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Economic recovery to pick up pace in 2011, but risks lie ahead

Bulgaria: Recession is over, at least from a technical standpoint

Poland: Accelerating economic growth, but structural fiscal deficit remains a cause of concern

Romania: Yet two more votes of no confidence. Ruling government coalition makes small but steady progress in meeting IMF requirements amid heightened domestic political frictions

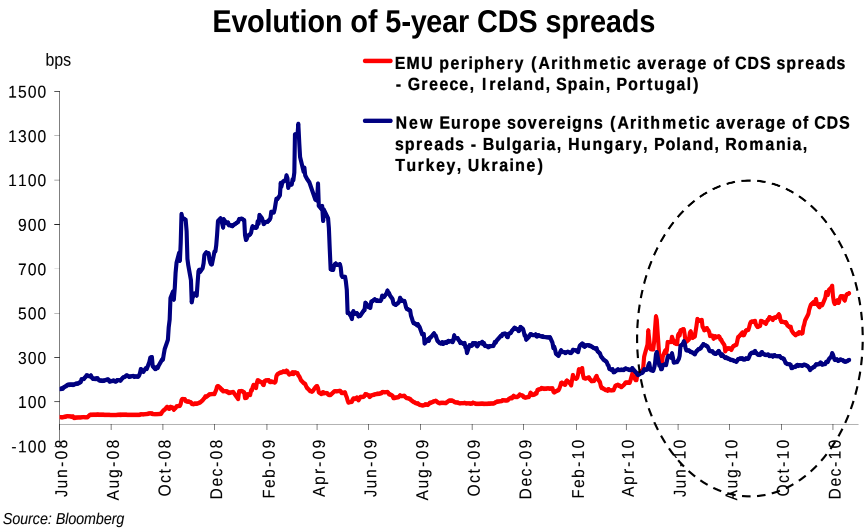
Serbia: NBS raised its key policy rate by a further 100 bps to 11.50% in December, in a move to address accelerating inflation and depreciation pressures on the dinar

Turkey: CBT cuts its key policy rate by 50bps to 6.50% in a move aiming to curb "hot money" inflows and strengthen domestic financial stability

Ukraine: Recovery remains on track despite Q3 GDP slowdown

New Europe market strategy highlights

In view of the lingering euro area debt crisis, **regional currencies** are likely remain under pressure in the near future. The **Turkish lira** has recently weakened on the back of a series of measures employed by the Central Bank to curb "hot money" inflows. On the other hand the **Polish zloty** has so far vindicated our expectations, remaining among the region's outperformers on comparably stronger macro fundamentals and widening interest rate differentials. Nevertheless, we see limited value in entering fresh long zloty positions at present levels, as most of the good news has already been priced in, while the market's median forecast for ca 100bps of cumulative NBP rate hikes in 2011 is probably a bit overdone. For the **Romanian leu** we maintain our earlier view that it will remain an underperformer in the region in 2011 as the domestic economic recovery remains fragile. Monetary tightening is unlike to materialize next year either, while political jitters and fiscal consolidation concerns will probably remain in the forefront in the coming months. **In the sovereign credit space,** there appears to be limited scope for further upside especially in high quality credit. The recovery in EM credit default swaps has been notably strong in 2009/2010 and although further tightening will probably materialize next year on the back of improving fundamentals, gains are likely to prove limited compared to the recent past.



Source: Bloomberg

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Introductory Comment

Dear reader,

For the majority of countries in New Europe, this year marked the exit from the severe economic recession that followed the Lehman collapse in September 2008. Most economies in the region featured positive, yet still below potential GDP growth in 2010, thanks to improving conditions in major trade-partners, the rebuilding of inventories and favorable base effects. The improvement of economic conditions in New Europe is broadly expected to continue uninterrupted in 2011, with a more balanced pattern of growth emerging thanks to strengthening domestic demand dynamics.

For the time being, the speed of economic recovery remains uneven across the economies of the region, depending largely on country-specific structural characteristics and their degree of dependency on foreign capital inflows. Turkey and Poland are leading the pack; Serbia and Ukraine are extending their earlier output gains, while Bulgaria is rebounding modestly. On the other hand, the Romanian economy remains mirred in recession, weighed down by the fiscal austerity measures introduced earlier this year to stabilize the country's fiscal position.

Inflation concerns remained off the policymakers' agenda for some time. However, upside inflationary risks materialized in late 2010, a trend that is expected to continue in the first half of 2011. Those risks originate from supply-side factors including, among others, higher food costs, excise tax hikes and elevated world commodity prices. As a result, a number of countries may find it difficult to meet their official inflation targets both this year and the next. However, the majority of central banks in New Europe are not expected to embark on aggressive monetary policy tightening, at least in the foreseeable future.

On the fiscal side, the ongoing improvement in the economic environment is expected to assist government consolidation efforts in 2011. The public sector balance sheets of most countries in the region are in a much better shape compared to their EMU peers. However, the accomplishment of 2011 fiscal targets will be an equally challenging task, not least because of rising social resistance to the austerity measures and the present state of political cycle in a number of countries. Many governments in the region will be required to step up their fiscal consolidation efforts in order to promote medium-term macroeconomic stability and enhance their access to the financial markets.

At a country-specific level,

Bulgaria's national accounts data for Q3 confirm that a mild economic recovery is currently underway, with the second positive quarterly GDP growth in a row marking the end of the domestic recession, at least from a technical standpoint. Furthermore, the parliament has endorsed an ambitious fiscal target for next year, which envisages a reduction in the general government deficit to 2.5% of GDP from 3.8% of GDP estimated in 2010.

GDP growth accelerated to 4.2% yoy in **Poland**, the fastest rate since Q3 2008. In our view, the main risks to the country's macroeconomic outlook stem from the fiscal side, especially as the government appears unlikely to implement aggressive fiscal consolidation ahead of the autumn 2011 national elections. We expect the NBP to remain in wait-and-see mode, at least until early 2011. Yet, strengthening inflationary pressure and a weaker zloty are likely support a switch to monetary policy tightening by the end of the coming quarter.

Political noise is still high in **Romania.** The opposition parties recently filed two votes of no confidence against the ruling government coalition, with one of them having already failed and the other standing an extremely limited chance to succeed. Revised GDP data for Q3 leaves the macro picture unchanged: Romania will record negative output growth for a second consecutive year in 2010. On the positive side, the fiscal performance to date sends encouraging signals with respect to the government's ability to attain this year's fiscal target.

Authorities are struggling with accelerating inflation in **Serbia**. The NBS raised its key policy rate by a further 100 bps to 11.50% in December, in a move to address accelerating inflation and continuing depreciation pressures on the dinar.

In spite of the Q3 GDP slowdown, **Turkey** continues to lead the economic recovery in New Europe. We expect full-year growth of 7.5%yoy but, even more importantly, the recovery is characterized by relatively low inflation pressures, despite the recent strong rally in domestic food prices. In a move apparently unjustified by the strong domestic demand dynamics, the Central Bank of Turkey cut its key policy rate by 50bps to 6.50%. The rate cut was aimed at preventing a further significant surge in "hot money" inflows that could risk undermining domestic financial stability. In our view, further policy rate cuts may follow in Q1, but a new monetary tightening cycle is likely to begin in Q3 2011.

In **Ukraine**, following a catastrophic recession last year, the domestic economic environment appears to have been stabilized since the beginning of 2010. Although the recovery lost some steam in Q3, the most recent readings in a range of higher-frequency indicators suggest that domestic economic activity got off a solid start in Q4. On top of that, the implementation of IMF-agreed reforms remains broadly on track.

Equity markets in New Europe have broadly recovered from lows recorded in late November. Yet, local rates markets remain under pressure on the back of concerns about the spillover effects of the EMU debt crisis and lingering fiscal worries in several countries in the region. In a similar vein, regional currencies broadly remain under pressure, having broadly shed most of their year-to-date gains. The Polish zloty and the Ukrainian hryvnya are so far proving to be the exception, currently standing somewhat firmer relative to their early 2010 levels. Elsewhere, external debt markets have firmed since late November, with 5-year CDS spreads in the region moving towards lows hit about a month ago.

Looking ahead, currencies as well as stock and credit markets in New Europe are likely to continue receiving support from a more broad-based economic recovery in the region. Local rates markets are likely to underperform in view of narrowing output gaps and gradually strengthening domestic demand dynamics. Nevertheless, key challenges remain in the face of the region's fiscal consolidation, uncertainty surrounding monetary policy outlooks and the euro area's lingering credit crisis. A slower than expected economic recovery in main trade-partners is yet another risk factor to monitor.

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Group Chief Economist & Director of Research

Summarry of key macroeconomic indicators

Realizations and forecasts

	Real GDP (yoy)			Consumer Prices (p.a.)			Fiscal Balance (%GDP)		
	2009	2010	2011	2009	2010f	2011f	2009	2010f	2011f
Bulgaria	-5.0	0.0	2.5	2.5	3.1	2.7	-4.7	-3.8	-2.8
Poland	1.8	3.7	3.8	3.5	2.6	2.8	-7.1	-8.0	-7.0
Romania	-7.1	-2.0	1.5	5.6	6.5	4.5	-8.3	-7.8	-6.4
Serbia	-3.0	1.5	3.0	8.2	6.5	6.0	-4.2	-4.8	-4.1
Turkey	-4.7	7.5	5.0	6.3	8.6	6.9	-5.5	-3.8	-2.7
Ukraine	-15.1	4.3	4.5	15.9	9.5	11.0	-8.7	-6.5	-3.5
New Europe	-4.3	4.4	4.0	6.5	6.4	5.7	-6.6	-5.9	-4.5
Euro area	-4.1	1.7	1.7	0.3	1.5	1.7	-6.3	-6.2	-5.0
USA	-2.6	2.7	2.4	-0.3	1.6	1.8	-12.9	-11.1	-9.7

	Current Account (%GDP)			Policy Rate (e.o.p.)			FX* (e.o.p.)		
	2009	2010	2011	current	2010f	2011f	current	2010f	2011f
Bulgaria	-9.4	-2.0	-5.5		currency board		1.96	1.96	1.96
Poland	-1.6	-3.0	-3.2	3.50	3.50	4.00	3.97	3.90	3.90
Romania	-4.4	-5.5	-6.0	6.25	6.25	6.25	4.29	4.29	4.35
Serbia	-5.7	-8.5	-9.5	11.50	11.50	10.50	105.6	108.0	115.0
Turkey	-2.2	-5.5	-6.0	6.50	6.50	8.00	1.56	1.55	1.35
Ukraine	-1.5	-1.3	-2.0	7.75	7.75	7.75	7.89	7.90	7.90
New Europe	-2.6	-4.2	-4.6	-	-	-	-	-	-
Euro area	-0.6	0.0	0.2	1.00	1.00	1.00	1.32	1.32	1.24
USA	-2.9	-3.3	-3.4	0.125	0.125	0.125	0.76	0.76	0.81

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

I. Overview

Q3 GDP data suggest economic recovery in New Europe continues, albeit in an uneven mode

Most economies in New Europe remain in a recovery path thanks, primarily, to an export-driven bounce in industrial production. As highlighted by the region's Q3 GDP data, exports growth remains strong in most countries, although a slowdown was observed relative to the prior quarter. Private consumption is strengthening gradually, while a tentative improvement is also witnessed in investment activity. Although unemployment remains at high levels, labour market conditions appear to be stabilizing. Overall, the recovery continues in a two-speed mode, mirroring the different macroeconomic conditions and structural characteristics of regional economies. Turkey and Poland are leading the way, already exhibiting strong domestic demand dynamics. In Hungary, total consumption posted its first positive growth reading in Q3, breaking a seven-quarters-long streak of contraction. On the other end, Romania is the primary laggard, with domestic consumption and investments remaining mired in recession, weighed down by the fiscal austerity measures introduced earlier this year. Looking ahead, we expect the recovery in New Europe to continue in 2011 as negative output gaps narrow gradually and domestic demand conditions improve. On a less positive note, government spending is unlikely to provide any substantial support, given the ongoing fiscal contraction. Exports are likely to continue supporting growth, but their contribution may lessen somewhat as a result of softer external demand.

Inflationary pressures in the region remain subdued; diverging monetary policy paths start to emerge

Underlying inflation pressures in New Europe remain relatively benign, with the recent elevated CPI readings appearing to be mainly the result of such temporary factors as base effects, higher food costs and significant hikes in VAT rates and administrative prices. For the time being, demand-pull pressures remain rather limited against a background of still negative output gaps. Yet, inflation pressures may become more evident next year as the rebound in regional economies gains traction. In view of the still benign underlying inflation pressures we expected most central banks in New Europe to stay put on rates for the remainder of the year. Yet, our expectations were confounded after Hungary's Central Bank (MNB) surprised market participants in late November by hiking its key policy rate by 25bps. The Bank cited increased inflation risks stemming from higher food prices and the potential deployment of second-round effects, as year-on-year CPI remains firmly above the 3% official medium-term target. Increased uncertainty regarding the country's fiscal consolidation program may have also had a bearing on the latest MNB decision. On the flipside, Turkey's Central Bank, being apparently alarmed by a potentially destabilizing surge in "hot money" inflows decided in December to cut its key 1-week repo rate by 50bps to 6.50%. Elsewhere, Serbia's National Bank (NBS) raised its key policy rate by another 100bps earlier this month, having delivered a total of 350bps of rate hikes since early August. The NBS cited rising inflation pressures in view of higher regulated and agricultural products prices, as well as the pass-through of the dinar depreciation. Note that the currency has lost ca 11% of its value against the euro since the beginning of the year.

2011 monetary policy outlook remains blurry

Looking ahead, the monetary policy outlook of most economies in New Europe remains clouded by an unusually high degree of uncertainty. Higher capital inflows and pre-emptive monetary tightening could induce undue appreciation pressures on regional currencies, with adverse implications for competitiveness and exports. As a result, although most central banks in New Europe are likely to initiate monetary policy tightening before the end of 2011, we expect it be gradual and relatively limited in size. In Turkey, there still appears to be some room for moderate rate cuts in Q1-11, but we expect these to be accompanied by increases in reserve requirements and other measures aiming to contain rapid credit expansion. Eventually, we see the CBT embarking on a rate tightening trajectory in H2 in order to address rising inflation risks. In Poland, we anticipate the Central Bank to start raising policy rates in the first quarter of next year, though for the year 2011 as a whole we continue to see scope for a maximum 50-75bps of rate hikes, which constitutes a significantly less steeper tightening trajectory that the market currently expects *(consensus forecast: 125bps-150bps of NBP rate hikes in 2011).* On the other hand, we anticipate Romania's Central Bank to stand pat on rates throughout next year.

Fiscal consolidation remains a key policy challenge

Fiscal consolidation in the region remains a key policy challenge, especially in view of the ongoing sovereign debt crisis in the euro area. Most countries in New Europe have reversed earlier economic stimulus plans and several employed strict austerity measures, aiming to reduce their fiscal deficits towards the Treaty's 3% of GDP threshold in the coming years. Most governments in the region have already unveiled new budget plans, envisaging lower fiscal deficits in 2011. However, domestic political landscapes have lately become considerably more jittery due to unpopular fiscal consolidation programs announced for next year. As a result, the actual implementation of these programs remains a challenge in a background of increased domestic political frictions and risk to the economic growth environment stemming from the EMU debt crisis.

Regional stock markets remain near November highs; lingering EMU crisis poses downside risks

Equity markets in New Europe firmed over the last few weeks approaching anew multi-year highs recorded in early November. This has been a reflection of improving investor attitudes towards risk following new quantitative easing by major central banks (including the Fed and the BoJ) and a recent flurry of upbeat data from China, Germany and the US. However, lingering concerns about potential spillover effects into the region from the EMU debt crisis remain in the spotlight, while investor's reluctance to establish fresh sizable positions ahead of year-end is putting a lid on additional market gains. At the market close of December 16, the benchmark MSCI Emerging Market equities index was ca 3% higher from its late November levels, standing not far off a 29-month peak of 1,159.98 hit earlier that month. The corresponding Emerging Europe sub-index has again outperformed its major peers over the last month or so, registering gains in the vicinity of 7%. The latter remains within distance from a 26-month high of 539.24 hit on November 9, having registered year-to-date gains of around 13%. In New Europe, Ukraine's PFTSI index remains the star outperformer of 2010, recording gains in excess of 60% year-to-December 17. Turkey and Poland follow suit standing ca 20% higher over the same period.

Local rate market under pressure; Turkey outperforms on CBT rate cuts

Local bond markets came under pressure in late November-early December amid growing investor fears over the EMU debt crisis. Heightened fiscal worries in several countries in the region also weighed. Hungary's debt market was among the underperformers, weighed down by a number of controversial fiscal measures employed recently by the government. Although the measures are likely to facilitate a reduction in the country's budget deficit below the key 3%-of-GDP threshold as soon as next year, concerns remain over the sustainability of its fiscal accounts longer-term. Such concerns appear to have played a major role in the MNB's surprise decision to hike its key policy rate by a cumulative 50bps over the last two moths. As a result, Hungary's 3- and 10-year government bond yields spiked to 15-month highs of 8.2% and 8.6%, respectively in late November (both have eased by ca 50-70bps since then). In Poland, given increased expectations for rate hikes in Q1 2011, the 2- and 10-year yields remain within distance from multi-month highs near 4.9% and 6.2%, respectively, touched last month. Elsewhere, Turkey's August 8, 2012 benchmark bond yield stood close to 7.5% on December 20, having temporarily slid towards new record lows near 7.3%, boosted by growing expectations about further CBT rate cuts in the months ahead.

Regional currencies not far from late November lows as EMU-related concerns continue to weigh

Local currencies recouped part of the losses suffered in late November when concerns about the debt crisis in the euro area escalated. However, with the exception of the Polish zloty and the Ukrainian hryvnia most currencies have fully erased earlier gains for the year, currently standing not far off recent multi-month lows. The Turkish lira, which was until recently among the region's outperformers, slid as far as a 5-month low of 1.5583/USD on December 20 having lost more than 4% year-to-date, weighed down by the Central Bank's measures to containing speculative capital inflows. Depreciation pressures on the Turkish currency are likely to persist in the short-term as the CBT is likely to proceed with more rate cuts. Elsewhere, the Polish zloty has gained 3.5% since touching a 4-month low of 4.1081/EUR on November 29, deriving supported by strong underlying macroeconomic fundamentals and expectations that the NBP will likely be among the first in the region to embark on a monetary policy tightening cycle as soon as in Q1 2011. Romania's leu stands not too far from a 3-½-month low of 4.3240/EUR hit in late October against a background of a fragile political landscape and a weak growth outlook. The Serbian dinar recently recouped part of its recent losses, with the EUR/RSD rate sliding to a 5-month trough of 103.7 from record highs neat 108 touched in late October. Year-to-date the currency remains the region's major underperformer, standing nearly 10% weaker vs. the EUR amid increased corporate demand for hard currency and a lack of foreign capital inflows in the domestic economy.

External debt spreads remain near multi-year lows

New Europe external debt spreads in the CDS space have tightened since late November, after Ireland announced it would seek a bailout package. Five-year CDS spreads in most of the region have shrunk by ca 15% over the last month or so. Hungary remains among the primary laggards in New Europe, with 5-year CDS spreads standing close to a 6-month peak of 397bps touched on December 10, amid lingering concerns about the country's long-term fiscal position.

Strategy

In view of the lingering euro area debt crisis, **regional currencies** are likely remain under pressure in the near future. The **Turkish lira** has confounded our expectations for some further appreciation in the coming months, having recently weakened on the back of a series of measures employed by the Central Bank to curb "hot money" inflows. The TRY touched a 5-month low of

1.5670/USD on December 20, currently standing some 12% weaker relative a 2-year peak recorded in early November. The door is open for some further depreciation of the Turkish currency in Q1 2011 as the CBT seems poised to deliver some additional rate easing. Looking further ahead, we expect a brighter TRY outlook from Q2 onwards, provided that the CBT turns more hawkish and embarks on monetary tightening cycle in the second half of the year. A favorable elections outcome in July may also provide some additional composure. Separately, the **Polish zloty** has so far vindicated our expectations, remaining among the region's outperformers on comparably stronger macro fundamentals and widening forward interest rate differentials. It is currently among the exceptions in New Europe to stand stronger year-to-date (+3% on December 21 vs. the EUR). Nevertheless, we see limited value in entering fresh long positions at present levels. In support of the aforementioned, most of the good news has already been priced in, while the market's median forecast for ca 100bps of cumulative NBP rate hikes in 2011 is probably a bit overdone. For the **Romanian leu** we maintain our earlier view that it will remain an underperformer in the region in 2011 as the domestic economic recovery remains fragile. Monetary tightening is unlike to materialize next year either, while political jitters and fiscal consolidation concerns will probably remain in the forefront in the coming months. Meanwhile, short **EUR/RSD** positions at current levels may prove of value through exploiting a 13% carry in 3-month tenors.

In the sovereign credit space, there appears to be limited scope for further upside especially in high quality credit. The recovery in EM credit default swaps has been notably strong in 2009/2010 and although further tightening will probably materialize next year on the back of improving fundamentals, gains are likely to prove limited compared to the recent past. Note also that for countries enjoying strong macroeconomic fundamentals, such as Turkey, most of the good news has already been priced in. Meanwhile, the recent surge of capital towards the region may be caped should the economic recovery in the US proves faster than currently anticipated, which, in turn, would put a lid on the Fed's QE. On the other hand, any external negative developments may bear significant upside pressure on CDS spreads.

In the local rates markets, payer positions look attractive under current conditions. In the cases of Poland and Turkey, which are expected to lead the economic recovery in the region, inflation risks loom ahead in view of strengthened domestic demand dynamics. The recent rise in oil prices in tandem with a firmer USD (Turkey has a high net oil import component) and rising pressures on the regional currencies on the back of the EMU debt crisis also pose as risks to inflation. Moreover, the CBT's decision to cut its key policy rate in December adds to concerns that the Central Bank may fall behind the curve and to eventually have to resort to more aggressive monetary tightening. Potential fiscal slippages ahead of the July 2011 general elections also bear inflationary risks in the coming months. That said, we are not particularly concerned about the latter after September's referendum showed that the ruling AKP party still enjoys strong support and is likely to be able to form a new single party government. We remain sidelined in Hungary and Romania as fiscal uncertainty and political jitters bode ill for local rates in both countries in the coming months.

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

Recession is over, from a technical standpoint

- GDP grew by 0.5% yoy in Q3, registering its first year on year increase since the fourth quarter of 2008
- The parliament endorsed the budget for 2011, which targets a reduction in the fiscal deficit (ESA95 definition) to 2.5% of GDP from 3.8% of GDP estimated in 2010
- Inflation hit 4.6% yoy in November on higher food prices and excise taxes

GDP data in Q3 confirms a mild economic recovery underway

According to revised data, GDP expanded by 0.7% qoq in Q3 on top of a 0.5% qoq rise in Q2. The final reading came closer to market expectations about the magnitude of the growth rebound in Q3 and compares with a 0.3% qoq flash estimate. Overall, the second positive quarterly GDP print in a row marks the end of the domestic recession, at least from a technical point of view. More importantly, GDP grew by 0.5% yoy in Q3, following a 0.3% yoy contraction in the prior quarter. This was the first increase on a yearly basis, since the onset of the international economic crisis in late 2008. Yet, decomposition of the data reveals that domestic demand is not recovering at the pace expected. More specifically, private consumption contraction deepened to -6.4% yoy in Q3 (compared to -7.3% yoy in the flash estimate) against -4.3% yoy in Q2. Public consumption was also particularly weak, contracting by -7.8% compared to -8.9% yoy in Q2. Investments were still negative, yet they improved to -5.3% yoy against -15.6% yoy in Q2.

On the other hand, the rebound of net exports surpassed any expectations. Exports recorded astonishing growth of 18.5% yoy in Q3 after rising by 12.6% yoy in Q2. The rebound of the Russian and Turkish economies is having a lasting beneficial impact on Bulgarian exports to non-EU markets, which continue to expand in a rapid pace. Imports are lagging behind, having recorded growth of 3% yoy in Q3 after recording broadly flat growth in Q2. In conclusion, this is the first time the positive contribution of net exports outweighed the negative contribution of domestic demand, bringing GDP growth in positive territory. That fact itself should by no means be underestimated.

Our assessment on the domestic macro outlook has remained unchanged. Having seen the worst of the recession in Q4 2009, the Bulgarian economy is recovering slowly. Domestic demand still remains weak. However, Bulgaria seems to be addressing

Bulgaria: Eurobank EFG Forecasts

	2008	2009	2010f	2011f
Real GDP (yoy%)	6.0	-5.0	0.0	2.5
Final Consumption	6.0	-5.0	-4.0	2.0
Gross Capital Formation *(Fixed)*	20.4	-26.9	-6.5	2.5
Exports	2.9	-9.8	13.0	5.0
Imports	4.9	-22.3	2.5	4.0
Inflation (yoy%)				
HICP (annual average)	12.0	2.5	3.1	2.7
HICP (end of period)	7.2	1.6	4.8	3.0
Fiscal Accounts (%GDP) - *EU Methodology*				
General Government Balance	1.7	-4.7	-3.8	-2.8
Gross Public Debt	13.7	14.7	18.6	21.7
Primary Balance	3.9	0.0	-2.0	-1.5
Labor Statistics - *National Definitions*				
Unemployment Rate (% of labor force)	6.3	7.6	9.5	8.0
Wage Growth *(total economy)*	26.5	8.5	7.5	5.5
External Accounts				
Current Account (% GDP)	-25.4	-9.4	-2.0	-5.5
Net FDI (EUR bn)	6.2	3.3	1.2	2.0
FDI / Current Account (%)	75.8	103.6	165.0	100.0
FX Reserves (EUR bn)	12.7	12.9	12.5	11.5
Domestic Credit	**2008**	**2009**	**Q2 10**	**Q3 10**
Total Credit (%GDP)	75.2	79.2	79.2	78.7
Credit to Enterprises (%GDP)	47.8	49.4	49.4	49.4
Credit to Households (%GDP)	26.0	28.2	28.1	27.4
FX Credit/Total Credit (%)	57.2	58.6	60.1	60.9
Private Sector Credit (yoy)	32.3	4.5	2.8	2.7
Loans to Deposits (%)	119.3	120.5	114.3	116.0
Financial Markets	**Current**	**3M**	**6M**	**12M**
Policy Rate		Currency Board		
EUR/BGN	1.96	1.96	1.96	1.96

Source: National Sources, Eurostat, IMF, Eurobank Research

successfully the key challenge of rebalancing its economy. In our past trip Notes in December 2009, we highlighted the need for Bulgaria to switch to a new economic development model. Indeed this shift from the previous credit-driven and consumption-based model of development to a new one, emphasizing competitiveness and exports has been taking place during 2010 in a painful, yet orderly manner. More importantly, it is important to note that the transition is taking place under a fixed exchange regime. The currency board constrains monetary policy in such a way that the option of devaluation of the local currency to regain competitiveness is not available. The adjustment can only come from a supply-side adjustment aiming to boost productivity.

All in, we maintain our forecast for flat growth in 2010. We upgraded our forecast in our last trip to Sofia back in mid October, when we witnessed a gradual improvement in the domestic economic environment. For the coming quarters, we anticipate domestic demand dynamics to improve gradually. In our view, the first gradual signs of revival are expected to show up in the 2H 2011. The spillovers of the strong export performance are going to diffuse in other industries as well, so that a more balanced pattern of growth will slowly unfold in the coming quarters. On top of that, the improved absorption of EU funds could support investments recovery as well.

Fiscal discipline lays the foundations for a stronger economic recovery in 2011; paves the way for ERM II entry

The parliament endorsed the 2011 budget, which envisages a budget deficit of BGN 1.9bn or 2.5% of projected GDP. Total revenues are forecasted to rise by 5.3% yoy to BGN 25.8bn or 33.5% of GDP. Expenditures are expected to stay flat in nominal terms at BGN 27.8bn, which means a decrease as a percentage of GDP, to 35.5%, from 37.7% in 2010. The main macroeconomic assumption of the new budget is 3.6% GDP growth in 2011.

The attainability of next year's fiscal target has been a focal point in our discussions during our trip in Sofia back in mid-October. Most of our discussants argued that next year's fiscal target remains within reach. Yet, some of them expressed certain reservations regarding the official forecast for GDP growth next year. We do share these concerns. However, we note that the final deficit will not only depend on the headline GDP outcome, but also on the composition of growth next year. Naturally, that is because a shift towards a more domestic-demand oriented growth environment has, by definition, higher tax content (because of the VAT).

The government has stated that it does not intend to change the present VAT or the corporate and personal income tax rates next year. However, it has announced its intention to raise excise taxes on some goods. In addition, it intends to increase the social security contribution rates, most probably by 3pps, taking back the prior year's reduction. The government has a number of options to finance the 2011 budget deficit with domestic and external resources, but it has not made clear yet the precise financing mix it intends to use. One option is the issuance of Eurobonds in international markets worth €1.0-1.2bn.

There are two important implications with respect to the achievement of the fiscal target in 2011. The revelation of the hidden annexes in public contracts last March had a negative impact on the image of the country, but not a devastating effect on the credibility of its fiscal statistics. Yet, the breach of the 3%-of-GDP deficit threshold was enough to defer the ERM -II application and put the country in the adventures of the Excessive Deficit Procedure. For that reason, it is imperative that the fiscal target of 2011 is achieved. From our discussions with the authorities and a number of high-level industry officials during our recent trip in Sofia in mid October, we concluded that the government remains committed to swift euro adoption as soon as domestic and external macroeconomic and political conditions allow. As such, an official application for ERM-II entry could materialize as early as in 2012, especially if the government manages to meet next year's fiscal target.

Most importantly, the relatively solid fiscal position lays the foundations for a healthy economic rebound next year, while, at the same time, allows for greater predictability with respect to the government's policies on wages and pensions. Last but not least, the government needs to ensure successful execution of its fiscal consolidation program in order to strengthen medium-term sustainability of public finances. An important element in that process is the acceleration of the structural reforms in the pension system, health care and education sectors. The current solid fiscal position offers domestic authorities a valuable time window to implement these reforms in a gradual and orderly manner. For that reason, structural reforms in those areas are not likely to lose momentum ahead of next year's Presidential elections.

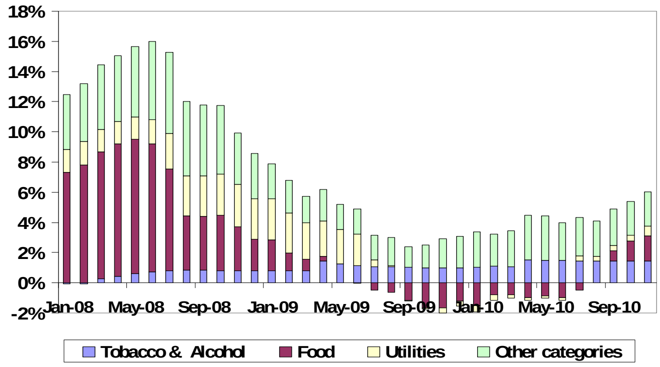
Inflation accelerated to 4.6% in November, the highest level since April 2009

The upside inflationary risks we warned about in our August **New Europe Economics & Strategy Monthly** issue have started to materialize. Those risks originate from supply side factors such as higher food prices, excise tax hikes and elevated world commodity prices, which have lately pushed CPI readings higher (Figure 1)

Inflation climbed up to 4.6% yoy in November against 3.9% yoy in October, compared to only 1.4% yoy in June. Accordingly, the Harmonized Consumer Price Index (HICP) increased from 2.5% yoy in June to 4.0% yoy in November (the fourth highest performance in the EU-27) against 1.9% yoy in Eurozone. As a result, consumer prices are expected to climb at a level close to 5% by year end, that will bring the annual average inflation at 2.5% yoy in 2010 little below that in 2009 (2.8% yoy).

Figure 1

Inflation accelerated to 4.6% on higher food prices and excise taxes



Source: National Statistics, Eurobank Research

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

Accelerating economic growth, but structural fiscal deficit remains a cause of concern

- GDP growth accelerated to 1.3%/4.2% qoq/yoy in Q3-10, from 1.2%/3.5% qoq/yoy in the period quarter. This was the fastest pace of expansion since Q3-08
- Wide fiscal deficit appears to be mainly reflecting structural rather than cyclical influences; government unlikely to implement aggressive fiscal consolidation ahead of the autumn 2011 national elections
- CPI came in at 2.7% yoy in November, slightly lower that expected and down from October's 2.8% yoy. We continue to expect the first NBP rate hike in Q1-11
- New loan restriction in the domestic banking system have already started to affect negatively FX lending

GDP growth accelerates more than expected in Q3

GDP growth accelerated to 4.2% yoy (1.3% qoq) in Q3-10, from 3.5% yoy (1.2% qoq) in Q2-10. This was the fastest pace of growth since the third quarter of 2008. Of components, private consumption jumped to 3.5% yoy from 3.0% yoy, while fixed investment increased by 0.4% yoy after 1.7% yoy fall in the prior quarter and a 12.8% yoy decline in Q1-10. Furthermore, government consumption accelerated to 4.3% yoy in Q3-10, from 2.2% yoy in Q2-10. What's more, net exports exerted a broadly flat contribution to GDP growth in Q3, after subtracting ca 0.01ppt a quarter earlier.

After a sharp drop in the first quarter of 2010, investment rebounded strongly, supported by a sizeable inflow of EU funds and improved absorption rates (Poland is entitled to receive up to €67bn of EU funds over the period 2007-2013**,** with ca €10bn expected to finance road construction projects). Looking ahead, public sector investment is expected to remain supported ahead of the 2012 European Football Championships. Meanwhile, strong external demand is fuelling the domestic manufacturing sector and facilitating the turnaround in inventories. The manufacturing PMI index reached in November its highest level since May 2004, rising to 55.9 from 55.6 in the prior month, on the back of a sharp rise in new orders. Polish industrial production rose by 8% yoy in October down from 11.8% yoy.

Elsewhere, retail sales surprised on the upside in October, accelerating to 9.0% yoy (its fastest pace since October 2008) from 8.6% yoy in the prior month. Also on a positive note, labor market conditions have been improving lately, with employment growth accelerating to 2.0% and the unemployment rate remaining unchanged to 11.5% in October for a second month. The still elevated rate of unemployment explains the relatively weak wage growth (+3.9% yoy in October).

Poland: Eurobank EFG Forecasts

	2008	2009	2010f	2011f
Real GDP (% yoy)	5.0	1.8	3.7	3.8
Private Consumption	5.8	2.3	2.9	3.0
Government Consumption	7.4	1.9	2.8	2.5
Gross Capital Formation	6.4	-13.8	5.6	6.5
Exports	7.3	-7.8	11.4	11.0
Imports	8.4	-13.5	11.0	11.2
Inflation (% yoy)				
CPI (annual average)	4.2	3.5	2.6	2.8
CPI (end of period)	3.3	3.5	2.8	2.8
Fiscal Accounts (% GDP)				
General Government Balance	-3.7	-7.1	-8.0	-7.0
Gross Public Debt	47.2	51.0	55.0	57.0
Labor Statistics (%)				
Unemployment Rate (% of labor force)	9.8	11	11.9	11.5
Wage Growth *(private sector - average)*	NA	4.2	3.4	3.7
External Accounts				
Current Account (% GDP)	-5.0	-1.6	-3.0	-3.2
Net FDI (bn EUR)	8.0	6.1	6.5	8.0
FDI / Current Account (%)	43.7	122.2	75	90
FX Reserves (bn EUR)	40.6	54.8	76	70
Domestic Credit	**2008**	**2009**	**Q2-10**	**Q3-10**
Total Credit (% GDP)	50.9	53.1	54.4	54.6
Credit to Enterprises (% GDP)	17.6	16.1	15.8	15.6
Credit to Households (% GDP)	29.7	31.6	33.6	33.6
FX Credit/Total Credit (%)	32.6	30.2	31.8	30.1
Private Sector Credit (% yoy)	38.1	7.2	7.2	7.6
Loans to Deposits (%)	106	102.6	103.2	102
Financial Markets	**Current**	**3M**	**6M**	**12M**
Policy Rate	3.50	3.50	3.75	4.00
EUR/PLN	3.97	3.90	4.00	3.90

Source: NBP, EcoWin, Bloomberg, Eurobank Research

Overall, domestic economic activity remains on a rising trend, supported by resilient consumption and improving investment dynamics. We anticipate full-year GDP growth of 3.7% yoy in 2010 and expect a further acceleration to 3.8% yoy in 2011. However, downside risks to our forecasts come from the deterioration of the fiscal stance.

Structural deficit remains a cause of concern

The budget deficit came in at 7.1% of GDP in 2009 and according to the ministry of finance it will reach 7.9% of GDP in 2010. The latter is clearly too high, especially for an economy that was amongst the few in the region to avoid recession in 2009. However, the government presented, in early August, a full-year plan to address the country's fiscal deterioration. But, the measures taken so far have not been particularly ambitious, doing little to curb spending on a more permanent basis. What's more, Poland's fiscal deficit appears to have a large structural component. According to the EC's autumn 2010 forecasts, the cyclical-adjusted budget deficit is expected to amount at 7.4% of GDP and 6.1% of GDP in 2010 and 2011, respectively. In our view, that is not entirely surprising given that, for instance, public sector employment has risen by 100,000 since 2005. Besides, Poland has introduced private pension funds as an alternative to the pay-as-you-go state scheme. This is estimated to cost the budget as much as 2.4ppt of GDP until 2014. More to the point, municipalities have borrowed heavily to finance EU co-funded infrastructure projects. Municipal borrowing reaches the 1.2% of GDP in 2010. Moreover, government spending on EU co-financed motorway construction projects is estimated to cost the budget a further 1ppt of GDP in 2010-2011.

General government debt is now approaching the 55% of GDP legal debt limit, but that level is not very likely to be exceeded in 2010. If the threshold were breached, then the government would be obliged to prepare a new budget, targeting a surplus next year. Fiscal consolidation is likely to be delayed due to upcoming parliamentary elections scheduled for autumn 2011. But, the government will have to eventually address the structural deficit or risk undermining investor confidence towards the country.

Strong balance of payments inflows

The current account deficit narrowed in 2009 to 1.6% of GDP on the back of improved terms of trade and a drop in Poland's imports. Strong balance of payments inflows over the last two years allowed the National Bank of Poland (NBP) to accumulate reserves, which stood at €74.2bn in October 2010. Besides, the 12-month rolling current account deficit reached €10.5bn in October which is about 2.6% of GDP and was fully financed by portfolio inflows, foreign direct investments (FDI) and loans. Only FDI amounted to €1.7bn in October. We anticipate the full-year current account deficit to widen to 3.0% of GDP in 2010.

Consumer inflation eased slightly in November

November inflation came in at 2.7% yoy (0.1% mom) slightly lower that expected and down from October's 2.8% yoy (0.5% mom). What's more, core inflation - the measure excluding food and energy prices - shows no signs of demand-pull pressures, remaining steady at 1.2% yoy in October for 4th month in a row. On a less positive note, higher food prices and dwelling costs continued to drive headline inflation in November. Although recent data suggest that the inflationary impact of rising consumer demand has been limited so far, we flag for upside price risks in the period ahead stemming from a closing output gap. We anticipate headline inflation to average at 2.6% yoy this year and accelerating further to 2.8% yoy in 2011.

NBP remains in wait-and-see mode

The National Bank of Poland (NBP) kept the key interest rate unchanged at 3.5% for 17th month in a row in November. In the accompanied policy statement the decision was justified on the basis of still limited inflationary pressures domestically, persisting risk of excessive currency appreciation due to strong capital inflows and a weakening external economic environment.

The release of the stronger than expected Q3 GDP report in late November, is likely to strengthen calls for higher policy rates in the period ahead and harden the position of the hawks in the Monetary Policy Council (MPC). But, other MPC members are understandably wary of attracting potentially destabilising capital inflows that could lead to excessive zloty appreciation with negative consequences for Polish exports. We expect the NBP to remain in wait-and-see mode, at least until early 2011. Yet, strengthening inflationary pressure and a weaker zloty should support policy tightening by the end the coming quarter. As such, we do not expect any interest rate hike at the next MPC meeting scheduled for the 22nd of December. As it stands, we have now pencilled in two 25bp hikes in 2011, with the policy rate been raised to 4.00% by the end of the 2011.

New loan restrictions may stifle credit growth

Polish supervision authority (KNF) has introduced stricter requirements on foreign-currency denominated loans since August. Moreover, KNF proposed limiting FX lending to 50% of total bank loans so as to reduce the sector's vulnerability to sudden currency moves. Yet, foreign owned banks control almost 70% of the sector and some of them have made as much as 90% of their lending in foreign currency. Therefore, the alternative proposed by the KNF was to limit FX lending to 30% of banks' new loans in a phased approach by mid-2012.

The new rules have already affected FX credit growth. It fell by 2.7% mom in September and by further 1.1% mom in October. Private sector credit shifted to a negative growth territory in October, coming in at -0.1% mom; yet, it grew by 6.2% year-to-October. On the funding side, total bank deposits decreased by 0.1% mom in October, bringing the corresponding annual growth rate to 6.4% year-to-October.

Polish banks had relative thick capital cushions, enabling them to absorb losses on bad loans. However, the current pace of growth of non-performing loans (NPLs) remains a wary. NPLs grew from just 4.2% of banks' portfolios at the end of 2008 to 7.5% at end of 2009 and 8.5% in October this year with the majority of bad loans coming from the corporate sector.

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

Yet two more votes of no confidence

- The opposition parties filed two votes of no confidence after the government coalition sought a vote of confidence to speed up the implementation of policies agreed with the IMF
- Revised GDP data for Q3 leaves macro picture unchanged: Romania will record negative output growth for a second consecutive year in 2010.
- Fiscal performance to date sends encouraging message with respect to the ability of the government to attain this year's fiscal target

Ruling government coalition makes small but steady progress in meeting IMF requirements amid heightened domestic political frictions

Despite local media allegations to the opposite, the sixth review of the present stand-by arrangement was completed on a staff level. The joint mission of the IMF, the World Bank and the EU assessed that all quantitative criteria of the program were met, with the exception of the ceiling on government arrears. On the latter issue, the government has committed to tackle a contentious issue that has never been addressed properly throughout the program. Unpaid government obligations had reached RON 2bn compared to an IMF-agreed ceiling of RON 1 bn last June. The government has to bring them down to RON 0.5bn by the end of 2010 and eliminate them by the end of May 2011, when the present IMF program expires.

Furthermore, in order for the IMF Board to approve the sixth review and release the respective tranche, the government has to fulfill three additional conditions. These include the enactment of the legislation of the uniform wage law, the approval of the budget for 2011 and the implementation of the pension reform law. The opposition parties are reportedly trying to boycott the voting of the laws in Parliament or to amend the proposed legislations so as to bring the procedure in a stalemate.

In response, the government is struggling to overcome the political stalemate and get the relevant legislation enacted. After the opposition parties rejected a Presidential appeal for a 45-day moratorium to permit the enactment of the laws, the government started to pursue a new strategy. The aim of the government has been to put into force legislation through a series of confidence votes. With this strategy, the ruling coalition is trying to prevent the opposition from boycotting the parliamentary discussion or putting forward legislative amendments. According to the Romanian legislation, the government has the right to ask Parliament to approve a law without accepting any amendments, provided that it (the government) invokes the procedure of responsibility assumption. This way, the legislation will only fail to pass if the majority of the MPs vote against it. Starting with the uniform wage law, the government sought a vote of confidence in Parliament.

In response, the opposition parties filed two votes of no confidence against the government. The first one refers to the

Romania: Eurobank EFG Forecasts

	2008	2009	2010f	2011f
Real GDP (yoy%)	7.3	-7.1	-2.0	1.5
Private Consumption	9.5	-10.5	-2.5	1.0
Govern. Consumption	7.1	0.8	-2.0	-1.0
Gross Capital Formation	16.2	-25.3	-10.0	2.5
Exports	8.7	-5.5	20.0	10.0
Imports	7.8	-20.6	15.0	8.5
Inflation (yoy%)				
CPI (annual average)	7.9	5.6	6.5	4.5
CPI (end of period)	6.3	4.7	8.0	4.0
Fiscal Accounts (%GDP)				
General Government Balance (ESA 95)	-5.4	-8.3	-7.3	-4.9
Gross Public Debt (ESA 95)	13.4	23.9	35.5	40.0
Labor Statistics (annual avg,%)				
Unemployment Rate (% of labor force)	4.0	6.3	9.0	7.5
Wage Growth (total economy)	23.6	8.4	5.5	6.5
External Accounts				
Current Account (%GDP)	-11.6	-4.4	-5.5	-6.0
Net FDI (EUR bn)	9.5	4.8	4.5	5.0
FDI / Current Account (%)	57.6	94.3	65.0	61.5
FX Reserves (EUR bn)	26.2	28.3	31.5	35.0
Domestic Credit *(end of period)*	**2008**	**2009**	**Q2 10**	**Q3 10**
Total Credit (%GDP)	42.7	50.2	53.3	52.4
Credit to Enterprises (%GDP)	18.8	19.6	20.9	20.5
Credit to Households (%GDP)	19.7	20.4	21.1	20.5
FX Credit/Total Credit (%, private)	53.1	60.1	61.6	62.5
Private Sector Credit (yoy)	33.7	0.9	6.4	4.5
Loans to Deposits (%)	131.9	130.6	136.6	134.8
Financial Markets	**Current**	**3M**	**6M**	**12M**
Policy Rate	6.25	6.25	6.25	6.25
EUR/RON	4.29	4.25	4.30	4.35

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

2011 public wages law and the second one to the uniform wage law. The first one foresees that the bonuses of public sector employees are going to be incorporated in their regular wage payments, so that nominal public wages would increase by 15% in 2011. The second one, the uniform wage law, provides for a uniform payment scale across the public sector and links public wages to productivity, as is the case in the private sector.

More importantly, the implementation of next year's budget hinges upon the uniform wage law. That said, the government can only submit the new budget to Parliament after the endorsement of the uniform wage law. That is expected to take place by December 24. In contrast, the government accomplished to pass the pension law through the regular parliamentary procedures in the chamber of MPs. After its original endorsement from the ruling party in a controversial plenary meeting, President Trian Basescu returned the law to the parliament for a revote, asking the body to increase women's retirement age to 63 years. Finally, after the Constitutional court ruled that the bill was legitimate, the President signed the pension law.

Meeting IMF requirements is crucial for the short-term RON outlook.

Total financing from official lenders received thus far has reached €15.3 bn (€11.6 bn from the IMF in six disbursements and €3.7 bn from EU in three installments). Upon approval by the IMF Board, the completion of the sixth review in early January will result in the last disbursements from both IMF and EU. More specifically, the IMF will disburse a seventh tranche worth €913.2 mn, while the EU will release its fourth tranche worth €1.2bn. IMF funding will be utilized to boost FX reserves while EU funding will be used to finance the budget deficit.

In our view, meeting the financing program's remaining requirements will not only enable access to funding, but also prove vital for the short-term outlook of the RON. Markets are monitoring closely the developments on that front. The euphoria from a positive outcome could provide a temporary boost to RON in late December/early January, pushing it towards 4.20-4.25/€ from 4.29/€ currently.

Looking further ahead, it is still unclear what kind of arrangement will be the successor the current stand-by arrangement after its expiration in May 2011. In that direction, the government has already said that Romania is not in need of an extension of the current form of arrangement. In fact, Romanian Prime Minister stated that discussions for a *precautionary* stand-by facility with the IMF may start on the 20th of January when the EC/IMF next review mission is scheduled.

Domestic political landscape likely to remain challenging in the coming months, but probability of the current government going down is less than before.

The current government, who relies on independent and ethnic minority MPs for a very thin parliamentary majority of 4 seats, is likely to continue facing problems in the near future. The participation of the UDMR party, which represents the ethnic Hungarians, in the coalition government has attracted the attention of the media because of the ongoing developments with the new proposed education law. The new educational legislation touches upon a very sensitive issue: the education of ethnic minorities in the country.

The government attempted to pursue an accelerated legislation-approval process for this legislation as well, although many MPs of the ruling DLP party have expressed their disagreement over the law provisions for ethnic minorities. However, the constitutional court ruled against a government initiative to speed up the approval of the law through the procedure of a confidence vote. This prompted the minor opposition party PNL to file a no confidence motion on this bill, which it later withdrew. As a result, the President of the Senate, a PSD member, together with other MPs from both opposition parties contested this law at the Constitutional Court. The Constitutional Court has yet to issue a verdict on this issue.

The UDMR party considers this law important as it increases minorities' rights in education. The party leader has made it clear that UDMR's participation in the coalition is conditioned upon the progress made in issues related to minorities' rights. The latter was a clear hint that the UDMR might exit the ruling coalition if the new education law is not passed in its original form. In our previous *New Europe Economics & Strategy Monthly* issue we highlighted that the UDMR party has no other real option to form another government coalition with the rest of the opposition parties (PSD and PNL) under the current circumstances. On the other hand, the UDMR minority party could only promote its agenda on ethnic minority education reforms under the current government coalition.

However, some of its MPs appear divided over whether UDMR should continue participating in the government coalition. It would take only a few of them to vote against in the forthcoming crucial bills for the government coalition to collapse. In addition, there is one more risk factor. The opposition parties, especially the PNL, threaten to initiate an impeachment procedure for President Basescu that would ultimately lead to a referendum in a period of low popularity for him.

In both our previous *New Europe Economics& Strategy Monthly issue*s we warned that the rejection of the June 2010 and October

2010 no-confidence votes did not necessarily mean a more stable domestic political environment going forward. All recent opinion polls suggest that a new general election would see the major opposition party, SDP, being able to gain the first position, with a good chance to form a new coalition government. As such, the polls give a strong incentive to the opposition parties to attempt to overthrow the ruling coalition. In our view, the chances that current government may not be able to end its term in late 2012 are still material, yet less than earlier this year.

Fiscal performance to date sends a positive signal with respect to the attainment of the fiscal target in 2010.

The government has negotiated twice the current year's fiscal target with the IMF. Originally projected at 3.6%-of-GDP, the fiscal deficit target was eventually raised to 6.8%-of-GDP. Yet, the latter was still based on the optimistic assumption of a swift return to economic growth this year. In view of the present recessionary environment, the IMF indicated that without further corrective action, the full-year budget gap would skyrocket to 9.1% of GDP. As a result, the government came up with a fiscal correction package to reduce the 2010 deficit by 2.3pps of GDP. After the Constitutional Court's blocking of pension cuts, the final fiscal consolidation package incorporated steep cuts in public wages (horizontally by 25% yoy) and a VAT rate hike by 4pps (from 19% to 24%) effective since last July.

The consolidated budget deficit climbed to RON 23.7 billion in the first ten months of 2010, down by 7.2% yoy, compared to the first 10 months of 2009 against RON 20 bn in January-July 2010. As a percentage of the (projected) full-year GDP, the consolidated government deficit stood at 4.6% in October, compared to 3.6% in last June and 5.2% in the same month of last year. The data in the last couple of months demonstrate that the fiscal performance is consistent with the achievement of the revised full-year deficit target of 6.8%-of-GDP. Chances are that the latter target will be attained, provided that the recent fiscal performance continues.

This is also the view of a recent report published by the Fiscal Council, a body designed under the IMF/EU agreement to assess the government's macroeconomic and fiscal forecasts. Yet our analysis suggests that the attainability of this year's fiscal target may require incurring significant unpaid bills (arrears) to the private sector (contractors, suppliers etc).

The budget execution data have indeed started to look better since August, as they begun to incorporate the impact of the latest aggressive fiscal consolidation package. Total revenues over performed in Q3, compared to 1H. VAT collections and excise taxes have increased by 30% yoy and 17.4% yoy respectively in Q3. The VAT hike coupled with increased collection efforts by the tax authorities allowed total revenues to increase by 10.8% yoy in Q3, bringing the overall increase to 4.3% yoy year-to-October. In contrast, receipts from income tax and social contributions were still lower (by -3.6% yoy and -5.5% yoy, respectively), reflecting the weak labor market conditions.

On the expenditures side, total budget outlays were modestly higher (by 2.5% yoy) year-to-October. This was the combined result of massive cut backs in capital spending (-22.9% yoy) and increased social security expenditure for unemployment benefits (+8% yoy). However, the alarming new element in expenditure is that payroll expenses appear to have decreased by 10.7% in Q3 (which incorporates two months of public wages cuts) and by only 9.7% yoy in October instead of 25%.

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Special Focus - Romania

Looking for the turning point

The Romanian economy ends the second consecutive year of recession since the turn of the millennium. All relevant comments and analysis now focus on the illusive turning point, trying to grasp whether the economy has already bottomed out or whether more pain lies ahead. So far, the signals are mixed: for the first time since the recession started in Q4 2008, sentiment metrics look better than macroeconomic data. The former broadly indicate that the economy has bottomed out mid-year; the latter suggest the trough still lies ahead.

GDP contraction in Q3 2010 broadly in line with expectations

GDP contracted by 2.5% YoY in Q3 2010, broadly in line with our forecasts. The fall was driven by market services (-6.5% Q3 YoY) and construction activity (-14.9% YoY). Rather surprisingly, agriculture (-7.6% YoY) was another contributor to the dip. Crops for grains and maize were very strong this year (the latter amounted to 9 million tones, up 13.9% YoY and the second largest production in Europe behind France). There's still a chance that Q4 agriculture will be more robust than in 2009 (because value added in agriculture is usually accounted for with a significant delay). Industry remains the best performing sector (+4.2% YoY in Q3 2010), assisted by very strong foreign orders (+48.3% YoY). Financial services were surprisingly robust in Q3 (+2.6% YoY), especially considering that loans fell in real terms by 9% YoY, deposits shrank 2.7% adjusted for inflation, while net interest margins didn't cover provision making over the corresponding time span (unlike in Q3 2009).

On the expenditure side, private consumption fell 1% in Q3 2010 compared to its level in the same period a year earlier. The main drivers were:

- a 5 pp VAT hike at the beginning of July;
- the drop in consumer loans (-12.1% YoY in Q3 2010 in real terms);
- lower net wages (-8.4% YoY in Q3 in inflation adjusted terms). Public sector wages were cut by 15% on July 1st, while the private sector literally froze paychecks in 2010.

Looking at the causes of the drastic strains on consumption, it is clear that the marginal slump of just 1% was achieved by eating into savings (hence the drop in deposits) and by receiving 764 million euros in net remittances during Q3 2010.

Elsewhere, gross fixed capital formation plummeted 13.7% YoY in Q3, foreign direct investments (in euro terms) declined by 10.3% YoY and loans for inventories and equipment acquisitions fell 3.6% in real terms over the same horizon. Exports rose faster than imports (15.2%YoY and 12.6% YoY respectively), but this was not enough to narrow the trade gap (up 8.6% YoY in Q3 2010).

Rapid growth resumption not in the cards

Data releases for October 2010 paint a rather mixed picture regarding the potential imminence of growth resumption:

- Industrial production growth stood at 2% YoY in October, having decelerated from 2.8% YoY in the prior month and 4.3% YoY in the first half of the year. At the same time, sentiment in the sector improved in October-November, with the majority of respondents assessing activity trends and outlook as positive for the first time since the recession began in late 2008;
- Exports rose 28% YoY in October 2010, being probably boosted by the weaker euro. Intra-EU exports were 19% higher than in October 2009, a slowdown from the 26.5% YoY growth rate recorded in the first nine months of this year. This could be the effect of softening domestic demand in the euro area during the summer months and in early autumn or just the diminishing of the strong base effects that pitted 2010 numbers against last year's poor performances. Meanwhile, imports were ca 15% YoY higher in October 2010, regardless of provenience;
- Construction works fell 6.8% YoY (much less than during the first nine months of the year, when the slump averaged 16.1% YoY), on the back of improving building works. If the overall surface approved for construction remains a good leading indicator for building activity, the recovery could be short lived and activity could weaken again by December (on seasonally adjusted data). Order books are still close to all-time lows, covering 4 months in November 2010. Although government incentives for mortgage buyers will remain in place, supply continues to easily surpass demand. This means infrastructure works will have to compensate for a another possible slump in building works, but the outlook remains dire: the 2011 budget targets a 2.4pp deficit reduction to 4.4% of GDP and social payments could crowd out public investments, if further reforms to the pension system and to public sector employment are not finalised rapidly;
- The VAT hike hit retail sales less than expected in July and August, but year-to-date sales have failed to pick up in September and October, being virtually flat since June 2010 at around -4.5% YoY. Nevertheless, sentiment and expectations for future orders and activity have been improving in the past two months. Retailers seem to be

operating with very low inventories, meaning that any boost to domestic demand will translate rapidly into import growth.

Summing up, the economy will probably bottom out during the first half of 2011 (mainly because of favourable base effects stemming from a poor performance of early 2010). This bodes ill primarily for interest rates and inflation:

- The budget projections for next year counts on the economy growing in real terms by 1.5% in 2011. We think this is too optimistic a scenario and budget revenues will likely undershoot expectations, at least in H1 2011. Hence, we expect yields on Romanian sovereign debt to go up in the first part of 2011, especially when taking into account the busy issuance schedule in other EU countries (both Eurozone members and CEE countries such as Poland and Hungary);
- If revenues fail to meet targets, the budget balance could improve by hiking administered prices (for energy and utilities), by reducing subventions and/or by increasing taxes on ores and minerals. All three measures would lead to higher prices, putting pressure on domestic inflation. This, in turn, would further impede interest rates from falling.

The budget deficit saga

The political landscape looks even more divided than earlier this year, with infighting among opposition parties and especially among Social-Democrats (main opposition party) taking centre stage during the last couple of months. Therefore, the governing coalition has more chances to pass the budget, pension and education system laws in order to secure the €0.8-0.9bn disbursement of the penultimate IMF loan tranche in January 2011. The latter would also boost the chances of successfully tapping international markets by early 2011 in order to relieve local banks from shouldering most of the accumulating sovereign debt. If the Ministry of Finance manages to issue debt in euros, this would provide indirect support to the Romanian leu during Q1 2011 (until the precautionary IMF agreement will be signed). The MoF spends in lei and will dump the borrowed euros on the market or, more likely, on the National Bank, effectively cementing the tight flotation of the leu.

In our view, the government will meet the 6.8% of GDP deficit target for this year only by accumulating arrears. It is unlikely that the IMF will tolerate this in 2011 and a future precautionary agreement (extending the current loan facility) will probably underline this prerequisite. Hence, we expect a bias towards paying back overdue debt and meeting social payments in 2011, at the expense of investments and co-financing for European funds. Since foreign direct investments are unlikely to rise, FX inflows will probably be meagre in 2011, thus hitting the growth outlook and weakening the Romanian leu during the second half of next year.

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

Struggling with accelerating inflation

- NBS raised its key policy rate by a further 100 bps to 11.50% in December, in a move to address accelerating inflation and continuing depreciation pressures on the dinar
- The government reached an agreement with the IMF staff on the actions required to complete the sixth review of the present Stand-By Arrangement
- Increased price pressures in the domestic economy suggest Central Bank will likely miss year-end inflation target (6%, +/-2%) and probably find it difficult to attain next year's inflation target as well (4.5% +/- 1.5%)

Central Bank hikes interest rates again, struggles with accelerating inflation

On December 10, NBS raised its key policy rate by 100 bps to 11.50%. This was the fifth rate hike since the Central Bank terminated its easing cycle in early August. In a statement released after the policy meeting, the Central Bank cited once again the inflationary impact of higher agricultural product prices as a result of a poor domestic wheat crop and the Russian export ban. In addition, there was an explicit reference to the dinar depreciation and its inflationary implications for the domestic economy.

According to a Bloomberg survey conducted ahead of the December NBS policy meeting, the majority of economists polled (11 out of 21) expected a 50bps hike. Six out of 21 expected a 100bps hike while four foresaw no change. The new NBS rate hike and its magnitude hardly came as a surprise to us. In our previous *New Europe Economics & Strategy Monthly* issue and a Special Focus note on the Serbian economy published on November 11, we forecasted a 100bps hike in the last policy meeting for 2010.

The latest (November 2010) retail prices inflation reading (+1.8%/+10.9% mom/yoy), made it apparent that domestic inflation pressures continued to intensify, raising the risk of a double -digit CPI print at the of the year. Indeed, consumer price inflation came in at 9.6% in November, compared to 8.9% yoy in October, and only 4.8% yoy in January 2010. Since August, food prices have been a positive contributor to headline inflation because of the poor domestic crop and the rally in world commodity prices. Their impact on headline inflation is magnified by their significant weight in the CPI basket (~37.8%).

The recent Central Bank rate hikes aim to prevent heightened inflation expectations from triggering a second round of price increases. Yet, inflation volatility continues to undermine the government's efforts to contain the pace of Euroization taking place in the domestic economy: Given the traumatic experiences of hyper inflation and bank defaults of the 1990s, the level of confidence in the domestic currency as a storing value is low. This is reflected in the high Euroization level in the economy. FX deposits have a lion's share in total deposits: FX deposits comprised 72% of total deposits.

Serbia: Eurobank EFG Forecasts

	2008	2009	2010f	2011f
Real GDP (yoy%)	5.5	-3.0	1.5	3.0
Inflation (yoy%)				
CPI (annual average)	12.5	8.2	6.5	4.8
CPI (end of period)	8.6	6.6	10.0	4.5
Fiscal Accounts (%GDP)				
General Government Balance	-2.6	-4.2	-4.8	-4.0
Gross Public Debt	25.6	31.3	37.0	41.0
Labor Statistics (%)				
Unemployment Rate (%of labor force, ILO)	14.7	16.1	18.5	16.5
Wage Growth *(total economy)*	17.9	4.1	4.8	6.7
External Accounts				
Current Account (% GDP)	-17.1	-5.7	-8.5	-9.0
Net FDI (EUR bn)	1.8	1.4	1.5	2.0
FDI / Current Account (%)	30.0	78.7	55.0	70.0
FX Reserves (EUR bn)	8.2	10.6	11.3	10.2
Domestic Credit	**2008**	**2009**	**Q2 10**	**Q3 10**
Total Credit (%GDP)	41.0	48.7	56.1	57.0
Credit to Enterprises (%GDP)	25.8	29.4	32.9	33.4
Credit to Households (%GDP)	14.0	14.7	16.4	16.9
Private Sector Credit (yoy)	34.9	14.3	23.1	26.5
Loans to Deposits (%)	125.1	127.0	138.7	141.6
Financial Markets	**Current**	**3M**	**6M**	**12M**
Policy Rate	11.50	14.50	12.50	9.50
EUR/RSD	105.60	110.00	110.00	115.00

Source: National Sources, IMF, Eurobank Research & Forecasting

In our view, the aforementioned developments will likely have two important consequences: The latest CPI readings suggest that the inflation target (6%, +/-2%) will be missed this year, for the first time since the introduction of the inflation targeting regime in August 2006. It appears that the Central Bank may also find it difficult to attain the official inflation target for next year (4.5% +/- 1.5%). In fact, the attainability of next year's inflation target has already stirred intense public debate domestically. For that reason, the Central Bank is currently in discussions with the government on the possibility of deploying administrative measures aiming to stabilize domestic food prices.

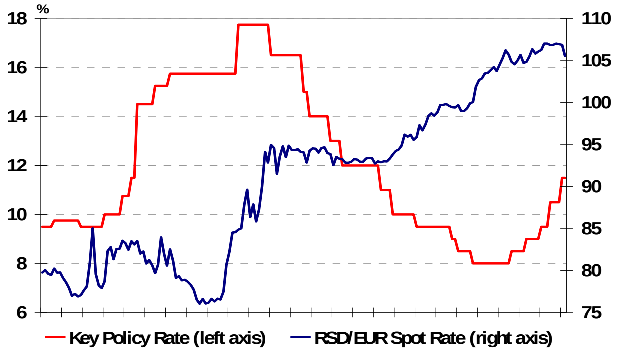
On the other hand, the most important factor that weighed on the NBS's policy decision was the rapid pace of dinar depreciation in recent months, the weak capital inflows as well as the low demand for dinar denominated securities. Note here that the latest auction of three-month Treasury bills on Dec 6th was undersubscribed, with the Ministry of Finance managing to attract only 49% of the requested funds (RSD 2.44 bn with an average yield of 12.3%).

Since September 2009, the dinar has come under significant depreciating pressure that intensified during the past summer months, despite repeated Central Bank interventions in the FX market. Officially, the Central Bank does not have an explicit exchange rate target. Yet, it has spent some €2.5bn (more than the IMF assistance received so far-€1.5 bn) so far this year in an attempt to smooth excess volatility in the market.

After remaining broadly flat at levels around 105/€ for a short period of time, the dinar started to depreciate again. When the dinar reached a new historic low at 108.05/€ on October 28th, the Central Bank was, apparently, forced to intervene again and raise interest rates twice in less than sixty days. Dinar traded at 107.15/€ on December 11th, right after the announcement of the latest hike. The domestic currency recouped some of its losses, reaching 105.6/€ on December 20. At the current level, the Dinar has lost nearly 10 percent year to date and about 40 percent since the start of the global financial crisis in 2008.

Figure 1

NBS hiked interest rates aggressively in the last 2 months



Source: Bloomberg, Eurobank Research

Looking further ahead, we see room for further interest rate hikes in the first months of 2011. According to the projections of the NBS, inflation will most likely move into double digit territory, fluctuating in a range between 10-14.5% in the 1H 2011.

Looking ahead, the Central Bank is likely to move more aggressively in order to protect its credibility and contain the elevated inflation expectations. We see the key policy rate peaking at 14.5% in 2011 *i.e.,* 300 bps higher from current levels. However, unless there are quite unpleasant surprises on the inflation and/or the currency fronts, the Central Bank may start reducing interest rates again before the end of next year. That is in line with our forecast that domestic inflation will start receding again from 2H 2011, assisted by contained demand pressures and favorable base effects. If inflation is finally contained within the band (4.5% +/- 1.5%) at the end of next year, then the NBS may be able to reduce its key policy rate back to 10.50%-11.00% by December 2011.

Government and IMF staff conclude discussions ahead of the sixth review of the existing Stand-By Arrangement

The government concluded discussions with the IMF staff ahead of the sixth review of the Stand-By Arrangement. Although all of the quantitative targets were met (including that of the fiscal deficit target in Q3-2010), the review was not completed. The Serbian government has to fulfill two more requirements in order for the IMF Board to approve the sixth review. The first requirement relates to the pension reform law and the second to the adoption of the fiscal target of 2011.

The Serbian government undertook the obligation to send a slightly modified version of the (still uncompleted) pension reform law back to the parliament. The pension law was originally submitted to parliament for debate last June, as part of the government's commitment ahead of completion of the fourth review. However, the strong opposition from labor unions led to its withdrawal in late October. The government is obliged to resend the bill to the parliament with two changes relative to the original draft.

The first relates to a gradual increase in the minimum number of years of service for women starting from 2013 instead of 2011. The second refers to the establishment of a quantitative rule with respect to the minimum level of pension payments. The modified bill provides that the minimum pension cannot fall below 27% of the average salary. This rule has been a point of confrontation between labor unions and the government. Labor unions demanded that the threshold for the minimum pension ought to be 60% of the average salary. Finally, labor unions reached an agreement with the government, which was backed by IMF. The agreement stipulates that if pensions go below 60% of the average salary, then the government will be obliged to adopt legislation that would protect pensioners.

During the technical discussions with the IMF mission, it was also agreed to vote the 2011 budget by the end of December. More specifically, the government agreed on a fiscal deficit target of RSD 140mn (or 4% of GDP) for next year. The most important element in the new budget is the unfreezing of wages and pensions. The modified agreement now foresees that indexation should take place three times a year (January, April and October) in a backward looking manner. The first indexation will be based on the use of inflation only, and is expected to boost wages by 2% in January. The second will take into account the GDP performance of the prior year. The third will be based on the previous six-month average inflation.

Wages have already started recovering in the domestic economy providing a signal that the worst is already behind. Net salaries rose by a 2.5% yoy in Jan-Sep in real terms, with the corresponding nominal rise reaching 7.3% yoy. The unfreezing of public wages and pensions is anticipated to push wages in the private sector higher as well. The rise in real wages combined with positive credit growth is expected to bolster the domestic demand recovery in 2011.

In all, the implementation of the IMF program is still on track. So far, the government has successfully completed five reviews of the program, which was initiated in Jan 2009. The successful implementation of the IMF program gave the government extra leverage in negotiations with the Fund. In fact, the government succeeded in bringing forward the implementation of the unfreezing of wages and pensions by three months earlier in 2011. With respect to the financing part of the agreement, the government drew only €56 mn from the last tranche in last June. Thus far, the government has made use of €1.5bn of IMF financing out of a total of €2.9bn of available funds. The government has stated that will make no further use of the last two IMF tranches. However, it is still unclear whether the government will extend the current arrangement which expires in April 2011. In that direction, Deputy Prime Minister, Bozidar Djelic, has stated recently that the external fiscal position of the country allows the government not to use the full funds provided by the SBA

Year-to-October budget execution data signal *revised* fiscal target within reach

The budget deficit rose 14.5% yoy year-to-October, reaching RSD 86bn *(or 2.7% of projected GDP)*. Tax revenues recorded a 7.4% yoy increase, while budget outlays were up by 8.3% yoy, boosted by increased social security expenditures. The budget execution data for the first ten months of the year suggested that the achievement of the original fiscal deficit target of this year (RSD 102bn) was not going to be accomplished.

As a result, the government submitted a revised budget draft for this year, which has already been endorsed by the Parliament. The revised budget envisages a 12% yoy increase in this year's targeted fiscal deficit to RSD 125bn. The target for total revenues was revised up by 0.5% to RSD 660bn. Total expenditures were also revised up by 2.2% to RSD 780bn.

In our view, unless there is significant fiscal loosening in the last two months of 2010, the revised deficit target for this year will be attained. On the positive side, the revision is not expected to have an impact on the overall deficit to GDP ratio, Indeed, the higher than anticipated nominal GDP increase in 2010, allows consolidated budget deficit to remain at 4.8% of the full year GDP, as initially agreed with IMF.

On the negative side, the revision of the budget is performed at the expense of the public investment program. The extra expenditures targeted by the revised budget are solely channeled to current outlays, thus providing a boost to consumption. The Republican Pension and Disability Insurance Fund will be a recipient of RSD 7bn. to provide extra financial assistance to pensioners of RSD 5,000. Social protection expenditures will be increased by RSD 3.5 bn. Public sector employees will receive a one time financial assistance of RSD 2bn. Subsidies for industry and agriculture will increase by a total of RSD 2.6 bn.

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

CBT cuts its key policy rate to curb "hot money" inflows, strengthen financial stability

- Real GDP slows more than expected in Q3, exposing unbalanced growth dynamics.
- CPI eased to an 11-month low in November, supporting our view that the recent inflation spike will likely prove temporary
- Fiscal consolidation remains on track, but risks lie ahead of the July 2011 elections
- Economic overheating, rising external vulnerabilities are key macroeconomic risks ahead.

Real GDP slows more than expected in Q3, exposing unbalanced growth dynamics.

Turkey's real GDP growth slowed to 5.5%yoy in Q3, after expanding by 11.0%yoy in H1:2010. This was the first disappointing GDP reading after several quarters of upside surprises, coming as a result of waning base effects, a slowdown in the pace of inventory adjustment and a widened external imbalance. Note that the market's median forecast was for a 6.6%yoy reading. The favorable impact of the rebuilding of inventories is gradually diminishing, with the change in stocks subtracting 0.4ppts from growth in Q3. This halted a positive contribution trend over the prior four quarters. Meanwhile, government spending fell by 1.1%yoy in Q3 (+2.2%yoy in H1), slashing some 0.1ppts off GDP growth. However, a major drag came from net trade, which took away 4.6ppts as exports fell by 2%yoy, after expanding by nearly 12%yoy a quarter earlier. On the other hand, imports' growth remained robust at 16.9%yoy (+20.4%yoy in January-June) benefitting by strong domestic demand. In support of the latter, overall domestic demand contributed ca 10.1ppts to Q3 growth as private consumption jumped 7.6%yoy, adding 5.1ppts to the GDP. Moreover, investments soared by 31.3%yoy (+22.3%yoy in H1), recording their highest rate of increase since 2004, and providing 5.5pts to overall GDP growth. Calendar adjusted real gross domestic product grew by 6.4%yoy, while on a quarter-on-quarter basis seasonally and calendar adjusted GDP rose by 1.1%.

Higher-frequency data point to further growth deceleration in Q4…

Most recent data suggest that the economic recovery continues. However, the pace of GDP growth is likely to decelerate further in Q4, against a background of abating base effects and weaker external demand. In detail, the strong recovery in industrial production witnessed since December 2009 is cooling down, with growth in the sector easing to 9.84%yoy in October after a 13.5% jump over the first nine months of the year. According to Turkish Exporters' Assembly (TIM), exports growth decelerated slightly to 10.94%yoy over the January-November period, from a 12.45%yoy increase in the first nine months of the year. The number of foreign visitors to Turkey came in at 8.6%yoy in October from an 11.7%yoy jump recorded in the prior month, bringing the number of visitor arrivals 6.25%yoy higher year-to-October. On a more positive note, PMI manufacturing bounced to 56.4, its highest level since May. Automotive production growth slowed to 16.9%yoy in November, pushing the rate of annual increase to 26.7% over the first eleven months of the year. However, sales in

Turkey: Eurobank EFG Forecasts

	2008	2009	2010F	2011F
Real GDP (yoy%)	0.7	-4.7	7.5	5.0
Private Consumption	-0.3	-2.3	4.5	5.0
Govern. Consumption	1.7	7.8	5.0	3.0
Gross Capital Formation	-6.2	-19.2	16.0	10.0
Exports	2.7	-5.4	6.0	8.0
Imports	-4.1	-14.4	18.0	10.5
Inflation (yoy%)				
CPI (annual average)	10.4	6.3	8.6	6.9
CPI (end of period)	10.1	6.5	7.0	6.0
Fiscal Accounts (%GDP)				
Central Government Balance	-1.8	-5.5	-3.8	-2.7
Gross Public Debt	39.5	45.4	42.5	41.5
Primary Balance	3.5	0.1	1.0	1.5
Labor Statistics (%)				
Unemployment Rate (%of labor force)	13.6	13.5	12.0	11.0
External Accounts				
Current Account (% GDP)	-5.7	-2.2	-5.6	-6.0
Net FDI (USD)	15.7	6.7	6.5	7.0
FDI / Current Account	37.5	43.5	17.0	15.0
FX Reserves (USDbn)	71.0	69.0	80.0	90.0
Domestic Credit	**2008**	**Q4 09**	**Q1 10**	**Q2 10**
Total Credit (%GDP)	31.1	34.8	33.4	37.4
Credit Private Sector (%GDP)	29.7	32.9	31.6	35.5
FX Credit/Total Credit (%)	13.2	14.9	16.9	18.7
Private Sector Credit (%yoy)	22.9	11.3	22.8	34.0
Loans to Deposits	82.4	78.7	79.9	82.1
Financial Markets	**Current**	**3M**	**6M**	**12M**
Policy Rate	6.50	6.00	7.00	8.00
USD/TRY (where applicable)	1.56	1.55	1.45	1.35

Source: National Sources, Eurostat, IMF, Eurobank Research & Forecasting the sector soared by 165%yoy last month for a 31.8%yoy jump in January-November. Capacity utilization, considered to be a leading indicator of both manufacturing activity and GDP growth, marked a four-month rising streak in November, touching a 2-year high of 75.9%. With respect to domestic consumption dynamics, the consumer confidence index eased slightly to 89.02pts in October from a 2-½-year high of 90.4pts in September. Meanwhile, credit activity remains on an uptrend in recent months, with year-to-date credit to the private sector expanding by 29%yoy in September.

…but Turkey still expected to lead the recovery in New Europe

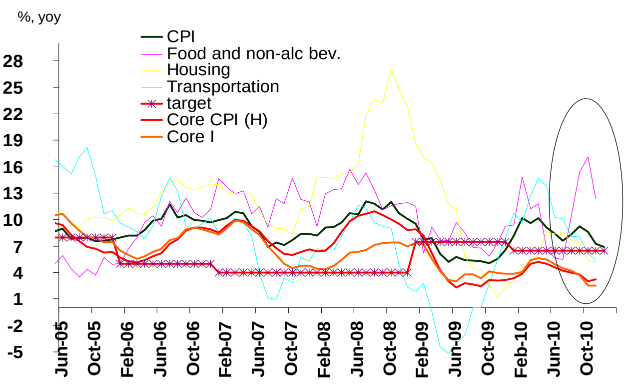
In spite of the Q3 GDP slowdown, Turkey continues leading the economic recovery in New Europe. We expect full-year growth at 7.5%yoy. Domestic demand will likely remain the primary driver of growth in the quarters ahead in view of the rapid credit expansion and gradually improving labor market conditions. On the flipside, net exports are seen remaining a drag on growth as the pace of domestic economic recovery outpaces that of main trade partners. For 2011, we continue to anticipate a GDP growth slowdown to 5.0%, on back of unfavorable base effects and an increasingly negative contribution from net exports.

Inflation eases to an 11-month low in November…

Headline CPI remained nearly flat on a monthly basis in November, confounding market expectations for a 0.93% gain and coming in well below a 1.23% rise a month earlier. The breakdown of the data showed that most of the components recorded relatively small increases, with three out of the twelve sub-indices falling. The primary culprit of the slowdown in headline CPI was a 1.9%mom drop in food prices, which follows a sharp acceleration over the August-October period due to seasonal factors and adverse weather conditions. On an annual basis, headline CPI eased to an 11-month low of 7.29% in November, sliding below the CBT's 7.5% 2010-end estimate and marking a gradual deceleration from September's 5-month peak of 9.24% YoY. Four out of the nine core CPI indices eased on an annual basis in November while the CBT's favourite measures "H" and "I", remained near respective historic lows of 3.02% and 2.50% touched in October, suggesting that underlying inflation pressures remain subdued. Producer prices also surprised to the downside coming in better than expectations for a 0.4%mom rise, marking a 0.31%mom decline against a 1.21%mom jump in October. On an annual basis, producer price inflation slowed to 8.17% from 9.92%yoy in the prior month.

Figure 1

Inflation eases significantly in November on lower food prices



Source: National statistics

…supporting our view that the recent inflation spike will likely prove temporary.

The November data vindicates, once more, the Central Bank's long voiced view, which coincides with ours, that the recent spike in inflation was likely to prove temporary, being primarily driven by higher food prices and base effects. We believe that the November data marks a reversal of the recent uptrend in headline inflation, which has been mainly driven by cost-push rather than demand-pull factors. We anticipate food price inflation to continue decelerating gradually in the coming months, thanks to improved weather conditions and a better harvest. Favorable base effects are likely to assist the disinflation process going forward, while risks of second-round effects are likely to prove limited. In view of the significant improvement witnessed in headline CPI in November, we revised our end-2010 forecast to 7.0% from 8.0%yoy previously, which is still slightly above the CBT's 6.5%yoy target for this year. The disinflation trend is likely to continue through to Q1 2011 on base effects and easing food inflation, while headline CPI will probably converge towards the 5% level in Q1 2011. A pickup thereafter is possible in view of potential fiscal slippages ahead of July's parliamentary elections and a narrowing output gap. Looking further ahead, we expect inflation to come in around 6.0% (vs. our earlier 6.7%yoy forecast) in December 2011, exceeding the CBT's 5.5%yoy target for next year. Higher oil prices, public expenditure overruns and FX fluctuations present upside risks to our forecasts. However, we regard these risks to be relatively contained as we anticipate budgetary pending in the run-up to the polls to prove relatively contained and the lira to remain supported by domestic economic fundamentals, barring any significant worsening in the global environment.

November CPI data supports the case for CBT to stay put on rates until Q4 2011.

Until recently, we expected the CBT to stay put on interest rates in the months ahead and incept its monetary tightening cycle in Q4 2011, as it was explicitly mentioned in the Central Bank's latest Inflation Report (October-2010). The most recent inflation data suggests that underlying price pressures remain relatively subdued. What's more, the divergence of the pace of recovery between the Turkish economy and those of developed countries raises a key policy risk ahead, as hasty monetary tightening is likely to exert further appreciating pressures on the local currency and exacerbate the country's rising external vulnerabilities. Thankfully, the CBT has already expressed concerns about the recent surge in capital inflows and has already taken steps to address it.

CBT cuts key policy rate to curb "hot money" inflows and preserve financial stability

At its latest MPC meeting on December 16 the Central Bank cut its key policy rate, the one-week repo rate, by 50bps to 6.50%. In reality, strong domestic demand dynamics did not justify such a move. Yet, the rate cut actually aimed at preventing a further significant surge in "hot money" inflows that could risk undermining domestic financial stability. The CBT also decided to widen its interest rate corridor by reducing its overnight borrowing rate by 25bps to 1.50% and by increasing the corresponding lending rate by 25bps to 9.00%. Meanwhile, in order to offset a potential increase in credit growth activity as a result of the aforementioned measures, the CBT announced a day after its MPC meeting that it would raise domestic banks' short-term TRY reserve requirement ratios and cut those with long-term maturities as of January 7, 2011. In detail, the ratio of TRY deposits with up to 1 month maturities was raised to 8% from 6% previously, which was the requirement on all lira deposits. For TRY deposits with up to six months of maturity the ratio was increased to 7%; for up to one year it remained unchanged at 6%, while for one year and longer the ratio was cut to 5%. For FX deposits the ratio was maintained stable at 11%. The Bank highlighted that the aforementioned measures would not have an expansionary effect in monetary policy conditions.

Latest MPC decision not a complete surprise.

The CBT's latest announcements did not take financial markets by complete surprise. In a presentation by Central Bank Deputy Governor Erdem Basci on December 11, it was highlighted that, at present, the best monetary policy mix would be short-term rate cuts to curb an appreciation of the lira in tandem with higher reserve requirement ratios to cushion the rapid expansion in credit growth. Separately, at its semi-annual financial stability report in early December, the CBT left the door open for a rate cut should capital inflows strengthen. Nevertheless, it retained its baseline scenario which envisions stable interest rates until Q4 2011, with a gradual tightening thereafter.

Further policy rate cuts may follow in Q1, but monetary tightening cycle likely to begin in Q3 2011.

Additional Central Bank measures, aimed at restraining the recent strong acceleration in credit growth (+35%yoy in September) and curbing the inflow of capital, remain on the cards in the coming months. In view of the aforementioned, we expect another 50bps cut, likely to be combined with further increases in the reserve ratio requirements in Q1. However, these measures will have to be eventually reversed as the output gap gradually narrows demand-led price pressures intensify. We anticipate 100-150bps of cumulative rate hikes in H2 2011

Fiscal consolidation remains on track…

The improvement in government finances continues, with the January-October consolidated central government deficit shrinking by 46.5%yoy to TRY 23.1bn. According to our calculations the latter figure amounts to 2.1%-of-projected-GDP, reflecting a significant narrowing from a deficit of 4.5%-of-GDP registered over the same period a year earlier. The main drivers of the narrowing in the budget deficit are restrained expenditure and higher tax revenues assisted by the strong economic rebound. In view of the ongoing improvement in public finances over the first ten months of the year we continue to expect the central government deficit to slightly outperform the 4.0%-of-GDP shortfall envisioned in the new MTP as well as last year's 5.5% realization.

…but risks lie ahead in view of the 2011 elections.

Looking ahead, we expect a further improvement in Turkey's fiscal position in the months ahead and expect the central government deficit to narrow further towards levels of 2.7%-of-GDP in 2011. Risks to our forecast lie in the face of fiscal slippages in the run-up to the upcoming general elections scheduled for July 2011, Nevertheless, we assign a rather limited probability for a significant deterioration in government finances over the coming months, in view of the government's stated commitment to fiscal prudence - even in the absence of an IMF anchor - and the high public support the AKP party currently enjoys. Back in October, the government unveiled a credible Medium-Term Plan, in a move that largely soothed criticism for the removal of the much-anticipated fiscal rule from the government's near-term agenda. In early November, Finance Minister Mehmet Simsek acknowledged that government spending may rise ahead of the polls but underscored that fiscal discipline will be reinstated in the second half of next year. Meanwhile, as recently as in early December Prime Minister Tayyip Erdogan reiterated the government's dedication to fiscal discipline. As highlighted by the CBT, fiscal prudence is key, against a background of increasing widening pressures on the country's current account deficit. A sustainable improvement in the country's fiscal fundamentals may also lead to a credit rating upgrade, as recently voiced by Moody's, while in late November Fitch upped its outlook on the country's credit rating to positive from stable, citing improving public finances.

Economic overheating and rising external vulnerabilities are key macroeconomic risks ahead.

The strengthening of domestic demand dynamics has lately fanned concerns about rising economic overheating and external imbalances. In reality, rapid credit expansion and improving labor market conditions bear potential for stirring demand-pull inflation pressures anew. Meanwhile, the recent surge in foreign capital inflows (in tandem with strengthening domestic demand) has exerted appreciating pressures on the lira. This, in turn, has boosted imports and weighed on exports, thus exercising widening pressures on the current account deficit. The shortfall's financing does not appear to pose a significant risk at present, being primarily matched by adequate capital inflows. That said, the short-term nature of current account financing do raise some concerns as it leaves the country highly susceptible to sudden swings in global investor sentiment. Note that in January-October the shortfall soared nearly threefold to USD 35.7bn (or ca 5%-of-GDP), with just 13% of the gap financed by FDI inflows. The government and the Central Bank appear aware of the aforementioned risks and we expect to see them step in, if necessary, to cool down the rapid acceleration of credit activity, as well as the surge in capital inflows. In the meantime, we expect the current account deficit to rise to 6.0%-of-GDP in 2011 from 5.5% of GDP expected this year and 2.2%-of-GDP in 2009 .

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

Recovery remains on track despite Q3 GDP slowdown

- Preliminary data shows GDP growth slowed to 3.5% yoy in Q3 from 5.9% yoy in the prior quarter
- Consumer price inflation decelerated to 9.2% yoy in November from 10.1% yoy in October, driven by lower food prices
- October current account deficit underwent its worst deterioration in two years
- Encouraging trends with respect to domestic deposits and corporate lending; Non-performing loans remain elevated.

New revised tax code adopted by the parliament

In early December, Ukrainian President, Viktor Yanukovych, vetoed the new tax code in a response to a wave of protests by small and medium business owners following parliamentary approval of the code in mid- November. The new tax code would significantly broaden the category of small businesses that would need to submit details of their operations to the state tax inspectorate and pay 25% of their profits, instead of making fixed payments as it was the case until now. The small and medium sized businesses owners protested against the new code on the basis that the latter would expand the powers of the internal revenue service and reduce the rights of taxpayers, by adding more administrative rules and procedures. They also argued that the new tax code would actually decrease government revenues by drowning many businesses and fuelling corruption among tax officials. The President proposed a new version of the tax code which included concessions to small business owners. Ukrainian Parliament adopted the revised version of the tax code incorporating all changes suggested proposed by the President. The amended tax code is not expected to affect substantially the overall performance of the 2011 budget.

Consequently, the government will submit its 2011 budget proposal to lawmakers early this month so as to have it approved before December 20, in line with the requirements of the present IMF Stand-By Arrangement. The Fund is scheduled to vote on releasing a $1.6bn instalment by the end of December ($1bn of which will be provided for budgetary support).

Implementation of IMF-agreed reforms broadly on track

In its first review of the present Stand-By-Arrangement with Ukraine, the IMF pointed out that fiscal consolidation will be underpinned by reforms in the energy sector (which are expected to allow Naftogaz to balance its finances in 2011), measures to strengthen the finances of the pension system and improvements in public administration. As a result, the IMF said that next year's budget deficit should not exceed 3.5% of GDP. Moreover, it was stated that measures are required to address non-performing loans, which remain at elevated levels.

Ukraine: Eurobank EFG Forecasts				
	2008	**2009**	**2010f**	**2011f**
Real GDP (% yoy)	2.3	-15.1	4.3	4.5
Private Consumption	9.9	-12.1	2.5	3.5
Government Consumption	0.4	1.8	1.0	1.5
Gross Capital Formation	32.6	-48.4	4.0	8.0
Exports	5.1	-23.6	9.0	9.0
Imports	18.4	-36.8	10.0	11.0
Inflation (% yoy)				
CPI (annual average)	25.2	15.9	9.5	10.8
CPI (end of period)	22.3	12.3	10.0	10.5
Fiscal Accounts (% GDP)				
General Government Balance	-3.2	-8.7	-6.5	-3.5
Gross Public Debt	19.9	34.6	39.6	41.5
Labor Statistics (%)				
Unemployment Rate (% of labor force)	6.9	9.4	8.5	8.0
Wage Growth *(real - private sector)*	6.3	-10.3	6.5	5.0
External Accounts				
Current Account (% GDP)	-7.0	-1.5	-1.3	-2.0
Net FDI (bn USD)	9.9	4.7	5.0	7.0
FDI / Current Account	77.6	34.0	140.0	90.0
FX Reserves (bn USD)	31.5	26.5	33.0	30.0
Domestic Credit	**2007**	**2008**	**2009**	**Q2 10**
Total Credit (% GDP)	59.9	77.3	79.1	70.8
Credit to Enterprises (% GDP)	36.5	46.7	50.5	46.6
Credit to Households (% GDP)	22.5	29.5	26.4	22.3
FX Credit/Total Credit (%)	49.9	59.0	50.8	18.5
Private Sector Credit (% yoy)	74.9	68.5	-3.1	1.4
Loans to Deposits	150.4	204.0	215.9	192.2
Financial Markets	**Current**	**3M**	**6M**	**12M**
Policy Rate	7.75	7.75	7.75	7.75
USD/UAH	7.89	7.90	7.90	7.90

Source: NBU, IMF, Bloomberg, Eurobank Research

Preliminary data shows GDP growth decelerated to 3.5% yoy in Q3

According to preliminary data, real GDP growth slowed to 3.5% yoy in Q3-10, from 5.9% yoy in the prior quarter. To a large extent, the deceleration was probably the result of the summer heat-wave, which affected heavily agricultural production. On a more positive note, the most recent readings in a range of higher-frequency indicators suggest that the economy got off a solid start in Q4. Among them, industrial production growth remained unchanged at 10.2% yoy in October, beating the 8.5% yoy market consensus forecast. Moreover, retail sales growth rose to 5.9% yoy in October, its fastest pace since December 2008. Admittedly, the recovery appears to have lost some steam but one has to also take into consideration a less favourable base of comparison, which is affecting negatively the year-on-year GDP readings in H2-10. We expect full-year GDP growth of 4.3% yoy, along with a further acceleration to 4.5% yoy next year. Downside risks to our GDP forecasts stem from the recent loss of momentum in the global economy, which may hurt the Ukrainian economy that relies heavily on still exports.

Inflation decelerating again

Ukrainian inflation decelerated in H1-10, reaching 6.9% yoy in June, from 11.8% yoy in January. This, along with weak domestic demand and negative credit growth allowed the Central Bank to ease policy rates by 250bps cumulatively in June-July, bringing its key policy rate to 7.75%. More recently, inflationary pressures intensified, driven by a 50% hike in gas tariffs in August and poor agriculture harvest in the summer months. Yet, consumer prices decelerated to 9.2% yoy in November from 10.1% yoy in October, assisted by a slowdown in food prices (to 11.4% yoy, from 13.1% yoy in the prior month). Food prices account for more than half of the CPI basket. Looking ahead, we do not expect inflation to abate significantly in the following months as recovering domestic demand coupled with a further 50% hike in utilities tariffs scheduled for April 2011 will likely unleash further price pressures. We forecast consumer price inflation to average to 9.5% yoy this year, ahead of a further acceleration to 10.8% yoy in 2011.

October current account deficit hits its widest level in two years; capital and financial account surplus declines substantially

The current account balance surprised negatively in October, recording a shortfall of $0.9bbn compared to a deficit of less than $0.2bn in the prior month. This was the worst monthly print since November 2008. According to the National Bank of Ukraine (NBU), the deterioration was mainly caused by the increase in gas imports and the decline in the services surplus. In the first ten months of 2010, the current account deficit amounted to $1.8bn, more than double compared to the same period in 2009 (10m09 c/a gap was $0.78bn). What's more, the 12-month rolling current account deficit increased in October to $2.8bn (or ca 2.0% of GDP).

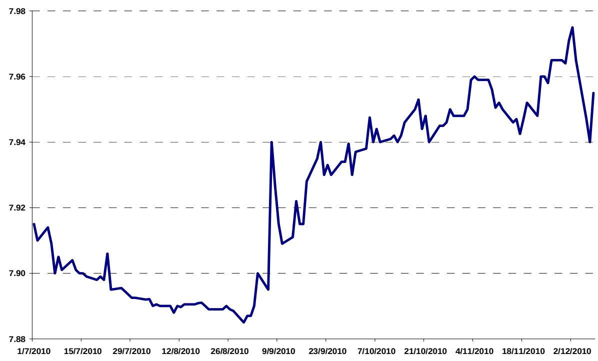
At the same time, the capital and financial account surplus declined substantially in October mainly due to absence of large government borrowings. It dropped to $0.3bn, from a surplus of $1.4bn in September. With the ongoing de-leveraging in the domestic banking sector broadly offsetting increased external borrowings by domestic corporates, net inflows of borrowed capital summed up to $0.6bn in October, down from $2.6bn in September. Foreign Direct Investment (FDI) inflows in October remained at a high level of $0.5bn with the banking sector attracting a third of the total. Year-to-October, net FDI inflows amounted to $4.1bn and remained broadly at the same level relative to in the same period last year.

In October, the financial and capital account surplus was more than offset by the current account deficit for the first time since February 2010, with the resulting shortage ($0.6bn) being covered by NBU reserves. Official reserves assets stood at to $33.5bn at the beginning of December down from $34.3bn at the end of October. All in all, we believe that current account improvement has past its best and a sustained surplus is rather unlikely in the months ahead. We anticipate the overall current account deficit to reach 1.3% of GDP in 2010 and to widen further to 2% of GDP in 2011.

Hryvnia on a depreciating trend since September

After strengthening modestly in the months following the presidential elections and the resumption of the IMF loan, the hryvnia has been on a depreciating mode since early September (Figure 1). The domestic population, which holds about 48% of its banks deposits in foreign currency, has recently increased their holdings of hard currency. The NBU estimates that net FX purchases by households were around $3.6bn in September-October. Looking ahead, the UAH may continue its depreciation against the USD in Q1-11 due to a seasonally weak current account performance in the first quarter of the year, but the NBU is ready to intervene in case there is another round of hryvnia sell-off so as to preserve currency stability (NBU spent $0.5bn in October to maintain stability in the exchange rate).

Figure 1
Hryvnia's recent sell-off



Source: Reuters, Eurobank Research

Encouraging trends in deposit and corporate growth

Recent trends in deposits and corporate lending are encouraging. Private sector credit grew by 4.3% year-to-October, with domestic MFI loans to corporates recording growth of 7.0% over the same period. Yet, household credit growth continued to decelerate; declining by 9.9% year-to-October with mortgages loans recording the largest fall over the same period (down 14.2%). Moreover, private sector FX denominated credit accounts for 48% of total loans. This high FX leverage makes the banking system vulnerable to abrupt exchange rate fluctuations. On the other hand, private sector deposits continued their acceleration trend, growing by 22.5% over the first ten months of the year. Note that almost half of the total household deposits are denominated in FX (48.6%).

The main challenge to Ukrainian banking system is the elevated level of non-performing loans (NPLs); they accelerated further in October reaching 12.2% of total loans from 9.7% at the end of 2009. NPLs grew by 28.2% in the first ten months of 2010.

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