly optimistic. The deepening financial crisis changed the landscape. The Central Bank expects that core inflation would end at 10.9% while headline inflation is expected to be at 9.7% by year end. In response, the Central Bank increased interest rates by 200 bps at 17.75%, the highest in New Europe. The Central Bank action during the Q3 was dictated by the strong currency appreciations strongly after the elections.

The Central Bank sees no room for monetary policy easing before the 1H-2009. At that time the core inflation is expected to recede, as the domestic demand will become much weaker. In fact, it had signaled that further tightening would be likely in the case of another wave of local currency depreciation. The high degree of Euroization makes in our view such a move ineffective. (Figure 6)

Figure 6



Banking developments

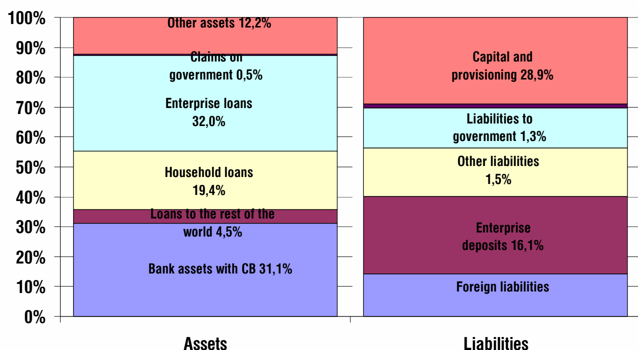
The global financial crisis finds the Serbian banking sector in a relative stronger position than the regional peers. The implementation of the Central Bank restrictive measures since 2006 had already moderated banking sector assets growth. Total assets increased by 19.6% yoy in September 2008, compared to 28.1% yoy a year earlier. Total assets as a percentage of GDP already stood at 71.1% in Q3 2008.

The legacy of the Milosevic era in which Serbia has gone through the worst hyperinflation and banking crisis in its history has led policymakers to be vigilant in terms of the macro prudential measures they have adopted. The measures initially aimed at putting a cap on credit expansion to households, but inevitably helped to shield the banking sector and cushion vulnerabilities. The decision of the Central Bank to impose high Tier I capital requirements on the banks secured high capital adequacy.

When the crisis spread in Serbia, a run to the banks effectively took place. The living memory of the 1990s savings episode resulted in a deposits outflow from the system of 13-14% of total. The high liquidity of the banking sector prevented the system from collapsing. Almost one third of total assets (31.1%) of the banking sector are assets kept with the Central Bank. Only one bank, Metals Bank, was put under receivership by the Central Bank. (Figure 7)

Figure 7

Assets and Liabilities Decomposition



In response to the deepening crisis, the Central Bank undertook some initiatives to increase liquidity and decrease the cost of FX borrowing. In a first move to reduce the cost of FX borrowing, the central bank reduced the reserve requirement on new external borrowing to nil to offset the cost increase. In addition, the Central Bank changed the decomposition of required reserves-placing more weight on Dinars in order to release more FX liquidity to the banks. Last, the Central Bank decided to take into account the decline in deposits at Oct 30th instead of Oct 15th, when it calculated the required reserves. The government took some measures to increase confidence in the domestic banking sector. First of all, it raised the level of deposits insurance from 3,000 up to 50,000. In addition, the government abolished taxes on interest income and FX deposits in 2009.

Even though the Serbian banking system is not at imminent risk, there will be a negative impact on the lending side. The banking sector will not eventually escape from the negative impact of the deepening financial crisis in the region. The banking sector is predominantly foreign owned. The market share of foreign-owned banks is very high. Precisely, at the end of June 2008, 20 out of 34 banks were in majority foreign owned, possessing 75% of total assets. Access to external financing becomes more expensive and scarce. Although the banking sector doesn't rely on primarily on external financing, it will certainly be affected. Thus we expect the credit growth to subside further on top of the restrictive measures taken by the Central Bank.

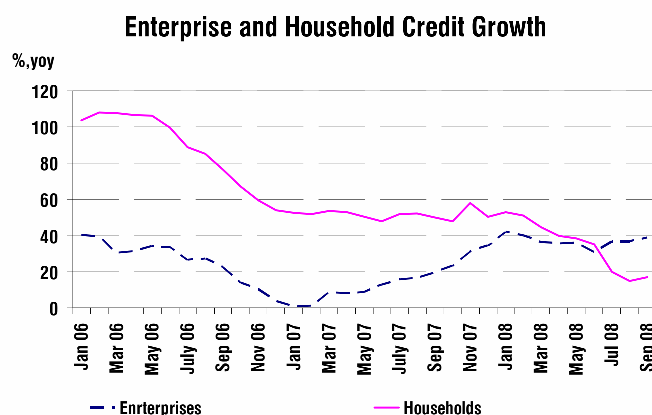
Credit Developments

The Central Bank restrictive measures on credit to households, adopted in the autumn of 2007, had a negative impact on credit growth during 2008. Credit expansion peaked at 45% in January. Ever since, it followed a decelerating trend. The latest data show that credit expansion grew by 31.2% yoy in September 2008, down from 45% yoy in January 2008.

Credit to households slowed down significantly. Credit growth landed to 16.9% yoy in September 2008, against 50.2% yoy a year earlier. Credit to enterprises followed a steady trend throughout 2008 after stepping up significantly in late 2007. The credit to enterprises growth rate increased to 38.6% yoy in September 2008 against 42% yoy at the beginning of the year. (Figure 8)

Figure 8

Enterprise and Household Credit Growth



The picture would be incomplete if private external borrowing was not taken into account. The private sector external debt stood at 36.2% of GDP at Q3-2008 against 26.4% in 2007. Banks encouraged corporates to resort to cross border borrowing. Instead of borrowing externally themselves, which was subject to reserve requirements, banks dislocated some part of their corporate portfolio from their balance sheets. They transferred part of their corporate portfolio in the off-balance sheet against guarantees given to their mother companies.

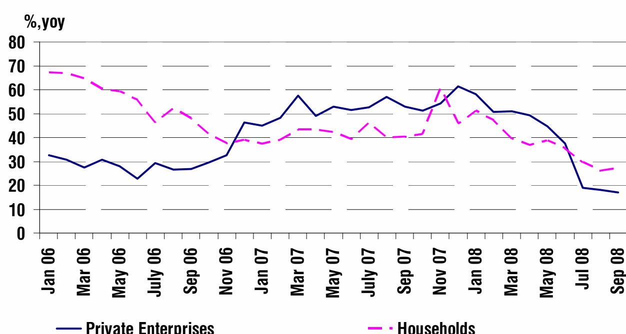
Despite concerns for the opposite, credit penetration in Serbia was still one of the lowest in the New Europe region. Total credit stood at 40.9% of GDP in Q3 2008, as opposed to 35% in Q3 2007. Loans to enterprises maintained the largest share in total credit portfolio (62.7%), whereas 33% of total credit was household loans

Deposits Developments

Deposits are main source of funding for banks. Total deposits grew by 27% yoy in September 2008, down from 46.9% yoy in December 2007. Household deposits decelerated to 27.1% yoy in September 2008, compared to 40.2% yoy a year earlier. Household deposits in FX growth remained stable at 26.7% yoy in H1 2008, against 27.8% yoy in H1 2007. Private enterprises deposit growth slowed down, as well. Thus, enterprise deposits growth decreased to 16.9% yoy in September 2008, from 52.9% yoy a year earlier. Private enterprises deposits in FX declined to 26.2% yoy in June 2008 from 32.1% a year earlier. (Figure 9)

Figure 9

Corporate and Household Deposits Growth



Deposits decelerated faster than loans in the 2H-2008. The higher deceleration in deposits than in loans in the 2H-2008 resulted in the loans to deposit ratio climbing over the 100% level again. Thus, the loan to deposit ratio stood at 113.2% in September 2008, down from 109.5% a year earlier but up from 101.4% at end-2007.

Banking Sector's Profitability and Capital Adequacy

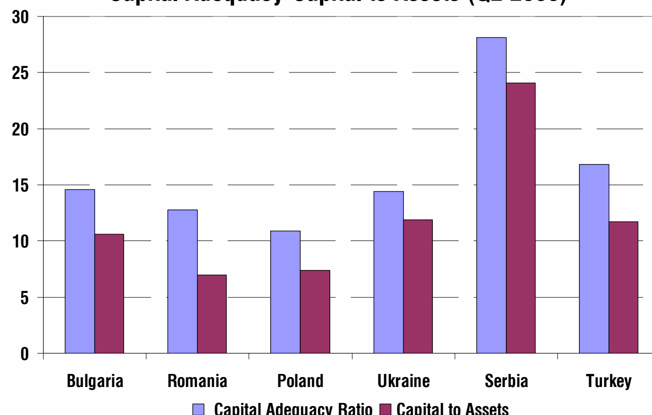
The banking sector profitability almost doubled in H1 2008. The pre-tax profits reached approximately RSD 21 bn, compared to RSD 13 bn in H1 2007. Net interest income was the main contributor to the positive financial performance. Net Interest Margin rose at 7.50% in Q2 2008, against 6.54% at end-2007. Return on Assets (ROA) reached 2.6% in Q2 2008, up from 1.7% in Q4 2007. Return on Equity (ROE) stood at 11.51% in Q2 2008, higher than 8.54% at the end of 2007.

The Capital Adequacy Ratio stood at very high levels. It reached 28.1% in the 1H 2008, compared to 24.5% a year earlier. The main driver behind this development was banks' capital increases in order to finance their lending activities. The Serbian banking sector has managed to limit solvency risk, despite political instability and the global financial crisis.

The banking sector capital adequacy is at very high levels. The decision of the Central Bank to impose high Tier I capital requirements on the banks to tame credit expansion had impressive results. The banks had to increase capital in order to finance their credit expansion. In turn, the capital to assets ratio stood at 24.1% which is the highest level in the region. Moreover the capital adequacy ratio stood at similarly high levels at 28.1%. (Figure 10)

Figure 10

Capital Adequacy-Capital to Assets (Q2 2008)



Serbia: MacroEconomic Indicators								
	2003	2004	2005	2006	2007	Q2 2007	Q2 2008	Q3 2008
Output and expenditure				*(Percentage Change in Real Terms)*				
GDP	2.5	8.4	6.2	5.7	7.5	7.0	6.2	6.7
Industrial production	-3.0	7.9	0.3	5.7	3.3	5.2	2.9	1.0
Labour Market								
Unemployment (official data)	26.1	23.9	25.3	26.6	24.0	-	22.1	21.4
Prices				*(Percentage Change)*				
Retail Price Index (annual average)	11.8	9.9	17.3	12.8	6.5	4.7	11.9	10.7
Producer prices (annual average)	4.6	9.6	14.1	13.4	5.9	4.4	13,1	14.0
Government sector				*(In Per Cent of GDP)*				
RS budget (Deficit/Surplus) balance (National Definition)	-1.4	-0.1	1.5	1.4	1.3	0.15	-2.7	-3.0
General government debt	69.9	55.4	48.0	41.6	33.7	32.8	30.2	-
Monetary and Financial Indicators				*(Percentage Change)*				
M3	29.1	31.2	39.1	37.4	41.1	39.1	37.4	24.6
Total Credit	32.9	46.6	52.1	16.7	39.2	23.0	32.2	31.2
				(End of Period)				
Reference Rate (Key Policy Rate- 2w repo)	-	-	-	14.00	10.00	9.50	15.75	17.75
Exchange rate CSD/USD (end-period)	54.64	57.94	72.22	59.98	53.73	58.80	50.01	53.28
Exchange rate CSD/EUR (end-period)	68.31	78.89	85.50	79.00	79.24	79.00	78.98	76.60
Real Effective Exhange Rate (Index)	101.90	98.90	101.60	116.50	110.10	99.90	105.80	107.10
International Position				*(In Per Cent of GDP)*				
Current account balance	-9.5	-11.9	-8.0	-12.0	-15.9	-20.8	-23.0	-16.5
Trade balance	-23.8	-28.7	-21.2	-20.5	-21.9	-29.9	-27.5	-23.4
Foreign direct investment. net	6.5	3.9	5.7	14.4	5.3	21.6	9.8	5.7
Gross External Debt	66.7	57.5	59.1	64.5	64.5	-	62.2	60.6
Memorandum items				*(Denominations as Indicated)*				
Population (middle-year)	7480591	7463157	7440769	7411569	7397651	–	–	-
GDP (in Mil of EUR)	17922.1	19673.0	21235.5	25316.8	31340.8	–	–	-
GDP per capita (in EUR)	2395.8	2636.0	2853.9	3415.8	4236.6	–	–	-

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

**REER:end of previous year=100*

Serbia: Banking Indicators						
	2004	2005	2006	2007	Q2 2007	Q2 2008
			Percentage of GDP (%)			
Assets	43.0	52.2	59.9	67.4	68.0	68.2
Total Credit	23.4	29.1	28.0	34.8	32.8	36.5
Credit to Enterprises	17.3	20.1	18.0	19.6	19.8	21.8
Credit to Households	4.6	7.5	8.9	12.3	11.6	13.3
Deposits	19.0	22.8	26.1	32.7	28.3	33.0
			Percentage Change (%, yoy)			
Assets	36.1	48.7	39.4	31.7	32.4	18.9
Total Credit	46.6	52.1	16.7	39.2	23.0	33.2
Credit to Enterprises	33.8	41.5	38.5	34.6	12.7	30.9
Credit to Households	126.2	98.7	54.2	50.2	47.9	35.1
Deposits	36.0	46.7	39.6	46.9	37.1	38.3
			Percent (%)			
Capital Adequacy Ratio	27.9	26.0	24.7	27.9	24.5	28.1
Capital to Assets	19.5	16.2	18.5	21.0	18.9	24.1
NPLs to Total Loans	-	-	-	5.1	4.7	5.3
Share of risky loans to total loans	22.2	23.8	23.1	24.7	21.4	29.5
Provisions to NPLs	-	-	-	40.3	38.9	34.1
Return on Assets	-1.0	1.1	1.7	1.7	2.1	2.6
Return on Equity	-5.3	6.6	9.7	8.5	11.2	11.5

Sources: NBS, IMF

5. Turkey

The economy on the brink of recession

- **The deepening international financial crisis and the weakening external demand bring the Turkish economy in 2009 on the brink of recession for the first time since 2001.**
- **The decline in commodities and energy prices and weak domestic demand will result in the current account deficit shrinking from 7% to 4% in 2009.**
- **The Central Bank surprised the markets, lowering policy rates by a cumulative 175 bps to 15.00% in November-December. Further rate cuts are in the pipeline in 2009, in order to boost growth**
- **Inflation is expected to drop close to the Central Bank end of year target of 7.5% in 2009 on weaker domestic demand, but the TRY depreciation trend (20% against the USD in Oct- mid Dec) and the pending administered price hikes are expected to protract the disinflation process**
- **The prevailing credit crunch makes financing the current account deficit and refinancing the private sector external debt a challenging task next year: Turkey is in need of a new regular standby agreement with the IMF in order to tap new sources of funding as well as bolster investors' confidence**
- **The corporate sector, unlike the banking sector and households, carries a significant net FX position which is a key vulnerability for the economy if the TRY depreciation trend persists**
- **The global credit crunch has hit the Turkish banking sector. New lending activity is restrained since October**
- **The banking sector, although much better shielded than during the 2001 crisis, will come under pressure: Rolling over the existing syndicated loans and maintaining asset quality will emerge as key issues in 2009**

Outlook

Turkey has registered significant improvements in macroeconomic fundamentals in recent years. That allowed the economy to cushion the consequences of the crisis until Q3 relatively well, despite the high political risk from the AKP closure case. The healthy banking sector position was a positive contributor to this effort. The economic crisis became so intense since October that Turkey has started to feel the impact of the world credit crunch. TRY depreciated by 40% against USD in Oct-Nov, the pressure on TRY denominated assets-both stocks and bonds-was significant, CDS spreads jumped up. The crisis was not only confined to the Turkish financial markets, but also soon transmitted in the real economy. Consumer and business sentiment plunged into new lows, industrial production contracted for a second month in a row which discounts the worst scale growth scenario. Although Turkey narrowly escapes recession in 2008, on a more relaxed fiscal policy than initially envisaged, the chances are that it will not avoid it in 2009. Domestic demand is depressed while external demand has weakened substantially since Q3. GDP growth is set to slide from around 2.5% in 2008 to below 1% in 2009. In that context, the current account deficit is about to contract sharply towards 3% next year under the influence of weak growth prospects and lower oil prices. We expect inflationary pressures to subside as well. (Table 1)

Countries with high external financing requirements, such as Turkey, are put under scrutiny for their difficulty to attract funding. In that respect, Turkey needs the anchor of a new IMF regular agreement not only to bolster investors' confidence in the economy but also tap new sources of funding. In addition, the government has announced its intention for a stimulus support package that will enable offset partially some of the negative consequences.

Table 1

Turkey	2007	2008	2009
Real GDP growth	4.6	2.5	1.0
Inflation (annual average)	8.8	10.3	9.2
Current account balance (% of GDP)	-5.8	-6.0	-3.0

Source: IMF, CBRT, National Statistics, Eurobank Research

Political Environment

The Constitutional court decision provided some relief for the financial markets and supported the TRY. The ruling AKP party and its prominent members escaped politics ban narrowly. Nevertheless, it found the AKP party guilty of anti secular activities and imposed financial sanctions on it. The court decision averted a mass-scale political crisis but at the same time sent a strong warning.

Political uncertainty dropped substantially, but the probability of a new clash between AKP and the secular forces cannot be ruled out. Political jitters may re-emerge, in case the government decides to go ahead with constitutional amendments on areas that touch upon sensitivities of secular institutions.

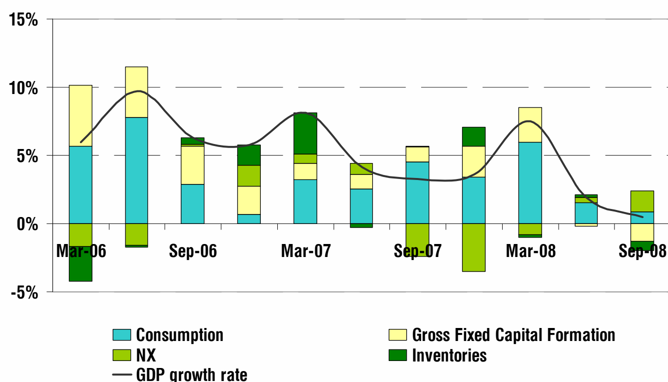
In the short term, the focus shifts to the domestic economy. Initially hesitant, the government protracted negotiations in an attempt not to engage in an agreement that would restrict pre-local elections spending. The deepening financial crisis and domestic pressures has led the government to change attitude towards a new IMF loan agreement. A regular loan agreement, instead of a precautionary is more probable to be announced. The size is expected to be in the range of 20-40bn USD. In addition, the government has unveiled its plans for a stimulus package. Reportedly, the plan foresees tax incentives to encourage mergers and support for consumer loans besides cutting reserve requirements for banks.

Growth Performance

Economic activity is decelerating rapidly throughout 2008. After expanding by 6.7% in Q1, growth landed sharply to 2.3% in Q2 and further to 0.5% in Q3. This brings the cumulative performance at 3% overall during 2008. Public sector spending (1.4 pps) and Net Exports (1.5 pps) are the main GDP growth drivers in Q3. (Figure 1)

Figure 1

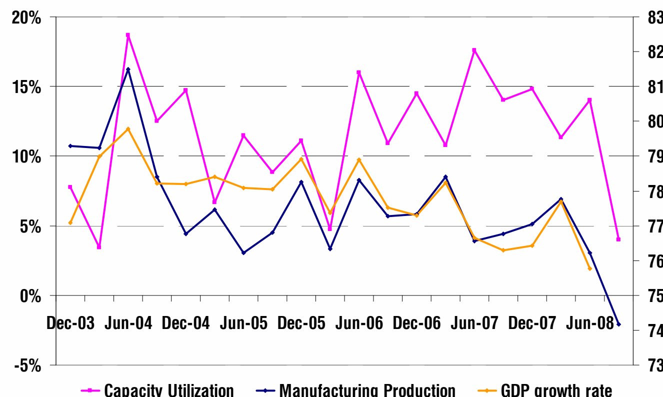
GDP growth rate drivers in Turkey



The onset of the deepening financial crisis had a dramatic effect on economic activity in Oct-Nov. Industrial production posted a second consecutive decline of 8.5% yoy in October. This is the sharpest decline since the 2001 recession. The feedback from exports decline in November impacts industrial production further negatively. The capacity utilization came at 73%, which signals further slowdown on the horizon. (Figure 2)

Figure 2

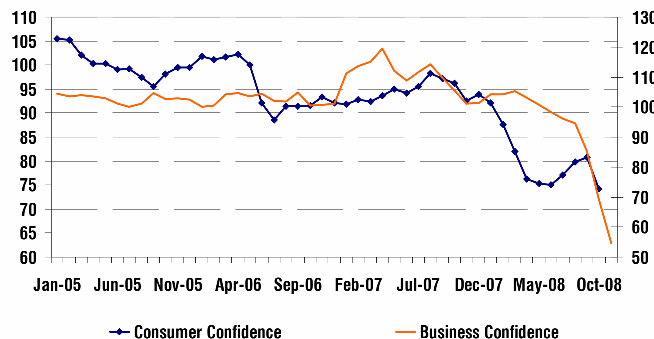
Manufacturing Production & Capacity Utilization



Consumer spending is under continued pressure. The survey evidence in Oct-Nov suggests that both business and consumer confidence plunged. The CNBC e-index, which reflects consumers' propensity to consume, eased towards the previous recorded lows in May. (Figure 3)

Figure 3

Consumer & Business Confidence Indicators



The economic slowdown developments are reflected in the labor market softening. Unemployment follows an upward trend. It has risen to 9.8% in Q3-2008 against 9.2% last year. The construction sector lay-offs led non agricultural employment to shrink. Non agricultural employment increases absorbed the decreasing employment in agriculture in the past quarters. This is not the case any more, which is going to result in unemployment increasing rapidly, and increasing fears of negative social repercussions in Turkey.

Public Finances

Fiscal performance weakened in the last two months. Not only tax revenues started to slack but also expenditures growth speeded up. The weak revenues performance comes as a result of the economic slowdown. Tax revenues in Sep-October increased by only 1.5% as economic slowdown kicked in. On the other hand, government infrastructure spending on South-east Anatolian Project and transfers to local authorities pushed up capital expenditures and capital transfers by 38.4% and 178.7% respectively.

After a fiscally loose election year 2007, markets expected the government to tighten fiscal policy. Indeed, the government initially planned a 4.2% consolidated government sector primary surplus in the medium term fiscal framework. The government scaled the target back to 3.5% of GNP, which is still not attainable under the current circumstances. In fact, the government sees the year end performance at 2.7%.

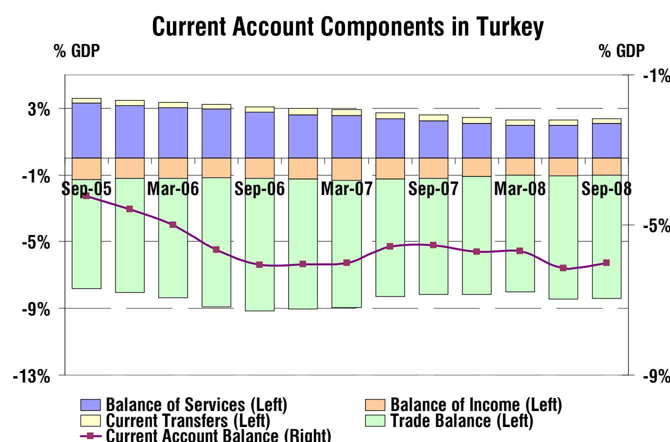
Going on forward, we expect fiscal performance to deteriorate further as the consequences of the economic slowdown become more pronounced. Achieving next year target would be a challenging task. The assumption on growth for next year budget stands at 4%, which is out of reach. In principle, fiscal loosening would be hard to criticize in such weak growth environment. Increasing expenditure is going to support growth rather than put the disinflation process at risk. Nevertheless, Turkey is in dire need of a fiscal anchor after the expiration of the IMF standby agreement. The absence of a fiscal anchor increases the risk premium investors are asking for which is already elevated from the deepening financial crisis.

Balance of Payments

The BoP developments are under the microscope because of the high external financing needs. The declining energy and commodities prices had a favorable impact on the current account. The current account started to shrink to 6.0% of revised GDP in Q3-2008 after peaking in 1H at 6.2% of GDP. The trade deficit will narrow down as both imports (34% yoy in the Jan-Sep) and exports (38% in the Jan-Sep) are expected to show significant weakness by the end of 2008 and further in 2009. Imports will slow down on weak domestic demand. Exports are going to struggle on weak EU markets demand, but show more resilience than in past recessionary episodes as exports have diversified their market shares in the Gulf States. (Figure 4)

Figure 4

Current Account Components in Turkey



However, the focus is shed on financing the current account deficit. The capital inflows decomposition has changed dramatically from non-debt inflows (FDI and portfolio investment) towards debt. The lack of big privatization tickets, as well as the poor market conditions, brought the FDI inflows down significantly. The net FDI inflows declined to USD 10 bn in the first nine months of 2008, certainly not to beat the 23 bn USD record inflows of 2007. In turn, the Net FDI inflows coverage declined from 41% in Q3-2007 to 28.3% in Q3-2008.

The capital inflows were always considerably above the levels required to finance the deficits in the recent past. That is not necessarily going to be the case in the future. Meeting the financing requirements in a world environment of tight credit markets and emerging markets risk aversion will be challenging in 2009. The prospects for portfolio flows (both equities and bonds) and FDI inflows are not rosy.

Borrowing by the non-bank corporate sector external debt has swollen to 125 bn in 1H-2008 double from 60 bn in 2006. The corporate sector will need to roll over approximately 37 bn out of it in the next 12 months, which is going to be a challenging task in difficult world market conditions. The first signs in Sep-Oct are encouraging: corporates kept borrowing from abroad. Nevertheless at some point we anticipate borrowing to cut back. In our view, private sector external debt is a key vulnerability to the economy. A

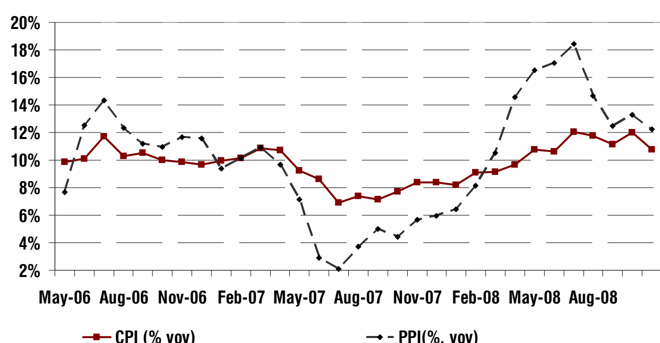
new IMF regular standby agreement would not only ensure uninterrupted funding but also bolster investors' confidence.

Inflation- Monetary Policy

Having peaked at a four year high of 12.1% yoy in July, consumer prices started to moderate. Inflation readings since August contained some more benign data for food and energy prices. This is already reflected in the declining trend of producers' price index (PPI). (Figure 5)

Figure 5

CPI and PPI Indices in Turkey

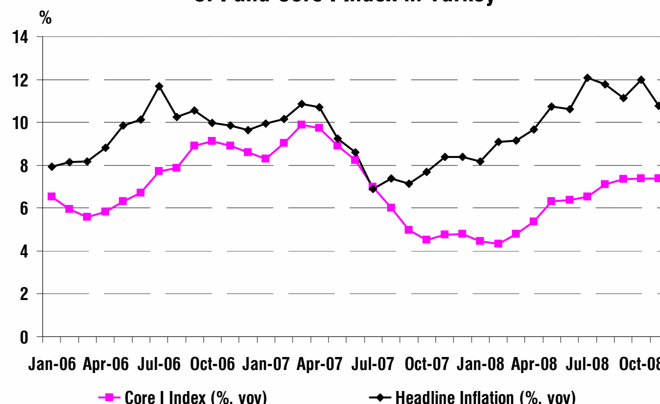


Nevertheless, the lagged second round effects hindered the disinflation process. In that respect, the adjustment of electricity and gas prices in October pushed regulated prices up, offsetting partially some of the decline. As a result, inflation reached 10.8% yoy in November up from 8.4% last year, but way above the 4% target.

Going on forward, we expect that inflation will continue to decelerate on declining commodity prices and weaker demand, but on a much slower pace than expected. The biggest risk to the disinflation is the pass through effects of the weakened TRY. Meanwhile, despite most core measures declining trend in the latest months, the core measure I (which doesn't include food, energy tobacco and gold) remained fairly high at 7.4% yoy in November. (Figure 6)

Figure 6

CPI and Core I Index in Turkey



Other things equal, the disinflation process will be not gain momentum before the first months of 2009, in line with the Central Bank revised target of 7.5%.

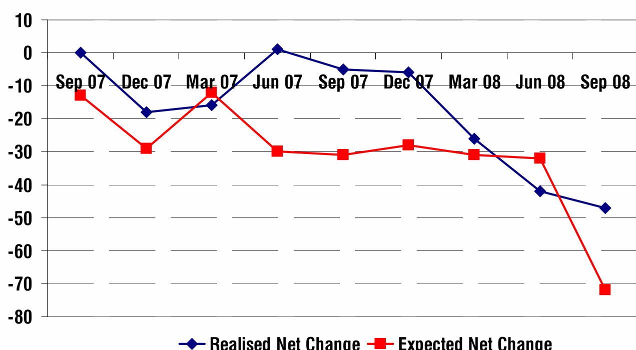
The negative economic developments led the Central Bank to initiate the monetary policy easing cycle in November instead of the end of Q1-2009 after the local elections. The move was thought to be a risky move by many that will leave TRY relatively exposed in the global financial turbulence. To the surprise of economists, the Central Bank lowered policy rates by a total of 175 bps in Nov-Dec bringing them at 15.0%. The Central Bank has signaled that further cuts in order to boost growth are on the cards in 2009, as downside risks to growth outlook persist.

Banking Developments

The deepening financial crisis brought the Turkish banking sector ahead of the most challenging environment since 2001. The global credit crunch waves hit the Turkish banking sector in October. The sharp TRY depreciation of 40%, led FX denominated balance sheet items to grow instantaneously at the same rates. New lending activity is restrained, as the banks seek more liquidity rather than expand their loan portfolios. For that reason, the minimum reserve requirements ratio in FX deposits was reduced by 2pps to 9%. The Central Bank survey is illustrative of the lending standards tightening. (Figure 7)

Figure 7

Loans Tendency Survey



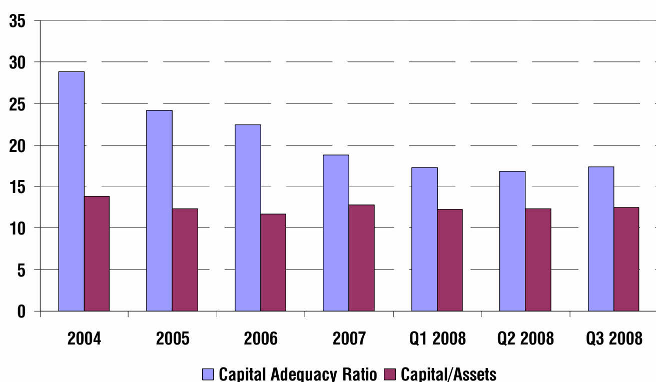
The banking sector is in a much healthier position than in the crisis of 2001. Unlike the corporate sector, the banking system has a minimal net short FX position. The net short FX position to Equity ratio stood at 2% in mid 2008.

The banking sector has addressed its fundamental institutional weaknesses, becoming more resilient. Banks used to generate on balance sheet net liabilities positions, hedged by off balance sheet forward contracts. At the time of the 2001 crisis, these contracts were not honored, resulting in massive losses. In contrast today, the regulatory watchdog BRSA closely monitors these off balance sheet positions.

Moreover, the Turkish banking sector is not highly leveraged compared to its Western Europe peers. Capital to assets ratio stood at 11.7% in 1H-2008. (Figure 8)

Figure 8

Capital Adequacy, Capital/Assets Ratio



Although the banking sector is not highly dependant on wholesale financing, funding will emerge as a key issue for the banking sector in 2009. Not only has the cost of external funding has gone up, but also liquidity has tightened globally. The banking sector has a big outstanding amount of syndicated loans to roll over next year. Inevitably, banks will come up against refinancing problems. (Table 2)

Table 2

Syndicated Loan Rollovers 2008-2009 (USDmn unless otherwise stated)

	Nov-08	Dec-08	Jan-09	Feb-09	Mar-09	Apr-09	May-09	Jun-09	Jul-09	Aug-09	Sep-09
AKBNK		1050						500		1000	
Libor+		43-60						75		75	
GARAN	700						600				
Libor+	62,5						67,5				
ISCTR						900					825
Libor+						37,5					75
YKBNK		700									1000
Libor+		62,5									75
VAKBN		503							750		
Libor+		62,5							77		
TEBNK	240										
Libor+											
FINBN	900										
Libor+	25-42.5										
ASYAB						86					
Libor+						85					
TEKST											
Libor+											
TSKB			40			105					
Libor+											
SKBNK									80.5	170	
Libor+									70	80	
Others		100	135	66	250						
Month Tot	1,912	2,353	175	66	250	1,091	780	650	831	2,046	1,825
Subtotal	11,978										

Source: EFGI

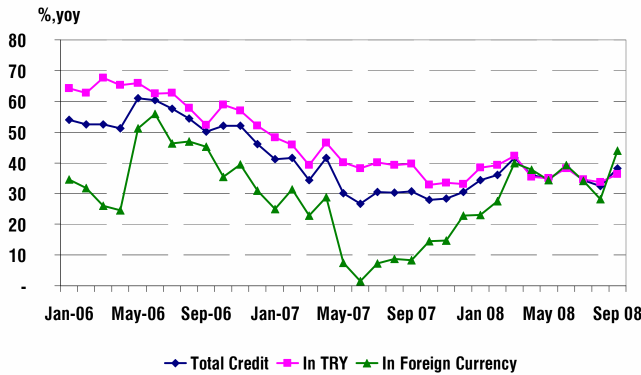
Last but not least, the level of foreign ownership in the Turkish banking sector is much less than in the rest of the countries of New Europe. Foreign banks accounted for only 22% of total assets. At this point, this can be an advantage for Turkey. At those countries where the banking sector is predominantly foreign owned, there is the risk that the parent banks will likely not provide extra funding to the subsidiaries. From that perspective, the Turkish banking sector is safe.

Credit Developments

Credit expansion was rapid in the first nine months. The deepening financial crisis will have a negative impact on lending. The increased funding costs have reduced banking sector willingness to roll over the outstanding loans. Total credit grew by 38.1% yoy in September 2008, up from 30.7% yoy a year earlier.Credit growth in TRY increased to 36.3% yoy in September 2008, instead of 39.8% yoy a year earlier, on account of the strong demand for residential and other purpose consumer loans during this period. Credit growth in FX accelerated to 44% in September 2008, against 8.4% yoy a year earlier. (Figure 9)

Figure 9

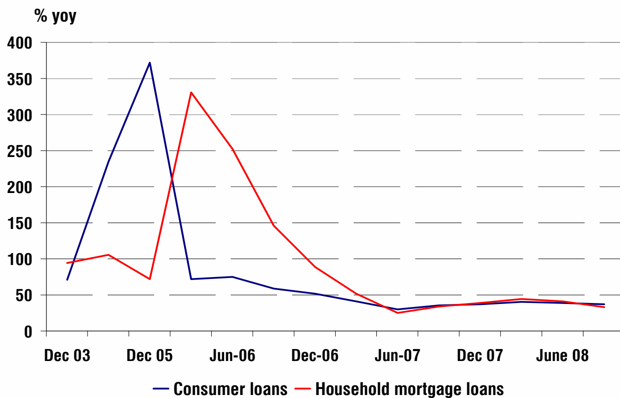
Credit Expansion



Consumer loans were the main driver behind the credit expansion in the first nine months. Consumer credit growth rate increased to 37.1% yoy in September 2008, down from 35.8% yoy a year earlier. Credit cards, the most profitable product of Turkish banks, accelerated by 32.5% yoy as of September 2008, compared to 23.2% as of September 2007. The credit card rates decline gave credit cards business a boost. Mortgages grew by 32.9% yoy in September 2008, compared to 34% a year earlier. Low mortgages penetration (4.1% of GDP in Q2 2008) and increasing housing needs will be the main supporters of mortgages credit growth. (Figure 10)

Figure 10

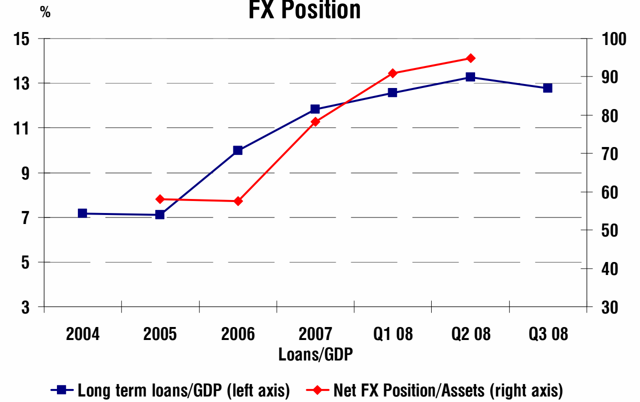
Consumer-Mortgage Loans Growth



The net FX position of the corporate sector rose to USD 81.4 bn in Q2 2008, with a 66% and 34% upsurge compared to the previous year and the beginning of 2008 respectively. As far as credit obligations of corporate sector firms are concerned, they increased during the first nine months of the year by 26.5% with industrial sectors accounting for 42% of the total loans. (Figure 12)

Figure 11

Loans Received from Abroad by private sector-FX Position

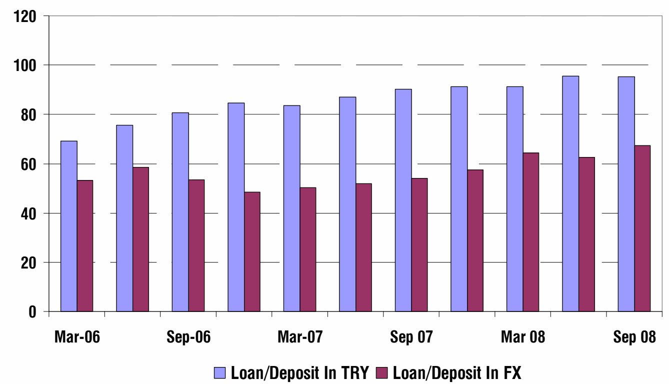


Deposit Developments

Liquidity has tightened, nevertheless still remains at sound levels. The loans to deposits ratio stands well below unity. It reached 86.3% in September 2008, compared to 77.7% last year, which is the highest in six years. Since the beginning of the year, loans to deposits ratio in FX and TRY increased to 67.2% and 95.2% from 59.5% and 91.2% respectively. Liquid assets as a percentage of total assets have remained broadly unchanged since the beginning of 2008 (11-13%). (Figure 12)

Figure 12

Loans to Deposits Ratio



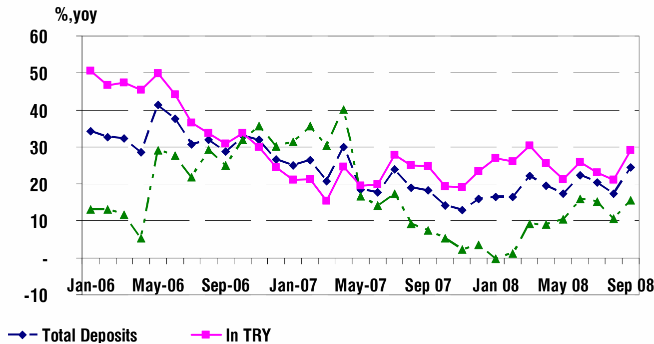
Core funding importance grows. Deposit side becomes the epicenter, the focus of our attention. The cost of deposits has gone up by 200 bps. Foreign funding will be more difficult to access. The competition among banks to attract more deposits intensifies. The tendency of the population to convert their FX savings to LC was disrupted in October.

Although failed to catch up with credit growth, deposits grew in 2008 with the same average rate as in 2007. Total deposit growth increased to 24.5% in September (the highest growth rate in 2008) compared with 18.2% a year earlier. TRY deposits were the main driver behind this development. Thus, deposits in TRY accelerated by 29.1% yoy in September against 24.8% a year earlier. Deposits in FX exhibited a more moderate growth in 2008. In September growth reached its peak at 15.7% compared to 7.4% the year before.

TRY deposits account for 68% of the total deposit portfolio in September and have illustrated more rapid growth rates than those of the deposits in FX. However, according to data released for October deposits in domestic currency growth rate has remarkably slowed down. FX deposits growth seems to accelerate by 6.8% mom in October but if we take into account the depreciation effect of the Turkish lira, growth rate becomes more moderate and does not constitute a change in the trends observed during the first nine months of 2008. To prove this, preliminary data for November indicate 2.9% mom growth for deposits in domestic currency compared with 0.3% a month earlier and 2.2% for deposits in FX against 6.8% in October. (Figure 13)

Figure 13

Total Deposit Growth

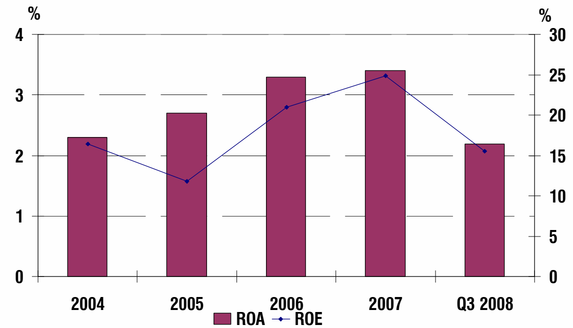


Banking Sector's Profitability and Capital Adequacy

In the first nine months of 2008, the Turkish banking sector did not succeed the profitability performance of 2007. The net profit of the banking sector decreased by 5.8% yoy in September 2008 and amounted to 11.1 billion Turkish liras. Net interest income, the main contributor in profitability, grew by 20.7% yoy in September 2008. Non-interest expenses increased by 28.3% yoy the same period. Return on Assets (ROA) stood at 2.2% in September 2008 compared to 2.7%a year earlier and Return on Equity (ROE) reached 15.5% from 19.7%, respectively. We expect that the banking sector biggest hit will be on profitability. Weak loan growth will squeeze margins. Deposits competition will push up the offered deposit rates which will not be counterbalanced by loans repricing. (Figure 14)

Figure 14

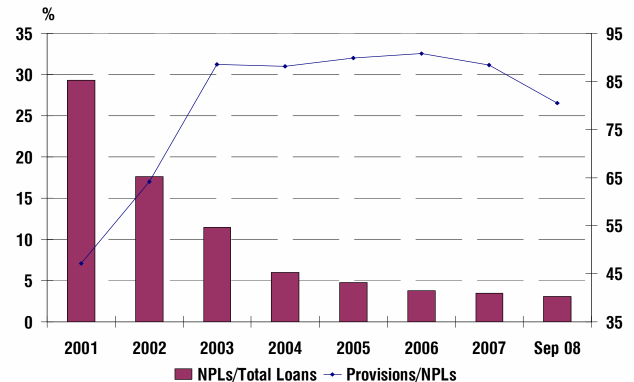
Banking Sector's Profitability



Credit risk seems to be well contained and manageable up to now. The NPLs ratio stands still close to historically low levels. In September 2008, it stood at 3.1%, compared to 3.6% a year earlier. The provisions to non-performing loans ratio continued to decrease and reached 80.5% in September 2008, down from 87.6% a year earlier. Nevertheless, the asset quality problem can arise from the ongoing economic slowdown. The FX risk is less of a concern for households than in the rest of the New Europe countries. FX lending is contained at significantly low levels, as such lending is not allowed. (Figure 15)

Figure 15

NPLs, Provisions



Turkey: MacroEconomic Indicators								
	2003	2004	2005	2006	2007	Q2 2007	Q2 2008	Q3 2008
Output and expenditure	*(Percentage Change in Real Terms)*							
GDP	5.3	9.4	8.4	6.9	4.6	4.1	2.3	0.5
Private consumption	9.2	10.2	7.5	4.6	3.4	1.4	2.8	-0.2
Public consumption	-2.6	6.0	2.5	8.4	6.5	13.5	-3.7	7.7
Gross fixed capital formation	14.2	28.4	17.4	13.3	5.5	3.9	-0.8	-5.4
Exports of goods and services	6.9	11.2	7.9	6.6	7.3	9.8	2.5	1.5
Imports of goods and services	23.5	20.8	12.2	6.9	10.7	5.0	0.9	-4.2
Industrial production (in nominal terms)	8.7	9.8	5.4	5.8	5.4	3.9	3.1	-2.1
Labour Market								
Employment	-0.8	2.0	1.7	-0.4	-3.6	-4.5	2.0	2.0
Unemployment (in per cent of labor force)	10.5	10.3	10.2	9.9	9.9	8.9	8.9	9.8
Prices	*(Percentage Change)*							
Consumer prices (annual average)	21.6	8.6	8.2	9.6	8.8	9.5	10.3	11.7
Producer prices (annual average)	22.7	14.6	5.9	9.3	6.3	6.5	16.0	15.2
Average monthly wage in industry	23.0	13.4	12.2	11.5	9.5	8.9	10.3	-
Government sector	*(In Per Cent of GDP)*							
Primary balance (National Definition)	4.1	4.7	5.5	5,5	4,1	1,0	1,4	1,4
Central Government Budget balance (National Definition)	-8.8	-5.4	-1.5	-0.5	-1.6	-0.3	0.6	-0.7
General Government debt (ESA95)	67.4	59.2	52.3	46.1	38.8	–	35.8	–
Monetary and Financial Indicators	*(Percentage Change)*							
M3	32.3	39.5	31.2	32.2	17.7	14.0	22.9	22,2
Total Credit	35.2	50.6	54.2	46.1	30.4	26.7	38.5	38.1
	(End of Period)							
Reference rate (Overnight- Borrowing)	26.00	18.00	13.50	17.50	15.75	17.50	16.25	16.8
Exchange rate YTL/USD (end-period)	1.40	1.34	1.35	1.41	1.16	1.31	1.22	1.30
Exchange rate YTL/EUR (end-period)	1.76	1.83	1.59	1.86	1.70	1.77	1.92	1.80
Real Effective Exhange Rate (Index) (1995=100)	140.60	143.20	171.40	160.10	190.30	176.00	179.80	191.80
International Position	*(In Per Cent of GDP)*							
Current account balance	-2.5	-3.7	-4.6	-6.0	-5.7	-5.6	-6.2	-6.0
Trade balance	-4.4	-5.8	-6.8	-7.8	-7.1	-7.0	-7.4	-7.4
Foreign direct investment. net	0.4	0.5	1.9	3.6	3.0	3.7	2.2	2.1
Memorandum items	*(Denominations as Indicated)*							
Population (end-year. thousand)	70712	71789	72065	72974	70586	–	–	-
GDP (in Mrd of EUR)	257.1	305.0	408.0	407.5	470.1	–	–	-
GDP per capita (in EUR)	3635.9	4248.6	5661.6	5584.2	6660.0	–	–	-

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

Turkey: Banking Indicators						
	2004	2005	2006	2007	Q2 2007	Q2 2008
Percentage of Revised GDP (%)						
Assets	54.9	62.7	65.9	69.5	91.1	71.5
Total Credit	17.4	23.1	28.9	34.2	42.2	37.3
Total Credit in FX	–	6.6	7.4	8.2	10.5	9.3
Credit to Enterprises	14.2	18.9	22.7	26.1	32.4	28.3
Credit to Households	4.7	7.0	9.1	11.4	13.5	12
Credit to Household in FX	–	0.0	0.0	0.0	0.0	0.0
Mortgages	–	1.9	3.1	3.9	4.6	4.1
Deposits	34.2	37.5	40.6	42.7	56.6	44.2
Deposits in FX	–	13.6	15.2	14.3	20.2	14.9
Percentage Change (%, yoy)						
Assets	22.7	29.5	22.8	16.4	14.2	23.1
Total Credit	50.6	54.2	46.1	30.4	26.7	38.5
Total Credit in FX	–	–	31.0	22.8	1.4	39.4
Credit to Enterprises	54.5	53.9	40.1	27.2	21.5	37.1
Credit to Households	106.0	76.7	51.8	37.5	29.7	39.1
Credit to Household in FX	–	–	17.3	73.1	3.2	8.2
Mortgages	–	–	88.4	38.8	31.6	40.7
Deposits	23.0	27.2	26.5	16.0	17.8	22.3
Deposits in FX	–	–	30.2	3.6	14.2	15.9
Percent (%)						
Capital Adequacy Ratio	28.8	24.2	22.4	18.8	18.7	16.8
Capital to Assets	14.4	12.9	11.3	13.0	12.4	11.7
NPLs to Total Loans	6.0	4.8	3.8	3.5	3.8	3.2
Provisions to NPLs	88.1	89.8	90.7	88.3	87.4	82.5
Return on Assets	2.3	2.7	3.3	3.4	1.9	1.7
Return on Equity	16.4	11.8	21.0	24.9	13.5	11.4

Sources: CBRT, IMF

6. Ukraine

A full blown recession in 2009

- **Political risk in Ukraine increased after the outbreak of the Russia-Georgia conflict and the long lasting dispute between President Yushchenko and Prime Minister Tymoshenko, which led in the dissolution of the government coalition; parliamentary elections, initially planned for December, are postponed indefinitely**
- **Access to international financial markets has come to a standstill; the cost of accessing external financing has reached sky high levels; capital inflows have dried up**
- **The heavily curtailed industrial production, caused by the sharp decrease of external demand for steel products, is likely to bring Ukraine's economy into a full blown recession in 2009**
- **Inflation on average will most likely not fall significantly below 20% in 2009, as hryvnya depreciation will kick in**
- **The hryvnia lost over 47% against the US dollar between September and mid-December due to the deteriorating steel export prices and the increasingly limited access to external financing**
- **The sharp currency depreciation, which is threatening banks' asset quality, and the alarming rate of deposit withdrawals confirms that the Ukrainian banking sector is undergoing a significant crisis**
- **In an effort to boost confidence among depositors and hold back the withdrawal wave, the Central Bank took over the 6th largest bank in the country**
- **Ukraine has agreed a $16.4bn loan with the IMF on the condition of pursuing budgetary and financial sector reforms; $4.5bn has already been disbursed.**

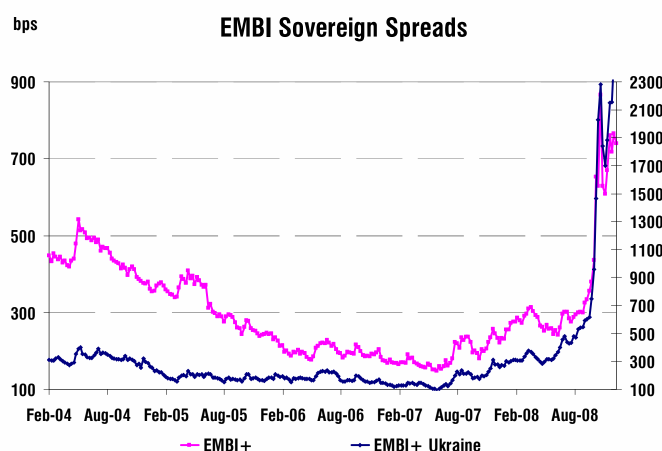
Outlook

The impact of the ongoing financial crisis in emerging markets has already been gravely felt in Ukraine. Access to international financial markets has come to a standstill; the cost of accessing external financing has reached sky high levels. International credit rating agencies downgraded the country's debt causing the capital inflows to dry up. The recent sharp contraction in industrial production -by almost 20% yoy in October and further by 28.6% yoy in November - suggests that Ukraine's economy is heading towards a full blown recession in 2009. Furthermore, due to the deteriorating steel exports and the increasingly limited access to external financing, the domestic currency has fallen sharply in the interbank market. Since last September, it has lost 47.5% against the US dollar.

This series of negative developments has led Ukraine to seek a $16.4bn loan from the IMF. The latter responded positively under the condition that Ukraine will pursue budgetary and financial sector reforms. The package calls for a flexible exchange rate, measures to recapitalize the banking system and for prudent fiscal and income policies. The government's goal is twofold; to restore confidence and financial stability and at the same time help the economy recover some of its lost competitiveness.

Presently, Ukraine's short-term financial future is threatened by two imminent dangers. First, there is always the risk of sharply increased imported gas prices, caused by the ongoing political tensions with Russia. A second risk stems from the impaired asset quality of Ukrainian banks. This may be severely affected by the impact of the hryvnya depreciation on unhedged foreign-currency borrowers. These factors are reflected in the substantial widening of Ukraine's sovereign spreads. (Figure 1) (Table)

Figure 1



Table

Ukraine	2007	2008	2009
Real GDP growth	7.3	3.5	-5.0
Inflation (annual average)	12.8	25.5	19.5
Current account balance (% of GDP)	-4.2	-7.0	-5.0

Source: IMF, NBU, National Statistics, Eurobank Research

Political Environment

The current political situation in Ukraine is disquieting. The escalating antagonism between President Yushchenko and Prime Minister Tymoshenko vis-ΰ-vis the 2010 Presidential election, in which both are expected to run for office, caused the deferral of any policymaking initiative and finally the fall of the government. Tymoshenko's Bloc allied with the pro-Moscow opposition Party of Regions in an attempt to pass certain laws which would limit Mr. Yushchenko's Presidential powers. In response, Yushchenko's "Our Ukraine" party withdrew its support from the government coalition on the 3rd of September. As the Parliament failed to form a new ruling coalition within 30 days, Mr Yushchenko dissolved the parliament in early October and called a snap election, just nine months after the government was formed. The elections were finally announced for the 14th of December. However, due to the current Ukrainian economic crisis, they have been postponed indefinitely.

Once again, relations with Russia heated up after the outbreak of the Russia-Georgia conflict. President Yushchenko condemned Russia's actions and attempted to restrict the movement of the Russian fleet. The tension escalated by the decision to grant access of missile warning systems to NATO countries. However, negotiations regarding Ukraine's NATO entry are not anymore high in the alliance's agenda. All these developments occurred amid negotiations with Russia over the crucial issue of imported gas prices. In late November, Russia increased the pressure on Ukraine enforcing the payment of $2.4bn in gas debts. Moreover, next year Russia will charge Ukraine more than $400 per 1000 cubic meters for gas supplies, instead of the current price of $179.5.

Growth Performance

After eight years of rapid GDP growth, the sharp 20% yoy decline of industrial production recorded in October confirms that Ukraine is heading towards a period of painful recession. Real GDP growth decelerated to 5.8% yoy in the first ten months of 2008, against 7.3% yoy in the same period of 2007. Note that, GDP growth was strong in January-September 2008 (6.9% yoy) but it slowed abruptly in October (-2.1% yoy). Consumption remained resilient in H1-2008 (13.6% yoy in real terms vs. 13.9% yoy in H1-2007), deriving support from negative real interest rates and the generous government wage and benefits policies. This trend has continued, with retail sales increasing by 23.1% yoy in October 2008. Real disposable income rose by 13% yoy in the first three quarters of 2008, while wage growth stood at 34.6% yoy. The persistent high inflation is expected to erode real incomes. In addition, the first signs of moderation in credit growth, especially consumer credit, have become apparent. Households' credit growth stood at 64.5% yoy in Q3-08 against 91.5% yoy in H1-08. Thus, consumption, the main growth driver, will lose its momentum. The consumption decelerating trend will come into full force in 2009, pushing GDP growth lower down the scale. Recent data suggest that the GDP growth for the eleven first months of 2008 stands at 3.6% yoy.

News from the investment front is equally discouraging. Investment activity is coming to a standstill. Investment growth slowed down to 4.7% yoy in January-September 2008, against 28.5% yoy in the same period of 2007. Higher inflation and tighter lending conditions have had a debilitating effect on investment activity. Industrial investment, which accounts for one third of total investment, decelerated to 2.3% yoy in January-September, after rising by 30% yoy in the same period a year earlier. Real estate market activity also took a plunge, down to a 0.4% yoy growth against 36.5% yoy in January-September of 2007. The increase of investment in the agricultural sector by 56.2% yoy cannot compensate for the previous decelerations.

Most of the key economic sectors have slowed down significantly. Namely, manufacturing production growth decelerated to 2.9% yoy in January-October 2008, while wholesale and retail trade expanded by 6.3% compared to 17.2% yoy in the same period a year earlier. The construction sector performance has been notably poor, owing chiefly to the limited financing in construction projects. Its gross value added declined by 12.7% yoy in the first ten months, after recording a positive growth of 11% yoy in 2007. On a more optimistic note, the favorable weather conditions boosted agricultural production. The gross value added by agriculture expanded by 18.3% yoy following a 5.3% yoy contraction in the first ten months of 2007. The Ministry of Agriculture expects total domestic grain production to amount 40 million tons this year compared to 29.3 million tons in 2007. The decision to recall the grain-exports ban is expected to provide the country with precious export revenues.

Overall, the recent sharp decline of external demand for steel products has caused a sharp reduction of the Ukrainian metals' output. Note that steel products represent 40% of the country's total exports. The crisis in industrial production is inaugurating for Ukraine a period of deep and painful adjustment in 2009. Real GDP is expected to contract substantially -5%.

Public Finances

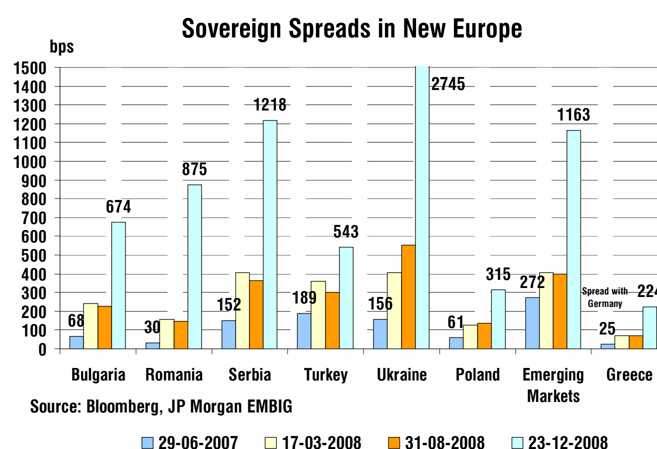
The pro-cyclical fiscal policy has so far added to the overheating of the economy, allowing current spending in the form of generous wage rises and social benefits to increase excessively. Yet, the public debt to GDP ratio remains low, projected to reach 10.6% and 17.4% of GDP at the end of 2008 and 2009, respectively, according to IMF data. During the first ten months of 2008, a surplus at around 0.9% of GDP was recorded in the consolidated government budget balance. However, this is expected to turn to a deficit by the end of the year.

Strong nominal GDP growth over the first three quarters of this year boosted VAT receipts, which account for 56% of the total tax revenue. Yet, no real progress was made over the same period in restraining public spending (41.2% yoy in Q3-08). According to the recently agreed IMF program, the full-year general government deficit must not exceed 1.0% of GDP in 2008, while a balanced budget position should be targeted next year.

The financing of the country's borrowing requirement is a major challenge, given the uncertain global economic environment and the scarcity of credit. The budget provides for privatization revenues and borrowing to cover for the deficit. The privatization program performs rather poorly so far. The international financial crisis has resulted in sovereign spreads of Ukraine skyrocketing at extremely high levels, higher than the other emerging markets. Effectively access to the international markets is blocked. (Figure 2)

Figure 2

Sovereign Spreads in New Europe

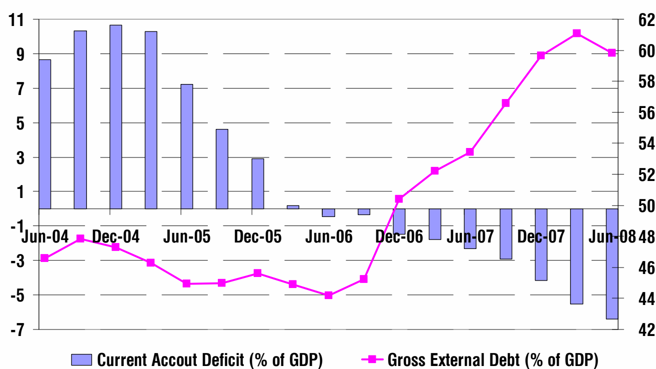


Balance of Payments

Over the last couple of years, large capital inflows in Ukraine financed the rapid import growth as well as the rising current account deficit. Moreover, the country went through a strong positive terms-of-trade shock by virtue of high international steel prices. The current account deficit swung from a 7% of GDP surplus in 2004 to a 6% of GDP deficit in 2007. The deficit continued to widen in 2008 reaching 6.5% of GDP in the first ten months. Over the same period, the trade gap widened sharply, hitting 10% of GDP. These unflattering trends can be attributed to an excessive domestic demand which has manifested itself via a strong acceleration in the growth of imports. The latter skyrocketed to 52.5% yoy in H1-08 against 34.3% yoy in H1-07. However, the most recent data showed imports growth to have declined in October to 31% yoy. Following the sudden stop in global capital flows in emerging markets, the present level of Ukraine's current account deficit has become unsustainable. Furthermore, the lingering financial crisis has lately been accompanied by a 65% drop in steel prices. In addition, the debt inflows increased significantly causing external debt to grow rapidly. The total gross foreign debt grew by 53.3% yoy in H1-08, reaching the level of 60.5% of GDP in the first semester of 2008. (Figure 3)

Figure 3

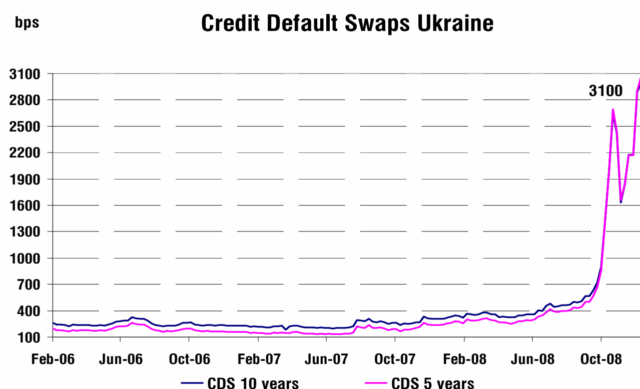
Current Account Deficit & External Debt in Ukraine



A weaker exchange rate coupled with a mediation of domestic demand is inevitable given the balance of payments shock that Ukraine is starting to experience. Under the IMF's strictures, the decline in real domestic demand should reach the level of 14% and the hrynvya should depreciate by 53% in order to bring the country's external position back to a more sustainable position. The IMF package aims to shorten the recession and limit its impact but it remains to be seen whether domestic authorities will tolerate such a deep contraction in domestic demand. Nonetheless, the IMF calls for a strong commitment by political leaders to prudent policies. Despite the recent IMF deal, CDS keep rising from their previously historical high due to the currency and private credit risk. (Figure 4)

Figure 4

Credit Default Swaps Ukraine

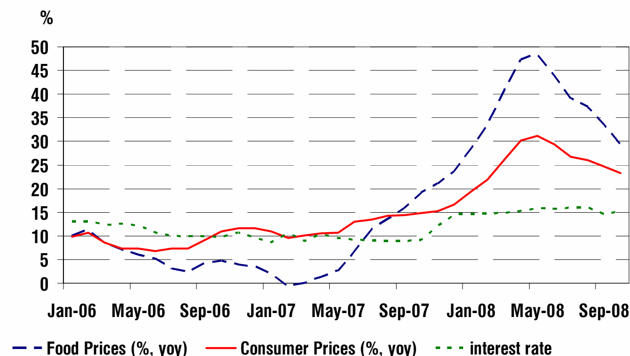


Inflation- Monetary Policy

Inflation kept rising throughout 2008, peaking at 31.1% yoy in May. It now stands at 22.3% yoy (November reading), much higher than the 15.2% of October 2007. The initial spur was energy prices, especially the gas supply shock, and food prices. Inflation is projected not to reach below 20% yoy by year end. (Figure 5)

Figure 5

Inflation Spiral & Interest Rate in Ukraine

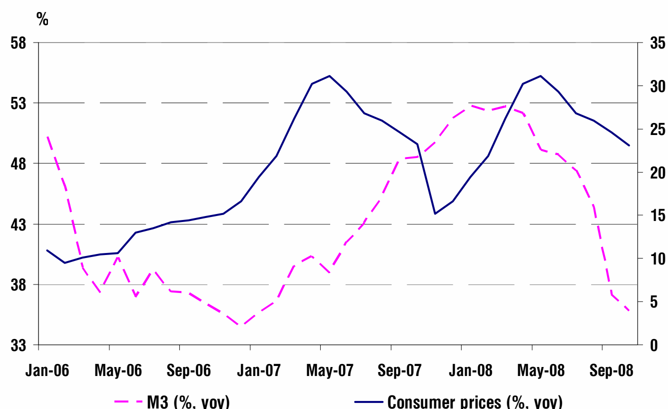


The recent inflationary pressures are closely related to the domestic financial crisis fuelled by the sharp currency depreciation. The slowdown in domestic demand coupled with lower global food, oil and steel prices should help to curb the inflationary trend in the period ahead. Though, a persisting currency weakness will most likely result in imported inflation. Note, also, that prices of gas imports from Russia are also likely to increase significantly. Furthermore, under pressure from the IMF, households will possibly bear the brunt of this potential rise in gas cost to a greater extent than in the past. This should be understood as an attempt to curb excessive domestic demand. Overall, the inflationary tendency is expected to undergo a further slowdown in the course of 2009, albeit remaining in double digit territories.

The sudden stop of global capital flows to emerging markets has had a grave impact on Ukraine where capital inflows have practically dried up. This led to a significant deceleration in money supply growth. (Figure 6)

Figure 6

Inflation and Monetization in Ukraine



The Central Bank (NBU) altered its exchange rate policy last May. The exchange rate regime shifted from an affixed currency peg to a horizontal band system. The new official exchange rate band set by the NBU council for H2 2008 was USD/UAH 4.85 +/- 4%, implying a USD/UAH fluctuation range of 4.66-5.04. This constitutes a 4% revaluation, aimed at anchoring inflationary expectations. The move also indicated the Central Bank's intention to gradually shift towards greater exchange rate flexibility, so as to protect the economy from unfavorable terms-of-trade shocks. However, taking into account the recent intensification of global financial turmoil and the ensuing pressures on the hryvnya, this new exchange rate arrangement turned out to be insufficient. The NBU council adjusted its (targeted) central parity USD/UAH rate to 4.95 and broadened the corresponding fluctuation band to +/- 8%. Even this, however, proved inadequate to countain mounting depreciation on the local currency. Due to the deteriorating steel export prices and the increasingly limited access to external financing, the domestic currency - the hryvnya - has fallen sharply on the interbank market, falling even outside the new band announced by the NBU. Since last September the hryvnya has depreciated by 47.5%. At the same time, the Central Bank lost 20% of its FX reserves trying to defend the currency. With limited foreign exchange reserves of its own and under pressure from the IMF, the NBU has recently adopted a free-floating exchange rate regime - most likely leading to further currency depreciation - in an attempt to narrow the balance of payments gap. At the end of November, the Ukrainian central bank had to tolerate acceleration in the devaluating trend of the hryvnya; USD/UAH went up to 7.5 vs. 6.0 a week earlier. At the time of writing (mid December), the USD/UAH stands at around 8.9. (Figure 7)

Figure 7

USD/UAH

Banking Developments

Despite the political turbulence and inflationary pressures, the banking sector has been bolstered by strong growth in the last few years. Ukrainian banks have enjoyed strong inflows of funding. The National Bank of Ukraine (NBU) foreign exchange interventions were the key hryvnya supply channel for the sector. The NBU's interventions proved favourable for banks as the latter received a virtually unlimited source of hryvnya funding. In March 2008, the NBU shifted to a more restrictive monetary policy stance, aiming to lessen its foreign exchange intervention. This resulted in a scarcity of hryvnya resources. The NBU's more restrictive measures caused a hryvnya deficit in domestic banks; domestic interbank interest rates rose to an average 17% in the second quarter of 2008 compared to levels between 2% and 5% in 2007. Consequently, many banks faced a funding deficit last August. The liquidity squeeze has already adversely affected bank lending expansion. In view of the ongoing liquidity tightening, the banking sector's total assets growth is expected to decelerate to 38% in 2008 from a record high of 76% of 2007.

In mid-October, the liquidity crisis in the Ukrainian banking sector led to the liquidation of thirteen banks which was accompanied by an abrupt deposit withdrawals wave. These developments coupled with dwindling foreign capital inflows and severe pressures on the hryvnya led Fitch Rating Services to downgrade Ukraine from BB- to B+.

It is obvious that the Ukrainian banking sector is undergoing a significant crisis. Two are the underlying factors; a sharp currency depreciation threatening banks' asset quality (through the impact on unhedged foreign-currency borrowers) and an alarmingly large run on deposits. The latter prompted the Central Bank to take over the 6th largest bank in the country, Prominvestbank, in order to boost confidence among depositors and hold back the withdrawal wave. Moreover, at the beginning of December the government decided to inject capital in two state-owned banks. In particular, their capital will be increased by 89% and 48% respectively. In both banks 100% of the stakes are to remain in state ownership. These capital injections should be conducted via a seven-year government bond issue. This development is in line with the recently adopted anti-crisis legislation and complies with the IMF requirements. Under the IMF agreement, a UAH40bn stabilization fund will be created. It will be used to recapitalize the domestic banking sector by issuing loans and conducting banks bailouts.

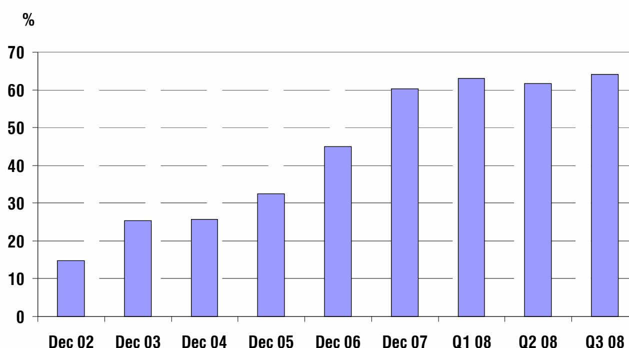
Subsequent proposals from the IMF aim at further securing liquidity access to viable banks by imposing a higher ceiling for 100% guarantee on individual accounts (increasing the coverage to €20.000) and by a stricter monitoring of banks through cross-border supervisory cooperation. The NBU, on its part, has embarked upon an effort to alleviate the deposit run by imposing a six month moratorium on early withdrawal of all term deposits. Additionally, in an attempt to ease pressure on foreign exchange markets, it has prohibited the availability of FX denominated credit to applicants with no FX income revenues.

Credit Developments

Credit growth peaked at 80% yoy in January 2008, before embarking upon a gradual deceleration trend, reaching 62.1% yoy in October 2008 (latest available data). The total stock of credit outstanding stood 64.1% of GDP in Q3-2008. (Figure 8)

Figure 8

Credit as percentage of GDP

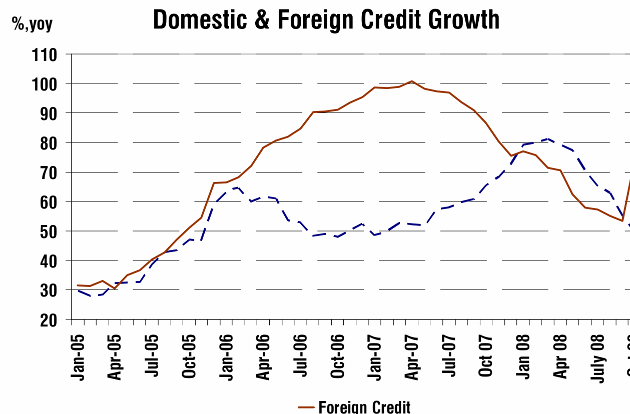


Credit growth is projected to subside further by year-end and perhaps even reach 30% yoy. Demand for credit will also slow down on the back of a deteriorating macroeconomic environment and increased geopolitical tensions in the region.

Credit growth in Hryvnya, the local currency, accelerated to 61% yoy in Q3-2008, to decelerate to 50% in October. Conversely, FX credit growth accelerated to 73.6% in October against 55.3% in Q3-08. (Figure 9)

Figure 9

Domestic & Foreign Credit Growth

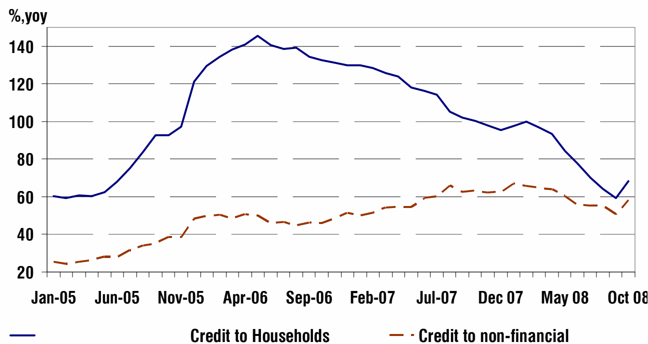


Consumer credit, the main engine of domestic credit expansion, witnessed the largest slowdown. Household lending growth reached 68.4% yoy (67% yoy in FX) in October 2008, as opposed to 100.3% yoy (116.5% yoy in FX) in October 2007. Mortgages have become more expensive and lending conditions tougher. The mortgage segment showed more signs of weakness than consumer loans. Mortgage lending grew at 69.6% yoy in October against 127% yoy in December last year.

The corporate market is affected less by the general credit growth slowdown. Corporate credit grew by 58% yoy in October 2008, against 63% a year earlier. This relatively mild slowdown masks the diverging trends in local and FX corporate lending. Corporate credit growth in Hryvnya increased by an impressive 80% yoy in October compared to a 60% yoy growth in August. (Figure 10)

Figure 10

Household & Corporate Credit Growth

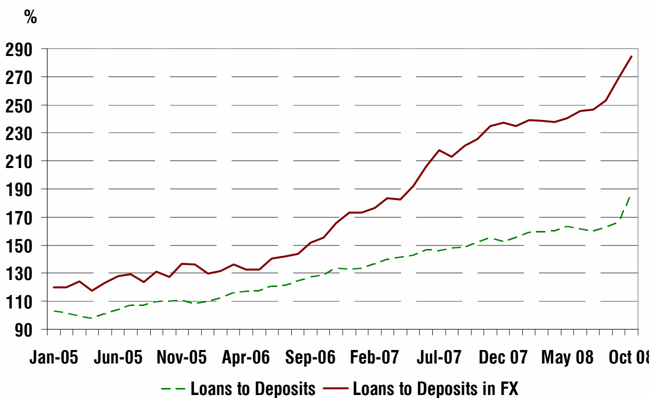


Deposit Developments

Liquidity risk remains high despite the credit growth slowdown. In recent years, Ukraine has had the highest loans-to-deposits ratio among the countries of New Europe. This ratio stood at 187.1% in October 2008, compared to 162.9% in August. This latter implies tight liquidity conditions expose the country to an additional risk in the current environment of liquidity shortage. Moreover, the FX loans to deposits ratio increased to 284.4% in October, as opposed to 253.2% in August. (Figure 11)

Figure 11

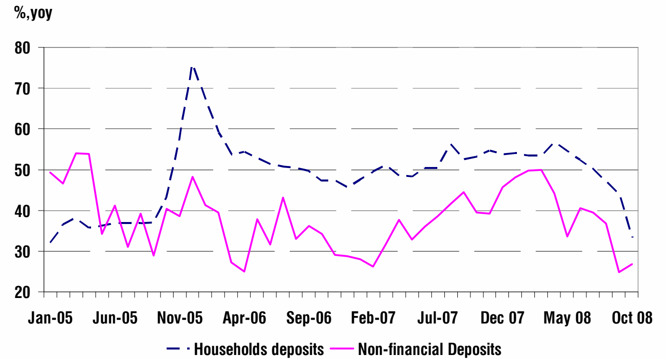
Loan to Deposit Ratio



Total deposits grew by 31.6% yoy in October down from 49.2% yoy in H1-08. Household deposits decelerated to 33.5% yoy in October compared to 47.2% yoy in Q3-08. Corporate deposit growth grew by 26.7% in October against 33.7% yoy in Q3-08. (Figure 12)

Figure 12

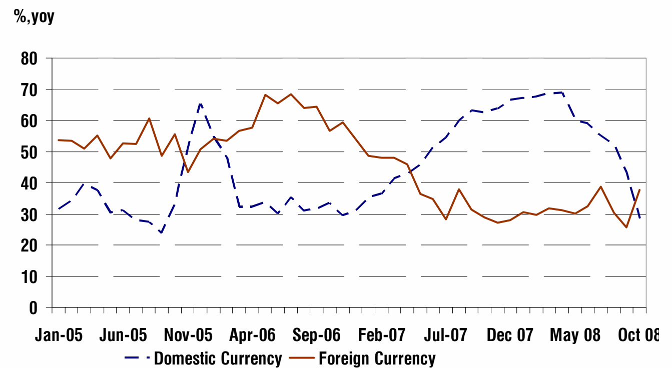
Household and Corporate Deposits



The Hryvnya deposits growth decelerated to 28.4% yoy in October against 50.2% yoy in Q3-08. Conversely, the FX deposits growth accelerated to 37.6% yoy in October compared to 31.6% yoy in Q3-08. In October there is a decline of 2.6% in total deposits compared to September. (Figure 13)

Figure 13

Total Deposit Growth



Banking Sector Profitability and Capital Adequacy

The recent deceleration of credit growth and the higher funding costs have already reflected on the banks' balance sheets. Return on Assets (ROA) declined slightly to 1.3% in Q3 2008 while the Return on Equity (ROE) stood at 11% in the same period. The Capital Adequacy Ratio increased to 14.5% in Q3-08 from 14.3% in Q1-08.

Ukraine: Macroeconomic Indicators							
	2003	2004	2005	2006	2007	Q2 2007	Q2 2008
Output and expenditure	*(Percentage Change in Real Terms)*						
GDP	9.6	12.3	3.0	6.8	7.8	8.6	6.5
Final Consumption	9.8	10.2	15.3	12.5	13.4	13.5	10.2
Gross Fixed Capital Formation	27.9	4.9	18.6	19.0	22.2	27.8	31.0
Exports of goods and services	10.3	16.6	-11.9	-5.1	3.3	4.6	8.9
Imports of goods and services	16.3	10.9	6.5	6.6	19.5	20.7	25.6
Industrial production	15.2	12.1	3.2	5.9	10.2	10.9	7.3
Labour Market							
Unemployment (in per cent of labor force)	9.1	8.6	7.2	6.8	6.4	6.6	6.2
Prices	*(Percentage Change)*						
Consumer prices (annual average)	5.2	9.1	13.6	9,1	12.8	11.4	30.2
Produce Prices (annual average)	7.7	20.3	16.7	9.5	19.5	19,7	40,3
Average monthly wage in economy	23.0	27.7	36.5	29.4	29.7	26.8	39.4
Government sector	*(In Per Cent of GDP)*						
Consolidated Budget Deficit	0.2	3.2	1.8	0.7	1.1	1.6	1.5
General government debt	29.1	24.7	18.4	15.2	14.9	9.1	7.5
Monetary and Financial Indicators	*(Percentage Change)*						
M2	48.2	45.2	38.6	38.4	43.1	39.4	50.0
Total Credit	61.4	30.6	61.9	71.0	74.1	75.6	64.1
	(End of Period)						
Reference Rate (Discount Rate)	*7.00*	*9.00*	*9.50*	*8.50*	*8.00*	8.00	12.00
Exchange rate UAH/USD (end-period)	5.33	5.30	5.04	5.04	5.04	5.00	4.53
Exchange rate UAH/EUR (end-period)	6.72	7.21	5.95	6.65	7.37	6.80	7.15
Real Effective Exhange Rate (Index)	98.29	96.13	105.89	110.99	112.57	111.08	125.57
International Position	*(In Per Cent of GDP)*						
Current account balance	5.8	10.7	2.9	-1.5	-4.2	-2.3	-6.4
Trade balance	1.0	5.8	-1.3	-4.8	-7.5	-6.6	-9.4
Foreign direct investment, net	2.8	2.6	8.7	5.3	6.5	5.5	6.6
Gross External debt	47.5	47.2	45.9	50.6	59.9	53.4	59.9
Memorandum items	*(Denominations as Indicated)*						
Population (end-year, thousand)	–	–	46924.8	46607.4	46749.2	–	–
GDP (in millions of EUR)	–	–	70338.6	84804.0	102737.2	–	–
GDP per capita (in EUR)	–	–	1499.0	1819.5	2197.6	–	–

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

Ukraine: Banking Indicators						
	2004	2005	2006	2007	Q2 2007	Q2 2008
Percentage of GDP (%)						
Total Credit	25.7	33.8	45.6	60.3	51.7	61.7
Total Credit in FX	10.8	14.1	22.3	30.1	26.5	30.5
Credit to Enterprises	20.7	25.0	29.5	36.8	32.9	37.2
Credit to Enterprises in FX	8.3	9.4	12.7	15.4	14.1	15.8
Credit to Households	4.3	8.4	15.1	22.6	18.3	23.7
Credit to Household in FX	2.5	4.6	9.4	14.4	12.3	14.5
Deposits	24.0	31.3	33.9	39.5	35.2	38.3
Deposits in FX	8.8	10.3	12.9	12.7	12.9	12.4
Percentage Change (%, yoy)						
Total Credit	30.6	61.9	71.0	74.1	75.6	64.1
Total Credit in FX	32.2	66.3	95.4	75.4	97.4	57.9
Credit to Enterprises	24.7	48.2	51.3	62.3	59.3	55.4
Credit to Enterprises in FX	24.8	44.1	67.4	58.0	68.3	54.6
Credit to Households	63.1	121.0	130.0	95.6	116.3	77.7
Credit to Household in FX	62.7	138.8	152.1	98.7	147.4	61.4
Deposits	35.2	60.0	38.8	51.8	44.8	49.2
Deposits in FX	54.3	50.8	54.0	28.1	34.7	32.5
Percent (%)						
Capital Adequacy Ratio	16.8	15.0	14.2	13.9	14.0	14.4
Capital to Assets	13.7	11.9	12.5	11.6	11.5	11.9
NPLs to Total Loans	30.0	19.6	17.8	13.2	16.5	-
Provisions to NPLs	21.1	25.0	23.1	26.3	23.7	-
Return on Assets	1.1	1.3	1.6	1.5	1.4	1.3
Return on Equity	8.4	10.4	13.5	12.7	11.3	11.2

Sources: NBU, IMF

Statistical Annex

Country Ratings - foreing currency long term debt

		Current	From	On (date)	Outlook	Date
Bosnia & Herzegovina	Moody's	B2	B3	17-May-06	Stable	24-May-06
	S&P	-	-	-	-	-
	Fitch	-	-	-	-	-
Bulgaria	Moody's	Baa3	Ba1	01-Mar-06	Stable	25-Sep-08
	S&P	BBB	BBB+	30-Oct-08	Negative	30-Oct-08
	Fitch	BBB-	BBB	10-Nov-08	Stable	11-Oct-08
Croatia	Moody's	Baa3	-	-	Stable	19-Nov-08
	S&P	BBB	BBB-	22-Dec-04	Negative	27-Oct-08
	Fitch	BBB-	BB+	28-Jun-01	Stable	28-Aug-07
Czech Republic	Moody's	A1	Baa1	12-Nov-02	Stable	8-Dec-08
	S&P	A	A-	02-Oct-07	Stable	02-Oct-07
	Fitch	A+	A	04-Mar-08	Stable	04-Mar-08
Estonia	Moody's	Aa1	A1	24-May-06	Negative	7-Nov-08
	S&P	A	A-	17-Nov-04	Negative	21-Jan-08
	Fitch	A-	A	03-Oct-08	Negative	03-Oct-08
Hungary	Moody's	A3	A2	7-Nov-08	Negative	7-Nov-08
	S&P	BBB	BBB+	17-Nov-08	Negative	17-Nov-08
	Fitch	BBB	BBB+	10-Nov-08	Stable	10-Nov-08
Kazakhstan	Moody's	Baa2	-	-	Stable	09-Jun-06
	S&P	BBB-	BBB	08-Oct-07	Negative	29-Apr-08
	Fitch	BBB-	BBB	28-Nov-08	Negative	17-Dec-07
Latvia	Moody's	A3	A2	7-Nov-08	Negative	25-Sep-08
	S&P	BBB-	BBB	10-Nov-08	Negative	10-Nov-08
	Fitch	BBB-	BBB	11-Nov-08	Negative	11-Nov-08
Lithuania	Moody's	A2	A3	12-Sep-06	Negative	7-Nov-08
	S&P	BBB+	A-	27-Oct-08	Negative	27-Oct-08
	Fitch	A-	A	03-Oct-08	Negative	03-Oct-08
FYROM	Moody's	-	-	-	-	-
	S&P	BBB-	BB+	12-Jun-07	Negative	1-Dec-08
	Fitch	BB+	-	02-Dec-05	Stable	4-Nov-08
Poland	Moody's	A2	Baa1	12-Nov-02	Stable	24-May-06
	S&P	A-	BBB+	29-Mar-07	Stable	27-Oct-08
	Fitch	A-	BBB+	18-Jan-07	Stable	10-Nov-08
Romania	Moody's	Baa3	Ba1	06-Oct-06	Stable	06-Oct-06
	S&P	BB+	BBB-	27-Oct-08	Negative	27-Oct-08
	Fitch	BBB	BBB-	31-Aug-06	Negative	10-Nov-08
Russia	Moody's	Baa1	Baa2	16-Jul-08	Stable	12-Dec-08
	S&P	BBB	BBB+	8-Dec-08	Negative	23-Oct-08
	Fitch	BBB+	BBB	25-Jul-06	Negative	10-Nov-08
Serbia	Moody's	-	-	-	-	-
	S&P	BB-	-	18-Jul-05	Negative	11-Mar-08
	Fitch	BB-	-	19-May-05	Stable	02-Aug-07
Slovakia	Moody's	A1	A2	17-Oct-06	Positive	31-Jul-08
	S&P	A+	A	27-Nov-08	Stable	27-Nov-08
	Fitch	A+	A	08-Jul-08	Stable	08-Jul-08
Slovenia	Moody's	Aa2	Aa3	26-Jul-06	Positive	29-Jul-06
	S&P	AA	AA-	16-May-06	Stable	02-Mar-07
	Fitch	AA	AA-	12-Jul-06	Stable	16-Oct-07
Turkey	Moody's	Ba3	B1	14-Dec-05	Stable	24-May-06
	S&P	BB-	B+	17-Aug-04	Negative	13-Nov-08
	Fitch	BB-	B+	13-Jan-05	Stable	12-Dec-07
Ukraine	Moody's	B1	B2	8-Aug-08	Stable	20-Oct-08
	S&P	B	B+	24-Oct-08	Negative	24-Oct-08
	Fitch	B+	BB-	17-Oct-08	Negative	17-Oct-08

Exchange Rates-EURO										
	Quarterly-eop.				Latest	Latest YTD				
	Q4 2007	Q1 2008	Q2 2008	Q3 2008	19-Dec-08	% change	Max	Date	Min	Date
Bulgaria	1,96	1,96	1,96	1,96	1,96	0,11	1,96	18/11/2008	1,95	29/10/2008
Poland	3,60	3,52	3,35	3,40	4,13	14,87	4,13	19/12/2008	3,20	25/7/2008
Romania	3,58	3,73	3,65	3,75	3,93	9,92	3,96	6/10/2008	3,48	6/8/2008
Turkey	1,72	2,09	1,94	1,79	2,11	22,93	2,19	17/12/2008	1,70	24/12/2007
Ukraine	7,36	7,89	7,19	7,15	11,47	55,77	12,99	18/12/2008	6,67	10/9/2008
Serbia	78,80	82,43	78,51	76,84	86,00	9,14	91,70	3/12/2008	75,79	6/8/2008
Croatia	7,33	7,27	7,24	7,11	7,24	-1,25	7,36	7/1/2008	7,07	19/11/2008
Czech R.	26,55	25,24	23,88	24,50	26,48	-0,24	26,62	28/12/2007	22,97	21/7/2008
Hungary	252,86	260,65	235,38	242,15	264,95	4,78	279,03	22/10/2008	228,49	21/7/2008
Kazakhstan	176,07	190,52	190,25	168,96	167,54	-4,85	192,66	22/4/2008	149,73	20/11/2008
Latvia	0,70	0,70	0,70	0,71	0,70	0,42	0,71	8/10/2008	0,70	20/2/2008
Russia	35,89	37,09	36,94	36,14	39,10	8,94	39,24	18/12/2008	34,15	27/10/2008
Slovakia	33,61	32,50	30,22	30,30	30,21	-10,11	33,97	23/1/2008	36,17	12/12/2008

Exchange Rates-USD										
	Quarterly-eop.				Latest	Latest YTD				
	Q4 2007	Q1 2008	Q2 2008	Q3 2008	19-Dec-08	% change	Max	Date	Min	Date
Bulgaria	1,34	1,24	1,24	1,39	1,40	4,65	1,57	28/10/2008	1,22	22/4/2008
Poland	2,46	2,22	2,13	2,41	2,97	20,76	3,09	27/10/2008	2,03	18/7/2008
Romania	2,45	2,36	2,32	2,66	2,82	15,09	3,08	12/11/2008	2,22	22/4/2008
Turkey	1,17	1,32	1,23	1,27	1,52	29,91	1,73	20/11/2008	1,15	15/1/2008
Ukraine	5,05	5,00	4,57	5,08	8,27	63,88	8,95	17/12/2008	4,51	1/7/2008
Serbia	54,00	52,21	49,83	54,52	61,81	14,46	72,10	3/12/2008	49,00	4/8/2008
Croatia	5,03	4,61	4,59	5,05	5,20	3,48	5,76	27/10/2008	4,53	21/7/2008
Czech R.	18,18	15,98	15,16	17,38	19,01	4,58	20,66	20/11/2008	14,43	21/7/2008
Hungary	173,23	165,14	149,41	171,82	190,95	10,23	217,75	24/10/2008	143,50	21/7/2008
Kazakhstan	120,68	120,68	120,77	119,90	120,80	0,10	121,08	27/12/2007	119,48	15/9/2008
Latvia	0,48	0,44	0,45	0,50	0,50	4,65	0,57	20/11/2008	0,44	22/4/2008
Russia	24,60	23,49	23,44	25,64	28,17	14,51	28,17	19/12/2008	23,16	14/7/2008
Slovakia	23,01	20,57	19,18	21,54	21,78	-5,36	24,38	27/10/2008	19,04	14/7/2008

Money market interest rates-3 Month								
	Quarterly-eop.				Latest	Latest YTD		
	Q4 2007	Q1 2008	Q2 2008	Q3 2008	19-Dec-08	% change	Max	Date
Bulgaria	6,5	6,7	6,7	7,4	7,7	17,9	8,0	27/11/2008
Poland	5,7	6,2	6,7	6,6	6,5	14,1	6,9	24/10/2008
Romania	8,4	11,0	12,0	13,7	15,5	85,0	49,8	20/10/2008
Turkey	17,2	16,7	19,2	18,5	17,5	2,0	21,7	30/10/2008
Croatia	7,4	6,4	6,4	8,3	8,4	13,1	9,2	20/11/2008
Czech R.	4,1	4,1	4,2	4,0	3,7	-9,8	4,5	31/10/2008
Hungary	7,5	8,2	8,8	8,7	10,4	38,7	12,4	27/10/2008
Kazakhstan	14,0	11,0	9,0	9,0	10,4	-25,7	14,0	10/1/2008
Latvia	10,5	6,0	6,3	7,2	11,6	10,5	14,6	19/12/2008
Russia	6,9	7,4	6,4	9,4	20,5	197,1	22,4	27/11/2008
Slovakia	4,3	4,3	4,4	4,3	3,2	-25,6	4,4	7/7/2008

Stock Markets					
				Performance	
Country	Closing Price 19-Dec-08	Highest Level of 52 Weeks	Lowest Level of 52 Weeks	Since Last Quarter (%)	Since January (%)
Poland	27.222,22	56.560,93	24.852,95	-32,36	-50,97
Romania	2.847,86	9.825,38	2.596,30	-46,88	-70,23
Ukraine	306,66	1.208,61	222,26	-36,00	-73,57
Serbia	479,48	2.346,24	479,48	-63,44	-63,44
Bulgaria	357,28	1.767,88	319,04	-63,89	-79,79
Turkey	26.205,40	55.698,42	21.228,27	-33,01	-52,10
Czech R.	818,70	1.818,20	699,80	-41,12	-54,73
Russia	634,22	2.487,92	549,43	-54,54	-72,38
Hungary	12.664,51	26.318,29	10.751,23	-36,68	-51,08
Slovakia	359,18	467,08	346,32	-16,70	-19,78
Croatia	1.737,64	5.279,14	1.503,36	-49,58	-66,87
Estonia	285,53	744,22	260,19	-48,58	-61,53
Latvia	265,05	625,92	256,19	-47,84	55,89

5-Y Credit Default Swaps (USD,bp)						
	quarterly-eop.				Latest	Latest YTD
	Q4 2007	Q1 2008	Q2 2008	Q3 2008	19-Dec-08	% change
Romania	82	203	193	260	710	765,9
Turkey	167	310	309	297	437	161,7
Bulgaria	72	180	159	225	556	672,2
Poland	24	74	51	74	276	1050,0
Ukraine	242	299	378	718	3225	1232,6
Croatia	66	133	95	138	485	634,8
Czech R.	16	42	28	62	178	1012,5
Hungary	49	176	134	166	443	804,1
Kazakhstan	203	282	222	435	686	237,9
Latvia	138	156	167	330	868	529,0
Russia	88	148	108	261	759	762,5
Slovakia	17	54	30	60	170	900,0

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