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CEE Quarterly

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"CEE: Strong rebound, fragile recovery"

3Q 2020

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CEE

Strong rebound, fragile recovery

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- Activity is rebounding in CEE as restrictions are being removed, but it remains well below the levels registered before the COVID-19 crisis. Moreover, the recovery is facing many risks.
- Governments and central banks have implemented sizeable support programs that range from 3.5% of GDP in Russia to 23.5% of GDP in Czechia.
- Support programs differ in size, scope, efficiency and speed of implementation. These characteristics will shape the recovery in 2H20 and 2021.
- The biggest risk for CEE economies is a second wave of the pandemic, even if restrictions are not as tight as in March-May 2020.
- In EU-CEE[1], we expect GDP to fall by 8.3% in 2020 and grow by 7.3% in 2021. Western Balkan economies could evolve similarly.
- Russia's economy could contract by around 5.4%in 2020, with a 3.8% rebound next year.
- In Turkey, GDP could fall by approximately 5.6% this year and grow by 6.6% in 2021.
- We expect additional rate cuts in Czechia, Romania, Russia, Serbia and Turkey. Only Czechia and Poland might consider raising rates in 2021.
- Inflation targets could be met in 2020-21 but may be threatened thereafter if domestic demand rebounds.
- According to our models, the CZK, the HUF and the PLN are undervalued, but poor trade data and volatile risk appetite may cut potential rallies short; the RUB, RON and RSD are overvalued.
- ROMGBs and ROMANI EUR remain our top picks in the region, as the rating downgrade risk previously priced in to the bonds could continue to diminish.
- OFZs, POLGBs and long-end CZGBs offer attractive valuations but face FX risks.
- The EU's Recovery and Resilience Facility is a game changer for EU-CEE but not in the next twelve months.

Back in business…

Restrictions are being eased throughout CEE…

…mostly for economic reasons

Three months into the COVID-19 pandemic, CEE economies are gradually opening up. EU-CEE is leading the way, having imposed strict lockdowns early into the outbreak and controlled the spread. At the time of writing this CEE Quarterly, it is unclear whether the rise in new cases is just a rebound following the reopening or the start of a second wave of the pandemic. Even if the latter proves to be true, it is unlikely that governments will re-impose the tight restrictions in place from March to May. This is true also for the laggards in containing the spread, Russia and Turkey, where governments decided to re-open parts of the economy despite a high number of new infections[2] and a rise in outstanding cases.

Traffic is yet to recover in work places and shops

Thus, in many countries the reopening seems to be motivated by economic, rather than health reasons. April data were universally bad, with foreign trade and exports being the worst hit by widespread lockdowns. The rebound in May is mostly driven by base effects.

[1] EU-CEE comprises Bulgaria, Croatia, Czechia, Hungary, Poland, Romania, Slovakia and Slovenia – all CEE countries that are members of the EU.
[2] And, in Russia's case, no significant decline from the peak.

Shop closures affected retail sales, with cars, clothing and consumer electronics suffering from plummeting demand more than other categories of consumer goods. With the easing of lockdowns in mid-May, traffic in shops rebounded more than traffic in work places (Chart 1), but trailed other indicators, such as card payments and higher electricity consumption. Data from China's earlier removal of the lockdown show that footfall in physical shops may take a long time to recover but could benefit from a temporary boost immediately after the reopening. Thus, monthly growth rates in May-June may not be sustained in 3Q20.

Car manufacturing could be a liability in the recovery…

…due to its importance for most CEE economies

In some sector, the rebound is more muted. It is too early to gauge the impact of the crisis on investment beyond anecdotal evidence. Some large FDI projects have been postponed, with Hungary hit hardest due to its impressive pipeline of projects. Car manufacturing, an engine of growth in EU-CEE after the global financial crisis, could become a drag due to poor sales (Chart 2). Car scrappage schemes and government incentives implemented in western Europe powered the rebound in car manufacturing in 2009-10. The situation is very different this time around, mostly because European car producers entered the COVID crisis without a competitive line of electric and hybrid cars, whose development has been delayed, in some cases, by more than a year. With the exception of Skoda's Citigo iV assembled in Slovakia, no electric or hybrid cars are produced in CEE.

The uncertain outlook in car manufacturing is important for the other economic sectors as well, given the signaling role it plays in wage setting and the spillover to other types of manufacturing. It is no surprise that the production of machinery, rubber and chemical products is also lagging[3] the rebound in total industrial output. If this trend continues, employment in manufacturing will be significantly affected.

CHART 1: TRAFFIC RECOVERING IN SHOPS AND WORK PLACES

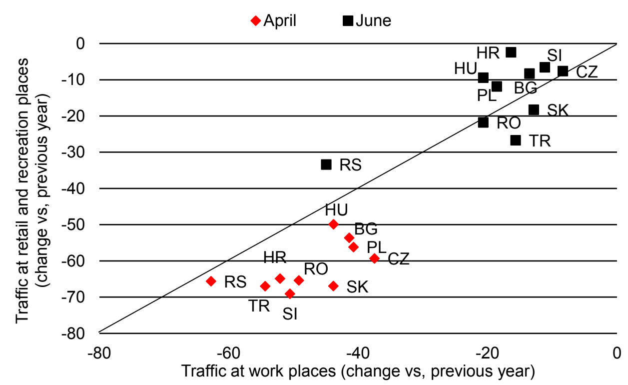
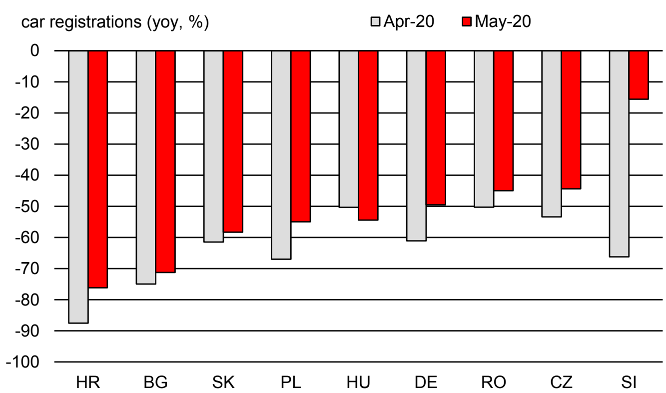


CHART 2: CAR DEMAND TRAILS THE INCIPIENT RECOVERY



Source: Google Mobility, Eurostat, UniCredit Research

Widespread weakness in labor markets

Yet labor-market weakness goes beyond manufacturing, with retail and leisure services heavily affected by lockdowns. The labor-intensive tourism season will open too late to save revenues in July for operators in countries heavily reliant on foreign arrivals, such as Croatia and Turkey. The negative impact could be felt not only on household income and unemployment but also lower inflation. In central Europe, migrant labor was more affected by redundancies and reduced working hours than the domestic workforce.

[3] An example can be seen in the left-hand side chart on page 39, in the section on Hungary. In Hungary, Czechia and Slovakia, spillover from car manufacturing to the rest of the economy is the greatest.

Labor decline through redundancies and fewer hours worked

The reopening of economies led to a reduction in furloughed workers across sectors but was unable to stop redundancies from rising[4]. Some companies, especially in central Europe and Russia, cut hours worked to avoid layoffs, with a negative impact on wages.

Slower wage growth in all countries

All these factors led to aggregate wage bills slowing sharply or even falling in real terms (Chart 3). A recovery is not on the cards in 2020 as labor shortages could fall further throughout CEE. In Poland and Russia, the labor market adjustment has been greater than during the global financial crisis.

The labor market could trail the recovery…

There are several reasons why we believe that the labor market will trail economic activity in this recovery.

…due to several waves of unemployment…

1. Unemployment could rise in several waves, with the number swelling if governments end official support for furlough and part-time working before economic activity rebounds. Some countries intend to do so as early as in 2H20 (Russia, Serbia), while most plan to continue support until year-end. We believe that furlough schemes are very important, despite significant differences across countries (Chart 4). Together with other types of support that prevent layoffs[5], furlough support will have to continue at least into 1Q21, if not beyond. Otherwise, the peak in unemployment is likely to be delayed until next year.

…lower income growth for pensioners and public sector employees…

2. Governments will be less generous with public sector employees and pensioners. These two categories have been cushioned against the current crisis by stable income flows compared to private sector employees. Continuing to favor them over private sector employees could stoke discontent as many countries in the region head into the next election cycle. Fiscal constraints will also cap the governments' wage and pension bills. While markets and rating agencies prepare for budget deficits to balloon in 2020, populist profligacy will be penalized in 2021.

…and a gradual recovery in optimism

3. It could take consumers until 2H21 to turn more optimistic, reduce precautionary savings and start spending again, especially on big-ticket acquisitions.

Another wave of the pandemic is the biggest threat for the economic rebound

There could be a fourth potential reason, namely a second wave of the pandemic, which would postpone the recovery in consumer spending to 2022 or beyond. This is not part of our baseline scenario due to the level of uncertainty related to the spread, resilience and mutations of the virus, but it is certainly the biggest risk in the year ahead.

CHART 3: NEGATIVE WAGE GROWTH IN MOST COUNTRIES

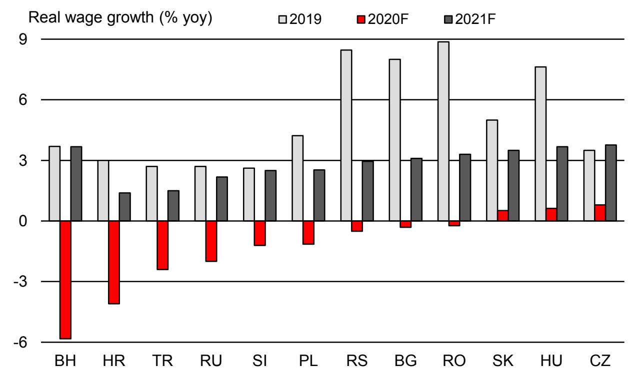
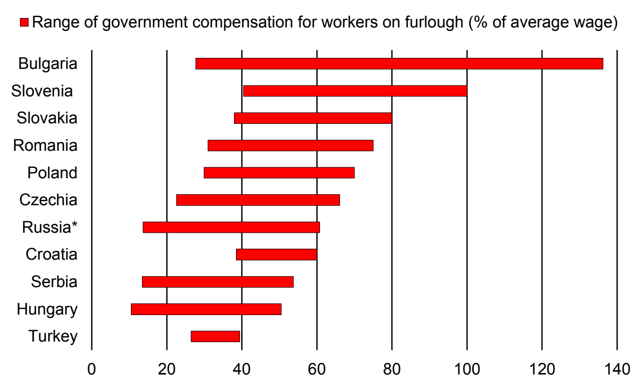


CHART 4: FURLOUGH SUPPORT



*For Russia, the range for furlough support is computed using average wages in Moscow and the poorest regions.

Source: Eurostat, governments, national statistical offices, UniCredit Research

[4] An example is Romania, which published daily data on furlough and redundancies in April and May. Please see page 47 for details.
[5] E.g., grants and subsidized lending to companies that maintain employment at pre-crisis level.

Construction less affected during the lockdown…

…but demand for real estate is likely to remain low this year

A sector that has been less affected by the COVID-19 crisis is construction. Most building sites did not close during the lockdowns, while many governments continued to spend on infrastructure. However, the flow of funds dried up, both from home buyers and from real estate investors. Investors could be the first to return, targeting logistics and industrial construction, in particular. Both could be in demand if global supply chains remain fully or partially disrupted and/or are shortened. The outlook is less clear for office space, where working from home and the need for social distancing are having contrasting effects on demand. Demand for housing could return next year in a region where the home ownership rather than renting, is the norm. The rebound will be staggered, with Poland being favored by western investors and Turkey preferred by Middle Eastern investors. Czechia and Hungary could follow, although valuations are stretched, especially in the two capital cities, Prague and Budapest. Pent-up demand for real estate in Russia remains huge by regional standards, but the market is dominated by local buyers, both retail and funds.

…with a better outlook for 2020…

Reasons for a more upbeat outlook than in April:

Despite this uncertain outlook, we have upgraded our forecasts for this year in most countries. There are four reasons for a slightly better outlook, which still places us at the lower end of the forecast range for all CEE countries.

Restrictions removed sooner than expected

First, restrictions started being eased in mid-May, one month sooner than we assumed in our April *CEE Quarterly*. This translates into a shallower trough in 2Q20 and a stronger rebound during the summer.

Decisive official reaction

Second, the official response to the crisis was better than expected. This refers both to the size of packages and to their implementation.

Better outlook for the eurozone

Third, our outlook for the eurozone has improved compared to April, for the same reasons mentioned above. We now expect the eurozone economy to contract by 11% in 2020, compared to 13% in the previous forecast. There are two stand-out reasons for being more optimistic for CEE economies. First, the gigantic German fiscal package bodes well for German demand of goods made in CEE. That said, we need to add a note of caution for capital goods, the largest item on the list of CEE exports to Germany, whose demand may not recover as fast as that of consumer goods. Second, the support packages announced by the EU are already reinforcing the European recovery. Even if negotiations will take some time and the bulk of support might not arrive before mid-2021 (more on which on page 14), there are reasons for optimism.

Better-than-expected growth in 1Q20

Fourth, some economies were more resilient than expected in 1Q20, at least according to available data. Serbia and Romania stand out. Data could still be revised lower, but leaving annual forecasts unchanged would translate into a more pessimistic outlook than we expect in 2H20 for these two economies.

…thanks to unprecedented official support…

Fiscal packages grew and became more complex during 2Q20…

…resulting in wider budget deficits

The size of official support packages increased since lockdowns were imposed and their scope broadened to cover most economic sectors and most types of economic agents (Table 1). Since mid-April, the biggest additions to the list of measures target individual entrepreneurs, microenterprises and large enterprises, as well as other types of financial instruments besides bank lending, such as trade finance, factoring, leasing and insurance. As a result, expected government deficits are, on average, 2% of GDP larger than in our previous forecast for EU-CEE countries. This happened while the size of EU transfers increased, as some investment funds were repurposed for emergency funding for unemployment, furlough, worse-off households and SMEs under the Coronavirus Response Investment Initiative.

Thus, fiscal impulses will be positive this year in all countries but Hungary, where the net fiscal package is around 1.3% of GDP and the expected widening of the budget deficit is more than offset by the cyclical downturn in the economy. At the other end of the spectrum stand Czechia, Slovakia, Slovenia and Poland, all with fiscal impulses exceeding 5% of GDP (Chart 5).

Implementation issues remain

One caveat regarding support packages is the speed and efficiency of implementation. All EU-CEE countries had to cut red tape and move most of the allotment process online. This took time and, in some countries, support programs did not start working in earnest until late April or early May. In addition, eligibility criteria are very tough. Often, companies that weathered the first phase of the crisis better only to see their activity fall in late-April and May did not qualify for support. In some cases, the government was not to blame: the habit of paying large dividends and/or tax avoidance through overstating expenses came to haunt companies that could not get support due to a lack of sufficient capital, large losses accumulated in the past and/or a poor history of debt repayments.

Not all packages are equally efficient…

However, large fiscal support is not a guarantee of quality measures and a strong boost to the economy. Czechia stands out due to the risk that significant funding may be poured into populist measures ahead of next year's parliamentary elections. Such spending could help weather the crisis this year by cushioning the blow to households, but bodes ill for the strength of the recovery in 2021.

…or implemented equally quickly

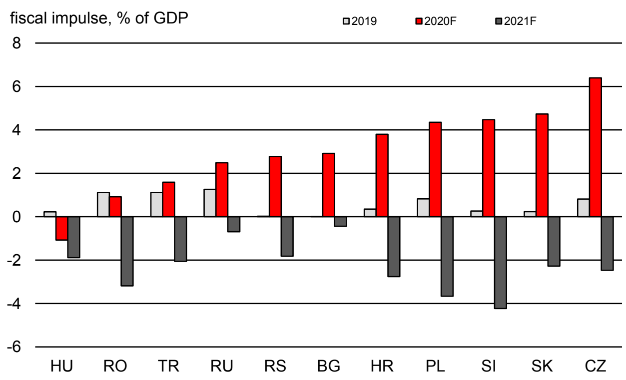
Another risk is that the size of actual support may fall well short of the amounts officially pledged. This is true for both direct fiscal support (comprising all types of payments, transfers, tax cuts and tax exemptions) and indirect support (comprising loans, guarantees and other types of financial support). There are some exceptions, such as Hungary and Poland, where the disbursement of direct support exceeds half of the allocation. In Poland, this is true also for the indirect support package.

TABLE 1: CURRENT SIZE OF SUPPORT PACKAGES

Country	Direct support	Indirect support	Total
Bulgaria	3.0	2.5	5.5
Croatia	7.8	4.0	11.8
Czechia	6.3	17.2	23.5
Hungary	4.4	5.7	10.1
Poland	7.0	7.9	14.9
Romania	3.2	1.6	4.8
Russia	2.3	1.2	3.5
Slovakia	4.0	1.8	5.8
Slovenia	9.1	5.9	15.0
Serbia	6.6	5.0	11.6
North Macedonia			5.0
Turkey	3.7	7.1	10.8

Amounts are expressed in percent of GDP. Amounts are maximum allotments. Some of the direct support includes temporary tax exemptions.

CHART 5: FISCAL IMPULSES VARY GREATLY



Source: governments, national statistical offices, Eurostat, UniCredit Research

Direct fiscal support targets five broad categories

Direct fiscal support ranges between 2.3% of GDP in Russia and 11% of GDP in Slovenia. It can be divided in five broad categories (Table 2[6]):

1. **Support for the health-care sector** to cope with the crisis. This includes the purchase of ventilators and other medical and personal protective equipment, the construction of temporary care facilities to increase the emergency capacity and reduce the burden on existing hospitals, and higher pay for medical personnel.

[6] The individual country sections go into more detail about the content and implementation of fiscal packages.

2. **Support for companies**, especially individual, micro, small and medium enterprises, through direct payments, tax exemptions, tax cuts and tax holidays (especially for social security payments), moratoria on loan repayments, the coverage of interest payments on corporate borrowing, financial help to pay wages for remaining and returning workers, and partial coverage of furlough.

3. **Support for households** through payments to redundant workers, worse-off households and households with homeschooled children, tax breaks, moratoria on mortgage loan repayments, and other forms of support for reintegration into the labor force.

4. **Support to local government** due to the loss of tax revenues.

5. **Public investment** in infrastructure, research and development, and retraining.

Indirect support matches direct payments…

Indirect support ranges between 1.2% of GDP in Russia and 17.2% of GDP in Czechia and includes:

1. **Subsidized loans** granted by government banks, funds and/or agencies.

2. **State guarantees** for bank lending.

3. **Support for other financial instruments**, such as trade credit (insurance, guarantees), factoring and leasing.

…but disbursements are delayed by the banks' risk checks

There is also significant differentiation in how indirect support is implemented, especially for lending and guarantee facilities. Where the banking system is involved, funds are disbursed with a delay due to the time required to process applications. The involvement of banks slows down the disbursement of loans and the short-term positive impact but ensures a smaller fiscal burden in the years to come. The exception is Hungary, where SME lending was granted under NBH-sponsored schemes before the crisis, so the process was tried and tested. To avoid such delays, Poland implemented this support through the state-owned development bank BGK and the sovereign investment fund (PFR). The assumption of credit risk by governments constitutes a contingent liability and could lead to higher public debt down the line.

TABLE 2: MEASURES INCLUDED IN DIRECT AND INDIRECT SUPPORT PACKAGES THROUGHOUT CEE

Direct fiscal support		Bulgaria	Croatia	Czechia	Hungary	N. Macedonia	Poland	Romania	Russia	Serbia	Slovakia	Slovenia
Support for healthcare sector	Equipment	red	red	red	red	red	red	red	red	red	red	red
	Wage increases/bonuses	red	red	red	red	red	red	red	red	red		red
Support for individual, micro, small and medium enterprises	Direct payments					red		red	red	red		
	Tax exemptions/cuts/holidays	red	red	red	red	red	red	red	red	red	red	red
	Moratorium on loan repayments	red	red	red	red	red	red	red	red	red	red	red
	Interest coverage for existing loans							red	red	red		
	Help for furloughed workers	red	red	red	red	red	red	red		red	red	red
	Help for remaining/returning workers		red		red	red	red	red	red	red	red	red
	Help for new employment	red			red		red	red			red	red
Support for large companies	Tax exemptions/cuts/holidays	red	red		red	red	red	red	red	red	red	red
	Other		red		red	red		red	red	red	red	red
Support for households	Payments for redundant workers	red		red	red	red	red	red		red	red	red
	Payments for poor households	pink		red		red		red	red	red		red
	Payments for homeschooled children			red	red		red		red		red	
	Moratorium on mortgage loan repayments	red	red	red		red	red	red	red	red	red	red
	Tax breaks	red		red			red	red				
	Support for re-integration into the labour force				red	red	red	red				
Support for local government	Transfers	red	red	red	red		red	red	red		red	
Public investment	Infrastructure, R&D, human capital		red	red	red	red	red	red	red	red	pink	red
Indirect fiscal support												
Loan guarantees		red	red	red	red	red	red	red	red	red	red	red
Loans	disbursed through government banks/agencies	red	red	red	red	red	red			red		red
Support for trade credit	insurance, transfers				red		red	pink				
Support for factoring					red			pink				
Support for leasing								pink				

red: measures are implemented. pink: measures will be implemented later this year.

Source: governments, central banks, UniCredit Research

Other financial instruments targeted for support

Some governments wish to support other types of financial instrument as well. Trade credit is larger than bank credit throughout the Balkans and it is paramount for governments to avoid financial blockages among firms. Leasing, factoring and insurance are also receiving support in some countries to ensure liquidity does not dry up.

Both Russia and Turkey rely more on lending than on fiscal support

Central bank action has also been more decisive than we previously expected, especially in Russia, Turkey and Romania. In Russia and Turkey, this was needed because lending is the main tool to fight the downturn. In both countries, the fiscal impulse will be limited, albeit for different reasons. The Russian government is reluctant to broaden support for the economy. Its labor support scheme is the second weakest in the region after Turkey's, while the package for SMEs is the smallest in CEE. Moreover, President Vladimir Putin said that some of the limited support will be withdrawn already in 2H20. The CBR's efforts will have to go a long way, since the credit impulse was already negative before the COVID-19 crisis. Turkey entered the crisis with stretched public finances and the size of the fiscal impulse could be around 1.6% of GDP. In contrast, the credit impulse is at its highest level since 2010, but in our view, it is not sufficient to offset the lack of stronger fiscal support for more than a few months. As a result, our forecast revisions are smaller for these two countries than for the rest of the region, with sizeable downside risks for Russia.

…which will underpin the economic recovery in 2020-21

EU-CEE GDP could fall by 8.3% in 2020 and grow by 7.3% in 2021

We expect GDP in EU-CEE to fall by around 8.3% this year and to increase by approximately 7.3% in 2021, returning to pre-crisis levels in 2022 (Charts 6 and 7). The western Balkans are expected to grow at a similar pace next year and in 2022.

Bulgaria and Poland could outperform in 2021

Bulgaria and Poland could outperform in EU-CEE given the size of their fiscal packages, with contractions of less than 7% this year. In our view, the laggards will be Slovakia (due to its reliance on car exports) and Croatia (due to tourism). In Slovenia and Czechia, the fiscal packages are large but both economies are too reliant on the eurozone to prevent a deep contraction. In Hungary, the fiscal package is too small compared to what the economy needs. One reason is the constitutional requirement to reduce public debt every year. This inflexible rule will be breached this year in any case, so providing almost 60% of the direct fiscal package by repurposing other types of fiscal spending makes little sense. In Romania, past fiscal profligacy and red tape limit the support that the government can offer the economy, although the package is broad in scope.

Recessions of less than 6% in Russia, Turkey and Serbia

Serbia is an unlikely outperformer in the region after a stellar 1Q20 (by regional standards). However, excluding the impact of positive base effects in industrial production and government investment, the contraction is similar to that in EU-CEE.

Russia and Turkey, the two economies where domestic demand represents the biggest share of GDP, could shrink by less than 6% this year.

Partial recoveries in 2021, with Turkey outperforming…

While we expect fiscal impulses to turn negative in 2021 throughout CEE, next year's economic rebound will depend on how efficient the support packages were in 2020 and on how much of this support is extended into 2021. In this respect, Slovenia and Poland stand out in EU-CEE. Elsewhere, Turkey and Serbia are expected to fully recover this year's GDP loss by the end of 2021. In countries where governments will actively try to shrink deficits next year (Hungary and Romania) or where fiscal expenditure may veer towards inefficient populist spending (Czechia), only part of this year's slump will be recouped. The same is the case for Croatia and Slovakia, where we do not expect tourism and car manufacturing, respectively, to recover fully by next year.

Turkey is expected to return to its pre-crisis GDP level already in 2021 by virtue of its higher potential growth. However, the output gap looks set to remain negative into 2022, employment is not likely to recover fully, and unemployment will probably remain among the highest in the region.

…and Russia lagging

In the absence of a larger and broader support package, Russia is expected to recover only part of this year's GDP loss. This is true even if transfers to households increase ahead of the Duma elections, expected before mid-September 2021. A slow recovery of the global economy bodes ill for commodity prices. For Russia, this means that budget revenues are unlikely to grow quickly, capping public spending.

CHART 6: SHARP RECESSION IN 2020…

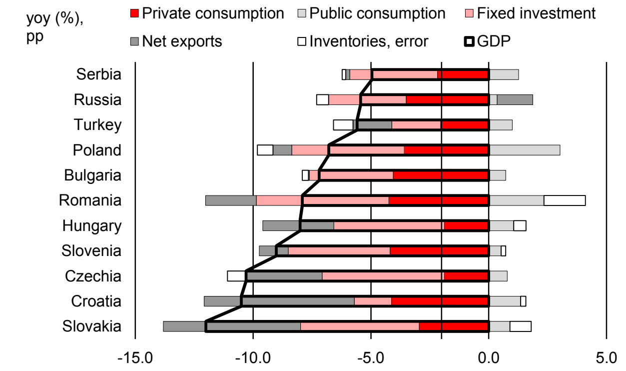
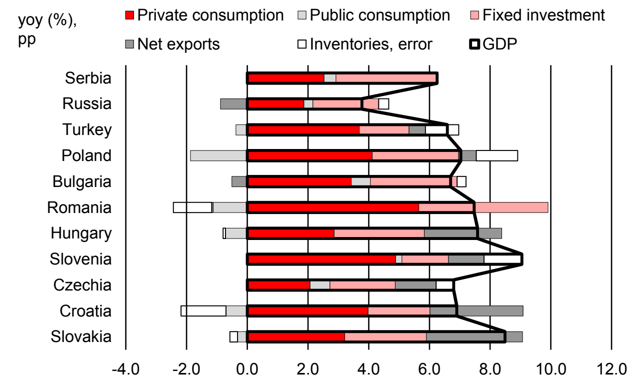


CHART 7: …FOLLOWED BY A REBOUND IN 2021



Source: governments, national statistical offices, Eurostat, UniCredit Research

Monetary policy – a paradigm shift that may last

The shift to multiple central bank goals may not be temporary

We have dedicated a separate piece[7] to monetary policy in CEE and the shift to multiple goals. We believe that stimulating growth and protecting the price of financial assets (primarily bonds and currencies) will take primacy over inflation mandates at least in 2020-21, under the large umbrella of protecting financial stability. But the foray into economic support risks further undermining central bank independence, which was already tested in Hungary, Serbia and Turkey before the crisis.

Focus on currency stability comes at the price of interest rate volatility

Time will tell whether CEE central banks have opened a Pandora's box that may be unable to close in the coming years. The behavior of central banks in developed markets made broader mandates, asset purchases and direct market interventions more palatable to investors, but this cannot mask the risk of suboptimal behavior ahead. This is already the case with FX interventions by the NBS, the NBR and the CBRT that translate into more volatility in short-term interest rates, undermining the necessary switch from FX to local-currency lending. The NBH is facing the same risk of volatile short-term rates, especially after it unexpectedly cut the key rate to 0.75% and vowed to lower the remuneration for excess liquidity. Subsequent HUF depreciation suggests that additional cuts may come only if risk appetite improves further and EUR-HUF moves safely below 340. This is not our baseline scenario.

Inflation risks to rise beyond 2021

Does this translate into higher inflationary risks? In short: not in 2020-21 (Chart 8), but probably beyond. This year and next, week domestic demand will weigh on core inflation, which could decline gradually. This is true even if second-round effects from tax, fuel and food-price increases are sizeable.

[7] For details, please see the EEMEA Country Note "CEE central banks: wider mandates to fight the downturn" published on 17 June 2020.

Additional rate cuts expected this year to 0% in Czechia, 1% in Romania…

But sticky core inflation in central Europe is a reminder that inflation could break out of target ranges once labor markets recover. In the absence of savings opportunities, households will return to spending next year, which could threaten inflation mandates in EU-CEE in 2022 and beyond. Despite this, we expect rate cuts to continue to 0% in Czechia and to 1% in Romania (Chart 9). Part of this year's cuts might be reversed next year only in Czechia and Poland, but real interest rates are likely to remain negative in all countries.

…7.5% in Turkey...

At the extreme, Turkey's ongoing target miss is likely to continue, with inflation expectations unanchored and threatened by currency depreciation whenever real interest rates are close to or below zero[8]. This is unlikely to deter the CBRT from cutting more, probably to 7.5%, and keeping the key rate at that level in 2021.

...4% or lower in Russia…

Two central banks, Russia and Serbia, face the opposite problem, namely a lack of inflationary pressure. In Russia, the CBR is revising its inflation expectations after the lockdown limited the FX pass-through from the sharp RUB depreciation in March, before higher oil prices and better risk appetite pushed USD-RUB lower. The Russian central bank faces the risk of a long-term target miss, with inflation likely to stay below 4% in 2020-21. While we expect the target to be lowered in the coming years, the undershooting of the target and the negative output gap that could persist into 2022 require lower interest rates, which the CBR will continue to deliver. We expect the policy rate to be cut to 4% or lower.

…and 1% in Serbia.

In Serbia, the fiscal adjustment of recent years was achieved by curtailing household income growth and, as a result, the output gap never ballooned like it did in EU-CEE. After successfully lowering the deficit, the government increased regulated prices less than in the past. Thus, inflation has been running below target recently and is likely to do so in 2020-21. As a result, we expect the NBS to cut once more to 1% this summer and keep the policy rate unchanged until the end of next year.

CHART 8: BELOW-TARGET INFLATION THIS YEAR…

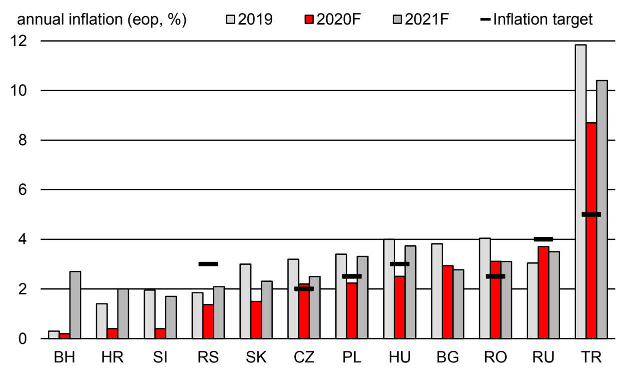
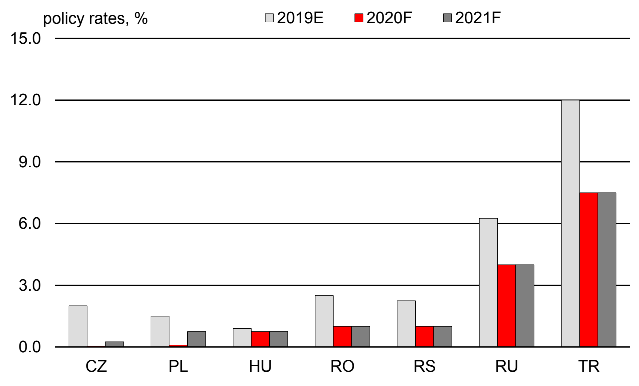


CHART 9: … LEAVES ROOM FOR ADDITIONAL RATE CUTS



Source: national statistical offices, central banks, UniCredit Research

CEE financial assets – the boring EM outperformer (once again)

CEE bonds likely to outperform EM peers in a volatile environment, helped by…

CEE bonds tend to outperform EM peers in times of trouble due to the region's better fundamentals. To these, we can add a few more sweeteners:

…preference for EUR and EUR-based bonds…

1. **The preference for bonds in EUR and European currencies linked to the EUR among EM investors:** More attractive spreads compared to USD bonds, previous underinvestment and strong domestic support help CEE bonds outperform.

[8] For details, please see the EEMEA Country Note – Turkey's recovery is reliant on lending, 9 June.

…EU funding…

2. **EU crisis packages and the beefed-up EU budget for 2021-27 under the multi-year financial framework (MFF):** The reaction of European authorities during the current crisis has been unexpected. While investors have been too preoccupied with the size of support to southern Europe, they appear to have only recently realized that, in GDP terms, EU-CEE is yet again the top recipient of the EU's Recovery and Resilience Facility (RRF) and from MFF funding.

3. **Potential debt mutualization in the EU:** Hard to fathom three months ago, this possibility is now on the table. If agreed upon, it should lower the risk of all EU-CEE countries. In our view, this is a long-term change, rather than a temporary market reaction, and rating agencies seem to agree.

…and central bank support.

4. **Central bank support:** Bond purchases show that performance is proportional to the price insensitivity of central banks. POLGBs, CROATEs and TURKGBs outperformed the rest of the region due to the unflinching support from their respective central banks. In contrast, the NBH's half-hearted support for HGBs is currently being tested by investors, with the curve underperforming regional peers (Chart 10). Even if central banks vow to step out of bond markets later this year or in 2021, the bar is low for a return, especially if risk-off episodes lead to sizeable selloffs.

OFZs attractive but vulnerable to RUB corrections

5. **Russia's status as a safe haven among large EM.** Rate cuts, low bond holdings by local banks and their permanent misreading of central bank action, low financing needs and a positive net international investment position, a rare situation among EM, make OFZs an attractive investment in EM. The main risks are currency valuation and large issuance.

The CZK, the HUF and the PLN are undervalued, but are also vulnerable to changes in risk appetite

The RUB is overvalued…

…as are the RON and the RSD

Many bond investors prefer to hold an open FX position, despite low hedging costs in central Europe. Our fair value models show that the CZK and the PLN are moderately undervalued, the HUF is significantly undervalued and the RUB is overvalued. The three central European currencies could benefit from favorable seasonal flows over the summer, but are vulnerable to changes in risk appetite and to poor C/A data. This may be the case especially for the HUF, with EUR-HUF a buy below 340. Conflicting verbal interventions by the NBP and the Polish ministry of finance could stoke up EUR-PLN volatility. However, we believe this is a short-term phenomenon that could be enhanced by uncertainty surrounding the second round of presidential elections held on 12 July. In our view, EUR-PLN should trade below 4.40. The RUB remains strongly correlated with oil prices when Brent is close to or below USD 40/bbl. According to our models, USD-RUB fair value could be closer to 75, rather than to current levels. While the RON and the RSD remain overvalued, the NBR and the NBS will be able to cap depreciation through FX interventions and moral suasion.

ROMGBs the top pick among EU-CEE local-currency bonds…

…followed by POLGBs and long-end CZGBs

ROMGBs remain our top pick among local-currency EU-CEE bonds. They continue to trade close to BB levels, despite lower risks of a rating downgrade this year, both from S&P (which expects a 10% pension increase this year) and from Fitch (which considers the EU's RRF a support to ratings in EU-CEE). Strong local support is a plus for POLGBs and long-end CZGBs, but both carry higher currency risks than ROMGBs.

Despite solid performance of TURKGBs, foreign interest has been curtailed by the authorities' decisions to reduce the provision of TRY liquidity to foreign investors. This alone reduces the eligibility of TURKGBs for the portfolios of many long-only funds.

ROMANI top the EUR space

Throughout the region, EUR bonds remain cheaper than local-currency bonds and may be preferred by investors who do not want to assume currency risk. ROMANI spreads to the rest of the region should fall further as the bonds shed some of the downgrade risk that was previously priced in to them (Chart 11).

CHART 10: BOND PERFORMANCE PROPORTIONAL TO CENTRAL BANK SUPPORT

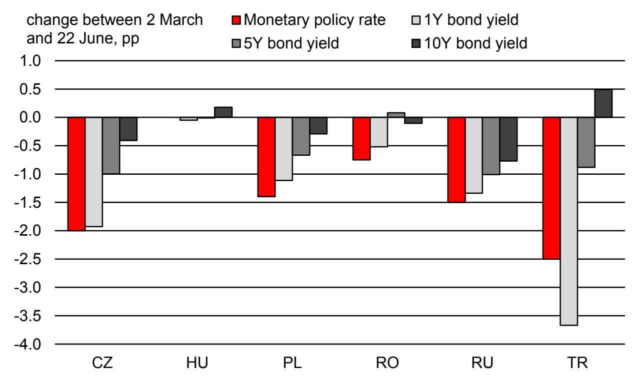
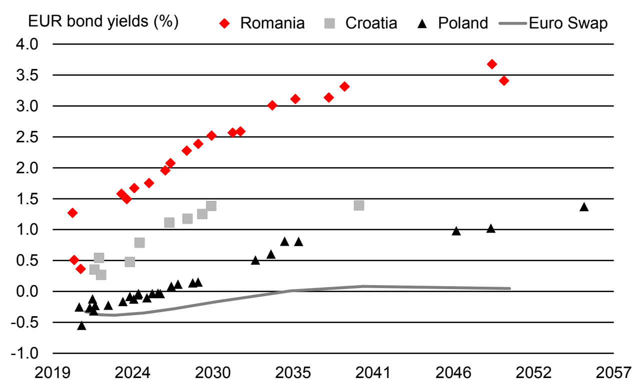


CHART 11: ROMANI YIELDS SHOULD REFLECT A LOWER DOWNGRADE RISK



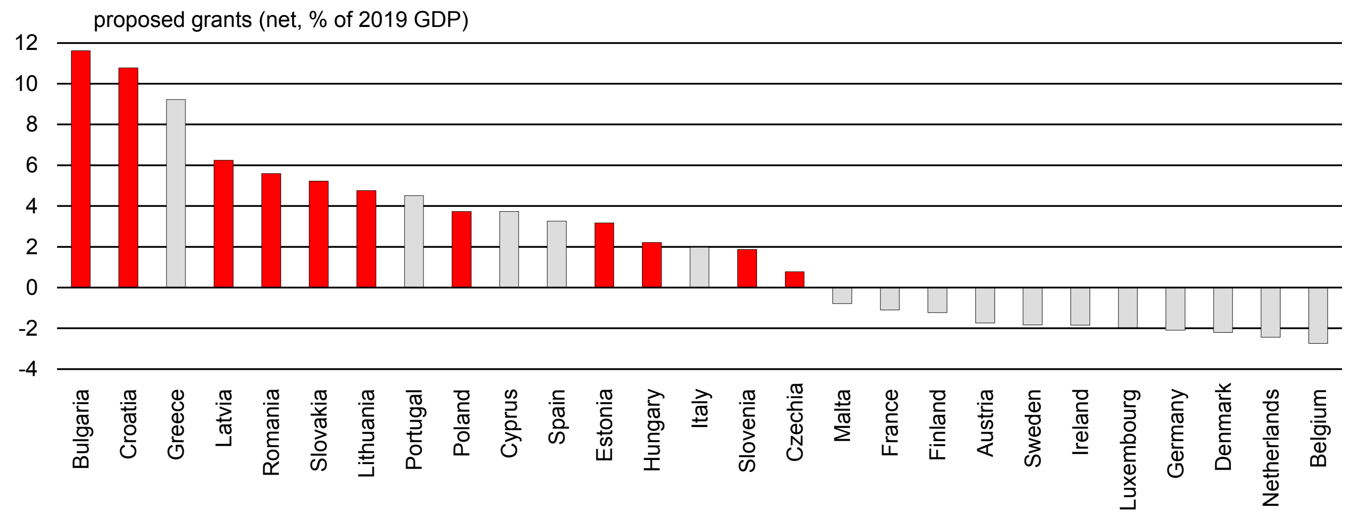
Source: central banks, Bloomberg, UniCredit Research

The RRF – a game changer, but not in the short term

The RRF would significantly boost EU fund flows into EU-CEE in 2021-27

If adopted, the EU's RRF will be a game changer both due to its size (in combination with the 2021-27 MFF) and to its common European borrowing. Chart 12 shows that, in net terms, EU-CEE countries stand to benefit the most from the grant part of the facility, together with southern European countries. Assuming that the MFF remains as proposed earlier this year, the RRF would result in more funding in 2021-27 compared to the previous 2014-20 MFF, for Bulgaria, Croatia and Romania (as a percentage of GDP). At the same time, the RRF would reduce the gap in funding for the other EU-CEE countries. For the Visegrad Four, the net cut in funding would halve from around 0.8-1% of GDP per year in the MFF proposition.

CHART 12: EU-CEE COUNTRIES WILL BE AMONG THE MAIN BENEFICIARIES OF THE RRF



Source: European Commission, Eurostat, UniCredit Research

The disbursement could start in 2H21 at the earliest and pick up from 2022 onwards

However, expectations of a rapid disbursement are too optimistic. The European Commission (EC) released its own expected schedule of disbursement[9] that shows little funding in 2021, followed by a rapid pick-up in 2022 and beyond. This looks plausible when assuming that an agreement on the framework may be reached only in late 2020 and the EC is likely to use the current procedure for disbursing structural and investment funds for the RRF. From the point of view of the recipient, this implies several stages: **1**. a national investment program submitted to the EC; **2**. approval by the EC or, alternatively, requests to amend the program (with a return to step 1); **3**. tenders for project execution; **4**. prefunding received from the EC; **5**. start of projects, including the securing of bridge funding; **6**. project implementation; **7**. national checks and invoices submitted to the EC; **8**. European audit and invoice payment; **9**. post-project audit and potential financial sanctions. This framework, which looks cumbersome to start with, is still not considered good enough to prevent fraud in most stages of an EU-funded project. Using a simpler framework could result in more fraud and a large portion of the money being spent inefficiently.

More timely preparation for the new MFF in EU-CEE

Knowing what awaits them down the line, several EU-CEE countries are already developing a national program for eligible projects, hoping to get a greenlight from the EC by early 2021. Even if the EC accedes to increase prefunding, RRF funds will not start flowing in earnest until 2H21 at the earliest, picking up in subsequent years.

However, the current crisis is likely to act as a catalyst for better fund absorption throughout EU-CEE. Even past laggards such as Bulgaria and Romania are developing their project frameworks significantly faster than in the past, knowing that the governments' own resources for investment may be limited in the coming years. This could significantly reduce the period of low growth that marks the start of every EU MFF in EU-CEE, from two-three years in the past to less than a year. As a result, public investment and EU fund absorption could start to pick up from as early as 2H21, helping EU-CEE recover the ground lost in 2020.

[9] Details can be found on page 40 of the "Proposal for a Regulation of the European Parliament and of the Council establishing a Recovery and Resilience Facility", published on 28 May

OUR GLOBAL FORECAST

	GDP growth, %			CPI (Avg), %			Policy rate**			10Y bond yield (EoP), %			Exchange rate (LC vs. USD)		
	2019	2020F	2021F	2019	2020F	2021F	2019	2020F	2021F	2019	2020F	2021F	2019	2020F	2021F
Eurozone	1.2	-11.0	8.0	1.2	0.4	1.3	-0.50	-0.50	-0.50				1.12	1.15	1.18
Germany*	0.6*	-8.0*	8.0*	1.4	0.3	2.2				-0.19	-0.40	0.10			
France	1.5	-12.3	9.5	1.1	0.7	1.2									
Italy	0.3	-14.0	7.0	0.6	0.0	0.6				1.41	1.60	2.10			
UK	1.4	-9	6.6	1.8	0.9	1.6	0.10	0.10	0.10				1.32	1.30	1.35
USA	2.3	-7.4	6.3	1.8	0.9	1.7	1.75	0.25	0.25	1.92	0.90	1.45			
Oil price, USD/bb (avg)l													64	41	47.5

*Non-wda figures. Adjusted for working days: 0.6% (2019), -8.3% (2020) and 8.0% (2021): **Deposit rate for ECB*Source: Bloomberg, UniCredit Research

THE OUTLOOK AT A GLANCE

Real GDP (% change)	2018	2019	2020F	2021F
CEE-EU	4.4	3.7	-8.3	7.3
Bulgaria	3.1	3.4	-7.2	6.7
Czechia	2.8	2.5	-10.3	6.8
Hungary	5.1	4.9	-8.0	7.6
Poland	5.3	4.1	-6.8	7.0
Romania	4.4	4.1	-7.9	7.5
Croatia	2.7	2.9	-10.5	6.9
Russia	2.3	1.3	-5.4	3.8
Serbia	4.4	4.2	-5.0	6.3
Turkey	2.8	0.9	-5.6	6.6

CPI (% change)	2018	2019	2020F	2021F
CEE-EU	1.9	3.4	2.2	3.0
Bulgaria	2.7	3.8	2.9	2.8
Czechia	2.0	3.2	2.2	2.5
Hungary	2.7	4.0	2.5	3.7
Poland	1.1	3.4	2.2	3.3
Romania	3.3	4.0	3.1	3.1
Croatia	0.8	1.4	0.4	2.0
Russia	4.3	3.0	3.7	3.5
Serbia	2.0	1.8	1.4	2.1
Turkey	20.3	11.8	8.7	10.4

C/A balance (% GDP)	2018	2019	2020F	2021F
CEE-EU	-0.8	-0.4	-1.3	-0.2
Bulgaria	1.4	4.0	2.1	2.9
Czechia	0.4	-0.4	-2.5	-1.2
Hungary	0.0	-0.9	-2.5	-0.9
Poland	-1.0	0.5	0.5	1.1
Romania	-4.4	-4.6	-4.7	-4.3
Croatia	1.9	2.9	-5.6	1.2
Russia	6.8	4.2	1.9	1.5
Serbia	-4.8	-6.9	-6.3	-6.0
Turkey	-2.7	1.2	-1.4	-2.0

Extended basic balance (% GDP)	2018	2019	2020F	2021F
CEE-EU	2.6	2.8	2.0	2.7
Bulgaria	3.6	6.5	4.9	7.4
Czechia	1.6	1.2	-1.5	0.0
Hungary	4.3	2.2	2.1	2.9
Poland	3.6	4.4	4.9	4.4
Romania	-1.1	-1.2	-1.6	-1.4
Croatia	4.8	6.9	-0.2	5.8
Russia	5.4	4.3	2.0	1.4
Serbia	2.5	0.9	-1.1	-0.5
Turkey	-1.5	1.9	-0.9	-1.3

External debt (% GDP)	2018	2019	2020F	2021F
CEE-EU	68.8	64.9	69.7	63.2
Bulgaria	60.3	56.2	58.8	54.6
Czechia	82.8	77.5	87.9	82.6
Hungary	81.1	73.9	80.8	70.9
Poland	63.3	59.0	60.5	51.6
Romania	33.4	33.0	37.0	36.1
Croatia	82.7	75.7	90.7	84.3
Russia	28.0	28.3	29.7	27.9
Serbia	62.2	61.9	69.0	65.0
Turkey	56.4	58.0	64.0	61.7

General gov't balance (% GDP)	2018	2019	2020F	2021F
CEE-EU	-0.6	-1.1	-7.7	-4.0
Bulgaria	2.0	2.1	-3.3	-1.6
Czechia	0.9	0.3	-9.0	-5.5
Hungary	-2.1	-2.0	-3.9	-1.9
Poland	-0.2	-0.7	-8.4	-4.3
Romania	-2.9	-4.3	-8.0	-4.3
Croatia	0.2	0.4	-8.3	-3.0
Russia	2.6	1.8	-5.0	-2.5
Serbia	0.6	-0.2	-10.0	-1.5
Turkey	-3.5	-5.4	-7.7	-5.6

Gov't debt (% GDP)	2018	2019	2020F	2021F
CEE-EU	46.6	44.4	55.0	53.9
Bulgaria	21.8	19.9	24.8	25.5
Czechia	32.6	30.8	42.2	44.3
Hungary	68.5	64.7	73.1	68.0
Poland	48.4	45.4	55.4	53.9
Romania	34.7	35.2	44.8	44.8
Croatia	74.7	73.2	89.9	85.8
Russia	12.0	12.4	16.6	16.9
Serbia	54.4	52.9	64.0	61.0
Turkey	30.4	33.1	39.7	38.7

Policy rate (%)	2018	2019	2020F	2021F
CEE-EU				
Bulgaria	-	-	-	-
Czechia	1.75	2.00	0.05	0.25
Hungary	0.90	0.90	0.75	0.75
Poland	1.50	1.50	0.10	0.75
Romania	2.50	2.50	1.00	1.00
Croatia	-	-	-	-
Russia	7.75	6.25	4.00	4.00
Serbia	3.00	2.25	1.00	1.00
Turkey	24.00	12.00	7.50	7.50

FX vs. EUR	2018	2019	2020F	2021F
CEE-EU				
Bulgaria	1.96	1.96	1.96	1.96
Czechia	25.7	25.4	26.5	25.6
Hungary	322	331	345	345
Poland	4.30	4.26	4.40	4.35
Romania	4.66	4.78	4.85	4.95
Croatia	7.42	7.44	7.50	7.50
Russia	79.5	69.3	78.2	81.3
Serbia	118.2	117.6	118.3	118.9
Turkey	6.1	6.7	7.8	8.9

Source: National statistical agencies, central banks, UniCredit Research

EM VULNERABILITY HEATMAP

	BG	CZ	HR	HU	PL	RO	RS	RU	SK	TR	UA	MX	BR	CL	SA	ID	IN	CN	AG
External Liquidity																			
Current account (% of GDP)	5.9	0.3	2.9	-0.8	1.3	-4.3	-7.1	3.1	-4.0	0.2	-0.8	0.5	-2.6	-3.7	-3.0	-2.5	-0.9	0.6	-2.6
Extended Basic Balance (% of GDP)	8.8	2.2	6.9	2.3	4.8	-1.8	0.4	4.3	1.3	0.9	0.7	2.2	-0.6	-1.2	-3.5	-0.9	0.4	0.9	-2.5
FX Reserves coverage (months of imports)	8.6	9.1	8.1	2.7	4.4	4.4	6.1	14.8	-	2.6	4.0	4.4	15.3	5.7	5.7	6.8	8.4	15.1	8.4
External Debt (excl.ICL, % of GDP)*	38.4	78.3	64.4	52.9	43.1	33.0	61.8	18.6	91.6	58.0	78.6	36.2	59.2	73.2	52.7	34.9	19.9	14.3	53.2
Short-term debt (% of GDP)	14.8	45.7	24.5	9.1	9.5	6.2	4.2	4.0	43.8	15.7	10.5	3.7	5.0	8.2	9.8	4.1	7.4	8.4	12.2
REER (Index, 2010=100)	104.4	95.0	97.7	83.8	89.3	98.3	124.3	80.3	-	56.6	97.5	69.2	51.1	82.2	76.3	92.5	104.7	122.4	-
Domestic Finances																			
Corporate debt (% of GDP)	47.1	52.3	62.9	51.6	44.1	35.9	43.5	32.8	54.2	71.8	60.5	37.1	42.3	86.1	57.7	39.3	45.8	153.6	15.7
Household Debt (% of GDP)	23.6	34.4	35.9	21.7	35.1	18.6	20.5	16.5	45.8	15.0	5.7	16.3	45.9	37.4	34.2	16.3	12.6	54.6	6.6
Nonresident holdings of gov.debt (% total)	1.0	36.8	-	28.1	18.2	18.5	16.8	39.4	51.9	4.6	-	26.1	13.4	-	37.1	38.6	-	8.9	-
Banking System																			
Credit Impulse (% of GDP)	**-0.1**	**-0.2**	**0.4**	**2.1**	**-0.6**	**-0.2**	**0.5**	**-3.3**	**0.5**	**4.2**	**-5.2**	**0.5**	**3.3**	**3.5**	**0.9**	**-1.6**	**-2.1**	**5.3**	**-2.0**
Loans/deposit ratio (%)	72.3	64.0	82.4	71.0	91.2	70.9	92.0	91.0	102.8	103.9	151.2	99.9	108.3	103.2	106.1	98.6	111.9	74.9	152.1
NPL (% of total loans)	5.9	2.5	7.0	1.5	4.0	3.9	4.0	9.3	2.9	4.6	48.9	2.1	3.0	1.9	3.7	2.8	9.2	1.8	4.9
Domestic Banks CAR (%)	20.4	19.7	23.2	16.4	18.4	20.3	22.7	12.3	18.2	18.7	19.3	15.7	17.1	12.9	16.8	21.7	15.4	14.2	17.5
Domestic Banks RoE (%)	8.0	18.2	11.3	19.6	7.6	11.7	10.2	19.5	9.5	11.5	32.8	20.9	18.0	16.5	19.2	16.1	2.7	11.7	-

*External debt incl. ICL for CZ, RS, TR, MX, CL and SA

Source: Haver, Bloomberg, National Statistics Offices, Central Banks, IMF, UniCredit Research

Legend
Low vulnerability
Moderate vulnerability
Significant vulnerability
High vulnerability

EM VULNERABILITY HEATMAP (CONTINUED)

	BG	CZ	HR	HU	PL	RO	RS	RU	SK	TR	UA	MX	BR	CL	SA	ID	IN	CN	AG
Policy																			
Policy Rate, nominal (%)	-	0.25	-	0.75	0.10	1.75	1.25	4.50	0.00	8.25	8.00	5.50	3.00	0.50	3.75	4.50	4.00	3.85	38.00
Real policy rate (%)	-	-3.2	-	-1.4	-2.7	-0.5	0.5	1.5	-2.0	-3.1	6.2	2.6	1.1	-2.2	1.1	2.3	-1.4	1.3	-3.8
Real Money market rate (%)	-	-3.1	-1.8	-1.3	-2.7	-0.2	0.3	2.1	-2.4	-3.5	5.5	2.8	-0.2	-2.1	1.0	2.6	0.1	0.4	-18.8
Headline inflation (% yoy)	1.3	3.6	-0.6	2.2	2.9	2.3	0.7	3.0	2.0	11.4	1.7	2.8	1.9	2.8	4.1	2.2	5.9	2.5	43.4
Core Inflation (% yoy)	1.0	2.4	1.7	3.5	3.8	3.7	1.2	2.9	2.0	10.3	3.0	3.6	1.6	2.1	3.5	2.9	4.0	1.0	46.2
GG Fiscal balance (% of GDP)	-2.2	0.3	0.4	-4.5	-1.5	-3.9	-2.4	1.3	-1.3	-2.7	-2.0	-1.4	-6.2	-2.8	-6.6	-2.0	-4.6	-4.8	-3.2
GG Primary balance (% of GDP)	-1.6	0.5	2.6	-2.0	-0.3	-2.7	0.4	2.3	-0.9	-0.4	-	1.3	0.9	-1.8	-2.8	-0.2	-1.6	-3.8	-
Government Debt (% of GDP)	24.0	30.8	73.2	64.7	45.4	35.9	52.9	12.2	48.0	33.1	50.4	42.8	79.3	38.0	62.2	34.6	47.0	50.6	56.6
Markets																			
External Debt Spread (10Y, bp)**	123.9	51.5	175.0	153.7	66.9	290.2	268.2	183.3	69.7	593.4	618.5	254.6	334.6	126.5	440.2	230.1	215.1	72.5	2179.0
Local Currency Curve (5Y, %)***	0.4	0.4	0.8	1.5	0.8	3.6	2.6	5.0	-0.2	11.9	6.3	5.1	5.4	1.6	8.0	6.7	5.4	2.6	39.7
Local currency bond spread (2s10s)****	89.4	86.8	35.6	115.6	121.2	51.1	134.7	111.0	66.2	427.0	147.1	112.2	320.0	416.0	264.8	138.0	144.5	56.9	-1428.4
CDS (5Y, bp)	52	46	83	78	63	140	121	98	56	483	511	159	269	94	292	128	116	50	-
FX 3m implied volatility (%)	-	7.0	4.0	6.6	6.4	2.3	-	13.9	-	16.1	-	16.8	21.6	12.9	17.7	12.4	6.6	4.5	15.2
Structural*****																			
IBRD Doing Business	61	41	51	52	40	55	44	28	45	33	64	60	124	59	84	73	63	31	126
WEF Competitiveness Ranking	49	32	63	47	37	51	72	43	42	61	85	48	71	33	60	50	68	28	83
Unemployment (%)	6.2	2.3	6.4	3.7	3.1	4.8	10.2	5.8	6.0	13.2	8.2	4.7	12.6	9.0	29.1	5.0	23.5	5.9	9.7

**Spread between 10Y EUR government bond yields and the corresponding German government bond yields for BG, HR, HU, PL, RO. For CZ, the spread refers to the 5Y yield. For the other countries, the spread is computed with respect to US government bond yields; ***Data for UA refer to the generic USD bond. Data for HR refer to the 4Y bond; ****Data for UA refer to the generic USD bond. Data for CL refer SA to the spread between 8Y and 2Y bond and 9Y and 2Y bond; respectively. Data for HU refer to spread between 10Y and 3Y bond; *****IBRD and WEF indicators for 2019;

Source: Haver, Bloomberg, National Statistics Offices, Central Banks, IMF, UniCredit Research

Legend
Low vulnerability
Moderate vulnerability
Significant vulnerability
High vulnerability

CEE Strategy: A glass half full

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- Appetite for risk returned in 2Q, pushing equity prices higher and credit spreads tighter. EM bonds benefited as well, but only higher-rated issuers have shown consistently positive returns during 1H20.
- Central banks have indicated that they will do what is needed to keep financing conditions easy and this will help to offset risks from lingering threats to economic recovery. We see room for a weaker dollar and tighter credit spreads (also across EM) in 2H. However, downgrades and default rates are on the rise, especially in the regions and sectors most exposed to the crisis.

Recent performance

A return of appetite for risk has characterized market performance in the second quarter. Equity markets built on the sharp rebound recorded in the second half of March and moved higher for most of 2Q, sustained by unprecedented policy support and signs of improvement in growth outlooks. Risk-free rates moved mostly sideways, caught between central banks' asset purchases and rising funding needs. The positive mood eased buying pressure on the US dollar and allowed for a tightening of credit spreads, which also benefited from direct support from asset-purchasing programs. EM bonds have benefited from improved risk sentiment and have delivered positive performance across most segments of the market in 2Q. Hard-currency-denominated bonds have outperformed local-currency-denominated bonds. Lower-rated bonds have tightened more in 2Q but continue to show negative YTD performance.

Better-rated bonds have shown a more-consistent performance in 1H. Chart 2 shows the QTD and YTD returns for USD-denominated bonds issued by EM sovereigns. Countries rated BBB and higher have shown positive returns across both samples. Countries rated BBB to BB- have displayed a more-mixed a picture, while those rated below BB- have yet to recover 1Q losses and are down YTD. Several CEE countries are listed among those that have registered a consistently positive performance – a positive feature during a period of market tension.

Our strategy view for 2H

Our forecasts for 2H remain based on the expectation that central banks will do what is needed to keep financing conditions easy and will help to offset the risks from lingering threats to economic recovery. The Fed's actions seem set to keep the 0-5Y segment of the UST curve anchored around current levels, while we expect the 10Y yield to reach 0.9% by the end of this year.

CHART 1: A QUICK RECOVERY

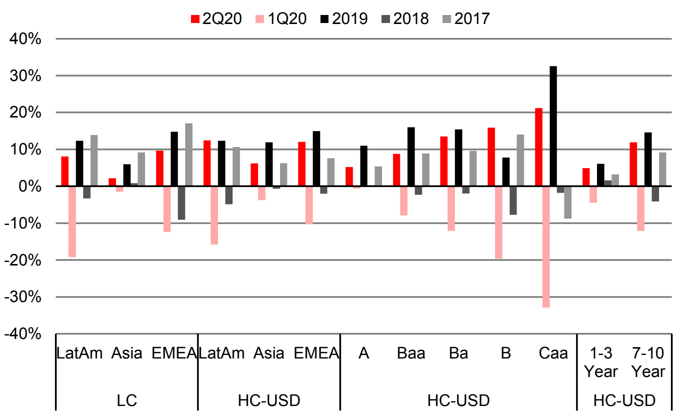
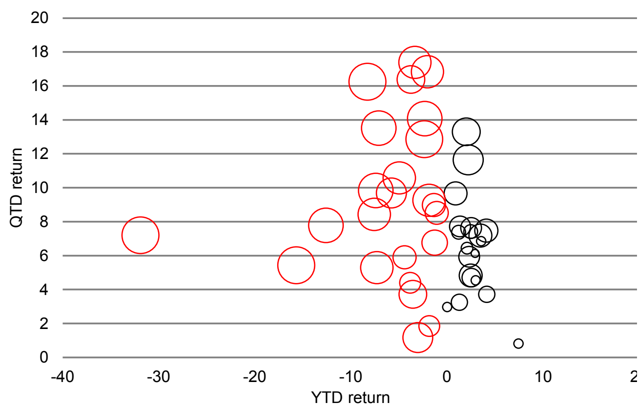


CHART 2: EM USD SOVEREIGN: YTD, QTD PERFORMANCE



Larger bubbles indicate a lower sovereign rating (Bloomberg composite). Only issuers with more than USD 3bn of bonds outstanding have been considered.

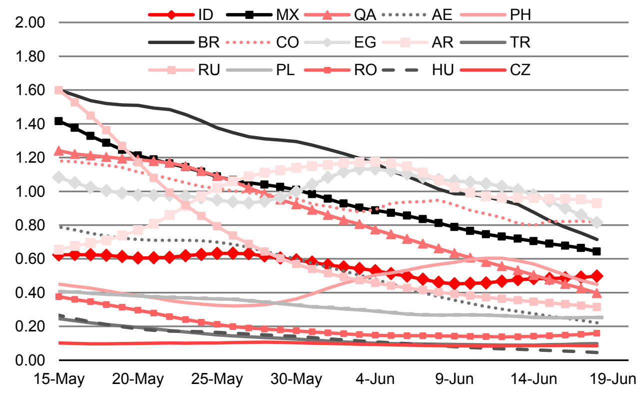
Source: Bloomberg, UniCredit Research

Despite the increase in Germany's deficit, scarcity will remain a key feature of the Bund market due to the significant amount of purchases being made by the ECB. We are maintaining our view on 10Y Bund yields; we project that their yield will be at -0.4% at the end of this year.

We also expect central-bank action to remain a key driver of credit spreads. The IG universe should benefit from quantitative-easing programs, but high-yield bonds will likely tighten too on the back of improved market sentiment, which should also sustain equity valuations as earnings improve gradually. We expect positive sentiment to continue to weigh on the US dollar, but with most news on the EUR probably already priced in, we see EUR-USD moving more gradually in 2H and closing the year at 1.15. With downward pressure on credit spreads, UST yields in check, the prospects of a weaker US dollar still prevalent and central bank liquidity remaining abundant, financing conditions across the globe should remain easy, benefiting EM exposure.

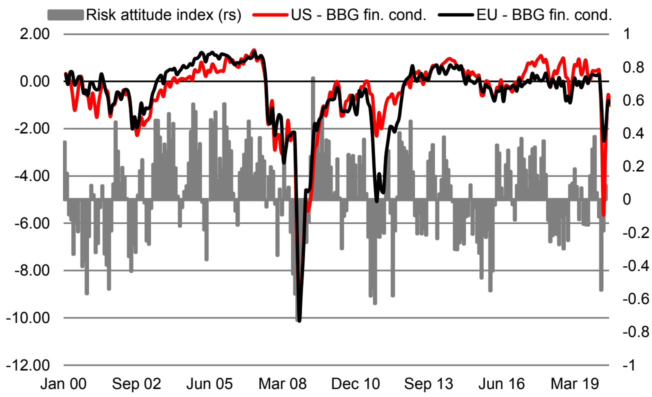
That said, after a sharp rally – and considering the uncertainty surrounding the economic recovery and the lingering threat of a surge in COVID-19infection rates – we believe that volatility will remain high over the coming months. Moreover, credit markets will have to cope with rising default rates and an increasing amount of fallen angels, especially in the regions and sectors most exposed to the economic fallout from the pandemic.

CHART 3: INFECTION RATES STILL HIGH ACROSS SOME EM



Increase in COVID-19 cases over 14 days as a share of the total number of cases 14 days before

CHART 4: FINANCING CONDITIONS



Risk attitude index: For more info, see *UniCredit Risk Dashboard*, July 2018.[10]

Source: Bloomberg, UniCredit Research

A stronger EUR might benefit CEE

The US dollar's safe-haven role was confirmed during the recent market sell-off. As tension has eased, it has started to weaken. The US Dollar Index (DXY) remains above its 5Y average and, amid an improvement in global growth prospects, it should soften further. The Franco-German proposal to establish a recovery fund, followed by the announcement of the European Commission's recovery package, boosted confidence in the EUR and favored a rapid rise in EUR-USD. CEE currencies have historically been highly correlated with the development of the EUR (as shown in Chart 3). This is especially the case for PLN, CZK, HUF and RON, while the development of the TRY and RUB has been increasingly more asynchronous in the past few years. Hence, the seemingly positive market attitude shown toward the EUR and toward EUR-denominated assets might have a positive effect on CEE markets. The region is also set to benefit directly from disbursements made under the European Commission's recovery plan. The ECB's asset-purchasing programs have been extended, and its pandemic emergency purchasing program (PEPP) will run until at least mid-2021. The redemption of bonds under the PEPP will be rolled over until YE 2022.

[10] For more information, see https://www.research.unicredit.eu/DocsKey/economics_docs_2018_165530.ashx?M=D&R=61500230.

The increasing size of the ECB's balance sheet wil help markets digest the large supply of sovereign and corporate bonds but is also likely to support – over time and especially amid improved market sentiment – a reallocation towards higher-yielding assets. In this respect, CEE bonds might benefit from portfolio reallocation flows both in hard-currency-denominated paper and in local-currency-denominated bonds if the risk of depreciation for EUR crosses subdues.

Flows into EM have room to catch up

While contributing to stabilizing sentiment across global market, central banks' actions have also helped halt outflows from EM assets. Data from the International Institute of Finance (IIF) show that, over the past few weeks, net flows into EM portfolios have become more balanced and that there are some signs of a return of inflows across equity exposure. It should be noted that in both Europe and the US, credit funds have already seen a sharp rebound in net flows. The recovery started with IG exposure, but after the Fed stepped up its support for the credit market, high yield-funds also recorded sharp inflows and have been progressively offsetting 1Q redemptions. EM might be next if the recovery in global growth does not stall. That said, given recent deterioration in fiscal positions and differences in COVID-19 infection levels across regions and also considering the good performance seen in 2Q, a selective and cautious approach seems warranted across EM.

CHART 5: CORRELATION WITH EUR-USD

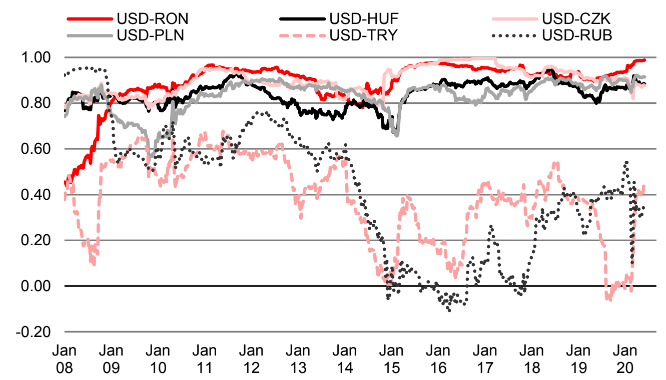
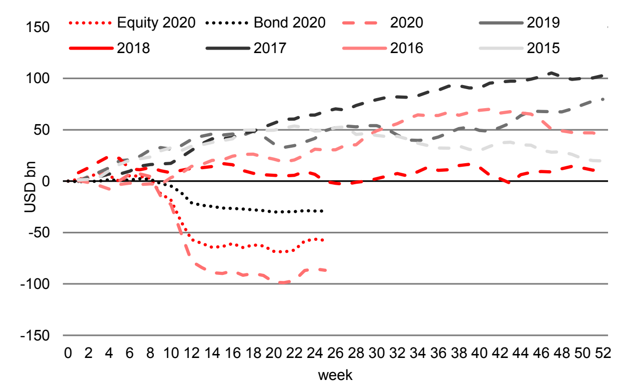


CHART 6: CUMULATIVE EM PORTFOLIO FLOWS



Source: IIF, Bloomberg, UniCredit Research

The sharp fall in the VIX suggests that CEE currencies and EM bonds could recover further

Credit-spread dynamics across EM (and in global markets more generally) have historically been strongly correlated with measures of implied volatility, such as the Chicago Board Options Exchange Volatility Index (VIX). With markets being driven more and more by risk appetite and central-bank liquidity, such relationship will likely persist and become stronger over the coming months. Over the past 15 years, the VIX has gone through four main episodes of tension, often characterized by a double spike in volatility before volatility gradually eased. The record high reached by the VIX in March of this year was comparable to its peak during the financial crisis of 2008-09, when tensions lasted longer and the VIX fell back to its historical average very gradually. In 2010 and 2011, the VIX rose again to above 45 points, while more recent spikes have been short-lived and less-pronounced. Chart 8 shows a comparison of the performance of several segments of the EM bond market and CEE currencies in the aftermath of such a volatility spikes to the ongoing easing of implied-volatility levels. After the financial crisis of 2008-09, the performance of several of the assets considered was outstanding. Recent market moves appear more comparable to exampled pertaining to the periods 2010-11 and 2011-12. The data in the chart suggest that there might be more room for the US dollar to weaken, while the PLN, CZK, HUF and TRY might benefit, lacking idiosyncratic reasons for weakness. Across EM, local-currency-denominated bonds might have more room to catch up, while long-duration bonds might have already fully contributed to performance. Additional easing in the VIX would offer more support.

CHART 7: CREDIT SPREADS, THE VIX AND THE USD

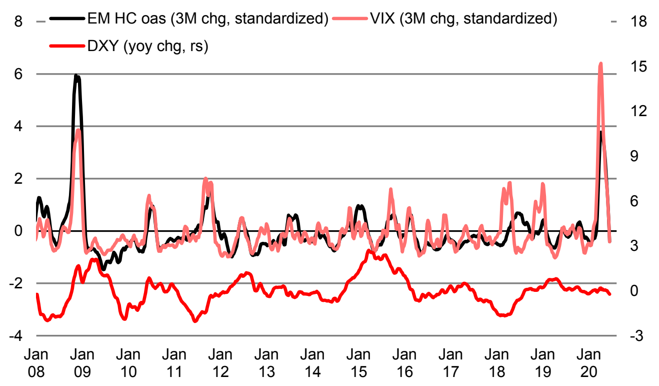
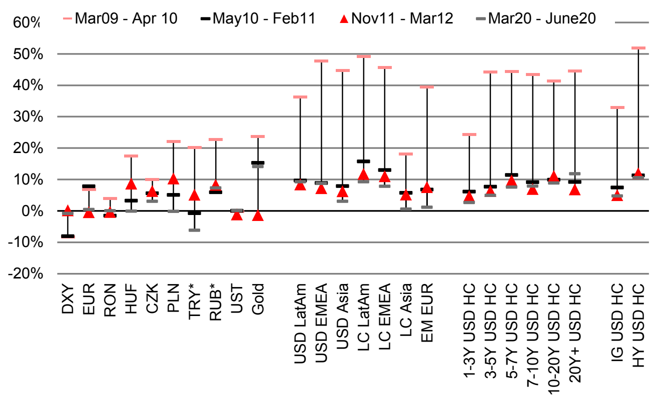


CHART 8: PERFORMANCE WHEN THE VIX FALLS



Source: Bloomberg, UniCredit Research

Funding conditions have improved, and supply does not present a threat

Fiscal support measures to economies battered by the coronavirus has sharply increased funding needs for sovereign issuers. For the riskiest borrowers, accessing primary markets has been difficult for several weeks, especially during the recent sell-off. However, as central-bank liquidity has eased tensions, supply activity on the part of IG issuers has reached a record pace and markets have gradually reopened to lower-rated issuers. The amount of EM bonds issued YTD is larger than the amount issued during the first halves of 2019 and 2018, and this has had no material implication for credit spreads across the market. The acceleration in funding for both EMEA and Asia has been material across sovereign issuers, but the same holds true also for corporate and financial issuers. Moreover, issuers have had the option of tapping the market at long tenors as well, keeping average life at issuance above levels seen in 2019 and 2018. Most of the investable universe of USD-denominated sovereign paper in the EM space comes with a duration (OAD) of between four and ten years. Only higher-rated issuers have sizable amounts outstanding with durations of beyond ten years, and they generally are associated with credit spreads of below 200bp. Distribution across duration and spread is of particular interest, considering that central-bank policies have been limiting volatility and keeping risk-free rates close to historical lows. On the one hand, this might strengthen the hunt for yield and should favor tightening in credit spreads. On the other hand, it might push higher-rated issuers to extend further the average maturity of their debt. Hence, supply does not seem to pose a major threat to EM bonds.

CHART 9: SHARP RECOVERY IN SUPPLY

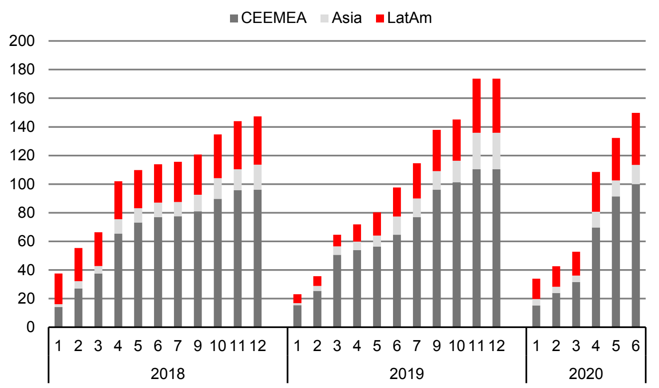
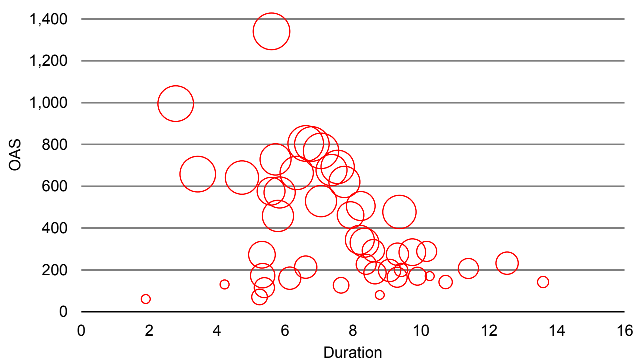


CHART 10: SOVEREIGN EM IN USD

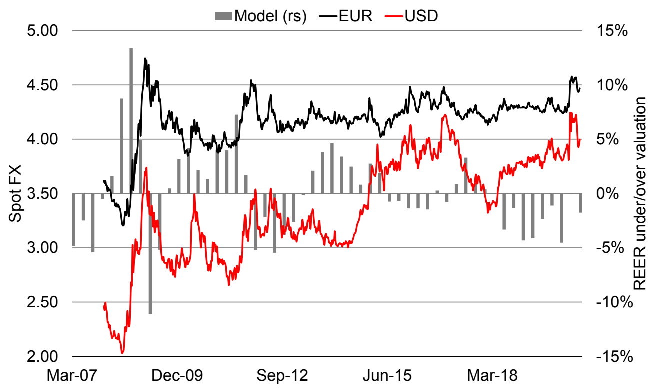


Source: Bloomberg, Bondradar, UniCredit Research

Updating our REER models

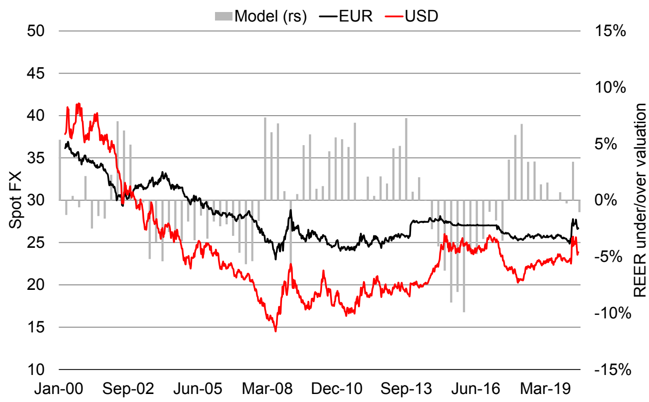
PLN

- Some improvement in market sentiment has allowed the PLN to recover part of its earlier losses, but it remains more than 4% cheaper against EUR and USD YTD. In REER terms it is down 2% YTD, after its May rebound.
- Our model suggests that the PLN is still moderately undervalued, by nearly 2%. The gap could be easily recovered if market conditions improve in the second half of the year.
- We see EUR-PLN moving to 4.42 by 3Q and closing the year at 4.40. Conflicting verbal interventions by the NBP and the ministry of finance could temporarily boost volatility. The same is valid for the too-close-to-call presidential election runoff scheduled for 12 July.



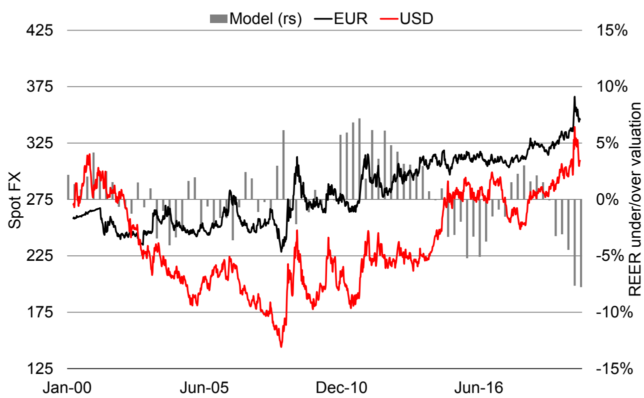
CZK

- CZK has recovered over 50% of the losses it recorded during the March sell-off. Most of the gains happened in May, after some very volatile months. Still, the CZK remains nearly 5% down against the EUR and USD YTD.
- Our model shows the CZK to be modestly undervalued in REER terms (approx. 1%), broadly within error bands.
- We think that EUR-CZK will remain relatively close to current levels in 2H20, before falling below 26 in 2021. Our year-end target is 26.5. Poor trade data and another rate cut could bring EUR-CZK temporarily under pressure. We do not see the need for CNB interventions to appreciate the CZK.



HUF

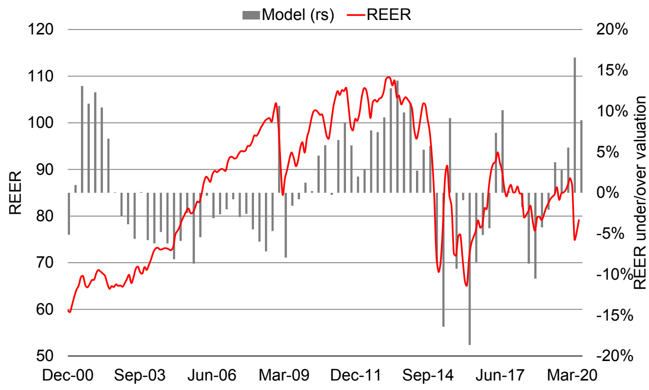
- Like other countries in the region, HUF has rebounded in 2Q. Improved sentiment allowed the currency to recover two thirds of its earlier losses in REER terms. There was a solid performance also compared to EUR and USD, but EUR-HUF and USD-HUF are still down by more than 4% YTD.
- The currency remains undervalued in REER terms, the extent of the undervaluation is stable compared to 1Q and still quite significant (approx. 8%).
- We see the EUR-HUF in the 342-345 during the last two quarters of the year. Dips below EUR-HUF 340 offer good buying opportunities. The NBH has become more reactive and seems to prefer a large liquidity surplus in the interbank market. This, in turn, is weighing on short-term rates, cheapening HUF shorts.



Source: Haver, Bloomberg, UniCredit Research

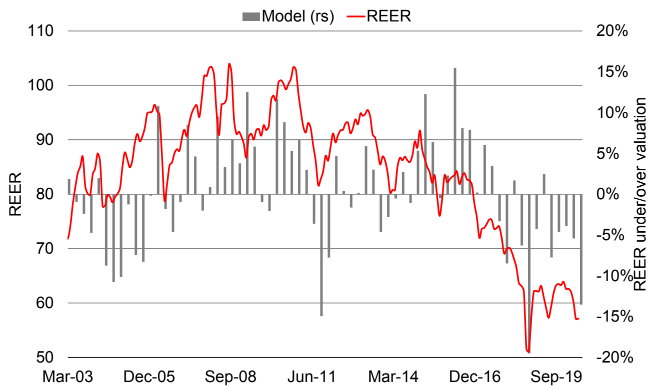
RUB

- The RUB has fallen back below 70 against the dollar, thanks to increased appetite for risk and rising oil prices. In REER terms, the RUB has recovered the lion's share of its drop of over 20% in March, but remains lower than at year-end 2019.
- The currency is shown as overvalued by our REER model, but the extent of the overvaluation has dropped recently, falling into single-digit territory.
- We think oil prices will remain close to current levels in 2H20 and see the RUB at 68 against the US dollar by the end of the year. This implies that the overvaluation will persist throughout the year.



TRY

- The TRY has remained under pressure in 2Q, showing only brief signs of recovery, while risk appetite returned to global markets. EUR-TRY and USD-TRY are trading nearly 15% above their year-end 2019 levels.
- The currency has also become more than 7% cheaper in REER terms since the beginning of the year and our model suggests it is undervalued by more than 10%.
- Despite the above factors, we think that the TRY will remain under pressure for the rest of the year, posting a modest recovery from current levels. We forecast EUR-TRY and USD-TRY at 7.79 and 6.77, respectively, at the end of the year. Most of the depreciation could be prompted by external financing needs, which remain large. Since the provision of TRY liquidity to foreign investors has been curtailed, risk-off episodes could have a stronger impact on short-term rates than on the exchange rate.



Source: Haver, Bloomberg, UniCredit Research

Countries

Bulgaria

Baa2 positive/BBB stable/BBB stable*

Outlook

Bulgaria has remained on the periphery of the coronavirus pandemic. Stepped up fiscal support will help the country avoid a sharp increase in unemployment. However, this is unlikely to prove enough to prevent a major drop in household income and purchasing power, which will send the economy into its deepest recession since 1997. ERM II membership and the lack of major excesses in the expansion period preceding the coronavirus-induced recession will be the main stabilization factors.

Strategy

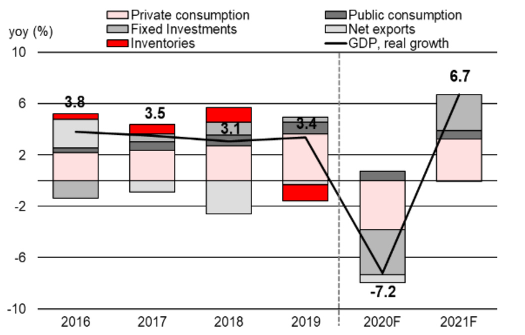
Market attention has shifted to the Eurobond issue planned for July, amid better-than-expected fiscal metrics in the early stages of the coronavirus-induced recession.

Author: **Kristofor Pavlov**, Chief Economist Bulgaria (UniCredit Bulbank)

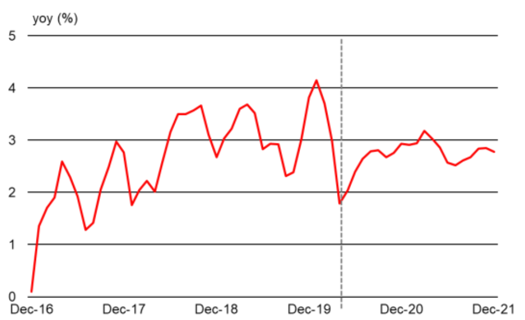
KEY DATES/EVENTS

- 15 July, 17 Aug, 15 Sep: CPI
- 12 Aug: Labor force (2Q20)
- 14 Aug, 04 Sep: 2Q20 GDP (flash, structure)
- 21 Aug: rating review from Fitch

GDP GROWTH FORECAST



INFLATION FORECAST



Source: National Statistical Institute, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2017	2018	2019	2020F	2021F
GDP (EUR bn)	52.3	56.1	60.7	58.0	63.5
Population (mn)	7.1	7.0	7.0	6.9	6.9
GDP per capita (EUR)	7 420	8 012	8 728	8 395	9 261
Real economy, change (%)					
GDP	3.5	3.1	3.4	-7.2	6.7
Private consumption	3.8	4.4	5.8	-6.0	5.0
Fixed investment	3.2	5.4	2.2	-18.5	16.9
Public consumption	4.3	5.3	5.5	4.5	3.5
Exports	5.8	1.7	1.9	-18.8	18.0
Imports	7.4	5.7	2.4	-17.7	17.6
Monthly wage, nominal (EUR)	530	586	651	667	705
Real wage, change (%)	7.3	7.7	8.0	-0.3	3.0
Unemployment rate (%)	6.2	5.2	4.2	7.0	5.6
Fiscal accounts (% of GDP)					
Budget balance	1.1	2.0	2.1	-3.3	-1.6
Primary balance	1.9	2.7	2.7	-2.7	-1.0
Public debt	25.0	21.8	19.9	24.8	25.5
External accounts					
Current account balance (EUR bn)	1.8	0.8	2.5	1.2	1.8
Current account balance/GDP (%)	3.5	1.4	4.0	2.1	2.9
Extended basic balance/GDP (%)	6.8	3.6	6.5	4.9	7.4
Net FDI (% of GDP)	2.5	1.3	1.3	0.5	1.2
Gross foreign debt (% of GDP)	64.7	60.3	56.2	58.8	54.6
FX reserves (EUR bn)	23.7	25.1	24.8	25.9	29.5
Months of imports, goods & services	8.1	8.0	7.8	10.7	10.0
Inflation/monetary/FX					
CPI (pavg)	2.1	2.8	3.1	2.7	2.8
CPI (eop)	2.8	2.7	3.8	2.9	2.8
LEONIA (eop)	-0.39	-0.50	-0.61	-0.58	-0.50
USD/BGN (eop)	1.63	1.71	1.74	1.70	1.66
EUR/BGN (eop)	1.96	1.96	1.96	1.96	1.96
USD/BGN (pavg)	1.74	1.66	1.75	1.73	1.67
EUR/BGN (pavg)	1.96	1.96	1.96	1.96	1.96

Source: Bulgarian National Bank, Eurostat, National Statistical Institute, UniCredit Research

*Long-term foreign-currency credit ratings as provided by Moody's, S&P and Fitch, respectively

Fiscal support will not prevent a sharp fall in income

The length and severity of the recession will depend on the stringency of the lockdown measures as well as the magnitude and the quality of the policy response

So far, Bulgaria has remained on the periphery of the COVID-19 pandemic. Both the number of registered cases and the number of deaths from COVID-19 infection calculated per one million inhabitants, continued to follow the benign trajectory experienced in CEE. As Bulgaria was among the less affected countries, the lockdown measures implemented in its economy were less stringent than those deployed in most countries in Europe. This is positive for the economy because the damage that the lockdown has inflicted is likely to prove smaller.

Faster and more robust recovery than the one following the recession in 2009 remains our baseline scenario

To reflect the latter, along with the upward revision in our growth scenario for the euro area, we are raising our 2020 real GDP growth forecast for Bulgaria to -7.2% from the -7.8% we had anticipated in April. We expect GDP to contract by around 14% qoq in 2Q20. The pace and shape of recovery remains very uncertain. Still our baseline scenario is for a "V" shaped recovery, which should start in 2H20, if there is no second wave of the disease.

Public capex and investment in residential construction will recover soon…

…but investments in machinery and equipment will likely lag behind

Public capex will play an important role in the recovery process. The government remains committed to fully implementing its public capex plan envisaged for the current year. Construction of the Hemus highway, financed from the budget surpluses posted in 2018 and 2019, is progressing rapidly. However, the big difference is EU's Next Generation Plan, where Bulgaria is likely to be among the biggest beneficiaries. Importantly, banks are now in a much stronger position than a decade ago and will continue to provide credit to the real economy. Investment in residential construction is also likely to shift up a gear soon, in our view, as housing prices are more in line with household income and there have been no major excesses during the expansion years preceding the coronavirus-induced recession.

More increases in direct fiscal support are likely by the end of the year

After a slow start, the authorities have stepped up fiscal support. The furlough scheme was extended until September and will most likely be in force at least until the end of this year, while, at the same time, its scope was expanded to include all sectors of the economy. Special support measures were put in place for the most badly affected sectors. Including all the new measures, the total direct fiscal support is set to increase to around 3% of GDP in 2020.

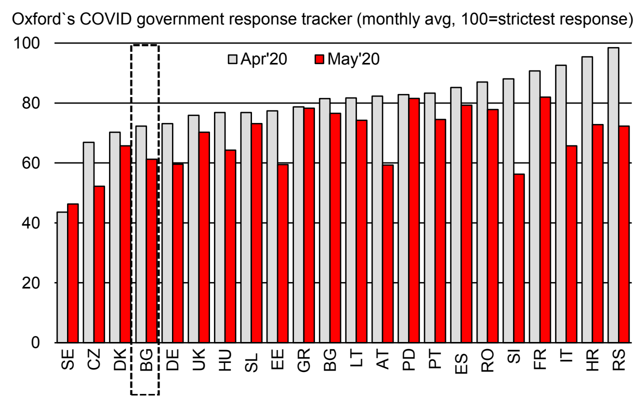
Saving so many jobs this time around would be a remarkable success

We think that, if deployed in full and without major delays, the fiscal support measures will prevent a sharp increase in unemployment. They are likely to keep 240k jobs (5.4% of the working age population) on the payroll, thereby reducing average job losses to 114k in 2020. This would be a remarkable improvement compared to the 2009 recession, when 428k jobs (8.4% of the working age population) were lost and unemployment peaked at 13.8% in 1Q13.

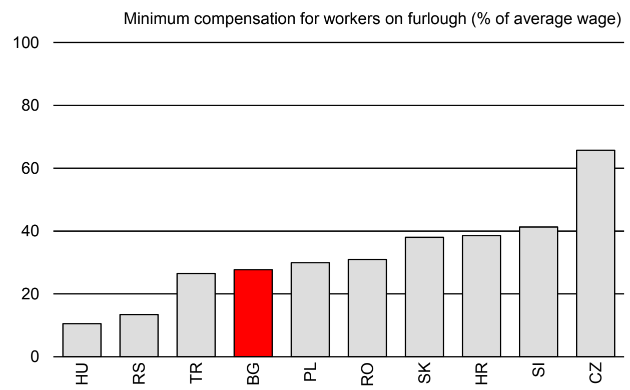
Due to the large grey economy, the design of the furlough scheme significantly reduces the compensated income

However, this is likely to prove insufficient to prevent a major drop in household income. The problem is that while furlough scheme will stave off major job losses, the beneficiaries will be entitled to receive only a small portion of their pre-crisis income. To make matters worse, the sectors worst hit by the pandemic are some of those with the largest share of the grey economy.

LOCKDOWN IN BULGARIA WAS LESS STRINGENT



MINIMUM COMPENSATION OF INCOME LOOKS SMALL



Source: Oxford University, governments, UniCredit Research

While assisting citizens and businesses is the right thing to do, the structure of this assistance is important. This is more so in Bulgaria, where poverty indicators were already elevated before the pandemic

Increasing number of companies are resorting to reducing wages

As the size of benefit, under the furlough scheme, is linked to the volume of social contributions paid prior to the pandemic, the resulting income compensation is small. In the hospitality sector, for example, remuneration reported for contribution payment purposes is usually close to the minimum wage, while the amount actually paid is often more than two times higher. As a result, the furlough scheme in this sector rarely compensates for more than one third of the lost income from the pre-pandemic period. Losses of income have been further exacerbated by the fact that some employees were urged to take unpaid leave, while others have seen their wages cut (see charts). Calculating precise household income losses resulting from wage cuts is impossible at such an early stage. However, there is evidence that these may prove significant as, for example, 8.2% of managers in a poll conducted in April responded that they had already implemented wage cuts, while another 17% planned to do so in May.

The possibility of the economy being significantly crippled justifies an even larger increase in both the scope and scale of government interventions

To fix the problem the government could raise the minimum compensation under the furlough scheme, which currently stands at EUR 187. On the positive side, this would help to increase the compensated income, amid the deepest recession since 1997. On the negative side, it could undermine confidence in the scheme, as the link between the volume of contributions paid and the benefits received will be lost. Alternatively, the authorities could take the opportunity to broker a deal with the representatives of business and trade unions, under which unemployment benefit is raised and the volume of income compensation under the furlough scheme is increased immediately, with the proviso that the unemployment contribution rate and minimum employment income for insurance contribution purposes will be increased when the crisis is over.

There is enough fiscal space to double the proportion of lost income compensated for by the government

The design of the fiscal measures will also matter

It is now clear that the pandemic will last longer than we thought when the fiscal measures were initially deployed. This implies that the fiscal measures may have to be extended well into 2021, as some sectors, such as mass tourism and other sectors related to international travel, for example, will remain under pressure for longer. The magnitude of the ongoing shock means that there will be some permanent losses of income, as some companies will go bankrupt and employees will lose their jobs. Therefore, the design of the measures will be important. The aim should be to concentrate on the viable companies that the coronavirus-induced recession is threatening and provide support to them instead of just prolonging the life of weaker players.

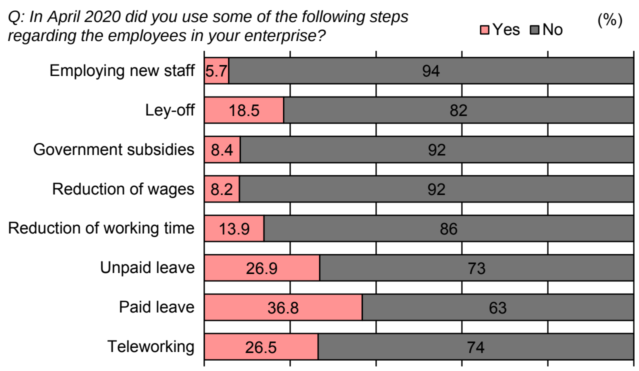
The last remaining obstacle before ERMII membership was removed

The amount paid for a 19% share stake in First Investment Bank was BGN 140 mn, or less than 0.1% of the country's GDP

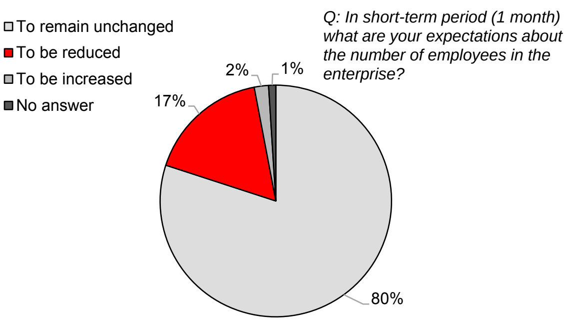
Our baseline scenario envisages Bulgaria to join the euro area on January 1, 2023

The government took part in the capital increase of First Investment Bank. The move was largely anticipated, as attracting capital from the private sector amid the ongoing economic downturn became difficult even in a country like Bulgaria, where banking is a very profitable business. Once the remaining formalities are addressed, we expect Bulgaria to become part of the ERM II and the banking union in the next few months. The years the country will spend in the ERM II will be important. The focus will be on boosting the supervisory capacity of the banks regulator and on preparing the BNB for Eurosystem membership. Above all, the country will have to press ahead with the structural policies needed to ensure that its economy will remain competitive within the fixed exchange rate regime and will fully benefit from being part of the EU's inner core.

SOME COMPANIES IMPLEMENTED WAGE CUTS IN APRIL



MANY COMPANIES ARE CONSIDERING LAYOFFS IN MAY



Source: National Statistical Institute, UniCredit Research

The focus has shifted to the Eurobond issue due in July

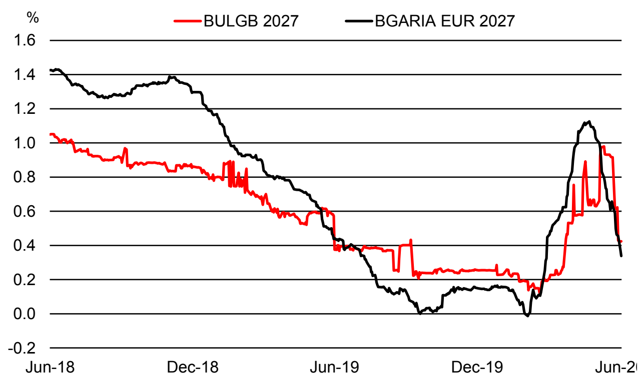
Bulgarian sovereign scrapped 5Y BGN-denominated paper in May

In early May, the Ministry of Finance rejected all orders for 5Y local-currency paper, after three months earlier similar securities had been successfully placed on the primary market at 67bp lower yield. No more domestic market issues are likely, in our view, before the sovereign taps the euro bond market in July. We expect EUR 2bn to be placed externally and another BGN 500nm internally by the end of 2020. This represents a small downward revision of the sovereign funding needs this year, when compared to the forecast we had three months ago.

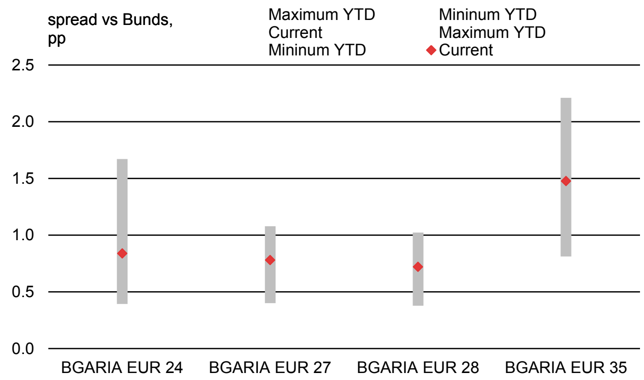
Most fiscal metrics remained at better-than-expected levels in the early stages of the coronavirus-induced recession, which bodes well for the yield on Eurobond issue due in July

The country's fiscal reserve remains at a very comfortable level of BGN 9.1bn (or 8.1% of GDP) at the end of May, according to the balance sheet of the BNB's Issuing Department. At the same time, the budget balance posted a better-than-expected surplus of BGN 1.3bn (or 1.1% of GDP) at the end of May, according to preliminary data from the Ministry of Finance. Tax revenues were 13.8% down yoy in April, which is also positive, as it turned out smaller than the slip in tax revenues we had observed in the early stages of the recession triggered by the global financial crisis in 2009.

BONDS EXPECTED TO FULLY RECOVER LOSSES



BETTER VALUE IN THE LONG END AND MAYBE NEW ISSUES



Source: Bloomberg, UniCredit Research

THE GOVERNMENT'S GROSS FINANCING REQUIREMENTS

EUR bn	2019	2020F	2021F
Gross financing requirement	**1.2**	**3.4**	**2.0**
Budget deficit	0.6	2.6	1.4
Amortization of public debt	0.7	0.7	0.6
Domestic	0.5	0.5	0.4
Bonds	0.5	0.5	0.4
Bills	0	0	0
Loans/other	0	0	0
External	0.2	0.2	0.2
Bonds and loans	0	0	0
IMF/EU/other IFIs	0.2	0.2	0.2
Financing	**1.2**	**3.4**	**2.0**
Domestic borrowing	0.5	0.9	0.8
Bonds	0.5	0.9	0.8
Bills	0	0	0
Loans/other	0	0	0
External borrowing	0.6	2.1	1.6
Bonds and loans	0	2.0	1.5
IMF/EU/other IFIs	0.6	0.1	0.1
Privatization/other	0	0	0
Fiscal reserves change (- =increase)	0.1	0.4	-0.4

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2019	2020F	2021F
Gross financing requirement	**9.4**	**9.7**	**9.5**
C/A deficit	-2.5	-1.2	-1.8
Amortization of medium and long term debt	3.7	3.3	3.7
Government/central bank	0.2	0.2	0.2
Banks	0.5	0.5	0.5
Corporates/other	3.0	2.5	3.0
Amortization of short-term debt	8.2	7.7	7.7
Financing	**9.4**	**9.7**	**9.5**
FDI (net)	0.8	0.3	0.8
Portfolio equity, net	-1.6	0.6	0.7
Medium and long-term borrowing	4.8	9.0	4.7
Government/central bank	0.6	2.1	1.6
Banks	0.6	0.5	0.6
Corporates/other	3.6	6.5	2.5
Short-term borrowing	7.7	7.7	7.8
EU structural and cohesion funds	0.7	1.3	2.1
Other	-3.2	-8.1	-2.9
Change in FX reserves (- = increase)	0.2	-1.0	-3.6
Memoranda:			
Nonresident purchases of LC gov't bonds	0	0	0
International bond issuance, net	0	2.0	1.5

Source: Bulgarian National Bank, Bulgarian ministry of finance, UniCredit Research

Croatia

Ba2 positive /BBB- stable /BBB- stable*

Outlook

The full impact of the COVID-19-induced lockdown on the Croatian economy is still unknown, but some data hint at how deep the economy has nosedived. Data available so far are consistent with our baseline scenario of a 10.5% drop in 2020, despite restrictions having been relaxed slightly earlier than initially projected. Growth in 2020 will very much depend on the performance of tourism in 3Q20. General elections will take place in earl y July with the main party of the outgoing government, HDZ, leveraging on its competent reaction to the COVID-19 spread and on having hit defined milestones in the country's application for ERM II. A positive decision on ERM II now seems very likely.

Strategy

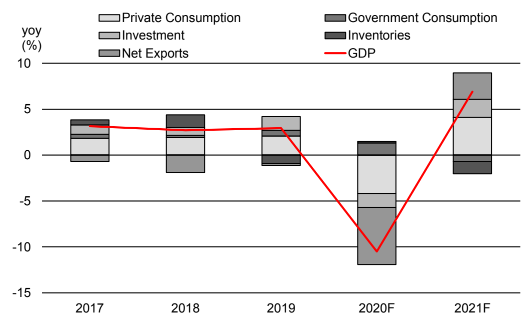
Limited scope for further rally in CROATI EUR, although valuation is not tight and benefits indirectly from CNB bond purchases
.

Author: Hrvoje Dolenec, Chief Economist Croatia (Zagrebacka banka)

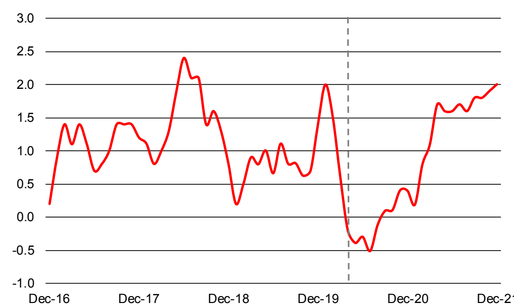
KEY DATES/EVENTS

- July: Decision on ERM II participation
- 5 July: General elections
- 28 August: 2Q GDP

GDP GROWTH FORECAST



INFLATION FORECAST



Source: Eurostat, CNB, Crostat, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

EUR bn	2017	2018	2019	2020F	2021F
GDP (EUR bn)	49.1	51.7	54.0	47.4	52.0
Population (mn)	4.1	4.1	4.1	4.1	4.0
GDP per capita (EUR)	11,907	12,636	13,268	11,678	12,902
Real economy, change (%)					
GDP	3.1	2.7	2.9	-10.5	6.9
Private consumption	3.2	3.2	3.6	-7.2	6.7
Fixed investment	5.1	4.1	7.1	-7.0	8.7
Public consumption	2.2	1.3	3.3	6.9	-3.0
Exports	6.8	3.7	4.6	-31.1	31.0
Imports	8.4	7.5	5.0	-18.1	19.1
Monthly gross wage, nominal (EUR)	1080	1139	1182	1113	1169
Real wage, change (%)	2.8	3.4	3.0	-4.1	2.5
Unemployment rate (%)	11.2	8.4	6.6	10.2	7.8
Fiscal accounts (% of GDP)					
Budget balance	0.8	0.2	0.4	-8.3	-3.0
Primary balance	3.5	2.5	2.6	-5.9	-0.6
Public debt	77.8	74.7	73.2	89.9	85.8
External accounts					
Current account balance (EUR bn)	1.7	1.0	1.6	-2.6	0.6
Current account balance/GDP (%)	3.4	1.9	2.9	-5.6	1.2
Extended basic balance/GDP (%)	6.8	4.8	6.9	-0.2	5.8
Net FDI (% of GDP)	2.3	1.5	1.9	2.8	1.9
Gross foreign debt (% of GDP)	88.9	82.7	75.7	90.7	84.3
FX reserves (EUR bn)	15.7	17.4	18.6	15.0	17.3
Months of imports, goods & services	7.8	7.9	7.9	7.3	7.2
Inflation/monetary/FX					
CPI (pavg)	1.1	1.5	0.8	0.3	1.5
CPI (eop)	1.2	0.8	1.4	0.4	2.0
Central bank target					
Central bank reference rate (eop)	0.3	0.3	0.3	0.05	0.2
3M money market rate (Dec avg)	0.55	0.49	0.35	n.a.	n.a.
USD/FX (eop)	6.27	6.47	6.65	6.76	6.70
EUR/FX (eop)	7.51	7.42	7.44	7.50	7.50
USD/FX (pavg)	6.62	6.28	6.62	6.83	6.70
EUR/FX (pavg)	7.46	7.41	7.41	7.58	7.50

Source: Eurostat, CNB, NBS, UniCredit Research

*Long-term foreign currency credit rating provided by Moody's, S&P and Fitch, respectively

Testing recovery and resilience with ERM II in sight

Data revealing the extent of the damage caused by COVID-19 has just started to flow in…

…suggesting a significant impact in 2Q20…

…but restrictions were lifted earlier than projected, albeit gradually

The little data available so far reveal the extent of the damage done to the economy by the spread of COVID-19 and restrictions implemented to protect public health. Tourist arrivals in April were almost completely absent and turnover in retail dropped 26% yoy in real terms. In May tourism was at 5-6% of its 2019 level. This leads us to project a yoy decline of between 20% and 25% in 2Q20, but with significant uncertainty regarding the performance in June. Serious restrictions were implemented in response to COVID-19 in the second half of March, amplified by the impact of an earthquake in late March. Restrictions started to be lifted in late April in three phases, with most of the harshest restrictions lifted by the end of May, earlier than expected. The remaining restrictions will be relaxed gradually as the epidemiological picture has improved significantly.

Relaxation of restrictions for foreign visitors is encouraging for tourism performance in 3Q

Growth in 2020 will very much depend on the performance of tourism in 3Q20. Restrictions to the entry of foreign visitors were relaxed from 11 May for business purposes and for real estate owners. Restrictions were further eased from 1 June for visitors from ten countries (including important tourist markets and neighboring countries). This relaxation came earlier than initially projected and should help the economy and especially the tourism sector to at least partly alleviate the blow caused by the lockdown. However, we still only expect the main tourist season to reach 30% of 2019 performance, with this assumption to be tested in July and August (which usually account for almost a third of annual revenue and tourist nights). This scenario does not include a second wave of the pandemic and further travel bans. In January to May, the tourism sector was at around 20% of its 2019 performance.

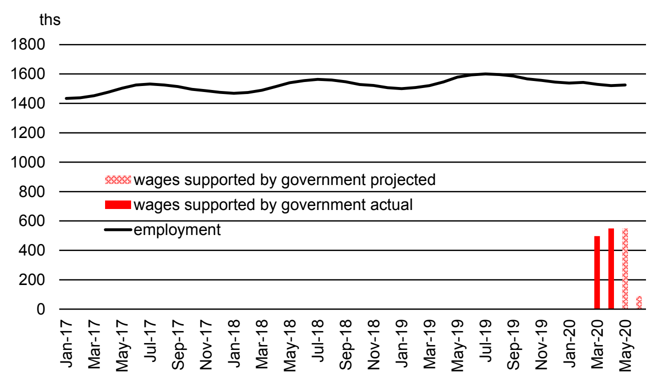
We stick with our baseline projection of a 10.5% drop in GDP in 2020…

…with a strong contribution from government spending, particularly measures to support wages and employment, playing a major role

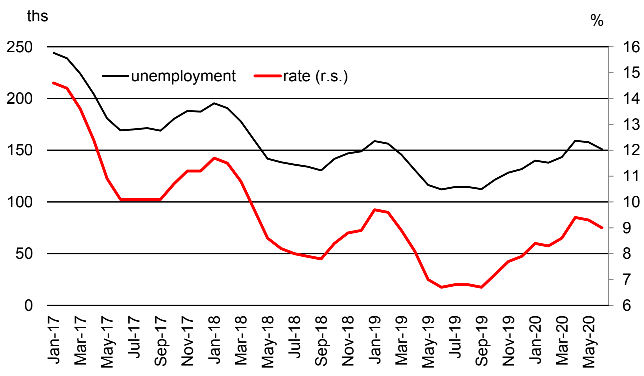
Measures to support March-May wages will likely be replaced with lighter version for a limited set of sectors from June

Our baseline projection remains a 10.5% drop in GDP in 2020. This scenario is based on strong support for public spending connected to two segments of spending. The first is COVID-19-related health-sector spending (roughly estimated at around 1% of GDP). The second is spending to support the wages of employees of distressed companies and affected sectors. The latest available data suggest that more than 550,000 employees (35% of the total workforce) from more than 97,000 companies have applied for support up to a net wage of HRK 4,000 per employee. It is envisaged that this will cost the government some HRK 2.4% of GDP), which will be covered through available funds from the cohesion policy and by borrowing through the SURE facility. However, the measure was originally envisaged only to cover wages from March until May. From June, there will be a new version of the scheme with a narrower scope – the scheme will support wages for 80-100,000 employees in the most affected sectors.

WAGE SUPPORT EASED PRESSURE IN LABOR MARKET ...



…BUT UNEMPLOYMENT LIKELY TO RISE AFTER SUMMER.



Source: Crostat, Ministry of Finance, central bank, UniCredit Research

Unemployment growth will likely rise in remainder of the year

Wage support measures have had a significant impact on containing unemployment growth so far. Yet, despite signs of rising activity (in tourism and retail), we still expect unemployment to rise once wage-support measures end. We estimate that unemployment will rise by 50-60,000 by year end, resulting in an average unemployment rate of 10.2% for the full year, despite the new measures introduced (including support for shorter working week).

Fiscal impact of measures introduced will be significant…

…resulting in weaker fiscal position…

Government measures known so far amount to around 12% of GDP. Wage support will have a direct fiscal impact of around 3% of GDP if pursued until the autumn. Combined with tax relief for the worst-affected companies it could rise to more than 4% of GDP. The government also introduced deferred tax payments, which may amount to as much as 3.8% of GDP, and guarantees defined so far total 4% of GDP. Altogether, with a significant decline in tax revenue due to squeezed economic activities we estimate that the budget gap will rise to 8.3% of GDP in 2020, resulting in public debt rising to close to 90% of GDP. We see a consolidation in 2021 potentially cutting the deficit to 3% of GDP and return to the path of declining public debt ratio.

…and rising funding needs, with strong support from the central bank through QE measures

So far the market has responded well to the country's funding needs, most of which is already covered through new issuance on both the local and international markets. The prospects for funding the remaining EUR 4.5bn by year end look good. However, it is unlikely that this will be met without the central bank intervening on the local bond market. The central bank bought local bonds amounting to some 3.8% of GDP, mostly from pension funds, and may be prepared to undertake similar action to support further local bond issuance with purchases worth 2.5-2.8% of GDP.

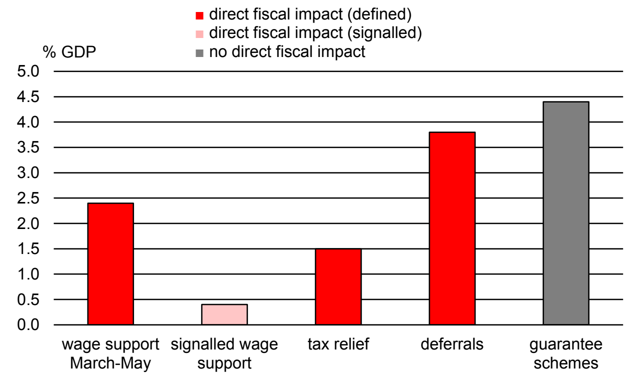
Investor interest in Croatian bonds may well be sustained after good news on ERM II prospects…

A likely positive response on the country's ERM II application in July and a decision on the date of joining could support investor appetite for Croatian bonds. Such an outcome seems very likely after the ECB's recent confirmation of a comprehensive assessment (no capital shortfalls) for five local banks. In May, the government confirmed its tasks from the action plan for joining ERM II had also been performed and implemented. ERM II accession could happen in the autumn, and, if so, this would create an opportunity for the country to adopt the euro in 2023 at the earliest, although this timescale would be very ambitious currently.

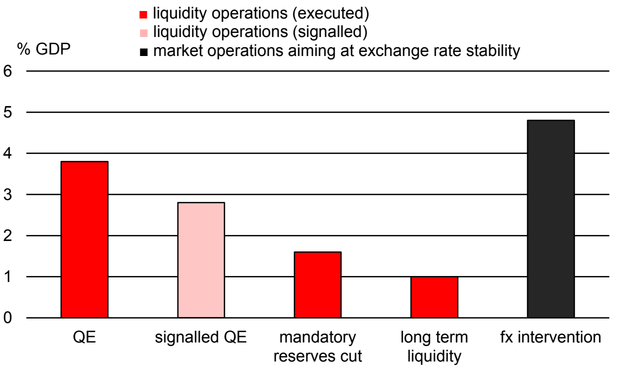
...that may also give an edge to parties from the current government in parliamentary elections set for 5 July

The ERM II decision could come just before the general election set for 5 July. HDZ (Christian Democratic Union, the main center-right party in Croatia), the major party of the current government, remains favorite in the polls, but it is closely followed by the coalition led by the SDP (Social Democratic Party, the main center-left party in the country). Strong performance in containing the spread of COVID-19 and the potential positive decision on ERM II may favor HDZ. Victory by the HDZ would likely reduce uncertainty regarding the likelihood of sustained economic and fiscal policy. If SDP were to win, with economic agenda yet to be fully clarified, uncertainty may be prolonged though both parties remain supportive for Euro adoption.

GOVERNMENT MEASURES WITH FISCAL IMPACT…



…ROUGHLY MET BY THOSE OF CENTRAL BANK (8-9% GDP)



Source: UniCredit Research, Ministry of Finance, central bank

Strong official support anchors yields

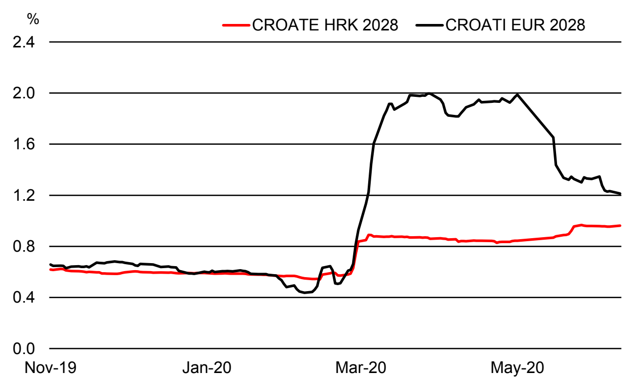
CROATE HRK supported by CNB purchase

Sizeable central bank support helped stabilize CROATE HRK yields, despite large issuance. If the central bank continues to purchase up to the equivalent of 2.8% of GDP in bonds, as we expect, CROATE HRK yields could fall closer to those registered before the COVID-19 crisis.

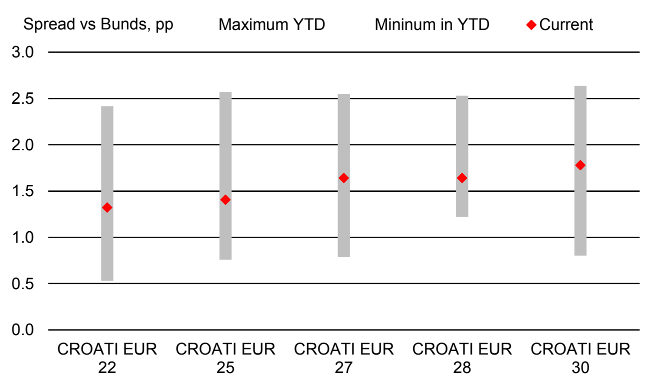
Limited scope for a rally in CROATI EUR, but valuation is not tight

CROATI EUR bonds have recouped most of the spread widening vs. CROATE HRK, as we predicted in the previous CEE Quarterly. From here on, the scope for a further rally may be limited, although valuation is not tight when compared to previous yield levels and when taking into account the spread to Bunds.

CROATI EUR RECOUPING THE LOSSES VS. CROATE HRK



CROATI EUR SPREADS TO BUNDS ARE NOT EXCESSIVELY TIGHT



Source: Bloomberg, UniCredit Research

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2019	2020F	2021F
Gross financing requirement	**9.0**	**11.6**	**8.2**
Budget deficit	0.1	4.0	1.5
Amortization of public debt	8.9	7.6	6.7
Domestic	6.4	5.6	4.7
Bonds	1.0	1.7	0.8
Bills	4.1	3.4	3.4
Loans	1.3	0.6	0.5
External	2.4	2.0	2.0
Bonds and loans	2.3	1.9	1.9
IMF/EU/other international financial institutions	0.1	0.1	0.1
Financing	**9.0**	**11.6**	**8.2**
Domestic borrowing	7.3	8.8	6.5
Bonds	2.7	4.5	2.4
Bills	3.6	3.4	3.5
Loans	1.1	0.9	0.7
External borrowing	1.6	2.8	1.7
Bonds	1.5	2.0	1.5
IMF/EU/other international financial institutions	0.1	0.8	0.2
Privatization/other	0.1	0.0	0.0

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2019	2020F	2021F
Gross financing requirement	**12.1**	**13.6**	**10.7**
C/A deficit	-1.6	2.6	-0.6
Amortization of medium and long term debt	7.2	5.4	5.3
Government/central bank	2.4	2.0	2.0
Banks	0.7	0.4	0.5
Corporates/other	4.1	3.0	2.8
Amortization of short-term debt	6.4	5.6	6.0
Government/central bank	4.1	4.0	4.0
Banks	1.5	1.1	1.0
Corporates/other	0.8	0.5	1.0
Financing	**12.1**	**13.6**	**10.7**
FDI (net)	1.0	1.1	0.9
Portfolio equity, net	0.5	-1.5	0.7
Medium and long-term borrowing	4.0	4.7	4.2
Government/central bank	1.6	2.8	1.7
Banks	0.8	0.6	0.8
Corporates/other	1.6	1.3	1.7
Short-term borrowing	5.6	4.3	4.8
EU structural and cohesion funds	1.1	1.4	1.3
Other	1.0	0.0	1.0
Change in FX reserves (= increase)	-1.1	3.6	-2.3
Memoranda:			
Nonresident purchases of LC gov't bonds	n.a.	n.a.	n.a.
International bond issuance, net	0.2	0.8	0.2

Source: CNB, Croatian ministry of finance, UniCredit Research

Czechia

Aa3 stable/AA- stable/AA- stable*

Outlook

Since May, the economy has been on a V-shaped recovery path, which, however, may lose momentum over the summer. GDP will likely decline by 10.3% this year and rebound by 6.8% in 2021, with capex posing the biggest drag. Looser labor-market conditions and precautionary spending will also slow the recovery. The government is proposing to raise the budget deficit to above 9% of GDP, opening the door to pre-election spending. The ČNB may deliver its last rate cut in autumn.

Strategy

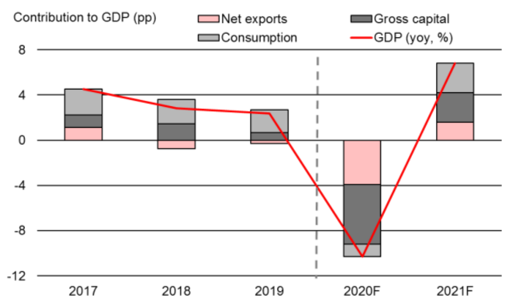
During the March-April sell-off, CZGBs benefitted from the strongest support among EU-CEE bonds, allowing the government to ramp up issuance. CZGB 2057 still offer value on a curve that has tightened vs. Bunds.

Author: Pavel Sobíšek, Chief Economist Czech Republic (UniCredit Bank Czech Republic and Slovakia)

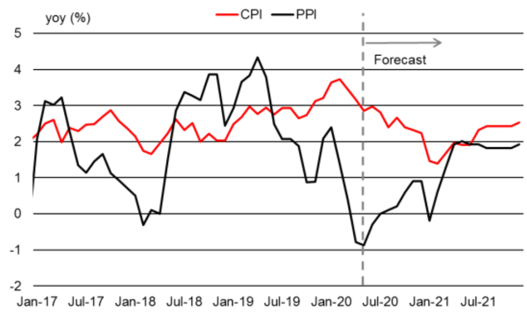
KEY DATES/EVENTS

- Regional and Senate elections – Oct 2-3
- ČNB policy meetings – Aug 6, Sep 23
- 2Q GDP – Jul 31 (flash), Sept 1 (structure)

GDP GROWTH FORECAST



INFLATION FORECAST



Source: CZSO, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

EUR bn	2017	2018	2019	2020F	2021F
GDP (EUR bn)	191.9	207.8	220.3	195.3	218.9
Population (mn)	10.6	10.6	10.7	10.7	10.7
GDP per capita (EUR)	18,125	19,559	20,647	18,255	20,430
Real economy, change (%)					
GDP	4.5	2.8	2.5	-10.3	6.8
Private consumption	4.4	3.2	3.0	-3.9	4.0
Fixed investment	4.0	7.5	2.7	-19.5	9.0
Public consumption	1.3	3.4	2.6	4.2	3.0
Exports	7.1	4.4	1.0	-12.2	9.2
Imports	6.3	5.9	1.5	-8.9	7.8
Monthly wage, nominal (EUR)	1126	1250	1329	1317	1405
Real wage, change (%)	4.2	5.9	3.5	0.8	1.5
Unemployment rate (%)	4.2	3.2	2.8	3.9	4.8
Fiscal accounts (% of GDP)					
Budget balance	1.5	0.9	0.3	-9.0	-5.5
Primary balance	2.2	1.6	1.0	-8.0	-4.2
Public debt	34.7	32.6	30.8	42.2	44.3
External accounts					
Current account balance (EUR bn)	3.2	0.9	-0.8	-4.8	-2.7
Current account balance/GDP (%)	1.7	0.4	-0.4	-2.5	-1.2
Extended basic balance/GDP (%)	3.4	1.6	1.2	-1.5	0.0
Net FDI (% of GDP)	0.9	1.0	1.1	0.5	0.7
Gross foreign debt (% of GDP)	86.5	82.8	77.5	87.9	82.6
FX reserves (EUR bn)	123.4	124.5	133.4	135.0	140.0
Months of imports, goods & services	10.7	10.0	10.5	10.9	10.7
Inflation/Monetary/FX					
CPI (pavg)	2.5	2.1	2.8	2.9	2.1
CPI (eop)	2.4	2.0	3.2	2.2	2.5
Central bank target	2.0	2.0	2.0	2.0	2.0
Central bank reference rate (eop)	0.50	1.75	2.00	0.05	0.25
3M money market rate (Dec avg)	0.75	2.01	2.18	0.15	0.35
USD/FX (eop)	21.29	22.47	22.62	23.25	21.69
EUR/FX (eop)	25.54	25.73	25.41	26.50	25.60
USD/FX (pavg)	23.38	21.74	22.93	24.14	22.22
EUR/FX (pavg)	26.33	25.64	25.67	26.80	26.00

Source: CZSO, CNB, UniCredit Research

*Long-term foreign-currency credit rating provided by Moody's, S&P and Fitch, respectively

The V-shaped recovery may be a bumpy one

Demand conditions replace supply-side COVID-19-related measures as main driver of economic activity

The lifting of economic restrictions related to the COVID-19 pandemic started a few weeks earlier than we had expected in April but may spread over a longer period of time. The measures still in place at the end of June (ban on cultural or sporting events with more than 500 people and restrictions on tourist arrivals from outside the EU) are estimated to affect 2% of the economy's production capacity – a relatively minor share. Thus, supply-side constraints will start playing a secondary role to demand conditions in driving growth going forward.

A V-shaped recovery in early summer…

Economic output hit a bottom in April and has since been on a V-shaped recovery path. All three car manufacturers operating in the country resumed full production on 25 May. As confirmed by payment card statistics, households have been catching up on retail spending, with their income boosted by government transfers. Leading indicators have overcome their troughs, at least for industry and consumer confidence. Along with 1Q20 GDP dynamic, which turned out slightly less bad than expected, this allows us to slightly temper our pessimism on the full-year GDP decline.

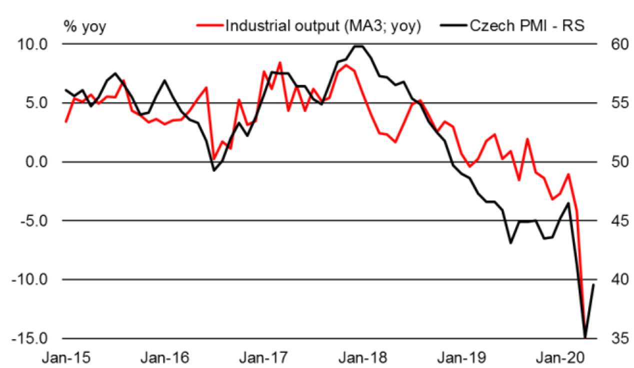
…likely to lose steam

Nevertheless, we expect the recovery to lose some momentum. According to our calculations, temporary shutdowns at the car plants were proportionate to 14% of the country's annual unit production capacity. With full-year car demand in Europe estimated to be down at least 20%, more output reductions will be needed in 2H20. In addition, manufacturing PMIs point to only limited improvement in order books, with foreign orders faring worse than domestic ones. We are drawing two conclusions from this, both negative. First, a fragile recovery in domestic demand, even if it were to occur, would be of limited help to the export-oriented economy. Second, the structure of Czechia's manufacturing, dominated by investment goods, may be a disadvantage at this stage, as fixed capital is expected to be the last demand-side component of GDP in the EU to resume growth.

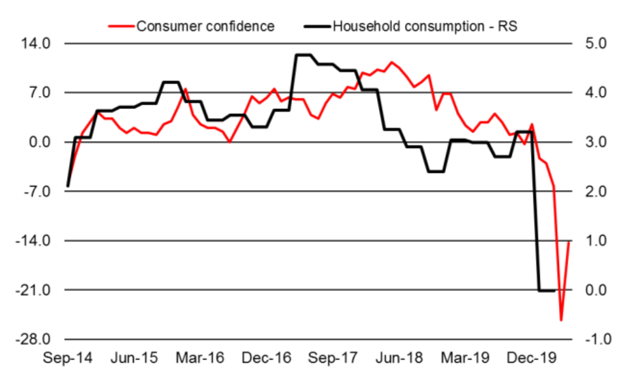
Unemployment rate is seen jumping above 5% by early 2021, despite foreign employment acting as a buffer

Also on the negative side, income from tourism is set to remain depressed this year. The tourism industry accounts for a relatively modest 3-4% of GDP, but for over 5% of total employment. Part of the employment may be lost in 2H20, the bulk of it in the city of Prague. Along with some lay-offs in manufacturing, this will add to the unemployment rate rising above 5% by early 2021. However, redundancies are expected to be rather contained compared to the GDP decline, as foreign employment has acted as a buffer. We estimate the number of foreign workers to have dropped by 150,000 (3% of total labor force) at the start of the lockdown. Only a fraction have returned. The limited surge in jobless numbers also adds to the labor market adjustment, primarily in the form of fewer hours worked. This is achieved by replacing full-time jobs with part-time ones, more frequent sick leave and the government-sponsored furlough scheme.

APRIL SLUMP IN INDUSTRIAL OUTPUT (-34% YOY) WAS A ONE-OFF BUT THE REBOUND MAY TAKE TIME



PRIVATE CONSUMPTION SET TO DROP IN 2Q20 DESPITE THE MAY UPTURN IN CONSUMER CONFIDENCE



Source: CZSO, Markit, Macrobond, UniCredit Research

Changes in spending habits will see private consumption drop in 2020

Under these circumstances, private consumption is set to decline in 2020 with a drop in real household income and a rise in precautionary savings largely to blame. Normalization in spending habits may lead to a lower household savings ratio and higher consumption in 2021.

Capex will pose the most severe drag on GDP

Capital spending is expected to pose the most severe drag on GDP in 2020. What may contribute to this from the corporate side is **1.** the prevailing focus of the government's supportive measures on households rather than companies, and **2.** the fact that, as shown by the 1Q20 GDP structure, capex would have retreated even without the coronavirus impact. The government may allocate more resources to infrastructure building but that would be of limited help due to persisting, albeit somewhat easing, supply-side bottlenecks of construction companies. Capex may improve partly by 2021, with two-thirds of the 2020 slump still waiting to be recovered in the following years, according to our forecast.

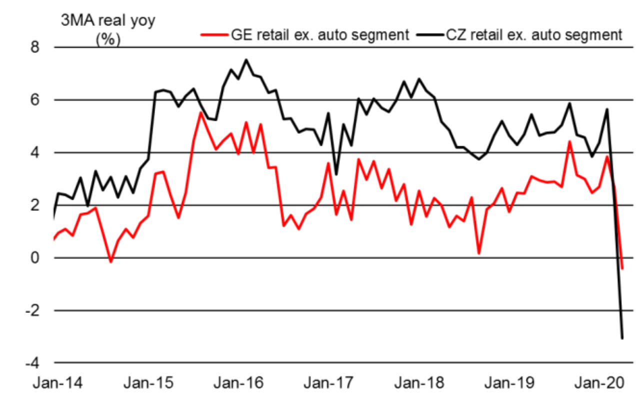
Raising budget deficit to CZK 500bn opens the door to pre-election spending

Apart from slowing the increase in unemployment, the government's efforts were aimed at mitigating the loss in income for workers and preserving liquidity for enterprises. The key measures related to this included the following: **1.** distributing a subsidy to the self-employed for three months, **2.** waiving social and healthcare contributions for entrepreneurs and small-sized businesses for three months, **3.** providing care benefits to parents of school children, and **4.** introducing a loan guarantee scheme for companies. Along with automatic stabilizers, this year's cost for government financing was estimated at CZK 216bn (4.2% of expected GDP) in April, when the 2020 state budget deficit was officially amended to CZK 300bn. Meanwhile, some measures were broadened or extended at an estimated cost of several tens of billions CZK. However, the government took markets by surprise in early June, announcing a deficit of CZK 500bn (over 9% of GDP). Of the deficit increase versus the previous amendment, CZK 137bn are penciled in as a budgetary reserve. This leaves the impression that the government is opening the door to casual, pre-election spending, with little consideration regarding its efficiency.

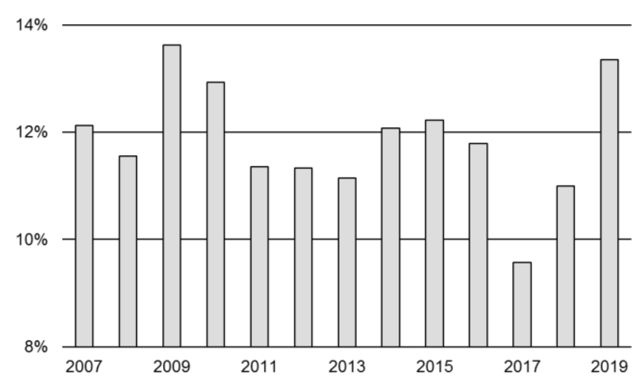
The ČNB is expected to stay on hold in June, probably delivering its last cut in autumn

With the repo rate at 0.25%, the ČNB is getting close to the end of its standard monetary policy easing. There are few indications that reaching the technical zero rate (0.05%) would be an aim for the 24 June policy meeting. Even the recent koruna strengthening by 2% from the EUR-CZK level assumed by the CNB in its latest forecast is unlikely to be a game changer. That said, we believe the central bank is ready for the last shot, when its signal role would have a maximum effect. This could be the case in autumn when the economic recovery may lose steam. We regard it as unlikely for the ČNB to introduce non-standard policy measures anytime soon. Such an option was mentioned as part of an alternative scenario in the May inflation report but, when translated into market forward rates, several central bankers stepped in to put the option aside.

CZECH RETAIL SALES FOLLOW THE SAME TRENDS AS IN GERMANY BUT FELL DEEPER DURING THE LOCKDOWN



HOUSEHOLD SAVINGS RATIO WAS CLOSE TO ALL-TIME HIGH IN 2019 BUT IS ESTIMATED TO INCREASE FURTHER IN 2020



Source: CZSO, UniCredit Research

A safe haven in EM

CZGB benefitted from strongest investor support in EU-CEE…

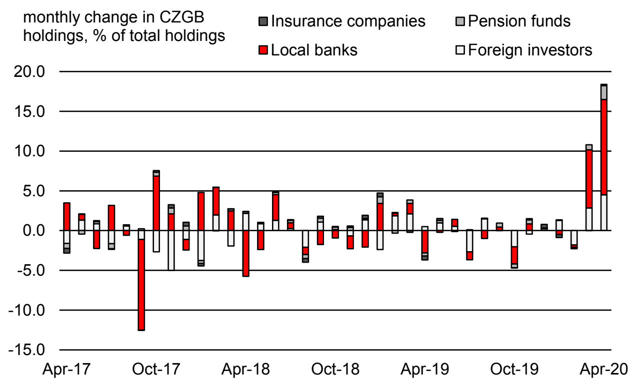
The CZGB market stands out in central Europe as having been the most stable during the COVID-19 pandemic. Despite the general sell-off in EM, CZGB issuance met strong demand both from local and foreign investors. This support made the CNB forego bond purchases, since the market never lacked bids. 91.6% of bond issuance since the beginning of the year until 12 June occurred after the start of the crisis. The new CZK 500bn deficit target leaves the equivalent of EUR 7.1bn to be issued this year compared to approximately EUR 17bn issued already.

…and the government ramped up issuance

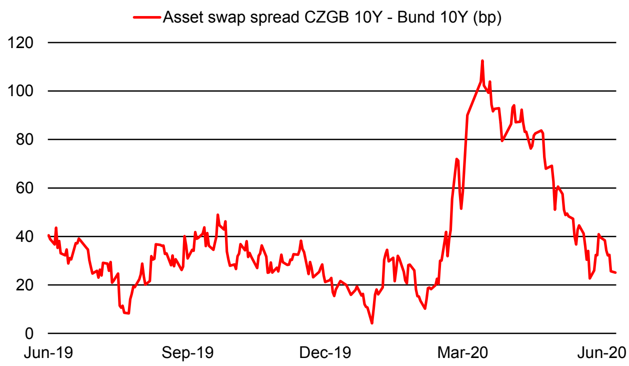
CZGB 2057 still offer good value

The CZK curve steepened the most in EU-CEE, helped by the largest policy rate cuts in the region. As the market priced out further rate cuts, we think the CNB could surprise the market with one last cut. The 10Y spread between CZGB and Bunds is close to multi-year lows and value remains mostly in the very long end of the curve (CZGB 2057).

STRONG DEMAND FOR CZGB SINCE THE CRISIS STARTED



CZGB-BUND SPREAD CLOSE TO ALL-TIME LOWS



Source: Ministry of finance, CNB, Bloomberg, UniCredit Research

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2019	2020F	2021F
Gross financing requirement	**10.5**	**23.8**	**20.9**
Budget deficit	1.1	16.6	12.0
Amortization of public debt	9.4	7.2	8.8
Domestic	9.4	6.2	6.9
Bonds	9.2	6.0	4.9
Bills	0.3	0.2	2.0
Loans	0	0	0
External	0	0.9	1.9
Bonds and loans	0	0.9	1.9
IMF/EU/Other IFIs	0	0	0
Financing	**10.5**	**23.8**	**20.9**
Domestic borrowing	9.7	21.7	20.8
Bonds	9.4	19.7	20.7
Bills	0.2	2.0	0.1
Loans	0.1	0	0
External borrowing	0.8	2.1	0.1
Bonds	0.7	2.0	0
IMF/EU/Other IFIs	0.1	0.1	0.1
Privatization/Other	0	0	0

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2019	2020F	2021F
Gross financing requirement	**111.0**	**112.9**	**114.6**
C/A deficit	0.8	4.8	2.7
Amortization of medium and long term debt	9.5	7.5	8.9
Government/central bank	4.4	3.5	4.3
Banks	3.1	1.9	2.1
Corporates/Other	1.9	2.1	2.5
Amortization of short-term debt	100.7	100.6	103.0
Government/central bank	7.5	6.4	7.0
Banks	59.6	58.7	59.0
Corporates/Other	33.7	35.5	37.0
Financing	**111.0**	**112.9**	**114.6**
FDI (net)	2.4	0.9	1.5
Portfolio equity, net	0	-0.6	-0.8
Medium and long-term borrowing	9.6	13.0	14.4
Government/central bank	4.5	9.0	9.8
Banks	3.1	1.9	2.1
Corporates/Other	1.9	2.1	2.5
Short-term borrowing	105.4	98.0	102.2
EU structural and cohesion funds	2.7	3.2	2.2
Other	0	0	0
Change in FX reserves (- = increase)	-8.9	-1.6	-5.0
Memoranda:			
Nonresident purchases of LC govt bonds	0.1	5.5	5.5
International bond issuance, net	0.7	2.0	0

Source: CNB, MoF, CZSO, UniCredit Research

Hungary

Baa3 stable/BBB stable/BBB stable*

Outlook

The Hungarian economy could contract by 8% in 2020 due to poor external demand weighing on industrial production, especially car manufacturing, and exports. The government's direct fiscal support of 4.4% of GDP implied net spending of just 2.1% of GDP. Despite this, unemployment is likely to rise and real wage growth to slow below 1%, affecting consumption. The NBH is expected to remain on hold due to currency worries, with abundant liquidity provisions when the HUF is not under pressure.

Strategy

The HGB curve could bear-steepen if the NBH does not resume bond purchases. At least EUR 1bn expected in REPHUN.

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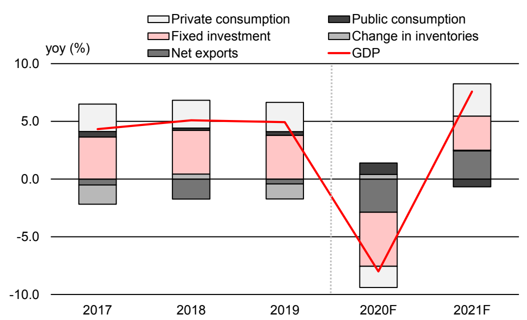
Dr. Ágnes Halász, Head of Economics & Strategic Analysis Hungary (UniCredit Bank Hungary)

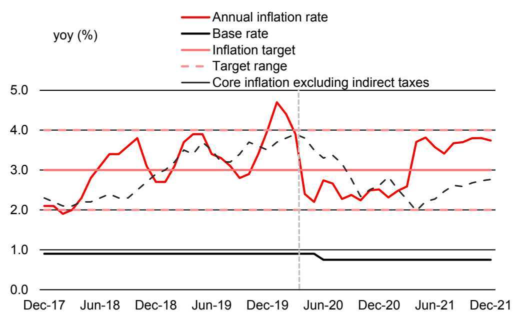
KEY DATES/EVENTS

- 8 July, 11 August, 9 September: CPI
- 21 July, 25 Aug, 22 September: monetary policy decisions
- 14 August, 1 September: 2Q20 GDP (flash, structure)
- 14 Aug, 25 Sept: rating updates from Fitch, S&P, Moody's

GDP GROWTH FORECAST



INFLATION FORECAST



Source: HCSO, NBH, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

EUR bn	2017	2018	2019	2020F	2021F
GDP (EUR bn)	125.6	133.8	143.8	129.1	145.9
Population (mn)	9.8	9.8	9.7	9.7	9.7
GDP per capita (EUR)	12,795	13,680	14,750	13,286	15,067
Real economy, change (%)					
GDP	4.3	5.1	4.9	-8.0	7.6
Private consumption	4.7	4.8	5.1	-3.7	5.3
Fixed investment	18.7	17.1	15.3	-17.2	12.1
Public consumption	2.4	1.0	1.7	5.5	-3.3
Exports	6.9	4.3	6.0	-13.1	13.8
Imports	8.2	6.8	6.9	-10.6	11.2
Monthly wage, nominal (EUR)	960	1035	1131	1109	1183
Real wage, change (%)	10.1	7.9	7.6	0.6	2.2
Unemployment rate (%)	5.2	4.2	3.7	3.5	3.9
Fiscal accounts (% of GDP)					
Budget balance	-2.5	-2.1	-2.0	-3.9	-1.9
Primary balance	0.2	0.2	0.2	-1.3	0.5
Public debt	71.0	68.5	64.7	73.1	68.0
External accounts					
Current account balance (EUR bn)	2.9	0.0	-1.4	-3.2	-1.3
Current account balance/GDP (%)	2.3	0.0	-0.9	-2.5	-0.9
Extended basic balance/GDP (%)	4.8	4.3	2.2	2.1	2.9
Net FDI (% of GDP)	1.6	2.0	1.3	0.3	1.4
Gross foreign debt (% of GDP)	84.2	81.1	73.9	80.8	70.9
FX reserves (EUR bn)	22.6	25.8	26.5	28.8	30.9
Months of imports, goods & services	2.7	2.9	2.8	3.5	3.2
Inflation/Monetary/FX					
CPI (pavg)	2.5	2.9	3.6	3.1	3.5
CPI (eop)	2.1	2.7	4.0	2.5	3.7
Central bank target	3.0	3.0	3.0	3.0	3.0
Central bank reference rate (eop)	0.90	0.90	0.90	0.75	0.75
3M money market rate (Dec avg)	1.35	0.13	0.16	0.75	0.75
USD/FX (eop)	258.8	280.9	294.7	300	292
EUR/FX (eop)	310.1	321.5	330.5	345	345
USD/FX (pavg)	274.4	270.2	290.7	307	340
EUR/FX (pavg)	309.3	318.8	325.4	344	340

Source: Eurostat, HCSO, NBH, UniCredit Research

*Long-term foreign currency credit rating provided by Moody's, S&P and Fitch, respectively

A reality check

Sharp fall in activity led by the car sector…

Three months into the COVID-19 pandemic, the Hungarian government continues to hold one of the most upbeat views on the economy among European authorities. When looking at the data, however, there is little reason to cheer. Activity fell significantly in April, with car manufacturing and orders plummeting by 80%. Mobility data show a very slow recovery in traffic at work places, with Budapest and the counties hosting large car factories still down around 20% compared to last year. While we expect European demand to recover, lifting Hungarian exports as well, the rebound in car manufacturing could be more tenuous. One reason is the product line: Hungarian factories do not manufacture electric and hybrid cars and will not benefit from European car-scrappage schemes. A slow recovery in car demand would also affect other sectors, such as rubber, electronics and metal producers. The four sectors account for more than 50% of industrial production and around 11% of total employment in Hungary.

…with a muted recovery ahead…

…affecting FDI and domestic demand

The knock-on effect of weak industrial production on domestic demand could be significant. First, important foreign investment projects have been postponed, from BMW's factory in Debrecen to Hankook's tire factory in Rácalmás. There is also good news: Samsung will continue to expand its largest European battery factory. Second, weak exports could have spillover effects to companies that cater mostly to domestic demand, since they will affect household income and the propensity to spend in the entire economy.

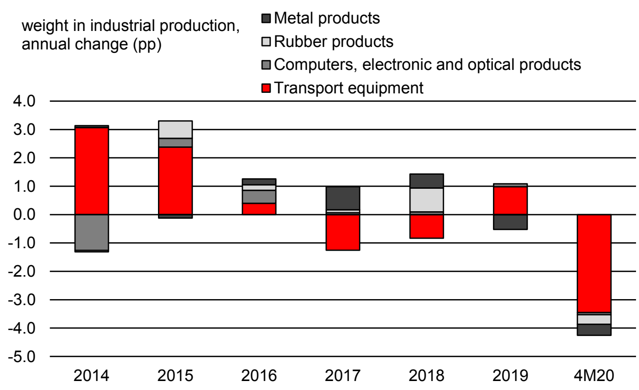
The anti-crisis program accounts for 4.4% of GDP, with net spending of just 2.1% of GDP

The government adopted direct fiscal support measures totaling the equivalent of 4.4% of GDP. However, net spending is just 1.3% of GDP (the lowest in EU-CEE) as the equivalent of 2.1% of GDP will be reallocated from local administrations and different ministries, while the equivalent of 1% of GDP will come from the Unemployment Fund. So far, the government has spent around 2.6% of GDP, almost equally divided between the Anti-Epidemic Protection Fund and the Economy Protection Fund. The former fund deals with spending in healthcare and the direct response to the pandemic and is close to reaching its maximum amount. The latter can be expanded 2.5 times under the current allotment of HUF 1.35tn and is divided into the Economic Protection Program and support for employment. Official communication on how programs are implemented is often confusing, with some ministers discussing actual spending, while some are mentioning allocations. The main achievements of the program are that 114,000 jobs (5.2% of private-sector employment) were saved through the furlough scheme, more than 70,000 received a wage subsidy, more than 32,000 received financial support before retirement, and 97,600 people received unemployment benefits. There are also forms of indirect support to employment, through the suspension of tax payments (KATA) for small businesses (HUF 85.5bn), helping companies that employ more than 150,000 people (6.9% of private-sector employment), and of the tourism development tax until 30 June (HUF 20.7bn), with beneficiaries employing around 210,000 people (almost 10% of private-sector employment).

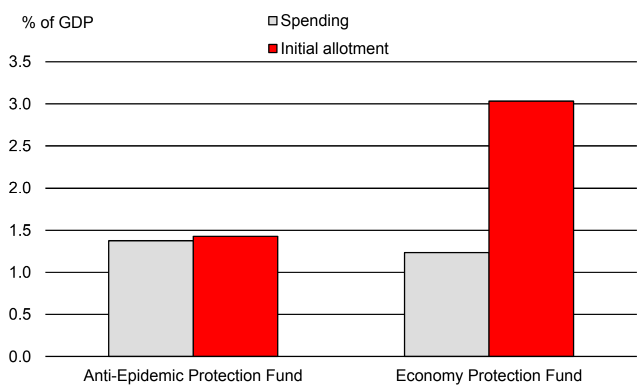
Direct and indirect measures to support employment…

…may have saved more than 400,000 jobs

THE AUTO SECTOR IS A DRAG ON INDUSTRIAL PRODUCTION



ANTI-CRISIS DIRECT SPENDING AT 60% OF ALLOTMENT



Source: HCSO, ministries, UniCredit Research

Unemployment increase halted by declining labor force

Public support could cap the unemployment rate at around 4.5%, with a subsequent decline to around 4% by the end of next year. However, when accounting for people who left the workforce, the unemployment rate could peak at over 6% and remain above 4.5% until the end of 2021. In addition, real wage growth could slow below 1% this year as private-sector firms face far less stringent labor shortages, public-sector wage growth slows in the middle of the election cycle and the public-sector working schemes are ramped up, paying wages well below the economy's average. This will undermine the recovery of private consumption in 2H20 and 2021. Moreover, the government may have to increase fiscal support next year to prevent other waves of unemployment if there is a second wave of the pandemic and/or exports and industrial production take longer to recover.

Real wage growth likely to slow below 1% this year

We expect GDP to fall by 8% in 2020 and recover by 7.6% in 2021

Thus, we expect the Hungarian economy to contract this year by around 8%, with a partial recovery of around 7.6% in 2021. Besides a temporary drop in FDI, local capex will be hit by uncertainty, while building projects will accelerate their decline that started in 2019 when the VAT increased. The government aims to invest in several infrastructure projects, the largest one being the Budapest-Belgrade high-speed train line (0.2% of GDP).

A larger C/A deficit will be covered mostly through EU funds…

The trade balance will be hit by both lower exports of goods and services, due to lower tourism revenues and transport disruptions in Europe. The high import content of exports (around 70%), lower imported machinery and income from investment in Hungary will cushion the blow to the C/A, but the deficit is likely to widen this year to around 2.5% of GDP. As expected, foreign companies are supporting their Hungarian subsidiaries with intercompany lending, while equity investment is expected to fall to a trickle. At the same time, EU fund inflows will increase as the government taps the EU's anti-crisis programs and the European Commission speeds up the disbursement of structural and investment funds. As a result, the extended basic balance (EBB) could remain above 3% of GDP in 2020. The same is valid for 2021, when the C/A deficit and EU fund inflows could be lower, while FDI may increase.

…with the EBB remaining above 3% of GDP in 2020-21

The budget deficit could rise to 3.9% of GDP, with debt above 70% of GDP in 2020

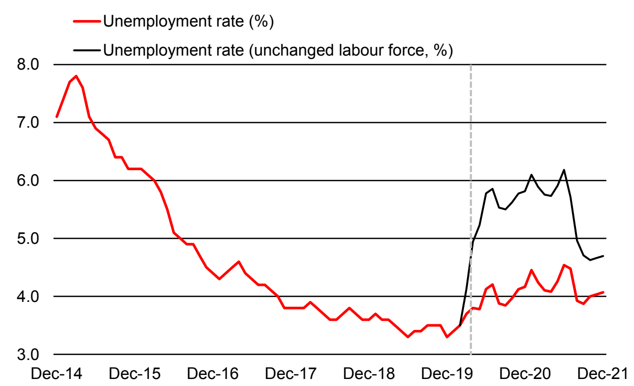
Although net support to the economy is small, a cyclical fall in budget revenues and GDP could send the budget deficit close to 4% of GDP and public debt above 70% of GDP this year. Both are likely to decline in 2021, with debt below the 2019 level by 2022.

NBH's focus on liquidity helped by stable currency…

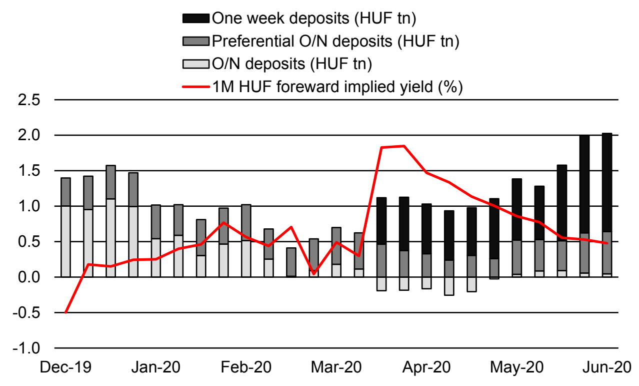
The NBH retains its contradicting mandates of providing abundant liquidity to banks and preventing HUF depreciation. Better risk appetite allowed the central bank to focus on the former in May-June and cut the key rate to 0.75%. Additional rate cuts and a deeper fall in interbank rates may not be on the cards unless EUR-HUF stabilizes below 340. This is not our baseline scenario, as investors will tend to sell the HUF when the carry falls. Even if supply shocks and tax hikes were to push headline back above 3%, weaker core inflation could help the NBH meet its inflation target in 2020-21.

…and inflation inside the target range

RISING INACTIVITY REDUCES UNEMPLOYMENT DYNAMICS



INTERBANK LIQUIDITY RISING AS EUR-HUF STABILIZED



Source: HCSO, NBH, Bloomberg, UniCredit Research

HGBs need more official support

Large financing needs…

The NBH decided to stop bond purchases after buying just HUF 149bn (0.3% of GDP) in four weeks. At the same time, the NBH lent banks more than HUF 1.2tn in 5Y loans paying 0.75% after the June rate cut, helping the Debt Management Agency (AKK) increase the average maturity of issuance. The AKK will have to issue the equivalent of EUR 5bn in HGBs during the remainder of the year. While this is some 20% less than in 1H20, many Hungarian banks cannot significantly increase their exposure to the sovereign and the NBH may have to resume purchases if the level of the 10Y yield is still an operational target for the Monetary Council. Otherwise, the curve could bear-steepen, since Hungary lacks other large local buyers of bonds. The pension fund system was nationalized in 2010 and the investment fund sector has been undermined by the government's generous retail bond programs. The HUF remains a danger for HGBs, especially if implied interest rates remain low, inviting renewed short positions in the Hungarian currency.

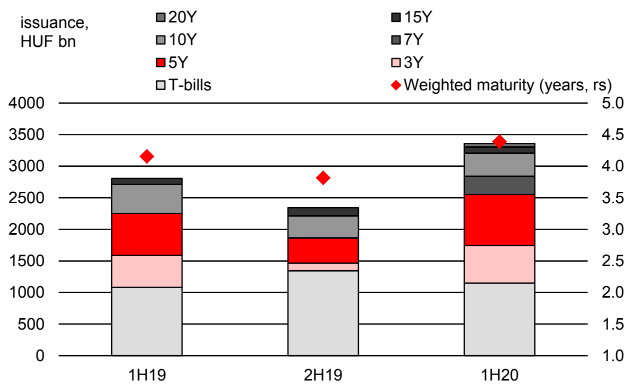
…may require the NBH to resume bond purchases…

…in order to prevent the HGB curve from steepening

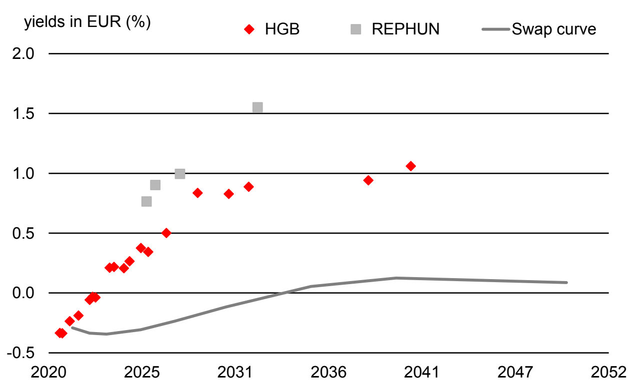
At least EUR 1bn more expected in REPHUN issuance

The AKK returned to the EUR market, issuing EUR 3.5bn this year. The AKK could issue at least EUR 1bn more later this year, with issuance increasing if demand for HGBs is not strong enough. Like everywhere in CEE, REPHUN EUR are cheaper than HGBs.

NBH SUPPORTING ISSUANCE OF 3-7Y BONDS



REPHUN EUR COMPARATIVELY CHEAPER THAN HGBS



Source: AKK, Bloomberg, UniCredit Research

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2019	2020F	2021F
Gross financing requirement	**30.7**	**26.4**	**25.6**
Budget deficit	3.7	5.8	3.8
Amortization of public debt	27.0	20.6	21.8
Domestic	25.6	17.9	18.7
Bonds	6.8	4.6	6.0
Bills	3.1	2.0	1.7
Loans	15.7	11.3	11.0
External	1.4	2.7	3.0
Bonds and loans	1.3	2.5	2.7
IMF/EU/Other IFIs	0.1	0.2	0.3
Financing	**30.7**	**26.4**	**25.6**
Domestic borrowing	30.8	20.9	21.6
Bonds	8.1	9.7	9.9
Bills	2.2	1.7	1.7
Loans	20.5	9.5	10.0
External borrowing	0.2	5.5	4.0
Bonds	0	4.5	4.0
IMF/EU/Other IFIs	0.2	1.0	0
Fiscal reserves change (- =increase)	-0.3	0	0

Source: HCSO, NBH, GDMA, UniCredit Research

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2019	2020F	2021F
Gross financing requirement	**22.9**	**25.0**	**23.0**
C/A deficit	1.4	3.2	1.3
Amortization of medium and long term debt	8.4	10.4	10.7
Government/central bank	3.0	3.9	4.2
Banks	4.0	5.3	4.7
Corporates/Other	1.5	1.2	1.8
Amortization of short-term debt	13.1	11.4	11.0
Financing	**22.9**	**25.0**	**23.0**
FDI (net)	1.9	0.4	2.0
Portfolio equity, net	-0.5	0	0
Medium and long-term borrowing	7.4	10.3	10.4
Government/central bank	2.2	5.1	5.1
Banks	3.8	4.0	3.6
Corporates/Other	1.4	1.3	1.8
Short-term borrowing	11.4	11.0	9.1
EU structural and cohesion funds	2.6	5.5	3.5
Other	1.0	2.0	3.0
Change in FX reserves (- = increase)	0.1	-2.3	-2.0
Memoranda:			
Nonresident purchases of LC govt bonds	2.0	-0.4	1.1
International bond issuance, net	-1.3	2.0	1.3

Poland

A2 stable/A- stable/A- stable*

Outlook

The Polish economy could shrink by 6.8% in 2020 and rebound by 7.0% in 2021, outperforming the rest of EU-CEE due to a large fiscal impulse. The "anti-crisis shield" worth around 15% of GDP (with more than 5% of GDP in net spending and including a "financial shield" of around 8% of GDP) will support the recovery. The budget deficit could widen beyond 8% of GDP in 2020. The biggest risks for growth are foreign demand, especially for capital goods, poor private investment, consumer pessimism and tighter financial conditions. The NBP has ended rate cuts, but will continue to buy bonds issued by BGK and PFR.

Strategy

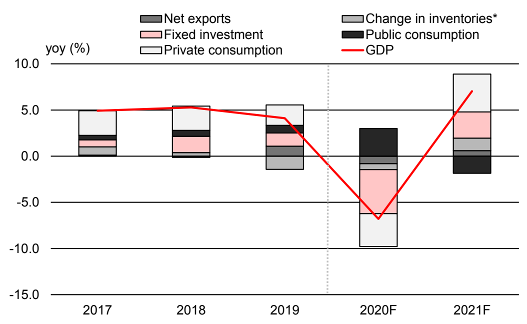
POLGBs will continue to receive strong support from local banks and, if needed, from the NBP. The PLN remains slightly undervalued and verbal interventions may not have a lasting impact on EUR-PLN.

Author: Dan Bucșa, Chief CEE Economist (UniCredit Bank AG, London)

KEY DATES/EVENTS

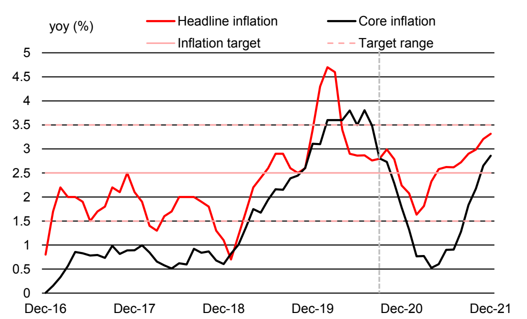
- 8 July, 9 September: monetary policy decisions
- 30 Jun (15 Jul), 31 Jul (14 Aug), 1 Sep (15 Sep): CPI
- 12 July: presidential elections run-off
- 14 August, 31 August: 2Q20 GDP (flash, structure)
- 11 Sep, 25 Sep: rating updates from Moody's and Fitch

GDP GROWTH FORECAST



*adjusted with the statistical error

INFLATION FORECAST



Source: UniCredit Research

MACROECONOMIC DATA AND FORECASTS

EUR bn	2017	2018	2019	2020F	2021F
GDP (EUR bn)	467.6	497.4	529.1	492.7	556.0
Population (mn)	38.4	38.4	38.4	38.4	38.4
GDP per capita (EUR)	12,166	12,941	13,766	12,819	14,464
Real economy, change (%)					
GDP	4.9	5.3	4.1	-6.8	7.0
Private consumption	4.5	4.5	3.8	-6.2	7.0
Fixed investment	3.9	9.3	7.2	-23.4	17.0
Public consumption	2.8	3.7	4.9	17.7	-8.7
Exports	9.6	7.0	4.6	-12.0	8.5
Imports	9.8	7.6	2.7	-11.1	7.7
Monthly wage, nominal (EUR)	1061	1134	1199	1187	1271
Real wage, change (%)	3.6	5.3	4.2	-1.5	2.1
Unemployment rate (%)	7.3	6.1	5.4	6.0	6.6
Fiscal accounts (% of GDP)					
Budget balance	-1.5	-0.2	-0.7	-8.4	-4.3
Primary balance	0.0	1.2	0.5	-7.0	-3.0
Public debt	50.4	48.4	45.4	55.4	53.9
External accounts					
Current account balance (EUR bn)	0.3	-5.0	2.5	2.5	6.1
Current account balance/GDP (%)	0.1	-1.0	0.5	0.5	1.1
Extended basic balance/GDP (%)	2.8	3.6	4.4	4.9	4.4
Net FDI (% of GDP)	1.4	2.5	1.9	0.4	1.4
Gross foreign debt (% of GDP)	67.7	63.3	59.0	60.5	51.6
FX reserves (EUR bn)	90.2	96.5	103.3	107.4	115.6
Months of imports, goods & services	4.6	4.5	4.6	6.2	5.5
Inflation/Monetary/FX					
CPI (pavg)	2.0	1.7	2.3	3.3	2.6
CPI (eop)	2.1	1.1	3.4	2.2	3.3
Central bank target	2.50	2.50	2.50	2.50	2.50
Central bank reference rate (eop)	1.50	1.50	1.50	0.10	0.75
3M money market rate (Dec avg)	1.72	1.72	1.72	0.35	1.00
USD/FX (eop)	3.48	3.76	3.80	3.86	3.69
EUR/FX (eop)	4.17	4.30	4.26	4.40	4.35
USD/FX (pavg)	3.78	3.61	3.84	3.98	3.70
EUR/FX (pavg)	4.26	4.26	4.30	4.42	4.32

Source: Eurostat, Statistics Poland, NBP, UniCredit Research

*Long-term foreign currency credit rating provided by Moody's, S&P and Fitch, respectively

Setting the standard for crisis response in CEE

The largest crisis response package in CEE…

…with total support of around 15% of GDP

Poland stands out in CEE as having had the most decisive reaction to the COVID-19 crisis. Swift action from the government and the central bank, as well as a higher share of domestic demand in GDP, leaves Poland in a good position to lead the rebound in EU-CEE. The support package comprises several rounds of direct fiscal support under the "anti-crisis shield". Its current size is around PLN 330bn (15% of GDP), more than 5% of GDP of which is new spending. It includes a "financial shield" that comprises PLN 100bn (4.5% of GDP) in loans granted by the sovereign investment fund PFR, 60% of which could turn into grants. In addition, the development bank BGK is offering guarantees of up to PLN 75bn (3.4% of GDP) for corporate borrowers.

The "anti-crisis shield" has a wide coverage,…

…from households...

The "anti-crisis shield" is the largest direct fiscal support program in EU-CEE. Its first phase was launched at the beginning of April, preceding similar programs in most EU-CEE countries. The program is aimed at protecting the population and companies, while also providing financial help for health services. Transfers to households (including support for families with children, transfers to farmers and a three-month moratorium on loan repayments for those who have lost their jobs) supplement the existing generous benefits for children, pensioners and the young.

…to self-employed, microenterprises, SMEs and local government.

The government's aim to prevent a sharp rise in unemployment and bankruptcies led to a wide range of programs, including support for furloughed workers, the self-employed, micro-enterprises and SMEs (including full or half exemptions for social security payments for three months, the coverage of loan interest payments by BGK, protection for trade credit and support for leasing) and for local authorities (to compensate for missing budget revenues).

Two thirds of companies are benefitting from support…

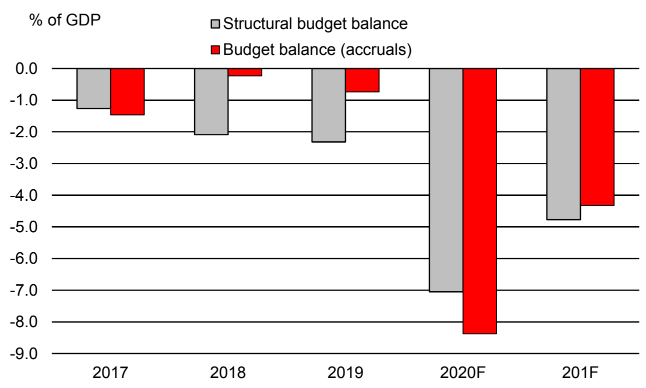
…with up to 3 million jobs saved and 637,000 furloughed

The government estimates that almost two thirds of companies have benefited from support so far, with up to three million jobs saved, which would represent around 18% of employment. According to official sources, the number of employees furloughed by microenterprises and SMEs exceeds 1.6 million. The "financial shield" had disbursed more than PLN 69.2bn (3.1% of GDP) in loans by 18 June. A loan scheme for companies with more than 250 employees that have suffered revenue losses of more than 25% will be launched in 2H20. Out of the PLN 25bn of available funding, around PLN 5.6bn (0.2% of GDP) could be turned into grants. These programs come with a protectionist agenda, with the government banning foreign takeovers of Polish companies.

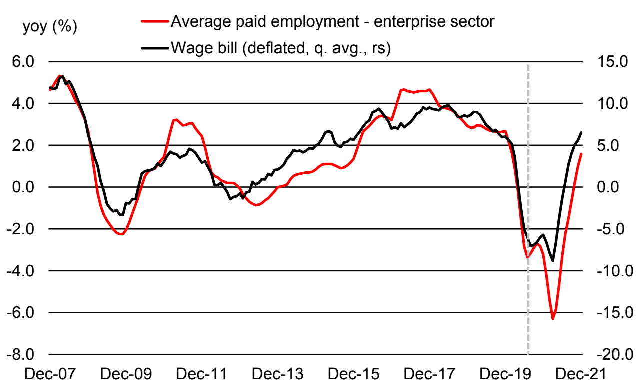
Budget deficit likely to exceed 8% of GDP in 2020

The government expects the impact of anti-crisis spending and the cyclical fall in budget revenue to push the budget deficit to around 8.4% of GDP this year. Our forecast is similar, as the effect of a deeper recession than in the authorities' forecast could be offset by lower spending from the "anti-crisis shield" than currently planned.

SHARP WIDENING OF THE BUDGET DEFICIT…



…WILL NOT PREVENT A DROP IN HOUSEHOLD INCOME



Source: Ministry of Finance, Statistics Poland, UniCredit Research

A 6.8% contraction in 2020 could be followed by a 7.0% rebound in 2021

We expect GDP to contract by around 6.8% in 2020, with a rebound of around 7.0% in 2021. Thus, Poland could lead the region in recouping economic losses from 1H20 in 2H20 and 2021, mostly from the fiscal impulse. This year's recovery will be shaped by four major factors:

Exports of investment goods likely to underperform

6. Foreign demand will continue to weigh on industrial production and exports. Large stimulus in the eurozone bodes well for Polish output, but not for capital goods, which could lag the recovery. Machinery and cars represent almost 40% of Polish exports.

Investment expected to drop in 2020…

…with rebound in infrastructure and building activity in 2021

7. Investment is likely to fall. Both domestic and foreign companies may postpone capex in Poland. Output in building projects is probably going to decline further this year, especially if demand for housing remains temporarily depressed. There is also good news: the government allotted PLN 30bn (1.4% of GDP) from the anti-crisis shield to investment. Its spending on infrastructure was more resilient than other types of construction during the lockdown and could rebound strongly in 2H20 and 2021 as Poland absorbs more EU funds than it has in recent years. Finally, the Polish construction market – being the largest, most developed and most liquid market in the region – may be the first to rebound in EU-CEE.

Consumer demand affected by the sharpest fall in the real wage bill on record

8. Consumers are likely to reduce spending amid the sharpest decline in the economy's real wage bill since Poland joined the EU. Unemployment could peak at around 7.5% in 1H21, declining subsequently, but the wage bill will grow at a much slower pace than in previous years. Household wealth may provide a cushion and accelerate next year's recovery.

Financial conditions expected to tighten

9. Fourth, banks anticipate much tighter financial conditions. The financial shield comes at a time when momentum in PLN lending is weakening. However, the bank tax and a flat interest rate curve will weigh on banks' willingness to lend.

The NBP ended rate cuts…

…but will continue to buy more bonds

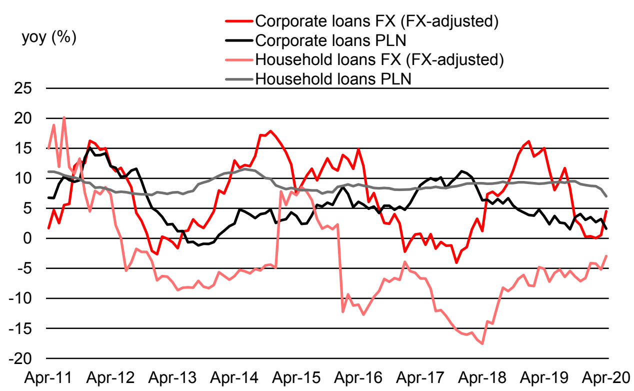
The NBP has ended rate cuts at 0.10% and is now focusing on purchasing bonds issued by BGK and PFR (2% of GDP by mid-June) to add to the POLGBs it holds (equivalent of 2.4% of GDP). Total bond purchases could rise to more than 8% of GDP by year-end as BGK and PFR continue to support the economy. The central bank need not worry about inflation, which is likely to remain inside the target range in 2020-21. However, the NBP's deflationary fears may be overblown, with inflation likely to climb back towards 3% by the end of 2021.

A tight run-off in the presidential election …

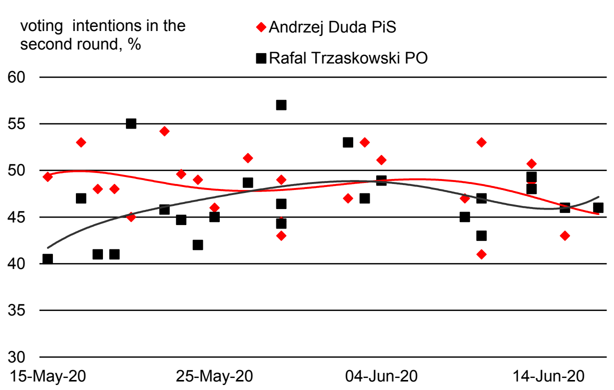
…but the result may have little impact on economic policies

Opinion polls for the presidential elections suggest a tight run-off on 12 July between the incumbent, Andrzej Duda, supported by the Law and Justice-led government, and the candidate of the Civic Coalition, Rafał Trzaskowski. Mr. Duda benefits from the government's strong economic record, but his recent homophobic comments are opposed by a majority of voters aged below 50. A win for Mr. Duda will leave things as they are. A win for Mr. Trzaskowski will severely hamper the government's conservative social agenda, but is unlikely to change the economic course of the country. In last year's parliamentary elections, the Civic Coalition ran on a similar economic platform to that of the government.

WEAK MOMENTUM IN PLN LENDING



THE PRESIDENTIAL ELECTION IS A TOSSUP



Source: NBP, polling agencies, UniCredit Research

Strong local support for POLGBs

Local support for POLGBs remains very strong…

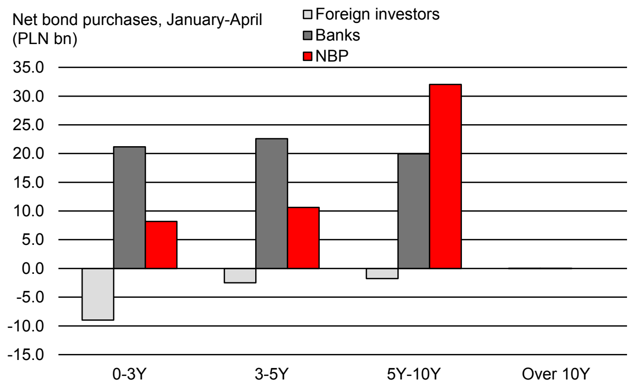
POLGBs benefit from strong domestic support. The NBP has proved that it can support POLGBs without being price sensitive. This proof, on its own, should be sufficient for POLGBs to be more stable than their regional peers. In addition, banks are likely to increase demand for bonds as the rate cut to 0.1%, coupled with the bank asset tax of 0.44%, leads to costly liquidity holdings. Like in the past, banks could purchase bonds with short maturities to use as liquidity instruments that do not incur the bank asset tax. This anchors the short end of the POLGB curve. At the same time, banks continue to purchase bonds across the curve, dwarfing outflows from foreign investors since the start of the year.

… dwarfing outflows from foreign investors

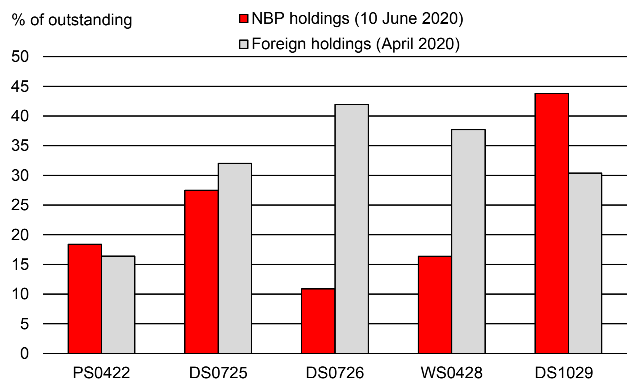
The PLN remains slightly undervalued

The biggest risk to POLGBs is currency volatility, especially after the MPC said that the recovery may be hampered by too strong a currency. In contrast, Finance Minister Tadeusz Koscinski sees the PLN as being too weak, an opinion that echoes the NBP's own assessment of fair value. In our view, the PLN remains slightly undervalued and any verbal interventions may only have a short-term effect on the currency .

DOMESTIC BOND BUYERS OFFSET FOREIGN OUTFLOWS



NBP PURCHASED BONDS WITH HIGH FOREIGN OWNERSHIP



Source: Ministry of Finance, Bloomberg, UniCredit Research

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2019	2020F	2021F
Gross financing requirement	**30.5**	**52.7**	**55.4**
Budget deficit	3.2	28.4	24.0
Amortization of public debt	27.3	24.3	31.4
Domestic	20.0	17.5	24.1
Bonds	20.0	17.5	21.6
Bills	0.0	0.0	2.5
Loans/Other	0.0	0.0	0.0
External	7.3	6.8	7.3
Bonds	5.9	5.3	6.8
Loans, IFIs, other	1.4	1.5	0.5
Financing	**30.5**	**52.7**	**55.4**
Domestic borrowing	28.7	41.8	42.0
Bonds	28.7	34.3	37.0
Bills	0.0	5.0	5.0
Loans/Other	0.0	2.5	0.0
External borrowing	3.2	10.0	11.0
Bonds	2.0	5.0	6.0
Loans, IFIs, other	1.2	5.0	5.0
Change in fiscal reserves/Other (-=increase)	-1.4	0.9	2.4

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2019	2020F	2021F
Gross financing requirements	**91.8**	**95.5**	**86.8**
C/A deficit	-2.5	-2.5	-6.1
Amortization of medium and long-term debt	50.1	47.9	50.4
Government/central bank	13.3	10.3	11.6
Banks	11.9	11.1	10.5
Corporates/Other	24.9	26.4	28.2
Amortization of short-term debt	44.2	50.1	42.5
Financing	**91.8**	**95.5**	**86.8**
FDI (net)	10.0	2.2	8.0
Portfolio equity, net	0.7	-2	1.0
Medium and long-term borrowing	34.0	38.8	44.6
Government/central bank	1.2	9.9	14.6
Banks	7.1	7.8	7.4
Corporates/Other	25.6	21.1	22.6
Short-term borrowing	42.6	45.2	37.3
EU structural and cohesion funds	10.6	19.4	10.2
Other	3.2	-4.0	-6.0
Change in FX reserves (- = increase)	-9.2	-4.1	-8.3
Memoranda:			
Non-resident purchases of LC govt bonds	-7.8	-3.1	-0.1
International bond issuance, net	-3.9	-0.3	-0.8

Source: Statistics Poland, NBP, Ministry of Finance, UniCredit Research

Romania

Baa3 negative/BBB- negative/BBB- negative*

Outlook

GDP could fall by almost 8% in 2020, with a partial recovery of more than 7% expected in 2021. After widening to around 8% of GDP this year, the budget deficit will have to fall towards 4% of GDP next year to preserve the investment grade rating. This means a 10% pension increase this year (rather than 40%) and further spending cuts in the coming years. The fiscal package of around 3% of GDP in direct support and 3% of GDP in guarantees could prevent a sharp rise in unemployment. Nevertheless, labor market conditions will loosen, pushing core inflation below target and allowing the NBR to cut the policy rate to 1%.

Strategy

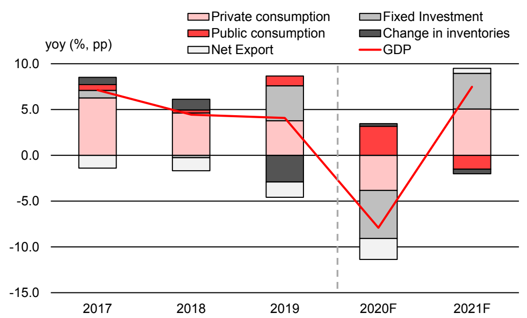
ROMGB and ROMANI bonds are attractive but face the risk of large financing needs.

Authors: Dan Bucsa, Chief CEE Economist (UniCredit Bank, London)
Anca Negrescu, Senior Economist (UniCredit Bank Romania)

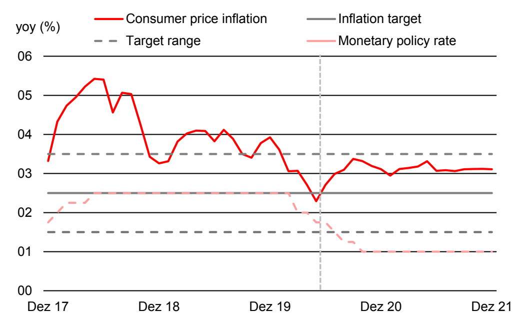
KEY DATES/EVENTS

- monetary policy calendar is suspended
- 10 July, 12 August, 10 September: CPI
- July: decision on pension increase
- 14 August, 8 September: 2Q20 GDP (flash, structure)
- late August (?): inflation report

GDP GROWTH FORECAST



INFLATION FORECAST



Source: UniCredit Research

MACROECONOMIC DATA AND FORECASTS

EUR bn	2017	2018	2019	2020F	2021F
GDP (EUR bn)	188	205	223	212	230
Population (mn)	19.6	19.5	19.4	19.4	19.3
GDP per capita (EUR)	9,560	10,479	11,504	10,938	11,917
Real economy, change (%)					
GDP	7.1	4.4	4.1	-7.9	7.5
Private consumption	10.0	7.3	5.9	-6.0	7.8
Fixed investment	3.6	-1.2	18.2	-22.2	19.9
Public consumption	4.2	2.1	6.4	18.3	-6.8
Exports	7.6	6.2	4.6	-18.2	16.6
Imports	10.8	9.1	8.0	-11.4	13.0
Monthly wage, nominal (EUR)	724	965	1069	1080	1134
Real wage, change (%)	13.0	29.7	8.9	-0.2	3.8
Unemployment rate (%)	4.9	4.2	3.9	5.3	5.6
Fiscal accounts (% of GDP)					
Budget balance	-2.6	-2.9	-4.3	-8.0	-4.3
Primary balance	-1.4	-1.5	-3.2	-6.7	-3.1
Public debt	35.1	34.7	35.2	44.8	44.8
External accounts					
Current account balance (EUR bn)	-5.2	-9.0	-10.2	-10.0	-10.0
Current account balance/GDP (%)	-2.8	-4.4	-4.6	-4.7	-4.3
Extended basic balance/GDP (%)	0.9	-1.1	-1.2	-1.4	-1.4
Net FDI (% of GDP)	2.6	2.4	2.4	0.8	1.4
Gross foreign debt (% of GDP)	36.5	33.4	33.0	37.0	36.1
FX reserves (EUR bn)	33.5	33.1	32.9	33.7	32.9
Months of imports, goods & services	4.8	4.3	4.0	4.7	4.1
Inflation/Monetary/FX					
CPI (pavg)	1.3	4.6	3.8	3.0	3.1
CPI (eop)	3.3	3.3	4.0	3.1	3.1
Central bank target	2.50	2.50	2.50	2.50	2.50
Central bank reference rate (eop)	1.75	2.50	2.50	1.00	1.00
3M money market rate (Dec. avg.)	2.13	3.05	3.12	1.40	1.48
USD/FX (eop)	3.89	4.07	4.26	4.22	4.19
EUR/FX (eop)	4.66	4.66	4.78	4.85	4.95
USD/FX (pavg)	4.05	3.94	4.24	4.31	4.21
EUR/FX (pavg)	4.57	4.65	4.75	4.83	4.92

Source: Eurostat, NSI, UniCredit Research

*Long-term foreign currency credit rating provided by Moody's, S&P and Fitch, respectively

Little room for error

Pension increase likely to be scaled back to 10%

Romanian authorities will have to reduce the budget deficit to avoid rating downgrades to junk. Before the end of July, the government will have to scale back the pension increase scheduled for 1 September 2020 from 40% to around 10%. This can be done through emergency ordinance, as parliament wants pensions to rise ahead of local elections, expected on 27 September or 4 October, and parliamentary elections, which are expected to take place on 6 December.

The budget deficit could swell above 8% of GDP…

…with the direct fiscal support package of around 3% of GDP…

…and cyclical losses of budget revenues

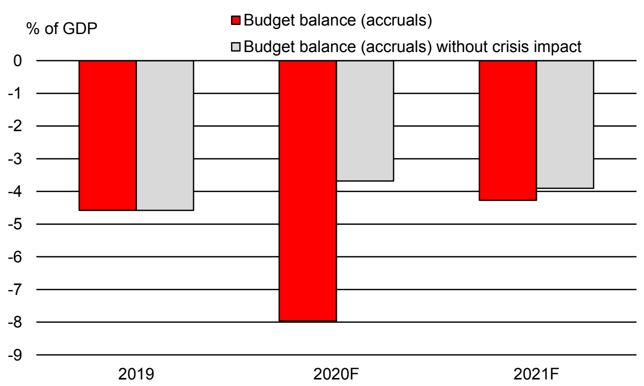
The starting point is bad: the budget deficit reached 2.4% of GDP at the end of April, the largest four-month shortfall in more than 20 years. Even if pensions increase by only 10%, the deficit could exceed 8% of GDP by year-end if, in 2H20, the government continues to invest at the same pace as in 1H20. At around 3% of GDP, the direct support package for the economy is one of the smallest in the EU but is well diversified, including support for furloughed and returning workers, 50% of wages for three months for new employees aged below 29 and over 50, tax holidays for SMEs and a nine-month moratorium on loan repayments for SMEs and mortgage borrowers. The economic slowdown will take an additional toll on budget revenues. First, indirect tax receipts are likely to lag last year's revenues due to a partial recovery in retail sales and leisure services. Second, not all firms that benefited from differed tax payments will survive to pay those taxes. Third, social security contributions will fall as unemployment rises. The number of furloughed workers peaked at around 1.1 million at the height of the lockdown but halved by late May. Out of the reduction, half of the employees returned to work and half where made redundant, with the number of newly unemployed swelling to around 430,000 (8.7% of pre-crisis employment) since the start of the COVID-19-induced lockdown. Yet the numbers could have been far worse had Romania not offered the fourth most-generous furlough support in CEE of up to 75% of wages. We expect the unemployment rate to peak above 6% and fall to 4.5% by end-2021.

Support programs were launched late…

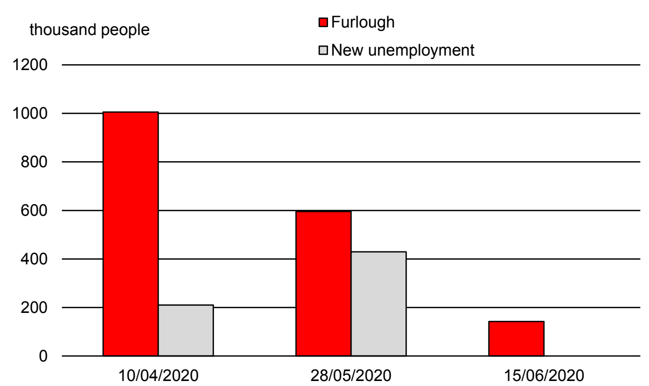
….but are picking up

Direct fiscal support was implemented with a delay due to red tape and restrictive criteria, and excluded companies that weathered the first phase of the crisis better. The government eased access to support for SMEs and furloughed workers (e.g. by easing restrictions and moving the whole granting process online), but issues remain. For example, 41.5% of wages (up to RON 2,250) can be paid for three months to returning workers, but not to those whose employers did not qualify for furlough support or did not request it. The "IMM Invest" program that can disburse up to 3% of GDP in loans to SMEs did not start until late May, with banks processing more than 200,000 loan applications. Even at the rate of more than 1000 loans disbursed per week (more than banks were disbursing in six months in normal times), many SMEs may not benefit from liquidity injections in time to save their businesses. For 2H20, the government is preparing schemes targeting leasing factoring and trade credit.

THE BUDGET DEFICIT COULD SWELL ABOVE 8% OF GDP



FURLOUGH REDUCED THE SPIKE IN UNEMPLOYMENT



Source: Ministry of Finance, NSI, Ministry of Labor, UniCredit Research

GDP could fall by almost 8% in 2020 and grow by more than 7% in 2021

The government may have to support the economy in 2021 as well

Despite public support, we expect GDP to fall by around 8% this year, with the trough in 2Q20 as suggested by high-frequency labor, energy and mobility indicators. The ensuing recovery is likely to be gradual and uneven due to both domestic and external factors. International supply chains remain disrupted and many Romanian companies that restarted activity had to scale it back due to missing supplies or poor foreign demand. These issues could persist in 2H20, especially in car, textile, footwear, chemical and rubber manufacturing, which account for 39% of employment in manufacturing. Domestic supply chains are affected as well, with liquidity shortfalls being only partly mitigated by public support, probably explaining why jobs lost in manufacturing outnumber those in other sectors. The prevalence of trade credit, three times larger than bank lending, leaves the economy vulnerable to solvency risks. Thus, the government may have to extend fiscal support into 2021 to support the recovery.

Next year's recovery will be slowed by fiscal adjustment

Despite trouble in the labor market, we expect consumer demand to see a stronger rebound than investment and exports. Public consumption is likely to fall next year as the government tries to contain the budget deficit. We expect the public shortfall to decline towards 4% of GDP in 2021, with the economy unlikely to recover this year's losses. A potential second wave of the pandemic is unlikely to trigger comparable restrictions to those from March-May 2020 but will further slow the recovery.

Core inflation to trend lower, diverging from headline inflation

With real wage growth coming to a standstill this year and the negative output gap likely to persist until late 2022, we expect core inflation to fall below target this year. Discrepancies between retail sales and prices for clothing and durable goods suggest that current inflation may be overestimated. Supply shocks could turn mostly inflationary from 2H20 onwards, with food prices rising due to a poor 2020 harvest and fuel prices recouping some of the losses from 1H20. As a result, headline inflation could climb back above 3% later this year and in 2021, without exiting the target range. Nevertheless, second-round effects from supply shocks may not be strong enough to push core inflation higher, in line with the headline rate.

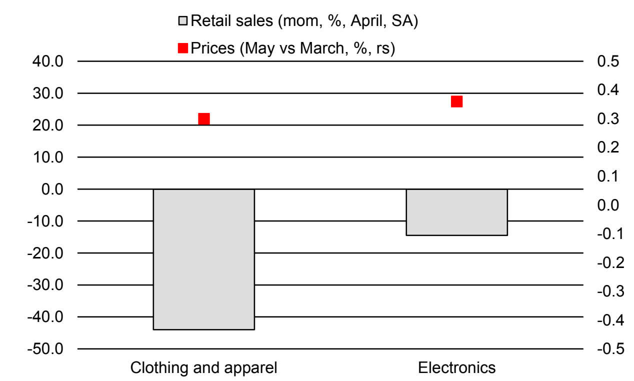
The NBR could cut the policy rate to 1% this year

Pressure on the currency is manageable

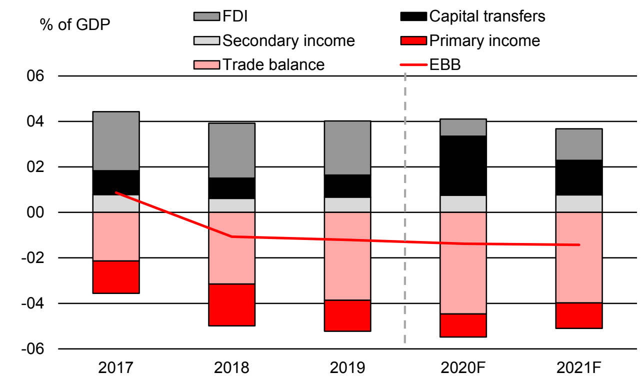
EU transfers are picking up

The NBR's bleak outlook for the economy leaves room to cut the policy rate to 1% before year-end. Otherwise, monetary conditions would tighten too much at the end of 2020, once the government stops paying the interest on IMM Invest loans and the moratorium on other SME and mortgage loans ends. Concerns about the RON could be temporarily alleviated after Romania avoided the downgrade to junk and the central bank concluded a EUR 4.5bn repo line with the ECB. Yet pressure on the currency and FX interventions are likely to continue as the C/A deficit could remain above 4% of GDP in 2020-21. The wider trade deficit with goods is offset by higher exports of IT services and lower imports of tourism services and transfers of income from investment. The external shortfall will be only partly financed by FDI and EU funds, although Romania already tapped the EU's anti-crisis funds for EUR 1.7bn to cover costs related to furlough, the health care sector, and one million people living in poverty. Inflows are likely to continue, helping to narrow the extended basic balance.

DISCREPANCY BETWEEN RETAIL SALES AND INFLATION



EBB HELPED BY CAPITAL TRANSFERS AND SERVICES



Source: EC, Eurostat, NBR, NSI, UniCredit Research

A relief rally curtailed by large issuance needs

Local support and rate cuts make ROMGBs attractive

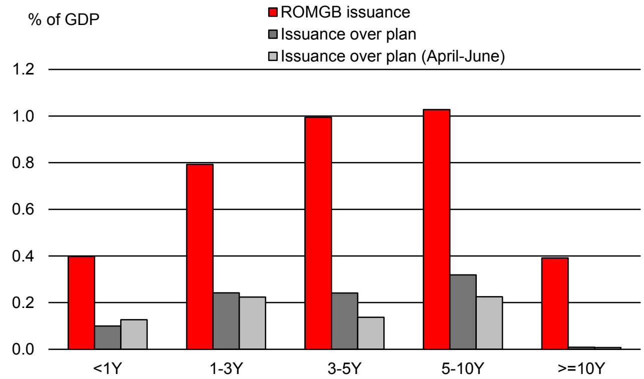
The government has been very active in terms of issuance this year, with EUR 6.3bn (3% of GDP) issued abroad and 3.6% of GDP on the local market, of which 0.9% of GDP above the announced monthly issuance plans. The central bank has been keeping liquidity conditions loose, supporting local demand for bonds. If the NBR cuts rates as we expect, bonds are likely to rally as local investors will adjust yields to lower financing costs. The currency is not a risk, since the central bank will continue to defend the RON using FX interventions and moral suasion (for details, please see our EEMEA Country Note “CEE central banks: Wider mandates to fight the downturn” from 17 June).

ROMANI still trading at BB

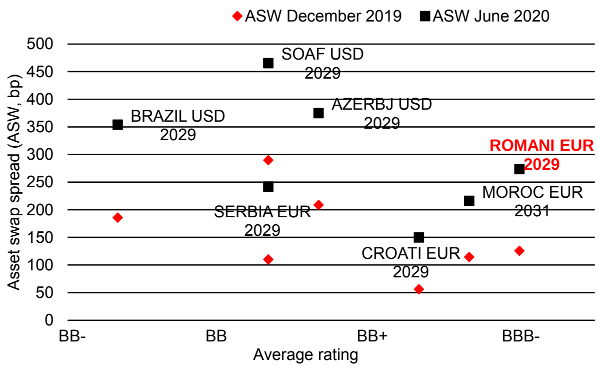
Large financing needs are the main risk for a bond rally

ROMANI bonds are also attractive. While the risk of losing its investment grade rating has declined significantly and could be postponed to next year if the government increases pensions by 10%, EUR bonds trade in the middle of the BB range. The main risk for both ROMGBs and ROMANI bonds is additional issuance. We expect the government to tap foreign markets for at least EUR 3bn more and issue ROMGBs worth EUR 2.6bn in 2H20.

STRONG SUPPORT FOR ROMGBS FROM LOCAL INVESTORS



ROMANI EUR STILL TRADE IN JUNK TERRITORY



Source: NBR, NSI, Bloomberg, UniCredit Research

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2019	2020F	2021F
Gross financing requirement	**19.7**	**26.2**	**19.2**
Budget deficit	10.2	17.7	8.1
Amortization of public debt	9.5	8.5	11.2
Domestic	7.0	6.5	11.2
Bonds	5.9	5.8	7.9
Bills	0.8	0.4	2.0
Loans	0.3	0.3	1.3
External	2.5	2.0	0
Bonds and loans	1.5	2.0	0
IMF/EU/Other IFIs	1.0	0	0
Financing	**19.7**	**26.2**	**19.2**
Domestic borrowing	13.6	13.6	14.0
Bonds	12.2	11.0	12.5
Bills	0.4	2.0	1.0
Loans	1.0	0.6	0.5
External borrowing	6.6	11.1	5.0
Bonds	5.0	8.3	4.0
IMF/EU/Other IFIs	1.6	2.8	1.0
Privatization/Other	0	0	0
Fiscal reserves change (- =increase)	-0.5	1.5	0.3

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2019	2020F	2021F
Gross financing requirement	**39.3**	**38.9**	**36.7**
C/A deficit	10.2	10.0	10.0
Amortization of medium and long term debt	14.5	14.0	11.7
Government/central bank	3.5	2.9	0.9
Banks	2.2	1.7	1.6
Corporates/Other	8.8	9.4	9.3
Amortization of short-term debt	14.6	14.9	15.0
Financing	**39.3**	**38.9**	**36.7**
FDI (net)	5.3	1.6	3.2
Portfolio equity, net	0.1	0.1	0.1
Medium and long-term borrowing	17.5	17.6	15.6
Government/central bank	6.7	8.1	5.0
Banks	2.0	1.6	1.4
Corporates/Other	8.8	8.0	9.3
Short-term borrowing	14.5	14.6	13.4
EU structural and cohesion funds	2.2	5.5	3.5
Change in FX reserves (- = increase)	-0.3	-0.5	0.9
Memoranda:			
Nonresident purchases of LC govt bonds	2.5	1.0	-0.2
International bond issuance, net	3.5	6.3	4.0

Source: Eurostat, NBR, NSI, Ministry of Public Finance, UniCredit Research

Slovakia

A2 stable/A+ stable/A stable*

Outlook

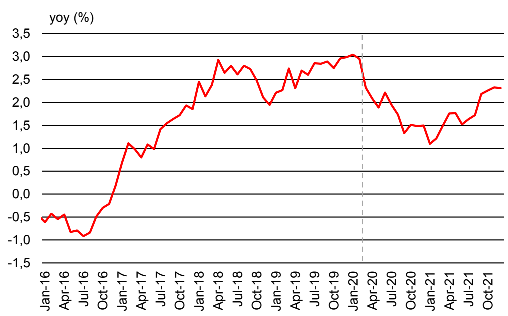
Slovakia has had some of the lowest numbers of COVID-19-related cases and deaths in Europe, but the economic impact of the pandemic on Slovakia has been severe due to the openness of Slovakia's economy and its dependency on car production. The speed of the recovery in external demand, particularly in car sales, will be crucial for Slovakia's economic rebound. Slovakia's 2020 GDP loss may not be fully recouped until 2022. The reopening of the local economy started in May, a month earlier than we expected, with most economic activity running by early June. Rising unemployment will slow the recovery in consumer demand. Sixteen percent of Slovakia's workers were furloughed, with government support facing several issues in the early stages of the crisis. The state plans to implement anti-COVID-19 measures amounting to 5.8% GDP, half of which will be financed with EU funds, sending public debt above 60% of GDP.

Author: L'ubomír Koršňák, Chief Economist Slovakia (UniCredit Bank Czech republic and Slovakia)

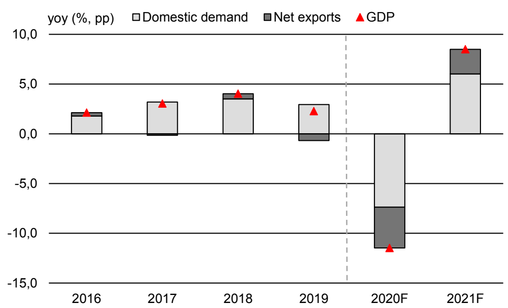
KEY DATES/EVENTS

- 10 Jul, 10 Aug, 10 Sep: industrial production
- 14 Jul, 13 Aug, 14 Sep: CPI
- 14 Aug: flash 2Q20 GDP
- 4 Sep: 2Q20 GDP structure
- 24 Jul, 11 Sep: rating reviews by S&P and Moody's

INFLATION TO MODERATE BELOW 2% IN 2020



V-SHAPED RECESSION DRIVEN BY COVID-19



Source: UniCredit Research

MACROECONOMIC DATA AND FORECASTS

EUR bn	2017	2018	2019	2020F	2021F
GDP (EUR bn)	84.5	89.6	94.2	84.2	92.6
Population (mn)	5.4	5.4	5.4	5.4	5.4
GDP per capita (EUR)	15 539	16 460	17 288	15 456	16 989
Real economy, change (%)					
GDP	3.0	4.0	2.3	-12.0	8.5
Private Consumption	4.5	4.2	2.1	-5.7	5.8
Fixed Investment	3.5	2.6	6.8	-22.4	13.6
Public Consumption	1.0	0.2	4.6	5.0	-1.5
Exports	3.6	5.3	1.7	-28.0	23.5
Imports	3.9	4.9	2.6	-23.9	20.0
Monthly wage, nominal (EUR)	954	1 013	1 092	1 120	1 168
Real wage, change (%)	3.3	3.6	5.0	0.5	2.5
Unemployment rate (%)	8.1	6.5	5.8	8.3	8.5
Fiscal accounts (% of GDP)					
Budget balance	-1.0	-1.0	-1.3	-9.0	-5.0
Primary balance	0.5	0.3	-0.1	-7.6	-3.4
Public debt	51.3	49.4	48.0	62.7	62.0
External accounts					
Current account balance (EUR bn)	-1.6	-2.4	-2.7	-2.1	-1.2
Current account balance/GDP (%)	-1.9	-2.6	-2.9	-2.5	-1.3
Extended basic balance/GDP (%)	1.0	-0.4	0.3	-1.1	0.5
Net FDI (% of GDP)	2.8	0.9	2.2	0.2	0.5
Gross foreign debt (% of GDP)	108.2	113.7	111.9	115.7	110.3
FX reserves (EUR bn)	EUR	EUR	EUR	EUR	EUR
Months of imports, goods & services	-	-	-	-	-
Inflation/monetary/FX					
CPI (pavg)	1.3	2.5	2.7	2.0	1.8
CPI (eop)	1.9	1.9	3.0	1.5	2.3
Central bank reference rate (eop)	EUR	EUR	EUR	EUR	EUR
USD/FX (eop)	EUR	EUR	EUR	EUR	EUR
EUR/FX (eop)	EUR	EUR	EUR	EUR	EUR
USD/FX (pavg)	EUR	EUR	EUR	EUR	EUR
EUR/FX (pavg)	EUR	EUR	EUR	EUR	EUR
Real effective exchange rate, 2000=100					
Change (%)					

Source: Eurostat, NSI, UniCredit Research

*Long-term foreign currency credit rating provided by Moody's, S&P and Fitch, respectively

The course of pandemic in Slovakia has been mild, but its economic impacts have been severe

Economic contraction is severe, despite mild course of pandemic

Gradual reopening of the economy

Slovakia emerged from the first stage of the COVID-19 pandemic with some of the lowest numbers of cases and deaths in Europe. Nevertheless, the economic impact of the pandemic in Slovakia has been severe; Slovakia has shown above-average GDP contraction so far. The price for controlling the pandemic through an early lockdown was a sharp decline in domestic economic activity, while the openness of Slovakia's economy and its reliance on car production affected its manufacturing sector. The reopening started in May, a month earlier than we expected, with most economic activity having resumed by early June. However, social distancing and hygiene norms have hampered a recovery in demand. This is confirmed by Google mobility data, which show a slightly weaker recovery in Slovakia, even compared to its regional peers, (local mobility was 20-30% below where it was at this time last year). The same picture is shown by Google search data. For example, searches in Slovakia for "tickets" has recovered from an April low but remains 30% below last year's level. Consumer confidence sunk to an 11-year low in April, while its recovery could be slowed by rising unemployment.

Unemployment to reach 10%, as short-time work and furlough schemes were delayed by implementation issues

The government has decided to use tailored measures to support employment based on the extent of the decline in activity. Higher administrative burdens have reduced the effectiveness of aid, especially in the initial phase. The use of support did not start to increase until May and still falls short of expectations. As a result, unemployment rose by more than 1pp in April, mainly due to a rise in the number of newly unemployed in tourism and trade. On a positive note, Google search data and reported collective redundancies suggest that the number of new redundancies may have already peaked. However, a second wave of unemployment increases may take place in the autumn, when school-leavers register and short-time-work and furlough programs end. The number of short-time and furloughed workers climbed to 400,000, or 16% of domestic employment. Furthermore, the unemployment rate may be swollen by imported unemployment, as it is estimated that more than 10% of Slovakia's domestic workforce works abroad, while foreigners represent 3% of local employment. We estimate that unemployment may reach 10% in the autumn before falling gradually in 2021.

External demand recovery is crucial to economic rebound, with car production critical

Full recovery unlikely before 2022

…despite state support

Rising unemployment and consumer pessimism are likely to slow the recovery in domestic demand. However, the speed of the recovery in external demand, particularly in car sales, will be crucial for Slovakia's economic rebound, as Slovakia is one of the most open economies globally. All four local automakers resumed production by mid-May, but pre-crisis levels may not be reached before late 2021. Weak demand and the lack of fuel-efficient and electric cars in product lines (an issue that also affects Slovakian car manufacturing) could hamper car sales across Europe. Car-scrappage schemes could support demand, but their size is likely to fall short of similar schemes implemented in 2008-10. We expect GDP to decline by 12.0% in 2020 before rebounding by 8.5% in 2021. However, the GDP loss is unlikely to be fully recovered until 2022. A potential second wave of infection may slow any recovery, intensifying the negative effects of the pandemic on the local labor market and further weighing on domestic-demand growth.

Budget deficit is projected to remain above 3% until 2023...

…while the public-debt brake could be amended

COVID-19 measures are projected to increase Slovakia's 2020 budget deficit by 2.8% of GDP, with an additional 3.0% GDP covered by EU funds. The new government would also like to improve the business environment and spur innovation in an effort to boost economic growth in the coming years. Furthermore, Slovakia is one of the largest net recipients of EU funds and grants under the proposed 2021-27 framework. Lost tax income could add the equivalent of 2.9% of Slovakian GDP to the 2020 budget deficit. The government expects the budget deficit to widen to 8.4% GDP in 2020, while we expect it to widen to around 9% of GDP. Slovakia's debt agency has already covered the majority of pandemic-driven financial needs, leaving EUR 2-3bn in issuance for the rest of the year. A gradual decline below 3% of GDP after 2023 would require additional tightening measures equivalent in size to 3.2% of GDP. Public debt is set to rise above 60% of GDP, breaking all debt-brake thresholds. The new government could use its constitutional majority in parliament to amend the debt-break rule.

Slovenia

Baa1 positive/AA- stable/A stable*

Outlook

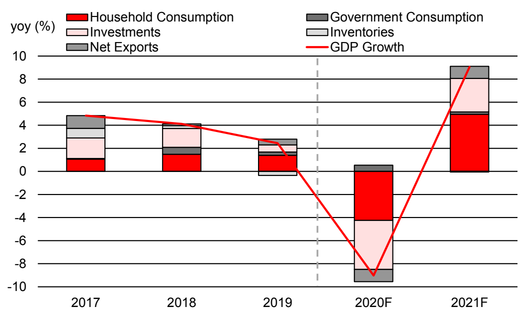
We expect GDP to contract by 9% in 2020 due to the impact of COVID-19. The Slovenian economy will likely be affected mainly in 2Q20, with a partial rebound in 2H20. In 2021, we expect growth to be 9%, boosted by strong carryover at the end of 2020. The fiscal support measures and the economic downturn will likely lead to fiscal metrics deteriorating in 2020, before some improvement in 2021, although financing will not be a problem. Regarding politics, the focus will be on facing the challenges relating to COVID-19 and therefore we see no threat for government stability in the short term.

Author:
Mauro Giorgio Marrano, Senior CEE Economist (UniCredit Bank, Vienna)

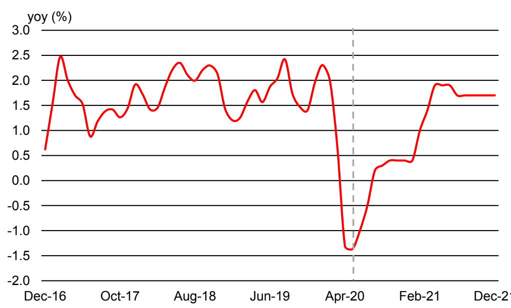
KEY DATES/EVENTS

- 31 Aug: 2Q20 GDP
- 10 Jul, 10 Aug, 10 Sep: Industrial production
- 17 Jul: rating update from Fitch

GDP GROWTH FORECAST



INFLATION FORECAST



Source: SURS, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2017	2018	2019E	2020F	2021F
GDP (EUR bn)	43.0	45.8	48.0	43.8	48.4
Population (mn)	2.1	2.1	2.1	2.1	2.1
GDP per capita (EUR)	20,809	22,083	22,983	20,896	23,065
Real economy, change (%)					
GDP	4.8	4.1	2.4	-9.0	9.0
Private Consumption	2.0	2.8	2.7	-8.1	9.3
Fixed Investment	10.4	9.1	3.2	-22.4	17.9
Public Consumption	0.3	3.2	1.6	2.9	1.0
Exports	10.5	6.1	4.4	-22.7	20.7
Imports	10.1	6.6	4.2	-23.8	21.7
Monthly wage, nominal (EUR)	1,626	1,681	1,754	1,736	1,786
Real wage, change (%)	1.1	1.4	2.6	-1.2	1.3
Unemployment rate (%)	6.6	5.1	4.5	6.5	5.0
Fiscal accounts (% of GDP)					
Budget balance	0.0	0.7	0.5	-8.0	-2.0
Primary balance	2.5	2.7	2.3	-6.3	-0.3
Public debt	74.1	70.4	66.1	82.0	78.0
External accounts					
Current account balance (EUR bn)	2.7	2.8	3.2	2.6	3.0
Current account balance/GDP (%)	6.3	6.1	6.6	6.0	6.2
Extended basic balance/GDP (%)	7.8	8.8	8.7	7.9	8.9
Net FDI (% of GDP)	1.2	2.0	1.4	0.9	1.4
Gross foreign debt (% of GDP)	100.5	92.0	91.8	97.7	92.4
FX reserves (EUR bn)	0.7	0.8	0.9	0.9	0.9
Months of imports, goods & services					
Inflation/Monetary/FX					
CPI (pavg)	1.6	1.9	1.7	0.2	1.6
CPI (eop)	1.9	1.4	2.0	0.4	1.7

Source: SURS, Eurostat, UniCredit Research

*Long-term foreign currency credit rating provided by Moody's, S&P and Fitch, respectively

A sharp contraction in 2Q20 followed by a recovery in 2H20

We expect GDP to contract by 9% in 2020 and grow by 9% in 2021

We expect GDP to contract by 9% in 2020 due to the impact of COVID-19. The Slovenian economy will likely be affected mainly in 2Q20, where we assume a contraction of 15% qoq (18% yoy) with a partial rebound in 2H20. In 2021, we expect growth to be 9%, boosted by strong carryover at the end of 2020.

Initial data for 2Q20 broadly in line with our forecast

Initial data for 2Q20 appear to be broadly in line with our forecasts. In April, industrial production and retail sales declined 23% yoy while exports and imports fell by 37% yoy and 40% yoy respectively. We assume that April was the trough in industrial and overall economic activity, as most European countries have since started to ease restrictions. The first indicators for May seem to confirm our view. Retail sales increased 13% mom. IMAD reported that freight traffic on motorways, after falling 40% between Mid-March and Mid-April, started to recover in May, although the last week of May was still a fifth below the same period last year. Electricity consumption was down 14% yoy in May, after declining 20% yoy in April. In addition, the number of registered unemployed, after having registered a sharp increase in March, started to increase at a slower pace in May and has shown some declines in June.

A raft of measures to mitigate the impact of COVID-19

The government introduced various packages of measures to mitigate the impact of COVID-19, totaling around EUR 6.6bn (15% of GDP). These include **1.** credit guarantees (EUR 2bn); **2.** direct support measures (EUR 3bn), including furlough support, exemptions for payments of contributions, compensation for all sick leave, tax deferral, bonuses for health workers and temporary income support for vulnerable groups; **3.** liquidity to companies (EUR 0.6bn); and **4.** the recent package announced at the end of May (EUR 1bn) to support the recovery, which includes subsidies for shortened work time, vouchers for tourism and liquidity loans.

Focus on guarantee scheme and measures for recovery

The direct support measures expired at the end of May as the government declared the end of the pandemic, therefore the focus now will be on guarantees and the recently announced targeted measures to support the recovery.

The banking sector is better placed to face the crisis than it was in the past

The banking sector is better placed to face the impact of the COVID-19 crisis compared to the past thanks to its high capital ratio (18.5% at the end of 2019), adequate liquidity (the liquidity-coverage ratio was almost three times the regulatory requirement) and better asset quality (NPL ratio was 3% in 1Q20), although profitability remains low. In addition, ECB liquidity measures will support the banking sector. Data available up to March do not show a meaningful impact of the crisis yet. However, banks are likely to be affected by the economic downturn and by the one year loan moratorium (and macro prudential measures from November 2019 relating to retail lending). The EUR 2bn guarantee scheme, if implemented in full, would lead to 5% growth in lending compared to 2019, other things being equal.

A likely deterioration in fiscal metrics in 2020

The contraction in GDP and the fiscal package could lead to a budget deficit of around 8%, which would temporarily push government debt above 80% of GDP, before falling back somewhat in 2021

Financing will not be an issue

Financing is unlikely to be an issue. The government issued an additional almost EUR 3.5bn in March and April to finance the fiscal packages after the original bond issuance for 2020 plan (EUR 1.5bn) had been completed. This brought total fiscal reserves to EUR 6.4bn at the end of April. This should be more than enough to cover financing needs for 2020, which we estimate at around EUR 3.5bn. Other sources of financing include potential IMF funding through the Rapid Financing Instrument (EUR 800mn) and EU funding (around EUR 600mn). Part of the funds could also be used as pre-financing for 2021, when repayments amount to EUR 3.5bn and we expect the deficit to be around EUR 1bn. With issuance for 2020 completed, government bonds will be supported by ECB purchases, which we estimate could purchase around EUR 2.5bn of Slovenian bonds by year end.

Politics: in the short term the focus will be on facing the challenges related to COVID-19

Regarding politics, two members of the SMS, one of the members of the four-party coalition, left their party, reducing the parliamentary majority to 46 out of 90. As highlighted before, and as was the case with the previous government, a coalition of such a large number of parties with different agendas bodes ill for the long-term stability of the government and its effectiveness in implementing necessary reforms. However, the immediate focus will remain on facing the challenges relating to COVID-19 and therefore we see no threat to government stability in the short term.

Bosnia and Herzegovina

B3 stable/B stable/not rated*

Outlook

The performance of Bosnia and Herzegovina's economy has rapidly deteriorated amid the special circumstances caused by COVID-19 outbreak in April and May. However, a state of emergency was lifted in late May, and restrictive measures are gradually being relaxed. Although there are still few data that can confirm the full effects of the pandemic, the data that are available are broadly in line with our GDP forecast of -7.7%. Foreign trade data for the first four months of 2020 show an expected sharp decline in both exports and imports. Domestic demand is also contracting in line with our expectations – this was confirmed by a huge drop in retail trade during April. The country's fiscal position is also worsening as a result of the government's intervention in an effort to mitigate the magnitude of the crisis. S&P has already revised its outlook for its unchanged B rating from positive to stable as part of an extraordinary assessment. However, the financing of Bosnia and Herzegovina's significant fiscal deficit should be covered by funding assistance from the IMF, other international financial institutions (IFIs) and the EU.

Authors: Hrvoje Dolenec, Chief Economist Croatia (Zagrebacka banka)
Nenad Golac, Senior Economist (Zagrebačka banka)

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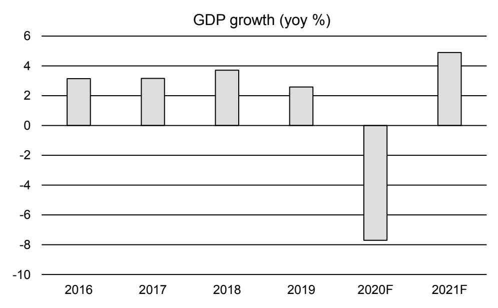
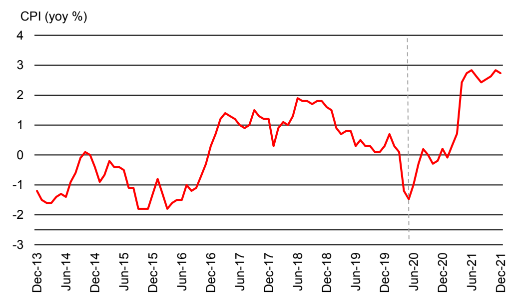
KEY DATES/EVENTS

- 20 July: CPI June 2020
- 20 July: foreign trade June 2020
- 27 July: industrial production June 2020
- 30 September: balance of payments 2Q20
- 30 September: GDP 2Q20

GDP GROWTH FORECAST



INFLATION FORECAST



Source: UniCredit Research

MACROECONOMIC DATA AND FORECASTS

EUR bn	2017	2018	2019	2020F	2021F
GDP (EUR bn)	16.04	17.10	17.91	16.50	17.67
Population (mn)	3.50	3.50	3.49	3.48	3.47
GDP per capita (EUR)	4578	4891	5136	4744	5099
Real economy, change (%)					
GDP	3.2	3.7	2.6	-7.7	4.9
Monthly wage, nominal (EUR)	676	697	727	683	723
Real wage, change (%)	0.3	1.7	3.7	-5.8	3.7
Unemployment rate (%)	38.4	36.0	33.3	37.5	34.0
Fiscal accounts (% of GDP)					
Budget balance	1.8	1.5	2.1	-5.0	-1.0
Primary balance	2.6	2.4	2.8	-4.2	-0.2
Public debt	40.5	35.8	34.9	39.9	37.3
External accounts					
Current account balance (EUR bn)	-0.7	-0.6	-0.6	-1.0	-0.9
Current account balance/GDP (%)	-4.3	-3.7	-3.5	-6.4	-4.9
Extended basic balance/GDP (%)	-1.2	-0.3	0.1	-4.0	-1.5
Net FDI (% of GDP)	2.1	2.5	2.7	1.5	2.5
Gross foreign debt (% of GDP)	72.0	64.4	64.8	74.1	70.5
FX reserves (EUR bn)	5.4	5.9	6.4	6.2	6.4
Months of imports, goods & services	7.1	7.3	7.8	8.4	8.0
Inflation/monetary/FX					
CPI (pavg.)	1.3	1.4	0.6	-0.2	2.1
CPI (eop)	1.2	1.6	0.3	0.2	2.7
1M money-market rate (Dec. avg.)	-0.37	-0.36	-0.44	-0.45	-0.45
USD/FX (eop)	1.63	1.71	1.75	1.70	1.66
EUR/FX (eop)	1.96	1.96	1.96	1.96	1.96
USD/FX (pavg.)	1.74	1.66	1.75	1.74	1.67
EUR/FX (pavg.)	1.96	1.96	1.96	1.96	1.96

Sources: Central bank of Bosnia and Herzegovina, Agency for Statistics of Bosnia and Herzegovina, UniCredit Research

*Long-term foreign currency credit ratings provided by Moody's, S&P and Fitch, respectively

Economy restart from the deep bottom

According to available data, our first estimate, that GDP will fall by 7.7% in 2020, seems realistic

Although the data available so far do not allow a comprehensive assessment of the depth of the crisis caused by the COVID-19 pandemic, they are broadly consistent with our projection of a -7.7% decline in GDP. Data for March, and especially for April, show expected strong deterioration in foreign trade. Merchandise exports fell by 14.2% yoy in March and 32.7% in April, whereas imports dropped even more, by 16.3% and 35.2% respectively. The containment measures also had a huge impact on retail trade, which fell by 34.5% yoy in April. Industrial production output dropped by 16.2% yoy in April despite a 3.5% increase recorded in the energy sector. The state of emergency was ended at the end of May and restrictive measures are gradually being relaxed and lifted. In annual terms, the strong reduction in GDP is expected to be driven by a sharp drop in exports due to severe deceleration in the economies that serve as the country's main trading partners. Personal consumption, which was the main driver of growth in recent years, is expected to revert to a considerable decrease in the remainder of the year due to an expected contraction in employment and wages.

Exports are expected to be affected the most by the COVID-19 pandemic. This has been confirmed by April data

The C/A deficit is likely to widen considerably due to weakening exports and declining remittance inflows, but it should be covered by IFI and EU funding and FDI

Bosnia and Herzegovina's current-account deficit is likely to widen to 6.4% of GDP in 2020, from the 3.5% recorded in 2019 as a result of a sharp decline in export revenues and remittance inflows (8% of GDP last year). The IMF already approved and disbursed EUR 333mn (2% of GDP) of emergency assistance under the Rapid Financing Instrument in April to help Bosnia and Herzegovina's authorities meet urgent balance-of-payments requirements. This has supported credit with very favorable terms (an interest rate of 1.05% and a grace period of 39 months). The Extended Fund Facility agreement that expires in September of this year has been effectively abandoned. Of the approved EUR 544mn, only EUR 156mn were disbursed due to prolonged political stalemate and a lack of progress with regard to reforms. IMF representatives and Bosnia and Herzegovina's authorities have expressed an interest in negotiations on a successor EFF arrangement. IMF financing is expected to play a vital role in catalyzing emergency assistance from the international community, in particular from other IFIs and the EU. The European Commission has also sent emergency aid (of EUR 7mn) to cover the current needs of the country's healthcare system. In addition, it has diverted EUR 73.5mn of funds (0.5% of GDP) from the instrument for pre-accession assistance to facilitate socio-economic recovery. It has also announced additional support to the western Balkans region in the amount of EUR 1bn. The expected C/A deficit of EUR 1bn should be covered by FDI inflows (which are expected to be lower than they were in 2019), the aforementioned IMF and EU financial support and other IFI financing.

Bosnia and Herzegovina's fiscal position is likely to remain sustainable despite that the general government deficit is estimated to amount to 5% of GDP

Due to Bosnia and Herzegovina's complex system of political decision making, it is very difficult to estimate the actual amount and effect of measures taken so far to mitigate the magnitude of the current crisis. We assume that the costs of all measures could bring Bosnia and Herzegovina's fiscal deficit for this year to 5% of GDP. However, Bosnia and Herzegovina's fiscal position is likely to remain sustainable, with expected external financing coming from the IMF, the EU and IFIs. Most of these measures have been taken at an entity level, whereas measures have also been taken by the authorities in the cantons within the Federation of Bosnia and Herzegovina. Measures taken include the postponing of payments of business taxes from end-March to end-June or end-July and the speeding up of the distribution of tax refunds. From April, the partial payment of wages from budgets was introduced, as was the writing off of payroll contributions and the implementation of a moratorium on the repayment of loans in the most-hard-hit sections of Bosnia and Herzegovina's economy and society. These measures should last at least until end-July, two months after the official end of Bosnia and Herzegovina's state of emergency. Additional measures aimed primarily at facilitating a recovery in the hardest affected segments of the economy are still being considered. They comprise the formation of special stabilization and guarantee funds (worth 3% of GDP), which would support the liquidity of enterprises through development bank's credit lines.

Measures aimed at mitigating the effects of the pandemic have already been taken or discussed

Political stalemate not overcome yet

The stalemate at the level of federal political institutions caused by the decision by representatives of the Republika Srpska entity not to participate in decision-making has not yet been overcome. Thus, political risk has further increased the level of economic uncertainty caused by the pandemic.

North Macedonia

Not rated/BB- stable/BB+ Neg*

Outlook

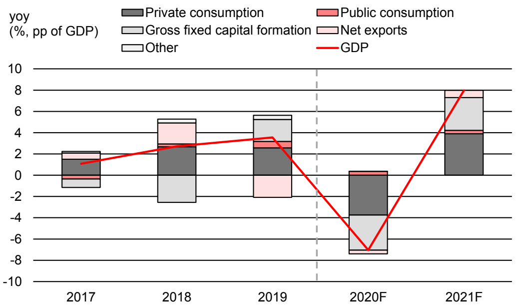
We expect a GDP contraction of around 7% in 2020, reflecting a sharp fall in economic activity in 2Q20 due to the impact of the coronavirus-induced lockdown and the drop in external demand, followed by a partial recovery in 2H20. Initial data for April appear consistent with a double-digit contraction in 2Q20. The government measures and the contraction in GDP might widen the deficit to 8% of GDP and the general government debt ratio to close to 50% before falling back in 2021. The necessary funding will likely be covered by borrowing from IFIs, reserves, and securities issuance. General elections will take place on 15 July.

Author: Mauro Giorgio Marrano, Senior CEE Economist (UniCredit Bank, Vienna)

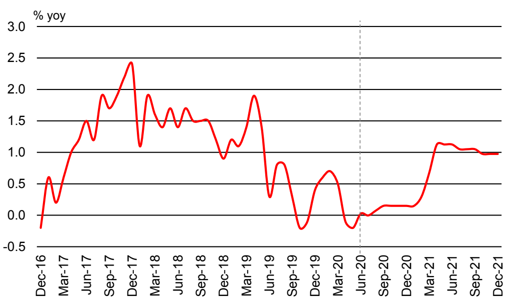
KEY DATES/EVENTS

- 15 July: parliamentary elections
- 6 Aug: 2Q20 GDP
- 4 Sep: rating update from S&P

GDP GROWTH FORECAST



INFLATION FORECAST



Source: State statistical office, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

EUR bn	2017	2018	2019	2020F	2021F
GDP (EUR bn)	10.0	10.7	11.2	10.4	11.3
Population (mn)	2.1	2.1	2.1	2.1	2.1
GDP per capita (EUR)	4,778	5,094	5,314	4,953	5,392
Real economy, change (%)					
GDP	1.1	2.7	3.6	-7.0	8.0
Private consumption	2.1	3.7	3.5	-5.1	5.2
Gross capital formation**	-2.2	-7.3	6.6	-10.2	9.9
Public consumption	-2.6	2.0	4.5	2.6	2.1
Exports	8.3	15.6	8.3	-16.9	26.4
Imports	5.2	9.1	9.0	-12.8	18.8
Monthly wage, nominal (EUR)	548	579	604	588	604
Real wage, change (%)	1.3	4.2	3.5	-0.9	1.4
Unemployment rate (%)	22.4	20.7	17.3	19.0	17.0
Fiscal accounts (% of GDP)					
Budget balance (central government)	-2.7	-1.8	-2.0	-8.0	-3.0
Primary balance (central government)	-1.4	-0.6	-0.8	-6.8	-1.8
Government debt (general government)	39.4	40.6	40.2	49.0	46.0
External accounts					
Current account balance (EUR bn)	-0.1	0.0	-0.3	-0.3	-0.3
Current account balance/GDP (%)	-1.0	-0.1	-2.8	-2.9	-2.2
Extended basic balance/GDP (%)	1.0	5.6	-0.2	-1.4	-0.4
Net FDI (% of GDP)	1.8	5.6	2.6	1.4	1.8
Gross foreign debt (% of GDP)	73.4	73.3	72.2	80.0	76.0
FX reserves (EUR bn)	2.3	2.9	3.3	3.3	3.2
Months of imports, goods & services	4.0	4.4	4.6	5.3	4.3
Inflation/Monetary/FX					
CPI (pavg)	1.4	1.5	0.8	0.2	0.9
CPI (eop)	2.4	0.9	0.4	0.2	1.0
Central bank target	-	-	-	-	-
Central bank reference rate (eop)	3.25	2.50	2.25	1.75	1.75
USD-MKD (eop)	51.5	53.7	55.0	53.5	52.1
EUR-MKD (eop)	61.50	61.50	61.5	61.5	61.5
USD-MKD (pavg)	54.4	52.2	55.0	54.2	52.8
EUR-MKD (pavg)	61.6	61.5	61.5	61.5	61.5

**Gross capital formation also includes inventories. The national statistics office does not publish a separate quarterly series for gross fixed capital formation

Source: State Statistical Office, ministry of finance, National Bank of the Republic of North Macedonia, Bloomberg, UniCredit Research

*Long-term foreign currency credit rating provided by Moody's, S&P and Fitch, respectively

Focus on COVID-19 impact and elections

GDP likely to contract by 7% in 2020

We expect a GDP contraction of around 7% in 2020, reflecting a sharp fall in economic activity in 2Q20 due to the impact of the lockdown and the drop in external demand, followed by a partial recovery in 2H20.

April data consistent with double-digit contraction in 2Q20

Initial data for April appear consistent with a double-digit contraction in 2Q20. Industrial production contracted by over 30% yoy April, after falling 14% in March. Wholesale and retail trade contracted by 35% yoy. Exports fell by 26% yoy in March and imports by 15% yoy, with the fall likely to be more pronounced in April given the decline in economic activity in North Macedonia's main trading partners. Google mobility data point to a resumption of activity in May/June, with the mobility gap compared to the baseline for shops, transport and workplaces having halved in the second half of June compared to April.

Growth at 7.4% in 2021

The main risks relate to the pace of economic recovery in North Macedonia's main trading partners and therefore the expected bounce back in 2H20. We expect growth to rebound by 8% in 2021, with growth boosted by carryover from 2020.

Fiscal support measures likely to lead to a deterioration of fiscal metrics in 2020

The government announced various fiscal packages worth a total of EUR 500mn or 5% of 2020 GDP. Direct support includes subsidies for private sector wages and social security contributions for firms that maintain employment, postponement of income tax payments, support for the worst-hit sectors, and financial assistance to vulnerable households. Additional measures include loans at favorable terms and loan guarantees. In terms of implementation, the government reported that wage subsidies covered 21,215 companies in April and 20,507 companies (almost a third of total companies) in May employing 140,000 workers (a quarter of the private-sector workforce), at a cost of around EUR 30mn per month. The subsidies for wages will expire at the end of June, which represents a risk to SMEs and the rate of employment. The government measures and the contraction in GDP might widen the deficit to 8% of GDP and the general government debt ratio to close to 50% before falling back in 2021.

Funding from IFIs, reserves, and additional securities issuance

The necessary funding will likely be covered by borrowing from IFIs, reserves, and securities issuance. The government will borrow around EUR 500mn from the EU (EUR 220mn) and IFIs, namely the IMF, through the Rapid Financing Instrument (EUR 175mn), and the World Bank (EUR 100mn assumed). It issued EUR 700mn Eurobond in May, with fiscal reserves standing at EUR 550mn at the end of May. Together with additional domestic issuance (EUR 200mn), these funds appear sufficient to cover the financing needs until the end of the year, namely debt repayments (around EUR 500mn) and the deficit (a deficit of 8% of GDP would be around EUR 850mn, therefore a EUR 650mn increase to the deficit in January-April). A more pronounced widening of the deficit would require additional funding.

The financing of the current account deficit should not be a problem

In terms of external financing, we expect the current account deficit, envisaged at 2.9% of GDP (EUR 300mn) in 2020, to be covered in part by FDI (EUR 150mn or 1.5% of GDP) and the rest from the IFIs and the portfolio fund flows mentioned above.

Official start of EU accession negotiations likely in the autumn

Regarding the opening of EU accession negotiations, the European Commission is expected to propose a draft negotiating framework soon, which will be discussed over the summer. The accession negotiations could start in autumn.

Elections to take place on 15 July

Elections originally scheduled for 12 April were postponed 15 July. The fact that the green light has been given to EU accession negotiations should boost support for former Prime Minister Zoran Zaev's party, the Social Democratic Union of Macedonia (SDMS), which recent opinion polls reported in the press showed as leading its main rival, the Internal Macedonian Revolutionary Organization–Democratic Party for Macedonian National Unity (VMRO-DPMNE), in terms of support. If it wins the elections, SDMS is likely to need the support of some of the Albanian parties to form a government, as it did to form the previous government. The scenario of a VMRO-DPMNE victory is unlikely to represent a risk for the Prespa agreement. Although before the COVID-19 outbreak, it said it would repeal the agreement if it obtained a two-thirds majority, the party is unlikely to obtain such a large share of the vote. In addition, ethnic Albanian parties are unlikely to enter a coalition with the VMRO-DPMNE due to differences on issues such as the rights of ethnic Albanians and the Prespa agreement.

Russia

Baa3 stable/BBB- stable/ BBB stable*

Outlook

Russia's economy is emerging from lockdown later than those of other CEE countries. Fiscal support equivalent to less than 4% of Russian GDP is the smallest in the region and is doubled by monetary support through rate cuts, regulatory forbearance and subsidized lending. We expect GDP to fall by 5.4% in 2020, with a recovery of 3.8% in 2021. The negative output gap should persist into 2021, helping inflation stay below target in 2020-21. We expect the CBR to cut its policy rate to 4% or lower.

Strategy

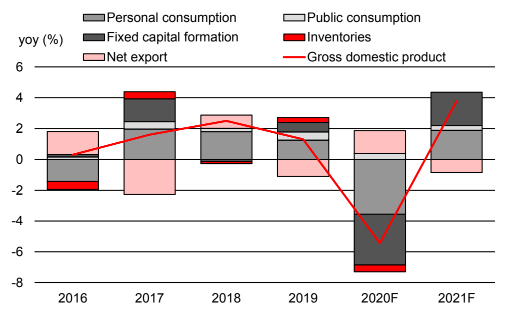
OFZs remain attractive, given local support and monetary easing. Risks stem from large net issuance and potential RUB depreciation if the global economic recovery falters, pushing oil prices lower.

Authors: Artem Arkhipov, Head of Macroeconomic Analysis and Research Russia (UniCredit Russia)
Ariel Chernyy, Economist, Macroeconomic Analysis and Research Russia (UniCredit Russia)

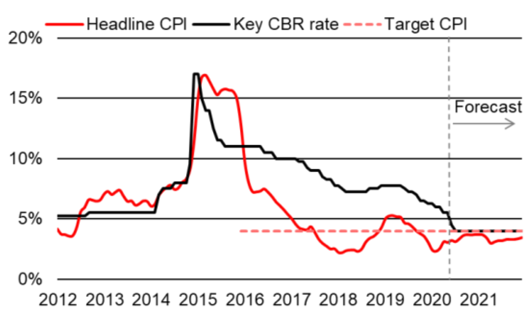
KEY DATES/EVENTS

- 1 July: constitutional referendum
- 6 July, 6 August: CPI
- 24 July, 18 September: monetary policy meetings
- 18-22 of each month: monthly economic data

GDP GROWTH FORECAST



INFLATION FORECAST



Source: CBR, Rosstat, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

EUR bn	2017	2018	2019	2020F	2021F
GDP (EUR bn)	1393.6	1414.8	1518.1	1377.5	1444.2
Population (mn)	146.9	147.0	147.0	147.0	146.9
GDP per capita (EUR)	9487	9626	10327	9372	9829
Real economy, change (%)					
GDP	1.6	2.3	1.3	-5.4	3.8
Private consumption	3.2	2.2	2.3	-6.5	3.5
Fixed investment	5.5	2.3	1.4	-15.0	11.0
Public consumption	2.5	0.9	2.8	2.0	1.5
Exports	5.0	6.3	-2.1	-8.0	5.0
Imports	17.4	3.8	2.2	-15.0	10.0
Monthly wage, nominal (EUR)	594.3	586.8	642.4	602.9	631.1
Real wage, change (%)	2.9	6.8	2.7	-2.0	3.5
Unemployment rate (%)	5.2	4.8	4.6	7.5	6.0
Fiscal accounts (% of GDP)					
Budget balance	-1.4	2.6	1.8	-5.0	-2.5
Primary balance	-0.7	3.4	2.5	-4.1	-1.6
Public debt	12.6	12.0	12.4	16.6	16.9
External accounts					
Current account balance (EUR bn)	29.4	96.4	63.1	26.1	21.8
Current account balance/GDP (%)	2.1	6.8	4.2	1.9	1.5
Extended basic balance/GDP (%)	1.6	5.4	4.3	2.0	1.4
Net FDI (% of GDP)	-0.5	-1.4	0.2	0.1	-0.1
Gross foreign debt (% of GDP)	31.0	28.0	28.3	29.7	27.9
FX reserves (EUR bn)	288.6	324.2	386.4	368.6	364.9
Months of imports, goods & services	10.6	11.3	13.1	14.9	13.1
Inflation/monetary/FX					
CPI (pavg.)	3.7	2.9	4.5	3.5	3.6
CPI (eop)	2.5	4.3	3.0	3.7	3.5
Central bank target	4.0	4.0	4.0	4.0	4.0
Central bank reference rate (eop)	7.8	7.8	6.3	4.0	4.0
3M money market rate (Dec avg.)	8.1	8.6	6.6	4.3	4.3
3M money market rate (year avg.)	9.4	7.7	7.8	5.4	4.3
USD-RUB (eop)	57.6	69.5	61.9	68.00	68.90
EUR-RUB (eop)	68.9	79.5	69.3	78.20	81.30
USD-RUB (pavg.)	58.4	62.7	64.7	69.28	68.45
EUR-RUB (pavg.)	65.9	74.0	72.5	78.34	80.26

Source Rosstat, CBR, UniCredit Research

*Long-term foreign currency credit rating provided by Moody's, S&P and Fitch, respectively

Recovery postponed to 2021

Russian fiscal support has come later than in the rest of CEE…

Russia is emerging from one of the longest lockdowns in the CEE in response to the COVID-19 pandemic. The economy's reopening has been carried out in two stages: s nation-wide vacation ended on 12 May. On 9 June, Moscow, which accounts for a fifth of Russian GDP, started to reopen businesses, in a signal to other regions. Russian authorities have come up with a fiscal support package that is small (it amounts to about 3.5% of Russian GDP) and implemented it later than in other CEE countries. Direct spending measures amount to 1.7-1.8% of GDP, with the equivalent of around 0.5% of GDP going to the unemployed and families with children. In addition, the fiscal package includes support for the most-affected sectors (such as air transport), an increase in medical spending (for new clinics, equipment, research and higher wages for medical personnel) and grants to the worst-hit SMEs to be used for wage payment. The package also seeks to make up for lost revenue in regional and local budgets. On the revenue side, direct measures include the permanent reduction of social-security contributions, from 30% to 15%, for all SMEs starting in April 2020 at a cost in budget revenues in 2020 equivalent to 0.3% of Russian GDP and equivalent to 0.4-0.5% of GDP per year thereafter. Deeper social contributions and profit tax cuts were announced for IT sector. Some SMEs and self-employed workers will also benefit from temporary tax rebates totaling 0.1-0.2% of GDP. Indirect fiscal support amounts to 1-1.5% GDP and includes lending programs with government guarantees and subsidized interest.

….and amounts to less than 3% of Russian GDP. Of this, direct support amounts to 1.1-1.2% of Russian GDP

…and guarantees and lending programs amount to up to 1.5% of GDP

The budget deficit could reach 4.4% of GDP in 2020 and 2.5% of GDP in 2021

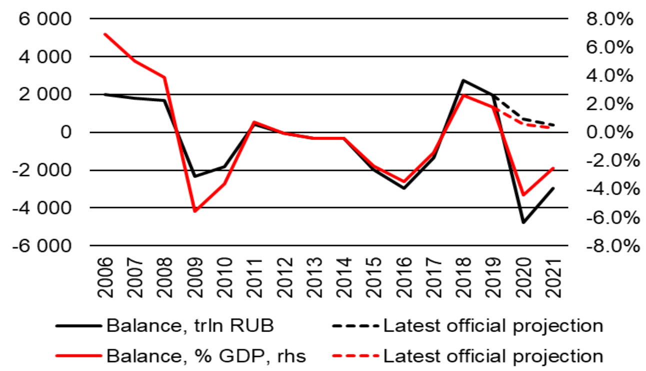
Although limited in size, the Russian government's crisis-response package still marks an easing of fiscal policy after two years of budget surpluses. Public spending has been flat or declining as a percentage of GDP since 2013, but will rise in 2020 by around RUB 3.3tn (or 3.3% of GDP) compared to 2019. With total spending expected to amount to RUB 21.5tn this year, Russia's budget could register a deficit equivalent to around 5.0% GDP in 2020 (a surplus of 1.8% of GDP was recorded in 2019), followed by a deficit equivalent to 2.5% of GDP in 2021. Russia's budget rule remains in place and most extra spending will be financed via borrowing of around RUB 3-3.5tn, which is two times higher than originally planned. However, Russia's National Wealth Fund has been tapped as well; about RUB 1.7tn, the equivalent of the Sberbank deal, will be recorded as budget revenue in 2020-21.

The CBR is trying to ease financial conditions via regulatory forbearance…

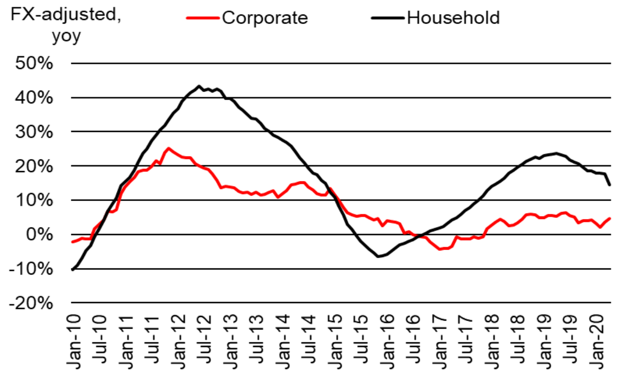
…and via subsidized lending

In addition to fiscal support, the CBR has introduced several measures to safeguard financial stability while the economy is dealing with the consequences of the COVID-19 outbreak. First, pressure on bank capital has been eased. Credit institutions are allowed to postpone the marking-to-market of securities purchased in 1Q20 until the end of 2020 and of FX-denominated assets until 30 September 2020. Second, borrowers from affected sectors of the economy are allowed to restructure or postpone loan repayments for up to six months, with banks being able to delay provisioning. However, applications covered only 5% of loans. Third, a number of other regulatory requirements have been eased (e.g. lower risk weights for mortgage loans, lower liquidity coverage ratio etc.). Fourth, the CBR has launched a RUB 500bn loan refinancing program, under which banks pay 3.5% for funding to support lending to SMEs. Fifth, the CBR has introduced longer-term repo auctions to support market liquidity

HIGHER FISCAL STIMULUS DUE TO INCREASED SPENDING



LENDING HAS NOT SLOWED MUCH YET



Source: Rosstat, Russian Ministry of Finance, UniCredit Research

Employment figures have been more resilient due to wage reduction

It is too early to judge the efficacy of Russia's fiscal and monetary pandemic response measures. Russia's unemployment rate increased to 6.1% in May (+1.4 pp since March), but wages shifted more. Data from companies suggest that businesses have preferred cutting salaries to firing employees. Industrial production was down by 8% yoy on average in April and May, affected by Russia's need to comply with OPEC+ production cuts. Retail sales were down by 20% yoy, mostly due to a collapse in auto sales. Meanwhile, higher-frequency indicators point to a turnaround in economic activity. The volume of transfers via the national payment system, shopping trips and transport usage suggest that the Russian economy is rebounding. However, economic activity remains well below normal levels.

The recovery could be bumpy and slow

We are keeping our forecasts for Russian GDP at -5.4% yoy in 2020, followed by a 3.8% yoy recovery in 2021. Consumption is expected to fall this year by 6.5% amid higher unemployment and lower incomes. Investment plans have been heavily affected by the pandemic, partly due to the aforementioned OPEC+ deal and partly due to subdued demand. Therefore, we expect investment to contract by 15% yoy in 2020, followed by growth of 11% in 2021. Domestic demand in Russia has also been affected by tighter financial conditions, which explains the dovish turn by the CBR.

We expect the CBR to cut rates to 4% or lower by year-end.

…as inflation could undershoot its target in 2020-21

We expect rates to be lowered to 4% by year-end, with the risk of a deeper reduction in policy rates. Besides the need to boost lending, more easing is supported by the benign inflation outlook, with the headline rate likely to remain below the 4% target in 2020-21. First, we expect the widening negative output gap to further ease pressure on core prices. The demand shortfall is unlikely to be closed in 2021, and we see a small probability that there will be rate hikes next year. Second, the RUB sell-off in March turned out to be short-lived, as oil prices rebounded close to USD 40/bbl. Close to or above that level, the correlation between USD-RUB and oil prices weakens. In addition, the lockdown further reduced the FX pass-through by curtailing demand. Third, external accounts are improving, reducing the risk of significant RUB depreciation in the coming months. We expect a rebound in commodity prices to support exports and Russian bonds to remain in demand from investors.

The CBR could lower its estimate of equilibrium rates

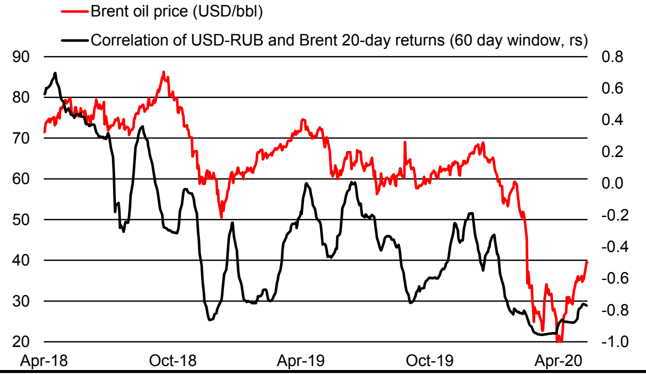
Later in 2020 or in 2021, we also expect the CBR to reconsider its estimate of the neutral range for its key rate. In our view, the middle point for its neutral range should be around 4.5-5% if the inflation target is maintained at 4% or close to 4% if inflation undershoots the target for longer. Thus, policy normalization would result in interest rates that are lower than they were before the crisis, boding well for yields on Russian government bonds.

BoP flows do not threaten sharp RUB depreciation

The convergence of Russian rates to levels consistent with low and stable inflation supports further flows into OFZs, thus removing the risk of strong pressure from portfolio investment on the currency. Despite an expected fall in exports of over 20% in 2020, the deterioration in the C/A could be limited by a large decline in imports. In 1Q20, imports fell from 20.6-20.9% of GDP in 2014-19 to approximately 19% of GDP, a level last seen during the 2009 financial crisis. Travel restrictions during the summer are expected to reduce service imports. Thus, balance-of-payment flows could be consistent with the RUB's being slightly overvalued in real terms in 2020-21, with USD-RUB expected to average 69.3 in 2020 and 68.4 in 2021.

WAGE GROWTH SHOULD TURN NEGATIVE IN 2020

RUB-OIL CORRELATION DISSIPATES WHEN BRENT PRICE RISES



Source: CBR, Russian Ministry of Finance, Rosstat, InfraONE, UniCredit Research

OFZ – A top pick among EM bonds, with two caveats

OFZ could rally further if the policy rate is cut by another 50bp…

…with RUB depreciation the biggest risk

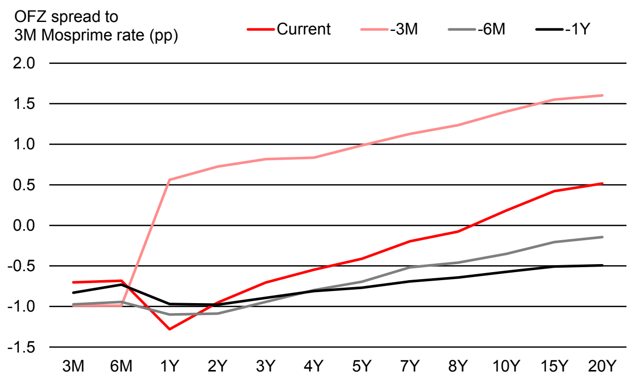
Foreign holdings of Russian sovereign bonds are at an all-time high…

…but not much above pre-Crimean-crisis levels

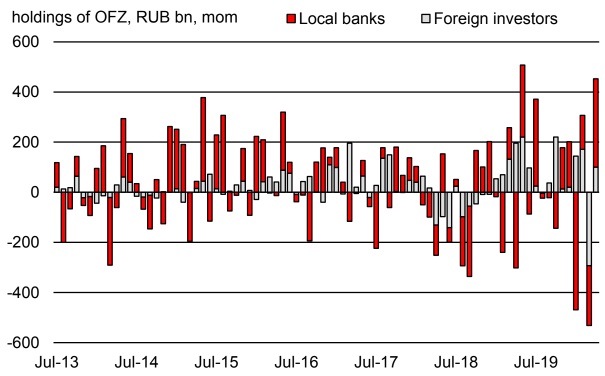
OFZs have been some of the best performing bonds in CEE, despite having suffered a sharp selloff during the March oil-price rout. Facing redemptions at the onset of the COVID-19 crisis, many foreign investors were forced to sell OFZ holdings since the market remained open and well-bid by local banks. Strong local support has added to expected rate cuts in keeping OFZs attractive.

There are two caveats to investing in OFZs. The first is a large bond supply. Russia's higher budget deficit, equivalent to 5% of GDP, implies net issuance of around RUB 3-3.5tn, a doubling compared to about RUB 1.7tn in the original financing plan. In the first five months of the year, net issuance amounted to approximately RUB 0.8tn, or around a quarter of Russia's annual financing needs, meaning that a large amount will need to be issued in the remaining months. The second risk is associated with the currency, if oil prices dip again. While it is not part of our baseline scenario, a second wave of COVID-19 infections could depress oil prices again, weighing on the RUB.

THE OFZ CURVE COULD FLATTEN FURTHER FOLLOWING CUTS



RUSSIAN BANKS BOUGHT LARGE AMOUNTS OFZS IN APRIL



Source: Russian Ministry of Finance, CBR, UniCredit Research

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2019	2020F	2021F
Gross financing requirement	**-15.2**	**81.4**	**52.0**
Budget deficit	-27.1	68.4	36.7
Amortization of public debt	11.9	13.0	15.3
Domestic	9.7	8.6	14.9
Bonds	9.7	6.8	12.9
Bills	--	--	--
Loans	0.0	1.7	1.9
External (bonds and loans)	2.2	4.5	0.5
Other	0.0	0.0	0.0
Financing	**-15.2**	**81.4**	**52.0**
Domestic borrowing	29.5	52.6	34.3
Bonds	28.7	51.5	32.2
Bills	--	--	--
Loans	0.8	1.1	2.0
External borrowing	5.7	2.7	2.6
Bonds	5.7	2.7	2.6
Other	0.0	0.0	0.0
Privatization/Other	0.0	0.0	0.0
revaluation	-14.0	0.0	0.0
Change in fiscal reserves/Other (-=increase)	-36.4	26.1	15.1

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2019	2020F	2021F
Gross financing requirement	**27.9**	**56.5**	**52.8**
C/A deficit	-62.5	-26.1	-21.8
Amortization of medium and long term debt	47.2	31.5	37.5
Government/central bank	3.6	3.4	4.0
Banks	8.2	2.7	3.7
Corporates/Other	35.5	25.4	29.8
Amortization of short-term debt	43.2	51.0	37.1
Financing	**27.7**	**56.5**	**52.8**
FDI (net)	2.3	1.2	-1.5
Portfolio investments (net)	-4.7	-2.5	-2.3
Medium and long-term borrowing	40.1	25.5	34.9
Government/central bank	24.2	15.8	17.1
Banks	-13.4	-6.4	-5.8
Corporates/Other	29.3	16.1	23.6
Short-term borrowing	51.5	38.5	34.2
other investment (net)	-2.1	-14.6	-6.7
Change in FX reserves (- = increase)	-59.4	8.4	-5.7
Memoranda:			
Nonresident purchases of LC gov't bonds	21.3	11.1	12.8
International bond issuance, net	3.5	-1.8	2.1

Source: CBR, Rosstat, Russian Ministry of Finance, UniCredit Research

Serbia

Ba3 positive/BB+ stable/BB+ stable*

Outlook

We expect a GDP contraction of around 12% qoq (10% yoy) in 2Q20 followed by a partial recovery in 2H20. In terms of annual average for 2020, Serbia might appear to be an outperformer in CEE, with a contraction 5%. However, this due to a significant carryover from 2019 and strong growth in 1Q20. In 2021, we see growth at above 6%. The government package to mitigate the economic impact of COVID-19 (EUR 5.1bn) could push government debt above 60% of GDP in 2020 before it falls back in 2021. Inflation will likely to remain close to the lower end of the target range (1.5%) in 2020. We expect the NBS to cut its policy rate further to 1.00%.

Strategy.

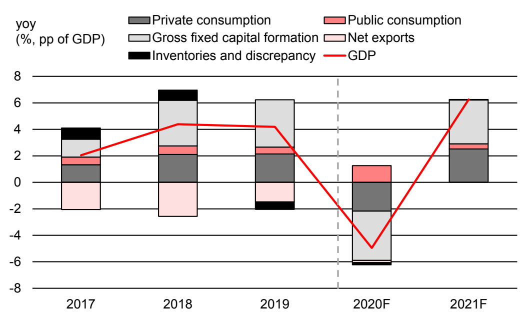
We estimate Serbia has enough resources and buffers to cover financing needs for the rest of the year. Planned SERBGB issuance amounts to EUR 2bn and can be absorbed by local institutions and foreign investors, when appetite for EM improves.

Author: Mauro Giorgio Marrano, Senior CEE Economist (UniCredit Bank, Vienna)

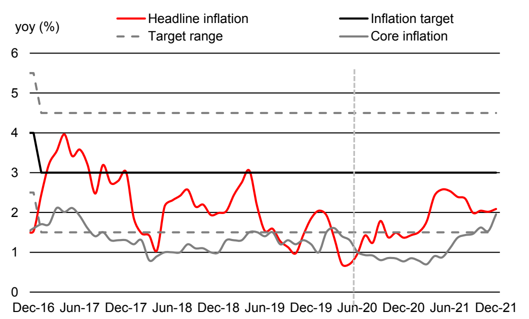
KEY DATES/EVENTS

- 9 Jul, 13 Aug, 10 Sep: NBS monetary policy meetings
- 13 Jul, 12 Aug, 11 Sep: CPI inflation
- Jul: IMF fourth review of the Policy Coordination Instrument
- 31 Aug: 2Q20 GDP
- 25 Sep: sovereign rating update Fitch

GDP GROWTH FORECAST



INFLATION FORECAST



Source: SORS, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

EUR bn	2017	2018	2019	2020F	2021F
GDP (EUR bn)	39.2	42.9	45.9	44.3	47.8
Population (mn)	7.0	7.0	6.9	6.9	6.9
GDP per capita (EUR)	5,577	6,137	6,609	6,411	6,960
Real economy, change (%)					
GDP	2.0	4.4	4.2	-5.0	6.3
Private consumption	1.9	3.1	3.2	-3.2	3.7
Fixed investment	7.3	17.8	16.4	-15.3	15.2
Public consumption	3.3	3.7	2.9	7.3	2.0
Exports	8.2	8.3	8.5	-13.7	13.3
Imports	11.1	11.6	9.5	-11.3	10.9
Monthly wage, nominal (EUR)	533	580	643	640	671
Real wage, change (%)	-1.1	4.0	8.5	-2.0	3.1
Unemployment rate (%)	14.1	13.3	10.9	12.8	11.5
Fiscal accounts (% of GDP)					
Budget balance	1.1	0.6	-0.2	-10.0	-1.5
Primary balance	3.6	2.8	1.8	-7.9	0.4
Public debt	58.7	54.4	52.9	64.0	61.0
External accounts					
Current account balance (EUR bn)	-2.1	-2.1	-3.2	-2.8	-2.9
Current account balance (% of GDP)	-5.2	-4.8	-6.9	-6.3	-6.0
Extended basic balance/GDP (%)	0.9	2.5	0.9	-1.1	-0.5
Net FDI (% of GDP)	6.2	7.4	7.8	5.2	5.4
Gross foreign debt (% of GDP)	65.2	62.2	61.9	69.0	65.0
FX reserves (EUR bn)	10.4	12.1	13.5	13.9	13.7
Months of imports, goods & services	5.6	5.8	5.8	6.7	5.9
Inflation/Monetary/FX					
CPI (pavg)	3.1	2.0	1.8	1.4	2.1
CPI (eop)	3.0	2.0	1.8	1.4	2.1
Central bank target	3.0	3.0	3.0	3.0	3.0
Central bank reference rate (eop)	3.50	3.00	2.25	1.00	1.00
3M money market rate (Dec avg)	3.09	3.04	1.67	1.00	1.20
USD/FX (eop)	99.1	103.4	104.9	103.8	90.1
EUR/FX (eop)	118.5	118.2	117.6	118.3	118.9
USD/FX (pavg)	107.8	100.2	105.2	106.2	95.7
EUR/FX (pavg)	121.4	118.3	117.9	117.8	118.2

Source: Bloomberg, Eurostat, SORS, NBS, Public Debt Agency, UniCredit Research

*Long-term foreign currency credit rating provided by Moody's, S&P and Fitch, respectively

Economic challenges amid high uncertainty

A significant contraction in 2Q20 followed by a partial recovery in 2H20

We expect a GDP contraction of around 12% qoq (10% yoy) in 2Q20, due to the impact of the lockdown and the drop in external demand, followed by a partial recovery in 2H20.

First data appear consistent with our forecast for 2Q20

Initial data for April and May appear broadly consistent with our forecast for 2Q20. Manufacturing production fell by around 20% yoy, but the contraction would have been 28% yoy were it not for a base effect in the chemicals, coke and refined petroleum products industries due to maintenance work last year. Retail sales fell by 20%, while exports and imports dropped by 30% yoy. We assume that April was the trough in industrial and overall economic activity and initial indications for May seem to confirm our view. The Economic Sentiment Indicator recovered around half of the decline in March and April and data from Google mobility point to a resumption of activity, with the mobility gap compared to the baseline having halved compared to April. The German truck-toll-mileage index, which is closely correlated with Serbian industrial production, recovered half of the loss experienced in April.

Annual average for 2020 boosted by carryover and strong 1Q20

In terms of the annual average for 2020, Serbia might appear to be an outperformer in CEE, with a contraction of only 5%. However, this due to a significant carryover from 2019, which we estimate to have contributed 1.9pp, and stronger-than-expected 5% yoy growth in 1Q20, almost half of which was driven by inventories, which we assume will be reversed. We expect 6.3% growth in 2021, boosted by a strong carryover at the end of 2020. Risks to our forecast for 2020 relate to exports of key sectors such as automotive and metals if the global recovery is slower than expected.

A comprehensive fiscal package

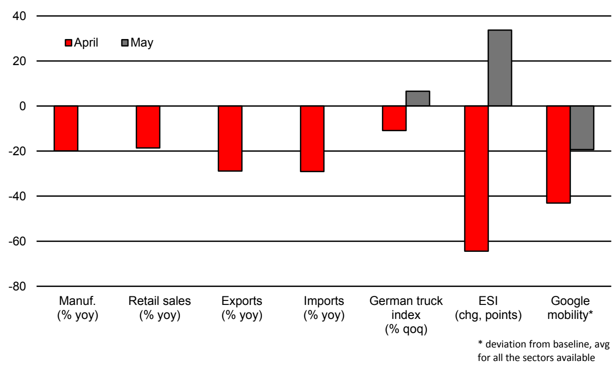
The government introduced a fiscal package worth EUR 5.1bn (11% of 2019 GDP) to mitigate the economic impact of COVID-19. Almost half of the package consists of guarantees, EUR 2.2bn or 4.8% of GDP, with the rest comprising direct support measures, around 6.5% of GDP. Direct measures include furlough support for three months (EUR 800mn or 1.8% of GDP), a three-month delay for taxes and other mandatory payments for companies (EUR 1.3bn, 2.9% of GDP), and other direct measures (EUR 800mn or 1.8% of GDP), largely consisting of a one-off payment of EUR 100 for all adult citizens. In addition, the government announced an increase of EUR 200mn in infrastructure investment, implemented a 10% wage increase for health-care workers (EUR 100mn) and made a one-off support payment for pensioners.

Implementation of the measures ongoing:

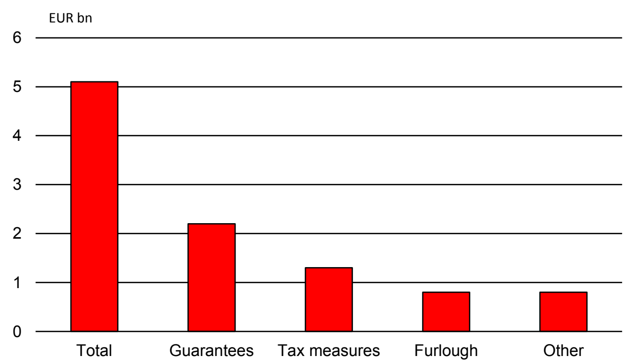
1. Guarantees

The implementation of the package is ongoing. According to the banking association, EUR 300mn of guarantees have been agreed and EUR 200mn have been disbursed since 1 May. The disbursement of the full amount (EUR 2bn) by year-end would imply a 10% yoy increase in lending, although with more loans for liquidity and less for investment. This should support companies during the economic downturn.

A SHARP GDP CONTRACTION LIKELY IN 2Q20



FISCAL PACKAGE TO MITIGITE THE IMPACT OF COVID-19



Source: SORS, ministry of finance, UniCredit Research

2. Furlough

3. Tax measures

In terms of the implementation of furlough measures, according to the authorities one million Serbian workers had received furlough support by the end of April, around a third of the total funding available for three months. The measure appears to have supported employment, as in April and May numbers of newly registered unemployed were below the average of the past twelve months. Regarding the tax measures, there are no public data on the take up of the initiatives, however fiscal data show that corporate income tax declined by 40% yoy in April and social contributions fell by 17% yoy (in total around EUR 120mn less than in April 2019).

Deterioration in fiscal metrics

We expect the fiscal deficit to be around 10% of GDP, temporarily pushing government debt to 64% of GDP before returning to around 61% of GDP in 2021. At the moment there is no indication that the furlough and tax measures will be extended after they expire at the of June, which represents a risk for employment and the resilience of micro-enterprises and SMEs. These companies account for 60% of employment and 50% of value added. In terms of fiscal cost, as an indication, a three-month extension of the full furlough and tax exemption measures could cost about 5% of GDP, although an extension would probably focus on SMEs and therefore the amount would likely be lower.

Current account deficit likely to narrow due to energy prices

After widening to 6.9% of GDP in 2019, the current account deficit is likely to narrow to 6.3% of GDP in 2020, primarily on the back of lower energy prices. The energy bill, which accounts for 10% of total imports, will decline significantly, with average oil prices assumed to be 40% lower than in 2019. We expect the current account deficit to be financed by FDI, which we forecast at around EUR 2.3bn or 5.3% of GDP, compared to more than EUR 3.5bn in 2019 (inflows were already close to EUR 1bn in 1Q20) with the rest covered by portfolio and other investment inflows. The dinar might experience some pressure in periods of EM risk-off sentiment, however, the NBS is likely to intervene to preserve the stability of the currency.

Inflation likely to remain at lower end of target range in 2020

Inflation is likely to remain close to the lower end of the target range (1.5%) in 2020. Base effects in food and energy prices are likely to push inflation slightly above 1.5% between June and September before it falls back to 1.4% due to a negative base effect in food prices at the end of the year. In 2021, inflation could accelerate to 2.0-2.5%, driven by a base effect in oil prices and a gradual acceleration of core inflation in the second half of the year.

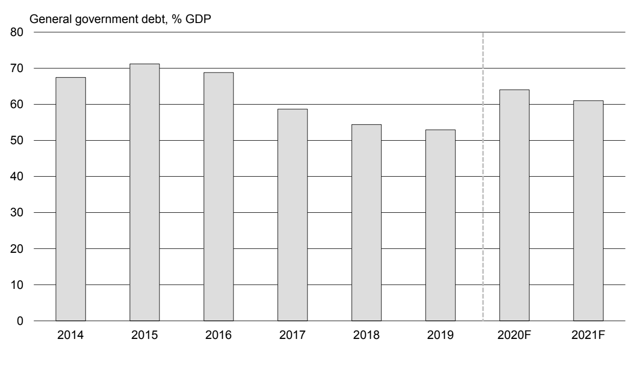
NBS: a further cut and focus on providing liquidity

The NBS might cut its policy rate once to 1.00% during the summer in light of the inflation outlook and the deterioration of the economic environment related to the impact of COVID-19 (see our EEMEA Macro Serbia: NBS – A cut now and another in the summer). Thereafter, we expect the central bank to remain on hold in 2020-21. This implies a slightly negative real policy rate – although less than that in most countries in the region. In addition, the NBS is also likely to continue to focus on providing liquidity through FX-swap and repo auctions.

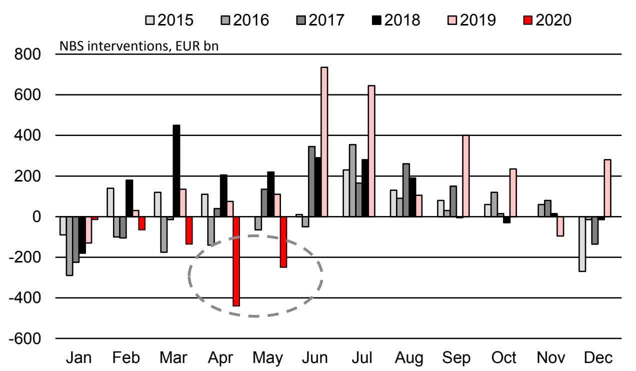
Elections results as expected

As expected, Serbian President Aleksandar Vučić's Serbian Progressive Party (SNS) won the most recent parliamentary elections, taking 189 seats out of a total of 250 seats. It was followed in the ranking by current junior collation party, the Socialist Party of Serbia (SPS), in alliance with United Serbia (JS), which took 32 seats. The Serbian Patriotic Alliance (SPAS) won 12 seats. The remaining seats will be assigned to the minority parties. The main opposition group, Alliance for Serbia, boycotted the 21 June poll. SNS can now form a government with a constitutional majority on its own, and it will have virtually no opposition. In our view, such dominance on the part of a ruling party is generally not good for a democracy.

GOVERNMENT DEBT TO RISE ABOVE 60% OF GDP



PRESSURE ON FX IN THE PAST MONTHS

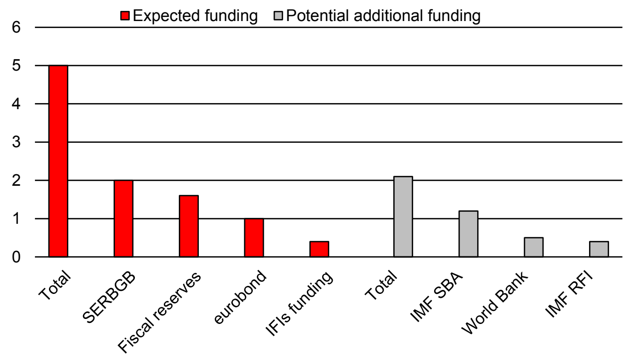


Source: NBS, SORS, ministry of finance, UniCredit Research

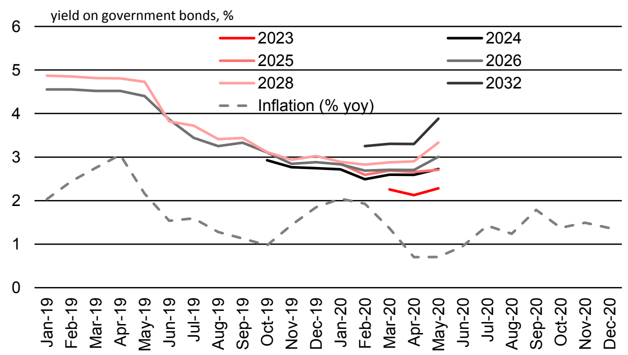
Sufficient buffer to cover financing needs

We estimate that the financing needs for the remainder of the year can be covered with fiscal reserves, planned issuance and IFI financing. We estimate financing needs at around EUR 4.0bn from the beginning of June until the end of the year, excluding the potential buyback of the Eurobond maturing in 2021 (EUR 1.5bn). This can be covered with fiscal reserves (estimated at EUR 1.6bn at the end of May), planned SERBGs issuance (EUR 2bn), IFI funding (assumed to be around EUR 400mn from the EU and the World Bank), and, if needed further Eurobond issuance (EUR 1bn). In case of need, Serbia could have a substantial buffer in the form of the IMF Rapid Financing Instrument (Serbia is entitled to EUR 400mn) and the World Bank emergency funding (around EUR 500mn). In addition, the IMF could transform the current Policy Coordination Instrument, which does not involve financing, into an SBA, which could unlock EUR 1.2bn for a year.

SUFFICIENT BUFFER TO COVER FINANCING NEEDS



IMPLICIT FX HEDGE BY NBS MAKES SERGBS ATTRACTIVE



Source: NBS, ministry of finance, Public Debt Agency, SORS, UniCredit Research

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2019	2020F	2021F
Gross financing requirement	**5.1**	**9.0**	**4.4**
Budget deficit	0.1	4.4	0.7
Amortization of public debt	5.0	4.6	3.8
Domestic	2.7	2.6	1.9
Bonds	2.5	2.1	1.3
Bills	0.1	0.1	0.1
IFIs/others	0.1	0.4	0.5
External	2.3	2.0	1.9
Bonds	1.7	1.7	0.7
IFIs/others	0.6	0.3	1.2
Financing	**5.1**	**9.0**	**4.4**
Domestic borrowing	3.1	4.3	3.3
Bonds	3.0	3.9	3.2
Bills	0.1	0.1	0.1
Others	0	0.3	0
External borrowing	2.3	3.5	1.3
Bonds	1.7	3.0	1.0
IFIs/others	0.6	0.5	0.3
Fiscal reserves change (- =increase)	-0.3	1.2	-0.2

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2019	2020F	2021F
Gross financing requirement	**9.3**	**9.2**	**8.9**
C/A deficit	3.2	2.8	2.9
Amortization of medium and long term debt	4.4	4.7	4.4
Government/Central Bank	2.6	2.4	2.1
Banks	1.0	1.1	1.1
Corporates	0.9	1.2	1.2
Amortization of short-term debt	1.7	1.6	1.6
Government/Central Bank	0	0	0
Banks	1.2	1.1	1.1
Corporates	0.5	0.5	0.5
Financing	**9.3**	**9.2**	**8.9**
FDI (net)	3.6	2.3	2.6
Medium and long-term borrowing	5.6	6.0	4.0
Government/central bank	3.7	4.5	2.1
IFIs/others	0.6	0.5	0.3
Banks	1.1	0.6	0.9
Corporates	0.9	1.0	1.0
Short-term borrowing	1.6	1.1	1.1
Change in FX reserves (- = increase)	-1.4	-0.3	0.2
Memoranda:			
Nonresident purchases of LC govt bonds	0.3	0.5	0.3
International bond issuance, net	0	1.3	0.4

Source: Bloomberg, NBS, ministry of finance, Public Debt Agency, SORS, UniCredit Research

Turkey

B1 negative/B+ stable/BB- stable*

Outlook

The Turkish economy is set for a gradual rebound in 2H20, which looks set to cap the full-year contraction at 5.6%, followed by growth of 6.6% in 2021. The government will likely try to keep stimulus in place to ensure that the recovery progresses, with a direct fiscal package of around 3.7% of GDP and indirect support of 7.1% of GDP. The C/A could return to a deficit this year amid domestic stimulus and may not be covered by FDI in 2020-21 The CBRT might lower its policy rate further to 7.5% by focusing on the disinflationary impact of demand conditions. The policy rate could be kept on hold next year, even if inflation returns to double digits. The currency could stabilize in 3Q20 but gradual depreciation may follow in 2021 as the private sector remains dependent on foreign borrowing, despite gradual external deleveraging.

Strategy

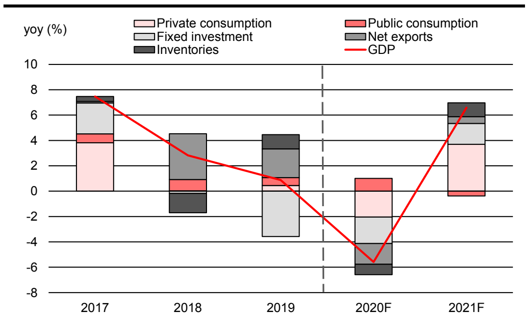
Bond purchases by the CBRT and local banks will likely support TURKGBs.

Author: Gokce Celik, Senior CEE Economist (UniCredit Bank, London)

KEY DATES/EVENTS

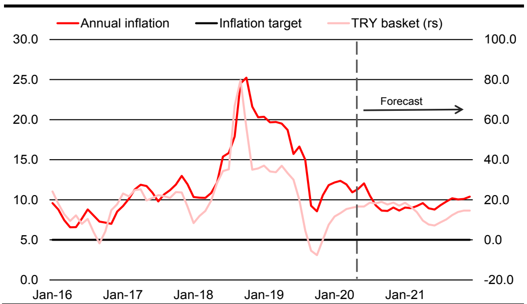
- 3 Jul, 4 Aug, 3 Sep: CPI
- 23 Jul, 20 Aug, 24 Sep: monetary-policy decisions
- 31 Aug: 2Q20 GDP
- 24 Jul, 21 Aug: rating reviews by S&P and Moody's

GDP GROWTH FORECAST



Source: Turkstat, UniCredit Research

INFLATION FORECAST



Source: Turkstat, CBRT, Bloomberg, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

EUR bn	2017	2018	2019	2020F	2021F
GDP (EUR bn)	753.5	654.4	673.9	598.3	624.5
Population (mn)	80.8	82.0	83.2	83.9	84.9
GDP per capita (EUR)	9325	7980	8104	7131	7356
Real economy, change (%)					
GDP	7.5	2.8	0.9	-5.6	6.6
Private consumption	6.2	0.0	0.7	-3.5	6.2
Fixed investment	8.2	-0.6	-12.4	-8.4	6.8
Public consumption	5.0	6.6	4.4	6.9	-2.3
Exports	12.0	7.8	6.4	-23.4	18.5
Imports	10.3	-7.8	-3.6	-19.9	18.0
Monthly wage, nominal (EUR)	828	696	753	691	699
Real wage, change (%)	2.0	-0.4	2.7	-2.4	3.3
Unemployment rate (%)	10.9	11.0	13.7	15.7	15.3
Fiscal accounts (% of GDP)					
Budget balance	-2.3	-3.5	-5.4	-7.7	-5.6
Primary balance	-0.5	-1.5	-3.0	-4.6	-2.6
Public debt	28.2	30.4	33.1	39.7	38.7
External accounts					
Current account balance (EUR bn)	-35.9	-17.6	7.8	-8.3	-12.6
Current account balance/GDP (%)	-4.8	-2.7	1.2	-1.4	-2.0
Extended basic balance/GDP (%)	-3.7	-1.5	1.9	-0.9	-1.3
Net FDI (% of GDP)	1.0	1.2	0.7	0.5	0.8
Gross foreign debt (% of GDP)	53.3	56.4	58.0	64.0	61.7
FX reserves (EUR bn)	74.3	63.5	71.7	46.1	50.8
Months of imports, goods & services	4.1	3.5	4.3	3.4	3.0
Inflation/Monetary/FX					
CPI (pavg)	11.1	16.3	15.7	10.4	9.6
CPI (eop)	11.9	20.3	11.8	8.7	10.4
Central bank target	5.0	5.0	5.0	5.0	5.0
Central bank reference rate (eop)	8.00	24.00	12.00	7.50	7.50
3M money market rate (Dec avg.)	14.40	24.70	11.80	7.50	7.50
USD/TRY (eop)	3.9	5.3	6.0	6.8	7.5
EUR/TRY (eop)	4.6	6.1	6.7	7.8	8.9
USD/TRY (pavg)	3.6	4.8	5.7	6.6	7.1
EUR/TRY (pavg)	4.1	5.7	6.4	7.5	8.3

Source: Turkstat, CBRT, Ministry of Finance, Bloomberg, UniCredit Research

*Long-term foreign-currency credit ratings are provided by Moody's, S&P and Fitch, respectively.

Credit-led recovery

Turkish economy will contract by 5.6% this year

The impact of COVID-19-related restrictions on the economy has deepened dramatically in 2Q20, following a limited impact on 1Q20 economic activity, which was boosted by the rising credit impulse. The gradual relaxation of containment measures will pave the way for a partial recovery in 2H20. We maintain our view that the Turkish economy will contract by 5.6% this year, before expanding by 6.6% in 2021.

Leading indicators signal muted recovery in May and June, following the nosedive in April

Economic activity took a drastic hit in April, which was reflected in hard data, such as a 31.4% yoy drop in industrial production and a 19.3% yoy drop in retail sales. Sentiment indices hinted at a bottoming out in May and further improvement in June, as did electricity consumption and weekly credit card payments, while capacity-utilization ratios implied an asymmetric recovery across sectors. The automotive sector reversed a large part of April's decline, whereas the clothing and machinery productions have not rebounded at all. Given the available data, we continue to expect GDP to contract by 15% qoq in 2Q20.

The recovery will continue in 2H20…

The recovery will likely gain momentum in 2H20, supported by further relaxation of restrictions (travel bans) and a sizable credit impulse. However, the pace of the recovery will depend on external demand. While there has not been a positive signal from the export orders PMI so far, the rebound expected in the EU could support merchandise exports and consequently Turkey's export-oriented manufacturing sector. Meanwhile, the service sector will likely experience a slower recovery, with fewer domestic and foreign tourists keeping capacity utilization low in restaurants and hotels.

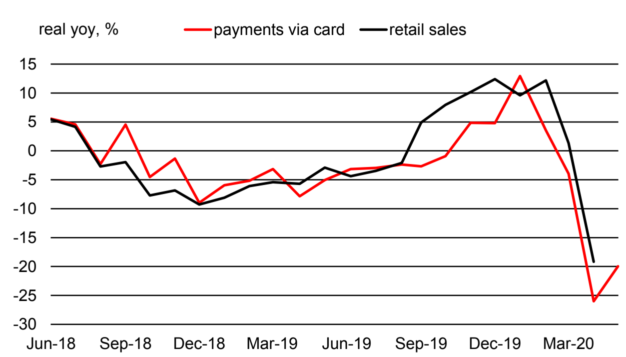
…supported by the government's efforts to boost lending,…

The government opted to provide the bulk of the stimulus to fight the downturn caused by COVID-19 by boosting lending[11]. In 2Q20, the credit impulse reached its highest level since 2010, as loan growth was supported by the expansion of loans provided by the Credit Guarantee Fund (from TRY 165bn in March to TRY 319bn in early June), monetary easing provided by the CBRT and regulatory forbearance introduced by the banking regulator.

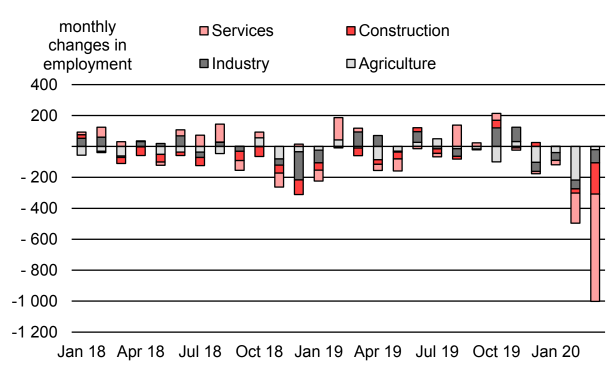
…mitigating the negative impact on the labor market…

The government has also been implementing support measures targeting the labor market. According to Unemployment Insurance Fund (UIF) data, 3.1mn workers (up from only 96K in March) were paid a total of TRY 5.2bn under the part-time working scheme in May. An additional 1.4mn workers who were on unpaid leave were paid TRY 1.7bn. Roughly 14% of the workforce are benefitting from these two schemes. These benefits, along with a ban on layoffs, were initially implemented for a three-month period. However, the government might consider extending the measures for a further three months until the end of 3Q20, which would postpone and mitigate a further drop in employment. The number of employed came down by a total of 1.5mn in February and March while the pick-up in the unemployment rate was low because of the drop in labor force participation, which is negative news for the recovery and the medium to long-term growth outlook.

Early indicators: signs of bottoming out…



…from a deep trough



Source: CBRT, TurkStat, UniCredit Research

[11] For a more detailed discussion, see our EEMEA Country Note – Turkey's recovery is reliant on lending, 9 June 2020.

…and fiscal measures, which have driven the budget deficit higher.

The fiscal measures include a deferral of tax and social security premiums from 2Q20 to 4Q20 for the hardest-hit service sectors, and liquidity aid to low-income households. According to the government's guidance, the deferred payments would amount to TRY 66bn (1.5% of GDP) while the liquidity aid has reached TRY 5.5bn. The corresponding budget items for deferrals explained roughly 60% of the TRY 30bn yoy widening in the budget deficit in April and May. While the deterioration due to the deferrals should be largely reversed, the budget deficit will likely increase further as weak growth continues to weigh on tax revenue while expenditure growth remains elevated. We expect the budget deficit to increase from 2.9% of GDP (IMF defined: 5.4%) in 2019 to 6.1% of GDP (IMF defined: 7.7%) in 2020; before easing to 4.2% of GDP next year. Our forecasts imply a fiscal impulse of around 2% this year and a negative one in 2021.

Current account balance has also been deteriorating

After recording surpluses for a year, the C/A balance fell back into deficit in April as the annual drop in exports intensified due to the lockdown measures implemented by major trade partners (the eurozone, the UK, the Middle East and the US). The seasonally adjusted merchandise trade balance has already started to improve, with the contraction in imports gaining pace. However, the cumulative C/A deficit could widen further until late summer, as the loss in tourism revenues becomes more visible. Turkey has restarted international flights gradually in the second half of June. However, non-essential (tourism) travel restrictions with the EU might remain in place for a while longer. Even after the restrictions are lifted, foreign visitor numbers will likely pick up only slowly and in any case remain well below those of 2019. The C/A deficit could end this year at 1.4% of GDP and widen slightly to 2% in 2021.

Disinflation will likely resume in 3Q20

Currency depreciation pushed annual inflation higher in May and annual inflation might have remained elevated in June as well, with companies passing on some of their cost pressure to customers as the economy reopens. However, we expect disinflation to resume in 2H20 as a decline in core inflation due to a widening output gap is likely to offset the impact of cost-push factors due to recent import tariff increases and other supply-chain disruption. Food inflation might support disinflation too, with the lack of tourists leading to reduced demand. Annual inflation could decelerate to single digits in 3Q20 and to 8.7% by the end of the year. The base effects and supply shocks could have a reflationary effect and push inflation to 10.4% in 2021.

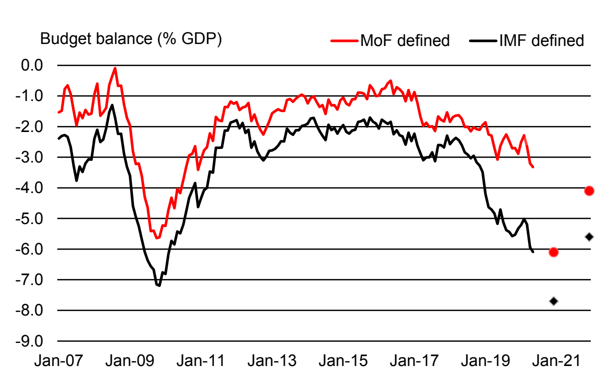
The TRY should benefit from the improved risk appetite in 3Q20

Due to significant external financing needs, the performance of TRY remains sensitive to global risk appetite. In this respect, the return of investor demand for emerging market assets could support the currency in 3Q20. However, the final quarter of the year might become more challenging, especially if the risk of a second wave of pandemic looms larger.

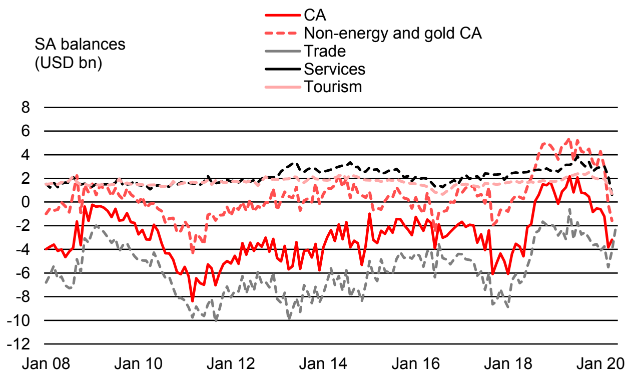
The central bank could cut more

The CBRT could cut the real policy rate to zero (based on its own inflation projection of 7.4%). Consequently, we expect the CBRT to reduce its policy rate to 7.5% this summer and then keep it unchanged until the end of 2021. This could increase the volatility of the exchange rate, with the TRY depreciating once again in 2021.

Budget deficit will widen further



CA and trade balances have begun to improve



Source: Ministry of Finance, Turkstat, CBRT, UniCredit Research

The CBRT is supporting TURKGB issuance

The government has issued heavily on the domestic market to finance the widening budget deficit.

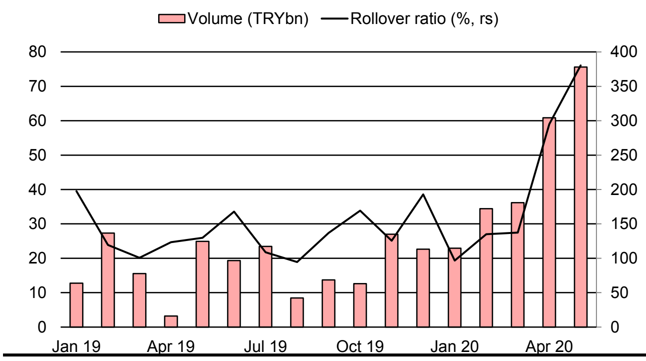
The government has increased its domestic borrowing significantly to finance the widening budget deficit. Local bond rates rallied as the CBRT and local banks absorbed the increased supply and the selloff by the foreign investors, while the central bank cut rates. The CBRT increased its bond portfolio by TRY 60bn in 2Q20. This corresponds to almost 24% of the Treasury's borrowing from the domestic market in 1H20. We expect further widening in the budget balance. However the pace might slow, along with the domestic rollover ratio of the Turkish Treasury. Domestic issuance might amount to TRY 165 (3.7% of GDP) bn in 2H20, although the Treasury might opt for an even larger amount depending on external borrowing.

Turkish Treasury might resume external borrowing soon

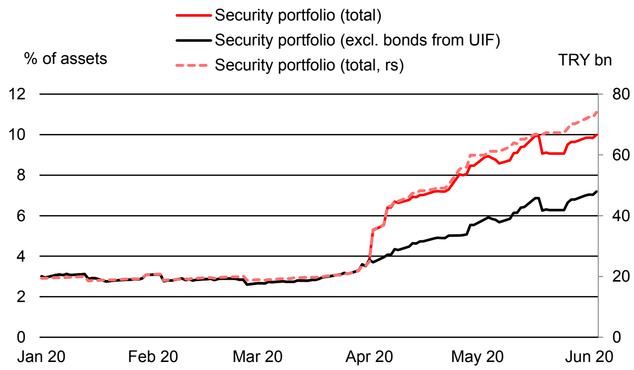
The Turkish Treasury has completed its big-ticket external debt repayments (USD 2.8bn in May and USD 2.4bn in June) for this year. The total repayments scheduled for the rest of the year amount to USD 3.5bn.

We maintain our view that the government could issue up to USD 8bn externally this year, on top of the USD 4bn issued in February), which would also make up for part of the decline in FX reserves. The Treasury might be in the market in July, especially if the recent improvement in Turkey's risk premium continues.

Treasury's domestic rollover ratio soared



CBRT purchases are helping absorb the supply



Source: Ministry of Finance, CBRT, UniCredit Research

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2019	2020F	2021F
Gross financing requirement	**53.0**	**73.7**	**62.6**
Budget deficit	34.4	44.1	32.8
Amortization of public debt	18.6	29.6	29.8
Domestic	13.0	24.2	23.9
Bonds	11.1	20.7	21.3
Bills	1.9	3.5	2.6
Loans	0.0	0.0	0.0
External	5.7	5.4	6.0
Bonds	3.7	4.7	5.5
Loans	1.9	0.7	0.5
Financing	**53.0**	**73.7**	**62.6**
Domestic borrowing	31.6	53.9	42.0
Bonds	28.6	50.0	40.0
Bills	3.0	3.9	2.0
Loans	0.0	0.0	0.0
External borrowing	10.1	10.9	11.6
Bonds	9.2	10.4	10.7
Loans	0.9	0.4	0.9
Privatization/other	15.8	9.0	9.0
Fiscal reserves change (- =increase)	-4.5	0.0	0.0

Source: CBRT, Ministry of Finance, UniCredit Research

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2019	2020F	2021F
Gross financing requirement	**154.3**	**160.5**	**153.1**
C/A deficit	-7.8	8.3	12.6
Amortization of medium and long-term debt	60.9	45.1	41.3
Government/central bank	5.7	5.4	6.0
Banks	33.6	22.1	18.8
Corporates/other	21.6	17.7	16.5
Amortization of short-term debt	101.2	107.0	99.2
Financing	**154.3**	**160.5**	**153.1**
FDI (net)	5.0	2.8	4.7
Portfolio equity, net	0.4	-3.2	1.0
Medium and long-term borrowing	52.1	34.2	49.0
Government/central bank	7.4	5.8	12.9
Banks	25.6	15.4	19.2
Corporates/other	19.1	13.0	16.9
Short-term borrowing	109.8	102.2	104.2
Other	-7.4	0.0	0.0
Change in FX reserves (- = increase)	-5.6	24.5	-5.8
Memoranda:			
Nonresident purchases of LC gov't bonds	-2.8	-5.0	1.3
International bond issuance, net	5.5	5.7	5.2

Acronyms and abbreviations used in the CEE Quarterly

- BNB – Bulgarian National Bank
- C/A – current account
- CBR – Central Bank of Russia
- CBRT –Central Bank of the Republic of Turkey
- CE – Central Europe
- CEE – Central and Eastern Europe
- CNB – Czech National Bank
- DM – developed markets
- EA – euro area
- EC – European Commission
- ECB – European Central Bank
- EDP – Excessive Deficit Procedure of the European Commission
- EM – emerging markets
- EMU – European Monetary Union
- EU – European Union
- FCL – Flexible Credit Line (from the IMF)
- FDI – foreign direct investment
- IFI – international financial institutions
- IMF – International Monetary Fund
- MoF – Ministry of finance
- NBH – National Bank of Hungary
- NBP – National Bank of Poland
- NBR – National Bank of Romania
- NBS – National Bank of Serbia
- NBU – National Bank of Ukraine
- PLL – Precautionary and Liquidity Line (from the IMF)
- PM – prime minister
- PPP – public – private partnership
- qoq – quarter on quarter
- sa – seasonally adjusted
- SBA – Stand-by Arrangement (with the IMF)
- SOE – state-owned enterprise
- WB – World Bank
- yoy – year on year
- ytd – year to date

Notes

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