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Upbeat Q1 GDP readings boost investors' optimism towards the region

REGIONAL MACROECONOMIC DEVELOPMENTS & OUTLOOK

- **First quarter output performance** of the region surprised to the upside
- The **revival of consumer spending** is supported by lower energy costs plus higher real disposable incomes
- To make this growth momentum last, it is essential to **reinvigorate investments**
- Most regional central banks **to remain accommodative** for the remainder of the year

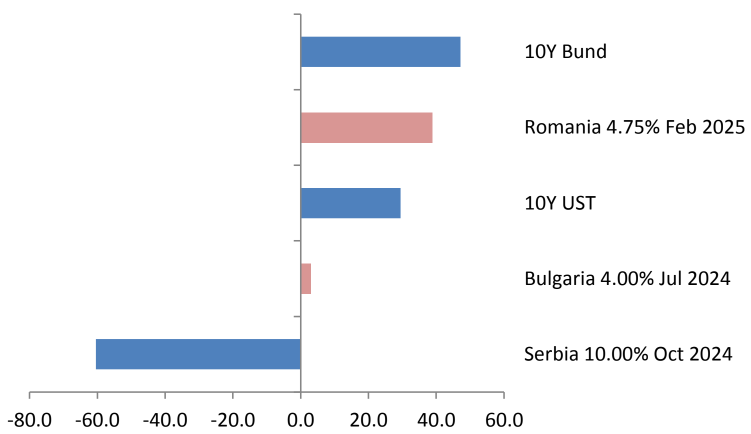
REGIONAL MARKET DEVELOPMENTS & OUTLOOK

- **Emerging bourses remain underpinned** by ECB's QE, scaled back Fed rate hike expectations and optimism about further stimulus measures in China
- Being largely influenced by domestic developments, **regional stock markets have presented a rather mixed picture** over recent weeks
- **Government bond yields rise** trailing the recent sell-off in core Eurozone and US bond markets

COUNTRY FOCUS

- **Bulgaria:** GDP growth gained momentum in the first quarter
- **Cyprus:** Successful tapping of international markets through a new 7Y issuance
- **Romania:** Front-loaded food VAT rate cut will push inflation in negative territory
- **Serbia:** Staff-level agreement with the IMF reached in the context of the SBA's first review

Recent rise in Bund and US Treasury yields weighs on regional bond markets
(change in yields, bps from end-March)



Source: Bloomberg, Reuters, Eurobank Research

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I. Regional Macroeconomic Developments & Outlook

First quarter GDP performance of the region surprised to the upside

The flash estimates of first quarter GDP growth rates spur optimism on full year growth prospects

The flash estimates of GDP growth contained an optimistic message for the full year growth prospects for a number of economies in the region. In most cases, growth accelerated both on a quarterly and yearly basis. The stronger than expected growth readings - some of them were the strongest in the post Lehman period- reinforces our view that growth prospects in the broader region are likely to be far better in 2015 than last year despite global economy concerns and ongoing headwinds from the crisis in Russia-Ukraine.

Consumer spending has taken over as the leading growth driver versus investments or net exports

Although there is no detailed breakdown yet, based on the analysis of high frequency indicators it would be fair to say that, in most cases, consumer spending has taken over as the leading growth driver versus investments or net exports. The revival of private spending, also mirrored in the strength of retail sales, is supported by robust real wage growth, improved consumer and business confidence as well as favorable labor market developments. Meanwhile, even though world energy prices have rebounded in recent months from their recent lows they are still much lower on a yearly basis. Lower energy costs continue to keep inflation pressures at bay, supporting real disposable incomes and provide more flexibility to household, corporate, and sovereign balance sheets. In addition, the region is well positioned to benefit from improving economic growth prospects in the Eurozone, the main trade partner and primary generator of capital flows for the region. In spite of the recession in Russia, exports are likely to benefit from the euro's recent depreciation trend because some sizeable portion of their export activity is headed towards non Euroarea neighboring countries. Yet the recovery of imports stemming from the rebound of domestic demand will probably cap net exports' positive contribution to growth.

Underinvestment is a key concern for the medium-term outlook of the region

Our key concern is whether regional economies will be able to generate self-sustained and more balanced growth once the impact of these temporary factors fades away. To achieve this as well as avoid a painful stagnation in the near future, it is essential to invigorate investments. In the majority of regional economies investment spending as percent of GDP has been on a downward trend since 2008. The currently available forecasts are not optimistic about their recovery in the short-term. Investments in the region are constrained by pre-crisis legacies, namely structural bottlenecks and high stock of NPLs.

Policy in the region will most probably remain accommodative in the period ahead

From a policy standpoint of view available degrees of freedom on the monetary and fiscal policy front vary across regional economies, depending on country-specific fundamentals and pre-crisis legacies. On balance, monetary policies are expected to remain accommodative, supported by the ongoing QE of ECB and the scaled back expectations of upcoming FED's rate hikes. In contrast, fiscal policy cannot be more growth supportive as governments need to adopt a more fiscally responsible stance in 2015, either as part of their multi-year commitments towards international lenders, and/or lax fiscal policies last year.

Cyprus registered the first positive quarterly and yearly growth performance after 14 consecutive quarters of negative growth

On a country by country basis, **Bulgaria** registered in Q1-2015 the strongest growth rate since Q2-2011 vindicating our expectations that, instead of slowing down, growth would gain momentum in 2015. Yet, structural reforms are urgently required in order for Bulgaria to speed up the convergence of living standards with EU-28 in the foreseeable future. The extraordinary first quarter growth performance - the highest in EU28 - makes **Romania** stand out of the pack for a second consecutive year. Robust real wage growth in private and public sector in tandem with improving sentiment and labor market tightening conditions appear to be fueling a revival of consumption spending. Surprising consensus analysts, NBR continued monetary easing delivering a double cut, one in the key rate (from 2.00% to 1.75%) and another one in local currency MRRs. **Cyprus** registered the first positive quarterly and yearly growth performance after 14 consecutive quarters of negative growth. Even though the economic recovery is fragile and subject to external downside risks, it is apparent that the successful implementation of the economic adjustment programme makes the Cypriot economy a visible turnaround paradigm. The recent tapping of international markets for the second time since June 2014 through a new 7Y issuance provides further evidence of that. **Serbia** is still mired in recession undermined by weak domestic demand and the lasting impact from last year's floods. Despite the challenges imposed by the fiscal consolidation, growth is likely to return to positive territory in the 2H helped by a reconstruction in investments and improved exports. The positive assessment from IMF on the precautionary agreements first review and the budget overperformance so far this year, provides room for further NBS monetary easing in a more predictable domestic environment

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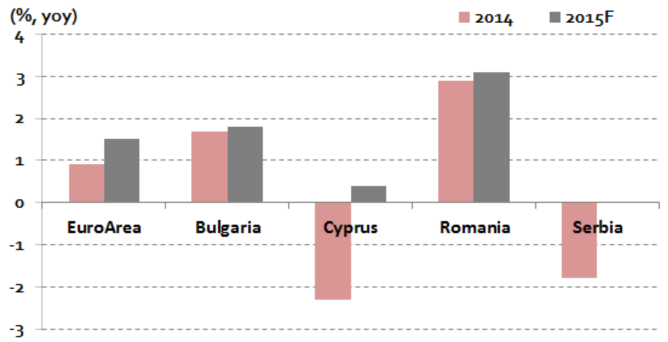
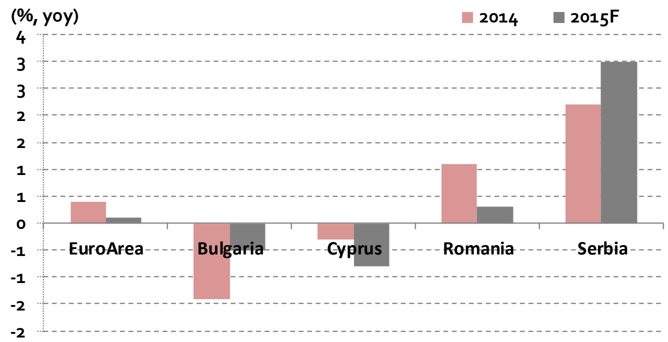
FIGURE 1: **Growth performance 2014 vs. 2015**



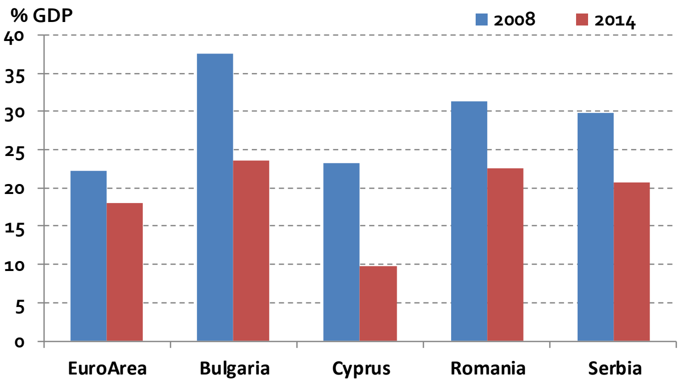
Source: Eurostat, National Authorities, Eurobank Research

FIGURE 2: **Annual average inflation 2014 vs. 2015**



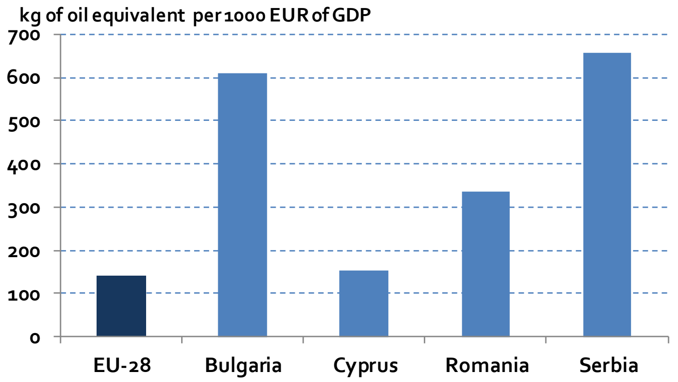
Source: Eurostat, National Authorities, Eurobank Research

FIGURE 3: **Investments to GDP ratios 2008 vs. 2014**



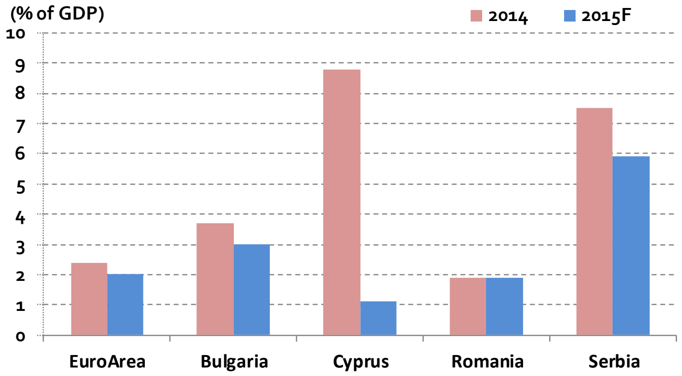
Source: IMF WEO, Eurobank Research

FIGURE 4: **Energy intensity of the individual countries, 2013**



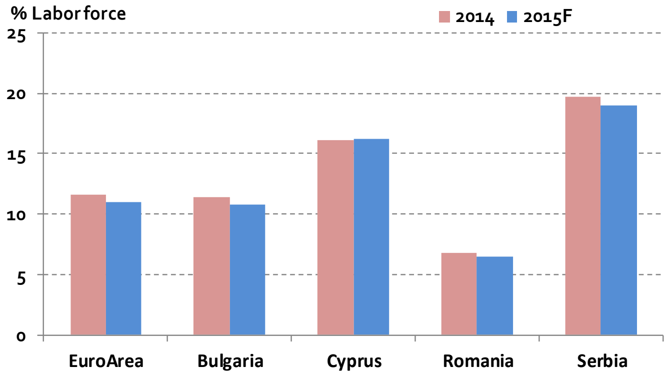
Source: Eurostat, National Authorities, Eurobank Research

FIGURE 5: **Fiscal Balance (% of GDP, ESA2010) 2014 vs. 2015**



Source: Eurostat, National Authorities, Eurobank Research

FIGURE 6: **Annual average unemployment rates 2014 vs.2015**



Source: Eurostat, National Authorities Eurobank Research

II. Regional Market Developments & Outlook

Regional currencies and bonds pressured by the recent rise in Bund and US Treasury yields

Emerging bourses remain underpinned by ECB's QE, scaled back Fed rate hike expectations and optimism about further stimulus measures in China

The expansion of the ECB's assets purchases programme has continued to favor regional and global stock markets alike over recent weeks. Additionally, low global oil prices and a benign inflation environment have allowed leeway to many Central Banks across the globe for significant monetary easing over recent months, underpinning respective equity markets. Providing an important breather to world bourses, expectations for a Fed rate hike have been somewhat scaled back lately following a recent streak of weaker-than-anticipated data from the US. Weak macroeconomic data recently released from China have stirred optimism about further stimulus measures by the country's authorities, largely overshadowing concerns over the prospects of the world's second largest economy. Against this backdrop, the MSCI Emerging Markets index has rallied approximately 7% since the end of March, standing ca 9% higher year to mid-May.

Regional stock markets stage a mixed performance

Regional stock markets have presented a rather mixed picture since late March. Being largely influenced by domestic developments, Serbia's BELEX 15 and Romania's BETI amassed respective gains to the tune of 8.5% and 6.0% over the last month or so, with the former recently standing within distance from a 4-year peak reached in mid-April and the latter hitting 7-year highs in early May. For the case of Serbia, the IMF agreement, sealed in February, and the improving fiscal position seem to have largely shifted investors' perceptions in favour of the country's assets. M&A activity and hefty rate cuts over recent months have also benefited domestic equities. In Romania, comparably strong growth dynamics and a Central Bank monetary easing bias appear to be supporting the domestic stock market. With relatively stronger trade and financial links, stock indices in Bulgaria and Cyprus have lost ground over recent weeks, possibly weighed down by market caution in view of the ongoing negotiations between the Greek government and the Institutions.

Regional currencies lately trimmed part of gains recorded so far this year

Regional currencies have lost some ground over the last few weeks, paring part of the gains recorded so far this year, on Central Bank monetary easing and uncertainty over developments in Greece as a final agreement between the government and the Institutions is still pending. The rise in Bunds and US Treasury yields since mid-April added to the negatives lately, though the recent US dollar's weakness has somewhat cushioned the impact. In more detail, the Romanian leu hit multi-month lows near 4.4665/EUR in mid-May. On the other hand, the Serbian dinar has remained range-bound around 120-121 against the euro over recent months in view of ongoing Central Bank interventions in the FX markets from either side of the aforementioned range. From a broader CESEE perspective, the TRY remains not far off a record low near 2.7430/USD hit in late April in view of mounting domestic political uncertainty ahead of the June general elections and rate-cut pressures on the Central Bank by high level officials. Ongoing external vulnerabilities compared to other economies in the region and looming Fed hikes also weigh on the domestic currency. In spite of a near 40% rebound since hitting a lifetime trough of 33/USD in February, the Ukrainian hryvnia continues to stand ca 30% weaker on a year-to-date (mid-May) basis on persisting geopolitical tensions.

Government bond yields rise trailing the recent sell-off in core Eurozone and US bond markets

The sell-off in core Eurozone T-bonds and US Treasuries since mid-April did not leave regional local bond markets unscathed. As a result, yields broadly pulled back from recent lows hit on the back of benign inflation pressures in the region and hefty Central Bank monetary easing over the last few months. Indicatively, Romania's 10-year benchmark bond yield has risen by ca 40bps since the end of March to a multi-month high near 3.7% and Bulgaria's inched up some 15bps over the same period to stand around 2.55% in mid-May. Notwithstanding the aforementioned, it is worth noting that regional bond markets have proved relatively resilient to previous similar episodes of heightened risk aversion thanks to improving domestic fundamentals. With the recent Bund/USTs sell-off appearing to have been rather overstretched, an eventual correction in regional yields is on the cards in the weeks ahead.

ECB's QE to continue providing support to regional asset markets but risks linger

Looking ahead, we continue to anticipate that the ECB's QE will provide further support to regional asset markets. With several Central Banks in the region now close to the end of their monetary easing cycle, depreciation pressures on regional currencies may gradually wane. Main risks to our view lie on a faster than expected recovery in the US economy, which may precipitate the inception of the Fed's rate-tightening cycle, and slower growth dynamics in the Eurozone, the region's main trade partner. Prolonged uncertainty over the Greek issue and downbeat data from China being translated as global growth concerns, rather than optimism about new economic stimulus ahead, may also weigh.

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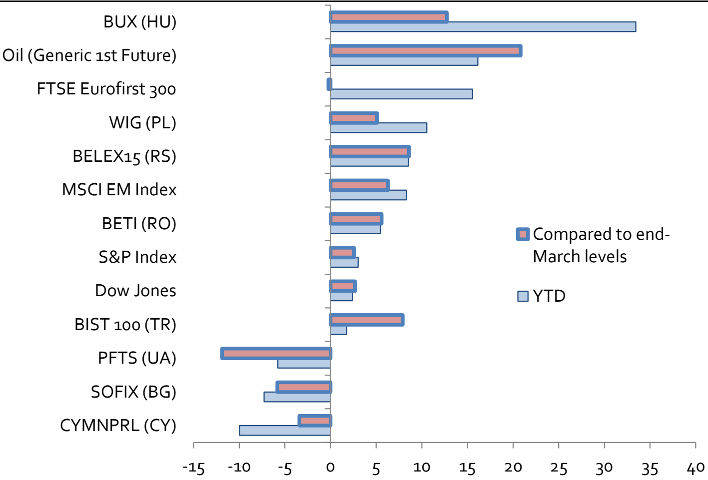
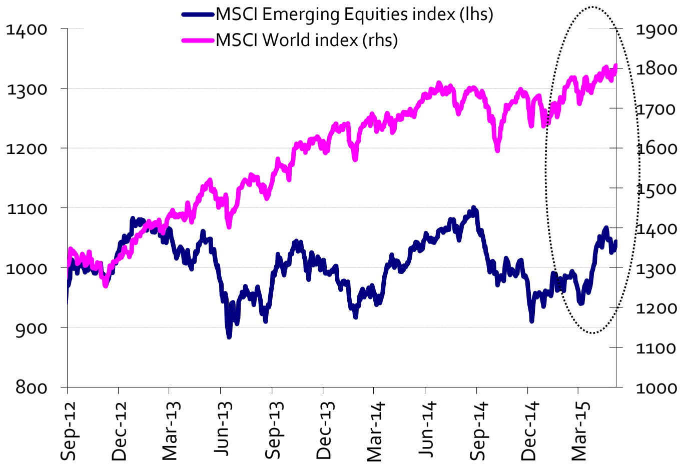
FIGURE 7: **Major world & CESEE stock markets performance (%)**



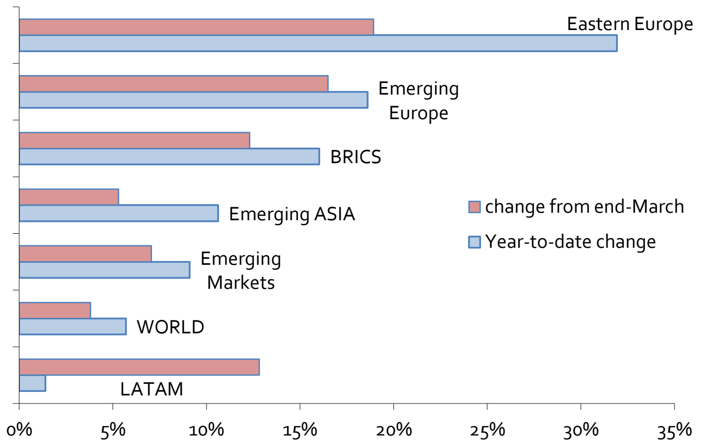
Source: Reuters, Bloomberg, Eurobank Research

FIGURE 8: **World & CESEE stock markets YTD performance**



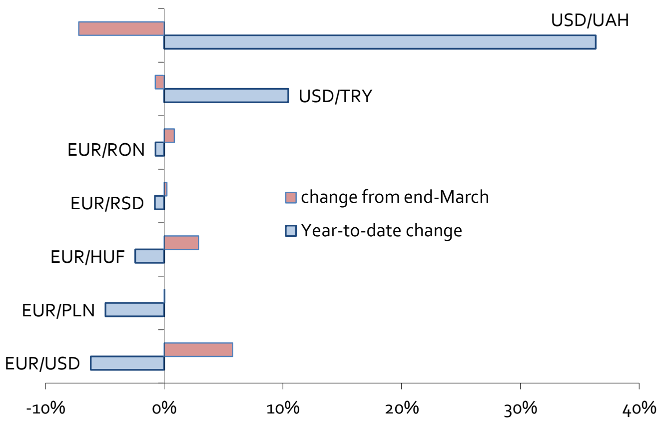
Source: Reuters, Bloomberg, Eurobank Research

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



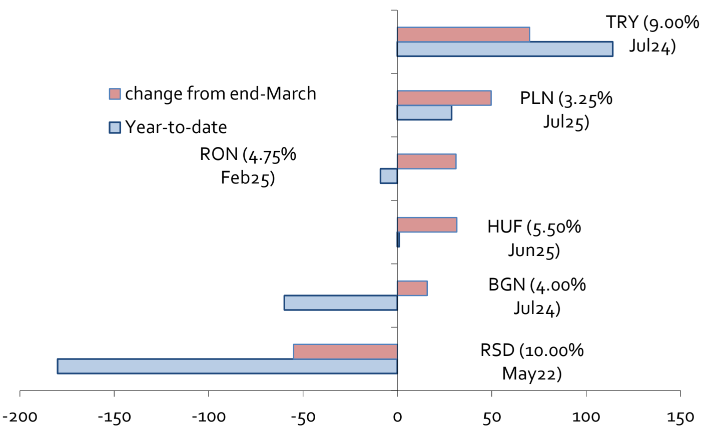
Source: Reuters, Bloomberg, Eurobank Research

FIGURE 10: **CESEE FX performance**



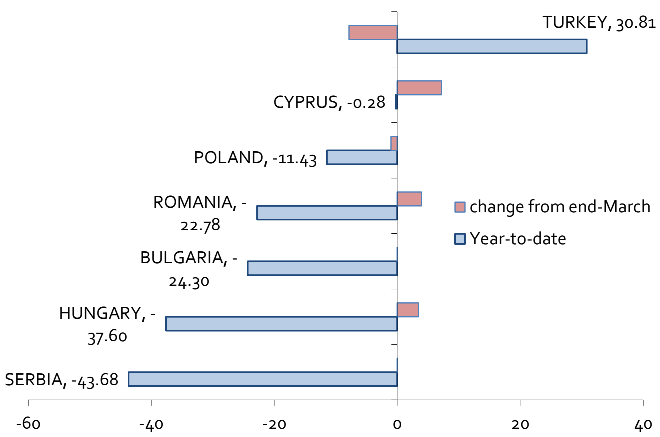
Source: Reuters, Bloomberg, Eurobank Research

FIGURE 11: **Change in CESEE government bond yields (in bps)**



Source: Reuters, Bloomberg, Eurobank Research

FIGURE 12: **Change in 5-Year CDS spreads (in bps)**



Source: Reuters, Bloomberg, Eurobank Research

Trader's view

FX

Buy the EUR/RSD on dips

As has been the case for some time now, the Serbian dinar remained bound within 120.00-121.20 against the euro over the last month or so, in view of repeated Central Bank interventions on either side of the aforementioned range. Against this backdrop, we anticipate range-trading to continue around these levels in the weeks ahead and favor buying the EUR/RSD on dips. A breach above the upper bound of the said range currently appears more likely than the lower as the Central Bank has already shown its determination when it comes to keeping the floor at 120.00 (bought €400mn so far in 2015). Also, in view of a light RSD-denominated government bond auction calendar over recent weeks, euro supply from abroad may gradually decrease.

Local Rates

Short-to-medium term Romanian government bonds appear to provide pockets of opportunity

Security	Position	Entry	Carry	Target	Stop loss	Comments
ROMGB 5.6% November 2018	Long	2.20%	+130bps	1.70%	2. 50%	financed via 1M EUR/RON rolling swap (currently implied rate around 0.90%

Romania's Central Bank (NBR) cut its key policy rate by 25bps to a new record low of 1.75% at its MPC meeting in May, also reducing by 200bps the minimum required reserves ratio for RON liabilities to 8%. Further monetary easing may follow later in the year and the NBR will likely maintain excess RON liquidity in the money market, keeping short term RON rates below 1% for the following months. In response, RON-denominated bonds, particularly those of short-to-medium term maturity are likely to benefit and the significant steepness in this segment of the yield curve appears to provide pockets of trade opportunities. Note that the November 2018 yield currently stands around 40bps higher than that of the June 2017, suggesting that the former will likely outperform in the short-term. Positioning is also favorable, as foreign market participants appear to be mainly invested in bonds of longer maturity (8-10 year), which makes the November 2018 less vulnerable to externally driven sell-offs. We do not recommend FX unhedged exposure to the local bonds, as the leu remains vulnerable to external developments.

Bulgarian sovereign bonds to recover, once the situation in global bond markets stabilizes

Bulgarian government bonds came under pressure over the last few weeks, trailing the recent sell-off in US and core Eurozone paper. Positively, Bulgarian Eurobonds managed to eventually stabilize and swap spreads tightened compared to their levels a month ago, in an indication that investors remain constructive on the country's assets. Taking into account the recent improvement in budget performance, we expect Bulgarian paper to recover notably once the situation in global bond markets stabilizes. Domestic risks are skewed to the upside as Q1 2015 GDP data revealed that annual growth unexpectedly posted the strongest increase in 4 years.

Bulgarian stock market appears attractive

On the back of the aforementioned rather positive local developments in Bulgaria, we are quite surprised with the recent underperformance of the domestic stock market. Albeit main benchmarks are losing ground, turnovers remain very scarce suggesting that the market could easily change its direction. Therefore, we see current levels as an attractive entry opportunity for both short-term and long-term investors.

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III. Country Focus

Bulgaria (Baa2/BB+/BBB-)

GDP growth gained momentum in the first quarter

First Quarter GDP growth performance surprised to the upside

The economy picked up pace in Q1-2015, growing at the strongest annual rate since Q2-2011. In more detail, real GDP growth expanded by 0.9%QoQ/+2.0%YoY in Q1-2015, up from +0.4%QoQ/+1.3%YoY in Q4-2014 and +0.1%QoQ/+1.5%YoY in Q1-2014.Final consumption appeared weak -0.6%QoQ/+0.6%YoY, slowing down from +0.3% QoQ /+3.3%YoY in Q1-2014. The latter is explained to some extent by the high base of Q1-2014 but also from the negative contribution of public consumption as fiscal consolidation started taking hold. The performance of investments was mediocre for yet another quarter, as gross fixed capital formation grew by +0.4%QoQ/+2.6%YoY in Q1-2015, down from +1.1%QoQ/+4.8%YoY in Q1-2014. Net exports appeared to have made a strong positive contribution. The latter reflects the external environment improvement stemming from the better than anticipated Eurozone growth performance but also the terms of trade gains versus non-Euroarea partners from the devaluation trend of the Euro to which Lev is pegged. Lower input costs also helped as energy prices were down on a yearly basis, which implies huge gains, given that Bulgaria has the highest energy intensity in EU-28. Exports impressed accelerating by +1.2%QoQ/+9.1%YoY in Q1-2015, up from +8.3% qoq/+5.4% yoy in Q4-2014 vs. -2.2%QoQ/+2.1%YoY in Q1-2014. Meanwhile, imports came at +0.1%QoQ/+4.9%YoY in Q1-2015 down from +4.6%QoQ/+7.5%YoY in Q4-2014 vs. +2.6%QoQ/+5.5%YoY in Q1-2014.

Structural reforms are urgently needed to accelerate living standards convergence with EU-28

All in all, the first quarter growth performance exceeded market expectations. Yet, the reading is closer to our full year growth forecast-currently at 1.8%, vindicating our expectations that domestic economic activity would gain momentum in 2015 instead of slowing down. Overall, the growth rebound would have been much higher had it not been for the financial sector turbulence in the 2H-2014. However, we note that structural reforms are urgently needed to accelerate living standards convergence with EU-28. The GDP per capita, in PPS terms, stood at 45% of the average EU-28 in 2013, almost unchanged compared to 2008, remaining the lowest among EU members. In any case, growth in Bulgaria has been lackluster in the aftermath of the international crisis in 2008-2009. Bulgaria capitalized on its strong fiscal position and buffers to avoid a deep prolonged recession, but recovery ever since has been extremely slow. Even after the revision of last year's data, the average GDP growth stood at 0.9% in 2010-2013, a low gear rebound from the -5.5% output contraction recorded in 2009 and significantly lower than the 6.5% recorded in 2004-2007

Fiscal performance in Q1 downplays concerns on tax revenues
.

The budget execution of the first quarter creates optimism that the full year fiscal deficit target - set at 3% of GDP, in cash terms, will be achieved comfortably. The general government surplus has widened further to 1.2% of projected GDP in Jan-April 2015, up from +0.4% of GDP in Jan-March 2015 and -1.1% of GDP in Jan-March 2014. Total revenues expanded by 15.2% yoy in Q1-15 driven by higher VAT revenues (+ 21.8%YoY) and excises (11.1%YoY). On the other hand, total expenditures reached +3.5%YoY as the most important items-public wages, pensions and procurement-remained broadly flat on an annual basis in nominal terms at +0.2%, +0.7 and +0.5% respectively. The fiscal deficit in cash terms widened to 3.8% of GDP in 2014 up from 1.8% in 2013 surpassing the Maastricht threshold for the first time since 2010, primarily reflecting spending slippages from the electoral cycle and the bail-out costs from the banking sector. Accordingly, the general government gross debt increased from 18.6% at end 2013 to 27.7% of GDP at end 2014, inching higher to 29.5% of projected GDP in Q1 2015.The fiscal reserve stood at BGN 11.1bn in Q1-2015 up from BGN 8.1bn at end 2014.

Inflation turned positive in March & April for the first time in the last 19 months.

Inflation registered the first positive yearly readings in March (+0.3%MoM/+0.1%YoY) and April (+0.7%MoM/+0.5%YoY) since August 2013. Thanks to higher fruit and vegetable prices as a result of the severe flooding earlier this year, the deflation of the food component in the consumer basket (35% weight) has turned into inflation in March and April adding 0.2pps and 0.5pps in the yearly CPI respectively. In addition, energy inflation decelerated in March and April as a result of the world energy prices rebound in Q1 (liquid fuels decelerated from -24% yoy in last January down to -11.2% yoy in April). On top, the electricity prices hikes which came into effect last October are also positive contributors to inflation. In any case, despite the volatility in energy and food prices, core prices are still set to remain in negative territory (-0.4% yoy in March down from -1.1% yoy in December) keeping inflation subdued during 2015 as well.

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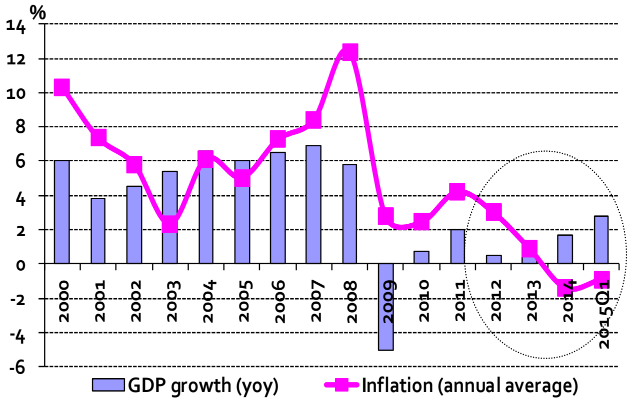
Bulgaria: Macro & Market Data				
	2012	2013	2014	2015f
Real GDP (yoy%)	0.5	1.1	1.7	1.8
Final Consumption	2.9	-1.3	2.4	2.5
Gross Capital Formation *(Fixed)*	2.0	-0.1	2.8	1.5
Exports	0.8	9.2	2.2	3.0
Imports	4.5	4.9	3.8	2.0
Inflation (yoy%)				
CPI (annual average)	3.0	0.9	-1.4	-0.5
CPI (end of period)	4.2	-1.6	-0.9	0.3
Fiscal Accounts (%GDP) - *Cash Basis*				
General Government Balance	-0.4	-1.8	-3.7	-3.0
Gross Public Debt	18.3	18.6	27.7	31.0
Primary Balance	0.3	-1.0	-3.0	-2.5
Labor Statistics				
Unemployment Rate (LFS, %)	12.3	12.9	11.4	10.8
Wage Growth *(total economy)*	6.6	6.0	6.8	2.8
External Accounts				
Current Account (% GDP)	-1.1	1.0	0.9	0.5
Net FDI (EUR bn)	1.1	1.4	1.3	1.5
FDI / Current Account (%)	284.3	Na	Na	Na
FX Reserves (EUR bn)	15.5	14.4	16.5	18.0
Domestic Credit	**2012**	**2013**	**2014**	**Q1-2015**
Total Credit (%GDP)	72.3	72.9	67.7	65.9
Credit to Enterprises (%GDP)	47.7	47.7	41.8	41.1
Credit to Households (%GDP)	23.0	23.0	22.3	22.1
FX Credit/Total Credit (%)	64.0	60.9	57.0	55.9
Private Sector Credit (yoy)	3.8	0.6	-6.7	-7.5
Loans to Deposits (%)	99.4	92.1	84.2	86.4
Financial Markets	**Current**	**3M**	**6M**	**12M**
Policy Rate		Currency Board		
EUR/BGN	1.96	1.96	1.96	1.96

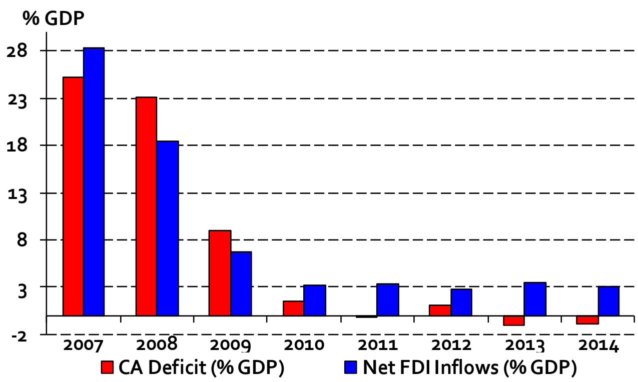
Source: National Sources, Eurostat, IMF, Eurobank Research

FIGURE 13: **GDP growth & Inflation 2000-2015**



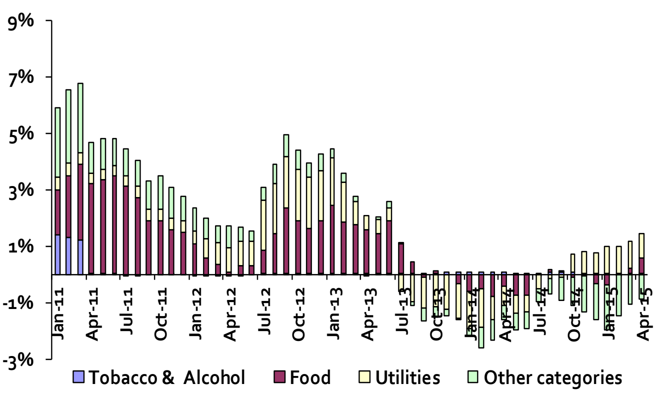
Source: National statistics, Ecowin Reuters, Eurobank Research

FIGURE 14: **CA Deficit & Net FDI inflows 2007-2014**



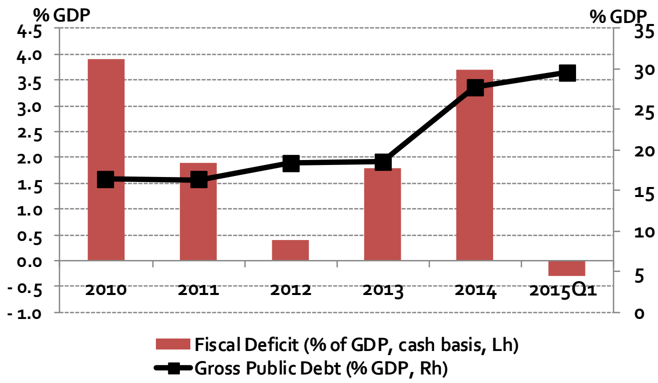
Source: National statistics, Ecowin Reuters, Eurobank Research

FIGURE 15: **Inflation dynamics 2011-2015**



Source: National statistics, Ecowin Reuters, Eurobank Research

FIGURE 16: **Fiscal deficit & Gross Public Debt 2010-2015**



Source: Eurostat, Eurobank Research

Cyprus ((P)B3/B+/B-)

Successful tapping of international markets through a new 7Y issuance

Cyprus tapped international bond markets for the second time since June2014

On April 28th, Cyprus raised €1bn selling a new 7Y bond at a yield of 4.00%. This is the second time Cyprus tapped international markets since June 2014, when it raised €750mn issuing a new 5Y bond at a yield of 4.85%. Financial market perceptions have improved dramatically after June 2013. The strong declining trend of the long term bond yields continued in Q1-2015 enabling Cyprus to make a faster come-back to the markets. Driven by swifter than expected macroeconomic outcomes plus the ECB's QE, long term bond yields dropped below 4% for the first time since 2011. The progress was also mirrored in the assessment of rating agencies. In late March, S&P revised the outlook on the Republic of Cyprus to positive from stable. The revision comes after the rating agency upgraded the sovereign rating from B to B+ on October 24th, 2014. According to the Ministry of Finance, the auction proceeds will be utilized to repay costlier short-term domestic borrowing, which in turn will result in a further improvement of the public debt profile. The weighted average maturity increased to 8 years in Q4-2014 up from 4.7 years in Q4-2012.The weighted average debt servicing cost amounted to 2.9% in Q3-2014 down from 4.2% in 2012.

The long delayed endorsement of the insolvency framework by the parliament puts the program back on track

On April 18th, the parliament of Cyprus endorsed the new corporate and personal insolvency framework with a majority of 33 votes in favor and 23 against. The insolvency framework, a set of bills complementary to the foreclosures legislation, is designed to balance borrowers' rights with their obligations to lenders, offering them protection from foreclosure under certain circumstances. The foreclosures bill was adopted last September but its implementation was conditional on the adoption of the new insolvency framework. The contentious deliberations in the adoption of the insolvency framework may have helped cushion political reactions within the parliament, but has also put the program temporarily off-track. The endorsement of the new insolvency framework is a very important step in the Cypriot programme. Together with the implementation of the foreclosures law, it will pave the way for the successful completion of the combined fifth and sixth review of the program. Cyprus has already completed 4 reviews successfully and made use of about €5.75 bn of funds disbursed under the program by the IMF & ESM. In addition, the legislation will allow Cyprus to benefit from the ECB QE program. Even though the size of the bond buy-backs seems not to exceed €500mn, it still represents a sizeable proportion of the outstanding stock (around 25%).

The efficient implementation of the asset repossession framework will allow for a speedier economic recovery

More importantly, the new framework will put the incentives in place allowing for a speedier cleanup of the banking sector balance sheets. Addressing the complicated issue of non-performing loans is of high systemic priority. Non-performing loans reached 47.5% in 2014 and originate from the downturn of the real estate market (mortgage or construction loans). This is the third highest ratio in recent history after Ukraine (1998) and Iceland (2008) and is still not entirely justified by the deterioration in economic activity and the subsequent rise in unemployment and the disposable income adjustment. The latter implies that a number of strategic defaulters have emerged primarily as a result of the bail-in events. The high levels of NPLs deters banks from extending new lending, thus leading to a more prolonged period of limited credit supply and hinders economic recovery. As a result, it creates distortions in the economy, because resources are trapped in unproductive assets.

The economy recorded the first positive growth rate on a quarterly and yearly basis since Q2-2011

In Q1-2015, Cyprus recorded the first positive growth rate on a quarterly and yearly basis since Q2-2011. GDP growth expanded by +1.6% qoq/+0.2% yoy in Q1-2015 up from -0.4% qoq/-1.8% yoy in Q4-2014 vs. -0.4% qoq/-3.2% yoy in Q1-2014. Even though the reading is marginally positive, it is still a tangible sign of a turnaround in the making. Sentiment has been on an improving trend, recovering towards pre-Lehman era levels (ESI April 2015: 107.3). In addition, capital controls have been fully lifted as a result of the confidence coming back to the financial sector. Moreover, the fiscal and external accounts adjustment is impressive by any standards of comparison. We reiterate our view of flat or marginally positive growth in 2015, yet the risks are heavily skewed to the downside. The main source of concern stems from the external sector headwinds. The negative spillovers from the unfolding recession in Russia and the Russia-Ukraine conflict cast shadow on the official projections of the external sector variables. In addition, the ongoing private sector deleveraging and the fiscal consolidation threatens to maintain domestic demand's contribution to growth slightly negative.

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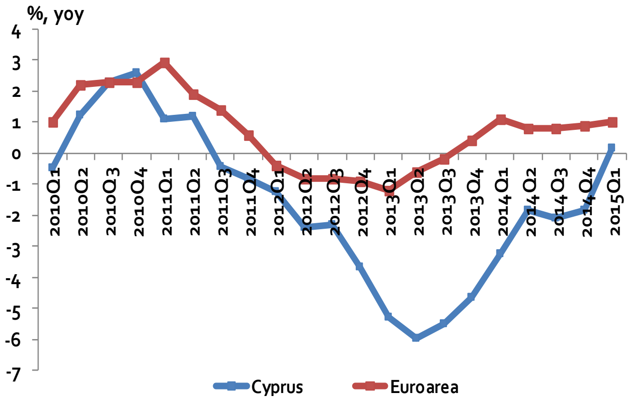
Cyprus: Macro & Market Data	2012	2013	2014	2015f
Real GDP (yoy%)	-2.4	-5.4	-2.8	0.4
Private Consumption	-0.7	-6.0	-1.2	-0.5
Public Consumption	-2.7	-4.9	-4.7	-0.9
Gross Capital Formation *(Fixed)*	-20.7	-17.1	-11.1	-1.6
Exports	-1.7	-5.0	0.3	2.0
Imports	-4.6	-13.6	-0.5	-0.1
Inflation (yoy%)				
HICP (annual average)	3.1	0.4	-0.3	-0.8
HICP (end of period)	1.5	-1.3	-1.0	-0.5
Fiscal Accounts (%GDP) - *ESA2010*				
General Government Balance	-5.8	-4.9	-8.8	-1.1
Gross Public Debt	79.5	102.2	107.5	106.7
Primary Balance	-2.9	-1.8	-6.0	1.7
Labor Statistics				
Unemployment Rate (LFS, %)	11.9	15.9	16.1	16.2
Wage Growth *(total economy)*	-0.8	-6.0	-4.7	-0.2
External Accounts				
Current Account (% GDP)	-6.3	-3.0	-5.1	-3.9
Net FDI (EUR bn)	1.2	0.2	1.1	0.7
FDI / Current Account (%)	98%	55%	127%	104%
Domestic Credit	**2011**	**2012**	**2013**	**2014**
Total Credit (%GDP)	351.4	373.5	351.4	356.0
Credit to Enterprises (%GDP)	159.5	171.1	160.2	150.1
Credit to Households (%GDP)	138.8	138.9	140.0	143.5
Private Sector Credit (yoy)	4.8%	-0.5%	-6.0%	-3.2%
Loans to Deposits (%)	98.9%	103.3%	135.3%	133.5%

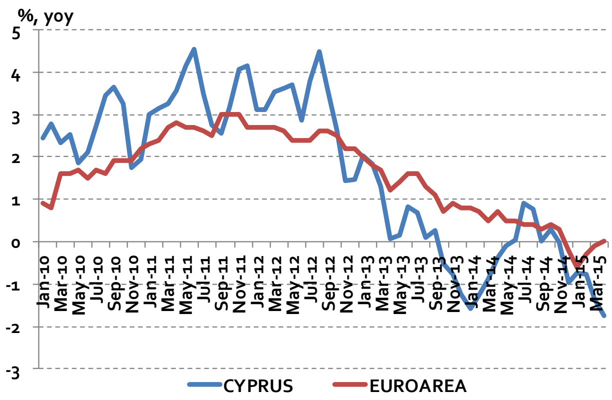
Source: National Sources, Eurostat, IMF, Eurobank Research

FIGURE 17: **Growth performance Cyprus vs. Euroarea 2010-2015**



Source: Eurostat, Eurobank Research

FIGURE 18: **HICP Cyprus vs. Euroarea 2010-2015**

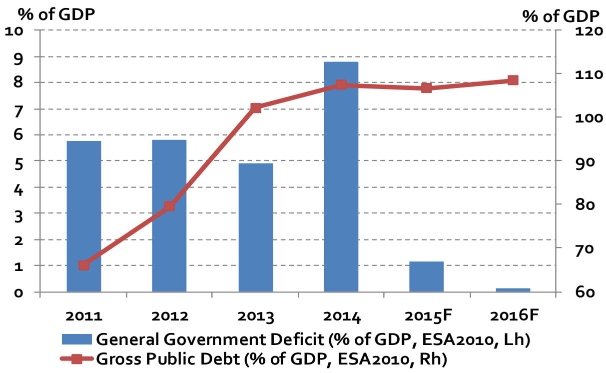


Source: Eurostat, Eurobank Research

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

Source: Bloomberg, Eurobank Research

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



Source: Eurostat, Eurobank Research

Romania (Baa3/BBB-/BBB-)

Front-loaded food VAT rate cut will push inflation in negative territory

The government decided to implement the VAT rate cut for food earlier than scheduled

The government decided to cut the VAT rate for food from 24% to 9% effective from June 1st, six months ahead of schedule. The government argued that there is enough fiscal space to do so already during 2015, citing the budget performance in Q1. The government plans offsetting the impact from lower VAT revenues with increased revenue from the subsequent domestic demand boost, improved tax compliance and lower public infrastructure spending. The decision is part of the broader tax reform package endorsed in last April. Among other clauses, the package foresees a cut of the main VAT rate from 24% to 20% in 2016. In principle, the VAT rate cut favors consumption, crowding out public investment, with negative implications for potential growth, adding to concerns that fiscal policy is going to be eased once in an election year without international creditors consent. A much looser fiscal stance over the medium term poses a downside risk on public finances, which is credit negative from a rating agencies point of view. Meanwhile, the fiscal deficit target in 2015 has been agreed with official lenders at 1.8% of GDP in cash terms (1.4% of GDP in ESA terms), almost flat versus the outcome of 2014.

The front-loaded food VAT rate cut will push inflation into negative territory

The VAT cut for all food products is a strong argument for revising the inflation outlook of the next twelve months. Given the high share of food products in the consumption basket (32%), inflation is now expected to slip and remain into negative territory for most of the 2H-2015 and marginally above zero in the 1H-2016. Although inflation moved a bit higher from 0.4% in February to 0.8% in March and further down to 0.7% in April, it will most likely end slightly above zero at 0.2% yoy in next December under the assumption of a partial pass-through of the VAT rate cut, yet significantly below the lower bound of NBR target interval (2.5%±1%).

NBR surprised with a rate cut in early May bringing down the key policy rate to 1.75% and lowered local currency MRRs down to 8%

The 25bps rate cut last March, before the announcement of the VAT change, was widely anticipated to be the last of this easing cycle. Yet, NBR decided to lower the key policy rate by 25bps down to 1.75% on May 6th taking the market aback. The majority of analysts were expecting interest rates to remain unchanged (17 out of 21) in the Bloomberg survey. Instead, the shift of focus towards the use of MRRs was widely anticipated. From that point of view, NBR lowered minimum reserve requirements by 2pps at 8% for RON and maintained those for FX denominated liabilities at 14% unchanged. At the same time, NBR in an attempt to further strengthen the monetary policy transmission mechanism, lowered the Lombard rate by another 50bps down to 3.25% and maintained the deposit rate unchanged at 0.25%. As a result, the interest rate corridor narrowed down to 1.75%.

We anticipate NBR to terminate the current easing cycle at 1.5% and remain on hold in the coming months looking beyond the fiscally induced supply side shock

Surprisingly, there was no forward guidance provided in the interview but the NBR Governor Mr. Isarescu commented that any rate action would be data dependent. At this point, the real interest rate differential is still positive versus other regional peers, which allows for more flexibility on the issue of future rate setting. Taking into account that NBR appears to feel comfortable with a lower level of real interest rates compared to the past (1% vs. 2.5% on an ex-post basis) and the persistent negative output gap, ceteris paribus, some room for additional rate cuts is created. In addition, the impact from ECB's QE and the complacency for an imminent FED's hike minimized concerns about external environment variables. That is why we have revised our forecast for the terminal monetary easing policy rate down to 1.50%. After reaching that level, we still anticipate NBR to adopt a more prudent stance that looks beyond the fiscally induced supply side shock. In our view, NBR will most likely remain on hold in the coming months, given the downside risks from the ambitious fiscal easing plan, and that output growth will most probably have reached its potential in 2016.

The extraordinary output performance of Q1 is driven by sustained improvement in private spending

According to the flash estimate, GDP expanded by +1.6%QoQ/+4.3%YoY in Q1-2015 up from +1%QoQ/+2.7%YoY in Q4-2014 largely exceeding consensus expectations (+0.6%QoQ/+2.6%YoY). Although there is no breakdown at the moment, it is evident from high-frequency indicators analysis that consumer spending has taken over as the leading growth driver. Sustained improvement in private spending is supported by robust real wage growth (broad-based gains in both private and public sectors), improved consumer sentiment and labor market tightening. Wages accelerated by 7.2%YoY in March, the highest rate in the last three years. Subtracting for inflation, real wage growth stood at 6.4% yoy in March. The economic sentiment index (ESI) has been climbing in the recent months touching over a new post-Lehman period high at 103.0 in April. Lastly, total employment increased by 110k on a yearly basis in February. The key question arising is to what degree investments have contributed to this extraordinary performance as well. All in all, the extraordinary performance of Q1 prompts us to upgrade our full year growth forecast of 2015 from 2.7% to 3.1%.

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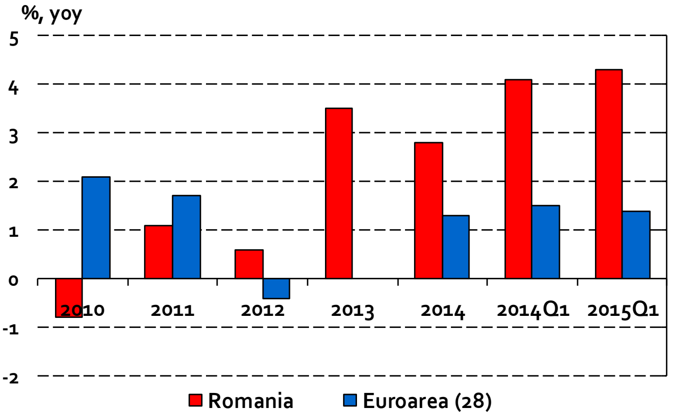
Romania: Macro & Market Data				
	2012	2013	2014	2015f
Real GDP (yoy%)	0.6	3.4	2.9	3.1
Consumption	1.0	0.4	3.0	4.2
Investment	0.1	-7.9	-3.6	2.0
Exports	1.0	16.2	3.5	5.5
Imports	-1.8	4.2	7.7	6.5
Inflation (yoy%)				
CPI (annual average)	3.3	4.0	1.1	0.3
CPI (end of period)	5.0	1.6	0.8	0.2
Fiscal Accounts (%GDP, Cash Basis)				
General Government Balance	-3.0	-2.2	-1.9	-1.9
Gross Public Debt (including guarantees)	37.3	37.9	39.5	39.1
Labor Statistics (annual avg,%)				
Unemployment Rate (ILO, % of labor force)	6.9	7.1	6.8	6.5
Wage Growth (total economy)	4.2	4.8	5.3	3.5
External Accounts				
Current Account (%GDP, BPM5)	-4.5	-0.8	-0.4	-1.0
Net FDI (EUR bn)	2.4	2.9	2.5	3.0
FDI / Current Account (%)	39.6	250.1	385.0	187.0
FX Reserves (EUR bn)	35.4	35.4	35.5	35.0
Domestic Credit *(end of period)*	**2011**	**2012**	**2013**	**2014**
Total Credit (%GDP)	52.7	52.0	47.0	44.4
Credit to Enterprises (%GDP)	20.7	20.3	18.0	15.7
Credit to Households (%GDP)	18.7	17.8	16.5	15.4
FX Credit/Total Credit (%, private)	63.4	62.5	60.9	56.2
Private Sector Credit (yoy)	6.6	1.3	-3.3	-3.1
Loans to Deposits (%)	142.5	133.9	118.4	106.3
Financial Markets	**Current**	**3M**	**6M**	**12M**
Policy Rate	1.75	1.50	1.50	1.50
EUR/RON	4.44	4.45	4.45	4.40

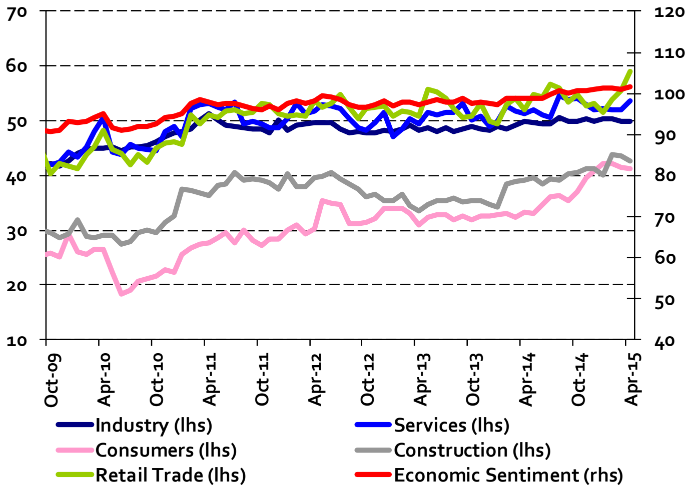
Source: National Authorities, EC, IMF, Eurobank Research

FIGURE 21: **Growth rates Romania vs. EU - 28 2005-2014**



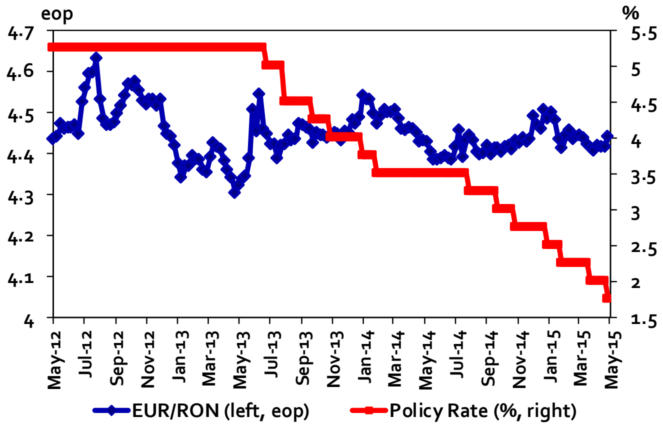
Source: Eurostat, Eurobank Research

FIGURE 22: **Sentiment indicators 2009-2015**



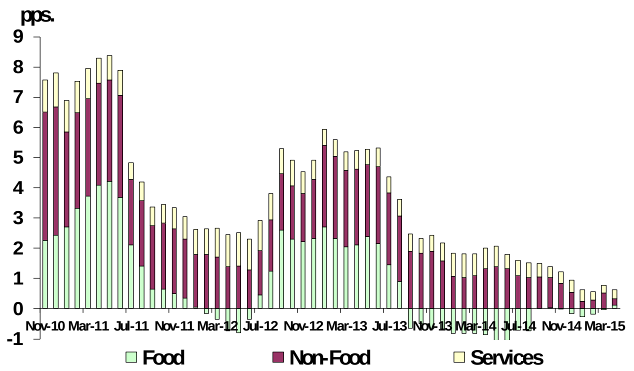
Source: Eurostat, Ecowin Reuters, Eurobank Research

FIGURE 23: **Monetary policy & FX rate 2012-2015**



Source: Bloomberg, Eurobank Research

FIGURE 24: **Inflation components 2010-2015**



Source: National statistics, Eurobank Research

Serbia (B1/BB-/B+)

Staff-level agreement with the IMF reached in the context of the SBA's first review

Economic contraction in real GDP growth slightly deepened in Q1 2015

The annual rate of contraction in real GDP growth slightly deepened in Q1 2015, with economic activity shrinking by 1.9%YoY, following a decline of 1.8%YoY registered a quarter earlier, as well as in FY2014. With QoQ data and a detailed breakdown not yet available, the main culprits of this aforementioned marginal deterioration in economic activity appear to be base effects and weak domestic consumption. The latter is confirmed by Q1 2015 high frequency indicators, such as real wage and retail sales data, which reflect the impact of recently endorsed fiscal consolidation measures. Yet, the recent contraction in industrial production appears to be gradually abating since late last year.

A return into positive annual growth rates in H2 2015 is likely

A return into positive annual growth rates in H215 is likely, thanks to a projected recovery in investments, driven by a more favourable business environment in view of the IMF programme agreement, low global oil prices and base effects. An eventual improvement in net exports' contribution will also provide support, against a backdrop of recovering growth in main trade partner economies, while austerity measures weigh on imports. Private and public consumption are envisioned to remain constrained by ongoing fiscal tightening, tipping the scale towards flat GDP growth for the whole of the year. A further rebound in domestic economic activity is likely from 2016 onwards, as the negative impact of austerity measures gradually wanes and structural reforms pave the way for a more sustainable growth pattern.

Early 2015 fiscal data suggest significant budget outperformance so far this year

Upon the conclusion of a 2-week visit to Serbia under the country's 3-year €1.2bn precautionary Stand-By Arrangement, the IMF said in a statement in May that the mission reached a staff-level agreement with domestic authorities on the set of policies needed to complete the programme's first review. The completion is subject to a final approval by the Fund's Management and the Executive Board in late June, and will make about €146mn available for disbursement, though the government is unlikely to draw any of the SBA's available funds. As noted in the said statement the budget performance in Q1 2015 was "fully in line with the programme targets". Indeed, the adopted austerity measures are already bearing fruit, with Prime Minister Aleksandar Vucic recently expressing belief that the fiscal deficit for the first four months of 2015 would come in at RSD 21bn (€180mn), vs. a RSD 71bn (€590mn) shortfall planned in the budget. In view of this outperformance in budgetary targets so far this year, the government has signaled its intention to seek some softening of the terms attached to the IMF agreement. An example may be a request for a delay in the implementation, or a lesser rise, of a 15% hike in electricity prices, already deferred from April to June. Moreover, the Prime Minister recently signaled that the government plans to begin in August negotiations with the IMF over potential increases in civil servants wages and pensions, which, he added, may come into effect as early as October. It is rather questionable whether the IMF will agree in such a swift reversal of recently adopted reforms, at least this early in the program. Furthermore, the slow progress in other areas of the programme, such as on the restructuring of unprofitable state utilities' companies as well as the sale, or closure, of some 500 loss-making state-owned organisations also argues against a positive IMF nod.

NBS further reduces interest rates in view of subdued inflation pressures

In spite of a recent uptick in HICP from January's historical lows of 0.1%YoY, the Central Bank (NBS) delivered three consecutive rate cuts of 50bps in monetary policy meetings in March, April and May, pushing the key policy rate (KPR) to a new record low of 6.50%. The last two announcements took the markets aback, confounding investor expectations that the NBS would stay put on its monetary policy. In addition, the NBS also narrowed the corridor of interest rates set in reference to the key policy rate from ± 2.5% to ± 2.0% in an effort to help stabilise interest rates in the interbank money market. Justifying its decisions, it highlighted that inflation remains below the lower bound of the 4±1.5% target tolerance band (HICP at 1.8%YoY in April), price pressures are persistently subdued, and inflation expectations declined further over recent months while domestic demand dynamics remain weak. Investor sentiment towards Serbia also appears to have significantly improved in the aftermath of the IMF agreement, while the Fund has also signaled its support towards gradual monetary easing ahead in order to support the domestic economic recovery. Further monetary easing ahead cannot be ruled out, especially if inflation keeps undershooting expectations. However, the room for such action is limited and any such moves are likely to be of measured size amid lingering external uncertainties and fiscal consolidation risks. Also, the KPR has rather limited potential to stimulate credit (ca 70% of loans are EUR-linked). The risk of the key policy rate being reduced to levels below 6.00%, is present, though such hefty easing may weigh on the local bond markets.

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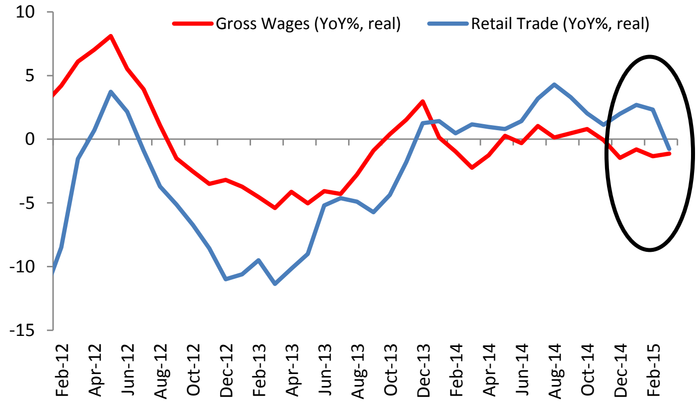
Serbia: Eurobank Forecasts				
	2012	2013	2014	2015
Real GDP (yoy%)	-1.0	2.6	-1.8	0.0
Inflation (yoy%)				
CPI (annual average)	7.3	7.9	2.2	3.0
CPI (end of period)	12.2	2.2	1.7	4.2
Fiscal Accounts (%GDP)				
Consolidated Government Deficit	-7.2	-5.6	-7.5	-5.9
Gross Public Debt	58.3	61.4	69.9	76.4
Labor Statistics (%)				
Unemployment Rate (%of labor force, ILO)	24.6	23.0	19.7	19.0
Wage Growth *(total economy)*	8.9	5.7	1.2	0.0
External Accounts				
Current Account (% GDP)	-11.5	-6.1	-6.1	-4.7
Net FDI (EUR bn)	0.8	1.3	1.2	1.5
FDI / Current Account (%)	13.6	33.8	33.9	85.1
FX Reserves (EUR bn)	10.9	11.2	9.9	10.6
Domestic Credit	**2011**	**2012**	**2013**	**2014**
Total Credit (%GDP)	58.0	62.5	56.7	61.3
Credit to Enterprises (%GDP)	32.6	34.1	28.6	29.4
Credit to Households (%GDP)	17.7	18.3	17.4	18.7
Private Sector Credit (yoy%)	5.9	9.7	-4.5	-0.8
Loans to Deposits (%)	141.9	144.6	136.9	136.9
Financial Markets	**Current**	**3M**	**6M**	**12M**
Policy Rate	6.50	6.00	6.00	6.00
EUR/RSD	120.5	122.0	123.0	125.0

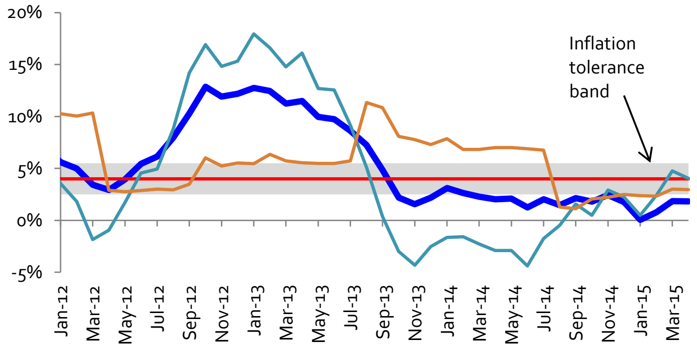
Source: National Authorities, EC, IMF, Eurobank Research

FIGURE 25: **Austerity measures weigh on private consumption (3MMA)**



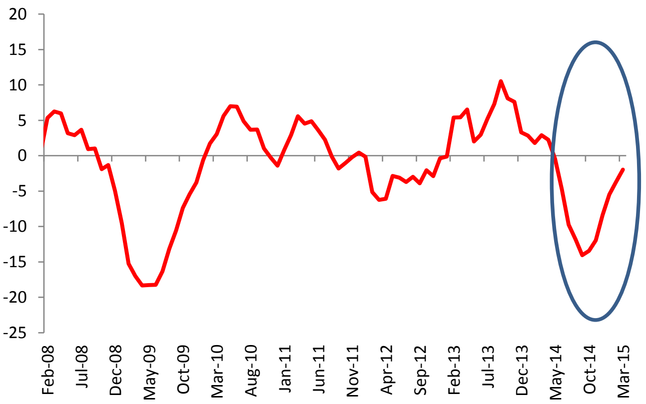
Source: National Authorities, EC, IMF, Eurobank Research

FIGURE 26: **Inflation remains below NBS target over recent months**



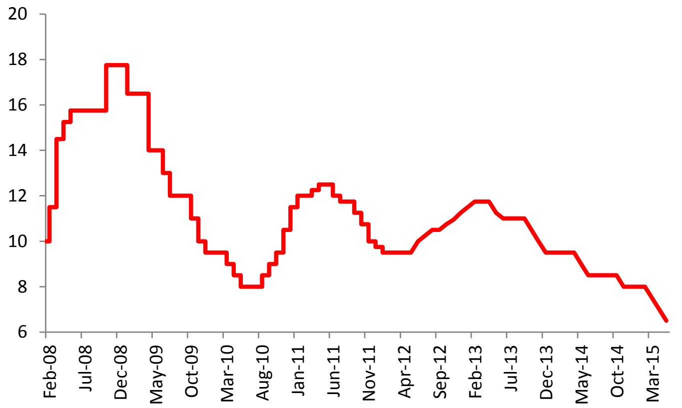
Source: National Authorities, Eurobank Research

FIGURE 27: **Industrial production on a recovery mode (3MMA YoY %)**



Source: National Authorities, EC, IMF, Eurobank Research

FIGURE 28: **Policy rate cut for the 3rd month running to record low in May**



Source: National Authorities, EC, IMF, Eurobank Research

IV. Calendar of Data & Events

Key Data and Events, May - June, 2015				
Country	**Date**	**Indicator/Event**	**Median**	**Previous**
		May 2015		
SERBIA	May 20	Current account (Mar, EURmn)	N/A	-150.3
SERBIA	May 25	Real wages (%YoY, Apr)	N/A	-2.9
ROMANIA	May 27	International reserves (May, EURbn)	N/A	33.7
BULGARIA	May 28	Gross external debt (Mar, EURbn)	N/A	38.7
	May 29	Budget balance (Apr, EURmn)	N/A	257.1
SERBIA		Industrial production (%YoY, Apr)	N/A	-0.2
		Trade balance (Apr, EURbn)	N/A	-454.7
		Retail sales (%YoY, Apr)	N/A	-5.1
		GDP (Q1, %YoY, nsa, f)	N/A	-1.9
		June 2015		
EU	June 6	ECB meeting & press conference		
SERBIA	June 11	MPC meeting	N/A	6.50
US	June 16-17	FOMC meeting		
BULGARIA	June 2	International reserves (May, EURbn)	N/A	38.1
ROMANIA	June 3	ILO U/E rate (%, Apr)	N/A	6.5
	June 4	Retail sales (%YoY, Apr)	N/A	-0.5
		GDP (Q1, %YoY, nsa, p)	N/A	4.3
CYPRUS		CPI (%YoY, May)	N/A	-2.1
BULGARIA	June 5	GDP (Q1, wda, %YoY, f)	N/A	2.0
	June 8	Industrial production (%YoY, Apr)	N/A	2.9
		Retail sales (%YoY, Apr)	N/A	0.8
ROMANIA		Net wages (%YoY, Apr)	N/A	7.2
BULGARIA	June 9	Trade balance (Apr, EURbn)	N/A	-0.5
CYPRUS		HICP (%YoY, May)	N/A	-1.7
	June 9	GDP (Q1, nsa, %YoY, f)	N/A	0.4
ROMANIA	June 10	Industrial sales (%YoY, Apr)	N/A	13.1
		Trade balance (Apr, EURbn)	N/A	-812.8
	June 11	CPI (%YoY, May)	N/A	0.7
SERBIA	June 12	HICP (%YoY, May)	N/A	-1.9
ROMANIA	June 15	Current account (YTD, Apr, EURmn)	N/A	416
BULGARIA		CPI (%YoY, May)	N/A	0.5
		U/E rate (%, May)	N/A	10.7
	June 17	Current account (Apr, EURmn)	N/A	433.0
SERBIA	June 22	Current account (Apr, EURmn)	N/A	N/A
	June 25	Real wages (%YoY, May)	N/A	N/A
BULGARIA	June 26	Gross external debt (Apr, EURbn)	N/A	N/A
SERBIA	June 30	Industrial production (%YoY, May)	N/A	N/A
		Trade balance (May, EURbn)	N/A	N/A
		Retail sales (%YoY, May)	N/A	N/A
ROMANIA		ILO U/E rate (%, May)	N/A	N/A
BULGARIA		Budget balance (May, EURmn)	N/A	N/A

SEE Bond Supply Calendar, May - June, 2015			
		May 2015	
SERBIA	May 21	3Y T-Notes	N/A
ROMANIA		5.75% 2020 T-Bonds	N/A
BULGARIA	May 25	T-Bonds	N/A
		June 2015	
BULGARIA	June 22	T-Bonds	N/A
SERBIA	June 24	Floating T-Bonds	N/A

Source: National Authorities, Bloomberg, Reuters, Eurobank Research

Eurobank Economic Analysis and Financial Markets Research

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