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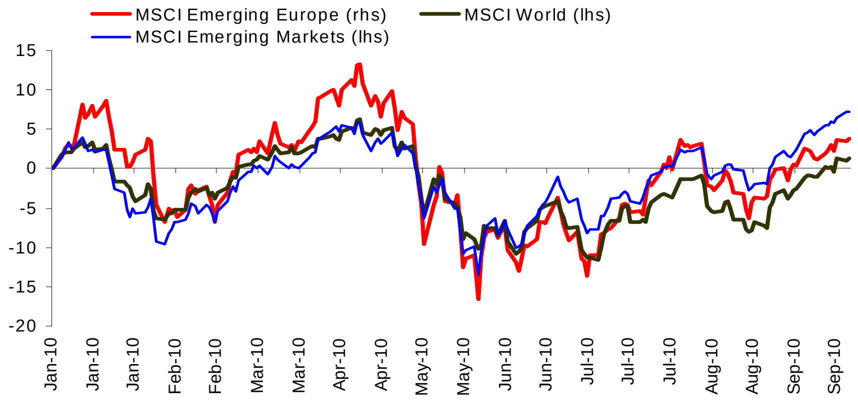
Regional markets rebound on improving investor sentiment

- **Bulgaria:** Robust export growth leads industrial sector's rebound and helps current account improve by more than expected. Yet, with domestic demand still weak, we expect full-year GDP growth to contract by 0.3%
- **Poland:** Monetary Policy Committee strongly divided on rates. We anticipate the first NBP hike to occur in Q1-2011, with the key policy rate reaching 4.00% by the end of next year
- **Romania:** Public discontent grows against IMF program amid challenging economic conditions. Aggressive fiscal consolidation program weighs negatively on domestic economic activity, high frequency indicators point to further GDP contraction in H2-2010
- **Serbia:** Central Bank hikes interest rates again on rising inflation risks, increasing risk premia
- **Turkey**: In spite of an anticipated slowdown in H2, full-year growth is likely to prove stronger than expected earlier. AKP achieves victory in key constitutional referendum
- **Ukraine:** Domestic inflation accelerates on steep hike in gas prices**.** Fitch affirms Ukraine's external debt rating at B with outlook stable; forecasts further rise in NPLs ratio to 50%

New Europe market strategy highlights

We continue to expect **local rates markets** to remain supported in the coming months on lingering concerns over the global growth environment and relatively tame domestic inflation pressures. Nevertheless, gains may prove more limited than in recent months as the asset class has been an outperformer for some time now and positioning in some regional markets is probably over stretched. We continue to favor receiver positions in the short-end of the POLGB curve. **Regional currencies**, which have so far broadly underperformed other asset classes in New Europe, have further appreciation potential in the coming months, reflecting improving macro fundaments and broadly manageable external borrowing requirements. We continue to expect the **Polish zloty** and the **Turkish lira** to outperform other regional peers in the coming months on the back of comparably stronger domestic fundamentals.

Global stocks rallied in September; emerging Europe underperformed their peers in LATAM and ASIA, affected by the lingering sovereign debt crisis in the euro area & aggressive fiscal tightening in the region



Source: Bloomberg

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Introductory Comment

Dear Reader,

Most emerging economies in New Europe continue to recover from their late-2008/2009 downturn, amid challenging external conditions due to the lingering sovereign debt crisis in the euro area and double-dip fears in the US economy. However, the speed and dynamism of the ongoing recovery are not uniform across economies in the region. They depend largely on country-specific structural characteristics and the amount of austerity measures local authorities need to apply in order to correct lingering macro imbalances and, thus, reverse earlier policy accommodation.

A three-speed economic recovery is witnessed among the group of New Europe economies we cover in this issue. Turkey and Poland show strong growth, Serbia and Ukraine are rebounding modestly, while Romania and Bulgaria are lagging behind the league.

In Turkey, full-year GDP is expected to exceed 6% this year, while the Polish economy is seen growing by around 3%. The global financial crisis found these economies with relatively low levels of financial leverage and in a better position to deal with external shocks.

Serbia and Ukraine continue to show convincing signs of economic improvement, with the former poised to record GDP growth of around 1.5% in 2010, primarily due to a strong recovery in exports. Serbian authorities continue to implement the present IMF stabilization program with notable success. In Ukraine, following a catastrophic recession last year, the stabilization in the domestic economic environment this year will allow the country to record output growth of 4%. The new government is pursuing new agreements with multilateral organizations, leaving behind an era of domestic political frictions and pronounced uncertainty, thus facilitating a further improvement in investor sentiment.

Bulgaria is expected to display broadly flat - if not slightly negative - growth this year. Yet, the government's fiscal consolidation efforts and a rapidly improving current account balance make us optimistic for a rosier outlook in 2011. Romania is still mired in recession, ghosted by the legacy of credit exuberance and fiscal derailment in the euphoria years. As a result, the government's aggressive fiscal consolidation program (a 25% cut in public wages and a 5pps VAT hike) will continue to weigh negatively on domestic growth for the rest of 2010.

On the monetary policy front, central banks in the region will most likely remain put on rates for the remainder of this year. Market jitters from the ongoing fiscal crisis in EMU and the necessity to maintain low interest rates to support the economic recovery are currently weighing on policy decision. Inflation concerns have remained off the agenda of policymakers for some time now. However, we see increasing upside inflationary risks in the second half of this year, driven by weaker currencies, tax hikes, bad weather conditions and extraordinary events such as the summer wild fires, which destroyed wheat production in Russia and other CIS countries.

On the fiscal front, the accomplishment of the 2010 fiscal targets is challenging and requires additional effort on the part of governments. Many of them are pursuing highly unpopular policies with a view to promote fiscal consolidation, support medium-term macroeconomic stability and secure much-needed funding from international organizations.

Financial markets in New Europe staged a strong rebound in September. Earlier, they had exhibited a remarkable resilience to the euro area sovereign debt crisis and the fears over a double-dip growth trajectory in the world economy. Risk sentiment has clearly improved. Yet, the recent rally should not conceal the fact that the region has broadly underperformed its Asian and Latin America emerging market peers. New Europe does suffer from its close ties with the debt-stricken euro area and from the stringent fiscal tightening programs employed by a number of local governments.

Local rate markets continue to receive support from tame inflationary pressures, a weak domestic demand and scaled-back expectations for future monetary policy tightening. Meanwhile, regional currencies, having underperformed other asset classes in New Europe earlier this year, in recent weeks show an appreciating trend. Vindicating our earlier expectations, the Polish zloty and the Turkish lira were among the outperformers in the recent rally, with both currencies remaining our preferred picks over the next 3-6 months.

External debt markets also firmed since early September, reflecting reduced risk aversion and soothed investor fears over a double-dip in the world economy. Nevertheless, we continue to believe that most markets in the region are expensive, remaining highly susceptible to sudden sentiment shifts in international markets.

Prof. Gikas A. Hardouvelis
Chief Economist & Director of Research

Summary of key macroeconomic indicators
Realizations and forecasts

	GDP real (yoy)			Consumer Prices (annual average)			Current Account (%GDP)		
	2009	2010f	2011f	2009	2010f	2011f	2009	2010f	2011f
Bulgaria	-5.0	-0.3	2.5	2.5	3.0	2.7	-9.4	-3.5	-7.0
Poland	1.8	3.3	3.4	3.5	2.5	2.7	-1.6	-3.1	-3.2
Romania	-7.1	-2.0	1.5	5.6	6.5	4.5	-4.4	-5.5	-6.0
Serbia	-3.0	1.5	3.0	8.2	5.0	4.8	-5.7	-8.5	-9.0
Turkey	-4.7	7.0	5.0	6.3	8.3	7.2	-2.2	-5.5	-5.3
Ukraine	-15.1	4.0	4.2	15.9	10.2	10.5	-1.5	-1.0	-2.1
New Europe	-4.3	4.1	3.9	6.5	6.3	5.7	-2.6	-4.2	-4.5
Euro area	-4.1	1.7	1.8	0.3	1.4	1.6	-0.6	0.0	0.2
USA	-2.4	2.9	2.8	-0.3	1.6	1.5	-2.9	-3.3	-3.4

Source: National statistics, IMF, EC, Eurobank Research forecasts

Foreign exchange and policy interest rates
Realizations and forecasts

		FX Rates			Interest Rates		
eop		2009	2010f	2011f	2009	2010f	2011f
Bulgaria	**vs EUR**	1.96	1.96	1.96	*Currency Board*		
Poland	**vs EUR**	4.10	3.90	4.00	3.50	3.50	4.00
Romania	**vs EUR**	4.23	4.30	4.30	8.00	6.25	6.50
Serbia	**vs EUR**	96.2	110.0	110.0	9.50	9.00	9.50
Turkey	**vs USD**	1.50	1.45	1.40	6.50*	7.00	8.50
Ukraine	**vs USD**	8.00	7.80	8.00	10.25	7.75	7.75
Euro area	**vs USD**	1.43	1.30	1.25	1.00	1.00	1.00
USA	**vs EUR**	0.70	0.77	0.80	0.125	0.125	0.125

Source: National statistics, IMF, EC, Eurobank Research forecasts
*As of May 2010 the CBRT's key policy rate is the 1-week repo rate

I. Overview

Market sentiment brightens on easing double-dip fears

High-frequency macroeconomic data from both sides of the Atlantic over the last few weeks leave not doubt that a slowdown in the pace of global economic recovery is currently under way. That is despite our conviction that investor fears over a double-dip recession in the global economy will likely prove exaggerated. A recent flurry of data released by China, including PMIs and industrial production, surprised on the upside raising optimism that domestic growth is re-accelerating as the authorities started to back away from their earlier aggressive tightening stance. In the Eurozone, news on the macroeconomic front has been generally encouraging. Not surprisingly, at the September policy meeting the ECB revised upwards its real GDP forecasts for both this year and next, primarily thanks to Germany's stellar performance. However, at the post-meeting press conference President Trichet noted that the euro area growth pattern is likely to be uneven and risks are tilted to the downside given lingering global economic uncertainties. Worries over a double dip recession have been actually more pronounced for the US economy lately, in view of stubbornly high unemployment and persistent weakness in the housing market. However, recent positive data surprises in the form of *e.g.* strong gains in business inventories in July, an unexpected improvement in the ISM-manufacturing index in August and upbeat July retail sales have increased optimism that recent double-dip fears may actually prove overblown.

Supportive liquidity condition, expectations for additional QE favors improvement in risk appetite

Strong action from policymakers around the globe to maintain supportive liquidity conditions and safeguard economic growth has also contributed to the recent improvement in market sentiment. At its early September policy meeting, the ECB decided to extend the full allotment regime on weekly, monthly and three-month refinancing liquidity operations in an effort to smooth conditions in the money markets and mitigate funding risks for banks. Furthermore, President Trichet underlined that liquidity-boosting policies will remain in place as long as is necessary, even after the central bank embarks on a monetary tightening cycle. The above followed BoJ's decision in an emergency meeting late last month for more unconventional policy measures aiming to encourage a decline in market interest rates and ease monetary conditions further. Along similar lines, the FOMC repeated its pledge at the September meeting to maintain its key federal funds rate at exceptionally low levels for an extended period. The US central bank also kept the option open to provide further monetary stimulus –probably through asset purchases- if domestic economic conditions deteriorate further or worries over low inflation intensify. In line with the FOMC policy statement, the September BoE MPC minutes showed that policy members fully acknowledged the deterioration in the domestic growth outlook and are prepared for a new round of quantitative easing to stimulate a stagnating UK economy.

Basel III allows longer transition period for banks to comply with new capital requirements

The recent Basel III agreement, which gives banks a longer-than-earlier-anticipated transition period to comply with tougher capital requirements, was an additional factor supporting market sentiment in the last couple of weeks. In an effort to reduce risk-taking by banks and prevent repeated state rescues in the future, global regulators agreed to force banks to more than triple the amount of top-quality capital they must hold in reserve. But, to ease the burden, regulators agreed to give banks a longer transition period to comply with the rules, extended in some cases to January 2019 or later. Growing corporate merger activity also boosted risk appetite. Thomson Reuters data showed that global mergers and acquisition activity announced so far this year totaled $1.678trn, surpassing volumes in the first nine months of last year. M&A activity in June-September period stood at $599bn, the third consecutive quarter of growth, making it the strongest quarter for worldwide activity since Q3 2008.

Global equity indices bounce from late August lows

Reflecting the recent improvement in market sentiment, global equity markets have bounced from their late-August lows, with the Eurofirst 300 index hitting a near five-month high earlier this month. In the European corporate credit space, the investment-grade iTraxx Europe index hit six-week lows a few sessions earlier while the iTraxx Senior Financials pulled back from late August highs. In a similar vein, the S&P 500 implied volatility index, VIX, has come close to its lowest level in 5½ months after hitting a near two-month peak in late August.

…but headwinds remain

Not withstanding the most recent bout of risk appetite, a sustained economic recovery is still some way off as the global economy continues to face important headwinds. Fiscal worries in EMU periphery persist and aggressive austerity programs in several euro area economies pose downside growth risks. Debt restructuring issues in EMU sovereigns remain in investors' radar screens and the danger of another wave of immense market pressures is far from over.

Economic recovery in New Europe continues, albeit at an uneven pace

New Europe financial markets have so far exhibited remarkable resilience to the euro area sovereign debt crisis and rising fears over a double-dip growth trajectory in world economy. Recent macro data broadly point to a continuation of the economic recovery from last year's recession, albeit at an uneven pace across economies in the region. Among the growth outperformers, Turkey and to a lesser extend Poland exhibit already concrete signs of domestic demand recovery. Notably, Turkey posted yet another stellar GDP growth reading in Q2 (+10.3%yoy vs. +11.7% yoy in the prior quarter), outpacing its regional peers by a significant margin and thus, cementing expectations that the country will be the top growth performer in New Europe this year. Poland's economy expanded by 3.5% yoy in the second quarter of this year, following 3% yoy growth in Q1, while Ukraine and Serbia marked respective average growth readings of 5.5% and 1.1%yoy in January-June period. Bulgaria and Romania are poised to underperform other economies in the region as aggressive fiscal austerity programs in both countries have already started to take a toll on domestic consumption and investments. Bulgaria is anticipated to register flat - if not slightly negative - GDP growth this year, after contracting by 3.2%yoy and 1.4%yoy in Q1 and Q2, respectively. Meanwhile, Romania is seen posting negative growth of 2% in 2010, following respective declines of 2.6%yoy and 0.5%yoy in Q1 and Q2. Certainly, the government's recent decisions to cut public sector wages by 25% cut and implement a 5ppts hike in the main VAT rate in a move to comply with the conditions set under the IMF-led financial aid package do not augur well for the outlook of the Romanian economy over the coming few quarters. As we noted in our previous *New Europe Economics and Strategy* issue, headwinds to the region's recovery remain in the face of fiscal austerity programs and a slower rebound in key export markets. Yet, we continue to expect most economies in New Europe to embark on a sustainable growth trend in 2011, with the silver lining of the recent global financial crisis being the correction of earlier acute macro imbalances.

Inflation pressures remain broadly contained, with most central banks in the region likely to stay put on rates in the remainder of 2010

Weak domestic demand dynamics and tame oil prices have assisted to keep price pressures at bay in recent months. Budget revenue boosting measures in Romania (e.g. higher VAT rates) are likely to push domestic inflation even higher in the following months, but price pressures are likely to prove temporary, given continuing weakness in domestic demand. In a similar vein, adverse weather conditions across Central & Eastern Europe and the CIS region in the summer months risk pushing food prices higher near-term. However, any such impact will be cost-push rather than demand-driven and, as such, it should gradually alleviate going forward. As a result, monetary tightening in most countries in the region has been postponed until 2011, as inflation pressures remain subdued and authorities would prefer to avoid measures that risk derailing domestic demand. Note that precipitated monetary tightening at times when major central banks in G7 are seen holding their horses will not only weigh on domestic demand through tightened lending conditions but also promote undue currency appreciation that could hurt New Europe's export-driven economies. Nevertheless, inflation risks may become more apparent next year on the back of improving economic conditions and closing output gaps.

Regional stock markets rally on easing double-dip fears

Financial markets in New Europe have rallied since early September as fears over a double-dip in world economic growth eased, pushing world stocks higher. Nevertheless, the region's close ties with the debt-stricken euro area in tandem with fiscal austerity measures announced recently by a number of governments in New Europe meant a underperformance of the region relative to other emerging markets in Asia and Latam. The *MSCI Emerging Europe* sub-index staged a 7% recovery bouncing to 1-½-month highs in September, but lagged behind a 9% jump recorded by, each, the *World* and benchmark *Emerging Markets* MSCI indices over the same period. Year-to-day, Ukraine's PFTSI index remains the region's top performer, having registered gains to the tune of ca 40%. In a similar vein, Turkey's XU100 has registered gains in excess of 20% since the beginning of the year, while Poland and Romania each stood 12% higher relative to their late 2009 levels.

Local rates markets continue to receive support from bullish global trends, scaled-back expectations for policy tightening by regional central banks

Local bond markets in New Europe firmed further in recent weeks, with monetary tightening by central banks in the region now echoing as a distant prospect. Although double-dip recession fears have somewhat eased recently, the economic recovery in several economies in New Europe remains fragile, being primarily driven by base effects and improving net exports rather than strengthening domestic demand dynamics. At the same time, concerns linger about the sustainability of growth in major trade-partner economies, while global oil prices and domestic inflation pressures remain largely contained. As a result, Romania's 5-year benchmark bond yield stood ca 40bps lower at 5.42% at the end of September from peaks reached earlier in that month. Elsewhere, Turkey's April 25, 2012 benchmark bond stood a tad above an all time low of around 8% achieved a couple of weeks earlier, having risen slightly after the central bank announced it would increase the banks' reserve requirement for both FX and TRY and drain ca $3bn of liquidity from the domestic economy. Among the under performers in the region is the Polish bond market, where a flurry of recent macroeconomic data indicates that the rebound in domestic demand is gaining momentum, adding to expectations that the NBP will be among the first central banks in New Europe to embark on monetary tightening. Along these lines, the 2-year benchmark bond yield spiked to 3-week highs of 4.78% in late September, while the 10-year yield stood 24bps higher from a 16-month low of 5.29% in August.

Regional currencies firm on improved risk sentiment, but still-off their April highs

New Europe FX markets embarked on an uptrend in recent weeks, having largely underperformed other asset classes in the region so far this year. Scaled back expectations of monetary tightening ahead, weak domestic demand dynamics, political jitters in view of fiscal tightening measures and high budget shortfalls are all to blame for the lackluster year-to-date performance of regional currencies. Nevertheless, the recent improvement in risk appetite provided some support, with countries enjoying the strongest fundamentals leading the gains. Along these lines, the Turkish lira rallied strongly in recent weeks, favored by scaled-back expectations of monetary tightening by the CBRT, which is now expected to begin delivering rate hikes not earlier than in H2 2011. A market-friendly outcome in a referendum of constitutional amendments earlier this month also favored. Reflecting these developments, the USD/TRY slid on September 28 as far as a 5-½-month low of 1.4650, with the pair now standing ca 2% lower year-to-date. On the same day, the Polish zloty was hovering near a 4-month peak of 3.9143 vs. the EUR achieved a few sessions earlier when Moody's signaled upward pressures on the country's sovereign credit ratings. Elsewhere, the Serbian dinar broadly continues to trade in tight ranges, with the EUR/RSD rate standing at 105.7 on September 28, remaining below a life time high of 107.78 hit in early August following numerous interventions by the central bank aimed at halting the currency's sharp year-to-date downtrend.

External debt spreads tightened further in September

External debt spreads in New Europe, in the CDS space, tightened by ca 10% since early September, reflecting reduced risk aversion and soothed investor fears over a double-dip in the world economy. Turkey and Poland were among the major outperformers in September, with the former's 5-year CDS spread easing from a 2-month peak of 184bps reached in late August to near three-year lows around 160bps, currently.

Strategy

We continue to expect local rates markets to remain supported in the coming months on lingering concerns over the global growth environment and relatively tame domestic inflation pressures. Nevertheless, gains may be prove more limited than in recent months as the asset class has been an outperformer for some time now and positioning in some regional markets is probably over stretched. In our view, a rate hike scenario in Poland this year may be somewhat exaggerated as the current momentum in domestic demand does yet justify higher policy rates. As such, we continue to favor receiver positions in the short-end of the POLGB curve. In a similar vein, we do not expect Turkey's central bank to incept its monetary tightening cycle before H2 2011, which is somewhat later than that implied by the current market consensus. Note that the median analyst forecast in the most recent Bloomberg poll was for a 50bps rate hike as early as in Q1 2011. Regional currencies, which have so far broadly underperformed other asset classes in New Europe, have further appreciation potential in the coming months, reflecting improving macro fundaments and broadly manageable external borrowing requirements. We continue to expect the Polish zloty and the Turkish lira to outperform other regional peers in the coming months on the back of comparably stronger domestic fundamentals. That said political noise could exert some sporadic depreciation pressures on these currencies, as both countries are braced for general elections next year. Meanwhile, we would not rule out yet another NBP intervention in the FX markets to stop a further sharp appreciation of the PLN, as was the case earlier this year. However, as the rebound in the domestic economy gains traction, the likelihood for such a move is gradually diminishing. Elsewhere, Romania's leu touched 2-week highs near 4.2220 vs. the euro in mid-September receiving support from improving market sentiment and new fund disbursements from the IMF and the EU, as part of the country's EUR 20bn Stand-By Arrangement. Nevertheless, the RON may come under pressure in the coming weeks primarily due to political jitters. Note that the government is facing a no-confidence vote in October as opposition parties are trying to cash in on the minority coalition's fiscal austerity measures. With regards to external debt market developments, we continue to believe that sovereign credit spreads remain too tight at current levels and thus, highly susceptible to external shocks including new fears over the sustainability of the euro area and/or a sharper than expected slowdown in the global economy in the period ahead.

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II. New Europe – Country Analysis

Bulgaria

Robust export growth leads industrial sector's rebound, helps current account improve by more than expected

- **With domestic demand still weak, we expect full-year GDP growth to contract by 0.3%**
- **Robust exports growth drives current account deficit down to 0.8% of GDP year-to-July, a higher than expected improvement**
- **Domestic credit conditions remain tight, but level of non performing loans in H1-2010 remained low by regional standards**

Bulgaria: Eurobank EFG Forecasts

	2008	2009	2010f	2011f
Real GDP (yoy%)	6.0	-5.0	-0.3	2.5
Private Consumption	4.8	-6.2	-3.0	2.0
Government Consumption	0.0	-5.7	2.0	0.4
Gross Capital Formation *(Fixed)*	20.4	-26.9	-8.0	2.5
Exports	2.9	-9.8	6.5	5.0
Imports	4.9	-22.3	-0.5	4.0
Inflation (yoy%)				
HICP (annual average)	12.0	2.5	3.0	2.7
HICP (end of period)	7.2	1.6	4.2	3.0
Fiscal Accounts (%GDP) - *EU Methodology*				
General Government Balance	1.8	-3.9	-3.8	-2.8
Gross Public Debt	14.1	14.8	18.6	21.7
Primary Balance	3.9	0.0	-2.0	-1.5
Labor Statistics - *National Definitions*				
Unemployment Rate (% of labor force)	6.3	7.6	9.0	8.0
Wage Growth *(total economy)*	26.5	8.5	2.0	2.5
External Accounts				
Current Account (% GDP)	-25.4	-9.4	-3.5	-7.0
Net FDI (EUR bn)	6.2	3.3	1.0	1.5
FDI / Current Account (%)	75.8	103.6	80.0	60.0
FX Reserves (EUR bn)	12.7	12.9	12.0	11.5
Domestic Credit	**2008**	**2009**	**Q1 10**	**Q2 10**
Total Credit (%GDP)	75.2	79.2	78.9	79.2
Credit to Enterprises (%GDP)	47.8	49.4	49.2	49.4
Credit to Households (%GDP)	26.0	28.2	28.1	28.1
FX Credit/Total Credit (%)	57.2	58.6	59.5	60.1
Private Sector Credit (yoy)	32.3	4.5	3.3	2.8
Loans to Deposits (%)	119.3	120.5	116.3	114.3
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

Revised Q2 GDP data leaves our assessment for full-year growth unchanged

The statistical agency revised the flash estimate for Q2 GDP from -1.5% yoy to -1.4% yoy. Although the headline figure remained broadly unchanged, the composition was significantly different relative to the initial readings. From a sectoral standpoint, agriculture expanded by 3.8% yoy (revised upwards from 1.6% yoy in the flash GDP report). The gross value added in industry turned positive by 1.6% yoy (compared to a -0.3% yoy decline in the flash data), following a -0.9% contraction in Q1. The latter was a reflection of two opposing forces: weak construction activity (-1.6% yoy in Q2) due to still anemic conditions in the domestic real estate market and a strong rebound in manufacturing output (+2.9% yoy in Q2) thanks to higher external demand for Bulgarian exports. Services were to be the only sector with negative performance, reflecting still subdued domestic demand dynamics. Yet the pace of contraction in services slowed down relative to both the advance Q2 reading and the prior quarter (-0.3% yoy vs. -1.7% yoy and -1.2% yoy, respectively). As a result, overall gross value added in all sectors expanded by 0.5% yoy in Q2. However, GDP declined by 1.4% over that quarter due to the adjustment of VAT and excise taxes, which implies high level of tax evasion and low tax revenue collection.

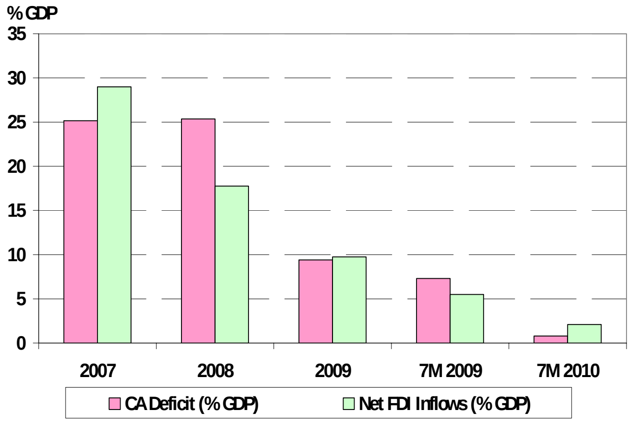
On the demand side, the pace of contraction in private consumption slowed to -4% yoy in Q2 compared to -7.6% yoy reported initially *(flash estimate)* and -6.8% yoy in the prior quarter. Public spending was also particularly weak (-19.2% yoy) affected by the government's fiscal consolidation program, with investments also recording a steep decline (-12.2% vs. -1.4% yoy reported in the flash data and -15.8% yoy in the prior quarter). On a more favorable note, the (positive) contribution of the external sector increased in the second quarter relative to Q1, as exports growth accelerated to 12.4% yoy, from 7.6% yoy and imports remained broadly flat on an annual basis after declining by.-2.6% in the first quarter.

All in all, the Q2 GDP revisions do not alter our full-year growth forecast of -0.3 yoy. In line with what we suggested in our previous New Europe Economics & Strategy issue *(August 2010)*, the most recent macro data confirm our view that the worst of the domestic recession was seen in the last quarter of 2009. For the time being, the continued slump in domestic demand is outweighing marginally the recovery in net exports. For the year 2010 as a whole, we do not anticipate domestic demand to have a positive contribution to overall GDP growth, given its pace of contraction in H1. Yet, we expect domestic demand's contribution to become less negative in the second half of this year. If this is combined with a continuing boost from the external sector, annual GDP growth should turn positive in H2, especially in the last quarter of 2010. Unless positive exports dynamics fade out in H2, we stick to our earlier forecast for ful-year GDP contraction of -0.3% yoy, which is now quite close to the market's consensus (*Focus Economics Consensus* in August:-0.4% yoy).

Robust exports growth drives significant improvement in the current account balance

The current account recorded a surplus for a second month in a row in July, coming in at €529mn, from an *(upwardly revised)* €13.4 mn in June and comparing with a deficit of €76.2 mn in the same month a year earlier. For the first seven months of 2010, the cumulative current account recorded a deficit at €278mn, which was down 89.2% yoy relative to that in the same period in 2009. In percentage of (projected) GDP terms, the current account gap stood at 0.8% year-to-July 2010 vs. 7.3% of GDP in the first seven months of 2009. (Figure 1)

Figure 1: Current account deficit shrinks further in Jan-July 2010



Source: National Bank of Bulgaria

This improvement reflects mainly a smaller trade gap (down 3.8ppts of GDP year-on-year in January-July 2010 at 4% of GDP), owing to a strong recovery of exports (+29.8% yoy). Imports grew by 6.1% yoy in January-July 2010, having recorded negative annual growth until April. Exports to non EU-markets expand more rapidly benefiting mainly from the rebound in the Turkish economy (+77.3% yoy in July against 49.1% yoy in June). Besides a lower trade gap, other elements have also contributed to the current account improvement year-to-July. Although revenues from tourism and transportation from foreign visitors remained flat compared to last year, net services recorded a surplus increased by 52% yoy thanks to less transportation services used by domestic residents. In addition, the income deficit came out much lower (down by 18.5% yoy) because foreign-owned companies paid out less dividends to mother companies abroad. Moreover, net current transfers recorded a higher surplus (+69% yoy), thanks to increased EU funds inflows.

From the funding side, the capital and financial account recorded a deficit of €317mn in the first seven months of this year. The most important component, net FDI inflows, remained sharply lower (down 64.7% vs. a year earlier), amounting to €663 mn. The sectors affected the most were real estate and financial intermediation. However, the FDI-to-current account coverage improved to 238% year-to-July, from 73% in the corresponding period last year. Elsewhere, net portfolio investments remained negative (-€467mm vs. -€537mn in January-July 2009), while the negative net balance of €635 mn in other investment reflects the repayment of foreign debt obligations by the banking and corporate sectors. Overall, the private sector's gross external debt registered a small decline to 93.6% of GDP in August compared to 96% in late 2009.

Overall, the balance of payments was negative (-€802 mn) in the first seven months, which explains the drop in international reserves. Despite the 10% drop in international reserves (FX reserves plus gold and IMF drawing rights) since the beginning of the year, those were maintained at relatively high levels (€12.5 bn or 35.8% of GDP in August 2010), enough to cover the country's external financing needs, despite earlier concerns to the opposite. International reserves coverage of short term debt improved to 105.9% in August vs. 92% in August 2009, though remaining significantly lower than 130% in late 2007.

Domestic lending conditions still tight; nonperforming loans remained low by regional standards in H1: 2010

The Lehman Brothers collapse in September 2008 brought an abrupt end in the lending boom in Bulgaria, with BNB measures aiming to boost domestic liquidity and encourage lending (e.g. cuts in minimum reserve requirements) having only partial success. Credit growth to the non government sector landed to a single digit of 4.5% yoy at the end of 2009 compared to 47.9% yoy a year earlier. Ever since, credit creation remained stagnant, growing cumulatively by just 0.3% yoy in H1-2010. The lack of adequate domestic funding sources, as this is manifested in the high loans to deposits ratio (114.3% in 1H-2010), severely constrains new lending. Credit to households has retreated slightly by -0.1% yoy cumulatively in H1 as households prefer to repay their debts. At the same period, credit to corporates registered negligible growth of 0.3% yoy. Total credit as a percentage of GDP stood at 79.2% at the 1H-2010, one of the highest ratios in New Europe.

On the other hand, NPLs have risen modestly so far, reaching 9.5% in June 2010 compared to 5.2% in September 2009. Overall, it appears that the domestic banking sector has fared pretty well during the economic downturn. Banks have been very successful in renegotiating loan agreement with existing clients. Yet taking into account that NPLs is a lagging indicator of economic activity, it is very likely to rise a little further in the coming months. Part of the Bulgarian banking sector's resilience to the global credit crunch and, more recently, the euro area sovereign debt crisis is due to its (geographically) diverse ownership structure, which is a crucial difference relative to the Baltics region. Moreover, the local banking sector carries strong capital buffers. Those are reinforced by those large foreign-own subsidiaries who have committed to maintain their overall exposure in the country to at the levels recorded in last May. In contrast to 1997, where a banking crisis turned into an economic crisis, the solid domestic banking system now appears to be an anchor of stability in the Bulgarian economy. In terms of capitalization, the banking sector scores relatively high in the region. The capital adequacy stood at 17.3% in H1 against 14.3% before the onset of the crisis in September 2008 which provides enough comfort against rising NPLs and optimism for the banks to extend new lending when economic conditions improve.

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Poland

Monetary Policy Committee strongly divided on rates

- **Economic activity remained strong in the second quarter of 2010, with real GDP rising by 3.5% yoy; the fastest pace of growth since Q3-2008**
- **Narrowing fiscal deficit largely due to revenue-side rather than cost-cutting measures. Further fiscal tightening likely to be needed in the period ahead**
- **July's current account widening reflects worsened trade balance on the back of slowing exports growth**
- **August inflation at 2% yoy, unchanged from a month earlier**
- **MPC strongly divided on policy rates**

Poland: Eurobank EFG Forecasts

	2008	2009	2010f	2011f
Real GDP (% yoy)	5.0	1.8	3.3	3.4
Private Consumption	5.8	2.3	2.8	3.0
Government Consumption	7.4	1.9	2.4	2
Gross Capital Formation	6.4	-13.8	1.6	7
Exports	7.3	-7.8	12.5	10.2
Imports	8.4	-13.5	13.4	10.4
Inflation (% yoy)				
CPI (annual average)	4.2	3.5	2.5	2.7
CPI (end of period)	3.3	3.5	2.4	2.8
Fiscal Accounts (% GDP)				
General Government Balance	-3.7	-7.1	-7.3	-7.0
Gross Public Debt	47.2	51.0	55.0	57.0
Labor Statistics (%)				
Unemployment Rate (% of labor force)	9.8	11	11.5	11
Wage Growth *(private sector - average)*	NA	4.2	3.0	3.2
External Accounts				
Current Account (% GDP)	-5.0	-1.6	-3.1	-3.2
Net FDI (bn EUR)	8.0	6.1	7.5	8.5
FDI / Current Account	43.7	122.2	80	85
FX Reserves (bn EUR)	40.6	54.8	72	68
Domestic Credit	**2008**	**2009**	**Q1-10**	**Q2-10**
Total Credit (% GDP)	50.9	53.1	52.2	54.4
Credit to Enterprises (% GDP)	17.6	16.1	15.7	15.8
Credit to Households (% GDP)	29.7	31.6	31.6	33.6
FX Credit/Total Credit (%)	32.6	30.2	29.3	31.8
Private Sector Credit (% yoy)	38.1	7.2	1.2	7.2
Loans to Deposits (%)	106	102.6	100.6	103.2
Financial Markets	**Current**	**3M**	**6M**	**12M**
Policy Rate	3.50	3.50	3.75	4.00
EUR/PLN	3.97	3.90	4.00	3.90

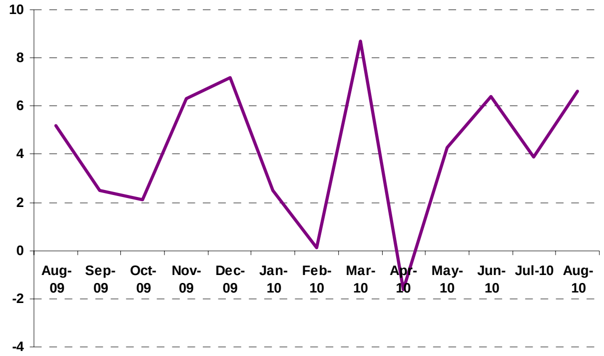
Source: NBP, EcoWin, Bloomberg, Eurobank Research

Economic activity remained strong in the second quarter of 2010

Economic activity continued to be strong in the second quarter of 2010, with GDP growth rising by +1.1% / 3.5% qoq/ yoy, the fastest rate since Q3-2008. The major driver of Q2 growth was domestic demand, which accelerated further on the back of higher inventories and strengthened private consumption. On a less positive note, private investment continued to suffer from uncertainties about the global economy and low capacity utilization rates in industry. Yet, public investment (especially EU co-financed infrastructure projects) continued to grow at a strong pace, reflecting increased public works ahead of the 2012 European football championship, which will be hosted by Poland. With the impetus from stock-building likely to somewhat peter out in the period ahead and employment growth remaining sluggish we may see some moderation in the pace of economic expansion during the second half of 2010. We forecast full-year GDP growth of 3.3% yoy, which compares with European Commission's current forecast of 3.4% yoy.

With respect to higher-frequency indicators of domestic economic activity, note that industrial production *(in seasonally adjusted terms)* expanded by 13.5% yoy in August, following growth of 10.5% yoy in the second quarter of 2010. Retail sales also surprised on the upside in the same month, growing by 6.6% yoy compared to a median market forecast of 5.2% yoy and July's 3.9% yoy realization. The main driver of the strong retail sales reading in August was household goods (+33.7% yoy), which appears to be consistent with private consumption growth of around 3.0% yoy in Q3-2010 (the same level as in Q2-2010) (Figure 1).

Figure 1
Retail sales surprised on the upside reflecting private consumption resilience



Source: National Statistics, Eurobank Research

Further fiscal tightening measures likely to be needed down the road

The Polish government has recently put forward a plan which limits expenditure growth to no more than domestic inflation plus 1%. But, this rule only covers discretionary spending, which comprises just a quarter of total government expenditure. The remaining three quarters of total public spending, *i.e. the so called fixed spending* component, comprise the main structural problem of the country's fiscal position, in our view. Containing that relative inelastic component of government expenditure certainly requires more drastic *(and potentially unpopular)* fiscal consolidation measures. Yet, taking into account that parliamentary elections are scheduled to be held in autumn 2011, it appears unlikely that the government will instrument more fiscal austerity before then. The government forecasts the general government deficit to edge down to 6.9% of GDP in 2010 from 7.1% of GDP in 2009, based largely on revenue-raising measures.

July current account deficit nearly double than expected

Poland's current account deficit widened to €1.54bn in July, nearly twice as much as the market consensus of €0.95bn. This came out as imports outpaced exports and payments to foreign investors increased. What's more, the current account deficit almost doubled relative to a year earlier; it stood at €776mn in July 2009. This deterioration reflects mainly a widened trade gap on the back of slower export growth. The trade deficit reached €865mn in July, driven by lower export receipts (+16% yoy vs. June's 29% yoy), which more than offset a concomitant slowdown in imports *(19% yoy vs. 28% yoy in June).* If these trends continue in the August-September period, net exports will likely exert a higher drag on GDP growth in Q3, relative to the prior quarter. Another contributing factor to the current account deterioration in July was higher dividend payments (€753mn) by foreign subsidiaries operating in Poland. Lower FDI inflows (€154mn in July compared to average €720mn/month in H1-2010) also played a role, though this slowdown is likely to prove temporary. Note that 12-month cumulative figures for FDI inflows reach €10.7bn in July vs. €7.6bn a year earlier. All in all, we anticipate a further widening in the current account deficit in the following months, with the full-year gap coming in at 3.1% of GDP.

Domestic CPI flat in August; reaches lowest level since early 2007 in EU-harmonized terms

Polish inflation was 2.0% yoy in August, unchanged from a month earlier and slightly less than the consensus of 2.1% yoy. On a monthly basis, inflation fell to -0.4% mom, following a -0.2% mom reading in June. In EU-harmonized terms, Polish HICP inflation fell to 1.9% in July; its lowest level since February 2007. Inflation has been running below the lower bound of the NBP's target of 2.5% and below expectations for several months, driven mainly by lower-than-previously anticipated food price increases. We forecast annual inflation to average ca 2.5% yoy in 2010 compared to 3.5% yoy in 2009.

Monetary Policy Committee strongly divided on policy rates

Policy minutes following the August MPC meeting were published recently and revealed that some MPC members advocated a rate hike of 50bps, while others a 50bps rate cut. However, none of the motions did get a majority and interest rates remained, for 14th month in a row, unchanged at 3.50%. The MPC doves pointed out that domestic economic activity might be negatively affected by weakening growth abroad and higher risk premia in case of a further significant fiscal relaxation.

They also emphasized that despite initial worries, domestic food prices have so far been broadly contained and headline inflation remains below the 2.50% NBP inflation target. On the other hand, the MPC hawks, pointed out that higher growth in producer prices might be indicative of increase pipeline pressures in the period ahead. They also initiated a debate about lowering the current NBP inflation target to 2% so as to be consistent with the ECB's price stability threshold. Moreover, they appeared confident about the rebound of the Polish economy and they addressed the long lags associated with the effects of monetary policy moves. We don't expect NBP to deliver any interest rate change until at least the first months of 2011, given lingering uncertainty over the outlook of the Euro zone economy. We anticipate the first hike to occur in Q1-2011 taking the key policy rate at 4.00% by the end of next year.

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Romania

Public dissatisfaction grows against IMF programamid challenging economic conditions

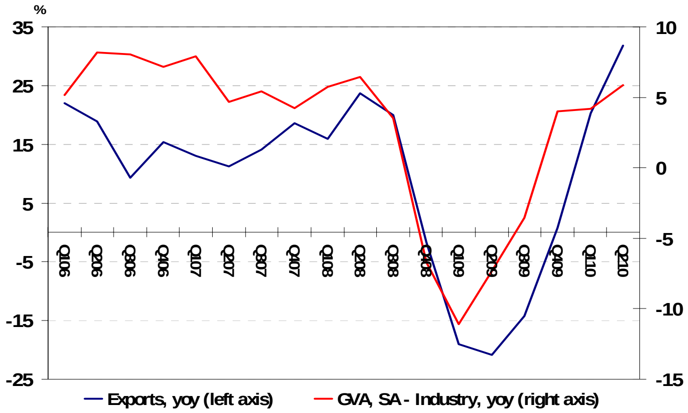
- **Aggressive fiscal consolidation program weighs negatively on domestic economic activity; high frequency indicators point to further contraction in H2-2010**
- **Growing public discontent against the weak government coalition may lead to new political jitters ahead**
- **Fiscal austerity package likely to push NPLs even higher, forcing banks to generate additional provisions in H2**

High frequency indicators portray a less encouraging picture for the domestic economy in the second half of 2010

The final data released on second quarter GDP contained no surprises. Economic growth declined by -0.5% yoy in Q2 on top of a 2.5% yoy contraction in the prior quarter. On a seasonally adjusted basis, GDP grew by 0.3% qoq, a positive reading for the first time since the third quarter of 2009. The decomposition of the Q2 GDP data showed that the recovery was driven by the industrial sector, which recorded growth of 5.9% yoy /4.2% qoq. The improvement was largely driven by higher exports. The surge in June factory orders (+34.6% yoy) sends a positive signal for the outlook of domestic industry, with positive growth in the sector likely to continue in the months ahead, albeit at a slower pace as a result of lower external demand from the EU (Figure 1).

Figure 1

Exports pulled industrial sector out of recession



Source: National Statistics

Romania: Eurobank EFG Forecasts

	2008	2009	2010f	2011f
Real GDP (yoy%)	7.3	-7.1	-2.0	1.5
Private Consumption	9.5	-10.5	-2.5	1.0
Govern. Consumption	7.1	0.8	-2.0	-1.0
Gross Capital Formation	16.2	-25.3	-10.0	2.5
Exports	8.7	-5.5	20.0	10.0
Imports	7.8	-20.6	15.0	8.5
Inflation (yoy%)				
CPI (annual average)	7.9	5.6	6.5	4.5
CPI (end of period)	6.3	4.7	8.0	4.0
Fiscal Accounts (%GDP)				
General Government Balance (ESA 95)	-5.4	-8.3	-7.8	-6.4
Gross Public Debt (ESA 95)	13.3	23.7	35.5	41.9
Labor Statistics (annual avg,%)				
Unemployment Rate (% of labor force)	4.0	6.3	9.0	7.5
Wage Growth (total economy)	23.6	8.4	5.5	6.5
External Accounts				
Current Account (%GDP)	-11.6	-4.4	-5.5	-6.0
Net FDI (EUR bn)	9.5	4.8	4.5	5.0
FDI / Current Account (%)	57.6	94.3	65.0	61.5
FX Reserves (EUR bn)	26.2	28.3	31.5	35.0
Domestic Credit *(end of period)*	**2008**	**2009**	**Q1 10**	**Q2 10**
Total Credit (%GDP)	42.7	50.2	50.5	53.3
Credit to Enterprises (%GDP)	18.8	19.6	19.7	20.9
Credit to Households (%GDP)	19.7	20.4	19.9	21.1
FX Credit/Total Credit (%, private)	53.1	60.1	60.4	61.6
Private Sector Credit (yoy)	33.7	0.9	-1.6	6.4
Loans to Deposits (%)	131.9	130.6	126.5	136.6
Financial Markets	**Current**	**3M**	**6M**	**12M**
Policy Rate	6.25	6.25	6.25	6.50
EUR/RON	4.26	4.30	4.35	4.35

Source: National Sources, Eurostat, IMF, Eurobank Research

The performance of services was exceptionally weak in Q2. Retail services, the most important indicator of consumer vigor, contracted by -4.2% yoy/-1.9% qoq. Construction activity also declined in the second quarter (-8.3% yoy/-0.1% qoq vs. -17.3% yoy/ -5.9% qoq in Q1). The relative slowdown in the pace of contraction in domestic construction activity in Q2 is likely to prove temporary, given the postponement of a number of big infrastructure projects and the lingering recession in the residential housing sector.

On the demand side, only consumption posted a minor gain in Q2. It grew by 0.6% qoq against -1.6% qoq in Q1, remaining though on a negative territory on a year-on-year comparison (-0.7% yoy in Q2 vs. -4.0% yoy in Q1). Investments had a negative contribution for another quarter declining, significantly by -9.5% yoy /-4.4% qoq. Furthermore, faster growth in imports (+24.5% yoy) relative to exports (+21.4%) render the external sector a negative contribution to overall growth in Q2.

Looking ahead, recent readings in a range of high-frequency indicators of domestic activity portray a gloomier picture for the Romanian economy in H2-2010.

The sharp contraction in July retail sales (-10.5% mom), following the implementation of the 5ppts VAT hike as well as the weaker industry output (+3.4% yoy vs. 6.8% yoy) and construction (-25% yoy) readings predispose for a further decline in real GDP growth in Q3. The disappointing data strengthen the possibility of a double-dip recession is the Romanian economy in the period ahead. The new austerity measures, put into effect on July 1, are likely to hit domestic demand, which is already the weakest link of the Romanian economy. Besides the recent aggressive VAT rate hike, public wage cuts of 25% and the slashing of public spending on goods and services by another 20% are expected to put disposable incomes under more severe pressure.

All in all, the government's austerity fiscal package will likely result in the economy contracting again in 2010. We forecast -2% yoy growth for the year as a whole. To complicate things further, uncertainties with respect to the implementation of the fiscal consolidation are high and may weigh negatively on the growth outlook. The biggest risk for private consumption stems from any further revenue-boosting measures that might be needed down the road (e.g. a new hike in VAT and/or higher income taxes). Furthermore, the potential spillover impact of a slowdown in the Eurozone recovery on the external sector will put even more strain on the economy.

Public discontent against the government's austerity program grows; IMF approves fifth program review

On Sep 24th, the IMF Board endorsed the fifth review of the present SBA with Romania. The Fund assessed that all conditionalities were met in H1, with the exception of the target for government arrears and the indicative target of current primary spending. The completion of the review enables the Central Bank to gain access to a further €913mn tranche of IMF funding bringing the overall disbursements to €11.3 bn. The sixth tranche, since the beginning of the program in March 2009, will be utilized to boost FX reserves for balance of payments support. Accordingly, EU disbursed the latest €1.15bn EU tranche, out of the total designated €5bn.

On the other hand, public dissatisfaction grows against the ruling coalition. The popularity of President Basescu and his ruling party DLP have plunged to new lows. According to the latest polls, both the President and the DLP rank third behind their major competitors. Prime Minister Boc, who narrowly escaped being overthrown by his own party, reshuffled his cabinet in early September, in an attempt to change the climate. Six of the fifteen ministers were replaced, including the Finance Minister Mr Vladescu.

Recent opinion polls hint that the major opposition party, SDP, would be able to gain the first position with a good chance to form a new coalition government. As such, the latest polls give a strong incentive to the opposition parties to attempt to overthrow the present current coalition government, which relies on independent and ethnic minority MPs to maintain very thin majority in parliament (4 seats). The opposition is preparing to file another vote of no confidence against it in the new parliamentary session. In a more alarming note, the opposition could attempt to challenge President Basescu with a new poll, initiating the impeachment procedure, given his low popularity. According to a survey, 65% of the respondents would vote to overthrown him.

In our previous (August 2010) *New Europe Economics& Strategy* issue, we had warned that the rejection of the no vote confidence last June did not necessarily mean a more stable domestic political environment in the period ahead. At that time, the government coalition survived a no confidence vote by a narrow margin of 8 votes. The parliament members who voted for the motion were more than those who voted against it (228 against 197), yet less than those required for the motion to be approved.

In conclusion, there is still a high risk of increased social unrest in the coming months. Labor unions are preparing new demonstrations to confront the government's austerity package. All in, the current government will may not be able to complete its full term, which expires in late 2012. There is a strong chance that political instability may hurt the ability of the government to implement its fiscal consolidation program. If such a scenario materializes, then RON and RON denominated assets will look highly vulnerable.

Focus Romania

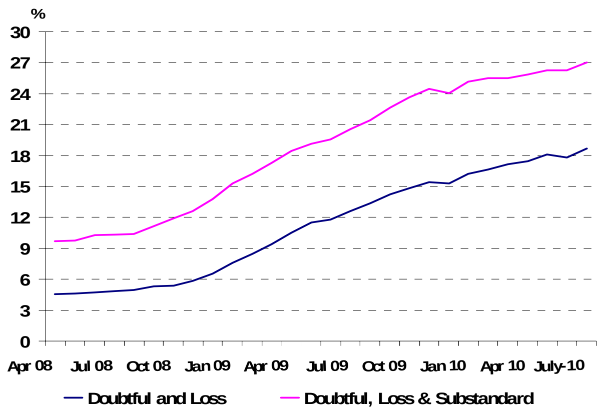
The impact of fiscal consolidation on the banking sector and recent credit developments

Fiscal austerity package may undermine asset quality further

The impact of the fiscal consolidation package introduced in June has started to take a toll on the domestic banking sector. The austerity measures will most probably undermine further the quality of credit portfolios. NPLs, based on the loans categorized as doubtful and loss by the Central Bank, have more than doubled from 6.5% in 2008 to 15.3% in late 2009 and climbed further in recent months, reaching 18.6% in July 2010. According to the IMF definition, which includes also loans classified as substandard, NPLs amounted even higher to around one third of total MFI loans in July. (Figure 2)

Figure 2

NPLs still on a rising trend



NPLs in the consumer segment are expected to rise further. According to the latest IMF report (released in July), the recent slowdown in the impairments of consumer loans may suggest that NPLs in the sector may have peaked. However, public sector employees are going to sustain further income losses that would impair further their ability to service their debts. Before the onset of the international crisis, public sector employees were favored by the banks as customers. Their steady employment status gave them easier and preferential access to bank lending.

In addition, bankruptcies in the small and medium enterprise and corporate sectors are still rising. Despite the loosening of insolvency criteria in the amended bankruptcy law, the percentage of firms in financial distress has climbed to 5.9% since the onset of the international financial crisis in September 2008. Among other factors, that happened because of deteriorating economic conditions. In addition, the receivables turnover rate, which measures how quickly clients pay their obligations, has risen considerably. This is an illustration of the deterioration in credit conditions, limited access to bank loans and weak domestic demand.

More importantly, the rise of government unpaid bills has played an equally important role. The rise of government arrears to the private sector has created a negative environment for domestic contractors to the public sector. The government has been systematically postponing paying its outstanding debts in order to achieve the quarterly fiscal targets set in the IMF program. As a result, unpaid bills had reached 1.95 bn RON (approximately €460 mn) at the end of July. Half of the aforementioned amount comes from local governments. For that reason, the IMF has conditioned the approval of the next tranche on the decline of the government arrears to zero. Such a move could give additional breathing space for the real economy, helping to partially offset the negative impact of aggressive public wages cuts.

Banking sector holds sufficient capital, but may need to generate additional provisions in lieu of a further deterioration in economic conditions

According to the Financial Stability report, banks hold sufficient capital buffers to withstand the potential deterioration of economic conditions. In fact, the capital adequacy ratio increased at 14.3% in H1-2010 compared to 14% in 2009 and 13.8% in 2008. Central Bank has been proactive in asking for capital increases in a number of banks. In addition, profits were used to increase retained earnings instead of given out dividends. On the positive side, all domestic banks have capital ratios in excess of 10%. Greek banks remain a bright example in terms of capital adequacy standards. The average capital ratio for Greek bank subsidiaries (20% of total banking system assets) stood at around 17.5%, higher than the corresponding average industry-wide average.

Nevertheless, we anticipate domestic banks to come under renewed pressure in H2. They are expected to make additional NPLs provisions, following an aggressive provisioning policy in the first half of the year. Total provisions of the banking sector had reached RON 20.1bn in July, having increased by 41% yoy in the first seven months of 2010. Yet they still covered around only 51% of official NPLs against 45.8% in last December. That said, the banking system will likely be forced to generate additional provisions to withstand the deteriorating loan portfolios quality. The latest stress tests performed by the Central Bank indicate that provisioning could increase as much as by 38% in 2010 and further by 21% in 2011.

Credit activity in the non government sector shows some signs of revival, underpinned by FX loan creation

Credit to the private sector has lately shown some signs of revival. Lending to the private sector expanded by 3.4% yoy year to July against -0.1% at the same period in 2009. After recording negative year-on-year growth earlier this year, non-government credit was up by 4.4% yoy in July compared to 6.4% yoy in June. 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 macro/prudential risks in case of a sharp depreciation of the local currency. FX credit grew by 5.3% year to July against 3.1% in the same period last year. That came as the result of the positive contribution of both segments, corporate and household which expanded by 5.4% yoy and 8.6% respectively. In contrast RON lending contracted by 3.3% over the same period. The household component was particularly weak, declining by 3.7% yoy while credit to the non-financial corporations grew slightly by 1.3% yoy.

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Serbia

Central Bank hikes interest rates again on rising inflation risks, increasing risk premia

- **The second hike in less than a month of the key policy rate to 9.00% halted the depreciation trend of the dinar at around 105/€**
- **Inflation climbed further to 7.2% yoy in September on higher food prices, almost touching the ceiling of the Central Bank target band**
- **The IMF reached an agreement with the government to unfreeze pensions and public wages three months earlier than expected**

The Central Bank surprised markets once again in early September, hiking rates further and putting a temporary floor in dinar depreciation

On September 8, the Central Bank raised its key policy rate by 50 bps to 9.00%. This was the second rate hike after another hike in early August, when the NBS terminated its policy easing cycle, which had begun in late 2008. The move was not entirely expected by the market. While the Central Bank had signaled that further monetary tightening was probable before the end of this year, markets expected this to happen only at a later stage. An earlier Bloomberg poll, which was conducted ahead of the policy meeting, showed that sixteen out of twenty-two economists surveyed, expected rates to remain unchanged. In the statement released after the policy meeting, the Central Bank cited the negative impact on inflation from increased prices of agricultural products due to the poor domestic wheat crop and higher international prices as a result of the Russian export ban.

Food prices were a negative contributor to July inflation, but that trend changed in August. Food prices, which carry significant weight in the CPI basket (37.8%), rose by 2.6% mom / 4.4% yoy. Regulated prices also climbed higher in August, reaching 10% yoy compared to 9.5% yoy in July. On the other hand, transportation prices, which were a key driver of domestic inflation in the previous two months, eased to 10.5% yoy in August from 11.1% yoy in July. Reflecting the aforementioned developments, domestic consumer price inflation climbed to 6.7% in August, from 5.1% yoy in July and 4.2% yoy in June. The Central Bank anticipates the spike in food prices to continue in the following months, with headline inflation reaching 7.2% yoy in September. Yet, even such a reading would still lie within the official target band (4-8%) for year-end 2010. Nonetheless, given that the rising trend in domestic inflation is likely to continue, further hikes in the key NBS policy interest rate cannot be ruled out.

Serbia: Eurobank EFG Forecasts

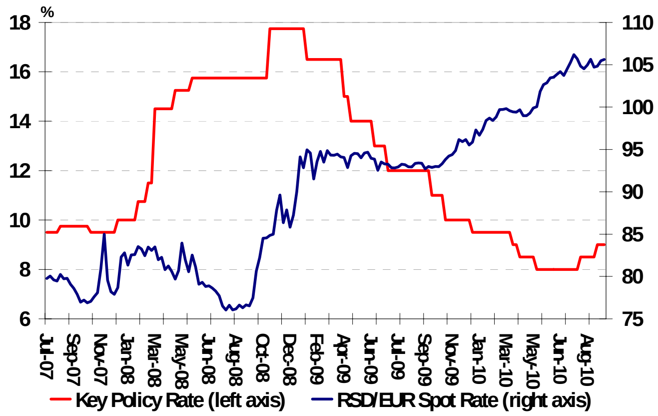
	2008	2009	2010f	2011f
Real GDP (yoy%)	5.5	-3.0	1.5	3.0
Inflation (yoy%)				
CPI (annual average)	12.5	8.2	5.0	4.8
CPI (end of period)	8.6	6.6	6.5	4.5
Fiscal Accounts (%GDP)				
General Government Balance	-2.6	-4.2	-4.8	-4.0
Gross Public Debt	25.6	31.3	37.0	41.0
Labor Statistics (%)				
Unemployment Rate (%of labor force, ILO)	14.7	16.1	18.5	16.5
Wage Growth *(total economy)*	17.9	4.1	4.8	6.7
External Accounts				
Current Account (% GDP)	-17.1	-5.7	-8.5	-9.0
Net FDI (EUR bn)	1.8	1.4	1.5	2.0
FDI / Current Account (%)	30.0	78.7	55.0	70.0
FX Reserves (EUR bn)	8.2	10.6	11.3	10.2
Domestic Credit	**2008**	**2009**	**Q1 10**	**Q2 10**
Total Credit (%GDP)	41.0	48.7	51.2	56.1
Credit to Enterprises (%GDP)	25.8	29.4	30.8	32.9
Credit to Households (%GDP)	14.0	14.7	15.3	16.4
Private Sector Credit (yoy)	34.9	14.3	12.9	23.1
Loans to Deposits (%)	125.1	127.0	133.2	138.7
Financial Markets	**Current**	**3M**	**6M**	**12M**
Policy Rate	8.50	9.00	9.00	9.00
EUR/RSD	105.60	110.00	110.00	110.00

Source: National Sources, Eurostat, IMF, Eurobank Research

Macro implications of monetary policy tightening

An additional factor, and the most important one in our view, weighs more in NBS policy deliberations. This is the pace of dinar depreciation in recent months and the recent rise in government bond yields. The Dinar has come under significant depreciation pressures since late September 2009. Those pressures were intensified in the summer months despite repeated Central bank interventions. The Central Bank spent a total of over €1.7bn in the first eight months of 2010 in (broadly unsuccessful) dinar-supporting interventions. Then, when the dinar reached a new historic low at 107.04/€ on August 2, the Central Bank was apparently forced to hike interest rates. The domestic currency recouped some of its losses before starting to weaken again, reaching 105.6/€ on September 6, thus prompting the Central Bank to intervene again. Ever since, the dinar has remained broadly flat and volatility has subsided in the domestic FX market. (Figure 1)

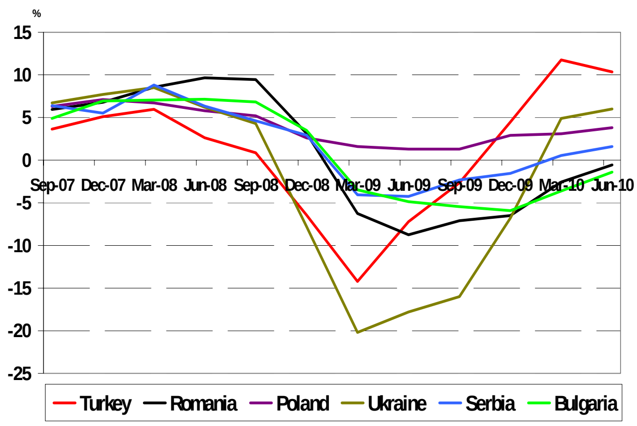
Figure 1:
A second hike in less than a month of the key policy rate to 9.00% halted the depreciation trend of the Dinar at around 105/€



Source: Bloomberg, National Bank of Serbia

The negative developments mentioned above along with the recent surge in domestic inflation have dented investor demand for dinar-denominated securities. The government failed to attract the required amount in its latest auction of twelve-month Treasury bills on September 23. The Ministry of Finance sold RSD 2.22bn in Treasuries, which represents 73.9% of the targeted amount. The average yield rose to 12.8% from 12.5% at the previous auction last month. It is not the first time this is happening during this summer. Recall there were not enough bids in six out of 25 debt auctions since the start of June.

Figure 2:
Real GDP grows modestly compared to other New Europe economies in 1H-2010



Source: National Statistics

The recent stream of macroeconomic data suggests that Serbia exited the recession at the end of last year. After four consecutive quarters of negative growth, the Serbian economy registered a mild rebound compared to other New Europe peers (Figure 2). Real GDP grew by 0.6% yoy in Q1 and accelerated further to 1.6% yoy in Q2 (flash estimate of the Statistical Service vs. 1.8% yoy estimate of the Central Bank). However, the economic recovery remains fragile, having so far been mainly driven by higher exports.

The depreciation of the dinar is a double-edged sword for the Serbian economy. On the one hand, it helps to boost export competitiveness and, thus, growth - exports showed signs of revival expanding by 13.6% yoy in Jan-July against imports growing by only 4.3% yoy over the same period. On the other hand, dinar depreciation increases inflationary pressures because of a high pass-through. The Central Bank has estimated the pass through effect at 0.2-0.3 in the current quarter and 0.6 in the next 12 months. For that reason, in our previous *New Europe Economics & Strategy* issue (August 2010), we expressed some concern about the potential negative consequences of additional rate tightening for the domestic growth outlook. In our view, additional policy tightening will have a negative impact on economic recovery, considering that Serbia's economic environment contains considerable downside risks.

Last but not least, there is one more important factor that weighed on the decision to hike interest rates now and may support further hikes ahead: The expected unfreezing of wages and pensions in 2011. The latter combined with positive credit growth is expected to give domestic demand a mild boost. In our focus note of May 20th (under the title "Central Bank keeps key policy rate unchanged at 8.00%", we had highlighted the unfreezing of pensions and wages as a key risk of price pressures reemerging from the demand side.

The issue of unfreezing public wages and pensions has been the subject of a heated political debate domestically since the beginning of 2010. The coalition government has frozen public wages and pensions for a second year in a row in 2010, as part of the IMF program's commitments. Yet, public discontent and the prospect of a growth rebound had led to growing voices both within the government and the opposition for an imminent unfreezing of wages and pensions.

Fifth IMF review successfully completed; agreement between the government and the Fund reached over the contentious issue of unfreezing public sector wages and pensions in January 2011, instead of April 2011 as specified in the framework of the fiscal responsibility law

The recent negotiations between the IMF staff mission and the government on the fifth review of the program were completed successfully. The approval of the agreement by the IMF Board enabled Serbia to gain access to an additional €383mn tranche of funding on September 27.

The fiscal responsibility law documents concrete rules for the setting of public wages and pensions. These will be indexed on the composition of public spending to ensure that infrastructure spending does not drop below 4% of GDP. In addition, the law foresees that the fiscal deficit will decline by 0.75pps annually until it reaches -1% of GDP. It also foresees that public debt is capped at 45% of GDP. Last but not least, there is a provision for public spending to decline as a percentage of GDP rather than through nominal reductions. The implementation of the law will be monitored by the Fiscal Responsibility Council. The three-member council will be comprised of appointees by the President, the government and the central bank.

Thus far, under the present arrangement which expires in April 2011, the government has made use of €1.5bn of IMF financing out of a total of €2.9bn of available funds. In fact, the government drew only €56mn from the previous tranche in June. Allegedly, the government may draw another €56 mn from the next tranche, which is expected to be the last withdrawal from the agreed funds. The IMF mission assessed that the program is performing satisfactorily across all areas. All of the main quantitative targets, including the fiscal deficit target, which was exceeded by a small margin in late March, were met in Q2.

The successful implementation of the IMF program gave the government extra leverage in the negotiations with the latest IMF mission in Serbia. The government has already implemented most of the politically-sensitive structural reforms including, among others, the pension system overhaul and the downsizing (by 10%) of central government personnel. In retrospect, the Serbian government has so far complied with the IMF program requirements more effectively than other governments in New Europe running similar programs. As a result, the government succeeded in bringing forward the implementation of the unfreezing of wages and pensions by three months earlier, in January 2011.

The first adjustment of wages and pensions will take place in January 2011 instead of April 2011. In the original IMF agreement, the indexation of public wages and pensions would be based on inflation during the previous six months plus one half of the real GDP growth rate achieved in the previous year. The modified agreement now foresees that indexation should take place three times a year (January, April and October). The first indexation would be based on the use of inflation only. The second will take into account the GDP performance of the prior year. The third will be based on the previous six-month average inflation. According to the Ministry of Finance, the adjustment of public wages and pensions would require an additional RSD 4bn in the budget on top of the RSD 8bn, which was forecasted earlier in the original agreement.

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Turkey

AKP achieves victory in key constitutional referendum

- **In spite of an anticipated slowdown in H2, full-year growth is likely to prove stronger than expected earlier.**
- **Consumer inflation ascends for the first time in three months; spike likely to prove temporary.**
- **Turkey's central bank keeps its key policy rate stable, implements second step of technical rate adjustment.**
- **Fiscal outlook improves further, but external imbalances deteriorating again as domestic economy returns to strong growth.**

Turkey: Eurobank EFG Forecasts

	2008	2009E	2010F	2011F
Real GDP (yoy%)	0.7	-4.7	7.0	5.0
Private Consumption	-0.3	-2.3	4.5	5.0
Govern. Consumption	1.7	7.8	1.0	3.0
Gross Capital Formation	-6.2	-19.2	16.0	10.0
Exports	2.7	-5.4	6.0	8.0
Imports	-4.1	-14.4	18.0	10.5
Inflation (yoy%)				
CPI (annual average)	10.4	6.3	8.3	7.2
CPI (end of period)	10.1	6.5	7.1	6.7
Fiscal Accounts (%GDP)				
General Government Balance	-1.8	-5.5	-3.0	-2.0
Gross Public Debt	39.4	45.5	43.5	42.5
Primary Balance	3.5	0.1	1.0	1.5
Labor Statistics (%)				
Unemployment Rate (%of labor force)	13.6	13.5	10.0	9.0
External Accounts				
Current Account (% GDP)	-5.7	-2.2	-5.5	-5.3
Net FDI (USD)	15.8	6.1	7.5	9.0
FDI / Current Account	37.5	43.5	19.0	22.0
FX Reserves (USDbn)	71.0	69.0	80.0	90.0
Domestic Credit	**2008**	**Q4 09**	**Q1 10**	**Q2 10**
Total Credit (%GDP)	31.1	34.8	33.4	37.4
Credit Private Sector (%GDP)	29.7	32.9	31.6	35.5
FX Credit/Total Credit (%)	13.2	14.9	16.9	18.7
Private Sector Credit (%yoy)	22.9	11.3	22.8	34.0
Loans to Deposits	82.4	78.7	79.9	82.1
Financial Markets	**Current**	**3M**	**6M**	**12M**
Policy Rate	7.00	7.00	7.00	7.50
USD/TRY (where applicable)	1.46	1.45	1.45	1.40

Source: National sources, IMF, Eurobank Research

Double-digit GDP growth in H1 2010

Turkey's economic growth decelerated less than expected in Q2, coming in at 10.3%yoy vs. 11.7%yoy a quarter earlier, beating expectations for a 9.0%yoy rise. On a quarter-on-quarter basis, real GDP grew by 3.7% in Q2 following a 0.4% rise a quarter earlier (seasonally-adjusted data), suggesting that the dynamic recovery of the domestic economy remains broadly on track. For the period January to June as a whole, GDP growth stood at 11%yoy, with domestic demand providing the primary driver (up 15%yoy, contributing around 14.5ppts to H1 GDP growth). In the January-June period, household consumption grew by 7.3%yoy and private investments by 27.7%yoy). Export activity was rose (+6.0%yoy), albeit being outpaced by a 19.9%yoy rise in imports. Net exports exerted a negative drag, slashing 3.5ppts off GDP growth in H1. From the production side, growth was led by an 18%yoy increase in the manufacturing sector, in January-June, followed by a 17%yoy jump in domestic trade and a 15.1%yoy rise in construction.

Domestic economic activity likely to slowdown in the second half of this year…

We continue to expect a relative slowdown in the pace of economic expansion in H2-2010 as the favorable impact of base effects and higher inventories gradually phases out. Furthermore, the drag from net exports may worsen further in the coming months, reflecting strong domestic demand for imports and decelerating growth abroad. Confirming the aforementioned, the most recent high-frequency macro data point to a slowdown in H2 2010. Industrial production growth slowed to 8.63%yoy in July, its lowest level since November 2009, following average growth of 15.5%yoy in the first six months of the year. Consumer confidence weakened slightly on a monthly basis in August, though it stood close to a 1½-year high recorded in June. In a similar fashion, manufacturing confidence eased slightly in August but remained above the boost-or-burst threshold of 100 for the 8th month running. Manufacturing PMI continued to grow in August for the 16th consecutive month, albeit at a slower pace relative to that recorded earlier this year. Capacity utilization in manufacturing fell 1.3ppt to 73.4% in August from a near 2-year high hit a month earlier. Providing additional support to the view that the pace of domestic economic expansion will likely decelerate in H2, but still remain firmly in a positive territory, the rate of unemployment on a three-month rolling basis recoiled to

10.5%, in July from an all time peak of 16.1% hit in Q1 2009. Elsewhere, car production rose by 22%yoy in August, pushing the January-August rate of growth to 31%yoy. Finally, foreign arrivals fell in August, for the first time in more than a year, marking a 1.1%yoy decline after a 7.7%yoy gain in the first seven months of the year, while credit activity remains on an uptrend in recent months.

Turkey: GDP

	YoY growth (ppts)		Contributions (ppts)	
	Q2 '10	H1 '10	Q2 '10	H1 '10
GDP	10.3	11.0		
Expenditure-side				
Domestic Demand	11.8	14.5	12.0	14.5
Consumption				
Private Consumption	6.2	7.3	4.5	5.4
Govern. Consumption	3.6	2.3	0.4	0.3
Investment	28.7	22.2	5.9	4.6
Private Investment	32.1	27.7	5.3	4.7
Govern. Investment	14.6	-2.8	0.6	-0.1
Change in stocks	-	-	1.2	4.2
Net exports	-	-	-1.6	-3.5
Exports	12.1	6.0	3.0	1.5
Imports	17.8	19.9	-4.6	-5.1
Production-side				
Agriculture, hunting and forestry	0.6	0.5	0.0	0.0
Fishing	15.7	9.9	0.0	0.0
Mining and quarrying	14.2	10.6	0.1	0.1
Manufacturing	15.4	18.0	3.8	4.3
Electricity, gas and water	8.3	5.6	0.2	0.1
Construction	21.9	15.1	1.2	0.8
Wholesale and retail trade	14.0	17.0	1.8	2.1
Hotels and Restaurants	3.2	1.3	0.0	0.0
Transport, storage and comm.	10.2	10.8	1.5	1.6
Financial intermediation	8.8	6.8	1.0	0.8
Ownership and dwelling	2.6	2.6	0.1	0.1
Real estate, renting & business	8.2	9.0	0.3	0.4
Public administration & defence	0.5	0.6	0.0	0.0
Education	1.2	1.3	0.0	0.0
Health and social work	2.4	3.5	0.0	0.1
Other community, social & pers. act.	3.1	3.1	0.0	0.1
Private household with empl. Indiv	7.1	7.6	0.0	0.0
Sectoral total	10.4	10.8	10.2	10.7
Financial intermediation	15.2	13.1	-1.1	1.0
Taxes-Subsidies	14.1	15.6	1.2	1.3

Source: National statistics, Eurobank Research

… but full-year growth likely to outpace initial forecasts

In spite of the anticipated slowdown in the pace of domestic economic recovery in H2 we expect Turkey to be the top growth performer in New Europe this year, with primary drivers being the strong rebound in domestic demand and a further recovery in exports. Strong popular support for the constitutional changes proposed by the government in the September 12 referendum is also seen favoring domestic investment activity, as it likely to lead to a more stable political environment in the period ahead. The plebiscite vote not only soothed worries over a coalition government after the July 2011 general elections but also lessened the risk of excessive government spending in the run-up to the polls and added to hopes about acceleration in the country's EU accession progress. Along these lines and taking into account the H1 stellar GDP readings, we have revised upwards our full-year growth forecast to 7.0%yoy, from 6.0%.

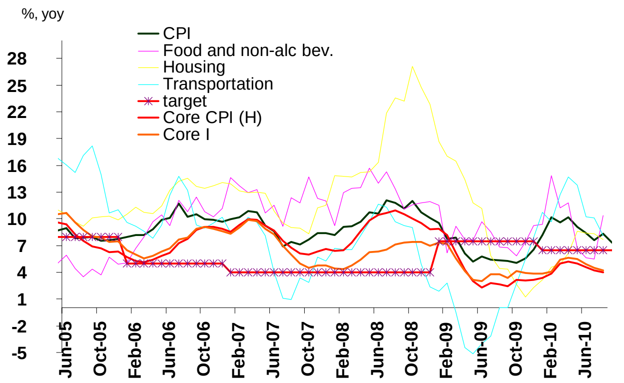
Consumer inflation ascends for the first time in three months, but spike likely to prove temporary.

Headline CPI surprised to the upside in August, coming in at 0.4%mom and exceeding expectations for a more modest, 0.2%mom, increase. On an annual basis consumer prices rose by 8.33% outpacing a 7.58% rise – the lowest in seven months - registered in July. The food component was the primary culprit of the August inflation spike, recording a 2.95%mom rise on the back of seasonal factors and adverse weather conditions. Note that during Ramadan, which took place in August and September this year, demand for food traditionally increases. Cost-push inflation was also instigated through heavy rain that affected Germany and a number of countries in Europe as well as the summer drought that hit Russian wheat production. Nevertheless, the breakdown of the August CPI data suggests that prices pressures remain relatively muted with six of the twelve components revealing monthly declines and the rest, with the exception of food, only modest increases. Signaling that the underlying inflation trend remains rather benign, most core inflation indicators eased further in August, with the "H" and "I" indices, closely monitored by the CBRT, marking respective declines of 0.46%mom and 0.69%mom, pushing both indices on an annual basis to their lowest level since February 2010. On the flipside, producer prices rose by 1.15%mom in August, also exceeding the market's median forecast of +0.23%mom and bringing the annual rate of increase in the index to 9.03% vs. an 8.24% gain in July.

In all, August's inflation data does not come as a complete surprise. The central bank had warned about a temporary spike in inflation in the short-term, but voiced expectations about reversal of the uptrend in Q4 2010. In line with other market participants, we had anticipated a spike in headline CPI to around 8% in August and September primarily due to seasonal factors. We expect a slowdown thereafter and see headline CPI easing towards 7.1%yoy by end-2010, slightly above its 6.5% target for the year. Note however, that the recent surge in wheat prices may have an inflationary impact in the coming months. Looking further ahead, we expect price pressures to remain relatively subdued through to Q1 2011, but become more evident in the second half of next year. The primary reason being, possible fiscal loosening ahead of parliamentary elections scheduled for July next year. Also ceasing to assist the disinflation process will be the narrowing of the output gaps created as a consequence of the crisis. In December 2011, we see CPI slightly below 7% but above the CBRT's 5.5% end-year target. Upside risks to our forecasts lie in the face of a stronger-than-expected rebound in the domestic economy and fiscal relaxation ahead of the July 2011 general elections.

Figure 1

Inflation temporally picks up in August on seasonal factors



Source: National Sources, Eurostat, IMF, Eurobank Research

Turkey's central bank keeps its key policy rate stable, implements second step of technical rate adjustment.

Turkey's central bank kept its key policy rate, the 1-week repo rate, stable at 7.00% at its MPC meeting on September 16, in line with market expectations. Yet, in a broadly unexpected move, the Committee decided to implement the second step of a technical rate adjustment, which constitutes part of the Bank's exit strategy from stimulus measures. Specifically, the CBRT lowered the overnight borrowing and lending rates by 25bps each to 6.25% and 8.75%, respectively. The first step of the adjustment was implemented in May when the central bank decided to switch its key policy rate to the 1-week repo from the overnight borrowing rate previously.

In our view, the cut in the overnight borrowing and lending rates should not be perceived as a change in the CBRT's stance. Notably, the central bank re-emphasized its confidence on disinflation, repeating that although inflation would temporarily spike in the short-term, the uptrend was expected to reverse in Q4 2010. It also reiterated that core inflation is expected to remain consistent with the medium-term targets. Moreover, the accompanying statement read, once again, that "it would be necessary to maintain policy rates at current levels for some time, and to keep them at low levels for a long period", signaling that, at present, the bank has no intension to change its key policy rate. In its "Monetary Policy Exit Strategy" announced in April, the CBRT had stated that should liquidity conditions permit the bank would proceed with the second phase of the technical rate adjustment by widening the spread between the 1-week repo and the overnight borrowing rates. The difference between the two interest rates could be changed by either increasing the 1-week repo rate or by decreasing the overnight borrowing and lending rates. Raising the 1-week repo, the bank's basic funding instrument, would have implied monetary tightening, which would be rather unsuitable at this stage. The reduction in the overnight borrowing and lending rates should not be translated as monetary loosening, but, rather as a step towards stimulating interbank lending. In effect, the CBRT now borrows overnight at a rate of 6.25%, when the respective mid interbank rate stands at levels around 6.66% (as of September 23). In support of the aforementioned, a day after September's MPC meeting Governor Durmus Yilmaz said that the second phase of the technical rate adjustment will facilitate interbank trade.

The rest of the policy statement issued after the September 16 rate decision was broadly similar to the one in August. The bank highlighted that the recovery in the domestic economy is slowing down following strong growth in Q2 2010, reiterating that uncertainty over external demand lingers. A notable difference was that the Committee stated it would implement further measures as envisaged in the exit strategy by the end of the year. Vindicating our earlier expectations, a week after the latest MPC meeting the central bank employed further measures as part of its exit strategy, by raising the TRY and FX bank reserve requirements ratios. The former was hiked by 0.5ppts to 5.5% and the latter by 1ppt to 11%, in a move which the bank estimates will drain ca $3.6bn of market liquidity.

Along these lines we maintain our view that the CBRT will likely remain on hold on its key policy rate in the months ahead and incept its monetary tightening cycle in H2 2011, after it assesses the impact of any additional budgetary spending in the run-up to the general elections, and the global economic outlook becomes more transparent. The CBRT's policy remains highly accommodative, after a total of 1,025bps of rate cuts being delivered between November 2008 and November 2009. As such, we continue to expect 150bps of rate hikes to be delivered by the end of 2011. The central bank warned in late August that it may resume its easing policy cycle should global economic conditions worsen to an extend that likelihood of a new domestic recession increases. However, we would assign a rather low probability to this scenario as domestic demand dynamics do not currently justify such a move.

AKP achieves victory in key constitutional referendum.

The government achieved a key victory on September 12 when the public endorsed with strong support (58%) a much awaited referendum on constitutional reforms backed by the ruling AKP. The outcome was stronger than that suggested by a number of opinion surveys conducted ahead of the poll, which signaled marginal support in favor of the amendments (50-55%). Among others, the constitutional amendments include changes in the structure and the way the Supreme Board of Judges and Prosecutors (HSYK) are elected. Other reforms include: a) making military personnel accountable in civilian courts for civilian claims, b) allowing for military court decisions to be appealed, c) terminating immunity from prosecution of members of the National Security Council and technocrats involved in the 1980 junta, d) strengthening of equality and children's' rights, right of multi-union membership and right to strike in the private sector and 3) allowing lawmakers to remain in parliament even if their party is banned from politics by the court

The government says that the constitutional changes will make the country more democratic and help improve the prospects of EU accession. Most of the 26 articles to be amended in the plebiscite were broadly uncontroversial. However, some of the changes are seen by stanch secularists as a threat on the basis that they limit the powers of the military and judiciary, both seen as bastions of secularism.

The outcome of the referendum was seen as a key test for the government, being considered as a vote of confidence on its policies and as an indication of public support ahead of the July 2011 general elections. The high share of votes in favor of the amendments added to hopes that the pro-business ruling AKP is braced to win a third consecutive general election and form a single-party government next year.

Worries over fiscal loosening in the run up to the polls also lessen. Although some additional expenditure may still emerge ahead of the vote, that would not be of such a magnitude as to unnerve investors and jeopardize the country's financial stability. Moreover, enhanced morale may add to the government's drive to instrument a broader overhaul of the constitution, a note already made by Prime Minister Tayyip Erdogan shortly after the announcement of the referendum's outcome.

Such a move would help to accelerate EU membership progress. The EU has repeatedly urged Turkey to overhaul its constitution, which was ratified in 1982 following a military coop and is being criticized as outdated containing articles seen as obstacles to the country's accession bid.

Meanwhile, the much-awaited "fiscal rule", which was initially expected to be endorsed in parliament this summer but was later said to be delayed, may also be brought back in the government's the agenda The reform is seen as a valuable policy anchor for budget deficits in the coming years, especially in the absence of a new IMF loan deal. Endorsement in parliament and adequate implementation will not only improve Turkey's finances but also bring about upgrades in the country's sovereign credit ratings. It is also worth mentioning that the door remains open for a snap elections scenario now that the government received concrete evidence of strong public support and may opt to alleviate uncertainty related to a protracted pre-election period.

On a less positive note, social polarization may deepen and political friction may escalate further in an ongoing power-play between the secular elite and the Islamist-rooted government. Among such risk-triggering events is a renewed drive towards constitutional amendments that have in the past stirred significant turmoil in Turkey's domestic politics. Among the latest was the AKP-backed waver of the ban on Muslim headscarf in universities. In 2008 the Constitutional Court had blocked the government's last such effort. It is also worth mentioning that in the aftermath of the referendum, Turkish prosecutors opened an investigation against three individuals involved in the 1980 coup, including former general and president Kenan Evren.

Fiscal outlook improves further….

Turkey's fiscal position improved further in July and August on the back of ongoing spending prudence and higher tax revenues due to the strong economic recovery. In detail, the consolidated government deficit dropped by 54%yoy to TRY 14.4bn in the first eight months of the year. The primary budget surplus jumped 127.4%yoy, to TRY 20.9bn over the same period. Nevertheless, concerns about fiscal slippages in the run-up to the 2011 general elections remain. That said, the strong public support September's referendum received somewhat allayed worries over excessive spending. Such a risk would have been elevated in the event of a lukewarm endorsement or dismissal of the plebiscite as the government would strive to lure votes thereafter. Taking into account the aforementioned, we revise our previous general government deficit forecast to 3.0%-of-GDP this year from 3.8%-of-GDP.

… but external imbalances worsen as the domestic economy returns to strong growth.

The strong rebound in Turkey's domestic demand has fueled a sharp worsening in the trade balance over recent months and, as a consequence, a widening in the country's current account deficit. The lira's recent appreciation and doubts over the sustainability of growth in trade-partner economies are additional factors weighing on the outlook of exports. Notably, the current account deficit jumped 630%yoy in July, pushing the the shortfall over the first seven months of the year 209%yoy higher to $24bn. According to our calculations, the current account deficit corresponds to 3.4%-of-projected GDP year-to-July. Meanwhile, FDI amounted to $3.3bn and covered just 14% of the deficit over that period. Along these lines we revised our earlier 4.5%-of-GDP deficit forecast for this year to 5.5%-of-GDP, a tad above the government's 5.0%-of-GDP projection. For next year anticipate the shortfall to ease slightly towards 5.0% as the recovery in domestic demand slows down and Turkey's trade-partner economies rebound further.

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Ukraine

Domestic inflation accelerates on steep hike in gas prices

- **Q2 GDP data point to a positive full-year growth reading**
- **Domestic recovery driven mainly by the industrial sector, reflecting strong external demand for steel exports**
- **Inflation accelerates to 8.3% yoy in August from 6.8% yoy in July on the back of a 50% rise in gas prices**
- **Fitch affirms Ukraine's external debt rating at B with outlook stable; forecasts further rise in NPLs ratio to 50%**
- **Tentative signs of improvement in domestic credit dynamics**

Ukraine: Eurobank EFG Forecasts

	2008	2009	2010f	2011f
Real GDP (% yoy)	2.3	-15.1	4.0	4.2
Private Consumption	9.9	-12.1	1.5	1.0
Government Consumption	0.4	1.8	0.5	1.0
Gross Capital Formation	32.6	-48.4	3.5	3.0
Exports	5.1	-23.6	4.0	5.0
Imports	18.4	-36.8	1.5	2.0
Inflation (% yoy)				
CPI (annual average)	25.2	15.9	10.2	10.5
CPI (end of period)	22.3	12.3	9.9	10.3
Fiscal Accounts (% GDP)				
General Government Balance	-3.2	-8.7	-6.5	-5.0
Gross Public Debt	19.9	34.6	39.5	41.5
Labor Statistics (%)				
Unemployment Rate (% of labor force)	6.9	9.7	9.0	8.5
Wage Growth *(real - private sector)*	6.3	-10.3	7.0	5.0
External Accounts				
Current Account (% GDP)	-7.0	-1.5	-1.0	-2.1
Net FDI (bn USD)	9.9	4.7	6.0	5.5
FDI / Current Account	77.6	230.0	300.0	250.0
FX Reserves (bn USD)	31.5	26.5	29.5	35.0
Domestic Credit	**2007**	**2008**	**2009**	**Q1 10**
Total Credit (% GDP)	59.9	77.3	79.1	74.4
Credit to Enterprises (% GDP)	36.5	46.7	50.5	48.0
Credit to Households (% GDP)	22.5	29.5	26.4	24.3
FX Credit/Total Credit (%)	49.9	59.0	50.8	49.9
Private Sector Credit (% yoy)	74.9	68.5	-3.1	0.5
Loans to Deposits	150.4	204.0	215.9	208.4
Financial Markets	**Current**	**3M**	**6M**	**12M**
Policy Rate	7.75	7.75	7.75	7.75
USD/UAH	7.89	7.80	7.90	8.00

Source: NBU, IMF, Bloomberg, Eurobank Research

Economic recovery gains traction

Real GDP growth of 6.0% yoy in Q2-2010 suggests a rebound of the Ukrainian economy for the year as a whole. The recovery has so far been driven mainly by the industrial sector, reflecting strong external demand for steel exports. Furthermore, the new IMF signed recently is helping to improve business sentiment in the domestic economy. We forecast full-year GDP growth of 4.0% yoy in 2010 and 4.2% yoy in 2011.

Industrial production grew by 9.2% yoy in August, from 6.4% yoy in the prior month (Table 1). Yet, on a monthly basis, the August reading stood at 1.5% mom, down from 2.9% mom in July, mainly reflecting seasonal factors.

Table 1
Industrial production dynamics

	August 2010	July 2010	June 2010	May 2010	April 2010	March 2010
Yearly %changes	9.2	6.4	8.9	12.7	17.4	13.8
Monthly %changes	1.5	2.9	-0.5	-2.4	-1.8	16.2

Source: National Statistics, Eurobank Research

Retail sales picked-up in August; they accelerated 4.6% yoy. This was the fourth consecutive month of positive growth after 17 months of contraction (retail sales tumbled 18.3% yoy in 2009).

Inflation accelerates on higher gas prices

Ukraine's CPI accelerated to 8.3% yoy in August, from 6.8% yoy in July. In monthly terms, the consumer price index grew by 1.2% mom in August, recording the first positive rate of change following four consecutive months of negative growth (-0.2% mom in July). The spike in the August reading was widely expected, in view of the 50% increase in gas prices for households and utility companies, effective from August 1st. Utility prices accelerated drastically to 9.6% mom. Furthermore, the increase in gas prices for households accounted for 1.1 ppt of the August month-on-month CPI reading. Another contributor to the rise of headline inflation last month was the increase in the excise tax on tobacco and alcohol, the price index of which rose by 3.7% mom, adding another 0.2% ppt to the monthly CPI reading (Table 2). As utilities tariff and tax hikes feed through in the coming months, inflation will continue to rise, albeit more gradually.

Table 2
CPI Index dynamics

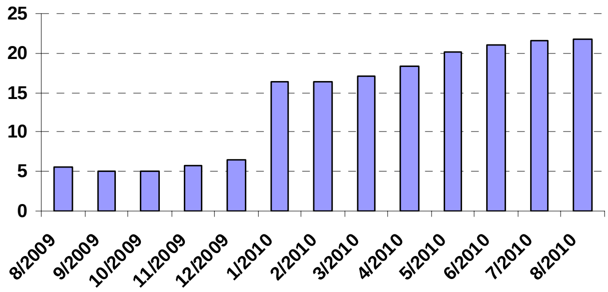
	Aug. 2010	July 2010	June 2010	May 2010	April 2010	Mar. 2010
CPI Monthly change	1.2%	-0.2%	-0.4%	-0.6%	-0.3%	0.9%
CPI Annual change	8.3%	6.8%	6.9%	8.5%	9.7%	11.0%

Source: State Statistics Committee of Ukraine, Eurobank Research

Food price inflation increased to 8.8% yoy in August from 7.6% yoy in July (sugar prices: +2.6% mom; milk: +4.2% mom; bread: +2.4% mom and meat prices: +2.0% mom.).

What's more, producer price dynamics point to rising pipeline pressures; they accelerated further in August reaching 21.8% yoy vs. 21.6% yoy in July and 5.6% yoy in August 2009 (Figure 3).

Figure 3
PPI Index Annual Change



Source: State Statistics Committee of Ukraine, Eurobank Research

Against this backdrop, we forecast inflation to average 10.2% yoy this year and 10.5% yoy in 2011 vs. 15.9% yoy recorded in 2009.

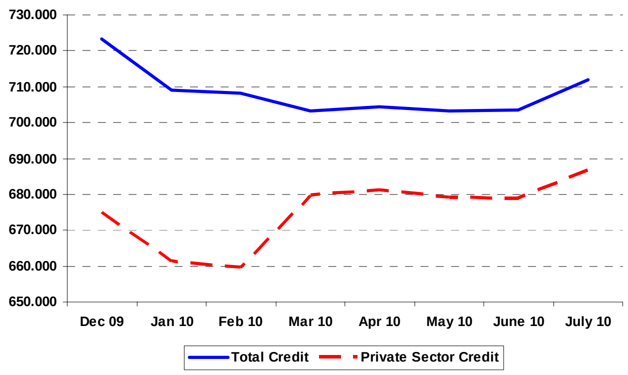
Fitch affirms Ukraine at B with outlook stable; sees NPLs reaching 50% of total loans

In mid-September, Fitch rating agency upgraded Ukraine's long-term foreign and local currency issuer default ratings to B from B- in July. Fitch cited authorities' strong start in implementing the recently-signed IMF program but added that a number of short-term risks prevented a further upgrade at this point; namely those related to the banking system as well as the county's rising gross external debt stock and rollover requirements. Ukraine remains vulnerable to an external demand and commodity price shock, while the growth outlook of its main European export markets remains uncertain. With respect to domestic banking sector developments, Fitch expects average non-performing loans (NPLs) which include restructured credits to reach 50% of total loans.

Encouraging signs for domestic credit

Monthly growth in total domestic credit remained in positive territory in July for second month in a row (+1.2% mom vs. +0.05% mom in June). This brought year-to-July growth to -1.6%, from -2.7% year-to-June. What's more, private sector credit recorded positive growth in annual terms for fifth consecutive month in July; coming in at 2.3% yoy from 1.4% yoy in the prior month (Figure 4).

Figure 4
Signs of improvement in domestic credit dynamics



Source: National Bank of Ukraine, Eurobank Research

Nevertheless, household credit growth remained negative at -12.6% yoy in July, having declining by 8.5% yoy since the beginning of this year.

Meanwhile, total deposits continue their rebound; they grew by 13.1% year-to-July while private sector deposits rose by 15.4% over the same period. Household deposits outperformed; they grew by 17.9% year-to-July, with deposits growth in national currency reaching 28% over the same period. Therefore, Loans to Deposits ratio decreased to 187.9% in July from 215.9% in December 2009.

On a more worrisome note, Non Performing Loans (NPLs) to total loans ratio keeps rising; it stood at 11.7% in July from 11% in June. NPLs increased by 19.3% year-to-July and by 7.5% mom in July. According to IMF 30-day NPLs ratio broad definition, (which includes substandard, doubtful and loss) NPLs reached 41.6% in March 2010 from 40.2% in December 2009. Consequently, Regulatory capital to risk-weighted assets rose to 20.8% in March 2010 from 18.1% in December 2009 and 15.4% in March 2009.

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