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Eurobank Research
www.eurobank.gr/research
EurobankGlobalMarkets
Research@eurobank.gr

Editor
Dr. Platon Monokroussos
Head of Global Markets Research
pmonokrousos@eurobank.gr

Written by
Galatia Phoka
Emerging Markets Analyst,
Coordinator of Emerging Markers Research
Eurobank Ergasias
+30 210 3718922
gphoka@eurobank.gr

Contributors
Zoran Korac
FX dealer,
Eurobank ad Beograd
+381 11 206 5821
zoran.korac@eurobank.rs

Petko Mikov, CFA, FRM
Head of Trading Desk,
Eurobank Bulgaria
+359 28166488
pmikov@postbank.bg

Ivan Radović
Head, Brokerage Department,
Eurobank ad Beograd
+381 11 30 27 53
ivan.radovic@eurobank.rs

CESEE stocks and bonds rally on accommodative monetary policies by major as well as regional Central Banks

CESEE MARKETS

- **CESEE stock markets and government bonds** recorded hefty gains in H1 2014. The prevailing market view that the Fed is in no hurry to raise interest rates and the adoption by the ECB of a package of measures aiming to address deflation risks and boost liquidity in the June policy meeting have supported capital inflows towards regional assets. Accommodative monetary policies by Central Banks in the region have also favored
- **Regional currencies** lag momentum witnessed in other asset classes on expectations for lower policy rates ahead

COUNTRY FOCUS

- **Serbia: Adverse weather conditions to take a toll on this year's economic activity and budget execution.** Real GDP growth likely to slide back into negative territory. Widening budget deficit this year and disagreement over the implementation of certain austerity measures prompt Minister of Finance resignation
- **Romania: CPI at a new record low in June.** NBR likely to stay put on interest rates, further MRR reductions seem to be on the cards
- **Bulgaria: Snap parliamentary elections set for October after coalition government fares poorly on EU Parliament polls.** Domestic bank-related jitters gradually dissipate; sector proves well positioned to withstand external and internal jitters

FIGURE 1: **Global stock markets end H1 2014 with strong gains**

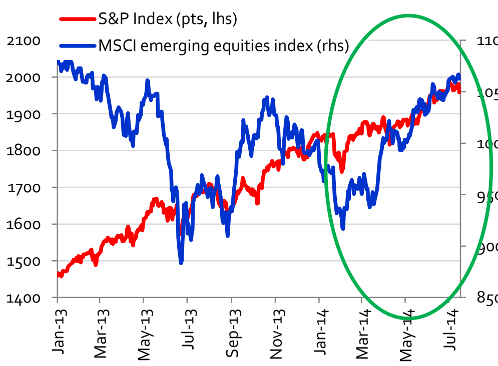
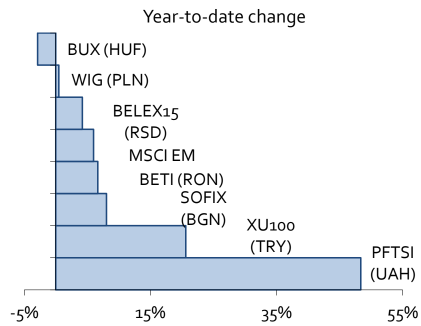


FIGURE 2: **Most CESEE bourses in the black**



Source: Reuters, Bloomberg, Eurobank Global Markets Research (as of July 17, 2014)

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CESEE stocks and bonds rally on accommodative monetary policies by major as well as regional Central Banks

CESEE stock markets record hefty gains in H1 2014

After kicking off the year on a negative footing, emerging stock markets staged a strong performance thereafter to end the first half of the year with hefty gains. The prevailing market view that the Fed is in no hurry to raise interest rates and the adoption by the ECB of a package of measures aiming to address deflation risks and boost liquidity in the June monetary policy meeting, have supported capital inflows towards regional assets. Accommodative monetary policies by Central Banks in the region have also boded well for emerging bourses. Meanwhile, lingering geopolitical jitters in Ukraine and Iraq have been largely overshadowed by the most recent bout of increased risk appetite. In reflection of the aforementioned, the S&P 500 index hit a new record clonig high in mid-July and the MSCI index of emerging equities touched its highest level in 17 months in the same month (Figure 1). With the exception of Hungary's BUX, all major indices in the CESEE region stood in the black year to mid-July (Figure 2). Bourses in Poland and Hungary remained laggards, having been mostly affected by the turmoil in Ukraine. Legislation that was recently adopted by the Hugarian parliament and fanned worries over the profitability of the domestic banking sector, weighed further on the domestic stock market.

Government bonds extend rally on investors' quest for carry, accommodative Central Bank monetary policies

Investors' quest for carry has also provided support to regional government bonds. Expectations that Central Banks in the region will continue to pursue ultra-accommodative monetary policies in the coming months have exacerbated gains in local paper (Figure 3). Despite June's CPI remaining near May's 2-year high of 9.66%YoY and well above the medium-term inflation target of 5.0%, the Central Bank of Turkey (CBT) is expected to deliver additional rate cuts later this year in a further reversal of January's hikes. The government has been a vocal proponent of materially lower interest rates for some time now and political pressure on the Central Bank is likely to continue unabated in light of August's Presidential elections where incumbent Prime Minister Tayipp Erdogan is anticipated to take over the post, possibly in the first round of the polls. The CBT has rendered in three separate moves a cumulative reduction of 175bps to 8.25% in the main benchmark (1-week repo) rate since the inception of its current monetary easing cycle in May. It also lowered the overnight borrowing rate by 50bps to 7.50% in July. Serbia's Central Bank took a breather in early July following unexpected cumulative policy rate cuts of 100bps over the prior two months. Concerns about fiscal slippages this year and recently instigated depreciating pressures on the dinar were likely behind this decision. But, the door remains open for further monetary easing in the coming months as inflation currently stands at a lifetime low and below the official inflation target range while real GDP growth is anticipated to slide into contraction this year due to the negative impact from the recent adverse weather conditions. In view of persistently subudued inflation dynamics and recent dissappointing macro data, market speculation has recently emerged about a resumption of rate cuts by the Central Banks of Romania and Poland. Along similar lines, emerging external debt markets have also recorded

FIGURE 3: **CESEE government bonds extend rally on accomodative Central Bank monetary policies**

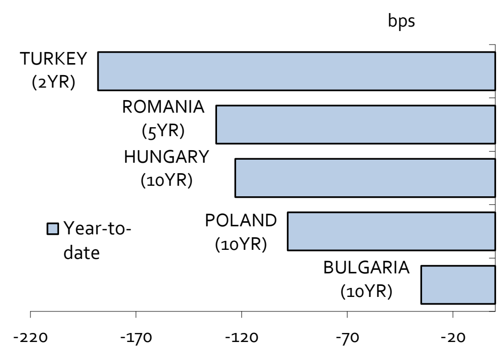
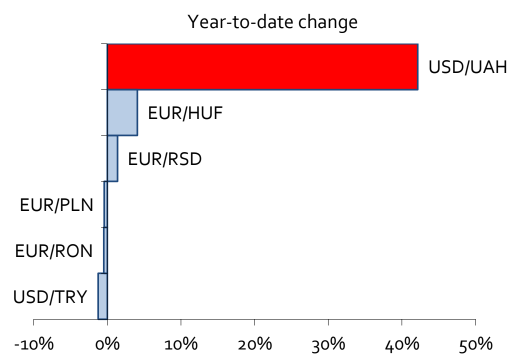


FIGURE 4: **CESEE currencies lag the momentum witnessed in other assets**



Source: Reuters, Bloomberg, Eurobank Global Markets Research (as of July 17, 2014) significant gains so far this year. Indicatively, overall returns on the EMBI+ index stood at 9.50% year-to-July-17, while spreads over USTs have returned near levels seen in May 2013 when the Fed first signaled gradual withdrawal of its QE programme (Figures 5&6).

Regional FX lags momentum witnessed in other asset classes on expectations for lower policy rates ahead

Regional currencies have lagged gains recorded in other emerging asset classes so far this year, as CESEE Central Banks are broadly anticipated to keep their benchmark policy rates near their current ultra-accommodative levels in the coming months in light of a low inflation environment and lingering risks to the region's economic outlook. Most regional currencies currently stand nearly unchanged since the end of 2013 (Figure 4). The Ukrainian hryvnia remained the main underperformer, weighed down by persisting geopolitical risks and concerns about the country's macroeconomic outlook. Nonetheless, the USD/UAH appears to have stabilized around levels of 11.5-12.0 over recent weeks remaining below a record high of 13.61 hit in April. In reflection of improving risk sentiment towards risky assets, the high-beta Turkish lira has recovered significant ground since hitting record lows of 2.39/USD in January this year.

Risk appetite is likely to continue supporting EM assets, but risks lie ahead

Looking ahead, risk appetite is likely to remain supported by the prevailing market perception that the Fed will likely stay put on interest rates for some time as risks to the sustainability of the US' economic recovery linger, while the ECB is braced to further ease monetary policy conditions, if needed, in order to underpin the Eurozone economy and address persisting deflation risks. Emerging local rate markets will possibly outperform other asset classes benefiting the most from concerns over CESEE GDP growth this year and subdued inflation pressures which are likely to ensure further monetary policy easing in the region. At this junction, an earlier-than-currently expected inception of Fed rate policy tightening appears to be the main source of risks towards emerging market assets. Persisting geopolitical risks in both the Middle East and Eastern Europe also pose challenges ahead, while local factors should not be ignored either. Growth prospects have deteriorated recently as a result of the turmoil in Ukraine, while adverse weather conditions earlier in the year are expected to take a toll on the region's economic activity. With several key dates on the CESEE political agenda this year already behind us (local elections in Turkey, general in Hungary and Serbia, Presidential in Ukraine), one might argue that certain risks on this front may have somewhat quiet down. That said, tensions may emerge anew in the way to the Presidential elections in Turkey and Romania (August and November respectively) and snap general elections in Bulgaria (October). In Poland, a leaked recordings scandal that implicated the Central Bank Governor as well as other high level officials and threatened to topple the current coalition government appears to have been largely phased out and a political crisis was eventually averted following the government's success in securing a vote of confidence in parliament in late June.

gphoka@eurobank.gr

FIGURE 5: **Year-to-date returns on the EMBI+ index**

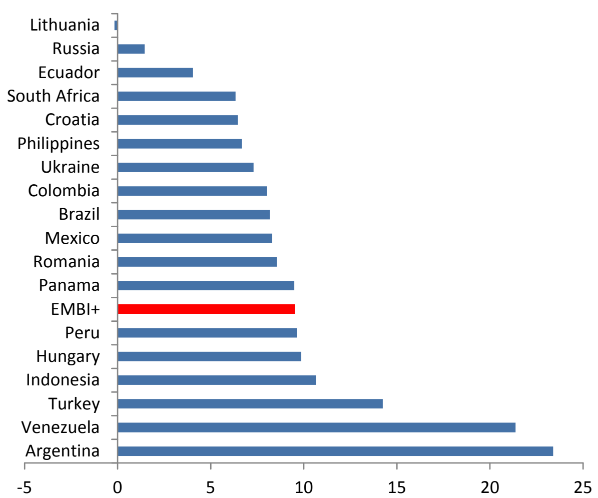
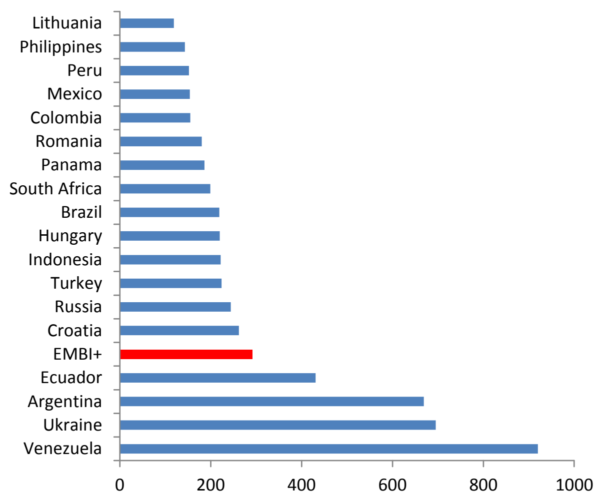


FIGURE 6: **Spreads over USTs on the EMBI+ index**



Source: Reuters, Bloomberg, JP Morgan, Eurobank Global Markets Research (as of July 17, 2014 close)

Trader's view

Range bound EUR/RSD deems carry trades profitable

FX: Although macroeconomic fundamentals argue in favor of a weaker **dinar**, the Serbian currency has shown formidable resilience so far this year. There are several reasons for that. First, the Central Bank (NBS) has repeatedly intervened in the FX markets to curb the currency's depreciation trend beyond 116.00/EUR. To achieve this, it has spent around €820mn in EUR purchases so far this year and has indicated its strong determination to restrain the cross's uptrend. Second, the ECB's decision to endorse additional measures to support the Eurozone's economy has largely favored capital inflows into emerging market assets, and therefore the dinar as well. Last but not least, the Central Bank's decision to keep the EUR/RSD in a tight range constrains the overall trading activity on the cross. With the pair expected to remain largely bound within its recent range in the coming weeks, we maintain our earlier recommendation for long dinar positions, from a near to medium-term perspective, on a carry trade basis. Good entry levels currently appear to be at 116.00 with 1M carry of ca 6.6% and a stop-loss at around 116.50. Central Bank abstinence from the FX markets to support the domestic currency may lead the EUR/RSD higher towards 117.00 or even to lifetime highs of 119.00 last seen in August 2012.

Dissipating banking sector jitters reflected in successful placement of 10-year €-denominated paper

Local Rates: Over the last couple of months or so, developments in **Bulgarian** local rates markets have been intertwined with two major events in the country: (i) the issuance of the long-awaited new Eurobond (deferred for after May's EU Parliament elections); and (ii) the short-lived domestic banking sector crisis. The adequate measures undertaken by the Bulgarian National Bank and government authorities soothed market concerns about the sector's outlook and the overall impact on rates proved rather limited after all. This was reflected in the successful placement of €1.5bn in 10-year €-denominated paper at a 3.055% yield (MS + 160bps), which took place in spite of news about Corpbank's financial troubles. The new Eurobond is currently priced just 5bps lower compared to the issue price, while the local sovereign curve experienced some flattening accompanied with a widening of the bid-ask spreads. Yet, risks to the attainability of this year's fiscal targets and elevated domestic political uncertainty in view of the upcoming snap elections in October will likely keep investors cautious towards Bulgarian debt. This year's fiscal deficit target will likely be revised higher in view of the overall budget underperformance so far, while the bailout package for Corpbank and the maturity of 3 T-bills for a total amount of €1.0bn in the autumn (Sept-Nov) are also likely to augment public finances further. The Ministry of Finance decided to withdraw the two scheduled auctions for July, but supply on primary market is expected to intensify toward the end of the year and, thus, to weigh on local rates markets. Nevertheless, we do not expect any notable re-pricing of the corresponding yield curve in the next months.

Bulgarian stocks underperform other asset classes giving back most of this year's gains

Stock Markets: The highest volatility caused by the aforementioned developments was witnessed in the domestic stock market where the main SOFIX index suffered significant losses in late June, temporarily erasing fully all gains (nearly 30%) registered this year. Since then, it has recovered some ground but remains well below a 5–½ year peak hit in April. Over the next couple of months, we expect ongoing political uncertainty to continue exerting a negative impact on investor sentiment towards the domestic stock market.

zoran.korac@eurobank.rs
pmikov@postbank.bg

II. SEE - Country Focus

Serbia (B1/BB-/B+)

- Adverse weather conditions to take a toll on this year's economic activity and budget execution
- Real GDP growth likely to slide back into negative territory
- Widening budget deficit this year and disagreement over the implementation of certain austerity prompt Minister of Finance resignation

Adverse weather conditions to take a toll on this year's economic activity and budget execution

Days of torrential rains resulted in unprecedented floods across large parts of Serbia in mid-May, killing dozens of people and ravaging huge parts of the countryside. Thousands of individuals were left homeless. Agriculture, energy production and infrastructure suffered heavily as a consequence. The final impact on the domestic economy is yet to be determined, but initial estimates suggest that the ensuing damage will total some €1.3 to €1.5bn (4-4.5% of GDP). The deluge came a few weeks after Prime Minister Aleksandar Vucic and his Serbian Progressive Party won an overwhelming parliamentary victory in the March general elections and were about to embark on their ambitious reform oriented platform. Moreover it revealed domestic weaknesses following two difficult decades of transition. Damages are expected to take years to be fixed in full. But, the EU will provide some €100mn, either through the natural disaster relief programs (for which Serbia now qualifies as a candidate country) or through redirecting some of the funds previously earmarked for other purposes. Further external assistance is on the cards. A special independent body was created to control the use of donated funds, in a well-received gesture by the government.

Real GDP growth back in negative territory

Overall, this year's output will be significantly affected by these developments. According to the Ministry of Agriculture, the corresponding sector is expected to take a considerable hit and contract by around 8% on an annual basis. To some extent, energy production is also expected to be affected, as does infrastructure. However, it appears that the impact of adverse weather conditions is not the only factor behind this year's slowdown in domestic economic activity. The first quarter official figure showed real GDP decelerated significantly to 0.1%YoY (revised lower from a flash estimate of 0.4% in April) from 3.0%YoY in Q4 2013. The said slowdown can be attributed mostly to the larger than expected contraction in construction (-7.8%YoY), and the sector of financial services and insurance (-3.7%YoY). By expenditure approach, private and government consumption fell a bit more than expected (2.1%YoY each). For the whole of the year, the National Bank of Serbia's latest forecast pencils in a drop in real GDP of 0.4%, downwardly revised from a previously envisioned 0.7% expansion. Net exports are once again anticipated to contribute positively in the overall figure, while both private and government consumption will likely fall deeper in negative territory.

Theoretically, governments should be increasing spending after natural disasters hit in order to re-build their capital assets. Some suggested this is the way to go in Serbia's case, especially since it would boost the struggling construction business (down 7%YoY in Q1 2014), but the soaring budget deficit prevents this from happening. The unconsolidated budget deficit in the first four months of the year totaled RSD 91.8bn (€790mn), amounting precisely to 50% of the projected full year unconsolidated gap. This sum does not include below the line items, such as guarantees for state-owned companies (and those in restructuring) and local municipality budgets.

Worsening budget deficit and disagreement over implementation of certain austerity measures prompts Minister of Finance resignation

The consolidated government deficit target is projected at 7.1%-of-GDP for 2014, (aggregate of €2.4bn). But, with the above mentioned republic's figures and with economic activity sliding into contraction, it will surely exceed this figure and possibly surpass 8.0%-of-GDP. The 10% wage cut for all public employees now seems not nearly enough and the administration is now contemplating the idea of reducing pensions as well. The Minister of Finance, Lazar Krstic stepped down, citing disagreement with Prime Minister Vucic over the extent in wage and pension cuts. The outgoing finance minister had been advocating decreasing pensions by as much as 20% and public servants' salaries by 15%. The vacant post was taken over by Minister of Economy Dusan Vujovic, a proponent of milder measures (10% in both pensions and salaries). In any case, the cuts, which had been initially planned for July 1st are now being postponed for October 1st, supposedly because the government is trying to assess the impact of the recent flooding on its finances. With this year's target currently appearing out of reach, laying ground for an improvement in the country's fiscal position in the medium term is crucial.

Consumer inflation lowest on record; key policy rate down to 8.50%

On the bright side, inflation remains in check. June's HICP eased to a new record low of 1.3%YoY, sliding further below the Central Bank's target of 4±1.5%. Looking ahead, inflation is expected to gradually inch back within the official range in H2 2014 and stay there for the remainder of the year as the impact of favorable base effects gradually wanes. Weak aggregate demand dynamics remain the main disinflationary factor. A low inflation environment provided leeway for the National Bank to reduce its key policy rate (in May and June) by a total of 100bps, to its current 8.50% level, in a move which took most analysts aback. Nonetheless, it is worth reiterating that changes in the Central Bank benchmark rate have a rather limited impact in the domestic economy as about three quarters of Serbia's aggregate loan portfolio is EUR-linked. It does, however, provide a benchmark for state RSD borrowings and with the abundance of liquidity (after ECB's slashing of their own rate) there was no need to keep it too high.

Exports still going strong, local demand falling

The trade deficit retained a narrowing trend through the first five months of the year. Exports rose by 14%YoY to €4.56bn over the said period, while imports grew by just 1.6%YoY to €6.21bn. Consequently, the trade gap shrunk by 21.9%YoY. Fiat Automobiles with €652mn worth of sales abroad and concomitant sales of €142mn by Gazprom-owned NIS provided a significant contribution to exports. Truth is, both these came through direct negotiations with buyers, without going through legalistic tender procedures. What is also encouraging is the fact that sectors of food, livestock, tobacco and drinks showed stable growth, nearly doubling the corresponding trade surpluses on an annual basis. All these business segments are seen as a big opportunity for Serbia's economic development. Still, firms are struggling with liquidity and remain reluctant on embarking in new investments in a slow or no growth environment. Even for those willing, loans are hard to come by. Banks are hesitant to lend, understandably since NPLs are "stable" at 23% countrywide. The figure has been at a record high in May, climbing from 21.4% at year-end 2013. Indicatively, credit to companies was down by 9.6%YoY in RSD terms in April. On the other hand, consumer lending was up 5.6%YoY over the same month. June corporate sector figures are expected to be much better thanks to the state subsidized program of restructuring loans worth €1.2bn.

Between a rock (EU) and a hard place (Russia)

Total FDIs for the first five months of the year amounted to €240m, trending way lower than the official CB projected €1bn for the year. Foreign direct investments have stalled, mostly due to the delay in the "South Stream" kick off, a project worth €2bn for the Serbian part of the pipeline. Apparently, the way the South Stream has been agreed, is violating some of European Union standards, but the Serbian side insists that the pipeline is crucial for energy sustainability in the country. Most of the inflow is currently targeting processing industry and trade, but the volumes are just still too thin. The "South Stream" setback reflects also the current political tensions around Ukraine. While the EU wants candidate countries to align their position via imposing sanctions against Moscow, Belgrade for the time being remains firm in taking the middle ground. Pressures from the EU are, however, mounting and the government is just hoping the big players will be able to find a resolution sooner rather than later.

Belgrade on Water to the rescue

One other project which has been at the centre of attention of late has been the "Belgrade on Water". This significant development was presented by Emirates Eagle Hills CEO Mohamed Alabbar and Serbia's Prime Minister Aleksandar Vucicon on June 27th. The scheme includes around two million square meters of apartments and business premises, two hotels, a shopping mall, and the future landmark - the tallest building in Serbia - the Belgrade Tower, all to be built on the banks of the Sava river, in midtown Belgrade. The project is estimated to cost €3bn, while Belgrade municipality will invest some €200m to clear the Sava amphitheater area. The land on which this development will be built will be leased for a significant number of years to the company. The venture, if materialized, would kick start Serbia's struggling construction sector, as well as much of the local economy.

Ivan.Radovic@eurobank.rs

FIGURE 7:

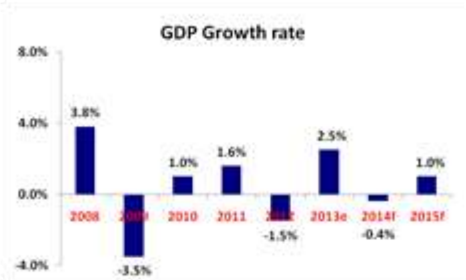
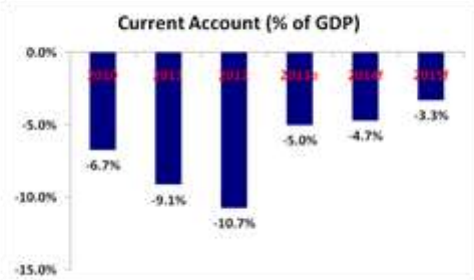


FIGURE 8:



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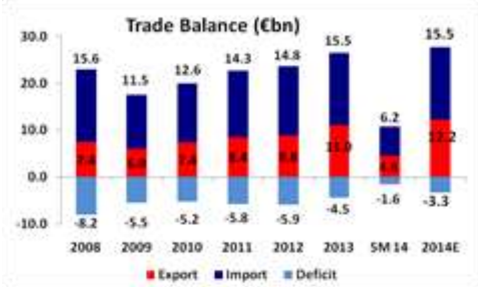


Source: National authorities, Eurobank Global Markets Research

Romania (Baa3/BBB-/BBB-)

- Romanian economy grew by 4.0%YoY in Q1 2014; further slowdown expected in the quarters ahead
- CPI at a new record low in June
- NBR to likely stay put on rates, further MRR reductions seem on the cards

Romanian economy grew by 4.0%YoY in Q1 2014; further slowdown expected in the quarters ahead

According to provisional seasonally adjusted data, domestic economic activity decelerated to 4.0%YoY in Q1 2014 from 5.1%YoY in the prior quarter. The deceleration came primarily on the back of a slowdown in agricultural production and a lessened contribution from net exports, as imports' growth more than doubled on an annual basis while the corresponding rate of increase in exports moderated slightly. Ongoing contraction in gross fixed capital formation continued to exert a negative impact on domestic economic activity. On the other hand, recovering private consumption and robust industrial production provided significant support. We anticipate real GDP growth to decelerate further in the quarters ahead and come in at 3.0% for the whole of the year as unfavorable base effects from last year's stellar agricultural output and exports will likely partly offset the positive input from recovering domestic demand.

Parliament approves 5ppts reduction in social security taxes for employers; fiscal slippage risks lie ahead

In an effort to support domestic economic activity, the lower house of parliament approved in early July a government-backed 5ppts reduction (to 15.8%) in social security taxes for employers scheduled to come into effect in October this year. It is estimated that this measure will generate a RON 850mn (0.1%-of-GDP) budget hole in Q4 2014, which the government reportedly plans to cover via higher than previously expected revenues from a recently introduced tax on special buildings. On its part, the Fiscal Council recently warned that the impact of this measure appeared largely underestimated, bearing potential to significantly affect the medium term budgetary targets in the absence of corrective steps. Note that the application of the said measure is estimated to create a revenue shortfall of RON 4.86bn in 2015 which according to the finance ministry's assumptions corresponds to around 0.7ppts of GDP. Meanwhile, the said measure was seemingly among the main factors behind a postponement of the third review under the country's €4bn 2-year precautionary arrangement led by the IMF. Prime Minister Victor Ponta said that the Fund has postponed the completion of its review until November when the upcoming Presidential elections are planned and the government drafts its FY-2015 Budget. For this year, the government envisions a budget deficit of 2.2% of GDP, while the shortfall stood at 0.2% of projected GDP year-to- May. We broadly concur with the Fiscal Council's view that additional measures will be required to offset the impact of the 5ppts reduction in employers' social security contributions, not least to avoid a slippage this year but to ensure fiscal prudence medium-term as well.

Consumer inflation slides to a new record low in June, but a reversal of the trend is expected later this year

With regards to the latest developments on inflation, CPI declined by 0.3%MoM in June, undershooting expectations for an unchanged reading and bringing the annual rate of increase to a new record low of 0.7%. So far this year, consumer inflation has remained firmly below the lower bound of the Central Bank 2.5% ±1% variation band target thanks to: (i) favorable base effects on food prices from the prior year's bumper harvest; (ii) a hike in regulated energy prices in December 2012 (by 7%) and January 2013 (by 10%); and (iii) a reduction (from 24% to 9%) in the VAT rate for certain bakery products last September. A 7 eurocents per litre increase in fuel excise duty, which came into effect in April this year, appears to have exerted lower than previously expected upside pressure on the latest CPI data. Nonetheless, we anticipate a gradual reversal of this disinflation trend in the coming months, with CPI coming in near 3.0% by year-end. This is primarily explained by an expected eventually waning impact of the aforementioned transitory statistical effects, recovering domestic demand and regulated price hikes. On the latter, it is worth noting that, apart from the aforementioned hike in fuel, the government is reportedly mulling on a 2-stage (by 2% and 3%) hike in natural gas prices for households as part of a wider plan to liberalize energy markets.

NBR to likely stay put on rates, but further MMR reductions remain on the cards

Despite some recently emerged market talk about potential rate cuts ahead, we anticipate the Central Bank (NBR) to stay put on interest rates this year. Inflation is expected to pick up pace as we march towards year-end while risks to its outlook (e.g. uncertainty surrounding the global oil prices, the impact of recent adverse weather conditions on food prices) linger. On the other hand, we see the door open for further reductions in the minimum reserve requirements (MRRs). A persistingly negative output gap is likely to keep inflation contained below both the upper limit of the NBR's targeted range and its 3.3% end-2014 forecast. Such reduction will assist into increasing liquidity into the domestic market and gradually bringing the MRRs closer to the levels maintained by the European Central Bank. However, any cuts will likely be gradual and measured as excess liquidity may bear depreciating pressures on the leu, while the difference between foreign and leu minimum reserve requirement ratios will likely be broadly preserved in order to discourage foreign-currency lending. Recall that the NBR kept its key policy rate at a record-low of 3.50% for the third consecutive time at its monetary policy committee meeting in July, after rendering 175bps of cumulative monetary easing since October last year. Nonetheless, it cut the minimum reserve requirement ratio on foreign currency-denominated liabilities of credit institutions to 16% from 18% previously, a measure estimated to inject up to €500mn into the market. The corresponding ratio on leu-denominated liabilities was left stable at its previous level of 12%.

gphoka@eurobank.gr

FIGURE 10: **CPI at a record low in June, below NBR targeted range**

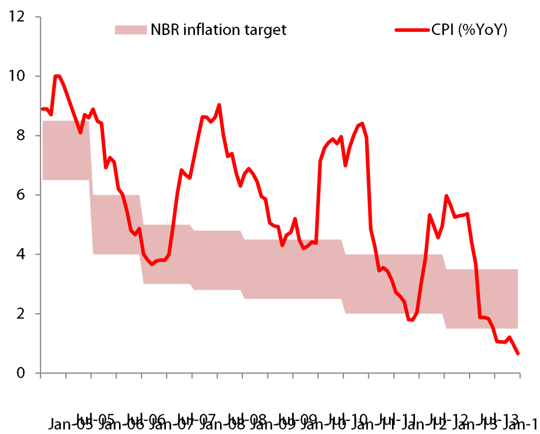
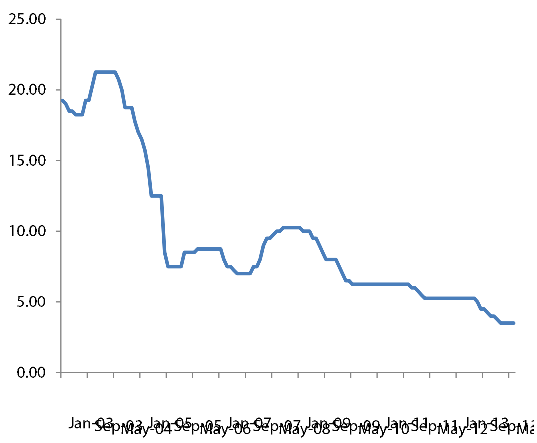


FIGURE 11: **Key policy rate at a lifetime low amid weak domestic demand dynamics and subdued inflation pressures**



Source: National Authorities, Eurobank Global Markets Research

Bulgaria (Baa2/BBB-/BBB-)

- Snap parliamentary elections set for October after coalition government fares poorly on EU Parliament polls
- Domestic bank-related jitters gradually dissipate
- Banking sector proves well positioned to withstand external and internal shocks
- Budget deficit to be revised higher on Corpbank's rescue

Snap general elections called for October 5

Upon the conclusion of an extraordinary meeting of the Consultative Council on National Security, President Rosen Plevneliev announced on June 17 that political leaders had reached an agreement on early parliamentary elections. Later in the month, the date was set for October 5, 2014. The current parliament will be dissolved on August 6 and a caretaker government will subsequently take office until the upcoming polls in autumn. The news does not come as a complete surprise. Early on its short tenure, the minority ruling coalition, which comprises of the *Coalition for Bulgaria* (KB) - led by the *Bulgarian Socialist Party* (BSP) - and the *Movement for Rights and Freedoms* (DPS), was mired in anti-government rallies with demonstrators calling for its resignation amid mounting popular dissatisfaction on allegations of corruption, economic mismanagement and nepotism. In order to pass legislation in parliament the government had to rely on the tacit support of the opposition Ataka Party. In mid-June 2014, it survived its fifth no-confidence motion since taking office approximately a year earlier. The BSP's poor performance in European Parliament (EP) elections in May - seen as a key test for the ruling coalition's survival - dealt the final blow. As suggested by the outcome of the recent EU polls as well as by the latest opinion surveys, the main opposition party, centre-right, *Citizens for European Development of Bulgaria* (GERB) is tipped to win the elections in October. However, it currently appears unlikely that GERB will manage to win an outright majority in Parliament and its leader Boiko Borisov was recently quoted by media as saying that he is not willing to be part of a coalition government. In this case, GERB will have to lure the tacit support of other parties in parliament and rule in a minority government. If no government is formed, the country will be faced with its 3rd general election in less than two years. A hung parliament is likely to lead to a period of prolonged political instability which risks delays in implementing important reforms and, as a consequence, may constrain the domestic economic recovery. In this context, we identify the prospect of a fragile political landscape in the coming months as the major challenge for the Bulgarian economy ahead.

Domestic banking system jitters gradually dissipate

To make matters worse, these latest developments in the domestic political landscape coincided with increased headwinds to the domestic banking system. Bulgaria's fourth-largest lender, Corporate Commercial Bank (Corpbank), was hit by a depositor run in late June amid media corruption reports. As a result, the bank stopped all payments and operations due to a liquidity drain and the Central Bank (BNB) put it under conservatorship. In a week's time, First Investment Bank, the country's third largest in terms of assets, also came under speculative attack and endured hefty deposit outflows, with ca $500mn (ca 10% of its assets) reportedly leaving its coffers in just a few hours. The Central Bank issued a statement underscoring that the country was facing an organized criminal action against the domestic banking sector and pledged to use all means in its disposal to safeguard people's deposits. On its part, the European Commission approved a BGN 3.3bn ($2.3bn) credit line requested from Bulgaria in support of the domestic financial system. The funds were deemed as "precautionary" and were earmarket at further enhancing liquidity and safeguarding the domestic financial system. They will be transferred to the banking system via the Bulgarian Development Bank (BDB) and the Bulgarian Deposit Insurance Fund (BDIF). Under the 1998 Law on Bank Deposit Guarantee, depositors' funds in banks up to BGN 196,000 (EUR 100,000) are protected.

Banking sector proves well positioned to withstand external and internal jitters

Notwithstanding the aforementioned, Bulgaria's banking sector has proved over the last few years that it is well positioned to withstand external as well as internal shocks; whether these are potential spillover effects from the euro area sovereign debt crisis or the most recent incidences of depositor run. Crisis insidents such as the one witnessed in the 90's currently appear to be mere reminiscents of the past. Undoubtedly, the European Union's and domestic authorities' decisive actions in June showed resolve and determination to swiftly contain the crisis, soothing investor concerns and quickly restoring confidence towards the country's assets. But, it should be additionally emphasized that the domestic financial system is stable, sound and well capitalized. The sector, which accounted for ca 107% of projected GDP in May 2014, is mostly dominated by foreign players who own around 70% of its assets. This implies that capital injections from foreign parents will most probably be made available, if needed. A recent such example is the "Vienna Initiative" which was undertaken in 2009 by banks and governments in Europe in order to ensure financial stability in developing countries in the region. Additionally, the most recent soundness indicators confirm that the system is healthy and profitable. In more detail, Q1 2014 profits amounted to BGN 224mn, having increased by one third on an annual basis, while Return on Assets (ROA) stood at 1.03% vs. 0.8% in March 2013. The sector's net foreign asset position remains positive and its capital position is strong, with the Capital Adequacy ratio (CAR) standing at 20.42% in Q1 2014, comfortably above the minimum regulatory requirement of 12.0%. Moreover, the stock of loans in terms of GDP stood below 70% over the first quarter of the year, while the ratio of loans to deposits was near unity. Importantly, thanks to a well-placed Currency Board Arrangement (CBA) foreign exchange reserves more than cover the entire monetary base, while BNB reserve assets financed around 6 months of imports in April 2014. Lastly, albeit remaining near recent peaks just below 24%, NPLs appear to have stabilized over recent months, with the rate of impaired loans as a share of the total loans portfolio (excluding overdrafts) having slowly eased towards 22% in May 2014 (Figure 12).

Macroeconomic fundamentals remain supportive

Bulgaria's macroeconomic fundamentals boded well in mitigating the risks stemming from the recent domestic banking sector jitters. External imbalances have improved significantly over recent years with the country's current account balance having reversed from a shortfall of 25.2% of GDP in 2007 to a 1.9% of GDP surplus in 2013. It stood at a surplus of 1.5% of projected GDP on a 12-month rolling basis to May, with the FY 2014 reading anticipated to record a small surplus near 1.0% of GDP. Meanwhile, despite the recent deterioration in the country's fiscal position, public debt stock remains comfortably below the 60% Maastricht criterion and is the second lowest after Estonia in the EU. It is expected to reach ca 23%-of-GDP by the end of 2014 from 18.9%-of-GDP last year. Limited exposure to capital markets also bodes well for shielding the domestic economy against external shocks. Price pressures have remained subdued, with the deflation trend witnessed since late last year continuing over the first six months of 2014 (CPI at -1.9%YoY in June). A gradual but modest pick-up in H2 is likely as the impact of favorable base effects wanes and domestic demand gains some momentum. We continue to anticipate an acceleration in real GDP growth to 1.8% this year from 0.9% in the last. This modest increase will probably be driven by recovering private consumption, higher EU funds absorption and a slow but gradual improvement in labor market conditions. In support of the latter, the rate of unemployment eased further in June, to 10.70% after reaching a near decade high of 12.20% earlier this year.

But risks lie ahead

Apart from the abovementioned political risks, challenges ahead also lie on the fiscal front. This year's budget deficit target of 1.8%-of-GDP appears to be out of reach. According to the latest budget execution data, the general government consolidated deficit (based on local accounting standards and calculated on a cash-basis) already stood at a 1.1%-of-GDP over the first five months of the year as revenues stalled, while expenditure remained strong. The recent deflation trend does not bode well for government proceeds, while spending will likely be additionally burdened by the funds needed for Corpbank's rescue as well as potential fiscal slippages in the run-up to the upcoming general elections. The possibility of prolonged political uncertainty in case of a fragmented parliament is likely to aggravate these risks further. Note also, that fiscal prudence is essential for Bulgaria given that monetary policy is largely constrained by the CBA, leaving fiscal policy as the main means of authorities influencing the domestic economy. Finance minister Petar Chobanov suggested recently Corpobank's rescue may cost around BGN 1.5-2.0bn (or $1.4bn) and widen the general government deficit in excess of 3.0%-of-GDP. The government suggested in mid-July an increase of the current deficit target to 2.7%-of-GDP, along with a concomitant rise in debt in order to generate the necessary funding. However, the measures must be endorsed by parliament and according to media reports three parliamentary commissions rejected the government's proposal to increase the public debt by up to BGN 3.4bn. Yet, it is worth noting that the envisaged deterioration from last year's 1.5%-of-GDP shortfall is attributed primarily to one-off factors – namely the banking sector's jitters – and is not expected to significantly affect the country's fiscal position in the medium term. And as public debt stock stands at relatively low levels, we do not see any major cause of concern for this year's increase.

S&P downgraded its credit rating on Bulgaria on mounting political uncertainty

Amid mounting political uncertainty of late, Standard & Poor's downgraded on June 13 its long and short-term sovereign credit rating on Bulgaria to one notch above non-investment grade BBB-/A-3 from BBB/A-2, respectively with outlook stable. The ratings agency highlighted that the domestic political arena continues to pose risks for the implementation of necessary reforms, such as fighting corruption and "strengthening the rule of law" as well as addressing the issue of "adverse demographics of net emigration and ageing population". It also noted that growth is expected "to remain lackluster and unemployment high". On its part, Fitch affirmed Bulgaria's long-term foreign and local currency sovereign credit ratings at BBB- and BBB respectively, with outlook stable. The agency cited "strong liquidity and capital buffers" which allowed the banking sector to withstand the recent deposit outflow in two domestic banks. The ratings agency identified potential "macroeconomic or geopolitical shocks" and a "significant slippage relative to official fiscal targets, or the emergence of instability in the banking sector" as the main risk factors to the domestic economy presently.

Banking sector and political jitters weigh on domestic financial assets; but Eurobond issue well received

In view of the aforementioned developments on the domestic banking sector and political agenda, Bulgaria's CDS spiked close to 2-year highs near 145bps in late June. In a similar vein, the domestic stock market gave up a significant portion of the gains recorded earlier in the year. Nonetheless, the government successfully resorted on June 27 to the international markets with the planned €1.5bn September 2024 Eurobond sale. The said issue attracted strong as well as diversified demand in reflection of ongoing as well as broad-based investor confidence towards Bulgarian assets. Total bids reportedly amounted to ca €3.7bn and the auction produced an average accepted yield of 3.055% or 160bps over mid-swaps.

gphoka@eurobank.gr

FIGURE 12: **NPLs appear to have stabilized recently**

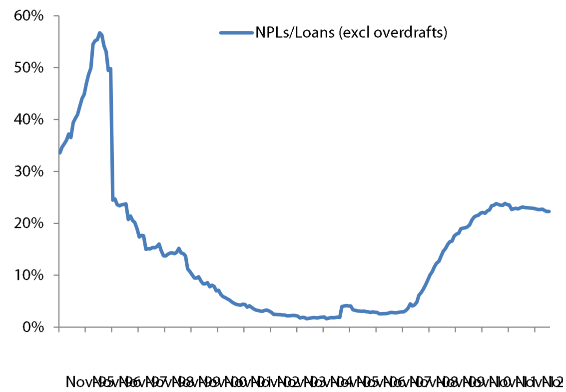
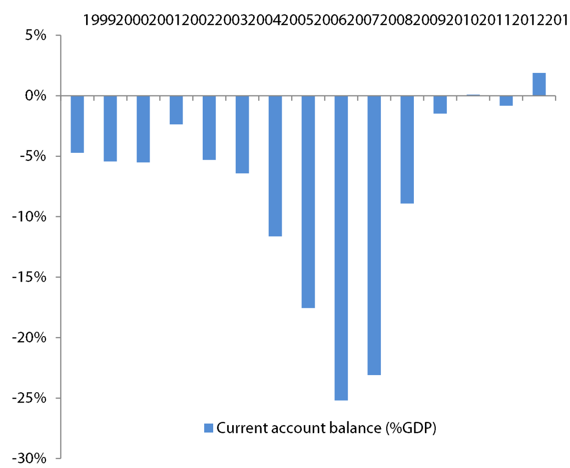


FIGURE 13: **External imbalances improve over the last few years**



Source: National Authorities, Eurobank Global Markets Research

III. SEE - Country Snapshot

REPUBLIC OF SERBIA	2012	2013	2014F
Real GDP (yoy%)	**-1.5**	**2.5**	**-0.4**
Private Consumption	-1.9	-1.5	-2.1
Govern. Consumption	1.8	-6.9	0.7
Gross Capital Formation	15.8	-2.2	3.1
Exports	1.8	16.6	5.8
Imports	1.9	2.0	3.5
CPI (annual average)	**7.8**	**7.8**	**2.5**
CPI (end of period)	**12.2**	**2.2**	**4.0**
Unemployment Rate (% of labor force)	**23.1**	**20.1**	**21.3**
General Government Balance	**-7.5**	**-5.8**	**-8.0**
Gross Public Debt	**59.3**	**62.5**	**68.1**
Current Account (% GDP)	**-10.9**	**-5.0**	**-4.2**
Policy Rate	**11.25**	**9.50**	**8.00**
EUR/RSD (eop)	**113.7**	**114.6**	**117.0**

ROMANIA	2012	2013	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**	**1.7**
CPI (end of period)	**5.0**	**1.6**	**3.0**
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**	**-1.0**
Policy Rate	**5.25**	**4.00**	**3.50**
EUR/RON (eop)	**4.4**	**4.5**	**4.4**

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**	**-0.9**
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**	**-3.0**
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, July - August 2014			
Country	**Date**	**Indicator/Event**	**Previous**
		July, 2014	
SERBIA	July 21	Current Account Balance (May)	-EUR 67.7mn
	July 25	Real Wages (Jun)	3.1%YoY
	July 31	GDP (Q2 2014, p)	0.1%YoY
		Industrial Production (Jun)	-7.0%YoY
		Trade Balance (Jun)	-EUR 368.9mn
		Retail sales (Jun)	-0.3
BULGARIA		Budget Balance (Jun)	-BGN 888.6mn
		August, 2014	
SERBIA	August 7	MPC meeting	8.50%
ROMANIA	August 4	MPC meeting	3.50%
POLAND	August 8	Sovereign credit rating review by S&P and Fitch	
TURKEY		Sovereign credit rating review by Moody's	
TURKEY	August 10	Presidential elections (1st round)	
ROMANIA	August 22	Sovereign credit rating review by Moody's	
UKRAINE		Sovereign credit rating review by Fitch	
TURKEY	August 24	Presidential elections (2nd round)	
ROMANIA	August 1	International Reserves (Jul)	EUR 34.4bn
	August 4	Retail sales (Jun)	10.1%YoY
ROMANIA	August 6	Net Wages (Jun)	4.4%YoY
BULGARIA	August 7	International Reserves (Jul)	EUR28bn
		Unemployment Rate (Jul)	10.7%
	August 8	Industrial Production (Jun)	4.9%YoY
		Retail sales (Jul)	1.3%YoY
	August 11	Trade Balance (Jun)	-EUR 0.6bn
ROMANIA	August 11	CPI (Jul)	0.7%YoY
		Trade Balance (Jun)	-EUR 534.5mn
		Industrial Production (Jun)	13.3%YoY
BULGARIA	August 12	CPI (Jul)	-1.9%YoY
SERBIA		HICP (Jul)	1.3%YoY
ROMANIA	August 13	Current Account Balance (Jun)	-EUR 351mn
	August 14	GDP (Q2 2014, A)	3.9%YoY
BULGARIA		GDP (Q2 2014, p)	1.2%YoY
		Current Account Balance (Jun)	-EUR15.2mn
SERBIA	August 20	Current Account Balance (Jun)	N/A
BULGARIA	August 23	Gross External Debt (Jun)	N/A
SERBIA	August 25	Real Wages (Jun)	N/A
	August 29	Industrial Production (Jul)	N/A
		Trade Balance (Jul)	N/A
		Retail sales (Jul)	N/A
BULGARIA		Budget Balance (Jul)	N/A

Bond Supply Calendar		
Country	**Issue/Maturity**	
	July, 2014	
ROMANIA	July 21	2021 T-Bonds
ROMANIA	July 24	2021 T-Bonds

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

Eurobank Global Markets Research

Global Markets Research Team

Dr. Platon Monokroussos: *Head of Global Markets Research*
pmonokrousos@eurobank.gr, + 30 210 37 18 903

Paraskevi Petropoulou: *G10 Markets Analyst*
ppetropoulou@eurobank.gr, + 30 210 37 18 991

Galatia Phoka: *Emerging Markets Analyst*
gphoka@eurobank.gr, + 30 210 37 18 922

Global Markets Sales

Nikos Laios: *Head of Treasury Sales*
nlaios@eurobank.gr, + 30 210 37 18 910

Alexandra Papathanasiou: *Head of Institutional Sales*
apapathanasiou@eurobank.gr, +30 210 37 18 996

John Seimenis: *Head of Corporate Sales*
yseimenis@eurobank.gr, +30 210 37 18 909

Achilleas Stogioglou: *Head of Private Banking Sales*
astogioglou@eurobank.gr, +30 210 37 18 904

George Petrogiannis: *Head of Shipping Sales*
gpetrogiannis@eurobank.gr, +30 210 37 18 915

Vassilis Gioulbaxiotis: *Head International Sales*
vgioulbaxiotis@eurobank.gr, +30 210 3718995

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