TURKEY ......................................................... 1
February balance of payments
Moody’s cut its outlook on sovereign rating to negative

ROMANIA ..................................................... 2
February fiscal performance
March inflation

BULGARIA .................................................... 3
Q1:14 leading indicators

SERBIA ....................................................... 4
A new pro-EU Government to be formed by April 27th
March inflation

FYROM ........................................................ 5
Results of the first round of presidential elections
January-February industrial production

ALBANIA ..................................................... 6
Q4:13 real GDP growth

UKRAINE .................................................... 7
A diplomatic agreement is reached with Russia to de-
escalate the crisis in Ukraine
Q4:13 banking sector performance

CYPRUS ....................................................... 8
Q4:13 balance of payments

EGYPT ....................................................... 9
March inflation
April policy rate

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External rebalancing continues, with the 12-month rolling current account deficit (CAD) retreating to 7.6% of GDP in February. The monthly CAD narrowed, for a second consecutive month (0.2 pps of GDP y-o-y) to USD 3.2bn (0.4% of GDP) in February. This positive performance was driven by a rise in goods exports (up 6.2% y-o-y), combined with a drop in goods imports (down 6% y-o-y) despite the effect of the devaluation. As a result, the 12-month rolling CAD receded to USD 62.2bn (7.6% of GDP) in February from an 18-month high of USD 65bn (7.9% of GDP) in December. Importantly, the gold balance showed signs of normalization for a second successive month, after 12 consecutive months of deterioration. Indeed, the 12-month rolling gold balance posted a deficit of USD 10bn (1.3% of GDP) in February against USD 11.8bn in December and a surplus of USD 5.7bn in December 2012.

Equally important, the financing outlook improved markedly from January to February, following the CBRT’s sharp tightening of monetary policy at its end-January emergency MPC meeting. Indeed, the capital and financial account (CFA) turned into a surplus of USD 2.6bn in February from a deficit of USD 3.1bn in January. Specifically, Turkish banks repatriated USD 2.8bn of deposits and were net borrowers from abroad in February (USD 1bn). Non-bank corporate net borrowing from abroad also accelerated to USD 1.1bn in February. On a negative note, net portfolio investments turned negative for the first time since July, standing at minus USD 1.5bn in February, mainly due to large outflows from the government debt market (USD 1.1bn).

Reflecting the improved performance of the current account and the capital and financial account balances, as well as large inflows of (net) errors and omissions (USD 2.2bn), the monthly balance of payments turned into a surplus of USD 1.6bn in February from a peak in January of a deficit of USD 5.8bn.

Going forward, assuming the continued normalization of the gold balance (to its long-term average deficit of around USD 2bn per year from a deficit of USD 11.8bn in 2013), we expect the CAD to moderate significantly to 5.6% of GDP (USD 46.4bn) this year from 7.9% of GDP (USD 65bn) in 2013 (despite the much lower USD-denominated GDP). The main drivers of the adjustment will be weaker imports, reflecting tighter domestic and global liquidity conditions, and stronger exports, in line with the global recovery and the improved competitiveness of exports (CPI-based REER depreciated by 12% over the past 3 years).

Moody’s cut its outlook for Turkey’s sovereign rating to negative (from stable). The agency cited two key factors. First, increased pressure on the country’s external financing position, due to heightened political uncertainty and weaker global liquidity, adding that political tensions are expected to persist until at least the end of the ongoing electoral cycle in June 2015 (when parliamentary elections will take place). Second, weaker growth prospects, as a more uncertain policy environment, reflecting heightened political risks, could reduce growth-enhancing structural reforms.

Moody’s reaffirmed Turkey’s current investment grade (Baa3), granted in May 2013, stating that it is justified by the country’s strong fiscal position, including a declining share of foreign debt and a lengthening of the debt’s maturity structure. It is also underpinned by the country’s economic strengths such as its size, wealth and diversification.

The change in the rating outlook leaves little room for policy slippage especially, until the completion of the electoral cycle in mid-2015. Note that Moody’s has Turkey’s sovereign debt rating at the lowest investment grade level – on par with Fitch but one notch above S&P.
Small fiscal consolidation in sight in 2014. The FY:14 budget targets a decline in the deficit to 2.2% of GDP, from 2.5% of GDP in 2013. Tax revenue is projected to accelerate markedly in FY:14 (up 7.1% versus our nominal GDP growth forecast of 4.4%), as a result of the implementation of a series of tax measures, worth 0.7 pps of GDP, including, *inter alia*, the indexation of excise duties to inflation (implying an average hike of 4.8%), the levy of an additional excise duty on fuels, and the enlargement of the tax base for healthcare contributions and property taxes. As agreed with the IMF, the revenue shortfall of c. 0.2 pps of GDP, arising from the delay in the implementation of the additional excise duty on fuels (April instead of January) and the partial refund of this excise duty to transporters, will be compensated by expenditure-saving measures.

Current expenditure is projected to rise modestly in FY:14 (by 5%), reflecting a prudent incomes policy (pensions will rise by 3.8%, while most public sector wages will remain frozen) and restraint in discretionary spending. At the same time, public investment is set to surge (up 20% in FY:14), in line with a higher absorption of EU funds. We expect the authorities to make any required budgetary savings mainly through cuts in other public investment. All said, we believe that the FY:14 budget deficit target of 2.2% of GDP is attainable (an implied fiscal contraction of 0.3 pps of GDP).

Note that additional measures will be needed if the authorities proceed with the reduction in social security contributions for employers by 5 pps in mid-year (implying an annualised net impact of 0.5 pps of GDP). Headline inflation remains broadly flat at a low 1% y-o-y in March. Specifically, positive base effects from the hike in regulated water prices by 1.9% in March 2013 offset the rise in fuel prices (by 0.2% in March 2014 against a decline of 0.6% in February), in line with a higher absorption of EU funds. We expect the authorities to make any required budgetary savings mainly through cuts in other public investment. All said, we believe that the FY:14 budget deficit target of 2.2% of GDP is attainable (an implied fiscal contraction of 0.3 pps of GDP).
Industrial production (IP) expands by 4.4% y-o-y in January-February, signaling the strengthening of activity. IP expanded by 4.4% y-o-y in 2M:14, following increases of 2.7% in Q4:13 and 0.4% in Q3:13. This improvement is attributed to the recovery in domestic demand (note that c. 67% of industrial output is absorbed by the domestic market). The IP performance would have been better, had exports not declined sharply in 2M:14 (by 5.9% y-o-y in EUR terms against an increase of 6.5% in H2:13), reflecting weaker demand from outside the EU (exports to the latter fell 14.2% y-o-y). Note that exports to Turkey, Bulgaria’s second largest export destination, fell markedly in 2M:14 (by 11% y-o-y in EUR terms), in line with a slowdown in domestic activity, as well as the recent depreciation of the Turkish Lira. At the same time, exports to Ukraine, which was one of the fastest growing markets for Bulgarian goods last year, plunged in 2M:14 (by 65% y-o-y in EUR terms), amid the escalating domestic political crisis and the sharp depreciation of the Ukrainian Hryvnia.

Importantly, Bulgarian industrial sector has undergone a major restructuring since the beginning of the crisis. Indeed, competitiveness in the sector has improved markedly, reflecting a surge in productivity (the industrial Gross Value Added per employee has risen by 27% since end-2008), as employment has declined rapidly (by c. 20% since end-2008). Note that Bulgaria’s industrial output has now returned to its pre-crisis levels.

Private consumption shows signs of improvement, as retail sales (volumes) continue to accelerate in January-February. Retail sales expanded by a solid 8.3% y-o-y in 2M:14, following increases of 6.6% in Q4:13 and 6.1% in Q3:13. Recall that the continuing build-up of precautionary savings (retail deposits rose by 12% y-o-y in real terms in February) and still poor labour market conditions (the unemployment rate, LFS definitions a.s., has remained broadly flat at 13% since early-2013), had held back private consumption. However, this has likely reversed in Q1:14, due to price deflation (-2.4% y-o-y in 2M:14 against -1.2% in H2:13) and a rebound in consumer lending (up 4.3% y-o-y in real terms in February against a contraction of 3.9% in June 2013).

The economy should strengthen in 2014, driven by a recovery in domestic demand. Despite still weak credit activity, we expect private consumption to strengthen this year, reflecting the positive impact of low inflation (-0.3% on average in 2014 against 0.9% in 2013) on real disposable income and gradually improving labour market conditions (we see employment growing by 12% y-o-y in real terms in February) and still poor labour market conditions (the unemployment rate, LFS definitions a.s., has remained broadly flat at 13% since early-2013), had held back private consumption. However, this has likely reversed in Q1:14, due to price deflation (-2.4% y-o-y in 2M:14 against -1.2% in H2:13) and a rebound in consumer lending (up 4.3% y-o-y in real terms in February against a contraction of 3.9% in June 2013).

All said, we expect real GDP growth to rise to a 3-year high of 1.8% in 2014 from 0.9% in 2013. Risks to the outlook remain firmly on the downside, however, reflecting the domestic political uncertainty. Indeed, public discontent remains high, leaving the 11-month old Government in a precarious position. Recall that Oresharski’s Cabinet, backed by the socialists, (BSP) and the Turkish minority party (MRF), lacks a parliamentary majority, and relies on tacit support from the nationalist Ataka party.
Reforms to gain momentum following the formation of a new pro-EU Government. The landslide victory of the pro-Presidential Serbian Progressive Party (SNS) in the March 16th snap parliamentary elections provides it a strong mandate to accelerate reforms. Recall that the SNS, the senior party of the outgoing Government-coalition, led by the deputy PM, A. Vucic, secured an absolute majority in the new parliament (gaining an unprecedented 158 seats in the 250-seat assembly). Vucic, whose strong personal popularity and anti-corruption stance contributed to large public support for the SNS, is set to become Prime Minister. Importantly, Vucic has announced his retain the 30-year old former McKinsey consultant, L. Krslic, in the post of Finance Minister, confirming his commitment to IMF-related reforms, including fiscal consolidation and the implementation of long-delayed structural reforms. He has also set a mid-July deadline for the approval of a Labour law, a Bankruptcy law, and a Privatisation law -- that the outgoing coalition Government had failed to approve.

Despite its outright parliamentary majority, the SPS is seeking coalition partners in order to secure broader political support for the implementation of (unpopular) reforms. It is widely expected that a deal could be reached with the New Democratic Party (NDS) of former President B. Tadic -- formed following his withdrawal from the Democratic Party (DS) in early February -- which has 18 seats in the new Parliament. The coalition is also more likely to include the Alliance of Vojvodina Hungarians, a minority party, holding 6 seats in the new assembly.

Headline inflation slowed slightly to 2.3% y-o-y in March. Headline inflation moderated to 2.3% y-o-y in March from 2.6% in February, remaining around the lower bound of the NBS target band (±1.5%) for a 7th consecutive month. The slowdown in annual headline inflation was driven exclusively by a sharper decline in vegetable prices (subtracting 0.2 pps from annual inflation in March compared with a zero contribution in February). Moreover, core inflation (that excludes food and energy prices, and accounts for 54% of the CPI basket) declined to a 2-year low of 4.4% y-o-y in March from 4.5% in February. Low core inflation has been supported by the continued decline in domestic demand and RSD stability.

Inflation is set to embark on an upward trend, ending the year at the upper end of the NBS’s target band. We expect inflation to accelerate to 5.4% y-o-y at end-2014 from 2.2% at end-2013, mainly due to unfavourable base effects from food prices, reflecting a good 2013 harvest. However, inflation will be held back by weak domestic demand, the envisaged fiscal consolidation, and a broadly stable dinar.

The NBS is set to resume its monetary policy easing. The NBS kept its key policy rate unchanged at 9.5% -- the highest in SEE-5 -- at its March meeting, for a 3rd consecutive month, following cumulative cuts of 225 bps since the initiation of the cycle of monetary policy easing in May 2013. The NBS is expected to resume rate cuts this month, in view of the strengthening of the RSD, reflecting dissipating political uncertainty after the March 16th elections and the landslide victory by the SNS. Note that the NBS purchased EUR 0.1bn after having sold EUR 0.8bn between January and March 16th. Provided that inflation remains subdued, the dinar stabilises at its current level of RSD 116 per EUR, and the envisaged fiscal consolidation is fully and timely implemented, we expect the NBS to proceed with additional rate cuts, totalling 150 bps in Q3-Q4:14, bringing the policy rate to 8%. Scope for the easing will be provided by the weak domestic demand. This would imply an average ex-post real rate of 2.5% at end 2014, below the 7-year average of 3.5%.
Presidential run-off on April 27th could prove inconclusive, plunging the country into a period of political uncertainty. The presidential run-off and early parliamentary elections will be held on April 27th. The presidential run-off includes the two best performers from the April 13th first round, namely: i) G. Ivanov, the current President and candidate of the senior party of the ruling coalition, Internal Macedonian Revolutionary Organisation – Democratic Party for Macedonian National Unity (VMRO-DMPNE, supported by 25.2% of voters), and ii) S. Pendarovski, the candidate of the major opposition party, Social Democratic Alliance of Macedonia (SDSM, supported by 18.3% of voters). Worryingly, there is a risk of an inconclusive run-off, in the event that the turnout fails to reach 40% plus one of registered voters. Note that the major ethnic Albanian party and junior partner of the ruling coalition, the Democratic Union for Integration (DUI), are boycotting the presidential elections, on the grounds that its proposal for a consensual presidential candidate has not been adopted. Note that the DUI’s call for a boycott appears to have been largely followed, as suggested by the low turnout in the first round (48.8% from 56.9% in the 2009 elections). Recall that the turnout in the 2009 presidential run-off was relatively low (42.6%). If no candidate is elected in the April 27th run-off, the entire election process will have to be repeated, plunging the country into a protracted period of political uncertainty.

Turnout will be bolstered by the fact that the snap parliamentary elections will also be held on the same date as the Presidential elections. Recall that general elections were initially scheduled for June 2015 and were triggered by the lack of consensus among the ruling coalition on a presidential candidate. These elections are not expected to lead to a significant change in the Parliament structure (the VMRO-DMPNE, the SDSM, and the DUI won 46%, 42%, and 15% of the 123 seats, respectively, in the 2011 general elections).

**Industrial production (IP) gained momentum in January-February, underlying the strength of the recovery.** IP expanded by a solid 5.3% y-o-y in 2M:14, following an increase of 3.2% in FY:13 and a slump of 6.8% in FY:12. Encouragingly, exports provided the main stimulus to IP growth -- industrial turnover in foreign markets increased by 18.3% y-o-y, in real terms, in January against a decline of 10.6% in FY:13 and accounted for c. 5% of total industrial turnover -- benefitting, *inter alia*, from increased geographical diversification of the export base achieved during the past several years. Indeed, Germany and China absorbed roughly 36% and 2.5% of total exports, respectively, in 2013, compared with c. 15% and 0% in 2009. IP production would have been better, had domestic demand for industrial goods not continued to disappoint (industrial turnover in FYROM fell by 19.2% y-o-y, in real terms, in January against a decline of 10.6% in FY:12. Encouragingly, exports provided the main stimulus to IP growth -- industrial turnover in foreign markets increased by 18.3% y-o-y, in real terms, in January against a decline of 10.6% in FY:13 and accounted for c. 5% of total industrial turnover -- benefitting, *inter alia*, from increased geographical diversification of the export base achieved during the past several years. Indeed, Germany and China absorbed roughly 36% and 2.5% of total exports, respectively, in 2013, compared with c. 15% and 0% in 2009. IP production would have been better, had domestic demand for industrial goods not continued to disappoint (industrial turnover in FYROM fell by 19.2% y-o-y, in real terms, in FY:13 vs. a decline of 19.2% y-o-y, in FY:13). IP expanded by a solid 5.3% y-o-y in 2M:14, following an increase of 3.2% in FY:13 and a slump of 6.8% in FY:12. Encouragingly, exports provided the main stimulus to IP growth – industrial turnover in foreign markets increased by 18.3% y-o-y, in real terms, in January against a decline of 10.6% in FY:13 and accounted for c. 5% of total industrial turnover – benefitting, *inter alia*, from increased geographical diversification of the export base achieved during the past several years. Indeed, Germany and China absorbed roughly 36% and 2.5% of total exports, respectively, in 2013, compared with c. 15% and 0% in 2009. IP production would have been better, had domestic demand for industrial goods not continued to disappoint (industrial turnover in FYROM fell by 19.2% y-o-y, in real terms, in FY:13 vs. a decline of 19.2% y-o-y, in FY:13).

**Economic activity to remain solid in 2014, at 3% y-o-y.** Looking ahead, the recovery in industrial production will partly offset the anticipated slowdown in construction activity following the completion of the Skopje 2014 project in H1:14. Moreover, private consumption is set to increase, supported by gradually improving labour market conditions. Indeed, employment increased by 4.3% in FY:13 versus a rise of 0.9% in FY:12, unemployment eased to a historical low of 28.6% in Q4:13, and public sector pensions increased by 5%, since the beginning of March, following a 3-year freeze. Furthermore, investment should accelerate, benefitting from an improvement in business confidence, following the successful reforms of the business environment in recent years. Overall, we see real GDP growth at 3% in FY:14 – broadly unchanged from 2013 and slightly below the IMF forecast of 3.2%.
Albania

Activity gained momentum in Q4:13, due to easing political and economic uncertainty, bringing the FY:13 real GDP growth to 0.4%. The quarterly seasonally-adjusted (s.a.) real GDP rose by 2.3% q-o-q in Q4:13, more than offsetting the plunge of 2.1% q-o-q in Q3:13, as consumer and business confidence improved significantly, on the back of easing political and economic uncertainty. Recall that uncertainty peaked in Q3:13, as the winner of the end-June legislative elections (Alliance for a European Albania, led by the Socialist Party) only took office two and half months later, due to procedural rules, while there was an urgency to address the country’s critical macroeconomic and financial situation. The uncertainty started to ease from late September, when the new Government initiated talks with the IMF on an ambitious 3-year economic adjustment programme, aiming primarily at putting public finances on a strong footing (the public debt-to-GDP ratio reached 70% in 2013) and securing unprecedented financial assistance from official creditors, worth EUR 720mn (6.6% of 2014 GDP, EUR 330mn from the IMF, EUR 290mn from the World Bank, and EUR 100mn from the EU). As a result, real GDP recovered, on an annual basis, by 1.1% y-o-y in Q4:13, after having declined by 2.5% y-o-y in Q3:13, bringing the FY:13 real GDP growth to 0.4%.

The recovery in activity in Q4:13 was broad based, with agriculture a notable exception. Industrial output expanded significantly by 7.2% y-o-y in Q4:13, more than compensating the 2.9% decline in Q3:13, driven by manufacturing production, which rose by 7.8% y-o-y following a decline of 4.9% in Q3:13. Activity in the construction sector rose by 3.7% y-o-y in Q4:13, following a sharp decline of 11% in Q3:13. Note that the construction sector has been in a slump since 2008, due mainly to: i) an excess supply of unsold apartments (6,500 -- of which 5,000 are located in Tirana and Durres); ii) banks’ tight credit conditions for both households and businesses (the NPL ratio reached an all-time high of 23.2% in December); and iii) a large amount of arrears by the State, dating back as far as 2005 (EUR 514mn or 5.3% of GDP at end-2013).

Activity in the services sector (accounting for 60% of value added) declined at a slower pace in Q4:13 (down 1.2% y-o-y against a drop of 2.3% in Q3:13), suggesting a moderating decline in domestic demand on the back of easing political and economic uncertainty.

Finally, agriculture is the only sector that did not improve in Q4:13. It posted moderate growth of 1.2% y-o-y in Q4:13 against 2% in Q3:13.

Economic growth to recover to a 3-year high of 2% in FY:14 from a 16-year low of 0.4% in FY:13. For 2014, we expect a moderate rebound in activity, driven by a favourable external environment, and strong official financial assistance. Indeed, activity in the country’s main partners, i.e. Italy and Greece, is expected to improve significantly in 2014 (to +0.6% in both countries from -1.8% and -4.2%, respectively, in 2013, according to the April IMF WEO forecasts). Recall that these two countries: i) are the traditional foreign investors in Albania; ii) host the majority of Albanian immigrant workers -- 46% and 36% of the migrant stock in Greece and Italy, respectively, in 2010; and iii) absorb the bulk of the country’s exports. On the other hand, the pledged official financial assistance for this year (EUR 250mn or 2.5% of GDP) will be fully devoted to the clearance of almost half of the stock of unpaid bills to businesses and VAT refunds. This will support domestic demand, strengthen private sector balance sheets, and facilitate the resumption of credit growth, as NPLs should decline. Overall, we see GDP growth accelerating to 2% in FY:14 from 0.4% in FY:13.
A diplomatic agreement is reached with Russia to de-escalate the crisis in Ukraine. After over a month of unrest in eastern Ukraine, a diplomatic meeting in Geneva, in the presence of Russia, Ukraine, the US, and the European Union, led to an agreement on the steps to de-escalate the crisis in Ukraine. The agreement stipulates:

i) the disarmament of illegal armed groups currently active in Ukraine and the evacuation of occupied buildings. According to Kiev, the armed people, who are present in a dozen cities are Russian special forces soldiers from the Crimea, that Vladimir Putin has again denied in a speech a few hours before the Geneva meeting;

ii) the end of "violent acts of intimidation or provocative actions" undertaken by all participants. Note that on Thursday, a shootout with local police killed three people and wounded thirteen pro-Russian demonstrators in the city of Mariupol;

iii) an amnesty should be given to pro-Russian protesters who participated in the uprising, with the exception of those who are guilty of crimes; and

iv) the monitoring mission of the Organization for Security and Cooperation in Europe (OSCE) will be responsible for assisting the Ukrainian authorities to implement these measures.

The agreement also calls for a "broad national dialogue" in Ukraine. However, no details were given on how this dialogue will be organised with the presidential election set to take place on May 25th, and regarded as illegitimate by Moscow.

The net income of the banking sector turned negative in Q4:13, due to higher provisioning. The banking system recorded net losses (after tax) of UAH 0.3bn (0.2% of GDP) in Q4:13 compared with cumulative profits of UAH 1.7bn in 9M:13. This negative performance reflects the fact that strengthening pre-provision earnings in Q4:13 was not sufficient to offset the impact of a surging cost of risk.

Overall, the FY:13 profitability remained positive, but below the FY:12 outcome. As a result, ROAE and ROAA fell to 0.8% and 0.1%, respectively, in FY:13 from a 4-year high of 2.9% and 0.4% in FY:12.

The cost of risk soared in Q4:13, ahead of an anticipated sharp devaluation of the domestic currency amid continued political unrest. NPL provisions increased sharply by 119% y-o-y in Q4:13, after a decline of 8.6% in 9M:13 -- absorbing almost 100% of net operating income in Q4:13 compared with 84% in 9M:13. Higher provisioning likely reflects customers' expectations of an imminent strong UAH devaluation, amid daily mass protests against the President initiated on November 19th. As a result, the cost of risk increased by 188 bps y-o-y to a 9-quarter high of 367 bps (annualised) in Q4:13.

Pre-provision earnings rose markedly in Q4:13, partly dampening the negative impact of higher provisioning on the bottom line. Pre-provision earnings increased by 36.5% y-o-y in Q4:13 compared with a decline of 6.9% in 9M:13, due to the rebound in net interest income, NII (up 15.3% y-o-y in Q4:13 compared with a drop of 5.5% in 9M:13). The improved performance in NII was supported by the continued acceleration in interest-earning assets (up by an 11-quarter high of 13.6% y-o-y in Q4:13 from 10.4% in 9M:13) as well as a rise in the NIM -- for the first time since Q3:10 (by 15 bps y-o-y to 425 bps in Q4:13 against 425 bps in 9M:13).

Although growth in operating expenses remained strong (9.1% y-o-y in Q4:13), the banking sector's efficiency improved slightly, with the cost-to-income ratio falling by 5 pps y-o-y to a still high level of 57.8% in Q4:13.
The external adjustment continued in Q4:13, bringing the FY:13 current account deficit (CAD) to a 9-year low of 1.9% of GDP. The quarterly current account balance (CAB) improved for a third quarter in a row in Q4:13, by 0.9 pps y-o-y to a deficit of 1.6% of GDP – albeit at a slower pace than in Q2:13 and Q3:13 (2.5 pps y-o-y and 2 pps y-o-y, respectively).

The trade deficit continued to narrow (down 0.6 pps y-o-y to 4.7% of GDP), encouragingly on the back of a strong increase in merchandise exports (up 0.4 pps of GDP y-o-y in Q4:13), which benefitted from the gradual recovery in the euro area. At the same time, merchandise imports continued to decline, albeit at a slower pace (-0.3 pps of GDP y-o-y in Q4:13), in line with the easing contraction in economic activity.

The services surplus rose by 0.1 pp y-o-y 4.4% of GDP), as a significant increase in net tourism receipts (up 0.4 pps of GDP to 1.1% of GDP) was largely offset by declining income from financial and business services.

The income and transfers balances also improved slightly (each by 0.1 pps y-o-y, to deficits of 1.2% of GDP and 0.2% of GDP, respectively); the former due to lower repatriation of dividends and profits of foreign companies established in Cyprus, and the latter due to lower net transfers to the EU.

Despite improving, the capital and financial account (CFA) surplus fell short of the CAD in Q4:13 and the resulting gap was covered by the Troika. The CFA surplus (excluding Troika support) increased slightly in Q4:13 (up 0.3 pps of GDP y-o-y to 1.3% of GDP), as a sharp improvement in "other net capital and portfolio inflows" (up 6.9 pps y-o-y to 2.8% of GDP), more than offset a significant deterioration in net FDI inflows (down 6.6 pps y-o-y to -1.5% of GDP in Q4:13). The improvement in other net capital inflows reflects a slower drawdown by non-resident banks of short-term deposits at domestic banks, while the deterioration in net FDI resulted from strong investments abroad (the Cypriot-based company, Emma Delta, purchased a 33% stake of the Greek gambling firm OPAP).

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Headline inflation stabilised in March at a 6-month low of 9.8% y-o-y. Headline inflation was 9.8% y-o-y in March, unchanged from February, after having declined for three successive months from a 4-year high of 13% in November. The decline in inflation mainly reflects the fact that regulated prices remained unchanged.

Core inflation (excluding prices of regulated items and fruit & vegetables, and representing 74% of the CPI basket) rose slightly to 9.9% in March from 9.7% in February after 3 successive months of decline. Core inflation has been relatively contained since last July on the back of: i) a moderating impact of currency depreciation on prices (the EGP depreciation against the USD eased sharply from a peak of 13.3% y-o-y in July to only 2.3% y-o-y in March); and ii) dissipating fuel shortages and disruptions in distribution channels. These positive developments followed the pledge of USD 12bn of support by Saudi Arabia, the United Arab Emirates (UAE) and Kuwait (of which USD 6bn is in the form of interest-free deposits in the CBE, USD 4bn worth of free oil shipments, and USD 2bn in cash grants), following the removal of Islamist President Mursi from power on July 3rd.

Annual headline inflation to moderate slightly by the end of the fiscal year 2013/14 (June) to 9.2% y-o-y. We expect inflationary pressures to ease further by the end of the current fiscal year (June), supported by: i) the stabilisation of the domestic currency at just below the psychological threshold of EGP 7 per USD; ii) the dissipation of fuel shortages and disruptions in distribution channels, due to continued free shipments of energy products from oil-rich Arab countries; and iii) a further delay in the implementation of unpopular fiscal measures related to the IMF programme, including tax increases and the rationalisation of energy subsidies. The latter are postponed until after the summer parliamentary elections.

Note that the expected stabilisation of the domestic currency and the dissipation of fuel shortages will be underpinned by a second assistance package pledged at end-January (in additional to the initial USD 12bn), worth USD 5.8bn (USD 4bn from Saudi Arabia -- of which USD 2bn is in the form of deposits at the CBE and USD 2bn in the form of fuel shipments -- and USD 1.8bn from the UAE in the form of fuel shipments).

Overall, we see headline and core inflation at 9.2% y-o-y and 9.5% y-o-y, respectively, at end-2013/14 (June), down from 11.7% and 11.9% in December. However, in view of the temporary support of oil-rich Arab countries, inflation should pick up sharply, once the elections have taken place. due to relative price re-alignments, increases in indirect taxes, and most likely currency correction. Note that reflecting FX shortages, the local currency is traded currently at EGP 7.5 per USD in the parallel market against EGP 6.98 per USD in the official market.

Despite the negative inflation outlook, we do not expect the CBE to embark on a cycle of monetary policy tightening before the completion of the election process in the summer, reflecting the relative weakness of the interest rate channel of monetary policy transmission. Note that it has cut its policy rates by 150 bps since the start of the loosening cycle last August. Currently, the overnight deposit, the overnight lending, and the 1-week repo rates stand at 8.25%, 9.25%, and 8.75%, respectively (negative in real terms).
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