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Regional markets broadly resilient so far to the EMU-periphery sovereign debt crisis; near-term contagion risks on the rise

Bulgaria: Government postpones ERM II entry application

Poland: Recent plane crash not expected to cause major domestic instability

Romania: Q1 fiscal performance broadly in line with IMF requirements

Serbia: New nomination for the Central Bank Governor post

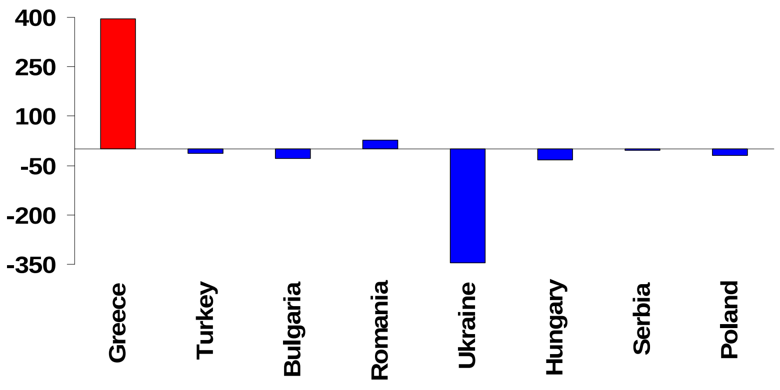
Turkey: Strong rebound in domestic economic activity expected in 2010

Ukraine: Gas deal with Russia to help resume IMF loan facility

New Europe market strategy highlights

- **Liquidity conditions in regional markets remain thin and the price action choppy.** Players remain in a wait-and-see mode, trying to assess the potential spill-over effects of the lingering sovereign debt crisis in the EMU and the next policy moves by EU authorities. We currently maintain a low risk exposure to the market mainly via relative value and curve plays.
- **FX:** Polish Central Bank present rhetoric is currently against further zloty appreciation. We favour holding **short PLN/RON cash positions** at 1.053 targeting 1.00 with a stop on a daily close above 1.0650. Turkish Lira is attractive at current levels, with a less dovish central bank and increased yield differentials providing scope for further TRY outperformance. We currently **favor long TRY positions versus other regional currencies**.
- **Local rates:** Holding **payer positions** in the short-end of the Polish government bond curve makes good sense, in our view. If the economy rebounds, rates hikes will soon follow. On the other hand, if a liquidity crisis emerges then cost of borrowing will rise across the board
- **Sovereign credit**: We remain **constructive on Romania sovereign credit**, looking for further normalization/steepening of the credit curve on 5-10 segment towards 50basis bonds (pre-crisis levels)

Change in 5-Year CDS spreads (bps)
(March 1, 2010 - May 3, 2010)



Source: Bloomberg

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Introductory Comment

Dear reader,

Financial markets in New Europe have come under some pressure in recent weeks but spill-over effects from the rapidly expanding euro area debt crisis have been broadly contained. Currently, equity markets in the region stand not far off their recent multi-year highs, local rate markets remain well supported and external debt spreads remain very tight by historical standards. This resilience can be attributed to a number of factors:

a) The majority of economies in New Europe feature relatively low public-debt burdens and broadly sustainable fiscal positions.

b) The recent large recession in the region has facilitated the partial absorption of past severe macro imbalances, which had earlier taken the form of wide trade deficits and bubbly housing markets.

c) Economic conditions in New Europe are now improving faster than previously expected, with high-frequency indicators and survey data suggesting that the worst of the downturn is already behind us.

d) A number of economies in the region remain cushioned under international financial aid umbrellas, signed long before the Greek debt crisis erupted.

e) The world economic outlook and investor risk appetite continue to improve.

f) There is still ample liquidity internationally with major central banks, including the Fed and the ECB, remaining biased to maintain it for a ‘‘considerable’’ period of time.

We continue to expect most economies in New Europe to record positive, yet below potential, GDP growth in 2010. The economic recovery remains primarily driven by inventories and exports, thanks to improving conditions in major trading partners. On a less positive note, domestic demand dynamics remain weak as unemployment continues on a rising path, credit growth is still anemic and disposable incomes are constrained by low wage growth and higher oil and food prices. Turkey and, to a lesser extent, Poland are expected to outperform other economies in New Europe in terms of GDP growth this year. This is due to their relatively low levels of private-sector leverage as well as a number of other cyclical and structural influences.

On the monetary policy front, most central banks in the region have already completed, or are close to conclude, their monetary-easing cycles. We continue to expect ca 150bps of cumulate interest rate hikes by the Central Bank of Turkey in Q4, with increasing signs of worsening domestic inflation dynamics already raising market worries over the risk that central bank may eventually be left ‘‘behind the curve’’. In Poland, the sudden deaths of President Lech Kaczynski, Central Bank Governor Slawomyr Skrzypek and a number of other key policy makers in a plane crash in early April has had a limited impact, thus far, on domestic markets. In our view, the unfortunate incident is not expected to seriously alter the political landscape nor bring about significant changes in NBP’s monetary policy stance. On the latter, financial markets currently discount some 25-50bps of rate hikes form the National Bank of Poland by the end of this year. We believe that such expectations may prove overly aggressive. Indeed, if the NBP embarks on a monetary tightening cycle well ahead of the ECB *(now expected to tighten policy not earlier than in H2 2011)*, widening interest rate differentials may risk an excessive appreciation of the Polish currency, with negative implications on competitiveness and exports. Elsewhere, we continue to see further room for monetary policy easing, specifically in Hungary and Serbia, and to a lesser extent, in Romania.

Lingering headwinds to the global recovery theme and persisting sovereign credit concerns are likely to remain in the spotlight in the near term, putting a lid on regional asset markets. Yet, from a longer-term perspective, we remain positive on the region as the recent recession helped absorb a great deal of past macro imbalances and as macroeconomic fundamentals continue to improve.

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)		
	2008	2009	2010f	2008	2009	2010f	2008	2009	2010f
Bulgaria	6.0	-5.0	-0.3	12.0	2.5	2.0	-25.4	-9.4	-6.0
Poland	5.0	1.8	2.7	4.2	3.5	2.5	-5.1	-2.0	-3.0
Romania	7.1	-7.1	1.0	7.9	5.6	3.6	-11.6	-4.4	-5.5
Serbia	5.5	-3.0	1.5	12.5	8.2	5.0	-17.1	-5.8	-8.5
Turkey	0.7	-4.7	5.0	10.4	6.3	9.4	-5.7	-2.2	-3.5
Ukraine	2.3	-15.1	2.0	25.3	16.0	12.0	-7.0	-1.7	-1.8
New Europe	3.2	-4.6	3.2	10.7	6.8	6.8	-7.5	-2.7	-3.7
Euro area	0.6	-4.1	1.1	3.3	0.3	1.3	-1.1	-0.4	0.5
USA	0.4	-2.4	3.0	3.8	-0.4	2.3	-4.9	-2.9	-3.0

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

Foreign exchange and policy interest rates
Realizations and forecasts

		FX Rates			Interest Rates		
eop		2008	2009	2010f	2008	2009	2010f
Bulgaria	**vs EUR**	1.96	1.96	1.96	*Currency Board*		
Poland	**vs EUR**	4.15	4.10	3.80	5.00	3.50	3.75
Romania	**vs EUR**	4.03	4.23	4.10	10.25	8.00	6.50
Serbia	**vs EUR**	89.79	96.23	105.00	17.75	9.50	7.50
Turkey	**vs USD**	1.54	1.50	1.50	15.00	6.50	8.00
Ukraine	**vs USD**	8.05	8.05	8.70	12.00	10.25	10.25
Euro area	**vs USD**	1.40	1.43	1.24	2.50	1.00	1.00
USA	**vs EUR**	0.71	0.70	0.81	0.125	0.125	0.75

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

I. Overview

Regional emerging markets broadly resilient so far to the sovereign debt crisis in the euro area

New Europe markets have so far exhibited remarkable resilience to the sovereign debt crisis in the euro area. Contrary to past incidences of generalized risk aversion that triggered significant capital outflows from emerging markets, downside pressures have so far been relatively limited. To be more precise, regional financial markets have suffered some modest losses in recent weeks, arguably related to the latest dramatic developments in the Greek debt saga. Yet, compared to past crises, one can fairly argue that so far New Europe emerging economies escaped relatively unscathed. One of the main reasons for this resilience is that a number of economies in the region are currently cushioned under international financial aid umbrellas, signed long before the eruption of the Greek crisis. Furthermore, relatively low levels of public debt, broadly sustainable fiscal positions and convergence prospects continue to render these markets relatively appealing to long-term investors.

Equity markets in the region remain close to recent multi-year peaks

Stock markets in New Europe, which were particularly hit in 2009, continued to outperform their main European peers in recent weeks, on improving economic recovery prospects in the region. The Emerging and Eastern Europe MSCI sub-indices each stood some 6% higher year-to-April 30, posting gains of 65-70% on an annual basis and outpacing a respective 34.2% yoy rise in the MSCI World index.

Local rates markets remain well supported

Government bond prices in most regional markets remain well supported, with respective yields hovering near recent multi-year lows, as output gaps remain negative and inflation pressures continue to be subdued. In Hungary, the yield of the 3-year benchmark bond touched in late April record lows below 5.50%, with the country's central bank remaining among the few in the region expected to cut policy rates further in the period ahead. In a similar vein, the 3-year and 10-year Romanian benchmarks was trading near multi-year lows of ca 7.60% at the time of writing, comparing to double-digit peaks around 18.50% recorded in late 2008/early 2009. That said, expectations for further near-term monetary policy easing in both Romania and Hungary have been scaled back somewhat lately, amid regional currency depreciation worries due to sovereign debt crisis in the euro area. On the flipside, the current market consensus is for some 50bps of cumulative rate hikes by the Polish central bank by the end of 2010. This is mainly on the view that the rebound in the domestic economy is gaining traction. Nevertheless, with domestic inflation pressures remaining subdued *(March's CPI at 2.6% yoy vs. NBP's 2.5% inflation-target midpoint)*, and the ECB now seen unlikely to hike its key policy rate this year, we believe that expectations for higher policy rates by the NBP before the end the year may prove overly aggressive. In the domestic rates market, the yields of the 2-year and 10-year bond benchmarks stood at the time of writing near 4.60% and 5.62% or ca 60bps and 70bps lower from highs reached earlier this year. Turkey's central bank is also among the ones seen embarking on a monetary tightening cycle in the second half of the year, amid market concerns that it may already have fallen ''behind the curve''. Such concerns have lately conspired with a deteriorating inflation outlook to push the yield of the November 16, 2011 benchmark bond to above 9.00% levels, or ca 100bps higher relative to lows hit in late 2009 (by the previous May 11, 2011 benchmark).

Depreciation pressures on regional FX lately, but most currencies remain close to year-to-date highs

Regional currencies in New Europe have been under pressure since late March on intensifying concerns over Greece's fiscal position and the stability of the euro area. Yet, most currencies remain not far off their highs touched in late March, on expectations that the region's economies will fare better than their Western European counterparts. As a result, the market presently expects a number of central banks in the region to incept monetary policy tightening well ahead of most central banks in major economies (including the ECB). The Polish zloty remains the major outperformer in the region year-to-date, having recorded a 16-month highs near 3.8205/€ in early April, prompting the NBP to intervene in the FX market to stop the currency from appreciating further. The demise of President, Lech Kaczynski, Central Bank Governor, Slawomyr Skrzypek, and a number of other key policy makers in early April has thus far had a limited impact on domestic markets. In our view, the unfortunate incident is not expected to seriously alter the political landscape nor bring about significant changes in NBP's monetary policy stance. Elsewhere, Romania's leu currently hovers not far off a 14-month peak of 4.0466/EUR touched on March 24, amid waning political risk and the recent resumption of the EUR 20bn IMF Stand-By loan Arrangement. On the flipside, the Serbian dinar remains under significant pressure since late 2009, currently hovering near record highs just above 100 touched in March amid growing fiscal-related concerns, increased demand for hard currency due to higher energy imports and corporate demand to service cross-border credits. The Turkish lira, which has earlier been a laggard in the region -- due to heightened worries over the CBRT risking to fall ''behind the curve'' and increased domestic political noise -- has lately recuperated some of its loses to touch 1.4650 3-month lows in late April.

External debt markets retreat modestly from recent multi-year highs

Emerging external debt markets came under pressure in recent weeks on heightened sovereign credit concerns in the euro area. After posting year-on-year gains of over 30%yoy in early March, returns on the EMBI+ index retreated to reach ca 22%yoy at the time of writing, while spreads over USTs on the index rose by around 35bps from lows of 230bps hit on April 15. On a similar note, five-year credit default swaps spreads in New Europe have slightly rebounded from multi-year troughs touched earlier in April. Notably, 5-year CDS spreads in Bulgaria, Hungary, Romania and Turkey currently stand at levels not much higher than 200bps, compared to 600bps-plus, levels in Greece, reflecting a lower cost of insuring against a sovereign debt default in the region relative to a similar event in debt-laden Greece.

Economies in the region on a sustainable rebound but risks lie ahead

With respect to real economy developments in the New Europe, recent data continue to point to a sustainable economic recovery ahead. As we mentioned in our previous monthly report, negative base effects and higher inventories are expected to provide significant support to GDP growth this year. Turkey is expected to outperform other economies in the region in 2010, having already recorded an impressive turnaround in Q4:2009 (+6.0% yoy), which partly reverses heavy output losses recorded earlier in the year. However, a number of risks lie ahead regarding the region's economic outlook and, we reiterate, that the rebound in New Europe is likely to lag that of the big emerging economies in LATAM and Asia. Firstly, having seen their finances severely deteriorating in 2009 as a result of the economic recession, governments in the region will need to follow tighter fiscal policies this year in order to bring their budget deficits to more sustainable levels. Secondly, a further significant escalation in the lingering sovereign debt crisis in the euro area could take a toll on regional economies, among other avenues via the trade and financial sector channels.

Domestic political risks abating lately

On the political front, risks in most economies in New Europe appear to have been ebbing lately. Ukraine's political landscape appears to be stabilizing after the January elections. A single party government is expected to be formed in Hungary this month, after the main opposition party Fidesz won a landslide victory in April's general elections. This will mark the first single-party cabinet in the country's post-communism era. Moreover, the new government will enjoy a crucial two-thirds majority, key for passing much needed reforms in parliament. The demise of Poland's President and a number of other key government officials and policy-makers is not expected to significantly change the country's political landscape and macroeconomic policies. Presidential elections (initially due in autumn 2010) are now expected to take place in June, with frontrunner and current acting President, Bronislaw Komorowski expected to win the post. In Turkey, although political noise remains relatively subdued, renewed tensions between the military elite and the ruling AKP can not be ruled, out especially in view of the proposed (by the government) constitutional changes and a potential referendum in the coming months. Also, the next general election (due in July 2011) has the potential to fan renewed political jitters.

Cautiousness to prevail ahead

In all, in spite of emerging economies in the region having so far been able to weather the government debt crisis in the euro area relative unscathed, global recovery and sovereign credit concerns are likely to remain in the spotlight in the near term, putting a lid on regional economies and markets. From a longer-term perspective, we remain constructive on the region as macroeconomic fundamentals continue to improve and the recent recession help to absorb a great deal of earlier macro imbalances.

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II. New Europe Markets Outlook & Strategy

Strategy highlights

*Contributed by **Christos Pnevmatikatos,***
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Liquidity conditions in regional markets remain thin and the price action very choppy. Players remain in a wait-and-see mode, trying to assess the potential spill-over effects of the lingering sovereign debt crisis in the EMU and the next policy moves by the EU authorities. We currently maintain a low risk exposure to the market mainly via relative value and curve plays.

COUNTRY	Type	Rational	Trade
POLAND	FX	Polish Central Bank rhetoric is currently against further zloty appreciation. We expect relative underperformance versus other regional currencies in the short-term. The Polish currency has appreciated significantly (both in nominal and real effective exchange rate terms since July 07), which means that a great deal of Poland's sound fundamentals is already priced. On the other hand Romania Central bank is closely monitoring developments in FX markets, trying to curb extreme market moves.	Hold short PLN/RON cash position at 1.053 targeting 1.00 with a stop on a daily close above 1.0650.
	Rates	Stopped out from our recommendation to go short POLGB 4.75 Apr 2012. Central bank verbal intervention and a further normalization in the interbank market led to lower rates. In our view, holding payer positions in the short-end of the curve makes absolute sense. If the economy rebounds, rates hikes will soon follow. On the other hand, if a liquidity crisis emerges then cost of borrowing will rise across the board.	
TURKEY	FX	Turkish Lira is attractive at current levels. Risk premia remain adequate and risks are correctly priced, in our view. A less dovish central bank and increasing yield differentials provide scope for further TRY outperformance.	Hold 2 Month USD put TRY call strike 1.50 RKO 1.43 for 0.32% of USD premium. Maximum pay 14.4:1 spot ref 1.5340 established late March.
	FX	We favor long TRY positions versus other regional currencies and see room for further lira appreciation.	Long TRYPLN at 2.00 target 2.05 stop on a close below 1.9670
	Credit	Credit spreads in Turkey are well inside pre-crisis levels. After a 30bps widening since late April we prefer booking our profits and reassess the situation.	Take profit on Buy 5 year Turkey CDS at 158 basis points with a stop below 140bps.
ROMANIA	Credit	We remain positive on sovereign credit, looking for further normalization/ steepening of the credit curve on 5-10 segment towards 50basis bonds (pre-crisis levels)	Hold DV01 neutral 5-10 CDS steepener in Romania selling 5yr protection at 295bps (now 229bps) and buying 10yr protection at 300bps (now 233).
SERBIA	FX	We favor building long positions on the Serbian currency at current levels. Easing external pressures, the IMF program and budgetary consolidation are expected to lead to an improved business environment and growth pattern. An active Central Bank has repeatedly intervened in the f/x market since the beginning of the year (562Mio EUR this year with a cap of EU2 BLN for 2010). Central Bank FX reserves total 10.6Bio. Deposit rates are currently amongst the highest in the region, making the volatility-adjusted carry superior.	Hold Short EURRSD spot at 100.50 for a target of 95.50 and a stop on a close above 101.50 now 99.29

III. New Europe – Country Analysis

Bulgaria

Government postpones once again ERM II application

- **Bulgarian government postpones temporarily ERM II application on revised fiscal data**
- **Additional austerity measures will be needed to contain the budget deficit at levels below 3% of GDP in 2010**
- **Domestic demand remained weak in early 2010, but economic outlook improves on better than expected exports data**

Bulgaria: Eurobank EFG Forecasts

	2007	2008	2009	2010f
Real GDP (yoy%)	6.2	6.0	-5.0	-0.3
Private Consumption	5.3	4.8	-6.2	-2.5
Government Consumption	3.1	0.0	-5.7	-0.1
Gross Capital Formation *(Fixed)*	21.7	20.4	-26.9	-8.7
Exports	5.2	2.9	-9.8	5.0
Imports	9.9	4.9	-22.3	-1.5
Inflation (yoy%)				
HICP (annual average)	7.6	12.0	2.5	2.0
HICP (end of period)	11.6	7.2	1.6	2.3
Fiscal Accounts (%GDP) - *EU Methodology*				
General Government Balance	0.1	1.8	-3.9	-2.8
Gross Public Debt	18.2	14.1	14.8	16.0
Primary Balance	4.6	3.9	0.0	-0.8
Labor Statistics - *National Definitions*				
Unemployment Rate (% of labor force)	7.7	6.3	7.6	9.0
Wage Growth *(total economy)*	19.5	26.5	8.5	2.0
External Accounts				
Current Account (% GDP)	-25.2	-25.4	-9.4	-6.0
Net FDI (EUR bn)	8.8	6.2	3.3	2.0
FDI / Current Account (%)	114.0	75.8	103.6	100.0
FX Reserves (EUR bn)	11.9	12.7	12.9	11.5
Domestic Credit	**2007**	**2008**	**Q3 09**	**Q4 09**
Total Credit (%GDP)	67.2	75.2	77.4	79.2
Credit to Enterprises (%GDP)	43.0	47.8	49.7	49.4
Credit to Households (%GDP)	23.0	26.0	27.4	28.2
FX Credit/Total Credit (%)	50.4	57.2	58.4	58.6
Private Sector Credit (yoy)	65.9	32.3	5.9	4.5
Loans to Deposits (%)	97.0	119.3	118.9	120.5
Financial Markets	**Current**	**3M**	**6M**	**12M**
Policy Rate		Currency Board		
EUR/BGN	1.96	1.96	1.96	1.96

Source: National Statistics, Eurostat, EcoWin, Eurobank Research

The Bulgarian government postpones once again ERM II application on revised fiscal data

The Bulgarian government announced in a press conference held by Finance Minister Djankov and attended by Prime Minister Borisov in early April that it will not apply for ERM II entry during 2010. The decision to postpone ERM II-entry application was reportedly triggered by the discovery of additional annexes in public procurement contracts that led to significant revision to past fiscal data. The government discovered unaccounted annexes to 150 procurement contracts that were signed during late 2008 and 2009 by the outgoing Socialist-led government, just ahead of the parliamentary elections.

According to the Prime Minister Borisov, the previous government never disclosed these annexes and, as a result, it submitted misleading information to the incoming government. The annexes were revealed only after Prime Minister Borisov ordered an investigation, but this happened only after the 2010 budget was drafted. The total value of the contracts amounted to 2.2 billion Leva (€1.1 billion) at a preliminary estimation.

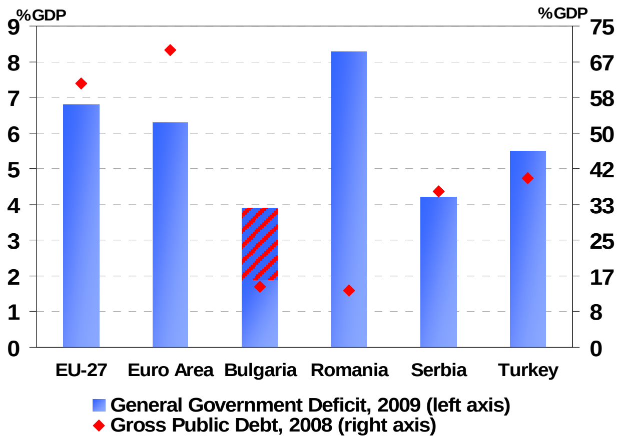
There have been months of market speculation over whether an application for ERM II entry would be submitted in 2010. Initially, the government had announced that it would seek to apply for ERM II entry in late 2009. Later on, it was announced that an entry application would be submitted after a European Commission's appraisal of Bulgaria's updated convergence program, some time before the end of June when the Spanish Presidency ends. Mr. Djankov said recently that Bulgaria may reapply for ERM II entry in early 2011, provided that there are no EU sanctions due to the hidden budget deficit.

Implications of fiscal data revisions

As a result of recent data revisions, the 2009 government deficit in ESA95 terms increased from 1.9% of GDP to 3.7% of GDP. The revised figure stands above the 3% threshold of the fiscal deficit Maastricht criterion, which automatically triggers the excessive deficit procedure. Yet, Bulgaria's fiscal situation remains healthier than in other EU countries. According to the latest EU forecasts, the EU-27 fiscal deficit amounted to 6.8% of GDP in 2009). Furthermore, Bulgaria's public debt ratio stood at 14.8% of GDP in 2009, remaining the second lowest (after Estonia) in EU27.

Figure 2

Bulgaria's fiscal situation remains healthier than in other EU countries



Source: National Statistics, Eurostat, IMF, Eurobank Research

In our view, there is no imminent threat to the stability of the currency board arrangement (CBA), given a still large pool of international reserves (€12.2 bn or 36.3% of GDP in late March) and the strong political commitment to the present regime. On the other hand, maintaining a sound fiscal position is a necessary albeit not sufficient condition to maintain public confidence on the currency board, and, subsequently, for the arrangement's sustainability. In our view, the government needs to make a harder effort to contain the budget deficit below 3% in 2010, in order to avoid the excessive deficit procedure being carried out. The government had previously announced 60 anti crisis measures in late March to contain the budget deficit below 2% of GDP, in order to increase the probability of being accepted to ERM II. In any case, the recent fiscal data revisions present a blow to the country's solid past fiscal record and the credibility of its fiscal accounts.

In addition, the decision of the Bulgarian government to postpone ERM II entry may entail significant implications for other EUR-adoption aspirants in New Europe. The first implication is that enlargement fatigue may increase in the period ahead, causing EUR-adoption plans to fall significantly behind for other candidates as well. In that sense, the recent sovereign credit crisis in the Euro area has raised valid concerns about Bulgaria's aspirations to apply for ERM II entry.

Last but not least, we anticipate the EU Commission to increase its level of scrutiny for all economies in New Europe, especially given the experience with Greece's fiscal statistics. On the positive side, pressure to accelerate structural reforms will likely intensify. The last EU interim report contained a relatively positive, though still cautious assessment with respect to the recent process of judicial and administrative reforms in Bulgaria.

Can higher exports drag Bulgaria out of recession?

The recent readings in a number of survey data and higher-frequency indicators demonstrate that economic conditions remain challenging. There are currently two opposing forces in the domestic economy. On the one hand, domestic demand is far from showing signs of improvement. Consumer confidence has retreated recently back towards the April 2009 record lows. Business confidence appears to have only marginally improved as well. Consumption remains depressed suffering from weak labor market, tight credit conditions and the implemented fiscal tightening by the new government.

Retail sales (including vehicles) continued to record negative double-digit growth readings in the first months of 2010. They were down by 18.5% yoy in February, against 16.3% in late 2009. Registered unemployment remains above the psychological level of 10%, compared to only 6.5% in January 2009. Construction output shows only partial signs of recovery, plunging by 30% yoy (when?) against 42% in last December. Finally, industrial output recorded a 9.1% yoy decline in February. The contraction is less severe at first sight. Yet, if one takes into account the favorable base effects from last year, the comparisons show that the economy is still mired in recession.

On the other hand, exports dynamics inspire optimism that the economy will gradually start to switch growth pattern. Exports grew by 10.4% yoy in Jan-Feb, for a fourth month in a row. Exports to non-EU markets expand more rapidly, benefiting particularly from the rebound in the Turkish economy. In addition, imports continued their declining trend, contracting by 8.4% yoy in the first two months of this year. The improvement in the outlook of exports, combined with a relatively high trade openness (exports stood at 50% of GDP in 2009) inspires optimism that net exports would be a positive contributor to growth in 2010, albeit to a lesser extent compared to 2009.

In view of the above, we upgraded our forecast for GDP growth in 2010 to -0.2%, from -0.5%. Our forecast is based on the assumption of a 5% yoy rise of exports and a 1.5% yoy decline in imports, in line with a scenario of still weak domestic demand dynamics. Yet, risks clearly lie to the downside with respect to the latter forecasts. These risks could materialize if the recovery in the exports markets proved to be weaker than expected. In addition, our forecast for weak domestic demand will push the current account deficit even lower this year, to 6% of GDP from 9.4% in 2009.

All in all, we do not share the optimism that the domestic economic downturn is already behind us. IMF maintains its GDP growth forecast +0.2% for 2010, while the government is about to revise its own forecast to 1.0%, from 0.3% currently. In our view, the economy is not likely to return to positive growth territory before the second half of 2010, at the earliest.

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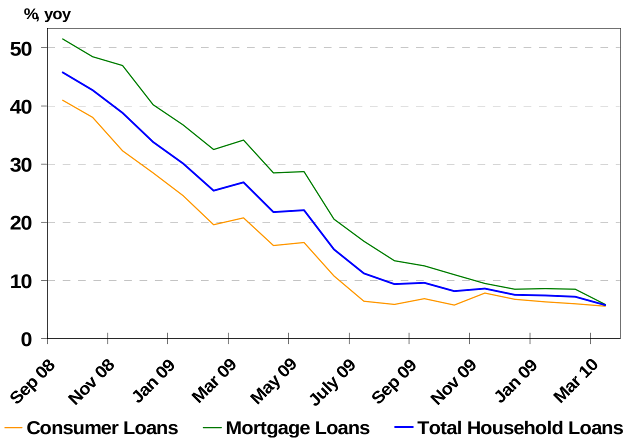
Recent credit developments and outlook

Credit market slowdown continued in February, with domestic credit declining by 0.3% mom. On a yearly basis, it increased by 3.4%, down from 3.8% in January. This is the lowest figure recorded the last decade. Indicatively, the corresponding figure in February 2009 was 27%, while between 2004 and 2008 credit ran with an average rate of 43% yoy. The decline in credit growth is mainly a result of the deceleration in corporate lending, which has decreased by almost 3% since November, when its decline started. (Figure 2)

Figure 2

Slowdown in household lending continues in Q110



Source: Bulgarian National Bank, Eurobank Research

On the positive side, deposit growth accelerated to 7.6% yoy, the highest figure since Q1:2009. The locomotive for this increase are deposits in Euro, which grew by 14.3% yoy in February. Moreover, it is encouraging that Leva deposits started recovering as well, after eight consecutive moths of negative growth. As a result of the above developments, loans to deposits ratio dropped to 1.16, the lowest level since the escalation of the crisis in September 2008.

The general outlook of the Bulgarian banking sector is rather mixed. One of its strengths is its healthy financial soundness indicators. Liquidity ratio (liquid assets over total liabilities) rose to a vigorous 23% in February, up from 21.6% in January, and 20.8% a year ago. Tier I capital adequacy ratio stood at 14% at the end of 2009. The debt burden of the economy, with total credit accounting for less than 80% of GDP, although high for regional standards, it still remains one of the lowest in the EU (the figure for EU-27 is around 145%). It is also worth noting that at least two of Bulgaria's top ten banks have decided to distribute dividends, for the first time since the outbreak of the financial crisis.

Nevertheless, we should not be very optimistic. Since credit expansion trails income growth, and given that Bulgarian economy hit a bottom just in Q4:2009, lending activity is expected to remain stagnant at least until Q2:2010, before starting to recover mildly. Furthermore, credit quality is expected to deteriorate in the months to come, a view we had expressed in our December *Trip Notes from Bulgaria*. Non-performing loans ratio, although being one of the lowest in the region (6.4% by the end of 2009), is on the rise. In its semi-annual report on financial stability, IMF forecasts that they will peak in 2010. The first bank statements are not encouraging either: profits declined by 23% in January-February 2010, compared to the corresponding period of the previous year.

The Bulgarian financial system has weathered the crisis rather satisfactorily so far. We believe that it is more than half of the way out of the woods; yet there are still challenges ahead in the rest of the way.

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Poland

Recent unfortunate plane crash not expected to cause major domestic instability

- **Recent unfortunate plane crash, in which Poland's President and Central Bank's President were killed, is not expected to cause major instability and, most likely, it will enable the Tusk-led government to solidify its political dominance**
- **Central Bank President's passing is not likely to affect monetary policy stance, at least in the short term, as inflation is falling and the strengthening of the zloty is already exerting a tightening effect**
- **March economic data surprised on the upside, reflecting the strong rebound of the Polish economy**

Poland: Eurobank EFG Forecasts

	2007	2008	2009	2010f
Real GDP (% yoy)	6.8	5.0	1.8	2.7
Private Consumption	4.9	5.9	2.3	2.7
Government Consumption	3.7	7.5	1.4	1.1
Gross Capital Formation	17.6	8.2	-13.1	1.8
Exports	9.1	7.3	-9.0	3.0
Imports	13.7	8.4	-14.2	3.3
Inflation (% yoy)				
CPI (annual average)	2.5	4.2	3.5	2.5
CPI (end of period)	4.0	3.3	3.5	2.8
Fiscal Accounts (% GDP)				
General Government Balance	-1.9	-3.6	-7.2	-7.0
Gross Public Debt	45.0	47.2	50.7	55.0
Labor Statistics (%)				
Unemployment Rate (% of labor force)	12.7	9.8	11.0	12.5
Wage Growth *(private sector - average)*	N/A	N/A	4.2	3.4
External Accounts				
Current Account (% GDP)	-5.2	-5.1	-2.0	-3.0
Net FDI (bn EUR)	13.2	8.0	6.1	7.5
FDI / Current Account	89.8	43.7	122.2	80.0
FX Reserves (bn EUR)	37.1	40.6	54.8	62.0
Domestic Credit	**2007**	**2008**	**Q3 09**	**Q4 09**
Total Credit (% GDP)	40.3	50.7	51.7	52.8
Credit to Enterprises (% GDP)	14.9	17.8	17.1	16.3
Credit to Households (% GDP)	22.0	29.3	30.9	31.0
FX Credit/Total Credit (%)	23.7	32.6	31.7	16.1
Private Sector Credit (% yoy)	33.5	38.1	18.4	48.2
Loans to Deposits (%)	92.9	105.2	102.9	100.9
Financial Markets	**Current**	**3M**	**6M**	**12M**
Policy Rate	3.50	3.50	3.50	3.75
EUR/PLN	3.93	3.80	3.70	3.80

Source: NBP, Eurostat, EcoWin, Bloomberg, Eurobank Research

Poland's President, Central Bank's President and a large part of political elite were killed in a plane crash in Smolensk, Russia

Polish President, Lech Kaczynski, was killed on April 10 in a plane crash in Smolensk, Russia. Other top Polish officials also lost their lives in the same accident, including the President of the National Bank of Poland (NBP), Stawomir Skrzypek, the Deputy Foreign Minister, Andrzej Kremer, and a number of high-ranking members of the PiS, the main opposition party headed by Lech Kaczynski's twin brother Jaroslaw Kaczynski. Understandably, this tragic event has created uncertainty with respect to Poland's political situation and the future course of monetary policy. However, our assessment is that any domestic instability created by the unfortunate incidence will be rather short-lived as the country's constitutional mechanisms should facilitate a smooth institutional transition and ensure long-term stability.

Presidential elections, originally due in October, are now set for June 20

The speaker of the lower house of the parliament, Bronislaw Komorowski, took over all presidential duties as Poland's constitution dictates. According to the Polish constitution, the presidency is an elected post and, therefore, no line of succession exists. Komorowski announced the date of new elections which had to take place within 60 days. Hence, domestic presidential elections are set for June 20, 2010. Komorowski is the presidential candidate of the ruling Civic Platform party, PO. Therefore, he would have been the main opponent of late Lech Kaczynski in the next presidential elections, which were originally due in October 2010. Lech Kaczynski was trailing far behind his opponent in the polls, but the recent tragedy may increase public sympathy for his party, PiS. According to recent announcements, Jaroslaw Kaczynski, who was also a former Prime Minister in the previous administration, was appointed as PiS candidate in the upcoming presidential elections. What's more, the junior partner in ruling coalition, the Peasant's Party (PSL), has named its leader, Waldemar Pawlak, who is also the current Deputy Prime Minister, as its candidate for the presidential run-off. Opinion polls published earlier this month, showed Poland's Acting President, Bronislaw Komorowski, would win 55% of the vote in the run-off against 32% for Jaroslaw Kaczynski. In case that no candidate manages to win more than 50% of the vote, there will be a second round scheduled for the 4th of July.

Overall, taking into account that the unfortunate accident will not change the balance of forces in the parliament, the country's macroeconomic fundamentals remain solid. The political implications will be the solidity of political dominance of the Tusk-led government. Moreover, most likely, there will be a smoother cooperation between government and the newly elected President. This, in turn, will enable the government to implement the set of reforms aimed to restore stability in public finances.

Central Bank clashes with the government are likely to abate

Deceased central banker Stawomir Skrzypek was appointed President of the National Bank of Poland (NBP) in January 2007 by Lech Kaczynski and was seen as belonging among the dovish members of the Monetary Policy Council (MPC). His responsibilities are now taken over by his First Deputy, Piotr Wiesiolek, who was also appointed by Lech Kaczynski, in March 2008. Under Polish law, the new NBP governor has to be appointed by the President within three months. The Acting President, Komorowski, has two options: Either to designate the new central bank head himself or leave the decision to the next elected President. The latter option seems less likely as the new President will not be sworn in before late June, which would be very close to the deadline of three months for appointing the new NBP governor.

Under Skrzypek, the central bank and the government had frequently clashed. In March, they clashed over accounting rules concerning the transfer of NBP profits to the Polish Treasury. The latest tension involved a dispute over whether Poland should renew its $20bn Flexible Credit Line (FCL). The late NBP President argued that FCL was no longer necessary. That said, we believe that relations between the central bank and the government will, most likely, improve under Skrzypek's successor.

Skrzypek's passing is unlikely to affect monetary policy

From a market perspective, the designation of the National Bank's President is a vital issue. However, Skrzypek's passing is unlikely to affect monetary policy, at least in the short term, as inflation is falling and the strengthening of the zloty is already exerting a tightening effect. As a result, even if the new NBP President proves more hawkish than his predecessor, the MPC is unlikely to hike interest rates before year-end (the benchmark rate currently stands at 3.50%). Moreover, Skrzypek is thought to have been the driving force behind early April's direct intervention in the FX market in order to halt a further significant appreciation of the zloty (the EUR/PLN hit 16-month lows near 3.82 on April 7th). Yet this move was politically uncontroversial and totally backed by the government. Therefore, we do not expect any major changes in future NBP policy deliberations. We see volatility in the zloty's exchange rates persisting in the short-term, but we do not expect the currency to weaken in any meaningful way.

All in all, the market implications after this tragic event are limited. Polish markets were relatively muted, showing resilience in the first trading session since the plane crash. Local bond yield dynamics will continue, in our assessment, to be determined by domestic macro developments with the size and reduction of the fiscal deficit being the key factors. We believe that the unfortunate incident will not threaten political and financial stability in Poland in any fundamental way.

Domestic macro data continue to surprised on the upside

The Polish Statistical Office revised upwards its full year 2009 GDP growth to 1.8% yoy from its preliminary estimate of 1.7% yoy. What's more, economic data released in March surprised on the upside, reflecting the strong rebound of the Polish economy. In more detail, Polish industrial production grew by 12.3% yoy up from 9.2% yoy in the prior month and well above the 10.1% yoy consensus forecast. The outcome confirms a strong recovery in the Polish industrial sector. Retail sales rose to 8.7% yoy, from 0.1% yoy in February. The consensus expectation for retail sales was 4.3% yoy. Even more positive are the most recent data released concerning the labour market. Wage growth accelerated to 4.8% yoy in March, beating the consensus of 2.8% yoy, up from 2.9% yoy rise in the previous month. Employment losses eased to -0.6% yoy from -1.1% yoy in February. On a less positive note, unemployment moderated gradually, but it still remains at high levels (12.9% yoy in March). (Figure 1) Overall, Polish consumer behaviour seems not to be much affected by the deterioration of the labour market conditions.

Figure 1
March economic data surprised on the upside

	Mar 10	Feb 10	Consensus
Wage growth	4.8%	2.9%	2.8%
Employment	-0.4%	-1.1%	-0.7%
Unemployment	13.0%	12.9%	12.9%
Retail sales	8.7%	0.1%	4.3%
Industrial production	12.3%	9.2%	10.1%

Source: Reuters, Eurobank Research

Inflation well under control

Poland's inflation dropped further to 2.6% yoy in March from a 2.9% yoy revised print in February. March CPI was in line with the consensus and it was driven primarily by a moderation in food price inflation. Moreover, core CPI stood at 2.0% yoy in March from 2.2% yoy recorded the previous month. We expect CPI to fall towards the lower bound of the NBP target, 2.5±1%, in the middle of the year and to average 2.5% yoy in 2010.

Taking into account that inflation remains under control, there is no immediate pressure on the NBP to tighten monetary policy. We expect the NBP to keep its policy rate unchanged at 3.5% throughout the year.

Current account showed a small surplus in February

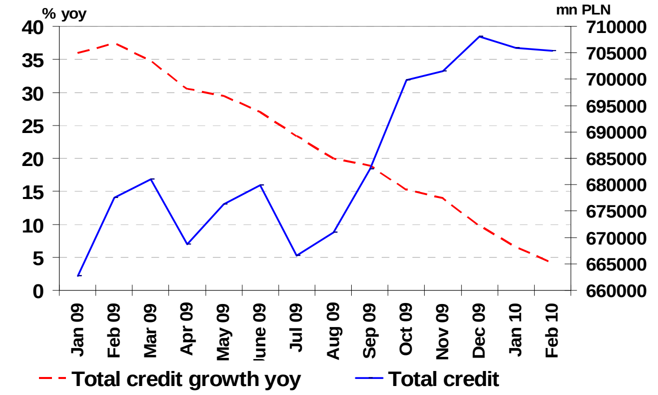
Current account balance for February recorded a surplus of €106mn from a deficit of €754nm in January. February's figure was in line with the €150mn consensus. Moreover, net FDI inflows remained strong at €814mn vs. €1153mn in the prior month. We expect the rebound in FDI to continue in the months as the privatisation programme moves on.

Credit growth still positive, but decelerating

Total credit growth stood at 4.1% yoy in February compared to 6.5% yoy in January and double-digit figures recorded until last November. (Figure 2)

Figure 2

Positive credit growth but with a decelerating trend

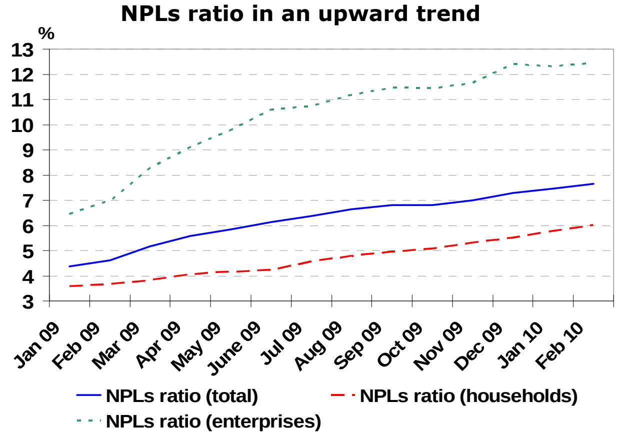


Source: National Bank of Poland, Eurobank Research

On the other hand, there is still an upward trend in the NPLs ratio which stood at 7.6% in February from 7.4% recorded in January. What's more, the corporate sector NPLs ratio reached 12.4%. (Figure 3)

Figure 3

NPLs ratio in an upward trend



Source: National Bank of Poland, Eurobank Research

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Romania

Q1 fiscal performance in line with IMF requirements

- **Government's fiscal consolidation programme on track with IMF requirements, but budget execution risks remain**
- **Greek debt crisis has so far limited, yet visible, impact on Romania's financial markets: EUR/RON bounced back to 4.15 and 5y-CDS spreads climbed by 50bps to levels above 250 bps in late April.**

Fiscal performance in Q1 in line with IMF requirements

The government fiscal consolidation program is largely on track. The consolidated budget deficit came at RON 8.22 billion in the first quarter of 2010 i.e., slightly lower that the RON 8.25 billion deficit target envisioned in the IMF-backed stabilization programme. As a result, the consolidated budget deficit stood at 1.53% of the GDP in Q1:2010, compared to a full-year target of 5.9% of GDP.

The collection of revenues in Q1 lagged behind initial budgetary plans. Total revenues amounted to 37.5 billion RON in the first quarter of 2010, with the corresponding annual growth rate coming in some 1.4ppts lower than the 4.6% budget target. Persisting weakness in private consumption had a negative impact on VAT collections (-11.5% yoy). On a more positive note, revenue from excise duties and the profits tax surprised positively (up by 5.9% yoy and 8.9% yoy, respectively). However, this was not enough to compensate for lower VAT receipts.

On the expenditures side, government outlays were marginally lower in Q1 (-0.5% yoy), with capital expenditure being reduced massively (by 36% yoy). Yet this was masqued behind the increase of government's arrears to the private sector. The wage bill was also lower in Q1 (by 8.7% yoy). The introduction of a 4-day unpaid leave for public sector employees and a number of lay-offs in the energy sector, were the drivers behind the latter development. On the other hand, spending on social security grew by 15.6% yoy in the first quarter of the year, mainly because of a rise in unemployment benefits (+119.4% yoy).

On a more positive note, the parliament adopted the fiscal responsibility law in late March. The law was stipulated in the IMF requirements. The fiscal responsibility law sets up procedures to improve budget planning, establish limits on budget revisions during the course of the year and lay out fiscal rules on expenditures, public debt and the primary deficit. In addition, the law provides for the establishment of an independent Fiscal Council, whose main task will be to assess the governments' strategies and budget forecasts.

Romania: Eurobank EFG Forecasts

	2007	2008	2009	2010f
Real GDP (yoy%)	6.3	7.1	-7.1	1.0
Private Consumption	10.3	8.7	-10.0	1.5
Govern. Consumption	7.7	3.8	1.2	-0.8
Gross Capital Formation	28.9	19.3	-28.0	2.0
Exports	7.8	19.4	-5.2	4.5
Imports	27.3	17.5	-21.3	6.0
Inflation (yoy%)				
CPI (annual average)	4.8	7.9	5.6	3.6
CPI (end of period)	6.6	6.3	4.7	3.5
Fiscal Accounts (%GDP)				
General Government Balance (ESA 95)	-2.5	-5.4	-8.3	-6.8
Gross Public Debt (ESA 95)	12.6	13.3	23.7	27.4
Labor Statistics (annual avg,%)				
Unemployment Rate (% of labor force)	4.3	4.0	6.3	9.0
Wage Growth (total economy)	22.6	23.6	8.4	1.0
External Accounts				
Current Account (%GDP)	-13.4	-11.6	-4.4	-5.5
Net FDI (EUR bn)	7.3	9.5	4.8	4.5
FDI / Current Account (%)	42.2	57.6	94.3	65.0
FX Reserves (EUR bn)	25.3	26.2	28.3	29.5
Domestic Credit *(end of period)*	**2007**	**2008**	**Q3 09**	**Q4 09**
Total Credit (%GDP)	39.0	42.7	48.3	50.2
Credit to Enterprises (%GDP)	18.0	18.8	19.2	19.6
Credit to Households (%GDP)	17.7	19.7	19.9	20.4
FX Credit/Total Credit (%, private)	51.0	53.1	59.7	60.1
Private Sector Credit (yoy)	60.4	33.7	2.4	0.9
Loans to Deposits (%)	108.9	131.9	128.8	130.6
Financial Markets	**Current**	**3M**	**6M**	**12M**
Policy Rate	6.50	6.00	6.00	6.50
EUR/RON	4.13	4.15	4.20	4.10

Source: National Sources, Eurostat, IMF, Eurobank Research

The Council's members will be nominated by the Romanian Academy, the Central Bank, the Academy of Economic Studies, the Romanian Bank Institute and the Romanian Banking Association. The appointment of the members will be for a five-year term, which can be renewed for an additional period.

In our view, the adoption of the law is a major step towards fiscal discipline. Romania has a long record of missing fiscal targets. Thus, the law will improve both the transparency and the predictability of budget execution. From a long-term perspective, the fiscal responsibility law will improve the sustainability of public finances.

2010 fiscal target still attainable, budget execution risks remain

As we emphasized in our previous issues of our *New Europe Economics and Strategy*, the implementation of this year's budget may well prove a Herculean task. IMF was very lenient with the implementation of Romania's budget last year. The 2009 fiscal target was revised several times from an initial deficit of 4.6% of GDP to 7.3% of GDP. The additional room for fiscal policy maneuvering came, mainly, from accumulated arrears to the private sector. In our view, there is rather limited room for the IMF to be as lenient in 2010, especially if the credibility of the programme is to be maintained.

In our view, the 2010 fiscal target is still attainable although there are significant risks to the fiscal outlook. The first one stems from negative surprises in the domestic growth environment. The budget was drafted on the assumption of 1.3% real GDP growth this year; an "optimistic" forecast according to the European Commission's assessment of the latest Romanian Convergence program. Furthermore, the 2010 budget envisions a 7.9% yoy increase in revenues, a rather ambitious target in the absence of additional revenue-generating measures such as an increase in the current flat tax rate on personal-incomes and corporate profits. This is especially true in the face of a domestic macro trajectory characterized by still rising unemployment and weak domestic-demand dynamics.

Furthermore, the government has committed to implement harsh and unpopular spending cuts. The total public-sector wage bill needs to be cut by 2 pps of GDP. The press has repeatedly mentioned that this necessitates some 100,000 layoffs in the public sector. Yet, there has been no plan announced by the government so far on how to implement such a measure. Understandably, these cuts may encounter significant resistance from trade unions and also test the cohesion of the government coalition.

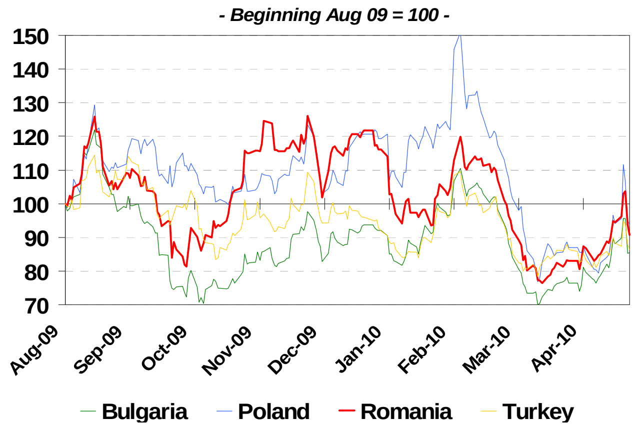
Finally, the achievement of the ambitious target for budgetary expenditures hinges on the completion of significant reforms, including the pension reform, and the unified public wages scheme. The adoption and the full implementation of those reforms are still pending. Originally scheduled for the end of 2009, the pension reform is now due by the end of June 2010. Although the government appears to be committed to the reform, the risk of not implementing it is still high. In addition, the activation of the uniform wage law requires the adoption of additional legislation. As a result, it may not be fully implemented before September.

EUR/RON back above 4.10 on lingering investor worries over the sovereign debt crisis in the euro area

After trading to as low as 4.05/€ in late March, the domestic currency weakened to trade around 4.13/€ at the time of writing. Initially, the Central Bank used both verbal jawboning and actual FX intervention to avoid further a appreciation of the RON. Vice Governor Popa expressed his concern that a stronger currency could hurt exports and undermine the recovery of the Romanian economy. The Central Bank has a very solid record of selective interventions in the FX market. When the global financial crisis spread to regional markets in New Europe in the autumn of 2008, the NBR successfully pulled liquidity out of the market and used its FX reserves, in order to defend the RON. Presently, a primary aim of the central bank is to prevent further significant currency appreciation. In our view, the latest weakening of the RON suits the needs of the exports-oriented sector of the Romanian economy.

In addition, the recent negative news flow from the Greek fiscal crisis has dominated the regional markets, adding to the domestic currency's depreciation trend. The RON hit multi-month lows near 4.15/€ on April 19. The local money-market reacted negatively to increased fears of contagion. At the same time, short-term interest rates jumped to around 6%, but lately returned to previous low levels near 4%, i.e., below the policy rate. Accordingly, 5y-CDS spreads climbed by 50bps to as high as 255 bps in late April. (Figure 1) However, we expect the effects of the Greek debt crisis to abate gradually, volatility to subside and regional markets to return to normality.

Figure 1
Regional CDS spreads climbed on increased fears of a Greek debt contagion



Source: National Institute of Statistics of Romania, Eurostat, Eurobank Research

We argued in our previous issue of New Europe Economics & Strategy that we expect the NBR to cut its key policy rate (6.5%, currently) by a further 50bps by the end of 1H-2010, assuming no unpleasant inflation surprises or renewed domestic political jitters. We reiterate the latter view, especially as domestic demand data continue to surprise to the downside. In our view, there is no reason for the central bank to maintain real interest rates as high as 250bps, a level recorded in the period before the Presidential elections, given that uncertainties with respect to IMF program have now diminished.

The Central Bank is likely to maintain its easing bias in the period ahead, probably adopting more cautious stance on further policy easing as long as market worries over the sovereign debt crisis in the euro area persist. For that reason, the NBR slowed down the easing cycle, cutting interest rates further by 25 bps to 6.25% in its meeting on

May 4. In addition, the Central Bank decided to keep unchanged the minimum reserve requirement ratio for both FX and RON denominated liabilities of credit institutions. With respect to the RON, we think that it will continue to fluctuate within the 4.00-4.20/€ range for the greater part of the year. Looking further ahead, we believe that RON still has the potential to appreciate on improved sentiment towards the domestic economy and Romanian assets, yet Central Bank interventions will most probably prevent it from doing so.

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Recent domestic credit developments and outlook

Conditions in the Romanian credit market continued to deteriorate, as contraction in private sector credit accelerated to -3.7% yoy in February from -3.5% yoy in January. This decrease may only partially be attributed to the appreciation of the leu: in FX-adjusted terms, credit to the private sector shrank by 0.9% yoy. The decline in credit activity can be attributed to banks' delays in lowering interest rates on household loans, despite the significant drops in central bank's policy rate, but to debtors' reluctance to borrow further.

This comes as no surprise, given the continuous deterioration of credit quality over the last eighteen months. (Table A) Non-performing loans (NPLs) climbed to 16.7% of total unadjusted loan exposure in February, and there are no signs that they have peaked yet. On the contrary, loans characterised as "substandard" increased by 11% yoy (although they fell slightly by 0.9% mom). Note that, unlike usual practices, substandard loans are not classified as non-performing in Romania. If, therefore, no dramatic changes occur, these loans are expected to become non-performing within the next few months, increasing thus the NPLs ratio. Furthermore, the composition of the NPLs portfolio has significantly worsened, with "loss" loans now constituting 77% of total NPLs.

Romanian Central Bank cut its monetary policy rate in late March for a third time this year, partly in order to encourage "a sustainable revival of lending". Its view is that bank lending rates remain high, despite the lower, inflation, the drops in the policy rate, and the improving financial soundness indicators of the credit institutions.

Nevertheless, banks may have good reasons for being thrifty. In March, the Senate passed a bill on personal bankruptcy, enabling individuals in economic hardship to reschedule loan payments, and write off up to a fourth of their debt to banks. The bill, supported by a large part of the centre-left opposition as well, is expected to be approved by the Parliament with a comfortable majority. It has, however, been criticised not only by the (mainly foreign-owned) commercial banks, but also by the central bank.

Lending to households accounts for almost half of private credit (or 40% of total domestic credit). The main concern for bankers is not the possible write-offs of overdue loans (which according to Moody's could reach up to 10% of bank capital), but rather the moral hazard issues that the new law could raise. The Romanian Banking Association warned that in case the law is enacted, the cost of credit will soar, due to the losses that banks will suffer. The impact of the new law on mortgage loans could be even greater. According to a clause, house foreclosures may be suspended for up to two years, without accounting for the delays in courtrooms. This would increase credit risk and lower the collateral value of the houses. Housing loans amount to 12% of private credit.

Outlook seems slightly brighter for corporate lending, which has increased by 1.7% ytd. Yet the close-down of about 20,000 firms in Q1:2010, largely due to liquidity problems, is not a positive sign. If this continues, banks and firms could find themselves caught into a vicious cycle. It would seem that credit activity in Romania has not yet bottomed.

Table A
Romania's credit outlook has been deteriorating since the crisis reached the country in Q3:2008

%	Sep 08	Mar 09	Sep 09	Dec 09	Feb 10
Private Credit Growth (yoy)	50.5	23.1	2.4	0.9	-3.7
NBR Policy Rate	10.25	10.00	8.00	8.00	7.00
Average Interest Rate, Lei-denominated Loans*	15.3	18.1	16.5	16.6	15.6
Average Interest Rate, Euro-denominated Loans*	8.4	7.4	6.9	6.8	6.7
FX-denominated Credit/ Total Credit (Private Sector)	56.1	59.0	59.7	60.1	60.1
NPLs ratio	5.3	9.4	14.2	15.3	16.7
Provisions / NPLs	46.4	47.9	42.2	45.9	46.0
Leverage (Tier I) Ratio	7.1	6.8	7.0	7.1	7.4
Overall Capital Adequacy (Tier II) Ratio	11.9	13.2	13.7	14.0	-
Total Loans/Toal Deposits	126.0	135.2	128.8	130.6	130.9

* *Average bank interest rate on outstanding household and corporate loans*

Source: National Bank of Romania, Eurobank Research

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Serbia

New nomination for the Central Bank Governor post

- **Output contraction contained to 3% in 2009; mild recovery expected this year**
- **Structural reforms in the public sector are lagging behind, yet IMF approves disbursement of third tranche of funds under the present Stand-By Arrangement**
- **New Central Bank Governor to face difficult balancing-act of delivering more rate cuts, while maintaining stability in Dinar exchange rates.**

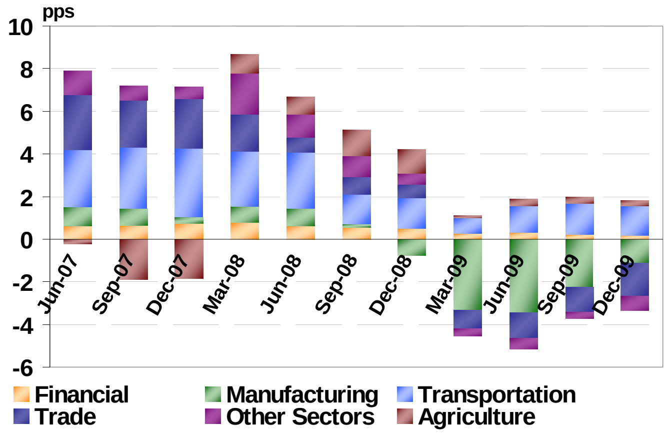
Output decline contained to 3% in 2009. Modest recovery is expected this year

Output losses in 2009 turned out to be much lower than expected. According to the latest available data, GDP shrunk by 3% yoy in 2009 after recording positive growth of 5.5% a year earlier. The annual pace of output contraction moderated to 1.6% in Q4, from 2.3% in Q3.

The domestic economy remains heavily influenced by the performance of the non-tradable sectors. Transportation & telecommunication and financial services grew by 8.1% yoy and 3.7% yoy, respectively in Q4:2009, cumulatively contributing some 1.6 pps to overall GDP growth. On the other hand, the global financial crisis continued to exert a negative impact on sectors such as hotels & restaurants (-16.6% yoy), construction (-19.6% yoy) and wholesale & retail trade (-10.9%). Manufacturing showed some improvement in Q4, contracting by 6.9% yoy, after recording double-digit negative growth in the previous quarters. Agriculture had a minor, yet still positive, contribution in Q4 (0.3%).

Figure 1

Non-tradales sectors still drive growth in Serbia



Source: National Statistics, Eurobank Research

Serbia: Eurobank EFG Forecasts

	2007	2008	2009	2010f
Real GDP (yoy%)	6.9	5.5	-3.0	1.5
Inflation (yoy%)				
CPI (annual average)	6.0	12.5	8.2	5.0
CPI (end of period)	11.0	8.6	6.6	5.5
Fiscal Accounts (%GDP)				
General Government Balance	-1.9	-2.6	-4.2	-4.0
Gross Public Debt	29.4	25.6	31.3	37.0
Labor Statistics (%)				
Unemployment Rate (%of labor force, ILO)	18.8	14.7	16.1	18.5
Wage Growth *(total economy)*	22.0	17.9	-3.3	2.0
External Accounts				
Current Account (% GDP)	-15.6	-17.1	-5.7	-8.5
Net FDI (EUR bn)	1.8	1.8	1.4	1.5
FDI / Current Account (%)	39.5	30.0	78.7	55.0
FX Reserves (EUR bn)	9.6	8.2	10.6	9.5
Domestic Credit	**2007**	**2008**	**Q3 09**	**Q4 09**
Total Credit (%GDP)	35.4	41.0	46.2	48.7
Credit to Enterprises (%GDP)	21.5	25.8	28.5	29.4
Credit to Households (%GDP)	12.9	13.9	14.0	14.5
Private Sector Credit (yoy)	40.2	34.9	20.2	14.3
Loans to Deposits (%)	99.9	125.1	130.7	127.0
Financial Markets	**Current**	**3M**	**6M**	**12M**
Policy Rate	8.50	8.00	7.50	7.50
EUR/RSD	99.46	100.00	105.00	105.00

Source: National Sources, IMF, Eurobank Research

A turnaround in the domestic economy appears to have begun already, but recovery will be weak. In that direction, industry has lately shown some signs of revival. Industrial production rose by 3% yoy in the first two months of 2010, returning to a positive growth territory after a year of losses. Nevertheless, this was mainly the result of favorable base effects. In addition, the recovery is disproportionably coming from the metals sector.

We maintain our GDP growth forecast for Serbia at 1.5% yoy in 2010, much lower than potential. Domestic consumption is expected to remain weak as a result of constrained disposable incomes. Potentially, the hotly-debated unfreezing of wages and pensions could add some stimulus to growth, but this effect may prove short-lived. On the positive side, investments and net exports are expected to have a significant positive contribution to overall growth this year. The completion of large privatization items (*e.g.* the award of the second license for fixed telephony) and the implementation of large infrastructure projects (*e.g.* Corridor X motorway) should favor investment spending in the period ahead. Moreover, the resumption of capital and trade flows (exports recovered by 4.2% yoy in January) should continue to support net exports, though the latter may not contribute to growth as much as it did in 2009, because base effects from imports will kick in.

Structural reforms in the public sector are lagging behind

The IMF Board approved in late March the disbursement of the third tranche of funds (€360m) to Serbia, under the existing Stand-By Arrangement. Serbia has made use of only half of this amount, which brings the overall amount of funds disbursed so far to €1.3bn out of a total of €2.9bn available under the Fund's present lending facility. In its latest review, the Fund assessed that Serbia performed well on its economic program, meeting all quantitative targets. However, fiscal adjustment in 2009 was largely the result of ad hoc measures which need to be replaced by more permanent spending cuts in the government-run sectors of education, health, and central administration. More also need to be done with respect to the planned pension system reform and the adoption of the fiscal responsibility law.

The accomplishment of the fiscal target (4.5% of GDP) in 2009 was mainly on the back of extra savings generated from slashing capital expenditure to a half of what was originally planned. In our view, meeting the 4% of GDP (revised) deficit target for this year will require a harder effort by the government to cut costs, restructure the public sector and achieve fiscal consolidation. The government has pledged to slash public-sector employment, particularly at the local government level, proceed with the pension reform and also freeze wages and pensions. Yet, progress on fiscal reforms has been rather limited thus far. To complicate things further, voices have lately increased within the coalition government to unfreeze wages and pensions. We anticipate the latter issue to become a contentious debate topic in the near-future, potentially increasing frictions with the IMF.

Government nominates new candidate for the Central Bank Governor post.

The coalition government reached a consensus to nominate the current Chairman of the NBS Council, Dejan Soskic, for the Central Bank Governor Post. The nomination came as a compromise between the main coalition partners, the Democratic Party and the G17Plus. The procedure for the appointment may last for up to three months. The nomination will be officially made by the finance committee and will be subject to parliamentary approval. A number of government officials have tried to reassure markets lately that the appointment of a new Central bank Governor will not produce any shift in the present policy framework. In any case, the latter is constrained, to a certain degree, by the IMF programme´s conditionalities.

The former NBS Governor, Radovan Jelasic, resigned unexpectedly on March 23rd on personal reasons. Nevertheless, there has been wide speculation over the reasons that led him to resign. Mr. Jelasic had a good working relation with the current government for a long time. Yet, it is widely believed that he resigned under political pressures to cut interest rates more aggressively in order to prop up lending and economic activity. Following his resignation, the Central Bank cut interest rates twice by 100 bps in less than a month (late March-early April).

It is also known that that the former Governor disagreed openly with the government initiatives on consumer lending. The Ministry of Economy plans to spend RSD 1.5bn on subsidies for commercial banks to provide a total of RSD 30 bn in consumer loans. The subsidized loans can be utilized to purchase domestic goods with the aim to boost economic activity. The outgoing governor argued many times in the past that fiscal stimulus ought to be channeled towards public investment instead of current consumption. This disagreement was on the basis that, boosting consumer demand does not bode well with the new export-oriented growth paradigm the Serbian economy needs to follow. The fact that his resignation was handed in at the very same day of the announcement of the plan may well be an illustration of that disagreement.

Will the appointment of a new Central Bank Governor signal a change in monetary policy stance?

In our view, Mr Jelasic's resignation may have significant implications of how foreign investors view the credibility of NBS´s monetary policy stance. Serbia will be losing a Governor who developed a very positive profile abroad. He managed in the past to establish himself as one of the anchors of credibility in terms of economic policy in the country. During his tenure, which coincided with the first transition period of the post-Milosevic area, the Central Bank became one of the most reliable institutions in the country. As one of the strongest advocates of the IMF programme, Mr. Jelasic led the Central Bank through the turbulent times of the international financial crisis.

Yet, the appointment of the new Governor will not necessarily bring a drastic change in the direction of domestic monetary policy. Shortly after the Central Bank last cut its key policy rate (by 50bps to 8.5% on April 8th 2010), Mr. Jelasic's successor signaled some further room for monetary policy easing. Nevertheless, he stressed the need for additional measures to ensure that extra liquidity is channeled to the real economy. In addition, he supported lowering reserve requirements further in an attempt to boost bank lending. Overall, the new Governor appears to place greater emphasis on domestic economic growth than his predecessor.

We believe that the new NBS Governor will be faced with a difficult balancing act in the period ahead. He will need to support the domestic economy via additional interest rate cuts, but, at the same time, contain inflation pressures and maintain currency stability. The Central Bank received a lot of domestic criticism for the recent depreciation of the Dinar.

Earlier this year, the Dinar slided close to an all time low of 100/€ from levels around 92-93/€ in last autumn *(the domestic currency stood around 99.47/€ at the time of the writing).* Back then, the press criticized the former Governor for not using the Bank's FX reserves more actively to defend the currency. Increased depreciation pressure on Dinar forced the Central Bank to spend already €620 mn during the first four months of 2010 out of a comfortable, yet declining, pool of FX reserves (€10.4bn in March).

Maintaining the Dinar stable will be a contentious and critical issue for the rest of the year. The new governor will have to strive to maintain confidence in the local currency, which is presently a key focus of market attention. Euroization in the domestic economy continues to be very high by regional standards, for a number of deep-rooted historic reasons. The phenomenon is dated back at the early 90s when the civil war in former Yugoslavia led to hyperinflation. The present high degree of Euroization diminishes the efficacy and efficiency of monetary policy. In addition, it entails important FX-related macro prudential risks. The present outstanding amount of FX-linked loans (84%) of total loans (RSD 1278bn in 2009) is partially matched, but not yet fully covered, by domestic FX-denominated deposits. Those represented (75%) of total deposits (RSD 1301bn in 2009).

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Recent domestic credit developments and outlook

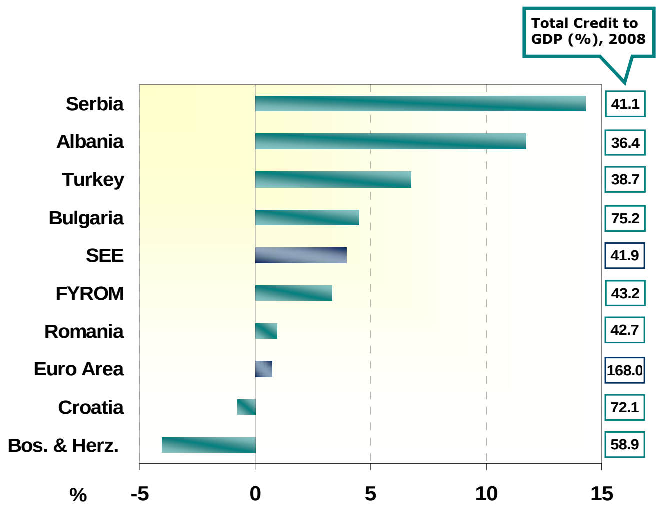
The outlook of the domestic credit market in Serbia remained pretty stable over the last month. Total credit resumed its upward trend, increasing by 23.1% yoy in February. A significant part of this increase can be ascribed to the expansion in general government borrowing, which has more than tripled over the last year. Nevertheless, private credit growth remained high by regional standards, increasing by 13.6% yoy. Even with the depreciation of the dinar accounted for, this figure remains above 8%. We do not believe that a reversal in this trend is very likely in the near future, rather the opposite: The relaxing of the regulations on banks' reserve requirements by Serbia's central bank last month, and its intention to lower them further, adds to the credit growth dynamics.

Deposits continued to grow as well. In February, deposits of the private sector increased by 17.2% yoy on FX adjusted terms. This is significantly higher compared to zero growth recorded last February.

The resilience of bank lending in Serbia may be explained in part by the following factors:

First, Serbia's credit market had been underdeveloped the past years (and probably still is) compared to the markets of other economies in the region. Total outstanding credit in Serbia did not exceed 41% of GDP by the end of 2008 (up from 35% in 2007), quite low even compared to other countries in the Western Balkans. (see Figure 2)

Figure 2
Private sector credit growth in Serbia the highest in SEE in 2009



Source: National Central Banks, National Statistics, ECB, Eurobank Research

Second, Serbia's banking system has been quite robust, and its financial soundness indicators have been distinctly better than its regional peers', in part due to the very strict regulatory environment until recently. Overall capital adequacy ratio in Serbia, for example, has remained over 20% in the past years, which is quite high even by global standards. In autumn 2008, when the financial crisis hit Serbia, it stood at 21.9%, being the highest in the region, while non-performing loans were only 4.3% of total loan portfolio. Hence, banks saw room for (relatively) safe credit expansion.

Third, Serbia did not delay to seek support from the IMF in the view of the upcoming recession. Financial aid came early enough and helped the Balkan nation to weather the crisis relatively well (the decline in Serbian GDP in 2009 was 3%, one of lowest in the region). More importantly for the banking sector, the Fund stipulated conditionalities aimed at modernising the banking supervision regime, and maintaining financial stability.

Another important factor that should be kept in mind, when examining the Serbian credit market, is the traditionally high euroisation of both debt and deposits.

Note that some of the above contingencies were present in other countries as well. (For example, Romania also received IMF support, although later than Serbia; in the Turkish credit market there is still room for further growth; Bulgaria's NPLs ratio is among the lowest in the region.) In conclusion, the good performance of credit activity in Serbia can be attributed more to the combination of these conditions, rather than to each one per se.

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Turkey

Strong rebound in domestic economy expected in 2010

- **Economic activity staged a surprisingly strong rebound in Q4:2010, bringing the 2009 annual rate of contraction to -4.7%**
- **Inflation outlook deteriorates and the CBRT is expected to start hiking rates in Q4 :2010**
- **Government evidently committed to fiscal consolidation, but risks lie ahead.**

Turkey: Eurobank EFG Forecasts	2007	2008	2009	2010f
Real GDP (yoy%)	4.7	0.7	-4.7	5.0
Private Consumption	5.5	-0.3	-4.0	2.5
Govern. Consumption	6.5	1.7	2.0	1.0
Gross Capital Formation	5.8	-6.2	-21.5	1.0
Exports	7.3	2.7	-7.0	16.0
Imports	10.7	-4.1	-18.5	18.5
Inflation (yoy%)				
CPI (annual average)	8.8	10.4	6.3	9.4
CPI (end of period)	8.4	10.1	6.5	8.7
Fiscal Accounts (%GDP)				
General Government Balance	-1.2	-1.8	-5.5	-4.5
Gross Public Debt	39.4	39.5	47.0	49.0
Primary Balance	3.0	1.7	-2.1	-0.3
Labor Statistics (%)				
Unemployment Rate (%of labor force)	10.6	13.6	13.5	12.0
External Accounts				
Current Account (% GDP)	-5.9	-5.7	-2.2	-3.5
Net FDI (USD)	19.9	15.8	6.1	8.5
FDI / Current Account	52.2	37.8	44.1	35.0
FX Reserves (USDbn)	73.3	71.0	69.0	70.0
Domestic Credit	**2007**	**2008**	**Q3 09**	**Q4 09**
Total Credit (%GDP)	28.0	31.0	33.0	35.0
Credit Private Sector (%GDP)	27.0	30.0	32.0	33.0
FX Credit/Total Credit (%)	11.5	13.2	14.0	14.9
Private Sector Credit (%yoy)	27.7	22.9	2.8	11.3
Loans to Deposits (%)	81.0	82.4	79.5	78.7
Financial Markets	**Current**	**3M**	**6M**	**12M**
Policy Rate	6.50	6.50	6.50	8.00
USD/TRY	1.48	1.50	1.55	1.50

Source: National Sources, Eurostat, IMF, Eurobank Research

Economic activity staged a surprisingly strong rebound in Q4

Domestic economic activity staged a strong rebound of 6.0%yoy in Q4:2009, reversing an 8.1%yoy contraction in the prior three quarters. The breakdown revealed strong gains in private spending (+4.7% yoy) and government consumption (+17.9% yoy), which along with higher inventories contributed cumulatively 8.1ppts to last year's GDP growth. Also depicting the recent improvement in domestic demand, the contribution of net exports became a drag for the first time since Q1: 2008, with a 10.5%yoy jump in imports' growth outpacing a 6.4%yoy rise in exports. On a less positive note, investment activity continued to deteriorate in Q4, albeit at a slower pace relative to the prior quarters (-4.7% yoy in Q4 vs.-19.2% yoy in the whole of 2009). Investments subtracting some 2.1ppts from GDP growth in Q4:2009. From the production side, significant improvements in wholesale and retail trade as well as manufacturing led the rebound, while a timid recovery was recorded in the transportation sector. For the year 2009 as a whole, GDP contracted by 4.7% yoy, official expectations for a deeper *(i.e., 6.0%yoy)* contraction.

High-frequency macro indicators suggest rebound is likely to prove sustainable

Recent macroeconomic data signals that the economic recovery will continue throughout this year. Namely, capacity utilization, which has remained in depressed levels for many months, bounced in April to reach its highest level since October 2008. Industrial production growth spiked to 18%yoy in February, posting a double-digit gain for the third consecutive month. Industrial output contracted considerably in August 2008-September 2009. The manufacturing confidence index surged to a 3-year high in April, remaining for the fourth month running above the 100-point threshold, which separates optimism from pessimism. Adding to evidence that the sector remains in expansionary territory, March's PMI manufacturing data revealed expansion for the 11th consecutive month. In yet another sign of a sustainable rebound in the domestic economy, vehicle production in Turkey soared by 69% yoy in March, pushing the January-March rate of increase to 81%yoy. A significant revival is also being observed in the tourism sector which normally accounts for ca 3% of Turkey's GDP. In detail, the number of foreign visitors to Turkey jumped 17.13% yoy in March pushing the Q1 2010 print 11.19% yoy higher. The latter followed a mere 2.8% yoy rise in 2009. Domestic consumption also appears to be on the mend, with consumer sentiment indicators and credit extended to households having embarked on an uptrend in recent months. Even so, unemployment remains not far off record highs hit late last year, suggesting that the rebound in consumption is likely to prove slow and gradual.

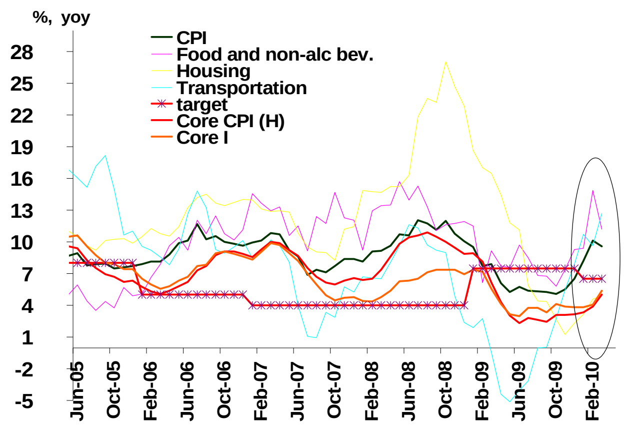
2010 GDP growth likely to outperform earlier expectations

Economic activity is likely to pick up further in the quarters ahead, being primarily driven by base effects and the adjustment in inventories. Domestic consumption and investments are also likely to improve. A rebound in goods exports and tourism is also likely to provide support, although we expect net exports' contribution to remain negative in the coming months as domestic demand recovers. Meanwhile, fiscal spending is likely to be reduced in 2010 as the government strives to contain its finances after a deep recession last year. Along these lines, we continue to expect GDP growth of 5% yoy in 2010 which still remains a tad above a 4.7% consensus forecast. That said, we would not be surprised to see the latter eventually converge with, or even exceed, our own forecast in the near future.

Inflation outlook worsening

Consumer inflation eased to 9.56% yoy in March after peaking at a 16-month high of 10.13% yoy in February. In fact, March marks the first month of lower headline CPI since October, when inflation stood at a 40-year trough (5.08% yoy). Since then, consumer inflation has embarked on an uptrend due to unfavorable base effects, higher food prices and regulated price hikes. At first glance, March's data could be seen as favorable. However, a rise in core indices and PPI that month, suggests that the increase in underline price pressures may also be attributed to a bounce in domestic demand and not solely temporary factors, as it was previously thought. Signaling rising input costs, PPI rose 1.94%mom in March for an annual rate of increase of 8.58%, vs. 6.82% yoy a month earlier, while the core CPI sub-index I, which is closely monitored by the CBRT and excludes food, energy, alcoholic and non-alcoholic beverages and tobacco products and gold, rose to 5.41% yoy from 4.05% yoy in February.

Graph 1
Inflation outlook deteriorates as core CPI measures pick up



Source: National Statistics, CBT, Eurobank Research

CBRT revises 2010-2012 inflation projections higher

Until recently, the CBRT had staunchly defended its view that the recent rise in inflation was due to one-off effects and was likely to prove temporary. However, at its latest inflation report released in late April, the Central Bank acknowledged that inflation was likely to significantly deviate from its targets this year. The reasons being a somewhat more robust-than-previously-expected rebound in domestic demand, rising food and energy prices and a higher-than-earlier anticipated impact of tax adjustments on inflation. Along these lines, assigned a 70% probability, end-2010 CPI is now projected at a mid-point of 8.4%, well above the CBRT's 6.5% target for this year and a prior 6.9% forecast. (Eurobank EFG Research forecasts year-end inflation at 8.7% yoy). For end-2011, the CBRT expects annual CPI to ease to 5.4% (vs. 5.2% previously), a tad lower than the 5.5% target for that year, while for end-2012 CPI is seen recoiling to its target of 5.0% (vs. 4.9% before). Moreover, in its inflation report the CBRT clearly signaled its intention to gradually withdraw liquidity from the domestic market and to embark on a monetary tightening cycle as early as during the last quarter of this year**.** Earlier in April, the CBRT had issued a statement outlining a "cautious and gradual" exit from liquidity measures employed during the global financial crisis. The central bank had also unveiled, among other measures, plans to switch the key policy rate to the one-week repo rate from the overnight borrowing rate currently, but had not provided a clear timeframe for that change.

We continue to expect ca 150bps of cumulative rate tightening by the end of 2010

Rising inflation pressures in tandem with a rebound in domestic economic activity pose a challenge to the CBRT. In recent years, impairments on the Central Bank's credibility had taken a severe toll on the domestic currency and markets. Until now, the CBRT's stance suggests that they are poised against hasty rate hikes that could choke the rebound in domestic economic activity. Since November 2009, the bank has kept its key policy rate at the current record low level of 6.50%, while advocating that interest rates must remain low for a long time. However, in view of rising inflation pressures against a background of unfavorable base effects, higher commodity prices, regulated price hikes and growing likelihood for second round effects, the CBRT may embark on a monetary tightening cycle sooner than in the fourth quarter of the year, which is what we previously expected (and what was indicated by the Central Bank itself at its latest inflation report). That said, we continue to expect 150bps of cumulative rate hikes by the end of the year. Risks to our forecast are on the upside and lie in the face of upward surprises in the domestic economic recovery, pockets of domestic political instability and renewed signs of fiscal slippage.

The government's commitment to fiscal consolidation is evident but risks lie ahead

With regard to public finances, the government has shown a clear commitment to fiscal consolidation in recent months. And, it appears, that measures employed to contain the shortfall are actually bearing fruit. In January-March the central government budget deficit narrowed by 44%yoy to TRY 11.3bn, simultaneously posting a primary surplus of

TRY 3.7bn. Better-than-anticipated tax revenues (+37.5% yoy in March alone), spending obedience, a more robust-that-earlier-expected rebound in economic activity and favorable base effects are the main factors behind the improvement. In all, the data adds to hopes that the year-end deficit target of 4.9%-of-GDP will be comfortably met. If so, it will mark a 1.4ppts of GDP improvement from 2009, when a deep recession took a heavy toll on the government's coffers. Risks for a higher fiscal deficit this year lie in the face of increased spending in the run-up to the 2011 general elections. On the positive side, an outperformance of the official fiscal target could be witnessed this year, against a background of a higher-than-expected GDP growth. Taking into account the government's fiscal performance over the last four months, and its macroeconomic assumption for GDP growth of only 3.5%yoy this year, we expect this year's deficit target to be comfortably met. It is also worth mentioning that last year, the government's 6.6%-of-GDP forecast was well outperformed by a 5.5%-of-GDP realization. At present, fiscal prudence is key for maintaining investor confidence towards Turkish assets, especially in the absence of an IMF policy-anchor. A fiscal rule is expected to be ready by this summer and to come into effect some time next year. The rule, which is expected to encompass a cyclical calculation of fiscal targets, is also seen strengthening the government's credibility on fiscal prudence.

Current account deficit resumes a widening trend

The sharp adjustment witnessed in Turkey's current account deficit against the background of a deep domestic recession seems to be waning lately. The shortfall in the 12-months-to-February 2010 shrunk by 45.8% over the same period a year earlier, amounting to USD 18.813bn. This compares with a 73%yoy contraction in the 12-months to October 2009, signaling that the pace of improvement has decelerated in recent months. According to our calculations, as a percentage of projected GDP the current account deficit widened to 2.7% in the 12-months to February 2010 from 2.2% in January-December 2009. Higher energy prices and a pick up in domestic demand are to blame. A further deterioration is expected in the months ahead as the economic rebound gains traction. Turkey's high dependency on commodities imports has also the potential to exert widening pressures on the deficit, which we expect to reach 3.5%-of-GDP by the end of 2010. On financing side, net foreign direct investment slid ca 66%yoy in the 12-months to February but covered nearly 30% of the current account deficit. The respective coverage ratio was 44% a year earlier. In spite of the annual fall in FDI the still low current account deficit makes external financing needs more manageable. Besides, as the global environment improves further portfolio and FDI inflows are likely to modestly improve in the coming months.

Dervis Eroglu's victory in April's presidential elections, in the breakaway enclave of northern Cyprus, raises concerns about Turkey's EU accession process

The island of Cyprus has been divided since 1974 following a Turkish invasion. Turkish Cypriots declared independence in 1983 but have received diplomatic recognition only from Turkey, while the Greek Cypriot government is internationally accepted. Reunification negotiations have so far yielded little results. Dervis Eroglu's victory on April 18 in the breakaway enclave, raised concerns that a solution on the reunification issue is unlikely to be reached soon. If so, Turkey's EU progress is also likely to be affected. The pending reunifications issue has so far blocked Turkey's EU accession bid and Eroglu's views about Turkish Cypriot independence contrasts that of the Greek Cypriot side. While we broadly agree with the view that Eroglu's victory will not particularly facilitate the process, we do not see this as the only obstacle to Turkey's EU accession. Even though former Turkish leader Mehmet Ali Talat had a signaled strong will to reach a solution on the reunification issue, its complexity and highly-debated nature suggest that a resolution could not be reached overnight. Besides, Turkey's EU accession process has been remarkably slow in recent years. Note that out of the 35 chapters that need to be completed for a country to enter the EU block, 13 have been opened and only one has been closed.

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Ukraine

Gas deal with Russia to help resume (and extend) existing IMF loan facility

- **Russia agreed to grant Ukraine a 30% discount on imported gas prices and invest $40bn in the country. The political price paid by Ukraine is the lengthening of stay of Russian's Black Sea Fleet in the domestic territory for an additional period of 25 years**
- **Lower gas prices likely to facilitate attainability of Ukraine's 6%-of-GDP budget deficit target this year. A new $12bn IMF loan is on its way**
- **Recent macro data have been broadly encouraging, reflecting improving conditions in the domestic economy**

Ukraine: Eurobank EFG Forecasts

	2007	2008	2009	2010f
Real GDP (% yoy)	7.9	2.3	-15.1	2.0
Private Consumption	17.2	21.7	-13.5	1.5
Government Consumption	2.5	29.8	1.8	0.5
Gross Capital Formation	23.9	27.6	-49.0	2.0
Exports	3.3	30.2	-16.0	2.0
Imports	21.5	22.1	-35.0	0.5
Inflation (% yoy)				
CPI (annual average)	12.8	25.3	16.0	12.0
CPI (end of period)	16.6	22.3	12.3	11.0
Fiscal Accounts (% GDP)				
General Government Balance	-2.0	-3.2	-7.2	-6.0
Gross Public Debt	12.9	19.9	30.0	35.0
Labor Statistics (%)				
Unemployment Rate (% of labor force)	6.9	6.9	9.7	9.0
Wage Growth *(real - private sector)*	12.5	6.3	-10.3	-5.5
External Accounts				
Current Account (% GDP)	-3.7	-7.0	-1.7	-1.8
Net FDI (bn USD)	7.6	9.9	4.5	5.0
FDI / Current Account	143.0	77.6	230.0	300.0
FX Reserves (bn USD)	32.5	31.5	26.5	25.1
Domestic Credit	**2007**	**2008**	**Q3 09**	**Q4 09**
Total Credit (% GDP)	59.9	77.3	81.6	79.3
Credit to Enterprises (% GDP)	36.5	46.7	51.2	50.7
Credit to Households (% GDP)	22.5	29.5	28.2	26.4
FX Credit/Total Credit (%)	49.9	59.0	52.8	50.8
Private Sector Credit (% yoy)	74.9	68.5	23.9	-3.1
Loans to Deposits	150.4	204.0	223.0	215.9
Financial Markets	**Current**	**3M**	**6M**	**12M**
Policy Rate	10.25	10.25	10.25	10.25
USD/UAH	7.93	8.00	8.40	8.50

Source: NBU, IMF, Bloomberg, Eurobank Research

New government in place

President Yanukovych managed to receive Ukrainian Court's approval to form a new coalition government, avoiding the need for early parliamentary elections. The first priority of the new government is to approve the 2010 budget, which has been delayed since last October.

New gas accord with Russia to help resume and extend IMF loan facility

Gas price talks between Russian President, Dmitry Medvedev and his Ukrainian counterpart, Viktor Yanukovych, reached a positive conclusion. Russia agreed to grant Ukraine a 30% discount on imported gas price relative to the price charged to the EU market. Russia has also pledged to invest $40bn per year in Ukraine over the next decade. In exchange, Ukraine has agreed to increase its gas imports and allow the presence of the Russian Black Sea Fleet in its territory for an additional period of 25 years.

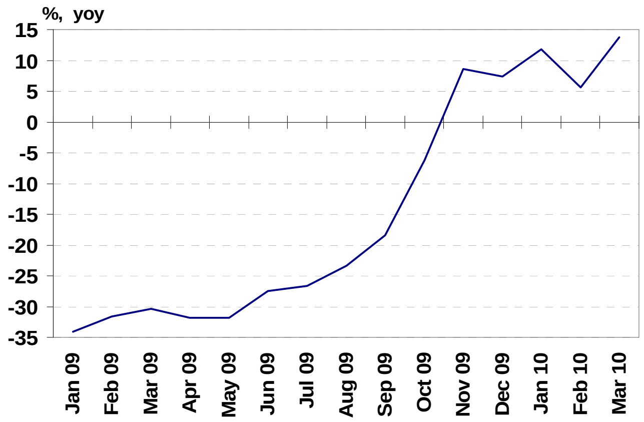
Lower gas prices are expected to help Ukraine put its fiscal position on a more sustainable path and allow the government to end subsidies to domestic households and utilities, a key precondition the IMF has put before it resumes operation of the existing Stand-By Agreement. Since the IMF incorporates gas supplier Naftogaz's budget in its calculation of Ukraine's overall budget deficit, lower gas prices should help improve the country's overall fiscal position.

Ukraine's 2010 budget is expected to be passed by Parliament at the end of April. The government has set its fiscal deficit target for this year to 6% of GDP, in line with the IMF requirement. Although there has not been an official report on the issue yet, the IMF and Ukraine have already agreed on the main terms of a new 2 ½-year $12bn loan facility. Ukrainian authorities anticipate the first tranche of the new IMF loan to be disbursed in June. Ukraine has already received $10.4bn under the previous $16.5bn IMF loan which has been frozen since last November, when the previous administration failed to fulfil the IMF-required budgetary cuts.

Recent domestic macro data generally encouraging

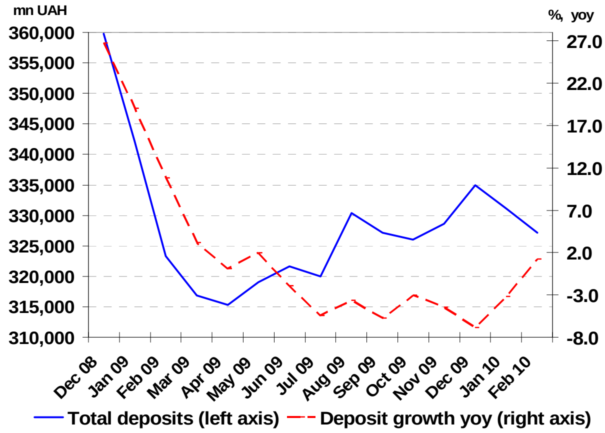
Economic data have been more encouraging lately, reflecting improving domestic market conditions. Among others, Ukraine's industrial production expanded by 13.8% yoy in March, following a 5.6% yoy rise in the prior month. Industrial production figures have been buoyed by favourable base effects and increased competitiveness gains, thanks to the large devaluation of the domestic currency in 2008-2009. In particular, metal producers have enjoyed stronger external demand for steel. (Figure 1) Meanwhile, consumer-vigour indicators have been improving lately. The year-on-year contraction in domestic retail sales has eased to -3.1% yoy in March, from -5.4% yoy the previous month What's more, real wages have been in positive territory in the first two months of this year, as a result of nominal wage gains and abating inflation. Nevertheless, the economic recovery remains fragile and is driven by external factors, while domestic demand is improving but at a slow pace. We pencil in annual GDP growth of 2% yoy in 2010.

Figure 1
Industrial production improves on stronger external demand for steel



Source: National Statistics, Eurobank Research

Figure 2
Total deposit growth has turned positive



Source: National Bank of Ukraine, Eurobank Research

Improved Balance of Payments dynamics

According to the national bank of Ukraine, the current account recorded a $239mn deficit in March, compared to a broadly flat reading in the prior month. The deficit increase was driven by a higher gap in the merchandise trade balance (-$699mn vs. -$332mn in February). Total reserve assets covered ca 4.6 months of imports in March. Although the 30% discount on the current imported gas prices will help contain the current account deficit, we expect the latter to amount to 1.8% of GDP in 2010 (almost at the same levels as in 2009) on the back of the rebound of Ukrainian economy.

Inflation developments

Domestic inflation stood at 11% yoy in March vs. 11.5% yoy in the prior month. The recent deal on lower gas prices will have a benign effect on inflation as it reduces the need to raise gas tariffs for households and utilities. We expect inflation to average around 12% yoy in 2010.

Domestic deposits growth turns into positive territory

According to the latest available data (February 2010), total credit contracted by -1.3% yoy, mainly as a result of a -13.4% yoy decline in FX-denominated credits. Furthermore, the growth of mortgage loans turned into negative territory since the beginning of this year (-9.4% yoy in February vs. -6% yoy in January 2010). On a more positive note, domestic deposits grew by 1.2% yoy in February, following many months of negative growth. (Figure 2) What is still worrisome though is the rising trend of non-performing loans. The NPLs ratio stood at 9.9% in February 2010 compared to 3.1% the same month last year.

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