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Euro area debt crisis remains in the spotlight

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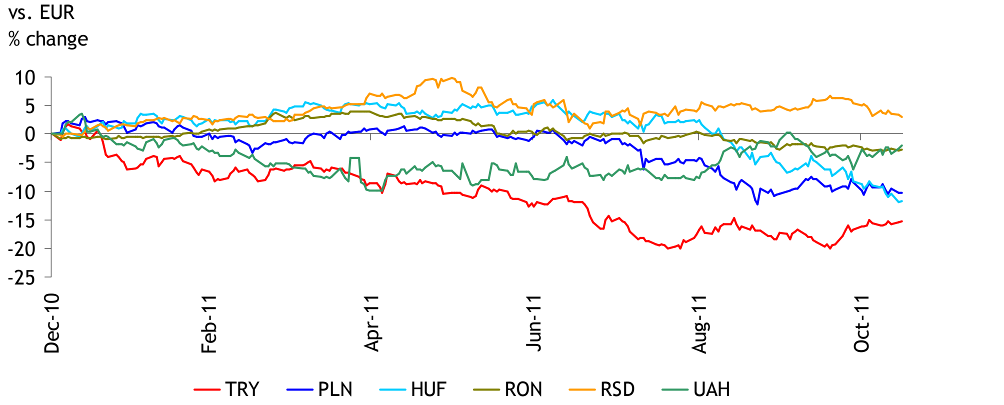
- **Bulgaria:** Current account surplus reaches record levels
- **Poland:** Market friendly parliamentary election result, with the ruling party winning a comfortable victory
- **Romania:** NBR delivers surprise 25bps rate cut
- **Serbia:** NBS cuts rates by a further 75bps
- **Turkey:** CBT embarks on monetary policy tightening to address rising inflation risks, contain pace of lira weakening
- **Ukraine:** Economy expanded by 6.6% yoy in Q3:2011, the fastest pace of growth in more than 3 years

New Europe market strategy highlights

Regional FX markets: New Europe currencies remained under pressure in recent weeks amid lingering uncertainty over the euro area debt crisis. Looking into the remainder of 2011, volatility is likely to remain elevated and with investor caution towards risky assets likely to increase as we approach year-end, there is little to suggest a reversal of the current trend. The Turkish lira is likely to continue range trading around its current levels. However, past experience indicates that a TRY-basket move above the 2.20 level is likely to prompt CBT intervention (verbal or actual). As such, we would favor shorting the TRY-basket at these levels, targeting 2.10 with a stop loss at 2.24. Similar action is likely to be witnessed by the central banks of Poland and Romania, should the EUR/PLN and EUR/RON rates approach/exceed respective levels of 4.45 and 4.36-4.37. Along these lines short EUR/PLN positions at 4.48 with a target of 4.33 and a stop loss of 4.53 appear to offer value at current levels. Separately, we favor entering EUR/RON shorts at 4.36-4.37 targeting 4.28 levels. We also like long €/RSD positions at entry levels below 102, targeting 104.0-104.5 and stops at 100.5, with the Serbian dinar seen remaining under pressure in the short-term on lingering euro area debt jitters. **In the sovereign credit space**, our earlier long Turkish risk via 5-year CDSs recommendation with entry level at 290bps hit our 220bps target on October 27. At current levels around 250bps we would reverse our previous call and go tactically long protection with a stop loss at the recent low of 220bps and a target at 300bps. **In the local rates markets**, our earlier 2/10-year flattener position in Polish cross currency swaps (entry level: 38bps), hit the recommended target in late October and we took profit at 25bps. At present, we prefer to stay sidelined on local rates due to a high degree of uncertainty regarding regional central banks' monetary policy deliberations in the period ahead.

Lingering pressures on regional currencies limit room for monetary policy maneuvering



Source: Reuters, Eurobank EFG Research

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Introductory Comment

Dear Reader,

The lingering euro area debt crisis and deteriorating conditions in main trading-partner economies remain among the main risks weighing on the region's growth outlook. Most recent macroeconomic indicators suggest that real GDP growth in the majority of economies in New Europe remains in a downward trend so far in the second semester, failing to deriver much support from higher agricultural production and a strong tourist season. Meanwhile, weakening external demand dynamics are likely to have a negative impact on domestic industrial production over the last quarter of the year. On the positive side, inflation remains on a firmly downward trend in most regional economies, assisted by favorable base effects, declining food and energy prices and muted demand-side pressures. Encouraged by a more benign inflation environment, a number of central banks in the region have already engaged in monetary easing, with other poised to follow.

More specifically,

Presidential and municipal elections in **Bulgaria** confirmed that the ruling GERB party continues to dominate the domestic political stage. This, in turn, points to an increased probability that the current minority government will stay in office until the end of its tenure. Once considered to be a major macroeconomic vulnerability, the current account balance continues to improve, with data for the first eight months of the year showing a 4%-of-GDP surplus on the back of higher tourism revenue and increased EU funds absorption. However, this has been accompanied by a proportional increase in capital outflows, with Bulgaria running a financial account deficit for a second year in a row.

Inflation in **Romania** declined rapidly over the last few months on favorable base effects, falling food prices and muted demand-side pressures. The sharper than expected drop in inflation, a persisting negative output gap and relatively tight credit conditions allowed the NBR to cut interest rates by 25bps to 6.00% earlier this month, following a 19 month-long pause. NBR's current dovish rhetoric and expectations for further inflation declines in the months ahead leave the door open for additional monetary easing next year.

Serbia's Central Bank, a frontrunner in monetary easing in the region, surprised markets twice over the last couple of months. The NBS cut rates by 50bps in October and by a further 75bps in November, bringing its key policy rate to 10.00%. The NBS has delivered 250bps of cumulative rate easing, since the inception of its current easing cycle in June 2011. In other news, the EU commission recommended Serbia to gain EU candidate status by December 2011.

The recent parliamentary elections in **Poland** did not yield any major surprises. The ruling Civic Platform partly claimed a clear victory and Prime Minister Tusk is the first Polish Premier to be appointed for a second term after the fall of communism. Although inflation remained on a downward trend for the fourth month in a row in September, annual CPI came in at 3.9%, standing well above the Central Bank's 2.5% target. Since July, the NBP has kept its key policy rate stable at 4.50%, after delivering 100bps of cumulative rate tightening in 2011H1. Currently, the consensus market view is for ca 50bps of cumulative rate easing until end-2012, on the back of worsening global growth prospects.

In view of rising inflation risks, in October, the Central Bank of **Turkey** widened its overnight interest rate corridor, hiking the corresponding lending rate to 12.50% from 9.00% earlier, and maintaining the o/n borrowing rate at 5.00%. The CBT dropped its easing bias and adopted an explicit hawkish stance. The high current account deficit, which is mainly financed by short-term capital inflows, represents a key risk for Turkey. Despite the sharp depreciation of the lira over the last few months, the 12-month rolling current account shortfall stood at ca 10%-of-GDP in August 2011.

Ukraine's GDP grew by 5.3% yoy in the first ten months of the year and inflation remained on a downward trend for the fourth month in a row in October, coming in at 5.4% yoy. The economy remains highly exposed to the anticipated global growth slowdown, especially in view of the domestic industrial sector's high exports orientation. Moreover, the IMF loan remains frozen despite government efforts. The IMF mission left Ukraine on November 4th without an agreement on the resumption of the USD 15.3bn SBA. The government's reluctance to implement an unpopular natural gas tariffs hike to ease the pressure from Naftogas's financial accounts remains a key unfulfilled requirement and contentious issue of negotiations for the resumption of the loan deal and subsequent disbursal of the next tranche.

In view of mounting contagion risks in an environment of worsening conditions in sovereign bond markets, regional currencies remained under pressure. In detail, the Hungarian forint touched a 31-month low near 310/EUR in November, while the Serbian dinar hit a 2-month trough. Separately, the Polish zloty and the Romanian leu touched in September respective two- and one-year lows, prompting hard currency selling interventions by the respective central banks. The Turkish lira firmed ca 6% since late October, after the CBT switched to a hawkish stance to fight inflation risks and defend the battered currency.

In local rates markets, the short-end of regional yield curves has broadly underperformed over the last month or so as weakening regional currencies are fanning expectations that some central banks in New Europe may embark on a monetary tightening path in the months ahead. Indicatively, there is growing speculation that the Central Bank of Hungary may hike interest rates in the near future to support the forint, which currently stands near multi-month lows against the EUR. Meanwhile, Turkey's 2-year benchmark bond yield spiked by nearly 200bps since the end of September to a 27-month peak of 10.4% in early November, in response to the recently announced CBT tightening measures. Elsewhere, external debt markets in New Europe have fared better than other asset classes with spreads having tightened in recent weeks.

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Summary of key macroeconomic indicators

Realizations and forecasts

	Real GDP (yoy)			Consumer Prices (p.a.)			Fiscal Balance (%GDP)		
	2010	2011	2012	2010	2011	2012	2010	2011	2012
Bulgaria	0.2	2.5	2.3	3.0	4.3	3.5	-4.0	-2.0	-1.5
Poland	3.8	4.0	3.7	2.6	3.9	3.4	-7.9	-5.6	-5.0
Romania	-1.3	1.7	3.0	6.1	6.5	3.5	-6.5	-4.4	-3.0
Serbia	1.8	2.5	2.5	6.8	11.0	6.0	-4.6	-4.6	-3.9
Turkey	9.0	7.0	3.5	8.6	6.2	7.1	-3.6	-2.0	-1.8
Ukraine	4.2	4.7	4.6	9.4	9.1	9.3	-6.5	-3.5	-2.5
New Europe	5.1	4.9	3.6	6.4	5.9	5.7			
Euro area	1.9	1.5	0.5	1.6	2.7	1.8	-6.2	-4.3	-3.5
USA	3.0	1.7	2.0	1.6	3.2	2.3	-10.5	-10.0	-7.5

	Current Account (%GDP)			Policy Rate (e.o.p.)			FX* (e.o.p.)		
	2010	2011	2012	2010	current	2011	2010	current	2011
Bulgaria	-1.3	2.0	1.5	currency board			1.96	1.96	1.96
Poland	-4.6	-4.4	-4.7	3.50	4.50	4.50	3.96	4.36	4.20
Romania	-4.1	-4.5	-5.0	6.25	6.00	5.50	4.28	4.36	4.30
Serbia	-7.2	-7.5	-8.5	11.50	10.00	8.50	106.1	102.5	103.0
Turkey	-6.5	-9.5	-8.0	6.50	5.75	5.75	1.54	1.78	1.76
Ukraine	-2.1	-3.8	-4.8	7.75	7.75	7.75	7.96	8.01	8.00
New Europe	-5.0	-6.2	-5.9	-	-	-	-	-	-
Euro area	-0.4	-0.4	0.0	1.00	1.25	1.00	1.34	1.35	1.33
USA	-3.2	-3.1	-2.9	0.250	0.250	0.250	0.75	0.74	0.75

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

I. Overview

Economic growth environment deteriorates; lingering pressures on regional currencies limit room for monetary policy maneuvering

Economic activity in New Europe has been on a downtrend in recent months, being negatively affected by the lingering debt crisis in the euro area and the slowdown in main trade-partner economies. The most recent readings in a range of key real activity and sentiment indicators point to a further weakening in domestic demand dynamics and export performance during the last quarter of the year, with the slowdown in output growth expected to be more pronounced next year in view of unfavorable base effects. Although monetary policy easing across the region could provide some support, the recent weakening of regional currencies leaves limited room for maneuvering, with many central banks in New Europe currently remaining on a *wait-and-see* mode. Poland's central bank remains pat on policy rates since July, having delivered 100bps of cumulative rate hikes in H1:2011. Earlier policy tightening expectations have already been evaporated, with the FRA's strip now pricing in nearly 50bps of cumulative rate easing over the next twelve months. However, with the zloty currently remaining not far off a 2-year low of 4.5276/EUR touched in late September, the NBP may refrain from reverting into an easing policy mode any time soon. Indeed, the Central Bank has lately showed increased discomfort with the domestic currency's recent weakening by intervening in the foreign exchange markets in September and October to defend the PLN. In Hungary, although weak domestic demand dynamics should normally argue for monetary policy easing ahead, the local currency's sharp weakening in recent months leaves limited room for lower policy rates, especially when taking into account domestic households' high FX exposure. The Hungarian Central Bank has held its key policy rate at 6.00% since January 2011 and there has even been some speculation lately that the MNB may eventually be forced to resort to an extraordinary rate hike similar to that implemented in the aftermath of the Lehman Brothers collapse. Please recall that the Central Bank aggressively hiked its key base rate by 300bps to 11.50% in October 2008, as the forint plummeted to 2-½-year lows near 316/EUR. Following the Bank's last policy meeting in October 2011, Central Bank Governor Andras Simor noted that a 25bps hike was indeed discussed thought the no-policy-change decision was eventually backed by the overwhelming majority. At present, the Hungarian FRAs strip prices in fully 100bps of cumulative rate hikes over the next three months. On the other side of the spectrum, Romania's Central Bank unexpectedly cut its key policy rate by 25bps to 6.00% in early November in order to assist the anemic domestic economic recovery. In Serbia, the Central Bank has been a frontrunner in the region's easing cycle, delivering a total of 250bps of rate cuts since June, with the latest (75bps) move taking place in mid-November as inflation remains on a downtrend. Turkey's Central Bank has been an exception in the region for a while now. Initially, it pursued an unconventional policy mix of record low interest rates to cushion hot money inflows that exacerbated widening pressures on the country's current account shortfall, in tandem with higher reserve requirement ratios for banks' deposits in order to restrain buoyant credit growth. However, in view of escalating inflation pressures, the CBT switched gears in October, embarking on monetary policy tightening.

New Europe currencies, local rate markets under pressure on lingering EMU debt jitters

Against an environment of mounting EMU jitters, regional currencies remained under pressure over the last few weeks. In detail, the Hungarian forint slid earlier today towards 2-½-year lows near 316/EUR, while the Serbian dinar fell on to a 3-month low near 103.0/EUR on November 8. Separately, the Polish zloty and the Romanian leu touched respective two- and one-year troughs of 4.5276 and 4.3734 against the euro earlier this month, having recovered limited ground since then assisted by central bank interventions in foreign exchange markets. The Turkish lira stood ca 7% firmer in mid-November against a record low of 1.9088/USD touched on October 4, with the CBT's recently adopted tightening measures providing some uplift. In the local rates markets, the short-end of regional yield curves has broadly underperformed over the last month or so as weakening regional currencies raised speculation that some banks in New Europe may resort to monetary tightening in the months ahead. Turkey has fared worse compared to its peers in response to the recently endorsed Central Bank tightening measures. In detail, the 2-year benchmark bond yield reached a 27-month peak of 10.4% in early November. Short-dated Hungarian government bonds have also come under pressure lately amid growing speculation about a potential rate hike by the MNB aimed at supporting the battered forint. News that S&P and Fitch cut their outlooks on Hungary's credit ratings for a possible downgrade in the coming months in view of weakening external financial and economic conditions also weighed on government bonds. Indicatively, the 3-year benchmark yield bounced more than 50bps since the end of September, hitting its highest level in 1-½-years above 8%.

Strategy - Emerging New Europe Markets

Regional FX markets: Currencies in New Europe remained under pressure in recent weeks amid lingering uncertainty over the euro area debt crisis. Looking into the remainder of 2011, volatility is likely to remain elevated and with investor caution towards risky assets likely to increase as we approach year-end, there is little to suggest a reversal of the current trend. The Turkish lira is likely to continue range trading around its current levels. However, the recent past indicates that a TRY-basket move above the 2.20 level is likely to prompt CBT intervention (verbal or actual). As such, we would favor shorting the TRY-basket at these levels, targeting 2.10 with a stop loss at 2.24. Similar action is likely to be witnessed by the central banks of Poland and Romania, should the **EUR/PLN**

and **EUR/RON** rates approach/exceed respective levels of 4.45 and 4.36-4.37. Along these lines short **EUR/PLN** positions at 4.48 with a target of 4.33 and a stop loss of 4.53 appear to offer value at current levels. Separately, we favor entering **EUR/RON** shorts at 4.36-4.37 targeting 4.28 levels. We also like **long €/RSD** positions at entry levels below 102, targeting 104.0-104.5 and stops at 100.5, with the Serbian dinar seen remaining under pressure in the short-term on lingering euro area debt jitters.

In the sovereign credit space, our earlier **long Turkish risk via 5-year CDSs** recommendation with entry level at 290bps hit our 220bps target on October 27. At current levels around 250bps we would reverse our previous call and go **tactically long protection** with a stop loss at the recent low of 220bps and a target at 300bps. Our previous **long 5-year Russian CDS vs. short 5-year Polish** recommendation at levels around +20bps was stopped at -10bps in late October in view of the recent unexpected reversal in oil prices. From a medium-term perspective, we would reverse our call and enter short **5-year Russian CDS vs. short 5-year Polish** at levels near +35bps, targeting zero bps, with a stop loss at +50bps. Elsewhere, we maintain our short Romanian 1-year CDS position to maturity.

In the **local rates markets,** our earlier 2/10-year flattener position in Polish cross currency swaps (entry level: 38bps), hit the recommended target in late October and we took profit at 25bps. At present, we prefer to stay sidelined on local rates due to a high degree of uncertainty regarding regional central banks' monetary policy deliberations in the period ahead.

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

Current account surplus reaches record levels

- Ruling party's candidate Rosen Plevneliev won the run-off in the presidential elections: GERB still maintains a clear lead against the opposition parties
- Current account surplus widened to 4% of GDP in January-August, surpassing market expectations; capital outflows on the rise

First and second rounds of presidential and municipal elections confirm that ruling GERB party maintains clear lead in the domestic political scene

The first round of presidential and municipal elections took place on Sunday, October 23rd. Incumbent President Georgy Parvanov was unable to run again after two successive terms in office. Ruling GERB party, Rosen Plevneliev, received 40.1% of the votes. Ivailo Kalfin, the opposition Socialist party nominee received 28.8%. A third independent candidate, Mrs. Meglena Kuneva who served as a former European commissioner won 14% of the vote. At the same time, municipal elections took place. In the capital Sofia, as well as other major cities (Plovdiv, Burgas, and Pleven) GERB candidates either won outrightly or faced a run off round with a high probability to be re-elected. As no candidate received a qualifying majority, a run-off took place on Oct 30. Mr. Plevneliev was elected President winning the second round with a 52.6% of the vote against his opponent Ivailo Kalfin who received 47.4%.

The presidential election results confirmed that the ruling right-wing party continues to dominate the domestic political stage, consolidating its electoral base two and a half years after the last parliament elections. The Citizens for European Development of Bulgaria (GERB) won the last elections held in July 2009 with 39.7 % of the vote and obtained 116 of the 240 seats in parliament i.e., 5 seats less than the absolute majority. However, it managed to form a minority government with the parliamentary support of the nationalist party "Attaka", which won 9.4% of the vote and 21 seats.

The parliamentary elections results mirrored the high popularity of GERB leader, Mr. Boyko Borisov, who served as the Mayor of Sofia. The support for the government has been declining ever since, being affected by the domestic economic difficulties, intergovernmental disputes and revelation of a high profile case of wiretapping. Despite waning support for the ruling party in recent opinion surveys, GERB evidently maintains a clear lead against the opposition parties. The next parliamentary elections are scheduled for July 2013. GERB stands a fairly good chance of extending its mandate for another four year period. If so, it will be the first party in the post communist era to win a second consecutive term.

Bulgaria: Eurobank EFG Forecasts

	2009	2010	2011f	2012f
Real GDP (yoy%)	-5.5	0.2	2.5	2.3
Final Consumption	-7.3	-1.1	1.0	1.6
Gross Capital Formation *(Fixed)*	-17.6	-16.5	3.5	4.5
Exports	-11.2	16.2	10.5	5.5
Imports	-21.0	4.5	8.5	4.5
Inflation (yoy%)				
HICP (annual average)	2.5	3.0	4.3	3.5
HICP (end of period)	1.6	4.4	3.0	3.0
Fiscal Accounts (%GDP) - *Cash Basis*				
General Government Balance	-0.9	-4.0	-2.0	-1.5
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	9.3	8.5
Wage Growth *(total economy)*	11.8	6.3	5.5	5.0
External Accounts				
Current Account (% GDP)	-8.9	-1.3	2.0	1.5
Net FDI (EUR bn)	2.4	1.8	1.0	2.5
FDI / Current Account (%)	78.2	374.0	n.a	n.a
FX Reserves (EUR bn)	12.9	14.1	13.5	15.0
Domestic Credit	**2009**	**2010**	**Q1 11**	**Q2 11**
Total Credit (%GDP)	79.2	76.4	75.1	73.8
Credit to Enterprises (%GDP)	49.4	48.2	47.4	46.8
Credit to Households (%GDP)	28.2	26.4	25.7	25.1
FX Credit/Total Credit (%)	58.6	61.3	61.6	62.1
Private Sector Credit (yoy)	4.5	2.1	2.9	3.3
Loans to Deposits (%)	120.5	112.9	109.7	108.2
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

Current account surplus reached record highs in January-August 2011

The current account surplus exceeded market expectations in the first eight months of this year, reaching a record €1.56bn in August, compared to €885 mn in July and a deficit of €475mn in December last year. As a percentage of projected GDP, the current account surplus widened to 4% in Jan-Aug up from 2.2% of GDP in Jan-July and a surplus of just 0.5% in the first five months of this year. The improvement in the current account in the last two months primarily reflects the robust performance of services and current transfers.

The surplus of services reached 4.7% of GDP in August compared to 0.8% of GDP last May, driven by strong tourism revenue. In addition, the current transfers' surplus amounted to

3.2% of GDP in August up from 2% in last May on increased EU funds absorption. Meanwhile, the deterioration in the balance of income continued in the first eight months, with the corresponding deficit widening to 2.4% of GDP compared to 1.2% in last May.

On the other hand, the trade deficit stabilized at relatively low levels, inching up to 1.5% of GDP in August, from 1.1% in May. Exports continued their robust recovery, still expanding at an astonishing 34% yoy rate in Jan-Aug. Even though exports slowed down from 48.4% in Jan-May, they still outpaced imports. Imports expanded by 20.3% yoy in Jan-Aug, down from 25.2% yoy in Jan-May. The Bulgarian economy benefits to some extent from the diversification of its export portfolio to high growth areas as well as high commodity prices. Non EU markets destinations now represent 40% of the total export portfolio (e.g. Russia & Turkey).

Capital outflows on the rise

From the financing side, the shift to hefty current account surpluses is partially outweighed by rising capital outflows. Bulgaria is running a financial account deficit for a second year in a row. The financial account deficit has reached 4.8% of GDP in Jan-Aug compared to 0.5% of GDP deficit in 2010. If the capital account surplus is included, the deficit is contained at 3.9% of GDP in Jan-Aug compared to a 0.3% surplus recorded in 2010.

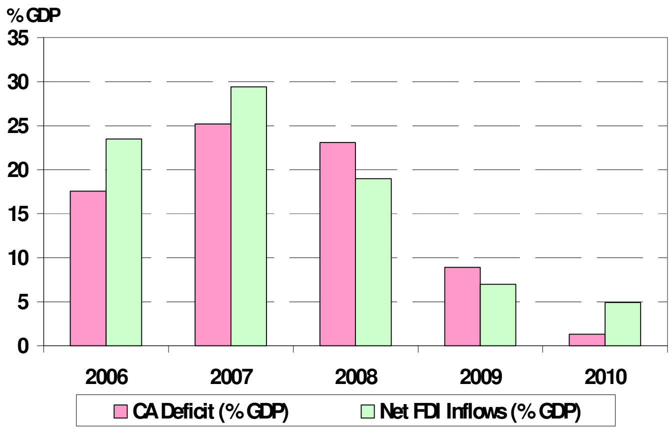
Net FDI inflows remained subdued in Jan-Aug , amounting to only €225 mn compared to €926.5mn a year earlier (down by 75.5% yoy). The drying up of net FDI inflows is particularly important from a policy standpoint. The Bulgarian economy was a major beneficiary of capital flows in the broader region in the past booming years, which served as the main engine of domestic growth. Driven by convergence prospects, the Bulgarian economy received 27.1 bn Euros in FDI inflows during 2004-2008. In the aftermath of the crisis, capital inflows are sharply lower and are highly unlikely to reach their pre-crisis levels. In that challenging environment, it appears that the Bulgarian economy has adjusted relatively well switching to a more balanced domestic vs. external demand mix.

Net portfolio investments remained negative (-€483mm vs. -€567mn in January-August 2009). More importantly, the financial account deficit has been driven by the negative balance of other investments, which reached a cumulative deficit of €1.7bn in the first eight months of the year.

Overall, if net errors and omissions are included, the balance of payments recorded a surplus of €123mn in the first eight months of the year, which also explains the slight increase in FX reserves over that period. International reserves (FX reserves plus gold and IMF drawing rights) remain at relatively high levels (€13.1 bn or 33.2% of GDP in August 2011), enough to cover the country's external financing needs. International reserves coverage of short term debt improved to 122.9% in August vs. 111.5% in August 2009, the highest level in the post Lehman period. Moreover, international reserves covered 151.6% of the total FX deposits of the population almost unchanged from a year ago.

All in all, the unwinding of the external deficit, once considered to be the major vulnerability of the Bulgarian economy, has so far proceeded in an orderly, yet painful, fashion. Over the last two years, the current account deficit dwindled from 23.1% of GDP in 2008 to 8.9% of GDP in 2009 and finally landed to 1.3% of GDP in 2010 (Figure 1). With our conservative calculations, the full year current account surplus could exceed 2% of GDP in 2011. First of all, the trade deficit could widen as the Euroarea slowdown will eventually take its toll on Bulgarian exports and some pick up in imports-particularly energy related- is traditionally expected by the end of the year.

Figure 1
The current account deficit dwindled within 3 years from 25.2% in 2007 to 1.3% in 2010



Source: BNB, Eurobank Research

All in all, the sharp improvement in the current account balance gradually shifted risk perceptions away from the balance of payments helping Bulgaria contain financial risks of the deepening Euroarea sovereign crisis. However, despite its declining trend, the level of external debt is still at very high levels, which may entail significant refinancing risks in tight global liquidity conditions. External debt stood at 91.4% of GDP (the vast majority of which is private sector denominated) in last August down from 102.8% in 2010.

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

Market friendly parliamentary elections result with the ruling party winning a comfortable victory

- Polish ruling party won a comfortable victory in October's parliamentary elections
- Polish growth prospects remain solid but less bright due to euro-zone slump
- September's inflation slowed more than expected on food inflation drop
- Policy rate remained unchanged at 4.50% on the back of inflation easing and concerns over the zloty's depreciation
- Non-Performing Loans are still rising even though NPLs ratio to total loans decelerates due to rapid credit expansion.

Polish ruling party won a comfortable victory in October's parliamentary elections

Polish ruling Civic Platform party (PO) won 39.2% of the vote in October's parliamentary elections vs. 29.9% for its closest rival Law & Justice (PiS). The Peasants party (PSL), the junior partner in the current coalition, won 8.2% compared to 10% for the Palikot Movement (a party founded last year from a member of parliament who quitted Tusk's Civic Platform party) and 8.2% for the Democratic Left Alliance. Polish Prime Minister, Donald Tusk, won an unprecedented second consecutive election. This is the first post-communist government to serve out its entire four year mandate and the first to be re-elected. This coalition PO-PSL government may receive a boost to plans for more reforms. The Peasant party will have less bargaining power after this election result as there are other parties as alternatives in case they threaten to leave the coalition. Overall, the election result is market friendly and preserves political stability in Poland.

Growth prospects remain solid

The Polish economy keeps outperforming compared to its neighbouring countries. Although the economy has lost some steam, the slowdown has not been as severe as in its peers in the region. Admittedly, the growth rate is supported by preparations for the 2012 European Football Championship coupled with inflows of EU structural funds. However, business sentiment indicators suggest that economic activity may weaken somewhat in the coming quarters due to euro-zone slump; note that Poland's major trade partners are Germany, France and Italy. On a positive note, industrial production seems to have stabilised lately after a deceleration since the beginning

Poland: Eurobank EFG Forecasts

	2009	2010	2011f	2012f
Real GDP (% yoy)	1.6	3.8	4.0	3.7
Private Consumption	2.1	3.2	3.5	3.6
Government Consumption	2.1	3.9	3.0	2.5
Gross Capital Formation	-13.7	7.8	6.5	4.5
Exports	-6.8	10.2	6.8	7.0
Imports	-12.4	11.6	7.9	7.1
Inflation (% yoy)				
CPI (annual average)	3.5	2.6	3.9	3.4
CPI (end of period)	3.5	3.1	4.1	3.2
Fiscal Accounts (% GDP)				
General Government Balance	-7.3	-7.9	-5.6	-5.0
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	12.1	12.2	11.8
Wage Growth *(private sector - average)*	4.2	3.6	4.5	4.3
External Accounts				
Current Account (% GDP)	-3.9	-4.6	-4.4	-4.7
Net FDI (bn EUR)	6.1	2.5	8.0	9.0
FDI / Current Account (%)	90.6	65	75	70
FX Reserves (bn EUR)	55.2	70	60	65
Domestic Credit	**2009**	**2010**	**Q1 11**	**Q2 11**
Total Credit (% GDP)	53.1	55.4	55.0	56.3
Credit to Enterprises (% GDP)	16.1	15.2	15.3	15.8
Credit to Households (% GDP)	31.6	34.2	33.7	34.5
FX Credit/Total Credit (%)	30.2	30.8	30.1	30.6
Private Sector Credit (% yoy)	7.2	8.9	10.6	9.0
Loans to Deposits (%)	102.6	102.4	99.5	104.6
Financial Markets	**Current**	**3M**	**6M**	**12M**
Policy Rate	4.50	4.50	4.25	4.25
EUR/PLN	4.36	4.20	4.10	4.10

Source: NBP, EcoWin, Bloomberg, Eurobank Research of the year. Industrial production expanded by 7.8% yoy in September, down slightly from 7.9% yoy in August, but well above the 1.8% yoy recorded in July. Moreover, an upside surprise came from manufacturing PMI; it stood at 51.7 in October from 50.2 in September. Nevertheless, we anticipate industrial production to slow in the coming quarters, when the effects of a slowdown in Western European markets would be more apparent to the Polish economy.

Labour market data have been weaker than expected with moderate wage growth (5.2% yoy in September vs. 5.4% yoy in August) and still elevated unemployment (11.8% in September). Hitherto, this has not yet fed through into consumption as retail sales high figure indicate (11.4% yoy in September). All told, we expect GDP growth to average 4.0% yoy in 2011 as a whole and decelerate to 3.7% yoy in 2012 due to economic activity slowdown in most European trade partners of Poland.

Inflation slowed more than expected on food inflation drop

Headline inflation dropped more than expected in September. It stood at 3.9% yoy, down from 4.3% yoy in August, on the back of food inflation drop. Nevertheless, it still stands above the Central Bank's target of 2.5% for a 12th consecutive month. Clearly, the outlook for inflation is improving as weaker growth and lower commodity prices support inflationary pressures ease. We anticipate CPI to average 3.9% yoy in 2011 and abate further to 3.4% yoy in 2012 due to a lagged effect of monetary policy tightening implemented in the first half of the year and waning impact of January's 2011 VAT increases.

Monetary policy unchanged as was widely expected

As expected, the National Bank of Poland (NBP) kept the policy rates unchanged at 4.50%, after having implemented monetary policy tightening by 100bps in the first half of the year. As the minutes of the MPC meeting highlighted, in the medium term inflation will be curbed by lower domestic economic growth amidst fiscal tightening, as well as the expected global economic slowdown. Significant risk to domestic price developments stems from a weaker exchange rate. The zloty has already fallen by 10% against the Euro since the beginning of August and it remains vulnerable to swings in investors risk appetite. That said, concerns over the zloty mean that it might be early to start monetary policy loosening. However, with the growth outlook deteriorating, we anticipate the NBP to start easing policy early next year and the policy rate to reach 4.00% by end-2012.

Current account deficit narrowed but still at a relatively high level

The current account deficit amounted to €1.7bn in August narrowing from €2.0bn. One of the factors which contributed to lower current account deficit was that export growth exceeded considerably import growth (17.1% vs. 11.7%) in this period. Moreover, August's current account deficit was mainly driven by a deficit in the Incomes Balance, especially its part which goes towards investments and amounted to €1.7bn. As a result of capital inflows in Poland, the FDI inflows reached €1.0bn and the portfolio investment stood at €2.5bn.

The current account deficit was revised to 4.6% of GDP in 2010 (vs. 3.3% of GDP estimated previously), following a sharp upwards revision of imports and a correction of the sizeable errors and omission component of the Balance of Payments. We expect the current account deficit to narrow to 4.4% of GDP in 2011 as a result of a depreciating currency and a moderate increase in current transfers.

Additional fiscal measures are needed to reach the 2012 target for a fiscal deficit below 3% of GDP due to slower GDP growth

Following October's parliamentary elections, the new government will have to re-submit a 2012 budget. September's budget proposal was based on forecasts made last spring, but since then both growth and inflation projections have been revised downwards. Taking this into account, fiscal deficit in 2012 is estimated to reach 5.0% of GDP instead of below 3% of GDP initially forecasted by Polish authorities, unless additional fiscal measures are implemented.

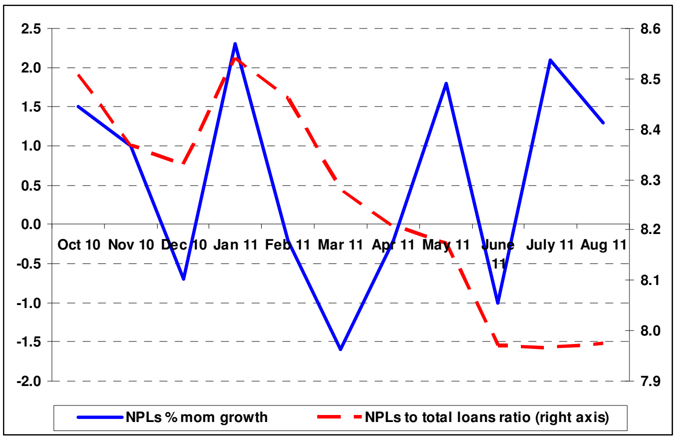
NPLs ratio deceleration is misleading since NPLs keep rising

Total credit growth continued to be robust in September; it grew by 15.4% yoy / 1.9% mom up from 13.9% yoy / 1.6% mom recorded in August. What's more, total credit expanded by 11.8% year-to-September. Private sector credit is driven both by corporates' and household lending, with mortgages loans increasing by 2.6% mom / 21.1% yoy and 14.8% year-to-September. On the other hand, we observe a slowdown in deposits growth; they increased by 0.4% mom in September vs. 1.9% mom in August. Yet, total deposits stand at 6.8% year-to-September.

What is worrisome in the Polish banking system is the large share of private sector credit denominated in FX; it stood at 32.5% of total in September, up from 30.6% in June. This mirrors the recent depreciation of domestic currency (the zloty) but it also poses concerns over the private sector disposable income on the back of the recent CHF appreciation (most FX denominated loans are in CHF in the Polish banking system).

Equally importantly, total Non Performing Loans (NPLs) are still rising (although at a slower pace than the one in 2010); they grew by 4.4% year-to-August and 1.3% mom in August. However, due to the robust credit growth, NPLs to total loans ratio is decelerating; it stood at 8.0% in August, down from 8.5% at the beginning of this year (Figure 1). The largest share of NPLs is recorded in the household sector, it accounted for 58.1% of total NPLs in August up from 55.5% in January.

Figure 1
NPLs recent acceleration although NPLs ratio deceleration



Source: National Bank of Poland, Eurobank Research

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

NBR delivers surprise 25bps rate cut

- Inflation declined sharper than expected in September on lower food prices and muted demand-side pressures.
- In the November inflation report, the Central Bank revised downwards its year-end 2011 CPI forecast to 3.3% from 4.6% previously; end-2012 inflation now seem at 3% vs. 3.5% previously
- After nineteen months of staying put on policy rates, NBR surprised market participants by cutting its key interest rate by 25bps to 6.00%

September inflation down more than expected on lower food prices and favorable base effects; Central Bank cuts its year-end CPI forecast to 3.3% from 4.6% expected previously

Consumer price inflation declined for a fourth month in a row in September, coming in at -0.2%/+3.5% mom/yoy, from -0.4% /+4.3% mom/yoy in the prior month. The September reading was significantly lower than the market's median forecast (+0.2% mom/+3.9% yoy). In EU-harmonized terms, HICP inflation stood at 3.5% yoy in September vs. 3% yoy in the Euroarea. In terms of convergence criteria, the 12-month average inflation declined further to 6.9% yoy, from 7.3% yoy in August, remaining though significantly higher than the corresponding euro area average of 2.9% yoy.

On the positive side, headline inflation in September was heavily influenced by favorable base effects, related to the 5ppts VAT rate hike implemented in July 2010. . Food prices (-1.2% mom/+1.7% yoy) also exerted a disinflationary impact, driven by sharp monthly declines in the prices of vegetables (-13.3% mom) and fresh fruit (-5.7% mom) thanks to a very good harvest season in the summer months and favorable seasonal effects. Meanwhile, non food prices edged higher (+0.2% mom/+4.8% yoy), with fuels registering the highest increase (+1% mom). In contrast, services prices expanded moderately (+0.5% mom/+3.5% yoy), assisted by the increases in water utilities and transportation.

We now forecast year-end CPI to stand at around 3.3-3.7%, remaining within the Central Bank's 3%+/-1% target range. Yet, we continue seeing some upside inflation drivers in the coming months, stemming primarily from the risk of fiscal slippage ahead of the 2012 parliamentary elections and further increases in the administered prices. On a more positive note, demand-side pressures remain weak, in line with the negative output gap. Notably, adjusted Core 2 inflation (CPI excluding regulated prices, fresh food, tobacco and alcohol) declined to 2.7% yoy in September, from 2.9% in the prior month and 4.8% in June.

Romania: Eurobank EFG Forecasts

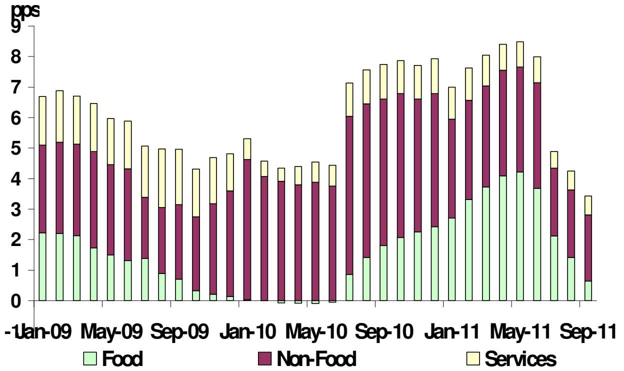
	2009	2010	2011f	2012f
Real GDP (yoy%)	-7.1	-1.3	1.7	3.0
Private Consumption	-10.7	-1.7	1.0	2.5
Govern. Consumption	1.5	-3.0	-2.5	1.0
Gross Capital Formation	-26.2	2.7	3.5	5.5
Exports	-5.0	13.1	8.0	6.5
Imports	-20.5	11.6	5.0	7.0
Inflation (yoy%)				
CPI (annual average)	5.6	6.1	6.5	3.5
CPI (end of period)	4.8	8.0	3.7	3.0
Fiscal Accounts (%GDP, Cash Basis)				
General Government Balance	-7.3	-6.5	-4.4	-3.0
Gross Public Debt	23.9	31.7	40.1	40.0
Labor Statistics (annual avg,%)				
Unemployment Rate (% of labor force)	7.8	6.9	7.0	6.5
Wage Growth (total economy)	8.4	2.5	1.4	4.5
External Accounts				
Current Account (%GDP)	-4.2	-4.1	-4.5	-5.0
Net FDI (EUR bn)	3.6	2.6	3.0	5.0
FDI / Current Account (%)	73.5	52.0	50.0	70.0
FX Reserves (EUR bn)	30.9	36.0	38.0	45.0
Domestic Credit *(end of period)*	**2009**	**2010**	**Q1 11**	**Q2 11**
Total Credit (%GDP)	50.2	52.7	50.7	52.7
Credit to Enterprises (%GDP)	19.6	20.4	19.8	20.5
Credit to Households (%GDP)	20.4	19.9	18.7	19.1
FX Credit/Total Credit (%, private)	60.1	63.0	62.2	62.9
Private Sector Credit (yoy)	0.9	4.7	2.3	1.3
Loans to Deposits (%)	130.6	137.7	136.9	134.9
Financial Markets	**Current**	**3M**	**6M**	**12M**
Policy Rate	6.00	5.75	5.50	5.50
EUR/RON	4.36	4.30	4.35	4.35

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

Central Bank surprised markets in early November by cutting its key policy rate by 25bps

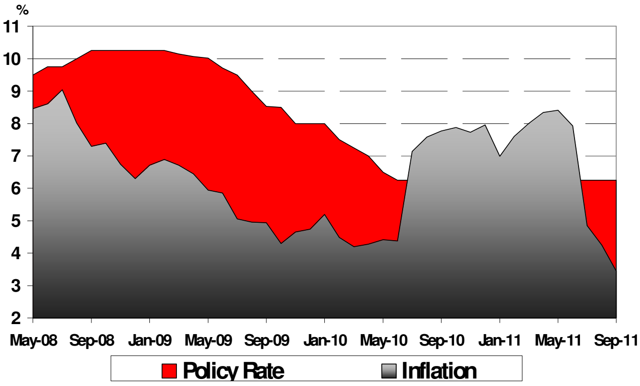
After staying put on rates for 19 consecutive months, the NBR delivered a 25bps cut on November 2, bringing its key policy rate to 6.00%. In a Reuters' poll conducted ahead of the policy meeting, 11 out of the a total of 15 analysts surveyed expected rates to remain on hold, with the rest forecasting a 25bps cut, In a written statement the Central Bank cited three main reasons for its latest rate decision, including: (i) an improved short-term inflation outlook; (ii), the persisting negative output gap; and (iii) still soft domestic credit dynamics. On the first point, the Central Bank

Figure 1
Inflation declined rapidly in the last months on favorable base effects, declining food prices and muted demand side pressures



Source: NBR, Eurobank Research

Figure 2
Real interest rates are positive again in Romania after the sharp inflation decline



Source: NBR, Eurobank Research

emphasized the disinflationary impact of lower food prices and the facing out of base effects related to the July 2010 VAT rate hikes. In our view, Inflation will not only remain low for the remainder of this year but it will also retreat further in 2012. Vice Governor Christian Popa was quoted as saying on September 29th that inflation will most probably slow to 3% in 2012, within the 2-4% Central Bank band.

Secondly, the persisting negative output gap allows the Central Bank to be more accommodative. The Central Bank notes that industrial production and exports are performing relatively well despite increased negative signals from the main export markets. Romania was among those economies in New Europe which exited recession last. Yet, the pace of domestic economic recovery has been rather modest so far this year and our full-year GDP growth forecast of 1.7% remains well short of potential growth. To make things worse, downside risks have increased lately, because of weakening economic conditions in the euro area and other trading partners. Last but not least, domestic credit conditions remain soft even after three years of the Lehman debacle.

It is also important to emphasize that the NBR' latest rate cut was instrumented in the midst of and exceptionally volatile and uncertain external environment characterized by a deepening sovereign debt crisis in the euro area. Yet, this implies that the Central Bank doesn't necessarily feel less comfortable with a weaker exchange rate in the current trajectory , especially in view of a revival of the carry trade in the domestic currency given that real interest rates are now positive (Figure 2).

Barring any unforeseen external shocks, stemming *e.g.* from the euro area debt crisis, we see room for more NBR rate cuts, though not earlier than in Q1-2012.

The rapid deterioration of growth prospects and accelerating disinflation trend should motivate such a decision. The dovish comments of the NBR governor Mr. Isarescu at the press conference of the new inflation report point to the same direction. The Governor stated that current market conditions leave room for more rate cuts, though these should be implemented in small and gradual steps so as to avoid undesirable disruptions in the domestic currency market. These comments only served to strengthen market expectations of lower policy rates in the period ahead, without, however, triggering any major moves in the FX market. On November 7th, the Leu traded at 4.35/€, having depreciated by approximately 2% year-to-date, outperforming many of its regional peers. In conclusion, more NBR rate cuts should be expected, though the need to maintaining positive real interest rates (for *e.g.* stimulating domestic savings and/or attracting capital inflows to help fill the external financing gap) may argue against an overly aggressive policy easing trajectory in the period ahead. We forecast the key policy rate to stand at 5.50%-5.75% at the end of Q2 2012 (Eurobank EFG Research forecast).

Third review of precautionary IMF programme completed

The new precautionary IMF agreement provides a financing cushion in case of a new global downturn thus reducing the sovereign risk premium of the country. The third review of the new agreement was completed by the IMF mission on November 7th. The assessment contained a positive note over the fulfillment of the criteria of the program for September end. However, additional emphasis should be given to the implementation of structural reforms particularly in the area of state-owned enterprises.

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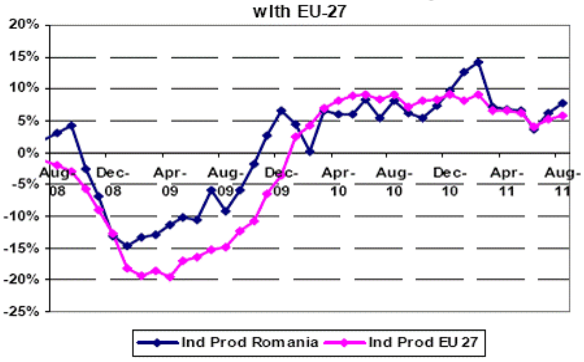
Focus: Industrial Production Outlook

For the past 2 years, the recovery of the Romanian economy has been predominantly driven by the industrial sector. Industrial production in Romania has been closely correlated with exports and industrial production in the Eurozone (as can be seen in figure 1).

Figure 1
Romanian Industrial Production is closely correlated with EU-27



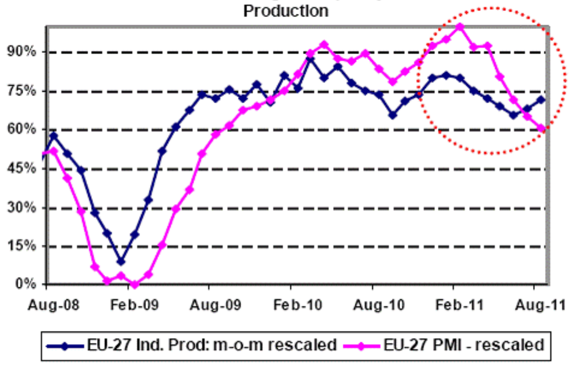
Source: Eurostat, National Statistics, Bancpost

However, as conditions in the external economy are showing signs of deterioration, analysts have come to expect a sharp slowdown in the Romanian recovery. While we agree this relationship invariably holds in the longer term, we believe there is a fair chance that growth will surprise to the upside in the short term.

Leading indicators have been the main sign that economic conditions in the European Core are worsening. EU-27 PMI fell from 54 points in May to 49 points in September, the lowest level since September 2008 (figures below the 50 threshold indicate contraction in the manufacturing sector); This trend has also been confirmed by other sentiment indicators such as the ZEW or IFO indices. While industrial production has slowed down (+5.7% in August vs. +6.1% in May on a yearly basis), the rate of deceleration has been smaller than the PMI would have otherwise indicated. This diverging dynamic is most apparent in our PMI-based forecasting models (where the forecasting error increased to approximately 1.5pp), but can also be observed in Figure 2 (which rescales EU-27 PMI and Industrial Production for the past 2 years).

This divergence may be attributed to different sensitivities of the indicators to conditions in financial markets. Leading indicators have an important sentiment component and thus are more susceptible to adverse movements in the markets. While the real economy is also influenced by conditions in the financial

Figure2
PMI has been deteriorating more quickly than industrial Production



Source: Eurostat, Bancpost

markets, the response is more lagged. Therefore, we expect this divergence to remain with us for the next months of the year.

Manufacturing in Romania shrank -1.47% on a monthly basis in June, but resumed growth shortly (+2.32% in July and +1.75% in August). This dynamic has been helped by a pickup in exports, but also by resilient domestic orders. The latter have been hovering around +11% y-o-y for the past 5 months (Polish New Domestic Orders have been similarly stable, as opposed to Hungarian and Czech ones). Managers' expectations for production in the months ahead have had a similar dynamic and remained stable around the 53 level for the past 5 months (the index shows the balance of positive answers).

Cumulatively, we believe the Romanian industrial sector can continue to prove resilient in the months ahead. By also factoring in the good harvest, it is very likely for the economy to overshoot growth expectations in 2011 (market consensus currently stands at 1.5%)

Fiscal Policy and Financing Outlook

The Romanian budget execution continues to remain comfortably within the targets agreed with the IMF. The year-to-date deficit reached 2.5% in September (-41% less than during the similar period of 2010).

While the budget for 2012 still hasn't been presented to the Parliament, it is increasingly likely that the Government will face severe headwinds in meeting its targets.

The fiscal strategy for 2012 initially saw a budget deficit of 3% of GDP and was relying on a rate of expansion for the economy of +3.5%. However, adverse developments in the external economy will force the Government to revise the rate of expansion downwards (Government officials were recently quoted referring to the figure of +2.1%).

Both the President and PM have recently asserted the deficit will be lower than 3% in order to comply with the Maastricht treaty conditions and avert the excessive deficit procedure from the European Commission. This however, will be a very tall order and will call for new and significant spending cuts in the budget;

On the upside, the better than expected budget execution in 2011 will create space for the Government to bring forward some of the 2012 spending.

Funding conditions for public debt have become more stringent during the past three months. In this period, the MoF has rejected 4 tenders in the primary market cumulatively worth RON 2.3bn (€ 1.6bn). Moreover, the average rate of collection for new issues also fell to 50% from an average of 99% for the first 8 months of the year.

As we asserted in the October New Europe Bulletin, the MoF recently announced its intention to tap international markets in November. Deputy Finance Minister B. Dragoi has also confirmed the Treasury plans to access the US market.

Recently, the MoF has made public the list of eight banks picked to manage and the two legal advisers for the €7bn programme.

Market conditions for this type of issue have fluctuated wildly for the past two months. The Romanian 5yr CDS stood at 254bp. in June (at the time of the first EMTN), spiked to 462bp. at the beginning of October, and later dropped to the current levels of 380bp. The 5-yr. Euro IRS fell from 1.8% in June to a minimum of 1.03% at the end of September, and stands currently at 1.4%. Market conditions are pictured in Figure 3.

Cumulatively, we believe these conditions set the stage for a relatively expensive issue and may push yields above 5.75%. Despite these higher costs, we expect the Government to try push through a larger amount of debt than at the first EMTN (€1.5 bn) due to the substantial risks that lie ahead.

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

NBS cuts rates by a further 75bps

- On November 10, NBS cut its key policy rate by a further 75bps to 10%; since the inception of its easing cycle in early June the Central Bank cut rates by a cumulative 250bps
- Inflation landed on single digits-8.7% yoy-in October on low demand pressures and stabilized food prices
- The new precautionary IMF agreement and the recent successful Eurobond sale are having a positive impact on Serbia's macroeconomic outlook
- EU Commission recommended Serbia to gain EU candidate status by December. However, accession negotiations can only start upon progress in the contentious Kosovo dispute issue

NBS cut rates further in October by 50bps and more aggressively by another 75bps in November. Since the inception of its easing cycle in early June the Central Bank cut rates by a cumulative 250bps from 12.5% to 10%

On November 10, the NBS lowered unexpectedly its key policy rate by a further 75 bps to 10%. This was the fifth rate cut since June 7th, when NBS initiated its latest monetary policy easing cycle. According to the Bloomberg survey conducted ahead of the last policy meeting, no analyst expected such a rate cut. The majority of participants surveyed (9 out of 22) expected a 25bps cut; six expected a 50 bps rate cut and eight anticipated no rate change.

In a written statement, the Central Bank emphasized the strong disinflationary impact of weak demand side pressures on top lower food and regulated prices. Food prices stuff (37.8% weight in the consumer basket) has been on a decelerating trajectory since the beginning of the year, declining to single digit levels at 9.9% yoy in October compared to 10.6% yoy in September, from 12.8% yoy in August and a peak of 22.9% yoy in March 2011. The sharp decline of food prices is driven by favorable base effects and the positive impact of the new agricultural season which started in July. In addition, inflation expectations are showing a nascent decline (by a full percentage point), according to the Bloomberg survey.

We have always advocated in our previous New Europe Economics & Strategy issues that domestic inflation has predominantly been driven by supply-side factors related e.g. to domestic food prices. Inflation gradually retreated more visibly towards the targeted band in 2H 2011, after having peaked at 14.7% yoy in April. Consumer prices stood at +0.4% mom/+8.7% yoy in October compared to +0.2% mom/+9.3% yoy in September against +0% mom/+10.5% yoy in August.

Provided that there are no other major supply-side shocks, year-on-year inflation is expected to end in single digit, little above the Central Bank target (4.5%+/-1.5%). However, the NBS forecast is that inflation will continue to decline and that it will return within the target tolerance band in Q1 2012 (2.5%-5.5%).

Serbia: Eurobank EFG Forecasts

	2009	2010	2011f	2012f
Real GDP (yoy%)	-3.5	1.0	2.5	2.5
Inflation (yoy%)				
CPI (annual average)	8.6	6.8	11.0	6.0
CPI (end of period)	6.6	10.3	7.5	5.0
Fiscal Accounts (%GDP)				
General Government Balance	-3.7	-4.6	-4.6	-3.9
Gross Public Debt	38.2	44.9	41.1	40.2
Labor Statistics (%)				
Unemployment Rate (%of labor force, ILO)	16.9	20	20.0	19.0
Wage Growth *(total economy)*	-3.5	8.0	8.3	9.0
External Accounts				
Current Account (% GDP)	-7.2	-7.2	-7.5	-8.5
Net FDI (EUR bn)	1.4	0.9	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	**2009**	**2010**	**Q1 11**	**Q2 11**
Total Credit (%GDP)	51.8	61.6	60.0	59.5
Credit to Enterprises (%GDP)	29.7	34.4	33.6	33.3
Credit to Households (%GDP)	17.3	19.1	18.3	18.4
Private Sector Credit (yoy)	14.3	26.5	18.1	11.0
Loans to Deposits (%)	127.0	144.6	148.9	148.8
Financial Markets	**Current**	**3M**	**6M**	**12M**
Policy Rate	10.00	9.50	9.00	9.00
EUR/RSD	102.50	103.00	105.00	106.00

Source: National Sources, IMF, Eurobank Research & Forecasting

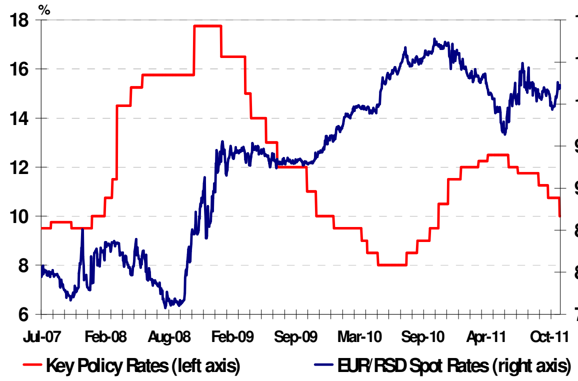
On the other hand, the latest NBS policy statement signals a shift of focus from concerns about inflation to growth-related worries. The recent readings in a range of higher-frequency indicators point to a rapid weakening of domestic economic activity. Industrial production was down by 1% yoy on seasonally adjusted terms in August, sliding by a further 1.8% yoy in September. The flash estimate of GDP growth in Q3-0.7% yoy- was also disappointing. The prospect of a more pronounced global economy slowdown weighs significantly on the outlook of Serbian exports and argued in favor additional policy accommodation by the Central Bank. The latter view is also supported by the dovish comments of the NBS governor Mr. Dejan Socic who stated that "Serbia has already been hit by the second wave of the economic crisis and should strive to ensure that all necessary mechanisms to minimize the damaging effects". Yet we donot anticipate that that there will be any further rate cuts in the last meeting of the year in December. That said, it is more likely for the Central Bank to switch to a wait and see mode until the beginning of next year in order to have more visibility in a global environment of heightened uncertainties. Ceteris paribus, we anticipate more rate cuts (around 100-150bps from 10% to 8.5%) to take place in 1H-2012 in line with the envisaged inflation decline-yet delivered at a slower pace.

New precautionary IMF agreement and successful Eurobond sale augur well for Serbia's macro outlook

The new precautionary agreement endorsed by the IMF board on Sep 30th, aims to provide a cushion in case of a new global downturn and to reduce sovereign risk premia. On top of that, Serbia was able to successfully launch it's first-ever Eurobond issue on September 23rd. The 10 year Eurobond bond issue (€1bn, 7.5% coupon) received bids of €2bn (twice as much as demanded) and it was priced at 7.75%. However, the secondary market yield of the aforementioned bond soon climbed to 8.1%, because of a wider sell off in the credit markets as a result of the deepening Euroarea sovereign crisis. The Eurobond sale already satisfied a part of the government's pressing borrowing need, with proceeds covering around 16% of the full-year financing requirement. In a more important note, Serbia puts itself on the map of CEEMEA credits gaining access to long-term sources of financing.

In contrast to other regional peers, the Dinar is still holding to some of its year-to-day gains. On November 14, dinar stood at 102.5/€, approximately 3% stronger vs. the single currency relative to its end-2010 levels. However, the attractiveness of the Dinar carry trade is fading away. The combination of lower interest rates, the downward revision of several key macro figures and analyst & Markets' concerns over potential spillovers from the deepening EMU sovereign crisis and global growth slowdown concerns paint a gloomier outlook for the local currency until the end of the year.

Figure 1
Since the inception of its easing cycle in early June the Central Bank cut rates by a cumulative 250bps from 12.5% to 10%



Source: NBS, Eurobank Research

EU Commission recommends Serbia to gain EU candidate status

On October 12th, the EU Commission published its annual report on enlargement (the so-called European Enlargement package 2011). The report contains an assessment of the progress made by individual countries (Western Balkans, Turkey, and Iceland) towards EU accession over the past year. A significant part of the report was devoted on the European Union membership application of Serbia. The key finding of the report was the recommendation for Serbia to gain EU candidate status.

First of all, EU Commission praised Serbia's efforts in the co-operation with ICTY (International Court) which resulted in the arrest and extradition of the two remaining indictees (Ratko Mladic and Goran Hadzic). The report acknowledged Serbia's progress with respect to both political and economic criteria. More specifically, the report acknowledged the institutional framework improvement in line with EU and international standards (financing of political parties, electoral law, and government relations with independent regulatory bodies). In addition, the report takes note of the progress in establishing a functioning market economy and the high economic integration with EU. However, the report underscores the structural weaknesses particularly those related to the business environment and the informal economy. Moreover, it urges Serbia to address the challenges in the implementation and enforcement of the EU related legislation through strengthening the capacity of the judiciary.

Even if all technical issues are resolved, the issue of Kosovo status remains an impediment towards EU accession. Negotiations for EU accession can only start upon progress in the contentious Kosovo dispute issue. The contentious issue stems from a struggle between Kosovo –– and Serbia over which state should exert authority in the mainly Serb populated north of part of Kosovo. Serbia does not recognize Kosovo's sovereignty whose ethnic Albanian majority declared independence in 2008. Both parties made some progress in a number of issues during the negotiations in order to reach a working relationship (e.g. freedom of movement for goods and citizens between territories, the mutual recognition of education diplomas etc)

However, the negotiations have come to a standstill over the thorny issue of Kosovo customs stamps on traded goods. Serbia refused to import goods with the Kosovo authorities' stamps on them. In retaliation, Kosovo's authorities decision to impose an import ban on Serbian goods. To make things worse, violence erupted in past July when Kosovo authorities together with EULEX (EU police and judiciary forces) attempted to seize border posts - staffed mostly by ethnic Serbs - to gain complete control and enforce the reciprocal import ban. Given that next parliamentary elections are scheduled to take place in May 2012, it would be highly unlikely for the current ruling government coalition to make any further concessions in this politically sensitive issue. Last but not least, we need to take into account that the support of Serbian citizens towards EU membership is waning. According to the latest surveys, the popularity of EU membership has dropped to the lowest level of the last five years.

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Focus: A short history of EU-Serbian relations

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

- The Stabilization and Association agreement (SAA), the most important contractual agreement between Serbia and EU, was signed in April 2008. Although Serbia has made steady progress in complying unilaterally with the SAA requirements, the agreement has not been ratified by all EU members
- Serbia applied for EU membership in a symbolic gesture in December 2009. At the same time, EU visa restrictions for Serbia citizens were abolished for the first time since the nineties. In addition, EU agreed to unblock the interim trade agreement, the most significant part of (SAA). The Interim Trade Agreement, the first step towards European trade integration, was entered into force in February 2010
- In fact, the SAA agreement ratification procedure by EU members was not launched until June 2010. Ever since, only 11 of the 27 member states have completed the process. Some EU members (e.g. Holland) refused to ratify the agreement on the basis that Serbian's co-operation with the ICTY was deemed insufficient. The ratification procedure is very important because it is a key prerequisite for granting EU candidate status and allowing access to increased pre-accession funds assistance for Serbia
- On October 25th 2010, EU foreign ministers asked the Commission to prepare a formal assessment of Serbia's application. Shortly after, the EU Commission sent a questionnaire with 2,500 questions to the Serbian authorities in order to assess its readiness to join EU.
- On January 19th 2011, the Euro-parliament ratified with an overwhelming majority (~90%) the Stabilization and Association agreement. In addition, the Euro-parliament welcomed Serbia's reform progress and steps "in the process of raising awareness of the atrocities that happened in the recent past and of regional reconciliation" with a separate resolution
- The EU Commission expressed its opinion on Serbia's EU application, recommending EU candidate status for the country on October 12th, 2011. The EU council in December is expected to adopt

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

CBT embarks on monetary policy tightening to address rising inflation risks, contain pace of lira weakening

- Domestic economic activity seen decelerating in H2:2011
- Medium Term Programme (2012-2014) focuses on containing the current account deficit
- CBT tightens monetary conditions, adopts five-point action plan to support the lira
- August current account deficit data confirms gradual adjustment in progress

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Domestic economic activity seen decelerating in H2:2011

Following real GDP growth of 10.2%yoy in H1:2011, domestic economic activity is expected to decelerate in the second semester. The slowdown in global growth, the ongoing euro area debt crisis and fiscal as well as monetary tightening measures employed by the government and the Central Bank are all expected to take a toll on the Turkish economy. However, as recent evidence suggests, the slowdown in the second half of this year is likely to be less pronounced than expected earlier. As a consequence of increasing unfavorable base effects growth in 2012 will likely be slower. In support of the aforementioned are the most recent readings in a rage of higher-frequency real activity and sentiment indicators. Among them, manufacturing PMI bounced to a 7-month high of 53.3 in October indicating a swing back into expansionary territory. It is worth noting that the index had fallen to below the 50-level threshold in August, signaling contraction in the sector for the first time since the 2009 recession. The breakdown of October's data showed that output and new orders were the strongest in seven months. Over the same month, capacity utilization rose to a 3-year high of 77.0%. The consumer confidence index rose to 93.7 in September from a 7-month trough of 91.74 in August, while year-to-October-28 credit activity marginally slowed to 25%yoy, in line with the CBT's target, from 28.5%yoy a week earlier. Passenger and light commercial vehicle sales rose by 6.74%yoy in October bringing the annual rate of increase over the first ten months of the year to 24.53%yoy to 670,682 units. In addition, industrial production staged an unexpectedly strong recovery in September, with growth in the sector rising to 12.00%yoy, its fastest pace of increase since February and following increases of 6.9%yoy and 3.7%yoy, respectively in July and August. The pace of annual increase in tourism arrivals accelerated to 12.5% in September from 9.6% in the prior month and 5.5% in July. On a less positive note, the manufacturing sector confidence index slid to 101.90 in October, its lowest level since December 2009, however remained marginally above the 100-level pointing to optimism in the sector. Meanwhile, tourism revenues decelerated to 9%yoy in Q3, from 17.8%yoy a quarter earlier. Along these lines, we revised our real GDP growth forecast for this year and the next to 7% and 3.5%, respectively from 6% and 4% expected earlier.

Turkey: Eurobank EFG Forecasts

	2009	2010E	2011F	2012F
Real GDP (yoy%)	-4.8	9.0	7.0	3.5
Private Consumption	-2.3	6.7	8.5	0.7
Govern. Consumption	7.8	2.0	5.0	3.0
Gross Capital Formation	-19.0	29.9	20.0	5.0
Exports	-5.0	3.4	5.0	5.5
Imports	-14.3	20.7	18.0	0.5
Inflation (yoy%)				
CPI (annual average)	6.3	8.6	6.2	7.1
CPI (end of period)	6.5	6.4	8.7	6.0
Fiscal Accounts (%GDP)				
Central Government Balance	-5.5	-3.6	-2.0	-1.8
Gross Public Debt	45.4	42.5	40.0	38.5
Primary Balance	0.1	0.8	1.5	2.0
Labor Statistics (%)				
Unemployment Rate (%of labor force)	13.5	12.0	10.0	9.0
External Accounts				
Current Account (% GDP)	-2.3	-6.5	-9.5	-8.0
Net FDI (USD)	6.9	7.3	15.0	10.0
FDI / Current Account	46.9	12.0	20.0	15.0
FX Reserves (USDbn)	69.0	79.0	85.0	85.0
Domestic Credit	**Q4 10**	**Q1 11**	**Q2 11**	**Q3 11**
Total Credit (%GDP)	43.0	40.3	44.6	47.6
Credit Private Sector (%GDP)	40.9	38.6	43.0	46.0
FX Credit/Total Credit (%)	21.0	22.2	22.5	24.6
Private Sector Credit (%yoy)	44.0	44.8	43.3	44.9
Loans to Deposits	85.7	89.5	93.8	96.1
Financial Markets	**Current**	**3M**	**6M**	**12M**
Policy Rate	5.75	5.75	5.75	6.50
USD/TRY (where applicable)	1.78	1.75	1.70	1.65

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

Medium Term Programme (2012-2014) focuses on containing the current account deficit

Turkey's government presented in mid-October the 2011-2014 Medium Term Programme (MTP). For this year, the programme envisages real GDP growth of 7.5%, a current account deficit of 9.4%-of-GDP, year-end CPI at 7.8%yoy and a 1.7%-of-GDP central government budget deficit (Table 1). In 2012, economic growth is anticipated to slow down to 4%, the current account deficit is seen marginally narrower at 8%-of-GDP, year-end consumer price inflation is expected to ease to 5.2%yoy and the central government fiscal shortfall is projected to be modestly curbed at 1.5%-of-GDP. Privatisation revenues are anticipated to increase to TRY12.5bn (equivalent to 0.87%-of-GDP) from TRY4.3bn (0.33%-of-GDP) in 2011. The current account deficit is envisaged to gradually ease to 8.0%-of-GDP in 2012 and converge towards 7%-of-GDP over the forecasted period. In order to curb the current account shortfall accordingly, the programme also included plans to diversify the country's exports, half of which are currently destined to the EU. It also envisioned hikes in special consumption taxes for goods such as tobacco, alcohol, cars and mobile phones. The latter measure is aimed at containing the trade deficit further, by curbing imports, and is also expected to generate additional budget revenues of ca TRY 5.5bn (equivalent to 0.4%-of-GDP) for 2012. In all, the assumptions in the MTP echo realistic and add to hopes for a soft landing of the Turkish economy. The programme also manifests ongoing fiscal prudence. Nevertheless, the Finance Ministry confirmed that the fiscal rule remains off the agenda for the time being. Furthermore, in spite of the aforementioned measures planned by the government, the current account deficit is projected to remain at elevated levels throughout the forecasted time horizon. And, with its financing relying heavily in short-term capital inflows, Turkey is likely to remain vulnerable to sudden shifts in global investor sentiment.

Table 1

Medium Term Programme: Main macroeconomic assumptions	2011	2012	2013	2014
Nominal GDP (TRYbn)	1,282	1,426	1,572	1,733
GDP Per Capita (USD)	10,363	10,973	11,716	12,412
GDP growth (yoy%)	7.5	4.0	5.0	5.0
Year-end CPI (yoy%)	7.8	5.2	5.0	5.0
Unemployment Rate %	10.5	10.4	10.2	9.9
Export/Import %	56.9	59.7	60.8	62.6
Current Account Balance (% GDP)	-9.4	-8.0	-7.5	-7.0
Central Government Budget (% GDP)	-1.7	-1.5	-1.4	-1.1
IMF-defined Public Sector Primary Surplus (% GDP)	0.9	1.0	1.2	1.4
Privatization Revenues (% GDP)	0.3	0.9	0.8	0.7
Public Nominal Debt stock (% GDP)	39.8	37.0	35.0	32.0

Source: Ministry of Development 2011-2014 MTP

Inflation pressures on the rise

Headline CPI spiked to 3.27%mom in October, marking its fastest monthly increase in nearly a decade and outpacing the market's median forecast of 2.83%mom. The increase primarily stemmed from a 4.3%mom rise in food prices, while tax hikes on alcohol and tobacco pushed the respective sub-indices higher, by 8.6%mom and 14.4%mom, respectively. Increases in utilities prices were reflected through a 7.4%mom rise in the electricity, gas & fuels sub-component. The pass-through from the TRY depreciation was evident in a number of items within the key core I measure, which excludes energy, food, beverages, tobacco and gold. Core I spiked to 7.67%yoy in October, its highest level since July 2007, bouncing further away from a record trough of 2.50%yoy hit late last year. Meanwhile, annual CPI accelerated to 7.66% from 6.15% in the prior month. In all, inflation pressures have been on the rise lately, with headline CPI now expected to surpass the 5.5% year-end target by a significant margin (Eurobank EFG research forecasts year-end CPI at 8.7 yoy). The recent flurry of tax hikes announced in mid-October and increases in utilities costs are already fanning cost-push price pressures. It is worth noting that state pipeline company Botas introduced in October natural gas price hikes to the tune of 12.28-14.35% for households and between 13.70 and 14.30% for industries. Additionally, a 9.57% increase in household electricity prices, a 9.26% hike in industrial electricity prices and a 0.55% rise in electricity used by business organizations came into effect on October 1. The lira's sharp weakening this year (-15% against the USD year-to-date) is another lingering risk to the near-term inflation outlook. Along these lines, we anticipate headline CPI to end the year at around 8.7%yoy and expect a slowdown towards 6.0% at end-2012 in view of favorable base effects and an eventual recovery of the TRY.

CBT tightens monetary conditions, adopts five-point action plan to support the lira

In late October, Turkey's Central Bank announced a new policy framework to arrest the recent sharp depreciation of the lira and address ensuing risks to the domestic inflation outlook. The new "five-point action plan" consists of the following main components:

1. **Price Stability**, the CBT acknowledged that inflation will rise considerably in the months ahead and noted that it has already embarked on monetary tightening in order to contain rising inflation risks. At the latest Inflation Report, the bank revised upwards its short-term inflation forecasts due to administered price increases, the lira's sharp depreciation and unfavorable base effects. End-2011 CPI is now seen at 8.3%yoy vs. 6.9%yoy previously, with higher tobacco prices boosting year-end inflation by 0.6ppts and the exchange rate pass-through contributing a further 0.9ppts (see Table 2). The CBT's end-2012 headline CPI projection was left unchanged at 5.2%yoy.
2. **Interest Rate Policy**, the CBT kept its key policy rate, the 1-week repo rate, stable at 5.75% at its latest MPC meeting on October 20, in line with the market's median forecast. However, in a rather unexpected move the CBT widened its

overnight (o/n) interest rate corridor, hiking the corresponding lending rate to 12.50% from 9.00% earlier and maintaining the o/n borrowing rate at 5.00%. Moreover, the late liquidity lending rate was raised from 12.00% to 15.50%. Effectively, with the decisions announced at the October policy meeting, the CBT is given the flexibility to decide on a daily basis whether to provide lower liquidity amounts through its 1-week repo auctions (at lending costs near 5.75%) and offer any addition amounts demanded via the o/n lending rate (at a 12.50% rate).

3. **Foreign Exchange Reserves Policy**, in order to alleviate the pressure on commercial banks due to increased funding costs, the upper limit for FX reserves that may be held to meet Turkish lira reserve requirements was raised from 20 percent to 40 percent of lira liabilities. This is expected to increase the CBT's FX reserves by $4.7bn if the facility is fully utilized. Moreover, up to 10% of the reserve requirements maintained for Turkish lira liabilities is now allowed to be maintained in the form of gold.
4. **Required Reserves Policy**, the Central Bank also announced a 5% cut on TRY deposits' Reserve Requirement Ratio (RRR) to 11% for maturities up to one month, a 1.5ppts reduction to 11% for maturities up to 3 months' and a 1ppt cut to 8% for up to 6 months maturity. The CBT anticipates that the changes in RRRs will provide markets with TRY11bn of additional liquidity.
5. **Financial Stability**, the CBT noted that that there is an undergoing improvement in the country's current account balance, which is expected to be more pronounced in Q4 2011. The Bank also acknowledged that loan growth must slow down further.

In all, the latest measures employed by the Central Bank signal a swing towards monetary tightening in view of lingering overheating concerns and rising inflation risks. We expect the CBT to maintain both its key policy rate and the o/n lending rate stable at current levels for the remainder of this year. However, in the event of renewed significant pressure on the lira and/or increased inflation risks a further adjustment in the o/n lending rate can not be ruled out. Further TRY RRRs reductions are also on the cards. Although the CBT's latest measures and the utilization of two key interest rates (the one-week repo and the overnight lending rates) do allow for greater policy maneuvering, they are already bearing a negative impact on domestic bond markets and prolong policy uncertainty. As such the current policy mix is unlikely to be utilized for long. Once the global environment becomes more transparent the 1-week repo rate will likely be re-established as the sole key policy rate, in order to reduce policy uncertainty and provide more clarity with regards to the Central Bank's monetary policy deliberations.

Table 2

Revisions to CBT's year-end forecasts

	2011	2012
July 2011 CPI forecast	**6.9**	**5.2**
Additional price adjustments in Tobacco	0.6	-
Exchange rate pass-through	0.9	0.4
Commodity Prices	-0.1	-0.2
Output Gap	-	-0.2
October 2011 CPI forecast	**8.3**	**5.2**

Source: CBT, October 2011 Inflation Report

August current account deficit data confirms gradual adjustment in progress

The latest flurry of balance of payment and foreign trade data vindicate the Central Bank's recently voiced expectations that an adjustment in the current account deficit (CAD) has already started. In support of the aforementioned, the current account shortfall gradually shrunk to a 10-month low of $4.0bn in August, in line with the market's median forecast, after touching a record peak of $7.9bn in May 2011. What's more, excluding energy imports the current account swung into a surplus, for the first time since October 2010 (figure 1). The recent adjustment has been primarily driven by a narrowing trade deficit. Notably, after reaching a record peak around $10bn in June the trade shortfall has embarked on a narrowing trend. July and August data showed a further improvement in export growth in tandem with a significant slowdown in imports. In detail, exports grew by 32.2%yoy to $11.3bn in August, marking the highest pace of increase since May last year. Moreover, August's rise outpaces July's 24%yoy jump and a 19%yoy gain in H1: 2011. On the flipside, imports' growth slowed to 26.3%yoy ($19.5bn) in August, its lowest annual rate in nearly a year, from 30%yoy a month earlier and an above-40%yoy average growth in H1. The recent significant adjustment in the trade, and as a consequence, in the current account balance has been, among other factors, driven by a sharp recovery in tourism revenues (+17%yoy in the first eight months of the year), which received an additional support from the political turmoil in the MENA region. The sharp depreciation of the lira over the last few months has also favoured exports significantly. This deems Turkish exports cheaper and more appealing and thus partly offsets any impact from the slowdown in Turkey's main trade partner, the EU (44% of all exports). At the same time, it also assists in containing imports' growth of foreign goods and services. Another factor behind the recent slowdown in imports' growth has been a relative easing in domestic demand pressures against a background of the lingering euro area debt crisis and slowing global growth.

The latest trade balance data (released ahead of the corresponding month current account figures), showed that the deficit bounced to a new record high of $10.4bn in September. The increase may be partly attributed to seasonal effects due to the month of Ramadan. An uptrend in gold prices, which touched a fresh record high of $1,920 per ounce in early September, may be another factor behind the worsening. It is worth noting however that gold prices have somewhat retreated since then and the Ramadan effect should have waned. Hence, the deterioration witnessed in the trade data in September may eventually prove to be short-lived. In spite of the aforementioned, the 12-month rolling current account shortfall widened 132%yoy to $75.1bn in August from $74.2bn a month earlier and $32.5bn over the same period a year earlier. According to our calculations the 12-month rolling CAD corresponded to nearly 10% of this year's projected GDP in August. This is well in excess of a 3.7%-of-GDP shortfall recorded over the same period a year earlier. At such high levels it remains among key risks for the Turkish economy.

Nature of external deficit financing remains dominated by short-term capital inflows

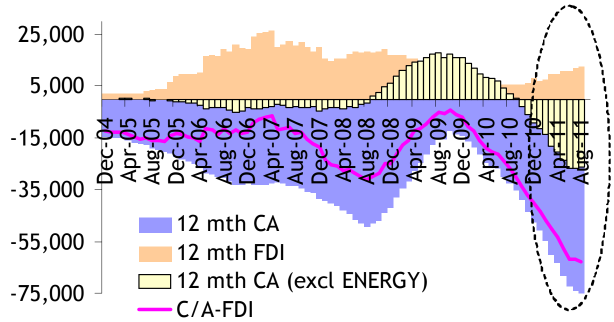
Another area of concern with regard to Turkey's elevated current account deficit is that most of its financing continues to be dominated by short-term capital inflows. Indicatively, over the 12-months to August net portfolio investment accounted for nearly 30% of the CAD, nearly double a 16.5% net FDI inflows coverage. This makes the country highly susceptible to sudden shifts in global investor sentiment. An indication of this sensitivity to the external environment was evident in August when Turkey witnessed outflows of ca $0.9bn of government bonds and $0.6bn of equities due to a worsening in global risk appetite. However, it is worth noting that FDI appears to be on an ongoing improving mode this year, with 12-month rolling net inflows having registered a 124%yoy increase to $12.4bn in August, after a meager 14%yoy growth in FY2010.

Current account adjustment likely to continue in the period ahead

In all, we expect the recent adjustment in the current account deficit to continue ahead as domestic economic activity cools down further, the lira remains under pressure and energy prices stay around current levels. Note that the pace of expansion of the 12-month rolling CAD appears to be on a gradual slowdown since reaching a peak of +240%yoy in December 2010. Government and CBT policies aimed at curbing the CAD will also be key for a sustainable improvement ahead. Along these lines, our 9.5%-of-GDP forecast for this year's current account deficit may eventually prove rather conservative. We pencil in a further contraction towards 8.0%-of-GDP next year as domestic economic activity is braced to slowdown further in 2012. Even so, in spite of the anticipated improvement next year, Turkey's current account deficit remains elevated. And, with its financing relying heavily on capital inflows, the domestic economy is braced to remain vulnerable to global risks ahead.

Figure 1

Current account deficit adjustment underway



Source: CBT, Turkstat, Eurobank EFG

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

Economy expanded by 6.6% yoy in Q3-11; the fastest pace of growth in more than 3 years

- Ukrainian economy grew by 6.6% yoy (2.2% qoq) in Q3-11 up from 3.8% yoy (0.5% qoq) in Q2-11 helped by strong agricultural production and domestic demand
- Tymoshenco's verdict on the charges of power abuse may undermine the EU-Ukraine bilateral relationship
- Food inflation drop pushed down headline inflation to a record low of 5.9% yoy in September
- IMF mission visited Ukraine to discuss resuming funding
- Credit growth is driven once more by lending to the corporate sector.

GDP growth came in at 6.6% yoy in Q3-11, much better than expected, helped by a rebound in agricultural production and strong domestic demand

Ukraine's economy expanded by 6.6% yoy in Q3-11, up from 3.8% yoy in Q2-11; this is its fastest pace of growth in more than three years (since Q1-08). Even in seasonally adjusted terms, the growth rate is brisk, at 2.2% qoq in Q3-11, up from 0.5% qoq in Q2-11 figure. Although acceleration in GDP growth was expected, mainly due to a weak base effect created by last year's heat wave, data exceeded the consensus of 5.9% yoy in Q3-11. Growth was helped by a good harvest and expected strong domestic demand (official GDP breakdown to be published on December, 30). We estimate that agriculture, which accounts for 7% of Ukrainian GDP, would have contributed significantly to Q3-11 GDP rise. Furthermore, taking into account the double digit rise of retail sales in Q3-11 (they average at 14.7% yoy in Q3-11) we anticipate private consumption to have remained the key driver of growth. Moreover, we expect fixed investment, after having picked up in Q2-11 (it stood at 8.6% yoy in Q2-11 up from 4.5% yoy in Q1-11), to continue to support growth in the coming quarters ahead of ongoing preparations of EURO 2012 European Football Championship in June 2012. All in all, we pencil in 4.7% yoy GDP growth in 2011 and an only slightly lower growth rate of 4.6% yoy in 2012 due to a high basis of comparison stemming from this year's very strong agricultural production. However, there are downside risks to our 2012 projection on the back of increased uncertainty about global growth prospects.

Ukraine: Eurobank EFG Forecasts

	2009	2010	2011f	2012f
Real GDP (% yoy)	-14.8	4.2	4.7	4.6
Private Consumption	-14.9	7.0	8.0	7.5
Government Consumption	-2.4	2.7	0.4	1.4
Gross Capital Formation	-53.5	15.4	7.5	8.0
Exports	-20.1	4.5	8.0	9.0
Imports	-37.1	10.9	12.0	10.5
Inflation (% yoy)				
CPI (annual average)	16.0	9.4	9.1	9.3
CPI (end of period)	12.3	9.1	7.5	9.2
Fiscal Accounts (% GDP)				
General Government Balance	-8.7	-6.5	-3.5	-2.5
Gross Public Debt	35.4	40.1	39.8	39.5
Labor Statistics (%)				
Unemployment Rate (% of labor force)	9.4	8.4	8.0	7.9
Wage Growth *(real - private sector)*	-9.8	6.7	10.1	9.0
External Accounts				
Current Account (% GDP)	-1.5	-2.1	-3.8	-4.8
Net FDI (bn USD)	4.7	5.8	6.1	6.5
FDI / Current Account	268.7	190.8	75.0	90.0
FX Reserves (bn USD)	26.5	34.6	34.0	32.0
Domestic Credit	**2009**	**2010**	**Q1 11**	**Q2 11**
Total Credit (% GDP)	79.1	66.9	66.0	64.7
Credit to Enterprises (% GDP)	50.5	45.8	45.8	45.5
Credit to Households (% GDP)	26.4	19.1	18.2	17.4
FX Credit/Total Credit (%)	50.8	46.0	45.7	44.4
Private Sector Credit (% yoy)	-3.1	0.4	2.3	5.2
Loans to Deposits	215.9	175.9	169.7	166.0
Financial Markets	**Current**	**3M**	**6M**	**12M**
Policy Rate	7.75	7.75	7.75	7.75
USD/UAH	7.99	8.00	8.10	8.10

Source: NBU, IMF, Bloomberg, Eurobank Research

IMF mission visited Ukraine to discuss resuming funding

In late October, the IMF mission visited Ukraine to assess progress on IMF loan requirements of cutting budget deficit; namely, adopting pension reform and increasing household gas prices. The issue of increasing gas prices remains open as the

Ukrainian authorities hope to secure a beneficial deal on gas imports from Russia, thus filling the gap in budget deficit without raising gas prices for public. The IMF is asking for 2012 state budget deficit of 2.5% of GDP vs. 3.5% of GDP planned for 2011. Negotiations are still ongoing.

Tymoshenko's verdict could undermine the EU-Ukraine bilateral relationships

Ukrainian court sentenced former Prime Minister Yulia Tymoshenko to seven years in prison and a $190 million fine on charges of power abuse while concluding a gas deal with Russia in 2009 causing financial losses of state energy firm Naftogaz. Tymoshenko denounced the charges and promised to fight the verdict accusing the incumbent Prime Minister Viktor Yanukovych of trying to remove her from the political scene ahead of October's 2012 parliamentary elections and 2015 presidential elections. The harsh verdict brought a huge wave of international criticism including from the EU and Russia. This could jeopardize the negotiations of free trade and association agreements with the EU, which has been ongoing since early 2008.

Recent agricultural production rebound led to a drop in food inflation, which in turn pushed down headline inflation to a record low of 5.9% yoy in September

Ukraine's September CPI eased to 5.9% yoy, down from an 8.9% yoy reading in August and a peak of 11.9% yoy in June, on the back of lower food prices. This record low print was due to a drop in food inflation due to the recent rebound in agricultural production. However, the expected rise in public utility tariffs would keep inflation pressures high, even if tariff increases would be postponed to 2012. Furthermore, inflation expectations over the coming 12 months have declined only slightly, from 14.5% in Q2-11, to 13.6% in Q3-11. All in all, even though the recent inflation print is positive for the Ukrainian economy, it does not really reduce inflation risk, thus we anticipate headline inflation to average at 9.1% yoy in 2011 and 9.3% yoy in 2012.

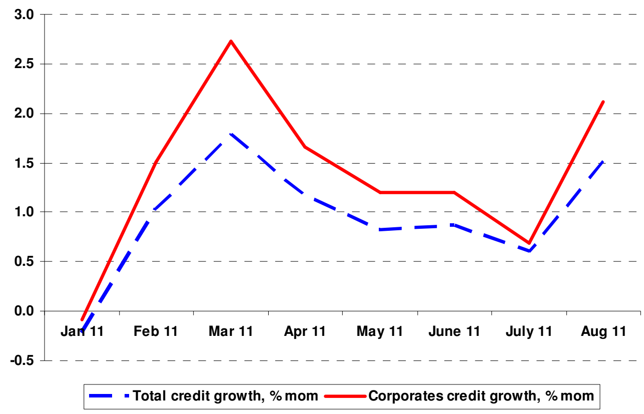
Current account widened in September on robust imports growth

Current account deficit has widened further to $1.0bn in September, remaining close to August's print. September's current account deterioration was due to a widening trade deficit. Imports of gas increased substantially in September on the back of expectations of increase in prices in Q4-11. Moreover, export growth (measured in value terms) slowed down as a result of deceleration of prices in world commodity markets. We expect current account deficit to widen further and reach 3.8% yoy in 2011 from 2.1% yoy recorded in 2010. What is more worrisome is the financial and capital account deficit of $1.0bn in September compared to $1.2bn surplus in August and after having recorded a surplus for the largest part of this year. The deficit was caused by the acceleration in accumulation of foreign cash in other sectors of economy to $1. In a more positive note, FDI inflows remained at a high level of $0.7bn - mainly recorded to the real sector of the economy. FDI inflows reached $5.3bn, compared to $3.6bn recorded at the same period last year. All in all, the overall balance of payments turned negative and amounted to $2.0bn which has offset the positive gains of the previous eight months. The deficit was financed by foreign reserves. Besides, the National Bank of Ukraine has been intervening in the currency market in an effort to keep the exchange rate against the dollar stable, resulting in an additional decrease by $1.2bn of foreign reserves. Thus, at the beginning of October, international reserves were reduced to $35.0bn.

Credit growth is driven once more by lending to the corporate sector

Total credit grew by 0.9% mom / 10.3% yoy in August, up from 0.6% mom / 9.3% yoy recorded in July. Total credit growth stood at 7.8% year-to-August. Once more, credit growth was driven by the corporate sector, with corporate lending expanding by 2.1% mom / 16.9% yoy in August. (Figure 1) Corporates' credit growth stood at 11.5% year-to-August.

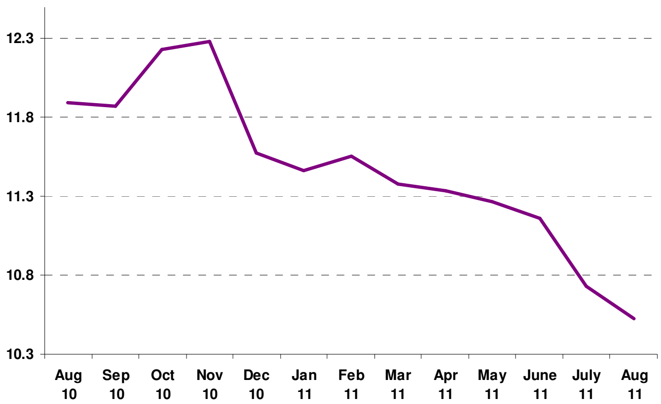
Figure 1
Corporate lending in line with total credit growth



Source: National Bank of Ukraine, Eurobank Research

According to National Bank of Ukraine, Non Performing Loans (NPLs) to total loans ratio stood at 10.5% in August down from 10.7% recorded in July. On a positive note, total NPLs decreased by 2.0% year-to-July. (Figure 2)

Figure 2
NPLs to total loans ratio deceleration



Source: National Bank of Ukraine, Eurobank Research

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A few words about Eurobank EFG Group

A European banking group that actively supports the economy.

Eurobank EFG group is a European banking organization with total assets of €86.5 bn, employing over 22,500 people and offering products and services through a network of more than 1,600 branches, business centres and points of sale, as well as through alternative distribution channels.

Eurobank EFG group has a systemic presence in 10 countries: Greece, Bulgaria, Serbia, Romania, Turkey, Poland, Ukraine, the UK, Luxembourg and Cyprus. It is a member of the EFG Group, an international banking group present in 40 countries.

Our strategy as a European banking group is mirrored in our history, our financial strength and our steady business expansion in the wider region of Central and South – eastern Europe, where we offer responsible banking based on innovative products and quality service. The performance of the Eurobank EFG people is recognized through numerous awards and distinctions that the Group receives at a local and international level.

Strong capital position and liquidity, vigilant risk management, a successful track record of steady growth, efficiency and solid profitability, as well as top quality personnel ensure the creation of value to the benefit of our clients and shareholders.

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