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REGIONAL ECONOMICS & MARKET STRATEGY FOCUS NOTE

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CYPRUS & SERBIA
On a virtuous cycle of sovereign rating upgrades

- On March 17th, Standard and Poor's upgraded the sovereign rating of Cyprus by one notch (from BB to BB+) with a stable outlook. The decision confirmed the expectations of 5 out 11 economist's StockWatch poll. The decision reflects the better than expected growth performance and fiscal progress so far. In all past editions we have extensively discussed the progress of the Cypriot economy in the last three years. Based on our fact findings on the ground and our analysis, we always advocated that Cyprus is a solid turn-around economic story. After a three year recession in 2012-2014 and a cumulative drop of 10.5% of GDP, the economy expanded by +1.7% YoY in 2015, accelerated to +2.8% YoY in 2016 and is expected to further gain momentum to 3% in 2017. From a demand point of view, growth was broadly driven primarily by the ongoing rebound in private consumption, itself being driven by the improvement in Economic Sentiment (ESI stands very close to the levels prior to Lehman Brothers international crisis), a flourishing tourism sector (tourist arrivals were up by 19.8% in FY2016) and the improvement in labor market conditions (down for a third consecutive year in a row from 15.0% in 2015 to 13.3% in 2016).

- After S&P's upgrade, one more notch is still required in its respective grading system for government bonds to get investment grade status, while the announcements of Moody's (currently at B1, four notches to reach investment grade) and Fitch (currently at BB-, three notches to reach investment grade) are expected on March 24 and April 21 respectively. Nevertheless, ECB's waiver for government bonds' eligibility for Euro system financing has been lifted as of April 1st, 2016 and Cyprus no longer qualifies for QE. The waiver allowed these instruments to be used in Euro system monetary policy operations despite the fact that they did not fulfill minimum credit rating requirements.

- Interestingly, Cyprus is presently the only economy in the Euro Area Periphery whose outlook is positive by both Moody's and Fitch. The positive outlook implies that rating agencies could upgrade Cyprus either now in the next few months, provided that the government stays focused on structural reforms. Even though Cyprus has made progress in a lot of areas, the risk of complacency following the exit from the Adjustment Program is material. There are a few pending important structural reforms of the economic adjustment program, which would allow the Cypriot economy not to backtrack. Particularly, parliamentary approval of the Bill setting a cap on the public sector wage bill, essentially linking the expenditure expansion with the GDP growth performance, is still pending. And as time moves on and the economy improves, it becomes increasingly unlikely the Bill will be voted into Law ahead of the Presidential elections scheduled for February 2018.

- Also on March 17th, Moody's announced its decision to upgrade Serbia's issuer rating to Ba3 from B1, with stable outlook. The agency acknowledged the significant fiscal consolidation that has taken place over the last couple of years, which has inhibited the rise in public debt and recent implementation of structural reforms that increase the resilience of the country's economy, which also bodes well for potential growth.

- We had long expected this upgrade as Serbia's domestic macroeconomic fundamentals have notably improved over the last couple of years thanks to enhanced domestic political stability, improvement of investor sentiment on the back of an IMF policy anchor, substantial fiscal consolidation and monetary easing, improving credit dynamics and labor market conditions as well as narrowing external imbalances.

- In support of the aforementioned, economic recovery continued through to 2016, with real GDP growth swinging from a negative reading of 1.8% in 2014 due to the floods-induced recession, to a positive print of 2.8% in 2016, the highest pace of increase in eight years. Investments – thanks to strong FDI inflows - and exports have acted as the primary growth contributors, while private consumption also rebounded last year amid improved labor market conditions and increased consumer lending. Economic activity is anticipated to gain further momentum this year as last year's positive trends are expected to continue and private consumption is expected to recover further on real wage growth and targeted increases in public wages and pensions.

- The country's fiscal position has also notably improved following strict austerity measures, such public sector wages and pensions' cuts as well as a reduction in the civil servants headcount and lowering financial support to State-Owned Enterprises (SOEs). Also assisted by better-than-anticipated growth dynamics and improved tax collection, the budget deficit was reduced to 1.4% of GDP last year, significantly outperforming initial and revised deficit targets for a 4% of GDP and 2.1% of GDP, respectively. This development also resulted in the first primary surplus since 2005 and assisted in a drop in the public debt, which decreased in 2016 (73.5% of GDP) for the first time in nearly a decade. At the same time, a further improvement in Serbia's fiscal position is earmarked for this year. With regards to the latest inflation developments, the Central Bank target has been overachieved over the last five years, necessitating the reduction of the previous 4+/-1.5% target by 1ppt as of this year. External imbalances have also improved with the current account deficit estimated to have narrowed to 4.0% of GDP last year from double digits in 2011 and 2012. It is also expected to be broadly covered by foreign direct investments (FDI).

- With respect to the looming presidential elections due to be held on April 2nd with a potential second round on April 16th, as also noted by Moody's, we do not expect to see a significant change in the domestic political landscape. The candidate of the major coalition partner Serbian Progressive Party (SNS), Prime Minister Aleksandar Vucic, is likely to easily win the ballot, while the opposition appears to still be fragmented and weak and is unlikely to pose a threat to the ruling coalition alliance or its presidential nominee. That said, the vote is seen as a key test to the SNS-led administration and economic reforms that have been adopted over the last couple of years. Some degree of uncertainty does lies ahead, especially on the incumbent Prime Minister's replacement. Although it is likely that Vucic will formally resign from the SNS leadership if he wins elections, his victory would effectively grand him additional authority as he would still bear high influence over the ruling SNS, which controls parliamentary majority, as well as over the new Prime Minister from his presidential post.

- As also noted by Moody's, a potential slowdown in the pace of reforms, especially given the recent overachievement of related targets, is likely to be mitigated by the country's ongoing progress towards the EU accession and a further IMF policy anchor. On the former, the EU accession path continues, with negotiations having picked up pace lately. Out of the thirty five chapters in total, four opened last year and two already in 2017, following two in 2015. Out of these, two have closed. Namely, 25 Science & Research in December 2016 and 26 Educations & Culture in February this year.

- Following a wave of rating downgrades in 2012-2014, all three major rating agencies appear to be acknowledging over recent months the ongoing improvement in Serbia's domestic macroeconomic fundamentals witnessed over the last couple of years. Before Moody's upgrade last Friday, S&P had revised higher in January the country's outlook to Stable from Negative, while affirming its "BB-" rating in July 2016. Fitch was the first agency to proceed with an upgrade on Serbia's sovereign rating, revising in June one notch higher its Long-Term Foreign and Local Currency Issuer Default Ratings (IDR) to "BB-" from "B+" with Stable outlook. All three major agencies currently rate Serbia equally. Provided that further progress is achieved on improving the country's macroeconomic fundamentals further positive credit rating moves are on the cards in the months ahead.

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