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Eurobank EFG

NEW EUROPE ECONOMICS & STRATEGY

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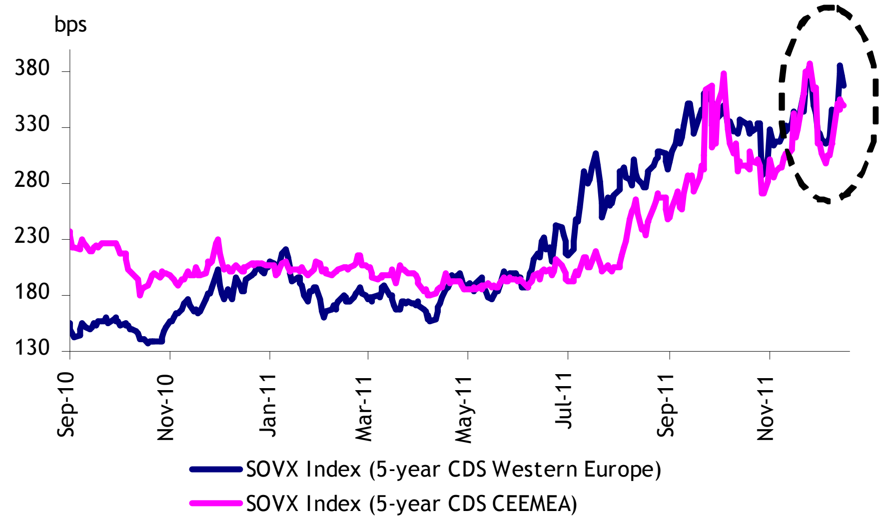
Bumpy 2012 ahead

- **Bulgaria:** Headwinds to the domestic growth outlook
- **Poland:** Growth remains strong but spillovers of global slowdown unavoidable
- **Romania:** Higher than expected GDP reading in the third quarter
- **Serbia:** NBS cut interest rates by another 25bps to 9.75%
- **Turkey:** Q3 growth surprises to the upside; overheating is lessening
- **Ukraine:** Vulnerable to deteriorating investor sentiment despite resilient growth in 2011

New Europe market strategy highlights

Regional FX markets: We prefer to stay broadly sidelined on regional currencies ahead of year-end. Yet, we maintain our earlier recommendation of shorting the TRY-basket with a target of 2.10 and a stop loss of 2.24. Similarly, we maintain our earlier short EUR/RON call, targeting levels around 4.28. Separately, we view levels above 103.5 as providing a good opportunity to enter short €/RSD positions with a target of 101.0 and a stop loss at 105.0**. In the sovereign credit space**, we favor entering long Turkish 5-year CDS positions, provided that the corresponding spread eases to 250bps from 280-290bps currently, with a stop loss near the October 27 low of 220bps and a target of 300bps. Our previous call for long 5-year protection on Russia vs. short 5-year on Poland remains in the money, at current levels around +10bps. With the recently erupted political noise in Russia, we believe there is room for further narrowing towards zero bps. We maintain our stop loss at 50bps. Separately, with the earlier outperformance of emerging vs. developed markets on the external debt space having largely phased out, we see value in selling protection on the Markit iTraxx SOVX index for Western Europe vs. buying on the corresponding CEEMEA. We favour opening the aforementioned position at current levels around 30bps targeting zero bps, with a stop loss at 50bps. **In the local rates markets**, we recently saw a massive flattening move (of around 80bps) in the Turkish 2/10s cross currency swaps in a very illiquid market. We would cautiously build a short-term steepener position, as we regard the latest move to have been broadly exaggerated (recommended entry level: -150bps; target: -100bps; stop loss: -180bps).

Exernal debt spreads: CEEMEA erases recent outperformance



Source: Bloomberg

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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	2.1	1.8	3.0	4.3	2.5	-4.0	-2.0	-1.5
Poland	3.8	4.0	3.4	2.6	4.3	3.5	-7.8	-5.6	-5.0
Romania	-1.3	2.5	1.0	6.1	6.3	4.5	-6.9	-4.4	-3.0
Serbia	1.0	2.0	1.0	6.8	11.2	5.5	-3.6	-4.5	-4.2
Turkey	9.0	8.2	3.0	8.6	6.4	7.9	-3.6	-2.0	-1.8
Ukraine	4.2	4.8	4.2	9.4	8.2	8.5	-6.5	-3.5	-3.0
New Europe	5.1	5.5	3.0	6.4	6.1	6.0	-5.6	-3.6	-3.1
Euro area	1.9	1.5	0.0	1.6	2.7	1.9	-6.2	-4.3	-3.5
USA	3.0	1.7	2.0	1.6	3.2	2.3	-10.5	-10.0	-7.5

	Current Account (%GDP)			Policy Rate (e.o.p.)			FX* (e.o.p.)		
	2010	2011	2012	2010	2011	2012	2010	2011	2012
Bulgaria	-1.3	2.5	0.5	currency board			1.96	1.96	1.96
Poland	-4.6	-4.8	-4.7	3.50	4.50	4.25	3.96	4.50	4.10
Romania	-4.3	-4.0	-5.0	6.25	6.00	5.50	4.28	4.31	4.40
Serbia	-7.2	-7.5	-8.5	11.50	9.75	9.00	106.1	103.0	106.0
Turkey	-6.5	-9.5	-8.0	6.50	5.75	6.50	1.54	1.88	1.70
Ukraine	-2.1	-4.5	-4.8	7.75	7.75	7.75	7.96	7.90	8.00
New Europe	-5.0	-6.4	-6.0	-	-	-	-	-	-
Euro area	-0.5	-0.6	-0.4	1.00	1.00	0.75	1.34	1.28	1.20
USA	-3.2	-3.1	-2.9	0.250	0.250	0.250	0.75	0.78	0.83

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

I. Overview

New Europe economies continued to expand in Q3, but headwinds loom ahead

In spite of the lingering euro area debt crisis, most economies in New Europe registered relatively strong domestic growth in the third quarter of this year. Turkey and Poland recorded respective annual GDP growth rates of 8.2% and 4.2% in the July-September period, remaining among the region's outperformers. The Romanian economy, which has been a laggard over the last couple of years, exhibited growth of 4.4%yoy in Q3, more than double the market's median forecast. This constitutes a notable acceleration from the prior quarter's 1.4%yoy increase, as a result of an exceptionally good agricultural season.

Bumper harvest was also behind a 6.6% annual rise in Ukraine's real GDP, its highest annual growth rate in 14-quarters. Separately, Hungary's output rose by 1.4%yoy, significantly outpacing expectations for a 0.8%yoy increase and coming in broadly in line with growth of 1.5%yoy recorded in the prior quarter. On a less positive note, Bulgaria's economy stagnated, with real GDP growth remaining flat on a quarter-on-quarter basis and registering annual growth of 1.3%, down from 2.0%yoy in Q2. Likewise, growth in Serbia decelerated sharply in Q3 coming in at 0.7%yoy vs. 2.4%yoy a quarter earlier.

In spite of the broadly better than anticipated Q3 GDP readings for the majority of economies in New Europe, a significant deceleration is likely during the last quarter of the year, mainly as a result of a worsening conditions in main trade-partner economies and the deepening debt crisis in the euro area. This trend is already evident in the most recent readings of a number of confidence and real activity indicators. Indicatively, November's regional PMI figures suggest that manufacturing activity in several countries is sliding into a recessionary territory. Even in the case of Poland, which has fared better than most of its neighbors over the last few years, manufacturing PMI eased below the 50-mark that separates expansion from contraction.

A bumpy 2012 ahead

A further deceleration is likely to be witnessed in 2012, as risks to the region's economic outlook intensify. Close trade and financial links to the euro area economies make New Europe one of the most vulnerable regions in the emerging markets space. Domestic demand remains relatively anemic across most economies, while lending conditions have tightened further in recent months, boding ill for the region's investment and consumption dynamics in the period ahead. With a more comprehensive resolution of the euro area debt crisis still not in sight, weaker capital inflows and the deceleration in core euro area trade-partner economies are likely to weigh on domestic investment and hurt exports, thus leaving limited room for a more sustained economic recovery. This applies especially in the case of the most open economies in New Europe, such as Hungary and Bulgaria. Tightened fiscal policies will not favor growth either, nor will unfavorable base effects linked to the broadly strong growth witnessed over the first nine months of this year. Meanwhile, the recent weakening of regional currencies may prevent some central banks from embarking on aggressive monetary easing, aiming to provide support to regional economies.

Currency depreciation hinders monetary policy's response to worsening economic conditions

With fiscal tightening under way in most regional economies, monetary policy remains the primary tool for supporting domestic economic growth and addressing contagion risks from the euro area debt crisis, especially in view of retreating supply-side inflationary pressures. However, the FX pass-through due to regional currency weakness and increases in regulated prices are stirring financial stability risks and thus, limit the room for policy maneuvering by central banks.

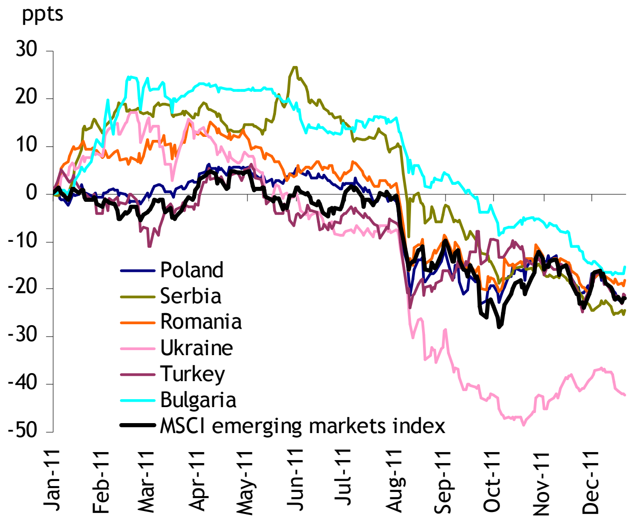
In an effort to cushion such risks, the Central Bank of Hungary (MNB) hiked its key policy rate by a total of 100bps to 7.00% in two separate tightening moves in November and December in spite of weak domestic demand. Under current conditions, risks stemming from high domestic FX lending and the pass-through from currency depreciation currently appear to outweigh downside risks to the domestic recovery as regards the Central Bank's policy deliberations. However, a final agreement on a financial aid deal with the IMF - currently under discussion and expected to be reached early next year - is likely to alleviate depreciating pressures on the HUF and open the door for monetary easing in H2:2012. Elsewhere, the Central Bank of Romania delivered in November a largely unexpected 25bps rate cut, bringing its key policy rate to 6.00% in an effort to provide support to the ailing economy. Further monetary easing is in the cards in the months ahead. Also focusing on risks to the domestic economy, and with disinflation well under way, the Central Bank of Serbia delivered a total of 275bps of rate cuts since the inception of its easing cycle in June, with the latest 25bps rate move taking place in mid December. Elsewhere, the Central Bank of Poland remains in a wait-and-see mode, as inflation is proving to be stubbornly high and the PLN stands close to multi-year troughs against the EUR. That said, the NBP is likely to begin cutting interest rates in the first half of the year as inflation pressures gradually ebb. The Central Bank of Turkey has swung to monetary tightening since late October, continuing along a broadly unorthodox policy mix that has been in place since late

2010. The CBT will likely continue in this mode for some time. However, we expect it to resort to more conventional measures at some point in 2012 in order to illuminate further its monetary policy deliberations and strengthen its credibility.

Regional financial markets remain under pressure

Equity markets in New Europe came under renewed pressure over the last few sessions with investors retaining a cautious tone as important details of the intergovernmental agreement reached at the December 9 EU Summit remain to be clarified. With a more comprehensive solution to the euro area debt crisis still some way off, the MSCI Emerging Europe Equity index slid to 2-month lows near 385 points in mid-December to stand ca 26.5% lower year-to-date. At a regional level, all major market indices have fully reversed earlier year-to-date gains, with most of them having incurred losses to the tune of 20%. Ukraine remains a major underperformer having plunged by ca 42% year-to-mid-December against a background of a slowing global economy that weighs on the country's exports, a frozen $15bn IMF Stand-By Arrangement and ongoing domestic political noise.

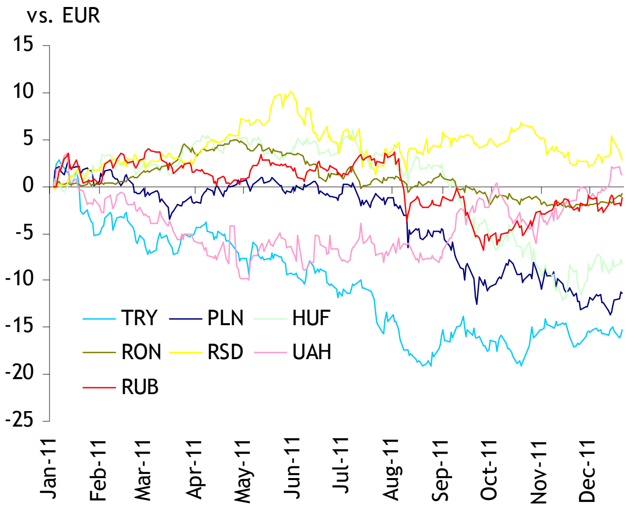
Major market indices: year-to-date performance



Source: Reuters, EFG Eurobank

In a similar vein, **regional currencies** broadly remained under pressure in recent weeks, with expectations for looser monetary policies going forward also weighing. At the time of writing (December 20) the USD/TRY hovered around 1.90 levels, standing within striking distance from a record high hit in early October. Elsewhere, the EUR/PLN stood near 4.50, not far from a 2-½-year high of 4.60 hit a few days earlier. The EUR/RON and the EUR/HUF remained close to a 1-½-year high of 4.3734 and a record peak of 317.72 hit in November respectively.

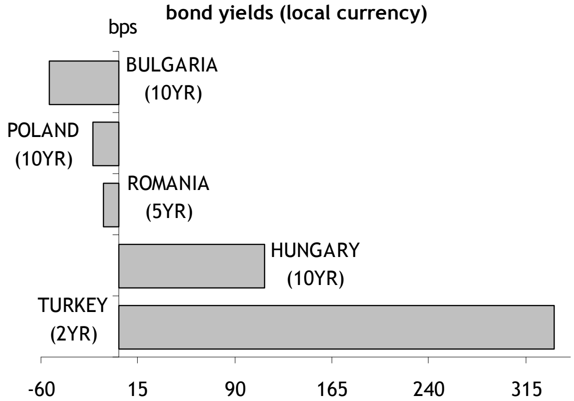
Regional FX markets year-to-December performance



Source: Reuters, EFG Eurobank

In the **local rates markets,** yields of government bonds have been on the rise in recent weeks. Turkey and Hungary have broadly underperformed their peers. In Turkey, the short-end of their yield curve has fared worse, with the 2-year benchmark note yielding levels near a 2-½-year high above 11% hit in late November. In Hungary, 3- and 10-year government bond yields spiked by around 100bps since the end of October.

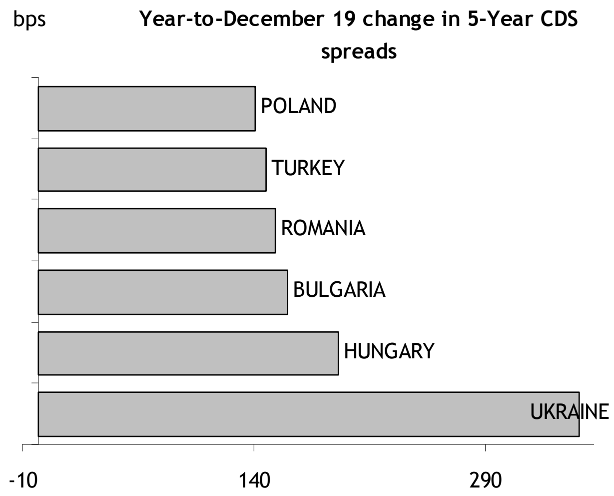
Year-to December-20 change in benchmark government bond yields (local currency)



Source: Reuters, Bloomberg, EFG Eurobank

EMU jitters did not leave **external debt markets** unscathed, with 5-year CDS spreads in New Europe having broadly widened over the last month or so. Ukraine largely underperformed with the 5-year CDS spread widening to having widened by ca 200bps since late

October to currently stand at ca 850bps. In a similar vein, Bulgaria's 5-year CDS spread currently stands near a 2-½-year peak of 420bps.



Source: Reuters, EFG Eurobank

Strategy - Emerging New Europe Markets

Regional FX markets: Under current conditions, we prefer to stay broadly sidelined on regional currencies ahead of year-end. Yet, we maintain our earlier recommendation of shorting the TRY-basket with a target of 2.10 and a stop loss of 2.24. Similarly, we maintain our earlier short **EUR/RON** recommendation targeting levels around 4.28. Separately, our long **€/RSD** position hit our 100.50 stop loss in mid-December. Since then, the pair moved back above the 103.0 area. We view levels above 103.5 as providing a good opportunity to enter short **€/RSD** positions with a target of 101.0 and a stop loss at 105.0.

In the sovereign credit space, our earlier long Turkish 5-year CDS recommendation hit our 300bps target in late November. We favor entering new long Turkish 5-year CDS positions, provided that the corresponding spread eases to 250bps from 280-290bps currently, with a stop loss near the October 27 low of 220bps and a target of 300bps. Our previous call for a long 5-year protection on Russia vs. short 5-year on Poland remains *in the money*, at current levels around +10bps. With the recently erupted political noise in Russia, we believe there is room for further narrowing towards zero bps. We maintain our stop loss at 50bps. with the earlier outperformance of emerging vs. developed markets on the external debt space having largely phased out, we see value in selling protection on the Markit iTraxx SOVX index for Western Europe vs. buying on the corresponding CEEMEA. We favour opening the aforementioned position at current levels around 30bps targeting zero bps, with a stop loss at 50bps.

In the local rates markets, we recently saw a massive flattening move (of around 80bps) in the Turkish 2/10s cross currency swaps in a very illiquid market. We would cautiously build a short-term steepener position, as we regard the latest move to have been broadly exaggerated (recommended entry level: -150bps; target: -100bps; stop loss: -180bps).

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

Headwinds to the domestic growth outlook

- Growth disappointed for another quarter: The Bulgarian economy slowed down further to 1.6% yoy in the third quarter compared to 2.0% yoy in the second
- The deterioration in the economic sentiment worldwide puts the growth recovery of the Bulgarian economy in 2012 at risk

The Bulgarian economy slowed down further to 1.6% yoy in the third quarter compared to 2.0% yoy in the second

The Bulgarian economy recorded in Q3 2011 the lowest growth reading in the last four quarters. On a yoy basis, real GDP grew by 1.6%-revised upwards from 1.3% in the flash estimate-down from 2.0% yoy in the second quarter and 3.3% yoy in the first quarter. On a quarter on quarter seasonally adjusted basis, GDP growth remain unchanged at 0.3% qoq- upwardly revised from flat in the flash estimate- in the third quarter, down from 0.3% qoq in the second and 0.5% qoq in the first. In any case, GDP growth in Q3-2011 was stronger than the EU-27 average (+0.2% qoq/+1.4% yoy) for a fourth consecutive quarter.

From a sectorial point of view, agriculture contracted by -1.3% qoq /-2.3% yoy in the third quarter, compared to 0% qoq/-2.5% yoy in the second quarter. The industrial sector expanded on a yoy basis, although its gross value added slowed to+4.2% (-1.6% qoq), from +6.5% yoy (+2.4% qoq) in the prior quarter. The services sector accelerated to +2.9% qoq/+1.9% yoy, from +3.5% qoq/-0.3% yoy in the prior quarter.

From the demand side, private consumption, the largest component of GDP, expanded by +0.3% qoq/+1.6% yoy, compared to +0.5% qoq/+1.4% yoy in the prior quarter. After two positive quarters, investment contracted on a qoq basis by -13.5% (-2.8% yoy) in the third quarter vs. +3.0% qoq/+8.4% yoy in the second. Exports demonstrated signs of weakness expanding by +1.7% qoq/+2.0% yoy in Q3 compared to -1.3% qoq/+12.2% yoy in Q2. Imports only slightly inched down to +1.1% qoq/+8.1% yoy in Q3 against +0.8% qoq/+7.5% yoy in the prior quarter.

Net exports' contribution turned negative in the third quarter. GDP reading not supportive of our FY 2011 forecast

Even after the revision in the detailed GDP data to be released in December, the third quarter GDP flash estimate is not supportive of our FY 2011 forecast (currently at 2.5%). After a very strong start in the year (+3.3% yoy in Q1), the economy slowed in the second (+2% yoy in Q2). The third quarter reading

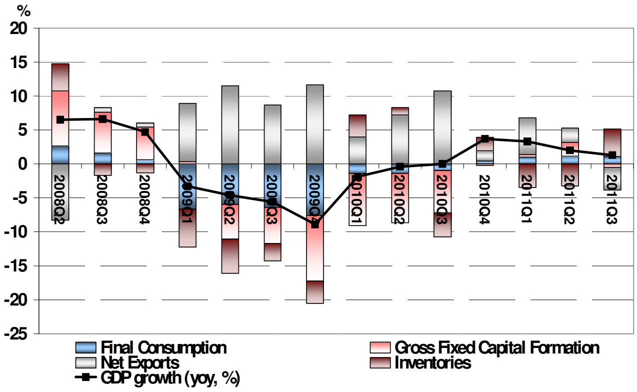
Bulgaria: Eurobank EFG Forecasts				
	2009	2010	2011f	2012f
Real GDP (yoy%)	-5.5	0.2	2.1	1.8
Final Consumption	-7.3	-1.1	1.2	1.1
Gross Capital Formation *(Fixed)*	-17.6	-16.5	1.0	2.5
Exports	-11.2	16.2	10.0	2.0
Imports	-21.0	4.5	7.5	3.5
Inflation (yoy%)				
HICP (annual average)	2.5	3.0	4.3	2.5
HICP (end of period)	1.6	4.4	3.0	2.0
Fiscal Accounts (%GDP) - *Cash Basis*				
General Government Balance	-0.9	-4.0	-2.0	-1.5
Gross Public Debt	15.6	16.7	17.5	18.3
Primary Balance	-0.2	-3.3	-1.0	-0.5
Labor Statistics - *National Definitions*				
Unemployment Rate (registered, %)	9.1	9.2	10.5	10.0
Wage Growth *(total economy)*	11.8	6.3	5.5	3.5
External Accounts				
Current Account (% GDP)	-8.9	-1.3	2.5	0.5
Net FDI (EUR bn)	2.4	1.8	0.9	1.5
FDI / Current Account (%)	78.2	374.0	Na	Na
FX Reserves (EUR bn)	12.9	14.1	13.5	15.0
Domestic Credit	**2009**	**2010**	**Q2 11**	**Q3 11**
Total Credit (%GDP)	79.2	76.4	73.8	72.7
Credit to Enterprises (%GDP)	49.4	48.2	46.8	46.7
Credit to Households (%GDP)	28.2	26.4	25.1	24.6
FX Credit/Total Credit (%)	58.6	61.3	62.1	63.3
Private Sector Credit (yoy)	4.5	2.1	3.3	3.2
Loans to Deposits (%)	120.5	112.9	108.2	105.6
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

brings the overall performance at 2.3% in the nine month period. First of all, agriculture exhibited a growth slowdown in Q3. In contrast to other New Europe peers, agriculture has recorded a negative annual year on year reading despite expectations and signs of a very good harvest; this is hard to interpret. Moreover, the excellent tourist season (the surplus of the travel services in the current account has reached 4.6% of GDP in Jan-Oct 2011) and positive news from services more generally was not strong enough to make the picture brighter.

To make things worse, the output boost from the industrial sector is fading away. The decelerating output trend is most likely related to the deterioration of economic sentiment worldwide during last summer. More specifically, the rapid deterioration of economic conditions in the major export EU markets had a more pronounced impact on the external sector performance. For that reason, net exports had a negative contribution in the third quarter (-3.3 pps in Q3 vs. +2.1pps in Q2) for the first time since the second quarter of 2008. In addition, investment is still dragging down economic activity despite increased EU funds absorption. In particular, a big component of investments, construction, has not yet emerged from recession after the collapse of the real estate market in 2008 (output contracted by -8.3% yoy in August vs. -14.2% yoy in July).

Figure1
Net exports had a negative contribution in the third quarter for the first time since Q2 of 2008



Source: National Statistics, Eurobank Research

Finally, it is important to note that total consumption held up well in Q3. The contribution of total consumption was positive for a fourth quarter in a row, remaining at 1.1pps in Q3. There is a two fold explanation for that. Firstly, private consumption received support from positive real wages as inflation has been rapidly decelerating. In particular, declining food and energy prices- the biggest spending items on family budgets- allowed households to take a breath, even if temporary. Secondly, public consumption stopped having a negative contribution to growth in Q3.

Looking ahead, the picture from high-frequency indicators is not particularly promising. External environment uncertainties have started affecting survey and real data. Firms and consumers are either showing or expressing plans for further retrenchment, which most likely points to a weaker growth reading in the last quarter:

- **Exports**: In principle, exports have held up well that far (up by 31.3% yoy in Jan-Oct 2011 vs. 41.1% yoy in Jan-June), even if they decelerated in Q3. Part of this strength is explained by the diversification of Bulgarian exports towards non-EU markets. Exports to non-EU markets expand more rapidly and now represent approximately 40% of total portfolio.
- **Industrial sales**: The industrial sector turnover was supported by robust exports. Industrial sales have slowed down to 10.8% yoy in October compared to 14.8% yoy in July and 32.8% yoy in Q1.
- **New manufacturing orders**: Manufacturing new orders were flat on a month on month basis in September (0.2% qoq vs. -2.3% qoq in EU-27), up from -3.9% qoq in August. Yet, on a yoy basis they rose by 14% in September (+2.3% yoy in EU-27), down from +15.9% yoy in August (+6% yoy in EU-27) and 20% yoy (+8.4% yoy in EU-27) in June.
- **Industrial production**: Accordingly, industrial production readings in recent months have been on a decelerating trend too. Industrial production in seasonally adjusted terms came at +0.4% qoq/+2.4% yoy in October vs. +1%qoq/+1.4% yoy in September, compared to -1.2% qoq /+7.6% yoy in last May.
- **Consumer-Business Surveys**: Both consumer and business surveys deteriorated in November. The composite business sentiment indicator fell by 2.1pps in a month. All sectors (industry, construction and services) showed deterioration of expectations.
- **Retail sales**: The contraction of retail sales volume (Eurostat data) has steadily worsened over the last months. Retail sales contraction deepened to -5.2% yoy in October vs. -2.9% yoy in September, -2.8% yoy in July and only -0.8% yoy in June.

- **Labor market**: After a short seasonal improvement in the summer, unemployment inched up again (registered unemployment higher by 0.2% to 9.6% in September).
- **Credit growth:** Growth in household credit was still negligible-almost zero (0.2% year to October), while total credit was still stagnating (2.3% year to October).

Threats to growth outlook on the rise- Softening growth outlook in 2012

Overall, the deterioration in the economic sentiment worldwide is particularly worrying and puts the recovery of the Bulgarian economy at risk. The recovery in 2010-2011 from the deep recession of 2009 was driven by net exports and industry. The openness of the Bulgarian economy (exports plus imports accounted for 110% of GDP in 2008) and the quick absorption of earlier macroeconomic imbalances (current account deficit dwindled from double digits in 2 years) allowed it to return to positive growth rates more quickly. At the same time, consumer spending has only stabilized but was never expected to be the main growth driver in the post-Lehman period.

At the current juncture, uncertainties are very high and risks are heavily skewed to the downside. A number of international organizations have also downgraded their forecasts for 2011-2012. EU Commission autumn forecast now stand at 2.2% and 2.3% in 2011 and 2012 respectively. IMF earlier forecast stood at 2.5% ad 3% in the World Economic Outlook of September. Only recently (December 9th) an IMF mission to Bulgaria downgraded the FY2011 forecast to 1.9% and FY2012 to 1.3%.

At the moment, the government assumptions in the budget stand higher at 2.8% in 2011 and 2.9% for 2012, but the Ministry of Finance has expressed its intention of lowering it. Although this is not our main scenario, the Bulgarian economy has started flirting with a recession again, at least from a technical point of view (two consecutive quarters with a negative reading) in 2012. While the emerging global slowdown does not bode well, the Euroarea sovereign crisis is the most imminent threat to Bulgaria. Bulgaria is highly dependent on EU, not only in terms of trade and capital flows, but also through banking system interlinkages. In the worst case scenario, an external shock from a prolonged EU debt crisis or a disruption in capital flows could push Bulgaria again in deep recession. On the positive side, Bulgaria has developed strong buffers that allow us to be more optimistic:

Currency Board Arrangement remains solid:

- Large International Reserves (FX reserves+ Gold+ IMF reserve position) at €13.2 bn in October 2011 (33.4% of GDP), enough to cover potential financing needs from future external liabilities
- The coverage of domestic monetary base by reserves still high at 183.3% October 2011

Banking sector in relatively good shape:

- Profitable and well capitalized (Capital to assets ratio at **10.6%,** Tier 1 at **15.4%** in March 2011)
- Diversified Foreign Ownership of banking sector (a crucial difference relative to Baltics, where there is an overwhelming presence of two Swedish banks)

Strong fiscal position and solid fiscal performance vs. EU & New Europe peers:

- The gross public debt to GDP ratio is the second lowest in EU27 (17.5% in 2011).
- The general government deficit stood below the 3% Maastricht threshold (FY 2011: 2.5%-of-GDP, way below that of the EU27 i.e.-4.7%)

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

Polish growth remains strong but spillovers of global economic slowdown unavoidable

- Q3-11 GDP growth remained resilient at 4.2% yoy supported by investment and exports
- Unexpected rise of November's inflation as the recent zloty slide fed into consumer prices
- MPC in a wait-and-see mode until late Q1-12
- Zloty's weakness since July on Euroarea debt crisis intensification
- Total credit continues its upward trend.

Polish Q3-11 growth surprised on the upside indicating the country's ability to weather the storm brewing in the Euroarea

Polish GDP growth remained strong in Q3-11 at 4.2% yoy (1.0% qoq), slightly down from 4.3% yoy (1.2% qoq) in Q2-11. Growth was still driven by domestic demand, yet less so on private consumption and more on fixed investment, which recorded an impressive increase of 8.5% yoy in Q3-11 (2.3% qoq) vs. 6.9% yoy in Q2-11, pushed by large infrastructure projects. Public consumption continued to fall as a result of government's effort to cut the budget deficit. Net exports had a substantial positive contribution to growth (+1.0pp) as exports grew much faster than imports, benefiting from the zloty's depreciation in the third quarter.

Polish economic activity seems so far largely unaffected by the Euroarea sovereign debt crisis. The economy is less open than other NE peers (exports account for ca 40% of GDP) and therefore less exposed to Euroarea demand. In addition, the recent zloty weakening was supportive to exports.

More frequent data suggest that the economy will slow down in the fourth quarter as domestic consumption decelerates and external demand further weakens. Overall, we expect GDP growth to average 4.0% yoy in 2011 as a whole and decelerate to 3.4% yoy in 2012, with risks skewed to the downside, due to a projected slowdown in the economic activity of the Euroarea.

Ambitious fiscal reforms in the agenda

Prime Minister Donald Tusk announced fiscal reforms to bring the public debt-to-GDP ratio at 52% in 2012 from ca. 54% projected for 2011. Already, fiscal consolidation implemented in 2011 resulted in the reduction of budget deficit to an

Poland: Eurobank EFG Forecasts

	2009	2010	2011f	2012f
Real GDP (% yoy)	1.6	3.9	4.0	3.4
Private Consumption	2.1	3.2	3.5	3.0
Government Consumption	2.1	4.3	1.5	2.0
Gross Capital Formation	-11.5	9.3	7.5	5.5
Exports	-6.8	12.1	7.1	7.2
Imports	-12.4	13.9	6.6	7.1
Inflation (% yoy)				
CPI (annual average)	3.5	2.6	4.3	3.5
CPI (end of period)	3.5	3.1	4.5	3.2
Fiscal Accounts (% GDP)				
General Government Balance	-7.3	-7.8	-5.6	-4.5
Gross Public Debt (ESA95 definition)	50.9	54.9	55.4	55.1
Gross Piblic Debt (national definition)	49.9	52.8	54.5	53.5
Labor Statistics (%)				
Unemployment Rate (% of labor force)	11.9	12.4	12.2	11.8
Wage Growth *(private sector - average)*	4.2	3.6	4.8	4.5
External Accounts				
Current Account (% GDP)	-3.9	-4.6	-4.8	-4.7
Net FDI (bn EUR)	6.0	2.5	5.0	7.0
FDI / Current Account (%)	75.9	41.6	50.0	60.0
FX Reserves (bn EUR)	55.2	70.0	72.0	65.0
Domestic Credit	**2009**	**2010**	**Q2 11**	**Q3 11**
Total Credit (% GDP)	53.1	55.4	56.3	58.7
Credit to Enterprises (% GDP)	16.1	15.2	15.8	16.3
Credit to Households (% GDP)	31.6	34.2	34.5	35.9
FX Credit/Total Credit (%)	30.2	30.8	30.6	32.5
Private Sector Credit (% yoy)	7.2	8.9	9.0	14.3
Loans to Deposits (%)	102.6	102.4	104.6	106.5
Financial Markets	**Current**	**3M**	**6M**	**12M**
Policy Rate	4.50	4.50	4.25	4.00
EUR/PLN	4.56	4.40	4.20	4.10

Source: NBP, EcoWin, Bloomberg, Eurobank Research

estimated 5.6%-5.8% of GDP, from 7.8% of GDP in 2010. The 2012 budget deficit target stands at 3.0% of GDP, showing the government's commitment to implement significant fiscal consolidation.

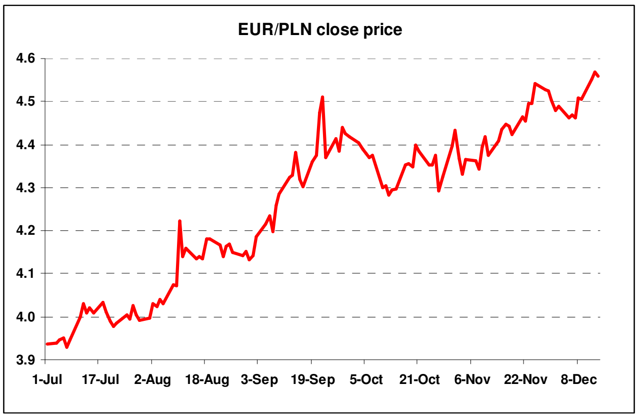
Inflation surprised on the upside

Poland's inflation rate accelerated to 4.8% yoy (0.7% mom) in November, up from 4.3% yoy (0.7% mom) recorded in October. This was the fastest pace since May 2011 and it is largely attributed to zloty's depreciation, which fed into consumer prices, as well as to the previous sharp rise in commodity prices. The above trends will continue to keep inflation at a high level in the coming months. However, waning impact of January's VAT rate increases and last year's commodity prices shock will be conducive to an inflation ease at the beginning of 2012. All in all, we expect headline inflation to average at 4.3% yoy in 2011 and to drop to 3.5% yoy in 2012.

Zloty's weakness since July when fears of the Euroarea debt crisis started to put pressure on Eastern European assets

Following some slight appreciation in July 2011, the zloty started depreciating against the Euro in August, with the depreciation gathering momentum in September. The zloty weakened mainly due to increasing uncertainty in global financial markets on further aggravation of the sovereign debt crisis in the Euroarea. This trend was common among most emerging markets' currencies, including the ones in Central Eastern Europe. For example, since early July to mid-December the Hungarian forint depreciated by 15.3% against the euro and the Czech koruna by 5.8%. During the same period, the zloty devaluated against the Euro by 15.8%. (Figure 1)

Figure 1
Zloty's slide by ca 15% against the euro over the course of 2011



Source: Bloomberg

The National Bank of Poland (NBP) has intervened four times in the last 3 months to prop up the currency by selling certain amounts of foreign currencies for zlotys (NBP's interventions occurred in 23 and 30 September, 3 October and 23 November 2011). The recent weakness of the zloty poses substantial threat to the financial conditions of Polish households which have borrowed in FX. Note that one-third of private sector loans in Poland are denominated in FX, compared e.g. to two-thirds in Hungary. Moreover, the slide of the currency has also fuelled concerns that public debt might increase above the 55% of GDP legal threshold since the PLN value affects Poland's foreign public debt (public debt denominated in FX accounts for 27.3% of total). Hence, NBP might intervene again before year-end to strengthen the zloty.

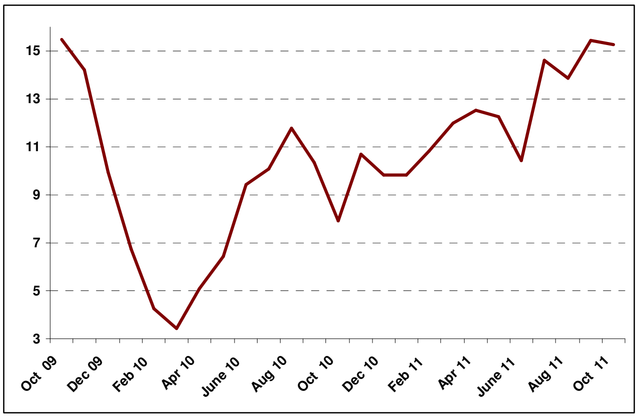
MPC in a wait-and-see mode until late Q1-12 on the back of zloty weakness and surge of inflation

The NBP kept interest rates unchanged at 4.50% for the fifth month running in December in line with expectations. The Monetary Policy Committee (MPC) decision was justified by still strong Q3-11 growth and inflation, well above the NBP's target. We expect the MPC to remain in a wait-and-see mode until late Q1-12 when the economic slowdown should be apparent. Inflation not only remains well above NBP's target but it is rising further. Meanwhile, the weakness of the zloty puts pressure on households that have borrowed in FX incomes. However, as the Polish economy is expected to slow down and inflation to wane in the coming months, we expect the NBP to remain in a wait-and-see mode until late Q1-12, when the economic slowdown should be apparent, and then cut policy rates cumulatively by 50bps, until the end of 2012.

Total credit continues its upward trend

Total credit continues its upward trend; it expanded by 15.3% yoy, albeit decelerating to 0.1% mom in October from 1.9% mom in September. Lending expanded in both the household and corporate sectors, even though in October, households' loans growth was slightly negative at -0.1% mom. Despite some faint signs of credit growth slowdown, total lending grew by 11.9% year-to-October. (Figure 2)

Figure 2
Total credit growth (% yoy) upward trend



Source: National Bank of Poland, Eurobank Research

Table 1
Polish credit growth in 2007-2011

	2007	2008	2009	2010	Jan-Oct 2011
Credit growth (% yoy)	29.6	36.5	10.0	9.8	11.9

Source: National Bank of Poland, Eurobank Research calculations

On the other hand, total deposits grew by 9.6% yoy in October and remained flat on monthly terms. Year-to-October, deposits increased by 6.9%, driven largely by household deposits, while in the corporate sector they remained almost flat. As a result, the Loan-to-Deposit ratio stood at 111% in October from 102.4% at the end of 2010.

On a positive note, the ratio of Non-Performing Loans (NPLs) to total loans decreased to 7.7% in October from 8.0% in September and 8.3% at the end of 2010. However, NPLs grew by 6.5% year-to-October, suggesting that the improvement comes from the quicker increase of total loans and not a fall in NPLs.

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

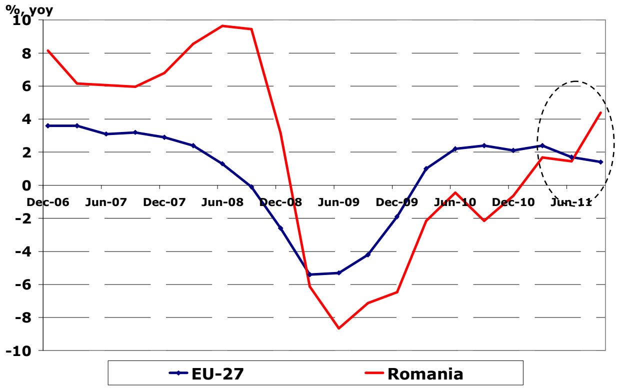
Romania: Higher than expected GDP reading in the third quarter

- Romania registered the highest growth rate in EU-27 in the third quarter: GDP jumped to +1.8% qoq/+4.4% yoy in Q3 compared to +0.2% qoq /+1.4% yoy in Q2
- GDP growth was driven by the extraordinary performance of agriculture while other sectors of the economy also performed better than anticipated

After a soft reading in the second quarter, GDP jumped in the third quarter above all analyst expectations

Growth jumped in the third quarter in comparison to the second. Real GDP expanded by 4.4% yoy in Q3, up from 1.4% yoy in Q2 and 1.7% yoy in Q1 2011. On a seasonally adjusted basis, GDP accelerated to 1.8% qoq (marginally down from a 1.9% qoq flash estimate), up from 0.2% qoq in the second and 0.5% qoq in the first quarter. The estimate came significantly above analyst consensus (Reuter's poll: +0.7% qoq/+1.8 yoy). It is the highest quarterly growth rate after Romania emerged from recession and in the post-Lehman period in general. In addition, this is the highest reading across EU-27 members (+0.3% qoq/+1.4% yoy in EU-27)

Figure 1
Romanian GDP growth in the third quarter was higher than EU-27



Source: Eurostat, Eurobank Research

The extraordinary performance of the agricultural sector was the main driver of GDP growth in Q3; other sectors of the economy performed satisfactorily as wel.

From a sectorial point of view, agriculture outperformed industry and services. Gross value in agriculture skyrocketed by +8.5% qoq/+22.1%yoy, accelerating from +2.5% qoq/+3.4% yoy in the second and -4.4% qoq/-0.4% yoy in the first quarter. The performance of the industrial sector also came out better than expected. Despite expectations of a retrenchment, the industrial sector expanded by +3.2% qoq/+5.9% yoy in Q3, compared to -0.4%qoq/+4.9% yoy in Q2 and +2.5%qoq/+10.1% yoy in Q1.

In services, all sub-sectors improved further. In more detail, retail and wholesale trade sectors accelerated to +1.4% yoy in Q3, compared to +0.9% yoy in Q2 and +1.1% yoy in Q1. This is important because retail and wholesale trade is the largest services sector and illustrative of households' consumption. Retail trade recorded positive growth on a yearly basis for a

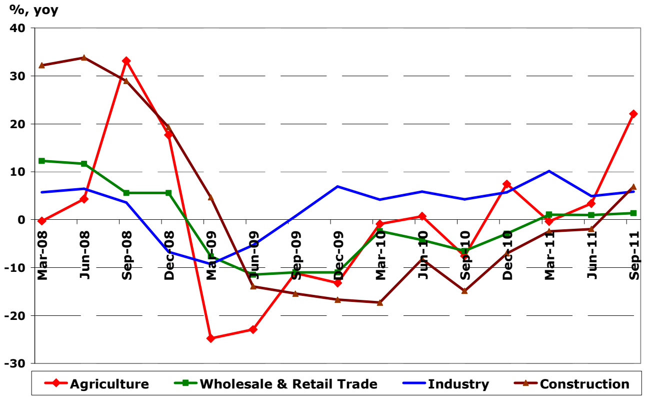
Romania: Eurobank EFG Forecasts

	2009	2010	2011f	2012f
Real GDP (yoy%)	-7.1	-1.3	2.5	1.0
Private Consumption	-10.6	-1.5	0.9	0.7
Govern. Consumption	1.2	-3.2	-2.5	-0.5
Gross Capital Formation	-21.7	7.8	5.0	5.5
Exports	-5.0	14.3	12.0	5.0
Imports	-21.4	12.4	9.5	6.5
Inflation (yoy%)				
CPI (annual average)	5.6	6.1	6.3	4.5
CPI (end of period)	4.8	8.0	3.4	4.0
Fiscal Accounts (%GDP, Cash Basis)				
General Government Balance	-9.0	-6.9	-4.4	-3.0
Gross Public Debt	23.9	31.7	40.1	40.0
Labor Statistics (annual avg,%)				
Unemployment Rate (% of labor force)	7.8	6.9	7.0	6.5
Wage Growth (total economy)	8.4	2.5	1.4	4.5
External Accounts				
Current Account (%GDP)	-4.2	-4.3	-4.0	-5.0
Net FDI (EUR bn)	3.6	2.2	1.5	2.5
FDI / Current Account (%)	72.3	45.5	35.0	37.0
FX Reserves (EUR bn)	30.9	36.0	34.0	45.0
Domestic Credit *(end of period)*	**2009**	**2010**	**Q2 11**	**Q3 11**
Total Credit (%GDP)	50.2	52.7	52.7	52.3
Credit to Enterprises (%GDP)	19.6	20.4	20.5	20.8
Credit to Households (%GDP)	20.4	19.9	19.1	19
FX Credit/Total Credit (%, private)	60.1	63.0	62.9	63.6
Private Sector Credit (yoy)	0.9	4.7	1.3	6.5
Loans to Deposits (%)	130.6	137.7	134.9	140
Financial Markets	**Current**	**3M**	**6M**	**12M**
Policy Rate	6.00	5.75	5.50	5.50
EUR/RON	4.31	4.35	4.35	4.40

Source: National Sources, Eurostat, IMF, Eurobank Research & Forecasting third consecutive quarter, which creates expectations that recession is finally over in consumption. Financial services were almost unchanged at +0.2% qoq/+0.2% yoy in the third quarter, compared to an anemic +1.2% qoq/+0.3% yoy growth in the second quarter but higher than a -0.9% qoq/-3.2% yoy decline in Q1 2011.

Figure 2

Agriculture outperformed all other sectors of the economy in Q3



Source: National Statistics, Eurobank Research

Domestic demand has finally crept out of recession in Q3, driven by higher households' consumption and non-residential construction repairs

In terms of components of GDP, both private consumption and investment improved, moving into positive territory on a yearly basis for the first time since 2008. Households' consumption growth expanded by +2% qoq/+3.1% yoy in Q3, compared to +0.2% qoq/-0.7% yoy in Q2 and -0.5/-1.7% yoy in Q1. This trend is in line with other New Europe peers, where the rapid inflation deceleration pushed real wages higher in Q3. In addition, declining food and energy prices helped households' budgets, at least temporarily. In addition, the contraction of government consumption slowed to -0.7% yoy (+8.4% qoq), compared to -3.2% qoq/-10.5% yoy in Q2. Overall, total consumption registered a very robust performance at +1.7% qoq/+2.8% yoy in the third quarter compared to +1.1% qoq/-0.7% yoy in Q2, with the contraction narrowing after a -0.8% qoq/-3.0% yoy decline in Q1 2010.

Investment was the most pleasant surprise in the GDP reading. Real gross fixed capital formation jumped to +0.8% qoq/+11.4% yoy against +0.2% qoq /-1.4% yoy and -2.0% qoq/-2.2% yoy in the second and first quarter respectively. This is in tandem with the first quarter of positive growth in construction after nine quarters in negative territory. Construction volume was up by +6.9% yoy after -1.9% yoy in Q2, -2.4% yoy in Q1 and -7% yoy in Q4-2010. Construction was driven mainly by capital repairs (construction work carried out on the existing buildings stock) in the non-residential sector. In contrast, new construction in the residential sector is still lagging behind (+3.8% yoy in Q3), while on a year-to-September basis it is still in recession (-14.5% yoy in January-September). Construction has been quite volatile throughout the year. Further improvement in EU funds absorption, which is geared towards infrastructure projects, could provide a sustainable boost to investment.

On the other hand, the external sector had a second successive quarter of negative contribution to growth. The improvement in domestic demand resulted in imports strengthening to 10.5% yoy in Q3, up from 7.7% yoy in the prior quarter. Exports lagged behind imports, accelerating to +8.9% yoy in Q3 vs. +7.7% yoy in Q2. Even so, exports' dynamics is stronger than anticipated despite the pronounced EU slowdown.

The implications of Q3 for the full year reading and the growth outlook in 2012

First of all, the third quarter reading is overall a pleasant surprise for the growth outlook in 2011. Robust GDP growth in the third quarter had been signaled by high frequency indicators for that period. In our previous New Europe Economics & Strategy, we highlighted the role of agriculture in making a meaningful contribution to the third quarter growth rate. However, the performance was exacerbated by last year's poor crop and was just stronger than a solid boost.

On the positive side, output gains from agriculture will, to a certain degree, extend in Q4. On the negative side, if not repeated, agriculture's solid performance will create a negative base effect for next year's growth prospects. Notwithstanding its volatile and unpredictable nature, agriculture may be a drag on growth in 2012.

Another take away from the Q3 is the turn around of domestic demand. This is the second quarter-on-quarter positive growth for domestic demand, which marks the end of recession from a technical point of view. However, domestic demand prospects are far from upbeat. In the best case scenario, domestic demand will only stabilize but still make a positive contribution in the following quarters. Yet, the safest projection is that it will not stage a dynamic come-back in the future as disposable income is expected to be constrained by low credit growth, fiscal consolidation and weak global growth.

All in, the third quarter reading has led us to revise upwards our full year forecast for 2011 at 2.5%, compared to our original 1.7%. Yet, this does not mark the return to a sustained growth trajectory. This year is a transitional one for Romania, which was the last New Europe country to exit recession, lagging behind peers in 2010. In our view, a more challenging year lies ahead, while a possible negative impact of agriculture can add up on growth concerns. For that reason, we have downgraded our 2012 forecast to only 1% (against consensus approaching 0.5%), with risks skewed to the downside.

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Focus: Fiscal Policy and Budget Execution

We believe a clear distinction is forming between the short term fiscal position of Romania (i.e. this year's budget execution) and the medium term one (i.e. 2012's budget execution.

2011 Budget Outlook – Comfortably within Targets

The year-to-date *cash* budget deficit for the first 10 months of 2011 has reached 2.4% of projected GDP, slightly down from 2.5% in the previous month.

Fiscal spending stood at RON 162bn for the period, increasing linearly throughout the year. Encouragingly, spending on investment projects (capital spending and financing of European projects) has been rising for the past three months (at an average of RON 200mn. per month), while spending on subsidies and personnel has been decreasing (at a cumulated average of RON -137mn. per month). Spending on goods and services also dropped on a monthly basis in October (-127mn. compared to the previous month), but the rate of adjustment remains slow.

Budget revenue outpaced the growth rate of spending in October (revenue rose RON 17.1bn, while spending increased RON 16.7bn) and stood at RON 149bn. This was the second month in the year in which the budget was at a surplus . The attainment was helped by seasonal profit tax collections. Also, VAT and excise tax collections remained stable, averaging RON +64mn per month.

The budget execution continues to lie comfortably within the IMF targets (maximum deficit of 4.4% of GDP in cash terms). Throughout the year, tax revenues have been higher than anticipated, while both current and capital expenditure have been lower; some capital expenditure shortfalls observed were caused by underperformance in EU structural funds absorption.

2012 Budget Execution – Highly Ambitious Plans

The budget plan for 2012 has been recently approved by the Government and Parliament. However, by the time of writing, the final version of the plan had not been released to the public. Thus, our assessment is based on the initial plan approved solely by the Government.

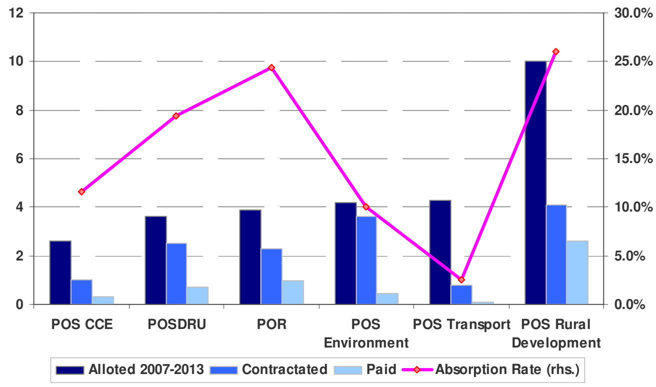
It is apparent that the Government has set very ambitious targets for next year, to limit the deficit to 3% of GDP in ESA95 terms, which corresponds to a 1.9% deficit in CASH terms. The sub-3% deficit is required in order to comply with the Maastricht treaty criteria and avert the Excessive Deficit Procedure. The bulk of the adjustment is expected to come from a reduction of spending to 35.6% of GDP in 2012 (from 37.8% of GDP in 2011). Revenue is also expected to rise, albeit at a more modest rate, and reach 33.7% of GDP.

To achieve this target, the government is relying on a projected rate of expansion for the economy of 2.1%, which coincides with the projection of the European Commission. However, we have reservations regarding the assumptions underlying this forecast. The main issue is that the EC projection assumes a budget deficit of 3.7% of GDP (in ESA 95 terms). Therefore, it is possible that the Government has not taken into account the feedback of fiscal retrenchment into the growth projection.

Another important reason why our own projection departs from the official forecast is that it takes into account the base effect created by the good crop in agriculture, as the EC projection was constructed before Q3 GDP data was released.

Another critical issue in the budget plan is a substantial projected increase in the absorption of European Funds. The Government is forecasting a +60% increase in funds (to € 3bn). While this is a very tall order, we believe the target is achievable, provided that the absorption of transport and regional development funds improves. The current rate of absorption for these funds is very low, at approximately 2.5%. However, there is ample room for improvement as total allocated amounts until 2013 stand at € 4.5 bn.

Figure 1
The absorption of transport and regional development funds is low



Source: Ministri of Finance

The Fiscal Council's opinion regarding the budget plan also raises concern as to the commitment to the budget target. In particular, the plan mentions it is possible to allow for a larger deficit should economic conditions improve. This casts a shadow of doubt on the Government's promise of fiscal rectitude and may need to be remedied before the budget plan is finalized.

Debt financing – Short Maturities Pose Large Threat

Debt financing remains an issue for the Government. As mentioned in our previous New Europe Issues, demand for debt in the local market has been hit by risk aversion and the Government has not been able to raise the amounts initially intended.

As an alternative, the MoF planned to tap international markets once more this year via an EMTN issue. However, market conditions have remained inauspicious and forced the Government to postpone these plans. Subsequently, debt managers were forced to enter the December spending peak with a small buffer and raise money in the local market. Also, the maturity structure of debt raises some worries for 2012. Average debt maturity for 2011 issues was 22 months and we expect the Government will have to serve approximately €16bn in 2012. This renders the Government vulnerable to unfavorable conditions in the international markets.

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

NBS cut interest rates by another 25bps to 9.75%

- According to the flash estimate, GDP growth sunk to 0.7% yoy in Q3, compared to 2.2% yoy in Q2, an illustration of both weaker domestic and external demand
- On December 8th, NBS cut its key policy rate by a further 25bps to 9.75%; since the inception of its easing cycle in early June the Central Bank cut rates by a cumulative 275bps

Growth sunk to +0.7% yoy in the third quarter, down from +2.2% yoy in the second quarter, on softer manufacturing readings; Full year forecast is revised downwards

After slowing down in the second quarter, growth sunk in the third. According to the flash estimate, growth came down to 0.7% yoy in Q3, compared to 2.2% yoy in the second quarter. On a seasonally adjusted quarterly basis, GDP contracted for a second consecutive quarter by -0.4% qoq in Q3 vs. -0.5% qoq in Q2. There is no official analytical sectoral breakdown of data at the moment of the writing. However, the Central Bank calculations bring the non-agricultural value added output-a more representative indicator of the real economy -to have declined further by -0.6% qoq/ -1.6% yoy vs. -0.4% qoq/+3.6% yoy in seasonally adjusted terms in the prior quarter.

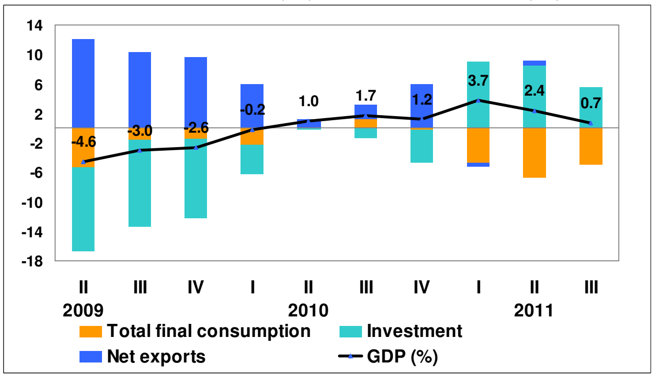
In terms of components of GDP, total consumption was exceptionally weak for another quarter despite higher real wages in Q3 (up by 2.0% yoy, driven primarily by private sector wages). The recession is evident in all key retail trade sectors; retail sales have contracted by 9.3% yoy in Jan-Oct. Household spending continued in negative territory (-0.9% qoq in Q3 vs. -1.1% qoq in Q2). Consumer spending was constrained by food and energy driven high inflation (food items comprise 37% of the consumer basket), bleak labor market conditions (registered unemployment at 743,000 in Q3, the last available official unemployment rate was at 22% in last April), as well as the tightening of credit conditions (the households' subsidized loan program has come to an end). In addition, a large part of spending is directed to the unofficial economy or explained by self consumption which is not recorded in official statistics. It is possible that the good crop supported unofficial incomes and consumption in Q3 and thus helped to contain the negative contribution of –official- private consumption to growth to 4.9pps, compared to 6.7pps in the prior quarter. Government spending did not have a positive contribution either as it was flat on a yearly basis or down by -1.4% qoq in real terms in Q3.

Serbia: Eurobank EFG Forecasts				
	2009	**2010**	**2011f**	**2012f**
Real GDP (yoy%)	-3.5	1.0	2.0	1.5
Inflation (yoy%)				
CPI (annual average)	8.6	6.8	11.2	5.5
CPI (end of period)	6.6	10.3	7.5	6.0
Fiscal Accounts (%GDP)				
General Government Balance	-3.3	-3.6	-4.5	-4.2
Gross Public Debt	34.1	41.9	44.1	44.4
Labor Statistics (%)				
Unemployment Rate (%of labor force, ILO)	16.9	20	20.0	19.0
Wage Growth *(total economy)*	-3.5	7.5	8.3	5.0
External Accounts				
Current Account (% GDP)	-7.2	-7.2	-7.5	-8.5
Net FDI (EUR bn)	1.4	0.9	1.7	1.0
FDI / Current Account (%)	78.7	39.9	65.0	75.0
FX Reserves (EUR bn)	10.6	10.0	11.5	10.5
Domestic Credit	**2009**	**2010**	**Q1 11**	**Q2 11**
Total Credit (%GDP)	51.8	61.6	60.0	59.5
Credit to Enterprises (%GDP)	29.7	34.4	33.6	33.3
Credit to Households (%GDP)	17.3	19.1	18.3	18.4
Private Sector Credit (yoy)	14.3	26.5	18.1	11.0
Loans to Deposits (%)	127.0	144.6	148.9	148.8
Financial Markets	**Current**	**3M**	**6M**	**12M**
Policy Rate	9.75	9.50	8.50	9.00
EUR/RSD	102.40	103.00	105.00	106.00

Source: National Sources, IMF, Eurobank Research & Forecasting

The contribution of net exports also deteriorated in the third quarter. In fact, net exports' contribution became zero compared to 0.6 pps in Q2. In contrast, total investment contributed 5.6pps to growth, compared to 7.8pps in the prior quarter. Investment has been mainly driven by private investments (+3.8% qoq in real terms) and government infrastructure projects (+1.3% qoq in real terms). In contrast, inventories in all three available product categories (capital, consumer and intermediate) were still in red in Q3 in seasonally adjusted terms.

Figure 1
GDP growth sunk to 0.7% yoy in Q3 against 2.2% yoy in Q2



Source: National Bank of Serbia Inflation Report, Eurobank Research

In our view, the third quarter performance is very disappointing. However, it is clearly illustrative of the softer growth readings we described in our September issue of New Europe Economics & Strategy. The recovery stemming from net exports is losing steam. The dynamics of net exports have been negatively influenced by the appreciation trend of the local currency; Dinar shot up on Q2 to as much as 98/€ or 7.5% higher than in the beginning of 2011 on high portfolio inflows to government T-bills. In addition, the slowdown in Europe affected exports as EU-27 generates 55% of total Serbian export revenues (if regional trade partners which depend on EU-27 are included then the percentage reaches 80%). To make things worse, the competitiveness of manufacturing is deteriorating. Nominal unit labor cost has accelerated to 8% qoq in Q3 vs. 2% qoq in Q2. What's more, industry-specific and geopolitical factors came into play, such as the wheat exports ban during June10-March11 or the ban of Serbian exports to Kosovo.

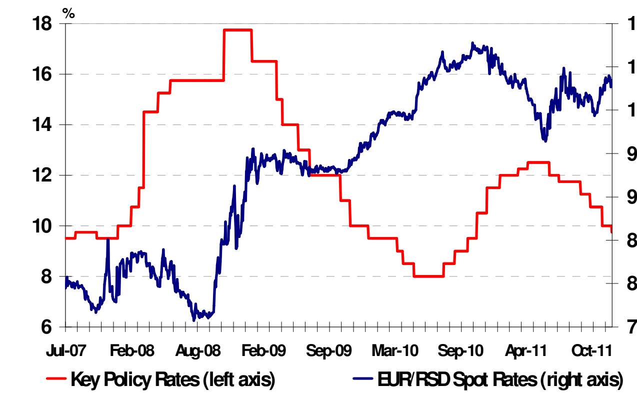
The slowdown of exports is also mirrored in industrial production indicators. Industrial production readings have been volatile throughout H1 with ups and downs. However, since Q3 industrial production is sending negative signals. The overall performance to date is significantly below expectations (Jan-Sep 2011:+2.0% yoy down from Jan-July: +3.5% yoy). On the other hand, a very solid agricultural season and a good tourist season (1.2 mn tourist visitors in Serbia this summer) are expected to partially offset the negative trend from the trade flows. Moving on to the last quarter, private consumption cannot be expected to be a positive contributor to growth either. Prospects in the current year have been adversely affected by high inflationary pressures, deteriorating credit conditions and fiscal retrenchment plans.

Overall, even after the significant upward revisions in the prior quarters, GDP growth has only reached 2.2% year to September. The rapid deterioration of global economic conditions in Q4 and their probable negative impact on the external sector, compel us to downgrade our forecast for 2011 to 2.0% instead of 2.5% in our last New Europe Economics & Strategy. However, we do note that this is still higher than the 1% recorded in 2010, albeit far from what could be described as a dynamic recovery.

On December 8th, NBS cut its key policy rate by a further 25bps to 9.75%. Further cuts are on the pipeline in 1H-2012

After a 75bps aggressive interest rate cut in November, NBS maintained an easing mode in the last meeting of the year. On December 8th, the NBS unexpectedly lowered its key policy rate by a further 25 bps to 9.75%. This was the sixth rate cut since June 7th, when NBS initiated its latest monetary policy easing cycle. According to the Bloomberg survey conducted ahead of the last policy meeting, only seven (out of 23) analysts expected such a rate cut. The majority of participants surveyed (13 out of 22) anticipated no rate cut, while three predicted a half-point cut.

Figure 2
Since the inception of its easing cycle in early June the Central Bank cut rates by a cumulative 275bps from 12.5% to 9.75%



Source: NBS, Eurobank Research

In the statement released, the Central Bank deemed monetary easing as a more appropriate policy stance in tandem with the projected inflation decline towards the moving target tolerance band in Q1 2012 (2.5%-5.5%). Domestic inflation has predominantly been driven by supply-side factors related to domestic food prices in 1H-2011. After having peaked at 14.7% yoy last April, inflation retreated more visibly within single digit territory in 2H 2011. Consumer prices stood at 0.9% mom/ 8.1% yoy in November, compared to +0.4% mom/+8.7% yoy in October and +0.2% mom/+9.3% yoy in September. Thus, year-on-year inflation is expected to end in single digits, little above the Central Bank target for Q4 of 2011 (4.5%+/-1.5%), despite many analysts' forecasts for the opposite.

However, inflation is expected to continue declining and to return within the target tolerance band in Q1 2012 (2.5%-5.5%). The projected disinflation trend in coming months will be driven by the strong disinflationary impact of weak demand side pressures, base effects from sharply higher food prices in the past and postponed hikes in regulated prices (related to the parliamentary elections scheduled for next May).

In our last issue of New Europe Economics & Strategy, our call was for rates to remain unchanged in the last meeting of 2011. We thought that it was more likely for the Central Bank to wait until the beginning of next year before delivering more cuts in order to have more visibility in a global environment of heightened uncertainties. The deterioration of world economic conditions and the increased probability of a Euroarea recession ahead weigh significantly on the outlook of Serbian exports. The latter, together with the tightening of credit conditions (real total credit growth declined to 9% yoy in October, compared to 14% yoy in the beginning of the year), argue in favor of additional policy accommodation by the Central Bank. Ceteris paribus, we anticipate more rate cuts (around 100-125bps from 9.75% to 8.5%) to take place until H1-2012, in line with the envisaged inflation decline-yet delivered at a slower pace.

On the other hand, the Central Bank statement cited two sources of risks with respect to the future path of monetary policy: those stemming from the international environment and those related to the implementation of fiscal policy and their impact on medium-term inflation. The international environment has a direct reflection in the FX market and the risk premium of the country. Fiscal factors are related to the risk of an undue fiscal relaxation ahead of the parliamentary election (scheduled for May 2012). Even in the post-election era, the new government will be confronted with important fiscal policy decisions that will have a direct inflation pass through e.g. to raise or not tariffs in utilities.

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

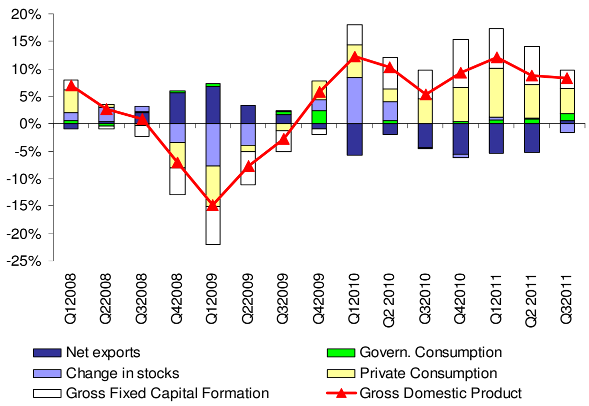
Q3 real GDP growth surprises to the upside; domestic demand overheating is lessening

- November's annual CPI spikes to a 19-month high on rising food prices, tax hikes and TRY pass-through
- Improvement in trade and current account deficits continues in October, signaling some correction in external imbalances
- Mixed signals from credit rating agencies

Q3 GDP growth surprised to the upside

Turkey's output growth continued to surprise to the upside in Q3-2011, with real GDP expanding by 8.2%yoy against the market's median forecast for a 6.3%yoy increase and average growth of 10.4% yoy registered in H1:2011. In spite of the reported resilience in the third quarter's output growth, the breakdown of the data confirmed a slowdown in domestic demand relative the prior two quarters (+ 7.4%yoy in Q3 from 15.1%yoy in H1). The deceleration was driven primarily by a slowdown in investment growth, which eased to 15.2%yoy from 31.1%yoy in the first half of the year, assisted by a reduction in inventories (for a detailed breakdown of the data please see Table 1). As a consequence of the softening domestic demand, imports growth slowed to 7.3% in July-September, after expansion by 23.0%yoy in H1. This, in tandem with a pickup in exports to 10.8%yoy from 4.4%yoy in H1, provided a positive contribution of the external sector to GDP growth in Q3 for the first time since Q3:2009. From the production side, manufacturing, financial intermediation, transports and storage and communication were the main drivers of GDP growth, with the first two sectors registering a notable acceleration in their annual pace of expansion.

Figure 1
Real GDP growth contributions



Source: National Statistics, EFG Eurobank Research

Turkey: Eurobank EFG Forecasts

	2009	2010E	2011F	2012F
Real GDP (yoy%)	-4.8	9.0	8.2	3.0
Private Consumption	-2.3	6.7	8.5	1.0
Govern. Consumption	7.8	2.0	10.0	3.0
Gross Capital Formation	-19.0	29.9	20.0	5.0
Exports	-5.0	3.4	5.0	5.2
Imports	-14.3	20.7	15.0	0.5
Inflation (yoy%)				
CPI (annual average)	6.3	8.6	6.4	7.9
CPI (end of period)	6.5	6.4	9.7	6.5
Fiscal Accounts (%GDP)				
Central Government Balance	-5.5	-3.6	-2.0	-1.8
Gross Public Debt	45.4	42.5	40.0	38.5
Primary Balance	0.1	0.8	1.5	2.0
Labor Statistics (%)				
Unemployment Rate (%of labor force)	13.5	12.0	10.0	9.0
External Accounts				
Current Account (% GDP)	-2.3	-6.5	-9.5	-8.0
Net FDI (USD)	6.9	7.3	15.0	10.0
FDI / Current Account	46.9	12.0	20.0	15.0
FX Reserves (USDbn)	69.0	79.0	85.0	85.0
Domestic Credit	**Q4 10**	**Q1 11**	**Q2 11**	**Q3 11**
Total Credit (%GDP)	43.0	40.3	44.6	47.6
Credit Private Sector (%GDP)	40.9	38.6	43.0	46.0
FX Credit/Total Credit (%)	21.0	22.2	22.5	24.6
Private Sector Credit (%yoy)	44.0	44.8	43.3	44.9
Loans to Deposits	85.7	89.5	93.8	96.1
Financial Markets	**Current**	**3M**	**6M**	**12M**
Policy Rate (1-week repo)	5.75	5.75	5.75	6.50
USD/TRY (where applicable)	1.87	1.85	1.80	1.70

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

Table 1

Turkey: GDP	YoY growth (ppts)		Contributions (ppts)	
	Q3:11	H1:11	Q3:11	H1:11
GDP	8.2	10.4	-	-
Expenditure-side				
Domestic Demand	7.4	15.1	7.7	15.6
Consumption				
Private Consumption	7.0	10.5	4.7	7.4
Govern. Consumption	13.7	8.4	1.2	0.8
Investment	15.2	31.1	3.3	7.1
Private Investment	17.2	36.1	3.1	7.0
Govern. Investment	6.2	4.3	0.2	0.2
Change in stocks	-	-	-1.6	0.3
Net exports	-	-	0.6	-5.3
Exports	10.8	4.4	2.5	1.1
Imports	7.3	23.0	-2.0	-6.3
Production-side				
Agriculture, hunting and forestry	4.4	6.2	0.7	0.4
Fishing	8.2	16.1	0.0	0.0
Mining and quarrying	0.3	5.4	0.0	0.0
Manufacturing	8.9	11.1	1.9	2.8
Electricity, gas and water	6.8	8.8	0.1	0.2
Construction	10.6	13.8	0.6	0.8
Wholesale and retail trade	9.6	15.8	1.1	2.1
Hotels and Restaurants	8.4	6.9	0.2	0.1
Transport, storage and comm.	9.7	12.6	1.3	1.9
Financial intermediation	15.8	11.6	1.7	1.4
Ownership and dwelling	1.4	2.0	0.1	0.1
Real estate, renting & business	9.4	8.3	0.3	0.3
Public administration & defence	6.5	4.1	0.2	0.1
Education	7.8	4.6	0.1	0.1
Health and social work	6.6	3.5	0.1	0.0
Other community, social & pers. act.	3.4	0.9	0.0	0.0
Private household with empl. Indiv	8.9	6.4	0.0	0.0
Sectoral total	8.6	10.5	8.6	10.4
Financial intermediation	15.9	16.4	1.2	1.2
Taxes-Subsidies	10.5	14.3	0.8	1.2

Source: National Statistics, EFG Eurobank Research

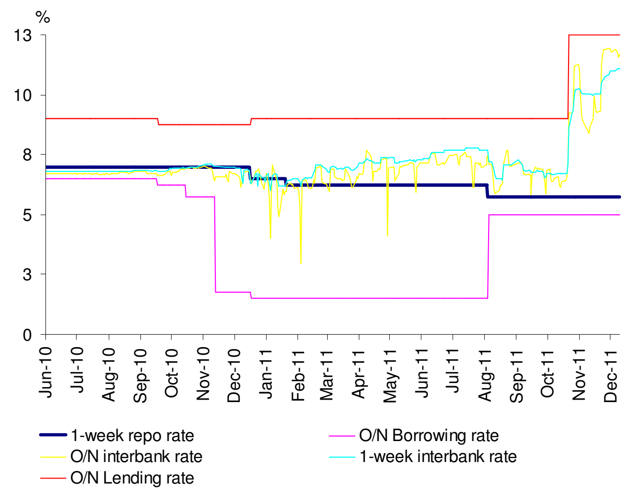
GDP growth likely to slow down in Q4:2011, with further deceleration expected in 2012

As suggested by the most recent higher-frequency data, the domestic economy is braced to further slowdown in Q4. Industrial production growth eased to 7.3%yoy in October, after registering average growth of 9.7%yoy in the first nine months of 2011. The rate of capacity utilization fell to 76.9% in November from a 3-year peak of 77.0% in the prior month, while confidence indicators have eased lately from levels recorded earlier this year. Confidence in the manufacturing sector remained in November close to a near 2-year trough of 101.9 hit a month earlier, while the consumer confidence index slid to a multi-year low of 89.7 in October. Manufacturing PMI fell to 52.3 points last month from 53.3 in October on easing growth in output and new orders as a result of weakening demand from main trade-partner economies (chiefly the euro area). In another evidence of weakening domestic and external demand, motor vehicle production was nearly flat in the October-November period, following growth of 12%yoy over the first nine months of the year. Automotive sales fell by 10%yoy after expansion of 31%yoy in 9M11. Furthermore, the annual increase in tourism arrivals decelerated to 7% in October from near 12% in the January-September period.

Along these lines, we pencil in a GDP growth slowdown to 4.5%yoy in Q4:2011, as a result of weakening external demand and tightening domestic monetary conditions. Lending conditions have tightened significantly since late October, as depicted in Graph 2, when the CBT decided to use a policy rate corridor and hiked the overnight lending rate in a move that would allow the Bank to tighten monetary conditions with greater flexibility (further analysis on the CBT's recent policy decisions can be found further below). As these measures affect the domestic economy with a certain lag, domestic demand growth is likely to decelerate further, while exports are unlikely to escape unscathed from the worsening external environment. It is worth noting that the EU market remains the main destination for Turkish exports (October trade data showed that 44% of Turkish exports were directed to the EU).

Nevertheless, with real GDP growth in the January-September 2011 period surpassing our earlier expectations, we revise our full-year growth forecast to 8.2%yoy from 7.0%yoy earlier. Accordingly, we revise slightly lower our real GDP growth projection from 3.5% to 3.0% in 2012, on unfavorable base effects, weaker demand from abroad and the potential for further monetary and fiscal tightening in the coming months.

Figure 2
Tighter lending conditions to contain domestic demand growth



Source: Central Bank, Bloomberg

November's annual CPI spikes to a 19-month high, on rising food prices, tax hikes and TRY pass-through

Consumer price inflation increased to 1.73%mom in November, outpacing expectations for a 1.27%mom rise. The main upward drivers were rising food costs (+3.4%mom), while tax hikes pushed alcoholic beverages & tobacco prices higher by 3.69%mom and clothing by 6%mom. Increases in utilities prices were reflected through a near 6%mom rise in the housing sub-component. On an annual basis, headline CPI registered a 9.48% increase in November, vs. a 9.00% market median forecast and October's 7.66% rise. November's year-on-year reading is the highest since April 2010 when CPI stood at 10.19%. It is also well above the CBT's 8.3% mid-point 2011-end forecast and has surpassed by a significant margin the CBT's 5.5% inflation target for this year. Primarily reflecting the exchange rate pass-through, core inflation I index (excl. food, energy, alcohol, tobacco, gold) surged to a 4-year peak of 8.18%yoy in November from 6.85%yoy in the prior month. In any case, the latest CPI reading did not take market participants aback. Recently, the CBT had warned about higher inflation in the short-term in view of negative base effects stemming from unprocessed food prices. Additionally, the exchange rate pass-through and hikes in regulated prices had already pushed in recent months headline CPI in an uptrend and well above a 3.99%yoy multi-decade low hit in March. In all, we expect annual CPI to end the year near 10% and see the Central Bank continuing to pursue its current two-rate monetary policy tightening in the coming months.

As a reminder, the CBT employed an unorthodox policy mix late last year, aimed at curbing widening pressures on the current account deficit. This, in tandem with growing risk aversion in view of the lingering debt crisis in the euro area, resulted in a sharp depreciation of the lira in recent months (USD/TRY +20% year-to-early-December). Only recently, the government hiked taxes on several items in order to provide an additional assistance in the correction of the country's external imbalances. As a consequence, risks to inflation have been on the rise lately. In response, the Central Bank introduced monetary tightening measures in October in order to curb strong domestic demand and defend the Turkish currency. It currently utilizes two key interest rates (the one-week repo and the overnight lending rates) in order to achieve higher policy maneuvering. However, the latter is already bearing a negative impact on domestic bond markets as it creates ambiguity on interbank rates and prolongs policy uncertainty. Indicatively, the 2-year benchmark bond spiked to a 2-½-year peak above 11% on November 25. As a consequence, it seems unlikely that the current policy mix will not be utilized for long. At its MPC meeting in November, the Central Bank stayed put on interest rates, maintaining its key policy rate, the one-week repo rate, at a record low of 5.75%, in line with market expectations. The overnight borrowing and lending rates were also kept stable at 5.00% and 12.50%, respectively. We expect the CBT to maintain both its key policy rate and the o/n lending rate stable at current levels in the near-term. However, we reiterate that in the event of renewed significant pressures on the lira and/or increased inflation risks, a further adjustment in the o/n lending rate can not be ruled out. Further TRY RRRs reductions also seem to be on the cards. However, once the global environment becomes more transparent, the 1-week repo rate will likely be re-established as the sole key policy rate, in order to reduce policy uncertainty and provide more clarity with regards to the Central Bank's monetary policy deliberations. The latter move may be precipitated in the event that the current policy poses a challenge on CBT credibility. In view of the aforementioned and against a background of rising inflation rises, we pencil in around 75bps or rate hikes in the CBT's key policy 1-week repo rate over the next twelve months.

Improvement in trade and current account deficits continues in October, suggesting some correction in external imbalances

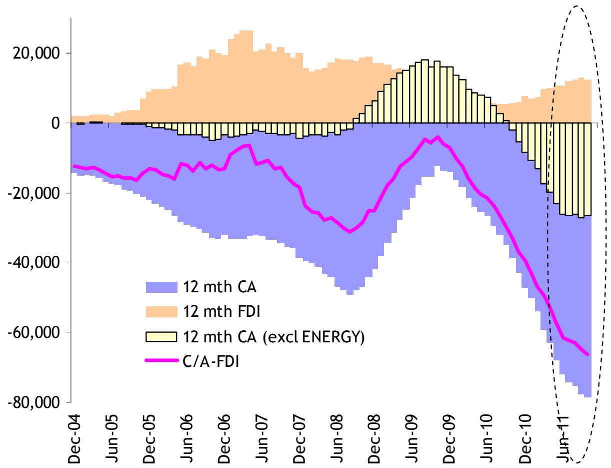
Turkey's trade deficit, the main factor behind the widening pressures on the current account shortfall, came in at $8bn in October, in line with market expectations, narrowing from a record high of $10.4bn in the prior month. As we had recently noted, September's lifetime peak trade gap may have been partly driven by seasonal effects due to the month of Ramadan and higher gold prices. Hence, we had expected the deterioration witnessed to prove short-lived. Note that gold prices hit a record peak of $1,920 per ounce in early September, having retreated since then to stand in mid December around the $1,700 per ounce area. On a year-on-year basis in October, the shortfall widened by 26%, with imports growth of 15.1% (at $19.9bn), outpacing an 8.9% increase in exports (to $11.9bn). However, the breakdown of imports revealed that the increase was primarily driven by a 21.6%yoy jump in intermediate goods, while consumption goods registered a marginal 0.1%yoy fall over the same month. This adds to recent evidence suggesting that domestic demand in Turkey is cooling. Moreover, with ca 73% of total imports accounting for intermediate goods, this provides some respite that the trade deficit is not solely consumption-driven but it also comprises of a high share of inputs used in the production of tradables. In a reflection of the lira's depreciation this year, energy imports – which accounted for ca 25% of total imports – spiked to nearly 40%yoy in October.

In a similar vein, albeit still augmenting, the latest current account (CA) deficit data is revealing signals of tentative improvement. In detail, the shortfall eased to $4.15bn in October from $6.38bn in the prior month, undershooting expectations for a $4.7bn gap. The latest CA reading showed that the deficit stands well below a monthly record peak of $9.5bn witnessed in March, while excluding the energy component it registered a surplus of $0.79bn in October, the highest in two years.

With regards to the CA financing, net FDI accounted for ca 16% of the 12-month rolling shortfall, vs. 14% over the same period a year earlier, while the net errors and omissions component corresponded to around 20% of the gap over the same period. Net portfolio investment provided $16.6bn of income, matching another 20% of the deficit. The rest of the gap was financed by other investment.

In view of the depreciating lira and a gradual deceleration in domestic demand, we anticipate Turkey's twin external deficits to continue narrowing in the months ahead. Government and CBT policies will also likely assist this correction. That said, the current account shortfall appears braced to end the year near the 10%-of-GDP area, with an improvement of only some 2.5-3ppts likely in the next. This suggests that the country's external imbalances will stay elevated in the forecasted horizon, and with their financing heavily relying on volatile capital inflows, Turkey is poised to remain exposed to external shocks.

Figure 3
Correction in external imbalances in sight



Source: CBT, National Statistics, EFG Eurobank

Mixed signals from credit rating agencies

The background of rising near-term risks to macroeconomic stability in view of an elevated current account deficit and heightened inflation pressures, as well as the deteriorating economic and financing environment, motivated Fitch to cut Turkey's credit rating outlook to stable from positive in November. The agency affirmed the country's "BB+" ratings. The move was largely unexpected by market participants. In contrast, over the last couple of years there was growing speculation about a potential upgrade on Turkey's sovereign credit ratings in view of the country's strong resilience to the global financial and Euroarea debt crisis. Until Fitch's move, all three major rating agencies had assigned a positive outlook to Turkey. Fitch highlighted that a soft landing of the domestic economy and correction of macroeconomic imbalances could lead to an upgrade. However, the agency also warned that in the event of severe macroeconomic or financial instability and failure to ensure a disinflationary trajectory, a negative rating action would be possible. A few days later Moody's said that if Turkish authorities pursued adequate fiscal and monetary policies that would result to a correction in both internal and external imbalances the country's ratings could be upgraded as a result. However, the agency noted that the country's primary risk lies in the face of the near-double digits current account deficit.

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

Ukraine vulnerable on investors' risk appetite swing despite high 2011 GDP growth

- Q3-11 GDP growth at 6.6% yoy; the fastest pace since Q1-08
- IMF postponed its decision on lending to Ukraine until the end of negotiations with Russia on lowering gas price
- November's headline inflation unexpectedly declined further to 5.2% yoy -an 8-year low- due to record grain harvest and a subsequent food inflation ease
- Sizable deterioration of the current account in October on falling exports and surging investment goods imports
- Credit growth continues its upward trend driven by corporate lending.

Deterioration of global economic growth casts doubt on next year's growth

The Ukrainian economy grew by an unexpected 6.6% yoy in Q3-11, beating expectations of 5.9% yoy. In the second quarter, real GDP had slowed to 3.8% yoy, after growing by 5.3% yoy in Q1-11. The Q3-11 growth rate was the fastest since Q1-08. This year's domestic output is helped by capital investments ahead of preparations for the Euro 2012 (European Football Championship), which benefit construction and tourism sectors. Although official numbers of Q3-11 GDP breakdown will be published on December 30, initial data show that private consumption is strong. Despite fiscal austerity and a still-fragile banking sector (with negative household credit growth) constraining growth in domestic demand, we anticipate growth to average at 4.8% yoy in 2011 as a whole. Yet, the forecast for 2012 GDP is less optimistic, given weak external markets and growing risks of continued global economic slowdown. In addition, the high basis of comparison, stemming from a very strong agricultural production in 2011, would not favour 2012 growth. Overall, we expect 2012 growth to average at 4.2% yoy as a whole.

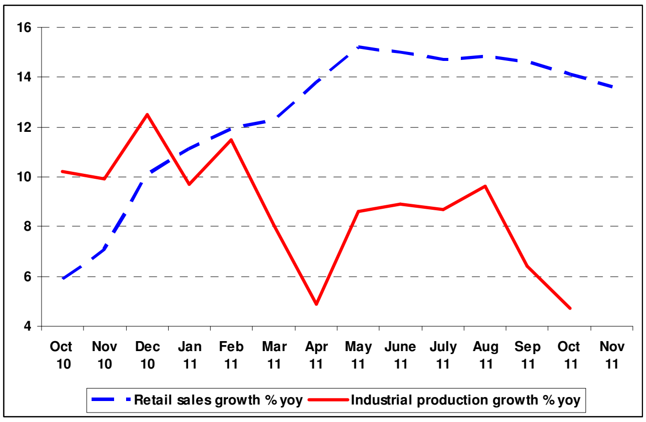
More frequent data are not encouraging. Industrial production keeps on slowing; it landed to 4.7% yoy in October after a drop to 6.4% yoy in September from 8.9% yoy recorded in August. One reason is that Ukraine's key export sectors, chiefly steel and machinery, created a high base of comparison last year. On the other hand, retail sales remain in double digit growth; yet they slowed to 13.6% in November from 14.1% in October. (Figure 1)

Ukraine: Eurobank EFG Forecasts

	2009	2010	2011f	2012f
Real GDP (% yoy)	-14.8	4.2	4.8	4.2
Private Consumption	-14.9	7.0	9.5	7.5
Government Consumption	-2.4	2.7	0.4	1.4
Gross Capital Formation	-53.5	15.4	22.5	17.0
Exports	-22.0	4.5	7.0	8.0
Imports	-38.9	11.1	14.0	12.5
Inflation (% yoy)				
CPI (annual average)	16.0	9.4	8.2	8.5
CPI (end of period)	12.3	9.1	6.5	7.5
Fiscal Accounts (% GDP)				
General Government Balance	-8.7	-6.5	-3.5	-3.0
Gross Public Debt	35.3	41.7	42.4	43.0
Labor Statistics (%)				
Unemployment Rate (% of labor force	9.6	8.8	8.0	7.9
Wage Growth *(real - private sector)*	-9.9	6.7	10.1	9.0
External Accounts				
Current Account (% GDP)	-1.5	-2.1	-4.5	-4.8
Net FDI (bn USD)	4.7	5.8	6.1	6.5
FDI / Current Account	268.7	190.8	75.0	90.0
FX Reserves (bn USD)	26.5	34.6	34.0	32.0
Domestic Credit	**2009**	**2010**	**Q1 11**	**Q2 11**
Total Credit (% GDP)	79.1	66.9	66.0	64.7
Credit to Enterprises (% GDP)	50.5	45.8	45.8	45.5
Credit to Households (% GDP)	26.4	19.1	18.2	17.4
FX Credit/Total Credit (%)	50.8	46.0	45.7	44.4
Private Sector Credit (% yoy)	-3.1	0.4	2.3	5.2
Loans to Deposits	215.9	175.9	169.7	166.0
Financial Markets	**Current**	**3M**	**6M**	**12M**
Policy Rate	7.75	7.75	7.75	7.75
USD/UAH	7.98	8.00	8.10	8.10

Source: NBU, IMF, Bloomberg, Eurobank Research

Figure 1
Retail sales and industrial production indicate a growth slowdown



Source: National Bank of Ukraine, Eurobank Research

IMF to wait until the end of Ukraine's negotiations with Russia on lowering gas price

In November, the IMF announced that it postponed its decision on lending to Ukraine until the end of Ukraine's negotiations with Russia on lowering gas price. Should Ukraine manage to obtain a good reduction on gas prices, it may not need to substantially hike household utility tariffs in order to fulfil the IMF requirement and unlock the next tranche of the loan which is on hold since spring 2011.

Meanwhile, in December, Ukraine and Russian VTB bank agreed to prolong the $2bn loan, maturing in the coming weeks, for another six months, to June 2012 with all loan parameters unchanged (which entails an interest rate of 6.68%). According to the initial agreement with VTB, reached in June 2010, the loan could be prolonged every six months until June 2012 with the interest rate subject to revision at the time of each extension.

Even though the government is trying, either to find alternative sources of funding, e.g. from China, or to achieve a reduction in gas payments to Russia, investors remain wary of Ukraine's ability to meet its debt payments. The fact that IMF negotiations are in pause cast a long shadow over the country's financial sustainability next year. Much will depend on how investor risk appetite will evolve, with risks lying on the downside.

Sizable deterioration of the current account on growing imports and falling exports

In October, the current account deficit increased to $1.5bn vs. $1.0bn in September. Further enlargement of machinery imports -primarily for investment purposes- and falling exports enlarged the trade deficit. The current account deficit went up to $7.0bn during the ten first months of this year vs. $1.4bn recorded in January-October of the previous year.

As to the financing of the current account deficit, FDI inflows in October shrank to $0.3bn, compared with $0.7bn in September. Yet, in the first ten months FDI inflows reached $5.5bn vs. $4.0bn recorded the same period last year, a 35.7% growth. The larger part of financing came from the financial account. The capital and financial account deficit fell significantly to $96mn in October from $1.0bn in September due to the decline in accumulation of foreign cash outside banks.

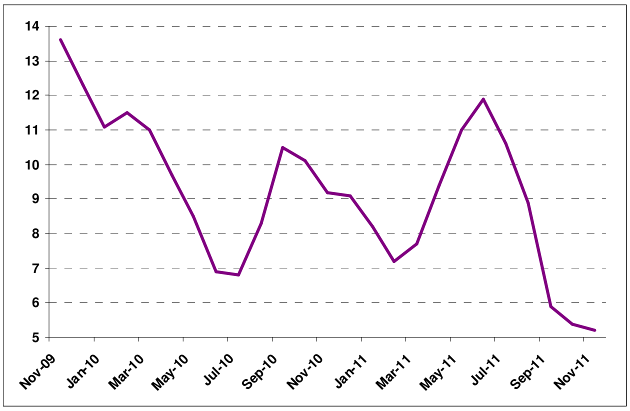
The overall balance of payments deficit stood at $1.6bn in October, down from $2.0bn in September, due to the financial account improvement. In October, international reserves dipped by $0.8bn and reached $34.2bn.

Going forward, we expect these trends to persist, even though the current account deficit should diminish from its current level in the coming months thanks to decelerating imports (as economic growth is expected to decelerate in the fourth quarter) and rising grain exports (due to good harvest). Overall, we anticipate the current account deficit to reach 4.5% of GDP in 2011 from 2.1% of GDP in 2010.

November's CPI declined at an 8-year low on food inflation ease

Inflationary pressures in Ukraine peaked in June at 11.9% yoy and, since then, follow a downward trend. In November, CPI slowed further to 5.2% yoy (0.1% mom), down from 5.4% yoy recorded in the prior month. This low inflation rate was unexpected and it is the lowest reading since May 2003 (Figure 2). The decline was the result of a good harvest, which contributed to the surge in supply on the food markets, coupled with a decline in global commodity prices. In addition, the Ukrainian government has not so far hiked utility tariffs, removing a potential source of CPI acceleration in 2011. All in all, we anticipate headline inflation to average at 8.2% yoy in 2011. Provided that the government will keep the household utility tariffs stable, we do not expect inflation to surge in 2012, although some inflationary pressures may appear due to the political cycle (hikes in social spending, government employees' salaries etc) in H2-2012 and beyond, ahead of October's parliamentary elections.

Figure 2
Unexpected November's CPI further slowdown on a record grain harvest which helped ease food costs

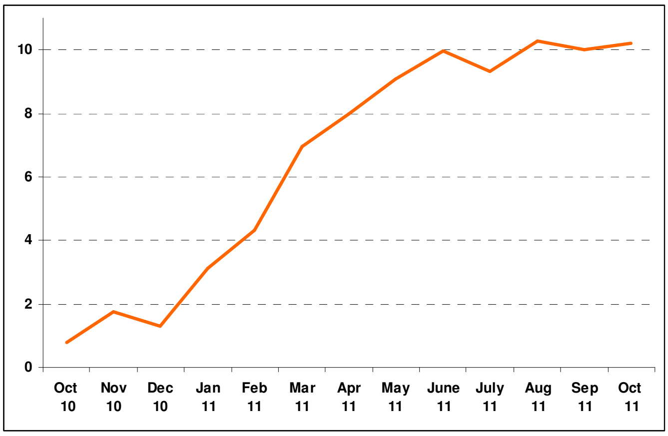


Source: National Bank of Ukraine, Eurobank Research

Credit growth continues its upward trend

Credit growth continues its upward trend driven by corporate lending, while household lending is still in negative territory. Total credit (including private and public sector credit) grew by 10.2% yoy in October 2011 with corporate lending increasing by 16.7% yoy and credit to households falling by -4.7% yoy. (Figure 3) Since the beginning of this year (year-to-October), total credit increased by 15.1%, with corporate lending increasing by 15.1% and household credit decreasing by 1.2%.

Figure 3
Annual credit growth in an upward trend since October 2010

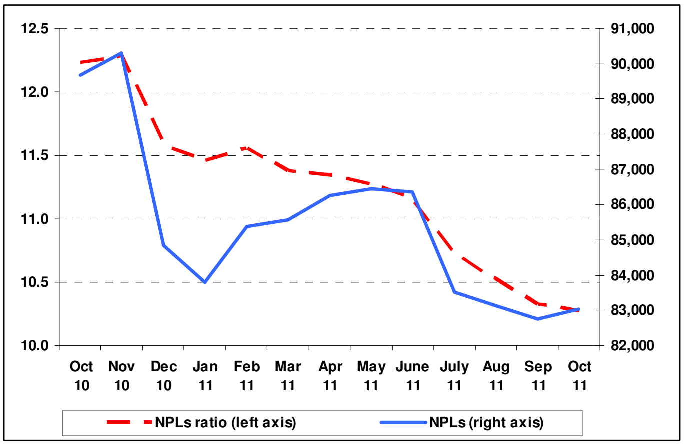


Source: National Bank of Ukraine, Eurobank Research

Total deposits continue to grow since the first quarter of 2010, both in the corporate and household sectors. Namely, total deposit growth stood at 15.2% year-to-October, with corporate deposits increasing by 24.6% and household deposits' augmented by 10.4%. As a result, the Loan to Deposit ratio fell at 168.3% in October from 175.9% at the end of 2010.

Non performing loans (NPLs) have started to decelerate recently since their peak recorded last November. They decreased by 2.2% year-to-October. The NPLs to total loans ratio stood at 10.3% in October from 11.6% in the end of 2010. This high deceleration in the NPLs ratio of 1.3% can be attributed mainly to credit growth, which stood at 15.1% year-to-October, rather than the NPLs fall. (Figure 4)

Figure 4
NPLs ratio fall mainly due to credit growth rather than large NPLs deceleration



Source: National bank of Ukraine, Eurobank Research

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