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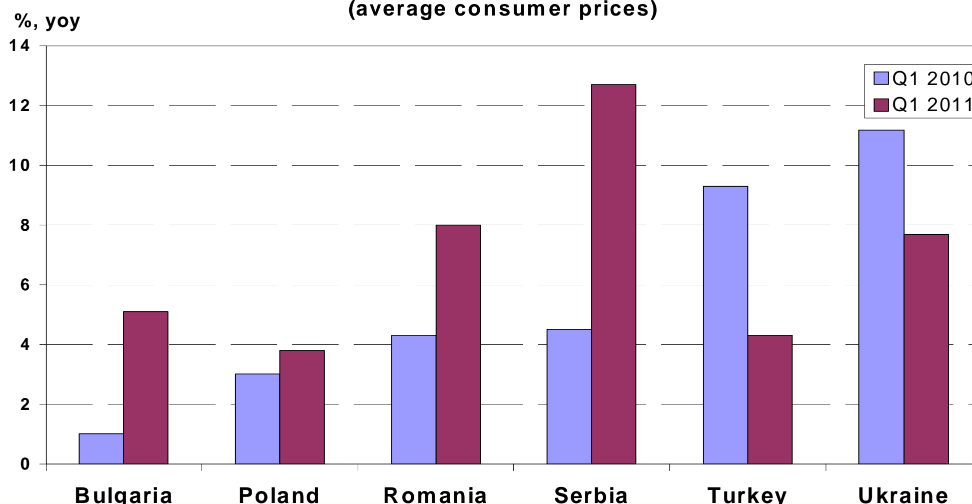
Regional markets shrug off lingering debt crisis in the euro area

Bulgaria: Moody's puts Bulgaria's "Baa3" sovereign rating on review for a possible upgrade, citing the country's healthy fiscal position.
Poland: Headline inflation unexpected rises to 4.3% yoy in March, driven by soaring food and fuel prices.
Romania: Fiscal performance showed a clear improvement trend in Q1:2011, yet Eurostat expresses reservations over the quality of reported data.
Serbia: Central Bank Governor urges the government to take special measures in the domestic market to contain surging food prices
2010 real GDP growth estimated at a higher than expected rate of 8.9%yoy; higher-frequency indicators point to vibrant domestic demand dynamics in Q1:11
Ukraine: Economic recovery remains on track, but IMF disbursements to be delayed until June
Turkey: CBT likely to hold its key policy rate unchanged for the rest of H1:2011, in spite of rising inflation pressures; Central Bank revised upwards its end-2011 and end-2012 annual CPI forecasts

New Europe market strategy highlights

FX: In line with our earlier short recommendation, the **EUR/RSD** temporarily touched our 98.40 target on May 6. Having recently broken below key support levels, the pair appears to have some further downside potential in view of an improving domestic macroeconomic backdrop and the NBS's proactive policy stance. Yet, we prefer closing our short position at current levels and collect profits. Elsewhere, the assessment behind our earlier short **PLN/HUF** trade remains broadly unchanged. The forint is among the outperformers in the region year-to-date, continuing to receive support from ongoing fiscal consolidation optimism. On the other hand, the Polish zloty has yet to embark on a convincing appreciation trend, in view of lingering concerns over Poland's twin (fiscal and current account) deficits. As such, we maintain our previous short recommendation, preserving our earlier stop-loss and take-profit targets of 68 and 64, respectively. We suggest going long the **EUR/TRY** at current levels of 2.2450, with a stop-loss below 2.20 and immediate target of 2.35 ahead of 2.50. **In the sovereign credit space,** we continue to favor longs in Turkey's 5-year CDS at current levels around 150bps targeting 170bps. Elsewhere, we would close our short positions in Bulgaria's 4-year CDS spread and take profit as the security currently stands a tad above our second line target of 170bps (the first target, of 200bps, was hit in March) and the recent sharp narrowing appears to be running out of steam. A trade that is becoming increasingly interesting lately is that of entering long the Markit iTraxx SOVX index for Western Europe vs. short on the corresponding CEEMEA. With inflation concerns remaining a key theme at present, **local rates markets** in the region remain under pressure. As such, we prefer staying sidelined. We maintain our earlier recommendation on 2s/10s steepeners in Polish cross currency swaps at current levels around 38bps, keeping a stop loss of 15bps and a target at key resistance level of 60bps.



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Introductory Comment

Dear Reader,

Recent data releases in New Europe were broadly encouraging, signaling an improving growth environment in 2011. However, recent weakness in a number of German industrial activity indicators, including manufacturing orders and the IFO manufacturing survey for March, predispose for some softening ahead in industrial activity and exports for a number of emerging market economies in the region. Moreover, the recent rallies in world food prices may undermine a more sustained recovery in private consumption dynamics this year, especially given their large weight in consumption baskets across the region.

Inflation is now a major theme in New Europe, risking to derail year-end targets for a number of inflation-targeting Central Banks and necessitating more aggressive policy moves to preempt inflation risks. Supply side factors including higher food and energy costs as well as administrative price hikes have pushed headline CPI readings higher in early 2011. On the positive side, inflation should be peaking soon unless there are nastier supply-related surprises on the horizon.

Inflation will remain elevated until at least the end of the current quarter, before it starts scaling down, assisted by favorable base effects. On top of already known risks stemming from escalating geopolitical tensions in the Middle East and North Africa (oil & fuel prices) and the prospective ECB rate hikes (private and public debt servicing & refinancing) comes the onset of election cycle in a number of countries in the region.

Revised fiscal data in Bulgaria showed a lower than previously estimated budget gap of 3.2%-of-GDP in 2010, bring the deficit even closer to the Maastricht threshold. More importantly, the sound fiscal performance has placed the country under the microscope of Moody's for a potential sovereign rating upgrade. Having argued over the soundness of public finances in the country for a long time, we now expect other rating agencies to follow suit. Elsewhere, the continued industrial and exports recovery predisposes for a robust GDP reading in the first quarter despite lingering concerns about domestic demand dynamics.

The government's progress in promoting important structural reforms in Romania has not escaped the attention of rating agencies either, despite increased tension in the domestic political landscape. However, the recent Eurostat reservations over the quality of fiscal data casts shadow over the fiscal consolidation progress accomplished in 2010.

Inflationary risks remain elevated in Serbia. CPI skyrocketed to 14.1% yoy in March, driven by food prices. In view if these developments, the NBS Governor called for special measures in the food market to address rallying prices. The high inflationary risks led NBS to raise its key policy rate further in April by 25 bps to 12.50%

Poland continues to perform robustly in term of output growth on the back of strong domestic demand. However, lax fiscal policies pose a serious threat to the economic outlook. Although public debt as a percentage of GDP in 2010 remained below the 55% constitutional threshold, the fiscal deficit widened to 7.9% of GDP, remaining above the Treaty's 3%-of-GDP thresholds for a third consecutive year.

In Ukraine, the government's reforms drive, which is interconnected with requirements of the present IMF programme, has slowed down recently. As a result, new IMF funding is likely to be delayed until at least June. In addition, the domestic economy has not managed to escape rising inflation pressures due to the rise in world food and energy prices. Consumer prices reached multi-month highs of 9.4% yoy in April while producer prices skyrocketed to 19.3% yoy.

In contrast to other New Europe peers, price pressures remain muted in Turkey. However, all eyes have turned to the new CBT Governor, Erdem Bacsi, who is expected to maintain the present monetary policy mix until at least the June national elections.

Major stock market indices in New Europe eased in recent weeks, as profit taking emerged and concerns over the euro area debt crisis intensified. Nevertheless, most of them remain near multi-month highs touched in mid-April, standing in a positive territory on a year-to-date basis. Turkey continues to be among the laggards as heightened inflation and balance of payments related risks continue to weigh on domestic equities. The Central Bank's decision to employ an unorthodox policy mix in order to contain rampant credit creation has raised worries over domestic banks' profitability this year. Bulgaria's main stock index continues to lead gains in the region, having firmed ca 22% since the beginning of the year.

External debt markets have remained impressively resilient in recent weeks, broadly shrugging of new debt jitters in euro area periphery markets. Credit default swap spreads narrowed further, though at slower pace that earlier this year. In detail, 5-year CDS spreads in Bulgaria and Romania each shrunk by ca 4% over the last month or so. Poland remains a laggard, with spreads falling just 2% since late March and standing marginally wider on a year-to-date basis as concerns linger over the country's fiscal outlook.

In the foreign exchange markets, local currencies eased over the last few weeks on profit taking. The Serbian dinar remains the region's top performer, having touched 1-year highs near 98.40/EUR in early May. The Hungarian forint is the runner up, having firmed more than 5% since the end of December against the euro. The Turkish lira and the Ukrainian hryvnya pose among the exceptions in New Europe to stand in a marginally negative territory year-to-date. On the former, the CBT's monetary policy mix employed since late 2010 has exerted depreciating pressures on the national currency. On the latter, the sidetracking of the IMF programme earlier this year continues to weigh on the UAH.

Regional bond markets firmed in recent weeks, with government yields easing from highs touched lately on heightened inflation concerns. Reversing earlier losses Turkey and Poland were among the region's top performers.

Prof. Gikas A. Hardouvelis

Group Chief Economist & Director of Research

Summary of key macroeconomic indicators

Realizations and forecasts

	Real GDP (yoy)			Consumer Prices (p.a.)			Fiscal Balance (%GDP)		
	2010	2011	2012	2010	2011	2012	2010	2011	2012
Bulgaria	0.2	3.2	4.0	3.0	5.0	3.5	-3.9	-2.5	-2.0
Poland	3.8	4.0	4.1	2.6	3.6	2.9	-7.9	-7.0	-6.5
Romania	-1.3	1.7	3.5	6.1	6.5	4.5	-6.5	-4.4	-4.0
Serbia	1.8	3.0	5.0	6.5	10.0	7.5	-4.4	-4.0	-3.2
Turkey	8.9	5.0	4.7	8.6	5.5	6.3	-3.6	-2.7	-2.6
Ukraine	4.2	4.5	4.8	9.4	10.6	9.6	-6.5	-3.5	-2.5
New Europe	5.1	4.2	4.4	6.4	5.8	5.5	-5.6	-4.3	-3.9
Euro area	1.7	1.6	1.8	1.6	2.5	2.0	-6.0	-4.8	-3.8
USA	2.9	3.1	2.9	1.6	2.4	2.2	-8.9	-10.9	-7.5

	Current Account (%GDP)			Policy Rate (e.o.p.)			FX* (e.o.p.)		
	2010	2011	2012	2010	current	2011	2010	current	2011
Bulgaria	-1.0	-4.0	-5.5	currency board			1.96	1.96	1.96
Poland	-3.3	-3.5	-4.2	3.50	4.00	4.50	3.96	3.93	4.00
Romania	-4.2	-5.5	-6.0	6.25	6.25	6.25	4.28	4.09	4.20
Serbia	-7.0	-8.0	-8.5	11.50	12.50	10.50	106.1	99.3	105.0
Turkey	-6.6	-7.5	-6.7	6.50	6.25	7.75	1.54	1.56	1.48
Ukraine	-2.5	-2.8	-3.4	7.75	7.75	7.75	7.94	7.98	7.90
New Europe	-4.6	-5.4	-5.5	-	-	-	-	-	-
Euro area	-0.6	-0.5	0.0	1.00	1.25	1.75	1.34	1.43	1.45
USA	-3.2	-3.2	-3.0	0.250	0.250	0.250	0.75	0.70	0.69

Source: National statistics, IMF, EC, Eurobank Research forecasts
vs. EUR (TRY and UAH vs. USD)

I. Overview

Regional stock markets marginally weaker in recent weeks on profit taking, euro area debt crisis jitters

Equity markets in New Europe eased slightly in recent sessions on profit taking, after most regional indices touched multi-month highs in mid-April. With Japan's devastating earthquake and political and social tensions in the Middle East and North Africa (MENA) on the back burner, the region's bourses have been closely trailing global developments in recent weeks. Among them, the euro area's credit crisis, the Fed and ECB policy meetings, policy tightening from a number of Asian central banks and a flurry of, mostly upbeat, corporate earnings announcements. Year-to-May 6 most indices in New Europe stood in positive territory, having though trimmed part of their earlier gains on profit taking. New Europe broadly underperformed its regional peers in recent weeks with the MSCI Emerging Europe Equity index having registered losses to the tune of 2% since the end of March. Nevertheless, it remains not too far from a 2-½-year peak of 625.64 hit in mid-April and around 10% higher year-to-date. Since the beginning of the year, the benchmark MSCI Emerging Markets index gained just 1%, while the corresponding global equities index marked a near-6% rise. In comparison, LATAM and BRICS emerging equity markets continued to underperform, recording losses of around 5%, each since the end of March. In New Europe, Turkey was the region's outperformer on a monthly basis, posting gains in excess of 6% and hitting multi-month highs in early May. Even so the index has lagged its peers so far in 2011. Concerns about the country's external vulnerabilities linger, while an unorthodox policy mix employed by the central bank to contain rampant credit creation has weighed on the domestic banking sector's profits outlook. Note that banking shares account for ca 40% of Turkey's main index XU100. On the other hand, Bulgaria continues to lead the gains year-to-date with a 22% jump.

Regional bond markets firm but risks linger as inflation concerns remain in the forefront

Local rate markets firmed in recent weeks, with government bond yields easing from multi-month highs touched earlier in this year on heightened inflation concerns. Turkey and Poland, which lagged their peers in March, recently posed among the region's main outperformers, especially for shorter maturity paper. In Turkey, April's CPI remained near 4-decade lows, somewhat soothing concerns that the CBT may be falling behind the curve in its fight against inflation. In Poland, rate hike expectations in the coming months have been recently watered down after the government said it mandated a state bank to convert part of the country's EU funds into zlotys. The plan has already provided a lift to the domestic currency, with previous monetary tightening expectations for this year being scaled back. Indicatively, the 2-year Turkish and Polish benchmark bond yields have registered respective declines of 78bps and 16bps since end-March, currently standing at 8.43% and 4.86%. Elsewhere, Hungary's government bonds recovered a further part their recent losses amid ongoing fiscal consolidation optimism. Along these lines, the 3- and 10-year Hungarian government bond yields each fell by ca 15-20bps over the last month or so to respective levels of 6.6% and 7.2% on May 9.

Regional FX markets ease from recent highs on profit taking, growing euro area debt jitters

Regional currencies weakened over the last few weeks on profit taking, after hitting multi-month highs. Recently escalating euro area jitters, which weighed on the euro, did not favor either. Inflation risks and the debt crisis in the euro area remain key themes for FX markets in New Europe. On the former, the prospect of widening interest rate differentials vis-à-vis developed economies is supportive of capital inflows to the region, and, by implication, for regional currencies. So far this year, the Serbian dinar and the Hungarian forint remain among the outperformers, favored by aggressive central bank rate hikes to address increased inflation risks. The door remains open for further monetary tightening by NBS, while the NBP is unlikely to pursue any additional rate hikes that may hurt the domestic economic recovery. Along these lines, the Serbian dinar hit a 1-year peak at 98.40 on May 6. Separately, the **EUR/HUF** remained range-bound in recent sessions, at levels around 262.70-266.60, within distance from a 1-year trough of 262.40 achieved in early April. The Polish zloty climbed to an 11-week peak of 3.9158/EUR in early May, receiving significant support from the government's plan to convert part of the EU funds to the local currency. However, the PLN has broadly underperformed its peers so far in 2011 as fiscal consolidation concerns have weighed on investor confidence. In Romania, the leu retreated from a recent 1-year peak of 4.0607 vs. the EUR as its recent rally – driven by an improving macroeconomic outlook and a new IMF deal signed in March - ran out of steam. Elsewhere, the **Turkish lira** recently embarked on a depreciating trend, remaining in a marginally negative territory vs. the dollar year-to-date. The **USD/TRY** touched a peak above 1.55 levels in early May after hitting 4-month lows of 1.4970 a couple of weeks earlier.

External debt markets firm further, but pace of spread tightening loses momentum

New Europe's external debt markets remained on a tightening mode in recent weeks, largely shrugging off lingering euro area concerns and geopolitical tensions in MENA. Yet, the narrowing in spreads lost some momentum lately. In detail, Bulgaria's and Romania's 5-year CDS spreads each narrowed by ca 4% over the last month or so, currently standing near respective multi-month lows of 198bps and 211bps recorded in early April. Poland lagged its peers, as concerns about the country's fiscal position and upward current account deficit revisions weighed on investor sentiment. The country's 5-year CDS spread narrowed just 2% since late March, standing marginally wider year-to-date, when spreads in Hungary, Romania, and Bulgaria have narrowed 20-40% over the same period. Turkey's sovereign credit spreads shrunk 3% in recent days, remaining however among the worst performers so far this year. At levels of 153bps currently, spreads stand off February's 6-month peak of 182bps.

Strategy - Emerging New Europe Markets

FX: In line with our earlier short recommendation, the **EUR/RSD** temporarily touched our 98.40 target on May 6. Having recently broken below key support levels, the pair appears to have some further downside potential in view of an improving domestic macroeconomic backdrop and the NBS's proactive policy stance. Yet, we prefer closing our short position at current levels and collect profits. So far this year, the Serbian dinar has broadly outperformed its peers in New Europe, having firmed by more than 6% against the euro. Its rally may eventually run out of steam, with a technical correction remaining a possibility in the short-term. Elsewhere, the assessment behind our earlier short **PLN/HUF** recommendation remains broadly unchanged. The forint is among the outperformers in the region year-to-date, continuing to receive support from ongoing fiscal consolidation optimism. On the other hand, the Polish zloty has yet to embark on a convincing appreciation trend, in view of lingering concerns over Poland's twin (fiscal and current account) deficits. As such, we maintain our previous **PLN/HUF** short recommendation, preserving our earlier stop-loss and take-profit targets of 68 and 64, respectively. On **EUR/TRY,** we would close our earlier short position and take profits. The pair has broken above key resistance levels several times in recent months and there is little to suggest a sustainable weakening of the euro in the imminent future. In fact, we would opt to reverse our earlier recommendation and suggest going long the **EUR/TRY** at current levels of 2.2450, with a stop-loss below 2.20 and immediate target of 2.35 ahead of 2.50. Separately, we would close our earlier short **EUR/RON** position at current levels near 4.1 as, as the leu's rally recent appears to be somewhat overextended.

In the sovereign credit space, we continue to favor longs in Turkey's 5-year CDS at current levels around 150bps targeting the 170bps level. Not much has changed since our previous *New Europe Economics and Strategy* report, with risks lingering in the face of rising external imbalances. Meanwhile, although we do not expect any surprise developments in the upcoming national elections, we do believe that a single-party AKP government is largely priced in by investors. As such its impact on financial markets is likely to prove limited. Since our initial (January 2011) short Romanian 1-year CDS recommendation, spread have tightened significantly from 200bps to near 100bps in late April. In view of Romania's improving macroeconomic outlook, we remain constructive on the latter recommendation, preferring to hold this position to maturity. We also continue to like our long Poland 5-year CDS vs. short Russia 5-year CDS call as a pure oil play on the latter and twin deficit concerns on the former. Elsewhere, we would close our short positions in Bulgaria's 4-year CDS spread and take profit as the security currently stands a tad above our second line target, of 170bps (the first target, of 200bps, was hit in March) and the recent sharp narrowing appears to be running out of steam. A trade that is becoming increasingly interesting lately is that of entering long the Markit iTraxx SOVX index for Western Europe vs. short on the corresponding CEEMEA. The indices currently trade at par, with both around levels of 188bps. In this case the carry is zero and there appears to be potential for further widening in the Western Europe index in view of lingering concerns about the euro area's debt crisis. On the flipside, the CEEMEA region has displayed remarkable resilience in risk events recently with additional tightening being in the cards as growth in the region recovers further and fiscal positions improve as a result of ongoing consolidation efforts.

With inflation concerns remaining a key theme at present, **local rates markets** in the region remain under pressure. As such, we prefer staying sidelined. We maintain our earlier recommendation on 2s/10s steepeners in Polish cross currency swaps at current levels around 38bps, keeping a stop loss of 15bps and a target at key resistance level of 60bps. Another trade idea that could bear some value is 2s/5s flatteners in Turkish cross currency swaps. The market currently prices in around 100bps of rate hikes by year end, which is more or less in line with our projection. However, with the impact of the CBT's unconventional monetary policy yet to become evident in the domestic economy, risks lie ahead in the form of the CBT eventually been left behind the curve in its fight against inflation. In such risks materialise, the market's median forecast for monetary tightening may prove too dovish and the short-end of the yield curve is likely to rise. Along these lines, we

recommend entering flatteners at levels around 60bps with a target of 0 bps and a stop-loss above 80bps.

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II. New Europe – Country Analysis: **Bulgaria**

On Moody's review for a possible upgrade

- In early April, Moody's put Bulgaria's sovereign "Baa3" rating on review for a possible upgrade, citing the country's healthy fiscal position
- The ESA 95 general government deficit for 2010 came at 3.2% of GDP, better than the 3.6% initial estimate
- The continued improvements in industrial production and exports predisposes for a robust GDP reading in the first quarter of 2011, despite lingering concerns over domestic demand dynamics

Revised fiscal data for 2010 (in ESA95 terms) beat initial estimate, bring deficit closer to the 3% threshold

The general government deficit in ESA 95 terms (the methodology which calculates fiscal metrics in accrual terms and is used as part of the Maastricht criteria assessment) came at 3.2% of GDP in 2010 vs. a target of 3.8% in last year's budget. The reading also compares favorably to an earlier deficit estimate of 3.6% of GDP, and 4.7% of GDP in 2009. Accordingly, the gross public debt ratio came at 16.2% of GDP in 2010 vs. 14.6% in 2009.

The revised outcome brings fiscal deficit closer to the 3% Maastricht threshold. It places Bulgaria among the most fiscally sound countries in the EU-27 and in the broader region. Fiscal metrics in EU-27 fare much worse both in terms of deficit (EU-27 average: 6.4%) and indebtness (EU-27 average: 80%). The better-than-expected deficit outcome provides tangible evidence of the authorities' commitment in fulfilling the Maastricht criteria for euro adoption. The reduction in the deficit came as the combined result of the following: the central government posted a 2.4% of GDP deficit, down from 4.1% in 2009; the social security fund recorded a deficit at 1.1% of GDP, down from a 0.5% surplus in the prior year. Finally, the sector of local government had a positive balance of 0.4% of GDP, compared to a 1% deficit in 2009 (Figure 1).

Looking ahead, the government targets a general government deficit of 2.5% of GDP (both on accruals and cash basis) in 2011. In our previous trips in Sofia (October 2010 and March 2011), the attainability of the target was a focal point in our discussions. Consequently, we argued strongly in favor of the attainability of the 2011 fiscal target. Yet, we warned back then that the deficit outcome would not only depend upon the headline GDP figure but also on the composition of growth. Naturally, that is because a shift towards a more domestic-demand oriented growth environment has, by definition, higher tax content. Provided recovery this year, we now believe that the probability of attaining the 2011 fiscal target has increased. The first indications from the Jan-March data released are sending an encouraging message. The fiscal deficit on a cash basis came down by 55% yoy, reaching 1% of GDP compared to 2.4% of GDP in Jan-March 2010.

Another point to be made refers to predictability and prudence of the fiscal policies in the medium term. This is particularly important for the sustainability of the Currency Board arrangement. Finally, the government has reiterated its political will to maintain low deficits in the medium term as part of the commitments it has undertaken in the context of the framework 2012-2014 and the revised convergence program. Within this framework, the government targets a gradual reduction of the budget deficit to 1.5% of GDP in 2012, 1% of GDP in 2013 and 0.5% of GDP in 2014.

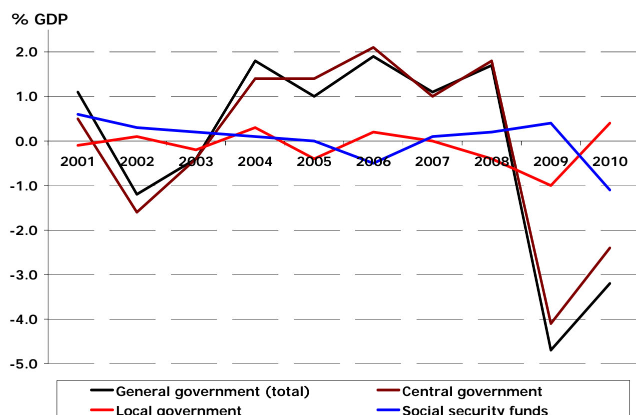
Bulgaria: Eurobank EFG Forecasts

	2008	2009	2010	2011f
Real GDP (yoy%)	6.2	-5.5	0.2	3.2
Final Consumption	2.6	-7.3	-1.1	1.0
Gross Capital Formation *(Fixed)*	21.9	-17.6	-16.5	4.5
Exports	3.0	-11.2	16.2	8.5
Imports	4.2	-21.0	4.5	6.5
Inflation (yoy%)				
HICP (annual average)	12.0	2.5	3.0	5.0
HICP (end of period)	7.2	1.6	4.4	4.6
Fiscal Accounts (%GDP) - *Cash Basis*				
General Government Balance	2.9	-0.9	-3.9	-2.5
Gross Public Debt	15.5	15.6	16.7	19.5
Primary Balance	3.7	-0.2	-3.3	-2.0
Labor Statistics - *National Definitions*				
Unemployment Rate (registered, %)	6.3	9.1	9.2	8.9
Wage Growth *(total economy)*	26.5	11.8	6.2	7.5
External Accounts				
Current Account (% GDP)	-23.0	-8.9	-1.0	-4.0
Net FDI (EUR bn)	6.7	2.4	1.6	2.2
FDI / Current Account (%)	82.4	77.4	460.0	145.0
FX Reserves (EUR bn)	12.7	12.9	13.0	13.5
Domestic Credit	**2008**	**2009**	**Q3 10**	**Q4 10**
Total Credit (%GDP)	75.2	79.2	78.7	76.3
Credit to Enterprises (%GDP)	47.8	49.4	49.4	48.2
Credit to Households (%GDP)	26.0	28.2	27.4	26.3
FX Credit/Total Credit (%)	57.2	58.6	60.9	61.3
Private Sector Credit (yoy)	32.3	4.5	2.7	2.1
Loans to Deposits (%)	119.3	120.5	116.0	112.9
Financial Markets	**Current**	**3M**	**6M**	**12M**
Policy Rate		Currency Board		
EUR/BGN	1.96	1.96	1.96	1.96

Source: National Sources, Eurostat, IMF, Eurobank Research

Figure 1

Fiscal performance improved further in 2010



Source: Eurostat, Eurobank Research

Moody's places Bulgaria under review for a possible sovereign rating upgrade; more action should be expected by other rating agencies in the period ahead

Bulgaria's robust fiscal performance has not escaped the attention of the rating agencies. On April 5th, Moody's Investors Service put Bulgaria's 'Baa3' rating on review for a possible upgrade, citing its healthy fiscal position. In the sovereign report assessment released on May 4th, the rating agency praised the conservative fiscal policies that have allowed Bulgaria to avoid the fiscal fate of most Eurozone members. In addition, the agency assessed that the target to reduce the deficit to 2.5% of GDP as attainable, yet a lot will depend upon the March-April tax revenue performance. Lastly, Moody's ranks susceptibility to event risk as moderate to reflect the country's extensive Euroization, high external debt and weak external liquidity. The latter would only pose a risk in the case of an exchange rate regime change which is seen as very unlikely.

We have long argued in all our past New Europe Economics & Strategy issues over the health of public finances in Bulgaria. The report brings up a more important issue: the sovereign rating of Bulgaria vs. that of its New Europe peers. More importantly, Bulgaria fares much better in terms of fiscal metrics compared to all other Baa countries according to the Moody's rankings (with the exception of Kazakhstan and Russia, which are commodities-driven economies) (Table 1).

The Bulgarian economy has fared much better in terms of output contraction, fiscal consolidation and, various external susceptibility metrics compared to the Baltic peers (Latvia and Lithuania who also have a currency board). In addition, Bulgaria fares better than Croatia (which is still in recession) or Hungary (which resorted to an IMF program to shore up its public finances). Yet Bulgaria is assigned with the same long- term rate by both Moody's and Fitch. Standard and Poor's differentiated itself from the above assigning Bulgaria an one notch higher rating than Hungary and same rate as Lithuania. From that point of view, Bulgaria qualifies for a rating upgrade (Table 1).

Table 1

Sovereign rating actions on Bulgaria vs. its New Europe peers (Long-term-Foreign Currency)

	Moody's			S&P			Fitch		
	Current Rating	Date of last rating action	Action	Current Rating	Date of last rating action	Action	Current Rating	Date of last rating action	Action
Lithuania	Baa1	28.9.09	from A3 to Baa1	BBB	24.3.09	from BBB+ to BBB	BBB	8.4.09	from BBB+ to BBB
Latvia	Baa3	23.4.09	from Baa1 to Baa3	BB+	7.12.10	from BB to BB+	BBB-	15.3.11	from BB+ to BBB-
Hungary	Baa3	6.12.10	from Baa1 to Baa3	BBB-	30.3.09	from BBB to BBB-	BBB-	23.12.10	from BBB to BBB-
Croatia	Baa3	27.1.97	-	BBB-	21.12.10	from BBB to BBB-	BBB-	28.6.01	from BB+ to BBB-
Romania	Baa3	10.6.06	from Ba1 to Baa3	BB+	27.10.08	from BBB- to BB+	BB+	10.11.08	from BBB to BB+
Bulgaria	Baa3	1/3/2006	from Ba1 to Baa3	BBB	30.10.08	from BBB+ to BBB	BBB-	10.11.08	from BBB to BBB-

Source: Rating agencies, Eurobank Research

Last but not least, we do take note that the sovereign rating did not drop below investment grade in the post-Lehman environment. That said, we anticipate that the economic environment improvement coupled with the improving macroeconomic fundamentals should lead other rating agencies reassess their stance soon.

High frequency indicators point to sustained exports-led recovery in Q1; IMF upgraded its GDP forecast to 3% for 2011 in the latest World Economic Outlook

The most recent high frequency indicators in the first two months of the year point to a continuation of the exports-led recovery. In addition, early signals of recovery from the domestic demand side have shown up. The continued industrial and exports recovery predisposes for a positive GDP reading in the first quarter of 2011 despite lingering downside concerns with respect to domestic demand.

More specifically:

- Exports are still booming: Exports expanded by an astonishing 46.5% yoy in February in addition to the 72.5% yoy in January, which brings the two-month performance at 58.9% yoy. Exports to the non-EU markets are still outperforming those to EU markets (65% yoy to non-EU vs. 55% yoy in EU). On the other hand, imports are lagging behind by 36.3% yoy in the same period.

- Industrial production accelerated to 15.2% yoy in February (-1.4% mom) compared to 10.1% yoy in January. Although the figure is preliminary and influenced by the low base from February 2010, a comparable figure on a yearly basis has not been recorded since January 2007. The exports-oriented sectors (chemicals, textiles, tobacco, pharmaceuticals) are driving manufacturing production up by 22% yoy in February compared to 15.6% yoy in January.

- Industrial sales performance is keeping up: they expanded by 32% yoy in February vs. 35.9% yoy in January.

- After a one-off deterioration in March, business confidence improved further in April (by 2.4pps to 17.5) driven by improved perceptions in the industry and services sectors. On the other side of the spectrum, the sectors of construction and retail remain pessimistic.

- Retail sales volume (seasonally adjusted) turned positive on a yearly basis in March. Retail sales t by 1.4% yoy in March compared to -0.1% yoy in February, up from -0.2% yoy in January and -3.7% yoy in last December.

In our key notes from our last trip to Sofia in late March, we focused on the growth prospects of 2011. Among the key conclusions of our trip was to upgrade our baseline GDP forecast, based on the discussions with our contacts. In our view, GDP growth this year may exceed the 3% mark, taking into account a set of assumptions we described in our analysis. The improvement in the economic environment during the last quarter of 2010, in combination with our global outlook forecast assumptions, led us to upgrade our GDP forecast to 3.2% from 2.5% previously.

Our updated forecast still lies significantly above consensus, yet we still find it attainable and realistic. Having said that, risks to our GDP forecast remain high and skewed to the downside. Such risks relate mainly to the outlook of the household sector. In our analysis, we identified the following factors as presenting the main risks to our 2011 GDP growth forecast:

- Inflation climbed further to 5.6% in March vs. 5.2% in February on rising food and oil prices deteriorating further the headline CPI-REER

- Weak domestic credit activity: Credit to households remains on a negative territory since the beginning of the year (-0.2% year-to-March)

- High refinancing needs of private-sector external debt: gross private external debt stood at 83.6% of GDP in February down from 89.9% in last December on a steadily declining trend

- High unemployment rate: registered unemployment stood at 9.5% in March vs. 9.2% in last December

Since late March, a number of international organizations have published their updated forecasts for the Bulgarian economy. IMF published its semi-annual publication on world economy in April, the World Economic Outlook. IMF upgraded its 2011 GDP forecast for Bulgaria to 3% compared to 2.5% in the previous publication back in October. In contrast, World Bank has maintained its 2.5% GDP forecast in 2011 in the latest EU-10 Progress Report. However, both organizations forecast growth to accelerate further at 3.5% and 3.4% respectively in 2012.

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II. New Europe – Country Analysis: **Poland**

Growth prospects remain solid

- Domestic economic outlook remains supported by vibrant domestic demand dynamics, investment boom ahead of the 2012 European Football Championships
- Headline inflation unexpected rise to 4.3% in March, driven by soaring food and fuel prices. Yet, NBP will most likely remain on hold on rates in May, since recent inflation spike reflects factors outside its control and March's labour market data mitigate the risk of rapid build-up of wage pressures
- According to national definition, the public debt in 2010 stood at 53.0% of GDP. This is still below the 55% constitutional threshold that would trigger automatic consolidation measures which, in turn, would be politically harmful in the run up to October's elections
- Tighter lending policies on the back of increasing NPLs ratio

Growth prospects remain solid

The Polish economy remains strong with domestic demand its main driver of growth. Q4-10 GDP growth was revised upwards to 4.5% yoy, from 4.4% yoy estimated previously, confirming that economy grows close to its estimated potential rate of growth (4%). Real economy data have remained robust through the first quarter of 2011 and point to a relatively strong Q1-11 GDP reading, albeit likely down from that of Q4-10. We anticipate Polish growth to remain close to the economy's potential in 2011, helped by the investment boom ahead of the 2012 European Football Championships. However, there are downside risks to the growth outlook stemming from fiscal and current account deficits.

Higher frequency data were slightly weaker in March. Industrial production slowed to 7.0% yoy in March, down from 10.7% yoy. Retail sales slowed to 9.4% yoy, down from 12.2% yoy in February, but they exceed expectations of 7.2% yoy. March's wage growth stood at 4.0% yoy from 4.1% yoy in the prior month. At the same vein, unemployment eased slightly to 13.1% while employment dropped faintly to 4.0% from 4.2% in February. What's more, Germany and Austria lifted labour market restrictions on CEE-10 countries. This implies that from May 1, 2011 workers from these countries are allowed to apply for every job in Germany and Austria. According to German officials, most potential jobseekers would come from the neighbouring Poland, whose people have already been allowed to take up seasonal jobs without work permits in Germany since January 1, 2011. This development will likely shrink the Polish workforce and thus would weigh on the labour market.

Poland: Eurobank EFG Forecasts				
	2009	2010	2011f	2012f
Real GDP (% yoy)	1.7	3.8	4.0	4.1
Private Consumption	2.3	3.2	3.5	3.6
Government Consumption	1.9	3.4	3.0	2.5
Gross Capital Formation	-13.6	6.3	6.5	4.5
Exports	-7.8	7.8	6.8	7.0
Imports	-13.5	8.3	7.9	7.1
Inflation (% yoy)				
CPI (annual average)	3.5	2.6	3.6	2.9
CPI (end of period)	3.5	3.1	3.2	2.6
Fiscal Accounts (% GDP)				
General Government Balance	-7.3	-7.9	-7.0	-6.5
Gross Public Debt (ESA95 definition)	50.9	55.0	57.0	56.0
Gross Piblic Debt (national definition)	49.9	53.0	54.5	54.0
Labor Statistics (%)				
Unemployment Rate (% of labor force)	11.0	12.0	12.3	11.8
Wage Growth *(private sector - average)*	4.2	3.6	5.0	4.5
External Accounts				
Current Account (% GDP)	-2.2	-3.3	-3.5	-4.2
Net FDI (bn EUR)	6.1	7.5	8.0	9.0
FDI / Current Account (%)	90.6	65	75	70
FX Reserves (bn EUR)	54.8	70	60	65
Domestic Credit	**2008**	**2009**	**Q3-10**	**Q4-10**
Total Credit (% GDP)	50.9	53.1	54.6	55.4
Credit to Enterprises (% GDP)	17.6	16.1	15.6	15.2
Credit to Households (% GDP)	29.7	31.6	33.6	34.2
FX Credit/Total Credit (%)	32.6	30.2	30.1	30.8
Private Sector Credit (% yoy)	38.1	7.2	7.6	8.9
Loans to Deposits (%)	106.0	102.6	102.0	102.4
Financial Markets	**Current**	**3M**	**6M**	**12M**
Policy Rate	4.00	4.00	4.25	4.50
EUR/PLN	3.93	3.90	4.00	4.10

Source: NBP, EcoWin, Bloomberg, Eurobank Research

Incumbent government aspires to a second consecutive four-year term in office largely on the back of comparative economic success of the past couple of years

Parliamentary elections are scheduled for October, either on the 16th or on the 23rd of the month. Recent polls suggest that the ruling party (PO) will remain the largest party after the elections and could even increase its share of seats in the Sejm (the lower house of the Polish parliament, it's made up of 460 deputies). Actually, the PO aims to capitalise the comparative economic success of the past two years. Poland was the only EU country with positive growth in 2009 and recorded the third highest

growth in 2010 among EU countries. The economic recovery is robust and employment is picking up. What's more, the main opposition party (PiS) is divided. Therefore, as it stands, the incumbent Prime Minister, Donald Tusk has a high chance to secure a second consecutive four-year term in office. He would be the first Prime Minister to be re-elected since the fall of communism in 1989.

Fiscal performance: a growing challenge

Poland's general government deficit widened to 7.9% of GDP in 2010 from 7.3% of GDP in 2009 and 3.7% of GDP in 2008, exceeding the European Union limit of 3.0% of GDP for a third consecutive year. The government approved in late-April the updated Euro Convergence report aiming to cut the fiscal deficit to 5.9% of GDP in 2011 and to 2.9% of GDP in 2012. In order to achieve this target, the government has announced some fiscal consolidation measures. Namely, an 1% VAT hike effective from January, a public sector wage freeze and a limit on discretionary spending to headline CPI+1%. However, the government has shown no clear signs of tackling its sizeable structural deficit, which amounts currently to around 6% of GDP. Reforms in the labour market are needed and could save up to two thirds of the structural deficit. Abolition of early retirement schemes[1] and privileged farmers pension schemes[2] are some of the pending reforms. But, ahead of the October's parliamentary election the government will likely backtrack from legislating any unpopular measures. Moreover, given the very uncertain global economic environment, the government is not willing to undertake an aggressive fiscal tightening which may weigh heavily on near-term growth. Nonetheless, given that the budget deficit has more than quintupled since 2007 (from 22.1bn PLN in 2007 it climbed to 111.1bn PLN in 2010) and that the economy is now growing above its potential level, this fiscal deficit is clearly too large for this stage in the cycle and has to be tackled so as to secure continued growth and convergence to the Euro-zone over the medium term. What's more, if the government does not undertake a comprehensive reform programme to cut its fiscal deficit; this would result in Poland facing higher external financing needs. Markets will surely be looking for decisive action on fiscal consolidation once the elections have passed. It's worth noting that total external debt accounted for 65.4% of GDP in 2010, up from 59.6% of GDP in 2009 and 48.4% of GDP in 2007. Moreover, public debt denominated in FX accounted for 23.1% of GDP in 2010 up from 18.6% of GDP in 2009 and just 16.4% of GDP in 2007. This implies that the 43.4% of public debt is FX denominated in 2010, up from a 36.5% share in 2009. This is justifying concerns that potential zloty devaluation would markedly raise the public debt to GDP ratio. According to the national definition, the public debt in 2010 remained below the 55% of GDP constitutional threshold. Exceeding this threshold would trigger automatic consolidation measures which, in turn, would be politically harmful in the run up to October's elections. The 53.0% of GDP public debt outturn is slightly better than the September's official projection of 53.2% of GDP. (Table 1)

Table 1

Fiscal slippage in recent years

	2007	2008	2009	2010
GDP nominal, bn PLN	1,176.7	1,275.4	1,343.6	1,415.5
GDP % growth	6.8	5.1	1.7	3.8
Fiscal deficit nominal, bn PLN	22.1	46.8	98.7	111.1
Fiscal deficit % of GDP	1.9	3.7	7.3	7.9
Public debt nominal, bn PLN	529.4	600.8	684.1	778.2
Public debt % of GDP (national definition)	44.8	46.9	49.8	53
Public debt % of GDP (ESA95 definition)	45	47.1	50.9	55
Total External debt	569.9	727.1	801.2	925.4
External Public debt	192.8	200.5	250.1	326.3
Share of public debt in FX	36.4%	33.3%	36.5%	43.4%

Source: National Bank of Poland, Eurostat, National Statistics, Eurobank Research calculations.

All in all, we anticipate the fiscal deficit to narrow this year on the back of suggested consolidation measures but not at the level it is officially projected since backtracking may also appear ahead of October parliamentary elections.

Current account widened further exceeding consensus

Current account deficit widened further in February to €685mn exceeding consensus of €308mn. The cumulative 12-month current account deficit amounted to €13.7mn, against €6.7mn in the corresponding period a year before. This deterioration has mainly resulted from increases in the trade (from €2.9mn to €5.9mn) and income (from €11.9mn to €14.3mn) deficits.

The net errors and omissions component stood at €103mn from €-1.5mn recorded in the previous month. This component has ballooned since 2006 and is now equivalent to around 4.0% of GDP. The President of the National Bank of Poland (NBP), Marek Belka, announced that the Bank is working to explain this rise and the data will be revised. While any possible revisions would likely see the errors and omissions component shared between the current account and the capital account, the implications would be significant and probably nominal GDP would be lower.

[1] Uniformed service workers including the police soldiers and firemen are currently allowed to retire in full after just 15 years of service.

[2] Farmers currently pay reduced social contributions; instead of income tax they pay a lower lump-sum agricultural tax.

March CPI's sharp unexpected rise propelled by soaring food and fuel prices

Poland's inflation rate in March soared to a two and a half year high at 4.3% yoy, outpacing expectations of 3.9% yoy, up from a 3.6% yoy print in February. It is clear that underlying price pressures are starting to pick up. What's more, core inflation (measure which excludes food and energy prices) rose to 2.0% yoy up from 1.7% yoy in February. We anticipate headline inflation to remain elevated throughout 2011 and average to 3.6% yoy but to drop back to target once the impact of VAT hikes fade out and global food and energy prices start to decelerate.

MPC will most likely keep interest rates unchanged in May on the back of mitigated risk of rapid build-up in wage-related pressures

Higher than expected headline inflation in March increased chances that the central bank would raise interest rates in its meeting in May. However, the current elevated rate of inflation largely reflects temporary factors, such as January's VAT hike and the recent spikes of food and energy prices, which are out of NBP's control. What's more, March's labour market data were slightly weaker than expected. This may tip the balance away from a second consecutive hike in May (NBP has raised interest rates by 25bps in January and in April; currently the policy rate stands at 4.00%). All told, we anticipate NBP to most likely keep interest rates unchanged in May, invoking the argument that recent inflation soar reflects factors outside its control and March's labour market data mitigate the risk of rapid build-up of wage and inflationary pressures. However, we expect the key policy rate to reach 4.5% at year-end.

Tighter lending policies on the back of growing share of impaired loans in banks' loan portfolios

According to National Bank of Poland survey, in the fourth quarter the standards for granting loans were further tightened on the back of the growing share of impaired loans in banks' loan portfolios. Yet, in the fourth quarter of 2010, there was an increasing demand for loans in the corporate sector, driven by the rise in financing needs for inventories and working capital. Demand for corporate loans has increased in the first quarter of 2011, as well. Corporate loans grew by 3% year-to-March, with 1.4% mom increase in March, accelerating from 0.9% mom rise recorded in February. Contrariwise, in the household sector a fall in demand for consumer loans was observed in the fourth quarter due to tighter lending standards coupled with the fall in the financing needs for durable goods. This drop has eased in the first quarter of 2011 with household credit growth at 0.4% year-to-March. Household credit grew by 0.5% mom in March, decelerating from 0.8% mom recorded in February. Furthermore, in the fourth quarter of 2010, the banks registered a considerable drop in demand for housing loans of 30%. This drop however, according to Senior loan officer opinion survey of the NBP, was primarily because of banks' tighter lending policy due to implementation of Recommendation T (regulation which scopes to improve the quality of credit risk management in banks in Poland). Mortgages loans denominated in FX account for 57% of the total. Therefore, there is a significant exchange rate risk in case of domestic currency devaluation. What's more, non-performing mortgage loans have increased recently; they account for 15.2% of total household NPLs in February 2011, up from a 14.5% share in December 2010 and 11.9% in March 2010. Household NPLs ratio to total loans stood at 7.3% in March 2011.

In contrast to total credit, which grew slightly by 1.3% year-to-March, total deposits increased by 3.9% since the beginning of this year. This increase was attributed to households' deposits which grew by 2.8% year-to-March. As a result, the Loan to Deposits ratio in March 2011 dropped under the unit, to 99.5%, for the first time since August 2008.

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II. New Europe – Country Analysis: **Romania**

Government reiterates goal of euro adoption in 2015

- Inflation accelerated again in April, hitting 8.3% yoy, from 8% yoy in the prior month
- Fiscal performance showed a clear improvement trend in Q1:2011, yet Eurostat expresses reservations over the quality of the reported data
- Standard and Poor's report on Romania leaves rating upgrade option open

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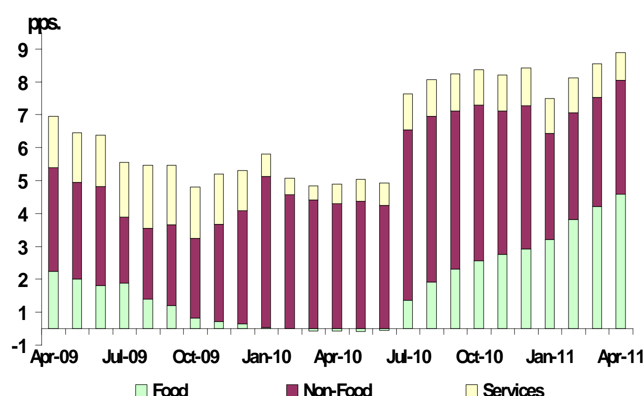
Inflation accelerated again in April; Central Bank revises year end inflation forecast to 5.1%

Consumer prices climbed to +0.7%/8.3% mom/yoy in April, from +0.8%/+8.01% mom/yoy in the prior month. The reading was above market expectations (Reuters consensus: +0.5%/+8.2% mom/yoy), driven by the ongoing surge in food prices (+0.9%/+10.9% mom/yoy). In addition, the non-food component (+0.9%/+7.7% mom/yoy) accelerated on the back of higher electricity tariffs (+5.0% mom) and tobacco prices (+1.2% mom). The services component continued to decline (-0.4%/+4.8% mom/yoy), helped by the Leu appreciation against the Euro.

Figure 1

Inflation climbed again in April on rising food prices



Source: National Statistics, Eurobank Research

The latest inflation developments confirmed that the official year-end target CPI (3+/-1%) is out of reach, a fact which led the Central Bank to revise its year-end forecast to 5.1% (from 3.6% previously) in the latest inflation report. As things stands at this point, disinflation is expected to resume from H2:2011 after the impact of last year's VAT hike falls out of the equation. However the domestic inflation outlook remains subject to significant risks, stemming mainly from supply side

Romania: Eurobank EFG Forecasts

	2008	2009	2010	2011f
Real GDP (yoy%)	7.3	-7.1	-1.3	1.7
Private Consumption	9.0	-10.6	-1.5	1.0
Govern. Consumption	6.3	1.2	-3.2	-2.5
Gross Capital Formation	15.6	-25.3	-13.1	3.5
Exports	7.3	-5.0	14.3	8.0
Imports	7.1	-21.4	12.4	5.0
Inflation (yoy%)				
CPI (annual average)	7.9	5.6	6.1	6.5
CPI (end of period)	6.3	4.7	8.0	5.2
Fiscal Accounts (%GDP, Cash Basis)				
General Government Balance	-4.8	-7.3	-6.5	-4.4
Gross Public Debt	21.3	29.5	35.2	36.1
Labor Statistics (annual avg,%)				
Unemployment Rate (% of labor force)	4.0	6.3	7.6	7.0
Wage Growth (total economy)	23.6	8.4	2.5	1.4
External Accounts				
Current Account (%GDP)	-11.6	-4.2	-4.1	-5.5
Net FDI (EUR bn)	9.3	3.6	2.6	3.5
FDI / Current Account (%)	57.6	72.3	51.4	65.0
FX Reserves (EUR bn)	26.2	28.3	32.4	38.0
Domestic Credit ***(end of period)***	**2008**	**2009**	**Q3 10**	**Q4 10**
Total Credit (%GDP)	42.7	50.2	52.4	52.7
Credit to Enterprises (%GDP)	18.8	19.6	20.5	20.4
Credit to Households (%GDP)	19.7	20.4	20.5	19.9
FX Credit/Total Credit (%, private)	53.1	60.1	62.5	63.0
Private Sector Credit (yoy)	33.7	0.9	4.5	4.7
Loans to Deposits (%)	131.9	130.6	134.8	137.7
Financial Markets	**Current**	**3M**	**6M**	**12M**
Policy Rate	6.25	6.25	6.25	6.25
EUR/RON	4.09	4.15	4.20	4.20

Source: National Sources, Eurostat, IMF, Eurobank Research & Forecasting

factors, including the ongoing rally in food and fuel costs and further increases in the administered prices.

After cutting interest rates by 175bps cumulatively in the beginning of 2010, the NBR was forced to terminate its easing policy cycle last June to address rising inflation risks stemming from a steep hike in main VAT rates. Ever since, the Central Bank has remained on hold, leaving its key policy rate at 6.25%. We broadly expect unchanged policy rates for the remainder of this year. Yet, we know see an increasing risk of higher policy rates sooner than latter, especially if inflation fails to decelerate in the second half of this year as significantly as currently expected. That will depend upon two more important factors among others: the RON appreciation trend (Leu strengthened to 4.09/€ on May 10th compared to 4.27/€ in early 2011) and the perceived sustainability of the growth rebound in 2011-2012.

Q1:2011 fiscal performance shows clear improvement; Eurostat expresses reservations over the quality of Romania's fiscal data

The most recent budget execution data (cash basis methodology) show a clear improvement trend. The consolidated budget deficit came at RON 5.2bn in Q1:2011, declining by 38% relative to the same period a year earlier. Q1. As a percentage of the projected full year GDP, the consolidated budget deficit stood at 1% in Q1: 2011 down from 1.6% a year earlier.

Total revenues were up by 10.2% yoy in Q1, whereas total expenditures grew by just 1.3% yoy over the same period. On the revenues side VAT collections and excise taxes increased by 35.9% yoy and 20.4% yoy respectively. In contrast, revenues from income tax and social contributions were still lower by 9.3% yoy in Q1, reflecting the weak labor market conditions. On the expenditures side, payroll expenses appear to have decreased by 20.6% yoy, reflecting the aggressive fiscal consolidation measures taken last June. Capital expenditure and co-financing for European projects are up 69.4% yoy. However, expenditures for goods, services and transfers appear to have increased by 18% and 6.2% respectively, ringing some alarming bells about public sector inefficiencies.

Overall, the fiscal performance to date sends a positive signal with respect to the attainment of the 4.4% of GDP fiscal target in 2011, provided that the recent fiscal performance continues. However, there are still significant uncertainties and risks. Firstly, it is important to note that on the expenditures side, authorities have already done most of the work with respect to fiscal consolidation, implementing politically sensitive measures (e.g. 100k lay-offs in the broader public sector, public wage cuts etc). The key challenge arising is to maintain them this strong performance throughout 2011. The risk of fiscal slippage will be rising as the time is approaching for the parliamentary elections in 2012. The latter view was also expressed by the recent IMF mission, which expressed concerns that the government might slow down the pace of reforms, encouraging by improving cyclical conditions in the domestic economy.

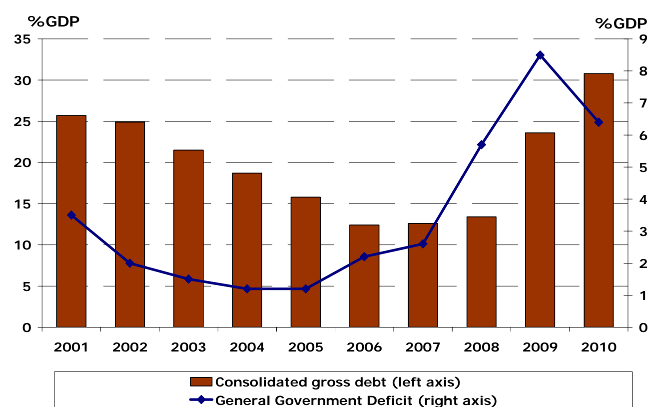
Secondly, there are risks related to the domestic growth outlook. Even if headline GDP numbers turn out to be in line with the budget forecast, if this is led by external demand it may not yield the required amount of tax revenues because only domestic demand can yield VAT. In addition, a significant source of tax revenues, such as income tax and social contributions, is still underperforming as the labor market recovery has yet to materialize.

Third and most important potential source of concern is the reliability of the fiscal data. As we have already warned in our previous issues of New Europe Economics & Strategy, the government has not eradicated the problem of arrears to the private sector (contractors, suppliers etc). It is worth noting here that this performance criterion was never met since the inception of the existing IMF programme. On a more alarming note, the full arrears number is yet to be known. The estimates coming from different sources are contradictory. According to the chief of the IMF mission in Romania, arrears amounted to as high as 5% of GDP at the end of 2010. IMF officials have promised to be less lenient on this issue in the new program, given that a waiver was granted throughout the past program.

On an alarming note, Eurostat expressed its reservations over the quality of fiscal data reported by the Romanian government in the notification of the debt and deficit data for 2010 (released on April 26th). In fact, Eurostat expressed doubts, not only on the issue of arrears, but also on uncertainties with respect to the impact of the results of state owned enterprises and the nature and impact of some financial transactions on the government deficit. For example, the general government budget deficit (in ESA95 terms) could reach 6.8-6.9% of GDP, up from the 6.4% initially reported, should financial results of state-owned railway company CFR Infrastructura and power generator Termoelectrica were incorporated.

Figure 2

The government accomplished to reduce the deficit in ESA95 terms by 2pps of GDP in 2010



Source: Eurostat, Eurobank Research

Standard and Poor's may upgrade sovereign rating of Romania

In our previous issue of New Europe Economics & Strategy we highlighted the progress the Romanian government has made in its structural reforms agenda. IMF requirements were fulfilled despite increased tension in the domestic political landscape. The new business-friendly labor code was only the latest area of

friction with trade unions and the opposition, following endorsement of the uniform wage law and the budget law of 2011. Additionally, we expressed the view that, provided that the government accomplishes to minimize uncertainties with respect to the 2011 budget execution, the next move by rating agencies on the assessment of the sovereign risk of Romania will probably be to the upside.

Indeed, the latest report of Standard and Poor's (out on April 28th) points to that direction. The report underlines the need for the government to maintain the momentum of its current structural reforms effort, to build a sustained track record of fiscal prudence and to preserve stability in the financial sector. Standard and Poor's has assigned Romania a BB+, a rating below investment grade, one notch above the sovereign rating of Serbia. However, Romania ranks very low by regional standards, taking in mind it is an EU member, a potential EMU candidate and is running a precautionary program with IMF.

Euro adoption goal time framework stays unchanged in 2015

The Romanian government submitted its revised convergence program 2011-2014. Although there has been speculation for the opposite, the government and the NBR decided to maintain 2015 as a target for Euro adoption. The government announced that a special body headed by the PM Emil Boc, will be charged with monitoring the adoption process and appointed Central Bank's governor as vice-president. The government is going to recommend an 11-month transition period between January 1st 2015 and December 2015, in which the Euro and the Leu would circulate in parallel, although in any other country the transition lasted two months.

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II. New Europe – Country Analysis: **Serbia**

Serbia: Food inflation spiral calls for extraordinary measures

- Inflation rallied to 14.1% in March registering the highest mom increase since January 2007
- Central Bank governor urged the government to undertake drastic measures in the food market in order to combat supply side inflationary pressures
- In a broadly expected move, the NBS raised interest rates further by 25bps to 12.5% on April 7th to address still elevated inflation expectations
- Dinar strengthened beyond 100/€ in late April, driven by high portfolio inflows

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CPI skyrocketed to 14.1% yoy in March on higher food prices. The Central Bank governor called for drastic measures in the food market to address rallying prices

March CPI recorded its highest month on month increase since January 2007. Consumer prices climbed by +2.6% mom/+14.1% yoy vs. +1.5% mom/12.6% yoy in February. The main driver behind higher inflation in the recent months is food prices. The food component carries a significant weight in the consumer basket (37.8% of the CPI basket). The prices of food & beverages spiraled at +5.3% mom/+22.9% yoy in March vs. +3.1% mom/+17.2% yoy in February. The second most important factor, alcohol and tobacco (4.9% weight in the CPI basket) accelerated to +5.8% mom /+22.2% yoy in March from 0.6% mom /+15.7% yoy in February.

The latest CPI reading brings inflation significantly above the target range of the Central Bank for March (5.6%+/-1.5%). This is the sixth month in a row that inflation deviated from the respective monthly target band. For that reason, the Central Bank governor Mr. Dejan Soskic sent a letter to the Prime Minister on April 12th, as part of the inflation targeting agreement with the government. In the letter, the governor identified the global rally in food prices, inflamed by the prevailing conditions in the local food industry as the key driver behind the latest inflation rise. The increase is much higher than other New Europe peers, so the idiosyncratic features of the economy come into play (the oligopolistic structure of the food industry); As a result, the Central Bank urged the government to undertake drastic measures in the food market immediately.

The Central Bank admitted that inflation would only gradually retreat towards the targeted band from Q3 2011 onwards, provided that there are no other supply-side shocks. The Central Bank anticipates upward pressure from food inflation to subside in the coming months, driven by favorable base effects and the positive impact of the new agricultural season

Serbia: Eurobank EFG Forecasts

	2008	2009	2010	2011f
Real GDP (yoy%)	5.5	-3.0	1.8	3.0
Inflation (yoy%)				
CPI (annual average)	12.5	8.2	6.2	10.0
CPI (end of period)	8.6	6.6	10.3	7.5
Fiscal Accounts (%GDP)				
General Government Balance	-2.6	-4.2	-4.5	-4.0
Gross Public Debt	25.6	31.3	41.4	45.0
Labor Statistics (%)				
Unemployment Rate (%of labor force, ILO)	14.7	16.1	19.2	18.0
Wage Growth *(total economy)*	17.9	4.1	7.5	8.3
External Accounts				
Current Account (% GDP)	-17.6	-6.9	-7.2	-8.0
Net FDI (EUR bn)	1.8	1.4	0.8	1.2
FDI / Current Account (%)	30.0	78.7	39.9	45.0
FX Reserves (EUR bn)	8.2	10.6	10.0	11.5
Domestic Credit	**2008**	**2009**	**Q3 10**	**Q4 10**
Total Credit (%GDP)	41.0	48.7	57.0	59.9
Credit to Enterprises (%GDP)	25.8	29.4	33.4	34.9
Credit to Households (%GDP)	14.0	14.7	16.9	17.1
Private Sector Credit (yoy)	34.9	14.3	26.5	26.5
Loans to Deposits (%)	125.1	127.0	141.6	144.6
Financial Markets	**Current**	**3M**	**6M**	**12M**
Policy Rate	12.50	13.00	12.50	10.50
EUR/RSD	99.55	100.00	100.00	105.00

Source: National Sources, IMF, Eurobank Research & Forecasting

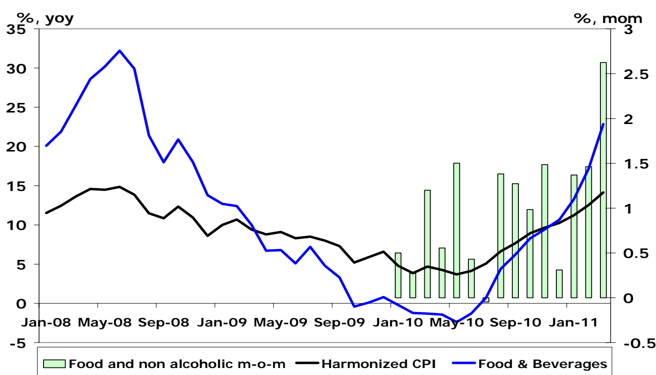
starting in July. In case of broadly normal season, inflationary pressures are expected to subside in H2:2011. However, the Central Bank now anticipates that inflation would only come back within the tolerance band in 1H-2012 and further closer to the midpoint by late 2012 (target for end-2012: 4% +/-1.5%).

In our view, the March inflation reading and the subsequent Central Bank rhetoric for bringing the medium term inflation within the band (coupled with the governor statements for single digit inflation by year end) simply imply that the fulfillment of the year-end CPI target now carries an insignificant probability. In fact,

inflation already reached 5.5% in Jan-March 2011 vs. a target range of 4.5% +/- 1.5% at year end. In lieu of the rising risks to the inflation outlook, we have revised our forecasts upwards for 2011-2012 as well. We now forecast year-end inflation to stand at 7.5%, above the target range of the Central Bank, with risks skewed to the upside.

Figure 1

Food prices are the main driver behind inflation rally



Source: National Statistics, Eurobank Research

NBS raised interest rates further by another 25bps to 12.5%

On April 7th, NBS raised its key policy rate by 25 bps to 12.50%. This was the eighth rate hike since the Central Bank terminated its policy easing cycle in early August, and the third during 2011. The Central Bank has delivered 450bps of cumulative rate hikes in an attempt to combat intensifying inflationary pressures.

In the statement released after the policy meeting, the Central Bank emphasized once again the role of the unexpected food prices shock in the deviation of inflation from the medium term target. According to the Bloomberg survey conducted ahead of the policy meeting, the majority of participants polled (14 out of 22) expected a 25bps hike, 7 out of 22 expected no rate change; one expected a 50bps rate hike and another one expected a jump by 75bps to 13%.

In our past issues of New Europe Economics & Strategy, we highlighted that the new hikes aim to prevent elevated inflation expectations from triggering a second round of price increases and thus, avert a wage-inflation spiral. The Central Bank governor showed evidence from the latest Gallup and Bloomberg surveys in his latest press conference presentation that inflation expectations have partially stabilized, yet remaining at high levels.

In addition, we do take note that the pace of hikes has slowed down. The bulk of previous hikes were at the range of 50-100bps. The Central Bank had already stated its decision to be less aggressive on policy rate hikes going forward after having mobilized the tool of the minimum reserves requirements. Provided there are no new nasty surprises on the inflation front, we anticipate that we may have seen the peak or currently come closer to the completion of the tightening cycle. The Central Bank has stated that the full effect of past monetary policy measures is yet to be felt on inflation. As a result, the NBS will assess whether further monetary tightening is needed, using the full array of instruments on hand. On the other hand, we cannot rule out the probability of further hikes. Yet, we believe that these may not be more aggressive. If those materialize, we anticipate rates to peak in the next couple of months at the level of 13.00%. After that, the Central Bank is expected to resume monetary easing sometime within H2:2011, once inflation uncertainties recede.

However, a number of factors will not allow the Central Bank to ease monetary policy as quickly as we envisaged in our previous issue of New Europe Economics & Strategy. Those factors stem from both international and country-specific developments. The international environment will be characterized by high energy and food prices, while the possibility of a new oil price shock as a result of the ongoing geopolitical tensions in the Middle East and North Africa cannot be ruled out. In addition, both ECB and other regional Central Banks will stay on a tightening mode that will not enable the NBS to move aggressively with rate cuts. On top of those, more regulatory prices adjustments in the energy market are in the pipeline. Gas prices are expected to rise as well after the adjustment in the electricity prices effective from April 1st. Last but not least, the onset of the pre-election cycle raises the risk of fiscal slippage; Serbia's parliamentary elections are officially scheduled for next May. For the above reasons, we have revised our year-end forecast for interest rates to 11.5%.

Dinar strengthened below the 100/€ threshold in late April vindicating our expectations

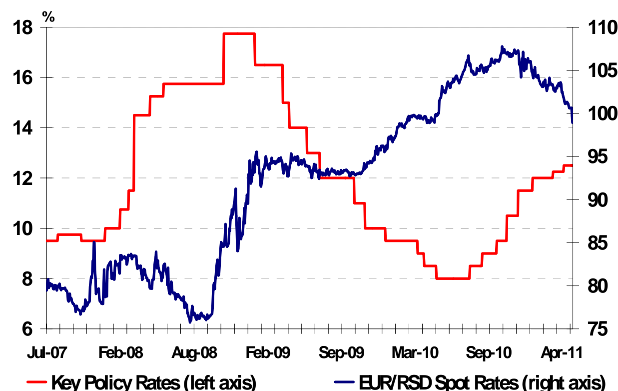
In our view, there is one more factor which argues against more aggressive interest rate hikes. The dinar appreciation trend during the first months of 2011 is going to assist the disinflation process due to the high pass through (0.3 according to the Central Bank estimates). In our February issue of New Europe Economics & Strategy we noted that there was a high probability that the domestic currency would appreciate beyond 100/€ in the forthcoming period on foreign investors' strong demand for high yields.

Indeed, driven by high portfolio inflows (which are volatile in principle), dinar has started recouping some of its recorded losses

(around 40% during 2008-2010) in the past three years. The reduction in the sovereign premium (JP Morgan EMBIG index declined to 380bps on May 2nd from 420bps at the end of last November) and the S&P sovereign upgrade in mid-March illustrate the turnaround in investors' perceptions which is taking place as of early 2011. Portfolio investment reached €286mn only in February and further €185mn in the first twenty days of March. Accordingly, net FDI inflows picked up slightly to €125mn in the same period of March. As a result, dinar strengthened below 100/€ on April 28th, compared to 105.9/€ at last year end and an historic low of 108.1/€ on October 28th, 2010. On May 3rd, dinar stood at 99.15/€, higher by 6.3% compared to the end of 2010 (Figure 2).

Figure 2

Dinar is strengthening below 100/€ in late April



Source: Bloomberg, Eurobank Research

IMF Board approved the last review of the expiring SBA; a new precautionary arrangement is the most probable scenario

The IMF board approved of the last review of the expiring SBA on April 8th.The approval enabled Serbia to gain access to an additional €383mn tranche of funding. The NBS made use of only €51.6mn from the last tranche, so that the total withdrawals reached €1.5 bn out of a total €2.9bn of available funds.

The IMF staff report released on the occasion of the completion contained an assessment of the program. The program accomplished to shield the country against the backdrop of the international financial crisis and to avoid a financial meltdown in late 2008. A number of steps were taken to push structural reforms (e.g. the establishment of a fiscal policy council, the introduction of fiscal responsibility law, pension reform, the introduction of a bankruptcy law etc).

The report focused particularly on the need for fiscal discipline ahead of the parliamentary elections next May. The government succeeded in bringing the implementation of the unfreezing of pensions and public wages forward by three months in 2011. This would be the first year that pensions and public wages will be given a raise after 2008. However, that decision by itself spurred a tsunami of individual public sector unions demands (police, teachers unions) for wage increases above the levels agreed within the IMF framework. Although authorities were praised for not giving away to those pressures, keeping fiscal consolidation on track will remain a challenging task in the pre-election period, given the rise in food prices.

The attainment of this year's fiscal target is going to be an issue of high importance in terms, not only of price, but also of fiscal stability and predictability. With the addition of this year's projected fiscal deficit of 4% of GDP in 2011, the public debt will be approaching the cap of 45% of GDP set by the fiscal responsibility law. If the credibility and integrity of the fiscal legislation is to be maintained, policymakers will need to adhere to the successful implementation of the budget.

In conclusion, the current IMF program came smoothly to its end. A new precautionary agreement is the most probable case scenario in the foreseeable future. The Prime Minister, Mr. Mirko Cvetkovic, announced on April 27th in the parliament that a new agreement would be signed in autumn after the completion of negotiations. The new program is expected to build upon the accomplishments of the previous. It is widely expected, that the new agreement would envisage elements of further reform in the public sector with a special focus on streamlining public enterprises, the pension system and improving the business environment.

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II. New Europe – Country Analysis: **Turkey**

Ruling AKP braced to win its third consecutive mandate in office

- CBT likely to hold its key policy rate unchanged for the rest of H1:2011, in spite of rising inflation pressures
- Central Bank revised upwards its end-2011 and end-2012 annual CPI forecasts
- CBT maintained the 1-week repo rate stable for the third month running in April, but delivered further hikes in RRRs
- Trade deficit widens to a record high in March signaling risks to domestic financial stability

Pace of economic activity to lose some momentum this year, after last year's stellar expansion

Following a stellar performance in 2010, recent evidence indicates that domestic economic activity is already losing momentum. Among them, industrial output growth eased to a 4-month low of 10.40%yoy in March following a 16.5%yoy rise in the prior two months. Separately, manufacturing PMI fell to a 7-month low of 52.7 in April from 56.1 in March, sliding further below February's record high of 58.5 (Figure 1). Albeit the headline reading remained above the 50-mark indicating continued expansion in the sector, the breakdown of the report showed that new export orders contracted for the first time in two years, while overall new business growth decelerated to a seven-month low. Elsewhere, March's consumer confidence index eased to 93.43 from a 3-year peak of 93.56 in February, while the rate of unemployment (measured on a 3-month rolling basis) spiked to a 9-month peak of 11.90% in December-February. Base effects (growth was particularly strong in 2010) and tighter fiscal as well as monetary conditions do not bode well for the 2011 growth outlook. In addition, net exports are unlikely to provide a positive input to real GDP growth over this year or the next as imports are likely to continue outperforming exports in view of the ongoing divergence between domestic and external demand dynamics. Along these, lines, we expect Turkey's economic activity to slowdown this year and the next. We forecast 2011 GDP to slow down to 5.0% from 8.9% last year, with a small deceleration towards 4.7% in 2012.

However, Turkey braced to outperform its regional peers for the second year running

Nevertheless, Turkey's domestic economy is poised to broadly outperform its regional peers. Private investment will probably remain the locomotive of growth over 2011 and 2012. The MENA unrest is likely to provide an additional influx of tourist inflows this year, supporting domestic economic activity and providing much-needed financing for the current account deficit.

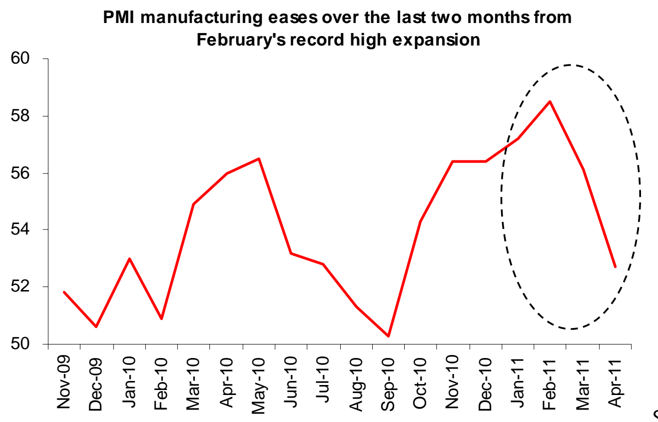
Turkey: Eurobank EFG Forecasts

	2009	2010E	2011F	2012F
Real GDP (yoy%)	-4.8	8.9	5.0	4.7
Private Consumption	-2.3	6.6	4.5	5.0
Govern. Consumption	7.8	2.0	3.5	2.0
Gross Capital Formation	-19.0	29.9	13.0	13.0
Exports	-5.0	3.4	9.5	11.0
Imports	-14.3	20.7	15.0	15.0
Inflation (yoy%)				
CPI (annual average)	6.3	8.6	5.5	6.3
CPI (end of period)	6.5	6.4	7.0	5.5
Fiscal Accounts (%GDP)				
Central Government Balance	-5.5	-3.6	-2.7	-2.6
Gross Public Debt	45.4	42.5	41.5	40.0
Primary Balance	0.1	0.8	1.5	2.0
Labor Statistics (%)				
Unemployment Rate (%of labor force)	13.5	12.0	11.0	10.0
External Accounts				
Current Account (% GDP)	-2.3	-6.6	-7.5	-6.7
Net FDI (USD)	6.9	7.3	8.0	8.5
FDI / Current Account	46.9	12.0	13.0	14.0
FX Reserves (USDbn)	69.0	79.0	90.0	90.0
Domestic Credit	**Q1 10**	**Q2 10**	**Q3 10**	**Q4 10**
Total Credit (%GDP)	31.4	35.1	37.2	41.5
Credit Private Sector (%GDP)	29.7	33.3	35.3	39.4
FX Credit/Total Credit (%)	16.9	18.7	18.8	21.0
Private Sector Credit (%yoy)	22.8	34.0	36.7	44.0
Loans to Deposits	79.9	82.1	84.3	85.7
Financial Markets	**Current**	**3M**	**6M**	**12M**
Policy Rate	6.25	6.75	7.75	8.25
USD/TRY (where applicable)	1.55	1.53	1.50	1.40

Source: National Sources, Eurostat, IMF, Eurobank Research & Forecasting

Also in support of the aforementioned, domestic credit activity remains robust in spite of the CBT's efforts to reduce its annual growth rate towards 20%-25% yoy, considered as appropriate for safeguarding financial stability and curbing inflation pressures. In fact, total bank credit to the domestic market rose by 35.9%yoy in the week ended April 29, remaining just off a 3-year peak of 36.1%yoy touched in March. In a similar vein, consumer loans expanded by 36.0%yoy over the same period, a tad below a 36.1%yoy rise a week earlier which marked its fastest annual gain since October 2008.

Figure 1



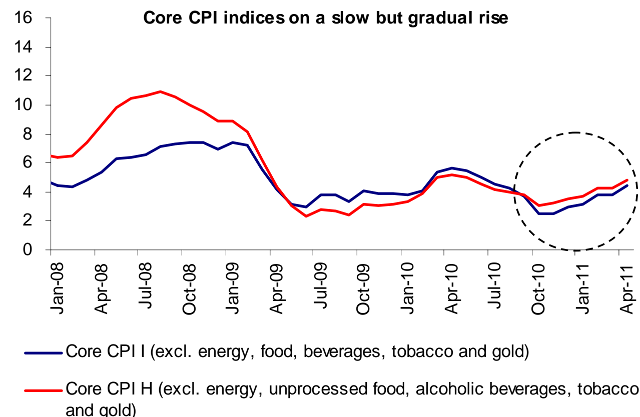
Sources: Reuters, HSBC

The CBT's policy mix appears to have had little impact on loan activity since its implementation late last year. However, the Bank has reiterated a number of times that any effects will become more evident in Q2. Separately, the business confidence index climbed to a 1-year peak of 116.70 in April. Tourism revenues rose by 28.5%yoy in Q1 after a 4.9%yoy rise a quarter earlier, while foreign arrivals increased by nearly 16%yoy on average over the same period following a meager 5.7%yoy gain in 2010. Similarly, capacity utilization bounced to its highest level so far this year (74.9%) in April.

April core CPI remained in a rising trend; headline CPI bounced from a 4-decade low

April CPI crept up by 0.87% on a monthly basis, nearly in line with expectations of +0.90%. The "Clothing & Footwear" sub-index posted the highest monthly increase (+10.91%) contributing 0.71ppts to the headline reading. The sub-indices for "Furnishings & Household Equipment" and "Transport" rose by 1.76% and 1.04%, respectively on a monthly basis, exerting a total of 0.25ppts of additional input. On the other hand, food and non-alcoholic beverages prices dropped 0.48%mom against a background of favorable base effects, while prices of communication services declined 1.84%mom. On an annual basis, headline CPI rose to 4.26% from a 4-decade low of 3.99% in March. Core inflation indicators rose across the board, reflecting a weaker lira and higher global commodity prices (Figure 2). The CBT's closely monitored index I (excluding energy, food, beverages, tobacco and gold) spiked to a 9-month peak of 4.42%yoy from 3.77%yoy in March, having embarked on a gradual uptrend from a record low of 2.50% in October last year. Meanwhile, PPI rose by 0.61%mom, coming in below the market's median forecast of +1.2%mom, with the annual rate of increase slowing to 8.21% last month from 10.08% in March. For end-2011 we anticipate consumer inflation to spike towards an annual rate of 7% and exceed the CBT's 5.5% target for this year.

Figure 2



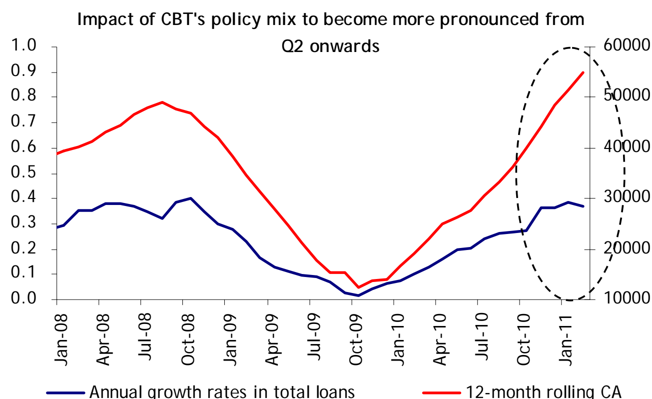
Sources: National Statistics

The CBT revised upwards its 2011 and 2012 year-end CPI forecasts

In view of higher-than-expected oil prices in the January Inflation Report and ongoing strong domestic demand dynamics, the Central Bank of Turkey revised its end-2011 annual CPI forecast to 6.9% from 5.9% previously, well above year-end target of 5.5%. It attributed 50bps of the increase in the headline CPI forecast on higher-than-previously-anticipated oil and other commodity prices, raising its assumption for oil prices to $115pb from $95pb for this year and beyond. The bank also upped its assumption for 2011 import prices growth, related to commodities, to an average of 16.2%yoy from 10.9%yoy in January. Another 50bps of the upward revision in headline CPI was credited to an increase in custom duties on fabric and apparel imports. Its revised projection is based on the assumption of additional limited monetary tightening in H2 2011 that would lead to a slowdown in bank lending to 20-25% yoy by the end of the year. It reiterated that it anticipates a slowdown in credit growth in Q2:2011 as a result of the new policy mix adopted late last year (Figure 3). According to a preliminary CBT study, the pass-through of changes in RRRs impacts the domestic economy with a lag of one quarter, while the effect on private consumption becomes evident with a lag of two quarters. Hence if the Bank's estimates are correct, tentative initial signs of a slowdown in domestic lending should gradually emerge in the coming weeks/months. In the press conference that followed the release of April's Inflation Report, the recently appointed Central Bank Governor Erdem Basci highlighted that he sees no signs of overheating in the domestic economy in view of

weak external demand dynamics. The CBT also revised slightly upwards its end-2012 CPI projection, to 5.2% from 5.1% earlier, but reiterated that it expects inflation to converge towards 5% in the medium-term.

Figure 3



Sources: National Statistics, BDDK, Central Bank

CBT maintains 1-week repo rate stable for the third month running in April, but delivers further hikes in RRRs

Turkey's central bank held its key policy rate unchanged at a record low level of 6.25% for the third month running in April, as was expected by market participants. However, the CBT surprised once again, by hiking banks' reserve requirement ratios. The latter move has been common practice for the Bank in recent months. The CBT introduced an unorthodox strategy late last year, which includes cuts in the key policy rate in tandem with higher reserve requirement ratios and a wider interest rate corridor, aimed at preserving financial stability and containing rising inflation pressures. However, following aggressive hikes in reserve requirement ratios in March, financial markets were braced for a no RRR-change decision this time around. In detail, the CBT raised the reserve requirement ratio on one month lira deposits to 16% from 15% before, also lifting the ratio on FX deposits with 1-year and longer maturity to 12% from 11% earlier. The Bank anticipates the aforementioned measures to drain $1.4bn and TRY 1.5bn from the market. Overall, the latest CPI data supports the case for the CBT to hold its key policy rate stable at least until June's general elections. Even so, further increases in reserve requirement ratios can not be ruled out by then. Nevertheless, we continue to expect a total of 150bps of rate hikes over the next twelve months as inflation pressures are likely to become more evident later this year in view of strong domestic demand dynamics and waning favorable base effects. It is also worth noting that April's MPC meeting was the first for newly incumbent Governor Erdem Basci. Basci was a Deputy Governor under the Committee's previous composure. He succeeded Durmus Yilmaz who retired in April. Given that he is considered a strong proponent and an engineer of the current policy mix, we do not expect to see any major shifts in monetary policy as a result of his appointment. Turalay Kenc, a member of the CBT's monetary policy council, has taken over the Deputy Governor position.

Trade deficit widens to a record high in March signaling risks to domestic financial stability

Turkey's current account deficit widened 127% on an annual basis in February to $6.1bn. As a result, the 12-month rolling shortfall spiked nearly 190%yoy to a new lifetime peak of $54.8bn. As we have stated several times in the past, the deterioration in the country's current account balance remains primarily driven by a widening trade deficit in view of strong domestic demand dynamics and higher commodity prices (nearly all of the gas and oil consumed domestically is imported). In support of the aforementioned, March's trade deficit data, which precedes the release of the current account figures for the corresponding month, widened more than 90%yoy to a record high of $9.8bn, exceeding the market's median forecast for a $7.8bn shortfall. Exports jumped 19.6%yoy to $11.8bn, while imports soared 44.1%yoy to $21.7bn underscoring ongoing strong domestic demand dynamics. Over the first three months of the year, the trade deficit widened 96.8%yoy to $24.595bn. In all, the data does not bode well for the Central Bank's efforts to address the dual objective of domestic price and financial stability. Nevertheless, the Bank has, in a number of occasions, highlighted that the impact of its measures will likely become more evident from Q2 onwards. Apparently, more time is required in order to get a preliminary indication of the effect of the CBT's policy mix on Turkey's external imbalances. The shortfall's high financing dependence on portfolio inflows remains an area of concern, being an item highly susceptible to swings in global market sentiment.

Ruling AKP braced to win its third consecutive mandate in office

With a few weeks left before the Turks head to the polls for the June 12 general election, there is little evidence to suggest that the ruling AKP will not comfortably secure a third mandate in office. A much awaited referendum of constitutional reforms in September last year, endorsed by strong public support (58%), provided a significant gauge of the government's popularity. In addition, most recent opinion surveys signal that Prime Minister Tayyip Erdogan's party is the frontrunner. Indicatively, in a survey conducted in early/mid-April by pollsters Metropoll and Genar the AKP scored 47-50% and 48.7%, respectively. Both shares are above the 46.7% result in the 2007 elections. The main opposition

Republican People's Party (CHP) is seen trailing with support of 27-30%, while the conservative Nationalist Movement Party (MHP) is lagging behind with a 12-14% score, slightly above the 10% threshold required to enter parliament. The stage appears set for a rather smooth election process where the AKP will likely lead the tally and form a single party government. What is less evident, however, is whether the ruling party will be able to achieve a 2/3 parliamentary majority that will grant the new government capability to change the constitution on its own. Prime Minister Erdogan has penciled in the overhaul of the constitution among its top priorities in his pre-election campaign. Against this backdrop, political noise may occasionally reemerge after the polls as feuds between the government and staunch secularists are likely to resurface. A constitutional overhaul may boost Turkey’s EU accession hopes. However EU accession is unlikely to happen any time soon.

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II. New Europe – Country Analysis: **Ukraine**

Economic recovery broadly on track but IMF tranche to be delayed until June

- Official preliminary estimates suggest 5% yoy Q1-11 growth boosted by stronger domestic demand
- IMF tranche disbursement delayed until June on pending pension reforms and hikes in residential gas and heating tariffs
- Headline inflation rose to 9.4% yoy in April up from 7.7% yoy in March reflecting surging fuel and food prices and gradual hikes in electricity and heating tariffs
- March total credit growth accelerated further on the back of strong lending in the corporate sector

Ukraine's economic recovery broadly on track

First quarter's GDP data are due to be released in late-May but official preliminary estimates suggest a 5.0% yoy economic expansion, led by domestic demand. Even though base effects that favored 2010 growth rates will play less of a role this year, we anticipate a 4.5% yoy growth in 2011 on the back of strengthening domestic consumption. However, downside risks to the growth stem from the potential IMF programme falling apart.

Retail sales grew further by 12.3% in March, up from 11.9% in February, helped by lower base of comparison since retail sales turned to positive territory last May. Yet, this retail turnover reflects a swift improvement in domestic consumption. Wage growth also supports consumption since early 2010. Real wages grew by 12.2% yoy in March, up from 8.4% yoy at the end of 2010.

Industrial production slowed to 8.0% yoy in March down from 11.5% yoy print in February. This weakness came largely on a less favorable base effect as March 2010 was a strong month in terms of steel output. Albeit the growth in industrial production is still strong enough to keep the economic recovery on track this year, production volumes might level off in the second quarter amid large inventories and demand hurt by high steel prices.

IMF tranche disbursement delayed until June on pending pension reforms and hikes in residential gas and heating tariffs

The IMF tranche scheduled for March has been delayed on pending pension reforms and increase in residential gas and heating tariffs. In late April, Max Alier, the IMF's representative to Ukraine announced that the Stand-by- Agreement programme review will be sent to the IMF Board once Ukraine fulfils all the conditions for pension reforms and finds ways to compensate a slower than initially agreed increase in gas prices.

Ukraine: Eurobank EFG Forecasts				
	2009	2010	2011f	2012f
Real GDP (% yoy)	-15.1	4.2	4.5	4.8
Private Consumption	-12.1	5.8	5.0	5.2
Government Consumption	1.8	1.5	1.0	2.0
Gross Capital Formation	-48.4	3.2	7.5	8.0
Exports	-23.6	4.6	9.0	9.5
Imports	-36.8	11.5	11.0	10.5
Inflation (% yoy)				
CPI (annual average)	15.9	9.4	10.6	9.6
CPI (end of period)	12.3	9.1	10.3	9.2
Fiscal Accounts (% GDP)				
General Government Balance	-8.7	-6.5	-3.5	-2.5
Gross Public Debt	35.3	41.7	42.4	44.0
Labor Statistics (%)				
Unemployment Rate (% of labor force)	9.4	8.1	8.0	8.3
Wage Growth *(real - private sector)*	-10.3	8.4	9.0	8.0
External Accounts				
Current Account (% GDP)	-1.5	-2.5	-2.8	-3.4
Net FDI (bn USD)	4.7	5.7	6.5	7.0
FDI / Current Account	268.0	222.0	90.0	85.0
FX Reserves (bn USD)	26.5	34.6	37.0	38.0
Domestic Credit	**2008**	**2009**	**Q3 10**	**Q4 10**
Total Credit (% GDP)	77.3	79.1	69.8	66.9
Credit to Enterprises (% GDP)	46.7	50.5	46.8	45.8
Credit to Households (% GDP)	29.5	26.4	20.9	19.1
FX Credit/Total Credit (%)	59.0	50.8	47.4	46.0
Private Sector Credit (% yoy)	68.5	-3.1	2.6	0.4
Loans to Deposits	204.0	215.9	183.3	175.9
Financial Markets	**Current**	**3M**	**6M**	**12M**
Policy Rate	7.75	7.75	7.75	7.75
USD/UAH	7.93	7.90	7.90	7.90

Source: NBU, IMF, Bloomberg, Eurobank Research

Concerning the pension reforms, the government asked for more time to agree the changes in the pension system with the Parliament; it stated its intention to approve pension reform legislation in six months time. Ukrainian authorities expect an IMF mission on May 10-20 to continue talks over pension reforms. However, if the pension reform bill is not enacted by the summer recess in July, there is a risk the IMF programme goes off track.

Regarding gas hikes tariffs, the government had earlier agreed with the IMF a 50% gas price hike in April, which was later revised to a 20% hike for April and another 10% for June. Even those tariff increases were postponed, which led the IMF to suspend its lending programme. Finally, the IMF has agreed to a milder and

gradual increase in public utility tariffs on the condition that Ukraine will compensate the shortfalls via other sources.

Furthermore, an additional core requirement for the resumption of IMF lending is the abolishment of the decree by which the NBU (National Bank of Ukraine) has to purchase recapitalization bonds at par value within 5 days upon their issuance. This amendment aims to strengthen central bank's independence.

All in all, even though the IMF tries to induce Ukraine to proceed faster with unpopular reforms (so as to reduce the deficits of both the Pension fund and Naftogaz) we do not expect the IMF programme to fall apart and loan tranche would be disbursed by the summer.

Inflationary pressures are building up in 2011 on food and fuel prices surge coupled with expected further hikes in utility prices

Headline inflation rose to 7.7% yoy (1.4% mom) in March up from 7.2% yoy (0.9% mom) recorded in February amid surging food and fuel prices. Food prices (accounting for over 50% of the CPI basket) grew by 1.8% mom due to sizeable increases in prices of vegetables, fruits and bread. Fuel prices grew by 9.3% mom in March propelled by the surge in global oil prices. Fuel prices account only for 1.6% in the CPI basket, thus their direct impact to inflation is rather low, albeit second-round effects will be more significant in the near term. What's more, if Ukraine wants to keep the IMF programme on track, it should proceed in further utility prices hikes, which in turn would lead to higher prices for other goods and services. Already, preliminary estimates of the Statistics' office indicate that headline CPI rose to 9.4% yoy (1.3% mom) in April. It's clear that inflationary pressures are building up in 2011; therefore we expect inflation to turn to double digits once more and average at 10.6% yoy in the year as a whole. In the light of elevating inflationary pressures the NBU may permit some limited appreciation of the exchange rate in the coming month, given that it is not targeting inflation.

March current account deficit narrowed significantly while capital and financial account turned to deficit

Following February's current account deficit widening of $1.1bn due to the hike in gas imports, the current account deficit narrowed significantly to $130mn in March. This was attributed to high export growth (especially of metallurgical products), coupled with current transfers inflow increase. The Capital and financial account turned to deficit of $0.4bn from February's surplus of $2.4bn, driven mainly by public sector debt flows, while inflows of both FDI and private loans remain low. The government redeemed sovereign Eurobonds of $0.6bn in March, after issuing $1.5bn of new bonds in February, which became the key reason for the financial account reversal. What's more, FDI in the banking sector decelerated in Q1-11 as most parent institutions had sufficiently recapitalized their subsidiaries last year. FDI inflows declined to $0.8bn in Q1-11 from $0.9bn last year. All in all, we expect the current account deficit to widen further this year and reach 2.8% of GDP on improving domestic demand and higher energy prices.

March total credit growth amplified further on the back of strong lending in the corporate sector

Total credit growth amplified further, growing by 1.8% mom in March, up from 1.0% mom rise recorded in the prior month. What's more, since the beginning of this year total loan portfolio of the banking system increased by 2.6% year-to-March on the back of strong lending activity in the corporate sector. Business lending stood at 4.2% year-to-March and 2.7% mom in March. Contrariwise, household credit decelerated further by 0.9% year-to-March and 0.5% mom in March.

Total deposits continued their strong growth reaching 3.4% mom rise in March boosted by 5.4% mom rise in the corporate deposits with strong hryvnia deposits (8.2% mom). As a result, Loan to Deposits ratio has pushed further down to 169% in March from 175% at the end-2010.

According to the NBU definition on Non Performing Loans (NPLs), the NPLs to total loans ratio eased to 11.4% in March from 11.6% in the prior month on the back of stronger credit growth coupled with weaker pace of NPL growth.

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