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Division of Research & Forecasting

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Commentary

The positive economic developments in the countries of New Europe during the second half of 2006 exceeded analysts' expectations. With the exception of Turkey, real GDP growth in Q4-2006 accelerated above our own projections, driven primarily by private consumption, credit expansion and gross fixed capital formation. At the same time, inflation either declined, i.e. in Romania and Serbia or remained under control, i.e. in Poland and Bulgaria. Only Ukraine is facing a double digit rate of inflation, due mainly to hikes in gas prices.

Turkey's economic growth is below par, buffeted by the emerging markets crisis in May/June 2006. The crisis and the subsequent resurgence of inflation forced the CBRT to raise its policy rates by 425bps, pushing real rates above 8%. The high real interest rates halted credit expansion in the second half of 2006, dragging down consumption and reducing gross fixed capital formation. As a result, we now estimate a real GDP growth in 2006 of 5%, down from 7.4% in 2005 and 8.9% in 2004. The May/June crisis highlighted the banking sector's resilience to adverse shocks and its ability to maintain adequate levels of profitability and capital adequacy. Nevertheless, it also revealed Turkey's excessive reliance on short-term portfolio flows for financing its current account deficit.

Looking ahead into 2007, our outlook is equally positive. In most cases, i.e. in Poland, Serbia, Bulgaria and Turkey, we envisage growth rates similar to those of 2006, while in Romania and Ukraine we expect a slight moderation in economic activity, down to more sustainable levels.

The key factors that could create downside risks to our positive outlook are political instability, stemming either from forthcoming elections or from unstable coalition governments, as well as the possibility of mismanagement of the substantial current account deficits that most of these countries maintain. Another - more subtle - risk is related to the ability of the banking sectors of these countries to continue providing the necessary funding for economic expansion. In countries such as Romania, Serbia and Ukraine, we are beginning to observe the first signs of liquidity constraints, which could grow bigger and affect the real economies.

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

1. Bulgaria

- **In 2007, we expect real GDP growth to remain at its current levels of 6.3% given that consumption growth will remain at its current levels and investment growth will cancel out any deterioration of net exports.**
- **Inflation exceeded government's projections in 2006 but is expected to moderate mildly to 5% by end-2007.**
- **The current account deficit poses a real threat to the economic stability as it will decline only marginally to 15% during 2007.**
- **In 2006, Bulgaria's budget recorded a surplus equal to 3.7% of GDP. For 2007, the government's target is for a surplus of 2% of GDP.**
- **FDI inflows reached 16.6% of GDP in 2006, up from 10.8% in 2005 and are expected to remain at high levels in 2007.**
- **Credit developments are getting increasingly difficult to monitor as lending is diverted into non-regulated channels in order to circumvent BNB regulatory restrictions.**

1.1 Macroeconomic Outlook

Summary

Real GDP growth will remain stable over 2007-2008, given that consumption growth will remain at its current levels and investment growth will cancel out any deterioration of net exports. In 2007, quarterly real GDP growth will average 6.3%, yoy, from 6.4%, yoy, in Q4-2006 and it will continue growing at 6.3%, yoy, in 2008.

Bulgaria	Q42006	2007*	2008*
GDP	6.4	6.3	6.3
Consumption	6.1	6.4	6.3
Investment	10.2	14.2	13.4
Exports	9.5	9.7	9.8
Imports	9.2	11.5	11.7
Current Account (% of GDP)	-16.0	-14.9	-15.0
Inflation (%, y/y)	5.9	4.9	5.6

Note: * Figures reported for GDP growth and its components are averages of y/y growth rates recorded every quarter of the corresponding year.

Consumption

Continuing labour market tightening and steady credit growth will enable consumption to maintain its positive momentum in both 2007 and 2008. Labour market tightening will continue in the light of higher minimum wages, effective from January 2007 and an expected decline of the unemployment rate, due to government programs supportive of long term employment. Expected income tax rate cut will increase disposable income in 2007 and will support further consumption growth. We expect consumption to grow on average 6.4%, yoy, and 6.3%, yoy, in 2007 and 2008, respectively. Expected monetary policy tightening by the European Central Bank in 2007, will raise Bulgaria's refinancing rate at 4% by year-end (currently at 3.5%), increase real interest rate and slightly restrain consumption growth in 2008. ECB's monetary stance is important for Bulgaria given EUR/BGN currency board.

Investment

We project that investment will continue its accelerating path in 2007 and 2008. Specifically, we estimate that investment will grow on average 14.2%, yoy, in 2007 and 13.4%, yoy, in 2008, up from 10.2%, yoy, in Q4-2006. The construction side will remain the principal driver of investment growth, as the economy continues to attract foreign investment, especially for real estate. The 5% reduction of corporate profit tax rate to 10% will render the Bulgarian corporate profit tax rate the lowest in the European Union and will provide an extra boost to investment.

Net exports

According to our forecasts, net exports will deteriorate over 2007-2008 since imports will grow at a faster pace than exports. On average, exports will grow 9.7%, yoy, in 2007 and 9.8% y/y in 2008, after growing by 9.5%, yoy, in Q4-2006. Steady export growth will continue, due to further integration of Bulgaria within the European Union that enhances trade with other European Union members. Contrary to exports, imports will increase, on average, by 11.5%, yoy, in 2007 and 10.7%, yoy, in 2008. Imports will also increase by 11.5% and 10.7% in 2007 and 2008 supported by the growing need for capital goods, raw materials and machinery necessary to improve Bulgaria's infrastructure.

Current Account

Bulgaria's persistent imbalance between savings and investments is reflected in the extreme current account deficit, standing at 16% of GDP at end-2006. In view of these imbalances, the government has adopted a prudent policy of fiscal surpluses in order to limit demand pressures in the economy. On the other hand, the expected monetary policy tightening by the ECB during 2007 will induce real exchange rate appreciation and lower competitiveness. According to our assessment, the end result of these two opposite factors will be a marginal narrowing of the current account to 15% throughout 2007 and 2008.

Inflation

Real exchange rate appreciation, through monetary policy tightening by ECB, will reduce inflation in Bulgaria in 2007. Prices will increase by 4.9% in 2007, down from 5.9% in 2006. Looking forward, we expect that the progressive labour market tightening during 2007 will result in a pick up in inflation in 2008 to 5.6%

1.2 Current Economic Developments

Since January 1st 2007, Bulgaria has become a fully fledged member of the European Union. Bulgaria's entry into the European Union constitutes a milestone not only in the transition of the former socialist country to a fully functioning market economy but also in the history of Southeastern Europe which becomes more integrated to Central Europe. Yet, despite the cosmogony taking place in Bulgaria, a paradox is emerging: Optimism for the Bulgarian economy is being reflected only in the business climate sentiment indicator, which has improved substantially over the past few months, but it has not affected households, given that the consumer sentiment indicator has been stagnant over a relatively long period of time (Figure1.1).

Real GDP continued to record an impressive growth throughout 2006 and we now expect to exceed our previous forecast of 6%. In the first nine months, total growth has averaged 6.3%, yoy, with domestic demand contribution reaching 11 percentage points (total consumption contributing 5.5 percentage points and gross fixed capital formation 5.7 percentage points). This comes as a result of the growth rate of household consumption which grew 6.7%, yoy in Q3-2006 and of gross fix capital formation which recorded another consecutive quarter of robust growth expanding by 15.9%, yoy, in Q3-2006, albeit below its recent growth rates of 24.0%, yoy, in Q3-2005 and 20.3% in Q2-2006. (Figure 1.2) Finally, net exports were the only negative component of GDP growth as they contributed a negative of 4.6 percentage points, a lower negative contribution compared to 2005 (Figure 1.3).

On the other hand, the fiscal surplus continues to provide a cushion against the current account imbalances and support to the currency

Figure 1.1

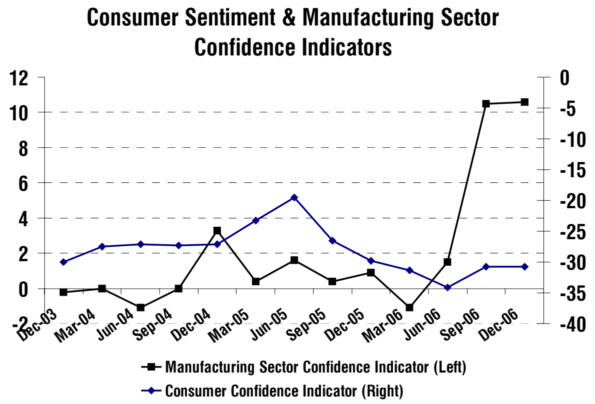


Figure 1.2

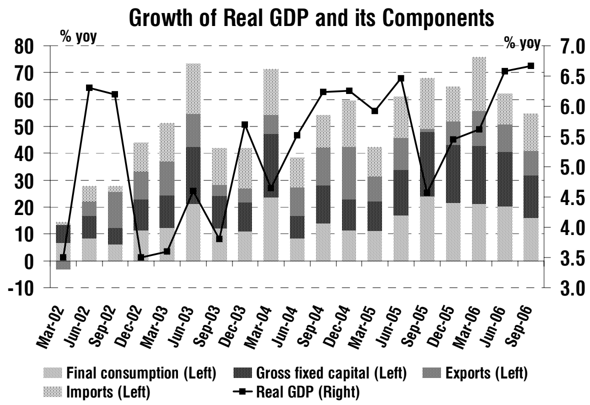
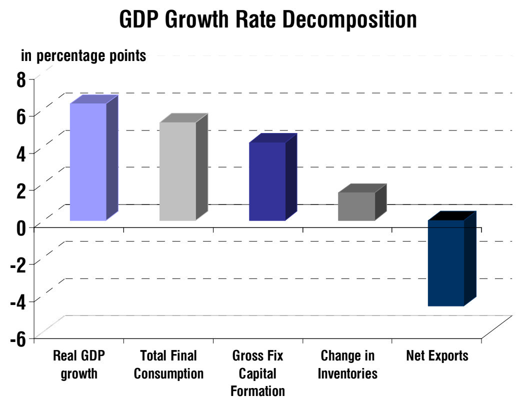
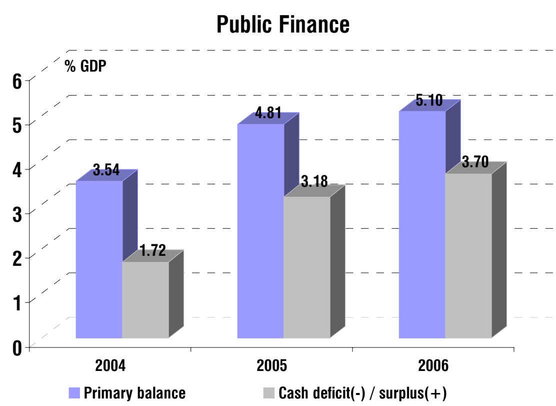


Figure 1.3



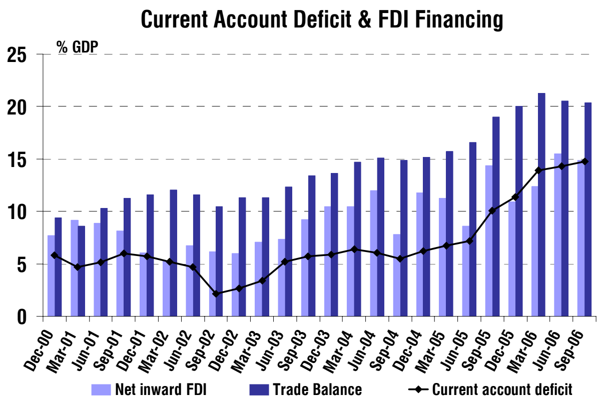
board. The government budget recorded a surplus equal to 3.7% of GDP in 2006, up from 3.2% of GDP in 2005. Expenditures containment, (expenditures recorded a cumulative growth of 9.7%, yoy, against an 11.3%, yoy, growth in revenues), led to the realization of a strong primary surplus of 5.1% of GDP, compared to 4.8% in 2005. According to the agreement with IMF (which is going to expire in March 2007), the government has agreed to target a fiscal surplus of at least 2% of GDP in 2007, and be prepared to increase this surplus should the current account deficit widen significantly. The challenges for the budget outlook for 2007 stem from the reduction in the corporate income tax rate, from 15% to 10%, and the sharp increase in government spending due to EU accession related outlays (Figure 1.4).

Figure 1.4



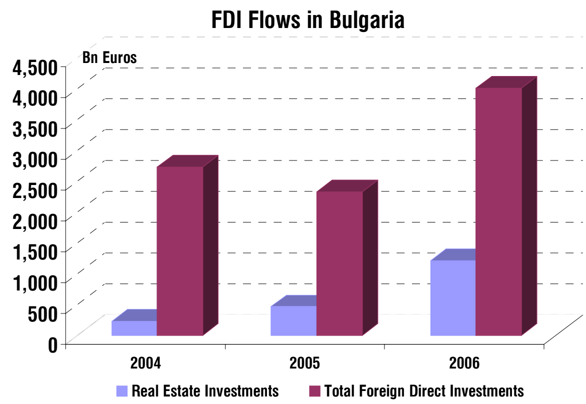
There has been a significant deterioration in the current account deficit in Q4-2006. The current account deficit has now approached 16% of GDP compared to 14.7% in Q3-2006 and 11.4% at end-2005. A closer look at the current account dynamics reveals that this deterioration can be attributed to both the widening of the trade balance and to the decline of the positive balance in services, income and net transfers. The trade balance deficit deteriorated from 20.2% of GDP in 2005 to 21.8% in 2006, despite the fact that exports have been growing faster (26% yoy in 2006) than imports (25% yoy in 2005). Exports growth has been fuelled by exports diversification at the neighbouring countries, while the increase in imports is primarily due to the increase of imported raw materials which increased by 28%, yoy, in 2006. The surplus in services declined by 1.4 percentage points (reduced tourism related revenues), the income surplus by 1.1 percentage points (investment earnings increase for maturing FDI inflows) and the current transfers surplus by 1.3 percentage points (Figure 1.5).

Figure 1.5



On the other hand, FDI inflows hit record-breaking levels, driven primarily by investments in real estate by non-residents. Foreign direct investment in Bulgaria grew by 43% in 2006 to €4015mn (16.6% of GDP), against €2809mn (10.8% of GDP) attracted in 2005. Receipts from real estate sales to non-residents amounted to €987.9mn, up from €464mn in 2005. According to our expectations, Bulgaria will continue to attract FDI inflows during 2007. Our optimism is based on the assumption that Bulgaria will continue to capitalise on its EU membership and take advantage of its low unit labour cost and very favourable corporate tax regime. Yet, it would be more natural to conclude that the FDI inflows structure will be re-oriented towards non-real estate activities (Figure 1.6).

Figure 1.6



Despite the substantial inflows of foreign capital, a large part of Bulgaria's economic expansion has been debt financed. During the first 9 months of 2006, Bulgaria's gross external debt has increased by 9 percentage points to 75.2% of GDP. A closer look at the decomposition of external debt shows that this increase is due to higher private sector borrowing, which accounts for 75% of total external debt, up from 70% in the beginning of 2006. Furthermore, the maturity structure of the debt is changing with short-term debt increasing its share to 29% of total debt, up from 25% at end-2005. Nevertheless, the external debt service has been trending downwards from 23% of GDP in 2005 to 13.5% of GDP in 2006 (Figure 1.7).

Strong demand from both domestic and external sectors of the economy led to higher than expected inflation throughout 2006. Specifically, average inflation came in at 7.3%, above government's projections of 5.5%. The main reason for inflation overshooting its projections was the acceleration of prices during the last quarter of the year, from 5.6% in September to 6.5% in December. Almost half of the inflation increase throughout the year can be attributed to the excise tax hikes on tobacco and alcohol products. These tax hikes passed through to non-food prices, which recorded an increase of 11.3%, yoy, and contributed 3.3 percentage points to inflation. Based on the assumption that the adverse base effects of these tax hikes will fade away during 2007, the government projects an inflation rate of 3.1% at end-2007 (or 4.4% yearly average).

1.3 Banking Developments

As we have mentioned in previous issues of the New Europe review, Bulgaria's rapid credit growth has prompted BNB to introduce, from end-2004, a series of restrictive prudential measures in order to control the expansion of credit in the economy.

Given the competitive climate in the Bulgarian banking sector and the strong demand for credit, banks have tried to meet this excess demand by diverting credit into channels not regulated by BNB. Thus, while it is true that in September 2006 credit did slow down to 20.2%, at the same time the value of outstanding leasing contracts grew from 2.4% of GDP in Q3-2005 to 4.0% in Q3-2006 (Figure 1.8). In addition, it has to be noted here that the majority of Bulgaria's leasing companies are banks' subsidiaries. Last but not least, borrowing from abroad, either in the form of direct foreign loans or in the form of loans transferred by local banks to their foreign parents abroad, has increased substantially. In Q3-2006, gross external debt of local individuals and legal entities grew by 60.4%, yoy, increasing

Figure 1.7

Gross External Debt Maturity Decomposition

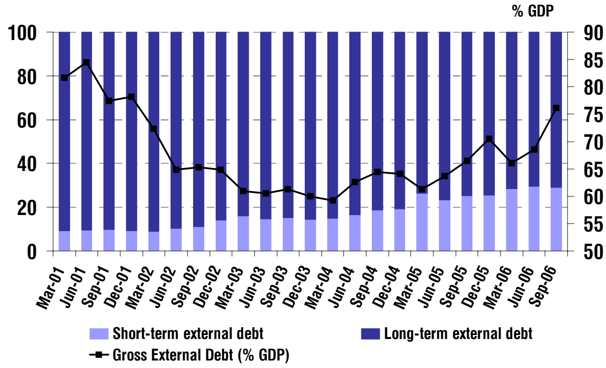


Figure 1.8

Lease Contracts to GDP

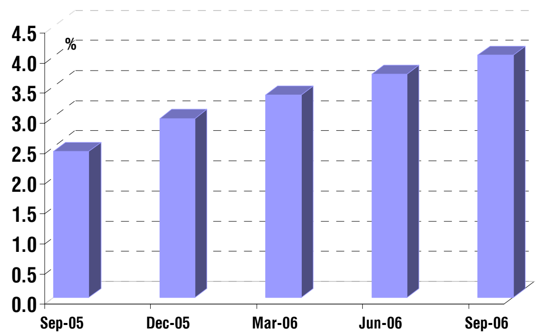
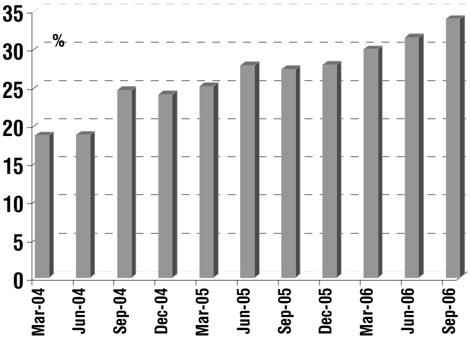


Figure 1.9

Gross External Debt of Local Individuals and Legal Entities (% of Total Gross External Debt)



its share in total external debt to 33.9%, up from 18.6% two years ago (Figure 1.9).

Household credit, which we believe is more accurately reflected in the official statistics, continued its robust growth. Consumer loans remained households' loans main component, with a share of 57% of total household lending. However, consumer loans' growth rate slowed down from 17.9% in Q3-2006 to 12% in Q4-2006, giving its place to the expanding market of mortgage lending which expanded by 73.4%, yoy, in December 2006, up from 68.9% in the previous quarter (Figure 1.10).

Moreover, the prudential measures taken by BNB had a positive effect on banking sector's fx exposure since credit growth in foreign currency slowed down to 18.6% yoy at end-2006, down from 31.4% yoy one year ago (Figure 1.11). The prospects of banking sector's fx exposure are rather favourable if we consider the fact that 96% of loans in foreign currency are in euros, up from 70% in Q1-2003. Bulgarian BGN is pegged to the euro, while Bulgaria is expected to have adopted the euro by 2010. It should be stressed, however, that borrowing in foreign currency is particularly popular with households, which consist of the most vulnerable economic participants. Thus, foreign-denominated credit granted to households still grew by 74.1% yoy as of Q4-2006, down from 185.1%, yoy, at end-2005.

Deposits & Liquidity

Deposits to Non-Financial Institutions and other clients grew by 34.8% yoy as of Q4-2006, currently standing at 54.5% of GDP. Deposits in foreign-currency grew by 38.3% yoy in December 2006, compared with 31.4%, yoy, for domestic-currency denominated deposits. According to BNB, the majority of deposits in foreign currency is Euro-denominated (73% as of Q4-2006), which grew by 60.1%, yoy, in December 2006, boosted by Bulgaria's accession to the European Union and remittances from abroad.

The strong growth in deposits - especially in foreign currency - and the diversion of business lending towards non-banking channels, has led to improvements in banking sector's liquidity. Hence, the ratio of loans to deposits declined from 89.9% at end-2005, to 80% in 2006 (Figure 1.12). The improvement in liquidity was even more pronounced in foreign currency, with the ratio of foreign currency denominated loans to deposits currently standing at 63.3%, 15 percentage points below its end-2005 level.

Figure 1.10

Consumer Loans and Mortgages Growth Rates

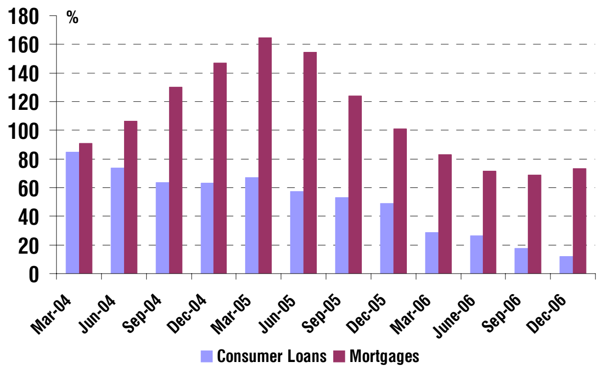


Figure 1.11

Credit Growth Rates in Domestic and in Foreign Currency

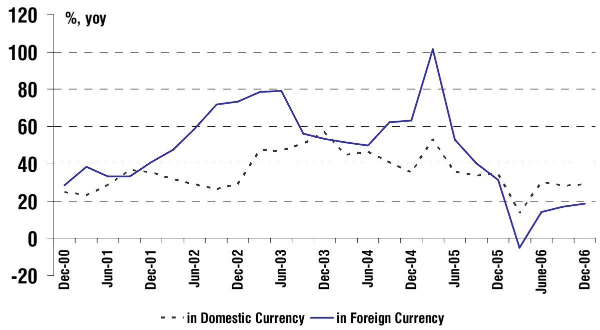
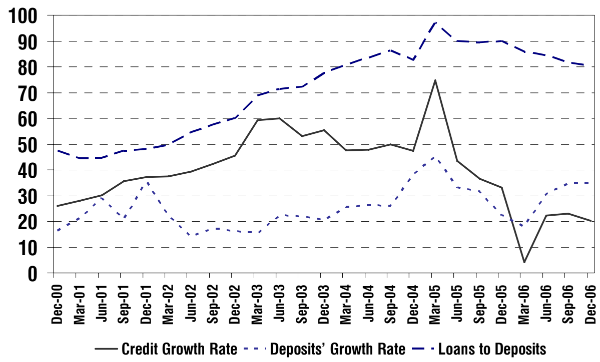


Figure 1.12

Bulgaria's Banking Sector Liquidity

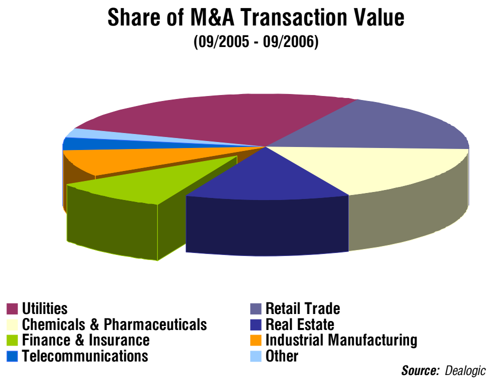


Other Developments

The Bulgarian banking sector was marked by the early entrance of foreign capital. As a result, in the Bulgarian banking sector we are able to observe the first stages of the second wave of consolidation between market participants, without the involvement of the state. Indications of this second wave are Slovenia's Nova Ljubljanska Banks acquisition of 97% of West-East bank and Greece's Eurobank EFG acquisition of 74% of DZI. Furthermore, 37% of ElBank was sold to Luxembourg's Novator Finance Bulgaria, 24.3% of its capital was acquired by Tsvelelina Karagyosova and 24.3% by Svetoslav Bozhilov. Finally, BACB went public selling to investors 30% of its shares.

According to data provided by Dealogic, in the period from September 2005 to September 2006, 22 bids took place in the Finance and Insurance sector, accounting for 9.3% of the total value of M&A activity in Bulgaria. The biggest share of M&A activity belongs to the Utilities' sector (27% share), followed by the Retail Trade sector (18.2% of total transaction value), the Chemicals and Pharmaceuticals (17.5%) and the Real Estate Industry (13.2%) (Figure 1.13).

Figure 1.13



Bulgaria: MacroEconomic Indicators	2001	2002	2003	2004	2005	Q1 2006	Q2 2006	Q3 2006	Q4 2006
Output and expenditure					*(Percentage Change in Real Terms)*				
GDP	4.0	4.8	4.5	5.6	5.5	5.6	6.6	6.7	-
Final Consumption	4.4	3.6	6.6	5.1	6.8	4.8	6.7	6.7	-
Gross fixed capital formation	19.9	9.3	13.9	12	19	21.4	20.3	15.9	-
Exports of goods and services	8.5	6.2	8	13.1	7.2	12.9	10.2	9	-
Imports of goods and services	13	4.7	15.3	14.1	14.6	20.0	11.4	13.7	-
Industrial production	2.5	4.7	14.1	17.1	6.7	6	6.2	6.7	3.6
Labour Market									
Employment (Labor Contract) % change	-0.2	1.6	6.8	5.1	2.7	0.8	0.6	1	-
Unemployment (in per cent of labor force)	19.8	17.8	13.7	12.0	10.1	9.7	9	8.8	-
Prices					*(Percentage Change)*				
Consumer prices (annual average)	7.4	5.9	2.3	6.1	5.0	8	8.3	6.7	6.1
Producer prices (annual average)	3.6	1.3	4.9	5.9	6.9	8.2	9.9	10.5	8.2
Average monthly wage in economy	6.9	7.3	6.1	7	9.3	9.9	9.8	11.6	12.7
Government sector					*(In per Cent of GDP)*				
General government balance (National Definition)	-0.6	-0.6	0	1.7	3.2	1.6	3.8	5.7	5.1
General government debt	69.9	55.9	48.2	40.7	31.9	26.7	26.4	26.3	25.6
Monetary and Financial Indicators					*(Percentage Change)*				
M3	25.8	11.7	19.6	23.1	23.9	10.1	20.9	24.7	26.9
Total Credit	37.2	45.5	55.4	47.3	33.1	4.1	22.4	22.8	20.2
					(End of Period)				
Base interest rate	4.48	3.96	2.68	2.61	2.04	2.25	2.54	2.81	3.1
Exchange rate BGN/USD	2.2	1.9	1.5	1.4	1.7	1.6	1.5	1.5	1.5
Exchange rate BGN/EUR	1.95	1.95	1.95	1.95	1.95	1.95	1.95	2	2
Real Effective Exhange Rate (Index)	126.8	131.4	140.1	141.9	141.8	146.8	146.1	144.6	149.3
International Position					*(In per Cent of GDP)*				
Current account balance	-5.6	-2.4	-5.5	-5.8	-11.3	-13.9	-14.3	-14.8	-16
Trade balance	-11.7	-11.4	-13.7	-15.1	-20.2	-21.3	-20.5	-20.34	-21.8
Foreign direct investment, net	6.1	6	10.4	11.8	10.9	12.4	15.5	14.9	16.6
External debt	78.6	65.1	60.2	64.2	70.4	66.2	70.6	76.3	-
Memorandum items					*(Denominations as Indicated)*				
Population (end-year, million)	7.891	7.846	7.801	7.761	7.761	-	-	-	-
GDP (in millions of leva)	29,618	32,323	34,410	38,008	41,948	-	-	-	-
GDP per capita (in US dollar)	1,718	1,983	2,545	3,109	3,433	-	-	-	-

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

Bulgaria: Banking Indicators									
	2001	2002	2003	2004	2005	Q1 2006	Q2 2006	Q3 2006	Q4 2006
Percentage of GDP (%)									
Assets	41.1	45.0	50.1	65.1	78.3	79.1	80.5	82.6	-
Total Credit	14.0	18.7	27.1	36.1	43.8	43.3	44.3	44.5	-
Credit to Enterprises	11.1	14.9	20.9	26.1	29.0	28.3	28.4	28.5	-
Credit to Households	2.8	3.7	6.1	9.9	14.7	14.9	15.8	15.8	-
Deposits	32.2	34.9	39.3	51.0	60.6	60.4	62.2	64.5	-
Percentage Change (%, yoy)									
Assets	25.0	19.1	19.0	43.8	31.8	17.0	28.9	30.4	28.4
Total Credit	37.2	45.5	55.4	47.3	33.1	4.1	22.4	22.9	20.2
Credit to Enterprises	35.0	45.6	50.2	38.1	21.7	-9.3	14.2	17.3	19.4
Credit to Households	46.3	45.3	75.0	79.3	63.0	43.8	39.9	33.8	32.1
Deposits	34.3	18.1	20.5	43.7	30.1	12.0	27.7	33.7	30.6
Percent (%)									
Capital Adequacy Ratio	31.3	25.2	22.2	16.1	15.2	16.0	-	-	-
Capital to Assets	13.5	13.3	13.1	11.0	10.5	-	-	-	-
NPLs to Total Loans	3.3	2.4	2.5	1.9	1.7	-	-	-	-
Provisions to NPLs	61.6	59.6	50.0	48.5	45.3	45.3	-	-	-
Return on Assets	2.9	2.1	2.4	2.1	2.1	2.6	-	-	-
Return on Equity	21.9	17.9	22.7	20.6	22.1	25.8	-	-	-

Sources: BNB, IMF

2. Romania

- **We expect real GDP to grow by 6.5% in 2007, down from 7.5% in 2006.**
- **The current account deficit widened to 10.5% of GDP in 2006, but we expect a slight moderation to 10% in 2007.**
- **Fiscal policy implementation posses some serious questions. In Q4-2006, total expenditure rose by 30% (in real terms) while capital spending increased by 45% in December alone.**
- **In 2006, FDI increased by 84%, covering 90% of the current account deficit.**
- **Inflation, in 2007, is expected to remain around 5%, at the upper end of NBR's inflation target band.**

2.1 Macroeconomic Outlook

Summary

Romania entered the European Union in the midst of a strong growth rebound. Following its accession into the EU, the key challenge for Romania would be to improve its institutional and administrative infrastructure, so as to fully take advantage of the benefits of EU membership. In 2007, Romania will be eligible for approximately €3.2bn of EU funds available for governmental policies ranging from infrastructure development to agricultural subsidies. The political leadership however will have to work hard in preparing the infrastructure needed to receive and administer these funds according to EU rules and regulations.

We expect a mild deceleration of real GDP growth in 2007 to 6.5%, yoy, average growth rate from 7.7%, yoy, in Q4-2006 due to lower consumption and investment growth and unchanged net exports.

Romania			
	Q42006	2007*	2008*
GDP	7.7	6.5	6.3
Consumption	12.0	9.7	8.6
Investment	12.3	9.4	8.5
Exports	10.3	10.2	10.9
Imports	20.6	13.4	12.3
Current Account (% of GDP)	-9.0	-8.5	-8.5
Inflation (%, y/y)	4.7	5.0	4.8

Note: * Figures reported for GDP growth and its components are averages of yoy growth rates recorded every quarter of the corresponding year.

Consumption

Consumption will register a marginal slowdown in 2007 and 2008 after growing on average 12%, yoy, in Q4-2006. In 2007, consumption will grow by 9.7%, yoy, and by 8.6% in 2008. We attribute this deceleration to a subtle slowdown of credit growth that will outpace the slowdown of unemployment as a result of the continuing labour market tightening. Additionally, higher administered and oil prices will reduce disposable income and contribute to lower consumption. The risks to our projection for consumption are to the upside conditional on more expansionary fiscal policy.

Investment

We expect investment growth to moderate to 11.5% in 2007 and 10.5% in 2008, from 12.3% in Q4-2006. Investment growth will be supported by lower nominal interest rates and acceleration of government's spending on infrastructure projects. On the other hand, we do not expect any immediate boost to capital formation from EU co-financed projects, which will start to materialise in late 2008.

Net Exports

Net exports will improve during 2007-2008 due to stable growth of exports and weaker growth of imports. Specifically, imports will grow on average 13.4%, yoy, in 2007 and 12.3%, yoy, in 2008 from 20.6%, yoy, in Q4-2006. Subtle deceleration of economic activity and consumption will contribute to lower growth of imports. In contrast, exports will grow on average 10.2%, yoy, in 2007 and accelerate in 2008 to 10.9%, yoy, from 10.3%, yoy, in Q4-2006.

Current Account

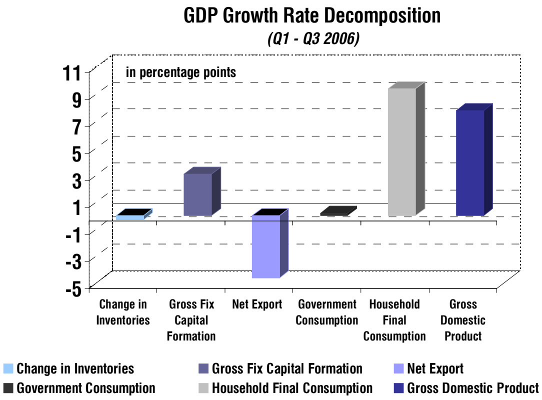
The current account deficit - standing at 10.5% of GDP in Q4-2006 - will improve to 10% of GDP in 2007 and to 9.5% in 2008. Marginal improvement of net exports, due to marginal deterioration of imports' growth and stable growth of exports, will improve the trade balance which is the principal component of current account balance. Additionally, lower real GDP and investment combined with expansionary government spending will produce lower net output defined as real GDP minus investment and government spending. Lower net output will drag the current account deficit down from its current level. Our current account deficit projection will be realized, to the extent that labour market tightening is not sufficient to increase net output.

Inflation

Procyclical fiscal policy and labour market tightening will result in a slight increase of inflation in 2007. Inflation will remain around 5% in 2007, at the upper end of the +/-1% band of the 4% inflation target set by the BNR for 2007. Labour market tightening is evident by lower unemployment especially for skilled workers and budgeted wage increases at the public sector that will have spillover effects to the private sector. Expected hikes of oil prices in 2007 will contribute to inflation hikes, too. Oil future contracts suggest that the price of Brent crude oil will be 61.45 USD/barrel by end of 2007 and 62.4 USD/barrel by end 2008, up from 55.85 USD/barrel as of 14 February 2007.

2.2 Current Economic Developments

Figure 2.1



During the first 3 quarters of 2006, real GDP recorded a 7.8% yoy increase and is on target for a 7.5% growth for the entire 2006. More specifically, in Q3-2006 economic growth accelerated to 8.5%, yoy, on the back of robust private consumption and investment growth. Total consumption continued to race at 11.2%, yoy, up from 7.5% in Q3-2005, contributing approximately 9.2 percentage points to GDP growth. Gross fixed capital formation growth surged to 15.3% in Q3-2006, compared with 12.2% in the previous quarter and against 8.9% growth in Q3-2005. As a result the contribution of gross fixed capital formation to GDP growth increased to 4.1%. Finally, net exports continued to make a negative contribution. Exports grew by 11%, yoy, in Q3-2006, up from 8.4%, yoy, in Q3-2005, while imports grew by 21.2%, yoy, up from 17.4% in Q3-2005 (Figure 2.1).

Romania's fiscal policy, its revisions as well as its (procyclical) impact on the economy have been the focus of our attention throughout 2006. In retrospect our interest has been fully justified. Having recorded a surplus of 1.3% of GDP for the period of January to November, Romania's budget spectacularly swung into a 1.7% deficit at year-end. Higher government spending at year-end has been endemic in Romania, but last year's surge in expenditure has been unprecedented - creating question marks about the prudent use of funds. In Q4-2006 total expenditure, a significant part of which is geared towards government consumption, grew by 30.5%, yoy (in real terms), while total revenue only by 8.2% (in real terms). Even more spectacular was the increase that capital spending registered in December compared to the Jan.-Nov. period. December's capital expenditure amounted to 45% of the total funds earmarked for infrastructure projects for the entire 2006 (Figure 2.2).

Looking ahead into 2007, government's fiscal policy is even more expansionary. The government is aiming for a fiscal deficit of 2.8% of GDP, which - to the extend that it materialises - will provide a procyclical stimulus to the economy. The danger is that, given that the economy is already operating above its potential level, this stimulus will add to inflationary pressures and conflict with central bank's policy of lowering inflation to 4%. Further challenges will arise from the impact of the implementation of a 16% flat tax on the budget revenues. Yet, most worrisome is the fact that given government's difficulties in planning and executing infrastructure projects, this extra spending will be reallocated from capital to current expenditure, such as public sector wages.

The single most important side-effect of Romania's above trend economic growth is the increasing size of its current account deficit. In Q3-2006, the current account deficit reached 10% of GDP and we now expect the final deficit for the entire 2006 to come in around 10.5% of GDP. Private consumption is fuelling an import boom, which has resulted in a significant deterioration of the trade balance deficit. In the period Jan-Nov 2006, the trade deficit widened by 48%, compared with the same period in 2005, as a result of a surge in imports by 24.5% (due to higher energy prices) and a slowdown in exports by 16.7%. As a result, in Q3-2006 the trade deficit reached 11.3% of GDP up from 10.6% in the previous quarter.

On the positive side, the Romanian economy is (still) in a position to finance a significant part of its current account deficit with non-debt creating FDI flows. Net FDI inflows reached 7.3% of GDP in Q3-2006 compared to 6.6% of GDP in Q3-2005. In 2006, FDI inflows increased by 75%, reaching €9.1bn (in November alone inflows of €400mn were recorded), covering 91% of the current account deficit (Figure 2.3).

BNR's inflation targeting credibility, careful management of administered prices by the government and consumer preference for imported rather than domestic goods (see comments on trade deficit above) are the main reasons behind the success of the disinflationary policies in Romania. The end of year inflation came in at the record low levels of 4.8%, just below BNR's inflation target of 5%, averaging 6.5% over the entire 2006. These developments in conjunction with the appreciation of the Leu (the real exchange rate

Figure 2.2

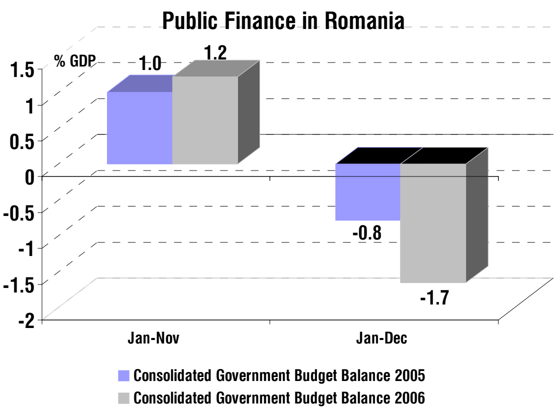
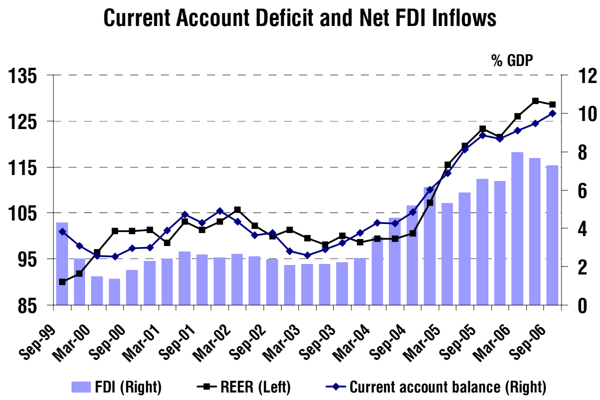
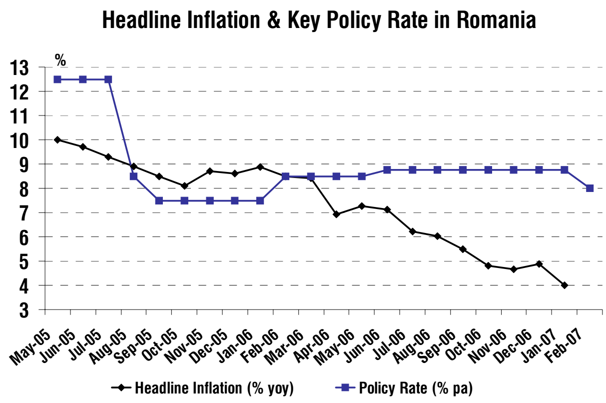


Figure 2.3



appreciated by 6.6% during 2006) have allowed the central bank to cut its policy interest rate by 75bps to 8%. As we discuss in our Outlook section, further decline of inflation (the 2007 target is set at 4% +/- 1%) might prove problematic given the tightening of the labour market and the procyclicality of the fiscal policy (Figure 2.4).

Figure 2.4

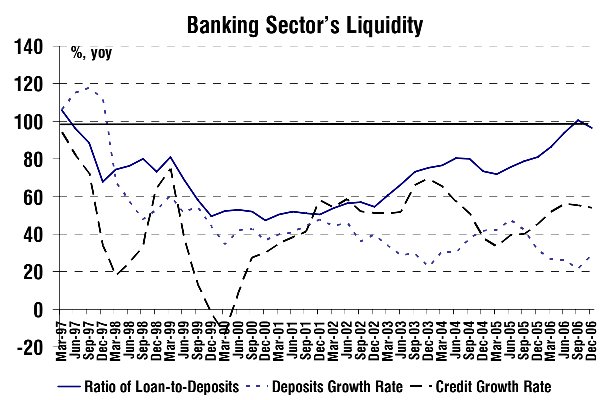


2.3 Banking Developments

Banking sector's growth continued unabated during the second half of 2006, with banking sector's assets growing by 34.7% yoy, in 2006 and with total private sector credit expanding by 53.7% yoy, over the same period. As a result, banking sector's assets and total credit reached 47.8% and 26.4% of GDP respectively. Furthermore, we expect that credit growth will receive a further boost, following NBR's recent cut of its key policy rate by 75bps. Despite this rapid growth, Romania has still plenty of growth potential, given that its banking sector has roughly half the size of the EU-8[1] new member countries.

Yet, as we elaborate below, the future growth of the Romanian banking sector could be severely constrained due to lack of liquidity. Credit growth has outpaced the growth of deposits for a number of consecutive quarters and as a result the ratio of loans to deposits has risen by 19% in one year alone, from 81% in December 2005 to 97% in December 2006 (Figure 2.5). Operating with a loan to deposits ratio close to or above 100% is possible only for banks with easy access to interbank markets or medium term notes programs (EMTNs) or for banks that can use modern financing tools, such as securitization of mortgage or business loans. Given the small size of the Romanian interbank market, which currently is able to finance only 6.5% of banks' lending activity, and the low ratings of Romanian banks, these funding resources will not be easily available. Hence, banks will either have to resort to their parent banks abroad for liquidity or will have to limit the expansion of their business to match the growth rate of their deposits.

Figure 2.5



Credit Developments

During 2006, total lending to households grew by 83.8%, yoy, with consumer loans up by 93.7% and mortgage loans by 53%, yoy. Household borrowing in foreign currency also increased by 71.8% in Q4-2006, up from 47% in the previous quarter.

[1] EU-10 new member counties, excluding Malta and Cyprus, whose financial system is close to that of EU-15 countries.

Finally, loans to private enterprises grew by 45.4% as of Q4-2006 and loans to state-owned enterprises by 6.1%. Loans to private enterprises still remain the largest component of total non-government credit, with a shape of 54.2 % (Figure 2.6).

Deposits & Liquidity

As already mentioned, deposits' growth rate has been outpaced by credit growth. Total deposits' growth rate is mostly driven by deposits to households, which grew by 32.7%, yoy, as of December 2006, while deposits of enterprises accelerated significantly from 16.9% yoy in September 2006 to 26.8% yoy in December 2006. Deposits of private enterprises grew by 27%, yoy, in Q4-2006 and deposits of state-owned enterprises recorded a strong growth of 24.3%, yoy, up from 6.1% in the previous quarter (Figure 2.7).

The main component of households' savings is RON-denominated deposits, their share being equal to 63.6% of total household deposits in Q4-2006. Households savings in domestic currency increased by 33.6%, yoy, in December 2006, while foreign-currency denominated household deposits grew by 31%, yoy, partially due to currency appreciation.

Enterprises have a clear preference for deposits in domestic currency, since their share in total business deposits was 79% in Q4-2006, growing by 32.9%, yoy, compared with a growth rate of only 8.6%, yoy, for foreign currency denominated deposits. This has resulted in a ratio of loans to deposits in foreign currency of 264% creating a significant imbalance between the assets and liabilities of Romanian private enterprises in foreign currency and exposing them to fx risks (Figure 2.8).

Credit quality & Lending Spreads

One of the positive developments is banking sector's stable credit quality profile. According to the latest data, loans classified as substandard, doubtful and loss currently consist of 5.5% of the total loan portfolio, down from 6.1% one year ago (Figure 2.9).

One negative development however is that NBR's measures to curb lending in foreign currency did not have the desired impact. Foreign currency denominated credit growth increased by 33.7%, yoy, in Q4-2006, up from 23.2% in the previous and from 29.1% yoy over the same period a year ago. Though it can be claimed that lending in foreign currency remains contained, the risk of unhedged

Figure 2.6

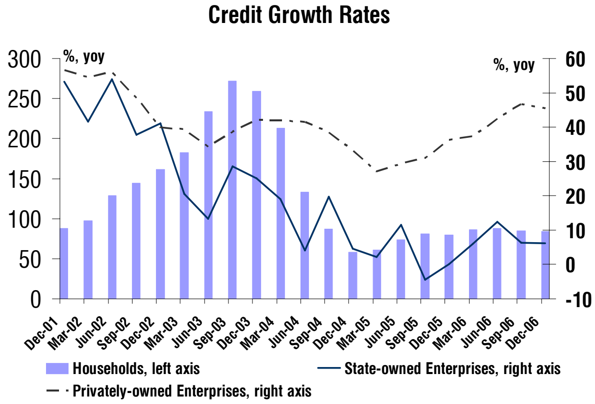


Figure 2.7

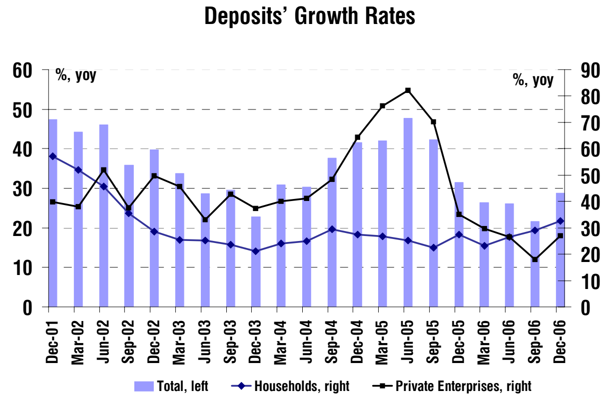
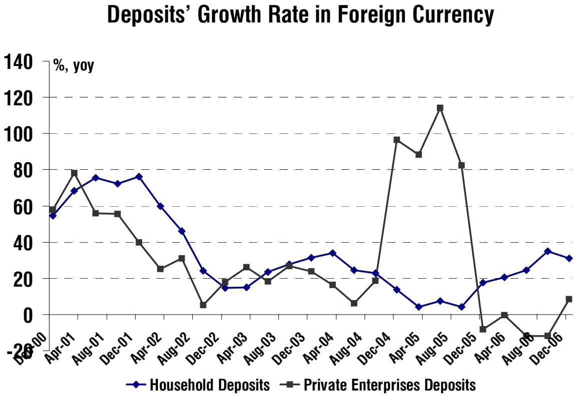


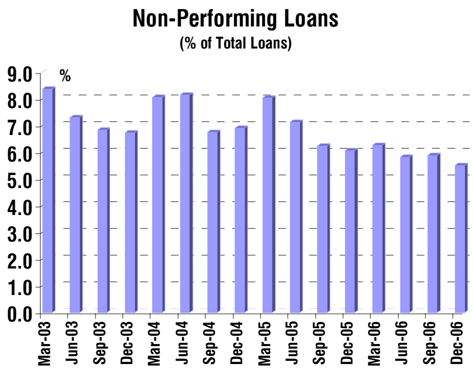
Figure 2.8



foreign currency positions remain, as it was highlighted in a recent report from the rating agency Standard and Poor's.

The combined effect of increased competition for market share in the banking sector and the continuous improvement in the credit quality of the loan portfolios resulted in a substantial decline in the banking sector's interest margins. The spread of average interest rates applied by credit institutions for RON-denominated transactions to non-government and non-bank clients has declined significantly by 313bps, from 11.49% in December 2005 to 8.36% in December 2006. This declining trend is going to continue due to the interest rate convergence towards European levels and the disinflation process becoming more entrenched.

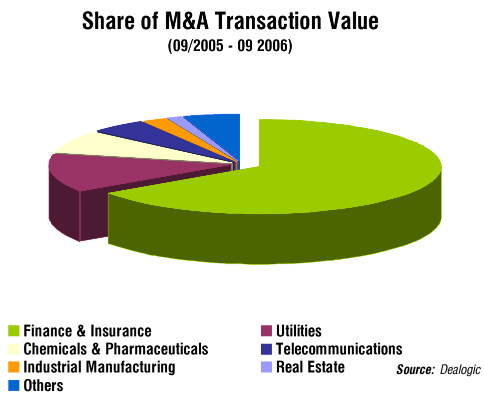
Figure 2.9



Other Developments

The most important characteristic of the period prior to Romania's accession to the European Union has been the significant increase of foreign participation in the financial sector. This was aided by the reforms linked to the EU accession and by the privatization of state-owned banks. During the period between September 2005 to September 2006, 16 bids took place in the Finance and Insurance sector with a total transaction value of US$5.4bn. As a result, the share of the Finance and the Industry sector was equal to 65.6% of the total M&A transaction value realized within this period, indicating the importance of financial sector for the Romanian economy (Figure 2.10).

Figure 2.10



Romania: Macroeconomic Indicators	2001	2002	2003	2004	2005	Q1 2006	Q2 2006	Q3 2006	Q4 2006
Output and expenditure				*(Percentage Change in Real Terms)*					
GDP	5.7	5.1	5.2	8.4	4.1	6.9	7.8	8.5	-
Private consumption	6.9	5.3	8.5	14.1	9.7	10.9	12.7	12.4	-
Public consumption	3.6	3.0	7.5	5.0	4.5	4.3	0.9	2.9	-
Gross fixed capital formation	10.1	8.2	8.6	10.8	13.0	11.4	12.2	15.6	-
Exports of goods and services	12.9	15.3	6.4	21.3	17.5	22.0	18.7	11.0	-
Imports of goods and services	22.1	8.6	12.3	24.0	23.9	28.6	22.7	21.2	-
Industrial production (cumulative)	8.2	6.0	3.1	5.3	2.0	4.5	6.7	7.2	7.1
Labour Market									
Employment (% change)	1.4	-2.8	0.1	1.0	2.6	1.6	0.9	1.1	1.5
Unemployment (in per cent of labor force)	8.8	8.4	7.4	6.3	5.9	6.2	5.6	5.0	5.1
Prices					*(Percentage Change)*				
Consumer prices (annual average)	34.5	22.5	15.3	11.9	9.1	8.6	7.1	5.9	4.9
Producer prices (annual average)	42.0	24.8	19.7	18.6	12.5	11.6	12.1	12.9	-
Average monthly wage in economy	40.9	26.8	25.4	22.5	23.7	15.0	14.7	15.6	21.5
Government sector					*(In per Cent of GDP)*				
General government balance (National Definition)	-3.2	-2.6	-2.2	-1.2	-0.8	0.6	1.1	1.7	-1.7
General government debt	23.2	25.0	21.5	18.8	15.9	-	-	-	-
Monetary and Financial Indicators					*(Percentage Change)*				
M2	46.2	38.2	23.3	39.9	33.9	28.8	28.1	23.9	29.4
Total Credit	46.4	42.4	49.2	32.5	43.7	51.1	53.3	51.2	52.0
					(End of Period)				
Reference rate	35.0	20.4	18.9	20.2	9.7	8.5	8.5	8.75	8.75
Exchange rate RON/USD (end-period)	3.2	3.4	3.3	2.9	3.1	2.9	2.8	2.8	2.6
Exchange rate RON/EUR (end-period)	2.8	3.5	4.1	4.0	3.7	3.5	3.6	3.5	3.4
Real Effective Exhange Rate (Index)	101.5	102.3	99.1	101.6	119.9	126.1	129.3	128.6	-
International Position					*(In per Cent of GDP)*				
Current account balance	-4.9	-2.8	-3.8	-6.0	-8.7	-9.1	-9.5	-10.0	-
Trade balance	-7.4	-5.7	-7.5	-8.8	-9.8	-10.6	-10.9	-11.3	-
Foreign direct investment, net	2.5	2.1	2.4	6.1	6.5	8.0	7.7	7.3	-
External debt	30.9	35.0	34.7	35.1	33.0	-	-	-	-
Memorandum items					*(Denominations as Indicated)*				
Population (end-year, million)	22.4	21.8	21.7	21.7	21.7	-	-	-	-
GDP (in billions of Lei)	116.8	151.5	197.6	246.4	287.2	-	-	-	-
GDP per capita (in US dollar)	1,793	2,103	2,738	3,483	4,535	-	-	-	-

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

Romania: Banking Indicators									
	2001	2002	2003	2004	2005	Q1 2006	Q2 2006	Q3 2006	Q4 2006
Percentage of GDP (%)									
Assets	30.2	31.6	31.3	37.1	45.4	45.5	47.4	47.8	-
Total Credit	13.4	14.7	16.8	17.9	22.0	22.8	25.2	26.9	-
Credit to Enterprises	9.2	9.9	10.6	10.9	12.4	12.5	13.5	14.4	-
Credit to Households	0.7	1.4	3.8	4.8	7.4	7.6	9.2	11.1	-
Deposits	20.1	21.7	20.4	23.1	26.1	25.6	26.3	26.3	-
Percentage Change (%, yoy)									
Assets	51.3	35.8	29.1	48.0	42.5	35.4	36.8	31.3	34.7
Total Credit	46.4	42.4	49.2	32.5	43.7	51.1	53.3	51.2	52.0
Credit to Enterprises	56.1	40.1	39.5	29.2	32.1	34.3	39.8	43.0	42.0
Credit to Households	87.6	161.5	258.9	58.3	80.0	73.3	76.4	84.8	83.8
Deposits	47.4	39.7	22.7	41.5	31.5	26.4	26.1	21.6	28.9
Percent (%)									
Capital Adequacy Ratio	28.8	25.0	20.0	18.8	20.2	20.0	-	-	-
Capital to Assets	12.1	11.6	10.9	8.5	8.8	9.2	-	-	-
NPLs to Total Loans	3.3	2.3	8.3	8.1	8.3	8.3	-	-	-
Provisions to NPLs	76.8	52.6	33.5	34.3	31.4	34.1	-	-	-
Return on Assets	2.5	2.7	2.7	2.5	1.9	1.9	-	-	-
Return on Equity	15.8	18.8	20.0	19.3	15.4	15.0	-	-	-

Sources: NBR, IMF

3. Serbia

- **Political uncertainty remains, as we await for the formation of a new coalition government.**
- **We expect real GDP to grow by 5.5% in 2007, from 5.8% in 2006.**
- **The fiscal policy remains in limbo, as political negotiations delay the drafting of a credible budget for 2007.**
- **The implementation and funding of the National Investment Plan also remain to be determined.**
- **We estimate that the current account deficit will increase to 11% in 2007, up from 10.4% in 2006. Yet, it will be easily funded via FDI inflows.**
- **Excess demand will push inflation to 7.5%, up from 6.6% in 2006.**
- **The process of re-monetization of the Serbian economy is well on its way, as total deposits grew by 40% during 2006.**

3.1 Macroeconomic Outlook

Summary

Based on the most recent data, we now expect the Serbian economy to expand by 5.5% in 2007, from an estimated 5.8% during 2006. The upside risk for our real GDP projection comes from the implementation (or not) of the National Investment Plan (NIP). Specifically, further implementation of NIP will boost domestic demand and will result in a higher GDP growth rate. Finally, a cut of the income tax rate scheduled for early 2007, will support disposable income and subsequently, consumption.

Serbia	2006	2007	2008
GDP (%, y/y)	5.8	5.5	5.5
Current Account (% of GDP)	-10.4	-11,0	-12.0
Inflation (%, y/y)	6.6	7.5	7.0

Current Account

The current account deficit is expected to increase to 11% of GDP in 2007 and 12% in 2008 from 10.4% in 2006. Demand for both investment and consumption purposes, coupled with the strengthening of the dinar vs. the Euro has resulted in a structural trade balance deficit that will be difficult to reverse, as along as the convergence process to European levels of living standards is in process.

3. Inflation

We project a mild increase of the inflation rate in 2007 by one percentage point to 7.5% in 2007 from 6.6% in 2006 attributed to higher domestic demand due to NIP. Higher capital expenditure under NIP will boost domestic demand and inflationary pressures. Higher oil prices projected for 2007 will reinforce inflation further. Despite the appreciation of the domestic currency, monetary policy will not be as affective in curbing inflation due to the high degree of euroization in the economy that weakens the impact of monetary policy on money growth and prices.

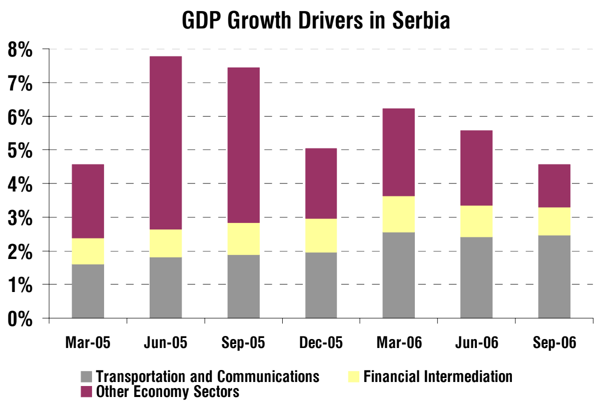
3.2 Current Economic Developments

There are two key facts that are driving political developments in late January in Serbia: the early parliamentary elections and the UN draft proposal for Kosovo. Firstly, the results of the early parliamentary elections confirmed analysts' expectations and opinion polls that were predicting a win of the Nationalist Party but not giving it a parliamentary majority.

As a result, the pro-Western political parties have now the opportunity to form a new stable government that will have enough political capital to push the economic agenda forward and tackle the outstanding issue of Kosovo. Secondly, the UN Special Envoy for Kosovo, Marti Ahtisaari, has presented both parties with a preliminary proposal for resolving the status of Kosovo-Metohija suggesting a de facto sovereignty and calling for further engagement of the EU and NATO; a solution strongly opposed by the Serbian side. Irrespective of the final outcome of the negotiations, the situation in Kosovo calls for immediate attention and international donors' assistance because it could destabilize the broader Western Balkans region.

According to our estimates, in 2006 GDP growth will slowdown marginally to 5.8%, down from 6.2% in 2005. Based on revised figures from the Serbian statistical office (due to change of the base year to 2002), GDP growth slowed down to 4.6% in Q3-2006, from 5.6% in Q2-2006 and significantly below the 7.4% growth recorded in Q3-2005. This slowdown is mainly attributed to the sharp

Figure 3.1



deceleration in Q3-2006 of household demand, which expanded only by 0.5%, yoy, compared with 11.7% and 5.2% in the first and second quarter respectively. From the supply side, industrial production accelerated by 4.7% in 2006. Manufacturing, which represents almost 75% of total industrial production, recorded the largest increase of 5%. Transportation and telecommunications were the most dynamic sectors expanding by 11.4% and 38.7% respectively (Figure 3.1).

Despite rapid growth, the number of workers unemployed increased during 2006 by 1.4% as a result of the restructuring process. In addition, the unemployment rate (admittedly estimated based on incomplete data) stood at extremely high levels of about 28%. Nevertheless, real wages did accelerate in 2006. As a result of the disinflation process, real wages grew by 9.7%, yoy, in Q3-2006 and by 16.4%, yoy, in Q4-2006, bringing average real wage growth for 2006 to 11.3%. These wage increases, though substantial, did not have a negative effect on the competitiveness of the economy. The unit labour cost in industry declined by 0.5%, as productivity gains (12.4%) outpaced real gross wage growth (Figure 3.2).

Despite the surplus of 1.9% that the government budget recorded for 2006 (mainly due to strong privatization revenues from the telecoms operator and the postponement of the National Investment Plan) serious question marks remain about the 2007 fiscal policy. The 2007 budget draft submitted to the parliament by the outgoing government has not been approved and - provided that a new coalition government is formed soon - the new budget will be resubmitted, at best, by the middle of the second quarter of 2007. Until then, the 2006 budget is applied on a pro-rata basis. If the current draft is any guide of what we should expect for 2007, then the fiscal policy will add a significant procyclical boost to the economy. According to the current draft, revenues will increase by 10.3% but current expenditure will rise by 18.3%, with public sector wage increasing by 37.2%. Despite the non-execution of the NIP and is postponement for this year, no funds have been provided for for its execution. Hence, only by this reduction in capital expenditures by 60%, a primary surplus of 1% of GDP was possible to justify (Figure 3.3).

The current account deficit widened further in 2006 and we estimate that it will reach 10.4% of GDP, up from 8.4% at end-2005. The main culprit behind this deterioration is the lower current transfers, especially lower inflows from exchange transactions and remittances. The trade deficit remained broadly around its 2005 levels, as we estimate that it will reach 19% of GDP in 2006, versus 20.4% in 2005. Exports, despite the appreciation of the local

Figure 3.2

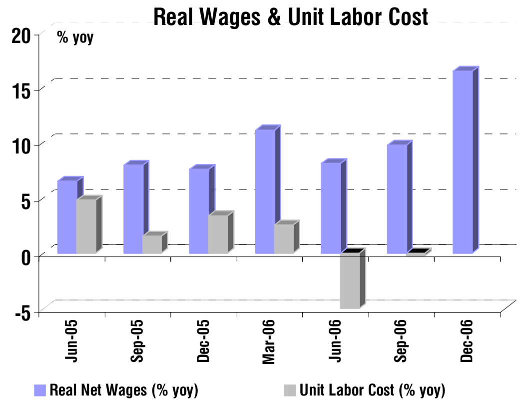


Figure 3.3

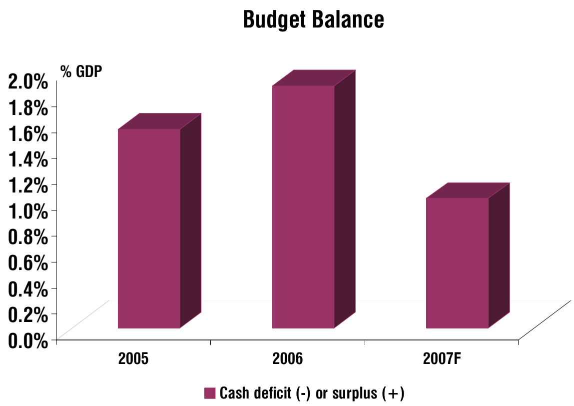
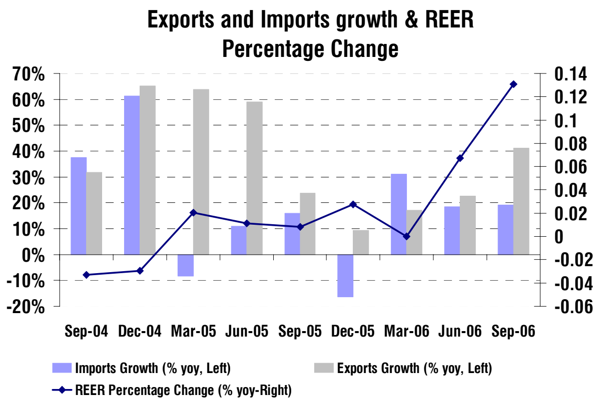


Figure 3.4



currency, soared by 28.2%, yoy, in the first 11 months of 2006, boosted by strong demand from the EU and improvements in the infrastructure, while imports grew moderately by 12.7% (Figure 3.4).

The extensive privatizations and acquisitions that took place in 2006, have resulted in a very strong growth in net FDI inflows, which reached US$3.4bn in the period of January to November, and thus more than covered the Serbia's current account deficit (the coverage was 120% of the current account deficit). FDI prospects for 2007 remain bright, provided that the investment climate is not disturbed by geopolitical concerns or the inability of political parties to form a coherent government coalition. The completion of several large-scale deals (sale of a minority stake in oil and gas company NIS and privatization of the DDOR, an insurer) coupled with a further pick-up in infrastructure and real estate sector investments will sustain high FDI inflows for another year (Figure 3.5).

As far as monetary policy is concerned, the key development during 2006 was the adoption of an inflation targeting policy regime. As we had anticipated in previous issue of this review, the strong disinflation process has continued. More specifically, inflation stood at 6.6% at end-2006, compared with 17.5% a year ago. The nominal and real exchange rate appreciation has allowed NBS to proceed with a substantial relaxation of the monetary conditions by cutting its key policy rate by 400bps (four consecutive cuts). Core inflation, which NBS is targeting, ended 5.9% yoy in December down from 14.5% in December 2005, below the targeted band 7% - 9%. According to NBS the target band for 2007 has been set at 4% - 8%. (Figure 3.6).

Figure 3.5

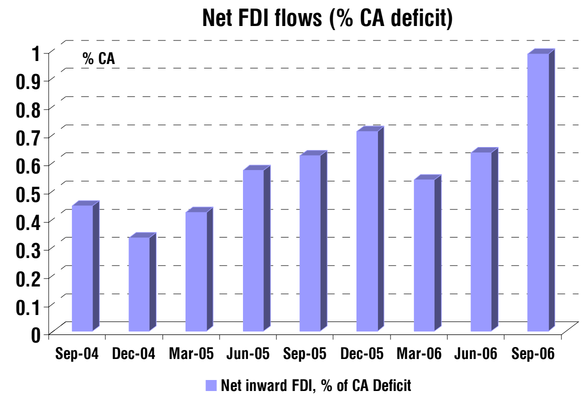
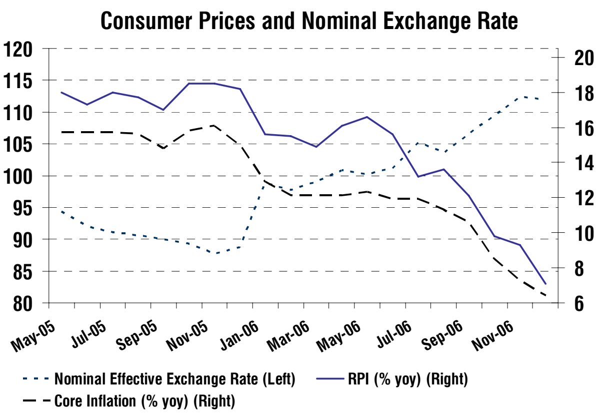


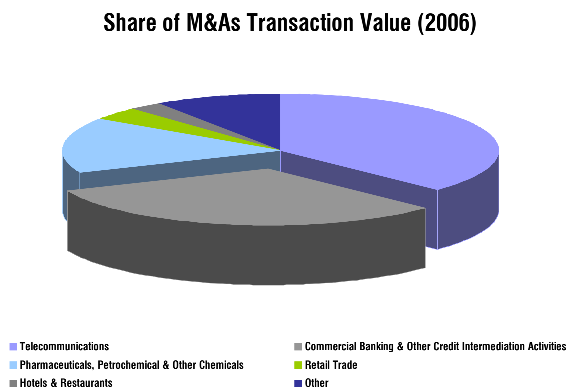
Figure 3.6



3.3 Banking Developments

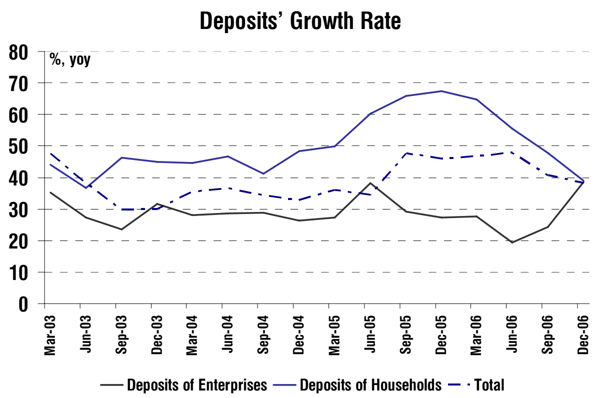
Developments during 2006 provide a clear indication that the Serbian banking system is well on its way to regain investors' and households' trust. Currently, 77% of Serbian banking sector's assets are controlled by foreign banking institutions and in 2006 alone, 10 bids took place in the sector of commercial banking, accounting for 31.4% of total transaction value of M&As that took place in Serbia. The largest share corresponded to the Telecommunication sector (37.4%), while the sector of pharmaceutical, petrochemicals and other chemicals came in the third place with a share of 15.7% (Figure 3. 7).

Figure 3.7



Even more importantly, deposits have been growing at rates that can not be justified by either the growth of disposable income or the savings rate in the economy, indicating that households have regained their confidence in the banking system and are in the process of channelling savings retained as "mattress money", back into the financial system. In Q4-2006, total deposits grew by 40.4% yoy, compared with 46.7% during the same period one year ago. The deposits' growth rate was mainly boosted by the rapid expansion of household deposits which make-up 51.2% of total deposits. Household deposits grew by 39%, yoy, in Q4-2006, while corporate deposits regained their pace growing by 38.5%, over the same period, up from 27.3%, yoy, one year ago (Figure 3.8)

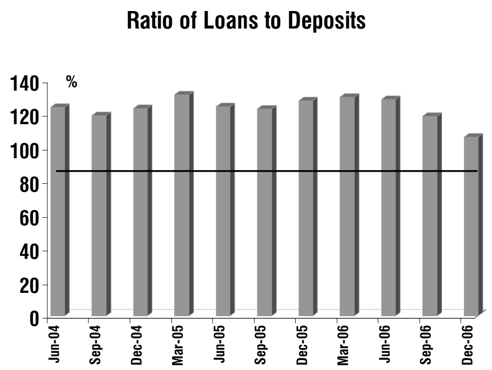
Figure 3.8



Credit & Liquidity

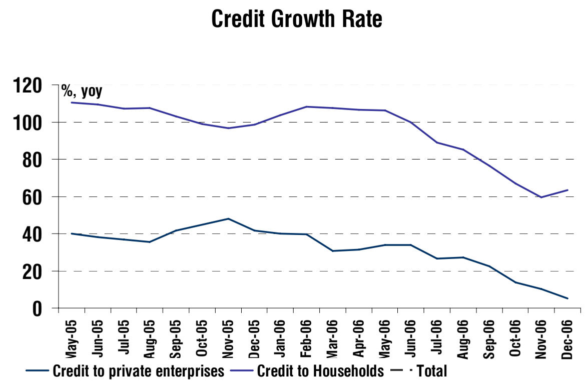
The rapid re-monetization of the economy is vital for the banking system to be able to support the expansion of the Serbian economy. Despite the robust growth in deposits mentioned above, the Serbian banking system is confronted with a substantial lack of funding sources. In December 2006, the ratio of loans to deposits stood at 106.3%, down from its 2005 levels of 128%, but still above the 100% threshold (Figure 3.9). In order to finance the expansion of their balance-sheets, Serbian banks have resorted to funding from abroad. For that reason banking sector's net foreign assets have decreased by 103.3% during 2006.

Figure 3.9



From its end the NBS has taken measures intended to improve liquidity and reduce the extent of euroisation of the economy. The mandatory reserve requirement ratio on dinar deposits was reduced from 18% to 15%, in order to encourage savings in local currency and to create cheaper sources of funds for lenders. Moreover, commercial banks are no longer obliged to hold an average daily balance of required reserves equal to at least half of the calculated mandatory reserves. In December 2006, a single reserve requirement ratio of 45% for foreign currency deposits as well as on domestic deposits with a foreign currency clause irrespective of their maturity was introduced. All the measures mentioned above, were introduced so that additional liquidity is freed in the system and that liquidity risk is mitigated.

Figure 3.10



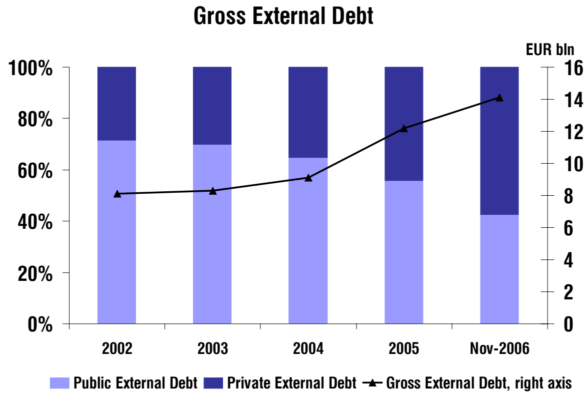
Credit Growth

Credit conditions in Serbia are beginning to follow the "Bulgarian Scenario". Worried about the impact that the rapid credit expansion might have on the Serbian economy, NBS has imposed a set of prudential and regulatory restrictions on credit extended by commercial banks to households and enterprises. Intense competition amongst commercial banks for market share forces banks to divert credit into non-regulated channels making difficult the overall assessment of credit growth in the economy.

Hence on a first reading of the data, total credit growth slowed down remarkably from 45.5%, yoy, in June 2006 to 16.8% in December 2006. Credit to households grew by 63.5%, below the average growth rate of the first 10 months of 2006 of 90%. Finally, business loans also recorded growth of only 5.1% yoy over the same period, down from the surging 41.5% yoy one year ago (Figure 3.10).

Yet, this picture is reversed when one takes into account private sector's direct borrowing from abroad. Serbia's private external debt increased by €2.7bn during the first 11 months of 2006 and currently makes-up 57.4% of Serbia's total external debt, up from 28.4% in 2002 (Figure 3.11).

Figure 3.11



Serbia: MacroEconomic Indicators	2001	2002	2003	2004	2005	Q1 2006	Q2 2006	Q3 2006	Q4 2006
Output and expenditure	*(Percentage Change in Real Terms)*								
GDP	5.1	4.5	2.4	9.3	6.8	6.2	5.6	4.6	-
Industrial production	-	-5.2	-3.0	7.1	0.4	5.2	6.1	3.6	7.7
Labour Market									
Employment	-	-3.4	-2.7	0.4	-6.7	0.1	-2.0	-1.7	-
Unemployment (official data)	12.2	13.3	14.6	18.5	20.8	21.4	21.6	21.5	-
Prices	*(Percentage Change)*								
Retail Price Index (annual average)	94.3	21.4	11.7	9.8	17.3	14.8	15.6	12.5	8.2
Producer prices (annual average)	-	10.7	5.9	9.5	13.0	14.3	16.2	14.6	8.4
Government sector	*(In per Cent of GDP)*								
General government balance (National Definition)	-0.2	-4.3	-1.4	-0.1	1.5	-0.5	-0.1	2.0	1.9
General government debt	106.5	73.7	67.9	53.7	46.2	-	-	-	-
Monetary and Financial Indicators	*(Percentage Change)*								
M3	-	-	27.5	30.3	43.2	44.4	38.5	35.7	-
Domestic credit	13.4	-35.3	11.2	51.7	57.1	58.5	58.0	43.8	
	(End of Period)								
Exchange rate CSD/USD (end-period)	67.7	59.0	54.6	57.9	72.7	71.9	66.8	65.3	60.4
Exchange rate CSD/EUR (end-period)	59.7	61.5	68.4	79.0	83.3	87.2	85.2	81.0	79.1
Real Effective Exhange Rate (Index)	130.0	116.8	101.9	98.9	101.6	100.3	104.7	110.7	116.5
International Position	*(In per Cent of GDP)*								
Current account balance	-2.7	-7.9	-7.2	-11.7	-8.4	-10.4	-10.4	-10.4	-
Trade balance	-21.7	-20.4	-21.2	-27.1	-21.1	-21.8	-21.7	-20.8	-
Foreign direct investment, net	1.6	3.0	6.7	3.9	5.9	5.5	-	-	-
Memorandum items	*(Denominations as Indicated)*								
Population (end-year, million)	8.3	8.3	8.3	8.3	8.3	-	-	-	-
GDP (in millions of CSD)	772	998	1,189	1,421	1,745	-	-	-	-
GDP per capita (in US CSD)	1,386	1,867	2,485	2,907	3,117	-	-	-	-

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

Serbia: Banking Indicators									
	2001	2002	2003	2004	2005	Q1 2006	Q2 2006	Q3 2006	Q4 2006
Percentage of GDP (%)									
Assets	126.9	35.2	38.6	43.0	52.2	52.9	58.3	59.2	-
Total Credit	37.2	16.8	19.5	23.4	29.1	29.4	30.3	29.5	-
Credit to Enterprises	29.6	14.1	15.8	17.3	20.1	19.6	19.9	18.9	-
Credit to Households	0.7	1.6	2.5	4.6	7.5	8.2	8.9	9.4	-
Deposits	14.1	14.5	17.1	19.0	22.8	22.7	23.5	24.9	-
Percentage Change (%, yoy)									
Assets	12.6	-60.1	25.9	36.1	48.7	48.6	54.2	49.0	39.5
Total Credit	18.3	-34.8	32.9	46.6	52.1	46.1	45.5	33.5	16.8
Credit to Enterprises	16.3	-31.3	28.6	33.8	41.5	30.6	33.8	22.3	5.1
Credit to Households	85.2	205.8	81.8	126.2	98.7	107.6	99.7	76.4	63.5
Deposits	84.8	47.6	35.3	36.0	46.7	47.7	40.6	38.3	40.4
Percent (%)									
Capital Adequacy Ratio*	-	25.6	31.1	27.9	25.2	-	-	-	-
Capital to Assets*	-	18.3	22.5	18.8	17.2	-	-	-	-
NPLs to Total Loans*	-	21.6	24.1	22.3	19.8	-	-	-	-
Provisions to NPLs*	-	-	54.0	58.9	47.8	-	-	-	-
Return on Assets*	-	-8.4	-0.3	-1.2	0.9	-	-	-	-
Return on Equity*	-	-60.6	-1.2	-5.3	5.4	-	-	-	-

* For 2005 the latest figure available is provided

Note: The data have changed compared to previous Quarterly Review due to data revisions by NBS.

Sources: NBS, IMF

4. Poland

- **We expect real GDP to grow by 6.2% during 2007, marginally above the 5.8% growth expected for 2006.**
- **Inflation will accelerate in 2007 and reach PNB's target of 2.5% by year-end.**
- **According to the 2007 budget, the government is planning to adhere to the PNL30bn nominal deficit anchor, targeting a deficit of 2.7% of GDP.**
- **Unemployment dropped to 14.8% during 2006, partially due to emigration.**
- **Business lending recovered in 2006, expanding by 17.3%, up from 4.4% in 2005.**
- **The new supervisory authority, the Commission for Financial Supervision (CFS), undertook its responsibilities for the regulation of capital markets and of the insurance and pension funds. It is expected to take over its banking supervision responsibilities in 2008.**

4.1 Macroeconomic Outlook

Summary

We maintain our positive outlook for real GDP growth in 2007-2008. Consumption growth will be the principal driver of economic expansion and will outpace expected deceleration of investment over the forecasting horizon, while net exports will remain roughly unchanged. As a result, real GDP will grow on average 6.2%, yoy, in 2007 and 6%, yoy, in 2008, up from 5.8%, yoy, in Q4-2006.

Consumption

Labour market tightening, due to lower unemployment and expected wage increases, will fuel consumption in 2007 and 2008. Specifically, consumption will grow on average 4.8%, yoy, in 2007 and 5.8%, yoy, in 2008, after registering a 3.9%, yoy, growth in Q4-2006. Lower unemployment rate, attributed to emigration of Polish workers to older members of the European Union (EU) and further wage convergence to the EU average, will intensify the labour market tightening, already evidenced, and improve the purchasing power of households. Already, the tighter labour market has

Poland	Q42006	2007*	2008*
GDP	5.8	6.2	6.0
Consumption	3.9	4.8	5.8
Investment	19.0	16.6	14.3
Exports	14.6	7.9	4.9
Imports	10.7	4.7	6.3
Current Account (% of GDP)	-1.9	-2.5	-2.7
Inflation (%, y/y)	1.3	2.5	2.8

Note: * Figures reported for GDP growth and its components are averages of y/y growth rates recorded every quarter of the corresponding year.

contributed to an average real wage growth of 4% between Q1 and Q3, 2006.

Investment

Investment will decelerate in 2007 and 2008, after peaking at 19% in Q4-2006, on the back of strong construction activity financed by mortgage credit. Investment will grow on average 16.6%, yoy, in 2007 and 14.3%, yoy, in 2008. Weaker investment will be the side effect of higher nominal interest by NBP. Higher nominal interest rate will outpace inflation and increase real interest rate, which will have a negative impact on investment.

Net Exports

Net exports will remain broadly unchanged in 2007-2008 at their Q4-2006 level, since annual growth of imports and exports will decrease by the same amount. Exports in 2007 will grow on average 7.9%, yoy, and 4.9%, yoy, in 2008 after reaching 14.6%, yoy, in Q4-2006. We attribute weaker growth of exports to expected zloty appreciation that will make polish exports more expensive relative to competitors. Despite expected zloty appreciation, imports will decelerate in 2007, but not in 2008. In fact, imports will grow on average 4.7%, yoy, in 2007 and 6.3%, yoy, in 2008, compared to 10.7%, yoy, in Q4-2006.

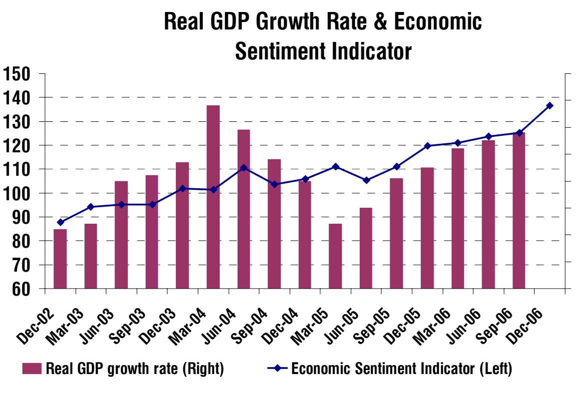
Current Account

Current account deficit will deteriorate in 2007 and 2008. It will increase by half a percentage point to 2.5% of GDP in 2007 and to 2.7% of GDP in 2008. Our views for a widening of the current account deficit in 2007 are based on the assessment that exports will slowdown more than imports. In 2008 imports will regain strength, while exports will continue their downward trend, resulting in higher current account deficit.

Inflation

We envisage that prices will accelerate in 2007 and 2008 after growing by 1.3%, yoy, at end-2006. In 2007, inflation will grow by 2.5%, yoy, and 2.8 %, yoy, in 2008. Labour market tightening will contribute to higher inflation due to improved purchasing power of households. In addition, expected Zloty appreciation will intensify

Figure 4.1



household credit denominated in foreign currency that will fuel consumption and increase inflation. Hence, despite standard economic thinking according to which currency appreciation lowers domestic prices, zloty appreciation will result in higher inflation via higher consumption supported by household credit denominated in foreign currency.

4.2 Current Economic Developments

Despite the politically unstable coalition government, the Polish economy has continued to expand throughout 2006, boosted by procyclical factors and the strong growth of the rest of the EU. Based on the latest data we have revised our forecast for 2006 GDP growth to 5.8%, up from 5.2% forecasted in the previous quarter. This positive economic climate is also reflected in the economic sentiment indicators, which display a continuous improvement for both consumers and businesses (Figure 4.1, 4.2). Yet, the absence of any long-term consolidation strategy may undermine Poland's long-term growth prospects, once the procyclical boost fades away.

In Q3-2006, GDP growth accelerated to 5.8%, yoy, up from both 5.2% in Q2-2006 and 4.1% in Q3-2005. The main contributor was private consumption which grew by 4.5%, yoy, up from 2.7% in Q3-2005 and contributed 3.7 percentage points to total GDP growth (Figure 4.3). In addition, gross fixed capital formation accelerated to 19.8%, yoy, up from 14.8% in Q2-2006, almost three times the growth rate of 2005. This strong investment activity is also reflected in the industrial output and construction activity. Industrial production grew by 12.8% in Q3-2006 against 4.4% in Q3-2005, while construction reached 13.7%, yoy, in Q3-2006, up from 11.5% during the previous year (Figure 4.4).

This strong economic growth has been accompanied by further labour market tightening. The unemployment rate dropped below 15% for the first time since 2000, reaching 14.8% in November 2006, down from 17.3% in November 2005. Employment growth has also recorded another quarter of dynamic growth, reaching 3.9% in Q3-2006, compared to 2.8% in the Q3-2005. Indicative of this trend is that corporate employment grew by 3.8%, reaching its highest level since the beginning of the 90s. As a result of the tightening of the labour market, real wage growth also picked-up, outpacing productivity growth. During the first three quarters of 2006, real wages grew by 4% and unit labour cost increased significantly to 6.1% in Q3-2006, up from 4.5% in the second quarter (Figure 4.5).

Figure 4.2

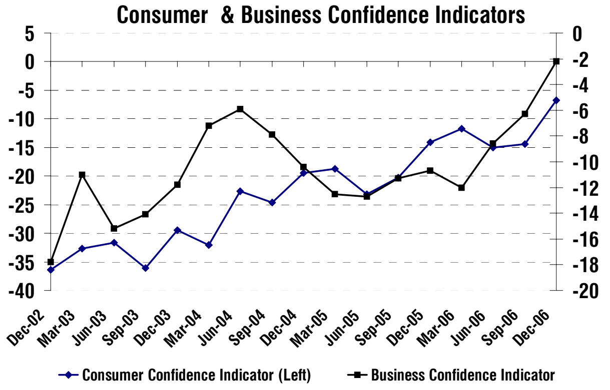
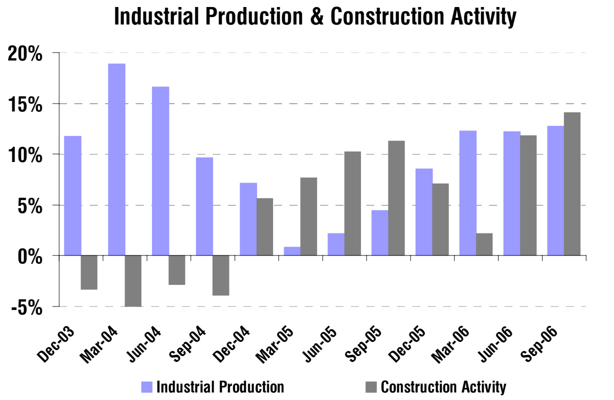


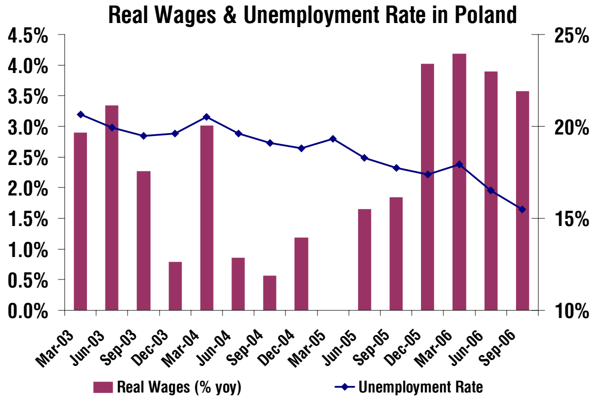
Figure 4.3

Figure 4.4



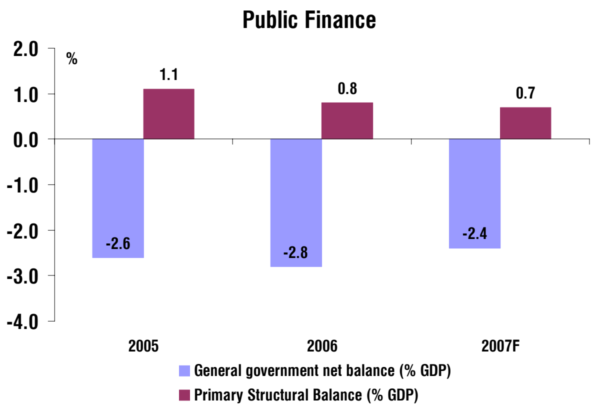
According to the budget act, the government is planning to adhere to the PLN30bn deficit anchor for 2007. Based on the assumption of a 4.6% real GDP growth, the central budget deficit is projected to 2.7% of GDP, while the general government deficit will reach 2.4% of GDP. This budget is based on rather aggressive revenue forecasts, projected to grow above nominal GDP levels. More specifically, general government revenue is expected to grow by 7.2% in nominal terms, while the central government revenues are expected to rise by 9.3%. These projections are based on high growth rates of VAT receipts, which are expected to grow by 11.4%. Expenditure, on the other hand, is expected to increase by 6.3% for the wider public sector and by 8.4% for the central government. Hence, even if the government's projections pan out the 2007 budget will have a marginal procyclical impact given that the primary structural surplus will decrease by 0.1 to 0.3 percentage points (Figure 4.6).

Figure 4.5



NBP's monetary policy stance continues to remain unchanged since the beginning of 2006, although inflationary pressures have increasingly made their presence felt. Inflation in January 2007 stood at 1.7%, yoy, up from 1.4% in December. "Net inflation", a measure of core inflation which doesn't include fuel and food prices, has also increased to 1.6% in December, unchanged from November. According to the central bank, although the inflation outlook remains neutral for Q4-2006 the inflation trend has been reversed upwards and without any monetary policy tightening, inflation rate will exceed the threshold of 2.5% during 2007 (Figure 4.7).

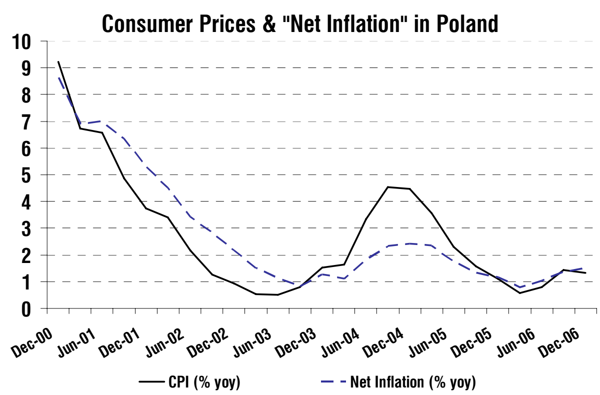
Figure 4.6



4.3 Banking Developments

Poland's financial landscape is being reshaped by the introduction of a single supervisory authority, responsible for regulating every aspect of the financial system from the capital market to insurance firms and banking institutions. In September 2006, the Commission for Financial Supervision (CSF) undertook its responsibilities for the supervision of capital markets and of insurance and pension funds, and is expected to take over its banking supervision responsibilities in 2008.

Figure 4.7



However, the Central Bank, which will have to give up its responsibilities as banking supervisor, has turned against the new centralized model that will soon be put into effect. Its (previous) governor argued that the new measures would lead to the worsening of banking sector's stability and reduce the effectiveness of its supervision. Moreover, he stressed the danger of foreign-owned banks' circumventing the new supervisory authority by transforming themselves into branches of their parent institutions and hence being supervised by the authorities of their country of origin. The IMF took also a negative stance against the new plans, expressing its fears that CSF could become subject to political pressures.

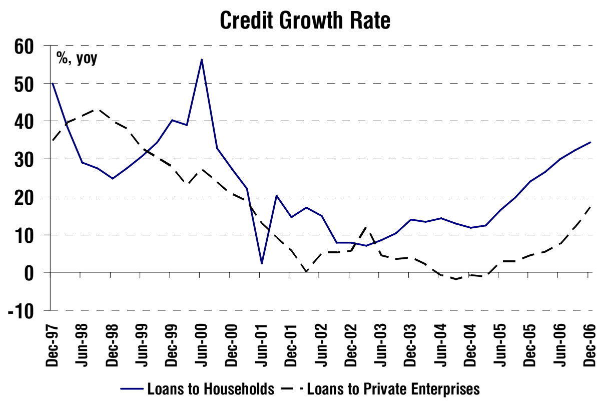
Credit Growth

The main theme in Poland's banking sector is its slow pace of convergence towards its European counterparts. Although the Polish banking sector is the largest in absolute terms among the 12 new EU member states, it ranks last in terms of financial intermediation. Its loans to GDP ratio stood at 32.1% as of Q3-2006, indicating that the banking industry has failed to keep up with developments in its wider region.

The main drag for credit expansion has been the slow pace of lending to the corporate sector. Credit growth to the private sector turned negative and reached its lowest point (-1.1% yoy) in Q1-2005 due to enterprises' high liquidity and the use of internal funding. However, this trend has been reversed and private corporate loans were growing by 17.3%, yoy, at end-2006, up from 4.4% in 2005. According to NBP, the demand for business lending has been particularly strong in the SME sector and it can be attributed to factors such as the increasing need for investment financing, banks' easing their lending policy towards enterprises and the enterprises' optimistic expectations about future profitability. An influx of EU infrastructure funds could also boost corporate lending in the future.

On the other hand, the main driver of credit expansion has been loans to households. During 2006, credit growth to households accelerated, being equal to 34.5%, yoy, as of Q4-2006 (Figure 4.8). The main component of household lending that is expanding briskly is that of mortgages, growing by 54.6% yoy as of Q4-2006, up from 40.5% at end-2005. The main reasons for this increase were, the improvement in the economic situation of households, households' expectations of further increase in the housing prices and the announced withdrawal of the tax relief (which helped bring demand forward). Finally, as competition among banks intensifies, banks introduce special offers regarding housing loans, extending loan maturities and easing the requirements with respect to loan-to-value ratio.

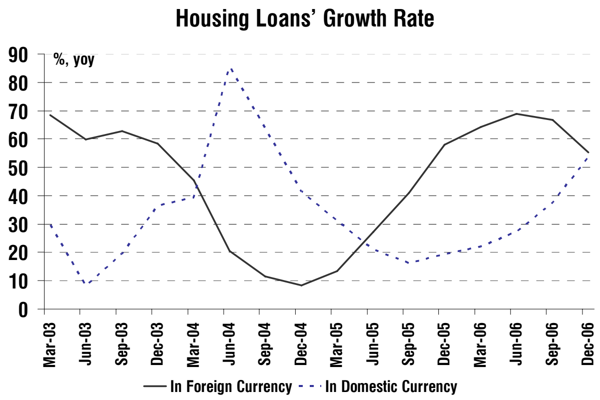
Figure 4.8



The main concern about housing loans remains the fact that 3/5 of them are denominated in foreign currency. Households are generally unhedged to fx risk but fortunately borrowing in foreign currency is concentrated in the upper and middle income groups. Mortgages in foreign currency grew on average by 63.8%, yoy, in 2006, almost double the 34.9% rate recorded in 2005. The main reasons supporting growth in fx are the favourable interest rate differentials between domestic and foreign-denominated loans and expectations about zloty appreciation.

However, zloty denominated mortgage lending intensified, during the second half of 2006. Housing loans in zloty grew by 53.5% yoy in December 2006, instead of 19.3% yoy one year ago (Figure 4.9).. This development was supported by a bill passed in the parliament, according to which, under certain preconditions, there will be a 50% refund of interest on zloty-denominated housing loans so that some lower-income families can buy a flat or a house.

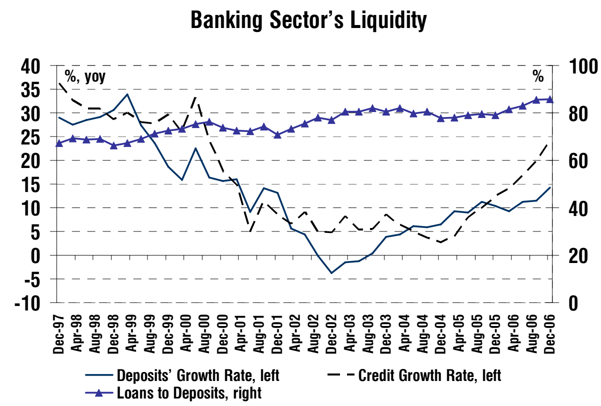
Figure 4.9



Deposits & Liquidity

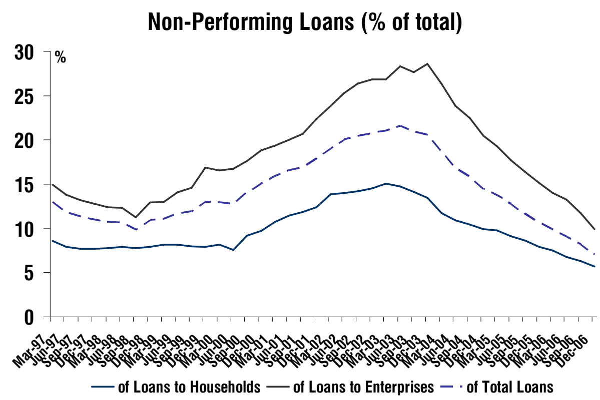
Total deposits are growing in a moderate pace, increasing by 14.3% yoy in December 2006. Zloty denominated deposits grew by 14.7%, yoy, as of Q4-2006, instead of 11.9%, yoy, for foreign currency denominated deposits. Household deposits grew only by 8.4%, yoy, having recovered from the negative growth rates realized two years ago. The fastest growing component of deposits is the one corresponding to the corporate sector, growing by 26.4% yoy as of Q4-2006. The main reason for this growth is corporate's sector strong profitability, which increased by 26.9% during the first 11 months of 2006 compared to the same period of 2005.

Figure 4.10



Banking sector's liquidity remains in good shape despite the fact that credit is growing faster than deposits. Thus, the ratio of loans to deposits stands at 85.9%, far below the 100% threshold (Figure 4.10).. On the other hand, there is need for intensive monitoring of foreign currency liquidity, since the ratio of loans to deposits in foreign currency remains at particularly high levels, being equal to 154.6% at end-2006. This is particularly risky if we take into account that most of banks' have in their portfolios foreign-denominated mortgages in long-term maturities which are funded by shorter-term liabilities.

Figure 4.11



Credit Quality and Spreads

During 2006, positive developments in the quality of non-performing loans were observed. Thus, non-performing loans in total loans portfolio decreased by 3.6 percentage points, from 10.6% in 2005 to 7% in 2006. The credit quality improvement was obvious in both household and corporate sector loans. At end-2006, household loans' NPLs were 5.7% of total household credit, while NPLs of enterprises stood a bit higher at 9.9% of total loans granted to enterprises (Figure 4.11).

Moreover, intensive competition among banks had a decreasing effect on interest rate spreads. Interest rate spreads on new business loans declined from 4.8% in 2005 to 3.9% in 2006. Moreover, the interest rates differential between PLN and EUR declined from 2.6 percentage points at end-2005 to 1.9 percentage points at end-2006. On the contrary, the interest rate differential between PLN and USD remained at the same levels (Figure 4.12).

Other Developments

Despite the early entry of foreign banks, the Polish market still remains fragmented, leaving space for further consolidation. Yet, according to data provided by Dealogic, in the period from September 2005 to September 2006, only 3 bids took place in the Finance and Insurance sector, accounting only for 9.3% of total M&A value. In terms of transaction value the financial sector ranked 4th after the Telecommunications sector, the Real Estate and the Media, Information & Software Industry (Figure 4.13).

Figure 4.12

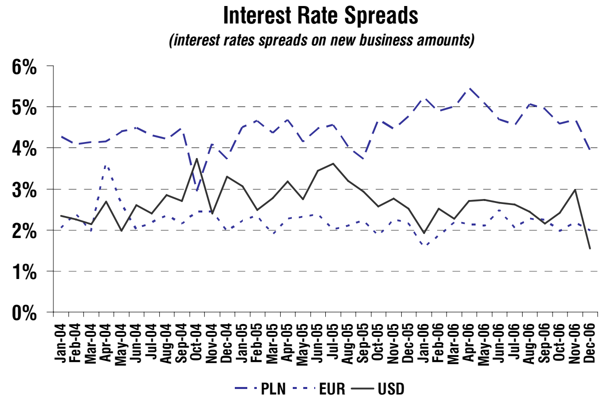
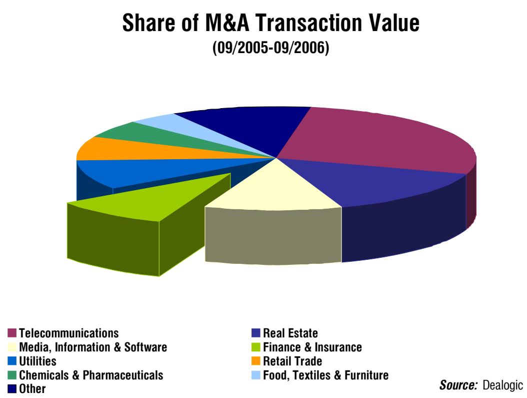


Figure 4.13



Source: Dealogic

Poland: MacroEconomic Indicators	2001	2002	2003	2004	2005	Q1 2006	Q2 2006	Q3 2006	Q4 2006
Output and expenditure					*(Percentage Change in Real Terms)*				
GDP	1.1	1.4	3.8	5.3	3.4	5.2	5.5	5.8	-
Private consumption	2.2	3.3	1.9	4.0	1.8	5.2	4.9	5.5	-
Public consumption	2.5	1.5	4.7	3.9	5.3	3.1	-0.9	1.1	-
Gross fixed capital formation	-9.7	-6.3	-0.1	6.4	6.5	7.4	14.8	19.8	-
Exports of goods and services	3.1	4.8	14.2	14.2	14.0	22.6	12.6	14.8	-
Imports of goods and services	-5.3	2.7	9.3	15.2	4.2	20.9	10.7	15.3	-
Industrial production	0.0	1.5	8.7	12.3	3.8	12.4	12.1	12.8	-
Labour Market									
Employment	-2.2	-3.0	-1.1	1.3	2.4	3.1	3.7	3.9	-
Unemployment (in per cent of labor force)	15.1	17.5	20.0	20.0	19.0	17.9	16.6	15.5	-
Prices					*(Percentage Change)*				
Consumer prices (annual average)	5.5	1.9	0.8	3.5	2.1	0.6	0.8	1.3	1.4
Producer prices (annual average)	1.7	1.2	2.7	7.1	0.8	0.6	2.3	3.5	2.8
Average monthly wage in economy	7.2	3.5	3.2	4.0	3.5	4.7	4.7	5.0	-
Government sector					*(In per Cent of GDP)*				
General government balance (ESA95)	-3.7	-3.2	-4.7	-3.9	-2.5	-	-	-	-
General gross government debt (ESA95)	35.9	39.8	43.9	41.8	42.0	-	-	-	-
Monetary and Financial Indicators					*(Percentage Change)*				
M3	9.4	-1.8	5.3	8.5	11.7	10.6	10.5	13.0	14.6
Total Credit	8.6	4.8	8.6	2.7	12.3	14.1	16.9	19.9	24.2
					(End of Period)				
Exchange rate Zloty/USD (end-period)	4.0	3.8	3.7	3.0	3.3	3.2	3.2	3.1	2.9
Exchange rate Zloty/EUR (end-period)	3.5	4.0	4.7	4.1	3.9	3.9	4.1	4.0	3.8
Real Effective Exhange Rate (Index)	112.7	108.1	96.3	96.2	107.4	111.1	108.7	108.3	-
International Position					*(In per Cent of GDP)*				
Current account balance	-2.8	-2.5	-2.1	-4.2	-2.2	-1.9	-2.0	-1.9	-
Trade balance	-4.0	-3.7	-2.6	-2.2	-0.9	-0.9	-0.9	-1.2	-
Foreign direct investment, net	1.1	0.9	0.5	0.9	0.9	1.0	1.1	1.3	-
Memorandum items					*(Denominations as Indicated)*				
Population (end-year, million)	38.6	38.2	38.2	38.2	38.1	-	-	-	-
GDP (in millions of Zloty)	779	808	842	922	968	-	-	-	-
GDP per capita (in US dollar)	4,928	5,181	5,670	6,609	7,849	-	-	-	-

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

Poland: Banking Indicators									
	2001	2002	2003	2004	2005	Q1 2006	Q2 2006	Q3 2006	Q4 2006
Percentage of GDP (%)									
Assets	70.1	69.0	71.9	68.4	70.2	71.7	73.7	-	-
Total Credit	27.6	27.8	29.0	27.2	28.7	29.9	30.9	-	-
Credit to Enterprises	15.1	14.6	14.3	12.6	12.1	12.4	15.6	-	-
Credit to Households	10.3	10.7	11.7	11.9	13.9	14.4	15.6	-	-
Deposits	38.9	36.1	36.0	34.9	36.3	36.3	37.2	-	-
Percentage Change (%, yoy)									
Assets	9.7	2.1	8.5	4.4	9.0	8.4	9.5	12.2	12.7
Total Credit	8.6	4.8	8.6	2.7	12.3	14.1	16.9	19.9	24.2
Credit to Enterprises	3.2	0.4	2.1	-3.7	2.6	3.8	5.1	9.5	14.7
Credit to Households	14.7	7.9	13.9	11.7	24.0	26.6	30.0	32.3	34.5
Deposits	13.1	-3.8	3.9	6.4	10.4	9.2	11.3	11.6	14.3
Percent (%)									
Capital Adequacy Ratio	13.5	14.2	13.8	15.4	14.5	14.7	-	-	-
Capital to Assets	8.0	8.7	8.3	8.0	7.8	7.9	-	-	-
NPLs to Total Loans	-	-	10.4	9.2	7.7	-	-	-	-
Provisions to NPLs	42.6	46.7	47.3	58.0	59.4	-	-	-	-
Return on Assets	0.9	0.5	0.5	1.4	1.6	1.5	-	-	-
Return on Equity	12.4	6.1	5.8	17.1	20.7	19.3	-	-	-

Sources: NBP, IMF

5. Ukraine

- **We expect real GDP growth to moderate to 5.5% during 2007, down from 7% in 2006.**
- **The current account deficit is expected to record a mild deterioration to 3% of GDP, on account of higher energy prices.**
- **Inflation will remain high, in the area of 10.5%, boosted by energy prices and procyclical government policies.**
- **In November 2006, Ukraine's budget recorded a 0.5% of GDP surplus, against a 2.5% planned deficit. A similar deficit (2.7% of GDP) has been budgeted for 2007.**
- **During 2006, FDI inflows declined by 45.2%, to US$4.5bn, due to lack of large scale privatizations.**
- **Total credit expanded by 71% during 2006, but lack of deposits has resulted in a loans to deposits ratio of 133%.**

5.1 Macroeconomic Outlook

Summary

We project real GDP to decelerate in 2007 and 2008 by a one and a half percentage point to 5.5% yoy. Growth will slowdown due to lower consumption growth, as higher oil and gas prices will negatively affect households disposable income and consumption. Increasing gas prices motivated investment in energy saving technologies that will strengthen gross capital formation and subsequently, growth in the foreseeable future. However, investment growth in energy saving technologies will not be sufficient to outpace the slowdown of consumption. The upside risk to our GDP projection will materialize in the event of higher consumption subject to a reduction of corporate and value added taxes.

Ukraine			
	2006	2007	2008
GDP (%, y/y)	7.0	5.5	5.5
Current Account (% of GDP)	-0.5	-3.0	-3.0
Inflation (%, y/y)	11.6	10.5	9.0

Current Account

We expect the current account balance to deteriorate further in 2007 and 2008 after recording a deficit of 0.5% of GDP in 2006. Specifically, the current account deficit will extend to 3% of GDP in 2007 due to higher gas and oil prices. It is expected that gas prices will further increase by 40% in 2007 after doubling in 2006, while oil prices will maintain their current high levels, due to supply problems and geopolitical tensions. Additionally, expected excess supply of steel goods is possible to drag steel prices down and decrease Ukraine's exports that heavily depend on steel products. However, Ukraine's major trading partner Russia is expected to grow well above 5% in 2007, implying that Russian demand for Ukrainian exports will remain strong.

Inflation

The inflation outlook for 2007 is challenging to assess. Further energy price increases have been scheduled which will intensify inflation pressures even further, while food prices will also pick up after the resumption of exports to Russia. On the other hand, we expect a mild economic slowdown which will subtract some of the pressure exerted on prices from domestic demand. Finally, government's budget for 2007 is characterised by a mild loosening of fiscal policy that incorporates higher minimum wages which will intensify inflationary pressures. However, an increase in the income tax rate in 2007 from 13% to 15% might cancel out increases of minimum wages. As a result, we expect inflation to average 10.5% in 2007, from 11.6% in 2006.

5.2 Current Economic Developments

The Ukrainian "Orange" revolution which, in January 2005, culminated with the election of a pro-western president seems to be fading away after only two years, while the battle for political dominance between the Prime Minister and the President is taking centre stage. The direct effect of this power struggle is that the presidential economic agenda and political initiatives seem to be overturned by the Prime Minister's policies.

Yet, despite the political turmoil, Ukraine's economy is growing fast, buoyed by favourable global economic and financial conditions. GDP growth rate in 2006 reached 7%, marking a strong rebound from the sharp deceleration of 2005, when the economy grew only by 2.6%. The main driver, final consumption, recorded another impressive 11.8%, yoy, growth in Q3-2006 compared to 13% yoy in Q3-2005. Consumption growth is fuelled by abundant credit, which grew by 60%, yoy, in Q3-2006, and a rapid increase in real wages, which increased by 11.7%, yoy, in 2006 (households disposable income grew by 16.3% in Jan.-Nov. 2006). Private consumption is expected to contribute a total of 12 percentage points to GDP growth, averaging 16%, yoy, in 2006. In addition, gross fix capital formation grew by 8.5%, yoy, in Q3-2006 compared to 7.3%, yoy, in Q2-2006. Net exports have been the only negative contributor to GDP growth. That is the result of the negative growth rate of real exports and the impressive growth rate of imports exacerbated by accelerating domestic demand. Real exports, after having contracted for two consecutive quarters, by 19.9% in Q1-2006 and by 11.2% in Q2-2006, grew marginally by 1.2% in Q3-2006, reflecting a rebound in the international demand for Ukrainian metal products, while real imports have risen by 7.1% in Q3-2006, compared with 3.9%, yoy, in Q3-2005 (Figure 5.1).

The supply shock of higher import gas prices (the average price for gas has increased by 64% in 2006) has led the energy intensive industries to become more energy efficient, while steel prices, the Ukrainian major export output has increased. In conclusion, the supply shock from higher import gas prices appears to have had a major, though decreasing, impact on the domestic economy. Manufacturing recovered in 2006, growing by 6.3%, yoy, against 3% in 2005 (Figure 5.2). Assuming that steel prices do not decline substantially, manufacturing production will accelerate further, leading to a further recovery in exports and a narrowing down of the net exports' negative contribution to GDP. In that respect, Ukraine's accession to World Trade Organisation (WTO), if completed by mid-2007, will enable Ukraine to implement a free trade regime with the EU and diversify its exports markets.

The drafting of government's budget for 2007, has created tensions between the President and the Prime Minister. The state budget submitted for 2007 was vetoed by the President and subsequently revised, in an attempt to be more illustrative of the presidential agenda. Based on the latest data released in October, total consolidated expenditures reached 73% of the total expenditures projected for 2006, whereas total consolidated revenues stood at 81% of total projected revenues, leaving a marginal surplus of 0.5% of GDP (Figure 5.3). This surplus stands at odds with the 2.7% of GDP planned fiscal deficit and is the result of lower than budgeted expenditure and higher than expected VAT collections as well as VAT under-reimbursements to exporters. The budget draft for 2007, targets a deficit of HRN15.7bn (2.6% of GDP) as well as a slowdown in total expenditures to 26% of GDP, down from 27.7% in 2006 and well below 33.3% in 2005. The government intends to finance this deficit via privatization proceeds and debt issuance. The budgeted privatization proceeds amount to HRN10bn, a target that we believe is overly optimistic, given the recent track of privatizations and

Figure 5.1

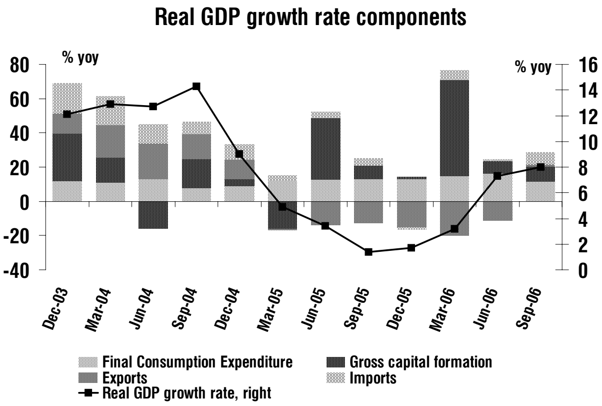


Figure 5.2

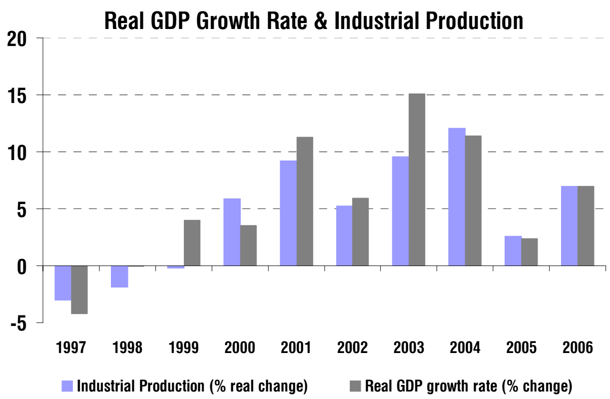
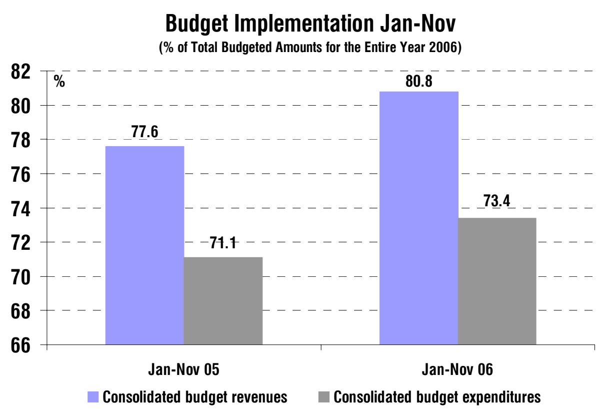


Figure 5.3



political opposition to the privatization of large state owned enterprises. In the (unlikely) event that the total budged expenditure is realised then the government will have to be more actively involved in the international capital markets. According to its fiscal plans, Ukraine will have to raise HRN7.8bn and HRN3.8bn, in foreign and local currency denominated debt.

Ukraine's external position has been extremely volatile as it reflects a wedge between export prices of steel products and import prices for energy, especially gas. As a result of this trade off, Ukraine's current account deficit has swung from a surplus of 10% of GDP in 2004 to a deficit of 0.5% in Q3-2006. This volatility is also reflected in the trade balance, which from a trade surplus of 5.1% in Q3-2004 and 0.2% in Q3-2005, moved to a trade balance deficit of 3.8% in Q3-2006. To the extent that energy price hikes, already scheduled for 2007 and 2008, are accompanied by stable or even declining prices for steel exports, then we should expect the current account deficit to widen even further in the short to medium term (Figure 5.4).

Ukraine's ability to finance its current account deficit has worsened substantially as FDI inflows declined by 48% to US$5bn, down from US9bn in 2005. The main reason for this sharp decline was political unwillingness from the side of the government to proceed with the privatization of large state owned enterprises, in the telecoms and chemical sectors (Figure 5.5).

Strong domestic demand and higher energy prices pushed end-of-year inflation to 11.6%, up from 6.8% in July and average inflation to 9.1% for 2006. In the previous months inflation had declined due, mainly, to lower food prices caused by the Russian embargo to Ukrainian food exports. Hikes in energy prices resulted in services price increases of 36% during the second half of the year, due to sharp increases in utility tariffs and other regulated prices (Figure 5.6).

5.3 Banking Developments

The Ukrainian banking sector suffers form a series of inadequacies, as it is small in size and highly fragmented with 170 operating banks, over a hundred of which are rather small. Faced with problems such as low levels of capital adequacy, the central bank has started taking important measures towards banking sector's reform and restructuring. The National Bank of Ukraine (NBU) has taken action in order to prevent small banks, with assets less than US$100mn, from investing in securities of other companies and in open account

Figure 5.4

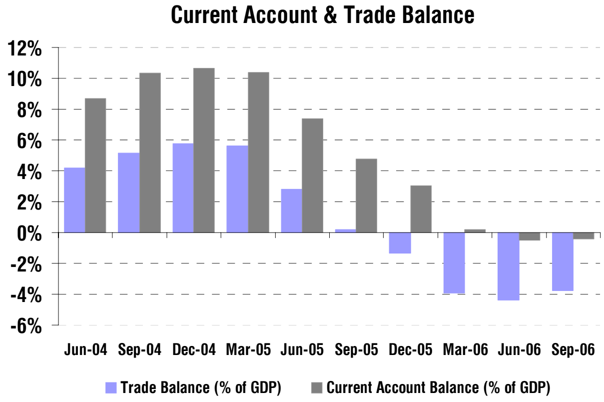


Figure 5.5

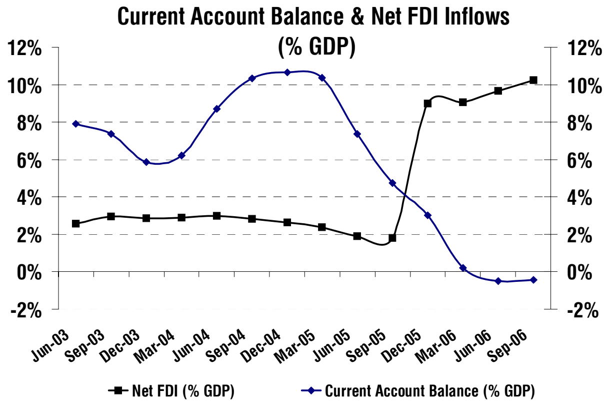
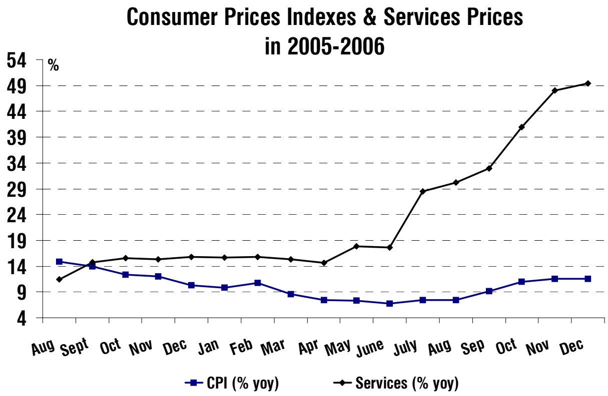


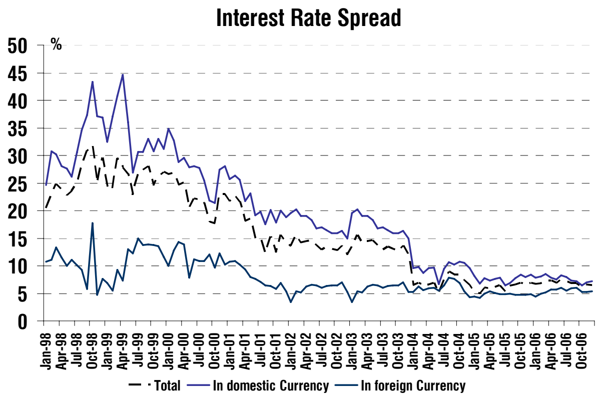
Figure 5.6



of foreign banks. Moreover, the NBU took steps to open up the Ukrainian banking sector to foreign capital, allowing by law the establishment of branches of foreign banks, under the preconditions that they originate from countries that co-operate with the Financial Action Task Force against money laundering (FATF) and that they hold statutory capital over €150mn.

On the positive side, Ukraine's banking sector is characterized by increasing competition and intermediation efficiency, which is reflected in the constantly declining lending spreads. Moreover, the difference between the interest rate spreads in domestic and foreign currency has decreased from 3.6 percentage points in 2005 to 1.8 percentage points in 2006, due to banks' increased competition boosted, by the entrance of foreign players in the banking sector (Figure 5.7).

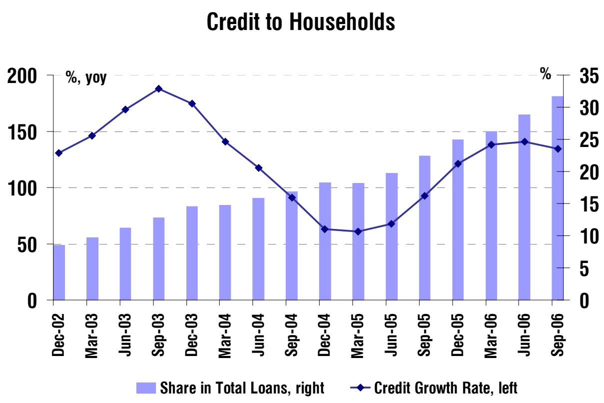
Figure 5.7



Credit and Deposits

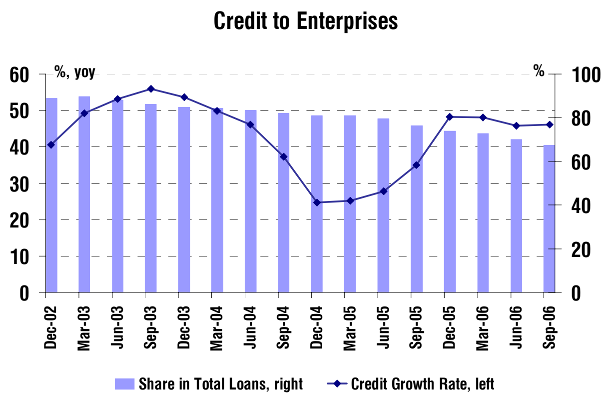
Ukraine is characterized by a rapid credit expansion, with credit growing by 71%, yoy, as of Q4-2006, up from 61.9%, yoy, over the same period a year ago. Due to the particularly low credit penetration, credit is expanding across all segments of the economy, but it is more pronounced amongst households. As a result, loans to households consist 31.6% of total loans, up from 8.6% in 2002, growing by 134.1% as of Q4-2006. This segment is perceived to have the greatest growth potential with some products such as mortgages still being in a nascent stage (Figure 5.8).

Figure 5.8



In 2006, loans to enterprises enjoyed a healthy growth rate of 46.1%, yoy, comprising 67.2% of total credit portfolio. However, enterprises have also resorted to borrowing from abroad, as it is indicated by gross external debt data. The share of gross external debt corresponding to the private sector stood at 47% in October 2006, remaining broadly unchanged from 49.5% in October 2005 (Figure 5.9).

Figure 5.9



On the other hand, deposits are currently standing at 34% of GDP, growing by 38.8%, yoy, in 2006 (Figure 5.10). The largest share of deposits corresponds to deposits in domestic currency, which grew by 30.8%, yoy. In addition, deposits in foreign currency grew by 54%, yoy, in Q4-2006. Yet, despite this rapid growth they are unable to keep up with foreign currency credit, which expanded by 95.4%, yoy.

Liquidity and Foreign Exchange Risk

Ukraine's banking sector faces a major shortage of liquidity, since it lacks the necessary deposits to fund its rapid credit expansion. Credit to GDP increased from 11.2% at end-2000 to 43.2% in Q3-2006 and the loan to deposit ratio shows that deposits have never been the only funding source of banks lending activities. The loan-to deposit ratio stands above the 100% threshold, being equal to 133.1% as of Q4-2006. In December 2006, loans' growth rate stood at 71%, yoy, double that of deposits', indicating that the banking sector needs to be increasingly funded by alternative sources (Figure 5.11). Indeed, since 2003 banks' net foreign assets have turned negative, due to banks' borrowing from abroad, in order to take advantage of the lower offshore lending rates. Thus, net foreign assets have decreased from a positive balance of US$123mn at end 2002 to a negative balance of US$8.4bn at end-2006, making banks more vulnerable to foreign-currency funding risk.

Moreover, liquidity problems caused by political turmoil, similar to those that appeared in the past, as well as the low confidence in the banking sector are key factors that could affect banking sector's stability. Indeed, the restructuring or closure of "pocket banks" and the improvement of corporate governance and compliance structures, would strengthen depositors' confidence and improve banking sector's stability.

The other major source of risk affecting the Ukrainian banking sector is exchange rate risk. Approximately half of banks' loan portfolio consists of loans that are denominated in foreign currency, up from 43.3% a year ago. More specifically, the share of loans in foreign currency to households, the group most vulnerable to foreign exchange risk, was 60.7% as of Q4-2006, growing by 151.5%, yoy. On the other hand, enterprises' loans in foreign currency make-up 41.3% of total loans, increasing by 62.6% yoy (Figure 5.12). The main reasons for the financial dollarization characterising Ukraine's banking system are the pegged exchange rate of hryvnia to the USD, which is responsible for a relatively stable real exchange rate, as well as the lower rates charged on foreign currency denominated loans. As the majority of the households are not aware of the risks, and the risk management systems used by most of the banks are in a nascent stage, there is an urgent need that fx risk of the banking industry is reduced. The Central Bank has already taken certain prudential measures to reduce fx risk, such as tightening quality standards for bank capital and demanding higher provisioning requirements for unhedged clients, but these are not adequate to contain banking sector's fx exposure. These risks are exacerbated by the foreign currency mismatch between assets and liabilities. The

Figure 5.10

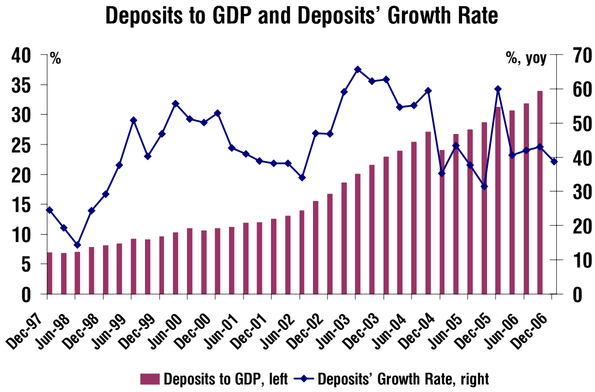


Figure 5.11

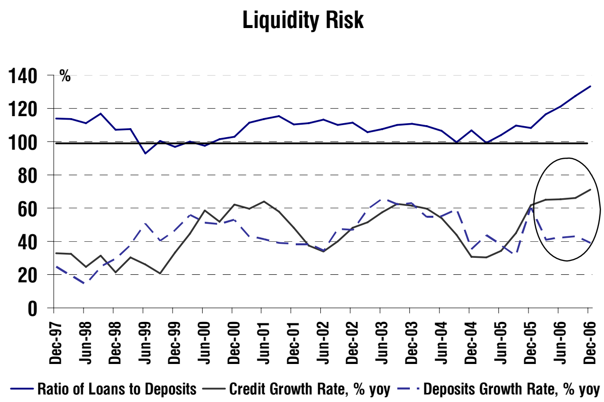
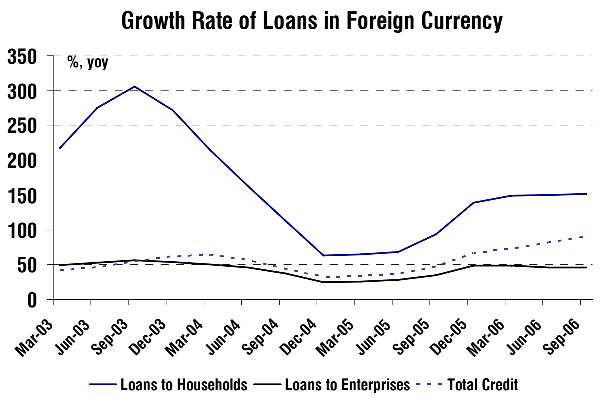


Figure 5.12



ratio of loans to deposits in foreign currency was 173.1% in December 2006 compared with 136.4% one year ago.

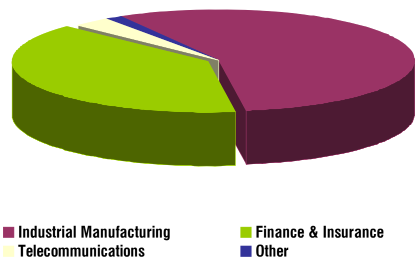
Other Developments

During the last two years, Ukraine's banking sector was marked by the dynamic entry of foreign participants. According to data provided by Dealogic, during the period between September 2005 and September 2006, 31 bids took place in the Finance and Insurance sector, accounting for 39.5% of the total value of M&A transactions. The largest share corresponds to the Industrial and Manufacturing sector (56.2%), whereas the Telecommunications sector remains far behind with a share of only 3% (Figure 5.13).

Figure 5.13

Share of M&A Transaction Value

(09/2005- 09/2006)



Source: Dealogic

Ukraine: Macroeconomic Indicators									
	2001	2002	2003	2004	2005	Q1 2006	Q2 2006	Q3 2006	Q4 2006
Output and expenditure	*(Percentage Change in Real Terms)*								
GDP	9.2	5.2	9.4	12.1	2.6	3.2	7.3	8.0	-
Industrial production	14.2	7.0	15.8	12.5	3.1	0.2	3.6	-	-
Labour Market									
Unemployment (in per cent of labor force)	3.6	3.7	3.5	3.5	3.1	3.2	2.9	2.9	2.5
Prices	*(Percentage Change)*								
Consumer prices (annual average)	12.0	0.8	5.2	9.0	13.5	9.7	7.2	8.0	11.4
Produce Prices (annual average)	8.7	3.0	7.6	20.4	16.8	8.4	5.5	10.3	-
Average monthly wage in economy	35.2	21.0	22.8	27.6	36.7	36.7	29.2	26.9	25.2
Government sector	*(In per Cent of GDP)*								
General government balance	0.3	0.7	0.2	3.2	1.8	0.4	0.5	0.7	-
General government debt	36.3	33.4	29.1	22.3	17.0	-	-	-	-
Monetary and Financial Indicators	*(Percentage Change)*								
M2	42.9	42.3	46.9	32.8	53.9	39.2	36.5	36.7	-
Total Credit	48.4	48.2	61.4	30.6	61.9	64.9	65.3	66.1	71.0
	(End of Period)								
Exchange rate UAH/USD (end-period)	5.3	5.3	5.4	5.3	5.0	5.1	5.0	5.0	5.0
Exchange rate UAH/EUR (end-period)	4.7	5.5	6.6	7.1	6.0	6.1	6.3	6.4	6.6
Real Effective Exhange Rate (Index)	114.2	102.6	95.3	95.8	112.8	112.0	108.2	108.8	-
International Position	*(In per Cent of GDP)*								
Current account balance	3.7	7.5	5.8	10.6	3.0	0.2	-0.5	-0.4	-
Trade balance	0.5	1.7	1.0	5.8	-1.4	-3.9	-4.4	-3.8	-
Foreign direct investment, net	2.1	1.7	2.9	2.6	9.0	9.0	9.7	10.2	-
Gross External debt	53.6	51.1	47.5	47.2	46.7	46.7	-	-	-
Memorandum items	*(Denominations as indicated)*								
Population (end-year, million)	48.5	48.0	47.6	47.3	47.1	-	-	-	-
GDP (in millions of UAH)	204.2	225.8	267.3	345.9	424.0	-	-	-	-

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

Ukraine: Banking Indicators									
	2001	2002	2003	2004	2005	Q1 2006	Q2 2006	Q3 2006	Q3 2007
Percentage of GDP (%)									
Total Credit	13.9	18.6	25.4	25.7	33.8	35.7	38.4	43.2	-
Credit to Enterprises	13.2	17.1	22.0	21.4	25.9	26.8	-	-	-
Credit to Households	0.7	1.5	3.4	4.3	7.9	8.8	-	-	-
Deposits	12.6	16.7	22.9	24.0	31.3	30.7	31.8	33.9	-
Percentage Change (%, yoy)									
Total Credit	48.4	48.2	61.4	30.6	61.9	64.9	65.3	66.1	71.0
Credit to Enterprises	45.7	40.5	53.6	24.7	48.2	48.1	45.8	46.1	-
Credit to Households	42.9	130.6	174.8	63.1	121.0	138.3	140.5	134.2	-
Deposits	38.1	46.9	62.7	35.2	60.0	40.5	41.9	43.0	38.8
Percent (%)									
Capital Adequacy Ratio	20.7	18.0	15.2	16.8	15.0	14.9	-	-	-
Capital to Assets	15.6	14.7	12.3	13.1	11.5	11.5	-	-	-
NPLs to Total Loans	25.1	21.9	28.3	30.0	19.6	18.3	-	-	-
Provisions to NPLs	39.2	37.0	22.3	21.1	25.0	25.9	-	-	-
Return on Assets	1.2	1.2	1.0	1.1	1.3	1.4	-	-	-
Return on Equity	7.5	8.0	7.6	8.4	10.4	11.8	-	-	-

Sources: NBU, IMF

6. Turkey

- **The economic slowdown of 2006, will continue into 2007. We now expect real GDP to grow by 5.2% in 2007 and increase to 5.8% in 2008.**
- **Inflation will overshoot CBRT's target by some margin. We expect year-end inflation at 7.4% and 6.1% for 2007 and 2008, respectively.**
- **In 2007, the current account deficit is expected to narrow to 7% of GDP, down from 8.4% in 2006.**
- **Turkey's overall budget deficit fell to 0.7% of GNP, in 2006, from 2% of GNP in 2005, while the primary balance recorded a surplus of 7.5% of GNP compared to 7.7% in 2005.**
- **Net FDI flows reached a record high in 2006, a total of US$19bn, compared with US$9bn in 2005, financing 60% the current account deficit, up from 40% in 2005.**
- **Banking sector's stability was unaffected by the economic slowdown, but credit growth has suffered. Total lending increased by 5.4% between June - November, down from 30% during the first half of 2006.**

6.1 Macroeconomic Outlook

Summary

According to our estimates, the economic slowdown observed during the second half of 2006, will be carried over into 2007. We now expect real GDP to grow by 5.2% in 2007 and increase to 5.8% in 2008. We attribute this slowdown during 2007 to a sharp drop in consumption and a mild slowdown in investments. From 2008 onwards we expect a pick-up in economic activity supported by a gradual decline in inflation and both real and nominal interest rates.

Turkey	Q42006	2007*	2008*
GDP	3.9	5.2	5.8
Consumption	2.0	7.8	6.0
Investment	9.0	10.2	12.0
Exports	8.0	9.3	9.8
Imports	2.0	4.0	5.0
Current Account (% of GDP)	-8.5	-7.0	-7.0
Inflation (%, y/y)	9.6	7.4	6.1

Note: * Figures reported for GDP growth and its components are averages of y/y growth rates recorded every quarter of the corresponding year.

Consumption

As expected consumption was the most affected component of GDP from the May/June crisis and the subsequent increases in both inflation and interest rates. For this reason, we expect consumption growth to slowdown to 2%, yoy, in Q4-2006, after registering a 2.3%, yoy, growth in Q3-2006. According to our projections the negative impact of the monetary policy tightening and Lira depreciation will gradually wane out during 2007 and will give its place to a more consumption supportive environment. According to our estimates consumption will grow on average by 4.8% in 2007 and 6% in 2008.

Investment

In contrast to the decline in consumption, gross fixed capital formation held up relatively well, growing by 9.4% in Q3-2006. According to out estimates gross fixed capital formation will make a small recovery in 2007 to 10% and increase further in 2008 to 12%. We believe that two major factors will restrain investment from making a full recovery, at least until mid-2008. The first is capacity utilisation that will remain low, in view of an increasing negative output gap, implying a below trend GDP growth during our forecasting period. The second is business confidence, which according to the relevant indicators appears dented by the recent economic developments and the forthcoming elections.

Net Exports

The upshot from the recent depreciation of the Lira was the improvement of the trade balance. Given the recent momentum, we expect exports to rebound on average by 9.3%, yoy, in 2007 and 9.8%, yoy, in 2008. The Turkish Lira may weaken further in 2007, as international investors are less confident about the government's determination to continue the privatization program ahead of presidential elections in May and parliamentary elections in November. Expected TRY depreciation will improve the trade balance as exports become cheaper and imports more expensive. On the other hand, the past monetary policy tightening will continue to drag consumption of imported goods in 2007, although to a lesser degree. As a result, imports will increase on average 4%, yoy, in 2007 and 5%, yoy, in 2008 after an estimated growth of 2%, yoy, in Q4-2006.

Current Account

Our benign outlook for net exports in 2007 and 2008 will contribute to a lower current account deficit, which peaked at (an estimated) 8.5% of GDP in Q4-2006. Specifically, we expect that the weakening of economic activity will allow the current account deficit to decrease to 7% of GDP in 2007 and remain stable in 2008. Any potential weakening of the Lira will also contribute to the slowdown of current account deficit in the light of a trade balance improvement.

Inflation

We expect that the disinflation process will gain momentum during 2007 and 2008, following inflation peaking at 9.6% in 2006. We project inflation to average 7.4% in 2007 and 6.1% in 2008 as a result of below trend real GDP growth, resulting in an excess aggregate supply that will generate a downward pressure to the price level. The effects of the USD/TRY depreciation by 18%, yoy, recorded in Q2-2006, following the global de-leveraging and increased volatility in asset prices, is beginning to wear out. Still, inflation will fall short the 4% inflation target set for 2007 and 2008 by the Central Bank of the Republic of Turkey (CBRT).

6.2 Current Economic Developments

The Turkish economy is slowing down as a result of the monetary policy tightening in May/June 2006 - in the aftermath of the emerging markets crisis - and of concerns about the impact of the forthcoming political developments on the state of the economy. On the European membership front, the European Council has decided to partially freeze the negotiations for Turkey's accession, spurring further anti-EU sentiment in the Turkish society.

The tightening of the monetary policy by 425bps resulted in a significant slowdown of the economic activity in the second half of 2006. GDP growth rate in the first three quarters slowed down to a 5.6% yoy, while our projections for the entire 2006 indicate that GDP growth will decline further to 5%. In Q3-2006, real GDP growth stood at 3.4%, well below the Q2-2006 growth of 7.5% and the 7.7% growth realized in Q3-2005. Private consumption, the largest component of GDP, grew by just 1.3%, yoy, compared to 10.4% in the previous quarter, contributing 2 percentage points to real GDP growth. Gross fixed capital formation also slowed down to 9.4%, down from 30.6% in Q3-2005 and as a result the overall contribution of investments (gross fixed capital formation plus changes in inventories) to GDP growth became marginally negative, for the first time since 2001. The substantial Lira depreciation supported exports growth to 5.7%, yoy, in Q3-2006, up from 3.9% in Q2-2006 and depressed imports growth to 1.7%, down from 10%, yoy, in Q2-2006. As a result , in

Q3-2006 net exports had a positive contribution to GDP growth for the first time since 2005 (Figure 6.1).

On the fiscal front, 2006 proved to be another strong year for the budget. The central government budget posted a primary surplus of TRY42bn (7.5% of GNP) and an overall budget deficit of TRY4bn (0.7% of GNP) in 2006, a fiscal performance equally strong if not better compared to 2005. (Graph 2: Fiscal Performance 2001-2006) This improvement in Turkey's fiscal position was the result of robust revenue - especially indirect taxes generated by strong domestic demand during the first half of the year- which more than offset higher non-interest expenditures, mainly for public sector wages and social security transfers. On the other hand, lower corporate income taxes as a result of the corporate tax rate cut from 30% to 20% contributed less than expected to total revenues.

The budget figures revealed a better than expected performance in terms of IMF defined targets. The IMF defined primary budget surplus reached 6.0% of GNP (compared to 5.0% of GNP in 2005), which led IMF to disburse another tranche of US$1.1bn - out of a total US$5.5bn. In addition, the release of the data for the consolidated government sector up until November 2006, suggested that the primary balance of a 6.7% of GNP would be achieved (in line with the IMF mission projection in October 2006), while the overall deficit would be around 1%.

For 2007, an equally ambitious target for the consolidated government sector primary budget surplus remains in place (a 6.5% of GNP target was agreed with the IMF). According to the 2007 budget plans, the government intends to achieve a 5% surplus on the budget of the central government budget while off-budget parts of the public sector will contribute the remaining 1.5%. Revenues are projected to increase by 9.8%, while total expenditure is estimated to increase by 16.9%, equivalent to an overall budget deficit of 2.7% of GNP. According to our opinion the successful execution of the budget will be challenging given our projected slowdown in economic activity, which will affect the revenue from indirect taxation, and the pre-election pressures which might lead to higher than budgeted wage increases. Finally the ability of the off-budget parts of the wider public sector to contribute 1.5% of GNP looks ambitious given the recent privatizations of large state enterprises which in the past have been the largest contributors to this surplus (Figure 6.2).

Despite the economic slowdown, the current account deficit widened further. In Q3-2006, the current account reached 8.4% of GDP

Figure 6.1

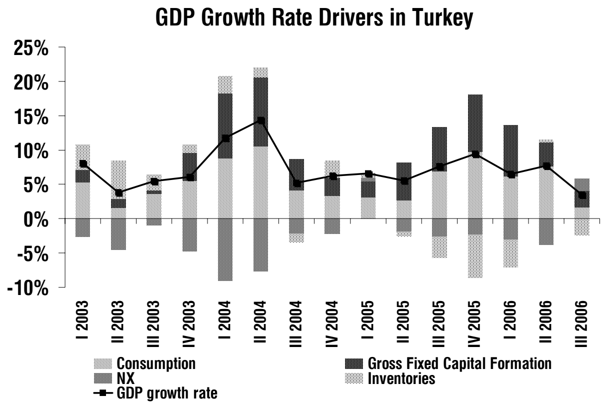
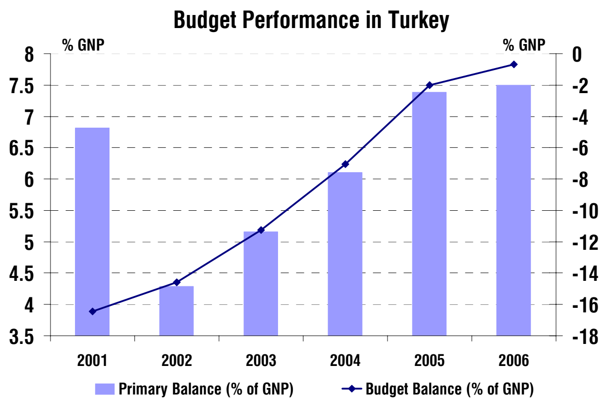


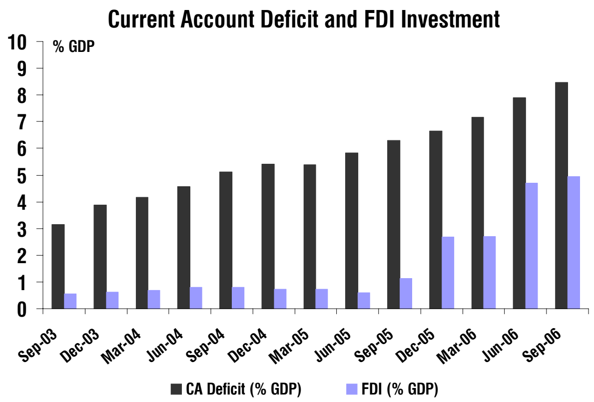
Figure 6.2



compared with 7.8% in Q2-2006 and 6.1% of GDP in Q3-2005. This comes not only as a result of the increasing trade deficit, but also of the reduced surplus of services. The trade balance deficit reached approximately 10.5% of GDP in Q3-2006, compared to 8.9% in Q3-2005 and 10.3% of GDP in Q2-2006. Exports have been growing by 14% in the first nine months, while imports have been rising by 19%. This trend has been put into reverse in Q3-2006, when both exports and imports grew by 18%, yoy, as exports started to benefit from the depreciation of Turkish Lira. The main driver of exports has been the value of road vehicles which grew by 33%, yoy, in Q3-2006 compared with 14% in Q2-2006. Imports have been rising by 18% in Q3-2006 being driven not only by oil price increases, but also by strong demand for intermediate goods for manufacturing. Additionally, the services surplus declined to 3.3 % of GDP in Q3-2006, down from 4.1% of GDP in Q3-2005, as a result of the decline in tourism revenues by 8% during the first 3 quarters of 2006.

On the other side of the ledger, FDI inflows reached record levels in 2006, providing the necessary capital to finance the current account deficit. Based on data for 2006, net FDI flows reached approximately US$19bn, covering 60% of the total current account deficit. In contrast, net FDI inflows in 2005 amounted to US$8.8bn (or 2.7% of GDP) or a 40% coverage of the current account deficit (Figure 6.3).

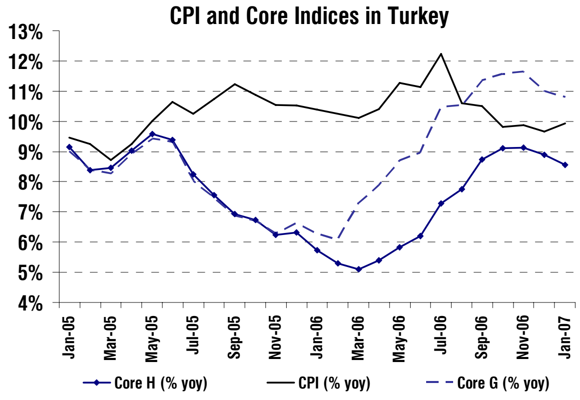
Figure 6.3



This remarkable achievement of 2006 has created the optimism that this stellar performance can be repeated in 2007, and the government now expects to attract another US$20bn of new capital. Yet, we believe that these expectations are overly optimistic and are based on projections that will be difficult to materialize, especially when one considers the political constraints of an election - both presidential and parliamentary - year. According to our estimates a more realistic outcome would be from inflows between US$10bn (most likely scenario) to US$15bn (best case scenario). Already we have seen some negative spillover effects from local politics on the privatization schedule as the government has already announced that it will postpone the privatization of regional electricity distribution networks because it does not want energy prices to become an issue during the forthcoming elections. Similar concerns have forced government to postpone the sale of Tekel, a tobacco company, and change its plans about Halkbank, Turkey's 6th largest bank, from a full privatization to the sale of a 25% stake through an initial public offering.

Consumer prices after peaking up in July at 11.6% have been easing ending up in December at 9.6% yoy, averaging at 10.5% yoy in 2006. Two factors helped consumer prices to moderate: the lira appreciation after the monetary policy tightening as well as the subsequent private consumption deceleration. Yet, despite the recent decline in consumer prices core inflation does not show any signs of moderation. More specifically, the core inflation indexes G and H - two out of the 8 core measures surveyed by the central bank - have registered a substantial increase. Core Index G continues to accelerate even after the lira appreciation in Q3-2006, from around 6% at the beginning of 2006 towards 9% in December, averaging 9.3% yoy in 2006. In addition, Core Index H rose to 8.9% in December from around 6% at the beginning of the year. On the producer prices (PPI) front, a measure that is more sensitive to increases in cost materials, PPI has doubled within a year from 5% to 12% in December, averaging 9.3% yoy in 2006. Given that the inflation outcome has been significantly above the original target of 5% set the CBRT, we expect that the monetary policy stance of the central bank will continue to remain hawkish (the target for 2007 for 4% +/-1%) (Figure 6.4).

Figure 6.4



6.3 Banking Developments

Following the emerging markets crisis that affected Turkey in May-June 2006 and the subsequent hike of interest rates (by 425bps) by CBRT, we had voiced our concerns regarding the impact that these developments would have on the stability and growth potential of the Turkish banking system. Although we do not have the complete picture for 2006, based on the data available thus far we can conclude, with a high degree of certainty, that while credit quality of Turkish bank's portfolio has remained intact (mainly due to the fact that all consumer and mortgage loans were granted at fixed rather than floating rates), the credit expansion has slowed down considerably.

The impact of the May-June mini crisis on credit expansion is obvious if we contrast the credit growth rates during the first six months of 2006 to those of the subsequent period of June-November 2006. Between June-November 2006, total loans increased by just 5.4%, compared with 30% credit growth recorded in the first half of the year. The slowdown in credit, as already stated, affected all loan categories. Consumer loans grew by 6.6% in the last 5 months for which data are available, contrary to 34.7% growth rate of the first half of 2006. The slowdown was even more pronounced in the housing loan component of household loans, as they grew only by 6% in the June-November period, down from

65.3% during the first half of the year. The business loans category has also suffered from the interest rate hike, with business lending growing by 28.9% in the first six months of the year but only by 7.1% during the last 5-month period (Figure 6.5)

The slowdown of credit growth was more intense in July and August, with total credit recording a negative growth rate, mom, in July (-0.33%) and a negligible rate of only 0.7%, mom, in August down from much higher levels during the previous months of the year (10.8%, mom, in May and 4.3%, mom, in June).

Deposits & Liquidity

In November 2006, deposits grew by 27.6%, standing at 53.4% of GDP. The breakdown of deposits into local and foreign currency varies according to fluctuations in the exchange rate. Between April and June, households took advantage of the Lira depreciation and converted their foreign currency deposits to domestic currency. As a result foreign currency deposits declined by 6.1% over this period. As the Lira started to recover the reverse pattern prevailed. Hence, according to the latest data available, foreign-currency denominated deposits grew by 36.3%, yoy, in November 2006, compared with 22.7%, yoy, growth for Lira denominated deposits. Household deposits make-up 63.9% of total deposits and they account for 71.3% of total households' financial assets, up from 64.3% in 2003 (Figure 6.6)

Despite Turkey's lending boom, local banks have still ample liquidity to fund further the expansion of their balance-sheets. The loans to deposit ratio stands at 70.7%, far below the 100% threshold, but higher than the 60.2% level of one year ago (Figure 6.7). Moreover, the ratio of securities, which can be used as collateral in case of sudden deposit withdrawals, to deposits is at an adequate level (40.1% as of Q3 2006), marginally lower than a year ago (44% at end-2005).

Credit quality

The recent crisis had no discernible effect on banking sector's loan quality. In November 2006, non-performing loans stood at 3.95% of the total loan portfolio, significantly below the 5.5% level one year earlier, aided by the rapid increase in new lending (Figure 6.8). In addition, the high provisioning policy followed is considered to be a favourable development, reducing banking sectors' credit risk. As of November 2006, provisions were equal to 90% of non-performing loans and to 3.5% of total banking sectors' loans. The Turkish Lira's

Figure 6.5

The Impact of the May-June Mini Crisis in Credit Growth Rates

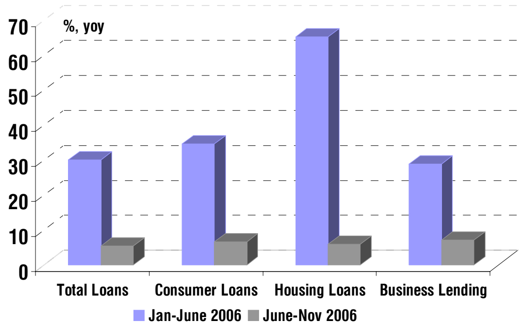


Figure 6.6

Deposits' Growth Rates

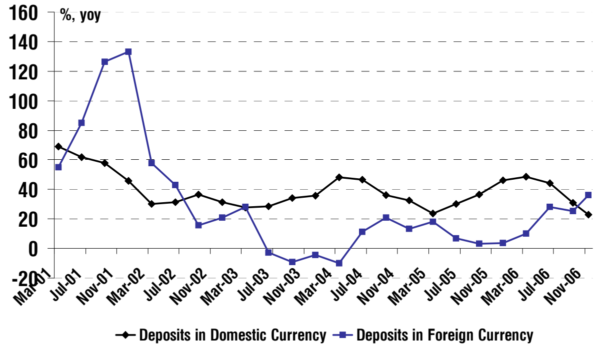
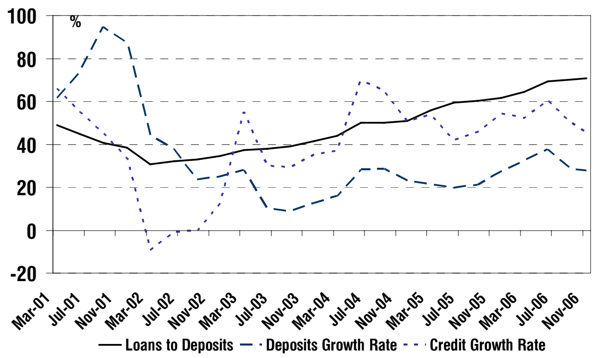


Figure 6.7

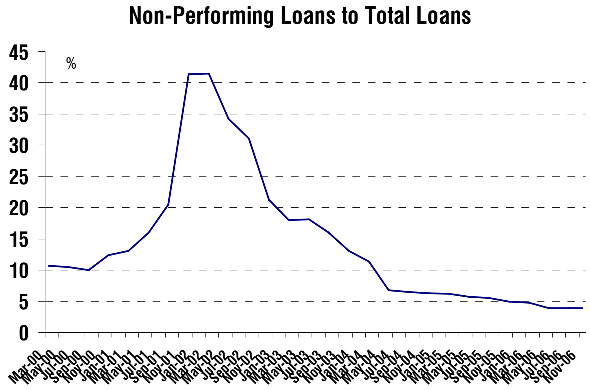
Banking Sector's Liquidity



sharp depreciation during the June-May emerging markets crisis created worries about the foreign-exchange risk of the banking sector. Since Q2-2003, loans in foreign currency have been growing at a lower pace than loans in YTL, making up only 26.5% of the total loan portfolio in November 2006. More significantly, households exposure to FX-risk is rather limited given that loans to households that are FX-indexed correspond only to 2.4% of total loans to households, down from 3% one year earlier.

Finally, the slowdown in credit growth had a beneficial effect on the capital adequacy ratio (CAR) of the Turkish banking sector. The decrease in the rate of growth of risk weighted assets (loans) resulted in CAR reversing its downward trend, reaching 20.5% in September 2006, up from 18.7% in June 2006 and significantly above the 12% target set by CBRT.

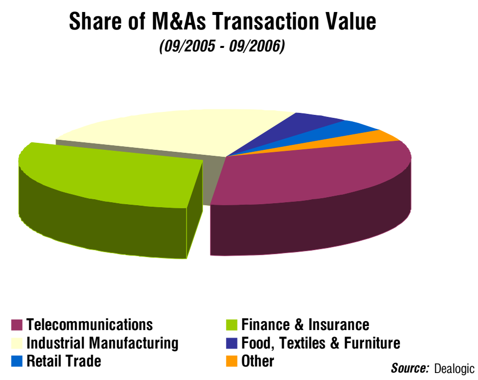
Figure 6.8



Other Developments

2006 was marked by foreign investors' increased appetite for Turkish banking assets. The low levels of financial intermediation, coupled with the improved outlook for the Turkish economy were the key factors that triggered foreign banks' interest in Turkey's banking sector. According to data provided by Dealogic, in the period of September 2005 to September 2006, 23 bids took place in the Finance and Insurance sector, accounting for 29.8% of total M&A value. The biggest share corresponds to the Telecommunication sector (31.8%), while the industrial and manufacturing sector occupies the third place with a 25% share (Figure 6.9).

Figure 6.9



Turkey: MacroEconomic Indicators									
	2001	2002	2003	2004	2005	Q1 2006	Q2 2006	Q3 2006	Q4 2006
Output and expenditure	*(Percentage Change in Real Terms)*								
GNP	-9.5	7.9	5.9	9.9	7.6	6.4	8.8	3.0	-
GDP	-7.5	7.9	5.8	9.0	7.4	6.5	7.8	3.4	-
Private consumption	-9.2	2.1	6.6	10.1	8.8	8.4	10.4	1.3	-
Public consumption	-8.5	5.4	-2.4	0.5	2.4	8.1	18.0	15.4	-
Gross fixed capital formation	-31.5	-1.1	10.0	32.4	24.0	30.4	15.4	13.0	-
Exports of goods and services	7.4	11.1	16.0	12.5	8.5	2.9	3.4	5.7	-
Imports of goods and services	-24.8	15.8	27.1	24.7	11.5	8.2	9.5	1.7	-
Industrial production (in nominal terms)	-8.7	9.4	8.7	9.8	5.4	3.4	9.3	5.6	-
Labour Market									
Employment	0.0	-0.3	-0.8	2.0	1.7	-1.1	0.6	1.9	3.3
Unemployment (in per cent of labor force)	8.4	10.4	10.5	10.3	10.2	11.9	8.8	9.1	9.6
Prices	*(Percentage Change)*								
Consumer prices (annual average)	54.4	45.0	21.6	8.6	8.2	7.6	8.1	9.6	10.8
Producer prices (annual average)	61.6	50.1	22.7	14.6	5.9	4.9	8.4	12.6	11.4
Average monthly wage in economy	31.8	37.2	23.0	13.4	12.2	11.4	10.6	11.5	10.6
Government sector	*(In per Cent of GNP)*								
Consolidated Government Overall balance (IMF)	-17.1	-13.6	-9.0	-4.7	-2.2	-	-	-	-
Net public sector debt (IMF)	90.5	78.5	70.4	63.5	55.8	-	-	-	-
Monetary and Financial Indicators	*(Percentage Change)*								
M4	56.0	36.5	31.9	40.9	30.9	42.2	41.1	28.2	-
Total Credit	33.4	12.4	35.2	50.6	54.2	52.4	60.2	49.8	45.5
	(End of Period)								
Reference rate	-	44.0	26.0	18.0	13.5	13.5	15.1	17.5	17.5
Exchange rate YTL/USD (end-period)	1.5	1.7	1.4	1.3	1.3	1.3	1.6	1.5	1.4
Exchange rate YTL/EUR (end-period)	1.1	1.4	1.7	1.8	1.7	1.6	2.0	1.9	1.9
Real Effective Exhange Rate (Index)	116.3	125.4	140.6	143.2	171.4	173.0	142.1	155.5	160.2
International Position	*(In per Cent of GDP)*								
Current account balance	2.4	-0.8	-3.3	-5.2	-6.4	-7.2	-7.9	-8.5	-
Trade balance	-2.6	-4.0	-5.8	-7.9	-9.1	-9.6	-10.3	-10.5	-
Foreign direct investment, net	2.0	0.5	0.5	0.7	2.4	2.7	4.7	5.0	-
Memorandum items	*(Denominations as Indicated)*								
Population (end-year, million)	68.5	69.6	70.7	71.8	72.1	-	-	-	-
GDP (in milliards of YTL)	178.4	277.6	359.8	430.5	487.2	-	-	-	-
GNP (in milliards of YTL)	176.5	275.0	356.7	428.9	486.4	-	-	-	-

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

Turkey: Banking Indicators	2001	2002	2003	2004	2005	Q1 2006	Q2 2006	Q3 2006	Nov 2006
Percentage of GDP (%)									
Assets	89.8	76.4	69.6	71.8	85.5	83.9	88.8	88.9	-
Total Credit	22.6	17.2	18.0	22.8	31.2	33.4	38.1	39.2	-
Credit to Enterprises	17.5	12.3	14.4	18.6	25.5	27.0	30.5	30.4	-
Credit to Households	-	2.4	3.6	6.2	9.7	10.4	12.3	12.2	-
Deposits	58.6	49.6	43.3	44.7	50.6	51.8	54.9	55.6	-
Percentage Change (%, yoy)									
Assets	62.0	25.9	17.4	22.7	29.5	31.5	35.3	26.9	26.2
Total Credit	33.4	12.4	35.2	50.6	54.2	52.4	60.2	49.8	45.5
Credit to Enterprises	-	3.8	50.5	54.5	53.9	51.6	57.7	48.7	44.0
Credit to Households	-	-	94.4	106.0	76.7	72.0	75.5	59.2	52.2
Deposits	87.3	25.1	12.6	23.0	27.2	32.3	37.7	28.7	27.6
Percent (%)									
Capital Adequacy Ratio	15.3	25.3	30.9	28.8	24.2	23.5	-	-	-
Capital to Assets	7.9	11.9	14.2	15.0	13.5	13.5	-	-	-
NPLs to Total Loans	29.3	17.6	11.5	6.0	4.8	4.5	-	-	-
Provisions to NPLs	47.1	64.2	88.5	88.1	89.8	89.6	-	-	-
Return on Assets	-5.5	1.1	2.3	2.3	1.7	0.7	-	-	-
Return on Equity	-69.4	9.3	16.0	16.4	11.8	5.3	-	-	-

Note:The data have changed compared to previous Quarterly Review due to data revisions.
Sources: CBRT, IMF