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NEW EUROPE ECONOMICS & STRATEGY

Monthly Bulletin

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Current trajectory & 2010 prospects

Bulgaria: Domestic economic downturn continues, with the new government pledging to maintain a balanced budget in the period 2010-2012. Application for ERM II entry is deferred until early next year

Romania: Political limbo delays disbursement of 3rd IMF tranche; puts fiscal targets at risk

Serbia: Conclusion of 2nd IMF review alleviates external financing concerns; provides hope that the government will go ahead with the necessary fiscal reforms. Serbia will likely file for EU candidate status soon

Poland: Resilience to the global crisis but fiscal worries cloud the outlook

Turkey: Return to positive GDP growth expected in 2010; expectations for a new IMF loan accord on the rise again

Ukraine: Unstable political climate threatens implementation of IMF program

Market strategy highlights - New Europe

- **Local currency markets are** expected to outperform other asset classes in the region in 2010 on improving macroeconomic conditions and a further hawkish shift in monetary-policy expectations
- We do not currently see much value in regional **local-rate markets** and investors should rather diversify to floating rate instruments and inflation linked bonds where available. We expect higher rates in Poland and Turkey in the coming months
- **Sovereign credit spreads** in emerging market economies currently appear to be more or less in line with current economic conditions, absolute level of rates, availability of cash and volatility. According to our fundamentals-based valuation framework, Hungary and Ukraine are now among the cheapest credits in the EM universe

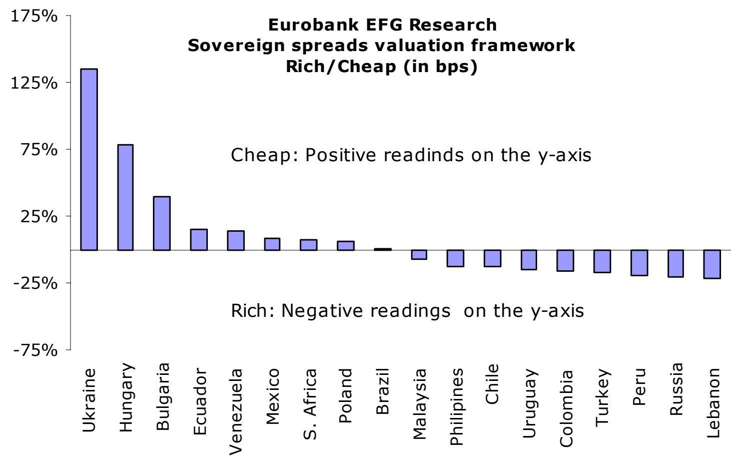


Table of Contents

Introductory comment

Dear readers,

With the present issue we inaugurate our *New Europe Economics & Strategy*, a monthly bulletin on the economic developments and market trends in six emerging economies: Bulgaria, Romania, Serbia, Turkey, Poland and Ukraine.

New Europe is an area of economic opportunity that deserves extensive coverage. Prior to the crisis, the region was growing at an average rate of ca 6% per annum. However, this growth was not sustainable. The dramatic events that followed the Lehman Brothers collapse in September 2008 caught New Europe overheating, with large current account deficits and unsustainable rates of credit expansion, a lot of it in foreign currency. As a result, the region was hit hard by a sudden collapse of export markets and a concomitant shrinkage of capital inflows, which caused significant output losses and immense pressure in local asset and currencies markets.

Since the middle of 2009, there is a ray of recovery hope in Europe and New Europe, in particular. Local currencies have recouped a significant part of their earlier losses and most economies in the region are now expected to record positive, yet substantially below-potential, rates of growth next year. The road to recovery is expected to be slow and painful, with a forced correction of imbalances. Yet, more sustainable rates of growth are expected in the medium-term, especially in countries featuring political stability and prudent policy frameworks.

The international financial crisis marks the end of the earlier demand-driven growth model in the region. This model delivered higher living standards in recent years but it appears to have reached its limits. In our view, a more balanced growth model is needed in the years to come, which would depend on improving the domestic savings rate, shifting domestic demand from consumption towards investment, focusing more on export markets, and fostering domestic competitiveness and total factor productivity. It is widely accepted that the latter benefits from the rule of law, the quality of institutions and domestic infrastructure, as well as the matching of human capital development and job training with the modern needs of an increasingly globalized world economy.

In the future, policy makers ought to be focusing more closely on the supply characteristics of their economies, while simultaneously ensuring macro-economic stability. Fiscal and monetary policy prudence are accompanied by an environment of economic and financial stability and low rates of domestic inflation, factors which are closely watched by the IMF, the rating agencies, fund managers and Greenfield investors. If achieved, they result in low real interest rates, low risk premia and significant FDI inflows.

I remain optimistic about the future of New Europe, among other reasons because policy making in the region is driven by the European anchor. Indeed, achieving EU and/or EMU membership implies a degree of discipline in economic policy making, which transcends the usual political business cycle and forces civilians and politicians to follow prudent macroeconomic and structural policies.

Gikas A. Hardouvelis

Chief Economist & Director of Research

Summary of key macroeconomic indicators
Realizations and forecasts

	GDP real (yoy)			Consumer Prices (annual average)			Current Account (%GDP)		
	2008	2009f	2010f	2008	2009f	2010f	2008	2009f	2010f
Bulgaria	6.0	-5.9	-1.1	12.0	2.4	1.6	-25.4	-12.0	-10.0
Poland	5.0	1.3	2.0	4.2	3.2	2.5	-5.1	-2.5	-3.0
Romania	6.2	-7.5	0.5	7.9	5.5	3.6	-12.3	-6.0	-5.5
Serbia	5.5	-3.5	1.5	11.7	8.0	7.0	-17.3	-8.5	-9.5
Turkey	0.9	-5.5	3.0	10.4	6.0	6.3	-5.7	-2.0	-3.0
Ukraine	2.1	-15.0	1.0	25.3	16.5	13.0	-7.0	-0.4	-1.0
New Europe	3.2	-5.1	1.9	10.5	6.5	5.7	-7.8	-3.1	-3.6
Euroarea	0.6	-4.0	0.8	3.3	0.3	1.0	-1.1	-0.7	-0.6
USA	0.4	-2.5	1.8	3.8	-0.4	1.3	-4.9	-2.6	-2.5

Foreign exchange and policy interest rates
Realizations and forecasts

		FX Rates			Interest Rates		
eop		2008	2009f	2010f	2008	2009f	2010f
Bulgaria	**vs EUR**	1.96	Currency Board		Currency Board		
Poland	**vs EUR**	4.15	4.15	3.80	5.00	3.50	4.00
Romania	**vs EUR**	4.03	4.32	4.30	10.25	8.00	7.00
Serbia	**vs EUR**	89.79	94.50	95.00	17.75	10.00	9.00
Turkey	**vs USD**	1.54	1.50	1.50	15.00	6.25	7.25
Ukraine	**vs USD**	8.05	8.40	8.50	12.00	10.25	10.25
Euroarea	**vs USD**	1.40	1.50	1.45	2.50	1.00	1.50
USA	**vs EUR**	0.72	0.67	0.69	0.125	0.125	0.75

Source: National statistics, IMF, EC, Bloomberg, Eurobank EFG Research forecasts

I. Overview

A. Current levels in world markets hardly reveal the extent and severity of the recent financial crisis

As 2009 draws to a close, a simple comparison of the early-December levels in world financial markets with those at the beginning of the year hardly reveals the depth and extent of the worst financial crisis in recent economic history. The S&P 500 index hit a fresh year-to-date closing high above 1110 in mid-November while the European benchmark FTSEurofirst 300 is now up by more than 53% from its record low of March 9 on increased optimism that a global economic recovery is now under way. In a similar note, other key metrics of investor attitude towards risk have improved materially in recent months, with their present levels suggesting that the scenario of a global financial system collapse has been almost completely priced-out (Table A).

Table A

Key metrics of investor attitude towards risk are now back to their pre-Lehman levels

Systemic Risk indications		
	Pre-Lehman	23-Noε-09
USD 3m Libor-OIS spread	87	13
EUR 3m Libor-EONIA spread	64	22
S&P volatility index (VIX)	26	22
DJ volatility index (Vstoxx)	27	27
USD gamma index	128	106
EUR gamma index	81	86

Asset prices		
	Pre-Lehman	23-Noε-09
S&P Index	1252	1091
S&P Financials Index	283	196
DJ €Stoxx	3278	2833
MSCI benchmark emerging market	855	965
ITRAXX Europe	103	86
ITRAXX XOVER	546	533
Raw industrials index	463	462
Baltic dry index	4800	4507
EMBI+ emerging Europe	289	257

Sources: Bloomberg, Reuters

The notable improvement in global market conditions since March 2009, has, to a great extent, been underpinned by aggressive policy measures taken by major central banks and governments around the world to support their economies and enhance investor sentiment. Recent press reports suggest that the Fed is leaning towards extending the Troubled Asset Relief Program (TARP) into next year, while the November FOMC policy statement reinforced the view that a rate hike still remains a distant prospect.

Meanwhile, recent statements by a number of key policymakers around the world helped allay fears of a premature withdrawal of liquidity measures, with G20 finance ministers pledging to keep current policy stimulus in place until the world economic recovery is entrenched. A fresh flurry of positive readings in real activity and sentiment indicators from both sides of the Atlantic further enhanced investor sentiment. Among others, US existing home sales rose in October by their highest monthly pace in nearly three years and Eurozone´s industrial output improved for the fifth straight month in September. Moreover, China's stronger-than-expected industrial output and retail sales for the month of October reinforced optimism that domestic real GDP growth this year will likely surpass an official forecast of 8.0%.

Adding to expectations that the global recovery is gaining momentum, US Q3 earnings results of the S&P 500 companies have generally outperformed expectations by a wide margin. According to Bloomberg, out of the 490 S&P companies that have reported results so far, 391 or 79.8% outperformed market expectations, 12.9% were below estimates and 7.3% were in line.

B. Emerging markets recovered strongly from early-2009 lows

In line with improving risk sentiment, emerging stock markets have embarked on a strong uptrend since reaching multi-year lows earlier this year. The benchmark Emerging Markets MSCI index, which shed nearly 70% from its November 2007 record high to reach a trough of 445.94 in October 2008, has since bounced by more than 110%. Year-to-date, emerging market (EM) equities have outperformed a 27% jump in their developed counterparts, having soared by more than 70% to touch a 15-month high above 988 in mid-November.

In New Europe, most regional indices rallied by more than 60% over that period (Figure 1). Yet, the region has lagged the momentum witnessed in the rest of the EM space, with a 90% rise in the MSCI BRICS sub-index over the January-November period outpacing gains of 80% registered in each of the Eastern Europe and the Emerging Europe sub-indices.

Local rate markets in New Europe have also rallied strongly over the last few months on improved investor sentiment, easing inflation pressures and aggressive policy-rate cuts. At a level of around 7.22% on December 1, the yield of the 3-year Hungarian benchmark government security stood not far from a 12-month low of 7.01% reached in late October, having declined by more than 700bps from its March highs. In a similar vein, its 10-year counterpart traded at 7.77% on December 1, some 500bps lower from a peak touched earlier this year.

Not surprisingly, following 1025bps of cumulative rate easing by the CBRT since November 2008, the Turkish local rates market remains amongst the outperformers in the region, with the yield of the August 3, 2011 benchmark T-bill having slid to multi-year lows around 8.00% presently, from highs near 9.30% earlier this year.

In spite of the ongoing improvement in investor sentiment, New Europe currency markets continue to lag the rally in other asset classes, mainly as a result of lingering financing vulnerabilities and their eroded carry appeal, following months of aggressive monetary policy easing in the region. Most regional currencies were weaker against major pears year-to-December 1, with the notable exceptions of the Turkish lira, the Russian rubble and the Czech crown, which, however, posted single-digit cumulative gains over that period (Figure 2).

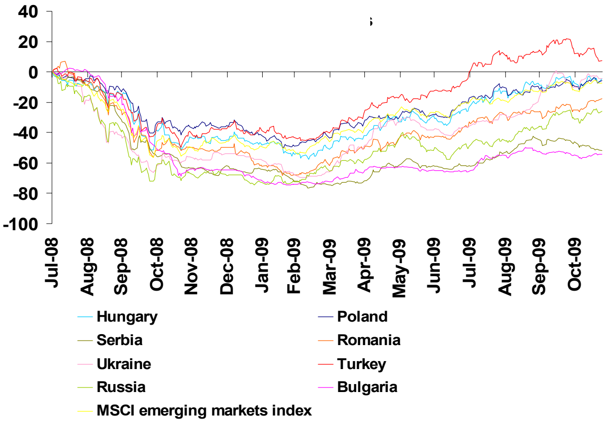
In the sovereign credit space, emerging bond spreads over US Treasuries on the EMBI+ index remain close to recent lows of 290bps touched in mid-October, having tightened from record highs beyond 900bps recorded in the same month a year earlier. Returns on the index have registered gains of more than 26% year-to-December 1. Meanwhile, five-year credit default swap spreads in New Europe have eased by more than 60%, from highs touched earlier this year, when contagion from the global financial crisis spilled over to the region, causing spreads to widen sharply (Figure 3).

With regard to real economic developments, though the pace of steep output declines in New Europe experienced earlier this year is now slowing down, and most economies in the region will likely see a return to positive growth in 2010, the recovery will be slow and lag that in other emerging economies in Asia and Latin America. Poland remains an outlier, being the only economy in the region (and in the EU-27) to have avoided recession in 2009.

With economic activity expected to remain below potential in the quarters ahead, inflation pressures are likely to stay subdued. Even so, many central banks in the region are now close to, or have already reached, the bottom of their monetary easing cycles after months of aggressive interest-rate easing. Notably, financial markets already price in rate hikes in Turkey and Poland as soon as early next year.

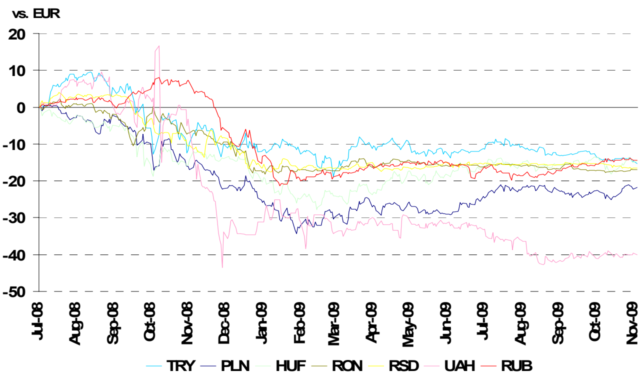
As has been the case with many developed economies, public finances are deteriorating rapidly in many countries in New Europe. The economic downturn is taking a heavy toll on tax revenues at a time when most governments are striving to pursue prudent fiscal policies in order to secure the disbursement of much needed funds under present loan arrangements with international monetary organizations. While Turkey and Bulgaria still pondering on the necessity of financial assistance from the IMF, Hungary, Ukraine, Iceland, Latvia, Serbia and Romania are currently under the Fund's umbrella.

Figure 1
Stock Markets (Cumulative Returns)



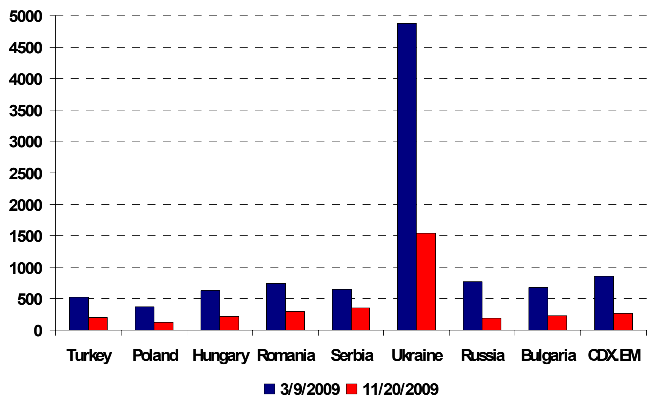
Source: Bloomberg, Reuters Eurobank EFG

Figure 2
Currencies (Cumulative Returns)



Source: Bloomberg, Reuters Eurobank EFG

Figure 3
5 YR CDS Spread



Source: Bloomberg, Reuters Eurobank EFG

So far, the Fund has shown leniency in a number of requests for increases in the initially-agreed budget deficit targets. However, with Romania and Ukraine both mired in political feuds ahead of presidential elections -- in December and January, respectively -- respective IMF Stand-By Arrangements have been put on hold. Although lingering worries over a major financial accident in the Baltics continue to haunt regional markets, the endorsement of steep budget-spending cuts by Latvia's parliament in early December raised hopes that the country would eventually receive fresh funds under its EUR 7.5bn IMF–led Stand-By Arrangement and thus, manage to avoid bankruptcy and devaluation.

The silver lining of the global financial crisis remains in the face of the ongoing adjustment in previously ballooning current account deficits. This positive trend should continue for as long as domestic demand remains at depressed levels -- likely to be the case throughout this year and part of the next -- helping to partially allay worries over high external financing requirements in the region.

In view of the present uncertain economic environment, it is rather early to assert that a *sustainable* economic recovery is assured. Consumers continue to face plenty of headwinds, while further increases in unemployment are expected as businesses continue to seek cost savings and maintain cautious hiring policies at a time when the road to a sustained economic recovery looks long and bumpy. Besides uncertain job prospects and slow income growth, tight credit conditions, higher oil prices and the expiration of the 'cash for clunkers' programs in a number of major economies all present serious headwinds to the global economic outlook. Last but not least, the Dubai crisis reminded investors that governments around the world may not have much ammunition left to deal with as new severe market turmoil. As a result, the current euphoria in global financial markets may well be proved excessive, with a lasting economic recovery being probably still some way off.

C. 2010 outlook and strategy – New Europe markets

We expect local currency markets to broadly outperform other asset classes in the region next year on improving macroeconomic conditions and a gradual hawkish shift in forward-looking monetary-policy expectations. We believe that capital inflows will remain supportive in Poland and Turkey and see further potential for zloty appreciation in the following months against a background of sound domestic macroeconomic fundamentals, a stable political environment and positive investor confidence. We also believe that there is room for TRY appreciation from current levels against both the EUR and the USD but also with respect to other national currencies in New Europe. Domestic political jitters, increased market uncertainty with respect to 2010 budget targets and the temporary suspension of the 3rd IMF financing tranche are likely to keep the Romanian leu under pressure near-term. However, we do not believe that a new RON crisis is in the cards as long as the authorities remain committed to prevent further significant current depreciation.

Sovereign credit spreads in emerging market economies currently appear to be more or less in line with current economic conditions, absolute level of rates, availability of cash and volatility. The road to further normalization will be slow as the prospect of higher policy rates before the end of 2010, withdrawal of official stimulus and increased supply constitute serious headwinds. Technicals are not that favorable either, given the recent increase in exposure by diversified type of investors (not EM dedicated). Our rich/cheap analysis based on country ratings and CDS levels shows that the 5-year Romania CDS is attractive and the curve is too flat on the 5-10 year sector. Furthermore, Hungary and Ukraine currently appear to be among the cheapest credits in the EM universe relative to our fundamentals-based valuation framework.

In local-rates space, we do not currently see much value in nominal bonds and investors should rather diversify to floating rate instruments and inflation-linked bonds where available, keeping in mind that real yields are at historical lows. We think that headwinds from rising core-market rates -- as demand from quantitative easing disappears and net debt supply increases -- will be significant for emerging economies in need to finance sizeable fiscal deficits. Overall, we expect higher rates in Poland and Turkey, regardless of when in 2010 respective central banks will resume monetary-policy tightening.

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II. New Europe Market Outlook & Strategy

Emerging market currencies in New Europe have largely underperformed their Asian and LATAM peers in the post-crisis market recovery that started in March 2009 (Table 1). To a large extent, this appears to have been due to the fact that the leading drivers of past currency appreciation remain broadly absent. Namely,

- **Collapsing demand for FX loans.** Following its post-Lehman collapse, the demand for foreign currency loans in the region remains very weak, with little evidence of any imminent recovery
- **Halted capital injections from parent banks.** Capital injections from parent banks - a significant source of foreign currency inflows and, by implication, currency strength in the region - have been halted in recent months and, from now on, domestic subsidiaries will need to increasingly depend on domestic deposits to finance their expansion
- **Sharply reduced FDI and Greenfield inward investment.** The European corporate sector, which has been hit hard by the global financial crisis, is now reluctant (or unable) to finance its expansion in the region. Focus will next shift to the countries exhibiting improving productivity as well as labour availability and cost trends.

It is the model of development economies in the region utilized in recent years to finance their phenomenal growth that is currently proving to be the major hurdle to their recovery. Namely, over-leveraged domestic demand and real-estate development leading to unsustainable current account balances and high dependency on foreign funding. It is now clear that the road to recovery will be slow. However, we remain constructive on the region and believe that the forced correction of imbalances will facilitate a shift to a less-geared, yet more sustainable, model of economic development.

Table 1: EM FX Performance	Nov-09	Mar-09	Jul-08	%Change Mar-09 to Today	%Change Jul-08 to Today
USDPLN	2.773	3.732	2.128	-25.70%	30.30%
USDRON	2.84	3.39	2.31	-16.15%	23.30%
USDTRY	1.53	1.79	1.24	-14.69%	22.74%
USDRSD	63.51	75.12	49.98	-15.46%	27.07%
USDUAH	8.00	7.85	4.51	1.89%	77.24%
USDBRL	1.756	2.376	1.598	-26.09%	9.87%
USDMXN	12.93	15.19	10.37	-14.87%	24.74%
USDZAR	7.40	10.48	7.89	-29.34%	-6.11%
USDINR	46.52	51.71	43.33	-10.05%	7.35%
USDIDR	9461	12023	9220	-21.31%	2.61%
USDPHP	47.205	48.505	45.010	-2.68%	4.88%

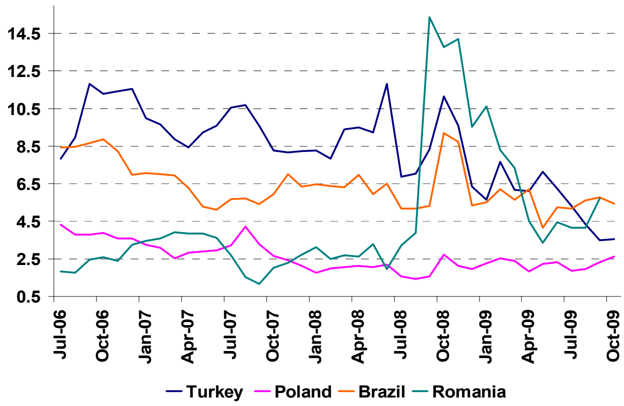
Spot Rates as of 6/3/09 (Mar-09), 1/7/08 (Jul-08) and 30/11/2009

Low real yields and steep yield curves usually render emerging market currencies unattractive for international investors as they rather prefer to earn carry via the rates market (i.e., local bonds) with no direct foreign exchange exposure. To that extent, ample local liquidity means that carry strategies via bonds/rates are now preferable to outright currency exposure (Figure 1).

Figure 1

Real Yields near all-time lows

(3-year nominal rates *minus* current inflation)

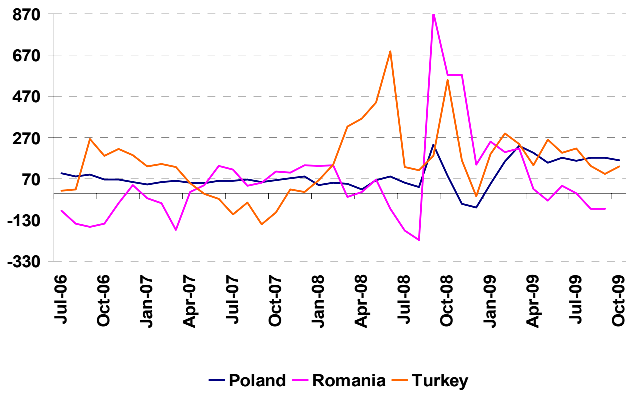


Source: Bloomberg, Reuters, Eurobank EFG

Figure 2

Post-crisis yield curves remain steep relative to past

(1M/2YR interest-rate differential in bps)



Source: Bloomberg, Reuters, Eurobank EFG

Looking further ahead into 2010, improving macroeconomic conditions in New Europe and higher real yields will likely support the case for gradually appreciating regional currencies. To that extent, we will be watching closely for signs of central bank rate tightening, especially in countries that now appear to be at or near the bottom of their easing cycle e.g., Poland, Turkey.

In our view, it will be a gradual sell-off in the front end of the local rate curves along with the inception of bearish-flattening curve dynamics that will signal the next phase of regional FX outperformance. Importantly, the latter will likely be the result to rising local rates due the economic recovery *rather than* the outcome of heightened risk aversion.

A major risk to our longer-term bullish view on New Europe currency markets is a massive unwinding of the USD carry trade e.g., as a result of increased global tightening expectations and/or a more-speedy-than-currently-expected removal of accommodative policies in the U.S. and other developed economies.

All things considered, we continue to differentiate our investment strategy in favour of countries featuring sound macro fundamentals, better adaptability to a less credit-dependent model of development, credible fiscal and monetary policy frameworks and solid banking systems. We believe that capital inflows will remain supportive in Poland and Turkey.

A. Regional FX focus

Polish Zloty: We see further potential for zloty appreciation near-term. Among other reasons, our bullish view hinges on the following considerations:

- Poland's sound macroeconomic fundamentals
- a stable domestic political environment and
- positive global investor confidence

EUR/PLN´s recent break below the key 4.20 level has opened the way for an extension of the down move towards our medium-term target of 3.87 multi-week/month. We would be looking to sell bounces towards the 4.17-4.20 area with a tight stop, looking for a retest/downward break of 4.07 (50% Fibonacci retracement of the July 2008-February 2009 cumulative upward move). Another, yet more risky, strategy would be to take advantage of the steep volatility skew in order to fund the purchase of PLN calls via selling PLN puts (a risk reversal). For instance, one can purchase a 6 month EURput/PLNcall with strike at 4.00 by selling a 6 month EURputPLNcall with strike at 4.55 for zero cost.

Turkish Lira: We think the TRY has potential to appreciate from current levels against both the EUR and the USD but also with respect to other EM currencies. Technicals are supportive as the currency moves are bounded by local retail activity and the lira tends to outperform during periods of increased risk aversion. We would be looking for EUR/TRY and USD/TRY to trade towards 2.18 and 1.43, respectively over the coming 2-3 months. Technically, a USD/TRY break below the 200-day exponential moving average (currently standing at 1.43) would signal further lira gains. We favour exploiting the cheapness of the EUR/TRY front-end volatility surface by buying 2-month 2.20 EUR put /TRY call for 0.86bps (spot reference: 2.21).

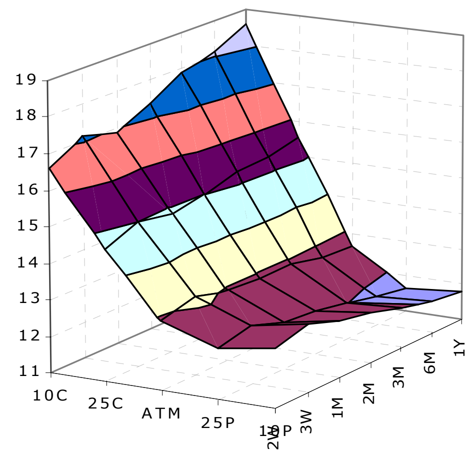
Figure 3

EURPLN break below 4.07 seen providing potential for further downside towards our technical target of 3.87 multi-month

Source: Bloomberg

Figure 4

EURPLN implied volatility skew is too steep



Source: Bloomberg

Figure 5

USDTRY a break below 1.43 opens the way for further substantial lira appreciation

Source: Bloomberg

A major risk to our call would be a new significant worsening in global economic and market conditions or further considerable CBRT rate easing. The Central Bank of Turkey has come out of this crisis with strengthened credibility but market participants may start worrying about the efficacy of monetary policy if the Bank insists on easing in the phase of improving macroeconomic data.

Romanian Leu: Domestic political jitters, increased market uncertainty with respect to the 2010 budget and the temporary suspension of the 3rd IMF financing tranche are likely to continue keeping the Romanian currency under pressure. We do not think that the picture will change soon (at least not before December presidential elections). On the other hand, we do not believe that a new RON crisis is in the cards as long as the authorities remain committed to support the currency. We look to enter tactical short EUR/RON positions as we get closer to the presidential elections in order to benefit from the high interest rate differential and the fact that volatility-adjusted carry makes this trade a good risk/reward.

Table 2: Volatility Adjusted Carry

	1 Year Carry	1 Year At the Money Spot Implied Volatlity	1 Year Realized Volatiity	Volatility Adjusted Carry
PLN	2.21%	19.40%	24.47%	9.02%
TRY	7.16%	15.42%	16.55%	43.24%
RON	8.67%	20.53%	16.87%	51.40%
CZK	0.96%	15.31%	19.68%	4.88%
HUF	4.68%	18.80%	24.86%	18.82%

Volatility Adjusted Carry is the Ratio of Carry to Realized Volatility for the period

Source: Bloomberg, Eurobank EFG

B. Sovereign Credit Strategy

Sovereign credit spreads in emerging market economies have normalized considerably from the multi-year highs reached earlier this year in line with the gradual pricing-out of systemic risk experienced in recent months. And, as the global economy recovers from its worst slump in almost 50 years, liquidity is again starting to flow out of the developed world and into emerging market economies. In this environment, sovereign debt instruments of solvent countries with good fundamentals and credible policy frameworks are the preferable vehicle of investment to benefit from the global recovery story.

In our opinion, **current spread levels are more or less in line** with current economic conditions, absolute level of rates, availability of cash and volatility. The road to further normalization will be slow as the prospect of higher policy rates before the end of 2010, withdrawal of official stimulus and increased supply constitute serious headwinds. Technicals are not that favourable either, given the recent increase in exposure by diversified type of investors (not EM dedicated).

Since March 09, emerging market sovereign spreads have broadly outperformed BB high-yield corporate paper and EMU Periphery spreads. On the other hand some regional spreads remain wide compared to both historical levels and current ratings as a result of country-specific reasons. In New Europe, regional CDS spreads with the exception of Ukraine have outperformed EMU periphery spreads but have so far lagged behind the performance of their Asian and Latin American peers.

Table 3: Five Year Sovereign Credit Default Swaps (bps)

	Nov-09	Mar-09	Jul-08	%Change Mar-09 to Today	%Change Jul-08 to Today	% Recovered
BULGARIA	239	683	160	-65%	50%	**85%**
POLAND	133	376	51	-65%	161%	**75%**
ROMANIA	295	754	197	-61%	50%	**82%**
TURKEY	211	522	190	-60%	11%	**94%**
UKRAINE	1458	4875	387	-70%	277%	**76%**
BRAZIL	130	425	121	-69%	7%	**97%**
RUSSIA	212	765	110	-72%	92%	**85%**
CHINA	84	245	74	-66%	14%	**94%**
JP EMBI+	330	695	299	-53%	10%	**92%**
BB HY CORP	556	1023	479	-46%	16%	**86%**
EMU Periphery	109	191	40	-43%	174%	**54%**

CDS Spreads as of 6/3/09 (Mar-09), 1/7/08 (Jul-08) and 30/11/2009

%Change: Cummulative % change of 5year CDS for the period

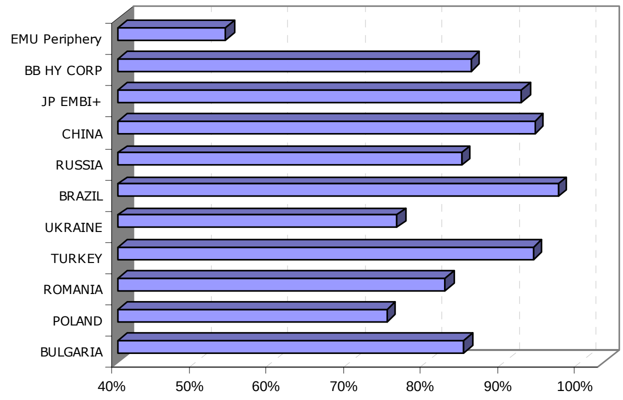
%Recovered: Percentage of cumm spread widening of the period Jul08-Mar09 been recovered

EMU Periphery: Average 5 Year CDS of Portugal, Italy, Greece and Spain

Source: Bloomberg, Reuters, Eurobank EFG

Figure 6

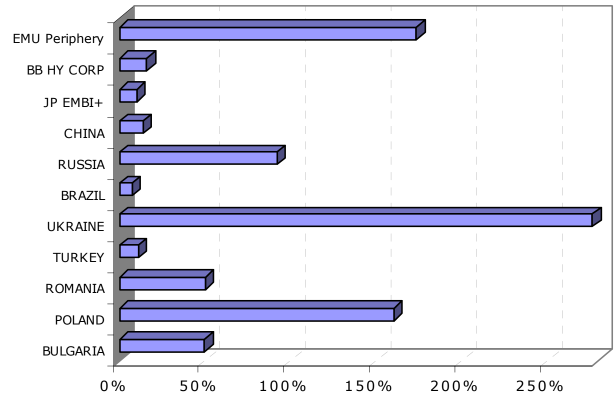
Percentage of crisis-induced widening in spreads having already been recovered



Source: Bloomberg, Reuters, Eurobank EFG

Figure 7

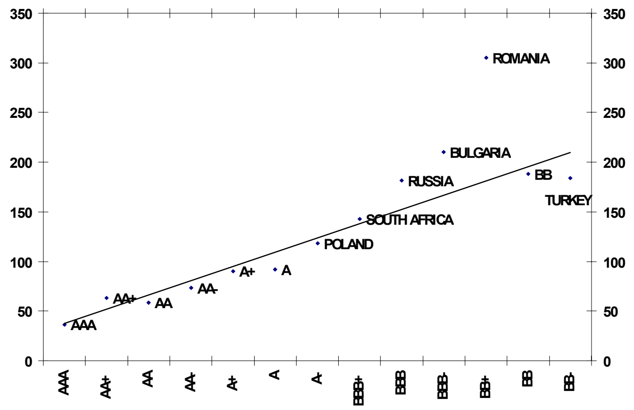
Cumulative % change in 5-year CDS spreads in Jul08-Nov09



Source: Bloomberg, Reuters, Eurobank EFG

Figure 8

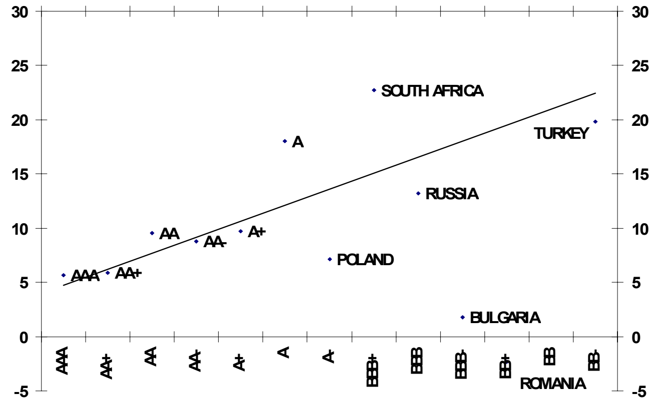
Five Year Credit Default Swaps (bps) versus Ratings



Source: Bloomberg, Reuters, Eurobank EFG

Figure 9

Spread between 5 and 10 year credit default swaps (bps) versus respective ratings



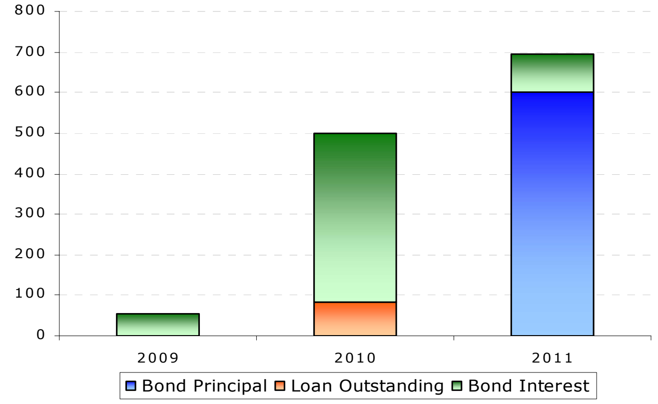
Source: Bloomberg, Reuters, Eurobank EFG

A simple rich/cheap analysis based on country ratings and CDS levels shows that the 5-year Romania CDS is attractive and the curve is too flat on the 5-10 year sector. Given our belief that Romania will not face significant financing pressures near-term, we favour a DV01 neutral 5-10year strategy selling 5yr protection at 295bps and buying 10yr protection at 300bps. The trade has a positive roll down of 20bps per year.

Hungary and Ukraine currently appear to be among the cheapest credits relative to a fundamentals-based valuation framework we present on section III of this report. We believe that risks to a large extent are already known/priced-in by the market and that Ukraine March 11s bonds offer good risk/reward at a yield to maturity of 17%. Debt maturity profile for Ukraine is very light until 2011. In particular, there are a total of 1.3Bio USD equivalent redemptions and coupon payments related to Sovereign or Sovereign guaranteed bonds or loans until March 2011. Current official reserves stand at 28Bn USD which makes servicing debt achievable even under a worsening financing gap. Political situation remains the major risk since it is only a matter of willingness and not ability to pay.

Figure 10

Ukraine Debt Maturity Profile till 2011



Source: Bloomberg, Reuters, Eurobank EFG

Another trading theme we like is negative basis trades, i.e., exploiting opportunities where Credit default swaps are trading very wide to bonds. As the markets start pricing the removal of accommodative policies and, predominantly, central bank funding facilities, we expect bonds on an asset swap basis to underperform credit default swap spreads for the following reasons: (1) funding pressures, (2) balance sheet restrictions and (3) diminishing default probabilities. More precisely, we believe that asset classes that benefitted the most from emergency policy measures will come under pressure when the market starts to more aggressively discount the removal of such measures. This will not necessarily imply systemic risks but rather a re-pricing of tighter funding conditions ahead. Expressing such a view in the regional bonds/CDS markets is problematic due to wide bid/offer spreads and illiquid conditions. Nevertheless. we would prefer expressing our bullish credit view via CDS and not cash bonds for the time being. In this context, 1year Ukraine CDS at 2000 bps (15.00% upfront and 500bps running) offers a better alternative to the Ukraine 11s.

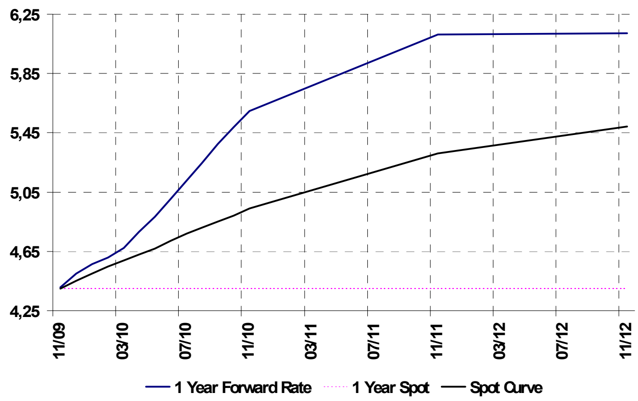
C. Local Rates Strategy

According to our central scenario, the majority of economies in New Europe will be out of recession by mid 2010, but growth will be below potential for couple of years due to lagged effects of corporate and consumer de-leveraging, high unemployment rates and the need to adjust to more volatile global economic conditions. We believe that most central banks in the regions are either done easing or approaching the end of their policy easing cycle but the road to normalization will be gradual as long as inflation pressures remain benign. We do not currently see much value in local nominal bonds and investors should rather diversify to floating rate instruments and inflation linked bonds where available, keeping in mind that real yields are at historical lows. We think that headwinds from rising core-market rates (as demand from Quantitative Easing disappears and supply remains) will be significant for EM countries in need to finance significant fiscal deficits.

Overall, we expect higher rates in Poland and Turkey, irrespective of what respective central banks will do with their base rates. In order to position ourselves in such an environment we favour receiving the 1 year 1 year forward in PLN at 5.57% with a target of 5.14% and stops above 5.75%. Effectively, we pay 1 year rates which we think are too low with respect to policy rate (1 year swap at 4.40 versus policy rate of 3.50 and 3Month WIBOR at 4.09) and receive 2 year rates at 4.94%. The trade has a positive roll down of 22bps per quarter, taking advantage of the steepness of the front end.

Figure 11

1 Year PLN Forward Rates versus Spot 1 Year



Source: Bloomberg, Reuters

We believe that issuance will be concentrated on the long end of the bond curves in order to exploit historically lows rates and the fact that much of this year's financing was implemented via issuing short-term paper. In case of increased supply and/or rising global rates this would put steepening pressures on the curves. The problem is that currently curves are quite steep on the front end, so the best way to express such a bearish steepening view is through forward curves.

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III. Emerging Markets Sovereign Spreads: An Empirical Valuation Framework

In this section we present the results of a simple econometric model that aims to explain sovereign spreads in emerging markets with reference to country-specific macroeconomic fundamentals. In particular, using a balanced panel of 21 emerging market economies from 2002 to 2009, we investigate the determinants of country risk premia as measured by their respective sovereign bond spreads[1]. Our results generally support some of the key findings in a number of recent empirical studies and can also be used as a fundamentals-based framework for performing ''rich vs. cheap'' analysis in the sovereign-credit space.

A. Theoretical Background

A sovereign spread is supposed to compensate a potential investor for the risk of sovereign default. As such, emerging market bond spreads over U.S. Treasury securities are often viewed as a good indicator of how market participants view a country's macroeconomic and political environment. More specifically, its ability and willingness to make full and timely principal and interest payments on its obligations to international creditors. Besides perceived default risk, other fundamental and technical factors can influence sovereign bond spreads, ranging from interest rate and currency risk to global liquidity conditions and changes in the investor base for a particular country's bonds.

Recent empirical studies find a close link between county-specific fundamentals and variations in respective credit risk premia. For instance, Baldacci, Gupta and Mati (2008) document that both fiscal and political factors affect credit risk in emerging markets. In particular, lower levels of political risk are often associated with tighter spreads, while credible fiscal policies tend to narrow sovereign spreads, especially in countries that experienced prior defaults. Min (1998) finds that a larger set of macroeconomic variables influence the evolution of sovereign spreads. These include domestic inflation, net foreign assets, real exchange rate and the terms of trade index. Rowland and Torres (2004) indicate that creditworthiness is also an important determinant of emerging market sovereign debt costs, while sovereign credit ratings themselves are found to be influenced by macroeconomic fundamentals.

[1] The emerging market economies under study are Argentina, Brazil, Bulgaria, Chile, China, Colombia, Ecuador, Egypt, Hungary, Lebanon, Malaysia, Mexico, Peru, Philippines, Poland, Russia, S. Africa, Turkey, Ukraine, Uruguay and Venezuela.

More recently, there has been increased emphasis on global factors such as contagion from systemically-important events, investor risk appetite, interest rate expectations and world market volatility conditions. In those lines, Weigel and Gemmill (2006) find that a small set of variables is able to explain up to 80% of the variance of the estimated *distance-to-default* for each one of the four Latin American emerging market economies under study. Specifically, country-specific variables account for only about 8% of the explained variance, while the largest part of the latter (45%) is explained by regional factors, including joint stock-market returns, volatility and market sentiment. Global conditions, related mainly to US stock-market returns, explain another 25% of the variance. Of the 20% variance which remains unexplained, more than half is due to another common (but unidentified) factor.

B. Data, Model Specification and Results

In our empirical study we use spreads data on 21 emerging market economies drawn from JP Morgan´s EMBIG index for the period 2002-2009. We employ a balanced panel framework with fixed and random effects to account for the cross-sectional as well as the time-series characteristics of our data. The baseline specification of our model has the following general form:

$Spread_{it} = c_i + b * F_{it} + e_{it},$

$i = 1, \ldots, 21$ and $t = 2002, \ldots, 2008$

Where

Spread$_{it}$, is the log (annual average) spread of country i in year t.

F$_{it}$ is a vector of fundamentals of country i in year t.

In our study, the following explanatory (fundamental) variables are used:

a. *Inflation*

Generally speaking, and in line with some of the key findings in the recent literature of sovereign spreads, high domestic inflation - *eg., as a result of monetization of the fiscal deficit* - tends to increase the cost of capital and thus, lead to higher interest rates. Other things equal, high domestic inflation tends to increase sovereign risk.

b. Overall fiscal balance as percentage of GDP

As can be surmised by our previous comments (see also Baldacci, Gupta and Mati (2008), a rise in the fiscal deficit would, ceteris paribus, contribute positively to sovereign credit spreads and vice versa.

This is also in line with Akitoby and Stratman (2006) finding that fiscal-policy prudence tends to reduce the probability of sovereign default.[2]

c. External vulnerability indicator

This indicator effectively shows the adequacy of respective country foreign exchange reserves to cover short-term external debt, currently maturing long-term external debt and total nonresident deposits over one year. The data source for our *external vulnerability indicator* is Moody's *Statistical Handbook, May 2009*

d. Slope dummy*:* Fiscal Balance*High Volatility

In the spirit of Baldacci, Gupta and Mati (2008) we add to the list of explanatory variables a dummy that is supposed to captures the global volatility environment. In our study the *High Volatility* dummy takes the value of 1 when the (annual average) value of the VIX index is higher that 25 and 0 otherwise. Note that our volatility dummy enters our regression in multiplicative form, i.e., it is multiplied with our *Fiscal Balance* variable. This specification aims to investigate whether the effect of adverse domestic fiscal developments on sovereign spreads in higher *(lower)* in periods of increased *(reduced)* global uncertainty and market instability.

Finally note that in our baseline regression we use data from the IMF, Moody's as well as Eurobank EFG Research's data base of macro forecasts.

Table A below shows the main results from estimating our baseline model:

TABLE A

Dependent Variable: Log (annual average) sovereign spread
Method: Panel EGLS (Period random effects)
Sample: 2003 2008
Periods included: 6
Cross-sections included: 21
Total panel (balanced) observations: 126
Swamy and Arora estimator of component variances

Variable	Coefficient	Std. Error	t-Statistic	Prob.
Constant	2.20***	0.45	4.93	0.00
Inflation	0.04***	0.01	3.54	0.00
External Vulnerability Indicator	0.65***	0.10	6.45	0.00
Fiscal balance	-0.03*	0.02	-1.57	0.10
Slope dummy	-0.05**	0.02	-2.11	0.04

R-squared	0.86
Adjusted R-squared	0.82

*Indicates statistically significance at the 10 percent level;
** at the 5 percent level; ***at the 1 percent level.

The above results indicate that all coefficient estimates of our explanatory variables are significant and have the expected signs.

C. Rich vs. Cheap Framework for Evaluating Current Market Spreads

To perform our fundamentals-based rich vs. cheap analysis on current sovereign spread levels we estimate our model over the period 2003-2008 and, subsequently, we perform one-step & two-steps-ahead *(i.e., one- & two-years-ahead)* forecasting of our *logspread* dependent variable. This is implemented by inserting ''actuals'' for out-of-sample observations.[3] Effectively, our model-based logspread forecasts can be seen as fundamentals-based ''fair value'' estimates of the spread than can then be compared with current market spread levels to give us a measure of the relative *cheapness* or *richness* of the corresponding spreads. Table B below depicts these ''fair value'' estimates along with the market level of these spreads on November 12, 2009.

[2] Another explanatory variable that can be used as an indicator of fiscal vulnerability is the public debt-to-GDP ratio. In our study, we use this variable to instrument for the overall fiscal balance-to-GDP in a specification test on our baseline model using two-stage least squares.

[3] Here, the ''actual'' values of our explanatory variables constitute IMF, Moody´s and Eurobank EFG Research forecasts for these variables in 2009 and 2010.

	Sovereign spread levels on Nov 12, 2009 (in bps)	Model-based "fair value" estimates (in bps)	% deviation from "fair value" Wide (+) / Tight (-)
Brazil	215	213	0,9%
Bulgaria	221	159	39,3%
Chile	132	145	-12,4%
Colombia	206	247	-16,6%
Ecuador	820	712	15,2%
Hungary	214	87	78,3%
Lebanon	345	438	-21,3%
Malaysia	161	173	-7,2%
Mexico	212	197	7,8%
Peru	188	241	-19,7%
Philipines	243	277	-12,3%
Poland	147	139	5,9%
Russia	242	303	-20,1%
S. Africa	191	159	7,4%
Turkey	239	289	-17,3%
Ukraine	1.037	441	135,4%
Uruguay	264	311	-15,1%
Venezuela	1.036	848	13,5%

Source: Eurobank EFG Research, Bloomberg

As it is illustrated in Table B, our fundamentals-based valuation framework suggests that Ukraine, Hungary and, to a lesser extent, Bulgaria currently appear to be the most cheap (i.e., wide) of all sovereign credits under examination. Yet, as it is usually the case with most empirical studies, the results of our econometric exercise need to be interpreted with a certain degree of caution and be simply utilized as an auxiliary toll in our broader valuation analysis of sovereign-spreads.

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IV. New Europe EMU Convergence Monitor

The table below offers a comprehensive view on where the CEE countries under examination currently stand with respect to the fulfillment of the Maastricht criteria for Euro zone entry as well the associated market-implied probabilities for entry.

Progress in meeting the Maastricht Treaty´s entry criteria

Maastricht Criteria	Price Stability	Sound public finances	Sustainable public finances	Durability of convergence	Exchange rate stability	Number of criteria met
Measure	HICP*	Government balance (% of GDP)**	Government debt (% of GDP)**	Long-term interest rate**	Deviation from a central rate	
Date	12m average *(as of Sept 09)*	FY2008	FY2008	12m average of 10yr gvn´t bond yield *(as of Sept 09)*	Sep-09	Sep-09
Reference value	1.3	-3.0	60.0	6.26	na	
Bulgaria	4.4	1.8	14.1	7.45	na	2
Czech Republic	1.6	-2.1	30.0	5.01	na	3
Hungary	3.8	-3.8	72.9	7.91	na	0
Poland	3.9	-3.6	47.2	6.17	na	2
Romania	6.2	-5.5	13.6	11.00	na	1

Sources: National statistics, EC, Eurobank EFG Research
* 12m YoY average should not exceed by more than 1.5ppts the coreponding average of the three lowest-inflation Member States
** Reference values as they apear in the EC Autumn 2009 forecasts
** Not more than 2ppts above the coresponding 12m average of the three lowest inflation Member States

EMU entry: Official target dates, consensus and market implied probabilities

	Official target or forecast	Latest Reuters poll	Eurobank EFG forecast	Market-implied cummulative probability		
	Year			2013	2015	2018
Bulgaria	2013	2014	2015	....	....	....
Czech Republic	2013 (at the earliest)	2015	2015	10%	45%	70%
Hungary	2012-2014	2014	2014	20%	50%	75%
Poland	2012-2013	2014	2013-2014	15%	55%	75%
Romania	2015	2015	2016	....	....	....

Source: National sources, Reuters, Eurobank EFG Research

Explanatory note on calculating EMU-entry probabilities

The mathematical formula we use to calculate market-implied EMU-entry probabilities is depicted below. The calculated probabilities need to be interpreted with caution and *do not* necessarily coincide with our assessment of respective-country entry prospects

EMU-entry probabilities formula:

$FrwdSpead (t, T) = Prob(EMU_T) * E_t(SpotSpead_T/EMU_T) + (1-Prob(EMU_T)) * E_t(SpotSpread_T/NoN\text{-}EMU_T)$

Where

t = today

T = The EMU-entry date under examination eg, 1.1.2013; 1.1.2015

E_t(./.) denotes conditional expectation (as of time t)

FrwdSpead (t, T)= The forward spread (CEE country vs. Euro) of, say, 1YR or 5YR rates X days/months ahead; Here X denotes the time between t and T in days or months. The above series can be estimated by the corresponding forward rates implied by the spot *e.g., zero-coupon* curves (to adjust for coupon effects)

$E_t(SpotSpead_T/EMU_T)$ is the expected spot spread in 1YR or 5YR rates at time T conditional on the assumption that T is indeed EMU-entry date. This spread should reflect *only* the sovereign credit spread of the CEE country under examination absent of any FX risk. A proxy for this series could be derived by the CDS market. Alternatively, the yield spread of a EUR-denominated sovereign bond of the CCE country over (similar-tenor) EUR swaps could be used.

$E_t(SpotSpead_T/NoN\text{-}EMU_T)$ is the expected spot spread in 1YR or 5YR rates expected at time T conditional on the assumption that T is not an EMU-entry date. Effectively, this latter variable is the expected future interest rate differential if the examined CEE country stayed out of Eurozone at time T. Here, we use properly chosen historical averages for the corresponding spread.

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V. New Europe - Country Analysis

Bulgaria

Economic Downturn not over yet

- **The domestic economic downturn continues at a time when other regional economies show concrete signs of bottoming out. We forecast Bulgaria's real GDP growth to fall by a further 1.1% in 2010 after contracting by 5.9% this year**
- **Application for ERM II entry is deferred until probably early next year**
- **The new government has pledged to maintain a balanced budget in the period 2010-2012, an essential element of its strong political commitment to the present Currency Board Arrangement.**

Application for ERM II entry is postponed to early 2010; Government aims to adopt the Euro in 2013

After three months in power, the new government announced a series of measures in line with its pre-election commitments. The measures aim to improve the situation in all contentious areas the EU commission identified in its latest progress report and, as a result which, pre-accession funds for Bulgaria have been frozen. More specifically, the new government policies aim to improve the management of EU funds, fight organized crime, reduce the grey economy and promote public-sector reform.

Euro adoption stands out as the cornerstone in the government agenda. According to recent comments by Minister of Finance Simeon Djankov, the government plans to file an application for entry into the European Exchange Rate Mechanism (ERM II) by early 2010, most probably in February. Both the central bank and the government pledged to maintain the present Currency Board Arrangement (CBA) until Euro adoption, which is now expected on 1.1.2013. As formally specified in the Maastricht Treaty, besides currency stability Bulgaria needs to fulfill four additional criteria for Eurozone entry, with the inflation criterion presently appearing to be the most challenging of all.

Bulgaria: Eurobank EFG Forecasts

	2007	2008	2009f	2010f
Real GDP (yoy%)	6.2	6.0	-5.9	-1.1
Private Consumption	5.3	4.8	-5.7	-2.1
Government Consumption	3.1	0.0	-0.2	-0.1
Gross Capital Formation	21.7	20.4	-21.1	-8.7
Exports	5.2	2.9	-13.3	2.3
Imports	9.9	4.9	-19.9	-2.8
Inflation (yoy%)				
HICP (annual average)	7.6	12.0	2.4	1.6
HICP (end of period)	11.6	7.2	0.2	1.5
Fiscal Accounts (%GDP) - *EU Methodology*				
General Government Balance	0.1	1.8	-0.8	-1.2
Gross Public Debt	18.2	14.1	15.1	16.2
Primary Balance	1.1	2.7	0.0	-0.3
Labor Statistics - *National Definitions*				
Unemployment Rate *(% of labor force)*	6.9	6.3	7.5	9.0
Wage Growth *(% change, total economy)*	19.5	21.7	7.5	2.0
External Accounts				
Current Account (% GDP)	-25.2	-25.4	-12.0	-10.0
Net FDI (EUR bn)	8.4	6.1	3.0	3.0
FDI / Current Account (%)	115	70	75	95
FX Reserves (EUR bn)	11.9	12.7	12.8	11.5
Domestic Credit	**2007**	**2008**	**Q1 09**	**Q2 09**
Total Credit (%GDP)	66.9	74.9	75.0	75.3
Credit to Enterprises (%GDP)	43.0	47.8	47.7	47.6
Credit to Households (%GDP)	23.0	26.0	26.2	26.4
FX Credit/Total Credit (%)	50.7	57.3	57.8	57.9
Private Sector Credit (yoy)	65.9	32.3	24.9	11.9
Loans to Deposits (%)	96.5	118.9	120.7	120.0
Financial Markets	**Current**	**3M**	**6M**	**12M**
Policy Rate		Currency Board		
EUR/BGN	1.96	1.96	1.96	1.96

Source: National Sources, Eurostat, IMF, Eurobank EFG

Newly elected government pledges to maintain restrictive fiscal stance

The new government undertook some bold initiatives to repair the fiscal accounts and help reverse the budgetary loosening that took place ahead of the July 2009 parliamentary election. The new government cut down budgetary spending by 15%, pushed back infrastructure projects and reformed the National Revenue Agency in an effort to boost tax revenues. These measures assisted the budget balance to switch to a small surplus in October (ca 8 million Leva), after recording a 74 million Leva deficit in September. Yet, this is not likely to be enough to avoid running a small full-year budget deficit in 2009 compared to a modest surplus of 1.8% of GDP in 2008. According to the latest data, the consolidated government budget in January-October recorded an overall deficit of 0.86% of (expected) GDP with total revenues declining by 11.1%yoy and expenditures rising by 16.9% yoy over the same period.

The 2010 budget, which was approved by parliament in December, envisages a broadly balanced fiscal position. On the expenditure side, pensions and public wages are expected to remain flat. On the revenues side, the budget provides for an increase in excise duties (of alcohol, tobacco and electricity) and a 1.1pps decrease in social security contributions. If EU related expenditures and revenues are incorporated, the overall consolidated budget balance is officially expected to record a deficit of 0.7% of GDP next year. Yet this would still likely be the lowest fiscal deficit among EU-27 countries.

Domestic economic downturn not yet over

Unlike other economies in the region, the pace of economic contraction in Bulgaria steepened in Q3 (-5.8% yoy vs. -4.9% yoy in Q2), bringing the overall decline in real GDP growth over the first nine months of the year to -4.8% yoy. On the demand side, the contraction in private consumption accelerated to 10.6% yoy in Q3, from -3.7% yoy in the prior quarter, amid declining housing prices, tightened credit conditions and slowing wage growth. Investments contracted by 22.9% yoy in Q3, following a 16.3% fall in Q2. At the same time, the contribution of net exports to growth turned positive. The pace of contraction in exports eased to -13.2% yoy in Q3, from -15.8% yoy in Q2, while imports declined by a further 28.3% yoy in Q3 from 24.3% yoy in Q2.

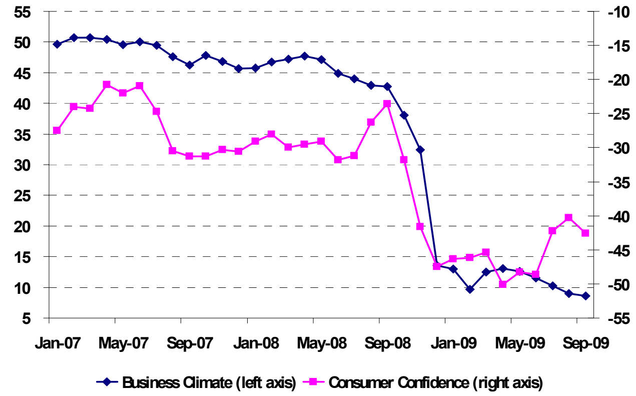
Meanwhile, recent readings in a number of survey data and higher-frequency indicators show no convincing signs yet of any imminent rebound in domestic economic activity. Among them, business and consumer confidence have recovered slightly in the last couple of months but remain close to their multi-year lows hit in the spring (Figure 1). Industrial production remains in a freefall (down by 19.3% yoy in September and 21.7% year-to-September, respectively). Retail sales also continue to record double-digit declines (down by 18.8% yoy in September and 17.3% year-to-September, respectively). In our view, the recession in the Bulgarian economy may last longer than in other pear-economies in the region; among other reasons as a result of a highly-leveraged private sector, and the current ultra-rigid exchange rate regime which facilitates a more direct - and in the present trajectory, more painful - balance of-payments adjustment to external shocks[4]. We now forecast a further GDP contraction of around 1% GDP in 2010, following an expected drop of 5.9% in 2009.

Current account deficit shrinks sharply; FX reserves increase marginally

Year-to-September current account deficit stood at 15% of 12month rolling GDP (or 6.3% of projected 2009 GDP), compared to 25.3% in 2008. On the financing side, capital inflows were down 85.3% yoy in January-September (Figure 2). The most important component, net FDI inflows reached 2 bn euros, which represents a 56% yoy decline. Nevertheless, they still covered 96% of the current account deficit, up from 82% last year. International reserves increased marginally to €12.4bn in September (37.2% of GDP) compared to €11.7bn in July, reversing their earlier down trend. The increase in reserves provides more comfort that the currency board's technical sustainability requirements continue to be comfortably met and future external debt service needs will be properly addressed. The international reserves coverage of short term debt stood at 100% in September, compared to 112% a year earlier.

Figure 1

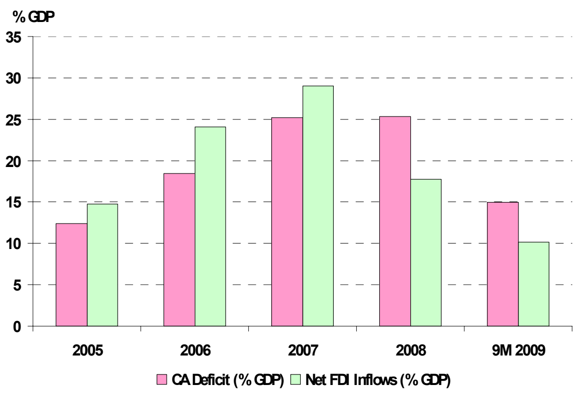
Confidence Indicators still at depressed levels



Source: Eurostat

Figure 2

Current account deficit shrinks considerably



Source: BNB

Disinflation accelerates

Domestic disinflation continues with the CPI rate declining to -0.3% yoy in October (first negative reading since 2002), from 0.2% yoy in the prior month and 7.1% yoy in January. Most CPI-basket components recorded annual

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

declines in October. Food prices fell by 4.7% yoy after rising by 10.5% yoy in the same month a year earlier, while non tradable goods inflation is adjusting at a much slower pace (catering services were still rising on 5.1% yoy) We anticipate average annual inflation to decline from an expected rate of 2.7% this year to 1.6% in 2010. Inflation pressures are likely to remain subdued in the following months reflecting weak demand pressures, tight credit conditions and decelerating growth in real wages (still up 10%yoy in September). The 12-month-rolling average Harmonized Consumer Price Index (HICP) has declined rapidly in recent months, coming in at 3.6% yoy in September compared to 11.5% in January. Nevertheless, that has not been enough so far to ensure fulfillment of the respective Eurozone-entry inflation criterion.

Domestic credit conditions remain very tight: some preliminary signs of stabilization start to emerge

Domestic lending conditions show some preliminary signs of improvement. Credit to the non-government sector posted a 1.7% mom increase in September, the highest rate in the current year thus far. Yet credit conditions remain sharply tighter relative to a year earlier: the growth of loans to the non-government sector was only 5.9% yoy in September against 47.9% yoy in the same month in 2008. Additionally, asset quality deterioration so far appears to be manageable. NPLs recorded a relatively modest rise to 5.7% in September from 2.4% in late 2008.

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Poland

Resilience to the crisis but fiscal worries cloud the outlook

- **Fiscal loosening in the form of personal income tax cuts and increased spending on social benefits has alleviated the impact of domestic economic slowdown**
- **The prospect of a higher fiscal deficit this year raises fears over rising public debt, now dangerously close to the constitutional threshold of 55% of GDP**
- **Poland is the only EU-27 country to avoid recession in 2009. We expect real GDP growth of 1.3% this year, on the back of resilient private consumption**
- **Deteriorated labour market conditions cast doubt over the speed and dynamism of expected economic recovery.**

Poland: Eurobank EFG Forecasts

	2007	2008	2009f	2010f
Real GDP (% yoy)	6.8	5.0	1.3	2.0
Private Consumption	4.9	5.9	2.2	2.6
Government Consumption	3.7	7.5	1.6	1.1
Gross Capital Formation	17.6	8.2	-2.0	1.8
Exports	9.1	7.1	-12.0	3.0
Imports	13.7	8.0	-18.0	3.3
Inflation (% yoy)				
CPI (annual average)	2.5	4.2	3.2	2.5
CPI (end of period)	4.0	3.3	3.2	2.8
Fiscal Accounts (% GDP)				
General Government Balance	-1.9	-3.6	-6.4	-7.0
Gross Public Debt	45.0	47.2	54.0	55.0
Labor Statistics (%)				
Unemployment Rate (% of labor force)	12.7	9.8	10.8	11.8
Wage Growth *(private sector, average)*	*N/A*	*N/A*	4.0	3.5
External Accounts				
Current Account (% GDP)	-5.2	-5.1	-2.5	-3.0
Net FDI (bn EUR)	13.2	8.0	4.0	7.0
FDI / Current Account	90.0	43.6	90.0	60.0
FX Reserves (bn EUR)	44.7	44.1	56.8	58.0
Domestic Credit	**2007**	**2008**	**Q1 09**	**Q2 09**
Total Credit (% GDP)	38.4	48.7	50.6	50.0
Credit to Enterprises (% GDP)	14.3	17.0	17.5	16.8
Credit to Households (% GDP)	21.5	28.9	30.5	30.4
FX Credit/Total Credit (%)	24.0	33.1	35.5	33.7
Private Sector Credit (% yoy)	29.2	37.1	35.1	27.2
Loans to Deposits	97.5	11.3	114.2	111.4
Financial Markets	**Current**	**3M**	**6M**	**12M**
Policy Rate	3.50	3.50	3.50	4.00
EUR/PLN	4.16	4.00	3.90	3.80

Source: National Sources, Eurostat, IMF, Eurobank EFG

2010 presidential election limits room for manoeuvre on the fiscal side

Presidential election is due next year and Prime Minister Donald Tusk is expected to run against the incumbent President Lech Kaczynski. Ahead of the presidential election, the government is loath to make any drastic budget cuts. Conformity with the constitutional public debt limit is being pursued largely through an ambitious privatisation programme. This will only delay the much needed consolidation of public finances until 2011. Moreover, Euro-area entry ambitions point to further tightening on the fiscal side, if Poland is to comply with the Maastricht criteria for timely Euro adoption. We expect Poland to join the Euro area not earlier than in 2014.

In September, the US administration decided to abandon a missile defence system that would have involved Poland among other countries in the region. This development has brought about a re-assessment of the country's foreign alliances making with a gradual shift towards prevailing EU positions being increasingly likely.

Fiscal worries cloud domestic economic outlook

Concerns over public finances started to surface after the fiscal deficit widened to 3.6% of GDP in 2008 (according to EU statistics) from 1.9 % of GDP in 2007. Moreover, the EU granted Poland a 3- year reprieve, i.e. till 2012, to bring its consolidated budget deficit (ESA 95 definition) back under the 3% of GDP threshold. In case of failure to comply with EU demands, the country could face a fine of 0.5% of GDP. Meanwhile, a sizeable deterioration in Poland's government finances took place in 2009, with the general government deficit expected to amount to 6.4% of GDP this year.

This fiscal loosening is largely due to the domestic economic slowdown, which has caused tax receipts to plummet and brought about a new scheme of full indexation of pensions and government spending in unemployment benefits. The deterioration can also be attributed to the effect of the personal income tax cut (whose budgetary cost is estimated at 0.75% of GDP) as well as to higher public investment outlays. The latter have increased by an amount equivalent 1.5% of GDP relative the prior year, but were broadly financed by EU funds.

Debt ratio getting dangerously close to the 55%-of-GDP constitutional threshold

In September the government approved the draft 2010 budget, which targets a fiscal deficit of 52.2bn PLN i.e. double than of prior year's revised target. While the execution of the 2009 budget appears to evolve as planned -in the first 9 months of the year the state budget deficit was 79% of the amended full-year plan of 27.2bn PLN- meeting the 2010 target will be challenging.

As a result of higher deficits, public debt is expected to increase significantly. The public debt-to-GDP ratio stood at 47.2% in 2008 and it is officially expected to reach

54.5% at the end of this year, i.e. a tad below the 55% constitutional threshold. If this threshold is breached, the government will be forced to impose painful cutbacks in 2011. However, the latter is an election year and thereby a marked fiscal tightening could reduce the government's chances for re-election. Fears over rising public debt led the government to change the way the central government budget balance is reported by placing EU transfers in a separate budgetary account. Authorities have also accelerated the privatization process in an effort to help contain the rise in public debt. More precisely, they plan to collect PLN 37bn (€8.9bn) through privatisation in 2009-2010, out of which PLN 25bn expected to be raised in 2010. Such plans include selling public stakes of companies in energy, copper mining, pharmaceuticals and other sectors. However, to execute its full privatisation programme the government will have to pay an enormous political price in the face of trade union opposition. Even if these efforts succeed, the evolution of the debt-to-GDP ratio will also depend on future GDP growth, public spending and tax revenues. It is also worth noting that the projected debt figures are subject to considerable uncertainty due to ensuing valuation effects of the foreign-denominated part of public debt, which accounts for more than a quarter of the coresponding total.

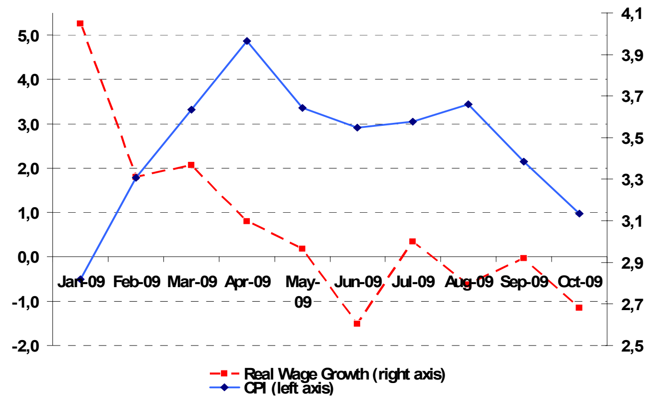
The only EU-27 country to have avoided recession in 2009

Poland will most likely be the only EU-27 country to come through the global financial crisis without having recorded a single quarter of economic contraction. This largely unexpected resilience to the crisis reflects several factors. First, the personal income tax cut (introduced in January 2009) coupled with increased social benefits supported households' disposable income and hence, private consumption. Second, the sharp decline in corporate investment was mitigated by increased (EU co-financed) public investment. Third, the 2001-2003 economic slowdown in Poland equipped domestic businesses with valuable experience on how to operate in a recessionary environment. Fourth, a prime reason for the observed resilience to the global crisis is Poland´s relatively low exports-to-GDP ratio (accounting for 40% of GDP), which has limited contagion via the trade channel. In addition, the zloty´s sharp depreciation (down by 37% against the Euro over the period October 2008 - February 2009) boosted the price competitiveness of Polish exports and translated to a positive contribution of net exports to overall GDP growth in 2009. Fifth, the $20.6bn Flexible Credit Line with the IMF helped to stabilise investor sentiment and reassured international investors. Finally, the Polish private sector is relatively under-leveraged (more than 30% of the population have no regular contact with a bank), thereby limiting the impact of credit crunch.

The domestic industrial sector has faired surprisingly well in recent months and it is expected to return to positive growth territory as early as in Q4-09. This development partly reflects favourable base effects as industrial production started to contract in Q4-08. There are also distinct signs of stabilisation in the manufacturing sector, which is now benefiting from the revival in European demand and the still weak zloty. Nevertheless, sectors of the economy that do not rely on external demand are not recovering at the same pace as industry does. Retail sales have rebounded and are now in a positive territory (2.1% yoy in October) but they have slowed from their peak of 5.7% yoy recorded in July. Moreover, Polish private sector wages grew by 2% yoy, in October, much less than expected. Hence, real wage growth has turned negative, thereby weighing on private consumption. (Figure 1) The latter is also adversely affected by higher unemployment (11.1% in October vs. 10.4% in Jan 09) and still tight credit conditions. These unfavourable labour market developments reflect a lagged response to the effects of the economic slowdown. Therefore, we expect private consumption -- the main pillar of support to domestic growth so far -- to decelerate in the coming quarters, hindering the speed and extend of economic recovery. In addition, budget constraints will also limit public consumption growth. All in all, we pencil in GDP growth of 1.3% yoy in 2009 and 2.0% yoy in 2010.

Figure 1

Negative real wages and signs of abating inflation



Source: Eurobank Research, NBP, National Statistics

Current account deficit shrinks as imports contract faster than exports

Poland's current account deficit in September stood at €57m. This came as a rather pleasant surprise as it was much smaller than expected. The improvement is primarily attributed to higher exports, which, to a great extent, reflect the recent strong industrial rebound in Germany - Poland's main trade partner. Year-to-September, goods exports fell by 22.5% yoy, while imports declined by 29.9% yoy. The trade deficit improved substantially this year; dropping from €483m in January to almost flat in September. The current account deficit totalled at €1457m year-to-September, which accounts for just 10.8% of the corresponding figure a year earlier.

Inflation stickiness mainly due to pass-through from earlier zloty depreciation

Domestic inflation has proved quite sticky in recent months, largely reflecting the pass-through from the significant zloty depreciation earlier this year. While headline CPI fell to an 8-month low of 3.1% yoy in October (from 3.4% in the prior month and a high of 4.0% reached in April), core inflation -- which excludes food and energy prices -- remained flat at 2.9% yoy for a fourth consecutive month. Looking ahead, inflation looks set to ease further in the coming months driven by a stronger zloty and labour market deterioration. We expect inflation to average at 3.2% in 2009 and ease further to 2.5% in 2010.

NBP has likely reached the bottom of its easing cycle

For the fifth month in a row, the National Bank of Poland (NBP) held interest rates unchanged at 3.50% in late November. Taking into account the present worrying state of fiscal situation and the likely bottoming out of growth, we expect the NBP to keep its policy rates on hold in the coming months. In our view, we have already seen the bottom of the easing cycle, while the market already prices-in interest rates hikes from Q2-10.

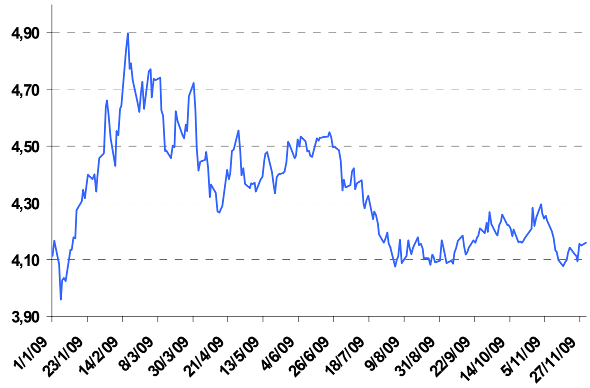
Nine MPC members to be replaced in February

The upcoming replacement of nine out of ten MPC members in February causes some concern with regard to NBP monetary policy outlook. Only the NBP president, Slawomir Skrzypek, who was appointed in January 2007, will serve in the next 6-year term. Considering that 2010 is a presidential election year, the appointment of new MPC members may become overtly politicised. The Polish president will appoint three new MPC members. In all likelihood, these members will be in favour of a policy trajectory that is conducive to economic growth, support the case of interest rates remaining low for longer and be sceptical about early Euro adoption. On the other side, the remaining six new MPC members will be appointed by the coalition government. These latter candidates will likely favour a more restrictive monetary policy and display a clear preference for swift Euro adoption.

The recent favourable external dynamics were supportive for zloty. Nevertheless, they were offset by concerns over the fiscal situation and the feasibility of the ambitious privatisation programme. At the time of writing (November, 30), the zloty stood at 4.16 vs. Euro. We see potential for further zloty appreciation in the coming months. (Figure 2)

Figure 2

Zloty has recouped most of its early-2009 loses against the Euro

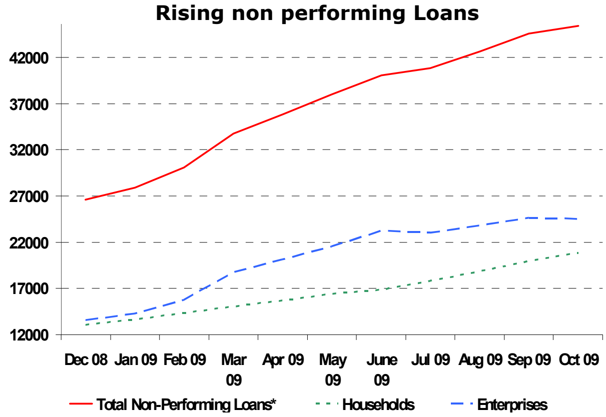


Source: Eurobank Research, Reuters

Non performing loans on the rise

In a distinct contrast with other economies in the region, Poland's banking system still records relatively resilient credit dynamics, with the total outstanding amount of loans to the private sector standing in October ca 7.4% higher relative to January 09 levels and mortgages loans increasing by 10.7% over the corresponding period. Yet, a worrying sign is the continuing rise in non performing loans (NPLs). The NPLs-to-total-loans ratio stood at 6.8% in October compared to 4.3% in December 2008. Even more alarming, the NPLs ratio for domestic businesses rose to 11.4% in October from 6.3% last December. As a result, banks have considerably tightened their credit policy. (Figure 3)

Figure 3
Rising non performing Loans



*Poland's National Bank NPLs definition: Loans overdue for 90 days or more. Retail loans overdue for 180 days or more.

Source: Eurobank Research, NBP

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Romania

Political limbo delays disburse of 3rd IMF tranche; puts fiscal targets at risk

- **The domestic political limbo ahead of the Presidential elections pushed back the third IMF loan installment, postponed further policy easing by the NBR and led to a significant overshooting of the 2009 revised fiscal target**
- **Preliminary, though encouraging, signs of bottoming out in domestic economic activity raise optimism that the worst may be over for the Romanian economy**
- **The most important foreign banks operating in Romania have reaffirmed their intention to continue their presence in the domestic market and maintain a capital adequacy ratio of no less than 10%.**

Romania: Eurobank EFG Forecasts

	2007	2008	2009f	2010f
Real GDP (yoy%)	6.3	6.2	-7.5	0.5
Private Consumption	11.9	8.9	-12.5	2.2
Govern. Consumption	-0.1	-0.3	-3.0	-4.0
Gross Capital Formation	30.3	19.3	-12.3	1.1
Exports	7.8	19.4	-8.9	3.1
Imports	27.3	17.5	-20.8	5.0
Inflation (yoy%)				
CPI (annual average)	4.8	7.9	5.5	3.6
CPI (end of period)	6.6	6.3	4.7	3.5
Fiscal Accounts (%GDP)				
General Government Balance	-2.5	-5.5	-7.8	-5.5
Gross Public Debt	12.6	13.6	21.8	27.4
Labor Statistics (% annual average)				
Unemployment Rate (% of labor force)	4.0	4.4	7.0	8.0
Wage Growth *(total economy)*	22.6	23.6	9.5	4.5
External Accounts				
Current Account (% GDP)	-13.5	-12.3	-6.0	-5.5
Net FDI (EUR bn)	7.3	9.0	4.5	4.5
FDI / Current Account (%)	43.4	54.8	70.0	65.0
FX Reserves (EUR bn)	25.3	26.2	27.9	28.5
Domestic Credit	**2007**	**2008**	**Q1 09**	**Q2 09**
Total Credit (%GDP)	39.0	42.7	45.5	46.6
Credit to Enterprises (%GDP)	18.0	18.8	19.1	18.8
Credit to Households (%GDP)	17.7	19.7	19.9	19.8
FX Credit/Total Credit (%)	51.0	53.1	51.6	49.9
Private Sector Credit (yoy)	60.4	33.7	23.1	11.2
Loans to Deposits (%)	114.8	130.8	131.5	125.3
Financial Markets	**Current**	**3M**	**6M**	**12M**
Policy Rate	8.00	8.00	7.50	7.00
EUR/RON	4.28	4.32	4.25	4.30

Source: National Sources, Eurostat, IMF, Eurobank EFG

Political instability delays third installment of IMF loan agreement

The dismissal of the Minister of Interior in October triggered a series of events, which escalated to a serious political crisis ahead of Presidential elections. The coalition government was toppled after the junior coalition partner party, PSD, initiated a no confidence motion against it. A viable solution for a new cabinet was not found and early elections could not be called for constitutional reasons. As a result, the interim minority government in place has so far not been able to:

i. amass enough political capital to push for the measures necessary to reduce the 2009 fiscal deficit to the levels agreed with the Fund and

ii. submit the 2010 budget for parliamentary approval.

To complicate things further, the current political upheaval puts the implementation of the IMF program at risk. Although the government met most of the required targets, the Fund has so far not been able to complete the second review of its present Standby agreement with Romania. As a result, the country is not expected to receive the third tranche of funds (1.5bn euros) until after a new government is formed. In our view, the unpredictable political environment represents a major risk to the economy**.** The political landscape might not even stabilize after the Presidential elections, while early parliamentary elections cannot be ruled out. It goes without saying that under current conditions, it would be hard for *any* government to implement coherent fiscal consolidation policies.

No fiscal reforms-No third tranche

The fiscal performance so far leaves no room for optimism that the revised budget targets will be accomplished. The consolidated budget deficit increased to a preliminary 5.2%-of-GDP in January-October 2009, compared to just 1.5% in the same period last year. The economic downturn pushed revenue growth in the first ten months of 2009 down to -3.8% yoy, while the increase in pensions-related outlays pushed total expenditures up by 11.6% yoy (social protection expenditures soared by 26% yoy over the corresponding period). Given that expenditures are customarily skewed towards the last 2-3 months of the year, we expect the full-year consolidated government budget deficit to surpass the 7.3%-of-GDP IMF revised target, coming in at 8.0% or higher against 4.9% last year. Under the current circumstances, the interim minority government lacks the political clout to push with the necessary structural reforms and fiscal consolidation measures. As such, the implementation of cuts in the public sector wage bill is quite doubtful, while major expenditures containment measures like the pension reform plan and the fiscal responsibility law are still pending. Even the revised budget deficit target for 2010 (5.9%-of-GDP vs. 3.6%-of-GDP initially agreed with the Fund) looks overly ambitious at this stage. Its implementation will require tougher and more aggressive spending cuts worth around 2%-of-GDP, according to our calculations.

The political turmoil has forced the government to resort to domestic sources of financing the fiscal deficit. A planned Eurobond issue of (1.5bn euros) was postponed after the political crisis erupted in October. Meanwhile, the disbursement of the 3dr IMF loan tranche (along with further assistance from multilateral organizations) is delayed and, as a result, the financing of the deficit is mainly implemented via issuing short-to-medium-term T-bills, which are mainly absorbed by foreign banks. Since this source of financing involves a higher cost, public debt is rising at a worrisome speed. The debt to GDP ratio is expected to increase from 13.6%-of-GDP to 31.6%-of-GDP in 2011, yet remaining low by EU standards.

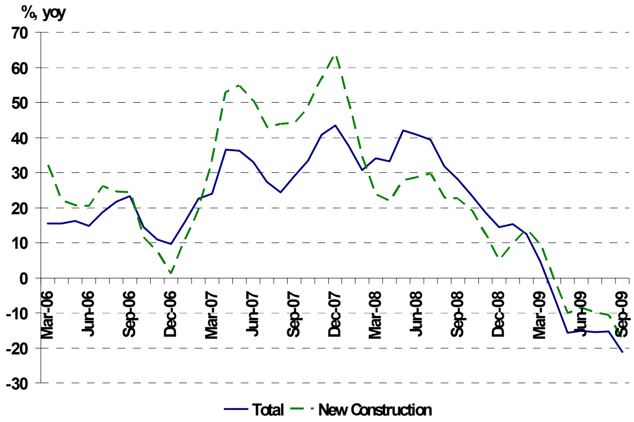
Encouraging, yet preliminary, signs of bottoming out in domestic economic activity

High frequency indicators portray a rather mixed picture of the domestic economy. On the one hand, the industrial sector shows convincing signs of a gradual improvement. The pace of contraction in industrial output eased to 4.3% yoy on a seasonally adjusted basis in Q3 from to 13.3% in Q1. On the other hand, major sectors of the economy such as construction and services remain under significant pressure. Construction output shrunk by 21% yoy in Q3 after contracting by 15.1% in the prior quarter (Figure 1). Separately, the monthly pace of declines in retail sales and domestic services has recently shown some signs of stabilization, yet both sectors continued to record double digit year-on-year declines (-12.2% and -21.6%, respectively) for a fifth consecutive month in August.

Figure 1

Construction sector still in recession

(Construction output% yoy & 3 month m.a.)



Source: National Statistics

The most recent national accounts data shows that the economy remained in recession in Q3, but the pace of contraction eased relative to the prior quarter. On a non-seasonally adjusted basis, real GDP growth fell by less than expected in Q3, coming in at -7.1% yoy vs. -8.7% in Q2. Although the worst seems to be over for the Romanian economy, we need to see more data to be convinced that domestic economic activity is indeed bottoming out. In that respect, we revised our GDP growth forecast to -7.5% yoy in 2009 (from -6.5% previously) and upgraded our 2010 forecast to 0.5% yoy in 2010 (from -1.5.%). Nevertheless, we still think that considerable macroeconomic risks still exist to the downside.

Current account balance improves as imports decline faster than exports

The sharp slowdown in domestic demand has facilitated a sizeable correction in the current account deficit, which we forecast to reach 6%-of-GDP at the end of this year. The deficit shrank by 74.6% yoy in January-September, reaching ca 5.3% of 12-month-rolling GDP against 12.3% in 2008. The main driver behind the improvement is a 67.3%yoy decline in the trade deficit as a result of goods imports (-36% yoy) retreating faster than exports (-18.3% yoy) over the corresponding period. On a less positive note, lower surpluses in balances of services and current transfers partially offset the concurrent improvement in the trade deficit. From the financing side, all other categories of capital inflows were significantly lower (-31.5% yoy). Net FDI inflows in January-September totaled 3.5bn euros, down by 49% yoy, but covering fully the current account deficit. The first IMF loan tranche (4.9 bn euros) averted a balance of payments crisis in Romania. It both helped the adequate financing of the gross external financing gap and also bolstered investor sentiment in the first nine months. As a result, FX reserves stood at 28.4 bn euros in October up from 24.9 bn in April.

Inflation falls within the NBR target band of 3.5% (+/-1%), but upside risks remain

The downward trend in inflation has shown signs of reversing in the last couple of months. Consumer prices rose by 0.44% mom in October, recording positive growth for a second month in a row. Rises in tobacco tariffs, fuels, and services inflation linked to exchange rate adjustments were the main culprits behind the increase. Yet, base effects facilitated a further decline in year-on-year CPI to 4.3%yoy in October from 4.94% in the previous month and a peak of 6.9% yoy in February. Nevertheless, inflation is still high compared to other economies in the region and in the EU-27. Eurobank EFG Research forecasts year-end inflation at 4.9%yoy i.e., close to the upper bound of the Central Bank target. The main upside risks to our forecast stem from further RON depreciation, energy prices rises and further adjustments in administered prices.

Banking sector developments

NBR´s recent measures to alleviate domestic credit conditions have so far limited success in reversing the sharp downturn in private sector credit. Despite the gradual decrease in the FX minimum reserve requirements to 25% (from 40%), credit growth has not demonstrated any significant pick up so far. Credit to the non-government sector recorded a 4.0% yoy rise year-to-October (data adjusted for the RON depreciation) against 33.8% in the same period last year. Separately, the banking sector already faces a dramatic rise in NPLs. Loans overdue more than 90 days (IMF standards) stood at 17.9% in September compared to 10.2% in the same month a year earlier. On a positive note, the most important foreign banks reaffirmed their intention to maintain their exposure and a 10% capital adequacy ratio in the domestic market. Nevertheless, a couple of banks have reduced their exposure below the agreed levels.

Strategy highlights

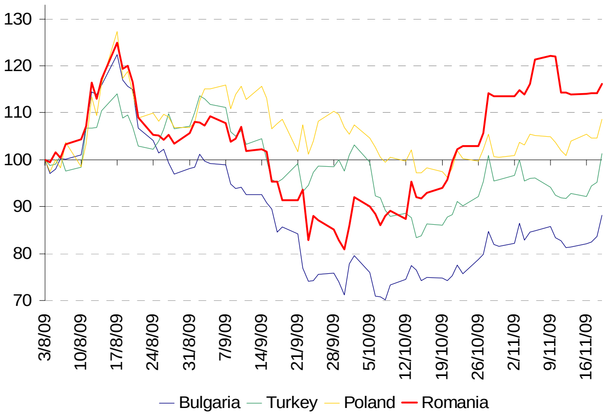
The current political turmoil is expected to delay further rate-easing by the NBR. The Central Bank last cut its key rate in September (by 50bps to 8.00%), having delivered 225bps of cumulative cuts since the inception of its easing cycle last February.

• Romania´s 5-year CDS spreads widened from their lows near 198 bps on Sept. 30 to ca 295 bps currently (Nov. 30) (Figure 2)

• The RON traded firmly within the 4.20-4.30 range against the Euro in the past couple of months, but it temporarily depreciated to levels beyond 4.3/EUR after the domestic political crisis erupted. The Central Bank was able to contain depreciation pressures on the RON only after it decided to cut the reserve ratio for FX liabilities from 30 to 25%, in a move that released an estimated EUR 1.2bn to the domestic market.

Figure 2

Romania 5Y CDS spreads widened again on rising domestic political jitters (03.08.09=100)



Source: Bloomberg

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Focus – Romania

Recent political developments and outlook

Post election scenarios and the future of the present IMF Stand-By Arrangement

The first round of presidential elections held on November 22 resulted in a narrow win of the incumbent, Traian Basescu, supported by the Liberal Democratic Party (PDL) (32.44% of the votes) over Mircea Geoana, the head of the Social Democratic Party (PSD) (31.14%). The second round to be held on December 6 could bring a reversal of fortunes, since the National Liberal Party (PNL) joined forces with the Hungarian minority party (UDMR) in supporting Mircea Geoana. The candidates of PNL and UDMR polled a combined 23.85% of the votes in the first round, but it is unclear whether their electorate will follow party guidelines.

If Mircea Geoana wins, he will probably name Klaus Johannis, the German mayor of Sibiu – a very popular independent with ties to the PNL – as the next prime minister, leading a coalition government made of PSD, PNL and UDMR. The broad guidelines for the future coalition have been agreed upon, with conflicting goals such as low taxation and high social protection on the list. This coalition would hold a 61% majority in the parliament and prove very stable. However, it might conflict with the IMF over restructuring plans, as the PSD has deep ties with the unions and draws massive support from the pensioners. In that case, the risk of an early termination of the stand-by agreement (SBA) would be rather high, since the reforming of budget expenditure for public wages and pensions is the most important issue in the IMF agenda,. Nevertheless, the liberals hope that the good reform track record of 2000 – 2004 -- when the PSD governed Romania and implemented most of the reforms needed in view of EU accession -- will be repeated.

If Traian Basescu wins, he is likely to name a representative of the PDL as the next prime minister. Finding a coalition partner could prove difficult. The natural tie would be with the PNL, since both parties belong to the centre-right (PDL is a member of the European Popular Party, while PNL belongs to the Liberals). The two parties were coalition partners between 2004 and 2007, but Mr Basescu and the most influential leaders of the PNL are now adversaries. The coalition would hold a 55% majority in the parliament (or more if the UDMR joins the government, as it usually does), but it might well be unstable. At the same time, it could prove the most flexible discussion partner for the IMF. If talks between PDL and PNL fail, PDL could enter again the behemoth coalition of 2009 with PSD. The 70% majority has already proven very unstable and not a reform-oriented partnership. The probability of not finding a stable coalition having PDL as its senior member is thus high. The ensuing early parliamentary elections would probably take place by March 2010, thus postponing the arrival of the third and fourth tranches of the IMF loan.

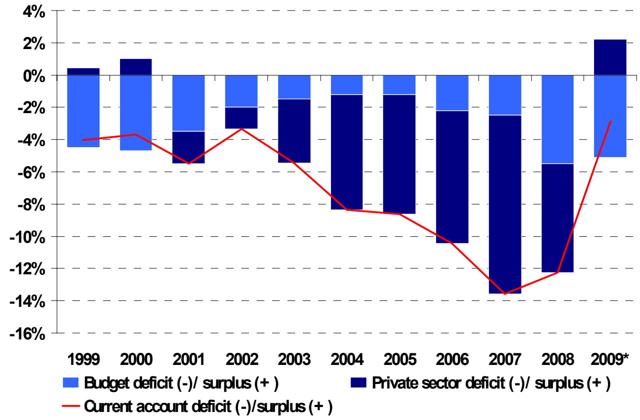
Conclusions:

- The danger of not completing the SBA is high regardless of the outcome of the presidential elections. IMF´s flexibility has so far proven to be the main factor supporting to the continuation of the SBA.
- If Mr Geoana gets elected, the ensuing PSD-PNL-UDMR coalition could be stable, but not necessarily reforms oriented. Under such a scenario, it is unlikely that budget expenditure will be cut, thus prolonging high deficits and keeping the pressure on interest rates and the leu. The short term risks are lower, but the medium term risks could be boosted by resistance to reforms.
- if Mr Basescu gets elected, the probability of forming a new coalition is significantly lower. This increases the public financing risk in the short run, as two IMF loan tranches could be postponed in case of early parliamentary elections.
- A PDL – PNL coalition could be more flexible when negotiating with the IMF, but very unstable politically. If consensus is reached within the coalition, the SBA could be completed successfully and the medium term risks could diminish.
- A PDL – PSD coalition could be unstable as well as not reforms-oriented.

Macroeconomic developments and market implications

The Romanian economy continues to adjust to sharply lower levels of foreign financing and, consequently, to stalling lending and tanking domestic demand. The adjustment in the current account balance has been quick (from 12.3% of GDP at the end of 2008 to around 4% after the first 9 months of 2009) but also very painful for the private sector, as the state sector failed to adjust (figure 1). The budget deficit has amounted to 5.1% of GDP in the first 9 months of 2009 and is expected to reach 7.8% by the end of December (according to the IMF estimates). The 2010 budget deficit projection stand at 5.9% of GDP (a very optimistic figure that assumes further expenditure cuts) and its financing will be a main policy challenge. The budget deficit target for 2010 is equivalent to at least 7 billion euros, while maturing government debt and interest payments on public debt will amount to another 5 bn Euros.

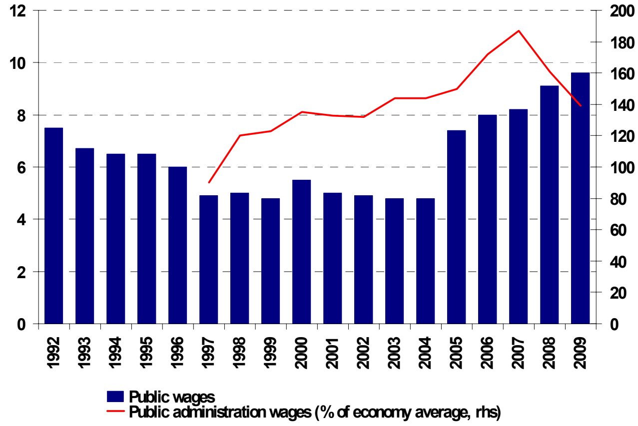
Figure 1



*First 9 months of 2009

Source: Eurostat

Figure 2

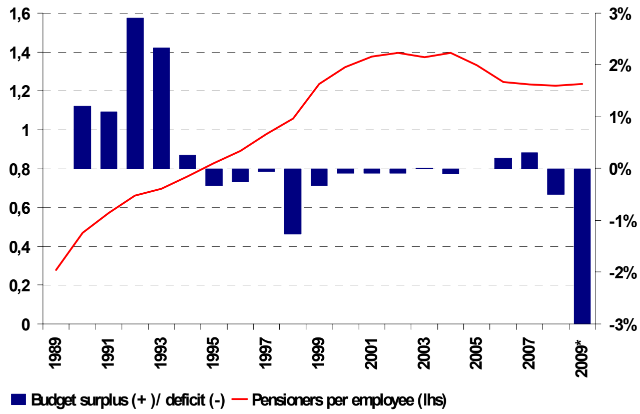


* Public wages are expressed as a percentage of GDP

Source: IMF

On May 4, 2009, Romania signed an agreement with the IMF, the World Bank and other international financial institutions (IFI) for a loan amounting to the equivalent of 20 billion Euro. Romania has received already 8.4 billion Euro and is supposed to get a further 4.3 billion until March 2010. So far, the IMF has been very supportive, acknowledging fulfillment of the Stand-By Agreement's macroeconomic targets, despite having to adjust the expected level of budget deficit and to waive the target set for the general government's domestic arrears. The required reforms have been fulfilled partially: a law establishing a unified public wage system, and one reforming governmental agencies have been adopted on November 5. Yet, the more delicate reform targets have not yet been addressed: the government is expected to layoff around 326,000 people until 2015 (in order to bring down wage expenditure to 2004 levels – figure 2), while requiring all state employees to contribute to the social security budget (in order to prevent a further widening in the budget deficit– figure 3). Both reforms are likely to be opposed or, at least, postponed by the future government, regardless of who will win the second round of presidential elections on December 6 i.e., incumbent Traian Basescu, a centre-right populist, or Mircea Geoana, a left wing populist. With the backing of a third-placed liberal candidate, Mircea Geoana looks to be the favourite one to win the election.

Figure 3



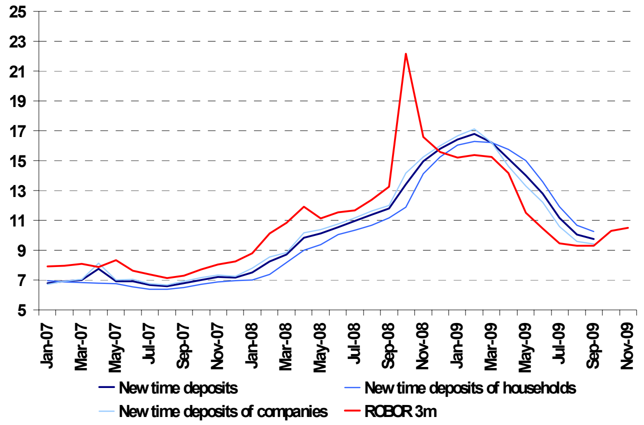
*2009: 9 months annualised

Source: IMF, Eurostat

The 2010 financing needs are likely to impact both the EURRON exchange rate and the level of domestic interest rates. Local banks cannot absorb a further significant amount of Romanian treasury securities. Their total holding of government debt is currently estimated at ca around 10% of total banking system assets. The other major buyers of treasuries are pension funds and private investors, both with limited absorption capacities. According to industry estimates, pension funds could add 500 million euros to their assets in 2010. If the share of treasuries in total investments is kept at 63%, pension funds could buy around 300 million euros of government debt. The government could try to issue bonds in foreign markets, despite its junk BB+ rating from Standard & Poor's and Moody's and the highest CDS spreads among Central and Eastern European EU members.

The Romanian leu is supported by central bank interventions in a very shallow FX market. The National Bank of Romania aims at limiting currency depreciation, thus staving off inflation and the rise in non-performing loans (more than 50% of private sector loans are in foreign currencies). The improving current account deficit and the 106.4% FDI coverage year-to-September (the coverage is likely to fall to around 75% by year-end) are also supportive for the leu, as are Euro sales from the Treasury account. Last but not least, Romania futures the highest domestic interest rate levels in the region, with interbank rates above 10% for tenors longer than one week. Note that the key policy interest rate currently stands at 8.00%, the Government issues treasuries at a minimum yield of 10%, while banks compete for the limited resources of the private sector by paying on an average rate of 9.75% for new deposits (10.26% for companies and 9.4% for households in September – figure 4). Deposit rates could increase again as banks compete with the government for limited resources. With EURRON historical volatility around 4%, carry trades are very attractive.

Figure 4



Source: NBR

Wrapping up, we expect the EURRON rate staying within the 4.0-4.3 range for the greater part of 2010. Yet, levels significantly below the lower boundary of that range will rather be difficult to materialize, especially if the Government chooses to focus on foreign markets for financing the budget deficit. Interbank interest rates will stay above the monetary policy rate as long as the Government is prepared to pay a premium for available liquidity and banks compete for the limited resources of the private sector.

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Serbia

Second IMF Review Completed

- **The successful conclusion of the second review of the €3bn IMF stand-by agreement alleviates external financing concerns and provides hope that the government will go ahead with the necessary fiscal reforms**
- **Serbia will likely exit recession in 2010, yet recovery will be slow: Output contraction is seen contained at 3.5% in 2009 while a mild recovery to 1.5-2.0% is expected in 2010**

Serbia expected to file for EU candidate status by year-end

Sentiment among EU policy makers towards Serbia and the Western Balkans appears to be improving. In its latest progress report, the European Commission made a positive assessment on Serbia's recent efforts towards EU integration. Serbia was praised for its effort to co-operate with the ICTY and meet the necessary requirements for visa regulations. In that direction, the European Commission recommended the lifting of visa restrictions for Serbian citizens for the first time since the 1990s. Yet the most important step would be the unblocking of the interim trade agreement, which is still pending. Serbia is already implementing the Stabilization and Association Agreement on a unilateral basis. All in, it is very likely that Serbia will file for EU candidate status by the end of this year.

Output contraction contained; fragile recovery expected

Output losses were contained in Q3. According to a revised, yet still preliminary, estimate by the NBS, GDP shrunk by 2.3%yoy in the third quarter, following a 4.0% contraction H1 2009. Separately, higher-frequency indicators and survey data show tentative signs of a bottoming out in domestic economic activity. The pace of declines in industrial output slowed down in Q3 following double-digit losses in H1 2009. Industrial production posted its first monthly rise (+3.1%) on a seasonally adjusted basis in September, yet it was still down 6.3% yoy. (Figure 1) US Steel resumed production in Serbia, giving manufacturing production a boost (+4.5% mom in September). Other key, export-oriented, sectors of the economy, such as base metals, food stuff and motor vehicles, improved their performance as well. Furthermore, the agricultural sector had an unexpected positive contribution to growth in Q3.

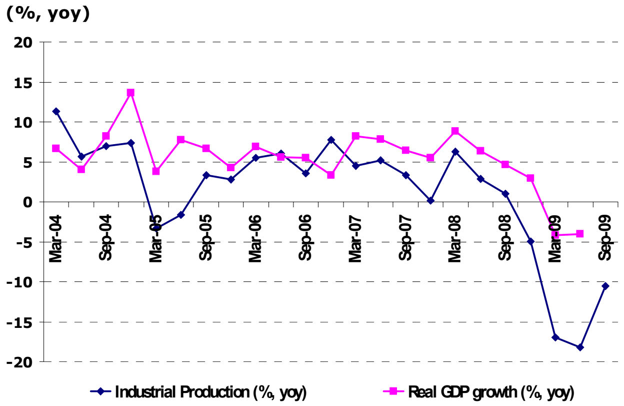
Serbia: Eurobank EFG Forecasts

	2007	2008	2009f	2010f
Real GDP (yoy%)	6.9	5.5	-3.5	1.5
Inflation (yoy%)				
CPI (annual average)	6.5	11.7	8.0	7.0
CPI (end of period)	11.0	8.6	7.9	7.0
Fiscal Accounts (%GDP)				
General Government Balance	-1.9	-2.4	-4.5	-4.0
Gross Public Debt	29.4	25.6	32.5	37.0
Labor Statistics (%)				
Unemployment Rate (*% of labor force, ILO*)	18.8	14.4	16.4	18.5
Wage Growth (*total economy*)	22.0	17.9	9.5	5.0
External Accounts				
Current Account (% GDP)	-15.6	-17.3	-8.5	-9.5
Net FDI (EUR bn)	1.8	1.8	1.2	1.5
FDI / Current Account (%)	38.0	30.0	75.0	55.0
FX Reserves (EUR bn)	9.64	8.15	9.8	10.0
Domestic Credit	**2007**	**2008**	**Q1 09**	**Q2 09**
Total Credit (%GDP)	36.4	41.1	44.0	43.9
Credit to Enterprises (%GDP)	22.3	26.1	28.6	28.6
Credit to Households (%GDP)	13.4	14.1	14.4	14.2
Private Sector Credit (yoy)	40.2	34.9	33.4	26.6
Loans to Deposits (%)	101.4	125.9	131.5	125.7
Financial Markets	**Current**	**3M**	**6M**	**12M**
Policy Rate	10.00	9.75	9.50	9.00
EUR/RSD	94.84	94.50	94.50	95.00

Source: National Sources, IMF, Eurobank EFG

Figure 1

Economic contraction eased in Q3



Source: National Statistics

In our view, these tentative signs of bottoming out in domestic economic activity suggest that the contraction in full-year real GDP growth will be contained to around -3.5% in 2009. Yet, recovery from the recent significant output declines will be slow and painful as the economy's export base remains low, public sector's contribution to overall GDP is still high by regional standards, and capital inflows are significantly lower compared to levels recorded in recent years. Domestic demand will be subdued in the coming few quarters as disposable incomes remain constrained: real wages are now negative, structural unemployment is high, and bank lending remains minimal. We expect a mild GDP growth rebound to 1.5% in 2010, even though fiscal policy next year is likely to be conducive to growth.

IMF and the government reach agreement over 2009 & 2010 fiscal targets

The IMF mission completed the second review of its Stand-by agreement with Serbia in early November after reaching an agreement with the government over the fiscal targets for 2009 and 2010. The IMF agreed to relax the budget deficit target for this year -- the only conditionality of the program the government was unable to comply with -- from 3.0% to 4.5% of GDP. Access to further IMF funding is contingent upon meeting the necessary requirements for facilitating the fulfillment of next year's deficit target of 4.0% of GDP. In a sense, any meaningful fiscal adjustment is postponed until after 2010. The budget expenditure for pensions and public wages will be frozen next year too. In fact, the government pledged to slash public sector work force, particularly at a local government level, and to proceed with the pension reform. These steps are considered to be necessary in order to achieve sustainable fiscal consolidation.

Official data on the execution of the budget in the first nine months of this year showed consolidated revenues lagging behind (-1.0% yoy) despite some improvement in tax collections (+6.9% yoy) in Q3. On the other hand, expenditures increased by 5.2% yoy in January-September despite the announced freeze in public-sector wages and pensions. As a result, the year-to-September consolidated budget deficit reached 80.9bn RSD or 2.7% of full year GDP and 90% of the target initially agreed with the Fund. If expenditure continues increasing faster than revenues in Q4, the deficit may reach the 4.5%-of-GDP revised target, although the Ministry of Finance expects a significantly better outcome. Last but not least, public debt increased to 32% of GDP in September, from 25.4% of GDP at the end of 2008, still remaining low by EU standards.

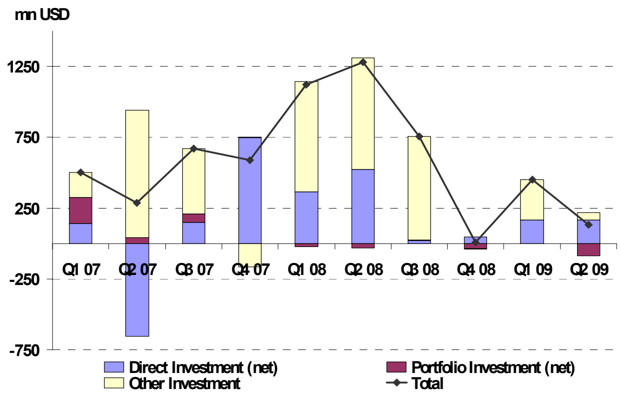
Completion of the second IMF review eases external financing concerns

The current account shrank by a faster-than-previously-expected pace of 72.3% yoy in January-September. The main driver behind the improvement was a 50%yoy decline in the trade deficit, though other BoP aggregates improved as well. Lower oil prices (energy imports: -44% yoy) and weaker investment spending (capital goods imports: -33% yoy) facilitated a 31%yoy decline in the overall imports bill over the corresponding period. On the other hand, exports (- 23.2% yoy in January-September) declined at a relative slower pace than imports, thanks to the recent resumption of metal exports and higher exports of food & beverages relative to the same period a year earlier. Furthermore, the IMF loan agreement boosted current transfers' surplus by 39.3%yoy. As a consequence, the 9-month current account deficit *(in annualized terms)* stood at 5.3% of expected GDP vs. 17.2% in 2008. EFG Eurobank Research has a 2009 full-year current account deficit projection of 6.5% of GDP.

On the financing side, capital inflows in Q3 2009 improved slightly compared to their level in the last quarter of 2008, but were lower by 41.8% year-on-year (Figure 2). Net FDI inflows declined by 37.6% yoy to EUR 1bn in January-September 2009, with the sale revenues from the privatization of NIS accounting for most of corresponding amount. Yet, net FDI inflows covered 84.9% of the year-to-August current account deficit, up from 48% in 2008. The surplus on other investment was 1.7bn, down by 43.2%, despite the IMF loan and the high roll over of long-terms debt. The announcement of the IMF loan agreement had assisted the country to address the sudden stop of capital inflows and to bolster investors' confidence. Furthermore, the completion of the second program review helps to alleviate external financing concerns, as it provides local authorities with access to the rest of the IMF funding (2.2 bn euros) at their own discretion. However, it is doubtful whether they will make use of it. The lower than expected current account deficit, increased currency reserves and the maintenance -- or even increase -- of foreign banks´ exposure in the Serbian market (Figure 3), inspires optimism that future external financing needs will be comfortably met.

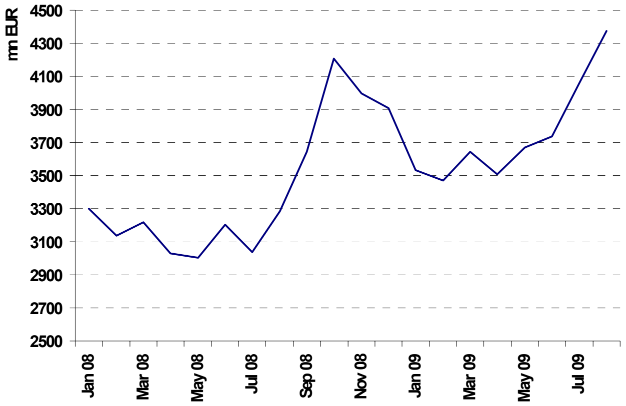
Figure 2

Capital inflows improve from their lows in Q4 2008



Source: NBS

Figure 3
Foreign banks increase exposure to the domestic market
(Foreign Liabilities of the Banking sector, million euros)



Source: NBS

Inflation eased to unsustainably low levels in Q3

Domestic inflation registered a steep decline in Q3. CPI eased below the lower bound of the (6-10%) Central Bank target in October, coming in at 5.2% yoy, compared to 12.3% yoy in the same month a year earlier. Prices for goods declined further to 3.6% yoy, reflecting weak domestic demand. In contrast, services inflation remained relatively high at 13.4% yoy. On top of that, food prices, which carry the most significant weight in the CPI basket, recorded an unexpected decline to -1% yoy in October, following average monthly increases of 4.0% yoy in the previous few months. New hikes in regulated prices and food prices inflation will result in consumer prices trending higher, with CPI seen ending the year at 8.0% yoy (Eurobank EFG Research forecast)

Domestic financial markets stabilize

Domestic financial markets recovered since last March in line with regional peers, currently discounting that the worst is over for the Serbian economy. Five-year credit default swaps traded at ca 350 bps in late November compared to levels around 600 bps at the end of 2008. The conclusion of the IMF review allowed the NBS to bring interest rates further down to 10.00%, marking a cumulative rate easing of 775 basis points since the beginning of 2009. The Central Bank has signaled that further cuts were in the pipeline. In our view, policy interest rates will not decline further before early next year, most probably not below 9.00% by end-2010, as we anticipate inflationary pressures to remain relatively elevated. Any new rate cuts will be contingent on new regulatory prices hikes (likely to be implemented in the next two months) as well as the government´s commitment to fiscal targets. In FX markets, the Dinar stabilized at 93-95 against the Euro in the last few months, without any intervention being conducted the Central Bank since late February.

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Special Focus- Serbia

A Structural Analysis of Challenges, Prospects and Insights from a Recent Trip

A recent trip to Belgrade gave us the opportunity to assess in the field the progress, but also the challenges, facing the Serbian economy in its pursuit of European integration and economic prosperity. In that trip we met with prominent figures of Serbia's economic life, including officials from the Central Bank, the Government, the World Bank and private banks. We also benefited from attending the 9th Serbian Economic Summit and holding discussions with participants.

Political landscape

The coalition nature of the pro-European government raises concerns as to its resilience to the social tension incurred by the crisis. However, the chances of a snap election are limited by the fact that none of the political parties has a motive to cause them. Stability of the political system should not be challenged medium term. Although EU entry seems remote, the prospect acts as a strong motivation.This is evident in the symbolic importance attached to the granting by the EU of visa-free travel for Serbian citizens in the Schengen area. This prospect enforces discipline in economic policy, thereby stabilising market expectations. The controversial Public Information Law, saw by some as limiting freedom of speech, was welcome by others as an effort to put a limit to some media's populism and defamatory conduct. The real challenge remains the dedication to consistent policies to fight the crisis, away from the sirens of popularity.

The International Crisis Calls for a Revision of Serbia's Growth Model

So far, the main consequences of the international financial crisis for Serbia have been a sharp contraction, dinar depreciation and the increase in the cost and difficulty of acquiring external financing. However, longer term repercussions should be expected and not all of them are bad.

As most countries in New Europe, Serbia's model of growth in recent years was based to a large extent in domestic demand. Expansion was financed by inflows of capital motivated by the country's dynamic growth potential. This optimism about market prospects and future income –perceived as being permanently higher- also encouraged domestic businesses and households to increase their borrowing exposure in order to support a higher level of consumption and investment respectively. Hence, the booming years were marked by rapid credit growth and sizable current account deficits. This behaviour is typical in catching-up processes; it was facilitated by the simultaneously implemented financial liberalisation. Unfortunately, the global financial crisis had a crucial impact on markets' appetite for risk in emerging markets. Thus, it was only natural that, when capital inflows dried up (FDI most importantly), Serbia took a course resembling, to some extent, a boom-and-bust pattern. The sudden reversal of expectations and capital inflows elected, if not magnified, the hysteresis of supply against the rapid pace of demand increase.

Strong domestic financial systems (dominated by banks) played an important role in avoiding a collapse. Ironically, Serbia was fortunate to be hit by the financial crisis relatively early in its booming phase. Had the indebtedness of private agents gone too far and external deficits caused the accumulation of an even larger external debt, the bust phase would have been more dramatic: deeper and more protracted recession, more dramatic dinar depreciation and associated defaults on loans, especially the FX denominated portion. The country would then be in much more difficult situation, for the additional reason institutions and agents lack the experience of crisis management.

Currently, psychology in the country is rebounding. A positive omen for Serbia is that there seems to be a wide consensus among policymakers and market participants that the country should pursue a new model of growth, not sufficing in a management of the current crisis occasion. The general strategy concerns the increase of the productivity of the economy and, accordingly, of the competitiveness of exports. The final goal should be to increase the contribution of the external sector among sources of growth, in replacement of the current paradigm, which is based in internal demand, consumption in particular. On the supply side, development of services and non-tradeables in general has been rapid. Hence, real wage growth has been consistently higher than GDP growth in previous years. This undermined competitiveness and contributed to the high unemployment rate. Now, unemployment would be an extra impediment in an attempted revival of the previous model of growth. Given the chronic character of the phenomenon, demand stimuli would be inadequate in addressing it. Labour market policies will help, in particular matching up of skills with the needs of the real economy. However, the final solution lies with a reorientation of the structure of the economy.

The government believes the general productivity of the economy will benefit if the manufacturing sector grows to match the rapid increase of services; hence the importance attached to the FIAT project. However, they will not slip into subsidies and protection policies. Instead, the effort should be focused around creating the framework that favours the development of productive activities: correcting macroeconomic imbalances, improving the quality of institutions, upgrading general infrastructure and human capital, fighting red tape and corruption. The challenge is to switch from traditional products to new ones, incorporating cutting edge technology. Quality agricultural products are an aim too; this would yield economies of scope with the country's food processing industry. The new, export-driven model will conclusively turn Serbia towards its main trade partner, the EU, given the lack of complementarities in products traded with Russia.

Notwithstanding challenges, it has to be noted that Serbia started from a very low benchmark. Furthermore, the transition from central planning to a market economy has been undermined by the turbulent geopolitical factors. This makes the country's progress even more remarkable. Still, the per capita GDP in Serbia still stands at only 69% of its 1989 level and 32% of the Eurozone average. Longer-term, this can only mean one thing: faster growth.

Longer-term, Serbia's growth prospects remain positive

A tangible progress in the course of EU candidacy would boost confidence in the economy but this is not realistic to expect for the next 6 to 7 years (and at least 5 more years for EMU entry). Regardless of that, Serbia possesses significant competitive advantages:

1. A well educated labour force combined with favourable unit labour cost and low overhead costs; professional training is needed for bridging academic education with practical skills required in the workplace.
2. A strategic geographical position, offering itself for transforming the country into a trade hub. Therefore, it is of utmost importance to proceed with upgrading transport infrastructure, first priority being the long overdue Corridor X.
3. An industrial culture, notwithstanding obsolete manufacturing infrastructure in some sectors.
4. An internationalised and –to a great extent- modernised financial system.
5. Duty-free access to markets of 1 billion people in total, in case the country is used as a platform for exports.

Economic Policy

A. Monetary Policy. The National Bank of Serbia declares its commitment to the price stability goal. Inflationary history and lack of convincing signals from the government in its stabilization and growth strategy fend off thoughts of succumbing to growth considerations in the design of its policies, i.e. becoming laxer. Competitive devaluations are also ruled out by the NBS arsenal, not just due to the pass-through to inflation but also because of the large portion of loans that are FX-denominated. Headline inflation is being targeted from 2009 but a serious assessment of the new strategy's success is hindered by the unusual width of the band targeted (4 pp). The NBS plans to narrow the band to ±1% as inflation declines. The relatively low pace of disinflation, especially as far as PPI and services are concerned, points to some wage inertia, market rigidities, oligopolistic features, and a lower productivity of the services sector. A question also arises as to the extent wage restraint was implemented. Inflation expectations are adjusting but with a lag, a fact that somehow increases the cost of disinflation.

A measurement of overall price competitiveness would require a reliable and intertemporally comparable REER index. The NBS REER index shows a mere 4% real appreciation since the Autumn 2008 rapid depreciation. This should be attributed to the decline of capital inflows, which were the main force behind appreciation in previous years. However, several analysts argue that the dinar is still overpriced (compared to its 2000 level or any equilibrium REER level). If this is the case, it will cost to price competitiveness of exports and, thus, recovery prospects. Given Serbia's inflation differential vis-à-vis the EU, Serbia's main trading partner, caution is needed. At the time being though, the consistency of interest rate and exchange rate policies is not being questioned, as evident from the lack of pressures in the Forex market. Whether the stabilisation of exchange rate expectations will last is early to say.

The rapid improvement of the current account (5,3 of GDP in Q3 2009 from 17,2% a year earlier) is also not a safe indication. Although beneficial –and a good benchmark for future adjustments- it is predominantly owed to the shrinkage of imports due to the recession and cannot be considered sustainable. Structural policies for improving price and quality competitiveness will be necessary to this end. Ceteris paribus, the current account deficit is expected to rise again from 2010.

B. Fiscal Policy. Given the depth of recession and the associated activation of automatic stabilisers of the government budget, a 4% budget deficit is not dramatic by Eurozone standards (neither is a public debt of 35% of GDP). However, there are at least three reasons why there is no room for complacency. Firstly, the recession inflicts blows to revenue. Secondly, the structure of public expenditure is inflexible, with more than half of the expenditures directed to wages and pensions. Finally, Serbia's international credit lines face limitations; the fact that more than 95% of T-bills have a maturity of 6 months or less is indicative. IMF accepted the fiscal reality and a deal was reached for disbursing the second and third tranches of the agreed loan, with a clause of using a part of it for budgetary purposes. Authorities may declare they do not need it but its presence is always useful, even as a mechanism for further stabilising investors' expectations. Fiscal policy faces the challenge of restructuring the composition of expenditures in order to allocate more resources to investment and to increase public sector efficiency. A reform of social security and the health system is a high priority: pension expenses are projected to amount to 10% of GDP in 5 years and demographic factors risk turning labour cost into an inflationary factor. Reductions in the number of public servants also seem unavoidable, non-priority investment will be cut back. A discussion on a tax reform has commenced. The creation of sustainable sources of long-term financing is also imperative in order to reduce reliance on T-bills, multilateral organizations donations and loans.

Financial Sector

A cap to scarcity of capital was provided by foreign banks' commitment to maintain their exposure in the country (Vienna initiative), which also acted as stabilisation device for expectations. Banks' commitment was assisted by the decision of the NBS to soften reserve requirements and make the stance of monetary policy less strict. Following criticism against NBS of a too quick deregulation of financial markets, banks anticipate changes in regulation. No manoeuvre on the repo rate is expected but obligatory reserves may change. Despite the high loans-to-deposits ratio, the banking sector enjoys strong capital adequacy ratios, even after their fall in 2009. Ratios remain well above CEE peers, due to prudent practices of both commercial banks and the NBS regulatory framework. NPLs rise less than expected.

Positive credit growth currently limits the deepening of recession. However, the future behaviour of credit will necessarily be in accordance with the needs of the new growth model that economic policy will be called to serve. It is not random that currently corporate loans hold better than construction funding and mortgages, which have plunged. Given the considerations mentioned above, sustainability will be given priority over rapid expansion. The same trajectory as for macroeconomic fundamentals, only with a lag. This is the only way to ensure that, limiting the size of the downturn now will not turn into an allocation of the adjustment cost in a number of years to come. The high private-sector FX risk further emphasises this necessity. Hence, economic agents should align themselves to the coming trends.

Epilogue

Another ironic analogy: the traumatic recent history of Serbia has strengthened the country's stoicism against hardship, a feature most useful in times of turmoil.

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Turkey

Return to positive GDP growth expected in 2010

- **Expectations about an imminent IMF loan accord on the rise**
- **Inflation pressures to remain subdued in the remainder of 2009; gradual acceleration expected next year**
- **November rate cut likely to prove the last in CBRT´s easing cycle**
- **The silver lining of the global financial crisis is a smaller current account deficit.**

Rising expectations for an IMF loan accord

There has been growing speculation lately that Turkey is closer to securing a loan accord with the IMF. According to Prime Minister Tayyip Erdogan one of the main topics of disagreement over the deal, the issue of an independent tax authority, has been overcome. A realistic and feasible medium-term fiscal plan announced by the government in September was well received by the Fund. Meanwhile, recent comments by government and central bank officials, including the Prime Minister, suggest that the cabinet appears increasingly inclined to acknowledge that an IMF loan deal would be beneficial for the Turkish economy; a view which we also share. The reason is not so much its potential usage to finance the country's external financing requirement. That has lessened in recent months due to a significant decline in the current account deficit and the stabilization of the local currency. Instead, the deal is mostly needed to support an economic recovery by lessening the crowding out effect on the private sector and helping to improve investor and consumer sentiment. Of course, part of the funds may also be used to assist easing the Treasury's roll-over burden and finance part of the country's external gap. All in all, recent developments suggest that an IMF deal is more likely to happen than not. According to our estimates, the 2010 net financing requirement will be around USD 14.5bn (*see Table 1*). Provided that the deal is a three-year Stand-By Arrangement we expect the loan to amount to around USD 25-35bn, out of which ca $10bn is likely to be used to strengthen the official reserves of the country and the rest to fill in the 2010 financing gap.

Turkey: Eurobank EFG Forecasts

	2007	2008	2009f	2010f
Real GDP (yoy%)	4.7	0.9	-5.5	3.0
Private Consumption	5.5	-0.1	-4.0	3.5
Government Consumption	6.5	1.9	1.5	1.0
Gross Capital Formation	5.8	-3.7	-24.1	5.0
Exports	7.3	2.3	-9.5	2.0
Imports	10.7	-3.8	-18.5	4.0
Inflation (yoy%)				
CPI (annual average)	8.8	10.4	6.2	6.6
CPI (end of period)	8.4	10.1	5.7	6.4
Fiscal Accounts (%GDP)				
General Government Balance	-1.2	-1.8	-6.6	-4.9
Gross Public Debt	39.4	39.5	48.0	49.0
Primary Balance	3.0	1.7	-2.1	-0.3
Labor Statistics				
Unemployment Rate (*% of labor force*)	10.6	13.6	14.8	14.6
External Accounts				
Current Account (% GDP)	-5.9	-5.7	-2.0	-3.0
Net FDI (USD)	19.9	15.8	8.0	10.0
FDI / Current Account	52.2	37.8	66.7	46.9
FX Reserves (USDbn)	73.3	71.0	70.0	69.0
Domestic Credit	**2007**	**2008**	**Q2 09**	**Q3 09**
Total Credit (%GDP)	28.0	31.0	32.0	33.0
Credit Private Sector (%GDP)	27.0	30.0	30.0	32.0
FX Credit/Total Credit (%)	11.5	13.2	12.4	14.0
Private Sector Credit (%yoy)	27.7	22.9	4.2	2.8
Loans to Deposits (%)	81.0	82.4	80.8	79.5
Financial Markets	**Current**	**3M**	**6M**	**12M**
Policy Rate	6.50	6.50	6.50	7.25
USD/TRY	1.52	1.52	1.50	1.40

Source: National Sources, Eurostat, IMF, Eurobank EFG

Table 1: Financing Requirement

(EFG Istanbul Securities estimations & forecasts)

(USD bn)	2007	2008	2009 Sep	2009	2010
Summary measures					
CURRENT ACC. BALANCE	-38.2	-41.8	-8.6	-12.5	-26.0
NET ERRORS & OMISSIONS	1.6	5.4	6.2	7.0	0.0
GROSS FINANCING REQUIREMENT	-36.6	-36.4	-2.5	-5.5	-26.0
TOTAL FINANCING (Sources)	36.6	36.4	2.5	5.5	11.5
NET FINANCING REQUIREMENT	**0.0**	**0.0**	**0.0**	**0.0**	**-14.5**
Breakdown - Sources of financing					
CAPITAL FLOWS (NET)	48.2	44.4	-1.7	-1.5	11.5
Direct Investment (Net)	19.9	15.8	5.2	6.5	8.0
Portfolio Investments (Net)	0.7	-5.0	0.7	1.6	2.8
Govt's net Eurobond Issues	0.9	0.6	1.8	1.8	1.8
Issuance	4.6	4.0	3.8	3.8	4.5
Redemption	-3.7	-3.4	-1.9	-2.0	-2.7
Non-residents's Equity Buyings in Turkey	5.1	0.7	1.8	2.5	1.5
Non-residents's Local Bond Buyings in Turkey	-3.3	-5.1	-0.9	-0.7	1.5
Resident's Security Buyings Abroad	-2.1	-1.3	-2.0	-2.0	-2.0
Borrowing (net)	30.4	33.4	-15.0	-18.1	-1.3
General Government	**-3.9**	**3.4**	**0.8**	**-0.1**	**-0.3**
IMF	-4.0	1.7	-0.7	-0.7	-2.3
Borrowing	1.1	3.6	0.0	0.0	0.0
Repayment	-5.1	-1.9	-0.7	-0.7	-2.3
Other	0.1	1.7	1.5	0.6	2.0
Borrowing	3.4	5.1	3.6	4.4	5.0
Repayment	-3.3	-3.4	-2.2	-3.8	-3.0
Central Bank	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
IMF	0.0	0.0	0.0	0.0	0.0
Other	0.0	0.0	0.0	0.0	0.0
Banks	**5.6**	**3.0**	**-6.3**	**-7.0**	**1.0**
Long-term	7.3	0.7	-1.9	-2.5	0.0
Borrowing	10.4	7.9	3.8	4.5	5.5
Repayment	-3.1	-7.2	-5.8	-7.0	-5.5
Short-term	-1.7	2.3	-4.4	-4.5	1.0
Other Sector	**28.7**	**26.9**	**-9.4**	**-11.0**	**-2.0**
Long-term	25.7	22.7	-7.2	-10.0	-5.0
Borrowing	48.0	47.3	16.8	25.0	27.0
Repayment	-22.3	-24.6	-24.0	-35.0	-32.0
Short-term	0.2	0.9	-0.1	0.0	1.0
Trade Credits (net)	2.8	3.3	-2.1	-1.0	2.0
Deposits	-3.3	3.4	6.1	7.0	1.0
in Central Banks	-1.5	-1.8	-0.8	-1.0	-1.0
in Banks	-1.9	5.2	6.8	8.0	2.0
Other	0.5	-3.1	1.3	1.5	1.0
CHANGE IN RESERVES (- increase)	-11.6	-8.0	4.2	7.0	0.0
Banks' FX assets	-3.5	-9.1	3.5	7.0	0.0
Official Reserves	-8.0	1.1	0.7	0.0	0.0

New medium-term fiscal plan sets out realistic assumptions and feasible targets

The government's new medium-term fiscal plan spanning the period 2010-2012 was comprised of seemingly realistic and feasible targets (see *Table 2)*. Announced in September the program envisages a correction in the fiscal balance from an expected deficit of 6.5%-of-GDP this year to a shortfall of 2.1% in 2012. In parallel, the budget's primary balance is anticipated to swing from a deficit in 2009 to a surplus in 2011. According to the plan's underlying assumptions, GDP growth is seen accelerating to +3.5%yoy in 2010 and picking up pace thereafter, following an expected contraction of 6.0%yoy in 2009. Year-end inflation is seen at 5.9%yoy in 2009 and gradually easing towards 4.8%yoy in 2012. The plan's targets echo conservative and the respective calculations do not account for the positive impact on the domestic economy an IMF loan agreement may have. A new Stand-By Arrangement is likely to support the economic recovery ahead, increase budget revenues through higher tax receipts and thus, lead to a speedier adjustment in the government's finances. What remains to be seen however, is commitment to these targets, especially as the 2011 general elections may dent fiscal consolidation efforts.

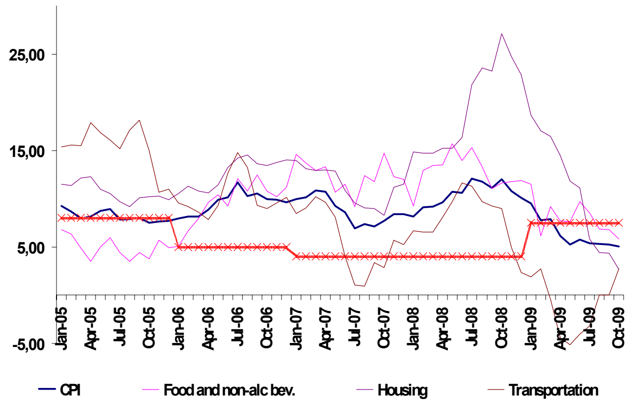
Table 2: Medium Term Programme: Main macroeconomic assumptions

Medium Term Programme: Main macroeconomic assumptions	2009	2010	2011	2012
Nominal GDP (TRYbn)	947	1.029	1.118	1.227
GDP Per Capita (USD)	8.456	8.821	9.096	9.732
GDP growth (yoy%)	-6,0	3,5	4,0	5,0
Year-end CPI (yoy%)	5,9	5,3	4,9	4,8
Unemploument Rate %	14,8	14,6	14,2	13,3
Export/Import %	73,5	70,3	70,2	69,5
Current Account Balance (% GDP)	-1,8	-2,8	-3,3	-3,9
Public Sector General Balance (% GDP)	-6,5	-4,2	-3,0	-2,1
Public Sector Primary Surplus (% GDP)	-2,1	-0,3	0,4	1,0
Privatization Revenues (% GDP)	0,5	1,0	0,8	0,7
Public Nominal Debt stock (% GDP)	47,3	49,0	48,8	47,8

Inflation pressures remain subdued; gradual acceleration expected next year

Against a background of weak domestic and external demand and tightened financing conditions inflation pressures are likely to remain subdued in the remainder of the year, with CPI expected to significantly undershoot the CBRT's year-end 7.5% target. (CPI hit a 40-year low of 5.08%yoy in October - see Figure 1), Looking further ahead, we forecast a sharp spike in domestic inflation in Q1 2010 to levels around 7.0%yoy as a result of adverse base effects. A slight slowdown is expected thereafter with domestic CPI likely to come in at around 6.5% yoy at the end of 2010, in line with the CBRT's target. In a sharp contrast to our view, the CBRT said in its latest inflation report that it continues to expect the downward path in inflation to be maintained over the next three years, with domestic CPI seen easing from 5.5%yoy at the end of 2009 to 4.8%yoy at the end of Q3 2012. In support of our view for higher CPI over the coming months, we believe that the revival in domestic economic activity, increased capital inflows from abroad, the lagged impact of past aggressive monetary policy easing and an expansionary fiscal stance (though to a lesser degree compared to this year) in the period ahead will most probably stir inflation pressures anew. Furthermore, a potentially sustainable uptrend in commodity prices (*note that Turkey is a major oil importer*) is likely to instigate cost-push pressures, although their impact may be partly mitigated by a stronger lira.

Figure 1
Inflation remains well below the CBRT's 7.5% year-end target



Source: Turkish National Authorities

November rate cut likely to prove the last of CBRT´s current easing cycle

We believe that the 25bps cut in the key policy rate in November is likely to prove the last one of the recent easing cycle. It marks a slowdown in the pace of easing after six consecutive 50bps-sized rate moves delivered since May, with the key policy rate currently at a record low of 6.50% and its difference from the annual CPI rate having slid by 4ppts since September 2008 to around 1.0ppts, currently. In another sign that the CBRT is likely to hold its horses in the near future, the November policy statement, in a stark contrast with the recent past, contained no explicit reference to the possibility of future rate easing. Nonetheless, we expect the easing bias to remain in place over the next few months, with the CBRT holding policy rates at current levels as it tries to assess the impact of past monetary easing on the domestic economy. We see room for some 100bps of rate hikes by the end of 2010. In contrast to our forecast, the front end of the swap curve currently prices in ca 50bps of rate hikes after February with the overnight borrowing rate seen reaching around 8.00% towards the end of 2010.

Rising evidence of a gradual slowdown in the pace of economic contraction

Following declines of 6.5%yoy in Q4 2008 and 14.3%yoy in Q1 2009, the pace of GDP contraction eased to 7.0%yoy in the second quarter of the year. In Q2, private consumption marked an improvement, with the corresponding annual rate of contraction easing to 1.2% from 10.2% in the prior quarter assisted by the government's temporary stimulus measures. Meanwhile, net exports continued to exert a positive contribution to overall economic growth, albeit as a result of imports declining faster than exports. Moreover, a number of recent readings in survey data and higher-frequency leading indicators signal further recovery ahead. Industry and consumer confidence indicators now stand well above lows touched late last year, while the latest PMI data showed that the manufacturing sector expanded for the sixth month running in October on the back of higher export orders. A recent improvement in demand from abroad was also confirmed by Turkish Exporters Assembly (TIM) data which revealed an annual increase in exports in October for the first month this year. Also, vehicle production rose by 4%yoy October, bringing the year-to-October decline in production to 34%yoy, from 36% in the first nine months of 2009. Overall industrial production recorded in August its smallest annual decline (*-6.3%yoy)* this year, while September's -8.6%yoy reading may be partially attributed to seasonal effects. Furthermore, a 9.6%yoy fall in tourism revenues in Q2 was followed by a smaller, 4.6%yoy, drop in Q3 (*tourism revenues accounted for ca 3%-of-GDP in 2008*). Along these lines, we expect a milder contraction in domestic economic activity in Q3 and a full-year real GDP reading of -5.5%yoy, nearly in line with the government's latest forecast.

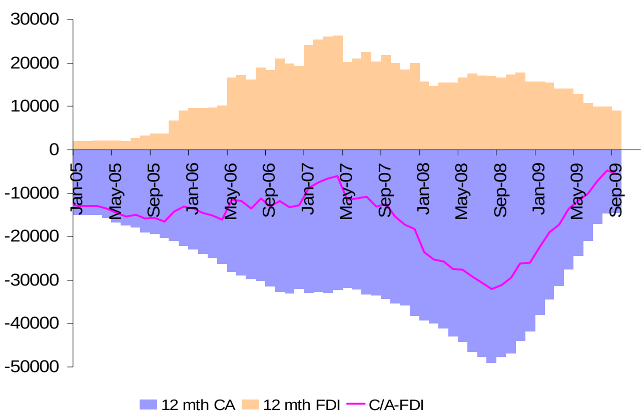
A return to positive GDP growth is expected in 2010, but recovery likely to prove a slow one

Looking further ahead, an industrial sector oriented towards higher-value added exports and an expected rise in tourism revenues are likely to support a rebound in domestic economic activity in the months and quarters ahead. Note that in 2008 Turkey ranked as the 6th largest car producer in Europe and the 15th worldwide, having also become in recent years a significant exporter of white-goods. Domestic interest rates are likely to remain at exceptionally low levels for most of next year and the full impact of 1025bps of cumulative rate easing delivered over the last 12 months may not have yet been seen. A well-capitalized domestic banking system is also likely to provide support while, a sharp run-down in inventories experienced in the period Q4 2008-Q2 2009 suggests that a cyclical rebound in economic activity is not far off. Yet, tight credit conditions and high unemployment (*13.4% in Q3 vs.an all-time peak of 16.10% earlier this year*) continue to weigh on domestic demand. Although considerable uncertainties over the extent and sustainability of the expected economic recovery still linger, a rebound in GDP growth to around 3.0%yoy (Eurobank EFG Research forecast) seems likely in 2010, with risks to our forecast being skewed to the upside should an IMF deal be sealed.

The silver lining of the global financial crisis is a smaller current account deficit

Weakening domestic demand has led to a sharp contraction in the growth of imports, which has so far significantly outpaced that of exports, resulting to a dramatic improvement in the current account shortfall. The 12-month rolling deficit shrunk by nearly 70%yoy through to September amounting to USD 14.6bn. Net FDI fell by 46%yoy over the same period to USD 9003m, but its current account coverage improved to ca 62% from 34.8% (Figure 2). Against a background of weak domestic demand, the current account shortfall is likely to retreat further in the coming months with the full-year deficit expected to narrow by 70%yoy, reaching levels around 2%-of-GDP vs. 5.7% in 2008. Net FDI is likely to finance most of the gap, anticipated to total around USD 12.5bn this year.

Figure 2
Sharp improvement in the current account balance



Source: Turkish National Authorities

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Focus-Turkey

An assessment of recent fiscal developments and the 2010 Draft Budget

A structural deterioration in Turkey's fiscal position since 2007

A significant deterioration in Turkey´s fiscal performance has occurred over the last three years. The primary surplus, which had amounted to around 5% of GDP through 2003-2006, dropped to 3% in 2007 and to 1.7% in 2008. Correspondingly, the budget deficit expanded to 1.8% in 2008, from 0.6% in 2006. This deterioration has been mostly structural. The most striking worsening has been observed in health expenditures and allocations to municipalities, as well as personnel expenditures, with average salary increases mostly exceeding nominal growth over the last two years.

Global crisis exacerbated fiscal imbalances

On top of this structural deterioration, the global crisis wreaked havoc on the budget. First, tax collections dwindled due to the contraction in economic activity. Second, in order to buttress economic activity, the government provided some tax incentives, which caused further deterioration on the revenue side. Finally, the government refrained from cutting back on expenditures, due to fears that doing so could result in further problems in the economy through choking off aggregate demand. For 2009, we predict a budget deficit of around 6.5-7% of the GDP, which will raise the (EU defined) debt-to-GDP ratio towards 48%, from 40% in 2008.

The 2010 Draft Budget has been proffered to Parliament and is currently undergoing discussions at the Parliamentary Planning & Budget Committee. The Draft Budget, which is fully compatible with the Medium Term Economic Programme (MTEP) unveiled two months ago, is not expected to be subject to any major revisions.

Highlights and Inferences from the 2010 Draft Budget

Although the government acknowledges the necessity to improve the fiscal position, the details of the 2010 Draft Budget does not reveal a forceful enough stance in terms of fiscal adjustment The new budget targets to narrow the budget deficit by about 1.7ppts to 4.9% of GDP (or TRL50bn) in 2010, from 6.6% of GDP (or TRL63bn) in 2009. With regard to the drivers of the targeted adjustment we note the following:

Some 0.4ppts of the budgeted decline in the overall, deficit is expected to come from lower interest payments, while the government does not target any reduction in non-interest outlays. The details reveal that the government has made critical decisions towards slashing health expenditures by 8%yoy; but current transfers - equally comprised of pension salaries and other social transfers - are expected to rise by around 10.6%yoy or 5.3% in real terms. This planning serves two purposes: First, in a year when economic recovery will not be strong enough to bring about any significant increase in real wages and profits or reduce the unemployment rate, the government will provide more subsidies to support consumption, especially among lower income groups. This, in turn, will support an acceleration in economic activity next year, without causing any significant increase in the current account deficit, as this population segment usually does not consume imported products. Second, increased transfers to the low income segment might also help the government maintain -- or even expand -- its voter base ahead of the upcoming elections.

Besides lower interest payments, the rest of the projected fiscal adjustment comes entirely from the revenue side. The government expects to increase tax revenues to 18.8% of GDP (or TRL193.3bn) in 2010, from 17.3% of the GDP in 2009. Yet, our analysis of the potential impact of the recently introduced tax measures yields no convincing argument that these will be sufficient to secure the indicated improvement. Note that in mid-2009, the government decided to: i. hike the Special Consumption Tax (SCT) on petroleum and tobacco products ii. raise the price of valuable papers used in official transactions and iii. Increase the VAT rate in first class restaurants to 18% from 8%. The full-year impact of these measures is estimated at 0.8% of GDP, half of which will be realised in 2009. Thus, the net impact in 2010 is expected to be 0.4% of GDP.

It was also announced that BOTAS (state-owned gas importer and distributer) would be fulfilling its tax obligations, which it had failed to meet for quite some time. This is set to improve the central government budget, but will not affect the overall balance of the public sector. BOTAS is projected to make a payment corresponding to 0.2% of GDP to the central government on an annual basis. We think that another 0.3% of GDP of the targeted adjustment in the overall fiscal balance will come from the buoyancy impact, on rising imports and VAT collections that exceed tax rebates.

In our view, the details of the 2010 Budget Draft does not provide enough clarification on where the remaining part (i.e. 0.6% of the GDP) of the targeted adjustment in the overall fiscal balance will come from. Deputy PM Babacan had claimed that the government would not hike the corporate, income or value added tax rates. Analysing the budget, we deduce that no upward adjustments are planned to the Banking and Insurance Transaction Tax or the Motor Vehicles Tax. Therefore, we conclude that the government will likely hike the SCT on tobacco products and petroleum products once again.

With or Without the IMF

Although the targets of the 2010 budget seem achievable, there are question marks over the government´s resolve to take all necessary measures to ensure its successful execution, especially given the structural deterioration occurred in the last three years. Furthermore, the there is a risk that the government's priorities change next year, prompting it to postpone certain policies, so as not to antagonise its voter base on the eve of the parliamentary elections in 1H11. A stand-by arrangement with the IMF could help a great deal towards filling the credibility gap. However, the Turkish authorities have been reiterating the very same claim for almost two years now that the negotiations have been under way: "Talks are proceeding at the technical level; some headway has been reached".

The most salient aspect of the Turkish economy is the inadequacy of domestic savings. Thus, in order to foster growth, Turkey needs to attract external funding. In that sense, an inflow of US$25-35bn of IMF funds in a country whose official reserves amount to US$70bn compared to short-term foreign debt of US$48bn would, undoubtedly, be non-negligible. Such financial support, which could also be instrumental in attracting increased inflows from the private sector, would help to accelerate the growth rate of the economy via reducing the Treasury's roll-over ratio from 115% to 95%; increasing the loanable funds to the private sector; filling the external gap; and helping improve consumer and investor confidence. The prospect of such sizeable funding would also temper interest and exchange rate volatility, which, in turn, would uplift market sentiment, one of the most crucial factors impacting growth. Finally, if Turkey took certain measures towards addressing its structural problems in the meantime in line with the suggestions of the IMF, this would also support disinflation, thereby rendering low interest rates sustainable.

Conclusions and Implications for Financial Markets

In our view, the 2010 fiscal targets are not overly aggressive, but with most of the measures having already been adopted and statements by the government suggesting that further measures will be taken if needed, we are hopeful regarding their attainability. However, even if the announced targets are met, the borrowing requirement will not fall dramatically. The Treasury will need to borrow 15% more than its redemptions, which implies that public sector pressure on financial markets will increase even further, as the growth in financial markets will be limited to around 10-15%, given net deposit rates of around 7-8%. Therefore, the 2010 Budget neither provides support to economic growth nor allows for any further diminution in interest rates from current levels, especially considering the massive redemptions due for the first four months of the year.

The CBT is expected to purchase bonds from the secondary market in order to replace the securities it currently holds, as these are all set to be redeemed within 2010. The CBT carries TRL9bn worth of government bonds in its TRL100bn balance sheet. Almost two thirds of these bonds are due to mature in 1H10. Therefore, the CBT claims that it needs to purchase government bonds from the market. We think they are likely to opt for long-term FRNs and CPI-linked bonds. These purchases could somewhat alleviate the pressure on the bond market, but the expected acceleration in annual inflation from 5% towards 7.5% in the coming 3-4 months could have an adverse effect on inflation expectations and interest rates.

CENTRAL GOVERNMENT BUDGET
(% of GDP)

	2006	2007	2008	2009E	2010T
EXPENDITURES	**23,5%**	**24,1%**	**23,8%**	**28,2%**	**27,9%**
Excluding Interest	**17,4%**	**18,4%**	**18,5%**	**22,3%**	**22,4%**
Compensation of Employees	5,7%	5,9%	5,8%	6,7%	6,9%
Good and Service Purchase	2,5%	2,6%	2,5%	2,9%	2,4%
Current Transfers	6,6%	7,5%	7,4%	9,8%	9,9%
Capital Expenditures	1,6%	1,5%	1,9%	2,0%	1,8%
Capital Transfers	0,3%	0,4%	0,3%	0,4%	0,3%
Lending	0,8%	0,4%	0,5%	0,7%	0,7%
Interest Payments	**6,1%**	**5,8%**	**5,3%**	**5,9%**	**5,5%**
REVENUES	**22,9%**	**22,5%**	**22,0%**	**21,5%**	**23,0%**
Tax Revenues	18,1%	18,1%	17,7%	17,3%	18,8%
Non-tax Revenues	4,7%	4,4%	4,3%	4,3%	4,2%
Budget Balance	**-0,6%**	**-1,6%**	**-1,8%**	**-6,6%**	**-4,9%**
Primary Balance	**5,4%**	**4,1%**	**3,5%**	**-0,8%**	**0,6%**

Source: Ministry of Finance

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Ukraine

Unstable political climate threatens implementation of IMF programme

▪ **Worrying banking-sector developments with NPLs increasing by 35% year-to-September, reaching 6.8% of total loans. Lending remains dormant and deposits continue to shrink**
▪ **Unfavorable political situation ahead of January's presidential elections threatens IMF programme, increases risks to fiscal deficit financing.**

Unstable political environment ahead of January 2010 presidential election

The main political issue presently in Ukraine is the clash between opposing political agendas of candidates for the presidential elections on January 17, 2010. The incumbent President, Viktor Yushchenko, the current Prime Minister, Yuliya Tymoshenko and the Russian-speaking opposition leader, Viktor Yanukovich, are all struggling to secure the support of the electorate. This ongoing political instability has serious ramifications and threatens the disbursement of the 4th tranche ($3.8bn) under the running IMF programme.

Ukraine's President, ignoring calls by the government and the IMF for a presidential veto, signed an opposition-authored law which allows for a 20% rise in public sector wages and pensions. The law was designed with the implicit intent to cast the Prime Minister in a bad light as the government has made a commitment to the IMF to avoid increased social spending.

The first round of voting, to be held on January 17, will most likely result in a second round run-off, scheduled for February 21st. The deep domestic economic slump has severely eroded Tymoshenko's electoral support and polls now indicate a victory of Yanukovych in the second round. If this scenario materializes, we expect the public finances situation to take a turn for the worse, as Mr. Yanukovych has explicitly indicated that he has no intention to continue cooperating with the IMF. All in all, it is highly likely that whoever the new president may be, he or she will call early parliamentary elections in order to break the current deadlock and ensure political coordination to tackle the economic crisis.

Increasing risks to fiscal deficit financing

According to the IMF, the Ukrainian economy has made progress through easing inflation and an improving current account, but the sharp growth contraction requires significant policy adjustments. These favorable trends have actually been the result of the severe domestic recession and thus, may not prove sustainable. The submission of an expansionary 2010 budget and the new social standards law seriously undermine fiscal-policy credibility and, as a result, hinder a return to sustainable economic recovery. More precisely, the government has submitted a draft 2010 budget which targets a deficit of 8% of GDP compared to a deficit of 3% of GDP agreed with the IMF in July. In addition, the outgoing President signed a law allowing a 20% rise in public sector wages and pension payments instead of a 10% increase, which would be in line with expected inflation in 2010 (as was the government's earlier commitment to the IMF). The cost of this law is estimated at as much as 2.5% of GDP – an alarming addition to Ukraine's sore budget deficit. Following these developments, the IMF confirmed that it is unlikely to make any further disbursements under the present SBA until after Presidential election.

In response to recent events, Ukraine´s 5-year CDS spread widened sharply hitting 1445bps on November 26, compared to levels around 1170bps a month earlier and 1090bps at the end of August. Yet, Ukraine's healthy stock of foreign currency reserves ($28.7bn at the end of October) is presently more than adequate to cover its immediate import and financing needs (the Naftogaz operational deficit included). Thus, an imminent default is unlikely. Although the current level of debt remains

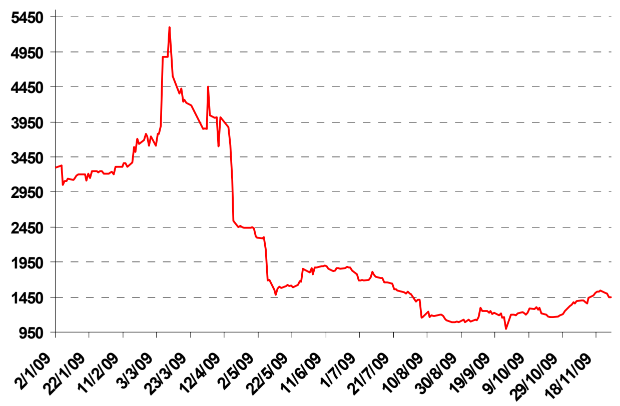
Ukraine: Eurobank EFG Forecasts

	2007	2008	2009f	2010f
Real GDP (% yoy)	7.9	2.1	-15.0	1.0
Private Consumption	17.2	11.8	-11.5	1.5
Government Consumption	2.5	0.4	-1.5	0.5
Gross Capital Formation	23.9	1.6	-48.0	2.0
Exports	3.3	5.2	-16.0	2.0
Imports	21.5	17.1	-35.0	0.5
Inflation (% yoy)				
CPI (annual average)	12.8	25.3	16.5	13.0
CPI (end of period)	16.6	22.3	13.0	11.0
Fiscal Accounts (% GDP)				
General Government Balance	-2.0	-3.2	-7.0	-4.0
Gross Public Debt	12.9	19.9	30.0	35.0
Labor Statistics (%)				
Unemployment Rate *(% of labor force)*	2.4	2.2	2.4	1.5
Wage Growth *(real, private sector)*	12.5	6.3	-10.3	-5.5
External Accounts				
Current Account (% GDP)	-3.7	-7.0	-0.4	-1.0
Net FDI (USD bn)	7.6	9.9	4.0	5.0
FDI / Current Account (%)	143.0	77.6	300.0	300.0
FX Reserves (USD bn)	32.5	31.5	26.7	25.2
Domestic Credit	**2007**	**2008**	**Q1 09**	**Q2 09**
Total Credit (% GDP)	59.9	77.3	75.8	80
Credit to Enterprises (% GDP)	36.5	46.7	46.3	49.9
Credit to Households (% GDP)	22.5	29.5	28.2	28.5
FX Credit/Total Credit (%)	49.9	59.0	56.7	53.3
Private Sector Credit (% yoy)	74.1	72.0	49.0	37.9
Loans to Deposits	152.6	205.5	228.9	226.6
Financial Markets	**Current**	**3M**	**6M**	**12M**
Policy Rate	10.25	10.25	10.25	10.25
USD/UAH	8.10	8.30	8.60	8.80

Source: National Sources, IMF, Eurobank EFG manageable, we are concerned about the government's ability to finance its large budget deficit in the medium term. Without the IMF loan and with restricted access to international source of financing, Ukraine's fiscal adjustment becomes a rather difficult task. (Figure 1)

Figure 1

Recent widening in Ukraine's 5-Year CDS spread



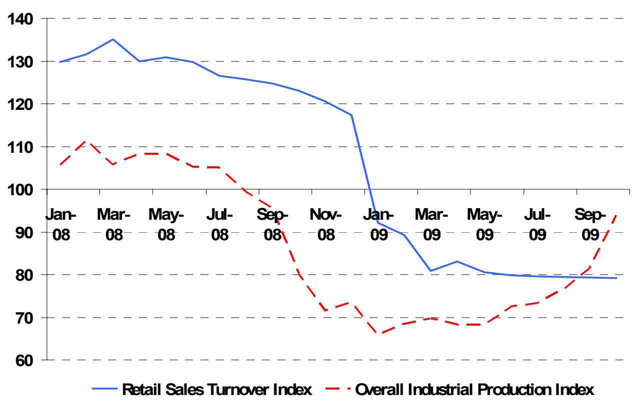
Source: Eurobank Research, Bloomberg

Vague signs of economic stabilization

Real GDP growth shrunk to 15.9% yoy in Q3-09, following a fall of 19.1% yoy in the first semester. Although the pace of contraction in industrial output eased substantially in recent months (-6.2% yoy in October compared to -18.4% yoy in Sep-09), retail sales continue to decline precipitously (-20.9% yoy in October), indicating a drain in domestic demand. Moreover, real wages stood at -11.3% yoy in September. Ukraine's economy shows vague signs of stabilization but fiscal and financial pressures leave no room for complacency. We forecast a 15% yoy contraction in real GDP growth this year. (Figure 2)

Figure 2

Industrial Production deceleration & Retail Sales drain



Source: Eurobank Research, NBU, National Statistics

Current account balance improves but capital account deteriorates

While the current account has almost balanced, net capital outflows remain a source of concern. In the first 9 months of 2009 the current account deficit amounted to $1bn, which is $8bn lower than the amount recorded in the respective period a year earlier. What's more, the external debt roll-over for banks and corporations reached $6.4bn of net outflows compared with a $13.7bn surplus in the first 9 months of 2008. Flight to foreign cash by residents drained out $7.2bn. The outflow of foreign capital reflects both external factors (global risk aversion) and country-specific ones (banking sector vulnerability, political instability, lack of confidence in the ability of the Ukrainian authorities to deal with the crisis). Foreign Direct Investment (FDI) in September was one of the largest in the current year ($835m). Yet, net FDI inflows over the first 9 months of 2009 amounted to only $3.3bn or 37% of last year's corresponding figure. FDI is expected to remain low in 2009 given the weak economic activity and the lukewarm progress of privatization. Given that before the current crisis over a third of FDI inflows went into the financial sector, the growth of financial business will be slow to recover. In the meantime, the National Bank of Ukraine (henceforth NBU) spent $1.2bn of its international reserves in an effort to buttress the currency. Since the beginning of the year the NBU has spent 9% of its reserves despite the disbursement of $5.9bn from the IMF loan. In October, official international reserves stood at $28.7bn.

Signs of abating domestic inflation pressures

The downward path in domestic inflation continued in October, assisted by sharply-curtailed domestic demand and the postponement of a number of earlier-planned increases in household gas tariffs. CPI eased to 14.1% yoy in October from 15% yoy in the prior month and 22.3% yoy in January. We expect inflation pressures to abate further in 2010, although the upcoming presidential election in January poses some upside risks. In any event, we think that the current pace of disinflation is slow relative to that one would expect to occur in the face of such a deep economic downturn.

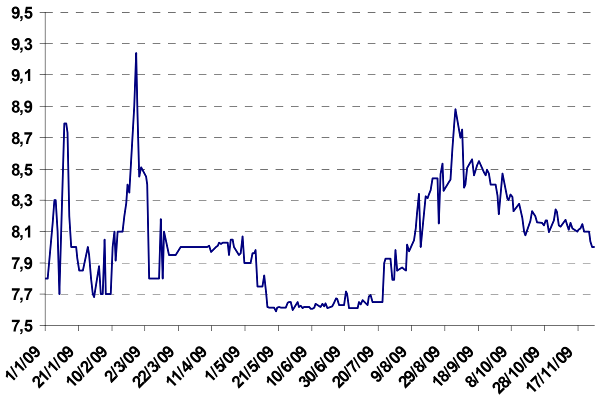
Money supply continues to decline; it fell by a further 0.4% mom in October (year-to-October decline in M2 amounting to 8.9%). This was partly attributed to capital outflows due to expectations of renewed Hryvnia weakness.

Uncertain political climate weighs on the hryvnia

Following a 100bps cut in June, the NBU further reduced the key policy rate by 75bps to 10.25% in mid-August.

Meanwhile, the Hryvnia has resumed its depreciating course, after remaining broadly stable in March-July. Since August the currency has lost 3.2% of its value against the US dollar. At the time of writing (November, 27th) it stood at 8.0 vs. USD One of the reasons for hryvnia´s recent depreciation is the easing in NBU FX interventions imposed by the IMF second review in July. In addition, market sentiment towards Ukraine has deteriorated recently given the uncertain political climate and the illiquid FX market. (Figure 3)

Figure 3
USD/UAH Spot Rates



Source: Eurobank Research, Reuters

A worrying rise in non-performing loans

Ukraine's banking sector remains vulnerable, with NPLs increasing by 35% year-to-September. The NPLs to total loans ratio stood at 6.8% in September 2009 compared to 2.3% in the beginning of this year. This increasing trend of NPLs will continue to drug down lending even further. According to the NBU, total credit granted to the economy dropped by 0.2% mom in October and declined by a cumulative 1.5% in the first 10 months of 2009 (loans to households down by 11.2% year-to-October). What's more, total deposits kept shrinking, albeit at a decelerating pace (-0.3% mom in October). Deposits plummeted by 11.4% year-to-October. To make matter worse, concerns about the stability of the banking system may lead to further deposit withdrawals.

The NBU recapitalization programme (initiated last July) continued with the implementation of the resolution strategies for two additional indebted banks, Nadra and Ukrprombank. Ukraine's government has so far nationalized five out of seven banks earmarked for state aid. It has issued bonds to the first three banks totaling UAH 9.4bn and has decided to liquidate the remaining two. The progress of the recapitalization program has been slow as banks are trying to restructure their external obligations first. The remaining banks destined for recapitalization are Oschadbank, a savings bank and Ukreximbank, a specialized export-import bank. In addition, the EBRD, World Bank and IFC have decided to use $2bn of funds to purchase minority shares in Ukrainian banks over the coming 12 months.

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