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NEW EUROPE ECONOMICS & STRATEGY

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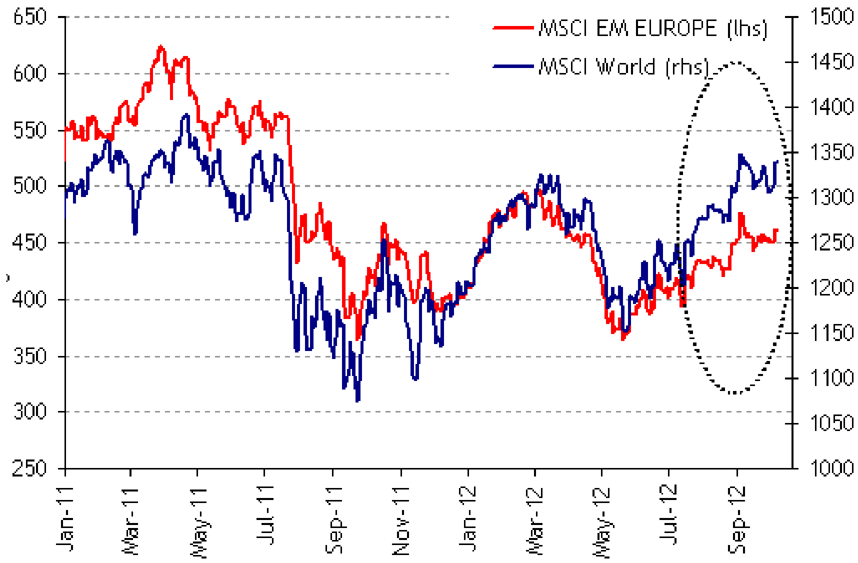
Stimulus measures by major central banks provide boost to regional financial markets

- **Bulgaria:** Decent growth performance in turbulent times
- **Romania:** Inflation stages a dynamic come-back
- **Serbia:** Coalition government introduced new fiscal consolidation measures

New Europe market strategy highlights

Regional FX markets: Taking into account the Serbian dinar's attractive carry, we favor EUR/RSD shorts at levels near 115, targeting 110 and stops at 116.5. **In the sovereign credit space**, the main impact of the upcoming short-selling ban has already been absorbed by the market. In view of the recent rally witnessed in New Europe sovereign credit markets, the upcoming US elections and the pending next EU/IMF tranche for Greece we prefer to stay sidelined for the time being on this particular asset class. **In local rate markets**, ongoing optimism about a new sovereign credit rating upgrade and Turkish Treasury's recent announcement for a lower-than-previously expected borrowing needs for the remainder of this year, we favour receiver positions in **Turkish 5-year cross-currency swaps** at current levels of 6.04%, with a stop loss at 6.25% and a target at 5.75%. Elsewhere, we like entering steepener positions in **Polish 2/5 PLN IRS** 1 year forward at current levels of -3bps, taking profits at +20bps and setting a stop-loss at -11bps.

Emerging Europe equity markets firm thanks to central bank stimulus



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)		
	2010	2011	2012	2010	2011	2012	2010	2011	2012
Bulgaria	0.4	1.7	1.0	3.0	3.4	2.0	-4.0	-2.0	-1.4
Poland	3.9	4.3	2.8	2.6	4.3	3.8	-7.8	-5.1	-2.9
Romania	-1.6	2.5	0.7	6.1	5.8	3.3	-6.4	-4.2	-2.2
Serbia	1.0	1.6	-1.5	6.2	11.2	8.0	-4.7	-5.0	-7.2
Turkey	9.2	8.5	3.0	8.6	6.4	9.0	-3.6	-1.4	-2.0
Ukraine	4.1	5.2	2.3	9.4	8.0	3.0	-6.5	-4.2	-4.0
New Europe	5.2	5.7	2.4	6.4	6.0	5.8	-5.6	-3.3	-2.7

	Current Account (%GDP)			Policy Rate (e.o.p.)			FX* (e.o.p.)		
	2010	2011	2012	2010	2011	2012	2010	2011	2012
Bulgaria	-1.0	0.3	-1.0	currency board			1.96	1.96	1.96
Poland	-4.6	-4.3	-3.8	3.50	4.50	4.50	3.96	4.46	4.10
Romania	-4.4	-4.3	-3.8	6.25	6.00	5.25	4.28	4.32	4.65
Serbia	-7.4	-9.5	-10.6	11.50	9.75	11.00	106.1	106.9	115.0
Turkey	-6.5	-10.0	-7.5	6.50	5.75	5.75	1.54	1.88	1.77
Ukraine	-2.2	-5.5	-6.5	7.75	7.75	7.50	7.96	7.99	8.10
New Europe	-5.0	-6.6	-5.7	-	-	-	-	-	-

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

Dear readers,

Following a weak start in the first quarter of this year, most emerging economies in New Europe recorded a modest improvement in Q2-2012. This improvement was on the back of positive domestic demand dynamics, which originated from a slight boost in real wages, lower food and energy prices and favorable base effects. Yet, the pace of recovery was constrained by weaker export performance and domestic manufacturing activity.

New Europe economies continue to struggle with the repercussions of the lingering Euro Area crisis and now face the additional downside risks of the global growth environment. We expect GDP growth in the region to weaken somewhat in H2-2012, yet we remain of the view that the majority of economies in the region will avoid a new round of painful and prolonged output contraction. The latter view remains valid provided that main trading-partner economies in the euro area avoid a pronounced downturn and that there are no new unforeseen negative external shocks.

As annual output growth readings for most economies in the region are not expected to live up to earlier, more upbeat, forecasts, market attention will naturally focus on regional authorities' efforts to stimulate growth in a fiscally-constrained environment. Lingering external vulnerabilities and the risk of higher food price inflation would continue to prevent local monetary authorities from playing a more active role in supporting economic activity.

The region consisting of **Bulgaria, Romania and Serbia** continued to display a more sluggish growth profile in H1-2012 compared to the rest of New Europe. More specifically:

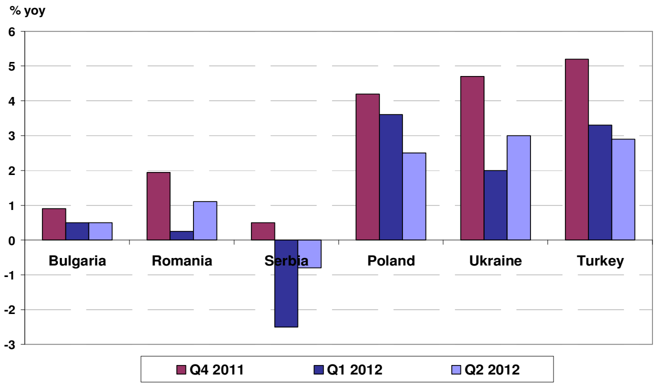
In **Bulgaria**, growth reached 0.5% yoy in Q2, same as in Q1. While the environment in EU-27 was adverse, growth was supported by higher private consumption and resilient export performance. In the second half of 2012, a higher than previously expected agricultural output during the summer months and a prospective higher absorption capacity of EU funds are anticipated to make a positive difference. At the same time, inflation jumped to 4.9% yoy in September, the highest rate since June 2012.

In **Romania**, inflation staged a dynamic comeback on higher food and energy prices. Inflation leaped to 5.3% in September against 3% last July. GDP growth accelerated to 1.1% yoy in Q2 compared to 0.3% yoy in Q1. Looking ahead, we anticipate a much weaker Q3 as downside risks prevail. The Euro Area sovereign debt crisis weighs negatively on net exports and industrial production dynamics. Moreover, negative base effects from last year's outstanding agriculture performance will likely put a lid on Q3 GDP growth.

In **Serbia,** the coalition government introduced a new package of fiscal consolidation measures. Those measures target the reduction of fiscal deficit to 3.5% of GDP in 2013 against a projected much higher 6.2% level in 2012. Reactions of the Fiscal Council and the IMF to those measures were not positive. Both institutions call for an additional fiscal consolidation effort.

Elsewhere in Serbia, the pace of output contraction narrowed to -0.8% yoy in Q2 vs. a revised -2.5% yoy in Q1. However, the flash GDP estimate of Q3 came at -2.2% yoy, which implies that the improvement 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. The latest data validate our view that output contraction deepens in the post-election landscape.

Figure 1
Performance of New Europe economies remains uneven



Source: National Statistics, Eurobank Research

Gikas Hardouvelis
Chief Economist & Director of Research

I. New Europe - Markets

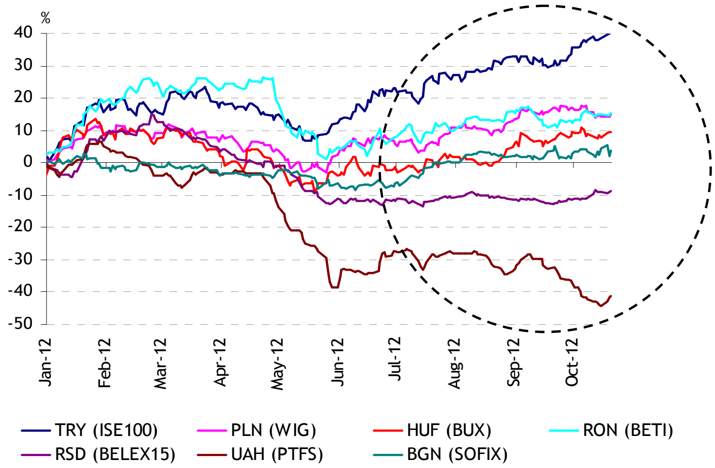
Major Central Bank stimulus measures provide boost to regional financial markets

In tandem with their world peers, equity markets in New Europe have rallied strongly since hitting year-to-date lows in June. Major equity indices in the region received a renewed boost over the last month or so, after major central banks around the globe announced new stimulus measures aiming to support liquidity conditions and real economic activity. Among others, the Fed introduced in September a third round of quantitative easing, while the ECB announced a *potentially-unlimited* government bond-buying scheme – termed as Outright Monetary Transactions (OMT) - aiming to support euro-periphery debt markets. A few days later, Bank of Japan announced an increase in the total size of its asset purchase programme and provided another extension in October.

However, gains in equity markets have been capped lately as worries over the sustainability of the global economic recovery linger, the euro area debt crisis remains at the epicenter of market attention and uncertainty persists over whether Spain will request any time soon a sovereign rescue package from international lenders. Reflecting growing uncertainty over the global economic outlook, the IMF cut in early October its global growth forecast for this year to 3.3%, from 3.5% previously (and revised down its forecast for 2013 to 3.6%, from 3.9%), warning that prospects for the world economy have deteriorated further while risks have increased. This followed a World Bank report a day earlier which included a downward revision in its growth forecasts for the East Asia and Pacific region. Caution also prevails in view of the US Q3 corporate earnings reporting season, which commenced in mid-October. According to data from Thomson Reuters, of the S&P 500 companies that had announced Q3 results until late October, only 37% beat the market's median forecast revenue-wise, well below the 62% share that historically exceeds expectations.

Against this backdrop, the **S&P 500 index** stood in late October near a 4-½ year peak achieved a month and a half earlier, while the **MSCI Asia ex-Japan index** hit 7-month highs on October 18th. On the same day, the **FTSEurofirst 300 index** approached anew a 1-year peak recorded a month earlier. In a similar vein, most indices in New Europe firmed over the last month or so, remaining close to highs hit earlier in the year. Indicatively, the **MSCI Emerging Europe Equity index** hovered near levels of 445 at the end of October, remaining within distance from a 6-month high just below 480 points touched in the prior month. On a regional level, Turkey's **ISE 100** remains an outperformer with year-to-mid-October gains in the tune of 40%, thanks to central bank monetary easing, comparably better fundamentals vs. peers, growing expectations for a sovereign credit rating upgrade in the non-too distant future and cautiously improving global risk sentiment. Looking ahead, accommodative policies endorsed by central banks around the globe argue in favour of firmer equity markets in New Europe. However, the unfolding of the third-quarter US earnings season, the lingering euro area debt crisis, uncertainty in the run up to November's elections in the US and persisting worries over the global growth outlook will likely keep regional stock markets range-bound in the near-term.

Figure 2
Majority of New Europe equity markets rebounded from lows hit in June 2012
(year-to-date returns)



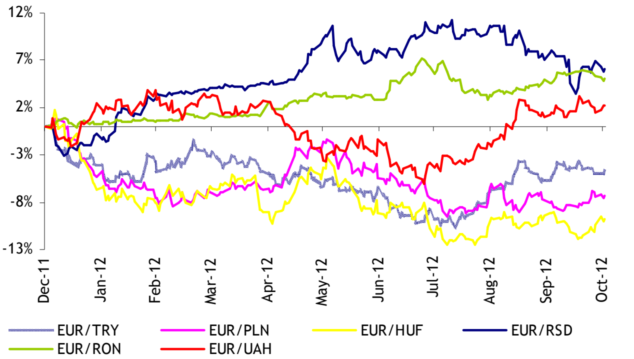
Source: Bloomberg, Eurobank Research

Performance of regional currency markets has been broadly mixed over the last month or so. Although currencies such as the Polish zloty and the Serbian dinar have gained ground as a result of the recent improvement in risk sentiment and local bond market inflows, others have fared worse on domestic factors. The **Romanian leu** has posed among the main underperformers in the region. **EUR/RON** hit a 2-month peak at 4.59 in early October, approaching anew a record high near 4.65 hit in August. Domestic political bickering, aggravated by the ongoing fiscal austerity program, saw two consecutive governments stepping down earlier this year, while impeachment procedures against President Basescu, initiated by incumbent Prime Minister Ponda, failed in July. Political uncertainty is unlikely to abate any time soon, especially in view of the upcoming parliamentary elections in November. Cumulative monetary easing of 100bps since November and the ongoing euro area debt crisis has also weighed on the leu in recent months. As a result, the central bank has intervened several times in the FX markets in order to support the currency and prevent ensuing inflationary pressures.

Local bond markets in New Europe have broadly firmed since September when major central banks around the globe announced new stimulus measures (Figure 3). Hungarian government debt has broadly outperformed its regional peers on comparably higher return potential and heightened expectations for further rate cuts in the period ahead. **Turkey** has lagged behind in view of growing inflation concerns after the introduction of regulated price hikes earlier this year, which resulted to a smaller-than-anticipated cut in the upper band of the central bank interest rate corridor in October.

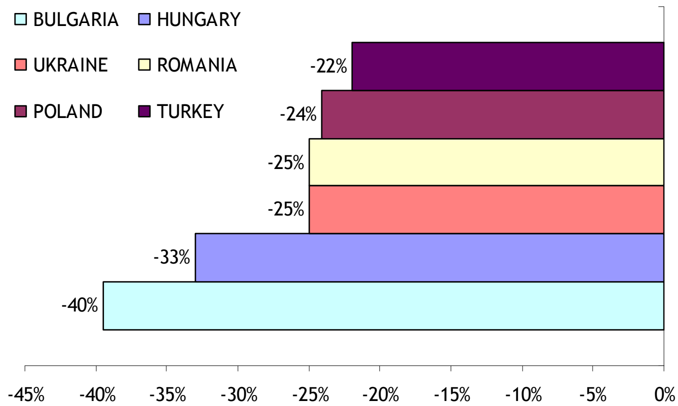
Rising inflation pressures and elevated political noise over recent months in **Romania** have also capped gains in the local-currency debt market.

Figure 3
New Europe currencies remain mixed on the back of diverging domestic fundamentals and policy moves
(Year-to-date returns)



Source: Bloomberg, Eurobank Research

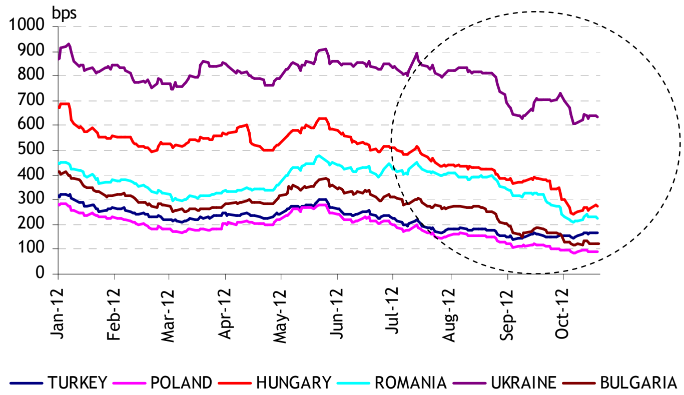
Figure 4
Local debt markets firm on improving risk sentiment, central bank monetary easing
(Change in 10-year bond yields since end-August)



Source: Bloomberg, Eurobank Research

Sovereign CDS spreads in New Europe tightened substantially in recent weeks, largely outperforming other asset classes. This move may be partly attributed to a new EU directive, anticipated to come into effect at the beginning of November, which effectively bans "naked" short selling of EU sovereign credit default swaps. Improved market sentiment in the wake of worldwide central bank stimulus measures also provided support. Indicatively, **Turkey's 5-year CDS spread** stood close to 165bps at the end of October, not far from a near 2-year low of 137bps hit a month earlier. On the same day, the **Bulgarian 5-year CDS spreads** hovered around levels of 125bps, standing just above a 4 -½-year low of 118bps hit a few days earlier, while the **Romanian equivalent** traded at 230bps, remaining close to the prior session's 2- ½-year intraday trough of 210bps.

Figure 5
External debt spreads tighten on improving risk sentiment, short-selling ban



Source: Bloomberg, Eurobank Research

Strategy - Emerging New Europe Markets

Regional FX markets: Taking into account the Serbian dinar's attractive carry, we favor EUR/RSD shorts at levels near 115, targeting 110 and stops at 116.5. Note that the Serbian central bank is the only central bank in the region to have lately embarked on a tightening mode, with a new interest rate hike delivered in October to contain rising inflationary pressures in the domestic economy. The NBS hiked its key policy rate by 125bps cumulatively since June to 10.75%, currently.

In the sovereign credit space, the main impact of the upcoming short-selling ban has already been absorbed by the market. The unwinding of short CDS positions and hesitation to enter new long positions before the said regulation comes into effect are possibly among the main reasons for the recent sharp spread narrowing. In view of the recent rally witnessed in New Europe sovereign credit markets, the upcoming US elections and the pending next EU/IMF tranche for Greece we prefer to stay sidelined for the time being on this particular asset class.

In local rate markets, ongoing optimism about a new sovereign credit rating upgrade and Turkish Treasury's recent announcement for a lower-than-previously expected borrowing needs for the remainder of this year, we favour receiver positions in **Turkish 5-year cross-currency swaps** at current levels of 6.04%, with a stop loss at 6.25% and a target at 5.75%. Elsewhere, the most recent macro data from Poland argue in favour of further monetary easing ahead.. As such, we like entering steepener positions in **Polish 2/5 PLN IRS** 1 year forward at current levels of -3bps, taking profits at +20bps and setting a stop-loss at -11bps.

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

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

Decent growth performance in turbulent times

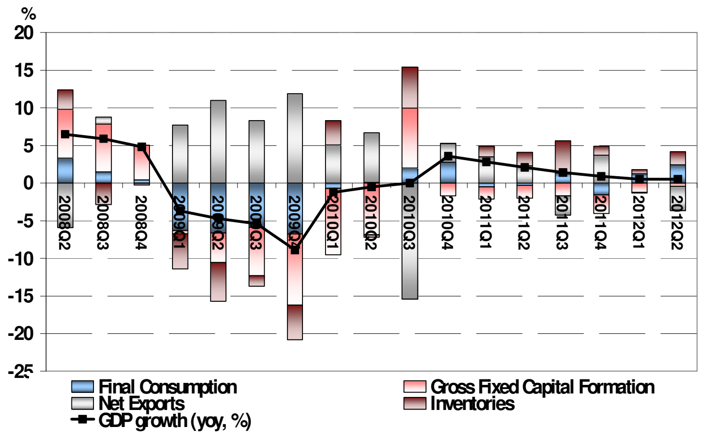
- GDP growth grew by 0.5% yoy in Q2, supported by higher private consumption and resilient export performance
- Inflation jumped to 4.9% yoy in September, the highest rate since June 2012
- Credit growth inched up to 4 % yoy in September, driven by recovering corporate lending

Decent GDP growth in Q2-2012

The domestic economy exhibited some signs of strength in the second quarter, despite a broadly adverse growth environment in the rest of EU-27. Real GDP grew on an annual basis by 0.5% in Q2, same as in Q1-2012. On a quarter on quarter seasonally adjusted basis, real GDP grew by 0.3% qoq in Q2, up from 0.0% qoq in the prior quarter.

Final consumption, the largest component of GDP, accelerated to +2.4% qoq/+3.2% yoy in Q2, from +0.4% qoq/+1.2% yoy in the prior quarter. As a result, the GDP growth contribution of final consumption doubled to 2.4pps from 1.2pps in Q1. Final consumption received support primarily from higher real wages despite weak labor market conditions. Average annual inflation declined further to 1.6% yoy in Q2, from 2.0% yoy in Q1 and 2.5% yoy in Q4-2011. At the same time nominal wages increased by 8.4% in Q2, after growing by 8.9% in Q1 and 8.7% yoy in Q4-2011. Unemployment stood at 11.0% in Q2-2012 marginally down from 11.4% in Q1 (the highest level in 2009-2011) (Figure 1).

Figure 1:
Q2 GDP growth supported by higher private consumption



Source: National Statistics, Eurobank Research

Bulgaria: Eurobank EFG Forecasts				
	2009	2010	2011	2012f
Real GDP (yoy%)	-5.5	0.4	1.7	1.0
Final Consumption	-7.3	0.5	-0.3	0.8
Gross Capital Formation *(Fixed)*	-17.6	-18.3	-9.7	1.0
Exports	-11.2	14.7	12.8	2.0
Imports	-21.0	2.4	8.5	3.5
Inflation (yoy%)				
HICP (annual average)	2.5	3.0	3.4	2.6
HICP (end of period)	1.6	4.4	2.0	3.8
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	18.3
Primary Balance	-0.2	-3.3	-1.2	-0.5
Labor Statistics - *National Definitions*				
Unemployment Rate (registered, %)	9.1	9.2	10.4	10.0
Wage Growth *(total economy)*	11.8	6.4	9.1	3.5
External Accounts				
Current Account (% GDP)	-8.9	-1.0	0.3	0.5
Net FDI (EUR bn)	2.5	1.0	1.2	1.5
FDI / Current Account (%)	80.4	275.3	Na	Na
FX Reserves (EUR bn)	12.9	14.1	14.9	15.0
Domestic Credit	**2009**	**2010**	**2011**	**Q2 12**
Total Credit (%GDP)	76.8	76.4	74.5	73.2
Credit to Enterprises (%GDP)	47.9	48.2	48.0	47.8
Credit to Households (%GDP)	27.3	26.4	24.6	23.7
FX Credit/Total Credit (%)	58.6	61.3	63.7	64.6
Private Sector Credit (yoy)	4.5	2.1	3.9	4.7
Loans to Deposits (%)	120.0	112.9	104.0	102.4
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

Investment activity remained in a contractionary territory for the fourteen quarter in a row, capping overall GDP growth performance. Investments contracted by 2.1% yoy in Q2, after declining by 5.4% yoy in Q1 and by 10.4% yoy in the last quarter of 2011. On a less negative note, investment registered its slowest pace of contraction since Q2-2009 deriving some support from higher absorption of EU funds. That said, investment recorded its second positive q-o-q growth since Q4 2008 (+1.5% qoq in Q2 vs. +0.4% qoq in Q1 and -1.2% qoq in Q4), which supports optimism that a bottoming out of the recession in the sector is nearing. Investments as a percentage of GDP have 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).

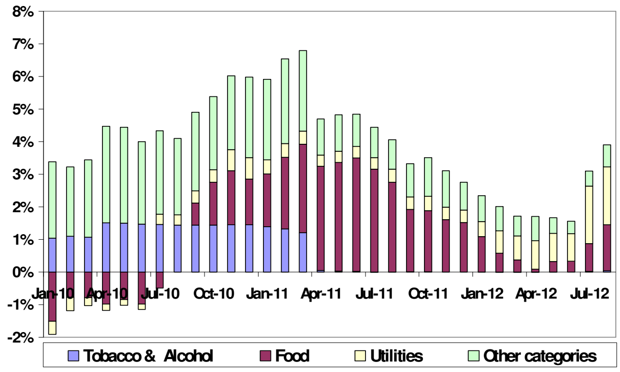
The positive news is the improving performance of exports. They expanded by 3.9% yoy in Q2 after recording a marginal decline (-0.1% yoy) in the prior quarter. This improving performance can be partly explained by the ongoing diversification of exports towards non-EU markets (currently around 40% of total exports). On the other hand, imports expanded by 8.6% yoy in Q2, after broadly stagnating in the prior quarter. As a result, the negative contribution of net exports rose to 3.2pps in Q2, from 0.1pps in Q1.

We continue to forecast full-year GDP growth of 1% in 2012 despite the relatively sluggish H1-2012 performance (+0.5% yoy). Higher than expected agricultural output in the summer months and higher EU funds absorption is anticipated to make a difference in the second half of the year. 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.

Rising electricity and food prices push inflation sharply higher

Inflation rose sharply during the summer months. Consumer prices climbed from a multi month low of 1.6% yoy in June to 3.1% yoy in July, 3.9% yoy in August and to 4.9% in September (Figure 2). The main driver behind the recent inflation rally was the spike in food and energy prices. Food prices (~38.5% weight in the CPI basket) accelerated further to 6% up from 4.0% yoy in August and only 0.9% yoy in June. Fuels increased by 8.8% yoy in August from 3.7% yoy in July and 3.6% yoy in June. In addition, the hike in electricity prices by 13% yoy and gas prices by 4.9% yoy in July added another 1.8pps to inflation in September and is expected to maintain inflation relatively high until Q2-2013.

Figure 2
Headline inflation on a rising path on higher food and utilities prices



Source: National Statistics, Eurobank Research

Credit growth expanded by 4.0% yoy in September driven by the recovery in corporate loans

Credit growth to the non-government sector stood at 4.0% yoy in September (2.1% year to September), moderately higher than the same month of last year. Credit developments have been shaped by two opposing forces. On the one hand, deleveraging continues in the retail segment, with consumer credit continuing to stagnate (-1.3% yoy in September vs. -0.6% yoy in December 2011). On the other hand, stronger appetite for credit comes from the corporate sector (+6.3% yoy in September up from +5.1% yoy in last January). In contrast, robust deposit growth (+9.6% yoy in September vs. 12.7% yoy in January) is currently helping to diminish external financing needs. Elsewhere, asset quality in the banking sector continues to deteriorate albeit at a slower pace. NPLs ratio climbed further to 16.9% in 1H-2012 against 14.9% in 2011. However capital adequacy remained strong at 16.59% in September 2012 marginally down from 16.7% in 1H-2012 compared to 17.63% in 2011. Accordingly, the system's Loans to Deposits ratio stood at 100.1% much lower than the pre-crisis levels. The latest IMF mission praised the domestic banking sector for its stability but at the same time pointed out that the low growth environment poses challenges in the areas of non-performing assets.

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

Inflation stages a dynamic come-back

- GDP growth accelerated in Q2 -2012
- Inflation stages a dynamic come-back on higher food and energy prices
- Domestic political risks ease after the presidential impeachment referendum

Inflation pressures on the rise. Central Bank kept interest rates unchanged at 5.25% in September and October meetings

Consumer price inflation leaped to 1.18%/5.33% mom/yoy in September, from 0.5%/3.9% mom/yoy in the prior month and 0.6%/3.0% mom/yoy in July. The latest readings were well above market expectations. Inflation dynamics are currently driven by higher food and energy prices. The summer drought had a negative impact on domestic agricultural output, creating significant base effects on year-on-year food prices. As a result, food prices, which carry a significant weight (37.5%) in the CPI basket, more than doubled to 6.91% yoy in September up from 3.3% yoy in August against 1.2% yoy in July (Figure 1).

Non food items were also a positive contributor to inflation, rising by 4.3% yoy in September, from 3.9% yoy in the prior month. The main driver behind the latter development was the rise in gas prices (2.8% mom) and the pass through impact from higher world fuel prices. Effective September 1st, gas prices were hiked 5% for consumers and 10% for corporate clients. On a more comforting note, services inflation eased to 4.79% yoy in September, from 4.9% yoy in August and 5.7% yoy in July. The appreciation of the domestic currency (during August and September) largely offset the rise in the utility services inflation (water and sewage +2.24% mom/+5.76% yoy) in September.

The latter developments point to a likely overshooting of the year-end official CPI target (3+/-1% yoy). In our view, the domestic inflation outlook remains subject to significant risks, stemming mainly from supply side factors. To complicate things further, additional increases in the administered gas and energy prices have already been agreed upon with the IMF. On a more positive note, adjusted CORE2 inflation came at 2.5% yoy in September, unchanged from August, but up from 2.3% yoy in July. This is evidence of negative output gap mitigating the impact from rising supply side pressures.

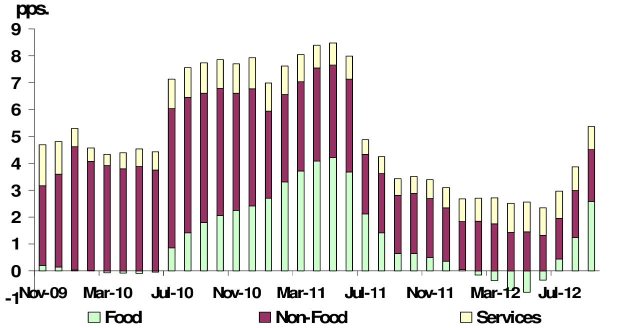
Romania: Eurobank EFG Forecasts

	2009	2010	2011	2012f
Real GDP (yoy%)	-6.6	-1.6	2.5	0.7
Consumption	-7.4	-1.3	0.4	0.5
Investment	-28.1	-2.1	2.6	6.5
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	5.5
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	-4.7
Net FDI (EUR bn)	3.6	2.2	1.9	2.5
FDI / Current Account (%)	72.3	40.5	31.7	37.0
FX Reserves (EUR bn)	30.9	36.0	37.3	35.0
Domestic Credit *(end of period)*	**2009**	**2010**	**2011**	**Q2 12**
Total Credit (%GDP)	49.2	51.8	50.8	52.1
Credit to Enterprises (%GDP)	19.2	20.0	19.9	20.1
Credit to Households (%GDP)	20.0	19.5	18.0	17.8
FX Credit/Total Credit (%, private)	60.1	63.0	63.4	63.7
Private Sector Credit (yoy)	0.9	4.7	6.6	9.6
Loans to Deposits (%)	130.6	137.7	142.5	139.3
Financial Markets	**Current**	**3M**	**6M**	**12M**
Policy Rate	5.25	5.00	5.00	5.00
EUR/RON	4.57	4.65	4.60	4.55

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

Figure 1

Inflation climbed higher during the summer months on rising food and energy prices



Source: National Statistics, Eurobank Research

Meanwhile, the NBR maintained interest rates at 5.25% at its November 2nd meeting for a fifth time in a row. At the same time, the minimum reserves requirements were kept unchanged (at 15% on RON liabilities and 20% on FX liabilities for maturities below 2 years). The move was in line with Bloomberg consensus (21 analysts). The Central Bank adopted a wait and see mode to assess the impact of two opposing forces; namely, the rapid deterioration of the inflation outlook and, on the other hand, the negative spillovers of the euro area sovereign debt crisis and downside risks to the domestic growth outlook. To sum up, we still anticipate interest rates to remain unchanged in the run up to the parliamentary elections on December 9.

Output growth accelerated in Q2-2012, but outlook remains subject to downside risks

Real GDP expanded by 1.1% yoy in Q2-2012, up from 0.3% yoy in Q1-2012 and 1.9% yoy in Q4-2011. On a seasonally adjusted basis, GDP accelerated to 0.5% qoq, up from 0.1% qoq in the first and -0.1% qoq in Q4 2011. From the demand side, consumption and investment dynamics improved. Private consumption expanded by +0.9% qoq/+1.4% yoy in Q2 from 0% qoq/+0.3% yoy in Q1, helped by historically low inflation which pushed real wages higher and prospective public wages hikes in H2-2012.

In addition, investments advanced by +4.4% qoq/+15.2% yoy in Q2, from +1.9% qoq/+12.2% yoy in Q1 underpinned by public investments in the construction sector. In contrast net exports were visibly weaker in the second quarter. Imports edged up by +1.2% qoq/+0.2% yoy from -0.2% qoq/-0.3% yoy. Exports were lower by -1.2% qoq/+0.7% yoy in Q2 against +0.3% qoq/-2.2% yoy.

Overall, real GDP grew by 0.8% in 1H-2012. Looking ahead, we anticipate a much weaker Q3 as downside risks to the growth outlook prevail, with a series of unfavorable international and domestic factors to possibly kick in. Firstly, the Euroarea sovereign debt crisis weighs negatively on net exports and industrial production dynamics. Moreover, negative base effects from last year's outstanding agriculture performance will likely put a lid on Q3 GDP growth.

Last but not least, the underperformance in EU funds absorption (only 8% vs. an ambitious government target of 19%) is explained by the fact that those funds earmarked for investments in the budget were cut in order to finance the public wages hikes in the coming months. Against this backdrop, we downgraded our growth forecast for 2012 to 0.7% from 1%. 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.

IMF concludes sixth review of precautionary agreement

Domestic political risks eased somewhat after the July 2012 referendum. President Trian Basescu returned to his post after the result of the impeachment referendum was deemed to be unsuccessful by the Constitutional Court. The court ruled that the participation of the electorate was below the constitutional threshold allowed to impeach the President. Nevertheless, this is by no means the end of the political rift between Prime Minister Victor Ponta and the President. Unless survey polls are not confirmed, the ruling coalition will win the elections which means that the rift may widen further after the parliamentary elections. All in all, the domestic political landscape is set to remain challenging in the coming months.

Meanwhile, the sixth review of the IMF precautionary agreement was concluded on September 28. The approval enabled the Romanian authorities to have access to a €512.9 mn tranche, or €3.2bn cumulatively since the beginning of the new arrangement. However, the government has indicated that it does not plan to utilize the funds unless needed.

The review assessed that all quantitative criteria were met with the exception of the central and local government arrears for which the government was granted a waiver. More importantly, the appraisal contained a positive assessment of the policies implemented. According to the IMF press release, the government is on track to meet the 3% of GDP fiscal deficit target in 2012. The review praised the government for its progress in liberalizing energy prices, its fiscal consolidation efforts as well as the solid position of the banking system.

On the negative side, the review underlined the lack of progress in structural reforms. The government reform agenda is lagging behind. It is important to speed up the process of privatizations of state-owned enterprises. 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 review, turned out to be a highly political and controversial issue. The privatization program also includes selling of stakes in Romgaz, Tarom, and the railway company CFR Marfa). Additional effort is needed to improve areas such as tax administration, the health care system, and the energy and transportation sectors.

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

Coalition government introduced new fiscal consolidation measures

- Supported by favorable market conditions, the government tapped international markets successfully in early October
- The government targets a reduction of the fiscal deficit to 3.5% of GDP in 2013, from 6.2% of GDP expected this year
- The post-election economic landscape is deteriorating, as the domestic recession deepens and the current account deficit widens
- Inflation is trending upwards on higher food prices
- Dinar recovers modestly from recent historic lows

Government introduces new package of austerity measures

The new coalition government adopted in September a revised budget and introduced a new fiscal consolidation package. The majority of measures came into effect on October 1st. The rest of the measures will be implemented after the adoption of the 2013 budget, which is expected to be debated in Parliament in the second half of November. The package includes interventions in the areas of taxation, public spending and the corporate taxation. Its main parameters include:

- 2ppt hike in the main VAT rate to 20%, effective from October 1 (the lower rate charged on food products will remain unchanged at 8%).
- Increase in excise taxes for cigarettes and diesel fuels
- Increases in the corporate tax rates: Capital gains tax on dividend and interest income will increase from 10% to 15%, while the corporate profit tax will rise from 10% to 12%. The measure will be implemented in 2013.
- The indexation of public wages and pensions will be limited below the levels required by the fiscal rules, while public wages will be capped at 162,000 Dinars
- 130 fiscal levies and duties are abolished in order to reduce red tape and streamline the tax system

The implementation of this package could yield savings of RSD 26 billion in the last quarter of this year and RSD 120 billion (approximately € 1bn) in 2013, according to government calculations. Those measures aim to contain the general government deficit to 6.2% of GDP against a projected 7.2% of GDP in 2012, above the original full-year target of 4.25%. The fiscal deficit target for 2013 was initially set at 4% of GDP but was later revised to 3.5% of GDP, following IMF recommendations and a relevant report by the Fiscal Council in Serbia.

Serbia: Eurobank EFG Forecasts

	2009	2010	2011	2012f
Real GDP (yoy%)	-3.5	1.0	1.6	-1.5
Inflation (yoy%)				
CPI (annual average)	8.1	6.2	11.2	8.0
CPI (end of period)	6.6	10.3	7.0	12.5
Fiscal Accounts (%GDP)				
General Government Balance	-4.5	-4.7	-5.0	-7.2
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**	**Q1 12**
Total Credit (%GDP)	51.7	63.9	62.2	66.1
Credit to Enterprises (%GDP)	29.6	35.7	35.0	37.3
Credit to Households (%GDP)	17.2	19.8	19.0	19.7
Private Sector Credit (yoy)	14.3	26.2	5.9	13.1
Loans to Deposits (%)	126.9	144.3	141.9	151.1
Financial Markets	**Current**	**3M**	**6M**	**12M**
Policy Rate	10.75	11.00	11.25	11.50
EUR/RSD	113.42	115.00	115.00	115.00

Source: National Sources, IMF, Eurobank Research & Forecasting

New austerity programme may not be adequate enough to stabilize the country's fiscal position

In our view, the new austerity **programme may not be adequate enough to stabilize the country's fiscal position**. On the one hand, there are measures in the right direction to raise taxes and collect more revenue, streamline the tax system, increase government efficiency and reduce red tape. However, revenue raising measures would be hard to yield impressive results in a recessionary economic environment (EFG growth forecast 2012: -1.5%) unless revenue collection improves substantially. To make things worse, there is not enough effort to consolidate public spending. In fact, new initiatives will increase total expenditures. The wage bill, the largest portion of public expenditures, will not be cut or at least frozen in nominal terms. In fact, pensions and wages will be assigned a 2% rise in October and a 2% rise in April. In addition, pensioners receiving less than RSD 15,000 a month will get "the 13th pension," of RSD 16,000, in four installments, with the first installment expected to be paid in late September and the second in late 2012. A total of RSD 4.2 bn will be set aside for this purpose by the end of the year. On top, the budget revision bill envisages increasing spending on social protection by a total of RSD 7 billion.

The reactions of the Fiscal Council and the IMF mission to the new consolidation package are not positive. The opinion of the Fiscal council, an independent body elected by the parliament whose task is to advise the government over fiscal policy issues is more critical. The Fiscal Council assessed that the first step of the new government towards fiscal consolidation was in the wrong direction and that the new measures would increase the fiscal deficit instead of lowering it. The conclusion of the IMF mission underlines that tangible fiscal consolidation is needed and calls for additional fiscal restraint. On a more alarming note, the achievement of the fiscal target in 2013 requires significant additional measures. Given the expansionary nature of the revised budget, it is more likely for IMF to ask for further spending cuts before a new regular agreement is approved. In addition, there is one more unresolved issue which may complicate the relations of the new government with the Fund. The amendments to the Central Bank law limit the independence of monetary authorities according to the IMF and EU officials. Those amendments resulted in the resignation of the previous Central Bank governor Dejan Soskic and his Vice Governor Bojan Markovic in last August.

Serbia successfully tapped international markets in early October

Encouraged by favorable market conditions, the government tapped the international markets on October 5th. The government utilized last year's 10 year Eurobond issue (2021 maturity) to raise an additional $1bn at 6.625% yield. Investor demand for the issue was strong, yielding a bid to cover ratio higher than 4, Furthermore, the spread over US bonds came at 497bps compared to 561bps a year ago. More importantly, investor demand for the retap was strong despite the visible deterioration in the domestic macro and fiscal environment as well as the downgrade by Standard & Poors by one notch to BB- in early August. All in all, the successful issuance enabled the government to cover a large part of its financing needs for the remainder of this year (€1bn out of a total estimated 1.5€ bn).

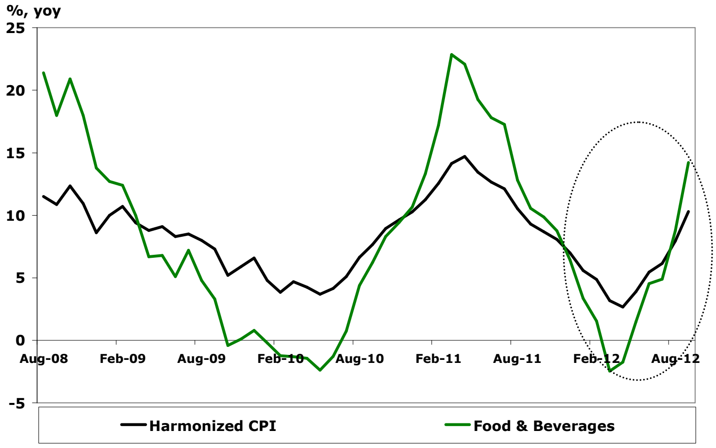
The government has expressed its intention to tap the markets again to start addressing the financing needs of 2013. The Minister of Finance Mr. Mladan Dinkic has stated that the government may issue new bonds before the end of November if market conditions remain favorable. The Treasury may initiate another Eurobond sale issuance ($500 mn) if yields donot exceed the threshold of 5.5%. In any case, although the situation is still manageable, it may 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 public financing needs (approximately €4bn according to Ministry of Finance estimates).

NBS hiked interest rates by another 25bps to 10.75%

On October 9th, the NBS raised interest rates by 25bps to 10.75%. This was the fourth hike since June 2012 (125bps of cumulative rate hiked delivered so far). In a statement released after the policy meeting, the Central Bank cited the inflationary effect of higher agricultural product prices, the anticipated rise in administered prices, the hike in the VAT tax and excise taxes and their ensuing impact on inflation expectations as the main reasons for the rate hike. Yet, NBS underlined the temporary nature of the supply side shock and that low aggregate demand will have a strong disinflationary impact on consumer prices.

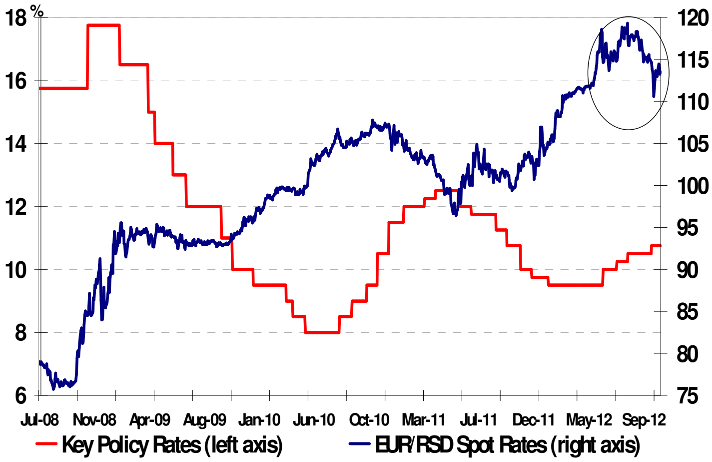
After bottoming out in April, inflation started accelerating in the summer months. Inflation has now reached 10.3% yoy in September compared to 7.9% yoy in August and 2.7% yoy in April 2012 (Figure 1). We now see inflation trending even higher, reaching 12-13% by year-end i.e., significantly above the target band of the Central Bank (4+/-1.5%). According to the Central Bank projection inflation will peak in 1H-2013. Then, disinflation is seen resuming in 2H 2013, assisted by favorable base effects. Looking ahead, the Central Bank has conditioned further hikes on the impact of the government's fiscal consolidation strategy, the success in containing inflation expectations and the evolution of the external environment. Moreover, two important factors will weigh decisively by the end of this year. Firstly, a potential appreciation of the Dinar in the last quarter of the year could help contain inflationary pressures. The Dinar has recovered modestly in the last two months recouping some of its earlier losses (trading at 113.87/€ on October30th against a year low at 119.3/€ on August 8th) (Figure 2). Dinar has benefited from the recent increase of the Dinar allocation in FX required reserves and the introduction of a new FX-indexed subsidized loan program for exporters. Secondly, the approval of a new regular IMF agreement could reduce sovereign risk premia. Ceteris paribus, we currently see room for further rate hikes of as much as 100bps at the last two policy meetings of this year.

Figure 1
Inflation skyrocketed to 10.3% in September on higher food prices



Source: National Statistics, Eurobank Research

Figure 2
Dinar recouped some of its losses against € in September-October



Source: NBS, Eurobank Research

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