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Regional markets on a correction mode on EMU sovereign debt worries

Bulgaria: Weak fiscal performance in Q1 leads to upward revision of 2010 budget deficit target

Poland: Q1 GDP rises 3.0% yoy, slightly below consensus

Romania: Government adopts package of tough austerity measures, in a move to facilitate fulfilment of this year's 6.8%-of-GDP deficit target

Serbia: No unfreezing of public wages and pensions

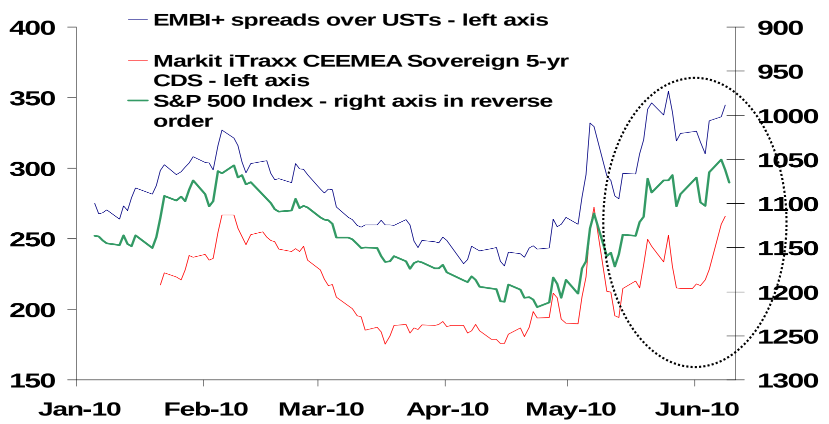
Turkey: Economic recovery continues, GDP growth likely to surprise to the upside this year

Ukraine: Resumption of the IMF lending still pending amid concerns about state budget deficit

New Europe market strategy highlights

- **FX:** the recent bout of risk aversion that spilled over to emerging economies in New Europe has taken a toll on regional currencies. Scaled back expectations for the timing of monetary tightening by a number of regional central banks have not favored either. As a result, regional currencies have fully erased earlier gains, with the exception of Romania's leu and Ukraine's hryvnia which stood in a marginally positive territory year-to-early June. At their current levels, regional currencies appear appealing from a medium-term valuation standpoint. From a more near-term perspective, we continue to prefer low risk exposure and remain constructive on currencies encompassing strong economic fundamentals.
- **Local Rates:** We continue to favor payer positions at the front-end of the Polish curve. Rate hike expectations have already been scaled back, the domestic economy was the only one in the EU to have avoided recession last year and is seen among the outperformers in the region this year, while the central bank is anticipated to be among the first in Europe to embark on a monetary tightening cycle.

Financial markets in the region on a corrective mode on rising global risk aversion



Source: Bloomberg

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Introductory Comment

Dear reader,

Financial markets in New Europe have come under pressure in recent weeks amid growing fiscal concerns in the euro area and incipient worries over the sustainability of the global economic recovery. Yet, most asset markets in the region remain well above their early 2009.

Equity markets in New Europe largely underperformed their Asian and Latam peers lately as regional links to a number of crisis-hit EMU countries are stronger than those in other emerging economies. Regional currencies have also embarked on a depreciating trend with expectations for imminent monetary tightening by central banks in the region having been largely scaled back on concerns that the EMU sovereign debt crisis may negatively affect economic growth in the region. In a similar vein, external debt markets have lost further ground lately, though CDS spreads remain close to recent trough touched a few weeks earlier. On the other hand, benchmark bond yield levels in the region remain close to recent multi-year lows as output gaps remain negative and inflation pressures continue to be subdued.

With regards to real economy developments, we continue to expect most economies in New Europe to record positive GDP growth in 2010. Favorable base effects, inventory restocking and a recovery in exports are expected to be the primary drivers of growth. However, risks to the recovery lie ahead.

Real GDP growth is expected to remain below potential in most economies in the region, domestic demand is likely to recover only slowly and ongoing troubles in domestic labor markets are expected to persist throughout this year. Turkey is still expected to outperform the rebound in New Europe, with Poland seen following suit.

With regards to developments on the monetary policy front, most central banks in the region have already completed, or are close to conclude, their monetary-easing cycles. The Turkish and Polish central banks are anticipated to be among the first to embark on a monetary tightening cycle. We continue to expect the former to deliver ca 150bps of rate hikes in Q4, but expectations for earlier monetary tightening have been scaled back recently in view of the ongoing sovereign debt crisis in EMU.

Along these lines, we expect the Polish central bank to stay put on interest rates for the remainder of the year. On the other side of the spectrum, the door remains open for further – albeit limited – monetary easing in Romania, Hungary and Serbia.

Fiscal consolidation remains a major challenge for governments in New Europe in the period ahead. Meanwhile, potential delays in the adoption of the euro can not be ruled out due to deteriorated fiscal positions, enlargement fatigue and a tighter monitoring of euro entry criteria.

We maintain a positive medium-term outlook for New Europe economies and expect financial markets in the region to resume their uptrend once concerns about fiscal sustainability in the euro area subside.

Prof. Gikas A. Hardouvelis

Chief Economist & Director of Research

Summary of key macroeconomic indicators

Realizations and forecasts

	GDP real (yoy)			Consumer Prices (annual average)			Current Account (%GDP)		
	2009	2010f	2011f	2009	2010f	2011f	2009	2010f	2011f
Bulgaria	-5.0	-0.3	2.5	2.5	2.2	2.7	-9.4	-6.0	-7.0
Poland	1.8	2.7	3.1	3.5	2.5	2.7	-2.0	-3.0	-3.2
Romania	-7.1	0.0	3.5	5.6	4.0	3.5	-4.4	-5.5	-6.0
Serbia	-3.0	1.5	3.0	8.2	4.5	4.8	-5.7	-8.5	-9.0
Turkey	-4.7	6.0	4.1	6.3	8.9	7.2	-2.2	-4.5	-5.3
Ukraine	-15.1	2.5	3.0	16.0	11.5	10.8	-1.7	-1.8	-2.1
New Europe	-4.3	3.5	3.5	6.5	6.4	5.7	-2.7	-4.0	-4.5
Euro area	-4.1	1.0	1.8	0.3	1.2	1.5	-0.6	0.0	0.2
USA	-2.4	3.2	3.4	-0.4	2.4	2.5	-2.9	-3.0	-3.0

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

Foreign exchange and policy interest rates

Realizations and forecasts

		FX Rates			Interest Rates		
eop		2009	2010f	2011f	2009	2010f	2011f
Bulgaria	**vs EUR**	1.96	1.96	1.96	*Currency Board*		
Poland	**vs EUR**	4.10	3.90	3.80	3.50	3.50	4.00
Romania	**vs EUR**	4.23	4.30	4.20	8.00	5.75	6.00
Serbia	**vs EUR**	96.23	105.00	110.00	9.50	7.50	7.00
Turkey	**vs USD**	1.50	1.50	1.40	6.50*	8.50	9.50
Ukraine	**vs USD**	8.05	8.20	8.40	10.25	10.25	10.00
Euro area	**vs USD**	1.43	1.10	1.05	1.00	1.00	1.50
USA	**vs EUR**	0.70	0.91	0.95	0.125	0.75	1.25

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

** As of May 2010 the CBRT's key policy rate is the 1-week repo rate*

I. Overview

Risk sentiment deteriorates on euro area sustainability concerns

Since our last monthly update, global investor sentiment has deteriorated with riskier markets retreating from their multi-month highs touched in mid-April. Euro area stability concerns deepened and fears over contagion effects to other fiscally-vulnerable peripheral countries intensified even though EU finance ministers agreed in early May on a €750bn IMF-backed emergency loan scheme for EMU member states facing acute financing difficulties. Meanwhile, participants are increasingly worried that fiscal consolidation in EMU debt-laden economies will likely derail the pace of the global economic recovery, with growing uncertainty about the degree of banks' exposure to euro area sovereign debt adding to market jitters. In its recently published Financial Stability Report, the ECB warned that that euro zone banks could face up to €195bn in a "second wave" of potential loan losses over the next 18 months due to the financial crisis. The central bank also noted that write-downs would even be larger if heightened sovereign debt risks and austerity measures undermine economic growth. The fragility of the European banking sector was highlighted by the recent bail-out of CajaSure, one of the largest regional lenders in Spain heavily exposed to the property market.

Governments move to toughen regulation in order to contain deepening of the crisis

Recent policy moves aiming to toughen US financial regulation by forcing banks out of proprietary trading and re-establish the division between commercial and investment banking have also contributed to the latest bout of risk aversion. Elsewhere, Germany's unilateral bank on naked short-selling on certain securities -- which highlighted a lack of coordinated approach among EMU member states to deal with the sovereign debt crisis -- kept investors on edge in recent weeks. A flurry of macro data released from both sides of the Atlantic added to worries that the world economic recovery might have already reached a local peak. Notably, China's PMI-manufacturing fell more-than-expected in May mainly due to a hefty drop in new orders, US May non-farm payrolls came in below expectations while German IFO business climate index surprised negatively in May posting its first decline in three months.

Global financial markets losing ground on deteriorating market sentiment

Reflecting the recent deterioration in market sentiment, the FTSE Eurofirst 300 index hit a near nine-month trough in late May, currently standing some 13% lower from highs recorded a month earlier. In the European credit derivates space, the iTraxx Crossover index marked an eight-month closing peak in early June, while the iTraxx Europe index was standing close to 140bps at the time of writing, its highest level in more than a year. In a similar vein, money markets have come under stress over the last few weeks, reflecting growing fears over counter-party risk with the LIBOR lending fixing rates reaching multi-month highs.

Regional markets under pressure in recent weeks

Financial markets in New Europe came under pressure in recent weeks on growing risk aversion. Although debt-laden Greece secured a sizeable financial aid package from the European Union and the IMF, lingering concerns over fiscal sustainability in the euro area have been keeping regional markets on edge. Growing worries over a Greek-style crisis in Hungary also sent shivers throughout the region. Yet, in spite of the recent bout of risk aversion, financial asset markets in New Europe still remain well off their 2009 lows.

Stock markets lower year-to-date

Stock markets in New Europe did not escape unscathed the new spell of risk aversion in global markets evidenced in recent weeks. Moving broadly in line with major global bourses, regional equities slid from multi-month peaks touched in mid-April. Emerging Europe largely underperformed its Asian and Latam peers as the region's links with a number of crisis-hit EMU countries are stronger to those in the rest of the EM space. The Emerging and Eastern Europe MSCI sub-indices each stood some 25% lower in early June from peaks touched in mid-April vs. a 15% slide recorded on the MSCI index over the same period.

Local rates markets just off recent highs

The recent rise in risk aversion exerted upward pressures on local government bond yields over the last few weeks. Yet, yield levels in most regional markets remain close to recent multi-year lows, as output gaps remain negative and inflation pressures continue to be subdued. Most central banks in New Europe are close to or have reached the end of their monetary easing cycle, but expectations for rate hikes this year have been scaled back lately. As the euro area's sovereign debt crisis has recently raised concerns about a slower global economic recovery ahead and with expectations that the ECB will likely stay put on interest rates in the months to come, regional central banks are likely to delay incepting their monetary policy tightening cycles. Romania and Hungary central banks are among the few in the region with potential for further monetary easing this year. However, the latter actually halted its rate easing cycle in May as the local currency depreciated significantly. In detail, Hungary's 3-year government bond yield stood nearly 200bps higher in early June from a near 5-year low of 5.39% achieved on April 26, yet, remained nearly 800bps tighter compared to multi-year highs reached early this year. Expectations for rate hikes in Poland have been significantly scaled back and the 2-year and 10-year yields of the local government bonds remain just above April's multi-month lows of 4.39% and 5.40%, respectively. In Turkey, the central bank is broadly expected to embark on its monetary tightening cycle before year end as inflation pressures remain high and the domestic economic rebound is expected to be among the strongest in the region.

Regional FX markets weaken

Regional currencies have embarked on a depreciating trend in recent weeks as the sovereign debt crisis in the euro area deepened. Concerns that the current credit crisis may put a brake on the global recovery and, especially, the economic turnaround in New Europe economies -- whose exports are primarily targeting the euro area -- weighed down on regional currencies over the last few weeks. Scaled-back expectations for rate hikes by regional central banks in view of the rising risks to the global recovery did not favour either. As a result, nearly all of regional currencies erased their earlier year-to-date gains over recent weeks and currently hover around multi-month lows. In detail, the Turkish lira touched a 1-year low of 1.6175/$ on June 7 and the Polish zloty slid as far as a 6-month trough of 4.2423/€ earlier that month. On similar grounds, the Hungarian forint recoiled to a 1-year low of 290.33 on June 4, with its losses being exacerbated by concerns about the country's fiscal outlook. Moreover, the Serbian dinar touched a record low at 104.05 against the EUR in late May. Since late 2009, the dinar has come under significant depreciating pressures amid growing fiscal-related concerns, increased demand for hard currency due to higher energy imports and corporate demand to service cross-border credits. Rising worries over the pace of domestic economic recovery are also taking a toll on the Serbian currency. Elsewhere, at 4.22 levels in early June, the EUR/RON stood close to a 6-month peak of 4.2468 touched a month earlier. All the same, the recovery in emerging Europe is expected to broadly outperform that in major economies, with high probability of regional central banks embarking on their monetary tightening cycles ahead of the ECB and other major central banks. Moreover, more appealing debt levels and the reduction in external financing requirements since last year are also expected to provide support to regional currencies in the months ahead. As such, potential for FX strengthening in the New Europe region lies ahead, although the road in the coming months is likely to prove bumpy.

External debt markets come under pressure

Emerging external debt markets have lost further ground in recent weeks. After posting year-on-year gains of over 30%yoy in March, returns on the EMBI+ index retreated to reach ca 16%yoy in early June. Reflecting the sharp deterioration in risk sentiment, spreads over USTs on the index rose by more than 120bps from lows of 230bps hit mid April. On a similar note, five-year credit default swaps spreads in New Europe have rebounded from multi-year troughs touched a month earlier. Notably, 5-year CDS spreads in most regional countries lie around or below 300-400bps and in spite of the recent uptick remain below Greece's 800bps-plus levels, continuing to signal a lower cost of insuring against a sovereign debt default.

Economies in the region on a recovering mode...

With respect to real economy developments in the New Europe, macroeconomic data continue to surprise to the upside, with Q1 GDP growth readings from the Czech Republic and Hungary suggesting that the worst of the economic downturn has already been seen and further recovery lies ahead. Although still in recessionary mode, the pace of contraction of Romanian GDP outperformed expectations in Q1, coming in at -2.6%yoy. Meanwhile, Polish Q1 GDP of 3%yoy, nearly in line with the prior quarter, signals a steady recovery ahead. Economic growth in Turkey is expected to outperform the rest of the region in 2010 and we have revised upwards our forecast for GDP growth this year, from 5.0% to 6.0%.

...but risks lie ahead

Nevertheless, risks to the economic recovery in New Europe lie ahead. Most countries saw their finances deteriorate sharply last year. As a result, and especially in view of the Greek crisis, fiscal tightening will be a major challenge for regional governments in the period ahead.

Undoubtedly, one of the most obvious repercussions stemming from the debt crisis in the euro area is that of potential delays to euro adoption. Although, Estonia did get the green light earlier this year to adopt the single currency in 2011, countries in New Europe are likely to wait more than previously expected before entering the EMU against a background of deteriorated fiscal positions, enlargement fatigue and a tighter monitoring of euro entry criteria.

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II. New Europe Markets Outlook & Strategy

In FX, the recent bout of risk aversion that spilled over to emerging economies in New Europe has taken a toll on regional currencies. Scaled back expectations for the timing of monetary tightening by a number of regional central banks have not favored either. As a result, regional currencies have fully erased earlier gains, with the exception of **Romania's leu** and **Ukraine's hryvnia** which stood in a marginally positive territory year-to-early June. At their current levels, regional currencies appear appealing from a medium-term valuation standpoint. And taking into account that we expect the Hungarian issue to gradually fade away -- as the government eventually employs fiscal-tightening measures to soothe investor worries and bring its budget deficit in line with this year's 3.8%-of-GDP target -- we continue to anticipate most currencies in the region to eventually reverse their current downtrend.

From a more near-term perspective, we continue to prefer low risk exposure and remain constructive on currencies encompassing strong economic fundamentals, *e.g.,* the Turkish lira and the Polish zloty. Economic activity in these two countries is expected to broadly outperform the rest of New Europe, with their central banks being anticipated to incept their monetary tightening cycles earlier than their regional peers. Long **PLN/RON** positions bear upside potential in the short-to-medium term and their regional correlation reduces the pair's exposure to the euro area's risks. That said, scope for further EUR weakening makes short **EUR/PLN** positions echo appealing as well. In spite of a persisting uptrend over the last three months we see further upside in the **TRY/HUF** pair in view of recent developments in Hungary and we also continue to favor short **EUR/TRY** positions**.**

On local rate markets, we continue to favor payer positions at the front-end of the Polish curve. Rate hike expectations have already been scaled back, the domestic economy was the only one in the EU to have avoided recession last year and is seen among the outperformers in the region this year, while the central bank is anticipated to be among the first in Europe to embark on a monetary tightening cycle. On Turkish rates, lingering inflation pressures and a strong rebound in the domestic economy suggest that the CBRT is likely to embark on a monetary tightening cycle in Q4. Although expectations have been scaled back due to a tamer inflation reading in May and growing concerns that the euro area debt crisis may impact the global economic recovery we continue to expect that the CBRT will eventually hike interest rates later this year as the domestic economy rebounds from last year's deep recession. As such, we like payer positions in the short-end of the Turkish yield curve.

With regards to **sovereign credit** in New Europe, we continue to believe that at current levels regional credit markets are rather expensive. However, in view of the recent bout of risk aversion triggered by Hungary's fiscal woes, Hungarian, Romanian and Bulgarian CDS spreads, which were among the worst hit in the region lately, may bear some near-term value.

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III. New Europe – Country Analysis

Bulgaria

Weak fiscal performance in Q1 leads to budget revision

- **Weak fiscal performance in Q1 leads to a revision of the cash-based deficit target for 2010 to 4.8%-of-GDP from 0.8%-of-GDP**
- **GDP declined by 4% yoy in Q1, disappointing analysts' expectations for a quick growth rebound in 2010**
- **Bulgaria needs to take advantage of the time window provided by the postponement of ERM II application to push forward with much needed structural reforms and fiscal consolidation**

Bulgaria: Eurobank EFG Forecasts

	2008	2009	2010f	2011f
Real GDP (yoy%)	6.0	-5.0	-0.3	2.5
Private Consumption	4.8	-6.2	-2.5	2.0
Government Consumption	0.0	-5.7	-0.1	0.4
Gross Capital Formation *(Fixed)*	20.4	-26.9	-8.7	2.5
Exports	2.9	-9.8	5.0	5.0
Imports	4.9	-22.3	-1.5	4.0
Inflation (yoy%)				
HICP (annual average)	12.0	2.5	2.2	2.7
HICP (end of period)	7.2	1.6	2.5	3.0
Fiscal Accounts (%GDP) - *EU Methodology*				
General Government Balance	1.8	-3.9	-3.8	-2.8
Gross Public Debt	14.1	14.8	17.0	18.8
Primary Balance	3.9	0.0	-2.0	-1.5
Labor Statistics - *National Definitions*				
Unemployment Rate (% of labor force)	6.3	7.6	9.0	8.0
Wage Growth *(total economy)*	26.5	8.5	2.0	2.5
External Accounts				
Current Account (% GDP)	-25.4	-9.4	-6.0	-7.0
Net FDI (EUR bn)	6.2	3.3	2.0	1.5
FDI / Current Account (%)	75.8	103.6	98.0	60.0
FX Reserves (EUR bn)	12.7	12.9	12.0	11.5
Domestic Credit	**2007**	**2008**	**Q4 09**	**Q1 10**
Total Credit (%GDP)	67.1	75.2	79.2	78.9
Credit to Enterprises (%GDP)	43.0	47.8	49.4	49.2
Credit to Households (%GDP)	23.0	26.0	28.2	28.1
FX Credit/Total Credit (%)	50.4	57.2	58.6	59.5
Private Sector Credit (yoy)	65.9	32.3	4.5	3.3
Loans to Deposits (%)	97.0	119.3	120.5	116.3
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

Flash Q1 GDP report disappoint market expectations

According to the latest national accounts data, the Bulgarian economy remained mired in recession in the first quarter of 2010. Real GDP growth is (preliminarily) estimated to have retreated by 4.0% yoy in Q1, a rate of contraction faster than market expectations (Bloomberg survey: -3% yoy) but still slower than the 5.9% yoy decline recorded in the prior quarter.

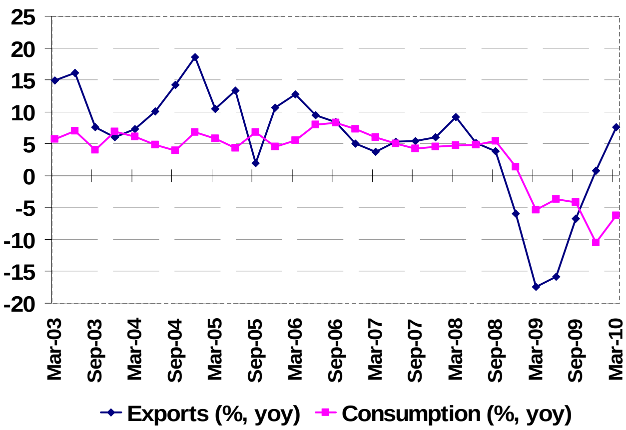
On the demand side, the contraction in consumer spending slowed to -6.3% yoy in Q1, from -10.5% yoy in the prior quarter. Yet, consumer demand remains depressed amid weak labor market conditions, tight credit and the implemented fiscal tightening by the new government. Investment contracted by 15.8% yoy in Q1, following a 35.4% yoy fall in Q4. At the same time, the contribution of net exports to growth improved compared to the previous quarter. Exports growth picked up to 7.6% yoy in Q1, from 0.8% yoy in Q4. Imports declined by a further 4% yoy in Q1 from 20% yoy in Q4. 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 will be a positive contributor to growth in 2010, albeit to a lesser extent compared to 2009.

From a sectoral standpoint, all sectors recorded negative annual growth rates in Q1. Agriculture recorded the steepest decline (-3.4% yoy), while the pace of contraction in the services sector accelerated to 2.2% yoy, from 1.7% yoy in Q4.

On a more positive note, it appears that the worst for the domestic industrial sector is already behind us. The contraction in industrial output slowed to 1.3% in Q1 against 8.1% yoy in Q4. In fact, industrial production recorded in March its first annual increase since autumn 2008, rising by 1.7% yoy, following double-digit declines throughout last year. On a month-on-month basis, this represents a 21.1% improvement, which is in line with the improvement in industrial sales.

Figure 1

Exports continued rebounding, while consumption remained weak in Q1



Source: National Statistical Institute of Bulgaria, Eurobank Research

In line with what we suggested in our previous *New Europe Economics & Strategy* issue, we reiterate our view that the worst of the domestic recession was seen in the last quarter of 2009. We forecast domestic economic activity is set to recover slowly in the coming quarters, with GDP growth turning positive in the second half of the year. In view of the above, we maintain our earlier forecast for GDP growth in 2010 at -0.3% yoy, which was already more bearish than consensus. Our forecast incorporates 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 (mainly EU-27) proved to be weaker than expected. EU Commission upgraded its GDP forecast for Bulgaria to flat growth in 2010 against a 1.1% contraction envisioned in the autumn forecasts. 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.

Poor budget execution in Q1 results in upward revision of official deficit target for 2010

The budget execution data for Q1 2010 demonstrated that the initial 0.7%-of-GDP full-year deficit target was unrealistic. The cash-based budget deficit increased to BGN 1.67 bn in Q1 or 2.5% of the projected full-year GDP compared to a surplus of 0.8% of GDP in Q1 2009. Preliminary official estimates indicated a budget surplus of BGN 0.3bn in April. The recession had a widespread negative effect on budgetary revenues, which declined in the first quarter by 19.2% yoy. VAT receipts lagged behind, fulfilling only 14.6% of the corresponding full-year target. On the other hand, increased spending on pensions and unemployment benefits boosted government expenditure, which rose by 16.2% yoy. On the positive side, around one third of the budget deficit in Q1 was attributed to the poor absorption of EU funds; it is anticipated that higher EU funds will cover this specific part of shortfall in the following months.

In view of the deteriorated fiscal situation, the government decided to amend the 2010 budget law. The new budget provides for a revision in the cash-based deficit target to 4.8% of GDP from 0.7% of GDP planned initially. It also forecasts that total revenues will be lower by BGN 2 bn or 2.9% of GDP against the initial target for revenue. At the same time, the new budget institutionalized a 20%yoy cut in expenditures, which was a part of the 60 anti-crisis measures announced in late March. The government has decided to finance (this year's) budget deficit through the use of its fiscal reserve account with the central bank, instead of resorting to the credit markets or IMF funding. The government assessed that the cost of a new Eurobond issue would be too high given prevailing current market conditions. Moreover, it repeatedly turned down the option of an IMF loan on the basis that such an arrangement would weigh negatively on the prospective application for ERM II entry, sending the wrong signal to the markets.

The recent budget amendments provide for a reduction of the fiscal reserve threshold to BGN 4.5 bn, from BGN 6.3 bn or 9.5% of projected GDP in February. The revised budget has just been approved by a tripartite council, comprised by trade unions, employers and the government. Yet, it has not yet being approved by the parliament.

In our previous issue of New Europe, we have highlighted the need of a harder effort on behalf of the government to contain the budget deficit below 3% of GDP. Hence, the revision of the law came as no surprise; it does a reality check to the budget execution and brings the fiscal target to a more realistic and attainable level.

Nevertheless, the fiscal situation in Bulgaria is much healthier than in other EU member states even after this revision. The revised draft of the budget foresees that the 2010 fiscal deficit in ESA 95 terms (EU methodology which calculates the deficit on an accrual basis) would reach 3.9% of GDP. Minister of Finance Simeon Djankov has vowed to maintain it below 3%. Even if this is not fully achieved, the fiscal performance would favorably compare to that of the rest of EU members. According to the latest EU forecasts, the EU-27 fiscal deficit will reach 7.2% of GDP in 2010. Furthermore, Bulgaria's public debt ratio stood at 14.8% of GDP which is the third lowest in the EU in 2009.

The EU commission launched in early May, as it was anticipated, the excessive deficit procedure against Bulgaria. For the time being, the activation of EU's disciplinary mechanism does not pose a serious threat to the Bulgarian economy. The excessive deficit was qualified as exceptional, as it resulted from the severe economic downturn. The 2009 fiscal deficit in cyclically adjusted terms was 2.8% of GDP, below the Treaty's 3% threshold and, more importantly, it was seen as temporary. At this point, the EU Commission expects that the 2010 deficit will decline to 2.8% of GDP, though recognized that there are certain risks to that outcome. Yet, a lot will depend on the execution of the 2010 budget.

However, the recent budget revision represents, in a broad sense, a significant fiscal relaxation relative to the initial budget targets. Although there is no imminent risk of a break up of the currency board arrangement, that relaxation is certainly not good news for its medium-term stability. Maintaining a sound fiscal position is a necessary condition to maintain public confidence on the present exchange rate regime. The IMF has estimated the level of budget deficit that poses no risk to the macroeconomic stability at 1.8% of GDP. Moreover, IMF advised Bulgaria's government to consider all available options before tapping into the fiscal reserve to fill in the budget gap. For that reason, markets are now expected to monitor more closely the developments on the fiscal front. Reflecting these developments as well as contagion risks stemming from the ongoing debt crisis in the euro area, the 5Y-CDS spreads jumped 57 basis points to 250 basis points since the end of March.

Euro-adoption prospects

The lingering sovereign credit crisis in EMU periphery has raised concerns over the Euro-adoption prospects of a number of candidate countries, including Bulgaria. Analysts are worried that the crisis may actually strengthen arguments against the enlargement of Euro area or lead to a revision of the criteria used to assess the eligibility of prospective EMU members. The decision of the Bulgarian government to postpone ERM II-entry application in such an environment was well justified. The discovery of additional annexes in public procurement contracts led to significant revision to 2009 fiscal data. The fiscal deficit was revised to 3.9% of GDP which is above the 3% threshold set by the Maastricht treaty. Yet, as it is widely known, a country's ERM II entry is not formally decided on the basis of the degree of fulfillment of any formal quantitative criteria.

On the positive side, the postponement could be seen as offering Bulgaria an additional time window to push ahead with much needed structural reforms and fiscal consolidation. If this opportunity is wisely exploited, EMU prospects are very likely to improve. The Bulgarian government needs to focus on accelerating structural reforms. In that direction, the country needs to urgently improve the absorption and management capacity of EU funds. Bulgaria has so far absorbed only 4% of available EU funds for the period 2007-2013. The last EU interim report made a relatively positive, though still cautious, assessment of the recent process made on judicial and administrative reforms in Bulgaria. If these aims are achieved, we anticipate a significant improvement in the country's potential economic growth and real convergence prospects.

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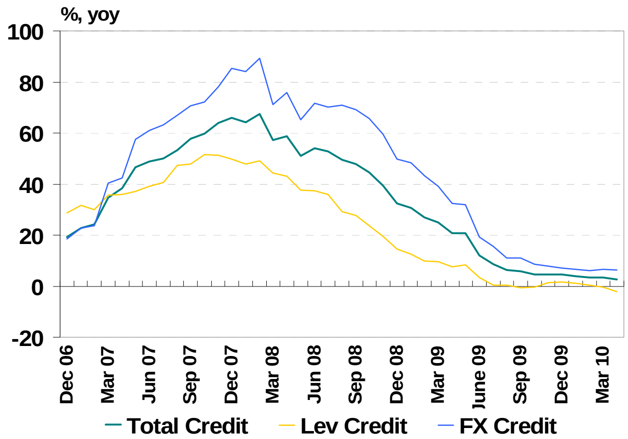
Recent credit developments and outlook

Total outstanding credit in Bulgaria picked up in March for the first time in 2010, increasing marginally by 0.2% mom. Nevertheless, credit activity in Bulgaria still remains stagnant. Private sector credit growth rate continued to decelerate for a sixth month in a row, falling to 3.3% yoy in March, and thus posting a new record low. Note that since the beginning of 2010, credit to the private sector has retreated slightly by 0.3%. Both households and firms reduced their credit positions, by 0.3% qoq and 0.4% qoq respectively. With lev exposures reducing by 2.4% qoq, it is lending in foreign currency (+1.2% qoq) that has kept credit running in Bulgaria.

Figure 2

Credit activity has yet to recover from the crisis



Source: Bulgarian National Bank, Eurobank Research

Private sector deposits continued to grow in March, increasing by 7.2% yoy, despite a trivial decrease (-0.1%) on a monthly basis. This decrease can be attributed to the reduction in FX deposits (-1% mom), which was almost completely offset by a 1.4% mom increase in lev deposits. Since the beginning of the year, total deposits have grown by 2.9%. The explanation lies in part to the relatively high interest rates offered by the banks, which amid the foreign capital inflow drought, have turned towards attracting domestic funds. Indicatively, the average interest rate on new deposits in national currency has fallen relatively slowly, by 121bps and 64bps yoy in March for households and firms respectively, in a period during which the Base Interest Rate (monthly average of the LEONIA rate) dropped by more than 330bps.

Despite the unfavourable economic conditions, Bulgarian banks achieved a BGN170m (€87m) net profit in Q1:10, increased by 6.9% compared to Q4:09. Furthermore, the banking system appears to be quite stable. Total capital adequacy ratio rose to 18.2% in Q1:10, up from 17% at the end of 2009, and well above the minimum threshold of 12% set by the Bulgarian National Bank. Loans to deposit ratio also improved over the same period, dropping to 116.3% from 120%.

Yet concerns still remain. The levels of non-performing loans (NPLs) are rising quickly. NPLs ratio climbed to 7.8% in March from 6.4% in December, and 4.3% in June 2009. It follows that banks will have to increase their provisions, reducing thus their profitability. Although it is encouraging that banks achieved a positive net result in a challenging period, we cannot ignore the fact that their profits level in Q1:10 was quite low, amounting to less than 0.1% of banks' total assets on an annualised basis. Credit recovery is also held back by the challenging general economic conditions, with flat growth being our upside scenario for 2010.

We reiterate our previous view that credit activity is not expected to experience any grave setback, such as that in Romania for example. Nevertheless, the rebound is not expected to come before autumn, and will most likely be anemic. In any case, we stress once again that the situation is quite fluid, and a lot will depend not upon the actions of the national authorities, but also upon the upcoming macroeconomic and financial developments.

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Poland

Q1 GDP growth at 3.0% yoy; slightly below consensus

- **Q1-2010 GDP growth slowed to 3.0% yoy from 3.3% yoy in the prior quarter**
- **Deteriorated fiscal position and uncertainty over Western Europe's pace of recovery posing downside risks to the domestic economic outlook**
- **April inflation at three year lows; NBP seen on hold on policy rates for the rest of the year**
- **Marek Belka, a well-respected and pro-market economist was nominated as central bank's President. Appointment waits parliamentary approval (expected on June 11, 2010)**

Pro-market economist Marek Belka nominated as new central bank President

In late May, the acting President of Poland nominated Marek Belka as the new central bank President. A major advantage of Mr. Belak´s nomination is that he is not affiliated to any of the main political parties in Poland. Therefore, the choice cannot be criticised as political. Moreover, Mr. Belka's professional credentials appear to be quite solid; he is a well-respected, pro-market economist and presently the Director of the IMF's European Department. However, Mr. Belka's appointment is not yet a done deal; the lower house of parliament has to approve the choice. The vote is scheduled for June 11, 2010 i.e., a few days before June 20 Presidential elections.

Acting President seen wining upcoming presidential election

Acting President, Bronislaw Komorowski, is the candidate of the ruling party for the upcoming presidential elections. Komorowski is a close ally of Prime Minister Donald Tusk. Jaroslaw Kaczynski, the twin brother of Poland's late President and the leader of the main opposition party is also running for the presidency. Opinion polls suggest that Komorowski would win 49% of the vote against 26% for Kaczynski.

Poland: Eurobank EFG Forecasts

	2008	2009	2010f	2011f
Real GDP (% yoy)	5.0	1.8	2.7	3.1
Private Consumption	5.8	2.3	2.7	3.0
Government Consumption	7.4	1.9	2.4	0.5
Gross Capital Formation	6.4	-13.8	1.1	1.8
Exports	7.3	-7.8	6.0	5.5
Imports	8.4	-13.5	5.8	6.5
Inflation (% yoy)				
CPI (annual average)	4.2	3.5	2.5	2.7
CPI (end of period)	3.3	3.5	2.7	2.8
Fiscal Accounts (% GDP)				
General Government Balance	-3.7	-7.1	-7.3	-7.0
Gross Public Debt	47.2	51.0	55.0	57.0
Labor Statistics (%)				
Unemployment Rate (% of labor force)	9.8	11.0	12.4	12.5
Wage Growth *(private sector - average)*	N/A	4.2	3.0	3.2
External Accounts				
Current Account (% GDP)	-5.0	-2.0	-3.0	-3.2
Net FDI (bn EUR)	8.0	6.1	7.5	8.5
FDI / Current Account	43.7	122.2	80	85
FX Reserves (bn EUR)	40.6	54.8	62	64
Domestic Credit	**2007**	**2008**	**2009**	**Q1 10**
Total Credit (% GDP)	40.4	50.9	53.1	52.2
Credit to Enterprises (% GDP)	14.8	17.6	16.1	15.7
Credit to Households (% GDP)	22.3	29.7	31.6	31.6
FX Credit/Total Credit (%)	23.6	32.6	30.2	29.3
Private Sector Credit (% yoy)	34.1	38.1	7.2	1.2
Loans to Deposits (%)	93.1	106	102.6	100.6
Financial Markets	**Current**	**3M**	**6M**	**12M**
Policy Rate	3.50	3.50	3.50	3.75
EUR/PLN	4.07	3.80	3.90	3.90

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

Deteriorated domestic public finances, but in a better fiscal position than many other EU states

Poland is at present subject to an EU Council decision on the existence of an excessive deficit. In 2009 the general government budget balance showed a deficit of 7.1% of GDP, i.e. significantly above the Treaty's 3.0% of GDP reference value. The general government debt-to-GDP ratio was 51.0% of GDP, i.e. below the 60% of GDP reference value. The deficit is forecasted by the EC to increase to 7.3% of GDP in 2010 and to fall to 7.0% of GDP in 2011. The government debt ratio is projected to increase to 53.9% of GDP in 2010 and to 59.3% of GDP in 2011. (Table 1)

Table 1
General government fiscal position

	2008	2009	2010	2011
General government balance (% of GDP)	-3.7	-7.1	-7.3	-7.0
Reference value: -3.0%				
General government debt ratio (% of GDP)	47.2	51.0	53.9	59.3
Reference value: 60%				

Source: European Commission

It must be noted that in Poland there is a constitutional threshold regarding the government debt ratio of 55% of GDP. If debt rises above 55% of GDP in 2010, the 2011 budget has to be prepared with a surplus. The latter would imply a substantial fiscal tightening in 2011, a year of parliamentary election, which could destroy the ruling government's chances of re-election. The risk of breaching the threshold is significant, especially if economic growth proves weaker than projected and progress on privatisation is slower than planned. Nevertheless, according to EC's 2009 Sustainability Report, Poland appears to be in a much better shape than that that of other EU member states including many EMU countries.

Q1-2010 GDP growth slightly below consensus

Poland's Q1-2010 GDP growth slowed to 3.0% yoy from a revised 3.3% yoy recorded in the last quarter of 2009. The outcome stood slightly below consensus expectations of 3.1% yoy. On a quarterly basis, the Polish economy grew by 0.5% qoq in Q1 compared with 1.0% qoq growth in Q4-2009. First quarter growth was mainly driven by domestic consumption and net exports. Fixed investment made a large negative contribution, which was nevertheless offset by higher inventories. Investment fell by 12.4% yoy in Q1, following a 1.1% yoy rise in Q4-09. Overall, real GDP is expected to grow by 2.7% yoy in 2010 and by 3.1% yoy in 2011. Factors contributing positively to GDP growth include the ongoing rebound in global trade, rising FDI, higher infrastructural spending fuelled by EU funds, the preparations for the 2012 football championship, and the gradual revival of private consumption. However, the deteriorating country's fiscal situation, coupled with uncertainty over Western Europe's pace of recovery, pose downside risks.

Industrial production remains in expansionary mode

Industrial production slightly surprised on the downside in April, growing by 9.8% yoy against the 10.8% yoy consensus forecast, and growth of 12.3% yoy recorded in the prior month. However, Polish industrial production remains solid and suggests continued recovery in the sector. Manufacturing PMI fell slightly to 52.2 in May, from 52.5 in April, confounding expectations for a rise up to 53.0. The slight decline was mainly attributed to the slowdown in the new orders growth (they edged down to 51.9 from 53.7 the previous month) which was driven by a moderation in domestic orders. Nevertheless, the level is consistent with continued growth in production over the coming months.

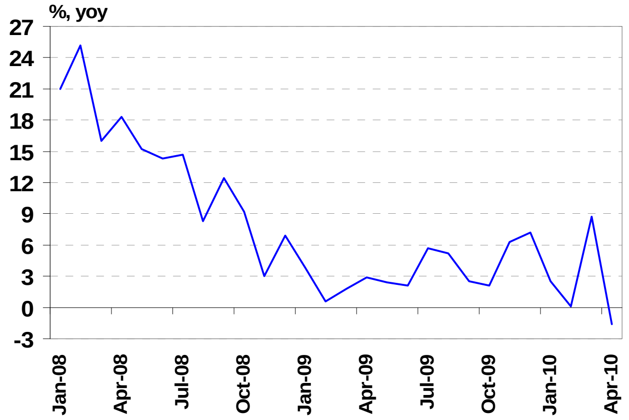
April labour market data broadly mixed `

Wage growth came out at 3.2% yoy, down from 4.8% yoy in March, underperforming expectations for a 4.2% yoy rise. Employment in the corporate sector improved, registering 0.1% yoy growth, following 14 consecutive months of contraction (-0.4% yoy in March). Unemployment eased to 12.3% in April from 12.9% in March and below a consensus forecast of 12.6%. However, according to the Ministry of Labour, the April unemployment reading can be attributed to seasonal effects, as Poles took seasonal work in construction, farming, transport, forestry and tourism. Overall, in our view, the labour market deterioration is less worrying than previously expected. The prospects of recovery and the recent reforms that reduced labour costs and favoured adjustment of real wages seem to be mitigating the effects of the downturn in employment. However, the situation of the labour market is still anticipated to weigh on real disposable income and consumption in 2010.

April retail sales surprised to the downside; dropped unexpectedly to a five year low

Polish retail sales in April surprised to the downside, contracting by 1.6% yoy against a median market forecast of +4.3% yoy and a positive growth of 8.7% yoy in the prior quarter. The April reading was the lowest since April 2005. Although this is a very volatile series and extraordinary factors may have negatively affected sales -- in particular, the unfortunate plane crash on April 10, which was followed by days of national mourning -- it has to be noted that retail sales were in a downward trend recent months (Figure 1). The breakdown of the data showed that a major driver of April's decline in sales was the Food component. Nonetheless, the exact factors behind April's retail sales figure are not clear. It might be a one-off reading but certainly it was a negative surprise.

Figure 1
Retail sales deceleration



Source: National Bank of Poland, Eurobank Research

March current account data broadly in line with expectations

Polish current account figure for March came out quite close to consensus expectations; it recorded a deficit of €559mn compared to a small surplus of €155mn in the previous month. Moreover, foreign direct investment (FDI) inflows in March were €1285mn, which was the highest figure since April 2008, reflecting the return of foreign capital to the country. The current-account deficit is expected to gradually increase to 3.0**%** of GDP in 2010 on the back of the rebound in domestic demand, the lagged effects of previous appreciation of the zloty, and improved profitability of foreign-owned companies which increases profits' expatriation.

April inflation at a three year low

Domestic CPI came in at 2.4% yoy in April**,** down from 2.8% yoy in the prior month and slightly below the 2.5% NBP target for the first time since September 2007. Headline inflation has been on a downward trend in recent months, with the corresponding measures which exclude the volatile food and energy components falling for a sixth month in a row in April to 1.9% yoy from 2.0% yoy recorded in March. Overall, inflationary pressures in the domestic economy remain low despite the rebound. Annual inflation is expected to average around 2.5% yoy this year compared to 3.5% yoy average in 2009, reflecting a still large negative output gap, contained wage pressure, and a limited rise in administrated prices.

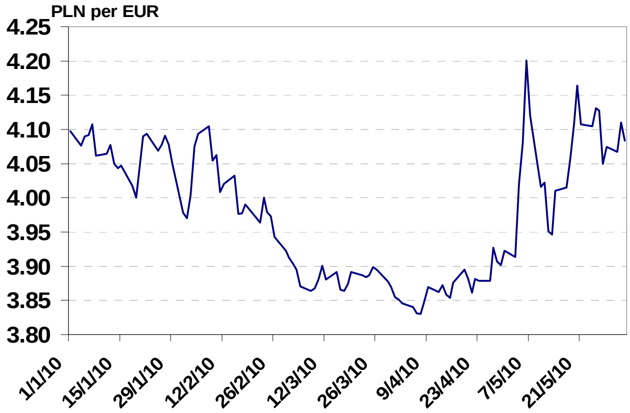
NBP seen remaining on hold on rates for the remainder of the year

As expected, the National Bank of Poland (NBP) kept its key policy interest rate unchanged at 3.5% for the tenth consecutive month in April. The minutes from the latest Monetary Policy Committee were rather dovish assessing that inflationary pressures are low and the external environment poses downside risk to the domestic economic recovery. Given the deepening crisis in the euro-zone (Poland´s main trading partners) and subdued domestic inflation pressures, we don't anticipate any policy rate move before 2011. However, if the zloty continues to decline, the NBP may consider raising rates earlier than currently anticipated.

Zloty weakens on concerns about fiscal sustainability in the euro area

The zloty weakened against the euro and the dollar in the past month on EMU-related fiscal sustainability worries. Recent experience suggests that the Polish currency tends to underperform in times of rising risk aversion; over the last month investors sold off polish assets. Moreover, the hampering demand in the euro area due to the debt crisis will weigh on Polish exports as the main Polish trade partners are in the euro area. This will pose an additional downside risk to the zloty. On the other hand, as country's authorities stated, the recent weakening of the currency is relatively beneficial to Poland's economy. (Figure 2)

Figure 2
Recent slump of the zloty



Source: Reuters, Eurobank Research

Overall credit growth in a downtrend since the beginning of 2010

Total credit growth stood at 5.1% yoy in April 2010 compared to 10% yoy recorded at the end of 2009. Total credit follows a downward trend since the beginning of this year; it declined by 0.9% year-to-April, reflecting that the demand for credit has started to weaken despite the positive credit growth dynamics in 2009. At the same time, total deposits are decelerating; they grew by 1.4% ytd (end of April) compared to 11% yoy growth recorded in 2009.

A source of concern in Polish banking system is the large share of household and corporate loans denominated in FX; 30.3% of total outstanding loans were indexed in foreign currency in April 2010. This makes the system vulnerable to exchange rate fluctuations. What's more, a large share of mortgage loans is denominated in FX; it stood at 56.7% in April 2010. It should be noted that mortgage loans amount to 40.6% of total outstanding loans and to 63.6% of total household loans, according to April 2010 data.

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Romania

Highly unpopular austerity measures adopted

- **The government adopted a package of tough austerity measures, in a move to facilitate fulfillment of this year's 6.8%-of-GDP revised deficit target**
- **Q1 GDP data weaker than expected; real growth down 2.6% yoy in Q1 against 6.5% yoy in Q4**
- **Latest balance of payments data showed a rise in the Q1 current account deficit to 1.2% of full year projected GDP against 0.8% in the same period a year earlier.**

Romania: Eurobank EFG Forecasts

	2008	2009	2010f	2011f
Real GDP (yoy%)	7.3	-7.1	0.0	3.5
Private Consumption	9.5	-10.5	-0.5	4.0
Govern. Consumption	7.1	0.8	-2.0	1.5
Gross Capital Formation	16.2	-25.3	2.5	6.0
Exports	8.7	-5.5	8.5	8.0
Imports	7.8	-20.6	6.5	8.5
Inflation (yoy%)				
CPI (annual average)	7.9	5.6	4.0	3.5
CPI (end of period)	6.3	4.7	3.8	3.0
Fiscal Accounts (%GDP)				
General Government Balance (ESA 95)	-5.4	-8.3	-7.8	-6.4
Gross Public Debt (ESA 95)	13.3	23.7	30.5	35.8
Labor Statistics (annual avg,%)				
Unemployment Rate (% of labor force)	4.0	6.3	9.0	7.5
Wage Growth (total economy)	23.6	8.4	5.5	6.5
External Accounts				
Current Account (%GDP)	-11.6	-4.4	-5.5	-6.0
Net FDI (EUR bn)	9.5	4.8	4.5	5.0
FDI / Current Account (%)	57.6	94.3	65.0	61.5
FX Reserves (EUR bn)	26.2	28.3	31.5	35.0
Domestic Credit *(end of period)*	**2007**	**2008**	**Q4 09**	**Q1 10**
Total Credit (%GDP)	39.0	42.7	50.2	50.5
Credit to Enterprises (%GDP)	18.0	18.8	19.6	19.7
Credit to Households (%GDP)	17.7	19.7	20.4	19.9
FX Credit/Total Credit (%, private)	51.0	53.1	60.1	60.4
Private Sector Credit (yoy)	60.4	33.7	0.9	-1.6
Loans to Deposits (%)	108.9	131.9	130.6	126.5
Financial Markets	**Current**	**3M**	**6M**	**12M**
Policy Rate	6.25	6.00	5.75	5.75
EUR/RON	4.19	4.30	4.30	4.15

Source: National Sources, Eurostat, IMF, Eurobank Research

Government adopted a package of tough corrective fiscal measures in order to achieve revised deficit target

President Trian Basescu announced in a public address on May 7 a package of corrective fiscal measures, aiming to facilitate fulfillment of the (IMF-backed) 6.8%-of-GDP revised fiscal target for 2010. Prime Minister Emil Boc invoked constitutionally emergency situation to bring the relevant legislation in the parliament. The new ambitious fiscal plan includes, among others, the following measures: a) effectively from June 1st (and until, at least, 1.1.2011) the public sector wage bill will be cut by 25% b) pensions and unemployment benefits will each be cut by 15% over the same period c) public subsidies will be drastically limited to low income families and d) the government will impose taxes on real estate transactions and will also raise property taxation.

In its review of Romania's stabilization program, the latest IMF mission revised down its forecast for domestic GDP growth in 2010 to ''flat or even negative'' from 0.8% expected earlier. In line with that revision, the Fund raised its fiscal deficit target for Romania this year from 5.9% of GDP to 6.8% in 2010. In order to ensure fulfillment of the revised target, the IMF requested additional fiscal measures to be taken before any new disbursement of funds is approved.

Opposition parties and public sector unions reacted negatively to the IMF demands. The main opposition party PSD announced that its plans to vote against the proposed fiscal package. The minor opposition party NPL criticized the government as well, though it was not immediately clarified whether it will vote for or against the measures. Trade unions have already announced that they are organizing a general strike against the package.

The consolidated budget deficit came at RON 8.22 billion in Q1 2010, within the RON 8.25 billion deficit target set at the IMF loan agreement. However, as we have repeatedly stressed in the past, the implementation of this year's budget may well prove a Herculean task. In our latest *New Europe Economics and Strategy monthly* issue (April 2010), we listed a number of potential risks to the 2010 Romanian fiscal outlook.

The government had earlier committed, but not entirely specified, how it would plan to achieve tough unpopular spending cuts equivalent to 2ppts of GDP. From that point of view, the announcement of auxiliary fiscal measures helps to clear out some uncertainty with respect to government's fiscal consolidation program. According to some preliminary calculations, the announced corrective measures will provide immediate savings of around €1.7 bn (approximately 1.4% of GDP) in 2010. Additionally, the Ministries will need to proceed with a considerable number of lay-offs before the end of this year so as to facilitate attainability of the new fiscal targets. The press has repeatedly mentioned that the latter would necessitate some 100,000 layoffs in the public sector. The IMF has brought the number of potential public sector lay offs up to 250,000.

On the other hand, the achievement of the ambitious target for budgetary expenditures hinges upon the completion of significant reforms, including the pension reform and the unified public wages scheme. Adoption of these reforms is still pending. Originally scheduled for the end of 2009, the introduction of the pension reform is now due by the end of June 2010. Although the government appears to be committed to a major overhaul of the pension system, considerable implementation risks lie ahead. The activation of the uniform wage law requires the adoption of additional legislation that will not be fully implemented before September. On a more positive note, the government has already adopted the fiscal responsibility law.

In our view, the adoption of the recently announced fiscal measures entails a number of significant implications. First of all, the timely implementation of the corrective measures should not be taken for granted. The package needs to be endorsed by the parliament in which the government enjoys only a slim majority. As a result, the government may encounter significant resistance from opposition parties which may well test the cohesion of the government coalition. Moreover, the package may be legally challenged in the Constitutional Court. Consequently, the implementation of the fiscal package may be subject to significant time delays. Provided that the fiscal package is implemented on time, the IMF will not disburse the next loan installment of €850 mn until July instead of the original schedule in June. In this way, IMF wanted to make sure that the government has enough time to enact the changes. The second implication is that fiscal austerity may have impact 2010 GDP growth negatively. Total consumption, which accounted for 81.1% of Romanian GDP in 2009, is likely to be negatively affected.

The third implication is that tax hikes cannot be ruled out of the agenda. From an economic policy perspective, the government chose wisely to cut down on public expenditures instead of raising taxes. At this point, this decision gives more flexibility to the private sector. President Basescu said the IMF mission and the government had considered the option to raise the main VAT rate to 24% from 19% and the income flat tax to 20% from 16% instead of cutting wages and pensions. However, the governments committed to tax hikes in case spending cuts don't live up to expectations.

Domestic economy seen remaining flat or even contracting further in 2010

Q1 GDP data dashed hopes for a more dynamic growth rebound in 2010. Romanian GDP contracted by 2.6% yoy in Q1 for a fifth quarter in a row, following a 6.6% yoy decline in the prior quarter. On a seasonal adjusted basis, GDP decline slowed to 0.3% yoy in Q1 against 1.5% yoy in Q4. The detailed breakdown of the components revealed that except for industry which grew by 4.2% yoy in Q1 flat against 4% in Q4 2009, all other major sectors of the domestic economy remained mired in recession in the first quarter of the year. Construction kept plummeting by double digit rates (-17.9% yoy). Services remain in a negative territory as well, though their pace of decline slowed to -2.0% yoy against -9.4% yoy in Q4.

On the demand side, consumption shrank further by 4.0% yoy, while gross fixed capital formation remained depressed at -28.9% yoy. Exports recorded solid gains advancing by 19.5% yoy in Q1 against 2.9% yoy in Q4. However, imports recovered as well by 14.9% yoy from -11.1% yoy in Q4, so that net exports continued to exert a positive contribution to overall GDP growth.

In our view, domestic economic growth will broadly stagnate, if not contract further in 2010. A relatively high unemployment level (8.1% in April) and negative private sector credit growth (-1.6% yoy in March) create an environment of low growth expectations. In addition, the recently announced aggressive spending cuts in wages and pensions will likely have an additional dampening effect on consumption. The current depressed levels of consumer and business morale leave little room for optimism for a swift revival in investment. On a more positive tone, a glimpse of hope is coming from the continuing rise in exports.

Last but not least, the still weak growth outlook ensures that the Central Bank will maintain its easing bias for a longer period than originally anticipated. In fact, in the absence of a new deterioration in the domestic political environment we anticipate rates to decline to 5.75% by the end of 2010, from 6.25%, currently.

Signs of swift current account reversal in Romania

The current account gap shows signs of renewed deterioration, having widened by 65% yoy to €1.5bn in Q1 2010 against € 0.9 bn in Q1 2009. The corresponding deficit climbed to 1.2% of the projected full year GDP in Q1 against 0.8% in the same period last year. The good news is that trade dynamics continued to improve, Exports continue their robust rebound (+19.3% yoy in Q1), assisted by the recovery in the Euro area where the majority of exports is heading to, coupled with the weakened RON. In contrast, imports picked up by 11% in Q1. The revival of imports is closely tied to the rebound in exports. A large part of imported materials is used as inputs for exported goods because of insufficient domestic industrial capacity. As a result, the trade deficit declined by 24% yoy in Q1.

The balance of services recorded a €273mn deficit which is three times higher than that of the same period last year. This was mostly the result of lower tourist receipts relative to the same period a year earlier. If the balance of services is accounted for, then the decline in the trade deficit of goods and services in Q1 is contained at 10% yoy. The bad news is that the current transfers' surplus appears to have declined by 63% yoy in the same period. The current account transfers surplus was traditionally the item that reduced the current account deficit. Declining remittances and low EU funds' absorption was the main culprit behind this development.

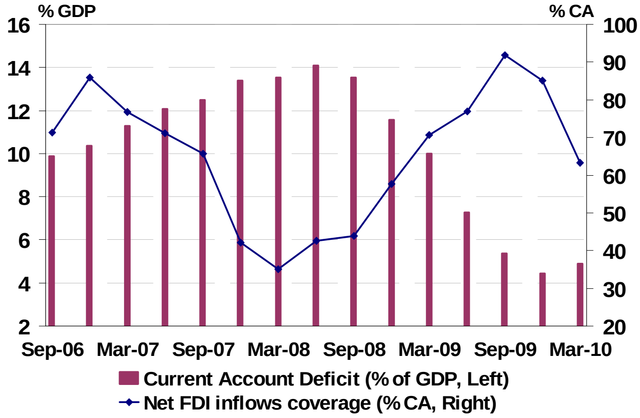
The economic crisis had a negative impact on remittances. Remittances from Romanian workers abroad in Italy and Spain were 38% yoy lower. In addition, net EU funds inflows appear to have decreased because of low absorption in March and the effect of Romania's contribution in the EU budget. However, we will be looking for more data in the coming months to see if this is going to be the trend for the rest of this year.

mn Euros	Q1 2009			Q1 2010			%
CURRENT ACCOUNT	10,525	11,435	-910	10,642	12,148	-1,506	65%
A. Goods & Services	8,280	9,891	-1,611	9,220	10,662	-1,442	-10%
a. Goods (exports fob - imports fob)	6,601	8,148	-1,547	7,879	9,048	-1,169	-24%
b. Services	1,679	1,743	-64	1,341	1,614	-273	327%
- transport	482	459	23	410	480	-70	
- tourism - travel	200	214	-14	115	234	-119	
- other	997	1,070	-73	816	900	-84	
B. Incomes	309	827	-518	207	725	-518	0%
C. Current transfers	1,936	717	1,219	1,215	761	454	-63%

On the financing side, net FDI inflows in Q1 plunged by 65% yoy to €750 mn, covering 50.1% the current account shortfall compared to 162% in Q1 2009. In our view, the data confirm our expectations of a partial reversal in improving current account dynamics in Romania this year. This is in line with our forecast of current account deficit at 5.5% of GDP in 2010, up from 4.5% in 2009.

Figure 1

Current account deficit widening again



Source: National Bank of Romania, Eurobank Research

Written by:

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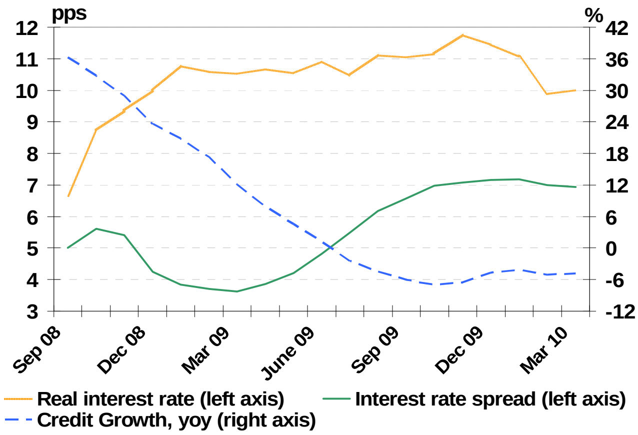
Recent domestic credit developments and outlook

Private sector credit remained stagnant in March, increasing by less than 0.1% yoy on an FX-adjusted basis. It is the first increase (although marginal) after nine months of negative yearly credit growth rates. Since the beginning of the year, private credit has cumulatively increased by 1.4% in real terms. This expansion can be attributed mainly to the borrowing of firms in FX, which has increased by 5.1% year to March, adjusted for the appreciation of the leu. On the contrary, real credit to households did not change significantly over the same period (-0.2%).

This comes as little surprise. Despite the accommodating policy followed by the National Bank of Romania (policy rate has been cut by 175bps since the beginning of 2010), the interest rates for household loans have remained persistently high. The average interest rate on outstanding leu-denominated loans to individuals has fallen only by 48 bps, while the tantamount for corporate loans has fallen by 273bps over the same period. As far as new loans are concerned, it was not before March that the average lending rate to households posted its first significant drop to 14.2%, yet still remaining well above the corresponding figure for new loans to businesses (12.1%). Note that the situation appears to be reversed compared to late 2008 and early 2009, when firms had to pay higher interests. This may be partly due to the increasing amount of household loans overdue by more than a month, which has grown more than 262% yoy in FX-adjusted terms. It is worth noting that about three quarters of these loans have been delayed by more than 90 days, and are classified as *loss*. Yet, commercial banks may still proceed in further (small) cuts in household loans interest rates, heeding thus central bank's recommendations.

Figure 2
Increased real bank lending rates and spreads take their toll on credit expansion



Source: National Bank of Romania, Eurobank Research

The developments in the credit market reflect above all the situation in the real economy, which, as discussed above, continued to shrink in the first three months of 2010. Moreover, credit quality deteriorated further in Q1:10. Loss loans more than doubled within a year, reaching RON 26bn (€6.3bn), or 13.4% of total loans in March. The value of dishonoured cheques exceeded RON 1bn, increasing by 44% compared to February. At the same time the demand for new loans has remained stagnant so far in 2010, and well below the pre-crisis levels. Hence, banks see the widening of interest rate spreads (which reached 693bps on average in March, compared to 362bps a year earlier) as a means to cover their risks and costs, as well as to preserve their interest rate profit margin. Indeed, the profits of the Romanian banking system were almost RON 430m (ca €105m) in Q1:10, when in Q1:09 it recorded a loss of nearly RON 200m (ca €50m). It is also quite indicative that the cost-to-income ratio fell to 56.6% in Q1:10 from 64% in 2009.

Nevertheless, we are not more optimistic regarding the short-term outlook of the Romanian credit market than we were in the previous months. If effective interest rates, especially on existing loans, remain at the present levels, we do not believe that it is very likely to see the levels of bad loans going down. To the extent that these loans have to be provisioned, the costs of the banks are expected to pick up, limiting in turn their profits. Provisions reached almost RON 17bn in March, more than three times the pre-crisis levels. Taking also into account the adverse economic environment faced by Romanian borrowers (the economy was still contracting in Q1:10), a recovery in the credit activity is not visible in the near future.

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Focus - Romania

A note on fiscal policy

Romania's budget deficit went from 5.4% of GDP in 2008 to 8.3% of GDP in 2009. Budget revenues fell in line with economic activity (32.2% of GDP in 2008 and 32.1% of GDP in 2009) while public expenditure rose to 40.4% of GDP from 37.6% of GDP in 2008.

The alternative measures aimed at shrinking Romania's budget gap are cutting public wages and pensions or increasing taxes. The Government has opted for the former, without completely waving the possibility of the latter. We argue that cutting expenditure, while the lesser of two evils, is unlikely to bring about the desired results. At the same time, increasing taxes will likely result in higher fiscal evasion and lower budget revenues as a percentage of GDP.

There is scope for cutting the public wage bill, evident in data published by the National Institute for Statistics (INS). Detailed data is available for October 2009 (the reference date for an annual, economy-wide survey):

1. Public sector employees have higher revenues. In October 2009, the employees of authorities, administration and companies where the state is a majority stake holder gained on average 32% more than the employees of privately owned or controlled companies (Figure 1). Public authorities and large companies active in public, naval, air transportation, public utilities and energy production and distribution pay the highest wages among state employees. Cutting 25% of wages will bring their average wage to the economy-wide benchmark.

2. Public sector wages increased more than the average wage in the economy since 2000, albeit at a different pace: wages in administration and defense were 48% larger than the economy-wide average in March 2010, those in the education system were 12% higher, while health system wages were 5% lower (Figure 2).

3. Private sector salaries are skewed towards lower wages: in October 2009, 54% of employees gained maximum 1000 lei, i.e., less than 250 euro, while the shares for mixed property and state employees were 18% and 35% respectively (Figure 3).

4. The public sector is overcrowded. In October 2009, there were 1.35 million people employed by state-owned or controlled companies or authorities (34.6%), and 2.55 million employees in the rest of the economy (65.4%). In 1990, one year after the communist regime fell, there were 1.26 million employees in administration, defense, health, education and other activities (15.1%) out of 8.35 million employees in the economy.

5. The public sector is inefficient. The weight of public wages in public sector value added has increased from 57% in 2003 to 77.1% in 2008 and 76.6% in 2009 (figure 4).

Wage levels are very different across the categories of public employees, but differentiated cuts are unlikely to succeed in limiting public spending:

- The top earners are in administration and big companies (many holding a monopoly position). There's a lot of resistance to cutting jobs or wages since most employees benefit from political influence and nepotism.

- Top earners are likely to benefit from any loopholes or gradualism in legislation.

- Implementing revenue cuts will be contested in court: the Government has invoked Article 53 of the Constitution that covers the temporary restraint of some rights, but it will be difficult to prove that the current recession/ crisis falls into any of the covered events (catastrophes, defense of national security, the need to preserve public order, morale or civil rights). Moreover, Article 53 states that any such measure must be applied proportionally to the size of the calamity/threat, indiscriminately and without threatening civil rights.

The pension cuts attempt to balance the social security budget, already in the red for the past two years (-3 billion euro) and facing some daunting challenges:

1. According to the IMF, the falling number of employees is set to double pension costs by 2060 as a percent of GDP (from 7.1% in 2008 to 14% if the pension point stays at 45% of the average wage).

2. Demographic mismatches are likely to worsen. Romania had 3.6 workers for each pensioner in 1989, but only 0.8 workers per pensioner in 2009, mainly because of the early retirement schemes of the 1990s and of increasing redundancies in 1997 –1999. The trend is unlikely to reverse as the population shrinks and the number of newly born

between 1990 and 2008 is 30% lower than between 1950 and 1975.

3. The Prime Minister has declared that the 15% cut will be applied until 31st December 2010, but further solutions are needed in order to balance the social security budget. The IMF and the World Bank have suggested a mixture between indexing pensions with the inflation rate and tying them to social security contributions rather than the current wages.

Rampant populism failed to deal with this growing problem as political parties catered heavily to the most active electoral group (i.e., pensioners). Without support from other parties and under fire from media, the current government could retract such unpopular measures.

The possible tax increases refer to hikes of the VAT (from 19% to 25%) and of the flat tax (from 16% to 20%). Apart from shrinking consumption, increasing inflation and reducing external competitiveness, such measures could backfire and decrease budget revenues as a percent of GDP. By being far more reaching than public sector wage and pension cuts, their contractionary effect could be greater.

Annual[1] VAT (and other VAT-type) revenues have increased to 8.3% of GDP in Q1 2008, but fell to 6.7% of GDP at the end of 2009. The drop is mirrored by the weight of VAT revenues in total consumption (from 9.8% in Q3 2008 to 8.2% at the end of 2009 – figure 5). It is the likely effect of increasing tax evasion and tax credit and it will probably be spurred by a VAT increase. Current estimates point that an increase in VAT will result in lower VAT revenues after one year because of weaker economic activity.

Likewise, annual taxes on production, imports, income, and wealth fell from 19.8% of GDP in Q2 2008 to 17.6% in 2009 (figure 6). The weight shrank by 3 percentage points when budget revenues were compared to value added in retail services, industry and constructions (the top 3 generators of value added).

The threat of tax evasion (and of sending back to the black economy some of the businesses that started paying taxes after the 2004 flat tax was applied) diminishes the effectiveness of tax increases.

The solution for increasing budget revenues is enforcing better fiscal discipline. Although the main VAT level is 19%, VAT budget revenues amount to only 8.2% of gross value added by total consumption. Even when accounting for tax exemptions and reduced tax levels, the weight is very low. Taking the weight up to 10% would mean adding 1.7 billion euros (or 1.5% of GDP) to budget revenues; taking it to 15% would add 6.4 billion euro or 5.5% of GDP (at the GDP and consumption levels of 2009). On top of that, the Government estimates that the tax evasion for tobacco products amounts to 1 billion euro per year (0.8% of GDP in 2009).

The needed fiscal adjustment will be very difficult. Capping wage and pension expenditure will face the opposition of unions, media and populist politicians and will probably end up in legal challenges solved by the Constitutional Court. Increasing taxes would likely weaken the efficiency of fiscal policy since Romania has a history of tax evasion, tax credit and arrears. Better fiscal discipline could be the answer to higher budget revenues, but it would need an overhaul of fiscal authorities and lower corruption, both difficult to achieve in the short run.

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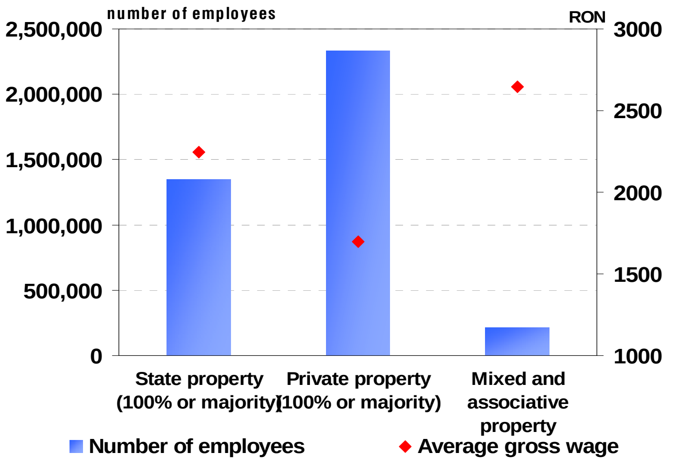
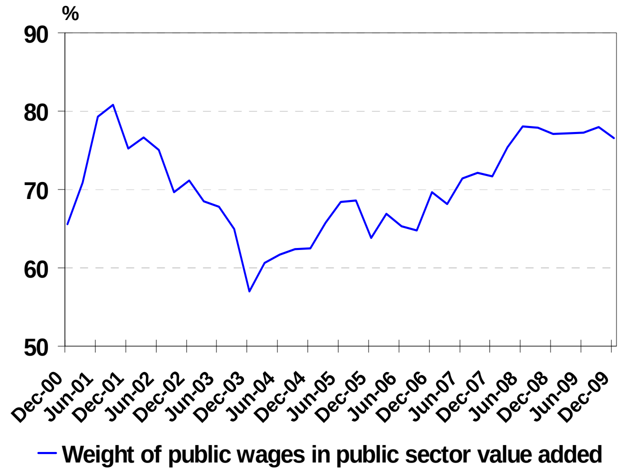
[1] The sum of revenues for the past 4 quarters

Figure 1



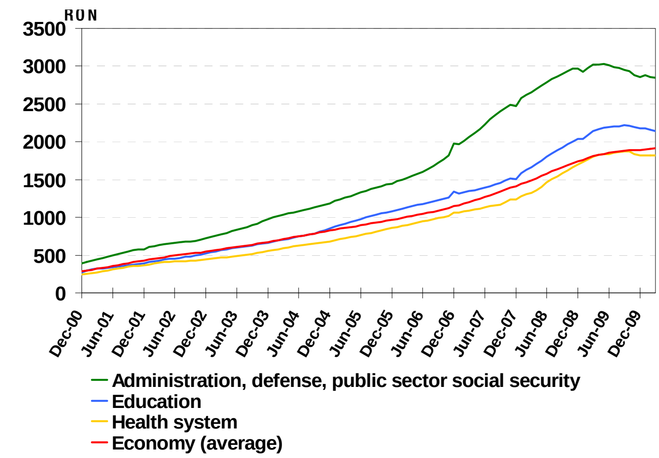
Source: National Institute of Statistics of Romania, Bancpost

Figure 4



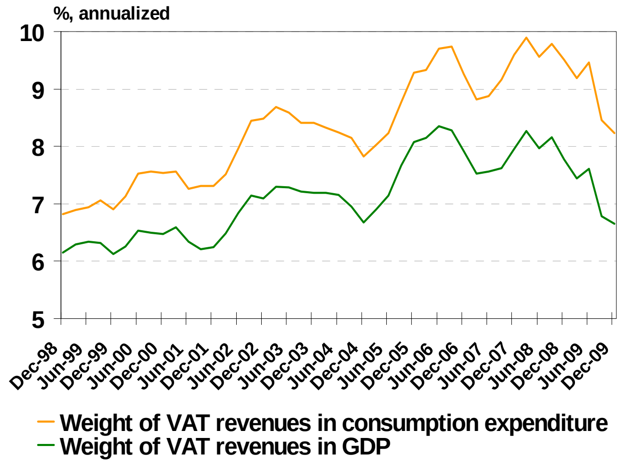
Source: National Institute of Statistics of Romania, Bancpost

Figure 2



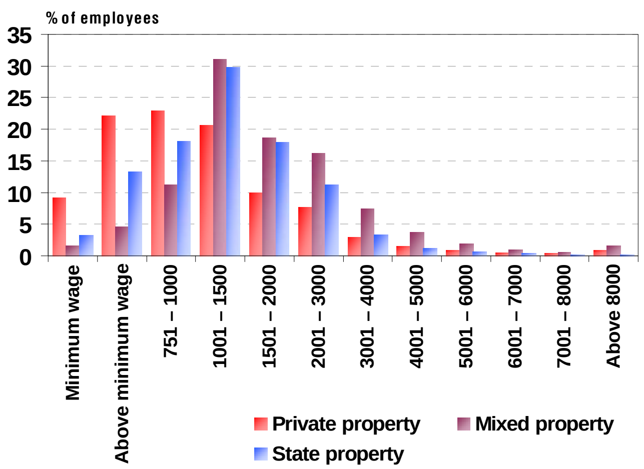
Source: National Institute of Statistics of Romania, Bancpost

Figure 5



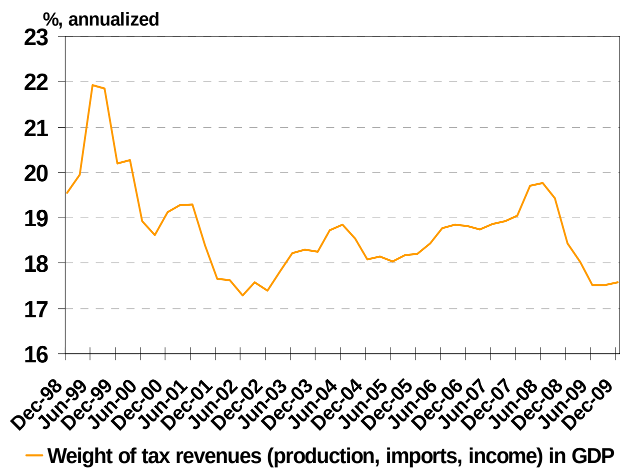
Source: Bancpost computations

Figure 3



Source: National Institute of Statistics of Romania, Bancpost

Figure 6



Source: Bancpost computations

Serbia

No unfreezing in wages and pensions

- **In its latest review of Serbia's existing Stand-By Arrangement, the IMF agreed to relax the 2010 budget deficit target from 4.0%-of-GDP to 4.8%.of-GDP. Yet, the Fund did not allow the government to breach an earlier conditionality to keep public wages and pensions frozen this year**
- **The government needs to push urgently for structural reforms in the public sector in order to tap the 4th tranche of IMF funding on time**
- **The lingering fiscal crisis in the Euro area prevented the Central Bank from cutting interest rates further in May and kept the Dinar under pressure**

Fourth IMF review successfully completed; government needs to accelerate reforms to be able to tap available funds on time

The more recent negotiations between the IMF staff mission and the government were completed successfully. The approval of the agreement by the IMF Board will allow the government to tap an additional €380mn. The government has already made use of €1.3bn of IMF financing out of a total of €2.9bn of available funds under the present arrangement. The IMF mission assessed that the program is performing satisfactorily on all targets, except that of the budget deficit which was exceeded in Q1 by a small margin, owing to a revenue shortfall. The IMF revised its forecast for Serbian GDP growth in 2010 to 1.5% (in line with our own forecast), from 2.0% previously citing weak domestic demand dynamics. Accordingly, the IMF agreed to relax the budget deficit target in 2010 from 4.0% to 4.8% of GDP.

There are two important developments stemming from the latest IMF review of the existing loan program. First, the government conceded to IMF requests not to unfreeze public wages and pensions, confirming our expectations. The issue has been the subject of a heated political debate domestically since the beginning of the year. The coalition government has sought to freeze public wages and pensions for a second year in a row in 2010, as part of the IMF program's commitments. Yet, public discontent and the prospect of a growth rebound in 2010 had led to growing voices both within the government and the opposition for an unfreezing of wages and pensions.

Serbia: Eurobank EFG Forecasts

	2008	2009	2010f	2011f
Real GDP (yoy%)	5.5	-3.0	1.5	3.0
Inflation (yoy%)				
CPI (annual average)	12.5	8.2	4.5	4.8
CPI (end of period)	8.6	6.6	5.5	4.5
Fiscal Accounts (%GDP)				
General Government Balance	-2.6	-4.2	-4.8	-4.0
Gross Public Debt	25.6	31.3	37.0	41.0
Labor Statistics (%)				
Unemployment Rate (%of labor force, ILO)	14.7	16.1	18.5	16.5
Wage Growth *(total economy)*	17.9	4.1	4.8	6.7
External Accounts				
Current Account (% GDP)	-17.1	-5.7	-8.5	-9.0
Net FDI (EUR bn)	1.8	1.4	1.5	2.0
FDI / Current Account (%)	30.0	78.7	55.0	70.0
FX Reserves (EUR bn)	8.2	10.6	11.3	10.2
Domestic Credit	**2007**	**2008**	**Q4 09**	**Q1 10**
Total Credit (%GDP)	35.4	41.0	48.7	51.2
Credit to Enterprises (%GDP)	21.5	25.8	29.4	30.8
Credit to Households (%GDP)	13.2	14.0	14.7	15.3
Private Sector Credit (yoy)	40.2	34.9	14.3	12.9
Loans to Deposits (%)	99.9	125.1	127.0	133.2
Financial Markets	**Current**	**3M**	**6M**	**12M**
Policy Rate	8.00	8.00	7.50	7.50
EUR/RSD	102.73	105.00	105.00	110.00

Source: National Sources, IMF, Eurobank Research

In the March 2010 issue of our *New Europe Economics & Strategy* bulletin, we argued that an unfreezing would not be possible under the current economic circumstances.

However, the government secured the consent of the IMF to increase spending on low income social groups. As a result, the government could utilize RSD 6.5 billion to provide one-off payments this year to public sector employees, pensioners, poor municipalities, as well as to increase targeted social assistance.

In our view, the IMF had the least lenient stance on the review of the program since its beginning. Although it provided some flexibility with respect to the quantitative fiscal target, it tied access to further funding upon pushing ahead the pension and public sector reforms. The government has pledged many times to slash public sector employment, particularly at the central government level. Yet, progress on that front has been limited so far. In addition, the pension reform law is still awaiting parliamentary approval, while the adoption of the fiscal responsibility law has been postponed to next September. In a nutshell, there is limited room for further significant delays in government action on structural reforms. The government needs to push urgently for public sector lay offs in order to tap IMF funding on time.

Central Bank keeps key policy rate unchanged at 8.00%

On May 19, the Serbian Central Bank kept its key policy rate unchanged at 8.00%. The lingering fiscal crisis in the Euro area supported the no-policy-change decision, while the recent turmoil in global financial markets has instigated some further pressure on the Dinar despite favorable domestic inflation developments. The current level of the NBS's key policy rate is the lowest since 2006. The Central Bank has so far delivered 975bps of cumulative rate cuts since late 2008, when it first started its latest monetary easing cycle. The Central Bank last cut its key rate on May 4 (by 50bps to 8.00%).

The favorable inflation developments in Q1 allowed the Central Bank to reduce interest rates by a total 150bps year-to-date. Inflation moderated further in April to 4.3% yoy, from 4.7% yoy in March and 6.6% yoy in December last year. Inflation is expected to trend lower near-term, falling to 3.6% by June, below the 4-8% target band of the Central Bank. In our view, the scenario of inflationary pressures reemerging carries a significant probability only in the case pensions and wages are unfrozen, which is highly unlikely under the present circumstances.

In its latest inflation report issued in May, the NBS stated that it will maintain its easing bias. In these lines, Deputy Governor Bojan Markovic expressed the view that the Central Bank is likely to keep cutting rates, but at a slower pace than in the last three months. However, the Central Bank stressed that its future policy decisions will be determined by a number of factors, including among others: a) the evolution of domestic demand dynamics b) food price inflation developments c) perceived risk premia and d) the pace and extent of any further Dinar depreciation.

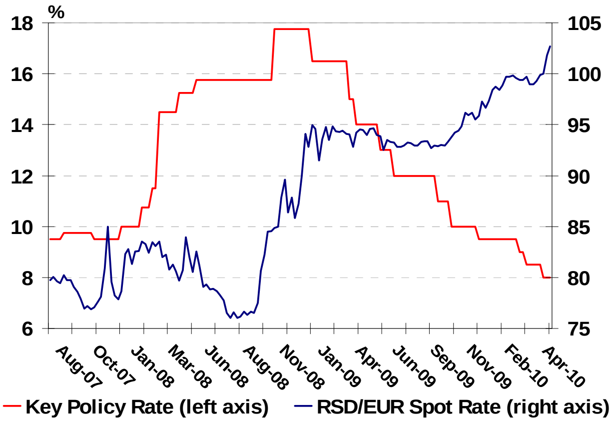
Pressures on the Dinar persist

The Dinar has lost ca 8.3% of its value against the Euro since last September, moving lately beyond the psychological level of 100/€. On May 18, the local currency hit a new time low of 101.70/€, broadly shrugging off repeated interventions by the NBS to stem its pace of depreciation against the Euro. The Central Bank has spent €978.5mn so far (the time of the writing-May 31st) this year in Dinar-supporting interventions. Yet, it foreign exchange reserves reached a record high at EUR 10.8bn at the end of April, supported by IMF loan.

In our view, the depreciation of the Dinar is a mixed blessing for the domestic economy. On the one hand, it helps to boost export competitiveness and thus, economic growth (exports grew by 13.9% yoy in Q1). On the other hand, it increases inflationary pressures because of the high pass-through. The Central Bank has estimated the pass through effect at 0.2-0.3 in the current quarter and 0.6 in the next 12 months. In our latest *New Europe Economics & Strategy* issue we highlighted the risk of further depreciation of the local currency. Maintaining the Dinar stable will be a contentious and critical issue for the rest of the year. The new governor Mr Soskic, who will be replacing Mr Jelasic in early June, will have to strive to maintain confidence in the local currency, which is presently the key focus of market attention.

Figure 1

Dinar under continuous depreciation pressure despite Central Bank efforts



Source: National Bank of Serbia, EcoWin, Eurobank Research

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Recent domestic credit developments and outlook

Domestic credit continued to expand in March. Total outstanding domestic credit exceeded RSD 1,500bn (€15bn), increasing by around 2% mom on an FX-adjusted basis. Credit to the private sector also resumed its expansionary trend, growing by 8.4% yoy. Since the beginning of the year, private credit in Serbia has increased by 3% in real terms, which is one of the highest figures in the region. Note that in several Balkan countries, real credit growth remained in negative ground in Q1:10. Private sector deposits, adjusted for the volatility of the dinar, grew by 19.5% yoy compared to a 3.8% contraction in Q1:09.

In early May, the National Bank of Serbia (NBS) announced a relaxation in the regulations concerning the *classification of balance sheet assets and off-balance sheet items*. This action was partly aimed at bolstering bank lending, which is seen by the government as one of engines that could drive the economy out of recession in 2010. However, the main stimulus behind the above decision was different.

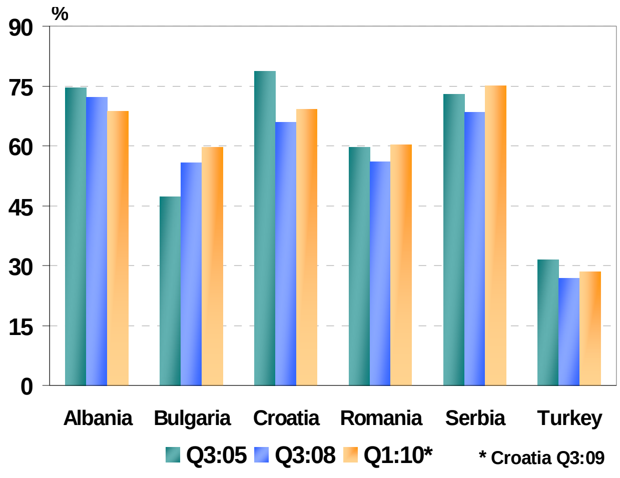
At the end of March, FX-credit and dinar credit linked to other currencies amounted to more than three quarters of total outstanding credit in Serbia. This figure is high even by the standards of the region, where borrowing in FX is a common practice (Figure 2). This may be partly explained by Serbs' traditional mistrust towards the dinar, which kept plummeting during the conflicts in Yugoslavia in the nineties. Even presently, households keep more than 90% of their savings in FX deposit accounts. Additionally, subsidiaries of foreign banks, which have a 75% share in Serbia, have strongly encouraged firms and households to borrow in FX. Since the majority of these loans are denominated or indexed in euro (ca 80%), and to a smaller extent in Swiss franc (ca 14%), this phenomenon is often referred to as debt euroisation. Although not detrimental per se, euroisation can have adverse effects if it reaches high levels.

The main dangers are two. First, it limits the effectiveness of Central Bank's monetary policy, since the base on which its policy rate decisions apply is restricted. A change in ECB's key policy rate, for example, would directly affect the interest rate applying to more than two thirds of Serbia's domestic loans; the respective figure for NBS's rate would be less than a quarter.

Second, the euroisation of a loan increases the foreign exchange risk associated with its repayment, especially if the working currency of the country is rather weak and highly volatile, such as the dinar. According to the NBS, "foreign exchange risk is the largest systemic risk at the moment". We should note though that foreign exchange risk is partially mitigated by the high deposit euroisation (74.4%).

The amendments in the regulations adopted by the NBS largely aim at reducing the FX exposure of the borrowers, by providing incentives, such as looser creditworthiness requirements, to persons who borrow in the currency of their regular income. These changes come as a first step towards a policy that will encourage debt de-euroisation, a commitment that Serbia has undertaken towards the IMF. Of course, the above measure is not sufficient by itself, and additional initiatives and regulatory actions are needed to achieve this target. However, this may not be enough either. As explained above, high euroisation is a symptom of problems with deeper roots. NBS and the government should work towards achieving currency stability (dinar has lost about 7% of its value even against the embattled Euro since the beginning of 2010), and subduing inflation (which has indeed been kept under control over the last months). Unless decisive steps are taken to this direction, we do not see FX positions reducing significantly in either side of Serbian banks' balance sheets.

Figure 2
Credit euroisation in Serbia has been steadily among the highest in the region



Source: Central Banks, Eurobank Research

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Turkey

Economic recovery continues; GDP growth likely to surprise to the upside in 2010

- **Impact of EMU sovereign debt crisis on the domestic economy limited so far**
- **CBRT maintains key policy rate unchanged at 6.50% and implements first step of technical interest rate adjustment**
- **CPI retreats unexpectedly in May**
- **Implementation of new legislation key for fiscal consolidation ahead**
- **Current account deficit widening continues**

Economic recovery continues…

Domestic economic activity appears to have gained traction since Q4 2009, when real GDP growth recorded a 6%yoy rise. Domestic demand is showing ongoing signs of recovery. Namely, April's consumer confidence bounced to its highest level since early 2008. Though easing slightly in May, manufacturing confidence stood close to a 3-year peak touched a month earlier and remained for the fifth month running above the 100-level threshold that separates optimism from pessimism. The rate of unemployment marginally improved to 14.4% in Q1 and has remained consistently below am all time peak of 16.1% touched in February 2009. Credit growth has embarked on an uptrend since Q4 2009. A 21%yoy jump in industrial production in March pushed the Q1 annual rate of increase in the sector to 17.1%yoy, signaling a sustainable recovery in investment activity. April's manufacturing PMI registered its fastest pace of expansion on record, remaining in an expansionary territory for the 12th consecutive month. Meanwhile, Turkish automotive production jumped 21% in April, pushing the January-to-April annual rate of increase to 60%. A 0.32%yoy decline in the number of foreign visitors to Turkey in April was largely attributed to Iceland's volcano ash, while arrivals registered a 6.8%yoy increase in the first four months of the year. On the external side, Turkish exports have also staged a strong rebound over the first four months of the year, reflecting the economic recovery in main trade partner economies.

…pointing to a strong GDP growth reading this year

We continue to expect domestic economic activity to pick up further in the quarters ahead. Favorable base effects against a background of a deep recession in 2009 and a substantial adjustment in inventories are likely to be the primary drivers of growth this year.

Turkey: Eurobank EFG Forecasts

	2008	2009	2010f	2011f
Real GDP (yoy%)	0.7	-4.7	6.0	4.1
Private Consumption	-0.3	-2.3	3.5	4.0
Govern. Consumption	1.7	7.8	1.0	3.0
Gross Capital Formation	-6.2	-19.2	4.0	9.0
Exports	2.7	-5.4	6.0	8.0
Imports	-4.1	-14.4	10.0	10.5
Inflation (yoy%)				
CPI (annual average)	10.4	6.3	8.9	7.2
CPI (end of period)	10.1	6.5	8.0	5.4
Fiscal Accounts (%GDP)				
General Government Balance	-1.8	-5.5	-3.8	-3.3
Gross Public Debt	39.4	45.5	45.3	45.0
Primary Balance	3.5	0.1	1.0	1.5
Labor Statistics (%)				
Unemployment Rate (%of labor force)	13.6	13.5	13.2	12.8
External Accounts				
Current Account (% GDP)	-5.7	-2.2	-4.5	-5.3
Net FDI (USD)	15.8	6.1	7.5	9.0
FDI / Current Account	37.5	43.5	23.0	24.0
FX Reserves (USDbn)	71.0	69.0	70.0	71.0
Domestic Credit	**2008**	**Q3 09**	**Q4 09**	**Q1 10**
Total Credit (%GDP)	31.0	33.0	35.0	34.0
Credit Private Sector (%GDP)	29.7	31.0	32.9	31.9
FX Credit/Total Credit (%)	13.2	14.0	14.9	16.9
Private Sector Credit (%yoy)	22.9	2.8	11.3	22.8
Loans to Deposits (%)	82.4	79.5	78.7	79.9
Financial Markets	**Current**	**3M**	**6M**	**12M**
Policy Rate	7.00	7.00	8.50	9.00
USD/TRY	1.58	1.55	1.50	1.45

Source: National Sources, Eurostat, IMF, Eurobank Research

Domestic consumption has already embarked on an uptrend, which is likely to continue in the near-term as credit conditions improve further. Government plans to launch a job creation scheme in the imminent future may also favor. Meanwhile, we anticipate investment activity, which has remained a drag on GDP growth since Q2 2009, to rebound and begin exerting a positive impact as of early 2010. The rebound in goods exports and tourism is also likely to continue. Nevertheless, the net export's contribution to real GDP growth turned negative in Q4 2009 and the trend is likely to persist as the recovery in domestic demand is seen outpacing that of main trade partner countries this year. With most data signaling a sustainable and strong economic recovery ahead, we revise our GDP growth forecast for this year by 1ppt higher to 6%yoy, following a contraction 4.7%yoy in 2009. Note that government officials have recently voiced expectations for a 10-12%yoy rise in Q1 GDP. Risks to our forecast remain to the upside and lie in the face of a stronger than expected recovery in domestic and external demand. On the other hand, downside risks stem from a slower than anticipated rebound in Turkey's main export markets, especially in view of the current euro area sovereign debt crisis.

The impact of EMU sovereign debt crisis on the domestic economy limited so far

Turkey proved among the very few countries in the region to be able to stir through the crisis without international financial aid. Fiscal consolidation, substantial monetary easing and liquidity enhancing incentives as well as a strong banking system provided a significant cushion against the global financial crisis. Nevertheless, risks lie ahead against a background of a sovereign debt crisis in the euro area. Potential spillover risks lie in the face of four separate channels: foreign trade, foreign investments and the financial sector. With regard to the foreign trade channel, economic activity may be negatively affected if external demand for Turkish exports stalls. However, according to the most recent trade data, the impact of the EMU debt crisis appears to have been limited so far, Specifically, total exports rose ca 26%yoy over the first four months of the year, with the share exports going to European Union countries as a percentage of total Turkish exports improving to 47.4% from 41.7% over the same period last year. The aforementioned development was actually observed in tandem with an appreciating lira, which boosted the cost of Turkish exports (USD/TRY slid more than 8%yoy on average over the January-April 2010 period). A standstill in foreign investment could also weigh on domestic economic activity but could also have negative repercussions on the financing of Turkey's widening current account gap, as well as on the lira. That said, pressure on capital outflows appear relatively limited so far. With regards to the financial system, potential spillover from the euro area debt crisis remains a risk to global financial stability. Nevertheless, key prudential indicators of capital adequacy and liquidity in the domestic banking sector suggest lower exposure to credit-related contagion risks relative to other CEE peers. As also outlined in the CBRT's Financial Stability report released in late May, although financial stability risks linger in view of the current euro area debt crisis, Turkey's banking sector appears healthy and well capitalized. Turkish banks have higher quality of assets and capital adequacy ratios compared to other countries, with a capital adequacy ratio of above 12%, while the loans to deposits ratio remains below unity and NPLs have stabilized below 5% in recent months. Note also that Turkey remains amongst the least leveraged economies in the CEE region. In general, although risks lie ahead in view of the sovereign debt crisis in the euro area, the Turkish economy appears better shielded to withstand contagion from the euro area crisis.

CBRT maintains key policy rate unchanged at 6.50%....

On May 18, CBRT kept its key policy rate, the overnight borrowing rate, at its record low level of 6.50%, in line with market expectations. Overall, the Bank's assessment on the domestic economy was largely in line with that in the April statement. It reiterated that policy rates are likely to be maintained at low levels for a long period of time as core inflation is expected to remain below the year-end target of 6.50% in the remainder of the year. Main differences compared to the MPC meeting in April were that May's statement read that "domestic demand is following a stable growth trend", rather than "gradual". On the other hand, the CBRT highlighted concerns about uncertainties surrounding external demand.

...and implements first step of technical interest rate adjustment

Nevertheless, the most important aspect of the last MPC meeting was that the Committee decided to put into practice the first step of the technical interest rate adjustment process outlined in its exit strategy report published on April 14. The Central Bank changed its key policy rate from the overnight borrowing rate to the 1-week repo rate, which was set 50bps above the overnight borrowing rate, i.e. at 7.00%. Moreover, the CBRT will now base its repo auctions on the amount with a fixed interest rate and not on the interest rate, as was practiced before. Additional liquidity will continue to be provided to the markets, however, in relatively decreasing amounts. As liquidity provision slows down in line with the Bank's expectations, the CBRT will eventually initiate the second step of the technical interest rate adjustment process, which includes a widening of the spread between the 1-week repo and the overnight borrowing rates. The increase of the spread is expected, inter alia, to stimulate interbank lending. In all, the Bank's decision to proceed with the technical interest rate adjustment does not indicate a change in the CBRT's stance. In view of tightened liquidity conditions fanned through the global financial crisis, the Central Bank had become a net lender in money markets in recent months, which deemed the overnight borrowing rate less credible as a policy rate. The 1-week repo rate had become the CBRT's basic funding instrument and had recently stabilized around levels of 7.00%.

CPI unexpectedly retreated in May

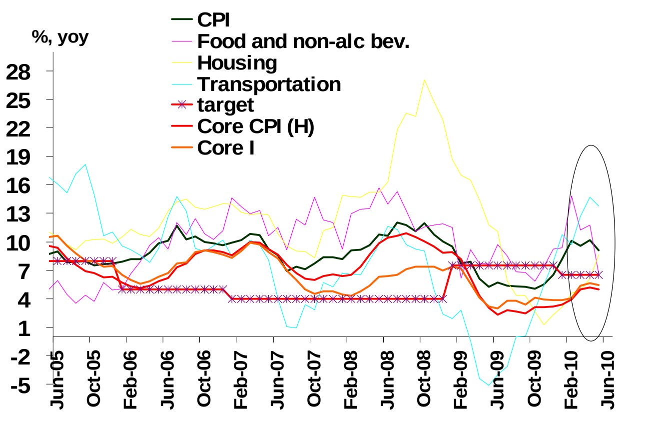
Consumer inflation registered a 0.36%mom decline in May, confounding expectations for a 0.4%mom rise and pushing the annual rate of increase to 9.10% from 10.19% in the prior month. Nearly all core CPI components eased on an annual basis, while PPI fell by 1.15%mom outperforming the market's median forecast for a 0.73% gain and bringing the annual rate of growth to 9.21% below a 10.42% print in April. May's disinflation was primarily driven by a 4.38%mom drop in food and non-alcoholic beverages prices. On an annual basis, strong gains were observed in the "alcoholic beverages and tobacco" component, which registered a 43% rise in view of regulated price hikes. Transportation costs rose by 13.8%yoy, while "hotels and restaurants" and "miscellaneous goods and services" also registered double-digit increases.

CBRT likely to incept monetary tightening cycle in Q4

In spite of the recent improvement in inflation in May, just a month earlier CPI stood at its highest level since November 2008, when the global financial crisis began taking its toll on the Turkish economy. The rebound in the domestic economy, unfavorable base effects, higher food prices and regulated price hikes are all to blame for the sharp rise in CPI from multi year-lows of 5.08% in October last year. May's data suggests that there is increasing likelihood that CPI is likely to come in below the CBRT's year-end forecast of 8.4%yoy as well as our previous 8.7%yoy projection - which we now revise to 8.0%yoy. Along these lines, expectations for an earlier-than–in-Q4 inception of the central bank's monetary tightening cycle are likely to be scaled back. Further delays in rate hikes can not be ruled out and in view of the ongoing sovereign debt crisis in the euro zone, risks to our previous forecast for 150bps of cumulative rate hikes by year-end are on the downside.

Graph 1

Inflation bounces retreated from double digits in May



Source: National Statistics Office

Fiscal consolidation continues...

The government's budget ran a TRY 4.455bn deficit in April, contracting from a TRY 5.9bn shortfall a month earlier. According to the Finance Ministry a 370.6%yoy widening registered in April was primarily attributed to a high level of interest rate payments that month, thus it should not be perceived as deterioration in the government's fiscal consolidation path. In fact, interest payments jumped 132%yoy to TRY 7.1bn in April, while tax revenues, which have materially improved since Q4 2009, rose nearly 20%yoy to TRY 15.3bn. Meanwhile, the primary surplus rose 62%yoy to TRY 2.597bn. Overall, during the first four months of the year, Turkey's fiscal deficit shrunk by 21.3%yoy to TRY 15.796bn, tax revenues jumped 24%yoy, while the primary balance soared by nearly five times to TRY 6.256bn. Taking into account that the domestic economic recovery will probably continue in the months ahead, tax revenues are likely to remain supported by cyclical factors. Along these lines, the general government deficit target of 4.7%-of-GDP for this year is likely to be comfortably met, with potential for a below 4%-of-GDP realization. Risks for a higher fiscal deficit this year remain primarily in the face of laxer policies in the run-up to the 2011 general elections. A higher-than-expected GDP growth could lead to a further outperformance of the government's target this year.

...with the government reaffirming its commitment to the fiscal rule; yet, implementation is key

Further declaring its drive towards fiscal consolidation, the government presented in May its much awaited fiscal rule. The bill, submitted in parliament in late May and expected to be endorsed into law by end-of July, has been much awaited by financial markets as it is broadly seen as a fiscal policy anchor in view of the absence of a new IMF loan deal. The reform envisages a medium term budget deficit of 1%-of-GDP and real GDP growth 5%yoy. It encompasses a cyclical calculation of fiscal targets and is based on the following equation (with all budget deficit components noted as % of GDP):

Adjustment in the general government budget deficit = -0.33 (previous year's budget deficit – M/T fiscal target) – 0.33 (real GDP growth – M/T real GDP growth target)

In effect the equation implies that should real GDP growth exceed its medium term target of 5%yoy in the prior year, the adjustment required in the budget will be equivalent to a tightening of 1/3 of this difference. In a similar vein, if the budget realization a year earlier underperforms the 1%-of-GDP target then the government will have to curb its budget deficit by an amount equivalent to one third of that exceeded. The equation is rather simple and the medium term targets set are broadly considered realistic. Moreover, the rule spans the broader public sector and not just the central government (i.e. the central government, social security system, local administration and the unemployment fund), which is likely to provide a more comprehensive study of public finances. Furthermore, transparency is expected to be improved through regular monitoring of the rule. Consultations with the IMF and the World Bank in order to design the rule, add to its credibility. On the other hand, potential weaknesses to be spotted are: a. the law does not specify sanctions if the targets are not met, a fact that could undermine its effectiveness b. auditing of the rule will be undertaken by the Court of Accounts and not by an independent authority which could weigh on transparency and credibility, c. the law will not be included in the constitution, which could lead to repetitive revisions on its parameters (albeit the latter is not essentially negative as the necessary 2/3 parliamentary majority necessary to change the constitution could also hinder implementation of needed amendments).

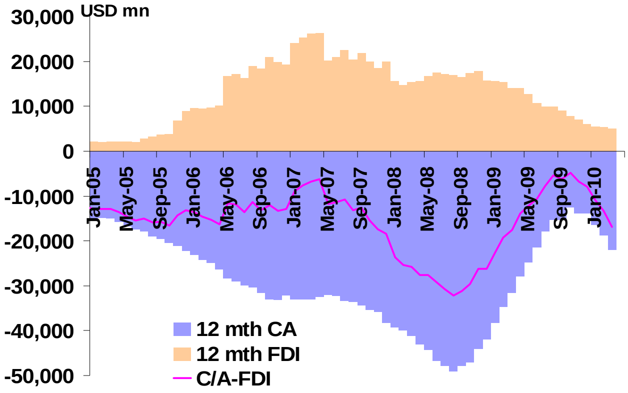
All in all, the rule has so far been well received by market participants and is seen strengthening the government's credibility on fiscal prudence and improve transparency in public finances. However, a rule by itself does not imply fiscal consolidation and key will be the government's commitment to put the rule into practice. Accurate implementation also bears significant potential for credit rating upgrades. Nevertheless, as the rule will be valid as of next year it is not expected to affect this year's budget performance.

Current account deficit widening continues

Turkey's current account deficit widened sharply in the first three months of the year in tandem with rebounding domestic demand and higher energy prices. In detail, the Q1 shortfall widened by ca 400%yoy to USD 9.95bn, reversing an 84%yoy contraction registered over the same period a year earlier, when the recession in the domestic economy reached its trough. As a result, the 12-month trailing current account jumped to USD 21.93bn, which according to our calculations is equivalent to 3.1%-of-GDP. Nevertheless, the sharp rise is largely affected by a very weak base in Q1 2009, when the recession in the domestic economy touched its trough. As base effects somewhat ease in the months ahead, the pace of the widening is likely to slowdown. That said, the CAD is expected to continue widening in the remainder of this year as the economic rebound gains traction. In view of the recent deterioration in the CAD and the upward revision to our forecast for GDP growth this year, we also revise our 2010 CAD forecast to 4.5%-of-GDP. On the financing side, FDI fell by 50%yoy to USD 1.028bn in the first three months of the year covering just 10% of the shortfall. On the other hand, portfolio inflows improved significantly totaling USD 2.632bn in Q1 2010 vs. a net outflow of USD 3.142bn over the same period a year earlier. In all, in spite of the recent deterioration in net FDI inflows, the financing of Turkey's CAD does not appear to pose as a significant risk presently as portfolio inflows remain strong and external financing conditions are likely to improve further in the months ahead.

Graph 2

Current account deficit widens in view of a rebound in domestic demand and higher oil prices



Source: Central Bank of the Republic of Turkey

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Ukraine

Resumption of the IMF lending still pending amid concerns over 2010 budget deficit

- **The new $19-20bn IMF loan programme to Ukraine is still pending. The Fund recognised the good news on Q1-10 GDP growth but has concerns over the government's ability to keep the 2010 budget deficit under control**
- **In May, Standard & Poor's (S&P) upgraded further Ukraine's sovereign rating by one notch to B/C and raised the local currency ratings to B+/B, while keeping the outlook stable, citing improved policy coordination**
- **Ukraine's real GDP growth returned to positive territory of 4.8% yoy in Q1-10 after five consecutive quarters of contraction**

Ukraine: Eurobank EFG Forecasts

	2008	2009	2010f	2011f
Real GDP (% yoy)	2.3	-15.1	2.5	3.0
Private Consumption	9.9	-12.1	1.5	1.0
Government Consumption	0.4	1.8	0.5	1.0
Gross Capital Formation	32.6	-48.4	2.0	3.0
Exports	5.1	-23.6	4.0	5.0
Imports	18.4	-36.8	1.5	2.0
Inflation (% yoy)				
CPI (annual average)	25.3	16.0	11.5	10.8
CPI (end of period)	22.3	12.3	11.0	10.5
Fiscal Accounts (% GDP)				
General Government Balance	-3.2	-7.2	-6.0	-5.5
Gross Public Debt	19.9	30.0	35.0	34.0
Labor Statistics (%)				
Unemployment Rate (% of labor force)	6.9	9.7	9.0	8.5
Wage Growth *(real - private sector)*	6.3	-10.3	3.0	4.0
External Accounts				
Current Account (% GDP)	-7.0	-1.7	-1.8	-2.1
Net FDI (bn USD)	9.9	4.5	6.0	5.0
FDI / Current Account	77.6	230.0	300.0	250.0
FX Reserves (bn USD)	31.5	26.5	25.1	21.5
Domestic Credit	**2007**	**2008**	**2009**	**Q1 10**
Total Credit (% GDP)	59.9	77.3	79.3	N/A
Credit to Enterprises (% GDP)	36.5	46.7	50.7	N/A
Credit to Households (% GDP)	22.5	29.5	26.4	N/A
FX Credit/Total Credit (%)	49.9	59.0	50.8	49.9
Private Sector Credit (% yoy)	74.9	68.5	-3.1	0.5
Loans to Deposits (%)	150.4	204.0	215.9	208.4
Financial Markets	**Current**	**3M**	**6M**	**12M**
Policy Rate	10.25	10.25	10.25	10.25
USD/UAH	7.92	8.00	8.20	8.30

Source: NBU, IMF, Bloomberg, Eurobank Research

Approved state budget for 2010 targets 5.3%-of-GDP deficit

On April 27, Ukraine's Parliament approved the long-awaited state budget for 2010, paving the way for a resumption of the IMF loan and the start of the much needed economic reforms. The approved state budget targets a 5.3%-of-GDP deficit. The latter includes the State Pension Fund's deficit (2.7%-of-GDP), but excludes state support to Naftogaz (the Ukrainian natural gas supplier). Naftogaz deficit amounted to ca 2.5%-of-GDP in 2009, but given the new gas deal with Russia, the government anticipates to reduce Naftogaz support to 1%-of-GDP in 2010 or even to zero. The IMF called for a state budget deficit of 6%-of-GDP including the support for Naftogaz and the State Pension Fund but excluding banking sector recapitalization costs. The budget is based on an assumption of real GDP growth of 3.7% yoy in 2010 and year-end inflation of 13.1% yoy, which appear to be realistic. However, two areas for reducing current expenditure pointed out by the IMF in the previous program were left largely untouched. Firstly, the government did not cancel the increase in minimum social standards passed by the previous administration. Instead, they allocated UAH21.8bn or 2%-of-GDP in the 2010 budget for that purpose. Secondly, little progress has been made on reforms to generous gas subsidies – considered to be a key prerequisite for a resumption of IMF lending.

Reports suggest that a new $19-20bn loan programme of 2.5 years (2010-2012) is under discussion between Ukraine's authorities and the Fund. An IMF mission was expected to arrive to Kiev on May 17, for further talks, but the trip was postponed due to uncertainty over the government's ability to keep the budget deficit under control. The Fund appears to be concerned about the situation regarding Naftogaz and energy reforms, as well as on the progress in the pension system. Although the IMF realised the good news on growth (coming from the Q1-10 GDP reading), it is clear that negotiations will be tough. If a deal with the IMF is not reached any time soon, the markets' confidence in the new administration may well start to fade, risking a substantial sell-off of domestic assets.

S&P upgrades Ukraine's sovereign rating, cites improved policy coordination

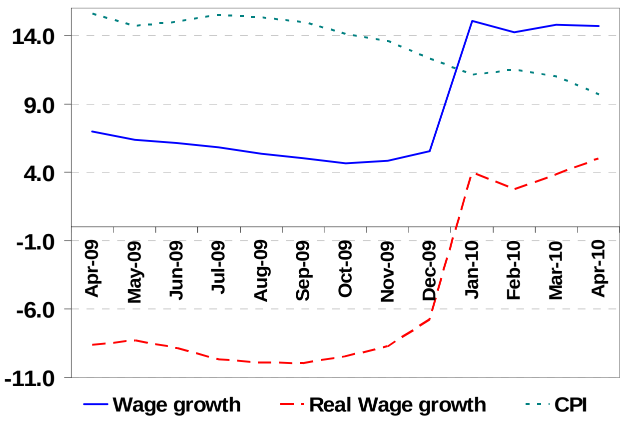
On May 17, 2010, Standard & Poor's (S&P) upgraded Ukraine's sovereign rating to B/C from B-/C and raised the local currency ratings to B+/B from B/B, while keeping the outlook stable. S&P last raised the sovereign rating (by one notch to B-/C) on March 12, 2010, after the formation of the new government. S&P cut Ukraine's sovereign rating five times in the past two years. Regarding the current upgrade, the rating agency cited improved policy coordination, a stabilizing external liquidity position, expectations for an increase in useable foreign exchange reserves relative to short-term debt, and a moderate general government debt burden (expected to reach 27%

of GDP). The upgrade reflects improved investor sentiment towards Ukraine as domestic activity gains pace and February's elections ended months of domestic policy and political uncertainty.

GDP growth returned to positive territory after five consecutive quarters of contraction

Ukraine's economy grew by an impressive 4.8% yoy in Q1-2010, following five consecutive quarters of contraction (-6.8% yoy in Q4-09). The economic recovery is driven by a substantial rebound in exports (they grew by 24.2% yoy in Q1-10, following a rise of 3.2% yoy in Q4-09) on the back of stronger external demand for steel, coupled with favourable base effects. Industrial production rose to 17.4% yoy in April from 13.8% yoy increase in March, beating consensus of 14.0% yoy (last April's reading for industrial production was -31.8% yoy). We expect a rebound in Ukraine's industrial production to continue. Note that industrial production accounts for nearly a quarter of Ukrainian GDP. On the other hand, domestic demand remains weak; however, it is expected to start recovering in H2-2010, as conditions for consumers have shown signs of improvement. The annual pace of decline in retail sales has eased further; it stood at -2.7% yoy in April 2010 from -3.1% yoy recorded in the previous month and -20.6% yoy in December 2009. In addition, real wages returned to positive territory since the beginning of this year, although this partly reflects falling inflation. Wage growth stood at 14.8% yoy in April 2010 compared to 5.5% yoy in December 2009. (Figure 1)

Figure 1
Real wage growth returned to positive territory since January 2010



Source: National Statistics, Eurobank Research

All in all, we forecast a GDP growth of 2.5% yoy in 2010 on the back of uncertainty regarding the Eurozone growth (given Ukraine's high trade openness), still subdued domestic demand and absence of room for fiscal stimulus.

Inflation hits a 3-year low in April 2010

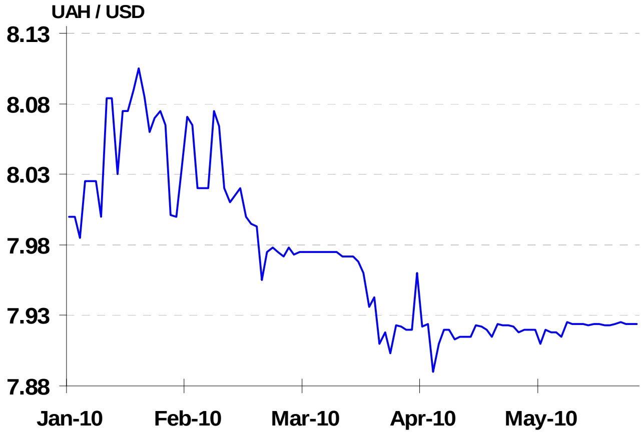
Ukraine's inflation rate dropped to a single-digit figure of 9.7% yoy in April 2010 from 11% yoy recorded in the previous month, beating the consensus of 10.8% yoy. This inflation reading was the lowest since February 2007. The recent agreement with Russia on lowering gas import prices implies some disinflation benefits. We forecast inflation to average 11.5% yoy in 2010 from 16% in 2009.

Slowing inflation may allow the Ukrainian central bank (NBU) to cut its key discount rate, currently at 10.25%, to spur lending. What's more, at the beginning of May, the NBU cut its overnight interest rates for the second time this year as the inflation rate fell to a 3-year low reading. The overnight rate was reduced to 11.5% from 12.5%.

Exchange rate policy aims in preventing hryvnia's appreciation in order to support domestic industry

The hryvnia has appreciated modestly following the presidential elections as investor sentiment improved. (Figure 2)

Figure 2
Hryvnia's appreciation following presidential elections highlights improved investor sentiment



Source: National Bank of Ukraine, Eurobank Research

A trend of moderate appreciation is expected to continue as higher steel prices will be supportive of the currency. However, current NBU (National Bank of Ukraine) broad policy continues to prevent hryvnia's appreciation in order to support the domestic industry. Hence, despite a fundamentally more supportive backdrop for the currency, our 3-month forecast UAH/$ remains at ca 8.00, unless the NBU shifts to a more flexible exchange rate policy in coming months. Nonetheless, some downside risks remain due to the uncertainty over the resumption of the IMF lending.

NPLs estimated to be much higher than the official figures suggest

Non Performing Loans (NPLs) increased by 6.3% ytd (end of April). However, NPLs are estimated to be much higher than the official figures as the NBU definition of NPL includes only overdue loan payments and not the full outstanding loan amount or restructured loans. This is the reason which explains why the NBU figures, regarding NPLs ratio to total loans, are much lower than those stated at the IMF country report; 7.1% and 33.8% respectively, in September 2009. In April, according to the NBU, the NPL ratio reached 10.6% from 10.2% a month earlier, and 9.6% in January 2010.

Private sector credit continues its growth for a second month in a row; it stood at 1.2% yoy in April from a 0.5% yoy rise in March. Moreover, private sector credit increased by 0.9% ytd (end of April). At the same time frame, private sector deposits grew by 7.2% ytd. There is a reversal in the negative deposit cycle of the private sector, the one which started last April. Private sector deposits grew by a double digit figure of 12.3% yoy in April from 6.8% yoy in March, recording positive growth for a third consecutive month. Notably, households' deposits grew by 5.1% mom in April compared to 2.3% mom increase in March. Consequently, in April, loans to deposits ratio stood at 200.2% which is a 1.5 years low level but still a very high one.

The private sector FX leverage remains at a high level despite the recent decelerating trend; it stood at 50.5% of total loans in April compared to 53.5% at the end of 2009 and 61.3% at the end of 2008

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