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NEW EUROPE ECONOMICS & STRATEGY

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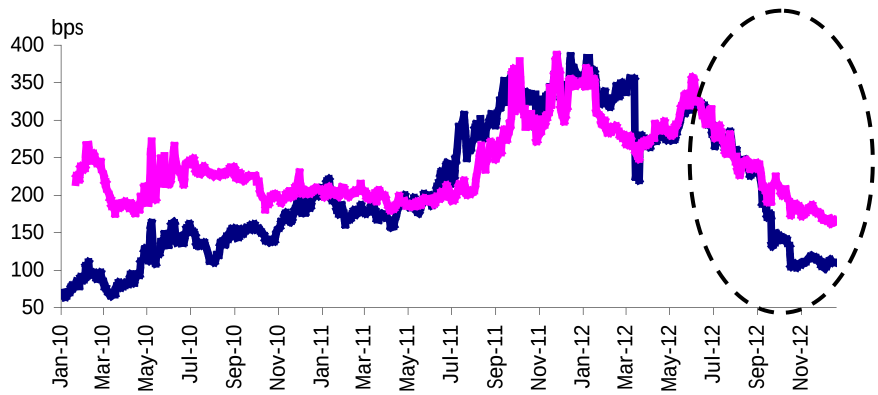
New Europe financial markets firm on US "fiscal cliff" optimism, global stimulus measures & somewhat alleviated euro area debt crisis fears

- **Bulgaria:** Sluggish growth rebound continued in third quarter
- **Romania:** Sweeping victory for incumbent government
- **Serbia:** New Eurobond issue secures financing needs of 1H-2013

New Europe market strategy highlights

Regional FX markets: We continue to favour EUR/RSD shorts at levels near 115, targeting 110 and stops at 116.5 purely on an attractive-carry basis. Elsewhere, in view of the euro's recent upside move, we favor short €/TRY positions at levels of 240 targeting 235 and setting a stop-loss at 243. **In the sovereign credit space**, with spreads currently standing at very tight levels and with the recent rally in sovereign credit markets seeming to have been overdone, we would hesitate to establish fresh positions ahead of year-end. **In local rate markets**, our previous receiver position in **Turkish 5-year cross-currency swaps** hit the 5.75% target in early November. Meanwhile, our earlier steepener position in **Polish 2/5 PLN IRS 1 year forward** at levels near zero, and target at +20bps currently stands at +7bps. With the trade currently in the money, we monitor this position in order to take profit ahead of year-end.

CEEMEA external debt outperformance over Western Europe phases out



Source: Bloomberg, Eurobank Research

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Summary of key macroeconomic indicators
Realizations and forecasts

	Real GDP (yoy)			Consumer Prices (p.a.)			Fiscal Balance (%GDP)		
	2011	2012	2013	2011	2012	2013	2011	2012	2013
Bulgaria	1.7	0.7	1.5	4.2	2.9	2.5	-2.0	-1.4	-1.0
Poland	4.3	1.8	1.5	4.3	3.7	3.1	-5.1	-2.9	-2.8
Romania	2.5	0.4	1.3	5.8	3.3	4.1	-4.2	-2.2	-1.8
Serbia	1.6	-2.0	1.0	11.2	7.8	9.0	-5.0	-6.7	-4.0
Turkey	8.5	3.0	4.0	6.4	9.0	6.5	-1.4	-2.0	-1.8
Ukraine	5.2	0.8	0.3	8.0	0.6	0.8	-4.2	-4.5	-3.0
New Europe	5.8	1.9	2.4	6.0	5.5	4.5	-3.3	-2.7	-2.3

	Current Account (%GDP)			Policy Rate (e.o.p.)			FX* (e.o.p.)		
	2011	2012	2013	2011	2012	2013	2011	2012	2013
Bulgaria	0.3	-1.0	-1.5	currency board			1.96	1.96	1.96
Poland	-4.3	-3.8	-4.0	4.50	4.25	3.50	4.46	4.10	4.10
Romania	-4.3	-3.7	-3.8	6.00	5.25	5.00	4.32	4.50	4.60
Serbia	-9.5	-10.6	-8.0	9.75	11.00	10.50	106.9	115.0	120.00
Turkey	-10.0	-6.5	-7.0	5.75	5.50	5.50	1.88	1.80	1.75
Ukraine	-5.5	-6.5	-4.0	7.75	7.50	7.50	7.99	8.10	8.10
New Europe	-6.8	-5.3	-5.2	-	-	-	-	-	-

Source: National statistics, IMF, EC, Eurobank Research forecasts
vs. EUR (TRY and UAH vs. USD)

Dear readers,

Growth in most emerging economies of New Europe weakened in the third quarter of 2012, following an earlier modest improvement in the second quarter. The slight deterioration was mainly due to a softening in domestic demand, which originated from a decline in real wages as inflation staged a dynamic come back across the region on higher food and energy prices. The Q3 deterioration was also due to unfavorable base effects from last year's outstanding agricultural performance plus a weaker export performance and weaker domestic manufacturing activity. Conditions in the fourth quarter do not seem they have improved dramatically, supporting the case for a downward revision in our full year forecasts.

Looking ahead into the new-year 2013, the majority of economies in the region are expected to avoid a new round of painful and prolonged output contraction, which characterized 2012. We anticipate a sluggish, if not modest, GDP growth trajectory in 2013 for the economies of continental South-Eastern Europe, Bulgaria, Romania and Serbia. This view remains valid provided that the main trading-partner economies in the Euro Area avoid a pronounced downturn.

Risks to growth in 2013 originate mainly outside New Europe. The Euro Area triple problem, namely a sovereign debt crisis, an economic recession and a banking crisis, clouds the growth prospects of New Europe through its high exposure to trade and capital flows as well as its inter-financial market linkages. In addition, uncertainties on the resolution of the US fiscal cliff, lower growth in China and geopolitical tensions in the Middle East end up impacting negatively the region either directly or indirectly through their effect on the Euro Area itself. The good news is that financial markets stress has receded in the aftermath of the decisive ECB policy actions and market sentiment has improved significantly across the board, allowing the global economies to take a breath.

Market attention in 2013 will focus on regional authorities' efforts to stimulate growth in a fiscally-constrained environment. From that point of view, Bulgaria and Romania have already done their homework to ensure fiscal sustainability, while Serbia has to make an additional extra effort of consolidation. During the past year, markets have rewarded all three countries with access to funding in relatively favorable terms compared to their peers. In 2013, local monetary authorities would be constrained from playing a more active role in supporting economic activity until at least the second half of the year. This is due to lingering external vulnerabilities and the impact of higher inflationary pressures.

Initiating reforms and improving the efficiency of the public sector and the absorption of EU funds could be important catalysts for boosting growth both in the short and medium term. There is a lot of room for reforms and the timing for doing them is perfect, as the electoral cycle is over in both Romania and Serbia. Bulgaria has already achieved a lot in the areas of public administration and pension system reform but more is needed.

In **Bulgaria**, growth is expected to double from a projected 0.7% in 2012 to 1.5% in 2013. While the environment in EU-27 is adverse, growth will be supported primarily by stronger domestic demand. Domestic demand is expected to receive support from the planned rise in minimum wages and pensions. In addition, the long recession in private investment seems to have bottomed out. Improved EU funds' absorption has also helped capital spending. Bulgaria is now running a financial account surplus of 4% of GDP, following two consecutive years of a deficit. Similarly, there is an improvement in market sentiment, significantly less banking sector outflows, access to Eurobond markets on favorable terms and a mild rebound in FDI inflows.

In **Romania**, we forecast GDP growth to reach 1.2% in 2013 against a projected 0.4% in 2012. The Euro Area sovereign debt crisis weighs negatively on net exports and industrial production dynamics. The incumbent government coalition party – called "Social Liberal Union" - under the leadership of Prime Minister Ponta gained a sweeping victory in the December parliamentary elections. More importantly, the ruling coalition earned a sufficient number of seats (66% of total seats) in the parliament, which enables the coalition to change at will the rules of the constitution. In addition, the government now has more flexibility in passing politically difficult bills than its predecessor governments, implying a decrease in overall political risk. The election results were also well received by domestic markets, as was mirrored in the increased appetite of foreign investors for domestic bonds. On the negative side, downside risks prevailed on growth in Q3. GDP growth contracted by -0.6% yoy in Q3 on disappointing agricultural production performance and negative base effects from last year's outstanding record.

In **Serbia,** our forecast is that GDP growth will only post a mild rebound of 1% in 2013 after contracting by approximately -2% in 2012. The GDP estimate of 2012-Q3 came at -2.2% yoy vs. -0.8% yoy in Q2, which implies that the improvement recorded in Q2 was only short-lived. Heavy winter and summer droughts had a negative impact on output in both Q1 and Q3. Headwinds from the Euro Area sovereign debt crisis and the urgent need for fiscal consolidation put even more pressure on growth. On the positive side, the coalition government tapped successfully the Eurobond market for a second time in Q4-2012. According to the Ministry of Finance, the latest Eurobond issue, in combination with a bilateral loan from Russia, secures the public sector financing needs until the middle of 2013. However, the full year financing needs cannot be covered without a new IMF agreement. The IMF mission reached no closure on a new stand-by arrangement with the government. The IMF has called for additional fiscal consolidation in 2013 in order to ensure the eventual reduction of fiscal deficit to 3.5% of GDP against a projected much higher 6.7% level in 2012.

Gikas Hardouvelis
Chief Economist & Director of Research

I. New Europe – Markets

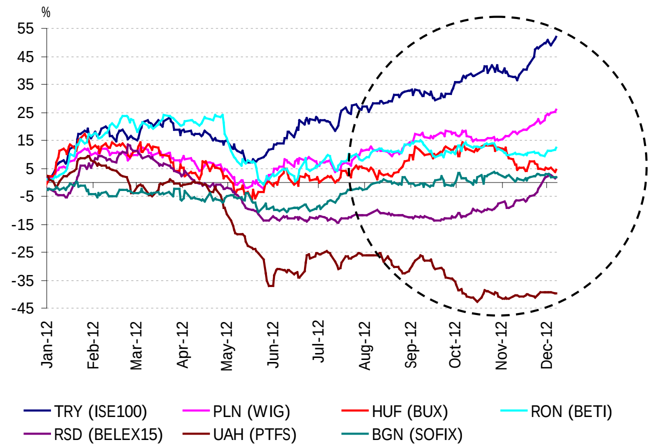
New Europe equity markets firm on US "fiscal cliff" optimism, global stimulus measures and somewhat alleviated euro area debt crisis fears

New Europe equity markets broadly firmed over the last few weeks, trailing major global bourses higher. Investor optimism that US authorities will soon reach a compromise agreement to avert the "fiscal cliff" of some €600mn in tax hikes and spending cuts scheduled to be in force in January 2013 - feared to take a toll on the world's largest economy - favored market sentiment. The Fed announced at its December policy meeting new stimulus measures to bolster the domestic economy. In a surprise move, effectively illuminating further its monetary policy deliberations ahead, the US Central Bank signaled it will hold interest rates at their current near zero levels until the unemployment rate falls to at least 6.5% and inflation stays below 2.5% over the coming two years while inflation expectations remain contained. Along similar lines, the Chinese government indicated recently that it intends to maintain its economic policies in 2013 and deepen reforms in order to stimulate the domestic economic recovery, while the victory of Japan's main opposition Liberal Democratic Party bolstered expectations about further stimulus measures ahead. Separately, fears over contagion risks of the euro area's debt crisis were somewhat alleviated recently after the Eurogroup agreed on a flurry of debt relief strategies for Greece and approved the second disbursement under the country's second economic adjustment programme. It also approved a €39.9bn loan tranche for the recapitalization of the Spanish banking sector. Meanwhile, recent upbeat data from the two largest economies in the world, the US and China, somewhat easing concerns about the prospects of the global growth outlook ahead, also added to the positive tone. Yet, further gains in global stock markets appear contained over the last few days amid profit taking ahead of year-end.

Against this backdrop, the **S&P 500 index** hit a near 2-month peak, while the **MSCI Asia ex-Japan index** spiked to a 16-month peak in mid-December. Similarly, the **FTSEurofirst 300 index** jumped to a 1-½-year high on December 12th and the **MSCI Emerging Europe Equity index** reached its highest level in nine months on the following day. Along these lines, most bourses in New Europe firmed over the last month or so (Figure 1), with major indices in Turkey, Poland and Serbia touching lifetime, 16-month and near 2-year highs, respectively, a few days later. On a year-to-date basis, Turkey's **ISE 100** is the primary outperformer in the region, poised to end 2012 with gains in excess of 50%. The index has been buoyed by Central Bank monetary easing, comparably better economic fundamentals against regional peers and a sovereign credit rating upgrade to investment level by Fitch in November. On the flipside, Ukraine's **PFTS** leads the losers' pack having plunged by around 40% since the beginning of the year in view of growing fiscal concerns, escalating political noise and weak economic growth outlook. Going into 2013, accommodative policies endorsed by Central Banks around the globe are likely to provide support to regional equity markets. However, downside risks lie in the face of a pending resolution over the US "fiscal cliff" and the lingering euro area debt crisis.

Figure 1
Majority of New Europe equity markets poised to end 2012 with gains

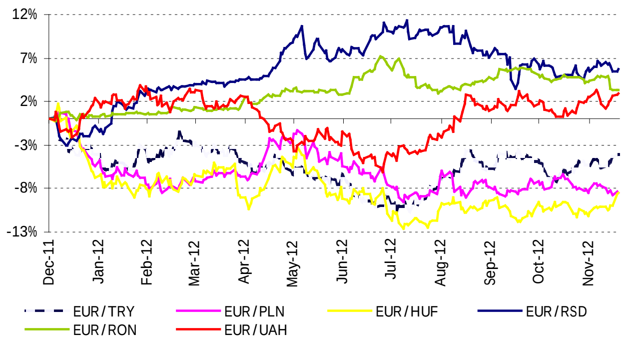
(year-to-date returns)



Source: Bloomberg, Eurobank Research

The performance of **regional currencies** has been mixed over the last month or so in view of diverging domestic fundamentals (Figure 2). Meanwhile, the outlook ahead remains weak as most Central Banks in New Europe currently follow easing monetary policies in order to support their economies against a background of domestic fiscal tightening and the euro area's sovereign debt crisis. The **Romanian leu** has recouped most of the losses suffered since late August as the Central Bank halted its monetary easing cycle earlier this year amid rising inflation and escalating political uncertainty. In addition, the December general election's outcome gave ground to optimism about political stability ahead and a potential new IMF deal in the near future, underpinning the local currency. In view of the aforementioned, the **EUR/RON** eased as far as a 4-month trough of 4.4529 on December 17, sliding further away from October's 2-month peak at 4.59. On a year-to-date basis, the **Hungarian forint** and the **Polish zloty** have broadly outperformed their peers standing nearly 10% firmer against the euro in mid-December. Nonetheless, the former has lost ground over the last few months after the MNB incepted its monetary easing cycle in August, having rendered 125bps of cumulative rate cuts since then, to bring the key policy rate to 5.75% currently. A sovereign rating downgrade on the country's status by S&P in late November and the ongoing uncertainty regarding the government's policy deliberations ahead may also had an impact. On the other hand, the **Polish zloty** has retained a firm tone over recent weeks in spite of two consecutive 25bps rate cuts to 4.25% since November, while last month's 2-year low CPI reading added to expectations for further monetary easing next year. That said, the main drivers behind the zloty's outperformance appear to be comparably better economic fundamentals to those of regional peers, a tight fiscal policy as well as an anticipated economic recovery in H2-2013 and strong capital inflows to the domestic bond and equity markets.

Figure 2
New Europe currencies mixed on domestic fundamentals
(Year-to-date returns)

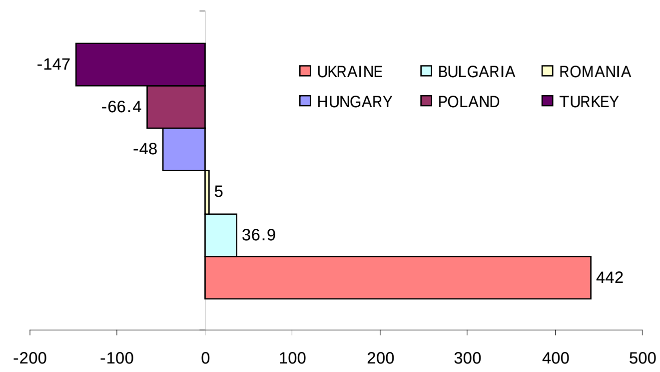


Source: Bloomberg, Eurobank Research

Increased rate cut prospects around the world and a risk-on backdrop bode well with **local bond markets** in New Europe (Figure 3). **Turkish government bonds** have broadly outperformed their regional peers over the last month or so as weaker-than-anticipated GDP data for Q3, a drop to a 10-month low in November's CPI and a narrowing current account deficit this year boosted expectations for further monetary easing ahead. Fitch's credit rating upgrade to investment status has also provided support to local rate markets. Indicatively, the 2- and 10-year benchmark paper yields have fallen around 130bps and 150bps since end-October, with each having hit record lows in December. Elsewhere, the corresponding 3- and 10-year **Hungarian yields** have slid around 35-45bps each, drawing support from lower interest rates and a fall in November's headline inflation to a near 1-year trough. Central Bank rate cuts and relatively better economic fundamentals compared to regional peers have underpinned local **Polish paper**. Against this background, 2- and 10-year bond yields remained near record lows hit over recent weeks. On the flipside, **Ukrainian government bonds** have been notable underperformers in the region in view of deteriorating domestic macroeconomic fundamentals and escalating political noise domestically.

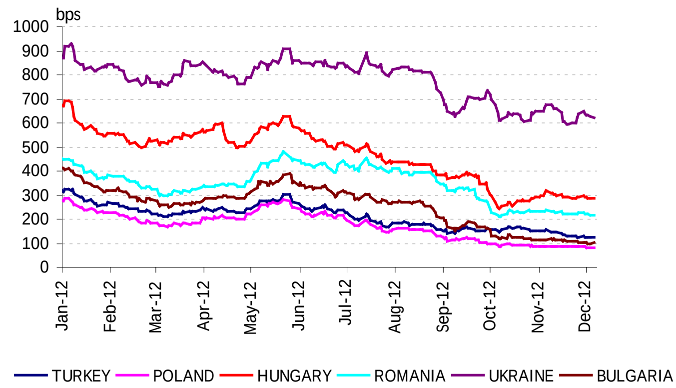
Sovereign CDS spreads in New Europe have extended their recent rally over the last few weeks, in line with the improving market sentiment (Figure 4). **Turkey** is the region's best performer following the credit rating upgrade by Fitch. Indicatively, the country's **5-year CDS spread** hit a 6-½-year low near 121bps on December 12, having narrowed by ca 50bps since a 1-½-month high hit on October 23. A few days later, the corresponding **Polish spread** eased as far as a 4-year trough of 80.1bps in view of comparably better economic fundamentals, while the **Bulgarian 5-year CDS spread** recoiled to its lowest level since early 2008 just below 93bps.

Figure 3
Local debt markets firm on increased rate cut prospects, risk-on environment
(Change in 10-year bond yields since end-October, bps)



Source: Bloomberg, Eurobank Research

Figure 4
External debt spreads remain on a tightening mode



Source: Bloomberg, Eurobank Research

Strategy - Emerging New Europe Markets

Regional FX markets: We continue to favour **EUR/RSD shorts** at levels near 115, targeting 110 and stops at 116.5 purely on an attractive-carry basis. The Serbian Central Bank remains the only exception in New Europe to buck the trend and follow a tightening monetary policy at present. Rising inflation was behind the NBS's latest rate-hike moves, with a 30bps rate hike on December 14 pushing the key policy rate to 11.25%, the highest in the region. Cumulatively, the Central Bank has rendered 175bps of monetary tightening since June. Elsewhere, the euro's recent upside move against the Turkish lira may eventually prove overdone. Hence, we favor short **€/TRY positions** at levels of 240 targeting 235 and setting a stop-loss at 243.

In the sovereign credit space, with spreads currently standing at very tight levels and with the recent rally in sovereign credit markets seeming to have been overdone, we would hesitate to establish fresh positions ahead of year-end.

In the local rate markets, our previous receiver position in **Turkish 5-year cross-currency swaps** hit the 5.75% target in early November. Meanwhile, our earlier steepener position in **Polish 2/5 PLN IRS** 1 year forward at levels near zero, and target at +20bps currently stands at +7bps. With the trade currently in the money, we monitor this position in order to take profit ahead of year-end.

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Special thanks to: Costas Katsileros, Stavros Daliakopoulos, Konstantinos Dimaresis

II. New Europe – Country Analysis: **Bulgaria**

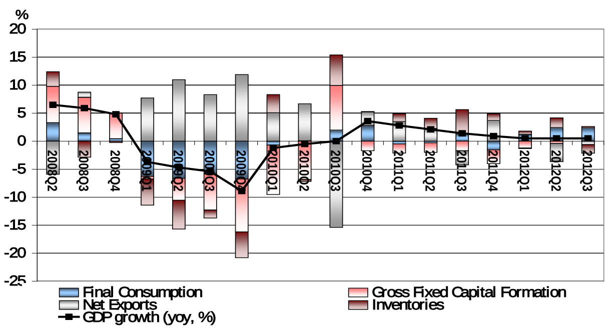
Sluggish growth rebound continued in third quarter

- GDP growth remained at 0.5% yoy in Q3, as in Q3, underpinned by stronger domestic demand
- The financial account surplus reached 4% of GDP in Jan-Oct2012 compared to a deficit of 2% in Jan-Oct2011
- IMF consultation underlined the importance of structural reforms and higher EU funds absorption in order to boost growth

Growth recovery remains sluggish in the third quarter

Growth remained sluggish in the third quarter. Real GDP grew on an annual basis by 0.5% in Q3, same as in Q2-2012. On a quarter on quarter seasonally adjusted basis, real GDP grew by 0.1% qoq in Q3, down from 0.3% qoq in Q2. Final consumption, the largest component of GDP, outperformed for a third consecutive quarter, staying at +0.5% qoq/+3.0% yoy in Q3, slightly down from +2.4% qoq/+3.2% yoy in Q2, but significantly higher than a +0.4% qoq/+1.2% yoy growth in Q1. As a result, the GDP growth contribution of final consumption remained flat at 2.4pps in Q3 compared to Q2, up from 1.2pps in Q1. Main drivers behind final consumption strength were relatively high real wages and the seasonal improvement in labor market conditions. Real wages slowed down to 5.7% yoy in Q3, down from 6.4% yoy in Q2, on higher inflation pressures stemming from food prices. However, they still exceeded average annual inflation, which spiked to 3.9% yoy in Q3, up from 1.6% yoy in Q2 and 2.0% yoy in Q1. At the same time, nominal wages accelerated to 8.8% yoy in Q3, after growing by 8.4% in Q2 and 8.9% yoy in Q1-2011. Unemployment (LFS survey) improved to 11.5% in Q3, down from 12.3% in Q2-2012 and a peak of 12.9% in Q1 (the highest level in 2009-2012) (Figure 1).

Figure 1
Q3 GDP growth supported by higher private consumption and investments



Source: National Statistics, Eurobank Research

Bulgaria: Eurobank EFG Forecasts				
	2009	**2010**	**2011**	**2012e**
Real GDP (yoy%)	-5.5	0.4	1.7	0.7
Final Consumption	-7.3	0.5	-0.3	3.0
Gross Capital Formation *(Fixed)*	-17.6	-18.3	-9.7	-1.5
Exports	-11.2	14.7	12.8	2.0
Imports	-21.0	2.4	8.5	5.5
Inflation (yoy%)				
CPI (annual average)	2.8	2.4	4.2	2.9
CPI (end of period)	0.6	4.5	2.8	4.2
Fiscal Accounts (%GDP) - *Cash Basis*				
General Government Balance	-0.9	-4.0	-2.0	-1.4
Gross Public Debt	15.6	16.7	17.0	19.5
Primary Balance	-0.2	-3.3	-1.2	-0.2
Labor Statistics - *National Definitions*				
Unemployment Rate (registered, %)	9.1	9.2	10.4	11.0
Wage Growth *(total economy)*	11.8	6.4	9.1	8.5
External Accounts				
Current Account (% GDP)	-8.9	-1.0	0.3	-1.0
Net FDI (EUR bn)	2.5	1.0	1.6	1.5
FDI / Current Account (%)	80.4	275.3	Na	285.0
FX Reserves (EUR bn)	12.9	13.0	13.4	15.2
Domestic Credit	**2009**	**2010**	**2011**	**Q3 12**
Total Credit (%GDP)	76.8	76.4	74.5	75.4
Credit to Enterprises (%GDP)	47.9	48.2	48.0	49.5
Credit to Households (%GDP)	27.3	26.4	24.6	24.2
FX Credit/Total Credit (%)	58.6	61.3	63.7	64.3
Private Sector Credit (yoy)	4.5	2.1	3.9	4.0
Loans to Deposits (%)	120.0	112.9	104.0	100.1
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

The positive news comes from investment. Investments moved into positive territory for the first time since Q4-2008. Deriving support from the higher absorption rate of EU funds, investments advanced by 1% yoy in Q3, against having contracted by a 2.1% yoy in Q2, 5.4% yoy in Q1 and by 10.4% yoy in the last quarter of 2011. That said, investment recorded its third positive q-o-q growth since Q4 2008 (+0.4% qoq in Q3 vs. +1.5% qoq in Q2), which supports optimism that a bottoming out of the recession in the sector is nearing. Investment's share to GDP had dropped to 23% in 2011 against a record high at 37% in 2008. The post-crisis drop in investments is largely explained by the decline of FDI inflows (from €9 bn in 2007 to €1.3bn in 2011 and to just €0.85 bn in January-July 2012).

The performance of net exports was volatile for another quarter. On a seasonally adjusted basis, exports expanded by 3.3% yoy in Q3, marginally down from 3.9% yoy in Q2, after recording a marginal contraction (-0.1% yoy) in the prior quarter. In contrast, on a volume basis, exports remained flat in Q3 vs. 5.1% yoy in Q2 and -4.4% yoy in Q1. On the other hand, imports slowed down to 4% yoy in Q3, down from 8.6% yoy in Q2, after broadly stagnating in the prior quarter. In turn, the negative contribution of net exports declined to 0.6pps in Q3 vs. 3.2pps in Q2.

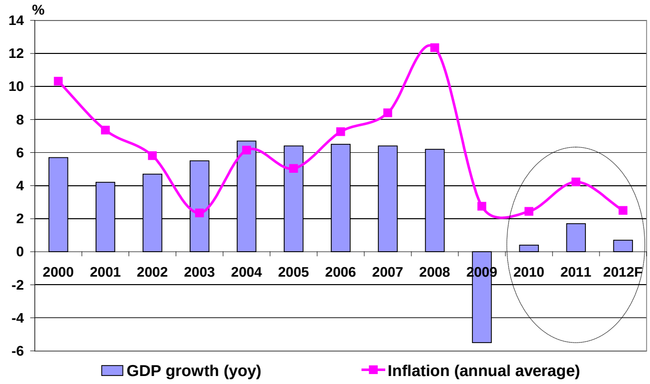
Near term growth outlook remains weak given the external headwinds. Structural reforms and higher EU funds absorption are required to boost growth and living standards

Overall, the domestic economy exhibited another quarter of sluggish growth recovery. On the positive side, it is important to note that principal growth drivers have switched to domestic demand from net exports given that the primary trade partner of Bulgaria, the Euroarea, is in recession. In addition, the ongoing diversification of exports towards non-EU markets (currently around 40% of total exports) is offsetting partially the negative contribution from net exports side. Higher than expected agricultural output in the summer months, and higher EU funds absorption is making a positive difference in the second half of the year. If this is combined by the bottoming out of investment, it lends support to our assumption that there will not be another round of painful contraction of domestic demand.

We do not anticipate economic activity to post a strong come back in Q4. The higher frequency data from business and consumer surveys, industrial production and retail sales predispose for a subdued reading in Q4 and most probably not supportive of the full year forecast. As a result, we have downgraded our full-year GDP growth forecast to 0.7% in 2012 from 1% previously. However, downside risks to our forecast are significant and stem from the lingering euro area sovereign debt crisis. Bulgaria is highly dependent on the EU, not only in terms of trade and capital flows, but also through banking system interlinkages. In the worst case scenario, an external shock from a further prolongation in the sovereign debt crisis or a more severe disruption of capital flows could push Bulgaria again into deep recession.

Output rebound in 2010-2011 has been lackluster after the recession in 2009 (Figure 2). Bulgaria capitalized on its strong fiscal position and buffers to avoid a deep prolonged recession, but recovery has been slow. Initiating structural reforms and improving public sector efficiency and EU funds absorption could be a catalyst for boosting growth both in the short and medium term and raise living standards. According to the IMF consultation published in last December, Bulgaria has already achieved a lot in the areas of public administration and pension system reform but more is needed.

Figure 2
Output rebound in 2010-2011 has been lackluster after the recession in 2009



Source: National Statistics, Eurobank Research

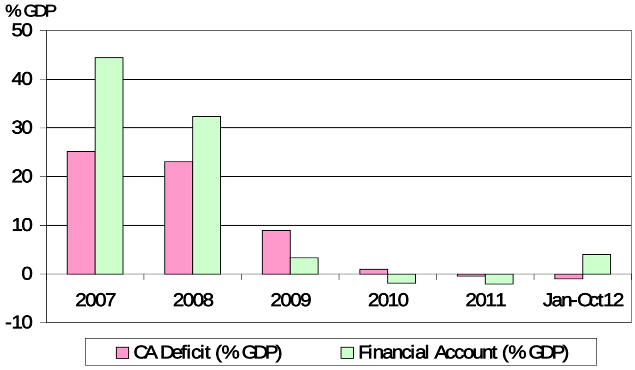
Current account shifted to 0.1% of GDP deficit in Jan-Oct2012. The increase of capital inflows pushed the financial account surplus to 4% of GDP in Jan-Oct2012

After recording three consecutive months of surplus, the current account switched into a minor deficit in October. Overall, the current account deficit stood at 0.1% of GDP in Jan-Oct2012 against a 1.9% surplus in Jan-Oct2011. The main driver behind that was the deterioration in the trade deficit. The trade deficit doubled, from 3.8% of GDP in Jan-Oct2011, to 7.8% of GDP in Jan-Oct2012. The improvement in the surpluses of current transfers, services and the income deficit was not enough to counterbalance the deterioration of the trade balance. The surplus of services improved marginally to 6.1% of GDP in Jan-Oct2012 against 5.8% in Jan-Oct2011. Current transfers improved to 4.1% of GDP Jan-Oct2012 compared to 3.7% a year ago. The income deficit improved to 2.5% of GDP in Jan-Oct2012 against 3.7% at the same period a year ago.

From the financing side, the shift to current account deficit was outweighed by rising capital inflows. After two consecutive years of deficit, Bulgaria is running a financial account surplus in 2012. The financial account surplus reached 4% of GDP in Jan-Oct2012 compared to 3.2% of GDP deficit in Jan-Oct2011. If the capital account surplus is included, the overall surplus reached 4.3% of GDP in Jan-Oct2012 compared to a 2.7% deficit recorded in 2011.

The main driver behind the switch to surplus comes from net other investments. The balance of net other investment turned from -4.7% of GDP in Jan-Oct2011 to 0.4% of GDP in Jan-Oct2012. The explanation behind that is that capital outflows coming from the banking sector were significantly lower, while banks also reduced their assets abroad and deposits inflows from non-residents increased as a result of sentiment improvement. In addition, the balance of portfolio investments turned positive to 0.6% of GDP in Jan-Oct2012 against a -0.7% of GDP in Jan-Oct2011 (figure 3).

Figure 3
After two years of deficit, financial account moved into surplus in 2012



Source: BNB, Eurobank Research

The proceeds of the €950mn Eurobond issued in last July outweighed outflows for purchases of foreign assets. Lastly, Net FDI inflows made a comeback increasing by 22.6% yoy in Jan-Oct2012, amounting to €1.335 mn compared to €1.080 mn a year earlier.

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II. New Europe – Country Analysis: **Romania**

Sweeping victory for the incumbent government

- The parliamentary election results contained no surprise: The Social-Liberal (SLU) union led by Prime Minister Mr. Victor Ponta gained a sweeping majority of the vote and constitutional majority of seats in the parliament
- The election result was well received in local markets yet more challenges lie ahead for the new government cabinet

Parliamentary election results show a sweeping victory for the incumbent government coalition

The results of the parliamentary elections on December 9th, gave an outstanding victory to the centre-left alliance Social-Liberal Union (USL). The Social Liberal Union is an alliance composed of three political parties-the Social Democratic Party, the National Liberal Party and the Conservative Party. The Social Liberal Union came into power after a no-confidence vote passed in late April to overthrow the previous Prime Minister Ungureanu government. A new government under the leadership of Victor Ponta emerged from the successful no-confidence motion in parliament on April 27th. The USL obtained 58.63% of votes in the Chamber of Deputies, the lower house of parliament, and 60.03% in the Senate. As a result, the ruling coalition secured 395 seats out of a total 588 seats in both chambers. More importantly, this translates into a constitutional majority in the parliament.

The pro-presidential opposition Right Romania Alliance followed second by a wide margin. The Right Romania Alliance gained 16.5% and 16.7% of the popular vote in the Chamber of deputies and senate respectively, which is equivalent of only 80 seats. The party of media tycoon Dan Diaconescu came third collecting 13.99% and 14.65% of the vote for the lower and upper chamber respectively, winning 68 seats. The party of ethnic Hungarians (Hungarian Democratic Union) was the last party to pass the 5% minimum threshold to participate in the allocation of seats. Ethnic Hungarians collected 5.15% and 5.25% of the vote in the lower and upper chamber respectively, winning 27 seats. The representatives of other minorities were assigned 18 seats.

The election result was well received in local markets. That was mirrored in both increased foreign investors appetite for domestic bonds and the FX market. Moreover, interest for two post-election Ministry of Finance issuances was significantly higher, leading to a slight decrease in yields and an oversubscription of both. The Ministry of Finance sold RON 1.01bn in 2Y T-bonds (2.5 times higher than the targeted RON 400mn) at an average yield of 6.57%, compared to 6.66% paid in the previous auction in November. In addition, the Ministry of Finance sold RON 1.0bn in 5Y T-bonds (5 times higher than the targeted RON 200mn) at an average yield of 6.44%, unchanged compared to the previous auction in early December. Thus, the Ministry was able to raise RON 3.6bn against a schedule of RON 3.1bn in December with two more auctions scheduled in Dec17th & 20th. At the same time, Leu firmed as much as 1% reaching 4.47/€ on December 13th, returning to September levels.

Romania: Eurobank EFG Forecasts

	2009	2010	2011	2012e
Real GDP (yoy%)	-6.6	-1.6	2.5	0.4
Consumption	-7.4	-1.3	0.4	0.5
Investment	-28.1	-2.1	2.6	7.5
Exports	-6.4	14.0	11.7	-2.5
Imports	-20.5	11.9	11.2	1.0
Inflation (yoy%)				
CPI (annual average)	5.6	6.1	5.8	3.3
CPI (end of period)	4.9	8.0	3.1	4.5
Fiscal Accounts (%GDP, Cash Basis)				
General Government Balance	-7.3	-6.4	-4.2	-2.2
Gross Public Debt	30.0	37.9	40.0	39.4
Labor Statistics (annual avg,%)				
Unemployment Rate (% of labor force)	7.8	7.0	5.1	6.5
Wage Growth (total economy)	8.4	2.5	4.9	5.8
External Accounts				
Current Account (%GDP)	-4.2	-4.4	-4.3	-3.7
Net FDI (EUR bn)	3.6	2.2	1.9	1.5
FDI / Current Account (%)	72.3	40.5	31.7	28.0
FX Reserves (EUR bn)	30.9	36.0	37.3	33.5
Domestic Credit *(end of period)*	**2009**	**2010**	**2011**	**Q3 12**
Total Credit (%GDP)	49.2	51.8	50.8	51.5
Credit to Enterprises (%GDP)	19.2	20.0	19.9	20.3
Credit to Households (%GDP)	20.0	19.5	18.0	17.7
FX Credit/Total Credit (%, private)	60.1	63.0	63.4	63.3
Private Sector Credit (yoy)	0.9	4.7	6.6	4.2
Loans to Deposits (%)	130.6	137.7	142.5	139.3
Financial Markets	**Current**	**3M**	**6M**	**12M**
Policy Rate	5.25	5.25	5.00	5.00
EUR/RON	4.50	4.55	4.55	4.60

Source: National Sources, Eurostat, IMF, Eurobank Research & Forecasting

Uncertainties in the political scene clear out yet more challenges lie ahead for the new government cabinet

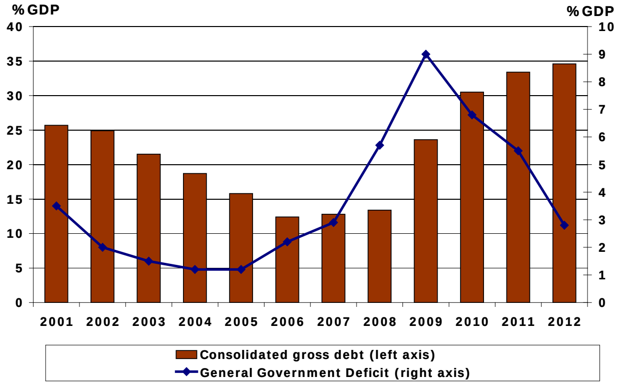
The parliamentary elections in December gave an outstanding result for the incumbent government coalition. This was the last episode in a heavy election calendar year in Romania. In our view, there are significant chances that the victory of USL will translate into so much needed political stability which is equivalent of a decrease in the political risk. USL will have more flexibility and leverage to pass bills in the parliament with this majority compared to its predecessors. That would mean fewer obstacles to adopt and implement politically difficult decisions. On top of that, the USL leaders have also addressed an invitation to the ethnic Hungarian party to form a governing alliance with USL that will increase even further the majority in both chambers.

On the other hand, we still cannot rule out the probability of new tensions between President Basescu and Prime Minister Ponta. USL had attempted to impeach President Basescu unsuccessfully. The constitutional court, after the low turnout in the past July referendum, reinstalled President Basescu in his position for the rest of his term ending in 2014. An illustration of these tensions was that there was widespread speculation ahead of the elections, that in case of an unfavorable, unsuccessful electoral result, the President would nominate another candidate for Prime Minister. In any case, markets are likely to follow very carefully political developments in Romania.

On the other hand, the new government cabinet will be confronted with challenges. Firstly, the USL government will have to negotiate a new precautionary agreement with IMF and the EU before next spring. Romania is currently running a €5bn two-year precautionary arrangement with the IMF and the EU which expires in March 2013. Within the adjustment program, Romania's fiscal position improved significantly in the past five years. The general government deficit on a cash basis has declined to 4.1%-of-GDP in 2011 from 7.3%-of-GDP in 2009 and further to 2.2% of GDP in 2012, if the fiscal target is accomplished. The adjustment was even more impressive in ESA-95 accounting terms, with the deficit having declined by nearly 4ppt-of-GDP from 9% of GDP in 2009 to 5.2%-of-GDP in 2011 and is projected to end below 3% in 2012 (Figure 1). That will allow Romania to exit the Excessive Deficit Procedure soon.

Secondly, USL has pledged to stick to the requirements of the precautionary agreement. That said, the USL government will need to implement fiscal austerity policies and structural reforms which may bring them in confrontation with their constituents in the future. The fiscal target in 2013 is already set high at 1.8% of GDP in cash basis or 2.2% of GDP in ESA terms. In the pre-election period, USL has promised to soften fiscal austerity under the assumption that economy improves in the medium term.

Figure 1
ESA-95 fiscal deficit was reduced by over 6ppts-of-GDP in 2009-2012



Source: Eurostat, Eurobank Research

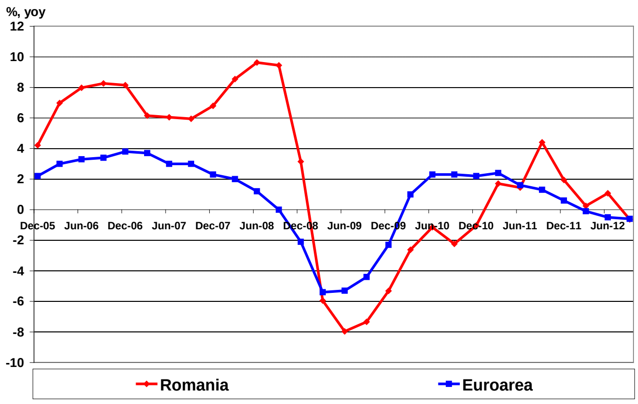
More specifically, USL has vowed to lower the VAT rate for food staples and to replace the flat tax regime with a progressive income tax scale. Those measures will be hard to implement if the government has to achieve further fiscal consolidation and attain the fiscal target of 1.7% of GDP in 2013. At the same time, the new precautionary agreement is a great opportunity to address some of the medium-term issues of the Romanian economy. The implementation of a wide array of public sector reforms would boost public sector efficiency while an improvement of EU funds absorption rate would facilitate public investment and attract further private investments.

Output growth contracted in the third quarter on improved domestic demand dynamics; Downside risks stemming from volatile weather conditions and the Euroarea recession may have prevailed in the 2H

Output growth contracted in the third quarter, so that the economy will most probably not avoid reaching the technical recession point again in the fourth quarter. Real GDP contracted by -0.6% yoy in Q2-2012, down from +1.1% yoy in Q2 and +0.9% yoy in Q1-2012. On a seasonally adjusted basis, the GDP contracted by -0.5% qoq, down from +0.5% qoq in the second and +0.1% qoq in the first (Figure 2).

A series of unfavorable international and domestic factors have coincided in Q3. Firstly, the Euroarea sovereign debt crisis weighed negatively on net exports and industrial production dynamics. Moreover, negative base effects from last year's outstanding agriculture performance have put an additional drag on growth in Q3. This year's harvest did not repeat last year's output record. To make things worse, the summer drought already exacerbated the impact on this year's harvest, so that agriculture will have a negative contribution in the 2H-2012. As a result, agriculture plunged by -29.8% yoy in Q3 compared to only -1.6% yoy in Q2 and +4.0% yoy in Q1.

Figure 2
Growth in Romania is highly sensitive to changes in Euroarea growth



Source: National Statistics, Eurostat, Eurobank Research

In terms of GDP components, consumption and investments underperformed. Private consumption moved into negative territory on lower real wages -despite public wages hikes- and higher food prices. Private consumption contracted by -1.5% yoy in Q3, down from +1.8% yoy in Q2 and +0.3% yoy in Q1. In addition, investments decelerated to +9.9% yoy, down from +15.2% yoy in Q2 and +12.2% yoy in Q1. The investment slowdown was underpinned by the decline of public investment in the construction sector due to the underperformance in EU funds absorption. The EU funds absorption rate has reached only 8% against an ambitious government target of 19%. Funds earmarked for investments in the budget were cut in order to finance the public wages hikes as part of the budget revision in 2012. In contrast, net exports were visibly weaker in the third quarter. Exports contracted by -4.2% yoy in Q3 compared to +0.7% yoy in Q2 and -2.2% yoy in Q1. At the same time, imports shrank again by -1.9% yoy against +0.2% yoy in Q2 and -0.3% yoy in Q1.

Overall, the Jan-Sep growth performance came at 0.2%. We had warned in our previous issues of New Europe Economics & Strategy that downside risks to growth outlook may prevail in the 2H. In our last issue, we downgraded our long held growth forecast of 2012 from 1% to 0.7%. Given the surprising magnitude of contraction in Q3, we are obliged to downgrade our full year forecast to 0.4% in 2012. Accordingly, the most recent polls also show a deterioration of growth expectations for 2012. In the Reuters poll, the median estimate of GDP growth in 2012 has adjusted some 0.3ppt lower and currently stands at 0.4%. The median forecast in the December poll of Focus Economics is slightly more optimistic at 0.7%. Taking a step back, the government has cut their forecast from 1.5% to 1.2%. Accordingly, the IMF mission has revised their growth forecasts at 0.9% down from 1.5% previously.

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II. New Europe – Country Analysis: **Serbia**

New Eurobond issue secures financing needs of 1H-2013

- The government tapped successfully the Eurobond market for a second time in Q4-2012 at a favorable funding cost
- The latest Eurobond issue secures budget financing needs of the 1H-2013, but provides no substitute for a new IMF agreement
- The conclusions of the IMF staff mission underline the need for further fiscal consolidation

The government tapped successfully the Eurobond market for a second time in Q4-2012

After a successful Eurobond placement in late September (9Y, 6.625%) the government tapped international markets again in mid-November. The government raised 750 mn USD, instead of 500mn USD originally planned, issuing 5Y Eurobonds priced at 5.45%, down from a 5.65% initial price guidance. The demand for the Serbian government bonds was strong once again. The bid-to-cover ratio reached almost five times (4.9x), an illustration of the high investors' demand for Serbian government bonds.

The successful tapping of international markets is an event of particular importance. Firstly, the government is still reaping the benefits of favorable international markets conditions. Thus, it accomplished to maintain funding costs relatively low. Indeed, the spread over US bonds came at 483bps, the lowest for this rating level. In terms of regional comparison, Serbia was able to draw funds at a lower price than Croatia back in last spring. The latest 5Y issue (maturing 2017) was better priced than Croatia USD 2017, which was priced at 553bp back in mid-April amid global market jitters. However, the newest Serbian issue yields 177bp above the current yields of Croatia USD 2017.

More importantly, the successful issuance enabled the government to start covering a sizeable part of the hefty financing needs of next year. The funding needs amount to 6bn USD in 2013. Eurobond sales so far cover one third of total financing needs for 2013. The funding plan for next year foresees that one third of the refinancing needs will be covered through the Eurobond market (a total of €2bn out of the 6€ bn), while another half will be covered through the domestic market and the rest from a bilateral loan from Russia.

The Serbian side is expecting USD 1bn support to come from a seven year bilateral loan from Russia to bridge the financing gap. The details of this bilateral loan are yet to be fully disclosed. However, government officials briefed have stated that USD 300mn will be utilized to finance this year's deficit and the rest will be disbursed in three installments. On top of that, the Russian government approved a new five year credit line facility (USD 800mn-4.1% pa) aimed at upgrading the railway infrastructure.

Serbia: Eurobank EFG Forecasts

	2009	2010	2011	2012f
Real GDP (yoy%)	-3.5	1.0	1.6	-2.0
Inflation (yoy%)				
CPI (annual average)	8.1	6.2	11.2	7.8
CPI (end of period)	6.6	10.3	7.0	12.5
Fiscal Accounts (%GDP)				
General Government Balance	-4.5	-4.7	-5.0	-6.7
Gross Public Debt	34.5	44.0	47.7	60.0
Labor Statistics (%)				
Unemployment Rate (%of labor force, ILO)	16.1	19.2	23.0	25.0
Wage Growth *(total economy)*	-3.3	7.5	11.1	6.5
External Accounts				
Current Account (% GDP)	-7.2	-7.4	-9.5	-10.6
Net FDI (EUR bn)	1.4	0.9	1.8	0.6
FDI / Current Account (%)	65.8	41.3	61.6	18.0
FX Reserves (EUR bn)	10.6	10.0	12.1	10.5
Domestic Credit	**2009**	**2010**	**2011**	**Q3 12**
Total Credit (%GDP)	51.7	63.9	62.2	69.6
Credit to Enterprises (%GDP)	29.6	35.7	35.0	35.3
Credit to Households (%GDP)	17.2	19.8	19.0	20.2
Private Sector Credit (yoy)	14.3	26.2	5.9	16.1
Loans to Deposits (%)	126.9	144.3	141.9	149.8
Financial Markets	**Current**	**3M**	**6M**	**12M**
Policy Rate	11.25	11.00	10.50	10.50
EUR/RSD	113.22	115.00	115.00	115.00

Source: National Sources, IMF, Eurobank Research & Forecasting

The successful issuance partially eases financing concerns for next year thus allowing the government to focus on fiscal consolidation. A side effect of this is that it allows for more flexibility in the domestic market, pushing Dinar denominated yields lower. Lastly, it sends an important positive signal to the markets and some leverage to the government position in the negotiations with the IMF. The government was able to tap international markets with the IMF precautionary agreement on freeze, despite the visible deterioration in the macro environment and the Standard & Poors downgrade by one notch to BB- in early August.

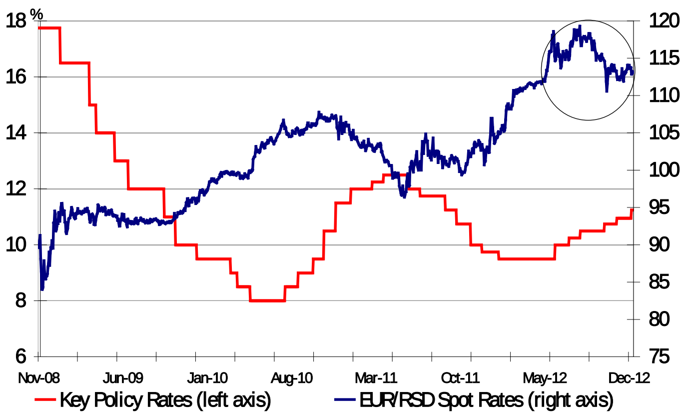
All in, refinancing risks are broadly eliminated in the 1H-2013. According to the Minister of Finance Mr. Mladan Dinkic, the financing needs of Serbia are secured until 1H-2013 upon the second Eurobond issuance (USD750 mn, 5.45% yield for 5Y maturity) in mid-November 2012.

However, this is no substitute for a new precautionary IMF agreement. Effectively, the IMF put the precautionary agreement on freeze since last February because it challenged the outgoing government's commitment on the agreed framework. The precautionary IMF agreement serves not only as a cushion for external financing needs but also acts as an anchor of expectations for investors and gives government policies more credibility, thereby reducing the risk premium of the country. Although the situation is still manageable, it will be harder to get access to funding in 2013 given the difficulties posed by the Euroarea sovereign debt crisis, the riskier sovereign profile of Serbia and the size of government financing needs.

The Dinar has recovered modestly in the last three months recouping some of its earlier losses (trading at 113.23/€ on December20th against a year low at 119.3/€ on August 8th) (Figure 1). Dinar has benefited from the recent increase of the

Dinar allocation in FX required reserves, the introduction of a new FX-indexed subsidized loan program for exporters and the 75bps cumulative hikes of the Central Bank (from 10.5% on August 9th to 11.25% on December 14th).

Figure 1:
Dinar has recouped some of its earlier losses in Q4-2012



Source: Bloomberg, NBS, Eurobank Research

IMF staff mission reached no agreement with the government on a new stand-by arrangement. Talks will resume in next spring.

An IMF mission held talks with the government officials in order to discuss the possibility of a new regular stand-by arrangement. However, no agreement was reached so that discussions will continue in next spring. The IMF mission focused on the implementation of the fiscal consolidation program, the execution of the budget and the medium term macroeconomic outlook. Fiscal policy and the implementation of next year's budget were in the epicenter of discussions. The statement of the IMF mission highlighted the challenges the Serbian economy is confronted with.

On the positive side, the IMF mission welcomed the monetary policy tightening and the continuation of the inflation targeting framework. On the other hand, IMF was very critical of the fiscal position of the country. The level of the fiscal deficit is deemed to be unsustainable while the public debt has increased significantly. Therefore, fiscal consolidation is considered to be a top priority. In that direction, IMF mission believes that the identified budget measures may not fully translate into the full adjustment in 2013. In our view, IMF implies by this that the fiscal target of 2013 is not attainable and that authorities ought to adopt additional fiscal consolidation measures in the budget. Under these circumstances, the application for a new regular stand-by arrangement will most probably be denied unless there is more fiscal consolidation.

In turn, the budget deficit target is considered to be overly ambitious. In that direction, scope remains for improving the budget quality. Over the medium term, policies need to target a sustained multi-year fiscal consolidation to reduce public debt below the 45% of GDP threshold and focus on expenditure rationalization. According to the Fiscal Council, the fiscal deficit is projected to end at RSD 222bn or 6.7% of GDP in 2012. Consequently, the public debt to GDP ratio could reach or even exceed 60% of GDP in 2012, significantly above the 45% threshold of the fiscal rule, compared to 47.7% in 2011 and only 29.2% in 2008.

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