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# REGIONAL ECONOMICS & MARKET STRATEGY MONTHLY

June-July 2017

Bulgaria | Cyprus | Romania | Serbia

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*The authors wish to thank Dr. Tasos Anastasatos, Deputy Chief Economist, for his insightful comments*



## Regional assets broadly extend gains in H1 2017

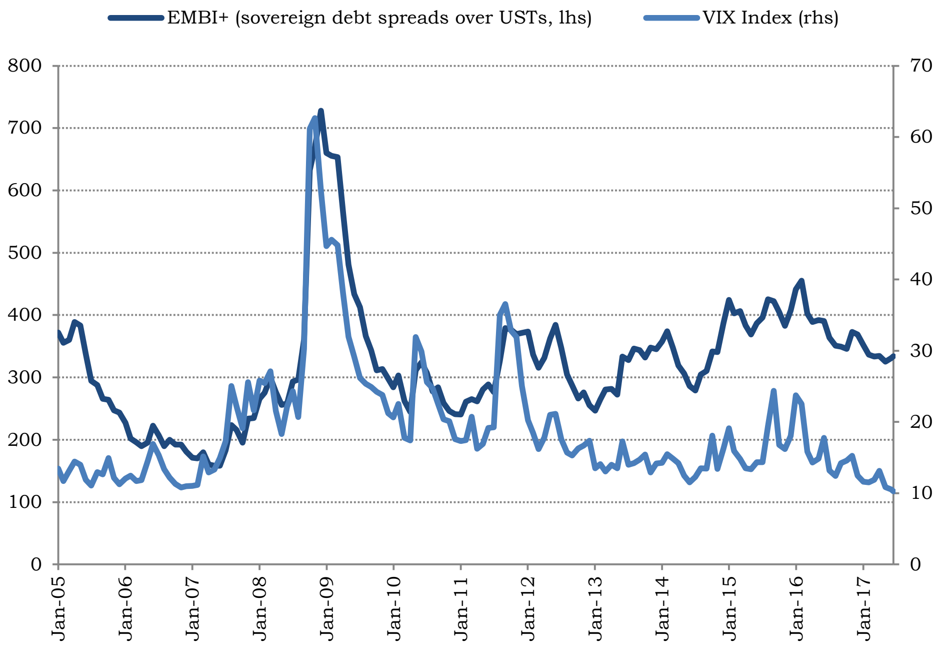
### REGIONAL MACROECONOMIC & MARKET DEVELOPMENTS & OUTLOOK

- **Q1-2017 second GDP estimates** confirm a solid start for the economies of the region
- **Consumer spending revival** continues unabated driven by sustained sentiment gains, eased financial conditions, tighter labor markets and robust real wage dynamics
- **Regional assets extend gains** in H1 2017
- Regional **bourses firm** in line with the move higher in emerging and major global stock markets
- **Emerging external debt** markets also firm; **regional currencies remain range-bound**
- Major **CB rhetoric & global growth** reality vs. perception divergence to set the tone for EM assets ahead

### COUNTRY FOCUS

- **Bulgaria:** The incoming government has vowed to push for ERM2 application
- **Cyprus:** New bond issuance allows for streamlining of debt repayments in 2019-2020
- **Romania:** Swift end to the looming political crisis
- **Serbia:** New government expected to continue previous administration's policies

***Multi-year low volatility supports sentiment towards EM assets***




*Source: Bloomberg, Eurobank Research*

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# I. Regional Macroeconomic & Market Developments & Outlook

## *Private spending revival continues unabated in the region; regional assets extend gains in H1 2017*

*Private spending continued unabated throughout Q1-2017, a trend that will most likely continue throughout 2017*

The second GDP growth estimates for Q1-2017, released for the countries of our focus (Bulgaria, Romania, Cyprus, and Serbia), confirmed a solid start for the region in the year. Now that the detailed breakdown for all the economies is available, it would be fair to say that the revival of private spending continued unabated throughout the first quarter despite local political uncertainties and the spike of headline inflation. Sustained consumer sentiment gains, eased financial conditions, tighter labor markets combined with robust real wage dynamics boost consumer spending, a trend that will most likely continue throughout the rest of the year. Although headline inflation rates across the region have rebounded from recent troughs, price pressures remain relatively muted allowing local Central Banks to maintain an accommodative stance and delay the tightening process further. Meanwhile, external imbalances also remain under control despite the uptick on the imports side. On the negative side, the underperformance of EU funded projects kept investment spending below expectations, a trend that we anticipate to change in the 2H allowing for fiscal policy to become more growth supportive.

*Most emerging market assets extended last year's gains in H1 2017*

Despite a correction over the last couple of weeks amid higher core government yields and rising geopolitical tensions, the majority of emerging market (EM) assets extended their gains in Q2 2017, marking a positive performance in H1 2017. Inflows towards EM assets have remained strong as political risks in Europe are now behind us and market volatility has fallen to multi-year lows. Global growth optimism and a weaker US dollar have led to this positive performance. Notably, most recent data from major developed economies confirmed that the global growth recovery remained on track. Meanwhile, still relatively subdued price pressures have mitigated reflation concerns, supporting the view for only gradual monetary policy normalization. At the same time, the DXY dollar index - which measures the USD's value against a basket of key US trade partners' currencies - reached 8-month lows in early June. The move was mostly led by the unwinding of "Trump trades" and a recently emerged hawkish rhetoric from major Central Banks, which signaled that the FOMC will probably not be alone in its pursuit of cautious normalization of monetary policy in the months ahead.

*Regional bourses firm in line with the move higher in emerging and major global stock markets*

Against this backdrop, emerging equity markets have broadly trailed the rally in global bourses so far this year. Indicatively, the MSCI Emerging Markets index gained 5.5% in Q2, approaching 2-year highs in early June and bringing the total advance so far this year (as of July 12, 2017) in excess of 18%. The latter reflects one of the index's best H1 performances in years. It is also nearly double the 9.5% concomitant increase registered in the World MSCI index. In a similar mode, bourses in the CESEE region and countries of our focus have rallied over the January-early July period. Indicatively, Turkey's BIST index reached a record peak on July 12, standing more than 30% higher year-to-date. Bulgaria's SOFIX followed suit with positive returns of ca. 20%, having hit a 9-year peak a few days earlier. Meanwhile, Romania's BET index currently stands 15% firmer compared to its start-of-the-year levels, despite having rendered 7% of its gains after reaching its highest level since 2008 on June 6 amid elevated fiscal risks and mounting domestic political jitters.

*Emerging external debt markets also firm; regional currencies remain range-bound*

Emerging external debt markets have also fared well, with corresponding spreads over USTs standing on July 11 at 338bps, just 19bps above a 3-year low hit in mid-May. At the same time, YTD total returns have increased by approximately 5.6%, while CESEE 5-year CDS spreads have notably tightened over the same period. Regional currencies continued to trade in ranges over recent months. The Serbian dinar has firmed to a 1 ½ year peak of 120/€ in early July, having staged a ca 3% YTD rally. Idiosyncratic factors have also remained at play. Such is the case of the Romanian leu which has bucked the positive trend to stand modestly weaker vs. end-2016 levels. The currency reached a 4.5995/€ 5-year low on fiscal worries and a political turmoil which resulted in a new Prime Minister and government.

*Major CB rhetoric & global growth reality vs. perception divergence to set the tone for EM assets ahead*

Looking ahead, the prospect of less accommodative monetary policies in Developed Economies is likely to remain a key factor behind capital flows towards emerging markets in H2 2017. The Fed is expected to start unwinding its balance sheet and further hike interest rates before year-end. Meanwhile, the ECB has lately toned up its hawkish rhetoric with the market's prevailing view being that it will announce in the coming months the start of QE tapering for the beginning of 2018. The divergence between soft and hard global macroeconomic data will also be a key driver over EM performance.

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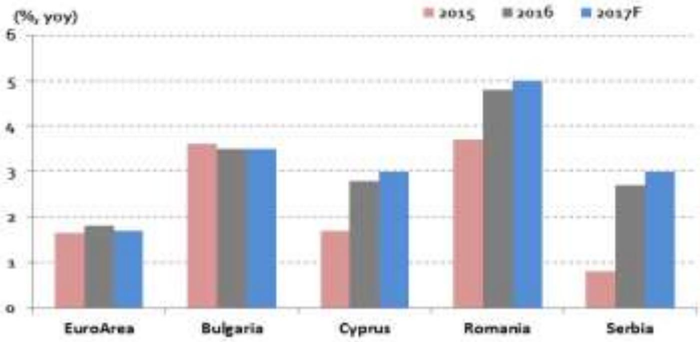
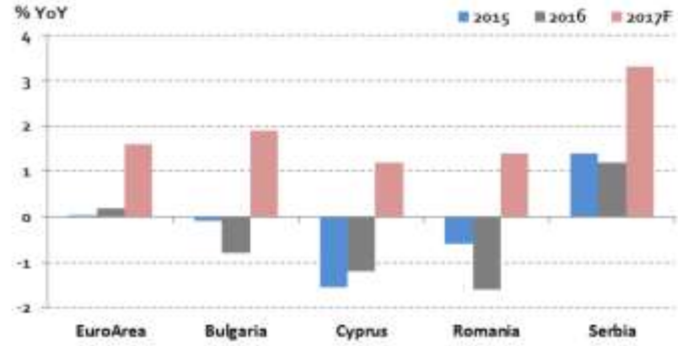
FIGURE 1: **GDP Growth performance 2015-2017**



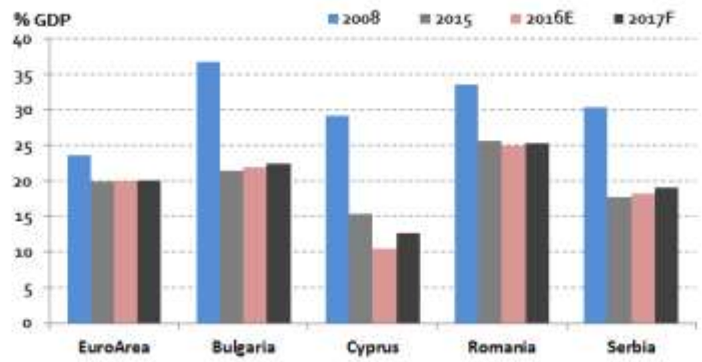

*Source: Eurostat, National Authorities, Eurobank Research*

FIGURE 2: **Annual average inflation 2015- 2017**



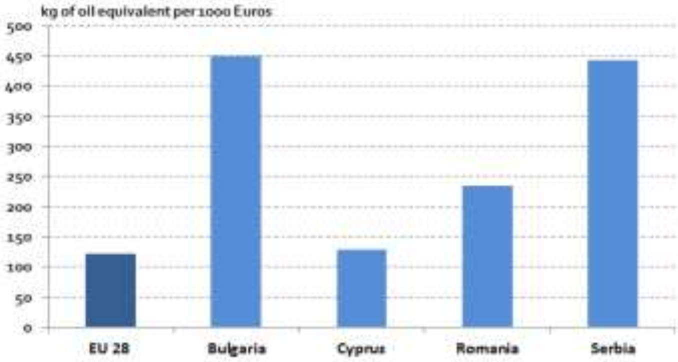

*Source: Eurostat, EU Spring Forecasts, Eurobank Research*

FIGURE 3: **Investments to GDP ratios 2008 vs. 2017**



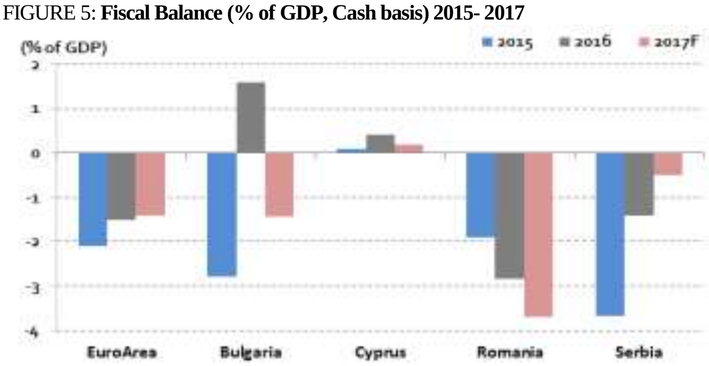

*Source: IMF WEO, Eurobank Research*

FIGURE 4: **Energy intensity of the individual countries, 2014**



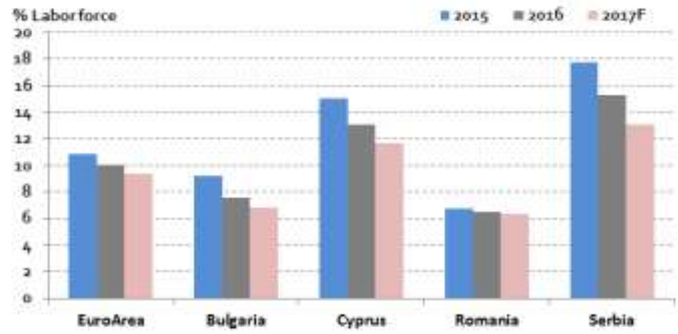

*Source: Eurostat, National Authorities, Eurobank Research*

FIGURE 5: **Fiscal Balance (% of GDP, Cash basis) 2015- 2017**



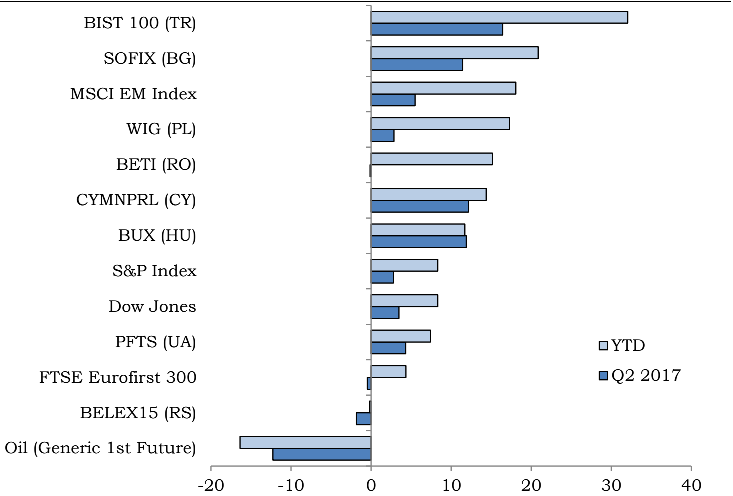

*Source: Eurostat, National Authorities, Eurobank Research*

FIGURE 6: **Annual average unemployment rates 2015-2017**



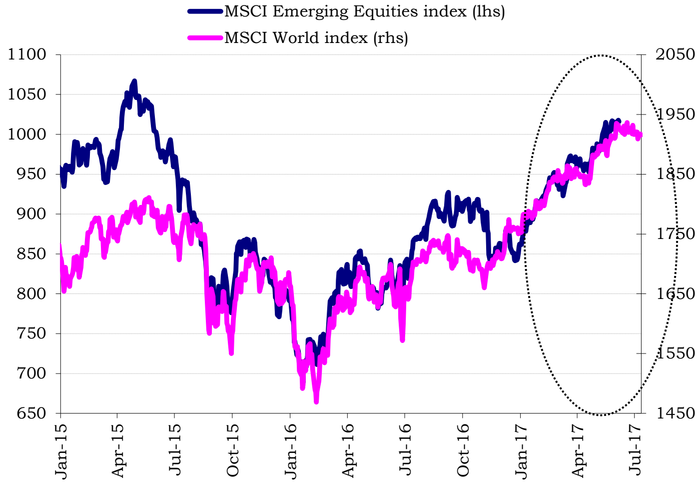

*Source: Eurostat, National Authorities Eurobank Research*

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




*Source: Reuters, Bloomberg, Eurobank Research*

FIGURE 8: **World & EM stock markets performance**




*Source: Reuters, Bloomberg, Eurobank Research*

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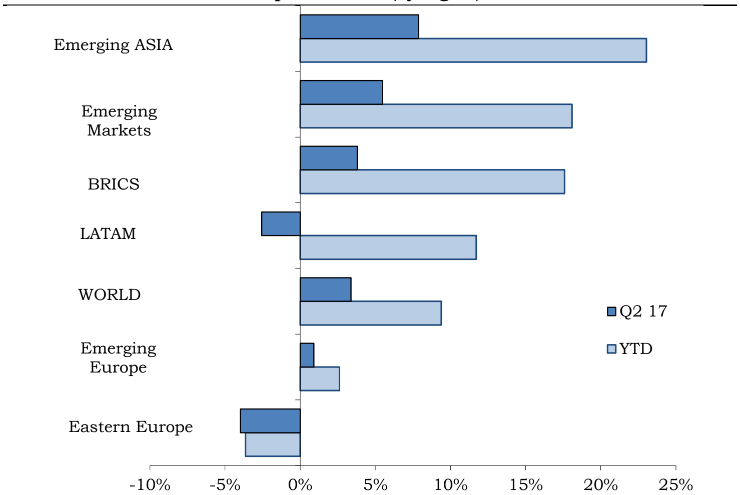
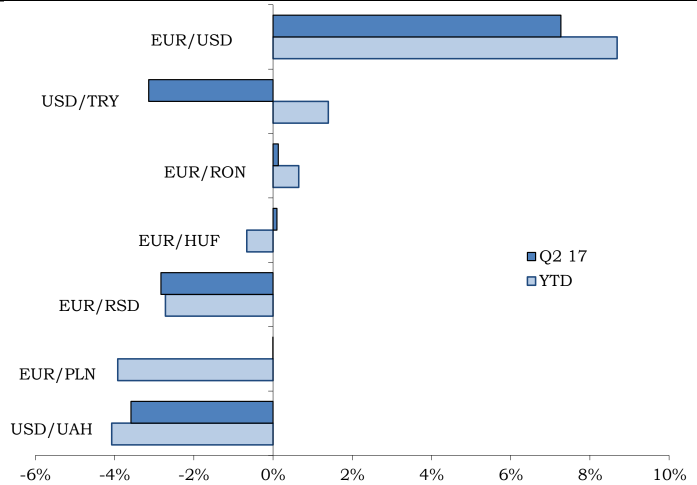


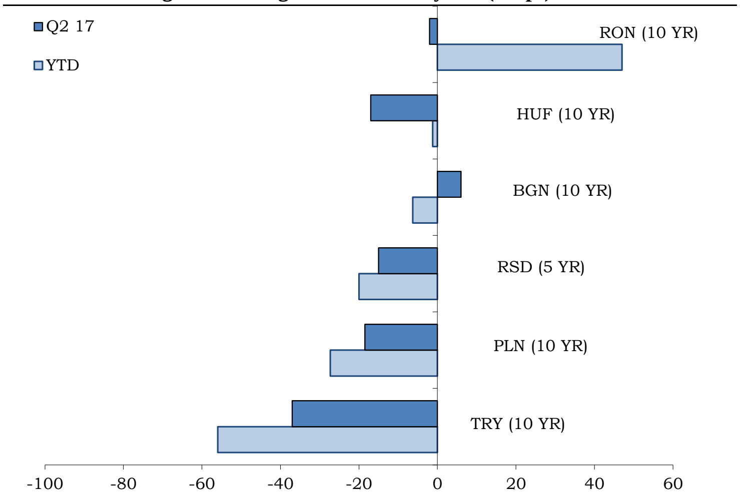

*Source: Reuters, Bloomberg, Eurobank Research*

FIGURE 10: **CESEE FX performance**



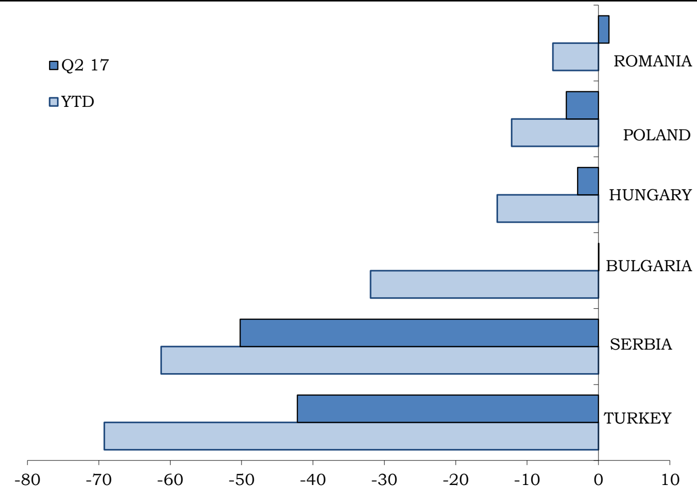

*Source: Reuters, Bloomberg, Eurobank Research*

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

**FX**

*Our previous short EUR/RSD vs. long 3M RSD bond position remains favorable at present*

In late May, EUR/RSD breached strong support level of 123.0 established over the past twelve months, on the back of persistent selling pressure of hard currency, mainly due from local EUR indexed loan disbursements. On the other side, the National bank of Serbia (NBS) was not decisive in its intention to defend a certain level as was the case in 2016. As a result, EUR/RSD continued its decline to reach a 1 ½ year low near 121.00, having marked a 1.6% drop during May and June. Comparing to the same period a year before, EUR/RSD was moving in the opposite direction (Euro has strengthened against dinar by 0.5%), so it is clear that seasonal factors did not have an impact on the dinar strengthening.

This EUR/RSD downward movement appears to have been driven by the lack of more aggressive NBS action as well as stabilization in the domestic political space after April's Presidential election and the formation of a new government as well as appointment of Prime Minister. Taking into account the fact that consumer inflation seems to have peaked at 4% in April, getting closer to the upper bound of the target tolerance band of 3±1.5%, NBS had an incentive to show more tolerance towards the recent RSD rally. In other words, NBS continues intervening in the FX market just to avert sharp one-day fluctuations, but not to completely stop further strengthening of the local currency, in order to anchor inflation expectations. Consequently, a gradual decline below or at least stabilization around 120.0 could be expected in the Q3, especially if we take into account very low trade volumes during the summer lull. Therefore, as bearish sentiment still appears to exist on EUR/RSD, and yields on the T-bill market are not likely to significantly deviate from current levels, we are continue to favor our previous "short EUR/RSD vs 3M bond" position. It should be emphasized that timing is crucial in taking/exiting the EUR/RSD position as we expect exhaustion of this trend at the end of September. When demand towards EUR/RSD strengthens, the move higher is unlikely to be assisted by NBS intervention as it was on its way down. At least not until we reach levels near 123.00. So, we expect much steeper route up when time comes. As the EUR/RSD has fallen towards 120.10 currently, we revise our earlier stop loss recommendation lower.

| Security | Position | Entry | Stop loss | Period |
|---|---|---|---|---|
| EUR/RSD<br>vs. 3M RSD bond | Short EUR/RSD<br>&<br>Long 3M RSD bond | EUR/RSD: 123.95<br>3M Bond yield: 3.7% | EUR/RSD: 121.00 | 3-months initially (One month now left) |

**Local rates**

*We prefer to remain on the sidelines on BGN-denominated bonds*

Yields on the Bulgarian sovereign debt market continued to slide in May and June on the back of low volumes and relatively scarce supply. The shift was more pronounced in the belly of the curve, where yields declined by 11-17 bps during that period. The Ministry of Finance re-tapped for the third time its 4-year paper for BGN 50mn on June 19th. The placement was made at a record low yield of 0.05% against 0.18% earlier in February and 0.11% in April as banks continue to have limited options in placing their extra liquidity elsewhere. In fact, banks acquired the largest amount of the auction with a 79.6% share, followed by pension funds (10.4%) and other investors (10%). The auction's bid-to-cover ratio stood at 2.06. The next treasury auction is set for July 17th for BGN 100mn in 10-year T-bonds. All in all, we prefer to remain on the sidelines on BGN-denominated bonds.

**External debt markets**

*We consider some profit-taking on BGARIA 24 and remaining still on the Eurobond market in the summer*

On the other hand, Bulgarian Eurobonds outperformed over the last two months with yields dropping by 20-21 bps in the 5-10 year sector. Longer maturities saw a more modest, around 6bps, decrease. Moreover, the market proved more resilient to the recently emerged negative global risk sentiment, with the correction being limited to an approximate average increase of 4 bps. Our previous recommendation of buying the Bulgaria 2024 paper met the target of 1.25% in the first week of June. We consider some profit-taking is likely to follow as the bond yield is currently trading about 21bps lower than two months ago. For the rest, we prefer to stay on the sidelines in the summer and wait for a cheaper entry positions.

| Security | Position | Entry | Target | Stop loss |
|---|---|---|---|---|
| BGARIA 2024 | Short | 1.39% | 1.25% | 1.55% |

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*We would also like to the Eurobank Trading Team in Athens for its most valuable comments*

# II. Country Focus

## Bulgaria (Baa2/BB+/BBB-)

### *The incoming government has vowed to push for ERM2 application*

*The winner of the snap election, GERB, formed a government coalition with United Patriots in line with expectations*

The centre-right pro-EU ruling party Citizens for European Development of Bulgaria (GERB) won the snap parliamentary election held in late March but failed to secure an outright majority. In line with expectations, GERB formed an alliance with United Patriots, a nationalist coalition of parties, which earned a 9.07% share of the popular vote. The new government coalition was endorsed by 132 MPs out of 240 in total. Besides the MPs of both parties, the government received the tacit support of VOLYA, a newly formed party led by businessman Veselin Mareshki which earned 4.15% of the popular vote. The new GERB-led administration signals internal and external policies continuity. However, the participation of smaller parties in such an alliance will likely cast a populist tone. United Patriots oppose immigration and call for increases in pensions and maintaining low electricity prices. The new government has pledged to increase wages, raise pensions and continue infrastructure development which may translate in moderate fiscal easing. One of the key challenges for the new administration will be to balance between deepening Bulgaria's integration in the European structures (Schengen area & Euroarea membership) and the Eurosceptic stance of its minor coalition partner. Recent market talk has focused on the probability of Bulgaria's joining the ERM2 mechanism. Joining the ERM2 mechanism for a period of at least two years is a formal prerequisite for Euroarea membership. The incoming government of GERB has vowed to accelerate the application to ERM2 on top of the efforts by the caretaker government before the elections of late March 2017. According to press reports, Prime Minister Borissov has received support from both Chancellor Merkel and President Macron to go ahead with ERM2 application membership.

*Bulgaria fulfills most of the nominal convergence criteria*

Currently, Bulgaria fulfills most of the nominal convergence criteria for Euroarea entry: 1) from a fiscal point of view, public finances are sound: public debt as a percentage of GDP stands well below 60% and the fiscal balance was in surplus. 2) As of May2017, the 12 month average HICP stood below the average of the three lowest (+/-1.5%) EU member HICP inflation rates (Ireland, Cyprus, and Romania). Even if Romania is excluded, given the impact of the tax-cuts on its inflation rate, and Slovakia takes its place, the argument would still be valid. 3) Long-term government yields are no more than 2ppts higher, than the unweighted arithmetic average of the similar 10-year government bond yields in the 3 EU members with the lowest HICP inflation (having qualified as benchmark countries for the calculation of the HICP reference value): as of May2017, the long government yield for the purpose stood at 1.74% for Bulgaria vs 2.54% for the 3 EU members. 4) Compatibility of legislation: According to the latest ECB convergence report assessment in April 2016, the Bulgarian law does not comply with all the requirements for Central Bank independence, the monetary financing prohibition, and legal integration into the Euro system.

*Bulgaria lags behind real convergence with the rest of EU-28*

On the other hand, critics of Bulgaria's potential Euroarea application membership focus their argumentation on the facts that real convergence criteria are not satisfied, although officially these are not part of the evaluation procedure. The living standards are the lowest in EU-28, productivity is equally the lowest in EU-28. The country is still subject to the Co-operation and Verification mechanism, which was set up in 2007 to monitor Bulgaria and Romania's progress in the fields of judicial reform, corruption and (for Bulgaria) organized crime. The GDP per capita, in PPS terms, stood at 47% of the EU-28 average in 2015, compared to 45% in 2010, still remaining the lowest in EU-28. Even after accounting for the fast GDP growth trajectory in 2015-2018, GDP per capita in PPS terms will have only climbed to 50% by the end of 2018. Among the key challenges for the new government will be to push for the so much needed, but politically sensitive, structural reforms in the economy that will accelerate living standards' convergence with EU-28.

*Bulgaria is expected to register a second consecutive year of strong-above potential- growth in 2017.*

The first quarter GDP estimate (+0.9% QoQ/+3.5% YoY) demonstrated that growth remained on track. Private consumption appeared very strong (+2% QoQ/+5% YoY in Q1-2017 vs. +1.4% QoQ/+1.7% YoY in Q4-2016). Private consumption dynamics are broadly set to remain strong as the economy benefits from a more expansionary fiscal policy stance, sustained labor market improvement, positive real wage growth and still relatively low energy prices (Bulgaria has the highest energy intensity in EU-28). On the negative side, investments were in negative territory for yet another quarter, with the rate of decline (-0.6% QoQ/-4.6% YoY) being the largest in the last three years, mirroring the lingering political uncertainty ahead of the elections and the under-execution of public investment program, which is traditionally skewed to the last quarter of the year. The contribution of net exports turned negative as imports outpaced exports (+1.9% QoQ/+7.1%YoY vs. +0.9% QoQ/+5.8% YoY) for the first time since Q4-2015. Looking ahead, investments are going to receive support from improved EU funds absorption in the new programming period while a vibrant export-oriented manufacturing sector and an emerging tourism industry boost net exports. Overall, Bulgaria is expected to register a second consecutive year of strong-above potential- growth expanding at 3.5% YoY in 2017 vs. 3.4% in 2016, 3.6% in 2015 and only 1.3% in 2014.

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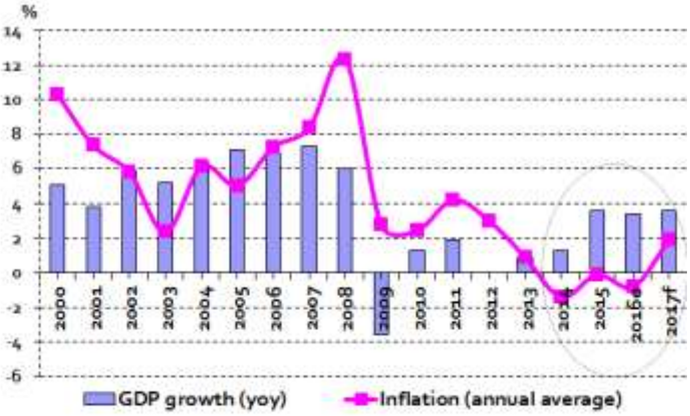
| Bulgaria: Macro & Market Data | | | | |
|---|---|---|---|---|
| | **2014** | **2015** | **2016** | **2017f** |
| **Real GDP (yoy%)** | 1.3 | 3.6 | 3.4 | 3.6 |
| **Inflation (yoy%)** | | | | |
| CPI (annual average) | -1.4 | -0.1 | -0.8 | 1.9 |
| CPI (end of period) | -0.9 | -0.4 | 0.1 | 2.0 |
| **Fiscal Accounts (%GDP)** | | | | |
| General Government Balance | -3.7 | -2.8 | 1.6 | -1.4 |
| Gross Public Debt | 27.2 | 26.3 | 29.6 | 26.0 |
| Primary Balance | -3.0 | -2.0 | 2.4 | -0.2 |
| **Labor Statistics** | | | | |
| Unemployment Rate (LFS, %) | 11.4 | 9.2 | 7.6 | 6.8 |
| Compensation of employees/head | 5.6 | 5.6 | 3.8 | 4.8 |
| **External Accounts** | | | | |
| Current Account (% GDP) | 0.1 | -0.1 | 4.2 | 2.0 |
| Net FDI (EUR bn) | 1.3 | 1.6 | 0.7 | 1.5 |
| FDI / Current Account (%) | Na | Na | Na | Na |
| FX Reserves (EUR bn) | 16.5 | 20.3 | 23.9 | 25.0 |
| **Domestic Credit** | **2013** | **2014** | **2015** | **2016** |
| Total Credit (%GDP) | 72.9 | 67.7 | 57.1 | 54.6 |
| Credit to Enterprises (%GDP) | 43.9 | 38.1 | 34.9 | 0.2 |
| Credit to Households (%GDP) | 21.7 | 21.0 | 20.8 | 2.0 |
| FX Credit/Total Credit (%) | 59.8 | 54.3 | 49.4 | 44.0 |
| Private Sector Credit (yoy) | 0.2 | -8.2 | -1.2 | 1.5 |
| Loans to Deposits (%) | 92.1 | 84.2 | 78.2 | 74.1 |
| **Financial Markets** | **Current** | **3M** | **6M** | **12M** |
| Policy Rate | | Currency Board | | |
| EUR/BGN | 1.96 | 1.96 | 1.96 | 1.96 |

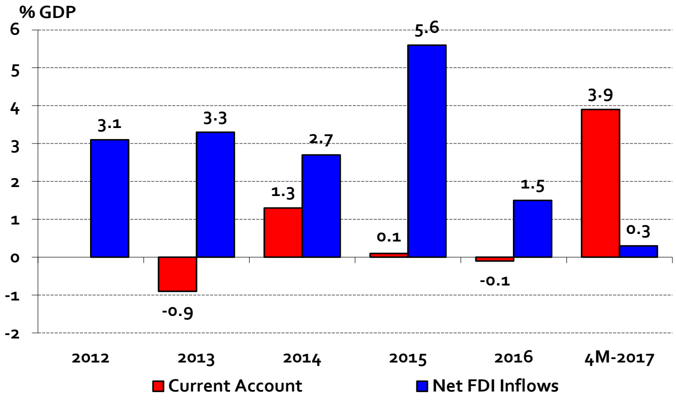
*Source: National Sources, Eurostat, IMF, Eurobank Research*

FIGURE 13: **GDP growth & Inflation 2000-2017**



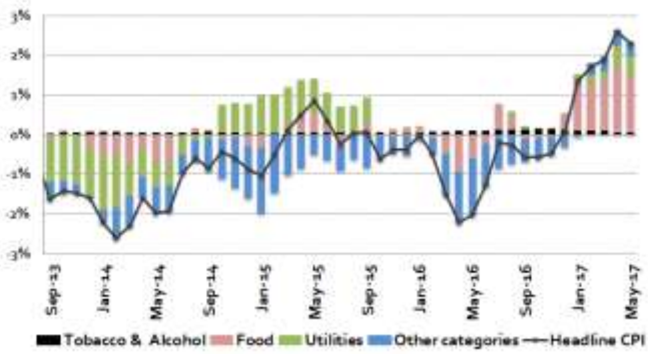

*Source: National statistics, Ecowin Reuters, Eurobank Research*

FIGURE 14: **CA Balance & Net FDI inflows 2010-2016**



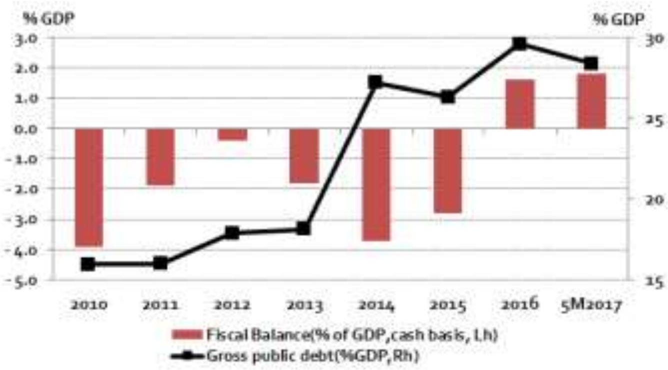

*Source: National statistics, Ecowin Reuters, Eurobank Research*

FIGURE 15: **Inflation dynamics 2013-2017**




*Source: National statistics, Ecowin Reuters, Eurobank Research*

FIGURE 16: **Fiscal deficit & Gross Public Debt 2010-2017**




*Source: Ministry of Finance, Eurobank Research*

# Cyprus ((P) B1/BB+/BB-)

## *New bond issuance allows for streamlining of debt repayments in 2019-2020*

*Cyprus tapped international markets for the second time after graduation from the economic adjustment programme*

On June 21th, Cyprus tapped international markets with a new 7Y-Eurobond for the second time after exiting from the Economic Adjustment Programme in March 2016. In the latest tender, the Public Debt Management Office (PDMO) sold an offered amount of €850mn of 7-year government bonds as part of its €9bn Euro Medium Term Note (EMTN) programme. Citigroup, Goldman Sachs and HSBC were appointed by the Cypriot government as lead managers. The issue was more than four times over-subscribed with total bids amounting to €3.7bn. The average accepted price was at 99.686 and the corresponding yield at 2.80%. The latter compares with an initial price target of 3.0% and guidance of 2.9%. The issue matures in June 27, 2024 and bears a 2.750% fixed annual coupon. From a historical point of view, this is the lowest coupon rate the Republic ever achieved in a benchmark bond debt issuance and reflects strong investor confidence towards the country's improving macroeconomic fundamentals. The previous 7-Y offer in July 2016 amounted to €1bn and was priced at 3.8% with a 3.75% coupon. Earlier, and within the first year of its MoU program, Cyprus was already a credible borrower and had made the fastest come-back to international markets among other Euro Area program countries. Cyprus had issued bonds three times in the international markets, once in June 2014 and then again in April 2015 and in October 2015. New bond issuance allows for streamlining of debt repayments in 2019-2020. The proceeds from the latest tender will be used to repay more expensive debt outstanding, including the buyback of three outstanding securities with a combined face value of €1.4bn and higher yields. In this context, the government simultaneously offered yesterday switch offers of 4.75% June 2019 notes, 4.625% February 2020 paper and 6.5% May 2020. The total aggregate amount accepted for the purchase of these securities by the Republic of Cyprus came in at €514.906mn, with the breakdown at €336.558mn, €101.994mn and €76.354mn, respectively.

*The second Q1 GDP reading confirmed that the economy is on a fast growth recovery track*

The second estimate of CYSTAT on the seasonally adjusted Q1 GDP reading confirmed the flash estimate of +0.6% QoQ/+3.3% YoY. The strong reading compares to +0.7% QoQ/+2.9% YoY in Q4-2016 vs. +0.3% QoQ/+2.8% YoY in Q1-2016. The GDP growth rate of Q1 is among the highest in EA-19 and EU-28, and the highest since 2008. Final consumption expanded by +0.3% QoQ/+2.1% YoY in Q1-2017 compared to +0.3% QoQ/+2.4% YoY in Q4-2016, vs. +0.6% QoQ/+1.1% YoY in Q1-2016, making a +1.5ppts contribution to growth. The consumption rebound is driven by the strong sentiment improvement mirroring the lasting progress within the programme, a flourishing tourism sector, improved labor market conditions, further property market stabilization, the impact from the envisaged fiscal relaxation, and the further normalization of banking sector conditions. Tourist arrivals grew by 17.6% YoY in Jan-May2017, with the corresponding levels over that period heading for a new all-time record high in the history of the Republic. Unemployment resumed its downward trend declining further to 11.0% in May 2017, down from 11.6% in April 2017 vs. 12.8% in May 2016. Moreover, investments were four times higher on an annual basis in Q1-2017, a trend also repeated in Q2 and Q4-2016, driven entirely by transportation equipment purchases, which most probably could be attributed to ship and airplanes' imports. As a result, the hefty contribution of investments was largely offset by the negative contribution of net exports (imports: +15.6% YoY vs. exports: -10.2%YoY).

*Even though solid growth performance is expected to continue in 2017, the risk of complacency is material*

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 at least 3% in 2017. Even though Cyprus has made progress in a lot of areas, the risk of complacency following the exit from the Economic Adjustment Programme is material. On the domestic front, the reform momentum seems to have stalled ahead of the Presidential elections in 2018. Still, a handful of unfinished structural reforms need to progress in the areas of privatizations, public and health sectors, while addressing the challenges of a still high bad loans stock (NPEs ratio at 47% in Dec2016, the second highest in EA). 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. As time moves on, it becomes increasingly unlikely the Bill will be voted into law ahead of next year's Presidential elections.

*Despite aggressive sovereign upgrades of last autumn, rating agencies still have divergent views on their rating assessment for Cyprus*

Following the latest round of sovereign rating assessments, major rating agencies appear to continue having divergent views on Cyprus. Currently, the distance from investment grade status is: one notch for S&P (currently at BB+, last upgrade in mid-March), four notches for Moody's (currently at B1), and three notches for Fitch (currently at BB-). As a result, 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 the PSPP program. 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. Nevertheless, the medium-term Cypriot bond yields have been on a declining trend since March2016. Yet, they have stopped outperforming those of Portugal in the Euroarea periphery since February 2017.

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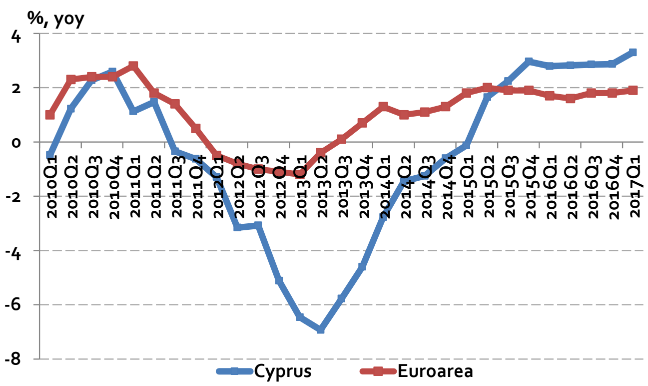
| Cyprus: Macro & Market Data | | | | |
|---|---|---|---|---|
| | **2014** | **2015** | **2016** | **2017f** |
| **Real GDP (yoy%)** | -2.5 | 1.7 | 2.8 | 3.0 |
| **Inflation (yoy%)** | | | | |
| HICP (annual average) | -0.3 | -1.5 | -1.2 | 1.2 |
| HICP (end of period) | -1.0 | -1.4 | 0.1 | 1.2 |
| **Fiscal Accounts (%GDP)** | | | | |
| General Government Balance | -0.2 | 0.1 | 0.4 | 0.2 |
| Gross Public Debt | 107.1 | 107.5 | 107.8 | 104.00 |
| Primary Balance | 2.6 | 2.7 | 3.0 | 2.6 |
| **Labor Statistics** | | | | |
| Unemployment Rate (LFS, %) | 16.1 | 15.0 | 13.1 | 11.7 |
| Compensation of employees/ per head | -3.8 | -1.1 | -0.6 | 0.7 |
| **External Accounts (% GDP)** | | | | |
| Current Account | -4.0 | -3.0 | -5.7 | -5.9 |
| Trade Balance (Goods) | -16.0 | -18.0 | -21.2 | -22.2 |
| Terms of Trade (of Goods) | 7.1 | 3.2 | -0.4 | 0.2 |
| **Domestic Credit** | **2013** | **2014** | **2015** | **2016** |
| Total Credit (%GDP) | 351.4 | 353.5 | 360.8 | 308.3 |
| Credit to Enterprises (%GDP) | 160.2 | 148.1 | 151.5 | 125.3 |
| Credit to Households (%GDP) | 140.0 | 142.7 | 136.4 | 127.5 |
| Private Sector Credit (yoy) | -12.2 | -2.3 | -3.4 | -11.0 |
| Loans to Deposits (%) | 135.3 | 133.4 | 136.6 | 112.6 |

*Source: National Sources, Eurostat, IMF, Eurobank Research*

FIGURE 17: **Growth performance Cyprus vs. Euroarea 2010-2017**




*Source: Eurostat, Eurobank Research*

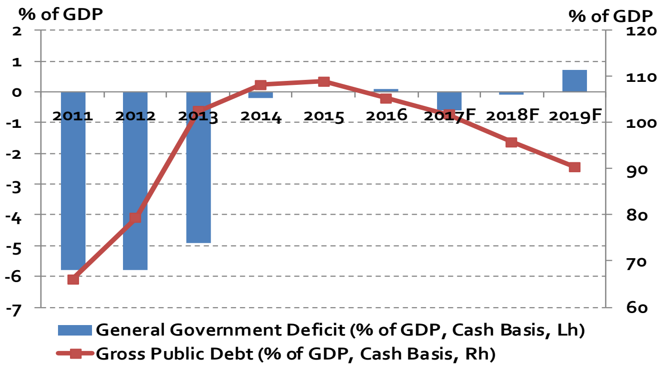
FIGURE 18: **HICP Cyprus vs. Euroarea 2010-2017**


*Source: Eurostat, Eurobank Research*

FIGURE 19: **5Y Generic Government Bond Yield**


*Source: Bloomberg, Eurobank Research*

FIGURE 20: **Fiscal deficit & Gross Public Debt 2011-2019**




*Source: Ministry of Finance, Eurobank Research*

# Romania (Baa3/BBB-/BBB-)

## *Swift end to the looming political crisis*

*Politics came into the forefront again as the ruling coalition toppled down the incumbent PM with a vote of no-confidence in the parliament*

Politics came to the forefront once again but a swift end was given to the looming political crisis. Prime Minister Sorin Grindeanu was ousted, after he had refused to resign, following the withdrawal of the major coalition partner Social Democratic (PSD) party's support and the ensuing successful no confidence motion against his government in parliament in late June. Sorin Grindeanu was removed from the post just six months into his tenure for allegedly not delivering on the party's pre-election promises. Sorin Grindeanu had assumed the post of the Prime Minister in the government coalition cabinet, after President Iohannis refused to appoint PSD leader Liviu Dragnea because of his conviction over electoral fraud in a 2012 referendum to impeach the President. Mihai Tudose, the minister for economy in the outgoing government, not a very prominent, or at least not well known, ruling party leader was nominated by the alliance of the PSD and ALDE for the post of the Prime Minister and received the tacit support of Ethnic Hungarians (UDMR). As expected, several ministers from the outgoing cabinet (17 out of 28) kept their seats. The new cabinet of the new Prime Minister Mihai Tudose was endorsed by 275 votes to 102 on June 29.

*A safe parliamentary majority argues in favor of government stability but it does not necessarily mean the end of political turmoil.*

The credibility and prestige damage from the public outcry against the controversial judicial reform plan, the recent cabinet reshuffle and the confrontational relationship between the President and the PSD leader leave the door open for political tensions to resurface again. Despite the swift end to the looming political crisis, populist policies still cast a threat to macroeconomic outlook. The new government pledged to reform taxation in order to boost the labor share in the economy and increase the minimum wage by 38% in 2018, which may result in significant competitiveness losses. On top of that, the unitary public wage law will result in significant increases of wages in the public sector in the following years (by 25% as of January 2018) and is expected to have a detrimental impact on fiscal metrics. Although President Iohannis admitted the necessity of the unitary wage law in the public sector to eliminate inequities and dysfunctionalities and promulgated the law, he warned the ruling coalition to focus on the country's public finances.

*Fiscal risks start materializing in the budget execution data*

The consolidated government balance in cash terms recorded a deficit of RON2.5bn in May compared to RON168mn in April, vs. only RON 909mn in the same month a year ago. Overall, the consolidated government deficit reached RON2.2bn or 0.27% of projected GDP in 5M-17, higher than the deficit of 0.1% of GDP registered in the same period last year. The revenues performance deteriorated in May (+5.3% YoY), so that total revenues were still up by +7.9% YoY in Jan-May but nevertheless well below the FY target of +13.9% YoY. This trend will most probably continue as further tax cuts have come into force since the beginning of the year. On the other hand, total expenditures expanded by 9.4% YoY in Jan-May, below the FY target of 15.2% YoY. Nevertheless, spending in the areas of wages has started to accelerate as of February (+19.1% YoY in the 5M-17, well above the 12% FY budget plan) as the budget implementation incorporated the ruling coalition's electoral program for further generous hikes. Other spending items, such as procurement for goods & services and capital expenditure declined by -0.5% and -23.1% respectively. Finally, debt servicing expenses were up by +1.6% YoY in Jan-May2017. According to the latest IMF forecast, the fiscal deficit is expected to increase to 3.7% of GDP in 2017 and further up to 3.9% in 2018, which may put the government on a collision course with EU institutions. In that case, the MoF has pledged to contain expenditures; practice has shown that this usually results in the under execution of the public investments program (4.2% of GDP in 2017) at the expense of neglecting infrastructure.

*Real GDP dynamics surprised to the upside in Q1-2017*

The revised estimate of the Statistical Service on the seasonally adjusted Q1-17 GDP reading confirmed the flash estimate of +1.7% QoQ/+5.6% YoY, +5.7% YoY in unadjusted terms. The estimate was the positive surprise of the region, coming out significantly above analysts' consensus expectations (+1.0% QoQ/+4.5% YoY). The stronger than expected print compares to +1.5% QoQ/+5.0% YoY in Q4-2016, up from +1.1% QoQ/+4.0% YoY in Q1-2016. Driven by higher disposable income as a result of the VAT rate cut and the rapid rise in real wages, private consumption jumped by +5.7% QoQ/+7.4% YoY in Q2, making a hefty contribution of 4.8ppts to growth. Gross fixed capital formation contracted on an annual basis by +3.1% QoQ/-0.7% YoY, for a third quarter in a row, translating into a negative -0.1ppts contribution to growth, and was largely offset by the positive contribution of inventories (+1.1ppts). Investments were negatively affected by the lower EU funds absorption and the underperformance of the public investments program. On the other hand, net exports made a negative contribution of -0.1ppts, mirroring the deceleration of exports (+3.9% QoQ/+10.8% YoY) both on a quarterly and annual basis. By contrast, imports exhibit robust dynamics (+5.3% QoQ/+10.5% YoY), which is broadly expected as domestic demand recovery is accompanied by a recovery of imports. It is evident that growth is largely driven by private consumption, financed by an overly expansionary fiscal policy, and leads to a revival of macroeconomic imbalances.

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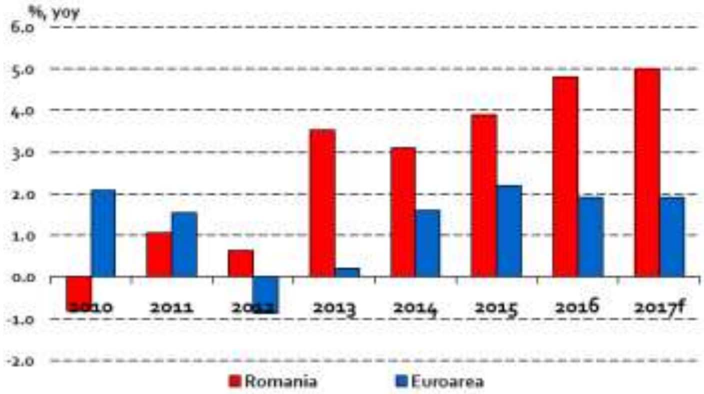
| Romania: Macro & Market Data | | | | |
|---|---|---|---|---|
| | **2014** | **2015** | **2016** | **2017f** |
| **Real GDP (yoy%)** | 3.1 | 3.7 | 4.8 | 5.0 |
| **Inflation (yoy%)** | | | | |
| CPI (annual average) | 1.1 | -0.6 | -1.6 | 1.4 |
| CPI (end of period) | 0.8 | -0.9 | -0.5 | 1.8 |
| **Fiscal Accounts (%GDP, Cash Basis)** | | | | |
| General Government Balance | -1.9 | -1.9 | -2.4 | -3.7 |
| Gross Public Debt (including guarantees) | 39.5 | 39.1 | 39.2 | 40.6 |
| **Labor Statistics (annual avg,%)** | | | | |
| Unemployment Rate (ILO, % of labor force) | 6.8 | 6.8 | 5.9 | 5.7 |
| Wage Growth (total economy) | 7.6 | 9.8 | 13.0 | 8.0 |
| **External Accounts** | | | | |
| Current Account (%GDP, BPM5) | -0.4 | -1.1 | -2.2 | -3.0 |
| Net FDI (EUR bn) | 2.5 | 2.7 | 3.9 | 4.0 |
| FDI / Current Account (%) | 385.0 | 157.1 | 93.8 | 72.7 |
| FX Reserves (EUR bn) | 32.2 | 32.2 | 34.3 | 35.5 |
| **Domestic Credit** | **2013** | **2014** | **2015** | **2016** |
| Total Credit (%GDP) | 47.0 | 44.4 | 43.9 | 41.2 |
| Credit to Enterprises (%GDP) | 18.0 | 15.7 | 15.5 | 13.4 |
| Credit to Households (%GDP) | 16.5 | 15.4 | 15.4 | 14.9 |
| FX Credit/Total Credit (%, private) | 60.9 | 56.2 | 49.3 | 42.8 |
| Private Sector Credit (yoy) | -3.3 | -3.1 | 3.0 | 1.2 |
| Loans to Deposits (%) | 118.4 | 106.3 | 106.6 | 114.3 |
| **Financial Markets** | **Current** | **3M** | **6M** | **12M** |
| Policy Rate | 1.75 | 1.75 | 1.75 | 2.00 |
| EUR/RON | 4.57 | 4.60 | 4.62 | 4.65 |

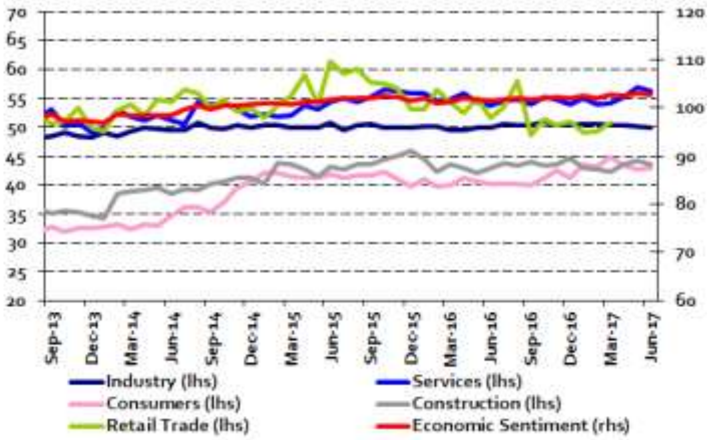
*Source: National Authorities, EC, IMF, Eurobank Research*

FIGURE 21: **Growth performance Romania vs. EU28 2010-2017**



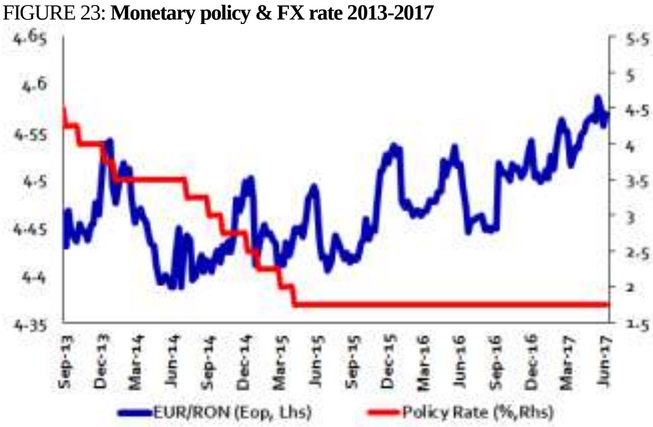

*Source: Eurostat, Eurobank Research*

FIGURE 22: **Sentiment indicators 2013-2017**



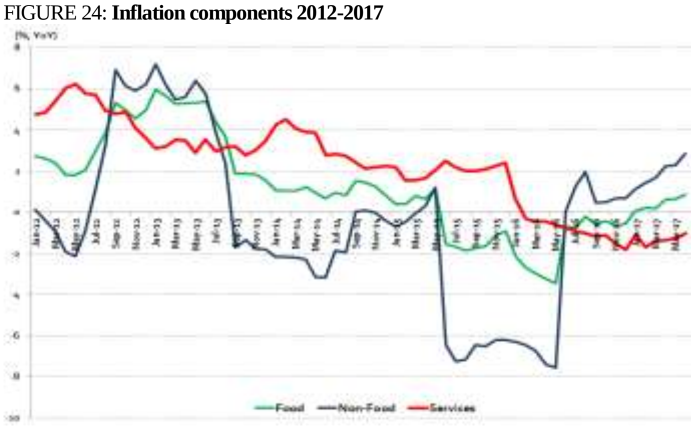

*Source: Eurostat, Ecowin Reuters, Eurobank Research*

FIGURE 23: **Monetary policy & FX rate 2013-2017**




*Source: Bloomberg, Eurobank Research*

FIGURE 24: **Inflation components 2012-2017**




*Source: National statistics, Eurobank Research*

# Serbia (Ba3/BB-/BB-)

## *New government expected to continue previous administration's policies*

*First female Prime Minister and cabinet endorsed in Parliament*

The National Assembly approved in late June the new cabinet and Prime Minister, in a development that places newly appointed Premier Ana Brnabic as the first female head of government in the country's history. The new administration received the support of 157 MPs in the 250-parliament, while 55 lawmakers voted against. The procedure was considered rather as a formality as the parties of the ruling coalition government, the Serbian Progressive Party (SNS) and the Socialist Party of Serbia (SPS), enjoy an absolute majority in Parliament. The recently endorsed Prime Minister is not a member of any political party but she is considered a close ally of former Premier and incumbent President Alexandar Vucic. She previously held the state administration and local government portfolios and was nominated for the post by her predecessor after he vacated the position to become President following his landslide victory on the first round of the April 2nd presidential elections. The new cabinet comprises of 18 ministries, with most of the prior government's members, including Finance Minister Dusan Vujovic, maintaining their posts. This prompts the belief that the prior administration's economic, fiscal, reform-oriented and pro-EU policies will continue, in tandem with a high degree of influence from President and leader of major coalition partner SNS party Alexandar Vucic. Indeed, in her speech to Parliament, the new Premier named amongst her cabinet's top priorities faster EU accession, modernization of state administration and strengthening of ties with Russia. In a further indication of the latter, she placed Nenad Popovic, a renowned businessman with strong links to Russia, as the Minister without portfolio responsible for innovations and technology. At the same time, the newly established Ministry of European Integration signals a stronger drive towards EU membership. On the latter, Serbia received a full candidate status in 2012, with the momentum towards EU integration having gained pace lately. Two more chapters under the country's EU accession negotiations opened in June. Namely, Chapter 7 on Intellectual Property Law and Chapter 29 on the Customs Union. This brings the total number of chapters opened to 10, out of 35 in total, with two (25, Science & Research and 26, Education & Culture) having been closed.

*Real GDP growth slowed in Q1 2017 on adverse weather conditions*

Final national accounts data showed real economic activity grew by 1.2%YoY in Q1, revised upwards from a preliminary 1.0%YoY. This marks a significant slowdown from increases of 3.8%YoY and 2.5%YoY in Q1 and Q4 2016 respectively. However, the breakdown vindicated our expectations that adverse weather conditions weighed on agriculture and construction. Base effects may also be partly to blame as the Q1 2016 reading was exceptionally strong. From the expenditure side, the deceleration was mainly due to a pick up in the growth of imports, which were inflated due to higher energy imports - as a result of bad weather – and strengthening domestic demand. This resulted in a switch of net exports' contribution to negative. At the same time, growth in investments slowed down further, with the rate of annual increase in gross fixed capital formation coming in at 1.3%, vs. 6.8% and 2.6% in Q1 and Q4 of 2016 respectively. Yet, household consumption gained momentum. According to the latest available higher frequency data, an economic rebound is in the making in Q2, in confirmation of the view that temporary factors were mostly at play behind the prior quarter's slowdown. Looking further ahead, economic activity is likely to pick up additional pace towards 3.0% this year and accelerate further slightly in 2018, from an 8-year high growth rate of 2.8% in 2016, as last year's positive trends are likely to continue.

*Fiscal over-performance continued to end June, providing leeway for NBS to retain accommodative – yet cautious – stance*

Budget over-performance appears to have continued through to end June. President Vucic reportedly highlighted in early July that the general government budget is estimated at a surplus of up to RSD 28.0bn (€230mn) in H1 2017. This reflects a further improvement from a surplus of RSD 23.0bn in January-May and compares with a shortfall of RSD 24.6bn ran over the first five months of 2016. According to the President, the improvement was boosted by exceptional economic growth over the months of May and June. With such positive developments already evident over the first half of 2017, last year's fiscal deficit of 1.3% of GDP is likely to narrow to around 0.5% of GDP in 2017 and a small surplus is possible to be registered in 2018, in tandem with a further decline in public debt that period. In line with the aforementioned, the IMF acknowledged the major macroeconomic performance turnaround witnessed over the last couple of years, following a staff-level agreement of the 7th review under the country's Stand-By Arrangement (SBA) earlier in July. In its concluding statement, the IMF staff noted that it anticipates a narrowing of the fiscal deficit to 1.1% of GDP this year, projecting economic activity at 3%. It also underscored that public debt is falling at a faster rate than previously anticipated. The Fund also acknowledged that the ongoing fiscal consolidation has provided leeway for the Central Bank (NBS) to substantially ease monetary conditions. NBS has kept the key policy rate at the current record low of 4.00% since July 2016, maintaining a cautious stance. Despite higher readings in headline CPI over the last few months (3.6%YoY in June), the Central Bank has repeatedly expressed belief that the index will remain within the target tolerance band (3±1.5%) over the coming months, as one-off price pressures gradually wane and the base effect from global oil prices slows down, while upward pressures are seen stemming from the recovery in domestic demand and inflation from abroad. This will allow the MPC to maintain its accommodative monetary policy stance throughout this year and hold the key policy rate at current levels.

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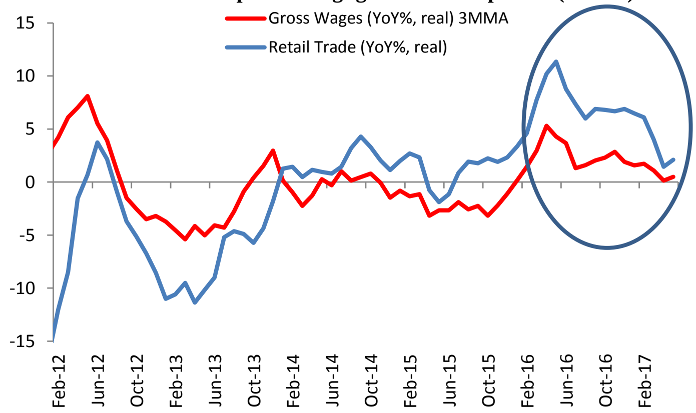
| Serbia: Eurobank Forecasts | | | | |
|---|---|---|---|---|
| | 2014 | 2015 | 2016 | 2017 |
| **Real GDP (yoy%)** | -1.8 | 0.8 | 2.8 | 3.0 |
| **Inflation (yoy%)** | | | | |
| HICP (annual average) | 2.1 | 1.4 | 1.1 | 3.3 |
| HICP (end of period) | 1.7 | 1.5 | 1.6 | 3.0 |
| **Fiscal Accounts (%GDP)** | | | | |
| Consolidated Government Deficit | -6.6 | -3.7 | -1.3 | -0.5 |
| Gross Public Debt | 70.4 | 74.6 | 73.6 | 69.0 |
| **Labor Statistics (%)** | | | | |
| Unemployment Rate (%of labor force) | 19.2 | 17.7 | 15.3 | 13.1 |
| Wage Growth (total economy) | -1.5 | -2.1 | 2.5 | 2.7 |
| **External Accounts** | | | | |
| Current Account (% GDP) | -6.0 | -4.7 | -4.0 | -4.0 |
| Net FDI (EUR bn) | 1.2 | 1.8 | 1.9 | 2.1 |
| FDI / Current Account (%) | 62.3 | 114.4 | 135.8 | 145.0 |
| FX Reserves (EUR bn) | 9.9 | 10.4 | 10.2 | 10.6 |
| **Domestic Credit** | **2013** | **2014** | **2015** | **2016** |
| Total Credit (%GDP) | 57.0 | 61.0 | 62.3 | 63.6 |
| Credit to Enterprises (%GDP) | 28.7 | 29.2 | 28.7 | 26.8 |
| Credit to Households (%GDP) | 17.4 | 18.6 | 18.7 | 19.9 |
| Private Sector Credit (yoy%) | -4.8 | 0.5 | 3.3 | 5.6 |
| Loans to Deposits (%) | 113.8 | 102.5 | 99.0 | 92.0 |
| **Financial Markets** | **Current** | **3M** | **6M** | **12M** |
| Policy Rate | 4.00 | 4.00 | 4.00 | 4.00 |
| EUR/RSD | 120.10 | 121.00 | 122.00 | 123.50 |

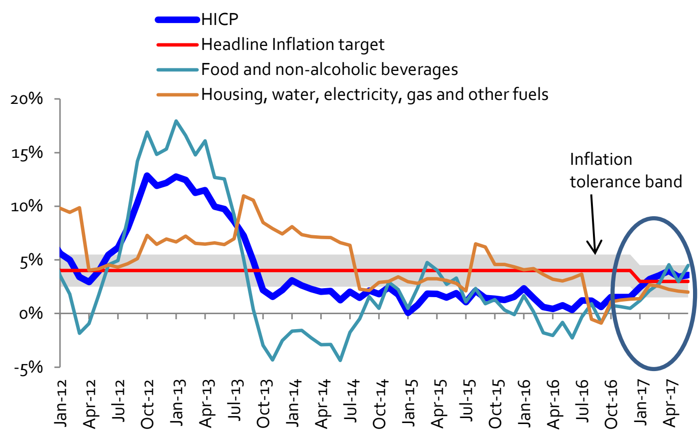
*Source: National Authorities, EC, IMF, Eurobank Research*

FIGURE 25: **Private consumption & wage growth remain positive (3MMA)**



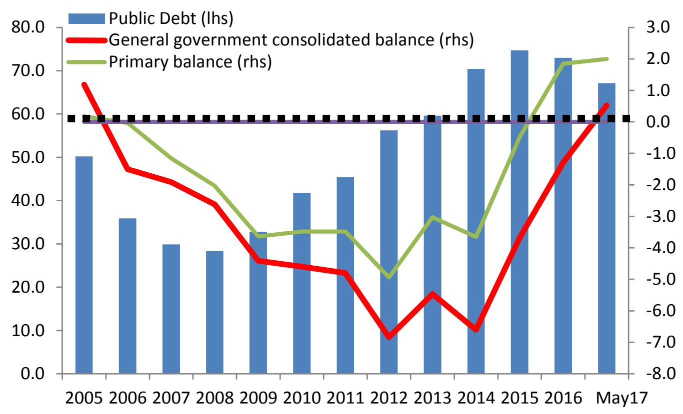

*Source: National Authorities, EC, IMF, Eurobank Research*

FIGURE 26: **Inflation pressures rise in H1 2017, but remain within target band**



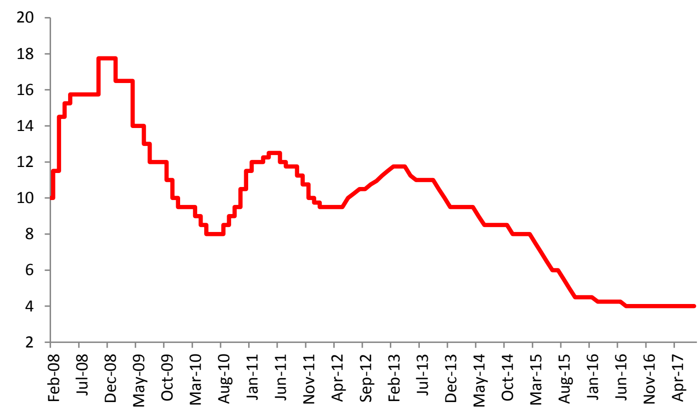

*Source: National Authorities, Eurobank Research*

FIGURE 27: **Serbia's fiscal position improves notably since 2014 (% of GDP)**




*Source: National Authorities, EC, IMF, Eurobank Research*

FIGURE 28: **Key policy rate at 4.00% record low for a year**




*Source: National Authorities, EC, IMF, Eurobank Research*

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