Eurobank Research
www.eurobank.gr/research
research@eurobank.gr

# NEW EUROPE ECONOMICS & STRATEGY

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**Written By:**

**Gikas Hardouvelis:**
*Chief Economist & Director of Research*

**Platon Monokrousos:**
*Head of Financial Markets Research Division*

**Tasos Anastassatos:**
*Macro Strategist*

**Ioannis Gkionis:**
*Research Economist Coordinator of Macro Research*

**Stella Kanellopoulou:**
*Research Economist*

**Galatia Phoka:**
*Emerging Markets Analyst*

*SPECIAL CONTRIBUTION:*
**Mihai Patrulescu**
*Junior Economist*
**Giazitzoglou Michalis**
*Junior Economic Analyst*

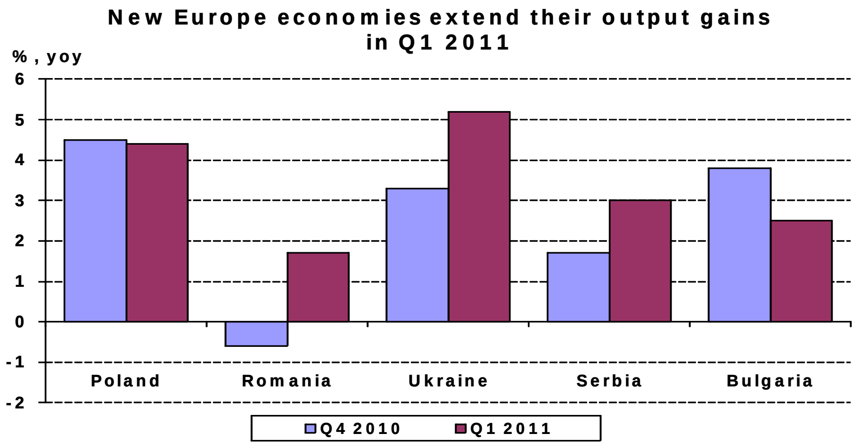


## Regional markets remain resilient despite persisting EU sovereign debt concerns

- **Bulgaria:** The economy's growth recovery remained on track in Q1:2011, continuing to be primarily driven by net exports
- **Poland:** GDP breakdown points strengthening domestic demand dynamics
- **Romania:** Domestic economy exits recession in Q1 2011. The government is tapping the EMTN market after nine months of postponement
- **Serbia:** Arrest of fugitive general Mladic is boosting Serbia's EU candidate status. Central Bank signals an end to the tightening cycle
- **Turkey:** AKP achieves another landslide victory on the June 12 general elections, winning its third consecutive single party mandate in office
- **Ukraine:** GDP growth remained solid in Q1-11, improving fiscal position keeps IMF loan on hold

***New Europe market strategy highlights***

**FX:** Our previous long **EUR/TRY** recommendation (entry level at 2.2450) vindicated our bullish expectations, with the pair rallying towards 2.33 earlier this month. At current levels (~2.28) we prefer to take profits and wait for new opportunities to arise in order to initiate a new trade. Separately, our earlier **PLN/HUF** short recommendation hit our stop-loss at 68 in early May. We prefer staying sidelined on the pair, for now. **In the sovereign credit space,** we would tactically take profits on our long position in Turkey's 5-year CDS at current levels around 163bps, but would continue to play the 145bps-175bps range, becoming sellers of protection at levels above 175bps and buyers at levels below 150bps. We remain constructive on our earlier short Romanian 1-year CDS position to maturity. On the flipside, we believe that there is value in long 5-year CDS positions, as this year's strong downside momentum (from levels near 320bps) appears to have lately stalled. We remain constructive on our recent long Poland 5-year CDS vs. short Russia 5-year CDS call at levels near 7bps (June 10) as a pure oil play on the latter and a way to express twin deficits-related concerns on the former. Separately, we close our long Markit iTraxx SOVX index for Western Europe vs. short on the corresponding CEEMEA position and take profits,. Elsewhere, we like long positions in Bulgaria's 5-year CDS spreads at current levels around 205bps targeting 245bps. **Local rates markets** we believe that risks loom ahead as higher inflation becomes more evident and we continue to prefer staying broadly sidelined in this asset class. Nevertheless, we continue to see opportunity in 2/10 steepeners in Polish cross currency swaps and stick with our previous 2s/5s flattener recommendation in Turkish cross currency swaps.




*Source: National Statistics, Eurobank Research*

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# Introductory Comment

Dear Reader,

A number of countries in New Europe have already published their estimates of GDP growth in the first quarter of 2011. The majority extend their output gains, after managing to broadly stabilize their economies last year. Growth prospects have improved even in economies which lagged behind in 2010, *e.g.* Romania and, to a lesser extent, Bulgaria.

Downside risks do exist. The high integration levels of regional economies with a number of crisis-hit countries in euro area periphery *(vis-à-vis the trade and financial channels),* coupled with a significant dependence on world commodities markets, imply that the region is vulnerable to downside growth risks and to sudden shifts in investor sentiment. On the positive side, contagion from the lingering euro area debt crisis has been broadly limited so far. Yet, heightened inflation risks stemming from the sharp rallies in food and energy prices, pose a serious challenge for domestic policymakers and the macroeconomic stability in the broader region. In addition, the improving growth outlook has not yet been translated into any dramatic improvement in the labor market conditions or a significant reduction in NPLs.

More specifically,

Following a similar move by Standard and Poor's last month, FITCH upgraded the sovereign credit outlook of **Bulgaria** to positive from negative (l-t rating at BBB- currently). The economy's growth recovery remained on track in Q1:2011, continuing to be primarily driven by net exports. Additionally, the EBRD revised its GDP growth forecast for Bulgaria this year to 3.1%, from 2.6% in January. On the negative side, the recent violent incident in the Banya Bashi mosque of Sofia complicates the domestic political environment ahead of the presidential and municipal elections in October 2011.

In **Romania**, the domestic recession appears to be finally over, at least from a technical standpoint. Real GDP expanded by 1.7% yoy in Q1 2011, following a 0.6% yoy contraction in the prior quarter. Industry was once again the star performer of the domestic economy, assisted by the ongoing process of inventory rebuilding and higher net exports. Meanwhile, ongoing fiscal consolidation, a new precautionary agreement with the IMF and the improving domestic macro environment, allowed the Romanian government to tap the international markets with a new 5Y Eurobond issue.

The arrest of the fugitive general Mladic gave a new impetus to the efforts of **Serbia** to join the EU. We anticipate Serbia to be given candidacy status by the end of this year. With domestic inflation having probably reached a cyclical peak, the NBS singled an end to its recent aggressive policy tightening cycle. Yet, the rejection of an improved bid by Telekom Austria for the purchase of a 51 % stake in Telekom Serbia comes as a big market disappointment. The sale would have been a great opportunity to attract much needed FDI inflows, spurring a wave of investments in the obsolete infrastructure of the country.

**Poland** registered solid output growth of 4.4% yoy in the first quarter of 2011, in line with our earlier expectations. Faced with elevated inflation risks, the Central Bank has unexpectedly raised its key policy rate twice within thirty days, to 4.5%, currently. Given the slow pace so far in implementing much-needed structural reforms, additional measures may be required after the October's parliamentary elections to ensure fiscal consolidation in 2011-12.

Economic growth in **Ukraine** is gaining momentum, assisted by rising global commodity prices and improving domestic demand dynamics. Real GDP growth came at 5.2% yoy in Q1:2011, having accelerated from 3.3% in the prior quarter. However, the domestic economy has not managed to escape rising inflationary pressures, stemming from higher food and energy prices. Consumer prices reached multi-month highs of 11% yoy in May. Meanwhile, IMF loan disbursements remain on hold, as domestic policymakers continue to fall behind on the agreed reforms agenda.

As was broadly expected, **Turkey**'s ruling Justice and Development Party (AKP) achieved another landslide victory on June 12 parliamentary elections. The party won its third consecutive tenure in office, but fell short of the two-thirds majority required for the party to change the constitution on its own. Underlying inflationary pressures are building, pushing the headline CPI rate significantly above market expectations in May, to 7.2% from 4.3% in the prior month. The deteriorating outlook for inflation, coupled with the widening current account deficit, call for a more aggressive tightening in the country's monetary and fiscal policies.

**Major stock market indices in New Europe** extended their losses over the last few weeks amid rising worries over the outlook of the global economy and the lingering euro area sovereign debt crisis. Although the region broadly underperformed its emerging market peers in recent weeks, year-to-date it remains the best performer with most equity indices standing on positive territory. Serbia's BELEX15 bucked the region's trend, jumping 4% since late April and having recorded gains of nearly 20% so far this year, amid rising optimism over the country's EU prospects. Turkey remained an underperformer, plunging by more than 8% in recent weeks to stand in a negative territory year-to-date, as the CBT's unorthodox policy mix is expected to take a toll on the country's banking sector.

**External debt markets** continue to display impressive resilience in spite of lingering debt jitters in the euro area, with 5-year CDS spreads standing close to their tightest levels in months. Turkey lagged its peers in recent weeks, as lingering overheating concerns and CBT's unorthodox monetary policy mix continue to weigh.

In the **foreign exchange markets**, local currencies extended their recent losses over the last few weeks. The Serbian dinar bucked the region's trend firming by more than 8% against the euro since the beginning of the year and hitting a 1-½-year peak of 95.85 in late May on improved EU accession prospects. The Hungarian forint remains the runner up, remaining within close distance (ca 1% weaker) from a 1-year high of 262.40/€, which was recorded in early April amid rising fiscal consolidation hopes.

**Regional bond markets** firmed in recent weeks, continuing to shrug off lingering inflation pressures, with government yields easing from highs touched lately on heightened inflation concerns. Reversing short lived gains, Turkey and Poland were among the region's worst performers.

Professor 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 | 3.8 | 3.1 | -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 | 6.0 | 5.0 | 8.6 | 6.1 | 6.8 | -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 | 6.1 | 5.8 | -5.6 | -4.3 | -3.9 |
| **Euro area** | 1.8 | 1.8 | 1.8 | 1.6 | 2.6 | 2.0 | -6.0 | -4.8 | -3.8 |
| **USA** | 2.9 | 2.5 | 3.0 | 1.6 | 3.2 | 2.5 | -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** | -3.1 | -3.5 | -4.2 | 3.50 | 4.50 | 4.50 | 3.96 | 3.95 | 4.00 |
| **Romania** | -4.2 | -5.5 | -6.0 | 6.25 | 6.25 | 6.25 | 4.28 | 4.16 | 4.20 |
| **Serbia** | -7.0 | -8.0 | -8.5 | 11.50 | 12.00 | 10.50 | 106.1 | 98.3 | 100.0 |
| **Turkey** | -6.7 | -7.5 | -7.0 | 6.50 | 6.25 | 7.75 | 1.54 | 1.58 | 1.50 |
| **Ukraine** | -2.0 | -2.5 | -3.0 | 7.75 | 7.75 | 7.75 | 7.96 | 7.99 | 7.90 |
| **New Europe** | -4.6 | -5.3 | -5.5 | - | - | - | - | - | - |
| **Euro area** | -0.4 | -0.7 | 0.0 | 1.00 | 1.25 | 1.75 | 1.34 | 1.45 | 1.45 |
| **USA** | -3.2 | -3.2 | -3.0 | 0.250 | 0.250 | 0.250 | 0.75 | 0.69 | 0.69 |

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

# I. Overview

**Regional stock markets extend losses on growing global growth concerns, lingering euro area debt crisis**

Equity markets in New Europe broadly lost further ground lately, remaining off multi-month highs touched in mid-April as evidence pointing to a loss of momentum in the US economy continues to accumulate. The latter view is also supported b y Fed Chairman Ben Bernanke's comments in early June suggesting that US economic growth is currently running well below potential. Limited expectations for a third round of Fed stimulus measures, following expiration of the 2nd quantitative easing programme (QE2) in June are aggravating global growth worries further. From the other side of the Atlantic, market worries over the euro area sovereign debt crisis linger. Meanwhile, the ECB is already on a tightening mode, with President Jean Claude Trichet singling recently a new rate hike as early as in July.

The MSCI Emerging Europe Equity index has registered losses to the tune of 6.7% since the end of April. Yet, on a year-to-date basis, the index remains among the outperformers in the entire Emerging Markets (EM) universe, recording gains in excess of 8%. As a matter of comparison, the benchmark MSCI Emerging Markets index stood in a marginally negative territory year-to-June 8th. BRICS and LATAM emerging equity markets continued to lead the losers pack, having plunged by ca 2.5% and 5.5%, respectively since the beginning of 2011. In New Europe, Turkey was the worst performer in May plunging by more than 8%, as the CBT's unorthodox policy mix, aimed at addressing overheating pressures in the domestic economy, is expected to take a toll on the country's banking sector. Serbia's BELEX15 bucked the region's trend jumping 4% amid growing hopes about the country's EU prospects after the arrest of Bosnian Serb general Ratko Mladic. His capture and extradition to the Hague war crimes Tribunal was among the key obstacles in the country's EU accession process. Since the beginning of the year the index has firmed by ca 20%, outperforming its peers and taking the lead from Bulgaria's SOFIX, which lagged behind with year-to-June-8 gains of around 15%.

**Regional bond markets firm, shrugging off heightened inflation worries**

Local rate markets firmed in recent weeks, largely shrugging off lingering inflation risks. Turkey and Poland, which lagged their peers in March, recently posed among the region's main underperformers, especially for shorter maturity paper. Turkey remained among the worst performers with 2- and 10-year bond yields jumping by ca 50bps to levels above 9%, after May's CPI touched a 6-month high. The latter supports the view that the CBT will have to resort to more conventional measures to contain overheating pressures in the domestic economy. In Poland, government bonds firmed as rate hike expectations cooled down recently. The NBP increased its key policy rate by 25bps in June to 4.50%. This was the fourth consecutive hike in the key rate so far this year. However, the Central Bank signaled it plans to hold its horses for a while. Indicatively, the 2- and 10-year Polish benchmark bond yields fell by 11bps and 26bps, respectively, since the end of April standing at levels of 4.87% and 5.88% on June 9. Elsewhere, Hungary's government bonds weakened slightly, paring part of their recent gains driven by ongoing fiscal consolidation optimism. Along these lines, the 3- and 10-year Hungarian government bond yields each fell by ca 10bps over the last month or so to respective levels of 6.7% and 7.2%.

**Regional FX markets slightly weaker in recent weeks on growth, euro area sovereign-related jitters**

Regional currencies weakened over the last few weeks as global growth concerns and the euro area debt crisis weighed on risky assets. The Turkish lira remained under pressure, posing among the worst performers in the region over the last month or so on mounting overheating concerns in the domestic economy. The lira stood 2.5% weaker vs. the USD year-to-June 20, being the only regional currency – with the exception of the Ukrainian hryvnia – to have recorded losses so far this year. On a less negative note, the TRY regained some ground after the Central Bank announced it was reducing its daily hard currency purchases as the euro area debt crisis somewhat trimmed strong capital inflows into the country. As a result, the **USD/TRY** slid to 1-month lows near 1.5660 on June 10, having recoiled from a 2-½-month peak of 1.6130 in late May. Elsewhere, Romania's leu has weakened by ca 1.5% since the end of April, being among the most hit by the lingering market uncertainty over the Eurozone sovereign debt crisis, particularly as the domestic banking sector maintains a significant exposure to Greece (according to reports, it is estimated that Greek banks own ca 17% of Romania's banking system assets). Along these lines, the **EUR/RON** spiked to 3-month peaks of 4.1856 in mid-June from a 1-year trough of 4.0607 recorded on April 29. The Serbian dinar now poses as the region's outperformer, standing more than 8% firmer year-to-date against the euro and having hit a 1-½-year peak of 95.85 in late May after Mladic's arrest. The Hungarian forint follows suit with gains in excess of 5% vs. the EUR so far this year, hovering around levels of 264 at the time of writing, not far from a 1-year high of 262.40 achieved in early April on growing fiscal consolidation hopes.

**Recent rally in external debt markets is running out of steam**

External debt markets took a breather recently, following an impressive performance earlier this year. Bulgaria's 5-year CDS spread stood slightly above 200bps on June 9, within distance from 1-year lows near 190bps reached a month earlier. In a similar vein, Romania's 5 year CDS spread at 232bps in early June was just 20bps higher from a 12-month low recorded in April amid growing fiscal consolidation hopes and good progress on IMF-agreed structural reforms. Turkey remained among the region's laggards, as overheating worries and an unorthodox monetary policy mix continue to weigh ahead of the June 12 general elections. The country's 5-year CDS spread widened by 10.2% since late April, currently holding near a 2-month peak of 168bps hit in late May. On the other hand, Poland outperformed its regional peers, with spreads shrinking by ca 6% to 138bps in May amid easing concerns about the country's fiscal outlook and external sector developments in the period ahead.

**Strategy - Emerging New Europe Markets**

**In the FX markets, o**ur previous long **EUR/TRY** recommendation (entry level at 2.2450) vindicated our bullish expectations, with the pair rallying towards 2.33 earlier this month. At current levels (~2.28) we prefer to take profits and wait for new opportunities to arise in order to initiate a new trade. Separately, our earlier short **PLN/HUF** short recommendation hit our stop-loss at 68 in early May. We prefer staying sidelined on the pair, for now.

**In the sovereign credit space,** we would tactically take profits on our long position in Turkey's 5-year CDS at current levels around 163bps. Nevertheless, we would continue to play the 145bps-175bps range, becoming sellers of protection at levels above 175bps and buyers at levels below 150bps. As we recommended earlier this year (January 2011), we favor maintaining our short Romanian 1-year CDS position to maturity as Romania's macroeconomic outlook continues to improve. On the flipside, we believe that there is value in long 5-year CDS positions, as this year's strong downside momentum (from levels near 320bps) appears to have lately stalled. Along these lines, we favor entering buyer positions of protection at 235bps, targeting levels around 290bps. Separately, we remain constructive on our recent long Poland 5-year CDS vs. short Russia 5-year CDS call at levels near 7bps (June 10) as a pure oil play on the latter and a way to express twin deficits-related concerns on the former. On that trade, we have revised our target to 30bps from 25bps earlier. With regards to our long Markit iTraxx SOVX index for Western Europe vs. short on the corresponding CEEMEA trade, we close our position (entered at par) and take profits at current levels near +10bps. Elsewhere, we like long positions in Bulgaria's 5-year CDS spreads at current levels around 205bps targeting 245bps. However, it is worth noting that the latter trade runs the risk of a contract roll over on June 20.

**Local rates markets** have so far displayed an impressive resilience against a background of rising inflation pressures. However, we believe that risks loom as higher inflation becomes more evident. Along these lines we continue to prefer staying broadly sidelined in this asset class. Nevertheless, we continue to see opportunity in 2/10 steepeners in Polish cross currency swaps at current levels of 26bps with a stop loss at 15bps and a target at 60bps. Regarding our previous 2s/5s flattener recommendation in Turkish cross currency swaps (entered at 60bps), we stick with our call for another 15bps move from 52bps on June 10. Otherwise, we favour closing that position flat at 60bps.

**Written by**

**Platon Monokroussos**
**Assistant General Maanger**
**Head of Financial Markets Research**
pmonokrousos@eurobank.gr

**Galatia Phoka**
**Emerging Markets Analyst**
gphoka@eurobank.gr

**Special thanks to:**
Costas Katsileros
Christos Pnevmatikatos
Konstantinos Dimaresis

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

## Net exports boost Q1 GDP reading

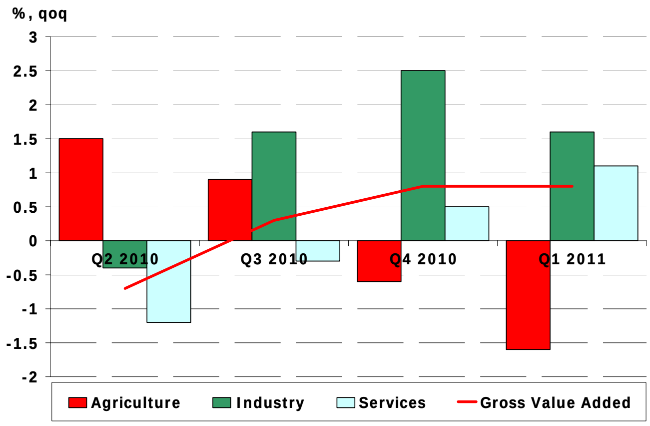
- Flash GDP report shows economy expanded by 2.5% yoy in Q1:2011 on strong export growth
- The violent incident in a Sofia mosque complicates the domestic political situation ahead of the upcoming presidential election in October 2011
- FITCH upgrades Bulgaria's sovereign credit outlook to positive from negative, keeps long-term rating at BBB-

**Flash Q1 GDP report shows economy expanded by 0.4% qoq/2.5% yoy, driven primarily by strong export growth**

The flash GDP data for the first quarter of the year recorded grow of +0.4% qoq/2.5% yoy compared to +0.5% qoq/2.9% yoy in Q4:201o. From a sectoral standpoint, only agriculture recoded negative growth in Q1:2011 (-0.4% qoq/ -1.6% yoy vs. -0.9% qoq/-0.6% yoy in Q4). Industrial output slowed to -0.2% qoq/+1.6% yoy, from 0.3% qoq/+2.5% yoy in the prior quarter. On the other hand, services accelerated to +0.3% qoq/+1.1% yoy, from 0.3% qoq/+0.5% yoy in the prior quarter.

**Figure 1**

**Services accelerated in the first quarter of 2011**




*Source: National Statistics*

On the demand side, private consumption remained depressed for another quarter. Total consumption growth came in at -1.2% qoq/-2.1% yoy in Q1 from -0.4% qoq/-1.1% yoy in Q4. However, this was the combined result of a slightly better picture in individual consumption and a very weak picture in collective consumption. The pace of decline of individual consumption slowed down (on a yearly basis) to -0.5% qoq/-0.2% yoy compared to +0.7% qoq/-0.5% yoy in Q4. Gross capital formation recorded a negative reading (-0.7% qoq), yet on yearly basis the contraction slowed down further to -2.7% yoy in Q1, from -3.8% yoy in the prior quarter. On a more positive not, net exports recorded another quarter of astonishing growth. Exports accelerated to 7.3% qoq/+22.2% yoy in Q1 compared to -2.2% qoq/+15.1% yoy in Q4. On the other hand, imports slow down to -4.0% qoq/+4.9% yoy in Q1, from +5.4% qoq/+10.6% yoy in Q4.

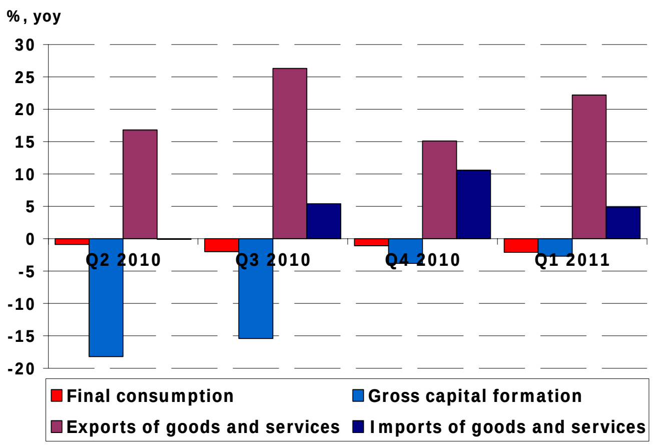
**Bulgaria: Eurobank EFG Forecasts**

| | 2009 | 2010 | 2011f | 2012f |
|---|---|---|---|---|
| **Real GDP (yoy%)** | -5.5 | 0.2 | 3.2 | 4.0 |
| Final Consumption | -7.3 | -1.1 | 1.0 | 3.5 |
| Gross Capital Formation *(Fixed)* | -17.6 | -16.5 | 4.5 | 6.5 |
| Exports | -11.2 | 16.2 | 8.5 | 7.5 |
| Imports | -21.0 | 4.5 | 6.5 | 7.0 |
| **Inflation (yoy%)** | | | | |
| HICP (annual average) | 2.5 | 3.0 | 5.0 | 3.5 |
| HICP (end of period) | 1.6 | 4.4 | 4.6 | 3.0 |
| **Fiscal Accounts (%GDP)** - *Cash Basis* | | | | |
| General Government Balance | -0.9 | -3.9 | -2.5 | -2.0 |
| Gross Public Debt | 15.6 | 16.7 | 19.5 | 21.5 |
| Primary Balance | -0.2 | -3.3 | -2.0 | -1.0 |
| **Labor Statistics** - *National Definitions* | | | | |
| Unemployment Rate (registered, %) | 9.1 | 9.2 | 8.9 | 7.0 |
| Wage Growth *(total economy)* | 11.8 | 6.2 | 7.5 | 6.0 |
| **External Accounts** | | | | |
| Current Account (% GDP) | -8.9 | -1.0 | -4.0 | -5.5 |
| Net FDI (EUR bn) | 2.4 | 1.6 | 2.2 | 2.5 |
| FDI / Current Account (%) | 77.4 | 460.0 | 145.0 | 85.0 |
| FX Reserves (EUR bn) | 12.9 | 13.0 | 13.5 | 15.0 |
| **Domestic Credit** | **2008** | **2009** | **2010** | **Q1 11** |
| Total Credit (%GDP) | 75.2 | 79.2 | 76.4 | 75.5 |
| Credit to Enterprises (%GDP) | 47.8 | 49.4 | 48.2 | 47.6 |
| Credit to Households (%GDP) | 26.0 | 28.2 | 26.4 | 25.9 |
| FX Credit/Total Credit (%) | 57.2 | 58.6 | 61.3 | 61.6 |
| Private Sector Credit (yoy) | 32.3 | 4.5 | 2.1 | 2.9 |
| Loans to Deposits (%) | 119.3 | 120.5 | 112.9 | 109.7 |
| **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 2**

**Gross capital formation contraction eased on a yearly basis in Q1**




*Source: National Statistics*

Our initial take on the flash GDP estimate is that the growth recovery remains on track yet at a slower pace than in the previous quarter. However, we ought to wait for the announcement of the final data before we make a more detailed analysis. That is because the final data within the individual categories (particularly on the demand side) usual contain significant deviations from the original announcements. In addition, there has been a major revision in the methodology of seasonally adjusted data. In essence, it should be wise not to jump into conclusions before the final data are published.

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. Additionally, the EBRD has revised its growth forecast to 3.1% this year from 2.6% in its January projection, according to its latest Regional Economic Prospects report. In contrast, World Bank has maintained its 2.5% GDP forecast in 2011 in the latest EU-10 Progress Report.

**The violent incident in the mosque of Sofia complicates the political situation in Bulgaria ahead of the presidential and municipal elections in October 2011**

A violent incident in the mosque of Sofia shuttered the political life of Bulgaria on May 20th. The rally organized by the right wing party ATAKA against the use of loudspeakers by the mosque in downtown Sofia got out of hand. Activists of ATAKA reportedly assaulted praying Muslims in front of the mosque. The violence that followed resulted in the arrest of three ATAKA supporters and the injury of one of the party's MPs, Mr. Denitsa Gadzheva.

The incident had multiple repercussions both in the society and the political stage. First of all, it resurfaced tensions between the two communities within the Bulgarian society. It stirred up the debate about religious freedoms in Bulgaria an issue which has not come up in the surface in the post-Communist era. The Muslim-ethnic Turkish community is represented by the Movement for Rights and Freedom (DPS) who served as a coalition partner in the previous government. From a political point of view, the incident is expected to consolidate its power. The latter is very important given that the country is on its way to local and presidential elections in autumn. The party received 14.45% of the vote in the last parliamentary elections and 38 seats in the parliament.

Secondly, it created the conditions for the eruption of a political crisis. An investigation was ordered to ban the ATAKA party for stirring up ethnic and religious hate. In fact, the parliament adopted a declaration which condemned the actions of ATAKA and prescribed the party as dangerous for the country's governance institutions and national security (127 MPs voted in favor out of 240). In retaliation, the ATAKA leader Mr. Volen Siderov denounced violence and claimed that those who were involved in the incident were not party members. However, the most important implication has to do with the potential withdrawal of parliamentary support to the government. The ruling party Citizens for European Development of Bulgaria (GERB holds 116 seats) relies on the votes of ATAKA to hold a parliamentary majority (ATAKA holds 21 seats). In essence, the parliamentary majority should not be taken for granted particularly when it comes to the endorsement of politically sensitive legislation. Last but not least, it has opened up the question whether the ruling party GERB will be able to finish its regular term (parliamentary elections are scheduled for July 2013).

**FITCH ups sovereign outlook of Bulgaria from negative to positive**

On May 24th, FITCH upgraded the sovereign outlook of Bulgaria from negative to positive, retaining the long tem ratings at BBB- and BBB for FX and local currency respectively. The sovereign report assessment cited "the reduction in Bulgaria's current account deficit, declining external debt ratios and strong fiscal consolidation has significantly reduced risks to macroeconomic and financial stability."

In our previous issue of New Europe Economics we argued that Bulgaria qualifies for a rating upgrade. 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 vs. its New Europe peers. Only, Standard and Poor's differentiate itself from the above assigning Bulgaria a one notch higher rating than Hungary and same rate as Lithuania. It is worthwhile to mention that the sovereign rating of Bulgaria did not lose its investment grade status in the post-Lehman environment.

First of all, we take note that both FITCH and Moody's have put the sovereign rating under review. In our view, this is a strong signal of a forthcoming rating upgrade. From their reports it is evident that rating agencies are waiting to see more clear evidence of improvement in two areas. The first one relates to the sustainability of the GDP growth rebound in 2011. Further improvement in the quality of GDP growth in terms of diversification towards domestic demand will also lead to an improvement in the domestic banking sector's asset quality. The second one relates to the attainability of the ambitious 2011 fiscal deficit target of 2.5% of GDP. The rating agencies are looking for more concrete evidence in terms of the budget execution to ensure that fiscal consolidation remains on track. The economic environment improvement coupled with the improving macroeconomic fundamentals should lead other rating agencies reassess their stance soon.

**Written by**

**Ioannis Gkionis**
**Research Economist**
**Coordinator of Macro Research**
igkionis@eurobank.gr

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

## Economic recovery set to broaden further

- Q1-11 GDP growth at 4.4% yoy, driven primarily by strengthening domestic demand dynamics
- Headline inflation hits (multi-month) highs in April, fuelled by higher food prices
- Polish central bank unexpectedly raised its key policy rate in June by 25bps to 4.50%, citing concerns over persisting inflationary pressures
- Current account gap rose further in March mainly as a result of widening deficits in the incomes and trade balances
- Total credit growth at 12.5% yoy favoured by easing bank lending standards. NPLs have started to decelerate, particularly in the corporate sector.

### Q1 GDP breakdown points to strengthening domestic demand dynamics

Poland revised slightly downwards its estimate for 2009 real GDP growth to 1.6% yoy, from 1.7% yoy previously. Real GDP growth in 2010 stood at 3.8% yoy driven by private consumption and inventory restocking. Q1-11 GDP release show that the economy got off a solid start in 2011, growing by 4.4% yoy (1.0% qoq) from 4.5% yoy (0.8% qoq) in Q4-10. First quarter's GDP growth breakdown indicates that domestic demand remained the main drive of growth, with its contribution becoming broader relative to the prior quarters. Private consumption grew by 3.9% yoy (0.9% qoq) while investment growth accelerated too to 6.0% yoy (2.4% qoq) reflecting the ongoing preparations ahead of the 2012 European Football Championships. The recovery in Polish economy is set to broaden further this year, with real GDP growth projected at 4.0% yoy in 2011 and 4.1% yoy in 2012. The main growth drives are a gradually improving labour market and a long-awaited increase in private investment coupled with increased foreign capital inflows. However, there are downside risks stemming from the absence of a more meaningful consolidation in public finances. These could adversely affect market sentiment and increase borrowing costs for the private sector.

Higher-frequency data are also encouraging. Retail sales jumped in April to 18.6% yoy up from 9.4% yoy in the prior month. At the same time, employment rose to 3.8% yoy while wage growth stood at 5.9% yoy reflecting the ongoing improvement in labour market conditions. On a somewhat less positive note, industrial production slowed to 6.6% yoy in April from 6.9% yoy recorded in March, while the PMI manufacturing index dropped to 52.6 (from 54.4). However, the latter remained above the 50 boost-or-bust threshold for the 19th month in a row, indicating ongoing expansion in the sector.

| Poland: Eurobank EFG Forecasts | | | | |
|---|---|---|---|---|
| | **2009** | **2010** | **2011f** | **2012f** |
| **Real GDP (% yoy)** | 1.6 | 3.8 | 4.0 | 4.1 |
| Private Consumption | 2 | 3.2 | 3.5 | 3.6 |
| Government Consumption | 2 | 3.5 | 3.0 | 2.5 |
| Gross Capital Formation | -13.6 | 6.3 | 6.5 | 4.5 |
| Exports | -6.8 | 10.2 | 6.8 | 7.0 |
| Imports | -12.4 | 10.7 | 7.9 | 7.1 |
| **Inflation (% yoy)** | | | | |
| CPI (annual average) | 3.5 | 2.6 | 3.8 | 3.1 |
| CPI (end of period) | 3.5 | 3.1 | 3.5 | 2.8 |
| **Fiscal Accounts (% GDP)** | | | | |
| General Government Balance | -7.3 | -7.9 | -7.0 | -6.5 |
| Gross Public Debt (ESA95 definition) | 50.9 | 55.0 | 55.4 | 55.1 |
| 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) | -5.3 | -3.1 | -4.0 | -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** | **2010** | **Q1 11** |
| Total Credit (% GDP) | 50.9 | 53.1 | 55.4 | 55.0 |
| Credit to Enterprises (% GDP) | 17.6 | 16.1 | 15.2 | 15.3 |
| Credit to Households (% GDP) | 29.7 | 31.6 | 34.2 | 33.7 |
| FX Credit/Total Credit (%) | 32.6 | 30.2 | 30.8 | 30.1 |
| Private Sector Credit (% yoy) | 38.1 | 7.2 | 8.9 | 10.6 |
| Loans to Deposits (%) | 106.0 | 102.6 | 102.4 | 99.5 |
| **Financial Markets** | **Current** | **3M** | **6M** | **12M** |
| Policy Rate | 4.50 | 4.50 | 4.50 | 4.75 |
| EUR/PLN | 3.96 | 3.90 | 4.00 | 4.10 |

Source: NBP, EcoWin, Bloomberg, Eurobank Research

### Current account deficit widens further

The current account gap widened further to €1.4mn in March from €0.8mn in the prior month. This was mainly attributed to wider deficits in the incomes and trade balances. On a more positive note, in March, foreign direct investment inflows in

Poland increased further and amounted to €1.46bn (including €0.78bn net inflow of financial debt instruments, €0.7bn positive reinvested earnings). Furthermore, the balance of foreign portfolio investment was positive and amounted to €1.78bn mainly attributed to non-residents' purchase of State Treasury bonds issued on the domestic market (€1.4bn).

What's still worrisome is the net errors and omissions component which widened further to €0.7bn equivalent to more than half of current account deficit. According to National Bank of Poland (NBP) this component is large because of difficulties in estimating in one hand the activity of companies investing through affiliates domiciled offshore and on the other hand the value of foreigners' deposits in Polish banks. The NBP announced that it will revise the balance of payments data in the near future but concerns over the effect on GDP estimate remains. A likely negative revision in c/a data could also result in country's ratio of public debt to GDP revision; in case GDP growth has been overstated, public debt to GDP ratio could be understated.

We anticipate current account deficit to widen further in the next couple of years, reaching 4.0% and 4.2% of GDP in 2011 and 2012 respectively, as global commodity prices inflate the import bill. The income deficit is expected to be large as the profitability of foreign-owned enterprises is expected to remain strong. Moreover, the current transfers' surplus is expected to widen as transfers from the EU increase.

**Fiscal consolidation underway**

In the 2011 Budget Law, the government has implemented a range of reforms to consolidate public finances. These measures, together with strengthening domestic economic growth, are expected to bring about a considerable reduction in the headline budget deficit. Yet, the official fiscal deficit target for this year (5.8%-of-GDP) may not be fully reached. The government has done little structural reforms and additional measures would be needed following the October's parliamentary elections if the government is to achieve its goal of 3.6% of GDP budget deficit in 2012.

On the public debt front, it is projected that the general government debt ratio will slow considerably, supported by the liquidity management reform introduced in 2011 and ambitious privatisations plans. Moreover, the government seeks to maintain public debt below the 55% of GDP threshold. According to national definition, public debt is estimated to reach 54.5% and 54.0% of GDP in 2011 and 2012 respectively up from 53.0% of GDP in 2010. However, the projected debt figures are subject to considerable uncertainty due to high exchange rate volatility and the ensuing valuation effects on the large foreign-denominated part of the debt (in 2010 the 43.4% of public debt is FX denominated).

**Inflation remained at elevated levels in April fuelled by higher food prices**

Headline inflation rose to 4.5% yoy in April, from 4.3% yoy in the prior month, in line with market expectations. This was the highest CPI reading since September 2008. The main drive remained fuel and food prices (food inflation stood at 6.4% yoy in April up from 6.1% yoy in March). Furthermore, core inflation (measure which excludes food and energy prices) rose to 2.1% yoy in April up from 2.0% yoy in the prior month. What is more worrisome though, is the lingering upward trend in inflation expectations which increases the risk of second round effects on wages and core inflation stemming from higher domestic food and energy prices. However, we anticipate headline inflation to fall in the second half of this year as commodity prices would ease further. We expect inflation to average at 3.8% yoy in 2011 and fall to 3.1% yoy in 2012.

**NBP delivers unexpected rate hikes in May and June on concerns over persisting inflationary pressures**

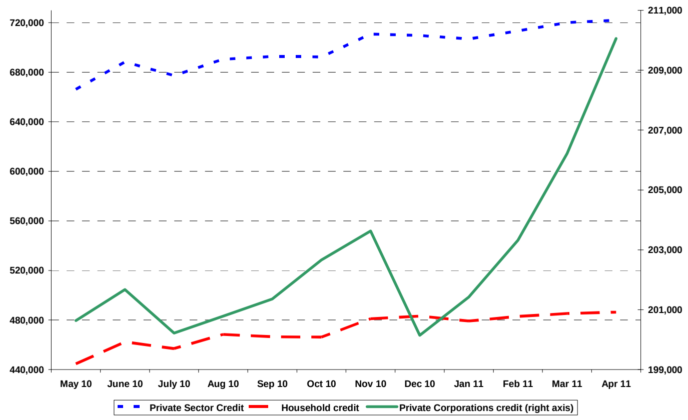
The Council of the National Bank of Poland (NBP) decided in May to raise the key policy rate by 25bps to 4.25%. This was the third hike from the NBP so far this year following similar 25bps rate-increasing moves in January and March. According to the policy statement accompanying the May 2011 MPC meeting, the continuing economic recovery coupled with further employment growth may gradually increase wage pressures, In a further move to pre-empt inflation risks the central bank delivered another 25bps rate hike in June, bringing its key rate to 4.50%. With inflation setting to resume a decelerating path in H2-11 we anticipate interest rate to remain at 4.50% for the remainder of this year (although the markets expect more aggressive tightening pricing interest rates at 5.00% by year-end.

**Credit growth improves**

Total credit grew by 12.5% yoy in April favoured by easing lending policies on the back of growing competition among domestic banks, increasing loan demand particularly from small and medium-sized enterprises and an improvement in the quality of loans portfolio (with the exception of mortgage loans). Private corporate credit has been on an upward trend since the beginning of this year; it grew by 6.5% yoy in April and by 5% year-to-April. At the same time, household credit, which accounts for ca 67% of total private sector credit, has rather stabilised in the first quarter of 2011; it stood at 12.5% yoy in April and grew by 0.7% year-to-April. (Figure 1) What's more, mortgages loans grew slightly by 1% year-to-April.

**Figure 1**

**Corporate credit in an upward trend while household credit stabilizing**

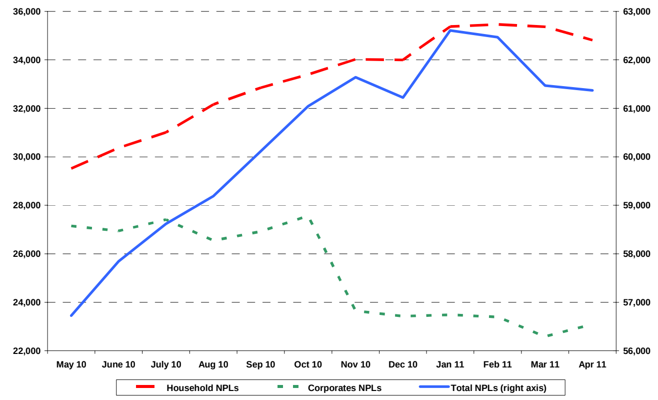



*Source: National Bank of Poland, Eurobank Research calculations*

Total deposits grew by 1.9% year-to-April bringing Loans to Deposits ratio at 102.2%. Furthermore, Non-Performing Loans (NPLs) ratio to total loans stood at 8.2% in April. NPLs have peaked in January 2011 and since then they have started to decelerate. Enterprises' NPLs have decelerated significantly since October 2010 with NPLs to total loans in the corporate sector easing to 10.8% in April 2011, from 13.3%. in October 2010. Household NPLs (which account for ca 57% of total NPLs) have started to ease the last couple of months, as well. (Figure 2)

**Figure 2**

**NPLs decelerating**




*Source: National Bank of Poland, Eurobank Research calculations*

**Written by**

**Dr Stella Kanellopoulou**
**Research Economist**
Skanellopoulou@eurobank.gr

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

## Domestic economy exits recession in Q1 2011

- Romanian GDP registered positive growth on a quarter on quarter basis for a second time in a row (+0.7% qoq), which marks the end of the recession from a technical point of view

- First review of the new precautionary agreement: The government ought to speed up the pace of restructuring in the state-owned enterprises

**Romania's economy finally exited recession, from a technical standpoint, in the first quarter of 2011**

Real GDP growth expanded by 1.7% yoy in Q1 2011 compared to -0.6% yoy in Q4 vs. -2.2% yoy in Q1 2010. On a seasonally adjusted basis, the GDP grew by 0.7% qoq (marginally higher than the original flash estimate: +0.6% qoq). The flash estimate came above analyst expectations (Reuter's poll: +0.2% qoq). This is the second quarter on quarter positive growth, which marks the end of the recession from a technical point of view. More importantly, this the first positive year-on-year reading since the collapse of the Lehman Brothers.

From a demand point of view, GDP data showed that private consumption is stabilizing at lower levels. Households' consumption growth shrank -1.7% yoy in Q1, flat compared to Q4. In contrast, government consumption plummeted by 14% yoy on continued efforts of fiscal consolidation. Overall, total consumption fell by 3% yoy, with the contraction narrowing after a 4.3% yoy plunge in Q1 2010. The contraction in real gross fixed capital formation eased to -2.2%yoy compared to -4.7%yoy in Q4. Meanwhile, the rebuilding of inventories pushed gross capital formation higher by 11.5% yoy in Q1. Growth in the most illustrative sector of capital investments, construction, remained in negative territory, but with the pace of contraction slowing down to -2.4% yoy in Q1 compared to -7% yoy in Q4.

The picture in services, the most labor intensive sector of the economy, remained mixed. The contraction deepened in financial services, which marked a 3.2% yoy decline in Q1 compared to -1.5% yoy in Q1 2010. The retail sector, the most important sector of consumption, recorded a positive growth reading for the first time since the last quarter of 2008. In detail, retail services expanded by 1.1% yoy in Q1 compared to -2.9% yoy in Q4. The industrial sector was once again the star performer in the economy. Industrial production jumped by 10.1% yoy on the back of strong foreign demand which boosted exports (+23.6% yoy). On the other hand, imports' growth accelerated to 15.2% yoy in Q1 from 12.2% yoy in Q4 as domestically manufactured products incorporate a significant amount of imported materials.

In retrospect, the first quarter marked the end of the recession, at least from a technical point. The contraction during 2010 also proved softer than our initial forecast and the one expected by Romanian authorities: -1.2% vs. -1.9% respectively.

**Romania: Eurobank EFG Forecasts**

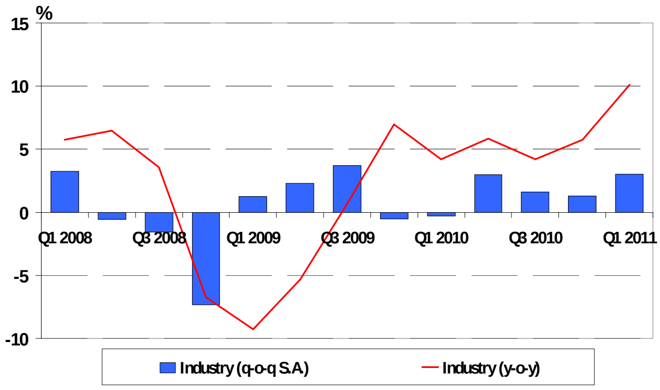
| | 2009 | 2010 | 2011f | 2012f |
|---|---|---|---|---|
| **Real GDP (yoy%)** | -7.1 | -1.3 | 1.7 | 3.5 |
| Private Consumption | -10.6 | -1.5 | 1.0 | 3.3 |
| Govern. Consumption | 1.2 | -3.2 | -2.5 | 1.0 |
| Gross Capital Formation | -25.3 | -13.1 | 3.5 | 6.5 |
| Exports | -5.0 | 14.3 | 8.0 | 7.0 |
| Imports | -21.4 | 12.4 | 5.0 | 8.0 |
| **Inflation (yoy%)** | | | | |
| CPI (annual average) | 5.6 | 6.1 | 6.5 | 4.5 |
| CPI (end of period) | 4.7 | 8.0 | 5.2 | 4.0 |
| **Fiscal Accounts (%GDP, Cash Basis)** | | | | |
| General Government Balance | -7.3 | -6.5 | -4.4 | -4.0 |
| Gross Public Debt | 29.5 | 35.2 | 36.1 | 40.0 |
| **Labor Statistics (annual avg,%)** | | | | |
| Unemployment Rate (% of labor force) | 6.3 | 7.6 | 7.0 | 6.5 |
| Wage Growth (total economy) | 8.4 | 2.5 | 1.4 | 4.5 |
| **External Accounts** | | | | |
| Current Account (%GDP) | -4.2 | -4.1 | -5.5 | -6.0 |
| Net FDI (EUR bn) | 3.6 | 2.6 | 3.5 | 6.0 |
| FDI / Current Account (%) | 72.3 | 51.4 | 65.0 | 70.0 |
| FX Reserves (EUR bn) | 28.3 | 32.4 | 38.0 | 45.0 |
| **Domestic Credit *(end of period)*** | **2008** | **2009** | **2010** | **Q1 11** |
| Total Credit (%GDP) | 42.7 | 50.2 | 52.7 | 48.8 |
| Credit to Enterprises (%GDP) | 18.8 | 19.6 | 20.4 | 19.0 |
| Credit to Households (%GDP) | 19.7 | 20.4 | 19.9 | 18.0 |
| FX Credit/Total Credit (%, private) | 53.1 | 60.1 | 63.0 | 62.2 |
| Private Sector Credit (yoy) | 33.7 | 0.9 | 4.7 | 2.3 |
| Loans to Deposits (%) | 131.9 | 130.6 | 137.7 | 136.9 |
| **Financial Markets** | **Current** | **3M** | **6M** | **12M** |
| Policy Rate | 6.25 | 6.25 | 6.25 | 6.25 |
| EUR/RON | 4.16 | 4.15 | 4.20 | 4.20 |

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

In a special focus piece in the February issue of New Europe Economics & Strategy, we had pre-announced that the end of recession was in sight. The better-than-anticipated 2010 data prompted us to upgrade our forecast for this year to 1.7% shortly after its release. Growth prospects have improved even in countries like Romania which lagged behind in 2010. Yet this is short of sustainable growth since, this year will be a transitional year for Romania. The recovery is expected to gain further momentum in 2012 unless another external shock materializes: Both government and IMF forecast output to accelerate to 3.5% next year.

**Figure 1**

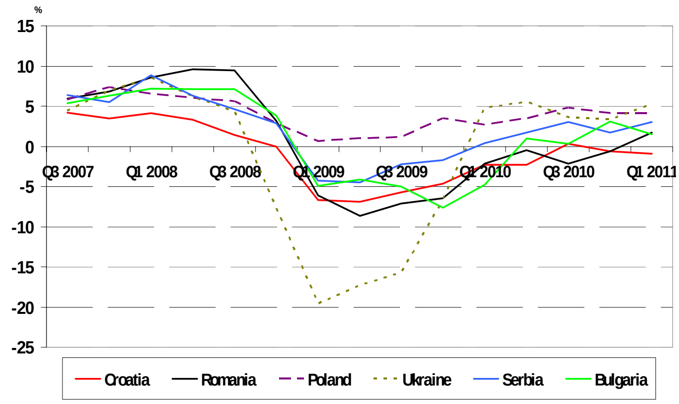
**The industrial sector was once again the star performer of the economy**




*Source: National Statistics, Eurobank Research*

**Figure 2**

**Romania was one of the last countries in New Europe to exit recession in Q1**




*Source: National Statistics, Eurobank Research*

**Romanian authorities reached staff level agreement on the first review of the new precautionary agreement**

On May 9th, the IMF mission reached an agreement with the Romanian government on the first review of the new precautionary lending agreement. The new agreement envisages total funding of €5bn (€1.4bn from EU and €3.6bn from IMF). A new € 0.4 bn loan from World Bank has been secured as well. The approval of the review will enable the Romanian authorities to have access to a €475 mn tranche. However, the current arrangement is of a precautionary nature and the government has indicated it does not plan to utilize the funds unless needed. More importantly, the appraisal contained a positive assessment of the policies implemented in Q1. According to the press release, the government is on track to meet the 4.4% of GDP fiscal target in 2011. However, noted that special attention should be given in the context of the new agreement on structural reforms in the area of state owned enterprises. The government ought to implement a new strategy to deal with the losses of public corporations.

In our view, the government ought to speed up the pace of restructuring in the state-owned enterprises. That is particularly important because of the of the political cycle onset. Parliamentary elections are scheduled to take place in late 2012. The current favorable local financial market conditions also provide a time-window of opportunity to the government to address this issue. It is worth mentioning that past 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 the endorsement of the uniform wage and budget laws in 2011.

We have highlighted in all our previous analysis two key issues with respect to fiscal uncertainties. One comes from the arrears of the government and the other one from the incorporation of results of state owned enterprises. On a more alarming note, the full arrears number is yet to be known. 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. In fact, Eurostat has expressed doubts on the issue of arrears, 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 according to unofficial calculations, up from the 6.4% initially reported in 2010, should financial results of state-owned railway company CFR Infrastructura and power generator Termoelectrica be incorporated.

**Written by**

**Ioannis Gkionis**
**Research Economist**
**Coordinator of Macro Research**
igkionis@eurobank.gr

**New Europe Economics and Strategy, May 2011 – Focus Romania**

**Recent fiscal developments and outlook**

Romania's consolidated fiscal deficit came in at RON 4.36bn in the first four months of 2011, declining by 64% relative to the same period a year earlier. It eased to 0.8% of projected GDP in the first four months of the year, from 1%-of-GDP in Q1:2011. Revenues were up 10.3% yoy, boosted by VAT and excise duty receipts (+35.6% yoy and +24.3% yoy, respectively). Spending was curtailed by 3.6% yoy, assisted by lower wage-related costs (-19.7% yoy) and subsidy cuts (-22.7% yoy). One important area in which spending has increased relates to the implementation of EU co-financed projects (+62.1% yoy).

Arrears continue to pose as significant risks, especially in view of lingering uncertainty about their overall size. Estimates range from one billion lei (less than 0.25 billion euros) in February 2011 (according to Government sources) to 5% of GDP (i.e., 6 billion euros) at the end of 2010 (according to the IMF mission in Romania). The government has committed itself to construct an inventory of arrears by the next visit of the IMF mission in late June. All-in-all, budget execution remains on track to achieve the 4.4%-of-GDP deficit target for 2011.

**Tapping the international markets…**

After 9 months of postponement, the Government has commenced its new EMTN note on June 9th (through an initial issue of 1.5 billion Euros worth of 5-year €-denominated bonds at an average accepted yield of 5.29%). The total sum of money expected to be collected through the program may reach 7 billion euros.

The Ministry appears to have been concerned mainly with the timing of supply-related factors, as the general picture currently looks satisfactory: Romania has a new agreement with the IMF, budget execution is on track, tax collection is improving and the domestic economy appears to have already exited recession. However, the right timing of demand-related factors has proved to be a much more complicated exercise. Lingering sovereign concerns in the euro area periphery have generated a more risk-averse market environment. Furthermore, the approaching end of QE2 in the US and the worries over the global macroeconomic backdrop have helped create a more challenging environment for emerging market sovereign debt issuers down the road.

**Unemployment rate falls rapidly, but caution in interpreting the decline is advised**

Economic theory indicates that labor market conditions generally constitute a lagging indicator of the state of the domestic economy. The Romanian unemployment rate stood at 5.45% in April, having eased significantly from a multi-year peak of 8.4% reached in March 2010. From a pure theoretical perspective, and interpreting the April unemployment reading in isolation, one would be tempted to assume that the latter is a testament of a strong recovery in the domestic economy. Yet, this is not necessarily the case, in our view. After passing the new labor code earlier this year, the government started engaging in coercive measures to bring workers out of the informal sector. Most likely, the recent drop in the unemployment rate has been a corollary of these measures.

**Monetary policy stance**

The annual inflation rate reached a multi-month high of 8.4% in May on accelerating prices for electricity, fruits and vegetables. The Central Bank revised in April its end-of-year CPI forecast by 1.5ppts to 5.1%. A new decision by the government to eliminate heating subsidies at a central level may however push inflation over 6% by the end of the year.

As it becomes increasingly apparent this year's CPI target will likely be missed, policymakers are now shifting their attention inflation developments beyond 2011. The IMF has recently expressed concerns that the current monetary policy is too loose to reach the 2012 target of 3%. The key parameters that will likely determine future monetary policy developments include, among others, the following:

1. The degree to which the NBR believes that the current surge in world commodity prices is driven by temporary factors or structural changes (i.e. increased demand from emerging market economies);
2. Whether the short-term shocks to the domestic economy (VAT and excise tax hikes, subsidies cuts) will generate second round effects by altering inflationary expectations.

We believe the central bank will keep the key interest rate at 6.25% for the rest of the year. However, it is quite likely it will manage interbank liquidity tighter, thus pushing ROBOR closer to the key policy interest rate. Additionally, loan rates may be driven down by improvements in the domestic risk environment. Note here that the credit-risk ratio (volume of new doubtful credit to total credit) and provisions-to-loans ratio (volume of new provisions to total credit) shrank by 20% from the beginning of the year.

***Written by:***

**Mihai Patrulescu**
**Junior Economist**
Mihai.Patrulescu@bancpost.ro

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

## Central Bank signals an end to its tightening cycle

- Arrest of fugitive general Ratko Mladic is boosting Serbia's EU candidate status
- NBS left unchanged its key policy rate at 12.5% in May, signaling an end to its tightening cycle
- Domestic inflation climbed further in April, reaching a 34-month high of 14.7% yoy
- The cancellation of the bid of Telekom Serbia implies that the government will need to rely more on debt issuance this year to cover its borrowing requirement

### Arrest of general Ratko Mladic gives a boost to the country's prospective EU candidate status

On May 26th, war crime fugitive general Ratko Mladic was arrested by the Ministry of Interior security forces. General Mladic, who was indicted by the International Criminal Tribunal for the former Yugoslavia (ICTY) with charges for genocide during the 1992-95 Bosnian war, has been on the run in the past 16 years. The arrest of General Mladic is a flagstone in the country's road towards EU membership. EU has conditioned Serbia's accession on full co-operation with the ICTY. The latter has always been a controversial and sensitive issue with respect to Serbia's EU integration efforts. The present government coalition has made steady progress on that front over the last three years. After managing to arrest Bosnian-Serb leader Radovan Karadzic in 2008 and, more recently, general Mladic the arrest of Croatian-Serb leader Goran Hadzic is the only high profile case left that needs to be addressed.

In retrospect, EU-Serbian relations have been steadily improving during the last three years. EU integration was set as a key policy priority by the coalition government since the beginning of its term. From that perspective, the progress made so far has been impressive.

- The Stabilization and Association agreement (SAA), the most important contractual agreement between Serbia and EU, was signed in April 2008. Although Serbia has made steady progress in complying unilaterally with the SAA requirements, the agreement has not been ratified by all EU members
- Serbia applied for EU membership in a symbolic gesture in December 2009. At the same time, EU visa restrictions for Serbia citizens were abolished for the first time since the nineties. In addition, EU agreed to unblock the interim trade agreement, the most significant part of (SAA). The Interim Trade Agreement, the first step towards European trade integration, was entered into force in February 2010
- In fact, the SAA agreement ratification procedure by EU members was not launched until June 2010. Ever since, only 11 of the 27 member states have completed the process. Some EU members (e.g. Holland) refused to ratify the agreement on the basis that Serbian's co-operation with the ICTY was deemed insufficient. The ratification procedure is very important because it is a key prerequisite for granting EU candidate status and allowing access to increased pre-accession funds assistance for Serbia
- On October 25th 2010, EU foreign ministers asked the Commission to prepare a formal assessment of Serbia's application. Shortly after, the EU Commission sent a questionnaire with 2,500 questions to the Serbian authorities in order to assess its readiness to join EU. The EU Commission is anticipated to express its opinion on the subject by October 2011

**Serbia: Eurobank EFG Forecasts**

| | 2009 | 2010 | 2011f | 2012f |
|---|---|---|---|---|
| **Real GDP (yoy%)** | -3.0 | 1.8 | 3.0 | 5.0 |
| **Inflation (yoy%)** | | | | |
| CPI (annual average) | 8.2 | 6.2 | 10.0 | 7.5 |
| CPI (end of period) | 6.6 | 10.3 | 7.5 | 6.5 |
| **Fiscal Accounts (%GDP)** | | | | |
| General Government Balance | -4.2 | -4.5 | -4.0 | -3.2 |
| Gross Public Debt | 31.3 | 41.4 | 41.1 | 40.2 |
| **Labor Statistics (%)** | | | | |
| Unemployment Rate (%of labor force, ILO) | 16.1 | 19.2 | 18.0 | 17.0 |
| Wage Growth *(total economy)* | 4.1 | 7.5 | 8.3 | 9.0 |
| **External Accounts** | | | | |
| Current Account (% GDP) | -6.9 | -7.2 | -8.0 | -8.5 |
| Net FDI (EUR bn) | 1.4 | 0.8 | 1.2 | 2.0 |
| FDI / Current Account (%) | 78.7 | 39.9 | 45.0 | 75.0 |
| FX Reserves (EUR bn) | 10.6 | 10.0 | 11.5 | 10.5 |
| **Domestic Credit** | **2008** | **2009** | **2010** | **Q1 11** |
| Total Credit (%GDP) | 41.1 | 48.7 | 59.7 | 58.8 |
| Credit to Enterprises (%GDP) | 24.2 | 27.8 | 33.4 | 33.0 |
| Credit to Households (%GDP) | 15.7 | 16.2 | 18.6 | 18.0 |
| Private Sector Credit (yoy) | 34.9 | 14.3 | 26.5 | 18.1 |
| Loans to Deposits (%) | 125.1 | 127.0 | 144.6 | 148.9 |
| **Financial Markets** | **Current** | **3M** | **6M** | **12M** |
| Policy Rate | 12.00 | 12.00 | 10.50 | 10.50 |
| EUR/RSD | 98.25 | 100.00 | 100.00 | 105.00 |

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

- On January 19th 2011, the Euro-parliament ratified with an overwhelming majority (~90%) the Stabilization and Association agreement. In addition, the Euro-parliament welcomed Serbia's reform progress and steps "in the process of raising awareness of the atrocities that happened in the recent past and of regional reconciliation" with a separate resolution

The arrest of General Mladic and his extradition to ICTY will only improve sentiment toward Serbia. The country has been under intense pressure by the international community to provide tangible results in co-operation with ICTY. Reportedly, the latter's general prosecutor was about to submit a very negative report that would have complicated things further.

In contrast, the arrest of the fugitive general provides evidence of the Serbian authorities' commitment towards co-operation with the ICTY. At this point, EU members will most probably accelerate SAA ratification procedures. For the reason above, it also gives a boost to the country's prospective EU candidate status. Yet it will be no substitute for full EU membership. In the most optimistic scenario, the Serbian authorities' aspiration is to get a date as early as spring 2012 for pre-accession talks to begin. Even if all technical issues are resolved, the issue of Kosovo status will remain an impediment towards EU accession. Notwithstanding EU enlargement fatigue, Serbia's accession to EU could reach as far as 2017.

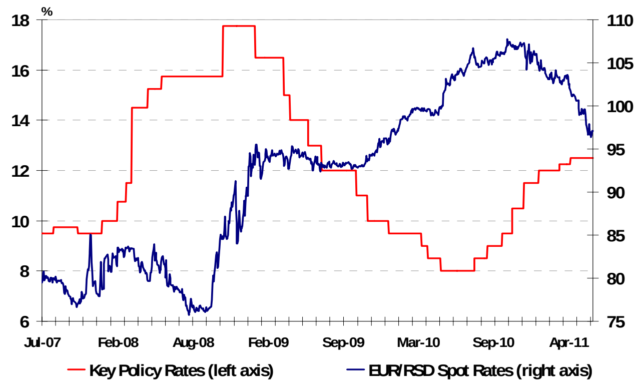
Last but not least, the arrest of the long wanted fugitive marks the end of an era and the beginning of a new for the Serbian society. "We ended a difficult period in our history and removed the stain from the face of the members of our nation wherever they live." President Tadic commented in a press conference. More importantly, public reaction to the arrest did not spur a wave of violence throughout Serbia. In earlier times, public reaction would have been more negative. This is the combined result of two evolving trends within the society. Firstly, both the judicial and the police authorities are less lenient with ultranationalist violence. Secondly, the support for ultra nationalistic ideas is waning away, so is the support for those political parties who support those views.

**NBS left its key policy rate unchanged at 12.5% in May, signaling that the end of its monetary policy tightening cycle has probably been reached**

On May 12th, NBS left the key policy rate unchanged at 12.5%. After eight rate increases, three of them since of the beginning of this year, the Central Bank made a pause. The Central bank has delivered a cumulative rate hike of 450bps since August 2010 in an attempt to combat rising inflation. According to a Bloomberg survey conducted ahead of the monetary policy meeting, 10 participants (out of 21) expected no rate change, 7 expected a 25bps hike, and 3 expected a 50bps hike, whereas 1 expected a 25bps cut. In the statement released after the policy meeting, the Central Bank said that the key policy rate has reached or it is very near the peak of the tightening cycle. At the same time, the Central Bank implied that it will be cautious with respect to any prospective monetary policy easing, taking into account all available instruments.

**Figure 1**

**The monetary policy tightening cycle came to an end in Serbia**

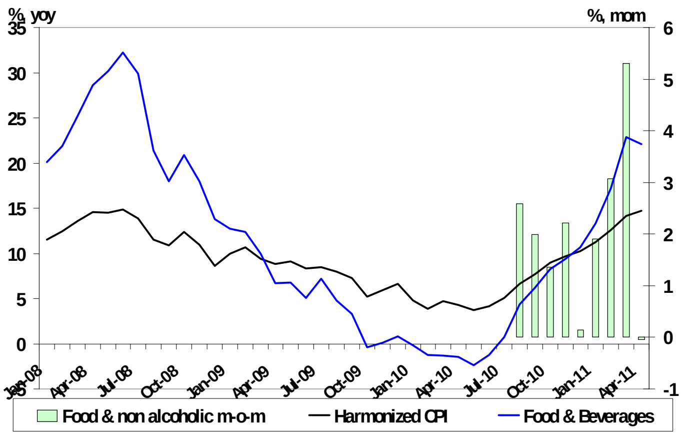



*Source: Bloomberg, Eurobank Research*

In our last New Europe Economics & Strategy issue, we opinioned that the NBS's monetary policy tightening cycle was probably close to its end. As we noted back then, 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. Secondly, the Central Bank had stated that the full effect of past monetary policy measures was yet to be felt on inflation. With respect to its May 2011 latest no-policy-change decision, the most important element the Central Bank took under consideration was that the future path of inflation has finally become more predictable. That said, inflation has probably peaked in April (or is about to peak in May) according to the Central Bank projections. In addition, the Dinar strengthening course provides an additional tool for inflation containment.

**Figure 2**

**Inflation has probably peaked in April or is about to peak in May**




*Source: National Statistics, Eurobank Research*

Looking ahead, we still hold the view that the Central Bank would be very cautious to engage in any monetary policy easing as inflation uncertainties remain elevated. The international environment continues to 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 stay on a tightening mode, making it more difficult for the NBS to embark on aggressively rate cuts.

Last but not least, a number of country-specific factors come into play. Namely, the regulatory prices adjustment has already exceeded the limits set by the mutually agreed framework with the government. On top of the electricity prices adjustment effective from April 1st, gas prices are expected to rise as well. In addition the onset of the pre-election cycle raises the risk of fiscal slippage; Serbia's parliamentary elections are officially scheduled for next May. Once inflation uncertainties recede, the Central Bank is expected to resume monetary easing sometime within H2:2011. Our year-end forecast for interest rates stands currently at 11.5%, 100bps lower from the peak.

**Government rejects improved bid for Telekom Serbia**

On May 4th, the government rejected an improved offer by Telekom Austria (€ 1.1 bn for the 51% stake) for the state-owned fixed line operator Telekom Serbia. President Boris Tadic attributed the bid rejection to poor market conditions that failed to produce "the necessary offer and means for Serbia's economic progress". Mr. Tadic said that the privatization would be postponed until market conditions improve.

The original deadline for the submission of bids for Telekom Serbia ended with only one bidder. Telekom Austria offered €950 mn ($1.34 billion) in cash and €450 mn in committed investments over the next three years. The offer was below the official minimum offer threshold of €1.4bn. In response, the Serbian government asked on Telekom Austria to improve its bid, extending the deadline twice.

The cancellation of the most important privatization project in the agenda is very disappointing. The privatization program would have been a great opportunity to attract much needed FDI inflows that could spur a wave of investments in the obsolete infrastructure of the country. Moreover, it would provide a more sustainable source of balance-of-payments financing. From this point of view, the completion of the Telekom Serbia's privatization was of great importance in terms of attracting more FDI inflows in the country.

Net FDI inflows have been on a downward trend in the aftermath of the international financial crisis. FDI inflows reached €860mn in 2010 compared to €1.3bn in 2009, down by 37% yoy. Net FDI covered only 41% of the current account in 2010 compared to 65.8% in 2009. FDI inflows had showed encouraging signs of resumption in the first months of 2011. FDI inflows reached €424mn in Q1 2011 compared to €396.8bn in Q1 2010 up by 7.0% yoy. However, we anticipate that even if the recent rising trend continues, full-year FDI inflows would not even come close to our initial forecast of €2bn in 2011. The initial announcement of bids made us skeptical about the completion of the privatization. Taking into account the latest developments, we have downgraded our forecast of FDI inflows this year to €1.2bn.

In addition, given that the Telecom Serbia privatization project did not come through, the Ministry of Finance will have to rely more on debt issuance this year to finance the budget deficit. The Head of Debt management agency has already expressed its preference over a Eurobond issue (approximately €1bn) most probably in autumn 2011.

**Written by**

**Ioannis Gkionis**
**Research Economist**
**Coordinator of Macro Research**
igkionis@eurobank.gr

**Credit developments in Serbia in the first four months of 2011- Focus Serbia**

Credit from Serbian banks has been on a declining trend since the beginning of 2011. Total domestic credit growth came in at 17.9% yoy (-2.04% mom) in April 2011, marking its slowest annual pace of increase since March 2007. Similarly, after peaking at 27.8% yoy in October last year, private sector credit slowed down to 15.1% yoy in April 2011, the lowest reading since May 2010 .

Furthermore, FX credit growth adjusted for currency fluctuations has decelerated from 15.7% yoy in December 2009 to 3.3% yoy in April this year. FX adjusted private sector credit growth is also losing steam. Following a temporary rise in the September 2009 - December 2010 period, FX adjusted private sector credit growth resumed its downturn thereafter to stand at 14.1% yoy in April 2011.

The picture these figures paint for the credit market is of a decelerating growth rate mainly driven by a slowdown of FX credit which, however, is partly offset by ongoing strong growth domestic currency lending. In April 2011, domestic currency (RSD) denominated loans came in at 45.3% yoy remaining in a downward but still exploding trend for the fourth month in a row after peaking at 53.4% yoy in December. The underlying factors behind these movements in FX and RSD credit are de-Euroization and subsidized dinar loans.

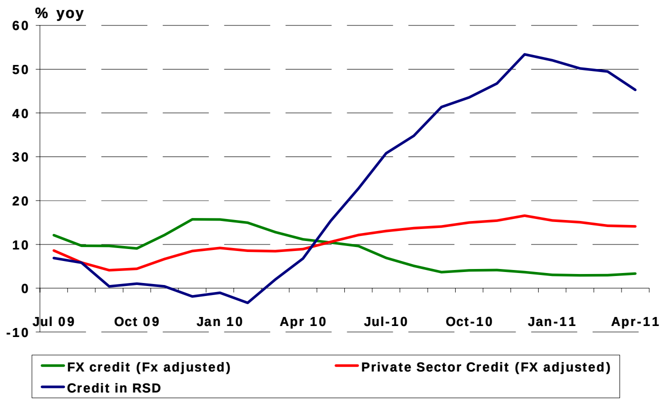
The ratio of FX loans over total loans in Serbia came to 67% in April 2011, following a 76% peak in February 2010. This is the lowest value since June 2008 and that is without taking into account the dinar's depreciation, which inflates the ratio. This ratio improvement reflects government, IMF and banking sector efforts to facilitate de-Euroization*. Serbian banks have made significant progress in de-euroizing their credit, yet there is still room for improvement. Moreover, latest IMF developments include extending the cooperative framework of the Vienna agreement for reducing Euroization stability risks, as well as campaigns for public awareness such as FX hedging conferences.

*These measures and further details on Serbia's Euroization status have been previously covered in New Europe, namely in our May 2010 issue.

In February 2009, the Serbian government launched a domestic credit support program that subsidizes certain types of loans and offers capped interest rates. This program was introduced in order to sustain credit demand throughout the economic crisis. At present, the government plans to include the gradual phase-out of these – still in effect - subsidies due to fiscal tightening. What remains to be seen is the rate of this phasing-out and its effects on domestic currency credit growth. The program was adopted in February 2009 but credit in domestic currency started its aforementioned surge in March 2010, when a second smaller program was introduced that only subsidized dinar lending (Fig 1).

**Figure 1**

**Subsidized loans have boosted RSD loans during 2010**




*Source : NBS, Eurobank Research*

In February 2009, the Serbian government launched a domestic credit support program that subsidizes certain types of loans and offers capped interest rates. This program was introduced in order to sustain credit demand throughout the economic crisis. At present, the government plans to include the gradual phase-out of these – still in effect - subsidies due to fiscal tightening. What remains to be seen is the rate of this phasing-out and its effects on domestic currency credit growth. The program was adopted in February 2009 but credit in domestic currency started its aforementioned surge in March 2010, when a second smaller program was introduced that only subsidized dinar lending (Fig 1).

In a similar fashion, the annual rate of increase in total deposits in April came in near a record low of 6.6%. Private sector deposits' growth slowed to 7.0% yoy, the lowest since May 2009. In currency-adjusted terms, private sector deposits increased by 6.7% yoy in April 2011, recording the lowest rise since October 2009. Growth in dinar deposits decelerated to -6.3% yoy, having slid into a negative territory since August 2010. Growth in FX deposits reached its lowest level since April 2009 at 11.6% yoy vs. the July 2010 peak of 37.2% yoy.

De-Euroization of deposits has not been very successful, mainly in the household sector, which constitutes 64.5% of total deposits. Household deposits in FX peaked at 92% of total household deposits in January 2011 and declined to 91% in April 2011. This ratio has rarely dropped below 88% since November 2005 and has remained over 90% since March 2010. While this is subject to dinar depreciation, it still signifies lack of notable change in the FX situation. Serbian households have yet to trust saving in local currency and this increases Euroization and obstructs any regulating actions. The April decline and the low FX deposit growth are good signs, but it is too soon for any verdict.

We expect demand on FX credit to sustain its present low growth rate, given that further de-Euroization efforts will be targeting deposits rather than credit. However, should these efforts fall short, public distrust in dinar expressed through high FX deposits might reveal itself in credit as well, once the credit support program ends, unmasking the growth of credit in RSD. Therefore we remain cautious in all of our expectations about the sustainability of de-Euroization on credit and deposits. RSD-denominated credit growth should further decline in the months ahead but remain at relatively high levels. Nevertheless , once the subsidized loan program starts phasing out,there will be a significant slowdown, albeit rebalanced by the improving economic climate and hopefully by further appreciation of the dinar. Subsequently, total credit activity will trail growth in RSD-denominate credit and limit its acceleration in a similar manner.

Separately, the ratio of non-performing loans (NPLs) increased to 17.1% in Q1 2011 up from 16.9% in Q4 2010 but below from 17.8% in Q3 2010. According to the National Bank of Serbia's (NBS) Banking Supervision Report, the Q4 2010 decline was partly seasonally induced, as NPLs had a similar decline amidst a worse economic environment in Q4 2009. We remain cautious about the evolution of NPLs since the loans to deposits ratio came to a new all-time high of 149.8% in April, being on the rise since January 2010. However, given the constantly improving economic environment coupled with the dinar's appreciating trend, a stabilization or drop in the NPLs ratio in the coming months will not come as a surprise to us.

**Written by**

**Giazitzoglou Michalis**
**Junior Economic Analyst**
v-mgiazitzoglou@eurobank.gr

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

## AKP achieves another landslide victory on the June 12 general elections, winning its third consecutive single party mandate in office

- Increasing evidence of a loss of momentum in the pace of economic activity this year and the next, but domestic demand dynamics remain strong, with economy braced to fare better than most regional peers
- Annual CPI spikes to a 6-month peak in May, on rising food and clothing prices
- Ongoing widening pressures on the current account deficit call for monetary as well as fiscal tightening

**AKP achieves another landslide victory on the June 12 general elections, winning its third consecutive single party mandate in office**

As was broadly expected, the ruling Justice and Development Party (AKP) achieved another landslide victory in Sunday's parliamentary elections which marked an 87% turnout of the eligible electorate. Prime Minister Tayyip Erdogan's party scored a record high 49.9% in the June 12 vote, equivalent to 326 seats in parliament, winning its third consecutive single party tenure in office. The Republican People's Party (CHP), led by new head Kemal Kilicdaroglu, was the runner up with 25.9% of the tally, marking its best outcome in more than three decades. The Nationalist Movement Party (MHP) trailed behind, having collected 12.99% of the vote, some 1.3ppts lower compared with the 2007 elections but above the 10% threshold required to enter parliament in spite of a scandal that resulted to the resignation of 10 party members before Sunday's ballot. Finally, Kurdish independent candidates achieved a record 36 seats in parliament.

Ahead of the polls, Prime Minister Erdogan had pledged to proceed with an overhaul of the constitution, should his party obtain a strong mandate. However, in spite of the AKP's strong win, the party fell short of the two-thirds parliamentary majority (367 seats) required in order to change the constitution on its own without having to resort to a referendum. It also lacks the 330 parliamentary seats needed to call a referendum on constitutional changes. Even so, the result was well received by financial markets as the ruling AKP achieved another strong mandate, but will still have to seek parliamentary consensus in order to proceed with constitutional amendments. Needless to say that complete capability of a single political party to be able to change laws on its own would not necessarily be the most market friendly outcome as it would in effect jostle the overseeing power of other members in parliament.

**Turkey: Eurobank EFG Forecasts**

| | 2009 | 2010E | 2011F | 2012F |
|---|---|---|---|---|
| **Real GDP (yoy%)** | -4.8 | 8.9 | 6.0 | 5.0 |
| Private Consumption | -2.3 | 6.6 | 5.1 | 4.5 |
| Govern. Consumption | 7.8 | 2.0 | 4.1 | 2.0 |
| Gross Capital Formation | -19.0 | 29.9 | 15.0 | 10.0 |
| Exports | -5.0 | 3.4 | 9.5 | 11.0 |
| Imports | -14.3 | 20.7 | 15.0 | 12.0 |
| **Inflation (yoy%)** | | | | |
| CPI (annual average) | 6.3 | 8.6 | 6.1 | 6.8 |
| CPI (end of period) | 6.5 | 6.4 | 7.5 | 6.0 |
| **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 | -6.7 | -7.5 | -7.0 |
| 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** | **Q2 10** | **Q3 10** | **Q4 10** | **Q1 11** |
| Total Credit (%GDP) | 36.4 | 38.5 | 43.0 | 41.4 |
| Credit Private Sector (%GDP) | 34.5 | 36.6 | 40.8 | 39.7 |
| FX Credit/Total Credit (%) | 18.7 | 18.8 | 21.0 | 22.2 |
| Private Sector Credit (%yoy) | 34.0 | 36.7 | 44.0 | 44.8 |
| Loans to Deposits | 82.1 | 84.3 | 85.7 | 89.5 |
| **Financial Markets** | **Current** | **3M** | **6M** | **12M** |
| Policy Rate | 6.25 | 6.75 | 7.75 | 8.25 |
| USD/TRY (where applicable) | 1.58 | 1.55 | 1.50 | 1.40 |

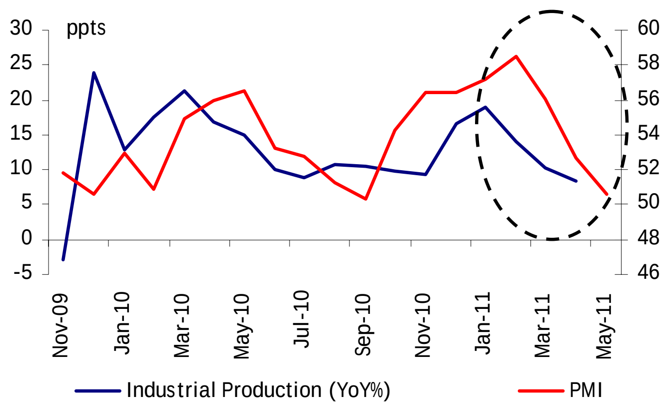
Source: National Sources, Eurostat, IMF, Eurobank Research & Forecasting

**Increasing evidence of a loss of momentum in the pace of economic activity this year and the next**

As we noted in our previous New Europe Economics & Strategy reports, economic activity in Turkey is losing momentum in recent months after a year of impressively strong growth in 2010 and an anticipated 9-10%yoy expansion in Q1 2011. The slowdown is being primarily driven by base effects, tighter fiscal as well as monetary conditions and an ongoing negative contribution from net exports as domestic demand continues to outpace external. Importantly, most recent higher-frequency macro-indicators vindicate expectations for a gradual economic slowdown this year. According to seasonally and calendar adjusted data, industrial output fell 0.6%mom in April, marking the third consecutive monthly decline. Meanwhile, unadjusted data surprised to the downside posting a deceleration in production growth to a 17-month trough of 8.3%yoy following a 14.2%yoy print in Q1. Pointing to a sluggish expansion in the manufacturing sector, PMI recoiled to an eight-month low of 50.6 in May (Figure 1). The index further retreated from a record high of 58.5 in February, as total new order receipts slightly declined – falling into contractionary territory for the first time in eight months, while output and new export orders increased only marginally, with the former marking its lowest expansion in 25 months. According to the survey, uncertainty ahead of the June 12 general elections, rising prices, the turmoil in MENA and disruption of supplies in view of the devastating earthquake in Japan are all to blame for the deterioration in the sector's pace of expansion. In spite of signs of improvement lately in labour market conditions, the rate of unemployment (measured on a 3-month rolling basis) stood in Q1 just 40bps below a 9-month peak of 11.90% hit in December-February and remained ca 1.5ppts above pre-crisis levels. Similarly, capacity utilization was little changed over recent months, standing at levels around 75% since late last year, some 5ppts below pre-crisis levels.

**Figure 1**

**Industrial output/manufacturing PMI on a gradual slowdown**




*Sources: Statistical Institute*

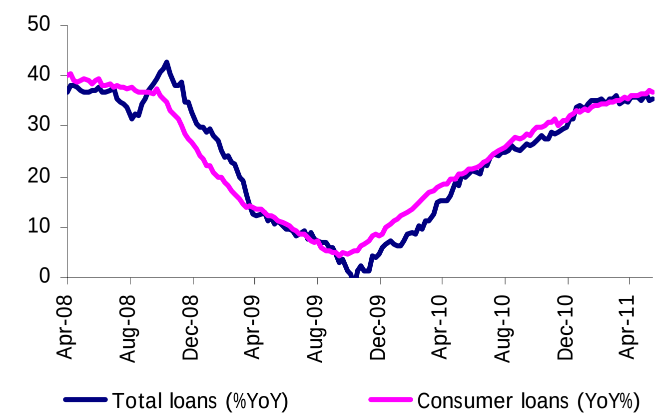
**But domestic demand dynamics remain strong, with economy braced to fare better than most regional peers**

In spite of the slowdown in the pace of momentum in economic activity over the last few months, the Turkish economy is expected to remain the front runner in New Europe. In support of the aforementioned, April's consumer confidence index bounced to 93.46 approaching anew a 3-year peak of 93.56 touched in February, while manufacturing confidence spiked to a 1-year high of 117.20 remaining above the 100-threshold for the 17-month running in an indication of ongoing optimism towards the sector. Car sales soared by 56.26%yoy over the first five months of the year, as domestic consumption remains rampant in view of the ongoing credit growth boom. In fact, according to the most recent BDDK data, total bank lending grew at an annual pace of +35.6% on the week to May 27 (Figure 2), well above the 20-25% rate the CBT targets in order to address overheating risks, and not far off a 3-year high growth rate of 36.4%yoy marked a couple of weeks earlier. Meanwhile, consumer loans expanded by 36.9%yoy over the same period, marginally at a slower pace compared to a 37%yoy rise a week earlier which marked its fastest annual gain since October 2008. Elsewhere, the tourism sector remains on a rebound, with the MENA turmoil having favoured with an additional influx of foreign arrivals seeking safer destinations in the region. In support of the aforementioned foreign arrivals increased by nearly 31.3%yoy in April after an average growth rate of 16%yoy in Q1.

Notwithstanding the aforementioned, we revised our 2011 to 6.0%, in line with the government's latest forecast, from 5.0% as higher frequency data point to a higher than we previously expected first quarter growth. In a similar vein, we project GDP growth at 5.0% in 2012, up from 4.7%yoy previously.

**Figure 2**

**Credit activity remains on an uptrend despite of the CBT's measures**




*Sources: Statistical Institute*

**Annual CPI spikes to a 6-month peak in May, on rising food and clothing prices**

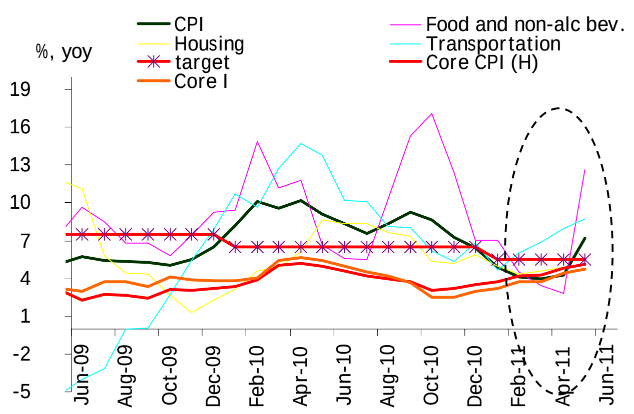
Turkey's May CPI jumped 2.42%mom, bringing the annual rate of increase to a 6-month high of 7.17%. The latest headline CPI reading came in well above expectations of 5.69%yoy and April's 4.26%yoy print. Following two consecutive months of declines, food prices rose by 4.71%mom in May, while clothing and footwear costs spiked 11.68%mom, marking a double digit monthly increase for the second month running possibly due to seasonal factors. The CBT had warned about consumer inflation spiking above its end-2011 5.5% target in May in view of unfavorable base effects in unprocessed food prices. In truth, food inflation is traditionally highly volatile in Turkey and affects headline readings significantly as it occupies a large share (ca a third) in the weight basket. However, rising pressures were also evident in core indicators. The CBT's favorite core measures H (excluding alcoholic beverages, unprocessed food and tobacco products, gold and energy) and I (excluding energy, food, beverages, tobacco and gold), spiked to respective 7-month high of 5.14%yoy and to 4.72%yoy, bouncing from April's 4.81%yoy and 4.42%yoy. Both indices embarked on a gradual uptrend from respective record lows of 3.02% and 2.50% in October last year. Separately, PPI crept up 0.15%mom in May pushing the year-on-year increase to 9.63% vs. 8.21%. On a less negative note the latter came in below the market's median forecast for a 10.3%yoy rise.

**Heightened concerns about the CBT falling behind the curve, rate hikes likely in H2: 2011**

The CBT's primary aim is to safeguard price stability. However, the low inflation readings over recent months had until now allowed the Central Bank to turn its focus on preserving financial stability as well. In order to address the dual objective of financial as well as price stability, amid emerging evidence of overheating pressures, the CBT adopted late last year an unorthodox policy mix. The measures endorsed included, among others, cuts in the main policy rate and hikes in reserve requirement ratios on banks' deposits. The CBT highlighted repeatedly that the net effect of its policies was for tightening and officials have played down overheating risks in several occasions. However, as the issue of rising inflation came back to the forefront, the grace period may be approaching an end. Real interest rates are currently negative and do not bode well for curbing the currently strong domestic demand dynamics. The Central Bank has repeatedly highlighted that the impact of its policy mix is likely to become more pronounced in H2 having recently voiced that tentative effects are already visible in credit activity and domestic demand. However, there are little indications to suggest that the Bank's measures are bearing an adequate impact (Figure 3). In support of the aforementioned, the 12-month rolling current account deficit hit a new record high in March, which corresponded to around 7.5%-of-GDP according to our calculations. Headline consumer inflation embarked on a gradual uptrend after hitting a 4-decade low of 3.99%yoy in March and total credit growth of 35%yoy (35.6%yoy as of the week ended on May 27) stands well above the 20-25% level the CBT deems as adequate to maintain financial and price stability. The CBT defended once more its policies citing cherry and plum prices for May's sharp spike that pushed unprocessed food costs higher. It also penciled in a retreat in June. Even so, May's increase in headline CPI and core indices raise alarm bells, stirring concerns about the CBT falling behind the curve. Inflation is likely to pick up further in the months ahead in view of waning base effects and strong domestic demand dynamics. The prospect of second round effects from deteriorating inflation expectations against a background of higher CPI readings lately, rising oil prices and fx fluctuations bear potential to exacerbate inflation pressures ahead (in April the CBT revised upwards to 6.9%yoy from 5.9%yoy its end-2011 CPI forecast on the back of higher oil and import prices). We anticipate headline CPI to rise to around 7.5%yoy by year-end, above the CBT's inflation target of 5.5% and its end-2011 forecast of 6.9%yoy. Along these lines, we anticipate the CBT to eventually start hiking its key policy rate from the current record low 6.25% level in the coming months and pencil in around 100bps of rate hikes in H2. Even so, the slowdown in economic growth momentum this year (most recent data already points to a slowdown in Q2) and the fact that May's inflation rise was primarily driven by the volatile food prices component may provide some ammunition to the MPC to delay hiking rates in the imminent future.

**Figure 3**

**Inflation pressures on the rise**




*Sources: National Statistics*

**Ongoing widening pressures on the current account deficit…**

Turkey's trade deficit widened 63%yoy to $9.1bn in April, having shrunk just 7% from a record high $9.8bn shortfall a month earlier. Exports advanced 26.5%yoy totaling $11.898bn, while imports jumped 40.2%yoy to $20.95bn amid high energy prices and strong domestic demand dynamics. Nevertheless, the latter marked a slowdown from a 44%yoy increase to $21.6bn in March adding to hopes that imports' growth may be decelerating as the CBT's measures are taking effect. Although April's trade deficit beat expectations somewhat soothing economic overheating concerns, it remains on a widening trend. Moreover, more data is required in order to make adequate inferences. It is also worth repeating that the shortfall stood at a lifetime peak just a month earlier, pushing the current account gap to record highs as well. The latter hit lifetime peaks both on a monthly as well as on a 12-month rolling basis in March amounting to $9.766bn and $60.512bn, respectively. The financing of the shortfall is yet another area of concern, with portfolio net inflows providing a large share of the income. However, capital inflows remain highly susceptible to global mood swings and the more secure means of financing, the FDI has shrunk to levels below $10bn over the last couple of years from $20bn in 2006-2008.

**… call for monetary as well as fiscal tightening**

With the CBT's measures having had little success in restraining the rapid credit expansion and strong domestic demand dynamics so far, the government signaled in early June it is set to tighten its fiscal policies in order to assist an improvement in the country's external imbalances, if needed. Economy Minister Ali Babacan was quoted as saying that the new Medium-Term Programme, scheduled to be announced after the elections would be focused on public finances as well as on the current account shortfall. Earlier, the government had noted that it can finance the shortfall, should this be needed, having added that excluding energy items, the deficit should narrow at a slower pace in H2 as the CBT's measures take affect in the domestic economy. At first glance Turkey's fiscal position appears to be significantly improving. From a state deficit of 5.5%-of-GDP in 2009 the shortfall narrowed to 3.6%-of-GDP and this year's 2.8%-of-GDP target is likely to be comfortably met. In support of the aforementioned, the central budget swung to a surplus of TRY1.056bn in April, from a deficit of TRY 6.118bn in March, pushing the shortfall 80%yoy narrower to TRY3.068bn over the first four months of the year. A 21%yoy gain in tax receipts supported by strong economic growth was the primary culprit behind an 18.7%yoy rise in revenues. A TRY190mn of additional income was collected by restructuring of public receivables in April as part of a government tax debt restructuring scheme announced late last year aimed at generating extra revenues over a three year time span by effectively encouraging citizens to pay their taxes. Expenditure increased only marginally (+1.9%yoy). In addition, the primary surplus, which excludes interest rate payments on government debt, more than doubled over the January-April totaling TRY13.741bn. All these suggest a significant improvement even ahead of a general elections poll in June. Nevertheless, it should be noted that revenues are being significantly assisted by the strong rebound in economic activity since last year. As such, when growth dynamics become more balanced the sharp improvement witnessed so far in revenues is likely to stall. As such tighter budgets will ensure a medium-term improvement in the country's fiscal position and will also support the CBT's policy mix.

**Written by**

**Galatia Phoka**
**Emerging Markets Analyst**
gphoka@eurobank.gr

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

## GDP growth remained solid in Q1-11 while improving fiscal position keeping IMF loan on hold

- Official preliminary estimates suggest 5% yoy Q1-11 growth boosted by stronger domestic demand
- GDP growth at 5.2% yoy in Q1-11 up from 3.3% yoy in Q4-10 looks set to become more broadly based
- IMF loan remains on hold since Ukraine fell behind with the reforms required, arguably due to lack of funding constraint and no political will to pass unpopular reforms ahead of 2012 parliamentary elections
- Overall balance of payments turned positive in April supported by substantial FDI inflows boosting international reserves accumulation to historical high level of $38.4bn
- Inflation significantly accelerated to 11.0% yoy in May unfavoured by base effects
- Growing total credit fuelled by corporate lending while NPLs following an upward trend.

### GDP grew by 5.2% yoy in Q1-11 and looks set to become more broadly based

According to preliminary data, the Ukrainian economy expanded by 5.2% yoy (2.9% qoq) in the first quarter in 2011 up from 3.3% yoy in Q4-10. This expansion is the result of both high global commodity prices and an improvement in domestic demand. We expect investment in infrastructure projects to drive further growth in capital investments ahead of preparations of Euro 2012 football championships. Overall, we anticipate a 4.5% yoy growth in 2011. However, there are downside risks to our forecasts stemming from the potential IMF programme fall out. What's more, given the country's strong dependence on steel exports, Ukraine is vulnerable to external shocks.

The industrial sector appears to have been the main factor behind economic growth since it accounts for more than 30% of the Ukrainian GDP. Despite recent sharp slowdown in industrial sector in April (we expect the 4.9% yoy April's deceleration to be rather temporary and unfavoured by high rate of comparison), we anticipate industry to continue to drive the economy in the coming quarters. Production still grew by 9.7% yoy in Q1-11 as a whole and the latest pick-up in steel prices should give industry a boost over the second half of the year. Meanwhile, real wage growth is robust, especially since the beginning of this year, supporting household consumption as retail sales suggest (Figure 1). All in all, GDP growth looks set to become more broadly based.

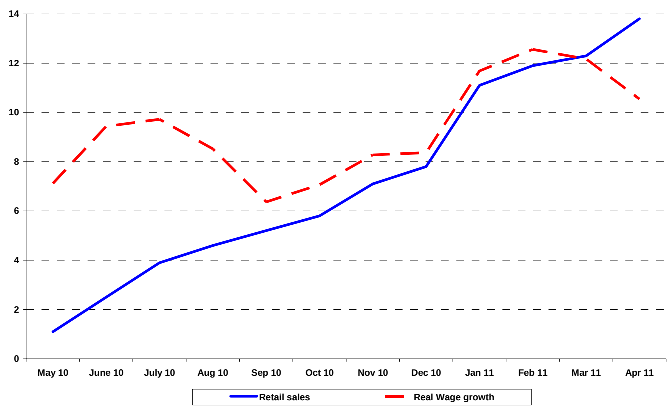
**Ukraine: Eurobank EFG Forecasts**

| | 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 | 2.0 | 1.6 |
| 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 | -2.0 | -2.5 | -3.0 |
| Net FDI (bn USD) | 4.7 | 5.7 | 7.5 | 7.0 |
| FDI / Current Account | 268.0 | 222.0 | 90.0 | 85.0 |
| FX Reserves (bn USD) | 26.5 | 34.6 | 39.0 | 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 | 7.98 | 7.90 | 7.90 | 7.90 |

Source: NBU, IMF, Bloomberg, Eurobank Research

**Figure 1**

**Robust real wage growth support household consumption**




*Source: National Statistics, Eurobank Research*

**IMF $15.15bn loan remains on hold since last March on failure to meet IMF conditionality on gas prices rise and pension system reforms**

The $15.15bn IMF loan to Ukraine remains on hold since last March. The country has already received two tranches of the loan amounting to $3.4bn. The third tranche scheduled for March has been delayed as the Cabinet failed to meet IMF conditionalities regarding gas prices rise and pension system reforms. In early June, Ukrainian authorities inched closer towards meeting IMF's demands by re-submitting the pension legislation and cancelling mandatory purchases of government bonds by the National Bank of Ukraine (NBU). Admittedly, the government is not willing to pass unpopular reforms ahead of October's 2012 parliamentary elections. Moreover, the continued economic recovery has allowed an improvement in fiscal position and the government could finance the budget this year without IMF funds. This could be a reason of why Ukraine delays to comply with IMF requirements. However, in our view, should Ukraine have access to external markets, the IMF programme has to be on track. What's more, should cooperation with the IMF remain stalled, Ukraine would not receive $7.7bn from international lenders, including the World Bank.

**May inflation print rose to 11.0% yoy while it slowed to 0.8% mom**

Ukraine's May inflation rose to 11.0% yoy up from 9.4% yoy in the prior month mainly because of base effects since inflation has started to moderate in May last year. Base effects would remain strong in the coming months as well. On a more positive note, May inflation slowed to 0.8% mom down from 1.3% mom in April and 1.4% mom in March due to smaller increase in food inflation (0.8% mom in May compared to 1.6% mom in April). Overall, food inflation and higher energy prices are the main factors fuelling so far inflation in 2011. Moreover, any further increase in regulated energy prices, as the IMF programme requires, would push up inflation too. We anticipate inflation to average at 10.6% yoy in 2011.

**Overall balance of payments turned positive in April supported by substantial FDI inflows resulting in further international reserves accumulation; they amounted to historical high level of $38.4bn**

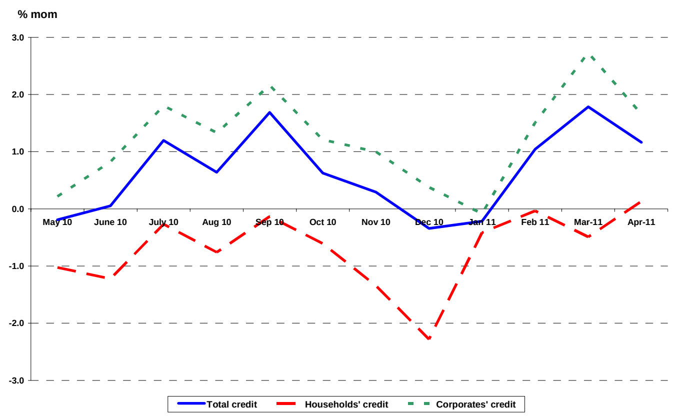
Overall balance of payments exceeded a surplus of $1.0bn in April due to a $1.3bn positive capital and financial account. Moreover, lower gas imports, a surge in FDI inflows (chiefly attributed to the payment of the first tranche for the privatisation of Ukrtelecom amounting to $0.54bn) and an increase in government borrowing (mainly due to a $0.7bn Eurobonds placement to finance expenditure on infrastructure projects for the Euro 2012 football championships) contributed to the surplus of the overall balance of payments in April. The aggregate surplus of balance of payments in the first 4 months of 2011 hit $2.1bn compared to $0.6bn recorded in the corresponding period of 2010. What's more, the April's surplus resulted in further international reserves accumulation; they amounted to historical high level of $38.4bn, up from $34.6bn at the end of 2010. However, the current account remained negative at $0.29bn as imports (even decelerating due to shortage in gas supply) rose faster than exports. All in all, we anticipate current account deficit to reach 2.5% of GDP in 2011 and to be financed by the surplus in capital and financial account.

**Total credit continued growing boosted chiefly by corporate lending**

Total credit continued to grow in April reaching 8.0% yoy (1.2% mom). Total credit is chiefly driven by corporate credit which stood at 1.7% mom in April while household credit stood at 0.1% mom (Figure 2). What's more, since the beginning of the year total credit in the banking system grew by 3.8% year-to-April with corporate lending accelerating to 5.9% year-to-April while households' credit decelerated by 0.8% year-to-April.

**Figure 2**

**Total credit growth fuelled chiefly by corporate lending**




*Source: National Bank of Ukraine, Eurobank Research*

Total deposits continued their growth in April reaching 2.6% mom boosted by corporate deposits which stood at 5.1% mom while household deposits increased by 0.9% mom. Loans to deposits ratio dropped to 167.3% in April which is the lower print since September 2008.

According to the NBU definition, Non Performing loans (NPLs) to total loans ratio stood at 11.3% in April down from 11.6% at the end of 2010. The slight ease of NPLs ratio comes as a result of stronger credit growth as nominal NPLs grew by 1.7% year-to-April and by 16% yoy. What's more, according to official sources, Ukrainian banks had written off 10bn hryvnia of bad loans or 16% of total NPLs through March, 31.

**Written by**

**Dr Stella Kanellopoulou**
**Research Economist**
Skanellopoulou@eurobank.gr

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**Theodosios Sampaniotis,** *Senior Economic Analyst*
**Theodoros Stamatiou,** *Research Economist*

Eurobank EFG, 20 Amalias Av & 5 Souri Str, 10557 Athens, tel: +30.210.333 .7365, fax: +30.210.333.7687, contact email: Research@eurobank.gr

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