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REGIONAL ECONOMICS & MARKET STRATEGY MONTHLY

March-April 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 growth momentum sustained in Q1-2017

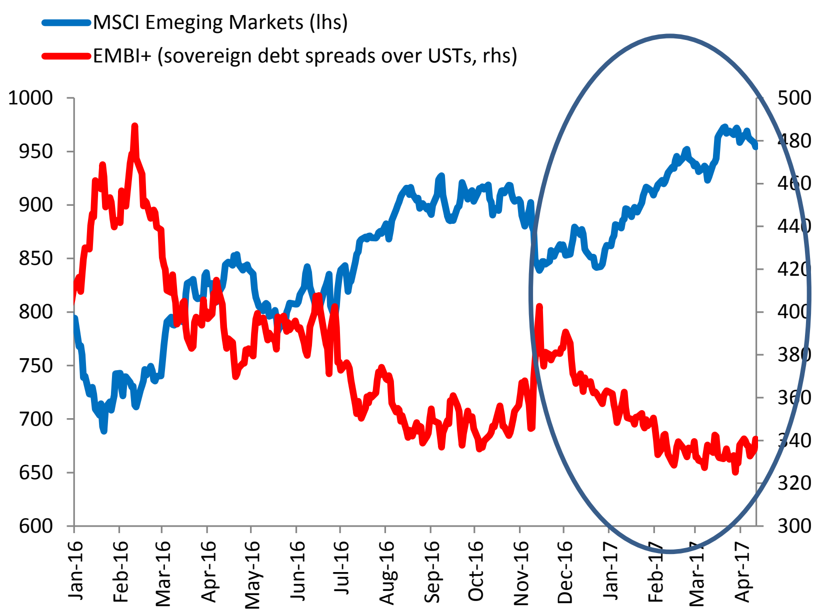
REGIONAL MACROECONOMIC & MARKET DEVELOPMENTS & OUTLOOK

- **Q4-2016 second GDP estimates** confirm that the economies of the region are in good shape
- **Growth momentum** in the region sustained in Q1-2017
- **Sentiment indicators** on an upward trend despite **local political uncertainties** and temporary food & energy driven **inflation spike**
- Most **emerging market assets** end Q1 2017 **in the black**
- **Regional bourses firm** in line with the move higher in emerging and major global stock markets
- **CESEE currencies remain range-bound,** with **idiosyncratic factors** setting the tone in several cases
- Despite several **political risk events** already being behind us, **French & German elections** lure market attention; **major CB policies** remain in the forefront

COUNTRY FOCUS

- **Bulgaria:** GERB wins early parliamentary elections
- **Cyprus:** Inflation jump in February
- **Romania:** Focus shifts to budget execution risks
- **Serbia:** Prime Minister Vucic wins decisive victory in April's presidential elections

Emerging market equities rally in Q1 2017 thanks to improving risk sentiment



Source: Bloomberg, Eurobank Research

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I. Regional Macroeconomic & Market Developments & Outlook

Sentiment on an upward trend in Q1-2017 despite local political uncertainties and headline inflation spike; most regional assets end Q1-2017 in the black

Sentiment indicators across the region were still on an upward trend in Q1-2017 despite local political uncertainties and energy & prices spike

The second GDP growth estimates for Q4-2016, released for the countries of our focus (Bulgaria, Romania, Cyprus, and Serbia), confirmed that these economies are in relatively good shape. Sentiment and high frequency indicators still pointed to relatively strong growth momentum in the region in Q1-2017. In the economies of our focus, economic sentiment indicators-an aggregate of five sub-indices-were still on a rising trend driven by the sustained good performance of consumer-related subsectors. Local political uncertainties plus the headline inflation spike across the region have had a slightly negative, yet temporary so far, impact on sentiment and most probably have not put a break on the revival of private spending. The region is leaving behind a heavy political calendar in Q1: snap parliamentary elections in Bulgaria in late March, political upheaval in Romania during February, presidential elections in Serbia in early April. In addition, the energy and food prices rebound in the first couple of months led headline inflation rates across the region higher from recent troughs. To the extent that this price adjustment fades away, headline and core inflation are set to remain subdued in the coming months, still allowing local Central Banks to maintain an accommodative stance and delay the tightening process further. Finally, fiscal policy is now expected to be more growth supportive given the targets' overachievement of the past year in some cases (Bulgaria, Serbia and Cyprus) which allows more flexibility in 2017, or the expansionary policies followed stretching budgets' capacity (Romania).

Most emerging market assets end Q1 2017 in the black

Emerging market assets retained a firm tone over the first quarter of 2017 extending gains amassed a year earlier. Ongoing global growth recovery, improving macro fundamentals in developing economies, somewhat mitigated concerns about US trade protectionism, lingering hopes about fiscal stimulus from the US and still relatively low interest rates globally continue to underpin appetite towards risky assets. Rather diminished concerns over a further rise in political uncertainty in Europe have also helped. In CESEE, Serbian Prime Minister Aleksandar Vucic comfortably won the polls in the first round, in an outcome that was largely perceived as a continuation of the government's current pro-EU policies, while it eliminated risks of a prolongation of domestic political uncertainty. Likewise, the victory of the centre-right pro-EU ruling party Citizens for European Development of Bulgaria (GERB) on the 26th of March national polls implies pro-EU policy continuity and disciplined fiscal stance. The Dutch general election outcome, where centre-right Prime Minister Mark Rutte's VVD party won in mid-March the national ballot over the anti-EU party of Geert Wilders, somewhat soothed concerns about a further rise in Euroscepticism.

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

Tracking the move higher in major bourses globally, developing nations shares retained a firm tone in Q1 2017. The MSCI Emerging Markets index marked in March the third consecutive month of positive returns, ending the quarter with gains to the tune of 11%. The index, which recently reached new 1 ½ year highs, comfortably outperformed a concomitant performance in the MSCI World index. Along similar lines, stocks in the CESEE region have broadly firmed, with Bulgaria's SOFIX leading the way higher (+8%MTD/+12%YTD). A similar pattern continues to be evidenced in the external debt markets, where Emerging Market spreads over USTs reached new 2 ½ year lows in late March and YTD total returns have increased by approximately by more than 4%. Serbia's 5-year CDS spreads reached near decade lows after Moody's upgraded in March the country's sovereign credit ratings as domestic macroeconomic fundamentals continue to improve.

CESEE currencies remain range-bound, with idiosyncratic factors setting the tone in several cases

Despite a weaker US dollar CESEE currencies have traded in a small range so far this year. Idiosyncratic factors have remained at play in several cases. The Polish zloty stands out as the region's outperformer, having rallied by 4% against the euro YTD. Following last year's H2 sell-off the currency has recovered significant ground firming as far as a 1 ½ year peak of 4.2080/€ in late March thanks to a strong economic growth performance in tandem with improved global risk sentiment. On the flipside, the Turkish lira continues to lead the losers' pack, standing weaker 2%MTD and 6%YTD against the US dollar. Comparably large external vulnerabilities in tandem with escalated domestic political uncertainty and worries over the country's economic growth prospects have weighed on the TRY, while the looming referendum on April 16th lures market attention. Albeit several key risk events in Europe are already behind us, the looming French elections take centre stage in April and May ahead of the German polls in September-October. US President Trump's administration ability to implement pre-election fiscal promises will also play a key role in global risk sentiment. Meanwhile, ECB and Fed monetary policies will also remain a key driver for emerging market assets and, by implication, those of the countries of our focus.

Despite several political risk events already being behind us, French & German elections lure market attention; major CB policies remain in the forefront

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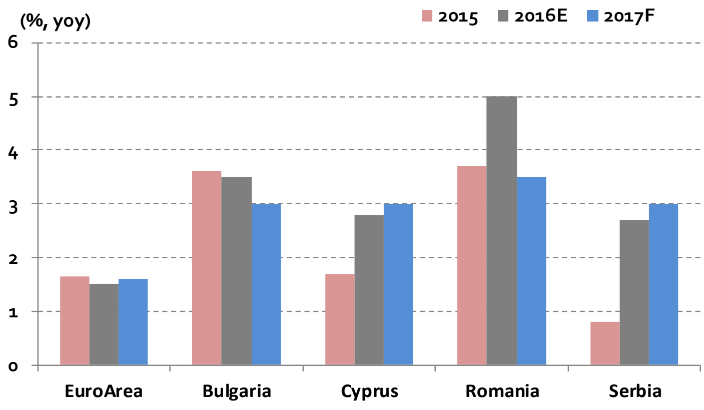
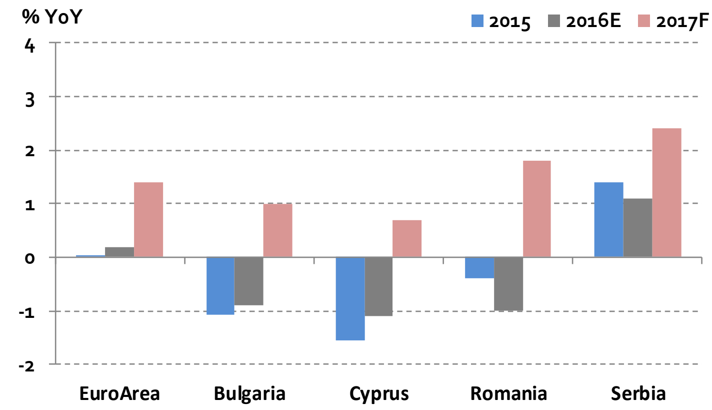
FIGURE 1: **GDP Growth performance 2015-2017**



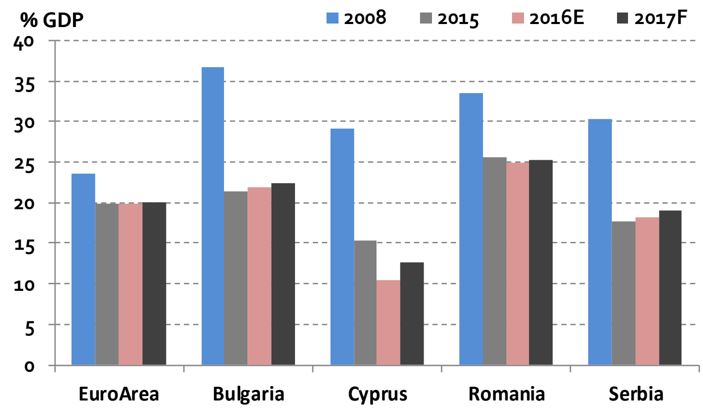
Source: Eurostat, National Authorities, Eurobank Research

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



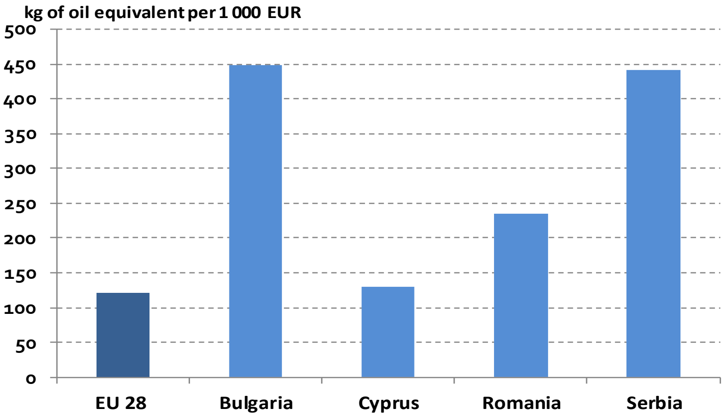
Source: Eurostat, EU Spring Forecasts, Eurobank Research

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



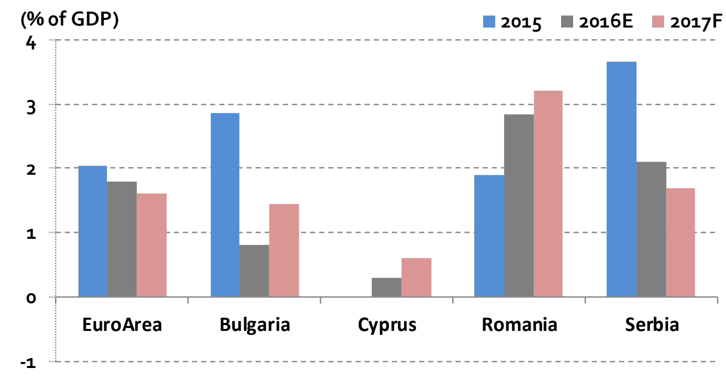
Source: IMF WEO, Eurobank Research

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



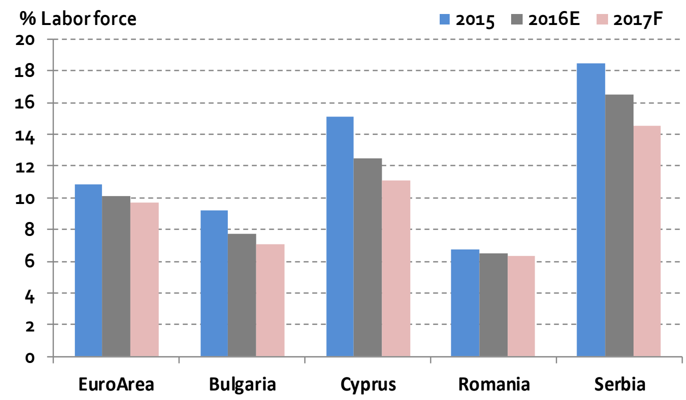
Source: Eurostat, National Authorities, Eurobank Research

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



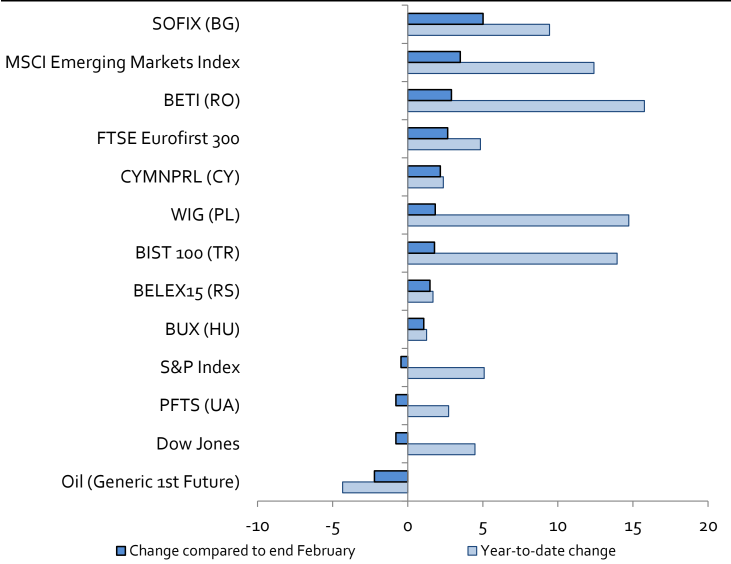
Source: Eurostat, National Authorities, Eurobank Research

FIGURE 6: **Annual average unemployment rates 2014-2016**



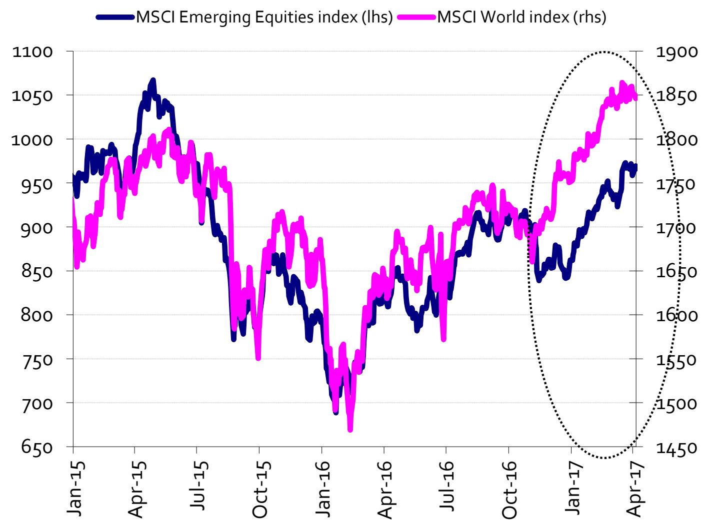
Source: Eurostat, National Authorities Eurobank Research

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



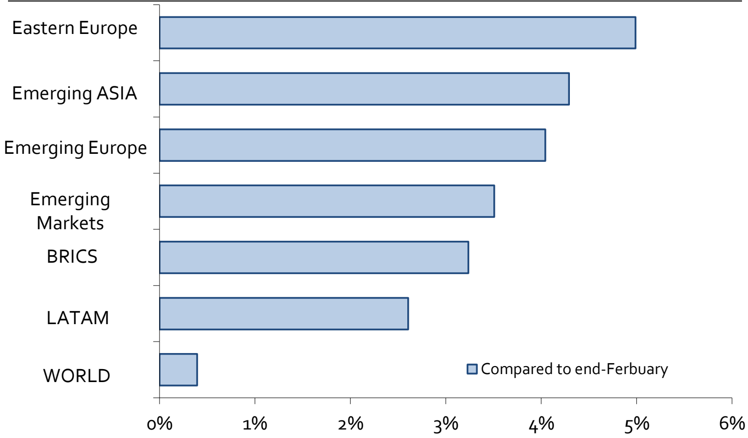
Source: Reuters, Bloomberg, Eurobank Research

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



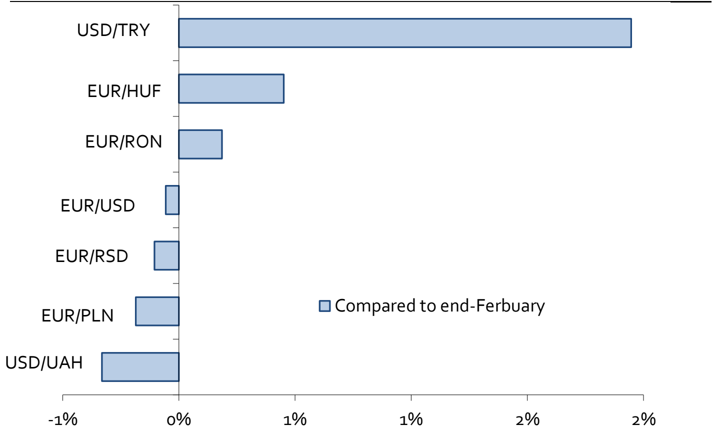
Source: Reuters, Bloomberg, Eurobank Research

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



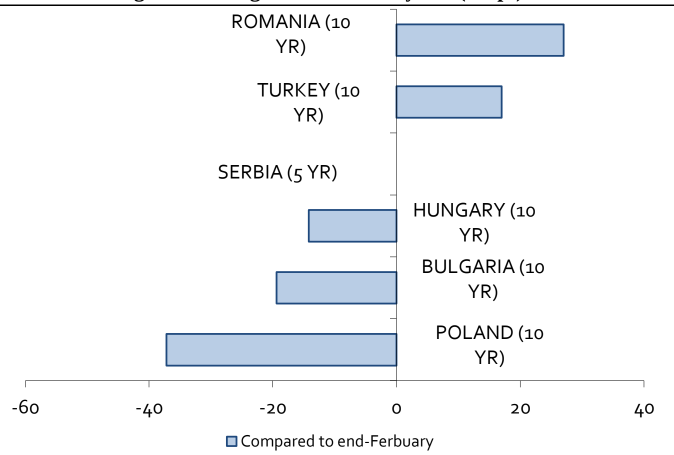
Source: Reuters, Bloomberg, Eurobank Research

FIGURE 10: **CESEE FX performance**



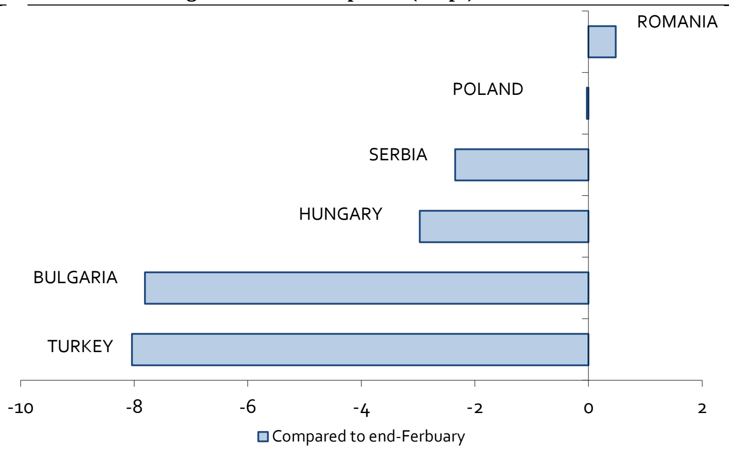
Source: Reuters, Bloomberg, Eurobank Research

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

FX

Short EUR/RSD vs. long 3M RSD bond positions seem favorable at present

During the course of the last month or so, the EUR/RSD fell to its start-of-the year and immediate support level of 123.45. The currency's thus much appreciation raised the prospect for renewed Central Bank intervention aimed at halting further upside for the RSD. With that in mind, the dinar swiftly moved back towards upper bound of its yearly range (124.00). As the EUR/RSD stabilized during the first two post-election days, we still believe it will continue to hover in very narrow three-month range of 123.45 and 124.10 on a short term basis. However, a "very" gradual depreciation of the currency in a 6-12 month time frame is likely.

Therefore, we are inclined to say that playing on a "short EUR/RSD vs 3M bond" position seems appropriate strategy in given circumstances. In same time frame we are expecting a depreciation of the dinar not bigger than 50 pips.

Security	Position	Entry	Stop loss	Period
EUR/RSD vs. 3M RSD bond	Short EUR/RSD & Long 3M RSD bond	EUR/RSD: 123.95 3M Bond yield: 3.7%	EUR/RSD: 124.50	3 months

Local rates

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

The Bulgarian Sovereign market remained relatively quiet over the last month or so. Curve shifts on BGN-denominated paper followed the moves in major papers globally, rather than being driven by trading activity. The Ministry of Finance successfully re-tapped the 10-year benchmark placing another BGN 100mn on March 20th. The bid/cover ratio came in at 1.92, lower compared to that achieved in previous auctions, while the average accepted yield increased to 1.80% against 1.76% earlier in January. Pension funds remained the major buyers on the primary market with a 47% share, followed by banks and insurance companies with 27% and 15% of the size, respectively. The next treasury auction is set for April 24th for BGN 60mn in 4-year T-bonds. All in all, we prefer to remain on the sidelines on BGN-denominated bonds as we consider the current levels expensive.

External debt markets

We prefer BGARIA 24 to our previous recommendation for BGARIA23 amid favorable yield differential

Bulgarian Eurobonds, on the other hand, were strongly favored by local banks that sought to place extra liquidity leading to tightening of credit spreads. Foreign investors remained mainly on the sell side, ahead of snap elections, especially in the long-end of the curve. With the center-right GERB party winning over their main opponent, the Bulgarian Socialist Party, political concerns eased and yields dropped further. As market opportunity, we switch our focus from BGARIA 23 to BGARIA 24, where the yield differential is more than 43 bps at the moment. BGARIA 24 is trading 15 bps lower than a month ago and 25 bps lower compared to two months ago.

Security	Position	Entry	Target	Stop loss
BGARIA 2024	Long	1.39%	1.25%	2.55%

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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-)

GERB wins early parliamentary elections

GERB wins early parliamentary elections with a clear margin from the runner up.

The centre-right pro-EU ruling party Citizens for European Development of Bulgaria (GERB) won with a share of 32.65% in the early parliamentary elections held in March 26. The second largest party in Parliament, the Bulgarian Socialist Party (BSP), was the runner up having scored 27.2%. The outcome renewed doubts on polls' reliability in predicting election results as they had pitted GERB and BSP as running neck-to-neck. Three more political parties managed to pass the 4% threshold to enter the 240-seat Parliament, namely, the nationalist coalition United Patriots (9.07%), the Movement for Rights and Freedoms DPS (8.99%), which represents primarily the ethnic Turkish minority, and the newly formed "Volya" (4.15%), led by businessman Veselin Mareshki. The elections were called earlier this year after Prime Minister Boyko Borisov handed in his government's resignation in Parliament in the wake of last November's Presidential elections that saw the defeat of his party's candidate. They took place two years ahead of schedule and mark the country's return to national polls for the third time in four years. According to FITCH, it is unlikely that the snap election results will break the pattern of unstable governments that has hindered structural reform. As long as the formation of a stable government that would serve out its full-term appears unlikely, the pattern of unstable governments is a weakness for Bulgaria's BBB-/Stable Outlook sovereign rating (affirmed in last December).

A coalition between GERB and United Patriots is currently being speculated as the most probable scenario for the formation of the new government.

GERB and United Patriots together are seen occupying a small majority of 123 seats in parliament, as the former is estimated to have obtained 96 seats and the latter 27 out of the 240 total. Among its pre-election promises, GERB has pledged to continue pursuing prudent fiscal policies supportive of the Currency Board Arrangement, increase public wages and improve the business environment, while United Patriots oppose immigration and call for increases in pensions and maintaining low electricity prices. A three-party coalition cannot be ruled out either. Such an alliance including "Volya", which is estimated to have won 12 seats in the National Assembly, will strengthen the government's mandate. Another possible scenario is that of a minority government with the tacit support of other parliamentary groups. If GERB fails to receive parliamentary support to form a government, then the President will entrust this task to the second parliamentary group, the BSP. All in all, a GERB-led administration implies a pro-EU policy continuity and disciplined fiscal stance. However, the participation of other parliamentary groups in such an alliance will likely cast a populist tone.

From a macro fundamentals point of view, the country is now in much better shape to withstand an internal or external shock.

The country's external and fiscal position is strong, the banking sector capital position is solid and the buffers (fiscal and FX reserves) are sizeable. Budget execution outperformed the target by a wide margin in 2016 (+1.6% of GDP surplus vs. a target of a - 2.0% deficit). The CA balance -in surplus for the fourth consecutive year-climbed to +3.9% of GDP in FY16, up from -25.2% in FY07. GDP growth remained on track in Q4-2016, bringing the FY2016 at 3.4%, an inch down from 3.6% in FY2015. Sustained labor market improvement coupled with positive real wage growth (9.4% YoY in 2016 vs. 9.9% YoY in 2015) supported final consumption recovery throughout 2016. The unemployment rate declined further to 7.1% in 2016 vs. 9.2% in 2015 (7.1% in Q4 down from 8% in Q4-2015) as the economy adds new jobs in the areas of specialized services. Bulgaria is expected to register a second consecutive year of strong above-potential growth in 2017 driven by robust private consumption dynamics. Our GDP growth forecast for 2017 stands currently at 3.3%, above the recently released BNB quarterly economic review forecast of 2.8%. Yet, we note that structural reforms are critically needed for accelerating living standards' convergence with EU-28. 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 among EU members.

Inflation accelerated for a third month in a row in February.

Consumer prices jumped to +0.0% MoM/+1.7% YoY in February, up from +1.3% MoM/+1.4% YoY in January, rising for a third consecutive month. Food prices, both the largest as well as the most volatile component of CPI, were kept high at +0.9% MoM/+3.7% YoY, down from -0.1% MoM/-0.2% YoY in January. The main driver was the rise in the prices of vegetables (+15.2% YoY). Reflecting the normalization of global energy prices in Jan-Feb2017, transportation prices jumped to +0.4% MoM/+6.0% YoY, compared to only +1.1% MoM+2.3% YoY in January and a one year low of +1.2% MoM/-11.5% YoY in last May. Energy prices fell to their lowest level in mid-March despite the OPEC efforts to contain crude production. Yet, negative base effects plus the planned sharp adjustment of gas prices as of April are expected to maintain inflationary pressures intact in the coming months.

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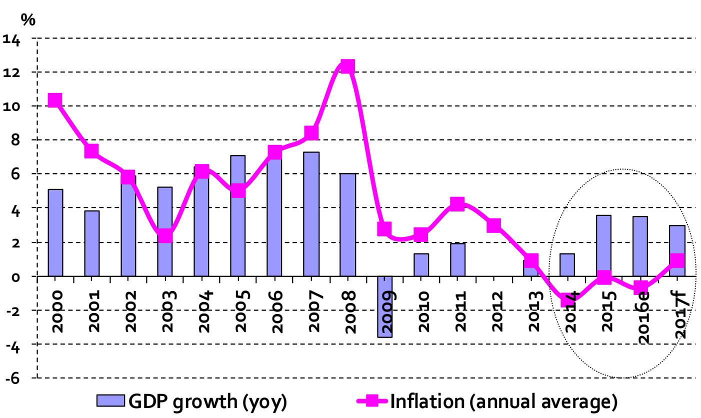
Bulgaria: Macro & Market Data				
	2014	**2015**	**2016**	**2017f**
Real GDP (yoy%)	1.3	3.6	3.4	3.3
Inflation (yoy%)				
CPI (annual average)	-1.4	-0.1	-0.8	1.5
CPI (end of period)	-0.9	-0.4	0.1	1.7
Fiscal Accounts (%GDP)				
General Government Balance	-3.7	-2.9	1.4	-1.4
Gross Public Debt	27.7	26.7	29.7	26.3
Primary Balance	-3.0	-2.1	2.4	-0.2
Labor Statistics				
Unemployment Rate (LFS, %)	11.4	9.2	7.6	7.3
Compensation of employees/head	5.6	5.6	3.8	4.8
External Accounts				
Current Account (% GDP)	0.1	0.4	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

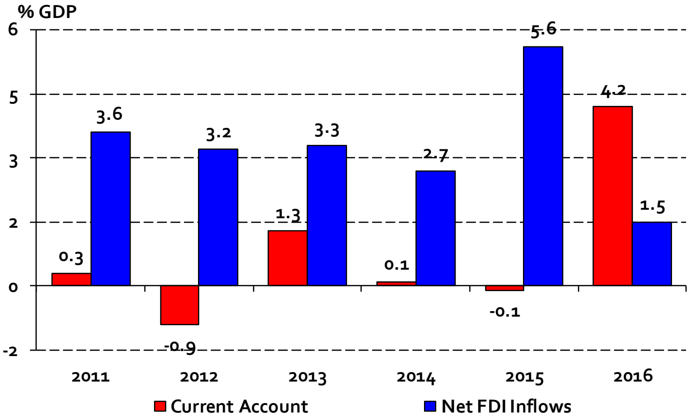
Source: National Sources, Eurostat, IMF, Eurobank Research

FIGURE 13: **GDP growth & Inflation 2000-2016**



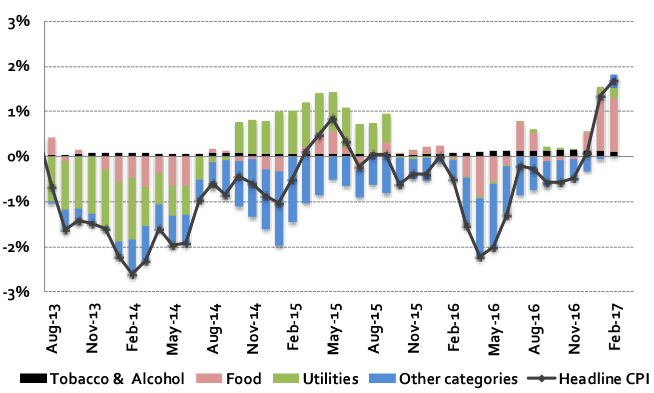
Source: National statistics, Ecowin Reuters, Eurobank Research

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



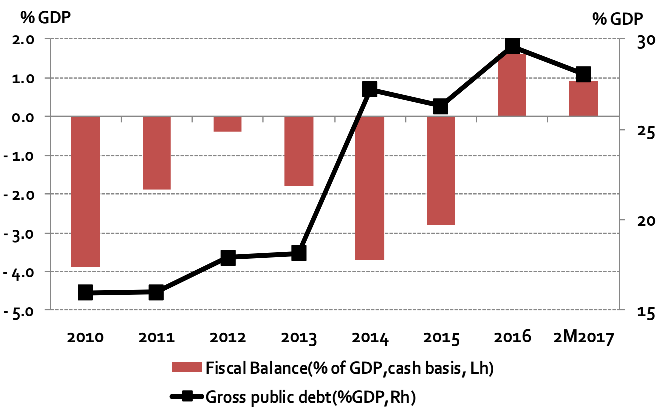
Source: National statistics, Ecowin Reuters, Eurobank Research

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-)

Inflation jump in February

The second Q4 GDP reading confirmed that the economy is on a fast growth recovery track

The second estimate of CYSTAT on the seasonally adjusted Q4 GDP reading revised marginally the flash estimate of +0.5% QoQ/+2.8% YoY to +0.7% QoQ/+2.9% YoY. The strong reading compares to +0.7% QoQ/+2.9% YoY in Q3-2016 vs. +0.7% QoQ/+3.0% YoY in Q4-2015. The GDP growth rate of Q4 is among the highest in EA-19 and EU-28, both on a quarterly and an annual basis. Final consumption expanded by +0.2% QoQ/+2.3% YoY in Q4-2016, down from +0.3% QoQ/+2.5% YoY in Q3-2016, vs. +0.4% QoQ/+1.5% YoY in Q4-2015, making a +1.9ppts contribution to growth. The consumption rebound is driven by the strong sentiment improvement mirroring the lasting progress within the economic adjustment program (The ESI index stands very close to the levels prior to Lehman Brothers international crisis), a flourishing tourism sector (+19.8% YoY in tourist arrivals and +11.9% YoY in tourism revenues in FY2016), visible labor market conditions improvement (unemployment declined for a third consecutive year in a row from 15.0% in 2015 to 13.3% in 2016), and a rise in real incomes. Moreover, investments skyrocketed by 96.7% YoY, a trend also repeated in Q2-2016, driven entirely by transportation equipment purchases which most probably could be attributed to ship imports. As a result, the hefty contribution of investments was largely offset by the negative contribution of net exports (imports: +12.0% YoY vs. exports: +0.1%YoY).

Solid growth performance is expected to continue in 2017

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. In our view, solid real GDP growth performance is going to be driven by a number of factors. First of all, private consumption recovery is going to continue due to sustained strong improvement in consumer confidence, mirroring both the graduation from the Program as well as the envisaged fiscal relaxation. The latter comes at the expense of reducing public debt to GDP ratio less rapidly in the medium term. Secondly, the flourishing tourism industry is going to provide a further boost to the economy, mirroring the enrichment of its tourist product and the evolving geopolitical crisis in the neighboring competing countries. Third, further normalization in banking sector conditions is on the cards, as domestic banks, equipped with more liquidity from increased deposits and with more support to their balance sheets from viably restructured NPEs, are now more capable to restore lending to the economy. Finally, partial – yet somewhat limited - progress in the implementation of pending structural reforms, prescribed in the expired Economic Adjustment Program and the efficiency gains already accrued to the economy. Risks and challenges to our forecast view do exist. The downside risks stem from a resurfacing of core Euro Area political and sovereign crisis, given the heavy political calendar of this year. On the domestic front, the most important risk stems from reform fatigue. There are a few pending important structural reforms of the economic adjustment program, which would help the Cypriot economy avoid backtracking. 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 and the economy improves, it becomes increasingly unlikely the Bill will be voted into Law ahead of the Presidential elections in February 2018.

HICP jumped to +1.4% YoY in February up from +0.7% YoY in January

Consumer prices, measured by HICP, jumped to +0.1% MoM/+1.4% YoY in February, up from -0.8% MoM/+0.7% YoY in January and only +0.3% MoM/+0.1% YoY in December. The biggest increases on an annual basis were observed in the categories of transportation (-0.2% MoM/+4.1% YoY) and utilities (+1.7% MoM/+7.7% YoY), which reflect the pass through of rising world energy prices and the subsequent increase in the local electricity tariffs. As of February, the rise of energy prices accounted for 1.1 ppts while volatile food (fruit and vegetables) and services contributed another 0.2 ppts and 0.1 ppts respectively. The February reading is the second consecutive positive in 2017, but also the highest reading since March 2013, after that of last January which marked the end of the prolonged-four year- period of deflation in the island.

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

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. After S&P upgrading, one more notch is still required in its respective grading system for the government bonds to get investment grade status. On March 24th, Moody's left the sovereign rating of Cyprus unchanged (currently at B1, four notches to reach investment grade) while the announcements of Fitch (currently at BB-, three notches to reach investment grade) is expected on April 21st respectively. 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 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.

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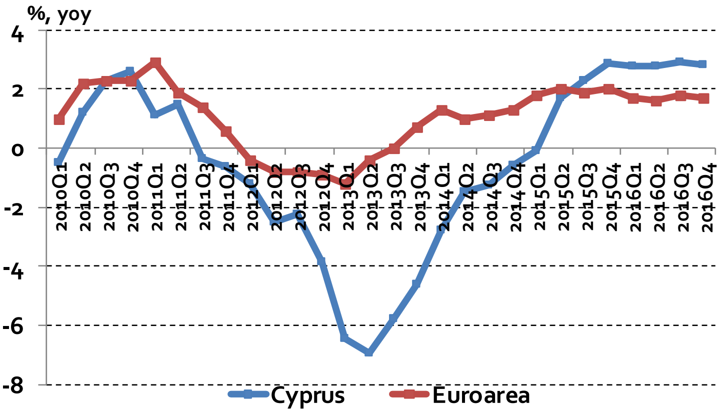
Cyprus: Macro & Market Data				
	2014	2015	2016	2017f
Real GDP (yoy%)	-2.5	1.7	2.8	3.0
Inflation (yoy%)				
HICP (annual average)	-0.3	-1.5	-1.2	1.2
HICP (end of period)	-1.0	-1.4	0.1	1.2
Fiscal Accounts (%GDP)				
General Government Balance	-0.2	-0.1	0.1	-0.6
Gross Public Debt	107.1	107.5	107.8	105.3
Primary Balance	2.6	2.7	2.6	2.0
Labor Statistics				
Unemployment Rate (LFS, %)	16.1	15.0	13.1	12.0
Compensation of employees/ per head	-3.6	-0.5	0.1	0.9
External Accounts (% GDP)				
Current Account	-4.4	-3.0	-1.6	-2.1
Trade Balance (Goods)	-16.0	-18.0	-18.7	-20.8
Terms of Trade (of Goods)	7.1	3.2	3.9	0.3
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

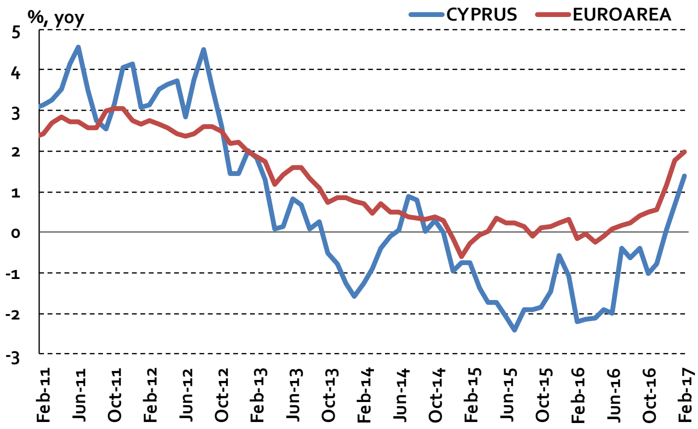
Source: National Sources, Eurostat, IMF, Eurobank Research

FIGURE 17: **Growth performance Cyprus vs. Euroarea 2010-2016**



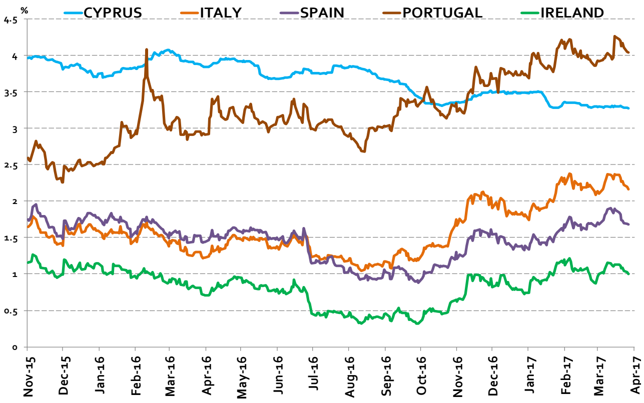
Source: Eurostat, Eurobank Research

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



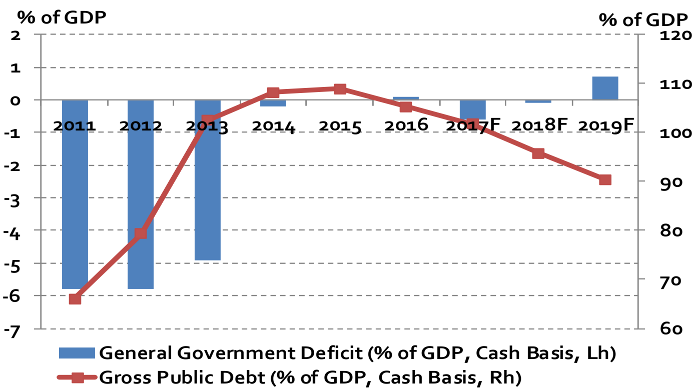
Source: Eurostat, Eurobank Research

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



Source: Bloomberg, Eurobank Research

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



Source: Ministry of Finance, Eurobank Research

Romania (Baa3/BBB-/BBB-)

Focus shifts to budget execution risks

Market focus has shifted from the political scene to the budget execution downside risks

The street protests and the domestic and international institutions' public outcry forced the government to scrap its highly controversial judicial reform plan widely perceived as a setback to the anticorruption campaign. However, given the credibility and prestige damage plus the confrontational relationship between the President and the Prime Minister, political tensions could resurface again. Meanwhile, the focus has now shifted to the budget execution downside risks, given the overly optimistic assumptions it is based upon, which may put the government on a collision course with EU institutions. The consolidated government balance in cash terms switched to a deficit of RON2.6bn in February down from a surplus of RON3.0bn in January. Overall, the surplus narrowed down to a negligible 0.05% of projected GDP in the first two months of the year, half than that registered in the same period last year. Even though their performance improved in February (+4.5% YoY), total revenues were still down by -1.4% YoY in Jan-Feb compared to the FY target of +13.9% YoY, a trend which may continue as further tax cuts have come into force since the beginning of the year. On the other hand, total expenditures expanded by 3.5% YoY–below the FY target of 15.2% YoY. Nevertheless, spending in the areas of wages has started accelerating as of February (+13.3% YoY in 2M-2017) as the budget implementation incorporated the ruling coalition's electoral program for further generous hikes. All other spending items, procurement for goods& services, interest and capital expenditure declined by -5.1%, -4.1% and -16.3% respectively in the same period. 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. Thus, the incoming government may be inclined to adopt a more conservative fiscal stance in 2H that may have a negative impact on this year's growth dynamics. 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.

Surprisingly, inventories had a more positive contribution than private consumption to GDP growth in Q4

The revised estimate of the Statistical Service on the seasonally adjusted Q4-2016 GDP reading confirmed the flash estimate of a +1.5% QoQ/+4.8% YoY growth, +4.7% YoY in unadjusted terms. The stronger than expected print -above analyst call for +1.0% QoQ/+4.3% YoY- compares to +0.5% QoQ/ +4.4% YoY in Q3-2016 and +1.5% QoQ/+5.8% YoY in Q2-2016, up from +0.9% QoQ/+4.5% YoY in Q4-2015. From a demand point of view, private consumption expanded by +0.2% QoQ/+4.3% YoY in Q4, down from -0.7% QoQ/+6.4% YoY in Q3, making a hefty contribution (+2.7ppts). Gross fixed capital formation registered the first negative reading (-3.7% QoQ/-6.6% YoY) on an annual basis since Q4 2013. Investments were also negatively affected by the high base in Q4-2015, the lower EU funds absorption throughout 2016 and the underperformance of the public investments program. Surprisingly, inventories had an even more positive contribution than private consumption (+3.3ppts) outweighing the negative contribution of gross fixed capital formation (-1.9ppts). On the positive side, net exports had a small positive contribution (+0.3ppts) mirroring the better quarterly performance of exports (+0.2% QoQ/+9.7% YoY) vs. imports (+1.5% QoQ/+7.4% YoY). Overall, real GDP expanded by 4.8% in FY2016, up from 3.9% in FY2015, outperforming regional peers for a fourth consecutive year. 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. Hence, the economy is driven close to, if not above, its potential growth rate at the expense of pushing government finances off consolidation track and deteriorating the external position. The CA deficit jumped to -2.4% of GDP in 2016, up from only 1.1% in 2015 and 0.4% in 2014.

Headline inflation is slowly crawling up in the first two months of the year. Underlying inflationary pressures are building up, necessitating NBR attention some time during the 2H

Consumer prices edged up to -0.1% MoM/+0.2% YoY in February, up from -0.2% MoM/+0.1% YoY in January in line with market consensus expectations. The decline on a monthly basis was dictated by the scrapping of the TV-Radio tax cut which subtracted 0.4ppts from the headline number and pushed the prices of services down to -1.8% MoM/-1.7% YoY. Meanwhile, food prices leaped to +0.7% MoM/+1.4% YoY driven by higher prices for the volatile components of vegetables (+3.9% MoM) and fruits (+1.9% MoM), which added 0.5ppts. In contrast, non-food prices remained almost unchanged at +0.1% MoM/+0.1% YoY as tobacco and energy prices were flat on a monthly basis. Underlying inflationary pressures are building up. The adjusted Core CPI (excluding administered and volatile prices, alcohol and tobacco) spiked to +0.9% YoY in February, the highest level since May 2015, up from +0.5% YoY in January and only +0.3% YoY in December. The PPI (Producer Price Index) climbed further to +3.9% in March up from 2.7% YoY in January and only +0.9% YoY in December driven by higher energy and intermediary goods' prices. Moreover, HICP at constant taxes stood at 2.3% in February vs 1.8% YoY in January. In any case, given the projected inflation trajectory and the elevated fiscal risks, it is highly likely that NBR will initiate the tightening cycle in the 2H, most probably by increasing the interest rate corridor instead of the key policy rate, currently at 1.75%.

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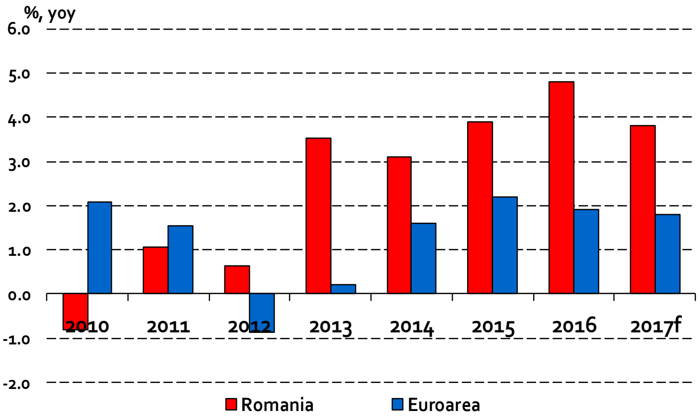
Romania: Macro & Market Data				
	2014	2015	2016	2017f
Real GDP (yoy%)	3.1	3.7	4.8	3.8
Inflation (yoy%)				
CPI (annual average)	1.1	-0.6	-1.6	1.1
CPI (end of period)	0.8	-0.9	-0.5	1.7
Fiscal Accounts (%GDP, Cash Basis)				
General Government Balance	-1.9	-1.9	-2.4	-3.7
Gross Public Debt (including guarantees)	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	4.55	4.58	4.60	4.60

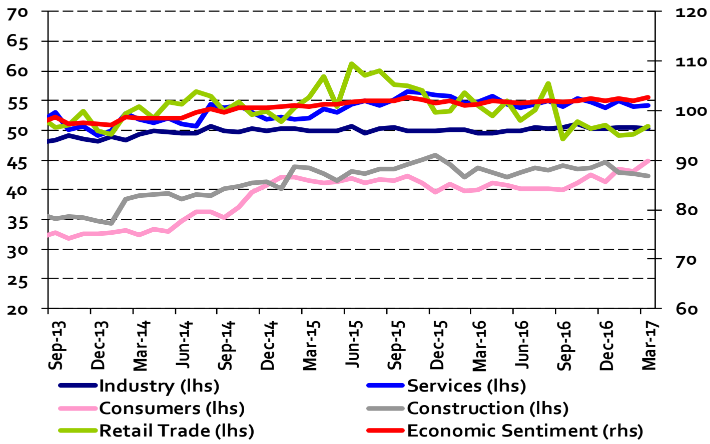
Source: National Authorities, EC, IMF, Eurobank Research

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



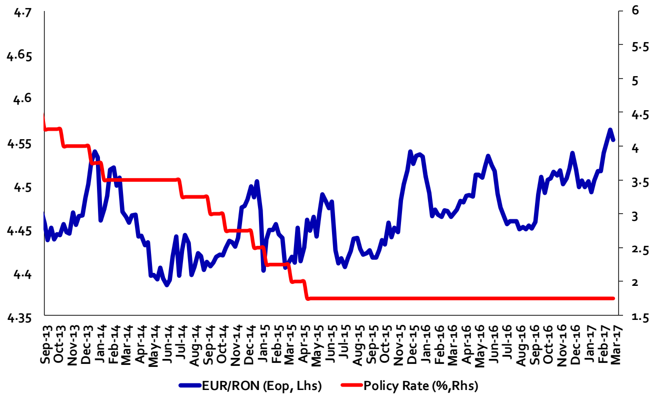
Source: Eurostat, Eurobank Research

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



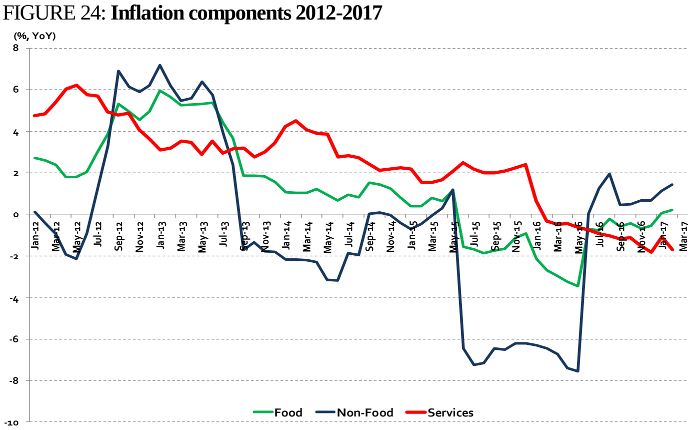
Source: Eurostat, Ecowin Reuters, Eurobank Research

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-)

Prime Minister Vucic wins decisive victory in April's presidential elections

Prime Minister comfortably wins presidential race in 1st round

PM and leader of the ruling Serbian Progressive Party (SNS) Aleksandar Vucic won a decisive victory on the April 2nd Presidential elections. According to preliminary results, he scored 55.1% of the ballot, exceeding the absolute majority threshold in order to win the polls in the 1st round. His landslide victory does not come as a surprise as most recent opinion surveys had indicated he was well ahead of other presidential candidates and close to achieving around 50% of the vote. The runner up, Sasa Jankovic, ex-Ombudsman and a favorite of the civil society, achieved 16.3% of the ballot. Luka Maksimovic, who came third, received 9.4% and was followed by Vuk Jeremic (5.6%), ex-Foreign Minister and former president of the UN General Assembly. Further behind were Vojislav Seselj (4.5%), Bosko Obradovic (2.2%), Sasa Radulovic (1.3%), Milan Stamatovic (1.1%), Nenad Canak (1.1%), Aleksandar Popovic (1.1%) and Miroslav Parovic (0.3%). The turnout at the elections is estimated to have slightly exceeded 50% of the electorate. Although a 2nd round will not be held, possibly to the opposition's disappointment which likely hopped for a run off in this election process, Sunday's results indicate potential changes in the domestic political landscape ahead. Independent candidate Sasa Jankovic's score is quite an achievement for a newcomer in politics; he succeeded in attracting disgruntled Democratic Party (DS) voters, large parts of civil society and urban electorate. Be it with the DS or by creating a new political organization, he could position his party at the left center wing in the future. At the same time, right after the polls closed, Vuk Jeremic hinted that he will form his own political party. Given his past political experience it is possible that he may take up a center right position. The next test for President-elect and the Progressives is not that far away. The Belgrade elections, due early next year, - although local - are of high importance as the city is home to more than ¼ of the electorate. They are considered as a gauge of the country's political orientation and any swings in the trend usually emerge then. Bearing in mind that Mr. Vucic won around 45% of the vote in Belgrade on Sunday's polls, ca 10pps less than his countrywide score, it could be a challenging task retaining power in next year's ballot, especially having in mind the strengthening of the two new opposition figures. Incumbent President Tomislav Nikolic's 5-year tenure expires on May 31st. He is expected to remain in his post until then. Mr. Vucic is expected to be inaugurated in early June and is not yet clear who will take over the PM post, but is likely to be a close ally. Media speculate a number of names, such as incumbent Ministers of Finance and Public Administration, Mr. Vujovic, and Mrs. Brnabic, who are both expected to steer the country towards an even stronger pro-EU path with a continuation of public sector reforms, including a more ambitious revamping of the SOEs. Minister of Police, Nebojsa Stefanovic and ex-Minister of Justice, Nikola Selakovic, are also being mentioned. Socialist Party of Serbia (SPS) leader Ivica Dacic could also figure for the post.

Moody's upgrade's Serbia's sovereign credit rating by 1-notch to Ba3

Acknowledging the recent significant fiscal consolidation, which has inhibited the rise in public debt, and the recent implementation of structural reforms, that increase the resilience of the country's economy and bode well for potential growth, Moody's upgraded in March Serbia's issuer rating to Ba3 from B1, with stable outlook. 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. Importantly, recovery of economic growth rates took place in parallel to a notable improvement in the country's fiscal position following strict austerity measures, such as public sector wages and pensions' cuts, a reduction in the civil servants headcount and lowering of financial support to State-Owned Enterprises (SOEs). Better-than-anticipated growth dynamics contributed to an improved tax collection, thereby assisting a reduction of the budget deficit to 1.4% of GDP last year, significantly outperforming initial and revised deficit targets of 4% and 2.1% of GDP, respectively. This fiscal performance resulted in the first primary surplus since 2005 and assisted in a drop in the public debt, which decreased in 2016 (72.9% of GDP from in 74.7% in 2015) for the first time in nearly a decade, while further improvement is earmarked for this year. 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, eight have opened, out of which two have closed. Following a wave of rating downgrades in 2012-2014, all three major rating agencies acknowledge the ongoing improvement in Serbia's domestic macroeconomic fundamentals recently. S&P had revised higher the country's outlook to Stable from Negative in January, 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 ratings 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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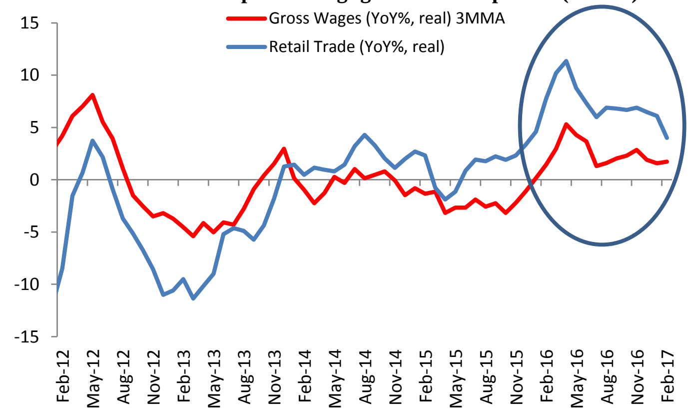
Serbia: Eurobank Forecasts	2014	2015	2016	2017
Real GDP (yoy%)	-2.0	0.8	2.7	3.0
Inflation (yoy%)				
HICP (annual average)	2.9	1.9	1.2	2.1
HICP (end of period)	1.7	1.5	1.6	2.5
Fiscal Accounts (%GDP)				
Consolidated Government Deficit	-6.6	-3.7	-1.4	-1.3
Gross Public Debt	70.4	74.7	73.5	72.3
Labor Statistics (%)				
Unemployment Rate (%of labor force)	19.4	17.7	13.2	14.5
Wage Growth *(total economy)*	-1.5	-2.1	2.8	3.0
External Accounts				
Current Account (% GDP)	-6.0	-4.7	-4.1	-3.9
Net FDI (EUR bn)	1.2	1.8	1.8	2.0
FDI / Current Account (%)	60.0	114.4	128.5	143.6
FX Reserves (EUR bn)	9.9	10.4	9.8	10.0
Domestic Credit	**2012**	**2013**	**2014**	**2015**
Total Credit (%GDP)	62.8	57.0	61.5	63.6
Credit to Enterprises (%GDP)	31.2	26.1	25.0	25.0
Credit to Households (%GDP)	18.2	17.4	18.7	19.6
Private Sector Credit (yoy%)	9.5	-4.8	0.5	3.2
Loans to Deposits (%)	126.9	114.1	111.8	112.6
Financial Markets	**Current**	**3M**	**6M**	**12M**
Policy Rate	4.00	4.00	4.00	4.00
EUR/RSD	123.30	123.80	124.20	125.50

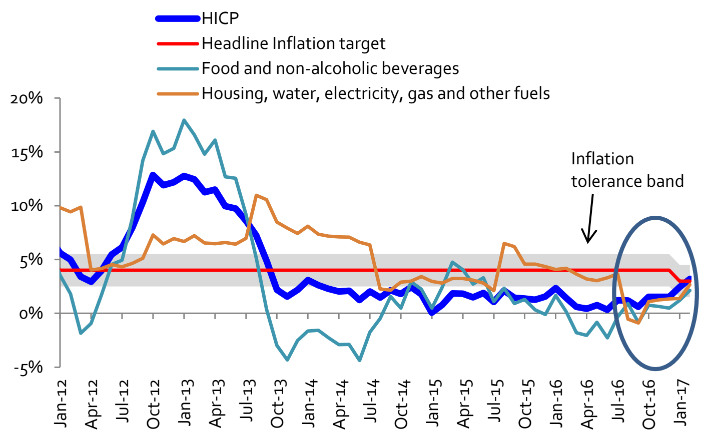
Source: National Authorities, EC, IMF, Eurobank Research

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



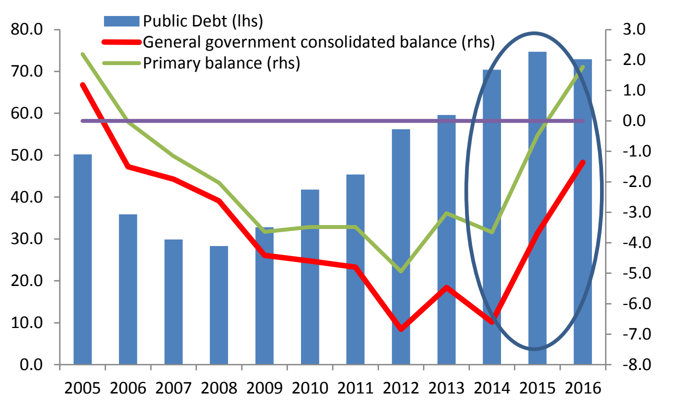
Source: National Authorities, EC, IMF, Eurobank Research

FIGURE 26: **CPI rises in early 2017, but to remain within target band this year**



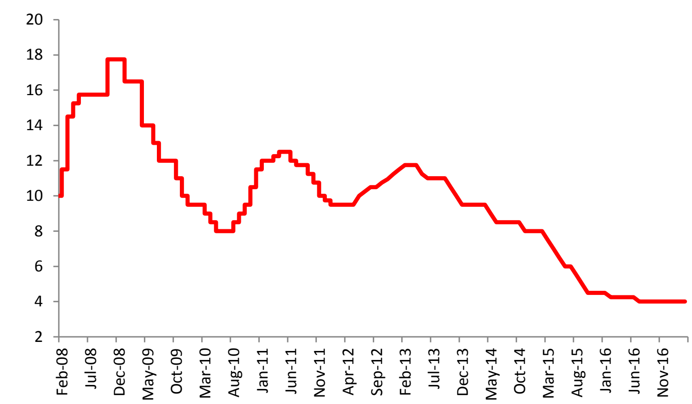
Source: National Authorities, Eurobank Research

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**



Source: National Authorities, EC, IMF, Eurobank Research

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