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NEW EUROPE ECONOMICS & STRATEGY

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Q1 GDP data suggest region increasingly susceptible to euro area debt crisis

- **Bulgaria:** First quarter GDP data signal downside risks to the domestic growth outlook
- **Poland:** Domestic economy on a moderate slowdown
- **Romania:** Risks of fiscal slippage in a period of heightened political uncertainty remain material
- **Serbia:** Fiscal outlook concerns amid increased political jitters
- **Turkey:** Soft landing underway
- **Ukraine:** Economy decelerated in Q1-2012 on weaker export demand
- **Albania:** Economic slowdown ahead; domestic banks' asset quality deteriorates but capital adequacy improves
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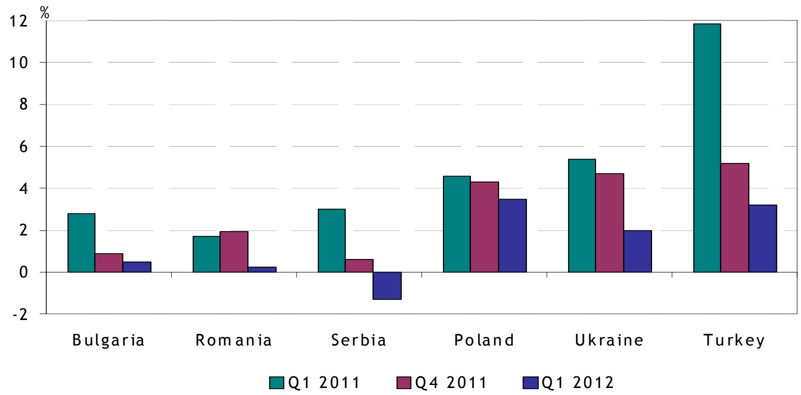
New Europe market strategy highlights

Regional FX markets: In view of the recent better-than-anticipated inflation readings and heightened expectations that the CBT may soon lower the upper limit of its interest rate policy corridor, we see increased risks of a further lira weakening in the short-term and prefer buying the USD/TRY on dips, with entry at ca 1.8150-1.8180, a target of 1.8300-1.8350 and a stop loss of 1.8040. Elsewhere, we favor entering long €/RSD positions at levels near 114, targeting the 117-118 area and stops at 112 as we expect upside pressures on the EUR/RSD to return. **In the sovereign credit space**, we favor entering short **Turkish 5-year CDS** positions at current levels near 230bps targeting 180bps and stops at 250bps. **Bulgaria's new 5-year EUR-denominated benchmark bond** looks attractive (mid-swaps +320bps). **In local rates markets,** we like entering payer positions in Turkish 2-year cross currency swaps, with entry near current levels of 6.95%, a target of 7.25% and stop-loss at 6.75%.

Impact from the euro area debt crisis increasingly evident in regional macroeconomic data (GDP %YoY)



Source: Ecowin, Eurobank Research

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Summary of key macroeconomic indicators

Realizations and forecasts

	Real GDP (yoy)			Consumer Prices (p.a.)			Fiscal Balance (%GDP)		
	2010	2011	2012	2010	2011	2012	2010	2011	2012
Bulgaria	0.4	1.7	1.0	3.0	3.4	2.0	-4.0	-2.1	-1.4
Poland	3.9	4.3	3.0	2.6	4.3	3.5	-7.8	-5.1	-2.9
Romania	-1.6	2.5	1.0	6.1	5.8	2.8	-6.4	-4.2	-2.2
Serbia	1.0	1.6	0.0	6.2	11.2	5.5	-4.7	-5.0	-4.4
Turkey	9.2	8.5	4.0	8.6	6.4	9.4	-3.6	-1.4	-1.5
Ukraine	4.1	5.2	2.8	9.4	8.0	4.5	-6.5	-4.2	-4.0
New Europe	5.2	5.7	3.0	6.4	6.0	5.9	-5.6	-3.3	-2.4
Euro area	1.9	1.5	-0.3	1.6	2.7	2.3	-6.2	-4.1	-3.5
USA	3.0	1.7	2.0	1.6	3.1	2.3	-10.6	-10.0	-8.5

	Current Account (%GDP)			Policy Rate (e.o.p.)			FX* (e.o.p.)		
	2010	2011	2012	2010	2011	2012	2010	2011	2012
Bulgaria	-1.0	0.9	0.5	currency board			1.96	1.96	1.96
Poland	-4.6	-4.3	-3.8	3.50	4.50	4.50	3.96	4.46	4.10
Romania	-4.4	-4.3	-4.7	6.25	6.00	5.00	4.28	4.32	4.45
Serbia	-7.4	-9.5	-8.5	11.50	9.75	11.00	106.1	106.9	115.0
Turkey	-6.5	-9.9	-8.0	6.50	5.75	5.75	1.54	1.88	1.75
Ukraine	-2.2	-5.5	-6.5	7.75	7.75	7.50	7.96	7.99	8.10
New Europe	-5.0	-6.6	-5.9	-	-	-	-	-	-
Euro area	0.1	0.2	0.3	1.00	1.00	1.00	1.34	1.27	1.24
USA	-3.2	-3.1	-2.9	0.250	0.250	0.250	0.75	0.79	0.81

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

I. Overview

Q1-2012 GDP data suggest region increasingly susceptible to euro area debt crisis

GDP data for Q1-2012 suggest emerging economies in New Europe are becoming increasingly susceptible to the euro area debt crisis, with recent readings in a range of high-frequency real activity and sentiment indicators predisposing for an even worse second quarter. **Bulgaria's** real GDP growth eased to 0.5% yoy in Q1-2012, from 0.9% yoy in the prior quarter and 2.8% yoy in Q1-2011. In **Romania,** economic activity slowed to 0.3% yoy in Q1-2012, from 1.9% yoy in Q4 and 1.7% yoy in the first quarter of last year. In a similar mode, **Serbia**'s real GDP came in at -1.3% yoy. This was the first negative annual reading since Q1-2010 and compares with positive growth rates of 0.5% yoy and 3.0% yoy in Q4 and Q1-2011, respectively. Relative to the rest of the economies in the region, Poland and Ukraine remained in better shape, though the signs of slowdown became more visible in Q1-2012. In **Poland**, real GDP growth slowed to 3.5% yoy in Q1, in line with market expectations, down from 4.3% yoy in Q4 and 4.6% yoy in Q1-2011. In **Ukraine**, Q1-2012 growth came in at 2.0% yoy, less than half the rates recorded in the first and fourth quarters of last year (5.4% yoy and 4.7% yoy, respectively). **Turkey** seems to have so far escaped a hard landing, despite the strong adjustment in its trade balance. Nevertheless, domestic economic activity slowed down sharply in Q1-2011, coming in at 3.2% yoy vs. 11.9% yoy in Q1-2011 and 5.2% yoy in Q4-2011.

Central Bank Watch: Currency weakness, increased risk aversion leave limited room for monetary policy easing

Headline inflation remains on a declining trend in most economies in New Europe, primarily assisted by weak demand-side pressures, favorable base effects and easing food and energy prices. However, increased depreciation pressures on regional currencies and heightened risk aversion leave limited room for additional monetary policy easing in the short-term.

More specifically,

Since last April, **Romania's** Central Bank has discontinued its earlier policy easing cycle (100bps of cumulative rate cuts delivered since November 2011), adopting a wait-and-see stance in an effort to contain increased risks to domestic financial stability.

Serbia: At its last policy meeting on June 7, the Central Bank hiked its key policy rate by 50bps to 10.00% and raised further the required domestic-currency reserves ratio in an effort to alleviate heightened depreciation pressures on the dinar. The move signals a shift in the emphasis of monetary policy from inflation and other macro developments to domestic financial stability. The freezing of the precautionary IMF agreement since last January, increased risks to the domestic fiscal outlook and heightened political uncertainty following the (inconclusive) May 6th elections have seen the dinar and dinar-denominated assets coming under increased downward pressure.

Poland: In May, the Polish Central Bank hiked its key policy rate by 25bps to 4.75%. The move primarily aimed to support policy credibility, given that domestic inflation has been above the Bank's tolerance band since February 2011. We expect the NBP to remain pat on rates at its upcoming policy meeting (August 2012), being encouraged by the most recent easing of domestic headline inflation. We continue to anticipate a 25bps rate cut towards the end of this year due to weak demand-side pressures and further inflation moderation in the second semester.

Ukraine: The NBU has eased rules for mandatory reserve requirements further. This should help the banking system maintain enough short-term monetary liquidity. Moreover, since late March easing inflation pressures have allowed the NBU to cut its key policy rate by 25bps to 7.50%, after maintaining it unchanged since August 2010.

Turkey: In line with market expectations, the Central Bank left interest rates unchanged at its MPC meeting in June. Accordingly, the key 1-week repo rate remained at a record low level of 5.75%, while the overnight borrowing and lending rates were kept at 5.00% and 11.50%, respectively. The CBT also announced a 5ppts increase to 50% in the amount of lira reserves banks can hold in foreign currency, This was the second increase in mandatory reserve requirements since the May 2012 policy meeting, aimed at boosting TRY liquidity and central bank FX reserves. It also raised by 5ppts the amount of TRY reserves to be held in gold. The CBT reiterated that it may implement further monetary tightening, if necessary, adding that it would retain its present flexible monetary policy in view of the ongoing uncertainties surrounding the global economy.

Increased political uncertainty weighs on investor sentiment towards the region

In recent weeks, the region was hit by a new bout of political uncertainty.

In **Serbia**, two months after May's parliamentary elections, a new government has yet to be formed. Ivica Dacic, the leader the of the Socialists party that came third in the elections (SPS) is in currently in coalition talks with two other political parties. Namely, the Serbian Progressive Party (SNS) which came first in the the May election but did not obtain parliamentary majority and its ally United Regions of Serbia.

In **Romania**, political turmoil persists even after the new government, supported by the Social Liberal Union (USL), a coalition of three parties (PSD, PNL and PC), and headed by Victor Ponta as the new Prime Minister, took office in late April. The USL won also the local elections on June 10th. However, it has initiated the impeachment procedure for President Basescu in Parliament. After the suspension motion successfully passed in Parliament on July 6, a referendum to determine whether the President remains in office is expected to be held on July 29. An impeachment would trigger early presidential elections, which should be held within 3 months from the day of dismissal. In any case, the domestic political calendar remains heavy with parliamentary elections scheduled in late November.

Elsewhere, geopolitical tensions escalated in recent weeks between Turkey and Syria after the latter shot down a Turkish military jet in late June. Relations between the two countries have been strained lately amid the 2011 Syrian uprising, with throusands of refugees fleeing to Turkey.

Strategy - Emerging New Europe Markets

Regional FX markets: Our earlier **short EUR/TRY and USD/TRY positions** were stopped out in mid-May, amid escalating euro area risks and heightened global growth concerns. In view of the recent better-than-anticipated inflation readings and heightened expectations that the CBT may soon lower the upper limit of its interest rate policy corridor, we see increased risks of a further lira weakening in the short-term. As such, we prefer buying the USD/TRY on dips, with entry level at ca with entry at ca 1.8150-1.8180, a target of 1.8300-1.8350 and a stop loss of 1.8040. Elsewhere, the **Serbian dinar** has trimmed some of its recent losses after hitting new record lows of 120/EUR on June 5. Even so, we expect upside pressures on the EUR/RSD to return, taking into account the ongoing political uncertainty after the May 2012 election, the freezing of the precautionary IMF Stand-By Arrangement earlier this year and the recent deterioration in the country's fiscal position. Against this background, we favor entering long €/RSD positions at levels near 114, targeting the 117-118 area and stops at 112.

In the sovereign credit space, we collected profits on our earlier **long Turkish 5-year CDS** trade initiated in mid-May (entry level at 230bps and target at 270bps). The spread currently stands near 230bps. From a technical stand point, we favor entering short positions at current levels targeting 180bps and stops at 250bps. Bulgaria's new 5-year EUR-denominated benchmark bond looks attractive at mid-swaps plus 320bps, especially taking into account the country's limited amount of external debt outstanding, half of which matures in January 2013. Investors who face high funding costs for this position may alternatively short Bulgarian 5-year CDSs near 300bps, with a target of 250bps and a stop loss of 325bps. Separately, our earlier **long Hungarian 5-year CDS spread** trade with entry level at 545bps and target at 750bps hit our stop loss (490bps) in early July. Also, we closed our earlier basis trade of **buying 5-year protection on Turkey along with the Turkish USD-denominated 7½% February 2017 bond** and collected the carry, as the trade has remained relatively stable over the last few weeks. Similarly, we closed the previous **long Romanian 10-year CDS vs. buying the Romanian 6 ¾ February 2022 USD-denominated bond**. Our previous call of going **long 5-year protection on Russia vs. shorting 5-year protection on Poland** hit our stop loss in May and we prefer to stay sidelined at current levels.

In the **local rates markets**, in view of lingering global risks and the CBT's apparent commitment to support the domestic currency during periods of increased volatility through higher short-term rates, we like entering payer positions in Turkish 2-year cross currency swaps, with entry near current levels of 6.95%, a target of 7.25% and stop-loss at 6.75%.

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

First quarter GDP data signal downside risks to the domestic growth outlook

- Real GDP growth slowed down to 0.5% yoy in Q1 2012 compared to 0.9% yoy in Q4 2011 on weaker net exports
- Fiscal performance in Jan-April shows tangible evidence of achieving the full year target
- The EU Commission recommended to have the Excessive Deficit Procedure abrogated for the case of Bulgaria

The Bulgarian economy slowed down further to 0.5% yoy in the first quarter of 2012 compared to 0.9% yoy in the previous quarter

The Bulgarian economy recorded the lowest growth reading in the last six quarters. On a yoy basis, real GDP grew by 0.5% in the first quarter of 2012, down from 0.9% yoy in the fourth quarter and 1.4% yoy in the third quarter of last year. On a quarter on quarter seasonally adjusted basis, GDP growth remained flat in the first quarter, down from 0.1% qoq in the fourth and the third quarters of 2011. Still, GDP growth in Q1-2012 was still stronger than the EU-27 average (+0.0% qoq/+0.1% yoy).

Private consumption, the largest component of GDP, expanded by 1% yoy in Q1, up from -0.4% yoy in the prior quarter and -0.6% yoy in the first quarter of 2011. Private consumption received support primarily from positive real wages despite weak labor market demand. Unemployment stood at 12.9% in Q1-2012, the highest level in 2009-2012. Nominal wages increased by 8.8% yoy in Q1, at the same time when average annual inflation declined to 1.9% yoy.

Investment activity was once again in red for a thirteen quarter in a row dragging down growth performance. Investment contracted by 5.4% yoy in Q1 vs. 10.4% yoy in the last quarter of last year. However, the good news is that investment registered its first positive qoq growth since Q4 2008 (+0.4% qoq in Q1 vs. -1.2% qoq in Q4), which creates hopes of bottoming out. Investments as a percentage of GDP have dropped to 23% in 2011 against a record high at 37% in 2008. The post-crisis drop in investments is largely explained by the decline of FDI inflows (from 9 bn. Euros in 2007 to 1.3bn Euros). In addition, firms have expressed their retrenchment plans postponing capital investments in fear of a new round of recession induced by the Euroarea sovereign crisis.

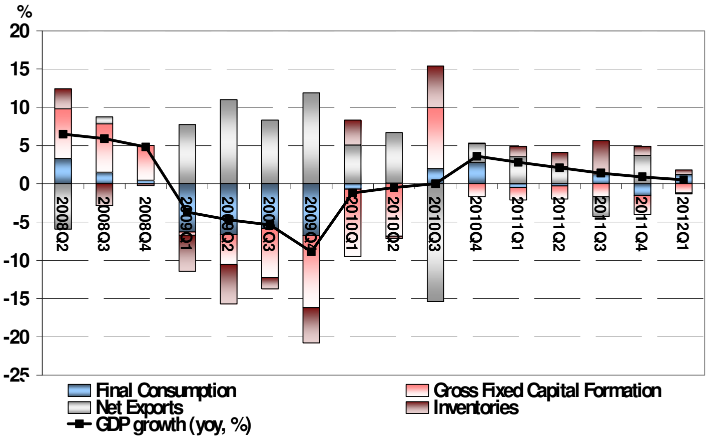
Bulgaria: Eurobank EFG Forecasts

	2009	2010	2011	2012f
Real GDP (yoy%)	-5.5	0.4	1.7	1.0
Final Consumption	-7.3	0.5	-0.3	0.8
Gross Capital Formation *(Fixed)*	-17.6	-18.3	-9.7	1.0
Exports	-11.2	14.7	12.8	2.0
Imports	-21.0	2.4	8.5	3.5
Inflation (yoy%)				
HICP (annual average)	2.5	3.0	3.4	2.0
HICP (end of period)	1.6	4.4	2.0	1.8
Fiscal Accounts (%GDP) - *Cash Basis*				
General Government Balance	-0.9	-4.0	-2.1	-1.4
Gross Public Debt	15.6	16.7	17.0	18.3
Primary Balance	-0.2	-3.3	-1.4	-0.5
Labor Statistics - *National Definitions*				
Unemployment Rate (registered, %)	9.1	9.2	10.4	10.0
Wage Growth *(total economy)*	11.8	6.4	9.1	3.5
External Accounts				
Current Account (% GDP)	-8.9	-1.0	0.9	0.5
Net FDI (EUR bn)	2.4	1.2	1.3	1.5
FDI / Current Account (%)	78.2	321.6	371.1	Na
FX Reserves (EUR bn)	12.9	14.1	14.9	15.0
Domestic Credit	**2009**	**2010**	**2011**	**Q1 12**
Total Credit (%GDP)	76.8	76.4	74.5	74.9
Credit to Enterprises (%GDP)	47.9	48.2	48.0	48.3
Credit to Households (%GDP)	27.3	26.4	24.6	24.6
FX Credit/Total Credit (%)	58.6	61.3	63.7	64.1
Private Sector Credit (yoy)	4.5	2.1	3.9	3.6
Loans to Deposits (%)	120.0	112.9	104.0	102.0
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

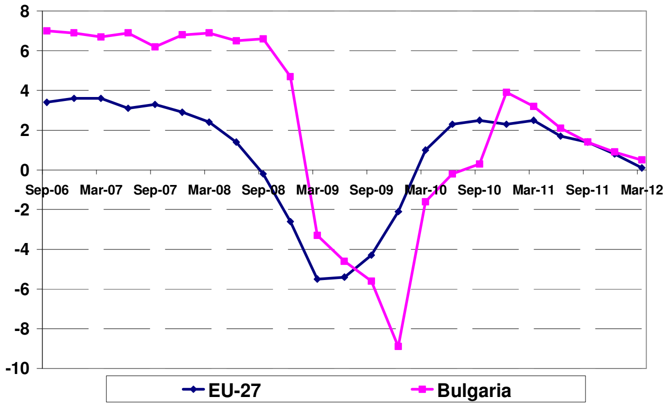
Exports registered the first negative yearly performance since the start of recovery in 2010. On a quarterly basis, exports contracted by 2.8%, which translates into a 0.1% decrease on an annual basis. In contrast, imports were lower by only 0.8% on a quarterly basis but remained flat on a yearly basis.

Figure 1
The principal growth driver switched to domestic demand from net exports



Source: National Statistics, Eurobank Research

Figure 2
Bulgaria still fared better than EU average in the first quarter of 2012



Source: Eurostat, Eurobank Research

Overall, the first quarter output performance is weak and underlines the downside risks to the annual growth outlook. The Euroarea sovereign crisis and bad weather conditions weighed negatively on the growth performance of Q1-2012. On the positive side, total consumption was the only element with a positive contribution (+1.2 pps in Q1). If this is combined by the bottoming out of investment, it lends support to our assumption that there will not be another round of painful recession of domestic demand. Thus, the principal growth driver will switch to domestic demand from net exports given that a number of downside risks are materializing for exporters. Although the exports portfolio has accomplished to diversify to non EU market destinations in recent years (to reach approximately 40% of total exports), the magnitude and duration of the recession in Euroarea casts a shadow on growth prospects in 2012.

Our full year forecast still assumes a mild recession in Euroarea (our dedicated economists' forecast has been revised downwards to -0.3% in 2012) with no major deleveraging banking sector spillovers in Bulgaria. While the global environment does not bode well, the Euroarea sovereign crisis is the most imminent threat to Bulgaria. Bulgaria is highly dependent on EU, not only in terms of trade and capital flows, but also through banking system interlinkages. In the worst case scenario, an external shock from a prolonged EU debt crisis or a disruption in capital flows could push Bulgaria again into deep recession.

Fiscal performance in Jan-April demonstrates tangible evidence of achieving the full year target.

The latest budget execution data reveals that the full-year deficit target for 2012 will most likely be attained. The year-to-April general government deficit (cash basis) declined by 60.1% yoy to BGN 0.22bn or 0.3%-of-projected GDP. This compares to a 0.9%-of-GDP deficit realization in the same period a year earlier. According to the Ministry of Finance, the full-year general government deficit in ESA terms declined to 2.1%-of-GDP in 2011, from 3.1%-of-GDP in 2010, and is expected to shrink further to 1.9%-of-GDP this year and to 1.7%-of-GDP in 2013.

Bulgaria's full-year deficit compares favorably to the corresponding EU-27 average for 2012 (~3.6%-of-GDP as per the European Commission's Spring 2012 Forecasts). Furthermore, the country's public debt is forecasted to increase moderately from 16.3%-of-GDP at the end of 2011 to 17.6%-of-GDP in 2012, the second lowest ratio in the EU in 2012 behind Estonia. As a result, the EU Commission recommended in late May to having the Excessive Deficit Procedure abrogated for Bulgaria.

The government plans to issue Eurobonds to address the redemption needs of January 2013

Bulgaria is about to tap the international markets after eleven years. The cabinet approved the issuance of five or seven year Eurobonds worth €950 mn. The issuance is geared to address the external debt redemption needs (1.8bn Leva-€835 mn) in January 2013. In principle, the budget law allows for the repayment of debt and the projected deficit to be financed through privatization receipts, short-term (up to three years) domestic market denominated securities and a Eurobond placement in the international market. The Ministry of Finance opted for the Eurobond solution as market conditions are relatively favorable. The latter is illustrated in EMBIG spreads of around 250bps. Moreover, Bulgaria never lost its investment grade credit rating status throughout the post-Lehman Brothers period. In addition, the issuance is going to further increase the fiscal reserve, thus ensuring currency board stability. The fiscal reserve stood at BGN 4.9bn in May, above the BGN 4.5bn threshold stipulated in the Budget law.

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

Domestic economy on a moderate slowdown

- GDP growth was solid in the first quarter at 3.5% yoy in line with market expectations
- Fiscal consolidation is on track to meet the general government deficit target of 2.9% of GDP in 2012
- Inflation fell to its lowest print for more than a year on the back of easing food and energy inflation
- National Bank of Poland kept interest rate unchanged at 4.75% in June as inflation has started to moderate
- Lending to enterprises continued to rise while households credit decelerated further.

GDP growth was solid in Q1-12 at 3.5% yoy in line with market expectations

Poland's economic growth slowed in Q1-12 to 3.5% yoy (0.8% qoq), down from 4.3% yoy (1.0% qoq) in Q4-11 on exports weakening coupled with declining contribution from investments. Namely, fixed capital formation increased by 6.7% yoy in Q1-12, slowing from 9.7% yoy in Q4-11. Investments accounted for 0.8ppts of the 3.5% headline growth while Q4's investment contribution was 2.8ppts, well above half of the headline GDP growth figure, as projects related to EURO 2012 (sport facilities, road and railway upgrades) have completed. Exports slowed to 4.8% yoy (-2.4% qoq) in Q1-12, compared to 7.9% yoy (2.4% qoq) in Q4-11 on Euroarea turmoil, which reduced demand for exports; exports contributed 0.7ppts to GDP growth. Private consumption grew by 2.1% yoy in Q1-12, the same as in the previous quarter. In all, domestic demand contributed 2.7ppts to Q1-12 GDP growth vs. 3.2ppτs in Q4-11.

Real GDP growth is projected to decelerate from 4.3% yoy in 2011 to 3.0% yoy in 2012 as a result of softer external demand, uncertainty related to the Euro area crisis, the ongoing fiscal consolidation, the marked deceleration of public investment in the aftermath of the EURO 2012 Football Championship and the levelling off of the EU funds. Despite the gradual slowdown in 2012, the Polish economy remains one of the strongest performers in Emerging Europe and is one of the most resilient in the region. However, should the euro-crisis deepens, prospects for Polish exports to the Euro-zone economy, which account for 55% of total exports, look grim. Overall, negative trends in foreign trade are expected to continue in 2012, with both exports and imports slowing down in comparison to developments in previous years. Nevertheless, the contribution of net exports to growth will increase as growth in exports, driven partially by still weak currency, should exceed that in imports.

Poland: Eurobank EFG Forecasts

	2009	2010	2011	2012f
Real GDP (% yoy)	1,6	3,9	4,3	3,0
Private Consumption	2,1	3,2	3,1	2,2
Government Consumption	2,2	4,2	-1,4	0,5
Gross Capital Formation	-11,5	9,3	9,6	6,5
Exports	-6,8	12,1	7,5	4,8
Imports	-12,4	13,9	5,8	2,9
Inflation (% yoy)				
CPI (annual average)	3,5	2,6	4,3	3,5
CPI (end of period)	3,5	3,1	4,6	3,2
Fiscal Accounts (% GDP)				
General Government Balance	-7,4	-7,8	-5,1	-2,9
Gross Public Debt (ESA95 definition)	50,9	54,8	56,3	54,9
Gross Piblic Debt (national definition)	49,8	52,8	53,5	52,5
Labor Statistics (%)				
Unemployment Rate (% of labor force)	11,0	12,1	12,4	12,5
Wage Growth *(private sector - average)*	5,2	4,2	5,2	4,7
External Accounts				
Current Account (% GDP)	-3,9	-4,6	-4,3	-3,8
Net FDI (bn EUR)	6,0	2,5	6,6	6,0
FDI / Current Account (%)	76,9	40,6	65,0	60,0
FX Reserves (bn EUR)	55,2	70,0	75,7	78,0
Domestic Credit	**2009**	**2010**	**2011**	**Q1 12**
Total Credit (% GDP)	53,0	55,2	58,9	57,6
Credit to Enterprises (% GDP)	16,1	15,1	16,6	16,4
Credit to Households (% GDP)	31,5	34,1	35,5	34,5
FX Credit/Total Credit (%)	30,2	30,8	32,5	30,9
Private Sector Credit (% yoy)	7,2	8,9	13,5	11,5
Loans to Deposits (%)	102,6	102,4	105,2	104,5
Financial Markets	**Current**	**3M**	**6M**	**12M**
Policy Rate	4,75	4,75	4,50	4,50
EUR/PLN	4,28	4,10	4,20	4,10

Source: NBP, EcoWin, Bloomberg, Eurobank Research

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Fiscal consolidation is on track for 2012

The government is on track to meet its general government target of 2.9% of GDP in 2012 as a result of a better than expected budget outcome in 2011 and consolidation measures. Almost half of fiscal measures concern the revenue side, with the largest items being a rise in the disability pension contribution and the weakening of the second pension pillar. On the spending side, the continued freeze on the wage bill and the maintenance of a spending cap on discretionary spending, coupled with lower public investment, will contribute to deficit reduction.

Inflation fell on the back of easing food and energy inflation

Polish headline inflation for May decelerated to 3.6% yoy, from 4.0% yoy in April, undershooting the expectation of 3.8% yoy. This was the lowest print since February 2011. Moreover, core inflation (measure that excludes food and energy prices) fell pretty sharply as well, from 2.7% yoy in April to 2.2% yoy in May. Admittedly, headline inflation fell pretty much everywhere in Emerging Europe in May on the back of easing food and energy inflation. However, in Poland the headline rate could rise back in June due to EURO 2012 and the associated spike in accommodation prices. Yet, this will likely be limited and temporary. Overall, we forecast inflation to start converging towards the target's upper limit (of 3.5% yoy) until the end of 2012 reflecting a gradual decline in commodity prices and weaker domestic demand.

Monetary policy to keep rates on hold

In May, the Polish Central Bank (NBP) hiked its key policy rate by 25bps to 4.75%. That move was rather intended to support NBP's credibility in adhering to the inflation targeting monetary policy since headline inflation has been above the upper inflation target's upper limit since February 2011. In June, the NBP kept the policy interest rate unchanged. Given the recent large fall in headline inflation we do not expect an interest rate hike in the July MPC meeting. We anticipate a rate cut of 25bps towards the end of this year due to economic slowdown coupled with inflation moderation in the second semester.

Lending to enterprises continued to rise while households' credit decelerated further

In April, lending to enterprises continued to rise, albeit at a slower pace; it grew by 13.3% yoy compared to 15.0% in the prior month. At the same time, growth in lending to households decelerated further 0.4% mom in April from 0.7% mom in March and -4.0% year-to-April due to ongoing decline in consumer loans and slower growth in mortgages.

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

Risks of fiscal slippage in a period of heightened political uncertainty remain material

- The economy slipped again into technical recession in Q1-2012, contracting by 0.1% qoq
- The precautionary IMF-EU agreement remains on track: all quantitative criteria except those of public sector arrears were met in the fifth programme review
- The current account deficit came in at €1.23bn in Jan-April, 44% lower on a yearly basis

New coalition government remains committed to the existing precautionary IMF-EU agreement

The collapse of the previous government under Prime Minister Ungureanu on April 27th through a no confidence vote in the parliament, raised concerns about the country's commitment to the existing IMF-EU agreement. However, the new government supported by the Social Liberal Union, a coalition of three parties (PSD, PNL and PC) and headed by Victor Ponta as the new Prime Minister, vowed to remain committed to the structural reforms and fiscal consolidation program underlying the existent EU-IMF precautionary agreement.

Romania earlier completed successfully four reviews under the present precautionary programme without making any use of the designated funds. The fifth review of the existing programme incepted in April 24 and was about to finish in May 7. Yet, its completion was delayed until May 10 to account for the formation of the new government. The IMF mission assessed that all quantitative criteria were met with the exception of public sector arrears, which was missed by a small margin. At the same time, the IMF mission encouraged the government to accelerate structural reforms.

Overall, Romanian authorities have established a record of successful co-operation within the program with IMF despite political turbulence. Part of this success can be attributed to the flexibility of IMF in the revision of quantitative targets. In contrast, the pace of structural reforms has been disappointing. The privatization program has remained sidetracked following a series of unsuccessful auctions of a number of state-owned companies. However, the new government has pledged to abide by the timetable for the sale of stakes through initial public offerings in the state owned energy companies (Romgaz-Hidroelectrica-Nuclearelectrica). Moreover, the EU funds absorption of total allocations in 2007-2013 remains still relatively low despite its improving trend (from 3.7% in Sep2011 to 8.8% in May2012 against a full year target of 20%).

Romania: Eurobank EFG Forecasts

	2009	2010	2011	2012f
Real GDP (yoy%)	-6.6	-1.6	2.5	1.0
Real Domestic Demand	-12.0	-1.5	2.8	0.7
Consumption	-7.4	-1.3	0.4	-0.5
Investment	-28.1	-2.1	2.6	5.5
Exports	-6.4	14.0	11.7	5.0
Imports	-20.5	11.9	11.2	6.5
Inflation (yoy%)				
CPI (annual average)	5.6	6.1	5.8	2.8
CPI (end of period)	4.9	8.0	3.1	3.2
Fiscal Accounts (%GDP, Cash Basis)				
General Government Balance	-7.3	-6.4	-4.2	-2.2
Gross Public Debt	30.0	37.9	40.0	39.4
Labor Statistics (annual avg,%)				
Unemployment Rate (% of labor force)	7.8	7.0	5.1	6.5
Wage Growth (total economy)	8.4	2.5	4.9	5.8
External Accounts				
Current Account (%GDP)	-4.2	-4.4	-4.3	-4.7
Net FDI (EUR bn)	3.6	2.2	1.9	2.5
FDI / Current Account (%)	72.3	40.5	31.7	37.0
FX Reserves (EUR bn)	30.9	36.0	37.3	35.0
Domestic Credit *(end of period)*	**2009**	**2010**	**2011**	**Q1 12**
Total Credit (%GDP)	49.2	51.8	50.8	52.4
Credit to Enterprises (%GDP)	19.2	20.0	19.9	20.0
Credit to Households (%GDP)	20.0	19.5	18.0	17.9
FX Credit/Total Credit (%, private)	60.1	63.0	63.4	63.7
Private Sector Credit (yoy)	0.9	4.7	6.6	10.0
Loans to Deposits (%)	130.6	137.7	142.5	135.1
Financial Markets	**Current**	**3M**	**6M**	**12M**
Policy Rate	5.25	5.00	5.00	5.00
EUR/RON	4.46	4.45	4.45	4.40

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

Public finances are still on track, yet the risk of fiscal slippage ahead of parliamentary elections is material

The outgoing coalition government had targeted a general government deficit of 1.9% of GDP on a cash basis in 2012 (or 2.1%-of-GDP after a number of IMF-approved off-budget expenditure items). However, following the formation of the new cabinet, an agreement was reached with the IMF to revise upwards the 2012 deficit target to 2.2% of GDP, from 1.9%, so as to create room for an increase in public wages to their early 2010 levels. This is estimated to increase this year's shortfall by ca 0.4ppts-of-GDP, with a further 0.1ppts-of-GDP coming from a return of health contributions paid earlier by pensioners. Public sector wages will rise in two installments. The first will take place in June (wages will rise by 8%) and the second will take place in January (wages will rise by another 7.4%). Nevertheless, in ESA95 terms, the fiscal deficit target for 2012 remains unchanged at 3%-of-GDP.

For 2012, the risk of fiscal slippage in view of this year's heavy election calendar remains material (local elections in June, parliamentary elections in late November). Rating agencies (Fitch and Moody's), have already warned about risk of a downgrade in the long term credit rating if fiscal slippages are generated in the future. The budget execution data for January-April 2012 revealed an overall deficit figure of RON 5.02bn, higher by 5.8% yoy. This is an equivalent of 0.83%-of-projected GDP, the ratio staying almost flat compared to the same period last year. Consolidated budget revenues grew moderately by 7.4% yoy to RON 62.3bn in January-April 2012, driven by better revenue collection. Consolidated budget expenses stood at RON 67.3bn, up by 7.9% yoy. Higher spending on debt servicing (+44% yoy) together with higher outlays related to EU funded projects-bridge financing (+65.8% yoy) were the main drivers behind the rise. In conclusion, the fiscal performance is broadly in line with the revised full year target. However, any acceleration of primary spending ahead of the parliamentary elections may derail fiscal performance and put the achievement of the revised fiscal target at risk.

The current account deficit came in at €1.23bn in January-April, 24% lower on a yearly basis

The current account data published in January-April 2012 may not be illustrative of the full year trends. The current account deficit came in at €1.23bn during January-April, 24% lower on a yearly basis (Table 1).

Table 1
Balance of Payments January-April 2012

mn Euros	January-April 2011			January-April 2012			%
CURRENT ACCOUNT	18.754	20.367	**-1.613**	19.557	20.787	**-1.230**	**-24%**
A. Goods & Services	16.448	18.288	**-1.840**	16.838	18.605	**-1.767**	**-4%**
a. Goods (exports fob - imports fob)	14.443	16.242	-1.799	14.545	16.414	-1.869	**4%**
b. Services	2.005	2.046	-41	2.293	2.191	102	**-349%**
- transport	618	416	202	649	420	229	**13%**
- tourism - travel	287	376	-89	315	400	-85	**-4%**
- other	1.100	1.254	-154	1.329	1.371	-42	**-73%**
B. Incomes	341	1.231	-890	409	1.258	-849	**-5%**
C. Current transfers	1.965	848	**1.117**	2.310	924	**1.386**	**24%**

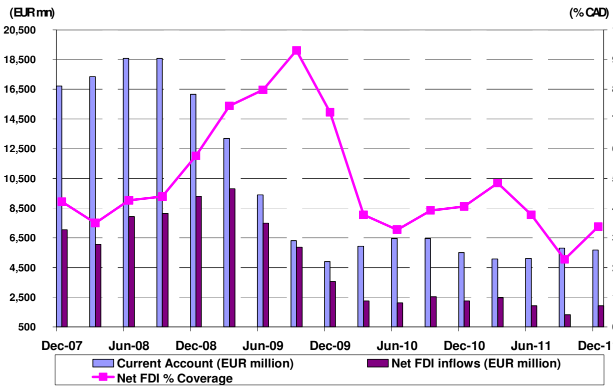
Source: NBR

ts dynamics are heavily influenced by the volatility in public transfers which boosted the current transfers' surplus. This is a pattern witnessed in the past years as well. The improvement in net current transfers (by 24.0% yoy to €1.3bn) was the major driver behind the current account improvement. The deterioration in the trade deficit (by 4.0% yoy to €1.8bn) partially offset the current account improvement. Exports increased by 0.7% yoy, while imports barely inched up by 1.1% yoy against a backdrop of a weak euro area macro environment.

On the financing side, Romania has been no exception from the regional pattern of capital inflows drying up in the aftermath of the international financial crisis. Net FDI inflows, the most important source of balance-of-payments financing during the boom times, lost significant ground in the aftermath of the crisis. Net FDI inflows declined from an all time high at €9.8bn in 2008 to €2.2bn in 2010 and to €1.8bn last year. In 2011, net FDI inflows covered only 31.7% of the corresponding current account deficit against 40.6% in the prior year and 72.3% in 2009. FDI inflows cover 36.3% of the current account deficit in Jan-April 2012. (Figure 1)

Portfolio inflows, climbed to €2.1bn in 2011, from €875mn in the prior year. Their relative share in the financial account surplus has increased from 3% in 2007-2008 to 16% in 2010 and to 43% in 2011. The rise can be broadly attributed to increased public debt issuance. Last but not least, net other capital investments-which comprise of new and rolled-over loans to the government and private sector-has come down to €1.89bn last year, from €5.83bn in 2010 as the government didn't make any use of IMF funding in 2011.

Figure 1
The coverage of the current account by FDI inflows has declined significantly since 2008



Source: Eurobank EFG Research, NBR

Looking ahead, we anticipate this pattern of financing to be repeated in 2012. The prospect of a significant rebound in capital inflows is limited in the foreseeable future, especially taking into account the lingering sovereign debt crisis in the euro area. Yet, the government's privatization program may provide some support. We forecast net FDI inflows to amount to €2.5bn in 2012. The financial account data in the first quarter showed that net FDI inflows came in at €446mn in Jan-April 2012 down by only 4.3% yoy, a rather encouraging sign considering that no privatization took place at that period and that FDI inflows are traditionally stronger in the 2H.

Moderate widening in the current account is still expected in 2012 on weakening conditions in main trade-partner economies

Our baseline macroeconomic scenario entails a moderate widening of the current account shortfall this year. Balance of payments developments in 2012 are expected to be driven by three major trends.

The first is the realized depth of expected recession in the euro area, by far the major trade partner of Romania. The Romanian economy is particularly sensitive in that respect, given that EU-27 absorbed as much as 70% of total Romanian exports in 2011. Secondly, the magnitude of domestic demand rebound in 2012. Under our baseline macroeconomic scenario, domestic demand is likely to take the lead over next exports as the primary GDP growth driver this year. In turn, the domestic demand rebound will lead to a further expansion of imports. That is going to be reflected both on imported consumer goods (around 20%), as well as on imported intermediate goods (around 50%) used as inputs in the manufacturing process. The two aforementioned trends will likely lead to widening pressure on the trade deficit.

Third, the rate of EU funds absorption. In principle, EU funds boost current transfers which traditionally offset some of the trade deficit. The outgoing government has promised to step up EU funds absorption by at least EUR 6bn (~5ppts-of-GDP) in each of the coming four years. However, EU funds are channeled to infrastructure projects, which necessitate even more imports of raw materials and capital equipment. At the same time, the public investment program targets spending totaling 6.5% of GDP that will have a strong positive impact on investments but also a negative impact on the balance of payments.

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Focus: Economic Growth: NIS confirms flash estimates of q-o-q contraction

Official estimates from the National Institute of Statistics confirmed that the Romanian economy shrank 0.1% in the first quarter of 2012 compared with the previous quarter. As mentioned in our previous bulletin, the q-o-q contraction was to a large extent the effect of harsh weather conditions in the first two months of the year. Against this backdrop, domestic demand shrank by 1.9% q-o-q. Fiscal retrenchment added to the contractionary pressures as public administration consumption decreased by 3.6%.

Gross capital formation was the GDP component that recorded the highest increase, albeit only at 0.7% q-o-q. Encouragingly, investment growth was driven by gross fixed capital formation (up 1.1% q-o-q) as opposed to inventories. Weak external demand took its toll on exports, which increased marginally by 0.6% q-o-q. Imports shrank by 0.8% q-o-q. The slowdown of trade is evident if one considers that both exports and imports decreased in annual terms (2.9% and 1.2% y-o-y respectively).

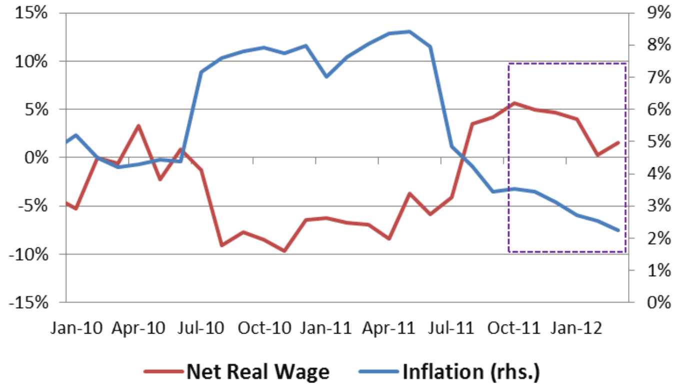
Monthly indicators show economic activity has rebounded from the weather shocks, but further progress is likely to remain slow.

Retail

Retail sales decreased by 2.3% m-o-m in February, most likely as a corollary of the adverse weather shocks, but recoiled in the subsequent months. Total sales increased by 0.8% m-o-m in March and a further 1.7% in April. The pick-up was primarily generated by non-food products and fuel (0.7% and 1% respectively m-o-m in April).

Consumer confidence also improved in recent months. The index increased from 29.2 points in March to 35.3 in May. These developments are particularly important when we take into consideration income dynamics. The annual growth rate of net real wages had accelerated to a 4-6% range starting from July 2011, but later decelerated in the 0-2% range from February 2012, as shown in Figure 1. We believe these developments have been closely related to inflation dynamics. Consumer prices receded quickly starting from July 2011 and undershot inflationary expectations of consumers. Net nominal wages remained sticky in the short term, and net real wages increased subsequently. We believe the adjustment of net real wages that started in November 2011 has been a direct corollary of consumers adjusting their future price expectations (the purple box in Figure 1 shows how net real wages and inflation have been moving in tandem). Romanian inflation expectations have a very strong backward looking component. As inflation has remained at very low historical levels for the past three quarters, we believe consumers are now pricing in a lower level for future consumer prices.

Figure 1
The dynamic of net real wages is a direct corollary of adjustments of inflationary expectations



Source: National Statistics

Industrial Production

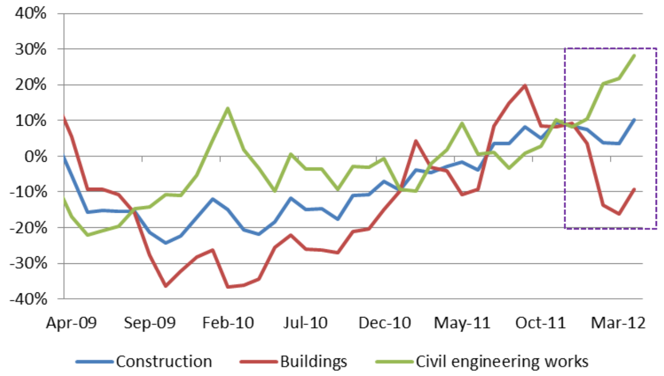
Developments in the industrial sector have been relatively slow. Aggregate industrial production increased by 1.3% m-o-m in March (after shrinking by -1.4% m-o-m in February) and a further 1% in April. The rebound was expected as February figures were influenced by the bad weather. Manufacturing recorded a similar dynamic (fell by 2.3% in February, rebounded by 2% in March and a further 1.3% in April). Akin with Q1 exports, manufacturing is now shrinking on an annual basis. Production in this sector fell 0.2% y-o-y in April, and has been hovering around low levels for the past 5 months.

However, the short-term outlook for industrial production is not benign. New domestic orders had increased on a monthly basis throughout the first three months of the year, but shrank 0.5% m-o-m in April. Moreover, foreign orders shrank by 7.1% m-o-m in April.

Construction

Economic activity in the construction sector over the first four months of 2012 has been marked by a growing division between building construction and civil engineering works. The former shrank by 9.2% y-o-y in April, whereas the latter increased by 28.3%, as shown in Figure 2. However, monthly data show that the gap between the two sub-components is shrinking. Building works increased by 7.4% m-o-m on average from February to April. Over the same period, civil engineering works increased by 4.3% m-o-m on average.

Figure 2
The gap between construction of buildings and civil engineering works has increased in the first four months of the year



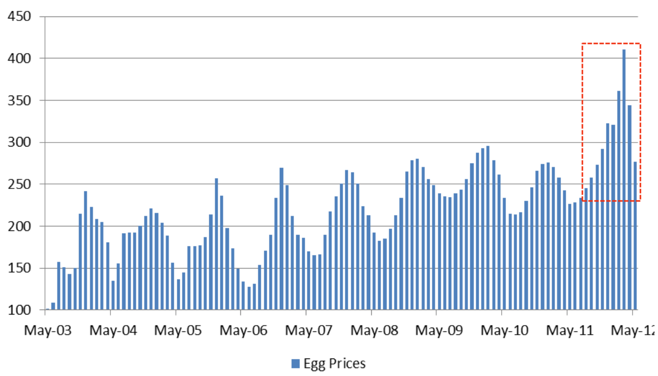
Percentage points, y-o-y growth rates
Source: Eurostat

Romanian inflation rate falls to historical low levels on the back of very low food prices.

May headline inflation descended to 1.79%, marginally lower than the previous month's reading of 1.8%. This is the lowest level ever recorded by the index. Food prices remained the main driver of this short term trend (-2.1% y-o-y). However, a growing divide is now evident between food prices, non-food goods (3.3% y-o-y) and services (6.2% y-o-y). Subsequently, headline inflation remains lower than CORE3 inflation (at 2.2%).

Egg prices have been one of the most volatile components of the CPI in recent months, as Figure 3 shows. The price of eggs increased by 80% from May 2011 to March 2012, but receded 32% in April and May 2012. The Central Bank has acknowledged this factor in its May inflation report and described it as a transitory supply shock generated by an expiring EC directive. Moreover, such shocks were recorded in other EU countries such as the Czech Republic, Bulgaria or Hungary.

Figure 3
Egg prices have been one of the most volatile components of the CPI



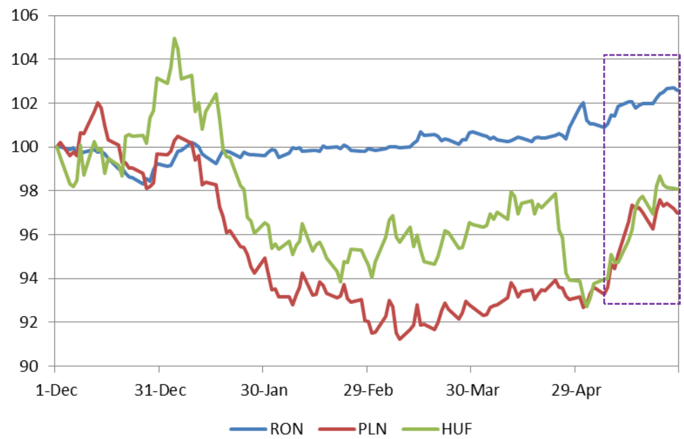
Index, Jan 2000 = 100
Data Source: NIS

Subsided inflationary pressures have created space for a further reduction of the NBR policy rate at this month's meeting. However, the Bank has signaled a growing focus on maintaining financial system stability after its last monetary policy meeting. At the time, political instability had increased the volatility of the domestic currency and capital flows. The Bank subsequently decided to suspend its rate cutting cycle to provide support for the RON.

The domestic currency had disconnected from other regional currencies in the first four months of the year However, this trend was quickly reversed towards the end of May when growing uncertainty over Europe trickled into CEE currencies, including the RON. Against this backdrop, it is important to note the relative stability of the RON, as shown in Figure 4. Moreover, Central Bank officials have recently come out in support of the Romanian currency stating that probability that the exchange rate may rise to 5 RON/EURO is very low and that the Bank stands ready to use all tools to defend against such depreciated levels.

Taking into account the elevated volatility in capital markets, we believe the NBR will maintain the reference rate unchanged at the June monetary policy meeting in spite of the benign inflationary environment.

Figure 4
The RON has been one of the most stable CEE currencies over the past two months



Index, Dec 2011 = 100
Data Source: Thomson Reuters

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

Fiscal outlook concerns amid increased political jitters

- Despite expectations for the opposite, Mr. Tomislav Nikolic was elected President in the second round of Presidential elections, complicating the formation of a multi-party government
- The Fiscal Council warns over a looming fiscal crisis if no fiscal consolidation measures are taken by the new government
- Recession deepens in the first quarter of 2012: Flash real GDP estimate came at -1.3% yoy, the first yearly negative performance since Q1-2010
- NBS hiked interest rates by 50bps to 10% in order to address significant currency depreciation pressures, signaling a change in the monetary policy

Both parliamentary and presidential elections are over, though political uncertainty remains; Negotiations to form a multi party government are underway

Against all odds, Mr. Tomislav Nikolic won the second round of the Presidential elections in May 20th. The leader of the main opposition Serbian Progressive Party (SNS**)** gained 49.5% of the vote vs. 47.3% for the outgoing President Boris Tadic, leader of the Democratic Party (DS). The result of the Presidential elections complicated the formation of the new government. The Democratic Party (DS) decided to nominate the outgoing President Boris Tadic for Prime Minister designate in the negotiations with other smaller parties. At the same time, for the first time a newly elected President may have to appoint a Prime Minister that is not from his own party, in case Mr. Tadic wins the support of other smaller parties. The latter created speculations that the SNS leader would seek a parliamentary election re-run.

In the parliamentary elections in May 6th, no party collected the required amount of votes to reach an absolute majority in the new 250 seats parliament. The election law provides proportional representation so that the probability of a single party government is practically non existent. The Democratic Party (DS) and the Serbian Progressive Party (SNS) gained 67 and 73 seats respectively. That makes the role of the Socialist Party (SPS), the third party in number of seats, absolutely decisive in the government formation.

The Socialist Party (SPS), a partner in the previous government coalition, together with its electoral allies PUPS & JS gained 44

Serbia: Eurobank EFG Forecasts				
	2009	2010	2011	2012f
Real GDP (yoy%)	-3.5	1.0	1.6	0.0
Inflation (yoy%)				
CPI (annual average)	8.1	6.2	11.2	5.5
CPI (end of period)	6.6	10.3	7.0	6.0
Fiscal Accounts (%GDP)				
General Government Balance	-4.5	-4.7	-5.0	-4.4
Gross Public Debt	34.5	44.0	47.7	52.0
Labor Statistics (%)				
Unemployment Rate (%of labor force, ILO)	16.1	19.2	23.0	19.0
Wage Growth *(total economy)*	-3.3	7.5	11.1	5.0
External Accounts				
Current Account (% GDP)	-7.2	-7.4	-9.5	-8.5
Net FDI (EUR bn)	1.4	0.9	1.8	1.0
FDI / Current Account (%)	65.8	41.3	61.6	75.0
FX Reserves (EUR bn)	10.6	10.0	12.1	10.5
Domestic Credit	**2009**	**2010**	**2011**	**Q1 12**
Total Credit (%GDP)	51.7	63.9	62.2	66.1
Credit to Enterprises (%GDP)	29.6	35.7	35.0	37.3
Credit to Households (%GDP)	17.2	19.8	19.0	19.7
Private Sector Credit (yoy)	14.3	26.2	5.9	13.1
Loans to Deposits (%)	126.9	144.3	141.9	151.1
Financial Markets	**Current**	**3M**	**6M**	**12M**
Policy Rate	10.00	10.50	11.00	11.00
EUR/RSD	113.68	115.00	115.00	115.00

Source: National Sources, IMF, Eurobank Research & Forecasting

seats and had almost sealed an agreement with DS to participate in the new government. From that point of view, DS and SPS would only need the support of another smaller party such as the Liberal Democratic Party (DLP) which controls 19 seats and or even the United Regions of Serbia (a coalition of parties led by G17 plus a government partner of DS party in the outgoing government) which now controls 16 seats to secure majority. Yet, the post-election negotiations to form a multi party government are still inconclusive.

The Fiscal Council warns over a looming fiscal crisis if no fiscal consolidation measures are taken by the new government

The new cabinet will be confronted with significant challenges in the post-election landscape. Firstly, the new coalition government will have to deal with a mini budget crisis. The consolidated government data in the first four months sends a particularly alarming signal for the achievement of the full year target. The data of the consolidated government (central government plus social security institutions and local governments), which are published with one month delay after those of central government, bring the fiscal deficit up to RSD 78.1bn in Jan-April vs. a full year target of RSD 150 bn. The year-to-May 2012 central government budget deficit had already reached RSD 78.9bn or an equivalent 2.2% of projected GDP.

Moreover, the macroeconomic assumptions upon the current budget are far from realistic anymore. The original budget was built upon the assumption of 1.5% growth in 2012. However, the deterioration of the Euroarea growth outlook has made this obsolete. At the time of publication the forecast of the Central Bank stands at 0.5% with the risks skewed to the downside. Thus, the new government will have to present a supplementary budget and introduce fiscal consolidation measures on top of the RSD 15.7bn cuts on discretionary spending that were introduced in March. Bringing the fiscal deficit again within the targets agreed with the IMF (4.25% of GDP fiscal deficit target for 2012, 1% for debt guarantees), is a requirement to revive the precautionary agreement. Those measures will most probably include, not only spending cuts, but also revenue raising measures (e.g. VAT rate increase to 22%).

The Fiscal Council, an independent body elected by the parliament whose task is to advise the government over fiscal policy issues, has warned over a looming fiscal crisis. Unless corrective action is taken, the deficit could shot up to or even exceed RSD 200bn given the target overrun by RSD 30bn in Q1. That would be an equivalent of more than 6% of GDP in 2012 compared to a realization of 5% of GDP deficit in 2011. Accordingly, the public debt to GDP ratio could reach 55% of GDP in 2012, significantly above the 45% threshold of the fiscal rule compared to 47.7% in 2011 and only 29.2% in 2008.

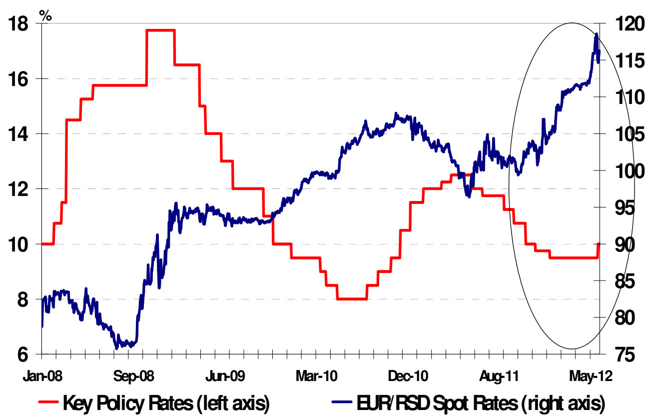
The Central Bank resorted to a 50bps interest rate hike to 10% and increased the domestic currency required reserves ratio further in order to avoid a currency depreciation crash.

On June 10th, the NBS increased the key policy rate by 50bps at 10.0% for the first time since April 2011. The move was broadly expected by Bloomberg consensus (14 out of 22 analysts expected a rate hike-8 expected no change). It had been pre-announced by the Vice Governor Mr. Bojan Markovic in a Bloomberg interview in June 1st.

The move signals a shift of focus in the monetary policy to deter further domestic currency weakness. The freezing of the precautionary IMF agreement, increased fiscal outlook risks and uncertainty in the political landscape after inconclusive May 6th elections have put pressure on the Dinar and Dinar denominated assets. To make things worse, the deepening Euroarea sovereign crisis puts additional strain on the region which is reflected across all currencies.

The use of strong FX interventions together with the mobilization of required reserves have not been efficient to discourage Dinar from reaching new historic lows. Dinar depreciated as much as 118.59/€ on June 4th, only to strengthen a bit to 116.8/€ on June 13th (-10.3% year to date, -16% year on year). The Central Bank has spent €1.28 bn, or 10% of its total FX reserves (more than half of it during April-May) since the beginning of 2012 in order to support the domestic currency (Figure 1). In addition, 5Y-CDS had climbed at 550bps on June 8th vs. 500bps in the beginning of 2012 and an intra year low at 360bps on March 9th (Figure 2).

Figure 1
Dinar traded close to historic low levels vs. € in mid June



Source: Ecowin, EFG Research

Figure 2
Five year CDS have climbed to multi month highs in early June 2011

Source: Bloomberg, EFG Research

Lastly, the key policy rate hike decision is also necessitated by the inflation outlook shift. After inflation reached its trough in April at 3.2% yoy and edged higher at 3.9% in May on base effects from last year food inflation rally. Inflation is expected to trend higher until year end at the upper end of the Central Bank band 4.5% +/- 1.5%), despite the weak growth outlook.

At the same time, NBS decided to mobilize further the tool of reserve requirements in order to reduce the cost of funding in Dinars and FX:

- keep the current foreign exchange required reserve ratios, while at the same time increasing the dinar share of allocations under foreign exchange required reserves from 20% to 27% for the sources of funding with maturity of up to two years, and from 15% to 19% for the sources of funding with maturity of over two years
- increase the required reserve ratio on dinar liabilities with a foreign currency clause to 50 percent for all maturities.

Looking ahead, the NBS rhetoric in the statement points to further tightening. However, that will depend primarily on the degree of fiscal consolidation after political uncertainties clear out among other factors.

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

Soft landing underway

- May's easing consumer inflation boosts confidence on CBT's policies
- Trade balance adjustment continues strong

Soft landing underway

Turkey's economy recorded stellar real GDP growth of 8.5% in 2011, broadly outperforming its European peers, primarily thanks to strong domestic demand dynamics and base effects. However, most recent macroeconomic data and sentiment indicators support the case for a notable slowdown in H1-2012, with a significant deceleration to 3.2% yoy already registered in first quarter output. The primary culprits of the deceleration are unfavorable base effects and weakening domestic demand as a result of central bank (CBT) monetary tightening employed since late last year and higher inflation rates which curb private consumption and investments. Ongoing fiscal prudence by the AKP government is unlikely to provide any significant support to growth this year. In addition, the euro area debt crisis is resulting to sluggish demand from Turkey's main trade partners, boding ill for exports and further weighing on consumer and business sentiment.

Even so, we continue to expect a gradual recovery in H2-2012 as the impact of negative base effects gradually fades away, while net exports continue to provide a positive contribution to growth thanks to weakening domestic demand and increased diversification towards non-EU economies. Government policies promoting domestic production of intermediate goods in key sectors of the economy (e.g. energy, automotives, mining) are also likely to favor. Tentative signs that the economic slowdown may be losing steam from Q2 onwards were also visible in other sectors of the economy as well (eg. labour market, manufacturing sector). In view of a higher-than-anticipated Q1-2012 GDP growth reading we revise our 3% growth forecast for this year, to 4%, in line with the government's projection. For 2013, we anticipate the recovery to gain momentum, conditional on an improvement in external developments and particularly on the unraveling of the euro area debt crisis.

May's easing consumer inflation boosts confidence on CBT's policies…

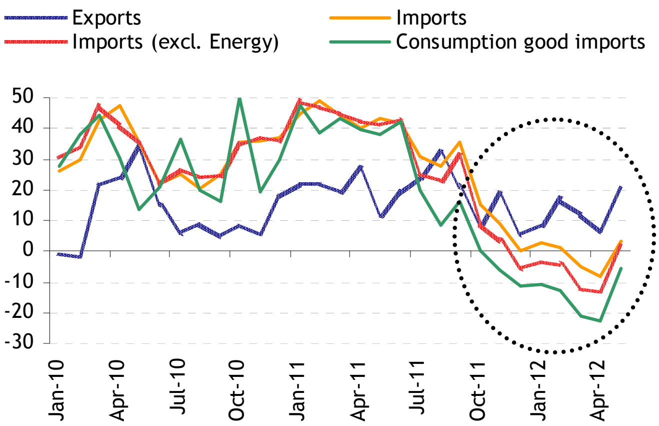
Consumer price inflation slowed more than anticipated in May, coming in at 8.28%yoy vs. a 3-½-year peak of 11.14%yoy in the prior month. The reading outperformed the market's median forecast which envisioned a slowdown to 9.00%yoy. The primary drivers of the deceleration were weaker food and energy prices, which were reflected in a 2.6%mom decline in the food component and a 1.4%mom fall in transportation costs. Importantly, a notable slowdown was also witnessed in all core CPI indices, suggesting easing underlying inflation pressures. Indicatively, the Central Bank's closely monitored measure "I" (excluding energy, food, alcoholic and non-alcoholic beverages, tobacco products and gold) eased by 57bps in May to a 7-month low of 7.67%yoy (Figure 2). Inflation is broadly anticipated to prove volatile in the coming months, with June's reading likely to show a pick up near 9% in the annual consumer price headline

Turkey: Eurobank EFG Forecasts

	2010	2011E	2012F	2013F
Real GDP (yoy%)	9.2	8.5	4.0	4.5
Private Consumption	6.7	7.7	1.0	1.7
Govern. Consumption	2.0	4.5	3.5	3.0
Gross Capital Formation	30.5	18.3	5.0	7.5
Exports	3.4	6.5	6.5	7.5
Imports	20.7	10.6	-0.5	3.0
Inflation (yoy%)				
CPI (annual average)	8.6	6.4	9.4	6.7
CPI (end of period)	6.4	10.5	7.5	5.5
Fiscal Accounts (%GDP)				
Central Government Balance	-3.6	-1.4	-1.5	-1.3
Gross Public Debt	42.5	40.0	38.0	36.0
Primary Balance	0.8	1.9	2.0	2.1
Labor Statistics (%)				
Unemployment Rate (%of labor fo	12.0	9.5	10.5	10.2
External Accounts				
Current Account (% GDP)	-6.5	-9.9	-8.0	-7.5
Net FDI (USDbn)	7.3	13.4	12.5	13.5
FDI / Current Account	12.0	17.4	19.0	22.0
FX Reserves (USDbn)	80.7	78.3	77.0	78.0
Domestic Credit	**Q2 11**	**Q3 11**	**Q4 11**	**Q1 12**
Total Credit (%GDP)	44.1	47.1	48.8	46.2
Credit Private Sector (%GDP)	42.5	45.5	47.2	44.8
FX Credit/Total Credit (%)	22.5	24.6	24.4	23.8
Private Sector Credit (%yoy)	43.3	44.8	34.7	28.0
Loans to Deposits	93.8	96.1	96.9	98.6
Financial Markets	**Current**	**3M**	**6M**	**12M**
Policy Rate (1-week repo)	5.75	5.75	5.75	5.75
USD/TRY (where applicable)	1.81	1.83	1.75	1.70

Source: National Sources, Eurostat, IMF, Eurobank Research & Forecasting index due to base effects. A gradual deceleration from these levels will likely become more pronounced in Q4-2012 primarily thanks to the CBT's monetary tightening since late last year and mild domestic demand dynamics.

Figure 1
Weak domestic demand dynamics reflected in declining consumer goods imports (%YoY changes)



Source: National Statistics, CBT, Eurobank EFG Research

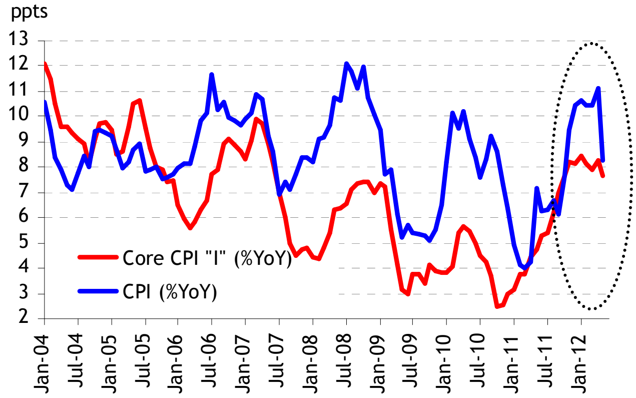
… supporting the case for a continuation of the CBT's complex strategy in the imminent future

Despite the better-than-anticipated CPI reading in June, we do not expect a change in the CBT's current policy stance as the TRY remains vulnerable to the current unfavorable global environment and any renewed lira depreciation will add to upside risks to inflation. A policy mix endorsed in late 2010 aimed at restraining overheating pressures in the domestic economy, in tandem with the escalating debt crisis in the euro area, have weighed significantly on the currency over the last 1-½-year (Figure 3).

In an indication of the currency's sensitivity to external shocks, the lira hit new 4-month lows near 1.88/USD in early June, largely shrugging off Central Bank monetary tightening endorsed since late 2011, as the debt crisis in the euro area deepened and concerns about the global growth outlook were aggravated. As long as the external situation does not change notably for the better, the Central Bank will likely continue pursuing a flexible strategy that will encompass short tightening periods as it tries to avoid exacerbating downside risks to the domestic economy, which is braced for a soft landing this year.

As a reminder, the Central Bank introduced last October a policy mix consisting of a record low key policy rate and a wide corridor between the overnight lending and borrowing rates, aimed at supporting growth, alleviating widening pressures from the current account deficit and containing inflation primarily via supporting the domestic currency.

Figure 2
Key inflation readings ease in May, on weaker energy & food prices, contained inflation expectations



Source: National Statistics, CBT, Eurobank EFG Research

At periods of monetary tightening the CBT reduces the amounts provided through the "cheap" 1-week fixed rate (5.75%) repo auctions, offering the rest of the necessary liquidity through more expensive means of funding such as the overnight facility (11.50%), the 1-month repo window and the 1-week intraday repo auctions. On *exceptional days* the bank substitutes its regular 1-week repo tenders, which are held at a fixed rate of 5.75%, with intraday repo auctions which bear much higher interest rates. As a result, the CBT's weighted average funding costs move to the desired direction; either towards the top end of the policy corridor which is the overnight lending rate (11.50%) or towards the lower end, which is the key policy 1-week repo rate. Over the last month or so, the Central Bank has maintained the average funding rate around 10%, as it aims to support the lira and contain ensuing price pressures.

CBT stays put on rates; turns slightly less hawkish

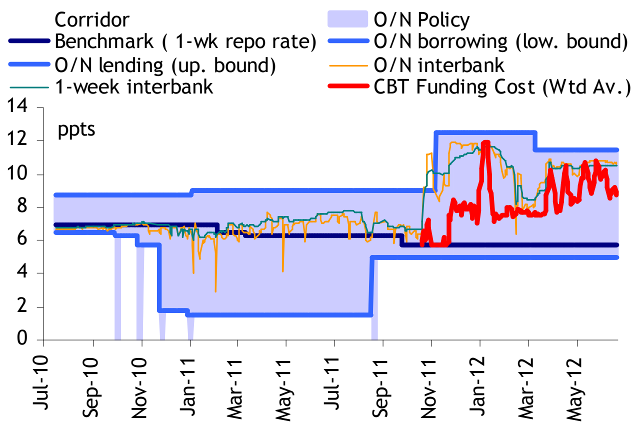
In line with market expectations, the Central Bank left interest rates unchanged at its MPC meeting in June. Accordingly, the key policy 1-week repo rate remained at a record low level of 5.75%, while the overnight borrowing and lending rates were kept at 5.00% and 11.50% respectively. The CBT also announced a 5ppts increase to 50% in the amount of lira reserves banks can hold in foreign currency, the second such move since May's meeting, aimed at boosting TRY liquidity and central bank FX reserves. It also raised by 5ppts the amount of TRY reserves to be held in gold. The Bank estimates the measures to cumulatively generate around TRY5.6bn of lira liquidity for the financial sector and increase CBT reserves by $4.9bn. Casting a rather dovish note in its accompanying statement, the CBT acknowledged an improved inflation outlook compared to the one envisaged in April's Inflation Report owed to a more favorable path followed by energy and unprocessed food prices. In addition, the statement read that "pricing behavior should be closely monitored as inflation will continue to stay above the target for some time". The latter replaced the phrase "the current ***tight*** policy stance will be maintained in the forthcoming period in order to contain risks regarding pricing behavior", which was in the prior month's statement, in a move suggesting a somewhat softened tone towards inflation. The CBT reiterated it may implement further monetary tightening, if necessary, adding that it would retain the current flexible monetary policy in view of the ongoing uncertainties surrounding the global economy.

Figure 3
USD/TRY on an uptrend, supported by late 2010 CBT policy mix & waning risk appetite

Source: Reuters, Eurobank EFG Research

Figure 4

CBT implements additional tightening to support the lira



Source: National Statistics, CBT, Eurobank EFG Research

Trade deficit continued to narrow in May

Since November 2011 the trade shortfall has embarked on a gradual narrowing mode primarily thanks to waning domestic demand for imports, partly fanned by CBT monetary tightening and a weaker TRY. A successful diversification of Turkish exports towards higher-growth economies, primarily in the Middle East, has also favored.

In support of the aforementioned, the latest trade balance data confirmed that the narrowing in the deficit continued in May. In detail, the shortfall shrunk by 16%yoy to $8.6bn after a 20%yoy shrinkage registered over the first four months of the year. Weak domestic demand dynamics were reflected through a 5.5%yoy drop in consumer goods imports, which came on the heels of a 17.5%yoy decline in the January-April period. However, a 7.7% yoy rise in intermediate goods imports pushed total imports' growth back into a positive territory, of 3.1%yoy, halting a two-month streak in contraction. On the other hand, exports grew at an impressive 20.3% annual rate in May after growth of 10.8%yoy in January-April, assisted by the ongoing diversification of Turkish products towards non-EU countries and improved competitiveness due to the lira's depreciation against major currency peers since early 2011. It is worth noting that last year exports to EU-27 accounted for ca 46% of Turkey's total exports. This share declined by ca 6ppts in January-May,, while the annual rate of increase marked a drop of 6.1%yoy over the same period. Compensating for the negative trend, exports grew significantly in other key trade markets such as Iraq (+37%yoy, currently the second largest trade partner after Germany), Iran (+200%yoy), USA (+27%yoy), Saudi Arabia (+64%yoy).

In reflection to the ongoing adjustment in Turkey's trade balance April's current account deficit (CAD) plunged 35%yoy to $5.0bn, pushing the 12-month rolling shortfall to $69.2bn, or 8.8% of this year's projected GDP (May's CAD data is due for release on July 11). This compares with a near 10% gap registered in the whole of 2011. In all, we anticipate the improvement in Turkey's external imbalances to continue in the months ahead but the pace of narrowing will likely lose momentum due to a potential recovery in the domestic economy in H2-2012. Against this background, we envisage a narrowing to 8%-of-GDP this year.

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

Economy decelerated in Q1-2012 on weaker export demand

- Revised GDP growth stood at 2.0% yoy in Q1-12, from 1.8% yoy estimated earlier, down from 4.7% yoy recorded in Q4-11
- Inflation fell to -0.5% yoy in May reflecting lower food prices and weakening domestic demand
- Limited lending growth with high share of FX denominated loans.

Ukraine's GDP growth slowed although the estimate was upgraded to 2.0% yoy in Q1-12 from 1.8% yoy estimated earlier

The Q1-12 GDP growth estimate is revised to 2.0% yoy, up from 1.8% yoy announced earlier and after a 4.7% yoy reading in Q4-11 In seasonally adjusted terms, GDP growth was down 0.2% qoq in Q1-12 (vs. the previous estimate of -0.3% qoq). Economic expansion drivers were private consumption and fixed capital formation, which grew by 9.8% yoy and 7.6% yoy respectively, while exports declined by 6.8% yoy due to broad weakness in global commodity prices. (Table 1)

Table 1
Q1-12 GDP components growth

	Chg, % yoy
Final Consumption	7.9
Private Consumption	9.8
Government Consumption	1.9
Gross Capital Formation	-24.2
Fixed Capital Formation	7.6
Exports	-6.8
Imports	-4.3

Source: UkrStat

Industrial production was flat in April after having contracted by -1.1% yoy in March. By contrast, the consumer sector is holding up relatively well with retail sales recording still double digit figures, most likely due to wage increases; they stood at 13.9 % yoy in April from 12.6% yoy in the prior month. Moreover, real wage growth keeps rising; it grew by 16.9% yoy in April from 15.8% yoy in March, benefited by the backdrop of deflation. Overall, we anticipate GDP growth to decelerate to 2.8% yoy in 2012, less than the official government projection of 3.7% yoy, on the back of a global risk aversion environment and commodity prices, which are unlikely to receive a boost, thereby hurting the country's export revenue. Political risks are building ahead of the

October 2012 parliamentary elections with social spending likely to increase which should stimulate growth even if temporary.

Ukraine: Eurobank EFG Forecasts	2009	2010	2011	2012f
Real GDP (% yoy)	-14.8	4.1	5.2	2.8
Private Consumption	-1.6	2.1	-1.4	5.0
Government Consumption	-2.4	4.0	-2.4	1.0
Gross Capital Formation	-53.5	16.4	25.6	12.0
Exports	-20.1	4.1	3.0	2.0
Imports	-37.1	11.1	18.9	11.0
Inflation (% yoy)				
CPI (annual average)	16.0	9.4	8.0	4.5
CPI (end of period)	12.3	9.1	4.6	6.0
Fiscal Accounts (% GDP)				
General Government Balance	-8.7	-6.5	-4.2	-4.0
Gross Public Debt	35.3	41.7	42.4	43.0
Labor Statistics (%)				
Unemployment Rate (% of labor force)	8.8	8.1	7.9	8.0
Wage Growth *(real - private sector)*	-9.8	6.7	10.7	14.5
External Accounts				
Current Account (% GDP)	-1.5	-2.2	-5.5	-6.5
Net FDI (bn USD)	4.7	5.7	7.0	7.5
FDI / Current Account (%)	268.7	190.8	77.9	60.0
FX Reserves (bn USD)	26.5	34.6	31.8	25.0
Domestic Credit	**2009**	**2010**	**2011**	**Q1 12**
Total Credit (% GDP)	79.2	67.7	60.9	59.1
Credit to Enterprises (% GDP)	50.6	46.3	43.7	42.8
Credit to Households (% GDP)	26.4	19.4	15.3	14.4
FX Credit/Total Credit (%)	50.8	46.0	40.3	40.0
Private Sector Credit (% yoy)	-3.1	0.4	8.5	5.8
Loans to Deposits	215.9	175.9	164.7	157.5
Financial Markets	**Current**	**3M**	**6M**	**12M**
Policy Rate	7.50	7.50	7.50	7.50
USD/UAH	8.11	8.10	8.20	8.10

Source: NBU, IMF, Bloomberg, Eurobank Research

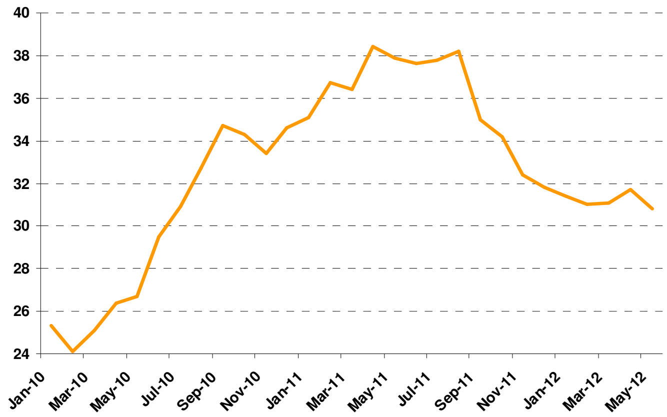
What's more, downside risks to growth will be somehow constrained by the Euro 2012 football championship (co-hosted with Poland in June), which has increased investments and could provide a boost via tourism revenues.

Meanwhile, there has been no progress towards a new deal with the IMF. On one hand, the government considers seeking a new aid package from the IMF in 2013 (i.e. after the October elections), for which it could agree in a gradual increase in utilities. On the other hand, the IMF statement, after its mission to Ukraine in late May, urged Ukraine to raise taxes for the richer persons as well as to raise gas and heating tariffs for households so as to resume the programme which has been frozen since March 2011. Consequently, we see little possibility for the IMF programme to be resumed this year, thereby leaving the country vulnerable to broader stress in global financial markets.

Balance of payments pressures have eased in the last couple of months (in April its surplus grew to $508mn compared with $375mn in March) helped by seasonal factors (such as lower gas imports), Euro 2012 related inflows (from investment and tourism) and repatriation of capital by Ukrainian businesses ahead of the elections. However, these factors are likely to fade over the second semester. What's more, sovereign debt repayments come due in H2-12 with $2.8bn needed to be repaid to the IMF for the 2008 loan by the end of this year. Up to now, the National Bank of Ukraine (NBU) has remitted $1.35bn almost half of this sum. As a result, the authorities will continue to tap the country's FX reserves (Table 2) in order to cover external imbalances and stabilise expectations.

Table 2

Ukraine's FX reserves ($bn) have stabilised over the past couple of months as balance of payments pressures have eased



Source: National Bank of Ukraine, Eurobank Research

Inflation fell in May for the first time in more than nine years

Consumer price inflation continued to moderate in April reflecting lower food prices and weakening domestic demand. Food prices have a large chunk of the consumer price index and hence they CPI fell to -0.5% yoy (-0.3% mom). Expectations of lower crop this year could trigger higher inflation in the second semester of this year. Moreover, strong wage growth (it averaged at 18.2% yoy in the first four months of this year) is expected to spur inflationary pressures All in all, we anticipate consumer prices to average at 4.5% yoy in 2012 from 8.0% yoy in 2011. Strongly influence CPI dynamics. In April, food inflation fell to -2.6% yoy (-0.2% mom) and CPI stood at 0.6% yoy (0.0% mom). In May, food inflation dropped further to -4.2% yoy (-0.8% mom) and

Inflation moderation left room for monetary policy easing to prop up economic activity

The NBU has eased rules for mandatory reserves requirements further. From end May onwards, mandatory reserves will fall to 50% from 60% previously. This should help the banking system to maintain enough short-term monetary liquidity. Moreover, since late March slower inflation has allowed the NBU to cut its key policy rate by 25bps at 7.50% after having kept it unchanged since August 2010.

Limited lending growth with high share of FX-denominated loans

Private sector credit growth accelerated to 5.4% yoy in April and 0.6% year-to-April. Admittedly, lending growth is limited reflecting banking sector's heavy exposure to sovereign risks. Credit growth is driven by short-term loans to corporates. Corporate credit grew by 9.8% yoy in April while household lending dropped by 6.8% yoy. What is worrisome is the high share (40%) of FX denominated loans which in possible currency devaluation can create further challenges to the banking sector asset quality. What's more, loans denominated in FX are mostly in the household sector (54% of total household loans in April) while mortgages denominated in FX account for 77% of total. On the other hand, local currency deposits account for 57% of total deposits in April. The loans-to-deposits ratio is still at a high level of 157%. According to the NBU, Non Performing Loans stood at 10.2% of total loans in April.

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

Economic slowdown ahead; domestic banks' asset quality deteriorates but capital adequacy improves

On June 11th, the Albanian parliament elected Mr. Bujar Nishani as new president of the republic. The new president has served twice in the cabinet of Prime Minister Sali Berisha, as Minister of the Interior and Justice Minister. In the first three rounds, when a two-thirds majority was necessary to elect a president, consensus between the opposition and the government was not achieved. In the next two rounds only an absolute majority in the 140 seats parliament was required. The new president, supported by the ruling party and its allies, was elected in the fourth round with 73 votes in favour. The election of a consensual president would had been a positive signal to the EU that a consensus among major political powers in order to push necessary political and economic reforms is possible. Reforms are necessary for Albania's bid for EU candidate status to be successful.

The Albanian economy grew faster (3.0% yoy) than other countries in the region in 2011 but is expected to slow down in 2012. Both the IMF and the EBRD in their latest forecasts (April and May 2012 respectively) predict a deceleration of economic activity in 2012. The IMF forecasts real GDP growth of 0.5% yoy in 2012 and a pick up in 2013 to 1.7% yoy. The EBRD is more optimistic than the IMF in its projections, forecasting a 1.2% yoy real GDP growth rate in 2012 and 1.8% yoy in 2013. The EBRD sites the weak performance of Greece and Italy, Albania's key EU markets, and the limited room for fiscal manoeuvring as the main reasons for the expected economic slow down. Unemployment remains fairly stable since mid 2010. The registered unemployment rate was 13.3% in Q1 2012 according to INSTAT (the state's statistics institute).

Inflationary pressures remain contained even though the annual rate of inflation picked up in May, reaching 1.9% yoy compared to 4.2% yoy a year before and 1.6% yoy in April 2012. Food prices increased by 1.9% yoy, prices in the group "Rent, water, fuel and power" also increased by 1.3% yoy, while clothing and footwear prices decreased by 2.0% yoy. The Bank of Albania, the IMF and the EBRD expect low inflation rates in 2012, well in line with the BoA's medium-term target for 2%-4% annual inflation rate.

In the first four months of 2012 the cash balance of the general government had a deficit of ALL -11.5 bn, decreased by 27.9% compared to the same quarter in 2011. This though was four times higher than planned, since revenue were 5.4% less and expenditure 3.2% more than the budget's target for January-April 2012. The first four months deficit was 27.9% of the full year target of ALL -41.2 bn or 3% of GDP. Prime Minister Mr. Sali Berisha announced that the government plans to increase wages and

Albania: Economic data				
	2009	2010	2011	2012f
Real GDP (% yoy)	3.6	3.3	3.0	0.5(IMF)
Inflation (% yoy)	**2009**	**2010**	**2011**	**2012f**
CPI (annual average)	2.3	3.6	3.5	1.9(IMF)
CPI (end of period)	3.7	3.4	1.7	3.1(IMF)
Fiscal Accounts (% GDP)	**2009**	**2010**	**2011**	**2012f**
General Government Balance	-7.0	-3.1	-3.5	-3.0(Gov)
Gross Public Debt	59.8	58.2	58.8	59.6(Gov)
Primary Balance	-3.9	0.3	-0.4	0.6(Gov)
Labor Statistics (%)				
Unemployment Rate (%)	13.8	13.7	13.3	12.1(Gov)
Wage Growth *(State sector)*	11.9	6.7	-	-
External Accounts				
Current Account (% GDP)	-15.2	-11.3	-12.2	-13.2(IMF)
Net FDI (bn EUR)	0.69	0.79	0.71	
FDI / Current Account (%)	55.3	84.5	67.1	
FX Reserves (bn EUR)	1.57	1.83	1.85	
Domestic Credit	**2009**	**2010**	**2011**	
Total Credit (% GDP)	38.3	38.9	41.0	
Credit to Enterprises (% GDP)	23.9	25.4	27.6	
Credit to Households (% GDP)	12.8	12.0	11.3	
FX Credit/Total Credit (%)	68.1	67.5	65.2	
Private Sector Credit (% yoy)	11.7	10.6	10.4	
Loans to Deposits (%)	63.9	66.5	61.5	
Financial Markets	**2009**	**2010**	**2011**	**Current**
Policy Rate (%)	5.25	5.0	4.75	4.25
ALL/EUR (end of period)	137.1	138.5	138.3	138.5
ALL/USD (end of period)	95.8	103.5	106.4	110.7

Source: BoA, INSTAT, IMF, Reuters

pensions starting from July 1st. Details are not clear and no estimates were given for the impact on the budget and inflation.

The asset quality of the Albanian banking sector deteriorated in Q1 2012. NPLs (defined as the total of Sub-standard, Doubtful and Loss Loans) increased to a ten year high of 20.1% of total loans in Q1 2012 (18.9% in Q4 2011 and 14.4% in Q1 2011). Despite this increase and the deteriorating external environment, the capital adequacy ratio improved for a third consecutive quarter to 15.9 % in Q1 2012 from a low of 14.6% in Q2 2011, mainly through capital injections.

Credit expansion to the private sector was strong in the first four months of 2012, registering a 8.1% yoy growth. Nonetheless, financial intermediation remains low, with total credit to the private sector reaching 38.3% of GDP in April 2012. Note that 65.4% of outstanding loans to the private sector are denominated in foreign currency. Deposits increased by 10.5% yoy in the first four months of 2012 supported by strong repatriations by emigrants. The loans to deposits ratio was just 61.7 in April 2012.

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II. New Europe – Country Analysis: **FYR of Macedonia**

Fiscal financing secured for 2012 without IMF resources; NBRM tests reveal a healthy and resilient banking system

Growth in 2012, according to the latest projections by the European Bank for Reconstruction and Development (EBRD) and the IMF, will be lower than in 2011, due to the weak external environment, mainly the euro area crisis. For 2012, the EBRD projects a real GDP growth of 1.3% yoy, while the IMF in its latest report (June 2012) projects a real growth rate of 2.0% yoy. According to the IMF, the medium-term outlook remains generally favourable and under its baseline scenario it projects a 3.2% yoy growth rate in 2013. Risks are on the downside, since a deeper than expected slowdown in the euro area would mean a deeper recession for FYROM's economy. Industrial production in the first four months of 2012 was lower by 8.1% yoy. In April industrial production fell for an eighth consecutive month (annual growth rates).

The National Bank of the Republic of Macedonia (NBRM) continues its exchange rate targeting strategy (de facto peg against the euro); the exchange rate of the denar against the euro remained stable close to 61.5 MKD/EUR. Consumer prices rose by 2.0% yoy in May 2012, driven mainly by housing (including fuel and lighting), clothing and footwear. The IMF expects inflation to slow down in 2012 and 2013 to 2.0% from 3.9% in 2011. Low inflation projections allowed the NBRM to reduce its key policy rate to 3.75% from 4.00% in order to support growth.

The current account (CA) deficit in Q1 2012 was €99.7mn or -1.3% of GDP, down 50% yoy compared to Q1 2011. The trade deficit (Goods and Services) was -5.3% of GDP in Q1 2012. It narrowed by 8.5% yoy with the exports decrease by 2.8% yoy being offset by the larger decrease in imports by 4.7% yoy. The net Current Transfers surplus was 4.3% of GDP, increased by 24.3% yoy in Q1 2012. The IMF in its latest report expects the CA deficit to widen in 2012 to -5.0% of GDP and to -6.2% of GDP in 2013 (2011: -2.75% of GDP) and to level off at around 5% of GDP in the medium term. The CA deficit was largely financed by FDI inflows which reached 1.1% of GDP in Q1 2012. According to the IMF, there is a large pipeline of greenfield FDI projects planned for the period 2012-15 totalling €518mn or 1.5% of the 2012-15 GDP. Gross external debt reached 66.7% of GDP in 2011 increasing by 17.9% yoy. Official foreign currency reserves reached €1.79bn in April 2012, increasing by 8.1% yoy, which is in the range considered adequate by the IMF.

In the first four months of 2012 the fiscal deficit reached -0.9% of GDP (full year target -2.5% of GDP). According to the IMF, foreign borrowing from private sources will provide the main source of budget financing in 2012, unlike in 2011 when the deficit of 2.6% of GDP was financed mainly from the standing two year Precautionary and Liquidity Line (PLL) agreement with the IMF. Thanks to a foreign bank loan of €130mn (backed by a World Bank guarantee), another €250mn five-year foreign bank loan, a $100mn World Bank planned loan and €60mn in planned domestic Treasury debt issuance, the government would not need to draw upon PLL funds in 2012 and has a significant buffer for 2013. Debt financing though remains a medium term risk due to IMF loans repayments in 2014-17, volatility and uncertainty in external capital markets and a swallow domestic debt market.

FYROM: Economic data

	2009	2010	2011	2012f
Real GDP (% yoy)	-0.9	1.8	3.0	2.5 (EU)
Final Consumption	0.8	1.4	1.8	1.2 (EU)
Gross Capital Formation	-1.5	-6.3	22.7	6.7 (EU)
Exports	-16.2	23.4	11.3	6.0 (EU)
Imports	-15.0	11.6	14.1	4,9 (EU)
Inflation (% yoy)				
CPI (annual average)	-0.8	1.6	3.9	2.0 (IMF)
CPI (end of period)	-1.6	3.0	2.8	2.0 (IMF)
Fiscal Accounts (% GDP)	**2009**	**2010**	**2011**	**2012f**
Central Government and Funds Balance	-2.7	-2.5	-2.6	-2.6 (IMF)
Gross Central Government Debt	23.8	24.6	28.2	30.5 (IMF)
Labor Statistics (%)	**2009**	**2010**	**2011**	**2012f**
Unemployment Rate (%)	32.2	32.1	31.8	31.2 (IMF)
Wage Growth *(Nominal gross, %)*	9.4	1.0	1.2	
External Accounts				
Current Account (% GDP)	-6.8	-2.2	-2.8	-5.0 (IMF)
Net FDI (bn EUR)	0.14	0.16	0.30	
FDI / Current Account (%)	30.0	104.8	150.1	
FX Reserves (bn EUR)	1.37	1.48	1.80	
Domestic Credit	**2009**	**2010**	**2011**	
Total Credit (% GDP)	44.8	46.4	48.5	
Credit to Enterprises (% GDP)	25.8	26.9	27.8	
Credit to Households (% GDP)	17.5	17.7	18.2	
FX Credit/Total Credit (%)	22.8	27.1	30.2	
Private Sector Credit (% yoy)	4.2	1.7	5.1	
Loans to Deposits (%)	88.2	84.4	86.6	
Financial Markets	**2009**	**2010**	**2011**	**Current**
Policy Rate	8.5	4.1	4.0	3.75
MKD/EUR	61.46	61.40	61.49	61.5
MKD/USD	43.98	46.20	43.96	49.06

Source: NBRM, SSO, IMF, European Commission, Reuters

Credit expansion to the private sector was strong in April 2012, registering an 8.3% yoy growth. Note that 27.2% of outstanding loans to the private sector are denominated in foreign currency and a further 27.7% have an FX clause. Deposits grew by 9.3% yoy in April with 47.4% of deposits being denominated in foreign currency. The loans to deposits ratio was 90.8% in April 2012. According to the May 22nd NBRM's Financial Stability Committee announcement, NPLs in March 2012 were 9.9% of total loans and the capital adequacy ratio was 17.5%. The banking system has almost no dependence on foreign financial markets for funding.

The Committee also announced that stress tests, designed to estimate the impact of the euro area crisis, showed that in none of the banks was the capital adequacy ratio reduced below the minimum required 8%.

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