

New Europe Economics & Strategy

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Global economic fears weigh on regional markets

Bulgaria: Output losses were contained in Q2, with net exports providing support; recent hikes in excise taxes and regulated prices combined with higher food prices will push inflation towards 4% by year end

Poland: Q2 GDP data shows economic rebound is gathering pace; IMF approved in early July a new 1-year lending facility for Poland worth \$20.43bn under its existing Flexible Credit Line

Romania: Improvement in domestic economic growth in Q2 likely to prove temporary; we now see full-year GDP contracting by 2%. Recent VAT rate hike likely to push inflation above 8% in the months ahead

Serbia: Unexpected interest rate hike offers dinar (temporary) support

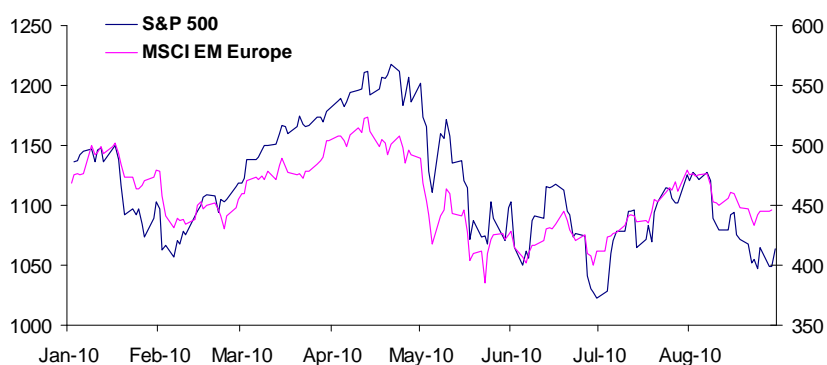
Turkey: Economic rebound continues, but pace of recovery likely to prove slower in H2; CBT revises 2010-2012 inflation projections lower, signals unchanged policy rates until 2011

Ukraine: IMF Board approves new Stand-By Arrangement

New Europe market strategy highlights

- We expect local rates markets to continue to broadly outperform other major asset classes in New Europe for as long as concerns about a re-weakening of global economic growth continue to fuel flight-to-safety flows and deflate expectations for imminent rate hikes by central banks in the region.
- Local currencies are likely to remain under pressure near-term, given lingering market uncertainties and scaled-back policy rate expectations. We continue to expect the Polish zloty and the Turkish lira to outperform other regional currencies over the next 3-6months, supported by strengthened domestic fundamentals.
- Most external debt markets in New Europe continue to be quite expensive at current levels.

August sell-off more contained than in major markets and relative to the January & May episodes



Source: Bloomberg

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Introductory Comment

Dear reader,

Macroeconomic conditions in New Europe improved further in the second quarter of 2010, with the region exhibiting notable resilience to the deepening sovereign debt crisis in the euro area. The pace of economic activity in Poland exceeded market expectation in Q2, with the country's real GDP growth expanding at an annual rate of 3.5 percent on strengthening domestic demand and higher exports. Elsewhere, Serbia's annual GDP growth accelerated to 1.6 percent, the pace of economic contraction in Bulgaria slowed to 1.5 percent from 3.6 percent in the prior quarter and the Romanian economy recorded its first positive quarter-on-quarter GDP reading since Q3 2009, pointing to a (temporary) exit from recession, at least from a technical standpoint.

The region's economic recovery has so far been mostly driven by base effects, a sizeable reaccumulation of business inventories and higher exports to main trading-partners (Western European economies and, mainly, Germany). On a less positive note, domestic-demand dynamics remain weak in most economies in the region, with the bright exception of Turkey and, to a lesser, Poland.

Looking ahead, we expect the pace of economic recovery in New Europe to slowdown somewhat in the second half of the year, especially in economies that continue to rely mainly on higher exports to generate positive GDP growth. A less sanguine world economic growth trajectory in H2 and fiscal austerity measures employed by a number of governments in New Europe are unlikely to leave regional economies entirely unaffected. Yet, barring any unforeseen circumstances, including a double-dip in the global economy, we anticipate the present soft-patch to prove only temporary, with a return to more dynamic growth expected next year. Romania is likely to be an underperformer in terms of GDP growth in the region in the following couple of quarters, as the new austerity fiscal measures introduced recently by the government are likely to further compress domestic demand.

Inflation concerns have remained off policy makers' agendas for some time. Accumulating evidence in favor of a slower growth in major world economies in the months ahead and the recent softening in world oil and commodity prices have kept inflation

expectations broadly contained. As a result, market participants have lately moved to scale back earlier expectations for an inception of monetary tightening by a number of central banks in the region before the end of the current year. Notably, the Central Bank of Turkey (CBT) revised recently its medium-term inflation projections, signaling that its baseline scenario is now for a resumption of monetary tightening not earlier than in 2011. In a similar vein, the latest policy statement from the Central Bank of Poland delivered a broadly balanced assessment with respect to monetary policy outlook ahead, disappointing market hawks who were looking for more concrete signal for a rate hike by the end of 2010.

In this challenging environment, we expect local rates markets to continue to broadly outperform other major asset classes in New Europe in the period ahead, as relatively benign inflation and concerns about a re-weakening of the world economy continue to reduce expectations for any imminent hikes in policy interest rates. Meanwhile, local currencies are generally likely to remain under pressure near-term, with the Polish zloty and the Turkish lira remaining our preferred picks over the next 3-6 months, on favorable macro fundamentals, manageable sovereign borrowing requirements and higher FDI. On the external debt space, most markets in the region remain expensive, facing significant downside risks if the global environment deteriorates further.

To recap, although we remain constructive on the region in the medium-term significant near-term risks lie ahead. That is especially in the case of a more severe bout of global risk aversion that could take a much heavier toll on regional market in the period ahead.

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

Summary of key macroeconomic indicators

Realizations and forecasts

	GDP real (yoy)			Consumer Prices (annual average)			Current Account (%GDP)		
	2009	2010f	2011f	2009	2010f	2011f	2009	2010f	2011f
Bulgaria	-5.0	-0.3	2.5	2.5	3.0	2.7	-9.4	-5.5	-7.0
Poland	1.8	3.2	3.4	3.5	2.5	2.7	-1.6	-3.0	-3.2
Romania	-7.1	-2.0	1.5	5.6	6.5	4.5	-4.4	-5.5	-6.0
Serbia	-3.0	1.5	3.0	8.2	5.0	4.8	-5.7	-8.5	-9.0
Turkey	-4.7	6.0	4.5	6.3	8.3	7.2	-2.2	-4.5	-5.3
Ukraine	-15.1	4.0	4.2	15.9	10.2	10.5	-1.5	-1.0	-2.1
New Europe	-4.3	3.5	3.7	6.5	6.3	5.7	-2.6	-3.9	-4.5
Euro area	-4.1	1.2	1.8	0.3	1.3	1.5	-0.6	0.0	0.2
USA	-2.4	2.9	3.2	-0.4	2.1	2.2	-2.9	-3.3	-3.4

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

Foreign exchange and policy interest rates

Realizations and forecasts

eop		FX Rates			Interest Rates		
		2009	2010f	2011f	2009	2010f	2011f
Bulgaria	vs EUR	1.96	1.96	1.96	<i>Currency Board</i>		
Poland	vs EUR	4.10	3.90	4.00	3.50	3.50	4.00
Romania	vs EUR	4.23	4.30	4.35	8.00	6.25	6.50
Serbia	vs EUR	96.2	110.0	110.0	9.50	8.50	9.50
Turkey	vs USD	1.50	1.55	1.45	6.50*	7.00	8.50
Ukraine	vs USD	8.00	7.90	8.00	10.25	7.75	7.75
Euro area	vs USD	1.43	1.20	1.15	1.00	1.00	1.50**
USA	vs EUR	0.70	0.83	0.87	0.125	0.125	1.00**

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

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

** Bloomberg August survey

I. Overview

Worries over sustainability of global economic recovery come to the fore

The improvement in global investor sentiment witnessed in late July/early August thanks to a generally good Q2 US corporate earnings season and the lack of negative surprises in the EU-wide bank stress tests, proved short-lived. Concerns about the sustainability of the global economic recovery came to the fore following a flurry of lackluster real activity data in recent weeks, from the main engines of global economic growth; namely Asia and the US. Among others, US existing home sales posted a record monthly drop in July, while new home sales plunged to all-time lows in the same month, making clear that federal home buyer tax credits - expired earlier this year - provided only temporary support. Aggravating fears that the US economic recovery is stalling, Philly Fed business activity index unexpectedly contracted in August to its lowest level in more than a year while, in spite of last week's marginal improvement, the trend in initial jobless claims remains consistent with a lackluster pace of job growth. Not surprisingly, the FOMC downgraded its economic assessment at the August 10th policy meeting while, in an effort to mitigate downside growth risks, the committee decided to keep its bloated balance sheet constant by reinvesting the proceeds from its vast portfolio of mortgage-backed securities into longer-dated Treasuries. Along similar lines, Chairman Bernanke noted at the annual meeting at Jackson Hole last week, that the pace of US economic recovery has slowed more than the FOMC expected earlier this year and underlined that the Central Bank is ready to provide additional monetary accommodation, through unconventional measures, if economic conditions deteriorate further.

Resurfaced euro area sovereign credit woes fuel risk aversion

In its semi-annual European Sovereign Outlook, published earlier this month, Moody's warned that a renewed economic slowdown in Europe might spark a new round of ratings downgrades, especially for countries facing increased downside growth risks amid ongoing fiscal challenges and deleveraging. Contributing to the latest bout of risk aversion, the ratings agency cautioned that divergence growth trends among member countries continue to spread, adding to the view that, in spite of stronger-than-expected GDP data in Q2, growth sustainability worries are far from over. In particular, Q2 growth in core euro area economies outperformed, with Germany' stellar performance masking lingering

weaknesses in the debt-laden periphery, where crippling competitiveness losses, structural inefficiencies and aggressive fiscal consolidation continue inhibit economic activity. But, Germany's quite strongly dependence on exports could become a further concern for the Eurozone growth outlook, as a bulk of global leading indicators point to a renewed deceleration in the pace of the world economic activity. That risk was highlighted by European Commissioner for Economic and Monetary Affairs, Olli Rehn, who warned recently that a slowdown in China, India or the US would have a "serious negative impact" on Eurozone growth. Separately, S&P cut Ireland's long-term sovereign credit rating by one notch to AA- and retained a negative outlook, saying that the cost to the government of supporting the financial sector has increased significantly. Furthermore, renewed concerns about Irish banks, kept investors on edge. Bank of Ireland (more than 1/3-owned by the government) reported in mid-August a pre-tax H1 2010 loss nearly twice as large as that reported a year ago. In addition, state-owned Anglo Irish Bank received approval for an €10 billion recapitalization from the European Commission, on top of emergency funding of €4 billion in 2009 and more than €10 billion in March this year.

Risk assets retreat from early-August highs

Reflecting the recent deterioration in market sentiment, global equity markets retreated from their early-August highs in recent weeks, failing to gain from sizable M&A activity. Indicatively, the Eurofirst 300 index slid to a five-week low in late August, currently standing some 5% lower from a near three-month peak recorded early this month. In the European corporate credit space, the investment-grade iTraxx Europe index hit last week its highest level since mid-July, while the iTraxx Senior Financials widened to its highest level since July 6 following a temporary decline to four-month lows in early August. In a similar vein, the S&P 500 implied volatility index, VIX, bounced to a near two-month high, coming close to the psychologically important level of 30.0.

Economic recovery in New Europe continued in Q2...

The recovery witnessed in most economies in the region in Q1:2010 continued broadly uninterrupted in the second quarter of the year, despite the disruptive effects of the deepened sovereign debt crisis in the euro area. The rebound has so far been mostly driven by base effects, the rebuilding of business inventories following an aggressive decumulation phase in the post-Lehman period and higher exports to main trading-partner economies. On a less positive note, domestic-demand dynamics remained weak in most economies in the region, with the bright exception of Turkey (+17.2% YoY

in Q1) and, to a lesser, Poland (+2.2% YoY in Q1 and 3.9% YoY in Q2). Among the rest of economies covered in this report, Serbia's GDP growth rose by (a preliminary) 1.6%yoy in Q2 2010, following a 1%yoy gain a quarter earlier. Elsewhere, the pace of economic contraction in Bulgaria slowed to -1.5% yoy in the second quarter, from -3.6% in Q1. Similarly, Romania's economy shrank less than anticipated in Q2 (-0.5% YoY), while on a quarterly basis, growth bounced back into a positive territory (+0.3%), suggesting that the country (temporarily) exited recession, at least from a technical standpoint. In Ukraine, GDP grew 6.0%yoy in the second quarter of the year following growth of 4.9%yoy in Q1.

...but pace of rebound is seen moderating in H2 on fiscal policy restrain, slower growth in major trading-partners

A critical mass of real activity and sentiment indicators point to a continuation of economic expansion in most countries in New Europe. Yet, most recent evidence suggests that the pace of recovery may slowdown somewhat in the second half of the year, especially in economies that still experience weak domestic-demand dynamics and continue to rely mainly on higher exports (*to core euro area and, primarily, Germany*) to generate positive GDP growth. Truth be told, a slower than previously anticipated world growth trajectory in H2 and fiscal austerity measures employed by a number of governments in the region were unlikely to leave economies in New Europe entirely unaffected. Yet, barring any unforeseen circumstances, including *e.g.* a double-dip in the global economy (*a still low probability scenario*), we anticipate the present soft-patch to prove only temporary. That is because most economies in the region possess the necessary credentials to resume sustainable growth from 2011 onwards; especially as the post-Lehman economic recession has facilitated a pronounced correction of long-standing imbalances, including bubbly housing markets, overheating demand conditions and bloated external sectors. Romania is likely to be an underperformer in terms of GDP growth in the region, at least in the 3rd and 4th quarters of this year, as the new austerity fiscal measures introduced recently by the government are likely to weigh further on domestic demand.

Inflation pressures in the region remain broadly tame but risks linger

Price pressures in most economies in New Europe were broadly subdued in recent months, as domestic demand dynamics remain weak and the economic uptrend has so far been mainly driven by exports. Accumulated evidence suggesting that the global economic recovery is

likely to prove more moderate than previously anticipated and the recent softening in world oil and commodity prices have assisted to keep inflation expectations broadly contained, with market participants scaling back expectations for an inception of monetary tightening by a number of central banks in the region as early as in the current year. Among them, the Central Bank of Turkey (CBT) revised its medium-term inflation projections lower due to a weaker outlook for external demand, softer unprocessed food prices and a stronger-than-anticipated deceleration in domestic pipeline price pressures. Moreover the Bank clearly nullified its earlier view for rate hikes as early as in Q4:2010, highlighting in its latest inflation report that its baseline scenario is now for a resumption of monetary tightening in 2011. In similar vein, the latest policy statement from the Central Bank of Poland delivered a broadly balanced assessment with the respect to monetary policy outlook ahead, disappointing market hawks who were looking for more concrete signal for a NBP rate move (*i.e.*, hike) by the end of this year. Note here that the ECB is now seen incepting a policy normalization campaign not earlier late 2011/early 2012, meaning that a premature rate hike in Poland could induce an unwanted strengthening of the zloty, threatening the still export-driven economic recovery.

Despite broadly subdued price pressures in the region so far this year, upside risks on inflation loom ahead. Undoubtedly, as output gaps turn positive and the global recovery becomes more sustainable, domestic price pressures are likely to intensify anew. More imminently, the spike in wheat prices in the summer months due to adverse weather conditions across Central & Eastern Europe and the CIS region is posing inflation risks near-term, that can be amplified by the recent weakening in a number of regional currencies. In Turkey for instance, the Ramadan season in August and September traditionally sees temporary rises in food prices. In Romania, things look significantly more worrying as the 5ppts VAT rate hike implemented in early July is seen pushing headline inflation well above 8%yoy in the following months.

Regional stock markets under pressure on resurfaced global economic worries

Financial markets in New Europe came under renewed pressure in August amid growing worries over the pace of the global economic recovery. A downward revision in the global growth outlook following a string of disappointing data from the US and a number of major Asia emerging economies is to blame. Meanwhile, concerns about the debt crisis in the euro area – though having eased somewhat after the release of the

European banks stress tests – continue to keep market participants on the edge. Major stock indices in the region broadly recoiled in late August from 3-month peaks hit a few weeks earlier. The *MSCI Emerging Europe* sub-index currently stands some 4% lower year-to-August, while over the same period, the *Eastern Europe* sub-index lost ca 6%. Nevertheless both indices remain above 1-year lows touched in May, when euro area sovereign debt concerns escalated, outperforming the *Developed World* sub-index which registered a 7% drop over the first eight months of the year. Ukraine's PFTSI index remains an outperformer, having registered gains in excess of 40% since the beginning of the year. In a similar vein, main stock market indices in Turkey and Bulgaria stood in late August some 11% higher relative to their levels early this year.

Local bond markets remain supported by bullish rate trends globally, scaled-back expectations for policy tightening by regional central banks

Recent downward revisions in the world economic outlook have favored rate markets around the globe. The ensuing bout of risk aversion prompted a rally in safe-haven government debt, with scaled-back expectations for higher policy rates by major central banks providing additional support. Local rate markets in New Europe have largely benefited by the recent rally in major government bond markets, Poland's 2-year and 10-year benchmark bond yields recently approached multi-month lows touched in April, recording respective troughs of 4.55% and 5.29% in late August. Elsewhere, Turkey's April 25, 2012 benchmark bond yield slid to near 8.00% levels recently, assisted by improving domestic inflation dynamics which overshadowed fiscal concerns following a government decision to delay the much awaited fiscal rule. On the flipside, earlier forecasts for further rate cuts by central banks in Hungary and Romania recently shifted towards a no-policy-change outlook over the coming months as inflation risks loom ahead. Along these lines, Hungary's 3-year benchmark bond was hovering over the last few sessions not far from a multi-month peak of 7.32% touched in late July, when the government signaled it would not opt to renew a financial aid deal with the IMF raising concerns about the country's capacity to finance itself through the bond markets next year. Meanwhile, the 10-year benchmark bond yield was nearly 70bps lower at 7.35% compared to a 9-month peak hit in June.

Regional FX markets mostly under pressure recently, but still well off lows touched in the January and May episodes

Local currencies remain close to multi-week lows touched a few sessions ago amid growing growth

concerns and fiscal-related worries. In late August, the Polish zloty approached anew a 2-½-week trough of 4.0262/EUR hit a few sessions earlier to stand at ca 3.99 at the time of writing. In a similar vein, the Turkish lira stood at 1.5260 against the U.S. dollar from 1-month lows of 1.5357/USD touched on August 24, when the Hungarian forint came under significant pressure after the NBH revised downward its outlook for the domestic economy with inflation and fiscal concerns also adding to the currency's downtrend. After touching record lows against the euro, the Serbian dinar re-gained some composure over the last few sessions, receiving some support from numerous interventions by the central bank aimed at halting its sharp year-to-date downtrend (*EUR/RSD~105.36 at the time of writing vs. an all-time high of 107.78 hit in early August*). Elsewhere, Romania's leu remained relatively flat over the last couple of months against the single currency, with the EUR/RON rate standing around 4.26 vs. a record peak of 4.4023 touched in late June, after the Constitutional Court ruled against part of the government's fiscal austerity package, fanning worries over the country's fiscal outlook.

External debt spreads widened in August but remain at historically tight levels

External debt spreads in New Europe, especially in the CDS space, have widened by ca 10% since early August, reflecting heightened fears over a double-dip in the world economy and lingering worries over the sovereign debt crisis in the euro area. Yet, sovereign CDS spreads in most countries in the region remain not far from lows touched in the wake of the well-received European bank stress tests and some of them are currently below their pre-Lehman levels (*e.g. Turkey*). Hungary and Poland pose among the major underperformers in the August spread widening, with the former's 5-year CDS having bounced by nearly 24bps to 157bps currently, and the latter by 44bps to 368bps.

Strategy

We expect local rates markets to continue to broadly outperform other major asset classes in New Europe for as long as concerns about a re-weakening of global economic growth continue to fuel flight-to-safety flows and deflate expectations for imminent rate hikes by central banks in the region. Relatively contained inflation pressures in the foreseeable future also conspire in favor of the aforementioned. Meanwhile, local currencies are generally likely to remain under pressure near-term, given lingering market uncertainties and scaled-back policy rate expectations. We continue to expect the Polish zloty and the Turkish lira to outperform other regional currencies over the next 3-6months, supported by

strengthened domestic fundamentals, manageable sovereign borrowing requirements and higher FDI. That said potential headwinds lie ahead in the face of looming political developments, as both countries are braced for general elections next year (a key referendum in Turkey is being scheduled for September 12, 2010). Elsewhere, most external debt markets in New Europe continue to be quite expensive at current levels. And should the double-dip scenario materialize, sovereign bonds are likely to be hit hard. In all, although we remain constructive on the region in the medium-term, particularly towards Poland and Turkey, significant near-term risks lie ahead. The impact of renewed global recovery concerns on emerging markets globally, and in New Europe in particular, has proved relatively muted so far. Yet, a more severe bout of global risk aversion could take a much heavier toll on regional market in the period ahead.

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II. New Europe – Country Analysis

Bulgaria

Stable macroeconomic outlook

- **With domestic demand still suffering, Bulgarian economy is set to contract again in 2010 by 0.3% yoy**
- **The hikes in excise taxes and regulated prices combined with higher food prices will push inflation towards 4% by year end**

Output losses were contained in Q2 with net exports providing support

GDP continued to decline in Q2 albeit at a slower pace. According to the flash estimate, GDP contraction slowed to -1.5% yoy in Q2 against -3.6% in Q1. The reading was little worse than analysts' expectations. According to a Bloomberg survey, the median forecast of economists was for a contraction of 1.3%. From a sectoral standpoint, agriculture expanded by 1.6% yoy. The gross value added in industry posted a -0.3% yoy decline, following a -0.9% contraction in Q1. The latter was a reflection of two opposing forces: weak construction activity due to still anemic conditions in the domestic real estate market coupled with a strong rebound in manufacturing output. Services appear to be the only sector which registered a steeper decline in Q2 (-1.7% yoy against -1.2% yoy in Q1), which is in line with the weak domestic demand.

The pace of contraction in private consumption accelerated to 7.6% yoy, from 6.8% in Q1. Government spending was also particularly weak (-19.9% yoy in Q2) affected by the government's fiscal consolidation program. On the other hand, investments recorded a much milder decline in Q2 (-1.4% yoy compared to -15.8% yoy in the prior quarter and -24.9% in the full-year 2009). The much milder pace of contraction reflects mainly base effects from last year, rather than an improvement in the business sentiment. On the other hand, the ongoing improvement in the external sector remains the bright spot in Bulgaria. At the same time, imports continued to decline, albeit at a slower pace (-1.2% yoy in Q2 vs. -2.6% in the first quarter). Thus, the contribution of net exports to growth turned even more

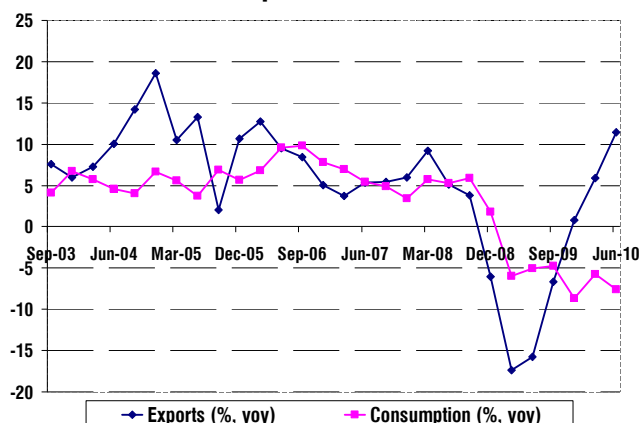
Bulgaria: Eurobank EFG Forecasts

	2008	2009	2010f	2011f
Real GDP (yoy%)	6.0	-5.0	-0.3	2.5
Private Consumption	4.8	-6.2	-3.0	2.0
Government Consumption	0.0	-5.7	2.0	0.4
Gross Capital Formation (<i>Fixed</i>)	20.4	-26.9	-8.0	2.5
Exports	2.9	-9.8	6.5	5.0
Imports	4.9	-22.3	-0.5	4.0
Inflation (yoy%)				
HICP (annual average)	12.0	2.5	3.0	2.7
HICP (end of period)	7.2	1.6	4.2	3.0
Fiscal Accounts (%GDP) - EU Methodology				
General Government Balance	1.8	-3.9	-3.8	-2.8
Gross Public Debt	14.1	14.8	18.6	21.7
Primary Balance	3.9	0.0	-2.0	-1.5
Labor Statistics - National Definitions				
Unemployment Rate (% of labor force)	6.3	7.6	9.0	8.0
Wage Growth (<i>total economy</i>)	26.5	8.5	2.0	2.5
External Accounts				
Current Account (% GDP)	-25.4	-9.4	-5.5	-7.0
Net FDI (EUR bn)	6.2	3.3	1.0	1.5
FDI / Current Account (%)	75.8	103.6	98.0	60.0
FX Reserves (EUR bn)	12.7	12.9	12.0	11.5
Domestic Credit	2008	2009	Q1 10	Q2 10
Total Credit (%GDP)	75.2	79.2	78.9	79.2
Credit to Enterprises (%GDP)	47.8	49.4	49.2	49.4
Credit to Households (%GDP)	26.0	28.2	28.1	28.1
FX Credit/Total Credit (%)	57.2	58.6	59.5	60.1
Private Sector Credit (yoy)	32.3	4.5	3.3	2.8
Loans to Deposits (%)	119.3	120.5	116.3	114.3
Financial Markets	Current	3M	6M	12M
Policy Rate		Currency Board		
EUR/BGN	1.96	1.96	1.96	1.96

Source: National Sources, Eurostat, IMF, Eurobank Research

positive in Q2, compared to the first quarter of 2010 (Figure 1).

Figure 1
Private consumption weakness continues



Source: National Statistics, Eurobank Research

Economy likely to remain in recession this year and grow only modestly in 2011

In line with what we suggested in our previous New Europe Economics & Strategy issues, the most recent macro data confirm our view that the worst of the domestic recession was seen in the last quarter of 2009. For the time being, the continued slump in domestic demand is being outweighing partially the recovery in net exports. Year-to-June, consumption was down by 6.7%

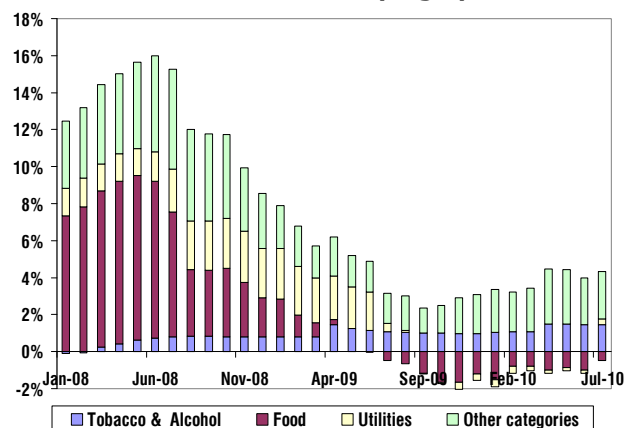
yoy, while investments decreased by 7.2% yoy. On the other hand, exports increased by 8.9% yoy, whereas imports were down by 1.8% yoy over that period. For the year 2010 as a whole, we don't anticipate domestic demand to have a positive contribution to overall GDP growth, given the former's pace of contraction in H1. Yet, we expect domestic economic activity to start recovering slowly in the coming quarters, with the contribution of domestic demand becoming gradually less negative. If this is combined with net exports, GDP growth should be turning positive in the second half of the year, especially in Q4. If positive exports dynamics don't fade out in H2, we stick to our earlier forecast for an overall, output contraction of -0.3% yoy in 2010, which is now quite close to the market's consensus (Focus Economics Consensus in August: -0.4% yoy). IMF maintains its GDP growth forecast +0.2% for 2010, while the government has revised its own forecast to +0.5% from 0.3% initially in the budget. Yet, risks clearly lie to the downside with respect to the latter forecasts, especially if the recovery in export markets (mainly EU-27) proves to be weaker than expected.

Inflation creeping up on base effects and higher excise taxes & regulated prices

Following a period of subdued price pressures, domestic inflation is creeping up anew. The latter is not due to demand-side pressures, but rather it is mainly because of higher excise taxes and regulated prices. CPI stood at 2.4% yoy in July, compared to 1.4% yoy in the prior month and 0.4% yoy in January. Accordingly, the Harmonized Consumer Price Index (HICP) increased from 2.5% yoy in June to 3.2% yoy in July (the fourth highest rise in the EU-27) against 1.7% yoy in Eurozone. The rise of indirect taxes on cigarettes and alcohol in early 2010 accounted for more than half of year-on-year inflation in July. Specifically, prices of tobacco & alcohol products increased by 27% yoy in July, contributing ca 1.5pps to July CPI (+2.4%). On top of that, the recently sanctioned hikes in gas and electricity (~17.5% weight in the CPI basket) pushed regulated prices 1.2% mom higher in July, adding another 0.3 pps to the corresponding year-on-year inflation figure that month (Figure 2). We anticipate domestic inflation to remain in a rising trend during the second half of the year. Base effects from the components which recorded the steepest declines in 2009 will start to fade out, notwithstanding any second round effects from higher energy prices. For instance, components with high weights in the CPI basket such as food and beverages (~36.8%) are expected to record positive growth in H2, following a protracted period of deflation. As an illustration of this, food price deflation narrowed to 0.0%/-1.4% mom/yoy in July, from -2.7%/-2.8%

mom/yoy in the prior month and 0.8%/-4.3% mom/yoy in January 2010. The rally in wheat prices recorded during the summer months as a result of the fires in Russia is expected to push food prices even higher in the remainder of the year. Nevertheless, we don't expect them to have such a pronounced impact on overall inflation as in 2008, when a severe drought destroyed domestic crops.

Figure 2
Inflation is creeping up



Source: National Statistics, Eurobank Research

We expect domestic inflation to reach levels around 4% by the end of this year. If that happens, average annual inflation will remain broadly unchanged from last year (Eurobank EFG Research forecast: 2.7% yoy in 2010 vs. 2.8% yoy in 2009). Yet, our forecast is based on the implicit assumption of unchanged VAT rates during 2010. Should there be a rise in VAT tax rates, which is not the most probable scenario for the time being, domestic inflation should turn out to be even higher this year.

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Poland

Q2 GDP data shows economic rebound is gathering pace

- **Polish economy grew by a stronger than expected 3.5% yoy in Q2-2010 accelerated from 3.0% yoy in Q1-2010**
- **Q2 domestic demand growth was primarily driven by higher private consumption and recovering investment. On the other hand, the external sector was a negative contributor to GDP growth for the first time since the start of 2009, as imports grew faster than exports**
- **IMF approved, in early July, a new 1-year lending facility for Poland worth \$20.43bn under its existing Flexible Credit Line**
- **Government embarks on aggressive privatization program to contain public debt growth ahead of 2011 parliamentary elections. Temporary hike (for 3 years) in main VAT rate, by 1ppt to 23%, to be implemented in January 2011**
- **Polish inflation surprised on the downside in July, easing to 2.0% yoy and remaining below the lower bound of the NBP's target for the fourth month in a row**
- **The National Bank of Poland kept its policy interest rate unchanged at 3.50% for the 14th month in a row on the back of contained inflation pressures and lingering uncertainty over the pace of recovery in Western economy.**

Strengthened political stability after early-July Presidential elections run-off

Strengthened political stability after PO (the ruling party) candidate and acting President, Bronislaw Komorowski, won in early July the second round run-off election against PiS (the main opposition party) candidate and former Prime Minister, Jaroslaw Kaczynski. The election result is considered to be positive for market sentiment towards Poland as it is expected to facilitate decision making within the PO-PSL coalition government. Under former PiS President, Lech Kaczynski, the government

Poland: Eurobank EFG Forecasts

	2008	2009	2010f	2011f
Real GDP (% yoy)	5.0	1.8	3.2	3.4
Private Consumption	5.8	2.3	2.7	3.0
Government Consumption	7.4	1.9	2.4	1.8
Gross Capital Formation	6.4	-13.8	-0.2	1.8
Exports	7.3	-7.8	6.0	5.5
Imports	8.4	-13.5	5.8	6.5
Inflation (% yoy)				
CPI (annual average)	4.2	3.5	2.5	2.7
CPI (end of period)	3.3	3.5	2.6	2.8
Fiscal Accounts (% GDP)				
General Government Balance	-3.7	-7.1	-7.3	-7.0
Gross Public Debt	47.2	51.0	55.0	57.0
Labor Statistics (%)				
Unemployment Rate (% of labor force)	9.8	11	11.9	12.1
Wage Growth (<i>private sector - average</i>)	NA	4.2	3.0	3.2
External Accounts				
Current Account (% GDP)	-5.0	-1.6	-3.0	-3.2
Net FDI (bn EUR)	8.0	6.1	7.5	8.5
FDI / Current Account	43.7	122.2	80	85
FX Reserves (bn EUR)	40.6	54.8	62	64
Domestic Credit	2008	2009	Q1-10	Q2-10
Total Credit (% GDP)	50.9	53.1	52.2	54.4
Credit to Enterprises (% GDP)	17.6	16.1	15.7	15.8
Credit to Households (% GDP)	29.7	31.6	31.6	33.6
FX Credit/Total Credit (%)	32.6	30.2	29.3	31.8
Private Sector Credit (% yoy)	38.1	7.2	1.2	7.2
Loans to Deposits (%)	106	102.6	100.6	103.2
Financial Markets	Current	3M	6M	12M
Policy Rate	3.50	3.50	3.75	4.00
EUR/PLN	3.99	3.90	4.00	3.90

Source: NBP, EcoWin, Bloomberg, Eurobank Research

was constantly confronted with the threat of a presidential veto, lacking the 3/5th parliamentary majority needed to overrule. Nevertheless, with local elections scheduled for later this year and parliamentary elections in 2011, domestic politics will continue to attract market attention in the period ahead.

IMF approves new \$20.43bn FCL facility for Poland

In early July, the IMF approved a one-year successor arrangement for Poland under its regular Flexible Credit Line (FCL) facility for a total amount equivalent to ca. \$20.43bn. The Polish authorities intend to treat the arrangement as precautionary and do not intend to draw from the FCL.

GDP growth up by a higher-than-expected 3.5%yoy in Q2

Polish GDP grew by 3.5%yoy in Q2-10 accelerated from 3.0%yoy in Q1-10. On a quarter-on-quarter basis, growth was strong as well, coming in at 1.1%qq from a revised 0.7% rate in the prior quarter. Higher domestic demand growth driven by stronger private consumption and recovering investments contributed some 3.9ppts to overall GDP growth in Q2. Further, as import growth outpaced export growth, for the first time since the start of 2009, net exports contributed negatively in the second quarter. Nevertheless, the dynamics of Polish exports were impressive in the second quarter, thanks, primarily,

to a vibrant industrial recovery in Germany (Poland's main trading partner) and the weaker zloty in May and June. Exports grew by 5.8%qoq (17%yoy), while imports were also up by 1.5%qoq (18.2%yoy). Private consumption expanded 3.0%yoy in Q2 vs. 2.2%yoy in Q1. Hence, the Polish consumer continues to hold up quite well. On the other hand, investments continue to weigh on GDP growth but to a less extent. Gross fixed capital formation declined by 1.7%yoy in Q2 compared to the 12.4%yoy drop recorded in Q1-10 (Table 1). In all, we expect full-year growth in total investments to remain negative in 2010, posing downside risks to the domestic economic outlook. Despite the stronger-than-expected Q2 GDP print, we anticipate economic growth to soften somewhat in the second semester of the year on the back of the ongoing soft-patch witnessed in main trading-partner economies and, as such, a possible deterioration in export markets later in the year. We forecast GDP growth of 3.2%yoy in 2010 and 3.4%yoy in 2011.

Table 1
Polish GDP breakdown

	Q2-2010	Q1-2010	Q4-2009	Q3-2009	Q2-2009	Q1-2009
GDP growth % yoy	3.5	3.0	3.3	1.8	1.5	3.8
GDP growth % qoq	1.1	0.7	1.2	0.7	0.5	0.4
Private consumption	3.0	2.2	1.7	2.3	1.6	3.3
Fixed Capital Formation	-1.7	-12.4	1.1	-1.4	-3.3	-0.8
Domestic demand	3.9	2.2	0.9	-1.3	-2.3	-1.6
Exports	17.0	9.8	1.8	-7.5	-12.3	-13.2
Imports	18.2	7.9	-4.4	-13.5	-18.8	-17.4

Source: Central Polish Statistics Office, Eurobank Research

Industrial production in July was less strong than expected, but continued to expand at a double-digit pace (+10.4% yoy vs. 14.5% yoy in the prior month). In a similar vein, the July PMI survey showed continuing expansion in the domestic manufacturing sector, with the headline reading standing at 52.1 (i.e., above the boost-or-burst threshold of 50) and strong gains reported in the key new orders and employment sub-indices.

With respect to the most recent indicators of consumer vigour, July retail sales stood at 3.9%yoy vs. 6.4%yoy recorded in June. Annual wage growth fell back to 2.1%yoy in July, from 3.5%yoy in June. These readings possibly suggest a less impressive private consumption growth reading in Q3, relative to that in the second quarter. On a more positive note, unemployment seems to have peaked earlier this year; coming in at 11.4% in July, from 11.6% in the prior month and 13% in February.

Current account deficit widens, but still at very manageable levels

Poland's current account deficit embarked on a gradual re-widening trend since the beginning of 2010 after having declined significantly last year (to 1.6% of GDP in 2009 from 5.1% of GDP in 2008). This has been mainly the result of a strong bounce in imports due to strengthening domestic demand dynamics, with the strong growth in exports (20% year-to-June) providing less of an offset. The current account gap is expected to widen further in the following months, reaching for the full-year, levels around 3.0% of GDP.

On a more reassuring note, strong capital inflows in the form of FDI and portfolio investments continue to provide comfortable coverage of the external imbalance, having already resulted in €12bn rise in FOREX reserves in the first semester of 2010. Over that period, FDI and net portfolio inflows amounted to €3.9bn and €10.5bn respectively, while Poland also raised €5.9bn from international markets via the issuance of Eurobonds.

Fiscal situation remains a cause of concern

The government aims to raise PLN25bn through privatization of state assets this year, with inflows already amounting to a higher-than-expected PLN12bn in H1. With the coalition government remaining unwilling to take strong action to reduce the fiscal deficit in any meaningful way ahead of next year's parliamentary election, aggressive divestiture of state assets appears to be the only possible strategy to prevent the public debt to GDP ratio from breaching the 55% constitutional threshold this year and the next. Note that the public debt reached almost 51% of GDP in 2009.

In early August, the government approved a four-year fiscal plan that aims to lower the general government budget deficit below the EU's 3% of GDP ceiling by 2013, meaning that Poland will not meet the deficit reduction deadline set by the European Commission for 2012. The government forecast privatization receipts in 2010-2013 to amount to PLN55bn which are expected to come from the sale of stakes in state companies including PKO BP bank and insurer PZU. Another key element in the plan to consolidate Polish finances is to hike the main VAT by 1% to 23% temporarily for three years. Prime Minister, Donald Tusk, said that the plan would help Poland to fulfil the Maastricht criteria for euro adoption by 2015, without however official announcing a new date for euro entry. It's worth noting that this fiscal plan lacks cohesive structural reforms in either the pension system or the labour market.

The 2011 budget plan was also introduced in conjunction with the fiscal strategy. The government is targeting a PLN45bn budget deficit for 2011; lower than last year's PLN52bn target. The economic growth and inflation assumptions used to underpin the 2011 budget plan were 3.5%yoy GDP growth and CPI of 2.3%yoy.

Inflation under control

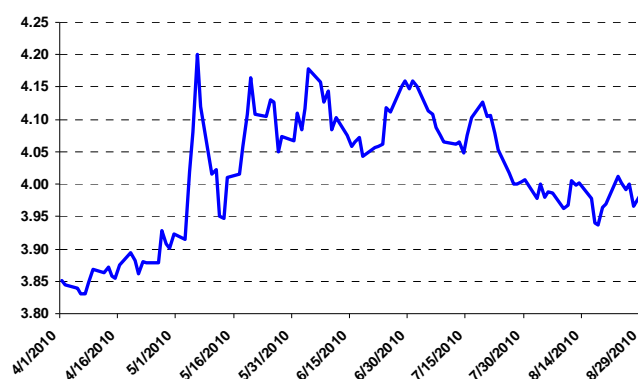
Polish inflation surprised on the downside in July when it eased to 2.0%yoy from 2.3%yoy in June, beating consensus expectations for a 2.2%yoy print. Headline inflation remained below the lower bound of the NBP's target for the fourth month in a row. Favourable base effects on domestic food and utility prices have been the main contributors to disinflation during the first half of this year. What's more, Polish net inflation, a measure which excludes food and energy prices, is falling too; it stood at 1.2%yoy in July, down from 1.5%yoy in June. We expect inflation pressures to remain contained in the remainder of the year on the back of restrained wage growth. However, the possible impact of the recent flooding to food prices might have some upside risks to inflation outlook in the coming months. We anticipate annual inflation to average ca 2.5%yoy in 2010 compared to 3.5%yoy in 2009. Meanwhile, the 1% hike in VAT to be implemented in January 2011 and last for three years will add to inflation pressures next year. Yet, Central Bank President, Marek Belka, said that he does not expect the VAT hike to have significant effect on inflation. From the start of next year, VAT hikes could add some 0.3 to 0.5ppts to headline inflation.

NBP seen start hiking policy rates from Q1 2011 onwards

In late August, the National Bank of Poland (NBP) kept its policy interest rate unchanged at 3.50% for the 14th month in a row; its last change was a 25bps in June 2009. In the press release following the meeting of the MPC, it was noted that conflicting forces are at play with regard to the inflation outlook. Overall, the statement provided a more balanced view on the outlook of monetary policy, disappointing market hawks looking for more concrete hints for an imminent rate hike. Poland enjoys positive real interest rates since February 2010 and so there is no rush to raise policy rates until inflation embarks on a more sustained uptrend. An important argument for not raising rates is also the continued uncertainty over the pace of economic recovery in Western European economies, where a big volume of Polish exports are destined to. In addition, a recent string of softer-than-expected domestic data in July (including, among others, softer inflation, wage growth, industrial output and retail sales), coupled with the recent strengthening of the zloty reinforce the case for

unchanged policy rates over the remainder of the year (Figure 1). All in all, we do not anticipate any interest rate hike in 2010, given weak inflation pressures and risks for somewhat slower GDP growth in the second semester of the year. We expect rate increases to start in Q1-2011 taking the key policy rate to 4.00% by year-end. By contrast, the market is pricing in rates rising sooner -in Q4-2010- and faster, reaching 5.00% by the end of 2011.

Figure 1
Recent strength of the zloty following Q2-2010 appreciation indicates high currency volatility



Source: Reuters, Eurobank Research

Credit growth in an upward trend since May

Total credit grew by 3.4% mom in June, up from 2.4% mom in May. Since May total credit returned to positive growth after having followed a downward trend since the beginning of the year. What's more, total credit increased by 5% year-to-June. In particular, household credit rose by 9.1% year-to-June with mortgages loans increasing by 12.3% over the same period. Total deposits remained on an upward trend growing by 4.6% year-to-June with household deposits rising by 4.2% year-to-June.

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Romania

The threat of double dip recession is looming

- **Positive quarter-on-quarter GDP growth in Q2, for the first time since Q3-2009; yet improvement may prove short-lived**
- **Fiscal deficit widens further to 3.9% of GDP in the first seven months, signaling weakness on the revenue-collection side and higher arrears**

Second quarter GDP improved on a quarter-on-quarter basis

As in a number of countries in New Europe, GDP in Romania improved in Q2, though it remained in a negative territory on a year-on-year comparison.. According to the most recent flash estimate, GDP declined by -0.5%yoy in Q2, following a 2.5%yoy contraction in the prior quarter. On a seasonally adjusted basis, GDP grew by 0.3%qoq, a figure which is marginally positive for the first time since the third quarter of 2009. The reading was weaker than the market's consensus forecast of 0.5%qoq and up from -0.3%qoq in Q1.

Up to a certain extent, the GDP growth acceleration in Q2 gives a false impression of improvement. The reality is that the economy is still mired in recession, with the second quarter bounce likely to prove temporary. The domestic downturn is expected to intensify in the remainder of the year on the back of steep cuts in public wages and the recently introduced VAT rate hike. The new austerity measures, put into effect on July 1st, will hit domestic demand which is already the weakest link of the Romanian economy. The five percentage points VAT hike from 19% to 24% is eroding the purchasing power of Romanians. The public wage cuts by 25% and the slashing of public spending on goods and services by another 20% put disposable incomes under more pressure. As such, the 4.8%yoy improvement recorded in retail sales in June probably reflects anticipatory spending of domestic consumers ahead of the imposition of the new VAT rates and thus, it may well be reversed in the coming months. Higher VAT rates pushed consumers to step up their spending so as to secure enough stocks with lower prices in a period of constrained household budgets. The situation in the domestic labor market is not encouraging either, though the unemployment rate eased to 7.4% in June, from a peak of 8.4% recorded in March. The proposed public

Romania: Eurobank EFG Forecasts

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

Source: National Sources, Eurostat, IMF, Eurobank Research

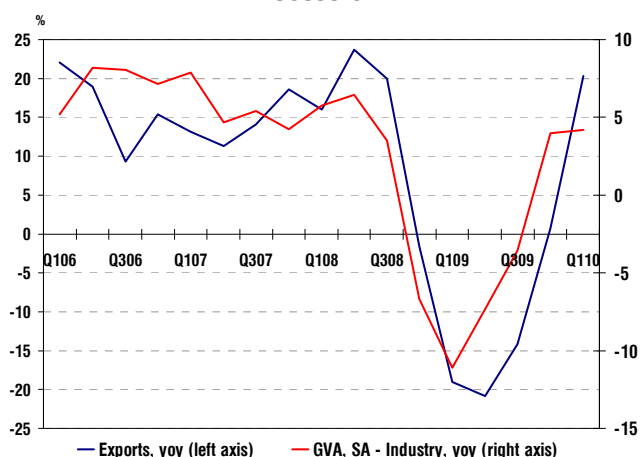
sector lay offs (the figure could reach 250,000 according to media reporting) will only make the problem worse. In addition, the outlook for credit activity remains bleak despite the Central Bank's efforts to revive lending. In our June issue of *New Europe Economics & Strategy*, we attributed the ongoing stagnation in the domestic credit market to insufficient demand rather than inadequate supply. In retrospect, private-sector credit growth has landed abruptly from a peak of 66.4% yoy/4.0% mom in March 2008 to 6.4% yoy/-1.9% mom in July.

Consequently, private consumption is set to plunge again by another 5% in 2010 after contracting by 9.4%yoy in 2009. Investment spending is not likely to prove supportive either with the all-important construction sector continuing to record double-digit contraction rates throughout the first four months of 2010 (-20.9%yoy in May vs. -21.3%yoy in Q1).

The only bright news seems to come from the industrial sector, which is a plus for GDP growth. Industrial production grew in June for the fourth straight month, accelerating to 6.7%yoy, from 5.8%yoy in May. The improvement is driven largely by the rebound in exports. The latter grew by 25.8%yoy in January-June, pulling the domestic manufacturing sector out of the recession. The surge in factory orders (34.6%yoy in June) points to a continuation of strong manufacturing activity, at least for

the near future. Yet, the pace of improvement in the industrial sector is set to slow in the second half of the year. Indeed, weaker domestic demand will hit not only household balance sheets but also factory orders. In addition, base effects are not favorable for the manufacturing sector in H2, notwithstanding any possible deceleration in external demand. As a result, we anticipate full-year industrial production growth to slow to around 3%yoy from 5.5%yoy in H1-2010).

Figure 1
Exports pulled manufacturing out of recession



Source: National Statistics, Eurobank Research

In conclusion, the tough austerity fiscal package will result in economy contracting again in 2010 (GDP contracted by 1.5%yoy in H1). Growth is expected to be equally negative, if not worse, in the second half of this year. Hence, we anticipate that GDP is more likely to contract by 2% in 2010. In a similar vein, IMF downgraded its forecast to -2% against -0.5% in early August. EBRD is even more pessimistic, now foreseeing a 3%yoy growth contraction against a flat reading projected earlier this year. Risks to our 2% yoy GDP forecast in 2010 are skewed to the downside. The uncertainties with respect to the implementation of the fiscal consolidation program are high and may weigh negatively on the growth outlook. The biggest risk to the outlook of private consumption stems from any further government measures aimed to boost budget revenue (for example a new hike in VAT or the flat income tax rate). Furthermore, the potential spillover impact of a slowdown in the Eurozone recovery on the external sector will put even more strain on the domestic economy.

Fiscal deficit widened further in the first seven months of 2010

The consolidated budget deficit climbed to RON 20 billion in the first seven months of 2010, rising by 13.9%yoy. As a percentage of (projected) full-year GDP, the consolidated government deficit stood at 3.9% in July, compared to 3.6% in June and 3.5% in the same month of last year and against a full year target of 6.8%-of-GDP.

The government has negotiated twice the current year's fiscal target with the IMF. Originally projected at 3.6%-of-GDP, the fiscal deficit target was eventually raised to 5.8%. Yet, the latter was still based on the optimistic assumption of a swift return to economic growth this year. The government put a lot of effort to achieve the RON 18.2bn corresponding budget deficit target for H1. Indeed, the target was attained at the expense of incurring significant unpaid bills (arrears) to the private sector (contractors, suppliers etc). Given the negative GDP growth dynamics, the IMF indicated that without further corrective action, the full-year budget gap would skyrocket to 9.1% of GDP. As a result, the government came up with a fiscal correction package at the IMF request to reduce the 2010 deficit by 2.3pps of GDP. The fiscal consolidation package included steep cuts for wages and pensions (horizontally by 25%yoy and 15%yoy, respectively). The Constitutional court decision not to allow for the pension cuts resulted in the announcement of offsetting revenue-enhancing measures to counterbalance the shortfall.

Revenue collection in the first seven months of the year was lagging behind budget planning. Total revenues were up by only 1.4%yoy against a targeted increase of 4.6%yoy over the corresponding period. Although the year-to-July growth of tax revenues was slightly stronger than in the same period a year earlier, tax collection was still problematic. Receipts from income tax and social contributions were also lower (by -6.3%yoy and -5.3%yoy, respectively), reflecting the impact of the weak labor market conditions.

VAT revenues also underperformed despite the 5pps VAT rate hike (from 19% to 24% effective from July 1st). VAT revenues were lower by 0.8%yoy in January-July, against -3.7%yoy in H1. In our previous (June 2010) issue of *New Europe Economic & Strategy*, we suggested that the risk of the VAT rate hike falling short of generating the expected results was not minimal. The data released so far appear to have corroborated the latter view. That is because higher tax rates in a recessionary environment generates additional tax evasion, lower economic activity and thus, lower tax

revenues. This is particularly the case in Romania where a large part of the economic activity is not yet properly recorded -grey economy.

On the expenditures side, total budget outlays were modestly higher (by 3.2%yoy) year-to-July. This was the combined result of a massive cut backs in capital spending (-23.2%yoy) and increased social security expenditure for unemployment benefits (+11.2%yoy). On a more positive note, we anticipate that the fiscal data for August will look better, as they will incorporate the impact of the 25% public wage cut and some further improvement in VAT revenue collection.

In our view, the 6.8%-of-GDP (revised) fiscal target looks more attainable than the previous ones, yet its fulfillment continues to be a Herculean task. The attainment of the target would require monthly budget deficits of approximately RON 2.9 bn. Given the progress on budget execution in the first seven months, the latter does not seem improbable. However, there are still significant uncertainties and downside risks. The first one is coming from negative surprises in the growth outlook. The impact of the looming double-dip recession on the domestic demand could turn out to be more-pronounced-than-currently-anticipated, affecting negatively tax collection. If such a risk materializes, additional fiscal adjustment on the spending side may be required.

Secondly, there is less room for fiscal policy maneuvering from the accumulation of arrears towards the private sector compared to last year. IMF cannot be as lenient even though the government is asking for a waiver, as the integrity of the program has to be maintained until the end (due in May 2011). In that respect, IMF has asked the government to pay off RON 2bn in arrears before the disbursement of the next tranche.

Furthermore, the government has committed to implement a range of harsh and highly-unpopular spending cuts. The total public sector wage bill ought to be cut by around 2 pps of GDP on a permanent basis. The press has repeatedly mentioned that this would necessitate significant layoffs in the public sector. Presumably, lay offs could reach 100,000-250,000, which is indeed horrifying. Yet, there has so far been no official announcement on how to implement these layoffs or whether the 25% public wage cut, introduced temporarily to generate the required public sector saving, will be extended after January 1, 2011. Finally, those cuts may encounter significant resistance from trade unions and also test the cohesion of the

government coalition. The political risk is high given the thin majority in the parliament-by only 4 seats. As such, the possibility of having early parliamentary elections that would derail the IMF program cannot be ruled out entirely.

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Focus - Romania

Quantifying the inflationary impact of higher VAT rates

July CPI came in at 2.58% month-on-month (mom), close to the 2.64% reading we had expected after the main VAT rate was increased from 19% to 24% (effective from July 1st onwards). The corresponding annual CPI figure rate was 7.14% (figure 1). The VAT impact on month-on-month inflation in July was lower than the corresponding 4.2ppts increase implied on a *ceteris paribus* basis for a number of reasons:

- not all consumption items included in the CPI basket bear the new VAT rate. Medical instruments, medicine, books, newspapers, museums and spectacles are subject to a 9% tax rate that was left unchanged;
- faced with feeble demand, retailers postponed some price increases, but left the door open for future hikes that could eventually push annual CPI well above 8%.

Price changes recorded after the VAT hike

Since the VAT hike and the public sector wage cuts enforced on July 1st are exogenous shocks, a breakdown on categories of consumer goods is necessary to assess future price moves.

Food prices rose by 1.92% mom in July, close to our 1.8% estimate. On the one hand, many farmers sell foodstuffs without paying taxes and thus, they did not respond to the VAT hike. Moreover, prices for processed food and (mostly imported) fruit rose by more than 3% mom. Meat prices grew at a slower pace because sales are seasonally lower during the summer, but we expect the latter effect to disappear in Q4. Moreover, retail sales data show a divergence in prices for foodstuffs (figure 2), suggesting that shoppers chose to buy from farmers rather than stores and this helps to explain why retail food sales are falling faster than non-food ones (food retail sales fell 7% and non-food retail sales fell 4% in H1 2010 compared to H1 2009). One reason for the switch is that the financial net worth of households (the difference between deposits and loans) has been shrinking since April, raising the elasticity of demand to price changes. Second round price increases could occur in August and September, pushing food price inflation towards 5%yoy by year-end (figure 3).

Non-food prices rose by 3.08% mom in July, close to our 3% estimate. Tobacco prices were 9.47% higher in July, while electricity and gas prices (both administratively determined) were up 4.2% mom. Slow sales reported by retailers could prevent further significant price increases;

helping annual inflation to peak at levels below 12%yoy in August with the caveat that heating subventions should have been scrapped already. But, the Government seems to have backtracked on its initial pledge. Heating subventions are set by local authorities and can amount to 45% of the price; a 20% price increase is estimated to add 0.25 percentage points to headline CPI and 0.6 percentage points to non-food CPI inflation. Our non-food CPI forecast for the end of 2010 lies between 9.4% and 12% year-on-year, with our central scenario being 11.5% year-on-year (figure 4).

Service prices grew 2.55% month-on-month in July against an expected 3.50% increase, helped by the stronger leu (down to 4.25 RON/EUR from a peak around 4.36 RON/EUR in late June). Depreciation pressure on the local currency could keep the annual inflation rate for service prices above 6% (6.2% in the central scenario, inside the 4% - 7.4% forecast interval – figure 5).

Our main inflation scenarios (baseline, optimistic and pessimistic) show year-end inflation above the target interval. Absent high pressures on the currency, the annual inflation rate could fall towards 5.7% by the end of 2010. The baseline scenario anticipates a year-end inflation of 7.8%. Depreciation pressures, additional tax increases and surging food prices could push inflation up to 9% (figure 7)

Balanced risks to our baseline inflation scenario

Upward risks to the baseline scenario stem from:

- any additional tax hikes that could be implemented in an attempt to boost fiscal revenues;
- fiscal woes and political uncertainty that could weigh on the leu towards year-end, especially if the IMF agreement is jeopardized by resistance to reforms.
-

Disinflationary pressures could come from:

- **repealing the VAT increase:** in July, VAT revenues remained flat relative to a month earlier, despite the rate hike. We had predicted this outcome since the weight of VAT revenues in consumption value added has been decreasing since 2008 (a sign of growing tax evasion). Retail sales peaked at the end of June in expectation of the higher VAT rate and lower demand in July completely offset the tax hike. At the beginning of September, the VAT ordinance will have to be passed into law by the Chamber

of Deputies, where the Government holds a very narrow majority and limited effects on budget revenues could bring the ordinance down;

- **Slack in the economy:** domestic demand is likely to shrink faster in H2, following the VAT hike and the wage cuts for public sector employees. Consumer confidence (as reported by the European Commission) was at an all-time low in June, depressed by the announcement of austerity measures. Furthermore, the Economic Sentiment Index stands close to 1992 lows, with managers anticipating lower sales and financial troubles ahead (figure 6). Core 3 inflation – which measures the impact of demand on prices by excluding administered and volatile prices plus tobacco and alcoholic beverages from the CPI basket– was up just 1.77% month-on-month in July and could remain inside the 2.5% – 4.5% interval set around the central target for the rest of the year.

NBR expected to keep rate at 6.25% for the remainder of the year

Despite domestic inflation appearing likely to spike to levels well above 8% yoy in the following months, we expect the National Bank of Romania to leave the monetary policy interest rate at 6.25% for the remainder of 2010. The main reasons are:

- the VAT hike is an exogenous shock and has nothing to do with demand-side pressures on inflation;
- the VAT hike will likely affect the annual inflation rate only temporarily;
- second round effects such as higher inflation expectations are likely to be offset by slack demand;
- the NBR has other instruments at hand (open market operations or the exchange rate) to influence the economy in the short run;
- negative real interest rates can facilitate a speedier economic recovery

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Serbia

Unexpected monetary policy shift

- **Strong dinar depreciation pressures force the Central Bank to hike interest rates by 50 bps to 8.50% for the first time since Q4 2008**
- **Current macroeconomic data confirm a mild, yet fragile, recovery in the domestic economy**

Unexpected interest rate hike prevents the Dinar from depreciating further

The Central Bank decided in early August to discontinue its monetary policy easing cycle. In a broadly unexpected move, the NBS hiked its key policy rate by 50 bps to 8.50%. The move ended a massive easing cycle that begun in the last quarter of 2008. The Central Bank delivered a cumulative 975bps of rate cuts in the last 19 months, from an initial starting level of 17.75% of its key policy rate.

In our previous (June 2010) *New Europe Economics & Strategy* monthly issue, we warned about the risk of higher policy rates in the period ahead. Specifically, our end-2010 forecast for NBS rates was explicitly conditional on the evolution of risk premia and the pace of depreciation of the Dinar. At that time, our judgment was that stronger depreciation pressures could even force the Central Bank to terminate the easing cycle at the then prevailing levels for its key policy rate. However, an interest rate hike was not our main scenario. The move still caught markets by surprise. The Central Bank has reassured the markets in the May inflation report that they would be more likely to keep cutting rates at a slower pace.

In our view, the early August rate hike came just in time to avoid further depreciation of the dinar. Throughout the past summer, dinar came under significant depreciation pressures despite repeated central bank interventions (€331mn spent only in June alone to support the local currency). The Central Bank has spent a total amount of over €1.7bn so far this year in dinar-supporting interventions, without accomplishing even to stabilize the currency. Had the Central Bank not intervened, the Dinar could have moved beyond 110/€, the next critical threshold after 105/€. On August 2nd, the dinar reached a new historic low at 107.04/€, which prompted the Central Bank to intervene. The domestic currency recovered some of its losses earlier this month

Serbia: Eurobank EFG Forecasts

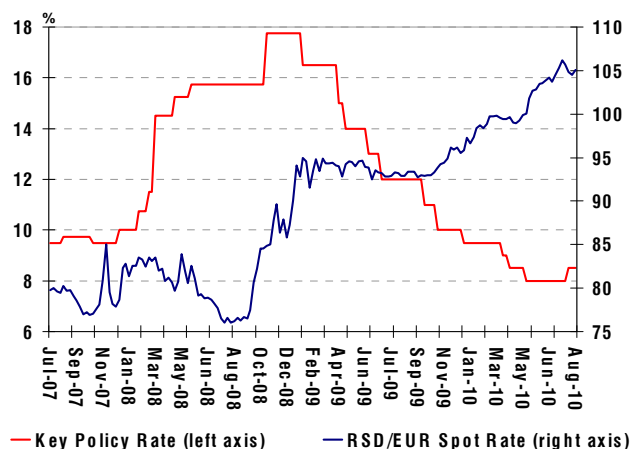
	2008	2009	2010f	2011f
Real GDP (yoy%)	5.5	-3.0	1.5	3.0
Inflation (yoy%)				
CPI (annual average)	12.5	8.2	5.0	4.8
CPI (end of period)	8.6	6.6	6.5	4.5
Fiscal Accounts (%GDP)				
General Government Balance	-2.6	-4.2	-4.8	-4.0
Gross Public Debt	25.6	31.3	37.0	41.0
Labor Statistics (%)				
Unemployment Rate (%of labor force, ILO)	14.7	16.1	18.5	16.5
Wage Growth (total economy)	17.9	4.1	4.8	6.7
External Accounts				
Current Account (% GDP)	-17.1	-5.7	-8.5	-9.0
Net FDI (EUR bn)	1.8	1.4	1.5	2.0
FDI / Current Account (%)	30.0	78.7	55.0	70.0
FX Reserves (EUR bn)	8.2	10.6	11.3	10.2
Domestic Credit	2008	2009	Q1 10	Q2 10
Total Credit (%GDP)	41.0	48.7	51.2	56.1
Credit to Enterprises (%GDP)	25.8	29.4	30.8	32.9
Credit to Households (%GDP)	14.0	14.7	15.3	16.4
Private Sector Credit (yoy)	34.9	14.3	12.9	23.1
Loans to Deposits (%)	125.1	127.0	133.2	138.7
Financial Markets	Current	3M	6M	12M
Policy Rate	8.50	9.00	9.00	9.00
EUR/RSD	105.18	110.00	110.00	110.00

Source: National Sources, IMF, Eurobank Research

(levels around 104.73/€ recorded on August 18), before starting to re-weaken again to stand at ca 105.55/€ at the time of the writing. At the current level, the dinar has lost ca. 13% of its value since last September (Figure 1). In a statement released after its latest policy meeting, the Central Bank said that the rate hike aimed to contain increased inflation expectations, stemming from, among other sources, increased prices of agricultural products due to the poor domestic wheat crop and international developments such as the fires in Russia. In addition, the Central Bank cited the inflationary influence of increased risk premia on imported prices (deployed, primarily, via the weaker dinar).

Figure 1

Central Bank has terminated its easing policy cycle



Source: National Statistics, Eurobank Research

Interestingly, the Central Bank signaled that it may increase interest rates further before the end of the year.

Yet, such a move could kill the still nascent economic recovery. In our view, any additional policy tightening should not only be very gradual, but also cautious, considering that the economic recovery is still fragile and subject to significant downside external risks.

We maintain a bearish dinar outlook for the rest of the year unless further aggressive interest rate hikes take place

Despite the NBS surprise rate hike in early August, the outlook for the dinar over the rest of the year does not change dramatically, in our view. Financial markets have so far ignored the recent positive domestic news flow (positive real GDP growth in 1H, shrinking current account deficit etc). What is more important, the government is on track with its IMF program. Implementation has been smooth so far, being current at the stage of the fifth program review. All the quantitative targets for end March were met, with the exception that of the fiscal deficit which was not met by a small margin. In fact, Serbia withdrew only €56 mn of the latest loan tranche (€383 mn in late June), bringing the overall disbursements so far to €1.5bn, out of a total financial package of €2.9bn.

Furthermore, the government is implementing successfully the required structural reforms. The government has already implemented most of the politically-sensitive structural reforms including, among others, the pension system reform and the downsizing (by 10%) of the central government personnel. In that respect, the Serbian government has so far complied with the IMF program requirements more effectively than other governments in New Europe running similar programs. *Ceteris paribus*, that should have already boosted the domestic currency.

In our recent *New Europe Economics & Strategy* publications we had been expressing a strong bearish view on the dinar, and we continue to see limited scope for a meaningful recovery in the foreseeable future. There are a number of reasons supporting that view:

In principle, the Central Bank has embraced the notion of a transition of the Serbian economy from being primarily driven by domestic demand to an exports-oriented model of development. In our view, this entails implications for FX policy, on the basis that the envisaged exports-driven growth model is, in principle, not generally compatible with a sustainably strong Dinar. In the boom years of 2004-2008 the currency had appreciated by more than 90% in real effective terms, with its sharp depreciation so far this year helping to offset some of this imbalance. Note also that the new

NBS Governor, Dejan Soskic, has recently stated that monetary policy should not allow for a (real or nominal) appreciation of the local currency in the coming period. Along these lines, Mr. Soskic has rebutted arguments in favor of a change in the present flexible exchange rate regime to a more rigid framework. According to Mr. Soskic, the introduction of such a regime could result in a depletion of FX reserves or the need for high real domestic interest rates that could strangle the still fragile economic recovery.

In addition, capital inflows remain weak. Net FDI inflows declined by 53.1% yoy in H1:2010, covering just 32% of the corresponding current account deficit. There is still a large stock of state-owned enterprises that need to be privatized in order to attract more FDI inflows in Serbia. However, present market conditions are such that there is little prospect of a strong recovery in FDI or other capital inflows. Finally, the government plans to sell a 40% stake in the Telekom Serbia through an international tender. When that finally takes place, it is going to boost the FX reserves giving more ammunition to the Central Bank to directly influence the FX rate.

In view of the aforementioned factors, the current dinar levels may well prove the starting point of a new depreciation phase. Maintaining the Dinar stable will be a contentious and critical issue for the rest of the year. The new NBS Governor will need to strive to maintain confidence in the local currency, which is presently the key focus of market attention. We still anticipate the Dinar to reach levels around 110/€ by the end of 2010, unless the central bank's monetary policy stance changes dramatically via e.g. a number of aggressive interest rate hikes in the remainder of the year .

Serbia exits recession: A modest, yet fragile, recovery is underway

A recent stream of macroeconomic data suggests that Serbia has already exited recession. After four consecutive quarters of negative growth, real GDP grew by 0.6%yoy (revised down from 1%yoy reported initially) in Q1-2010. Moreover, growth accelerated in Q2, reaching 1.6%yoy (flash estimate of the Statistical Service vs. 1.8%yoy estimate of the Central Bank).

Although there is no detailed breakdown of the Q2 GDP figure yet, manufacturing has likely been one of the main contributors to the rebound. Manufacturing already posted growth of 2%yoy in Q1, which compared with a contraction of 6.9% in Q4 2009. The improvement appears to have continued in Q2 as well. Indeed, industrial production, increased by 4.6%yoy in 1H-2010 (here you need to provide both Q1 & Q2 data) compared

to a decline of -17.4% at the same period last year. Manufacturing has been benefiting the most from the rebound in exports. Exports showed signs of revival expanding by 13%yoy in 1H against imports growing by only 3% over the same period. The economic recovery in EU-27, where ca two thirds of Serbian exports are heading, is one reason behind this. The depreciation trend of the Dinar provides an additional boost to exports, helping to boost export competitiveness and thus, economic growth.

There is one more distinct feature of the economic recovery in Serbia. The rebound is assisted by positive credit growth in the private sector. The latter registered a 23.1%yoy increase in nominal terms in the 1H-2010. This trend is underpinned by the government's subsidized Dinar loans program.

In conclusion, our view on the GDP outlook for 2010 has remained unchanged from the beginning of the current year. We forecast a mild output recovery of 1.5%yoy for 2010 as a whole, compared to -3%yoy in 2009. Our forecast is broadly in agreement with current market consensus. Note that the IMF recently downgraded its Serbia growth forecast for 2010 to 1.5% against a 2% expected earlier.

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Turkey

Referendum in the spotlight

- **Economic rebound continues, but pace of recovery likely to prove slower in H2.**
- **CBRT revises 2010-2012 inflation projections lower, signals unchanged policy rates until 2011.**
- **Following a temporary spike in the August-September period, CPI is expected to ease thereafter on favorable base effects and easing inflation expectations.**
- **Fiscal consolidation continues but implementation of much-awaited fiscal rule to be delayed.**

Economic rebound continues, but pace of recovery likely to prove slower in H2

After posting an impressive 11.7%yoy GDP growth reading in Q1, the domestic economic recovery is likely to prove slower in the quarters ahead. The favorable impact of base effects due to last year's sharp economic contraction is expected to wane gradually, while the inventory adjustment will decelerate and net exports' contribution will remain negative. A potential slowdown in the pace of economic recovery and persisting euro area sovereign woes may also exert downward pressures. Nevertheless, we expect economic growth to remain supported in the coming months, and we maintain our full-year GDP growth forecast of 6.0%, thus placing Turkey at the top of growth outperformers in New Europe. In support of the aforementioned, industrial production growth slowed to 10.2%yoy in June following a 16.9%yoy average year-on-year print in the first five months of the year. Yet, this still marks a significant improvement from the same period a year earlier. In a separate note, the July consumer confidence index was a tad off a 1½-year peak of 88.04 touched a month earlier, suggesting ongoing recovery in domestic consumption. Also pointing to strengthened domestic fundamentals, the manufacturing confidence index remained in July above the boost-or-burst threshold of 100 for the 7th month running, standing close to a 3-year pick of recorded in April. Though easing for the second month running in July, manufacturing PMI remained in an expansionary territory for the 15th consecutive month, hovering near May's record peak. Capacity utilization,

Turkey: Eurobank EFG Forecasts

	2008	2009E	2010F	2011F
Real GDP (yoy%)	0.7	-4.7	6.0	4.5
Private Consumption	-0.3	-2.3	3.5	4.5
Govern. Consumption	1.7	7.8	1.0	3.0
Gross Capital Formation	-6.2	-19.2	4.0	9.0
Exports	2.7	-5.4	6.0	8.0
Imports	-4.1	-14.4	10.0	10.5
Inflation (yoy%)				
CPI (annual average)	10.4	6.3	8.3	7.2
CPI (end of period)	10.1	6.5	7.1	6.7
Fiscal Accounts (%GDP)				
General Government Balance	-1.8	-5.5	-3.8	-3.3
Gross Public Debt	39.4	45.5	45.3	45.0
Primary Balance	3.5	0.1	1.0	1.5
Labor Statistics (%)				
Unemployment Rate (%of labor force)	13.6	13.5	13.2	12.8
External Accounts				
Current Account (% GDP)	-5.7	-2.2	-4.5	-5.3
Net FDI (USD)	15.8	6.1	7.5	9.0
FDI / Current Account	37.5	43.5	23.0	24.0
FX Reserves (USDbn)	71.0	69.0	70.0	71.0
Domestic Credit	2008	Q3 09	Q4 09	Q1 10
Total Credit (%GDP)	31.0	33.0	35.0	34.0
Credit Private Sector (%GDP)	29.7	31.0	32.9	31.9
FX Credit/Total Credit (%)	13.2	14.0	14.9	16.9
Private Sector Credit (%yoy)	22.9	2.8	11.3	22.8
Loans to Deposits	82.4	79.5	78.7	79.9
Financial Markets	Current	3M	6M	12M
Policy Rate	7.00	7.00	7.00	7.00
USD/TRY (where applicable)	1.53	1.54	1.55	1.50

Source: National Sources, IMF, Eurobank Research

which remains on a sustainably upward trend since September 2009, bounced to 74.7% in July, thus returning to pre-crisis levels last seen in September 2008. The rate of unemployment fell to 11.0% over the April-June period, converging towards its pre-Lehman levels and remaining well below an all-time peak of 16.1% touched in February 2009. Furthermore, tourism revenues and foreign arrivals remain on an uptrend, while credit growth and automotive production are also on the rise and exports have embarked on a strong recovery so far this year.

CBRT revises 2010-2012 inflation projections lower, signals no change in its key policy rate until 2011

In its latest inflation report released in late July, the CBRT assigned a 70% probability for end-2010 CPI coming in at a mid-point of 7.5%, below a previous forecast of 8.4%, but still above the 6.5% target for this year (Eurobank EFG Research forecasts year-end inflation at 7.1%yoy). For end-2011, the CBRT expects annual CPI to ease to 5.3% (vs. 5.4% previously), a tad lower than the 5.5% target for that year. The 2012 CPI forecast was unchanged, with inflation seen recoiling to 5.0%, a tad above its 5.5% target. Among the main reasons behind the revisions were a weaker-than-expected external demand outlook, lower unprocessed food and other commodity prices and a stronger-than-

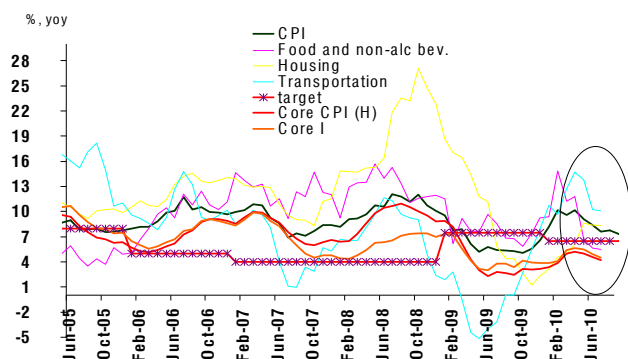
earlier anticipated deceleration in domestic pipeline price pressures. Along these lines, the central bank signaled it would hold interest rates stable for longer-than-previously anticipated, with its baseline scenario now being for a resumption of monetary tightening some time in 2011. This nullifies its earlier view for rate hikes as early the last quarter of this year.

Inflation eased further in July

Vindicating the CBRT's view of an improving inflation outlook, CPI surprised again positively in July, coming in at -0.48%mom due to seasonal factors, 0.1ppts less than expected (Figure 1). A 5.19%mom drop in clothing and footwear as well as a 0.73%mom fall in food prices were the main culprits of the decline, which pushed the annual headline reading to a 7-month low of 7.58%. Similarly, July PPI fell to -0.16%mom vs. expectations for a flat reading, with the corresponding year-on-year rate coming in at 8.24%. Furthermore, nearly all of the core inflation measures eased in July. The "H" and "I" components, which are closely monitored by the CBRT, marked respective monthly declines of 0.33% and 0.51%, with both indices easing to their lowest level on an annual basis since February 2010.

Figure 1

Inflation surprises to the downside, once again



Source: National authorities, Bloomberg

CBRT maintained key policy rate unchanged at 7.00% in August

In view of the most recent developments on the inflation front, the CBRT kept its key (1-week repo) rate stable at 7.00% at its August 19 MPC meeting, in line with market expectations. The accompanying policy statement was broadly similar to that in July. The bank highlighted that domestic demand outlook remains stable, but acknowledged evidence of a partial slowdown in external demand as global economy risks linger. It also repeated that core inflation is expected to remain consistent with the medium-term targets. Yet, casting a slightly more dovish tone relative to the prior (July 2010) policy statement, the press release read that it *"would be"* --

rather than *"may be"* -- "necessary to maintain policy rates at current levels for some time, and to keep them at low levels for a long period". The CBRT warned about a temporary spike in inflation in the short-term, with the uptrend expected to reverse in Q4 2010, a risk already highlighted in the July Inflation report.

Disinflation expected to resume from October onwards; CBRT likely to remain on hold until H2 2011

In line the aforementioned, we anticipate an increase in headline CPI towards 8% yoy by September on the back of seasonal factors. Note that during Ramadan, which takes places during August and September this year, demand for food traditionally increases. We expect a slowdown thereafter and see end-2010 headline CPI easing towards 7.1%yoy. The recent improvement in inflation expectations may also assist the disinflation process. Looking further ahead, we expect inflation pressures to remain relatively subdued through to Q1 2011, but become more evident in the second half of next year. The primary reason being, fiscal loosening, to which we assign a rather increased probability. The government's decision to delay the endorsement of the fiscal rule, suggests, in our view, that the AKP is rather wary of risking public support ahead of the polls. And, as such, we would not rule out increased spending aimed at luring voters at a time when the ruling-party's victory appears far from secured. Also seizing to assist the disinflation process will be the narrowing of the output gaps created as a consequence of the crisis. In December 2011, we see CPI slightly below 7%. In all, we expect the CBRT to hold its fire until H2 2011, after it assesses the impact of potential increased spending in the run-up to the upcoming general elections scheduled for July, and the global economic outlook becomes more transparent. The CBRT's policy remains highly accommodative, after a total of 1,025bps of rate cuts being delivered between November 2008 and November 2009. Along these lines, we expect 150bps of rate hikes to be delivered by the CBRT by the end of 2011.

Fiscal consolidation continues, but much awaited fiscal rule to be delayed

The fiscal position has improved considerably in the first half of this year, thanks to increased spending discipline and a cyclical improvement in tax revenues. The consolidated government deficit shrunk by 33.5%yoy to TRY 15.4bn in H1 2010 while the primary budget surplus soared 200%yoy, reaching TRY 12.129bn. However, concerns about the ruling party's commitment to fiscal consolidation ahead of the July 2011 elections have emerged recently. The AKP's victory is not a done deal and the party's decision to delay the much awaited fiscal

rule added to such worries. Note that the government presented in May a "fiscal rule", expected to provide a valuable policy anchor for budget deficits in the coming years, especially in the absence of a new IMF loan deal. However, although the bill has already been submitted to parliament -- with the intention to have it approved ahead of the summer recess in July in order to come into effect as soon as next year's budget -- the endorsement was delayed. Officials' comments that the 2011 budget will not be based on the rule exacerbated concerns about a looser fiscal stance ahead of next year's general elections. Nevertheless, in view of the significant improvement in the government's finances throughout the first half of the year (and taking into account that tax revenues are likely to remain supported by cyclical factors), we maintain our forecast for a general government deficit 3.8%-of-GDP this year.

September's referendum takes centre stage

The Constitutional Court's decision in early July to reject the opposition party CHP's call against the government's constitutional reform package and to approve most of the ruling AKP's plans paved the way for a referendum on the accepted constitutional amendments on September 12, as previously expected. The referendum is considered to be of utmost importance for Turkey's future political developments. Its outcome may affect the timing of the upcoming general elections, currently scheduled for July 2011. It is also seen as a key gauge for the result of next year's parliamentary polls. An overwhelming majority would suggest high public support for the government. In such a case, the AKP party might opt for a snap poll in a move to alleviate uncertainty related to a protracted pre-election period and thus, minimize the risk of defeat. On the flipside, rejection of the referendum is unlikely to precipitate early elections. According to the most recent opinion polls, rejection of the plebiscite by a slight majority remains the most likely scenario. As such, if the opinion surveys are vindicated we expect general elections to be held as currently scheduled. As we noted in our March 2010 *New Europe Economic & Strategy report*, even if the proposed constitutional changes are voted in the referendum, they may still be challenged in the Constitutional Court, which in the past has annulled AKP backed constitutional changes. Even if vetoed however, it will still renew the AKP's reformist image, which is likely to positively impact popular support towards the party. Among others, the constitutional amendments proposed by the AKP aim to make the closure of political parties more difficult and change the structure and the way the Supreme Board of Judges and Prosecutors (HSYK) is elected. The government states that the constitutional changes will make the country more

democratic and help improve prospects of EU accession. Staunch secularists see them as a threat as they are limiting the powers of the military and judiciary (seen as bastions of secularism). The ongoing power-play between the secular elite and the ruling AKP is among the main political challenges ahead. Nevertheless, somewhat alleviating them was the appointment of the head of the armed forces and the commander of ground forces earlier in August as General Basbug's tenure expires at the end of the month. Also, the change in the main opposition party's leadership, though allying the risk of early elections, bears increased potential for a coalition government in the next general elections.

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Ukraine

IMF Board approves \$15.15bn Stand-By Arrangement for Ukraine

- On July 28, the IMF approved a 29-month, \$15.15bn, Stand-By Arrangement for Ukraine. An initial tranche equivalent to \$1.89bn was disbursed in early August with subsequent disbursement being subject to quarterly reviews
- Ukraine's real GDP growth expanded 6.0% yoy in Q2-10 accelerating from 4.9% yoy in Q1-10
- The Central Bank of Ukraine cut further the key discount rate by 75bps to 7.75% on August, 9 to boost lending to companies and spur economic activity
- According to the IMF latest report, the ratio of non-performing loans to total loans reached 41.6% in March 2010 from 24% the same period a year earlier.

IMF Executive Board approved \$15.15bn Stand-By Arrangement for Ukraine

In late April, Ukraine's Parliament approved the long-awaited state budget for 2010, paving the way for the resumption of an existing IMF lending programme. In mid-July, the government announced that it will raise consumer gas prices by 50% from August 1st, suggesting that Ukraine is serious about the reforms needed to keep the IMF lending programme on track. On July 28, the IMF approved a new 29-month \$15.15bn Stand-By-Arrangement (SBA) for Ukraine in support of the authorities' economic adjustment and reform programme. An initial tranche equivalent to \$1.89bn was disbursed in early August with subsequent disbursement being subject to quarterly reviews. The IMF discontinued an earlier 2-year SBA facility for Ukraine (\$16.4bn) that was approved in November 2008. Ukraine has received \$10.6bn of this loan but payments were frozen in November 2009 when the previous government declined to cut spending in the run up to the January 2010 presidential elections. Key objectives of the new lending program are to consolidate public finances and put the Ukrainian economy on a path of durable growth through fiscal, energy and financial sector reform. Under the policies attached to the loan, the general government

Ukraine: Eurobank EFG Forecasts

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

Source: NBU, IMF, Bloomberg, Eurobank Research

deficit has to reach 3.5% of GDP in 2011 and 2.5% of GDP in 2012 (compared to an agreed ceiling of 5.5% of GDP this year) and the public debt ratio to be contained to levels no higher than 35% of GDP by 2015 (vs. levels around 33.4% of GDP in June 2010). The fiscal adjustment program envisions new tax and expenditure-containment policies, pension and energy sector reforms, as well as measures to strengthen Central Bank's independence and complete recapitalization plans of the banking system by end-2010. In particular, in the authorities' agenda is to initiate reforms to modernize the gas sector and eliminate Naftogaz's deficit starting from 2011 (vs. this year's ceiling of 1% of GDP). The government has already increased gas tariffs for households by 50% starting from August 1st and a further 50% hike is scheduled for April 2011.

Nevertheless, there are considerable risks to the programme. On the one hand, external risks remain elevated given the uneven recovery in Europe and still volatile financial markets. On the other hand, domestic risks include a fragile economy, rising non-performing loans in the banking sector, structural fiscal rigidities and Naftogaz's financial viability. In addition, with local elections on the horizon and parliamentary elections in fall 2012, political pressures are likely to weaken programme implementation. What's more, there are

downside risks to the fiscal adjustment effort related to significant spending pressures ahead of the Euro 2012 football championship.

Resumption of the IMF loan opens the way for additional financing by other international organizations; a loan of \$792mn from the European Commission and \$800mn loan from the World Bank.

Ukraine faces considerable financing needs in the coming years, mainly from reduced access to international financing. Gross external financing requirements are running high, expected to reach some \$31bn/annum average in 2010-2012, driven by current account deficits, large external debt obligations of the private sector, and the need to replenish reserves. According to the latest IMF country report, outstanding credit to the Ukraine is projected to reach \$14.8bn in 2012, equivalent to ca 18% of total external debt.

Real GDP growth accelerates to 6.0%yoy in Q2-10, from 4.9%yoy in the prior quarter

In mid-August, the Q2 GDP report was released, showing domestic growth accelerating to 6%yoy, from 4.9%yoy in Q1-10 and a 15.1% contraction recorded in 2009. GDP expanded 3.9%qq in Q2-10. The Ukrainian government expects GDP to grow by 4.5%yoy in 2011, up from 3.7%yoy in 2010. Admittedly, the economy is undergoing a recovery, even though from a low base. We do not expect growth to accelerate much further in the second semester, given weakening foreign demand and a lack of favourable base effects (industrial recovery started in summer-fall 2009). The rebound in industrial sector has shown signs of slowing; annual industrial production declined to 6.4%yoy in July from 8.9%yoy recorded in June. On the other hand, retail sales improved further in July, reaching 3.9%yoy compared to 2.5%yoy in May and -20.6%yoy in December 2009. Growth in retail sales is likely to continue in the remainder of this year, thanks to supportive base effects. There have also been additional signs of recovery in the consumer sector. Annual real wages continue to grow; they rose by 9.7%yoy in July from 9.5%yoy in June and 4%yoy in January. All in all, we anticipate GDP growth at 4.0%yoy in 2010 and 4.2%yoy in 2011.

S&P raised Ukraine's rating to B+

In late July, S&P rating agency raised Ukraine's long-term sovereign foreign currency rating by one notch to B+ and the long-term sovereign local currency rating to BB- from B+. The agency cited the government's decision to increase domestic gas tariffs as an encouraging sign for the IMF loan resumption which,

once on track, will reduce the external vulnerability of the Ukrainian economy.

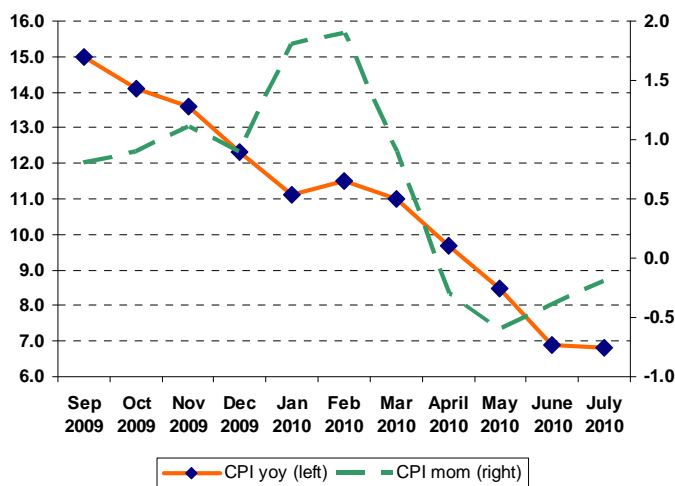
Balance of payments reached the highest level from the beginning of the crisis

The overall balance of payments reached \$2.8bn in June; this was the highest level recorded since the beginning of the financial crisis. This was facilitated by a \$2bn credit obtained by the Ukrainian government from the Russian Bank VTB for budget purposes. The surplus led to the increase in reserve assets of \$ 29.5bn in June. The current account surplus in June remained at the level of two previous months (\$195mn). The year-to-June current account surplus reached \$472mn (compared to a deficit of \$835bn in H1-2009). The improvement was due to increase in surplus of services. The decline in export of agricultural products was compensated by higher growth in the exports of ferrous metals. For the first half of the year, exports of steel increased by 55.7% yoy due to higher growth in both volume and prices. The financial account recorded a \$4bn surplus in H1-2010, compared to a deficit of \$6.4bn in H1-2009. Net FDI inflows amounted to \$2.3bn year-to-June (4.7% more than the amount recorded in H1-2009). Some 39% of total FDI was channelled to the domestic banking sector. We anticipate the full-year 2010 current account deficit to remain contained at levels below 1% of GDP.

Underlying price pressures are retreating

Annual inflation slowed to 6.8%yoy in July- its slowest rate on record - from 6.9%yoy in June. Inflation dropped to a single-digit figure in April following more than 3 years of double-digit rates. In addition, in monthly terms inflation fell 0.2% mom in July, the fourth monthly decline in a row (Figure 1).

Figure 1
CPI in monthly and annually terms



Source: National Statistics, Eurobank Research

Domestic authorities now project inflation to close the year at a single digit, compared with a previous forecast of 13.1%yoy. However, the planned 50% hike in gas prices for households and utility companies effective on August 1st is likely to add 2.5% pts to inflation. What's more, producer prices are already building up the inflation pressures for 2011; they accelerated further in July, reaching by 21.6%yoy vs. 21.1%yoy in June and 7.2%yoy in the same month of last year. Against this backdrop, we forecast inflation to average 10.2%yoy this year and 10.7%yoy 2011 vs. 15.9%yoy recorded in 2009.

Additional change in the discount rate, by 75bps in August

The central bank of Ukraine (NBU) cut the key discount rate by 75bps to 7.75% on August, 9 to boost lending to companies and spur economic activity. In the last two months, NBU cut the key discount rate by 275bps; 100bps in early June from 10.25% to 9.50%, another 100bps in July and further cut of 75bps in August (Table 1).

Table 1
Discount rate cuts

Year	Date	Discount rate	Change in bps
2008	April 2008	12.00	
2009	June 2009	11.00	100
	Aug. 2009	10.25	75
2010	June 2010	9.50	100
	July 2010	8.50	100
	Aug. 2010	7.75	75

Source: National Bank of Ukraine

The recent declines in domestic inflation have left room for additional rate cuts. Under the IMF loan the central bank is committed to maintain real interest rates positive. We anticipate the NBU to keep the discount rate at the current level for the remainder of the year, given that underlying price pressures will remain weak.

Deposits have begun to rebound, though total credit remains stagnant

The banking system remains under strain. The new IMF SBA for Ukraine aims to restore and safeguard banks' soundness through completion of recapitalization plans by end-2010 and strengthened supervision. According to the IMF latest report, Non-Performing Loans (NPLs) to total loans ratio reached 41.6% in March 2010 from 24% the same period a year earlier. NPLs increased by 19.3% year-to-July and by 7.5% mom in July. Capital adequacy levels have increased recently due to rising NPLs; capital adequacy ratio reached 20% in July from 18.1% in

January 2010 and 14% in January 2009. This will most likely put a spoke in bank recapitalization plans through private equity injections.

Deposits have begun to rebound. Total deposits grew by 9.3% year-to-June, while private sector deposits increased by 11.7% over the same period. What's more, household deposits rose by 13.8% year-to-June. It is worth noting that household deposits denominated in national currency grew by 23.4% year-to-June (over the same period the hryvnia appreciated by 1.2%). On a less positive note, overall credit growth remains in negative territory; it stood at -3.7% year-to-June although it recorded positive monthly growth of 0.05% mom in June. Private sector credit remains stagnant; it rose by 1.4% yoy in June and by 0.6% year-to-June. Household credit growth remained negative at -13.1%yoy in June.

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