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Commentary

Growth performance in the countries of New Europe was strong in Q1-2007. Poland raced with 7.4% yoy, Ukraine rallied with 8.0% yoy and Romania with 6% yoy. According to conjuctural data, Turkey and Serbia expanded at a less vibrant, though robust growth rate. The main growth drivers are i) Private consumption in Bulgaria, Serbia and Ukraine ii) Investment in Poland and iii) Net exports in Turkey. Growth drove unemployment down in all countries of New Europe. As a result, skilled labor shortages have been more evident than before.

Inflation is declining rapidly. Guided by local currency appreciation, inflation is declining in Romania, Serbia, and Turkey. In contrast, gas and utilities price hikes maintain inflation in Ukraine in double digit territory. Inflationary pressures in Poland triggered the first interest rate hike.

In the first months of 2007, political volatility increased dramatically, raising concerns for investors. The events in Ukraine, Turkey and Serbia showed how eruptive politics in those countries can be. Politics in Poland, Romania and Bulgaria are no less volatile. Nevertheless, the economies of New Europe turned out to be resilient to the political upheaval.

Another source of concern is the high current account deficit in many countries of New Europe. The current account deficit reached 16.9% of GDP in Bulgaria, 11.9% in Romania, 12.9% in Serbia, 8.2% in Turkey. The risks for the current account deficits are on the upside, given the prospective looser fiscal stance envisaged and the rapid credit expansion rates. However, the countries in New Europe continued to attract significant FDI inflows in Q1-2007. Net FDI inflows covered a significant proportion of the current account deficit in Bulgaria (91%), Turkey (80%), and Serbia (115%). An exception is Rumania, where unrealized privatization plans in Romania led to a visible decrease in the current account deficit coverage by net FDI inflows from 88% in 2006 to 72% in Q1-2007 as net FDI flows decreased by 28% yoy.

Rapid credit expansion continued in Q1-2007 in the countries of New Europe, though at a different pace in each country. Ukraine and Romania registered the highest credit growth rates at 71% and 52% yoy respectively. The attempt of monetary authorities in Bulgaria and Serbia to curb credit expansion led economic agents to resort to alternative unregulated channels, such as financial leasing, so that total credit growth remained strong. In contrast, political turmoil coupled with monetary tightening resulted in a slowdown in credit growth to 34% yoy in Turkey. A respectable proportion of credit in Turkey, about 25%, is foreign-currency-denominated, the same as in Poland, but substantially less than in Bulgaria, Romania and Ukraine where it stands at 50%

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

1. Bulgaria

- **The Bulgarian economy sustained a buoyant real GDP growth rate in 2006, accelerating at 6.1% yoy against 6.2% in 2005. Growth prospects for 2007-2009 are equally strong as the GDP growth is expected to rise on average by 6%.**
- **Skilled labor shortages have been more evident than before. Total Employment-according to labor force surveys-increased by 10.5% yoy in Q1-2007 and unemployment dropped to 8.4% in April 2007.**
- **Budget performance has been very strong in Jan-April 2007. Nevertheless, the budget envisages a fiscal surplus of 2.3% of GDP, compared to 3.6% of GDP in 2006.**
- **The current account deficit deteriorated further to 16.9% in Q1-2007 against 14.1% in Q1-2006. On a positive note, the current account deficit is financed 90% by FDI inflows. Real estate and construction related sectors along with the financial services sector are the niche industry destinations.**
- **After a temporary hike to 7.2% in January, consumer prices edged up to 4.3% yoy in Mal against 4.2% in April.**

1.1 Overview

The first target was attained with the Bulgaria's accession to European Union. The next policy challenge for Bulgaria would be to advance with structural reforms in the judicial and administrative mechanisms, in accordance with the EU commission recommendations. As a result, the EU Commission report released was skeptical on the progress made. The year 2006 marked another period of strong economic growth for Bulgaria. The Bulgarian economy sustained a buoyant real GDP growth rate in 2006, accelerating at 6.2% yoy against 6.1% in 2005. Private consumption, the main GDP growth driver accelerated by 7.1% yoy and Gross Fixed Capital Formation grew by a buoyant 17.6% yoy.

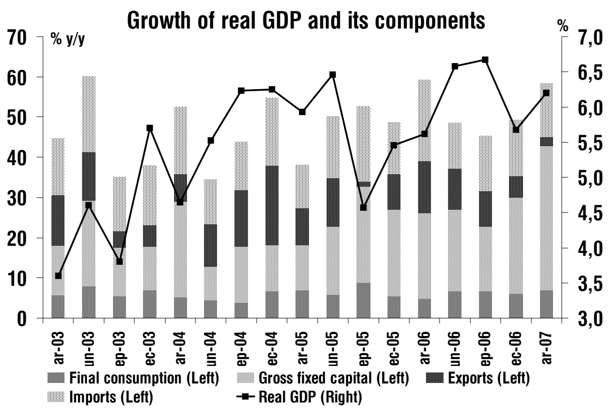
Bulgaria has made progress in the last four years. Nevertheless, Bulgaria is still the laggard in the European Union. GDP per capita in PPS now stands at 37.8% of EU-25 average. Growth prospects are equally rosy for the period 2007-2009. In the period 2007-2009 GDP growth is expected to exceed 6% on an annual basis. The motivation behind such a scenario is based most of all on the positive spillovers from Bulgaria's EU membership. Significant private investment inflows are anticipated that will pour into the country, directed to the financial and real estate sectors. Bulgaria tops Central and Eastern European rankings as the country that combines the lowest unit labor cost, relative to EU-25 average, and the highest FDI inflows as a percentage of GDP. This is also corroborated by UNCTAD's World

Investment Report, according to which the Bulgarian economy is classified as an economy of high potential and high growth in terms of FDI. Finally, in the period 2007-2013 Bulgaria is going to be a recipient of more than €6.8 bn in the form of EU structural funds.

1.2 Current Economic Developments

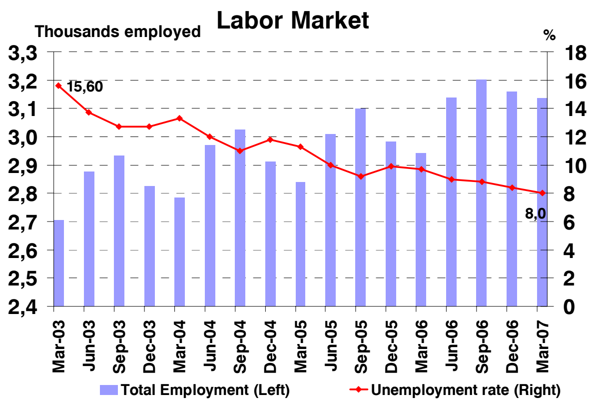
The Bulgarian economy accelerated at 6.2% yoy in Q1-2007 compared to 5.5% yoy in Q1-2006. Private consumption jumped to 7.0% yoy in Q1-2007, from 5% yoy in Q1-2006. Private retail sales increased grew by an equally strong real growth rate of 12.0% in Q1-2007 compared to 10.9% yoy in Q1-2006 fueled by acceleration in consumer credit and real wage growth. Moreover, investment activity reached historically high levels. Gross fixed capital formation doubled to 35.9% yoy in Q1-2007 from 17.1% yoy in Q1-2006. This is the strongest performance since 2001. Strong construction activity counterbalances the slight deceleration in the manufacturing activity. The slowdown in the manufacturing sector is evident from the industrial production data. Industrial Production slightly decelerated to 6.0% yoy in Q1-2007 compared to 7.2% yoy in Q1-2006. Industrial sales slightly decelerated to 7.2% yoy in Q1-2007 compared to 8.6% in Q1-2006. On the other hand, net exports had a negative contribution to the GDP growth rate by at least 8 percentage points in Q1-2007, as Imports growth by 13.2% yoy in constant prices outpaced a strong decelerated export growth of 2.2%. (Figure 1.1)

Figure 1.1



The average gross wage grew by 16.7% yoy in Q1-2007 (a real growth rate of 10.9%), compared to 10% in Q1-2006. The gap between the growth rates of wages in the private and the public sector has widened, a sign of increasing labor market tightening. Private sector wages soared by 20.1% in Q1-2007 compared to 7.1% yoy in Q1-2006. On the other hand, public sector wages increased by 13.1% yoy in Q1-2007 compared to 7.3% yoy in Q1-2006. In addition, unemployment dropped in April 2007 to 8.4% compared to 10.2% in April 2006. Total Employment-according to labor force surveys- has increased by 10.5% yoy in Q1-2007 compared to 5.6% yoy in Q1-2006. Furthermore, labor contract employment further accelerated to 3.4% in Q1-2007 compared to 0.8% yoy in Q1-2006. Skilled labor shortages have been more evident than before. The sectors that registered the biggest increases in employment were the construction sector (18.6% yoy), the financial sector (16.1% yoy) and the hotels and restaurants sector (15.40% yoy). Accordingly the wages in the construction (23.3% yoy) and the financial sector (17.6% yoy) registered some of biggest increases in Q1-2007. (Figure 1.2)

Figure 1.2



The budget performance has been very strong in the first four months of 2007. On the revenues side, despite one off collection delays in VAT revenues after European Union entry, total general government revenues increased by 17.6% yoy in Jan-April 2007 compared to 15.4% in Q1-2007. General government revenues now stand at 13.9% of GDP. Tax revenues recorded a healthy 17% growth rate yoy implying a strong boost for general government revenues. The fiscal performance is sufficient given the significant budget challenges in 2007. We need to take into account that the social contributions rate and income tax rate will be lower. Moreover, government spending will increase due to Bulgaria's contribution to EU budget. General government expenses were contained at 8.9% in Jan-April. Higher capital expenditure, posted a 36.9% yoy in Jan-April 2007, was the fastest expenditure component of general government.

Lower interest payments have improved the primary balance from 2.6% of GDP to 3.1%. Public debt has further dropped to 21% of GDP in April 2007 compared to 25.6% of GDP at the end of 2006. After the final review of a two-year IMF stand-by arrangement, the Bulgarian government agreed to revise its 2007 fiscal surplus target to 2.3% of GDP. The budget surplus has reached 2.4% of GDP in Jan-April compared to 1.8% of GDP at the same period last year. Nevertheless, we need to point out that this constitutes a fiscal relaxation from 2006's 3.6%.of GDP. (Figure 1.3)

Bulgaria's external position continues to deteriorate substantially. Gross external debt reached 74.5% of estimated 2007 GDP in Q1-2007 from 66.7% of GDP in Q1-2006. The rise was mainly driven by ongoing strong borrowing by the non-financial private sector, rising by a staggering 56.8% yoy in Q1-2007. The latest data show a current account deficit of €1.6bn in Q1-2007, up 37% yoy from the €1.1bn recorded in Q1-2006. This already represents 6% of forecasted 2007 GDP or according to our estimations 16.9% on an annualized basis compared to 14.1% of GDP in Q1-2006. The trade deficit reflects growing imports for investment goods and raw materials. High non-ferrous commodity metal prices and increased volume imports for raw materials had a significant impact on the trade balance.

As a result, the trade deficit has deteriorated by 41% yoy in Q1-2007 and is equivalent to 5.6% of the projected GDP. Imports increased by 16.6% yoy in Q1-2007 (down from 33% in Q1-2006) compared to a weak exports performance of 6.2% yoy in Q1-2007 (down from 28.4% yoy in Q1-2006). On the other hand, the impressive rebound in Exports in March leaves some room for optimism for the total exports performance over the year. Overall, the trade balance will continue to widen, as high commodity prices for imported raw

Figure 1.3

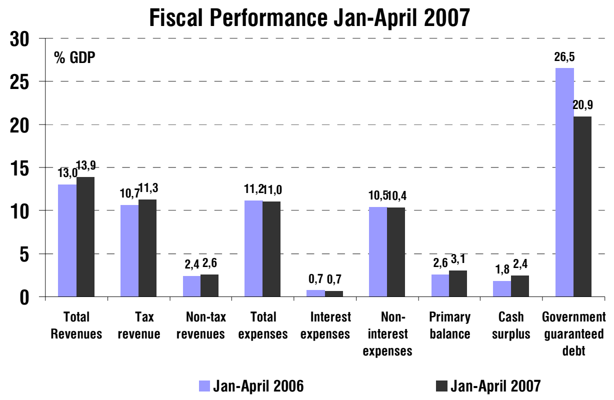
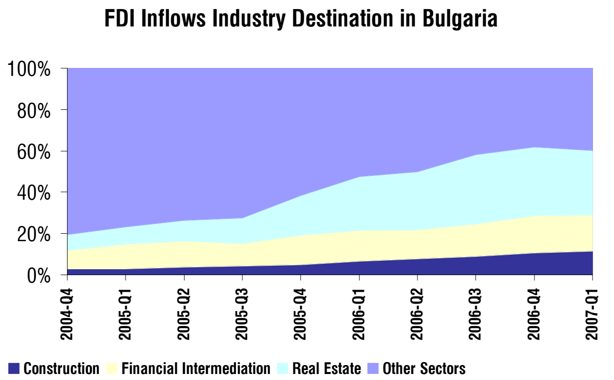


Figure 1.4



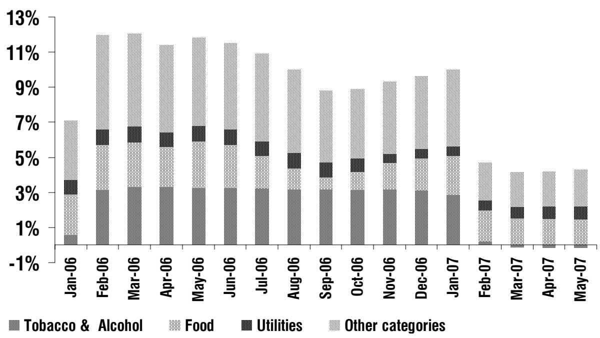
materials and minerals that support investments will contribute negatively. The outlook remains unfavourable and the risks for the current account are on the upside. We currently project that the current account deficit will be increased to about 17-18% of GDP, in line with the Ministry of Finance projection. We expect that the envisaged fiscal loosening, if materialized, as well as the increase in imported raw materials and investment goods for private investment will further deteriorate the trade deficit and will weigh negatively on the current account balance. (Figure 1.4)

On the other hand, foreign direct investments (FDI) continue to bolster strong capital inflows in the country. FDI in Bulgaria for Q1-2007 amounted to € 856 million (3.2% of GDP) against €789.6 million (3.1% of GDP) attracted in Q1-2006. This accounts for 16% of GDP on an annual basis. The Bulgarian niche industry sectors that attract non-privatization FDI inflows are the real estate and construction along with the financial services sector. This bodes well with the strong employment figures in these sectors.

Bulgaria fulfils all EMU criteria but one: Inflation. Inflation dynamics remain significantly above the line of the Euro adoption criterion. After a temporary hike to 7.2% in January, consumer prices edged up to 4.3% yoy in May against 4.2% in April. Cheaper imported foods from EU countries and increased competition in the local market contributed to the significant decline in the inflation, in March and April. In addition, the expected phasing out of the excise duties and taxes imposed the previous year contributed significantly to inflation slowdown. We are not optimistic about a significant deceleration in prices by year end. We expect an average inflation rate of 5%, just above the government prediction. That comes as a result of a couple of reasons: Draught on this year's harvest and potential hikes in the prices for public utilities will drive the headline inflation above the government prediction of 3.1% for the year end (or an equivalent of 4.5% for the year average). This is also corroborated by the Producer's prices which are exceeding the level of 8%. (Figure 1.5)

Figure 1.5

Consumer Prices Decomposition 2006-07



1.3 Banking Developments

- **Competition in the Bulgarian banking sector will further intensify due to the entry of EU-based credit institutions.**
- **Competition is also heating up due to the increasing activities of non-bank financial institutions.**
- **A major development in the Bulgarian banking sector is the rollback of the domestic lending restrictions from 1 January 2007.**
- **After the abolition of the restrictions, credit growth accelerated from 24% in 2006 to 37.8% yoy in March 2007. However, this acceleration is partly fictitious.**
- **Mortgage lending is the market segment with the highest potential, expanding by 74.8% yoy as of Q1 2007.**

EU accession had its first impact on the banking sector. According to Bulgarian National Bank (BNB), 42 notifications of EU-based credit institutions were received as of end-April. The latter expressed intention to enter the Bulgarian banking and financial services market under this EU 'passport' legislation. This development will further intensify competition among the 32 banks operating currently in Bulgaria. Foreign banks play a key role in the banking system possessing a market share of approximately 77% at end 2006. The competition is also heating up due to the increasing activities of the non-bank financial institutions. Leasing companies have emerged as the largest non-bank financial sector in Bulgaria. Namely, leasing companies' total assets accounted for 7.2% of the total banks' assets as of March 2007.

Another repercussion of Bulgaria's EU entry is the introduction of a new consolidated financial reporting framework, applicable to the EU credit institutions. The new framework supersedes the one used until December 2006. It is based on the International Accounting Standards/International Financial Reporting Standards (ISS/IFRS) adopted by the European Union. Hence, it should be noted here that the figures for 2007 are not fully compatible with those for 2006.

Credit Developments

A major development in the Bulgarian banking sector is the rollback from January 1st 2007 of the domestic lending restrictions. These administrative restrictions, in the form of additional minimum reserve requirements, were in effect from the second quarter of 2005 in order to tame surging credit expansion. It should be noted that the rapid credit expansion is often blamed for the country's widening current account deficit. A reason for the revocation of these measures could possibly be their ineffectiveness. Namely, banks in order to meet the excess demand for credit circumvented the restrictions by diverting credit into channels not regulated by BNB. These alternative funding sources are more difficult to regulate, increasing the risk for the entire economy. Moreover, this decision came on the back of the forthcoming entry of EU-based institutions in Bulgaria's banking sector. These restrictions would majorly disadvantage the local banks amid increasing banking competition.

After the abolition of BNB's administrative restrictions, credit growth accelerated from 24% in 2006 to 37.8% yoy as of Q1 2007. However, this acceleration is partly fictitious. According to BNB, surging credit growth reflects the repatriation of loans exported in the past to parent structures abroad so as to circumvent local lending restrictions. We expect that this trend will continue for the following quarters. Moreover, credit growth was boosted by the replacement of foreign corporate financing by domestic financing. Thus, the amount of total lending to the economic participants has not changed. What has changed, however, is the transfer of credit risk in the Bulgarian banking sector.

According to BNB, the growth rate of 20% remains the ceiling for sustainable credit expansion. However, we expect that the Central Bank will first examine the repercussions of the abolition of the restrictions before taking any further action to tame credit expansion.

Household credit remains the fastest growing segment of credit expansion, accelerating to 40% yoy as of Q1 2007 from 32% yoy one year earlier (Figure 1.6). Households' propensity to borrow was fuelled by households' improved financial conditions. These are reflected on the improving labor conditions – unemployment decreased to 8.4% as of April 2007 from 10.2% in April 2006 –, and on the increase in households' income levels – the average per capita income increased by 18.2% yoy in March 2007- (Figure 1.7). The mortgage market is the segment with the highest potential. Thus, housing loans soared by 74.8% yoy as of Q1 2007, up from 73.4% yoy one year earlier. Besides mortgages' market expansion, we note a pick up in real estate prices. Thus, the dwellings average market prices in levs/sq.m increased by 22.6% yoy as of March 2007. Despite mortgages' impressive expansion, consumer loans still dominate in households' loan portfolios. Namely, consumer loans still consist 56% of total household loans. This loan category has recorded a strong loan growth, expanding by 21.2% yoy as of Q1 2007 from 12% yoy one year earlier.

Corporate loans expanded briskly by 34.5% yoy as of Q1 2007

Figure 1.6

Credit Growth Rates

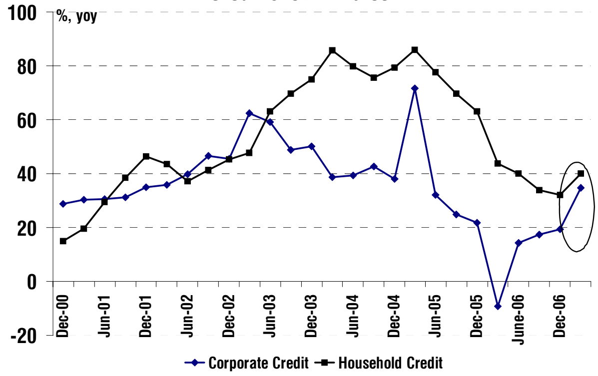
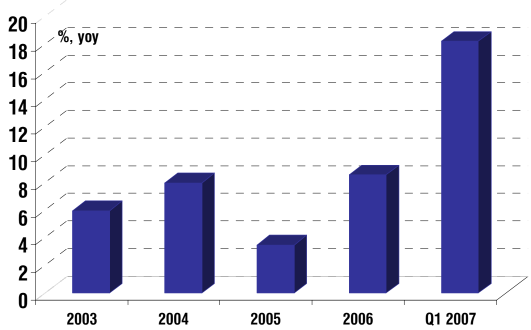


Figure 1.7

Growth Rate of Average per Capita Income



against 19.4% yoy in March 2006 (Figure 1.6). As aforementioned, business loan's acceleration is chiefly attributed to the repatriation of corporate credit and the replacement of foreign corporate financing by domestic financing. It should be also stressed out that the increasing competition among Bulgarian banks' in loans to firms has shifted their interest to the riskier and partly unexploited SME sector.

Despite the rescission of the domestic lending restrictions, lending through alternative credit channels continued expanding rapidly as of Q1 2007. Thus, the value of outstanding leasing contracts increased by 71.7% yoy at the end of March 2007, against 80.7% yoy at end 2006 (Figure 1.8). In addition, borrowing from abroad of local individuals and legal entities grew by 56.8% yoy as of Q1 2007, decreasing moderately from 64.6% yoy in 2006 (Figure 1.9).

Deposit Developments

Deposits of non-financial institutions and other clients continued expanding at a rapid pace reaching 37.9% yoy in March 2007 from 17.9% yoy one year earlier. Deposit developments are likely to have benefited from the positive macroeconomic outlook along with the improved households' financial conditions and the good corporate profitability. Deposits in domestic currency increased by 42% yoy as of Q1 2007 compared to 34.1% yoy growth of foreign denominated deposits (Figure 1.10).

Banking Sector's Profitability and Capital Adequacy

The Bulgarian banking sector enjoyed a healthy profitability in 2006, despite the increasing banking sector's competition and the domestic credit growth restrictions. Namely, according to BNB's data, profit improved by 37% in 2006 relative to the previous year. In addition, the sector's return on assets (ROA) rose to 2.15% in 2006 from 2.01% a year before. Return on equity (ROE) has also increased to 23.7% in 2006 against 21.6% in 2005. Interest income on corporate loans is the largest contributor to banking sector's income. In fact, interest on corporate loans contributed to its income by 37% in 2006. Despite the rapidly developing retail segment, interest income from retail loans contributed to banking sector's income to a lesser extent.

Capital adequacy remained at high levels during 2006 because of domestic lending restrictions. As a result, the capital adequacy ratio of the banking sector was 14.5% at end 2006 from 15.3% in 2005. However, we expect that the removal of the aforementioned measures will bend banking sector' capital adequacy. It should be stressed here that an important development was the introduction of

Figure 1.8

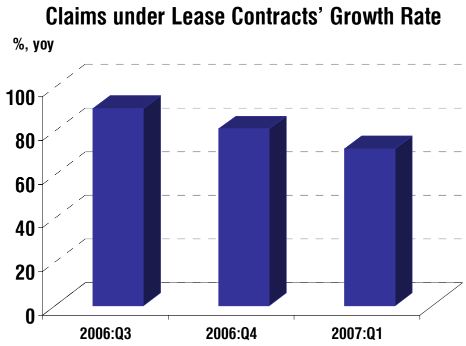


Figure 1.9

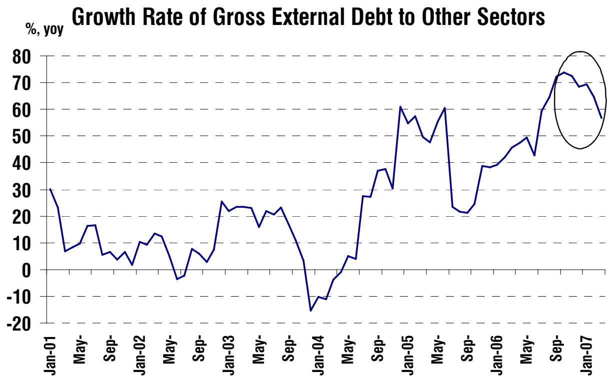
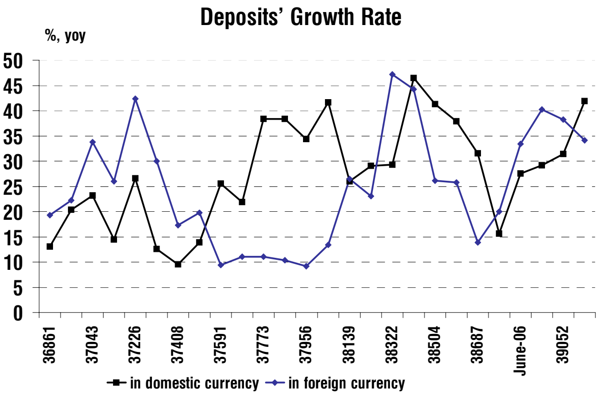


Figure 1.10



Basel II in the banking sector as of January 1st, 2007. According to a Basel Committee study, the implementation of Basel II will probably have a mild negative effect on capital ratios of the Bulgarian banks.

Bulgaria: MacroEconomic Indicators	2001	2002	2003	2004	2005	2006	Q1 2006	Q1 2007
Output and expenditure	*(Percentage Change in Real Terms)*							
GDP	4.0	4.8	4.5	5.6	5.5	6.1	5.6	-
Final Consumption	4.4	4.2	5.9	5.4	5.3	6.5	4.8	-
Gross fixed capital formation	19.9	9.3	13.9	12.0	19.0	17.6	21.4	-
Exports of goods and services	8.5	6.2	8.0	13.1	7.2	9.0	12.9	-
Imports of goods and services	13.0	4.7	15.3	14.1	14.6	15.2	20.0	-
Industrial production	2.5	4.7	14.1	17.1	6.7	5.9	7.2	6.0
Labour Market								
Employment (Labor Contract) % change	-0.2	1.6	6.8	5.1	2.7	0.8	0.8	3,4
Unemployment (in per cent of labor force)	19.8	17.8	13.7	12.0	10.1	9.0	9.7	8.0
Prices	*(Percentage Change)*							
Consumer prices (annual average)	7.4	5.9	2.3	6.1	5.0	7.3	8.0	5.2
Producer prices (annual average)	3.6	1.3	4.9	5.9	6.9	9.2	8.2	-
Average monthly wage in economy	6.9	7.3	6.1	7.0	9.3	11.0	9.9	16.9
Government sector	*(In per Cent of GDP)*							
General government balance (National Definition)	-0.6	-0.6	0.0	1.7	3.2	3.6	1.6	2.4
General government debt	69.9	55.9	48.2	40.7	31.9	24.7	26.7	20.9
Monetary and Financial Indicators	*(Percentage Change)*							
M3	25.8	11.7	19.6	23.1	23.9	26.9	10.1	28.2
Total Credit	37.2	45.5	55.4	47.3	33.1	23.9	4.1	37.8
	(End of Period)							
Base interest rate	4.48	3.96	2.68	2.61	2.04	2.69	2.25	3.49
Exchange rate BGN/USD	2.2	1.9	1.5	1.4	1.7	1.49	1.6	1.47
Exchange rate BGN/EUR	1.95	1.95	1.95	1.95	1.95	1.95	1.95	1.95
Real Effective Exhange Rate (Index)	126.8	131.4	140.1	141.9	141.8	149.3	146.8	150.8
International Position	*(In per Cent of GDP)*							
Current account balance	-5.6	-2.4	-5.5	-5.8	-11.3	-15.8	-13.9	-
Trade balance	-11.7	-11.4	-13.7	-15.1	-20.2	-21.5	-21.3	-
Foreign direct investment, net	6.1	6.0	10.4	11.8	10.9	16.4	12.4	-
External debt	78.6	65.0	60.1	64.2	70.4	78.4	66.2	-
Memorandum items	*(Denominations as Indicated)*							
Population (end-year, million)	7.89	7.85	7.80	7.76	7.76	-	-	-
GDP (in millions of leva)	29,618	32,402	34,628	38,823	42,797	40,091	-	-
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	2006	Q1 2006	Q1 2007
Percentage of GDP (%)								
Assets	41.1	45.0	50.1	65.1	78.3	86.0	79.1	–
Total Credit	14.0	18.7	27.1	36.1	43.8	46.4	43.3	–
Credit to Enterprises	11.1	14.9	20.9	26.1	29.0	29.6	28.3	–
Credit to Households	2.8	3.7	6.1	9.9	14.7	16.6	14.9	–
Deposits	32.2	34.9	39.3	51.0	60.6	56.1	60.4	–
Percentage Change (%, yoy)								
Assets	25.0	19.1	19.0	43.8	31.8	28.4	17.0	30.9
Total Credit	37.2	45.5	55.4	47.3	33.1	23.9	4.1	37.8
Credit to Enterprises	35.0	45.6	50.2	38.1	21.7	19.4	-9.3	34.6
Credit to Households	46.3	45.3	75.0	79.3	63.0	32.1	43.8	40.1
Deposits	34.3	18.1	20.5	43.7	30.1	34.8	12.0	37.9
Percent (%)								
Capital Adequacy Ratio	31.1	25.2	22.0	16.1	15.3	14.5	16.0	–
Capital to Assets	13.5	13.3	13.1	11.0	10.5	–	–	–
NPLs to Total Loans	3.4	2.6	3.2	2.0	2.2	2.2	–	–
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	2.0	2.2	2.6	–
Return on Equity	21.9	14.9	22.7	20.6	21.6	23.7	25.8	–

Sources: BNB, IMF

2. Romania

- **The GDP growth rate slowed down to 6.0% in Q1-2007, against 6.9% yoy in Q1-2006, due to stronger imports growth.**
- **Too many revisions in the targeted fiscal deficit create concerns. There is fiscal loosening, which is expected to become increasingly apparent as 2007 unfolds. Presently, the government aims to a revised general government deficit of 2.6% of GDP compared to an outcome of 1.9% of GDP in 2006.**
- **The current account deficit has been increasing at alarming levels. The current account deficit deteriorated to 11.9% in Q1-2007, from 10.3% of GDP in 2006 compared to the government projection was for a figure of 12% of GDP for 2007.**
- **In Q1-2007, net FDI inflows reached 1.3 bn. Euros, 27.7% yoy lower than in Q1-2006. This represents 43% coverage of the current account deficit in Q1-2007, a significant deterioration if it is compared to 124% in Q1-2006. Unrealized privatization plans will further deteriorate the current account coverage.**
- **Central Bank cut the interest rates aggressively by 25 bps to 7.0%, a total of 175 bps during 2007 in an attempt to curb speculative capital inflows appreciation pressures in the FX market.**

2.1 Overview

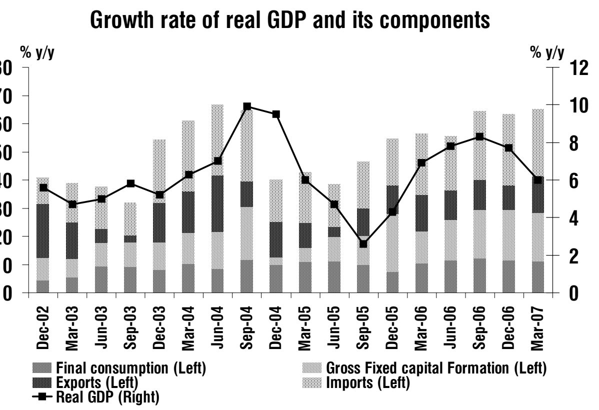
Romania followed the former Eastern European countries paradigm as once EU accession was endorsed. Local politics followed the introvert populist patterns. Hence, the longstanding vengeance between Prime Minister Tariceanu and President Basescu, surfaced after Romania's entry into the European Union. Nevertheless, the Prime Minister's attempt to force the resignation of the suspended President failed as the latter's impeachment was rejected in a referendum on May 19. The side effect of this collision was that the government coalition that secured Romania a position in the enlarged European Union collapsed. On the other hand, the minority government that came into office in early April is expected to make a series of compromises, if it is to survive until the end of 2008, when the next parliamentary elections will take place. The new minority government policies need to be monitored very closely. The current political environment is expected to have a negative effect on the reforms progress, and hamper the ability of Romania to absorb 32 billion Euros in EU programs and subsidies. Political instability has increased dramatically and by no means is this expected to end soon since three elections are going to take place by the end of 2008 (Elections for the European Parliament in October 2007, Local

Elections in Spring 2007, Parliamentary Elections at the end 2008).

On the economic front, Romania ended with an impressive growth rate at the expense of incurring further external imbalances. The real GDP growth rate accelerated to 7.7% in 2006 from 4.1% in 2005 because of strong consumer spending (12.6% in 2006 against 9.1% in 2005) and gross fixed capital investment figures (by 16.1% yoy in 2006 compared to 12.6% in 2005). In terms of external demand, real imports accelerated to 23% yoy in 2006 (compared to 16.6% yoy in 2005, whereas real exports grew by 10.6% in 2006 (against 8.1% yoy in 2005). (Figure 2.1)

On the other hand, strong domestic demand is stoked up by a pro-cyclical fiscal policy, and robust total credit growth. The latter coupled with continuous local currency appreciation (beyond forward market forecasts) pushed up the current account deficit to 11.9% in Q1-2007 against 10.3% of GDP in 2006. Due to the continuous RON appreciation trend in Q1-2007 we revised our forecast for the current account deficit to 12.5% compared to 10% of GDP in our previous issue. Inflation decelerated to 3.81% in May, on temporary reasons, that will push year-end inflation rate at 5% yoy, above the Central Bank target.

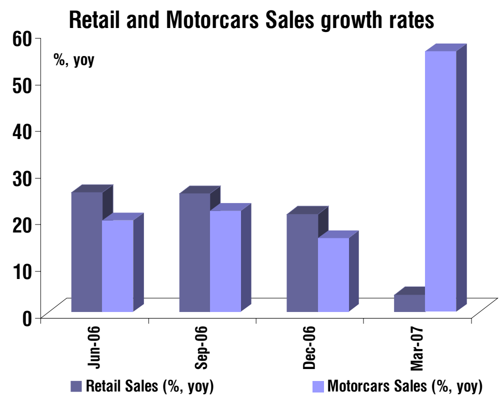
Figure 2.1



2.2 Current Economic Developments

The GDP growth rate slowed down to 6.0% in Q1-2007. This was substantially lower from the impressive growth rate of 7.7% recorded in Q4-2006, and 6.9% yoy in Q1-2006. Final consumption accelerated to 11.2% yoy in Q1-2007, compared to 10.5% yoy in Q1-2006. That came as a result of increased government and private consumption. Private consumption recorded a slight increase 11.3% yoy in Q1-2007 compared to 11.1% yoy in Q1-2006. The conjuctural data disclosed a deceleration in retail sales down to just 4.3% yoy in Q1-2007, compared to 25.4% yoy in Q1-2006. This was counterbalanced by the motorcars sales acceleration as Romania's EU membership rendered them less expensive as imports duties were abolished. Motorcar sales skyrocketed to 50% yoy in Q1-2007. (Figure 2.2)

Figure 2.2



The continued RON appreciation had an impact on the net external balance in Q1-2007. The negative net external demand contribution in the growth rate increased further to 7.1 pps compared to 6.5 pps for 2006. Exports growth rate remained roughly the same, whereas imports growth rate increased. Exports grew on 12.9% in Q1-2007 and imports accelerated to 23.8% yoy in Q1-2007 compared to

21.8% yoy in Q1-2006.

In addition, investment activity, the second pillar of strong domestic demand registered another impressive growth rate. Gross fixed capital formation accelerated to 17.2% yoy in Q1-2007 against 11.3% in Q1-2006. Similarly, industrial production grew 7.7% yoy and industrial sales surged by real 22.3% yoy in Q1-2007. Moreover, the construction activity soared to 33% yoy at the same time. Construction companies hired even more employees amid a building boom reinforced by Romania's EU entry. As a result, the unemployment rate fell to 4.5% in April from 4.9% in March, a 15-year low. Labor productivity has not kept up with wage increases. Labor productivity grew 13% yoy in Q1-2007 against real net wages growth by 18% yoy- the nominal wages growth rate is almost double, 22%.

Fiscal policy is increasingly under the microscope, for its impact on the economic policy mix. This is especially true now that the minority government is going to be challenged further by three consecutive elections. The government stance was already clearly expansionary as the general government fiscal deficit (ESA95) increased to 1.9% of GDP in 2006 from 1.4% in 2005. Fiscal targets were revised several times within the year, which reflects poor budget planning in investment expenditure. The government has adopted a much looser fiscal framework, which will further boost domestic demand and feed inflationary pressures. To that end, IMF has repeatedly recommended to the government adopts a restrictive fiscal policy. The impact of fiscal policy loosening is expected to become more apparent in 2007. The government now aims at a revised general government deficit of 2.6% of GDP according to the national methodology. The target was set initially at 2.8% of GDP in terms of national methodology, which was incompatible with the 3% Maastricht ceiling under ESA95. Additional government spending is directed towards infrastructure investment projects, aimed to make full use of EU transfers. Meanwhile, the general government debt (ESA95) at the end of 2006 was reduced to a record 12.4% of GDP from 15.8% the year before. (Figure 2.3)

As far as the execution of this years' budget is concerned, general government budget ended in April with a marginal surplus that amounted to 0.3% of GDP in Jan-April 2007. This is compared unfavorably to a surplus of 1% of GDP in Jan-April 2006 given that expenditures volume peaks at the end of the year. The general government budget revenues increased by 12.6% yoy in Jan-April, after strong revenues in April. This is a marked improvement from a modest 4% real growth in Q1-2007. Tax revenues increased by real 5.5% yoy (after registering a slump of 7.5% yoy in Q1-2007. Delayed

Figure 2.3

General Government Deficit (% of GDP, ESA 95)

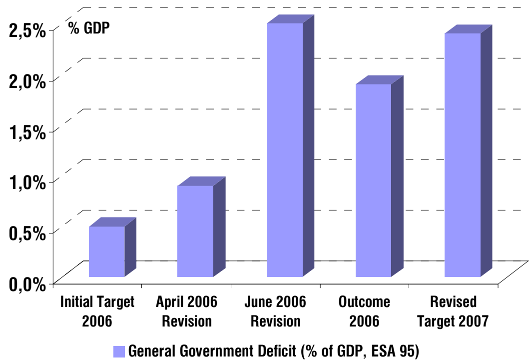
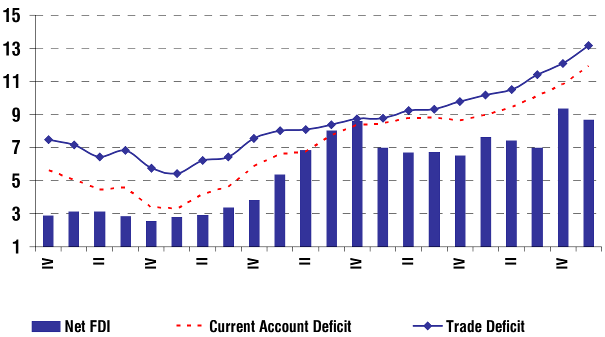


Figure 2.4

Balance of Payments in Romania (% of GDP)



VAT tax revenues for EU imports explain the one off drop in Q1-2007. This is likely to have a negative impact on the full-year revenues.

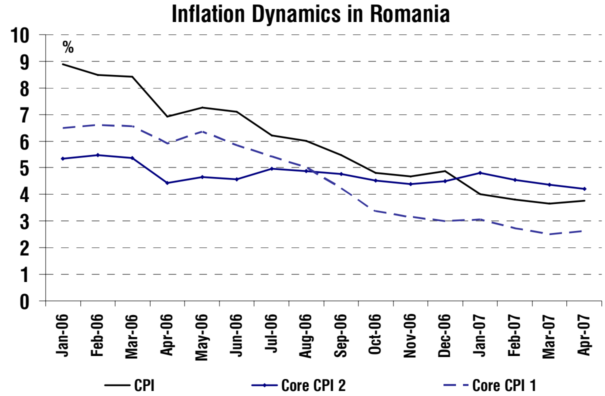
Most economic indicators in Romania reflect an expanding economy. However, the widening current account deficit is a concern. The current account deficit has been widening in alarming double-digit levels, a fact that has raised concerns over its sustainability in the long-term. The current account deficit widened further by 125% yoy to 3bn. This represents 11.9% of GDP in Q1-2007, from 10.3% in 2006 while the government projection was 12% of GDP for the whole year. (Figure 2.4) The main contributor to the increasing current account deficit in Q1-2007 is the trade deficit combined with minor income balance deterioration from profit repatriation (by 0.3 percentage points). The trade balance deteriorated from 9.8% of GDP in Q4-2005 to 12.1% of GDP in Q4-2006 and further to 13.1% of GDP in Q1-2007. Romania integration to European Union gave imports a new impetus as customs duties elimination resulted in cheaper imports. As a result, imports expanded by 30% in Q1-2007, compared to 25% in 2006. On the other hand, continued RON appreciation (cumulative 40% since 2004) started to have an impact, on exports. Exports growth rate decelerated to 14% yoy in Q1-2007, compared to a 16% yoy for 2006.

The structure of financing of the current account deficit changed in Q1-2007. The large current account deficit in 2006 was mainly covered by massive FDI inflows spurred by the country's EU accession and large-scale privatization. Net FDI inflows reached 9 bn Euros, a record high, and financed almost 90% of the current account deficit. In Q1-2007, net FDI inflows reached 1.3 bn. Euros, 27.7% yoy lower than in Q1-2006. This represents 43% coverage of the current account deficit, which the Central Bank considers sufficient. Nevertheless, the deterioration in Q1-2007 compared to Q1-2006, when the coverage was 124% needs to be stressed out. Additionally, the slowdown in FDI inflows is expected to become more visible in the coming months, due to the lack of large-scale privatization projects. In turn this means that current account financing will need to be relied on debt-creating mechanisms, subject to the investors' sentiment towards emerging markets.

The disinflation trend is sustained in the Q1-2007 as inflation continues to fluctuate around low levels. Headline inflation inched up slightly to 3.77% yoy in April from 3.66% in March and further to 3.81% in May just over the Central Bank inflation target but still the lowest level ever recorded in the post 90s period. This disinflation trend is guided by the sharp decline in the administered prices and the strong disinflation trend of volatile

Figure 2.5

Inflation Dynamics in Romania



prices. Administered prices dropped from 10.2% yoy in December 2006 to 7.3% yoy in April. The drop in the administered prices reflects the drop in the price of natural gas and the appreciation of RON. In addition, lower food prices (40% weight in the CPI basket) are driven by cheaper imported products, stronger competition in the retail trade sector and favorable base effects in food products (vegetables, sugar).

On the other hand, Q1-2007 marked one significant fact in inflation dynamics: The reversal of the trend between CPI and Core 2. Core 2 inflation now exceeds headline CPI. Core 2 inflation (CPI without administered and volatile prices) dropped to 4.2% yoy in April compared to 4.4% yoy in March. In addition, PPI inflation accelerated to 9.3% yoy in March from 8.8% yoy in February. As such, we maintain our skepticism that the year end inflation rate will adjust higher, as the RON appreciation is expected to slow down as well as robust wage growth is going to feed into inflation. Nevertheless this didn't prevent Central Bank from cutting interest rate by 25 bps to 7.0%, a total of 175 bps during 2007 in an attempt to curb speculative capital inflows appreciation pressures in the FX market. (Figure 2.5)

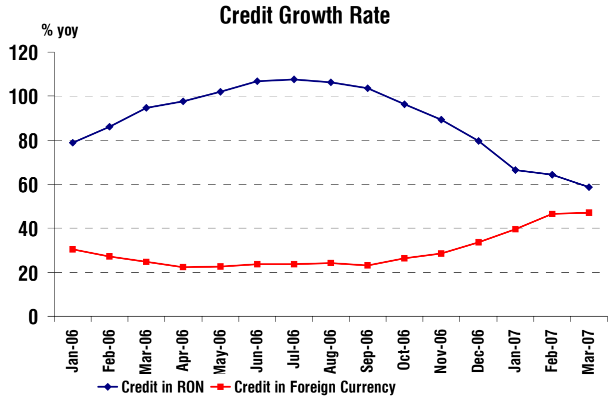
2.3 Banking Developments

- **Romania's banking sector is opening to EU-based banks. Already 51 banks have registered to operate in Romania. Thus, competition is heating up, bringing further consolidation to the banking sector.**
- **CEC's privatization is not prioritized for 2007, according to the Minister of Economy and Finance.**
- **Credit is thriving by 56% yoy as of Q1 2007, with households' lending remaining the fastest growing segment of credit expansion.**
- **The new NBR regulations regarding consumer and mortgage lending are expected to favor high income customers.**
- **Household deposits mark a significant expansion, stimulated by households' improved financial condition.**

Similar to Bulgaria, a main repercussion of Romania's EU entry is that the EU-registered banks, that submit notifications to the Central Bank, may provide services within Romania on a cross-border basis. The EU-based banks are now able to operate there without having to open a subsidiary. Officials of the National Bank of Romania expect that a series of foreign banks will start offering services to the Romanian market by autumn. Up to now, 51 banks have registered in Romania from only 7 in February. This development takes place amid increasing competition in the banking sector. 38 banks operate now in Romania. Foreign banks own 88.6% of total assets. The fight for market share that is already taking place between credit institutions is bound to intensify further due to Romania's banking market opening to EU-based banks. Hence, we expect that increased competition will lead to further consolidation in the banking system.

The privatization of CEC remains on the foreground. CEC is the largest state-owned bank in Romania with a market share of 4.1%. The government withdrew its offer to privatize CEC in 2006. The reason was that the offers for the share package available for sale by the state were too low. However, according to the Minister of Economy and Finance, the privatization of CEC is not a concern for 2007. On the contrary, a three- stage strategy will be followed. The strategy aims at reshaping and modernizing the institution.

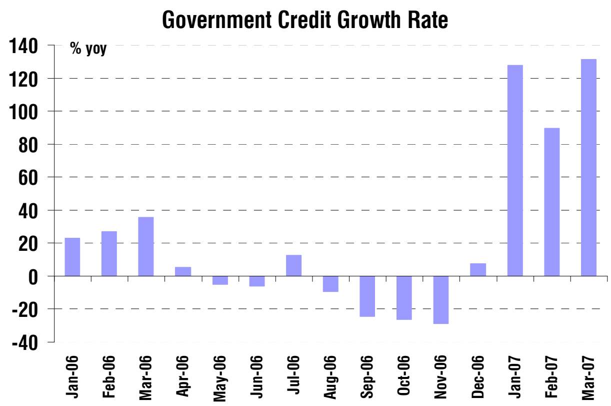
Figure 2.6



Credit Developments

The Romanian banking sector is witnessing strong credit expansion, with credit growth rates hovering at high levels. Non-government credit grew by 56% yoy as of Q1 2007, against 51% yoy one year earlier. Credit expansion was bolstered by robust economic growth, banks' strong competition and by the 125 bps interest rate cut within Q1 2007. The policy rate was further cut by 50 bps until May - June. Monetary policy easing is expected to give a further boost to credit activity. Credit in RON shrunk to 58.5% yoy as of Q1 2007 against 94.7% yoy one year earlier, losing ground against FX-loans. On the opposite, FX-denominated loans accelerated to 47% yoy as of Q1 2007 from 25% yoy as of Q1 2005. This shift toward foreign currency can be attributed to the continuous RON- appreciation, the higher minimum reserve requirements for RON-denominated liabilities as well as to the repeal of limits imposed on credit institutions for exposures to FX-denominated loans (Figure 2.6). This is a major vulnerability for the banking sector, in case the RON follows the opposite trajectory.

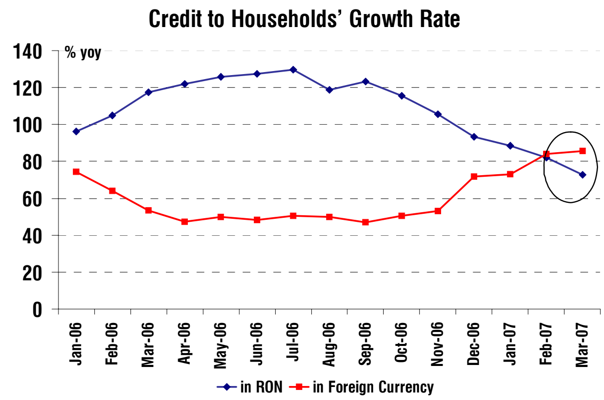
Figure 2.7



On the other hand, government credit growth recorded a trend reversal. Having turned negative, government credit growth reached its lowest point (-28.8% yoy) in November 2006. However, as of Q1 2007, it grew by the impressive 131.5% yoy (Figure 2.7). This reversal can be attributed to the surge in budget outlays, financed through government securities issues and bank loans.

Credit to households remains the fastest growing segment of credit expansion. Credit to households surged by 78% yoy as of Q1 2007, below the higher 83.8% yoy at end-2006. Household propensity to borrow was fuelled by households' improving financial conditions, the fast convergence of interest rates to the EU level and the still low credit penetration in the segment. Household credit was mainly triggered by its FX-denominated component, which grew in February higher than the Ron-denominated household credit (Figure 2.8).

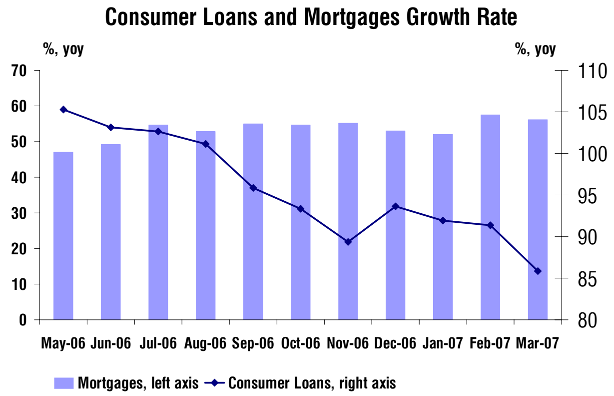
Figure 2.8



Consumer loans remain the growth engine of banking assets. They grew by 85.8% yoy as of Q1 2007 from 94% yoy at-end 2006. Mortgages' growth rate accelerated to 56% yoy in March 2007 from 53% yoy in 2006. The upward trend of housing credit is boosted by households' increasing demand for housing. It is also reflected on the surging construction activity. Namely, construction expanded by 28.6% yoy in February. The residential segment of construction was the main driver for its growth, expanding by 35.5% yoy (Figure 2.9).

Mortgage lending will be affected by the new NBR regulations. According to the latter, banks are allowed to set monthly payments above the 30%-40% of disposable income ceilings set so far and to eliminate the 25%-30% obligatory down payment. In addition, banks are asked to set up their own regulations in line with NBR's criteria. For instance, in order to establish the customer's capacity for indebtedness, NBR has asked the banks to calculate a basic goods basket. This will be then eliminated from the customer's income. Before coming into force, these regulations should be ratified by the Central Bank. Their impact is expected to be mixed as they appear to favor high income customers but not the low income ones.

Figure 2.9



Corporate loans expanded by 44.4% yoy as of Q1 2007, against 33.9% yoy a year earlier. The slower dynamics of corporate loans in the banking sector compared to other market segments can be explained by the repayment of old loans and the non-renewal of some credit lines. Another explanation is mirrored on the external debt developments. The private external debt, corresponding mainly to private enterprises, grew by 34.5% yoy as of Q1 2007. This indicates that private enterprises are also borrowing from abroad. The gradual saturation of credit penetration in the corporate segment along with the increasing banks' competition has turned them to new market segments, such as the financing of SMEs, municipalities and the agricultural sector.

Deposit Developments

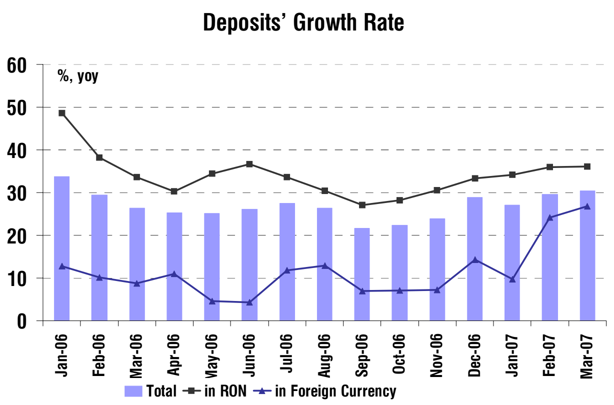
Deposits continued accelerating, expanding by 30.4% yoy as of Q1 2007, up from 26.4% yoy as of Q1 2006. Deposits in RON have recorded higher growth rates than FX-denominated deposits because of RON-appreciation. Namely, deposits in RON expanded by 36.2% yoy as of Q1 2007 instead of 26.8% yoy for deposits in foreign currency (Figure 2.10).

Household deposits mark a significant expansion, growing by 44.9% yoy as of Q1 2007 instead of 18.3% yoy in Q1-2006. Households' propensity for saving was stimulated by their improved financial condition reflected both on lower unemployment and on higher wages. The latter recorded a real growth rate of 18% yoy as of Q1 2007 against 15% yoy as of Q1 2006. Despite RON appreciation, household deposits in foreign currency grew rapidly. Namely, deposits in foreign currency grew by 43% yoy as of Q1 2007 instead of 20% yoy one year earlier. This could be attributed to the high inflow of remittances of Romanians working abroad.

On the contrary, corporate deposits decelerated significantly. Thus, corporate deposits' growth rate slashed down to 17.2% yoy as of Q1 2007, from 34.5% yoy as of Q1 2006. The flipside of the coin is enterprises' surging investment activity. This is reflected on economy's gross fixed capital formation, which accelerated to 17.2% yoy as of Q1 2007 compared to the lower 11.3% yoy one year earlier.

According to data provided by NBR, the banking system is fed by a substantial amount of deposits from non-residents. Thus, foreigners have deposited to domestic banks sums equivalent to 1.6 billion euros as of Q1 2006. These deposits, included in Romania's medium and long-term debt, have recorded an impressive growth of 92.6% yoy as of Q1 2006. Foreigners' propensity to save in the Romanian banking system could be explained by the significant positive deposit real interest rates differentials between the domestic and the Eurozone market.

Figure 2.10



Romania: Macroeconomic Indicators	2001	2002	2003	2004	2005	2006	Q1 2006	Q1 2007
Output and expenditure	*(Percentage Change in Real Terms)*							
GDP	5.7	5.1	5.2	8.4	4.1	7.7	6.9	6.0
Private consumption	6.9	5.3	8.5	14.1	9.7	12.6	10.9	-
Public consumption	3.6	3.0	7.5	5.0	4.5	2.7	4.3	-
Gross fixed capital formation	10.1	8.2	8.6	10.8	13.0	16.1	11.4	-
Exports of goods and services	12.9	15.3	6.4	21.3	17.5	10.6	22.0	-
Imports of goods and services	22.1	8.6	12.3	24.0	23.9	23.0	28.6	-
Industrial production (cumulative)	8.2	6.0	3.1	5.3	2.0	7.1	4.5	-
Labour Market								
Employment (% change)	1.4	-2.8	0.1	1.0	2.6	1.3	1.6	2.3
Unemployment (in per cent of labor force)	8.8	8.4	7.4	6.3	5.9	5.4	6.2	5.2
Prices	*(Percentage Change)*							
Consumer prices (annual average)	34.5	22.5	15.3	11.9	9.1	6.6	8.6	3.8
Producer prices (annual average)	42.0	24.8	19.7	18.6	12.5	-	11.6	-
Average monthly wage in economy	40.9	26.8	25.4	22.5	23.7	16.7	15.0	18.6
Government sector	*(In per Cent of GDP)*							
General government balance (National Definition)	-3.2	-2.6	-2.2	-1.2	-0.8	-1.7	0.6	-0.1
General government debt	23.2	25.0	21.5	18.8	15.9	12.8	-	-
Monetary and Financial Indicators	*(Percentage Change)*							
M2	46.2	38.2	23.3	39.9	33.9	28.0	28.8	29.2
Total Credit	46.4	42.4	49.2	32.5	43.7	52.0	51.1	56.0
	(End of Period)							
Reference rate	35.0	20.4	18.9	20.2	9.7	8.5	8.5	8.5
Exchange rate RON/USD (end-period)	3.16	3.35	3.26	2.91	3.11	2.57	2.91	2.50
Exchange rate RON/EUR (end-period)	2.79	3.49	4.11	3.97	3.68	3.38	3.52	3.35
Real Effective Exhange Rate (Index)	101.5	102.3	99.1	101.6	119.9	132.2	126.1	-
International Position	*(In per Cent of GDP)*							
Current account balance	-4.9	-2.8	-3.8	-6.0	-8.7	-10.3	-9.1	-11.9
Trade balance	-7.4	-5.7	-7.5	-8.8	-9.8	-13.1	-10.6	-13.1
Foreign direct investment, net	2.5	2.1	2.4	6.1	6.5	9.4	8.0	8.7
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	288.0	342.4	-	-
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	2006	Q1 2006	Q1 2007
Percentage of GDP (%)								
Assets	30.2	31.6	31.3	37.1	45.4	51.2	45.5	53.0
Total Credit	13.4	14.7	16.8	17.9	22.0	28.0	22.8	30.2
Credit to Enterprises	9.2	9.9	10.6	10.9	12.4	14.6	12.3	15.1
Credit to Households	0.7	1.4	3.8	4.8	7.4	11.5	8.2	12.4
Deposits	20.1	21.7	20.4	23.1	26.1	28.2	25.6	28.3
Percentage Change (%, yoy)								
Assets	51.3	35.8	29.1	48.0	42.5	34.7	35.4	37.1
Total Credit	46.4	42.4	49.2	32.5	43.7	52.0	51.1	56.1
Credit to Enterprises	26.1	40.1	39.5	29.2	32.1	43.0	33.9	44.4
Credit to Households	87.6	161.5	258.9	58.3	80.0	83.8	101.5	78.1
Deposits	47.4	39.7	22.7	41.5	31.5	28.9	26.4	30.4
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	8.9	9.2	–	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	45.6	45.6	–	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	23.7	17.3	–	15.0	–

Sources: NBR, IMF

*: 11/06

3. Serbia

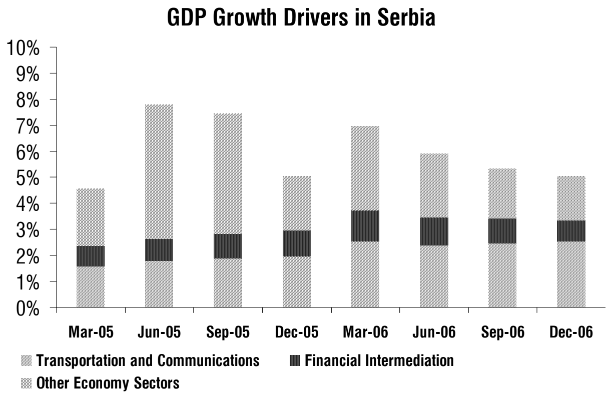
- **New Serbian government in place spurs optimism that reforms will accelerate. The European Commission resumed negotiations for a Stabilization and Association agreement (SAA) with Serbia.**
- **GDP growth increased by 6.8% in Q1-2007, in accordance with preliminary estimates, unchanged from Q1-2006, on the back of strong real household demand growth of 11.2% yoy.**
- **Strong expansionary fiscal policy, driven by a strong rise in public sector wages and social transfers-up by 18% yoy in Q1-2007. As a result, fiscal deficit reached 0.5% in Q1-2007 compared to the balanced budget of Q1-2006. The official deficit statistics are disputed, however, as they include non-recurrent privatization receipts (6.8% of GDP in 2006) in the regular government revenue flows.**
- **Current account deficit surged by 85% yoy in Q1-2007, reaching 12.9% of GDP. Net FDI flows cover 115% of the current account deficit.**
- **Retail prices increased by 4.2% yoy in May 2007 compared to the 6.6% at the end of 2006 due to the real local currency appreciation trend initiated in 2006, below the year-end Central Bank projection of 6%.**

3.1 Overview

After a prolonged post-election period of negotiations between the pro-Western parties that brought Serbia on the brink of elections again, Serbia has a new government in place. Nevertheless, it has yet to proven if it is going to be a long-term one. The new government faces a number of challenges, the most imminent one concerns the pending Kosovo issue. Any stop in the process of independence recognition could only come from the diplomatic front with a Russian veto in the UN Security Council. For the time being, any process has been postponed until the end of this year. On the other hand, the pragmatic challenge for Serbia is that the government needs to push for a reformist agenda that will focus on accelerating growth and set the country on EU accession track. The first indications are positive. The European Commission resumed negotiations with the new Serbian government on a Stabilization and Association Agreement (SAA). This was based on concrete action by the Serbian government wanting to match the commitment undertaken in order to achieve full co-operation with the ICTY.

Despite the high levels of unemployment, strong expansionary fiscal policy, both before elections in January 2007 and after elections, resulted in net wage acceleration. In turn, this had a significant pro-cyclical boost on the economy. Serbian economy expanded at 5.7% in 2006 against 6.2% in 2005. Dinar appreciation in the second half of 2006 led inflation to decelerate significantly to 6.6%. The disinflation trend continued. Even though, Central Bank has further reduced its key policy rate to 10%, a total of 400 basis points in 2007, monetary policy remains tight. Consequently, this keeps real interest rates high. Serbia attracted further FDI in the first three months of 2007, despite geopolitical concerns and political turmoil. Credit expansion slashed down to 16.8% yoy in 2006 against 52.1% yoy in 2005 as a result of the restrictive measures by the Central Bank. Nevertheless, corporations resorted to external borrowing, so that corporate sector's gross external debt, recorded an impressive growth of 61.4% yoy at end-2006. However, despite real effective exchange rate appreciation, robust exports growth leads to further Serbian economy integration in the world trade. We maintain our forecast for a real GDP growth of 5.5% for 2007, to be revised upwards, if reforms gain momentum and large privatization projects are completed.

Figure 3.1

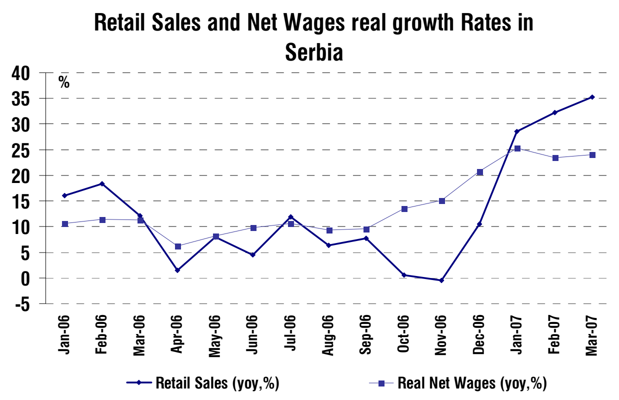


3.2 Current Economic Developments:

The Serbian economy is on a path of real GDP growth inertia and a trajectory of strong disinflation. Further revisions of the GDP growth data, revealed that the GDP growth rate slowed down to 5.0% yoy in Q4-2006 compared to 5.3% yoy in Q3-2006. From the supply side, the main driver was transportation (2.6 pps contribution), financial intermediation (0.8 pps points) and manufacturing (0.5 pps points). (Figure 3.1)

The preliminary data point to a GDP growth rate of 6.8% yoy in Q1-2007, on the back of strong household consumption. Household consumption accelerated driven by the net wage increases. According to the Central Bank estimates, household consumption in real terms rallied to 11.7% yoy in Q1-2007, compared to 11.1% yoy in Q4-2006. Net wages accelerated further in Q1-2007, by 30.2% compared to 24.7% in Q4-2006. The decline in inflation and the personal income tax cut increased net real wages by 24.3% in Q1-2007 from 11.1% in Q1-2006, against 16.5% in Q4-2006. Steep wage hikes were passed on to household consumption in Q1-2007, as this is evidenced from the strong performance of retail sales. The retail sales growth continued in March. The retail sales volume growth rate (adjusting for inflation) picked up to 35.2% y/y in March from 32.2% y/y in February. This increase represents the fourth consecutive acceleration after retail sales recorded a slight decline y/y in November. (Figure 3.2)

Figure 3.2



Wage hikes were not accommodated by equal weight increases in productivity. Unit labor costs in the industrial sector rose further by 5.4% yoy in Q1-2007 compared to 2.2% yoy in Q4-2006 yoy.

Average net public sector wages increased substantially in Q1-2007 by 31.5% yoy in Q1-2007 compared to 25.4% yoy in Q4-2006. The equivalent public sector real wages yoy growth equaled 25.5% yoy in Q1-2007 compared to 17.2% yoy in Q4-2006. As a result, the public sector wage bill grew by 28.8% yoy in Q1-2007 compared to 21.1% in Q4-2006.

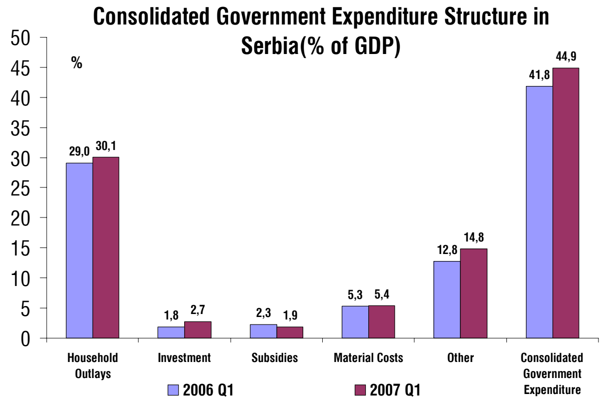
In addition, industrial production rose by 4.8% yoy in Q1-2007 compared to 2.5% yoy in Q1-2006 driven by strong manufacturing production growth. Ongoing industry restructuring combined with a robust manufacturing products exports growth rate, drove manufacturing production growth by 8.5% yoy in Q1-2007, compared to only 5.3% for 2006. The construction value works recorded a 50.2% yoy increase in Q1-2007, compared to 45% yoy in Q1-2006.

The main focus of attention should be the fiscal policy slippage in Q4-2006, which continued after the elections throughout Q1-2007. During the transition period from the pre-election period and until the new government formation, strong privatization revenues left enough room for the outgoing government, to undertake additional government expenditures geared to households. Outlays to households (including wages, social transfers) increased by 31% yoy in Q4-2006 and a further 18% yoy in Q1-2007. In addition, investment expenditures increased by 68% in Q1-2007 an equivalent of almost 1 pp of GDP. According to the Ministry of Finance, consolidated fiscal surplus reached 2.3% of GDP in Q1-2007. However, if non-recurrent privatization revenues are not included, according to IMF methodology, the consolidated fiscal result becomes a deficit of 0.5% of GDP. This follows the consolidated fiscal deficit jump to 4.7% of GDP in 2006 from 3.2% of GDP in 2005. Serbia has been running on a provisional and politically questionable budget for the 1H-2007.

The new 2007 budget calls for a budget deficit of 0.6% of GDP compared to a surplus of 1.4% of GDP (national methodology). Total expenditures, including those of the National Investment Plan, are planned to surge by 27% yoy. In our view the budget is overly expansionary and will augment the fiscal impact on the economy, on account of the implied inflationary repercussions. In addition, the full implementation of the National Investment Program is not feasible given the time and the planning constraints posed. As a result, we would expect that the realized fiscal outcome to be more balanced than the target announced. (Figure 3.3)

On the other hand, monetary policy has been tight enough to compensate for the loose fiscal policy. NBS cut interest rates

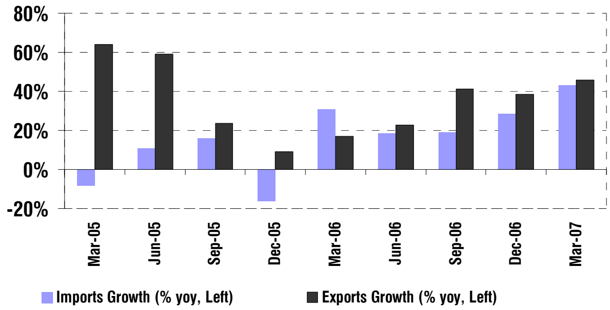
Figure 3.3



rates aggressively by 400 basis points to 10% during 2006, an amount equal as in 2005. Nevertheless, inflation has been decelerating more aggressively. Retail prices decelerated further in May to 4.2% compared to 6.6% in December. Core inflation, the measure targeted by the Central Bank, reached 3.0% in May against 5.9% in December, below the broader target of 4-8% for 2007. The accumulated real currency appreciation effect of the Dinar from the second half of 2006 has outweighed the inflationary pressures from domestic demand. The appreciation trend though reversed in Q1-2007. The Dinar depreciated by 2.3% yoy in Q1-2007 against the Euro. Import prices rebounded by 4.3%, above core inflation. Consequently, we would expect this to result in consumer prices averaging 5.5% yoy in 2007 against our projection of 7.5% yoy as stated in the previous issue, still within the NBS target range.

Figure 3.4

Exports & Imports Growth

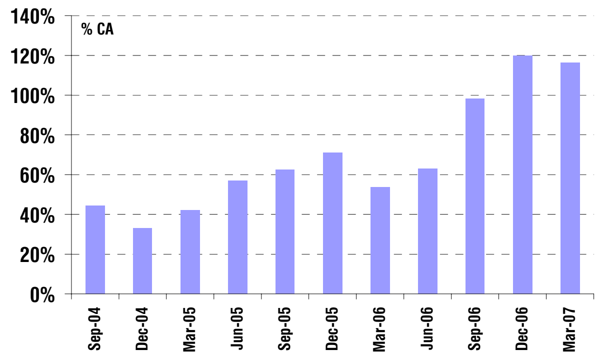


The current-account deficit accelerated further to an estimated 12.9% of GDP in Q1-2007 compared to 11.7% of GDP in 2006, and 8% in 2005. This deterioration is to an extent due to lower current transfers reflecting foreign companies' profit repatriation rather than a trade deficit deterioration. The current transfers went down from 8.8% of GDP in 2006 to 7.8% in Q1-2007. The trade deficit increased from 19.6% of GDP in 2006 to 20.0% of GDP in Q1-2007. The continuing upward trend in exports growth surpassed imports growth. Exports accelerated to 45.7% yoy in Q1-2007, against 31% yoy in 2006, benefiting from the EU growth speedup. On the other hand, imports soared by 43.7% yoy, compared to a 24% yoy total in 2006. As a result, Serbia's trade openness has reached 81.5% of GDP in Q1-2007, against 57% in 2002. So far, real wage acceleration has not translated into a shift to consumer oriented imports, as consumer goods represent 21% of total imports. (Figure 3.4)

On the financing side, the current account deficit financing has never been more comfortably dealt with. Net FDI inflows reached 4.3 bn. USD in 2006, a record high. This represents 120% coverage of the current account deficit. Almost half of those capital inflows (47%) were directed into the financial and telecommunications sectors. Foreign Exchange reserves doubled reaching 12.6 bn USD in 2006. Net FDI inflows have further accelerated 3.4 times to in Q1-2007 to 0.8 bn. USD, representing 14.9% of GDP on an annual basis. However, political will is needed on the behalf of the newly sworn in government to promote privatizations since large projects (NIS, DDOR) are behind schedule and need to be completed. If those are completed, net FDI inflows could be expected to reach approximately 3.5 bn. USD in 2007. In addition, high real interest rates prevailing in the domestic market coupled with the good stock market good performance has started to attract portfolio investments. Portfolio investments reached 350 ml. USD in Q1-2007

Figure 3.5

Net FDI flows (% CA deficit)



against only 6 ml in Q1-2006. (Figure 3.5)

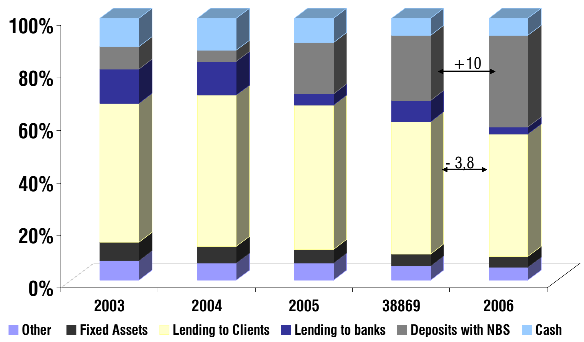
3.3 Banking Developments

- **NBS has adopted restrictive measures intended to tame credit expansion...**
- **... which resulted in a remarkable slowdown of credit expansion and in direct foreign borrowing by the private corporate sector.**
- **However, credit activity rebounded in March 2007 with total credit expanding by 20.8% yoy.**
- **Household Dinar savings, rapid acceleration sends out a positive signal for the stability of the financial system.**
- **Bank income statements were positive at end of 2006 for the second year in a row.**

Serbia's banking sector's balance sheet expanded by 50.8% yoy in 2006, indicating that the sector is growing at a fast pace due to capital increases. The latter were induced by the restrictive monetary policy followed by the National Bank of Serbia (NBS) in order to address the risk of overheating demand overheating. The main objective for banks was to increase capital so that they meet the new lending regulations set by the central bank. These capital increases are reflected in the rise of the share of banks' deposits with NBS. Deposits consist 35% of total assets at end 2006 from 19.5% in 2005. Only in the H2 2006, the share of deposits with NBS increased by 10.2 percentage points. On the other hand, loans to clients as a percentage of banks' assets decreased from 55% in 2005 to 50.4% in H1 2006 and further down to 46.6% at end 2006 (Figure 3.6).

Figure 3.6

Banking Sector's Assets Structure



Credit Developments

The restrictive policies adopted by the NBS resulted in a strong deceleration of credit expansion. Total credit grew by only 16.8% yoy in 2006 and decelerated even more during the first months of 2007 (14.2% yoy in January and 14.1% yoy in February 2007). Credit slowdown was more pronounced in credit to private enterprises, which grew by 3.5% yoy at the end of 2006 and by only 0.8% and 0.9% yoy in the first two months of 2007. Apart from the restrictive measures taken by the NBS, the Dinar appreciation was also partly responsible for the slowdown since the majority of approved credit was foreign-currency indexed. However, as we have also highlighted in previous issues, enterprises resort to direct borrowing from abroad, which is granted on more favorable terms. This is reflected on corporate sector's gross external debt, which recorded the impressive growth of 61.4% yoy at end-2006. This growth rate is almost double the rate recorded one year ago. Corporate sector's gross external debt continued growing at a rapid pace during the first months of 2007, expanding by 10.5% during the period January-March 2007 (Figure 3.7).

According to the NBS, business lending's plunge in record lows and its replacement by more attractive direct foreign borrowing entails the danger of banks' resorting to retail operations only. The NBS had, therefore, to apply a stiff measure on bridling bank lending to households. Thus, a restriction was placed prescribing that the ratio of household credit to capital should not be greater than 2:1[1]. Household credit expansion moderated, but still continued recording remarkable growth rates. Thus, household lending witnessed triple-digit growth rates during H1 2006. However, the latter grew by the lower 53% and 52% yoy in the first two months of 2007 respectively. Consumer credit, consisting of 76% of household credit, grew by 46.5% yoy at the end of 2006, down from 107% one year earlier. On the other hand, mortgages recorded a strong expansion, growing by 102% yoy in 2006 instead of 218% yoy one year earlier (Figure 3.8).

However, credit activity rebounded in March 2007, reversing the downward 9-month trend driven by the restrictive NBS policies. Thus, total loans expanded by 20.8% yoy as of Q1 2007 and loans to the private corporate sector grew by 8.9% yoy in March 2007 compared to the flat credit growth observed during the first two months of 2007. Credit to households increased by 54% yoy (Q1 2007) (Figure 3.9). The key reason for this reversal was the base effect from the steep decline of credit growth recorded in Q1 2006 (total credit declined by 0.9% m-o-m and credit to enterprises declined by 2.8% m-o-m one year earlier). Credit growth recovery in March 2007 was also supported by the monetary policy easing, including measures that reduced the reserve requirement ratio introduced at the end of 2006 and, principally, the sharp interest rate cuts realized during Q1 2007. It is worth noting that the key policy rate was reduced from 14% in January 2007 to 10.5% in March 2007, a total of 250 basis points in March only. The key policy rate cuts were rolled over in the weighted average lending rates, which were reduced by 2.82 percentage points, from 15.77 in February to 12.95 in March 2007.

Deposit Developments

Total deposits recorded a strong growth of 45% yoy as of Q1 2007, instead of 40% yoy one year earlier. Household deposits present a rapid growth of 43% yoy as of Q1 2007 instead of 39% yoy at end 2006. This acceleration can be well attributed to real wages rapid

Figure 3.7

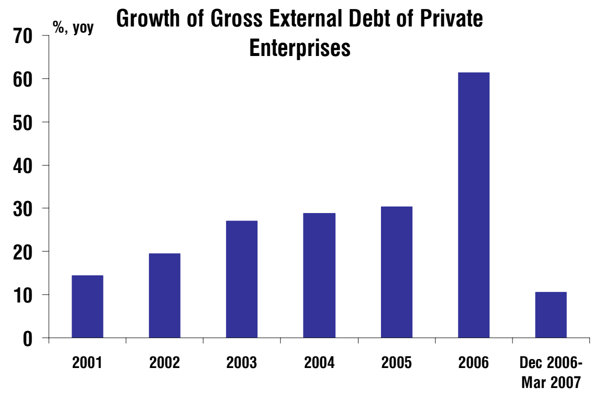


Figure 3.8

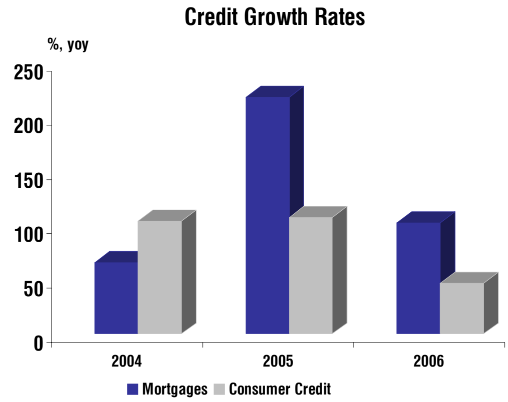
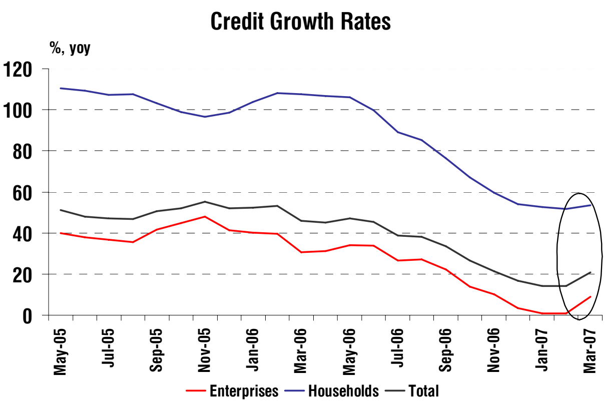


Figure 3.9

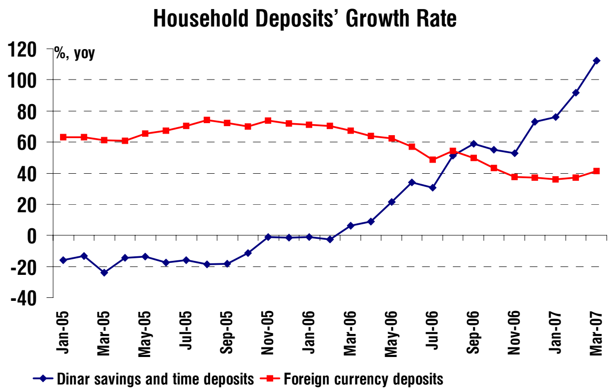


[1] This justifies the aforementioned capital increases observed in banks' balance sheets during 2006.

growth. Thus, as aforementioned, real wages grew by 24.3% yoy as of Q1 2007 instead of 11.1% yoy as of Q1 2006.

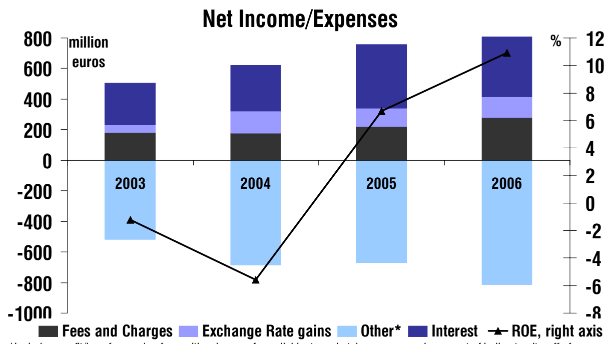
A factor limiting banking system stability and a source of FX-risk is the very low level of household Dinar savings, which consist of about 2% of total household savings deposited in banks. However, household Dinar savings have strongly recovered from the negative growth rates recorded during 2005, favored by a sharp Dinar appreciation. Thus, household Dinar savings grew remarkably by 112.5% yoy as of Q1 2007, from 73.1% yoy in 2006 and from 6.3% yoy one year earlier. On the other hand, household savings in foreign currency slightly moderated, growing by 41.2% yoy in March 2007 instead of 67.3% yoy in March 2006. They still consist the majority –approximately 90%- of households' deposits (Figure 3.10).

Figure 3.10



Deposits of the private corporate sector grew rapidly during the first months of 2007. They expanded by 58% yoy as of Q1 2007, up from 46% yoy at end 2006 and from 28% yoy one year earlier. The majority of private enterprises deposits are denominated in foreign currency (68% of total deposits of private enterprises). However, private enterprises' Dinar savings are steadily growing at a faster pace than deposits in foreign currency.

Figure 3.11



*Includes: profit/loss from sale of securities, income from dividents and stakes, expenses in respect of indirect write-off of lending and provisioning, other operating and extraordinary income/expenses and income/expenses from change in the value of assets and liabilities

Banking Sector's Profitability

Banks' incomes statements were positive at end 2006 for the second year in a row after a number of years with negative financial results. Thus, the banking sector's net income mounted to € 209 mln in 2006, having increased by € 120 mln compared to the previous year. This is quite an impressive result considering the restrictive monetary policy adopted by the NBS intended to curb credit expansion. This result was achieved mostly in the second half of 2006, due to a rise in net interest income and net exchange gains. In addition, a slowdown in expenses due to indirect write-off lending and provisioning was recorded. Namely, net interest income was the fastest growing component of banks' income statements, expanding by 46% in 2006, compared to a 26% rise of fees and charges and of 10.6% of exchange rate gains. The positive financial result of the Serbian banking sector is also reflected on the return on assets (ROA) ratio which climbed to 10.9% in 2006 from 6.7% one year earlier (Figure 3.11).

Serbia: MacroEconomic Indicators								
	2001	2002	2003	2004	2005	2006	Q1 2006	Q1 2007
Output and expenditure				*(Percentage Change in Real Terms)*				
GDP	4.8	4.2	2.5	8.4	6.2	5.7	7,0	–
Industrial production	0.1	1.8	-3.0	7.1	0.8	4.7	2.5	4.8
Labour Market								
Unemployment (official data)	12.2	13.3	14.6	18.5	20.8	20.9	21.4	–
Prices				*(Percentage Change)*				
Retail Price Index (annual average)	91.8	19.5	11.7	10.1	16.5	12.7	14.8	5.8
Producer prices (annual average)	29.0	6.2	4.6	12.0	15.4	7.3	14.3	–
Government sector				*(In per Cent of GDP)*				
RS budget (Deficit/Surplus) balance (National Definition)	-0.2	-4.3	-1.4	-0.1	1.5	1.4	-0.5	–
General government debt	106.5	73.7	67.9	53.7	46.2	38.8	–	–
Monetary and Financial Indicators				*(Percentage Change)*				
M3	92.3	52.7	27.8	31.9	42.1	38.3	42.4	41.8
Domestic credit	13.4	-35.3	11.2	51.7	52.1	16.7	46.1	20.8
				(End of Period)				
Exchange rate CSD/USD (end-period)	67.7	59.0	54.6	57.9	72.2	59.98	71.9	60.14
Exchange rate CSD/EUR (end-period)	59.7	61.5	68.3	78.89	85.5	79.0	87.2	80.4
Real Effective Exhange Rate (Index)	130.0	116.8	101.9	98.9	101.6	116.5	100.3	99.3
International Position				*(In per Cent of GDP)*				
Current account balance	-2.7	-7.9	-7.2	-11.7	-8.4	-11.5	-10.4	–
Trade balance	-21.7	-20.4	-21.2	-27.1	-21.1	-19.8	-21.8	–
Foreign direct investment, net	1.6	3.0	6.7	3.9	5.9	13.5	5.5	–
Gross External Debt	104.8	70.9	66.7	57.5	58.7	61.7	–	–
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	2006	Q1 2006	Q1 2007
Percentage of GDP (%)								
Assets	126.9	35.2	38.6	43.0	52.2	66.9	52.9	–
Total Credit	37.2	16.8	19.5	23.4	29.1	34.2	29.4	–
Credit to Enterprises	29.6	14.1	15.8	17.3	20.1	20.5	19.6	–
Credit to Households	0.7	1.6	2.5	4.6	7.5	12.1	8.2	–
Deposits	14.1	14.5	17.1	19.0	22.8	29.4	22.7	–
Percentage Change (%, yoy)								
Assets	12.6	-60.1	25.9	36.1	48.7	39.5	48.6	41.6
Total Credit	18.3	-34.8	32.9	46.6	52.1	16.7	46.1	20.8
Credit to Enterprises	16.3	-31.3	28.6	33.8	41.5	3.5	30.6	8.9
Credit to Households	85.2	205.8	81.8	126.2	98.7	54.2	107.6	53.6
Deposits	84.8	47.6	35.3	36.0	46.7	40.4	47.7	44.8
Percent (%)								
Capital Adequacy Ratio*	–	25.6	31.1	27.9	26.0	–	–	–
Capital to Assets*	–	18.3	22.5	18.8	16.2	–	–	–
NPLs to Total Loans*	–	21.6	22.5	23.3	23.2	–	–	–
Provisions to NPLs*	–	–	54.0	58.9	47.8	–	–	–
Return on Assets*	–	-8.4	-0.3	-1.0	0.9	–	–	–
Return on Equity*	–	-60.6	-1.2	-5.3	5.9	–	–	–

* 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

- **Polish economy grew at 7.4% yoy in Q1-2007 against 6.7% yoy in Q4-2006, on the back of strong consumption and investment figures. Construction activity thrives up by 50% in Q1-2007.**
- **Unemployment plunged to new record lows at 13.0% in May from 13.8% in April.**
- **Strong growth fundamentals have earned Poland an investment upgrade from Standard and Poor's in late March. Poland's long term foreign debt rating was changed to A- from BBB+.**
- **Higher prices for food and services pushed up the headline inflation to 2.5% in March 2007 only for it to drop slightly to 2.3% in April. Core measures of inflation have steadily been increasing since November 2006.**
- **The Central Bank raised key policy interest rates twice, from 4.0% to 4.50% in June 2007, in a first attempt to curb inflation pressures. Further increases in interest rates will be needed to keep inflation under control.**

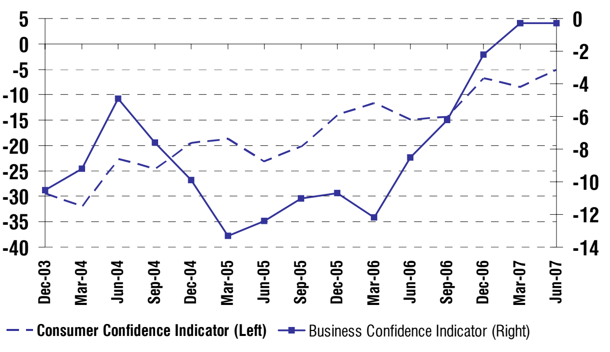
4.1 Overview

The Polish economy is expanding briskly. GDP growth rate was 6.2% in 2006, from 3.4% yoy in 2005. This remarkable performance exceeded our earlier forecasts and stands above market expectations. We expect a further acceleration of GDP growth on the back of stronger figures for private consumption and gross fixed capital formation. Further improvement in labor market conditions has started to make wage pressures more visible. Higher wages in turn, boost private consumption and consumer sentiment.(Figure 4.1) In addition, credit growth acceleration has enabled both businesses and consumers to make investments. For example, construction grew to double digit rates during 2006, pushing gross fixed capital formation up by 16.5%.

Economic expansion generates inflationary pressures as inflation edged the central bank targeted rate of 2.5%. The inflation rate in April 2007 was 2.3% from 1.4% in December 2005. In addition, all core measures have been rising steadily since late 2006. Above-trend growth acceleration and further labor market tightening signaled the beginning of the monetary policy tightening. The Central Bank raised interest rates by 25 basis points to 4.25% in April for the first time since late 2005. In fact, the market discounts further monetary policy tightening until the end of the year.

Figure 4.1

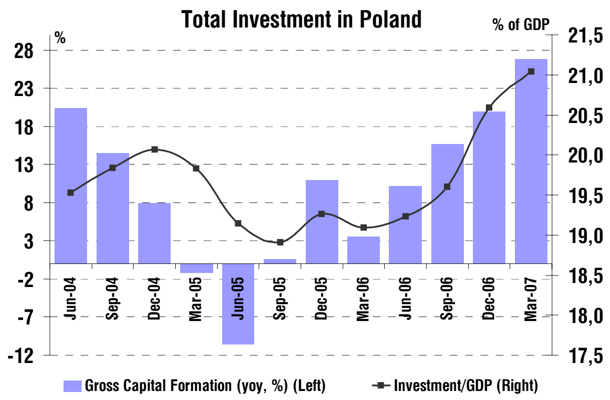
Consumer & Business Confidence Indicators



4.2 Current Economic Developments

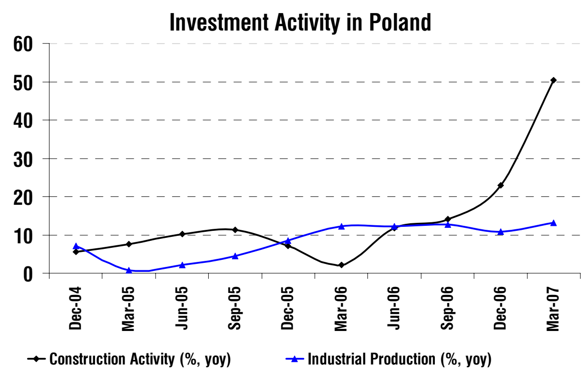
Since Q2-2005, the rate of economic growth in Poland is steadily increasing. The real GDP growth rate reached 7.4% yoy in Q1-2007, the fastest growth rate since 1997, compared to a revised 6.7% yoy in Q4-2006. The main drivers behind the strong growth record were private consumption and gross fixed capital formation. Private consumption continued growing at a rapid pace, helped by the improving households' financial situation. Private consumption grew at 6.9% yoy in Q1-2007 from 5.1% yoy in Q4-2006 against 5.4% in Q1-2006. As a result, the contribution of private consumption to GDP growth reached 4.6 pps. Real Exports remain dynamic, growing at 11.8% in Q1-2007 compared to 10.6% in Q4-2006. Yet, faster real imports growth at 14.7% in Q1-2007, made the net exports contribution to GDP growth slightly negative. The negative contribution of net exports to GDP growth reached 1.1 pps in Q1-2007.

Figure 4.2



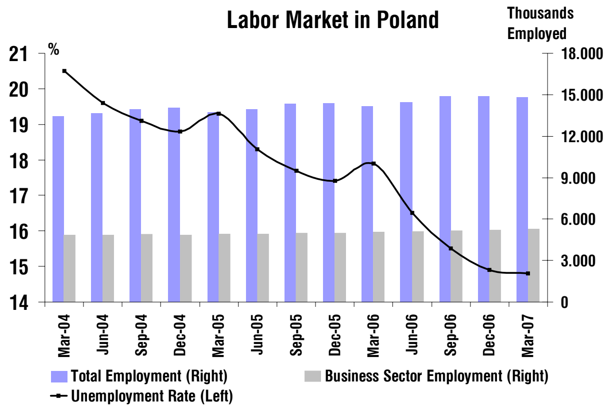
Investment is the other strong growth driver. Investment activity is thriving led by construction and manufacturing activity. Gross capital formation rose by 26.8% yoy in Q1-2007 compared to 19.9% in Q4-2006, against 10.9% in Q4-2005. Investment has now reached 21.0% of GDP in Q1-2007 from 19.1% in Q1-2006, one percentage point of GDP higher. (Figure 4.2) High investment activity is highly correlated with industrial production and buoyant construction activity. Industrial production accelerated further to 13.1% yoy in Q1-2007, compared to 10.9% in Q4-2006 against 12.3% in Q1-2006. Construction activity grew at 50% in Q1-2007, compared to 23% in Q4-2006, against only 1.4% in Q1-2006. To that end, the contribution of construction to GDP growth maintained high levels. It reached 1.2 pps in Q1-2007 compared to 1.4 pps in Q4-2006. (Figure 4.3)

Figure 4.3



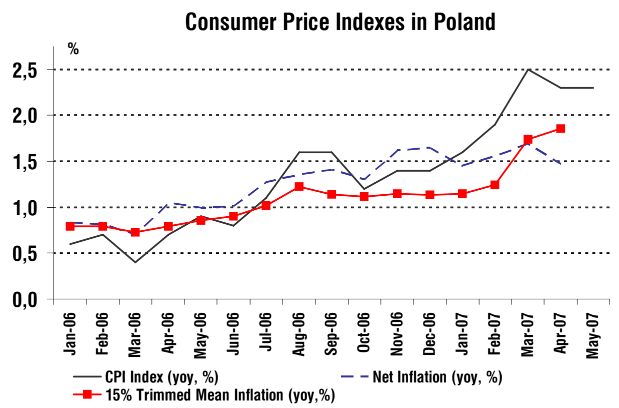
The labor market shows no sign of cooling off. Demand for labor keeps growing, which is reflected in the rising number of persons employed in the economy and the falling unemployment rate. Total employment increased by 5.3% yoy in Q1-2007, the highest increase after the 90s. Total Employment in the business sector, the most dynamic sector in the economy, increased by 4.2% and further accelerated to 4.4% in Q1-2007. Unemployment plunged into new record lows at 14.8% in Q1-2007, compared to 17.9% in Q1-2006. The drop in unemployment was reinforced by the drop in the employment rate to 54.1% since more Poles immigrated abroad. Unemployment dropped even further in May at 13.0% against 13.8% in April from 14.4% in March 2007. Robust recovery in the labor market is accompanied by a further increase in wage inflation. Nominal wages rose at 7.0% on average in Q1-2007, compared to 5.3% in Q4-2006. So far, wage increases had been offset by labor productivity increases. This is not the case for Q1-2007, since productivity in the total economy increased by 2% only. Rising unit labor costs in the economy predisposes us for a further rise in inflationary pressures if corporate margins are to remain the same. (Figure 4.4)

Figure 4.4



Economic recovery provided a strong boost to public finances. Fiscal projections have improved on the back of stronger than expected public revenues. According to the latest data, the general government deficit stands at 3.9% of GDP compared to a 4.2% (ESA95-pension reforms included) in 2006. Revenues from social contributions were higher than projected. Expenditures were lower because of lower than expected EU funds absorption. The sharp unemployment decline also resulted in a lower growth rate in social expenditures. Consequently, the general government deficit is on track to reach 3.4% in 2007, in accordance with the updated Convergence program. Strong growth fundamentals have earned Poland an investment upgrade from Standard and Poor's in late March. Poland's long term foreign debt rating was changed to A- from BBB+, which is expected to have a long-term positive impact on FDI pouring into the country.

Figure 4.5



Faster economic growth has been accompanied by a prices upswing. Higher prices of food and services pushed up the headline inflation to 2.5% in March 2007 only for it to drop slightly to 2.3% in April. Core measures of inflation have increased since November 2006, as we described in previous issues. This is increasing evidence that inflationary pressures are mounting. Net inflation rose from 1.6% in December to 2.3% in April 2007. Another core measure, the 15% trimmed mean, rose from 1.1% in December to 1.9% in April. Faster economic growth and the risk of further acceleration in wage growth convinced the Central Bank to engage in monetary policy tightening. The Central Bank raised the key policy interest rates twice from 4.0% to 4.50% in June 2007, in a first attempt to curb inflation pressures. With labor market tightening set to continue, further increases in interest rates will be needed to keep inflation under control. (Figure 4.5)

The balance of payments is not a source of concern for the Polish economy. However, the current account deficit has started to widen. It increased to 2.4% of GDP in Q1-2007 compared to 1.9% of GDP in Q1-2006, against 2.3% in Q4-2006. Exports continue to grow rapidly, but they have been outpaced by imports since Q3-2006. Exports grew at 18% yoy in Q4-2006 when Imports grew at 22% yoy in Q4-2006. The trend also continued in Q1-2007. Exports grew by 14.8% yoy, when imports grew at 18.6% yoy respectively. As a result, the trade gap widened to 1.7% of GDP in Q1-2007 from 0.9% of GDP in in Q1-2006, and we expect this trend to continue.

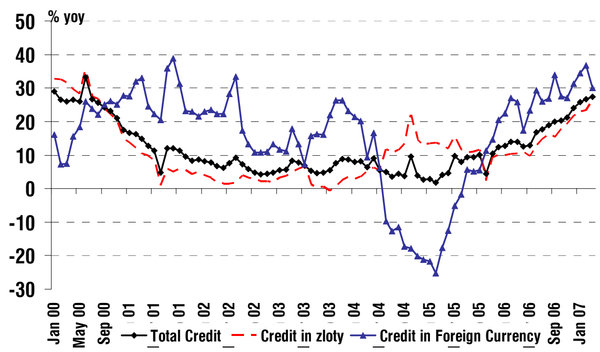
The current account deficit is forecasted to widen gradually to 3.3% of GDP by 2008, as investment demand would require bigger import volumes and continuing private-sector foreign borrowing. However, this will be partly offset by higher positive net transfers, from immigrants' remittances and EU inflows. On the other hand, net foreign direct investment (FDI) inflows should allow current account deficits of this size to be financed easily. Net FDI including reinvested profits has already reached 2.4% of GDP in Q1-2007, roughly lower than 2.5% of GDP in Q1-2006.

4.3 Banking Developments

- **Business lending continues accelerating, growing by 20.1% yoy as of Q1 2007, from 5.4% yoy one year earlier.**
- **Corporate financing gap indicator points to a continuing expansion of business lending.**
- **Expectations for elevated residential prices are the main factor fueling mortgage loans' growth rate.**
- **The diversification of Polish citizens' savings along with increasing savings ratio indicate that there is still space for mobilizing further deposits.**
- **Banking sector's profitability has increased at record highs in Q1-2007.**

Figure 4.6

Credit Growth Rate



Credit Developments

The first months of 2007 saw continuation of strong lending activity. Loans are growing by an accelerating pace since mid-2006. As of March 2007, total credit growth stood at 27.3% yoy, which is almost double the rate recorded one year earlier and the highest rate since 2000. Domestic and foreign-currency credit grew at similar rates. Credit in zloty grew rapidly by 26.3% yoy in March 2007 as compared with 10.5% yoy one year earlier, whereas loans denominated in foreign currency grew by 30.1% yoy as of Q1 2007 (Figure 4.6).

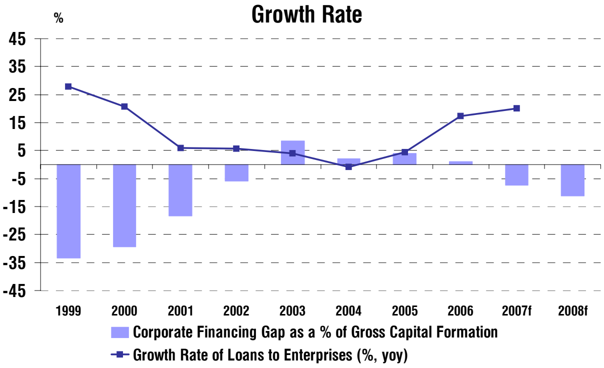
Loans to Enterprises

The main aspect in credit developments that needs to be stressed is the continued acceleration of lending to enterprises. Credit to the private corporate sector increased from 5.4% yoy as of Q1 2006 to 20.1% yoy in March 2007. According to NBP, the change in demand for corporate loans can be mainly attributed to enterprises' positive expectations regarding economic developments and especially to the intensification of their investment activity. It should be noted that according to the latest data available, investment as a percentage of GDP increased by 1 percentage point from 12/2005 to 12/2006 (see Figure 4.3 in Current Economic Developments' Section).According to the Central Bank, the rising demand for corporate loans was also triggered by the increase in financing needs for mergers and acquisitions. According to data provided by Dealwatch, during the period 01/01/2007-07/05/2007, 78 mergers and acquisitions took place in Poland with a total transaction value of $ 1.86 billion (€ 1.37 billion).

The evolution of the financing gap of the Polish corporate sector indicates the positive prospects of business lending. The financing gap is defined as the aggregate net corporate lending minus borrowing as a percentage of gross capital formation[1]. A positive ratio indicates that enterprises finance their investments by internally generated funds, whereas a negative ratio means that they finance most of their activities from external funds, i.e. bank loans, corporate bonds etc. Until 2001 it seems that Polish enterprises were borrowing in order to finance their investment activities. This observation goes in tandem with the high growth rates of loans given to enterprises during this period. However, enterprises gradually turned to internal funding, entering a process of restructuring their balance sheets and reducing their dependence on external funding sources. This trend was reversed again in mid-2006. Credit to the private sector started increasing at a rapid pace and the corporate financing gap turned negative again. According to the latest projections made by Eurostat, the corporate financing gap is estimated to stand to -7.4% at end-2007 and to -11.3% at end-2008. This is a positive hint regarding the future developments of the corporate sector lending growth (Figure 4.7).

Figure 4.7

Corporate Financing Gap and Loans to Enterprises' Growth Rate



Loans to Households

Total credit is still fuelled by strong growth in the retail segment. Credit to households was thriving in the first quarter of 2007, growing by 38.6% yoy in March 2007 instead of 26.6% yoy one year earlier.

Housing loans are still the main driving force behind the rise in lending to households. Thus, the portfolio of mortgages jumped by 57.2% yoy as of Q1 2007, up from 45.8% yoy one year earlier, but down from 63% yoy in February 2007. The strong growth of mortgage loans is induced by households' good financial condition. The substantial decrease in the unemployment rate –it decreased by 3 percentage points in a year-,the increasing trend in wages – nominal wages increased by 5% yoy at end 2006 and they are expected to have increased up to 9% yoy as of Q1 2007- as well as

[1] Source: Ameco

the strong demographic factors have pushed up demand for housing. The main factor accounting for the growing housing lending, however, is the booming real estate market itself, and the expectations about even higher residential prices. Figure 4.8 depicts the expectations of construction enterprises about residential price developments over the next three months. Since June 2005, the number of constructors who expect higher prices over the next three months is steadily increasing. This is in line with the surge in mortgage loans presented in the same Figure. However, NBP has expressed fears that the faster rise in residential prices relative to the increase in household income may soon cause a drop in the demand for housing loans.

The acceleration of housing loans in domestic currency is a favorable development since, as we have already stated in previous issues of New Europe Quarterly Economic Review, the growing portfolio of foreign currency denominated mortgage loans is a major risk for Poland's banking sector stability. Since January 2007, the growth rate of mortgages in zloty has outpaced that of FX-denominated housing loans. Thus, mortgages in foreign and in domestic currency grew by 49.4% and 70.9% yoy respectively, instead of 64.2% and 22% yoy a year earlier (Figure 4.9). This new trend reflects the shrinking interest rate differential between loans in zloty and those in foreign currency as well as the enforcement of a recommendation prepared by the Commission for Banking Supervision. According to the latter, banks granting loans in foreign currency should assess borrower's creditworthiness assuming that the interest rate on foreign currency loans is not lower than the interest rate on zloty denominated loans and that the loan principal is 20% higher than that to be granted.

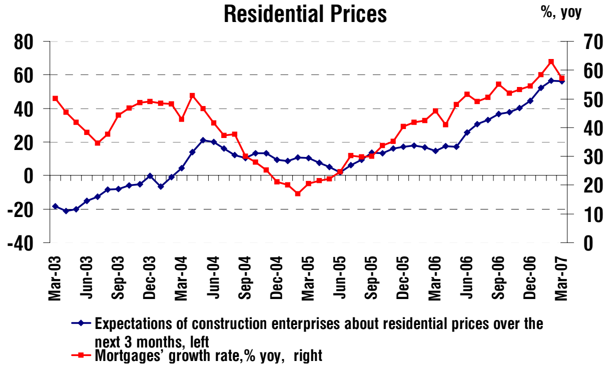
Loans granted for consumption purposes are growing rapidly as well. In particular, loans related to credit cards grew by 41% yoy as of Q1 2007 up from 37% in March 2006. We expect that the cards market in Poland will keep up its rapid pace of expansion due to the still low bank card penetration in the population.

Deposits of Enterprises and Households

The dynamic lending activity during the first quarter of 2007 was accompanied by a strong growth in deposits. Total deposits grew by 17.2% yoy in March 2007, up from 14.3% yoy at end 2006. Deposits of enterprises continued rising at a faster pace, growing by 30% yoy as of Q1 2007, up from 26.4% yoy at end-2006. This is indicative of the good financial conditions of enterprises and of their capacity to use their own funds in order to co-finance their investment activities.

Figure 4.8

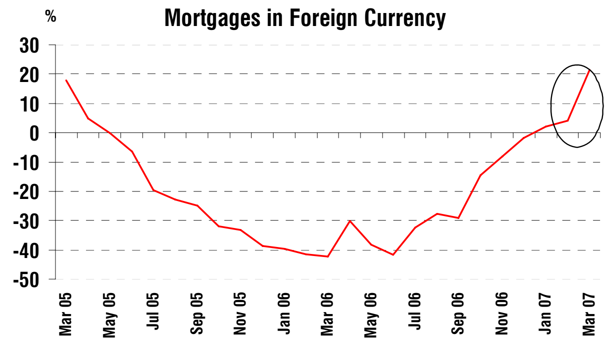
Mortgages' Growth Rate and Expectations about Residential Prices



Note: See European Commission's Construction Survey. The construction companies are asked the following question: How do you expect the (residential) prices you charge to change over the next 3 months? They will...
+ increase
=remain unchanged
- decrease
The answers to the question are given as balances between percentages of positive and negative options.

Figure 4.9

Growth Rate of Mortgages in zloty minus Growth Rate of Mortgages in Foreign Currency



Household deposits, on the other hand, continued growing moderately, i.e. by 8.85% yoy as of Q1 2007. However, household savings deposited in banks consist of 48% of their total savings (January 2007). The remaining 52% of households' savings is invested in other forms, such as investment funds, bonds, insurance schemes etc. (Figure 4.10). It is worth mentioning that since 2006, households' savings in investment funds is rising on average by five times as fast as households' bank deposits.

Figure 4.11 depicts Polish households saving ratio, defined as households' savings divided by their disposable income. Thus, in 2006 the Polish households' savings rate was 11%, up from 7.2% in 2005. According to Eurostat, the households' savings rate is projected to rise to higher levels, i.e. to 12.2% in 2007. Figure 4.11 shows that households' savings as a percentage of their disposable income continue to accelerate in line with households deposits in the banking sector. Considering the upward trend in households' savings, Polish banks can still mobilize deposits by attracting household savings from other sources so as to fund further credit expansion.

Banking Sector's Profitability and Capital Adequacy

Rapid credit expansion resulted in banking sector's profitability increasing at record highs. According to preliminary data of the General Inspectorate of Banking Supervision (GINB), the sector's return on equity (ROE) increased to 28.6% as of Q1 2007 from 25.9% a year before, while the return on assets (ROA) rose to 2.2% from 2.1% (Figure 4.12).

The acceleration of lending activity resulted in a decline in banks' capital adequacy. After the peak in 2004 of 15.6%, bank's regulatory capital to risk-weighted assets approached the 13.6% level (06/2006). An important development regarding banks' capital adequacy is the introduction of Basel II in the banking system. The new regulation for capital requirements will be introduced at the beginning of 2008. The local regulators were expected to have prepared detailed local rules, however, the procedure is still unwinding and the final impact of Basel II remains unclear.

Figure 4.10

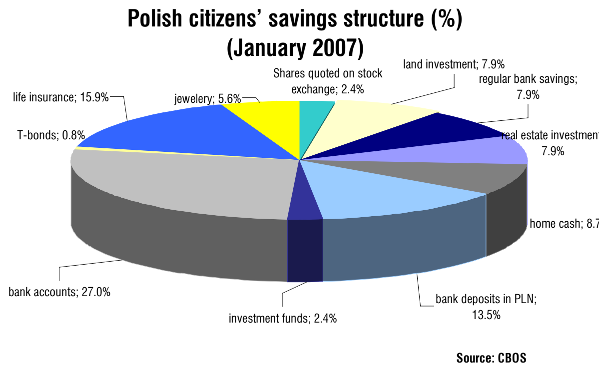


Figure 4.11

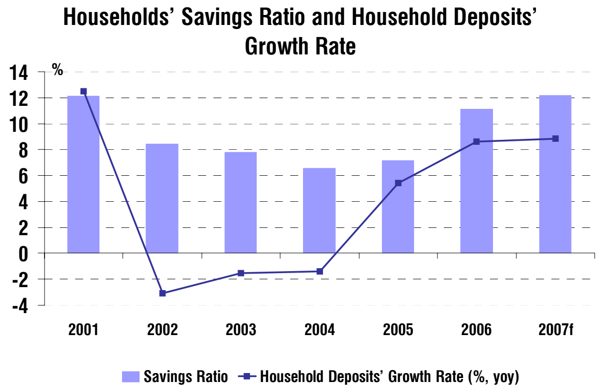
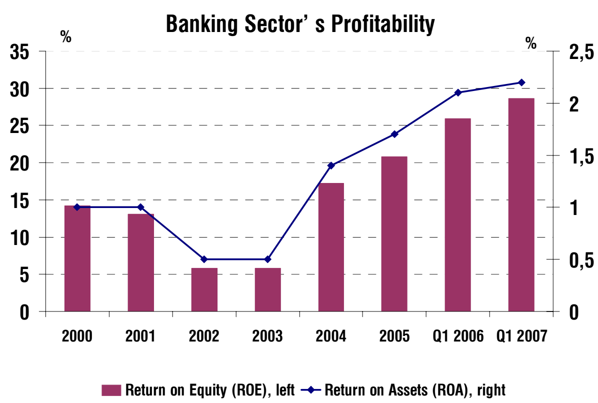


Figure 4.12



Poland: MacroEconomic Indicators	2001	2002	2003	2004	2005	2006	Q1 2006	Q1 2007
Output and expenditure				*(Percentage Change in Real Terms)*				
GDP	1.1	1.4	3.8	5.3	3.4	5.8	5.2	7.4
Private consumption	2.2	3.3	1.9	4.0	1.8	5.2	5.4	6.9
Public consumption	2.5	1.5	4.7	3.9	5.3	3.4	3.1	1.3
Gross fixed capital formation	-9.7	-6.3	-0.1	6.4	6.5	16.7	7.6	29.6
Exports of goods and services	3.1	4.8	14.2	14.2	14.0	15.1	21.7	11.8
Imports of goods and services	-5.3	2.7	9.3	15.2	4.2	15.4	21.3	14.7
Industrial production	0.4	1.4	8.7	12.7	4.1	12.0	12.4	13.1
Labour Market								
Employment	-2.2	-3.0	-1.1	1.3	2.4	3.6	3.1	3.6
Unemployment (in per cent of labor force)	15.1	17.5	20.0	20.0	19.0	16.2	17.9	14.8
Prices				*(Percentage Change)*				
Consumer prices (annual average)	5.5	1.9	0.8	3.5	2.1	1.0	0.6	1.9
Producer prices (annual average)	1.7	1.2	2.7	7.1	0.8	2.3	0.6	3.3
Average monthly wage in economy	7.2	3.5	3.2	4.9	4.0	4.9	4.7	7.1
Government sector				*(In per Cent of GDP)*				
General government balance (ESA95)	-3.7	-3.2	-4.7	-3.9	-2.5	-1.9	–	–
General gross government debt (ESA95)	35.9	39.8	43.9	41.8	41.9	42.0	–	–
Monetary and Financial Indicators				*(Percentage Change)*				
M3	9.4	-1.8	5.3	8.5	11.7	14.1	10.6	18.4
Total Credit	8.6	4.8	8.6	2.7	12.4	24.1	14.1	27.3
				(End of Period)				
Exchange rate Zloty/USD (end-period)	3.99	3.84	3.74	2.99	3.26	3.10	3.20	2.98
Exchange rate Zloty/EUR (end-period)	3.52	4.02	4.72	4.08	3.85	3.90	3.88	3.87
Real Effective Exhange Rate (Index)	112.7	108.1	96.3	96.2	107.4	109.8	111.1	–
International Position				*(In per Cent of GDP)*				
Current account balance	-2.8	-2.5	-2.1	-4.2	-2.2	-2.3	-1.9	-2.6
Trade balance	-4.0	-3.7	-2.6	-2.2	-0.9	-1.4	-0.9	-1.9
Foreign direct investment, net	1.1	0.9	0.5	0.9	0.9	1.5	1.0	2.4
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	923	981	1,051	–	–
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	2006	Q1 2006	Q1 2007
Percentage of GDP (%)								
Assets	70.1	69.0	71.9	68.4	70.2	73.8	71.7	75.4
Total Credit	27.6	27.8	29.0	27.2	28.7	34.12	29.6	34.5
Credit to Enterprises	15.1	14.6	14.3	12.6	12.1	13.3	12.4	13.3
Credit to Households	10.3	10.7	11.7	11.9	13.9	17.9	14.4	18.3
Deposits	38.9	36.1	36.0	34.9	36.3	38.7	36.3	38.9
Percentage Change (%, yoy)								
Assets	9.7	2.1	8.5	4.4	9.0	12.8	8.4	13.4
Total Credit	8.6	4.8	8.6	2.7	12.3	24.2	14.1	27.3
Credit to Enterprises	3.2	0.4	2.1	-3.7	2.6	14.7	3.8	17.2
Credit to Households	14.7	7.9	13.9	11.7	24.0	34.5	26.6	38.6
Deposits	13.1	-3.8	3.9	6.4	10.4	14.3	9.2	17.2
Percent (%)								
Capital Adequacy Ratio	13.5	14.2	13.5	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	56.3	53.4	61.3	61.6	–	–	–
Return on Assets	0.9	0.5	0.5	1.4	1.6	–	1.5	–
Return on Equity	12.4	6.1	5.7	16.7	19.9	–	19.3	–

Sources: NBP, IMF

5. Ukraine

- **The most serious confrontation, after the "Orange Revolution" events, pushed the country into political paralysis. Ukraine is heading towards early parliamentary elections scheduled for Sep. 30th.**
- **Ukrainian economy grows despite deep political crisis. The GDP growth registered 7.9% yoy in Jan-May 2007 compared to 4.0% yoy in Jan-May 2006. Construction jumped to 14.2%, compared with an average of about 9% in 2006.**
- **The current account deficit inched up to 1.8% of GDP in Q1-2007 against 1.5% of GDP in Q4-2006 and surpluses of 10% of GDP two years ago. Net FDI marked a 6% decline in Q1-2007, but on an annual basis, net FDI stood at 4.5% of GDP.**
- **The inflation rate has moderated to 10.6% in May 2007 compared to 11.6% at the end of 2006. End-of-year inflation is expected to remain at double digit figure above the 7.5% forecast set by the government, on the back of increased utilities and gas prices.**

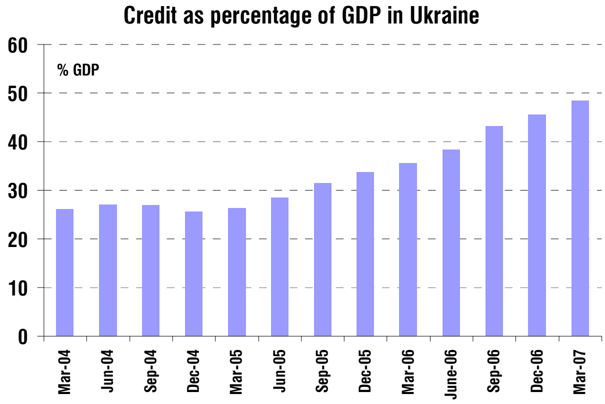
5.1 Overview

The political tensions between the President and the Prime Minister escalated to a severe political crisis during April-May of 2007. The most serious confrontation, after the "Orange Revolution" events, pushed the country into political paralysis. The deep political crisis resulted in a legislative standstill, a situation that is expected to continue until elections date. The post-elections political landscape does not seem to be much different, either. The cause of the political paralysis is deeply rooted in the lack of clarity in the division of powers between Parliament and President.

However, the most recent published statistics signal that the economic agents pay scant attention to the political unrest. After registering a remarkable 7.1% yoy GDP growth rate in 2006, GDP further accelerated by 8% in Q1-2007. Fixed capital investments grew by 32%, contributing to GDP growth. Exports rebounded strongly by 34.3% yoy in Q1-2007 on the back of high metal prices and strong global demand. On the other hand, impressive credit growth rates amounting to 70% yoy has pushed credit as a percentage of GDP to 48% in Q1-2007. The latter coupled with real disposable income growth stimulated by expansive fiscal policy, fed imports which soared by 32.8% in Q1-2007. (Figure 5.1)

Given the resilience that the Ukrainian economy displayed during the tions last

Figure 5.1



parliamentary elections last year, it wouldn't come as a surprise if the economy ignored political disturbance. That's why we maintain our full-year real GDP growth forecast for 2007, currently set at 5.5% yoy and inflation projection at 10.5%.

5.2 Current Economic Developments

The political crisis erupted in April when the President's decree to dissolve the parliament in an attempt to stop more of his own parliamentary members fleeing into the government faction. The ruling government coalition declared this move illegitimate and brought the case before the Constitutional Court to overrule the decree. The Constitutional Court was unable to reach a decision, which made the situation even less functional and led to protracted negotiations. The agreement between the President and the Prime Minister to hold early parliamentary elections failed to break the deadlock, as the confrontation shifted to the time of the vote. The situation escalated further, when the President ordered troops of the Interior Ministry into the capital, only to be blocked by the police loyal to the Prime Minister. After two unilateral attempts which failed to set an early parliamentary election date, the third one, a negotiated compromise now stands at Sep.30th, with the parliament to decide upon pending issues on the road to elections.

More importantly, early parliamentary elections will not signal the end of political turbulence and will not make politics more predictable in Ukraine. The last parliamentary elections took place in late March 2006. Then, it took five months before a new government was formed due to the absence of a clear majority. Never the less, the absence of a stable government didn't hinder the economic growth recovery in 2006. Even when political tensions in the country were high in April, local financial markets recovered quickly after the initial shock and sovereign spreads dropped further. (Figures 5.2, 5.3)

More importantly, the economy contrary to the low performance during the political crisis in 2004 proved to be more resilient to this political shock. Real GDP expanded by 8% yoy in Q1-2007, compared to 9.5% yoy in Q4-2006. This represents an increase from an average 7.1% growth in 2006. GDP growth over April-May when the political crisis peaked- did not recede at all. The monthly GDP growth rate in May increased to 7.7% yoy compared to 7.6% yoy in April. As a result, the GDP growth rate in Jan-May accelerated to 7.9% yoy against 4.0% at the same period in 2006.

Figure 5.2

Stock Market Index in Ukraine 2006-2007

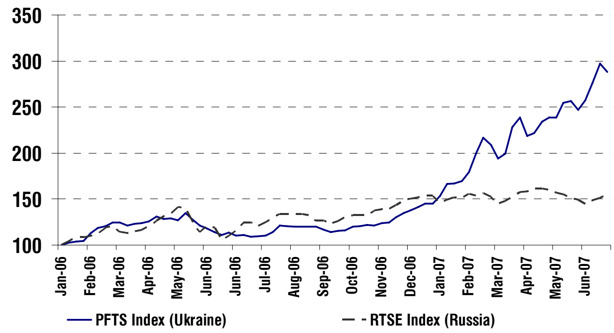
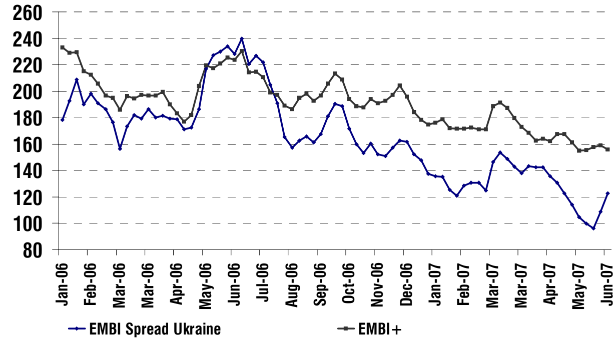


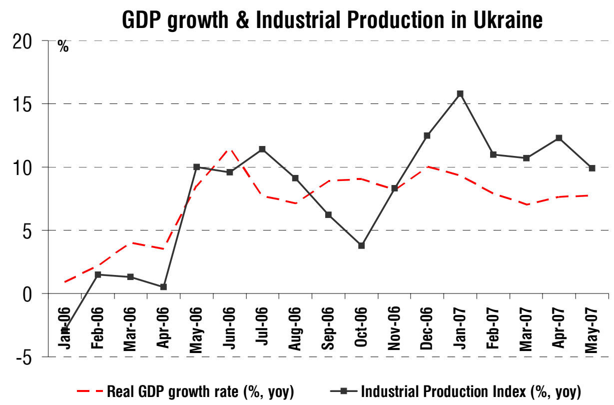
Figure 5.3

EMBI Sovereign Spreads Ukraine



In addition, strong domestic demand supports GDP growth, with the wholesale, retail trade, and construction sectors posting impressive results. Strong wage growth, coupled with higher social benefits, stoked real disposable income by 11% in Q1-2007. As a result, private consumption rose by 26.3% yoy in Q1-2007. In addition, this is also reflected in the growing value-added output from the wholesale and retail trade industry. After expanding by around 16% in 2006, output growth from wholesale and retail trade remained double-digit in the first quarter (14.1% yoy in Q1-2007).

Figure 5.4



Fixed capital investments in Q1-07 surged by 32% yoy in real terms, double than the growth registered in Q1-06. Industrial enterprises increased investment in fixed capital by 39% yoy, becoming the largest contributors to overall investment growth. Momentum in industrial production is also robust. Industrial output grew 12.5% yoy in Q1-2007 compared to only 0.6% yoy in Q1-2006. The value-added manufacturing output accelerated to 14.4% in Q1-2007, after growing by approximately 6% in 2006. Construction activity remained buoyant, unaffected by the pressure on margins from energy prices and the legislative standstill. Construction output jumped to 14.2%, compared with an average of about 9% in 2006. (Figure 5.4)

Strong external demand provided a significant boost to the country's main export-oriented industries. Thanks to favourable price trends prevailing on global steel and other ferrous-metals markets since mid-2006. The value of exports rose by 34.3% yoy to $10.8 billion. More than half of the exports growth is attributed to the 40% increase in metal exports. The latter increased to 43.5% of total exports, from 40.9% a year earlier. On the other hand, imports in the quarter grew by 32.8% yoy to $12.6 billion. Gas imports value increased by 50% in value as prices hiked further by 37% to $130 per 1,000 cubic meters from $95.

As a result, the current account deficit started to widen, confirming our expectations. It widened by 60% yoy and inched up to 1.8% of GDP in Q1-2007 against 1.5% of GDP in Q4-2006, following the trade balance deterioration trend. The trade deficit accounted for 5% of GDP in Q1-2007, from 4% of GDP in Q-2006. On the other hand, strong current transfers counterbalanced the contracted services surplus (by 14.4% in Q1-2007). The capital account figures were strong and supportive of the widening current account deficit in Q1-2007. Net FDI marked a 6% decline in Q1-2007 (US$969m), because of unrealized privatization plans. Nevertheless, on an annual basis, net FDI stood at 4.5% of GDP. Investments in the banking sector made up a quarter of the recorded inflow.

In addition, the emerging markets risk appetite gave rise to portfolio investments. Foreign borrowing in the form of medium and long-term loans and Eurobonds reached US$2.8bn (or seven fold yoy than in Q1-06). However, the mounting reserves (0.6 bn $ increase) makes it more convenient for the Central Bank to sustain the current de facto peg of Hryvnya. Furthermore, it is reasonable to believe, that if the deepening political crisis becomes more complicated this may become an additional disincentive for potential investors to expand in Ukraine. (Figure 5.5)

The 2007 Budget aims at a state budget deficit at 2.6% of the forecasted GDP and a consolidated budget balance of 2%, targets generally achievable in our view. That is so because revenues over performing and expenditures underperforming. The deficit is projected to be financed partially by privatization revenues and borrowing. Nevertheless, there are two down-side risks with respect to budget implementation, which make us believe that the government will resort to additional external borrowing. Firstly, the privatization revenues projections are overly optimistic (5 times more than the 2006 target, 10 times more than the 2006 realization). Secondly, additional social expenditures (approximately 8bn UAH or 1.3% of projected GDP) have already been decided by the government because of pressures from the Presidency in the struggle for power.

On the other hand, faster than expected GDP growth in Q1-2007, has led to an upward revision of the projected tax revenues. The available Q1-2007 data point to an acceleration of central government fiscal revenues by 6% yoy, as a result of higher than expected VAT revenues by 4% yoy and corporate tax revenues by 19.7% yoy. At the same time, the central government expenditures reached 87.9% of the plan. In total, the central government posted a surplus of 0.3% of GDP or 1% at the consolidated government level in Q1-2007.

Consumer prices have risen sharply after the second half of 2006 because of large increases in administered prices for natural gas and electricity. Nevertheless the inflation rate has moderated to 10.6% in May compared to 11.6% in the end of 2006. The 35% gas price increase combined with supply side bottlenecks in public utilities will weigh substantially on CPI in 2007. Moreover, the Producer's Price Index (PPI) accelerated further to 20.2% in May compared to 14.1% in the end of 2006. This reflects an increasing pass through of wage costs and commodity prices increases in the industrial production. In turn this is expected to pass through in the consumer prices. As a result, end-of-year inflation in 2007 is not expected to move below double digit rates, much above the 7.5% forecast set by the government. On the other hand, the National Bank of Ukraine decided to reduce the discount rate to 8.0%, which is going to boost domestic demand further. In addition, the Central Bank has started

Figure 5.5

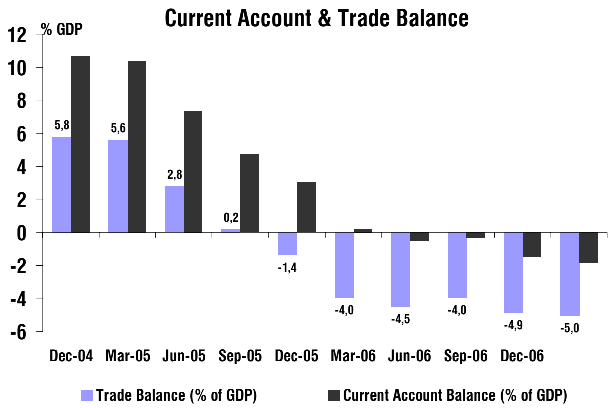
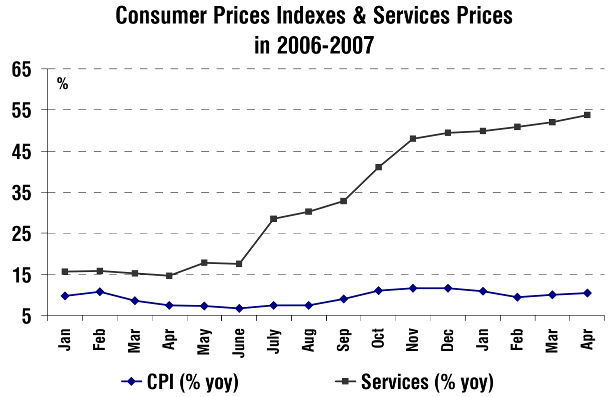


Figure 5.6



to tackle the issue of the local currency convertibility. From the Central Bank rhetoric it is becoming evident that full convertibility of the local currency is gaining more ground in the policy priorities. (Figure 5.6)

5.3 Banking Developments

- **The banking sector's stability seems to be unaffected by the outbreak of the political crisis.**
- **Ukraine's surging credit expansion is associated with the economy's financial dollarization.**
- **Mortgage lending is the most dynamic component of credit expansion, accelerating by 158.7% yoy in 2006.**
- **Household deposits are expected to continue expanding briskly, while the mild deceleration of corporates' deposits could be attributed to enterprises' increased appetite for investment.**

The main focus of attention in the Ukrainian banking sector is the unceasing entry of foreign participants. According to data provided by Dealwatch, 6 bids took place in the commercial banking and other credit intermediation activities sector during the period January-May 2007. These, accounted for 45% of total value of M&A transactions. The share of foreign capital in Ukrainian banks' statutory capital has increased by 8.1 percentage points during 2006 to 27.6% at the start of 2007. However, since January the share of foreign capital has increased even more to 29.3%. According to NBU, by the end of 2007, the share of foreign capital in the banking sector could grow to 35%. NBU sees no urgent need to impose restrictions. On the other hand, the central bank does not rule out the possibility of adjusting the share of foreign capital in the long run.

The most eminent concern regarding Ukraine's banking sector is the impact of the pending political crisis. On the crisis outbreak (early April 2007), NBU rushed to shield the stability of the banking sector and its vulnerability to political turmoil. According to NBU, the people's trust in the banking system counterbalanced the unfavorable political developments. The repercussions of the crisis cannot be fully assessed yet. However, the first signs are positive with total credit growth reaching historical highs in April 2007. Namely, credit growth rate was 73.8% yoy in April 2007 against the lower 71% yoy at end-2006. Moreover, the cut in the discount rate by 0.5 percentage points, from 8.5% to 8% -valid from 1st June 2007- is expected to be rolled over to credit rates. This will probably boost credit expansion. On the other hand, deposits continued expanding briskly in April 2007, accelerating by 44.2% yoy up from 38.8% yoy at end-2006.

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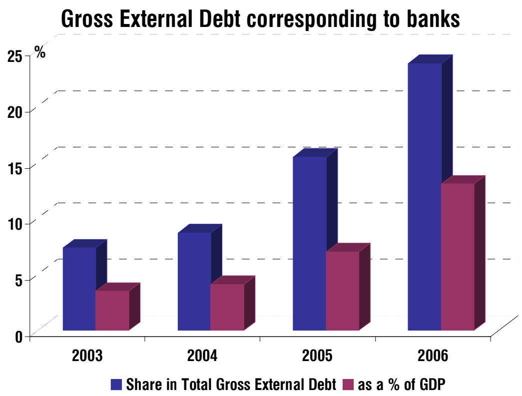
Credit Developments

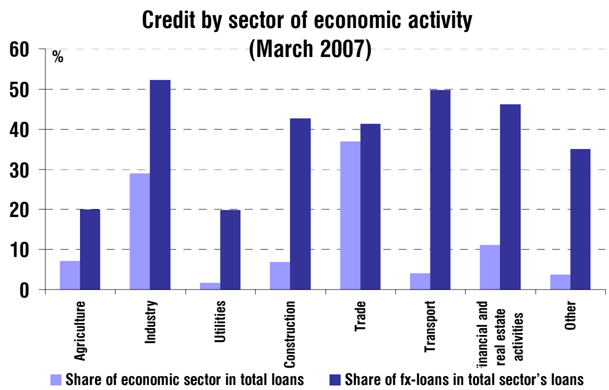
The Ukrainian banking sector is on a path of strong credit expansion and is witnessing surging credit growth rates. Thus, during a one-year period, credit penetration in the economy has increased by 12.7 percentage points, standing at 48% of GDP as of Q1 2007. The main issue on Ukraine's banking agenda is the association of the surging lending expansion in foreign currency. Namely, the credit growth rate of loans in foreign currency is twice the corresponding growth rate of loans in domestic currency (100.8% and 52.2% yoy respectively in April 2007). The majority of loans in foreign currency is denominated in US dollars (approximately 87 %), 11% is denominated in Euro and the rest 2% in other currencies.

Figure 5.7



The financial dollarization characterizes Ukraine's banking sector, as 43% of total loans are denominated in US dollars. This is a source of major concern for the banking sector's stability. In addition to credit risks due to unhedged foreign currency borrowers, the banking sector faces rising funding risks. Since bank FX-deposits are lower than FX-credit, banks resort increasingly to borrowing from abroad in order to fund their needs in foreign currency. As it is indicated by gross external debt data, the share of gross external debt corresponding to the banking sector has elevated to 24% from 7% three years earlier. Also, gross external debt corresponding to banks has risen from 3.5% of GDP in 2003 to 13% of GDP in 2006 (Figure 5.7). Namely, gross external debt corresponding to banks is expanding briskly, growing by 111% yoy in 2006. NBU has recently taken some measures with the intention to contain financial dollarization in the banking system. Hence, higher reserve requirements were introduced for credits in foreign currency for borrowers with and without foreign currency income. For some credit types reserve requirements increased by more than 1.5 times. Hence, these changes are expected to make foreign denominated loans more expensive for banks, creating disincentives for lending in foreign currency.

Figure 5.8



Credit to households remains the fastest rising segment of the banking sector's credit expansion. Loans to households maintained their strong momentum, having grown by 125.6% yoy in March 2007 against 138.3% yoy one year earlier. The household credit boom along with their lack of awareness about the risks hidden behind it, has prompted NBU to pass a resolution, indicating that banks should notify their borrowers of effective loan interest rates with commissions and insurance payments included. Namely, banks should notify the borrowers how much they owe in total, with all annual payments and commissions included.

Mortgage lending is the most dynamic component of household borrowing, growing by 158.7% yoy at end 2006. A principal reason for the surging mortgage market is their low penetration in the economy. Mortgages stood at only 5% of GDP in 2006 from 2.5% of GDP in 2005. This is also reflected on the accelerating construction activity. Thus, construction grew by 14.2% during Q1 2007, up from 9% during 2006. Also, according to the State Statistics Committee, about $ 1 billion or 4.1% of the total capital investment was invested by Ukrainians into house building in 2006.

Loans granted to enterprises grew by 54.1% yoy in March 2007 against 48.1% yoy one year earlier. Fx-denominated credit to enterprises grew by 70.0% yoy in March2007, twice the growth rate of loans denominated in hryvnia. The highest share of Fx-loans (about 72%) relates to export oriented sectors, such as industry, transport and trade. However, a large share of loans to the construction, financial and real estate activities and other sectors are also foreign currency denominated, indicating the existence of considerable FX-risks (Figure 5.8).

Deposit Developments

The dynamic lending activity is accompanied by strong deposit growth, which yet is unable to keep up with the banking sector's surging credit expansion. Household deposits are the most dynamic component of deposits. Hence, household deposits consist of 2/3 of total deposits and present the most dynamic expansion, accelerating by 51.1% yoy in March 2007 against 45.6% yoy at end 2006.

Similar to credit, household deposits in foreign currency maintain higher growth rates than domestic denominated deposits, expanding by 52.2% yoy instead of 54.6% yoy respectively in March 2007 (Figure 5.9). Household deposits strong acceleration is in line with households' savings ratio[1] which increased to 13.9% in 2006 from 11.8% one year earlier. We expect that the positive momentum of household deposits is bound to continue taking into account households' increasing trust to the banking sector.

On the other hand, enterprises deposits, consisting of approximately 1/3 of total deposits, grew by 31.8% yoy in March 2007, up from 27.3% yoy in 2006 (Figure 5.10). This acceleration in enterprises' deposits growth rate is in line with enterprises' improved financial results in early 2007 (Figure 5.11). Thus, after a deterioration in corporates' financial results in early 2006, the corporate sector's profitability accelerated by 131% yoy for January-February 2007. We should note, however, that enterprises also channel their profits in investments. This could be well reflected on the acceleration of Ukraine's fixed capital investments, which grew by 32% yoy as of Q1 2007.

Figure 5.9

Household Deposits Growth Rate

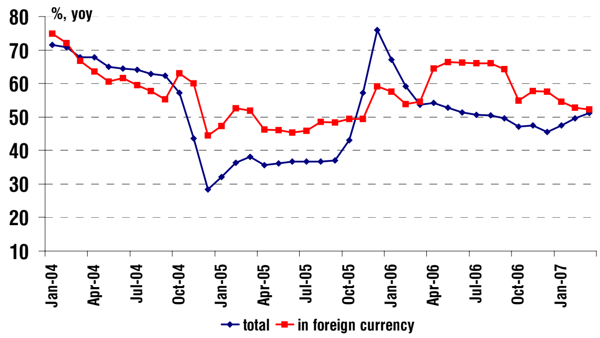


Figure 5.10

Enterprises' Deposits Growth Rate

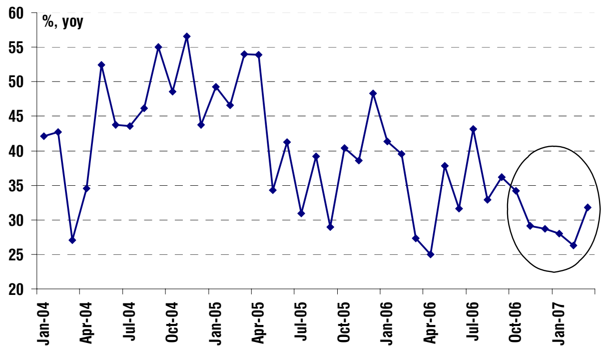
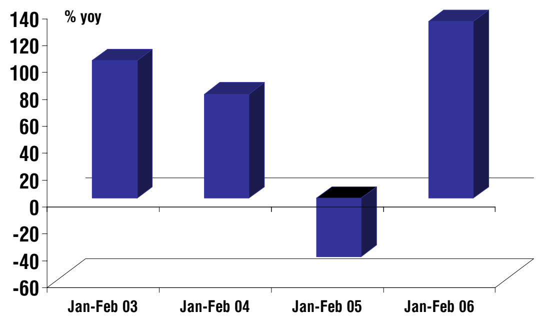


Figure 5.11

Financial results of enterprises (% yoy)



Ukraine: Macroeconomic Indicators	2001	2002	2003	2004	2005	2006	Q1 2006	Q1 2007
Output and expenditure				*(Percentage Change in Real Terms)*				
GDP	9.2	5.2	9.4	12.1	2.6	7.1	3.2	8.0
Industrial production	14.2	7.0	15.8	12.5	3.1	6.2	0.2	12.5
Labour Market								
Unemployment (in per cent of labor force)	3.7	3.8	3.6	3.5	3.2	2.8	3.2	2.8
Prices				*(Percentage Change)*				
Consumer prices (annual average)	12.0	0.8	5.2	9.0	13.5	9.1	9.7	10.2
Produce Prices (annual average)	8.7	3.0	7.6	20.4	16.8	9.6	8.4	16.7
Average monthly wage in economy	34.9	20.7	23.0	27.7	36.5	29.4	35.8	26.4
Government sector				*(In per Cent of GDP)*				
General government balance	0.3	0.7	0.2	3.2	1.8	0.7	0.4	4.8
General government debt	36.3	33.4	29.1	24.7	18.4	15.2	–	–
Monetary and Financial Indicators				*(Percentage Change)*				
M2	42.9	42.3	46.9	32.8	53.9	34.3	39.2	38.6
Total Credit	48.4	48.2	61.4	30.6	61.9	71.0	64.9	73.1
				(End of Period)				
Exchange rate UAH/USD (end-period)	5.3	5.3	5.4	5.3	5.0	5.05	5.1	5.03
Exchange rate UAH/EUR (end-period)	4.7	5.5	6.6	7.1	6.0	6.65	6.08	6.72
Real Effective Exhange Rate (Index)	114.2	102.6	95.3	95.8	112.8	112.4	112.0	–
International Position				*(In per Cent of GDP)*				
Current account balance	3.7	7.5	5.8	10.6	3.0	-1.5	0.2	-1.8
Trade balance	0.5	1.7	1.0	5.8	-1.4	-4.9	-4.0	-5.0
Foreign direct investment, net	2.1	1.7	2.9	2.6	9.0	5.0	9.0	4.5
Gross External debt	53.6	51.1	47.5	47.2	46.7	51.0	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	345.1	441.4	537.6	–	–

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

Ukraine: Banking Indicators								
	2001	2002	2003	2004	2005	2006	Q1 2006	Q1 2007
Percentage of GDP (%)								
Total Credit	13.9	18.6	25.4	25.7	33.8	45.6	35.7	48.0
Credit to Enterprises	13.2	17.1	21.5	20.7	25.0	29.9	25.9	31.1
Credit to Households	0.7	1.5	3.7	4.3	8.4	15.3	9.3	16.4
Deposits	12.6	16.7	22.9	24.0	31.3	34.3	30.7	34.3
Percentage Change (%, yoy)								
Total Credit	48.4	48.2	61.4	30.6	61.9	71.0	64.9	73.1
Credit to Enterprises	45.7	40.5	53.6	24.7	48.2	51.3	48.1	54.1
Credit to Households	42.9	130.6	174.8	63.1	121.0	130.0	138.3	125.6
Deposits	38.1	46.9	62.7	35.2	60.0	38.8	40.5	43.9
Percent (%)								
Capital Adequacy Ratio	20.7	18.0	15.2	16.8	15.0	14.2	14.9	–
Capital to Assets	15.6	14.7	12.3	13.1	11.5	12.1	11.5	–
NPLs to Total Loans	25.1	21.9	28.3	30.0	19.6	17.8	18.3	–
Provisions to NPLs	39.2	37.0	22.3	21.1	25.0	23.1	25.9	–
Return on Assets	1.2	1.2	1.0	1.1	1.3	1.6	1.4	–
Return on Equity	7.5	8.0	7.6	8.4	10.4	13.5	11.8	–

Sources: NBU, IMF

6. Turkey

- **Turkey is heading for early parliamentary elections on July 22, after the political confrontation of the government and the opposition during the Presidential elections.**
- **The monetary policy tightening of May 06 made its effect more apparent on growth in Q4-2006. As a result, GDP growth rate slowed down to 5.2% yoy in Q4-2006, compared to 9.5% yoy in Q4-2005. We forecast that GDP growth in Turkey will slow down to 5.2% yoy in 2007, on the back of more vibrant export activity and weaker private consumption.**
- **The current account deficit narrowed down to 8.2% of GDP in Q1-2007, in line with our forecasts in our previous issue. The weak domestic demand combined with the strong exports performance will further push the current account deficit down to 7% of GDP by the end of 2007.**
- **Nevertheless, FDI inflows came at 10 bn. USD in Jan-April compared to 1.7 bn. This represented 74% coverage of the current account deficit against 34% one year ago.**
- **Inflation declined to 9.2% yoy in May against 10.7% in April. If there are no adverse foreign exchange market developments, the average year inflation will be around 7.5% yoy.**

6.1 Overview

Turkey is heading to early parliamentary elections in late July, after the political turmoil in April-May. Until then, Turkey will have to balance between geopolitical concerns and politics. On the one hand, we have the battle between the secular parties' forces and the government regarding the Presidential election and the constitutional amendments. On the other hand, the geopolitical concerns arising from PKK violence are pointing towards possible military action on Turkey – Iraqi border.

As far as economic developments are concerned, the monetary policy tightening took its toll on the Turkish economy in the second half of 2006. As a result GDP growth slowed down from 7.4% yoy in 2006, compared to 6.1% yoy in 2005. As we had forecasted in the previous issue, GDP growth rate would slow down in 2007 to 5.2% yoy.

6.2 Current Economic Developments

The monetary policy tightening of May 06 made its effect more apparent on growth in Q4-2006. As a result, GDP growth rate slowed down to 5.2% yoy in Q4-2006, compared to 9.5% yoy in Q4-2005.

Private consumption growth was flat. Private consumption grew at a negligible 0.1% yoy in Q4-2006 compared to 16.7% yoy in Q4-2005. In addition, gross capital formation grew by 8.4% yoy in Q4-2006 against 6.0% yoy in Q4-2005 accounted for half of the GDP growth.

Private consumption's scant growth is mirrored in the industrial production slowdown of domestic-demand oriented industries such as food, refined petroleum products. For example, food industry production displayed a 5.2% yoy increase in Jan-April 2007 compared to 7.9% yoy last year. Chemicals decelerated to 3.2% yoy from 14.3% yoy at the same time.

On the other hand, domestic demand growth contribution has been counterbalanced by more vibrant export activity. Net exports contribution became positive for the first time since 2002 as imports growth landed to 1% in Q4-2006 (from 15.3% yoy in Q3-2006) against exports growing at 6.2% (from 10.9% yoy in Q3-2006). Net exports contribution increased to 2.4 percentage points, which accounts for the rest of GDP growth. (Figure 6.1)

Export-oriented industries (basic metals, textiles, electrical machinery) support strong industrial production growth. Industrial production stood at 6.2% yoy higher in Jan-April 2007, against 4.2% yoy a year before. (Figure 6.2) In addition, employment is growing fast after its moderate increase in 2006. Employment registered a robust growth of 3.8% yoy in Q1-2007 despite the base effect stemming from the -1.1% yoy employment decrease in Q1-2006.

The central government budget data point to a visible rise in the non-interest expenditure and a poor performance in tax revenues. Lower import related VAT tax collection combined with a lower corporate tax rate, effective from this fiscal year has resulted in unsatisfactory tax revenues. Tax revenue registered a weak increase of 8% yoy compared to a 15% yoy target. However, strong non-tax revenues from banking sector dividends (up 53.7% yoy) have boosted the total revenue up by 16.4% yoy against a target of 9.8% instead. Furthermore, in light of the forthcoming elections, the government has allowed significant overspending. Non - interest expenditure rose by 23.4% yoy against a target of 17.5% yoy in the program. The bulk of the expenditure increase was directed to public sector payments and social security institutions (19.1% yoy), current transfers (26.1% yoy) and agricultural subsidies (up 53.2% yoy). As a result, the central government recorded a primary balance of 3.2% of GNP in Jan-May 2007 against 3.6% of GNP at the same period last year. The budget recorded an overall deficit of 0.5% of GNP compared to a minimal surplus 0.3bn TRY at the same time last year. It is worthwhile mentioning that the magnitude of this deficit for this

Figure 6.1

GDP growth rate drivers in Turkey

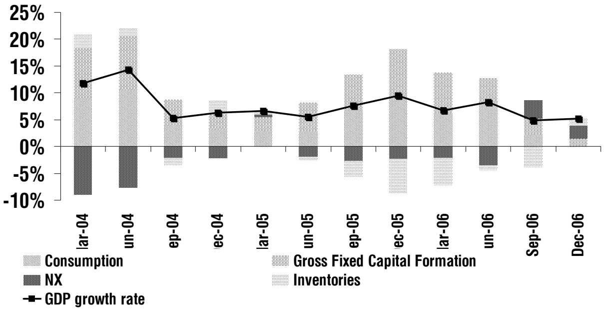
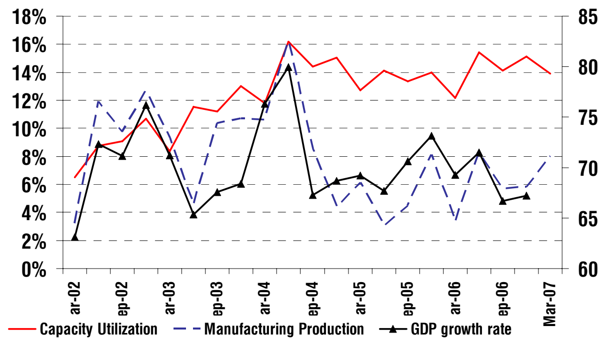


Figure 6.2

Manufacturing Production & Capacity Utilization



year so far is equal to the deficit recorded last year as whole.

The budget performance so far implies that discipline in fiscal performance is at stake. If the fiscal targets are to be achieved, then the post-elections government will be faced with a significant expenditure growth slowdown challenges in the second half of the year. According to the latest available data in relation to IMF defined targets, the central government primary surplus reached 0.8% of the projected GNP in April, against a target of 5% of GNP for year end. In addition, off-budget public sector accounts should contribute another 1.5% of GNP primary surplus, so that the consolidated government sector primary balance attain 6.5% of GNP, a target hard to achieve under the circumstances analyzed above.

The current account deficit narrowed down, in line with our previous forecasts. After peaking at 8.4% of GDP in Q3-2006, the annualized current account deficit is estimated at 8.2% of GDP in Q1-2007.

The major driver behind that development was the improving trade balance. Starting from Q3-2006, exports have been growing faster than imports, as they started to benefit from the depreciation of the Turkish Lira. The trend continued in the first months of the year more vibrantly. Namely, exports surged by 25.4% yoy, whereas imports increased by 15.3% yoy in Jan-April 2007. Consequently, the trade deficit improved from 10.5% of GDP at the end of 2006 to 10.3% of GDP in Q1-2007, in accordance with our estimations. However, the weak domestic demand combined with the strong export performance will further push the current account down to 7% of GDP at the end of 2007. FDI flows surprised to the upside, despite the prevailing political uncertainties. FDI inflows reached a record level of 20.2 bn USD by the end of 2006. At that time the government target for another 20 bn USD was overoptimistic given the political constraints arising for the privatizations program. Nevertheless, FDI inflows came at 10 bn. USD in Jan-April compared to 1.7 bn in the same period in 2006. This represented 74% coverage of the current account deficit against 34% one year ago, which implies a significant improvement in the quality of financing. Net FDI stood approximately at 6.5% of GDP in Q1-2007 compared to 5.0% of GDP at the end of 2006. (Figure 6.3)

In Q2 – 2007, Turkish economy has embarked on a moderate inflation deceleration trend, in line to the forecasts we made in the previous issue. The weakening of domestic demand after the interest rate hikes, and the strengthening of the Turkish Lira led to inflation easing. In addition, considerably lower food prices stemming from warmer weather, contributed to lower inflation in May 2007. As a result, inflation declined to 9.2% yoy in May against 10.7% in April.

Figure 6.3

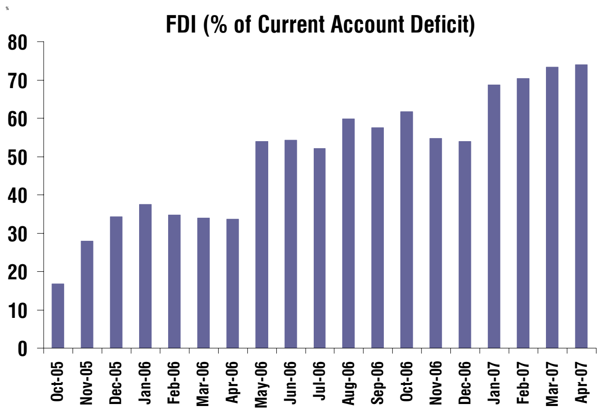
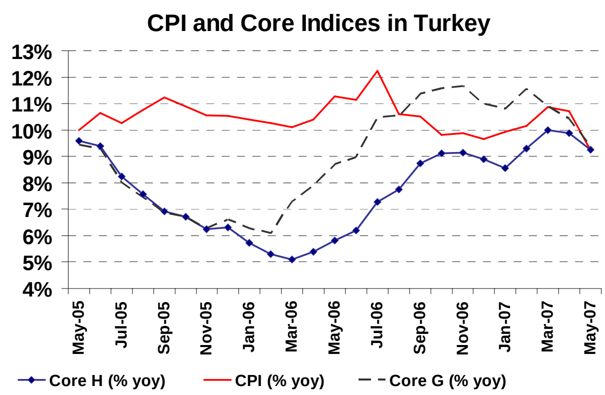


Figure 6.4



However, the core measures that the Central Bank follows closely remained high. Core H-index displayed a decrease from 9.9% yoy in April to 9.25% yoy in May. Core G-index declined from 10.4% yoy in April to 9.4% at the same time. We continue to expect that the disinflation process will gain momentum in the second half of the year, but will not be as fast as the Central Bank would want it to be (end year inflation target of 4%). If there are no adverse foreign exchange market developments, the average year inflation will be around 7.5% yoy, as the effect of last year's Lira's depreciation and energy prices supply shock will be phased out**.** (Figure 6.4)

6.3 Banking Developments

- **The May- June 2006 turbulence seems to have a limited impact to the Turkish banking sector.**
- **The banking sector witnessed a strong credit deceleration prompted by the lira depreciation and the sharp interest rate hikes. Credit growth remained also particularly sluggish during the first months of 2007.**
- **The introduction of the long-awaited Mortgage Act in February 2007 will boost the mortgage market in the Turkish banking sector.**
- **Deposits are the main component of households' financial assets, with a share of about 71% in September 2006.**

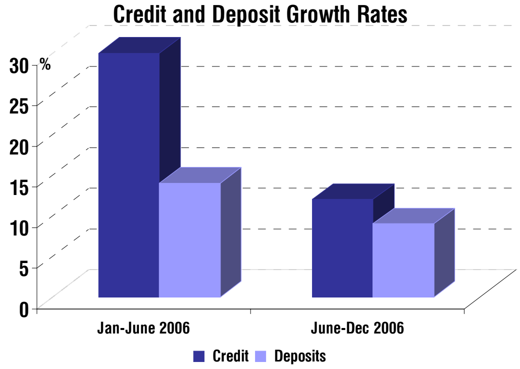
Banking Developments

The May-June 2006 turbulence seems to have a limited impact on the Turkish banking sector. The main effect of the fluctuations was a sharp credit slowdown. Namely, total credit grew by 46% yoy in December 2006 instead of 61% yoy in May 2006. Notably, total credit grew by 12% between June-December 2006 compared to 30% during January-June 2006. As a result, the banking sector's assets decreased slightly (by 2%) between June and August 2006. On the liabilities side, deposit growth decelerated to 9% during the second half of 2006 from 14% during the first half of 2006 (Figure 6.5). Owing to the lira depreciation, foreign-owned denominated deposits expanded at a more rapid pace compared to deposits denominated in domestic currency during the second half of the year. Thus, deposits in foreign currency grew by 11% during the period June-December 2006 compared to 8% for deposits in lira.

In terms of capitalization, the market turbulence had a temporary negative effect on the Turkish banking sector. Banks experienced losses from fixed-rate government securities held in trading

Figure 6.5

The Impact of the May-June 2006 crisis on Credit and Deposit Growth Rates



portfolios. Thus, the capital adequacy ratio fell from 23.1% in April 2006 to 19.4% in May. On the other hand, credit growth slowdown counterbalanced the negative effect of the losses mentioned above. As a result, the capital adequacy ratio was 22.4% at end 2006, slightly below the 24.2% ratio one year earlier (Figure 6.6).

On the profitability side, the May-June turmoil did not have an unfavorable impact on the banking sector. In fact, the profitability indicators have followed an upward trend since March 2006. At end of 2006 they recorded higher levels compared to a year before (Figure 6.7). The banking sector's asset quality was not affected by the market mini-crisis. More specifically, its non-performing loans stood at 3.75% of the total loans at end- 2006 against 4.75% in 2005. Taking into account the likelihood of lagged implications on credit quality, we should mark that non-performing loans stood at the particularly low level of 3.53% as of May 2007, one year after the crisis breakout.

Credit Developments

The Turkish banking sector witnessed, as aforementioned, a strong credit deceleration prompted by the lira depreciation and the sharp interest rates hikes. Credit growth remained particularly sluggish during the first five months of 2007. Namely, credit grew by 30% yoy as of May 2007 against 61% yoy one year earlier. During the first five months of 2007, credit expanded by only 11.2%. Credit in domestic currency grew by 40% yoy as of May 2007 instead of 66% yoy in May 2006. On the other hand, credit in foreign currency slashed down to 7.5% yoy in May 2007 against 51.2% yoy one year earlier. This sharp deceleration of FX-denominated credit could be attributed to a base effect due to the particularly high m-o-m growth rate of FX-denominated loans in May 2006 (21% m-o-m growth rate). To have a clear understanding of credit developments in the first months of 2007, it should be noted that during the period January-May 2007 both credit in domestic and in foreign currency grew by approximately 11%.

In the early months of 2007, credit slowdown was also reflected in consumer loans. According to preliminary data available, consumer loans are estimated to have increased by only 1% between the end of December and the end of February 2007, growing by 42.6% yoy in February 2007. However, we expect that consumer loans will rebound in the upcoming months after the unraveling of the current political upheaval. As a result, the resolution of the presidential elections and a possible interest rate cut in the second half of 2007 constitute the main factors that could boost consumer loans' expansion.

Figure 6.6

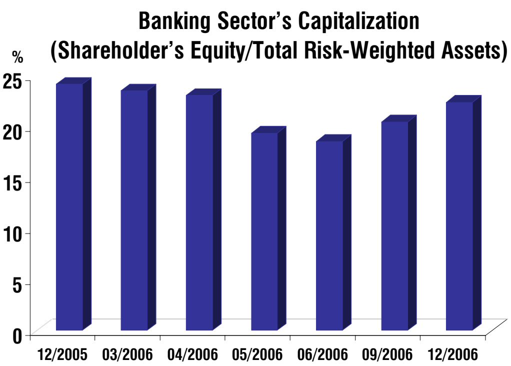
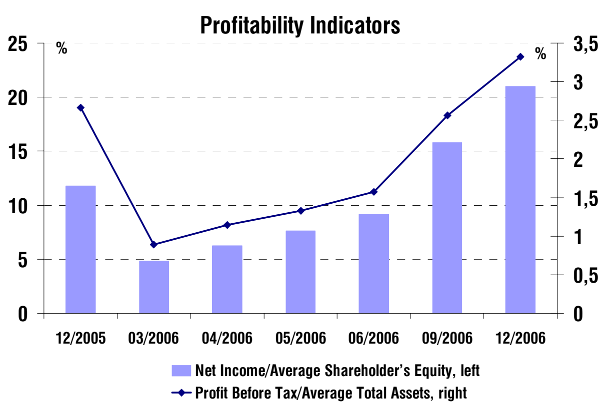


Figure 6.7



A major development in the Turkish banking sector is the introduction of the long-awaited Mortgage Act in February 2007, which will come into effect on January 1st 2008. Before this Act, it was only possible to issue mortgage loans with fixed interest rates. Now, mortgage loans can be issued with both fixed and floating interest rates. In addition, it reduces the level of a bank responsibility, in relation to the compensation for consumer damages. Another important amendment of the Act is the introduction of an effective procedural framework to be followed by banks in cases of bankruptcy or unpaid loans. The Act allows also the securitization of mortgages which permits banks to increase their liquidity.

The new Act, introducing a framework for the primary and secondary mortgage markets, is expected to have a major impact on it. This will come into effect, however, when interest rates are reduced to lower levels. It should be noted here that approximately 3% of house purchases in Turkey are currently financed by mortgages. The low mortgage penetration coupled with the increasing housing needs prevail in the Turkish market. The latter have been fuelled by the increase of immigration to big cities, demographic factors and the need to make antiseismic constructions. The factors cited above reveal the great potential for the mortgage segment. However, a limitation to the mortgages' rapid expansion is the removal of tax incentives in the Act. Thus, mortgage interest payments will not be deductible as it was initially expected.

Deposit Developments

Deposits grew moderately in the first months of 2007. Thus, total deposits grew by 7.9% during the period January- May 2007. Owing to lira appreciation, deposits in foreign currency were the main drag for deposits' expansion. Namely, deposits in foreign currency grew by only 4.8% during the first five months of 2007, or by 16.7% yoy as of May 2007 against 29.1% yoy a year earlier. On the other hand, deposits in domestic currency grew by 10% between the end of December and the end of May 2007 (Figure 6.8).

According to recent data available, deposits are the main component of households' financial assets. Namely, deposits consisted of about 64% of households' financial assets in 2003, with their share increasing to approximately 71% almost three year later. In addition, 61% of household deposits were denominated in domestic currency as of September 2006 compared to 45% almost three years earlier. The second larger component of households is consisted of domestic debt instruments and Eurobonds. However, the share of domestic debt and Eurobonds in the total household's financial assets decreased from 22.4% in 2003 to 12.5% as of September 2006 (Figure 6.9).

Figure 6.8

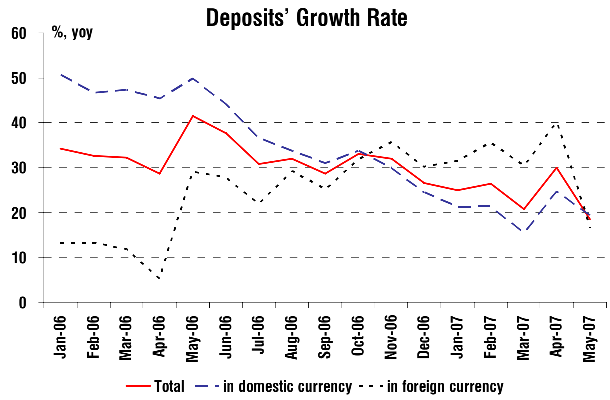
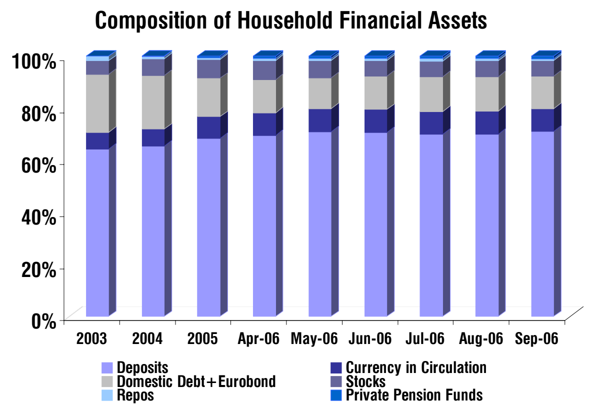


Figure 6.9



Turkey: MacroEconomic Indicators	2001	2002	2003	2004	2005	2006	Q1 2006	Q1 2007
Output and expenditure	*(Percentage Change in Real Terms)*							
GNP	-9.5	7.9	5.9	9.9	7.6	6.0	6.4	–
GDP	-7.5	7.9	5.8	9.0	7.4	6.1	6.5	–
Private consumption	-9.2	2.1	6.6	10.1	8.8	5.2	8.4	–
Public consumption	-8.5	5.4	-2.4	0.5	2.4	9.6	8.1	–
Gross fixed capital formation	-31.5	-1.1	10.0	32.4	24.0	14.0	30.4	–
Exports of goods and services	7.4	11.1	16.0	12.5	8.5	8.5	2.9	–
Imports of goods and services	-24.8	15.8	27.1	24.7	11.5	7.1	8.2	–
Industrial production (in nominal terms)	-8.7	9.4	8.7	9.8	5.4	5.8	3.4	8.0
Labour Market								
Employment	0.0	-0.3	-0.8	2.0	1.7	1.2	-1.1	3.9
Unemployment (in per cent of labor force)	8.4	10.4	10.5	10.3	10.2	9.9	11.9	11.4
Prices	*(Percentage Change)*							
Consumer prices (annual average)	54.4	45.0	21.6	8.6	8.2	9.6	8.1	10.3
Producer prices (annual average)	61.6	50.1	22.7	14.6	5.9	9.3	4.9	10.1
Average monthly wage in industry	31.8	37.2	23.0	13.4	12.2	11.5	11.4	–
Government sector	*(In per Cent of GNP)*							
Consolidated Gonernment Overall balance(IMF)	-17.4	-13.8	-11.2	7.1	-2.2	0.1	–	–
Net public sector debt (IMF)	90.4	78.4	70.3	64.0	55.3	44.8	–	–
Monetary and Financial Indicators	*(Percentage Change)*							
M3	46.7	27.3	34.3	34.7	41.0	19.8	44.0	14.3
Total Credit	33.4	12.4	35.2	50.6	54.2	46.1	52.4	34.4
	(End of Period)							
Reference rate	–	44.0	26.0	18.0	13.5	13.5	13.5	13.5
Exchange rate YTL/USD (end-period)	1.45	1.65	1.40	1.35	1.35	1.41	1.30	1.39
Exchange rate YTL/EUR (end-period)	1.09	1.43	1.69	1.77	1.67	1.86	1.60	1.86
Real Effective Exhange Rate (Index)	116.3	125.4	140.6	143.2	171.4	160.1	173.0	165.6
International Position	*(In per Cent of GDP)*							
Current account balance	2.2	-0.8	-3.3	-5.2	-6.3	-8.2	-7.2	–
Trade balance	-2.4	-4.0	-5.8	-8.0	-9.4	-10.5	-9.8	–
Foreign direct investment, net	2.0	0.5	0.5	0.7	2.4	5.0	2.6	–
Memorandum items	*(Denominations as Indicated)*							
Population (end-year, million)	68.5	69.6	70.7	71.8	72.1		–	–
GDP (in milliards of YTL)	188.1	278.2	375.5	427.1	480.9	551.8	110.3	–
GNP (in milliards of YTL)	176.4	275.0	356.6	428.9	486.4	575.7	107.5	–

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

Turkey: Banking Indicators

	2001	2002	2003	2004	2005	2006	Q1 2006	Q1 2007
Percentage of GDP (%)								
Assets	89.8	76.4	69.6	71.8	85.5	90.6	83.9	–
Total Credit	22.6	17.2	18.0	22.8	31.2	39.7	33.4	–
Credit to Enterprises	17.5	12.3	14.4	18.6	25.5	31.1	27.0	–
Credit to Households	–	2.4	3.6	6.2	9.7	12.5	10.4	–
Deposits	58.6	49.6	43.3	44.7	50.6	55.8	51.8	–
Percentage Change (%, yoy)								
Assets	62.0	25.9	17.4	22.7	29.5	25.9	31.5	31.4
Total Credit	33.4	12.4	35.2	50.6	54.2	46.1	52.4	34.4
Credit to Enterprises	–	3.8	50.5	54.5	53.9	40.1	51.6	–
Credit to Households	–	–	94.4	106.0	76.7	51.8	72.0	–
Deposits	87.3	25.1	12.6	23.0	27.2	26.5	32.3	20.7
Percent (%)								
Capital Adequacy Ratio	15.3	25.1	30.9	28.8	24.2	22.4	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	3.75	4.5	–
Provisions to NPLs	47.1	64.2	88.5	88.1	89.8	90.8	89.6	–
Return on Assets	-5.5	1.1	2.3	2.3	2.7	3.3	0.9	–
Return on Equity	-69.4	9.3	16.0	16.4	11.8	21.0	4.8	–

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