UniCredit

CEE Quarterly

Macro Research
Strategy Research
Credit Research

"The reopening"

3Q 2021

Contents

4 **The reopening**
15 **EU-CEE and NGEU: not rushing to spend**
23 **CEE Strategy: yield hunting and rate-hiking are key drivers of hard and local-currency exposure**
75 **Acronyms and abbreviations used in the CEE Quarterly**

COUNTRIES

31 **Bulgaria:** A V-shaped recovery is on track, but downside risks are up
35 **Croatia:** Accelerated recovery a realistic option
39 **Czechia:** A recovery amid inflation concerns
43 **Hungary:** A long electoral campaign
47 **Poland:** A New Deal to foster old plans
51 **Romania:** Resetting priorities
55 **Slovakia:** Supply-chain bottlenecks slow the recovery
57 **Slovenia:** Domestic demand driving the recovery

EU CANDIDATES AND OTHER COUNTRIES

59 **Bosnia and Herzegovina:** Recovery has begun somewhat earlier than expected
61 **North Macedonia:** Recovery and formal opening of EU accession negotiations
63 **Russia:** Faster recovery powered by private-sector leveraging
67 **Serbia:** Stronger growth
71 **Turkey:** Stepping up vaccinations

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The reopening

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- We expect economies in EU-CEE[1] and in the Western Balkans, to grow by around 5% in 2021 and 4.5% in 2022 after slumping by close to 4% in 2020. We see Hungary, Poland, Romania and Serbia returning to pre-pandemic levels of activity already in 2021, with the other countries following in 2022.
- Pent-up demand could drive the recovery, as consumers and companies increased their savings in 2020. Government transfers will further support household finances. Pre-funding from the EU's Recovery and Resilience Facility (RRF) might start arriving in 3Q21, further boosting investment.
- Turkey's economy could grow by 7.5% in 2021, the fastest in CEE, after avoiding a recession in 2020. In 2022, growth might slow to 3.5% if financial conditions remain tight.
- The Russian economy is expected to grow by around 3.4% this year and 2.6% next year, recouping all pandemic losses. Domestic demand could increase as households reduce their savings and companies start investing again.
- In 2021, the summer rebound will be driven by services, which suffered the most during lockdowns. The subsequent recovery could be bumpy, as all sectors face labor shortages. Manufacturing, which led the economic rebound since last summer, and construction also face supply-chain bottlenecks that will slow their growth.
- Throughout CEE, the main risk to growth is another spike in COVID-19 cases and deaths later in 2021 as the speed of vaccination has slowed since May. Bulgaria, Russia and Romania face bigger threats in this respect than Czechia, Turkey, Poland, Hungary, Slovenia and Slovakia.
- Supply shocks and stronger demand are expected to push inflation higher. The momentum in cyclical inflation continues to rise, while commodity prices may contribute less to inflation from here on. Czechia and Serbia are the only countries likely to hit inflation targets this year. Next year, stronger domestic demand will keep inflation outside or close to the top of target ranges.
- We expect additional rate hikes this year, to 1.35% in Hungary, 1.00% in Czechia and 6.5% in Russia. The NBP could start raising rates in 4Q21 or 1Q22, taking the policy rate to 1.5%. The NBR could take the key rate to 1.75-2% in 2022. The CBRT could cut the policy rate by 2.5pp this year and 3pp next year, to 13.5%, with the CBR cutting as well, to 5.5%.
- The main risks are domestic and mostly related to politics. Elections in Bulgaria and Czechia could result in fragile majorities. Infighting among Slovakia's governing parties could delay reforms. A leadership contest in the Liberal party could reshape the Romanian government. Political interference remains the biggest risk for monetary policy in Turkey. In 3Q21, the geopolitical risk premium on Russian financial assets could diminish.

CEE economies reopened after a third COVID-19 wave…

CEE economies reopened in late spring after the third (and worst) COVID-19 wave filled up intensive-care units and forced governments once more to lock down economies. The impact on economic growth varied with the stringency of measures. In Romania, Russia and Turkey, governments forwent tight lockdowns and allowed much more freedom of movement than their peers as people stopped observing the rules. However, other countries were also not immune to pandemic fatigue. Throughout CEE, people were more mobile than restrictions would have suggested, showing that further lockdowns may be less well-observed.

…without progress in testing, tracing and isolating cases

The number of COVID-19 cases dropped at the beginning of the summer, but so did the number of tests. As a result, the current infection numbers communicated officially are probably irrelevant. Test-trace-isolate frameworks were never implemented properly and most governments seem reluctant to implement them over the summer.

[1] EU-CEE refers to CEE countries that are members of the EU: Bulgaria, Croatia, Czechia, Hungary, Poland, Romania, Slovakia and Slovenia.

The risk is that they may not make the transition from containing the pandemic to managing it. Poor measurement of cases and spread will likely translate into reactive, late measures and, as a result, in casualties that could have been avoided.

Vaccination is slowing rapidly in all countries but Turkey

Governments have been focusing on vaccination (Chart 1), which accelerated in 1Q21, only to slow markedly since late May (Chart 2). The only exception is Turkey, which was a late starter in the vaccination process. Throughout CEE, most of the people who wanted to be vaccinated, have been. From here on, additional inoculations will depend on public policies to reach the old and the vulnerable, especially in the countryside. This process has several pillars: **1**. mobile vaccination units that involve locally trusted people (doctors, mayors and, in the Balkans, the clergy); **2**. incentives for the vaccinated, especially in allowing for more mobility; and **3**. fighting conspiracy theories, which are rampant in all countries and are often spread by mainstream media, oblivious to the social and economic costs of their actions.

Bulgaria, Russia and Romania face a higher risk of a fourth wave of the pandemic…

Considering the level and pace of immunization from June, Czechia, Turkey, Poland, Hungary, Slovenia and Slovakia are in a good position to avoid another wave of the pandemic later this year (or to undergo only a mild one). At the other extreme, Bulgaria, Russia and Romania are the most vulnerable to a fourth wave. The likely prevalence of the Delta variant – and the potential emergence of other, more infectious variants – makes the complacency of some CEE authorities difficult to understand.

… with a smaller impact on economic activity

However, another COVID-19 wave is unlikely to result in lockdowns comparable to those implemented in 2020 or even the one from 1H21. The governments that appear uninterested in speeding up vaccinations are also those that implemented looser restrictions and failed to enforce them. However, all of these governments are mistaken if they believe that weak restrictions will not have economic repercussions. Both companies and households increased their savings in 2020, but unleashing pent up demand (especially investment spending) requires assurance that further pandemic-related restrictions and layoffs will be avoided.

THE PACE OF VACCINATION IS SLOWING IN CEE WELL BEFORE REACHING HERD IMMUNITY

CHART 1: IMMUNIZATION IN CEE IS OUTPACING THE GLOBAL ROLLOUT…

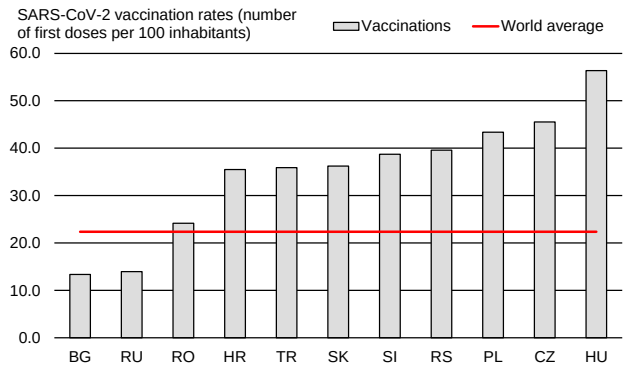
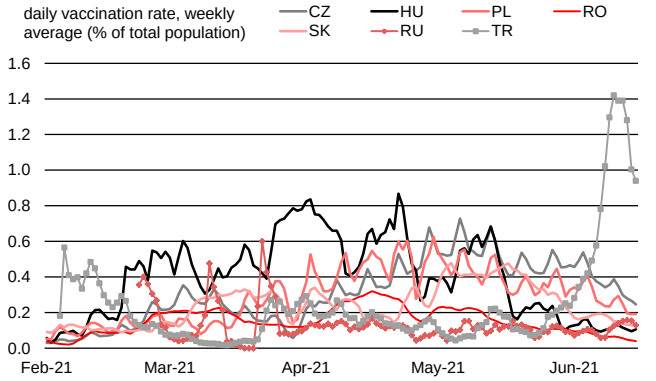


CHART 2: …BUT THE PACE OF VACCINATION IS SLOWING



Source: CEE governments, Oxford University, Imperial College London, UniCredit Research

Democratic values are at risk from the unprecedented powers assumed by states

Besides the economic outlook, upholding democratic values, trust in governments and efficiency of public policies is also at stake. Having promised that the first lockdown in the spring of 2020 was a one-off and a necessary infringement on personal freedoms, governments defaulted to lockdowns and restrictions all too easily. In a region where corruption is growing[2] and governments have infringed on press freedom and judicial independence[3], it might be very difficult to roll back some of the restrictions and temporary powers assumed by the state and its institutions (especially the police and the army).

[2] According to Transparency International's Corruption Perception Index and the Global Corruption Index.
[3] According to rulings by the Court of Justice of the EU, the Venice Commission and to infringement procedures started by the EU.

The summer boom could lead to a bumpy recovery

Short-term rebound will be strong over the summer…

As governments remove restrictions, it is once more necessary to differentiate between the short-term rebound and the longer-term recovery. The rebound is in full swing. Payment data show that in many CEE countries restaurants are close to pre-COVID-19 levels of sales, although foreign tourists are absent. Retail sales are also increasing fast, as is the number of staycations and vacations abroad for those allowed to travel. This is no surprise, with households willing to spend some of the savings accumulated last year. In 2020, net financial wealth rose even more than savings as equity markets and house prices surged after a temporary decline last spring (Chart 3). In addition, financial conditions remained loose. Furlough and part-time employment schemes, as well as loan moratoriums helped households weather the worst of the crisis, with unemployment rates expected to return to pre-pandemic levels in the next 18 months. This is in stark contrast to the aftermath of the global financial crisis, when tight financial conditions, high unemployment, and falling house and equity prices affected consumer spending across the region for 3-5 years.

…amid pent-up demand…

…and a rise in private-sector savings in 2020

Like households, CEE companies increased their net savings in 2020 (Chart 4), weathering the COVID-19 crisis better than they did the global financial crisis. Yet there is a wide disparity in outcomes, in terms of both size and sector of activity. Large companies were in a better financial position going into the COVID-19 crisis and state support (furlough, repayment moratoriums and tax holidays) helped them manage the liquidity squeeze during lockdowns. In contrast, many SMEs struggled to stay afloat in 2020. Except for Poland, where the government circumvented banks when disbursing funds to companies, all other governments lent through banks, a lengthy process that required regular risk checks. Many SMEs did not qualify for support because they had registered losses for several years and/or had fallen behind in tax payments. In many countries, these were considered solvency, rather than liquidity issues. In addition, many SMEs did not want to increase leverage significantly in a crisis year. Where governments preferred grants or transformed loans into grants, SMEs had a better chance of survival and laid off fewer employees. The more restrictions governments impose, the more support they have to dole out to SMEs, with grants much more efficient than loans.

Large companies in better shape than SMEs

In Russia and Turkey, the credit boom was in full swing when the pandemic struck and loans outpaced savings. Turkish companies are used to delaying payments and using trade loans in times of distress and these forms of support to business partners affects the official reporting of available liquidity.

THE PRIVATE SECTOR EMERGES FROM THE PANDEMIC WITH HIGHER NET SAVINGS

CHART 3: HOUSEHOLDS INCREASED THEIR NET WEALTH IN 2020…

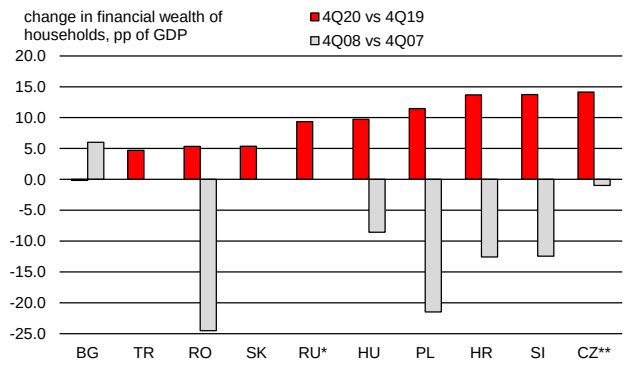
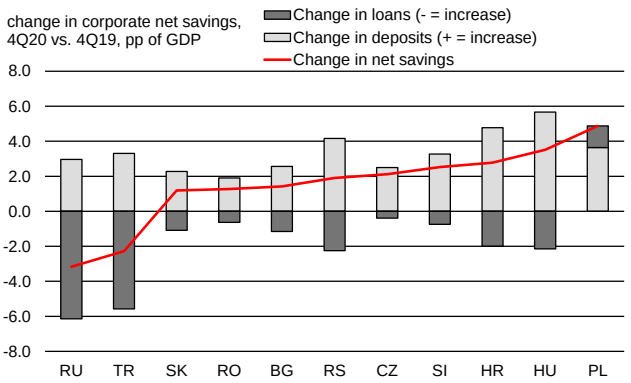


CHART 4: …AND COMPANIES INCREASED THEIR NET SAVINGS



*Russia: 3Q20 instead of 4Q20. **Czechia: 4Q09 vs 4Q08.

Source: national statistical offices, central banks, European Commission, UniCredit Research

Strong recovery in industry and construction…

Manufacturing and construction recovered after the initial lockdown. By April, manufacturing output was above pre-pandemic levels in all countries but Hungary, where activity has been fluctuating due to supply-chain bottlenecks. A further increase is on the cards as global trade grows rapidly and pent-up demand for housing remains high in a region where social norms favor ownership over rent. However, both sectors are facing rapidly rising labor shortages. Temporary jobs are especially difficult to fill as companies compete for available workers not only by offering higher wages, but also better/permanent contracts. Labor shortages are likely to rise further since they are affecting services as well. The strain is probably underestimated by many companies, especially foreign ones, which see tightening labor market conditions as a temporary feature. However, several factors point to a longer-lasting shortage of workers:

…slowed by labor shortages…

1. **Low geographic mobility:** This means that unemployment and activity rates will remain very different across regions of the same country. This is a feature that affects both small and large EU-CEE countries.
2. **Lack of migrant workers:** Cross-border mobility is affected by COVID-19 restrictions. Poland (where Ukrainian workers are not returning quickly), Czechia and Slovakia are the worst affected.
3. **Emigration:** Similar labor shortages and higher wages in Western Europe encourage many workers, especially form poorer areas, to look for opportunities abroad.

…supply-chain bottlenecks…

In both manufacturing and construction, supply-chain bottlenecks have emerged as one of the biggest impediments to production, affecting mostly the production of durable and investment goods (Charts 5 and 6). So-called bullwhip effects became prominent at the turn of the year, slowing or halting car production due to lack of microprocessors. A second wave of temporary factory closures at the end of 2Q21 is unlikely to be the last. In the first wave of the bullwhip effect, data showed that company strategies were more important than the geographic source of supplies in explaining how companies fared. Thus, car manufacturers in Hungary were worse affected than those from Czechia, which were harder hit than those in Poland, Romania and Slovakia. Starting in early spring, supply shortages and their effect on car and car-part production were more similar across countries.

Several other supply chains have been affected in 1H21, most notably those for plastics, paints, metals, wood and rubber products, and textiles. Anecdotal evidence shows that the prices of most construction materials increased by 15-20% over a two-months period throughout EU-CEE, leading some developers to reassess construction opportunities. As NGEU funds start being disbursed later this year, governments will start to compete for construction materials and workers with private companies, driving prices higher.

Charts 5 and 6 show that countries where car manufacturing represents a higher proportion of total output (Hungary, Czechia, Slovakia and Slovenia) also report the largest bullwhip effects. In construction, a dearth of equipment and inputs is slowing the rebound, mostly in Hungary, followed by Slovakia.

…and lack of sufficient funding

A lack of financing is affecting activity mostly in Bulgaria and Poland. This is a surprise in the case of the latter, where the government disbursed more grants and guaranteed loans to companies than any other country in CEE (measured both outright and as a percentage of GDP). A potential explanation could be that the sample contains more SMEs than in the other countries. At the other extreme, more than half of Romanian companies declare no impediment to their activity, with only Turkish companies coming close to this rosy assessment.

Demand for services is yet to recover fully

In 2020 and 1Q21, companies in leisure and transport services were much more affected by lockdowns and restrictions than those in manufacturing or construction. Since the reopening, they are seeing a very rapid recovery in activity and are catching up with the other sectors of the economy. Tourism will get a boost with the introduction of COVID-19 passports in July, yet the return to pre-pandemic levels of activity will be delayed to 2022 or even later if there are further waves of COVID-19 that trigger renewed restrictions. Similar to construction and manufacturing, restaurants and hotels are struggling to hire enough seasonal workers, but weak demand remains more important for their activity than supply shocks.

CHART 5: COMPANIES IN INDUSTRY WORRY THE MOST ABOUT A LACK OF DEMAND…

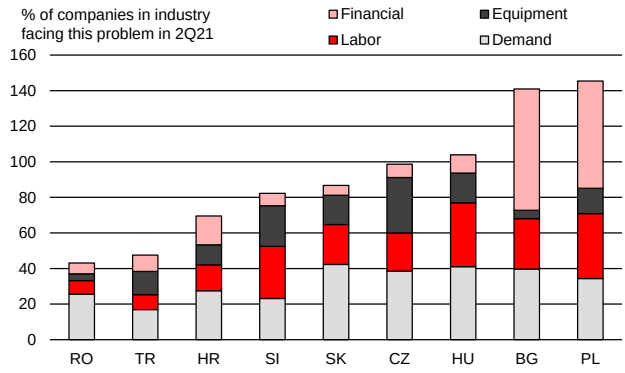
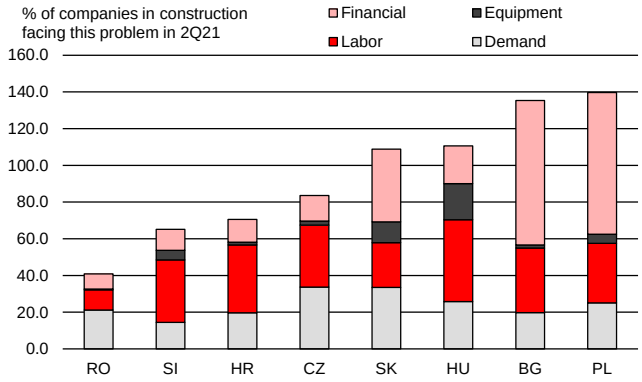


CHART 6: …WHILE THE SHORTAGE OF WORKERS IS WORSE IN CONSTRUCTION



Companies can report more than one problem.

Source: Eurostat, national statistical offices, central banks, UniCredit Research

Growth outlook: mind the carryover

We have upgraded our growth forecasts throughout CEE, after a better-than-expected 1Q21. Companies and consumers adapted further to restrictions despite the strong third wave of the pandemic. The second and third quarter of the year should see a further rebound, with growth slowing (or even reversing) in 4Q21 when a fourth wave of the pandemic is more likely.

EU-CEE and the Western Balkans could grow at around 5% in 2021 and 4.5% in 2022

We expect EU-CEE to grow by 5% this year and 4.5% in 2022, after a GDP contraction of 4.1% in 2020 (Chart 7). The Western Balkans could grow at a similar pace, driven mostly by Serbia, the largest economy in the region. The Turkish economy could grow by at least 7.5% this year, closing the output gap that opened in 2020, when the economy grew by just 1.8% (but managed to avoid a recession). Next year, growth could fall to around 3.5%, below Turkey's potential, if financial conditions remain tight. The Russian economy could grow by 3.4% in 2021, after slumping by 3.1% in 2020. Tighter financial conditions might slow GDP growth to around 2.6% next year.

Turkey will outpace CEE, Russia will lag

Most countries back to pre-pandemic levels of activity in 2021

While Turkey managed to return to pre-pandemic GDP levels in 2H20, Romania and Serbia did so in 1Q21. Bosnia-Herzegovina, Hungary, Poland, Russia and Slovenia are expected to recoup all pandemic losses in 2021. All other countries could return to pre-COVID-19 levels of activity in 1H22.

The carryover from 2020 explains most of the 2021 growth

This year, the carryover from 2020 has played a very important role in shaping our forecasts. The economies of Romania and Serbia (where the rebound from last year's slump was more gradual) and Turkey (where the rebound was the strongest and most resilient) will probably show higher growth rates in 2021. At the other extreme, the carryover from 2020 was negative in Russia and very low in Czechia, Slovakia and Poland, where supply-chain bottlenecks and anti-pandemic restrictions weighed more heavily on the recovery at the turn of the year.

Net of the carryover, Russia and Poland could outpace the rest of CEE

Excluding the carryover, Russia and Poland are likely to have the strongest recovery in 2021, helped by robust domestic demand. In Russia, credit, pent-up demand and a return to the low savings rates prevalent before COVID-19 will support consumer spending. A positive base effect will help investment growth. In Poland, consumption will benefit from transfers to households under the New Deal, a new redistribution program that adds to similar spending measures implemented before the pandemic. This time around, the funding will come from higher taxes, rather than better tax collection.

In many countries, most notably Croatia, future data revisions could show a lower carryover from 2020, with a larger contribution from quarterly growth in 2021.

We expect GDP growth to slow into year-end in most CEE countries due to another wave of COVID-19. However, GDP is unlikely to fall in quarterly terms, unless global demand weakens significantly. Countries where a fourth wave is likelier, such as Bulgaria and Romania, could see little excess growth beyond the carryover. While Russia is also exposed to the risk of another spike in infections and deaths, the reintroduction of restrictions is likely to have a limited impact, as was the case during the latest COVID-19 wave.

CHART 7:
GDP FORECAST: A STRONG RECOVERY

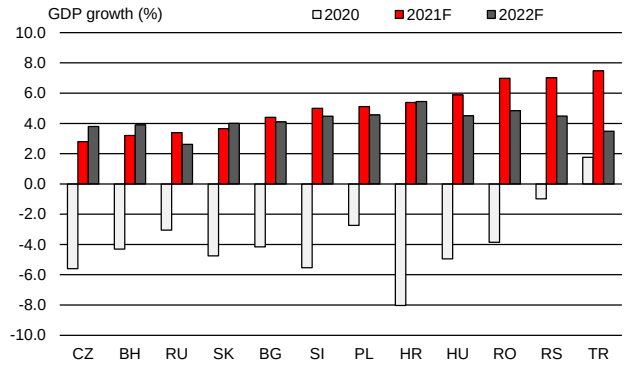
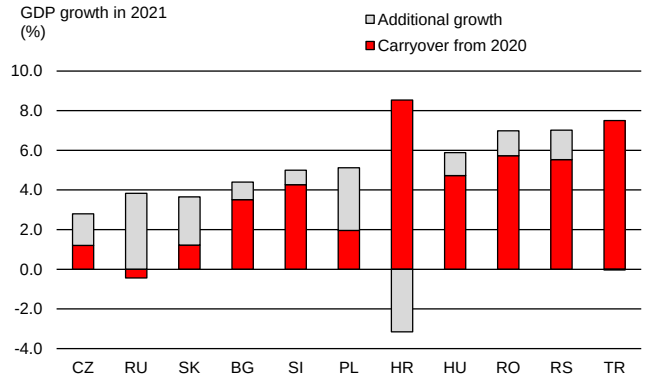


CHART 8: NET OF CARRYOVER, CENTRAL EUROPE AND RUSSIA STAND OUT



Source: Eurostat, national statistical offices, UniCredit Research

Inflation: the reopening is yet to make its mark

Inflation momentum is better captured by 3M SA price changes

When talking about inflation, most CEE central banks are using annual inflation and the base effect in fuel prices to justify inaction. However, annual rates are affected not only by fuel price fluctuations, but also by unusual price volatility and mismeasurement during the first lockdown. In our view, a better measure of inflationary momentum is three-month, annualized and seasonally adjusted inflation. The consumer basket is divided into three components (fuel/energy, cyclical[4] and non-cyclical[5] prices) to better gauge the underlying reasons for the current reflationary episode.

Comparing inflationary momentum to inflation targets, the main conclusions are:

Cyclical inflation has been rising since the reopening

1. Cyclical inflation excluding fuel/energy is on the rise in Hungary, Poland, Romania and Serbia, having turned positive in the spring. It is well correlated with the stringency of lockdowns and the timing of the removal of restrictions. In Czechia, the decline in May could be short-lived. Cyclical inflation excluding fuel/energy has peaked in Russia and Turkey, where the FX pass-through from past depreciation episodes has run its course.
2. Higher food prices globally contribute to faster cyclical inflation.
3. The contribution of fuel/energy prices has peaked everywhere. In Romania, further increases in regulated prices for energy, gas and electricity will give a renewed jolt to this component between July and September.

[4]The composition of cyclical inflation varies from country to country but it typically includes food, clothing and footwear, electronics and furniture, leisure and cultural goods, restaurants, tourism, transport and cultural services. In some countries, services associated with housing are cyclical and correlated with house prices.
[5]Prices not included in the other two categories.

Non-cyclical inflation is stronger where pent-up demand is higher

4. Non-cyclical inflation is higher where regulated prices, such as that of tobacco, have been raised. Excluding prices set by authorities, however, this inflation measure is very high in Czechia, Hungary and Poland, where pent-up demand (measured by the rise in net household deposits in 2020) is larger than in the other CEE inflation targeters).
5. Inflation excluding fuels/energy is only inside the target ranges in Czechia and Romania, and is accelerating in Poland, Romania and Serbia.

Inflation might end 2021 inside target ranges only in Czechia and Serbia…

The reopening of economies and a strong summer for consumer spending may further accelerate cyclical price inflation, keeping inflationary momentum outside target ranges even if fuel/energy contributes less to headline inflation. We expect targets to be missed this year in all countries but Serbia, where the target range is very wide, and potentially Czechia, where inflation will nevertheless hover at the top of the target range.

…with more target misses expected in 2022

In 2022, tighter labor-market conditions, the pass-through from producer prices and high transfers to households (boosted by elections) could keep core inflation high throughout CEE. Two exceptions might be Romania, where public wages and pensions are unlikely to exert the same pressure on prices as they did before 2019[6], and Russia, where consumer demand could slow down to potential growth, helping inflation to fall below the 4% target before the end of next year. In Czechia, Hungary and Poland, pressure on consumer prices will remain high and a lack of appropriate policy action could lead to targets being missed and inflation expectations de-anchoring from targets.

INFLATION MOMENTUM SUGGESTS THAT CYCLICAL INFLATION WILL RISE FURTHER

CHART 9:
NON-FUEL INFLATION MOMENTUM IS RISING IN CE4…

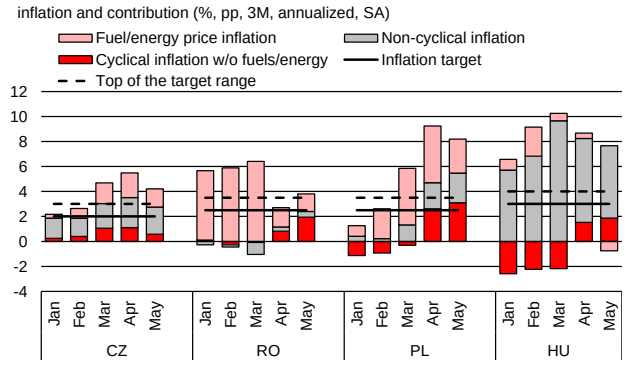
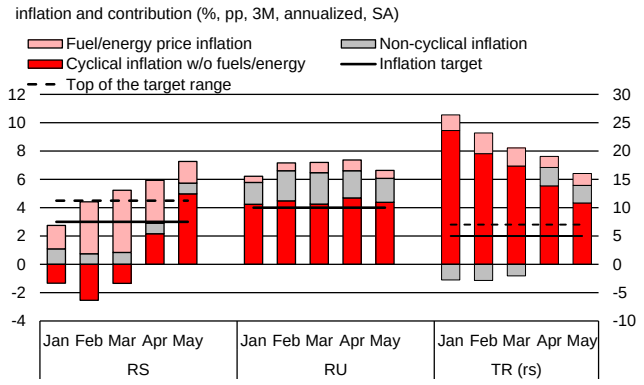


CHART 10:
…BUT HAS PROBABLY PEAKED IN RUSSIA AND TURKEY



Source: statistical offices, central banks, UniCredit Research

Monetary policy: not all boats shaken by the turning tide

Central banks are turning hawkish in CEE

Throughout CEE, central banks are more hawkish than they were a quarter ago. This change has been prompted by higher-than-expected inflation and growth. CEE central banks continue to mention that economic risks warrant a more cautious approach to normalizing monetary conditions but have admitted that inflationary risks are more prominent and also more resilient than previously thought.

Rate hikes can cap depreciation and reduce the FX pass-through

With monetary transmission taking 4-8 quarters, tighter monetary policy has one major goal: to prevent further currency depreciation at a time when supply shocks are inflationary and mostly external, affecting commodity prices and, thus, domestic food, fuel and producer prices.

[6] Please see the 2Q21 CEE Quarterly for details.

The impact of higher interest rates on debt servicing is low and has been offset by government transfers and higher household savings since the start of the COVID crisis. The direct impact on inflationary expectations is also limited in the short term, as they are backward-looking in all CEE countries and will continue to rise with realized inflation.

With price pressure likely to persist in 2022 and drivers probably switching from supply to demand shocks, central banks cannot afford to look too complacent. Yet, different starting points, inflation outlooks and dovish/hawkish biases could lead to diverging rate paths and, as a result, to heterogeneous financial asset performance.

The proactive

The CBR could hike to 6.5% in 2021 and cut to 5.5% in 2022

Inflation momentum suggests that the CBR has been right to hike and the CNB right to signal well in advance that it will tighten in 2021. We expect the CBR to raise the policy rate by another percentage point to 6.5% before year-end. Thus, the Russian central bank could temporarily exceed the neutral range for its key rate, estimated at 5-6%. If inflation falls back to or below target in 2022, as is widely expected, the policy rate could be lowered back to 5.5% before the end of next year. This means that the CBR will be moving against the tightening trend in EU-CEE and EM in general, which could reduce the scope for RUB appreciation.

The CNB's tightening cycle could be the longest, to 2%

The CNB could increase the policy rate twice more this year, to 1%, after starting its tightening cycle in June. Two more hikes next year and two in 2023 would take the policy rate to 2% and, thus, equal to the inflation target. The CNB's stand-out hawkishness in central Europe is not confined to rates: the Czech central bank expects EUR-CZK to fall to close to 25 this year, a level it considers close to fair value. This is a more hawkish assessment than the current market consensus.

The reactive

The NBH is likely to hike less than expected by markets, to around 1.5%

Until spring, the NBH was reluctant to acknowledge that inflationary pressure might be more persistent than its forecast suggested. Once inflation spiked well above target, the Hungarian central bank made a U-turn and fully embraced the prospect of rate hikes. Given that momentum in non-fuel inflation is significantly higher than in the rest of EU-CEE, this hawkish turn was overdue. We expect the NBH to deliver one more 15bp hike in July after the 30bp increase in June, then pause until 4Q21 if inflation falls temporarily in 3Q21. A renewed reflationary episode could prompt two more hikes in 2021 to 1.35%, followed by a final increase to 1.50% in 1Q22. The tightening cycle could be more frontloaded than in neighboring countries, but it is also likely to end at a lower key rate. As a result, depreciation pressure on the HUF might re-emerge in 2022, when we expect inflation to remain slightly outside the target range. The NBH signaled that bond purchases would continue, probably leading to a bear-flattening of the HGB curve. Smaller HGB purchases in 3Q21 are likely to be driven by lower issuance rather than weaker appetite.

The NBR could wait until early 2022 to raise rates to 1.75-2%

In Romania, headline inflation could rise above 5% in July if the prices of energy, natural gas and heating increase as announced. Even when excluding energy and fuel prices, inflation might narrowly miss the target range in 2021. However, rate hikes remain unlikely this year due to the potential of a fourth wave of the pandemic. As mentioned above, restrictions could be as loose and poorly enforced as they were during the third wave, with economic growth slowing, rather than reversing. This means that the NBR could start hiking in early 2022, taking the policy rate to 1.75% or even 2%, in a normalization of rates that will put Romania's key rate above those of its central European peers. If household income rises at a slower pace than in 2015-19 and core inflation settles inside the target range, as we expect, the NBR may not return the repo rate to 2.5%, where it was before the COVID-19 crisis. ROMGBs could perform better next year, when lower inflation could entice local pension funds to buy more duration.

The CBRT cannot afford to cut

In Turkey, President Recep Tayyip Erdogan's gamble to change the CBRT governor

too much or too soon

backfired. Had he kept Naci Ağbal in place, Mr. Erdogan would have probably avoided most of this year's TRY depreciation and, thus, the Turkish economy would have faced lower inflation in 2H21. Instead, CBRT Governor Şahap Kavcıoğlu may be able to cut rates only in the 4Q21 (provided Mr. Erdogan can wait until then) and by less than Mr. Ağbal might have been able to do with a more stable TRY. Mr. Kavcıoğlu took a much more hawkish line after his appointment than when he was a columnist writing about monetary policy, but that did not prevent the currency from selling off. The scope for rate cuts remains narrow, in our view, at around 2.5pp this year (to 16.5%) and 3pp in 2022 (to 13.5%).

TRY depreciation and higher import prices will continue to fuel inflation, while core inflation could remain high next year if the government increases transfers to households ahead of the 2023 elections. A better tourism season in 2022 would also add to core inflation. Given persistent external imbalances and the need to roll over external borrowing, Turkey will continue to face a trade-off between rapid rate cuts and TRY depreciation, high inflation and financial turmoil.

The inactive

The NBP could postpone tightening to 4Q21 or 1Q22…

The NBP has every reason to increase interest rates: even excluding transport prices, annualized 3M SA inflation is currently around 4.6%, more than a point outside the target range. Moreover, inflation is accelerating, especially in its cyclical component. The government's New Deal, announced in May 2021, will renew the redistribution from companies to households, targeting mostly hand-to-mouth consumers (the young, the old and families with several children). Thus, demand pressure on prices is very likely to rise further, threatening a longer-term miss of the target. Yet a majority of MPC members are reluctant to consider hikes before November or even before the end of their term[7]. By remaining staunchly dovish, the MPC majority is stoking up depreciation risks, which, in turn, could further contribute to inflation. Government bonds are not benefiting from the current monetary policy stance either. Low rates increase the pressure on the long end, as investors tend to reward financial assets in countries with more hawkish central banks. In addition, NBP President Adam Glapinski has not made up his mind about the central bank's bond purchases. Having declared that they should be phased out before rate hikes start, we think he (or his successor) might take a line closer to that of the NBH and continue bond purchases even after interest rates start rising. As POLGB spreads widened and demand in the primary market fell in 2Q21, government representatives started to argue in favor of rate hikes, an unprecedented stance for members of the executive. Mr. Glapinski's reaction was to exclude MPC members from future monetary policy-related press meetings, shrinking the platform of his more hawkish colleagues.

…eventually hiking to around 1.5%

In our baseline scenario, the NBP will start hiking in November, but there is a risk that the first hike will be delayed to January or February, when most of the dovish MPC members will be replaced and a more hawkish majority could emerge. The later it hikes, the more trouble the NBP could have in stabilizing inflation and, thus, the faster the tightening cycle might have to be. We expect the policy rate to be brought back to the pre-COVID-19 level of 1.50% by the end of next year. This would also help stabilise EUR-PLN, with the PLN remaining more competitive than its regional peers when adjusted by both unit-labor costs and producer prices.

The NBS could leave rates unchanged in 2021-22

Serbia has too wide a target range (1.5-4.5%) to worry excessively about the current reflation episode. Since the start of the spring, most of the surprise in higher inflation has been explained by the volatile prices of fresh food. Yet the reopening could accelerate core inflation as well, helping it to catch up after years of below-target increases. Household income and consumer demand have outpaced core inflation since Serbia ended its fiscal adjustment five years ago.

[7] Eight out of ten mandates, including that of NBP President Adam Glapinski, will end between January and June 2022.

Even if the post-reopening inflationary spike sends headline inflation above 4.5%, this overshoot could prove temporary and the NBS will probably not react to it unless the RSD comes under strong pressure and FX reserves are quickly depleted through interventions. In our view, this scenario is unlikely to transpire and we expect the central bank to keep rates on hold and EUR-RSD to remain stable in 2021-22.

MONETARY TIGHTENING COULD BE MORE GRADUAL THAN MARKETS EXPECT

CHART 11: RATE HIKES EXPECTED IN MOST CEE COUNTRIES…

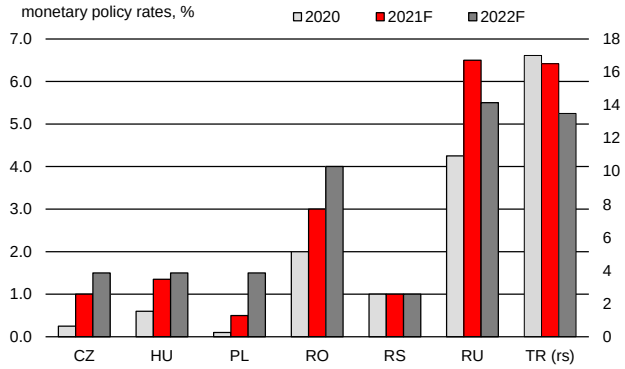
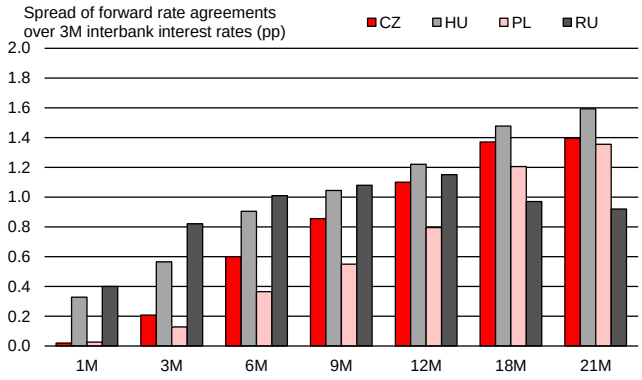


CHART 12: …BUT AT A SLOWER PACE THAN MARKETS PRICE IN



Source: Central banks, Bloomberg, UniCredit Research

Risks: focus on domestic politics

In 3Q21, the biggest risks for CEE countries are likely to originate domestically. Politics will come to the fore as Bulgarian voters head to the polls again, Czechs prepare for parliamentary elections on 8-9 October and the coalition ruling Slovakia tries to stay together. In Romania, a leadership race could divert the government from its current path. Duma elections in Russia and talks of early elections in Turkey complete the picture.

The next Bulgarian government could be a fragile one

Bulgarian voters will choose another parliament on 11 July, less than four months after an inconclusive election. Since April, the populist There Is Such a People party established by TV personality Slavi Trifonov closed the gap to the ruling GERB and could form the next government with Democratic Bulgaria and smaller parties. However, the minority government will have to rely on either GERB or the Socialists (BSP) for support. A fragmented parliament could either change the coalition composition or even lead to early elections as soon as next year.

Czech elections could be a three-way contest

Three main parties and coalitions have emerged ahead of Czech parliamentary elections. The Pirates and Mayors party is leading the ruling ANO Movement, with the center-right SPOLU in third place. It is too early to say which two of the three will form the next coalition. Regardless of its composition, the incoming government may struggle to contain public spending and reduce the budget deficit.

Slovakia's government is threatened by infighting

In Slovakia, the ruling coalition continues to enjoy a constitutional majority, but it is teetering on the brink of collapse as parties fail to agree on a common agenda. The main risks are slow fiscal adjustment and economic growth, if necessary investment projects are not implemented. Public-private partnership legislation and the issue of construction permits need to be addressed in order to accelerate infrastructure spending.

PNL leadership contest to shape Romania's direction

In Romania, a leadership contest in the National Liberal Party (PNL) will take place on 25 September. Prime Minister Florin Cîțu will run against PNL president and former prime minister Ludovic Orban. A win for Mr. Orban could end Mr. Cîțu's tenor and question the

government's commitment to reducing the budget deficit. Mr. Cîțu successfully steered Romania's problematic public finances through election year of 2020 and the COVID-19 crisis. Further on, the election of three Constitutional Court (CC) judges in 2022 could tip the majority in the country's top court in favor of a more reformist agenda and fewer conflicts with EU courts. This could happen only if a strong PNL remains in the current coalition, as the opposition is backing a more interventionist CC. The leadership election will also show whether the PNL remains united and whether it is able come up with a reformist agenda.

Geopolitical risks subsiding in Russia

Duma elections scheduled for 19 September should have a very predictable outcome. Thrifty budget execution and fragile household finances led the Russian authorities overplay the importance of geopolitical tensions. However, an anticlimactic and uneventful meeting between US President Joe Biden and Russian President Vladimir Putin should see both the war of words and financial risk premiums decline in the coming months. At the same time, a rapprochement between Russia and the EU, advocated by Germany and France, was thwarted by Russia's EU neighbors. The almost-completed Nord Stream 2 could start operation before year-end, with Russia putting pressure on marginal gas prices in order to accelerate the EU's approval.

Political interference in CBRT policy is the biggest economic risk in Turkey

In Turkey, general elections should happen on or before 18 June 2023. While some analysts predict early elections in 2022, we believe that the economic story may not be solid enough for President Recep Tayyip Erdogan and the ruling Justice and Development Party (AKP) to benefit from bringing elections forward. This will be especially true if Mr. Erdogan loses patience with the CBRT leadership again and presses for rapid and untimely rate cuts in 3Q21. Neither the credit, nor the fiscal impulses can be boosted without rekindling macroeconomic and financial imbalances that will ultimately affect the TRY, inflation and interest rates.

EU-CEE and NGEU: not rushing to spend

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- EU-CEE will be the main beneficiary of NGEU funds (9.4% of average expected GDP between 2021 and 2027) and the 2021-27 EU budget (6.8% of 2021-27 average GDP).
- EU-CEE countries applied for all available grants under the NGEU's main component, the Recovery and Resilience Facility (RRF), but for less than 30% of the available loans.
- The EC is expected to approve country RRFs during the summer and pre-funding could start arriving in August-September, significantly sooner than transfers from the EU budget.
- The impact of RRF funding on GDP growth could be largest in Croatia, Romania and Bulgaria (0.6-1.6pp per year) and lowest in Czechia, Hungary and Slovenia (0.2-0.6pp per year). Multipliers would be higher when factoring in externalities, especially to the labor market and consumption.
- It is likely that RRF funding will have a lower impact on GDP growth in 2021-22 than in 2023-27.
- RRF-funded projects might crowd out spending from the EU budget, at least in 2021-22, despite the latter being the main source of funding for road and rail infrastructure works.
- The RRF represents a big advantage of EU-CEE over other EM by supporting GDP growth, underwriting needed reforms and supporting financial stability.

EU-CEE is the main beneficiary of NGEU funds

Since the EU announced its anti-pandemic packages, the focus has been on Southern Europe and the unprecedented help it will get from the European Union. However, EU-CEE is the main beneficiary of NGEU and the 2021-27 EU budget when considering the weight in GDP of the transfers and loans negotiated last year. The RRF is equivalent to 9.4% of average expected 2021-27 GDP[8] in EU-CEE, with the EU budget adding 6.8% of average expected 2021-27 GDP.

NGEU funding, especially from its main component, the Recovery and Resilience Facility (RRF), will be disbursed much quicker than regular EU funds. By requiring clear and detailed allotment to financeable projects, the European Commission (EC) is trying to avoid the lengthy and bureaucratic process of project submission and approval that usually delays EU fund flows.

Pre-funding from the RRF could start arriving in 3Q21

Most EU countries submitted their national recovery and resilience plans before the end of June and the EC is expected to analyze and approve them over the summer. This opens the door for the first pre-funding transfers to arrive by late August or September. The laggard is likely to be Bulgaria, which is expected to submit its country framework only in July and start receiving pre-funding in October or November.

The final spending frameworks agreed with the EC could vary from the country submissions under the RRF. However, the main features are clear and there are important conclusions to draw.

EU-CEE countries applied for all grants but very few loans from the RRF…

A. **EU-CEE countries did not rush to ask for the loan part of the RRF**, while applying for all available grants. Total requested funds represent 5.7% of average expected GDP between 2021 and 2027 (Table 1). Only Romania applied for all RRF loans.

   There are three main justifications offered by CEE governments that forwent loans: **1.** They can apply for the loans until 31 August 2023 and will do so if they commit all grants by then; **2.** It is difficult to find a pipeline of green projects to cover at least 37% of the fund allocation while making sense from an economic point of view; **3.** By postponing a decision on borrowing under the NGEU, EU-CEE governments probably hope that more funds could be allotted later to other purposes, since the EC is notoriously reluctant to return unused funds to net contributors.

[8] GDP forecasts by UniCredit Research.

… despite a big pipeline of potential projects…

In our view, all three arguments are weak. First, all governments should know their national priorities for the medium and long term. Second, energy transition and energy independence are some of the most important problems to tackle in the coming years. Instead, governments are probably worried that the green transition the RRF wants to finance is not popular, especially in mining areas along the Carpathians. Holding on to coal means higher energy prices, since the price of green certificates is likely to rise further. Third, a large part of RRF funding will be borrowed by the EU, in a departure from regular EU budget financing through individual country contributions. Thus, the EC can tailor issuance to demand from EU countries and could issue less than planned if countries do not use their entire allotment.

…and below-market borrowing costs

Besides the economic motivations, there is also a funding reason in favor of RRF loans. They would reduce the pressure on primary-market issuance by allowing countries to tap bond markets with lower amounts, while anchoring yield expectations lower. The EU borrowed at 0.134% for 30 years when it issued to fund SURE, and NGEU bonds could be similarly priced. Thus, NGEU loans would be much cheaper than EUR bonds with similar maturities issued by EU-CEE countries.

TABLE 1: EU-CEE COUNTRIES PLAN FULL ABSORPTION OF RRF GRANTS, BUT LESS THAN A THIRD OF RRF LOANS

	Included in national RRF (EUR bn)			RRF allocation (EUR bn)			Planned take-up[9] (%)		
	Grants	Loans	Total	Grants	Loans	Total	Grants	Loans	Total
Bulgaria	6.4	0.0	6.4	6.3	4.6	10.9	101.6	0.0	58.7
Czechia	7.1	0.0	7.1	7.1	15.4	22.5	100.0	0.0	31.6
Croatia	6.3	0.0	6.3	6.3	3.5	9.8	100.0	0.0	64.3
Hungary	7.2	0.0	7.2	7.2	9.7	16.9	100.0	0.0	42.6
Poland	23.9	12.1	36.0	23.9	34.2	58.1	100.0	35.4	62.0
Romania	14.2	15.0	29.2	14.2	15.0	29.2	100.0	100.0	100.0
Slovakia	6.6	0.0	6.6	6.3	7.0	13.3	104.8	0.0	49.6
Slovenia	1.8	0.7	2.5	1.8	3.6	5.4	100.0	18.5	46.1
Total	73.5	27.8	101.3	73.1	93.0	166.1	100.5	29.9	61.0

Source: European Commission, national governments, national statistical offices, Eurostat, Bruegel, UniCredit Research

Around 40% of RRF funds will go to the green transition and 20% to the digital transition

B. The NGEU will probably have a lower impact on EU-CEE's potential growth than that of previous EU budgets. All EU-CEE countries observed the EC's requirements that at least 37% of RRF funds be dedicated to the green transition, with planned allocation being around 40%. With the exception of Slovakia and Slovenia, national RRF allotted at least 20% to the digital transition.

The green transition away from coal carries political and social costs

The green transition is mostly aimed at reducing reliance on coal-generated power. The move is likely to be gradual, first increasing the weight of natural gas in power generation, then focusing on renewable energy. We believe that nuclear power will be paramount for a successful energy transition, but political preferences could deter EU-CEE countries from developing their nuclear power plants. Mines will have to be closed in a move away from coal, so the net impact of the energy transition on employment is likely to be negative and politically costly. Other components, such as cleaner and more efficient public transport, the manufacturing of electric batteries and vehicles, and the manufacturing of machinery used in producing renewable energy will have a positive impact on growth and employment, at least in the medium term[10].

[9] Some countries applied for more than their official grant allotment, but will not get more money. If the projects are considered feasible, they could be funded with RRF loans.
[10] Limited availability of resources such as lithium could postpone the full functioning of electric battery factories currently under construction in EU-CEE. Nevertheless, the size of investment in this sector must be mentioned, with Bloomberg ranking Hungary and Poland joint twelfth globally and Czechia fifteenth in global supply chains of electric batteries. Projects are in the pipeline also in Slovakia and Romania.

In order to estimate the impact of green spending on GDP, we are using the multipliers computed by Batini et al (2021)[11], taking the range given for non-ecofriendly energy investment (such as gas and nuclear) for minimum multipliers and renewable energy for maximum multipliers. Developing further the production of electric batteries and cars could have similar multipliers to renewable energy, i.e. over 1.4 over five years.

The digital transition would include administrative reform and addressing regional disparities

The digital transformation could contribute to reducing red tape and increasing efficiency in administration. The COVID-19 crisis forced governments to cut paperwork and move some services online. A move back is unlikely and online services should be made available to a larger percent of the population. While the impact of reducing red tape may be difficult to quantify in GDP terms, it could encourage entrepreneurship and reduce tax evasion. Increasing the penetration of technology in rural areas could also help reduce disparities, offer employment opportunities and curtail labor migration that has left parts of EU-CEE almost deserted. Moreover, the digital transition could help reverse emigration if associated with policies to encourage private investment and infrastructure works.

TABLE 2: THE ALLOCATION OF RRF FUNDS ACROSS SPENDING CHAPTERS

Allocation (EUR bn)	BG	CZ	HR	HU	PL	RO	SK	SI
Green transition	2.6	2.9	2.6	3.0	17.4	12.0	2.7	1.1
Digital transformation	1.3	1.6	1.3	1.7	7.7	5.9	1.3	0.3
Other	2.5	2.6	2.4	2.6	10.9	11.3	2.6	1.2
% of planned allocation								
Green transition	40.6	40.8	41.0	41.1	48.3	41.1	40.9	42.0
Digital transformation	20.3	22.5	21.0	23.1	21.4	20.2	19.7	12.0
Other	39.1	36.6	38.0	35.8	30.3	38.7	39.4	46.0
% of 2021-27 GDP								
Green transition	3.2	1.0	4.0	1.7	2.5	4.2	2.4	1.8
Digital transformation	1.6	0.6	2.1	1.0	1.1	2.1	1.1	0.5
Other	3.1	0.9	3.7	1.5	1.5	3.9	2.3	2.0
Total	7.9	2.5	9.8	4.3	5.1	10.2	5.8	4.3

Source: European Commission, national governments, national statistical offices, Eurostat, Bruegel, UniCredit Research

Poor track record of labor market reforms in EU-CEE…

Yet none of these improvements can be achieved without efficient investment in human capital. This is an important chapter in RRF spending, but prior experience is not encouraging. None of the EU-CEE countries managed to adapt education to the needs of the private sector[12] and build a retraining network for the unemployed. More efficient investment in human capital would also help implement other chapters of RRF spending, namely improving efficiency and bridging regional gaps.

… and investment in health care

Finally, part of the RRF funding will go to support the health care sectors. This is long overdue, with obsolete medical equipment, and insufficient and poorly prepared personnel reflected in much higher mortality rates than in Western Europe. The COVID-19 pandemic shed light on the poor quality of health care in CEE, especially in the second and third waves.

We are using the impact computed for regular EU funds[13] for the NGEU transfers that are not assigned to the green transition. For the minimum impact estimated for funds committed to the digital transition, we adjust with the digital trust coefficients computed by Chakravorti and Chaturvedi (2017)[14] to account for the likely take-up of new technologies throughout EU-CEE.

[11] Batini, Nicoletta, Mario Di Serio, Matteo Fragetta, Giovanni Melina, and Anthony Waldron (2021), *"Building Back Better: How Big Are Green Spending Multipliers?"*, IMF Working Paper 21/87.
[12] As shown by the education sub-indices of Global Competitiveness Indices.
[13] For details, please see the CEE Quarterly from 3Q18. We are using production functions estimated for each country and the impact is measured mostly through the capital component. The range takes into account past EU-fund absorption rates.
[14] Chakravorti, Bhaskar and Ravi Shankar Chaturvedi (2017), *"Digital Planet 2017: How Competitiveness And Trust In Digital Economies Vary Across The World"*, The Fletcher School, Tufts University

While the difference in coefficients is not significant, they are lower in the older countries of the region, Slovenia and Bulgaria.

The impact of RRF on GDP could be highest in Croatia, Romania and Bulgaria…

Tying up all ends, RRF grants and loans could boost economic growth by 0.6-1.6pp per year in Croatia, Romania and Bulgaria (Chart 1). These are countries whose planned take-up of NGEU grants and loans is much higher in percent of GDP than for other EU-CEE countries (Table 2). In addition, these countries have a bigger need for infrastructure investment and could enjoy potential gains even from limited reforms in administration, education and healthcare. At the other end, the impact could be much smaller in Czechia (the smallest planned absorption), Hungary (the lowest efficiency of EU-fund spending) and Slovenia (a combination of low absorption, poor efficiency and more developed infrastructure), at around 0.2-0.6pp per year.

… and lowest in Czechia, Hungary and Slovenia

In all countries, the impact could be backloaded

The impact of NGEU-funded spending on GDP is likely to be smaller in 2021-22 than in 2023-27 (Chart 2). Even with a faster start than for normal EU-fund absorption, the impact on GDP will take a while to materialize as the first stages of such projects (planning, permits, tenders) will take time while contributing little to GDP.

GDP IMPACT OF NGEU FUNDING IS LIKELY TO BE BACKLOADED

CHART 1: POTENTIAL IMPACT IS CORRELATED WITH SIZE OF PLANNED TAKE-UP AND NEED OF PUBLIC INVESTMENT

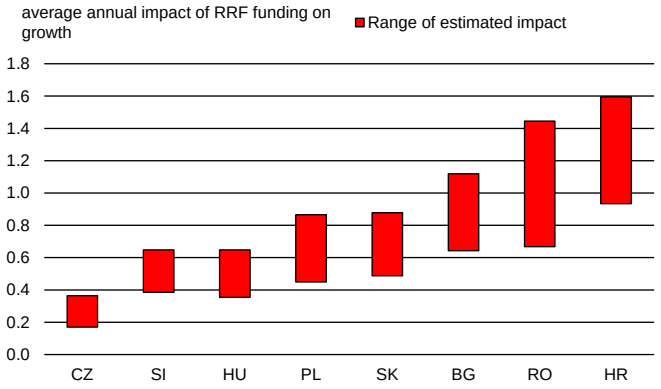
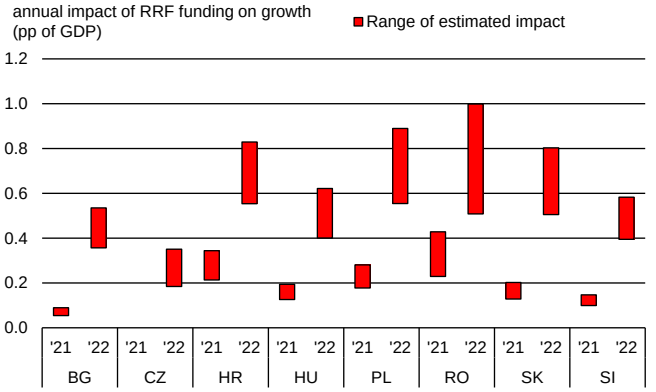


CHART 2: IMPACT OF NGEU FUNDS ON GROWTH IS LIKELY TO BE SMALLER IN 2021-22 THAN IN 2023-27



Source: European Commission, national governments, national statistical offices, Eurostat, Bruegel, UniCredit Research

Impact on growth could be higher when factoring in externalities

The estimated impact does not include externalities such as higher wage growth and higher consumer spending, although the public sector will have to compete with private-sector companies for available labor, further increasing worker shortages in EU-CEE economies. Such externalities could push multipliers above 1 in most of the region. At the same time, investment in the green and digital transitions will rely heavily on imports that will offset part of the positive impact on economic growth.

NGEU spending could crowd out other EU-funded projects…

C. **NGEU projects could crowd out projects funded from the 2021-27 EU budget**, at least in 2021-22. This is mostly because the same administration will have to deal with both, and we see limited institutional capacity to handle NGEU and EU-budget projects at the same time. Since NGEU funds will have to be committed by 2023, compared to 2027 for the EU budget, governments are expected to focus on the former this year and next. This is likelier in Bulgaria, Croatia, Czechia and Romania, while Hungary and Poland could do better in starting projects from both European funding schemes.

… although some infrastructure projects will have to be funded out of the EU budget

Thus, we would refrain for now from estimating the potential GDP impact of spending out of the 2021-27 EU budget. Saying that, many infrastructure projects dear to EU-CEE governments, such as developing road and rail networks, might not been approved under the RRF and will have to be financed from the regular EU budget.

The RRF is a differentiating factor for EU-CEE over other EM…

… by potentially supporting growth, reforms…

… and financial stability

The RRF is a big differentiating factor for EU-CEE over other EM. It offers a large pool of funding that can boost economic growth and underwrite needed reforms. By requiring very detailed planning, the EC wants to make sure that the disbursement will be faster than for regular EU funds. However, absorption and investment management will have to improve, while governments will have to incur political costs in order to implement most of the projects under the RRF umbrella. These are the main reasons why we expect a limited impact on GDP. Nevertheless, RRF transfers will add to other stable capital flows, making EU-CEE the largest recipient of such funds among EM. RRF loans would represent a sizeable and cheaper alternative to foreign bond issuance, offering a cushion against market volatility at a time when interest rates could rise globally. Thus, the RRF bodes well for EU-CEE currencies and financial stability in general.

OUR GLOBAL FORECAST

	GDP growth, %			CPI (Avg), %			Policy interest rate, %			10Y bond yield (EoP)**, %			Exchange rate (LC vs.USD)		
	2022	2020	2021	2022	2020	2022	2020	2021	2022	2020	2022	2020	2021	2016	2017
Eurozone	-6.7	4.5	4.3	0.3	2.0	1.5	-0.50	-0.50	-0.50	-0.26	0.15	0.30			
Germany*	-4.8*	3.5*	5.0*	0.5	2.4	1.6									
France	-8.0	5.2	4.2	0.5	1.4	1.4									
Italy	-8.9	5.0	4.2	-0.1	1.2	0.9				0.55	0.70	1.25			
UK	-9.8	6.9	6.2	0.9	1.9	2.1	0.10	0.10	0.10				1.37	1.42	1.45
USA	-3.5	6.6	3.8	1.2	3.9	2.6	0.25	0.25	0.25	0.91	2.00	2.50	1.22	1.22	1.25
Oil price, USD/bbl													43	66	63

*Non-wda figures. Adjusted for working days: -5.1% (2020), 3.5% (2021) and 5.1% (2022); ** For eurozone:10 Y swap rate

Source: UniCredit Research

THE OUTLOOK AT A GLANCE

Real GDP (% change)	2019	2020	2021F	2022F
EU-CEE	3.9	-4.1	5.0	4.5
Bulgaria	3.7	-4.2	4.4	4.1
Czechia	2.2	-5.6	2.8	3.8
Hungary	4.6	-5.0	5.9	4.5
Poland	4.7	-2.7	5.1	4.6
Romania	4.1	-3.9	7.0	4.8
Croatia	2.9	-8.0	5.4	5.5
Russia	2.0	-3.0	3.4	2.6
Serbia	4.2	-1.0	7.0	4.5
Turkey	0.9	1.8	7.5	3.5

CPI EoP (% change)	2019	2020	2021F	2022F
EU-CEE	3.4	2.0	4.0	3.3
Bulgaria	3.8	0.1	3.4	2.3
Czechia	3.2	2.3	3.4	2.7
Hungary	4.0	2.7	4.8	4.1
Poland	3.4	2.4	4.7	3.7
Romania	4.0	2.1	5.0	3.2
Croatia	1.4	-0.7	2.4	2.0
Russia	3.0	4.9	4.8	3.8
Serbia	1.8	1.3	3.6	2.7
Turkey	11.8	14.6	15.4	12.8

C/A balance (% GDP)	2019	2020	2021F	2022F
EU-CEE	-0.4	1.3	1.0	0.5
Bulgaria	1.8	-0.7	1.0	2.3
Czechia	0.3	3.6	3.9	2.5
Hungary	-0.4	0.1	0.1	1.0
Poland	0.5	3.5	2.7	1.8
Romania	-4.9	-5.2	-5.8	-6.0
Croatia	2.8	-0.8	0.1	-0.7
Russia	3.9	2.2	5.7	4.5
Serbia	-6.9	-4.3	-4.1	-4.0
Turkey	0.9	-5.2	-3.0	-1.8

Extended basic balance (% GDP)	2019	2020	2021F	2022F
EU-CEE	2.7	4.0	4.3	4.2
Bulgaria	4.8	3.9	5.4	7.7
Czechia	3.1	5.4	5.7	4.1
Hungary	1.6	2.4	3.9	5.7
Poland	4.1	7.4	6.0	5.4
Romania	-1.7	-2.9	-1.4	-1.1
Croatia	6.8	3.8	5.1	4.6
Russia	4.5	2.0	5.5	4.5
Serbia	0.8	2.0	1.5	1.4
Turkey	1.7	-4.6	-2.5	-1.2

External debt (% GDP)	2019	2020	2021F	2022F
EU-CEE	66.9	75.2	68.6	64.0
Bulgaria	57.6	63.4	61.0	59.3
Czechia	76.2	76.1	77.4	80.7
Hungary	95.4	153.9	122.9	104.2
Poland	59.1	56.9	48.8	41.3
Romania	33.3	42.5	44.0	45.2
Croatia	75.3	82.4	76.9	74.2
Russia	29.1	29.8	28.0	25.3
Serbia	61.5	66.3	66.9	65.2
Turkey	57.2	62.8	61.6	61.6

General gov't balance (% GDP)	2019	2020	2021F	2022F
EU-CEE	-1.1	-7.2	-7.1	-4.9
Bulgaria	2.1	-3.4	-5.5	-2.8
Czechia	0.3	-6.2	-8.0	-6.0
Hungary	-2.1	-8.1	-7.5	-5.7
Poland	-0.7	-7.0	-6.4	-4.0
Romania	-4.4	-9.2	-8.1	-6.3
Croatia	0.3	-7.4	-4.5	-2.8
Russia	1.8	-3.8	1.1	0.7
Serbia	-0.2	-8.1	-7.0	-3.0
Turkey	-5.3	-5.2	-4.8	-5.2

Gov't debt (% GDP)	2019	2020	2021F	2022F
EU-CEE	44.2	55.5	55.8	55.9
Bulgaria	19.7	24.4	26.7	27.4
Czechia	30.3	38.1	44.2	47.6
Hungary	63.9	80.4	78.7	78.0
Poland	45.6	56.3	54.1	52.9
Romania	35.3	47.5	48.5	49.8
Croatia	72.8	88.7	87.2	84.5
Russia	13.2	18.5	17.8	18.3
Serbia	52.9	58.2	60.3	59.8
Turkey	32.6	39.8	40.9	42.4

Policy rate (%)	2019	2020	2021F	2022F
EU-CEE				
Bulgaria	-	-	-	-
Czechia	2.00	0.25	1.00	1.50
Hungary	0.90	0.60	1.35	1.50
Poland	1.50	0.10	0.50	1.50
Romania	2.50	1.50	1.25	1.75
Croatia	-	-	-	-
Russia	6.25	4.25	6.50	5.50
Serbia	2.25	1.00	1.00	1.00
Turkey	12.00	17.00	16.50	13.50

FX vs. EUR (EoP)	2019	2020	2021F	2022F
EU-CEE				
Bulgaria	1.96	1.96	1.96	1.96
Czechia	25.4	26.2	25.4	25.0
Hungary	331	365	360	370
Poland	4.26	4.61	4.60	4.60
Romania	4.78	4.87	4.95	5.05
Croatia	7.44	7.54	7.53	7.53
Russia	69.3	90.7	84.8	88.1
Serbia	117.6	117.6	117.6	117.8
Turkey	6.67	9.08	11.59	13.33

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)	-1.3	3.0	3.8	0.6	3.7	-6.3	-1.8	1.9	0.8	-5.0	2.8	2.4	-0.9	0.8	2.2	-0.2	1.3	2.5	0.7
Extended Basic Balance (% of GDP)	2.6	6.2	7.9	2.2	7.2	-3.0	4.4	4.4	0.5	-4.5	3.4	4.0	0.4	-0.6	0.5	1.1	3.3	3.5	1.0
FX Reserves coverage (months of imports)	8.7	8.2	8.0	3.6	5.2	4.7	7.8	17.1	-	2.2	4.9	5.6	16.6	6.6	7.3	9.6	13.3	15.6	9.3
External Debt (excl.ICL, % of GDP)*	38.0	76.7	69.6	74.3	41.5	40.1	60.1	22.1	102.6	61.5	78.6	38.5	45.1	78.8	56.1	38.8	21.6	16.3	69.7
Short-term debt (% of GDP)	14.4	43.2	26.6	13.6	9.2	6.8	4.2	4.0	50.3	19.3	11.2	3.3	4.8	8.4	9.1	4.2	7.8	8.9	10.4
REER (Index, 2010=100)	106.4	103.8	101.4	87.1	92.8	98.6	127.5	75.0	-	49.3	94.7	82.5	146.4	88.5	105.1	89.2	105.3	125.1	-
Domestic Finances																			
Corporate debt (% of GDP)	48.0	52.3	65.3	55.2	44.3	39.6	47.5	62.2	54.4	74.6	48.6	27.2	54.0	115.4	58.1	38.7	56.9	160.0	19.3
Household Debt (% of GDP)	24.4	40.9	40.7	23.9	35.4	21.8	20.5	20.7	45.6	16.9	5.4	17.3	36.9	41.4	36.0	16.9	37.7	61.7	5.6
Nonresident holdings of LC gov.debt (% total)	0.7	32.9	-	14.7	16.3	18.1	22.3	39.4	42.9	5.1	-	19.8	10.1	-	30.5	30.0	-	9.5	-
Banking System																			
Credit Impulse (% of GDP)	-2.1	-0.6	0.0	-0.8	-2.8	-0.3	0.1	4.0	-0.1	7.0	4.6	-4.8	2.9	-9.7	-7.0	-2.6	2.4	-0.6	2.1
Loans/deposit ratio (%)	68.3	62.0	77.8	61.5	79.6	66.4	85.4	80.6	100.5	103.0	137.1	90.9	103.1	109.4	99.5	89.0	108.8	77.2	133.7
NPL (% of total loans)	8.1	2.7	7.2	2.7	3.2	3.9	3.7	8.8	2.6	3.7	39.9	2.5	2.2	1.6	5.2	3.2	7.9	1.8	4.1
Domestic Banks CAR (%)	22.5	22.1	24.5	21.9	20.1	24.6	22.4	12.5	20.4	17.9	22.6	18.3	16.8	14.3	16.6	24.0	15.6	14.7	23.2
Domestic Banks RoE (%)	10.5	8.4	6.8	4.4	3.7	12.2	6.7	17.5	6.9	10.7	22.5	14.5	12.3	7.3	7.7	12.0	20.7	9.5	22.4

BG = Bulgaria, BR = Brazil, CL = Chile, CN = China, HR = Croatia, CZ = Czech Republic, HU = Hungary, IN = India, ID = Indonesia, MX = Mexico, PL = Poland, RO = Romania, RU = Russia, RS = Serbia, SK =Slovakia, SA = South Africa, TR = Turkey, UA = Ukraine. *External debt incl ICL for CZ, RS, TR, MX, CL and SA

*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 (%)		0.50	-	0.90	0.10	1.25	3.00	5.50	0.00	19.00	7.50	4.00	3.50	0.50	3.50	3.50	4.00	4.35	38.00
Real policy rate (%)		-2.5	-	-4.0	-4.4	-2.4	-0.6	-0.5	-2.2	2.1	-1.8	-1.8	-3.8	-3.0	-1.6	1.8	-2.2	-1.5	-7.3
Real Money market rate (%)		-2.4	-0.3	-4.6	-4.3	-2.3	-0.6	0.3	-2.8	2.9	-2.5	-1.7	-3.4	-2.9	-1.8	2.0	-2.4	2.1	-9.9
Headline inflation (% yoy)	2.5	2.9	2.1	5.1	4.7	3.7	3.6	6.0	2.2	16.6	9.5	5.9	6.8	3.6	5.2	1.7	6.3	1.5	48.8
Core Inflation (% yoy)	1.8	2.6	0.6	3.4	4.0	3.0	2.0	6.0	2.6	17.0	6.9	4.4	3.5	3.1	3.2	1.4	6.6	0.9	52.5
GG Fiscal balance (% of GDP)	-4.2	-6.2	-7.4	-9.9	-7.0	-9.3	-6.2	-3.6	-6.2	-2.4	-6.6	-3.2	-12.9	-7.6	-11.4	-2.6	-9.2	-5.2	-6.6
GG Primary balance (% of GDP)	-3.7	-5.3	-5.4	-8.8	-5.7	-7.9	-4.3	-2.8	-4.9	0.3	-	-0.2	-7.1	-6.1	-6.8	-4.5	-5.8	n.a.	-
Government Debt (% of GDP)	24.4	38.1	88.7	80.7	57.6	48.0	59.6	18.1	60.6	40.4	60.7	46.1	82.1	47.2	78.8	65.6	56.6	60.0	86.2
Markets																			-
External Debt Spread (10Y, bp)**	62.2	3.4	108.4	70.1	37.6	174.7	157.8	122.9	28.7	470.9	526.6	105.2	196.9	64.1	249.9	129.9	90.8	-17.5	-
Local Currency Curve (5Y, %)***	0.0	1.7	0.2	2.1	1.4	2.7	2.2	6.9	-0.5	18.5	5.5	6.7	5.1	3.1	8.0	5.3	5.6	2.9	45.1
Local currency bond spread (2s10s)****	51.3	46.6	-19.4	106.9	142.4	127.0	171.9	51.0	106.5	-58.0	281.8	163.4	250.0	108.0	283.0	-437.0	124.2	42.1	294.6
CDS (5Y, bp)	65	59	126	85	74	118	144	138	68	398	429	162	302	102	265	138	133	36	1817
FX 3m implied volatility (%)	-	4.1	4.0	6.1	5.3	2.2	-	11.2	-	18.1	-	11.1	15.3	13.3	14.0	8.2	5.8	5.0	15.3
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 (%)	4.7	3.4	6.7	4.4	6.1	5.7	10.5	5.2	7.1	13.9	9.5	4.7	14.7	10.2	32.6	6.3	11.9	5.0	10.1

** 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: yield hunting and rate-hiking are key drivers of hard and local-currency exposure

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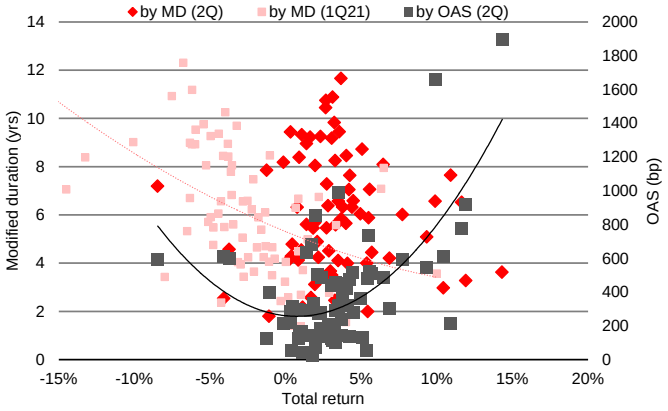
- Global financing conditions are likely to remain easy, and investors' hunt for yield will continue. However, decision time is approaching for both the ECB and the Fed, and communication will become more challenging, and could pose risks to long-duration exposure. We expect 10Y UST yields to reach 2.0% by YE 2021, 10Y Bund yields to close the year at -0.2% and EUR-USD to rise to 1.22.
- CEE-euro connection will mean more limited duration risks compared to other EM regions. With regard to hard-currency exposure, we see EUR-denominated Romani offering an attractive pick-up against Italian and Greek bonds at the 5-10Y tenors. Moreover, a very steep 5-10Y makes rolldown interesting at intermediate maturities. With the risk of market-moving sanctions declining, Russia's risk premiums should decline, benefiting hard-currency bonds. We also think that EUR-denominated Croati offer an interesting rolldown in the 0-5Y segment and that they are attractive against Greek government bonds in 3-5Y maturities.
- Bear flattening has probably run most of its curse on the OFZ curve, and yields north of 7% are attractive with a medium-term horizon. On the ROMGB curve, the 7Y area offers, in our view, the best risk-reward between rolldown opportunities and duration risks. That said, long duration might be unattractive to local pension funds until next year, when inflation is expected to move lower. A lack of NBP action creates steepening risks on the Polish curve and for the PLN, while the NBH's and CNB's stances speak for more curve flattening and relatively stronger currencies, particularly with regard to the CZK. We like HGBs at the long end and CZGBs at the belly.

Strong recovery in performance

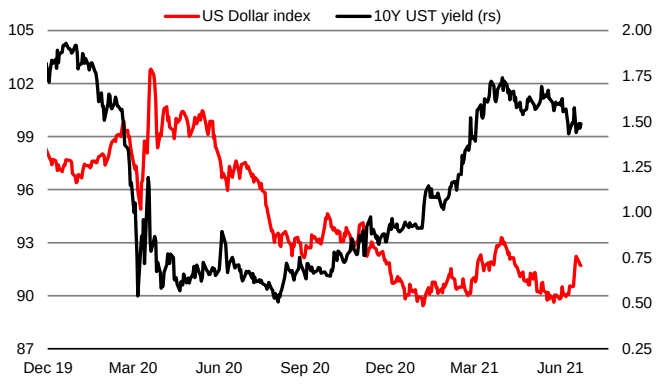
After a difficult start of the year, shaped by reflation trades and by a generalized steepening in global yield curves, fixed-income markets enjoyed a less-challenging risk-free-rate environment during 2Q. Duration has been less of a drag on performance in the last few months, as US nominal yields inched lower at the long end, and volatility as measure by the MOVE index, eased. Inflation expectations, as priced in by breakeven (BE), peaked in mid-May, while long-dated real yields fell sharply at the turn of the quarter, providing a tailwind to EM fixed income. The FOMC's June meeting was characterized by a hawkish turn in rate expectations over the next two years, with a majority of FOMC members expecting two 25bp rate hikes by YE 2023.

CHART 1:USD-DENOMINATED EM BOND PERFORMANCE



Performance, modified-duration and credit-spread metrics are aggregated by country of risk for the EM USD Bloomberg index, based on amount outstanding.

CHART 2: 10Y UST AND THE US DOLLAR



Source: Bloomberg, UniCredit Research

Yields moved higher at the short end, and so did interest-rate volatility. That said, interest-rate risks were in check for most of the quarter, fueling appetite for carry opportunities. USD-denominated EM bonds posted positive performances across maturities and rating classes. Long-duration and lower-rated segments outperformed, but often this was not enough to offset negative 1Q performance. Chart 1 shows the total return for 2Q along with the levels of duration and credit spreads prevailing at the beginning of the quarter. For comparison, returns and duration for 1Q are also reported. Performance is aggregated by country for the EM USD Bloomberg index. Compared to 1Q, when lower returns were associated with higher duration, in 2Q duration, exposure was less of a key factor, while higher carry (initial spread level) was generally associated with higher performance, albeit with a large dispersion. Across regions, EMEA did better than Asia and LatAm in 2Q, and since the beginning of the year. Local-currency performance was more volatile, with investors preferring assets backed by more-hawkish central banks. The US dollar had been weakening until earl June, while many EM central banks started to rein in their easing measures and turn more hawkish, which weighed on local yield curves.

Financing conditions going forward

Inflation and inflation expectations (as measured by surveys) have continued to move north. With the US economy having recovered its pre-crisis GDP level and a bright economic outlook over the quarters to come, the time for the Fed to start discussing tapering is approaching. We believe that such a discussion will become lively during the summer and that an announcement will happen before year-end. The outlook for official rates remains stable, and while the Fed's dot-plot shows increased confidence that two hikes might happen by YE23, it is still very early days, and the impact of hike expectations on the curve is likely to remain limited. Still, there is upside for long-term yields, and we see the 10Y UST yield reaching 2% by YE 2021 due to some normalization in the level of real yields. The short end of the curve is likely to be little changed, and with inflation BE already pricing in a very optimistic picture, real yields (particularly at the short end) are likely to stay negative for the coming few quarters. Hence, on the one hand, interest-rate risks seem set to resurface in global markets, and as the macroeconomic picture improves, the Fed might be willing to tolerate higher volatility. On the other hand, negative real yields in the US (and beyond) should continue to create incentives to channel funds towards higher-yielding alternatives.

CHART 3: US REAL-YIELD NORMALIZATION JUST STARTED

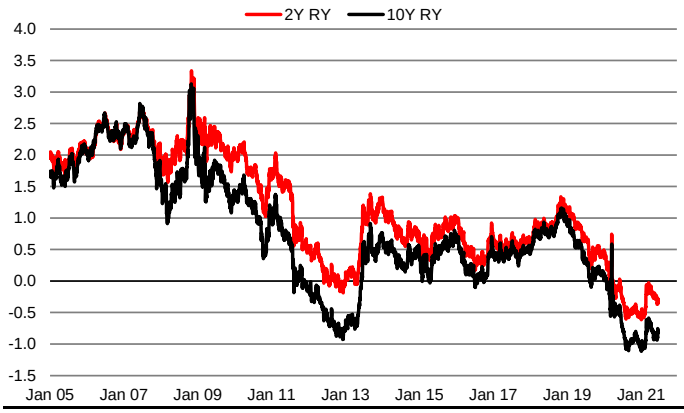
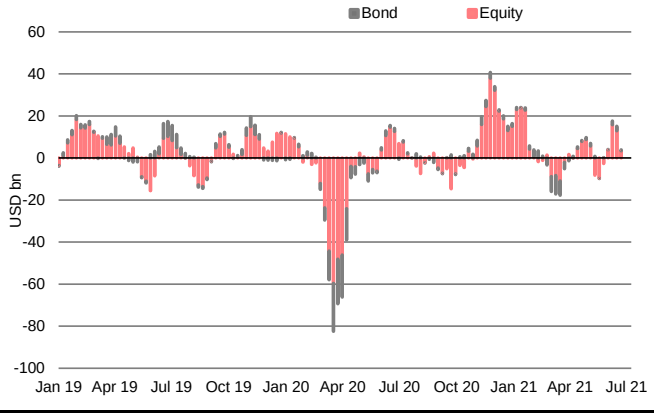


CHART 4: PORTFOLIO FLOWS INTO EM (4W ROLLING SUM)



Source: Bloomberg, IIF, UniCredit Research

US Dollar Index

Repricing in market expectations for Fed's monetary policy and higher bond yields at the long end of the curve might also cushion the downside for the US dollar. The US Dollar Index (DXY) has risen to the 92 area in recent weeks, but in spite of a recent recovery, it remains below its end-1Q level and at the lower end of its trading range since early 2018. As the economic recovery broadens across sectors and regions, EM countries are likely to benefit from positive data flows and from portfolio reallocation as investors seek out positive real yields.

In this environment, we expect the USD to remain within its recent ranges and to possibly weaken further against the EUR (we target EUR-USD 1.22 by YE 2021 and EUR-USD 1.25 by YE 2022). The most significant risks to this call come from a sharp deterioration in market sentiment, which might be triggered by rising geopolitical tension, negative pandemic developments and/or from too-quick repricing of tapering/rate-hike expectations with regard to the US. Indeed, with large central banks moving in synch in recent quarters, the scope for large deviation in FX pairs across G10 has been limited, and swings in risk appetite have been a key driver for the US dollar. This will likely change when, following a different speed of recovery, central banks' decisions start to diverge more significantly. Based on the projected pace of recovery in the US, this might bring about renewed support for the US dollar in 2022.

Credit spreads

The tightening in credit spreads that has characterized US and European markets following the crisis has shown some signs of fatigue recently, particularly across investment grade bonds. Carry is limited, and with spreads close to record lows, interest-rate moves quickly trigger negative performances. Hence, higher yielding options continue to be scrutinized, which also explains very good high-yield performance across regions. However, the credit-spread differential between US and European high-yield and broad EM hard-currency indices has been tightening steadily in recent months, increasing the relative attractiveness of the EM region for crossover investors with regard to hard-currency bonds or where central-bank action is supportive of the local currency.

Flows into EM

Lower UST yields and a tad weaker US dollar have contributed to an easing in global financing conditions and to channeling flows into EM portfolios in 2Q. These returned to being positive on average during 2Q after outflows had prevailed in March. Investors are more careful than they were in late 2020 about adding exposure to EM, in light of duration threats and high valuations across fixed-income and equity markets. However, as long as financial conditions are kept in check by central banks and return prospects across developed bond markets remain meager, yield hunting will continue to be a driver, and EM will be watched with interest.

CHART 5: ECB PURCHASES

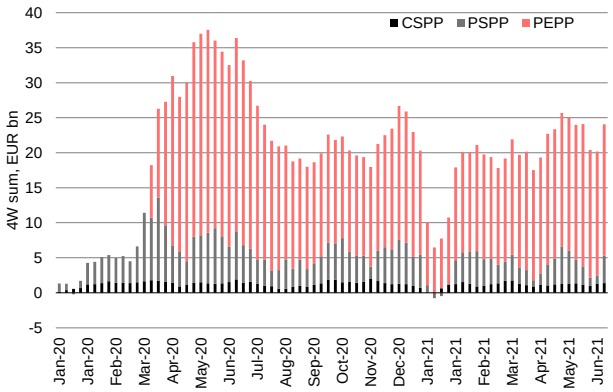
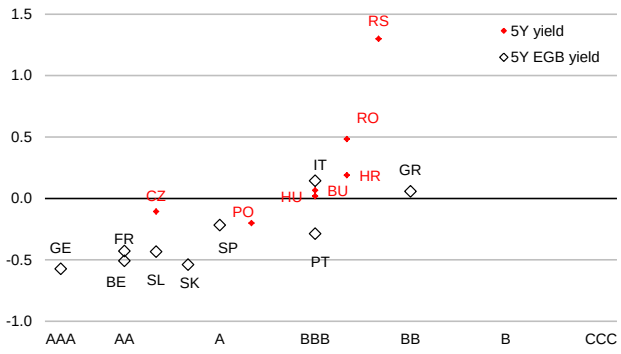


CHART 6: EUR YIELDS



Source: IIF, Bloomberg, UniCredit Research

EUR rates

When it comes to the CEE region, developments in eurozone markets are particularly key. The eurozone's economic recovery is not as mature as that which is occurring in the US and inflationary pressure is more subdued. Thus, the outlook for monetary policy poses less of a threat euro fixed income. This is reflected, in our view, in the 10Y Bund; we expect to see the 10Y Bund yield closing the year at -0.2% before moving towards 0% during 2022. That said, the ECB faces significant communication challenges, in particular with respect to the outcome of its strategy review and the outlook for monetary policy beyond March 2022, when the PEPP will expire. This poses some risk to yields and credit spreads within the euro area.

EUR-denominated bonds

Such risk should be factored in, also in EUR-denominated bonds issued by CEE countries, which would be exposed in particular to reduced appetite for carry at a time when credit spreads are widening. That said, we think the ECB will maintain its focus on financing conditions and that this will, in turn, reduce headwinds faced by Bund yields while supporting moderately tighter corporate-credit spreads into year-end. In such an environment, EUR-based investors are likely to continue to look for interesting yield-enhancement opportunities, including across CEE. At high ratings, EUR-denominated CEE bonds often trade in line with EGBs, and their associated risk-reward is not attractive. However, towards the lower end of the investment-grade spectrum, Romanian and Russian government bonds are trading sharply wider than Italian or Greek government bonds. This has been the case for a while, but since mid-May, CEE bonds have underperformed. The Romani curve trades nearly 100bp wider than BTPs at the 10Y tenor. While the Romani curve denominated in EUR is steeper than EGB curves, its pickup is sizable, also at shorter maturities, against both the Italian and the Greek curve. The balance of supply and the ECB's asset purchases will likely continue to preserve the difference in the shapes of such curves. However, after recent widening, the levels offered by the Romani curve at middle and long tenors appear attractive compared to the eurozone's periphery. Moreover, a steep 5-10Y segment paves the way for a sizable rolldown. EUR-denominated Russian bonds trade at cheaper levels than Romani at the long end and the gap at shorter maturities (e.g. 3Y), where a switch looks more interesting, has been widening. Moreover, with the risk of market-moving sanctions declining, Russia's risk premiums should decline. At the short end, Croatian EUR-denominated government bonds curve is steeper than the Greek one at the front end, and this gap has widened in recent weeks, making it more interesting to rolldown the 0-5Y segment. Strong appetite from local investors and the EMR II anchor make the curve attractive.

Exchange-rate performance has added to the returns of EUR-based investors in local bonds across CEE3 and Russia, while EUR-USD moved higher before trimming some gains in June. Implied volatility on CEE currencies inched lower or remained stable during the second quarter, and so did hedging costs, with HUF facing stronger headwinds more recently. EUR-hedged local-currency bonds remain significantly richer than foreign-currency debt, while the hawkish turn across central banks in the region might sustain local-currency exposure, albeit to a different extent. Moreover, lower issuance activity across the region will act as an additional tailwind to local-currency bonds.

Opportunities across local curves

After the recent 50bp hike, more hikes are in the pipeline in Russia, which might take the policy rate 100bp higher before inflation eases back again in 1Q22. In our view, the policy rate will peak 3-6M earlier than what is currently priced into FRAs. Bear flattening has probably run most of its course, but there is the risk that there will be further adjustment in the 2-7Y area. Nevertheless, the curve has remained pretty stable from the belly onward, and yields north of 7% seem to already offer an attractive entry level over a medium-term horizon.

Steepening over the past two months has taken the 2-10Y area on the ROMGB curve back to the upper end of the range that prevailed this year. The bar for monetary tightening in Romania is high, at least this year, in spite of rising inflationary forces. Moody's and Fitch have recently confirmed their negative outlooks, flagging that improvement on the fiscal side is needed for positive revision. The NBR will likely seek to keep EUR-RON within the 4.90-5.00 range, but inflation's current trend has added to risks at the long end of the curve, at least in the short term. The nearly 3% yield offered at the 7Y area might be a good compromise between attractive rolldown and duration risks. This is also the area where hedged local yields start to offer a premium on CEE3 curves. Long duration might be unattractive to local pension funds until next year, when inflation is expected to move lower.

Hungarian and Czech yield curves are also being shaped by expectations of monetary-policy tightening. The NBH's policy mix seems set to contribute to flattening the curve. More hikes are in the pipeline, possibly until the base rate reaches 1.50%, while asset purchases will continue, contributing to more flattening on the curve, as the long end seems to have found some support over the past month.

Two more hikes this year by the CNB would take the policy rate to 1%, which seems consistent with the picture painted by FRAs, after repricing since early May. The market might turn out to be a tad too hawkish, eyeing nearly 100bp more in hikes in 2022, we expect to see hikes by 50bp in 2022 and by 50bp in 2023. While bear-flattening remains a risk in case of hawkish remarks, we think that the 5Y area already reflects the hiking path to a material extent. The most hawkish central bank in the region will also be supportive of the CZK, while weakening pressure on the HUF could resurface next year. Depreciation risks are however higher for the PLN, due to the NBP's less-hawkish stance. Indeed, the bar for action in Poland remains high. The hiking path depicted by FRAs for the NBP appears too hawkish, in our view. Recent flattening on the 2-10Y has taken the curve spread back to the levels prevailing at the end of 1Q. Risks from here seem to be skewed towards a steeper curve, in case of upside inflation surprises, while the central bank remains on hold at least until November.

TABLE 1: CORRELATION WITH EUR RATES AND CREDIT SPREADS

	10Y RON	10Y CZK	10Y HUF	10Y PLN	10Y TRY	10Y RUB	HUF	CZK	PLN	TRY	RUB
5Y BE, EUR	-0.21	-0.01	-0.02	0.10	-0.06	-0.39	-0.30	-0.59	-0.49	-0.01	-0.58
5Y RY, EUR	0.38	0.36	0.36	0.26	0.14	0.34	0.32	0.47	0.50	0.16	0.53
5Y NY, EUR	0.34	0.58	0.56	0.57	0.14	0.04	0.13	-0.02	0.18	0.25	0.10
2-10Y EUR	0.35	0.49	0.45	0.51	0.07	0.06	-0.03	-0.09	0.07	0.13	-0.01
10-30Y EUR	-0.12	-0.03	-0.16	-0.02	-0.10	-0.10	-0.16	-0.34	-0.26	-0.06	-0.24
EUR IG corp.	0.50	0.20	0.22	0.10	0.14	0.37	0.27	0.69	0.52	0.04	0.42

Correlation of monthly changes. Sample Jan 2012 - June 2021. Exchange rates are against EUR (e.g. EUR-HUF), and their changes are expressed in log form.

Source: Bloomberg, UniCredit Research

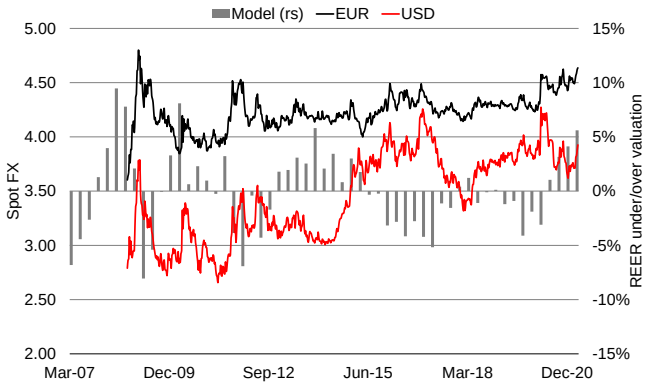
Correlation between CEE and EUR-denominated fixed income

Developments in the euro fixed-income market remain relevant for CEE bonds, including those denominated in local currencies. Table 1 shows the correlation between changes in a series of metrics related to euro-area fixed-income markets (including the level of rates, the slope of the curve and credit spreads) and changes in 10Y yields on selected CEE curves (monthly changes, from January 2012). Separately, it also shows the correlation of such variables with selected exchange rates for the CEE region. CEE yields are generally positively correlated with developments in the level of eurozone yields, such correlation arises particularly from developments in real yields and less so from BE. Polish and Czech bonds are more correlated than their peers with changes in the 2-10Y yield spread of euro curves, while correlation with the euro 10-30Y has been relatively close to zero over the period in focus. Romanian and Hungarian bonds have displayed a higher correlation with changes in euro IG credit spreads. This is where such links becomes more dependent on spread products, yield hunting and risk appetite and less dependent on risk-free-rate dynamics. Lower-rated issuers would be more exposed in case of mixed ECB communication particularly with regard to the PEPP, which is likely to be more relevant to credit-spread dynamics because of its flexibility. Correlation with exchange rates highlight the relevance of risk appetite for CEE FX, while the negative correlation between BE and Russian bonds and the RUB might be a function of how oil-price dynamics affect both variables.

Updating our REER models

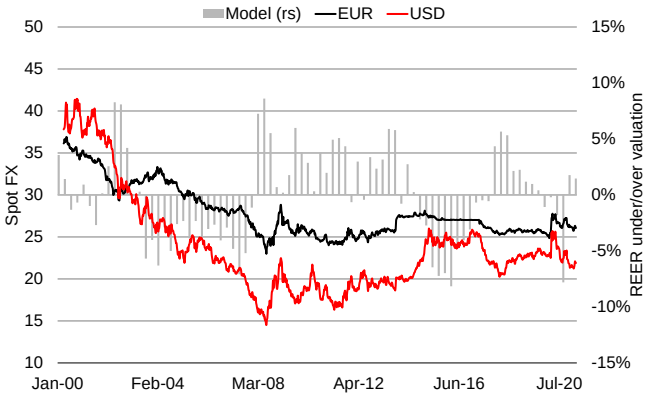
PLN

- EUR-PLN has been on a rising trend since early February, and currently trades in the 4.60-4.65 area.
- The zloty REER has been fluctuating in a 7-8% range over the past three years, and the large swings of 2020 have left room for a narrower trading band recently. At current levels, the REER is at a five-year average, and looks a tad overvalued based on our model, due to very low real interest rates. Adjusted for PPI and unit-labor costs, the PLN looks competitive compared to regional peers and the EUR.
- The NBP retains a dovish bias at the moment, compared to other central banks in the region but might be forced to hike to from 4Q21 or 1Q22. Before that, EUR-PLN could see spikes in the 4.40-4.65 interval.



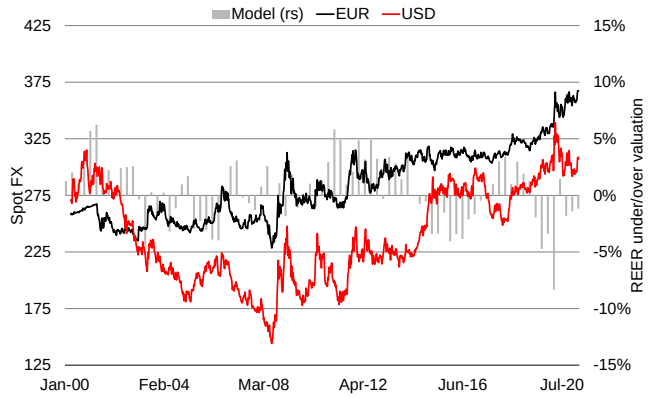
CZK

- The CZK remains within the 26.0-26.5 range, having held firmly despite a challenging global environment, and is nearly unchanged YTD.
- The CZK REER has returned to the upper end of the trading range prevailing over the past five years, where it looks broadly fairly valued (there is a modest overvaluation), according to our model. The CNB estimates fair value much lower, around EUR-CZK 25.
- We expect the CNB to deliver at least three rate hikes over the next twelve months. This should not be a surprise for the market but will likely fuel CZK outperformance within CEE.



HUF

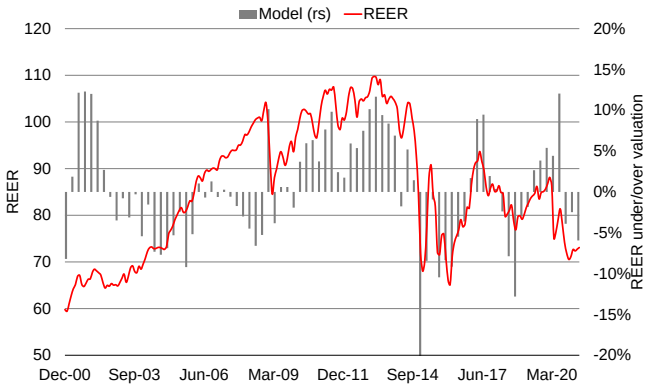
- EUR-HUF remains at the top of the past six-month range, in the 365 area, while USD-HUF is just shy of 310.
- In REER terms, the HUF remains well below average, albeit some 5% stronger compared to the March 2020 peaks. At these levels, it is broadly in line with the indications coming from our model.
- The NBH could lift the 1W deposit rate and the policy rate to around 1% in 3Q21. However, this might not be enough to stem inflation risks and to avoid HUF depreciation.



Source: Haver, Bloomberg, UniCredit Research

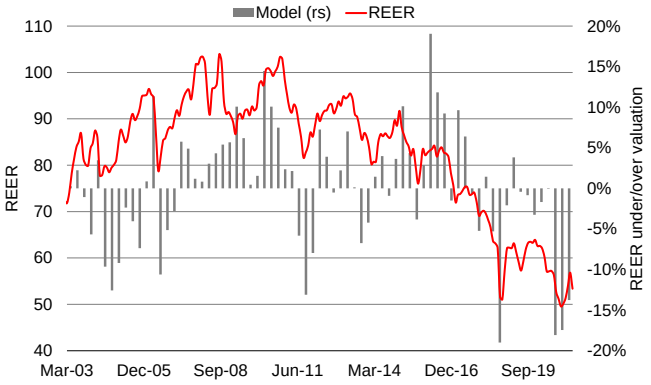
RUB

- USD-RUB broke above the 76 level recently, setting new highs for the year. The positive momentum on oil prices has slowed and, as short-term factors fade away, more downward pressure might emerge.
- In REER terms, the recent RUB drop took the currency back towards YE20 levels, at the lower end of the range prevailing over the past five years. At these levels, the RUB looks undervalued in real terms.
- A more-hawkish central bank will help reduce depreciation pressure, while the risk of sanctions should be priced out in 3Q21, at least partly. It such risks fade out, RUB will look attractive also as hedge against EM headwinds.



TRY

- Extreme volatility on USD-TRY has widened the 2021 trading range to nearly 15%. The downward trend, which took the pair below 7.00, was quickly reversed and current levels stand close to 8.00.
- The recovery of the TRY in REER terms was short-lived. The currency lost nearly half of the increase seen between November 2020 and February 2021. At these levels, the TRY looks largely undervalued (by around 15%), but persisting external imbalances could prevent appreciation.
- The outlook for the TRY remains very uncertain. Risks remain to the upside until more clarity emerges on the future path of monetary policy.



Source: Haver, Bloomberg, UniCredit Research

Countries

Bulgaria

Baa1 stable/BBB stable/BBB positive*

Outlook

The stronger-than-expected pace of economic recovery so far this year triggered an upward revision to our GDP growth forecast for 2021. With Bulgarians set to head to the polls in July for a second time this year, the outlook is for a fragmented parliament with large support for the populist parties backing last year's protests. Under the most likely scenario, the populist parties, ITN and IMV, will join forces with the right-wing DB to form a minority government, which will rely on the parliamentary support of the BSP. We remain of the view that the economic policy of the new government will not deviate significantly from the path pursued by the GERB over the past four years. The main downside risk to our favorable baseline scenario is related to another COVID-19 wave during the winter months.

Strategy

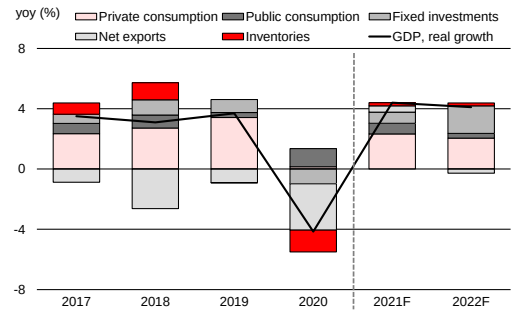
As the fiscal metrics have been in line with our expectations so far this year we see no need to revise our forecast for sovereign funding needs in 2021. The volume of the next Eurobond issue expected in September would be EUR 2-2.5bn.

Author: Kristofor Pavlov, Chief Economist (UniCredit Bulbank)

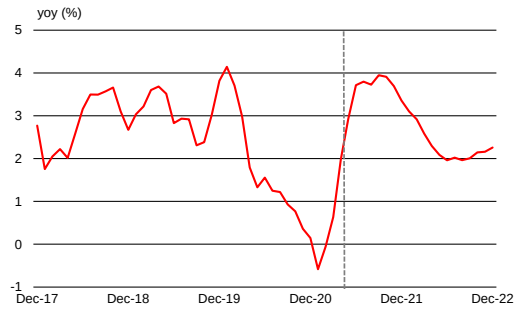
KEY DATES/EVENTS

- 11 Jul – parliamentary elections
- 23 Jul – rating update from Fitch
- 17 Aug, 7 Sep: 2Q21 GDP (flash, structure)

GDP GROWTH FORECAST



INFLATION FORECAST



Source: National Statistical Institute, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2018	2019	2020	2021F	2022F
GDP (EUR bn)	56.1	61.2	60.6	65.6	70.5
Population (mn)	7.0	7.0	6.9	6.9	6.8
GDP per capita (EUR)	8,016	8,809	8,768	9,544	10,333
Real economy, change (%)					
GDP	3.1	3.7	-4.2	4.4	4.1
Private consumption	4.4	5.5	0.2	3.5	3.1
Fixed investment	5.4	4.5	-5.1	3.8	9.6
Public consumption	5.4	2.0	7.5	3.9	1.7
Exports	1.7	3.9	-11.3	7.2	7.5
Imports	5.7	5.2	-6.6	6.1	7.5
Monthly wage, nominal (EUR)	586	648	709	776	841
Real wage, change (%)	7.7	7.5	7.7	6.8	6.1
Unemployment rate (%)	5.2	4.2	5.1	5.2	4.1
Fiscal accounts (% of GDP)					
Budget balance	2.0	2.1	-3.4	-5.5	-2.8
Primary balance	2.7	2.7	-3.0	-5.1	-2.4
Public debt	21.8	19.7	24.4	26.7	27.4
External accounts					
Current account balance (EUR bn)	0.5	1.1	-0.4	0.6	1.6
Current account balance/GDP (%)	0.9	1.8	-0.7	1.0	2.3
Extended basic balance/GDP (%)	3.2	4.8	3.9	5.4	7.7
Net FDI (% of GDP)	1.3	1.9	3.2	2.2	2.6
Gross foreign debt (% of GDP)	61.5	57.6	63.4	61.0	59.3
FX reserves (EUR bn)	25.1	24.8	30.8	32.8	36.3
Months of imports, goods & services	8.0	7.4	10.4	9.8	9.8
Inflation/monetary/FX					
CPI (pavg)	2.8	3.1	1.7	2.6	2.3
CPI (eop)	2.7	3.8	0.1	3.4	2.3
Central-bank reference rate (eop)	-0.50	-0.61	-0.70	-0.63	-0.55
USD/BGN (eop)	1.71	1.74	1.60	1.60	1.56
EUR/BGN (eop)	1.96	1.96	1.96	1.96	1.96
USD/BGN (pavg)	1.66	1.75	1.71	1.62	1.58
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

A V-shaped recovery is on track, but downside risks are up

Solid growth in 1Q21 triggered an upward revision to our 2021 growth forecast

We have significantly raised our real GDP growth forecast for 2021 to 4.4% (from 2.6%). This mostly reflects the stronger-than-expected recovery so far this year, as Bulgarian authorities decided to keep the economy as open as possible during the second and third wave of the COVID-19 pandemic. Our growth forecast for 2022 is now changed to 4.1% (from 4.4%). We now see output recovering to its pre-pandemic level in 4Q21. A decline in the unemployment rate close to the level associated with full employment is now anticipated toward mid-2022.

Economic activity improved in 1Q21…

…at the cost of letting COVID-19 infections spread unchecked

Less-stringent restrictions and poor compliance contributed to GDP growth surprising on the positive side in 1Q21. The solid growth of activity indicators in April underlined that a strong recovery continued at the start of 2Q21. With most high-frequency indicators in April already above their pre-pandemic level (left chart below), the overall picture is one of an economy that is on track for a V-shaped recovery. However, Bulgaria paid a heavy price for the solid pace of GDP growth in 4Q20 and in 1Q21. While the country was not affected as badly by the first wave of the corona virus pandemic, the early relaxation of restrictions caused the number of deaths to rise sharply during the second and the third wave (right chart below).

The US treasury imposed sanctions on three local citizens…

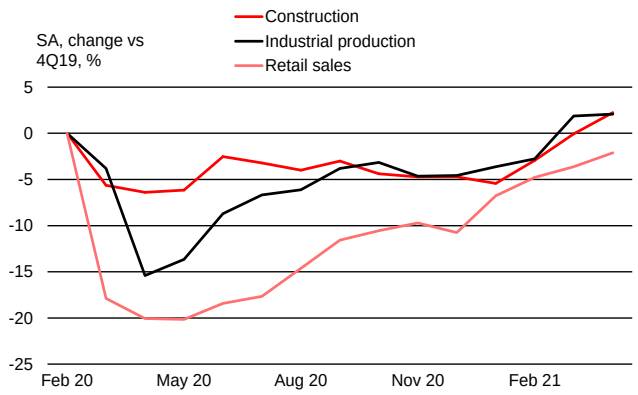
…just six weeks before the next parliamentary election

Just one month before the next election, the US imposed sanctions on three local citizens using the Magnitsky Act. The sanctions seem to target two murky business figures and local oligarchs - Vassil Bozhkov and Delyan Peevski. The former was sanctioned for "using bribery to create a channel for Russian political leaders to influence Bulgarian government officials", while the latter was sanctioned for "using influence peddling and bribes to protect himself from public scrutiny and exert control over key institutions and sectors in Bulgarian society". On balance, the US sanctions are likely to have a positive impact, as they should add to the pressure on local politicians to press ahead with their anticorruption efforts. Importantly, they will undermine the chances of Mr. Bozhkov's party, Bulgarian Summer (BS), to enter the next parliament. Several public opinion polls showed that prior to the announcement of the US sanctions, BS, the political creation of Mr. Bozhkov, looked likely to surpass the 4% threshold required for entry into parliament on 11 July, after gaining 3.1% of the vote in April.

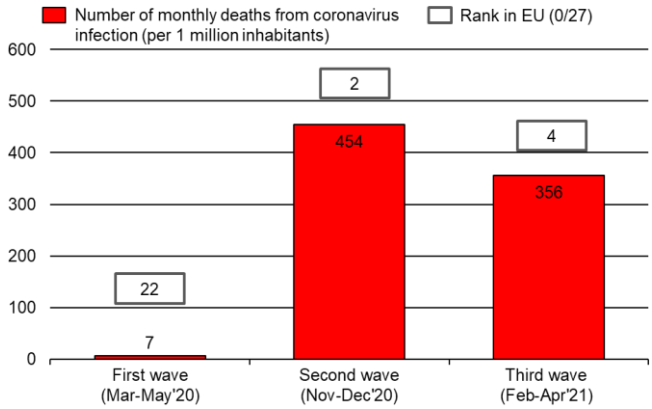
The parties that benefited the most from the protest against GERB are likely to form the next government

With Bulgarians set to head to the polls in July for a second time this year, the outlook is for a fragmented parliament with large support for the populist parties backing last year's protests. Recent opinion polls show that GERB is likely to remain the largest party in parliament, but GERB is in isolation and its chances to form a government are slim. Under the most likely scenario, the populist parties, ITN and IMV, will join forces with the right-wing DB to form a minority government, which will rely on the parliamentary support of the BSP.

MOST ACTIVITY INDICATORS ARE ABOVE PRE-PANDEMIC LEVEL



BULGARIA PAID A HEAVY PRICE FOR THE SOLID GDP GROWTH



Source: Worldometer, National Statistical Institute, UniCredit Research

Across-the-board increases in public sector wages are likely to be replaced by a more selective approach

The risk of some form of fiscal populism is limited. Across-the-board increases in public sector wages pursued by GERB over the past four years are likely to be replaced by a more selective approach, where the focus will be on sectors (such as education and health care) that are key to boosting the country's competitiveness. The reasons for this policy change are partly ideological, as the DB are the staunchest supporters of the small government doctrine and want to see public sector wage increases scaled down, and partly more pragmatic, as higher public sector spending pursued by GERB has exhausted some of the free fiscal space available prior to the pandemic. In addition, the pandemic-linked temporary increase in pensions (amounting to 0.8% of GDP annually) by the GERB, is likely to be made permanent by the new government, which would further squeeze any free fiscal space left unused after two hard years of unprecedented fiscal stimulus to support the pandemic-hit economy.

Minimum wages will lose in importance as a tool to support income convergence

Only small (if any) increases in minimum wages are likely if the DB dominate the economic policy making of the new government. Such shift seems disappointing to us. We regard minimum wages as one of the very few instruments available to the government to impact income levels. If used wisely, minimum wages can support income convergence and help to bring down to more sustainable levels the already elevated income inequality in the country.

No major changes in taxation anticipated

Under the most likely scenario, there would be no major changes in taxation. The BSP would have to abandon its plan to remove the regressive taxation of personal income, as no support for such move is likely to come from the right-wing DB, which made preserving a flat income tax its priority. The DB's plan for a reduction of small companies' taxation would also have limited chances to materialize, at least in the short-run, as the immediate priority of the new coalition government would be to demonstrate that it can sustain fiscal prudence, despite the alleged lack of sufficient expertise of some of its founding members.

Introduction of tax-free allowance on personal income looks likely

The only tax amendment we expect is the introduction of a tax-free allowance on personal income. This is because all parties likely to be represented in the next parliament, apart from GERB, have voiced support for such a move. While there is no clarity as to the size of the allowance and whether it will apply to all earners or only to the poor, we regard this tax change as growth-positive, since it should help those at the bottom of the income distribution.

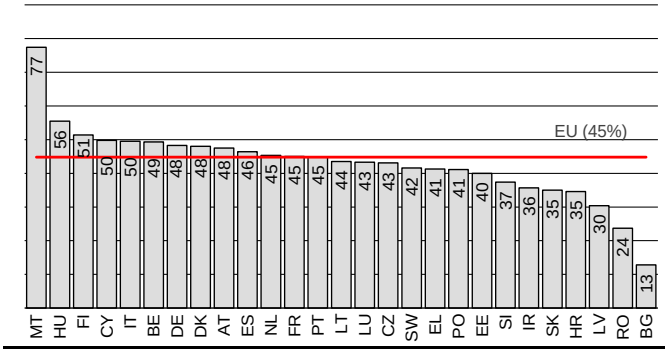
The risk of another wave of COVID -19 in the winter is significant

Boosting vaccination rates should be the upmost priority

The main downside risk to our baseline scenario is related to another wave of COVID-19 infections in the winter, as only 13% of the population has been vaccinated as of mid-June (left chart below). It is particularly worrisome that the amount of people willing to get the vaccine is much lower than what is needed to achieve herd immunity (right chart below), according to recent polls. We think urgent efforts are needed by the government and private sector to increase vaccination rates. The leaders in politics, business and art should organize and hold a large-scale campaign aimed at making widely available all relevant information regarding the pros and cons of vaccination.

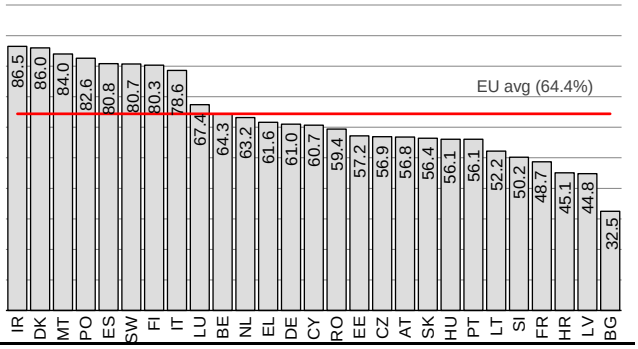
URGENT EFFORTS ARE NEEDED TO ACCELERATE VACCINATION

Share of the total population that have received at least one dose of COVID-19 vaccine (15 June 2021)



RISK OF ANOTHER PANDEMIC WAVE IS LARGE

Intention to get vaccinated in EU countries (as % of population over 18 years, May'21)



Source: Worldometer, Eurofound, UniCredit Research

The next Eurobond issue is likely in September

We are keeping our budget-balance projection unchanged

We see no need to revise our budget balance forecast for 2021, as the fiscal metrics for the first four months this year were in line with our expectations. We see the budget deficit at BGN 5.6bn (4.4% of GDP) this year, higher than the government target of BGN 4.9bn (3.8% of GDP), as we think that some temporary fiscal support measures associated with the COVID-19 pandemic will be transformed into permanent public sector payments.

We doubt the caretaker government will issue any debt

So far this year, the Treasury has issued domestic bonds for BGN 800mn and borrowed EUR 511mn of low-cost funding under the SURE financial assistance instrument. We remain of the view that the ministry of finance is unlikely to offer any new issues on the domestic market before the parliamentary elections and that the Eurobond market is tapped in September or October. We expect the size of the next Eurobond issue to be EUR 2-2.5bn. In addition, the Bulgarian sovereign is likely to issue BGN 500mn more bonds domestically in 4Q21.

Yields on Bulgarian bonds are likely to remain low…

Yields on Bulgaria's risk-free assets will remain anchored at very low levels. This is because the fiscal position is strong and the current account continues to run surpluses. The risk of a sharp worsening of the economic outlook is limited, despite the recent escalation of political confrontation and rising chances that populist parties take part in the next government.

…as no major changes are likely in the way fiscal policy is conducted

We think that after some easing this year and next, the new government will keep the budget deficit under control. It is normal to see some spending increases after a prolonged period of very tight fiscal policy. Also, tax collection may deteriorate as the BSP's track record on this front has been relatively poor. Some changes in taxation, aimed at reducing the tax burden on the poor is also likely and desirable given the country's high inequality of incomes. However, apart from this, we do not expect to see any major changes in taxation and in the way fiscal policy is carried out.

THE GOVERNMENT'S GROSS FINANCING REQUIREMENTS

EUR bn	2020	2021F	2022F
Gross financing requirement	**2.6**	**3.6**	**3.3**
Budget deficit	1.8	2.9	1.7
Amortization of public debt	0.7	0.7	1.6
Domestic	0.5	0.5	0.2
Bonds	0.5	0.5	0.2
Bills	0.0	0.0	0.0
Loans/other	0.0	0.0	0.0
External	0.2	0.2	1.4
Bonds and loans	0.0	0.0	1.3
IMF/EU/other IFIs	0.2	0.2	0.2
Financing	**2.6**	**3.6**	**3.3**
Domestic borrowing	0.6	0.7	0.8
Bonds	0.6	0.7	0.8
Bills	0.0	0.0	0.0
Loans/other	0.0	0.0	0.0
External borrowing	1.9	2.6	2.6
Bonds and loans	2.5	2.0	2.5
IMF/EU/other IFIs	-0.6	0.6	0.1
Privatization/other	0.0	0.0	0.0
Fiscal reserves change (- =increase)	0.1	0.3	-0.1

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2020	2021F	2022F
Gross financing requirement	**13.5**	**11.4**	**11.9**
C/A deficit	0.4	-0.6	-1.6
Amortization of medium and long-term debt	4.0	3.4	4.5
Government/central bank	0.2	0.2	1.4
Banks	0.5	0.6	0.5
Corporates/other	3.2	2.7	2.6
Amortization of short-term debt	9.2	8.7	9.0
Financing	**13.5**	**11.4**	**11.9**
FDI (net)	1.9	1.4	1.8
Portfolio equity, net	-0.6	-0.6	-0.9
Medium and long-term borrowing	6.4	4.8	4.7
Government/central bank	1.9	2.6	2.6
Banks	0.6	0.5	0.8
Corporates/other	4.0	1.7	1.3
Short-term borrowing	8.7	9.0	9.4
EU structural and cohesion funds	0.8	1.5	2.0
Other	2.3	-2.7	-1.6
Change in FX reserves (- = increase)	-6.0	-1.9	-3.6
Memoranda:			
Nonresident purchases of LC gov't bonds	0.0	0.0	0.0
International bond issuance, net	2.5	2.0	1.3

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

Croatia

Ba1 stable/BBB- stable/BBB- stable*

Outlook

We are raising our GDP growth forecast for 2021 and 2022, due to the better-than-expected economic performance to date and the renewed optimism stemming from reopening of economic activities. Our new growth projections are 5.4% in 2021 and 5.5% in 2022, compared to our previous forecasts of 4.6% and 4.8%, respectively. Private consumption is recovering faster than previously expected. On top of that, investment is accelerating and tourism performance is improving. The recovery in investment will be very much driven in the medium term by how efficiently EU facilities are absorbed and how well the National Recovery and Resilience Plan is implemented. Faster growth will likely be followed by a widened fiscal gap as the government deals with health sector challenges. Despite this, government may try to pursue a fast-track euro adoption agenda, seizing the opportunity offered by the suspension of EU fiscal rules until 2023.

Strategy

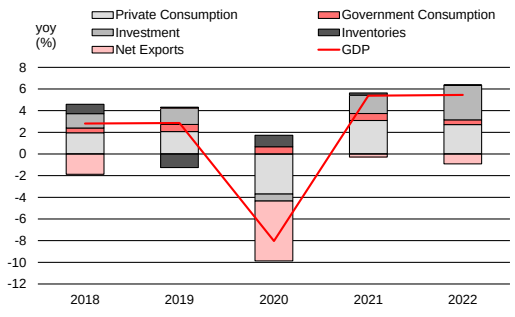
Spreads between CROATI EUR and Bunds could narrow further as euro adoption approaches and budget deficits decline.

Author: Hrvoje Dolenec, Chief Economist (Zagrebačka banka)

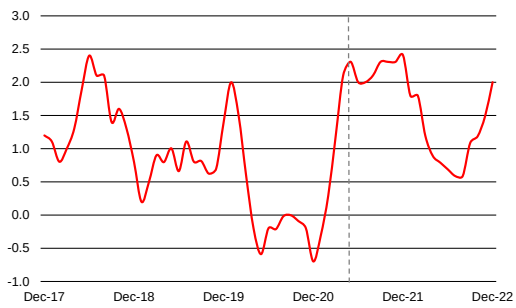
KEY DATES/EVENTS

- 27 Aug: 2Q21 GDP
- 24 Sep: Labor market H121
- Sep: Medium-Term Public Debt Strategy
- 30 Sep: Public debt June 2021

GDP GROWTH FORECAST



INFLATION FORECAST



Source: Eurostat, CNB, Crostat, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2018	2019	2020	2021F	2022F
GDP (EUR bn)	52.0	54.3	49.3	52.9	56.4
Population (mn)	4.1	4.1	4.0	4.0	4.0
GDP per capita (EUR)	12,715	13,349	12,186	13,135	14,087
Real economy, change (%)					
GDP	2.8	2.9	-8.0	5.4	5.5
Private consumption	3.3	3.6	-6.4	5.1	4.5
Fixed investment	6.5	7.1	-2.9	7.3	13.5
Public consumption	2.3	3.4	3.4	3.0	2.0
Exports	3.7	6.8	-25.0	19.0	12.5
Imports	7.5	6.3	-13.8	16.5	12.4
Monthly gross wage, nominal (EUR)	1,139	1,182	1,224	1,256	1,308
Real wage, change (%)	3.4	3.0	2.4	0.9	2.9
Unemployment rate (%)	8.4	6.6	7.5	7.8	6.7
Fiscal accounts (% of GDP)					
Budget balance	0.2	0.3	-7.4	-4.5	-2.8
Primary balance	2.5	2.5	-5.4	-2.6	-1.0
Public debt	74.3	72.8	88.7	87.2	84.5
External accounts					
Current account balance (EUR bn)	0.9	1.5	-0.4	0.1	-0.4
Current account balance/GDP (%)	1.8	2.8	-0.8	0.1	-0.7
Extended basic balance/GDP (%)	4.8	6.8	3.8	5.1	4.6
Net FDI (% of GDP)	1.6	1.9	1.9	2.0	1.9
Gross foreign debt (% of GDP)	82.2	75.3	82.4	76.9	74.2
FX reserves (EUR bn)	17.4	18.6	18.9	21.4	22.9
Months of imports, goods & services	7.9	7.9	9.3	9.2	8.9
Inflation/monetary/FX					
CPI (pavg)	1.5	0.8	0.1	1.8	1.2
CPI (eop)	0.8	1.4	-0.7	2.4	2.0
3M money market rate (Dec avg.)	0.49	0.35	-	-	-.
USD/FX (eop)	6.47	6.65	6.14	6.18	6.03
EUR/FX (eop)	7.42	7.44	7.54	7.53	7.53
USD/FX (pavg)	6.28	6.62	6.61	6.28	6.08
EUR/FX (pavg)	7.41	7.41	7.53	7.53	7.53

Source: Eurostat, HNB, UniCredit Research

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

Accelerated recovery a realistic option

We see an improved growth outlook, with projections of 5.4% in 2021 and 5.5% in 2022…

We raised our growth outlook, with growth rates now seen at 5.4% and 5.5% for 2021 and 2022, respectively, compared to earlier projections of 4.6% and 4.8%. The revision reflects better-than-expected economic performance to date, which implies a faster recovery cycle than initially expected. In 1Q21, the economic recovery was driven by an increase in investment and the export of goods on the expenditure side, while construction is leading the way among sectors, with manufacturing and ICT following. The main surprise was that private consumption is recovering faster than expected, as indicated by retail trade turnover already above the pre-crisis level in March-April. In addition, consumer confidence is now at its highest level since the first lockdown was introduced 15 months ago.

…based on improved outlook for Eurozone GDP and performance in 1Q21

The health environment improved, with a drop in new cases and vaccination roll out benefiting general economic sentiment

The health situation has also been improving and therefore restrictions are being gradually eased, which should benefit the economic recovery. The number of new cases of COVID has been dropping sharply (and lower than number of recovered) recently while the vaccination rate has accelerated, allowing for some easing of restrictions. This helped to improve the general sentiment ahead of the tourism season. Last summer's season was 45% of the 2019 tourism performance, so getting to 60-65% of the 2019 level would mean strong boost to the shaken tourism and service sector (linked to tourism and leisure). There are clearly downside risks to this scenario, for example a renewed increase in contagion, but it is also possible that tourism could outperform our expectations.

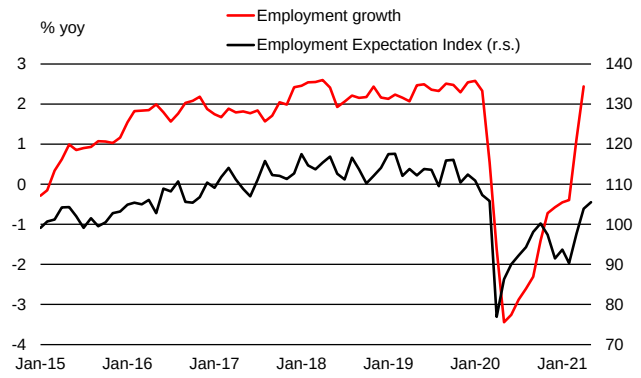
Private consumption is recovering, with labor market improvements

Private spending is being supported by an improvement in the labor market. There are more people employed than there were a year ago (up 2.4% in May) and this may increase with the seasonal employment that was absent last year. In the last couple of months, even the number of unemployed has been lower than it was a year ago, while average net wages rose some 4% in real terms, building consumption capacity for a continued recovery in spending.

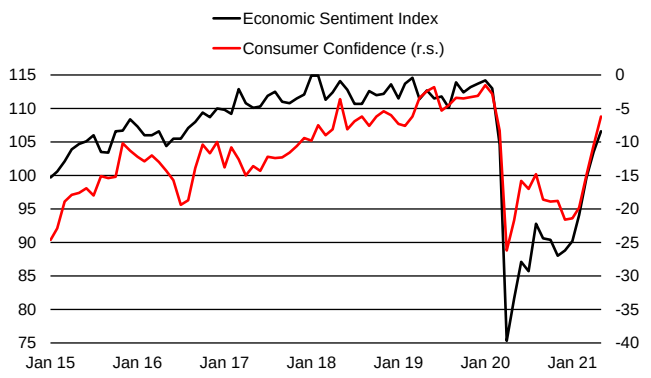
Investment has been increasing since 4Q20, linked to infrastructure projects, but more is to come with the absorption of EU facilities and a recovery in private investment

The investment segment is likely to improve from the end of 2021, though there are already some signs of recovery, mainly related to infrastructure works initiated just before local and regional elections in May. Investment will be supported by improved overall sentiment and EU funds, the latter starting from 2022, when we see double-digit growth in investment. This should be driven by EU facilities (remainder of 2014-20 allocation, roughly EUR 5bn, to be spent by 2023) and NGEU facility (EUR 10.6bn by 2026) where the National Resiliency and Recovery Plan is awaiting approval from the European Commission. In the plan, government presented how it intends to spend EUR 6.3bn (only the grant part) of the Resilience & Recovery Fund, which is linked to measures and reforms as allocation milestones. The government estimates it will increase GDP growth by 0.3pp in 2021 and 1.4pp in 2022 compared to their baseline scenario. Nevertheless, the recovery in private investment is also expected to start to contribute soon, as economic sentiment is reaching levels seen prior to the pandemic. Therefore, in 2022 we expect to see double-digit percentage growth in investment.

EMPLOYMENT IS RISING AGAIN…



… WITH SENTIMENT BUILDING WITHIN ECONOMY



Source: Crostat, HNB, European Commission Business Survey

Ambitious fiscal plan to cut deficit in 2021 and 2022 was abandoned…

…to deal with debt in the health-care sector…

...resulting in budget amendments and revised deficit targets of 3.8% in 2021 and 2.6% in 2022

The ambitious fiscal plan to reduce the deficit to below 3% of GDP already in 2021 (from 7.4% in 2020) in order to reduce public debt and comply with EU fiscal rules was abandoned. The need to address the issue of the financial gap in the health-care sector prevailed and required government action prior to the local elections. This resulted in a deal with pharmaceutical wholesalers to repay debt of 1.1% of GDP by June and then continue to keep to payment deadlines. The government therefore announced it would present its budget amendments in June while in its Convergence Program it increased its deficit target to 3.8% of GDP in 2021 (from 2.9% previously) and 2.6% of GDP in 2022 (from 2.1%). This will likely imply higher borrowing from local banks, whereas the original plan was to borrow mainly from capital markets.

Chance of higher revenues but also of higher expenditures

The performance of the tourist season will likely trigger some additional budget amendments

The budget's revenue assumptions are rather conservative, therefore a stronger-than-expected tourist season may be beneficial for the budget performance. However, there is the risk that expenditure might turn out to be higher than expected due to potential requests for additional support from some sectors of the economy (e.g. education and defense) and potential additional needs for the health-care sector. We expect a slightly higher deficit than the government forecast (4% vs. 3.8%), The finance minister hinted at another round of budget amendments after the summer (and review of revenue during the peak tourist season) which will again include a review of the funding plan.

Funding plan is also revised but without new international issues in pipeline

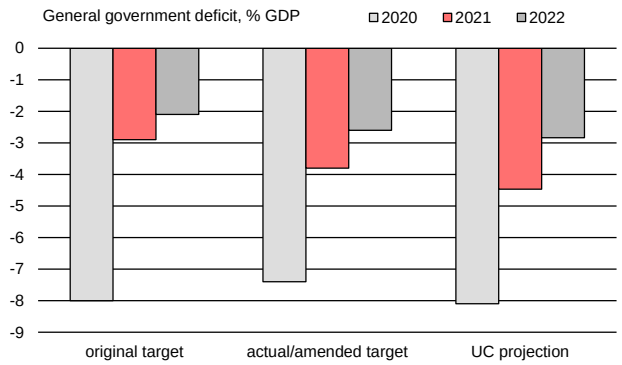
However, the recent funding plan does not include new issuance in international market (EUR 2bn issuance in February is unlikely to be topped this year) while the remainder of funding needs will be met in the domestic market, starting with new local bond issuance in July to redeem (but with bigger issue amount) EUR 0.8bn in local HRK bonds. The new plan also reflects the increasing exposure toward local banks and the increased amount of T-Bills issued (which are contrary to what was set out in the original budget plan).

Euro adoption has still no firm official date target though there are signs Croatia may try to seize the opportunity of EU fiscal rules suspension for fast track accession

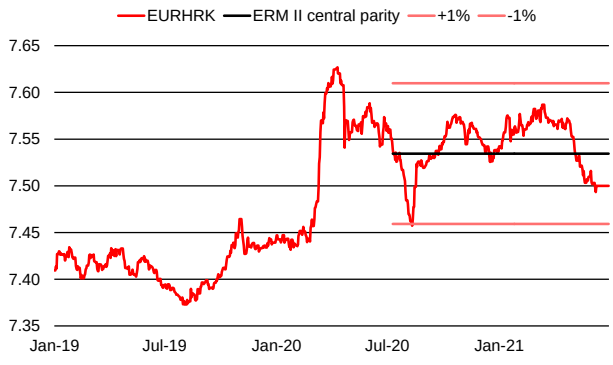
If so, clear signal from authorities may be expected soon

Finally, the euro adoption path is still not fully clear. Officially, there is still no expected date of euro adoption, though it seems preparation might be now accelerated in order to benefit from the suspension of EU fiscal rules until 2023. This means that despite deficit being above 3% and public debt having widened again (by almost 16pp) during the recession, the Excessive Deficit Procedure would not be triggered before 2023, satisfying fiscal criteria for adoption (economy not being under EDP). In such a scenario, Croatia may be in position to align with the fast-track scenario for 2023 accession, though hitherto we have seen the 2024 scenario as the likeliest. However, if the authorities decide to go for 2023 accession, we would expect them to provide a more explicit signal soon and an acceleration of the euro adoption action plan and the national plan for replacing the Croatian kuna with the euro.

FISCAL PLAN ADJUSTED TO TACKLE DEBTS AND ISSUES…



…BUT OTHER EURO ADOPTION CRITERIA ARE KEPT IN LINE



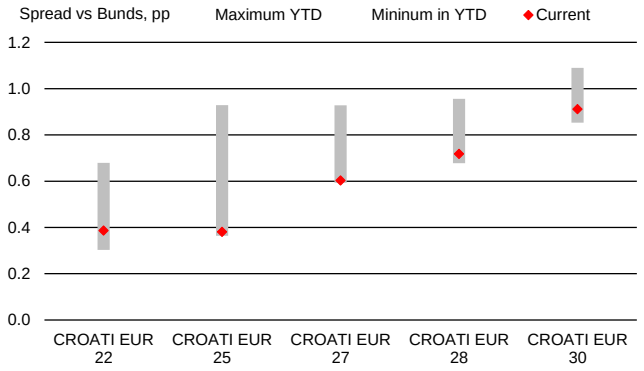
Source: Croatian ministry of finance, HNB, UniCredit Research

Lower spreads signal regime change

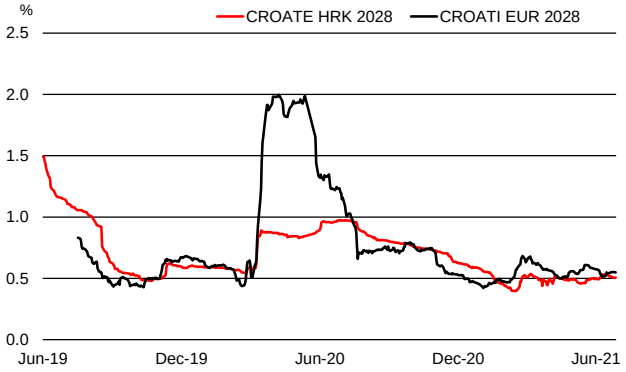
Croatia's expected adoption of the euro will mark the end of a transition to a new regime, one in which country risk and spreads will have to factor in ECB support. Thus, it is no surprise that CRAOTI EUR spreads to Bunds are close to all-time lows. As budget deficits will fall in the coming years, spreads could reach new lows.

HRK and EUR bond yields aligned back in 2021 and any spread opening between CROATI and CROATE bonds would provide a good entry point.

CROATI-BUND SPREADS NEAR ALL TIME LOWS, A FURTHER DECLINE IS POSSIBLE AS EURO ADOPTION APPROACHES



CROATI AND CROATE YIELDS SHOULD REMAIN CLOSE DURING ERMII



Source: Croatian ministry of finance, Bloomberg, UniCredit Research

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2020	2021F	2022F
Gross financing requirement	**11.1**	**9.3**	**9.5**
Budget deficit	3.6	2.4	1.6
Amortization of public debt	7.5	6.9	7.9
Domestic	5.7	5.0	6.0
Bonds	1.7	0.8	1.9
Bills	3.4	3.1	3.3
Loans	0.6	1.2	0.8
External	1.8	1.9	1.9
Bonds and loans	1.7	1.8	1.8
IMF/EU/other international financial institutions	0.1	0.1	0.1
Financing	**11.1**	**9.3**	**9.5**
Domestic borrowing	8.6	5.7	6.5
Bonds	4.3	1.2	2.2
Bills	3.4	3.3	3.3
Loans	0.9	1.2	1.0
External borrowing	2.5	3.6	3.0
Bonds	2.0	2.0	2.0
IMF/EU/other international financial institutions	0.5	1.6	1.0
Privatization/other	0.0	0.0	0.0

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2020	2021F	2022F
Gross financing requirement	**12.7**	**10.5**	**10.8**
C/A deficit	0.4	-0.1	0.4
Amortization of medium and long term debt	5.3	5.0	4.8
Government/central bank	1.8	1.9	1.9
Banks	0.5	0.5	0.4
Corporates/other	3.0	2.6	2.5
Amortization of short-term debt	7.0	5.6	5.6
Government/central bank	4.0	4.0	3.7
Banks	2.0	1.0	1.0
Corporates/other	1.0	0.6	0.9
Financing	**12.7**	**10.5**	**10.8**
FDI (net)	1.1	1.1	1.1
Portfolio equity, net	0.1	-0.5	-0.3
Medium and long-term borrowing	4.7	5.0	4.5
Government/central bank	2.5	3.6	3.0
Banks	0.7	0.5	0.5
Corporates/other	1.5	0.9	1.0
Short-term borrowing	5.6	5.6	4.9
EU structural and cohesion funds	1.3	1.6	1.9
Other	0.4	0.0	0.0
Change in FX reserves (= increase)	-0.6	-2.2	-1.3
Memoranda:			
Nonresident purchases of LC gov't bonds	-	-	-
International bond issuance, net	1.0	0.9	0.8

Source: HNB, Croatian ministry of finance, UniCredit Research

Czechia

Aa3 stable/AA- stable/AA- stable*

Outlook

The recovery has started but is facing, and will continue to face, headwinds in the rest of 2021, with a return to pre-COVID-19 levels of activity likely to occur only in 2022. Further acceleration is conceivable in 2022, when fixed capital formation is expected to join private consumption as an engine of growth. Monetary-policy tightening will probably continue, with the CNB delivering, in total, three rate hikes in 2021 and two more in 1H22. Public-sector imbalance may exceed 6% of GDP in 2022.

Strategy

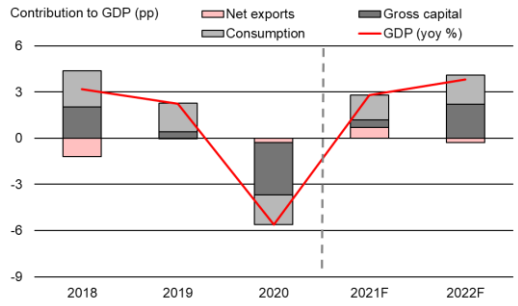
The hawkish CNB stance bodes well for CZK and CZGBs in 3Q21 in comparison to their peers.

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

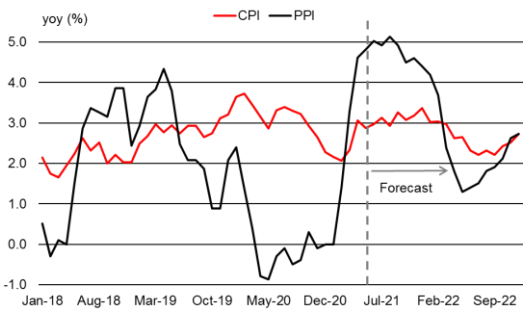
KEY DATES/EVENTS

- 5 Aug, 30 Sep: ČNB policy meetings
- 13 Jul, 10 Aug, 10 Sep: CPI
- 30 Jul, 31 Aug: 2Q GDP (flash, structure)
- 6 Aug: rating review from Moody's
- 8-9 Oct: parliamentary election

GDP GROWTH FORECAST



INFLATION FORECAST



Source: CZSO, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2018	2019	2020	2021F	2022F
GDP (EUR bn)	211.2	224.0	213.8	231.2	250.8
Population (mn)	10.6	10.7	10.7	10.7	10.7
GDP per capita (EUR)	19,875	20,999	19,985	21,573	23,386
Real economy, change (%)					
GDP	3.2	2.2	-5.6	2.8	3.8
Private consumption	3.5	3.0	-5.2	2.3	4.2
Fixed investment	10.0	2.2	-8.1	-0.7	7.0
Public consumption	3.8	2.2	3.5	2.5	-0.5
Exports	3.7	1.2	-6.0	7.2	4.2
Imports	5.8	1.3	-6.1	7.5	4.6
Monthly wage, nominal (EUR)	1,250	1,329	1,347	1,438	1,528
Real wage, change (%)	5.9	3.5	1.2	0.4	1.7
Unemployment rate (%)	3.2	2.8	3.6	4.1	3.7
Fiscal accounts (% of GDP)					
Budget balance	0.9	0.3	-6.2	-8.0	-6.0
Primary balance	1.6	1.0	-5.3	-6.7	-4.5
Public debt	32.1	30.3	38.1	44.2	47.6
External accounts					
Current account balance (EUR bn)	0.9	0.7	7.7	8.9	6.2
Current account balance/GDP (%)	0.4	0.3	3.6	3.9	2.5
Extended basic balance/GDP (%)	1.6	3.1	5.4	5.7	4.1
Net FDI (% of GDP)	0.9	2.4	1.3	1.3	1.1
Gross foreign debt (% of GDP)	81.5	76.2	76.1	77.4	80.7
FX reserves (EUR bn)	124.5	133.4	135.4	140.0	143.0
Months of imports, goods & services	10.0	10.5	11.8	10.9	10.3
Inflation/Monetary/FX					
CPI (pavg)	2.1	2.8	3.2	2.9	2.6
CPI (eop)	2.0	3.2	2.3	3.4	2.7
Central bank target	2.0	2.0	2.0	2.0	2.0
Central bank reference rate (eop)	1.75	2.00	0.25	1.00	1.50
3M money market rate (Dec avg.)	2.01	2.18	0.35	0.90	1.40
USD/FX (eop)	22.47	22.62	21.39	20.8	20.0
EUR/FX (eop)	25.73	25.41	26.25	25.4	25.0
USD/FX (pavg)	21.74	22.93	23.20	21.4	20.3
EUR/FX (pavg)	25.64	25.67	26.44	25.7	25.2

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

A recovery amid inflation concerns

Mobility restrictions were largely removed by early June, opening the space for private consumption to pick up in 2Q21

The economic recovery appears to be in a full swing, with the incidence of COVID-19 cases sharply down and the government having implemented five of six planned stages of the reopening of businesses by early June. Mobility has improved compared to the troughs it reached in March, but also against the same period last year. Despite that the lifting of restrictions has proceeded at a slower pace than we projected three months ago, private consumption is set to pick up in 2Q21 and to deliver a respectable boost to sequential GDP and growth of above 8% yoy.

Nevertheless, a number of headwinds (travel restrictions, changes to consumer habits) persist, and these have delayed a full recovery in private spending

Yet headwinds have not dissipated. Cross-border travel remains almost non-existent, as travel restrictions are more intense than they were last June, and the EU-wide COVID pass may improve the situation from 3Q21 at best. In the area of household spending, only a fraction of pent-up demand, mostly that related to consumer durables, may be realized. Sports and cultural events are facing a slow restart, while cold weather in May kept sales at restaurants with outdoor seating below 50% of their pre-COVID-19 level. It appears that spending is not primarily inhibited by a loss in household income or a higher propensity to save. Rather, in our view, 234 days of lockdowns may have changed consumer habits, and it will likely take time for these to return to normal.

High-frequency data in the corporate sector are broadly supported by last year's base, but the underlying picture has been impaired by supply-chain disruptions

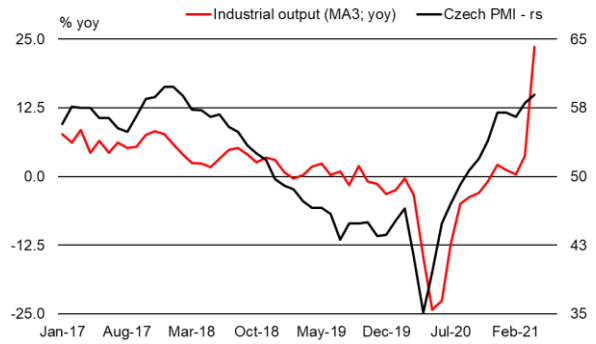
Uneven reopening in different economic sectors has boosted optimism. Unlike other sectors, industry was only indirectly affected by lockdowns, through supply-chain disruptions. Companies that process metals and plastics have frequently reported that they face supply-chain bottlenecks, and these have slowed production and/or raised costs. This not only applies to the automotive sector, where at least two of the three car assemblers in the country had to reduce their shifts in 2Q21 due to a lack of semiconductors. Volume output powered ahead in March in sequential terms (10.2% mom) but had lost much of its momentum by April (+0.4% mom). The unit output of cars is still likely to go up in 2021 compared to 2020 but only because of last year's shutdowns. Overall, industrial output is expected to expand in 2021 just enough to cover its 2020 contraction of 7.2%.

Corporate investment is expected to start catching up only slowly due to supply-side limits

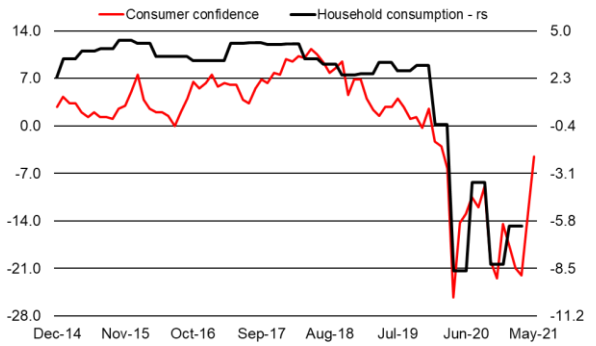
In financial terms, the corporate sector has been coping with pandemic-related constraints quite well. Gross operating surplus and mixed income accelerated to 4.9% yoy in 1Q21, after contracting by 1.8% for the whole of last year. Cash reserves have been on the rise, with bank deposits of non-financial corporations up by 9.1% yoy in April. That was reflected in a lower need for lending as well, with bank loans to corporations dropping by 1.5% yoy in 1Q21 and falling further by 4.9% yoy in April. Low investment appetite maintained a significant drag on GDP growth, with gross fixed-capital formation contracting by 3.9% yoy in 1Q21 in real terms. We expect there to be further contractions in the following quarters, with limits on the supply side also contributing to these. The situation should start improving from 4Q21. A recovery in household consumption should chiefly stand behind GDP growth of 2.8%, which is projected for 2021.

In 2022, we expect gross capital formation to accelerate strongly, as corporations will need to tackle stagnating productivity.

MANUFACTURING PMI OVERSTATES REBOUND IN ACTIVITY DUE TO METHODOLOGICAL ISSUES



CONSUMER CONFIDENCE HAS RISEN AFTER RESTRICTIONS WERE EASED



Source: CZSO, IHS Markit, UniCredit Research

Gross capital formation and private consumption will be the main drivers of GDP in 2022, with net exports and government consumption contributing slightly negatively

At the same time, household investment will probably slow due to the overheated residential-housing market and the expected rise in interest rates. Private consumption should continue to recover moderately, with households mobilizing part of their accumulated reserves. However, part of the deferred demand is unlikely to ever be realized. Gross capital formation and private consumption are expected to drive GDP up with similar contributions to overall GDP growth, projected to come in at 3.8% in 2022. The contributions of both net exports and government consumption, in contrast, are projected to be slightly negative.

Czechia is no exception in a global story of inflation acceleration, but no further surge from the current inflation rate is expected

Double-digit growth in many input prices is an unprecedented phenomenon. This has already affected Czechia's producer price index, and its impact on Czechia's consumer price index (CPI) looks unavoidable. So far, however, consumer-price inflation has been driven by a base effect from last year's decline in fuel prices at the outbreak of the pandemic and by an excise-tax hike on tobacco prices. While these two factors, which account for about two-thirds of the actual annual increase in the CPI, are considered transitory, other factors have brought about more uncertainty. In addition to pressure from supply chains, labor-market tension and low productivity gains may add to corporate costs, filtering into consumer prices over a longer period. Demand-side pressure has been rather contained as yet, but the massive re-opening of the economy is likely to change the picture. On balance, we expect inflation to continue hovering around 3% over the rest of 2021.

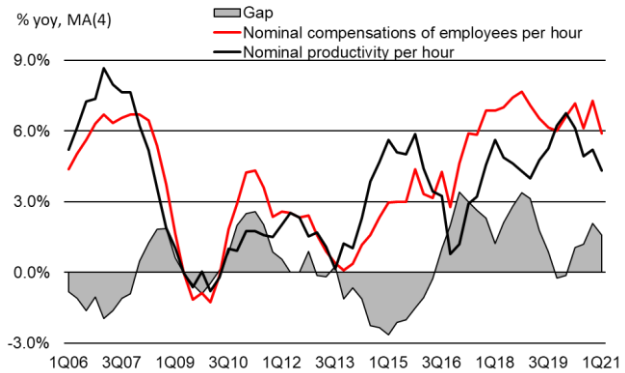
We expect the two-week repo rate to be hiked twice this year and twice next year, before settling at 1.25% at end-2022

With inflation likely settling close to the upper limit of the CNB's target, Czech policymakers have started speaking overwhelmingly in favor of starting policy tightening before long. The CNB staff's May inflation forecast assumes three hikes of a cumulative 75bp by end-2021. This view has not been broadly challenged by the board. Admittedly, Governor Jiří Rusnok noted in May that more than 50bp of hikes are less likely this year. New signs of inflationary pressure may nevertheless alter his view. Indeed, we now expect two more hikes in 2021, after the one delivered in June. Two additional hikes may follow during 1H22 before an interim pause in the tightening cycle.

Opinion polls show the ANO Movement of PM Andrej Babiš losing to a new coalition of Pirates and mayors ahead of the October general elections

In the run-up to general elections (to be held on 8-9 October), three major political contenders have emerged. Apart from the ANO Movement of Prime Minister Andrej Babiš, the Pirate Party has joined forces with Czechia's mayors to attract left-leaning and liberal voters, while three traditional center-right parties have formed another coalition. The coalition of Pirates and mayors took the lead in recent opinion polls, with 25-30% of the vote, overtaking ANO. While preferences are far from stable, it is now likely that the three formations may get 70-80% of the vote, and two of them will need to form a government. In our view, any future coalition will have to bridge very different opinions, and this bodes ill for tackling the challenges faced by the economy. As a result, the budget deficit could exceed 6% of GDP in 2022, and urgently needed reforms may be soft, rather than radical.

DURING THE PANDEMIC, PRODUCTIVITY STARTED TO UNDERPERFORM WAGES, REOPENING THE GAP AGAIN



CZECH EXPORTS OUTPERFORMED WORLD EXPORTS IN 4Q20, TURNING BACK TO BEING IN-LINE IN 1Q21

Source: CZSO, Macrobond, UniCredit Research

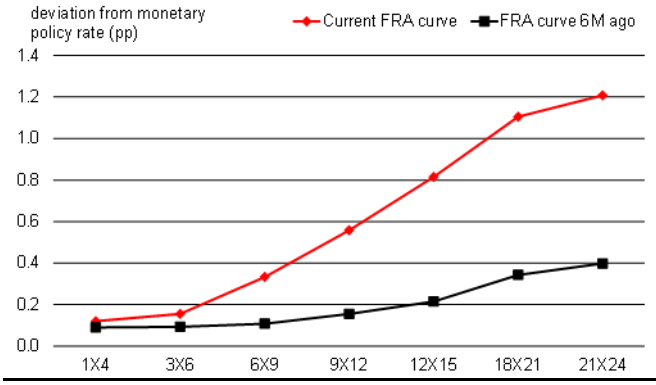
Czech financial assets benefit from hawkish CNB

Hawkish CNB tone bodes well for CZK and CZGBs in 3Q21 in comparison to peers

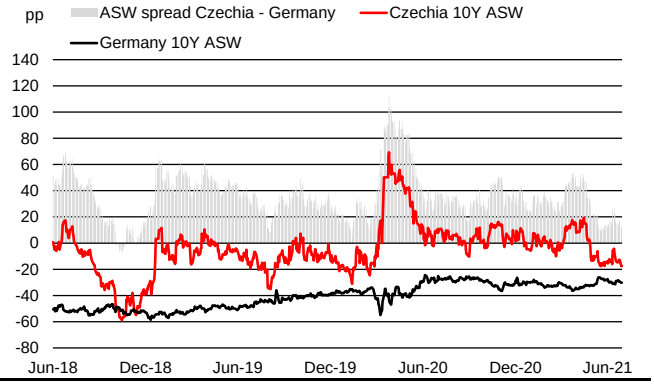
Since the post-COVID-19 recovery started, the CNB has been the most cautious and most pro-active central bank in central Europe. It has communicated well its intention to hike interest rates, and this has allowed the CZK to outperform its peers and imported inflation to remain lower than in neighboring countries. In Czechia, market expectations of rate hikes are the closest to what the central bank is likely to deliver among all CEE countries. This opens up room for CZGBs to outperform POLGBs and HGBs in 3Q21 if the NBP and the NBH disappoint markets with their actions. The same is valid for the CZK, with the CNB seeing fair value in EUR-CZK at close to 25; this is one of the most hawkish views among market observers.

The updated debt-issuance strategy for 2021 assumes borrowing needs of CZK 728bn, CZK 580bn of which should be covered by the issuance of bonds on the domestic market. By mid-June, CZK 272bn of bonds had been actually placed. After a planned late-June auction, 50% of Czechia's full-year borrowing needs will have been covered by mid-2021. We expect there to be a slowdown in activity over the summer, in line with general trends. While this may leave a decent chunk of the annual amount to be placed in the rest of the year, we are not overly concerned about any financing pressure. This strategy allows the government to also tap international markets if needed.

THE MARKET IS PRICING IN THREE HIKES IN 2021-22



LOW ASW SPREAD TO BUNDS IS A THREAT TO CZGBS



Sources: CNB, Bloomberg, UniCredit Research

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2020	2021F	2022F
Gross financing requirement	**19.8**	**26.6**	**26.0**
Budget deficit	13.3	18.5	15.0
Amortization of public debt	6.5	8.1	10.9
Domestic	5.6	6.1	8.1
Bonds	5.4	5.1	7.2
Bills	0.2	1.0	0.9
Loans	0.0	0.0	0.0
External	1.0	2.0	2.8
Bonds and loans	1.0	2.0	2.8
IMF/EU/Other IFIs	0.0	0.0	0.0
Financing	**19.8**	**26.6**	**26.0**
Domestic borrowing	19.4	25.7	25.0
Bonds	18.3	24.7	24.6
Bills	1.0	0.9	0.3
Loans	0.1	0.1	0.1
External borrowing	0.4	0.9	1.0
Bonds	0.3	0.9	1.0
IMF/EU/Other IFIs	0.1	0.0	0.0
Privatization/Other	0.0	0.0	0.0

Source: CNB, MoF, CZSO, UniCredit Research

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2020	2021F	2022F
Gross financing requirement	**100.4**	**93.0**	**100.1**
C/A deficit	-7.7	-8.9	-6.2
Amortization of medium and long term debt	7.5	9.6	8.3
Government/central bank	3.5	4.7	5.0
Banks	1.9	2.4	0.8
Corporates/other	2.1	2.5	2.5
Amortization of short-term debt	100.6	92.4	98.0
Government/central bank	6.4	6.1	8.0
Banks	58.7	52.9	56.5
Corporates/other	35.5	33.4	33.5
Financing	**100.4**	**93.0**	**100.1**
FDI (net)	2.8	3.1	2.8
Portfolio equity, net	1.4	0.0	0.2
Medium and long-term borrowing	7.5	9.6	8.3
Government/central bank	3.5	4.7	5.0
Banks	1.9	2.4	0.8
Corporates/other	2.1	2.5	2.5
Short-term borrowing	87.5	81.7	88.3
EU structural and cohesion funds	3.2	3.3	3.6
Other	0.0	0.0	0.0
Change in FX reserves (- = increase)	-2.0	-4.6	-3.0
Memoranda:			
Nonresident purchases of LC govt bonds	0.2	3.8	4.0
International bond issuance, net	-0.7	-1.1	-1.8

Hungary

Baa3 positive/BBB stable/BBB stable*

Outlook

The Hungarian economy could grow by almost 6% in 2021, recouping all 2020 losses, and by 4.5% in 2022. Domestic demand will drive growth, with consumption helped by pent-up demand and pre-election transfers to households, and investment benefiting from an impressive capex pipeline and from EU transfers. Inflation could end both 2021 and 2022 above target, this year due to large supply shocks and next year due to rising core inflation. The NBH could hike to 1.50% by 1Q22, but at a slower pace than the market is currently pricing in.

Strategy

After a potential hike in July, the NBH could take a break for the rest of 3Q21 if inflation falls temporarily. This could temporarily increase pressure on the HUF and HGB yields. NBH bond purchases will slow over the summer, in line with lower issuance.

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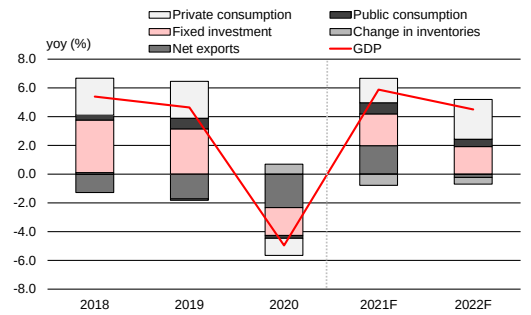
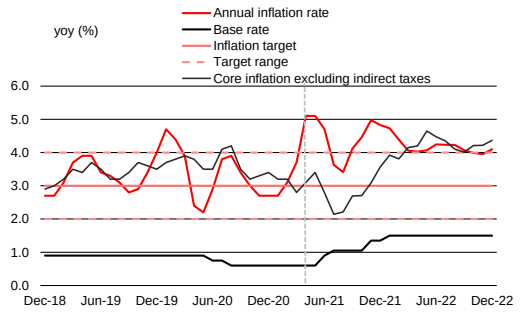
KEY DATES/EVENTS

- 8 Jul, 10 Aug, 8 Sep: CPI
- 27 Jul, 24 Aug, 21 Sep: monetary policy decisions
- 30 Jul, 13 Aug, 24 Sep: rating updates from Fitch, S&P, Moody's
- 17 Aug, 1 Sep: 2Q21 GDP (flash, structure)
- 18-26 Sep: first primary for opposition PM candidate

GDP GROWTH FORECAST



INFLATION FORECAST



Source: HCSO, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

EUR bn	2018	2019	2020	2021F	2022F
GDP (EUR bn)	136.0	146.1	136.0	150.3	160.3
Population (mn)	9.8	9.7	9.7	9.7	9.7
GDP per capita (EUR)	13,901	14,983	13,992	15,522	16,610
Real economy, change (%)					
GDP	5.4	4.6	-5.0	5.9	4.5
Private consumption	5.1	5.1	-2.3	3.3	5.4
Fixed investment	16.4	12.8	-7.3	8.6	7.2
Public consumption	1.7	4.0	-1.1	4.0	2.7
Exports	5.0	5.8	-6.8	9.6	6.0
Imports	7.0	8.2	-4.4	7.5	6.5
Monthly wage, nominal (EUR)	1,035	1,131	1,150	1,215	1,296
Real wage, change (%)	7.9	7.6	6.2	2.5	5.6
Unemployment rate (%)	3.6	3.4	4.0	4.1	3.6
Fiscal accounts (% of GDP)					
Budget balance	-2.1	-2.1	-8.1	-7.5	-5.7
Primary balance	0.2	0.2	-5.7	-5.1	-3.3
Public debt	67.5	63.9	80.4	78.7	78.0
External accounts					
Current account balance (EUR bn)	0.5	-0.6	0.1	0.2	1.6
Current account balance/GDP (%)	0.3	-0.4	0.1	0.1	1.0
Extended basic balance/GDP (%)	5.0	1.6	2.4	3.9	5.7
Net FDI (% of GDP)	2.4	0.2	0.3	1.4	2.2
Gross foreign debt (% of GDP)	99.3	95.4	153.9	122.9	104.2
FX reserves (EUR bn)	25.8	26.5	31.8	34.0	39.1
Months of imports, goods & services	2.9	2.7	3.6	3.4	3.6
Inflation/Monetary/FX					
CPI (pavg)	2.9	3.6	3.3	4.4	4.3
CPI (eop)	2.7	4.0	2.7	4.8	4.1
Central bank target	3.0	3.0	3.0	3.0	3.0
Central bank reference rate (eop)	0.90	0.90	0.60	1.35	1.50
3M money market rate (Dec avg)	0.13	0.16	0.75	1.35	1.50
USD/FX (eop)	280.9	294.7	297.4	293	294
EUR/FX (eop)	321.5	330.5	365.1	360	370
USD/FX (pavg)	270.2	290.7	308.0	293	292
EUR/FX (pavg)	318.8	325.4	351.2	355	363

Source: Eurostat, HCSO, NBH, UniCredit Research

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

A long electoral campaign

Ruling Fidesz facing a united opposition in next year's election

Although parliamentary elections will not be held until next spring, the electoral campaign is starting to take shape. The main opposition parties plan to hold primaries for a common list of candidates on 18-26 September (first round) and 4-10 October (second round). The last election results and current opinion polls suggest that a united opposition could defeat Fidesz in next year's election.

Hungary in a good position to avoid another lockdown

Aware of the threat of losing power after more than a decade, the Fidesz is ramping up spending while conducting one of the most aggressive vaccination campaigns worldwide. By 23 June, 56.4% of the population had received at least one dose of the vaccine, with 48.2% fully vaccinated. Thus, Hungary is in a good position to avoid another lockdown later this year. Even more impressive is the government's spending plan. The budget deficit target for this year has been increased by 1% of GDP to 7.5% of GDP, with 12% of GDP being pandemic-related support. After Hungary registered one of the highest COVID-19 death rates in CEE, the government intends to spend a third of RRF grants on health care. This is long overdue. The medical infrastructure is poor, while wage growth in health care lags behind in the region, and many doctors and nurses have emigrated to other European countries.

Budget deficit at 7.5% of GDP in 2021…

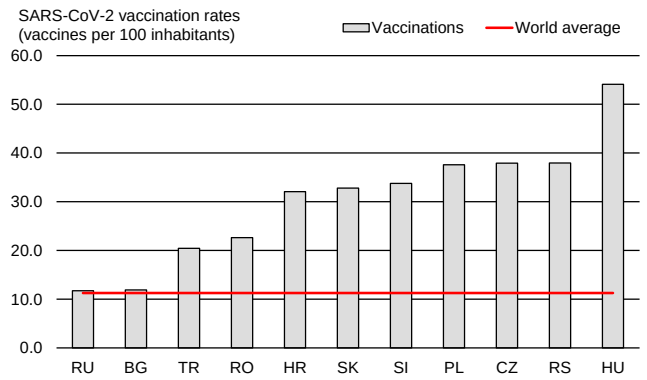
…and 5.9% of GDP in 2022, with public debt above 78%

This year's pandemic package looks good on paper, but last year many projects were bundled up under the umbrella of crisis support without having a meaningful connection to fighting the economic and health impact of COVID-19. Discretionary outlays have a very large weight in public spending and the lack of transparency is probably correlated with the low efficiency of last year's pandemic package (measured by comparing spending to economic performance). In a break with the past, the government looks in no hurry to reduce public spending, with next year's budget deficit target at 5.9% of GDP. The Fiscal Council criticized the slow adjustment in public spending, which could keep public debt above 78% of GDP in 2021-22 while making it more difficult to reduce it below 60% in five years.

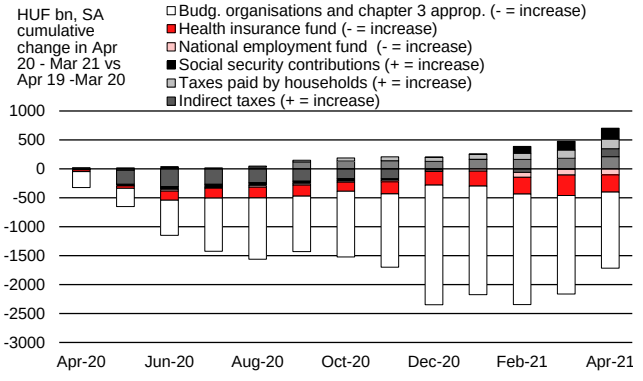
GDP could grow by 6% in 2021 and 4.5% in 2022

After slumping by 5% in 2020, the Hungarian economy could return to pre-pandemic levels of activity already this year. We expect GDP growth close to 6% in 2021 and at around 4.5% in 2022. After the pandemic-induced contraction in 1Q21, the recovery is gathering speed, driven by industry, construction and leisure services on the supply side, and by exports and investment on the demand side. Industry continues to power the recovery amid a flurry of investment projects that are gradually completed. Supply-chain bottlenecks could cap output growth in manufacturing at below 10% this year, as they are likely to further affect car producers. Planned investment projects could be revitalized in 2H21 and accelerate further next year. In addition, investment will be boosted by construction, with housing helped by a VAT cut and infrastructure by disbursements from the EU. 25% of the RRF is expected to fund green transport, with additional financing going to regional development.

HUNGARY LEADS CEE IN TERMS OF VACCINATIONS



DISCRETIONARY SPENDING HAS LIMITED EFFICIENCY



Source: University of Oxford, Ministry of Finance, UniCredit Research

Pent-up demand and public transfers will support consumption

Pent-up demand will support leisure services, but the absence of foreign tourists in 2021 and a gradual return in 2022 means that restaurants will recover quicker than hotels/tourism rentals. Consumer demand will continue to boost growth next year, helped by likely wage increases and transfers to households ahead of the election. With both households and companies exiting the COVID-19 crisis in a better financial position, demand for new credit could be limited, with the exception of mortgages and, gradually, investment loans. The combination of RRF and the 2021-27 EU budget will boost revolving and bridge loans.

Inflation could end 2021 and 2022 outside the target range

Rapid growth, strong private finance and large fiscal spending increase the danger of overheating. NBH Governor György Matolcsy mentioned the risk when the Fiscal Council analyzed the 2021-22 budget framework. The timing of a demand shock to inflation is unfortunate, as a series of supply shocks from higher fuel, tobacco and food prices, as well as HUF depreciation, pushed inflation above 5%, more than 1pp outside the target range. Even if core inflation declines in the coming months, it is likely to rebound before year-end as momentum in both cyclical and non-cyclical inflation remains strong. In 2022, supply shocks could subside, but demand pressure on prices will continue to be fueled by fiscal spending and rising labor shortages in the private sector, with the inflation target threatened once more.

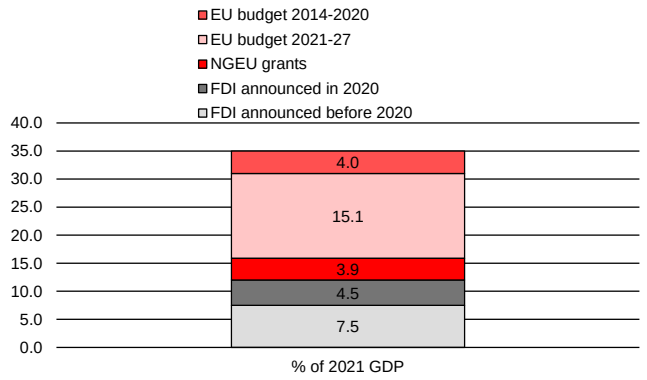
The NBH could hike to 1.50% by 1Q22

As inflation rose in spring, the NBH performed a spectacular U-turn and delivered a 30bp increase on 22 June. We expect the NBH to move in steps of 15bp from here on, with one rate hike coming in July, followed by a temporary break as inflation declines. Two more rate hikes in 4Q21 and one in 1Q22 could take the policy rate to 1.50%, still below the 2-4% target range. Thus, more tightening might have to be considered to contain inflation, since the impact on debt service in the private sector will be limited in the short term: SMEs that borrowed through the Funding for Growth Scheme pay fixed interest rates, while 60% of mortgages benefit from fixed rates for more than a year. In real terms, the Hungarian real rate will remain below those of the CNB and the NBR.

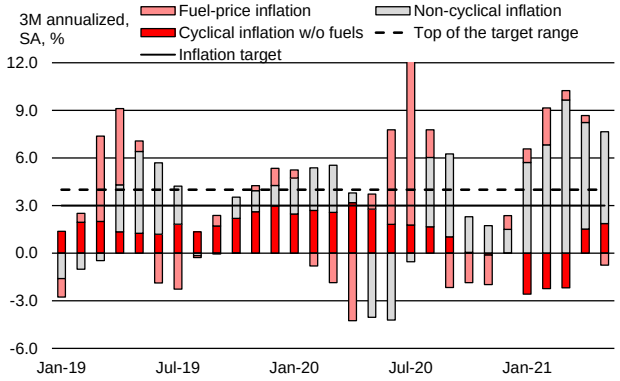
Positive extended basic balances will continue to support the HUF

Rate hikes remove the risk of a sharp HUF depreciation, but EUR-HUF could return above 350 by autumn. Further depreciation is on the cards for next year if wages continue to outpace productivity. Even if FX volatility returns, runaway depreciation is unlikely in 2022 as well. Capital flows will remain supportive for the currency. The C/A could move into a higher surplus next year, helped by larger exports, after ending 2021 close to balance. EU transfers will pick up as well: around EUR 3bn will be received in both 2021 and 2022 from the 2014-20 EU budget, with RRF pre-funding expected to start in August or September and pick up next year, while disbursements from the 2021-27 EU budget could start in 2022. FDI projects are very large: pre-pandemic commitments are around 7.5% of expected 2021 GDP, with investment projects announced in 2020 approaching 4.5% of expected 2021 GDP. Thus, the extended basic balance could exceed 5.5% of GDP in 2022, with FX reserves rising further.

SIZEABLE FDI AND EU TRANSFERS AHEAD



STRONG MOMENTUM IN INFLATION REQUIRES TIGHTENING



Source: HCSO, Ministry of Finance, European Commission, UniCredit Research

Market likely to be disappointed by pace of rate hikes

The NBH is likely to hike at a slower pace than FRAs price in

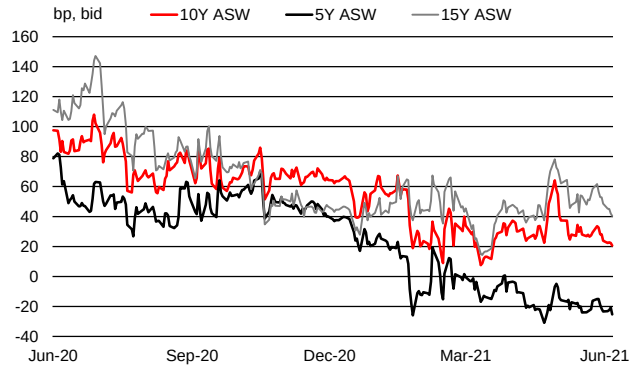
The NBH delivered a first rate hike in June and the market is pricing in 30bp in July, with 60bp more before year-end. This is too fast a pace compared to what the central bank is likely to deliver, at least this year. As a result, the HUF could come under pressure over the summer if the NBH pauses, as we expect. If depreciation is seen as excessive, the central bank could hike at a faster pace than we currently expect, since the FX pass-through is the most important component of inflation that monetary policy can influence in the short term.

NBH bond purchases will slow in 3Q21, in line with lower issuance

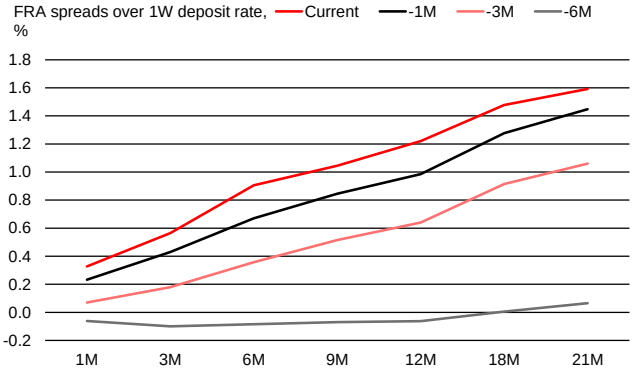
The rate hike also stopped the steepening of the bond curve, having a bigger impact than the NBH's recent bond purchases. The latter will continue as the central bank normalizes rates, but the pace will slow in 3Q21, in line with lower bond issuance over the summer. Longer-term yields could also come under pressure temporarily if the NBH is perceived as too dovish in the coming months, but the bear-flattening of the curve will eventually prevail.

The HGB curve is likely to bear-flatten

HGB CURVE STEEPENING STOPPED BY RATE HIKE



THE MARKET IS PRICING IN TOO MUCH TIGHTENING



Source: Bloomberg, UniCredit Research

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2020	2021F	2022F
Gross financing requirement	**35.3**	**34.8**	**27.9**
Budget deficit	15.8	14.9	12.5
Amortization of public debt	19.5	19.9	15.4
Domestic	16.8	17.2	14.9
Bonds	7.8	8.8	6.1
Bills	2.0	1.8	1.8
Loans & retail securities	7.0	6.6	7.0
External	2.7	2.6	0.5
Bonds	2.5	1.7	0.0
IMF/EU/Other IFIs	0.2	0.9	0.5
Financing	**35.3**	**34.8**	**27.9**
Domestic borrowing	28.8	29.7	27.4
Bonds	17.2	17.3	15.6
Bills	1.7	1.8	2.8
Loans & retail securities	9.9	10.7	9.0
External borrowing	7.5	1.0	0.5
Bonds	6.5	0.0	0.0
IMF/EU/Other IFIs	1.0	1.0	0.5
Change in fiscal reserves (- = increase)	-1.0	4.0	0.0

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2020	2021F	2022F
Gross financing requirement	**21.7**	**18.3**	**15.0**
C/A deficit	-0.1	-0.2	-1.6
Amortization of medium and long-term debt	10.4	8.7	8.2
Government/central bank	3.9	3.5	1.9
Banks	5.3	3.7	4.3
Corporates/other	1.2	1.5	2.0
Amortization of short-term debt	11.4	9.8	8.4
Financing	**21.7**	**18.3**	**15.0**
FDI (net)	0.4	2.0	3.5
Portfolio equity, net	0.0	0.0	0.0
Medium and long-term borrowing	12.9	6.4	5.4
Government/central bank	7.6	2.2	1.5
Banks	4.0	2.8	2.6
Corporates/other	1.3	1.4	1.4
Short-term borrowing	9.8	8.4	7.1
EU structural and investment funds	2.7	3.7	4.0
Change in FX reserves (- = increase)	-4.1	-2.3	-5.0
Memoranda:			
Non-resident purchases of LC govt bonds	0.1	1.2	1.0
International bond issuance, net	4.0	-1.7	0.0

Source: NBH, Ministry of Finance, UniCredit Research

Poland

A2 stable/A- stable/A- stable*

Outlook: The Polish economy could grow by around 5.1% in 2021 and 4.6% in 2022, returning to pre-COVID-19 levels of activity in 2H21. Private consumption will be boosted by high savings during the COVID-19 crisis and new transfers to households under the New Deal program. The danger of fiscal slippage is low, with taxation on the better-off and companies expected to rise. Investment will benefit from EU transfers and loans of around 21.5% of 2021 GDP. Inflation is likely to miss the target this year and next, but the NBP could postpone rate hikes to November or later.

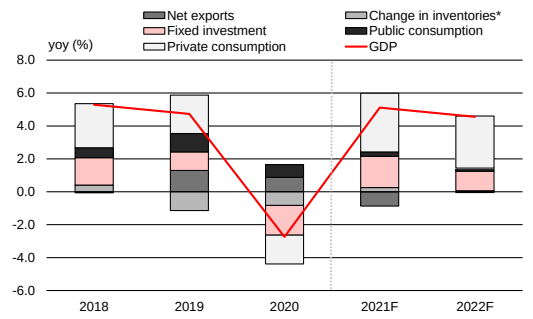
Strategy: Failure to hike despite high and persistent inflation could bode ill for the PLN and POLGBs in 3Q21.

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

KEY DATES/EVENTS

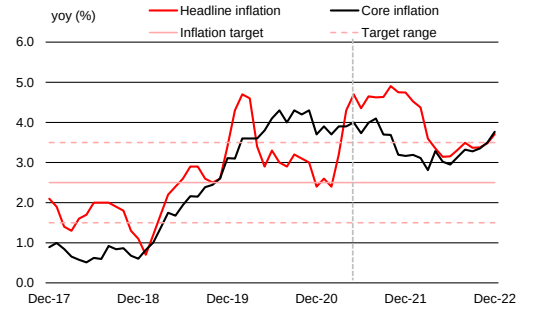
- 8 Jul, 8 Sep: monetary policy decisions
- 30 Jun/15 Jul, 30 Jul/13 Aug, 31 Aug/15 Sep: CPI
- 27 Aug: rating update from Fitch
- 13/31 Aug: 2Q21 GDP (flash, structure)
- Jul: potential Supreme Court ruling on CHF loans

GDP GROWTH FORECAST



*adjusted with the statistical error

INFLATION FORECAST



Source: Statistics Poland, NBP, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2018	2019	2020	2021F	2022F
GDP (EUR bn)	497.6	533.7	522.9	566.7	614.4
Population (mn)	38.4	38.4	38.4	38.4	38.4
GDP per capita (EUR)	12,948	13,885	13,605	14,744	15,984
Real economy, change (%)					
GDP	5.3	4.7	-2.7	5.1	4.6
Private consumption	4.5	4.0	-3.0	6.1	5.4
Fixed investment	9.3	6.1	-9.7	10.9	6.5
Public consumption	3.5	6.5	4.4	1.4	1.0
Exports	7.0	5.2	-0.1	8.0	5.6
Imports	7.6	3.0	-1.9	10.5	6.0
Monthly wage, nominal (EUR)	1,134	1,199	1,215	1,279	1,360
Real wage, change (%)	5.3	4.2	1.3	3.0	2.6
Unemployment rate (%)	6.1	5.4	5.9	6.0	5.2
Fiscal accounts (% of GDP)					
Budget balance (w. PFR)	-0.2	-0.7	-7.0	-6.4	-4.0
Primary balance (w. PFR)	1.1	0.5	-5.8	-5.1	-2.7
Public debt (w. BGK and PFR)	48.8	45.6	56.3	54.1	52.9
External accounts					
Current account balance (EUR bn)	-6.5	2.6	18.5	15.1	11.1
Current account balance/GDP (%)	-1.3	0.5	3.5	2.7	1.8
Extended basic balance/GDP (%)	3.4	4.1	7.4	6.0	5.4
Net FDI (% of GDP)	2.6	1.6	1.4	1.5	1.3
Gross foreign debt (% of GDP)	63.6	59.1	56.9	48.8	41.3
FX reserves (EUR bn)	96.5	103.3	112.8	119.5	124.1
Months of imports, goods & services	4.5	4.6	5.3	5.1	4.9
Inflation/Monetary/FX					
CPI (pavg)	1.7	2.3	3.4	4.2	3.6
CPI (eop)	1.1	3.4	2.4	4.7	3.7
Central bank target	2.50	2.50	2.50	2.50	2.50
Central bank reference rate (eop)	1.50	1.50	0.10	0.50	1.50
3M money market rate (Dec avg)	1.72	1.70	0.21	0.85	1.85
USD/FX (eop)	3.76	3.80	3.76	3.59	3.48
EUR/FX (eop)	4.30	4.26	4.61	4.60	4.60
USD/FX (pavg)	3.61	3.84	3.90	3.67	3.47
EUR/FX (pavg)	4.26	4.30	4.44	4.52	4.51

Source: Eurostat, Statistics Poland, NBP, UniCredit Research

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

A New Deal to foster old plans

Redistribution will continue in 2021-22 through the New Deal

In May, Polish authorities announced the New Deal, a development program to help the economy recover strongly from the pandemic. The New Deal will add to sizeable pre-pandemic redistribution measures that helped reelect the Law and Justice (PiS) party in 2019 and President Andrzej Duda in 2020. The young, the worse-off, pensioners and families with children will benefit the most from legislative changes implemented in 2H21 and 2022. The government will cut taxation for around 18 million taxpayers, while some 3 million contributors will pay higher taxes (especially those earning more than PLN 12,000 per month). At the same time, the tax-exempted limit will be increased to PLN 30,000 per year and the top personal income tax of 32% will apply from PLN 120,000 per year, targeting only around 600,000 employees. The government will provide guarantees and subsidies to young home buyers and will cut red tape for new residential projects. The highest child allowances in the region will be topped up for each child aged 1-3, starting with the second child. The total cost of the measures will be around 1% of GDP per year.

The young, the poor and the elderly will benefit the most from more progressive taxation

Transfers to healthcare will increase…

Second, the government plans to increase the allotment to healthcare to 7% of GDP by 2027, funding it by increasing the ceiling on contributions and removing the exceptions for the self-employed. Stronger economic growth and further improvement in tax collection could cap the net cost of all measures to less than 0.2% of GDP per year. Poland's EU-topping track record in improving tax collection in 2016-19 bodes well for the future adjustment in public deficits and debt. We expect budget deficits at 6.4% of GDP in 2021 and 4.0% of GDP in 2022, below the government's targets due to stronger economic growth.

…without a large effect on budget deficits

GDP growth expected at 5.1% in 2021 and 4.6% in 2022…

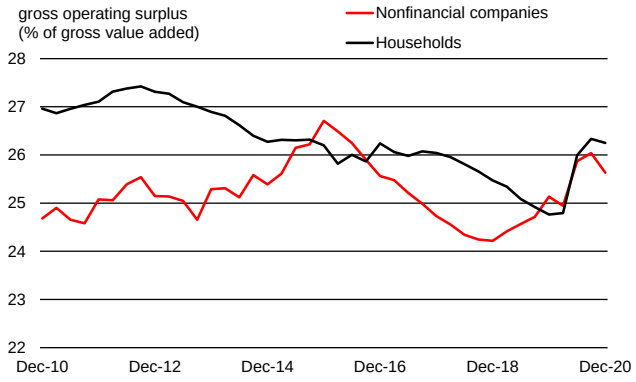
GDP could grow by 5.1% in 2021 and 4.6% in 2022, more than 1pp faster than in the government's forecast. Private consumption will benefit from pent-up demand, as households increased their net financial worth by 11.5% of GDP in 2020. With the country less reliant on foreign tourists than its EU neighbors, the recovery in leisure services could be faster and larger. Yet better-off households could postpone part of their spending on durables due to the impending rise in taxation and the upcoming Supreme Court ruling on CHF and CHF-linked mortgage loans. A solution that would allow for some contracts to be cancelled would lead to early loan repayments. Additional transfers will boost private consumption especially in 2022, although many households are likely to reduce debt and increase savings.

…powered by private consumption…

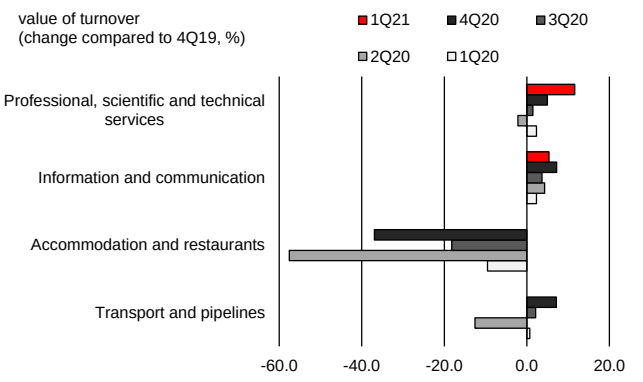
… and investment

The New Deal's third important pillar focuses on investment, with help from Recovery and Resilience Facility (RRF) transfers and loans amounting to EUR 58.1bn (10.2% of expected 2021 GDP) and the 2021-27 EU budget (EUR 63.9bn, 11.3% of 2021 GDP).

MORE SUPPORT TO HOUSEHOLDS THAN COMPANIES IN 2020



DIFFERENTIATED RECOVERY IN SERVICES



Source: Statistics Poland, Eurostat, UniCredit Research

The National Recovery Plan will focus on green transition, healthcare, competitiveness and digitalization…

The National Recovery Plan (NRP) assumes that total investment will be three times larger than RRF funding. Pending the EC's approval, grants of EUR 23.9bn will go to green energy (EUR 6.4bn) and green mobility (EUR 6.1bn), but also to the healthcare system (EUR 4.3bn), economic competitiveness and resilience (EUR 4.1bn), and digital transformation (EUR 3bn). The energy transition is Poland's biggest medium-term challenge. An economy dependent on coal-generated energy faces higher prices (due to more expensive green certificates) and backlashes against polluting mines and power plants. In May, the Court of Justice of the EU asked for the immediate closing of the Turow mine and the adjacent power plant, which produces approximately 8% of Poland's electricity. In addition, the Belchatow coal power plant, which generates 20% of Poland's electricity and is the largest and most polluting in the EU, should be closed by 2036.

…with the former needed to reduce dependency on coal

NRP and New Deal to have limited impact on potential growth…

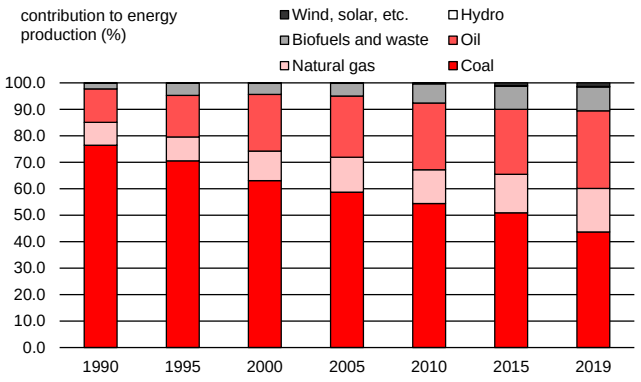
While investment is expected to accelerate in 2021-22 and beyond, the impact on long-term GDP is likely to be limited for several reasons. First, the green transition will focus on replacing polluting energy sources with greener ones, with the net impact on production and employment likely to be negative. Second, further investment into infrastructure may bring few productivity gains, except for less developed eastern and southeastern Poland. Third, capex could be curtailed by significantly higher effective tax rates in Poland than in Hungary, Romania or Slovakia. Yet the existing pipeline of investment, especially in electric batteries and vehicles, could support export growth going forward. Polish exports remain competitive in the EU, as shown by their good performance in 2021. While next exports may have a negative contribution to growth in 2022-23, GDP growth should exceed 4% in both years.

…but could keep inflation above the target range in 2021-22

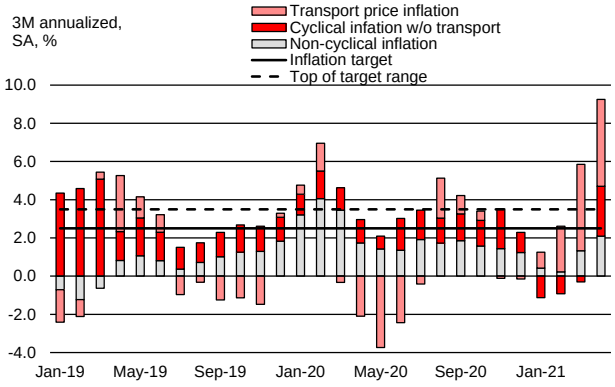
Redistribution under the New Deal may bring little in terms of additional growth, but could stoke up inflationary pressure. The NBP continues to downplay reflation, blaming it on supply shocks in fuel and utility prices. However, faster price growth is broad-based and momentum is higher than in all other EU-CEE countries in both cyclical and non-cyclical inflation. A later reopening than in other EU-CEE countries means service price inflation could accelerate further over the summer. Meanwhile, the FX pass-through might contribute to inflation and inflationary expectations if the NBP is perceived to be falling behind the curve. Thus, part of the increase in household income could be offset by higher inflation, explaining why several government representatives condoned timely rate hikes. A minority of MPC members seems willing to start hiking rates from November onwards if the inflation forecast shows a danger of missing the inflation target in 2022-23. Temporary disinflation in June-July may help the MPC delay a decision. We see inflation remaining above target in 2020-21, warranting rate hikes to 0.5% in 2021 and back to 1.50% in 2022. A new MPC majority appointed in 1H22 could be more hawkish.

The NBP could start hiking in November 2021 and take the key rate back to 1.5% in 2022

POLAND IS HEAVILY RELIANT ON FOSSIL FUELS



INFLATION MOMENTUM IS BROAD-BASED



Source: International Energy Agency, Statistics Poland, UniCredit Research

NBP inaction to fuel PLN and POLGB underperformance

In 2Q21, the PLN and POLGBs moved in line with their Central European peers. The PLN appreciated in line with better macroeconomic prospects for the region and its main trading partner, the eurozone. Bonds sold off amid higher Bund yields and rate hikes starting to be priced into FRA curves.

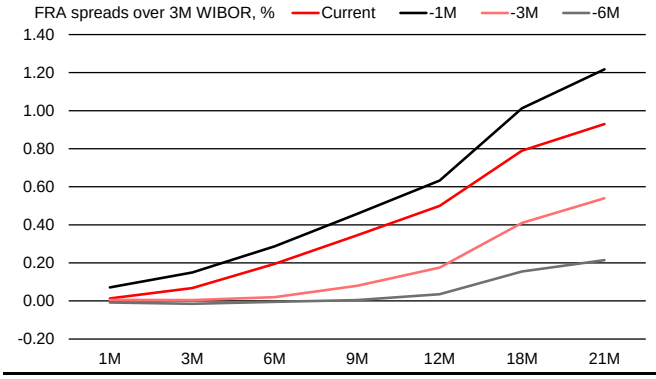
PLN and POLGBs vulnerable in 3Q21 from NBP inaction…

However, the NBP's decision to delay a first rate hike at least until November while the NBH and the CNB hiked already in June may lead to Polish financial assets underperforming peers in 3Q21. Temporary disinflation in June-July may not be enough to return inflation inside the target range, leaving the PLN and the long end of the POLGB curve vulnerable to sell-offs if risk appetite declines. Seasonality could help the PLN in 3Q21, but a return close to EUR-PLN 4.60 is possible before year-end.

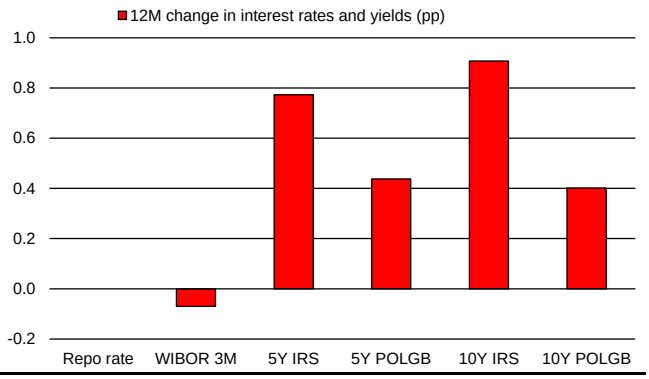
…despite support from NBP bond purchases and sizeable issuance in 1H21

A POLGB selloff could be limited by **1.** little pressure from issuance, as the Ministry of Finance has covered more than 75% of this year's funding needs and can reduce issuance if there is pressure on yields; and **2.** higher bond purchases by the NBP, if needed. The central bank could continue to buy bonds even if it starts raising rates.

MORE HIKES COULD BE PRICED IN IF INFLATION STAYS HIGH



BONDS SELLING OFF LESS THAN SWAPS DUE TO NBP



Source: Ministry of Finance, Bloomberg, UniCredit Research

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2020	2021F	2022F
Gross financing requirement	**59.3**	**71.1**	**62.7**
Budget deficit	36.3	35.9	24.3
Amortization of public debt	22.9	35.2	38.4
Domestic	16.0	27.8	32.6
Bonds	14.6	23.5	28.2
Bills	0.0	2.4	4.4
Loans/other	1.4	1.9	0.0
External	6.9	7.4	5.8
Bonds	5.4	6.9	4.8
Loans, IFIs, other	1.5	0.5	1.0
Financing	**59.3**	**71.1**	**62.7**
Domestic borrowing	66.6	53.3	49.4
Bonds	33.3	34.9	38.0
Bills	2.4	4.4	4.4
Loans/PFR/other	30.9	14.0	7.0
External borrowing	10.6	8.0	8.5
Bonds	5.3	5.0	5.0
Loans, IFIs, other	5.3	3.0	3.5
Change in fiscal reserves/other (-=increase)	-17.9	9.9	4.8

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2020	2021F	2022F
Gross financing requirement	**82.4**	**84.7**	**80.8**
C/A deficit	-18.5	-15.1	-11.1
Amortization of medium and long-term debt	50.7	51.8	52.4
Government/central bank	9.9	9.8	8.6
Banks	13.3	15.8	15.0
Corporates/other	27.6	26.2	28.8
Amortization of short-term debt	50.2	48.0	39.5
Financing	**82.4**	**84.7**	**80.8**
FDI (net)	7.4	8.5	7.8
Portfolio equity, net	3.2	-0.5	0.0
Medium and long-term borrowing	36.1	39.3	41.7
Government/central bank	4.6	10.4	11.2
Banks	9.3	7.9	7.5
Corporates/other	22.2	20.9	23.0
Short-term borrowing	46.6	39.5	27.5
EU structural and cohesion funds	12.6	10.6	14.4
Other	-7.7	-6.0	-6.0
Change in FX reserves (- = increase)	-15.9	-6.7	-4.6
Memoranda:			
Non-resident purchases of LC govt bonds	-8.4	0.6	0.3
International bond issuance, net	-0.1	-1.9	0.2

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

Romania

Baa3 negative/BBB- stable/BBB- negative*

Outlook

We expect GDP to grow at 7% in 2021 and 4.8% in 2022 after contracting by 3.9% in 2020. The economy returned to pre-pandemic activity levels in 1H21 and could close the negative output gap by early 2022. Public investment (helped by EU transfers) and construction will drive growth with private consumption boosted by pent-up demand. We expect inflation to stay outside the target range this year and to return below 3.5% in 2022. The NBR is likely to remain on hold this year if Romania undergoes a fourth pandemic wave before hiking next year to around 1.75%.

Strategy

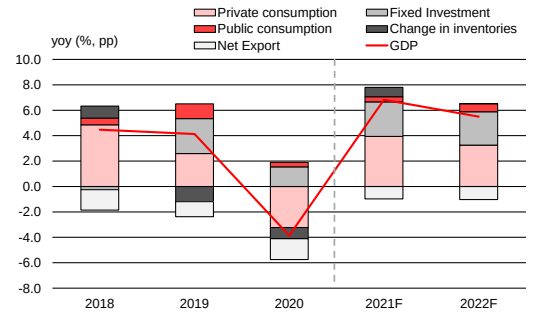
The ROMGB curve could steepen in 3Q21 due to higher inflation and the low appetite for duration among local buy-side funds.

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

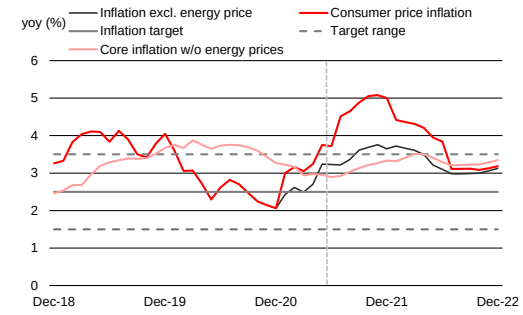
KEY DATES/EVENTS

- 7 Jul, 6 Aug: monetary policy decision
- 13 Jul, 11 Aug, 10 Sep: CPI
- 17 Aug, 7 Sep: 2Q21 GDP (flash, structure)
- 25 Sep: PNL leadership elections
- No rating updates in 3Q21

GDP GROWTH FORECAST



INFLATION FORECAST



Source: NSI, NBR, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

EUR bn	2018	2019	2020	2021F	2022F
GDP (EUR bn)	204.5	223.0	218.2	238.9	256.0
Population (mn)	19.5	19.4	19.3	19.2	19.2
GDP per capita (EUR)	10,470	11,486	11,290	12,411	13,332
Real economy, change (%)					
GDP	4.5	4.1	-3.9	7.0	4.8
Private Consumption	7.7	4.1	-5.2	5.9	5.1
Fixed Investment	-1.1	13.0	6.8	11.1	10.7
Public Consumption	3.3	6.9	2.0	2.1	3.5
Exports	5.3	4.6	-9.7	9.0	7.5
Imports	8.6	6.8	-5.1	9.9	8.9
Monthly wage, nominal (EUR)	965	1,069	1,116	1,182	1,240
Real wage, change (%)	29.7	8.9	3.6	3.6	3.5
Unemployment rate (%)	4.2	3.9	5.0	5.5	4.5
Fiscal accounts (% of GDP)					
Budget balance	-2.9	-4.4	-9.2	-8.1	-6.3
Primary balance	-1.5	-3.3	-7.8	-6.6	-4.8
Public debt	34.7	35.3	47.5	48.5	49.8
External accounts					
Current account balance (EUR bn)	-9.5	-10.9	-11.4	-13.9	-15.2
Current account balance/GDP (%)	-4.6	-4.9	-5.2	-5.8	-6.0
Extended basic balance/GDP (%)	-1.3	-1.7	-2.9	-1.4	-1.1
Net FDI (% of GDP)	2.4	2.2	0.9	2.3	2.5
Gross foreign debt (% of GDP)	33.4	33.3	42.5	44.0	45.2
FX reserves (EUR bn)	33.1	32.9	37.4	40.5	42.3
Months of imports, goods & services	4.3	4.0	4.9	4.7	4.6
Inflation/Monetary/FX					
CPI (pavg)	4.6	3.8	2.7	4.1	3.7
CPI (eop)	3.3	4.0	2.1	5.0	3.2
Central bank target	2.50	2.50	2.50	2.50	2.50
Central bank reference rate (eop)	2.50	2.50	1.50	1.25	1.75
3M money market rate (Dec avg)	3.05	3.12	2.04	1.55	1.80
USDRON (eop)	4.07	4.26	3.97	4.06	4.04
EURRON (eop)	4.66	4.78	4.87	4.95	5.05
USDRON (pavg)	3.94	4.24	4.24	4.10	4.06
EURRON (pavg)	4.65	4.75	4.84	4.92	5.03

Source: Eurostat, NSI, NBR, UniCredit Research

*long-term foreign-currency credit rating at Moody's, S&P and Fitch, respectively

Resetting priorities

Romania could start receiving RRF funds in 3Q21

The EU's Recovery and Resilience Facility (RRF) gives Romania the opportunity to address some of its most significant short-term and long-term economic imbalances. Besides the green and digital transitions prioritized by the RRF, Romania's National Plan for Recovery and Resilience (NPRR) should start addressing the widening social-security deficit. Alongside Poland and Portugal, Romania has the worst demographic trends in the EU. The NPRR would allow Romania to invest in education and retraining, in infrastructure, healthcare, regional development and better tax collection, which are all needed to confront the country's looming fiscal liabilities. Absorption from the RRF grants of EUR 14.2bn could start in August or September if the European Commission approves the NPRR in the coming months.

Focus on infrastructure spending

A stark change in priorities compared to 2014-19 saw the current government ramp up public investment in 2020 to its highest levels since 2012. This year's volume is likely to be the highest since Romania joined the EU with a further rise expected in 2022. Most projects will have to be funded out of the 2021-27 EU budget rather than the RRF. This year and next, the government will also rely on remaining transfers from the 2014-20 EU budget.

Construction to drive growth in 2021-22

Fixed investment could post double-digit growth rates in 2021-22, outpacing other GDP components. Besides infrastructure, building output will accelerate further. Housing will benefit from generous public guarantees, pent-up demand and a cultural preference for ownership over renting. Supply-chain bottlenecks in manufacturing and surging sales in Europe may boost demand for warehousing space and logistics in general.

Trade deficit expected to widen further

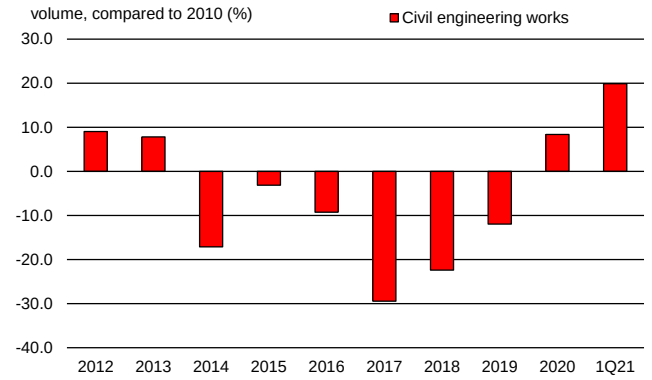
In April-May, both Renault and Ford reduced production and work time in Romania due to shortages of microprocessors. Further bottlenecks are possible although the two Romanian factories are less affected than other plants, according to the two companies. Other shortages could affect chemical, plastic and rubber, textile and metal production. The impact on exports may be offset by agricultural exports if the harvest is in line with the European Commission crop forecast, which shows double-digit growth rates for Romania compared to 2020. However, net exports may continue to subtract from growth due to higher imports, which rose sharply when the economy reopened in the spring, with the trade deficit widening sharply.

Private consumption supported by savings and private-sector wages…

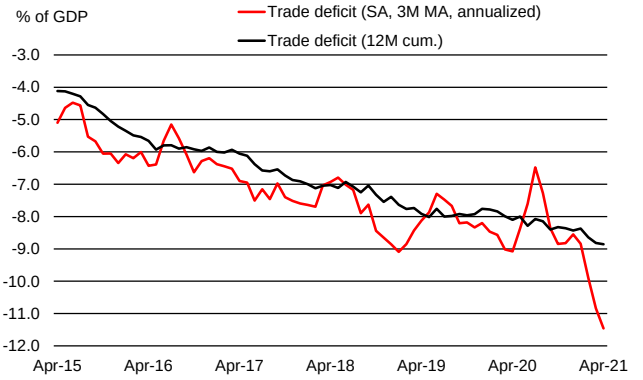
…but not by pensions and public-sector wages

Private consumption could accelerate this year and outpace GDP in 2022, helped by the financial wealth of households rising by 5.4% of GDP last year and a likely pick-up in consumer lending. In 2021, household spending may grow at the fastest pace in CEE as Romania removed restrictions earlier and the remaining limits on mobility and businesses are less stringent than in CEE peers. In 2022, we believe private-sector wages could increase faster than in 2021 due to growing labor shortages. At the same time, we believe pensions and public-sector wages will rise at a slower pace than in previous years, returning consumption growth to regional averages.

INFRASTRUCTURE SPENDING RISING IN 2020-21



IMPORTS AND TRADE DEFICIT SURGING IN 2Q21



Source: NIS, UniCredit Research

GDP growth expected at 7% in 2021 and 4.8% in 2022

We expect economic growth at 7% in 2021 (fastest in EU-CEE) and at 4.8% in 2022. GDP returned to its pre-pandemic level in 1H21 and could rejoin its pre-COVID trend in 1H22, thus closing the negative output gap.

Fiscal adjustment needs a plan to improve tax collection

Due to accrual accounting (ESA), the fiscal impulse will be higher than implied by narrowing budget deficits in 2021-22 because public spending continues to shift from income measures to investment (of which a large part is covered out of EU funds, most of them neutral to the budget, according to ESA). Starting in 2022, a new pension law could set annual indexation to inflation plus half of real wage growth. However, this is not enough to significantly reduce the weight of non-discretionary spending in total tax revenues. More has to be done to improve tax collection, even if stronger economic growth and automatic stabilizers are boosting budget revenues (as they did in 5M21). Yet the EC and rating agencies asked for a clear reform schedule to improve tax compliance and usher in rating upgrades. Until then, Romania's investment grade looks secure, as shown also by S&P's outlook upgrade to stable.

Inflation could miss the target in 2021 but not in 2022

After exiting the target range in May, inflation is likely to accelerate further in July due to gas and heating price hikes adding to the liberalized electricity prices paid by households and to higher fuel prices. Excluding these effects, inflation could end 2021 marginally outside the target range, returning below 3.5% in 2022. As the government reins in budget spending, we expect the wage bill to grow more slowly than in the past and to exert limited pressure on core inflation in 2022 and beyond. With EUR-RON moving to the 4.90-5.00 range in March, the FX pass-through may be negligible until 1Q22 when a shift to 5.00-5.10 is expected.

Romania is vulnerable to a fourth pandemic wave

The NBR could remain on hold this year, especially if Romania faces a fourth pandemic wave and renewed restrictions this winter. Vaccinations slowed in 2Q21 despite official efforts to reach a larger part of the population. As a result, herd immunity may not be achieved this year. Similar to the third wave of the pandemic, a fourth wave may only slow quarterly growth rates rather than reduce GDP with both official restrictions and public compliance likely to fall short of a full lockdown.

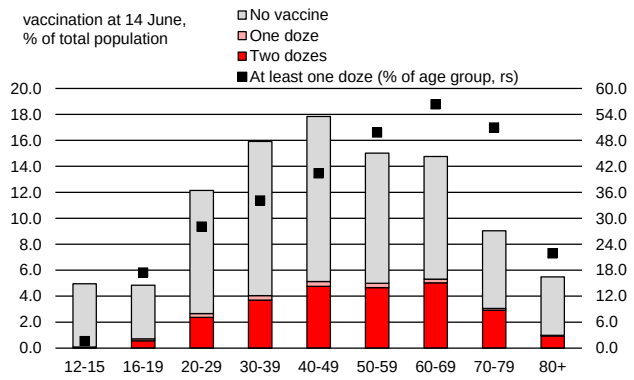
Rate hikes possible in 2022

Rate hikes are on the cards next year even if supply shocks subside and headline inflation remains inside the target range. The NBR could normalize interest rates by taking the repo rate to 1.75%, lifting both the nominal and real rates above those in central Europe.

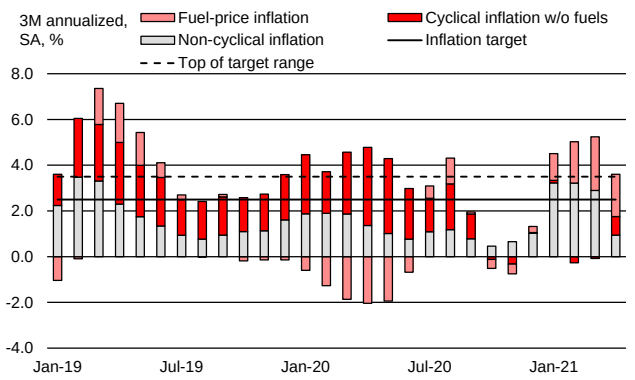
Leadership contest in the PNL could lead to a new PM

In politics, the main event this year could be the leadership election held in September by the National Liberal Party, the senior member of the governing coalition. The two candidates are PM Florin Cîțu and former PM and current party president Ludovic Orban. A win for Mr. Orban might see him return as PM. If Mr. Cîțu leaves government, the fiscal adjustment could slow.

MANY ELDERLY NOT YET VACCINATED



INFLATIONARY PRESSURE REMAINS CONTAINED



Source: Ministry of Health, NSI, UniCredit Research

ROMGBs: lacking local support

Higher inflation could reduce local appetite for duration…

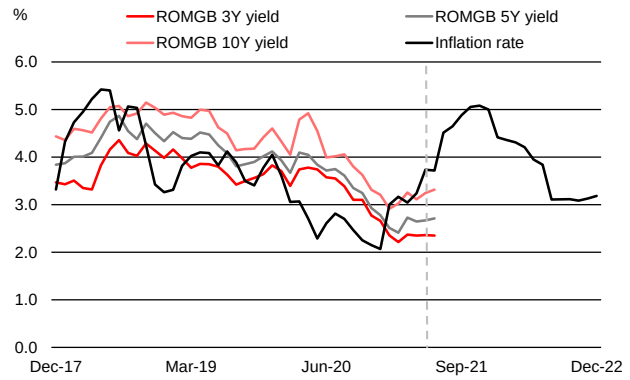
ROMGBs remain the cheapest local-currency bonds in the EU after yet another quarter when they failed to narrow the credit spread to regional peers. We continue to believe that Romanian bonds should fully price out the risk of rating downgrades to junk but this cannot happen if local investors have little appetite to load up on bonds. With inflation likely to spike above 4.5% from July onwards, mainly due to higher regulated prices, we do not expect local demand to recover in 3Q21. Pension funds need to deliver returns above the inflation rate and may want to avoid a potential correction in yields due to higher inflation. Banks are unlikely to offset missing demand for duration from the local buy side, with the ROMGB curve at risk of bear steepening.

…and steepen the ROMGB curve

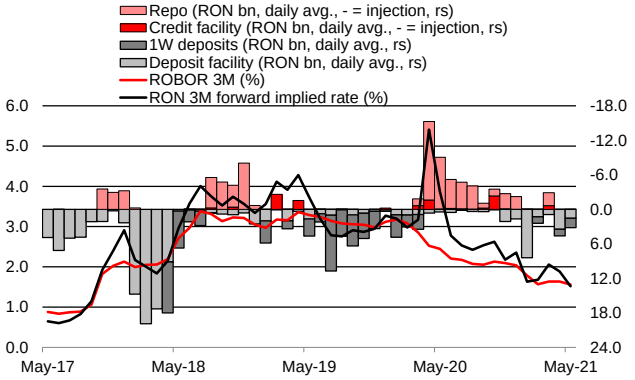
ROMANI issuance unlikely in 3Q21 if demand is not strong

The Ministry of Finance has already covered 57% of expected issuance and its reserves are enough to cover most of its remaining financing needs for the year. Thus, the MinFin could forego selling bonds of foreign markets in 3Q21 if demand is not strong. In 2021, ROMANI issuance could fall short of the initial plan of EUR 7bn, which we always considered excessive.

DEMAND FOR DURATION COULD BE AFFECTED BY REFLATION



SHORT-END ANCHORED BY ABUNDANT LIQUIDITY



Source: NBR, NSI, Bloomberg, UniCredit Research

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2020	2021F	2022F
Gross financing requirement	**25.9**	**23.7**	**26.0**
Budget deficit	17.4	13.5	14.0
Amortization of public debt	8.5	10.2	12.0
Domestic	6.5	10.2	9.4
Bonds	5.8	7.9	8.1
Bills	0.4	1.0	1.0
Loans	0.3	1.3	0.3
External	2.0	0.0	2.6
Bonds and loans	2.0	0.0	2.6
IMF/EU/Other IFIs	0.0	0.0	0.0
Financing	**25.9**	**23.7**	**26.0**
Domestic borrowing	17.9	16.0	15.0
Bonds	15.9	13.0	13.0
Bills	1.0	1.0	1.0
Loans and retail bonds	1.0	2.0	1.0
External borrowing	15.2	6.0	8.6
Bonds	11.7	4.5	4.0
IMF/EU/Other IFIs	3.5	1.5	4.6
Fiscal reserve change (- = increase)	-7.1	1.8	2.4

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2020	2021F	2022F
Gross financing requirement	**38.5**	**38.5**	**41.5**
C/A deficit	11.4	13.9	15.2
Amortization of medium and long term debt	12.1	9.7	12.1
Government/central bank	3.2	1.1	3.9
Banks	3.1	2.8	2.5
Corporates/Other	5.9	5.8	5.7
Amortization of short-term debt	15.0	14.9	14.1
Financing	**38.5**	**38.5**	**41.5**
FDI (net)	1.9	5.6	6.4
Portfolio equity, net	0.1	0.1	0.1
Medium and long-term borrowing	22.3	15.9	17.4
Government/central bank	14.6	7.9	9.7
Banks	2.8	2.5	2.2
Corporates/Other	5.0	5.5	5.4
Short-term borrowing	14.5	13.7	13.4
EU structural and cohesion funds	2.9	5.0	6.0
Change in FX reserves (- = increase)	-3.1	-1.8	-1.8
Memoranda:			
Nonresident purchases of LC govt bonds	1.9	2.4	1.5
International bond issuance, net	9.7	4.5	1.4

Source: NBR, MoF, NSI, UniCredit Research

Slovakia

A2 stable/A+ stable/A negative*

Outlook

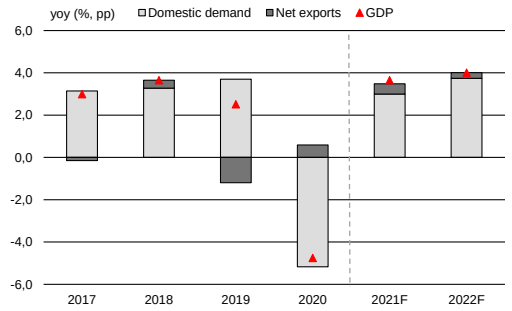
We expect Slovakia's GDP to grow by 3.7% in 2021 and 4% in 2022, reaching pre-pandemic levels at the turn of the year. The economic rebound will be led by consumption recovering supported by pent-up demand and tightening labor-market conditions. Slowing vaccination could lead to further restrictions and slower growth later this year. Several bottlenecks in supply-chains affecting key parts of local manufacturing, including the car sector, are also likely to slow the economic rebound and temporarily increase inflation towards 3%. From next year, we expect public investment driven by inflows from the EU budget and the NGEU to support growth. Fiscal tightening has been postponed until 2023, the pre-election year, but rising political instability increases the likelihood of early elections and slows reform progress.

Author: Ľubomír Koršňák, Analyst (UniCredit Bank Czech Republic and Slovakia)

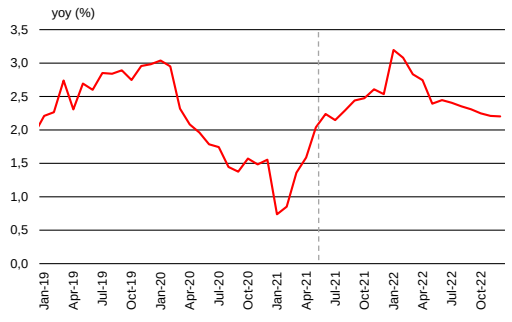
KEY DATES/EVENTS

- 9 Jul, 10 Aug, 10 Sep: industrial production
- 14 Jul, 13 Aug, 14 Sep: CPI
- 17 Aug: flash 2Q21 GDP
- 3 Sep: 2Q21 GDP structure

GDP GROWTH FORECAST



INFLATION FORECAST



Source: NSI, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2018	2019	2020	2021F	2022F
GDP (EUR bn)	89.4	93.9	91.6	97.0	103.5
Population (mn)	5.4	5.5	5.5	5.5	5.5
GDP per capita (EUR)	16,405	17,216	16,775	17,759	18,963
Real economy, change (%)					
GDP	3.7	2.5	-4.8	3.7	4.0
Private consumption	4.2	2.6	-1.1	0.7	3.4
Fixed investment	2.7	6.6	-12.0	3.5	8.7
Public consumption	0.1	4.6	0.3	1.5	-1.5
Exports	5.2	0.8	-7.5	7.0	9.1
Imports	5.0	2.1	-8.3	6.7	9.1
Monthly wage, nominal (EUR)	1,013	1,092	1,133	1,182	1,247
Real wage, change (%)	3.6	5.0	1.8	2.4	2.8
Unemployment rate (%)	6.5	5.8	6.7	7.4	6.7
Fiscal accounts (% of GDP)					
Budget balance	-1.0	-1.4	-6.2	-8.1	-4.7
Primary balance	0.4	-0.1	-4.9	-6.7	-3.2
Public debt	49.9	48.5	60.6	63.3	62.0
External accounts					
Current account balance (EUR bn)	-2.0	-2.5	-0.3	-0.8	-1.1
Current account balance/GDP (%)	-2.2	-2.7	-0.3	-0.8	-1.0
Extended basic balance/GDP (%)	0.0	0.2	-1.3	0.8	2.0
Net FDI (% of GDP)	1.3	2.2	-2.1	0.3	1.3
Gross foreign debt (% of GDP)	114.9	112.4	121.2	119.2	115.7
FX reserves (EUR bn)	EUR	EUR	EUR	EUR	EUR
Months of imports, goods & services	-	-	-	-	-
Inflation/monetary/FX					
CPI (pavg)	2.5	2.7	1.9	1.9	2.5
CPI (eop)	1.9	3.0	1.6	2.5	2.2
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

Source: Eurostat, NSI, UniCredit Research

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

Supply-chain bottlenecks slow the recovery

Household consumption to lead an economic recovery driven by rebounding confidence and pent-up demand…

… but low vaccination level may dampen recovery in the fall

The Slovak economy started to reopen in mid-April about a month earlier than we expected. As the number of COVID-19 cases decreased in March, household consumption rebounded despite non-food retail outlets being closed. Stronger consumer spending will lead the economic recovery in the coming quarters, driven by pent-up demand and the savings rate falling from the 1Q21 highs. Herd immunity in the country is unlikely to be reached before autumn as vaccinations have slowed due to low demand. This could lead to a potential third pandemic wave in the fall with restrictions temporarily slowing the recovery. Nevertheless, the third pandemic wave should have a milder economic impact than previous ones.

Several bottlenecks in supply chains raising volatility and endangering manufacturing growth

The manufacturing sector has proven resilient to the spring pandemic wave. The growth in the sector has been driven mostly by the car sector, followed by basic metals, which has received a new impulse in the form of tariffs on imports from China, Indonesia, Taiwan and, more recently, Turkey. However, supply-chain bottlenecks have disrupted the stable growth in manufacturing. The semiconductor shortage that emerged at the end of 1Q21 hampered local car production, especially in May. Several plants were forced to shut down production for several weeks (VW, JLR) with shortages of components likely to disrupt production at least until the late autumn.

Private investment to be supported by new investment in the car sector…

… public investment to restart in 2022 supported by EU budget and NGEU

Private investment could recover gradually from 2H21 onwards, supported by the EUR 1bn (1.1% GDP) investment of VW in a luxury car plant (VW Passat, Skoda Superb) with production scheduled to start in 2023. Transfers from the EU budget and the NGEU will boost public investment with a marked acceleration expected in 2022-23, driving the local construction sector. At the same time, residential real estate will still face supply issues as developers are waiting for an amendment to the Building Act, which is unlikely to be approved any time soon due to several controversies in the prepared draft.

Economy to reach pre-pandemic level at the turn of the year…

Unemployment to peak only in 2H21 but labor force shortage may re-emerge by the end of this year

We expect GDP to increase by 3.7% this year followed by 4% growth in 2022, reaching the pre-pandemic level at the turn of the year. Unemployment is likely to peak close to 8% in 2H21, just after the expected end of temporary furlough schemes. We do not expect it to return to the pre-pandemic level before 2H23 amid rising productivity. Nevertheless, as a result of regional disparities, labor shortages may re-emerge by the end of this year in the west of the country, especially in manufacturing. In a return to pre-pandemic conditions, labor immigration and wage pressure could rise again. Inflation will return above 2% level in the coming months, mostly due to base effects. After that, we believe reflation will be driven by tradable goods, pushed up by rising demand and input prices. Inflation should peak above 3% in 1Q22, supported by higher regulated energy prices. Renewed wage growth, which will be reflected in market services prices, should keep inflation above 2% throughout 2022.

2021 budget deficit increased, only partially driven by pandemic…

… fiscal tightening postponed until 2023

The 2021 budget deficit target has been increased by EUR 3.7bn of additional spending, from 7.4% of GDP to 10.3% of GDP, of which EUR 2.7bn is pandemic-driven, including EUR 300mn in reserves for a possible autumn pandemic wave. However, some chapters seem to overestimate spending so we expect the 2021 budget deficit to reach 8.1% of GDP. The government does not plan to undertake significant fiscal tightening next year, postponing fiscal consolidation to 2023 (the pre-election year). Public debt will remain anchored above 60% of GDP, exceeding all the debt brake thresholds, which remain deactivated at least until 2022. The governing coalition failed to agree on increasing the maximum tax burden.

Rising political instability increases likelihood of early elections…

… and endangers fiscal goals and reform progress

Growing tensions in the governing coalition threaten budget plans as well as the implementation of the reform plan to which the government has committed itself in the NGEU. The government still formally enjoys a constitutional majority in parliament, but disagreements within the coalition, as well as inside coalition parties, are growing. The probability of early elections is increasing. A referendum to hold early elections could be scheduled for September if the Constitutional Court approves it. However, the referendum is unlikely to succeed as it requires a turnout of 50%. A general election is currently scheduled for 2024 when the presidential elections should also take place. The next local elections are expected in autumn 2022.

Slovenia

A3 stable/AA- stable/A stable*

Outlook

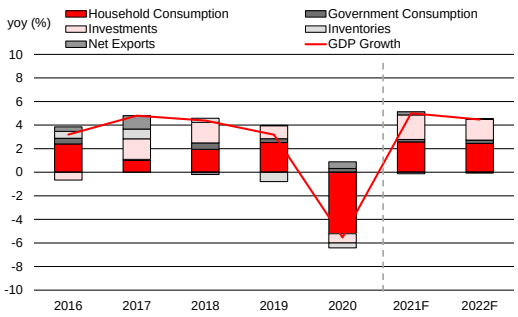
We are raising our GDP forecasts for 2021 from 4.2% to 5.0% due better-than-expected growth in 1Q21. We expect GDP growth to be driven by a rebound in consumption and investment, in particular public investment. In 2022, we see growth at 4.5%, driven by a boost from EU funding and faster growth in Slovenia's main trading partners. Around 60% of planned financing needs for 2021, estimated at EUR 7.6bn, have been covered, we do not see the country having difficulty in covering its remaining needs. Government bonds will be supported by ECB purchases. Political uncertainty has increased, but we expect general elections to take place as scheduled in 2022.

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

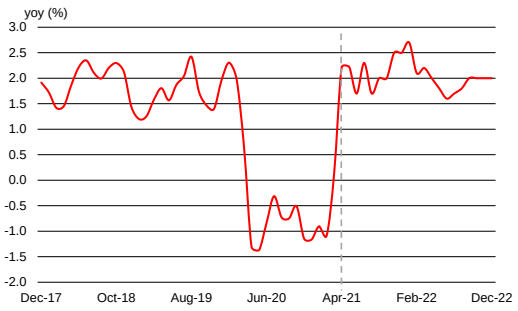
KEY DATES/EVENTS

- 31 Aug: 2Q21 GDP
- 9 Jul, 10 Aug, 10 Sep: Industrial production

GDP GROWTH FORECAST



INFLATION FORECAST



Source: SURS, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2018	2019	2020	2021F	2022F
GDP (EUR bn)	45.9	48.4	46.3	49.3	52.5
Population (mn)	2.1	2.1	2.1	2.1	2.1
GDP per capita (EUR)	22,135	23,165	22,014	23,384	24,896
Real economy, change (%)					
GDP	4.4	3.2	-5.5	5.0	4.5
Private Consumption	3.6	4.8	-9.7	5.0	4.8
Fixed Investment	9.6	5.8	-4.1	10.6	8.5
Public Consumption	3.0	1.7	1.8	1.1	1.5
Exports	6.3	4.1	-8.7	9.6	7.3
Imports	7.2	4.4	-10.2	10.4	8.0
Monthly wage, nominal (EUR)	1,681	1,754	1,858	1,933	2,010
Real wage, change (%)	1.4	2.6	6.2	2.6	2.0
Unemployment rate (%)	5.1	4.5	5.0	5.0	4.8
Fiscal accounts (% of GDP)					
Budget balance	0.7	0.4	-8.4	-8.5	-5.1
Primary balance	2.7	2.1	-6.7	-6.8	-3.5
Public debt	70.4	65.6	80.8	80.5	79.0
External accounts					
Current account balance (EUR bn)	2.7	2.7	3.3	3.5	3.5
Current account balance/GDP (%)	5.8	5.6	7.1	7.1	6.6
Extended basic balance/GDP (%)	9.3	8.2	8.2	9.9	9.5
Net FDI (% of GDP)	2.0	1.5	0.0	1.4	1.3
Gross foreign debt (% of GDP)	91.9	90.5	104.1	98.8	96.5
FX reserves (EUR bn)					
Months of imports, goods & services					
Inflation/Monetary/FX					
CPI (pavg)	1.9	1.7	-0.3	1.4	2.0
CPI (eop)	1.4	2.0	-1.2	2.5	2.0

Source: SURS, Eurostat, UniCredit Research

*long-term foreign-currency credit rating at Moody's, S&P and Fitch, respectively

Domestic demand driving the recovery

We are raising our growth projection for 2021

We are raising our GDP forecasts for 2021 from 4.2% to 5.0% due better-than-expected growth in 1Q21, driven by stronger-than-anticipated consumption and investment.

Recovery to be driven by consumption and investment

We expect GDP growth to be driven by a further rebound in consumption and investment. Two factors bode well for the recovery in consumption: **1.** household financial wealth rose during the crisis; and **2.** government measures contained job losses in most sectors. Investment will be supported by public spending, which is to increase by over 50%, from EUR 2bn to EUR 3bn, adding 2pp to growth. Private investment may lag behind due to uncertainty: lending to companies, which has been negative since August of last year, continued to contract (-3.6% yoy in April), while deposits are rising significantly (21% yoy).

Growth at 4.5% in 2022

In 2022, we see growth at 4.5%, supported by EU funding and faster growth in Slovenia's main trading partners.

Inflation likely to be volatile this year

The path of annual inflation this year is likely to be volatile due to base effects in energy prices and changes in the weights for calculating the index, amid upward pressure from international prices of food and raw materials. The base effects from last year's temporary reduction in electricity prices and the fall in oil prices, as well as a pick-up core inflation from -0.6% to 0.4% yoy, pushed inflation from -1.1% yoy in February to 2.4% yoy in May this year. Inflation could slow somewhat from here as the base effect from electricity prices will disappear and, according to the central bank, the changes in the weights in the inflation calculation could reduce average inflation for the year by 0.4pp, with the effect particularly pronounced in 3Q21. Upward pressure from international food and raw materials prices, and some strengthening of domestic demand could push inflation back to 2.5% yoy by year-end.

Large fiscal deficit in 2021 due to higher capital expenditure and support measure

The fiscal deficit will likely remain large in 2021, at 8.5% of GDP (vs. 8.4% in 2020) reflecting the extension of some of the support measures and a significant increase in capital expenditure. After implementing support measures worth EUR 2.8bn in 2020 (6% of GDP), the government estimates support will amount to EUR 1.3bn (2.7% of GDP) in 2021, including furlough and short-time work schemes, basic income for self-employed and partial compensation for fixed costs, bonuses for health-care staff and other critical workers, and tourism vouchers. Lower expenditure related to COVID-19 will be more than offset by a significant rise in public investment, from 4.2% of GDP in 2020 to 6.2% in 2021 (compared to an average of 3.6% of GDP from 2017 to 2019), although there are implementation risks. The government deficit is likely to narrow to around 5% in 2022 as the COVID-19 measures are phased out. Despite the large deficit in 2021, government debt is likely to narrow slightly due to a reduction in the government's cash buffers, and fall further in 2022.

Plenty of EU funding available to support the recovery

EU funding will play an important role in the recovery. In its Recovery and Resilience Plan, Slovenia applied for EUR 1.8mn of grants (2.1bn available), and EUR 666mn of loans (3.6bn available). The low amount of loans compared to the total available was explained by the fact the favorable market conditions have allowed it to borrow at negative interest rates. However the amount of loans could be increased if needed. In addition, Slovenia has still available funding from MFF 2014-20 (EUR 1bn) and MFF 2021-27 (EUR 3.3bn). The government expects RFF grants of EUR 300mn in 2021 and EUR 600mn in 2022 and RFF loans of EUR 36mn in 2022, with the remaining funding expected in the following years up to 2026.

No problem to cover funding needs

Around 60% of planned financing needs for 2021, estimated at EUR 7.6bn, have been covered, and we do not see the country having difficulty in covering the remaining needs. Slovenia has issued EUR 3.5bn in bonds and bills and has borrowed EUR 1bn from the EU SURE facility. To cover the rest of the financing needs it can roll over the bills expiring this year (EUR 1bn) and use its significant fiscal reserves. Slovenian government bonds will be supported by ECB purchases, which we estimate at around EUR 4.0bn in 2021. In 2022, we estimate financing needs of around EUR 4.2bn (EUR 1.5bn in repayments and EUR 2.7bn expected to cover the government deficit), which are likely to be covered with bond issuance. Slovenian bonds will likely continue to be supported by ECB purchases in 2022.

Election likely to take place as scheduled in 2022

Political uncertainty continues, with tensions between the opposition and the government. The government continues to rely on the external support of members of parliament representing minorities, the nationalist party (SNS) and three members of DeSuS to achieve a majority in the National Assembly. However, we expect general elections to take place as scheduled in 2022.

Bosnia and Herzegovina

B3 stable/B stable/not rated*

Outlook

Although the progress made in Bosnia and Herzegovina's vaccination campaign lags significantly behind other European countries, the third wave of the pandemic has started to diminish during 2Q21, allowing a somewhat stronger economic recovery than previously expected. However, we have lowered our GDP growth forecasts for 2021 to 3.2% from 4.0% and for 2022 to 3.9% from 4.5%. Since the 4.3% decline in economic activity in 2020 was much lower than previously estimated (5.2%), the bounce back will likely also be smaller. The recovery is expected to be driven by personal consumption, strong growth in export-oriented sectors of the economy and investment activity. Risks to our forecast are not only limited to a possible resurgence of COVID-19. In addition, there is continued risk from Bosnia and Herzegovina's unstable political environment and weak public institutions, as well as uncertainty surrounding an agreement with the IMF on a new financial-assistance arrangement worth about 4% of GDP.

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

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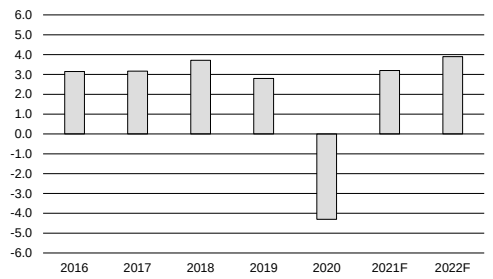
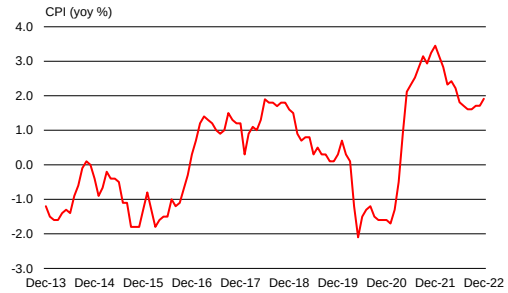
KEY DATES/EVENTS

- 20 Jul: GDP 1Q21
- 20 Jul: foreign trade Jun 2021
- 20 Jul: CPI Jun 2021
- 26 Jul: industrial production Jun 2021
- 30 Sep: balance of payments 2Q21

GDP GROWTH FORECAST



INFLATION FORECAST



Source: UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2018	2019	2020	2021F	2022F
GDP (EUR bn)	17.10	18.05	17.37	18.23	19.34
Population (mn)	3.50	3.49	3.48	3.47	3.46
GDP per capita (EUR)	4,891	5,169	4,986	5,250	5,590
Real economy, change (%)					
GDP	3.7	2.8	-4.3	3.2	3.9
Monthly wage, nominal (EUR)	697	727	755	775	801
Real wage, change (%)	1.7	3.7	4.9	1.0	1.2
Unemployment rate (%)	36.0	33.3	33.8	33.0	32.0
Fiscal accounts (% of GDP)					
Budget balance	1.5	2.1	-4.7	-4.2	-2.8
Primary balance	2.4	2.8	-3.9	-3.3	-1.9
Public debt	34.3	32.4	37.4	37.7	39.3
External accounts					
Current account balance (EUR bn)	-0.572	-0.556	-0.557	-0.735	-0.823
Current account balance/GDP (%)	-3.3	-3.1	-3.2	-4.0	-4.3
Extended basic balance/GDP (%)	0.6	-0.3	-0.4	-1.0	-0.9
Net FDI (% of GDP)	3.0	2.0	1.9	2.1	2.4
Gross foreign debt (% of GDP)	64.4	64.3	66.6	64.4	61.7
FX reserves (EUR bn)	5.9	6.4	7.1	7.1	7.1
Months of imports, goods & services	7.3	7.8	10.0	9.0	8.3
Inflation/monetary/FX					
CPI (pavg.)	1.4	0.6	-1.0	1.7	2.1
CPI (eop)	1.6	0.3	-1.6	3.4	1.9
1M money-market rate (Dec. avg.)	-0.36	-0.44	-0.55	-0.57	-0.47
USD/FX (eop)	1.71	1.75	1.59	1.60	1.56
EUR/FX (eop)	1.96	1.96	1.96	1.96	1.96
USD/FX (pavg.)	1.66	1.75	1.72	1.63	1.58
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 are provided by Moody's, S&P and Fitch, respectively.

Recovery has begun somewhat earlier than expected

Third wave of pandemic has started to diminish much earlier than expected, despite a low vaccination rate, enabling the start of an economic recovery

Bosnia and Herzegovina's economic recovery in 1H21 seems to be somewhat stronger than we expected, due to the earlier relaxation of restrictive measures. Our fear that the recovery could be threatened by a third wave of the COVID-19 pandemic fortunately did not materialize. Although the progress made in Bosnia and Herzegovina's vaccination campaign lags significantly behind other European countries (by the beginning of June, only around 10% of the population had been vaccinated, only 2% of which with two doses), the third wave of the pandemic started to diminish already at the beginning of April, allowing the authorities to relax restrictive measures much earlier than expected and enabling an almost complete reopening of the worst hit services sectors of the economy and their recovery. As significant quantities of vaccines did not begin to arrive in the country until April and May (through the World Health Organization's Covax vaccine-distribution scheme), the vaccination campaign is only just beginning to gather steam. We expect that as the vaccination program accelerates, the risks associated with the resurgence of the infection will be further reduced.

We have lowered our forecasts of GDP growth for 2021 and 2022 to 3.2% and 3.9% (from 4.0% and 4.5%), respectively, expecting smaller bounce back as the 4.3% decline in 2020 was much lower than the expected 5.2%

The main drivers of growth should be construction activity and activity in export-oriented manufacturing sectors, followed in 2022 by a stronger recovery in personal consumption

Despite the somewhat stronger-than-expected recovery in recent months, we have lowered our GDP growth forecasts for 2021 to 3.2% from 4.0% and for 2022 to 3.9% from 4.5%. Since the 4.3% decline in economic activity in 2020 was much lower than the 5.2% previously estimated, the bounce back will likely also be smaller. In 1Q21, according to available data year-on-year economic activity was probably still marginally in negative territory. In the remainder of 2021, we expect the recovery to be driven primarily by an acceleration in exports of goods and services and stronger growth in construction activity, as well as a mild recovery in personal consumption and some recovery in the service sectors of the economy. GDP growth is expected to speed up in 2022, additionally supported by a more-pronounced recovery in personal consumption as the increase in remittances is expected to accelerate and investment in construction activity will likely outperform activity in other sectors thanks to large ongoing infrastructure projects, especially those involving motorways and power plants.

Bosnia and Herzegovina's C/A deficit is likely to widen from -3.2% of GDP in 2020 to -4.0% in 2021 and should be covered by financing from international financial institutions and the EU and by FDI inflows

The C/A deficit is likely to widen as the recovery takes hold, but we see no issues in financing the gap. The C/A deficit in 2020 was unexpectedly small, at 3.2% of GDP, in nominal terms, exactly equal to those realized in pre-pandemic 2019. That was the result of the least negative trade balance recorded in the last twenty years, as significant decrease in merchandise exports (-7.6%) was markedly outweighed by the huge decline in merchandise imports (-13.3%). This positive effect was completely offset by a negative balance in the exchange of services, including remittances. However, due to the structural characteristics of the economy, we expect that imports of goods will outperform exports in the years of significant recovery of economic activity, leading to a widening of the C/A deficit (to 4.0% of GDP in 2021 and 4.3% of GDP in 2022). More than half of the projected C/A deficit is expected to be covered by FDI (2.1% of GDP in 2021) and the rest by IMF, EU and IFIs financing. In that regard, the IMF recently announced about EUR 300mn (1.6% of GDP) of unconditional support to Bosnia and Herzegovina as part of the general SDR allocation to all IMF members to support liquidity and economic recovery, and the EU announced the first tranche of its support of about EUR 250mn. The second tranche of EU financing of the same amount is conditional on the realization of reforms and a new arrangement with IMF.

A new arrangement with the IMF is expected to catalyze financing from other international financial institutions and the EU

Bosnia and Herzegovina's fiscal position remains sustainable despite a widening fiscal gap due to the pandemic

Since IMF financing plays a vital role in catalyzing financial assistance from the international community, it is very important to maintain its presence through a new arrangement (in an amount equal to more than 4% of GDP), which Bosnia and Herzegovina's authorities and the IMF are expected to conclude this year after the failure of negotiations at the end of last year. However, possible further delays represent a downside risk to our growth projections, as does the generally unstable political environment and weak public institutions. Nevertheless, the fiscal position remains sustainable, despite an estimated fiscal deficit of around 4.7% of GDP in 2020 and 4.2% of GDP in 2021.

North Macedonia

Not rated/BB- stable/BB+ neg*

Outlook

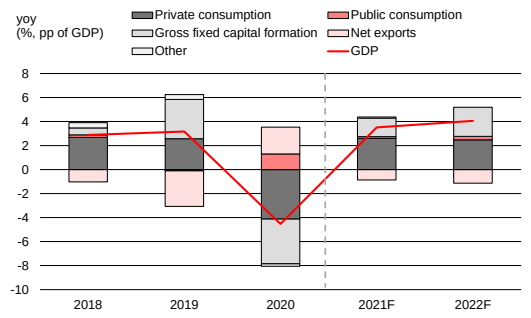
We expect GDP growth to amount to 3.5% in 2021 and 4.1% in 2020, after GDP contracted by 4.5% in 2020. The main driver of growth will likely be public investment and consumption. North Macedonia's fiscal deficit will likely narrow to 5% of GDP in 2021, with government debt increasing further. North Macedonia is unlikely to issue more debt internationally in 2021; remaining funding needs are likely to be covered by domestic issuance, international financial institutions and fiscal reserves. We expect the country's dispute with Bulgaria to be resolved and EU accession negotiations to be formally opened in 2H21.

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

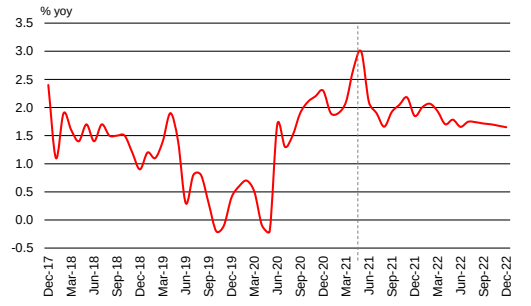
KEY DATES/EVENTS

- 7 Jun: 1Q21 GDP
- 29 Apr, 31 May, 30 Jun: industrial production
- 7 May: rating update by Fitch

GDP GROWTH FORECAST



INFLATION FORECAST



Source: state statistics office, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2018	2019	2020	2021F	2022F
GDP (EUR bn)	10.7	11.2	10.8	11.4	12.1
Population (mn)	2.1	2.1	2.1	2.1	2.1
GDP per capita (EUR)	5,116	5,318	5,135	5,418	5,739
Real economy, change (%)					
GDP	2.9	3.2	-4.5	3.5	4.1
Private consumption	3.7	3.5	-5.6	3.6	3.4
Gross capital formation**	1.7	9.5	-10.2	4.5	7.0
Public consumption	1.5	-0.8	10.1	1.0	2.0
Exports	12.8	7.2	-10.9	13.4	8.1
Imports	10.7	8.9	-10.5	10.9	7.3
Monthly wage, nominal (EUR)	579	609	660	693	727
Real wage, change (%)	4.2	4.3	7.0	2.8	3.2
Unemployment rate (%)	20.7	17.3	16.4	16.8	16.4
Fiscal accounts (% of GDP)					
Budget balance (central government)	-1.8	-2.0	-8.1	-5.0	-3.6
Primary balance (central government)	-0.6	-0.8	-6.9	-3.9	-2.5
Government debt (general government)	40.6	40.2	51.0	53.5	54.2
External accounts					
Current account balance (EUR bn)	0.0	-0.4	-0.4	-0.4	-0.4
Current account balance/GDP (%)	-0.1	-3.3	-3.5	-3.1	-3.1
Extended basic balance/GDP (%)	5.7	0.0	-1.5	-0.8	-0.4
Net FDI (% of GDP)	5.6	3.3	1.9	2.2	2.7
Gross foreign debt (% of GDP)	73.0	72.7	80.2	83.0	82.0
FX reserves (EUR bn)	2.9	3.3	3.4	3.7	3.7
Months of imports, goods & services	4.4	4.6	5.3	5.1	4.7
Inflation/monetary/FX					
CPI (pavg)	1.5	0.8	1.2	2.1	1.8
CPI (eop)	0.9	0.4	2.3	1.8	1.6
Central bank target	-	-	-	-	-
Central bank reference rate (eop)	2.50	2.25	1.50	1.25	1.25
USD-MKD (eop)	53.7	55.0	50.2	50.5	49.3
EUR-MKD (eop)	61.50	61.5	61.7	61.6	61.6
USD-MKD (pavg)	52.2	55.0	52.6	50.4	49.9
EUR-MKD (pavg)	61.5	61.5	61.6	61.6	61.6

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

Source: state statistics office, ministry of finance, National Bank of the Republic of North Macedonia, Bloomberg, UniCredit Research

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

Recovery and formal opening of EU accession negotiations

We expect GDP growth to amount to 3.5% in 2021 and to 4.1% in 2022

We expect GDP growth to amount to 3.5% in 2021, after GDP contracted by 4.1% in 2020. As expected, economic growth deteriorated in 1Q21. However, we expect a recovery to gather momentum as the year advances, supported by the easing of restrictions and economic recovery by North Macedonia's main trading partners. In 2022, growth could strengthen to around 4%, driven by the economic recovery in North Macedonia's main trading partners and higher domestic demand.

Public investment will be an important driver of growth

We confirm public investment as an important driver of growth. North Macedonia's budget includes a significant increase in capital spending of close to 50%. This would raise spending from 2.4% of GDP to 3.5% of GDP, boosting growth by around 1pp in 2021. Planned spending focuses on road and railway projects, energy and utility projects and projects in other areas, such as health care and education. As in previous years, the main risks are related to implementation. Private investment may take longer to recover. While growth in lending to companies is likely to remain modest (2.1% yoy in May). Sectoral support measures and a EUR 100mn soft-loan credit line from the Development Bank of North Macedonia could support lending to companies in 2021.

Consumption is likely to rebound once restrictions are eased

We expect consumption to rebound once restrictions are eased further. This is also supported by increases in public-sector wages, pensions and probably also in the minimum wage. The budget envisages an increase in wages and allowances of over 5% and in social transfers of 2.4%.

Inflation is likely to slow to around 2% in the reminder of the year

We expect inflation to slow towards 2% from June and to hover around that level for the reminder of the year. After remaining around 2% between September 2020 and March 2021, inflation reached 3% yoy in May, driven by base effects in oil prices and, to a much lesser extent, by food prices and some core inflation items. We expect inflation to slow to around 2% in the remainder of the year as the effect on annual inflation of last year's hike in electricity prices will disappear in August, and the contribution of fuel inflation will diminish. This will likely more than offset upward pressure from food prices and prices for raw materials.

The deficit should narrow in 2021, but government debt is likely to continue to increase

The central government's deficit as a percentage of GDP is likely to narrow from around 8% to 5% in 2021, reflecting improvement in the economic outlook and the expiration of most support measures. The fifth support package was approved in April, and it is worth EUR 160mn, or 1.5% of GDP, after a package worth close to 10% of GDP was approved in 2020. The package includes, among other measures, wage support for the most affected companies, the extension of personal income-tax advances to the end of June and sector support, all of which should help buoy the economy until a recovery gathers momentum. According to the government, 82% of the measures announced in 2020 and 2021 have been implemented, and the aim is to implement the remaining measures during the rest of the year. Large deficits in 2021 and 2022 mean that government debt will likely increase in these two years. Looking further ahead, North Macedonia's fiscal consolidation plan targets a reduction in the government deficit to 2.5% of GDP by 2025 through the improvement of revenue collection and a reduction in, and restructuring of, current expenditure.

Remaining funding needs for 2021 are to be covered by domestic issuance and funding from international financial institutions

We expect North Macedonia's remaining financing needs for 2021 to be covered by fiscal reserves, domestic issuance and funding from international financial institutions. We estimate financing needs for the reminder of the year amount to around EUR 1bn, which we expect to be covered in part by fiscal reserves (total available EUR 1bn), the remaining planned domestic borrowing (EUR 250mn) and loans from financial institutions (EUR 100mn, but this could be higher in case there is need). In 2022, financing needs will likely be lower due to lower repayments and a smaller deficit. We expect EU funding to play an increasing role considering an announced economic and investment plan for the Western Balkans.

Formal start of EU accession negotiations likely in 2H21

Formal EU accession negotiations are likely to get underway in 2H21, after having been blocked again by a dispute with Bulgaria at the European Council's meeting in June – Bulgaria vetoed the opening of such negotiations due to a dispute involving historical, identity and language issues. Bulgaria argues that North Macedonia has not honored a 2017 treaty to improve bilateral ties.

Russia

Baa3 stable/BBB- stable/ BBB stable*

Outlook

We expect GDP to grow by 3.4% in 2021 and 2.6% in 2022, with activity returning to pre-COVID levels already this year and the negative output gap closing in 2022. Consumption will lead the recovery, helped by a lower savings rate and rising consumer lending. While inflation momentum is likely to weaken from here on, the CBR could raise the policy rate to 6.5% this year, cutting it back to 5.5% in 2022 if inflation returns to target. High commodity prices and lower geopolitical risks support the RUB.

Strategy

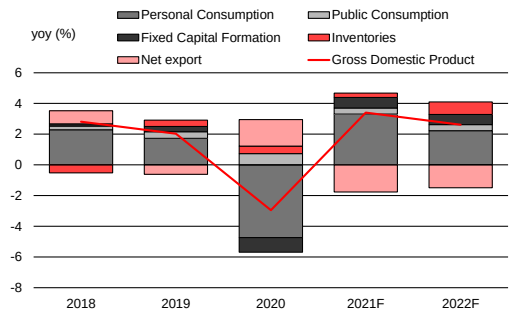
OFZs could outperform other EM bonds in 2H21, helped by low funding needs, the hawkish CBR and attractive valuations.

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

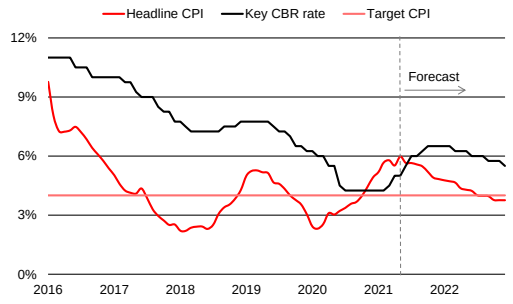
KEY DATES/EVENTS

- 7 Jul, 5 Aug, 8 Sep: CPI
- 23 Jul, 10 Sep: monetary policy meetings
- 18-22 of each month: monthly economic data
- 19 Sep: Duma elections

GDP GROWTH FORECAST



INFLATION FORECAST



Source: CBR, Rosstat, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2018	2019	2020	2021F	2022F
GDP (EUR bn)	1,404.4	1,506.3	1,292.7	1,329.1	1,419.6
Population (mn)	147.0	147.0	147.0	146.9	146.9
GDP per capita (EUR)	9,555	10,247	8,795	9,046	9,666
Real economy, change (%)					
GDP	2.8	2.0	-3.0	3.4	2.6
Private consumption	4.3	3.2	-8.6	6.4	4.1
Fixed investment	0.6	1.5	-6.2	3.2	3.1
Public consumption	1.3	2.4	4.0	2.0	2.0
Exports	5.6	0.9	-5.1	2.0	5.0
Imports	2.7	3.5	-13.7	10.6	12.0
Monthly wage, nominal (EUR)	591	674	628	643	686
Real wage, change (%)	8.5	4.8	2.5	2.5	2.0
Unemployment rate (%)	4.8	4.6	5.9	5.5	5.0
Fiscal accounts (% of GDP)					
Budget balance	2.6	1.8	-3.8	1.1	0.7
Primary balance	3.4	2.5	-3.1	1.9	1.5
Public debt	12.1	13.2	18.5	17.8	18.3
External accounts					
Current account balance (EUR bn)	96.4	58.4	28.5	76.1	64.1
Current account balance/GDP (%)	6.9	3.9	2.2	5.7	4.5
Extended basic balance/GDP (%)	5.5	4.5	2.0	5.5	4.5
Net FDI (% of GDP)	-1.4	0.6	-0.2	-0.2	-0.1
Gross foreign debt (% of GDP)	28.2	29.1	29.8	28.0	25.3
FX reserves (EUR bn)	324.2	386.4	363.9	398.8	420.5
Months of imports, goods & services	11.3	13.1	14.4	14.2	13.4
Inflation/monetary/FX					
CPI (pavg.)	2.9	4.5	3.4	5.3	4.3
CPI (eop)	4.3	3.0	4.9	4.8	3.8
Central bank target	4.0	4.0	4.0	4.0	4.0
Central bank reference rate (eop)	7.75	6.25	4.25	6.50	5.50
3M money market rate (Dec avg.)	8.55	6.60	4.93	6.75	5.75
USD-RUB (eop)	69.5	61.9	73.9	69.5	70.5
EUR-RUB (eop)	79.5	69.3	90.7	84.8	88.1
USD-RUB (pavg.)	62.7	64.7	72.2	72.4	69.9
EUR-RUB (pavg.)	74.0	72.5	82.5	86.9	86.7

Source Rosstat, CBR, UniCredit Research

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

Faster recovery powered by private-sector leveraging

Economic recovery underway…

Russia's economic recovery accelerated in 1Q21, registering a contraction of just 1% compared to 1Q20, which was affected by the COVID-19 pandemic only in second half of March 2020. Despite starting its vaccination campaign in early January, Russia only managed to administer at least one shot to just over 20% of the population by June. That said, existing restrictions are relatively mild and are being gradually lifted, with business surveys pointing to their highest levels of activity since the spring of 2019. However, the rapid recovery triggered supply chain bottlenecks in many sectors, resulting in longer delivery times, supply shortages and rising pressure on input prices. The input-price sub-index of the manufacturing PMI has been at elevated levels last seen in 2015 for several months already.

…despite limited vaccination success.

Business activity highest since 2019, resulting in supply shortages.

Labor market conditions particularly tight…

Unlike in the 2014-16 crisis, and uncommonly for Russia, the labor market reaction was very flexible, with firms rapidly reducing labor demand in the first months of the crisis only to restore it quickly during the post-pandemic rebound. Unemployment is not yet back to pre-COVID-19 levels of below 5%, but is falling fast, reaching 5.2% in April, while labor demand is growing at its fastest pace in ten years. Yet, the low-skilled labor market, where migrants represented a large share of labor supply, continues to be heavily affected by COVID-19. Many migrants had to leave Russia during the initial stages of the pandemic and are struggling to get back due to borders being closed. Anecdotal evidence indicates that labor shortages in construction amount to 1-1.5mn workers. Highlighting the severity of this problem, the government is discussing the deployment of prison labor in infrastructure projects.

…especially in construction sector, which is heavily reliant on migrants,…

…might lead to delays in realization of infrastructure projects.

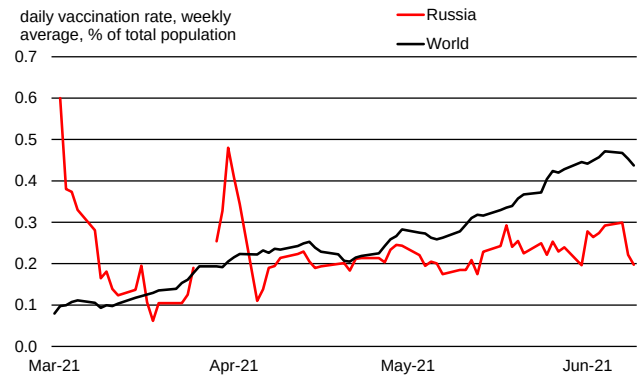
This might delay the implementation of national projects and infrastructure construction programs, and, thus, the more sustained investment recovery. We still think that investment will be the main driver of growth beyond 2022 if the government manages to roll out its ambitious investment programs and implement public-private partnership schemes.

Consumers lead the recovery…

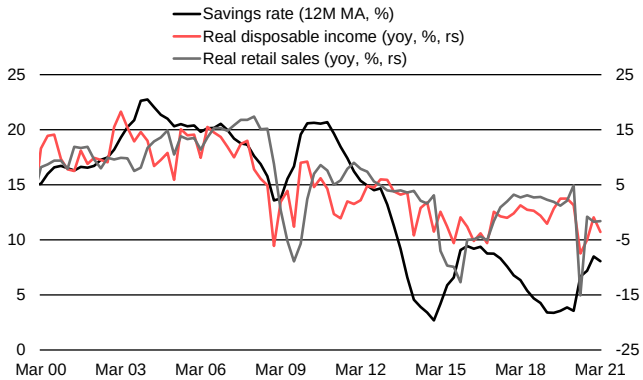
In 2021-22, economic growth will mostly be driven by consumption, where the recovery is in full swing. High-frequency indicators suggest that retail sales recovered to above pre-COVID levels in 2Q21. Household demand growth is not supported by a recovery in real disposable income (which is still falling in annual terms, despite positive real wage growth) but by a faster-than-expected reduction in the household savings rate to the very low levels prevalent before the pandemic. The quarterly savings rate was close to its historical all-time low in 1Q21, while uncollateralized household lending has been accelerating in 2021, growing by almost 20% yoy in April compared to 13-14% yoy in 2H20. Furthermore, a ban on popular overseas tourist destinations (e.g. Turkey) creates additional savings and demand for durable goods.

…by lowering savings rates.

VACCINATION SPEED IS TRAILING GLOBAL AVERAGE



CONSUMPTION SUPPORTED BY DECLINING SAVINGS



Source: Oxford University, Yandex, Rosstat, UniCredit Research

GDP could grow by 3.4% in 2021 and 2.6% in 2022

Demand for cars was already 2% higher in Jan-May 2021 than in a very successful 2019. Investment in home improvement is at an all-time high, partly a consequence of last year's rapid increase in mortgage lending. A faster-than-expected recovery in the labor market and a decline in the savings rate are the reasons for upgrading our private consumption and GDP forecasts. We now expect GDP to grow by 3.4% yoy in 2021 and by 2.6% in 2022.

Inflation accelerated due to both global and local factors…

Stronger domestic demand and supply disruptions resulted in more persistent inflation pressure than we had expected. Prices are increasing above target not only due to past RUB depreciation and higher food prices globally, but also due to increasing costs and elevated inflation expectations. In recent months, corporate inflation expectations exceeded the previous highs of 2014-15, with households also expecting inflation to accelerate further.

…but could run out of steam in 2H21

In our view, inflation momentum will inevitably run out of steam: last year's RUB depreciation is already reflected in prices, demand pressure on prices will decline once the savings rate returns to pre-COVID levels and food prices could stabilize if there is a bumper harvest in Europe (as expected). However, disinflation might take longer than we expected and we raised our inflation forecasts to 4.8% yoy in 2021 and 3.8% in 2022.

CBR eager to front-load rate hikes to prevent inflation spiral

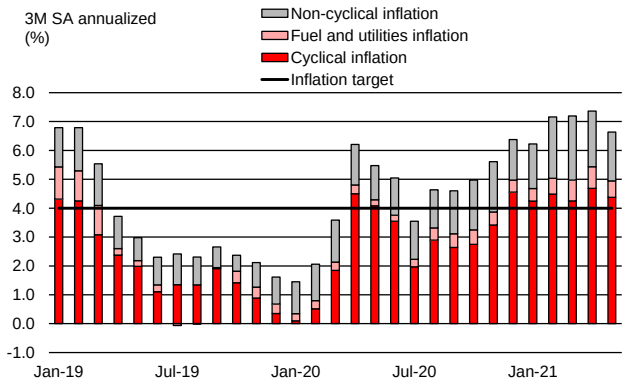
The CBR decided to react to inflationary supply shocks in order to prevent a vicious cycle of higher costs – higher inflation expectations – persistently higher inflation. The central bank delivered 125bp of hikes between March and June, taking the key rate to 5.50%. More hikes are likely to follow, we now expect the CBR to take the key rate to 6.50% before year-end and, thus, outside the "neutral" band of 5-6%. If disinflation continues next year, as expected, the key rate could be cut to 5.50%, in a return to the middle of the range.

RUB still has room to appreciate.

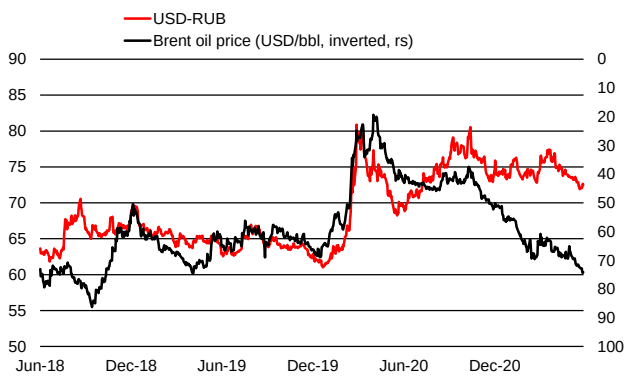
The RUB was supported by high oil prices and favorable global economic conditions in 1H21 but additional restrictions imposed by the US on OFZ purchases prevented a faster appreciation. We still consider the ruble to be somewhat undervalued and think USD-RUB could test 70 and remain close to current levels in 2022, helped by rising commodity prices, higher oil exports and portfolio investment being supported by attractive OFZ valuations.

The 16 June meeting between presidents Joe Biden and Vladimir Putin failed to yield clear conclusions, which were unlikely given the summit's vague agenda. We believe that geopolitical tensions are unlikely to escalate, unless tensions rise in Ukraine or the Middle East. This might not prevent the hawkish Congress from pursuing an agenda of additional sanctions, but their scope and effects are likely to be limited. The completion of Nord Stream 2 was met with resignation by US authorities and is now a closed chapter.

INFLATION MOMENTUM REMAINS WELL ABOVE TARGET



THE RUB IS UNDERVALUED AT CURRENT OIL PRICES



Source: CBR, Rosstat, Bloomberg, UniCredit Research

Upside for OFZ in a volatile EM environment

Foreign holdings of OFZs close to post-Crimea-crisis lows

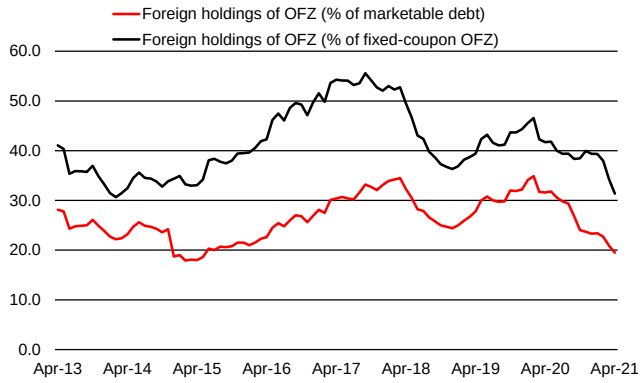
OFZs could outperform other EM bonds in 2H21, helped by low funding needs,…

…the hawkish CBR…

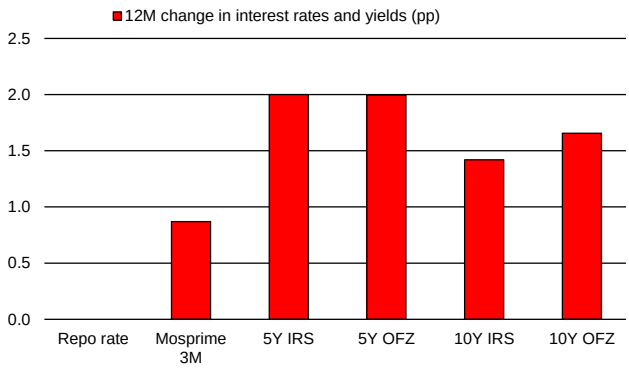
… and attractive valuations.

In April, US investors were banned from participating in the primary market for Russian government bonds. As a result, the foreign holdings of fixed-coupon OFZ approached the lows registered after the Crimean crisis. The scope for a further decline is limited, in our view, and OFZ could outperform other EM bonds in 2H21. The first reason is financing needs. Less than a third of the government's planned 2021 bond issuance of RUB 2.2tn remains to be covered in 2H21. The second reason is hawkish monetary policy, which is likely to stabilize inflation. Investors seem to prefer proactive central banks when purchasing EM bonds. The CBR is likely to be the first central bank to end its rate hiking cycle and deliver sustainable cuts next year. The third reason is valuation. The OFZ curve sold off 50-100bp more than the CBR is likely to hike. As the pricing in of geopolitical risks has declined somewhat and future cuts start to be priced in, there is room for the belly and the long end of the OFZ curve to rally. In addition, the RUB could be more stable than other EM currencies amid discussions of policy normalization in the US and Europe.

FOREIGN OFZ HOLDINGS CLOSE TO POST-CRIMEA-CRISIS LOWS



HAWKISH CBR BODES WELL FOR OFZ PRICES



Source: Russian Ministry of Finance, CBR, UniCredit Research

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2020	2020F	2021F
Gross financing requirement	**61.5**	**-2.8**	**4.8**
Budget deficit	49.7	-14.7	-9.7
Amortization of public debt	11.8	11.9	14.5
Domestic	7.0	11.3	12.2
Bonds	7.0	11.3	12.2
Bills	--	--	--
Loans	0.0	0.0	0.0
External	4.8	0.6	2.2
Other	0.0	0.0	0.0
Financing	**61.5**	**-2.8**	**4.8**
Domestic borrowing	62.9	42.8	36.6
Bonds	62.8	42.2	36.0
Bills	--	--	--
Loans	0.1	0.6	0.7
External borrowing	3.6	3.5	2.7
Bonds	3.6	3.5	2.7
Privatization	0.0	0.0	0.0
Revaluation	0.0	0.0	0.0
Change in budget accounts, "-": increase	-4.9	-49.1	-34.6

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2020	2021F	2022F
Gross financing requirement	**64.4**	**8.7**	**16.8**
C/A deficit	-27.8	-76.1	-64.1
Amortization of medium and long term debt	41.7	46.7	46.5
Government/central bank	3.5	3.6	4.3
Banks	3.0	3.5	3.5
Corporates/Other	35.2	39.7	38.6
Amortization of short-term debt	50.5	38.1	34.5
Financing	**64.3**	**8.7**	**16.8**
FDI (net)	-2.8	-2.9	-0.9
Portfolio investments (net)	-21.4	-18.7	-19.6
Medium and long-term borrowing	22.9	34.7	40.7
Government/central bank	6.3	1.3	5.3
Banks	-20.2	-10.1	-5.6
Corporates/Other	36.8	43.5	41.0
Short-term borrowing	40.1	35.6	32.9
other investment (net)	13.4	-4.9	-4.9
Change in FX reserves (- = increase)	12.1	-35.1	-31.5
Memoranda:			
Nonresident purchases of LC gov't bonds	1.8	-2.5	0.8
International bond issuance, net	-1.2	2.9	0.5

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

Serbia

Ba2 stable/BB+ stable/BB+ stable*

Outlook

We expect GDP growth 7.0% in 2021 and 4.5% in 2022. The new fiscal package and higher capital expenditure are likely to bring the government deficit to 7% of GDP this year and push debt slightly above 60% of GDP before stabilizing in 2022. We expect inflation to remain in the target range but higher compared to previous forecasts. We do not envisage any policy rate hikes in 2021-22. The government will continue to focus on normalizing relations with Kosovo and on its EU accession. A new IMF program was announced in June.

Strategy

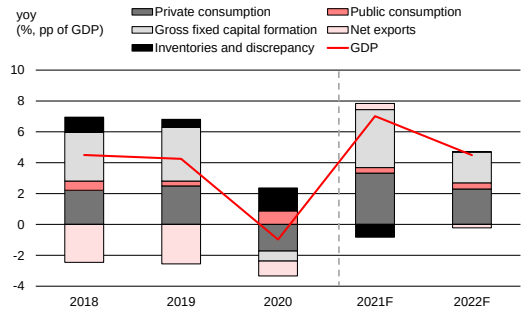
Higher real yields compared to most countries in the region and a stable currency could support government bonds.

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

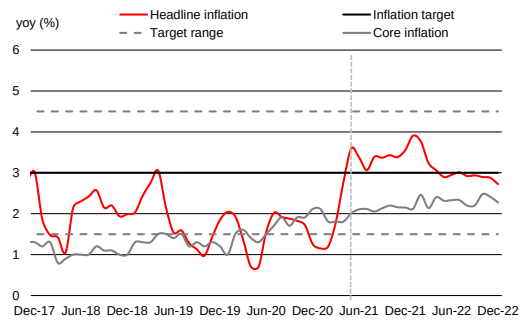
KEY DATES/EVENTS

- 8 Jul, 12 Aug, 9 Sep: NBS monetary policy meetings
- 7 Jul, 12 Aug, 13 Sep: CPI inflation
- 31 Aug: 2Q21 GDP
- 3 Sep: Fitch to update sovereign rating
- 10 Sep: Moody's to update sovereign rating

GDP GROWTH FORECAST



INFLATION FORECAST



Source: SORS, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2018	2019	2020	2021F	2022F
GDP (EUR bn)	42.9	46.0	46.5	51.2	54.8
Population (mn)	7.0	6.9	6.9	6.9	6.8
GDP per capita (EUR)	6,143	6,618	6,727	7,448	8,027
Real economy, change (%)					
GDP	4.5	4.2	-1.0	7.0	4.5
Private consumption	3.1	3.6	-2.5	4.9	3.4
Fixed investment	17.5	17.2	-2.8	16.8	8.2
Public consumption	3.7	2.0	5.6	2.1	2.5
Exports	7.5	7.7	-5.9	12.3	9.4
Imports	10.8	10.7	-3.5	9.4	8.2
Monthly wage, nominal (EUR)	580	643	706	749	788
Real wage, change (%)	2.0	8.5	7.8	3.2	2.1
Unemployment rate (%)	13.3	10.9	9.5	11.1	10.0
Fiscal accounts (% of GDP)					
Budget balance	0.6	-0.2	-8.1	-7.0	-3.0
Primary balance	2.8	1.8	-6.1	-5.1	-1.2
Public debt	54.4	52.9	58.2	60.3	59.8
External accounts					
Current account balance (EUR bn)	-2.1	-3.2	-2.0	-2.1	-2.2
Current account balance (% of GDP)	-4.8	-6.9	-4.3	-4.1	-4.0
Extended basic balance/GDP (%)	2.5	0.8	2.0	1.5	1.4
Net FDI (% of GDP)	7.4	7.7	6.2	5.6	5.5
Gross foreign debt (% of GDP)	62.2	61.5	66.3	66.9	65.2
FX reserves (EUR bn)	12.1	13.5	13.8	15.1	15.6
Months of imports, goods & services	5.8	5.8	6.3	6.1	5.7
Inflation/Monetary/FX					
CPI (pavg)	2.0	1.8	1.6	2.8	3.1
CPI (eop)	2.0	1.8	1.3	3.6	2.7
Central bank target	3.0	3.0	3.0	3.0	3.0
Central bank reference rate (eop)	3.00	2.25	1.00	1.00	1.00
3M money market rate (Dec avg)	3.04	1.67	0.94	0.90	1.00
USD/FX (eop)	103.4	104.9	95.7	96.4	94.2
EUR/FX (eop)	118.2	117.6	117.6	117.6	117.8
USD/FX (pavg)	100.2	105.2	103.2	97.8	94.9
EUR/FX (pavg)	118.3	117.9	117.6	117.6	117.6

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

Stronger growth

We revise up 2021 GDP growth from 4.2% to 7.0%

We revise our 2021 GDP growth forecast up from 4.2% to 7.0%. This revision reflects stronger-than-expected growth in 1Q21, driven mainly by net exports and investment, and higher planned government investment. The strong economic performance in 1Q21 implies that real GDP has already returned to its pre-pandemic level.

Consumption supported by higher incomes and government measures

We confirm our expected drivers of growth in 2021: consumption and investment. Consumption will likely be supported by: **1.** wage and pension increases; **2.** the contained increase in unemployment so far; **3.** new measures to support workers; **4.** pent-up demand as households are likely to reduce savings rates. The government plans to raise the public sector wage bill by 6.5%, pensions by 5.9% and the minimum wage by 6.6%, which will support household incomes. That said, the number of unemployed increased again in January-April after declining for a few months last year. This could reflect various temporary factors. First, the constraints on employers regarding laying off employees were ended in January and February and the new support measures only started in March. Second, it could be related to the pandemic wave that affected services in particular during the spring. Third, some people likely registered as unemployed to benefit from the new support measures. In May, the number of persons employed fell again.

Public investment again an important driver

Investment will be the main driver of growth. According to the 2021 budget, the central government plans to invest RSD 430bn (or 7.5% of GDP) mainly in infrastructure projects, a 45% increase on 2020, which we estimate could contribute over 2pp to GDP growth. The main risk of such an ambitious plan is implementation. Private investment will also contribute to growth, driven by the recovery in exports and confidence in the second part of the year, low interest rates and two new government guarantee schemes worth EUR 1bn in total.

Net exports will likely provide a small positive contribution

We believe net exports will provide a small positive contribution to GDP growth, although we expect the recovery in exports to be partly offset by a rebound in imports related to the recovery in consumption and investment.

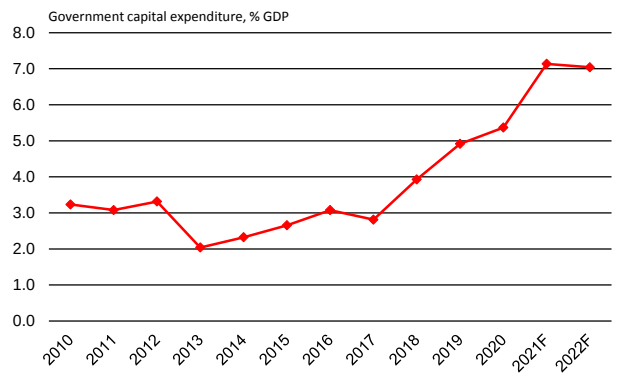
Growth at 4.5% in 2022

In 2022, we see growth of 4.5%, supported by domestic demand and a further rebound in Serbia's main trading partners.

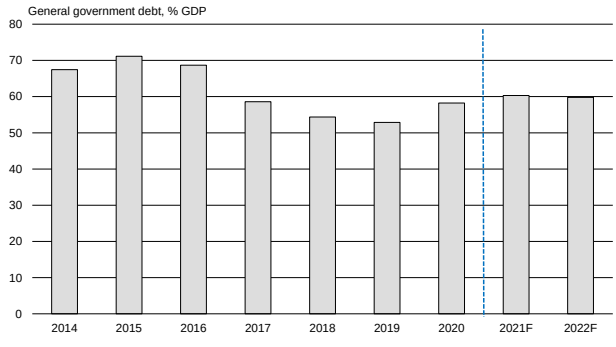
Larger deficit in 2021 mainly due to new fiscal package and higher capital expenditure

The government revised up their fiscal deficit forecast for 2021 in April from 3% of GDP to 7% (from EUR 1.5bn to EUR 3.5bn), which is the same as our new forecast. The revision reflects higher expenditure due to the fiscal package announced after the 2021 budget, which includes direct measures worth EUR 1.2bn (and EUR 1bn in guarantees), and higher capital expenditure (an additional EUR 750mn). We expect this deficit to push general government debt from 58.2% of GDP to above 60% by the end of the year. In 2022, we believe the deficit could narrow to 3%, resulting in government debt as a percentage of GDP falling slightly.

SINGIFCANT GOVERNMENT INVESTMENT ENVISAGED



GOVERNMENT DEBT TO START STABILIZING NEXT YEAR



Source: SORS, Haver, UniCredit Research

Inflation likely to remain slightly above target in 2021

Inflation is likely to remain above the central bank target of 3% for the remainder of the year. We revised higher our inflation forecast mainly due to volatile and processed food prices, the latter reflecting rises in global food prices. Inflation could slow slightly over the summer due to base effects from food and oil prices before rising again to around 3.5% by year-end. We assume core inflation will remain around 2.0% yoy in the coming months as a negative base effect from communication as well as recreation and culture prices could be offset by the impact of higher producer prices on consumer prices. In the first months of 2022, inflation could increase due to base effects in food prices before returning to the central target in 2Q22, with core inflation on a gradual upward trend. The main risks to the outlook are oil prices and global supply-chain disruptions.

Rate hike unlikely

We see a low likelihood of changes in monetary policy given that the increase in inflation experienced in recent months has been due to supply shocks and the target range is wide enough to accommodate further surprises. An interest-rate hike could be triggered in a scenario with significantly faster GDP growth, leading to a positive output gap and pushing headline and core inflation above target.

Current account

The current account deficit will likely remain large but we do not foresee financing risks. After narrowing to 4.3% of GDP in 2020, the current account deficit narrowed further in 1Q21 to around 2% of GDP (12-month rolling average) as the recovery in exports was not matched by imports. We expect imports to pick up again, bringing the deficit to 4.0% in 2021. We expect the current account deficit to be financed through FDI, which remained very resilient in 2020 at over 6% of GDP. The dinar is likely to remain stable, with the NBS intervening to preserve the stability of the currency if pressure arises. FX reserves remain comfortably high.

A new IMF program

A new two-year IMF program was approved in June. It is a new Policy Coordination Instrument (PCI) and therefore without financing; instead it focuses on structural reforms and anchoring the fiscal policy framework. This agreement reinforces Serbia's commitment to reforms and macro-financial stability, in our view, which would be welcomed by investors. It could also provide quick access to IMF funding if needed.

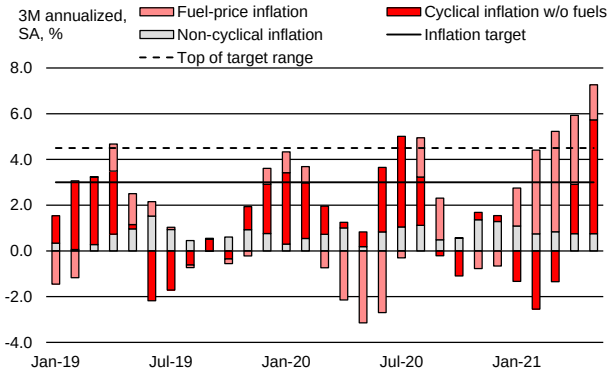
Continued focus on Kosovo and EU accession

Negotiations with Kosovo resumed in June with a meeting between Serbian President Aleksandar Vučić and Kosovo's Prime Minister Albin Kurti in Brussels. There was no significant progress but they agreed to meet again in July. Regarding EU accession, the focus will likely be on the next steps in the new enlargement methodology and on securing some of the funding available under the Western Balkans Economic and Investment program. Serbia aligned with the EU on sanctions against Belarus.

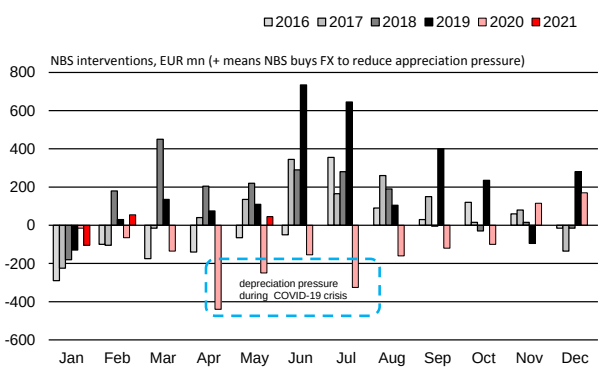
Early elections scheduled for 2022

Early elections are scheduled for April 2022 along with presidential and local elections. A pre-election challenge will be for the government to restart dialogue with opposition parties after they boycotted the elections in June 2020. The European Parliament (EP)-facilitated dialogue between government and opposition was expected to resume in 2Q21 but there has been no meeting yet. The government also started a dialogue with the opposition parties which refused the EP mediation.

CYCLICAL PRICES ARE DRIVING REFLATION



NO PRESSURE ON DINAR SINCE LAST SUMMER

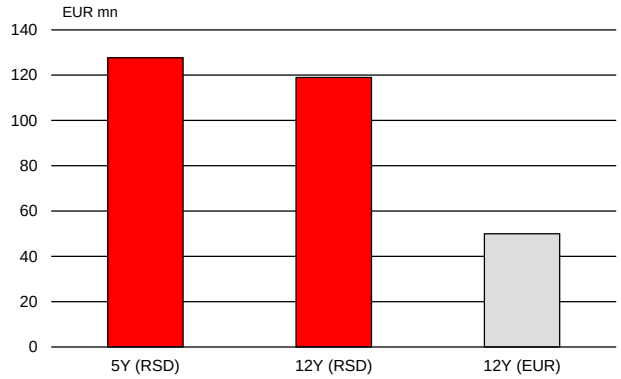


Source: NBS, SORS, UniCredit Research

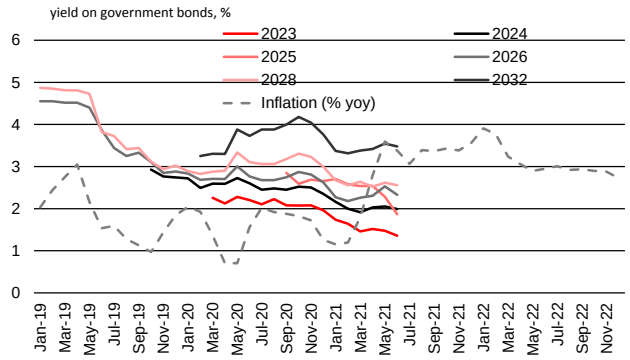
SERBGBs supported in 2021

In the new funding plan, Serbia's additional financing needs due to its larger deficit, at around EUR 2bn, are covered by budgetary reserves (EUR 1bn) and by additional borrowing of around EUR 1.1bn. The additional borrowing includes: **1.** EUR 300mn in SERBGBs for a total of EUR 2.8bn for 2021; **2.** EUR 500mn is Eurobond for a total of EUR 3.5bn; and **3.** EUR 300mn in other domestic borrowing and IFIs, for a total of EUR 1.3bn. It is important to highlight that these are upper limits and that the government could issue less than these amounts, especially given its high fiscal reserves (EUR 2bn in May according to the Ministry of Finance). The government issued around 40% of SERBGBs and 30% of Eurobond planned issuance in 1H21. Planned issuance for 3Q21 is around EUR 300bn (see left chart below). Higher real yields compared to most countries in the region and a stable currency could support government bonds.. Three SERBGBs, the 2026, 2028 and 2032 bonds, were included in the JPM GBI-EM index on 30 June, which should support these bonds going forward. Euroclearibility remains a work in progress without a clear timeline.

SERBGB ISSUANCE PLAN FOR 3Q21



REAL YIELDS REMAIN HIGHER THAN MOST CEE COUNTRIES



Source: NBS, Ministry of Finance, Public Debt Agency, SORS, UniCredit Research

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2020	2021F	2022F
Gross financing requirement	**6.6**	**7.2**	**5.1**
Budget deficit	3.8	3.6	1.6
Amortization of public debt	2.8	3.6	3.5
Domestic	1.5	1.6	1.9
Bonds	1.4	1.3	1.3
Bills	0.1	0.1	0.1
IFIs/others	0.0	0.2	0.5
External	1.3	2.0	1.6
Bonds	1.0	0.6	0.0
IFIs/others	0.3	1.4	1.6
Financing	**6.6**	**7.2**	**5.1**
Domestic borrowing	3.0	3.0	3.1
Bonds	2.7	2.8	3.0
Bills	0.1	0.0	0.1
Others	0.2	0.2	0.0
External borrowing	3.4	4.5	2.0
Bonds	3.0	3.5	1.5
IFIs/others	0.4	1.0	0.5
Fiscal reserves change (- =increase)	0.2	-0.3	0.0

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2020	2021F	2022F
Gross financing requirement	**6.0**	**7.6**	**7.3**
C/A deficit	2.0	2.1	2.2
Amortization of medium and long term debt	3.0	4.6	4.0
Government/Central Bank	1.7	2.3	1.9
Banks	0.7	0.6	0.4
Corporates	0.6	1.8	1.8
Amortization of short-term debt	1.0	0.9	1.0
Government/Central Bank	0.0	0.0	0.0
Banks	0.9	0.8	0.8
Corporates	0.1	0.1	0.2
Financing	**6.0**	**7.6**	**7.3**
FDI (net)	2.9	2.9	3.0
Medium and long-term borrowing	5.0	7.0	4.5
Government/central bank	3.9	5.1	2.6
IFIs/others	0.4	1.0	0.5
Banks	0.6	0.4	0.3
Corporates	0.5	1.5	1.6
Short-term borrowing	1.0	0.6	0.7
Other	-2.7	-1.3	-0.5
Change in FX reserves (- = increase)	-0.2	-1.5	-0.5
Memoranda:			
Nonresident purchases of LC govt bonds	-0.1	0.3	0.3
International bond issuance, net	2.0	2.9	1.5

Source: Bloomberg, NBS, Ministry of Finance, Public Debt Agency, SORS, UniCredit Research

Turkey

B2 negative/B+ stable/BB- stable*

Outlook

Turkey's economy could expand by 7.5% this year, with the recent pick-up in vaccinations improving growth prospects, and by 3.5% in 2022 as the government will likely ramp up efforts to stimulate activity in the pre-election year. Inflation could ease to 15.4% at the end of this year and to 12.8% in 2022. We expect the central bank to lower its policy rate (from 19% currently) to 16.5% in 4Q21 and to 13.5% next year although political pressure could push the CBRT to start easing already in 3Q21.

Strategy

Despite the support from a narrowing current account deficit, the TRY will likely continue to weaken. Premature and, generally, too much monetary easing remain the main risk factor going forward.

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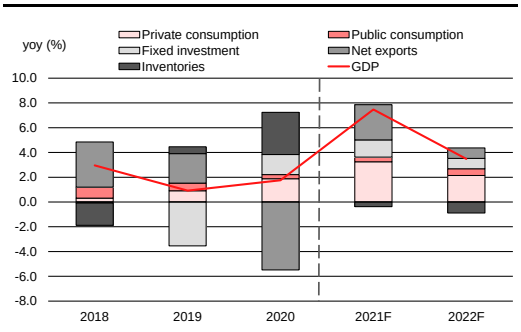
KEY DATES/EVENTS

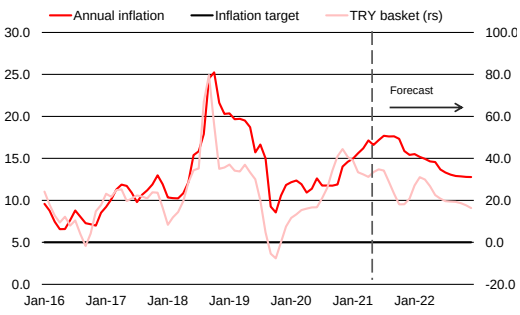
- 5 Jul, 3 Aug, 3 Sep: inflation data
- 14 Jul, 12 Aug, 23 Sep: monetary-policy decisions
- 1 Sep: 2Q21 GDP
- 13 Aug: Fitch's rating review

GDP GROWTH FORECAST



Source: Turkstat, UniCredit Research

INFLATION FORECAST



Source: Turkstat, CBRT, Bloomberg, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2018	2019	2020	2021F	2022F
GDP (EUR bn)	667.3	680.2	627.1	609.7	592.8
Population (mn)	82.0	83.2	83.6	85.2	86.2
GDP per capita (EUR)	8,138	8,180	7,500	7,157	6,878
Real economy, change (%)					
GDP	3.0	0.9	1.8	7.5	3.5
Private consumption	0.5	1.6	3.2	5.5	3.7
Fixed investment	-0.3	-12.4	6.5	5.3	3.3
Public consumption	6.6	4.4	2.3	2.6	3.9
Exports	9.0	4.9	-15.4	18.7	7.5
Imports	-6.4	-5.3	7.4	5.2	4.3
Monthly wage, nominal (EUR)	696	753	634	599	578
Real wage, change (%)	-0.4	2.7	-4.9	4.3	2.8
Unemployment rate (%)	11.0	13.7	13.1	13.4	13.2
Fiscal accounts (% of GDP)					
Budget balance	-3.4	-5.3	-5.2	-4.8	-5.2
Primary balance	-1.5	-3.0	-2.5	-2.0	-2.4
Public debt	30.2	32.6	39.8	40.9	42.4
External accounts					
Current account balance (EUR bn)	-18.5	6.0	-32.6	-18.6	-10.4
Current account balance/GDP (%)	-2.8	0.9	-5.2	-3.0	-1.8
Extended basic balance/GDP (%)	-1.6	1.7	-4.6	-2.5	-1.2
Net FDI (% of GDP)	1.2	0.8	0.6	0.6	0.6
Gross foreign debt (% of GDP)	55.7	57.2	62.8	61.6	61.6
FX reserves (EUR bn)	63.5	71.7	41.0	41.9	37.5
Months of imports, goods & services	3.5	4.3	2.6	2.4	2.1
Inflation/monetary/FX					
CPI (pavg)	16.3	15.7	12.3	16.6	13.9
CPI (eop)	20.3	11.8	14.6	15.4	12.8
Central bank target	5.0	5.0	5.0	5.0	5.0
Central bank reference rate (eop)	24.00	12.00	17.00	16.50	13.50
3M money market rate (Dec avg.)	24.70	11.80	16.60	16.50	13.50
USD/TRY (eop)	5.29	5.95	7.44	9.50	10.66
EUR/TRY (eop)	6.07	6.67	9.08	11.59	13.33
USD/TRY (pavg)	4.84	5.68	7.03	8.59	10.14
EUR/TRY (pavg)	5.69	6.35	8.05	10.38	12.58

Source: Turkstat, CBRT, Turkey's ministry of finance, Bloomberg, UniCredit Research

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

Stepping up vaccinations

We are revising our growth forecast from 4.7% to 7.5% for 2021 and from 2.3% to 3.5% for 2022

We are revising our GDP growth forecast for Turkey from 4.7% to 7.5% for 2021 and from 2.3% to 3.5% for 2022. The former revision is mainly due to the 1Q21 data, which proved stronger than we had penciled in for our initial forecast, and the recent pick-up in the vaccinations, which improves the prospects of a reacceleration in economic activity in 3Q21.

A gradual relaxation of restrictions since mid-May

Vaccinations have accelerated recently

The government has been rolling back pandemic-related restrictions since mid-May as the number of COVID-19 cases has eased from more than 60,000 per day in April to around 5,000, a level that is proving somewhat sticky. The pace of vaccination has picked up in recent weeks following the delivery of new batches. Turkey has delivered 49mn jabs so far, with 15mn (18% of the population) having received two doses.

The economy might have contracted in 2Q21 due to the lockdown…

… with supply bottlenecks acting as a drag on automotive sector output and exports

GDP might have recorded a decline (-0.4% qoq) in 2Q21 as stricter lockdown measures, especially during the first half of May, weighed on domestic demand. Industrial production and retail sales dropped by 0.8% mom and 6.3% mom, respectively, in April. The manufacturing PMI decelerated below the 50 threshold in May, with domestic orders having eased below this level already in April. Ford Otosan (with a 25% market share in automotive production) suspended production and moved the summer break forward at one plant due to a lack of semiconductors, noting that this led to a sharp drop in its exports in May. Capacity utilization in the automotive sector decreased to 62.7%, a level seen during the first wave of the pandemic. Loan growth hovered around 10% in 2Q21, keeping the qoq credit impulse negative for the fourth quarter in a row. That said, weekly credit card spending suggests that private consumption could have started to recover in late May with restrictions being rolled back while survey data imply that the real sector's investment appetite remained resilient.

Signs of a recovery have started to emerge

A reopening could curb the growth differentials across sectors …

…and boost growth this summer

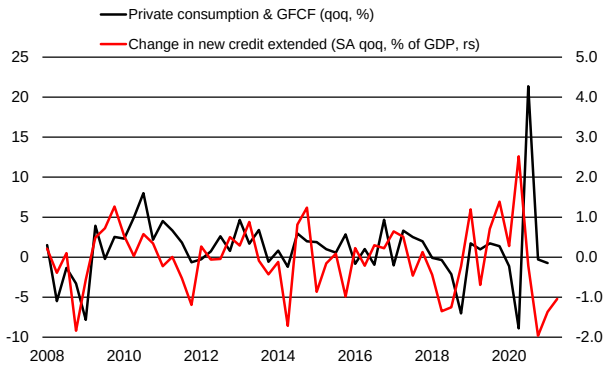
The reopening of the economy and a likely pick up in tourism will pave the way for some catching-up in the service sector in 3Q21. It has lagged behind manufacturing and trade, with food and accommodation, and administrative activity sub-indices (corresponding to 30% of overall service turnover) yet to reach pre-pandemic levels. The recovery in the construction sector could still trail behind due to the tight lending conditions. Manufacturing activity will remain supported by the export-oriented sectors although supply bottlenecks (implied by longer delivery times in sectoral PMIs) indicate downside risks on output and exports, especially in the automotive, metals and electronics sector. Credit conditions will remain restrictive until late 2021, slowing domestic demand after some pick-up over the summer.

However, credit conditions will remain restrictive

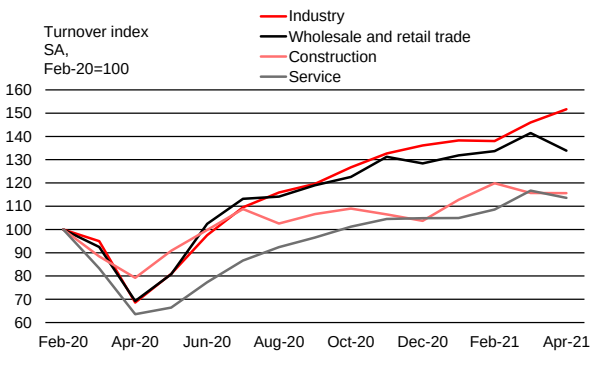
The government could revert to credit and fiscal policies to stimulate growth in the pre-election year

We expect GDP growth to slow to 3.5% next year. The government could resume credit expansion (primarily by state banks) and fiscal spending policies in preparation of election year. Lingering inflation could slow real wage growth to 2.8%, from 4.3% in 2021, curbing private consumption growth while part of the higher fiscal spending could be allocated to investment. Net exports might continue to add growth, with the contribution of a more visible recovery in tourism.

CREDIT IMPULSE HAS BEEN NEGATIVE FOR A YEAR



SERVICE AND CONSTRUCTION SECTORS HAVE LAGGED BEHIND



Source: CBRT, Turkstat, UniCredit Research

Recovery in service sector to support employment…

Employment exceeded its pre-pandemic level by 0.5mn as of April although it is still down around 0.8mn from its peak in mid-2018, while the unemployment rate increased to 13.9%. The latter might have increased further in May although additional job creation, especially in the service sector (which is 0.5mn below its February 2020 level) in 2H21, could push the rate down to 13.2% by end-2021. However, fading employment support measures (furlough, short-term work payments) at the end of 2Q21 and a further recovery in labor participation could limit this downward trend. Consequently, the (average) unemployment rate could remain elevated, at 13.4% this year, before declining slightly to 13.2% in 2022.

…while fading employment support measures would imply downside risks

Sharp yet temporary improvement in budget balance

The 12M rolling budget deficit eased from 3.5% of GDP (IMF defined: 5.2%) at the end of 2020 to 1.7% of GDP in May, mostly driven by base effects (revenue losses and spending surge during the first wave of the pandemic). The base effect on the revenue side will reverse going forward as tax revenue grew by 34% in June-December 2020. The government's revised 2021 deficit forecast of 3.5% of GDP (which includes 0.7% of GDP worth of anti-pandemic measures), looks broadly reachable although we see the deficit for this year slightly higher, at 3.7% of GDP. The budget deficit could widen next year to 4.1% of GDP.

Government pencils in support measures of 0.7% of GDP in its renewed budget

Recovery of tourism revenue will support adjustment in the current account balance

The current account deficit could ease from 5.2% of GDP in 2020 to 3.0% in 2021 and 1.8% in 2022. While the rising energy import bill curtails the adjustment in the trade balance, driven by stronger exports and lower gold imports, service revenue will support the current account balance more visibly going forward. We pencil in USD 16bn of net service revenue for 2021, assuming that travel restrictions by the UK will not extend beyond July. This corresponds to roughly 45% of the 2019 level, despite a 75% increase compared to 2020.

Inflation could remain above 17% until November…

Following a brief decline in May due to the lockdown, inflation could resume its rise in June and peak at around 18% in 3Q21 as producers could pass on their increased costs to consumers as economic activity recovers. It could remain above 17% until November, before easing to 15.4% at the end of the year, due to base effects. We expect gradual disinflation to 12.8% in 2022. Core inflation might remain above the headline well into 2H22, especially as service inflation could prove sticky due to its backward-looking nature.

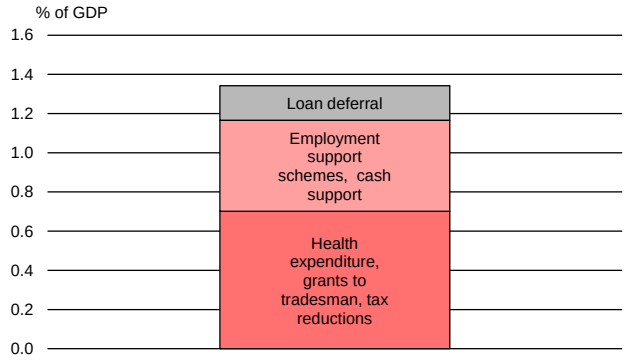
…prohibiting any monetary easing until then

However, President Erdogan demands lower rates sooner…

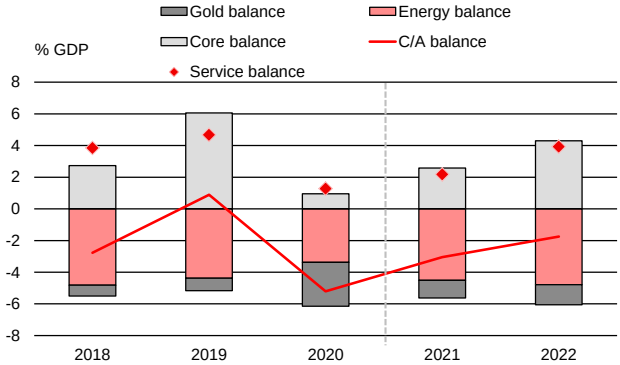
…keeping the risk of a premature rate cut very much alive

The central bank has repeatedly pledged to set its policy rate above actual and expected inflation. Thus, the CBRT could lower its policy rate to 16.5% in 2021 and 13.5% in 2022. Given the aforementioned inflation path, rate cuts for this year would need to wait until the final quarter of the year. However, President Recep Tayyip Erdogan seems to have an earlier date in mind. Resuming his call for "lower rates to bring inflation down", Mr. Erdogan hinted at a timetable around July-August in a recent interview. The central bank has tried to downplay the risk of a premature rate cut so far, stating that the current monetary-policy stance would be maintained until inflation drops significantly, possibly in September-October. Consequently, we cannot rule out a rate cut already in 3Q21, which would risk accelerating depreciation pressure for the TRY.

PANDEMIC SUPPORT MEASURES PENCILED IN FOR 2021



CURRENT-ACCOUNT DEFICIT TO NARROW



Source: Turkstat, Turkey's ministry of finance, CBRT, UniCredit Research

No respite for the TRY

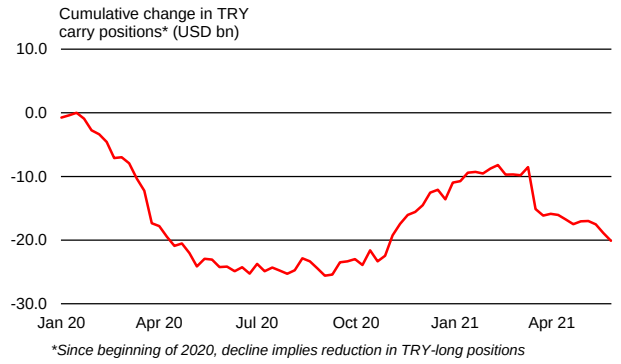
Investors have lost interest in Turkish assets

Following the selloff in the aftermath of the sacking of former CBRT Governor Naci Agbal, foreign-investor interest for Turkish assets has disappeared. There have been only USD 0.3bn of net inflows to the local bond market and USD 0.1bn of outflows from the stock market in 2Q21. Moreover, USD 12bn of TRY carry trade positions have been trimmed since 19 March. Meanwhile, local depositors have added USD 4.7bn to their FX deposits since early April, partly reversing the USD 15bn drop recorded since the beginning of the year.

The TRY could weaken further

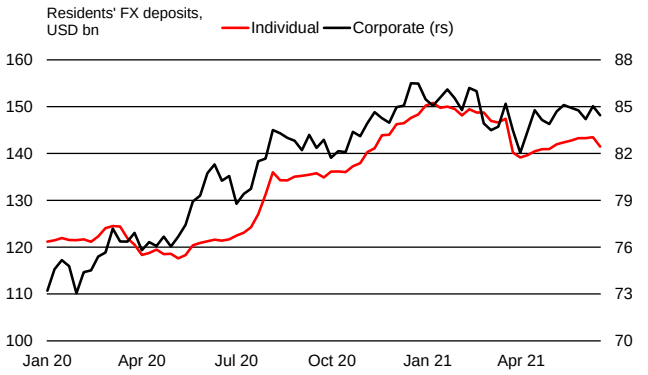
The risk of a premature rate cut might lead to further TRY weakness going forward. The narrowing of the current-account deficit and lighter external debt payments in 3Q21 (USD 7.2bn for the private sector and only USD 0.3bn for the central government) might partly curb the depreciation pace during the summer. In addition, higher external debt repayments in 4Q21 (USD 13.4bn for the private sector and USD 1.9bn for the government) and larger monthly current-account deficits after the summer could imply additional downside pressure for the TRY towards year-end.

TRY CARRY TRADE POSITIONS DOWN BY USD 12BN SINCE LATE MARCH



*Since beginning of 2020, decline implies reduction in TRY-long positions

LOCALS RESTARTED TO ADD TO THEIR FX DEPOSITS SINCE EARLY APRIL



Source: Haver, Bloomberg, BRSA, CBRT, UniCredit Research

GOVERNMENT'S GROSS FINANCING REQUIREMENTS

EUR bn	2020	2021F	2022F
Gross financing requirement	**65.4**	**66.3**	**54.4**
Budget deficit	32.9	29.4	30.6
Amortization of public debt	32.5	36.9	23.8
Domestic	27.1	30.5	17.5
Bonds	21.9	30.3	17.5
Bills	5.2	0.2	0.0
Loans	0.0	0.0	0.0
External	5.4	6.4	6.3
Bonds	4.1	5.2	5.2
Loans	1.3	1.2	1.1
Financing	**65.4**	**66.3**	**54.4**
Domestic borrowing	55.8	48.4	39.4
Bonds	52.8	48.4	39.4
Bills	3.0	0.0	0.0
Loans	0.0	0.0	0.0
External borrowing	8.6	9.0	7.8
Bonds	7.5	8.3	7.1
Loans	1.2	0.8	0.7
Privatization/other	10.6	7.3	6.3
Fiscal reserves change (- =increase)	-9.6	1.5	1.0

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2020	2021F	2022F
Gross financing requirement	**187.8**	**175.4**	**162.0**
C/A deficit	32.6	18.6	10.4
Amortization of medium and long-term debt	48.1	41.6	30.6
Government/central bank	5.1	5.8	6.3
Banks	26.2	26.2	12.7
Corporates/other	16.8	9.6	11.6
Amortization of short-term debt	107.2	115.1	120.9
Financing	**187.8**	**175.4**	**162.0**
FDI (net)	4.0	3.4	3.5
Portfolio equity, net	-3.6	-1.7	0.9
Medium and long-term borrowing	38.5	40.2	30.5
Government/central bank	4.8	9.0	8.6
Banks	21.4	22.0	11.4
Corporates/other	12.3	9.1	10.5
Short-term borrowing	122.6	124.8	123.8
Other	-1.4	2.9	0.0
Change in FX reserves (- = increase)	27.8	5.8	3.4
Memoranda:			
Nonresident purchases of LC gov't bonds	-4.4	0.0	0.8
International bond issuance, net	3.4	3.0	1.9

Source: CBRT, Turkey's ministry of finance, UniCredit Research

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
- w. PFR - with Polski Fundusz Rozwoju
- w. BGK - with Bank Gospodarstwa Krajowego (BGK)”

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