South-Eastern Europe Economic Review

November 2014

SEE Banking Sector: Fundamentally sound but haunted by the excesses of the past and the new EU regulatory landscape

The current issue of our SEE Economic Review focuses its attention on the current state of the banking sectors in the major economies of the region, namely Albania, Bulgaria, Romania, Serbia and Cyprus. The main takeaway from our analysis is that the banking sectors in the region are adequately capitalized with sufficient liquidity and decent levels of capital buffers and provisions. Furthermore, local Central Banks and regulators have demonstrated substantial skill and determination in solidifying their local banking institutions throughout the crisis. As a result, the average capital adequacy of the banking systems in SEE countries stood at 18% at end-2013, while Tier I capital reached 16% at the same point.

Yet, despite our positive and constructive stance regarding the SEE's growth potential throughout the crisis, we have also identified a set of challenges that the banking sectors in the region should tackle.

Specifically:

- Banks in the region should address the issue of a large and still growing stock of Non-Performing Loans. The fact that NPLs have grown so much, especially when we take into account the fact that these economies have not felt the full brunt of the global economic crisis and they have – by and large – been registering positive economic growth in the last few years, is an indication of two economic weaknesses. First, it is a sign of a hangover from the breakneck credit expansion of past years, which unavoidably led to a relaxation of the credit standards. Second, the fact that growth, while positive, remains below the levels necessary for a generalized lift to employment and peoples' disposable income.

- Lenders in the region are also exposed to substantial FX risk, given that they have granted loans to both households and corporations in foreign currency (mainly in EUR but also in CHF). As these borrowers, especially households, do not exhibit any natural FX hedge, abrupt changes in the FX rates can alter the risk profile of these exposures drastically.

- Finally, banking sectors in the region will have to deal with the potential pressures that the major European banking groups might face in order to curtail or abandon altogether their operations in the SEE region due to supervisory burden and extra capital needs imposed on them by the new pan-European regulator, the SSM, in the context of the implementation of the EU Banking Union.

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Table of Macroeconomic Forecasts

Table of Economic Forecasts								
	Real GDP (% YoY)		Inflation		Fiscal Balance (% GDP)		Current Account Balance (% GDP)	
	2013	2014f	2013	2014f	2013	2014f	2013	2014f
Albania	0.4	1.9	1.9	2.5	-4.7	-3.1	-10.6	-11.0
Bulgaria	0.9	1.9	0.9	-1.0	-1.8	-1.9	2.1	0.5
Cyprus	-5.4	-3.0	-0.4	-0.5	-5.1	-3.5	-3.1	-2.0
Romania	3.3	2.2	4.0	1.5	-2.5	-1.0	-1.1	-1.2
Serbia	2.6	-0.8	7.9	2.5	-4.9	-6.5	-6.5	-4.9
Ukraine	0.2	-6.0	-0.3	10.5	-4.4	-6.0	-9.2	-3.5

Source: Piraeus Bank Research

1. Banking Sector Analysis: Balkan Countries & Cyprus

The performance analysis in this report focuses on the banking sectors in four Balkan countries, Albania, Bulgaria, Romania, Serbia and also in Cyprus. Prolonged vulnerabilities and the weak macroeconomic outlook, continue to weigh on banks' outlook for asset quality and profitability in these countries. Nevertheless, the banking sector remains well-capitalised and liquid with reassuring capital buffers and provisions. The average capital adequacy of the banking system in the Balkan countries stood at 18% in December 2013 increasing by 80 bps from December 2008, and Tier I capital reached 16% for the same month. The banking sector in the region will likely maintain strong capital buffers.

Credit growth remains constrained by continued cross-border deleveraging and persistently high levels of non-performing loans (NPLs). Although NPL formation has slowed, NPL ratios are expected to remain high, because efforts to resolve the existing stock of NPLs are slow to yield results. NPL ratios are close to 20% in the Balkan countries and close to 50% in Cyprus.

The high prevalence of foreign currency lending is another vulnerability that persists. In all the countries of the Balkan region, the share of foreign-currency lending exceeds 60%.

Access to funding does not seem to be of particular concern at the current level of demand. Domestic deposits growth continues to compensate for the decline in foreign funding.

European banks continue to dominate the banking sector in the Balkan countries, with foreign ownership exceeding 70%. The market share trend in the area shows that there is no extensive withdrawal among the Western European banks.

One major external challenge to financial stability in the Balkan countries consists of preserving the orderly nature of deleveraging following the balance sheet adjustments by the main European banking groups with a view to ensuring compliance with the Basel III Accord requirements and the impact of the ECB's comprehensive assessment exercise. Furthermore, major external risks are the sluggish recovery of key trade partners in the EU and the escalation of the crisis in Ukraine.

Financial Soundness Indicators (1H' 2014)

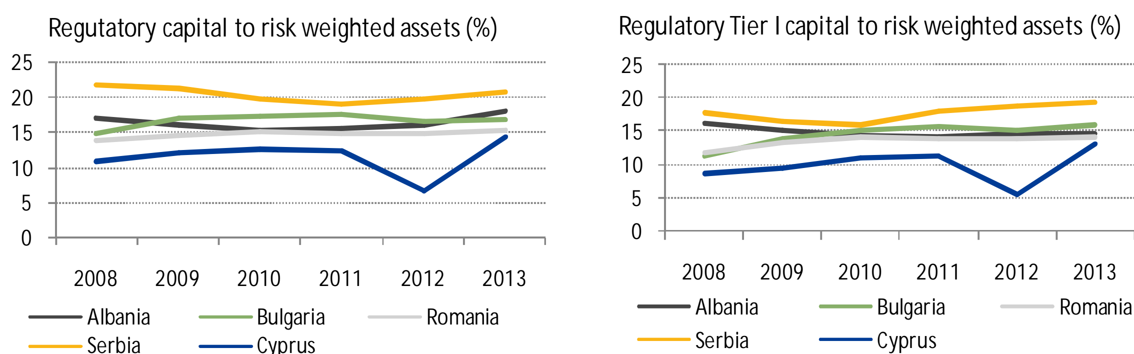
(in % unless otherwise indicated)	Albania	Bulgaria	Romania	Serbia	Cyprus
Regulatory capital to risk-weighted assets	17.5	21.2	17.0	20.4	15.3
Tier I capital to risk-weighted assets	14.5	19.3	14.9	17.6	14.5
Gross non-performing loans to total loans	24.1	17.0*	19.2	23.0	46.7***
Return on Assets - ROA	0.9	1.0	0.1	1.1	0.2
Return on Equity - ROE	10.4	8.0 **	1.1	5.0	1.9
Total (noninterbank) loans to customer deposits	55	98	101	94	155
Foreign-currency-denominated loans to total loans	62	62	57	70	28

* Estmation based on Dec 2013 figure.
** Estimation for ROE based on 9M 2014 results.
*** NPL ratio based on local operations.
Source: IMF, National Banks, Piraeus Bank Research.

1.1 Banking Sector Developments in Balkan Countries & Cyprus

The performance analysis in this report focuses on the banking sectors in four Balkan countries, Albania, Bulgaria, Romania, and Serbia and also in Cyprus. Despite the differences, especially between the Balkan countries, regarding the level of economic growth and the development of banking sector, there are similarities related to the large proportion of foreign-owned banks, high financial euroisation and the increase in non-performing loans. Although growth is picking up in most of the Balkan countries, the region faces a number of downside risks related to the geopolitical uncertainty, possible impact from the euro area due to the new supervisory landscape for banks, and prolonged low growth and/or low inflation in the euro area. Recent economic performance in the region has been mixed.

Vulnerabilities and the weak macroeconomic outlook continue to weigh on banks' outlook for asset quality and profitability in these countries. Nevertheless, the banking sector remains well-capitalised and liquid, with reassuring capital buffers and provisions. Adequate capitalisation has remained a characteristic of the Balkan banking systems primarily comprising Tier 1 capital. The average capital adequacy of the banking system in the Balkan countries stood at 17.8% in December 2013, an increase of 90 bps from December 2008. For the first half of 2014 the average capital adequacy ratio increased further from year-end 2013 by 210 pps to 19.0%.

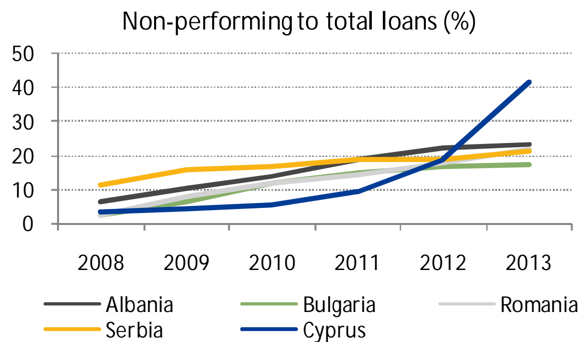


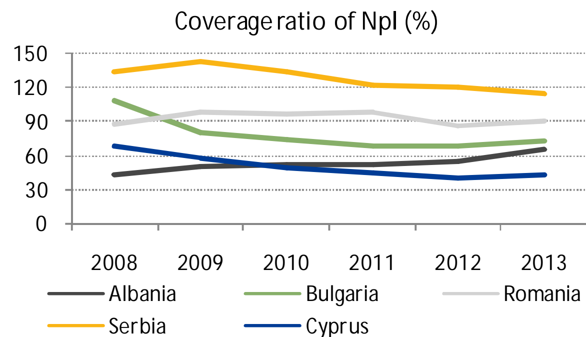
Source: IMF, Central Banks, Piraeus Bank Research

The banking system of the peer group countries is relatively stable but lending growth remains low or even negative and non-performing loans are increasing. Non-performing loan ratios have yet to peak, but the speed of deterioration has moderated. Cyprus maintains the highest level of NPLs of the peer group countries. Among the Balkan countries, Albania has the highest NPL ratio, followed by Serbia and Romania. Bulgaria posts the lowest level of NPLs with a level of 17%. Although NPL formation has slowed, NPL ratios are expected to remain high. This is because efforts to resolve the existing stock of NPLs (via expediting collateral sales, strengthening insolvency laws and providing incentives to sell and/or write-off NPLs) are slow to yield results.

The resolution of NPLs is key to ensuring a healthy flow of credit into the economy. Strengthening banks' balance sheets by bringing down high NPL ratios will allow banks to extend new credit. Experience from past financial crises suggests that lasting recovery requires a clean-up of the financial sector, including bringing down NPLs. Empirical evidence according to IMF, confirms that NPLs on banks' balance sheets do indeed create uncertainty and weigh on their ability to resume lending, and thereby aggregate demand and investment. According to Moody's, authorities are focusing on the following areas In order to reduce NPLs:

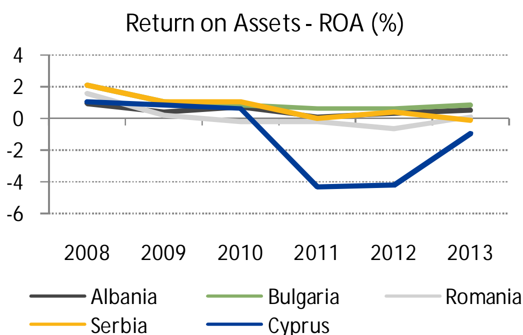
- Simplifying collateral enforcement procedures, accelerating the foreclosure process and making the collateral auction process more efficient by removing legal barriers.
- Introducing/strengthening insolvency frameworks and out-of-court loan-restructuring systems. This would better support the early rescue of viable firms and banks' speedy exit from non-viable ones.
- Taking out any tax disincentives relating to either NPL write-offs or the disposal/sale of such loans.

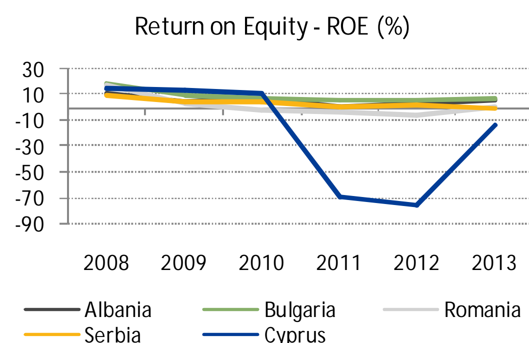


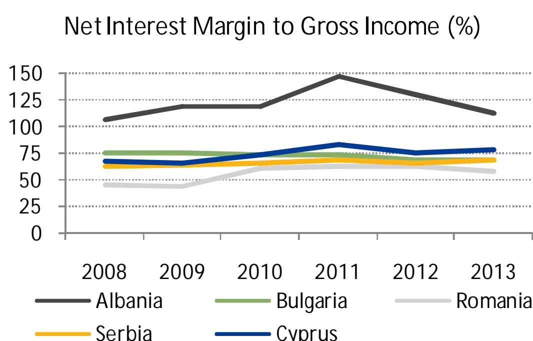


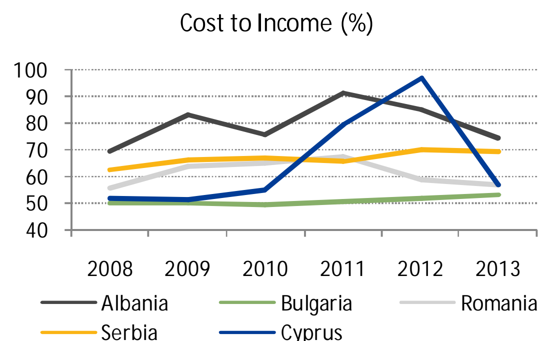
Source: IMF, Central Banks, Piraeus Bank Research

In the peer group of countries, high capital adequacy ratios and relatively high provisioning provide important buffers. However, provisioning varies considerably across the region. Profitability remains very sensitive to the evolution of credit losses. The average ROE in the Balkan countries declined from an average of 14% in 2008 to roughly 2% in the period 2011-2013. The overall profitability improved for banks in the group for 2013 compared to the previous year, with the exception of Serbia and Cyprus that reported losses. However, both countries according to 2Q2014 preliminary results, had positive ROE ratios at 5.0% and 1.9% respectively. Furthermore, Romania after three years of losses (2010-2012) was marginally profitable in 2013.









Source: IMF, Central Banks, Piraeus Bank Research

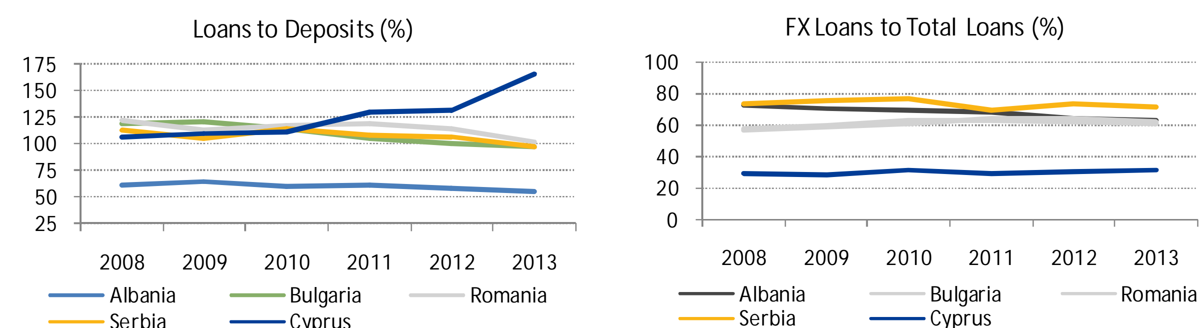
The average cost to income ratio improved in 2013 by almost 3.0 pps to 63.5% compared to 2012, although the level of ratio varies among the Balkan countries. Albania has the highest C/I ratio standing at 74% and Bulgaria the lowest at 53%. The steady cost to income ratios show that costs have been managed in line with revenue expectations and that many institutions have shied away from fundamental changes in their business models. With growth still slow and regulatory pressures continuing, astute cost management will remain an important way to improve performance.

European banks continue to dominate the banking sector in the Balkan countries, with foreign ownership exceeding 70%. The market share trend in the area shows that there is no extensive withdrawal amongst Western European banks. A recent EIB survey, shows that while Western cross- border banks remain committed to the region (Central, Eastern and South-Eastern European countries), they are more selective in their country strategies. Roughly 33% expect to reduce operations in the future, while 46% of the groups surveyed expect to expand operations. The main reasons are related to the gradual economic recovery, the low banking penetration (financial intermediation in nominal terms, calculated as the ratio of loans to the private sector to GDP is still far below the EU-27 average) and the profit potential.

Nevertheless, one major external challenge to financial stability in the Balkan countries consists of preserving the orderly nature of deleveraging following the balance sheet adjustment by the main European banking groups. The adjustment in European banks' exposures is reflected in all countries in the region. The latest monitoring report on deleveraging, drawn up by the Vienna Initiative, notes an ongoing decline in external funding from Western banks towards Central, Eastern and South-Eastern European countries. Gradual deleveraging is taking place and credit growth will therefore likely remain subdued. The tighter capital requirements, related to the capital increases necessary for parent banks to consolidate their capital base in view of the fast implementation of the Basel III capital requirements via the CRD IV/CRR package and the changes in lending policy pursued by parent banks brought about challenges that might generate unwanted spill-over effects likely to put a damper on lending. As a result, domestic private sector credit continues to decline across the Balkan countries, (being sharper in the case of FX loans), reflecting the slow pace of economic recovery, the high credit risk, the de-euroisation process through the limitation of FX loans to unhedged borrowers via the regulatory measures from central banks in several countries, and the continued adjustment of households' and domestic companies' balance sheets.

Furthermore, funding availability continues to improve. Access to funding does not seem to be of particular concern at the current level of demand. Domestic deposits growth continues to compensate for the decline in foreign funding. While foreign banks continue to reduce their external positions in the region, the increase in domestic deposits has on average offset the decrease in foreign bank funding since the beginning of 2013. The banking sectors of the Balkan countries are faced with the challenge of amending their business model in the coming years. That means collecting more deposits in local currencies instead of relying on loans from parents, reducing maturity and currency mismatches and structural liquidity gaps, and accumulating more liquid assets.

The average loan to deposit ratio in the Balkan countries dropped by almost 7.0 pps in 2013 compared to the previous year, as a result of the contraction in the volume of loans to the private sector and the increase of domestic deposits. The highest decrease (of 13 pps) was observed in Romania. Furthermore, in the first half of 2014, Albania maintained the lowest LtD ratio of 55% followed by Serbia with 94%. The relevant ratio for Cyprus's banking system decreased to 155% in the first half 2014 from 166% in 2013 and 132% at the end of 2012.



Source: IMF, Central Banks, Piraeus Bank Research

Another vulnerability that persists is the high prevalence of foreign currency lending. In all the countries of the Balkan region the share of foreign-currency lending exceeds 60%. Serbia has the highest ratio, exceeding 70% in 2Q 2014. It should be noted

that Cyprus also has a relatively high ratio of FX loans, more than 27% of the total loan portfolio (2Q 2014). The share of foreign currency lending in the Balkan region has not come down from the pre-crisis period in most of the countries – more often it rose due to valuation effects. Any large-scale depreciation of the local currencies would still significantly increase the debt burden of households and companies, negatively affecting the financial sector through a likely increase of non-performing loans.

The conclusion of the ECB's assessment of the main European banks, some of which are significant banking groups with their subsidiaries in these countries, removed any uncertainties accompanying this process in terms of asset quality and additional need for capital. Although the subsidiaries of these banking groups generally have adequate capitalisation and profitability parameters, they may become part of banking groups' strategies to control exposures outside the euro area, in their efforts to strengthen their respective balance sheet positions. This may delay a more active bank approach to increasing lending and condition these institutions to reduce their activity for a period of time.

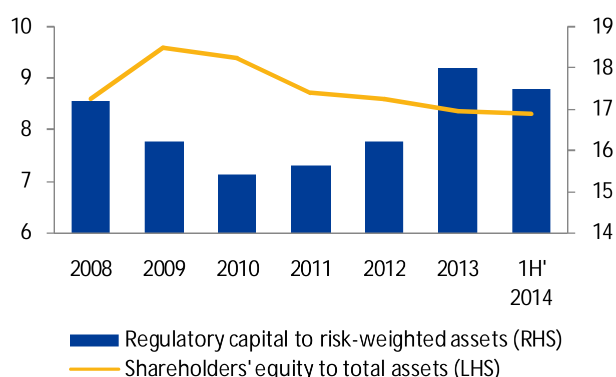
1.2 Banking Sector Analysis by Country

Albania

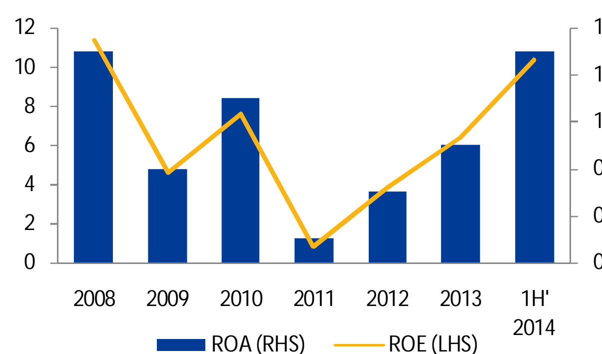
The Albanian banking system remains well capitalized, liquid and provisioning appears to be adequate. The loan portfolio quality remained a concern, although the non-performing loan ratio appeared more stable and the non-performing loans, in terms of absolute value, were lower year-over-year. Sound banking business capitalisation remains a distinguishing feature of the Albanian banking sector. In June 2014, the capital adequacy ratio stood at 17.5%, from 18% at end-2013. Risk-bearing assets increased only 1%, while regulatory capital narrowed by about 1.6%, mainly due to the contracted core capital.

Banking system profitability improved in the 1H2014 with Return on Assets (RoA) increasing to 0.9%, about 3.5 times higher than a year earlier and average Return on Equity (RoE) increasing to 10.4%, from 2.9% a year earlier. Net profit improved due to a slower increase in non-performing loans, improved value of debt securities and lower provisions for the credit risk of the assets. The net interest margin showed a slight increase due to the faster fall in interest expenses, compared to the fall in interest income.

Albania: Capital Adequacy (%)



Albania: Profitability (%)

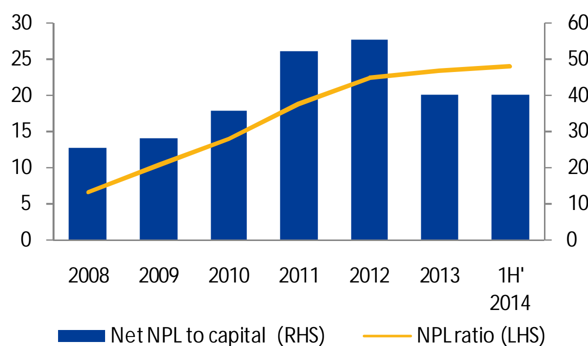


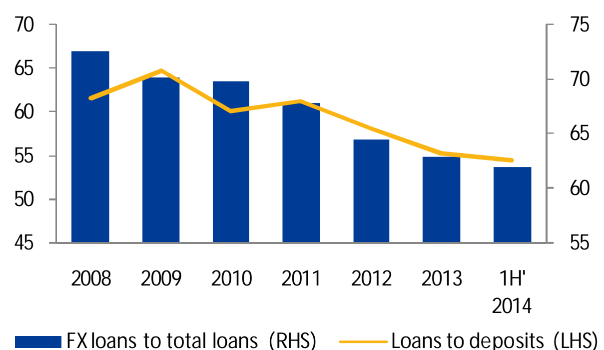
Source: IMF, Bank of Albania, Piraeus Bank Research

While bank profitability has improved because of lower provisioning expense associated with the slowdown of NPL build-up, NPLs remain high. The NPL ratio has increased from 6.6% in December 2008 to 23.5% as of end-2013. In June 2014, the non-performing loan ratio stood at 24.1% increasing marginally in annual terms. The slight increase in non-performing loans mainly reflected the increase of non-performing loans stock (contributing 58% of the increase in the ratio) and less the contraction of outstanding loans. The non-performing loan ratio for lek loans was 18.8%, down 1.3 pps from June 2013. The same ratio for

foreign currency loans was 27.3%, up 0.8 pps from June 2013. Loan quality worsening was accompanied by an increase in the loan loss provisioning ratio, which was 66.3% in 1H2014 from 57.4% a year earlier.

The slower growth of non-performing loans was mainly attributable to the sale of NPL portfolios and their write-off from balance sheets. Furthermore, several measures have been introduced to address high NPLs, such as changes in the civil code to ease collateral execution, passage of tax law amendments to ease NPL write-offs by banks, and requiring banks to write off loans that have been held in the "loss" category for longer than three years from the beginning of 2015. The early results of the changes in the Civil Procedures Code that were introduced in September 2013 have been encouraging, with an increase of 8.9% (y-o-y) in recovered amounts realized through the collateral execution process. These measures are expected to facilitate more proactive management of NPLs by banks and encourage them to clean their balance sheets.





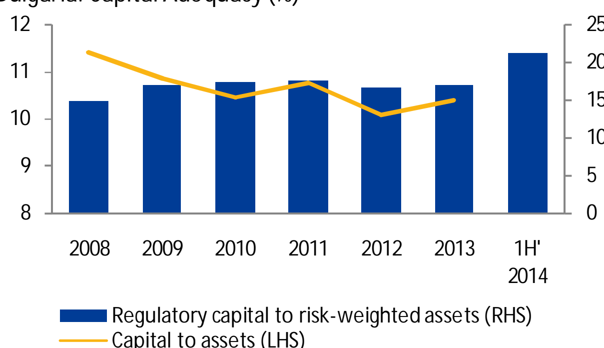
Source: IMF, Bank of Albania, Piraeus Bank Research

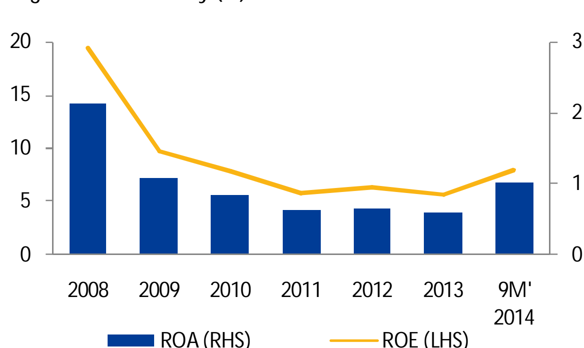
Credit growth in Albania slowed down considerably in 2013 and shrunk in the first half of 2014. Both supply-side and demand-side factors impacted this performance. Changes in parent bank policies, the weakening of banks' balance sheets at home and the application of tightened lending standards were the factors that contributed to the shrinkage of the credit supply. Since the end of 2008, credit growth pace has slowed, slipping into negative territory in 2H2013. Credit growth dropped to 11% in 2009 - 2012, from 45% in 2006 - 2009, and decreased to an average of –0.9% in 2013. Bank lending continued to shrink in 1H2014 by 2.2% y-o-y, driven by the fall in lending to businesses and foreign currency lending. Foreign currency lending fell by 5.9% y-o-y, whereas lek lending grew by 4.6% and its share of the loan portfolio climbed to 38%. Deposits represent the primary funding source for banks' operations, accounting for 82% of total sector assets. In the 1H2014 deposit expansion slowed down, recording an annual growth rate of 3%, driven by the higher return demand from investments of banking products abroad, and the performance of businesses' accounts impacted by the payment of Government arrears. In 1H2014 the loan-to-deposit ratio stood at 54.6%, from 55.3% at end-2013

The size and concentration of the government debt securities portfolio owned by banks represented another potential risk source. One-third of bank assets consist of government securities, and these holdings represent two-thirds of total government debt. Currently, this risk is assessed as downward, given that: 1) Government solvency improved due to the consolidated fiscal policy and the agreements with the IMF providing alternative income in foreign currency and 2) banks are in good liquidity and capital conditions, and do not currently prefer other forms of investment. Furthermore, the significant foreign bank presence represents an additional risk. The financial sector in Albania is concentrated and dominated by foreign banks. The largest five banks hold about three-quarters of system assets and deposits. Subsidiaries of foreign banks (which include four of the top five banks, including from Austria, Greece, Italy, and Turkey) represent about 90% of total banking sector assets. There are concerns regarding the supervisory developments in the euro area at the level of parent groups in Austria, Greece and Italy that may force local subsidiaries to reduce loans and/or shrink balance sheets. A further tightening of credit supply would put the economic recovery at risk.

Bulgaria

The banking sector is well-capitalised, liquid and profitable in aggregate, and non-performing loans have peaked. The recent developments in Bulgaria's sector highlight long-standing risks about corporate governance and related-party lending, which in turn weaken the business environment. However, these developments are not of a systemic nature, the subsidiaries of EU parent banks have not experienced withdrawals. Despite the liquidity problems experienced by First Investment Bank and Corporate Commercial Bank (KTB) during the summer, Bulgaria's banking sector, which is about 70% foreign-owned, is highly liquid. Total capital adequacy stood at 17.0% at the end of 2013, and Tier I capital reached 16.0%, as a result of strengthened primary capital. In the 1H2014, capital adequacy ratio rose substantially to 21.2%, and Tier I ratio to 19.3%, mainly due to the positive impact of the elimination of specific provisions (measured until the end of 2013 as a deduction from own funds).

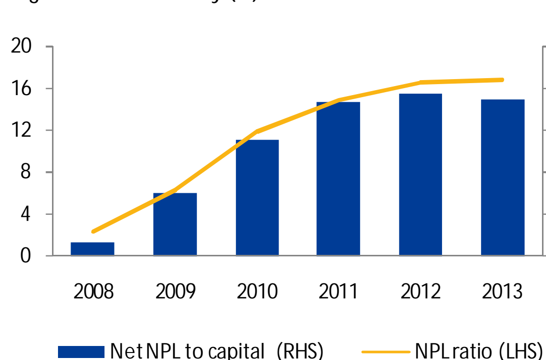


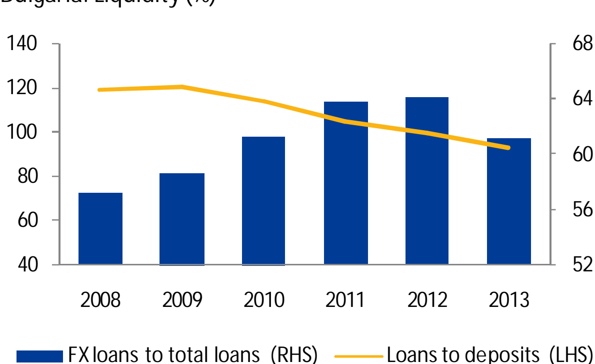


Source: IMF, Bulgarian National Bank, Piraeus Bank Research

Liquidity remained plentiful due to rising deposits and low credit demand. At the same time, external liabilities of the banking system declined further to 16% of GDP in 2013 compared to an end-2008 peak of 27%, and banks' net foreign assets reached a small surplus compared to a peak deficit of 18% of GDP in 2008. Deposits represent the primary funding source for banks' operations, accounting for 85% of total sector assets based on September 2014 figures. For the same period, the debt and capital instruments made up 13.1% of the banking system's assets and the cash and cash balances with the BNB had a share of 9.0%.

The annual growth rate of credit to the private sector, after the stagnation recorded in 2013 increased slightly based on September 2014 figures to 2.0% y-o-y. Loans to non-financial corporations, representing 66% of total loans, increased by 3.0% y-o-y, whereas loans to households remained stable, at the levels observed for the last 2 years. Deposits increased in September 2014 by 6.4% y-o-y. The net loans to deposits ratio stood at 100% according to September 2014 figures. It should be noted that regarding the ratio of foreign currency denominated loans to total loans remained at 62% in September 2014.





Source: IMF, Bulgarian National Bank, Piraeus Bank Research

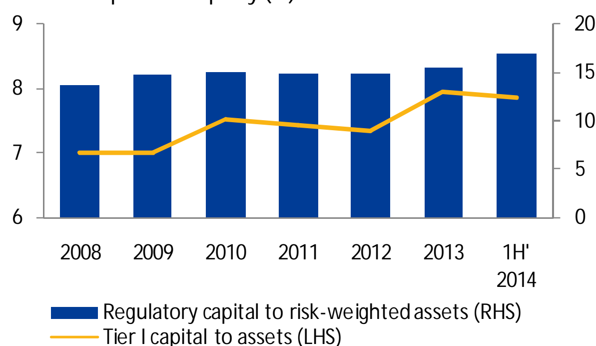
NPLs have stabilized, but remain near their peak. Although the non-performing loan ratio amounted to 16.9% of loans in December 2013, coverage by provisions is comfortable at 72.7%. Some banks have recently been more proactive in resolving NPLs by claiming and removing associated collateral from their balance sheets, a process that is made difficult by a number of factors, including a depressed real estate market and an ineffective and unpredictable insolvency framework. Based on the Bulgarian National Bank's figures, the ratio of bad and restructured loans to total private sector loans in September 2014 remained at the levels seen in December 2013. At the end of September 2014, the net (balance sheet) value of the loans past due more than 90 days was 10.48%. The value of net loans past due more than 90 days is derived by deducting the impairment costs incurred from their gross amount.

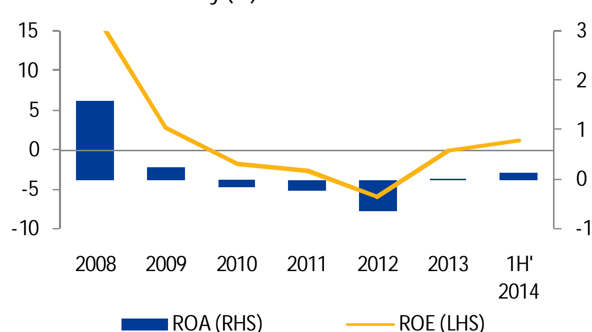
The financial sector in Bulgaria is concentrated and dominated by foreign banks. Nevertheless, domestic banks' market share by the end of March 2014 increased by 3.6 pp y-o-y, reaching 30.8% of total assets (acquisition of MKB Unionbank EAD by First Investment Bank AD). The share of EU subsidiaries decreased to 61.5% in the first quarter of 2014 from 64.8% a year ago. The banking system profitability in 2013 remained at an acceptable level with the ROA ratio standing at 0.70% and ROE at 5.64%. For the first nine months of 2014 ROA increased further to 1.0% and ROE is estimated to be around the levels of the 1st quarter 2014 (8.4%).

According to IMF staff comments about the financial sector, after the last visit in June 2014, the implementation of the new EU regulatory regime is on track, including the adoption of maximum capital conservation and systemic risk buffers applicable to all banks. In addition, the elimination of specific provisions resulted in a commensurate increase in regulatory capital. While credit growth remains low, the system is stable and liquid, with banks' non-performing loans buffered by provisions and significant capital, as well as a positive net foreign asset position. Efforts by banks to address the stock of distressed assets and claim associated collateral should continue in order to lower asset price uncertainty and thereby support renewed investment. Bulgaria's recent banking sector stress may have impacted market confidence, though the longer-term impact is likely to be contained, thanks to the authorities' rapid response. The latter included Bulgaria's announcement of its intention to opt into the Single Supervisory Mechanism (SSM) under Europe's banking union project. Acceptance is not automatic but, if implemented, this would put the European Central Bank (ECB) in charge of supervision of the key banks in the country in the future.

Romania

The Romanian banking sector remains well-capitalised and liquid with reassuring capital buffers and provisions, but faces increased pressures on asset quality. The banking system ability to support the recovery remains limited due to high NPLs and on-going deleveraging. The results of the banking sector solvency stress test spanning 2013 Q3-2015 Q2 showed that, overall, credit institutions remain resilient to significant adverse macroeconomic shocks, further maintaining an adequate level of capital ratio. Total capital adequacy of the banking system stood at 17.0% at the end of June 2014, and Tier I capital reached 14.9%.



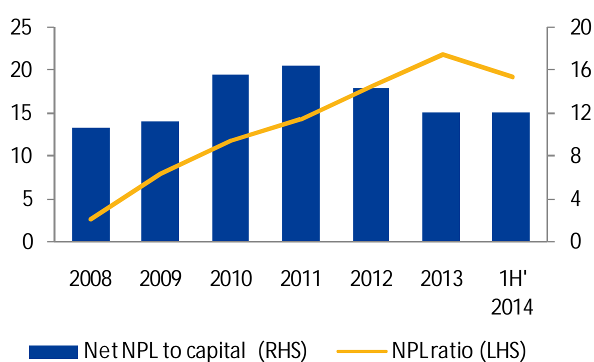


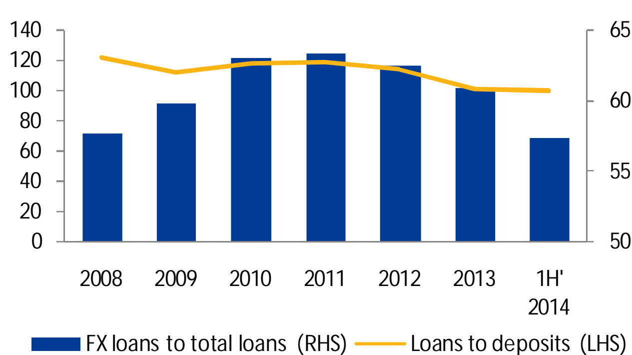
Source: IMF, National Bank of Romania, Piraeus Bank Research

Nonperforming loans rose to 22.3% of total loans in 1Q2014, from 21.9% at the end of 2013, reflecting the weak economic environment, previously weak credit standards, external funding that fuelled FX loans at nominally low interest rates and difficulties in removing NPLs from bank balance sheets. At the same time, part of the continuous upward trend despite a stable macroeconomic environment, is explained by the low or negative overall credit growth (denominator effect). It should be noted that starting from the first quarter of 2014, the NPL ratio has been recalculated by the National Bank of Romania. The new determination is based on reports from all banks (both those which use the standard approach in assessing credit risk and those applying internal rating models). The new ratio for the first quarter of 2014 was 1.9 pps lower than the previous estimation, (20.4% compared with 22.3%) which decreased to 19.9% in June 2014 and further to 17.7% based on July's 2014 figures.

The coverage ratio of non-performing loans with IFRS provisions stayed at a comfortable level of 66.2% (without prudential filters) in July 2014. In line with EU regulatory requirements, the prudential filter started its scheduled phase-out period at end-January 2014. It was reduced by one fifth, and will be gradually eliminated by 2018. This measure will have a positive impact on the level of own funds that are taken into account when determining the capital adequacy ratio due to the gradual decrease of the amount of prudential filters previously used as deductions from own funds.

Most problem loans are concentrated in the SMEs with an NPL ratio of 27.6% as of August 2014. Households have on average a lower incidence of loan deterioration, except for the sub-segment related to credit card debt and debt in foreign currency. A new guarantee scheme for the NPL-plagued SME sector has been started, where the government shares the credit risk of the loan with the lending bank. The success of the plan will depend on its adoption by the private sector and the minimization of moral hazard. Furthermore, the program that provides housing loans guarantees was switched to domestic currency from September 2013, and will gradually help reduce FX risk in the banks' portfolios.





Note: NPL ratio from the 1Q'2014 has been recalculated by the National Bank of Romania. The relevant figure for the 1Q' 2014 was 1.9 pps lower than the previous estimation.

Source: IMF, National Bank of Romania, Piraeus Bank Research

The market share of banks with majority foreign capital in total banking system assets stood at 81% in July 2014 from 90% in 2013. The concentration of the Romanian banking system, as reflected by the share of the top five banks in total bank assets, declined slightly to 54% for the same period. Credit to the private sector declined by 4.3% y-o-y in real terms in July 2014, given the weak economic activity, tightened lending standards and also due to the deleveraging process of the foreign banks. Private sector loans in domestic currency in July 2014 increased annually by 7.6%, whereas loans in foreign currency, representing 57.4% of total loans, decreased by 10.8%. With system-wide deposit growth of 6.9% (July 2014), overall liquidity conditions have improved. The Romanian banking sector's vulnerability to the overly high dependence on external financial resources has decreased noticeably. Exposure of parent undertakings to their subsidiaries in Romania has declined by 28% in the period December 2012 to August 2014. As a consequence, banks' reliance on local funding has increased, prompting a significant fall in the system's loan to deposit ratio to 99.8% in July 2014, from 110% in the same month of the previous year. While euroisation of loans has started to decrease in response to government programs in the local currency, the share of FX loans is still high and

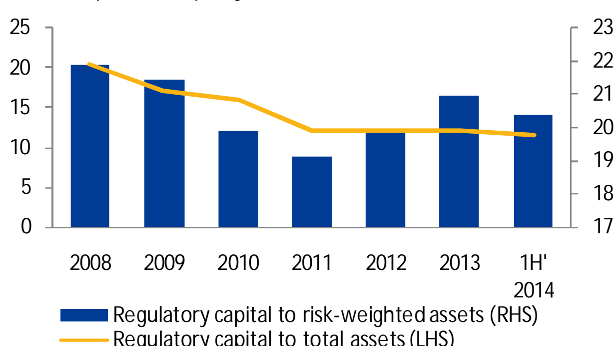
remains a weak spot of the system's balance sheet. The risks from continuing parent funding retrenchment remain significant, especially if credit demand recovers (it is expected to be negative by 2.1% in real terms, according to IMF projections, at the end of 2014 and positive by the same percentage at the end of 2015), though they are mitigated by the lower prudential filter and minimum reserve requirements.

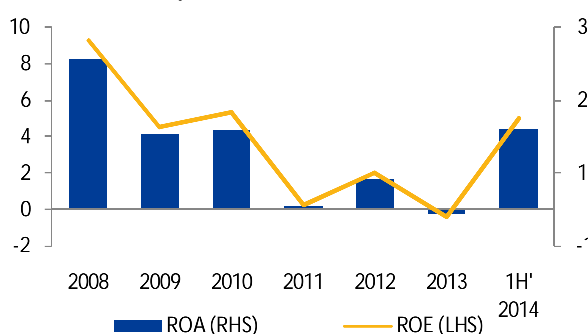
Prospects for bank profitability remain challenging, notwithstanding the small profit recorded in 2013 thanks to a slowdown in non-performing loan build-up and a positive growth rate of operating profitability, expressed by a ROA ratio of 0.1% and ROE of 1.3%. Profitability remained at positive, yet moderate, levels from January through July 2014, with ROA and ROE standing at 0.2% and 2.3% respectively. The Romanian banking sector is to undergo an extensive assessment following the Romanian authorities' decision to join the Banking Union's two pillars: the Single Supervisory Mechanism and the Single Resolution Mechanism. Romania's entering into a close cooperation agreement with the ECB regarding prudential oversight involves a comprehensive assessment exercise covering all significant credit institutions. The exercise is comprised of three stages, as follows: (i) a risk assessment; (ii) a bank asset quality review; and (iii) a stress test based on macroeconomic scenarios. In the case of credit institutions in Romania, this exercise is planned for 2015. The main challenges to Romania's banking sector over the period ahead are: ensuring a sustainable recovery of lending, preventing excessive balance sheet adjustments in the context of cross-border deleveraging, and improving bank asset quality indicators via clean-up measures aimed at removing non-performing loans from balance sheets, with a positive impact on banks' operational efficiency and intermediation capacity.

Serbia

The Serbian banking system remains stable overall. Capitalization and liquidity indicators are high and NPLs are well-provisioned. In 2014 banks maintained a high level of CAR from 2013, ending June 2014 with 20.4%, and Tier I capital 17.6%, mainly due to recapitalizations and lower credit risk-weighted assets. The degree of financial intermediation of the banking sector in the Serbian economy grew further in the second quarter of 2014 to over 78% of GDP (assets to GDP) following the growth rate of the last five years from 67% in 2008.

The major problem for the banking sector is the level of non-performing loans, which for the second quarter of 2014 amounted to 23.0% from 21.4% in December 2013. However, it should be noted that Serbia entered the crisis with a relatively high share of NPLs (11.3% at end-2008). The main drivers of total NPLs are companies in the manufacturing, trade and construction sectors and entities in bankruptcy procedure. In August 2014, the NPL ratio of corporate loans was 27.3%. The NPL ratio in the households sector is significantly below the average (10.3% in August 2014). IFRS provisions cover more than half of NPLs (54.3% in August 2014). Gross NPLs are fully covered by balance sheet loan loss reserves, i.e. regulatory provisions (111.0% in August 2014).

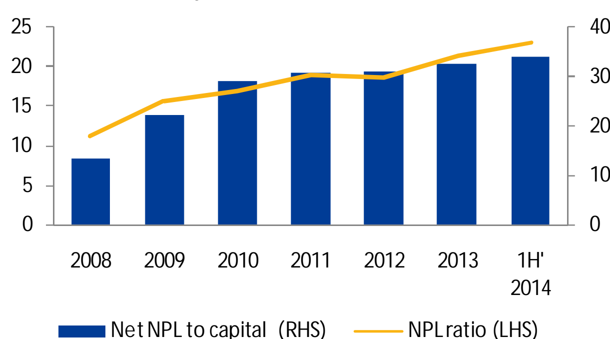


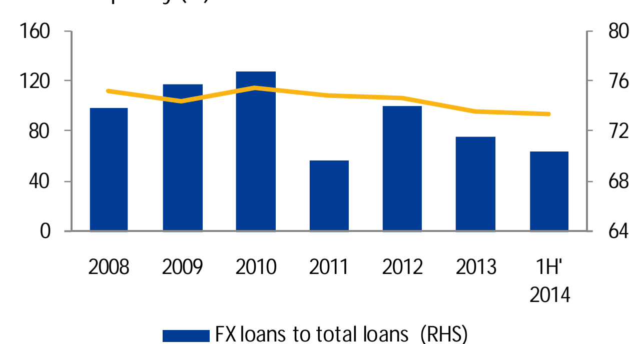


Source: IMF, National Bank of Serbia, Piraeus Bank Research

The market share of banks with majority foreign capital in total banking system assets stood at 75% in the second quarter 2014. While the share of foreign banks has remained stable over the last 5 years, the Greek and Austrian banks have reduced their share in contrast to the Italian and the French who have increased theirs. According to an NBS report, Greek banks reduced their share from 17% at end 2008 to 14% in the second quarter of 2014 and the Austrian banks from 22% to 15% over the same period. Serbia's banking sector is highly liquid and the liquidity risk poses no threat to financial stability. In the second quarter of 2014, the average monthly liquidity ratio of 2.6 was much higher than the regulatory minimum (1.0). The average monthly narrow liquidity ratio of 2.0 was also above the regulatory minimum (0.7).

As regards banking performance, ROA stood at -0.1% at the end of 2013 and the corresponding ROE ratio was -0.4% for the same period. In 2013 negative profitability of the banking sector was driven by 2 banks (which contributed to 50% of all banking sector losses), one of which withdrew from the market through the "firesale" of assets. For the second quarter of 2014, banking profitability improved substantially, with ROA increasing to 1.1% and ROE to 5.0% (for the first eight months of 2014 ROE is 5.43% and ROA is 1.14%). The efficiency ratio of operating expenses to operating revenues in the second quarter of 2014 improved by 4.9 pps compared to the end of 2013 to 64.5%.





Source: IMF, National Bank of Serbia, Piraeus Bank Research

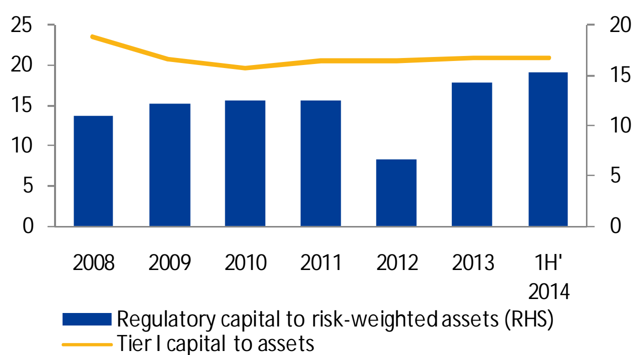
After a long period of sluggish growth, lending declined y-o-y as of mid-2013. Excluding the exchange rate effect, bank claims on domestic non-monetary sectors under loans fell by 2.2% in August 2014. After more than a year, the pace of contraction in bank lending has softened. Subsidized loans contributed to a mild recovery in bank lending to enterprises (liquidity loans and loans for financing of durable working capital). The y-o-y growth in credit to households picked up slightly to 5.0% in August 2014, whereas the growth in companies was negative by 6.6%. A rise in the deposit base and reduced lending dragged down the LTD ratio to 94% in June 2014, from 97% in December 2013 and 107% at the end of 2012. Another risk concerns the euroisation of the banking system. The proportion of foreign currency lending to total loans remains very high (70.4% in June 2014) and is one of the weaknesses of the banking system. Nevertheless, the new program of government subsidies gave a boost to corporate loan dinarisation from June 2014. In August 74.8% and 48.7% of new loans to households and enterprises, respectively, were denominated in the local currency.

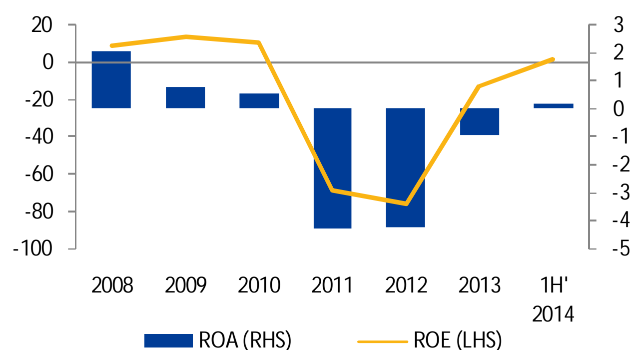
Cyprus

Significant progress towards stability in the Cypriot banking sector has been achieved in the past 20 months, since the severe shocks and restructuring of the banking sector in March 2013. Drastic measures have been taken to tackle the causes that led to the crisis and to restore the viability of the banking system. Banks have been recapitalized using private and public sector resources, the sector has consolidated and deleveraged significantly, and – while certain constraints on capital movements are still in place – the liquidity and deposit situation has improved. CET1 capital ratio is estimated to have increased to close to 14% of risk-weighted assets at end-August 2014 as a result of: (i) the BoC's recapitalization at no fiscal cost in 2013 and an additional private placement of €1 bn completed in September 2014, (ii) the recapitalization of Hellenic Bank through private funds in late

2013 and (iii) the injection of public funds (€1.5 bn) into the coop sector in early 2014. With the aim of preserving the sector, in March 2014, the state nationalized and recapitalized it by injecting €1.5 billion into the Central Cooperative Bank (CCB). Subsequently, the sector was consolidated from 93 into 18 institutions, which received capital from the CCB to meet regulatory minima.

In the October 2014 results of the European Banking Authority (EBA) EU-wide stress test, three out of the four largest Cypriot banking institutions showed a capital surplus. Specifically, these were the Bank of Cyprus, the Co-Operative Central Bank and the RCB Bank. Hellenic Bank with €105 mn capital shortfall identified under the adverse scenario of the EBA stress test, announced at the end of October a €220 mn rights issue, mentioning that its two largest shareholders will fully subscribe to their combined 40.6% allocation.





Source: IMF, Central Bank of Cyprus, Piraeus Bank Research

As regards banking performance, ROA stood at -1.0% at the end of 2013 and the corresponding ROE ratio was -13% in the same period. For the second quarter of 2014, the image is clearly improved with ROA at 0.2% and ROE at 1.9%.

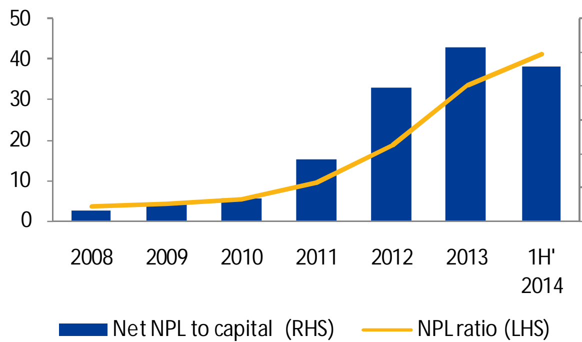
The pace of credit contraction has slightly moderated. The annual growth rate of total loans in September 2014 stood at -2.8% compared to 12% at end-2013. Both corporate and household credit continued to decline. Private-sector debt remains among the highest in Europe, at 410% of GDP at end-2013. The loans to deposits ratio stood at 155% at the end of June 2014 from 132% at the end of December 2012.

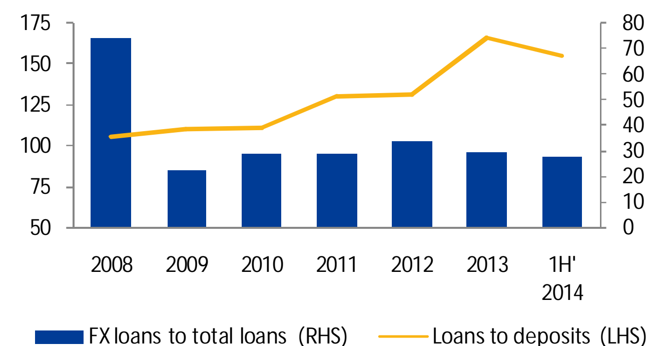
Customer deposits represent the largest source of funding for Cypriot banks, accounting for 70% of the banking system's assets as of June 2014. After falling by about 16% (excluding bailed-in amounts) during March-December 2013, deposits declined by a further 4.5% y-o-y in September 2014. Domestic residents' deposits representing 70% of total deposits decreased by 3.4% in the same period. The authorities gradually relaxed domestic payment restrictions, which were fully eliminated in May, and unfroze the BoC's uninsured deposits. External payment restrictions remain in place, given still tight bank liquidity and limited collateral buffers as asset quality deteriorates. While restrictions do not apply to fresh foreign inflows into Cyprus, they limit outflows, hampering trade credit and affecting overall confidence.

Although conditions in the financial sector are gradually normalizing, vulnerabilities remain. Cypriot banks face challenging operating conditions, including continuing financial sector deleveraging, falling consumption and declining business activity. High NPLs remain the key vulnerability of the Cypriot banking system, exposing banks' balance sheets to significant downside risks and binding a significant part of the banks' capital and operational capacity.

Although the recession has been less deep than expected, the ratio of non-performing loans in Cyprus (banks' local operations) is the highest in Europe standing at 48% in August 2014 increasing by 17 pps from June 2013. Corporate NPLs stood at 49%, with construction NPLs (representing 22% of total corporate facilities) now at over 73%. NPLs on primary-residence mortgages

are around 41%. Provision coverage remains relatively low, at 34% (March estimates) compared to the European average of 46%. This suggests that Cypriot banks' profitability will be significantly affected going forward.





Source: IMF, Central Bank of Cyprus, Piraeus Bank Research

Given the amount of NPLs, the constrained funding environment, tight capital buffers, and acute lack of fiscal space, the strategy focuses on dealing with NPLs through developing capacity and targeted policies within bank internal units. Policies and practices are guided by a sector-wide arrears management framework and code of conduct. In addition, the authorities are embarking on a reform of the legal framework.

While a recently adopted legislative package included important elements, it also introduced a number of new obstacles, including processes to delay foreclosures, moratoria, and debt-write-offs irrespective of viability considerations. Nevertheless, the supreme court of Cyprus on the 31st of October ruled against four amendments that the parliament added to the revised foreclosure law it passed on 6 September. The recent development is positive for the Cypriot banks because it allows for the immediate ratification of the revised foreclosure law, which speeds up foreclosures and improves bank recoveries against their large stock of nonperforming loans either through asset sales or restructurings. Until now, foreclosing on real estate collateral in Cyprus could take more than 10 years, thus reducing borrowers' incentive to repay. Under the new framework, foreclosure proceedings can begin once a loan is in arrears for 120 days. Moreover, the involvement of certain government bodies, such as the land registry, which previously slowed the process, has been eliminated.

The implementation of the revised law will prompt Cypriot borrowers to actively seek loan restructurings, considering that the threat of losing the asset securing their loan is now real, according to Moody's. Still, even with well-designed frameworks in place, cross-country experience suggests that it takes time for progress to materialize. Uncertainties related to NPLs contribute to high funding costs, which translate into lending rates that further constrain credit demand.

2. So what has happened to the Economies of SEE, Cyprus, Egypt and even Ukraine? Our Macro-Forecasts Review.

The rebound from the crisis ongoing since 2008 was a great challenge for emerging Europe. Those countries based their economies on their reliance on the EU. So the crisis was a great opportunity - that many countries actually seized - to redefine their growth models. A number of countries also saw political stability as an opportunity to address the main issues that kept macroeconomic and fiscal conditions volatile. For instance, Albania with the help of the IMF started to address the government arrears last year and started repaying debt. That alone means that the government will be able to follow a more effective fiscal policy, providing at the same time the necessary liquidity to the banking sector. Further, the geopolitical instability caused by the Ukraine-Russia conflict leaves enough space for the rest of the emerging countries to develop their production lines and act as a stability hub for companies' production and hosting of their activities. Serbia is one of those cases. While, Cyprus paves the way for most of the European countries on how to correctly implement the Economic Program. The impressive correction in just the 1.5 years since the country suffered the brutal deposits haircut and entered the Economic Program of the IMF and the European Union, is a factor adding to the improvement of the country's sovereign risk.

What has changed and was has been revised?

Table of Economic Forecasts

	Real GDP (% YoY)		Inflation		Fiscal Balance (% GDP)		Current Account Balance (% GDP)	
	2013	2014f	2013	2014f	2013	2014f	2013	2014f
Albania	0.4	1.9	1.9	2.5	-4.7	-3.1	-10.6	-11.0
Bulgaria	0.9	1.9	0.9	-1.0	-1.8	-1.9	2.1	0.5
Cyprus	-5.4	-3.0	-0.4	-0.5	-5.1	-3.5	-3.1	-2.0
Romania	3.3	2.2	4.0	1.5	-2.5	-1.0	-1.1	-1.2
Serbia	2.6	-0.8	7.9	2.5	-4.9	-6.5	-6.5	-4.9
Ukraine	0.2	-6.0	-0.3	10.5	-4.4	-6.0	-9.2	-3.5

Source: Piraeus Bank Research

2.1 Albania

Debt repayment = Stability

For 2014, we keep our forecast unchanged at 1.9% YoY for real GDP from 0.4% in 2013, but the potential output is expected to remain constrained if structural reforms do not progress. Although Albania has been among the top growth performers over the last few years, the contraction in economic activity in Italy and Greece – its main trading partners and source of remittances – has lead to weakened domestic demand. Moreover, the continuing shortages of electricity – a problem that is not expected to be resolved any time soon – takes its toll on the Albanian economy. A factor positively contributing to the improvement of the economic climate is the fact that the country was officially granted Candidate Country status by the European Union in the summer.

Prices in Albania follow the regions' trend, as inflationary pressures have slowed, keeping inflation below the Bank of Albania's (BoA) lower bound. We expect inflation to average 2.5% in 2014, which is within the BoA's target range, as monetary policy and stable economic activity provide much needed stability. We must note however that the BoA has followed an impressive easing since 2013, by cutting the key policy rate by 100bps to the historically low level of 2.5%. For the first nine months of the year inflation moderated to 1.8% from 2.1% in Jan-Sep 2013, as food prices halved to 2.5% YoY compared to 4.6% in the same periods.

The fiscal sector has improved since the beginning of the year, as the government has made significant progress on the repayment of the government arrears. The SBA loan from the International Monetary Fund (IMF) of EUR 330.9mn has strengthened the fiscal sector, ensuring the sustainability of public debt and placing the economy on a stable growth path over the medium term. We therefore revise our forecast for the fiscal deficit in 2014 to 3.1%. The fiscal deficit in Jan-Sep moderated significantly to 2.2% of GDP from 4.4% in Jan-Sep 2013, as public spending contracted to 21.3% of GDP from 21.9% for the same periods. Revenues increased to 19.1% in Jan-Sep from 17.5% for the same period last year.

The current account deficit is expected to widen marginally in 2014, while we anticipate an improvement in its financing as the flow of remittances last year was severely affected by the economic recession in Italy and Greece. The combination of low domestic savings and the subdued export sector, especially energy exports, limit the current account balance. We keep our forecast unchanged for the current account deficit at 11.0% of GDP in 2014 from 10.6% in 2013.

Albania Economic Indicators

	2011	2012	2013	Q3 2013	Q4 2013	Q1 2014	Q2 2014
			% YoY				
Gross Value Added	3.2	1.0	1.4	-2.3	2.2	1.7	-0.6
Unemployment Rate (avg)	--	13.4	16.0	16.8	16.8	18.2	17.2
Inflation (avg)	3.5	2.0	1.9	1.5	1.5	1.9	1.6
Monetary Policy Rate (eop)	4.75	4.0	3.0	3.50	3.0	2.75	2.5
EUR/ALL (avg)	140.4	139.0	140.3	140.3	140.4	140.4	140.1
			% GDP				
Fiscal Balance	-3.6	-3.5	-5.0	-4.4	-5.0	-0.1	-1.6
Current Account Balance	-13.4	-10.3	-10.6	--	--	--	--

Source: Piraeus Bank Research, National Sources

2.2 Bulgaria

Power disguised

Bulgaria continues to show signs of a steady recovery, as real GDP remains very stable although below its long-term average. We are keeping our forecast unchanged at 1.9% YoY for real GDP in 2014, as we anticipate that the country will continue to grow with exports, consumption and investments being the wheels of growth. The revision of the national accounts to convert to the ESA 2010 methodology brought up real GDP in 2013 to 0.9% compared to the previous 0.7% value. One factor that can lead to destabilization of the economy is the recent banking turmoil caused in the summer by the fraud scandals and bank run at the third and fourth largest banks in the country respectively. The government has yet to decide on the means of resolution of one of the largest lenders in the country, the CCB.

The Bulgarian economy has been on a deflationary path since September 2013. Reduction in the administratively set energy prices and a strong harvest (leading to lower food prices) made prices trend sharply downward. Moreover, there is a sizable amount of slack in the economy, as after the 2008–2009 crisis, it has been operating below its potential level. Indicatively, inflation in Jan-Sep averaged -1.7% from 1.7% in Jan-Sep last year, as most of the consumer price index constituents either declined or slowed down. Hence, we revise our forecast for average inflation in 2014 to -1.0%.

The fiscal finances remain stable, as previous fiscal consolidation leaves enough room for manoeuvre. The fiscal deficit in Jan-Aug widened to 1.6% of GDP from 0.3% in Jan-Aug last year, due to an increase in public expenditures. This number however is well below the maximum of 3.0% providing the necessary stability to the country. We keep our forecast unchanged at 1.9% in 2014.

The external sector remains stable, as the current account balance has turned to surplus since July this year, with impressive improvement in the income and services balance. The geopolitical turmoil in the periphery allows the country to seize net exports, hence we keep our forecast unchanged at a current account surplus of 0.5% of GDP in 2014 from 2.1% in 2013.

Bulgaria Economic Indicators							
	2011	2012	2013	Q3 2013	Q4 2013	Q1 2014	Q2 2014
% YoY							
GDP	2.1	0.4	0.9	1.1	1.9	1.5	1.8
Final Consumption	1.9	3.4	-1.5	-1.3	-1.3	3.3	1.2
Gross Fixed Capital Formation	-5.3	1.1	2.2	2.0	4.1	4.6	4.8
Exports of G&S	12.6	-0.2	10.1	11.5	10.5	2.1	3.0
Imports of G&S	8.4	3.4	6.6	6.5	6.4	5.5	3.7
Industrial Production	6.3	-0.2	0.1	0.1	2.9	4.0	3.2
Retail Sales	0.6	5.4	2.7	5.9	6.7	7.4	2.0
Unemployment Rate	10.4	11.4	11.8	10.8	11.5	12.2	11.2
Inflation (avg)	4.2	3.0	0.9	-0.6	-1.5	-2.4	-1.8
% of GDP							
Current Account Balance	0.1	-1.1	2.1	3.1	2.1	-0.8	-0.2
Fiscal Balance	-2.0	-0.4	-1.8	-0.4	-1.8	-1.1	-1.3
Public Debt	15.7	18.0	18.3	--	18.3	19.9	20.9
External Debt	94.3	94.5	93.5	n/a	93.5	91.0	91.5
EUR/BGN (avg)				1.95583			
USD/BGN (avg)	1.46	1.51	1.48	1.50	1.45	1.42	1.42

Source: Piraeus Bank Research, National Sources

2.3 Cyprus

An example to follow

Recently, Cyprus may have had some differences with the troika (IMF, EU, ECB) concerning the foreclosures bill and the disbursement of the next tranche of the loan. However this does not steal any thunder from its impressive correction of the fiscal finances and the rebound in economic activity. The improved economic sentiment leaves enough space for domestic demand to rebound and investors' confidence to return, while retail sales and tourism revenues gave a boost to economic activity in 2014Q3. Hence, we revise upwards our forecast for the current year to -3.0% YoY for real GDP. Further, the latest revision of the annual national accounts was a positive surprise as the nominal GDP was increased by an impressive 1.6bn in 2013.

Faltering domestic demand, a widening output gap and downward price dynamics in the Eurozone will keep the inflation rate negative in 2014. Hence, we revise our forecast for average inflation in 2014 to -0.5%. In Jan-Sep, inflation decreased by 1.6% from a marginal increase of 0.1% in Jan-Sep last year, as food, energy and housing prices declined significantly.

On the fiscal front, outperforming expectations is the theme of the year. The government has managed in just nine months to outperform the troika's targets by a significant margin. For Jan-Sep the fiscal balance turned to a surplus of 1.3% of GDP from a deficit of 2.5% in Jan-Sep last year and -5.1% in 2013. The structural changes and the noteworthy fiscal consolidation have had an effect on finances, while the country went to the markets and issued new debt in 2014 – just one year after the country suffered the brutal deposits haircut and entered the Economic Program of the IMF and the European Union. This alone improves the sovereign risk, while the recent resolution of the foreclosures bill builds the basis for the November disbursement of the next tranche. We therefore revise our forecast for the fiscal deficit to 3.5% of GDP. The only negative in this impressive performance of public finances is, we believe, the delayed in the privatization of the state power company, the telecom company and Cyprus Airways.

The external sector is expected to face some challenges, as the primary and secondary incomes are expected to take the heat due to the contracting economic activity and final consumption. However, the improvement of services is expected to counterbalance the negative effect. We thus revise our current account balance forecast to a deficit of 2.0% of GDP for 2014.

Cyprus Economic Indicators

	2011	2012	2013	Q3 2013	Q4 2013	Q1 2014	Q2 2014
			% YoY				
GDP	0.3	-2.4	-5.4	-5.7	-5.0	-3.9	-2.5
Final Consumption	1.6	-1.1	-5.8	-4.9	-6.5	-3.8	-1.4
Investment	-14.8	-15.6	-30.0	-36.3	-27.6	-15.0	18.0
Exports of G&S	4.2	-1.7	-5.0	-2.8	-0.9	1.1	0.6
Imports of G&S	-0.6	-4.6	-13.6	-12.6	-11.2	-2.1	7.1
Industrial Production	-7.6	-9.7	-12.3	-9.4	-10.0	-2.5	0.0
Retail Sales	-0.5	-3.7	-7.0	-5.1	-3.1	1.1	5.6
Unemployment Rate	7.9	11.8	15.9	16.2	16.0	16.9	15.4
Inflation (avg)	3.3	2.4	-0.4	-0.8	-2.0	-2.6	-1.4
			% of GDP				
Current Account Balance	--	--	-3.0	-2.1	-3.0	-5.6	-5.3
Fiscal Balance	-6.1	-4.9	-5.1	-2.5	-5.1	-0.1	0.0
Public Debt	71.1	86.6	112.1	112.1	112.1	115.3	--

Source: Piraeus Bank Research, National Sources

2.4 Romania

A change of heart – A change of numbers

The latest figures for real GDP were somewhat disappointing, as in 2014Q2 real GDP increased at a slower rate of 1.2% - much lower than anticipated - from 3.3% in 2014Q1 and 1.7% in 2013Q2, due to a sharp fall in investments as new taxes on construction were imposed and excise duties were increased. This limits the prospects for growth in 2014H2, while the RON stability counterbalances the negative effects and hence we revise our forecast for real GDP to a more modest 2.2%.

Inflation has fallen to historically low levels since September 2013, as a result of the abundant agricultural harvest, taxes imposed during last year and declining food prices. We therefore revise our forecast for average inflation in 2014 to 1.5%, while inflation is expected to return to the National Bank of Romania's (NBR) lower target band in 2015. The low inflation rate and EUR/RON stability have led the central bank to cut its key policy interest rate aggressively, by 225 basis points since May 2013. In 2014H2, the NBR is expected to keep its monetary policy on hold and will not proceed with further relaxation.

Public finances have improved significantly in 2014, as in Jan-Sep the fiscal balance turned to a surplus of 0.1% of GDP compared to a deficit of 1.3% in Jan-Sep last year, as public expenditures have declined. However, we expect some slippages in the last three months of the year due to the November elections. We therefore revise our forecast for the fiscal deficit in 2014 to -1.0% of GDP.

The external sector remains relatively firm, as the RON is stable and until now imports and exports have not been hit by the ongoing crisis in Ukraine and Russia. Hence, we revise our forecast for the current account to -1.2% of GDP. In Jan-Aug, the current account deficit was 0.6% of GDP compared to 0.4% of GDP in Jan-Aug 2013, as per the adoption of the new methodology, as the primary income deficit widened.

Romania Economic Indicators							
	2011	2012	2013	Q3 2013	Q4 2013	Q1 2014	Q2 2014
			% YoY				
GDP	2.2	0.6	3.3	4.3	5.0	3.7	1.5
Final Consumption	1.3	1.4	1.0	0.9	3.4	4.1	4.8
Investment	6.8	4.1	-4.0	-3.2	-4.5	-6.7	-11.3
Exports of G&S	12.2	-1.6	13.2	19.7	18.4	14.0	8.4
Imports of G&S	10.7	-0.3	2.2	6.7	5.7	11.9	7.8
Industrial Production	7.1	2.4	7.0	7.7	9.5	9.7	9.0
Retail Sales	-0.9	4.1	0.6	0.00	3.3	8.4	8.5
Unemployment Rate	5.4	5.1	5.3	4.9	5.6	5.7	5.0
Inflation (avg)	5.8	3.3	4.0	3.3	1.8	1.1	0.9
Monetary Policy Rate (eop)	6.0	5.25	4.0	4.50	4.00	3.50	3.50
EUR/RON Spot Rate (avg)	4.27	4.33	4.45	4.45	4.45	4.46	4.46
			% of GDP				
Current Account Balance	--	--	-0.8	-0.4	-0.8	-0.1	-0.3
Fiscal Balance	-4.3	-2.5	-2.5	-1.3	-2.5	-0.1	-0.5
Public Debt	40.0	41.1	42.6	41.7	42.6	40.6	40.9

Source: Piraeus Bank Research, National Sources

2.5 Serbia

Change of course, due to floods?

The economic prospects for the country during most of the first half of the year were much more positive than they are now. The country attempted to keep up with last year's pace of production and exports, which boosted economic activity. However, in May the catastrophic floods put a halt to any growth prospects the country had for this year. They not only resulted in a pause in production, but also a significant number of households suffered losses. This in turn led to a contraction of real GDP in 2014Q2 of 1.1% YoY from an increase of 0.1% in 2014Q1 and 0.4% 2013Q2, while the annual GDP has been revised according to the ESA 2010 methodology. Namely, real GDP in 2013 was 2.6% from 2.5% with the previous methodology. We therefore revise our forecast for real GDP to a contraction of 0.8% YoY.

Inflation has been a long term problem for the Serbian economy. High levels of food, housing and energy prices kept the consumer price index elevated and far above the National Bank of Serbia's (NBS) target. This trend, however, has reversed since last September, with inflation at record low values for the first nine months of the current year. We expect that this trend will continue until the end of 2014, as the weakened economic activity, reduced household spending due to the floods and the loosened monetary policy will keep inflation at low levels, but within the NBS's target lower bound. Any pass through effects of the exchange rate to inflation are only expected to stabilize prices. We therefore revise our inflation projection to 2.5%, while we estimate that the NBS will keep the monetary policy unchanged until the end of the year. Inflation in the first nine months of the year increased at a significantly slower rate of 2.1% from 9.8% in Jan-Sep 2013, as food prices alone shrank by 1.8% YoY compared to 11.7% in the same periods. Further, the NBS has eased its monetary policy by 100bps since the start of the year, bringing the key policy rate to 8.5%.

One could say that Serbia's Achilles heel at the moment is its fiscal sector. Widening fiscal deficit and overshooting public debt targets keep the balances volatile at both a macro and fiscal level, although the consolidation of public finances is starting to bear fruit. The general government deficit in the first nine months of the year amounted to 3.7% of GDP compared to 3.9%; however public debt has rocketed to 66.8% of GDP in September from 59.6% in 2013. We therefore keep our forecast unchanged at 6.5% of GDP.

External imbalances continue to be restricted, as the current account deficit is almost half what it was in previous years, due to the boost in export activity, the weakening of the local currency against the EUR and the deteriorated economic activity. We therefore keep our forecast unchanged at 4.9% of GDP. The current account deficit in Jan-Aug contracted to 3.4% of GDP from 3.7% in Jan-Aug 2013, due to a moderation in the trade deficit to 8.2% from 8.4% for the same periods. The services surplus widened to 0.8% of GDP in Jan-Aug from 0.5% in Jan-Aug last year, while the primary income deficit remained unchanged at 2.4% in the same periods. Moreover, the secondary income surplus amounted to 6.4% in Jan-Aug from 6.5% in Jan-Aug last year.

Serbia Economic Indicators							
	2011	2012	2013	Q3 2013	Q4 2013	Q1 2014	Q2 2014
			% YoY				
Real GDP	1.4	-1.0	2.6	3.8	3.0	0.1	-1.1
Unemployment Rate (avg)	23.0	24.0	22.1	24.1	20.1	20.8	20.3
Inflation (avg)	11.2	7.3	7.9	6.9	2.0	2.7	1.8
Monetary Policy Rate (eop)	9.75	11.25	9.50	11.0	9.5	9.5	8.5
EUR/RSD (avg)	102.0	113.0	113.1	114.2	114.3	115.7	115.6
			% GDP				
Fiscal Balance	-3.9	-5.4	-4.9	-3.9	-4.5	-1.0	-0.1
Public Debt	45.4	56.2	59.6	--	--	--	--
Current Account Balance	--	-12.4	-6.5	-4.4	-6.5	-1.5	-2.8

Source: Piraeus Bank Research, National Sources

2.6 Ukraine

Nothing and everything has changed after a year of clashes

Nearly one year after the clashes that resulted in the fall of the incumbent government, the deterioration and finally breaking off of Russia-Ukraine relations and the loss of part of Ukraine's geographic area, the situation remains particularly volatile. The social and geopolitical instability continues to affect not only Ukraine's economic and political well-being, but also relations between Russia and the rest of the world, as the international financial markets remain volatile. Ukraine engaged in a loan agreement with the IMF before the summer, having already received two tranches of the loan for ongoing fiscal consolidation. However we remain sceptical about whether this can contribute to an improvement in economic conditions. The future remains uncertain for the country, as two elections (one presidential and the most recent Parliamentary elections in October) have according to the announced results elected a pro-European government.

While the country is faced with a vicious circle of instability, economic activity in 2014H1 contracted by 2.8% and is expected to shrink further. We anticipate that in 2014 real GDP will decrease by 6.0% from 0% growth in the previous year, as domestic demand, investments and consumption have been severely hit. Another factor that we believe will negatively contribute to economic activity is the current situation in the Donetsk and Lugansk Region, where almost 75% of Ukraine's steel production comes from. It is indicative that the levels of steel production in Ukraine in the last few months have fallen to the 2008 crisis levels.

As the sanctions against Russia continue and the current imbalances in Ukraine remain, the local currency continues to devalue, production lines have deteriorated, credit to the economy remains constrained and net exports have been reduced. This has led to a gradual rise in prices with inflation in the first nine months of the year at 8.8% compared to -0.4% in Jan-Sep last year. We expect that inflationary pressures will continue and, by the end of the year, the consumer price index is anticipated to reach 10.5% from -0.2% in 2013.

While fiscal finances have deteriorated, the IMF deal has provided some stability. The fiscal deficit in the period Jan-Sep widened to 4.8% of GDP from 3.2% in Jan-Sep 2013, as expenditures shot up to 53.1% from 34.2% in the same periods. Revenues, however, also increased to 48.6% of GDP in Jan-Sep from 31.0% in Jan-Sep last year. We forecast that the fiscal deficit will widen further to 6.0% of GDP.

The devaluation of the Ukrainian Hryvnia and the deterioration in imports and exports have led to a favourable current account balance in 2014. Specifically, the current account deficit in 2014H1 contracted to 1.8% of GDP from 3.1% in 2013H1, as the trade deficit decreased accordingly. This is expected to continue until the end of 2014, as we expect the current account deficit to amount to 3.5% of GDP from 9.2% in the previous year. However, this correction is not always favourable. At this point, we must note that direct investment in the country and portfolio investment are at -1.1% of GDP in 2014H1 from 3.5% in 2013H1 and 7.5% in 2013, signalling the decreasing investment inflows in Ukraine.

Ukraine Economic Indicators							
	2011	2012	2013	Q3 2013	Q4 2013	Q1 2014	Q2 2014
% YoY							
Real GDP	5.5	0.2	0.2	-0.9	3.7	-1.2	-4.6
Inflation (avg)	8.0	0.6	-0.3	-0.3	0.2	1.7	9.9
Monetary Policy Rate (eop)	7.75	7.5	6.5	6.5	6.5	6.5	9.5
% GDP							
Fiscal Balance	-1.8	-3.6	-4.4	-3.2	-4.4	0.2	-3.0
Current Account Balance	-6.3	-8.1	-9.2	-6.4	-9.2	-1.0	-1.8
USD/UAH (avg.)	8.0	8.1	8.2	8.1	8.2	9.1	11.8

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