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REGIONAL ECONOMICS & MARKET STRATEGY MONTHLY

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Bulgaria | Cyprus | Romania | Serbia

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Regional growth on solid footing in Q2-2016

REGIONAL MACROECONOMIC DEVELOPMENTS & OUTLOOK

- **Q2-2016 GDP estimates** suggest that the economies of the region remained on solid footing
- **Lax monetary policies** together with sustained low world energy prices continue to provide a positive boost on **growth momentum** throughout 2016
- **Looming risks** for next year's growth outlook from a deeper than expected EU slowdown

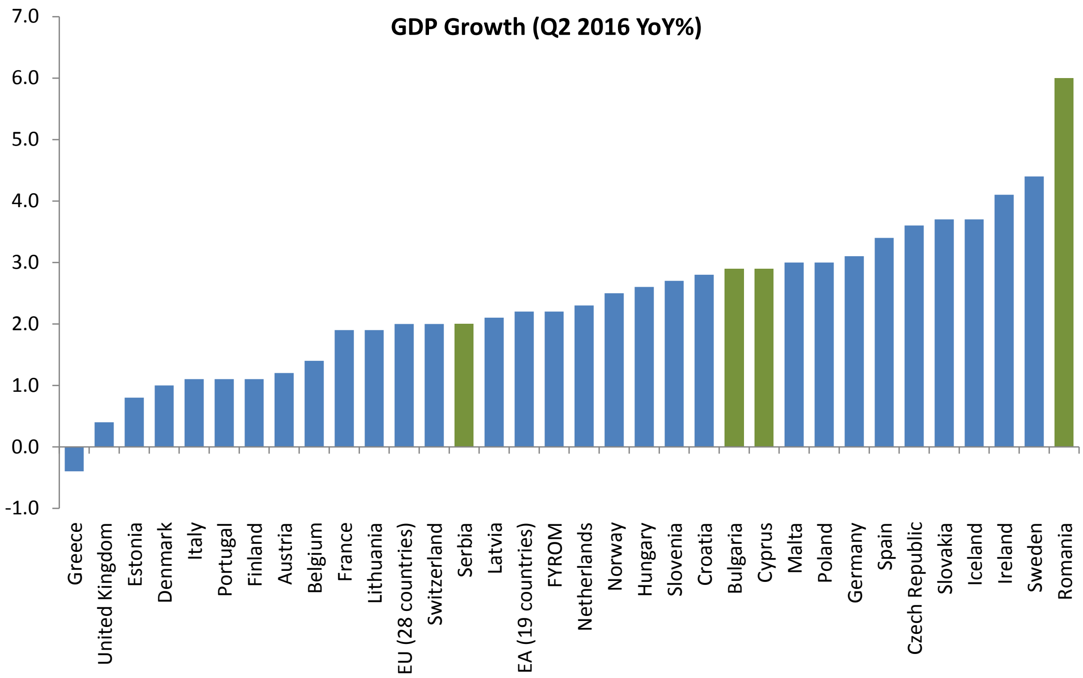
REGIONAL MARKET DEVELOPMENTS & OUTLOOK

- **Regional assets extended gains** amid ongoing Central Bank monetary policy accommodation
- **Regional stocks rallied** to multi-month/year highs
- **CESEE currencies and government bonds** broadly retained a firm tone over the last couple of months
- **Market volatility** likely to rise towards year-end

COUNTRY FOCUS

- **Bulgaria:** Strong growth momentum sustained in Q2-2016
- **Cyprus:** Economy continued to impress in Q2-2016
- **Romania:** Surprisingly strong second quarter GDP reading
- **Serbia:** IMF Executive Board completes 4th & 5th reviews of SBA

Regional growth remains on a strong footing in Q2-2016



Source: Eurostat

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I. Regional Macroeconomic Developments & Outlook

GDP growth estimates suggest that the economies of the region remained on solid footing in Q2-2016

The second GDP growth estimates released suggest that the economies of the region remained on solid footing in Q2

A number of national statistics offices across the region released earlier this month second estimates of GDP growth for Q2-2016 that confirmed the previous flash GDP estimates. Among them, the economies of our focus, Bulgaria, Romania, Cyprus and, earlier last month, Serbia published already a more bullish than expected estimate. Vindicating our and the market's expectations, those readings suggest that the economies of the region remained on solid footing in Q2. We still anticipate growth to accelerate in the economies of our focus compared to 2015. As things stand at this moment, it would be fair to say that 2016 is braced to prove another very good year for the region, most probably the best since 2008. On the other hand, risks are looming for next year's outlook. On average, the broader region is significantly exposed to a possible Euro area slowdown, given the EU's role as a key trade partner and a major capital flow generator for the region. An EU slowdown may ensue for a handful of reasons, not limited to a UK exit from the EU. By contrast, low direct trade, FDI and banking sector ties with the UK help the economies of our focus cushion any concerns of a negative short-term impact should BREXIT materialize.

Private consumption was in the driver's seat behind growth in Q2, while investments were constrained by lower EU funds absorption

The detailed break-down of GDP growth showed that private consumption was in the driver's seat behind growth in Q2. Lax monetary policies, together with much lower world energy prices -on an annual basis and despite their recent rally in the last couple of months- continue to provide a positive boost on the growth momentum. This boost is poised to carry throughout 2H-2016 as well before eventually fading away as energy prices normalize. Lower on an annual basis energy costs keep inflation pressures subdued, supporting real disposable incomes and providing more flexibility to household, corporate, and sovereign balance sheets. On average, consumer sentiment, services and retail trade are on an improving trend as consumers continue to benefit from rising real wages, firmer labor markets and low inflation. However, lower EU funds absorption, mirroring the end of the programming period 2007-2013, has had so far a negative impact on public investments, creating a gap that private initiative has not been able to fully compensate for. Finally, the performance of net exports has been mixed. In most cases, the private consumption acceleration has been accompanied by a concomitant imports recovery, trimming the contribution of net exports.

In Bulgaria, the results of the asset quality review (AQR) and stress tests in mid-August confirmed the strong capital position of the banking sector and illustrated that no state support will be required

At a country level, **Bulgaria** registered another quarter of robust growth performance in Q2. Rising real wages, the trend of improving consumer and business sentiment, lower on an annual basis energy prices, and further gains in employment were among the principal drivers of the spending recovery. Meanwhile, the results of the ongoing asset quality review and stress test of banks, conducted BY WHOM? as part of the ongoing banking sector reform process, confirmed the strong capital position of the banking sector to absorb losses from hypothetical adverse macroeconomic and financial shocks. In **Cyprus**, the economy continued to surprise positively as confidence indicators reached a new post-Lehman high in August, coming very close to the pre-crisis high recorded in August 2007, while other high-frequency indicators (e.g. tourist arrivals, retail sales, unemployment) are performing equally well. Nevertheless, following the clean exit from the adjustment program, the risk of complacency is looming as the reform momentum seems to have stalled ahead of the Presidential elections in 2018.

A new coalition government has come finally in office since mid-Aug in Serbia; it is expected to continue along its predecessor's policies

Strong growth in **Romania** is largely driven by private consumption, financed by an overly expansionary fiscal policy, and leads to a revival of macroeconomic imbalances. The current account deficit widened to 1.3% of GDP in the first seven months, up from 0.5% a year ago, driven by the swelling of the trade deficit and lower EU funds absorption. At the same time, inflation edged up to -0.7% YoY in June as a result of the phasing out of last's year food products' VAT rate cut from 24% to 9%. In **Serbia**, a new government coalition came finally in office in mid-August, several months after late April's early parliamentary elections. The new government is widely expected to continue along its predecessor's policies, speeding up the EU accession process and going ahead with the revamping of the economy. Even though real GDP growth decelerated to 2.0% YoY in Q2, down from 3.8% YoY in Q1, as a result of negative base effects, it is still considered to be good news compared to +0.8% YoY in FY2015.

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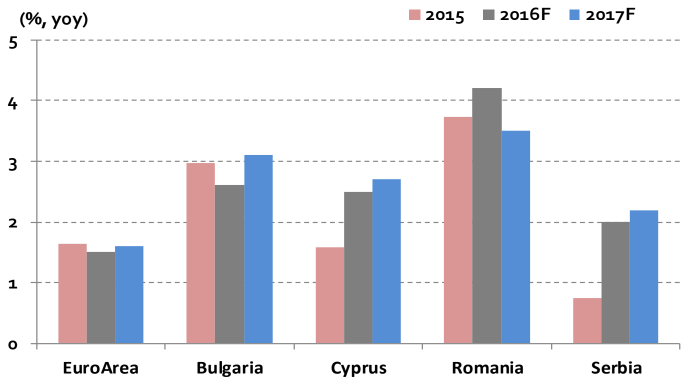
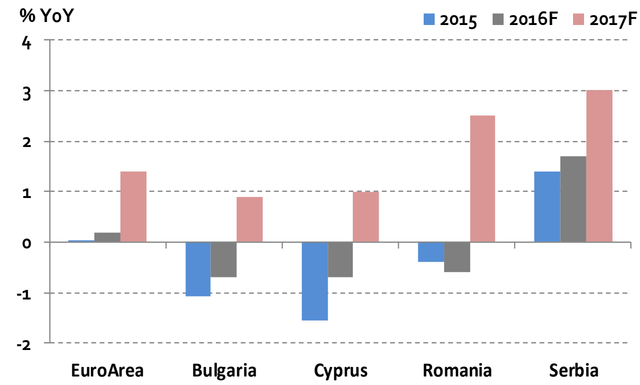
FIGURE 1: **GDP Growth performance 2015-2017**



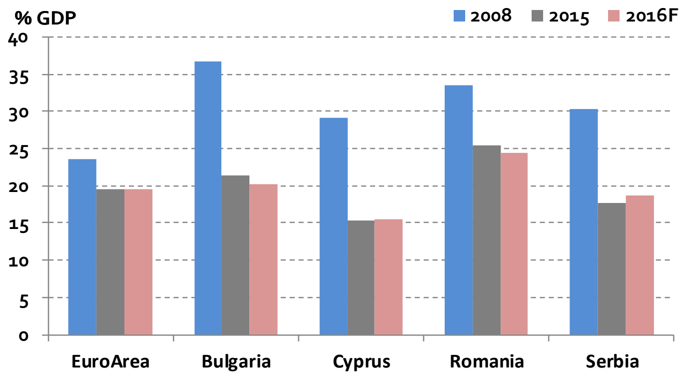
Source: Eurostat, National Authorities, Eurobank Research

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



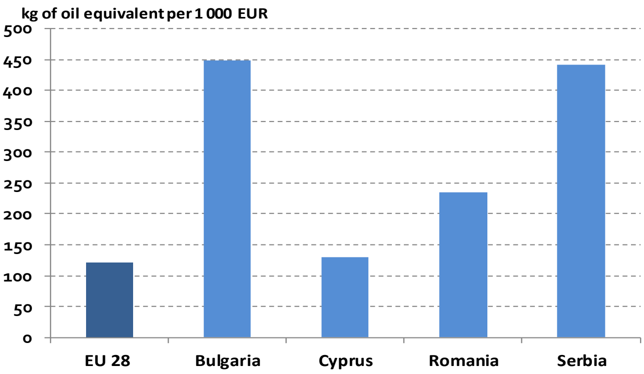
Source: Eurostat, EU Spring Forecasts, Eurobank Research

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



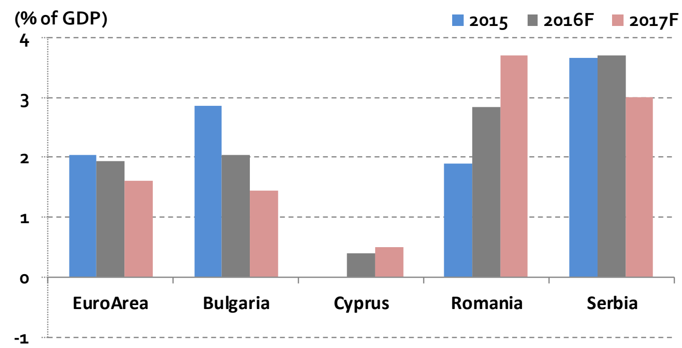
Source: IMF WEO, Eurobank Research

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



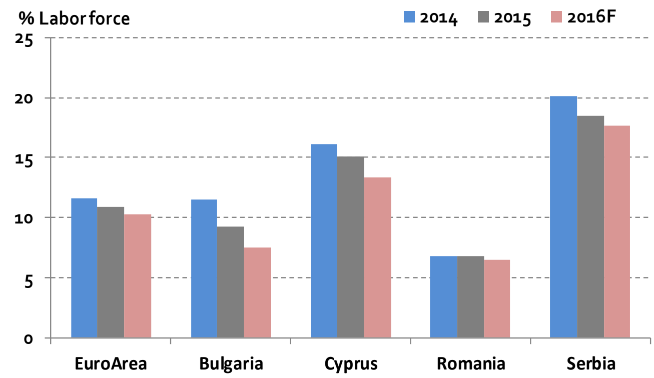
Source: Eurostat, National Authorities, Eurobank Research

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



Source: Eurostat, National Authorities, Eurobank Research

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



Source: Eurostat, National Authorities Eurobank Research

II. Regional Market Developments & Outlook

Regional assets extended gains amid ongoing Central Bank monetary policy accommodation

Emerging market assets broadly extendeded gains over the last couple of months

Emerging market assets broadly extended their year-to-date gains over the last couple of months, despite a few instances of resurgence in volatility especially on the FX front ahead of last week's Fed decision. Since our previous *Regional Economics & Market Strategy Monthly*, sentiment towards high-yield assets has strengthened further. Expectations of lower-for-longer Fed rates and ongoing monetary stimulus by major Central Banks around the globe, such as ECB and BoJ, have supported investor appetite towards risky assets. A two-week correction in emerging markets seen since mid-August amid hawkish Fed officials' remarks surrounding the Jackson Hole symposium proved temporary, with a soft US non-farm payrolls report for August having assisted the recovery. The latest FOMC and BoJ meetings acted as a positive catalyst setting the tone for Emerging Market assets in the coming weeks. In September's monetary policy meeting, the FOMC refrained from raising interest rates and signaled a slower pace of future tightening. Meanwhile, the Bank of Japan maintained in the same month its monetary stimulus but overhauled its policy framework and left the door open for further monetary accommodation ahead. These decisions somewhat mitigated previously heightened uncertainty over major Central Banks monetary policy trends. Additionally, they offset the negative impact on risk sentiment that was instigated by the lack of an ECB announcement over further easing measures and extension of the QE during its latest meeting, which disappointed market expectations and prompted a jump in core yields that raised concerns over an incident similar to the 2013 taper tantrum.

Idiosyncratic factors also at play

Idiosyncratic factors have also been at play in determining trends in Emerging Market assets. In the CESEE space, Hungarian assets broadly rallied in the aftermath of a largely unexpected S&P one-notch upgrade to the country's sovereign credit debt rating to investment grade (BBB-/A3) in mid-September. S&P is the second of the three main rating agencies to have placed the Hungarian government bonds to investment grade status, following a similar action by Fitch in May. The recent improvement in Hungary's sovereign credit rating comes on the back of improving fiscal position and growth outlook as well as narrowing external imbalances. A constitutional crisis in Poland put a cap on further gains in the country's assets, despite robust fundamentals. Meanwhile, Turkish assets continued to recover after a failed military coup attempt on July 15, as political noise seems to have been somewhat alleviated, for now.

Stocks rallied to multi-month/year highs

Against this backdrop, the MSCI Emerging Market index remained in late September near a 1-year high hit earlier in the month. Most bourses in the CESEE region as well as in the economies of our focus recorded gains over the last two months, with the majority having positive year to date performance. Although they have lagged the rally by other regional peers since the end of July - inching up only ca 2% over that period - the main Hungarian BUX index remains a star performer for the second year running with gains in excess of 17%, standing near 9-year highs achieved after the S&P upgrade. The Romanian BETI and the Serbian BELEX15 held near multi-month highs hit in early September, while the Bulgarian SOFIX index reached its highest level in more than a year during September.

CESEE currencies and government bonds broadly retained a firm tone over the last couple of months

CESEE currencies and government bonds retained a firm tone over the last couple of months. In FX markets, the Hungarian forint led the winners pack, standing near a 1-½-year high of 305/€ on improved economic and credit rating outlook. The Serbian dinar remained range-bound within 122.70-123.40/€ as has been the case for most of the year, amid repeated Central Bank interventions in order to cushion excessive fluctuations in the FX markets. In the local markets, Serbian paper remained among the region's best performers, with the 5-year benchmark bond yield tightening by 155bps since the end of July to a 5-year low of 5.45%. Yields of Hungarian external sovereign debt rallied towards this year's record lows of 2.8% after the S&P upgrade. This upgrade is considered supportive for the country's sovereign bonds as a double investment grade status allows their purchase by a significant number of real money accounts that can only purchase investment-grade assets. Also boosting the Hungarian government paper's allure was the Central Bank's ultra-accommodative monetary policy. Albeit maintaining its key policy at a record low level of 0.90% during its meeting in September, the MNB reduced the maximum volume offered at the three-month deposit tenders by year-end to HUF 900bn. The move, expected to release at least HUF 200-400bn of liquidity, aims to support bank lending and purchases of government bonds.

Market volatility likely to rise towards year-end

Looking ahead, market volatility is likely to rise towards the end of the year as a Fed rate hike seems possible in December, while the upcoming presidential elections in the US also involve inherent risks. The constitutional Italian referendum later in the year, which is viewed as a vote of confidence on Matteo Renzi's leadership, poses as a key risk event in the Eurozone.

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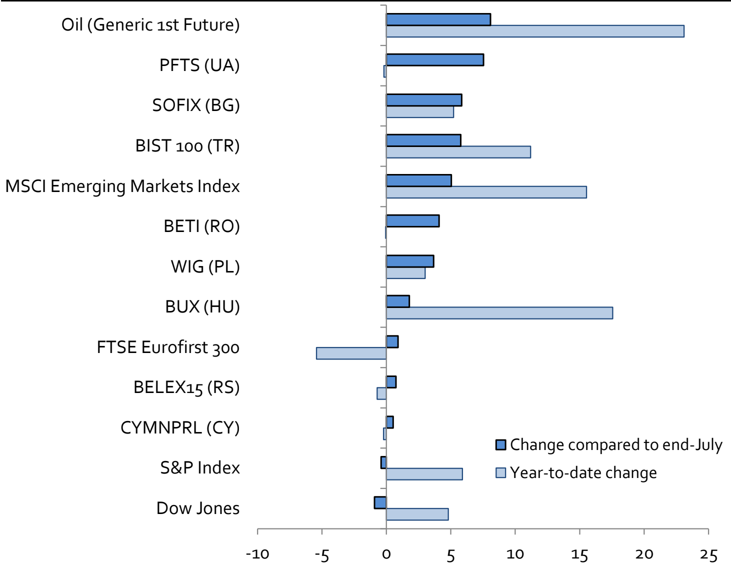
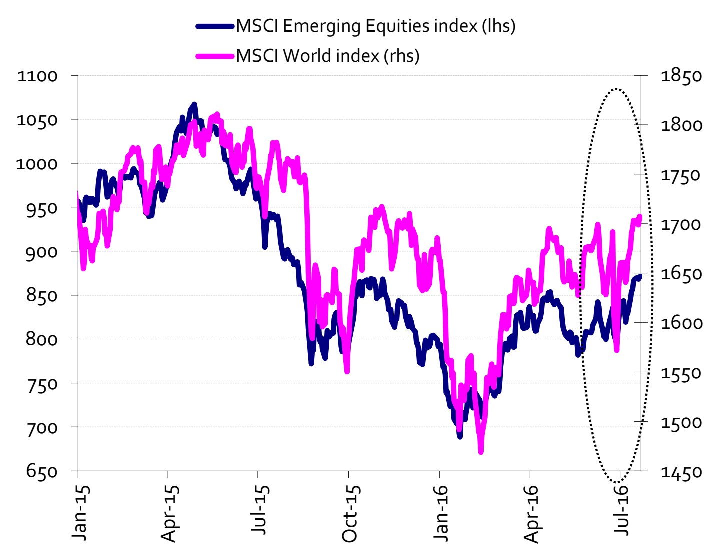
FIGURE 7: **Major world & CESEE stock markets performance (%)**



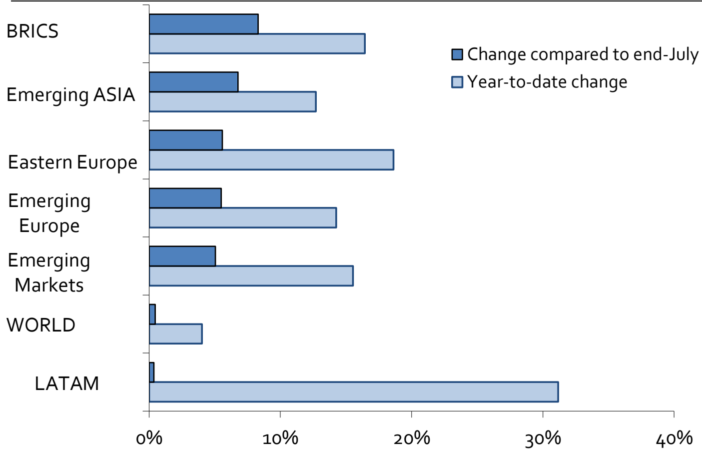
Source: Reuters, Bloomberg, Eurobank Research

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



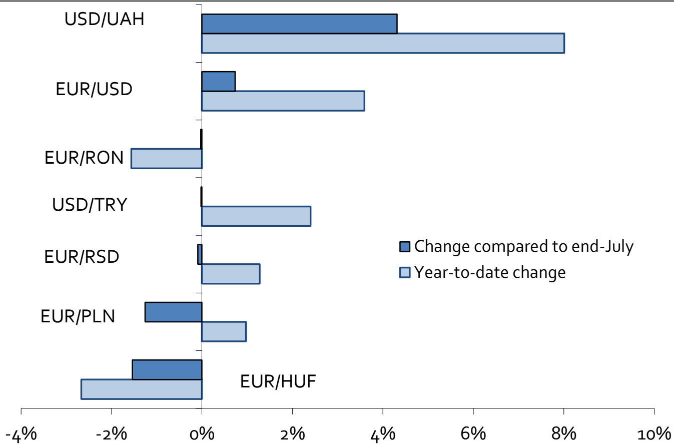
Source: Reuters, Bloomberg, Eurobank Research

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



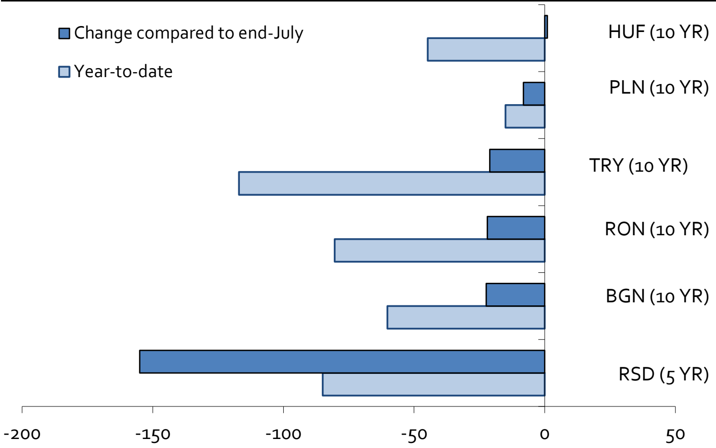
Source: Reuters, Bloomberg, Eurobank Research

FIGURE 10: **CESEE FX performance**



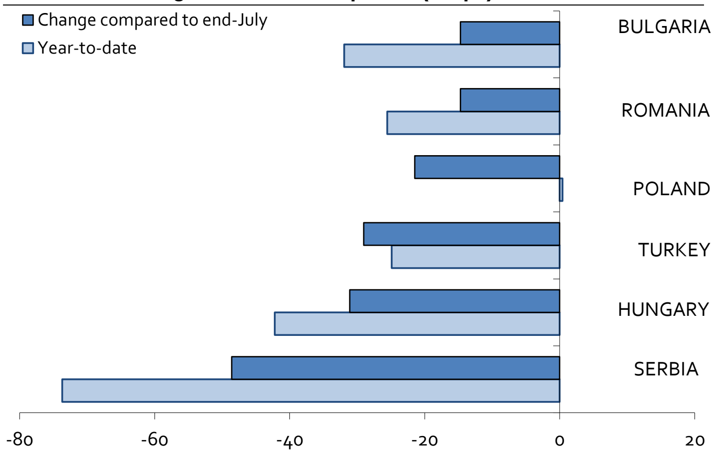
Source: Reuters, Bloomberg, Eurobank Research

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



Source: Reuters, Bloomberg, Eurobank Research

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



Source: Reuters, Bloomberg, Eurobank Research

Trader's view

FX

We remain constructive on long EUR/RSD positions

We expressed belief on several recent occasions that during the summer period the EUR/RSD would remain range-bound due to the season's lull. Our view was vindicated, with the pair trading in tight ranges around 123.30 since July. As was expected a significant drop in hard currency demand alleviated earlier depreciation pressures on the local currency instigated mostly due to seasonal factors. Simultaneously, positive appraisals by the EU and IMF on the government's fiscal consolidation efforts and improving economic growth outlook further supported the dinar. However, repeated Central Bank interventions in the FX markets halted further RSD upside. From July onwards, the targeting zone for intervention proved to be around 123.20 where the NBS scooped an amount of EUR505mn. Nonetheless, a reversal of the EUR/RSD's downward pressures is likely from this point onwards as uncertainty lingers over the FED's monetary tightening path ahead while an increase in corporate EUR demand is likely to re-emerge towards year-end due to seasonal factors and push the pair towards 124.00. A move further above that level remains largely depended on whether the NBS will act, once again, to cushion the pair's further upside.

Security	Position	Entry	Target	Stop loss
EUR/RSD	Long	123.30	124.04	122.85

Local rates

Bulgarian local currency bonds rallied over the last month or so

Bulgarian local currency bonds rallied over the last month or so, trailing gains in Eastern European markets and defying summer doldrums. Prices were also supported by the view of the improving fiscal outlook in the country and scarce supply on the primary market. The supply shortage will probably persist in the coming months mainly because of the expectations for smaller than projected budget deficit and record cash levels in the State Fiscal Reserve (around 13 bn BGN). As of today there is still no announcement by the Minfin regarding upcoming placements and the auction calendar is most likely to remain empty until October. BGN-denominated government bonds yield curve continued to flatten with the spread between 2y and 10y papers tightening by 27bps.

We change our recommendation on Serbian paper to neutral

The target on our earlier recommendation on Serbian government bonds was recently achieved. Having been positive on this trade so far this year, we downgrade our recommendation to neutral given recent statements from NBS Governor, who signaled that there is hardly any room for further interest rate cuts.

Security	Position	Entry	Target	Stop loss	P&L (MtM+carry)
RSMFRSD	Long	5.25%	4.75% (closed at target level)	5.50%	1.82% (MtM 0.90 + 0.92 Carry)

External debt markets

Long Bulgaria Eurobond 2023 T-Note position remains favorable

Bulgarian Eurobonds were strongly favored during August-September as flows moved from the Developed to Emerging Markets on hunt for yield. The demand pushed yields down by about 40-60 bps across the curve. Our favorite paper, BGARIA 23, is already trading 100 bps lower since issuance. We expect some consolidation in the market and revise our target at 1.00% as our previous 1.60% target was recently achieved.

Security	Position	Entry	Current level	Target	Stop loss
BGARIA 2023	Long	2.06%	1.15%	1.00%	2.20%

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We would also like to thank Costas Katsileros for his most valuable comments on the Regional Market Developments & Outlook

III. Country Focus

Bulgaria (Baa2/BB+/BBB-)

Strong growth momentum sustained in Q2-2016

Strong growth momentum was sustained in the second quarter combined with further improvement in the labor market conditions

The second estimate on the seasonally adjusted Q2 GDP reading matched the flash estimate of +0.7% QoQ/+3.0% YoY. The strong reading compares to +0.7% QoQ/+2.9% YoY in Q1-2016 vs. +0.7% QoQ/+2.9% YoY in Q2-2015. From a demand side point of view, final consumption expanded by +0.2% QoQ/+1.8% YoY in in Q2-2016 compared to +0.4% QoQ/+2.1% YoY in Q1-2016 vs. +0.5% QoQ/-0.1% YoY in Q2-2015, making a very strong contribution to growth. Rising real wages, improving consumer and business sentiment, declining energy prices on an annual basis -Bulgaria has the highest energy consumption intensity in EU-28- and further gains in employment were among the principal drivers of the spending recovery. Unemployment has declined further to 7.9% in July, from 9.2% a year ago, as the economy adds more jobs in the labor-intensive areas of specialized business services compared to traditional industries.

Investments were in red for a second consecutive quarter on lower EU funds and public investment spending

On the negative side, investments were in red for a second consecutive quarter in Q2 (GFCF: +0.5% QoQ/-4.4% YoY in Q2 down from -3.5% QoQ/-3.9% YoY in Q1-2015 vs. +1.1% QoQ/+1.3% YoY in Q2-2015). To some extent, the decline mirrors the negative base effects as a result of the increased EU funds absorption in the past year ahead of the closing of the programming period 2007-2013, as well as the fact that public investment spending is traditionally skewed to the last quarter of the year. Finally, net exports had a negative contribution in Q2 (Exports: +2.4%YoY in Q2 vs. +0.3% YoY in Q1 & Imports: +3.4% YoY in Q2 vs. -1.3% YoY in Q1). Overall, the strong growth momentum was sustained in Q2 bringing the 1H performance at 3%. Our current forecast still stands an inch below at 2.9% in 2016 (vs. 2.6% previously) as we see some downside risks for growth in the 2H due to lower EU funds absorption, a lower than last year's fiscal policy impulse and rising external environment headwinds for exporters, but also upside risks from a strong tourism season.

Deflation has slowed down in the last couple of months

Inflation edged lower at 0% MoM/-0.3% YoY in August, compared to -0.7% MoM/-0.2% YoY in July. Food prices, both the largest as well as the most volatile component of CPI, slowed down on a monthly basis, driven by lower prices of unprocessed food, namely fruits and vegetables, reversing the sharp rise of July. Food prices came at -0.2% MoM/+1.2% YoY in August vs. +1.7% MoM/+2.0% YoY in July, making the largest positive contribution on an annual basis. World energy prices, despite the spike in the past two months, are still much lower on an annual basis, thereby driving transportation prices lower by +0.5% MoM/-7.9% YoY in August compared to +1.8% MoM/-8.7% YoY in July. Overall, deflation has slowed down in the last couple of months, remaining in slightly negative territory. Looking ahead, inflation is expected to continue its gradual recovery in the coming months amid improving domestic demand dynamics in tandem with the waning impact of weak global energy prices. Finally, inflation dynamics are also going to receive some support from the recent regulatory prices' adjustment in the water supply and the forthcoming in the state energy sector in Q4.

Stress test results confirm the strong capital position of the domestic banking sector. No state support will be required to reinforce the capital adequacy and liquidity of the banking system.

The results of the asset quality review (AQR) and stress tests in mid-August confirmed the strong capital position of the domestic banking sector to absorb losses from hypothetical adverse macroeconomic and financial shocks. The AQR and the stress test were an important step in the 18-month banking supervision reform plan of the BNB after the election of the new Governor in July 2015, in the aftermath of the bankruptcy of Corporate Commercial Bank (KTB), the fourth largest bank in terms of assets. The AQR resulted in aggregate adjustments of BGN665mn (0.75% of projected GDP or 1.3% of risk-weighted assets). A large fraction of those adjustments (BGN474.9mn) came as a result of the reclassification of performing assets worth BGN 3.7bn (7.1% of RWA) into non-performing exposures (NPEs). The AQR adjusted core equity capital ratio (CET1) of the banking system stood at 18.9% at the end of 2015, significantly above the minimum regulatory requirement. Under the baseline scenario, the banking system CET1 ratio improves to 22.2% by the end of the forecasting period. Under the adverse scenario, the relevant ratio deteriorates to 14.4%.Follow up plans have been drafted with individual banks, which include measures to maintain or increase capital buffers for some or decreasing risk-weighted assets for others. FiBank, the third largest bank in the market, and Investbank are required to address a BGN205.7mn and BGN33.2mn capital shortfall respectively by April2017; Viktoria Bank has already addressed their respective shortfall by raising BGN30mn in last February. Overall, no state support will be required to reinforce the capital adequacy and liquidity of the banking system. From that point of view, Moody's reaction was credit positive. Equally importantly, the fiscal buffer created by the government through Eurobond issuance in last March (BGN 1.7bn out of BGN3.9bn) will be released and utilized for the repayment of the public debt.

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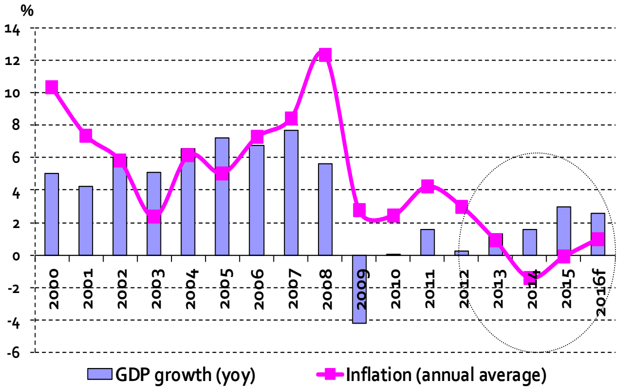
Bulgaria: Macro & Market Data	2014	2015	2016f	2017f
Real GDP (yoy%)	1.6	3.0	2.9	3.0
Inflation (yoy%)				
CPI (annual average)	-1.4	-0.1	-0.7	0.9
CPI (end of period)	-0.9	-0.4	0.3	1.2
Fiscal Accounts (%GDP)				
General Government Balance	-3.7	-2.9	-2.0	-1.4
Gross Public Debt	27.7	26.7	29.7	31.1
Primary Balance	-3.0	-2.1	-1.1	-0.4
Labor Statistics				
Unemployment Rate (LFS, %)	11.4	9.2	7.5	6.5
Wage Growth *(total economy)*	6.0	8.8	7.5	7.0
External Accounts				
Current Account (% GDP)	0.9	1.4	1.8	1.5
Net FDI (EUR bn)	1.3	1.6	1.5	1.5
FDI / Current Account (%)	Na	Na	Na	Na
FX Reserves (EUR bn)	16.5	20.3	21.0	22.5
Domestic Credit	**2012**	**2013**	**2014**	**2015**
Total Credit (%GDP)	72.3	72.9	67.7	57.1
Credit to Enterprises (%GDP)	44.1	43.9	38.1	34.9
Credit to Households (%GDP)	21.8	21.7	21.0	20.8
FX Credit/Total Credit (%)	63.1	59.8	54.3	50.6
Private Sector Credit (yoy)	3.0	0.2	-8.2	-1.2
Loans to Deposits (%)	99.4	92.1	84.2	78.2
Financial Markets	**Current**	**3M**	**6M**	**12M**
Policy Rate		Currency Board		
EUR/BGN	1.96	1.96	1.96	1.96

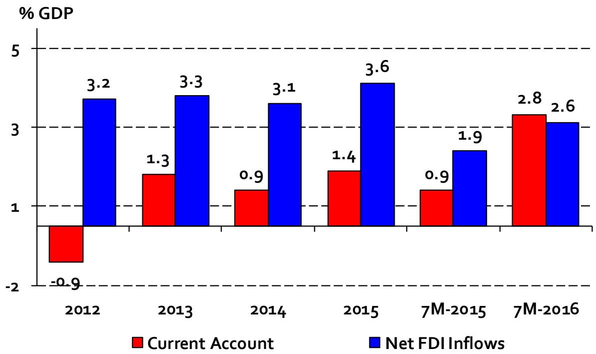
Source: National Sources, Eurostat, IMF, Eurobank Research

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



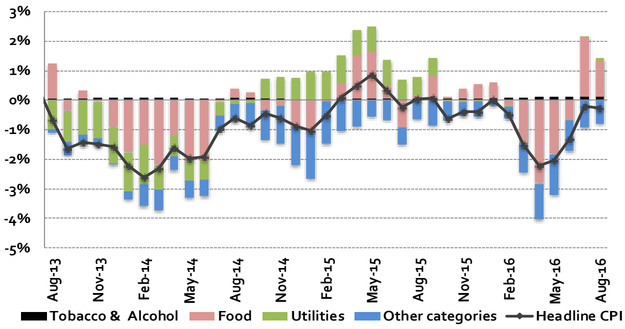
Source: National statistics, Ecowin Reuters, Eurobank Research

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



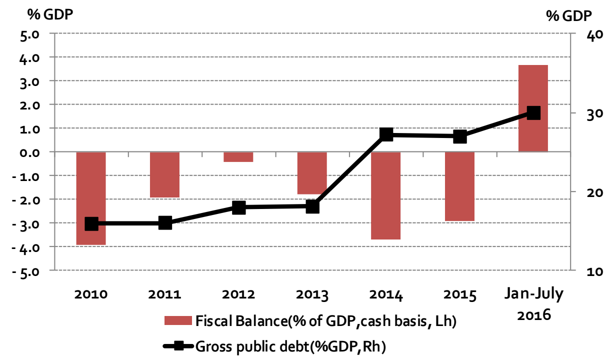
Source: National statistics, Ecowin Reuters, Eurobank Research

FIGURE 15: **Inflation dynamics 2013-2016**



Source: National statistics, Ecowin Reuters, Eurobank Research

FIGURE 16: **Fiscal deficit & Gross Public Debt 2010-2016**



Source: Eurostat, Eurobank Research

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

Economy continued to impress in Q2-2016

The Q2 GDP reading confirmed that the economy is on a fast growth recovery track

The second estimate of CYSTAT on the seasonally adjusted Q2 GDP reading matched the flash estimate of +0.7% QoQ/+2.7% YoY. The strong reading, the sixth consecutive positive one on both a quarterly and an annual basis, compares to +1.0% QoQ/+2.7% YoY in Q1-2016 vs. +0.8% QoQ/+1.2% YoY in Q2-2015. Final consumption expanded by +0.8% QoQ/+1.9% YoY in Q2-2016, up from +0.1% QoQ/+1.4% YoY in Q1-2016 vs. +0.3% QoQ/+1.0% YoY in Q2-2015, making a +1.6ppts contribution to growth. The consumption rebound is driven by the strong sentiment improvement mirroring the lasting progress within the economic adjustment program, a flourishing tourism sector (+19.8% YoY in tourist arrivals in 7M-2016 and +13.8% YoY in tourism revenues in 1H-2016), lower energy prices on an annual basis, lower unemployment (11.6% in July 2016 vs. 15% a year ago, the highest decline in EU-28 in the past twelve months), agents' expectations of further fiscal relaxation and a rise in real incomes. Moreover, investments skyrocketed by 104.7% YoY in Q2-2016, driven entirely by transportation equipment purchases which most probably could be attributed to ship imports. As a result, the hefty contribution of investments was largely offset by the negative contribution of net exports (imports: +18.9% YoY vs. exports: -3.3%YoY), so that both components added another 1.1ppts. Despite BREXIT woes, the Economic Sentiment Index (ESI) reached a new post-Lehman high in August, coming very close to the pre-crisis high recorded in August 2007. The ESI jumped by 6.1 points to 116.2 in August, compared to 110.1 in last July vs. 117.8 in August 2007. After a three year recession in 2012-2014, and a cumulative drop of 10.5% of GDP, the economy expanded by +1.6% YoY in 2015 and is expected to further gain momentum to +2.7% YoY in 2016, above the most recent EU Commission forecast of +1.7% YoY.

The risk of complacency following the exit from the Adjustment Program is material for Cyprus

The parliamentary election results in last May were not a game changer as they have no direct impact on the formation of the government. The incoming parliament is fragmented between more parties and appears less keen to back reform-friendly legislation. This was more evident in the cases of the immovable property tax and the civil service reform. After intense deliberations and disagreements the Parliament voted to slash the Immovable Property Tax (IPT) collected by the government by 75% on the 1980 property prices, and the abolishment of the IPT altogether in 2017. Moreover, the approval of the bill setting a cap to the public sector wage bill, linking the expenditure expansion with GDP growth performance, is still pending. The Parliament has postponed the vote for this crucial piece of legislation, which would keep the wage bill on a sustainable level, minimizing the risk of fiscal derailment. The risk of complacency following the exit from the Adjustment Program is material for Cyprus. Firstly, a number of structural reforms of the economic adjustment program are still pending; these reforms are important in avoiding a backtracking of the economy. The incumbent government has a political window of one year to carry on with the remaining reforms as well as to conclude key privatization projects. Secondly, fiscal policy achievements may lead to spending pressure, which is going to increase ahead of the Presidential Elections, scheduled for February 2018.

Cyprus tapped international financial markets for the first since its exit from its economic adjustment program.

The Ministry of Finance raised €1bn selling 7Y bonds with a 3.75% coupon at a 3.8% yield in late July. Investors' bids were strong so that the issue was oversubscribed 2.5 times. Cyprus became a credible borrower within the first year of its MoU program, making the fastest come-back to international markets among other Euro Area program countries, and thus tapping the markets three times (June 2014, April 2015 and October 2015). The faster than expected come-back to the financial markets not only reduced the dependency on program financing, but also improved the public debt maturity profile. As a result, the weighted average maturity increased to 8.5 years in Q4-2015, up from 4.7 years in Q4-2012. Moreover, Cyprus does not face any significant repayment obligations until at least 2019. As of end of June 2016, the amounts to be repaid in 2016, 2017 and 2018 stand at €656mn, €451mn and €945mn respectively, and most of the maturing bonds are held by domestic financial institutions. However, around €4bn or one fifth of the total outstanding debt stock - is maturing in 2019-2020. As a result, the issuance will allow the Ministry of Finance to buy-back bonds of those maturities, thereby reducing the required future debt issuance.

S&P upgraded the long-term sovereign rating of the Republic by one notch to BB in mid-September.

Despite the recent S&P upgrade by one notch from BB- to BB, an upgrade by 2 and 4 notches in their respective grading systems would be required in order for the government bonds to get investment grade status. As a result, ECB's waiver for government bonds' eligibility for Euro system financing has been lifted as of April 1st and Cyprus no longer qualifies for QE. The waiver allowed these instruments to be used in Euro system monetary policy operations despite the fact that they did not fulfill minimum credit rating requirements.

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Cyprus rankings in the "Global Information Technology Report" & "EU Commission Innobarometer"

The "Global Information Technology Report 2016" of World economic forum (WEF) has used the Networked Readiness Index which is a key indicator of how countries are doing in the digital world. It measures how well an economy is using information and communications technologies to boost competitiveness and wellbeing. Cyprus took the 40th place among 139 countries and has the best score than that of other South-east European countries (Greece-70th, Italy-45th, Bulgaria-69th, Romania-66th, Serbia-75th, Turkey-48th etc.). More thoroughly, Cyprus best scores the in "Readiness sub index" taking the 21th position because of its meaningful scores in Skills (16th among 139 countries), Affordability (22th) and Infrastructure (33th). These indexes proves that Cyprus is in a beneficial position to make good use of an affordable ICT infrastructure and digital content and people are enough well-educated. On the other hand Cyprus has lost 5 places since the economic crisis in 2013 and ,now, the worst scores of Cyprus are recorded in the "Government usage" (75th) and "Social impacts" (70th). Therefore, there is a lot of room for improvement if the government puts more focus on the ICT policies for competitiveness, well-being and e-participation.

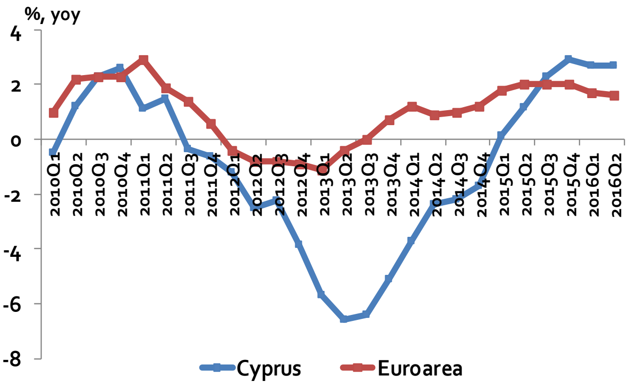
In addition the Innobarometer 2016 of the European Commission has already found a large increase in the proportion of Cypriot companies introducing at least one innovation since 2013 (74%). Cyprus is the only Member State where a majority of all companies have introduced new or significantly improved processes (56%) through following types of innovation. Companies in Cyprus (44%) are most likely to say accessing or reinforcing their presence in export markets would have the most positive impact, compared to all other EU countries. On the other hand, at least half of the companies in Cyprus (52%) say administrative or legal issues have been a problem about the commercialization of their company's goods or services since January 2013. Finally, despite the fact that 50% Cypriot entrepreneurs are likely to say that low demand for their innovative goods or services has been a problem since 2013, this percentage is down by 13 ppts compared to that of 2015.

Grigoris Katsavos
Eurobank Research Intern

Cyprus: Macro & Market Data				
	2014	**2015**	**2016f**	**2017f**
Real GDP (yoy%)	-2.5	1.6	2.7	2.5
Inflation (yoy%)				
HICP (annual average)	-0.3	-1.5	-0.7	0.5
HICP (end of period)	-1.0	-1.4	-0.3	0.8
Fiscal Accounts (%GDP)				
General Government Balance	-0.2	0.0	-0.4	-0.5
Gross Public Debt	108.2	108.9	105.6	101.7
Primary Balance	2.7	1.8	2.2	1.9
Labor Statistics				
Unemployment Rate (LFS, %)	16.1	15.1	12.5	11.5
Compensation per employee (%)	-3.5	-1.0	1.1	1.4
External Accounts (% GDP)				
Current Account	-4.6	-3.6	-4.2	-4.6
Trade Balance (Goods)	-16.2	-18.4	-18.4	-18.6
Terms of Trade (of Goods)	7.1	2.6	2.2	-0.3
Domestic Credit	**2012**	**2013**	**2014**	**2015**
Total Credit (%GDP)	371.6	351.4	353.5	360.8
Credit to Enterprises (%GDP)	170.2	160.2	148.1	151.5
Credit to Households (%GDP)	138.2	140.0	142.7	136.4
Private Sector Credit (yoy)	6.2%	-12.2%	-2.3%	-3.4%
Loans to Deposits (%)	103.3%	135.3%	133.4%	136.6%

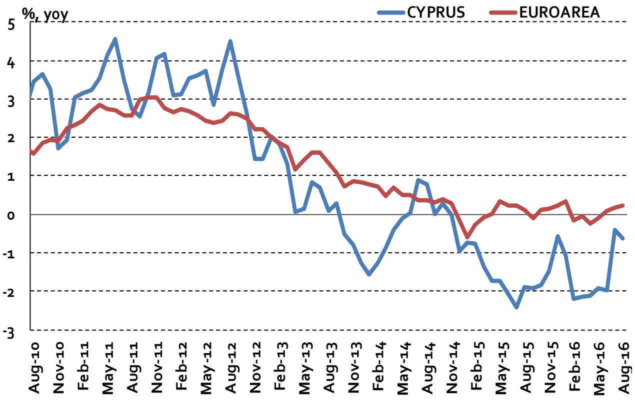
Source: National Sources, Eurostat, IMF, Eurobank Research

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



Source: Eurostat, Eurobank Research

FIGURE 18: **HICP Cyprus vs. Euroarea 2010-2016**

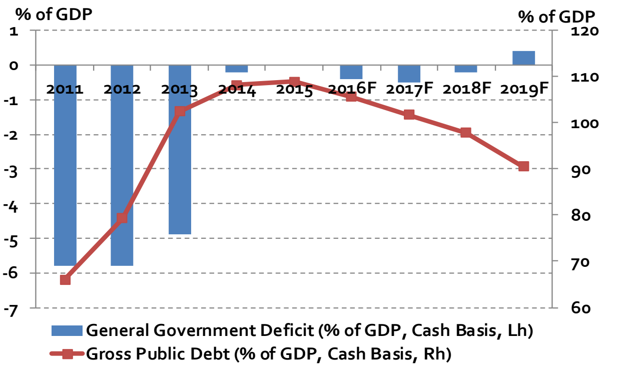


Source: Eurostat, Eurobank Research

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

Source: Bloomberg, Eurobank Research

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



Source: Ministry of Finance, Eurobank Research

Romania (Baa3/BBB-/BBB-)

Surprisingly strong second quarter GDP reading

The Q2-2016 real GDP growth reading was the positive surprise of the region exceeding analysts' expectations

The revised estimate of the Statistical Service on the seasonally adjusted Q2-2016 GDP reading confirmed the flash estimate of +1.5% QoQ/+5.9% YoY, +6.0% YoY in unadjusted terms. This estimate was the positive surprise of the region, coming out significantly above analysts' consensus expectations (+0.1% QoQ/+4.1% YoY). The stronger than expected print compares to +1.5% QoQ/+4.2% YoY in Q1-2016, up from -0.1% QoQ/+3.7% YoY in Q2-2015. From a demand side point of view, both private consumption and gross fixed capital formation posted very strong dynamics. Driven by higher disposable income as a result of the generous VAT rate cut for food stuff and the rapid rise in real wages, private consumption jumped by +3.3% QoQ/+10.4% YoY in Q2, making a hefty contribution of 7.5pps to growth. Gross fixed capital formation expanded by +6.5% QoQ/+10.6% YoY, making a 2.6pps contribution to growth, which was only partially offset by the negative contribution of inventories (-0.8pps). On the other hand, net exports made a negative contribution of -3.4pps mirroring the deceleration of exports (+1.0% QoQ/+3.5% YoY) vs. the robust dynamics of imports (+4.5% QoQ/+11.0% YoY). Given the robust dynamics of the 1H-2016 (+5.2% YoY), we have upgraded our FY2016 growth forecast from 4.2% to 5%. However, we do keep note that growth dynamics are driven by a private consumption spending boom, fuelled by the unwarranted pro-cyclical fiscal stimulus ahead of the parliamentary elections scheduled for late 2016. Hence, the economy is driven close to, if not above, its potential growth rate at the expense of pushing government finances off consolidation track and exacerbating the external position. The incoming government will most probably need to adopt a more conservative stance in order to bring the projected fiscal deficit below 3% (assuming no policy change the deficit is expected to reach 3.7% of GDP in 2017), which will have a material decelerating impact on the economy.

The current account deterioration is one of those warning signs that macroeconomic imbalances are reemerging as a result of the expansionary policy.

The current account deficit jumped to €2.2bn in January-July 2016, compared to a deficit of €756mn in January-July 2015. As a percentage of GDP, the current account deficit widened to 1.3% in Jan-July 2016, up from 0.5% in the same period last year. Stronger imports dynamics (+6.7% YoY) compared to those of exports (+3.3% YoY) resulted in the swelling of the trade deficit to 2.8% of GDP vs 2.2% in the same period last year. Both the primary income gap and the surplus of services remained at levels equal to those of the previous year, 1.6% and +2.5% of GDP respectively, unable to offset the trade gap deterioration. Moreover, the secondary income balance stood at 0.7% of GDP, lower by -21.3% YoY, as a result of lower EU funds absorption mirroring the end of the previous programming period and lower transportation services. From a financing point of view, net FDI inflows expanded by 19% YoY at €2.34bn, fully covering the current account shortfall. Capital investments accounted for €2,06bn (channeled to the financial sector) while intra-group loans stood at €279mn. In a nutshell, the current account deterioration is one of those warning signs that macroeconomic imbalances are reemerging. At this moment, our full year projection for the current account deficit stands at 3% for 2016, still very far though from the pre-crisis peak of 13.4% in 2007.

Inflation remained in negative territory in August for a fourteenth month in a row

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Inflation edged up at +0.1% MoM/-0.2% YoY in August vs. -0.2% MoM/-0.8% YoY in July. The print came above market expectations this time (BBG survey: -0.1% MoM/-0.4% YoY). The volatile food component of CPI inched down on a monthly basis, yet annual dynamics accelerated sharply. As a result, food prices came at -0.1% MoM/+2.0% YoY in August up from +0.04% MoM/+1.25% YoY in July. Food prices recorded the highest annual expansion rate in three years, by and large attributed to base effects from the phasing out of last year's food products' VAT rate cut from 24% to 9%. Non-food items expanded by +0.3% MoM/-1.4% YoY in August, up from -0.5% MoM/-2.2% YoY in July, driven by the higher than expected hikes in tobacco prices (+1.8%MoM/+2.5%YoY). Services remained almost flat at -0.1% MoM/-1.0% YoY in August compared to -0.1% MoM/-0.9% YoY in July. Overall, the August inflation reading, suggests that pace of deflation has slowed down. On the other hand, given the downbeat readings in the first half of the year, the inflation trajectory so far has been softer than envisaged before. Only recently, NBR slashed its year end inflation forecast to -0.4% in 2016, down from +0.6% in the previous May report, and +2.0% in 2017, down from +2.7% respectively. In the NBR's view, the short-term inflation trajectory will remain in negative territory for a few more months until the end of the year, mainly due to the low imports prices' dynamics. Moreover, inflation will most probably end below the mid-point of the 2.5% target at the end of 2017, while it is now seen at the upper bound of the inflation target interval (2.5-3.5%) by the end of Q2-2018.

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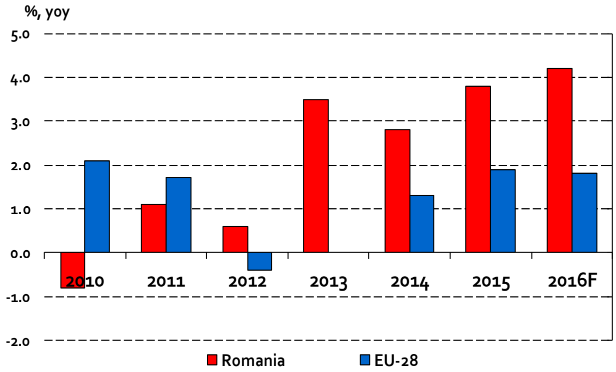
Romania: Macro & Market Data				
	2014	**2015**	**2016f**	**2017f**
Real GDP (yoy%)	2.9	3.8	5.0	3.0
Inflation (yoy%)				
CPI (annual average)	1.1	-0.6	-1.8	1.5
CPI (end of period)	0.8	-0.9	-0.4	2.0
Fiscal Accounts (%GDP, Cash Basis)				
General Government Balance	-1.9	-1.9	-2.8	-3.7
Gross Public Debt (including guarantees)	39.5	39.1	40.5	42.6
Labor Statistics (annual avg,%)				
Unemployment Rate (ILO, % of labor force)	6.8	6.7	6.5	6.3
Wage Growth (total economy)	7.6	8.4	12.5	5.0
External Accounts				
Current Account (%GDP, BPM5)	-0.4	-1.1	-3.0	-3.2
Net FDI (EUR bn)	2.5	2.7	3.0	3.5
FDI / Current Account (%)	385.0	157.1	58.8	60.8
FX Reserves (EUR bn)	32.2	32.2	33.5	32.0
Domestic Credit *(end of period)*	**2012**	**2013**	**2014**	**2015**
Total Credit (%GDP)	52.0	47.0	44.4	43.9
Credit to Enterprises (%GDP)	20.3	18.0	15.7	15.5
Credit to Households (%GDP)	17.8	16.5	15.4	15.4
FX Credit/Total Credit (%, private)	62.5	60.9	56.2	49.3
Private Sector Credit (yoy)	1.3	-3.3	-3.1	3.0
Loans to Deposits (%)	133.9	118.4	106.3	106.6
Financial Markets	**Current**	**3M**	**6M**	**12M**
Policy Rate	1.75	1.75	1.75	2.00
EUR/RON	4.45	4.50	4.50	4.40

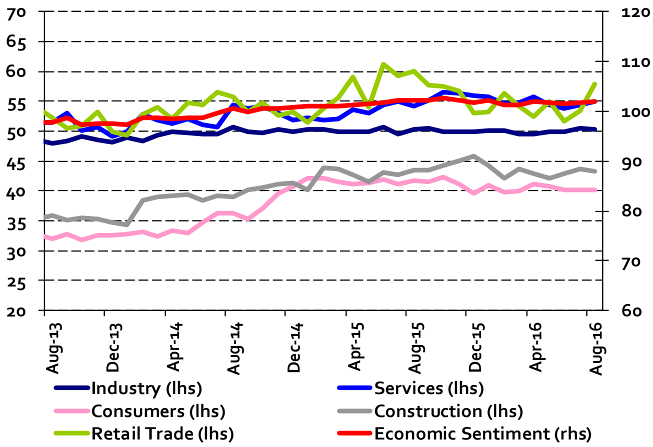
Source: National Authorities, EC, IMF, Eurobank Research

FIGURE 21: **Growth performance Romania vs. EU28 2010-2016**



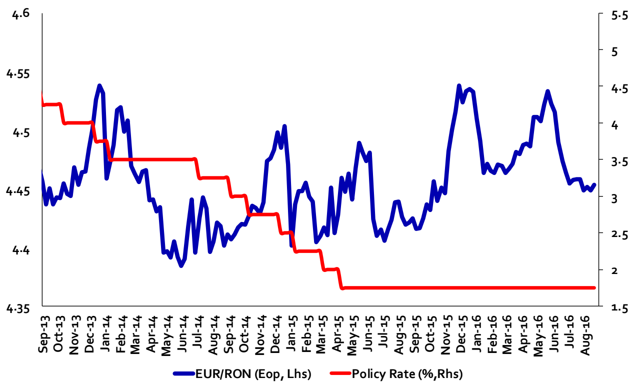
Source: Eurostat, Eurobank Research

FIGURE 22: **Sentiment indicators 2013-2016**



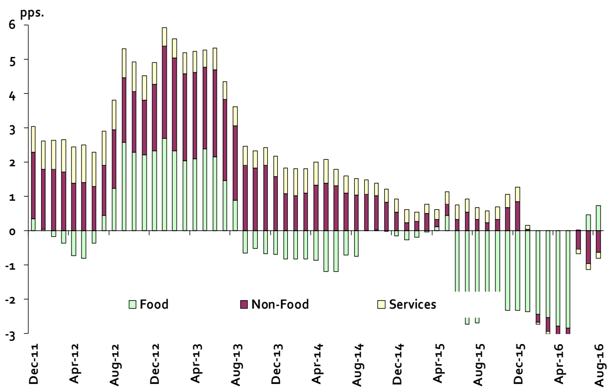
Source: Eurostat, Ecowin Reuters, Eurobank Research

FIGURE 23: **Monetary policy & FX rate 2013-2016**



Source: Bloomberg, Eurobank Research

FIGURE 24: **Inflation components 2011-2016**



Source: National statistics, Eurobank Research

Serbia (B1/BB-/B+)

IMF Executive Board completes 4th & 5th reviews of SBA

Economic recovery outperforms expectations in H1 2016

Economic recovery gained momentum in H1 2016, with last year's positive trends broadly continuing earlier this year. Real GDP rose by 3.8%YoY in Q1 and 2.0%YoY in Q2, bringing the annual rate of increase over the January-June period to 2.9%. The slowdown in the second quarter is primarily attributed to favorable base effects a quarter earlier, while it marks a pick up from growth of 1.1%YoY in Q2 2015 and 0.7% for the FY2015. Furthermore, it is the fifth consecutive quarter of positive annual growth rates after the 2014 floods, which pushed the domestic economy into recession. From the expenditure side, investments remained among the main engines of growth over the first six months of the year, marking a 6.5% annual rise. All domestic demand components provided a positive contribution. Consumption also showed concrete signs of recovery, advancing by 1.6%YoY in January-June, following a 0.7% decline in full-year 2015. Both private and public spending gained momentum during the said period. Private consumption rose by 1.1%YoY, after registering a 0.6% fall last year. Public consumption grew by 4.0%YoY, having marked an annual increase of 4.6% in Q2 2016 - the highest rate in four years – and following a 1.2% drop in FY2015 in view of fiscal restraint. Exports' growth remained robust (+10.8%YoY), continuing to provide the highest input in domestic economic activity during January-June. Yet, a significant acceleration in the annual rate of increase in imports in the second quarter of 2016 (+12.3%) resulted to an overall neutral contribution of net exports, reversing the positive contribution of the prior quarter.

Further pick up anticipated this year and the next after a 0.7% expansion in 2015

Looking ahead, economic activity is expected to accelerate to around 2.5% for the whole of this year, beating earlier official estimates for growth slightly below 2.0%. Robust investment expansion is likely to remain amongst the key growth drivers, thanks to ongoing structural reforms, improved lending conditions and investor sentiment, increased government capital expenditure, further recovery of main trade partner economies and relatively low oil prices that translate into lower operating costs for businesses. Exports will likely remain solid, though their net input may prove modestly positive due to a concomitant increase in imports due to recovering domestic demand. In contrast to last year's negative input, household consumption is anticipated to provide a positive contribution to growth for the whole of the year as disposable income benefits from rising private sector wages, lower borrowing costs and relatively low oil prices. A further pick up towards 3.0% is penciled in for real GDP growth in 2017, with investments, exports and household expenditure seen leading the way higher. Amongst the key challenges in the aforementioned outlook are the recovery in euro area's economic activity – Serbia's main trade partner – and the structural reforms process ahead. The future trajectory of global oil prices and agricultural conditions domestically are also looming risk factors.

New coalition government expected to continue along its predecessor's policies;
IMF Executive Board completes 4th & 5th reviews of SBA

Following unexpectedly lengthy negotiations, the new coalition government took office in mid-August. The winner of April's general elections, the Centre-right Serbian Progressive Party (SNS) party, renewed its partnership with the Socialist Party of Serbia (SPS), with the new coalition government controlling a comfortable absolute majority of 160 MPs in the 250-seat National Assembly. Most key ministers from the prior government held on to their posts, with Finance Minister Dusan Vujovic also renewing his mandate. This development is seen as ensuring continuation of the previous administration's policies, especially on the continuation the EU accession process and adherence to the IMF 3Y-precautionary SBA arrangement. With regards to the latter, the combined 4th and 5th reviews were completed at the end of August. Their completion made available the cumulative amount of SDR 608.01 million (about €761.6 million), but Serbian authorities have indicated their intention to continue treating the arrangement as precautionary. The Executive Board acknowledged that economic recovery has exceeded expectations, while the fiscal over-performance has continued in 2016. In this context, the Fund recently revised upwards its earlier real GDP growth forecast for 2016 to 2.5%, from 1.8% before, envisioning a further acceleration to 2.8% in 2017, while its projection for this year's fiscal deficit was lowered to 2.5% of GDP, from 4.0% of GDP previously. Yet, the IMF highlighted, inter alia, the importance of the implementation of structural reforms, such as the restructuring in state-owned enterprises and public sector headcount reduction, in order to achieve a reduction of fiscal risks and support economic growth and competitiveness. With regards to monetary policy, the Fund deemed the current cautiously accommodative stance as appropriate. Following a largely unexpected 25bps reduction to a new record low of 4.00% in the key policy rate in July, the NBS has held its horses over the last two meetings. Since May 2013, it has rendered a total of 775bps of cuts in view of subdued inflation pressures. The room for further monetary easing appears limited at present as CPI (at 1.2% in August) is anticipated to return within the 4.0±1.5% target tolerance band in the first half of 2017 on the back of increasing aggregate demand and base effects.

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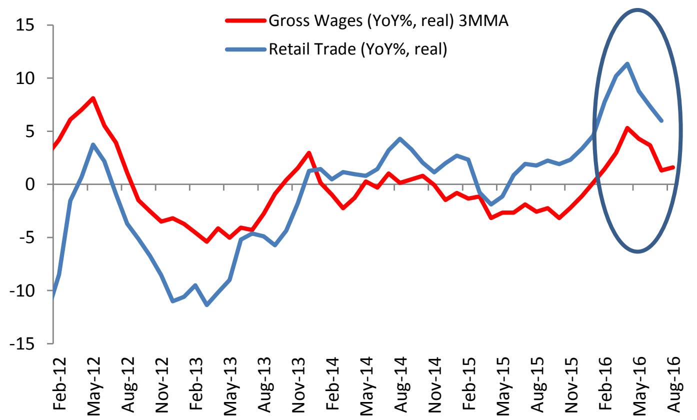
Serbia: Eurobank Forecasts

	2014	2015	2016	2017
Real GDP (yoy%)	-1.8	0.7	2.5	2.8
Inflation (yoy%)				
HICP (annual average)	2.1	1.4	1.3	3.2
HICP (end of period)	1.8	1.6	2.0	3.9
Fiscal Accounts (%GDP)				
Consolidated Government Deficit	-6.6	-3.7	-2.5	-2.2
Gross Public Debt	72.0	77.4	76.8	75.1
Labor Statistics (%)				
Unemployment Rate (%of labor force)	19.4	17.7	17.7	17.0
Wage Growth *(total economy)*	2.0	0.0	0.0	0.0
External Accounts				
Current Account (% GDP)	-6.0	-4.8	-4.2	-3.9
Net FDI (EUR bn)	1.2	1.8	1.6	1.5
FDI / Current Account (%)	60.0	112.5	114.3	107.1
FX Reserves (EUR bn)	9.9	10.4	10.1	10.3
Domestic Credit	**2012**	**2013**	**2014**	**2015**
Total Credit (%GDP)	62.8	57.0	61.5	63.6
Credit to Enterprises (%GDP)	31.2	26.1	25.0	25.0
Credit to Households (%GDP)	18.2	17.4	18.7	19.6
Private Sector Credit (yoy%)	9.5	-4.8	0.5	3.2
Loans to Deposits (%)	126.9	114.1	111.8	112.6
Financial Markets	**Current**	**3M**	**6M**	**12M**
Policy Rate	4.00	4.00	4.00	4.00
EUR/RSD	123.30	124.00	125.00	127.00

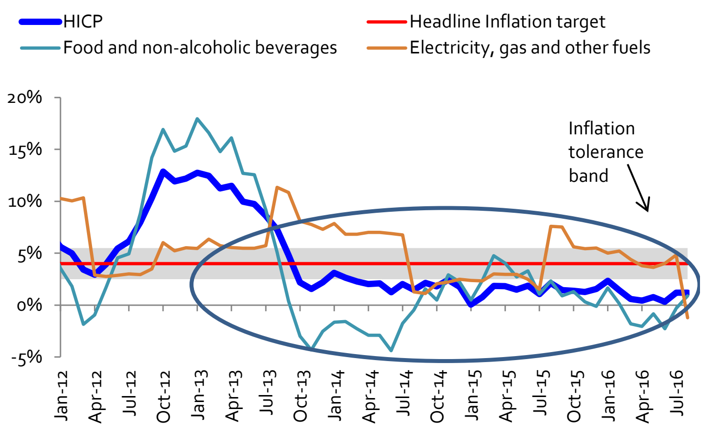
Source: National Authorities, EC, IMF, Eurobank Research

FIGURE 25: **Private consumption and wage growth remain robust (3MMA)**



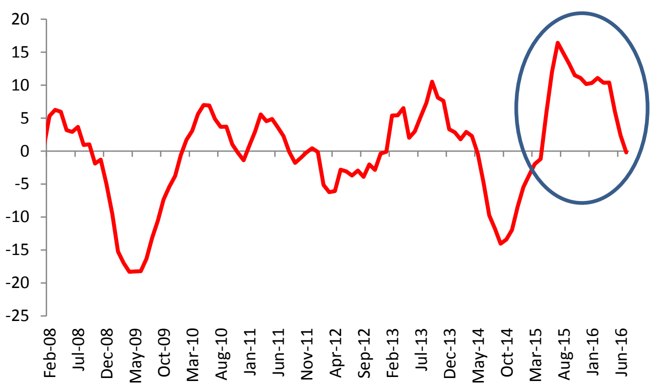
Source: National Authorities, EC, IMF, Eurobank Research

FIGURE 26: **Inflation remains below NBS target for more than two years**



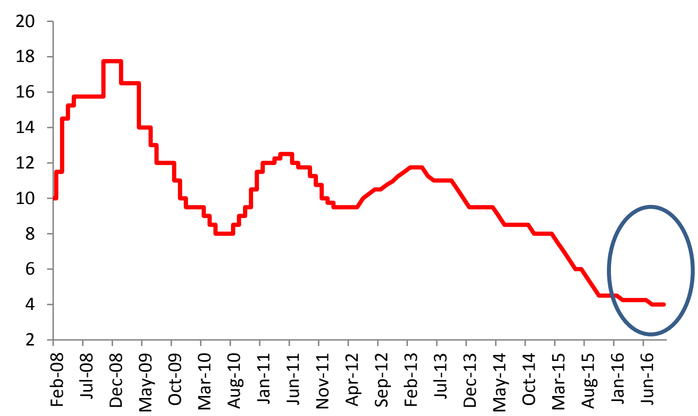
Source: National Authorities, Eurobank Research

FIGURE 27: **Growth in industrial production slows down on seasonal factors (3MMA YoY %)**



Source: National Authorities, EC, IMF, Eurobank Research

FIGURE 28: **NBS holds fire for 2nd month running in September**



Source: National Authorities, EC, IMF, Eurobank Research

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