Eurobank Research
Eurobank EFG
New Europe Economics & Strategy
www.eurobank.gr/research
Issue 3 | March 2010

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Regional markets remain on a rising mode, but headwinds linger

Bulgaria: Economy likely hit bottom in Q4 2009

Poland: GDP growth accelerated further in Q4-09; prospects remain positive for this year

Romania: Abating inflation pressures allowed the NBR to cuts its key interest rate by a further 50bps to 6.50% on March 29. We see room for more policy easing ahead

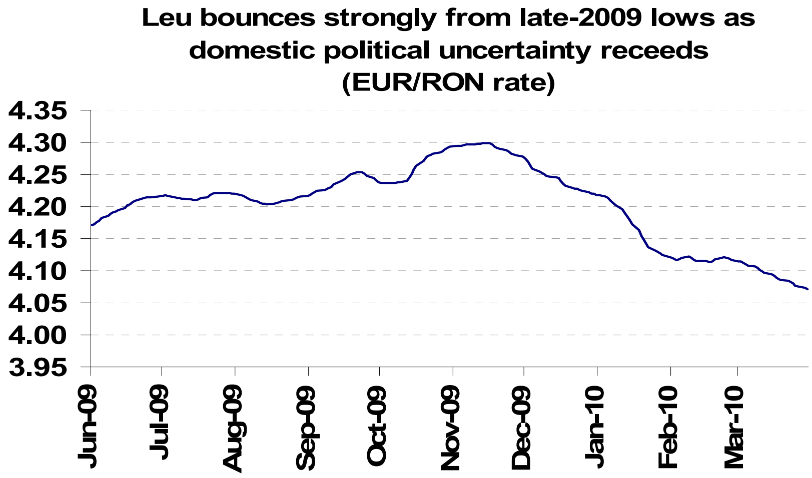
Serbia: Pressures on the dinar persist; resignation of NBS Governor Radovan Jelasic raises questions about future course of domestic monetary policy

Turkey: Politics taking centre stage once again, with jitters likely to escalate in the months ahead

Ukraine: Increasing signs of domestic political stability make swift restoration of IMF programme very likely

New Europe market strategy highlights

- **FX:** We expect the PLN to range trade in the coming weeks and underperform other regional currencies. We favour establishing short PLN/RON cash positions at 1.0534 targeting 1.0000 with a stop on a daily close above 1.0650. Elsewhere, the Turkish Lira is starting to look attractive again. We prefer to buy a 2 Month USD put/TRY call with strike at 1.50 and RKO at 1.43.
- **Local rates:** The time seems right to start paying rates in Poland. Polish bonds presently look expensive both on an outright and asset swap basis (Wibor-30bps). On Turkish local rates, we are currently neutral as positioning looks a bit crowded on the pay side.
- **Sovereign credit**: Credit spreads in Turkey remain well inside their pre-crisis levels. We tactically like owning some “cheap” protection in 5 year CDS. We remain positive on Romanian credit spreads looking for further normalization/ steepening of the credit curve.



Source: Reuters

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Introductory Comment

Dear reader,

Economic conditions in New Europe are improving faster than previously expected. High frequency indicators and survey data suggest we have already seen the worst of the downturn. Most economies in the region are now posed to feature positive, yet below potential, GDP growth in 2010. Thanks to improving conditions in major trading-partner economies, exports are expected to recover fast. The rebuilding of inventories and base effects also push growth rates to positive territory.

Yet unemployment continues to be on a rising path, credit growth is still anemic and disposable incomes are constrained by low wage growth and higher oil and food prices. Thus domestic demand dynamics remain weak. On a more positive note, serious economic imbalances and overheating conditions in domestic retail and real-estate markets appear a theme of the past that is not going to be repeated in the foreseeable future. GDP growth rates in Turkey and, to a lesser extent Poland, are now expected to outperform the rest of the league, partly because the global financial crisis found these economies with relatively low levels of financial leverage and in a better position to deal with external shocks.

Following a temporary slump early this year, local equity markets in New Europe have embarked on a new strong uptrend. Since early February, investor sentiment for the region is increasingly bullish, following the general market optimism of the global economy. Reflecting on these developments, major credit rating agencies announced a number of sovereign upgrades. In March, S&P raised Ukraine's sovereign rating and credit outlook and upgraded Romania's outlook to stable from negative. Fitch also raised Ukraine's outlook to stable from negative. In late February, S&P upgraded Turkey's sovereign credit rating following similar moves by Moody's in January and Fitch in December. In fact, we expect further rating upgrades in New Europe in the period ahead as economic conditions continue to improve and as many governments in the region take strong measures to remedy their worsened fiscal positions.

On the monetary policy front, most central banks in the region are likely to maintain their current stimulatory stance for longer than earlier expected thanks to subdued inflationary pressures and weak domestic demand dynamics. Receding expectations for higher policy rates in the euro area this year provide additional support to the latter view. Indeed, if regional central banks embark on a monetary tightening cycle well ahead of the ECB, widening interest rate differentials would risk undue excessive appreciation in regional currencies, with negative implications for competitiveness and exports. We continue to see room for further monetary policy easing in Romania and Hungary this year and expect higher policy rates in Turkey and Poland not earlier than in Q4 2010.

The recent sovereign debt crisis in the euro area has raised certain worries over the potential of spillover effects to the economies in the region, particularly from Greece to Bulgaria. The feared transmission channels are foreign trade, foreign investment and the banking sector. Yet, the gravity of the threat is likely to prove exaggerated. Bilateral trade between the two countries in 2009 amounted to no more than 7.2% of Bulgaria's total trade volume. Moreover, Greece is a long-term investor in the region with an uninterrupted presence from the early 90s.

Last but not least, the solvency and liquidity positions of Greek banks remain strong and their basic financial indicators wealthier than those of most of their competitors in the region. Moreover, the Greek government's strong determination to repair the country's fiscal position plus the recent supporting measures by the ECB and the Eurogroup are expected to gradually mitigate all market concerns and contribute to a sustained stabilization in the broader region.

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	2009e	2010f	2008	2009	2010f	2008	2009e	2010f
Bulgaria	6.0	-5.0	-0.5	12.0	2.5	2.0	-25.4	-8.6	-6.0
Poland	5.0	1.7	2.6	4.2	3.5	2.5	-5.1	-2.0	-3.0
Romania	7.1	-7.1	1.0	7.9	5.6	3.6	-11.6	-4.4	-5.5
Serbia	5.5	-2.9	1.5	12.5	8.2	5.0	-17.1	-5.7	-8.5
Turkey	0.9	-6.0	5.0	10.4	6.3	9.4	-5.7	-2.3	-3.3
Ukraine	2.3	-15.0	1.5	25.3	16.0	12.5	-7.0	-1.7	-1.8
New Europe	3.3	-5.1	3.1	10.7	6.8	6.9	-7.5	-2.7	-3.5
Euro area	0.6	-4.0	1.1	3.3	0.3	1.4	-1.1	-0.5	0.5
USA	0.4	-2.4	3.0	3.8	-0.4	2.3	-4.9	-2.8	-3.0

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	1.96	1.96	*Currency Board*		
Poland	**vs EUR**	4.15	4.10	3.80	5.00	3.50	3.75
Romania	**vs EUR**	4.03	4.23	4.10	10.25	8.00	6.00
Serbia	**vs EUR**	89.79	96.23	105.00	17.75	9.50	8.00
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
Euro area	**vs USD**	1.40	1.43	1.28	2.50	1.00	1.00
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

Global markets bounce from early February lows on improved market sentiment…

Since our last monthly update, risk sentiment has improved with major global equity markets recovering from their multi-month lows touched in early February. European Union leaders agreed to create a joint financial safety net to help crisis-hit Greece or any other euro area member state facing difficulties in accessing credit markets. The move removed the risk of sovereign default from a number of fiscally-vulnerable Eurozone countries. Separately, ECB President Jean-Claude Trichet announced that the central bank will maintain its present BBB- minimum rating threshold for collateral accepted against central bank funds beyond the end of 2010. This constitutes a positive development for lower-rated EMU sovereign credits, as uncertainty about becoming non-eligible next year has reduced certainly.

Elsewhere, a fresh flurry of robust real activity data coming from both sides of the Atlantic, reinforced optimism that the global economy remains broadly on a recovery path. Increased M&A activity news and the FOMC's renewed pledge at the March meeting to keep interest rates at current historically-low levels for an extended period, also enhanced market appetite for riskier assets.

In this environment, the FTSE Eurofirst 300 hit a 1½ year peak on March 25 while the S&P 500 index touched a fresh 18-month high earlier this month. The idex is now up by 11% from a three-month closing trough hit on February 8. In the European credit derivates market, the iTraxx Crossover index dropped to a two-month low of 407bps in mid-March after rising to levels above 500bps a month earlier, while the iTraxx Europe eased by some 16.5bps from a four-month high of 94bps in early February.

…but headwinds remain

Notwithstanding the improved global macro outlook, a sustained recovery remains uncertain and subject to several downside risks. The PBoC has delivered a cumulative 100bps of tightening in the Reserve Ratio Requirement so far this year, while ample liquidity conditions and mounting price pressures suggest potential for more aggressive policy tightening in the period ahead.

The fading effects of the massive support measures taken by governments around the world in response to the global crisis, add to market uncertainty especially as unemployment remains at historically high levels and lending conditions for consumers and businesses are still tight.

Furthermore, as economic and financial conditions have improved considerable in recent months, a number of major central banks have already started to implement a gradual phasing-out of ultra-stimulatory policies, with the ECB announcing in early March that it will return to ordinary competitive tenders for the 3-month loans as of late April. Further more, euro area sovereign debt worries are far from over despite the rescue mechanism agreed by EU leaders earlier this month.

Equity markets in New Europe post strong year-to-date gains on recovery hopes

Broadly trailing the positive momentum in global bourses, emerging stock markets have embarked on a new uptrend since early February, with the benchmark emerging equities MSCI index bouncing to an eight week high of 1,008 in mid-March. Meanwhile, equity markets in New Europe, which were among the most hit in 2009, have outperformed many of their Asian and LATAM peers in recent months. The consensus view is now that most economies in Central and Eastern Europe will fare better than their Western European peers.

The Emerging and Eastern Europe MSCI sub-indices each stood around 3.5% higher year-to-March 26, having recorded triple-digit gains since their lows touched in early March 2009. Their rally over the last twelve months outperforms a 110% jump in the main MSCI benchmark index of emerging equities over the same period. In spite of the most recent improvement in market sentiment, global recovery and sovereign credit concerns continue to keep market participants on the edge. The potential for further monetary tightening by the Chinese central bank is feared that it may choke a still fragile global economic recovery, while market jitters over euro area periphery sovereign credit markets are far from over.

Local rates markets remain near multi-year

Government bond yields in many New Europe countries hit new multi-year lows amid easing inflation pressures and accommodative central banks. A rally in regional currencies in recent weeks has also exerted downward pressures on bond yields across the region. Meanwhile, growing expectations that the ECB will not tighten its monetary policy this year -- in view of the lingering problems in Eurozone sovereign credit markets -- also adds to the view that central banks in New Europe are likely to refrain from hiking interest rates any time soon. The reasoning behind the latter argument is that if regional central banks embark on a monetary tightening cycle well ahead of the ECB, widened interest rate differential will potentially exert excessive appreciating pressures on the local currencies. As a result, exports in these economies are likely to suffer at a time when domestic demand dynamics remain weak.

In Hungary, the 3-year benchmark bond touched 4-½-year lows just below 6.00% on March 26 on rising expectations for further interest rate cuts by the NBH. This is especially true since the February CPI data signaled that inflation is likely to ease below the central bank's medium term target of 3.0% by early 2011. Government bond yields in Romania also declined over the last few weeks on expectations of further monetary policy easing in the coming months and a return to domestic political stability after the December presidential election. Romania's 3- and 10-year benchmark bond yields both slid towards 7.0% earlier in March from double-digit levels near 18.50% touched in late 2008-early 2009.

In spite of growing expectations that the central bank of Poland will be among the first in the region to incept monetary tightening, lower-than-expected CPI data for February and worries that the zloty's recent rally may impede a still fragile economic recovery pushed 2- and 10-year benchmark bond yields down by ca 50bps and 70bps to 4.7% and 5.5%, respectively.

On the flipside, Turkey's benchmark November 16, 2011 bond yield rose some 100bps to 9%, from lows hit late last year by the previous benchmark (May 11, 2011) as a result of heightening inflation worries. Turkey's central bank is expected to start hiking rates later this year (in Q4 2010 or earlier), having been holding its horses for several months now. Meanwhile, Romania's and Hungary's central banks are expected to ease their respective monetary policies further this year, albeit by a limited amount following hefty cuts in the recent past.

New Europe currencies firm to multi-month highs on improved investor sentiment towards the region

New Europe currencies vindicated our earlier expectations, staging a rally in recent weeks on improved investor sentiment. Expectations that the region's economies will fare better than most Western European peers provided support, while the potential for higher interest rate differentials vis-à-vis developed economies, also renders regional currencies more appealing.

Year-to-date, the Polish zloty is the major outperformer, having appreciated to as far as 3.8545 (15-month high) against the euro in early March. Romania's leu remains not far off a 14-month peak of 4.0466/EUR touched on March 24 on waning political risk and the resumption of the EUR 20bn IMF Stand-By Arrangement.

On the flipside, the Serbian dinar remains under significant pressure since late 2009 amid growing fiscal-related concerns, increased corporate demand for hard currency. The Serbian central bank intervened a number of times in the interbank market to support the RSD. Nevertheless, the EUR/RSD bounced to a new record peak above 100 earlier this month. Also backing the region's trend, the Turkish lira touched 7-month lows of 1.5641/USD in late February amid growing domestic political tensions.

External debt markets firm on improved risk sentiment

Emerging external sovereign debt firmed further over the last few weeks, with returns on the EMBI+ index having jumped by 30%yoy in late March. Reflecting the recent improvement in sentiment, emerging external debt spreads over USTs on the EMBI+ index narrowed more than 80bps recently to levels below 245bps.

In a similar note, five-year credit default swap spreads in New Europe have declined to new multi-year lows. The recent improvement in the region's external debt markets was also reflected in a number of sovereign upgrades by major credit ratings agencies. Namely, S&P raised in March Ukraine's sovereign rating and credit outlook and Romania's outlook to stable from negative. In late February the agency upgraded Turkey's following similar moves by Moody's in January and Fitch in December.

Economic recovery strengthens, but fiscal risks remain

With respect to real economy developments in New Europe, recent macroeconomic indicators add to the view that most economies in the region have already embarked on a sustainable rebound. Negative base effects and the rebuilding of inventories are expected to provide significant support to GDP growth readings ahead.

However, the recovery is expected to be slow and the region is expected to lag its emerging peers in Asia and LATAM. On the fiscal front, governments in the region are showing their commitment to fiscal consolidation after seeing their finances deteriorate sharply in 2009 due to a deep recession. As such, gradual improvements are expected to be witnessed this year although budget deficits in most CEE countries are likely to remain well above the EU's 3%-of-GDP threshold over the next couple of years.

A heavy political calendar ahead takes centre stage

On the political front, the recent developments in Romania and Ukraine raised hopes for a more stable environment in the period ahead. On the flipside political tensions in Turkey are escalating in an ongoing power play between the government and the secular elite. Taking into account that the next general elections are due in July 2011, the domestic political landscape is likely to prove noisy in the coming months. Parliamentary polls in Hungary take centre stage on April 11 and 25.

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II. New Europe Markets Outlook & Strategy

In FX, we see limited potential **for the Polish zloty to appreciate further** in the near term. Nothing echoes alarming yet, but trade is consensus and the Polish Central Bank's rhetoric appears poised against further appreciation at present. We expect the PLN to range trade in the coming weeks and underperform other regional currencies. We **favor establishing short PLN/RON cash positions** at 1.0534 targeting 1.0000 with a stop on a daily close above 1.0650.

Elsewhere, **the Turkish Lira is starting to look attractive again**. Risk premium is adequate and risks are correctly priced in, both in terms of political uncertainty and a dovish central bank. We expect the currency to gradually appreciate in the next 2 months, a move likely to trigger a less dovish monetary-policy stance and a higher yield differential. We **prefer to buy a 2 Month USD put/TRY call** with strike at 1.50 and RKO at 1.43 for a USD premium of 0.32%, for a maximum pay out of 14.4:1 (pricing at a spot reference 1.5340).

We also like the Serbian currency at current levels. Easing external pressures, the IMF program and budgetary consolidation all bode well for an improving growth and business environment ahead. An active Central Bank has intervened in a number of occasions in the f/x market (some EUR 562Mio sold by the central bank so far this year) and Central Bank FX reserves totaled around EUR 10.6Bio in January. Deposit rates are amongst the highest in the region, deeming the volatility-adjusted carry attractive. We favor **a short EURRSD spot position at 100.50** for a target of 95.50 and a stop on a close above 101.50.

In the local rates market, the time seems right to **start paying rates in Poland**. Positioning is clean (all payer positions unwound during the latest rates rally) and the Central Bank appears braced to soon start withdrawing ample liquidity from the system. Under this scenario, local bonds will probably underperform. As such, we would favor **short POLGB 4.75 Apr 2012 at 4.56%** targeting 5.00% with a stop on a daily close below 4.40%. Note that Polish bonds presently look expensive both on an outright and asset swap basis (Wibor-30bps). We would also **opt to close PLN 1year 1year FWD receivers** established in December 2009 at 5.57 now at 4.87.

On Turkish local rates, we are currently neutral as positioning looks a bit crowded on the pay side. Also, we expect the CBT to become less dovish gradually.

In regional credit markets, credit spreads in Turkey remain well inside their pre-crisis levels. We tactically **like owning some "cheap" protection in 5 year CDS**. As such we prefer buying the **5 year Turkey CDS at 158bps with a stop below 140bps**.

In Romania, credit markets continue to stabilize. Liquidity is ample and the new five year bond was successfully launched 2 weeks ago. We remain *positive* **on credit spreads looking for further normalization/ steepening** of the credit curve on 5-10 segment towards 50bps (pre-crisis levels). We also favor holding a **DV01 neutral 5-10 CDS steepener,** selling 5yr protection at 295bps (now 195bps) and buying 10yr protection at 300bps (now 207).

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III. New Europe – Country Analysis

Bulgaria

Economy likely hit a bottom in Q4 2009

- **Economic activity has likely hit a bottom in Q4, with unemployment recently hitting 10% levels**
- **Updated convergence program anchors expectations of fiscal-policy prudence maintenance of present currency board arrangement (CBA) until Euro adoption**
- **EU unblocks part of its structural and cohesion funds for Bulgaria, acknowledging recent improvements in domestic macro management**

Domestic economic activity likely hit a bottom in Q4; unemployment is set to rise further

According to preliminary national accounts data, GDP declined by 6.2% yoy in Q4 2009, a steeper pace of contraction relative to the prior quarter (-5.4% yoy) and below the -4.8% consensus forecast. In our view, the domestic economy hit a bottom in the last quarter of 2009 and economic activity is set to recover slowly in the coming quarters. On a more negative note, we expect the domestic labor market to remain weak throughout the year. The unemployment rate has accelerated in recent months with registered unemployment approached the psychological rate of 10% in January (9.9%), having risen from levels around 6.5% in the same month a year earlier

Meanwhile, domestic demand dynamics remain weak and prospects of a swift turnaround are rather limited. The fiscal tightening implemented by the new government in late 2009 weighted negatively on growth. It contributed to a further slump in private consumption by 9.2% yoy in Q4 following a 4.2% yoy contraction in the prior quarter. Accordingly, retail sales contracted by 11% yoy in December compared to 10.1% yoy in November and 8.8% yoy in October. News from the real estate sector -- i.e., the locomotive of investments in the booming years – are not encouraging either,. Construction output plunged by 33.3% yoy in December, after a 21.9% yoy slump in November, even though sentiment in the sector recorded a minor improvement.

On a positive note, high frequency indicators portray a less grim picture for export-related sectors. Exports of goods in euro-terms grew by 3.9% yoy and 4.8% yoy in November and December 2009, respectively after remaining in a contractionary territory for more than a year. The recovery was assisted by base effects, improving conditions in major trading-partner economies and higher commodity prices. In line with these developments, the contraction of industrial

Bulgaria: Eurobank EFG Forecasts

	2007	2008	2009e	2010f
Real GDP (yoy%)	6.2	6.0	-5.0	-0.5
Private Consumption	5.3	4.8	-6.2	-2.1
Government Consumption	3.1	0.0	-5.7	-0.1
Gross Capital Formation *(Fixed)*	21.7	20.4	-26.9	-8.7
Exports	5.2	2.9	-9.8	2.3
Imports	9.9	4.9	-22.3	-2.8
Inflation (yoy%)				
HICP (annual average)	7.6	12.0	2.5	2.0
HICP (end of period)	11.6	7.2	1.6	2.3
Fiscal Accounts (%GDP) - *EU Methodology*				
General Government Balance	0.1	1.8	-0.8	-1.2
Gross Public Debt	18.2	14.1	16.1	16.2
Primary Balance	1.1	2.7	0.0	-0.3
Labor Statistics - *National Definitions*				
Unemployment Rate (% of labor force)	7.7	6.3	7.6	9.0
Wage Growth *(total economy)*	19.5	26.5	8.5	2.0
External Accounts				
Current Account (% GDP)	-25.2	-25.4	-8.6	-6.0
Net FDI (EUR bn)	8.8	6.2	3.3	2.0
FDI / Current Account (%)	114.0	75.8	103.6	100.0
FX Reserves (EUR bn)	11.9	12.7	12.9	11.5
Domestic Credit	**2007**	**2008**	**Q3 09**	**Q4 09**
Total Credit (%GDP)	67.2	75.2	77.4	79.2
Credit to Enterprises (%GDP)	43.0	47.8	49.7	49.4
Credit to Households (%GDP)	23.0	26.0	27.4	28.2
FX Credit/Total Credit (%)	50.4	57.2	58.4	58.6
Private Sector Credit (yoy)	65.9	32.3	5.9	4.5
Loans to Deposits (%)	97.0	119.3	118.9	120.5
Financial Markets	**Current**	**3M**	**6M**	**12M**
Policy Rate	Currency Board			
EUR/BGN	1.96	1.96	1.96	1.96

Source: National Sources, Eurostat, EcoWin, Eurobank Research

output has recently showed some tentative signs of bottoming out. Industrial production receded by 12.1% yoy in December but losses were contained to -0.9% yoy in January. This performance is by far better compared to the same period of last year. In addition, the contraction of industrial sales eased to -8% yoy in December and to -2.8% yoy in January, following double-digit declines in the prior two months (down 19% yoy and 25% yoy in November and October, respectively).

Domestic economy hit by the global crisis less severely compared to other fixed-exchange-rate-regime countries in the region

After enjoying average growth of 6% in 2005-2008, the economy entered a severe recession last year, with real GDP declining by 5.1% yoy i.e., a slightly faster pace of contraction relative to that we forecast back in December 2009 (-4.9%), Yet, last year's downturn turned out milder than feared earlier *(e.g., back in October 2009, the IMF forecasted a 6.5% contraction in the Bulgarian economy in 2009)*. In addition, it compares favorably to other New Europe counties featuring rigid exchange rate regimes (i.e. Baltic States).

Contraction was widespread in all elements of economic activity in 2009. Private consumption and investments declined by 5.9% yoy and 24.9% yoy respectively. The pace of decline in imports was more than double that of exports (-21.8% yoy vs. -10% yoy), with the external sector's contribution turning significantly positive after being a drag on GDP growth in previous years.

As we have alluded in previous issues of our New Europe Economics & Strategy, the economy is undergoing a painful rebalancing which is not over yet. On the positive side, the improvement in the outlook of exports, combined with a higher share of exports on GDP (50% of GDP in 2009) inspires optimism that net exports will remain a positive contributor to growth in 2010, albeit to a lesser extent compared to last year. On the negative side, we do not foresee a strong rebound in domestic demand, given tight labor market conditions and the deceleration of bank credit to households and corporates.

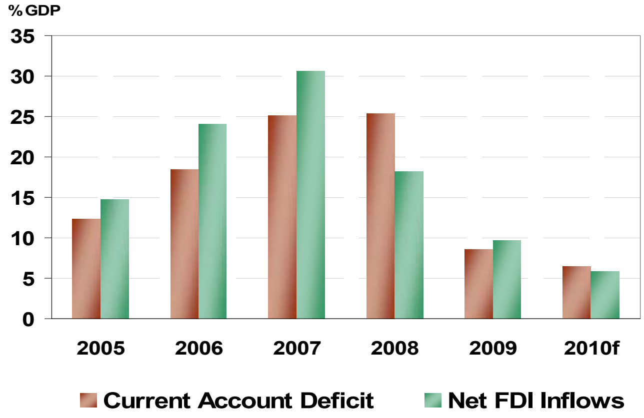
For those reasons, we have upgraded our forecast from -1.1% in our previous issue to -0.5% in 2010, with risks still tilted to the downside. Our forecast stands slightly below an (upwardly revised) forecast of 0.3% included in Bulgaria's updated convergence program, which was submitted to the European Commission earlier this year. A similar view is now shared by IMF who has upgraded its forecast for GDP growth in 2010 to 0.3% as well.

Current account improvement outperformed market expectations in 2009.

The global financial crisis had a more dramatic impact on Bulgaria's balance of payments than that expected earlier.. The current account deficit declined by 66% yoy, reaching €2.9 bn, compared to €8.6 bn in 2008. In percentage of GDP terms, the current account gap fell to 8.6% in 2009, compared to earlier forecasts of double-digit reading and a 25.4% deficit in 2008. The sharp slowdown in domestic demand facilitated a sizeable adjustment in the trade deficit, which registered a 52.5% yoy decline. That came as a result of exports declining by 22.5% and imports shrinking by 33.3% over the same period. Other elements contributed to the 2009 current account improvement as well. The services surplus increased by 77.2% yoy as net revenues from tourism remained strong. In addition, the income deficit came out much lower (down by 45.3% yoy) because foreign-owned companies paid out less dividends to mother companies abroad.

From a financing point of view, capital inflows were sharply lower (-77.8% yoy) in 2009. The most important component, net FDI inflows, dropped by 55% yoy to €2.7 bn, from €6.0 bn in 2008. The sectors affected the most were real estate and financial intermediation. However, the FDI-to-current account coverage improved to 93%, from 70% in 2008. The private sector proved capable of rolling over its debt obligations. In fact, the private sector gross external debt, edged up to 98.9% of GDP compared to 96.7% in 2008.

Figure 1
The current account deficit shrinks below forecasts



Source: National Statistics, Eurobank Research

International reserves (FX reserves plus gold and IMF drawing rights) were maintained at relatively high levels (€12.9 bn or 38.2% of GDP at the end of 2009), enough to cover potential financing needs despite earlier concerns to the opposite. International reserves' coverage of short term debt improved to 99.3% in 2009 vs. 97% in 2008, though remaining significantly lower than 130% in late 200.

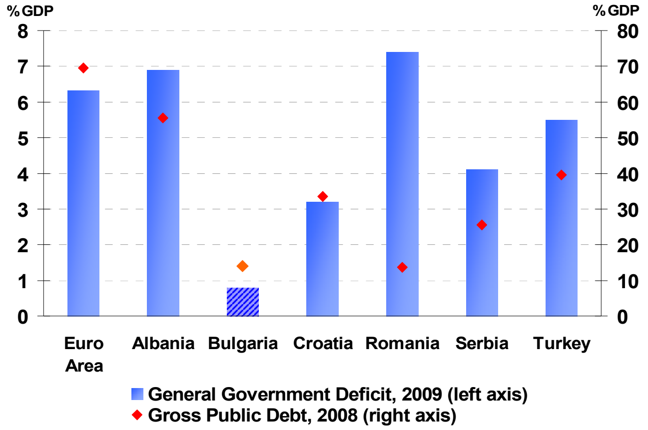
Bulgaria's ERM II entry prospects

The recent sovereign credit crisis in the euro area has raised concerns about Bulgaria's aspirations to apply for ERM II entry. Analysts are worried that the crisis may actually strengthen arguments against the enlargement of euro area or lead to a revision of the criteria used to assess the eligibility of prospective EMU members. Apart from the five nominal convergence criteria, critics suggest that additional emphasis will need to be placed on real convergence indicators *e.g.,* macroeconomic imbalance. Yet, as it is widely known, a country's ERM II entry is not formally decided on the basis of the degree of fulfillment of the formal EMU criteria. A broad consensus should be reached among EU institutions for Bulgaria to be allowed to enter ERM II. Bulgaria last attempted to enter ERM II back in 2008, albeit unsuccessfully. At that time the application was rejected purely on the basis of macroeconomic imbalances. The domestic economy was at an overheating phase back then, with inflation and the current account ratio standing at double-digit rates.

In terms of the formal Maastricht criteria, most of them are presently fulfilled. First of all, Bulgaria is one of the most fiscally-sound regional economies, currently enjoying the lowest fiscal deficit (as % of GDP) in the EU. After recording sizeable fiscal surpluses in the years preceding the eruption of the global financial crisis, Bulgaria recorded a minor budget deficit of 0.8% (cash basis) in 2009. The ESA95-equivalent deficit in 2009 was slightly lower than 2%-of-GDP i.e., comfortably below the 3%-of-GDP fiscal stability threshold. Moreover, the public debt ratio stood at 16.1% of GDP at the end of 2009, significantly below the Treaty's 60% threshold. On top of all that, the government's firm commitment towards fulfilling EMU criteria cannot be challenged. The Bulgarian government has a strong past record of fiscal consolidation even in recessionary times. As a result, the updated convergence program anchors expectations for a continuation of prudent fiscal policies and the maintenance of the currency board arrangement until euro adoption.

Figure 2

The most sound fiscal position in the EU



Source: National Statistics, Eurostat, IMF, Eurobank Research

The calendar of important dates

There have been months of speculation over when an application for ERM II entry will be submitted this year. Initially, the government had announced that it would seek to apply for ERM II entry in late 2009. Later on, it was announced that the government would file for an application after the appraisal of its updated convergence program. At this point, ERM II application is expected to take place some time until the end of June when the Spanish Presidency ends.

Looking ahead, three important EU reports this year could help to shape the outlook of Bulgaria's ERM II candidacy. The EU commission has published in late March its appraisal of Bulgaria's updated convergence program. The Commission opinioned that at the present economic juncture, the aim to maintain a sound budgetary position is a credible one. In addition, the EU´s interim report (published in late March), contained a relatively positive assessment of the progress Bulgaria has made so far with respect to judicial and administrative reforms. Nevertheless, the report was still cautious in its praise and has stressed the need to see more results on the ground. In turn, the progress with structural reforms has helped unblock part of the EU structural funds. Indeed, EU commission unblocked €8.2 bn in 7 operational programs. Finally, the ECB will publish the Convergence report in May to assess the extent to which the country fulfills the nominal criteria to enter the EMU.

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Focus - Bulgaria

Any contagion effects from the recent sovereign debt crisis in the euro area?

Since the Greek debt crisis erupted in late 2009, and the problems of the European economies of the South and Ireland came once again in the limelight, analysts have been expressing concerns about possible contagious effects to the emerging economies of South Eastern Europe (SEE). The greatest fears have mainly concentrated over Bulgaria, the only EU country sharing a land border with Greece, and one of its main economic partners. Yet, murky enough though the prospects for a Greek recovery may seem, the gravity of the threat may have been exaggerated.

The feared transmission channels are mainly three: foreign trade, foreign investments, and the banking sector. There is a fourth channel as well, that of macroeconomic similarities: if speculators judge that a country has a structure of its economy similar to an attacked one, they guess it will react similarly on an attack, hence providing a motive to test it. A look at Bulgaria's macros, though, and especially fiscals, would reveal that this is not the case.

According to the Bulgarian National Bank, Greece was the second most important importer of Bulgarian products in 2009, and occupied the fourth place in the list of exporters to Bulgaria. However, bilateral trade between the two countries accounted just for €2,140m, that is, no more than 7.2% of Bulgaria's total trade volume, down by €696m (-24.5%) compared to the previous year.

This decline, a consequence both of the global crisis and of bilateral factors, is lower compared to the 29.2% contraction in Bulgaria's total trade volume. Greece imports from Bulgaria mainly industrial products, chemicals, minerals, fuel, and electric power. Bulgaria's main imports are industrial products such as steel, iron, mineral fuel, clothing, machinery, and electronic equipment. Although trade of these products will be hit by the recession, we do not think it is likely to collapse. Industry will, possibly to a lesser degree, continue to operate in both countries, and hence inputs with inelastic demand will continue to be traded. Greece remained the fifth most important trade partner of Bulgaria in 2009, as it has been for the past five years. Since 2001, Greece has remained among the top four importers of Bulgarian products, and among the top seven exporters to Bulgaria.

The second possible contagion channel is direct investment. By the end of 2009, Greece was the third most important investor in Bulgaria, with investment stock amounting €2,773m. Greek net FDI to Bulgaria plunged by almost 88% (to €48m) in 2009, compared to a 57% decrease in the aggregate FDI inflows to Bulgaria. Although in Q309 net disinvestment was observed, in Q409, and with the crisis in Greece unfolding, figures returned to positive ground. We do not believe that withdrawals of Greek companies from Bulgaria are a very likely scenario. Greece is a long-term investor in the region. It was one of the very first countries to invest in Bulgaria, and its presence has been continuous. In any case, Greek investment represents less than 7.7% of total foreign investment stock, in a period when SEE nations have started to adapt to the post-crisis reality: their growth model can no longer be based on abundant FDI inflows and credit expansion boosted by foreign capital.

As far as the third channel is concerned, the banking sector, the presence of Greek banks is indeed significant. Greece ranks first by either total assets or credit exposure in Bulgaria. Five Greek banks hold a 29% market share in the Balkan nation, with four of them being in the top ten banks. According to the Bulgarian National Bank, by the end of 2009, the loan exposure of these five banks amounted to €8,432m or 31.4% of total loans. Their share in clients' deposits was 24.9% (€5,552m), up from 23.3% (€5,013m) in 2008. In other words, deposits to subsidiaries of Greek banks increased by almost 11%, when the overall increase in the banking system was 3.5% (or 1.3%, excluding Greek banks).

Based on the above figures, several analysts claim that, due to the exacerbation of the Greek fiscal crisis, the stability of the Bulgarian banking system could be jeopardised. Recently, Bulgarian government officials, expressed worries that Greek banks in Bulgaria may be channelling funds out the country. A more careful assessment, however, would suggest that the presence of Greek banking groups in the country is not the primary source of a possible destabilisation. The Greek banking system is better capitalised and healthier than the systems of many other EU members. Apart from Greece, the other main players in the Bulgarian banking sector are Italy, Hungary, and Austria. According to the European Central Bank, loans to deposits ratio in Greece was around 82.1% by the end of 2009, far more comfortable than the 115.7% of the Euro Area. Even if securitisations and the other debt instruments are included, this ratio still remains below 106%. At the same time, the corresponding figure for Austria was 114%, for Hungary 141%, and for Italy over 130%. (see Table A)

Greek banks are exposed to the same risks as all of the other banks operating in SEE. It is true that the Greek fiscal problem has raised some additional concerns. One of its symptoms was the downgrade of the credit rating of Greek banks; the downgrade of their subsidiaries is expected to follow, exerting upward pressure to their lending rates. Fears have been expressed by some analysts that Greek banks may dry out, due to having difficulty to gain access to the interbank financial market. Recently however, the European Central Bank announced that the special regime concerning the minimum threshold in the collateral framework is to be extended beyond 2010, mitigating the above fears.

Moreover, we must note that the position of the Greek banks is quite strong, and their basic financial indicators sounder than those of most of their competitors. Their investment strategy has been quite prudent, so when the crisis struck, they were not exposed to toxic assets. The support package that Greek banking groups received from their government during the crisis was significantly smaller than similar packages in other Euro Area countries, and no banks have been nationalised, as it was the case in Austria. It is also worth noting that the total write-downs of Greek banks did not exceed €1.4bn, while Italian banking groups, for example, had to cross out almost €8bn of bad debt.

Table A
Financial Soundness Indicators of Countries' Banking Systems

%	Greece	Italy	Hungary	Austria
Total Credit to GDP Ratio	122.6	119.6	71.2	127.3
Private Sector Credit (yoy)	1.5	1.8	-3.7	-0.6
Loans to Deposits Ratio *(Private Sector)*	105.5	130.5	141.0	114.0
NPLs over Total Loans[1]	7.2	5.5 [2]	4.8	2.2
Core Tier I Ratio[1]	11.7	6.9	10.3	8.7
Cost to Income Ratio[1]	52.7	67.4	44.6	51.6
ROE (after tax)[1]	4.7	3.5	10.9	2.9
ROA (after tax)[1]	0.2	0.3	0.8	0.2
Market Share in Bulgaria	**29.0**	**16.3**	**12.3**	**9.4**
Total Assets (€ bn)	491.7	3748.6	130.7	1039.7

[1] Data for Greece: Q309, Austria and Hungary: Q209, Italy: 2008
[2] Data for Q109

Source: National Central Banks, ECB, Eurobank Research

Back home, Greek banks have started to feel the pressure from the fiscal crisis. Some analysts and Bulgarian government officials have expressed fears that they may start draining liquidity from their subsidiaries due to difficulties in obtaining financing. However, such fears have started to subside after the adoption of a stark fiscal adjustment package by the Greek government. As an indication, the Greek 10-year bond issue in early March was, once again, oversubscribed, and by more than three times this time. Not only were the worries concerning capital outflows dismissed by top Greek banks' officials, but also the Bulgarian National Bank reassured that there have been no liquidity outflows from the Bulgarian banking system towards subsidiaries' parent banks in Greece.

We do not believe that the feared stagnation in the credit market will be a setback in Bulgaria's fragile recovery. Credit is not expected to be a stimulant of growth in the Balkans this year. Twentieth-century economic history has shown that credit expansion follows rather than triggers economic growth. We do not doubt that the Greek fiscal crisis will have adverse effects on Bulgaria's economy; yet there is quite a distance between this and Bulgaria falling back into recession due to being contaminated by its neighbour.

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Poland

GDP growth accelerated further in Q4-09; prospects remain positive for this year

- **Updated convergence programme targets significant budget consolidation, with the general government budget deficit seen declining to 2.9% of GDP in 2012, from 6.9% and 5.9% in 2010 and 2011, respectively**
- **Polish real GDP growth accelerated to 3.1% yoy in Q4-09, from 1.7% yoy in the prior quarter, mainly on a higher positive contribution from net exports to the tune of 2.2ppts**
- **NBP maintains neutral policy stance since upside and downside risks to domestic economic growth and inflation remain balanced for the time being**
- **Household NPLs accelerate while growth in corporates' NPLs eases.**

Poland: Eurobank EFG Forecasts

	2007	2008	2009e	2010f
Real GDP (% yoy)	6.8	5.0	1.7	2.6
Private Consumption	4.9	5.9	2.3	2.7
Government Consumption	3.7	7.6	1.4	0.9
Gross Capital Formation	25.6	5.4	-13.1	1.8
Exports	9.2	7.3	-9.0	4.5
Imports	13.8	8.4	-14.2	3.0
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	50.7*	55.0
Labor Statistics (%)				
Unemployment Rate (% of labor force)	12.7	9.8	11.0	12.5
Wage Growth *(private sector - average)*	N/A	N/A	4.2	3.0
External Accounts				
Current Account (% GDP)	-5.2	-5.1	-2.0	-3.0
Net FDI (bn EUR)	13.2	8.0	6.1	7.5
FDI / Current Account	89.8	43.7	122.2	80.0
FX Reserves (bn EUR)	44.4	45.9	54.8	62.0
Domestic Credit	**2007**	**2008**	**Q3 09**	**Q4 09**
Total Credit (% GDP)	40.3	50.7	51.7	53.0
Credit to Enterprises (% GDP)	14.9	17.8	17.1	16.4
Credit to Households (% GDP)	22.0	29.3	30.9	31.2
FX Credit/Total Credit (%)	23.7	32.6	31.7	30.4
Private Sector Credit (% yoy)	33.5	38.1	18.4	7.0
Loans to Deposits (%)	92.9	105.2	104.0	103.2
Financial Markets	**Current**	**3M**	**6M**	**12M**
Policy Rate	3.50	3.50	3.50	3.75
EUR/PLN	3.89	3.85	3.80	3.80

*actual September 2009

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

Opposition party endorses the incumbent President to run for a second term

Poland's opposition party endorsed the incumbent President, Lech Kaczynski, to run for a second term. After Prime Minister's decision not to be a candidate in the presidential elections (due to be held in October this year), the ruling party will select its candidates in a primary election open to party members. The two candidates are the Foreign Minister, Radoslaw Sikorski and the speaker of the lower house of the parliament, Bronislaw Komorowski.

Optimistic convergence programme envisages sizeable fiscal consolidation

The general government budget deficit widened to 7.2% of GDP in 2009 from 3.6% of GDP in the prior year, mainly as a result of higher government spending on EU co-financed projects and weak tax revenues. Notably, higher than expected GDP growth in 2009 did not translate into higher revenue due to an unfavourable shift in domestic growth composition and structural changes in the tax system introduced shortly before the eruption of the global financial crisis. According to Poland's updated plan for euro convergence published in February 2010, the budget deficit will fall to 6.9% of GDP this year, with further declines envisioned in 2011 (5.9% of GDP) and 2012 (2.9% of GDP). Under the plan, the expected deficit declines rely mainly on higher economic growth. In 2010-2011, total revenues are expected to increase by 3% of GDP, while expenditures are expected to rise by 1.6% of GDP over the same period. However, a 3% of GDP drop in spending is envisaged in 2012 to meet the EU recommendation for a general government budget deficit below the 3% of GDP threshold. (Table 1) The measures designed to achieve these deficit targets include a gradual increase and equalization of the retirement age for men and women at 67 years, as well as an acceleration of privatizations starting from 2010.

Table 1
Realizations and Updated Convergence Programme's forecasts/targets

ESA95, % of GDP	2008	2009	2010	2011	2012
General government balance	-3.6	-7.2	-6.9	-5.9	-2.9
Total revenues	39.6	37.4	39.6	40.3	40.3
Total expenditures	43.3	44.6	46.5	46.2	43.3
General government debt	47.2	50.7*	53.1	56.3	55.8
Real GDP growth	5.0	1.7	3.0	4.5	4.2

** Actual September 2009*

Source: Poland's Updated Convergence Programme, February 2010.

Sizeable privatization receipts seen as a main drive of targeted fiscal consolidation

In view of the present challenging fiscal situation, the government is seeking as much as $10bn or PLN25bn from privatizations this year. Privatization receipts totaled PLN6.7bn in 2009. An amount of PLN3.6bn was raised earlier this year from the sales of a) 16% of the third largest power utility Enea SA (PLN1.13bn), b) 10% of copper maker KGHM (PLN2.06bn) and c) 11% of oil refiner Grupa Lotos SA (PLN406mn). Although this is a good start to the year, there is the risk of missing the 2010 target for privatization receipts, especially if global market conditions take a turn to the worse; already Enea was sold at 8% below its market price.

2010 fiscal target seems attainable

Even if this year's privatization revenues underperform official expectations, we believe that the 2010 budget deficit target is feasible as it is based on rather conservative macroeconomic assumptions regarding both real GDP growth (1.2% yoy) and inflation (1.0% yoy). This fact, most likely, will lead to positive revenue surprises in 2010 since the updated official estimation for 2010 GDP growth stands at 3% yoy.

Public debt-to-GDP ratio set to increase further before resuming a declining path

According to the latest available official estimates, the public debt ratio stood at 50.7.% of GDP in September 2009. Moreover, the Updated Convergence Programme sees ratio rising further this year and the next (to 53.1% of GDP and 56.3% of GDP, respectively) before embarking on a decelerating path thereafter, reaching 55.8% of GDP at the end of 2012. However, if Poland fails to achieve its ambitious deficit reduction targets for 2011-2012, the public debt risks to approach the constitutional threshold of 60% of GDP by the end of the forecasting period.

Polish economy accelerated by 3.1% in Q4-09

Polish economic growth accelerated to 3.1% yoy in Q4-09, from 1.7% yoy in the prior quarter, bringing the corresponding full-year GDP growth rate to 1.7% yoy. Data released for the final quarter revealed that net exports were the key drive of GDP growth to the tune of +2.2ppts. Domestic demand accounted for 0.9ppts of Q4-09 GDP growth, after exerting a drag in each of the three preceding quarters. Looking at the components of the Q4-09 GDP report, the pick up in fixed investment growth (+1.6% yoy) was rather impressive after two successive quarters of contraction. In 2010, we forecast GDP growth of 2.6% yoy. Real sector indicators for the first two months of 2010 do not give a clear picture of whether GDP growth will accelerate in the short term. We expect weak labor market conditions to prevent a stronger economic recovery this year; wage growth dropped to 0.5% yoy in January and real wages were once again in negative territory. More worrisome, unemployment rate stood at 13% in February compared to levels around 10.4% in the beginning of 2009. What's more, retail sales growth dropped to 2.5% in January from 7.4% in the previous month. On a positive note, Polish industrial output grew by 9.2% yoy in February due to a surge in autos and electronics. Companies are expecting a pick up in foreign and domestic demand hence they are building up inventories. This was the forth consecutive month that industrial output has risen on an annual basis, even if the increase was slightly lower than the market consensus (of 9.6% yoy).

Current account deficit narrowed in January

Balance of payments data in January showed a narrowing in trade balance to €-171mn from €-711mn in December, as a result of positive growth in exports and still declining imports. Moreover, FDI inflows of €1.25bn contributed to the decline in the current account deficit in January. As the Polish economy continues to grow, we expect the current account deficit to widen to ca 3% of GDP in 2010, from 2% of GDP in 2009.

Domestic inflation on a decelerating path

Polish inflation reached a 13-month low of 2.9% yoy in February compared to 3.5% yoy in the prior month. What's more, core inflation dropped to 2.2% yoy in February from 2.4% yoy in January and 2.9% yoy in October 2009 when it started declining. According to the National Bank of Poland (NBP), average annual inflation is expected to fall from 3.5% yoy in 2009 to 1.8% yoy this year, before rising to 2.4% in 2011 and to 3.5% in 2012. The projected inflation deceleration in 2010 is mainly attributed to base effects as well as to the expected currency appreciation. We foresee year-on-year inflation to average around 2.5% yoy in 2010 as rising unemployment and slowing wage growth will curb consumer demand but not that substantially.

NBP neutral on policy rates for the time being

Even though domestic activity indicators (e.g., Q4 GDP, industrial production and PMI indices) continue to signal strong growth ahead, there is still no sign of a potential rise in NBP policy rate in the next few months. This reflects several factors. Firstly, the recent sovereign credit crisis in the euro area has shifted ECB tightening expectations well into 2011. And, in the present challenging domestic and global environment, the NBP does not feel any pressing need to instrument a premature widening in interest rate differentials vis-à-vis the euro area (Polish reference rate stands at 3.5% while that of Eurozone at 1%). Secondly, the government's ambitious privatization program, if executed successfully, will provide ample FX inflows that may cause a further undue strengthening of the zloty. The latter obvious argues against an early NBP rate hike that could cause excessive currency appreciation with potentially negative implications for competitiveness and domestic growth prospects. Moreover, lower than expected growth and inflation readings could allow the NBP to stay put on rates for longer than currently anticipated. All in all, we expect the NBP to initiate a new tightening cycle no earlier than Q4 2010, with one or two 25bps rate hikes being delivered by the end of the year.

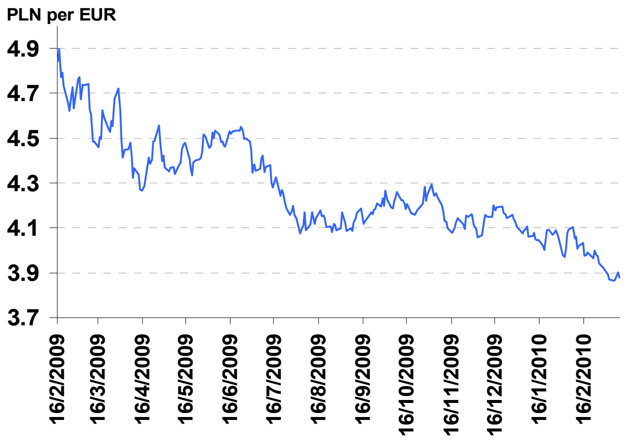
The government forecasts further zloty appreciation

In its updated convergence programme, the government revised its forecast on the (average annual) EUR/PLN rate in 2010 to 3.96, from 4.07 expected back in September 2009. Looking further ahead, the government expects the EUR/PLN rate to average at 3.69 in 2011 and at 3.55 in 2012. Our year-end forecast for the EUR/PLN currently stands at 3.80 per euro.

The zloty has appreciated by ca 20% cumulatively since hitting a five-year low of 4.89 vs. the euro in mid-February 2009, with its appreciation since the beginning of 2010 standing at 5.3%. (Figure 1) In January, the zloty traded at an average 4.06 per euro while the corresponding average in February was 4.01 per euro.

Figure 1

Zloty's appreciation supported by privatization flows



Source: Eurobank Research, Reuters.

Household loans still growing with dominating mortgages loans denominated in zloty

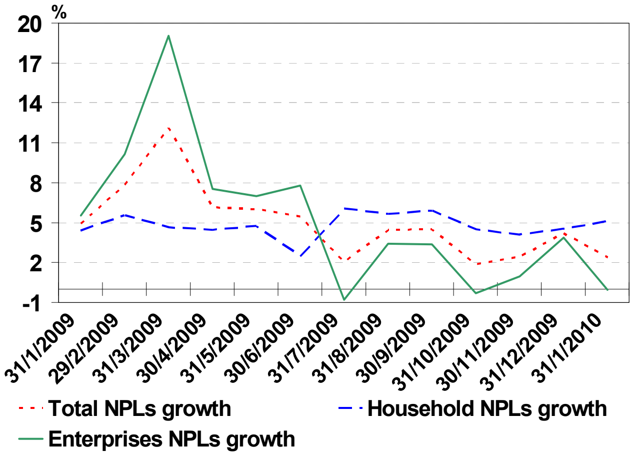
The Polish banking system has shown resilience to the recent global economic and financial crisis. Polish banks are predominantly domestic players and, as such, they have been partly insulated from the turmoil in world financial markets. Yet, this did not prevent domestic banks' cumulated profits declining by ca. 36% yoy in 2009. The tightening of banks' lending policies led, to a great extent, to contraction in lending; yet domestic credit is still showing positive growth (both on a year-on-year and a month-on month basis) led primarily by surprisingly strong consumer lending. Total credit stood at 6.5% yoy in January 2010. An important distinction needs to be made between household loans, which remain in growth mode (+8.5% yoy in January 2010), and the corporate loans segment which dropped by 5.6% yoy over the same period. Moreover, mortgages loans increased by 6.9% yoy in January. Due to the drying up of foreign currency; funding zloty mortgage loans rose faster in 2009 than mortgages denominated in foreign currencies (28% yoy and 4.5% yoy respectively) in contrast to the previous year's trend. At the same time, total deposit growth decelerated significantly and stood to a single digit figure of 9.1% yoy in January 2010. Consequently, Loans to Deposits ratio increased to 103.9% at the beginning of this year.

Household NPLs accelerate, while growth in corporate NPLs eases

Risks to the Polish banking sector lie in the face of an accelerating trend in non-performing loans (NPLs). In January 2010, NPLs jumped to 49.5bn zloty, their highest level since February 2004. This represents an increase of 77.5% relative to January 2009 (with zloty appreciating by 9.1% over the same period). Corporate bad loans rose by 44.5% yoy in January 2010, with the higher NPL ratio recorded in the manufacturing sector. The sector accounts for 30.5% of the total corporate loans. In the same month, household NPLs increased by 42.9% yoy, reflecting deteriorating labour market conditions amid lower wage growth and rising unemployment.

On a more positive note, the growth of total NPLs is showing some signs of deceleration on a month-on-month basis; it grew by 2.3% mom in January 2010 compared to a peak of 12.1% mom in March 2009. Yet, the decomposition of NPLs gives a more mixed picture. There is acceleration in the growth of household NPLs; they grew by 5.1% mom in January 2010, while corporate NPLs growth was only 0.06% mom in the same month. (Figure 2)

Figure 2
NPLs growth on a monthly basis



Source: Eurobank Research, National Bank of Poland (NBP).

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Romania

Eurobond issue heavily oversubscribed

- **The government tapped successfully the international markets with a €1bn Eurobond issue, priced at 268 bps over mid swaps**
- **Standard & Poor´s Ratings Services revises its outlook on Romania´s long-term local and foreign currency sovereign credit ratings to stable from negative**
- **Economy is crawling out of recession; pace of GDP contraction slowed to 6.5% yoy in Q4 2009 from 7.1% yoy in the prior quarter**
- **Abating inflation pressures and still weak domestic demand dynamics allowed the NBR to cuts its key policy rate by a further 50bps in late March**

Q4 GDP growth underperformed market expectations; full-year output losses in 2009 turned out to be lower than feared earlier.

Romanian GDP contracted by 6.5% yoy in Q4, following a 7.1% yoy decline in the prior quarter. This was worse than analysts´ median forecast of a 6% yoy contraction. The data showed that the Romanian economy remained in recession in the last quarter of 2009 as real GDP growth declined by 1.5% on a quarter-on-quarter basis, compared to analysts´ expectations for a 0.5% rise, Yet, the breakdown of the data showed signs of a gradual improvement. Private consumption was slightly more upbeat than expected, growing by 1.1% qoq, with the corresponding year-on-year pace of contraction slowing down to 4.0% from 9.2% in Q3. On a less encouraging note, the plunge in investments accelerated even further to 31.4% yoy compared to 27.6% yoy in Q3. Elsewhere, the contribution of net exports remained positive, but was lower than in the prior quarter. Exports registered a 3.9% yoy rise in Q4 against a 3.7% decline in Q3. Nevertheless, the decline of imports halved to 11.1% Q4 against 20.3% yoy in Q3. From a sectorial point of view, industry is leading the way with a 4% yoy rise, which bodes well with a faster growth in exports in the period ahead. On a negative note, construction remained in a contractionary territory in Q4, declining by 15.9% yoy.

The Romanian economy experienced its worst post-communist era recession in 2009, with its full-year GDP contracting by 7.1%, after growing by 7.3% in 2008. We forecast a switch to positive, though below potential, growth of 1.0% this year, mainly on the back of higher exports, inventory gains and base effects. On the other hand, domestic demand is expected to remain weak for the greater part of 2010, as rising unemployment (8.1% in

Romania: Eurobank EFG Forecasts

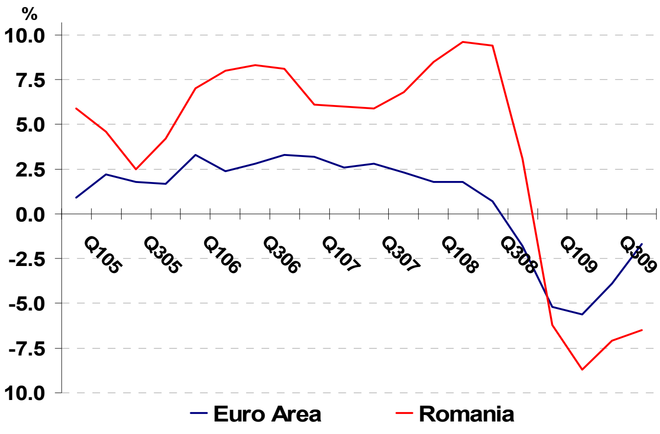
	2007	2008	2009e	2010f
Real GDP (yoy%)	6.3	7.1	-7.1	1.0
Private Consumption	10.3	8.7	-10.0	1.5
Govern. Consumption	7.7	3.8	1.2	-0.8
Gross Capital Formation	28.9	19.3	-28.0	2.0
Exports	7.8	19.4	-5.2	4.5
Imports	27.3	17.5	-21.3	6.0
Inflation (yoy%)				
CPI (annual average)	4.8	7.9	5.6	3.6
CPI (end of period)	6.6	6.3	4.7	3.5
Fiscal Accounts (%GDP)				
General Government Balance (ESA 95)	-2.5	-5.5	-7.8	-6.8
Gross Public Debt (ESA 95)	12.6	13.6	21.3	27.4
Labor Statistics (annual avg,%)				
Unemployment Rate (% of labor force)	4.3	4.0	6.3	9.0
Wage Growth (total economy)	22.6	23.6	8.4	1.0
External Accounts				
Current Account (%GDP)	-13.4	-11.6	-4.4	-5.5
Net FDI (EUR bn)	7.3	9.5	4.8	4.5
FDI / Current Account (%)	42.2	57.6	94.3	65.0
FX Reserves (EUR bn)	25.3	26.2	28.3	29.5
Domestic Credit *(end of period)*	**2007**	**2008**	**Q3 09**	**Q4 09**
Total Credit (%GDP)	39.0	42.7	48.3	50.2
Credit to Enterprises (%GDP)	18.0	18.8	19.2	19.6
Credit to Households (%GDP)	17.7	19.7	19.9	20.4
FX Credit/Total Credit (%, private)	51.0	53.1	59.7	60.1
Private Sector Credit (yoy)	60.4	33.7	2.4	0.9
Loans to Deposits (%)	108.9	131.9	128.8	130.6
Financial Markets	**Current**	**3M**	**6M**	**12M**
Policy Rate	7.00	7.00	6.50	6.00
EUR/RON	4.07	3.95	4.00	4.10

Source: National Sources, Eurostat, IMF, Eurobank Research

January 2010) and anemic credit growth will likely prevent a significant rebound in private consumption.

Figure 1

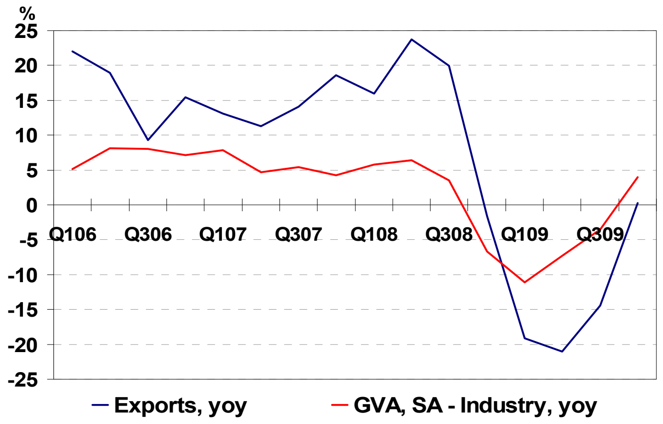
Romania is crawling out of recession slowly



Source: National Institute of Statistics of Romania, Eurostat, Eurobank Research

Figure 2

Industry is leading the recovery in Q4



Source: National Institute of Statistics of Romania, Eurobank Research

Rating upgrades, resumption of multilateral lending program strengthen appeal of RON-denominated assets.

On March 10, Standard & Poor's revised Romania's sovereign credit outlook to stable from negative and reiterated its current long-and short-term ratings (BB+ and B, respectively). The rating agency argued that the government will more likely continue to comply with the IMF/EU conditionalities, thus helping to further ease external financing concerns. The stable outlook also reflects the government' success with fiscal consolidation and it's determination to proceed with the required fiscal reforms.

The S&P move did not come as a complete surprise. Fitch took already similar action last February. The release of the second and the third tranche of IMF funds helped reduce external financing concerns. Romania just received €2.3 bn of funding from the 2nd and 3rd tranches, which brings the total amount of disbursements to €9.3 bn out of the €20 bn IMF-led support package. Half of the funds aim to address the external financing needs and boost currency reserves. The rest will be utilized to finance part of the budget deficit.

On a positive note, the credit outlook revision and the resuming of multilateral lending was undoubtedly good news for RON denominated assets. As a result, the government tapped successfully international markets for the first time since 2008. The Ministry of Finance sold € 1bn Eurobonds offering a 5.18% yield. The bond was priced at 268 bps above the benchmark mid-swap rate. The attractive yield compared to other bonds of equivalent ratings resulted in the five year bonds issue to be five times oversubscribed. Croatian bonds who share the same lowest investment grade rating from Moody's (Baa3) currently stand at ca 227 bps over mid-swaps.

Successful implementation of 2010 fiscal consolidation plan crucial for domestic macroeconomic stability

The IMF set the fiscal target at 5.9% of GDP in 2010, which implies a sizeable fiscal adjustment on the spending side. As a result, the implementation of the 2010 budget may well prove a Herculean task, as unpopular spending cuts may encounter significant resistance. The government has committed itself to cutting the public wage bill by 2 pps of GDP. The press has repeatedly mentioned that this necessitates some 100,000 lay offs in the public sector. On top of all that, the fiscal reforms agenda is quite challenging. The government, which enjoys a very thin majority in parliament, needs to go ahead with unpopular pension reforms after the adoption of the fiscal responsibility law.

In our view, a rigorous implementation of the fiscal consolidation program is of crucial importance for domestic macroeconomic stability. First of all, it is a prerequisite for the IMF to proceed with the multilateral lending program. In addition, one should not forget that the IMF had to revise the fiscal target of the agreement from 4.6% of GDP to 7.3% last year, thus offering the government additional room for fiscal policy maneuvering, particularly on the spending site. In our view, there is limited room for the IMF to be as lenient in 2010, especially if the credibility of the program is to be maintained. Secondly, rating agencies will be monitoring very closely government policies on structural reforms in the coming months in order to adjust their ratings. If the government shows firm evidence of succeeding in its fiscal consolidation plan, then rating agencies are likely to proceed with new rating upgrades by the end of 2010.

NBR cuts its key policy rate by a further 50bps to 6.50%

Recent benign CPI data (4.5% yoy in February vs. 5.2% yoy in the prior month) paved the way for further 50bps cut in the NBR key policy rate in late March. The excise duties and the regulatory prices hikes recorded in late December had limited second-round effects on domestic inflation. Food inflation, which carries a significant weight, was maintained close to zero levels (0.02% yoy in February). The appreciation trend of the RON (currently below 4.10/€ on improved investor sentiment) and favorable base effects led services inflation to decline even further to 2.8% yoy (0% mom) in February.

We argued in our previous issue of New Europe Economics & Strategy that we see room for a further 100 bps cut in the key policy rate in the absence of unpleasant inflation surprises or renewed domestic political jitters in the period ahead. We stick to that view and expect another 50bps cut in the NBR´s key rate as early as in May. We continue to see limited scope for the Central Bank to maintain real interest rates at their present (high) levels of ca 200bps, especially after the recent Presidential elections, which helped to ease domestic political tensions and uncertainties surrounding the smooth execution of the present IMF programme.

Looking further ahead, we see three important factors arguing in favor of the Central Bank maintaining its easing bias in the coming months: First of all, domestic demand pressures remain weak. This is reflected in both the most recent readings in a number of real activity data and the Core 3 measure of inflation which dropped to a historic low of 2% yoy in February. Second, provided that the strengthening trend of RON continues, it will maintain imported prices inflation low. Third, there is a marked improvement in liquidity conditions. Interest rates are now coming closer to the policy rates.

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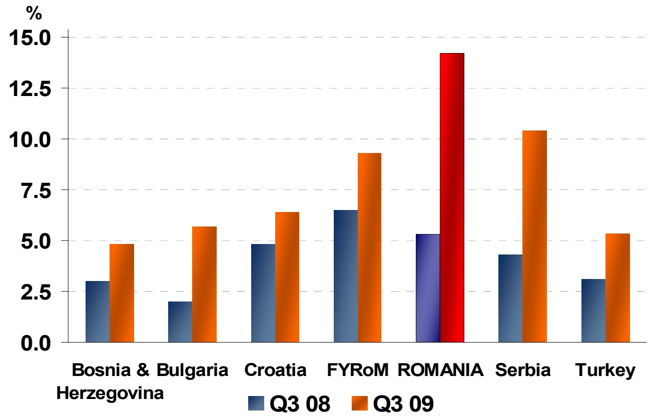
Recent credit developments and outlook

The recent financial crisis took a heavy toll o the Romanian credit market. Total outstanding credit grew by 9% yoy in January, the lowest rate in the last five years. In fact, the positive growth reading in January was mainly the result of a strong rise in government credit (127%), which now amounts to about a fifth of total outstanding credit. On the contrary, private sector credit growth turned negative (-3.5% yoy) for the first time in years, mainly dragged by a decrease in household borrowing (-4.3% yoy). Even as the leu strengthened against the Euro in January, and with more than half of the nation's private credit denominated in Euro, FX-adjusted credit growth remained in negative ground (-0.6%) for a seventh consecutive month.

These developments hardly come as a surprise. The average interest rate applied to new leu-denominated household loans was around 18.3% in 2009, more than 4.3 pps above the corresponding rate in 2008. Specifically, it remained above the 18% mark for seven months, before gradually retreating to 16.6% in December. For new business loans in national currency the increase was milder, around 2 pps. FX-denominated loans fared slightly better: Private sector credit in FX increased by 1.8% yoy in January (accounting for the changes in the exchange rates), reaching 60% of total credit (from 54% at the end of 2008).

It is worth noting that the policy rate of National Bank of Romania (NBR) dropped by 2.25 pps in 2009. Yet, increasing uncertainty due to the financial crisis, and a swift rise in non-performing loans (NPLs), pushed MFI's lending rates upwards. By the end of 2009, NPLs as defined by NBR stood at 15.3% of total loans, one of the highest rates in the region (see Figure 3). According to the Basel II definition adopted by the IMF, NPLs were even higher, almost a quarter of total loans. At the same time, liquidity channelled from abroad has been brought to a halt as a result of the global financial crisis. Loan to deposits ratio remained above 1.30 in January, as it has been for longer than a year now. Although it now stands lower than the 1.36 peak reached last July, it is still far from being comfortable, especially in view of lingering disfunctionalities in world credit markets.

Figure 3
Romania's NPLs ratio is the highest in SEE



Source: Central Banks, IMF, Eurobank Research

In brief, the developments in Romania's credit market over the last year could be readily summarised in two numbers, a small and a large one: 0.9% - the growth in private sector credit; and 134.4% - the increase in NPLs.

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Serbia

Pressures on the dinar persist; NBS Governor resigns

- **Ongoing pressures on the dinar exchange rates forced the Central Bank to repeatedly intervene in the FX market, spending some €450 mn since the beginning of 2010**
- **Central Bank cuts its key policy rate further to 9.00%**
- **Coalition government comes under increased pressure to unfreeze pensions and wages, risking to breach key IMF program conditionalities**
- **The resignation of NBS Governor Radovan Jelasic raises questions over the future course of domestic monetary and fiscal policies**

Serbia: Eurobank EFG Forecasts

	2007	2008	2009e	2010f
Real GDP (yoy%)	6.9	5.5	-2.9	1.5
Inflation (yoy%)				
CPI (annual average)	6.0	12.5	8.2	5.0
CPI (end of period)	11.0	8.6	6.6	5.5
Fiscal Accounts (%GDP)				
General Government Balance	-1.9	-2.4	-4.2	-4.0
Gross Public Debt	29.4	25.6	31.3	37.0
Labor Statistics (%)				
Unemployment Rate (%of labor force, ILO)	18.8	14.7	16.1	18.5
Wage Growth *(total economy)*	22.0	17.9	-3.3	2.0
External Accounts				
Current Account (% GDP)	-15.6	-17.1	-5.7	-8.5
Net FDI (EUR bn)	1.8	1.8	1.4	1.5
FDI / Current Account (%)	39.5	30.0	78.7	55.0
FX Reserves (EUR bn)	9.6	8.2	10.6	9.5
Domestic Credit	**2007**	**2008**	**Q3 09**	**Q4 09**
Total Credit (%GDP)	35.4	41.0	46.2	48.7
Credit to Enterprises (%GDP)	21.5	25.8	28.5	29.4
Credit to Households (%GDP)	12.9	13.9	14.0	14.5
Private Sector Credit (yoy)	40.2	34.9	20.2	14.3
Loans to Deposits (%)	99.9	125.1	130.7	127.0
Financial Markets	**Current**	**3M**	**6M**	**12M**
Policy Rate	9.00	9.00	8.50	8.00
EUR/RSD	99.65	100.00	105.00	105.00

Source: National Sources, IMF, Eurobank Research

The unfreezing of pensions and wages becomes a contentious debate issue within the coalition government

The coalition government has sought to freeze public wages and pensions for a second year in a row in 2010, as part of the IMF program's commitments. Yet, the granting of an 8% pay rise to electricity workers has raised demands for equal wage increases across the public sector, with strikes recently taking place in a number of public utilities. Meanwhile, two opposing and diverse economic policy views are emerging within the government. The first camp supports the unfreezing of public-sector wages and pensions in 2010 in order to support weak domestic demand. The achievement of the fiscal target in 2009 and an expected growth turnaround this year are used as arguments to support that view. A new formula of indexation to GDP growth is proposed to calculate wage increases. On the other hand, those who are against an unfreezing argue that such a policy change would be premature, unless GDP growth exceeds the government's economic growth forecast (upgraded recently to 2% in 2010).

In our view, the unfreezing of pensions and wages will be a major political and economic issue during 2010. The case of electricity workers has acted as an awkward reminder to the population of the strict fiscal austerity measures required by the present IMF lending program. Accordingly, the cohesion and the efficiency of the government coalition will likely be tested. As we have already mentioned in the previous issue of our *New Europe Economics & Strategy,* meeting the revised fiscal target for 2010 is likely to prove a challenging proposition. The implementation of the fiscal consolidation program which aims to contain the consolidated government deficit to 4% of GDP hinged upon politically sensitive decisions. The government pledged to slash public sector employment, particularly at the central government level and to proceed with pension reforms. In addition, the budget was drafted upon the assumption of frozen wages and pensions. Revising such a fundamental assumption would be very difficult for three reasons. Firstly, it would spur wage demands across all sectors of the economy, risking to erode competitiveness further and to hinder fiscal discipline. Secondly, it will test the government's working relationship with the IMF, which strongly opposes such policy deviations. In retrospect, the unfreezing of pensions and wages could endanger the execution of the rest of the IMF lending program, as it would necessitate higher recurrent tax revenues to offset increased public spending. From a policy standpoint, such a move would be too risky to do in a still fragile growth environment.

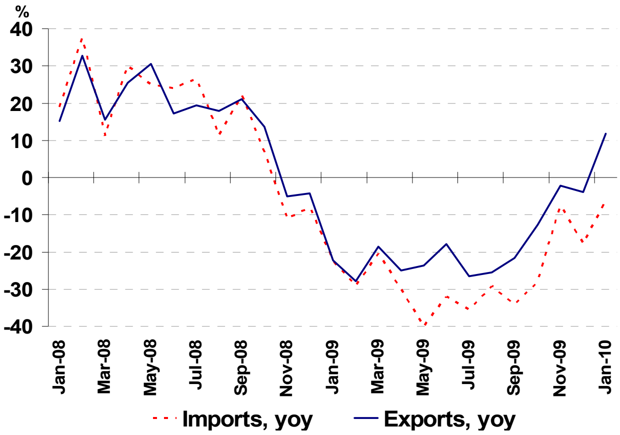
Trade and capital inflows rebounded in Q4; current account deficit hit a post-transition period low in 2009

The current account deficit hit a multi-year low in 2009, outperforming both official and market forecasts. It shrunk to 5.7% of GDP compared to 18.1% in 2008. The improvement would have been even higher had trade flows not recovered since Q3. The main culprit behind the improvement was the 36% yoy decline in the trade deficit. Weak demand for intermediate goods, mainly used as inputs in the industrial sector, was a key driver behind the 28% yoy decline in imports. On the other hand, exports proved relatively more resilient, contracting by 19.4% yoy over the same period. The resumption of metals trade and higher exports of food and beverages relative to 2008 helped to somewhat contain the full-year losses in the overall bill of goods and services exports Another influential factor was a 37.8% yoy increase in current transfers as a result of strong remittances.

On the financing side, inward capital investments (net of IMF and SDR funding) improved in the second half of 2009. Nevertheless, they were still 70% lower from a year earlier. Net FDI inflows declined by 24.8% yoy last year, totaling €1.4 bn. Big privatization items including NIS and the FIAT investment in Zastava supported 2009 FDI inflows, with the latter covering ca 78.7% of the current account deficit, relative to 48% in the prior year. The surplus on other investment increased to 2.9bn up by 5.4%, supported by the IMF loan and a high roll ratio of long-terms debts.

Figure 1

Trade flows rebounded in late 2009/early 2010



Source: National Bank of Serbia, Eurobank Research

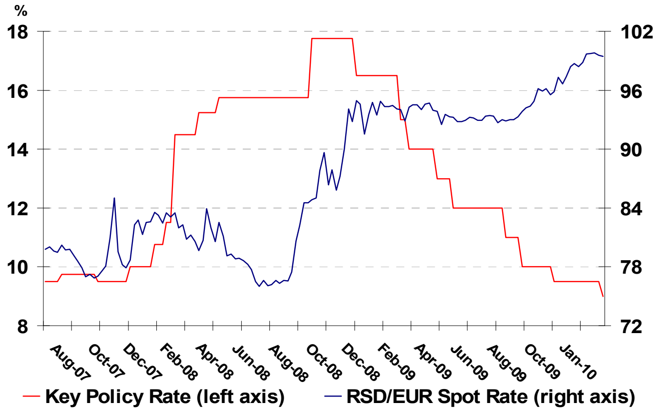
Central Bank lowers key policy rates further despite ongoing pressures on the dinar; NBS Governor resigns on personal reasons

The Central Bank cut its key policy rate by 50bps to 9.00% in late March, citing favorable inflation developments. This brought the total rate cutting instrumented since the beginning of the present policy easing cycle to 850 bps. The move surprised analysts who expected the Central Bank to proceed with additional rate cuts no earlier than in H2 2010. Domestic inflation decelerated temporarily in the first three months of the year, coming in at a two-year low of 3.9% yoy in *March i.e.,* well below the 6-8% official target for 2010 and down from]6.6% yoy in December. This was mainly the result of lower food and non-alcoholic beverages prices (-1.2% yoy drop in February). Notwithstanding these favorable developments, we expect inflation to trend up higher in the coming months because of postponed regulatory price adjustments (10% in electricity prices) and the pass through effects of the recent dinar depreciation[1].

The Central Bank has spent some €450mn of its FX reserves to maintain the dinar stable below the crucial level of 100/€. The dinar came under significant depreciation pressure in late 2009, and it is currently standing near historical lows against the U.S. dollar, despite recent significant interventions by the NBS.

In a move that took markets aback, NBS Governor Radovan Jelasic resigned, citing "personal reasons". Both the government and the Central Bank sought to reassure market participants that there will not be any significant change in monetary policy. Yet, considering that Mr. Jelasic strenuously resisted the fiscal relaxation implied by the unfreezing of wages and pensions, it remains to be seen whether his resignation will facilitate a more lax fiscal policy chance.

Figure 2: Dinar remains close to historic lows



Source: EcoWin, Eurobank Research

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Recent domestic credit developments and outlook

In March 2009, as the crisis was fully unfolding in South Eastern Europe (SEE), the ten largest foreign banks in Serbia, mainly Austrian, Greek, and Italian, made an agreement to maintain their overall exposure to the country at the end of 2008 levels. The *Vienna Initiative*, as it became known, was an IMF co-ordinated attempt to prevent massive capital outflows from the country, and to alleviate the fears of a collapse of the domestic financial system. The ten European banks stuck to their commitment, and in late February this year, they reaffirmed their support towards their subsidiaries in Serbia. However, since the crisis has started to subside, the new agreement, effective from April, will allow the banks to lower their exposure to 80% of its current levels.

[1] The Central Bank has estimated the pass through effect at 0.2-0.3 in the current quarter and 0.6 in the next 12 months.

A few days later, the National Bank of Serbia (NBS) decided to amend the regulations concerning banks' required reserves. The previous regime was simplified, in order for the effective reserves to correspond more closely to those stipulated in the NBS regulations. At the same time, the required ratio on deposits in national currency was cut to 5%, from 10%, and on deposits in foreign currency to 25% (down from 45%, on the FX reserve base, and from 40%, on the obligations arising from foreign currency savings). NBS hopes that the relaxed regulations will encourage banks to increase their lending.

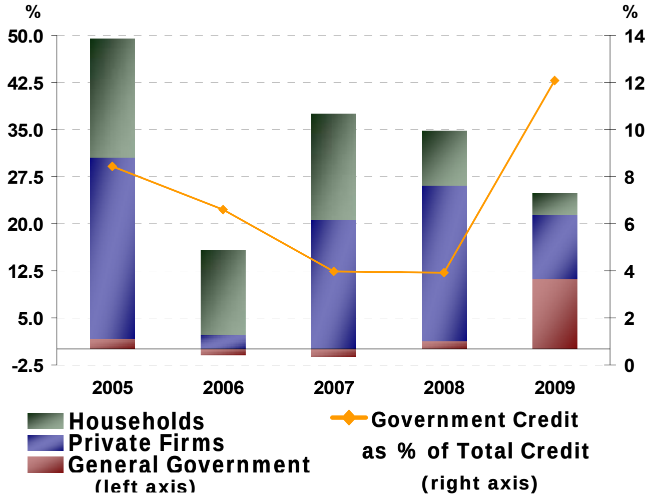
The above developments in large part reflect the Central Bank's view that prospects for the Serbian credit market are starting to improve. Indeed, the latter fared rather satisfactorily during the recent global financial crisis, at least compared to credit markets in other SEE countries. FX-adjusted total credit growth remained in two-digit rates throughout 2009, even though the dinar lost more than 7% of its value versus the euro. In January, private credit growth continued to accelerate, increasing by 9% yoy (adjusted for the devaluation of the dinar), after bottoming at around 4.0% yoy in October 2009. The corresponding figure for total credit was 19.3%, not far from 22.5% recorded in January 2009, yet significantly lower compared to the pre-crisis levels of 35% or higher.

We have to note though that the resilience of domestic credit growth rates has been supported by heavy government borrowing. Actually, 11.2 pps out of the 25% increase in credit in 2009 (almost 44% of total credit growth) can be attributed to loans to the public sector; the corresponding figure in 2008 was only 1.3 pp (3.8% of total credit growth). As a result, the share of government credit in total credit grew by more than three times (see Graph 3). Deposits have also started to recover, increasing by 17% yoy in January on an FX-adjusted basis. This could be interpreted as a first indication that confidence has started to return to the banking system, taking into account that this is the fourth consecutive increase, after ten months of negative yearly growth since December 2008.

Nevertheless, a more careful examination reveals certain areas of concern. According to the NBS, the level of non-performing loans more than doubled within twelve months, reaching 10.1% of total loans by the end of Q309. Finally, we note that FX deposits resumed their upward trend in 2010 as well. By the end of January, they made up for more than 70% of total deposits, reflecting perhaps Serbs' lack of confidence towards their embattled currency – which has lost about 30% of its value versus the euro, since the crisis hit SEE in autumn 2008.

Figure 3

Credit keeps running due to government borrowing



Source: National Bank of Serbia, Eurobank Research

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Turkey

Politics taking centre stage once again, with jitters likely to escalate in the months ahead; IMF loan negotiations fall through, with limited impact on domestic financial markets

- Excerpt from our recent Trip Notes report published on March 24 -

- **Politics taking centre stage once again, with jitters likely to escalate in the months ahead**
- **IMF loan negotiations fall through, with limited impact on domestic financial markets**
- **Economic recovery underway**
- **CBRT likely to start hiking rates in Q4**

Politics taking centre stage once again…

Political jitters -- which largely remained just a noise in the background after the AKP-closure case was dropped in July 2008 -- recently returned to the forefront. The "Ergenekon" case, which escalated last summer, was an awkward reminder of Turkey's frail political landscape. And, the recent tensions over the "Sledgehammer" plan, which also involved coup plot accusations against a number of military officials, once more revealed the ongoing power play between the secular elite and the Islamist-rooted AKP government. The military, which along with the judiciary and part of the academia are seen as bastions of the country's secular elite, has denied both counts. The AKP supports that these incidents highlight the need a move towards a more democratic state.

…with jitters likely to escalate in the months ahead

Over the last 50 years the army staged three separate coups, in the early 60s, 70s and 80s. More recently, in 1997, it assisted in overthrowing the then incumbent government. It appears that the military is presently facing its biggest challenge to date. However, we would assign a rather limited probability for another coup nowadays. The surroundings, domestic as well as international, are unlikely to create a fertile environment for a direct challenge to the government. Furthermore, General Chief of Staff Ilker Basbug acknowledged recently that coups belong to the past. And the recent meeting between the President, the Prime Minister and the General Chief of Staff does indicate improved communication between the two camps. That said the recent turmoil does raise concerns about the prospect of early general elections and, by implication, the government's commitment to fiscal consolidation and structural reforms. It also adds to worries over a deeper social polarization. A period of prolonged political uncertainty may also bear a brunt on the domestic economy and weigh down on consumption and investments.

Turkey: Eurobank EFG Forecasts

	2007	2008	2009e	2010f
Real GDP (yoy%)	4.7	0.9	-6.0	5.0
Private Consumption	5.5	-0.1	-4.0	2.5
Government Consumption	6.5	1.9	2.0	1.0
Gross Capital Formation	5.8	-3.7	-21.5	1.0
Exports	7.3	2.3	-8.7	16.0
Imports	10.7	-3.8	-18.5	18.5
Inflation (yoy%)				
HICP (annual average)	8.8	10.4	6.3	9.4
HICP (end of period)	8.4	10.1	6.5	8.7
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	13.5	12.0
External Accounts				
Current Account (% GDP)	-5.9	-5.7	-2.3	-3.3
Net FDI (USD bn)	19.9	15.8	6.1	8.5
FDI / Current Account (%)	52.2	37.8	44.1	35.0
FX Reserves (USD bn)	73.3	71.0	69.0	70.0
Domestic Credit	**2007**	**2008**	**Q2 09**	**Q3 09**
Total Credit (%GDP)	28.0	31.0	32.0	33.0
Private Sector Credit (%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

A public referendum for proposed constitutional reforms could instigate rapid political developments.

The government plans to pursue a number of reforms that could further aggravate tensions with the secularists. Among others, these include amendments to make the closure of political parties more difficult and change the structure and the way the Supreme Board of Judges and Prosecutors (HSYK) is elected. The latter would effectively curb the powers of the judiciary. Cabinet officials have signaled that if the two-thirds majority in the 550-seat parliament necessary to amend the constitution is not obtained, a referendum will be called. At present, opposition parties have indicated they will strive to block the changes and the AKP appears unlikely to lure the required quota in order to pass the amendments into law. However, the ruling party will probably be able to collect half of parliament's vote required to push through a referendum. According to the latest opinion poll, two-thirds of Turks would vote in favor of the referendum, while 79% believe that the judiciary needs to be reformed. That said, even if a referendum is passed it may still be challenged in the Constitutional Court, which in the past has annulled AKP-backed constitutional changes. Even if vetoed however, it will still renew the AKP's reformist image, which is likely to positively impact popular support towards the party. The government unveiled the details of its plan earlier this month and it appears likely that a referendum will be held in June. If passed, the amendments may come into effect after the general election. According to our contacts, strong public support for the proposed constitutional changes in the referendum would serve as an indirect vote of confidence for the current government. As such, the referendum's outcome is likely to bear significant importance on the upcoming political developments in Turkey.

Developments likely to pave the way for a snap election

Recent political frictions have fanned speculation that the July 2011 general election will be brought forward. Chief Prosecutor Abdurrahman Yalcinkaya, who was behind the 2008 case to ban the ruling party, is presently collecting evidence that may lead to another closure bid. Such an event may pave the way to early polls in an AKP-bid to increase its popularity as the public traditionally shows compassion towards the weak. However, we assign a rather low probability to that outcome, as the previous closure attempt fell through, not too long ago. Consequently, we see the referendum as key to the timing of the next general elections. Its pro-reform character is likely to boost the AKP's status. Note that popular amendments such as on political immunity, arbitration laws and labor unions' right to strike are also expected to be included in the proposed reforms. Should the referendum's outcome be in line with the AKP's expectations for 50-60% support, the prospect of snap polls is likely to be decreased. The reason being, that such a result would be perceived as a forerunner of a significant increase in the party's popularity, which currently stands below 40%. However, according to our contacts, a rejection of reforms in the upcoming referendum would likely open the door for a snap election, possibly in autumn 2010. We assign a rather limited likelihood for the latter outcome, as the AKP is rather unlikely to pursue a referendum if uncertain of its endorsement by the public. As such, if a referendum is held, we expect the vote to be a positive one for the ruling party.

Next general election crucial for political stability ahead

The latest opinion surveys show that support for the ruling AKP has slid to below 40% from 47% achieved in the previous general election in July 2007. If opinion polls are reasonably accurate, it is questionable whether the AKP would be able to form a single party government if elections were held today. Such an outcome would likely lead to lengthy coalition negotiations and, eventually, to an unstable multi-party cabinet that would weigh on fiscal and structural reforms and the country's EU convergence outlook. The MHP opposition party has recently indicated that they would not deny an alliance with Erdogan's bloc. A coalition with the ultra-nationalist CHP would also be another potential scenario. In any case, the political landscape is likely to become more transparent in three months time as we will know by then whether a referendum will be held, and if so, its outcome. Meanwhile, as developments gain pace, political noise is likely to become louder.

IMF loan negotiations fall through…

Following nearly two years of negotiations with the IMF on a new Stand-By Arrangement, it was announced in early March that discussions are no longer taking place. Turkey's Prime Minister Tayyip Erdogan later added that a new IMF package was "out of the question". Economy Minister Ali Babacan also confirmed that discussions were terminated, but left the door open for a resumption of negotiations after Article IV consultation review in May, when an IMF mission is expected to visit the country. In reality, Turkey is among the few countries in the region having managed to steer through the crisis without external financial aid. In recent months it was becoming increasingly clear that an IMF loan deal was not as important for Turkey as it used to be. The reason being that previously alarming external imbalances significantly improved lately. Thus, since late last year, it was acknowledged that, if agreed, the programme would be of a recovery-enhancing character. It would be primarily used to underpin the domestic economy by reducing the government's roll-over needs and thus, alleviating the crowding out of the corporate sector. It would also provide a valuable policy-anchor market participants would like to see in place. Yet, it was lately becoming increasingly evident that the AKP would be reluctant to agree on a programme that could encompass painful fiscal austerity measures ahead of the 2011 elections.

… with limited impact on domestic financial markets

News that negotiations with the IMF fell through had a limited impact on domestic financial markets, as the outcome had already been largely priced in. Yet, with support stemming from a potential IMF deal having been waved, Turkish assets may prove more susceptible to external as well as internal jitters in the period ahead as a result of e.g. sudden swings in global sentiment, domestic political uncertainty and upcoming fiscal and monetary developments. That said, even if it becomes apparent in the near future that financial aid is urgently needed, Turkey will still be eligible to ask for it. Also, in a rather reassuring note, news that an IMF deal will not be sealed does eliminate some uncertainty regarding the process and thus, it may act favorably on domestic investment and economic activity in the period ahead.

Economic recovery underway

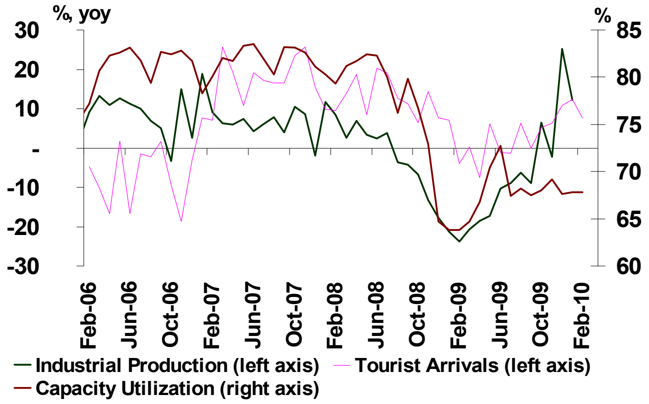
Since the second quarter of 2009 the pace of domestic economic contraction marked a notable slowdown. The recession appears to have reached its bottom in Q1 when GDP declined by 14.7%yoy, while economic growth (on an annual basis) is estimated to have been broadly flat, if not marginally positive, in Q4 2009. A further improvement is anticipated in the quarters ahead, primarily driven by base effects and the adjustment in inventories. A rebound in exports as well as tourism and a stabilization of credit conditions are also likely to provide support. Most of our contacts predicted GDP growth to reach 4%-5% this year, a view we broadly concur with. Downside risks to that forecast stem from slower that anticipated recovery in main trading-partner economies, further significant increases in commodity and food prices and domestic political uncertainty.

High-frequency activity and sentiment indicators continue to improve

Industrial production, which was badly hit against a background of a deep economic downturn, appears to have embarked on a sustainable rebound recently (Graph 1). Industrial output growth came in at 12.11%yoy in January, having swung into a positive territory in October for the first time in more than a year. Meanwhile, domestic credit growth is showing signs of a pick up lately, while recent employment increases in the construction and industrial sectors suggest that investment is on, or close to, a rebound. Capacity utilization, a leading indicator of manufacturing activity and GDP growth, stood at 67.8% in February, having rebounded from a record low of 63.8% reached in early 2009. In January, consumer confidence bounced above the 100pts threshold (which separated pessimism from optimism) for the first time since July, remaining above that level in February as well. Albeit with its rate of expansion slowing down, PMI manufacturing came in at 50.9 in February, signaling expansion in the sector for the tenth month running. Meanwhile, according to the Turkish Exporters Assembly (TIM), exports rose for the first time in a year in October (+4.6%yoy), mirroring improved external demand. Exports soared by 20.3%yoy in February 2010. Elsewhere, vehicle production jumped by 89%yoy cumulatively in January-February 2010, following a 24.2%yoy decline in the whole of 2009. And, the number of foreign visitors to Turkey rose for the seventh month running in January.

Graph 1

The trough of the recession appears to have been reached in early 2009



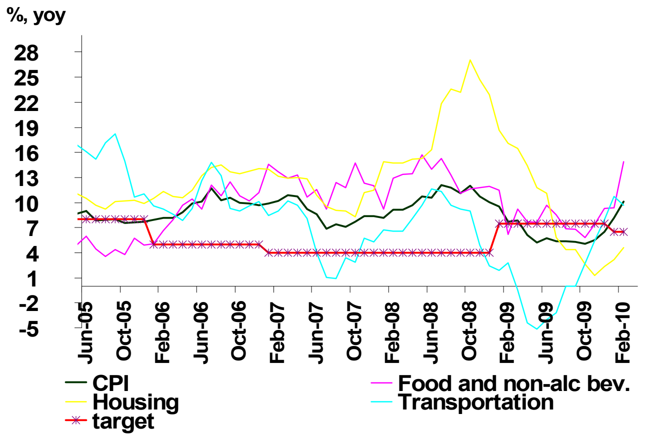
Source: National Statistics, CBT, Eurobank Research

Inflation bounced to double-digit levels in February

Having hit a 40-year trough at 5.08%yoy in October, headline CPI has accelerated significantly in recent months (Graph 2). The main culprits of the increase were unfavorable base effects, higher food prices - against a background of adverse weather conditions - and regulated price hikes. In February, the consumer price index exceeded expectations of 0.68%mom, coming in at 1.45%mom. On a year-on-year basis, headline CPI bounced to 10.13% in February (highest level since November 2008), deviating further from the CBRT's 6.5% year-end target. The rise was broad-based, with price increases being recorded in eight of the twelve sub-sectors. However, suggesting weak demand-side pressures, core CPI measures remain near recent lows, with the closely monitored sub-index I (excluding food, energy, alcoholic and non-alcoholic beverages and tobacco products and gold) coming in at -0.48%/+4.05% mom/yoy.

Graph 2

Inflation picking up on higher food prices and base effects



Source: National Statistics, CBT, Eurobank Research

CBRT turns more hawkish, but reiterates interest rates to stay at record lows for a long time

At its latest MPC meeting in early March, the CBRT kept its key policy rate unchanged at 6.50% for the four month running, in line with the market's consensus.

However, the Bank adopted a more hawkish tone in its policy statement, explicitly referring to the possibility of future rate hikes, for the first time in many months. In an obvious move aiming to reinstate its inflation-fighting commitment, the CBRT signaled it was ready to hike interest rates on evidence of worsened pricing behavior or rising inflation expectations. The Bank expects inflation to temporarily ease in March, but remain above its target for a while. It anticipates disinflation to resume in Q4, with CPI likely to ease in line with its targets early next year. In spite of turning notably more hawkish compared to recent months, the CBRT reiterated that interest rates need to stay at their current historically low levels for ''a long period of time''. Note that in its January quarterly inflation report, the Central Bank revised its 2010 CPI forecast higher due to base effects, tax hikes and firmer food prices. The CBRT assigned a 70% probability for end-2010 inflation to come in between 5.5-8.3%. If realized, the mid-point of that range (6.9%) is higher than the CBRT's 6.5% inflation target for this year. The Central Bank's forecast is also well below our own 8.7%yoy CPI projection for the end of the current year. As such, we expect the CBRT to resort to monetary tightening before the end of the year in order to contain rising price pressures and keep inflation close to its target.

CBRT likely to start hiking rates in Q4

Against a background of weak demand-pull pressures, still weak domestic demand dynamics and 1025bps of policy rate easing having been delivered since late 2008, we expect the CBRT to hold its horses over the next few months. That said we see the Bank hiking its key policy rate by 150bps in Q4, in order to contain medium-term inflation risks as the economic rebound gains traction. Risks to our forecast lie in the face of upside surprises in the domestic economic recovery, prolonged political instability and renewed signs of fiscal slippage.

A severe deterioration in government finances in 2009 due to the economic downturn

Although Turkey registered a strong fiscal performance in prior years, a significant deterioration occurred in 2009. As proved to be the case in other economies in the region, the crisis took a severe toll on the government's coffers in 2009. The public budget ran a deficit of TRY 52.2bn or 5.5%-of-GDP. In spite of outperforming earlier official expectations for a 6.6%-of-GDP gap, the realized shortfall marked a sharp widening from a deficit of 1.8%-of-GDP in 2008. Budgetary revenues were hit by lower-than-projected tax income and the temporary stimulus measures employed by the government to support domestic economic activity. On the other hand, expenditures were contained broadly in line with initial targets in spite of a deep GDP downturn.

Government reinstates commitment to fiscal consolidation

In spite of last year's deterioration in public finances, the government has lately shown renewed signs of commitment to fiscal consolidation. Since late last year the budget appears to be on the mend, assisted by improving tax receipts. The measures employed in 2009 to support the domestic economy expired and the government recently introduced tax hikes on several items to boost its coffers. In September, the AKP announced a realistic and feasible medium-term fiscal plan, which was well-received by both the IMF and financial markets. In addition, a "fiscal rule" is currently on the table, aiming to provide an anchor for future budgets, especially in view of the absence of a new IMF deal. In effect, it will allow increased spending in times of economic downturn, from savings generated in years of buoyant growth. It will also increase the credibility and transparency of fiscal policy. According to our contacts, a fiscal rule is expected to be ready by this summer and to come into effect some time next year. In the meantime, we expect this year's budget to run a deficit of 4.5%-of-GDP on the back of the economic rebound and rising taxation. Risks for a higher fiscal deficit this year lie in the face of the 2011 general elections. Risks for a potential outperformance include among others, high than expected GDP growth this year. Note that the 2010 budget is framed of a macroeconomic scenario assuming 3.5%yoy GDP growth this year; an assumption that may well prove pessimistic.

Public debt ratio seen stabilizing at around 49% of GDP in 2010, before resuming downward trend in the coming years

The recent deterioration in Turkey's fiscal balance is also being reflected in public debt. After falling to 39.4%-of-GDP in 2007 from near 100% levels in 2001 the (EU-defined) general government debt-to-GDP ratio is estimated to have ended last year at around 47.3%-of-GDP. The government expects the ratio to peak at 49% in 2010, before resuming a gradual downtrend in the following 2 years[2]. With respect the roll-over ratio for this year, the Treasury said in mid-March that it expects it to fall to 90-95% this year, compared to an earlier forecast of 99.5%.

[2] According to the government's Medium-Term Programme (2010-2012) public debt is expected to ease to 48.8%-of GDP in 2011 and 47.8%-of-GDP in 2012

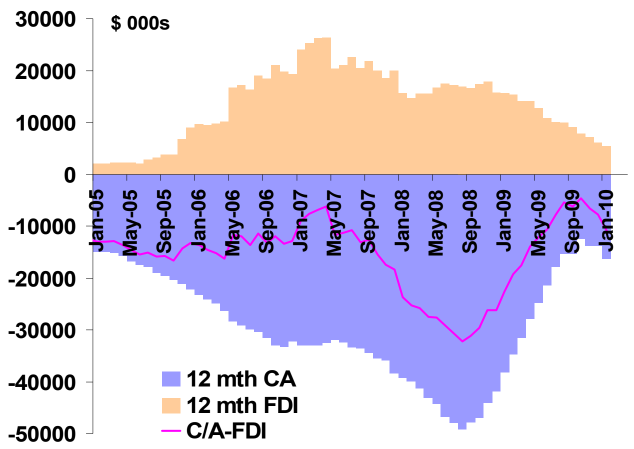
Current account deficit marked a significant improvement in 2009

A large and widening current account deficit was one of Turkey's main economic vulnerabilities in recent years. A high import content of domestically-produced manufacturing products for exports and the country's high dependence on energy imports were the main culprits of the current account deterioration in recent years. However, the current account gap fell by 67%yoy last year (to 2.3%-of-GDP from ca 5.7%-of-GDP in 2008), mainly on the back of a sharp drop in imports and lower oil prices (Graph 3). However, since November 2009, the pace of improvement in the current account balance has slowed down. Indeed, the deficit increased by 95%yoy cumulatively in November 2009-January 2010.

A further deterioration is expected in the months ahead as the economic rebound gains traction. Higher oil prices from a year earlier are also likely to weigh on the shortfall. We expect the full-year deficit to reach 3%-of-GDP or slightly higher levels. Meanwhile, foreign direct investment (down by 60%yoy to USD 6bn in 2009), financed 44% of the smaller, more easily financed, current account shortfall last year. The respective coverage ratio was 37.5% a year earlier. In 2010, FDI inflowing are expected to increase slightly, on improved investor sentiment and the global economic upturn.

Graph 3

The current account deficit improved in 2009 on the back of a deep recession and lower oil prices



Source: National Statistics, CBT, Eurobank Research

Market Strategy

FX: After hitting 7-month lows of 1.5641 against the USD on February 25 amid rising domestic political jitters, the TRY has staged a tentative recovery, recouping a small part of its losses. The fall-through of the IMF deal bore a limited impact (and it could actually be considered as a resolution to lingering uncertainty over whether a loan deal would finally be sealed). With the CBRT's monetary easing cycle having reached a trough and risks for an inception in the Bank's tightening cycle earlier than currently anticipated, especially if upcoming inflation data surprise to the upside, there appears to be room for some further lira appreciation in the coming months. Increased FDI inflows are also likely to provide support. On the flipside, pockets of global market instability, increased domestic political jitters, fiscal slippage ahead of the 2011 elections and perceptions that the CBRT is not doing enough to ensure medium-term price stability are among the main downside risks for the lira outlook in the period ahead.

Local rates: Inflation has embarked on an uptrend recently and although the Central Bank staunchly defends its view that the spike is temporary, potential for a rise in commodity prices in the imminent future, second round effects and the potential a speedier than anticipated economic recovery raise risks for sooner-than-expected rate hikes. This environment is rather unfavorable for the local rates market, especially since government bond yields touched record lows in recent months. That said, it is worth mentioning that foreign investors currently appear to be very light positioning in the local rates market. In addition, most of the government's credit appears to be parked among the few large domestic banks. The latter continue to view investments in TRY T-bills and notes as a major source of income, especially since domestic credit growth remains scarce. As such, we see limited room for a spike in local yields, at least in the short-term. Presently, the benchmark November 16, 2011 bond yields around 9%, some 100bps higher than lows hit late last year. Along these lines, we continue to see value in lira CPI-linked bonds.

External debt: After peaking at levels near 800bps in October 2008, Turkey's 5-year CDS spread has narrowed more than 600bps since then. The fall through of the IMF deal had limited impact on the country's external debt, as was largely priced in by markets. Meanwhile, all three major credit rating agencies upgraded Turkey's sovereign ratings over the last few months, on reflection of the government's fiscal consolidation efforts and its ability to steer through the global financial crisis. The new fiscal rule and the formation of the political landscape will be key for the market near-term. Eurozone credit periphery jitters may also play a role. Along these lines and with 5-year CDS near 156bps 4-year lows touched on March 10, we see limited room for further spread narrowing in the coming months.

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Inflation outlook 2010-2011

2010 inflation outlook & monetary policy implications

The global recession and the slump in world commodity prices set the stage for a dramatic drop in consumer price inflation to a multi-year low of 5.08% yoy in October 2009. The CBT capitalised on the sharp drop in domestic inflation to bring down its key policy interest rate (currently at 6.5%), through embarking on a 1025 bp easing cycle over a 12-month time frame ending in November 2009.
Such a radical drop in short term policy rates was one of the two main reasons (the other one being the sharp improvement in global risk appetite since March 2009) underlying the rally in the domestic bond and equity markets. As inflation starts to pick up again and the economy recovers, a big question remains over whether the Turkish Central Bank (like many others) will be in a position to hike rates aggressively enough so as to adequately pre-empt future inflation risks.

1. What is behind the most recent inflation spike?

There are three reasons behind the recent acceleration in the general level of domestic prices: Structural problems in unprocessed food sector; tax hikes and the low base effect.
The price hikes in four subsectors fully explain the recent acceleration in consumer price inflation:

1. Unprocessed Food: Structural problems remain in this sector, such as an insufficient number of storage facilities and a multitude of factors constraining unprocessed food imports. Additionally, a number of intermediaries between producers and consumers (i.e., traders and retailers) tend to abuse and exaggerate the pricing impact of temporary supply shocks (like the flooding in Feb'10 or the heavy snowfall in Nov'09 that hindered transportation) to raise mark ups. The impacts of these structural deficiencies have been more severe than we had expected.

2. Alcoholic Beverages & Tobacco Products: The government has scaled up the taxes on these items aggressively three times (Mar'09, Jul'09 and Feb'10) over the last 12 months, to generate additional tax revenues. Annual inflation in this item reached 53%, contributing some 2.8 pp to the 10.1% annual consumer price inflation in February 2010.

3. Housing - Energy: The increase in the energy sub-item of housing sector prices is primarily due to the low base effect. A year ago, oil prices were spiralling lower due to the global recession. Over the last 4 months, however, there has been no similar decline in oil prices. As a result, we are observing an increase in this item.

4. Transportation: The pick up in the prices of this item is driven by the tax hike on petroleum products, as well as the low base effect that we have mentioned above.

Table 1
The Four Sectors That Drove Up Headline CPI btw Oct'09 and Feb'10

	Oct'09	Feb'10	Change (pp)	Contribution (pp)
CPI	5.1	10.1	5.1	
1. Unprocessed Food	13.2	28.5	15.3	2
2. Alcoholic Beverages & Tobacco	20.9	52.9	31.9	1.7
3. Housing – Energy: Water/Elect./Gas	-2.1	3.3	5.4	0.4
4. Transportation – Petroleum Products	0.5	20.7	20.2	1
(1+2+3+4)				5

Source: TURKSTAT, EFG Istanbul

2. Where is inflation heading?

We expect inflation rates to increase further towards 11% yoy in the coming months, following a temporary decline in March. Core inflation looks poised to rise to 6.5% yoy from its current 4.0% yoy level, due to the low base effect stemming from tax cuts last year as well as the secondary impacts of food and energy price hikes. We do not foresee a deceleration in inflation until 4Q10, by which time the low base effect will have been eliminated.
We are now revising our year-end consumer price inflation forecast up from 6.8% yoy to 8.7% yoy, significantly above the official target of 6.5% and the market consensus of 8.2% yoy. The revision is mainly due to the disappointing trend in food prices, as well as the higher-than-expected tax adjustments in alcoholic beverages, tobacco and petroleum products.
We, nevertheless, expect inflation to decelerate back towards the CBRT´s target *i.e.,* to levels around 6.0-6.5% by the second quarter of 2011. The resumption of disinflation could be facilitated by the postponement of some price and tax adjustments for the period after the parliamentary elections, which will probably be held in 2Q11. Once these price adjustments are made following the elections, inflation should start to accelerate again towards 7% in 2H11, in our view.

2.1. Food prices

Structural problems in the food sector is expected to push up headline inflation in the coming months. We were previously expecting food price inflation to be around 8% in 2010 and

2011, above the rates forecasted by the CBT (7% for 2010 and 6% for 2011). However, recent developments suggest that food prices could rise even beyond our earlier assumptions. We now expect food price inflation to reach 10% and 9% in 2010 and 2011, respectively.

Our expectation is not driven by unfavourable weather conditions, which in any case should have only a temporary impact on prices. Rather, we have revised our food price forecasts on the view that the structural problems inherent in the unprocessed food sector will preclude any notable deceleration in inflation over the next couple of years, barring a significant positive supply side shock that would increase the production not only in Turkey but also across the region.

2.2. Energy prices

Energy prices have bounced strongly from their lows in early 2009. Turkey is an importer of energy. Almost 92% of crude oil and about 97% of natural gas requirements are covered by imports. Although there are automatic pricing mechanisms introduced by the authorities, we have serious question marks regarding the applicability of these mechanisms in natural gas and electricity markets.

Based on our computations, we suspect that there are price hikes pending, especially in natural gas and electricity sectors. The government is likely to have decided to delay the price adjustments in order not to put pressure on household budgets, which have already been hit by growing unemployment; reduced real wages; and eroding profits. We expect the government to make the necessary adjustment to natural gas prices in April, when usage of natural gas for heating purposes diminishes. Price hikes in electricity should follow thereafter.

In our upward revisions to the domestic inflation outlook for 2010-2011 we assumed that the government will abstain from making further sizeable price adjustments ahead of the elections in 2011 in order to facilitate a decline of headline inflation down towards 6% in the run up to the polls.

2.3. Core inflation

Core inflation has been broadly stable at around 4% in recent months. Core inflation I has been oscillating between 3-10% since the beginning of 2006 with an average of 6.2% yoy. The lowest level was observed in Jun'09 (+3% yoy) on dwindling economic activity; easing import prices; and the government slashing the tax rates in order to stimulate consumption. Despite the acceleration in food, energy, alcoholic beverage and tobacco product prices, core inflation has remained at around 4% over the last five months.

However, we think that the increases in these prices will pass through to core inflation with a certain time lag via increases in inflation expectations and costs. More importantly, we are not in anticipation of another tax subsidy in 2009, following last year's subsidy which caused a decline in core inflation of about 1.1 pp. Because of this low base effect and the pass through from the price hikes in food and energy sectors, we forecast an acceleration towards 6.5% by mid-2010. As the low base effect tapers off in Sep'10, we will observe a decline in core inflation towards 5.5%.

3. EFG Istanbul's inflation forecasts for 2010-2011

All in all, we expect inflation to reach 8.7% and 7%, in 2010 and 2011, respectively, thereby overshooting the official targets. This is primarily on the back of food prices, which do not show any convincing signs of deceleration; and of energy prices, where we reckon further price adjustments are pending. In the absence of an IMF deal, we are not in anticipation of a firmer TRL, which would have served to mitigate the effects of possible increases in import prices.

Although we estimate some acceleration in core inflation I in the coming months due to the low base effect from last year's tax cuts, in addition to the secondary impacts of food and energy price hikes, we expect core inflation to drop back towards 5.5% by the end of the year. We envisage a rather stable path for core inflation in 2010 and 2011, based on our assumptions of moderate growth; a stable outlook for the currency; and possible rate hikes.

Our predictions also indicate that the CPI inflation is set to decelerate towards the 6-6.5% range in 2Q11, with price adjustments delayed to the second half of 2011 due to the parliamentary elections.

Table 2

CPI Forecasts by EFG Istanbul

CPI Forecasts by EFGI			
	2009	2010 EFGI Est.	2011 EFGI Est.
Core I	3.8	5.5	5.5
Food	9.3	10.0	9.0
Energy	4.6	12.0	9.0
Alcohol/Tobacco	20.9	26.5	8.0
Gold	25.6	-5.0	0.0
CPI	6.5	8.7	7.0
Assumptions			
Crude Oil (Brent, ave)		$81	$85
USDTRL (ave)		1.5500	1.5850

Source: EFG Istanbul

4. Implications for monetary policy

Now, we think that CBT would use communication policy (read switch to a more hawkish tone in statements) to curb expectations; in the meantime, monitor the developments in

core inflation and hike if and when core inflation exceeds the projections: The CBT might start to communicate the message that inflation is set to overshoot the target for 2010 due to supply side factors; however, that it should revert to the target consistent path in 2Q11. On the other hand, it might underscore the significance of core inflation in monetary policy. In response to the increase in inflation expectations, the CBT should demonstrate that inflation expectations have been adoptive and have never been accurate predictors of future inflation. More importantly, it should effectively communicate its resolve to use the tools at its disposal in order to restrain inflation rates. In the meantime, the CBT needs to monitor core inflation indicators very closely: if and when it observes core inflation to be exceeding its base case projections, it should hike the rates.
We expect the CBT to launch a new tightening cycle in 3Q10, as we do not expect core inflation (excluding an acceleration due to the low base effect from last year) to accelerate until then. We reckon that the CBT would opt for gradual hikes, say 200-250 bps in 4-6 months, depending on movements in core inflation.

However, if the TRL depreciates and/or commodity prices rise for any reason, the CBT should and would hike the short term policy rates earlier, even before the impact of these factors on core inflation are observed, as the pass through from commodity prices and exchange rates to core inflation is quite high. In such a case, in order to rebuild credibility, the CBT should hike more aggressively, say 300-350 bps in 3-4 months.

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Ukraine

Increasing signs of a stable political scene make quick restoration of IMF programme very likely

- **Ukraine has paved the way for a better policy coordination; new coalition government is formed with Mykola Azarov, President Yanukovych's ally, as Prime Minister**
- **S&P raised Ukraine's foreign sovereign credit rating to B-/C from CCC+/C; assigned a positive outlook**
- **Negative credit growth dynamics persist with high level of total outstanding private-sector credit as % of GDP; it stood at 74% at the end of 2009.**

Increasing signs of political stability

In late February, the pro-Russian Viktor Yanukovych was sworn in as Ukraine's new President. The newly-elected President moved to oust Prime Minister Yulia Tymoshenko. In early March, Ukraine's parliament held a no-confidence vote against the government. The no-confidence resolution passed with 243 votes in the 450-seat chamber and Tymoshenko's government was overthrown. According to the Ukrainian law, a parliamentary coalition must be formed within 30 days that would be able to shape a new government within 60 days; otherwise early elections have to be called. Under the constitution, such a coalition much be formed by fractions rather than individual deputies. The party of the new President (Party of Regions, PoR) has overridden the established parliamentary rules and passed a law that allows a majority coalition to be formed with the support of individual deputies. Thus, Yanulovych's Party managed to form a coalition. On March 10th, a majority of 235 lawmakers in the 450-seat assembly backed the new coalition, well within the allotted 30 day timeframe. One day later, Mykola Azarov, a former finance minister and an ally of the new President, was installed as Prime Minister. If the legislative change is ruled to be unconstitutional by the Supreme Court, the new coalition will be rejected and early parliamentary elections will be called. However, it seems likely that the new ruling coalition will manage to form a new government before the beginning of May, thus avoiding the need for early parliamentary elections.

S&P raised Ukraine's sovereign credit rating; assigned positive outlook

Markets reacted positively to recent political developments in Ukraine as the expected consolidation power of the newly-elected president should help to ensure political stability and better policy coordination, thus ending months of political uncertainty. In view of these developments, S&P rating agency raised Ukraine's foreign sovereign credit rating to B-/C from CCC+/C and also issued a positive outlook.

Ukraine: Eurobank EFG Forecasts

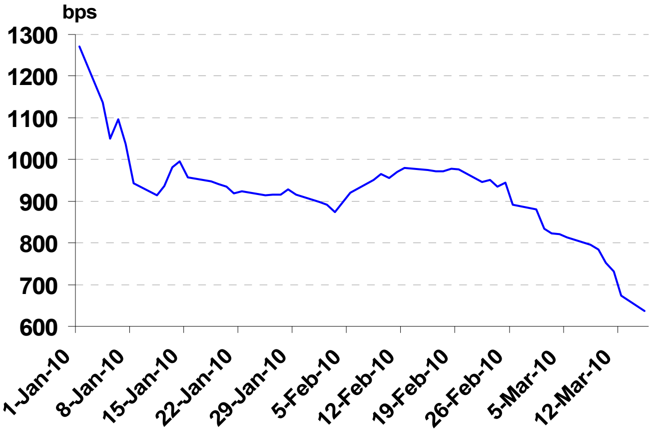
	2007	2008	2009e	2010f
Real GDP (% yoy)	7.9	2.3	-15.0	1.5
Private Consumption	17.2	21.7	-13.5	1.5
Government Consumption	2.5	29.8	1.8	0.5
Gross Capital Formation	23.9	27.6	-49.0	2.0
Exports	3.3	30.2	-16.0	2.0
Imports	21.5	22.1	-35.0	0.5
Inflation (% yoy)				
CPI (annual average)	12.8	25.3	16.0	12.5
CPI (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**	**Q3 09**	**Q4 09**
Total Credit (% GDP)	59.9	77.3	81.6	79.3
Credit to Enterprises (% GDP)	36.5	46.7	51.2	50.7
Credit to Households (% GDP)	22.5	29.5	28.2	26.4
FX Credit/Total Credit (%)	49.9	59.0	52.8	50.8
Private Sector Credit (% yoy)	74.9	68.5	23.9	-3.1
Loans to Deposits (%)	150.4	204.0	223.0	215.9
Financial Markets	**Current**	**3M**	**6M**	**12M**
Policy Rate	10.25	10.25	10.25	10.25
USD/UAH	7.97	8.00	8.40	8.70

Source: NBU, IMF, Bloomberg, Eurobank Research

According to the agency's announcements a further rating upgrade will depend on the new government's ability to draft and submit the country's 2010 budget law to the parliament by mid-April. What's more, Ukraine's 5-year CDS spread has narrowed further in recent weeks, hitting levels below 700bps, from ca 1270bps in early January. (Figure 1)

Figure 1

5-year CDS narrowed further after the formation of new coalition



Source: Bloomberg, Eurobank Research

A quick resumption of IMF programme appears very likely

The rapid formation of a new government is positive for Ukrainian assets as it may allow Ukraine to quickly resume negotiations with the IMF. In mid-March, an IMF mission visited Kiev to discuss a re-engagement with the Fund, which will require deep fiscal cuts and the passing of a 2010 budget. Moreover, on his first foreign trip as Ukraine's new President in Brussels, Mr. Yanukovych ensured $675mn of EU aid once the country gets back on track with the IMF. However, Mr. Barroso, President of the European Commission, stressed the need for Ukraine to modernise and restructure its gas sector.

Ukraine needs the IMF loan to cover its budget shortfall and pay Russia for its natural gas consumption ($754mn of gas payments due in April). Although Ukraine could use its FX-reserves for its domestic and foreign debt obligations, without the IMF funding it will remain vulnerable to swings in global investors risk appetite. In our view, the new government will adopt a 2010 budget that complies with the terms of the IMF programme (including household gas prices increase) so as to ensure the disbursement of the reminder of the loan (ca $6.1bn remaining tranches of initial $16.5bn loan), most likely before H2-2010.

Real GDP contracted by 15% yoy in 2009

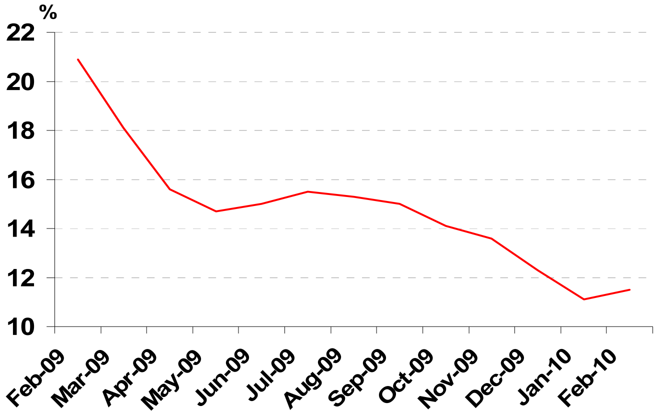
Official data released recently confirmed earlier estimates of a 15% yoy contraction in real GDP in 2009. This contraction was led mainly by a sharp output decline in the construction sector and in manufacturing activities (down by 48.3% yoy and by 26% yoy, respectively). Moreover, retail sales fell by 17.9% in 2009 reflecting weak domestic demand. With respect to higher-frequency indicators of domestic economic activity, industrial production decelerated to 5.6% yoy in February from a peak of 11.8% yoy in the prior month. On a brighter note, retail sales stabilised to 5% yoy contraction in the first two months of the year, compared to a 20% yoy drop in the previous seven months. This might be a sign of domestic demand recovery. We expect GDP growth to return to a positive territory in 2010, although the recovery will be rather moderate one, at ca 1.5% yoy. The government's new GDP forecasts are more optimistic than ours; they pencil GDP growth of 3.7% yoy in 2010.

Inflation likely to remain at high levels throughout 2010

The annual rate of inflation accelerated to 11.5% yoy in February from 11.1% yoy in January. (Figure 2) We expect annual inflation to average to 12.5% yoy in 2010 on the back of a likely increase in household gas prices during the year, if the government is to fulfil its commitments to the IMF programme. On the other hand, due to negative output gap, there are disinflation pressures which will help inflation to abate this year from an annual average of 16% yoy in 2009. Moreover, in view of the removal of administrative control and the necessity for public utilities' tariffs forced the government to raise its year-end inflation forecast for 2010 to 13.1%yoy, from an initially expected rate of 9.7% yoy.

Figure 2

Inflation abating but still at high levels



Source: Reuters, Eurobank Research

Key policy interest rate to remain at 10.25% for the rest of the year

Despite the recent inflation slowdown the real interest rate remains in negative territory. However, the National Bank of Ukraine will have to restrain money supply in view of the IMF programme restrictions, thus a further easing in monetary policy is unlikely in 2010.

Negative credit growth dynamics persist; private sector FX leverage remains high

The total credit growth remains in negative territory wit the latest available data (January 2010) showing a 2% mom drop. Meanwhile, total deposits are still decreasing (-1.1% mom in January). What's more worrisome is the high private sector FX leverage; FX-denominated loans accounted for 53.8% of total private sector loans in January, while FX-denominated mortgages climbed to 86.3% of total mortgages. In addition, non-performing loans (NPLs) are still rising with the NPLs ratio to total loans jumping to 9.6% in January 2010 from 7.1% in August 2009. Moreover, the level of private sector credit as a percentage of GDP remains very high, at 74% in Q4-09.

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