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ECONOMIC PERFORMANCE

Economic indicators for selected emerging European countries

<u>2001 Projected Growth and Inflation</u>		
Country	Growth	Inflation
Bulgaria	3.5%	7.0%
Czech Republic	4.0%	5.0%
Hungary	4.0%	8.0%
Poland	3.0%	5.5%
Russia	4.0%	17.5%
Turkey	-1.0%	35.0%

Growth = Real GDP; Inflation = CPI

MARKET OVERVIEW

An overview of the economic conditions in emerging Europe

The slowdown in growth in the euro area is likely to be less pronounced than in the U.S. Real GDP growth in the first quarter 2001 is expected to be broadly unchanged from the fourth quarter 2000, at 2.1%. Indicators of industrial growth have slowed recently and are likely to slump in Q2, but they still remain firm relative to those of the U.S. Indicators of domestic demand remain strong, with consumer confidence buoyed by tax cuts and falling unemployment. Even so, the European central bank is expected to cut rates a further 25 basis points in Q3, in light of decelerating M-3 growth and the likelihood of Euro appreciation against the dollar.

Growth in emerging Europe is holding up well in most countries, except Poland, as exports to Western Europe remain resilient. Growth is falling rapidly in Poland, but this reflects domestic factors, most importantly a very high level of Polish real interest rates.

The central bank in Hungary has been cutting rates gradually throughout the past two years. The Czech Republic is now pulling out of a protracted slump at a time when the rest of the world is slowing down. The Czech central bank cut its key interest rates in February but rising output growth and fiscal weakness should delay further rate cuts in the near term. In Poland, the central bank is keeping real interest rates at a very high level. Having cut only 100 basis points in Q1 2001, it may be faced with a strong macro-case for further rate cuts in Q2 as output growth is falling quickly, while inflation and the current account deficit are both shrinking.

For Turkey, international developments will remain far less important than the domestic developments, following the government's decision to float the currency on February 21. The focus in the Turkish financial markets has shifted from assessing the risk of devaluation towards assessing the risk of bank failures and of sovereign debt payment problems. The government is still in a position to stem the risk of payment default and to put Turkey back on track towards financial stability. The government's battle against this financial crisis has become extremely difficult and the risks of further deterioration remain high.

ON THE MARGIN

Items of Interest in the Emerging European Economies

The Mystery of Capital

For years, the creation of a viable mortgage lending has been hampered in many developing markets by the inability to maintain and transfer clear property rights, and the ability to enforce those rights through Western style foreclosure and eviction laws. Many countries have tried to pass these laws, but for the most part, they have been unsuccessful in developing a formalized mortgage market.

A recent book by Hernando de Soto, the President of the Institute for Liberty and Democracy, titled The Mystery of Capital: Why capitalism triumphs in the West and fails everywhere else, explores the development of property rights laws in the West. The book describes how the U.S. property rights systems were built, not by sophisticated mapping systems as many developing countries are attempting, but upon informal agreements that were made among miners and farmers and squatters in small districts all around the country. When the government failed to develop a property system that was fair and accessible to everyone, the people created their own informal systems that were recognized and enforced locally by citizen appointed groups.

This same thing is currently happening in many developing countries as squatters have set up local practices to handle land ownership and transfer. However, to develop a property ownership system that provides stable and secure land title that will enable landowners to realize the value of the assets they have accumulated, formal property rights for current landowners must be developed.

The benefits of this system are clear. The strengthening of the commitment that an owner feels to his property as its clear owner is a key factor in a lending decision. That is, when a buyer can clearly see the economic value of owning and maintaining a home, they are more likely to use mortgage financing wisely and more likely to keep up the payments in difficult times,

The book includes many impressive statistics to demonstrate that the poor are not as poor as they seem. Their wealth is simply not recorded, and is therefore not fungible. For example, the value of savings among the world's poor is forty times all the foreign aid received worldwide since 1945. Also, the value of informally owned property is estimated at \$9.3 trillion. However, the inability to properly register title and mobilize this wealth through mortgaging leaves this wealth dormant.

The formal property registration system in many emerging countries is expensive and time consuming. In Egypt, for example, it requires 77 bureaucratic procedures at 30 different public and private agencies to register title, and can take from five to fourteen years to complete. This bureaucracy and the cost associated with properly registering ownership only serves to promote extralegal ownership.

The book suggests that there is some urgency to develop acceptable methods to transfer title and to free up this dormant wealth. However, there is often considerable resistance to change, as the interests of established landowners as well as the political implications of turning millions of underclass citizens into property owners ensures that progress will be slow.

DEAL FOCUS

Moody' Report Questions Need for SPV

Moody's Investors Service recently released a report that suggests that certain transactions could be structured without SPV's in certain jurisdictions. The report indicates that Moody's believes there are circumstances in which a non-bankruptcy remote company can issue asset-backed notes with a rating significantly higher than the company's own rating, and properly insulate the transaction from reconsolidation risk without the presence of an SPV. The report describes the view that English insolvency law is particularly favorable to creditors and therefore it is legally possible to isolate the securitized assets within the originator.

This status would apply in the following countries with insolvency legal systems: England & Wales, the Cayman Islands, Hong Kong, Singapore, Australia, Malaysia and Bermuda. Some of these jurisdictions may actually be better suited to the procedure than the UK, because they do not have statutory administration proceedings, or company voluntary arrangements proceedings for small companies.

The impact of this could be very broad and could open up additional opportunities for the use of securitization techniques in corporate finance deals and bank balance sheet management.

Italian MBS Hits the Market

Royal Bank of Scotland securitized a portfolio of Italian mortgages originated by Italfondiaro in February. Italfondiaro underwent problems during the early 1990's because of the decline of the property market. It was recapitalized and restructured by its largest shareholder, Centro Banca.

The portfolio consisted of loans with a weighted average LTV of 38.4% and weighted average seasoning of 5.9 years. The strength of the characteristics of the loans is attributable to restructured loans remaining in the Italfondiaro portfolio.

COUNTRY REVIEW

A review of the economies of selected countries

Bulgaria

The crisis in Turkey and domestic political uncertainty are modest negative influences on an otherwise well-performing Bulgarian economy. Turkey's devaluation will adversely affect Bulgarian exports and has intensified general global concerns about the sustainability of fixed exchange regimes.

Bulgaria remains on track under the current IMF program. The main microeconomic variables, except inflation, have behaved nicely. Bulgaria is recording robust export-led economic growth (exceeding 5% of GDP in 2000). The government achieved a lower-than-targeted fiscal deficit of about 0.9% of GDP in 2000, down marginally from 1.0% in 1999. However, inflation increased from about 6% at the end of 1999 to more than 11% at the end of 2000, partly due to rising oil prices, a spike in food prices due to a drought and Euro weakness, but also due to the strength of domestic demand. The IMF program effectively ended at the end of March.

Czech Republic

The Czech economy is slowly proceeding towards faster growth, as fiscal and wage policies are turning more expansionary ahead of the election in June 2002. However, the acceleration in growth is likely to remain gradual this year. In particular, export growth will probably slow down with the weakening of the EU economy. Both inflation and the current account deficit are likely to rise moderately in 2001. The key risk to this scenario is a super-ambitious development plan, which the government recently worked out. This plan could significantly loosen the macroeconomic policy framework. However, the plan does not enjoy unambiguous support within the cabinet and it is unclear if it will be implemented at all.

GDP growth is expected to rise to about 4.0% in 2001, from 2.9% in 2000. An important source of this strengthening is consumer demand, which should be boosted by a likely rise in real household income. Total employment is likely to stabilize in 2001, after declining by about 1% in 2000. Wage regulation in the public sector has been set looser in 2001 than last year; the budget allows for a 4.5% increase in the nominal amount spent by the government on wages, compared to a 0% target for 2000.

Hungary

The basic economic trend had changed little in recent months, with output growth continuing to decelerate as industry is being hit by weakening external demand and as consumption growth is only marginal. Export growth is expected to weaken further while domestic demand should be strengthened by a moderately expansionary change in the fiscal status. As a result, output growth is likely to remain strong, although not quite as strong as in 2000. Inflation should edge down throughout this year on more benign fuel prices and declining demand pressures in the industrial sector.

GDP growth is likely to be driven more by domestic demand than by exports in 2001. Within the manufacturing sector, the growth rate for export orders fell to 8.9% year-on-year in November, from 30% in June. But growth in domestic orders (still within the manufacturing sector) remained resilient at 23.5% year-on-year.

There has not been much downward inflation momentum in recent months, although year-on-year rate of CPI inflation fell to 10.1% in January from a peak of 10.6% in November. Core inflation rose sharply to 10.5% in January from 9.7% in November.

Poland

The economy weakened sharply towards the end of last year, while there was a marked decline in both inflation and current account deficit. The central bank cut its key intervention interest rate in February, but rates remain too high to allow domestic demand to bounce back soon. Although the fiscal deficit may rise moderately in 2001, it is unlikely to offset the growth impact of the continued tightness of monetary policy. As a result of this policy mix and the weakening demand from the EU, output growth this year is likely to be lower than in any other year since 1993. Inflation will probably fall sufficiently to approach developed economy levels and the current account deficit should shrink to a level that is sustainable in the medium term.

The sharply improving inflation trend, which started in Q2 2001, has continued in recent months. Data for January shows CPI inflation at 7.4% year-on-year, a major decline from a peak of 11.6% in July 2000. Inflation is now within the central bank's target range of 6-8% for year end-2001 and is widely expected to decline below 7.0% at the end of Q1, partly because of the current benign price trends for fuel and food. It is expected that inflation will fall to 6.0% year-on-year by June and that the central bank's target range of 6-8% for end-2001 may be undershot.

Russia

While the overall performance of the Russian economy is unlikely to be as spectacular in 2001 as it was in 2000, nevertheless, it is likely to be pretty comfortable. Most importantly, growth is expected to remain a healthy 4% or more, and the central bank's foreign exchange reserves are likely to continue to rise, but at a slower pace than in 2000. The main reasons for expecting a moderate weakening of the economic performance are the prospect of lower oil prices, further real appreciation of the rouble and higher external debt payments. Lower earnings in the oil and gas sector will curb domestic demand growth and reduce the current account surplus. Weaker oil prices will also put pressure on the government to tighten fiscal and monetary policies. In absence of policy tightening, the central bank is likely to be forced to choose late in the year between exchange rate weakening and a loss of foreign exchange reserves. In the area of structural reform, the progress is likely to remain gradual but steady. Tax reform and revisions to the relationship between the central and regional governments are currently at the implementation stage. The next item on the agenda is land reform.

Real GDP growth rose to 7.7% in 2000 from 3.5% in 1999, but has been slowing more recently. Industrial output growth fell in December to its lowest rate since April 1999, 5.6% year-on-year. It fell further to just 2% in January 2001, in part due to widespread disruptions of electricity supplies in eastern regions. Despite this GDP growth is still expected to hold up around 4% for 2001.

Turkey

Turkey is in the midst of its second major financial crisis in less than four months. We believe that the government remains united in its pursuit of the revival of the IMF program, and that the negotiations are proceeding from both sides.

There currently is no sign that the government coalition is about to fall apart, although the currency devaluation in February is widely seen domestically as a symptom of serious policy failure. The popularity of two of the coalition parties, the Democratic Leftist Party (DSP) and the Motherland Party (ANAP), has clearly been weakened by the economic crisis.

Following the move to a currency float on February 21, the government has been concentrating power in the hands of a new economic policy head, Kemal Dervis, who came into the government from his role as a Vice President in the World Bank. He is formally in charge of an array of domestic economic institutions that previously had been spread to a number of different ministers that were affiliated with the DSP.

In light of the current crisis-events, the government will have to push out, by at least one year, the original target for achieving single digit inflation. The government is hoping to design a new program with the IMF that will last until the end of 2003.

The immediate task of the government and the IMF is to assess the impact on the banking system of the high interest rates and the floatation of the currency, calculate the immediate funding needs for the banks and agree on an accelerated restructuring plan for the sector.

AGS Financial LLC is an investment banking and advisory firm specializing in developing mortgage and asset securitization programs in Latin America, Europe and Asia.

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