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Many thanks to
Tassos Anastasatos
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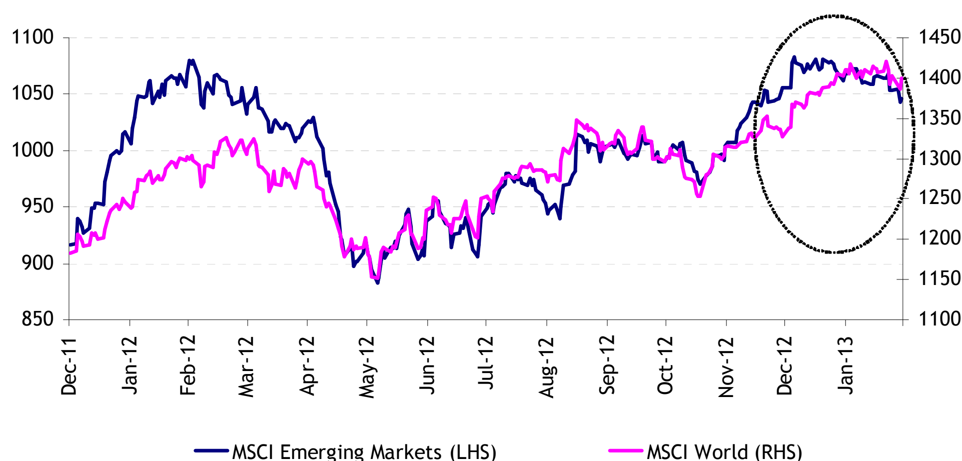
Initial 2013 rally in global stock markets runs out of steam on Fed, rekindled Eurozone worries

- **Bulgaria:** Government resignation led to early parliamentary elections
- **Romania:** Dissapointing full year output performance in 2012
- **Serbia:** Further fiscal consolidation is an urgent priority in 2013

New Europe market strategy highlights

Regional FX markets: We would favor re-entering **€/TRY shorts** at 240, which was proven to be a major resistance level for the pair, with a target of 235 and a stop loss at 243. We are also constructive on **EUR/PLN shorts** at 4.20 entry levels, taking profits at 4.10 and setting a stop loss at 4.23. Elsewhere, we remain constructive on **New Europe external sovereign credit** amid improving fundamentals. However, we prefer to currently stay sidelined at present on this asset class seeing limited upside ahead. In the **local rate markets**, it appears to be a good time to **enter 2s5s steepeners in Poland**. Currently at 9bps (-3bps per 3m carry).

Early 2013 rally in world stock markets runs out of steam



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	0.5	1.5	4.2	3.0	2.5	-2.0	-0.4	-1.5
Poland	4.3	1.8	1.2	4.3	3.7	2.4	-5.1	-3.5	-3.4
Romania	2.5	0.2	1.5	5.8	3.3	4.1	-4.2	-2.5	-2.0
Serbia	1.6	-2.0	1.0	11.2	7.3	9.0	-5.0	-6.6	-4.0
Turkey	8.5	3.0	4.0	6.4	8.9	6.5	-1.4	-2.0	-1.8
Ukraine	5.2	0.2	0.1	8.0	0.6	0.1	-4.2	-4.5	-3.0
New Europe	5.8	1.8	2.3	6.0	5.5	4.2	-3.3	-2.9	-2.5

	Current Account (%GDP)			Policy Rate (e.o.p.)			FX* (e.o.p.)		
	2011	2012	2013	2011	2012	2013	2011	2012	2013
Bulgaria	0.3	-0.7	-1.5	currency board			1.96	1.96	1.96
Poland	-4.3	-3.6	-2.7	4.50	4.25	3.50	4.46	4.07	4.10
Romania	-4.3	-3.8	-3.8	6.00	5.25	5.00	4.32	4.44	4.60
Serbia	-9.5	-10.5	-8.0	9.75	11.00	10.50	106.9	112.3	115.00
Turkey	-10.0	-6.2	-7.0	5.75	5.50	5.50	1.88	1.78	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	-5.1	-4.9	-	-	-	-	-	-

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 further in the fourth quarter of 2012, adding to the existing 2H weak performance. The estimates for full year growth disappoint the initial upbeat expectations as conditions in Q4 remained stagnant, both in domestic demand and in net exports. There is pressure on the export-oriented manufacturing sector due to the recession of the Euro Area. On top, domestic demand suffers from inflation, which has staged a dynamic come back on higher food and administered prices, thus eroding households' purchasing power. Credit conditions also remained weak, despite the slow-down of cross-border deleveraging in Q4. Local labor markets continue to be weak as feeble growth does not translate into meaningful job creation. Public investment, the main driver of total investment in the region, is underperforming on tight budgets and low EU funds absorption rates.

A number of domestic and external sources of pressure will most probably ease in 2013, thus the outlook for the region has improved. Fiscal and monetary policies are expected to be more growth supportive. In most cases, the pace of fiscal consolidation ought to slow down as most of the work has been completed. Inflation is expected to recede on favorable base effects and weak domestic demand. The improvement in external environment and financing conditions will allow the region to take a deep breath.

All in, we pencil 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.

On an individual country basis,

In **Bulgaria,** the government unexpectedly resigned on February 20th, following days of violent protests. The resignation will lead to early parliamentary elections on May 12th. The initial rallies were organized against the inflated electricity and heating bills, but soon escalated to massive protests against energy monopolies, high unemployment, low wages and low living standards. Thus it seems the outgoing government became the victim of a lackluster growth rebound in the aftermath of the financial crisis in 2008. The government had earned high marks in containing fiscal deficits and the growth of debt, but obviously the population did not see this translate immediately into higher living standards. Since the government resignation, yields and CDS spreads have spiked yet they remain significantly below pre-crisis levels. Thus stress in the domestic financial markets is contained despite the increased political uncertainty.

In **Romania,** the economy returned to marginally positive growth (+0.3% yoy) in Q4-2012, thus avoiding technically a recession. Full year growth performance slowed down to 0.2% in 2012 from 2.2% in 2011. Near term growth prospects remain weak on negative spillovers from the Euro Area sovereign debt crisis, even though fiscal and monetary policies are expected to be more supportive of growth in 2013. The medium term outlook depends on the implementation of structural reforms. The government was granted a three month extension in the current precautionary IMF agreement framework in order to take the corrective actions needed to achieve the objectives of the program and wrap up structural reforms in the area of state-owned enterprises.

Appetite for bonds remained strong in the first two months of 2013. Romanian assets have received a lot of market attention, particularly after the election results in December on improved prospects for political stability and expectations of accelerating structural reforms. The prospect of inclusion of long term government bonds in two popular emerging markets bond indices (JP Morgan and Barclays) has propelled investor interest further. The decision is expected to put Romania on the radar of portfolio flows again. This is particularly important given that non-residents had decreased their exposure in the local market because of the escalating political crisis in the past summer and the ongoing Euroarea periphery sovereign debt crisis.

In **Serbia**, output contraction slowed to -1.5% yoy in Q4-2012 vs. -2.5% yoy in Q3-2012, so that the full year estimate now stands at -2% in 2012. Serbia's special characteristic is the surge in pre-election spending plus inadequate fiscal consolidation measures, all of which resulted in a visible deterioration in public finances during 2012. A highly expansionary policy, followed from the previous cabinet, led to an unsustainable widening of the fiscal deficit from 2.6% of GDP in 2008 to 6.6% of projected 2012 GDP. Accordingly, the public debt to GDP ratio reached 61.5% of projected 2012 GDP, significantly above the 45% threshold of the Serbian fiscal rule. Those metrics put Serbia among the most indebted countries in the region. Fiscal consolidation now appears a challenging task, given the significant domestic and external uncertainties and risks. The eventual achievement of this year's ambitious fiscal target -3.6% of GDP – may require the implementation of additional measures.

Gikas Hardouvelis
Chief Economist & Director of Research

I. New Europe – Markets

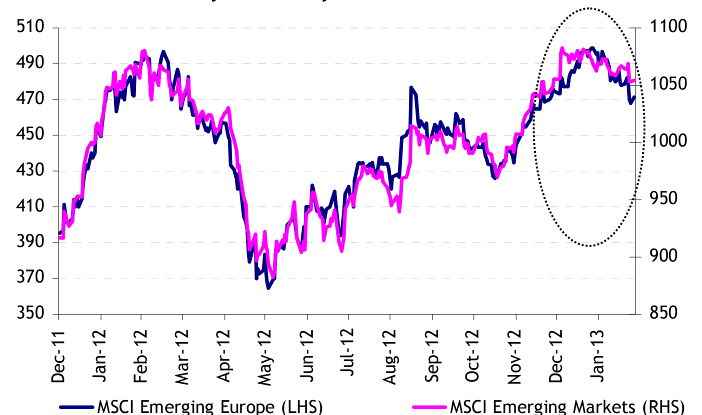
Initial 2013 rally in global stock markets runs out of steam on Fed, rekindled Eurozone worries

The early-year positive momentum in global financial markets appears to have come to a halt over the last couple of weeks. Among the main drivers of this move was an inconclusive result in Italy's February 24-25 general elections, which fanned fears about a hung parliament and potentially prolonged political uncertainty in the coming weeks. As a result, Eurozone debt crisis worries were rekindled. In addition, concerns about the Fed scaling back its monetary stimulus earlier than previously thought were spurred after the release of the January FOMC meeting minutes, which suggested that several monetary policy committee members were mulling on reducing the Bank's asset-purchasing programme sooner than expected.

Equity markets in New Europe started the year in a positive footing, moving higher in line with major global bourses over the first month or so of 2013. Notably, ultra-accommodative policies followed by major Central Banks around the world in order to support their domestic economies and bold measures adopted by EU authorities to address the euro area sovereign debt crisis have provided significant support to global stock markets over recent months. News that the US Congress approved at the beginning of the year a budget deal to avoid the so-called "fiscal cliff" of tax hikes and expenditure cuts worth some $600bn that would otherwise come into effect in January threatening to drag the US economy into another recession, favoured investor sentiment. In addition, a flurry of better-than-anticipated data releases from the US and China, the world's two largest economies, as well as upbeat US Q4 corporate earnings results fanned market optimism about the sustainability of the global economic recovery.

Against this backdrop, the **S&P 500 index** closed below the technically important 1,500 level on February 25 for the first time in three weeks after hitting temporarily a 5-year high of 1,530points a few days earlier. On the same day, the **FTSEurofirst 300 index** ended near levels of 1,166, slightly below 1,180 points – the index's highest since Q1-2011 -- hit at the end of the prior month. In the Emerging markets universe, the **MSCI Emerging Equity index** hovered around levels of 1,055, having eased from a 1-year high of 1,083 struck on January 3. Meanwhile, the corresponding **Emerging Europe index** stood almost 6% weaker on February 25 compared to a 1-½ -year peak of 500 tested in late January. In a similar fashion, bourses in New Europe trimmed part of their earlier 2013 gains. However, most indices in the region stood in a positive territory on a year-to-date basis, with Poland's **WIG20** and Turkey's **ISE 100** posing among the main exceptions. Indicatively, the former stood 6% lower on February 26 compared to its end-2012 levels, while the latter lost ca 3% over the first two months of 2013 after hitting a short lived record high of 86,787 in late January. Looking further ahead, any potential upside in regional stock markets may be capped by revived Eurozone jitters, escalating concerns about a potential Fed monetary stimulus withdrawal earlier than previously expected or renewed US fiscal concerns. On the flipside, a resolution of the current political dreadlock in Italy and additional signs of an economic rebound in major global economies are likely to provide support.

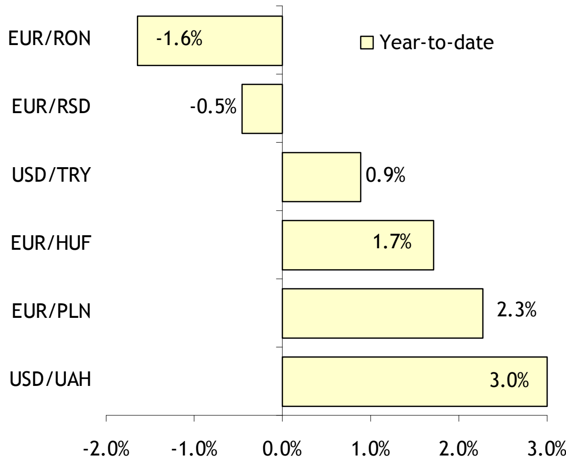
Figure 1
Early 2013 rally runs out of steam



Source: Bloomberg, Eurobank Research

Regional currencies have broadly weakened over the first two months of the year amid monetary easing expectations in view of weak domestic demand dynamics, which in turn resulted from fiscal tightening and the euro area sovereign debt crisis. Easing inflation trajectories, in many cases, have also argued in favor of lower policy rates in several economies in the region. The **Romanian leu** has largely outperformed its regional peers, primarily thanks to alleviated political uncertainty in the wake of December's general elections and a halt in the Central Bank's monetary easing cycle a year ago. The latter contrasts rate-cut policies followed by most Central Banks in the region. Romania's inclusion in JP Morgan's emerging market debt index in early 2013 also favoured the leu. Notably, the **EUR/RON** hit a 1-year trough of 4.3160/EUR in mid-January, having since rebounded to levels near 4.38. On the flipside, the **Polish zloty** has fared worse than most of its regional peers on a year-to-date basis weighed down by increased monetary easing expectations over recent months. The National Bank of Poland has rendered 100bps of cumulative rate cuts since November 2012, bringing the key policy rate to 3.75% currently and reversing a 25bps hike delivered in May last year. Against this background, the **EUR/PLN** hovered near levels of 4.17 in late February, having rebounded from a 4-½-month peak of 4.21 at the end of January. A revision of the country's sovereign credit ratings outlook to positive from stable by Fitch a few sessions ago and better-than-anticipated retail and industrial production data which raised expectations for pause in the NBP's tightening cycle in March, provided some support to the Polish currency recently.

Figure 2
New Europe currencies broadly weaken this year on monetary easing expectations

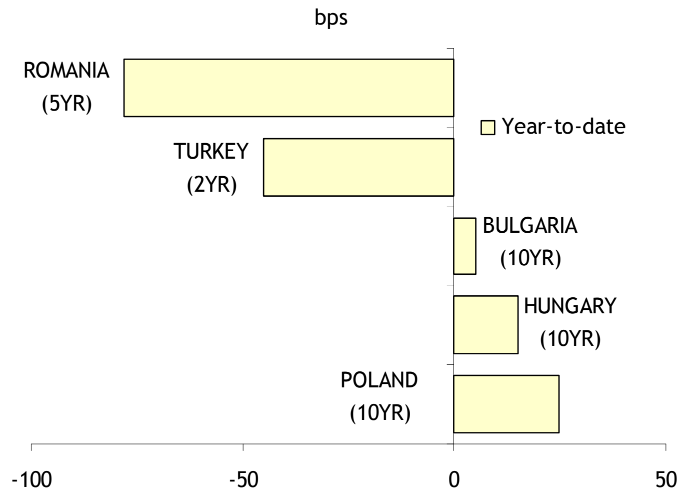


Source: Bloomberg, Reuters, Eurobank Research

The recent rally in **New Europe local bond markets** staged against a background of increased monetary easing prospects, appeared to be stalling over the first two months of the year. That said, Romanian government debt has broadly outperformed the region, with 5- and 10-year benchmark bond yields easing to record lows in January. The December general election result, which soothed concerns about potentially prolonged political instability, and the country's debt inclusion in the JP Morgan emerging market debt index are the main drivers behind the rally in Romanian government bonds. Meanwhile, **Turkish government bonds** have also fared better than most of their New Europe peers, primarily thanks to comparably better fundamentals, expectations for gradual credit rating upgrades to investment grade, following such a move by Fitch in November last year, and in view of Central Bank monetary easing. On the other hand, **Polish government paper** has underperformed regional peers amid increased expectations about a potential near-term halt in the Central Bank's monetary easing cycle.

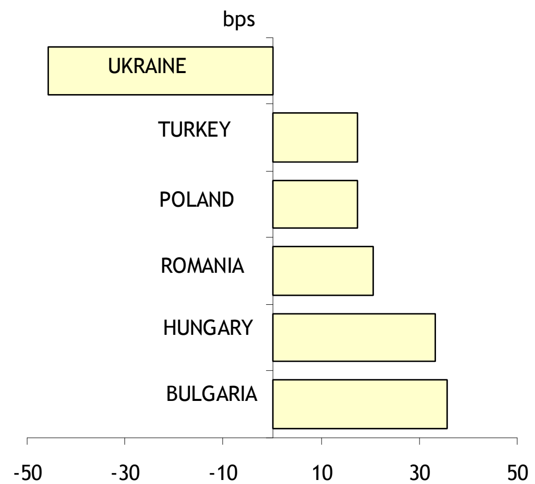
In the external debt space, sovereign CDS spreads in New Europe broadly widened in recent weeks with their recent rally running out of steam. **Bulgarian 5-year CDS spreads** spiked to a 4-month peak near 140bps in late February**,** in view of rising concerns about the domestic political landscape after the government collapsed earlier in February. Elsewhere, the corresponding **Turkish spread** rose above 145bps on the same day, its highest level since November 2012, while **Romania's** stood near 220bps, not far from a 4-½-year low of 179bps hit on January 24.

Figure 3
Recent rally in local debt markets runs out of steam
(YTD change in 10-year bond yields, unless indicated)



Source: Bloomberg, Reuters, Eurobank Research

Figure 4
External debt spreads weaken on the Fed, Italian politics



Source: Bloomberg, Eurobank Research

Strategy - Emerging New Europe Markets

Regional FX markets: Our previous recommendation for **EUR/RSD shorts** at levels near 115, targeting 110 and stops at 116.5 did not hit the entry level we suggested. For the time being we prefer to stay sidelined on this trade as the pair has already rallied significantly towards our recommended target. Elsewhere, our earlier **short €/TRY** idea at levels of 240 hit the 235 target on February 28. We would favor re-entering the same position at 240, which was proven to be a major resistance level for the pair, with the same target (235) and stop loss at 243. From a technical and stronger Polish fundamentals standpoint, we are also constructive on **EUR/PLN shorts** at 4.20 entry levels, taking profits at 4.10 and setting a stop loss at 4.23.

Elsewhere, we remain constructive on **New Europe external sovereign credit** amid improving fundamentals. However, we prefer to currently stay sidelined at present on this asset class seeing limited upside as the recent rally in sovereign credit markets appears to have been overdone.

In the **local rate markets**, it appears to be a good time to **enter 2s5s steepeners in Poland**. Currently at 9bps (-3bps per 3m carry). The 2vs5 segment is very flat whereas the 5vs10 is 28bps steep, close to the 4 year high at 38bps, giving further signals of 5years underperforming. MPC members have signaled a possible pause in the easing cycle but difficult current macroeconomic conditions and a still weak Eurozone economy could lead to further easing before H2 2013.

Written by

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Special thanks to: Christos Pnevmatikatos, Maria Katrantzi, Stavros Daliakopoulos

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

Government resignation led to early parliamentary elections

- The government led by Prime Minister Borisov unexpectedly resigned after days of violent protests against energy monopolies, high unemployment and low living standards
- After many years, fiscal policy will become more supportive of growth in an election year 2013 on higher minimum wages and pensions
- Although political uncertainty has increased, stress in the domestic financial markets is contained at low levels

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The unexpected resignation of the government in Bulgaria leads to early parliamentary elections most probably on May 12th.

On February 20th, the Bulgarian government led by Prime Minister Borisov unexpectedly resigned. The resignation came after days of violent protests in the streets of the main cities in Bulgaria. The rallies originally organized against the inflated electricity and heating bills, escalated to massive protests against energy monopolies, high unemployment, low wages and living standards.

On February 18th, the outgoing Prime Minister replaced the Minister of Finance who was considered to be the architect of the economic policy followed. At the same time, Mr. Borisov called for the revoke of the electricity distribution license of one of the utilities (CEZ) and the decline of electricity prices by 8% in next March. Neither the resignation of the Minister of Finance, Mr. Djankov, nor pledges to cut electricity prices was enough to defuse discontent. On Feb21th, the parliament accepted the resignation with a majority of 209 members, five were against and one abstained.

In line with the constitution, the President of the Republic, Mr. Rosen Plevneliev held consultations with the leaders of the parties to form a new government cabinet until parliamentary elections in next July. However, it was cleared out that the ruling party-GERB (117 seats out of 240) and most probably any other opposition party-the Bulgarian Socialist Party (BSP) or the Ethnic Turkish Movement for Rights and Freedoms (MRF) would not participate in the formation of such a new cabinet. In that case, the President will have to appoint a caretaker government and then with one single decree adjourn the parliament and schedule the next general elections. In that respect, early parliamentary elections will be held on May 5th instead of July.

Bulgaria: Eurobank EFG Forecasts

	2010	2011	2012	2013f
Real GDP (yoy%)	0.4	1.7	0.5	1.5
Final Consumption	0.5	-0.3	2.5	3.0
Gross Capital Formation *(Fixed)*	-18.3	-9.7	-1.5	3.5
Exports	14.7	12.8	2.2	3.5
Imports	2.4	8.5	3.0	5.0
Inflation (yoy%)				
CPI (annual average)	2.4	4.2	3.0	2.5
CPI (end of period)	4.5	2.8	4.2	2.8
Fiscal Accounts (%GDP) - *Cash Basis*				
General Government Balance	-4.0	-2.0	-0.5	-1.5
Gross Public Debt	16.7	17.0	19.0	17.0
Primary Balance	-3.3	-1.2	0.3	-0.5
Labor Statistics - *National Definitions*				
Unemployment Rate (registered, %)	9.2	10.4	11.4	11.5
Wage Growth *(total economy)*	6.4	9.1	8.5	7.5
External Accounts				
Current Account (% GDP)	-1.0	0.3	-0.7	-1.5
Net FDI (EUR bn)	1.0	1.7	1.4	1.5
FDI / Current Account (%)	275.3	Na	522.0	245.0
FX Reserves (EUR bn)	13.0	13.4	15.5	14.5
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

Overall, the Bulgarian government was a victim of the lackluster growth rebound in the aftermath of the financial crisis in 2008. The debt profile and fiscal fundamentals put Bulgaria among the few bright spots in EU-27. Yet, the prudent fiscal policy followed did not put enough emphasis on growth. The feeble growth did not translate into meaningful employment growth. As a result unemployment (ILO methodology) stood at 12.4% in Q4-2012 compared to 11.4% in Q4-2011, close to historic highs despite the improvement in economic conditions.

Looking ahead, the most probable scenario is for a coalition government to be formed after the parliamentary elections. According to the most recent polls, the ruling party GERB has lost a sizeable percentage points lead in the recent months. However,

it still maintains a slim advantage over its main rival BSP. However, if polls results are reflected in the final election results, no party will be able to gain absolute majority of the parliament seats to form a government. Both parties popularity stand around 20-25%, which is far below their previous election results. That leaves enough space for other parties to collect enough seats to participate in the next government. Other parties that will most probably collect at least the minimum 4% of the total vote to enter the parliament include the MRF and the former EU commissioner Kuneva's Bulgaria for the Citizens and the Blue Coalition.

Strong budget execution on the expenditure side resulted in outperformance of the full-year deficit target of 2012

The budget execution data reveals that the full-year deficit target of 2012 was outperformed. The general government deficit (cash basis) declined by 78% yoy to BGN 350mn. According to the Ministry of Finance, the full-year general government deficit in both cash basis and ESA terms is estimated to have outperformed the initial budget target of 1.4%-of-GDP, declining to 0.45%-of-projected GDP in 2012, against 2% of GDP in 2011 and down from 4%-of-GDP in 2010.

Budget revenues improved in 2012, albeit remaining below their pre-crisis levels. Total proceeds expanded by 8.2% yoy, to BGN 27.4 bn, assisted by improved tax collection and higher domestic inflation in the second half of the year. The direct connection of companies with the National Revenue Agency (NRA) through an integrated system helped in better VAT tax collection. However, total revenues still lagged behind a corresponding full-year budget target of BGN 28.7 bn. As a percentage of projected GDP, total revenues reached 35.4%, up from 33.7% in 2011. Delving into the revenue side, stronger indirect taxes (+6.8% yoy) boosted tax revenues by 4.5% yoy. Revenue from VAT and excise duties expanded by 6.9% yoy and 5.5% yoy respectively, while custom duties declined by 9.8% yoy. In contrast, direct taxes were up by only 2.7% yoy which reflects the weak labor market conditions. In a similar vein, social security contributions rose by 1.5% yoy.

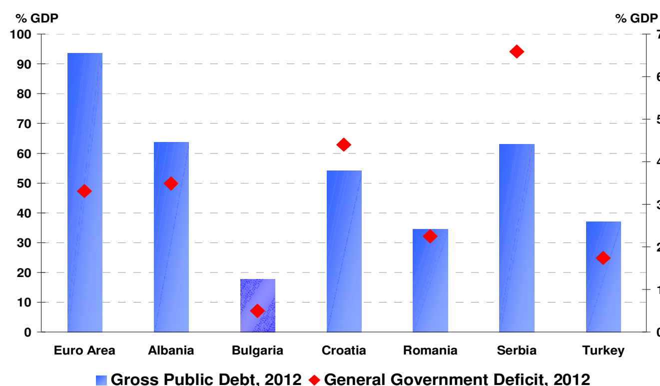
On the expenditure side, total budget outlays in 2012 grew by 3.2% yoy to BGN 27.8bn, remaining well below the corresponding full-year budget target of BGN 28.9bn. As a percentage of projected GDP, total expenditures reached 31.4%, down from 31.5% in the same period a year earlier. The most important components of budgetary expenditure, i.e., public wages and pensions, remained broadly flat in nominal terms for a third year in a row, while in ppt-of-GDP terms they amounted to 5.3% and 15.3%, respectively from 5.4% and 15.1% in 2011.

More importantly, the under-execution of the public investment program facilitated the observed restraint in budgetary expenditure. Only 70% of targeted full-year capital expenditure materialized in 2012 (BGN 3.67bn vs. BGN 5.25bn planned in the budget). In ppt-of-GDP terms, public investment expenditure in 2012 amounted to 4.7%-of-GDP compared to 4.1%-of-GDP in the same period a year earlier.

The debt profile and fiscal fundamentals put Bulgaria among the few bright spots in EU-27. Standard & Poors affirmed the investment grade rating of Bulgaria.

Bulgaria's full-year deficit compares favorably with the corresponding EU-27 average for 2012 (3.3%-of-GDP as per the European Commission's autumn 2012 Forecasts). Furthermore, the country's public debt is estimated to have reached ca 19.1%-of-GDP in November 2012, the second lowest ratio in the EU in 2011 behind Estonia (Figure 1). After the repayment of the Eurobond (€878 mn to retire the bond placed in 2002) maturing on January 10th and the prepayment of USD 45mn of the bond which matures in 2015, the debt to GDP ratio dropped to 14.75% in January2013. The repayment was financed with the proceeds from the 5 year €950mn Eurobond issued in last July. The debt repayment was accommodated with BGN 1.7bn from fiscal reserve, which dropped further to BGN 4.3bn in the end of January (below the BGN 4.5bn threshold) vs. BGN 7bn in the beginning of 2013.

Figure 1
Bulgaria's fiscal position is one of the healthiest in the region and EU-27



Source: National Statistics, IMF World Economic Outlook, Eurobank Research

All in all, the latest budget execution data reinforce our long-held views about the soundness of Bulgaria's fiscal position and the strong track record and consistency of policymaking. This strong track record of fiscal prudence, the low deficit and debt stock is acknowledged by rating agencies so that Bulgaria never lost its investment grade status in the post Lehman period. In late December, Standard & Poors affirmed Bulgaria's credit rating at BBB/A-2.

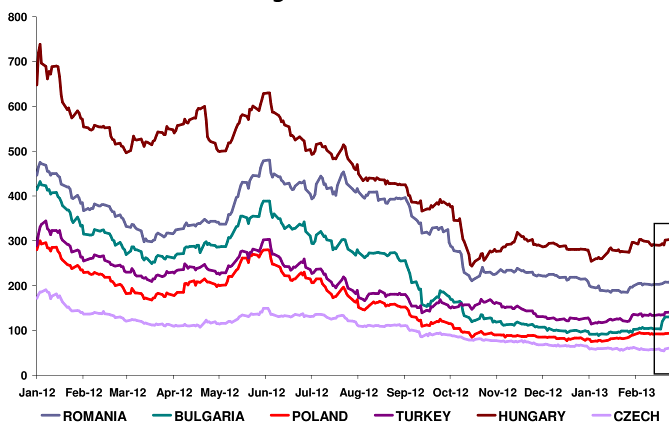
Although political uncertainty has increased, stress in the domestic financial markets is contained at low levels. In fact, the yield to maturity of the 10Y government bond was on a strong declining trajectory after past July. Bulgarian assets have benefited from the overall easing of financial conditions in the region. The yield stood little below 3% in early February 2013

compared to 5.3% in the beginning of 2012. In the aftermath of the political turmoil, the yield spiked to 3.5% in the end of February. Similarly 5Y-CDS spreads spiked to 135bps in late February compared to multi year low at 88bps in early 2013 (Figure 2, 3).

Figure 2
10Y Bond yields have declined below pre-crisis levels

Source: Ecowin Reuters, Eurobank Research

Figure 3
5Y-CDS spreads spiked to 135bps after the resignation of the government



Source: Bloomberg, Eurobank Research

Fiscal policy set to become more supportive of growth in 2013 driven by increases in pensions, minimum wage and pre-election spending

Looking ahead, the budget targets for the first time after many years a small increase in the fiscal deficit, more specifically a widening of the consolidated government deficit (on a cash basis) from 0.45% of GDP in 2012 to 1.3% in 2013. The revenues' target is set at 30.6bn Leva (37.5% of projected GDP,) increased by 11.4% compared to the realization in 2012. On the expenditures side, the target is set at 31.7 bn Leva (38.9% of projected GDP) increased by 14% compared to the realization in 2012.

In our view, there are significant downside risks to the implementation of this year's budget. In principle, the fiscal target will be harder to attain given that the next parliamentary elections are scheduled for mid 2013. Although provisions for increased discretionary spending have already been made, the government will have a hard task resisting pressures from individual social and professional groups. In any case, even if some fiscal slippage materializes, our base case scenario is built upon the assumption that the fiscal deficit will remain well contained below the 3% of GDP Maastricht threshold.

On the revenues side, the budget assumes that consolidated government revenues will increase by 2% of GDP. Improved EU funds absorption accounts for 80% of that increase which looks overly demanding, if not optimistic. From that point of view, EU transfer receipts ought to increase by 64% to reach 4.5% of GDP in 2013 vs. 2.9% in 2012.

The rest of the increase in revenues -0.4% of GDP- ought to come from the national budget revenues, which appears more feasible. To accommodate that purpose, the national budget provides for realistic, yet limited, revenue raising initiatives. Namely, the budget provides for the imposition of a 10% flat tax on interest earned from bank deposits. Until now, Bulgaria was the only EU country in which no tax was levied on deposits. In principle, that ought to generate BGN 120mn of additional revenue or 0.2% of GDP. The hike in excise taxes of gas and kerosene (from BGN 630 to BGN 645 per 1000l) and the 10% rise in the minimum social security contributions income threshold to capture shadow economy will be utilized to achieve the rest. The budget provides for no other change in taxation rates. As a result, the personal income tax and corporate tax rates are maintained at 10%, one of the lowest in the EU and VAT tax at 20%. The scope for better tax collection is limited in the short-term given that the interconnection of enterprises with the NRA has largely been completed.

On the other hand, the budget provides for an increase in minimum wages, pensions, public wages of some categories of civil servants and discretionary current spending. Firstly, the minimum wage has already increased from BGN 290 to BGN 310- 6.8% rise-since January 1st, measure which applies for both the private and the public sector. Pensions will increase on average by 9.3% effective April 1st. The budget does not provide for any broad based increases of public wages. However, increases within individual categories of civil servants will take place within the budget framework of each ministry. As an illustration of this policy, the wages of teachers and military personnel are projected to increase by 11% and 7% respectively.

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

Disappointing full year output performance in 2012

- Full year growth performance disappointed: GDP came at 0.2% yoy in 2012 vs. 2.2% yoy in 2011
- The non-residents' risk appetite for Romanian assets remained strong in Jan-Feb 2013
- The Romanian government was granted a three month extension in the current precautionary IMF agreement framework in order to take corrective action needed to achieve the objectives of the program and wrap up structural reforms in the area of state-owned enterprises

The economy returned to marginally positive growth in Q4-2012. Full year growth performance slowed down to 0.2% in 2012 vs. 2.2% in 2011

According to the flash estimate, output growth returned to marginally positive territory in Q4 2012. GDP expanded by +0.2% qoq/+0.3% yoy in the last quarter, up from -0.4% qoq/-0.5% yoy in Q3-2012. The reading was still above that of Euroarea, which was gripped in recession in Q4 (Figure 1). Full year GDP growth slowed down to a mere 0.2% yoy in 2012 down from 2.2% yoy in 2011. After registering moderate growth in the 1H, downside risks to growth prevailed in the 2H-2012. The revised real GDP growth came at -0.5% yoy in Q3 (marginally revised upwards from -0.6% yoy previously) on severe negative contribution from agriculture and external environment headwinds from the Euroarea sovereign debt crisis (70% of total exports head to EU-27).

Although the detailed break down is still not available, growth was largely driven by anemic domestic demand dynamics. Domestic demand displayed feeble improvement in Q4 after the slump recorded in Q3. Despite the negative surprise in December (-3.2% mom/-2.3% yoy), retail sales in volume terms (seasonally adjusted) were still up by 0.2% yoy in Q4. The improvement trend in retail trade consumer confidence and economic sentiment indicators in the run up to the holiday season gave the picture of a further boost to retail activity. On the other hand, construction confidence was on a visible downward trend in the 2H (Figure 2).

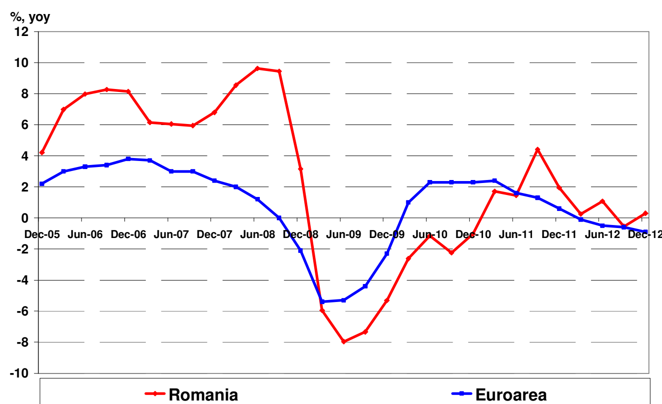
After a short-lived improvement in November (+5.1% mom/-1.5% yoy), construction activity plunged by -2.8% mom/-9.5% yoy in December. In the post-crisis period, construction activity derives support from non-residential building activity and civil engineering. Those areas are more or less tied to capital budget expenditures on behalf of the government sector. As a result, the underperformance of construction activity reflects two facts. Firstly, the government's effort to cut funds earmarked for public construction in the budget of capital investments in an attempt to consolidate expenditures. Secondly, the low EU funds absorption rate. Hence, scaling up of construction activity in the medium term would necessitate an improvement in EU funds absorption or spending allocations for public investments in the budget.

Romania: Eurobank EFG Forecasts				
	2010	2011	2012	2013f
Real GDP (yoy%)	-1.6	2.5	0.2	1.5
Consumption	-1.3	0.4	-0.2	1.2
Investment	-2.1	2.6	7.5	4.5
Exports	14.0	11.7	-3.5	1.5
Imports	11.9	11.2	-1.5	2.5
Inflation (yoy%)				
CPI (annual average)	6.1	5.8	3.3	4.1
CPI (end of period)	8.0	3.1	4.5	3.5
Fiscal Accounts (%GDP, Cash Basis)				
General Government Balance	-6.4	-4.2	-2.5	-2.0
Gross Public Debt (including guarantees)	31.2	33.0	34.6	34.5
Labor Statistics (annual avg,%)				
Unemployment Rate (% of labor force)	7.3	7.4	7.2	7.0
Wage Growth (total economy)	3.1	4.1	5.0	5.0
External Accounts				
Current Account (%GDP)	-4.4	-4.3	-3.8	-3.8
Net FDI (EUR bn)	2.2	1.9	1.6	2.0
FDI / Current Account (%)	40.5	31.7	30.0	36.8
FX Reserves (EUR bn)	36.0	37.3	35.4	33.0
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

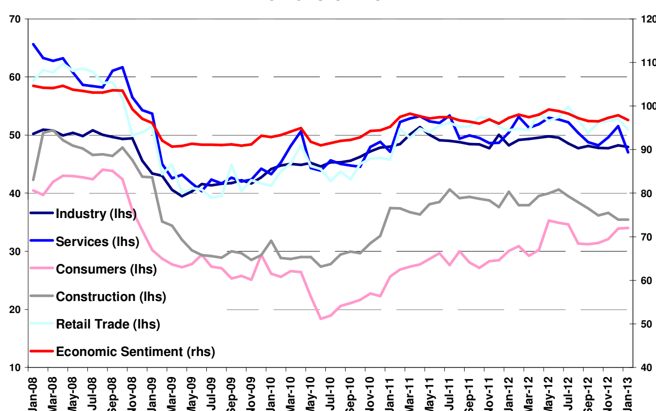
To make things worse, the recession in the Euroarea impacts exports negatively. Exports have been performing poorly in 2H. The latter translates into a weakness in domestic industrial dynamics in Q4. Industrial production dynamics remained in negative territory for a fifth consecutive month in December. Industrial production-on a seasonal and working day adjusted basis- remained broadly stagnant +0.0% mom/-0.6% yoy in December on deteriorating mining sector performance vs. -0.9% qoq/-1.3% yoy in November. Similarly, manufacturing sector confidence headed south again in December (-4.1 in December vs. -3.5 in November), remaining visibly lower than in the 1H-2012

Figure 1
In contrast to the Euroarea, growth in Romania was still marginally positive in Q4



Source: National Statistics, Eurostat

Figure 2
Consumer sentiment was on an improvement trend in the last months of 2012



Source: Eurostat, Eurobank Research

Near term growth prospects remain weak on negative spillovers from Euroarea sovereign debt crisis. Medium term outlook depends on the implementation of structural reforms

In any case, the latest macroeconomic data releases fail to impress and suggest that recovery is still fragile. Looking ahead, we anticipate growth prospects to improve moderately in 2013. Our current growth forecast stands at 1.2% in 2013, which is still very decent given that Euroarea will most probably be in recession for most of 2013. Our forecast stands below that of IMF (1.6% in the latest review) and European Commission (2.2% in the autumn forecasts). Risks are skewed to the downside. Short term growth prospects are clouded by the Euroarea sovereign debt crisis, which will continue to be a drag on net exports and capital inflows until at least 1H-2013. However, domestic demand will take the lead as the main growth driver in 2013. The contraction of private consumption in the post-Lehman period seems to have bottomed out. As an illustration, retail sales in volume terms posted the first- since 2008-annual positive reading in 2012 (+2.9% yoy). In addition, fiscal and monetary policies are expected to be more supportive of growth in 2013. The hike of public wages to the 2010 levels and the indexation of pensions are going to support household balance sheets this year.

In addition, economic activity will most probably receive a positive boost from agriculture in 2013. Provided that the negative performance of Q3-2012 will most likely not be repeated, we anticipate agriculture to be a positive contributor to growth in 2013.

In the medium-term, investments could take the lead as the primary engine of growth in Romania. The required elements are there: political stability after long time, an attractive large domestic market, a competitive -from a relative wages point of view- labor force etc. The implementation of structural reforms in the broad government sector could work as a catalyst for releasing the growth potential in the medium-term. There is room for significant improvement in two key areas: EU funds absorption (the lowest in EU-27) and public sector efficiency.

The Romanian government was granted a three month extension in the precautionary IMF agreement in order to take corrective action needed to achieve the objectives of the program

The government was granted a three month extension on the precautionary IMF agreement. In principle, the two year existing precautionary agreement will expire in March. The Romanian government has already successfully completed six reviews in the existing framework. The final review (7th and 8th combined) took place in January 15th-29th. According to the preliminary findings of the IMF and EU missions, the quantitative targets of general government cash deficit, public sector (both on the local government and state budget levels) arrears and the target for the Central Bank's net foreign assets were missed.

The general government cash deficit came at 2.5% of GDP in 2012, slightly above the revised target of 2.2% of GDP. However, the revised cash deficit target was missed, mainly due to suspensions of reimbursements for some EU-funded projects because of past irregularities discovered by the Romanian audit

authorities. In contrast, preliminary estimates suggest that the budget deficit in accrual terms was maintained below the 3% of GDP threshold in 2012. Provided that the final data in April confirm the original findings, Romania will no longer be subject to the Excessive Deficit Procedure, an important fact that will provide a positive signal to financial markets.

On the positive side, both the government and the authorities agreed upon the corrective action needed to achieve the objectives of the program. For that purpose, the government asked for an extension of the program for two more months in order to take both corrective action with respect to arrears and the budget implementation of 2013. At the same time, the government has reaffirmed its intention to push for structural reform in the area of state owned enterprises.

The structural reforms agenda has been lagging behind even before the parliamentary elections. The privatization of Oltchim (state owned chemical company), which together with the sale of a 15% stake in Transgaz was a prior action for the approval of the 6th review, turned out to be a highly political and controversial issue. In the next period, the government needs to wrap up the restructuring and privatization of three state-owned companies. The secondary public offering of 15 percent of Transgaz will be finalized in the coming months. In addition, a majority share in the state railway company CFR Marfa will be sold to a strategic investor. Oltchim will be put into insolvency. Finally, efforts to appoint professional boards and managers in public enterprises will have to step up.

Appetite for Romanian assets remained strong in the first two months of 2013

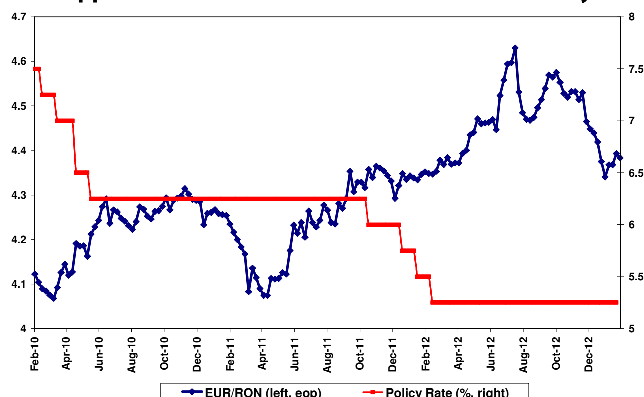
Risk appetite for Romanian assets has improved substantially since Q4-2012. Romanian assets have received a lot of market attention particularly after the election results in December. The strong election results for the ruling coalition, which gained constitutional majority, increased the prospects for political stability and expectations of accelerating structural reforms. In addition, the rhetoric of the new government on changing macro-policies in the context of the expiring precautionary IMF agreement softened. Therefore, the perceived risk premium declined, thereby making government bond yields more appealing.

In addition, the government bonds' inclusion in two major emerging market bond indices only propelled interest further. Barclays announced in last November that it would include local T-bonds, starting from April 2013, to its indices. JP Morgan announced in early January that local T-bonds were eligible to be included in the relevant popular index. However, the decision for the inclusion or otherwise will be taken in next spring (between March 1st and May 1st). Both decisions are important because those indices serve as a benchmark for the asset class allocation choices of institutional investors. The re-allocation will put Romania on the radar of portfolio flows. This is particularly important given that non-residents had decreased their exposure in the local market because of the escalating political crisis in the past summer and the ongoing Euroarea periphery sovereign debt crisis.

On the other hand, the Ministry of Finance has landed a great success in tapping the local market. The successful issuances enabled the government to start covering the hefty financing needs of 2013 in the last months of 2012. The public financing requirement amounts to 13.6% of GDP in 2013, one of the largest in the region. In addition, the eligibility of longer-term maturities for inclusion in the bond indices provides an incentive for the Ministry of Finance to prefer issuing such local currency instruments. If successful, this will result in developing the primary bond market further and it will also improve the maturity profile of the domestic debt.

The renewed interest for long-term government securities on behalf of non-residents continued in the first two months of 2013. The Ministry of Finance raised 11.4bn in local currency denominated bonds in January, twice as much than the initial plan of 4.6bn. Although demand was less strong in February, the Ministry of Finance raised 4.0bn vs. a plan of 3.7bn. Strong demand in the auction of 10-year local currency bonds led to an oversubscription and subsequently lower yields. The average yield came at 5.71%, the lowest recorded since 2005 and much lower than 6.75% recorded in the relevant auction of March2012. In the first international auction of 2013, the Ministry of Finance raised USD 1.5bn from a 10Y-USD denominated bond. Total bids reached USD7bn (bid to cover ratio 4.6) an illustration of strong demand. Thus, yield came much lower at 4.5% vs. 6.9% in the spring of 2012.

Figure 3
RON appreciation trend came to a halt in mid February 2013



Source: Bloomberg, Eurobank Research

Meanwhile, the NBR left the policy rate unchanged at 5.25% in January and February 2013. Instead, the Central Bank opted to utilize liquidity management operations in order to impact monetary conditions. After tighter liquidity conditions in late 2012, NBR opted for looser liquidity conditions in the first two

months of 2013. The NBR gradually eased the imposed ceiling on the volume of the weekly 7-day repo operations. On the other hand, the leu appreciation trend which begun in last October came to a halt in mid-February 2013. Leu traded at 4.37/€ on February 20th vs. a year low at 4.32/€ on January 16th (Figure 3).

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

Further fiscal consolidation is an urgent priority in 2013

- The consolidated general government deficit ended at 6.6% of projected GDP in 2012 vs. 5% of GDP in 2011
- The achievement of the fiscal target in 2013 will be a challenging task
- Inflation climbed to 12.2% yoy in December; average 2012 inflation at 7.3%, significantly above the NBS target range (4.5% +/-1.5%) in a very volatile year
- NBS hiked interest rates by 25bps to 11.75% bringing the cumulative hikes to 225bps since the beginning of the tightening cycle

Inflationary pressures still on the rise: Consumer prices climbed to 12.2% in Deember, significantly above the NBS target range.

Inflation registered in December the highest yea-on-year reading in a year. Consumer prices climbed to -0.9% mom/+12.2% yoy in last December vs. +0% mom/+11.9% yoy in November against only +0.6% mom/+2.7% yoy in April 2012. The categories with the highest increase on a monthly basis were health (+1.3% mom) and household equipment (+1.1% mom). Food prices, the main driver behind inflation in the past months declined further by -1.5% mom in December vs. -0.7% mom in November, the second consecutive negative reading after last July 2012.

2012 was a very volatile year as long as inflation is concerned. Average inflation declined to 7.3% in 2012 vs. 11.2% in 2011, only because inflation remained within the target band in 1H-2012. After bottoming out at 2.7% yoy in April 2012, inflation started accelerating in the 2H on a new supply side shock, related primarily to domestic unprocessed and processed food prices. The food prices shock was exacerbated by the high weight of food -37.8%- in the consumption basket. As a result, food inflation recorded its highest yearly reading in October (+3.1% mom /+17% yoy), up from only +1.3% mom/-2.5% yoy in March2012, only to step down to -1.5% mom/+15.4% yoy in December. Food inflation accounted for 70% of the cumulative rise in inflation between April and December. The implementation of a VAT hike in October (from 18% to 20%) coupled with higher oil prices worldwide contributed as well. Inflation is seen as rising further on administered prices and peaking within 1H-2013. The hikes in administered prices, including the rise in electricity (by 12%) and natural gas prices (by 10%) will weigh negatively on the inflation outlook in the period ahead. In contrast, the impact from higher food prices will start to fade away as the new agricultural season will kick in. All in, we continue to see inflation rising up to 13.5% in the 1H-2013 and then trend lower primarily on base effects and low aggregate demand pressures.

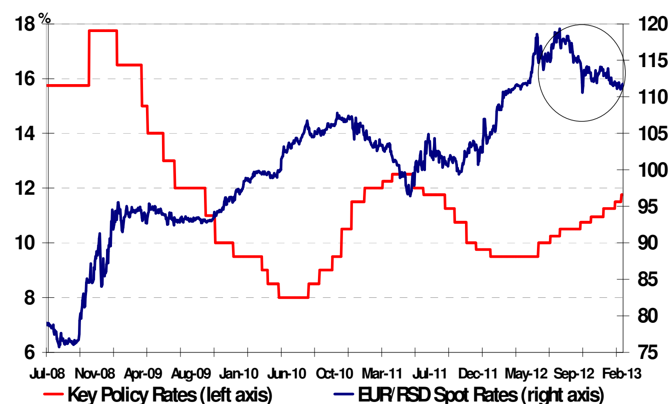
Serbia: Eurobank EFG Forecasts				
	2010	**2011**	**2012**	**2013**
Real GDP (yoy%)	1.0	1.6	-2.0	1.0
Inflation (yoy%)				
CPI (annual average)	6.2	11.2	7.3	9.0
CPI (end of period)	10.3	7.0	12.2	7.5
Fiscal Accounts (%GDP)				
General Government Balance	-4.7	-5.0	-6.6	-4.0
Gross Public Debt	44.5	48.7	61.5	62.0
Labor Statistics (%)				
Unemployment Rate (%of labor force, ILO)	19.2	23.0	23.9	23.0
Wage Growth *(total economy)*	7.5	11.1	11.0	5.5
External Accounts				
Current Account (% GDP)	-7.4	-9.5	-10.5	-8.0
Net FDI (EUR bn)	0.9	1.8	0.3	1.0
FDI / Current Account (%)	41.3	61.6	10.0	37.5
FX Reserves (EUR bn)	10.0	12.1	10.9	11.0
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	11.75	11.25	10.50	9.75
EUR/RSD	111.44	110.00	110.00	115.00

Source: National Sources, IMF, Eurobank Research & Forecasting

To address the rising inflation risks, NBS hiked interest rates by a cumulative of 225bps from 9.5% to 11.75% between June2012-February 2013. On February 5th, NBS hiked rates by 25bps to 11.75% despite the expectations of the majority of analysts. The Central Bank highlighted the inflationary impact of regulatory prices hikes and their potential spillover effects on inflation expectations as one of the main reasons behind the decision to hike. Looking ahead, the Central Bank has also brought up two more factors that may impact the future inflation outlook: the impact of the ongoing government's fiscal consolidation strategy and the relative stability of the domestic currency. From that point of view, it is important to note that visible fiscal consolidation is

expected to have an even more disinflationary effect on domestic demand throughout 2013. At the same time, the modest currency appreciation recorded in the last six months will have a disinflationary impact due to the high pass-through effect. Indeed, the domestic currency has recouped some of its earlier losses. Dinar traded at 111.16/€ on February 18th, against a an all time low at 119.3/€ on August 8th, 2012 (Figure 1).

Figure 1
NBS has hiked interest rates by a cumulative 225bps since the beginning of the tightening cycle in June 2012



Source: NBS, Bloomberg, Eurobank Research

Surge in pre-election spending and inadequate fiscal consolidation measures resulted in visible deterioration in public finances in 2012

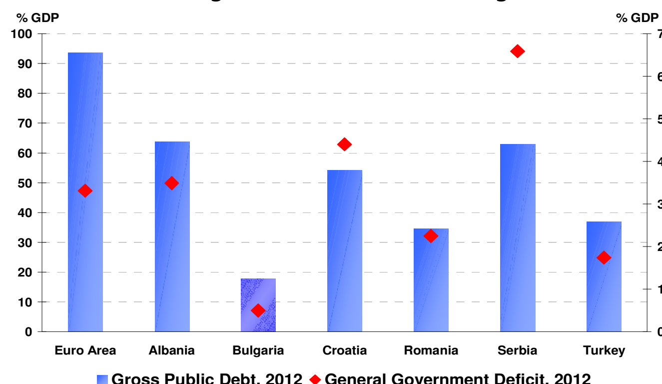
The fiscal position of Serbia deteriorated visibly in 2012. Driven by high pre-election spending, the fiscal deficit soared to 7% of GDP in the 1H-2012. In order to address the mini fiscal crisis, the incoming government adopted in September 2012 a revised budget and introduced a new fiscal consolidation package. Those measures aimed in containing the full year budget deficit at RSD 203.6bn or 6.2% of projected GDP in 2012. Both the Fiscal Council and the IMF assessed that the measures identified would be insufficient to contain the deficit. Although the package provided for some immediate revenue raising measures, it provided for additional expenditures initiatives so that the overall result would be negative.

The government accomplished to finish the year with a slightly smaller budget deficit, outperforming the revised target 6.2% of GDP. The budget deficit came at RSD 191.8bn or 5.9% of projected GDP in 2012 vs. RSD 132.5bn or 4.2% of GDP in 2011, expanding by 42% yoy. The outcome is considerably higher than the original deficit target of RSD 140bn agreed within the framework of the precautionary agreement with IMF last year.

Both revenues and expenditures underperformed respective targets of the budget revision. Total revenues stood at 788.5bn, 5% below the planned level of RSD 829.6bn. The underperformance was largely driven by non-tax revenues. On the positive side, VAT revenues expanded by 7.3% yoy driven by the VAT hike by 2pps (from 18 to 20%), performing relatively well in a recessionary environment. Total expenditures reached RSD 980.3bn, 5.2% below the planned level of RSD 1.033bn in the revised budget. The underperformance of expenditure was larger on a nominal basis (52bn vs. 41bn) and was explained by the underperformance of expenditure on wages and procurement and capital expenditures.

Overall, the full year budget performance sends an alarming message concerning the deterioration of the fiscal position of the country. The highly expansive policy followed from the previous cabinet led to an unsustainable widening of the fiscal deficit in 2008-2012. The consolidated government deficit widened from 2.6% of GDP in 2008 to 5% of GDP in 2011. Further on, the consolidated general government deficit ended at RSD 217.4bn in 2012 vs. RSD 158.4bn in 2011. As a percentage of projected GDP, the consolidated government deficit amounted to 6.6% of projected GDP in 2012. Accordingly, the public debt to GDP ratio reached 61.5% of GDP in 2012, significantly above the 45% threshold of the fiscal rule compared to 48.7% in 2011 and only 29.2% in 2008. Those metrics put Serbia among the most indebted countries in the region (Figure 2). For that reason, tangible fiscal consolidation and additional restraint, particularly on the expenditures side, is needed (total expenditures accounted for 49% of the projected GDP in 2012).

Figure 2
Serbia had the highest fiscal deficit in the region in 2012



Source: National Statistics, IMF World Economic Outlook, Eurobank Research

The implementation of the 2013 budget started on a good foot. The achievement of the full year fiscal target will be a challenging task.

Looking ahead, the government targets a significantly lower consolidated budget deficit at RSD132bn or 3.6% of GDP in 2013. The target for the central government (republican budget), which stands for the bulk of the consolidated government, is ambitiously set at 121.9bn or 3.3% of GDP in 2013.

The significant uncertainties and risks, both domestic and external, have rendered fiscal consolidation, not only imperative,

but also a challenging task. First of all, the budget is built upon the macro-assumption of GDP growth at 2% in 2013 (EFG forecast 1.5%). At the moment, Serbia is still gripped in recession. Output contraction slowed to -1.5% yoy in Q4-2012 vs. -2.5% yoy in Q3-2012 according to the flash estimate so that the full year estimate now stands at -2% in 2012. Even if headline GDP numbers turn out to be in line with the budget forecast, growth will be to a large extent driven by net exports, while private and government consumption will have a negative contribution. Consequently the tax revenues content of growth may not live up to budget forecasts. In contrast, higher inflation is going to give a boost on tax revenues, thus helping in fiscal consolidation.

Another source of concern lies with the forecasts of individual items. The assessment report of the Fiscal Council identifies two areas of overruns. Firstly, the revenues from corporate income and non-tax revenues have been overestimated by respective forecasts. The targets for expenditures on procurement and subsidies will most likely be missed because of insufficient preparation. That said, the Fiscal Council sees consolidated government deficit overshooting at 4.3% of GDP in 2013 (assuming 1% GDP growth).

The reaction of the IMF mission which visited Belgrade in past November is also skeptical. IMF conclusions viewed the announced 2013 budget deficit target as overly ambitious and underlined that the identified measures may not translate into the full needed adjustment in 2013. The latter implies that the achievement of the fiscal target in 2013 may require additional measures. Effectively, the IMF has put the precautionary agreement on freeze since February 2012. At that time, IMF challenged the outgoing government commitments on the precautionary agreement framework. Given the expansionary nature of the revised budget, IMF has indirectly conditioned the approval of a new regular or precautionary agreement upon the fiscal consolidation success in 2013. As a result, negotiations with IMF on that issue will most probably resume some time in next spring, upon the review of the budget execution in the first months of 2013. For that reason, all eyes are turned to the budget execution. The implementation of the budget in 2013 started on a good foot. The non-consolidated government deficit came at RSD 7bn in January 2013, which is half than the one planned in the budget and 33% down from that recorded in January 2012.

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