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NEW EUROPE ECONOMICS & STRATEGY

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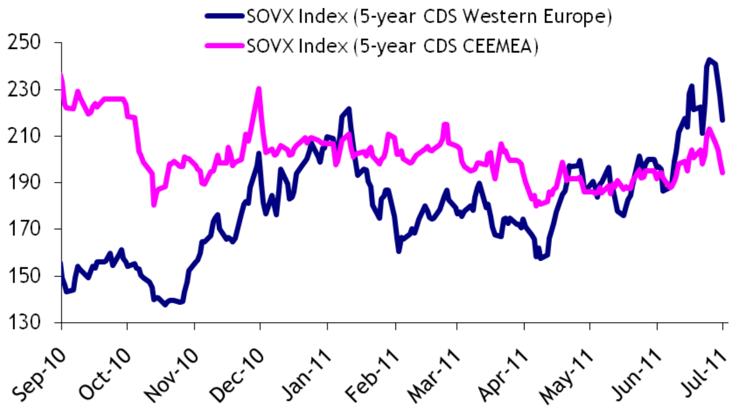
Lingering euro area debt crisis weighs on regional markets

- **Bulgaria**: First quarter GDP growth revised upwards
- **Poland**: Solid growth continues, powered by vibrant domestic demand
- **Romania**: Fitch upgraded Romania's long-term foreign currency rating by one notch to investment grade BBB
- **Serbia**: Central Bank initiates monetary policy easing
- **Turkey:** Political noise reemerges after simingly smooth June 12 general election; Q1:2011 GDP growth soars by 11%yoy, but higher-frequency data suggests a moderation in economic activity ahead
- **Ukraine**: Economic recovery continued in Q1-11, with GDP accelerating to 5.3% yoy from 3.3% in Q4-10

New Europe market strategy highlights

In the FX markets, the lira is likely to remain under pressure in the short-term in view of a record high current account deficit and market worries that the Central Bank may fall behind the curve in its fight against inflation. Yet, we are of the view that the **EUR/TRY** rally witnessed in recent months has been overdone. As such, we anticipate a reversal of the trend in the coming sessions and we would enter short positions at levels of 2.35 with a stop loss at 2.37 and a target of 2.26. **In the sovereign credit space,** we stick to our previous recommendation of playing the 145bps-175bps range in Turkey's 5-year CDS spreads, becoming sellers of protection at levels above 175bps and buyers at levels below 150bps. As recommended earlier this year (January 2011) we maintain our short Romanian 1-year CDS position to maturity as Romania's macroeconomic outlook continues to improve. We reiterate our earlier call that **local rates markets** may come under pressure later in the year as inflation risks loom ahead and we continue to prefer staying broadly sidelined. Even so, we would like to maintain our earlier 2/10 steepeners position in Polish cross currency swaps at current levels of 26bps with a stop loss some 15bps lower and a target at 50bps.

New Europe's external debt outperforms Western peers



Source: Bloomberg

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Introductory Comment

Dear Reader,

Following a very strong start in the first quarter of this year, GDP growth in most emerging market economies in New Europe appears to have slowed down slightly in Q2, reflecting the negative impact of higher food and energy prices, tighter monetary conditions, as well as softer euro area industrial readings. While domestic inflation rates appear to have already reached a cyclical peak, worries over the deepening euro area debt crisis remain a major cause of concern, not least because of the region's strong trade and financial links with a number of fiscally-vulnerable euro area countries.

More specifically,

Bulgaria's Q1:2011 GDP economic growth has been revised upwards to 3.4% yoy, from 2.5% yoy estimated in the initial flash report. The revision increases our level of conviction about our full-year growth forecast of 3.2%. The Bulgarian government is sending strong signals to the markets regarding its commitment to fiscal discipline. The government recently managed to pass in parliament a numbers of bills related to the proposed Stability Pact, which aims to enshrine fiscal discipline in the legislation. Risks to the domestic economic outlook remain skewed to the downside, but these originate mainly from abroad; especially given the ingering uncertainty over the euro area debt crisis.

FITCH upgraded the long-term foreign currency rating of **Romania** by one notch to investment grade, BBB. The government's ongoing fiscal consolidation effort, a new precautionary agreement with the IMF, the economic recovery from last year's recession and further progress in the country's privatization programme are among the arguments supporting further positive action by major rating agencies in the period ahead.

The prospect of lower food prices and stabilized inflation expectations in **Serbia** allowed the Central Bank to initiate a new policy easing cycle. The Central Bank has delivered 75bps of cumulative rate hikes since early June, bringing the key policy rate to 11.75%, currently In addition, the surge in portfolio inflows, which are driven by high demand for government T-bills, provides a short-term financing cushion for the widening current account deficit.

Poland's solid output growth in Q1:2011 masques the vulnerabilities stemming from its twin deficits. The large "net errors and omission"' component in the balance of payments data led the Central Bank to revise upwardly its 2005-2010 current account deficit figures by 1.4 ppts of GDP on average. In our view, the recent increase in the main VAT rate by 1 ppt and the channeling of private pension contributions to budgetary revenue provide only temporary solutions in the drive to reduce public deficits. Such temporary remedies don't reduce the necessity of aggressive fiscal consolidation measures, most probably after the October 2011 parliamentary elections.

The economy of **Ukraine** remains in a path to recovery following the deep recession of 2009. GDP growth came at 5.3% yoy in Q1:2011, accelerating from 3.3% yoy in the prior quarter. On the domestic political front, the government took a major step towards receiving fresh IMF financing by managing to pass through its parliament a major reform, aiming to improve the sustainability of the pension system. However, the government is still reluctant to raise gas tariffs to satisfy the second prerequisite for the release of the next IMF loan tranche.

The parliamentary elections in **Turkey** offered an outstanding victory to the ruling AKP party. At the same time, the political temperature rose, following the disqualification of an independent Kurdish MP by the Election Board on terrorism-related charges. On the domestic macro front, first quarter GDP growth soared to 11% yoy, sharply outpacing expectations and adding to overheating concerns. The CBT's unorthodox policy mix has so far had little meaningful impact on domestic demand, raising the need for a more restrictive fiscal policy going forward.

In spite of a relief rally following the parliamentary approval of Greece's 5-year austerity plan in late June, equity, fixed income and currency markets in New Europe came under renewed pressure in recent weeks. Parliamentary endorsement of Greece's Medium-Term Fiscal Plan was well received by markets, as it paves the way for a new financial aid package for the country as well as for the disbursement of the fifth tranche under existing EU/IMF adjustment programme. Even so, the euro area debt crisis is far from over and contagion fears remain in the spotlight, with global growth worries also continuing to weigh.

In regional FX markets, the Turkish lira is likely to remain under pressure in the short-term in view of a record high current account deficit and market worries that the Central Bank may fall behind the curve in its fight against inflation. Yet, we are of the view that the EUR/TRY rally witnessed in recent months has probably been overdone. Furthermore, we reiterate our earlier call that local rates markets may come under pressure later in the year as inflation risks loom ahead and, as such, we continue to prefer staying broadly sidelined. In the sovereign credit space, external debt markets in New Europe weakened modestly in recent weeks on worries stemming from the debt crisis in the euro area. Five-year CDS spreads for most countries in the region widened since the beginning of June, but remain significantly tighter relative to crisis-hit euro area periphery peers.

All in, we expect investor sentiment towards the region to remain cautious in the short term, with markets awaiting further concrete measures by euro area authorities to deal with the lingering sovereign debt crisis.

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	4.3	3.5	-7.9	-7.0	-6.5
Romania	-1.3	1.7	3.5	6.1	7.0	4.5	-6.5	-4.4	-4.0
Serbia	1.8	3.0	5.0	6.5	11.0	7.5	-4.4	-4.0	-3.2
Turkey	8.9	6.5	5.0	8.6	6.1	6.8	-3.6	-2.7	-2.6
Ukraine	4.2	4.7	4.8	9.4	10.6	9.8	-6.5	-3.5	-2.5
New Europe	5.1	4.8	4.5	6.4	6.3	5.9	-5.6	-4.3	-3.9
Euro area	2.9	2.5	3.0	1.6	2.6	2.0	-6.0	-4.6	-3.5
USA	1.7	1.9	1.8	1.6	3.2	2.5	-10.6	-11.0	-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	-2.5	-3.5	currency board			1.96	1.96	1.96
Poland	-4.5	-4.8	-4.7	3.50	4.50	4.75	3.96	3.98	4.00
Romania	-4.2	-4.5	-5.5	6.25	6.25	6.25	4.28	4.27	4.20
Serbia	-7.0	-7.5	-8.5	11.50	11.75	10.50	106.1	102.9	102.0
Turkey	-6.7	-8.0	-7.0	6.50	6.25	7.25	1.54	1.62	1.60
Ukraine	-2.1	-3.4	-4.5	7.75	7.75	7.75	7.96	7.98	7.90
New Europe	-5.0	-5.9	-5.8	-	-	-	-	-	-
Euro area	-0.4	-0.5	0.0	1.00	1.50	1.75	1.34	1.41	1.42
USA	-3.2	-3.2	-3.0	0.250	0.250	0.250	0.75	0.71	0.70

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

I. Overview

Regional stock markets remained under pressure on global growth concerns, lingering worries over the euro area debt crisis

In spite of a relief rally following the parliamentary approval of Greece's 5-year austerity plan in late June, equity markets in New Europe came under renewed pressure in recent weeks. Parliamentary endorsement of Greece's Medium-Term Fiscal Plan was well received by markets, as it paves the way for a new financial aid package for the country as well as for the disbursement of the fifth tranche under existing EU/IMF adjustment programme. Even so, the euro area debt crisis is far from over and contagion fears remain in the spotlight. Global growth worries also continue to weigh. Along these lines, most emerging market indices ended June with modest monthly losses. In spite of their close proximity to a number of fiscally-vulnerable euro area countries, regional equity markets outperformed their global emerging market peers, with the *MSCI Emerging Europe Equity* index standing in in a marginally negative territory in late June (-0.5% mom), from to its levels a month ealier. Over the same period, the benchmark *MSCI Emerging Markets* and the corresponding *World* indices each posted losses to the tune of 2% mom. Moreover, the Emerging Europe region remains the best performer on a year-to-date basis with the equivalent MSCI index standing 6.2% higher year-to-end-June, outpacing a 4% gain in the World and a 0.4% loss in the benchmark MSCI Emerging Markets indices. In New Europe, Turkey remains the worst performer so far this year, with the main XU100 index having encountered losses in excess of 8%, amid growing concerns about the country's external imbalances and increased fears that the CBT is falling behind the curve. On the other hand, Serbia's BELEX15 and Bulgaria's SOFIX lead the winners' pack with year-to-date gains of around 15%.

Regional FX markets extend losses

Regional currencies recoiled in recent weeks against a background of lingering euro area debt worries and resurfused global growth concerns. Serbia's dinar and Romania's leu were June's worst performers, registering respective declines of 3.6% and 2.6% against the euro. In detail, the **EUR/RSD** rate bounced to a 2-month peak of 102.94 on June 30 from a 1-½-year trough of 95.85 hit in May, folowign the arrest of war crimes fugitive Ratko Mladic. Meanwhile, the **EUR/RON** touched a 6-month peak at 4.2750 on June 20, firming from a 1-year trough of 4.0607 touched on April 29. The Romanian currency came under pressure recently, amid increased euro area contagion fears, with the domestic banking sector having a high exposure in Greece (according to reports, it is estimated that Greek banks own ca 17% of Romania's banking system assets). Elsewhere, Turkish lira's losses were exacerbated by growing concerns about potential overheating conditions in the domestic economy and worries that the CBT may eventually fall behind the curve. An opposition party's boycott in parliament, which may pave the way for by-elections, also weighed. As a result, the **USD/TRY** jumped to a 26-month peak of 1.6520 in late June. In a move to provide some support to the currency, the CBT announced shortly after that it will reduce by $10mn to $30mn its daily hard currency purchases. The Hungarian forint remains among the region's best performers on growing fiscal consolidation hopes. Acknowledging the recent improvement in the government's policies, Fitch revised the country's outlook to stable from negative in early June. In addition, the agency left the door open for an upgrade should the measures be implemented successfully. A surge in the Swiss franc pushed the **CHF/HUF** to record lows of 214.94 on July 1, exacerbating worries over the country's highly indebted households in CHF. Even so, the forint proved resilient, with the **EUR/HUF** sliding to a multi-session trough of 264.00 on the same day, standing not far off a 1-year low of 262.40 hit in April. The Polish zloty gained some ground in late June after the much awaited 2010 current account revision proved smaller-than-feared. The **EUR/PLN** hovered around levels of 3.97 on July 1, remaining within distance from 2-½-month highs of 4.0185 touched in late June.

Regional bond markets mixed as euro area jitters weigh

Local rate markets were mixed in June as contagion fears from the euro area's sovereign debt crisis weighed. Nevertheless, government bonds remain broadly firmer year-to-date, with still weak domestic demand dynamics in many countries providing support. Turkey underperformed its peers as concerns grow over the prospect of overheating pressures in the economy, while the CBT's policy mix does not seem to have had the desired impact on domestic demand. The recently emerged political feuds also weighed. As a result, the 2-year benchmark bond jumped to a 1-year peak of 9.29% on June 23, in the wake of in the last MPC meeting, which failed to provide any hints about a more conventional policy approach in the period ahead, as hoped by market participants. On the other hand, Polish government bonds firmed in recent sessions as the NBP is expected to hold its fire in the coming months after four 25bps rate hikes so far this year. Tight debt supply in Q3 also favored. Indicatively, the 2- and 10-year Polish benchmark bond yields fell by 20bps and 30bps, respectively, since the end of May standing at levels of 4.82% and 5.75% on July 1. Elsewhere, Hungary's government bonds weakened modestly in June, with the 3- and 10-year yields easing by ca 5bps and 10bps, respectively, over the last month or so to levels of 6.75% and 7.40%.

External debt markets weaken on euro area debt crisis spillover concerns, but continue to outperform European peers

External debt markets in New Europe modestly weakened in recent weeks on spillover worries stemming from the debt crisis in the euro area. Five-year CDS spreads for most countries in the region widened (by around 2.5-7%) since the end of May. However, they continue to fare much better compared with Western Europe peers. Indicatively, spreads in Hungary hit a 308.5bps 4-month peak on June 24 before narrowing slightly after the Greek parliamentary MTFP approval. Similarly, Polish 5-year CDS spreads rose to 167.5bps on the same day, touching their highest level since November 2010. Turkey underperformed, with spreads widening ca 7% from the end of May and touching a near 1-year peak of 193bps in late June, as overheating worries and an unorthodox central policy mix continue to weigh. The recent emergence of political noise did not favor either. On the other hand, Ukraine outperformed, with spreads standing little changed on the month at 461bps on hopes that talks on the IMF financial aid package, which had been brought to a standstill earlier this year, will resume in the coming months.

Strategy - Emerging New Europe Markets

In the FX markets, the lira is likely to remain under pressure in the short-term in view of a record high current account deficit and market worries that the Central Bank may fall behind the curve in its fight against inflation. However, from a longer term perspective we remain constructive on the Turkish currency as domestic growth fundamentals remain resilient and the CBT is expected to adopt a more conventional policy approach later this year. Even so, we are of the view that the **EUR/TRY** rally witnessed in recent months has been overdone. The pair hit a 5-year peak of 2.3660 on June 29 and stood at ca 2.33 at the time of reading. As such, we anticipate a reversal of the trend in the coming sessions and we would enter short positions at levels of 2.35 with a stop loss at 2.37 and a target of 2.26.

In the sovereign credit space, we stick to our previous recommendation of playing the 145bps-175bps range in Turkey's 5-year CDS spreads, becoming sellers of protection at levels above 175bps and buyers at levels below 150bps. As recommended earlier this year (January 2011) we maintain our short Romanian 1-year CDS position to maturity as Romania's macroeconomic outlook continues to improve. We collected gains on our previous long 5-year CDS position, which hit our 290bps target on June 23. Meanwhile, we maintain our recent long Poland 5-year CDS vs. short Russia 5-year CDS position at levels around 10bps (July 1) as a pure oil play on the latter and twin-deficit-concerns view on the former, with a target of 30bps and a stop loss at +5bps. Although our earlier call for long positions on the Markit iTraxx SOVX index for Western Europe vs. short on the corresponding CEEMEA trade were vindicated, we remain sidelined as a narrowing momentum may eventually emerge when the recent rally runs out of steam. Elsewhere, we took profit on the long positions in Bulgaria's 5-year CDS spreads which touched its 245bps target on June 24.

We reiterate our earlier call that **local rates markets** may come under pressure later in the year as inflation risks loom ahead and we continue to prefer staying broadly sidelined. Even so, we would like to maintain our earlier 2/10 steepeners position in Polish cross currency swaps at current levels of 26bps with a stop loss some 15bps lower and a target at 50bps. With regards to our previous recommendation of 2s/5s flatteners in Turkish cross currency swaps (entered at 60bps) we closed our position at levels of 50bps, collecting a small profit. The pair's technical picture suggests that a steepening momentum is likely to emerge ahead. Also in support of the aforementioned the market appears to have already priced in a significant amount of rate hikes. The 1 year cross currency swap has moved to 7.65% levels from 7% earlier this year, while the central bank continues to staunchly support its current policy mix and may eventually confound rate hike expectations

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

First quarter GDP growth revised upwards

- GDP growth in the first quarter of 2011 has been revised to 3.4% yoy, from 2.5% yoy in the initial flash report on strong export growth
- Parliament adopted basic elements of the new Stability Pact, which enshrines fiscal discipline in the legislation.

First quarter GDP growth revised to 3.4% from 2.5% in the flash estimate

Q1:2011 real GDP growth came in at 3.4% yoy, from 2.5% yoy estimated earlier. On a quarter-on-quarter seasonally adjusted basis, real GDP grew by 0.6% in the first quarter of this year, from 0.5% qoq in Q4:2010. From a sectoral standpoint, agriculture and construction recorded negative annual growth rates in Q1:2011. Agriculture contracted by -3.3% yoy (+1.1% qoq) in Q1 vs.-2.3% yoy (-3.8% qoq) in Q4. Construction was also in red, declining by -1.8% qoq/-0.8% yoy in Q1 compared to +0.9% qoq/+2.3% yoy in the prior quarter. On the other hand, the industrial sector expanded on a yoy basis, although its gross value added slowed to -1.2% qoq/+2.2% yoy, from 3.5% qoq/+7.1% yoy in the prior quarter. The positive news come from the services sector, which accelerated to +1.6% qoq/+3.6% yoy, from 0.3% qoq/+2.1% yoy in the prior quarter.

From the demand side, private consumption inched up to -0.1% qoq/+0.8% yoy, from +0.3% qoq/+0.3% yoy in Q4. However, this was broadly offset by weaker government spending, leaving total consumption growth at -0.3% qoq/+0.1% yoy in Q1 vs. +0.3% qoq/0% yoy in Q4. Gross fixed capital formation recorded a marginally positive qoq reading (+0.9%), with the corresponding yearly reading improving further to 1.6% yoy in Q1, from -1% yoy in the prior quarter. In contrast, inventories had a negative contribution to overall Q1:0211 GDP growth. Overall gross capital formation contraction deepened to -3.7% qoq/-9.4% yoy in Q1 compared to +2.7% qoq/-4.8% yoy in Q4. On a more positive note, net exports recorded another quarter of astonishing growth. Exports accelerated to 4.6% qoq/+20.1% yoy in Q1 compared to -3.9% qoq/+15.1% yoy in Q4, while imports slowed down to -1.0% qoq/+8.6% yoy in Q1, from +5.9% qoq/+10.7% yoy in Q4.

Net exports continue leading the growth recovery; contribution of private consumption stayed positive for a second quarter in a row in Q1:2011

In our previous (May 2011) New Europe Economics & Strategy report, we expressed certain reservations about the Q1:2011 flash GDP report, prefering to to wait for the announcement of the revised data before providing a more detailed analysis. The announcement of the finalized data contained significant deviations from the original announcements within the individual categories (particularly on the demand side).

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	-2.5	-3.5
Net FDI (EUR bn)	2.4	1.6	1.5	2.5
FDI / Current Account (%)	77.4	460.0	150.0	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

Furthermore, there was a major revision in the methodology of adjusting data for seasonality.

Our impression from the Q1:2011 GDP data is very positive. However, we do note that net exports remained the main driver behind the economic recovery. Net exports contributed 6.1pps to growth in Q1-2011 compared to 1.5 pps in the previous quarter as exports growth remained exceptionally high (54% yoy in Jan-May). The contribution of net exports is expected to remain positive throughout 2011, yet its impact is expected to start fading away gradually, as exports growth is expected to decelerate in 2H on deteriorating sentiment in the main EU trading-partner ecopnomies..

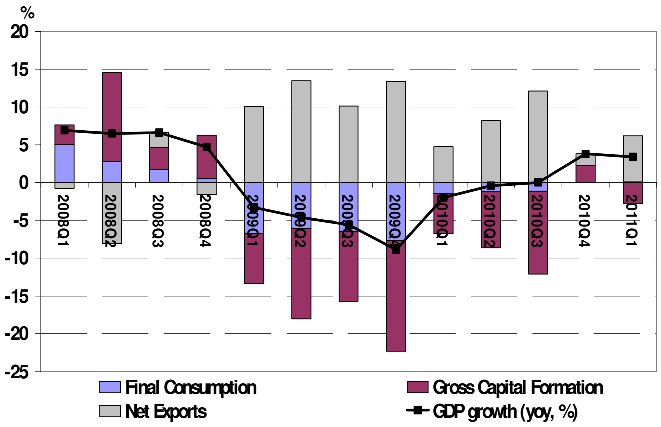
On the other hand, domestic demand remained a drag on the economy in Q1. Public consumption did not, and it is not expected to contribute positively in the period ahead given the fiscal consolidation process underway. However, the contraction in private consumption has bottomed out. In fact, private consumption is showing the first signs of a (still timid) revival.

Private consumption had a positive contribution in the GDP print for a second quarter in a row since the onset of the crisis (0.5pps in Q4 2010 and Q1 2011 respectively). This is particularly important if we take into account that a larger proportion of disposable income was used for food and energy purposes (because of significantly higher prices). We anticipate that private consumption will remain relatively subdued, but continue to contribute positively in the period ahead, especially as a number of fa vorable factors will come into play in H2: the indexation of lowest pensions due in July, the increase of minimum wage by 12.5% and some improvement in the labor market conditions. Registered unemployment has only mildly declined to 8.9% in May compared to a 9.8% high recorded in last January.

On the negative side, investments had a negative contribution which was further pulled down by inventories (a total of -2.8pps). However, a shift to a positive territory remains in the cards in the period ahead. Investments are going to receive increased support from the continuing inmprovement in EU funds absorption (which is mainly headed towards infrastructure investments) and the government's privatization program (state owned tobacco company, ammunition industries etc).

Figure 1

Net exports remain the engine of the economic recovery



Source: National Statistics, Eurobank Research

All in, our assessment on the domestic macro outlook has remained broadly unchanged. We upgraded our full year GDP forecast to 3.2% in our last trip to Sofia back in March, when we witnessed an improvement in the domestic economic environment. Back then, our forecast seemed to lie significantly above consensus. The announcement of the first quarter GDP data suggests that our forecast is within reach. The updated forecasts of international organizations for the Bulgarian economy released since April are now more optimistic. IMF upgraded its 2011 GDP forecast to 3% compared to 2.5% in the previous publication of World Economic Outlook in October 2010. 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.

Having said that, risks to our GDP forecast remain significant and, on balance, skewed to the downside. Bulgaria has escaped unscathed from unfavorable trade and financial market spillovers steming from the lingering euro area debt crisis. At best, a slowdown in the euro area economy is likely to put a lid on the strength of Bulgarian exports (45.6% of total exports headed towards the Eurozone in 2010) despite their ongoing diversification to the dynamic markets such as Russia and Turkey. In addition, the outlook of the domestic household and private sector may have improved, but downside risks remain. In our analysis, we identify the following factors as presenting the downside main risks: rising food and oil prices, weak domestic credit activity, high refinancing needs of private-sector external debt and the still high unemployment rate.

Parliament adopted two important elements of the proposed Stability Pact, which aims to enshrine fiscal discipline in the legislation

On June 30, the Parliament adopted two of the main elements of the proposed Financial Stability pact in the budget law legislation (Organic Budget Law). More specifically, the Financial Stability Pact introduced a fiscal rule which foresees two main amendments in the budget planning effective from 2012:

- The introduction of a cap on fiscal deficit: The general government deficit cannot exceed 2% of GDP. The cap set in the budget law is stricter than the 3% of GDP threshold provided in the first draft of the Financial Stability pact.
- The introduction of a cap on the redistributive role of the state: General government expenditure (including EU funding related spending) is capped at 40% of GDP. The first draft proposed a 37%-of-GDP cap on government expenditure, though without accounting for the contributions to the EU budget or participation in EU co-financed projects.

In principle, the Financial Stability Pact constitutes a framework aiming tp ensure that fiscal discipline is instilled in the legislation. The original version of the Pact was subject to public consultation and negotiations with political parties and social partners which resulted in several new drafts. The main elements of the latest draft became a part of the budget planning law.

However, there are elements that will be debated further and will require an extended majority in order to become a part of the constitution. There is an extra provision within the pact that there can be no changes in direct taxation rates or new direct taxes without a two-thirds majority in the parliament. Finally, the latest draft provides for a requirement of two-thirds majority in the parliament for an approval of the budget deficit to exceed the 2% limit.

On the other hand, more time and a broader consensus among political parties will likely be needed for the Pact to become a part of the Constitution. The Financial Stability Pact has to be approved by 180 out of 240 members of the Parliament (majority of ¾). In case of a 2/3 majority in the first vote, the procedure foresees another hearing and a revote in the parliament between 2 and 5 months later. in the second vote, a majority of at least 160 members is required for the pact to become a part of the constitution. Further developments from that point of view are expected to take place after the Presidential election scheduled for October 23rd. However, the consensus view is that major opposition parties will not consent to the fiscal rule becoming a part of the constitution despite the improvements.

In our trip notes to Sofia published in mid March, we provided an extensive coverage of the proposed legislation in its original version. Following our discussions with domestic officials, we became even more convicted about the usefulness of adopting a certain kind of fiscal rule. The most important benefit from such a mechanism is that the proposed framework institutionalizes the prudent fiscal policy stance of the recent years. The set of simple and transparent rules strengthens longer-term fiscal discipline, while, at the same time, rationalizing the redistributive role of the state. At the same time, fiscal discipline ensures the creation of buffers accumulated during economic boom times.

However, we think that the final version of the legislation adopted in the budget law contained even more rigid rules. In turn, it reduces the degrees of freedom of policymakers or at least it would require a broader consensus among the implementation of counter-cyclical fiscal policies in economic downturns. This is important given the existence of a currency board which prohibits an independent monetary policy, It is also important to note that the proposed legislation is stricter than any other fiscal rule applied in Western Europe. That is because it touches upon the socially sensitive issues of taxation and reduces fiscal policy flexibility in a macroeconomic environment already constrained by an ultra-rigid monetary policy regime.

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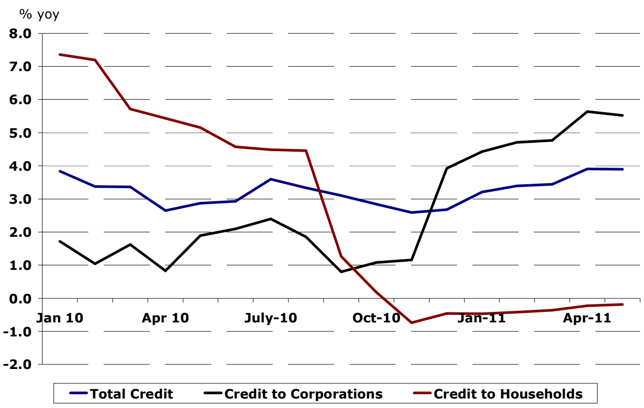
Focus: latest developments in the Bulgarian banking sector

Total domestic credit extended from Bulgarian banks in May 2011 increased by 3.9% yoy / 0.2% mom, recording little change from April, when the rate of increase stood at 3.9% yoy/0.4% mom. This figure on a yearly basis was the highest since December 2009. In a similar fashion, private sector credit growth came to a 3.3% yoy/ 0.2% mom, close to April's 3.3% yoy/0.4% mom, the highest reading since March 2010. In between these values, credit growth bottomed out two times in April at 2.6% yoy and November 2010 again at 2.6% (Figure 1).

Figure 1

Total credit supported by corporate credit growth.



Source: Bulgarian National Bank, Eurobank Research

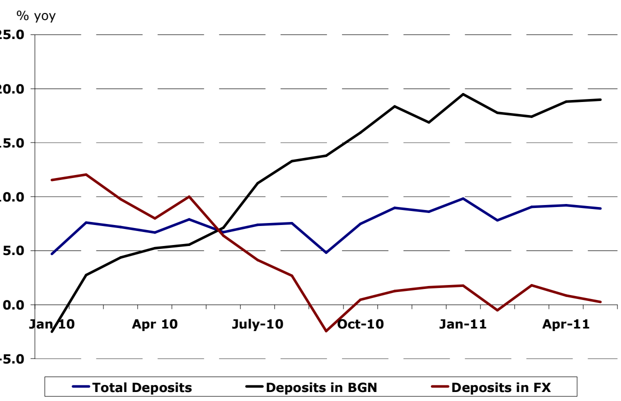
Breaking down the components of credit dynamics, corporate credit seems to support total credit single-handedly. Credit to corporations increased by 5.5% yoy/0.3% mom in May 2011. This was marginally lower than April's 5.6%yoy figure. Corporate credit growth has been on a positive territory since September 2010, when it grew by 0.8% yoy/2.5% mom. Credit to corporations accounted for 63.4% of total credit in May 2011. Consumer loans are poles apart however, still decreasing in May, at -3.2% yoy/0.0% mom, the third month in a row of null monthly growth. Nevertheless, this passes as an improvement, since consumer loans have had negative growth since September 2010, decreasing at a steadily diminishing rate since a November 2010 bottom of -4.5%yoy/-0.1% mom.

In terms of currency breakdown, credit in foreign currency leads growth whereas local currency credit has yet to turn positive. Credit in foreign currency grew by 7.6% yoy in May 2011, while in local currency it was negative (-1.6%yoy) . Over the past 12 months, average FX credit growth has been around 7.5% and credit in LC has retreated at an average rate of -2.5% yoy.

Deposits exhibit stronger growth than credit and an inverse behavior in respect to currency denomination. Total deposits came to 8.9% yoy/0.7% mom in May 2011, falling slightly from 9.2% yoy/0.7% mom in April. Deposit growth is following a vacillating trend, mildly increasing throughout the last 12 months after an August 2009 bottom of -0.11%, the only instance of negative growth. The increasing trend is attributed to deposits in LC running at 19.0% yoy/0.4% mom, while FX deposits, stand roughly inert at 0.3%yoy/1.1% mom in May 2011. Past values for these rates are shown in Figure 2, where the steep growth of deposits in BGN during 2010 stands out. In 2011, growth seems to be reaching a point of saturation where further speed up is unlikely.

Figure 2

Local currency deposits drive deposit growth



Source: Bulgarian National Bank, Eurobank Research

The result of the gap between deposits in FX and BGN is a decrease in the FX deposits over total deposits ratio, namely 49.5% in May compared to 55.0% in November 2009, around the height of the crisis. Vise versa, the same ratio for FX credit rose to 62.1% in May 2011 from a 58.3% low in November 2009.

Lingering contagion risks from the Euro area debt crisis continue to dominate fears since the onset of the debt crisis. This is important because EU bank subsidiaries hold 72.8% of Bulgarian market share. In our March 2010 analysis of contagion effects from the sovereign debt crisis in the euro area we concluded that the fiscal crisis will affect the Bulgarian economy but not to any degree that quenches stabilization or induces recession. Additionally, the Bulgarian banking sector is well protected against negative spillover effects. The banking system boasts a capital adequacy ratio that stood at 17.66% and Tier I capital adequacy at 15.36% in end-March 2011. This easily covers the capital adequacy ratio required for Bulgarian banks by the Bulgarian Central Bank, namely 12%, and about twice the

8% minimum requirement in EU. As Bulgarian National Bank's governor Ivan Iskrov put it in a much-quoted statement, Greek banks are a main pillar of stability in Bulgaria's banking sector.

Non-performing and restructured loans in May 2011 reached all time high rates of 20.9% for non-financial corporations, 18.4% for consumer loans and 17.5% for housing loans. For comparison, in May 2010 corporate NPLs were 10.4%, consumer loans 15.2% and mortgages 13.2%. As long as NPLs remain at high levels, credit conditions will continue to be tight.

Banks show increasing profits amounting to 280mn BGN in January to end May 2011, a 3.3% increase from a year before. Full year 2010 profits came to 617mn BGN, a 0.84% return over assets, dwarfing in front of profits in the before crisis era in the amounts of 1.4bn. However, not once through these adverse conditions have profits turned negative.

In conclusion, these two months are not necessarily a peak in credit growth. Potential for improvement is scarce and double-digit credit growth rates are a distant prospect while it has been clear for quite some time now that credit growth may only recoup its before-crisis rates of over 40% in the far long term. Nevertheless, in slow steps, we anticipate a mild improvement on the back of macroeconomic conditions. News of a generally improving Bulgarian economy, such as the recent positive value of private consumption growth in Q1, will eventually show up in the statistics of consumer credit. Furthermore, the strong export growth Bulgaria has achieved in the past may slow down and credit to corporations focusing on exports will subsequently suffer a minor drop. Increasing real domestic demand can offset this imbalance through loans to domestic corporations and households. However, these developments will probably come in the form of minor corrections rather than salient fluctuations from the present situation.

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

Solid growth continues

- Solid growth continues, powered by vibrant domestic demand
- Revised BoP data shows current account deficit at 4.5% of GDP in 2010 vs. 3.4% of GDP reported earlier
- Headline inflation eased to 4.2% yoy in June, after spiking to 5.0% yoy in the prior month due to higher food prices
- NBP keeps key policy rate unchanged at 4.50%, after delivering 100bps of rate hikes earlier in the year.

Solid GDP growth continues, supported by vibrant domestic demand and EU co-financed infrastructural projects ahead of 2012 European Football Championships

The outlook of the Polish economy remains positive, with strengthened domestic demand dynamics helping to offset the slowdown in key export markets. The manufacturing PMI slowed in June to the lowest level in 18 months (51.2 down from 52.6 a month earlier) due to a slump in the new export orders component. Even though the PMI marked the 20th month of consecutive expansion, manufacturing activity lost pace for the third month in a row. Nonetheless, Poland's industrial production still grew by 7.8% yoy in May up from 6.6% yoy in April. Meanwhile, retail sales slowed to 13.8% in nominal terms in May down from the 18.6% yoy recorded in April (this print was favored by comparison to negative print of April 2010). At the same time, labor market conditions continue to improve. Wage growth slowed to 4.1% yoy in May down from 5.6% yoy in April, while the unemployment rate fell for the third month in a row in May, to 12.2% from 12.6% in the prior month. Overall, we anticipate full-year GDP growth to reach 4.0% yoy in 2011, supported by strong domestic demand ahead of EURO 2012 (European Football Championships) ongoing preparations.

Poland: Eurobank EFG Forecasts				
	2009	**2010**	**2011f**	**2012f**
Real GDP (% yoy)	1.6	3.8	4.0	4.1
Private Consumption	2.0	3.2	3.5	3.6
Government Consumption	2.0	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	4.3	3.5
CPI (end of period)	3.5	3.1	4.1	3.2
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	12.2	11.8
Wage Growth *(private sector - average)*	4.2	3.6	4.5	4.3
External Accounts				
Current Account (% GDP)	-3.9	-4.5	-4.8	-4.7
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

Following NBP's revisions, the current account deficit is drifting upwards

The National Bank of Poland (NBP) released the first quarter current account and balance of payment data including revisions for the period 2004-2010 to reflect the large errors and omissions component. The NBP changed its accounting rules to reduce the volume of unclassified transactions. Some 90% on average in errors and omissions have been allocated to the current account balnce, with the remainder anmount being added to the financial account. The overall level of annual revisions in the current account deficit averaged 1.4ppts, below expectations of ca 2ppts of GDP. Yet, the current account deficit in 2010 was higher than previously reported; it stood at 4.5% of GDP versus 3.4% of GDP. What's more, in 2009 the current account deficit increased to 3.9% of GDP from 2.1% of GDP estimated earlier. Actually, given the revisions the current account deficit has never been below 3% of GDP since 2005. (Figure 1). In the first quarter of 2011 the current account deficit widened to €3.4bn from €2.1bn recorded in Q1-10. The 12-month rolling current account gap reached €17bn (or 4.7% of GDP) in March 2011. Overall, given the recent NBP's revisions we have revised upwards our forecasts, now expecting the current account deficit to reach 4.8% of GDP in 2011.

Figure 1: **Revised current account deficit as % of GDP for period 2005-2010**

	C/A deficit % of GDP after the revisions	C/A deficit % of GDP before the revisions
2005	2,4%	1,2%
2006	3,8%	2,7%
2007	6,2%	4,7%
2008	6,6%	4,8%
2009	3,9%	2,1%
2010	4,5%	3,4%

Source: National bank of Poland, Eurobank Research.

Fiscal performance is improving

In late April, the European Commission approved Poland's plan to reduce its general government deficit to 2.9% of GDP in 2012 from 5.6% of GDP in 2011. The budget deficit target, under ESA95 accounting, is PLN85bn in 2011 vs. PLN110bn in 2010. The government has implemented a number of measures to lower the budget deficit and has already made considerable progress in that direction; the H1:2011 budget deficit amounted to 47% of the full-year target. However, apart from improved spending discipline, part of the recorded budget improvement was attributed to the 1ppt VAT increase as of 1.1.2011, higher than expected inflation and the pick-up in domestic consumption, with all of the aforementioned factors boosting budgetary revenues. Overall, the performance to date indicates that the budget deficit is declining relative to 2010. Therefore, the government's goal to contain the public debt below the 55% of GDP threshold in 2011 seems achievable.

June inflation eases, following prior month's unexpected surge

Polish CPI accelerated in May to 5.0% yoy from 4.5% yoy in the prior month and consensus expectations for a 4.6% yoy print. This was the higher year-on-year inflation reading since August 2001. Headline inflation is above the NBP's 2.5% target for the eight month running. It is clear that global food and fuel prices coupled with the lagged impact of January's increase in the VAT rate have contributed to the domestic inflation surge. Food inflation stood at 9.4% yoy in May compared to 7.7% a month earlier. Accordingly, food inflation accounted for about half of the rise taken into account that the food component weights ca 30% in the CPI basket. In June, headline CPI dropped to 4.2% yoy, assisted by lower food price inflation (+6.7% yoy). Once the effects of high global food prices unwind, probably at the last quarter of 2011, headline inflation is likely to ease. However, core inflation (measure that excludes food and energy prices) also accelerated in May, reaching 2.4% yoy vs. 2.1% yoy in the prior month. This signals secondary effects from commodity price increases. Overall, in view of a likely stabilization in food and energy prices during the second half of this year, we anticipate CPI to average ca 4.3% yoy in 2011.

MPC leaves key policy rate unchanged

In early July, the Monetary Policy Committee (MPC) in its meeting decided to keep the policy rate unchanged at 4.50%. Earlier this year**,** the MPC has raised the interest rates at four out of five meetings, delivering total rate hikes of 100bps. The NBP's President has indicated that the Bank is likely to pause in its tightening tightening cycle so as to assess the impact of its earlier rate hikes. Moreover, the June's PMI slowdown suggests a weakening of the economic activity in the coming months. In addition, CPI inflation may be peaking. Much of the impetus behind rising domestic prices is due to higher global food and energy prices, which should unwind by the end of the year once global commodity prices stabilize. PPI inflation peaked in March at 9.5% yoy and dropped to 6.5% yoy in May reflecting an easing of global commodity prices.

The MPC front-loaded interest rates rises in H1:2011 and this appears to have lessened the for further policy action for the remainder of the year. Given a time lag (6-12 months) for the past rate hikes to be reflected in domestic demand, it may turn out that the NBP has already raised rates enough. Overall, we anticipate policy rate to remain at 4.50% in 2011. By contrast, the market expects rates to rise to 5.00% by year-end.

Credit developments

In May, private sector credit grew by 2.3% mom (up from 0.3% in April) and 4.0% year-to-May. This was mainly due to household credit growth, which stood at 2.6% mom in May and 3.3% year-to-May. At the same time, we observe a slowdown in total deposits growth; they decelerated to 0.2% mom in May and to 2.1% year-to-May. On Non Performing Loans (NPLs), although the NPLs to total loans ratio showed signs of stabilization (it stood at 8.2% for second month in a row in May) the nominal NPLs grew by 1.8% mom in May and 2.0% year-to-May with household nominal NPLs to increase by 4.5% year-to May.

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

Sovereign upgrade to investment grade by FITCH

- Fitch upgraded Romania's long-term foreign currency rating by one notch to investment grade BBB
- Current account deficit declined by 37.7% yoy in Jan-May on a lower trade gap and higher current transfers.

Fitch upgraded Romania's long-term foreign currency rating by one notch to investment grade BBB-

On July 5th, Fitch upgraded the sovereign ratings of Romania by one notch. More specifically, Fitch upgraded Romania's long-term foreign currency rating to 'BBB-' from 'BB+' and the long-term local currency rating to 'BBB' from 'BBB-'. At the same time, the agency upgraded the country ceiling to 'BBB+' from 'BBB' and the short-term foreign currency rating to 'F3' from 'B'. The sovereign rating report assessed that the upgrade reflects Romania's ongoing economic recovery, its solid export performance and a lower budget deficit. On the whole, there is a palpable lower risk associated to Romania, representing a comeback to 'investment grade' ratings. The Fitch upgrade puts Romania on par with Hungary (which currently lacks access to IMF funding, folowiong the collapse of an earlier financing programme backed by the Fund), Latvia (which has suffered a much worse output contraction and fares relatively poorly in a range of external vulnerability metrics) and Croatia (which is still in recession). Finally, ratings are still supported by income per capita above the BBB median.

The upgrade does not come as a surprise to us. In our March issue of New Europe Economics & Strategy, we argued that the next move by rating agencies on the assessment of the sovereign risk of Romania will probably be to the upside, provided the government minimized uncertainties with respect to the 2011 budget execution.

The Romanian government has come a long way since late 2009 when both Fitch and Standard& Poors had downgraded the sovereign rating of Romania to junk status amid heightened domestic policy uncertainty. Ever since, the minority government has implemented a very ambitious fiscal consolidation programme, despite the economic recession.

The plan entailed public wage cuts (-25% on the wage bill), public sector lay offs (broader public sector employment declined by 130,000 between Q1:2009 and Q1:2011 and a 4ppts VAT rate increase (from 19% to 24%). Provided that these measures will stay in place for the remainder of this year there will be a further reduction in the fiscal deficit to 4.4% of GDP in 2011, from 6.5% of GDP in 2010 and 7.3% in 2009. In addition, the government made steady progress in promoting important structural reforms (e.g. a new business friendly labor market law, the uniform public wage law, the fiscal responsibility law), thus fulfilling IMF requirements, despite increased tension in the domestic political landscape. More importantly, the economy exited recession in Q1 driven by net exports and is bound to grow modestly in 2011, by 1.7%, according to our forecasts. Last but not least, a new precautionary IMF stand-by agreement is in place to shield the economy in case of an emergency.

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	7.0	4.5
CPI (end of period)	4.7	8.0	5.4	4.0
Fiscal Accounts (%GDP, Cash Basis)				
General Government Balance	-7.3	-6.5	-4.4	-3.0
Gross Public Debt	29.6	37.7	40.1	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	-4.5	-5.0
Net FDI (EUR bn)	3.6	2.6	3.0	5.0
FDI / Current Account (%)	72.3	51.4	50.0	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	4.27	4.20	4.20	4.20

Source: National Sources, IMF, Eurobank Research & Forecasting

Additional rating upgraded likely by end of this year

Standard and Poors currently rates Romania's sovereign rating at BB+, just one notch above Serbia. Standard and Poor's affirmed Romania's current sovereign rating on June 9. According to S&P, the ratings on Romania balance the view of the country's substantial economic growth potential and moderate general government debt against its limited administrative capacity, relatively low prosperity and high, though declining, external debt levels. However, S&P left open the door for a future rating pgrade of Romania, provided that the government maintains a good momentum in implementing structural reforms, builds a sustained track record of fiscal prudence and maintains stability in the financial sector. In conclusion, we anticipate Standard and Poors to upgrade Romania by the end of this year. On the other hand, Moody's maintained Romania's rating at investment grade throughout 2008-2011 and intends to leave them unchanged for at least one more year.

The initial FX market reaction to the Fitch upgrade was positive, though it proved short-lived. On July 5th, the leu traded ca 1% higher to hit levels around 4.19/€. The currency has been losing ground since reaching a multi-month high near 4.07 against the euro in late April, reflecting rising concerns about spillover effects from the ongoing Greek sovereign crisis. In addition, Romania 5Y-CDS traded at 258bps on July 15th, the highest level in the last three months. There are two main reasons for these recent negative developments. Firstly, prices have already incorporated the improvement in macroeconomic fundamentals. Secondly, the Euroarea periphery crisis weighs negatively on the currencies of the region at this stage.

In our view, the sovereign upgrade is expected to have a more lasting impact on Romanian asset markets. More specifically, it will help mitigate the adverse market impact from the ongoing Euroarea sovereign crisis, thereby alleviating concerns of contagion from the Euroarea periphery. In addition, it will make the Romanian market a more attractive destination for capital inflows (both FDI and portfolio investment), which have declined during the 1H-2011.

Current account deficit down 37.7% year-to-May, driven by a lower trade gap and higher current transfers

Current account dynamics continue to improve in January-May albeit at a slower pace relative to the the first quarter of this year. The current account deficit declined by 37.7% yoy to €1.8bn in the first five months of 2011, following a 58.9% yoy drop in Q1:2011. Overall, the current account deficit on a twelve month rolling basis improved modestly to 3.1% of GDP in Janury-May against 4.1% at the end of 2010 and 5.5% in Jan-May 2010.

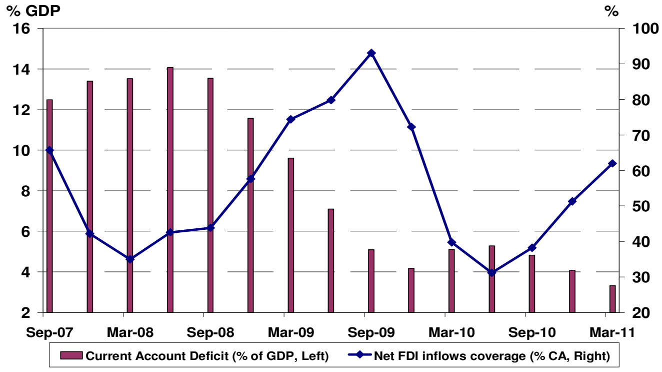
A lower trade deficit was the main driver behind the improvement in the current account balance. The trade gap improved to €1.9bn in Jan-May compared to €2.6bn in the same period a year earlier. However, the pace of improvement in the trade deficit narrowed down to 23.9% yoy in Jan-May against 64.6% yoy in Q1. This was the combined result of stronger readings in both exports and imports compared to those in April. Both exports and imports growth accelerated to 27.1% yoy and 23.4% after a temporary slump in April.

Exports continue their robust rebound, rising by 32% yoy, following a 39.4% yoy increase in the first three months of the year. In contrast, imports picked up by 23.2% in Jan-May against 24.8% in Q1. The revival of imports is closely tied to the rebound in exports. A large part of imported materials is used as inputs for exported goods because of insufficient domestic industrial capacity.

Meanwhile, the deterioration in the balance of income continued in the first five months of 2011, with the corresponding deficit widening by 25.2% yoy. In contrast the BoP services deficit improved by 10.2% yoy in the same period.

Figure 1

Current account dynamics improved in 2008-2011



Source: BNR, Eurobank Research

Table 1

Balance of Payments Jan-April 2010-2011

mn Euros	Jan - May 2010			Jan - May 2011			%
CURRENT ACCOUNT	18,568	21.485	**-2,917**	23,879	25,697	**-1,818**	**-38%**
A. Goods & Services	16.166	19.119	**-2,953**	20.978	23.279	**-2,301**	**-22%**
a. Goods (exports fob - imports fob)	13,806	16,380	-2,574	18,229	20,188	-1,959	**-24%**
b. Services	2,360	2,739	-379	2,749	3,091	-342	**-10%**
- transport	699	794	-95	826	1018	-192	**102%**
- tourism - travel	310	431	-121	364	486	-122	**1%**
- other	1,351	1,514	-163	1559	1587	-28	**-83%**
B. Incomes	375	1136	**-761**	419	1417	**-998**	**31%**
C. Current transfers	2027	1230	**797**	2,482	1001	**1481**	**86%**

Source: BNR, Eurobank Research

The good news is that current transfers recorded a €1.5bn surplus, which is 85.8 % higher from the same period a year earlier. The current transfers' surplus traditionally provides a buffer to the current account deficit in Romania. However, lower remittances from abroad (-18% yoy in 2010) had put pressure on the surplus of current transfers last year. The latest statistics point to a reversal of the trend because of increased EU funds absorption, which is expected to be illustrated in an improvement in investments as well.

From the financing side, both FDI inflows and portfolio investment disappointed. FDI inflows declined to €799mn, down by 23.3% yoy in Jan-May. At the moment, net FDI inflows cover only 43.9% of the current account shortfall compared to 60% in Q1, yet still higher than 38.5% in Jan-April. However, FDI inflows should register a small increase by the end of the year, supported by the privatization program of the government. At the same time, net portfolio investment was down by 31% yoy to €1bn. Finally, total external debt rose by €5.5m to €94.7bn in Jan-May or approximately 72.1% of GDP, driven primarily by the IMF tranches. The majority of the total external debt was of medium- and long-term duration (78.7% of total). Half of the the medium and long-term was private-sector denominated origin.

June CPI surprises to the downside

CPI surpised to the downside in June, easing to -0.3% mom /+7.9% yoy, from +0.2% mom/+8.4% yoy in the prior month. This was a much softer reading that the market's median forecast of +0.1% mom/+8.5% yoy. Food inflation surprised to the downside, slowing to -1.3%/+9.8% mom/yoy, from +0.2%/+11.2% mom/yoy in May. Vegetable prices tumbled by 11% mom in June, slashing some 0.4pps off the headline inflation figure (3.6% percentage weight in the consumer basket). We expect food inflation to subside further in the coming months, reflecting a good crop season this year.

In the March 2011 issue of our New Europe Economics& Strategy we had expressed the view that disinflation is expected to resume some time after March because of seasonal factors. The data released support this view. Disinflation will most probably gain momentum in H2-2011, when the impact of last year's VAT hike falls out of the equation. However, we still believe that this is not going to be enough to push year-end inflation back within the official target 3%+/-1%. Note that Central Bank now forecasts year-end inflation at 5.1% yoy.

In any case, the domestic inflation outlook remains subject to significant risks, stemming mainly from supply side factors such as the volatility in food and fuel costs, further increases in the administered prices, while the negative impact from RON depreciation (against the euro which weighs negatively on services) cannot be ruled out if the Euroarea sovereign crisis deepens further.

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Focus: latest economic developments in the Romanian economy

Monetary policy outlook: No tightening bias

The NBR has kept the key interest rate unchanged at 6.25% in its monetary policy meeting on June 29th. In the accompanying policy report, the bank signaled no bias towards tightening interest rates, as long as the output gap remains negative. Tightening risks, which stem from commodity prices increases, second round effects of supply side shocks and administered prices pressures, have eased in the past month. The IEA recently took action to curtail oil prices, while the Government decided to postpone cuts in thermal energy subsidies for consumes until 2012.

The IMF concludes its first review

The IMF completed its first review of the Romanian economy under the 3.5 bln euro precautionary stand by agreement. The Fund concluded that all program targets were met and, accordingly, they disbursed the first tranche of 481 million euro. The local authorities decided not to draw any funds, confirming the precautionary nature of the current arrangement.

The report stressed that further efforts would be needed to reach the 2012 monetary and fiscal targets. The local authorities' main point of focus should be state-owned enterprises, arrears, fiscal efficiency and absorption of EU funds.

Budget deficit accelerates in May, but still on target to meet the mid-year target

The Budget execution deteriorated in May compared to the previous month. The deficit has risen from 0.8% in the first four months of the year to 1.4% of projected GDP in the first five months of the year. We are particularly apprehensive about the current structure of spending.

Outlays for goods and services have been one of the fastest growing components of budgetary spending, rising by 11% yoy in the first five months of the year. This is a reflection of lingering inefficiencies in public spending management.

Although the government had earlier described capital spending as a key priority, this component has actually decreased 5% yoy in the first five months of the year over. The situation improves slightly if we would take into account spending on EU co-financing programs (+15%yoy), though this should have proceeded at an event faster pace.

Rising short-term debt will prompt the Government to issue more bonds under the EMTN program

Another important challenge facing domestic policy-makers is Romania's mounting short-term debt, which increased by 3.7% qoq in Q1 2011, reaching 19.1 billion euros. Although the short/long term financing ratio (3/10) remains far from the pre-crisis peak (6/10), the dynamic does raise some concerns especially as the increase has been driven exclusively by government borrowing.

During the first 6 months of the year, the Romanian treasury has issued around 8 billion Euros in the local market, 80% of which being in short-term debt instruments. Partly, this has been due to higher demand by local banks. The Treasury has been able to sale more government securities in the local market at a lower average yield than in the previous year (6.79% vs 7.27%). Although the majority of short term debt is owned by local banks (72%), thus limiting the risk of rollover crises, Romania currently has the shortest debt maturity structure in the region. Matters are further aggravated by the country's poor growth performance.

The government plans to change this arrangement in two ways: issue longer maturity debt in the local market and issue Eurobonds in the international markets. The latter will most likely become the preferred option, as local banks' demand for longer term instruments remains limited.

The MoF plans to issue Eurobonds through an EMTN program with a maximum value of 7 billion euros. The first issue under the program was launched in June and successfully managed to raise Eur 1.5 bln at a yield of 5.3%. Although the accepted yield was slightly higher than for a 5Y Eurobond from March 2010, this was not due to lack of investors' interest. Market conditions between the two periods have changed. The 5Y CDS for Romania in June 2011 was 30bp higher than in March 2010, while the 5Y swap rate for euros increased from 2.4% to 2.8% (as the ECB started to tighten interest rates). Moreover, the issue was oversubscribed more than two times.

The architecture of the EMTN program makes is very flexible and will allow the MoF to tap the international markets at any time during the next three years. The Government is also planning a Dollar-bond counterpart to the program.

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

Central Bank initiates monetary policy easing

- NBS cut its key policy rate by 25 bps to 11.75% on July 7th; move follows 50bps rate reduction in early June
- Domesitc CPI decelerated further in June, reaching 12.7% yoy , from 13.4% yoy in the prior month; cyclical peak in inflation has already been seen
- Current account deficit up by 14.3% yoy in January-April 2011, financed primarily by portfolio inflows.

NBS initiates monetary policy easing cycle

On July 9th, the NBS cut its key policy rate by 25 bps to 11.75%. This is the second rate reduction since June 7, when NBS slashed cut interest rates by 50bps, initiating a new monetary policy easing cycle.

According to a Bloomberg survey conducted ahead of the July 9 policy meeting, the majority of participants polled (8 out of 22) expected no rate change; 6 expected a 50 bps rate cut and 7 expected a 25bps cut. In the monetary policy meeting on May 12th, the NBS had left interest rates unchanged at 12.5%. The Central Bank had explicitly mentioned that monetary policy tightening had come to an end. However, the NBS had stated that it would be cautious with respect to any prospective monetary policy easing, taking into account all available information about domestic and international macro developments.

In our last New Europe Economics & Strategy issue, we opinioned that the Central Bank would be very cautious in switching to a new monetary policy easing cycle as inflation uncertainties remained elevated. Admittedly, the latest easings moves of the Central Bank have been relatively quick, though not entirely surprising. Note, that the monetary policy cycles since the adoption of the semi-inflation targeting regime in September 2006 lasted on average only few months (minimum 6-maximum16 months) and were followed by swift reversals in policy directions. Specifically:

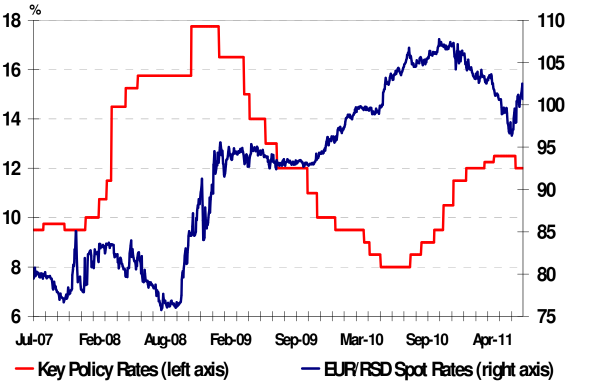
- The previous monetary policy easing cycle lasted 16 months: The NBS delivered a total of 975bps from 17.75% in Jan 2009 to 8% in May 2010. The NBS remained on hold for only 3 months.
- The latest monetary policy tightening cycle lasted nine months-from August 2010 to May 2011. Over that period, the Central Bank delivered a cumulative of 450 bps (from 8% to 12.5%) in eight rate hikes. However, the NBS remained on hold for only 2 months before cutting rates in early June 2010.

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	11.0	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	-7.5	-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	11.75	11.00	10.50	10.50
EUR/RSD	102.90	102.00	102.00	105.00

Source: National Sources, IMF, Eurobank Research & Forecasting

Figure 1
NBS initiated the monetary policy easing cycle in early June



Source: Bloomberg, Eurobank Research

CPI decelerated further in June, vindicating the Central Bank's view that domestic inflation has already reached its cyclical peak

In the last policy statement released after the July 7 policy meeting, the Central Bank appeared convinced that a number of uncertainties surrounding the domestic inflation outlook have been already subsided. Inflation has already peaked at 14.7% yoy in April and will continue declining over the coming period. The main driver behind the expected disinflation is expected to come from the sharply declining food prices. In fact, the Executive Board assessed that once the new agricultural season sets in, food prices will probably have a disinflationary impact on inflation. This should be reinforced by the spillover effects of lower global wheat and corn prices, which are yet to be felt in the domestic market.

In addition, the full effect of past monetary policy tightening, and the still subdued domestic demand pressures are also expected to contribute favorably to the domestic inflation outlook in the near future. Furthermore, inflation expectations have stabilized at 8% according to the latest surveys providing more ammunition to the Central Bank advocates of lower policy rates.

Positive dynamics continued in June. After recording the lowest month-on-month rise in May so far this year, inflation recorded its first negative month on month reading in June in the last one and a half year. Consumer prices decelerated to -0.3% mom/+12.7% yoy in June against +0.4% mom/+13.4% yoy in May and +1.1% mom/+14.7% yoy in April. The prices of food & beverages (37.8% share in the CPI basket) decelerated to -1.1% mom/+17.8% yoy compared to +0.4% mom/+19.3% yoy in May and 0% mom/+22.1% yoy in April. Lower prices of vegetables (-15% mom) a leading indication of a good agricultural season, was the main driver behind the improvement. The second most important disinflationary driver, alcohol and tobacco (4.9% weight in the CPI basket) slipped to +0% mom/+19% yoy in June, from -0.1% mom /+19.4% yoy in May and -1.6% mom /+19.8% yoy in April.

All in, we expect inflation to retreat further in the coming months. Provided that there are no other supply-side shocks, inflation would gradually retreat more visibly towards the targeted band from Q3 2011 onwards. However, although there is good chance that year-end inflation will end in single digit, it may still lie significantly above the Central Bank target (4.5%+/-1.5%). That said, we continue to see room for additional 125-150 bps rate cuts from current levels, as we already indicated in our previous New Europe Economics & Strategy.

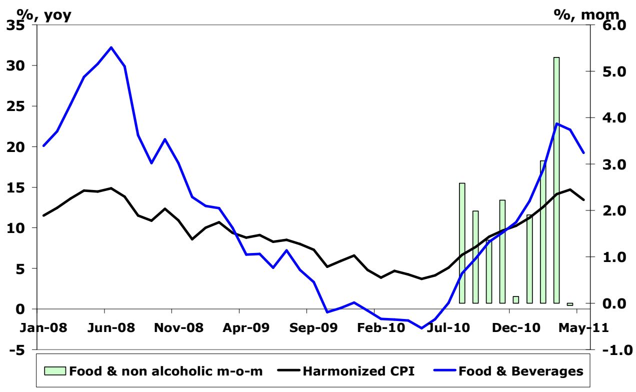
More specifically, food inflation is expected to subside further in the coming months, driven by favorable base effects and the positive impact of the new agricultural season starting in July. While the possibility of a new oil price shock as a result of the ongoing geopolitical tensions in the Middle East and North Africa cannot be ruled out, oil prices must have peaked after the IEA (International Energy Agency) decision to release strategic oil supplies to meet the disrupted supply from Libya's production.

Additionally, inflation will benefit from the recent appreciation of the local currency at least in the short-term. Even though the dinar appreciation is losing steam, the currency is still holding some of its gains recorded earlier this year. Dinar has started to lose some ground since mid-June, on concerns over potential spillovers from the ongoing Greek sovereign crisis. The local currency strengthened against the euro during H1:2011, hitting 98/€ on June 10th, from levels around 105.9/€ in late December and a historic low of 108.1/€ in late October, 2010. On July 18th, the dinar stood at 103.3/€, higher by approximately 2.5% compared to the end of 2010.

On a less positive note, certain upside risks to the domestic inflation outlook remain. Namely, the regulatory prices adjustment has already exceeded the limits set by the mutually agreed framework with the government. In addition to the adjustment in electricity prices implemented on April 1st, gas prices are expected to rise as well effective from June. Last but not least, the onset of the political cycle (parliamentary elections are scheduled in May 2012) poses the risk of undue fiscal relaxation, prompting the Central Bank to be more cautious in cutting rates further down the road.

Figure 2

Food inflation is about to subside further in the coming months



Source: National Statistics, Eurobank Research

Current account deficit widened by 20.6% yoy in January-May 2011, financed primarily by portfolio inflows

The current account deficit widened by 20.6% yoy in the first five months of 2011. Exports maintained their strong momentum, growing by 25.9% yoy. The rally in exports has been supported by high commodities prices worldwide. Base metals-iron and steel products-comprise a large component in the exports portfolio (around 20%). In addition, high demand for corn and other cereals boosted agricultural products exports. Despite the increased energy bill, total imports still lagged behind, rising by 20.9% yoy over the same period. As a result, the trade deficit deteriorated moderately by 13.9% yoy in nominal terms. Yet, the exports to imports coverage ratio improved further to 60% in Jan-May compared to 58% a year earlier. Overall, the current account deficit on a twelve month rolling basis deteriorated marginally to 7.5% of GDP in May 2011 against 7% in December and 6.8% in May 2010.

In addition, the balance of services improved from a €5.1mn deficit to a €50.6mn surplus in the same period. Current transfers continued to run a surplus of €1.1bn, boosted by the last disbursement of the IMF loan agreement that was received in April. However, the surplus was still lower by 1.4% compared to the previous period, partially due to reduced remittances (--4.4% yoy) and higher government transfers (+35.3%). Furthermore, the balance-of-incomes ran a lower deficit of €0.28bn (down by 1.4% yoy vs. the same period a year earlier)

On the financing side, Serbia benefits from the resumption of capital inflows to the emerging market economies in the region. The rebound of capital inflows (up by 109% yoy in Jan-May) was underpinned by a surge in portfolio inflows (up by 1224% to €700mn). The rise in portfolio inflows stemmed from the high demand for government T-bills. The turnaround in foreign investor perceptions is still driven primarily by the high real yields, the recent appreciation of the dinar and the favorable developments in the sovereign risk premia.

Despite the absence of any significant privatization, FDI inflows showed encouraging signs of resumption in the first months of 2011. Net FDI inflows picked up by 23.4%, reaching €485mn against €393mn in the same period last year. Equally importantly, the bulk of FDI inflows headed towards the sectors of manufacturing and financial intermediation.

However, the prospects of attracting significant new FDI inflows are limited given that that the privatization of Telekom Serbia was effectively postponed until, at least, the next parliamentary election (officially scheduled for May 2012). 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. Taking into account the latest developments, we have downgraded our forecast of FDI inflows this year to €1.2bn.

Attracting FDI inflows is crucial for securing a more sustainable source of balance-of-payments financing in contrast to portfolio inflows which are by nature more volatile. From this point of view, the completion of the privatization program is 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.

In contrast, other financial account elements registered a significant decline. The balance of "other investments" was reduced by 49.8% in the first five months of 2011. In essence, this primarily reflects the impact of the repayment of long term lending by the private sector and the banking sector. Inflows from new long term government borrowing and foreigners' deposits in the banks were not enough to fill the gap. The overall result was that "other investments" recorded a surplus of €82mn down from to €160 mn a year earlier.

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

Political noise emerges after an ostensibly smooth June 12 general election

- Q1:2011 GDP growth soared to 11%yoy, but higher-frequency data suggests a moderation in economic activity ahead
- Impact of CBT's *unorthodox* policy mix on domestic credit demand appears to have been limited so far; latest data adds to concerns about economic overheating
- Improving fiscal outlook signals limited impact from the June 12 general elections; 2011 targets to be comfortably met

Political noise re-emerges after June 12 general election

Political feuds resurfaced a few days after the seemingly smooth June 12 general election. The trigger was the disqualification of independent Kurdish MP, Hatip Dicle, by the Election Board on terrorism-related charges. His seat was offered to a nominee from the ruling Justice and Development Party (AKP) who had been the runner up in the polls. The pro-Kurdish Peace and Democracy Party (BDP) that supported Mr. Dicle's candidacy in the elections has warned it may refrain from attending parliament. In fact, it refused to be sworn in on June 28, the date when other parties took oath. The party may enter parliament at a later stage. However, in the event of a permanent refusal, 35 seats will be left vacant. According to the constitution, the resignation of 28 MPs (equivalent to 5% of the 550 seats in parliament) would trigger by-elections. It may also increase tensions in the mainly Kurdish southeast regions. Adding to the jitters, a few days later Turkish courts decided to strip eight other elected candidates from their recently acquired posts on the grounds of anti-government conspiracies. Their seats remain vacant. Among them were five members of the BDP, one from the far right Nationalist Movement Party (MHP) and two members of the main opposition Republican People's Party (CHP).

Recall than in June's general elections, the AKP scored a record high victory of nearly 50% of the tally and according to final results obtained 327 seats in parliament (Table 1) securing its third single party mandate in office. The lower number of seats from the party's previous tenure (341) was largely due to a redistribution of votes across different provinces. At first this was translated as the most favorable possible outcome. It supported Prime Minister Erdogan's pre-election pledge of a more modern and democratic constitution that would replace the current one, which was drafted after a coup in 1980 and is considered to be outdated. Importantly, the party fell short of the 367 seats (2/3 majority) required to change the constitution unilaterally and lacked the three seats needed to enable it to independently call a referendum for such changes without the overseeing power of

Turkey: Eurobank EFG Forecasts

	2009	2010E	2011F	2012F
Real GDP (yoy%)	-4.8	8.9	6.5	5.0
Private Consumption	-2.3	6.6	5.9	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	-8.0	-7.5
Net FDI (USD)	6.9	7.3	8.0	8.5
FDI / Current Account	46.9	12.0	12.3	13.8
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	6.25	7.25	7.75
USD/TRY (where applicable)	1.62	1.65	1.60	1.50

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

other members in parliament. A reallocation of seats through by-elections may grant the AKP a stronger mandate and lead to a power monopoly that would effectively not require parliamentary consensus for constitutional amendments. However, an increase in the AKP's power through the disqualification of other MPs may weigh on the party's public support. Rumor has it that among the amendments Prime Minister Erdogan plans to pursue is a tilt towards a more presidential system of government. Under current legislation, he will not be eligible for another term in 2015 and speculation is growing that he may opt to enhance presidential powers and run for the post thereafter.

Table 1: Parliamentary composition

Party	Number of seats in parliament	Party Leader
Justice and Development Party (AKP)	327	Recep Tayyip Erdoğan
Republican People's Party (CHP)	135	Kemal Kılıçdaroğlu
Nationalist Movement Party	53	Devlet Bahçeli
Independent	35	-
	550	

Source: T.C. Yüksek Seçim Kurulu Başkanlığ

Q1 GDP growth soared to 11%yoy, sharply outpacing expectations …

Turkey's Q1 GDP growth soared to 11.0%yoy outpacing expectations for an expansion of ca 9.6%yoy as well as a 9.2%yoy increase in the fourth quarter of last year. The rebound was primarily driven by strengthening domestic demand dynamics (Table 2). In detail, private consumption spiked 12.1%yoy contributing 8.7ppts to real GDP growth, while gross fixed capital formationsoared 33.6%yoy, with private investments posting a whopping annual rate of increase of 38.3% which added 7.4%ppts. The contribution from net exports remained negative as growth of 27%yoy in imports sharply outpaced a 7.7%yoy increase in exports subtracting around 5.5pts from economic activity. From the production side, the recovery was broad-based with manufacturing, construction, trade, transport & communication and financial intermediation being among the main contributors in domestic economic activity. In view of the sharper-than-anticipated increase in real GDP growth in Q1, we revised our previous forecast for 2011 real GDP growth to 6.5%, from 6.0% previously and acknowledge that risks to our projection lie to the upside.

… but, higher-frequency data suggests a moderation in domestic economic activity ahead

Most recent data support the view that economic activity is slowing down. Unfavorable base effects, tighter fiscal and monetary conditions as well as the ongoing negative contribution from net exports are all to blame. As mentioned in our previous New Europe Economics & Strategy report, 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 recording a deceleration in production growth to a 17-month trough of 8.3%yoy following a 14.2%yoy print in Q1:2011. Furthermore, June's PMI stood at 52.3, remaining near an eight-month low of 50.6 touched in May and pointing to a weakened expansion in the manufacturing sector. In spite of a tentative improvement in labour market conditions, the rate of unemployment, measured on a three month rolling basis, stood at 10.80% in the February-April period.

Table 2

Turkey: GDP

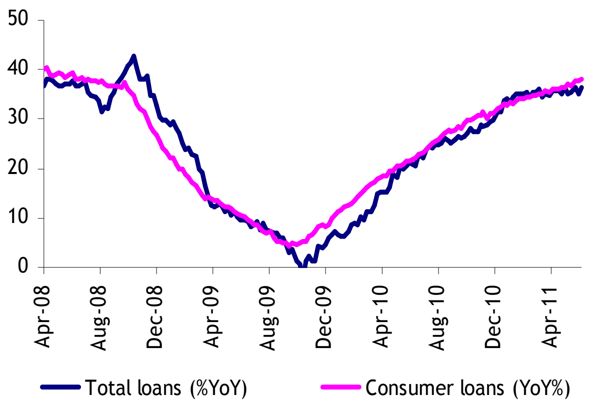
	YoY growth (ppts)		Contributions (ppts)	
	Q1 '11	2010	Q1 '11	2010
GDP	11.0	9.2	-	-
Expenditure-side				
Domestic Demand	15.9	13.3	16.5	13.3
Consumption				
Private Consumption	12.1	6.6	8.7	4.7
Govern. Consumption	6.7	2.0	0.7	0.2
Investment	33.6	29.9	7.4	6.0
Private Investment	38.3	33.5	7.2	5.4
Govern. Investment	4.9	15.1	0.2	0.6
Change in stocks	-	-	-0.3	2.5
Net exports	-	-	-5.5	-4.4
Exports	7.7	3.4	1.8	0.9
Imports	27.0	20.7	-7.4	-5.2
Production-side				
Agriculture, hunting and forestry	3.6	1.2	0.2	0.1
Fishing	11.4	14.2	0.0	0.0
Mining and quarrying	10.9	4.7	0.1	0.0
Manufacturing	12.3	13.6	3.1	3.2
Electricity, gas and water	12.3	7.3	0.2	0.2
Construction	14.8	17.1	0.8	0.9
Wholesale and retail trade	17.2	13.3	2.2	1.6
Hotels and Restaurants	5.1	0.3	0.1	0.0
Transport, storage and comm.	12.2	10.5	1.8	1.5
Financial intermediation	9.1	7.2	1.1	0.9
Ownership and dwelling	2.2	1.9	0.1	0.1
Real estate, renting & business	9.7	7.6	0.5	0.3
Public administration & defence	2.5	0.5	0.1	0.0
Education	3.2	0.6	0.1	0.0
Health and social work	2.5	1.1	0.0	0.0
Other community, social & pers. act.	-2.0	0.9	0.0	0.0
Private household with empl. Indiv	5.8	5.4	0.0	0.0
Sectoral total	10.5	8.9	10.5	8.9
Financial intermediation	11.8	13.0	1.0	1.0
Taxes-Subsidies	17.1	12.9	1.5	1.1

Sources: Statistical Institute

It stands within distance from a 9-month peak of 11.90% touched a couple of months earlier and remains above pre-crisis levels. Separately, new industrial orders grew at an annual rate of 27% in April after an average increase of 30.8%yoy in Q1. Although the tourism sector remained on a strong rebound throughout the first four months of the year, May's foreign arrivals to Turkey rose by a meager 4.28%yoy. This followed a 31.3%yoy jump in April and an average growth rate of 16%yoy in Q1, taking the number of visitors 14.6%yoy higher over the first five months of the year. Similarly, in spite of a rise to 76.7 in June's capacity utilization from 75.2 a month earlier, the index remains firmly below pre-crisis levels around 80. Furthermore, the business confidence index slid to a four month trough of 114.6 from 117.2 in May and the corresponding confidence indicator eased to 92.8% in May, its lowest reading since January.

Figure 2

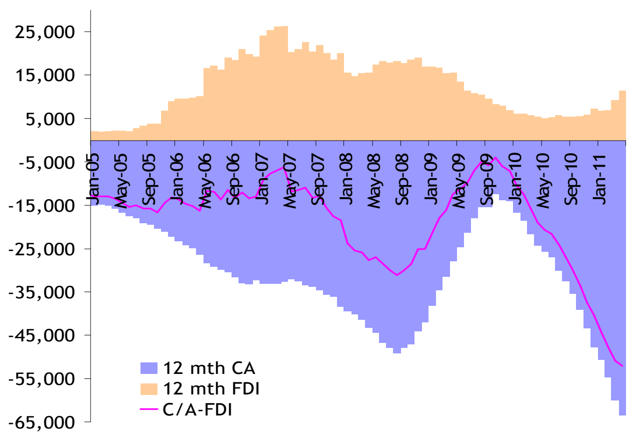
Loans growth continues to expand



Sources: Statistical Institute

Figure 3

Current account hit a fresh record high in April



Sources: CBT, Eurobank EFG

CBT held its horses in June, reaffirming commitment to the current policy mix

The CBT adopted an unorthodox policy mix late last year, holding its key policy rate at record low levels and hiking banks' reserve requirement ratios. This approach was utilized in order to contain a strong influx of hot money inflows that exacerbate widening pressures in the current account deficit and fuel domestic demand, adding to inflation and financial stability risks. In June, the Central Bank maintained its key policy rate stable at its record low level of 6.25% for the fifth month running, in line with the market's consensus. As was broadly expected, the CBT also stayed put on reserve requirement ratios (RRR), as well. The accompanying statement was rather dovish with the Bank expressing belief that domestic demand dynamics are weakening. It also read that annual CPI is anticipated to return to the path outlined in the CBT's latest inflation report as May's jump in unprocessed food inflation will likely prove of temporary nature. The CBT noted that measures endorsed recently by the Banking Regulation and Supervision Agency "will contribute to the rebalancing of domestic and external demand" adding that it will closely monitor the effect of its policy leaving the door open for additional measures "along the same lines", reaffirming its commitment to the current policy mix. The Bank abstained from indicating an upcoming rating hike trajectory and disappointed many market participants who expected a reversal of the current monetary policy mix to a more conventional one, especially now that the general elections are already behind.

Impact of CBT's unorthodox policy on the domestic economy rather limited so far; latest data adds to overheating concerns

In our view, there is little evidence so far to suggest that the policies adopted by the Central Bank are bearing the desired impact on the domestic economy. Indeed, with real interest rates currently in negative territory, concerns are on the rise lately that the CBT will fall behind the curve. Indicatively, the 12-month rolling current account deficit hit a new record high in April, which according to our calculations stands around 8%-of-GDP. Separately, May's trade deficit (goods and services) at a record high of $10.6bn (+104.2%yoy) failed to provide any comfort. In a sign of ongoing strong domestic demand dynamics, credit growth at around 35%yoy currently remains well above the 20-25% level the CBT deems as adequate to maintain financial and price stability.

In detail, total and consumer loans jumped by 36.4%yoy and 38.1%yoy respectively at the week that ended on June 17. In a move to support the Central Bank's efforts to contain the fast pace of increase in credit activity, Turkish Banking Regulator (BDDK) warned in late June it would impose higher sanctions on banks whose consumer loans are in excess of 20% of total loans. The measures include higher provisions of 4%, instead of 1% previously, on banks that breach the 20% threshold. Consumer inflation remains on an uptrend in recent months with May's headline index spiking to a 6-month peak of 7.2%yoy. The CBT highlighted that May's increase was driven primarily by a temporary rise in fruit prices, namely cherries and plums, adding that it anticipates a correction in these items in June. Even if this proves to be the case, the latest inflation reading did not bode well with the CBT's credibility and adds to concerns about second round effects. According to the latest bi-monthly survey of expectations conducted by Turkey's Central Bank, short-term inflation expectations deteriorated, with 2011-end CPI seen at 7.61%yoy vs. 7.54% in the prior poll. Furthermore, we reiterate that in view of potential second round effects, rising oil prices and fx fluctuations 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. The bank has so far abstained from raising its key policy rate in an effort to avoid encouraging hot money inflows into the country that are exerting widening pressures on the current account deficit. Moreover, it has signaled several times its commitment to its current policy mix. However, with little evidence so far suggesting a meaningful impact of the current policies on domestic demand and thus, on the current account deficit and inflation we believe that a reversal towards a more conventional policy will eventually prove inevitable. We expect around of 100bps of interest rate increases in Q4 to be followed by further tightening in 2012. A vindication of its expectations for a correction in fruit prices in June and lower CPI reading that month may provide some ammunition for the CBT to refer a swing to more conventional measures at a later stage.

Government remains committed to meet 2011 fiscal deficit target

As we mentioned in our previous New Europe Economics and Strategy report, fiscal tightening is an essential tool that should complement the CBT's efforts to facilitate domestic financial and price stability. Thankfully, the government's finances continued to improve even in the run-up to the June 12 general elections. The improvement was driven primarily by pro-cyclical factors and further tightening may be required in order for the trend to continue when the strong rebound in economic activity cools down. Indicatively, the central budget posted a TRY 2.835bn surplus, in May taking the shortfall over the first five months of the year nearly 100%yoy lower to TRY0.2bn. The 12-month trailing shortfall stood at 2.4%-of-GDP according to our calculations, signaling that the 2.8%-of-GDP target for this year remains within reach. The primary surplus which excludes interest payments jumped by 45%yoy amounting to TRY20.64bn.

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

Ukraine's economic recovery continues

- Inflation accelerated in June to 11.9% yoy, the fastest pace since December 2009, driven by higher utility and food prices
- Current account deficit remains on a widening mode, but financing remain adequate
- Next IMF loan disbursement is unlikely before September 2011
- NBU intervens to stabilise the local currency, following liberalisation of the domestic FX market

Ukraine's economy continues to recover from the deep recession of 2009

Ukrainian GDP growth accelerated to 5.3% yoy (2.9% qoq) in Q1-11 from 3.3% yoy (1.0% qoq) recorded in Q4-10. High frequency data suggest that economic growth remains robust. Industrial production increased by 8.6% yoy in May, up from 4.9% yoy in April, while retail sales continued their upward path; they stood at 15.2% yoy in May up from 13.8% print a month earlier. What's more, real wage performance stayed above 10% yoy since the beginning of this year to ease to 8.2% yoy in May. Admittedly, Ukraine's economy looks to be on the path of recovery from the deep recession of 2009. However, we foresee more subdued growth in the rest of the year as export demand is likely to remain moderate and the cost of imported natural gas continues to increase (since the price formula in the contract with the Russian Gazprom is driven by a 9 month lag to oil prices). On the other hand, we expect further robust growth in investment on the back of EURO 2012 preparations. All in all, we anticipate 4.7% yoy GDP growth in 2011, given that the IMF programme carries on to secure flows for current account deficit financing.

Current account deficit on widening mode, but financing remains adequate

In April, the current account deficit amounted to $0.3bn, which is the lowest print since the beginning of this year. Nevertheless, the current account deficit for the first four months of 2011 stood at $1.6bn compared to $0.2bn the same period a year earlier. As a result, the 12-month rolling current account continued growing and in April increased to $4.7bn or 3.2% of GDP. The deficit continued to widen in 2011 due to a fast expansion of imports, driven by higher energy prices and a continued recovery of domestic demand. However, net inflows in the capital account (in particular Eurobonds placements by the public and private sectors, and Ukrtelecom privatization proceeds) covered the current account deficit and allowed the NBU to improve its foreign exchange position in the first five months of 2011. The current account deficit is expected to continue growing as higher gas prices remain a drag on the economy. Therefore, the need to finance the current account deficit is likely to increase in the coming months, making the rigorous implementation of the IMF programme even more important. We anticipate the current account deficit to reach 3.4% of GDP in 2011.

Ukraine: Eurobank EFG Forecasts				
	2009	**2010**	**2011f**	**2012f**
Real GDP (% yoy)	-15.1	4.2	4.7	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	9.8
CPI (end of period)	12.3	9.1	11.0	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	-2.1	-3.4	-4.5
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**	**2010**	**Q1 11**
Total Credit (% GDP)	77.3	79.1	66.9	66.0
Credit to Enterprises (% GDP)	46.7	50.5	45.8	45.8
Credit to Households (% GDP)	29.5	26.4	19.1	18.2
FX Credit/Total Credit (%)	59.0	50.8	46.0	45.7
Private Sector Credit (% yoy)	68.5	-3.1	0.4	2.3
Loans to Deposits	204.0	215.9	175.9	169.7
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

IMF programme still frozen

The next IMF loan disbursement is unlikely before September as the key issues of pension reform and gas price hikes are unlikely to be resolved before Rada goes into summer recess in mid-July. Given that Ukraine continues to witness favourable developments on the balance of payments coupled with continued access to external markets, the lack of IMF funds does not pause any serious funding problems in the near term. If none of the IMF-agreed reforms gets parliamentary approval this summer, the chance of the IMF programme being off-track for the rest of 2011 increases. This is especially as the October 2012 parliamentary elections cycle will start soon, rendering the government unwilling to pass unpopular reforms.

Inflation accelerated in June to 11.9% yoy, the fastest pace since December 2009

Inflation accelerated in June to 11.9% yoy (up from 11.0% yoy recorded a month earlier) the fastest pace since December 2009 due to utility and food prices increase. In monthly terms, inflation grew by 0.4% mom in June compared to 0.8% mom in May. What's more, producer prices, an early indicator of inflation trends, rose by 20% yoy (0.5% mom) in June. We anticipate CPI to average at 10.6% yoy in 2011.

NBU's regulations on banking system liquidity to contain inflation and the recent downward pressures on hryvnia

In line with the IMF recommendation, the National Bank of Ukraine (NBU) at the end of May liberalized the FX market, allowing banks to carry out swaps and forward FX operations as well as forward contracts, despite breaches in their FX position limits. What's more, intraday buying and selling foreign currency by banks were allowed (until then banks could only buy or sell in a day), as well as unlimited FX operations between banks and households. Consequently, banks have started more aggressively buying dollars and increasing their long-term foreign currency positions. As a result of the stronger demand for dollars, pressures on hryvnia intensified and forced the NBU to spend an estimated $1.2bn of reserves in June on intervention to protect exchange rate stability. In late June, the NBU response to Ukrainian banks' speculative appetite was to cut the limit for open foreign currency positions from 20% of capital previously to 5% and switched to daily reporting from monthly. This measure came into effect on June 29, 2011 and provided banks with 30 days to adjust their position. Moreover, the NBU also announced monetary policy tightening, through deposit rates and reserve requirements hikes, which is estimated to remove over UAH 3bn in liquidity. This aimed to contain inflation as well as the recent downward pressures on domestic currency.

Lending activity continues to recover driven by corporate lending while household loans still contract, albeit at slower pace

Total credit growth continues to recover driven by loans to corporates while household lending is still in the red. Namely, total credit grew by 9.1% yoy in May (up from 8.0% yoy a month earlier) and 4.7% year-to-May; corporate lending stood at 16.9% yoy (up from 15.7% yoy in April) and 7.2% year-to-May while household loans continued to contract, albeit at an increasingly slower pace 7.1% yoy in May and -0.7% year-to-May (vs. 8.2% yoy contraction in April and 9.5% yoy recorded in the prior month). On the deposits front, the first notable decline in total deposits posted in May, by -0.5% mom (down from +2.6% mom in April) driven mainly by corporates' deposits decline by -2.4% mom (down from +5.1% a month earlier). Nevertheless, total deposits grew by 8.6% year-to-May while corporates' deposits increased by 9.5% year-to-May.

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