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The continuity of the new Cabinet reassures markets. Following ten years as PM, Recep Tayyip Erdogan was sworn in as President on August 28th, having won almost 52% of the vote in the country’s first ever direct presidential elections on August 10th.

President Erdogan immediately approved a new cabinet, headed by former Foreign Affairs Minister Davutoglu, who had previously been confirmed by the ruling Justice and Development Party (AKP) as the successor to Erdogan as party leader. Davutoglu reiterated Erdogan’s pledge for a new Constitution, following the 2015 legislative elections, that would provide greater powers to the presidency.

The new ministerial line-up was little changed from Erdogan’s cabinet. More importantly, the two key members of the economic management team, Babacan and Simsek, retained their respective posts as deputy prime minister in charge of economic affairs and finance minister, a move which reassured markets, which see them as guarantors of policy continuity.

The key challenge for the new government is to maintain AKP’s popularity ahead of the 2015 general elections, amid a difficult macroeconomic backdrop (slowing growth, challenging inflation outlook and a more turbulent international environment). A strong performance at the upcoming general elections is crucial for securing a (stable) single-party government and changing the constitution directly through parliament (in the event that the AKP wins more than 2 thirds of seats in the new parliament -- a constitutional majority).

The CBRT maintains its key policy rate unchanged at 8.25%. The CBRT kept the one-week repo rate (the central rate) at 8.25%, in line with expectations, following 3 consecutive cuts totalling 175 bps. However, in a surprise move, it reduced the overnight lending rate (the marginal funding rate) by 75 bps to 11.25%.

The decision to leave the 1-week repo rate on hold was widely expected in view of: i) increasing downward pressures on the TRY during recent weeks; and ii) the fact that the tightness of the monetary policy stance, defined as “a flat yield curve” by the CBRT, eased significantly since the July MPC meeting. Recall that according to the CBRT, the monetary stance is tight, when the difference between the 5-year bond yield and its average funding rate is “close to zero”. Indeed, prior to the August rate decision (of no change), the 5-year bond yield and the CBRT funding rate stood at 8.8% and 8.3%, respectively, against 8.51% and 8.75% prior to the July rate cut decision (50 bps).

On the other hand, the decision to cut the overnight lending rate suggests that the CBRT is comfortable with the currency outlook, at least in the short term. Indeed, it appears that the CBRT considers that the resulting policy buffer (the difference between the 1-week repo rate and the marginal funding rate, down from 3.75 pps to 3 pps) is sufficient in the current environment to dampen any strong pressure on the currency (by pushing up money market rates towards the ceiling of the corridor through the tightening of domestic liquidity conditions). It could also be considered a conciliatory move to appease those who are arguing for lower interest rates amid rising concerns regarding the growth outlook.

Looking ahead, in view of the negative inflation outlook (headline inflation stood at 9.5% y-o-y in August, far above the CBRT’s end-year forecast of 7.6%), and uncertainties associated with the domestic political outlook (ahead of the June 2015 legislative elections) and geopolitical risks, we expect the CBRT to remain cautious and keep its central rate on hold throughout the end of the year.
The NBR surprises markets with a 25 bp policy rate cut to 3.25%. Contrary to our and consensus expectations, the NBR Board cut the 1-week repo rate by 25 bps to a recent low of 3.25% at its meeting on August 4th. Recall that after the aggressive monetary easing cycle initiated in July 2013 – with 175 bps of cuts in 8 months – the NBR had maintained its key rate flat at the three previous meetings. In our view, the resumption of the cycle of monetary policy easing is attributed to favourable inflationary developments and the slowdown in the pace of economic expansion. Indeed, headline inflation remains persistently low, at 1% in August against the NBR’s target range of 2.5±1%, supported by favourable food prices on the back of a stronger-than-initially-expected summer harvest, and the stronger RON (up by 3% against the EUR since the beginning of the year). At the same time, the Romanian economy has re-entered a technical recession (real GDP was down 0.2% q-o-q s.a. in Q1:14 and 1% q-o-q s.a. in Q2:14), due to continuing disinvestment and weaker private consumption.

Overall, with the ex-post real policy rate estimated at 2.3%, slightly above its historical average of 2%, monetary conditions appear relatively tight (see our MCI), also reflecting the recent appreciation of the RON. Nevertheless, liquidity in the banking system remains abundant, as suggested by the negative spread between the 1-week money market rate (ROBOR) and the policy rate (-80 bps currently and -130 bps on a y-t-d basis). Recall that the NBR has boosted liquidity significantly since the beginning of the year (by c. 1.4% of GDP), by reducing its reserve requirement ratios (RRRs) on RON and FX-denominated liabilities by 3 pps and 4 pps, respectively, to 12% and 16%. Note, however, that a part of this liquidity has been remitted to parent banks.

The NBR is expected to refrain from any rate cut until end-year, but likely to reduce further its RRRs. We believe the NBR has little room to cut its key rate further, in view of the projected pick-up in inflation (note that in light of the y-t-d developments, we revised down our end-year headline inflation forecast to 2.2% from 3% previously) and the anticipated rebound in economic activity (we expect sequential real GDP growth to return to positive territory in H2:14, bringing FY:14 growth to a solid 2.8%). The heightened global uncertainty and the outstanding issues on the IMF programme, as well as the risk of political instability ahead of the November presidential elections should also deter the central bank from cutting rates. Recall that following the failure of the Government and the IMF to reach an agreement over the reduction of social security contributions for employers by 5 pps in October, the 3rd review of Romania’s Stand-By Agreement with the IMF was postponed until November. In this context, we expect the NBR to maintain its 1-week repo rate at its current level of 3.25% throughout the year, implying an ex-post real policy rate of 1% at end-2014.

At the same time, in view of the need to revive credit to the private sector, which has been contracting since mid-2013 (down 3.8% y-o-y in July 2014), we believe the NBR will continue to ensure excess liquidity in the banking system and will likely reduce further its RRRs, which still remain high compared with EU standards. However, in a bid to rebalance banks’ portfolios towards LC loans (currently accounting for just 42% of total loans) and in view of the risk of capital outflows to parent banks, we expect the central bank to apply these cuts only to LC-denominated liabilities (down by another 2 pps to 10% by end-year).
Corporate Commercial Bank’s (CCB) fate remains in limbo. In late-July, the outgoing Parliament failed to approve the central bank’s (BNB) rescue plan for the CCB. The plan provided for the transfer of all CCB’s healthy assets and liabilities to its subsidiary, Crédit Agricole Bulgaria, which would in turn be nationalized with funds from the Deposit Insurance Fund, the BNB and the State budget. Now, with the caretaker Government having no power to issue debt, a state-funded rescue of the CCB is unlikely before the October 5th general elections. The prospect of private backing also appears far off, with the two largest shareholders in CCB, namely T. Vassilev and Oman’s Sovereign Wealth Fund, having failed to come up with concrete plans for the bank’s rescue. Note that the exact size of the “capital hole” in CCB will be determined following a detailed audit of the bank’s books, due in mid-October. In the meantime, the BNB has allowed borrowers to repay their loans to the bank, but deposits remain frozen. According to the Minister of Finance, depositors may get partial access to their accounts (up to EUR 255-510) later in the month.

The 12-month rolling budget deficit widens significantly to 3.1% of GDP in July from 1.9% in December. The consolidated budget deficit stood at 1.5% of GDP in 7M:14 against only 0.2% in 7M:13. This deterioration was solely due to increased budget spending in 7M:14 (up 1.5 pps of GDP y-o-y). Specifically, current expenditure rose in 7M:14 (by 0.9 pps of GDP y-o-y), reflecting higher social spending (up 0.7 pps of GDP y-o-y, due, inter alia, to base effects from the 9.3% hike in pensions in April 2013) and subsidies (up 0.3 pps of GDP y-o-y). Public investment also surged in 7M:14 (by 0.6 pps of GDP y-o-y). Note, however, that following the suspension of payments under the EU Environment and Regional Development Programmes (due to irregularities in their management), the EU’s contribution to jointly-funded projects (0.6% of GDP) was covered by the state budget. At the same time, budget revenue improved in 7M:14 (by 0.2 pps of GDP y-o-y), as the rise in EU grants and tax revenue (by 0.1 pp and 0.4 pps of GDP y-o-y, respectively) more than offset the decline in non-tax revenue (by 0.3 pps of GDP y-o-y, due to lower dividends from state enterprises). The drivers of the improved tax revenue were PIT/CIT (up 0.3 pps of GDP y-o-y) and social security contributions (up 0.2 pps of GDP y-o-y, on the back of the hike in the minimum wage).

The FY:14 budget deficit is set to reach 3% of GDP. In early-August, in light of the y-t-d budget slippage, the caretaker Government announced that the FY:14 budget deficit could reach 3% of GDP, far higher than the deficit cap allowed under Bulgaria’s fiscal rule (2% of GDP) and the FY:13 outcome of 1.9%. However, reaching even this upwardly revised target appears challenging. Our main concern is budget spending, which will continue to expand at a rapid pace during the remainder of the year, reflecting: i) the increased financing needs of the health system (the latter’s budget was raised by 0.3 pps of GDP in August, but we estimate that additional funding of 0.2 pps will be needed by year-end); ii) the need to repay arrears (0.4 pps of GDP); and iii) the impact of the 3% hike in pensions in July (0.1 pp of GDP). The increased spending will only be partly offset by an improvement in tax revenue. Indeed, the projected pick-up in economic activity (we see nominal GDP growth at 1% in H2:14 against -0.8% in H1:14), combined with better tax collection following the introduction of reverse VAT charging and the launch of “on-the spot” audits, should help revenue rebound in H2:14. All said, the authorities will need to restrain capital expenditure so that the FY:14 deficit will not exceed the EU threshold of 3% of GDP. Should payments under the suspended EU programmes resume by end-year, the FY:14 budget deficit could be smaller.
Economic activity declined by 1.1% y-o-y in Q2:14, mainly due to devastating floods. According to our estimates, the quarterly seasonally-adjusted (s.a.) real GDP declined, for a third successive quarter in Q2:14, by 0.6% q-o-q, reflecting the negative impact of the mid-May heavy floods (whose damages amount to EUR 1.5bn, or 4.7% of GDP, according to preliminary official estimates). This follows declines of 1% q-o-q in Q1:14 (driven by a normalization in agricultural output) and 0.4% in Q4:13. On an annual basis, real GDP growth contracted -- for the first time since Q4:12 -- by 1.1% y-o-y in Q2:14, according to the flash estimate, following a small rise of 0.1% in Q1:14.

The deterioration in economic activity was broad-based in Q2:14. Though a detailed breakdown is not due until end-September, we estimate that growth in the industrial sector (20% of GDP) turned negative for the first time since Q3:12. Note that industrial production slipped into the red in Q2:14, declining by 4.7% y-o-y, compared with a rise of 2.1% in Q1:14. This was driven by a sharp decline in power generation and mining (15% and 8% of industrial production, respectively) by 14.5% and 14.1% y-o-y in Q2:14, respectively, following an average rise of 2.1% in Q1:14, as mid-May heavy rains disrupted production in hydro-power plants and flooded coal mines, thus also limiting power generation in large thermal-power plants. The reduction in electricity supply and damages in infrastructure also constrained production in the manufacturing sector (that recorded a decline of 2.4% y-o-y in Q2:14 compared with a rise of 3.6% in Q1:14).

The deterioration in activity in Q2:14 was also attributed to: i) the estimated sharper drop in agricultural output, due not only to its normalization, following a bumper harvest in 2013, but also the negative impact of floods; and ii) the estimated slowdown in the services sector, driven by a weakening in the trade and transportation subsectors, due to damages in public infrastructure.

Activity in H2:14 is set to contract by 0.5% y-o-y, as in H1:14. Looking ahead, we expect a rebound in the construction sector. Construction is set to post double-digit growth in H2:14 -- after 8 successive quarters of negative growth -- boosted by the rehabilitation of public infrastructure (including roads and railways) and residential buildings following the mid-Q2:14 floods. The contribution of the services and industrial sectors to overall growth is expected to remain broadly unchanged in H2:14. In fact, full production capacity will not be restored in flooded mines in H2:14, limiting coal production and electricity supply and therefore reducing the benefit of the industrial sector from the gradual rebound in economic activity in the euro area (which accounts for a sizeable 63% of Serbia’s exports, and is expected to experience growth of 1.1% y-o-y this year following a contraction of 0.4% in 2013). Moreover, the positive impact on the services sector from a somewhat looser monetary policy stance (real policy rate is set to decline to an average 5% in H2:14 from 7.3% in H1:14) and the introduction of state subsidised loans (amounting to RSD 140bn, or 3.7% of GDP) should be counterbalanced by additional fiscal consolidation measures (to be announced soon).

Overall, real GDP growth is set to weaken significantly in FY:14, recording a marginal decline of 0.5% -- for the first time since 2012 -- compared with a rise of 2.5% in FY:13. Note that this deterioration reflects: i) the impact of the floods (estimated to subtract c. 1 pp from growth); ii) base effects from strong agricultural production in 2013 (subtracting c. 0.5 pps from real GDP growth this year after contributing 1.4 pps in 2013); and iii) the fading-out of the impact of the strengthening of the production base in 2013 (including the start of production by the carmaker FIAT in H2:12).
The fiscal deficit in 7M:14 remained unchanged from the same period a year earlier, despite a targeted reduction. The general government budget deficit widened by 0.1 pp y-o-y to 3.1% of GDP in 7M:14, following a cumulative improvement of 0.8 pps of GDP y-o-y in FY:13. The deterioration in 7M:14 was driven by a weak non-tax revenue performance, which was counterbalanced by significant expenditure restraint. Revenue narrowed by 0.5 pps y-o-y to 16.6% of GDP in 7M:14, as a better tax revenue performance (up 0.3 pps of GDP y-o-y) was more than offset by a significant decline in non-tax revenue (down 0.8 pps of GDP y-o-y). The strong tax revenue performance resulted from a significant increase in VAT revenue (up 0.4 pps y-o-y), reflecting base effects from Q1:13 VAT refunds, while the poor non-tax performance resulted from a lower dividend from the state stake in Telekom. Revenue would have been even lower if social security contributions had not remained at their past year’s level of 5.1% of GDP, despite a 0.4 pp cut in the pension contribution rate to 18%, starting from January 1st.

On the other hand, expenditure declined by 0.4 pps y-o-y to 19.7% of GDP in 7M:14, reflecting cuts in current expenditure, mainly goods & services and transfers. Capital expenditure stood at 2% of GDP in 7M:14, unchanged from the same period a year earlier.

As a result, the 12-month rolling deficit stood at 4.2% of GDP in July -- broadly unchanged from the December 2013 level of 4.1%, but above the FY:14 target of 3.7%.

The observance of the FY:14 fiscal deficit target will require large expenditure cuts. The 2014 budget envisages a tightening of the fiscal stance, targeting a fiscal deficit of 3.7% of GDP against the 2013 deficit outcome of 4.1% of GDP. In our view, in light of the y-td performance (a deficit of 3.1% of GDP in 7M:14) and recent trends, the observance of the 2014 Budget target of 3.7% of GDP will require expenditure cuts.

Indeed, on the revenue side, the 2014 budget envisages a sharp increase in tax revenue (up 10.7% or 2.6 pps of GDP against the FY:13 outcome). Although improving compared with the FY:13 outcome, we expect tax revenue to underperform the budget target in FY:14 by 1.5 pps of GDP, in view of the y-td performance (+5.7% y-o-y in 7M:14), a moderate nominal GDP growth (NBG projections are for 4%) and the absence of new tax measures. Moreover, non-tax revenue is also projected to underperform significantly its FY:14 target, by 1.2 pps of GDP, mainly on the back of a lower-than-budgeted dividend from the state stake in Telekom.

In view of the authorities’ good track record, we believe the FY:14 deficit target of 3.7% is achievable through lower-than-budgeted expenditure (+3% y-o-y in 8-12M:14), bringing FY:14 spending growth to 2.3%, at most, against a target of 10.7%.

Should our deficit forecast materialise, the general government debt is set to rise to a 9-year high of 36.5% of GDP at end-2014 from 35.6% in FY:13. The deterioration in 7M:14 was driven by a weak non-tax performance, which was counterbalanced by a significant increase in VAT revenue (up 0.4 pps y-o-y), reflecting base effects from Q1:13 VAT refunds, while the poor non-tax performance resulted from a lower dividend from the state stake in Telekom. Revenue would have been even lower if social security contributions had not remained at their past year’s level of 5.1% of GDP, despite a 0.4 pp cut in the pension contribution rate to 18%, starting from January 1st.

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Should our deficit forecast materialise, the general government debt is set to rise to a 9-year high of 36.5% of GDP at end-2014 from 35.6% of GDP at end-2013 -- still in line with the emerging market average and well below the SEE-5 average of 45% of GDP.

Covering public sector financing needs in 2014 should not be a cause for concern. The authorities are set to cover their financing needs for 2014, estimated at EUR 1,250mn or 15.5% of GDP, through: i) the domestic debt market (EUR 917mn or 11.4% of GDP); ii) government deposits (EUR 96mn or 1.2% of GDP); and iii) external borrowing (EUR 237mn or 2.9% of GDP). Recall that, in July, the authorities raised EUR 500mn (6.2% of GDP) through their largest Eurobond issue ever, at a favourable spread of 362 bps over midswaps (a debt yield of 4.25%).

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**Consolidated Fiscal Balance (% of GDP)**

<table>
<thead>
<tr>
<th></th>
<th>2013 Outcome</th>
<th>7M:13 Outcome</th>
<th>7M:14 Outcome</th>
<th>2014 Budget</th>
<th>NBG 2014 Forecast</th>
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Fiscal consolidation continued in 7M:14, on the back of a strong tax revenue performance and a temporary decline in capital spending. Fiscal consolidation, initiated in mid-September 2013 when the new Government took office, continued during the first seven months of the year, with the cumulative fiscal deficit, narrowing significantly from 3.6% of GDP in 7M:13 to 0.4% of GDP in 7M:14 (excluding the repayment of arrears of 1.8% of GDP in 2014). Recall that there was an urgent need to initiate fiscal consolidation in order to: i) contain the surging fiscal deficit, which reached a 4-year high in September, of 5.8% of GDP on a 12-month rolling basis, in the wake of the legislative elections; and ii) conclude talks with the IMF on a 36-month EUR 330mn (3.3% of GDP) arrangement under the EFF.

The improvement in 7M:14 was driven by a sharp decline in expenditure (down 2.3 pps of GDP y-o-y) and a robust increase in revenue (up 0.9 pps of GDP y-o-y). The decline in expenditure mainly reflects a significant under-execution of capital spending (1.6 pps of GDP y-o-y), due to a review of the investment budget by the new government. The positive revenue performance is attributed to the ongoing tax administration reform, which has boosted tax compliance and reduced fraud (VAT and corporate income tax were up 0.5 pps and 0.2 pps of GDP y-o-y, respectively). Importantly, the revenue performance should improve further in the coming months, due to the implementation of revenue-enhancing measures, targeting mainly excise and corporate taxes (see below). As a result of the continued fiscal adjustment in 7M:14, the 12-month rolling fiscal deficit, excluding the clearance of arrears, eased to 1.5% of GDP in July from 4.8% in December -- well below the FY:14 target of 4% (excluding the budgeted 2.5% of GDP clearance of arrears, see below).

The FY:14 fiscal deficit is set to overperform its target of 4% of GDP (excluding the repayment of arrears), mainly on the back of a better-than-projected revenue performance. The 2014 Budget targets a fiscal deficit of 6.5% of GDP, up from the FY:13 outcome of 4.8% of GDP. However, excluding the budgeted clearance of the bulk of accumulated arrears, the adjusted FY:14 fiscal target is 4% of GDP. Indeed, the 2014 Budget envisages the clearance of unpaid bills to corporates and VAT refunds of EUR 250mn or 2.5% of GDP, out of total arrears of EUR 514mn or 5.3% of GDP (dating as far back as 2005), to be cleared by end-2016. Note that the repayment of arrears began in March and reached EUR 184mn or 1.8% of GDP in 7M:14 (74% of the envisaged amount for this year), resulting in a cumulative overall fiscal deficit of 2.2% of GDP in 7M:14.

We expect FY:14 revenue growth to exceed its target of 11% by 3.5 pps, in view of the y-t-d performance (10.7% y-o-y in 7M:14), the past year’s poor performance, the improving efficiency of tax administration, and the approved revenue-enhancing measures. Specifically, the envisaged measures, projected to yield 1.8% of GDP, mainly consist of i) the profit tax rate from 10% to 15%; ii) the excise tax on cigarettes, wine, beer, alcoholic beverages, energy, drinks and tobacco; and iii) gasoline prices by about 6.5%. On the other hand, the FY:14 expenditure growth target of 5.8%, excluding the clearance of arrears and contingency reserves, should be observed, mainly through a surge in capital spending. Indeed, the authorities are expected to accelerate the execution of budgeted capital spending over the course of the year so as to catch up with the full-year plan, in line with the IMF Staff recommendation at the end of the first review (in June), aiming at avoiding a fiscal drag on growth. Overall, we foresee the FY:14 budget deficit, excluding the repayment of arrears, standing at 3% of GDP -- below its target of 4% and the 2013 outcome of 4.8%.
Ukraine

Rating Group Poll Results (2014 Parliamentary Elections)

<table>
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<tr>
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<tbody>
<tr>
<td>Party of the Regions</td>
<td>185</td>
<td>107</td>
<td>77</td>
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<tr>
<td>Tymoshenko Party</td>
<td>101</td>
<td>95</td>
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<tr>
<td>UDAR</td>
<td>40</td>
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<tr>
<td>Svoboda (Freedom)</td>
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<td>36</td>
<td>35</td>
</tr>
<tr>
<td>Communist Party</td>
<td>32</td>
<td>32</td>
<td>50</td>
</tr>
<tr>
<td>Economic Development</td>
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<td>-</td>
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<tr>
<td>Sovereign European Ukraine</td>
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<td>-</td>
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<tr>
<td>For Peace and Stability</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Independent</td>
<td>43</td>
<td>32</td>
<td>94</td>
</tr>
<tr>
<td>Other</td>
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</tr>
<tr>
<td>Vacant</td>
<td>5</td>
<td>6</td>
<td>5</td>
</tr>
<tr>
<td>Total</td>
<td>450</td>
<td>450</td>
<td>450</td>
</tr>
</tbody>
</table>

2014 Presidential Election (% of vote)

- Poroshenko: 54.7%
- Tymoshenko: 12.8%
- Liakho: 8.3%
- Grytsenko: 5.5%
- Tiganio: 5.2%
- Dobkin: 3.0%

Kiev representatives and separatists meet for peace talks as fighting continues. An agreement on a ceasefire between the Ukrainian authorities and pro-Russian separatists is expected to be signed today (September 5th) in Minsk, set to end the 5 month long conflict, despite ongoing fighting in Donetsk and Mariupol. Note that the separatists expanded their strongholds in late-August, taking control of a land route linking Russia to Crimea (Ukraine’s peninsula annexed by Russia in March).

A pro-President pro-EU coalition Government to emerge from October 26th parliamentary elections. As stipulated by the constitution, President Poroshenko dissolved the parliament and called for early legislative elections to be held on October 26th -- 3 years ahead of schedule -- due to a political vacuum. Indeed, a new government was not formed within a month after the (interim) Government coalition -- formed in February by the former opposition parties after Yanukovych’s overthrow -- broke up on July 24th. Note that the government collapse was intended to trigger snap elections.

According to an opinion poll, held in July, the pro-Presidential Bloc of Poroshenko enjoys strong public support (around 23%), capitalising on the President’s popularity and benefiting from his pro-reform, pro-EU agenda and his reaction to the fight against pro-Russian separatists. The populist pro-EU Radical party of O. Liashko (an MP and presidential candidate in May elections) ranks second, polling around 13%, close to the senior party of the outgoing (interim) Government-coalition, Y. Tymoshenko’s Fatherland, that polls around 11%. Two other parties are likely to pass the 5% threshold to enter parliament: i) the junior party of the interim coalition, Klitschko’s UDAR (7%); and ii) Grytsenko’s pro-EU Civil Position (5%). The polls indicate that the pro-Russian Party of Regions -- the senior ruling party of the deposed President until he was ousted -- and its partner in the Government-coalition, the Communist party, are unlikely to enter parliament.

The October 26th election is crucial to restoring legitimacy to the Kiev Government, and thus strengthen its authority amid a challenging economic and geopolitical situation, as the 5-month long fight against pro-Russian separatists intensifies in the East and tensions with Russia are heightening. The early poll will also increase the number of pro-EU parties and pro-Presidential MPs in the Rada, enabling the new coalition Government to implement fully and timely its adjustment programme needed for continued support from IFIs.

The IMF Executive Board approved, on August 29th, the 1st review of Ukraine’s exceptional 2-year USD 17bn SBA. The approval enabled the disbursement of the 2nd tranche of USD 1.4bn (1% of GDP), that brought total disbursements under the SBA, approved on April 30th, to USD 4.5bn. Moreover, in view of the escalating conflict in the East and the ongoing tensions with Russia, the authorities agreed with the IMF on a revised economic programme, envisaging a sharper real GDP contraction, by 6.5% y-o-y this year (from 5% y-o-y previously), in line with our forecast, and targeting a consolidated fiscal deficit (including Naftogaz) of 10.1% of GDP (from 8.5% of GDP initially) -- despite the adoption of additional fiscal measures of 1 pp of GDP in H2:14 -- and a higher-than-initially targeted drop in FX reserves. Recall that Ukraine’s USD 17bn SBA is part of a total financial assistance package of USD 27bn (after the repayment of USD 6bn to the IMF in 2014-16). Its implementation will also unlock further substantial international assistance, totalling USD 16bn over the next 2 years, from other official bilateral and multilateral donors (including the EU and the US, the World Bank, the EBRD and the EIB).
A positive Troika statement following the 5th review of the financial assistance programme. On July 25th, the Troika mission -- EC, ECB, and the IMF -- successfully completed the 5th review of the country’s EUR 10bn financial assistance programme approved in late-March 2013. It commended the authorities on the significant progress made to date. However, the completion of the review by the ESM and IMF Board of Directors will hinge on the approval of the new legal framework for foreclosure by September 5th (a prior action).

On the fiscal front, the end-June quantitative targets were met with a considerable margin. Indeed, the primary surplus (EUR 225mn or 1.4% of GDP in H1:14 versus a target of EUR 6mn; 0.04% of GDP) and primary expenditure (EUR 2,821mn or 17.9% in H1:14 versus a ceiling of EUR 3,158mn; 20.0% of GDP) largely outperformed their respective end-June targets. Accordingly, the stock of public debt (EUR 18,203mn or 111.5% in March 2014) is also estimated to have overperformed its end-June ceiling target of EUR 18,697mn (118.5% of GDP).

Regarding financial sector stability, the central bank continued its efforts to strengthen banking sector regulation and supervision and enhance the operational capacity to address the high level of NPLs (c. 46.5% of total loans in June). Specifically: i) the governance directive on the interaction between the banks’ internal audit units and bank supervisors was brought into line with best practices; and ii) the Central Bank required banks and cooperatives to submit reports prepared by their external auditors on the effectiveness of their debt restructuring.

In the area of structural reforms, the authorities implemented a welfare reform, providing a guaranteed minimum income (GMI) scheme, while decisive steps were taken to improve tax collection and fight tax evasion through the consolidation of the two existing tax authorities into a single Department of Taxation.

However, there are delays in the implementation of the programme, in particular, the approval of the new legal framework for foreclosure to address the high level of NPLs. The Troika made it clear that the passage of the new bill, aiming mainly at speeding up auctions of property used as collateral against bank loans (to a maximum time-span of 1.5 year) is a precondition for the completion of the 5th review by the ESM and the IMF Board of Directors. Indeed, the new bill allows the seizure and sale of loan collateral by mortgage creditors through private auctions, without government interference (currently the official Land Registry).

Note that under the current law, it can take banks up to 20 years to recoup an NPL and Cypriot banks will fail EU stress tests, due in the autumn, as NPLs must be classified as non-recoverable. The new bill, approved by the Cabinet in late August, will facilitate the restoration of confidence in the banking system and the resumption of credit expansion -- two essential preconditions for a durable expansion of output and employment growth. The approval of this legislation will, however, be difficult. Indeed, the minority coalition government, comprising the Democratic Rally (DISY) and the European Party (EUROKO), needs the full support of the Democratic Party (DIKO), which withdrew from the coalition government in late-February (due to its disagreement with the terms of the resumption of reunifications talks), while the Communist party (AKEL) and the Socialist party (EDEK) have stated they will oppose this legislation. Note that, in an effort to address social concerns, DIKO has proposed several amendments, as preconditions for the approval of the bill.

The completion of the 5th review by the Eurogroup and the Executive Board of the IMF, expected in mid-September, will enable the release of EUR 350mn by the ESM and EUR 86mn by the IMF, bringing total disbursements to EUR 5.7bn, out of a total of EUR 10bn (61% of GDP).
Egypt

The fiscal deficit is estimated to have narrowed in FY:13/14 for the first time in 5 years, on the back large support from oil-rich Arab countries. The fiscal deficit eased significantly by 2.4 pps y-o-y to 9.3% of GDP in 11M:13/14 (July 2013-May 2014), on the back of higher revenue (up 1.1 pp of GDP y-o-y) and lower expenditure (down 1.3 pps of GDP y-o-y). The improvement in the revenue performance was exclusively driven by a surge in grants (up 2.3 pps y-o-y to 2.5% of GDP, of which 1% of GDP from Gulf countries), which largely offset a decline in tax revenue (down 1.2 pps of GDP y-o-y). On the other hand, the decline in expenditure in 11M:13/14 resulted mainly from a sharp drop in subsidy repayments to the Egyptian General Petroleum Company (down 2.4 pps of GDP y-o-y), on the back of free oil shipments from some oil-rich Arab countries. Recall that following the removal of power of Islamist President Mursi on July 3rd 2013, Saudi Arabia, Kuwait and the UAE pledged to the Interim Government 2 assistance packages (July 2013 and January 2014), totalling USD 18bn (6.1% of GDP). In view of the y-t-d performance and the usual surge in expenditure in the last month of the fiscal year (June), we estimate that the deficit narrowed for the first time in 5 years in 2013/14 to 11.3% of GDP from 13.7% in 2012/13. However, excluding the temporary support from oil-rich Arab countries (estimated at EGP 77bn or 3.8% of GDP), the fiscal deficit is estimated to have widened by 1.4 pps y-o-y to the unsustainable level of 15.1% of GDP in 2013/14.

The fiscal deficit is set to widen in 2014/15, in the absence of additional corrective fiscal measures and/or further assistance from Gulf countries. The 2014/15 Budget envisages further fiscal tightening, targeting a fiscal deficit of 10% of GDP compared with our FY:13/14 deficit estimate of 11.3%. The expected fiscal consolidation is set to result mainly from the implementation of a series of repeatedly-delayed revenue-enhancing and expenditure-saving measures, starting from July 1st.

A close look at the 2014/15 Budget figures suggests that the fiscal deficit is set to exceed not only its target but also its past year’s level, despite the recent adoption of bold corrective measures. Indeed, following his landslide victory of the presidential elections, el-Sissi signed a series of laws at the beginning of July, stipulating inter alia: i) a sharp increase in subsidised prices of energy and electricity (expected to save EGP 44bn or 1.8% of GDP); ii) a 10% capital gains tax on stocks and investment fund certificates (expected to generate EGP 3-5bn or 0.2% of GDP); and iii) increases in taxes on cigarettes and alcohol by 100% and 120%, respectively (expected to generate EGP 3.5bn or 0.2% of GDP).

The tax revenue target (up 23.3% versus our FY:13/14 estimate) appears overly optimistic, in view of delays in the replacement of Egypt’s current “complex and unfair” sales taxes by the VAT, expected to boost budget revenue by EGP 23bn (1% of GDP). The expenditure target (up 12.2% compared with our FY:13/14 estimate) also appears unattainable. Specifically, meeting the budgeted growth target of subsidies, grants & social benefits (7% versus our FY:13/14 estimate) would need further cuts in fuel subsidies and/or additional free shipments of oil from oil-rich Arab countries (totalting EGP 20bn or 0.9% of GDP).

Overall, the FY:14/15 fiscal deficit is likely to reach 11.8% of GDP, surpassing its target of 10% and the estimated FY:13/14 outcome of 11.3%, unless the planned VAT is introduced, additional energy subsidies cuts are implemented and/or additional assistance from oil-rich Arab countries is secured (EGP 43bn or 1.8% of GDP against EGP 77bn or 3.8% in 2013/14).
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Sectoral Studies - Sectoral Reports
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