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REGIONAL ECONOMICS
& MARKET STRATEGY MONTHLY

June -July 2015

Bulgaria | Cyprus | Romania | Serbia

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Regional assets recover on subsided Greece-related concerns post the July 12 Euro Summit agreement

REGIONAL MACROECONOMIC DEVELOPMENTS & OUTLOOK

- **Sentiment indicators** in the region suggest economic rebound to continue in the second quarter
- Good performance of **consumer-related** sectors is the key driver for the rise in sentiment indicators
- There is little evidence to suggest that recent developments in Greece will have a lasting impact on the economic activity in the region

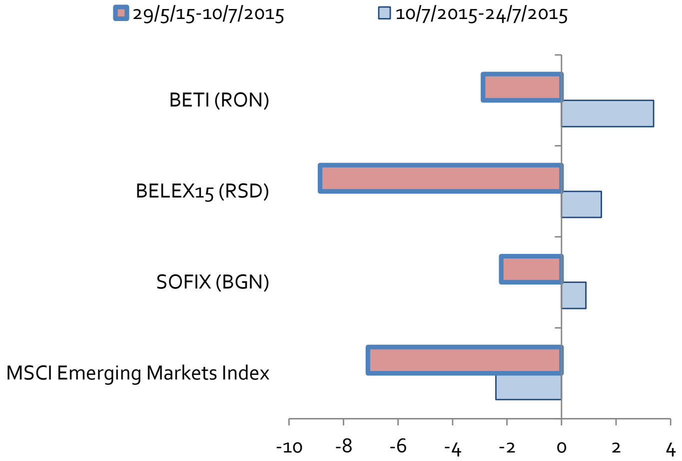
REGIONAL MARKET DEVELOPMENTS & OUTLOOK

- Despite coming under pressure since end-May, **emerging market assets** received some respite after the July 12 Euro Summit agreement
- Regional currencies recouped earlier losses and T-bond yields eased from June's highs
- With Greece-related concerns having somewhat been mitigated of late, the prospect of **higher Fed interest rates** returned to the forefront and is likely to set the tone for emerging market assets ahead

COUNTRY FOCUS

- **Bulgaria:** GDP growth in the first quarter largely driven by net exports
- **Cyprus:** Implementation of Economic Adjustment Programme fully back on track
- **Romania:** Increased political noise as a result of the anticorruption campaign
- **Serbia:** IMF completes first review under 3-year €1.2bn SBA
- ***Special focus:*** *Bank holiday and capital controls in Greece; what can be learned from the Cypriot experience?*

Regional stock markets recover part of their recent losses lately (% change)



Source: Bloomberg, Reuters, Eurobank Research

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I. Regional Macroeconomic Developments & Outlook

Sentiment indicators in the region suggest economic rebound to continue in the second quarter

Sentiment and other high frequency indicators point to relatively strong growth in the region in the second quarter

The first quarter growth readings in the region came out broadly above expectations. Sentiment and high frequency indicators still pointed to relatively strong growth in the region in the second quarter. In most economies of our focus, economic sentiment indicators-an aggregate of five sub-indices-were on a rising trend during the months of the second quarter. The preliminary analysis of the surveys′ breakdown suggests that the strong performance of consumer-related subsectors- the key driver for ESI upward performance- extended in the second quarter as well. The revival of private spending in the region is supported by robust real wage growth, improved consumer and business confidence as well as favorable labor market developments. Meanwhile, even though world energy prices have rebounded from lows hit at the beginning of the year, they are still much lower on a yearly basis. Lower energy costs continue to keep inflation pressures at bay, supporting real disposable incomes and provide more flexibility to household, corporate, and sovereign balance sheets.

Growth in the region is going to be much better in 2015 than last year

In addition, the region is well positioned to benefit from improving economic growth prospects in the Euroarea, the main trade partner and primary generator of capital flows for the region in spite of the recession in Russia,. Yet the recovery of imports stemming from the rebound of domestic demand will probably cap net exports' positive contribution to growth. Overall, sentiment readings are consistent with our view that growth in the region is going to be much better in 2015 than last year despite global economy concerns and ongoing headwinds from the crisis in Russia-Ukraine.

The unfolding events in Greece appear to have a limited impact on the region

On the other hand, the unfolding events in Greece in late June-mid July have stirred up concerns about the region's short-term growth prospects. Our view is that despite the ongoing uncertainty there is little evidence to suggest that developments in Greece have had a lasting impact on the economic activity in the region. The fairly muted reaction of the domestic financial markets is a reflection of the discounted limited impact on these economies. Moreover, the existing direct trade links with Greece are not sizeable, while concerns over spillovers to the domestic banking sectors appear to have been overstated. The subsidiaries of the Greek banks are autonomous -well capitalized entities- subject to the regulatory requirements within the individual banking sector systems. Greece's agreement in 12 July renews hope that normalization will ensue and, thus, any impact on SEE may prove temporary.

Political instability has resurfaced again in Romania as a result of the anticorruption campaign

On a country by country basis, **Bulgaria** registered in Q1-2015 the strongest growth rate since Q2-2011, vindicating our expectations that, instead of slowing down, growth would gain momentum in 2015. From a qualitative point of view, net exports made the strongest positive contribution to growth since Q4-2013, but domestic demand data turned out less strong than expected. The extraordinary first quarter growth performance - the highest in EU28 - makes **Romania** stand out of the pack for a second consecutive year. Robust real wage growth in private and public sector in tandem with improving sentiment and labor market tightening conditions have been fueling a revival of consumption spending in the second quarter of 2015. On the negative side, domestic politics returned to the forefront once again following a criminal investigation against Prime Minister Ponta. Even though the government survived a no confidence vote in Parliament on June 12th, political instability has resurfaced again as a result of the anticorruption campaign.

The approval of the combined reviews (5th-6th-7th) of the Economic Adjustment Programme allowed Cyprus to take advantage of the ECB QE program

The economy of **Cyprus,** a notable turnaround paradigm, bottomed out in Q1-2015 after three consecutive years of recession. The approval of the combined reviews (5th-6th-7th) of the Economic Adjustment Programme paved the way for the disbursement of additional official funding. More importantly, the approval of the reviews will allow Cyprus to take advantage of ECB's QE program. Even though the relevant size of buy backs seem not to exceed €500mn in the case of Cyprus, it still represents a sizeable proportion of the outstanding tradable public debt stock (around 25%). **Serbia** is slowly rebounding from the 2014 floods induced recession, benefiting from low oil prices and the euro area recovery, which have helped to somewhat mitigate short-term fiscal consolidation effects. The positive assessment from IMF on the precautionary agreement's first review and the budget overperformance so far this year, provided room for further-more aggressive than envisaged by the markets- NBS monetary easing in a more predictable domestic environment.

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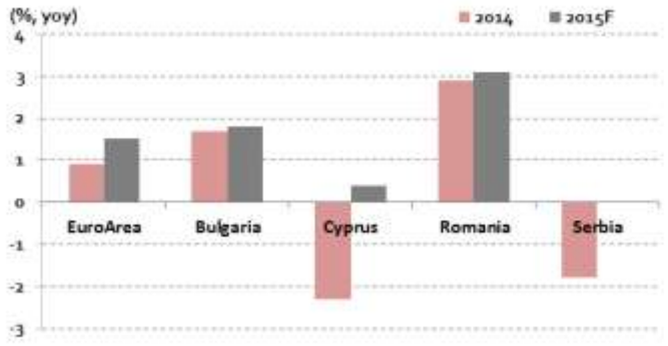
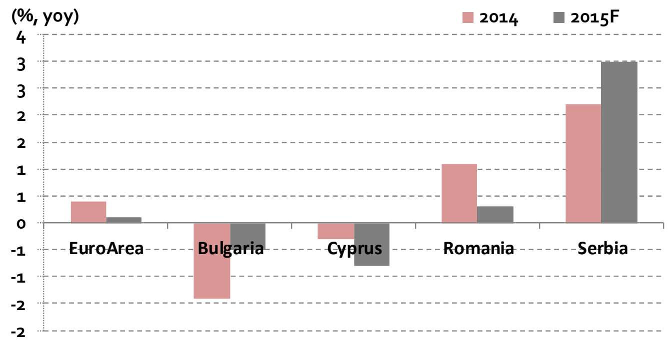
FIGURE 1: **Growth performance 2014 vs. 2015**



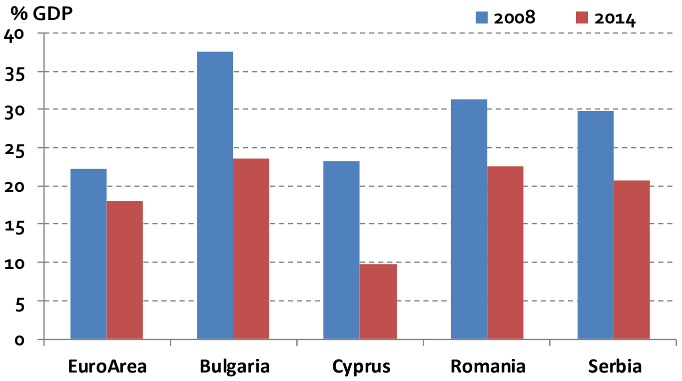
Source: Eurostat, National Authorities, Eurobank Research

FIGURE 2: **Annual average inflation 2014 vs. 2015**



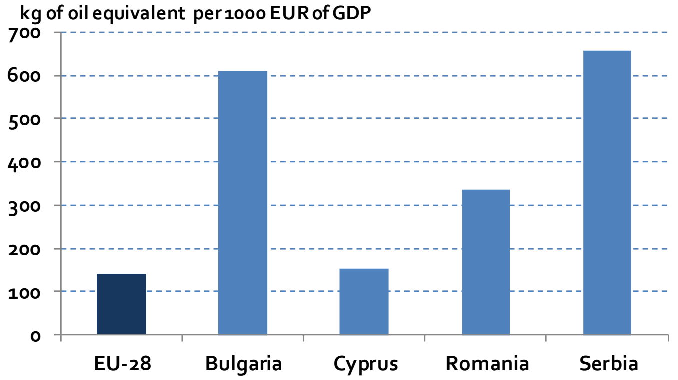
Source: Eurostat, National Authorities, Eurobank Research

FIGURE 3: **Investments to GDP ratios 2008 vs. 2014**



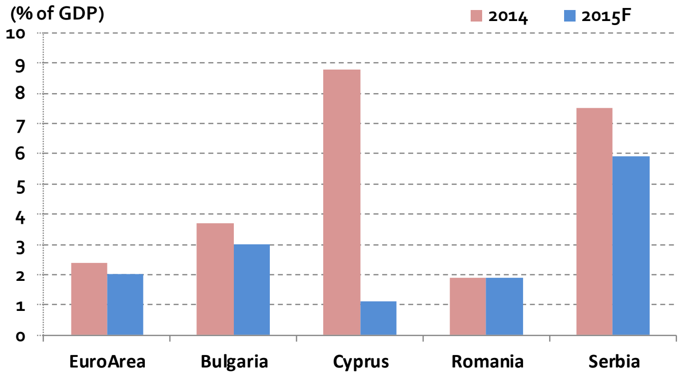
Source: IMF WEO, Eurobank Research

FIGURE 4: **Energy intensity of the individual countries, 2013**



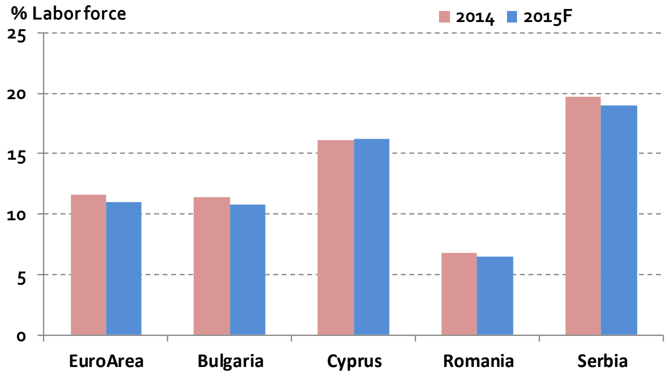
Source: Eurostat, National Authorities, Eurobank Research

FIGURE 5: **Fiscal Balance (% of GDP, ESA2010) 2014 vs. 2015**



Source: Eurostat, National Authorities, Eurobank Research

FIGURE 6: **Annual average unemployment rates 2014 vs.2015**



Source: Eurostat, National Authorities Eurobank Research

II. Regional Market Developments & Outlook

Regional assets recover on subsided Greece-related concerns after the July 12 Euro Summit agreement

Despite coming under pressure since end-May, emerging market assets received some respite after the July 12 Euro Summit agreement

Emerging market assets came under pressure over the last couple of months or so, in a broad reversal of gains registered earlier in the year. The tone has been primarily set by external developments. Greece-related concerns and China's recent equity market turbulence, which revived worries over growth prospects of the world's second largest economy, have largely dominated headlines. That said, financial markets received some respite since the July 12 Euro Summit, when a tentative agreement between Greece and official creditors was reached on a 3-year ESM loan facility, while some signs of stabilization have been evidenced over recent sessions in the Chinese stock market after domestic authorities stepped up efforts to sooth jitters. Investor sentiment was further supported over the last couple of weeks by news that the first and second set of agreed prior actions were approved on time by the Hellenic Parliament earlier in the month, paving the way for the inception of official discussions on a 3-year ESM loan facility. The European Union finance ministers' approval for a €7.16bn bridge loan to Greece, in order for the country to cover its immediate financing needs until the completion of official discussions on the new ESM programme, as well as the ECB's recent decisions to raise further the ceiling of the ELA funding to the Greek banks, confirmed that Greece-related immediate risks have been mitigated of late. Subsequently, investors' focus appears to have now returned towards the prospect of higher US interest rates later this year. Recent comments by several Federal Reserve officials, including Fed Chair Janet Yellen, and a new streak of upbeat macroeconomic data from the US, reinforced expectations for a Fed rate hike later in 2015, putting a lid to a more notable recovery on emerging market assets being witnessed since mid-July.

Regional stock markets lost ground over the last couple of months; with most indices having however recouped part of their recent losses

Against this backdrop, regional stock markets stood broadly weaker in late July compared to their end-of-May levels, with most key indices having given back their earlier 2015 gains to stand in a negative territory year-to-date at the time of writing this report. In more detail, Serbia's main BELEX15 led the downtrend, encountering losses to the tune of 7% since end-May, standing in late July within distance from a 10-month trough reached a couple of weeks earlier. The said index swung back into red for the year, recoiling from a 4-year peak achieved in mid-April, The prior increase was primarily due to an improving fiscal position and an IMF policy anchor, which shifted investors' perceptions in favour of the country's assets. The broader MSCI Emerging Markets index marked similar losses since end-May, having also shed all of its earlier year-to-date gains and slid to its lowest level in two years in mid-July. Elsewhere, Bulgaria's main SOFIX index was modestly lower from the end of May, standing nearly 8% weaker compared to its end-2014 levels. On the other hand, Romania's BETI bucked the negative trend to pose among the CESEE region's best performers. BETI fully offset losses encountered since late May, having so far amassed 2015 gains to the tune of 6%, and touched a 7-year high on July 17th amid comparably strong growth dynamics and Central Bank monetary easing.

Regional currencies recouped earlier losses and T-bond yields eased from June's highs; looming higher Fed rates to remain in the forefront

Albeit coming under pressure over the last couple of months in view of Greece-related concerns, regional currencies staged a notable recovery after the July 12th Euro Summit agreement. The Romanian leu led the winners' pack standing modestly firmer against the euro in late July vs. end-May, hovering within distance from a 2 ½-month high near 4.3975/EUR hit earlier that month. In a similar vein, the Serbian dinar also firmed modestly over the same period, remaining though range-bound around 120-121/EUR, with further RSD gains capped in view of ongoing Central Bank interventions in the FX markets to halt the currency's upside momentum. From a broader CESEE perspective, the Turkish lira has remained under pressure over recent weeks, amid heightened domestic political uncertainty. More specifically, the USD/TRY stood around 2.75 in late July, not too far from a record peak near 2.8085 hit in the wake of the June 7 general elections. In those elections, the ruling AK party fell short of achieving parliamentary majority for the first time since 2002, paving the way for lengthy coalition negotiations. The prospect of early national elections is also on the cards, if a government is not formed by late August. Terrorist attacks that stirred anti-government rallies in late July exacerbated domestic political noise. Regarding regional government bonds, they recouped part of their recent losses over the last few weeks, with corresponding benchmark yields having eased from multi-month peaks hit in mid-June. Indicatively, Romania's 10-year benchmark bond yield stood in late July ca 60bps lower from a 4.3% 10-month peak hit about a month earlier, remaining though ca 15bps above its end-May level. Looking ahead, the prospect of higher Fed interest rates is likely to remain in the forefront and set the tone for emerging market assets, while developments in China and Greece will also be closely scrutinized by market participants.

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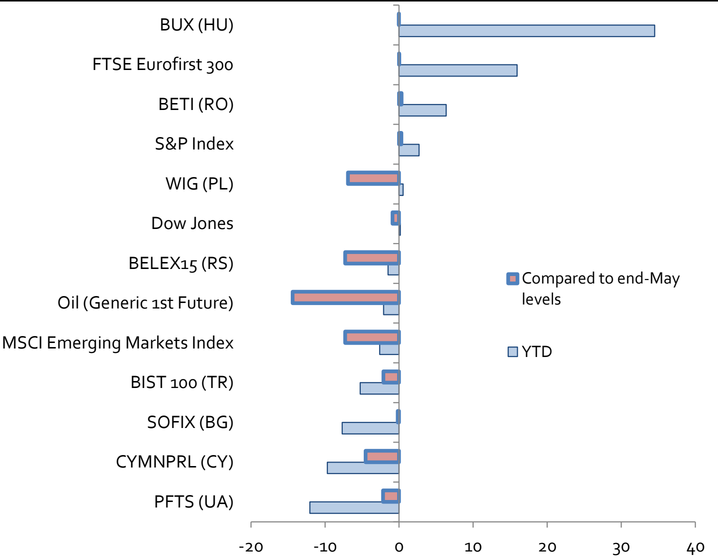
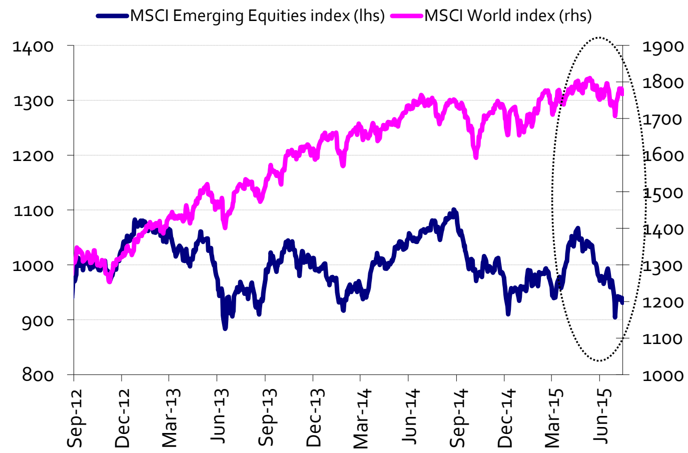
FIGURE 7: **Major world & CESEE stock markets performance (%)**



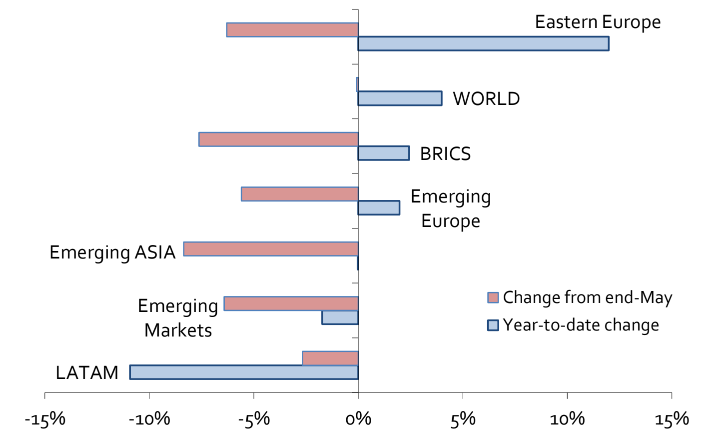
Source: Reuters, Bloomberg, Eurobank Research

FIGURE 8: **World & CESEE stock markets YTD performance**



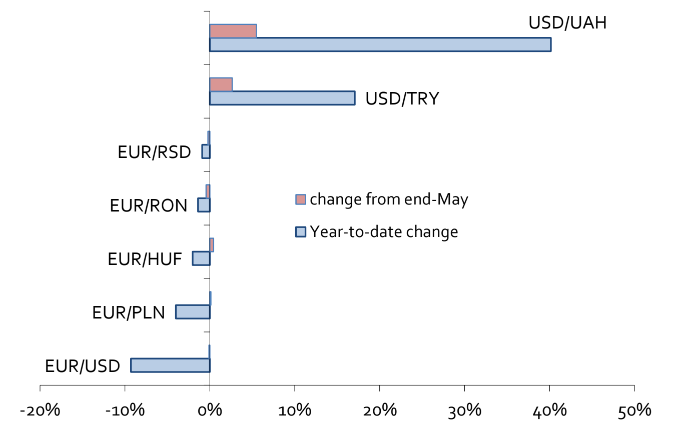
Source: Reuters, Bloomberg, Eurobank Research

FIGURE 9: **MSCI stock indices performance (by region)**



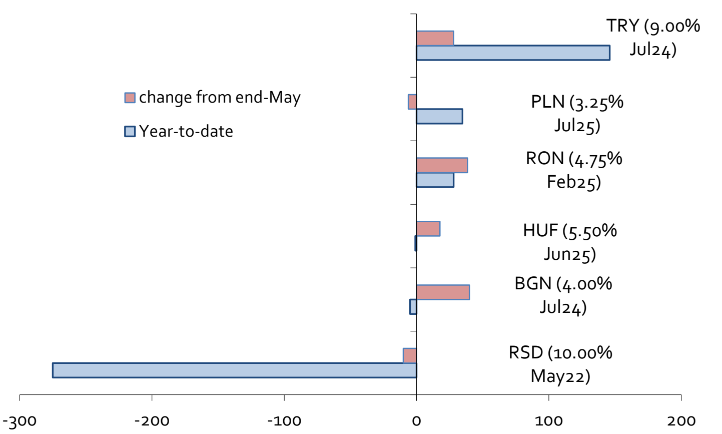
Source: Reuters, Bloomberg, Eurobank Research

FIGURE 10: **CESEE FX performance**



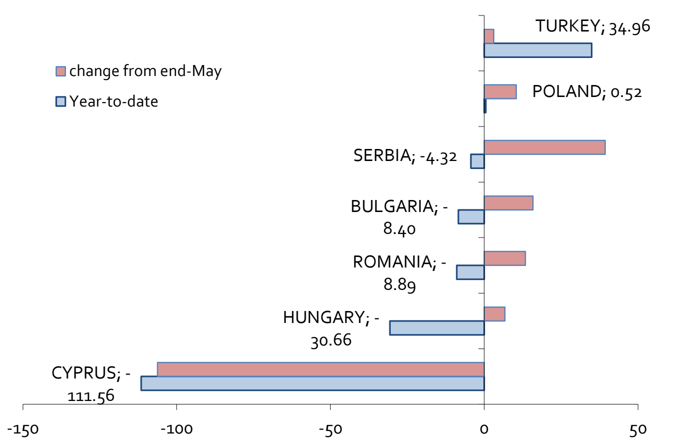
Source: Reuters, Bloomberg, Eurobank Research

FIGURE 11: **Change in CESEE government bond yields (in bps)**



Source: Reuters, Bloomberg, Eurobank Research

FIGURE 12: **Change in 5-Year CDS spreads (in bps)**



Source: Reuters, Bloomberg, Eurobank Research

Trader's view

Long EUR/RSD n-t positions appear favourable; timing of entry is essential due to negative carry

FX

The Serbian dinar continued to trade within 120.00-121.20 against the euro over the last few months, as any recent attempts towards the lower end of the said range were obstructed by repeated Central Bank interventions aimed at halting the RSD's upside momentum. In July alone, the NBS is estimated to have purchased approximately €200mn. In the imminent future we anticipate range-trading to continue around these levels. Looking further ahead, we anticipate a weakening of the dinar to be instigated by seasonal factors after the summer. Moreover, August's T-bond auction calendar is relatively thin, thus mitigating the risk of heavy hard currency inflows in the FX market in the coming weeks. At this junction, the timing of entering a long EUR/RSD position is crucial due to the negative carry this trade entails.

Security	Position	Entry	Carry	Target	Stop loss	Comments
EUR/RSD	Long ⇧	120.15	-3.58%	120.95 (1st) 121.80 (2nd)	119.80	Absence of Central Bank intervention near 120.00 argues in favour of closing this position

We continue to like long ROMGB November 2018 positions financed via 1M EUR/RON rolling swap

Local Rates

With government bonds of short-to-medium term maturity likely to continue benefiting from ample RON liquidity in the money market in the coming weeks and taking into account the significant steepness in this segment of the yield curve, we maintain our previous trade for long positions on the ROMGB November 2018. Also in support of the latter is the high concentration of foreign investors in bonds of longer maturity (8-10 year), which suggests that the said paper is less vulnerable to external risks. Confirming this, was the recent case of June/July sell-off where the November 2018 T-bond fared better than other issue, with the maximum increase witnessed in the corresponding yield being 25bps compared to the entry level, while the 10-year yield jumped by a maximum of 80bps over the same period. Maintaining financing via 1M EUR/RON swap, with the implied funding rate currently around 0.80%, alleviates FX risk.

Security	Position	Entry	Carry	Target	Stop loss	P&L (MtM)	Comments
ROMGB 5.6% November 2018	Long ⇧	2.20%	+140bps	1.70%	2. 50%	+19bps	financed via 1M EUR/RON rolling swap (currently implied rate around 0.80%)

Bulgarian T-bonds to recover further; 5/10-year segment of BGN curve to likely outperform

Since the July 12 Euro Summit, when a deal was reached between Greece and official creditors, a decent recovery has been evidenced in both local and external Bulgarian debt. With Greece-related concerns having been somewhat mitigated of late, we expect a further recovery in Bulgarian government bonds in the near future. In addition to the country's improving fiscal position, supply-side factors such as the redemption of two large local T-Bills for total amount of EUR 550mn in September are also expected to provide support. In addition to Bulgarian Eurobonds, we also favor the long end of the BGN curve (5-10Y sector) where the effect from the sell-off in May/June was mainly concentrated.

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III. Country Focus

Bulgaria (Baa2/BB+/BBB-)

GDP growth largely driven by net exports

Strong performance of net exports overshadowed by weak domestic demand data

The economy expanded at the strongest pace in Q1-2015, since Q2-2011. Real GDP growth expanded by 0.9%QoQ/+2.0%YoY in Q1-2015, up from +0.4%QoQ/+1.3%YoY in Q4-2014 vs. +0.1%QoQ/+1.5%YoY in Q1-2014. According to the detailed national accounts data, private consumption appeared weak at -0.3%QoQ/+0.3%YoY in Q1-2015 slowing down from +1.1%QoQ/+0.9%YoY in Q4-2014. This is explained to some extent by the high base of Q1-2014 but primarily from the negative contribution of fiscal policies restraint. The performance of investments was mediocre for yet another quarter, as gross fixed capital formation grew by -0.1%QoQ/+2.1%YoY in Q1-2015 down from +1.1%QoQ/+4.8%YoY in Q1-2014. The double digit performance of exports impressed (+4.8%QoQ/+12.9%YoY in Q1-2015 up +8.3%QoQ/+5.4%YoY in Q4-2015) but also imports were very strong too (+4.7%QoQ/+9.7%YoY in Q1-2015 up from +4.6%QoQ/+7.5%YoY in Q4-2014). However, net exports made the strongest positive contribution to growth since Q4-2013, with their contribution growing to 1.7pps in Q1-2015 up from -1.4pps in Q4-2014. The latter reflects the improvement of the external environment stemming from the better than anticipated Euroarea growth performance but also the terms of trade gains versus non-Euroarea partners from the devaluation trend of the Euro to which Lev is pegged. Lower input costs also helped as energy prices were down on a yearly basis which implies huge gains because Bulgaria has the highest energy intensity in EU-28.

Inflation registered the fourth positive yearly reading in June since August 2013.

Inflation registered the fourth positive yearly reading in June since August 2013. Consumer prices slipped to -0.9%/+0.4%MoM/YoY in June up from -0.2%/+0.9%MoM/YoY in May, bringing the annual average inflation up to 0% in the first six months of the year. The slowdown in food prices (-2.3%/+0.5% MoM/YoY in June vs. -0.9%/+1.6% MoM/YoY in May) was the main culprit behind easing price pressures. Higher fruit and vegetable prices, the most volatile food items, as a result of severe flooding and increased food exports had pushed higher the food component of the consumer basket (34% weight) in last March-April. As a result, the normalization of fruit (+1.8%MoM) and the hefty decline of vegetable prices (-14.7%MoM) resulted in a food prices slowdown in June. Regulated prices (+4.9%YoY in June vs. +5.0%YoY in May) provided one of the highest contributions to inflation on a yearly basis in June (+0.8pps). On the flipside, the energy deflation receded from -13.8%YoY in April down to -9.9%YoY in May and further down to -8.8%YoY in June as a result of the energy prices rebound trend which pushed transportation prices higher (-5.8%YoY in June down from -6.6%YoY in May vs. -9.0%YoY in April). Looking ahead, the announced 7.5% wholesale gas price cut in July threatens to push inflation back into negative territory. To some extent, an electricity hike of 2% approved by the electricity regulator effective from August will offset it. In addition, elevated services' price pressures (+2.6%YoY in June vs. +3.1%YoY in May) -a reflection of recovering domestic demand- is going to maintain consumer prices will also provide a positive input to inflation. Unless there is some unforeseen new supply side shock in food and world energy prices, inflation is expected to remain in marginally positive territory bringing the average reading to +0.3% in 2015 up from -1.4% in 2014.

Parliament ratified Mr. Dimitar Radev as the new central bank governor

The election of the new Central Bank governor took take place in the extraordinary session of the parliament on July 14th. The outgoing Central Bank (BNB) governor, Mr. Ivan Iskrov whose regular term expires in October, had expressed his intention to step down as early as when his successor would be elected by the parliament. Among the four candidates for the position, the candidacy of senior IMF economist Mr. Dimitar Radev, who was backed by ruling GERB party and their junior partner, the Reformist Bloc was approved by parliamentary majority. The incoming Central Bank governor, who was being cited as a favorite by the media, reportedly highlighted in his speech to the parliament that he plans to pursue "three sets of policy measures consisting of bank supervision reform, bank-crisis management mechanism and asset quality assessment". He reportedly added that "the central bank will support the government's efforts to join the European bank union, while seeking a balance between rights and responsibilities." The banking sector turmoil following the collapse of the Corporate Commercial Bank in late June 2014, has raised attention on the issues of banking supervision effectiveness and corporate governance. Although the collateral damage to the economy was minimized and the noise was short-lived, there has been a lot of media criticism on BNB. On the other hand, BNB had expressed their intention to submit itself to an independent assessment by the European Banking Authority (EBA) as well decide upon an application for Single Supervisory Mechanism (SSM) entry.

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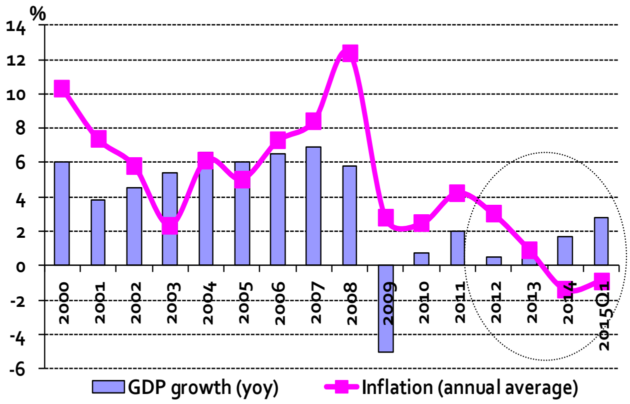
Bulgaria: Macro & Market Data	2013	2014	2015f	2016f
Real GDP (yoy%)	1.1	1.7	1.8	2.2
Final Consumption	-1.3	2.4	2.0	2.5
Gross Capital Formation *(Fixed)*	-0.1	2.8	1.5	3.0
Exports	9.2	2.2	8.5	3.5
Imports	4.9	3.8	7.0	4.5
Inflation (yoy%)				
CPI (annual average)	0.9	-1.4	0.3	1.2
CPI (end of period)	-1.6	-0.9	0.7	1.5
Fiscal Accounts (%GDP) - *Cash Basis*				
General Government Balance	-1.8	-3.7	-2.5	-2.4
Gross Public Debt	18.6	27.7	29.8	31.2
Primary Balance	-1.0	-3.0	-1.5	-1.4
Labor Statistics				
Unemployment Rate (LFS, %)	12.9	11.4	10.8	10.2
Wage Growth *(total economy)*	6.0	6.8	7.0	6.0
External Accounts				
Current Account (% GDP)	1.0	0.9	2.0	1.5
Net FDI (EUR bn)	1.4	1.3	1.5	1.5
FDI / Current Account (%)	Na	Na	Na	Na
FX Reserves (EUR bn)	14.4	16.5	19.0	21.5
Domestic Credit	**2012**	**2013**	**2014**	**Q1-2015**
Total Credit (%GDP)	72.3	72.9	67.7	65.9
Credit to Enterprises (%GDP)	47.7	47.7	41.8	41.1
Credit to Households (%GDP)	23.0	23.0	22.3	22.1
FX Credit/Total Credit (%)	64.0	60.9	57.0	55.9
Private Sector Credit (yoy)	3.8	0.6	-6.7	-7.5
Loans to Deposits (%)	99.4	92.1	84.2	86.4
Financial Markets	**Current**	**3M**	**6M**	**12M**
Policy Rate		Currency Board		
EUR/BGN	1.96	1.96	1.96	1.96

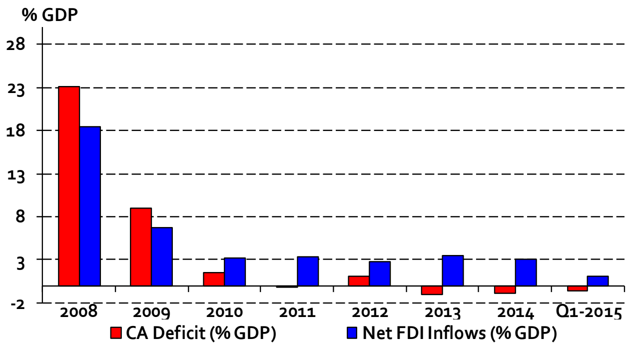
Source: National Sources, Eurostat, IMF, Eurobank Research

FIGURE 13: **GDP growth & Inflation 2000-2015**



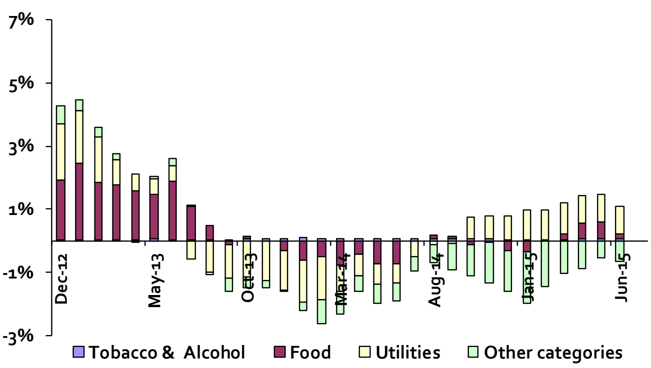
Source: National statistics, Ecowin Reuters, Eurobank Research

FIGURE 14: **CA Deficit & Net FDI inflows 2008-2015**



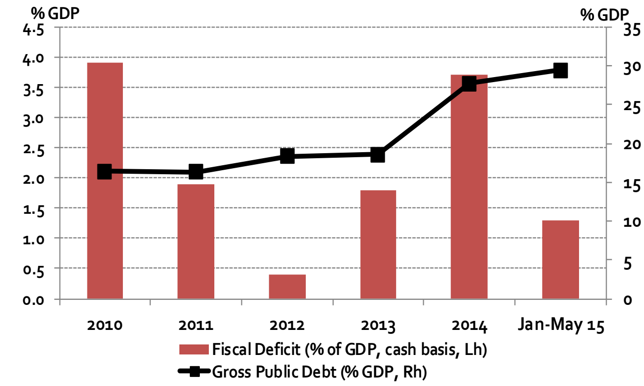
Source: National statistics, Ecowin Reuters, Eurobank Research

FIGURE 15: **Inflation dynamics 2012-2015**



Source: National statistics, Ecowin Reuters, Eurobank Research

FIGURE 16: **Fiscal deficit & Gross Public Debt 2010-2015**



Source: Eurostat, Eurobank Research

Cyprus ((P)B3/B+/B-)

The implementation of the Economic Adjustment Programme is fully back on track

The approval of the combined 5th-6th-7th reviews paved the way for access to additional financing

The IMF board approved in late June the combined 5th-6th-7th review of the Economic Adjustment Programme which enabled access to an additional combined amount of €280mn and accordingly the disbursement of another €100mn tranche by ESM. Up until now, Cyprus had completed successfully four reviews within the programme making use of about €6.75bn out of the €10bn combined package. The endorsement of the long delayed new personal and corporate insolvency framework by Parliament in late April paved the way for the completion of the reviews. More importantly, the approval of the reviews allowed Cyprus to take advantage of the ECB QE program. Even though the relevant size of buy backs seem not to exceed €500mn in the case of Cyprus, it still represents a sizeable proportion of the outstanding tradable public debt stock (around 25%).

The 8th review begun on July 14th, focusing on the implementation of foreclosures and the privatization plan

The 8th review- which begun on July 14th- will focus on the issue of effective implementation of the new personal and corporate insolvency framework, plus two more issues: the facilitation of sales of bank loans by the domestic credit institutions and addressing the issue of untitled property sales by developers. The first one refers to the legislation to facilitate the sale of bank loans to foreign institutional investors and private funds through securitization. The creation of a new market for non-performing assets will allow banks to dispose of them, thus cleaning up their balance sheets more quickly and efficiently. The second one refers to the Land Registry. The Land Registry is the only institution responsible to determine the property values as well as for the issuance and transfer of the title deeds. The Land Registry is currently confronted with a backlog of many requests which complicates things further in terms of the required collateral repossession and foreclosures procedures. In addition, many property sales from developers (mortgage properties) have taken place without the issuance of a title for the buyer in order to avoid the high transfer tax.

The privatization process is about to reach decisive stage where the political commitment will be tested in the parliament in the coming period

During the ongoing review, Troika will also discuss about issues of the privatization of state-owned public utilities widely known as semi government organizations: the Telecomm Utility (CYTA), the Electricity Authority (EAC) and the Port Authority (CPA).The implementation of the privatizations plan, a key component of the overall programme, has been advancing slowly in the recent months. After the adoption of the law in Parliament (back in June 2014), a privatization unit has been created in line with the MoU requirements. The privatization process is about to reach a decisive stage where the political commitment will be tested in the parliament in the coming period. The process is politically sensitive because multiple stakeholders (government, parliament, political parties, and unions) are involved. The government has committed that several steps ought to be taken in order not to undermine workers' rights (e.g. voluntary retirement schemes). In addition, legislation needs to be approved in Parliament for the transformation of the semi-government organizations to private entities and then begin the tender process

The benefits from the privatization process are not limited only to the sale revenues

The project of privatization of the telecom company CYTA is at a more mature stage: the advisers for this project have been selected. The project of EAC is more complicated and time consuming because an energy adviser needs to come in and advise on restructuring, legal unbundling and corporatization options. Consultations with Troika for making a detailed plan for the separation and privatization of the commercial operations of the CPA are expected to take place in the following months. The benefits from the privatization process are not limited only to the sale revenues. Efficiency gains are going to accrue from a structural point of view. According to the programme, revenues of €1.4bn are anticipated to lower public debt. More importantly, the successful process will most probably foster more competition with multiple benefits for the domestic economy (attracting FDI inflows, creating jobs etc.).

The economy bottomed out in Q1-2015 after three years of recession

In Q1-2015, Cyprus recorded the first positive growth rate on a quarterly and yearly basis since Q2-2011. GDP growth expanded by +1.6%QoQ/+0.2%YoY in Q1-2015 up from -0.4%QoQ/-1.8%YoY in Q4-2014 vs. -0.4/QoQ-3.2%YoY in Q1-2014. Even though the reading is marginally positive, it is still illustrative of the progress Cyprus has made within the programme period. After two years under the programme, Cyprus is showing tangible signs of a turnaround. Sentiment has been on an improving trend recovering towards pre-Lehman era levels (April 2015: 107.3). In addition, capital controls have been fully lifted as a result of the confidence coming back to the financial sector. Finally, the fiscal and external accounts adjustment is impressive by any standards of comparison. More importantly, the progress is acknowledged by rating agencies while the compression of yield spreads has led to a gradual restoration of access to the financial markets.

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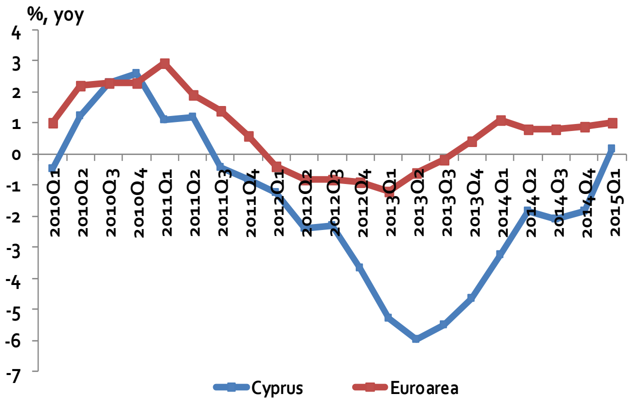
Cyprus: Macro & Market Data				
	2013	2014	2015f	2016f
Real GDP (yoy%)	-5.4	-2.3	0.4	1.4
Private Consumption	-6.0	0.4	-0.1	1.1
Public Consumption	-4.9	-8.7	-2.1	-0.8
Gross Capital Formation *(Fixed)*	-17.1	-18.8	1.3	3.6
Exports	-5.0	5.7	1.5	1.5
Imports	-13.6	8.1	-0.1	1.0
Inflation (yoy%)				
HICP (annual average)	0.4	-0.3	-0.8	0.9
HICP (end of period)	-1.3	-1.0	-0.5	1.1
Fiscal Accounts (%GDP) - *ESA2010*				
General Government Balance	-4.9	-8.8	-1.1	-0.1
Gross Public Debt	102.2	107.5	106.7	108.4
Primary Balance	-1.8	-6.0	1.7	2.6
Labor Statistics				
Unemployment Rate (LFS, %)	15.9	16.1	16.2	15.1
Wage Growth *(total economy)*	-6.0	-4.7	-0.3	1.1
External Accounts				
Current Account (% GDP)	-3.0	-5.1	-3.9	-4.2
Net FDI (EUR bn)	0.2	1.1	0.7	0.7
FDI / Current Account (%)	55%	127%	104%	106%
Domestic Credit	**2012**	**2013**	**2014**	**Q1-2015**
Total Credit (%GDP)	373.5	351.4	356.0	368.9
Credit to Enterprises (%GDP)	171.1	160.2	150.1	155.3
Credit to Households (%GDP)	138.9	140.0	143.5	140.5
Private Sector Credit (yoy)	-0.5%	-6.0%	-3.2%	3.7%
Loans to Deposits (%)	103.3%	135.3%	133.5%	137.5%

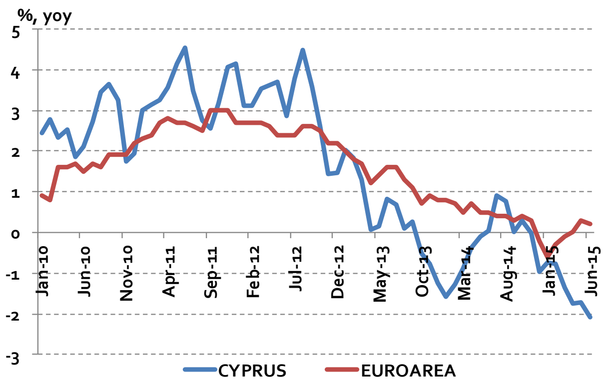
Source: National Sources, Eurostat, IMF, Eurobank Research

FIGURE 17: **Growth performance Cyprus vs. Euroarea 2010-2015**



Source: Eurostat, Eurobank Research

FIGURE 18: **HICP Cyprus vs. Euroarea 2010-2015**

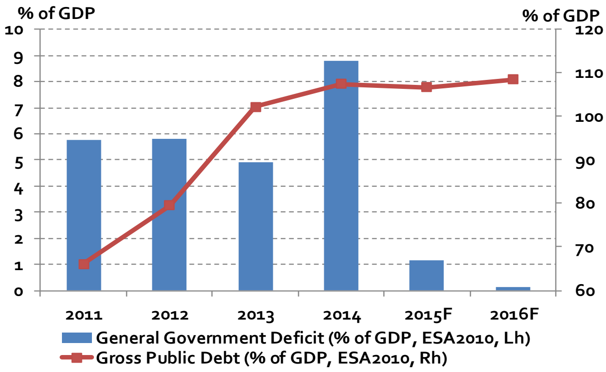


Source: Eurostat, Eurobank Research

FIGURE 19: **10Y Government Bond Yield**

Source: Bloomberg, Eurobank Research

FIGURE 20: **Fiscal deficit & Gross Public Debt 2011-2016**



Source: Eurostat, Eurobank Research

Romania (Baa3/BBB-/BBB-)

Increased political noise as a result of the anticorruption campaign

Domestic political jitters have resurfaced as a result of the anticorruption campaign

The parliament veto on the prosecution charges brought against the Prime Minister Ponta by the National Anticorruption Directorate (DNA) triggered the filing of a no-confidence motion by the opposition in early June. However, the no-confidence motion failed on June 12th because it was backed by only 194 MPs, falling short of the majority needed in the 555-seat house. Yet, the Prime Minister was confronted with increased pressure thereafter given that the ongoing corruption investigation expanded on additional allegations related to his activities before assuming the post of the Prime Minister. As a result, Mr. Ponta was inclined to step down from the leadership of the ruling Social Democratic Party (PSD), but signaled that he doesn't intend to resign from his post. The corruption charges against Prime Minister are another blow to his prestige and raise the probability of an early step down. Even if those allegations are not confirmed, they have stirred a lot of internal debate within the ruling coalition in a pre-election year. Defections in the ruling camp, that may put the stability of the governing coalition led by PSD at risk, cannot be ruled out. Even if the political landscape does not change radically, the case against Prime Minister Ponta could undermine government efficiency particularly in the lower levels of administration. To make things worse, there is high risk that the agenda will shift to more populist policies that will be market negative, pushing back crucial structural reforms**.** Last but not least, the stance of the President is going to be a catalyst going forward given recent frictions with the government. Feuds between the President and the incumbent Prime Minister have already created enough political noise. In the case of indictment, the President has the discretion by the constitution to nominate a new PM provided that a new parliamentary majority backs him.

Consumer prices slipped into negative territory as a result of the food VAT rate cut implementation

Inflation came at -2.95%MoM/-1.55%YoY in June vs. +0.5%MoM/+1.2%YoY in May, significantly lower than market consensus (Bloomberg:-2.0%MoM/-0.6%YoY). The sharp decline in the food prices component (-8.2MoM/-6.4%YoY) was the main driver behind the inflation decline. The front-loaded food VAT rate cut (from 24% to 9% effective from June 1st) pushed inflation into negative territory, given the high share of food products in the consumption basket (32%). Under the assumption of a partial pass-through of the VAT rate cut, inflation is now expected to remain in a negative territory for most of the 2H-2015 and stay marginally above zero in Q1-2016, significantly below the lower bound of NBR target interval (2.5%±1%). On the other hand, the planned gas prices increases stemming from the energy prices liberalization schedule for household consumers-effective from July-could push administered prices higher, counterbalancing the impact of the food VAT rate cut.

NBR has most probably taken further interest rate cuts out of the table

On July 1st, NBR left interest rates and MRRs for RON and FX denominated liabilities unchanged at 1.75%, 8% and 14% respectively. As far as monetary policy is concerned, the comments from NBR governor hint that the June's 25bps cut may have been the last under the current easing cycle. Although the subdued inflation outlook allows more flexibility on the issue of future rate setting, we anticipate NBR to remain on hold in the near term. There are some good reasons why NBR could refrain from further rate cuts. The robust growth performance which implies the sooner than expected closing of the output gap, downside risks stemming from the ambitious fiscal easing plan which has raised deep concerns, also voiced by the EU and IMF, and the expiration of the precautionary agreement plus worries over external risks on the radar. That said, there is still enough space for NBR to lower the domestic currency MRRs should the need arise.

The extraordinary output performance of Q1 is driven by sustained improvement in private spending

The detailed GDP data for the first quarter confirmed our expectations that private consumption has taken over as the leading economic growth driver. Private consumption (+4.2%YoY) provided a hefty +3.2pps contribution. The performance of gross fixed capital formation (+8.0%YoY, 1.2pps) together with inventories pile up (+1.3pps) suggested that investments are making a comeback. Despite their robust performance, exports (+9.7%YoY, +5.0pps) were outpaced by imports (+12.6%YoY, +6.3pps) due to the revival of domestic demand, so that the overall contribution remained negative (-1.3pps). Sustained improvement in private spending is supported by robust real wage growth (+6.4%YoY in March), improved sentiment (ESI-Index climbing for an eight month in a row touching a new post-Lehman period high at 103.2 in May) and labor market tightening (+110k yoy more jobs added in March). The extraordinary first quarter growth performance (+1.6%QoQ/+4.3%YoY) - the highest in EU28 - makes Romania stand out of the pack for a second consecutive year.

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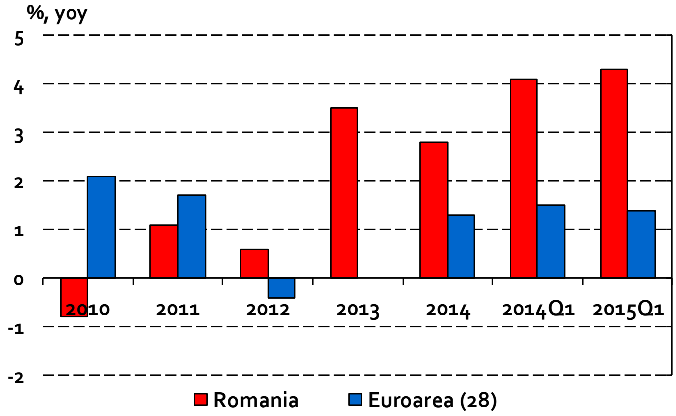
Romania: Macro & Market Data				
	2013	2014	2015f	2016f
Real GDP (yoy%)	3.4	2.9	3.4	3.5
Consumption	0.4	3.0	4.2	4.0
Investment	-7.9	-3.6	5.0	6.5
Exports	16.2	3.5	7.5	5.0
Imports	4.2	7.7	10.5	8.0
Inflation (yoy%)				
CPI (annual average)	4.0	1.1	-0.5	1.8
CPI (end of period)	1.6	0.8	0.0	2.5
Fiscal Accounts (%GDP, Cash Basis)				
General Government Balance	-2.2	-1.9	-1.9	-2.8
Gross Public Debt (including guarantees)	37.9	39.5	39.1	41.5
Labor Statistics (annual avg,%)				
Unemployment Rate (ILO, % of labor force)	7.1	6.8	6.5	6.4
Wage Growth (total economy)	4.8	5.3	7.0	6.5
External Accounts				
Current Account (%GDP, BPM5)	-0.8	-0.4	-1.0	-1.5
Net FDI (EUR bn)	2.9	2.5	3.0	3.5
FDI / Current Account (%)	250.1	385.0	187.0	140.0
FX Reserves (EUR bn)	35.4	35.5	35.0	36.0
Domestic Credit *(end of period)*	**2012**	**2013**	**2014**	**Q1-2015**
Total Credit (%GDP)	52.0	47.0	44.4	44.5
Credit to Enterprises (%GDP)	20.3	18.0	15.7	15.5
Credit to Households (%GDP)	17.8	16.5	15.4	15.1
FX Credit/Total Credit (%, private)	62.5	60.9	56.2	55.0
Private Sector Credit (yoy)	1.3	-3.3	-3.1	-3.6
Loans to Deposits (%)	133.9	118.4	106.3	106.5
Financial Markets	**Current**	**3M**	**6M**	**12M**
Policy Rate	1.75	1.75	1.75	2.50
EUR/RON	4.44	4.45	4.45	4.40

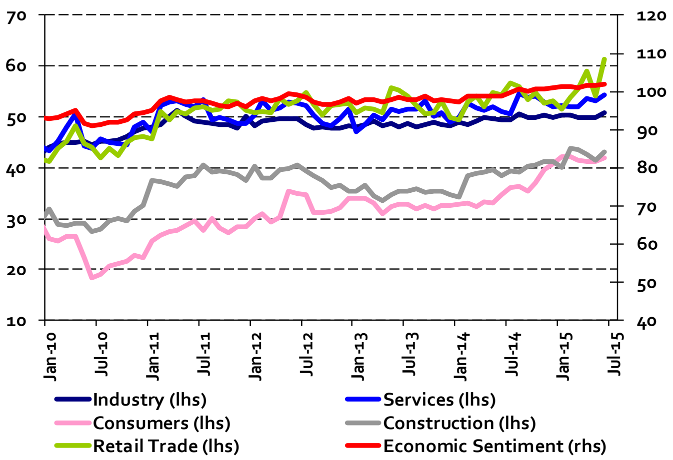
Source: National Authorities, EC, IMF, Eurobank Research

FIGURE 21: **Growth rates Romania vs. EU - 28 2005-2014**



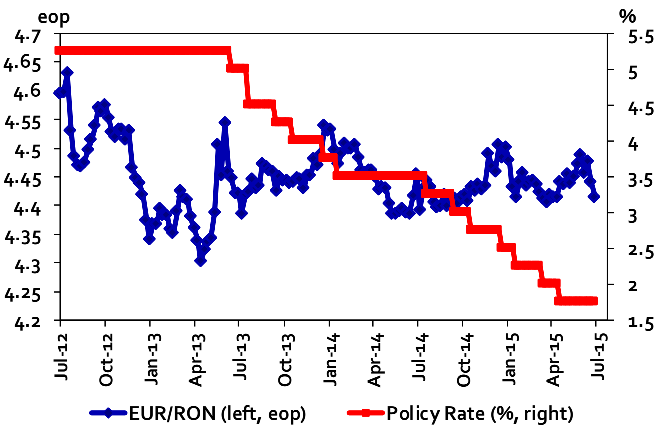
Source: Eurostat, Eurobank Research

FIGURE 22: **Sentiment indicators 2010-2015**



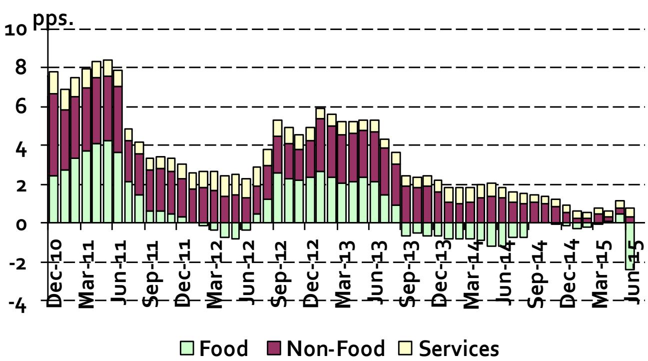
Source: Eurostat, Ecowin Reuters, Eurobank Research

FIGURE 23: **Monetary policy & FX rate 2012-2015**



Source: Bloomberg, Eurobank Research

FIGURE 24: **Inflation components 2011-2015**



Source: National statistics, Eurobank Research

Serbia (B1/BB-/B+)

IMF completes first review under 3-year €1.2bn SBA to Serbia

Final GDP data show that Q1 2015 contraction primarily driven by net exports, weak consumption

According to final national accounts data, real economic activity slid back into contraction, of 0.4%, in Q1 2015 on a seasonally adjusted quarterly basis. This follows a short-lived bounce to a positive growth reading of 0.2%QoQ in the October-December 2014 period. Against this backdrop, real GDP growth (non-seasonally adjusted) was revised modestly higher at -1.8%YoY, from -1.9%YoY previously reported, in line with the rate of annual decline registered in the prior quarter. Vindicating our expectations, the breakdown of the data showed that domestic consumption continued to exert a negative input on growth, with household and government expenditure recording respective annual declines of 0.6% and 3.5%, both mirroring the adverse impact of fiscal restraint. Despite a pick up to 9.7% in the rate of annual increase in exports (RSD 337.9bn) their net contribution remained negative due to a concomitant 11.0%YoY gain in imports (RSD 445.4bn) amid unfavorable base effects. On a positive note, investments appeared to be on the mend, with gross fixed capital formation posting a positive annual growth rate for the second quarter running, of 4.4%, in Q1 2015 after a meagre advance of 0.9%YoY in the prior quarter which followed eight consecutive quarters in contraction.

Economic recovery in H2 2015 to push FY 2015 real GDP growth towards zero

Looking into the remainder of the year, we anticipate a recovery in economic activity in H2 2015 to push real GDP growth towards a flat reading. The main culprits of this expected improvement lie in the face of favorable base effects and a further revival envisioned in investments. Markedly, industrial production growth bounced by 17.7%YoY in May, returning to a positive growth reading for the first time in a year, after contraction of 0.1%YoY in the prior month. The breakdown of the data showed that mining led the way higher (+23.9%YoY) as the damage incurred on coal mines from last year's floods is gradually restored. Recently adopted monetary easing and low global oil prices are also likely to provide support to economic activity in the coming months. As it has been indicated recently by high frequency data, household and government expenditure are poised to remain weak and exert a negative contribution to growth this year. For 2016, we pencil in a further rebound in output as the negative impact stemming from fiscal consolidation gradually wanes, while external demand picks up further. Additionally, an improving fiscal position, the IMF's policy anchor and a stable political landscape bode well for investments and the country's business environment.

IMF completes first review under 3-year €1.2bn SBA to Serbia

With respect to Serbia's 3-year €1.2bn precautionary Stand-By Arrangement with the IMF, it is worth noting that the Fund's Management and the Executive Board completed, as was broadly anticipated, in late June the programme's first review. Echoing a statement released in May after an IMF mission reached a staff-level agreement with domestic authorities on the set of policies needed to complete the programme's first review, the Fund acknowledged the government's fiscal consolidation efforts noting the budget's outperformance performance so far this year. Notably, the consolidated budget deficit narrowed by 69%YoY to RSD 35.3bn over the first half of 2015, thanks to a 6.5%YoY increase (to RSD 805.2bn) in public revenues and a concomitant decline of 3.3%YoY (to RSD 804.5bn) in expenditures. All in all, the aforementioned figures suggest high likelihood for an outperformance of this year's 5.9%-of-GDP budget deficit target. The completion of the aforementioned review releases about €380mn of funds for disbursement. That said, the government has signaled that it opts to treat the programme as precautionary and does not plan to utilize any of the funds offered.

NBS held fire in early July; future rate cuts, if any, will likely be of rather limited nature

In line with the market's and our expectations, Serbia's Central Bank (NBS) stayed put on its monetary policy at its MPC meeting in early July, maintaining its key policy rate at a record low of 6.00%. This decision snaps a 4-month streak of a 50bps reduction delivered in each MPC meeting since March. In support of its decision, the NBS reiterated that it anticipates inflation to return within the 4±1.5% target tolerance band in the coming months, thanks to the impact of recent monetary policy easing, upcoming regulated price hikes and the waning effect of temporary disinflation factors. Additionally, it cited risks associated with the Greek crisis. Looking ahead, although further monetary easing in the coming months cannot be ruled out, the Central Bank appears to be close to the end of the current monetary cycle. While domestic demand dynamics remain weak and HICP stood at 1.9%YoY in June remaining below the lower bound of the Central Bank's target tolerance band for the 16^{th} month running, external risks linger and inflation is anticipated to rebound within its target in H2 2015. Moreover, the looming inception of the Fed's rate-hiking cycle, penciled in for later in the year, also suggests that, future NBS rate cuts, if any, will likely be of rather limited nature.

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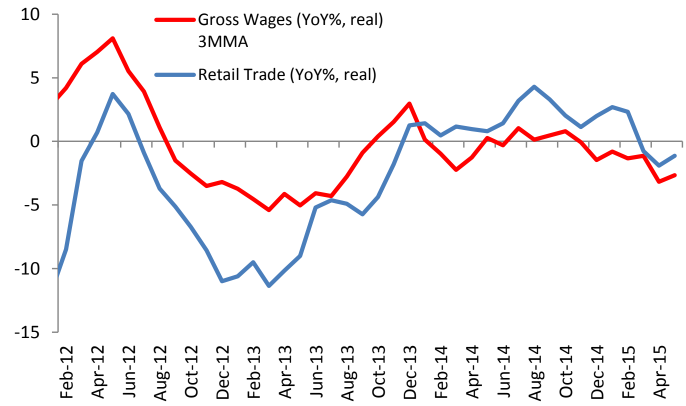
Serbia: Eurobank Forecasts

	2013	2014	2015	2016
Real GDP (yoy%)	2.6	-1.8	0.0	1.5
Inflation (yoy%)				
HICP (annual average)	7.9	2.1	2.2	3.8
HICP (end of period)	2.2	1.7	4.0	4.2
Fiscal Accounts (%GDP)				
Consolidated Government Deficit	-5.6	-6.7	-5.3	-4.6
Gross Public Debt	61.4	72.4	77.3	78.8
Labor Statistics (%)				
Unemployment Rate (%of labor force)	23.0	19.7	21.3	20.9
Wage Growth *(total economy)*	5.7	2.0	0.0	0.0
External Accounts				
Current Account (% GDP)	-6.1	-6.0	-4.3	-4.1
Net FDI (EUR bn)	1.2	1.2	1.3	1.3
FDI / Current Account (%)	57.1	60.0	92.9	92.9
FX Reserves (EUR bn)	11.2	9.9	10.6	11.5
Domestic Credit	**2011**	**2012**	**2013**	**2014**
Total Credit (%GDP)	58.3	62.8	57.0	61.5
Credit to Enterprises (%GDP)	29.9	31.2	26.1	25.0
Credit to Households (%GDP)	17.7	18.2	17.4	18.7
Private Sector Credit (yoy%)	5.7	9.5	-4.8	0.5
Loans to Deposits (%)	137.6	141.3	132.6	130.6
Financial Markets	**Current**	**3M**	**6M**	**12M**
Policy Rate	6.00	5.50	5.50	5.50
EUR/RSD	120.00	122.00	123.00	124.00

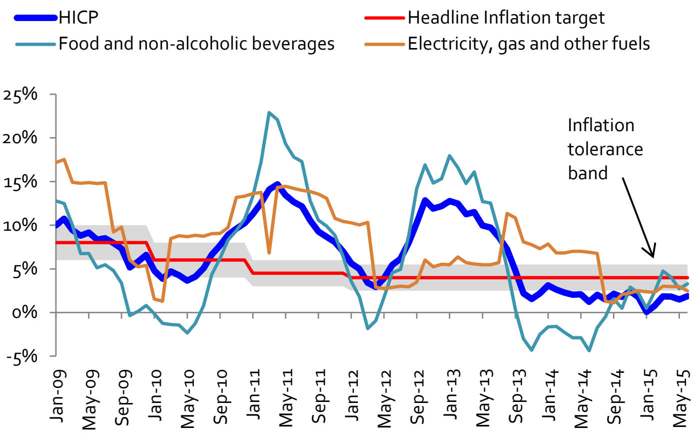
Source: National Authorities, EC, IMF, Eurobank Research

FIGURE 25: **Austerity measures weigh on private consumption (3MMA)**



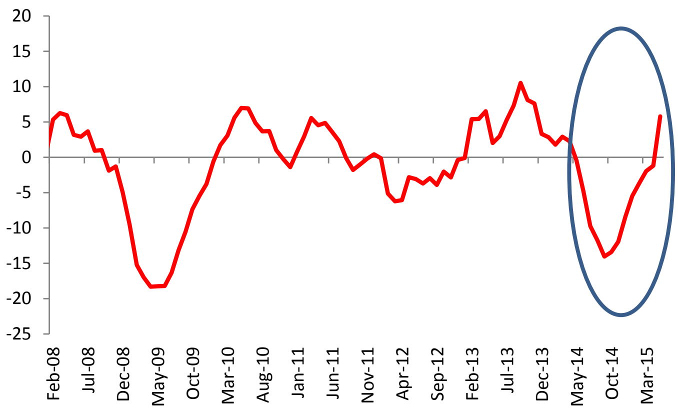
Source: National Authorities, EC, IMF, Eurobank Research

FIGURE 26: **Inflation remains below NBS target over recent months**



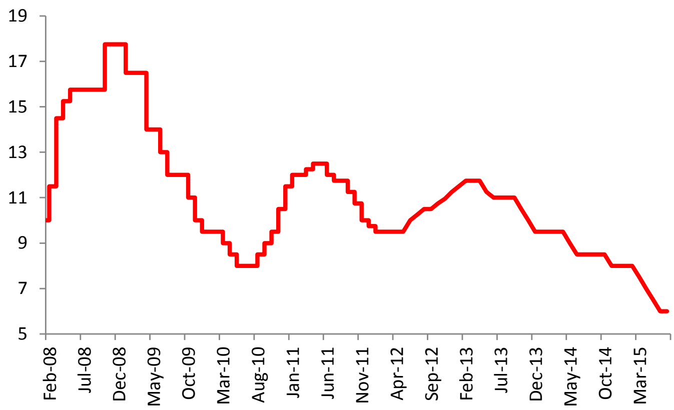
Source: National Authorities, Eurobank Research

FIGURE 27: **Industrial production on a recovery mode (3MMA YoY %)**



Source: National Authorities, EC, IMF, Eurobank Research

FIGURE 28: **NBS held fire in early July**



Source: National Authorities, EC, IMF, Eurobank Research

Special Focus

Bank holiday and capital controls in Greece: what can be learned from the Cypriot experience?

Greece has become the second EMU member state after Cyprus to introduce capital controls. This section attempts to highlight some key similarities and differences in the conditions that forced domestic authorities to impose capital controls in these two economies. Cyprus has been the first economy to introduce restrictions in the free movement of capital in the context of a monetary union. The country first applied for an ESM-IMF borrowing arrangement in June 2012. This was to be supported by an economic adjustment program, aiming to enhance fiscal discipline, reclaim lost economic competiveness and restore the domestic financial's system health. After protracted negotiations which lasted nine months (between June 2012 - March 2013), Cyprus reached a last minute agreement[1] with official creditors on March 25, 2013. The main purpose of the capital controls imposed in Cyprus[2] effective after the announcement of the aforementioned agreement was to prevent a bank run and, at the same time, facilitate the orderly implementation of a major restructuring of the domestic banking system. Therefore, the imposition of transaction restrictions even between domestic banks was inevitable, as essentially two of them were insolvent.

The Cypriot banking sector had earlier been identified as outsized and weak from a capital-adequacy standpoint, featuring a sizable exposure to the crisis-hit Greece. More specifically, the country's two largest credit institutions, Laiki and Bank of Cyprus, were deemed as heavily undercapitalized. The results of the PIMCO stress test (delivered in January 2013) identified an overall capital shortfall of €5.9bn under the baseline scenario[3]. However, the main objective of the €10bn financing program agreed with official creditors was to support public finances and utilize some of the programme funding to recapitalize the cooperative banking sector, but not the two large banks. Unavailability of (public or program) funds for the recapitalization of the two major credit institutions made it imperative to turn to alternative sources of financing. The balance sheet structure of the two major credit institutions was such that the principle of "bail-in" had to be applied for unsecured depositors[4]. That depositor base comprised mainly of large non-resident entities (*e.g.* Russian companies registered in Cyprus). According to the final plan, all Bank of Cyprus uninsured depositors were bailed-in, with the 47.5% of any amount exceeding €100,000 being converted into common equity. In contrast, the uninsured depositors of Laiki would be compensated from the liquidation of Laiki assets.

In the case of Greece, the main purpose of capital controls was to preserve stability in the domestic banking system, following the breakup of negotiations on June 26th between the government and official creditors in the context of the agreement reached on February 20 2015. This, along with the decision of the government to hold a referendum[5] on July 5, led the ECB to refuse the application for a further increase of Emergency Liquidity Assistance (ELA). Public confidence in the stability of domestic banks was eroded and capital controls became inevitable to fend off an incipient bank run. Following two rounds of recapitalization (with the participation of private investors in the second one), the position of the Greek banking system in the period leading to the imposition of capital controls was healthier relative to that in Cyprus at the time. In the period ahead of the

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[1] See *"Eurogroup reaches last-minute agreement on Cyprus; worst-case scenario averted",* Eurobank Research, 26 March, 2013 as well as *"Notes from out Trip to Limassol & Nicosia, Cyprus, 14-16 April 2013,"* Eurobank Research, April 2013
http://www.eurobank.gr/Uploads/Reports/New%20Europe%20Cyprus%20March%2026.pdf
http://www.eurobank.gr/Uploads/Reports/Cyprus%20Trip%20notes%2030%20April%202013.pdf

[2] Before the implementation of capital controls in March 27, 2013, a bank holiday had been declared between March 19 and March 26, 2013 (18th March and 25th March were a public holiday anyway). The bank holiday was put in place to prevent a "run on the banks" and give Parliament time to ratify a proposed bill. The proposed bill would give effect to the initial agreement reached in the early hours of Saturday 16th March 2013, which involved a haircut for all deposits in all banks operating on the island. On 19th March 2013, Parliament rejected the bill almost unanimously and repeatedly declarations were made that any financing agreement necessitating a "haircut" on deposits would not be accepted.

[3] The base-case scenario envisaged a €5.9bn shortfall in order for the Core Tier 1 to maintain 9% by the end of the programme. The adverse scenario envisaged a €8.8bn shortfall for the Core Tier 1 to maintain 6% by the end of programme

[4] The scheme aimed at funding the resolution of the second largest bank, Cyprus Popular Bank (CPB), and the restructuring and recapitalization of the largest Bank of Cyprus (BoC). The resolution of CPB minimized the use of public funds with a full bail-in of shareholders and bondholders and a partial bail-in of uninsured depositors (above €100k). CPB was split in two units. The first unit -the legacy- contains all uninsured deposits and nonperforming assets. The legacy unit of CPB remains under special administration. The second unit assumed specific CPB assets at fair value, insured CPB deposits and the bank's Emergency Liquidity Assistance (ELA) exposure at nominal value. The second unit was folded into the recapitalized BoC. In exchange for the positive net asset position transferred, the legacy unit received 18% of the equity shares into the recapitalized BoC. The uninsured depositors of CPB would be compensated through the proceeds from the asset liquidation of the legacy unit, including this equity stake.

[5] The July 5 referendum question was as follows: "The Greek people is called to decide by vote whether to accept the draft staff level agreement which was submitted by the European Commission, the European Central Bank and the International Monetary Fund to the Eurogroup of 25 June 2015 and consists of two documents: the first titled is Reforms for the completion of the Current Program and beyond and the second is the Preliminary debt sustainability analysis".

imposition of capital controls, the relative size[6] of the Greek banking system was much smaller than the Euroarea average and the Cypriot in 2013. Finally, a distinctive characteristic of the Cypriot case was that at the time of the imposition of capital controls there was no banking union in place so that the Central Bank of Cyprus was the supervising authority. Contrary to that, in Greece, from the beginning of 2015, the four systemic banks fall under the authority of the Single Supervisory Mechanism.

The macroeconomic impact of capital controls in Cyprus

The imposition of capital controls found the Cypriot economy in a weakening phase. Domestic macro fundamentals had worsened considerably following the 2008/2009 global financial crisis, with the ensuing euro area sovereign debt upheaval in late 2009/2010 and the munitions blast in the naval base of Mari in July 2011 inflicting additional blows. On the fiscal side, an overly generous and, in many instances, untargeted policy stance offered only temporary support to domestic output, albeit at the expense of undermining the country's sovereign solvency position. To make things worse, the once-vibrant domestic banking sector had turned into a big contingent liability on the sovereign as a result of the Greek PSI-related losses incurred by Cypriot banks.

- **Sentiment:** The Economic Sentiment Index (ESI) was already on a downtrend when capital controls were imposed. The ensuing plunge in sentiment lasted 2-months, with the relevant index dropping to 69.1 in May 2013, from 85.4 two months earlier. However, after the initial shock which lasted two months, the ESI embarked on an upward trend, soon reclaiming its pre-capital control levels in line with the successful implementation of the program.
- **Output losses**: The economy was already mired in recession since Q4-2011 with the pace of output contraction accelerating throughout 2011-2013. Hence, it is not straightforward to attribute the entire amount of the 2013 recession in the imposition of capital controls On a quarterly basis, GDP contracted by -6.0%YoY in Q2-2013 down from -5.3%YoY in Q1-2013 and -3.7%YoY in Q4-2012. The full year output outcome came in at -5.4% in 2013 down from -2.4% in 2012. The full year output performance of 2013-2014 compares favorably to the initial (and revised thereafter) programme forecasts[7]. The full year contraction of 2013 came at -5.4% vs. -8.7% in the initial programme forecast (in May 2013). The full year contraction of 2014 came at -2.3% vs. an initial forecast of -4.8% (in May 2013).
- **Unemployment:** The increase in unemployment - a pan European disease - was among the direct consequences of the adjustment process. Unemployment was already on the rise before the imposition of capital controls. Unemployment jumped to 15.9% in Q2-2013 vs. 14.7% in Q1-2013 and 13.3% in Q4-2012. Unemployment peaked at 16.8% in October 2013 and embarked on a decreasing path ever since, bringing the average rate at 16.1% in 2014. This is the fourth highest rate in EU-28 after those in Greece, Spain and Croatia.
- **Credit expansion:** Credit expansion was slowing down primarily as a result of the liquidity constraints in 2011-2012 (+6.2%YoY in 2012 down from +11.2%YoY in 2011). Credit expansion was in marginally positive territory (+3.4%YoY in March 2013) at the time when the capital controls were imposed. It turned negative in the following months. The rate of credit contraction bottomed at -12.8%YoY in January 2014 and remained in negative double digits until May 2014. It took more than twelve months before it stabilized around -2% & -3%**.** However, it is worth noting that the initial conditions are different. The private sector indebtedness level of Cyprus was at the time and still is the second highest in EU-28.
- **NPLs:** Non performing loans were already on a steady rise since late 2010, reflecting the deterioration of domestic macro fundamentals and the exposure of Cypriot banks to Greece. The NPLs ratio had climbed from around 13% in 2010 to 25% in March 2013. The change in the methodology[8] used since June 2013 weighted negatively in the recalculation of the NPLs. The NPLs ratio jumped to 31% in June 2013 and reached 47.5% by the end of 2014, having earlier surpassed the 50% threshold. This is among the highest ratios following any recent banking crisis after Ukraine (1998) and Iceland (2008). More importantly, it is not entirely justified by the consequences of the deterioration in economic

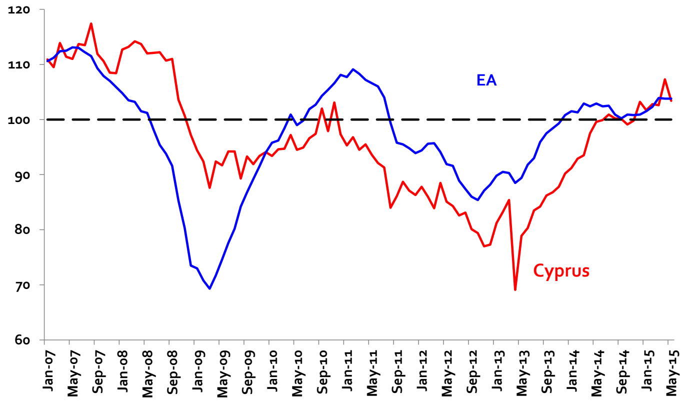
[6] Total banking sector assets in Greece stood at 213% of GDP in 2014 vs. 550% for the domestic regulated banking sector (740% of GDP including overseas operations) in Cyprus in early 2013.

[7] The quite unique features of the Cypriot crisis rendered the short term outlook of the Cypriot economy subject to an unprecedented level of uncertainty at the time. The main channel through which the Adjustment Programme impacted the domestic economy was related to the loss of wealth (non-residents paid 2/3 of the total cost) and impairment of business and consumer confidence by the bail-in. This had profound negative consequences for private consumption and investment decisions. However, macroeconomic outturns came out better than expected in the initial and revised programme forecasts. Firstly, the recession of 2013-2015 has turned out milder than that forecasted earlier. The cumulative output losses amounted to 7.5pps vs. 13.5pps projected in the programme. A large part of the difference stems from the fact that the wealth effect of the bail-in and the spillover effects to the domestic economy were widely overestimated. From a domestic demand point of view, private consumption remained resilient as both consumers and corporates used part of their precautionary savings to smooth out consumption. On the supply side, economic activity in the sectors of tourism and professional services remained relatively resilient as both of them are less credit dependent but also more extrovert, internationally competitive and thus more able to withstand the shock.

[8] The change in the methodology used weighted negatively in the recalculation of the NPLs ratio. The old definition was based on the amount of loans overdue for more than 90 days, but not covered by collateral. The new definition is more conservative as it follows the IFRS standards and it raised the volume of NPLs. The new definition includes restructured loans that at the time of restructuring were classified in NPLs or were in arrears for more than 60 days. In addition, the conservative methodology includes clauses that inflate NPLs. For instance, one NPL triggered from the same debtor renders all his outstanding loans as NPLs. For an extensive analysis on the issue of NPLs in Cyprus please see http://www.eurobank.gr/Uploads/Reports/Cyprus%20Trip%20JUNE2015.pdf

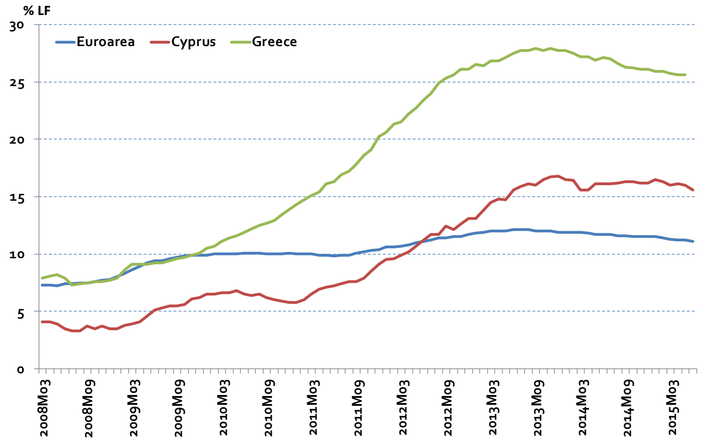
activity (rise in unemployment, disposable income decline). This implies that a number of strategic defaulters have emerged primarily as a result of the bail-in event.

Figure 29: Economic Sentiment Index (ESI) Cyprus vs. Euroarea 2007-15



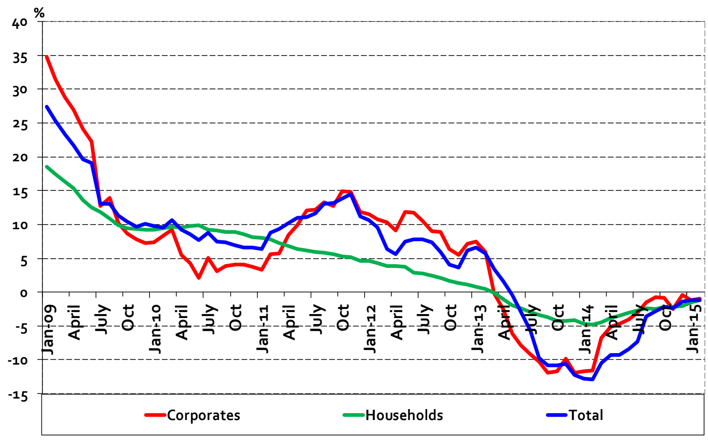
Source: European Commission, Eurobank Research

Figure 30: Unemployment rate in Cyprus vs Euroarea 2008-2015



Source: Eurostat, National Statistics, Eurobank Research

Figure 31: Total Credit Expansion in Cyprus 2009-2015



Source: Central Bank of Cyprus, Eurobank Research

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Calendar of Data & Events

Key Data and Events, July - August, 2015				
Country	**Date**	**Indicator/Event**	**Median**	**Previous**
		July 2015		
US	28-29	FOMC meeting		
BULGARIA	28	Gross external debt (May, EURbn)	N/A	38.9
	31	Budget balance (Jun, BGNmn)	N/A	1091.1
ROMANIA	31	ILO U/E rate (%, Jun)	N/A	7.1
SERBIA	31	Industrial production (%YoY, Jun)	N/A	17.7
		Trade balance (Jun, EURbn)	N/A	-259.9
		Retail sales (%YoY, Jun)	N/A	1.5
		GDP (Q2, %YoY, nsa, p)	N/A	-1.8
		August 2015		
ROMANIA	4	MPC meeting	N/A	1.75
SERBIA	13	MPC meeting	N/A	6.00
BULGARIA	1	International reserves (Jul, EURbn)	N/A	37.6
ROMANIA	3	International reserves (Jul, EURbn)	N/A	33.6
	4	Retail sales (%YoY, Jun)	N/A	4.2
	6	Net wages (%YoY, Jun)	N/A	7.4
CYPRUS	6	CPI (%YoY, Jul)	N/A	-2.42
ROMANIA	7	Industrial sales (%YoY, Jun)	N/A	-2
	10	Trade balance (Jun, EURbn)	N/A	-547.3
BULGARIA	10	Trade balance (Jun, EURbn)	N/A	-0.5
	10	Industrial production (%YoY, Jun)	N/A	3.9
	10	Retail sales (%YoY, Jun)	N/A	0.8
	10-15	U/E rate (%, Jul)	N/A	9.6
ROMANIA	11	CPI (%YoY, Jul)	N/A	-1.6
		Industrial production (%YoY, Jun)	N/A	2.6
CYPRUS	11	HICP (%YoY, Jul)	N/A	-2.1
	12	GDP (Q2, %YoY, nsa, p)	N/A	0.4
BULGARIA	12	CPI (%YoY, Jul)	N/A	0.4
SERBIA	12	HICP (%YoY, Jul)	N/A	1.9
ROMANIA	13	Current account (YTD, Jun, EURmn)	N/A	-296
BULGARIA	14	GDP (Q2, %YoY, wda, p)	N/A	2
ROMANIA	14	GDP (Q2, %YoY, A)	N/A	4.3
BULGARIA	17	Current account (Jun, EURmn)	N/A	51.3
SERBIA	20	Current account (Jun, EURmn)	N/A	7.5
	25	Real wages (%YoY, Jul)	N/A	-2.9
BULGARIA	26	Gross external debt (Jun, EURbn)	N/A	N/A
	29	Budget balance (Jul, BGNmn)	N/A	N/A
SERBIA	31	Industrial production (%YoY, Jul)	N/A	N/A
		Trade balance (Jul, EURbn)	N/A	N/A
		Retail sales (%YoY, Jul)	N/A	N/A
		GDP (Q2, %YoY, nsa, f)	N/A	N/A

SEE Bond Supply Calendar, July - August, 2015				
		July 2015		
SERBIA	28	EUR 2025 T-bonds		N/A

Source: National Authorities, Bloomberg, Reuters, Eurobank Research

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