Eurobank Research

Eurobank EFG

New Europe Economics & Strategy

www.eurobank.gr/research

Issue 2 | February 2010

EFG Eurobank Research Team

Gikas A. Hardouvelis
Chief Economist &
Director of Research

Platon Monokroussos
Assistant General Manager
Head of Financial Markets Research

Tassos Anastasatos
Macro Strategist

Ioannis Gkionis
Research Economist
Coordinator of Macro Research

Stella Kanellopoulou
Research Economist

Galatia Phoka
Emerging Markets Analyst

Special Contributors to this issue

Christos Pnevmatikatos
Head of Trading Strategy & Support Desk
Global Markets, EFG Eurobank S.A.

Baturalp Candemir
Chief Economist
EFG Istanbul Securities

Many thanks to Mr Theodoros Rapanos for his excellent research support

Additional Eurobank EFG Research publications available at www.eurobank.gr/research

On a correction mode after strong bounce from March 2009 lows

Bulgaria: Disciplined fiscal policy improves ERM II entry outlook

Poland: Polish economy to expand further in 2010; yet, fiscal concerns remain

Romania: End of domestic political deadlock allows the new government to tap international markets with a new Eurobond issue *(expected some time in Q1 2010, according to government officials).* International organizations resume lending program

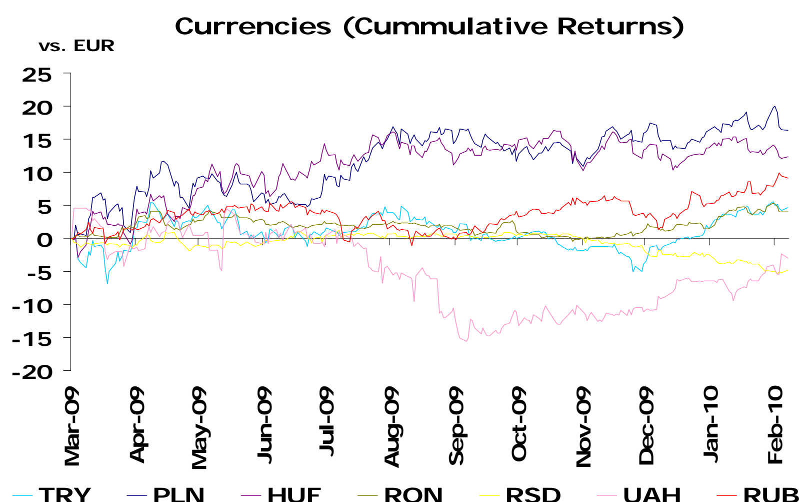
Serbia: Unblocking of EU interim trade agreement to bring immediate benefits to Serbian exporters. Central Bank signals more interest rate cuts are on the cards despite depreciation pressures on the Dinar

Turkey: Return to positive GDP growth expected in 2010. Improving external imbalance, successful placement of first 10-year benchmark bond help to ease financing concerns

Ukraine: Persisting political uncertainty weighs on economic outlook

Market strategy highlights

- **FX:** We closed our long positions in PLN and TRY given increasing risks of unwinding of the USD carry-trade and contagion from EMU sovereigns. We have also turned neutral on RON, following the recent impressive rally from the 4.30/EUR area. We presently favor being long volatility in high-beta currencies such as the South African rand and the Turkish lira
- **Local rates:** We are looking to buy inflation-linked bonds in Poland and Turkey but wait for better entry levels. Current real yields are very low and risk premia compressed due to low cost of funding from ample CB liquidity
- **Sovereign credit**: current spread levels are rather expensive with respect to present economic conditions, absolute level of rates and volatility



Source: Bloomberg, Reuters, Eurobank Research

Table of Contents

Introductory Comment.............................3

Eurobank EFG Research Forecasts...........4

I. Overview..5

II. New Europe Markets Outlook & Strategy............................8

III. Special Focus - Emerging Markets Sovereign Spreads: An Empirical Valuation Framework......................10

IV. New Europe Country Analysis

a. **Bulgaria:** ***Disciplined fiscal policy improves ERM-II entry outlook***...............12

b. **Poland:** ***Polish economy to expand further in 2009; yet, fiscal concerns remain***.. 15

c. **Romania:** ***International organizations resume lending program***........................18

d. **Serbia:** ***Interim trade agreement finally unblocked***..................21

e. **Turkey:** ***Trough of domestic recession likely reached in Q1 2009***.......24

Focus - Turkey: Strong GDP growth rebound to be mainly driven by inventories...27

f. **Ukraine:** ***Persisting political uncertainty weighs on economic outlook***.................................. 32

Introductory Comment

Dear readers,

2010 is expected to be a year of slow economic recovery in New Europe. As the severe recession experienced in most economies in the region comes to an end, New Europe emerges with fewer macro imbalances and a more solid base for future growth. Indeed, it is becoming increasingly obvious that the combination of double-digit current account deficits, high inflation and huge rates of credit expansion seen in the past is a phenomenon that is not going to be repeated in the foreseeable future. Yet, as it is always the case following severe recessionary episodes, unemployment in the region remains on a rising path, real wages are declining, non-performing loans keep going up and governments are struggling with bloated public sectors. Nevertheless, the worst of the economic downturn is clearly over. The region managed to avoid a broad-based collapse in the first half of 2009 and it is now emerging from recession at a faster pace that than previously anticipated. Reflecting on these encouraging developments, international organizations including the IMF and the OECD have already started to revise upwards their 2010 growth forecasts for the region, while rating agencies have begun changing for the better their sovereign-risk assessment.

Naturally, not every economy in the region is expected to behave identically. Each one has its own strengths, weaknesses and idiosyncratic characteristics. Turkey, for instance, appears to be differentiating itself substantially from the rest of the pack, as it is anticipated to enjoy a much stronger recovery in 2010 relative to regional peers. Having already gone through a major financial-sector restructuring in 2001, Turkey has managed to absorb the shock emanating for the 2007-2009 world credit crisis. Its external imbalance is more or less gone and the earlier pubic-financing difficulties are now less of a concern for the markets, even in the absence of an IMF support package. Poland also withstood the negative global shock quite resiliently, being the only EU-27 economy to record positive GDP growth in 2009. Bulgaria, whose real exchange rate appreciation and currency board are under continuous scrutiny since last spring, did manage to contain its fiscal deficit in 2009, hence enhancing its prospects of entering ERM II with the current exchange rate arrangement. Serbia, whose banking system was well capitalized long before the arrival of the international crisis, can now follow a more expansionary monetary policy, yet always constrained by the movement of domestic inflation and the possibility of Dinar depreciation. Romania, which has long suffered from a domestic political stalemate, now has a stable government that appears able to constrain fiscal expansion and credibly re-tap the international markets. Ukraine, a country that went through a very harsh recession in 2009, faces lessened political uncertainty following the recent presidential elections, which heralds a more stable domestic policy-making environment in the period ahead.

Most central banks in New Europe appear to be getting close to the bottom of their easing cycles. Some are now widely expected to resume interest rate tightening as early as H2 2010, *e.g. Turkey and Poland*. Others appear to have some additional room for easing, *e.g. Romania and Serbia*. In any case, the prospect of lower policy rates appears increasingly as a theme of the past. Thus, in an environment of rising policy-tightening expectations and improved prospects for growth and FDI inflows, it is also natural to expect FX to broadly outperform other major asset classes in the region, *e.g.* local rates and credit. This is especially true, as the latter currently appear to offer rather limited value following the strong market rallies since March 2009.

A major challenge for most governments in 2009 is the control of their fiscal deficits. In the previous recessionary environment, fiscal deficits naturally increased. Now is the time to reign on them, without, however, endangering the prospects of recovery. We are optimistic that the right balance of fiscal tightening and economic stimulus will be found.

Prof. 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	-4.9	-1.1	12.0	2.5	1.6	-25.4	-9.5	-6.5
Poland	5.0	1.7	2.4	4.2	3.5	2.5	-5.1	-2.0	-3.0
Romania	7.1	-7.0	1.0	7.9	5.6	3.6	-12.4	-4.5	-5.5
Serbia	5.5	-2.9	1.5	11.7	8.2	7.0	-17.3	-6.0	-8.5
Turkey	0.9	-5.5	5.0	10.4	6.3	7.5	-5.7	-2.0	-3.0
Ukraine	2.1	-14.0	1.5	25.3	16.0	13.0	-7.0	-1.7	-1.8
New Europe	3.2	-4.7	2.9	6.5	6.7	6.2	-7.8	-2.8	-3.5
Euroarea	0.6	-4.0	0.9	3.3	0.3	1.0	-1.1	-0.9	-0.7
USA	0.4	-2.4	2.6	3.8	-0.4	1.5	-4.9	-2.7	-2.9

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

Foreign exchange and policy interest rates
Realizations and forecasts

		FX Rates			Interest Rates		
eop		2008	2009	2010f	2008	2009	2010f
Bulgaria	**vs EUR**	1.96	*Currency Board*		*Currency Board*		
Poland	**vs EUR**	4.15	4.10	3.80	5.00	3.50	4.00
Romania	**vs EUR**	4.03	4.23	4.00	10.25	8.00	6.00
Serbia	**vs EUR**	84.79	96.23	100.00	17.75	10.00	8.50
Turkey	**vs USD**	1.54	1.50	1.50	15.00	6.50	8.00
Ukraine	**vs USD**	8.05	8.05	8.70	12.00	10.25	10.25
Euroarea	**vs USD**	1.40	1.43	1.34	2.50	1.00	1.50
USA	**vs EUR**	0.72	0.70	0.75	0.125	0.125	0.75

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

I. Overview

Sentiment takes a turn for the worse on china worries…

After a bullish start to the year, market sentiment took a turn for the worse over the last few weeks. Global equity markets moved lower and major government bond markets benefited from flight-to-quality flows. A catalyst behind the more recent worsening in investor sentiment was market fears over the removal of monetary policy accommodation in China. The PBoC took markets by surprise in January with its decision to raise its Reserve Ratio Requirement (RRR) by 50bps. Chinese bank lending surged in the first two weeks of January with new loans amounting to about CNY 1.1trn or nearly 15% of the government's CNY 7.5trn loan target for the whole year. Ample liquidity and rising inflation pressures in the world's third largest economy suggest potential for more aggressive policy tightening in the period ahead.

…and EMU sovereign credit jitters

Heightened sovereign credit concerns in a number of euro area periphery markets including Greece, Portugal, Spain and Ireland were also behind the recent deterioration in market sentiment. In its latest European Sovereign Outlook report published last month, Moody's warned that both Portugal and Greece could face "a slow death" if they do not take rapid action to address their fiscal problems. The three major rating agencies cut Greece's long-term sovereign credit rating by one notch in December, citing the country's deteriorated fiscal position. Separately, Fitch Ratings warned recently that a downgrade for Portugal's rating is "more likely than not" after its 2009 budget deficit was revised sharply higher. Last but not least, market uncertainty regarding the implementation of US President Obama's proposed tougher restrictions on banks added to recent jitters for riskier markets.

World economies already started to emerge from recession…

On the macro front, major economies have already started to emerge from recession, with most of them recoding positive GDP growth readings in the second half of 2009. The recovery has so far been supported by quantitative easing by major central banks and a massive amount of policy stimulus provided by authorities around the world to support economic activity and enhance investor sentiment. But, as a number of major central banks are already preparing their exit strategies from ultra-stimulatory policies, new worries over the pace and the sustainability of the global economic recovery have started to emerge. This is especially true as the positive effect from inventory restocking on world growth will fade away during the course of the year and the full impact of the global crisis on the labour market is yet to be seen.

…but, concerns over sustainability of recovery linger

Against this background, Mr. Bernanke's confirmation for a second term as chairman of the Fed and upbeat Q4 earnings results from the U.S. failed to exert any material impact on riskier asset markets. Indicatively, the S&P 500 index is now down nearly 7.6% from its 15-month highs touched in mid-January, while the FTSE Eurofirst 300 index has lost ca 8% from a 1½-year peak near 1,065 reached three weeks earlier. In the European credit derivates market, the iTraxx Crossover index recorded a fresh post-Lehman Brothers low of 383bps in early January, before visiting levels around 460bps mid last week, while the iTraxx Europe index has bounced above 80bps after hitting a two-year low around 65bps a month earlier. Not surprisingly, in this environment demand for safe-haven assets increased, with core government bond markets being the main beneficiaries (Table A).

Table A

Key metrics of investor attitude towards risk on a weakening mode after bouncing strongly from March 2009 lows

Systemic Risk indications	Pre-Lehman	31-Dec-09	8-Feb-10
USD 3m Libor-OIS spread	87	9	10
EUR 3m Libor-EONIA spread	64	27	24
S&P volatility index (VIX)	26	22	26
DJ volatility index (Vstoxx)	27	24	31
USD gamma index	128	106	122
EUR gamma index	81	86	88

Asset prices	Pre-Lehman	31-Dec-09	8-Feb-10
S&P Index	1252	1115	1066
S&P Financials Index	283	194	188
DJ €Stoxx	3278	2965	2645
MSCI benchmark emerging market	855	989	898
ITRAXX Europe	103	74	92
ITRAXX XOVER	546	432	496
Raw industrials index	463	483	466
Baltic dry index	4800	3005	2715
EMBI+ emerging Europe	289	210	257

Source: Bloomberg, Reuters

Emerging markets on a corrective phase following strong recovery from March 2009 lows

Naturally, emerging markets did not escape unscathed the latest market jitters over sovereign credit risk in the so-called euro area periphery and the sustainability of the global economic recovery. And, although most regional stock indices touched multi-year highs in mid-January, over the last couple of weeks they have embarked on a corrective phase, trailing major bourses in the US, Asia and Europe (Figure 1). The MSCI benchmark index of emerging equities has posted its worst monthly performance in nearly a year in January, before touching a 3-month trough late last week. Nevertheless, the index remains around 110% higher from its October 2008 lows and continues to outperform a 23%

rally in its developed markets counterpart over the same period.

CBs in New Europe already reached, or are approaching, the bottom of their easing cycles

Following months of aggressive monetary easing by the majority of central banks in New Europe, there seems to be limited room for further rate cuts, especially as the economic recovery appears to be increasingly gaining traction. In fact, several central banks in the region (*e.g., in Poland and Turkey)* are already braced for incepting new monetary tightening cycles, most likely in H2 2010. Others, including the central banks of Romania and Hungary, have already touched (or are close to) the bottom of their easing cycles.

Local rate markets on a weakening mode, driven by monetary-tightening expectations, EMU sovereign credit jitters

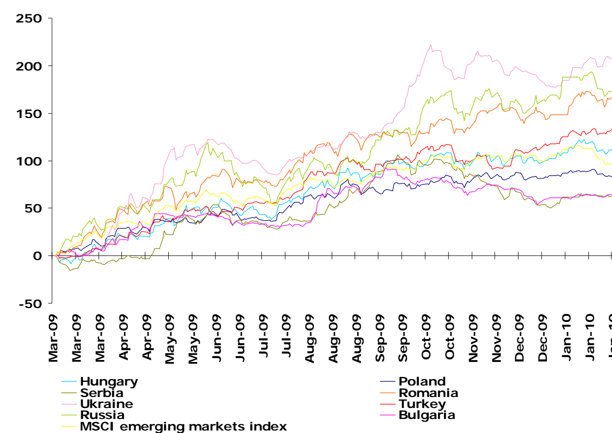
Along these lines, regional government bond yields have lately moved slightly higher from multi-year lows touched in late 2009. In Turkey, the yield of the November 16, 2011 benchmark bond bounced above 9.00% in late January, from levels around 8.50% earlier that month, amid rising expectations that the CBRT will embark on a monetary tightening cycle as early as in H2 2010. In Hungary, where the central bank appears to be getting close to the bottom of its monetary easing cycle, the 3-year benchmark government yield stood at ca 7.20% in early February, compared to a 1-year low around 7.00% touched in late October. On the other hand, in Romania, where the central bank appears poised to remain on a monetary easing mode in the months ahead, the 3- and 10-year benchmark bond yields slid in early February to levels below 8.00% and 9.00%, respectively, after peaking at ca 18.5% in early 2009.

Most currencies in the region register small year-to-date gains

Most regional currencies in New Europe, which lagged the rally in other EM asset classes in 2009, have registered small gains year-to-date (Figure 2). In early February, the Romanian leu posed among the outperformers, striking 1-year highs against the euro on waning political risk and the resumption of the IMF stand-by loan arrangement. The zloty also spiked to 13-moths highs against the common currency after Poland was confirmed to be the only EU-27 economy to have avoided recession in 2009. On the flipside, the Serbian dinar has shed more than 8% against the euro since September, amid growing fiscal concerns and increased demand for hard currencies due to higher energy imports. Since the beginning of this year, the Serbian central bank has repeatedly intervened in the interbank market to support the RSD, having so far sold more than EUR 300m. External debt markets have broadly outperformed emerging market equities in recent weeks, with their year-to-date returns remaining in a marginally positive territory. Emerging external debt spreads over USTs on the EMBI+ index stood on February 4 at around 315bps, remaining well below record highs of 900bps recorded in October 2008 (Figure 3).

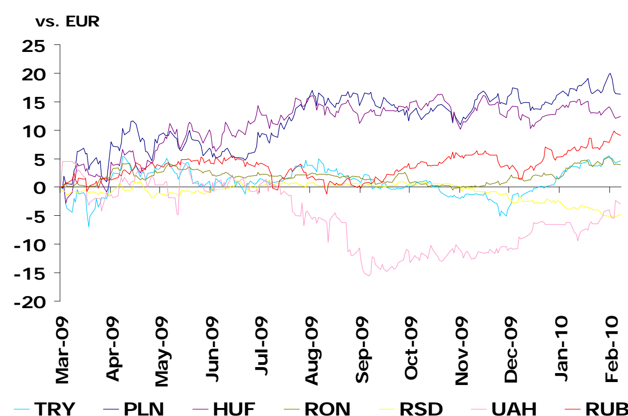
Figure 1

Stock Markets (Cumulative Returns)



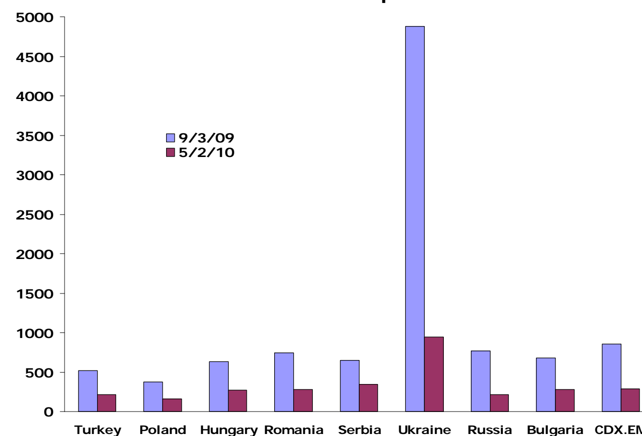
Source: Bloomberg, Reuters, Eurobank Research

Figure 2
Currencies (Cumulative Returns)



Source: Bloomberg, Reuters, Eurobank Research

Figure 3
5 YR CDS Spread



Source: Bloomberg, Reuters, Eurobank Research

Real economic developments in New Europe continue to lag recent recovery in regional financial markets

That said, recent readings in higher-frequency activity and sentiment indicators signal that the trough of recession in most economies in the region has already been reached. In fact, most of these economies are estimated to have recorded positive GDP growth in the last quarter of 2009. Looking ahead, higher inventory levels and favorable base effects are expected to provide support to annual GDP growth rates for the greater part of the year. However, economic recovery will be slow and likely to lag that in major emerging market economies in Asia and Latin America. Weakened labour markets in the region are expected to continue weighing on consumer spending; investor morale continues to be fragile and overall economic growth will likely remain below potential throughout the year. Turkey and Poland are expected to be among the frontrunners in the economic recovery trend in 2010. On the other hand, regional economies continuing to be highly exposed to private-sector FX-lending and recessionary property markets *eg.,* Romania, Bulgaria, Hungary and the Baltics remain more vulnerable and are seen trailing their peers' uptrend. On the fiscal front, public finances are expected to start improving gradually, after deteriorating significantly in 2009. However, budget deficits in most CEE countries appear likely to remain well above the EU's 3%-of-GDP threshold over the next couple of years, against a background of still weak domestic demand dynamics.

Sovereign credit outlook improves for a number of CEE countries...

Following months of successive rating downgrades, it has lately become evident that sovereign credit ratings in Central and Eastern Europe (CEE) are improving. A number of rating agencies have already praised a number of countries for their prudent policies aiming to navigate their economies through the global financial crisis. Russia, Kazakhstan, Serbia, Lithuania, Romania and Bulgaria all saw their outlooks being raised from negative to positive over the last couple of months. The most notable change was a 2-notch upgrade by Fitch on Turkey on December 3 which preceded a 1-notch upgrade by Moody's.

...but pockets of political instability continue to weigh

Back in December, political unrest risked IMF funding in Romania and Ukraine. In both cases the IMF decided to freeze upcoming reviews and disbursements of funds until the political landscape becomes more transparent and the governments show renewed commitment to conditions under the respective loan agreements. In Romania, the re-election of the incumbent President and the formation of a new government facilitated parliamentary endorsement of key IMF-sought conditionalities, effectively leading to the resumption of the loan deal. The 3rd and 4th tranches of the funds now expected to be disbursed in mid-February. In Ukraine a final outcome of the Presidential elections is still pending with a run-off scheduled for February 7. In Turkey, negotiations over a Stand-By Arrangement with the IMF continue.

A heavy election calendar in New Europe this year

With a heavy election calendar lurking in New Europe this year, pockets of political instability continue to represent a lingering risk to the outlook. Ukraine (February 7), Hungary (June) and Poland (October) are braced for Presidential elections in the imminent future. Latvia (October), the Czech Republic (June) and Hungary (June) are scheduled to have general elections in the coming months. Presidential elections in the Northern part of Cyprus in April, though not directly related to the region, may bear a significant impact in the island's unification progress as well as on Turkey's EU bid. The Latvian issue – albeit having taken the back seat lately – is another source of concern; primarily for countries with fixed exchange rate regimes, like Bulgaria and the rest of the Baltics. Romania and Hungary are on the risk-of-contagion front line.

Written by:

Platon Monokroussos
Assistant General Manager
Head of Financial Markets Research
pmonokrousos@eurobank.gr

Galatia Phoka
Emerging Markets Analyst
gphoka@eurobank.gr

II. New Europe Markets Outlook & Strategy

We broadly adopt a more cautious stance towards risk relative to our previous New Europe Economics & Strategy (Dec 2009), amid rising headwinds to the global recovery stemming from:

Tightening liquidity conditions and the prospective removal of blanket stimulus

Refinancing risk and re-pricing of EMU sovereign credit

Signs of a tighter regulatory environment in the global financial sector

We currently stay neutral on riskier markets, running low or no risk at all, as the prospect of further policy-tightening by the Chinese authorities will likely continue to take its toll on emerging equity, rate and credit markets as well as commodities and commodity-based currencies.

There currently appears to be a large number of investors who are overweight Chinese and, more generally, emerging market equities, credit and commodity-based currencies. Position squaring and unwinding of crowded positions might trigger further stop-loss activity. Additionally, an appreciating US dollar, rising volatility and deteriorated technicals may see further market weakness in coming weeks.

In the credit space, we feel that widening risks in EMU periphery amid concerns over refinancing and sustainability of public finances pose a significant risk for credit markets in New Europe. Contagion effects can be triggered through the re-pricing of credit for sovereigns and overcrowded positioning. Domestic banking-sector developments may also prove sensitive to European parent banks coming under pressure.

Last but not least, regulatory developments pose an additional challenge to financial-sector profitability in the coming year and may asymmetrically skew the risk/reward profile of holding positions to the downside.

Foreign Exchange Outlook & Strategy

Regional currencies in New Europe have performed remarkably well since out latest update (Dec 2009). With increasing risks of unwinding of the USD carry-trade and contagion from EMU sovereigns, we have closed our long positions in PLN vs EUR (entered at 4.20; now at 4.00), TRY vs EUR (entered at 2.21; now at 2.0750) and TRY vs USD (entered at 1.49; now at 1.50). We also turned neutral on RON at 4.12 after the impressive rally from the 4.30 area where we suggested that volatility-adjusted carry was favoring the Romanian currency.

Table 1: EM FX Performance

	Feb-10	Mar-09	Jul-08	%Change Mar-09 to Today	%Change Jul-08 to Today
USDPLN	2.972	3.732	2.128	-20.38%	39.64%
USDRON	3.02	3.39	2.31	-11.10%	30.73%
USDTRY	1.53	1.79	1.24	-14.82%	22.56%
USDRSD	72.11	75.12	49.98	-4.01%	44.28%
USDUAH	8.04	7.85	4.51	2.39%	78.12%
USDBRL	1.877	2.376	1.598	-20.99%	17.45%
USDMXN	13.17	15.19	10.37	-13.35%	26.98%
USDZAR	7.69	10.48	7.89	-26.59%	-2.46%
USDINR	46.25	51.71	43.33	-10.55%	6.75%
USDIDR	9326	12023	9220	-22.43%	1.15%
USDPHP	46.170	48.505	45.010	-4.81%	2.58%

Spot Rates as of 6/3/09 (Mar-09), 1/7/08 (Jul-08) and 04/02/2010

Source: Bloomberg, Reuters, Eurobank Research

We presently favor being long volatility in high-beta currencies such as the South African rand and the Turkish lira. Especially, in Turkey we think that the market is increasingly worried about repeated delays over a new IMF deal. It thus makes sense to be long some tail risk via buying out of the money calls in USDTRY. We recommend buying a 25 delta 3 month USD call TRY put strike 1.60 for 1.10%.

Sovereign Credit Strategy

We believe that current spread levels are expensive with respect to present economic conditions, absolute level of rates and volatility. We would rather take profit on our bullish recommendations to i. buy Ukraine March 11s bonds at 17% yield (now at 9.3%) and ii. sell 1 year CDS in Ukraine at 2000 basis points (now at 1200 bps) We maintain to our recommendation to enter a 5s vs. 10s CDS steepener in Romania as we feel that this trade can perform further after having steepened by 10 basis points during the last month. We think that current credit spread differentials between EMU periphery and New Europe markets are due for correction. Yet, our generally positive stance towards the region makes us not going underweight credit in New Europe, but rather staying neutral for the time being.

Table 2: Five Year Sovereign Credit Default Swaps (bps)

	Feb-10	Mar-09	Jul-08	%Change Mar-09 to Today	%Change Jul-08 to Today	% Recovered
BULGARIA	254	683	160	-63%	59%	**82%**
POLAND	150	376	51	-60%	193%	**70%**
ROMANIA	269	754	197	-64%	37%	**87%**
TURKEY	207	522	190	-60%	9%	**95%**
UKRAINE	898	4875	387	-82%	132%	**89%**
BRAZIL	147	425	121	-65%	21%	**91%**
RUSSIA	201	765	110	-74%	83%	**86%**
CHINA	86	245	74	-65%	17%	**93%**
JP EMBI+	316	695	299	-55%	6%	**96%**
BB HY CORP	488	1023	479	-52%	2%	**98%**
EMU Periphery	173	198	40	-13%	333%	**16%**

CDS Spreads as of 6/3/09 (Mar-09), 1/7/08 (Jul-08) and 04/02/2010

%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

Local Rates Strategy

We still favor receiving the 1 year 1 year forward in PLN at 5.57% with a target of 5.14% and stop above 5.75% (now 5.47%).
We expect inflation to pick-up in the region in the next months. We are looking to buy inflation-linked bonds in Poland and Turkey but wait for better entry levels because current real yields are very low and risk premia compressed due to low cost of funding from ample CB liquidity. As extraordinary measures are withdrawn we expect to see better levels to buy into the weakness.

Written by:

Christos Pnevmatikatos
Head of Trading Strategy & Support Desk
Global Markets, EFG Eurobank S.A.
cpnevmatikatos@eurobank.gr

III. Special Focus
Emerging Markets Sovereign Spreads: An Empirical Valuation Framework

In this section we update the sovereign spreads model we first presented in the December 2009 issue of our *New Europe Economics & Strategy* bulletin. Our valuation framework utilizes a balanced panel of 21 emerging market economies and investigates the determinants of country risk premia[1]. A sovereign spread is supposed to compensate a potential investor for the risk of sovereign default. 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. Particularly, its ability and willingness to make full and timely payments of interest and principal obligations to international creditors. Besides perceived default risk, other fundamental and technical factors can influence sovereign bond spreads, including interest rate and currency risk, global liquidity conditions and changes in the investor base for a particular country's bonds.

Recent studies find a close link between county-specific fundamentals and variations in respective credit risk premia. It is empirically documented, for instance, that fiscal and political factors can 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. Other macroeconomic variables that can influence the evolution of sovereign spreads include domestic inflation, net foreign assets, the real exchange rate, the terms-of-trade index and market sovereign debt costs. Sovereign credit ratings themselves have found to be influenced by macroeconomic fundamentals. 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.

Data, model specification and empirical results

In our empirical study we utilize sovereign 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:

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

$i = 1,.....,21$ and $t=2002,..., 2008$

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, we use the following explanatory (fundamental) variables:

a. Inflation

Generally speaking, and in line with some 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

The list of our explanatory variables includes 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

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

[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.

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

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.

Rich-cheap valuation framework for market sovereign 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 two-steps-ahead *(i.e., 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 shows these "fair value" estimates along with the market level of these spreads on January 28, 2010.

TABLE B

	Sovereign spread levels on Jan 28, 2010 (in bps)	Model-based "fair value" estimates (in bps)	Deviation from "fair value" (in bps) Wide (+) / Tight (-)
Lebanon	272	438	-166
Russia	226	303	-77
Turkey	237	289	-52
Uruguay	261	311	-50
Peru	202	241	-39
Malaysia	145	173	-28
Philipines	249	277	-28
Chile	120	145	-25
Colombia	233	247	-14
Brazil	226	213	13
Mexico	214	197	17
Poland	160	139	21
S. Africa	191	159	32
Bulgaria	211	159	52
Ecuador	801	712	89
Hungary	202	87	115
Venezuela	978	848	130
Ukraine	773	441	333

Source: Eurobank EFG Research, Bloomberg

As it is illustrated in table above, our fundamentals-based valuation framework suggests that Ukraine, Venezuela, 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.

Written by:

Platon Monokroussos
Assistant General Manager
Head of Financial Markets Research
pmonokrousos@eurobank.gr

[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.

IV. New Europe – Country Analysis

Bulgaria

Disciplined fiscal policy improves ERM-II entry outlook

- **Fiscal discipline helped contain the 2009 (cash) budget deficit to 0.8% of GDP, the lowest in EU-27**
- **The Bulgarian government aims to apply for ERM-II entry in 2010**
- **GDP growth in 2009 is now estimated to have contracted by less than expected earlier; domestic economic downturn not over yet.**

Domestic economy likely contracted in 2009 by less than previously expected; economic downturn not over yet

The domestic economy remains in contractionary territory, though revised GDP data for Q3 were slightly better than initially thought (-5.4% yoy vs. -5.9% yoy reported in the flash report). Yet, this was not sufficient to alter the gloomy picture of a deepening economic downturn, with the pace of output decline in the third quarter of the year being the steepest since the economic crisis of 1997. The breakdown of the latest GDP report showed private consumption in Q3 declined less than estimated initially (-4.7% vs. -10.2%), while investments were down by 36.5% yoy (vs. 22.9% reported in the flash report). The pace of contraction in exports was also milder (6.7% yoy against 13.2%) and imports recorded a less steep decline (-23.4% yoy vs. -28.3% yoy).

Agricultural output rose unexpectedly in Q3

From a sectoral perspective, services contracted in Q3 by -5.1% yoy (vs. -5.7% in the flash estimate) and industry by -6.0% yoy (vs. -10.0 yoy initially reported). On the other hand, agriculture had a positive contribution, despite initial estimates from the Ministry of Agriculture for a worse harvest relative to last year. Agricultural output recorded a surprise increase of 2.3% yoy in Q3, after contacting by 6.3% yoy in the prior quarter. Traditionally during that period of the year, domestic country-side households make preparations for the winter season. Arguably, the latter gave a boost to agricultural production (particularly forestry) in Q3. On top of that, agriculture output has yet to recapture fully the levels recorded before the poor crop season in the summer of 2007.

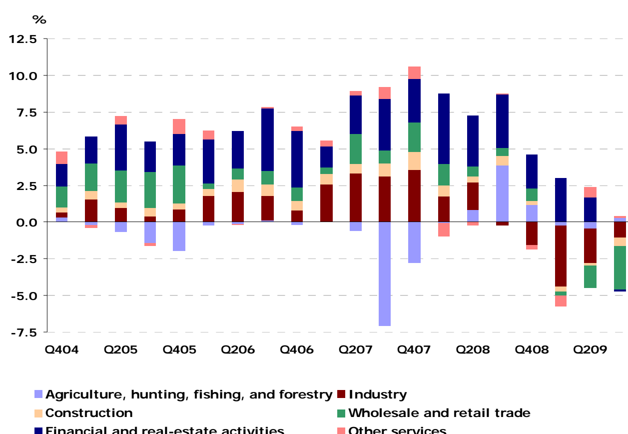
Bulgaria: Eurobank EFG Forecasts

	2007	2008	2009e	2010f
Real GDP (yoy%)	6.2	6.0	-4.9	-1.1
Private Consumption	5.3	4.8	-4.0	-2.1
Government Consumption	3.1	0.0	-0.5	-0.1
Gross Capital Formation	21.7	20.4	-25.0	-8.7
Exports	5.2	2.9	-13.5	2.3
Imports	9.9	4.9	-22.0	-2.8
Inflation (yoy%)				
HICP (annual average)	7.6	12.0	2.5	1.6
HICP (end of period)	11.6	7.2	0.9	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	16.2	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	9.1	9.0
Wage Growth *(total economy)*	19.5	21.7	7.5	2.0
External Accounts				
Current Account (% GDP)	-25.2	-25.4	-9.5	-6.5
Net FDI (EUR bn)	8.4	6.1	3.0	2.0
FDI / Current Account (%)	115	70	95	90
FX Reserves (EUR bn)	11.9	12.7	12.9	11.5
Domestic Credit	**2007**	**2008**	**Q2 09**	**Q3 09**
Total Credit (%GDP)	67.2	75.2	75.6	77.4
Credit to Enterprises (%GDP)	43.0	47.8	47.6	49.7
Credit to Households (%GDP)	23.0	26.0	26.4	27.4
FX Credit/Total Credit (%)	50.7	57.2	57.7	58.5
Private Sector Credit (yoy)	65.9	32.3	11.9	5.9
Loans to Deposits (%)	96.5	119.3	120.5	118.9
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

Figure 1

Agriculture helps to contain output contraction in Q3



Source: National Statistical Institute of Bulgaria, Eurobank Research

Positive contribution from net exports masks steep decline in domestic demand

In the first three quarters of 2009, gross domestic product contracted by 4.7% yoy, with private consumption and investments falling by 5.2% yoy and 23.2% yoy, after growing by 5.0% yoy and 22.5% yoy, respectively in the same period a year earlier. The pace of decline in imports was almost double than of exports in January-September 2009 (-22.8% yoy vs. -12.8% yoy), with external sector's contribution turning significantly positive after being a

sizeable drag on GDP growth over the same period a year earlier. In conclusion, a significant rebalancing in the structure of domestic growth has taken place in recent quarters, with the positive contribution from net exports partially overweighing a deep contraction in domestic demand. The latter subtracted ca 17.1pps from GDP growth in the first nine months of 2009.

Return to positive growth unlikely before H12010 at the earliest

As we have alluded in our last *New Europe Economics & Strategy* monthly bulletin (Dec. 2009), the domestic economic downturn is not over yet, though the pace of decline of gross domestic product is likely to prove slower than envisaged earlier. In our view, the economy is not likely to return to positive growth territory until the second half of 2010 at the earliest. Yet, both the government and the IMF now appear somewhat less pessimistic with respect to the extent and duration of recession. The Ministry of Finance has upped its estimate for real GDP growth in 2009 to -4.1%, from -6.3% seen earlier, while the IMF is about to also revise upwards its own projection. The Central Bank has reaffirmed its forecast of a 4.5% contraction last year. With respect to the growth outlook for 2010, the Central Bank now expects anemic growth +0.5%, while the Ministry of Finance has upgraded its forecast to +0.3%, from an earlier projection of -2.0% included in the new budget.

Macroeconomic imbalances unwind in an orderly, yet painful, manner

The correction in the external imbalance is taking place more quickly than envisaged previously. The weakness of domestic demand is behind the ongoing improvement in current account deficit as import volumes continue to decline much faster than exports. The January-November current account deficit stood at 7.6% of projected GDP (or 8.3% in annualized terms), below our original revised full-year forecast of 10%-of-GDP. Although capital inflows over the first 11 months of the year were much lower than a year earlier (net FDIs down 55% yoy to €2.5bn), the corresponding coverage of the current account deficit improved to 93.5% from 72.5% in the same period of 2008.

Domestic policymakers don't see need for IMF support

The orderly unwinding of external imbalances is seen having some important implications for the Bulgarian economy. Primarily, external re-financing needs are becoming more manageable. The private sector remains able to roll-over its external obligations, given that debt roller ratio was maintained at rates above 90% in 2009. This implies a lesser need for Bulgaria to apply for external financing aid and, understandably, an IMF support package is no longer a policy priority. Let alone that an IMF loan would not bode well for the image of a country preparing to apply for ERM II entry.

Disinflation is gaining momentum

Inflation deceleration has gained momentum in 2009. HICP stood at 0.3%yoy in December vs.6.0%yoy in the beginning of the year and a peak at 14.8%yoy in June 2008. The most recent price developments provide optimism that Bulgaria will fulfill the Maastricht inflation criteria soon. In our view, domestic price pressures will remain subdued throughout this year (Eurobank EFG Research forecasts average inflation of 1.6% in 2010). This is not only due to the negative output gap and base effects, but also because no other major adjustment of administered prices is expected in the foreseeable future.

Belt-tightening measures help contain the budget deficit

The new government reversed a great deal of fiscal slippage incurred in the pre-election period by adopting a more prudent stance. The Minister of Finance embarked on an aggressive cost cutting program, swiftly introducing a 15% reduction in current expenditure, delaying certain other payments and even postponing infrastructure projects, particularly in the energy sector. Additionally, the government has attempted to improve tax collection by reforming the revenues administration, a move which is expected to yield more tangible results longer-term.

As a result, the budget started displaying minor surpluses in October (ca 8m Leva) and November (48m Leva). The government implemented some discretionary spending towards the end of last year, directed mainly towards pensions and EU co-financed projects. However, these had a rather minor effect on the budget deficit. Small budgetary surpluses during the second half of last year helped contain the budget deficit at levels recorded back in July, when the new government was sworn in office. According to preliminary government estimations, the 2009 budget posted a cash deficit of BGN 529.5m or 0.8% of projected full-year GDP. In ESA-95 terms, it is estimated to have been lower than 2%, which is still the lowest in EU. This year's government deficit will not be financed with debt issuance, but instead via running down the fiscal reserve account.

2010 budget targets a broadly balanced position

The budget for 2010 was recently approved by the parliament. It provides for a broadly balanced position. If EU related expenditures and revenues are incorporated, the overall consolidated government budget deficit is expected to reach 0.7% of GDP this year. The target for consolidated government revenues is set at 26.4bn Leva (41.6% of projected GDP) and for consolidated government expenditures at 26.9bn Leva (42.3% of projected GDP). The

budget provides for a higher tax on gambling (15% vs. 10%) and a 40% increase in excise duties on tobacco. On the other hand, social contributions will be reduced by 1.1 pps. On the expenditures side, public wages and pensions are projected to remain flat next year. The implementation

Disciplined fiscal policy improves Bulgaria's EMU entry outlook

In our meetings in December 2009 with officials at the Ministry of Finance and the Central Bank we had the opportunity discuss domestic fiscal developments. Our discussants argued that a vigilant fiscal stance is imperative for Bulgaria, even in a recessionary environment such as the present one. From an EMU-convergence standpoint, fiscal policy prudence ensures fulfill of the respective Maastricht criteria. It is also of primary importance for maintaining confidence on the present FX regime. A disciplined fiscal stance since the establishment of the currency board arrangement allowed Bulgaria to achieve very strong primary surpluses, which, in turn, promoted a rapid recline in the public debt burden. Even after the small consolidated government deficit recorded last year, public debt as a percentage of GDP came at 16.2% at the end of 2009, compared to 16.1% in 2008 (and a high of 105.1% recoded back in 1997). In fact, Bulgaria is estimated to have recorded the lowest budget deficit and the third lowest public debt ratio in EU-27 in 2009. International credit agencies have already shown signs of appreciation for the new government's commitment to fiscal discipline. Standard & Poor's Ratings revised recently its outlook on Bulgaria's long-term sovereign credit to stable from negative, reaffirming its current BBB rating (investment grade).

Domestic lending conditions remain tight; Nonperforming loans expected to rise further in 2010

The deepening of the global financial crisis after Lehman Brother's collapse in September 2008 prompted an abrupt end to the lending boom in Bulgaria. BNB´s measures to cut minimum reserve requirements in order to boost liquidity and encourage lending have so far had only partial success. The annual growth rate of credit to the non government sector landed to a single digit in December (4.5%) compared to 32.3% yoy a year earlier. The lack of adequate domestic funding sources, as manifested in a still high loan-to deposits ratio (120.5% in December) continues to severely constrain new lending.

During our recent meetings in Sofia we had the opportunity to discuss with our contacts how the domestic banking sector deals with the issue of nonperforming loans. NPLs have risen modestly so far from 2.4% at 2008 to 5.2% in last September, as domestic banks managed to renegotiate loan agreement with existing clients. Yet taking into account that NPLs is a lagging indicator of economic activity, it is very likely to see them rising further in the coming months. A couple of our contacts even estimated that NPLs would double by the end of this year. In our view, the banking sector has enough buffers to address the current downturn. This is reinforced by the commitment of large foreign parent banks to maintain their overall exposure in the country at levels recorded in May 2009.

In terms of capitalization, the banking sector scores relatively high in the region. Industry-wide capital adequacy currently stands at 17.6% and the capital to assets ratio is 12.7%, which provides enough comfort against rising NPLs. Moreover, resent stress tests conducted by the Central Bank showed that the domestic banking system would remain stable even under an extreme scenario envisioning a 7.5% GDP growth contraction in 2009 and a rise in the share of overdue loans in bank portfolios to 16.5%

Shift to a new development model is needed to reclaim past output losses

The Bulgarian economy has been a major beneficiary of international capital inflows to the broader region in recent years. Driven by improving convergence prospects, Bulgaria attracted some €27.1bn in FDI inflows in 2004-2008. The majority of those flows were channeled to non-tradable sectors, with the most representative one being the real estate market. Yet, if there is something the global financial crisis has taught us, is that the time of ease money and abundant capital flowing into emerging economies has passed.

As such, Bulgaria needs to tap into new sources of growth in the years to come. Capital inflows cannot longer serve as the locomotive of growth. As a result, a main challenge facing policymakers is to facilitate an orderly shift from the previous credit-driven and consumption-based model of development to a new one, emphasizing competitiveness and exports. In that respect, Bulgaria enjoys a significant comparative advantage over other emerging market economies. Better utilization of EU structural funds could give potential growth a significant boost. To that end, it is rather conforming that the new government has already managed to unfreeze €300m of pre-accession EU funding, thanks to its efforts thus far to combat corruption and organized crime.

Written by:

Ioannis Gkionis
Research Economist
igkionis@eurobank.gr

Poland

Polish economy to expand further in 2010; yet, fiscal concerns remain

- **Confounding long-held expectations, Poland's Prime Minister announced recently his decision not to run for president in upcoming elections (autumn 2010), so as to drive forward the government's reforms agenda**
- **According to official estimates, Poland was the only EU economy to record positive growth in 2009. We forecast real GDP growth to accelerate to 2.4% yoy this year, from an estimated 1.7% yoy in 2009**
- **Worsening fiscal position poses a main risk to the domestic macroeconomic outlook in 2010.**

Prime Minister Donald Tusk will not run for president in autumn 2010 elections

Confounding long-held expectations, Poland's Prime Minister, Donald Tusk, announced recently that he will not run for president in the upcoming (Autumn 2010) election. The reasons for this decision remain unclear. Until early January, it appeared almost certain that Mr Tusk would challenge the incumbent President, Lech Kaczynski, for the presidential post, with recent opinion polls indicating that the Prime Minister enjoys much higher popularity ratings than the President. According to Mr Tusk, his decision not to run for president is because he wants to drive forward the government's agenda which includes ambitious fiscal reforms. Yet, another explanation may relate to internal politics within the Prime Minister's party (PO). Since last September when the so-called gambling scandal broke out, a lot of high-ranking PO politicians were forced to resign. Hence, a departure of Mr Tusk (i.e., to take presidential post), might tempt disgruntled PO politicians to try to bolster their own power bases within the party, thus threatening party's stability. At the time of writing, PO has not yet announced an alternative presidential candidate. However, Foreign Minister, Radoslaw Sikorski appears to be a possible candidate.

General government deficit amounted to 7.2% of GDP in 2009, much higher than previously estimated

The current stage of Poland's political cycle (presidential elections in autumn 2010 and parliamentary elections in 2011) is *prima facie* in conducive to fiscal reform, on the basis that it is always tough for politicians to announce significant spending cuts in an election year. However, the Prime Minister unveiled, in late January, two measures of particular importance for the country's fiscal outlook. The first is an expenditure rule which will restrict some budgetary spending and the second relates to changes in the pension system. These new initiative come in the face of

Poland: Eurobank EFG Forecasts

	2007	2008	2009e	2010f
Real GDP (% yoy)	6.8	5.0	1.7	2.4
Private Consumption	4.9	5.9	2.4	2.7
Government Consumption	3.7	7.5	1.8	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	3.5	2.5
CPI (end of period)	4.0	3.3	3.5	2.8
Fiscal Accounts (% GDP)				
General Government Balance	-1.9	-3.6	-7.2	-7.0
Gross Public Debt	45.0	47.2	54.5	55.0
Labor Statistics (%)				
Unemployment Rate (% of labor force)	12.7	9.8	11.0	11.8
Wage Growth *(private sector - average)*	N/A	N/A	4.2	3.5
External Accounts				
Current Account (% GDP)	-5.2	-5.1	-2.0	-3.0
Net FDI (bn EUR)	13.2	8.0	6.8	7.5
FDI / Current Account	89.8	43.7	90.0	60.0
FX Reserves (bn EUR)	37.1	40.6	48.4	58.0
Domestic Credit	**2007**	**2008**	**Q2 09**	**Q3 09**
Total Credit (% GDP)	40.3	50.7	52.1	51.7
Credit to Enterprises (% GDP)	14.9	17.8	17.6	17.1
Credit to Households (% GDP)	22.0	29.3	30.9	30.9
FX Credit/Total Credit (%)	23.7	32.6	33.2	31.7
Private Sector Credit (% yoy)	33.5	38.1	27.1	18.4
Loans to Deposits (%)	92.9	105.2	104.3	104.0
Financial Markets	**Current**	**3M**	**6M**	**12M**
Policy Rate	3.50	3.50	3.50	4.00
EUR/PLN	4.10	4.00	3.90	3.80

Source: NBP, Eurostat, EcoWin, Bloomberg, Eurobank research

heightened domestic fiscal risks and the ensuing worsening of public-debt dynamics. Note that the government revised recently its estimate for the 2009 general government deficit to 7.2% of GDP, from 6.4% of GDP initially estimated. What's more, they also indicated that the 2010 budget deficit could be as high as 7% of GDP. In line with these developments, it is highly likely that the pubic debt ratio reached the 55% of GDP constitutional threshold in late 2009, and without additional restraining measures it remains on route to hit even higher levels at the end of this year. The ambitious privatisation program and upside risks to domestic growth outlook (the government expects real GDP growth of only 1.2% in 2010) may support public finances but it remains to be seen whether these will be enough to prevent the debt ratio from overshooting the constitutionally-imposed security level.

Economic recovery underway, but GDP growth to remain sub-trend this year

One clear message extracted from the recent global financial crisis is the differentiation within the Central Eastern Europe region with respect to country-specific strengths and vulnerabilities. Poland is the bright example; it was the only EU economy to record positive growth in 2009 (estimated at 1.7% yoy i.e., slightly higher than the 1.6% yoy consensus). This figure indicates significant acceleration in the last quarter of 2009. As suggested by the most recent trade and retail sales data, private consumption – traditionally the main drive to Polish GDP growth - remained resilient in the last quarter of 2009. Looking ahead, considerable support to the domestic economy will continue to come from the

rebound in main trading-partner economies in Western Europe, as well as from sizeable inflows of EU structural funds helping to offset the decline in private sector investments.

In the domestic industrial sector, output grew by 7.4% yoy in December, the second successive month of growth, favoured by strong base effects. Yet, this came as a negative surprise (the consensus was for a double-digit growth in industrial production in December), signalling brightening prospects for the sector, though no strong acceleration. The more recent (slight) decline in Polish manufacturing PMI (to 51.0 in January from 52.4 in December) provides additional support to the latter view.

Elsewhere, significant uncertainty continues to surround domestic labour market conditions. Although Polish wage growth in December surprised to the upside - coming out at 6.5% yoy and hence bringing real wage growth back to positive territory - unemployment rose further to 11.9%. (Figure 1) We expect a deterioration in labour market conditions with a growing unemployment in 2010 as economic growth remains below potential.

Figure 1

Weak wage growth and growing unemployment

Source: National Statistics, Eurobank Research

Worsened labour market conditions will also weigh on households' disposable income in 2010. In addition to deteriorated public finances, this should keep private consumption under pressure. As a result, Polish GDP growth will likely remain below trend in 2010; we anticipate real GDP growth of 2.4% yoy this year.

Current account deficit widened considerably in November

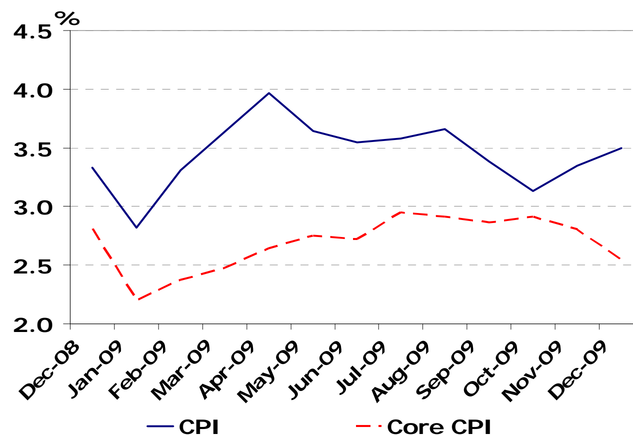
Poland's current account deficit was worse that expected in November (€1272m), but the related 12-month-rolling figure stood at €5709m that month, less than one-third of the corresponding deficit a year earlier. Most of the improvement was due to the narrowing of the foreign trade deficit. (€4522 on a 12-month rolling basis in Nov09 vs. €17,603 a year earlier)

Inflation rise led by higher energy prices and unfavourable base effects

Headline CPI rose to 3.5% yoy in December, reaching the upper limit of the central's bank inflation target. This increase was mainly driven by higher energy prices and unfavourable base effects. On a more comforting note, December headline CPI remained flat from a month earlier. What's more, core inflation (measure that excludes food and energy prices) fell to 2.6% yoy the lowest reading since last March. (Figure 2) Sluggish wage growth and a gradual tightening in domestic monetary policy will likely allow annual average inflation to fall in 2010-11 from an estimated 3.5% in 2009. We expect inflation to average to 2.5% in 2010.

Figure 2

Core inflation decline indicates easing price pressures



Source: National Statistics, Eurobank Research

MPC members' replacement increases policy uncertainty

As was widely expected, the National Bank of Poland (NBP) kept the key policy rate unchanged at 3.5% in January for the seventh consecutive month. The tone of the accompanying press conference was rather neutral, communicating a strong call for rapid euro adoption and lasting fiscal consolidation. Five new MPC members participated in the January policy meeting, with the rest four existing members due to be replaced in February (three of them will be presidential nominees). In its new six-year term, the new MPC will play a crucial role in managing Poland's participation in ERM-2 and euro adoption.

With the economy continuing to recover, albeit at a modest pace, there is currently no overwhelming urgency by the NBP to tighten its monetary policy as inflation remains relatively tame. Moreover, it currently appears to be limited scope for a further narrowing in interest rates differentials vis-à-vis

the euro area as the ECB key reference interest rate remains well below the Polish one (1% vs. 3.5%) and it is not expected to be raised any time soon. Against this backdrop, we expect a measured-tightening rather than aggressive hikes; Eurobank EFG Research forecasts the NBP to start hiking interest rates not earlier than H2-2010, with the key rates reaching 4.0% at the end of the current year.

A brighter outlook for the Zloty in 2010, supported by monetary tightening expectations and higher privatisation receipts

The impressive resilience of the domestic economy in the face of the global financial crisis and limited risks to political stability broadly favoured zloty in 2009. We expect the national currency to strengthen further this year on the back of the continuing recovery of the Polish economy and the relatively attractive carry on long zloty positions. Moreover, the return to monetary tightening in H2-2010 and the government's privatization programme will be key factors spurring zloty demand. However, there is a downside risk to our forecast attributed to fears over public finances and/or spill over effects from a renewed financial distress in other CEE markets.

Banking-sector developments

The total outstanding amount of loans was still growing in December 2009 (up 7.4% from a year earlier). Loans to deposits ratio declined in December to 108.2%, from 111.8% a month earlier, thanks to higher deposits growth (up 3.3% mom in December, the highest rate of growth since December 2008). On a less positive note, Non-Performing Loans (NPLs) remain on an upward trend; the Dec09 figure is 81.9% higher than a year earlier. Even more worrisome, the NPLs to total loans ratio stood at 7.3% in Dec09 compared to 4.3% in Dec08. What's more, the NPLs ratio to corporate sector rose to the alarming 12.4% in December 2009.

Written by:

Dr Stella Kanellopoulou
Research Economist
skanellopoulou@eurobank.gr

Romania

International organizations resume lending program

- **End of domestic political deadlock allows the new government to tap international markets with a new Eurobond issue *(expected some time in Q1 2010, according to government officials)***
- **International organizations resume lending program**
- **Budget deficit target was achieved in 2009; accomplishment of this year's target likely to prove a challenging proposition**
- **Improving macro outlook, decline of domestic political risk suggest room for further RON appreciation**

Romania: Eurobank EFG Forecasts				
	2007	2008	2009e	2010f
Real GDP (yoy%)	6.3	7.1	-7.0	1.0
Private Consumption	10.3	8.7	-12.0	1.5
Govern. Consumption	7.7	3.8	1.0	-0.8
Gross Capital Formation	28.9	19.3	-11.0	2.0
Exports	7.8	19.4	-10.5	4.5
Imports	27.3	17.5	-25.0	6.0
Inflation (yoy%)				
CPI (annual average)	4.8	7.9	5.6	3.6
CPI (end of period)	6.6	6.3	4.7	3.5
Fiscal Accounts (%GDP)				
General Government Balance (ESA 95)	-2.5	-5.5	-7.5	-6.5
Gross Public Debt	20.2	21.8	30.0	33.0
Labor Statistics (annual avg,%)				
Unemployment Rate (% of labor force)	4.0	4.4	6.3	9.0
Wage Growth (total economy)	22.6	23.6	8.8	1.0
External Accounts				
Current Account (%GDP)	-13.5	-12.4	-4.5	-5.5
Net FDI (EUR bn)	7.3	9.5	3.8	4.5
FDI / Current Account (%)	43.4	54.8	80.0	65.0
FX Reserves (EUR bn)	25.3	26.2	28.3	29.5
Domestic Credit *(end of period)*	**2007**	**2008**	**Q2 09**	**Q3 09**
Total Credit (%GDP)	39.0	42.7	46.6	49.0
Credit to Enterprises (%GDP)	18.0	18.8	18.8	19.5
Credit to Households (%GDP)	17.7	19.7	19.8	20.2
FX Credit/Total Credit (%, private)	51.0	53.1	49.9	60.2
Private Sector Credit (yoy)	60.4	33.7	11.2	2.4
Loans to Deposits (%)	108.9	131.9	136.2	128.8
Financial Markets	**Current**	**3M**	**6M**	**12M**
Policy Rate	7.00	7.00	6.50	6.00
EUR/RON	4.14	4.20	4.05	4.00

Source: National Sources, Eurostat, IMF, Eurobank Research

Domestic political deadlock finally resolves; risks still hanging over

Incumbent President Traian Basescu from the ruling Democratic Liberal Party (DLP) was re-elected on December 6, albeit with a very narrow margin. Mr Basescu collected 50.4% of the vote in a controversial election challenged by Mircea Geoana, the opposition candidate of the Social Democratic Party (SDP). Nevertheless, the Constitutional court validated initial results, which resulted in the renewal of Mr. Basescu´s 5-year term in presidency.

On a positive note, the December 2010 presidential election signified the end of the recent domestic political crisis. A new government was formed under the leadership of Emil Boc, nominated by the Democratic Liberal Party (DLP). The government gained a very narrow majority in Parliament (4 seats), with the support of the Hungarian minority party as well as other ethnic minorities and independent MPs who defected from both opposition parties NLP and SDP.

The formation of a new government resolved a protracted political deadlock, but risks have not vanished completely. The government has enormous challenges to face and expectations to live up to until the end of its term in late 2012. Indeed, the implementation of tough structural reforms and fiscal consolidation could endanger the cohesion and the stability of the government.

Endorsement of 2010 budget unblocks multilateral organizations funding

The resolution of the protracted domestic political deadlock and the passage of the 2010 budget in Parliament gave new impetus to the implementation of the lending program. In late January, an IMF mission concluded the second and third review of the existing Stand By agreement (SBA) with Romania, pledging to recommend to the Executive Board to disburse the 3rd and 4th tranches (€2.3bn in total). On top of that, the EU will also disburse another €1bn bringing the total amount received by the country so far to €10bn out of a total of €20bn allocated to Romania under the existing support package. The use of the new funds (expected to be disbursed by mid February) will be two fold. Half of the funds will be directed to finance the budget deficit, and half of that to support FX reserves. According to the Finance Minister, the government will probably need no further support from IMF for financing the budget deficit, provided that tax collection meets budgetary targets.

The IMF mission noted that Romania met most of the conditionalities attached to the Stand by Arrangement. On the other hand, the conditionality on budget arrears, an issue likely to be given more attention by future IMF missions, was not met. Other key reforms including an overhaul of the pension system and the fiscal responsibility law are still pending and are expected to get parliamentary approved during 2010.

Implementation of the 2010 budget may well prove a Herculean task

According to the latest (preliminary) data, the fiscal deficit (on a cash budget basis) came in at 7.1% of GDP in 2009, a tad below the IMF-agreed fiscal target of 7.3% of GDP. The IMF set the fiscal target at 5.9% of GDP for 2010, which represents a sizeable fiscal adjustment.

The 2010 budget envisions a 7.9% yoy increase in revenues, a rather ambitious target in the absence of additional revenue-generating measures such as an increase in the current flat tax rate on personal-incomes and corporate profits. This is especially true in the face of a domestic macro trajectory characterized by still rising unemployment and weak domestic-demand dynamics (the government expects real GDP growth of 1.3% in 2010). On a more constructive note, revenues as a percentage of GDP are still at a very low level for EU standards (2010 forecast: 31.8% of GDP vs. in the EU-27), suggesting room for additional measures aiming to broaden the tax base and reign in tax evasion.

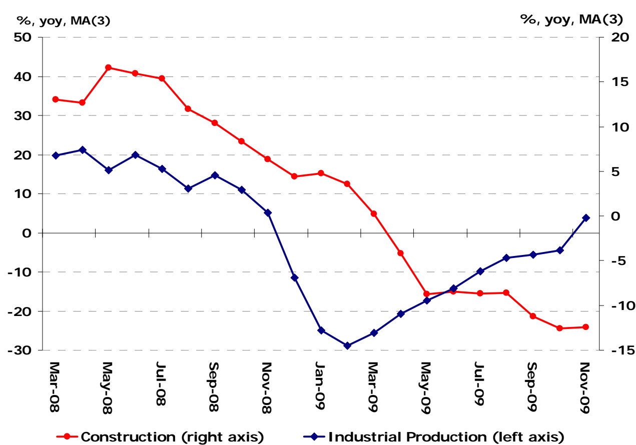
On the expenditure side, a great effort will be needed to contain the growth of expenditures at just 4.2% yoy. Public wages and pensions are projected to stay flat-frozen in 2010. In addition, the government has committed itself to reduce the overall wage bill by 2 pps, to 7% of GDP from 9% of GDP in 2009. This leaves no other option but to cut public sector employment. A figure of 100,000 lay offs in the public sector was quoted in the local media, but has not yet been confirmed by the government. In any case, spending cuts aiming to achieve the 2010 budget deficit target will need to be harsh. Therefore, it appears that the new government will have to pursue highly unpopular policies in order to achieve fiscal consolidation.
To recap, the achievement of the 2010 fiscal target is subject to significant risks. First of all, Romania doesn't have a solid record of successfully executing tight budgets. Secondly, budget revenue may again disappoint this year, constrained by still weak domestic economic growth. Achievement of the ambitious target for budgetary expenditures will also necessitate significant reforms, including adoption of the pension reform, the fiscal responsibility law and the unified public wages scheme. Furthermore, implementation of harsh and unpopular spending cuts may encounter significant resistance from trade unions and also test the cohesion of the government coalition. In that respect, fiscal slippage constitutes ones of the major risks for the domestic macro trajectory in 2010.

Output contraction moderated in Q3. Macroeconomic outlook improved further in 4th quarter of 2009

The more recent national accounts data showed that the pace of output contraction (in seasonally adjusted terms) moderated to 0.6% qoq in Q3, from 1.1% qoq in the prior quarter. On an annual basis, real GDP growth was -7.1% yoy, compared to -8.7% yoy in Q2, bringing the year-to-September 2009 cumulative output losses to 7.4% yoy. In Q3 2009, consumption remained depressed (-11.8% yoy), while gross capital formation dropped by a further 13.7% yoy despite the positive contribution from inventories. On the other hand, net exports was the main driver of growth during that quarter as exports of goods and services recorded mild positive growth (+1.6% yoy) and imports continued to contract at a double-digit rate (-15.3% yoy).

Nevertheless, recent readings in a range of higher-frequency indicators suggest that the Romanian economy may soon exit from recession. Particularly, industrial production recorded consecutive month-on-month gains in June-November 2009 (latest available data), with the corresponding annual pace of industrial output growth returning to a positive territory in November (1.7%/4.4% mom/yoy) for the first time since autumn 2008. These favorable developments and the unlocking of multilateral funding support our expectations for a return to positive, though still below-potential, economic growth in 2010. We have revised our real GDP growth forecast for Romania this year to 1.0%, from +0.5% previously. The main risk to our forecast stems from external demand, in case that recovery in exports markets disappoints. In addition, from a growth perspective, fiscal consolidation will deduct resources from GDP growth.

Figure 1
Industrial production recovers more quickly than construction



Source: National Institute of Statistics of Romania, Eurobank Research

Central Bank missed inflation target for slim margin last year; 2010 target seems ambitious but achievable

Inflation inched up to 4.74% yoy in December 2009, from 4.65% yoy in the prior month, slightly overshooting the NBR´s target range (2.5-4.5%), but still coming below our year-end forecast (4.9%yoy). Higher tobacco prices (+3.58% yoy) and increases in administered prices (+1.13% yoy in water and sewage services) were the main culprits. Going forward, we anticipate domestic inflation to record a further (temporary) spike in the first months of 2010 as a result an additional 12.4% rise in excise taxes. On a more positive note, demand pressures remain weak as portrayed in the downward trend of all core measures. More

specifically, Core 3 inflation (CPI without administered prices, alcohol, tobacco, and food prices) declined to 2.8% yoy in December from 3.3% in the prior month and 6.5% yoy in the beginning of 2009.

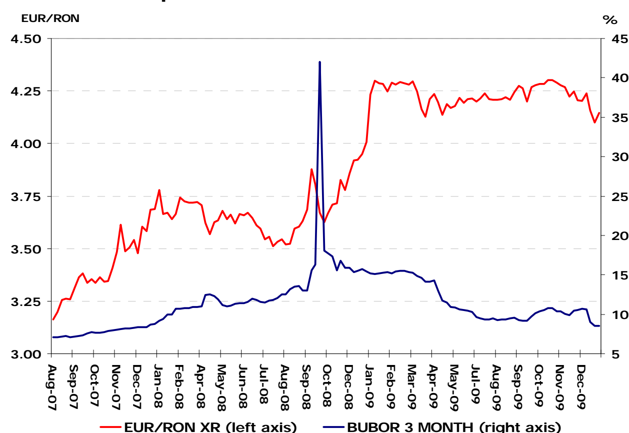
The Central Bank missed the inflation target for a third year in a row in 2009, endangering a blow to its credibility. This might be partially justified by the extraordinary situation the Central Bank was faced with: the worst domestic economic crisis in the post-communism era and investor risk aversion towards regional markets. Though a severe contraction of 7pps in output is at face value disinflationary, the Central Bank had to face significant depreciation pressure on the Leu. The latter unleashed inflationary pressures in the domestic economy vis-a-vis a high pass through (around 30%).

The Central Bank inflation target is set at (2.5% +/-1%) in 2010. In our view, this is ambitious, yet realistic. The outcome will likely depend on a range of supply- rather than demand-side factors. On the positive side, the recent strengthening of the local currency is likely to provide support to domestic disinflation. On the other hand, higher domestic food prices this year as a result of bad crops season and unfavorable base effects pose significant upside risks. Note that food costs carry a disproportionally high weight in the Romanian CPI basket (37.6%)

RON strengthens on improving domestic outlook, attractive carry

The end of the domestic political crisis helped to push Romanian sovereign spreads and money-market interest rates lower. 10 year CDS spread stood at ca 250 bps in early February, compared to around 310 bps in late November (when the domestic political crisis erupted) and 650 bps in late 2008. On the FX side, RON traded at 4.09/€ compared to levels around 4.23/€ in late 2009, having recording a ca 3.5% nominal appreciation against the single currency since the beginning this year.

Figure 2: RON on a strengthening mode after the political deadlock resolved



Source: EcoWin, Eurobank Research

The recent easing of domestic political uncertainly allowed monetary authorities more room for manoeuvre in order to boost lending and growth. Since the beginning of the year, the Central Bank reduced its key policy rate by a further 100 bps to 7.00% currently (lowest level in two years). We see room for more policy easing by the NBR, provided that there are no unpleasant inflation surprises (Eurobank EFG Research forecasts a further 100bps cumulative cut in the key policy rate by year-end)

In the absence of renewed political jitters domestically and/or unfavorable developments in regional markets, the RON is likely to strengthen further in the period ahead. The outlook for RON and RON-denominated assets may improve further if government proceeds with further fiscal consolidation, which is the key to bolster investors' confidence.

Written by:

Ioannis Gkionis
Research Economist
igkionis@eurobank.gr

Serbia

Interim trade agreement finally unblocked

- **The unblocking of the EU interim trade agreement will bring immediate benefits for Serbian exporters, even though EU membership remains a distant prospect**
- **Central Bank signals that more interest rate cut are on the cards in 2010 despite depreciation pressures on the Dinar**
- **Meeting the revised fiscal target in 2010 is manageable, but may require additional consolidation efforts on the part of the government**

Serbia applies for EU membership; interim agreement unblocked

EU agreed to unblock the interim trade agreement in late December, the most significant part of the Stabilization and Association Agreement (SAA). This represents the first important step towards European integration because it is the first contractual agreement between Serbia and EU. Its implementation implies immediate and significant benefits to the Serbian economy, given that more than half of the country´s exports are heading towards EU markets. In addition, it extends the benefits of the *existing* trade agreement, particularly in the area of agricultural products, which is an important market for Serbian exporters. From a longer-term perspective, the agreement will eventually lead to a free trade area between Serbia and EU. Additionally, it will impact the perceived risk premium of the country and thus, help to reduce sovereign borrowing costs. Yet, full EU membership is still far away. The first obstacle to overcome is the ratification of Stabilization and Association Agreement, which remains blocked. Despite those difficulties, the Serbian government submitted its application for EU membership in a symbolic gesture, just before Christmas.

Preliminary estimates put GDP contraction at 2.9% in 2009

Output losses in 2009 turned out to be much lower than originally expected. According to preliminary Central Bank estimates, GDP contracted by 2.9% yoy in 2009, following positive growth of 5.5% yoy in 2008. Domestic demand subtracted 11.9 pps, reflecting weak consumption (-5.8% yoy) and the collapse in investments (-25.2% yoy). The vast decline in the imports bill made net exports the main driver of growth. Net exports added 9.1 pps to overall GDP growth in 2009, helping to partially offset the drag from domestic demand. High frequency indicators confirm that the decline in economic activity is bottoming out in line with the Central Bank estimates. Industrial output contraction was further contained in Q4 to -3.8% yoy against -10.6% yoy in Q3.

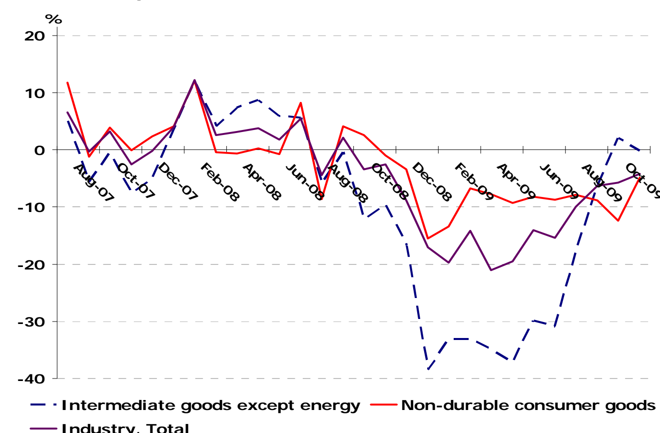
Serbia: Eurobank EFG Forecasts

	2007	2008	2009e	2010f
Real GDP (yoy%)	6.9	5.5	-2.9	1.5
Inflation (yoy%)				
CPI (annual average)	6.5	11.7	8.2	7.0
CPI (end of period)	11.0	8.6	6.6	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	14.7	16.4	18.5
Wage Growth *(total economy)*	22.0	17.9	8.8	3.0
External Accounts				
Current Account (% GDP)	-15.6	-17.3	-6.0	-8.5
Net FDI (EUR bn)	1.8	1.8	1.2	1.5
FDI / Current Account (%)	38.0	30.0	70.0	55.0
FX Reserves (EUR bn)	9.6	8.2	10.6	10.0
Domestic Credit	**2007**	**2008**	**Q2 09**	**Q3 09**
Total Credit (%GDP)	35.4	41.1	45.8	46.7
Credit to Enterprises (%GDP)	21.5	25.8	28.4	28.8
Credit to Households (%GDP)	12.9	13.9	14.1	14.1
Private Sector Credit (yoy)	40.2	34.9	26.6	20.2
Loans to Deposits (%)	99.9	125.1	130.2	130.7
Financial Markets	**Current**	**3M**	**6M**	**12M**
Policy Rate	9.50	9.50	9.00	8.50
EUR/RSD	98.98	100.00	100.00	100.00

Source: National Sources, IMF, Eurobank Research

Figure 1

Industrial production contraction is further contained



Source: Statistical Office of the Republic of Serbia, Eurobank Research

Turnaround appears to have already began, but recovery will likely be weak and subject to significant downside risks

We expect the Serbian economy to grow by 1.5% yoy in 2010, above the regional average, but much lower than potential. The turnaround has already begun, but more evidence is needed to confirm that a sustainable economic recovery is in the offing. Risks to our growth forecast remained skewed to the downside. First of all, uncertainty remains with respect to the breath and extent of recovery in main exports markets, though the interim trade agreement is definitely a plus. In any case, net exports could not contribute to growth as much as in 2009, because base effects from the imports side will kick in. On top of all that, domestic consumption is expected to remain weak in 2010,

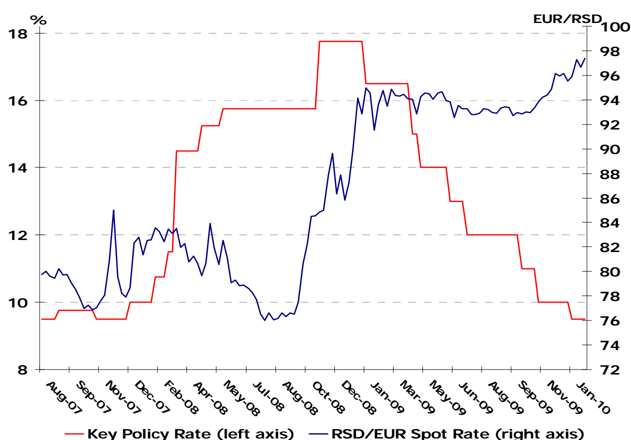
provided that government maintains wages and pensions frozen. Consumer demand will remain subdued as a result of constrained disposable incomes due to negative real wage growth, high structural unemployment and tight financial conditions. On a more positive note, a number of recent developments have boosted optimism for a modest recovery of investments in 2010. Among them, recent progress towards EU integration, a €1bn Fiat investment in Zastava and increased signs of strengthening political will for the completion of some long awaited privatization tickets can be highlighted as the most important factors. Yet, we will still be looking for more hard evidence to corroborate our expectations for an economic recovery this year.

Central Bank signals further interest rates cuts despite depreciation pressures on the Dinar

The Dinar came under depreciation pressure since late December. Seasonal demand for FX from corporates who repatriate their profits and the release of local-currency liquidity as a result of the cut in minimum reserve requirements were the main drivers of currency weakness. Increased depreciation pressure on the Dinar forced the Central Bank to intervene selling Euros for the first time since last February. Nevertheless, Dinar dropped below 96/€ hitting an all time low against the Euro (98.68/€ on February 5th), stirring considerable internal debate within the country.

Figure 2

Local currency hits new low in late 2009



Source: EcoWin, Eurobank Research

Citing the conclusion of the IMF agreement and the achievement of inflation target last year, the Central Bank cut interest rates by another 25 bps to 9.5%. This represents a total of 800bps since the monetary policy easing cycle begun. In our view, it would be hard to see any further cuts before the end of Q1 2010. Even though the Central Bank signaled that there is room for a further 200 bps rate easing, we are not convinced that this could be delivered if pressures in the FX market continue. *(The Central Bank has stated that 100/€ is the level above which it will intervene again)*. Moreover, inflation is expected to trend higher in the first months of 2010, as a result of new regulatory prices hikes and higher oil prices. This is going to make it even more difficult to justify any imminent further cuts. Consumer prices already returned within the 6-10% band, ending up to 6.6% in December, confirming our forecasts in our previous issue of New Europe Economics & Strategy.

Execution of 2009 budget better than expected earlier; access to IMF funding secured

The 2009 budget deficit came at RSD 95.3bn or 9.5% below the revised target agreed with IMF (RSD 105.5bn). Total revenues amounted to RSD 651.2bn and were broadly flat relative to the prior year despite the economic recession. Tax revenues were marginally lower (-1.4% yoy), a decline that was offset by a modest increase in non tax revenues (6% up yoy). Total expenditures climbed to RSD 746.5bn, up by 6.4% yoy, yet still below the agreed level with IMF (RSD 752.3bn). Current expenditures increased by 10.6% yoy despite government efforts to contain them. Transfers to social security funds skyrocketed by 46.2% yoy. Moreover, the wage bill of public employees increased by 2.1% yoy despite an earlier government commitment for a freeze in public wages.

The government made the necessary savings by slashing capital expenditure to half than originally budgeted. As a result, the budget deficit came at 3.2% of GDP in 2009 compared to 1.8% in 2008. The better than previously expected fiscal outcome in 2009 implies that last year's consolidated government deficit closed the year near 4%-of-GDP, broadly in line with the IMF revised target (4.5% of GDP in 2009). The accomplishment of the target secures continued access to IMF funding in 2010, provided that there is no backing out of the government's commitment for prudent public spending down the road.

Meeting the revised fiscal target for 2010 likely to prove challenging

The fiscal performance in 2009 outperformed expectations. The government is faced with an equally challenging, yet not entirely impossible task in 2010. The new budget, which was approved by narrow political support in late December, targets a deficit of RSD 107 bn or 3.4%-of-GDP in 2010 *(and 4%-of-GDP at a consolidated government level)*. In our view, meeting the revised target for 2010 will require a harder effort on the part of the government. First of all, the 1.5% GDP growth assumption underpinning the 2010 budget does not sound unrealistic. Nevertheless, on the expenditures side, it will be politically difficult to implement generous cost cuts. The government has pledged to slash public sector employment particularly at the local government level and proceed with pension reform. Voices that pensions and

wages should be unfrozen in 2010 have already started to grow louder.

Written by:

Ioannis Gkionis
Research Economist
igkionis@eurobank.gr

Turkey

Return to positive GDP growth expected in 2010. Improving external imbalance, successful placement of first 10-year benchmark bond help to ease financing concerns

- **IMF deal yet to be reached; government officials more vocal on the issue lately**
- **CPI to rise further in H1 2010 on higher food prices, indirect tax hikes and base effects**
- **CBRT is seen remaining on hold in H1 2010**

IMF deal yet to be reached; government officials more vocal on the issue lately

This is increasingly becoming a never ending story. Since the expiration of the last $10bn Stand-By Arrangement (SBA) in May 2008, Turkey and the IMF have been locked in lengthy discussions, aimed at reaching a conclusion over a new financial aid deal. A solution has yet to be reached with vocal (negotiation) days followed by quiet ones, and vice versa. Most recently, discussions appear to be gaining traction and expectations that an agreement would soon be reached grew anew. In late December, Economy Minister Ali Babacan said that both parties agreed that the agreement would span two years rather than three expected previously. His comments preceded local media reports quoting Prime Minister Erdogan as saying to his deputies that the Fund had accepted their terms and that the deal would last for two years. These reports were neither confirmed nor denied by the government. More recently, Mr. Erdogan stated that negotiations with the IMF over a loan deal were close to an end and unconfirmed local media reports read that talks could be concluded in Davos in January. However, hopes were deflated anew after he and Economy Minister Ali Babacan separately warned that a deal was not a necessity, later adding that negotiations may continue until May. Their absence from the recent Davos conference added to uncertainty, while it has yet to be *officially* confirmed that major hurdles such IMF´s requirements regarding an independent tax administration and payments to municipalities have been overcome.

Improving external imbalance, successful placement of first 10-year benchmark bond help to ease financing concerns

The successful placement of Turkey's first ten-year 5.25% fixed coupon bond provided additional support to the view that the country may be capable of stirring through the crisis without external financial aid. Indeed, one may even argue that an IMF loan deal is not as important for Turkey as used to be, as previously alarming external imbalances have significantly improved and the central bank's sizeable FX reserves *(~ $70bn in November 2009)* provide a substantial cushion against renewed liquidity pressures. Notably, the 12-month-to November 2009 current account balance recorded a near $13bn deficit, having shrunk by more than 70% from a year earlier on a lower bill for goods and services imports and easing oil prices. As a result, net FDI coverage of the shortfall improved to 53.2% from 40.5% over the same period a year earlier, in spite of a 61%yoy decline in net foreign direct investment.

Turkey: Eurobank EFG Forecasts

	2007	2008	2009f	2010f
Real GDP (yoy%)	4.7	0.9	-5.5	5.0
Private Consumption	5.5	-0.1	-4.0	3.5
Govern. 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	6.3	7.5
CPI (end of period)	8.4	10.1	6.5	6.9
Fiscal Accounts (%GDP)				
General Government Balance	-1.2	-1.8	-5.5	-4.5
Gross Public Debt	39.4	39.5	47.0	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	7.0	10.0
FDI / Current Account	52.2	37.8	51.0	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	8.00
USD/TRY	1.53	1.54	1.55	1.50

Source: National Sources, Eurostat, IMF, Eurobank Research

We still expect an IMF deal, though for a smaller aid package than expected previously

We reiterate that financial aid from abroad would be beneficial for the domestic economy and also provide a valuable policy-anchor market participants would like to see in place. Funds from a new Stand-By Arrangement could be used to help finance the budget deficit, which ballooned last year amid increased government spending to support the ailing domestic economy. That way, the Treasury's roll-over burden would ease, allowing extra liquidity in the banking system and helping to reduce the crowding-out effect on the private sector. We continue to assign a higher-than-even probability to an agreement being reached and expect the amount to total $15-25bn. This is less than our previous estimate for a $25-35bn aid package. It has to be noted though that the time span of a new agreement would likely be two rather than three years quoted initially. From a market standpoint, many participants have lately scaled back their expectations for successful conclusion of an IMF loan accord in view of the

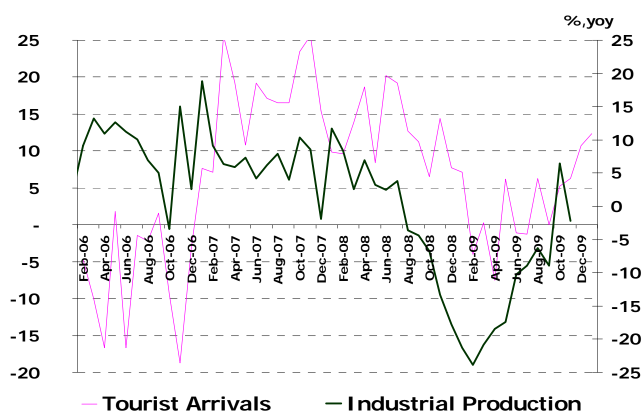
ongoing negotiations fatigue. Thus, securing the deal would likely have a positive impact on Turkish assets.

Trough of domestic recession was likely reached in Q1 2009

The pace of economic contraction eased to -3.3%yoy in Q3 2009, bringing the January-September real GDP growth print to -8.4%yoy. The notable slowdown in the pace of contraction in the last two quarters signals that the domestic recession has likely reach a trough in Q1 when GDP declined by 14.7%yoy. From the expenditure side, final household consumption improved marginally in Q3 to -0.9%yoy from -1.5%yoy in the prior quarter. Furthermore, the annual rate of decline in investments slowed to 18% from 24.3% in Q2, with inventories remaining a significant drag on growth. On the flipside, the decline in total domestic demand was partly offset by a 5.2%yoy jump in government expenditure, while net exports continued to exert a positive contribution as imports continued to decline faster that exports *(-11.9%yoy vs. -7.4%yoy).* From the production side, manufacturing, construction, transport, storage and communication as well as wholesale and retail trade were the main drags on Q3 growth, improving only marginally from a quarter earlier. Financial intermediation remained the primary supporter, posting a 7.8%yoy rise.

Figure 1

The domestic economy is on the mend



Source: National Statistics

GDP growth was probably positive in Q4 2009

A mild recovery in private consumption and a slowdown in the pace of deccumulation of inventories have likely supported economic activity in the last quarter of 2009. Real GDP growth is estimated to have switched to a positive territory in Q4, though net exports' (positive) contribution has likely lessened that quarter, thanks to a pick up in domestic demand. In support of the latter views, recent readings in a range of higher-frequency indicators show that the economy has probably embarked on a slow uptrend in recent months. Capacity utilization, a leading indicator of manufacturing activity and GDP growth, bounced marginally in January from a 4-month low of 67.6% reached in the prior month, remaining firmly higher relative to a record low of 63.8% recorded in the beginning of 2009. Industrial production (adjusted for seasonal factors and working days) swung into a positive territory in October-November, after 16-months of ongoing contraction in the sector. In a similar note, PMI manufacturing came in at 53.0 in January, signaling expansion in the sector for the ninth month running, with production growing at its strongest pace since August 2009. Separately, vehicle production soared by 143.7%yoy in December following a 30%yoy rise in the prior month, bringing the corresponding full-year figure to -24.2%yoy. Last by not least, tourism revenues jumped 11.6%yoy in Q4, with the sector bouncing following steep declines in the prior quarters.

CBT sees 5% growth in 2010, but considerable uncertainty surrounds the outlook

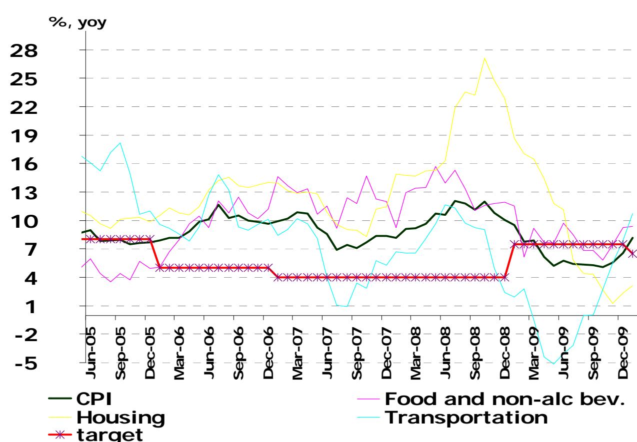
In line with our forecasts for a positive GDP reading in Q4, we now estimate full-year growth to have contracted by 5.5%yoy in 2009. With respect to the 2010 outlook, CBT governor Durmus Yilmaz said recently that favorable base effects may push annual GDP growth to as high as 5% in 2010 even if quarter-on-quarter growth remained unchanged throughout the year. Certainly, easing domestic financial conditions, rising exports as a result of improving conditions in major trading-partner economies, expectations for a better tourism season and the lagged effects of past monetary easing are all factors supporting a more upbeat assessment over the prospect of economic growth this year. A bounce in inventories could be another positive driver (please also see our special-focus section *"The Anatomy of Growth in 2010", EFG Istanbul Securities 12.01.2010*). We broadly concur with the view that economic growth may surprise to the upside this year, but warn against considerable risks still surrounding the outlook. On the latter point, note that consumer confidence fell to an 8-month low of 78.38 in December, reflecting still difficult labor market conditions. The rate of unemployment slid to 13% in October from a record high of 16.1% in February.

CPI to rise further in H1 2010 on higher food prices, indirect tax hikes and base effects

Consumer inflation spiked 1.85%mom in January, marginally outpacing a 1.80%mom expected rise and bringing the annual rate of increase to 8.19% against a market median forecast of 7.10%. Higher food prices, strong base effects and tax hikes were the main culprits of the higher-than-expected reading. Yet, the breakdown of the data and a 0.54%mom drop in core CPI index-I reveal that inflation pressures remain subdued against a background of weak domestic demand. Looking ahead, regulated price hikes on tobacco and alcoholic beverages, increases in highway tolls and base effects are expected to push headline inflation higher in the first half of

2010. Yet, inflation is likely to ease towards 7.0% yoy by the end of the year, assisted by weak demand-side pressures, base effects and potential lira appreciation. In its quarterly inflation report released in January, the central bank highlighted that 2010 CPI would be higher than expected previously, as a result of tax hikes and firmer food prices. It added though that policy interest rates are likely stay at current *(historically-low)* levels for a long period of time. The bank assigned a 70% probability for end-2010 inflation coming in between 5.5-8.3%, which implies a mid-point forecast of 6.9% *i.e.,* slightly above its 6.5% inflation target. Note that in 2009 CPI undershot the CBRT's end-year target of 7.5%yoy for the first time in three years coming in at 6.53%.

Figure 2
Inflation picking up on higher food prices and base effects



Source: National Statistics

CBRT seen remaining on hold in H1 2010

The CBRT concluded its 13-months-long easing cycle in December, following a total of 1025bps in rate cuts, which pushed the key overnight borrowing rate to a record low of 6.50%. We expect the central bank to resort to monetary tightening before the end of 2010 in order to contain rising price pressures and keep headline CPI below its target. The bank's previous mid-point projection for end-2010 was at 5.4%. For 2011 the CBRT revised its CPI mid-point forecast to 5.2%, up from last October's 4.9% and for 2012 to 4.9% from 4.8%. Governor Durmus Yilmaz said recently that expected inflation pressures in the first months of 2010 are likely to prove temporary, adding that CPI is seen stabilizing at around 5.0% over the medium-term. With a number of major central banks expected to embark on monetary tightening as early as in the second semester of this year, we expect the CBRT to start hiking its key policy rate from late Q3/early Q4, delivering some 150bps of cumulative tightening by the end of the year. Fiscal slippage ahead of the general elections in late 2011 and the absence of an IMF policy-anchor constitute upside risks to our interest rate forecasts.

2009 budget deficit lower than expected, but up strongly from a year earlier

Last year's budget deficit outperformed expectations *(government forecast at -6.6%-of-GDP)* coming in at TRY 52.2bn or 5.5%-of-GDP. Nevertheless, the shortfall tripled from a year earlier as the government employed a number of stimulus measures to underpin private consumption against a background deepening recessionary pressures. Finance Minister Mehmet Simsek noted that the government managed to raise tax revenues in spite of the stimulus measures adopted. Looking into 2010, a gradual recovery in domestic demand will likely bring additional revenues to state coffers. Tax hikes in petrol, tobacco and alcoholic beverages are also likely to assist narrowing the fiscal shortfall in the months ahead. With regard to the budgeted pension hikes in 2010 *(estimated to total TRY 3.042bn),* the cabinet stressed that they will not affect fiscal discipline. Along these lines, we expect the budget to record a deficit of 4.5%-of-GDP in 2010, marking a 1ppt improvement from last year.

Written by:

Galatia Phoka
Emerging Markets Analyst
gphoka@eurobank.gr

Special focus - Turkey

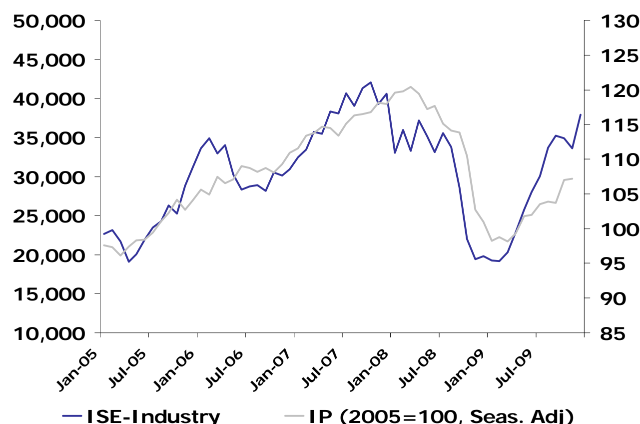
Strong GDP growth rebound in 2010 to be mainly driven by inventories and base effects

- **Our 2010 growth forecast for Turkey's GDP stands at 5.0%.** However, that will be discernible more by statisticians and economists, rather than by the man on the street
- **We estimate around half of this year's growth to stem from inventory accumulation.** This is crucial for investors, as growth driven by inventory accumulation does not necessarily produce earnings growth
- **Growth will not be uniform across sectors of the domestic economy.** Those sectors that have benefited from the tax incentives might find it difficult to replicate past year's performance, unless any ensuing shortfall in domestic sales shortfall is counterbalanced by exports
- **With respect to the 2010 growth outlook in the domestic manufacturing and services, we recognise that this will not be uniform across sub-sectors:** there are sectors that may exhibit double-digit growth and others we expect to contract further. The year 2009 sets a low base for some sectors, though others, especially those that have benefited from tax incentives, will be cycling a period of strong growth, making it difficult for them to outpace their 2009 performance

Rapid economic recovery is probably the most compelling theme to attract investors in 2010

Undoubtedly, this is of particular importance for Turkey, a county that has been severely hit by the global crisis, despite its healthy banking system and low leverage relative to other economies in the region. With domestic markets having recovered sharply from their March 2009 lows and the CBT having already completed its rate-cutting cycle, a fresh theme is needed to drive a further appreciation in Turkish asset markets in the months and quarters ahead. Arguably, that could be a pace of economic growth that outpaces that in other large emerging market economies.

Graph 1
Industrial Production vs. ISE-Industry



Source: ISE, TURKSTAT, EFG Istanbul

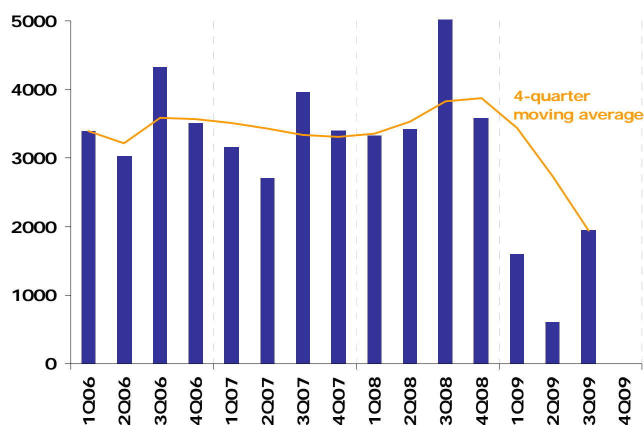
Poised to achieve trend growth rate; yet, half of it likely to emanate from inventory accumulation

We forecast 2010 economic growth at 5.0%, which is above the market consensus of 3.7% and the government's projection of 3.5%. Yet, almost half of our growth forecast stems from inventory accumulation. It is worth noting here that TURKSTAT does not measure inventories; rather, it calculates their changes as the residual between GDP estimates based on expenditures and production. Thus, the data include errors and omissions, along with the actual change in inventories, making it difficult to predict the latter. According to TURKSTAT, in the first three quarters of 2009 inventories dropped by 45% and 60% respectively, from their levels in 4Q08 and 3Q08. Over the last decade, inventories have never increased in the fourth quarter. Thus, even if we assume that no further declines occurred in 4Q09, inventory levels at the end of 2009 were likely significantly lower than in the preceding years.

Graph 2 depicts the evolution of a *proxy variable* we use for the level of inventories[4].

[4] Here we make an assumption regarding the value of that variable in 4Q97 and use TURKSTAT´s change-in-inventories data to calculate the representative *level* of inventories.

Graph 2
Inventory Level



Source: TURKSTAT, EFG Istanbul

Our calculations suggest that if domestic producers were to decide to rebuild their inventories so that their end-2010 levels reached the corresponding 2007-2008 average, full-year real GDP growth would bounce to 3.5%. That is, even if consumption, investment and net exports remained unchanged throughout this year. Of course, the argument above is somewhat cyclical in the sense that the assumed rebuilding of inventories will only occur if producers forecast improving domestic-demand dynamics in the period ahead. Yet, in an environment of relatively high inflation, maintaining a high level of inventory does not necessarily constitute a significant problem for producers, as the prices of products maintained in the warehouse increase over time. On the flipside, in an environment of low inflation or even deflation, products in the inventory might even cause companies to incur losses. During the recent crisis, we have indeed seen a number of companies caught up with massive inventory levels, which they have generally failed to whittle down. As such, in our 2010 GDP forecast we assume that producers will build up their inventories by a much slower pace than back in 2007-2008. Specifically, assuming that the annual pace of inventory rebuilding reaches 30% this year this would contribute around 2.5ppts to full-year GDP growth.

Private consumption to be a positive contributor to GDP growth this year…

Consumer spending is forecast to grow by c.a. 2.5% in 2010, contributing some 1.6ppts to full-year real GDP growth. If the tax incentives applied in 2009 had not brought durable goods consumption forward, we might even forecast a higher growth rate for private sector consumption in 2010, especially in view of lower interest rates on loans relative to last year. However, with a significant portion of demand for durables already satisfied in 2009 and with no significant jump expected in other consumption-demand components such as energy, food and clothing, we regard our 2010 consumer spending forecast to be a generally realistic one.

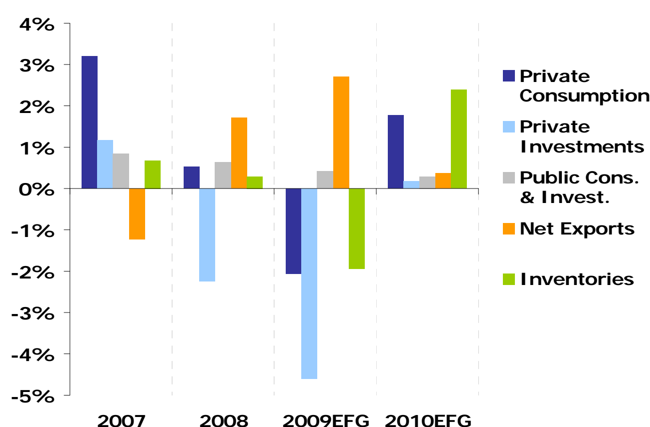
…but investments will likely be slower to rebound

As of December 2009, 13 of the 22 subsectors in the manufacturing industry were utilising less than 75% of their capacity, with 8 of them running utilisation levels below 70%. Given low capacity utilisation rates in many sectors, and with parliamentary elections in the horizon, we expect investment spending to remain broadly subdued for the greater part of 2010, with its contribution to full-year GDP growth amounting to around 0.5ppts. Given this year's budgetary constraints, we reckon that public sector consumption will not contribute substantially to economic growth. Even though we anticipate some populist spending on the eve of the 2011 elections, we still estimate a slight decline in public sector investment expenditures this year.

Net exports' contribution likely to turn slightly negative this year

With respect to external sector developments, although we expect 16% growth in exports, the contribution of net exports to growth will likely turn marginally negative this year, as imports are forecast to rise slightly faster than exports. All in all, we expect economic growth to reach 5% in 2010; but since half of this is expected to emanate from inventory accumulation, the improvement in economic activity will not be what GDP growth that rate would normally imply.

Graph 3
Contribution to Growth Rates, 2007-2010



Source: TURKSTAT, EFG Istanbul

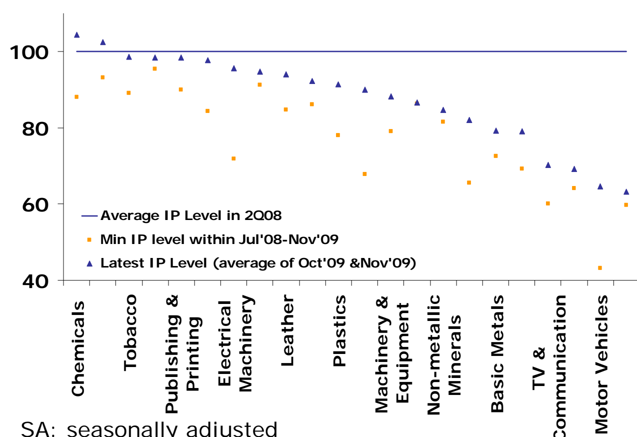
A non-uniform sectoral growth profile

With respect to the outlook for 2010 growth in the manufacturing and the services sectors, we recognise that this will not be uniform across sub-sectors: there are sectors that could exhibit double-digit growth and others we expect to contract further. The year 2009 sets a low base for some sectors, though others, especially those that have benefited

from tax incentives, will be cycling a period of strong growth, making it difficult for them to outpace their 2009 performance.

Graph 4 shows production levels on a sectoral basis. The blue line represents the average level of industrial production in 2Q 2008 i.e., a quarter before the Lehman Brothers collapse and the ensuing intensification of the global crisis. In order to facilitate a cross-sector comparison, we next set the level of production for all sectors in 2Q08 at 100. The orange squares indicate the lowest level of production in the post-crisis period. In some sectors, the lowest level was observed in December 2008; in others the trough has been registered during the first four months of 2009. The dark blue triangles indicate the latest level of production, again with respect to the level of output in 2Q 2008. The four orange squares remaining above the blue line imply the sectors least affected by the crisis. In turn, the larger is the distance between the blue line and the orange squares, the greater the impact of the global crisis on the respective sector. On the other hand, the more distant is a blue triangle from the corresponding orange square, the faster the recovery in the sector.

Graph 4
Industrial Production (SA): Sector Performance, 2008-2009

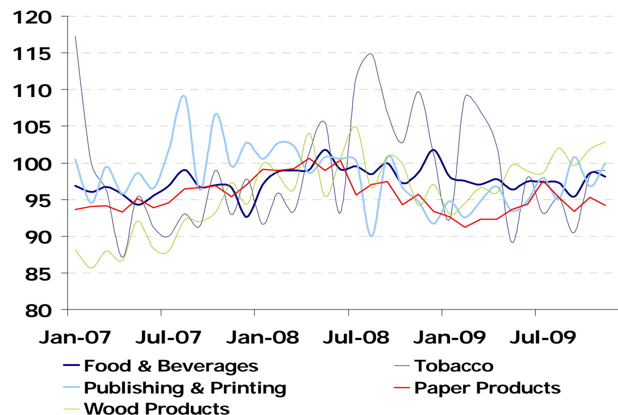


SA: seasonally adjusted
Source: TURKSTAT, EFG Istanbul

In line with the points made above, we have classified the manufacturing industry into four groups:

The first group is composed of sectors that have not been impacted much by the global crisis. It includes food; hotel and restaurant services; health; energy; tobacco; publishing; paper and wood products. We expect these sectors to maintain their robust performance in 2010, though we do not anticipate any significant acceleration in their output growth relative to last year.

Graph 5
Sectors Not Impacted Notably by the Global Crisis
Industrial Production Index, SA, 2007=100



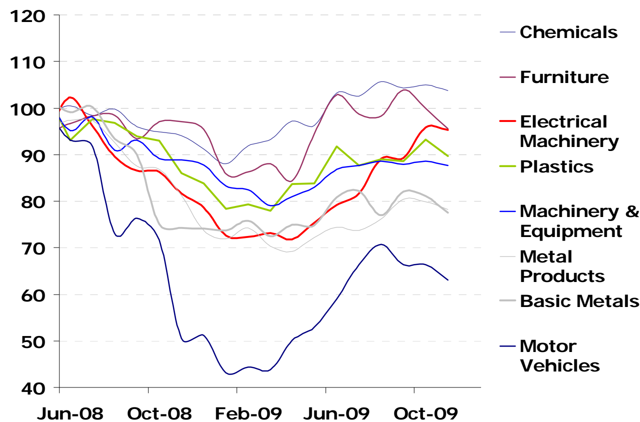
Source: TURKSTAT, EFG Istanbul

The second group includes the largest number of sectors within the manufacturing industry, including furniture; optical equipment; chemicals; electronics; machinery (including white goods); plastics; metals (iron and steel); and automotive sectors. These could be characterised as **sectors that were affected negatively by the global crisis, but bounced back notably** in the second and third quarters of 2009.

Production levels in some of these sectors -- eg., white goods, furniture and automotives -- have been bolstered by the tax incentives extended in the second and third quarters of 2009. Some other sectors in this group have benefited indirectly from these incentives, as they constitute intermediate goods utilised for the production of white goods, automotives and furniture.

EFG analysts expect output growth around 5% in the white goods and automotive sectors in 2010. Producers of intermediate goods for sectors such as iron & steel and electricity are expected to perform slightly better, registering growth of 5-10% this year.

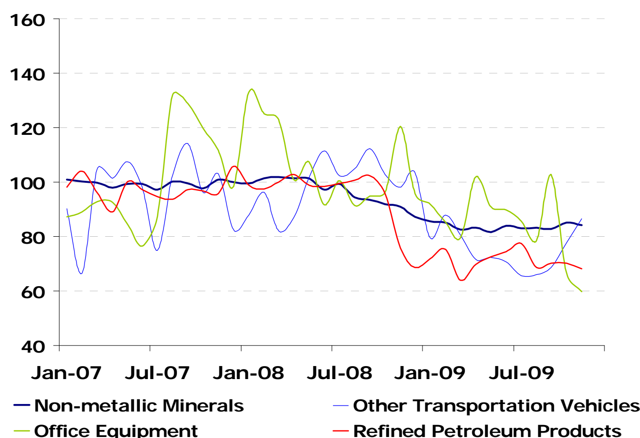
Graph 6
Sectors That Recovered Relatively Faster
Industrial Production Index, SA, 2007=100



Source: TURKSTAT, EFG Istanbul

The third group is composed of transportation vehicles (excluding automobiles); non-metallic minerals (sanitary products, ceramics and cement); office equipments; construction; and refinery sectors, **which were hammered by the global crisis and failed so far to recover.** We expect these sectors to improve their production levels in 2010, either due to improved export performance (eg., refined products) or as a result of a slight recovery in the construction sector following last year's steep downturn. Nonetheless, it is likely to take a couple of years for construction-related sectors to reclaim their 2006 performances.

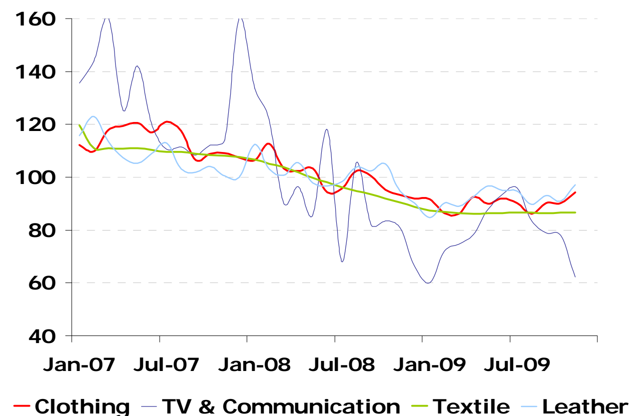
Graph 7
Sectors Impacted by the Global Crisis
and Failed to Recover
Industrial Production Index, SA, 2007=100



Source: TURKSTAT, EFG Istanbul

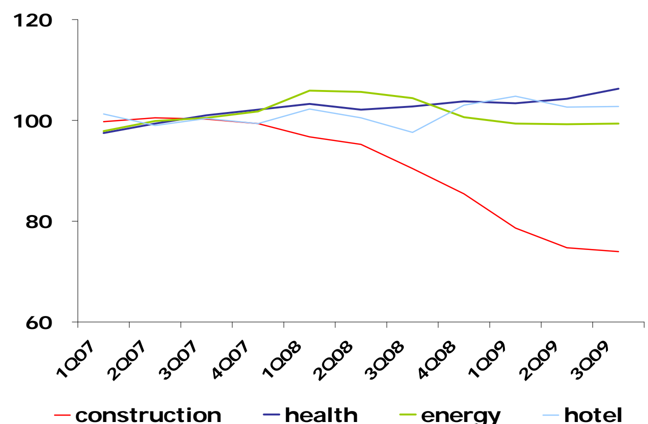
The fourth group is composed of sectors that were already on a deteriorating path prior to the global crisis and the downturn did not materially alter that trend in either direction. The fourth group includes textiles; clothing; leather; and radio-TV sectors to this category. While we maintain negative outlook for the former three, we are more optimistic for the prospects in the radio and television sectors, mainly due to the anticipated increases in the market shares of Turkish exports to the European market.

Graph 8
Sectors Already on a Deteriorating Path
Industrial Production Index, SA, 2007=100



Source: TURKSTAT, EFG Istanbul

Graph 9
Performance of Services, 2007=100



Source: TURKSTAT, EFG Istanbul

Relative Performance

Turkey features in the group of emerging market economies that have been particularly hit by the global crisis. Graph 10 and 11 portray the recent dramatic output losses in the manufacturing industry. Graph 10 shows the relative performance of EM industries. Graph 10 shows the level of (seasonally-adjusted) manufacturing industry production. For simplicity, we set all the levels of production in 2007 to 100 for all countries.

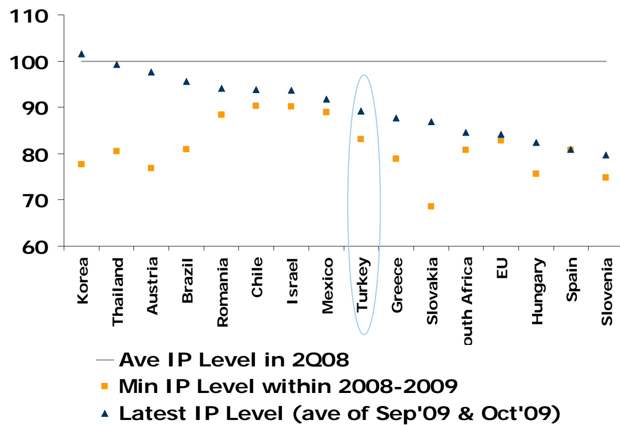
The graphs indicate that a recovery is under way in terms of production volume in Turkey. However, the recovery is not

vigorous enough to place Turkey among the top-performing group, which includes Brazil, Austria, Korea, and Thailand.

Graph 10

IP Performance by Country - I

Industrial Production Index, SA

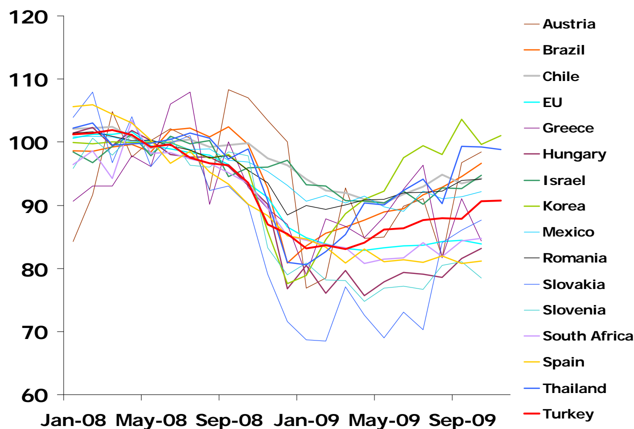


Source: TURKSTAT, ISI, EFG Istanbul

Graph 11

IP Performance by Country - II

Industrial Production Index, SA, 2007=100



Source: TURKSTAT, ISI, EFG Istanbul

Written by:

Baturalp Candemir

Chief Economist, EFG Istanbul Securities

www.efgistanbulsec.com

Ukraine

Persisting political uncertainty weighs on economic outlook

- **Favourable base effects and higher exports helping economy to rebound. Yet, turbulent political scene with successive presidential elections pose risks to the economic recovery**
- **Grim banking sectors developments with NPLs jumping to 9.7% in December from 2.8% in early 2009.**

Ukraine: Eurobank EFG Forecasts				
	2007	2008	2009e	2010f
Real GDP (% yoy)	7.9	2.3	-14.0	1.5
Private Consumption	17.2	21.7	-13.5	1.5
Government Consumption	2.5	29.8	1.8	0.5
Gross Capital Formation	23.9	27.6	-49.0	2.0
Exports	3.3	30.2	-16.0	2.0
Imports	21.5	22.1	-35.0	0.5
Inflation (% yoy)				
CPI (annual average)	12.8	25.3	16.0	13.0
CPI (end of period)	16.6	22.3	12.3	11.0
Fiscal Accounts (% GDP)				
General Government Balance	-2.0	-3.2	-7.2	-4.0
Gross Public Debt	12.9	19.9	30.0	35.0
Labor Statistics (%)				
Unemployment Rate (% of labor force)	6.9	6.9	9.7	9.0
Wage Growth *(real - private sector)*	12.5	6.3	-10.3	-5.5
External Accounts				
Current Account (% GDP)	-3.7	-7.0	-1.7	-1.8
Net FDI (bn USD)	7.6	9.9	4.5	5.0
FDI / Current Account	143.0	77.6	230.0	300.0
FX Reserves (bn USD)	32.5	31.5	26.5	25.2
Domestic Credit	**2007**	**2008**	**Q2 09**	**Q3 09**
Total Credit (% GDP)	59.9	77.3	77.9	81.6
Credit to Enterprises (% GDP)	36.5	46.7	48.5	51.2
Credit to Households (% GDP)	22.5	29.5	27.7	28.2
FX Credit/Total Credit (%)	49.9	59.0	53.2	52.8
Private Sector Credit (% yoy)	74.9	68.5	32.9	23.9
Loans to Deposits	150.4	204.0	222.5	223.0
Financial Markets	**Current**	**3M**	**6M**	**12M**
Policy Rate	10.25	10.25	10.25	10.25
USD/UAH	8.03	8.00	8.40	8.70

Source: NBU, IMF, Bloomberg, Eurobank Research

Turbulent political scene with successive presidential elections

First round of Ukraine's presidential elections failed to produce a clear winner. Former President, Victor Yanukovych, who was ousted in 2004's elections, won the first round. He received 35.3% of the vote against Yulia Tymoshenko, the incumbent Prime Minister, who took 24.6%. This result came as no surprise given rising public disappointment with the government's efforts to tackle the steep domestic economic recession. Notwithstanding the former's comfortable victory at the first hurdle, the outcome of the February 7 run-off ballot proved out to be a much closer call. Arguably, as the Prime Minister was able to form political alliances and won votes from the candidates who participated in the first election round. Namely, Victor Yanukovych won in the second round receiving 48.23% of the vote against Yulia Tymoshenko who took 46.14%. Given the current fractious political situation, the result will in strong likelihood be contested in court with appeals of fraud. Whoever be the new president, will face immense tasks in the form of restoring Ukraine's financial credibility and getting the government to function properly. Moreover, the winner may prompt an early parliamentary election to consolidate its position, which would lead to a prolonged domestic political instability. What's more, due to the upcoming elections, the authorities are reluctant to pass any corrective fiscal measures. As a result, a full-scale fiscal deterioration is underway. On a positive note, the Ukraine's 5-year CDS spread has narrowed recently, indicating an improvement in investor sentiment towards Ukraine. (Figure1)

Figure 1

Recent narrowing in Ukraine's 5-Year CDS spreads

Source: Bloomberg, Eurobank Research

Lower floor on net reserves allows Ukraine to meet gas payments in Q1-2010

At the end of December, the IMF agreed to the government's request to lower by $2bn the floor on National Bank of Ukraine's net reserves. This important step will enable authorities to use existing resources to make external payments, and meet gas payments in Q1-2010. Thereafter, in the absence of any IMF financing, Ukraine will likely face increasing pressures to fulfil its debt obligations, despite its sizable FX reserves ($26.5bn at the end of December 2009 vs. $31.5bn a year earlier).

Favourable base effects and rebound in global trade helping economy to recover

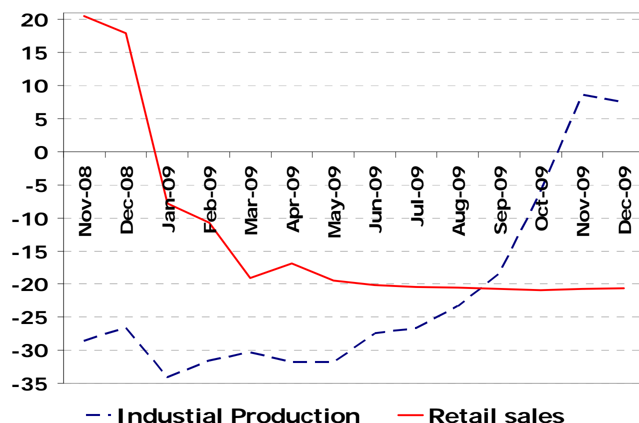
Although the likelihood of a prolonged political instability is still high, the economy shows some signs of stabilization, setting the base for a return to a growth path. Base effects are currently favouring industrial production readings, with many categories now witnessing double-digit year-on-year growth, following sharp falls in 2009. More precisely, Ukraine's industrial output returned to positive territory in November (+8.6% yoy), and expanded by a further 2.6%/7.4% mom/yoy in December (Figure 2). The improvement was driven by export-oriented sectors such as mining, chemicals and steel industries. Looking ahead, base effects will dominate the recovery and external demand will play a role in maintaining confidence.

Less encouraging is the continuing decline in retail sales (down by slightly more than 20% yoy in December 2009), indicating persisting weakness in domestic demand dynamics. (Figure 2) As a result of sluggish demand-side pressures, headline inflation fell to 12.3% yoy in December 2009, from 13.6 % yoy in the prior month and 22.3% yoy in January 2009. What's more, the annual real wage growth remains mired in a negative territory, indicating that economy will be rather slow to recover.

In our view, the successful completion of recapitalisations and consolidation in the domestic banking sector constitute a crucial prerequisite for a broad-based economic recovery. That is because this would support domestic demand and help ease credit conditions which remain very tight. Against this backdrop, we forecast a return to positive (yet, still well-below potential) GDP growth of around 1.5% this year, after an estimated contraction of 14% yoy last year,

Figure 2

Industrial output recovery favoured by base effects and higher exports; retail sales growth continue to record double-digit declines



Source: NBU, National Statistics, Eurobank Research

Current account balance improved sharply in 2009

According to National Statistics of Ukraine, the current account balance recorded a deficit of $1.9bn or 1.7% of GDP in 2009 compared to $12.8bn deficit or 7.1% of GDP in 2008. From the financing side, the financial account deficit in 2009 reached $11.8bn while in 2008 had recorded a surplus of $9.6bn. At the same time, inflows of foreign direct investment (FDI) remained subdued in 2009 and amounted to half of the FDI inflows recorded a year earlier. More than one-half of FDI inflows in the last two quarters of 2009 were linked to the recapitalisation of foreign-owned banks. We broadly expect the current account deficit to remain at late year's levels in 2010.

Hryvnia stabilises but downside risks persist

Despite increased political uncertainty and growing fiscal risks, the hryvnia managed to strengthen against the U.S. dollar since last September mainly due to an improvement in trade deficit. (Figure 3) Furthermore, the National Bank of Ukraine (NBU) has sufficient FX reserves to maintain currency stability in the short-term. A benign domestic political environment after the upcoming presidential elections should lend additional support to the hryvnia. A further rise in steel prices would also favour. Nevertheless, persisting political uncertainly, increasing fiscal problems and the absence/delay of new IMF financing constitute main downside risks to the hryvnia outlook in the period ahead.

Figure 3

Hryvnia: stabilising following recent appreciation

Source: Reuters, Eurobank Research

Grim banking sector developments

Total outstanding credit dropped by 1.5% year-to-November with credit to households declining by 12.6% over the same period. Even though total deposits grew by 0.8% mom in November, they decreased by 9.5% year-to-Novembers. As a result, Loans to Deposits ratio fell to 219.1% in November, from 223.1 a month earlier, yet remaining higher relative to January 2009 level (211.1%). An alarming rise in the number of NPLs has occurred in the more recent months;

they stood at 65,317 in November 2009 compared to 18,015 at the beginning of 2009. Accordingly, NPLs to total loans ratio jumped to 9.7% in November 2009 vs. 2.8% in January 2009.

Written by:

Dr Stella Kanellopoulou
Research Economist
skanellopoulou@eurobank.gr

Disclaimer

This report has been issued by EFG Eurobank Ergasias S.A. (Eurobank EFG), and may not be reproduced or publicized in any manner. The information contained and the opinions expressed herein are for informative purposes only and they do not constitute a solicitation to buy or sell any securities or effect any other investment. EFG Eurobank Ergasias S.A. (Eurobank EFG), as well as its directors, officers and employees may perform for their own account, for clients or third party persons, investments concurrent or opposed to the opinions expressed in the report. This report is based on information obtained from sources believed to be reliable and all due diligence has been taken for its process. However, the data have not been verified by EFG Eurobank Ergasias S.A. (Eurobank EFG), and no warranty expressed or implicit is made as to their accuracy, completeness, or timeliness. All opinions and estimates are valid as of the date of the report and remain subject to change without notice. Investment decisions must be made upon investor's individual judgement and based on own information and evaluation of undertaken risk. The investments mentioned or suggested in the report may not be suitable for certain investors depending on their investment objectives and financial condition. The aforesaid brief statements do not describe comprehensively the risks and other significant aspects relating to an investment choice. EFG Eurobank Ergasias S.A. (Eurobank EFG), as well as its directors, officers and employees accept no liability for any loss or damage, direct or indirect, that may occur from the use of this report.

Eurobank EFG Economic Research

More research editions available at
http://www.eurobank.gr/research

- ✓ **New Europe: Economics & Strategy**
  Monthly edition on the economies and the markets of New Europe
- ✓ **Economy & Markets**
  Monthly economic research edition
- ✓ **Global Economic & Market Outlook**
  Quarterly review of the international economy and financial markets

Subscribe electronically at ***http://www.eurobank.gr/research***