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Global growth optimism overshadows geopolitical fears

Bulgaria: Output growth is expected to strengthen further this year, with domestic demand taking the lead over net exports as the primary driver of economic recovery; Eurobank research now expects 3.2% real GDP growth in 2011, with risks remaining skewed to the downside

Poland: Latest macro releases suggest softness in a number of key domestic activity indicators in January was only temporary; current account deficit probably underestimated, as suggested the excessively large net errors and omissions component

Romania: Central Bank leaves policy interest rates unchanged at 6.25%, lowers minimum FX reserve requirements by 5% to 20%

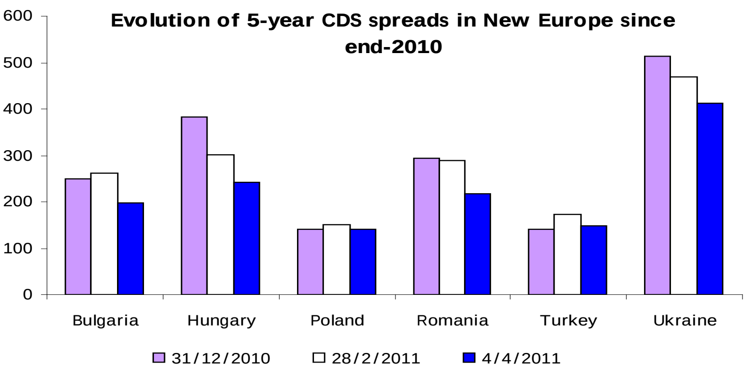
Serbia: Standard and Poor's upgrades Serbia's long term sovereign rating by one notch from BB- to BB, outlook stable. Positive rate action by other rating agencies likely this year

Turkey: 2010 real GDP growth estimated at a higher than expected rate of 8.9%yoy; higher-frequency indicators point to vibrant domestic demand dynamics in Q1:11

Ukraine: IMF programme broadly on track with domestic economy stabilizing and inflation easing

New Europe market strategy highlights

Regional currencies markets: In view of Serbia's improving domestic macroeconomic backdrop and the NBS's proactive policy stance we continue to favor short **EUR/RSD** positions, maintaining our earlier target of 98.40 in 3 to 6 months, from levels around 102, currently. In Hungary, earlier concerns that the appointment of four MPC members by a government-backed parliamentary committee would cast a dovish tone on the new committee's stance have waned recently, with growing optimism over the country's fiscal position providing additional support to the local currency. Separately, worries are growing over rising twin deficits in Poland. Along these lines, we remain constructive on our earlier **PLN/HUF** short recommendation, from levels around 65.0, currently. In view of the zloty's recent underperformance and with little to suggest that the currency is about to embark on a sustainable appreciation trend any time soon, we close our previous **EUR/PLN** short (entry at 4.000-4.050) and take profits at the current levels near 4.020. On the other hand, we continue to favor our earlier short **EUR/TRY** recommendation with a target of 2.0, as we continue to believe that the lira's recent weakening is overdone and the pair's current downside momentum is likely to persist, at least in the short-term. ***Local rates markets:*** Rising inflation pressures remain a key theme at present, continuing to weigh on regional government bond markets. The ongoing turmoil in MENA, a favorable global growth outlook and Japan's earthquake all suggest that commodity prices are likely to retain their upward momentum in the months ahead. In spite of a tentative recovery in regional government bond markets in recent weeks, further significant upside is unlikely. As such, we prefer to stay sidelined in the regional local rates markets for the time being. Even so, we like **2s/10s steepeners** in Polish government bonds with a stop loss of 15bps and a target of 30bps as the 100bps of rate hikes currently priced in by FRAs may prove overly aggressive.



Source: Bloomberg

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Introductory Comment

Dear Reader,

Recent GDP data releases confirm that most countries in New Europe exited recession in 2010, with economic prospects for this year remaining promising. We reiterate our view that GDP growth will accelerate further in 2011, though it will remain below potential for the majority of regional economies. More promisingly, a more balanced pattern of economic recovery has started to emerge, with domestic demand taking the lead over net exports as the primary engine of growth. On a less positive note, the recent rally in the prices of food and energy products, which constitute a relatively large chunk of consumption baskets in the region, risks undermining the prospect of a sustainable recovery in private consumption dynamics.

Inflation is now a major theme across the region, threatening the year-end central bank targets. Supply side factors including higher food and energy prices as well as excise tax hikes have pushed headline CPI readings higher in early 2011. Annual inflation will broadly remain elevated throughout H1:2011, with unfavorable base effects starting to fade out thereafter. Besides current risks stemming from escalating geopolitical tensions in the Middle East and North Africa (Oil prices and investor sentiment) and the prospective ECB rate hikes (private and public debt servicing & refinancing), the evolution of electoral cycles in a number of countries in New Europe is another factor deserving close monitoring.

Earlier this month we traveled to Sofia, **Bulgaria** where we met with high level officials from the government and the IMF. This report includes the excerpts from a Trip Notes report we published in the aftermath of these meetings. In a nutshell, output growth is expected to strengthen further in 2011, with domestic demand taking the lead over net exports as the primary driver of economic recovery; Eurobank research now expects 3.2% GDP growth in 2011, with risks to that forecast being skewed to the downside. The government remains firmly committed to swift euro adoption, despite the lingering EMU sovereign debt crisis. In our view, besides emphasizing nominal convergence, Bulgaria also needs to facilitate a faster pace of real convergence by pushing ahead with ambitious structural reforms.

In **Romania**, the government has survived another vote of no confidence, the fifth so far in its term. It has already made steady progress in promoting important structural reforms in the economy, despite increased tension in the domestic political landscape. The improvement in the domestic growth outlook together with a new precautionary IMF deal have provided a boost to the local currency, bringing it close to multi-month highs against the euro.

The major news in **Serbia**, one of the few SEE countries to avoid a rating downgrade in the post-Lehman period, was the recent Standard and Poor's upgrade. S&P upped Serbia's long-term sovereign rating by one notch to BB, with stable outlook. We view the ratings move as a strong testament of improving investor perceptions towards the country's sovereign outlook. Meanwhile, elevated inflationary risks in the domestic economy led the NBS to raise its key policy rate further by 25 bps to 12.25%.

Poland continues to perform robustly in term of output growth. The latter combined with concerns over increased inflationary pressures led NBP to hike rates again by 25 bps to 4.00%. Looking ahead, lax fiscal policies continue to pose a threat to the domestic economic outlook. In addition, the large 'net errors and omissions' component in the balance of payments data received a great deal of market attention lately.
The strong growth momentum is maintained in **Turkey**. Output accelerated to 9.2% yoy in the last quarter of last year, well beyond the most optimistic analyst forecasts. Driven by strong domestic demand, full year GDP growth last year came at the astonishing 8.9% yoy. Downside risks stemming from a widening current account deficit and the ongoing tensions in MENA region necessitate increased government emphasis on fiscal prudence, an element which is particularly important ahead of the June 2011 general election.

Most stock markets in New Europe rallied in recent weeks on growing global economic growth optimism. Nearly all bourses fully erased losses suffered in the wake of social unrest in North Africa and the Middle East and a devastating earthquake that hit Japan in early March. Presently, all major equity market indices in the region stand in a positive territory year-to-date, with New Europe remaining the outperformer in the global emerging markets universe. Turkey continues to be a laggard against a background of heightened inflation and balance of payments related risks, with the unconventional monetary policy mix recently employed by the CBT also capping additional gains. On the other hand, Bulgaria's and Serbia's main stock indices are the frontrunners so far this year, each standing around 20% higher year-to-date.

Similarly, external debt markets rallied in recent weeks, with 5-year CDS spreads in Bulgaria, Hungary and Romania each narrowing by ca 20% over the last month or so. Poland has been a laggard, seeing its spreads narrowing by just 7% over the same period, amid growing concerns about the country's twin deficits.

In the foreign exchange markets, local currencies broadly firmed over the last few weeks on increasing monetary tightening expectations. The Hungarian forint and the Serbian dinar remain the region's top performers. Meanwhile, easing uncertainty related to the CBT's policy deliberations ahead and the stellar Q4 GDP readings provided a boost to investor sentiment, assisting the Turkish lira recoup part of its earlier losses.

Regional bond markets firmed slightly over the last month or so, but rising inflation risks continue to weigh on market sentiment. Turkey and Poland remain the region's worst performers, on a year-to-date basis, as strong domestic demand dynamics support the case for monetary tightening in the period ahead.

Prof. Gikas A. Hardouvelis

Group Chief Economist & Director of Research

Summary of key macroeconomic indicators

Realizations and forecasts

	Real GDP (yoy)			Consumer Prices (p.a.)			Fiscal Balance (%GDP)		
	2009	2010	2011	2009	2010f	2011f	2009	2010	2011f
Bulgaria	-5.5	0.2	3.2	2.5	3.0	3.7	-0.9	-3.9	-2.5
Poland	1.7	3.8	4.0	3.5	2.6	3.2	-7.1	-7.9	-7.0
Romania	-7.1	-1.3	1.5	5.6	6.1	5.5	-7.3	-6.5	-4.4
Serbia	-3.0	1.7	3.0	8.2	6.5	9.0	-4.2	-4.4	-4.0
Turkey	-4.8	8.9	5.0	6.3	8.6	5.5	-5.5	-3.6	-2.7
Ukraine	-15.1	4.2	4.5	15.9	9.4	10.6	-8.7	-6.5	-3.5
New Europe	-4.3	5.1	4.1	6.5	6.3	5.5	-6.4	-5.6	-4.3
Euro area	-4.1	1.7	1.7	0.3	1.6	2.3	-6.3	-6.3	-5.0
USA	-2.6	2.9	3.9	-0.3	1.6	2.3	-12.9	-8.9	-9.8

	Current Account (%GDP)			Policy Rate (e.o.p.)			FX* (e.o.p.)		
	2009	2010	2011	2010	current	2011f	2010	current	2011f
Bulgaria	-8.9	-1.0	-4.0	currency board			1.96	1.96	1.96
Poland	-2.2	-3.3	-3.5	3.50	4.00	4.50	3.96	4.02	4.10
Romania	-4.4	-4.2	-6.0	6.25	6.25	6.25	4.28	4.11	4.20
Serbia	-6.9	-7.0	-9.0	11.50	12.25	10.50	106.1	102.0	105.0
Turkey	-2.3	-6.5	-7.0	6.50	6.25	7.50	1.54	1.52	1.45
Ukraine	-1.5	-2.5	-2.5	7.75	7.75	7.75	7.94	7.93	7.90
New Europe	-2.8	-4.6	-5.2	-	-	-	-	-	-
Euro area	-0.6	-0.3	0.0	1.00	1.00	1.75	1.34	1.43	1.40
USA	-2.7	-3.3	-3.2	0.25	0.25	0.25	0.75	0.70	0.71

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

I. Overview

Regional stock markets hit post-Lehman highs as global growth optimism overshadows geopolitical fears

Equity markets in New Europe staged an impressive recovery in recent weeks, mirroring gains in major developed bourses. Most regional stock indices shrugged off rising political and social tensions in the Middle East and North Africa (MENA) as well as a devastating earthquake in Japan which raised worries over the pace of global economic recovery. Nearly all bourses in the region have fully erased losses suffered in early March, as investor sentiment improved and the focus returned back to favorable global economic prospects. Optimism about a comprehensive solution to the euro area debt crisis also favored. New Europe remains a frontrunner so far this year, outperforming most of its emerging market peers. In detail, the MSCI Emerging Europe Market Equity index spiked to a 2-½-year peak in early April, recording gains of ca 8.9% since early March and standing 15.4% higher year-to-date. In comparison, the benchmark MSCI Emerging Market Equity index posted respective gains of around 7.7% and 3.6%. LATAM emerging equity markets have been the worst performer since the beginning of 2011, recording cumulative gains of around 2%.

Regional bond markets slightly firmer, inflation concerns keep yields near recent highs

Local rate markets broadly firmed in March, despite rising inflation risks against a backdrop of higher oil and commodity prices due to strong global demand and lingering geopolitical tensions in MENA. Turkey and Poland remain the region's worst performers year-to-date, as strong domestic demand dynamics support the case for additional monetary tightening in the period ahead. The Polish Central Bank incepted its tightening cycle earlier this year in order to contain rising inflation pressures, with additional rate hikes remaining in the cards for the remainder of the year. Increased fiscal jitters have also weighed on domestic government bond prices. .Meanwhile, the Central Bank of Turkey is expected to begin raising key policy rates in H2:2011. The country's close links to MENA and high dependence on oil imports have exacerbated concerns about inflation and financial stability risks, setting the stage for the recent underperformance of TRY-denominated government bonds. Turkey's 2-year benchmark note yield rose to multi-month highs above 9%, in the wake of the unexpectedly strong Q4 GDP data release. Although the yield subsequently eased to sub-8.70% levels, assisted by the slide of annual CPI to a new 4-decade low in March, it remains some 160bps higher compared to its end-2010 level. Elsewhere, the 2- year POLGB rate stood at around 5.025% in early April remaining not far off a 12-month peak of 5.19% recorded in February reflecting market expectations for additional policy tightening by the NBP in the following months. Elsewhere, Hungary's government bonds recouped part their recent losses on growing fiscal consolidation optimism and easing concerns about the recent appointment (by the government) of a number of new MPC members. The 3- and 10-year Hungarian government bond yields each fell by ca 20bps over the last month to respective levels of 6.8% and 7.31% \t the time of writing.

Regional FX markets rally on monetary tightening expectations

Regional currencies have broadly firmed over the last few weeks, with worries over ongoing tensions in MINA and Japan's devastating earthquake gradually moving to the back seat. Monetary policy outlooks appear to be the driving force behind the recent uptrend in regional currencies. That is because increasing interest rate differentials vis-à-vis developed economies favor capital inflows to the region and thus, fanning currency appreciation. Romania is among the last few countries in the region whose central bank maintains an easing policy stance. However, in view of higher food and oil prices as well as regulated price increases the NBR now looks increasingly likely to stay put on rates for the remainder of this year. A new, precautionary IMF agreement and expectations for a further improvement in the country's fiscal outlook have also provided support to the **leu**, which touched a 1-year peak of 4.0730 vs. the EUR in late March. The **Hungarian forint** remains New Europe's best performer on fiscal consolidation hopes. Easing concerns about a dovish tilt in the MPC's stance after a government-led committee appointed four of the seven rate-setting members also favored. As a result, the **EUR/HUF** touched an 11-month low of 264.30 in early April. The **Serbian dinar** touched a near 1-year peak of 101.58 on April 5 as the NBS has been among the most proactive central banks in the region, having hiked its key policy rate by 375bps cumulatively since last summer. Elsewhere, the **Turkish lira** and the **Polish zloty** remain the region's major underperformers. The former touched near 2-year lows of 1.6206 vs. the USD in early March as higher commodity prices added to concerns about a further deterioration in the country's current account deficit. The CBT's unconventional policy mix adopted since December last year also weighed. Even so, the currency lately recouped part of its earlier losses to stand marginally in a positive territory year-to-date as the strong economic growth momentum supports the case for rate hikes by the Central Bank later this year. Separately, the Polish zloty remains under pressure amid lingering worries over the country's fiscal outlook. Concerns about a further deterioration in the country's current account deficit also weighed on the currency lately. On March 17, the zloty hit 8-month lows near 4.12/€.

External debt markets extend recent gains

New Europe's external debt markets extended recent gains, exhibiting an impressive resilience to the lingering sovereign debt crisis in the euro area, increased inflation risks in the region and the geopolitical events in Japan and the Middle East. In March alone, Bulgaria's and Romania's 5-year CDS spreads each narrowed by ca 20% to respective multi-month lows of 198bps and 218bps. Poland was the worst performer on increased concerns about the country's fiscal position. Meanwhile, worries about an upward revision in last year's current account figures fanned concerns about rising twin deficits. As such, the country's 5-year CDS spread narrowed around 10bps since late February, standing at levels around 140bps on April 4. Turkey's sovereign credit spread shrunk 15% in recent days, moving further below February's 6-month peak of 182bps.

Strategy - Emerging New Europe Markets

FX: In view of Serbia's improving domestic macroeconomic backdrop and the NBS's proactive policy stance we continue to favor a short **EUR/RSD** position, maintaining our earlier target of 98.40 in 3 to 6 months, from levels around 102, currently. Elsewhere, the forint has outperformed other currencies in New Europe, having firmed by 4.5% year-to-April 4. Concerns that the appointment of four of the seven MPC members by a government-backed parliamentary committee would cast a dovish tone on the new panel's stance have waned recently, after the new rate-setters pledged to follow a cautious approach and expressed their support to the Bank's inflation fighting credentials. Growing optimism about an improvement in the country's fiscal position has also favored the Hungarian currency. Separately, worries are growing over rising twin deficits (fiscal and current account) in Poland. Along these lines, we remain constructive on our earlier **PLN/HUF** short recommendation, from levels near 65, currently. At these levels, we would lower our stop-loss to 68 (from 70 previously) - which is effectively the entry point of our initial short PLN/HUF trade - , while maintaining our initial target of 64. Meanwhile, in view of the zloty's recent underperformance and with little to suggest that the currency is about to embark on a sustainable appreciation trend imminently, we would close our previous short **EUR/PLN** recommendation (entry at 4.000-4.050) and take profits at the current levels near 4.020. On the other hand, we continue to favor our earlier short **EUR/TRY** recommendation with a target of 2.0, as we continue to believe that the lira's recent weakening (15-month low of 2.2494 on March 7) is overdone and the pair's current downside momentum is likely to persist, at least in the short-term. In view of recently waning expectations for rate cuts by the Central Bank of Romania and a renewed IMF fiscal policy anchor, we also like short **EUR/RON** positions with an entry at 4.13, targeting 3.95 (200-day moving average) and a stop loss above 4.15.

In the sovereign credit space, Turkey's 5-year CDS spread narrowed by ca 25bps from our proposed entry levels of 170bps. At this stage we would take profit as the spread is approaching the low end of its recent range. We would actually reverse our strategy, now entering longs at levels below 145bps targeting 170bps as uncertainty remains over the CBT's future policy deliberations, the current account deficit is at a lifetime peak (on a 12-month rolling basis), while the turmoil in MENA and Japan's catastrophic earthquake may also take a toll on Turkish economy. On a more constructive note, an upgrade in Turkey's sovereign credit ratings remains in the cards, but we do not expect such a development ahead of June's general elections. Elsewhere, we continue to like short positions in Romania's 1-year CDS. Since our initial recommendation (*New Europe Economics and Strategy* January 2011 issue), credit spreads on the aforementioned security have narrowed some 60bps. In view of the improving fiscal outlook and the endorsement of the new IMF, precautionary, deal we anticipate the downtrend to continue in the months ahead. As such, we would hold this position to maturity. We recommend the same for the long 8.50% May 2012 position. We also remain constructive on our long Poland 5-year CDS vs. short Russia 5-year CDS recommendation as a pure oil play on the latter and fiscal and balance of payments concerns on the former. Under the current conditions we would maintain this position, but change the stop loss to +5bps (from -5bps previously) and raise our target to 35bps (from 25bps earlier). Elsewhere, short positions in Bulgaria's 4-year CDS spread remain attractive, especially in view of a potential upgrade. Note that Moody's placed the country's sovereign ratings on review for an upgrade on April 5. However, with the CDS having hit the 200bps spread target we suggested in our previous monthly report (and currently standing around 190bps), we would revise our target to levels around 170bps (from 200bps previously), and our stop loss to 210bps (from 260bps proposed in February).

Rising inflation pressures remain a key theme at present, not boding well for **local rates markets** in the region. The ongoing turmoil in MENA, a favorable global growth outlook and Japan's earthquake all suggest that commodity prices are likely to retain their upward momentum in the months ahead. In spite of a tentative recovery in regional government bond markets in recent weeks, further significant upside is unlikely. With uncertainty continuing to surround the global inflation outlook and central bank policy deliberations ahead, we would prefer to stay sidelined in the regional local rates markets for the time being. Even so, we like 2s/10s steepeners in Polish government bonds with a stop loss of 15bps and a target of 30bps as the 100bps of rate hikes currently priced in by FRAs may prove overly aggressive. Although inflation risks loom ahead and an upcoming ECB rate hike leaves room for further policy manoeuvring, February's better-than-expected CPI, subdued core inflation readings and still rising unemployment may provide some ammunition to the MPC's doves in forthcoming meetings.

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

Key notes from our recent trip to Sofia: March 17th- 18

- Economy exited recession in 2010, with full-year real GDP growth bouncing to +0.2%, following a contraction of 5.5% in the prior year
- Output growth is expected to strengthen further in 2011, with domestic demand taking the lead over net exports as the primary driver of economic recovery; Eurobank research now expects 3.2% GDP growth in 2011, with risks to the latter forecast remaining skewed to the downside
- Fiscal performance improved markedly in 2010; achievement of this year's deficit target is critical for fulfilling the nominal convergence criteria, and supporting market perceptions over the stability of the Currency Board Arrangement (CBA)
- The legacy of prudent fiscal policies is about to be enshrined into national legislation, helping to increase policy predictability and credibility going forward
- The government remains firmly committed to swift euro adoption, despite the lingering EMU sovereign debt crisis; conditions for applying to ERM II mechanism likely to improve further this year
- Besides facilitating nominal convergence, Bulgaria also needs to emphasize real convergence by pushing ahead with ambitious structural reforms
- Real estate prices close to bottoming out; more future investment opportunities likely to be found in the tradable sector
- The adjustment of earlier macroeconomic imbalances surpassed all expectations in 2010. Yet, the current account is expected to widen anew this year on a higher energy bill and improved domestic demand prospects
- Credit activity remains weak despite solid conditions in the domestic banking system

Output recovery gained momentum in Q4 2010, with domestic demand exerting a positive contribution

The domestic macro outlook has improved further since our previous visit in Sofia in October 2010. As we forecasted back then, the Bulgarian economy exited recession in Q3 2010. Real GDP recorded a further acceleration to 2.1%/2.8% qoq/yoy in Q4 2010, from 0.7%/0.5% qoq/yoy in the prior quarter. After the latest revision, Bulgaria actually exhibited the strongest quarter-on-quarter growth performance in EU-27 during the fourth quarter of last year.

Looking more closely at the underlying drivers of domestic output growth, the positive surprise in Q4 data came mainly from domestic demand (+3.7ppts contribution to GDP growth vs. -8.2ppts in Q3 2010), More specifically, total consumption registered its first quarterly rise since Q4 2008, accelerating to +1.7% qoq from -2.7% qoq in the prior quarter. Both private and public spending showed a significant improvement. The annual pace of contraction in real private spending slowed down to -1.3% yoy in Q4, from -6.4% yoy. In addition, public consumption grew by +12.7% yoy compared to -7.8% yoy in Q3.

Another element of surprise was the rebound in investments, which exerted a positive contribution to Q4 GDP growth. Gross fixed capital formation rose for the first time since the onset of

Bulgaria: Eurobank EFG Forecasts

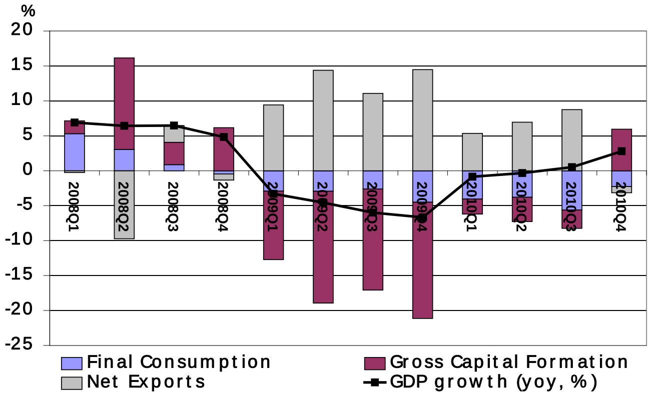
	2008	2009	2010	2011f
Real GDP (yoy%)	6.2	-5.5	0.2	3.2
Final Consumption	2.6	-7.3	-1.1	1.0
Gross Capital Formation *(Fixed)*	21.9	-17.6	-16.5	4.5
Exports	3.0	-11.2	16.2	8.5
Imports	4.2	-21.0	4.5	6.5
Inflation (yoy%)				
HICP (annual average)	12.0	2.5	3.0	3.7
HICP (end of period)	7.2	1.6	4.4	3.2
Fiscal Accounts (%GDP) - *Cash Basis*				
General Government Balance	2.9	-0.9	-3.9	-2.5
Gross Public Debt	15.5	15.6	16.7	19.5
Primary Balance	3.7	-0.2	-3.3	-2.0
Labor Statistics - *National Definitions*				
Unemployment Rate (registered, %)	6.3	9.1	9.2	8.9
Wage Growth *(total economy)*	26.5	11.8	6.3	7.5
External Accounts				
Current Account (% GDP)	-23.0	-8.9	-1.0	-4.0
Net FDI (EUR bn)	6.7	2.4	1.6	2.2
FDI / Current Account (%)	82.4	77.4	460.0	145.0
FX Reserves (EUR bn)	12.7	12.9	13.0	13.5
Domestic Credit	**2008**	**2009**	**Q3 10**	**Q4 10**
Total Credit (%GDP)	75.2	79.2	78.7	76.3
Credit to Enterprises (%GDP)	47.8	49.4	49.4	48.2
Credit to Households (%GDP)	26.0	28.2	27.4	26.3
FX Credit/Total Credit (%)	57.2	58.6	60.9	61.3
Private Sector Credit (yoy)	32.3	4.5	2.7	2.1
Loans to Deposits (%)	119.3	120.5	116.0	112.9
Financial Markets	**Current**	**3M**	**6M**	**12M**
Policy Rate		Currency Board		
EUR/BGN	1.96	1.96	1.96	1.96

Source: National Sources, Eurostat, IMF, Eurobank Research the international crisis in Q4 2008, registering annual growth of 7.2% yoy. In combination with the built up of inventories, gross capital formation expanded by 4.0% yoy in Q4 from -4.9% yoy in Q3.

The strong performance of the external sector continued in the fourth quarter of last year, though its contribution to overall economic growth deteriorated relative to the prior three quarters. Exports growth eased to +16% yoy in Q4 (revised upwardly from 10.7% yoy in the flash estimate), from +18.5% yoy in Q3. On the other hand, imports recovery gained momentum in Q4, with the corresponding annual growth rate accelerating to 15.0% yoy in Q4, from 3.0% yoy in the prior quarter. As a result, the positive contribution of net exports became marginally negative in Q4 to the tune of -0.9pps, compared to a positive contribution of 8.8pps in Q3.

Figure 1

Domestic demand had a positive contribution in Q4-2010



Source: National Statistics, Eurobank Research

To recoup, after recording output losses of 5.5% in 2009, the economy exited recession in 2010, managing to generate marginally positive GDP for the full year. The main driver behind the recovery was net exports with domestic demand lagging behind during the greater part of 2010. Exports of goods and services were the brightest spot of the Bulgarian economy last year, growing by 16.2% yoy in real terms, following a 11.2% yoy contraction in 2009. In contrast, full-year imports growth remained negative (-4.5% yoy), with the overall external sector contributing ca +6.2pps to GDP growth vs. +11.8pps a year earlier.

2011 growth outlook improves

The growth prospects for 2011 dominated our discussions with our government and industry contacts. The majority of our discussants are in the process of revising their own macroeconomic forecasts, based on the latest higher-frequency data releases and the recent GDP data revisions. Overall, there was a unanimous agreement that the economic environment has improved considerably since last October.

The consensus view among all of our discussants is that growth will accelerate in 2011, though there were diverging opinions over the magnitude of the rebound. That is because, understandably, the speed of the economic recovery depends on the evolution of a number of important parameters that are still subject to high volatility *e.g.* prices of commodity exports and imports (oil, base metals, and agricultural products prices).

With respect to most recent domestic macro data, private consumption, one of the key GDP growth drivers, is already exhibiting some preliminary, though not yet entirely convincing, signs of recovery. On the positive side, big ticket items such as car sales registered an unexpected increase in the late months of 2010 (October-November), albeit from a low base. In addition, retail sales remain in slightly negative territory, though they have been gradually improving lately. The volume of retail sale was marginally negative in January (-0.3% yoy), following declines of 2.9% yoy and 5.2% yoy in December and November, respectively.

On the other hand, the industrial sector continues to thrive, with sales growth accelerating to 36% yoy in January, from 25.7% yoy in November-December 2011. This positive trend was underpinned by sales abroad which expanded by 65.5% yoy in the first month of this year. These upbeat developments have been also reflected in the most recent BoP statistics, which saw exports of goods and services registering growth of 71% yoy in January 2011. Industrial production grew by 10.8% yoy in the corresponding month, with the major contribution coming from investment and intermediate goods.

In view of these positive developments, our discussions with government and industry representatives primarily focused on the potential growth drivers in 2011. On that front, the prevailing view is that these drivers are likely to allow domestic demand taking a lead over next exports as the primary engine of GDP growth this year. The picture portrayed by the revised Q4 GDP data is a good illustration on that account. Private consumption is expected to remain relatively subdued for the greater part of this year, though a shift to a positive territory remains in the cards in the period ahead. On the later view, our optimism primarily stems from two important factors. Firstly, real wages are still rising (up by 3.3% yoy economy-wide in 2010). Secondly, the prospect of indexation of lowest pensions (if tax revenues turn out better than expected) announced by Minister of Finance Simeon Djankov may prove another catalyst supporting a faster turnaround in private spending. However, uncertainties with respect to the recovery of the household sector are still very high. In any case, expectations for a dynamic rebound of domestic consumption this year were judged to be rather premature at this stage. On top of that, public consumption is not expected to contribute positively given the fiscal consolidation process underway.

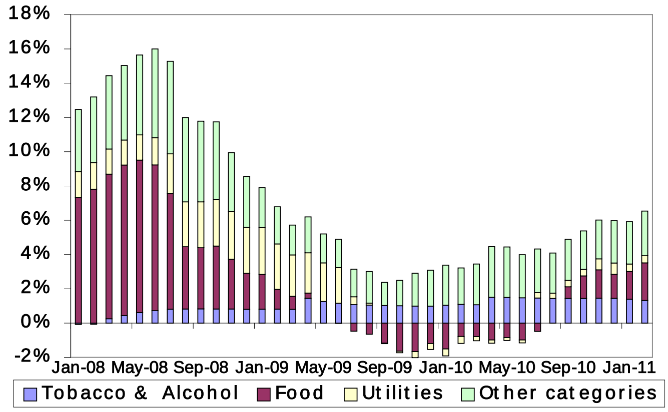
News from the investments side is significantly more encouraging. After recording two consecutive years of sharp contraction, investments are expected to record positive growth this year. The ongoing improvement in the business climate survey (headline index up by 8.5 points in February) provides a clear manifestation supporting the latter view. There are a number of good reasons behind this optimism. Firstly, investments are going to receive increased support from the continuing rise in EU funds absorption (which is mainly headed towards infrastructure investments) and the government's privatization program (state owned tobacco company, ammunition industries etc). Secondly, the situation in the real estate sector has stabilized, with prices now bottoming out. However, the higher return investment opportunities in the post crisis period are likely to be found in the tradable sectors, in our view. Such a process would be welcomed, helping to increase the exporting capacity of the economy. The rebuilding of inventories, a factor which has not come into effect during 2010 will also play out this year.

Exports are expected to improve further in 2011, yet to at a slower pace relative to last year. Anecdotal evidence relating to both orders and prices of commodity exports confirms that trend. In addition, the all important tourism sector is expected to receive a boost from the ongoing upheaval in Middle East and North Africa region. Imports are also expected to rise in 2011, following an extended period of negative growth. The domestic demand recovery (primarily from the investments side), Bulgaria's high energy dependency and the high import component of exports are all going to contribute to such a trend. All in, the contribution of net exports is expected to remain positive in 2011, but to a lesser extender than in the prior two years.

According to our baseline projections, GDP growth this year may exceed the 3% mark, taking into account the set of assumptions described above. The improvement in the economic environment during the last quarter of 2010, in combination with our global outlook forecast assumptions, led us to upgrade our GDP forecast to 3.2% from 2.5% previously. Our updated forecast lies significantly above consensus, yet we still find it attainable and realistic.

Having said that, risks to our GDP forecast remain high and skewed to the downside. Such risks relate mainly to the outlook of the household sector. In our analysis, we identify the following factors as presenting the main risks to our 2011 GDP growth forecast: rising food and oil prices, weak domestic credit activity, high refinancing needs of private-sector external debt and the still high unemployment rate (currently close to its December 2010 multi-year peak of 9.8%). On the other hand, recent developments on the inflation front remain a source of concern, with a further significant increase in consumer prices threatening to derail household consumption recovery. Inflationary pressures have been on the rise in recent months, mainly as a result of high food and energy prices (ca 45% weight in the domestic CPI basket). In fact, the recent rally in food and energy prices has stirred a heated social and political debate domestically, which eventually pushed government popularity even lower.

Figure 2
Inflationary pressures on the rise



Source: National Statistics, Eurobank Research

2010 fiscal deficit target outperformed; legacy of strong past fiscal performance to be formally enshrined into national legislation

Among the key points of our previous Trip Notes report on Bulgaria (October 2010) was that achievement of last year's fiscal target should more or less be considered as a done deal. In fact, we had diagnosed back then that there was room for overachieving the target, given the apparent reversal of the earlier negative trend in tax revenues. Indeed, the full-year budget execution data vindicated our expectations.

Specifically, the 2010 full-year cash deficit came in at BGN 2.78bn or 3.9% of GDP compared to a deficit of 0.9% of GDP in 2009. This proved out to be significantly lower than the mid-year revised target of 4.8% of GDP. In addition, the general government deficit in ESA95 terms came in at 3.6% of GDP, down from 4.7% of GDP in 2009.

The importance of this strong performance should be not underestimated. Firstly, it places Bulgaria among the most fiscally sound countries in the EU-27 and the broader region. Secondly, it reinforces market confidence over the sustainability of the currency board arrangement (CBA) and maintains sovereign borrowing costs at low levels. Last but not least, it revitalizes ERM II application prospects by providing tangible evidence of the authorities' commitment regarding fulfillment of the nominal convergence criteria (even though there is no formal prerequisite for ERM II entry).

Furthermore, the government has presented a framework to ensure that fiscal discipline is instilled in the legislation. Minister of Finance, Simeon Djankov, has presented a draft of the so called *Financial Stability Pact*. The Pact provides for a set of rules to strengthen longer-term fiscal discipline, while, at the same time, rationalizing the redistributive role of the state. More analytically, there is a proposed 37%-of-GDP cap on government expenditure. That is, without accounting for the contributions to the EU budget or participation in EU co-financed projects. In addition, there can be no changes in direct taxation rates or the introduction of new direct taxes without a two-thirds majority in the parliament. But more importantly, the framework guarantees a broadly balanced budget position (or at least a deficit of not more than 3% of GDP), provided that public debt would not exceed 40% of GDP, depending upon the evolution of the economic cycle.

Following our discussions with domestic officials, we became even more convicted about the usefulness of adopting a certain kind of fiscal rule. The most important benefit from such a mechanism is that the proposed framework institutionalizes the prudent fiscal policy stance of the recent years. In addition, it allows some valuable room for the implementation of counter-cyclical fiscal policies in economic downturns, while providing for the creation of buffers at economic boom times.

However, it is important to note that the proposed legislation is stricter than any other fiscal rule applied in Western Europe. That is because it touches upon the socially sensitive issues of taxation and reduces fiscal policy flexibility in a macroeconomic environment already constrained by an ultra-rigid monetary policy regime.

Finally, the proposed changes are subject to public consultation at the moment and an issue of negotiations with political parties and social partners. Yet, the consensus view at the moment is that major opposition parties will not consent to the fiscal rule becoming a part of the constitution.

Successful implementation of 2011 fiscal target is only one of the challenges on the road to ERM II

Looking ahead, our discussions with officials focused on the fiscal target for 2011. The target is ambitiously set at 2.5% of GDP both at an accruals and a cash basis. In our previous trip to Sofia, we had delved into the attainability of that target. Back then, our view was that the final deficit outcome would not only depend on the evolution of headline GDP growth in 2011, but also on its composition. Naturally, that is because a shift towards a more domestic-demand oriented growth environment has, by definition, higher tax content. Provided that there is no significant fiscal relaxation and given our expectations for a more pronounced domestic demand recovery this year, we now believe that the probability of attaining the 2011 fiscal target has increased. The state budget execution data for the first two months of this year are encouraging in that respect. The budget deficit declined by 55% yoy in January-February, reaching ca 0.84% of projected GDP compared to 2% in the same period a year earlier.

Besides nominal convergence, we maintain that promoting real convergence is another vital issue domestic authorities need pay increasing attention to. Among other important reasons, that is because financial markets have recently increased their level of scrutiny on real convergence issues for new euro area entry aspirants. To that end, speeding up EU funds absorption is an important tool in the government hands to facilitate that process.

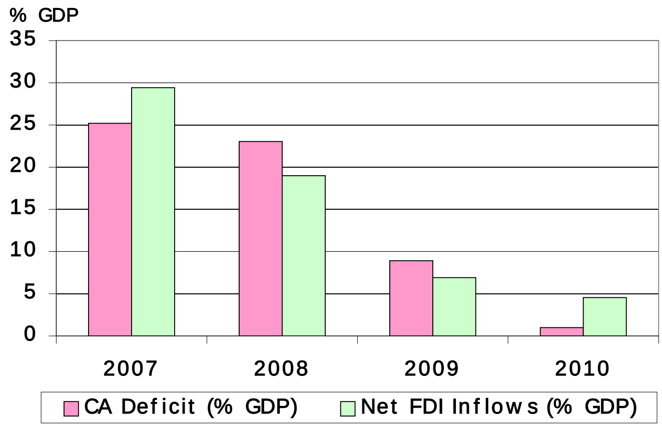
In our view, the successful implementation of this year budget should be seen an integral part of an ERM II application strategy. Another important element in that process is the acceleration of the structural reforms in the judicial, health care and education sectors. The current solid fiscal position offers domestic authorities a valuable time window to implement these reforms in a gradual and orderly manner. For that reason, structural reforms in those areas should not to lose momentum ahead of Presidential and municipal elections in autumn.

Current account gap undershot market expectations in 2010; deficit set to re-embark on widening trend this year

The creation of serious macroeconomic imbalances was a contentious issue during the boom years. However the onset of recession in early 2009 accelerated the process of their unwinding. Over the last two years, the current account deficit dwindled, gradually shifting risk perceptions away from the balance of payments. As a result, the current account deficit landed to 1% of GDP in the end of 2010, significantly undershooting analyst expectations. The latter reading compares favorably to deficits of 8.9% of GDP and 23% in 2009 and 2008, respectively.

Figure 3

Current account deficit dwindled within 3 years



Source: BNB

The improvement in the current account deficit reflects primarily a smaller trade deficit (down 5.3pps last year to 6.7% of GDP). Exports grew by an astonishing 33% yoy in 2010 (growth rates in excess of 40% yoy in five out of the full twelve-month period), recovering strong from a 23.1% yoy decline recorded in 2009. As a result, last year's exports exceed by ca10.4% its pre-crisis level in 2008. According to an analysis of the Bulgarian Industrial Association, some 60% of the rise in exports is attributed to the rise in the volume of goods sold abroad, with the rest 40% being attributed to the increased prices.

Analyzing the most recent trends in exports and competitiveness developments was an additional focal point in our discussions. Bulgarian exports have been a major beneficiary of two favorable underlying trends. Firstly, the rise in commodities prices worldwide and secondly the geographical diversification of exports portfolio to the most dynamic emerging market economies in the world. More specifically, exports to the non EU markets continue to expand rapidly, mainly benefiting by the strong rebound in the Turkish economy.

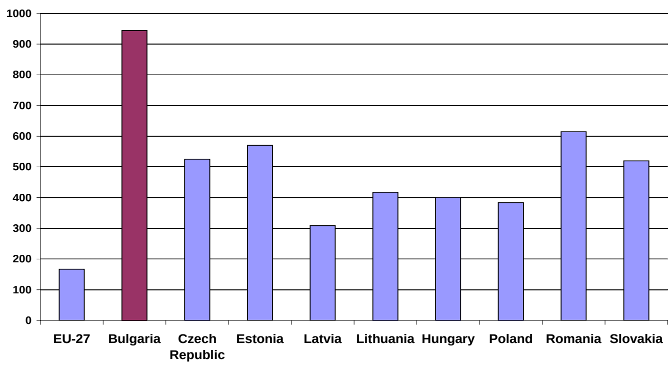
On the other hand, exports' relatively low adding value remains an issue of concern. According to the World Bank, Bulgaria's strong export performance is concentrated in industries processing natural resources as well as in lower value-added, labor-intensive manufacturing. That said, only 7% of Bulgarian exports are high-technology products, below both the EU-27 average (20%) and the rest of Eastern Europe (Hungary-24%; Czech Republic-14%; Croatia-9%).

From the funding side, the capital and financial account registered a minor surplus of €289 mn or 0.8% of GDP in 2010 (revised upwardly from a deficit of €403 mn) compared to €1.7bn or 4.8% of GDP in the prior year. The most important component, net FDI inflows, recorded a steep decline for a second consecutive year (-32% yoy in 2010). These amounted to €1.6bn (upwardly revised from €1.2bn), against €2.4bn in 2009. Overall, the private sector's gross external debt declined to 89.9% of GDP compared to 96.0% in 2010, a clear sign that the deleveraging process in the private sector continued.

In our view, the current account deficit is set to widen again in 2011, reaching around 4% of GDP. The main driver behind the reversal is expected to be an increased energy bill. According to Eurostat, the Bulgarian economy is the least energy efficient in the EU-27, with industry being the most energy consuming sector. According to 2008 data, Bulgaria's energy intensity, defined by kilogram of oil equivalent per 1000 Euros GDP, is five times higher than in EU-27 (944 toe/M€ '00 vs. 167 toe/M€ '00).

Figure 4

Energy intensity of the economy 2008
Gross inland consumption of energy divided by GDP (kilogram of oil equivalent per 1000 Euro)



Source: Eurostat

Recent trends in the domestic banking sector: Credit activity remains weak; Household deposits on a rising trend

Recent domestic banking sector developments were also an integral part of our discussions in Sofia. On that account, we broadly agreed with our contacts that recent credit developments have not been supportive to the economic recovery so far. Yet, the ongoing improvement in the domestic economy should translate into higher demand for credit going forward. Solid condition in the domestic banking system and the ongoing improvement in global economic trends would also facilitate that process. Yet, credit expansion to the domestic economy is not likely to recover to anywhere near pre-crisis levels in the foreseeable future as the repair of domestic private sector's balance sheets continues and the lingering EMU sovereign debt crisis constrains the ability of foreign parent banks to extend credit to their local subsidiaries.

Credit to the non-government sector remained broadly stagnant in 2010, with its annual growth easing to 2.7% yoy, from 4.5% yoy in 2009. Credit to households remained on downward trend throughout last year, shifting to a slightly negative territory (-0.5% yoy vs.7.5% yoy in 2009). In contrast, the corporate segment has been more vibrant particularly in the late months of last year. As a result, credit to corporates expanded by 3.7% yoy in 2010 compared to 2.6% yoy in 2009.

Last year's decline in household credit was the combined result of two trends: a contraction of consumer loans to the tune of -3.8% yoy, which was partially offset by the rise in mortgage loans by 3.2% yoy. These developments have partly to do with households' response to the recession. Households have focused on repairing their balance sheets and increasing precautionary savings. A clear illustration of this is the concomitant rise in household deposits. Household deposits growth accelerated further to 13.6% yoy in 2010 from 12.1% yoy in 2009. In addition, banks tightened lending standards to protect themselves from further asset-quality deterioration in their portfolios. However, an improvement in that direction comes out from the financial sector survey conducted in Q4 2010. From the supply side, there has recently been a relative shift of focus in domestic banks' strategy away from concerns about the macro-environment, rising NPLs and liquidity management. Currently, banks look more eager to extend new loans based on stricter credit screening criteria such as income. By and large, this is considered to be a leading positive signal of future credit dynamics.

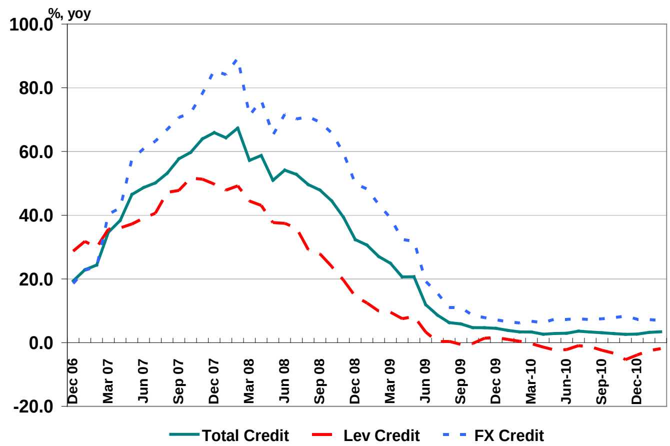
Non-performing loans are a more sensitive and difficult to analyze. The NPLs ratio (non performing loans above 90 days) climbed further to 11.9% in 2010, from 6.4% in September 2009, remaining though relatively low by regional standards. There are two caveats with respect to NPL data. First, the ratio doesn't include restructured loans, which domestic banks have successfully renegotiated with existing clients. If restructured loans are added, the ratio rises to 18.1% at the end of 2010 and to 19.1% in February 2011. Secondly, NPLs is a lagging indicator of economic activity. The latter effectively means that the corresponding ratio may rise a little further in the following period. On the positive side, the latest growth reading of NPLs was the lowest recorded since the beginning of the downturn, which makes us optimistic that the peak is around the corner.

Furthermore, the banking sector has maintained strong capital buffers throughout the crisis. The capital adequacy ratio stood at 17.5% in late 2010 (Tier I ratio at 15.2%) against 14.3% before the onset of the crisis in September 2008. This provides enough comfort against rising NPLs and optimism for the banks' capacity to absorb new provisions for potential losses.

Overall, the domestic banking sector has fared pretty well during the economic downturn. Part of the resilience to the global credit crunch and, more recently, to the euro area sovereign debt crisis can be attributed to its geographically diverse ownership structure, which is a crucial difference relative to the Baltic region. Another explanation is the prudent supervision policies followed during the boom years. Banks are still profitable even though profits may have plunged (down from 1.4bn Leva to around 0.6bn Leva). That said, the domestic banking sector is at a good starting point to reap the benefits of the forthcoming recovery.

Figure 5

Credit activity remains weak



Source: BNB, Eurobank Research

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

Concerns about twin deficit on the rise

- Latest macro releases suggest softness in a number of key domestic activity indicators in January was only temporary
- Current account deficit probably underestimated, as suggested the excessively large *net errors and omissions* component
- February headline CPI slightly above target for the second month running; core inflation remains subdued
- NBP raises key policy rate by a further 25bps to 4.00%. We continue to see room for 50bps of additional hikes before year-end
- Rising NPLs pose a risk to the domestic banking system

2011 GDP growth to remain close to potential; twin deficits posing downside risks

Polish economy grew by 3.8% yoy in 2010, with Q4-10 GDP advancing at its strongest pace in two years (+4.4% yoy). Yet, the composition of last year's growth was a bit worrisome, as net exports contributed negatively and public consumption in Q4-10 accounted for one-third of quarterly GDP growth. Looking ahead, domestic demand should remain the main driver of domestic economic activity in the following quarters, assisted by higher infrastructural spending ahead of the EURO 2012 football championships and strong private consumption. Overall, we anticipate GDP growth to remain close to its potential rate of around 4.0% yoy in 2011, with the fiscal and current account deficits continuing to cast a cloud over the longer-term growth outlook.

The more recent higher-frequency macro data have been encouraging, suggesting that January's deceleration in retail sales, industrial production and PMI was rather temporary. Retail sales growth (in volume terms) accelerated to 12.2% yoy in February, from 5.8% yoy in the prior month, beating analysts' median forecast for a 7.2% yoy rise. These point to improving consumer spending, following a temporary slump in sales due to the January 2011 VAT rate hike. Similarly, encouraging signals are lately coming from the domestic industrial sector. Polish industrial production accelerated by 10.7% yoy in February up from 10.2% yoy in January (vs. 10.3% consensus). This was the fourth month in a row of double-digit output growth. What's more, the PMI manufacturing index rose to 54.8 in March, confounding expectations for a fall to 53.4 from February's 53.8 print.

Unemployment rate continues to rise despite higher employment

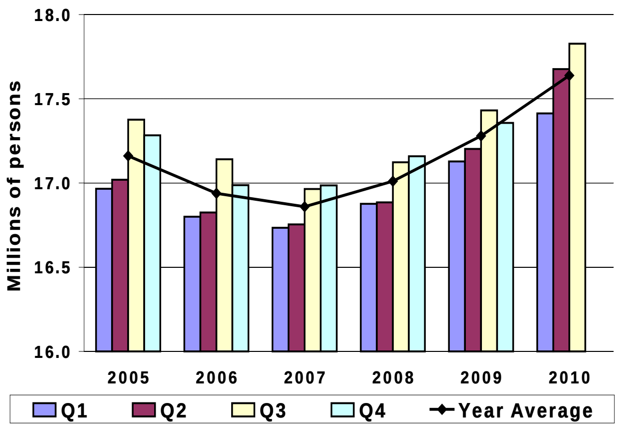
In September 2008, the government concluded work on a pension bill aiming to significantly reduce early retirement for arduous professions. These encompassed particular occupational groups, including, miners, steelworkers, transport workers and teachers. From January 1, 2009, none of these occupational groups would be entitled to early retirement. As a result, the economically-active population has increased significantly over the last couple of years (Figure 1). This may explain the fact that both employment and the unemployment rate have been simultaneously growing in recent months. The rise in the unemployment rate during last winter months was also due to harsh weather conditions, which forced many constructions and road building projects to a halt. More recently, the unemployment rose to 13.2% in February 2011, from 13.0% in the prior month, while employment growth accelerated by 4.2% up from 3.9% in January (Figure 2).

Poland: Eurobank EFG Forecasts				
	2008	**2009**	**2010f**	**2011f**
Real GDP (% yoy)	5.0	1.7	3.8	4.0
Private Consumption	5.8	2.3	3.2	3.5
Government Consumption	7.4	1.9	3.4	3.0
Gross Capital Formation	6.4	-13.6	6.3	6.5
Exports	7.3	-7.8	7.8	6.8
Imports	8.4	-13.5	8.3	7.9
Inflation (% yoy)				
CPI (annual average)	4.2	3.5	2.6	3.2
CPI (end of period)	3.3	3.5	3.1	2.8
Fiscal Accounts (% GDP)				
General Government Balance	-3.7	-7.2	-7.9	-7.0
Gross Public Debt	47.2	51.0	55.0	57.0
Labor Statistics (%)				
Unemployment Rate (% of labor force)	9.8	11.0	12.0	12.3
Wage Growth *(private sector - average)*	NA	4.2	3.6	5.0
External Accounts				
Current Account (% GDP)	-4.8	-2.2	-3.3	-3.5
Net FDI (bn EUR)	8.0	6.1	7.5	8.0
FDI / Current Account (%)	40.6	90.6	65	75
FX Reserves (bn EUR)	40.6	54.8	70	60
Domestic Credit	**2008**	**2009**	**Q3-10**	**Q4-10**
Total Credit (% GDP)	50.9	53.1	54.6	55.4
Credit to Enterprises (% GDP)	17.6	16.1	15.6	15.2
Credit to Households (% GDP)	29.7	31.6	33.6	34.2
FX Credit/Total Credit (%)	32.6	30.2	30.1	30.8
Private Sector Credit (% yoy)	38.1	7.2	7.6	8.9
Loans to Deposits (%)	106.0	102.6	102.0	102.4
Financial Markets	**Current**	**3M**	**6M**	**12M**
Policy Rate	4.00	4.00	4.25	4.50
EUR/PLN	4.02	4.10	4.00	4.10

Source: NBP, EcoWin, Bloomberg, Eurobank Research

Figure 1

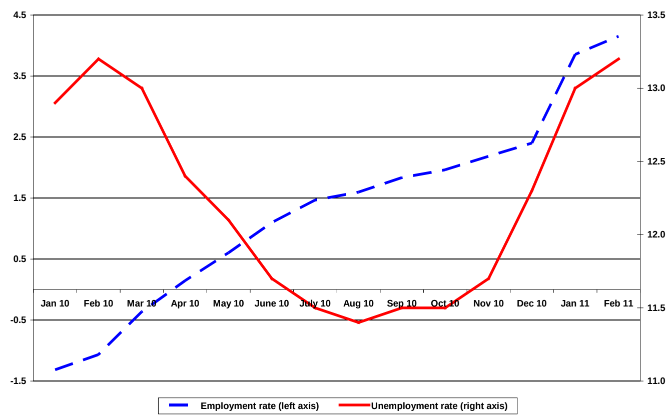
Economically active population increasing after abolition of early retirement schemes in January 1, 2009



Source: Central Statistical Office of Poland, Eurobank Research

Figure 2

Both unemployment and employment keep rising



Source: Central Statistical Office of Poland, Eurobank Research

Elsewhere, wage growth undershoots consensus expectations in February, easing to 4.1% yoy, from 5.0% yoy in the prior month. It seems that wage –related pressures are still limited, with the recent elevated inflation readings not yet been translated into higher wage demands, suggesting some real wage inertia.

Growing concerns over twin deficits

According to the Central Bank's adviser, Miroslaw Gronicki, there have recently been some serious problems with respect to the balance of payments statistics, as suggested by the unusually large "net errors and omissions" component. The latter has been on a rising path since 2006, reaching around 4.0% of GDP last year. Note that the overall current account deficit amounted to 3.3% of GDP in 2010. This huge errors and omissions component can be attributed to a larger current account deficit relative to what has been reported in the official BoP statistics. In our view, the risk is that the current account deficit has actually been underestimated, implying, in turn, certain downside risks to past years' official GDP numbers. If so, last year's deficit and debt rations may have also been underestimated. In view of these developments, we see external sector developments posing a risk to the zloty outlook going forward.

Poland's 12-month rolling current account deficit widened further in January 2011, reaching €11.7bn (or 3.3% of GDP). This was almost doubled from a year earlier, when it stood at -€6.6bn or 2.1% of GDP. The main drive behind the deterioration in the current account balance is a higher trade deficit as imports continue to grow faster than exports. Another contributing factor is a widening deficit in the incomes account due to higher dividend payments abroad. Over the same period, capital inflows fell by €2bn yoy due to declines in FDI, while net errors and omissions amounted to -€14.3bn.

February headline and core CPI readings below expectations

Consumer price inflation rose to 3.6% yoy in February, matching the downwardly revised January figure and coming below the 3.9% yoy median market forecast.. February's inflation reading was driven as in the previous months by higher food and energy costs coupled with the effect of January's VAT hike. What's more, core inflation (measure which excludes energy and food prices) stood at 1.7% yoy in February up from 1.6% yoy in the prior month and against the 2.1% yoy consensus forecast. All told, while headline inflation is likely to remain above the 3.5% target in the coming months, we expect it to decelerate in the late part of this year and average around 3.2% yoy in 2011 as a whole.

NBP raises policy rate by a further 25bps to 4.00%, in spite of slower than expected inflation and easing wage growth

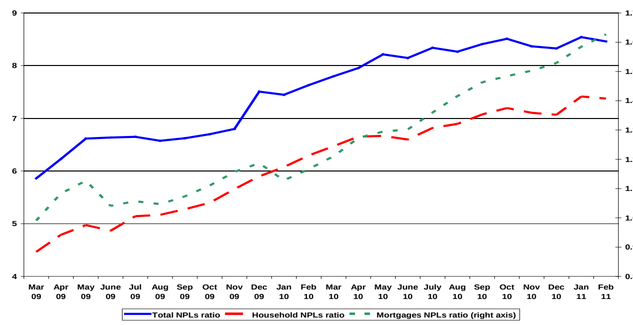
On April 5, the Monetary Policy Committee (MPC) decided to hike its key interest rates by 25bps to 4.00%. National Bank of Poland (NBP) has started its tightening cycle in January, delivering 50bps of cumulative rate hikes so far this year. Earlier comments by NBP President suggested that markets were pricing in an overly steep future rate-tightening trajectory by the NBP. Yet, the policy statement accompanying the latest MPC meeting was more hawkish than expected. According to the Council's assessment, recent domestic macro data suggest that the risk of a slowdown in economic activity has diminished. Furthermore, recent employment gains may gradually translate into higher wage demands, which, combined with higher food and oil prices, could multiply upside risks to the inflation outlook. Expectations for higher ECB rates in the no distant future appear to have also played a role in the latest NBP policy decisions. All in all, we anticipate the key policy rate to reach 4.5% at year-end.

Rising NPLs remain a risk for the domestic banking system

Private sector credit grew by 0.9% mom (+9.4% yoy) in February (following a 0.3% mom deceleration in the prior month) driven by higher bank lending to both domestic households and corporations. Household credit grew by 13.7% yoy in February up from 12.6% in the previous month while corporate lending increased by 1.2% yoy compared to 0.3% yoy recorded in January. Specifically, mortgages loans increase by 1.3% mom (19.1% yoy) in February following 19% yoy growth in 2010. By contrast to 2009, new mortgage loans are now denominated in zloty (43.8% in total mortgage loans February 2011 vs. 36.3% in February 2009). Opposing driving forces will affect mortgages lending in the near term. On one hand, persisting demand for residential real estate (residential construction market grew by 10% yoy in 2010) and stable financial condition of households should continue to support demand for mortgage loans. On the other hand, a more restrictive regulatory environment and anticipated cuts in government subsidies for first home buyers are likely to weigh on mortgages loans volumes in the period ahead. Overall, we expect mortgages loans to grow slightly this year, in contrast to double digit growth of the previous years. Apart from weaker growth in mortgage lending, banks will need to respond to certain growing risks, including the recently observed growth in Loans-to-Value (LVT) ratios. The share of loans with high LTV (over 80%) reached almost 45% of mortgages loans sold in Q3-10, indicating a declining quality of new mortgages portfolios. Even more worrisome is the constantly increasing Non-Performing-Loans (NPLs) ratio. It reached 8.5% in February 2011 from 7.6% recorded in last year's February with household NPLs ratio steadily growing; from 6.3% in February 2010 increased to 7.4% in February 2011 (Figure 3).

Figure 3

Steadily rising NPLs ratio in household and mortgages loans



Source: National Bank of Poland, Eurobank Research calculations

In this respect, the Polish banking supervision authority (KNF) imposed strict requirements to adjust total debt obligations of individuals to their income, such as loan payment cannot exceed 50% of client's net income. Additional regulation is expected soon to further reduce risks resulting from FX-loans. Nonetheless, the FX denominated loans to total loans ratio has decelerated the last couple of years; from 34.2% in January 2009 dropped to 30.4% in February 2011 (Figure 4)

Figure 4

FX denominated loans to total loans ratio

Source: National Bank of Poland, Eurobank Research calculations

On a more positive note, total deposits grew by 1.6% mom (9.3% yoy) in February following a 1.3% mom (+8.3% yoy) deceleration in January.

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

Central Bank likely to stay put on rates for the remainder of the year

- Ruling government coalition makes further progress on structural reforms amid increased political tensions
- Central Bank leaves policy interest rates unchanged at 6.25% lowers unexpectedly minimum FX reserve requirements by 5% to 20%
- Inflation bounces back in February, rising to 7.6% yoy, from 7.0% yoy in the prior month on rising food and energy prices
- IMF Board approves new precautionary arrangement for Romania, providing a safety net for the country's financing needs

Opposition fails once again to bring down the government; further progress made on structural reforms in the domestic labor market

On March 16, the government managed to survive another no-confidence motion (the fifth in its term) initiated by the opposition with the aim to boycott endorsement of the new labor code. According to the Romanian legislation, the government has the right to ask Parliament to approve a law without accepting any amendments, provided that it (the government) invokes the procedure of responsibility assumption. If there is no confidence motion initiated against it within three days, then legislation is automatically adopted. In fact, this was the strategy the government followed this time around to pass the new labor market law and prevent the opposition from boycotting the parliamentary discussion or putting forward amendments to it. The government assumed responsibility for the new labor law, instigating a no-confidence motion by the opposition. As broadly expected, the motion failed by 24 votes, as only 212 MPs voted for the no-confidence motion out of a total of 236 required for its endorsement. Only 4 voted against it, while most of the MPs from the ruling coalition abstained.

In our previous *New Europe Economics& Strategy* issues we highlighted that the current government coalition relies on independent and ethnic Hungarians minority MPs for a very thin parliamentary majority of 4 seats. Yet, under the current circumstances, the Hungarians minority party, UDMR, has no other real option to form a government coalition with the two main opposition parties (PSD and PNL). The UDMR party could promote its agenda on ethnic minority education reforms only under the current government coalition. As a result, this provides them with a strong incentive to remain in power until the end of the term of the current government (Dec 2012).

As we have already warned, the rejection of as many as four no-confidence votes against the government last year (in June, October and two more in December 2010) did not necessarily mean a more stable domestic political environment going forward. This is especially as recent opinion polls suggest that

Romania: Eurobank EFG Forecasts

	2008	2009	2010	2011f
Real GDP (yoy%)	7.3	-7.1	-1.3	1.5
Private Consumption	9.5	-10.5	-2.1	1.0
Govern. Consumption	7.1	0.8	-3.9	-2.5
Gross Capital Formation	16.2	-25.3	-14.1	3.5
Exports	8.7	-5.5	13.1	7.5
Imports	7.8	-20.6	11.6	5.0
Inflation (yoy%)				
CPI (annual average)	7.9	5.6	6.1	5.5
CPI (end of period)	6.3	4.7	8.0	4.5
Fiscal Accounts (%GDP, Cash Basis)				
General Government Balance	-4.8	-7.3	-6.5	-4.4
Gross Public Debt	19.5	27.4	33.2	36.1
Labor Statistics (annual avg,%)				
Unemployment Rate (% of labor force)	4.0	6.3	7.8	7.0
Wage Growth (total economy)	23.6	8.4	2.0	1.4
External Accounts				
Current Account (%GDP)	-11.6	-4.4	-4.2	-6.0
Net FDI (EUR bn)	9.3	3.5	2.4	3.5
FDI / Current Account (%)	57.7	72.2	57.6	65.0
FX Reserves (EUR bn)	26.2	28.3	32.4	38.0
Domestic Credit *(end of period)*	**2008**	**2009**	**Q3 10**	**Q4 10**
Total Credit (%GDP)	42.7	50.2	52.4	52.7
Credit to Enterprises (%GDP)	18.8	19.6	20.5	20.4
Credit to Households (%GDP)	19.7	20.4	20.5	19.9
FX Credit/Total Credit (%, private)	53.1	60.1	62.5	63.0
Private Sector Credit (yoy)	33.7	0.9	4.5	4.7
Loans to Deposits (%)	131.9	130.6	134.8	137.7
Financial Markets	**Current**	**3M**	**6M**	**12M**
Policy Rate	6.25	6.25	6.25	6.25
EUR/RON	4.11	4.15	4.20	4.20

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

the popularity of the government coalition has reached a new low (15% of the vote). On the other hand, the main opposition party, SDP, maintains a strong lead, with a good chance to form a coalition government in a new general election. As such, the polls give a strong incentive to the opposition parties to attempt to overthrow the ruling coalition.

All in all, the domestic political landscape is set to remain challenging in the coming months. The next area of political friction could well be a new bill capping teachers' salaries. The ruling coalition has drafted a bill to freeze teacher salaries that were actually entitled to a 50% increase according to an earlier Constitutional Court decision. In late 2008, Mr. Tariceanu's government had issued an emergency ordinance to postpone enforcement of the law. Instead, back then teachers were granted a 17% wage rise. The Constitutional court ruled that the ordinance was not in line with the Constitution, violating teachers' rights. At this point, the government is prepared to assume responsibility for this bill as well, which will likely lead to another vote of no confidence filed against it.

Central Bank signals recent RON appreciation trend in line with economic fundamentals

As we noted above, the coalition government has so far survived five votes of no-confidence. The new business-friendly labor code became the latest area of friction with the trade unions and the opposition, following endorsement of the uniform wage law and the budget law of 2011. Yet, it appears that the government has already made steady progress in promoting important structural reforms and fulfilling IMF requirements, despite increased tension in the domestic political landscape. Provided that the government accomplishes to minimize uncertainties with respect to the 2011 budget execution, the next move by rating agencies on the assessment of the sovereign risk of Romania will probably be to the upside.

These structural reforms are not only favoring the economy's medium-term growth outlook but, more imminently, are providing a boost to the local currency. The leu reached multi-month highs near 4.10/€ in early April, having appreciated by 4% since the beginning of the year. When asked to comment on the recent RON appreciation trend, Deputy Governor Cristian Popa said that this is in line with economic fundamentals and also helps to anchor inflation expectations. Our interpretation of this statement is that the Central Bank feels relatively comfortable with the current exchange rate levels, suggesting limited risks for direct intervention in the FX market to weaken the leu.

Central Bank leaves key policy rate unchanged, but lowers minimum FX reserve requirements

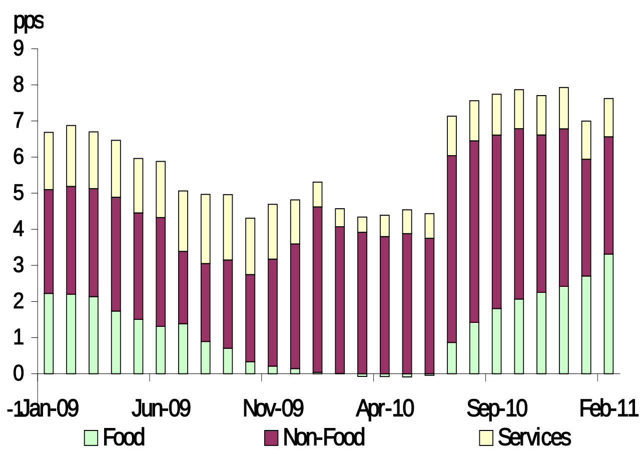
On March 31, the Central Bank decided to keep its key policy and associated deposit facility rates unchanged at 6.25% and 2.25%, respectively. The NBR also maintained the minimum reserves requirement on leu deposits at 15%. However, in a broadly unexpected move, the board decided to lower the reserve requirement on FX liabilities of less than 2-year maturities from 25% to 20%. The last time the Central Bank lowered the mandatory minimum reserve requirements on FX deposits (by 5ppts to 25%) was in Nov. 2009. The statement accompanying the latest policy announcement read that the move aims to facilitate a gradual alignment to European Central Bank standards. In our view, the latest minimum reserve requirement adjustment aims to strike a balance between the Central Bank's intention to relax monetary conditions and, at same time, its unwillingness to cut policy rates because of elevated inflation risks in the domestic economy. The country's T-bills issuance program for this year may have also played a role in that latest NBR decision. Allegedly, the cut will result in the release of ca €1bn of additional liquidity in the domestic market, part of which could be invested in the domestic government securities. In any case, the reserve requirements cut will partially offset the recent rise of Euribor rates, but, on a less positive note, it may also encourage more FX lending in the domestic market, aggravating macro-prudential risks.

February inflation bounce suggests year-end CPI target hard to fulfill

Consumer price inflation climbed to +0.8%/7.6% mom/yoy in February, from +0.8%/+7% mom/yoy in the prior month. This was a bit higher than the market's median forecast of +0.6% mom/+7.3% yoy. In EU-harmonized terms, HICP inflation rose to 6.5% yoy in February, from 6.2% yoy in January. This was the highest inflation reading in the EU-27 for the seventh consecutive month. Food inflation surprised to the upside, surging by +1.8%/+8.3% mom/yoy in February compared to +1.1%/+7.2% mom/yoy in January.

Figure 1:

Inflation bounces back in February on rising food prices



Source: National Statistics, Eurobank Research

In our view, headline inflation has likely peaked last December at 8% yoy. Disinflation is expected to resume after March (because of seasonal factors) and probably gain momentum in H2-2011, when the impact of last year's VAT hike falls out of the equation. However the domestic inflation outlook remains subject to significant risks, stemming mainly from supply side factors such as the ongoing rally in food and fuel costs and further increases in the administered prices. According to our forecasts, annual inflation is set to end this year at around 4.5% yoy, above the upper boundary of the 3%+/-1% official target.

After cutting interest rates by 175bps in the beginning of 2010, the NBR was forced to terminate its easing policy cycle last June to address rising inflation risks stemming from a steep hike in main VAT rates. Ever since, the Central Bank has remained on hold on policy rates. If inflation does not decline as much as expected once the VAT impact fades out in H2 - an increasing risk , in our view - the NBR may be inclined to maintain interest rates unchanged until end-2011.

IMF Board approves of new precautionary arrangement for Romania

The IMF board reached an agreement with the Romanian government on a new precautionary lending agreement to succeed the expiring Stand by Arrangement. The new agreement envisages total funding of €5bn (€1.4bn from EU and €3.6bn from IMF). A new € 0.4 bn loan from World Bank has been secured as well.

According to an IMF report released in March 2011, the new agreement will aim to promote more structural reforms and maintain domestic macroeconomic stability. The government will undertake the commitment to implement further structural reforms in the areas of tax collection, EU funds absorption, the liberalization of energy prices and the privatization of state owned enterprises in transportation and energy sectors. The duration of the new agreement will surpass the political cycle and thus, minimize the cost of fiscal slippage ahead of the parliamentary elections which are scheduled for late 2012. Furthermore, the new deal will be binding for the next government who will need to maintain the same set of policies in place.

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

Standard and Poor's upgrades sovereign rating to BB

- Standard and Poor's upgrades Serbia's long term sovereign rating by one notch from BB- to BB, outlook stable
- Government asks Telekom Austria to improve bid for Telekom Serbia
- In a broadly unexpected move, NBS raised its key policy rate by another 25 bps to 12.25% in a move to address persisting inflation risks

S&P ups Serbia's sovereign credit rating by one notch

Standard & Poor's raised Serbia's long-term local and foreign currency credit rating from BB- to BB, with a stable outlook. The country's short-term local and foreign currency credit ratings were affirmed at B. In a statement accompanying the rating move, S&P said that the action reflected Serbia's improved EU integration prospects as well as a new momentum in fiscal consolidation, structural reform and economy rebalancing. On less positive note, the rating agency flagged against medium-term risks to the rating outlook stemming from a relatively high external debt burden, limitations to the effectiveness of monetary policy because of the high degree of Euroization in the domestic economy and high inflation. S&P also warned that government handouts ahead of next year's parliamentary elections and/or undue fiscal policy relaxation thereafter could potentially affect Serbia's sovereign rating in a negative way.

S&P's latest positive rating action on Serbia follows a decision by Fitch Ratings in November 2010 to revise its outlook on the country's sovereign debt from negative to stable (Fitch currently rates Serbia with BB-). Note also that the country has been one of the few in South East Europe to suffer no rating downgrade in the post-Lehman period. Furthermore, Serbia's current sovereign ratings compare favorably with those of other regional peers considered to be in a more advanced stage towards EU integration (e.g. it currently ranks only one notch below Romania, which is an EU member). Clearly, the S&P rating upgrade provides a strong testament of improving investor perceptions over Serbian sovereign risk and it is conducive for the outlook of capital inflows to the country both a short- and a more medium-term perspective.

Note here that the risk premium of the country as it is depicted by the JP Morgan EMBIG index has declined from 420bps at the end of last November to 369bps on March 30th.

Serbia: Eurobank EFG Forecasts

	2008	2009	2010	2011f
Real GDP (yoy%)	5.5	-3.0	1.7	3.0
Inflation (yoy%)				
CPI (annual average)	12.5	8.2	6.5	9.0
CPI (end of period)	8.6	6.6	10.3	6.0
Fiscal Accounts (%GDP)				
General Government Balance	-2.6	-4.2	-4.4	-4.0
Gross Public Debt	25.6	31.3	41.5	45.0
Labor Statistics (%)				
Unemployment Rate (%of labor force, ILO)	14.7	16.1	19.2	18.0
Wage Growth *(total economy)*	17.9	4.1	4.6	8.3
External Accounts				
Current Account (% GDP)	-17.6	-6.9	-7.0	-9.0
Net FDI (EUR bn)	1.8	1.4	0.8	2.0
FDI / Current Account (%)	30.0	78.7	38.5	70.0
FX Reserves (EUR bn)	8.2	10.6	10.0	11.5
Domestic Credit	**2008**	**2009**	**Q3 10**	**Q4 10**
Total Credit (%GDP)	41.0	48.7	57.0	59.9
Credit to Enterprises (%GDP)	25.8	29.4	33.4	34.9
Credit to Households (%GDP)	14.0	14.7	16.9	17.1
Private Sector Credit (yoy)	34.9	14.3	26.5	26.5
Loans to Deposits (%)	125.1	127.0	141.6	144.6
Financial Markets	**Current**	**3M**	**6M**	**12M**
Policy Rate	12.00	13.00	12.50	10.50
EUR/RSD	102.08	100.00	100.00	105.00

Source: National Sources, IMF, Eurobank Research & Forecasting

Government asks sole bidder for Telekom Serbia to improve bid

The deadline for the submission of bids for Telekom Serbia, one of the most important projects in the government's privatization agenda, ended with only one bidder. This was Telekom Austria, who offered €950 mn ($1.34 billion) in cash and €450 mn in committed investments over the next three years. The offer was below the official minimum offer threshold of €1.4bn. In response, the Serbian government asked on March 29th Telekom Austria to improve its bid during the next two weeks. The completion of the Telekom Serbia's privatization is of great importance in terms of attracting more FDI inflows in the country. FDI inflows reached €860mn in 2010 compared to €1.3bn in 2009 down by 37% yoy. Net FDI covered only 41% of the current account in 2010 compared to 65.8% in 2009. In addition, if the project is not completed, the Ministry of Finance will have to rely more on debt issuance to finance the budget deficit.

In a broadly unexpected move, NBS raised its key policy rate further by 25 bps to 12.25% to address high inflationary expectations

On March 10th, NBS raised its key policy rate by 25 bps to 12.25%. This was the seventh rate hike since the Central Bank terminated its policy easing cycle in early August. The Central Bank has delivered 425bps of cumulative rate hikes since then in an attempt to combat intensifying inflationary pressures.

According to the Bloomberg survey conducted ahead of the policy meeting, the majority of participants polled (13 out of 22) expected no rate change; 8 out of 22 expected a 50bps rate hike, while there was one analyst who expected a 50bps rate cut. The latter was despite recent statements to the opposite by the NBS Governor.

In a statement released after the policy meeting, the Central Bank cited once again the inflationary effect of higher agricultural product prices and their ensuing impact on processed food prices. In addition, there was an explicit reference to the recent dinar appreciation trend and its positive impact on imported prices and subsequently, to the non-food component of inflation.

Note that domestic consumer prices have been on a rising trend in recent months, reaching a two-year high of +1.5% mom/12.6% yoy in February 2011. This was mainly the result of higher food inflation (+3.1% mom/+17.2% yoy in February 2011 vs. -1.2% mom/+0.7% yoy last July) due to the poor domestic crop and the rally in world commodity prices. The impact on headline inflation was magnified by the significant weight of food prices (~37.8%) in the domestic CPI basket. To complicate things further, regulated prices have also been on a rising trend in recent months. Tobacco and Alcohol products have taken the lead since February (+0.6% mom/+15.7% yoy in February vs. 0.1% mom/+9.5% yoy in last July), a month in which traditionally hikes in excise taxes take place. Furthermore, the state power utility has announced increases in the electricity prices (13.5% for households and 15% for corporates) effective from March 1st, that would further weigh on the domestic inflation outlook. All in, the Central Bank sees inflation peaking around 14.5% in late Q1 or early Q2. Then, disinflation is seen resuming in the 2H, assisted by favorable base effects.

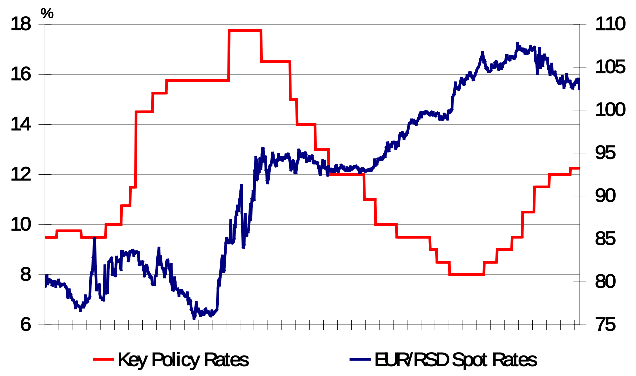
The last CPI reading deviated further from the upper boundary of the Central Bank's band for February 2011 (5.8%+/-1.9%). The tolerance band is defined for each month so that the Central Bank monitors the target throughout the year. From that point of view, it appears that the Central Bank may find it difficult to attain the end-2011 official inflation target (4.5% +/-1.5%). In fact, the attainability of this year's inflation target has already stirred intense public debate domestically. Given that the Central Bank missed last year's target by a wide margin, it is important that this year's target is attained so that some credibility is still maintained.

The latest rate hike validated our earlier view that the NBS pause, at its February policy meeting was only temporary. We had warned in our January issue of New Europe Economics & Strategy that even though the Central Bank left interest rates unchanged at 12% on February 12th, it still maintained a tightening bias. In our view, the new hikes aim to prevent elevated inflation expectations from triggering a second round of price increases and thus, avert a wage-inflation spiral. The Gallup and Bloomberg surveys in the latest inflation report presentation, showed evidence that this aim has been partially accomplished.

As we pointed out in our previous New Europe Economics & Strategy issue, the Central Bank is likely to be less aggressive on policy rate hikes going forward. The Central Bank has already stated that its decision to mobilize the tool of the minimum reserves requirements tool means less reliance on the policy rate in the future. The minimum reserve requirement for short-term deposits (maturities of less than two years) has been lifted from 25% to 30%.

In view of the aforementioned, the latest rate hike strikes a balance between two (potential conflicting) policy objectives: Namely, proactive rate tightening to preempt increased inflation risks vs. concerns about further domestic currency gains from the carry trade. Central Bank governor, Dejan Soskic, has already voiced worries over further currency gains triggered by higher policy rates. Additionally, he said that the NBS should use all available tools at its disposal to fight inflation, except of the exchange rate, which could hurt exporters if it was left to appreciate significantly. Deriving support from higher policy rates and re-invigorated demand for government T-Bills from both local and foreign accounts, the dinar recouped some of its earlier losses during the first months of 2011. On March 30th, the dinar strengthened to 103.5/€ compared to 105.9/€ at the end of last year and a historic low of 108.1/€ recorded on October 28th. As a result, the Central Bank has only intervened once in the FX market since the beginning of 2011. In fact, the intervention amounted to €5bn and aimed at buying Euros and selling dinar. (Figure 1)

Figure 1:
Dinar strengthened in the first months of 2011



Source: Bloomberg, Eurobank Research

All in, although we may not have yet seen the peak in NBS's policy rates, we believe that we are getting close to the completion of the Bank's tightening cycle. That said, provided there are no new nasty surprises with respect to inflation, we anticipate rates to peak in the next couple of months at the level of 12.50-13.00%, The central bank is expected to resume monetary easing in H2:2011, once inflation uncertainties subside. We currently see room for cumulative rate cuts of as much as 150-200 bps in the second half of this year.

On the other hand, the Central Bank is now increasingly confronted with new risks arguing against a swift switch to policy easing once the present tightening cycle is completed. Such risks emanate from the new oil price shock, ongoing geopolitical tensions in Middle East and North Africa, the prospective tightening by the ECB, and the approach of the pre-election cycle in the country (parliamentary elections are officially scheduled for next May).

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

GDP posts stellar growth of 9.2%yoy in Q4:10; full-year growth at 8.9%yoy, significantly higher that market expectations

- Higher-frequency indicators point to vibrant domestic demand dynamics in Q1:11
- CBT stays put on policy rates in March, but hikes RRRs aggressively. Central bank expects impact of recent policy measures to become more evident in Q2:11
- Current account deficit and the short-term nature of its financing remain key economic risks going forward

GDP posts stellar growth of 9.2%yoy in Q4:10

Turkey's Q4 GDP rose by 9.2%yoy outpacing expectations for an expansion of 7.3%yoy as well as a 5.2%yoy increase in the third quarter of last year. For the whole of 2010, growth rebounded to 8.9%yoy from a contraction of 4.8%yoy in the prior year. This was higher than our 8.0% forecast as well as GDP growth recorded in most emerging market peers. Private and government consumption registered respective annual increases of 6.6% and 2.0% in 2010, adding cumulatively 4.9ppts to overall output growth. Investments spiked nearly 30%yoy contributing 6ppts, while inventory adjustment added 2.5ppts. The net exports' contribution remained negative subtracting 4.4ppts from last year's growth as a 20.7%yoy jump in imports outpaced a meager 3.4%yoy gain in exports.

Turkey: GDP

	YoY growth (ppts)		Contributions (ppts)	
	Q4 '10	2010	Q4 '10	2010
GDP	9.2	8.9		
Expenditure-side				
Domestic Demand	14.7	13.3	14.8	13.3
Consumption				
Private Consumption	9.0	6.6	6.2	4.7
Govern. Consumption	3.2	2.0	0.4	0.2
Investment	42.1	29.9	8.8	6.0
Private Investment	49.5	33.5	8.0	5.4
Govern. Investment	17.1	15.1	0.8	0.6
Change in stocks	-	-	-0.7	2.5
Net exports	-	-	-5.6	-4.4
Exports	4.3	3.4	1.1	0.9
Imports	25.4	20.7	-6.7	-5.2
Production-side				
Agriculture, hunting and forestry	4.3	1.2	0.4	0.1
Fishing	18.4	14.2	0.1	0.0
Mining and quarrying	0.9	4.7	0.0	0.0
Manufacturing	11.3	13.6	2.7	3.2
Electricity, gas and water	6.5	7.3	0.2	0.2
Construction	17.5	17.1	0.9	0.9
Wholesale and retail trade	13.1	13.3	1.6	1.6
Hotels and Restaurants	-0.9	0.3	0.0	0.0
Transport, storage and comm.	12.9	10.5	1.8	1.5
Financial intermediation	10.3	7.2	1.3	0.9
Ownership and dwelling	1.2	1.9	0.1	0.1
Real estate, renting & business	4.5	7.6	0.2	0.3
Public administration & defence	1.5	0.5	0.0	0.0
Education	0.9	0.6	0.0	0.0
Health and social work	-0.7	1.1	0.0	0.0
Other community, social & pers. act.	0.1	0.9	0.0	0.0
Private household with empl. Indiv	2.8	5.4	0.0	0.0
Sectoral total	9.3	8.9	9.4	8.9
Financial intermediation	14.9	13.0	1.3	1.0
Taxes-Subsidies	13.3	12.9	1.1	1.1

Source: National statistics, Eurobank EFG

Turkey: Eurobank EFG Forecasts

	2008	2009	2010E	2011F
Real GDP (yoy%)	0.7	-4.8	8.9	5.0
Private Consumption	-0.3	-2.3	6.6	4.5
Govern. Consumption	1.7	7.8	2.0	3.5
Gross Capital Formation	-6.2	-19.0	29.9	13.0
Exports	2.7	-5.0	3.4	9.5
Imports	-4.1	-14.3	20.7	15.0
Inflation (yoy%)				
CPI (annual average)	10.4	6.3	8.6	5.5
CPI (end of period)	10.1	6.5	6.4	6.7
Fiscal Accounts (%GDP)				
Central Government Balance	-1.8	-5.5	-3.6	-2.7
Gross Public Debt	39.5	45.4	42.5	41.5
Primary Balance	3.5	0.1	0.8	1.5
Labor Statistics (%)				
Unemployment Rate (%of labor force)	13.6	13.5	12.0	11.0
External Accounts				
Current Account (% GDP)	-5.7	-2.3	-6.6	-7.0
Net FDI (USD)	15.7	6.7	7.1	7.5
FDI / Current Account	37.5	46.9	12.0	14.0
FX Reserves (USDbn)	71.0	69.0	79.0	90.0
Domestic Credit	**Q1 10**	**Q2 10**	**Q3 10**	**Q4 10**
Total Credit (%GDP)	31.4	35.1	37.2	41.5
Credit Private Sector (%GDP)	29.7	33.3	35.3	39.4
FX Credit/Total Credit (%)	16.9	18.7	18.8	21.0
Private Sector Credit (%yoy)	22.8	34.0	36.7	44.0
Loans to Deposits	79.9	82.1	84.3	85.7
Financial Markets	**Current**	**3M**	**6M**	**12M**
Policy Rate	6.25	6.25	6.75	7.50
USD/TRY (where applicable)	1.52	1.53	1.50	1.45

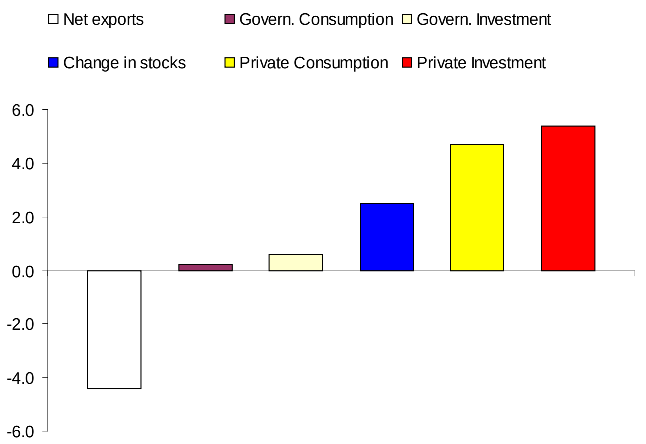
Source: National Sources, Eurostat, IMF, Eurobank Research & Forecasting

Higher-frequency indicators point to continuation of strong domestic demand growth in Q1:11

Recent higher-frequency macro indicators suggest that last year's strong growth momentum continued in Q1:11 thanks to vibrant domestic demand and strong exports. Industrial output grew by 18.9%yoy in January, following a 12.1%yoy rise in Q4 2010. January's print marked the sharpest annual pace of increase since March 2010. Total banking credit to the domestic market rose by 36%yoy in the week ended March 18, remaining well above the 20-25% level considered as appropriate by the CBT and the government so as to safeguard financial stability and curb inflation pressures. Consumer credit growth stood at 35%yoy in the same week, registering its

Figure 1:

Domestic demand led last year's stellar growth



Source: National statistics, Eurobank EFG

fastest pace of increase since October 2008. Although the PMI manufacturing index eased to a 5-month low of 56.1 in March as growth in output and new orders slowed, possibly due to the unrest in the Middle East, it remained close to February's record high of 58.5. Strong domestic demand dynamics were also mirrored in the latest trade data with imports' growth of 44.3%yoy in January outpacing a 36%yoy average increase in Q4. Signaling ongoing optimism, the consumer confidence index spiked to a 3-year peak of 93.56 in February. Similarly, the corresponding business survey showed an increase to a 10-month high of 114.8 in March and an average reading around 113.1 in Q1 vs. 107 in the fourth quarter of last year. External demand is also revealing signs of strengthening. Importantly, the number of foreign visitors jumped by an average of 16.8%yoy in the first two months of the year after a 5.7%yoy increase in 2010. Furthermore, exports rose by ca 22%yoy in the first two months of the year, following an average rise of ca 11%yoy in Q4. On a less positive note, capacity utilization in manufacturing industry weakened in Q1 2011 vs. Q4 2010, yet marked a tentative gain of 2bps to 73.2 in March. Capacity usage currently stands just 2.7ppts below a 2-year high recorded LAST November. Also, the rate of unemployment (measured on a 3-month rolling basis) bounced to 11.4% in November-January from 11.0% in Q4. Even so, it remains well below a record high of 16.1% marked in Q1 2009. In all, we expect a modest quarter-of-quarter pick up in annual GDP growth over the first three months of the year, with base effects likely to cap a more significant upside potential. A gradual slowdown thereafter is likely in view of higher commodity prices, unfavorable base effects, the continuously negative contribution from net exports and tightened monetary policy conditions.

CBT stays put on rates , but hikes RRRs aggressively

Turkey's central bank held its key policy rate unchanged at a record low level of 6.25% at its MPC meeting on March 23, in line with the market's median forecast. However, in a largely unexpected move, the CBT raised further domestic bank reserve requirement ratios on TRY deposits across most maturities. It is worth noting that as of December last year , Turkey's Central Bank has adopted an unorthodox monetary policy mix by lowering its key policy rate twice (75bps in total) and raising reserve requirement ratios (RRR) on commercial bank deposits in order to preserve financial stability and combat rising inflation pressures. Since then a number of unpredictable external factors have come into the forefront, complicating further the monetary policy outlook. Among them, we note the ongoing turmoil in MENA that is inflationary impact on oil prices as well as the earthquake in Japan and its global repercussions. The primary reason behind the Bank's decision to hike RRRs in March was to avoid overheating of the domestic economy and curb inflation pressures, especially in view of the recent rise in energy and commodity prices. In detail, the TRY required reserve ratios were increased for: i) demand deposits, notice deposits and private current accounts by 3ppts to 15%, ii) up to 1-month deposits by 5ppts to 15%, iii) up to 3-month deposits from 9% to 13%, iv) up to 6-month deposits from 7% to 9%, v) liabilities other than deposits/participation funds from 9% to 13%. As a result of the aforementioned measures, the CBT anticipates that approximately TRY 19.1bn will be withdrawn from the market. Since September the Central Bank has increased five times the RRRs, draining total liquidity of caTRY 40bn from the domestic banking system. The CBT had so some initial success in curbing hot money inflows that added to already strong domestic demand, fanning inflation and widening pressures on the current account deficit. As a result of the measures, it was estimated that there was an outflow of around $10bn in short-term capital since December. However, according to a WSJ report citing Governor Durmus Yilmaz in mid-March, a majority of these outflows have returned back. Defending his policy, the CBT Governor added that most of the inflows have been invested into longer-term maturities, which was among the CBT's targets. Effectively, much of the foreign inflows invested in short-term assets appear to have been switched to long-term assets. Note also that March's meeting was the last Governor Durmus Yilmaz attended as his mandate ends on April 18. On the other hand, a material effect of the CBT's macroprudential measures on credit activity as well as on the trade balance has yet to be witnessed. Note that January's current account deficit jumped 91%yoy while, on a 12-month rolling basis, the shortfall reached a record high of $51.4bn. A further worsening is likely in February as the latest external trade data showed that the corresponding shortfall bounced 110%yoy as imports' growth (48.7%yoy) sharply outpaced that of exports (22%yoy) during that month. Separately, the latest BDDK data showed that total loan growth stood at a 2-½-year high of 36%yoy on the week ended March 18, well above the level of 20-25% the CBT sees as sustainable for preserving financial stability. Nevertheless, the Bank said at its accompanying policy statement in March that the impact of its policy mix on domestic demand and credit will become more evident in Q2 as the effect of the measures have yet to feed through to the economy. The rest of the statement was broadly in line with February's. It noted that economic activity continued to strengthen, being primarily supported by rising domestic demand. On the other hand, external demand remains relatively weak and unemployment is still at high levels in spite of the ongoing improvement in labor market conditions. Importantly, the Committee noted that oil and other commodity prices have increased above those assumed in January's Inflation Report, signaling a possible upward revision in the Bank's 5.9% year-end CPI forecasts in April.

Annual CPI unexpectedly slides to a new 4-decade low; CBT to stay put on rates until June's elections

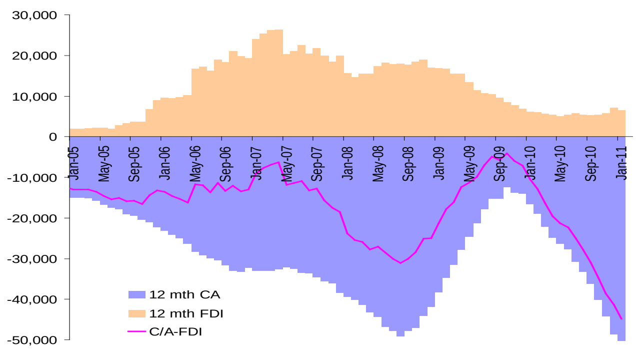
Annual CPI slid to a new 4-decade low of 3.99% in March from 4.16% a month earlier, confounding expectations for an uptick to 4.40%. Month-on-month consumer prices rose by 0.42%, undershooting a 0.66% increase anticipated by market participants. The downside inflation surprise primarily stemmed from a 0.41%mom fall in food prices. Core CPI indices were little changed from February, indicating that the impact of a weaker lira and higher global commodity prices was relatively muted. On the other hand, producer price inflation (PPI) rose by 1.22% mom in February, overshooting the +0.95% mom consensus forecast and signaling increase pipeline inflation risks in the period ahead. In all, the data supports the view that the CBT is likely to hold its key policy rate unchanged at its current 6.25% level at least until June's general elections, although further increases in reserve requirement ratios are possible by then. However, we expect the Bank to start raising its key policy rate in H2 and deliver a total of 150bps of rate hikes before the end of the year. The latest data suggest that pipeline pressures are building up while domestic demand remains robust. As such inflation pressures will likely become more pronounced after April when favorable base effects wane. Notwithstanding the aforementioned, there is potential for interest rate hikes to be brought forward should inflation surprise on the upside in the coming months. Fiscal prudence will also be key for the upcoming CBT decisions. Nevertheless, we see limited risks for significant fiscal slippages as the ruling AKP party is the frontrunner for the polls according to most recent opinion surveys, being braced to win its third term. Moreover, with the budget having swung into a surplus of TRY 1.993bn cumulatively in January and February from a deficit of TRY 5.392bn over the same period a year earlier, we expect the government to meet this year's 2.8%-of-GDP central government fiscal deficit target. If so, this will mark an improvement from last year's 3.6%-of-GDP realization.

Current account deficit and the short-term nature of its financing remain key economic risks

After touching a record high deficit of $48.56bn in 2010 (or ca 6.6%-of-GDP, broadly in line with our expectations), Turkey's current account shortfall widened 91%yoy in January to $5.9bn, undershooting the $6.1bn market consensus. On a 12-month rolling basis, the gap spiked 209%yoy to a fresh record peak of $51.4bn. The deficit, among Turkey's main macroeconomic vulnerabilities, is being primarily driven by a higher trade shortfall against a background of growing divergence between domestic vs. external demand dynamics and rapid credit expansion. Note that February's trade shortfall soared 110.9%yoy to $7.41bn exceeding the market's median forecast of $6.8bn as imports rose by 48.7%yoy to $17.52 sharply outpacing exports' growth of 22%yoy ($10.11bn). The recent surge in global commodity prices is exacerbating the energy import bill as Turkey imports ca 95% of gas and oil it uses.

Figure 2

12-month rolling current account deficit hits a record high in January



Source: CBT, Eurobank EFG

The lira's weakening in recent months did not favor either. The USD/TRY hit a near 2-year peak at 1.62 on February, but recoiled towards 1.54 recently. The deterioration in the current account and trade deficits is expected to linger near term as loan growth remains strong and the CBT's policy mix has yet to bear significant results. Apart from boosting import prices, the crisis in MENA may bring about negative repercussions for Turkish exports as well. That said, the impact is likely to be rather limited as Egypt, Libya and Tunisia accounted for less than 4% of Turkey's total exports in January. This may also be compensated by an increase in tourism influx as Turkey may be perceived as a substitute holiday destination for MENA. Yet, another area of concern lies in the short-term nature of the current account financing. Twelve-months-to-January net FDI inflows rose by 5.5%yoy to $6.5bn covering just 12.6% of the current account deficit over the same period. Around a third of the 12-month rolling shortfall was matched by portfolio investment, while the rest by other investment, such as non-residents short-term deposit and drawings of deposits from banks located outside Turkey's geographical boundaries. With domestic demand having so far failed to show any concrete evidence of a slowdown in spite of the CBT's policy mix, we see upside risks to our earlier 7.0%-of-GDP current account deficit forecast.

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

IMF programme broadly on track with domestic economy stabilizing and inflation easing

- Q4-10 GDP growth revised upwards to 3.3% yoy from 3.0% yoy estimated earlier on higher private spending
- IMF programme broadly on track, but next tranche likely to be delayed due to ongoing negotiations over gas price hikes and the pension reform
- Domestic CPI eased to 7.2% yoy in February, its slowest pace since July 2010, largely due to easing food price inflation
- Preliminary signs of a resumption in private-sector lending, driven entirely by corporate credit; deposit growth returns to pre-crisis levels.

Economy shows signs of stabilisation

After contracting by 15.1% yoy in 2009, gross domestic product grew by 4.2% yoy last year on the back of recovering exports and strengthening private consumption. Q4 GDP growth was recently revised upward to 3.3% yoy from 3.0% yoy estimated earlier (down from 3.6% yoy in Q3-10). Conditions in the domestic industrial sector remain solid and conducive to overall output growth. Industrial production rose by 11.5% yoy in February up from 9.7% yoy in the prior month, with the construction materials segment exhibiting the fastest pace of expansion (+33.2% yoy in February). This is a positive signal for the outlook of domestic economic activity going forward, pointing to continuing revival in the domestic construction sector. According to the most recent official figures, last year's overall number of dwellings produced was 1.5 times higher than in the prior year. In all, we forecast full-year GDP growth to reach 4.5% yoy in 2011 on the back of higher fixed investment ahead of Euro 2012 football championships and strengthening consumer spending dynamics.

Wage growth has been supportive to consumer spending since mid-2010 (Figure 1). In fact, real wages have been growing at double-digit rates since the beginning of this year (12.6% yoy in February vs. 11.7% yoy in the prior month). This has provided a boost private consumption, with retail sales (in volume terms) growing by 11.9% yoy in February up from 11.1% yoy in January (and from an average 1.8% in 2010 as a whole).

Next IMF tranche likely to be delayed due to ongoing negotiations over gas prices and the pension reform

The Ukrainian government and the IMF agreed on an overall gas tariff hike of 30% in 2011 instead of an originally expected hike of 50% on April 1st. The first instalment of the gas tariff increase (+15%) is now scheduled to take place on April 15. This will be accompanied by a 26% hike in heating rates for households. The subsequent 10% increase in the gas tariff is scheduled for June 30, to be accompanied by a 26% increase in the heating rate for households. These would leave Naftogaz with an estimated deficit of about 0.7% of GDP in 2011 instead of a balanced position (i.e., 0% of GDP) agreed previously.

Ukraine: Eurobank EFG Forecasts

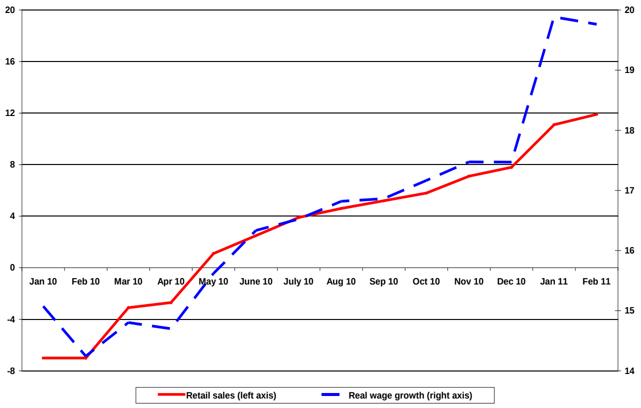
	2008	2009	2010f	2011f
Real GDP (% yoy)	2.3	-15.1	4.2	4.5
Private Consumption	9.9	-12.1	5.8	5.0
Government Consumption	0.4	1.8	1.5	1.0
Gross Capital Formation	32.6	-48.4	3.2	7.5
Exports	5.1	-23.6	4.6	9.0
Imports	18.4	-36.8	11.5	11.0
Inflation (% yoy)				
CPI (annual average)	25.2	15.9	9.4	10.6
CPI (end of period)	22.3	12.3	9.1	10.3
Fiscal Accounts (% GDP)				
General Government Balance	-3.2	-8.7	-6.5	-3.5
Gross Public Debt	20.5	35.3	41.7	42.4
Labor Statistics (%)				
Unemployment Rate (% of labor force)	6.9	9.4	8.1	8.0
Wage Growth *(real - private sector)*	6.3	-10.3	8.4	9.0
External Accounts				
Current Account (% GDP)	-7.0	-1.5	-2.5	-2.5
Net FDI (bn USD)	9.9	4.7	5.7	7.0
FDI / Current Account	77.6	268.0	222.0	100.0
FX Reserves (bn USD)	31.5	26.5	34.6	37.0
Domestic Credit	**2008**	**2009**	**Q3 10**	**Q4 10**
Total Credit (% GDP)	77.3	79.1	69.8	66.9
Credit to Enterprises (% GDP)	46.7	50.5	46.8	45.8
Credit to Households (% GDP)	29.5	26.4	20.9	19.1
FX Credit/Total Credit (%)	59.0	50.8	47.4	46.0
Private Sector Credit (% yoy)	68.5	-3.1	2.6	0.4
Loans to Deposits	204.0	215.9	183.3	175.9
Financial Markets	**Current**	**3M**	**6M**	**12M**
Policy Rate	7.75	7.75	7.75	7.75
USD/UAH	7.93	7.90	7.90	7.90

Source: NBU, IMF, Bloomberg, Eurobank Research

An outstanding issue for the next IMF disbursement to be released is the pension reform. The Ukrainian authorities have committed to finalise the draft of the pension legislation in April. The main themes to be agreed upon with the Fund are the increasing retirement age for women (from 55 to 60) and the tightening early retirement provisions. In all, we anticipate the next IMF tranche to be released in May (or in July at the latest) -from end-March initially planned- since the national authorities have acknowledged the importance of keeping the IMF programme on track for macroeconomic stability and as a necessary condition for access to external debt markets.

Figure 1

Wage growth has been supporting consumption since mid-2010



Source: National Statistics, Eurobank Research calculations

Gross external debt up13.5% in 2010

According to the National Bank of Ukraine (NBU), gross external debt rose by 13.5% yoy in 2010, reaching $117.3bn. In ppt-of-GDP terms, external debt eased to 85.1%, from 90.8% in 2009. Last year's increase in the level of gross external debt came largely from government borrowing ($25bn) and external loans to the non-financial private sector ($50.8bn). On the other hand, the domestic banking sector continued deleveraging, contributing some $28.1bn to overall external indebtedness compared to $30.9bn in 2009 and $39.5bn in 2008. We maintain confident that both the public and private sectors will face no problems in rolling over their external borrowing in 2011. We see the public sector driving external debt growth in 2011, primarily in the form of new IMF lending and a further Eurobond placement.

Current account deficit widening again

The current account deficit for the first two months of 2011 amounted to $816mn compared to a surplus of $304mn in the same period last year. A higher import bill for natural gas was the main driver behind the recent deficit deterioration. Specifically, gas imports amounted to $3.3bn in January-February 2011 i.e., 2.4 times higher than in the corresponding period of last year. This was due to stronger consumer demand and despite a 13.5% yoy decline in gas prices over the first two months of this year. The widening of the current account deficit implies a modest, yet still manageable, increase in external funding needs in 2011. We anticipate current account deficit to remain at levels around 2.5% of GDP in 2011, being comfortably covered by capital inflows. In addition, NBU reserves are high; $36.7bn at the end of February 2011.

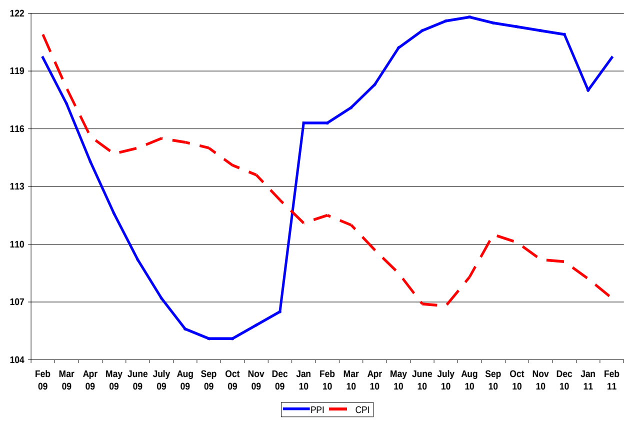
Inflation eases in February

Ukraine's inflation eased to 7.2% yoy in February, its slowest pace since July 2010, down from 8.2% yoy in the prior month. This was mainly attributed to the slowdown in food prices growth. Domestic food prices, which are the weightiest component of the CPI basket with a 53% share, will likely continue to diverge from global trends as long as the agricultural harvest remains sufficient to cover domestic needs and the government remains focused on curbing domestic food prices. Moreover, the direct impact of the global oil price shock on headline CPI has been relatively muted so far, thanks to the very low share of gasoline prices in the domestic consumption basket; just 1.6%, which is the lowest among regional peers. The above factors may explain why Ukraine's inflation has recently been on a downward path, despite rising price pressures in other economies in the region e.g. Russia and Kazakhstan.

We expect domestic disinflation (in annual terms) to continue through to April, when the authorities will start adjusting gas and heating tariffs. Taking into account these developments, we expect annual inflation to average around 9-10% this year vs. 9.4% yoy in 2010. However, we see upside risks to this projection. Ukraine's electricity regulator approved a 15% hike in household electricity tariffs effective April 1, 2011. Higher oil prices present another serious risk to the domestic inflation outlook. Note also that the producer price index (PPI) grew by 4.8% mom in February 2011, its highest pace since May 2010. In annual terms, PPI accelerated to 19.7% yoy in February up from 18% yoy in January (Figure 2).

Figure 2

PPI growth may be foreshadowing of a future acceleration in consumer prices as producers attempt to pass on increase costs to consumers



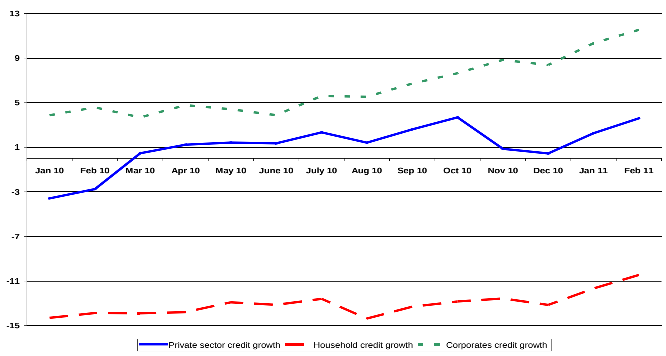
Source: National Statistics, Eurobank Research calculations

Preliminary signs of revival in private sector credit

Total private sector credit growth continued its upward trend in February, reaching 3.6% yoy, from 2.3% yoy in January. This was mainly on the back of higher business lending (11.5% yoy in February vs. 10.3% yoy in the prior month). On the other hand, the contraction in household credit growth eased to -10.5% yoy in February from -11.7% yoy recorded in January (Figure 3). On a more positive note, deposits are growing fast with 31.6% yoy growth in the private sector in February (Figure 4). As a result, loans to deposits ratio fall to 172.3% in February 2011 from last February's level of 216.5%. Despite recent preliminary signs of revival in the domestic banking sector, a rising NPLs ratio remains a major drag, hindering a more sustained resumption of private-sector lending. NPLs ratio stood at 11.6% in February 2011, up from 9.9% in the same month a year earlier (National Bank of Ukraine data).

Figure 3

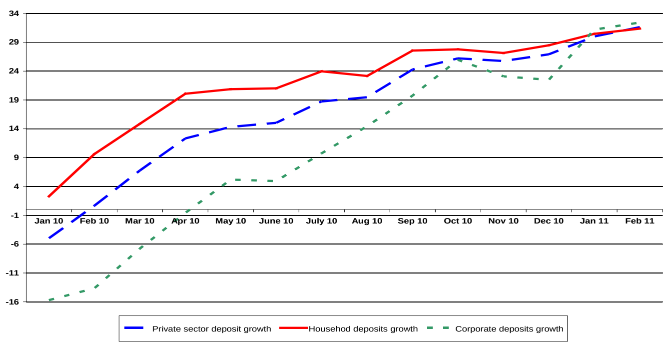
Credit growth decomposition



Source: National Bank of Ukraine, Eurobank Research calculations

Figure 4

Growth of private sector deposits breakdown



Source: National Bank of Ukraine, Eurobank Research calculations

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