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CESEE markets regain ground after early 2014 sell-off on hopes for further stimulus measures in major economies

CESEE MARKETS

- **CESEE stock markets** recovered ground over the past few weeks amid expectations for further monetary policy stimulus in the Eurozone and China; additional support provided investor perceptions that the Fed is not in a hurry to hike interest rates
- **Regional currencies** largely recoup earlier losses thanks to improving risk sentiment
- Political jitters in CESEE region ease for now; as election results provide upside surprises
- **Government bonds** firm on accommodative monetary conditions and improving growth prospects

COUNTRY FOCUS

- **Serbia: Progressives (SNS) cement strong position in National Assembly**
  Serbian Progressive Party (SNS) cemented its grip on power for the next four years after a landslide victory in the March 16th election.
- **Romania: Budget execution improves significantly in Q1 2014**
  The general government budget deficit improved significantly in the first three months of the year after unexpectedly posting a surplus in March
- **Bulgaria: Breakdown of Q1 GDP data reveals recovery in domestic demand**
  According to flash NSI estimates, real GDP growth came in at 1.1%YoY in Q1 2014, not much changed compared to 1.2%YoY a quarter earlier. Yet, the breakdown of the data confirmed a recovery in domestic demand

FIGURE 1: **Investor sentiment towards risky assets improves**

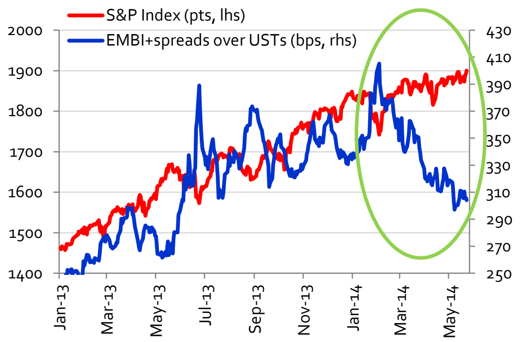
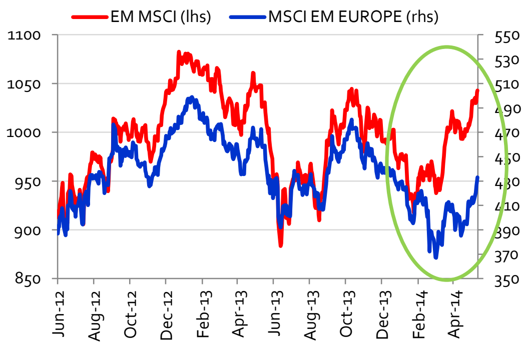


FIGURE 2: **Emerging Europe lags EM stock markets' recovery on geopolitical tensions in Ukraine**



Source: Reuters, Bloomberg, Eurobank Global Markets Research

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I. CESEE Markets

CESEE markets regain ground after early 2014 sell-off on hopes for further stimulus measures in major economies

CESEE stock markets regain ground after early 2014 sell-off

Emerging stock markets recovered ground over the past few weeks, supported by expectations of further monetary policy accommodation in several developed economies, with the early 2014 sell-off appearing to have been overstretched. This shift in sentiment was led by optimism that Chinese authorities will adopt additional stimulus measures to prevent a more pronounced slowdown in the world's second largest economy. In the US, the Fed has signaled that it is not in a hurry to hike interest rates, while QE tapering appears to have been largely priced in by markets. In a similar vein, expectations that the ECB will likely take some action at its next policy meeting in June in an effort to address deflation risks, have also supported investor appetite towards risky markets. These developments have largely overshadowed geopolitical wobbles in Ukraine and recent data releases from China suggesting a gradual slowdown in the domestic economy. Reflecting the recent improvement in market sentiment, the S&P 500 index hit a record high just above 1,900points on May 13 and EM debt spreads over USTs on the EMBI+ index hit a 1-year low near 297bps a few days earlier. In a similar vein, the MSCI index of emerging equities staged a 13% rally after hitting a 5-month trough in early February, to stand at a 7-month peak of 1,041 points on May 22.

Some CESEE bourses lag behind on ongoing geopolitical tensions

The picture has been somewhat different in the CESEE region, which remains susceptible to geopolitical jitters emanating from Ukraine. Stock markets in Poland and Hungary have lagged their peers' recovery (Figure 3) as several domestic companies have presence in Ukraine and Russia and tensions between the two countries raise concerns about potential disruptions in their operations. The Russian stock market has been among the most hit with the MICEX and RTS indices standing well below their respective end-2013 levels (Figure 4). Despite the ongoing upheaval in Ukraine, the country's domestic stock market stands out as a major outperformer so far this year. The PFTS index currently appears rather undervalued, having encountered a severe sell-off since early 2011 (ca -75% between February 2011 and January 2014). Domestic investors had been placing their assets in foreign currency deposits, at least until recently, in view of strong depreciation pressures on the hryvnia last year. However, an upcoming tax on private investor deposits (expected to come into effect this summer) has encouraged many of these depositors to place their funds in the domestic stock market.

Geopolitical tensions in Ukraine remain elevated

Geopolitical tensions in Ukraine have remained elevated over recent months after former President Yanukovich rejected last November an EU trade agreement and instead opted for closer ties with Russia. Following a few months of pro-EU demonstrations, he was eventually removed from the Presidential post in February and early Presidential elections were set for May 25th. Later in February unidentified armed pro-Russian forces seized government buildings in part of the country and an ensuing March 16th referendum in Crimea – deemed as illegal by the West - resulted in the region's annexation under the Russian Federation. Yet, tensions escalated further in the following weeks. An agreement signed on April 17 between the EU, the US, Ukraine and Russia outlining steps to alleviate tensions in the region was never effectively implemented as mounting violence in the country resulted to dozens of deceased individuals. In response to the said developments, the US and EU have imposed sanctions, including travel restrictions and asset freezes, on a number of companies and individuals deemed as responsible for the current crisis. However, these have so far proven to be less strict than initially feared, with their impact on the Russian economy being rather ineligible so far.

The Executive Board of the International Monetary Fund approved on April 30 a two-year US$17bn Stand-By Arrangement (SBA) in order to assist Ukraine meet its financial obligations in the period ahead. Around $3.2bn were made available for immediate disbursement, with $2bn earmarked for supporting the government budget.

The said package is expected to unlock financial aid from other donors, with official financing from World Bank, the European Commission, the EBRD and other sources projected to exceed US$6bn in 2014 and US$5bn in 2015.

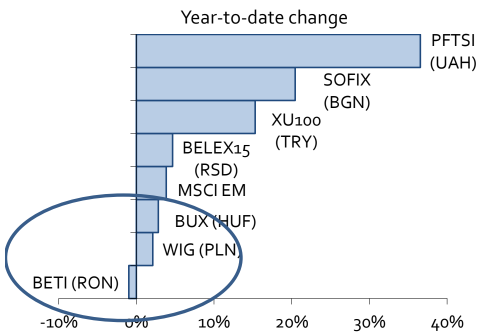
Political uncertainty eases, for now; regional polls provide upside surprises

Notwithstanding the aforementioned, political worries have somewhat subsided in the wake of elections held in several countries in the region. Notwithstanding a corruption scandal, reportedly involving high level businessmen and politicians closely linked to Prime Minister Tayyip Erdogan and leaked audio recordings targeting the Prime Minister himself, the ruling AK Party fared strongly in the March 30 local elections. The party garnered more than 40% of the vote. This compares with 38.6% achieved in the 2009 ballot and 49.8% scored in the 2011 general elections. Similarly, the outcome of the March 16 snap general elections in Serbia surprised to the upside. The pro-reform, pro-EU Serbian Progressive Party (SNS) achieved a landslide victory, collecting a record high share of 49% of the vote and securing an absolute majority in parliament. Vindicating market expectations, elections in Hungary revealed a clear victory for the ruling Fidesz party and Prime Minister Viktor Orban. The party secured a second 4-year term in office and another valuable two-thirds majority in parliament (including seats allocated to its ally Christian Democratic People's Party, KDPN). This will allow it to proceed, if needed, with constitutional amendments. Even in Ukraine, a decisive win by business man Petro Poroshenko in the country's Presidential elections first round, raised hope for an eventual easing in geopolitical tensions in the region.

Regional currencies largely recoup earlier losses thanks to improving risk sentiment

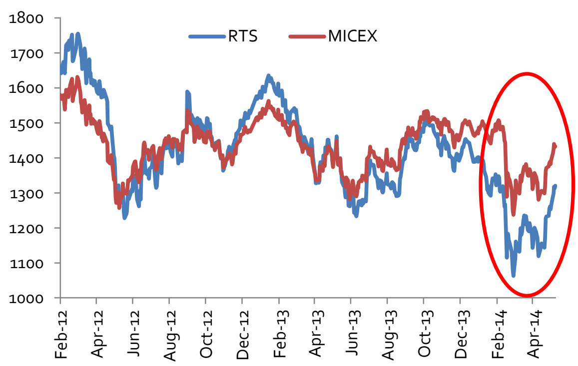
Easing domestic political tensions in several countries in the region, improving global risk appetite and recent data releases suggesting improved prospects in CESEE economies, have all boded well for regional currencies over the last few weeks. Most of them have largely recouped losses suffered earlier this year (Figure 5), to currently stand little changed on a year-to-date basis. Additional gains have been capped by broadly accommodative monetary policies in the region as inflation pressures remain subdued. Indicatively, April's CPI data in Hungary, Poland, Serbia and Romania all undershot expectations, despite recent PMI data suggesting a pickup in economic activity. The Ukrainian hryvnia remains the region's worst performer so far this year. The currency has recoiled by more than 40% against the US dollar since end-2013, touching a lifetime low of at 13.61/USD in mid-April against a backdrop of persisting geopolitical tensions. The Hungarian forint has also lagged the recovery of other regional currencies, remaining slightly weaker compared to its year-to-date levels, as 450bps of cumulative monetary policy rate cuts since August 2012

FIGURE 3: **Some CESEE bourses lag emerging stock market recovery on geopolitical jitters**



Source: Reuters, Bloomberg, Eurobank Global Markets Research

FIGURE 4: **Russian stock markets under pressure on tensions with Ukraine**



and prospects for some further easing ahead continue to weigh on its carry allure. Note that annual CPI unexpectedly came out negative for the first time in four decades in April, fanning speculation that the MNB's current rate-cut cycle may not have bottomed out yet. On the other hand, the Turkish lira leads the revival in CESEE FX thanks to aggressive Central Bank rate hikes in January. Somewhat easing domestic political uncertainty after the March 30 local elections and hopes that this year's economic slowdown may prove less sharp than initially feared also favored. Along these lines, the USD/TRY has plummeted by more than 13% since reaching a record peak at 2.39 on January 27, having temporarily touched a 5-month trough of 2.0617 on May 14.

Government bonds firm on accommodative monetary policies and improving growth prospects

Along similar lines, government bonds firmed over the last few weeks (Figure 6). Expectations that regional Central Banks will continue along their accommodative monetary policies for some time, despite signs of a gradual pick up in the region's economic activity, also provided support. Turkish and Hungarian paper have fared better, with the former fully erasing losses suffered in the wake of a hefty Central Bank rate hike in January. The recovery in Turkish government bonds has been primarily fanned by easing domestic political tensions, expectations for a gradual reversal of January's monetary policy tightening and improving sentiment towards risky assets. Indicatively, the 2-year benchmark bond yield slid to a 6-month trough of 8.65% on May 23, a day after the Central Bank unexpectedly cut by 50bps to 9.50% its key policy rate (1-week repo rate), having eased from a 4-½-year peak of 11.76% hit on March 20.

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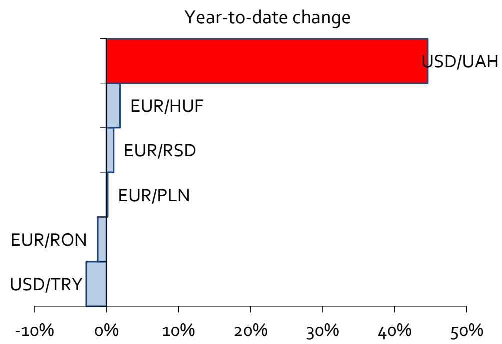
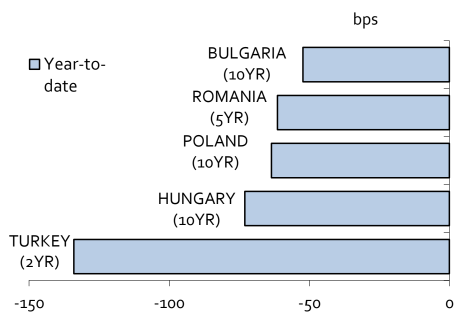
FIGURE 5: **Most CESEE currencies recoup earlier losses registered this year; Ukrainian hryvnia underperforms**



Source: Reuters, Bloomberg, Eurobank Global Markets Research

FIGURE 6: **Government bond yields ease from peaks hit earlier in the year**



Trader's view

Range bound EUR/RSD deems carry trades profitable

FX: With the March 16 general elections in **Serbia** now out of the way, we currently see limited room for renewed political jitters domestically. A potential announcement of IMF support is also likely to favor domestic asset markets and the dinar. Nonetheless, the Central Bank's presence in the FX markets has been rather eloquent so far this year, keeping the EUR/RSD within a tight range between 115.50 and 116.35. We expect this policy to continue in the period ahead, rendering carry trade quite attractive over the next three to four months. It is also worth noting that Central Bank governor Jorgovanka Tabakovic is a highly ranked member of the ruling SNS, hence we do not expect any changes or interference in NBS's current policies. In view of the aforementioned, we favor short EUR/RSD positions at levels around 115.80, with a stop loss at 116.50 and a target of 114.50, looking for a carry of around 7.80% (current 3M T-bill at 7.70%) over the next three months.

Bulgarian interbank market near their recent record low levels; local government bonds expected to remain well-bid

Local Rates: Abundant liquidity will likely keep local rates in the **Bulgarian** interbank market near their recent record lows. Transactions remain primarily concentrated in the very short tenors (up to 1 week). Two of the recently placed T-Bill issues (3mn & 6mn, BGN 400mn each) mature in the next two months, while there are no auctions for similar instruments scheduled in Q2 2014. This could put additional downward pressure on local MM rates. Similarly, local government bonds are expected to remain well-bid in the foreseeable future, underpinned by the postponement of new Eurobond issuance for the period after the EU parliament elections in late May. All major types of investors – banks, institutional investors (pension and insurance companies) & state guarantee funds – currently hold large amounts of cash and they bid aggressively in the last MoF auctions. Rates in both the primary and the secondary market decreased by 40 to 50 bps in March & April, with the exception of the very short end of the curve. Local sentiment is deriving additional support by the favorable rates at which peer countries secure funding in international markets. In **Serbia**, current geopolitical concerns over Ukraine represent a serious factor preventing local T-bill rates from moving below 7.50%.

Rally in Bulgarian stock market runs out of steam on profit taking and tensions in Ukraine

Stock Markets: Profit-taking and increased geopolitical tensions in Ukraine took the wind out of a rally staged over the first two months of the year in the **Bulgarian** bourse. Nonetheless, downward pressures have so far proven rather limited, with the main SOFIX index continuing to enjoy year-to-date gains in excess of 20% (as of May 20, 2014). Looking ahead, we expect strong demand for equities to re-emerge in the second half of the year thanks to an improving economic and political background domestically.

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II. SEE - Country Focus

Serbia (B1/BB-/B+)

- Progressives (SNS) cement strong position in National Assembly after the March 16th poll
- Economy overhaul to be primary issue of the new administration
- GDP to grow by 1% in 2014, on the back of continuing strong exports and recovery in EU zone

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Progressives (SNS) cement strong position in National Assembly after the March 16th poll

S erbian Progressive Party (SNS) cemented its grip on power for the next four years after a landslide victory in the March 16 elections. Riding on the wave of huge popular support for the party's leader, Aleksandar Vucic, the Progressives gathered a record high 49% share of the vote, securing absolute majority of 158 (out of 250) seats in Parliament. The opposition block, which comprises of the Democratic Party (DS) and New Democratic Party (NDS), trailed far behind, jointly receiving 12%. Meanwhile, the Socialist Party of Serbia (SPS), led by former Prime Minister Ivica Dacic, replicated their 2012 election result, collecting 14% of the vote. Interestingly, the pro-EU Liberal Democratic Party (LDP) and the Eurosceptic Democratic Party of Serbia (DSS) failed to achieve the 5% parliamentary threshold.

Coalition Government to be led by pro-EU SNS leader Aleksandar Vucic

On April 27, SNS leader Aleksandar Vucic was sworn in as the new Prime Minister, along with the new coalition government, comprising of his party and two junior allies; the Socialist Party of Serbia (SPS) and the Alliance of Vojvodina Hungarians (SVM). The new administration got the backing of 198 MPs, equivalent to four fifths of the total number of votes (250), signaling a strong parliamentary support to the new government. Mr. Vucic, once an ultra-nationalist who changed course in 2008, adopting a pro-EU stance, currently appears to be one of the most popular figures in the domestic political scene. He managed to lure strong public support after initiating an anti-corruption campaign and successfully opening EU membership talks in January 2014.

The Progressives are thus assuming a challenging task of overhauling Serbia's ailing economy in tumultuous times. In the current trajectory, the country faces a spider-web of challenges, including, among other, an elevated fiscal deficit and public debt burden along with a slow growth environment characterized by record-high unemployment rates. On the geopolitical arena, the country faces the difficult task of remaining on a steady course towards EU integration and, at the same time, maintaining close relations with Russia, a country with which it has strong economic and political ties.

Economy overhaul to be primary issue of the new administration

Prior to taking oath of office, Prime Minister Vucic gave a key note speech in the Assembly, laying out his government's plans under its four year tenure. The plan consisted overwhelmingly of economic issues - as opposed to what had been the case in previous governments when Kosovo and EU membership were at the top of the agenda - a clear indicator of the government's priorities in the period ahead. In more detail, the said plan comprises of the following main items:

Immediate measures needed to mend public finances

First, the government must deal swiftly with the record high fiscal deficit, which is projected to exceed 7% of GDP by year end, or ca €2.4bn. Most consolidation measures planned for adoption by mid-year target public spending. Minister of Finance Lazar Krstic recently laid out some basic guidelines in this respect. All civil servants will have to take a 10% wage cut, which on aggregate will save some €300mn per year (or €150mn in H2 2014). The solidarity progressive tax, which had been implemented late in 2013 as a temporary measure, will be removed. A crackdown on shadow economy, ad hoc savings from public procurements and certain hikes in excise duties could further facilitate the reduction of the fiscal gap, by a targeted €350mn-€400m in the second half of this year.

If by year end the measures taken prove insufficient, a likely outcome in our view, the may proceed with pension cuts.

Finding a solution for highly subsidized "firms in restructuring" will be the first test for new administration

In the medium term, the real test of will for the newly-formed government will be the promised demise of the companies in restructuring (with direct or indirect annual subsidies of €550mn), and the revamping of loss making "public" companies (annual cost to the budget ca €400mn), such as the Railroads of Serbia, Electro Production Distribution Co., Srbijagas. There are 157 firms in restructuring (employing 60,000 people), most of which have lost significant market share in the nineties, with obsolete technologies and poor business models. Prime Minister Vucic has signaled commitment to concluding this chapter by Jan 1st, 2015, via either finding a suitable strategic partner for the struggling companies, or closing them down and selling their assets. With the said deadline approaching, a big question mark arises as to the government's readiness to bite this bullet and take such unpopular (yet necessary) decisions, not least because the aforementioned issue has been on the agenda for the past 15 years. Interestingly, the severance pay for the 60,000 employed, along with the projected training programs should cost half a billion EUR, right around the cost of yearly subsidies to keep them running. The public companies (mostly utilities) present a fully different issue, mostly because they provide important goods and services such as electricity, transport and gas and, in addition, it is hard to differentiate how much money is lost due to providing services at below market prices and how much due to incompetence and corruption. In the medium -term, initial projections for next year's (2015) fiscal gap currently run around 5.6% of GDP, while the goal is to stabilize it between 3 and 4% in the period 2016-2017. The recently released 2014 Q1 fiscal deficit figures show the gap rising faster than projected. Over the first three months of the year the cumulative central government deficit already amounted to 40% of the full-year target of RSD 187bn (€1.58). These are unconsolidated figures, since below-the-line items are not released until mid-year.

Enacting a group of "systemic laws" to create a much healthier business environment

The second step should be the enacting of a number of laws in the Assembly, crucial for an improvement in domestic macroeconomic conditions. By July 15, laws on Labour, Planning and Construction, Bankruptcy, Foreign Investments, the Tax law, Privatization act, and several others should be adopted. This plan sounds overly ambitious as it is practically impossible to amend a big part of the existing legislature in a quick fix manner. That is, regardless of the fact that the Prime Minister asked MPs to work night shifts in order to get the work done on time. This involves the risk of ending up with a non-coherent and ambiguous legal framework that is susceptible to frequent amendments.

Loans worth €1.2bn to be partially subsidized by state

Along with these lines, the government also plans to introduce a number of measures aiming to underpin domestic economic activity. Among others, they plan to subsidize RSD loans, especially for export-oriented SMEs. As per the current plans, some €1.2bn of bank loans will be disbursed to domestic companies, with the state committing €60mn in the form of interest rate subsidies. Prior to the beginning of the program, the state will pay off old debt due to commercial banks, accumulated under similar programs over the past 4-5 years. Measures are also expected to be undertaken to facilitate a further "dinarization" of the domestic financial system . At the moment, about three quarters of the total stock of loans and deposits in the country are euro-nominated, therefore significantly impeding the functioning of the monetary policy transmission mechanism. In addition, with NPLs as high as 22% in the domestic banking sector, the administration announced the introduction of a professionally run "investment fund", designed to buy and manage problematic assets currently held by commercial banks.

"Public" utility companies privatization in the works

In respect to the government's privatization plan, Telekom Srbija, the largest state-owned (profit making) company, should be sold in a tender by the end of 2015. Operating in a capital intensive business where the state doesn't have the appropriate knowhow, Telekom Srbija risks losing its market share to larger regional players and therefore its sale appears to be the most appropriate solution. On the other hand, the optimal strategy for electricity producer and distributor EPS (Elektro Privreda Srbije), which is the largest Serbian company in both revenues and assets, is to attract a strategic minority partner, who would be given managerial prerogatives.

Furthermore, Srbijagas (the Serbian gas distributor and producer) is earmarked for restructuring, with parts of it (*e.g.* gas distribution arm) being sold out. RTB Bor, the copper and smelting plant, as well as the state lottery company (Drzavna Lutrija Srbije) will need to attract strategic partners. Nevertheless, it should be mentioned that most, if not all, previous governments have come up with the exact same plans regarding the privatization of these firms, starting from 2007, with little success.

GDP to grow by 1% in 2014, on the back of continuing strong exports and recovery in EU zone

Real Gross Domestic Product is projected to increase by 1% in 2014, newest Central Bank and Ministry of Finance forecasts show. Last year's good performance, which resulted to an expansion of 2.5% in domestic economic activity, is unlikely to be witnessed this year as well, mostly because of last year's exceptional output in two key industrials (FIAT and NIS), as well as a very strong agricultural season. First quarter flash estimates for 2014 are showing growth of 0.4%YoY, when in Q1 2013 domestic gross product rose by 2.7%YoY. CPI has been lingering towards the lower end of the target range (4±1.5%) for the past few months, and there is no reason why it shouldn't stay there for the remainder of the year. For the time being, the government is not contemplating major hikes in utility prices, overall domestic demand remains weak, and only a disastrous agricultural season could push food prices significantly higher and, as a consequence, instigate a strong uptick in inflation. In a rather surprising move, the Central Bank lowered the key policy rate from 9.50% to 9.00% on May 8th, citing stronger disinflationary pressures in the medium term, stemming from low aggregate demand, credit downturn and adverse developments in the labour market. Notwistanding the aforementioned, there appears to be limited room for significant monetary easing ahead, as the key policy rate determines to some extend the yield on the local market RSD T-Bills, the vehicle for plugging budget holes. In addition, monetary easing in Serbia has proved to have a rather limited impact on the domestic economy as the "dinarization" level in the country is just around 25%.

The unemployment rate remains at elevated levels, currently estimated at 20.8%,. External imbalances seem to have definitely subsided, at least for the medium term, with growth in exports continuing to outpace that in imports. The current account deficit (CAD) is expected to end this year at around 4.2% of GDP, compared to levels above 10% just two years ago. Remittances keep pouring in (forecasted at €2.7bn in 2014, down just 3%YoY from 2013), while FDIs should end up close to €1bn (up 31%YoY) despite the elections that have just taken place.

FIGURE 7: **Real GDP (YoY%)**

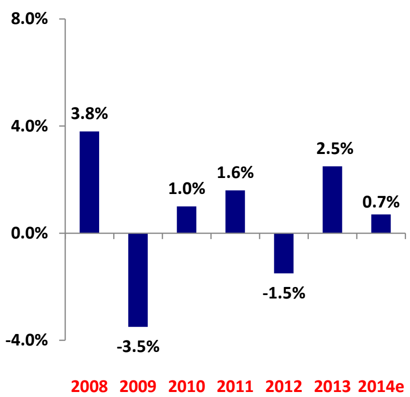


FIGURE 8: **Current Account Balance (GDP %)**

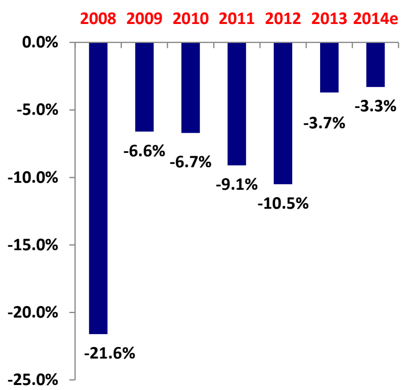
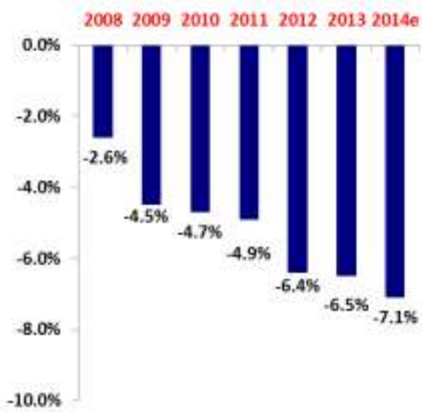


FIGURE 9: **Consolidated fiscal balance (GDP %)**



Source: National authorities, Eurobank Global Markets Research

Altogether, there could hardly be a worse time for a party to gain absolute majority. That is exactly the reason why the Progressives decided not to go at it alone; they wanted to establish a wide consensus for the painful reforms to come, as well as to hedge their party from taking all the blame in case things don't go according to plans. Nonetheless, with no opposition in sight, the ruling Progressives, and their undisputed leader Aleksandar Vucic will have no excuse for nonperformance.

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Romania (Baa3/BBB-/BBB-)

- Robust growth in 2013, primarily driven by exports; strong 2013 growth momentum continued in Q1 2014
- Budget execution improves significantly in Q1 2014
- NBR to likely stay put on rates amid subdued inflation pressures, weak domestic demand dynamics

Robust growth in 2013, primarily driven by exports

According to a second estimate (provisional national accounts data), real GDP growth was revised to 5.4%YoY in Q4 2013 - the highest reading in the EU - from 5.2%YoY reported earlier, compared to a 4.2%YoY increase in the prior quarter. For the whole of 2013, real output growth accelerated to 3.5%, from 0.5% in 2012. Last year's GDP increase was primarily driven by net exports, which exerted a positive contribution to the tune of 4.4ppts. This was on the back of a 13.5% rise in exports, which outpaced a concomitant increase in imports of 2.4%. Separately, total final consumption remained relatively weak throughout the year, registering an advance of 0.7% in 2013 and adding 0.6ppts to real GDP growth. On the flipside, gross fixed capital formation contracted by 3.3% subtracting 0.9ppts, while inventories also exerted a negative contribution to the tune of 0.6ppts. On the supply side, strong performances in the agricultural and industrial sectors provided significant contributions to growth last year.

Strong 2013 growth momentum continued in Q1 2014

The positive momentum in domestic economic activity during H2 2013 appears to have been sustained in early 2014, as illustrated by the most recent data releases. In more detail, real GDP grew by 3.8%YoY in Q1 2014. The breakdown of the data is not yet available, but robust industrial production and a recovery of private consumption have likely exerted a positive influence. It is worth noting that, industrial output recorded a double-digit increase of 10.7%YoY in January-March, driven by a 12.1%YoY jump in manufacturing thanks to strong car production. In a demonstration of strengthening domestic demand dynamics, retail sales advanced by 11.9%YoY in the same quarter, after a meagre 0.6%YoY gain in the whole of 2013. With the recent revision in last year's GDP data suggesting that domestic demand is already on the mend and most recent data signaling a continuation of the positive growth momentum in early 2014, we revise our economic growth forecast to 3.0% from 2.7% previously. The expected slowdown from 2013 is due to unfavorable base effects stemming from the strong performance of the agricultural sector and exports last year. That said, a gradual strengthening in domestic demand dynamics and enhanced absorption of EU funds will provide an offset, supporting domestic economic activity in 2014. Downside risks to our forecast lie in the face of persisting geopolitical tensions in Ukraine, while, on the upside, we note the possibility of increased spending ahead of the European Parliament elections in May and presidential polls in November 2014.

Budget execution improves significantly in Q1 2014

The general government budget deficit improved significantly in the first few months of the year, unexpectedly posting a surplus of RON 2.1bn in March and pushing the three-month cumulative shortfall 77.8%YoY lower to EUR 0.93bn (0.1%-of-projected-GDP). This positive development came on the back of a 3.8%YoY increase in revenues to EUR 48.8bn (ca 7.4%-of-GDP) and a 2.9%YoY drop to EUR 49.7bn (equivalent to 7.5%-of-GDP) in total expenditure over the said period. Revenues were primarily boosted by increases in excise taxes and social contributions (+14.0%YoY and +4.4% YoY respectively), mitigating the impact from nearly flat growth (-0.5%YoY) in VAT collection and lower non tax revenues (-12.7%YoY). Meanwhile, the aforementioned decline in expenditure was primarily fanned by lower interest payments, subsidies and capital spending (-20.4% YoY, 14.1%YoY and -48.5%YoY, respectively). For the whole of 2014, the government targets a 0.3ppts reduction in the fiscal deficit to 2.2%-of-GDP, primarily relying on revenue raising measures. Among other, these measures include higher excise duties and an expansion in the base of property taxation so as to offset the impact of a higher wage bill (a two-stepped minimum wage increase and discretionary hikes in public sector salaries) and a 3.8% increase in pensions. Higher EU funds absorption and co-financing have also been earmarked for this year. Meanwhile, freezes in certain expenditure items (e.g. among other, local government projects) will compensate for a 3-month delay in the introduction of a 7 eurocents/liter levy on fuels, which eventually came into effect on

April 1. In all, we continue to view this year's budget deficit target as attainable. Risks to our forecast are on the upside and include potential fiscal slippages ahead of May's EU Parliament elections and year-end Presidential polls. Furthermore, additional measures will be required if an up to 5ppts reduction in employers' social security contributions comes into effect in H2 2014.

The recent improvement in CAD appears to have bottomed out in January 2014

The recent improvement in the current account deficit (CAD) witnessed in recent months appears to have run out of steam early this year. In spite of a 62.9%YoY narrowing in the 12-month rolling external deficit in March, the pace of CAD improvement has slowed down in recent months. As a percent of projected 2014 GDP, the 12-month trailing CAD stood at 1.2% in March from a multi-year trough of 0.9% in January. In a possible reflection of recovering domestic demand dynamics, growth in imports of goods (+14%YoY) outpaced that of exports (+12%YoY) for the first time in 16 months in the month of February and remained strong in March too (+9.9%YoY vs. 11.8%YoY in exports). The breakdown of March's balance of payments data also revealed that 12-month cumulative FDI rose by 20.5%YoY covering around 157% of the CAD over that period. Meanwhile, net portfolio investments declined by 65.1%YoY. In all, as the recovery in domestic demand picks up further pace in the coming months, the trade balance and, by implication, the current account deficit are expected to widen accordingly.

NBR to likely stay put on rates amid subdued inflation pressures, weak domestic demand

With regards to the latest developments in inflation, last year's disinflation trend, primarily driven by favorable supply side factors, continued in the first months of the year. Headline CPI was nearly flat (+0.3%) on a monthly basis in April, bringing the annual rate of increase to 1.2% after hitting a record low of 1.04% in the prior month. Despite the slight uptick, the latest CPI reading stands just below the lower bound of the Central Bank 2.5% ±1% variation band target. Food prices continued to decrease thanks to the positive impact from last year's bumper harvest and a reduction in the VAT rate for some bakery products from 24% to 9% as of 1 September 2013. Nonetheless, inflation is expected to embark on a rising trend in the months ahead against a backdrop of higher excise duties (a 7 cents/liter increase on fuels which came into effect in April), the waning impact of base effects on food prices and recovering domestic demand dynamics.

FIGURE 10: **Improvement in CAD stalls in February**

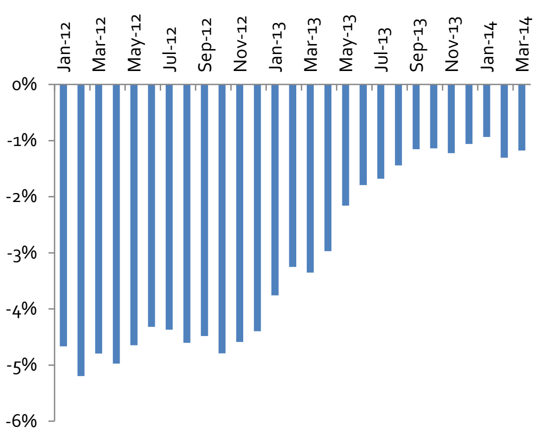
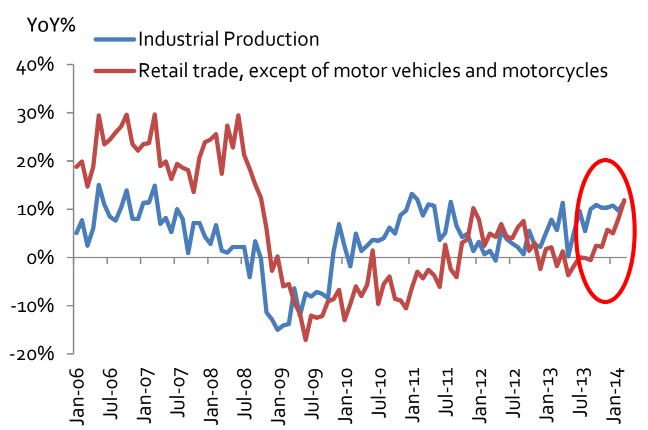


FIGURE 11: **H213 positive growth momentum sustained in early 2014**



Source: National Authorities, Eurobank Global Markets Research

In all, we anticipate annual headline CPI to converge towards the 3.5% upper bound of the NBR target range by year-end. Relatively weak inflation pressures, an annual inflation target within the Central Bank's reach this year and weak domestic demand dynamics argue in favor of stable policy rates in the coming months. Recall that, the NBR policy rate currently stands at a lifetime low of 3.50%. Further cuts in minimum reserve requirements (MMRs) this year, following reductions of 3pps in RON reserves to 12% and 2pps in foreign currency reserves to 18% in January are on the cards. Such moves will provide additional liquidity into the banking system and consequently support domestic credit activity.

S&P upgrades Romania's sovereign credit ratings investment grade

As had been expected for some time now, S&P upgraded in mid-May Romania's long- and short-term foreign and local currency sovereign credit ratings to "BBB-/A-3" from "BB+/B", with stable outlook. This move brings S&P's rating on par with the other two major rating agencies, Moody's and Fitch, which both rate Romania investment grade. S&P cited a rapid improvement in the country's external imbalances while "fiscal consolidation and financial sector stability continue to be on track". The agency also noted that it forecasts real GDP growth to average at 3% over 2014-2017 and underscored that "rapid export growth and flat import demand in 2013 helped lower the current account deficit to 1.1% of GDP, the lowest in two decades".

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Bulgaria (Baa2/BBB/BBB-)

- Political noise increased over recent weeks
- Breakdown of Q1 GDP (flash) data reveals recovery in domestic demand
- Budget deficit widens in January-March 2014

Political noise increased over recent weeks

Domestic political noise has increased in recent weeks. The government, which comprises of the *Coalition for Bulgaria* (CP) - led by the *Bulgarian Socialist Party* (BSP) - and the *Movement for Rights and Freedoms* (DPS), is expected to face a no-confidence vote in Parliament in late May, its fourth since taking office in the middle of 2013. The motion was called by the main opposition party, the *Citizens for European Development of Bulgaria* (GERB), on allegations of delays in the inception of the South Stream pipeline project. The government currently controls a total of 119 seats in the National Assembly, two short for an absolute majority. But, it enjoys the unofficial support of the opposition Ataka Party which has 23 lawmakers in Parliament. GERB has 94 seats. As such, there is little to suggest that the no-confidence motion will succeed, as it must receive the backing of at least 121 MPs. Separately, earlier tensions which erupted in April between the Ataka Party and the ruling coalition appear to have somewhat subsided for the time being. Recall that, the leader of the opposition Ataka party warned in April that his party would withdraw its unofficial support and work towards overthrowing the current coalition government if it accepts additional EU sanctions on Russia over its annexation of Crimea. On his part, incumbent Prime Minister Plamen Oresharski reportedly noted recently that Bulgaria will not support a new wave of sanctions towards Russia, but would not veto them either in case they are imposed.

Opinion polls show BSP and GERB running neck and neck ahead of the EU elections

Increasing domestic political feuds resurfaced ahead of the European Parliament elections on May 25, which were seen as a key test for the ruling coalition's survival. According to exit polls, the main opposition GERB party was the frontrunner in the EU elections, coming well ahead (by around 7-8ppts) of the ruling BSP. A negative outcome for the government could pave the way for snap national elections later in the year. In this case, a period of prolonged political instability is possible, which may risk a delay in implementing important reforms.

Breakdown of Q1 GDP (flash) data reveals recovery in domestic demand

According to flash NSI estimates, real GDP growth came in at 1.1%YoY in Q1 2014, not much changed compared to 1.2%YoY a quarter earlier. The breakdown of the data confirmed a recovery in domestic demand with final consumption rising by 3.1%YoY, following a 0.6%YoY decline in Q4 2013 and growth in gross fixed capital formation picking up pace to 3.2%YoY from 3.0%YoY. On the other hand, imports of goods and services grew by 5.1%YoY outpacing a 0.7%YoY rise in exports. Notably, the latter marked a significant slowdown from growth of 9.2%YoY in October-December last year. Trade balance data confirm that demand from abroad faltered over the said period. Total exports declined by 6.9%YoY with those destined to non-EU countries marking a 16.8%YoY plunge. This deterioration may be explained by a 15.2%YoY drop in exports to Turkey - Bulgaria's largest non-EU trade partner – in view of the lira's sharp depreciation in early 2014 and weaker growth prospects for the Turkish economy this year. Additionally, those destined to EU countries (which accounted for nearly 65% of total exports) fell marginally (0.3%YoY).

Real GDP growth to accelerate ahead

For the whole of the year we maintain our earlier forecast for a pickup in real GDP growth to 1.8% from 0.9% in 2013, as private consumption recovers on the back a higher disposable incomes. The latter will be supported by a low inflation environment (CPI at -1.6%YoY in April) , a 9% hike in pensions last year and a gradual improvement in labour market conditions. Notably, the unemployment rate appears to have stabilized at a 9-year 12.2% peak over the first three months of the year. Investments are also expected to revive this year in view of improving lending conditions and enhanced EU funds absorption. The expected economic recovery in the European Union is anticipated to provide a significant support on exports. But, the positive contribution from net exports to real GDP growth is likely to lessen on the back of weaker demand from non-EU countries and stronger domestic demand dynamics. Downside risks to our forecast remain in the face of a weaker-than-anticipated recovery in domestic demand and a potential revival of domestic political jitters. Possible disruptions in gas imports due to the crisis in Ukraine may also bear negative implications on the domestic economy, though we would assign a rather low probability for such a development.

Budget deficit widens in January-March 2014

The consolidated general government budget ran a deficit of BGN 874.0mn, or 1.1%-of-projected-GDP (based on local accounting standards and calculated on a cash-basis) over the first three months of the year, marking a 9.8% widening on an annual basis. Among the main drivers of the said deterioration was a 7.2%YoY increase in overall expenditure, which came on the back of a near 50%YoY jump in public investment and a 10.7%YoY rise in social spending. The latter was primarily the result of a 9.3% increase in pensions that came into effect in April 2013. These widening pressures were partially offset by a 38%YoY decline in interest payments following last year's bond redemptions and a 6.8%YoY advance in EU grants. Tax revenues increased modestly (+1.6%YoY) amounting to 6.4ppts of projected GDP, while non-tax revenue fell by 2.9%YoY corresponding to 1.1ppts of GDP. For the whole of the year the government targets a deficit of 1.8%-of-GDP, nearly in line with a 1.9%-of-GDP shortfall registered last year. That said, challenges for the government meeting its budget deficit target lie ahead and may be identified in a potentially slower than anticipated economic recovery, the prospect of escalating domestic political tensions and increased social expenditure (hike in pensions and minimum wages) earmarked in 2014. Looking further ahead, the government has penciled in a gradual decrease to a deficit of 0.9% of GDP by 2017, as envisaged in the government's medium term fiscal strategy for 2015-17 endorsed in mid-April.

Current account shrinks YoY in Q1 2014

The current account came in at a deficit of EUR 82.6mn, or 0.2% of GDP, in Q1 2014, shrinking by nearly 84%YoY. This compares with a shortfall of 1.0%-of-GDP registered over the same period last year and a surplus of 1.9%-of-GDP recorded for the whole of 2013. The said improvement was mainly attributed to a narrower income gap which stood at BGN 55.4mn in Q1 2014 vs. BGN 352.7mn over the same period a year earlier. This offset an 84%YoY increase in the trade deficit to BGN 825.6mn. Meanwhile, net foreign direct investment dropped by more than 81%YoY in Q1 2014 to BGN 65.9mn, financing nearly 80% of the current account shortfall. All in all, we expect a modest decrease in the current account surplus this year compared to its 2013 levels, in line with a pick-up in domestic demand.

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FIGURE 12: **High frequency indicators reflect recovery in domestic consumption and investment in Q114**

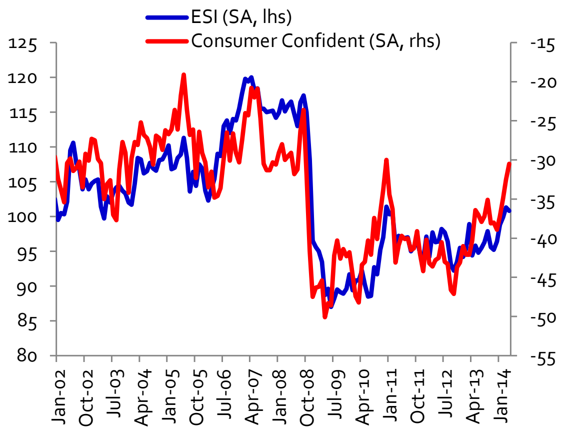
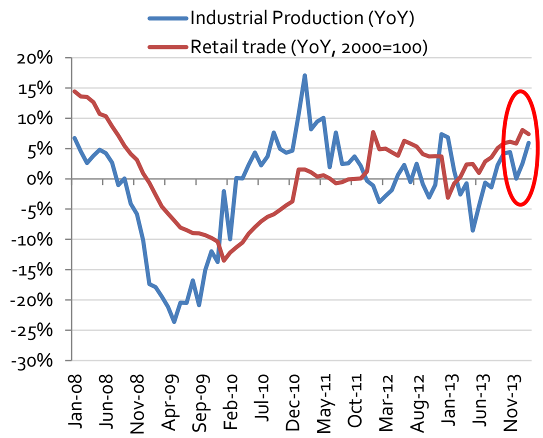


FIGURE 13: **High frequency indicators reflect recovery in domestic consumption and investment in Q114**



Source: National Authorities, Eurobank Global Markets Research

III. SEE - Country Snapshot

REPUBLIC OF SERBIA	2012	2013E	2014F
Real GDP (yoy%)	**-1.5**	**2.5**	**1.0**
Private Consumption	-1.9	-1.5	-1.8
Govern. Consumption	1.8	-6.9	0.0
Gross Capital Formation	15.8	-2.2	3.8
Exports	1.8	16.6	7.9
Imports	1.9	2.0	2.9
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**	**20.1**	**21.2**
General Government Balance	**-7.5**	**-5.8**	**-7.1**
Gross Public Debt	**59.3**	**62.5**	**66.9**
Current Account (% GDP)	**-10.9**	**-5.0**	**-4.2**
Policy Rate	**11.25**	**9.50**	**8.50**
EUR/RSD (eop)	**113.7**	**114.6**	**116.5**

ROMANIA	2012	2013E	2014F
Real GDP (yoy%)	**0.6**	**3.5**	**3.0**
Private Consumption	1.5	1.3	2.0
Govern. Consumption	1.2	-1.8	1.8
Gross Capital Formation	3.8	-3.3	3.0
Exports	-1.5	13.5	7.0
Imports	-0.2	2.4	5.5
CPI (annual average)	**3.3**	**4.0**	**2.3**
CPI (end of period)	**5.0**	**1.6**	**3.5**
Unemployment Rate (% of labor force)*	**7.0**	**7.3**	**7.2**
General Government Balance (%GDP, ESA 95)	**-3.0**	**-2.3**	**-2.2**
Gross Public Debt	**38.0**	**38.3**	**39.9**
Current Account (% GDP)	**-4.4**	**-1.1**	**-1.2**
Policy Rate	**5.25**	**4.00**	**3.50**
EUR/RON (eop)	**4.4**	**4.5**	**4.4**

Source: National Sources, Eurostat, European Commission, IMF, Bloomberg, Reuters, Eurobank Global Markets Research
*Eurostat definition

BULGARIA	2012	2013E	2014F
Real GDP (YoY%, sa)	**0.6**	**0.9**	**1.8**
Private Consumption	3.7	-2.3	1.3
Govern. Consumption	-0.5	2.5	1.5
Gross Capital Formation	4.0	-0.3	5.5
Exports	-0.4	8.9	5.1
Imports	3.3	5.7	5.5
CPI (annual average)	**3.0**	**0.9**	**-0.2**
CPI (end of period)	**4.2**	**-1.6**	**1.8**
Unemployment Rate (% of labor force)*	**12.3**	**13.0**	**12.8**
General Government Balance (%GDP, ESA 95)	**-0.8**	**-1.5**	**-1.8**
Gross Public Debt	**18.4**	**18.9**	**23.1**
Current Account (% GDP)	**-0.9**	**1.9**	**1.0**
Policy Rate	**N/A**	**N/A**	**N/A**
EUR/BGN (eop)	**1.96**	**1.96**	**1.96**

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

IV. SEE - Global calendar of key upcoming developments

Calendar of Key Data and Events, May-July 2014			
Country	**Date**	**Indicator/Event**	**Previous**
		May, 2014	
UKRAINE	May 25	Presidential & Local elections	
SERBIA	May 26	Real Wages	1.4%YoY
BULGARIA	May 27	Gross External Debt (Mar)	EUR37.4bn
	May 30	Budget Balance (Apr)	-BGN874.0mn
SERBIA	May 30	Industrial Production (Apr)	3.8% YoY
		Trade Balance (Apr)	-EUR314.9mn
		Retail sales (Apr)	2.7%YoY
		June, 2014	
EUROZONE	June 5	ECB monetary policy meeting & press conference	
USA	June 17-18	FOMC meeting	
BULGARIA	June 2	International Reserves (May)	EUR27.5bn
ROMANIA	June 2	International Reserves (May)	EUR35.6bn
ROMANIA	June 3	Retail sales (Apr)	11.9%YoY
BULGARIA	June 4	GDP (Q1 2014, f)	1.1%YoY
ROMANIA	June 4	GDP (Q1 2014, p)	3.8%YoY
	June 6	Net Wages (Apr)	5.5%YoY
BULGARIA	June 9	Industrial Production (Apr)	4.2%YoY
		Trade Balance (Apr)	-EUR0.8bn
		Retail sales (Apr)	5.8%YoY
		Unemployment Rate (May)	11.8%
ROMANIA	June 10	Trade Balance (Apr)	-EUR551.4mn
	June 11	Industrial Production (Apr)	11.6%YoY
ROMANIA	June 12	CPI (May)	1.2%YoY
SERBIA	June 12	MPC policy rate announcement	9.00%
		HICP (May)	2.1%YoY
BULGARIA	June 12	CPI (May)	-1.6%YoY
ROMANIA	June 13	Current Account Balance (Apr, YTD)	-EUR261mn
BULGARIA	June 16	Current Account Balance (Apr)	-EUR322.6mn
SERBIA	June 20	Current Account Balance (Apr)	-EUR188.2mn
	June 25	Real Wages	N/A
	June 30	GDP (Q1 2014, nsa, f)	0.4%
		Industrial Production (May)	N/A
		Trade Balance (May)	N/A
		Retail sales (May)	N/A
		July, 2014	
EUROZONE	July 3	ECB monetary policy meeting & press conference	
USA	July 29-30	FOMC meeting	
ROMANIA	July 1	International Reserves (Jun)	N/A
	July 2	MPC policy rate announcement	3.50%
		Retail sales (May)	N/A
		GDP (Q1 2014, f)	N/A
	July 7	Net Wages (May)	N/A
	July 10	CPI (Jun)	N/A
		Industrial Production (May)	N/A
		Trade Balance (May)	N/A
SERBIA	July 10	MPC policy rate announcement	N/A
	July 11	HICP (Jun)	N/A
	July 14	Current Account Balance (May, YTD)	N/A

Bond Supply Calendar		
Country		**Issue/Maturity**
		June, 2014
ROMANIA	May 22	RON500mn T-Bonds
BULGARIA	May 26	2021 T-Bonds
SERBIA	June 4	10-year EUR T-Bonds
	June 10	2-year RSD T-Bonds
	June 11	2-year EUR T-Bonds
	June 24	2-year floating RSD T-Bonds
	June 25	5-year T-Bonds

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

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