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Deteriorating investor confidence hits regional markets

Bulgaria: Parliament endorses revised fiscal targets for 2010, amid concerns about quality of fiscal statistics

Poland: Acting President Bronislaw Komorowski wins runoff ballot for the presidential post; Government requests new arrangement under IMF's Flexible Credit Line as insurance against external macro shocks

Romania: Constitutional court ruling against IMF-agreed pension cuts forces government to hike VAT rates by 5ppts; Central Bank leaves key rates unchanged at 6.25% on market worries over the progress of the IMF-led stabilization program and the inflationary effects of VAT rate hikes

Serbia: New central bank governor against Dinar appreciation in the period ahead

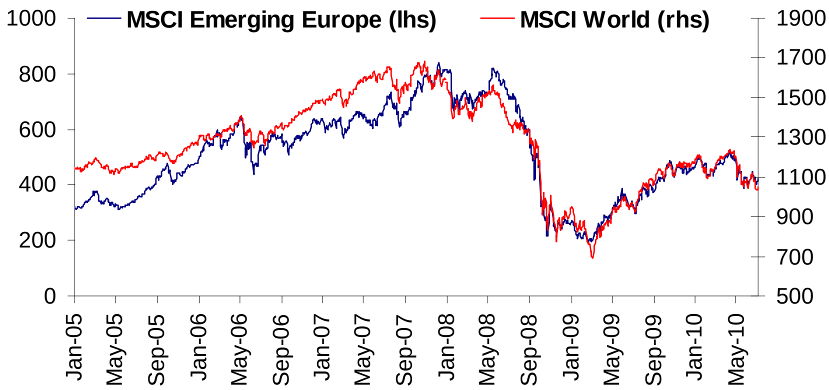
Turkey: Q1 GDP growth higher than expected; pace of economic recovery likely to slowdown in the following quarters; CBRT maintains its key policy rate unchanged at 7.00%, voices optimism over domestic inflation dynamics

Ukraine: IMF mission visited Kiev for the second time in June to discuss economic policies supported by a new Stand-By-Arrangement (SBA)

New Europe market strategy highlights

- Liquidity conditions in regional markets remain thin and the price action choppy. Uncertainty remains high over the pace of the global economic recovery, with market participants trying to evaluate the potential spill-over effects of the lingering sovereign debt crisis in the EMU.
- As a result, doubt has been also cast on central bank policy deliberations ahead. With the picture unlikely to become more transparent in the imminent future, we expect risk aversion to prevail and keep riskier assets under pressure over the coming weeks. In this environment, we maintain relative low risk exposure to the region.

Financial markets in the region remain under pressure as risk aversion weighs



Source: Bloomberg

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Introductory Comment

Dear reader,

Macroeconomic conditions in New Europe continue to improve in the second quarter of 2010. High frequency indicators and survey data suggest that the economic rebound remains on track. Most economies in the region are now expected to feature positive, yet below potential, GDP growth in 2010. Thanks to improving conditions in major trading-partner economies, exports are recovering fast. The rebuilding of inventories and base effects also remain supportive factors for the ongoing recovery.

The speed of recovery is not uniform across the economies of New Europe and depends largely on the intrinsic characteristics of each particular economy. Turkey and, to a lesser extent Poland, are expected to outperform the rest of the league, partly because the global financial crisis found these economies with relatively low levels of financial leverage and in a better position to deal with external shocks. Serbia and Ukraine show signs of improvement, featuring a moderate growth rebound. Bulgaria and Romania are expected to display broadly flat, or even slightly negative, GDP growth this year. Yet this would be accompanied by aggressive fiscal consolidation efforts and single digit current account deficits.

On the monetary policy front, most central banks in the region have already completed their monetary-easing cycles. Yet, heightened market jitters from the ongoing fiscal crisis in Western Europe as well as the necessity to maintain low interest rates to support the economic recovery, suggests that a generalized shift to monetary policy tightening is still some way off.

Inflation concerns have remained off policy makers´ agendas for some time. Yet we do see increasing upside price risks in the second half of the year, driven by weaker currencies, tax hikes and bad weather conditions, which have been much harsher in some countries.

On the fiscal front, the accomplishment of the fiscal targets set in 2010 will be a major challenge, requiring additional efforts by most governments in the region. Many of them are faced with the dilemma of pursuing highly unpopular policies with a view to promote fiscal consolidation, support medium-term macroeconomic stability and secure much-needed funding from international organizations.

The ongoing fiscal crisis is broader and affects EMU as well, casting doubts over the sustainability of its economic rebound. Market sentiment deteriorated further in recent weeks on growing worries over the sustainability of the global economic recovery and lingering concerns about Euro Area´s stability. Contagion fears and the degree of exposure of European banks to Euro Area sovereign and private debt have added to market jitters.

Financial markets in New Europe came under renewed pressure in recent weeks, largely trailing global developments. The region's high growth correlation with the crisis-hit EMU economies and country-specific domestic fragilities are likely to keep market participants on edge in the short-term.

In this challenging environment, local government bond yields remain near multi-month highs, which were touched in late June. Also, most regional currencies continue to be under pressure amid heightened risk aversion. Emerging external debt markets have also went through of correction phase lately, with five-year credit default swaps spreads in New Europe currently standing not far off multi-month highs touched a month earlier.

We maintain a constructive view on the medium-term outlook of most economies in New Europe and expect regional markets to recover once global uncertainties subside.

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Chief Economist & Director of Research

Summary of key macroeconomic indicators
Realizations and forecasts

	GDP real (yoy)			Consumer Prices (annual average)			Current Account (%GDP)		
	2009	2010f	2011f	2009	2010f	2011f	2009	2010f	2011f
Bulgaria	-5.0	-0.3	2.5	2.5	2.2	2.7	-9.4	-6.0	-7.0
Poland	1.8	2.8	3.1	3.5	2.5	2.7	-2.0	-3.0	-3.2
Romania	-7.1	0.0	3.5	5.6	6.5	4.5	-4.4	-5.5	-6.0
Serbia	-3.0	1.5	3.0	8.2	4.5	4.8	-5.7	-8.5	-9.0
Turkey	-4.7	6.0	4.5	6.3	8.3	7.2	-2.2	-4.5	-5.3
Ukraine	-15.1	3.0	3.2	16.0	10.5	10.0	-1.7	-1.0	-2.1
New Europe	-4.3	3.6	3.7	6.5	5.3	5.7	-2.7	-3.9	-4.5
Euro area	-4.1	1.0	1.8	0.3	1.2	1.5	-0.6	0.0	0.2
USA	-2.4	3.2	3.4	-0.4	2.4	2.5	-2.9	-3.3	-3.4

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

Foreign exchange and policy interest rates
Realizations and forecasts

		FX Rates			Interest Rates		
eop		2009	2010f	2011f	2009	2010f	2011f
Bulgaria	**vs EUR**	1.96	1.96	1.96	*Currency Board*		
Poland	**vs EUR**	4.10	4.10	3.90	3.50	3.50	4.00
Romania	**vs EUR**	4.23	4.30	4.15	8.00	6.25	6.50
Serbia	**vs EUR**	96.2	105.0	110.0	9.50	7.50	7.00
Turkey	**vs USD**	1.50	1.55	1.45	6.50*	7.75	8.50
Ukraine	**vs USD**	8.05	8.10	8.20	10.25	9.50	9.50
Euro area	**vs USD**	1.43	1.18	1.10	1.00	1.00	1.00
USA	**vs EUR**	0.70	0.85	0.91	0.125	0.125	1.00

Source: National statistics, IMF, EC, Eurobank Research forecasts
*As of May 2010 the CBRT's key policy rate is the 1-week repo rate

I. Overview

Economic recovery sustainability worries keep world markets on edge

Market sentiment deteriorated further in recent weeks on heightening worries over the sustainability of the global economic recovery. The tentative revival witnessed in the US housing market since mid-last year has come to a halt over the last few months, following the expiration of the federal home buyer tax credits. US new home sales plunged to record lows in May, while sales of previously owned homes unexpectedly dropped in the same month, even though mortgage rates remained near all-time lows. To add to intensifying growth-related woes, non-farm payrolls declined in June for the first time this year while the pace of expansion in the US manufacturing sector, as indicated by the ISM index, has slowed down in the last couple of months, following a peak earlier in 2010. Not surprisingly, at its latest policy meeting (June 22-23) the FOMC adopted a more downbeat tone about the pace of the US economic recovery with the accompanying statement reading that economic activity "is proceeding" as opposed to the April statement saying that "has continued to strengthen".

Lingering EMU stability concerns fuelling risk aversion

Lingering euro area stability concerns and ensuing contagion fears have also contributed to the latest bout of risk aversion. Meanwhile, participants are increasingly worried that fiscal consolidation in EMU debt-laden economies will likely derail the pace of economic recovery, with fears over the degree of banks' exposure to euro area sovereign and private debt adding to market jitters. In its latest quarterly economic report, the Bank for International Settlements warned that banks based in the euro area accounted for $1.58trn or 62% of all internationally active banks' exposures to fiscally-vulnerable Greece, Spain, Portugal and Spain, with German and French banks being the most exposed. Meanwhile, worries over the outlook of the European banking sector intensified as banks in EMU-periphery countries remain heavily reliant on ECB funding. Bank of Portugal figures showed that ECB borrowing by domestic banks doubled in May to a record €35.8bn from €17.7bn in the prior month, while banks in Greece, Portugal, Spain and Ireland have borrowed more than two-thirds of the increase in ECB lending to eurozone financial institutions between June 2008 and May 2009. Separately, S&P's rating agency announced recently that it raised its estimate for Spanish banking sector loan losses in 2009-2011 due to faster deprecation of real estate assets, while Fitch downgraded PNP Paribas by one notch citing "structural issues". Against this environment, the Fed's renewed pledge last month to keep interest rates at current historically low levels for an extended period and the recent announcement by the People's Bank of China about making the yuan´s exchange rate regime more flexible failed to exert any significant support to market sentiment.

Global financial markets under pressure on deteriorating market sentiment

After partly recouping steep losses suffered in late May, when concerns about the euro area's credit crisis reached unprecedented levels, global stock markets re-embarked on a downward trend on global macro worries and uncertainty over the stability of the European banking sector. The FTSE Eurofirst 300 index slid to a six-week low in early July, currently hovering just 4% higher from a 9-month low hit in late May. In the European corporate credit space, the iTraxx Crossover index, which is constituted of 50 (mostly junk-rated) European credits, stood at the time of writing just 70bps narrower from a 9-month peak of 628bps hit a month earlier. Its investment-grade counterpart, iTraxx Europe index, remained not far off a one-year peak near 140bps recorded in early June. Elsewhere, , the S&P 500 implied volatility index, VIX, hit 3-week closing highs near 35 in late June, approaching anew a 15-month peak of 45.8bps hit a month earlier. Similarly, money markets remained under stress over the last few weeks with the LIBOR rates reaching fresh multi-month highs in late June.

Regional markets under renewed pressure

Financial markets in New Europe came under renewed pressure in recent weeks on lingering sovereign credit concerns in the euro area and growing worries over the pace of the global economic recovery. The *MSCI Emerging* and *Eastern Europe* sub-indices each stood ca 12% lower year-to-June, trailing losses recorded by the *Developed World* sub-index. Ukraine's PFTSI index remains an outperformer, having registered gains in the excess of 32% year-to-early July. Turkey's main stock market index is another bright exception, standing in early July in a slightly positive territory (ca 3%) relative to its end-2009 levels. Despite these positive trends, the region's growth correlation with the crisis-hit Eurozone economy and country-specific domestic fragilities are likely to keep market participants on the edge in the months ahead. In this challenging environment, many governments in the region are currently faced with the dilemma of pursuing highly unpopular policies with a view to promote fiscal consolidation, support medium-term macroeconomic stability and secure much-needed funding from international organizations. In Romania, a Constitutional Court ruling against part of the government's austerity measures raised concerns about the country's fiscal position and the progress made on the IMF rescue deal. Even so, the Fund approved a scheduled tranche disbursement in early July after the government increased the VAT rate in order to compensate for lost budgetary revenues as a result of the to court ruling. Similar, worries loom over Hungary, where the newly elected government recently announced measures, aiming to contain the 2010 budget deficit at 3.8%-of-GDP levels. Elsewhere, Ukraine's government is close to sealing a new IMF loan, after the previous $16.4bn financial aid programme was suspended late last year as a result of diverging opinions on fiscal-related issues between the previous administration and the Fund.

Local rates move higher on deteriorating investor sentiment

Government bond yields remain near multi-month highs touched in late June on heightened risk aversion. At the time of writing, Poland's 2- and 10-year benchmark yields stood just 20bps narrower from 3-month peaks around 4.96% and 6.03%, respectively touched in late June. Similarly, Hungary's 10-year benchmark rate stood at 7.60% compared to a 9-month peak near 8.10% touched early last month. On the other hand, Turkey's January 2012 benchmark bond yield hit in early July a 5-month low near 8.50% on improving domestic inflation dynamics. Taking into account that the global macro worries are likely to persist in the short-term, we expect regional rate markets to remain under pressure in the coming weeks, despite still negative output gaps and relatively subdued inflation pressures. On the monetary policy front, the recent weakening in regional currencies and VAT rate hikes in Hungary and Romania have prompted a scale back in rate easing expectations for the period ahead. On the other hand, rate hike expectations in Turkey and, to a lesser extent, Poland have retreated somewhat in recent weeks on growing worries over the global economic outlook.

Regional FX markets remain close to recent multi-month lows

Albeit slightly firming over the last few sessions, local currencies remain close to recent multi-month lows as concerns about the sovereign debt crisis in the euro area and the pace of the global economic recovery continue weighing on sentiment towards the region. The Polish zloty hit on June 29 a near six-month trough of 4.1762/EUR, while the Turkish lira remains not far off a 1-year low of 1.6175 touched in early June. The Hungarian plunged to a 1-year low of 290.33/EUR early last month, when concerns about the country's fiscal outlook escalated, while the Serbian dinar remains close to an all-time low of 104.81/EUR recorded last month. Elsewhere, Romania's leu temporarily touched in late June a record low of 4.4023 against the single currency, after the Constitutional Court ruled against part of the government´s fiscal austerity package, fanning worries over the country's fiscal outlook. New Europe FX is likely to remain primarily driven by global developments in the near-term. And, as the global macro outlook is likely to stay blurry in the imminent future, a sustainable appreciation trend may be still some way off.

External debt markets remain under pressure

Emerging external debt markets have come under renewed pressure over the last few weeks. Returns on the EMBI+ index stood ca 5% higher year-to-July 2. Yet, spreads over US treasuries on the index stood around 340bps in early July, compared a 2-½-year low of 230bps recorded in April. In a similar vein, five-year credit default swaps spreads in New Europe remained not far off multi-month highs touched in early June. Romania and Bulgaria remain among the main underperformers in the region on concerns about their domestic state finances. In detail, Bulgarian and Romanian 5-year CDS spreads each rose by more than 120bps in June to currently stand at levels around 400bps.

Economic recovery in the region continues, but pace may prove slower than expected previously

The most recent macroeconomic data confirm that the economic recovery in New Europe continues, though the region is unlikely to escape the EMU sovereign debt crisis entirely unscathed. Serbia's GDP growth rose for the first time in eight quarters in Q1 2010, though it recorded a smaller-than-expected rise of 0.6%yoy. Elsewhere, Turkey's Q1 GDP grew by 11.7% yoy in the first quarter of this year, after rising 6.0% yoy in Q4 2009. Nevertheless, risks to the economic recovery in New Europe continue to lie ahead. Main risks to the economic outlook in the region remain in the face of weaker growth in major trade-partner economies and domestic fiscal austerity measures. Social unrest and political jitters should not be ruled out either, as governments in the region introduce unpopular policies to address deteriorated fiscal dynamics.

New Europe Markets Outlook & Strategy

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Liquidity conditions in regional markets remain thin and the price action choppy. Uncertainty remains high over the pace of the global economic recovery, with market participants trying to evaluate the potential spill-over effects of the lingering sovereign debt crisis in the EMU.

As a result, doubt has been also cast on central bank policy deliberations ahead. With the picture unlikely to become more transparent in the imminent future, we expect risk aversion to prevail and keep riskier assets under pressure over the coming weeks. In this environment it appears prudent to maintain a low risk exposure to the region.

In FX, we do not expect regional currencies to embark on a sustainable appreciation trend in the short-term. The rebound in New Europe economies is now encountering a number of important headwinds, expectations for monetary policy tightening in the region have lately been scaled back, and sentiment remains fragile. Lingering worries over the region's fiscal outlook are also weighing on market sentiment.

Along these lines, taking into account that FX presently appears to be the most liquid asset class in the EM space, short positions (mainly via call spreads) in regional currencies vs. the USD and the EUR, remain appealing in the short-term. From a more medium-term perspective, we remain constructive on the outlook of regional FX markets and we expect local currencies to re-embark on lasting an appreciation trend once present uncertainties subside.

In the **local rates market**, the near-term outlook remains blurry. Scaled back expectations over the timing of the inception of monetary tightening cycles by central banks in the region are supportive of local currency denominated bonds. However, upside potential in the local rate markets appears rather limited at present as global risk sentiment remains fragile.

With regards to **sovereign credit** in New Europe, the recent bout of risk aversion pushed regional 5-year CDS spreads wider. Although this may appear as a *buy-on-dips* opportunity, there may still be limited value in external credit in the imminent future, in view of the recent deterioration in investor sentiment.

II. New Europe – Country Analysis

Bulgaria

Revised fiscal targets for 2010 endorsed

- **Parliament endorses revised fiscal targets for 2010, amid concerns over quality of fiscal statistics**
- **Shift to a new growth paradigm required to maintain the Bulgarian economy in a convergence path**

Parliament endorses revised fiscal targets for 2010

In view of the deteriorating fiscal situation, the Bulgarian parliament endorsed recently revised fiscal targets for this year. The latter provide for a (cash-based) deficit target of 4.8%-of-GDP compared to a 0.7%-of-GDP deficit planned initially. It also forecasts that total revenues will reach BGN 15.2 bn, an amount lower by 11% yoy *(or 2.9%-of-GDP*) relative to an original target of BGN 17.1 bn. On the expenditure side, total budget outlays this year are now seen amounting to BGN 18.9 bn or 5.7% yoy higher than the initial target of BGN 17.9 bn.

The budget execution data for the first five months of 2010 have demonstrated that the initial fiscal targets were unrealistic, particularly on the revenues side. The (cash-based) budget deficit reached BGN 1.36 bn (or 2% of projected GDP) in January-May, which compares with a surplus of 0.8%-of-GDP over the same period a year earlier. After recording a surplus of BGN 0.3bn in April -- thanks to the transfer of profits from the Central Bank and the dividends of state-owned energy distribution companies --, the budget recorded a deficit of BGN 60 mn in May.

The lingering economic downturn has had a pronounced (negative) effect on budgetary revenues, which declined by 15.2% yoy in the first five months of this year. Although VAT receipts increased by 30% yoy in May, they are still lagging behind, having fulfilled only 29.2% of the corresponding full year target. On the other hand, increased spending on pensions and unemployment benefits boosted government expenditure, which rose by 16.2% yoy in Q1. However, the government put an extra effort to limit the expenditure of ministries in April-May. As a result, overall expenditure growth in January-May was contained at 2.2% yoy.

Bulgaria: Eurobank EFG Forecasts

	2008	2009	2010f	2011f
Real GDP (yoy%)	6.0	-5.0	-0.3	2.5
Private Consumption	4.8	-6.2	-2.5	2.0
Government Consumption	0.0	-5.7	-0.1	0.4
Gross Capital Formation *(Fixed)*	20.4	-26.9	-8.7	2.5
Exports	2.9	-9.8	5.0	5.0
Imports	4.9	-22.3	-1.5	4.0
Inflation (yoy%)				
HICP (annual average)	12.0	2.5	2.2	2.7
HICP (end of period)	7.2	1.6	2.5	3.0
Fiscal Accounts (%GDP) - *EU Methodology*				
General Government Balance	1.8	-3.9	-3.8	-2.8
Gross Public Debt	14.1	14.8	17.0	18.8
Primary Balance	3.9	0.0	-2.0	-1.5
Labor Statistics - *National Definitions*				
Unemployment Rate (% of labor force)	6.3	7.6	9.0	8.0
Wage Growth *(total economy)*	26.5	8.5	2.0	2.5
External Accounts				
Current Account (% GDP)	-25.4	-9.4	-6.0	-7.0
Net FDI (EUR bn)	6.2	3.3	2.0	1.5
FDI / Current Account (%)	75.8	103.6	98.0	60.0
FX Reserves (EUR bn)	12.7	12.9	12.0	11.5
Domestic Credit	**2007**	**2008**	**Q4 09**	**Q1 10**
Total Credit (%GDP)	67.1	75.2	79.2	78.9
Credit to Enterprises (%GDP)	43.0	47.8	49.4	49.2
Credit to Households (%GDP)	23.0	26.0	28.2	28.1
FX Credit/Total Credit (%)	50.4	57.2	58.6	59.5
Private Sector Credit (yoy)	65.9	32.3	4.5	3.3
Loans to Deposits (%)	97.0	119.3	120.5	116.3
Financial Markets	**Current**	**3M**	**6M**	**12M**
Policy Rate		Currency Board		
EUR/BGN	1.96	1.96	1.96	1.96

Source: National Sources, Eurostat, IMF, Eurobank Research

EU commission expresses concerns over quality of Bulgaria's fiscal statistics

The quality of fiscal statistics in Bulgaria has lately come to the epicenter of investor interest. Initially, the discovery of additional annexes in public procurement contracts led to significant revisions in 2009 fiscal data. Last year's fiscal deficit *(on an accrual basis)* was revised to 3.9%-of-GDP, which is above the 3%-of-GDP threshold set by the Maastricht treaty. The sudden and sharp revision has unavoidably waken up memories of the fiscal situation in Greece and Hungary.

Later on, the government also decided to revise its budget targets for 2010. The revision led the EU Commission to express some concern over the quality of Bulgaria's fiscal accounts. In addition, EU Commission stated it was not in a position to assess the budgetary situation without more details from the Bulgarian authorities. As a result, Eurostat is sending a mission to carry out an investigation on the efficacy of the revised fiscal targets for 2010. On their part, authorities argued that the delay to notify Eurostat of the budget revisions is linked to the legislative process.

As we alluded in our previous *New Europe Economics & Strategy* issue, we anticipate that EU Commission will increase the level of scrutiny in all economies of New Europe given the recent experience with Greek statistics. Nevertheless, we should note that Bulgaria's fiscal data for 2009 are not any more in question, as the recent revisions have been already approved by Eurostat. In any case, these revisions represent a blow to Bulgaria's past fiscal record and the credibility of data reporting. As a result, markets will not only be closely monitoring fiscal developments but also become more sensitive to negative news on that front. As a result, it is imperative for Bulgaria to achieve the revised fiscal targets for 2010 or the country risks losing investor confidence, with negative implications for the perceived stability the of currency board. Reflecting on these developments as well as contagion risks stemming from the ongoing EMU debt crisis, the Bulgarian 5Y-CDS spread widened significantly recently, hitting 384.5 bps (on June 30th) against 250 bps in late March.

On a more positive note, the fiscal situation in Bulgaria appears to still be healthier compared to those of other EU members. The revised draft of the budget foresees that the 2010 fiscal deficit in ESA 95 terms (EU methodology which calculates the deficit on an accrual basis) would reach 3.9% of GDP. According to the latest EU forecasts, the EU-27 fiscal deficit will reach 7.2% of GDP in 2010. Furthermore, Bulgaria's public debt ratio stood at 14.8% of GDP which is the third lowest in the EU in 2009 behind Estonia and Luxemburg.

Domestic economy in need of new growth paradigm

The Bulgarian economy has been a major beneficiary of strong capital inflows in the region in recent years. Driven by strong convergence prospects, Bulgaria received some €27.1 bn in FDI inflows in 2004-2008. These inflows supported an economic boom, which was translated in a rise in the standards of living. Reflecting on these favorable developments, GDP per capita as percentage of EU-15 in PPS terms increased from 29.8% in 2004 to 37.3% in 2008, a cumulative increase of 8pps.

Strong capital inflows to Bulgaria in the years before the escalation of the global financial crisis in late 2008 provided a strong boost to domestic demand, primarily private consumption and investments in less productive sectors of the economy, including housing. The strong rise in domestic demand translated to higher GDP growth and employment rates, but also double digit inflation and wage growth.

Meanwhile, the lack of adequate supply of domestic resources resulted in a sharp rise of imports in the period 2004-2008, which subsequently led to unsustainable current account deficits. The rise in the share of consumption and investments above the level of GDP during that period is a clear illustration of the aforementioned trends. At the same time, the majority of these inflows were channeled to non-tradable sectors at the expense of not enhancing the export capacity of domestic economy. The most representative sector in the case of Bulgaria was that of the real estate market.

If there is something that the global financial crisis has taught us, is that the time of abundant capital inflows has passed. Capital inflows in the region are highly unlikely to reach their pre-crisis levels. As such, the global economic crisis has prompted a serious test of the growth model in Bulgaria in recent years. The Bulgarian government needs to take of advantage of this historic opportunity to maintain the Bulgarian economy in convergence orbit with EU average living standards. In turn, Bulgaria needs to tap into new sources of growth in the medium term. This can only be accomplished through two main channels.

The first one is to take advantage of EU funds. In that respect, Bulgaria has a significant comparative advantage over other emerging markets in the broader region. Bulgaria is entitled to a trust of €13bn in the designated period 2007-2013. However, Bulgaria has managed to absorb only 4.6% of the EU funds according to the latest data in June. That said, better utilization of EU structural funds could give potential growth a significant boost. For that reason, the absorption and management capacity of EU funds needs to improve significantly. The second one could come from increasing the domestic economy´s total factor productivity. A prerequisite for the last to happen is that the government focuses on structural reforms.

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Poland

Request for a renewal of the IMF's Flexible Credit Line

- **Marek Belka appointed new President of the National Bank of Poland**
- **Acting President Bronislaw Komorowski wins runoff ballot for the presidential post**
- **Poland requests new arrangement under the IMF's Flexible Credit Line (FCL) for an amount ofSDR 13.69bn (ca. $20.1bn) covering a period of 12 months. The new FCL facility is expected to provide a powerful insurance against external economic shocks.**
- **Central bank seen remaining on hold on rates for the remainder of the year**

Acting President Bronislaw Komorowski wins presidential elections

Final results of the runoff ballot for the presidential post on July 4 confirmed election of the acting President and speaker of parliament Bronislaw Komorowski *(53% of the vote).* Former Prime Minister, leader of the main opposition party and twin brother of the deceased President, Jaroslaw Kaczynski, followed with a share of 47% of the vote. Most recent opinion polls had signalled a neck and neck race. Note that in the first round the former led the polls with 41.5% of the vote, while the latter had come second achieving 36.5%. Komorowski's victory has been broadly perceived as positive for financial markets. He was the ruling party's candidate and is expected to cooperate efficiently with the government on the adoption of the euro and on fiscal policies aiming to eliminate the country's excessive budget deficit in the coming years. Jaroslaw Kaczynski and his deceased brother had in many occasions been at odds with the government. That said, the tight victory Komorowski achieved casts some doubt on the government's future reform progress ahead of next year's parliamentary elections. Komorowski backs a specific timetable for euro adoption, tight fiscal policies aiming at curbing country's budget deficit and he is pro-market reforms. In contrast, Kaczynski is known for opposing setting a date for euro adoption and calls for increasing spending to offset the impact of the global crisis. Kaczynski's base is made up of older, rural and religious Poles.

According to the Polish constitution, the President, along with the Parliament, is responsible for foreign policy, represents Poland abroad and is the head of the army; hence he can exert considerable influence in the above

Poland: Eurobank EFG Forecasts

	2008	2009	2010f	2011f
Real GDP (% yoy)	5.0	1.8	2.7	3.1
Private Consumption	5.8	2.3	2.7	3
Government Consumption	7.4	1.9	2.4	0.5
Gross Capital Formation	6.4	-13.8	-0.2	1.8
Exports	7.3	-7.8	6.0	5.5
Imports	8.4	-13.5	5.8	6.5
Inflation (% yoy)				
CPI (annual average)	4.2	3.5	2.5	2.7
CPI (end of period)	3.3	3.5	2.7	2.8
Fiscal Accounts (% GDP)				
General Government Balance	-3.7	-7.1	-7.3	-7.0
Gross Public Debt	47.2	51.0	55.0	57.0
Labor Statistics (%)				
Unemployment Rate (% of labor force)	9.8	11	12.3	12.4
Wage Growth *(private sector - average)*	NA	4.2	3.0	3.2
External Accounts				
Current Account (% GDP)	-5.0	-2.0	-3.0	-3.2
Net FDI (bn EUR)	8.0	6.1	7.5	8.5
FDI / Current Account	43.7	122.2	80	85
FX Reserves (bn EUR)	40.6	54.8	62	64
Domestic Credit	**2007**	**2008**	**2009**	**Q1-10**
Total Credit (% GDP)	40.4	50.9	53.1	52.2
Credit to Enterprises (% GDP)	14.8	17.6	16.1	15.7
Credit to Households (% GDP)	22.3	29.7	31.6	31.6
FX Credit/Total Credit (%)	23.6	32.6	30.2	29.3
Private Sector Credit (% yoy)	34.1	38.1	7.2	1.2
Loans to Deposits (%)	93.1	106	102.6	100.6
Financial Markets	**Current**	**3M**	**6M**	**12M**
Policy Rate	3.5	3.5	3.5	3.75
EUR/PLN	4.1	4.0	4.1	4.0

Source: NBP, Ecowin, Bloomberg, Eurobank Research

areas if he so desires. In addition, the Polish president has the power to veto any laws. His veto can be overridden by a 3/5 parliamentary majority, which is difficult for any parliament to achieve. For this reason a win for Komorowski is expected to consolidate the present government's position, ending divisions that caused frequent conflict during Lech Kaczynski's presidency.

Marek Belka appointed as new NBP President

On June 10, Poland's 450-seat parliament approved, with 253 votes, Professor Marek Belka as the new President of the National Bank of Poland (NBP). Belka, aged 58, has served as a Director of the IMF European Department and is widely respected economist. The President of the NBP serves a six-year term, meaning that Belka will be heading the central bank as Poland moves toward euro adoption. Belka's appointment represents a solid choice; he pledged to defend the stability of the zloty and cooperate with the government. His appointment is unlikely to prompt a marked shift in the MPC (Monetary Policy Council) decisions.

IMF Flexible Credit Line to be renewed

Only a few days after Belka´s appointment at the helm of the central bank, Poland requested a new arrangement under the IMF's Flexible Credit Line (FCL)[1] for an amount of SDR 13.69bn (ca. $20.1bn) covering a period of 12 months. The first FCL arrangement with Poland was approved on May 6, 2009 and expired unused on May 5, 2010. A successor FCL arrangement would provide a useful insurance against external risks. The IMF has already welcomed Poland's interest in FCL renewal and intends to seek approval of the request in early July.

Fiscal adjustment is being delayed until 2012

A big challenge facing the government in 2010 is to keep the public debt ratio below the 55%-of-GDP constitutional threshold. With the government's main priority being currently to support domestic growth and alleviate the impact of recent flooding, the fiscal deficit is likely to remain around 7% of GDP in 2010. The government plans to have completed many of the EU co-financed capital projects by the end of 2011. This should allow considerable cut backs in capital spending in 2012, with a view to lower the fiscal deficit. Parliamentary election in late 2011 (which may be brought forward *i.e., in the first semester of next year* since Poland is taking over the European Union Presidency in H2-2011) is not conducive to any significant fiscal adjustment in 2010.

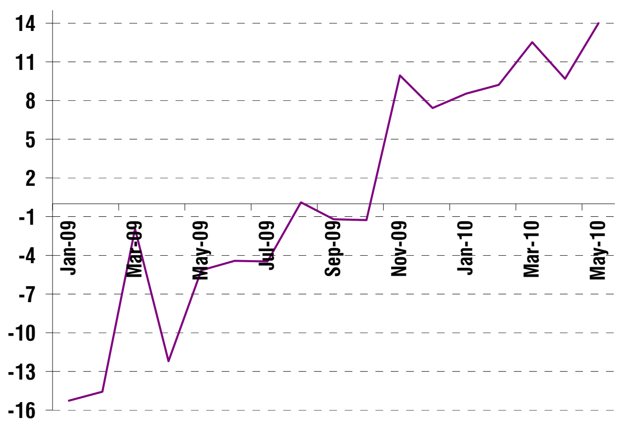
Domestic growth environment remains sound

The Q1 GDP report showed that inventory building contributed ca 2.0 ppts to overall economic growth, while investment had a negative contribution of -1.8ppts. The decline in investment spending was largely attributed to a very bad weather, which hurt Polish construction activity significantly. Hence, it is likely to prove temporary. The present cycle of inventory rebuilding is likely to ebb gradually in the following months, whereas private investment will remain constrained by low capacity utilization in the industrial sector. Yet, public investment is likely to accelerate further as many of the EU co-financed infrastructure projects will have to be completed by end-2011, on time for the hosting of the 2012 European football championship. On a more positive note, industrial production in May came in stronger than anticipated. It grew by 14% yoy, following a 9.7% yoy rise in April and comparing with the +7.0% yoy market consensus forecast. Moreover, the manufacturing PMI recorded in June its highest headline reading in almost three years, reaching 53.3, vs. 52.2 in May and remaining well above the 50-mark which separates expansion from contraction. (Figure 1) In all, we expect total investment to record broadly stagnant growth in 2010, following a 13.8 yoy contraction in 2009.

On the consumer sector, retail sales in May have surprised on the upside, increasing by 4.3% yoy, following a 1.6% yoy decline in the prior month. Wage growth also came out better than expected; it stood at 4.8% yoy in May vs. 3.2% yoy rise in April and consensus expectations of 3.8% yoy. Overall consumption growth *(both private and public)* is expected to accelerate further this year, providing, along with higher exports, the main driver of GDP growth, We forecast GDP growth of 2.8% yoy in 2010, but see some risks of (temporary) weakening in growth dynamics in the second half of this year, as a result of the lingering debt crisis in the euro area.

Figure 1

Industrial production acceleration



Source: National Statistics, Eurobank Research

Inflation pressures remain muted

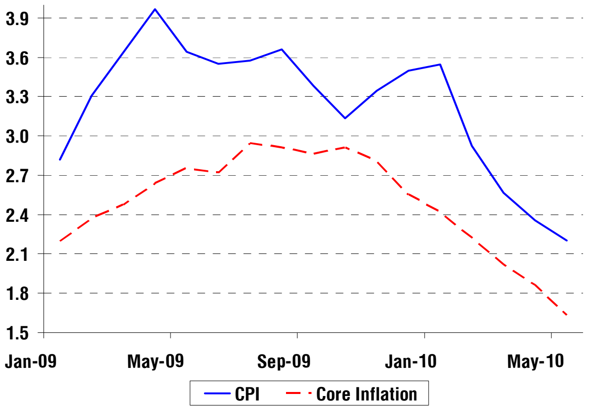
Domestic prices have eased considerably since the beginning of the year, with disinflation becoming widespread in virtually all major components in the CPI basket. The decline in food inflation reflects softer world food prices as well as the lag impact of the earlier zloty appreciation. On the other hand, lower inflation in the services sector reflects weaker wage growth and subdued demand-driven pressures. What's more, core inflation, *i.e., headline CPI excluding the volatile food and energy prices,* is decelerating too. Core inflation

[1] The FCL is an instrument established in March 2009 and is available to countries with strong fundamentals, policies and track records of policy implementation. Access to FCL based on country having met these criteria, rather than on fulfilling ex-post performance criteria.

stood at 1.6% yoy in May (lowest reading since January 2008) compared to 1.9% yoy in the prior month. (Figure 2)

Figure 2

Headline and core CPI on a deceleration trend since the beginning of 2010



Source: National Statistics, Eurobank Research

We anticipate annual inflation to average 2.5% yoy in 2010 compared to 3.5 % yoy in 2009 on the back of still weak domestic demand dynamics. However, the impact of the recent flooding coupled with the zloty´s recent weakening pose some upside risks to the inflation outlook in the period ahead.

NBP likely to stay put on rates for the remainder of the year

The National Bank of Poland (NBP) kept its policy interest rate unchanged at 3.50% in late June. This was the 12th consecutive month of a *no-policy-change* decision. Notably, the Monetary Policy Council, which held its first meeting under the new President Marek Belka, appears to have adopted a slightly more hawkish stance relative to the prior policy meeting, as a result of rising inflation risks and the recent zloty weakening. As we have already stated, we do not anticipate any interest rate hike in 2010, given the domestic benign inflation outlook and the recent scaling back of ECB rate hike expectations.

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Romania

Constitutional court decision made tax hikes inevitable

- **The Constitutional court ruling that the IMF-agreed pension cuts are illegal forces the government to hike VAT rates by 5ppts to 24%**
- **Central Bank leaves key rates unchanged at 6.25% on market worries over the progress of the IMF-led stabilization program and the inflationary effects of VAT hikes**

No confidence vote fails to bring down government coalition

The government coalition survived on June 15 a no confidence vote initiated by the leftist main opposition party, PSD, in an attempt to boycott the IMF-agreed austerity fiscal package Specifically, 228 parliament members voted for the motion, 197 against, while 13 abstained. These compare with a majority of 236 votes needed to bring down the government. The latter had earlier invoked an emergency situation to ask for an endorsement of the package in the parliament. The opposition argued against the implementation of pension cuts on the basis that they would trigger a "social genocide". In contrast, Prime Minister Emil Boc characterized the proposed spending cuts as a responsible decision in order for the government to be able to service its obligations.

Although the PSD was unsuccessful to pass in parliament a non-confidence vote against the government, it may again attempt to do so before the end of the year (most probably in autumn). On the other hand, the endorsement of the IMF-agreed package in parliament in mid-May and open criticism by President Trian Basescu against a number of key ministers of the ruling PDL party have sparked rumors over an imminent cabinet reshuffle. Mr. Basescu gave the current cabinet a certain deadline (by September 1) to fully implement the required structural reforms. In addition, he warned that the ministers who would not complete them by that time would be replaced. In that sense, the threat of a cabinet reshuffle may cause frictions among the coalition partners, without necessarily boosting the productivity of the weak government coalition.

Constitutional court's decision against pension cuts leads to VAT hikes

The Constitutional court ruled that part of the fiscal austerity package was unconstitutional. The court rejected the 15% cut in pensions and the recalculation of magistrates' pensions. These created an estimated gap of 0.7% of GDP in the 2010 budget. As a result, the government had little choice but to proceed with alternative revenue-enhancing measures. Effectively from July 1, the Ministry of Finance decided to hike the VAT tax rate from 19% to 24%.

We expect the VAT rate hike to have a number of implications for the domestic economy. At first sight, it appears that the hike counterbalances the budgetary impact of the cancellation of the 15% pension cut. The latter was estimated to reduce the budget deficit by 0.7ppts of GDP. Note that for each percentage point increase in the VAT rate, the gain to the budget in term of additional revenue is estimated at 0.16ppts. However, this estimate is based on the unrealistic assumption that consumption will remain constant relative to 2009, even though a 25% cut in public wages has already been endorsed.

All the above support our view that the risk of the VAT rate hike falling short of generating the expected revenue is not minimal. In our previous *New Europe Economics & Strategy* issue we argued that raising taxes is order to fill

Romania: Eurobank EFG Forecasts

	2008	2009	2010f	2011f
Real GDP (yoy%)	7.3	-7.1	0.0	3.5
Private Consumption	9.5	-10.5	-0.5	4.0
Govern. Consumption	7.1	0.8	-2.0	1.5
Gross Capital Formation	16.2	-25.3	2.5	6.0
Exports	8.7	-5.5	8.5	8.0
Imports	7.8	-20.6	6.5	8.5
Inflation (yoy%)				
CPI (annual average)	7.9	5.6	6.5	4.5
CPI (end of period)	6.3	4.7	8.0	4.0
Fiscal Accounts (%GDP)				
General Government Balance (ESA 95)	-5.4	-8.3	-7.8	-6.4
Gross Public Debt (ESA 95)	13.3	23.7	30.5	35.8
Labor Statistics (annual avg,%)				
Unemployment Rate (% of labor force)	4.0	6.3	9.0	7.5
Wage Growth (total economy)	23.6	8.4	5.5	6.5
External Accounts				
Current Account (%GDP)	-11.6	-4.4	-5.5	-6.0
Net FDI (EUR bn)	9.5	4.8	4.5	5.0
FDI / Current Account (%)	57.6	94.3	65.0	61.5
FX Reserves (EUR bn)	26.2	28.3	31.5	35.0
Domestic Credit *(end of period)*	**2007**	**2008**	**Q4 09**	**Q1 10**
Total Credit (%GDP)	39.0	42.7	50.2	50.5
Credit to Enterprises (%GDP)	18.0	18.8	19.6	19.7
Credit to Households (%GDP)	17.7	19.7	20.4	19.9
FX Credit/Total Credit (%, private)	51.0	53.1	60.1	60.4
Private Sector Credit (yoy)	60.4	33.7	0.9	-1.6
Loans to Deposits (%)	108.9	131.9	130.6	126.5
Financial Markets	**Current**	**3M**	**6M**	**12M**
Policy Rate	6.25	6.25	6.25	6.50
EUR/RON	4.26	4.30	4.30	4.15

Source: National Sources, Eurostat, IMF, Eurobank Research any budgetary gaps does not necessary constitute an optimal decision[2]. In our view, increasing taxes further risks generating higher tax evasion, lower economic activity and, by implication, lower budget revenues. Note that VAT revenue dropped from 8.3% of GDP in Q1 2008 to 6.7% at the end of 2009. The drop is mirrored also in the share of VAT revenues as a percent of total consumption (down from 9.8% in Q3 to 8.2% in the last quarter of 2009), which likely reflects increased tax evasion. Even the Ministry of Finance itself admitted that it is likely to collect only 70% in additional revenues relative to that implied by the nominal increase in the VAT rate.

In addition, the adoption of higher tax rates will increase inflationary pressures. The price for products with low elasticity (like fuel and tobacco) has already gone up by 4-5% in the first days after the introduction of the hike. Other important consumption goods such as food and beverages, which still carry a heavy weight in the consumer basket, are expected to register even higher increases. An illustration of this is that local media are reporting that retail sales have increased by 20-30% during the time window just before the VAT hikes are implemented. Moreover, the recent floods will exacerbate the inflationary impact of the VAT hike. At the worst case scenario, higher VAT rates may spur a generalized wave of price increases that will feed through in inflation via both first- and second-round effects. All in all, the VAT hike will likely jeopardize the inflation target of NBR (currently set at 3.5% at the end of 2010).

What is more worrying from that point of view is that more revenue raising measures may be in the pipeline. The Ministry of Finance has stated that the whole taxation system has to be reconsidered in 2011. The government is currently sketching a list of scenarios to be publicly debated by political parties and social partners. Those options include hiking the flat tax rate from 16% to 20% or switching to a progressive taxation system.

The fiscal performance so far leaves limited room for optimism that the H1:2010 fiscal target will be attained. The fiscal deficit climbed to RON 16.7bn in the first five months of 2010, which compares with a RON 18.2 bn deficit target for the first half of this year. Total revenue was down by -1.6% yoy in January-May against a +7.9% yoy full-year target in the initial budget. On the other hand, total expenditures rose by 5.2% yoy in the first five months of the year on higher social security outlays as a result of higher unemployment.

[2] Dan Bucsa, Focus-Romania: A note on fiscal policy, New Europe Economics & Strategy May 2010

The fiscal deficit reached 3.1% of GDP in January-May against 2.2% of GDP over the first four months of the year. The fiscal austerity package came in response to the IMF request for reducing the fiscal deficit to a revised target of 6.8% of GDP in 2010 from % last year. The Fund assessed that in the absence of corrective measures the 2010 fiscal deficit would spiral to 9.1% of GDP.

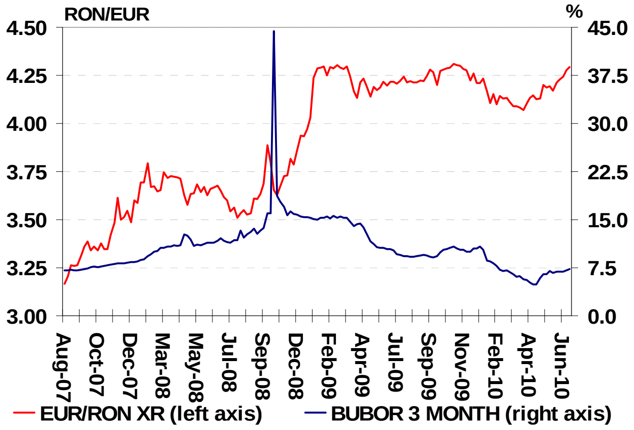
Central Bank maintains rates unchanged at 6.25% on renewed RON depreciation pressures and the VAT hike

The Constitutional Court decision came out only 4 days before the board of directors of IMF decides upon the release of the fifth tranche under the present Stand-by Agreement (SBA). The IMF had stressed that unless the implementation of the spending cuts is fully ensured and all legal obstacles removed, the release of funds will be discontinued. The Constitutional Court decision put temporarily the release of both the IMF tranche (€850 mn) and the third EU tranche (€1.1 bn) at stake. However, after the implementation of the VAT hikes, the IMF board the disbursement is higher. The next IMF Board meeting for the assessment of the program has been rescheduled for July 2.

The VAT hike appears to have also influenced the NBR´s policy deliberations. After cutting interest rates by 175bps since the beginning of the 2010, the Central Bank left rates unchanged at 6.25% on June 30th. The hawkish rhetoric in the accompanying statement may have probably signaled the end of the Bank's easing cycle. In our previous *New Europe Economics & Strategy* issue (May 2010), we made a call for some 50bps of additional cuts before year-end, mainly on the back of the weak domestic growth and inflation trajectory. However, it is evident that the recent VAT increase has change the inflation landscape dramatically and thus, the policy priorities of the NBR.

Last but not least the recent political instability has taken its toll on domestic financial markets. It has contributed to a 150bps spike in the 5-year Romania CDS spread since the beginning of May (the said spread currently stands at ca 395 bps). Furthermore, the local currency has come under significant depreciation pressure. Uncertainty over the government coalition's ability to implement a credible fiscal consolidation program has led the RON to new record lows near 4.4010 against the euro (currently at 4.34/€) and pushed government bond yields higher (around 7.5% currently in the secondary market). In the absence of further political instability domestically or significant difficulties in the implementation of the fiscal consolidation package, we expect the RON to gradually recoup some of its lost ground against the common currency, given also the NBR´s stated resolve to fight avoid excessive FX volatility (Figure 1).

Figure 1
RON under depreciation pressure



Source: Bloomberg, EcoWin, Eurobank Research

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Romania: Recent domestic credit developments and outlook

Conditions in the Romanian credit market remain tight. Although credit to domestic economy grew in May by 9.7% yoy in real terms, the largest part of the increase (8.6pps) can be attributed to government borrowing. Credit to general government has almost doubled within a year and now constitutes around 21% of total outstanding credit. Private sector credit grew by only 1.3% yoy in April, the highest annual rate of change in ten months. Yet, we believe that this is only incidental, and should not be interpreted as a sign of sustainable recovery in domestic private-sector credit in the medium term.

It seems that the ongoing stagnation in the domestic credit market is mainly a demand-driven rather than a supply-side phenomenon. As foreign banks operating in the domestic market started to get back on their feet, they sought to begin giving out loans again, aiming to return gradually to their past levels of profitability. Gradually, they lowered significantly the rates on new loans, as a part of their expansionary strategy, but also induced by central bank's successive policy rate cuts. At the same time, they hardly cut rates on the existing loans, not only in order to make up for the lower rates on new loans, but mainly to cover losses due to the rising levels of non-performing loans (NPLs). Three-month ROBOR, for example, fell to 4.74% in late April, posting a historical low.

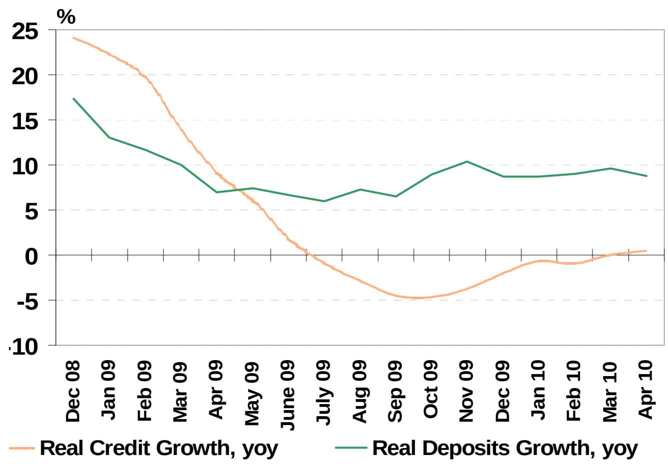
Nevertheless, we do not expect to see a rebound in credit activity in the near future. First, the worst financial crisis of the post-communist era has hit hard firms and households, and it seems that Romania has not got completely out of it yet. This is reflected in the high levels of NPLs, which hit a new record high in April (17.5%). Our view is that they are about to peak, although the increasing trend could resume for some months yet. In any case increases will be smaller, and at a significantly lower pace. Note that a recovery in lending is expected to follow the recovery in real economy, rather than lead it.

Second, the fiscal crisis in the euro area has boosted risk aversion and it increased uncertainty in financial markets throughout Europe. Interbank interest rates have started picking up again, with three-month ROBOR bouncing to as high as 6.85% in late June.

Third, the government introduced recently an ordinance facilitating early loan repayments, in order to provide relief to indebted households. In practice, this will enable debtors to swap the interest rate of their existing loans with the rates currently applying on new loans, at a very low cost. Banks are expected to react by increasing rates on new loans, in order to make up for the lower rates as well as the administrative and reallocation costs of the ordinance.

The increased aversion towards risk among firms and households is also reflected in the persistently high deposit growth rates. In April, private domestic deposits grew by 8.0% yoy on an FX-adjusted basis, led by a 10.4% increase household deposits. This could be yet another sign that Romanians do not believe that hard times are over.

Figure 2
Deposits keep growing at steady rates despite the slump in lending activity



Source: National Bank of Romania, Eurobank Research

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Serbia

Dinar hits new historic lows

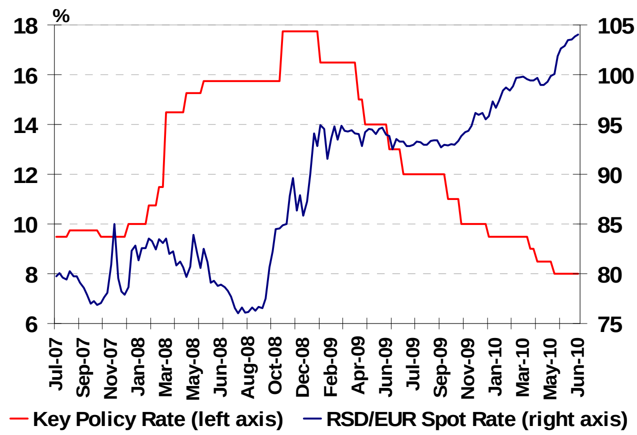
- **New central bank governor supports exports-oriented model of economic development, says "Dinar should not be allowed to appreciate in nominal or real terms in the upcoming period"**
- **Current account deficit shrunk by 26.3% yoy in the first five months of 2010.**

Dinar hits new historic lows

Depreciation pressures on the Dinar continue unabated despite repeated central bank interventions (€20-50mn spent in June alone to support the local currency). The Dinar reached a new time low at 104.28/€ on June 28, having lost ca 11.8% of its value since last September (Figure 1). The Central Bank has spent a total amount of over €1.4bn so far this year in supporting interventions, without accomplishing even to stabilize the Dinar.

Figure 1

Dinar under continuous depreciation pressure despite Central Bank efforts



Source: National Bank of Serbia, EcoWin, Eurobank Research

We had expressed a strong bearish view on the Dinar in all recent *New Europe economics & strategy* issues and continue to see limited scope for a meaningful recovery in the foreseeable future. First of all, the ongoing fiscal crisis in the Euro area exerts significant pressure on most regional currencies.

In addition, the Central Bank has embraced the notion of the transition of the Serbian economy from a domestic demand-driven to an exports-oriented model of development. In our view, this entails implications for the FX policy, on the basis that the exports-driven growth model the NBS envisages may not be compatible

Serbia: Eurobank EFG Forecasts

	2008	2009	2010f	2011f
Real GDP (yoy%)	5.5	-3.0	1.5	3.0
Inflation (yoy%)				
CPI (annual average)	12.5	8.2	4.5	4.8
CPI (end of period)	8.6	6.6	5.5	4.5
Fiscal Accounts (%GDP)				
General Government Balance	-2.6	-4.2	-4.8	-4.0
Gross Public Debt	25.6	31.3	37.0	41.0
Labor Statistics (%)				
Unemployment Rate (%of labor force, ILO)	14.7	16.1	18.5	16.5
Wage Growth *(total economy)*	17.9	4.1	4.8	6.7
External Accounts				
Current Account (% GDP)	-17.1	-5.7	-8.5	-9.0
Net FDI (EUR bn)	1.8	1.4	1.5	2.0
FDI / Current Account (%)	30.0	78.7	55.0	70.0
FX Reserves (EUR bn)	8.2	10.6	11.3	10.2
Domestic Credit	**2007**	**2008**	**Q4 09**	**Q1 10**
Total Credit (%GDP)	35.4	41.0	48.7	51.2
Credit to Enterprises (%GDP)	21.5	25.8	29.4	30.8
Credit to Households (%GDP)	13.2	14.0	14.7	15.3
Private Sector Credit (yoy)	40.2	34.9	14.3	12.9
Loans to Deposits (%)	99.9	125.1	127.0	133.2
Financial Markets	**Current**	**3M**	**6M**	**12M**
Policy Rate	8.00	8.00	7.50	7.50
EUR/RSD	102.73	105.00	105.00	110.00

Source: National Sources, IMF, Eurobank Research

with a sustainably strong Dinar. In fact, the new candidate for the NBS governor post, Mr. Dejan Soskic, stated recently that monetary policy should not allow for a (real or nominal) appreciation of the local currency in the upcoming period. Along these lines, Mr. Soskic rebutted arguments in favor of a change in the present flexible exchange rate regime to a more rigid framework. According to Mr. Soskic, the introduction of such a regime could result in a depletion of FX reserves or the need for high real domestic interest rates that could strangle the still sluggish economic recovery.

Central Bank maintains once policy rate unchanged at 8.00%

As was broadly expected, the Serbian Central Bank maintained in June its key policy rate unchanged for a second time in a row at 8.00%. Since the beginning of the year, the NBS slashed its policy rate three times, delivering a total of 150bps in rate cuts. The Central Bank last cut its key rate on May 4 by 50bps. We anticipate that the Central will maintain it unchanged again on July 6 given the ongoing pressures on the local currency and the sovereign fiscal crisis in the Euro area.

We anticipate the NBS to maintain its easing bias for the remainder of the year. In its latest inflation report issued in May, the Central Bank signaled that they are likely to keep cutting interest rates but at a slower pace than in the last three months. In that respect, we still see some room for a further 50bps cut in the key rate to 7.50% by the end of 2010. The latter forecast is conditional on two important factors. The first one has to do with the evolution of risk premia and the extent of any further Dinar depreciation. If the fiscal crisis in the Euro area were to prolong much further, ensuing depreciation pressures on the local currency could even force the Central Bank to terminate its easing cycle at the current levels. Sure enough, the Dinar depreciation increases inflationary pressures because of the high pass through. Yet, accomplishing this year's inflation target is not at stake. NBS officials anticipate that inflationary pressures from the depreciation of the currency would not surface until the Dinar exceeded the level of 110/€ because of the weak domestic demand dynamics. However, further Dinar depreciation will hurt the ability of unhedged borrowers to service their debts thus increasing the probability of NPLs rising more.

On another note, the parliament adopted the new NBS law. The new legislation introduces changes in the operation of the Central Bank, aiming to harmonize it with that of other central banks in Western Europe. The proposed changed are expected to increase the autonomy and independence of the institution. The bill envisages that the governor will be appointed by the President of Serbia and approved by parliamentary majority (instead of the parliament's finance committee) for a six year term. The executive Governor's council, a body that will include the governor and the deputy governors, will take over all responsibilities of the NBS monetary policy committee.

Improving CA deficit trend continues

The current account deficit continued to shrink during the first five moths of this year (down by 26.3% yoy), despite expectations to the opposite. On a twelve month rolling basis, the current account deficit improved to 5% of GDP against 5.7% at the end of 2009. The main driver behind the improvement was a 19.6% yoy decline in the trade gap. Exports showed signs of revival growing by 16.7% yoy. Base metal industries (iron and steel) as well as food & beverage producers are leading the rebound of exports. Demand from EU countries, the main destination market, remains on a recovering mode. Furthermore exports have started to reap the benefits of the interim trade agreement that was put in force in early 2010.

In contrast, the steep contraction in capital goods imports (-27% yoy in January-May) facilitated a 2.2% YoY decline in the total imports bill. The decline in imports of capital goods puts in question the extent to which the ongoing recovery in investments, and thus, in domestic demand is broad based. In addition, the deficit in the balance of services narrowed by 36.9% yoy. Current transfers continued to run a surplus of €0.9bn boosted by the last tranche of the IMF loan agreement that was received in last April. However, the surplus was still lower by 5.6% compared to the previous period, due to lower remittances (-10% YoY). The balances of income run a deficit of €0.17bn (up 3.3% yoy vs. the same period a year earlier).

On the financing side, capital inflows were 30% yoy lower in Jan-April, amounting to € 0.7bn. A 52% yoy decline of net FDI inflows was the main driver behind this. Net FDI inflows reached €358mn against €745mn in the same period last year. The recapitalization of Komercijalna Banka and US Steel accounted for the most part of them. No significant privatizations took place in early 2010. The figure of FDI inflows last year was inflated by the sale of NIS to Gazprom in early 2009. However, the prospects of attracting new FDI are limited given that that the sale of pharmaceutical company Galenika was cancelled and that the privatization of Telekom Serbia is not expected to be completed before the end of Q3. Net FDI inflows covered 44% of the current account deficit in January-April against 67% at the same period last year.

In contrast, other financial account elements showed an increase. The balance on "portfolio investments" turned positive at €63.3 mn in Jan-April compared to an outflow of €2.4 mn in the same period last year. The surplus of "other investments" tripled to €185.5 mn from €60.5 mn. In essence, this primarily reflects the impact of the last IMF tranche given in April. The inflows from new long term lending by the banking sector outpaced its repayments of both short and long-term external debt. However, the latter was offset by the withdrawal of deposits (ca €50 mn) by their parent banks and the deleveraging of the corporate sector (by around €200 mn).

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Serbia: Recent banking sector developments and outlook

The Serbian banking sector appears to have weathered the crisis rather well, compared to other economies in the region. In the years preceding the crisis it expanded significantly, yet it did not experience the stellar growth several other SEE markets did. Despite -or probably because of- that, it turned out to be relatively more resilient to the repercussions of the financial crisis. In May, credit to private sector grew by 10.6% yoy, while private sector deposits kept running at 19.0% yoy on an FX-adjusted basis, figures which are among the highest in the region.

The prudential framework of the National Bank of Serbia (NBS) had been (and still remains) quite conservative, which has kept the domestic banking sector liquid and well capitalised. According to the NBS, Capital Adequacy Ratio stood at 21.5% in Q1:10, being among the highest in Europe. Yet, according to an IMF assessment of Serbia's financial sector published in late March, the stringent and often overly complex regulations have increased the costs of the banks, and even induced private enterprises to borrow directly from the parent institutions of the Serbian banks. The Fund´s suggestion is that Serbia should take steps to simplify regulations and relax the current, rigid regime.

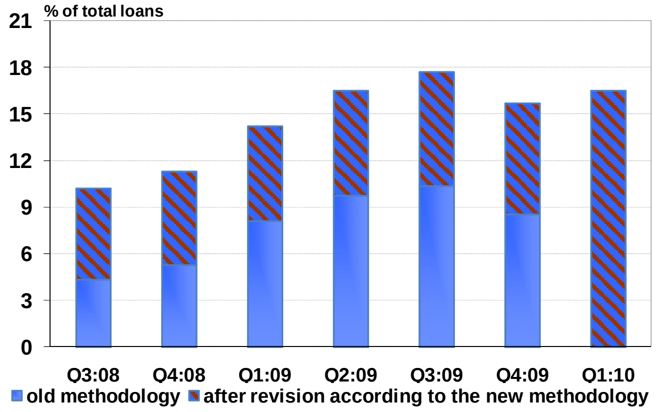
Another source of concern for the Fund is the very high level of euroisation of Serbia's financial sector, a topic discussed more extensively in our previous *New Europe: Economics & Strategy* issue. About three quarters of loans to the private sector are linked to, or denominated in, foreign currencies. Hence, the rapid depreciation of the dinar has rendered loan repayment by firms and households quite more costly, and significantly increased credit risk.

This is reflected in the high levels of non-performing loans (NPLs) published by NBS in its quarterly Baking Supervision report of June, for the first time in accordance with the methodology used by the Fund. NPL ratios have been revealed to be almost twice as high as those recorded in earlier reports, increasing worries about the overall health of the Serbian banking system.

Interestingly enough, NPLs share in loans to households does not exceed 8%, while the corresponding figure for private firms is almost 22%. This hardly comes as a surprise. The timely servicing of loans is traditionally embedded into the Serbian culture. Furthermore, over the past years, enterprises borrowed much heavier compared to individuals, who have been more cautious and hesitant. It is quite indicative that loans-to-deposits ratio for non-financial corporations in April stood at 268%, while the tantamount for households was less than 68%. One of the priorities of the Serbian authorities should be, according to the Fund, the enhancement of the insolvency mechanisms, especially for firms, since currently they are too costly and inefficient to effectively protect the lenders.

Figure 2

NBS method streamlining reveals NPLs significantly higher than previously reported



Source: National Bank of Serbia, Eurobank Research

Serbia's Deposit Insurance Fund (DIF) capacity remains limited, even more since deposit guarantee was expanded to include deposits up to €50,000. The report underlines the need to establish an emergency credit line between the government and the DIF, in order for the latter to gain credibility. At present, DIF's assets cover about 1.8% of total insured deposits, and no such link is in place.

As far as compliance to the Basel Core Principles is concerned, Serbia is rated by the IMF as largely -yet not fully- compliant; further steps need to be taken by the NBS towards improving banking supervision and adapting its regulatory framework to the international and EU standards.

Serbia appears to have made considerable progress in modernising and keeping its financial system stable. However, a further effort is required, since significant vulnerabilities still exist, and major challenges lay ahead. The main potential sources of instability for the financial system listed in the Fund's report are a reduction or reversal in capital inflows, a prolonged anaemic recovery of the real sector, as well as government's failure to achieve fiscal consolidation.

The Serbian banking system has proved to be quite resilient to the crisis so far. We believe that it has the potential to withstand further turbulences, as long as the

Serbian authorities implement the necessary reforms. In any case, we believe that the developments in the real sector are equally, if not more, important this period, and the prospects of the financial sector will be closely tied to the outlook of the Serbian macro-economy for some time yet.

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Turkey

Q1 GDP growth data reinforce the view Turkey will lead economic recovery in New Europe this year

- **Q1 GDP rises 11.7% YoY; pace of growth likely to slowdown in the following quarters**
- **CBRT maintains its key policy rate unchanged at 7.00%, voices expectations for an improved inflation outlook ahead.**
- **Inflation eases significantly in June and further deceleration expected ahead, but to overshoot the CBRT's year-end target; CBRT may incept monetary tightening cycle in Q4**
- **Budget posts in May its first surplus in 21 months, vindicating the government's fiscal consolidation efforts.**
- **Current account deficit widening continues unabated.**

Turkey: Eurobank EFG Forecasts	2008	2009E	2010F	2011F
Real GDP (yoy%)	0.7	-4.7	6.0	4.5
Private Consumption	-0.3	-2.3	3.5	4.5
Govern. Consumption	1.7	7.8	1.0	3.0
Gross Capital Formation	-6.2	-19.2	4.0	9.0
Exports	2.7	-5.4	6.0	8.0
Imports	-4.1	-14.4	10.0	10.5
Inflation (yoy%)				
CPI (annual average)	10.4	6.3	8.3	7.2
CPI (end of period)	10.1	6.5	8.0	5.4
Fiscal Accounts (%GDP)				
General Government Balance	-1.8	-5.5	-3.8	-3.3
Gross Public Debt	39.4	45.5	45.3	45.0
Primary Balance	3.5	0.1	1.0	1.5
Labor Statistics (%)				
Unemployment Rate (%of labor force)	13.6	13.5	13.2	12.8
External Accounts				
Current Account (% GDP)	-5.7	-2.2	-4.5	-5.3
Net FDI (USD)	15.8	6.1	7.5	9.0
FDI / Current Account	37.5	43.5	23.0	24.0
FX Reserves (USDbn)	71.0	69.0	70.0	71.0
Domestic Credit	**2008**	**Q3 09**	**Q4 09**	**Q1 10**
Total Credit (%GDP)	31.0	33.0	35.0	34.0
Credit Private Sector (%GDP)	29.7	31.0	32.9	31.9
FX Credit/Total Credit (%)	13.2	14.0	14.9	16.9
Private Sector Credit (%yoy)	22.9	2.8	11.3	22.8
Loans to Deposits	82.4	79.5	78.7	79.9
Financial Markets	**Current**	**3M**	**6M**	**12M**
Policy Rate	7.00	7.00	7.75	8.50
USD/TRY (where applicable)	1.56	1.55	1.55	1.50

Source: National Sources, IMF, Eurobank Research

Q1 GDP growth above expectations

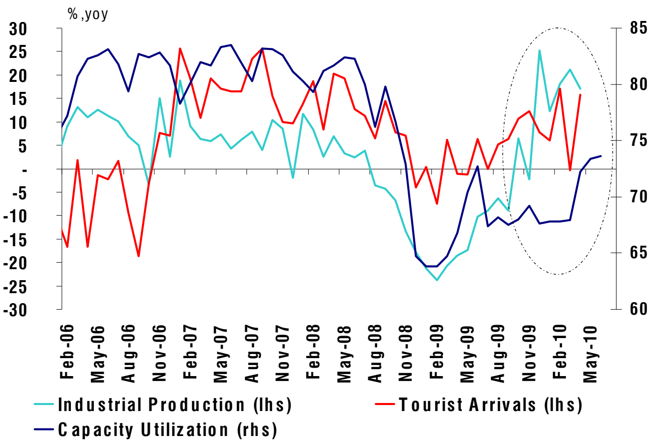
In line with expectations, the domestic economy posted double-digit growth in the first quarter of the year, after expanding by 6.0%yoy a quarter earlier. Real GDP registered remarkable growth in Q1 (+11.7%yoy), which exceeded market expectations for a 11.5%yoy reading and was just off an all-time high of 11.9%yoy recorded in Q2 2004. The strong rebound was primarily driven by favorable base effects *(real GDP growth contracted by a record 14.5%yoy in Q1 2009)*, higher domestic demand (private consumption: +9.9%; gross fixed capital formation: +14.4%yoy) and a substantial recovery in inventories. From the production side, the manufacturing and wholesale & retail trade sectors bounced by 20.6%yoy and 22.4%yoy, respectively, while strong growth was also recorded in several other components, including construction and real estate. On a less positive note, seasonal (as well as calendar adjusted) data showed that real GDP remained nearly unchanged on a quarter-on-quarter basis posting a mere 0.1% increase, which follows respective growth rates of 1.7% and 3.3% in Q4 2009 and Q3 2009.

But, pace of recovery is likely to slowdown in the following quarters

Finance Minister Mehmet Simsek said in mid-June that he expected gross domestic product to have registered growth of 10-14%yoy in Q1. However, he added that real GDP was unlikely to continue to expand at double-digit rates in Q2. Undoubtedly, the excessively favorable effect of a particularly weak base in Q1: 2009 is not seen repeated in Q2, at least to such an extent. However, high-frequency indicators of domestic activity continue to indicate that the economic recovery remains on track, with GDP growth expected to be a high as 8%yoy in the second quarter of the year *(Eurobank EFG Research forecast)*. Among others, industrial production rose by 17%yoy in April bringing the year-to-April rate of increase to 17.2%yoy and reversing a 21.16%yoy decline over the same period a year earlier. Confidence indicators also signal a steady recovery in domestic demand. Consumer confidence bounced to 86.58 in May, its highest level since February 2008. Meanwhile, confidence in the manufacturing sector, though weaker for the second month running in June, remained above the boost-or-burst threshold of 100 for the 6th month running. This indicates ongoing optimism in the sector, with the respective confidence index standing not far off a 3-year peak achieve in April. Elsewhere, May's manufacturing PMI registered its fastest pace of expansion on record and remained in an expansionary territory for the 13th consecutive month amid strong demand for new orders. Capacity utilization, which remains in a sustainably upward trend since September 2009, bounced to 73.6% in June, thus returning to levels last seen in October 2008. Though still above pre-crisis levels, the rate of unemployment fell to 13.70% over the February-April period, marking the second consecutive fall and remaining consistently below a 16.1% all time peak touched in February 2009. Prime Minister Tayyip Erdogan recently expressed confidence that the rate of unemployment will fall to 10% in the coming months, a level consistent with pre-Lehman levels. Moreover, the number of foreign visitors to Turkey jumped by 15.77%yoy in May, reversing a small decline in the prior month, when the volcanic ash disrupted flights across Europe. Cumulatively, in the first five months of the year, the number of arrivals from abroad rose by 10.14% to 8.07mn. Meanwhile, automotive production rose by 12.7%yoy in May, bringing the January-May print to 46%yoy higher. Finally, according to the Turkish Exporters Assembly, exports posted a 25%yoy gain in May, in line with April, reflecting improving conditions in major trade partner economies. Taking into account the Q1 GDP data released recently and the lingering sovereign debt crisis in the euro area, we decided, for the time being, to maintain our 6%yoy GDP growth forecast. That is even though risks to our forecast remain to the upside and lie in the face of a stronger than expected recovery in domestic and external demand. It is worth mentioning that a number of government officials recently voiced expectations for GDP growth of 5.5-7.0% this year, while the OECD and IMF forecasts currently standing at 6.80% and 6.25%, respectively. On the downside, risks lie primarily in the face of the sovereign debt crisis in the euro area and its implications for the growth environment in the region.

Figure 1

Domestic economy on a sustainable rebound



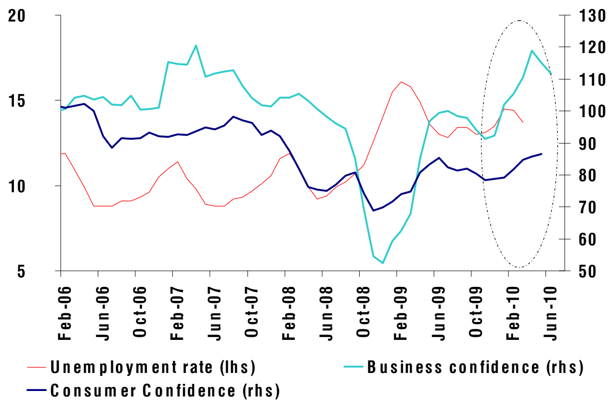
Source: National authorities, Bloomberg

CBRT maintains key policy rate unchanged at 7.00%, voices optimism over improved inflation dynamics in the period ahead

In line with market expectations, the CBRT kept its key (1-week repo) rate stable at 7.00% at its June 17 MPC meeting.

Figure 2

Confidence indicators, labor data signal that the worst is likely over



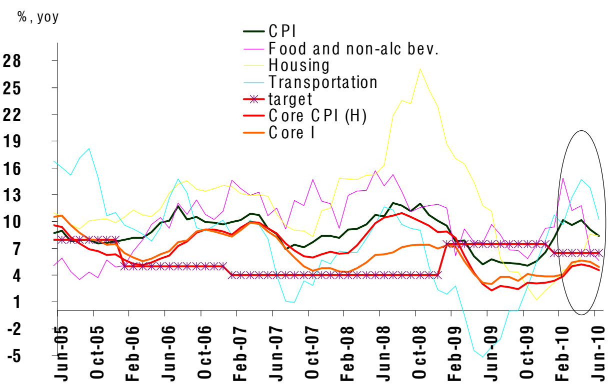
Source: National authorities, Bloomberg

The tone of the accompanying policy statement was broadly similar to that in May. Among the primary differences was that the Bank was more eloquent on external demand uncertainties stemming from the debt crisis in the euro area. Furthermore, the CBRT acknowledged that the decline in unprocessed food and easing commodity prices have resulted to an improved inflation outlook -- compared to that projected in the April Inflation Report --which is also likely to have a favorable impact on inflation expectations. This implies that the CBRT sees an increased likelihood for inflation to undershoot its 8.4%yoy year-end CPI forecast (see analysis below). The latter view is also supported by the May and June CPI data and somewhat vindicates the Bank's long-voiced stance "that it may be necessary to maintain policy rates at current levels for some time, and to keep them at low levels for a long period". At its statement, the bank also reiterated that it expects core inflation to remain below the year-end headline inflation target of 6.50% and to follow a path consistent with the medium-term targets.

Inflation eases significantly in June; further deceleration expected in the following months

CPI declined by more than expected in June, registering a 0.56%mom fall vs. consensus of -0.01%mom., The drop was primarily driven by a 2.52%mom fall in food prices, which follows a 4.38%mom drop a month earlier. As a result, the corresponding annual rate of increase eased to 8.37% in June from 9.10% in May, further recoiling from a 1-½-year peak of 10.19% in April. Nearly all core CPI components eased on an annual basis, while PPI also declined to 7.64%yoy from 9.21%yoy. Looking further ahead, inflation is anticipated to ease in the coming months. The last two CPI readings suggest that there is increasing likelihood that CPI undershoots the CBRT's year-end 8.4%yoy forecast. Note that according to the most recent bi-monthly surveys conducted by Turkey's Central Bank, inflation expectations have stabilized over the last few weeks, with year-end forecasts currently standing just above 8.0%yoy. A further improvement in expectations is likely over the next few weeks as market participants digest the latest CPI reading. Nevertheless, consumer inflation is still expected to exceed by a significant margin the CBRT's end-2010 official inflation target of 6.5%. Unfavorable base effects, the impact of regulated price hikes - which according to the Central Bank is likely to continue affecting negatively the inflation outlook until February 2011 – and an ongoing recovery in domestic demand are seen as main risks to the domestic inflation outlook in the coming months. On the flipside, the crisis in the euro area, a lift on a red meat ban, introduced a few years ago due to the mad cow decease, as well as electricity price cuts to be instituted as of July are the main factors expected to assist disinflation. Along these lines, we anticipate CPI to come in at 7.1%yoy in December, well below our previous 8.0%yoy forecast envisaged in our previous New Europe Economics & Strategy report and expect the CBRT to hold its fire in the near future. Nevertheless, the door remains open for it's the inception of the bank's monetary tightening cycle in Q4.

Figure 3
Inflation eases further in June



Source: National authorities, Bloomberg

In view of June's CPI we revise our previous forecast of 150bps of rate hikes by year end lower, to 75bps. If our expectations are vindicated, the CBRT's new key policy rate, the 1-week repo rate, will stand at 7.75% at the end of 2010. We acknowledge that risks to our forecast are presently skewed to the downside, while delays in monetary tightening can not be ruled out either. Taking into account that the CBRT appears poised to keep interest rates stable at their current levels for as long as possible, a hasty rate hike is rather unlikely in our view. Also, against the background of the ongoing debt crisis in the euro area and growing concerns about the pace of the US economic recovery, the CBRT is likely to implement its exit strategy outlined in April in a more gradual fashion. July's inflation report, due on the 27th, is expected to shed some light on the bank's policy deliberations ahead.

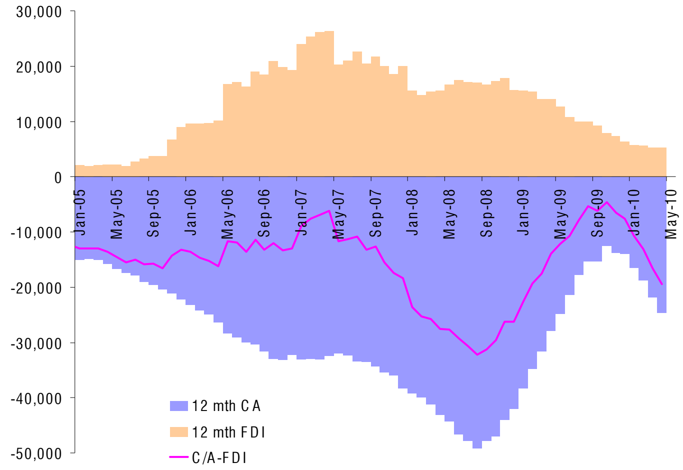
Government budget posts in May its first surplus in 21 months

The government's budget ran a surplus of TRY 5.812bn in May, the first surplus recorded since August 2008. Revenues soared by 31.9%yoy as the domestic economy rebounded from last year's recession. Spending discipline also bore some fruit with expenditure registering a 2.1%yoy drop. Tax income jumped 25%yoy, while the primary surplus, which excludes interest payments on government debt, rose to TRY 7.977bn from a TRY 2.597bn surplus in the previous month. Cumulatively, during the first five months of the year the budget shrunk by ca 52%yoy to TRY 9.984bn, with revenues rising 19%yoy to TRY 102.616bn, and expenditures advancing by just 5%yoy to TRY 112.6bn. Meanwhile, the primary balance soared by nearly two times to a surplus of TRY 14.232bn. According to our calculations, the January-May budget deficit corresponded to 0.9% of projected GDP, vs. a shortfall of 2.2% registered over the same period a year earlier. Taking into account that the government's assumption for 2010 growth of 3.5%yoy envisioned in the medium-term program is likely to be nearly twice outpaced, the corresponding general government deficit target of 4.7%-of-GDP appears increasingly likely to be outperformed by a significant margin. Some fiscal loosening may be observed towards the end of 2010, ahead of next year's parliamentary elections and as the rebound in domestic economic activity slows down. However, this does not change our view for a general government deficit of 3.8%-of-GDP this year. Turkey's fiscal position has improved significantly in recent months and we expect tax revenues to remain supported by cyclical factors. Spending discipline is also likely to help push the 2010 shortfall well below last year's 5.5%-of-GDP realization. Looking further ahead, a fiscal rule, presented by the government in May and expected to pass in parliament ahead of the summer recess in July, is seen as a key policy anchor ahead, especially in view of the absence of a new IMF loan deal. The reform envisages a medium term budget deficit of 1%-of-GDP and real GDP growth 5%yoy and encompasses a cyclical calculation of fiscal targets. Of course of outmost importance will be its actual implementation. If the bill becomes law this year, it will come into effect in 2011 and, as such, it will be closely scrutinized for next year's budget performance. Economy Minister Ali Babacan said earlier in June that the government will likely revise its medium-term economic program after the endorsement of the fiscal rule bill. However, he rejected the potential of major revisions to the program's projections regarding the budget deficit and debt stock.

Current account deficit back on a widening mode

Turkey's current account deficit continued to widen in April, with the cumulative January-April shortfall spiking 300%yoy to USD14.251bn, amid rebounding domestic demand and higher energy prices. Meanwhile, the 12-month trailing current account jumped to USD 24.65bn at the end of April, and although it is still ca 12% narrower on the year, it reveals a gradual and ongoing deterioration, having nearly doubled from a multi-year trough of USD 12.57bn achieved in October 2009. According to our calculations, the 12-months-to-April deficit is equivalent to 3.5%-of-GDP. Although standing narrower, at ca 4.4%-of-GDP, compared to the same period a year earlier it is worth noting that the 12-month shortfall has embarked on a widening mode after reaching a minimum level of 2.0%-of-GDP in October. Although we expect the pace of widening in the deficit to ease somewhat in the period ahead, thanks to the ebbing of (unfavorable) base effects, we anticipate a further widening in the CAD in the remainder of this year as the rebound in domestic demand continues. Presently, we stick to our forecast of a 4.5%-of-GDP deficit for the whole of 2010 and expect a further deterioration in 2011 as domestic demand becomes more robust and Turkey's main trade partner economies recuperate further. On the financing side, Prime Minister Tayyip Erdogan said recently that FDI inflows are seen exceeding USD 7.7bn in 2010. However, inflows dropped ca 30%yoy to USD 2.3bn in January-April, while net FDI fell by 40%yoy to USD 1.743bn over the same period, covering just 12.2% of the shortfall vs 80% in the same period a year earlier. On the other hand, portfolio inflows improved further, totaling USD 7.27bn in January-April 2010 vs. a net outflow of USD 2.267bn over the same period last year. We reiterate that, at present, we are not particularly concerned about the financing of the current account deficit. The silver lining of the global financial crisis was that Turkey's external financing requirement shrunk significantly compared to pre-crisis levels. Meanwhile, portfolio inflows are recently showing signs of recovery and external financing conditions are likely to improve further in the months ahead.

Figure 4
Current account deficit widens further



Source: Central Bank of Turkey

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Ukraine

GDP growth up 6.1% yoy in Jan-May 2010; inflation pressures abating

- IMF mission visited Kiev for the second time in June to discuss with Ukrainian authorities the economic policies supported by a new Stand-By-Arrangement (SBA) with the Fund
- Real GDP growth expanded by 6.1% yoy in Jan-May 2010, on the back of favourable base effects and higher exports. However, declining commodity prices and increased uncertainty over the pace of global economic recovery raise significant headwinds for the period ahead
- Domestic inflation decelerated in May for a second month in a row, hitting 8.5% yoy - the lowest level since August 2006. Nonetheless, upward risks to the inflation outlook remain
- Following recent inflation declines, the Central bank cut its key discount rate by 75bp to 9.50%

Ukraine: Eurobank EFG Forecasts

	2008	2009	2010f	2011f
Real GDP (% yoy)	2.3	-15.1	3.0	3.2
Private Consumption	9.9	-12.1	1.5	1.0
Government Consumption	0.4	1.8	0.5	1.0
Gross Capital Formation	32.6	-48.4	2.0	3.0
Exports	5.1	-23.6	4.0	5.0
Imports	18.4	-36.8	1.5	2.0
Inflation (% yoy)				
CPI (annual average)	25.3	16.0	10.5	10.0
CPI (end of period)	22.3	12.3	11.0	10.5
Fiscal Accounts (% GDP)				
General Government Balance	-3.2	-7.2	-7.0	-6.0
Gross Public Debt	19.9	30.0	35.0	34.0
Labor Statistics (%)				
Unemployment Rate (% of labor force)	6.9	9.7	9.0	8.5
Wage Growth *(real - private sector)*	6.3	-10.3	5.0	4.0
External Accounts				
Current Account (% GDP)	-7.0	-1.7	-1.0	-2.1
Net FDI (bn USD)	9.9	4.5	6.0	5.0
FDI / Current Account	77.6	230.0	300.0	250.0
FX Reserves (bn USD)	31.5	26.5	25.1	21.5
Domestic Credit	**2007**	**2008**	**2009**	**Q1 10**
Total Credit (% GDP)	59.9	77.3	79.3	
Credit to Enterprises (% GDP)	36.5	46.7	50.7	
Credit to Households (% GDP)	22.5	29.5	26.4	
FX Credit/Total Credit (%)	49.9	59.0	50.8	49.9
Private Sector Credit (% yoy)	74.9	68.5	-3.1	0.5
Loans to Deposits	150.4	204.0	215.9	208.4
Financial Markets	**Current**	**3M**	**6M**	**12M**
Policy Rate	9.50	9.50	9.50	9.50
USD/UAH		8.00	8.10	8.20

Source: NBU, IMF, Bloomberg, Eurobank Research

IMF mission back in Ukraine to discuss resumption of SBA facility

On June, 21st, an IMF mission visited Kiev for the second time that month to discuss with Ukrainian authorities the economic policies that could be supported by a new Stand-By Arrangement (SBA). According to the IMF representative in Ukraine, discussions focused on policies to achieve the 2010 fiscal target and set public debt firmly on a declining path. Significant emphasis was also placed on a new package of structural reforms, primarily in the financial and energy sectors, aiming to bring Ukraine on a path to stability and growth. The ongoing negotiations are expected to be quite tough taking into account the upcoming local elections, most likely to be set for October 2010, and the unwillingness of Ukrainian authorities to pass such unpopular fiscal measures as higher retail gas tariffs, lower privileged pensions, etc. Note that energy and pension reforms are prerequisite for a resumption of IMF lending. However, official authorities show strong commitment to get the IMF program back on track, having already acknowledged that without a strong external financing program in place, Ukraine will remain particularly vulnerable to sudden swings in foreign investor sentiment. Meanwhile, the recent $2bn loan from Russia helped the government to bridge its financing gap. In addition, in an attempt to diversify its financing sources, Ukraine plans to issue a Eurobond worth $1.3bn in the coming months.

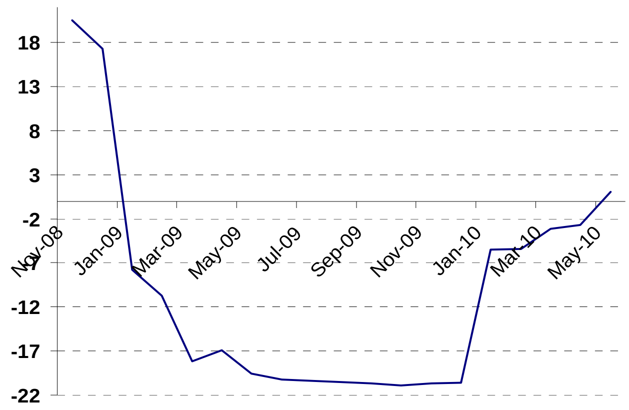
GDP growth up 6.1% yoy in January-May 2010

Prime Minister announced that GDP growth expanded by 6.1% yoy in Jan-May 2010. In Q1-2010, Ukraine's economy expanded by 4.8% yoy, mainly assisted by favourable base effects (Q1-2009 GDP stood at -20.3% yoy). Conversely, the acceleration in recovery in Q2-2010 is not merely driven by base effects, but also by a strong rebound in industrial production. More precisely, Ukraine's industrial output expanded by 12.7% yoy in May, following a 17.4% yoy rise recorded in the prior month. May´s lower growth reading is attributed to fewer working days (due to numerous holidays in May) and to the slowdown in steel industry as a result of weaker external demand and lower world steel prices.

Elsewhere, retail sales returned in May to positive territory following 17 months of contraction, rising by 1.1% yoy after recording a 2.7% yoy drop in the prior month.

Figure 1

Retail sales returned to positive territory following 17 months of contraction



Source: National Statistics, Eurobank Research

A contributing factor to bouncing growth in retail sales is the real wage growth which turned to positive territory since the beginning of the year. It accelerated further to 7.1% yoy in May from 5.0% yoy increase recorded in the previous month. All told, conditions for consumers have started to brighten.

Ukraine is co-organising with Poland the 2012 European football championship (EURO2012). In the coming months acceleration of EURO2012 infrastructure projects may give an additional boost to growth. Overall, real GDP growth is expected to grow by 3.0% yoy in 2010, from 15.1% yoy contraction posted in 2009, on the back of base effects and higher exports. Yet, downside risks to the domestic growth outlook remain in the face of declining commodity prices and increased uncertainty over the sustainability of global economic recovery.

Both current and capital accounts recorded surpluses in April and May

The current account balance posted a surplus for a consecutive second month. Over the first five months of 2010 the current account surplus reached $318mn compared to deficit of $765mn at the same period in 2009. What's more, capital and financial account remained positive for a third successive month in May. Since the beginning of this year financial account surplus amounted to $1.3bn compared to deficit of $5.8bn over the same period in 2009. This is largely attributed to the sharp decrease of capital outflows. Foreign direct investment (FDI) rose to $382mn in May and totalled $1.5bn in the first five months of 2010 compared with $1.9bn over January- May 2009.

Weak domestic demand coupled with the 30% discount on gas import prices will help contain the current account deficit to ca 1.0% of GDP in 2010 from 1.7% of GDP current account deficit in 2009. However, risks to the downside come from rising investor's risk aversion and tumbling global commodity prices.

Consumer prices keep declining while producer prices are on the rise

Ukraine's inflation rate decelerated for a second month in a row to 8.5% yoy in May from 9.7% yoy in the prior month. These were the lowest reading since August 2006 and significantly lower than the 9.5% yoy consensus forecast. Easing inflation pressures were facilitated by a 30% discount on gas import prices. Yet, once the IMF funding is resumed, the government will most likely be forced to raise retail gas tariffs and this will likely exert upward pressure on domestic prices. In addition, should political stability remain in the country is it likely that domestic consumption will be strengthen in the months ahead.. Furthermore, the recent strong rebound in the export-oriented industries has put upward pressure in domestic producer prices. Since the beginning of this year, producer prices returned to double-digit growth, accelerating to 20.2% yoy in May from 6.5% yoy in December 2009. In turn, this may likely have a lag effect on consumer prices over the coming 6-9 months. In all, despite the recent favourable inflation dynamics, risks on the inflation outlook remain skewed to the upside. We forecast inflation to average 10.5% yoy in 2010 from 16% yoy in 2009.

Drastic cut of key discount rate by 75bp to 9.5% effective on June, 8th

As was widely expected, the recent declines in domestic inflation have left room for rate cuts. Ukraine's central bank (NBU) announced on June, 8th the cut of its key discount rate by 75bp to 9.5% (from 10.25% effective since August 2009 when NBU last cut its policy rate). The Central bank is trying to support the stagnant credit growth and to boost liquidity in the money market.

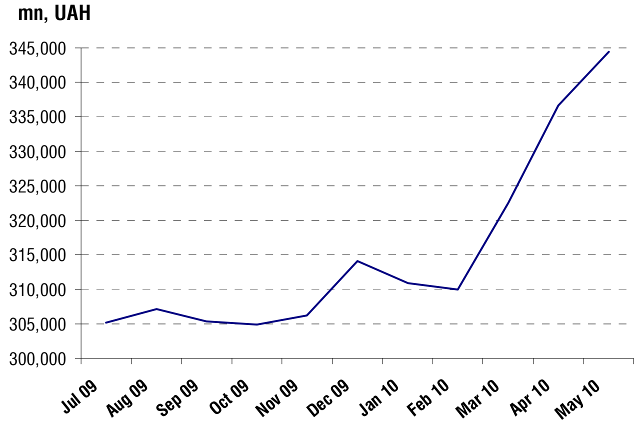
Low credit activity but strong deposit growth

Total credit growth remains in negative territory; it decreased by 0.2% mom in May and by 0.8% year-to-May. Household and corporates loans continue to show opposite dynamics; household credit fell by 1.0% mom in May and by 5.2% year-to-May while loans to corporates increased by 0.2% mom in May and by 1.3% year-to-May.

The banking system continues to enjoy strong deposit growth (Figure 2). Total deposits grew by 2.4% mom in May vs. 4.3% mom in April and 8.8% year-to-May. What's more, private sector deposits rose by 10.8% year-to-May. Household and corporates deposits grew by 10.4% year-to-May and 10.5% year-to-May, respectively. Total deposits denominated in national currency increased by 18% year-to-May.

Figure 2

Strong deposit growth continues



Source: National Bank of Ukraine, Eurobank Research

Consequently, loan to deposit ratio declined to 195.1% in May from the peak of 226.7% recorded in April 2009.

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