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Bi-Monthly overview of economic & market developments in the SEE region

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CESEE markets under pressure on worries about potential impact of Fed QE tapering, heightened geopolitical tensions in the broader region

CESEE MARKETS

- **CESEE stock markets** under pressure on worries over Fed QE tapering, heightened geopolitical tensions in the broader region
- **Regional currencies weaken,** with impact more pronounced on the assets of economies with high external financing requirements
- Snap **Presidential elections called in Ukraine** following months in turmoil
- **Local rate markets** remain vulnerable amid persisting depreciating pressures on regional currencies

COUNTRY FOCUS

- **Serbia: High popular support drives Progressives to call early elections, scheduled for March 16th**

  Following months of speculation, the main political party in the ruling coalition, the Serbian Progressive Party, called snap elections earlier this year.
- **Romania: Economy already undergone significant adjustments in external and fiscal imbalances**

  2013 growth recovery driven by strong export performance and bumper harvest, but small deceleration expected this year on adverse base effects.
- **Bulgaria: Rebalancing of Bulgarian economy continues, driven by improving export performance**

  Economic activity to pick up modestly in 2014, while inflation pressures likely to remain subdued this year and the next on weak domestic demand dynamics.

FIGURE 1: **US stocks rise on improved global growth prospects**

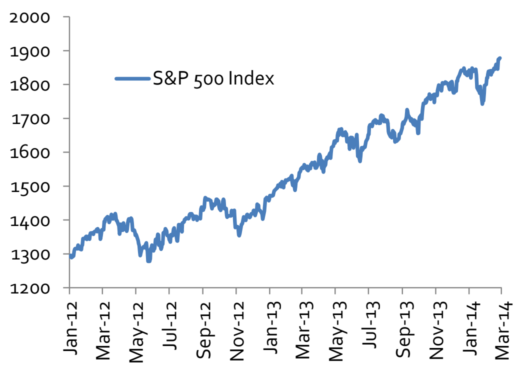
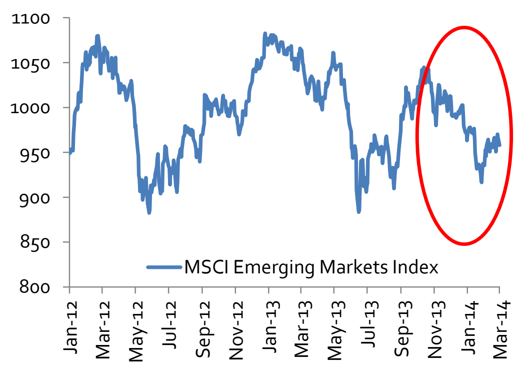


FIGURE 2: **EM stocks under pressure on worries over Fed tapering, geopolitical tensions**



Source: Reuters, Bloomberg, Eurobank Global Markets Research

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CESEE stock markets under pressure on worries over Fed QE tapering, heightened geopolitical tensions in the broader region

Emerging stock markets have broadly remained under pressure in recent months on rising uncertainty about the potential impact of the Fed's QE tapering on global capital flows, worries over the outlook of the Chinese economy and, at a more regional level, escalating political and economic tensions in a number of countries, including Ukraine, Venezuela and Turkey. An unexpected policy move earlier this year by the Central Bank of Argentina to relax currency controls and devalue the peso in an effort to preserve sharply diminished FX reserves added to downside market pressures. Although stock markets in the CESEE region did not manage to escape the latest bout of risk aversion unscathed, they have broadly fared better than other emerging peers on relatively sounder economic fundamentals (Figures 2& 3).

Regional currencies weaken, with impact more pronounced on the assets of economies with high external financing requirements

Along similar lines, regional FX markets have lost significant ground over the first two months of 2014 (Figure 4), with broadly accommodative monetary policies in the CESEE region adding to depreciating pressures on the local currencies. The impact of this latest bout of risk aversion has been more pronounced for economies featuring high external imbalances and elevated financing requirements. The Turkish lira has been one of the most severely hit emerging market currencies, as the country's current account deficit and corporate external debt exposure stand at comparably elevated levels, while inflation remains firmly above the Central Bank's medium-term target of 5%. Escalated domestic political tensions exacerbated depreciating pressures on the lira, following a corruption scandal reportedly involving high level businessmen and politicians closely linked to Prime Minister Tayyip Erdogan. As a result, the TRY plummeted to record lows of 2.39/USD on January 27, prompting aggressive Central Bank rate hikes in order to contain the currency's depreciation trend. In a similar vein, the Hungarian forint lost significant ground, having tested 2-year lows just off 315/EUR in late February. This follows 430bps of cumulative Central Bank policy rate cuts since August 2012, which have pushed the MNB base rate to a record low of 2.70%, presently. Besides these negative drivers, Hungary's relatively high public debt ratio (77.8%-of-GDP at the end of 2013) is an additional factor rendering domestic asset markets more vulnerable to rising external tensions comparing to other regional peers.

Snap Presidential elections called in Ukraine following months of turmoil

Elsewhere, the Ukrainian hryvnia hit a record low near 11/USD on February 27th in view of the intensifying domestic political crisis after President Yanukovich rejected last November an EU trade agreement and instead agreed to receive a $15bn credit line from Russia along with a near 30% reduction in gas prices. Violence between pro-EU anti-government protesters and the police intensified in February, resulting in the overthrow of the President from his post, early Presidential elections set for May 25th and a referendum (called for March 16th) on the potential secession of Crimea and its consequent accession to the Russian Federation. Consequently, tensions between the two neigbouring countries escalated and Russia decided to suspend its financial aid program to Ukraine. Sounding the alarm bells, Ukraine's acting President Oleksander Turchinov highlighted recently that "the Ukrainian economy is heading into the abyss and is in a pre-default state". Meanwhile, the Finance Ministry said that the country needs around $35bn of financial assistance over the next two years. The IMF and the European Union have signaled their willingness to provide financial support, if requested. However, any such agreement will reportedly entail painful reforms and seems unlikely to come ahead of May's ballot. Earlier in the month, the Central Bank imposed temporary capital controls in an effort to ensure banking sector and foreign exchange stability against a backdrop of persisting domestic political jitters. The measures included limits on private transfers abroad and bans on FX purchases for overseas investment or early loans repayments.

Although contagion risks from Ukraine via the trade channel seem rather limited for CESEE economies, regional assets have been relatively sensitive to the recent developments in their neighboring country. Concerns about potential foreign capital outflows from regional markets persist, while fears linger over potential disruptions in the operations of several CESEE companies residing in the country. Notably, Russian assets have been most hit, in view of the strong economic and political links between the two countries. Reportedly, Russian banks are estimated to have a $28bn exposure to Ukraine and significant trade links, including gas exports.

Local rate markets remain vulnerable amid persisting depreciating pressures on regional currencies

Elsewhere, local rate markets have broadly underperformed other asset markets in the EM space, as the recent weakening of domestic currencies has prompted significant monetary policy tightening in a number of emerging economies. Central Banks in Brazil, India, South Africa and Turkey have all raised interest rates this year in order to ease depreciation pressures on local currencies. Speculation recently emerged that the Hungarian Central Bank may eventually resort to higher policy rates following substantial monetary easing over the last 1-½-year, which has heavily weighed on the forint. Emerging government bonds will likely remain under pressure in the weeks/months ahead as domestic Central Banks are left with little leeway for further rate cuts against a background of improving growth outlooks and record-low policy rates. Additional monetary tightening remains in the cards, especially in the event of a new bout of renewed deterioration in market sentiment which will likely instigate fresh depreciation pressures on regional currencies. Upside risks to inflation as a result of the FX pass-through also bode ill for local rate markets.

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FIGURE 3: **CESEE stock markets performance mixed, but most regional bourses fare better than EM peers**

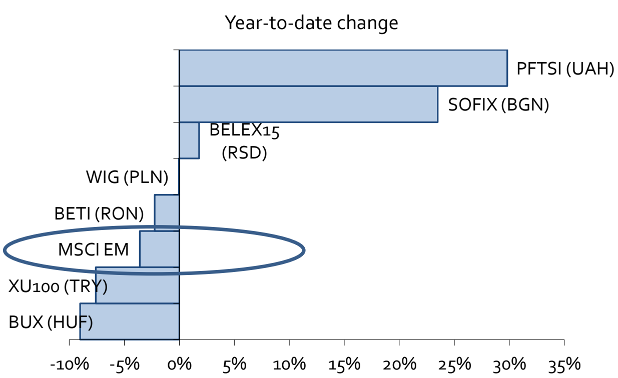
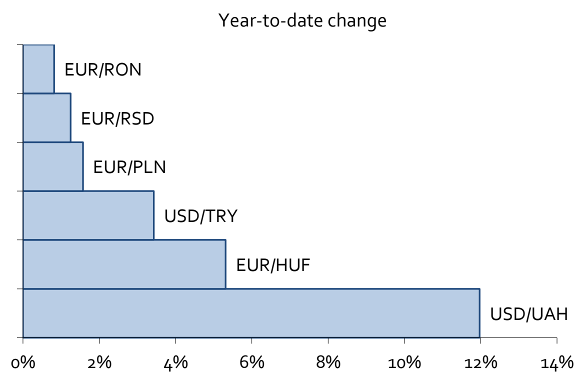


FIGURE 4: **CESEE currencies weaken since end-2013**



Source: Reuters, Eurobank Global Markets Research

Trader's view

Short EUR/RSD positions offer value as recent uptrend is probably overstretched

FX: So far this year, the Serbian dinar has been mostly driven by persisting domestic political uncertainty, with the government calling snap elections in January, following months of speculation. The period in the run-up to the March 16 polls may bring to standstill the implementation of important reforms and possibly lead to delays in crucial political and economic decisions. The timing is rather problematic, as Serbia's public finances continue to deteriorate and a number of reforms such as changes in labor and privatization legislation as well as the restructuring of unproductive state enterprises require urgent implementation. These developments have contributed to the recent depreciation of the dinar, which slid to a 16 month low near 116.05/25 in late February. Notwithstanding the aforementioned, news about the snap elections should not be overwhelmingly perceived as an outright negative. According to the latest opinion surveys, Serbian progressive party currently leads the polls, with a share of 45%. If these surveys are vindicated, Aleksandar Vucic will likely take over the post of Prime Minister and if he delivers on his pre-election agenda, a strengthening of the dinar over the next 2-4 months appears to be a realistic scenario. Note here that the Central Bank Governor recently pledged to safeguard the dinar's stability. This has already been vindicated by ongoing NBS interventions in the FX markets in order to halt the currency's recent depreciating momentum. So far this year, the Central Bank has sold ca EUR 760 million. Consequently, the EUR/RSD may eventually reverse its uptrend or, in the worst case scenario, levitate around 116.00. In either case, being long the dinar could prove a fruitful strategy. Against this background, we favor short EUR/RSD positions with entry levels at 116.00, stop loss of 116.60 and target at 115.00, looking for a carry of around 7.6% on an annual basis.

Local Rates: The Bulgarian local bonds market remained stable over the first few weeks of the year and Eurobond prices were little changed despite escalating EM jitters. As the primary market calendar is very light through to the end of Q1, demand in the secondary market should eventually revive and possibly push yields slightly downwards. Note that the forthcoming issuance of the new Bulgarian Eurobond, which is expected to take place before the EU parliament elections at the end of May, takes centre stage. Indications are for an amount of EUR 1.5bn in the 5/10-year sector with local investors, such as pension funds and banks, eagerly awaiting on the buy side.

Rally in Bulgarian stock market will likely prolong, but eruption of political tensions ahead of EU Parliament elections could instigate downside pressures

Stock Markets: Bulgarian equities enjoyed a decent rally over the last two months with the SOFIX index adding more than 20% over the said period. Liquidity improved noticeably and daily turnover in the main BES market have been well-above the mid-term average levels. While the rally is expected to prolong for some time, downside risks lie in the face of a potential eruption of domestic political tensions in the run-up to the EU Parliament elections in late May. Improved domestic risk sentiment could be easily harmed in the case of escalating tension between the main political parties, while a weak election outcome for the government could increase the likelihood of snap parliamentary elections in 2014.

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II. SEE - Country Focus

Serbia (B1/BB-/B+)

- High popular support drives Progressives to call early elections, scheduled for March 16th
- A new government under the leadership of the Serbian Progressive Party is a done deal; implementation of structural reforms remains of key importance
- Inflation and widening current account pressures subsiding
- Further progress is needed on the fiscal side

Early elections set for March 16th.

Serbian Progressive Party (SNS), the major partner in the ruling collation, recently called a snap election to be held on March 16, 2014. In support of its decision, SNS said that this was "the best possible solution to win new legitimacy and lead the country forward, soothing political tensions". In reality, the party seeks to capitalize on its strong popular support ratings and thus, assert itself as the ruling political force over the next four years. The opposition, led by the Democratic Party (DS), currently appears to be weak and divided. As such, it does not seem poised to create any significant surprises at the upcoming elections.

Accession talks with EU began on January 21st

The timing of the upcoming snap election appears to be particularly favorable for SNS. Serbia officially began accession talks with the EU on January 21st. The eagerly awaited accomplishment comes as a boon to the country in challenging times, both politically and economically. The SNS-led government was established in the wake of the May 2012 elections, after the Democratic Party could not manage to effectively address the challenges of the persisting economic crisis. Once in power, they quickly implemented a twofold strategy, entailing an acceleration of EU accession and an anti-corruption campaign. The speedy track to EU accession, albeit at the cost of relinquishing most of what had been left of Serbia's authority over the breakaway province of Kosovo, was welcomed by the vast majority of the population, where the official unemployment rate stands at 24%. Furthermore, the government's anti-corruption campaign culminated in a 7-month-long detainment of Serbian tycoon Miroslav Miskovic. As a result, the popularity of SNS and their leader, Aleksandar Vucic, has skyrocketed, reaching 40-45%, according to recent opinion polls.

SNS will likely acquire both the Prime Minister post and the commanding majority in the Assembly

Mr. Vucic, who now holds the post of the First Deputy Prime Minister, currently appears to be the most powerful figure in Serbia's political scene. Provided that there won't be any major surprises during the short campaigning period, SNS will likely acquire both the Prime Minister post and the commanding majority in the Assembly. Incumbent Prime Minister, Ivica Dacic, is affiliated to the Socialist SPS party. The latter won only 14.5% of the vote in the May 2012 elections (vs. 24% acquired by SNS), but was able, thanks to its high coalition potential, to negotiate and take over the said post.

The call for early elections was widely expected. Mr. Vucic knows all too well that the two pillars of his popularity (EU accession and anti-corruption) stand on fragile grounds. First of all, the EU accession process will not translate into better living standards for quite some time; not least because the EU pre-accession funds are thinning. It is, after all, a lengthy process with significant challenges along the way. Secondly, the anti-corruption campaign is not yet institutionalized, but it is rather based on ad hoc arrests, with not a single case having so far been resulted in a court conviction. Along these lines, early elections were called, despite some opposing voices raised from a number of EU officials and foreign diplomats.

Challenges for the Serbian Progressive Party lie ahead

The Serbian proportional electoral system entails a 5% parliamentary entrance threshold, which can theoretically allows a party with 40% of the total vote to attain absolute majority in Parliament. With a number of small parties currently eager to enter Parliament (DSS, LDP, URS), the strongest player is highly likely to get a disproportionately high number of seats. Although we do not expect the Serbian Progressive Party to gain absolute majority, a Vucic-led government is the most likely outcome of the upcoming election, in our view. Without the ballast of the "left" wing partners, this should present a perfect opportunity for the new government to embark on a path of structural reforms aiming to, among others, overhaul the public sector, finalize institutional reform and amend the legislative framework (Labor law, Law on Bankruptcy, Law on Privatization). By all accounts, the implementation of such reforms will be the ultimate test for Aleksandar Vucic and his team.

GDP growth deceleration expected this year

Driven mostly by strong net exports, real GDP grew by 2.4% in 2013, the fastest pace of increase in five years. FIAT Automobiles and Gazprom-owned NIS were major contributors to the country's export performance, while agricultural output grew by 18%. On a less positive note, consumption and government spending exerted negative contributions to last year's GDP growth.

CAD improving as a consequence of stronger exports

External imbalances improved last year thanks to exports' impressive performance, while a relatively high level of FX reserves (ca €11.2bn at the end of 2013) provided a considerable buffer to external funding pressures. The current account deficit (CAD) is estimated to have reached 4.6% of projected GDP in 2013, compared to levels above 10% only two years earlier. Customarily, high remittances are the single most stable FX inflow year after year, consistently amounting to around €2.8-€3.0bn. FDIs at €700mn in 2013 were meager, but are expected to hit €1bn this year, with a considerable part of inward investment being channeled to the domestic energy sector.

Net exports pose as the main driver of growth

Although the ongoing recovery in the euro area economy, which accounts for 64% of Serbia's exports, should provide some support, the strong performance of Serbian exports in 2013 is unlikely to be repeated this year, not least because both FIAT and NIS already operate near full capacity. Moreover, agricultural output growth may slowdown this year, on the back of unfavorable base effects, while domestic demand is anticipated to remain subdued, in view of the austerity measures introduced in late 2013. Overall, real GDP is expected to grow by between 1.0% and 1.5% in 2014 (Min Finance: 1.0%, EBRD: 1.3%, Eurobank: 1.2%, NBS 1.5%).

Inflation pressures subsiding

Inflation risks have waned gradually throughout 2013. A 2.2% CPI print at the end of last year stood just below the 2.5-5.5% target range, allowing the CB to maintain an accommodative policy stance. The key policy rate has been reduced by 225bps over the course of 2013 to currently stand at 9.50%. However, the room for more rate cuts appears to be limited at this stage. Note that the CB recently emphasized the need for caution, in view of risks stemming from international markets developments.

Further progress is needed on the fiscal side

A sustainable improvement in public finances remains a key challenge for the government at present. Despite the rationalization and consolidation measures introduced in late 2013, the projected consolidated general government deficit for this year stands at a still sizeable 7.4% of GDP. A hike in the lower VAT rate along with the increase in the tax for the state employees who earn over €550 per month are estimated to bring in additional revenue to the tune of 0.8% of GDP in 2014. On the expenditure side, the cut in subsidies to state-owned companies and those in restructuring will save another 0.3ppts. Other measures included in this year's fiscal program, such as the fight against tax evasion, savings on public tenders for goods and services and improvement of the business environment are rather difficult to quantify and thus, considerable uncertainty continues to surround their overall impact on government finances. Although recent actions taken on the fiscal side appear to be in the right direction, they may well prove inadequate to ensure sustainable fiscal consolidation without genuine structural reforms cutting deeply into the pension and civil servant systems, as well as publicly owned companies.

Rising indebtedness prompts Fitch to downgrade Serbia to from BB- to B+

An ongoing need for new borrowing pushed the gross public debt ratio to 61.2% of GDP at the end of 2013 (and to 61.8% in mid-February 2014). This stands significantly above the 45% legal threshold and far from the 28% pre-crisis level of 2007. The current readings place Serbia among the most indebted countries in the region. On January 17th, Fitch Ratings downgraded Serbia's long term foreign and local currency IDRs to B+ from BB-, citing ongoing deterioration in public finances and weak economic prospected ahead.

Nonetheless, thanks to abundant global liquidity, Serbia still manages to borrow in financial markets at reasonable rates. Despite its deficiencies and a challenging environment, Serbia is a country of solid upside potential. Its population is comparably highly educated, especially in tech sciences, and English literate. In addition, the country lies on the crossroads of pan-European corridors, and has entered into a Free Trade agreement with Russia- the only country in the region to do so.

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FIGURE 5: **Real GDP (YoY%)**

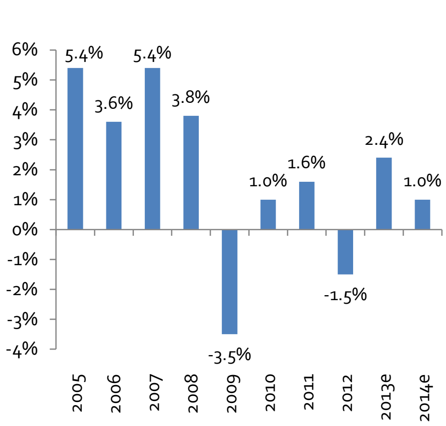


FIGURE 6: **Current Account Balance (GDP %)**

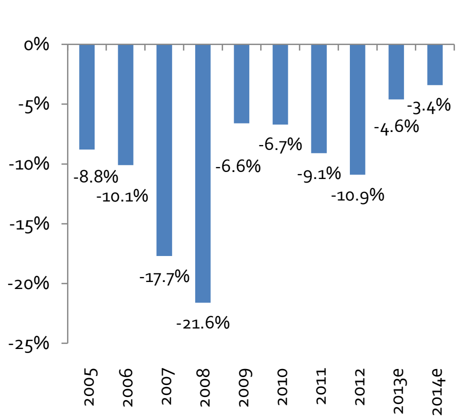
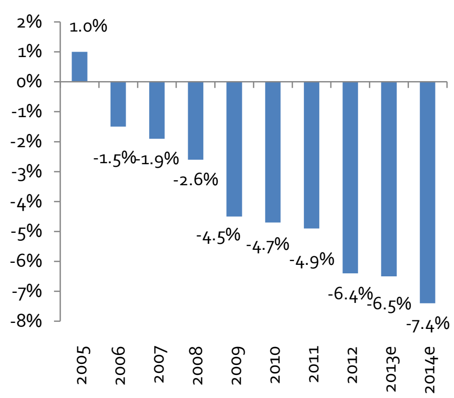


FIGURE 7: **Consolidated Budget Balance (GDP %)**



Source: National authorities, Eurobank Global Markets Research

Romania (Baa3/BB+/BBB-)

- Economy already undergone significant adjustments in external and fiscal imbalances
- 2013 growth recovery driven by strong export performance and bumper harvest; small deceleration expected this year on adverse base effects
- Rate-cutting cycle has probably came to an end in February, NBR likely to maintain accommodative policy stance throughout this year

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2013 growth recovery driven by strong export performance

Economic activity in Romania picked up significant pace in H2 2013. According to a flash estimate, real GDP grew by 5.1% YoY in Q4 2013 in seasonally adjusted terms, following a 4.1% YoY increase in the prior quarter and growth of 1.9% YoY in H1-2013. Along these lines, GDP growth came in at 3.3% in 2013, marking the highest print in the European Union. The latter stands well above an initial government forecast of 1.6% and compares with a 0.4% reading a year earlier. Over the first nine months of the year (the breakdown of Q4 2013 data was not available at the time of writing this report), the main contribution to GDP growth came from an impressive surge in exports (+14% YoY), primarily stemming from the automotive sector and an increasing share of exports towards non-EU countries. Note that according to international trade data, transport equipment and vehicles accounted for 42% of total exports in 2013. On the other hand, domestic demand continued to contract (-2.0% YoY) due to the ongoing decline of investment spending (-3.5% YoY) and subdued consumption dynamics (+0.1% YoY). From the supply-side, a double-digit annual increase in agricultural output and robust industrial production were among the main positive contributors to GDP growth.

Small deceleration expected in 2014 on base effects

A small slowdown in real GDP growth to 2.7% is expected this year (Eurobank Global Markets Research) due to unfavorable base effects stemming from the strong performances in agriculture and exports last year. This however, may be partially offset by potential spending increases in the run-up to the November 2014 presidential election. Domestic demand is anticipated to gradually pick up pace thanks to considerable monetary policy accommodation in recent months and enhanced absorption of EU funds. Recovering consumer confidence and higher disposable incomes as a result of rising wages and pensions are also likely to support private consumption. Yet, these positive developments may be overshadowed by a concomitant rise in imports.

Since 2008, the economy has undergone significant adjustment of twin deficits

Since the eruption of the 2008 crisis, the Romanian economy has undergone significant adjustments in its external and fiscal imbalances. The country's current account deficit (CAD) has narrowed substantially towards 4.4%-of-GDP in 2012 from a record peak of 13.6%-of-GDP in 2007. The adjustment continued in 2013, where the shortfall shrunk by 74% YoY to €1.5bn, or ca 1.1% of estimated GDP. The bulk of the aforementioned cumulative improvement came from a narrowing trade deficit. The latter shrunk by ca 54% YoY in 2013, as exports grew by 10%YoY thanks to a bumper harvest and an expansion towards non-EU countries. On the other hand, imports rose by a meager 1.0% YoY last year, reflecting weak domestic demand. Higher surpluses in the accounts of services (+129% YoY) and current transfers (+8% YoY) were also behind the realized improvement in the country's current account position. Adding to the positive tone, inward foreign direct investment amounted to €2.7bn, marking a 26.8% YoY increase and covering around 180% of the CAD. Notwithstanding the aforementioned, the current account deficit is expected to widen slightly this year, reaching ca 2%-of-GDP (Eurobank Global Markets Research), on improving domestic demand dynamics.

Romania's public finances have also improved significantly in recent years, with the consolidated general government budget deficit on a cash basis having been cut to 2.5%-of-GDP in 2013 (~ 2.6%-of-GDP in ESA 95 terms) from a record post-communism peak of 7.3%-of-GDP (~ 9%-of-GDP in ESA 95 terms) in 2009. Two consecutive financial support packages with official lenders over the period 2009-2013 have provided a valuable policy anchor, assisting the government to cope with risks emanating from the country's high external and fiscal imbalances. The last of these two packages was agreed last year and entails a loan of ca EUR 2bn under a precautionary Stand-By Arrangement extended by the IMF and EUR 2bn under the EU's balance of payments facility. The EU/IMF deal spans a 24 month period and Romanian authorities have already indicated that they intend to treat the arrangement purely on a precautionary basis, without planning to draw any funds under it. Nonetheless, the program provides valuable support on policy continuity, acts as a reserve buffer and focuses on structural reforms aimed at improving the country's future economic growth potential. Both the first and second reviews of the present program were successfully completed last February, with official lenders noting that the program remains on track. In addition to the aforementioned, a EUR 1bn credit line was made available from the World Bank in 2012, "to support the Government of Romania's efforts to meet the fiscal sustainability goals as defined by the European Union (EU) fiscal compact". The government has so far tapped ca EUR 700mn of the latter facility.

2014 budget target appears feasible

For 2014, the Budget Law stipulates a general government deficit of 2.2%-of-GDP (both in cash and in ESA 95 terms). From the expenditure side, it includes increases in the minimum wage and pensions as well as discretionary hikes in public sector salaries aimed at underpinning domestic demand. On the revenue side, it envisages, among other, higher excise duties and the broadening of the base for property taxation. The introduction of a new IMF-backed levy on fuels was deferred to April 1, amid heightened tensions between the President and the Prime Minister, with the former opposing the measure on the grounds that it would bear negative repercussions for the still-fragile economic recovery. To account for the financing shortfall created by this delay, the government plans to freeze expenditure on certain budgetary items. Slippages may occur this year on the back of increased spending in the run up to the upcoming EU Parliament and domestic Presidential elections. However we see such risks as rather limited. In spite of the cabinet reshuffle in February we anticipate the government to continue along its IMF-backed economic policies, and actively pursue, among others, the privatization of state-owned enterprises. Taking into consideration the recently completed reviews under the IMF Stand-By Agreement (SBA), we expect the fiscal consolidation process to continue broadly uninterrupted, facilitating the attainability of this year's budget deficit target. Looking further ahead, Romanian authorities are seeking to push the budget deficit further down towards a medium-term target of 1%-of-GDP.

NBR kicks off 2014 with further rate cuts

The NBR kicked off the year with substantial monetary easing, slashing its key policy rate by 50bps cumulatively in the first two monetary policy meetings in January and February, to a new record low of 3.50%. In a rather unexpected move, the Central Bank also reduced the minimum reserve requirements (MMRs) on RON and FX-denominated liabilities of credit institutions to 12% and 18% from 15% and 20% respectively. The latter measure came into effect on January 24th, and effectively provides additional liquidity into the banking system. As a consequence, it will likely support domestic credit activity. It is also destined to align the domestic minimum reserve requirement mechanism with European Central Bank standards and practices.

Recall that, since the inception of its latest monetary easing cycle in July 2013, the Central Bank has delivered a total of 175bps of rate cuts aiming to support the fragile economic recovery. Indeed, domestic demand dynamics remain weak and inflation has fallen significantly in recent months. CPI hit a record low of 1.1% YoY in January, just below the lower end of the Central Bank's 1.5-3.5% target range and well under a 4.96% print recorded at the end of 2012. The strengthening disinflation process in recent months may be largely explained by: (i) temporary factors, such as easing food prices thanks to a good agricultural season and a reduction in VAT rate for some bakery products from 24% to 9% as of September 2013; (ii) favorable base effects stemming from an electricity price hike which came into effect in December 2012; and (iii) longer-lasting influences, including a still negative output gap and well anchored inflation expectations.

Inflation likely to converge towards the upper bound of the NBR target range by December

Inflation is expected to remain below the lower bound of the NBR target range throughout this quarter due to base effects stemming from the regulated price increases on electricity and tobacco implemented in January 2013 as well as easing food prices. However, a reversal of this trend is likely to emerge from Q2 2014 onwards. This will likely be driven by higher excise duties (a 7 cents/liter increase on fuels is scheduled for April), the dissipating impact of base effects on food prices from last year's bumper crop as well as the VAT reduction on bread products and a narrowing output gap. As also acknowledged by the NBR, annual CPI is likely to converge towards 3.5%, the upper bound of the NBR target range by December. Risks to this forecast are skewed to the upside and primarily stem from a further potential depreciation of the domestic currency, especially in the event of a renewed bout of global risk aversion. The new harvest and the implementation date of the excise fuel hike are also likely to affect this year's inflation path.

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NBR to probably maintain accommodative stance over the remainder of this year

NBR likely ended its rate-cutting cycle in February, as a further reduction from current (record low) rate levels may instigate depreciating pressures on the leu, especially as the Fed is anticipated to further trim the pace of its asset purchases in the months ahead. An expected reversal of the current disinflation trend in H2 also argues in favour of a stable policy rate. That said, a gradual reduction in the minimum reserve requirement ratios is likely. Taking into account that FX-denominated loans account for a large share of total private sector credit (ca 60%), MMR reductions will probably be earmarked on RON-denominated liabilities in an effort to underpin domestic currency loans.

Former ruling coalition breaks up, new coalition government formed

Negotiations between the Social Democratic Party (PSD) and the National Liberal Party (PNL) for the appointment of new ministers to a number of vacant cabinet seats broke down in late February, with the latter withdrawing its ministers from the ruling coalition and moving into opposition. The PSD was left in power in an alliance with its two junior partners, the Conservative Party (PC) and the National Union for Romania's Progress (UNPR), occupying an estimated share of around 48% of the total seats in parliament. Following the conclusion of negotiations with minority parties in Parliament, and, particularly, with the Democratic Union of Hungarians in Romania (UDMR), Prime Minister Victor Ponta and leader of the Social Democratic Party (PSD), announced in early March the ministers of his new cabinet. A day later, Parliament approved in a vote of confidence the new PSD-led government. Ioana Petrescu, an economic adviser to the Prime Minister, assumed the post of the Finance Minister and is expected to continue along the Premier's policies. Cumulatively, the ruling parties control more than half of the seats in Parliament (reportedly around 55%) and the PSD is currently the prevailing party under this coalition which reduces the risk for potential frictions with allies, in contrast to the previous government.

FIGURE 8: **Public finances improve (%GDP, ESA 95)**

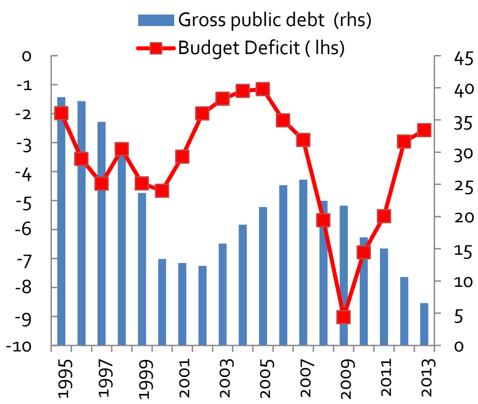
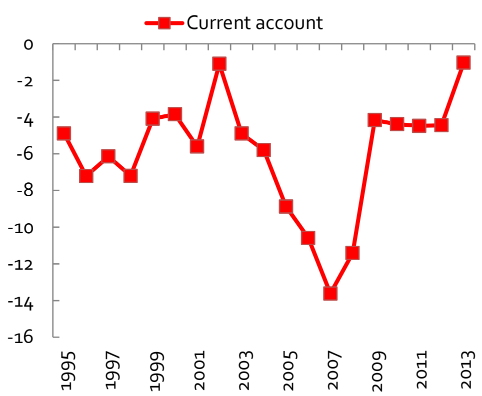


FIGURE 9: **External vulnerabilities ease (%GDP)**



Source: Reuters, Eurobank Global Markets Research

As a result, we currently see limited risk for snap general elections and political instability. In addition, the PSD can now propose its Presidential candidate for this year's election. Prior to the formation of the new government, the PNL was seeking to put forward its own nominee. Presently, high on the new government's agenda are IMF-backed reforms, including privatization and restructuring of inefficient state-owned enterprises as well as a further improvement in the country's fiscal position. Notwithstanding the aforementioned, the possibility of new frictions between the Prime Minister and the President cannot be entirely ruled out. However, the former's tenure ends in November, when the next presidential polls are scheduled, after two consecutive terms in office.

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Bulgaria (Baa2/BBB/BBB-)

- Rebalancing of Bulgarian economy continues, driven by improving export performance
- Economic activity to pick up in 2014
- Inflation pressures to remain subdued this year
- Multi-year improvement in public finances halted in 2013

Rebalancing of Bulgarian economy continues, driven by improving export performance

Economic activity in Bulgaria picked up pace in Q4 2013, with real GDP growth coming in at 1.2% YoY after a 0.6% YoY increase in the January-September period (seasonally and working days adjusted data). Including the latter, full-year GDP growth modestly accelerated to 0.8%, from 0.6% in 2012. As illustrated in the breakdown of the 2013 data, a rebound in exports (+8.9% YoY vs. +5.7% YoY in imports) and higher government spending (+2.6% YoY) provided a positive contribution to growth. On the other hand, domestic demand dynamics remained weak (-0.8% YoY) on the back of contraction in private consumption (-2.0% YoY) and investments (-1.2% YoY) Overall, domestic demand stood nearly 10% lower in 2013 compared to its pre-crisis levels (2007), largely driven by a steep decline in gross fixed capital formation (by ca 21%). Meanwhile, exports have increased by nearly 30% over the same period in terms of volumes.

Economic activity to pick up in 2014

A modest acceleration of real GDP growth to 1.8% is expected in 2014 (Eurobank Global Markets Research) on the back of recovering private consumption. Such a trend was already evidenced late last year, as reflected in the most recent retail activity data (Figure 10), which showed a 6.3%yoy increase in retail trade excl. motor vehicles and motorcycles in Q4 2013, following broadly stagnant growth in the preceding months of the year. Private consumption dynamics are expected to improve further this year thanks to higher household disposable incomes against a backdrop of subdued inflation pressures (Figure 11), rising wages (Figure 10) and a 9% discretionary increase in pensions as of April 2013. The recent expansion in investments (+2.5% YoY in Q4 2013) is also expected to pick up pace in the period ahead, receiving support from easing lending conditions. Additionally, the expected recovery in the European Union, Bulgaria's main trade partner (absorbing ca 60% of the country's total exports), is also anticipated to provide support. That said, stronger domestic demand is likely to instigate higher import growth and thus, to somewhat contain the positive impact from the net exports. Downside risks to our GDP forecasts for 2014 primarily stem from a more subdued than currently expected recovery in domestic demand and the possibility of revived political tensions – public dissatisfaction is already evidenced via ongoing anti-government protests.

2013 current account in surplus

Bulgaria's current account balance recorded a surplus of 2.0%-of-GDP last year. This compares with a shortfall of 1.3%-of-GDP in 2012. The aforementioned improvement comes on the back of a 32% YoY narrowing in the trade deficit to EUR 2,336mn, or 5.7%-of-GDP, over the said period, thanks to weak domestic demand dynamics (imports +1.3% YoY) and recovering exports (+6.9% YoY). Looking ahead, we anticipate a modest decrease in the current account suprplus this year, in line with a pick-up in domestic demand.

Inflation pressures to remain subdued this year

Domestic inflation pressures have remained subdued in recent months, with a deflation trend having emerged since August 2013. For the year 2013 as a whole, CPI averaged 0.9% YoY, compared to 3.0% in 2012. CPI slid to a 15-year trough of -2.2% in January 2014. This downward momentum has been primarily instigated by easing global oil prices, weak domestic demand dynamics and three separate reductions in regulated electricity prices following strong public discontent about high utility costs. Lower unprocessed food prices thanks to bumper agricultural production last year also assisted the recent disinflation trend. Base effects, especially in H2 2014 will likely push CPI towards 1.4% on average for the whole of this year, with a further acceleration expected thereafter on improving domestic demand dynamics.

3 year-long improvement in public finances halted in 2013

Following three consecutive years of improving public finances, the budget deficit widened in 2013. Weak economic growth, subdued investment spending and a number of stimulus measures that came into effect during 2013 are all to blame. In detail, the consolidated general government budget deficit (based on local accounting standards and calculated on a cash-basis) increased to BGN 1,448.4mn (or to 1.9% of estimated GDP) from BGN 358.8mn (or 0.5% of 2012 GDP) over the same period a year earlier. Expenditure rose by 9.2% YoY, with social expenditure – the highest contributor to government spending – gaining 7.3% YoY. Last year's budget deficit came in above an initially planned shortfall of 1.3%-of-GDP, but remained marginally below a revised deficit target of 2.0%-of-GDP. For 2014, the government envisions a deficit of 1.8%-of-GDP. As a result of a higher budget deficit, general government debt is expected to increase further this year, but still remain among lowest ratios in the EU.

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FIGURE 10: **Private consumption to improve ahead**

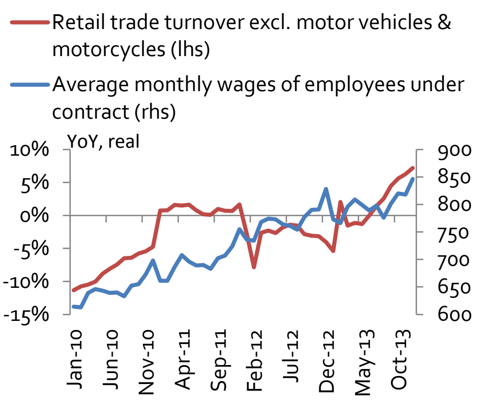
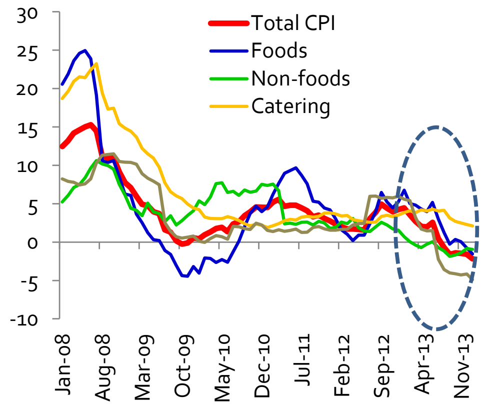


FIGURE 11: **Inflation pressures subside (YoY%)**



Source: National Authorities, Eurobank Global Markets Research

III. SEE - Country Snapshot

REPUBLIC OF SERBIA	2012	2013E	2014F
Real GDP (yoy%)	**-1.5**	**2.4**	**1.0**
Private Consumption	-1.9	-1.2	-1.8
Govern. Consumption	1.8	-3.0	-2.2
Gross Capital Formation	15.8	-3.4	4.7
Exports	1.8	14.0	6.4
Imports	1.9	2.3	1.6
CPI (annual average)	**7.8**	**7.8**	**3.5**
CPI (end of period)	**12.2**	**2.2**	**5.0**
Unemployment Rate (% of labor force)	**23.1**	**24.0**	**24.6**
General Government Balance	**-6.4**	**-6.5**	**-7.4**
Gross Public Debt	**59.3**	**61.2**	**67.2**
Current Account (% GDP)	**-10.9**	**-4.6**	**-3.4**
Policy Rate	**11.25**	**9.50**	**9.50**
EUR/RSD (eop)	**113.7**	**114.6**	**118.8**

ROMANIA	2012	2013E	2014F
Real GDP (yoy%)	**0.7**	**3.5**	**2.3**
Private Consumption	1.1	0.9	1.5
Govern. Consumption	1.7	-1.5	1.8
Gross Capital Formation	4.9	-2.7	3.4
Exports	-3.0	13.6	5.7
Imports	-0.9	2.9	5.0
CPI (annual average)	**3.3**	**4.0**	**3.8**
CPI (end of period)	**5.0**	**1.6**	**3.5**
Unemployment Rate (% of labor force)*	**7.0**	**7.2**	**7.2**
General Government Balance (%GDP, ESA 95)	**-3.0**	**-2.6**	**-2.2**
Gross Public Debt	**38.0**	**38.3**	**39.3**
Current Account (% GDP)	**-4.4**	**-1.0**	**-1.2**
Policy Rate	**5.25**	**4.00**	**3.50**
EUR/RON (eop)	**4.4**	**4.5**	**4.7**

	2012	2013E	2014F
Real GDP (YoY%, sa)	**0.6**	**0.8**	**1.8**
Private Consumption	3.3	-2.0	1.5
Govern. Consumption	-0.4	2.6	3.5
Gross Capital Formation	4.2	-1.2	3.0
Exports	-0.6	8.9	7.0
Imports	3.1	5.7	6.0
CPI (annual average)	**3.0**	**0.9**	**1.5**
CPI (end of period)	**4.2**	**-1.6**	**2.0**
Unemployment Rate (% of labor force)	**11.4**	**11.8**	**11.5**
General Government Balance (%GDP)**	**-0.5**	**-1.9**	**-1.8**
Gross Public Debt	**18.5**	**18.9**	**21.0**
Current Account (% GDP)	**-1.3**	**2.0**	**1.0**
Policy Rate	**N/A**	**N/A**	**N/A**
EUR/BGN	**1.96**	**1.96**	**1.96**

Source: National Authorities, Eurostat, European Commission, IMF, Bloomberg, Reuters, Eurobank Global Markets Research

**Eurostat definition*

*** Local accounting standards*

IV. SEE - Global calendar of key upcoming developments

Calendar of Key Data and Events, February-March-April 2014			
Country	**Date**	**Indicator/Event**	**Previous**
		February, 2014	
BULGARIA	February 28	Budget Balance (Jan)	BGN1448.4mn
SERBIA		Industrial Production (Jan)	0.5% YoY
		Trade Balance (Jan)	-EUR530.7mn
		Retail sales (Jan)	0.6% YoY
		March, 2014	
EUROZONE	March 6	ECB monetary policy meeting & press conference	
SERBIA	March 16	General & local elections	
USA	March 18-19	FOMC meeting	
TURKEY	March 30	Local Elections	
BULGARIA	March 3	International Reserves (Feb)	EUR27.1bn
	March 5	GDP (Q4 2014, wda, f)	1.0% YoY
ROMANIA		GDP (Q4 2014, nsa, p)	5.2% YoY
SERBIA	March 6	MPC policy rate announcement	9.50%
ROMANIA	March 7	Net Wages (Jan)	3.7% YoY
BULGARIA		Unemployment Rate (Feb)	12.2%
	March 10	Industrial Production (Jan)	-1.0% YoY
		Retail sales (Jan)	5.6% YoY
ROMANIA	March 11	CPI (Feb)	1.1% YoY
		Industrial Production (Jan)	7.9% YoY
	March 12	Trade Balance (Jan)	-EUR494.5mn
BULGARIA		Trade Balance (Jan)	-EUR0.9bn
SERBIA		HICP (Feb)	1.4% YoY
BULGARIA	March 13	CPI (Feb)	-2.2%
	March 17	Current Account Balance (Jan)	-EUR281.5mn
ROMANIA		Current Account Balance (Jan, YTD)	-EUR1505mn
SERBIA	March 20	Current Account Balance (Dec)	-EUR53.5mn
	March 25	Real Wages	-6.6% YoY
BULGARIA		Gross External Debt (Jan)	EUR37.1bn
ROMANIA	March 28	MPC policy rate announcement	3.50%
BULGARIA	March 31	Budget Balance (Feb)	N/A
SERBIA		GDP (Q4 2014, nsa, f)	2.6% YoY
		Industrial Production (Feb)	N/A
		Trade Balance (Feb)	N/A
		Retail sales (Feb)	N/A
		April, 2014	
EUROZONE	April 3	ECB monetary policy meeting & press conference	
HUNGARY	April 6	National elections	
USA	April 29-30	FOMC meeting	
ROMANIA	April 1	International Reserves (Mar)	N/A
BULGARIA		International Reserves (Mar)	N/A
ROMANIA	April 2	GDP (Q4 2014, f)	N/A
		Retail sales (Feb)	N/A
	April 7	Net Wages (Feb)	N/A
		Trade Balance (Feb)	N/A
BULGARIA		Unemployment Rate (Mar)	12.2%
ROMANIA	April 10	CPI (Mar)	N/A
		Industrial Production (Feb)	N/A
	April 11	Current Account Balance (Feb)	N/A
SERBIA		HICP (Mar)	N/A
	April 17	MPC policy rate announcement	N/A

Bond Supply Calendar, March 21 - 25, 2011		
Country		**Issue/Maturity**
		March, 2014
SERBIA	March 11	2-year RSD Bonds
ROMANIA	March 13	RON100mn T-Bonds
SERBIA	March 18	7-year RSD Bonds
SERBIA	March 25	2-year RSD Bonds
SERBIA	March 26	2-year RSD Bonds
SERBIA	March 28	3-year RSD Bonds

Source: National Authorities, Bloomberg, Reuters, Eurobank Global Markets Research

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