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Economic growth to accelerate in 2011; supply-side factors complicate monetary policy outlook in the region

Bulgaria: Fiscal deficit cut more than expected in 2010; GDP growth seen accelerating further in 2011, driven by improving domestic demand dynamics and a sustained exports recovery

Poland: National Bank of Poland raised its key policy rate by 25bps to 3.75%, citing inflation risks; more rate hikes lie ahead

Romania: IMF board approves sixth review of expiring stand-by arrangement with Romania. A new *precautionary* arrangement is in the pipeline

Serbia: Central Bank raises interest rates by a further 50bps to 12.00% and lifts minimum reserve requirements in a move to contain inflationary pressures, arrest dinar weakness

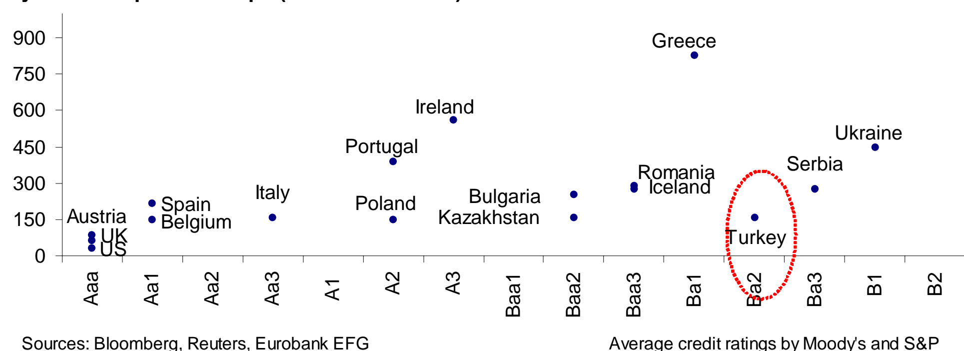
Turkey: CBT employs unconventional policy mix to address both inflation and financial stability risks

Ukraine: 2010 growth surpassed expectation; smooth implementation of new stand by arrangement with the IMF positive for market sentiment.

New Europe market strategy highlights

In **regional currencies** markets, the **Hungarian forint** and the **Serbian dinar** have lately outperformed their regional peers, deriving support from proactive central bank policy tightening. Elsewhere, a rather unorthodox policy mix adopted recently by the Central Bank of Turkey has taken a toll on the **lira**. Strong macroeconomic fundamentals and widening interest rate differentials vis-à-vis the euro and the US dollar are likely to provide support to the **Polish zloty** in the near future. However, we anticipate that current expectations for further significant monetary tightening by Poland's Central Bank will eventually prove overdone. Fiscal concerns are also likely to weigh on the zloty further ahead. Along these lines we prefer to stay sidelined on the **EUR/PLN** at current levels. Separately, we would also enter short positions in **EUR/RSD** at the current 103-104 levels, with a target of 98.40 in a 3 to 6 months horizon. A short **EUR/HUF** position also appears to bear value at current levels near 269, with a target of 260 and a stop-loss at 275 (50 day MA). We would rather remain neutral on **USD/TRY** as the pair recently failed to break above a near 2-year high of 1.6188 touched in late January and considerable uncertainty remains regarding the longer-term impact of recent CBT policy moves. Inflation pressures ahead stirred through narrowing output gaps and higher commodities prices bode ill for **local rates markets**. However, inflation risk premia in several countries, particularly in Turkey and Poland, appear overdone in our view. As we mentioned earlier, the amount of monetary tightening by Poland's Central Bank priced in by financial markets seems a bit exaggerated. This deems yields of short-term POLGBs rather attractive.

Markets price in further upgrades in Turkey's sovereign credit ratings



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Introductory Comment

Dear reader,

After exiting recession last year, most emerging market economies in New Europe are expected to perform better in 2011. Negative output gaps are set to decline in many countries or even nearly disappear in other *e.g.* in Turkey and Poland, with the speed of growth convergence reemerging as a key theme. Naturally, the magnitude of the rebound is going to remain broadly uneven and subject to downside risks.

Inflation concerns are in policymakers' antennas recently. The upside inflationary risks we had warned about in our New Europe Economics & Strategy issues have started to materialize in late 2010. These risks originate primarily from supply side factors, such as excise tax hikes and higher food and commodity prices. They have pushied headline CPI readings higher in recent months and we anticipate the trend to continue broadly uninterrupted throughout H1 2011. Yet, annual inflation readings should start easing from the second half of the year on favorable base effects and broadly contained domestic demand pressures.

With the exception of Turkey, most central banks are on a tightening mode or are expected to initiate one in the non distant future. Poland recently began its tightening cycle. Serbia has mobilized its minimum reserve requirements tool on top of a 400 bps cumulative tightening in its key policy rate since last August. Romania is still staying put on policy interest rates in anticipation of easing price pressures in the period ahead, following a recent inflation surge caused by higher VAT rates. At the other end of the spectrum, the Central Bank of Turkey in an attempt to curb capital inflows has cut rates by 75bps since December.

A number of countries in the broader region, including Hungary, Romania, Serbia, Poland, Bosnia, Latvia and Ukraine, adopted IMF-sponsored programs in late 2008/early 2009. Most of those agreements worked well enough to shield New Europe during the crisis, acting as a disciplining device for structural reforms and fiscal containment. Most of the IMF arrangements are bound to expire in 2011, yet this does not imply the end of the Fund's involvement. We anticipate a number of existing regular stand-by arrangements to turn into precautionary type of agreements.

Public sector balance sheets of most countries in New Europe are in a much better shape than most of their EMU peers. Many governments in the region are inclined to continue pursuing austerity programs, albeit at the expense of dampening near-term economic growth. The 2011 fiscal targets are challenging, yet absolutely necessary, especially in view of the political cycle in some countries.

Bourses in New Europe started the year on a positive footing, broadly discounting the optimistic view of a global recovery and the hopes of an EMU-wide solution to the Euro Area crisis. Regional stock markets have outperformed their emerging market peers in Asia and LATAM, with further upside potential seen this year in view of improving growth dynamics. Turkey's main stock index has lagged indices in the region as the central bank's restrictive measures on credit growth and hot money inflows are taking their toll.

Local rate came under renewed pressure in recent weeks on geopolitical and EMU-Periphery concerns. Worries over higher inflation down the road as a result of higher commodities prices and narrowing output gaps have also weighed on market sentiment. The former, being a worldwide phenomenon, is adding to risks that some central banks in the region may be caught off guard and "behind the curve" in their fight against inflation.

External debt markets have come under pressure lately on geopolitical concerns related to rising social tensions in North Africa. Turkey and Poland have been the region's main underperformers. Nevertheless, there is growing anticipation that Turkish sovereign debt will be upgraded this year to an investment grade category, in view of strengthening macroeconomic fundamentals and easing political jitters.

Local currencies are broadly firmer year-to-date. The Hungarian forint leads the gains thus far, on easing concerns about the country's long-term fiscal position. At the opposite end, the Turkish lira led the losers, weighed down by the CBT's recent policy moves.

With respect to country-specific developments,

An economic recovery is underway in **Bulgaria**, with GDP growth seen accelerating further in 2011, driven by improving domestic demand dynamics and a sustained exports recovery. The country's solid fiscal position, improved EU funds absorption and abated macroeconomic imbalances lay the foundations for a stronger economic rebound. More importantly, the government remains firmly committed to swift euro adoption under the current exchange rate regime.

The economy of **Poland** will continue to perform solidly this year, due to positive inertia as well as sizable inflows of EU structural funds and public infrastructural spending. However, comprehensive structural reforms have lagged considerably behind schedule due to the political cycle, while the stubbornly high fiscal imbalance is now emerging as a major source of risk that could bring future instability.

Having survived four votes of no confidence in 2010, **Romania's** coalition government is successfully implementing a fiscal consolidation program, which contains, among other measures, a 25% horizontal cut in public wages and a 5 pps VAT hike. Domestic demand is bound to dampen further. The bright spot is higher exports, which helped pull the manufacturing sector out of recession last year. Today exports are laying the foundation for a modest 2011 rebound.

Serbia exited recession in 2010, driven primarily by net exports. GDP growth in 2011 is expected to accelaerage to 3%, thanks to recovering domestic demand. The smooth implementation of the IMF programme has alleviated external financing concerns. At the same time, the banking sector remains in a sound condition and is able to continue channeling credit to the domestic economy.

Turkey is expected to outperform its New Europe peer-economies again in 2011, after expanding by ca 8% in 2010. We anticipate full-year GDP growth of about 5%. More importantly, the recovery is characterized by relatively low inflationary pressures, despite an earlier rally in domestic food prices. Following a referendum on a number of important constitutional changes last September, political risks remain contained ahead of the July 2011 general elections.

In **Ukraine**, following a catastrophic recession in 2009, the stabilization in the domestic economic and political environment led to a gradual improvement in the domestic macroeconomic outlook. After growing by 4.1% in 2010, the economy is expected to extend its output gains by another 4.5% this year. The smooth implementation of the new IMF agreement will help to further support investor sentiment.

Prof. Gikas A. Hardouvelis

Group Chief Economist & Director of Research

Summary of key macroeconomic indicators

Realizations and forecasts

	Real GDP (yoy)			Consumer Prices (p.a.)			Fiscal Balance (%GDP)		
	2009	2010	2011	2009	2010f	2011f	2009	2010f	2011f
Bulgaria	-5.0	0.0	2.5	2.5	3.0	2.7	-4.7	-3.9	-2.8
Poland	1.8	3.8	4.0	3.5	2.6	3.0	-7.2	-7.9	-7.0
Romania	-7.1	-2.0	1.5	5.6	6.1	5.5	-8.3	-7.3	-4.9
Serbia	-3.0	1.5	3.0	8.2	6.5	9.0	-4.2	-3.5	-4.0
Turkey	-4.7	8.0	5.0	6.3	8.6	5.3	-5.5	-3.6	-2.7
Ukraine	-15.1	4.1	4.5	15.9	9.4	10.8	-8.7	-6.5	-3.5
New Europe	-4.3	4.6	4.1	6.5	6.3	5.4	-6.7	-5.7	-4.4
Euro area	-4.1	1.7	1.5	0.3	1.6	1.9	-6.3	-6.3	-5.3
USA	-2.4	2.9	3.2	-0.3	1.6	1.7	-12.9	-11.0	-9.0

	Current Account (%GDP)			Policy Rate (e.o.p.)			FX* (e.o.p.)		
	2009	2010	2011	2010	current	2011f	2010	current	2011f
Bulgaria	-9.4	0.0	-2.5	currency board			1.96	1.96	1.96
Poland	-2.2	-3.3	-3.5	3.50	3.75	4.25	3.96	3.90	3.90
Romania	-4.4	-5.0	-6.0	6.25	6.25	6.25	4.28	4.26	4.35
Serbia	-5.7	-8.0	-9.0	11.50	12.00	10.00	106.1	103.6	110.0
Turkey	-2.3	-6.5	-7.0	6.50	6.25	7.50	1.54	1.60	1.45
Ukraine	-1.5	-1.9	-2.5	7.75	7.75	7.75	7.94	7.95	7.90
New Europe	-2.8	-4.6	-5.2	-	-	-	-	-	-
Euro area	-0.6	-0.5	0.0	1.00	1.00	1.00	1.34	1.38	1.35
USA	-2.9	-3.3	-3.4	0.125	0.125	0.125	0.75	0.72	0.74

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

I. Overview

Ongoing two-speed recovery

2011 is likely to see a continuation of last year's economic recovery, with its uneven character expected to persist among economies in the region. The economic upturn from the 2008/2009 recession, which has so far been primarily driven by an export-led rebound in industrial production, will probably gain momentum this year, in view of gradually strengthening domestic demand dynamics and narrowing output gaps. The acceleration is likely to be more pronounced in countries where 2010 growth proved rather anaemic. Such is the case of Romania, where the domestic economy was among the exceptions in New Europe to remain in contractionary territory last year. Other examples include Bulgaria, Serbia and Hungary, where economic growth was nearly flat in 2010. On the other hand, GDP growth in both Turkey is expected to ease somewhat from last year's brisk rates, as a result of fading base effects and widening external imbalances. Yet, economic growth rates in the region will again outperform growth in the euro area and other developed economies, though headwinds will continue to lie ahead in the face of fiscal austerity and the EMU sovereign crisis.

Most central banks in the region missed 2010 inflation targets, mainly as a result of cost-push factors

Recent data continue to suggest relatively benign underlying price pressures in most economies in New Europe, with core inflation readings remaining largely subdued. Even so, temporary factors such as base effects, higher food and energy costs as well as hikes in VAT rates and administrative prices are among the reasons to blame for most regional central banks missing their official inflation targets in 2010. Paradoxically, Turkey, which led the region's economic rebound last year was among the exceptions to see its Central Bank fulfil its year-end target of 6.5% yoy. On the flipside, consumer price inflation in Romania, where domestic economic activity remained in contractionary territory throughout last year, overshot the NBR's 3.5%+/-1% target by a significant margin (December CPI @ 8% yoy). This was mainly the result of a 5ppts VAT rate hike introduced last July as part of the government's IMF-backed austerity measures. In a similar vein, higher food and fuel prices pushed Hungary's end-2010 CPI reading to 4.7% yoy, 170bps above the MNB's medium-term target. Elsewhere, December CPI of 10.3% yoy in Serbia breached the 6.0% yoy+/-2% yoy target, driven by higher oil and domestic agricultural prices. A 9% weakening of the dinar vs. the EUR in 2010 had also an inflationary impact. In Poland, CPI reached an 11-month peak of 3.1% yoy in December, bouncing above the NBP's 2.5% mid-point target and moving closer to the 3.5% upper limit of the official target zone.

Negative output gaps limit second-round risks to the inflation outlook

The global economic rebound is likely to continue supporting the case for higher food and commodity prices this year. Nevertheless, still weak domestic demand dynamics, high unemployment rates and tight credit conditions in most economies in New Europe deem the region less susceptible to inflation risks relative to other emerging market economies in Asia and LATAM. Negative output gaps in countries such as Romania, Hungary and Bulgaria are unlikely to allow the recent food-driven price inflation to translate to more sustained price pressures, especially in view of still week demand-poll pressures. In Turkey and, to a lesser extent, Poland, inflation risks are higher, with preliminary signs of overheating domestic demand conditions becoming already apparent. In Turkey, the recent deceleration in food inflation and favourable base effects support the case for a CPI slowdown below the CBT's 5.5% yoy target over the coming months. That said, a rapidly narrowing output gap, near-zero real interest rates, brisk rates of domestic credit creation and the potential for higher commodity prices point to that inflation pressures eventually emerging in the second half of the year. In Poland, strengthening domestic demand as well as higher VAT, excise duties and electricity prices raise the risk of for higher CPI readings in the period ahead.

Uneven character of economic recovery across the region point to diverging monetary policy paths in the period ahead

Poland's Central Bank incepted its monetary tightening cycle in January, in line with market expectations, with more rate hikes anticipated in the months ahead. Serbia's National Bank (NBS) has raised its key policy rate by a cumulative 400bps since last August, in an effort to cap rising inflation pressures and arrest the pace of dinar depreciation. In Hungary, the MNB has increased its key policy rate by a cumulative 75bps over the last three months, starting with a broadly unexpected 25bps rate hike in November. In our view, the MNB's recent policy shift was primarily influenced by two factors. First, increased uncertainty regarding Hungary's fiscal position and the ensuing rise in sovereign risk premia. Secondly, the upcoming change in the structure of the Central Bank's Monetary Policy Committee (MPC). In March four of the seven incumbent MPC members will be replaced as their tenures. According to a law backed by the ruling Fidesz party, new members will be endorsed by a parliamentary committee, stoking

concerns about the MNB's independence and opening the door for a more dovish Council ahead. The Central Bank has staunchly rebuffed speculation that the Council revamp has been a factor in its recent decisions. Nonetheless, although one more rate hike may be delivered before the change in the MPC's composition, significant further monetary tightening appears unlikely as domestic demand remains fragile. Elsewhere, Turkey's Central Bank employed recently a rather unorthodox monetary policy mix, aiming to address the twin policy challenge of safeguarding both domestic price stability and financial stability. The CBT cut its one-week repo rate by a cumulative 75bps since December, though, at first look, the strong economic rebound would argue for the opposite. The move was aimed at curbing speculative capital inflows to the country that exacerbate widening pressures on the current account deficit and endangering the creation of domestic asset price bubbles. In a move to offset the inflationary impact of the rate cut and reduce interbank liquidity, the CBT also raised its reserve requirement ratios on TRY deposits with short-term maturities and reduced those with longer. It has repeatedly stressed that the net effect of the policy measures employed would be an overall tightening of monetary conditions. Separately, Romania's Central Bank has stayed put on rates since last May, as a 5ppts hike in the main VAT rate that came into effect this summer boosted headline inflation sharply. Yet, domestic demand dynamics remain weak and the NBR signalled recently that it remains ready to resume its monetary easing cycle if inflation expectations ease. Meanwhile, Ukraine's Central Bank kept its key policy rate on hold at 7.75% after slashing it by 250bps cumulatively in June-July 2010. As an overall assessment, the monetary policy outlook in the region remains highly uncertain, especially in view of increased market concerns that regional central banks may be risking to fall "behind the curve"in their high against inflation as output gaps narrow and global commodity prices continue to rise.

Regional stock markets start the year on a positive footing, assisted hy rising optimism over world economic prospects

Equity markets in New Europe entered 2011 on a positive track lifted by global economic recovery optimism. Hopes for a more holistic and comprehensive policy response to the lingering EMU debt crisis have also helped to largely outweighed concerns about spillover effects into the region. As a result, local bourses have broadly outperformed emerging market peers in Asia and Latin America so far this year and further upside potential lies ahead in view of improving growth dynamics. At the market close of January 28, the benchmark MSCI Emerging Market Equity index marked year-to-date losses to the tune of 2.2%. Over the same period, the corresponding Emerging Europe equity sub-index stood 2.2% firmer, with a further upside capped by Turkey's recent underperformance (-4%). Turkey's main stock index XU100 broadly lagged its peers in January weighed down by the Central Bank's policy measures to restrain credit activity and "hot money" capital inflows. Separately, Emerging Asia, which led last year's bounce with the equivalent MSCI sub-index rising by 16.6%, has so far lagged Emerging Europe's rebound standing in a marginally negative territory year-to-January 28. LATAM and the BRICS fared even worse posting respective losses of ca 5% and 3% over the same period. Notwithstanding the aforementioned, all indices remained close to multi year highs touched in January as the global economic recovery continues. In detail, the benchmark MSCI Emerging Market equities index touched a 2-½-year high of 1,169.46 on January 13, while the Emerging Europe sub-index, which is comprised of the Czech Republic, Hungary, Poland, Russia and Turkey touched a 28-month peak of 562.24 a few days later. More specifically, in New Europe, Serbia's BELEX15 and Bulgaria's SOFIX are the region's outperformers so far this year, posting gains in excess of 10%. Romania's BETI and Ukraine's PFTSI – the latter soared 70% in 2010 - trailed behind with a 9% rise.

Regional bond markets retreat on inflation, geopolitical concerns; CBT policy shift weighs on sentiment

Local rate markets lost ground in recent sessions on geopolitical concerns and the lingering EMU sovereign debt crisis. Worries over higher inflation down the road as a result of higher commodities prices and narrowing output gaps have also weighed on market sentiment. Polish debt has broadly underperformed so far this year in view of expectations for further rate hikes by the Central Bank in the coming months. Presently the 9x12 FRAs currently price in ca 125bps of rate hikes in Poland, which in our view is a bit exaggerated. The recent deterioration in the country's fiscal position and a pension reform that includes a transfer of employees' pension contributions from private to state funds also added to downward pressures on Polish government bonds. As a result, the 2-year PGB yield spiked 23bps since end-December, touching one-year highs above 5.00% in late January. Similarly, the yield of the 10-year benchmark bond jumped to levels near 6.40% from 6.10% at the end of December. Elsewhere, Turkey's 2-year benchmark note yield rose to 5-½-month highs of 8.33% on January 31, bouncing from a record low of 6.79% touched a few weeks earlier. The reasons was the CBT's unorthodox monetary policy mix that has lately stirred concerns about stoking inflation pressures in the months ahead and added to uncertainty about the Bank's future policy deliberations. On the other hand, Hungarian paper staged a recovery rally over recent weeks in view of fiscal consolidation hopes and easing rate hike expectations. The 3- and 10-year government bond yields fell by more than 120bps each in late January from multi-month highs

hit in November to touch 2-½-month lows, near respective levels of 6% and 7%.

Regional currencies mixed on uncertainty over future monetary policy moves

Regional currencies have broadly firmed so far this year with the Hungarian forint turning out to be the top performer. The currency had broadly underperformed its regional peers in 2010, amid concerns about the country's long-term fiscal position. However, the government recently soothed investor worries after hinting that it will soon unveil credible plans aimed at maintaining its budget deficit and debt at sustainable levels longer-term. A number of well-absorbed recent bond auctions also provided support. Along these lines, the EUR/HUF touched 271.05 on January 27, its lowest level since early November 2010. In a similar mode, the Serbian dinar recently recouped an additional part of its last year losses, touching a 7-month high of 102.97 in late January. The currency posed as a major underperformer last year, shedding ca 10% of its value on increased corporate demand for hard currency and a lack of foreign capital inflows to the domestic economy. The Turkish lira, further extended its losses (1-½-year lows near 1.6190/USD recorded on January 31), weighed down by the latest CBT interest rate cut and becoming the region's main underperformer. Separately, the Polish zloty has depreciated 3% after touching 9-month highs of 3.8250/EUR in early January as monetary tightening expectations for this year appear overdone. The lack of any convincing fiscal adjustment plans also weighed on the currency.

External debt markets come under pressure on geopolitical concerns

The most recent political developments in the EMEA space, namely the recent turmoil in Tunisia and Egypt, have weighed on New Europe's external debt markets. Poland and Turkey have been the major underperformers in the region. The former's 5-year CDS spreads have widened ca 15bps since late-December to hit multi-month highs near 156bps on January 31. In a background of lingering sovereign debt pressures in the euro area, Poland's high supply of external debt compared to the rest of the region and a relatively high debt/GDP ratio boded ill for the country's debt markets. In Turkey, close trade links and geographical proximity to the lingering North Africa unrest pushed 5-year CDS spreads 24bps wider in January to 165bps. Growing uncertainty over the country's future monetary policy path and concerns about the CBT falling "behind the curve" also weighed. Even so, further upside in spreads has been capped by anticipation for an upgrade in Turkish sovereign debt this year to an investment grade. If market expectations are vindicated Turkey's external debt will be included in several world market indices. This is expected to increase demand for Turkish Eurobonds. Hungary, which broadly underperformed its regional peers late last year, led the winners' pack in January on growing optimism about its longer-term fiscal situation. As a result, 5-year CDS spreads shrunk more than 10% to 2-month lows near 340bps at the end of January, sliding further below from a 7-month peak of 410bps touched a couple of weeks earlier.

Strategy

FX: Diverging monetary policy paths among economies in New Europe has largely led to a more distinct decoupling in the performance of regional currencies. The **Hungarian forint** and the **Serbian dinar** have lately outperformed their regional peers, deriving support from proactive central bank monetary tightening. Elsewhere, a rather unorthodox policy mix adopted recently by the Central Bank of Turkey has taken a toll on the **lira**. Looking further ahead, we expect a brighter TRY outlook in the second half of the year when the CBT will likely switch to interest rate tightening in order to contain rising inflation pressures and make its monetary policy path more transparent. A favorable elections outcome in July and credit rating upgrades also bear some upside potential. Even so, any future gains may well prove limited as both events have broadly been discounted by financial markets. Strong macroeconomic fundamentals and widening interest rate differentials vis-à-vis the euro and the US dollar are likely to provide support to the **Polish zloty** in the near future. However, we anticipate that current expectations for further significant monetary policy tightening by Poland's Central Bank will eventually prove exaggerated. Fiscal concerns are also likely to weigh on the zloty further ahead. Along these lines we prefer to stay sidelined on the EUR/PLN at current levels. Separately, we would also enter short positions in **EUR/RSD** at the current 103-104 levels, with a target of 98.40 in a 3 to 6 months horizon. A short **EUR/HUF** position also appears to bear value at current 269 levels, with a target of 260 and a stop-loss at 275 (50 day MA). We would rather remain neutral on **USD/TRY** as the pair recently failed to break above a near 2-year high of 1.6188 touched in late January, considerable uncertainty remains over the longer-term impact of recent CBT policy moves. Risks to the above FX market views lie ahead in the face of the lingering sovereign debt crisis in the euro area.

In the sovereign credit space, we continue to believe that spreads remain at particularly tight levels. That said, a potential upgrade of Turkey's credit rating later this year may well provide fresh spread narrowing momentum in the country's external debt

markets (Turkish CDS 5-year CDS spread currently at 157bps). Note that both Fitch and Moody's raised Turkey's credit rating outlook to positive from stable, raising hopes for eventual upgrade to investment grade. On the other hand, current spread levels already appears to price in positive rating action in the period, proving a cap to a further significant narrowing in spreads from present levels. Elsewhere, we like short positions in Romania's 1-year CDS at current levels near 200bps and longs in the 8.50% May 2012 EUR-denominated Eurobond as the country's fiscal position appears to be gradually improving, remaining well anchored by the IMF-led Stand-By Arrangement.

Inflation pressures ahead stirred through narrowing output gaps and higher commodities prices bode ill for **local rates markets.** However, inflation risk premia in several countries, particularly in Turkey and Poland, appear overdone in our view. As we mentioned earlier, the amount of monetary tightening by Poland's Central Bank priced in by financial markets appears a bit exaggerated. This deems yields of short-term POLGBs rather attractive. Similarly, we believe that cumulative rate hikes in excess of 200bps before year end by Turkey's Central Bank - as priced in by the forward rates curve - is way too aggressive. Even so, the uncertainty surrounding the longer-term impact of recent CBT policy moves and future Central Bank policy deliberations is likely to continue weighing and increased volatility is likely to dominate Turkey's local rates markets in the months ahead. Note also that, with higher commodity prices being a worldwide rather than country-specific phenomenon, there is a risk that some of Central Banks in the region may eventually find themselves behind the curve in their fight against inflation. If so, more aggressive monetary tightening will have to be eventually delivered, pushing local yield curves steeper. On that front, risks surrounding Turkish Central Bank's policy deliberations in the months ahead appear comparably higher. As such, we favour entering a 2y5y spread steepener position on the Cross Currency Swap curve at around 85bps with a target of 110bps and a stop loss at 75bps.

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

Fiscal deficit cut more than expected in 2010

- 2010 fiscal deficit at 3.9% of GDP, beating 4.8% of GDP revised official forecast
- Domestic recession technically over; private consumption still mired in contractionary territory
- Government bond yields drop to their lowest level since May 2008, despite EMU sovereign debt crisis
- 2011 may see economy delivering positive surprises; provided that medium-term macro challenges are properly addressed

Fiscal position remains one of the healthiest in EU-27

According to the preliminary results, the 2010 full-year cash budget deficit came at BGN 2.78 bn or 3.9% of projected GDP, compared to a deficit of 0.9% of GDP in 2009. This was significantly lower than the revised deficit target of 4.8% of GDP. In ESA 95 terms - the EU methodology that calculates the deficit on an accrual basis - the general government deficit come in at 3.6% of GDP last year, marginally lower than a revised target of 3.9% of GDP. The complete breakdown of the final data showed that last year's realized tax revenue was higher by over 100% relative to the revised government projection. At the same time, realized expenditure stood at 96% of the revised government projection.

The aforementioned developments confirm our long-held positive view regarding Bulgaria's fiscal sustainability, even after taking into account the 2009 data revisions. According to the European Commission's autumn 2010 forecasts, the EU-27 fiscal deficit reached 6.8% of GDP in 2010. Furthermore, Bulgaria's public debt ratio stood at 18.2% of GDP in 2010, compared to 79.2% in EU, which was the third lowest in EU-27 behind Estonia and Luxemburg

Bulgaria's favorable fiscal performance sends a positive signal to the markets with respect to the government's commitment to fiscal prudence in both good and bad times for the domestic economy. As we have noted in the past, the latter is of primary importance for reinforcing market perceptions over the stability of the Currency Board Arrangement. It is also important for revitalizing Bulgaria's EMU prospects. The breach of the 3%-of-GDP deficit threshold last year was the main reason for postponing the ERM -II entry application (despite the absence of specific entry criteria) and putting the country in the short-term adventure of the Excessive Deficit Procedure which ended in late January. According to the EU Commission, Bulgarian authorities have taken measures to ensure adequate progress towards the correction of the excessive deficit within the time limits set by the Council.

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	3.0	2.7
HICP (end of period)	7.2	1.6	4.4	3.0
Fiscal Accounts (%GDP) - *EU Methodology*				
General Government Balance	1.7	-4.7	-3.9	-2.8
Gross Public Debt	13.7	14.7	18.6	21.7
Primary Balance	3.7	-0.2	-3.3	-2.0
Labor Statistics - *National Definitions*				
Unemployment Rate (% of labor force)	6.3	7.6	9.5	9.0
Wage Growth *(total economy)*	26.5	8.5	7.5	5.5
External Accounts				
Current Account (% GDP)	-25.4	-9.4	0.0	-2.5
Net FDI (EUR bn)	6.2	3.3	0.8	1.5
FDI / Current Account (%)	75.8	103.6	9130.0	160.0
FX Reserves (EUR bn)	12.7	12.9	13.0	13.5
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 & Forecasting

As we have alluded in all our previous New Europe Economics & Strategy issue, the government remains committed to swift euro adoption as soon as domestic and external macroeconomic and political conditions allow. Ever since, the signals with respect to euro area entry have remained positive from the Bulgarian leadership. In that direction, Minister of Finance Simeon Djankov has stated recently that despite the mounting EMU sovereign debt woes the country has not given up on its long-standing bid to adopt the euro. 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.

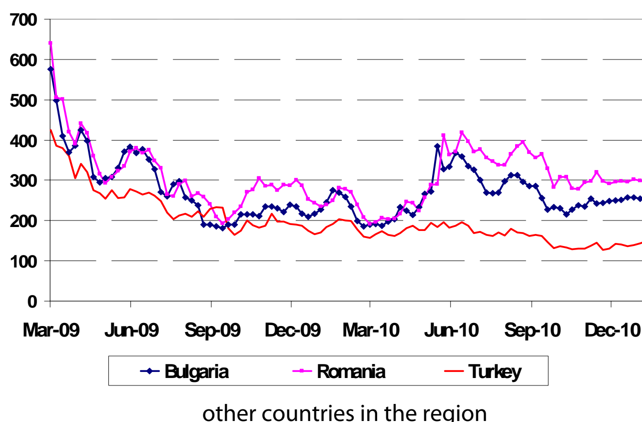
In that respect, the much better-than-projected execution of the 2010 budget, lays the ground for achieving this year's fiscal target. The government targets a fiscal deficit of BGN 1.9bn or 2.5% of

GDP in 2011, assuming broadly unchanged taxation rates and real GDP growth of 3.6%. That would be the combined result of expenditures staying flat in nominal terms and total revenues growing by 5.2% yoy. Although some analysts have argued that the 2011 budget is structured around an overly optimist scenario for domestic economic growth, we still hold the view that the new fiscal target remains within reach. In fact, the accomplishment of last year's target increases the credibility of the fiscal consolidation program and makes next year's target more manageable. More explicitly, it creates a solid basis on the expenditures side provided that public wages and pensions remain unchanged for a second consecutive year. If the fiscal target of next year is attained, Bulgaria will rank among the few EU-27 countries featuring a sub-3% of GDP fiscal deficit.

In addition, market perceptions over Bulgaria's sovereign risk remain favorable compared to other EMU members despite the lingering sovereign crisis in the euro area. Recent developmnts in the domestic bond market are an illustration of this. Specifically, the January 17 auction of BGN 45mn of a domestic-currency fixed-coupon bond maturing in July 2021 was oversubscribed by around three times, delivering an average-weighted yield of 5.49%. This is the lowest reading since May 2008, clear evidence that sovereign borrowing costs are maintained at relatively low levels despite the ongoing EMU debt crisis.

The picture in the CDS market is not different. Although CDS spreads spiked recently across the board, 5Y- Bulgarian CDS are still lower than a number of EMU member and other countries in the region. On February 1st, the 5Y Bulgarian CDS spreads stood at 250 bps, close to those of Spain (228 bps) and significant lower than spreads of Romanian (290bps), Portugal (400 bps) and Greece (836 bps). (Figure 1)

Figure 1: 5Y- Bulgarian CDS are still lower than EMU member or



other countries in the region

Source: Ecowin, Eurobank Research

Last but not least, the better than expected budget execution allows for greater flexibility with respect to government financing. The government opted to finance the 2010 fiscal deficit by drawing down on the fiscal reserve (down to BGN 6 bn in 2010 from BGN 7.6 BN in 2009) and issuing domestic debt. For this year, the Ministry of Finance has announced that it intends to issue less domestic debt i.e., some BGN 1bn, vs. BGN 1.5 bn in 2010. The Ministry is also reconsidering the option of issuing Eurobonds in what is expected to be a heavy debt issuance year in Europe. The government was planning to issue up to €1 bn in Eurobonds to finance part of the fiscal deficit. However, a lower than expected financing need this year allows the Ministry of Finance to seek the right timing for proceeding with such an issue. Deputy Finance Minister Boryana Pancheva was quoted as saying recently that Bulgaria will consider issuing a Eurobond if this is deemed necessary and market conditions allow.

Domestic demand remained the weakest link in the last quarter of 2010

Recent high frequency data disappointed expectations for a swift recovery in private consumption over the last quarter of 2010. Retail sales (in volume terms) recorded declines of 5.2% yoy and 4.6% yoy in November and October, respectively, though exhibiting some improvement from the double-digits falls recorded earlier this year. There are a number of factors which are not supportive of a quick consumption rebound. More specifically, credit conditions are still tight for households, unemployment rates remain at elevated levels, public wages and pensions remain flat and higher inflation in recent months has been a hindrance to disposable incomes.

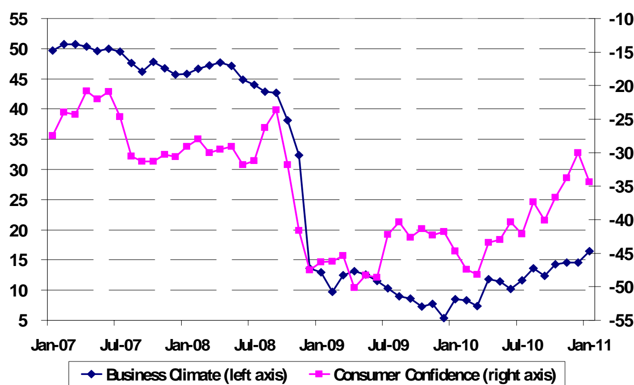
These factors render domestic households extremely cautious on their spending decisions, prompting them to continue repairing their balance sheets. On the positive side, the recent improvement in the consumer and business confidence is sending an encouraging signal in terms of the future prospects of domestic demand (Figure 2). However, this is yet to be reflected in hard data. All in, we estimate that the pattern of growth witnessed over the first three quarters of last year to have repeat itself in Q4: weak domestic demand accompanied by strong net exports performance

Our view for the Bulgarian economy in 2011 remains positive.

Having seen the worst of the domestic economic downturn in the last quarter of 2009, Bulgaria exited recession in Q3 2010, at least form a technically standpoint defined as the generation of two consecutive quarters of positive GDP growth. However, the economy is still at the early stages of a gradual recovery, with GDP

growth in 2010 being primarily driven by net exports. According to our forecasts, net exports contributed 4.5 pps, but this was more or less offset by the domestic demand decline of equal magnitude.

Figure 2: Business and Consumer confidence indicators on a improving trend



Source: Eurostat, Eurobank Research

Looking ahead, growth is seen accelerating further at 2.5% yoy in 2011 on sustained exports recovery, assisted by improved domestic demand prospects. Bulgaria has accomplished to diversify its exports portfolio in non EU markets, so that 40% of its exports are heading to rapidly growing non EU markets. For the coming quarters, we anticipate domestic demand dynamics to improve gradually, contributing to a more balanced pattern of economic growth. In that direction, the improved absorption of EU funds particularly in the area of infrastructure projects could be supportive to the recovery of investments. The Bulgarian government anticipates the absorption rate to double to 20% by the end of 2011. In addition, the spillovers of the strong export performance are going to diffuse in other industries as well. As a result, although still a laggard, private consumption is expected to stabilize in 2011 after two consecutive years of contraction. .

The solid fiscal position and the swift absorbition of earlier macroeconomic imbalances lay the foundations for a stronger economic rebound next year. Downside risks to our forecast stem from the ongoing euro area sovereign crisis and the refinancing of the high external private sector debt (89.4% of GDP in 2010 vs. 96% of GDP in 2009). In conclusion, Bulgaria can be a positive surprise in the New Europe universe if medium term challenges are addressed properly in 2011.

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

NBP hikes policy rates on inflation concerns

- After staying put on rates for eighteen consecutive months, the National Bank of Poland hiked its key policy rate by 25bps to 3.75% in January, citing inflation risks
- The IMF approved a new two-year Flexible Credit Line (FCL) for Poland for an amount equivalent to $29.5bn
- Government proposed changes to the pension system and announced measures to curtail public expenditures in case the public debt ratio exceeds 55% of GDP threshold
- Lending to businesses remains weak; household credit exhibits substantial growth

2010 GDP growth exceeded earlier expectations

According to the latest IMF estimates, the Polish economy grew in 2010 at a faster pace than expected earlier, deriving support from higher inventories, strengthened consumer spending and EU-funded public investment. Specifically, the Fund now estimates Polish real GDP to have grown by 4.0% yoy last year instead of 3.4% yoy projected in late October. Recent readings in a range of high-frequency real activity and sentiment indicators suggest that the economy's momentum remained strong in Q4-10 (official data for the 4th quarter of last year not published yet). Among these, industrial production recorded double-digit growth in November and December (10.0% yoy and 11.5% yoy, respectively) from 8.0% yoy recorded in October. PMI manufacturing also registered strong readings in late 2010 (55.9 and 56.3 in November and December, respectively) pointing to continuing expansion in the sector. Moreover, retail sales (in volume terms) surprised on the upside in December (+12.0% yoy vs. analysts' median forecast of +9.2%), recording the first double-digit growth reading since September 2008 (Figure 1). Elsewhere, wage growth accelerated to 5.4% yoy in December, from 3.6% yoy in November. All in all, we estimate GDP growth to have accelerated further in Q4-10. According to preliminary official estimates, full-year GDP growth stood at 3.8% yoy in 2010. We are fairly optimistic for 2011 growth outlook. We expect domestic demand to continue expanding on the back of increasing wages and on acceleration of spending of EU funds due to EURO 2012 football championships. Overall, we anticipate 2011 growth to remain strong at 4.0% yoy.

IMF approves new Flexible Credit Line for Poland

On January 21, the IMF approved a new two-year Flexible Credit Line (FCL) Arrangement for Poland for an amount equivalent to $29.5bn. Poland's first one-year FCL of $20.58bn was approved on May 6, 2009. A successor one-year arrangement of $20.43bn was approved on July 2, 2010. The new FCL fcility provides more flexibility both in terms of access and length to funding . Yet, Polish authorities intend to treat the new arrangement as precautionary, not seeing an urgent need to draw from it. Since July 2010, external uncertainty has intensified and downside risks have increased, especially related to the fragile economic and financial environment in Eurozone which represents Poland's major trade and financial partner. Against this background, replacing the current one-year FCL with a new two-year arrangement will help Poland to strengthen its resilience to external shocks.

Poland: Eurobank EFG Forecasts

	2008	2009	2010f	2011f
Real GDP (% yoy)	5.0	1.8	3.8	4.0
Private Consumption	5.8	2.3	3.3	3.5
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	3
CPI (end of period)	3.3	3.5	3.1	2.8
Fiscal Accounts (% GDP)				
General Government Balance	-3.7	-7.2	-7.9	-7.0
Gross Public Debt	47.2	51.0	55.0	57.0
Labor Statistics (%)				
Unemployment Rate (% of labor force)	9.8	11.0	12.0	11.5
Wage Growth *(private sector - average)*	NA	4.2	3.6	4.0
External Accounts				
Current Account (% GDP)	-4.8	-2.2	-3.3	-3.5
Net FDI (bn EUR)	8.0	6.1	6.5	8.0
FDI / Current Account (%)	40.6	90.6	80	75
FX Reserves (bn EUR)	40.6	54.8	70	60
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	3.75	3.75	4.00	4.25
EUR/PLN	3.97	3.90	4.00	3.90

Source: NBP, EcoWin, Bloomberg, Eurobank Research

Government introduces fiscal consolidation measures, reforms the social security system

In an attempt to reduce the general government deficit and to put public debt on a downward path, the government proposed changes to the pension system and announced measures to curtail public expenditures should the public debt ratio exceed

the 55% of GDP constitutional threshold. These include the abolition of early retirement for 4 million employees, freezing of public sector wages; immediate tax measures to increase revenues and automatic VAT rate increases. The proposed pension reform aims to lower contributions to the private pension system from 7.3% to 2.3% of base salary starting in April 2011, with the remaining amount retained by the state pension system. This reform is expected to reduce the 2011 general government deficit by 0.7ppts of GDP and by a full percentage point of GDP on an annualized basis, thereafter. Moreover, currently planned medium-term restrictions on local government expenditures are officially estimated to reduce the general government deficit by 0.6% of GDP in 2012 and a further 0.6% of GDP in 2013. Taking into account the planned fiscal consolidation measures, the IMF projected, in January, the general government deficit to fall to 5.8% and 4.6% of GDP in 2011 and 2012 respectively, down from an expected 7.9% of GDP in 2010.

In our view, the measures the government set for the 2011 budget are rather of short-term nature, focused on the revenues side- such as the VAT hike by 1ppt this January. Without any comprehensive structural reforms implemented, hope rests on GDP growth resolving the debt problem of the country in the long term. What's more, given that parliamentary elections will be held in autumn 2011, it's most likely that the 2012 budget will not include any further structural reforms either.

According to a recent IMF country report for Poland, government debt in ESA95 terms is projected to reach 55.6% and 56.6% of GDP in 2010 and 2011, respectively. However, the public debt based on the national definition, which excludes debts of the National Road Fund, amounted to 53.9% of GDP in 2010.

Current account deficit widens

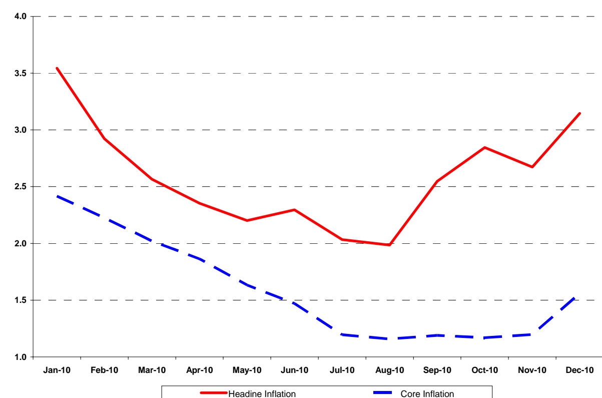
Poland's current account deficit is estimated to have widened to 3.3% of GDP in 2010, from 2.2% of GDP in 2009. Given moderating growth in key trading partners, the contribution of net exports to growth is projected to fall and the current account deficit to widen gradually to 3.5% of GDP in 2011.In our view, the trade deficit is widening at a rapid pace; t stood at 2.3% of GDP in Q3-10 compared to just 0.8% of GDP in Q2-10. Moreover, rising imports reflect strong household consumption rather than an investment boom. What's more, a large shortfall comes from the investment income balance.

Core inflation outpaced expectations signalling concerns about rising inflation pressures

Polish headline inflation came in line with expectations in December, increasing to 3.1% yoy up from 2.7% yoy in the prior month. Yet, core inflation (measure excluding food and energy) outpaced expectations coming in at 1.6% yoy in December (vs. 1.4% yoy anticipated previously) up from a 1.2% yoy in the prior month. Core inflation developments raise concerns about rising inflation pressures. We anticipate inflation to remain at levels around 3% in the following months on the back of wage growth and increases in the majority of VAT rates in 2011.(Figure 2)

Figure 2

Both headline and core inflation follows an upward trend signalling inflation pressures concerns (change title)



Source: National Statistics, Eurobank Research

NBP hikes policy rates on inflation concerns

After staying put on rates for 18 consecutive months, the National Bank of Poland (NBP) hiked its key policy rate last month by 25bps to 3.75%. Following earlier hawkish comments from the NBP President, the move did not come as a complete surprise. In the statement following the rate announcement, the rate decision was justified on the basis of risign wage-induced inflationary pressures and on the risk of headline CPI remaining above the target rate in the coming months due to previous food and fuel price increases and the effect of recent VAT hikes.

Low rate of corporate lending, but substantial household credit growth especially in mortgages

A specific feature of the Polish banking system is last year's low rate of credit growth in the corporate sector; it stood at 1.0% year-to-November, down from 29.1% yoy recorded in December 2008. This might be explained by the muted investment activity in the corporate sector. At the same time, corporate deposits grew by 3.7% year-to-November and by 2.4% mom in November 2010. This is an indication of a relatively sound financial position of companies. Household credit growth moves in a different direction. It grew by 15% year-to-November and 3.2% mom in November 2010, whereas household deposits at the same period grew by 6.6% ytd and 0.9% mom. As a result, total credit grew by 9.6% year-to-November and total deposits increased by 7.2% year-to-November. What's more, mortgages loans augmented by

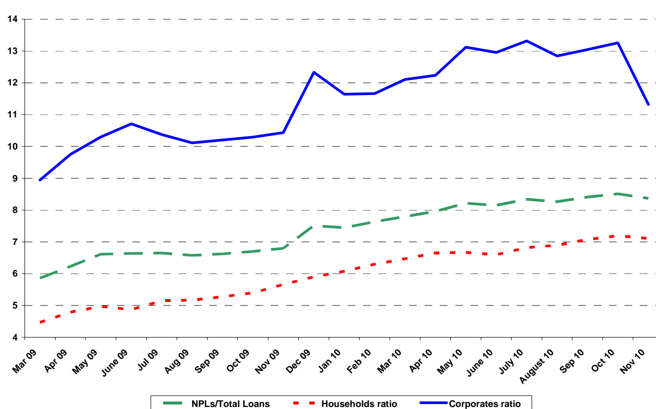
17.7% year-to-November, compared to 10.2% yoy growth in December 2009.

A weakness of the Polish banking system is the large share of household and corporate loans denominated in FX (30.7% of total outstanding loans in November 2010) with large share of mortgage loans indexed in FX (57.3%). It has to be noted that mortgages loans amounted to 40.7% of total outstanding credit and 66.2% of household loans in November 2010. Nevertheless, the overall leverage of the Polish private sector remains relatively low (50% of GDP as of Q3-10) with corporates' and households' debt amounting to 15.6% and 33.6% of GDP, respectively, as of Q3-10.

What is still worrisome is the rising trend in Non-Performing Loans (NPLs). They grew by 21.6% since the beginning of 2010, with households' NPLs increasing by 36.7% year-to-November. Yet, corporates' NPLs decreased by 7.5% year-to-November. Although the downward trend of corporate sector NPLs is a positive sign, the NPLs ratio in the sector is still elevated; it stood at 11.3% in November 2010, compared to 12.3% in December 2009 and 8.9% in March 2009. On the other hand, household NPLs ratio exibist an upward trend; it stood at 7.1% in November 2010 from 5.9% in December 2009 and 4.5% in March 2009. What's more, household NPLs accounted for 55.2% of total NPLs in November 2010, compared to 49.1% and 46.1% in December and March 2009, respectively. (Figure 3)

Figure 3

Household NPLs keep rising yet corporate NPLs start declining



Source: National Bank of Poland, Eurobank Research

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

New IMF deal in the pipeline

- IMF board approves sixth review of expiring stand-by arrangement with Romania. A new one to two-year precautionary arrangement is in the pipeline
- Fiscal adjustment broadly on track in 2010; achievement of this year's deficit target remains a challenge

IMF board approves sixth programme review

Having survived two no-confidence votes in Parliament in last December only, the coalition government managed to fulfill the three key conditionalities for the endorsement of the sixth review under the present stand by arrangement (SBA) with the Fund. These included the uniform public wage law, the pension reform law and the 2011 budget, which were endorsed by the Parliament in late December. Approval of the sixth programme review took place on January 7 *i.e.,* three weeks later than planned initially.

The sixth IMF review provided a positive assessment on the progress made so far in implementing the agreed reforms. The Fund stressed that Romania is now on a clear path to meet both its short- and medium-term fiscal goals. More specifically, all performance targets were met in 9M-2010, with the exception of the target for government arrears and the indicative spending of the public enterprises. The government received a waiver for the issue of government arrears until (March), when the last review of the current IMF arrangement is scheduled to take place.

Completion of the sixth review enabled Romania to gain access to a further €913mn of IMF funding, bringing total disbursements received so far to €12.4 bn. The new tranche will be utilized for balance of payments support *i.e.,* inflows will be used to boost FX reserves. Accordingly, both the EU and the World Bank disbursed their respective tranches of financial assistance to be used for the financing of the budget deficit. The EU disbursed another €1.15bn out of the total designated package of €5bn, while the World Bank disbursed another €300 mn, out of total designated amount of €1bn.

A new *precautionary* arrangement with the IMF is highly probable upon expiration of the present stand by arrangement

The government has already stated that Romania is not currently looking for an extension of the current form of arrangement with the IMF, after the present facility expires in May 2011. Instead, Prime Minister Emil Boc stated recently that discussions for a *precautionary* facility with the Fund may well start when the next IMF mission is scheduled. According to local press reports, the amount of a new IMF precautionary arrangement could reach €5-6bn and could rise to €8bn depending on the county's financing needs. The final amount will be probably known either during the last programme review in March 2010 or by May 2011 when the current SBA expires. Duration of the new agreement will also be a focal point during the negotiations with official lenders. The government has already expressed a preference for a one-year facility to match the date of parliamentary elections planned for late 2012. On the other hand, a number of local press reports suggested recently that Central Bank governor Mugur Isarescu advocates a two-year agreement that would surpass the political cycle and minimize the risk of fiscal slippage ahead of the elections. Recent comments by a number of IMF officials suggest that the Fund share the Mr. Isarescu's concerns. Separately, the government intends to extend the current agreement with 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	-3.5	-2.5
Gross Capital Formation	16.2	-25.3	-10.0	3.5
Exports	8.7	-5.5	20.0	7.5
Imports	7.8	-20.6	15.0	5.0
Inflation (yoy%)				
CPI (annual average)	7.9	5.6	6.1	5.5
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	7.6	7.0
Wage Growth (total economy)	23.6	8.4	2.5	3.0
External Accounts				
Current Account (%GDP)	-11.6	-4.4	-5.0	-6.0
Net FDI (EUR bn)	9.3	3.5	2.5	3.5
FDI / Current Account (%)	57.7	72.2	45.0	65.0
FX Reserves (EUR bn)	26.2	28.3	32.5	38.0
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	4.25	4.25	4.30	4.35

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

EU, so that the EU financing option will only be utilized in case of an emergency.

Significant fiscal adjustment in 2010; accomplishment of 2011 deficit target remains a challenge

The most recent budget execution data vindicated our earlier views regarding the attainability of last year's fiscal target. The full-year consolidated budget deficit came in at RON 33.3bn or 6.5% of projected GDP. This was broadly in line with an earlier official target of 6.6% of GDP and down sharply from 7.4% of GDP in 2009.

Yet, our analysis indicates that fiscal consolidation was attained without the government eradicating the problem of the arrears to the private sector (contractors, suppliers etc). It is worth noting here that this performance criterion was never met since the inception of the existing IMF programme. On the positive side, the government has started to address the problem since last September, both at a central government level and in social security organizations. However, even though the government reduced arrears by RON 230 mn (from RON 1.8 bn last March to RON 1.57 bn in September), it failed to bring them at the IMF-agreed level (RON 0.8 bn)

The budget execution data has shown a significant improvement since last August, when they started to incorporate the impact of the aggressive fiscal consolidation package. After the Constitutional Court's block on pension cuts, the government implemented an offsetting austerity package including steep horizontal cuts in public wages (by 25% yoy) and a 5ppts VAT rate hike (19% to 24%). The new measures have been in effect since last July.

Budgetary revenues started to outperform in Q3, boosting full-year VAT collection and excise tax revenues significantly higher. The VAT rate hike and increased government efforts to track down tax evasion boosted total revenues by 14.3% yoy in 2H, bringing the corresponding full-year growth rate to 7.2% yoy. This was only marginally lower than the 7.7% yoy target envisioned in the 2010 budget. On a less positive note, full-year growth of income tax receipts and social security contributions remained in a negative territory (-3.2% yoy and -4.5% yoy, respectively in 2010), reflecting weak labor market conditions. Furthermore, the double dip recession also had a profound impact on corporate tax receipts (down by -4.9% yoy).

On the expenditures side, total budget outlays were modestly higher last year (+4.2% yoy). This was the combined result of curtailed capital spending (-11.9% yoy) and increased social security expenditure for unemployment benefits (+7.3% yoy). The total bill for public wages decreased by 13.3% in the period June-December 2010, facilitated by a 25% horizontal cut in nominal wages and lower employment in the broader public sector, which includes employment in public enterprises. (According to the latest available data, public-sector employment had declined by around 80k in late October). Elsewhere, payments for interest were up by 20% yoy because of the rising borrowing costs. The repayment of the health sector contractors' arrears led expenditures on good and services to increase by 5.2% yoy.

The 2011 budget, which has already been endorsed by the parliament, envisages a further decrease of the fiscal deficit to 4.4% of GDP. Total expenditures are expected to remain broadly flat, whereas total revenues are forecasted to rise by 7% yoy. In our view, the implementation of this year's target will be equally challenging. Firstly, it is important to note that, on the expenditures side, authorities have already done most of the work. The key challenge arising is to maintain the restrictive policy stance throughout 2011. The risk of fiscal slippage will be rising as the time is approaching for the parliamentary elections in 2012. In addition, there are still significant uncertainties and downside risks. The first one stems from negative surprises in the growth outlook. The potential impact of a sluggish economic recovery or, in the worst case, a prolongation of last year's recession could be significant with respect to tax revenue. Another potential source of concern is the accumulated arrears to the private sector and the situation in the public enterprises. IMF officials have promised to be less lenient on this issue in the new program, given that a waiver has been granted throughout the past program.

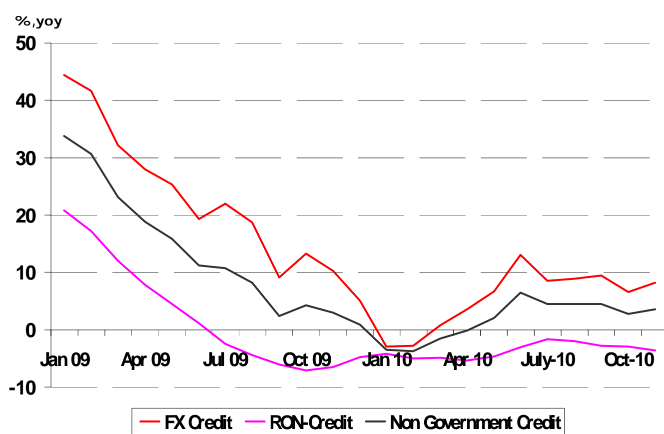
Lending to the private sector showing some preliminary yet inadequate signs of revival

Credit to the private sector has lately shown some preliminary signs of revival, which, however, are far from adequate to give domestic demand a significant boost. After recording negative year-on-year growth earlier this year, non-government credit was up by 4.4% yoy in December, compared to -1.6% yoy last March when the last negative reading was recorded. (Figure 1)

This trend is facilitated by FX loans creation, in contrast to the rest of the region. FX loans may be cheaper for the consumer. However, their use entails significant macroprudential risks in case of a sharp depreciation of the local currency. FX credit grew by 9.8% yoy in 2010 against 5% yoy in the prior year (6.4% and 0.0% when expressed in FX adjusted terms). That cames as the result of the positive contribution of both the corporate and households segments, which expanded by 16.2% yoy and 7.1% yoy respectively (12.6% yoy and 3.8% yoy when expressed in FX adjusted terms). In contrast, RON-denominated lending contracted by 3.0% over the same period. The household

component was particularly weak, declining by 7.5% yoy while credit to the non-financial corporations grew slightly by 1.3% yoy.

Figure 1: Minimal signs of credit growth revival in late 2010



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Special Focus - Romania

Focus-Romania

2011 domestic macroeconomic outlook

Key points

Domestic economy broadly expected to exits recession this year; recovery likely to prove slow and gradual

New IMF agreement (a precautionary credit line) should be in place by March 2011, boosting Romania's credibility in international debt markets and extending the list of reforms requested by the IMF.

Pre-election year 2011 should not bring changes to the government, but could see the formation of a large coalition comprising all parliamentary opposition.

Disinflation should resume, but considerable risks surround this year's inflation target

The impact of the VAT hike that sent annual inflation to 8% at the end of 2010 will disappear by July 2011. Inflation could fall subsequently in H2 and we assign a broadly even chance for the 3% year-end target to be met.

The main risks to our forecast include:

- administered price hikes, aiming to boost public revenues;
- higher producer prices globaly;
- higher food prices as a result of a poor agricultural year in 2010 an rising energy costs.

If such risks materialize, we expect headline inflation to ease to just 5.7% by the end of 2011 *(no other consumer tax hikes – VAT, excise duties – are currently anticipated this year, but they can never be completely excluded).*

Looser monetary policy expected in 2011

NBR maintained a tight policy stance throughout last year, citing increased inflation risks stemming from supply-side factors and the 5ppt hike in VAT rates in July. Yet, annual core3 CPI was just 4.1% last year, meaning supply shocks were accountable for at least half of overall rise in headline inflation. We expect a looser monetary policy in 2011, with the official policy rate standing at 5.25%-5.50% at the end of the year. The NBR should try to re-link the official interest rate with inter-bank interest rates if it plans to stick to its mechanism-of-transmission story. The monetary policy interest rate is not paramount to achieving policy objectives (both FX interventions and money market liquidity are more efficient instruments), but using an ineffective instrument in communication hinders the anchoring of inflation expectations and complicates the task of the central bank.

Positive GDP growth likely to resume in 2011, albeit at a very feeble pace

Romania is one of the few European countries still in recession. Real GDP dynamics between -1% and +1% in 2011 mean no sizeable change in economic conditions compared to 2010. The performers will be industry (still supported by foreign orders), financial services on higher intermediation, transport services and retail (especially pharmaceuticals, clothing and food sold in specialised stores). The construction sector is unlikely to perform markedly better in 2011, being hit by domestic banks' reluctance to extend new financing, excess supply for all building categories and rigid prices. Nevertheless, the picture is not uniform: prices and rents have fallen more outside Bucharest, boosting the chances of a market reawakening on retail, industrial and residential projects. If the Government sticks to its public investment plan, co-financing infrastructure works will be a major theme of 2011 (at the same time, all contractors could be affected by delayed payments and mounting arrears).

Lending could pick up selectively. A return of consumer lending may be in cards if consumer sentiment improves

Lending to exporters should intensify in 2011, while new loans to retail firms could be granted if consumption recovers. Overall loan disbursements booked in Romania can't rise very fast because:

- Loans in EUR at competitive interest rates are still granted directly by parent banks through their local subsidiaries in order to avoid the huge (and unexplainable, by now) minimum reserve requirements;
- Loans in RON depend on deposit building or on competitive interest rates on the FX swap market. Savings have exceeded 36% of GDP in 2010, growing more than 12 percentage points since 2006, but net new deposits are too low to insure a fast pace of growth

for loans. Swap market rates have been falling, but not enough to ensure a competition between EUR and RON rates;

- Foreign funds pouring into Romania are still meagre. This is visible in the growing correlation between the current account deficit and foreign direct investments. Moreover, in 2010 FDI levels explained much better the evolution of the CA deficit. This means portfolio flows (mostly outflows, if we disregard the money coming from the IMF) have not fuelled imports and lending like they did in 2007 and 2008.

Lending to consumers suffered from poor demand in 2010, but both consumer sentiment and purchasing expectations are expected to improve in 2011.

Precautionary credit line from the IMF – a boost to financing efforts

The new precautionary agreement to be signed with the IMF by the end of March will be less about funding (approximately 3.6 billion EUR, according to the press) and more about other conditionalities and needed reforms (among these privatisations, reducing the losses of state-owned companies, balancing contributors with social security receivers). Romania has to tap debt markets for some 16 billion EUR in 2011, so any prop to market confidence in the sustainability of its public finance is welcome.

Divided we stand – storm in a teacup before the 2012 general elections

The Romanian political landscape has never been more divided since the Communist regime was toppled back in December 1989. The widely expected coagulation of opposition forces is likely to be formalised in February 2011, with no immediate effect on Government: the Hungarian minority party is unlikely to leave its current coalition partners with whom they have more leeway in promoting their own political agenda. Moreover, 2012 is an election year and the current opposition is probably reluctant to grab power in a difficult year for the economy in general and public finance in particular. Their common agenda consists so far in the desire to topple President Basescu. A single economic vision is unlikely to arise without further alienating the political base of both social-democrats and liberals. Nevertheless, a common ticket for the general elections of 2012 will need a unified economic vision and it will be interesting to see how socialist, liberal and populist agendas will collide and be reconciled.

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

The belt is tightened further

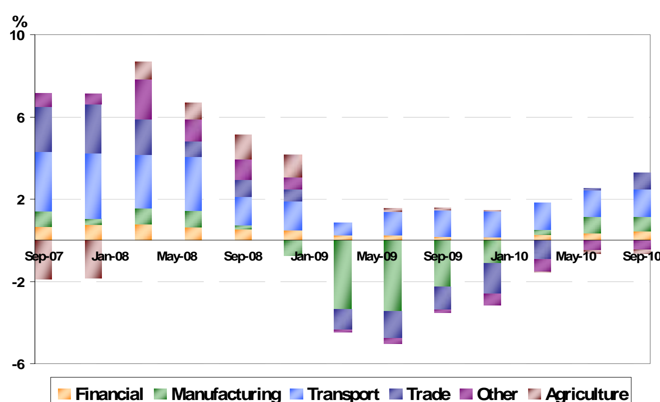
- Q3:2010 real GDP growth revised to 2.7% yoy, from 2.1% yoy reported initially
- Central Bank raises interest rates by a further 50bps to 12.00% and lifts minimum reserve requirements in a move to contain inflationary pressures, arrest dinar weakness
- Dinar depreciation trend interrupted in late December; prolonged period of increased currency volatility seen ahead
- 2010 consolidated government deficit closed at 3.3% of GDP, significantly below the 4.75% of GDP target

Revised data for Q3 GDP come out more upbeat than expected, aided by turnaround in the services sector

The revised national accounts for Q3:2010 contained a positive surprise. Real GDP growth was revised to 2.7% yoy, from 2.1% yoy reported initially and a rate of 2.0% yoy in Q2. This brought overall GDP growth in January-September to 1.7% yoy. On a seasonally adjusted basis, GDP growth accelerated to 1.6% qoq in Q3 against 0.7% qoq in Q2**.** Even if we take into account favorable base effects related to a low basis of comparison with Q3 2009 data (2.2% yoy GDP contraction), the Q3 reading still looks reasonably strong.

The services sector was a major growth driver in Q3:2010. The three highest growth rates were recorded in financial intermediation (8.7% yoy in Q3 vs. 6.9% yoy in Q2), transportation (7.4% yoy in Q3 vs. 6.6% yoy in Q2) and retail trade (6.2% yoy in Q3 vs. 1% yoy in Q2). Export oriented sectors such as manufacturing (5.0% yoy) and mining & quarrying (6.2% yoy) had a positive contribution as well. In contrast, the performance of construction (-9.2% yoy in Q3 vs. -12.5% yoy in Q2) and the agriculture sector (-1.4% yoy in Q3 vs. -1.6% yoy in Q2) remained in the red, thought their contribution were less negative compared to the prior quarters (Figure 1)

Figure 1: Services led the growth rebound in Q3



Source: Statistical Service of Serbia, Eurobank Research

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	9.0
CPI (end of period)	8.6	6.6	10.3	6.0
Fiscal Accounts (%GDP)				
General Government Balance	-2.6	-4.2	-3.5	-4.0
Gross Public Debt	25.6	31.3	41.5	45.0
Labor Statistics (%)				
Unemployment Rate (%of labor force, ILO)	14.7	16.1	19.2	18.0
Wage Growth *(total economy)*	17.9	4.1	4.6	8.3
External Accounts				
Current Account (% GDP)	-17.1	-5.7	-8.0	-9.0
Net FDI (EUR bn)	1.8	1.4	1.0	2.0
FDI / Current Account (%)	30.0	78.7	45.0	70.0
FX Reserves (EUR bn)	8.2	10.6	10.0	11.5
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	12.00	13.00	12.50	10.00
EUR/RSD	104.06	100.00	100.00	110.00

Source: National Sources, IMF, Eurobank Research & Forecasting

All in, the revised Q3 GDP data paint to a more optimistic picture for the domestic economic outlook. It is important to note that the all important services sector appears to be warming up again. In our view, this is a preliminary sign of a more pronounced domestic demand rebound, which is expected to unfold in the coming quarters.

On a less positive note, the domestic economic recovery has not yet been accompanied by any significant improvement in the labor market. To a certain extent, of course, this is understandable as employment is usually lagging the economic cycle. Moreover, unemployment in Serbia has been traditionally high, as a result of structural problems. The onset of the international crisis made things only worse, with the domestic unemployment rate climbed to 19.2% last March and staying near these levels ever since.

Elsewhere, high frequency data on industrial production and retail trade point to a temporary weakening of economic activity in Q4. The Central Bank estimates GDP growth to have slowed to around 1% yoy in the fourth quarter of 2010, so that full-year growth has not likely exceeded our initial forecast of 1.5%

2011 macro outlook

Coming next to our outlook on the Serbian economy in 2011, we anticipate that the economic recovery will gain pace this year. After growing by 1.5% yoy in 2010, driven primarily by the recovery in net exports, we expect GDP growth this year to accelerate further to around 3%. Domestic political leadership has been proactive enough to be the first in the SEE region to ask for precautionary IMF funding, which eventually took the form of a regular Stand-by Arangement (SBA) that is expected to expire in April 2011. A new precautionary arrangement afterwards remains in the cards, the duration of which is yet to be decided.

The approval of the sixth review by the IMF board allows access to the seventh tranche of funding (€ 383mn) under the current lending facility, with total disbursements so far amounting to ca €1.5bn out of the total available package of €2.9bn. The approval also represents a vote of confidence on the prospects of economic recovery, especially given that the government has already implemented a number of politically-sensitive reforms (fiscal responsibility law, public sector layoffs etc). In retrospect, the government has so far complied with the IMF program requirements more effectively than many other governments in New Europe running similar stabilization programs. The implementation of the unfreezing of wages and pensions by January 2011 *i.e., three months earlier than initially expected* is a testament of such a success.

On the positive side, the unfreezing will provide domestic demand a mild boost, allowing some breathing space for the most vulnerable, lower-income social groups. Positive rates of domestic credit creation (credit growth to the private sector reached 27% yoy in 2010, the highest in the region)**,** are also expected to continue supporting domestic demand dynamics in the period ahead. However, there remains a strong need to facilitate a switch to a new model of domestic economic development; one that will depend less on domestic consumption and, instead, emphasize competitiveness and exports. The recent depreciation of the dinar combined with the growth rebound of main trade-partner economies is currently facilitating that process. Yet, currency depreciation works as a double-edged sword for the Serbian economy. It helps to boost export competitiveness in the short-term, albeit at the cost of rising NPLs and increased inflation pressures, as a result of the economy's high Euroization levels and a high pass-through. In addition, currency depreciation alone may not be enough to restore export competeviness on a lasting, sustainable basis.

In view of the above, we believe that domestic policymakers will need to focus on accelerating structural reforms aimed at boosting competitiveness and improving the investment environment. During the boom years, there has been considerable progress in these areas, as acknowledged by e.g. the World Bank's Doing Business reports. Yet, it appears that these reforms have lost momentum in the post-Lehman era. Another urgent policy priority is to upgrade the domestic infrastructure. To that aim, fiscal policy needs to reprioritize capex over consumption spending. The efficient use of the NIP (National Investment Program) would turn out to be instrumental in facilitating that effort.

Central Bank hikes interest rates by a further 50bps to 12.00%, raises minimum reserve requirements in move to the contain domestic inflation and arrest dinar depreciation pressures

On January 17, NBS raised its key policy rate by a further 50 bps to 12.0%. *(This was the sixth rate hike since the Central Bank terminated its easing cycle in August 2010).* Two days later, the Central Bank announced new rules with respect to the maturity breakdown of the minimum reserve requirements. The minimum reserve requirement for short-term deposits *(maturities of less than two years)* denominated in foreign currency was lifted to 30% from 25%, while the ratio on deposits with maturities in excess of two years was left unchanged at 25%. The minimum reserve requirement for dinar deposits with maturities of less than two years was kept at 5.0% and that for deposits with longer maturity was abolished. In addition, the NBS asked domestic banks to allocate in dinars a part of their euro-denominated required reserves, by applying differentiated ratios – 15% for liabilities with maturities up to two years and 10% for those of longer maturities

The changes to minimum reserve requirements did not come as a major surprise to us. NBS Governor, Dejan Soskic, stated before the latest policy decision that the Central Bank was about to mobilize more tools in addition to the key policy rate in order to contain rising inflationary pressures. According to NBS, the new rules on minimum reserve requirements are expected to prevent an additional liquidity injection between February and April.

In its last policy statement, the Central Bank said that restrictive monetary policy is still required to restrain inflationary pressures stemming from regulated price hikes, as well as higher energy and food inflation domestically. Moreover, the NBS assessed that relatively weak aggregate demand will continue producing disinflationary pressures, particularly in view of the lower than expected increases in public sector pensions and wages.

Inflation has been on a rising path since last summer, driven by higher agricultural product prices as a result of a poor domestic wheat crop and the Russian export ban. Their impact on headline inflation was magnified by their significant weight in the CPI basket (~37.8%). Domestic inflation pressures were further exaggerated by more increases in regulated prices as well as the existence of oligopolistic structures in the domestic economy. On top of these, the most important factor that weighed on NBS's latest policy decision was the rapid pace of dinar depreciation in recent months (which fed into domestic prices because of the high pass through) as well as the low demand for dinar denominated securities in late December auctions.

The recent Central Bank rate hikes aim to prevent heightened inflation expectations from triggering a second round of price increases. Domestic CPI (+10.3% yoy) came well above the NBS's year-end inflation target (6% yoy, +/-2ppts), confirming our earlier expectation of consumer prices reaching double-digit levels by the end of 2010. On the positive side, the month-on-month rate of change slowed significantly to its lowest level since last July (0.3% mom). The latter implies that, inflation on a year-on-year basis should start approaching a peak sooner than later (expected in Q1).

At the same time, the statement of the Central Bank contained one important hint with respect to the future trajectory of the key policy rate: "The adopted changes reduce the need for increasing the restrictiveness of the key repo rate in the coming period". The statement implies clearly that the NBS aims to rely less on the key policy rate as a device to communicate its near-term policy. In conclusion, we anticipate less aggressive interest rate hikes in the near future. The 50bps hike in the last monetary policy meeting after the 100 bps delivered in last December was an illustration of this practice. That prompts us to conclude that the peak of the key policy rate should be around 13%, significantly lower than the forecast in our December 2010 New Europe Economics & Strategy issue.

Dinar depreciation trend discontinued in late December. Recent stabilization raises hopes that the worst for the domestic currency is already behind.

Since September 2009, the dinar has come under significant depreciating pressure that intensified during last summer, despite repeated Central Bank interventions in the FX market. Officially, the Central Bank does not have an explicit exchange rate target. Yet, it spent some €2.5bn (more than the IMF assistance received so far-€1.5 bn) in 2010 in an attempt to smooth excess FX volatility and to contain the pace of dinar depreciation.

The dinar recouped some of its earlier losses in December, after the NBS adopted a more aggressive policy stance by hiking its key policy rate by a further 100bps (at that point in time a cumulative 350 bps of rate hikes had been delivered since early August). The domestic currency gained some 1.4% in December, ending the month at 105.9/€. At that level, the currency was still lower by 9ppts compared to its levels in early 2010 and by about 40 ppts since the start of the global financial crisis in 2008. The dinar extended some of its gains in January, reaching 104.2/€ on January 25

In our view, the tightening bias of the Central Bank will provide a cap to the dinar weakness in the coming months. In addition, the government plans to issue new debt during the first months of 2011. They will seek to borrow €200 million euros in 53-week Treasury bills on Feb. 9 and €200 million in 15-year bonds carrying a 5.85 percent coupon. Moreover, the Ministry of Finance will also boost offerings of 18-month and 24-month dinar issues -- so far offered in 1 billion-dinar tranches -- planning to sell 10 billion dinars of 18-month bills on Feb. 8 and 20 billion dinars of two-year debt on Feb. 22. Looking ahead, we have revised our view with respect to the short-term outlook of the dinar (1-3months), currently looking for some additional appreciation to 98.40/€ vs. from 103.8/€

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

CBT employs unconventional policy mix to address both inflation, financial stability risks

- •High-frequency indicators suggest real GDP growth picked up pace in Q4
- End-2010 inflation target fulfilled; January CPI at a 4-decade low
- •2010 budget deficit outperforms 4.0%-of-GDP target; further improvement expected this year
- •Current account deficit touches record highs in November; remains primary macroeconomic risk ahead

High-frequency indicators suggest real GDP growth picked up pace in Q4

Turkish real GDP growth slowed down to 5,5% YoY in Q3:2010, after expanding by 11.0%yoy in H1:2010. Nevertheless, recent upbeat readings in a range of high-frequency economic activity and sentiment indicators suggest that growth gained momentum during the last quarter of 2010 and in the beginning of this year. Among them, growth in industrial output stabilized at levels above 9%yoy in October and November, after expanding by an average rate of 15.5% yoy in the first half of last year. The manufacturing PMI index expanded in Q4 at its fastest pace since May 2010 and touched in January its highest level since the beginning of the survey in 2005. After hitting a 17-month low of 50.3 in September, the PMI index bounced back to end the year at 56.4 and hit a record high 57.2 a month later. Also pointing to continuous strong expansion, confidence in the sector hit an 8-month high of 113.6 in January:2011 Capacity utilization, considered to be a leading indicator of both manufacturing activity and GDP growth, halted a four-month rising streak in December, but held close to 2-year high of 75.9% touched a month earlier. Meanwhile, private-sector credit grew by 32%yoy year-to-November, and the consumer confidence index touched a near 3-year high of 91.34pts in November, suggesting a continuation of strong domestic demand dynamics. With respect to external sector developments, goods exports grew by 11.3%yoy in 2010, with December alone marking a 21%yoy increase. It appears that, exporters' efforts to diversify their products towards Asia and the EMEA region in view of weakening demand from the euro area have already started to bear fruit. Sales of passenger cars and light commercial vehicles soared by 114%yoy in Q4, following a 28%yoy rise in Q3, pushing the full-year sales to a record 760,913 units (+36.6%yoy). Meanwhile, total automotive production growth accelerated to 23.7%yoy over the last three months of 2010, from an 8.2%yoy in July-September, pushing the rate of annual increase to 27.2% in 2010. On a less positive note, the number of foreign visitors to Turkey fell by 4.91%yoy in December, reflecting weakening external demand from Europe. Tourist arrivals recorded a 5.74%yoy increase in the year 2010 as a whole.

Turkey: Eurobank EFG Forecasts

	2008	2009	2010F	2011F
Real GDP (yoy%)	0.7	-4.7	8.0	5.0
Private Consumption	-0.3	-2.3	6.4	4.5
Govern. Consumption	1.7	7.8	3.2	3.5
Gross Capital Formation	-6.2	-19.2	24.0	13.0
Exports	2.7	-5.4	4.5	10.0
Imports	-4.1	-14.4	20.0	15.0
Inflation (yoy%)				
CPI (annual average)	10.4	6.3	8.6	5.3
CPI (end of period)	10.1	6.5	7.0	6.0
Fiscal Accounts (%GDP)				
Central Government Balance	-1.8	-5.5	-3.6	-2.7
Gross Public Debt	39.5	45.4	42.5	41.5
Primary Balance	3.5	0.1	0.8	1.5
Labor Statistics (%)				
Unemployment Rate (%of labor force)	13.6	13.5	12.0	11.0
External Accounts				
Current Account (% GDP)	-5.7	-2.3	-6.5	-7.0
Net FDI (USD)	15.7	6.7	5.5	6.0
FDI / Current Account	37.5	46.9	12.0	10.0
FX Reserves (USDbn)	71.0	69.0	79.0	90.0
Domestic Credit	**2009**	**Q1 10**	**Q2 10**	**Q3 10**
Total Credit (%GDP)	34.8	31.6	35.4	37.5
Credit Private Sector (%GDP)	32.9	29.9	33.6	35.6
FX Credit/Total Credit (%)	14.9	16.9	18.7	18.8
Private Sector Credit (%yoy)	11.3	22.8	34.0	36.7
Loans to Deposits	78.7	79.9	82.1	84.3
Financial Markets	**Current**	**3M**	**6M**	**12M**
Policy Rate	6.25	6.00	6.50	7.50
USD/TRY (where applicable)	1.60	1.60	1.50	1.45

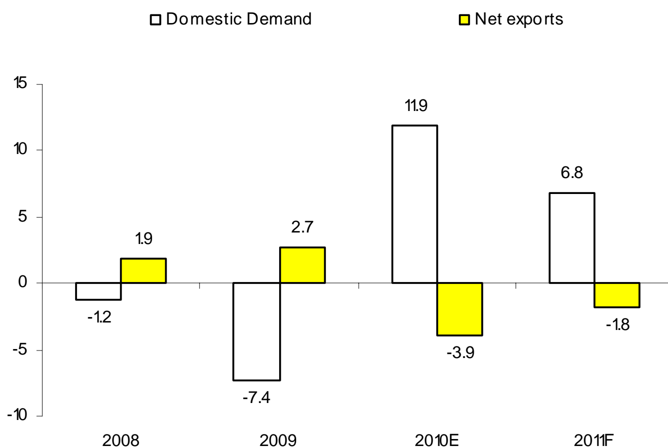
Source: National Sources, Eurostat, IMF, Eurobank Research & Forecasting

Turkey to remain among the world's best growth performers this year

In view of the most recent positive data surprises, we estimate the Turkish economy to have expanded by 8.0%yoy in 2010, a faster pace than the 7.5%yoy rate we anticipated earlier For 2011, we continue to anticipate a deceleration to 5.0%, on the back of unfavorable base effects, a continuous negative contribution from net exports (see Figure 1), and tightening monetary conditions in view of the recent CBT policy initiatives (see analysis below). Domestic demand will likely remain the main growth driver in the

quarters ahead as credit expansion remains strong and labor market conditions improve further.

Figure 1: Net exports to continue exerting a negative input in economic activity this year as well.

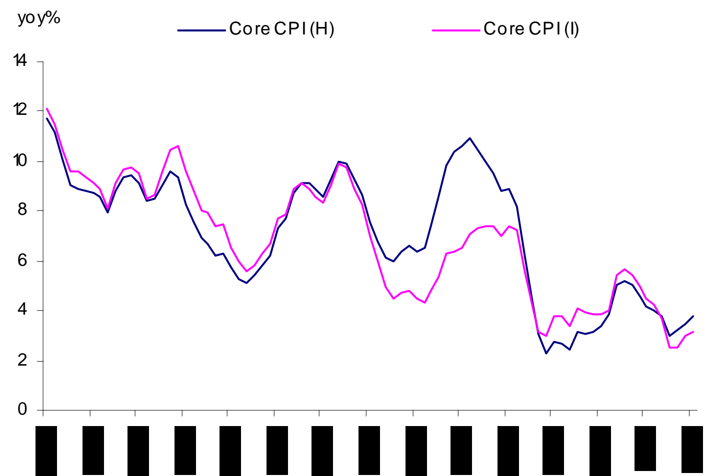


Source: National Statistics, Eurobank EFG

End-2010 inflation target fulfilled; January CPI at a 4-decade low

Headline CPI rose by 0.4%mom in January, coming in below a Reuter's poll median forecast for a 0.5%mom increase. The breakdown of the report revealed that food prices rose by 1.61%mom halting a two-month falling streak. This suggests that the correction in food price inflation witnessed recently (from double-digit annual rates in August-November to 7% yoy in December) may have come to an end in January. The breakdown of the report showed that two of the twelve CPI sub-indices declined on a monthly basis, namely "recreation & culture" and "clothing & footwear", with most of the rest recording modest increases. On an annual basis, headline CPI eased to 4.90% in January, its lowest level in more than forty years, from 6.40%yoy in the prior month, undershooting the Central Bank's 5.9% year-end projection as well as the 5.5% inflation target. Reflecting relatively subdued underlying inflation pressures, four of the nine core inflation indices eased on an annual basis in January while the CBT's favorite measures "H" and "I", stood ca 70bps higher each from respective historic lows of 3.02% and 2.50% touched in October. However, upside risks to the inflation outlook loom ahead especially in the face of cost-push pressures, as indicated by the January PPI reading. Produced price inflation outpaced expectations in January, rising by 10.8%yoy (+2.36% mom), bouncing further away from a 5-month low of 8.17% in November and outpacing December's 8.87%yoy rise. Even so, we continue to believe that headline CPI will decelerate further in the coming months thanks to favorable base effects and probably ease towards 4% by April. A pickup thereafter towards 6% by December is possible – above the CBT's 5.5%yoy target for the year - in view of the waning impact of a strong base and a rapidly narrowing output gap. Higher world commodities prices, domestic food inflation and FX fluctuations continue to pose as major upside risks to our forecasts.

Figure 2: Underlying inflation pressures remain subdued



Source: National Statistics

CBT delivers surprise rate cut, introduces package of macro-prudential measures to address dual objective of domestic price stability and financial stability

The recent deceleration witnessed in the latest annual CPI readings boded well for credibility of the Turkish Central Bank. Note that headline CPI of 6.4%yoy in December undershot the Central Bank's 7.5% year-end projection and came in below the CBT's 6.5% year-end inflation target. 2010 was the second year running that the Central Bank fulfilled its inflation target after consistently missing it by a wide margin since 2005. The visible improvement in the latest consumer inflation readings, supports the Bank's long-held view that an earlier inflation spike was likely to prove temporary. The latter was on the basis that higher inflation was primarily driven by extraordinary factors such as higher unprocessed food prices and base effects. However, the CBT has been sounding increasingly worried lately about diverging domestic and external demand dynamics, in tandem with a sharp acceleration in credit activity. These factors have been exerting widening pressures on the current account deficit, adding to financial stability risks. As a result, the CBT has introduced a set of macro-prudential measures aiming to address the dual objective of domestic price stability and financial stability. In detail, since last December the Central Bank:

a) Cut is key 1-week repo rate by a cumulative 75bps to 6.25% currently. The move aims to curb "hot money" inflows to the domestic economy attracted by hefty Turkish/foreign interest rate differentials

b) Widened its overnight interest rate corridor by reducing the o/n borrowing rate by 25bps to 1.50% and by increasing the corresponding lending rate by 25bps to 9.00%. The move aims to encourage investors to hold longer-term maturities in TRY money market transactions

c) Raised domestic banks' short-term reserve requirement ratios (RRR) on TRY deposits and cut those with long-term maturities. The move aims to reduce interbank liquidity, contain domestic credit creation and reduce maturity mismatched by increasing the maturity of the banking system's liabilities.

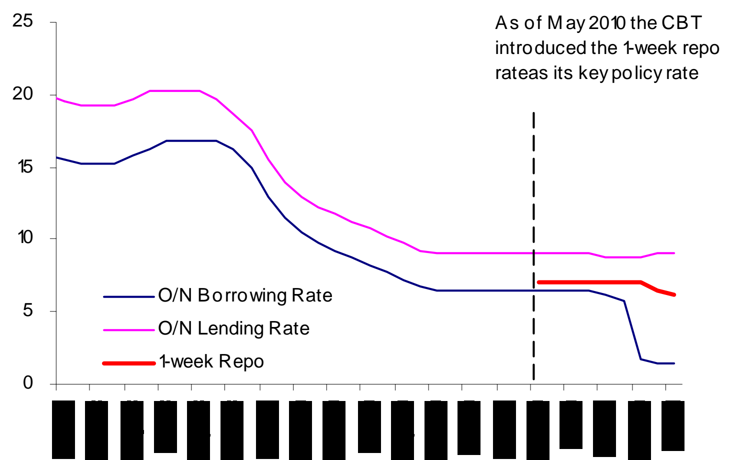
The Central Bank estimates that the measures introduced so far will reduce internal liquidity by ca TRY 17.4bn. Moreover, Finance Minister Mehmet Simsek said in early February that outflows of short-term capital from Turkey amounted to just over US$ 8bn as a result the CBT's measures.

In more detail, reserve requirement ratios on TRY deposits were changed as follows:

- for up to 1 month maturities they were raised by 400bps to 10%
- for up to 3 month maturities they were raised by 300bps to 9%
- for up to 6 month maturities they were raised by 100bps to 7%
- for up to one year maturities they remained unchanged at 6%
- for up one year and longer the ratio was cut by 100bps bps to 5%
- for FX deposits the ratio was maintained at 11%

The CBT highlighted that, in spite of the reductions in the 1-week repo rate, the net effect of the current policy mix will be a tightening in overall monetary conditions. Following a 50bps rate cut in December and ahead of January's MPC meeting -- when the CBT decided to deliver a further 25bps cut in its key policy rate -- we believed that the Central Bank would stay put on rates throughout H1 2011, especially after a 5 percent wakening of the lira since December's policy decision and recent hawkish comments by Governor Durmus Yilmaz. However, in view of January's unexpected rate cut, further, albeit limited, reductions in the 1-week repo rate in the imminent future can not be ruled out. In effect, another 25bps cut in the one-week repo rate in tandem with further increases in short-term reserve requirement ratios is our base case scenario for the February 15 MPC meeting. Looking further ahead, we expect a reversal of the recent or any further reductions in the key policy rate in H2 2011 , anticipating around 100-150bps of rate hikes by the end of the year as upside risks to the inflation outlook become more pronounced, primarily in view of a narrowing output gap.

Figure 3: CBT cuts its key policy rate, widens the corridor between overnight borrowing and lending rates



Source: CBT, National Statistics

CBT raises end-2011 CPI forecast

In its updated Inflation Report released in January, Turkey's central bank raised its CPI forecast for end-2011 to 5.9%yoy from 5.4%yoy previously. The main culprit of the upward adjustment was an increase in the CBT's oil price estimate, expected to have an extra 35bps impact on 2011 domestic inflation. The Bank also acknowledged that the recent increase in agricultural commodity prices is likely to offset the sharp fall in domestic unprocessed food inflation witnessed late last year, boosting annual headline CPI by a further 15bps. The CBT maintained its end-2012 CPI projection of 5.1%yoy and reiterated that it expects inflation to remain on downtrend in the coming months (sub-5.5% yoy levels expected in Q1 2011). The Central Bank also noted that core inflation indicators are likely to register limited increases in the following months. It also highlighted that it may pursue for a long

time its current policy mix of lower policy rates and higher reserve requirement ratios. However, presenting the latest Inflation Report, CBT Governor Durmus Yilmaz left the door open for a swing back to higher interest rates in tandem with hikes in required reserve ratios should global inflation pressures intensify.

2010 budget deficit outperforms 4.0%-of-GDP target; further improvement expected this year

The consolidated central government budget closed last year with a gap of TRY 39.6bn or 3.6% of projected GDP. This was lower than the 4.0%-of-GDP deficit outcome envisioned in the October 2010 Medium-Term Plan and a shortfall of 5.5%-of-GDP recorded in 2009 as a result of the domestic recession. Notably, last year's better -than-expected budgetary outcome was attained despite a 175%yoy rise in the central government deficit in December alone, primarily as a result of increased capital spending and seasonal factors. The primary deficit, which excludes interest payments on government debt, also marked a significant improvement in 2010, running a surplus of TRY 8.7bn (~ 0.8%-of-GDP), an eight-fold increase over the same period a year earlier. The government targets a further deficit reduction to 2.8%-of-GDP this year, easing market worries of increased public spending ahead of the July 2011 national elections. Earlier this month, Finance Minister Mehmet Simsek said that a comprehensive income tax reform was on the cards after the polls. We broadly concur with the government's target for 2011, which is broadly expected to be comfortably met. We repeat that some fiscal slippages in the run-up to the upcoming ballot can not be entirely ruled out. However, we see that risk as relatively limited as the government has so far exhibited strong commitment to fiscal discipline. Furthermore, the ruling AKP maintains a strong lead in recent opinion polls, which increases its chances to achieve its third consecutive mandate as a single-party government. In any case, the continuation of a prudent fiscal stance on the part of the government is crucial for maintaining investor confidence towards Turkey, especially in view of growing concerns about the country's widening external imbalance. Improving public finances also pave the way for an upgrade in Turkey's sovereign credit ratings.

Current account deficit touches record highs in November; remains primary macroeconomic risk ahead

The current account deficit more than trebled in November to touch a record high of $5.9bn. Over the first eleven months of the year the shortfall jumped 277%yoy to $41.6bn or ca 6.1%-of-GDP annualized which, compares with a 2.3%-of-GDP deficit in 2010.. The deterioration was mainly driven by a strong rebound in domestic demand which is exerting widening pressures on the trade deficit. Turkey has a long history of running high current account deficits in periods of strong economic expansion, but this time around the speed of deterioration is of primary worry. On the latter, the government aims to tackle the country's high dependency on energy imports through renewable energy investments and the construction of nuclear power stations. Moreover, it seeks to expand its exports towards fast-growing developing markets in Middle East and Asia, and also take measures to encourage state institutions to buy domestic goods. Another area of concern regarding Turkey's current account deficit is its financing. Net FDI inflows to the country shrunk 25%yoy in January-November, financing only 12% of the deficit, when over the same period a year earlier foreign direct investments matched nearly 60% of the gap. Presently, capital inflows adequately fund the current account shortfall. However, the short-term nature of such financing renders the domestic economy highly sensitive to sudden swings in global investor sentiment. On a rather comforting note, the Central Bank appears determined to address potential economic overheating risks. However, it remains to be seen whether the current controversial policy mix will prove adequate. Ceteris paribus, we expect current account deficit to rise to 7.0%-of-GDP in 2011, well above government's 5.4%-0f-GDP forecast and last year's 6.2% of GDP projected realization.

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

GDP growth in 2010 surpassed expectations

- According to Prime Minister Azarov, the Ukrainian economy expanded by a higher-than-expected 4.1% yoy in 2010
- Domesitc growth is expected to receive a boost from fixed asset investment this year, as a result of increased infrastructural spending ahead of the EURO 2012 football championship
- CPI stabilised at single-digit rates, but new gas price hikes likely to push inflation higher in the coming months
- In late December, the IMF Board approved the 2nd disbursement ($1.5bn) for Ukraine under the present Stand- By-Arrangement
- Domestic credit growth remains sluggish; asset quality remains the major concern for the banking sector despite the deceleration in NPLs growth in 2010.

2010 GDP growth surpassed expectations

According to Prime Minister Azarov, the Ukrainian economy expanded by 4.1% last year, following a 15.1% yoy contraction in 2009. This was a faster pace of expansion than the +3.7% rate expected earlier by both the government and the IMF. It was also attained despite the gradual winding down of base effects that boosted growth rates in H1-10 and a smaller grain harvest relative to the prior year. On a positive side, industrial production, which accounts for nearly a quarter of Ukrainian GDP, continued to expand at double digits in Q4-10. It stood at 12.5% yoy in December up from 9.9% yoy the prior month and 10.2% yoy in October (industrial production rose by 10.7% yoy on average in 2010) (Figure 1). What's more, domestic demand has showing increasing signs of improvement, driven by rising growth in real incomes. Retail sales (in volume terms) exhibited improved dynamics in Q4-10; they stood at 7.8% yoy in December, up from 7.1% yoy and 5.8% yoy recorded in November and October, respectively (Figure 2). Strong wage growth has supported retail sales since the beginning of 2010; wages grew by 16.1% yoy on average in 2010 up from 6.2% yoy average wage growth recorded in 2009 (real wage growth averaged at 6.7% yoy in 2010) (Figure 3).

Source: National Statistics, Eurobank Research

Ukraine: Eurobank EFG Forecasts

	2008	2009	2010f	2011f
Real GDP (% yoy)	2.3	-15.1	4.1	4.5
Private Consumption	9.9	-12.1	4.7	5.0
Government Consumption	0.4	1.8	1.5	1.0
Gross Capital Formation	32.6	-48.4	8.0	15.0
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	9.4	10.8
CPI (end of period)	22.3	12.3	9.1	10.5
Fiscal Accounts (% GDP)				
General Government Balance	-3.2	-8.7	-6.5	-3.5
Gross Public Debt	19.9	34.6	42.6	45.0
Labor Statistics (%)				
Unemployment Rate (% of labor force)	6.9	9.4	8.5	8.0
Wage Growth (*real - private sector*)	6.3	-10.3	6.7	7.0
External Accounts				
Current Account (% GDP)	-7.0	-1.5	-1.9	-2.5
Net FDI (bn USD)	9.9	4.7	5.7	7.0
FDI / Current Account	77.6	268.0	222.0	100.0
FX Reserves (bn USD)	31.5	26.5	34.6	32.0
Domestic Credit	**2007**	**2008**	**2009**	**Q3 10**
Total Credit (% GDP)	59.9	77.3	79.1	69.7
Credit to Enterprises (% GDP)	36.5	46.7	50.5	46.7
Credit to Households (% GDP)	22.5	29.5	26.4	20.9
FX Credit/Total Credit (%)	49.9	59.0	50.8	47.4
Private Sector Credit (% yoy)	74.9	68.5	-3.1	2.6
Loans to Deposits	150.4	204.0	215.9	183.3
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

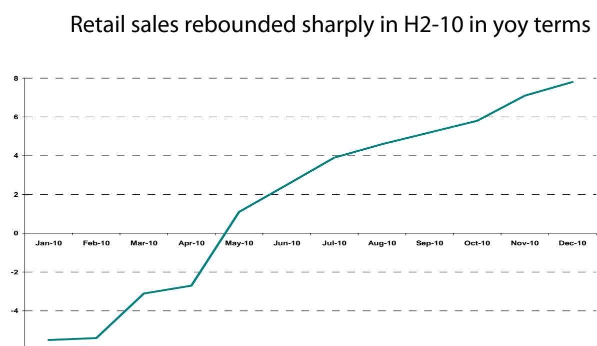
Source: NBU, IMF, Bloomberg, Eurobank Research

Figure 1

Industrial production expanded at double-digit yoy rates in Q4-10

Figure 2

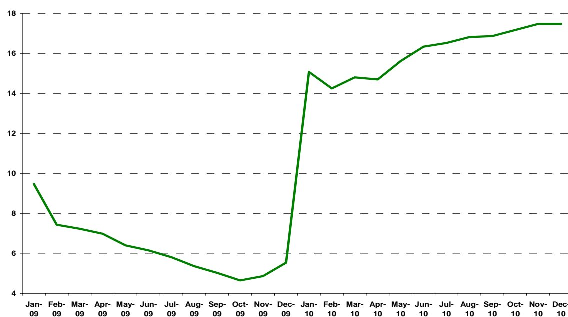
Retail sales rebounded sharply in H2-10 in yoy terms



Source: National Statistics, Eurobank Research

Figure 3

Wage growth more than doubled in 2010



Source: National Statistics, Eurobank Research

In 2011, we expect growth to receive a boost from fixed asset investment, which will be triggered by an infrastructure revamp associated to the EURO 2012 football championship that Ukraine prepares to host. All in we expect the Ukrainian economy to grow by 4.5% yoy this year.

IMF aproves $1.5bn disbursement for Ukraine

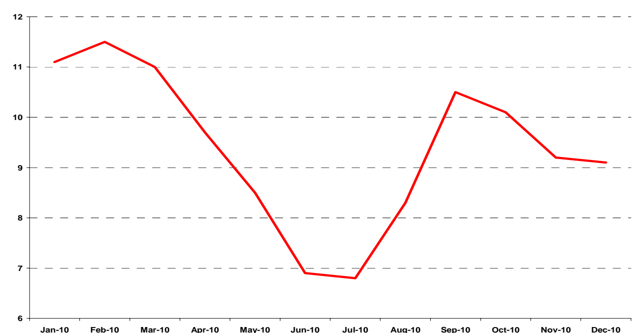
In late December, the IMF completed its first review of Ukraine's economic performance under the present Stand-By-Arrangement, leading to the disbursed a second tranche of funding ($1.5bn vs. $1.9bn was received last August). According to the IMF statement, Ukrainian authorities remain committed to the implementation of agreed reforms with respect to fiscal policy and in the energy and financial sector that are deemed essential to achieve the programme objectives. The IMF demand for a fiscal deficit target of 3.1% of GDP in 2011 (from 6.5% of GDP in 2010) has been met, with the new budget having already been approved by the Ukrainian parliament. However, new measures to curb the fiscal deficit have not been specified. What's more, the government's progress with respect to structural reforms, notable the pension reform, has lagged the programme benchmark. An IMF mission will visit Kyiv on February 1-11, for a second review under the current Stand-By-Arrangement for Ukraine. All in all, the IMF presence is positive for Ukraine as it lends credibility to needed economic reforms.

Inflation stabilised at single-digit rates, but further gas price hikes in 2011 likely to increase domestic price pressures

After bottoming out last July, inflation edged higher again in September on the back of a 50% hike in household gas prices and the rise in food prices due to a poor summer harvest. Ukraine is particularly vulnerable to a food-price shock since food items account for over 50% on the CPI basket. Inflation accelerated to double-digit rates yoy in September and October 2010 (10.5% and 10.1% yoy, respectively), before easing to 9.1% yoy in December (Figure 4).

Figure 4

Inflation (yoy rates) likely to edge higher in the coming months due to administered hikes in domestic gap prices



Source: National Statistics, Eurobank Research

Inflation is set to rise due to factors not related to monetary policy but instead to an additional 50% hike in gas prices, scheduled for April 2011 will most likely push inflation higher; we expect annual consumer price inflation to average to 10.8% yoy in 2011 up from 9.4% yoy in 2010.

The stance of monetary policy remains expansionary in the sense that the key interest rate, which currently stands at 7.75%, implies a negative real interest rate, although at lower level than last year (-1.35% at end-2010 vs. -2.05% at end-2009).

Current account deficit to widen further on strengthening domestic demand

In December, the current account deficit rose to $0.8bn, from $0.6bn in the prior month. Overall, the current account deficit widened to $2.6bn (1.9% of GDP) in 2010, up from $1.7bn (1.5% of GDP) in 2009, mainly on the back of a higher trade gap. Exports of goods grew by 29% in 2010. Rising export of ferrous metals, (by 42.7%) driven by steel price increases, made the biggest contribution to goods exports growth. At the same time, imports of goods increased by 35.4% in 2010. Energy import rose by 39.4% while the volume of non-energy goods imports grew by 33.6%. Moreover, after having dropped sharply in 2009 the import of machinery and equipment grew by ca 40% in 2010, supported by

the recovery in investments. We expect the current account deficit to widen to 2.5% of GDP in 2011 as improving domestic consumption and investment demand will continue fuelling imports.

In December, FDI inflows reached $0.9bn, their highest level in 2010 owing to real sector investments. In 2010, net FDI inflows amounted to $5.7bn, up from $4.6bn in the prior year. The banking sector attracted $2bn, same as in the previous year. Net flows on debt and bond operations were also positive and amounted to $6.7bn in 2010 (of which up to 3.8bn or 56.2% of the total amount were of a medium-to-longer-term nature) compared to net repayments of $9.1bn in 2009. We anticipate the current account gap to remain fully covered by FDI inflows this year, but the dependence on capital inflows (short-term sources of financing which rend the economy vulnerable to sudden shifts in market sentiment) and global commodity prices keep up the uncertainty in the Ukrainian economy.

Domestic credit developments

Corporate lending grew by 6% year-to-November while household credit decelerating by 11.1% over the same period with mortgages loans recording the largest fall (down by 15.8%). On the other hand, total deposits continued their acceleration trend, growing by 20.5% year-to-November with household and corporate deposits growth reaching 24.7% and 18.3%, respectively, over the same period. Given the divergent path of loans and deposits the loans to deposits ratio fell from 216% at end-2009 to 182% as end of November 2010.

Although the growth of NPLs decelerated significantly in 2010 compared to 2009, the asset quality remains a major concern for the banking sector. According to National Bank of Ukraine (NBU) official methodology, NPLs accelerated by 29% the first eleven months of 2010 with NPLs to total loans ratio reaching 12.3% compared to 9.7% as of end-2009 and 12.2% in October. We anticipate NPLs to stabilise in the coming months on the back of gradual economic recovery and banks' improved financial performance due to lower funding costs and revived lending activity. The return on equity improved from -32.5% at end-2009 to -8.1% in January-November 2010.

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