ERSTE Group

CEE Insights

Fixed Income and Foreign Exchange

Looking ahead this week…

Monday	Tuesday	Wednesday	Thursday	Friday
HU, RO: Trade Balance	**CZ**: Inflation	**PL**: No rate change **CZ**: Retail Sales, Industry	**RO:** Industry, Current Account	**HU**: Inflation

Click for: this week's detailed releases/events, market forecasts, macro forecasts

The second week of the new year offers many important data releases and events in CEE. The most important will perhaps be the inflation release in the Czech Republic, as it will be important to see where the annual index increased in December after the surprisingly strong growth in November. Admittedly, the surprising increase is due to non-core (food, fuel) items. The figure is still of significant importance for the timing of the exit from the koruna cap FX regime (which keeps the EURCZK above 27). This could come already in 2Q17 if inflation continues to grow strongly; the CNB is trying to fend off heavy speculative capital inflows with interventions. Many other important short-term macro-indicators will also be released that should be watched elsewhere in CEE, too.

In case you missed it last week…

- NBR left the policy rate at 1.75% on Friday, as expected
- Industrial output was solid in the Czech Republic in November, while showed weakness in Hungary
- Retail sales beat estimates in Hungary in November
- Social Democrat government formed in Romania, main task is to keep deficit below 3% in 2017
- Czech budget arrived at CZK 62bn surplus vs. plan of CZK 70bn shortfall one year ago
- For other events last week, please check respective countries: HR, CZ, HU, PL, RO, TR, SI, SK, SR

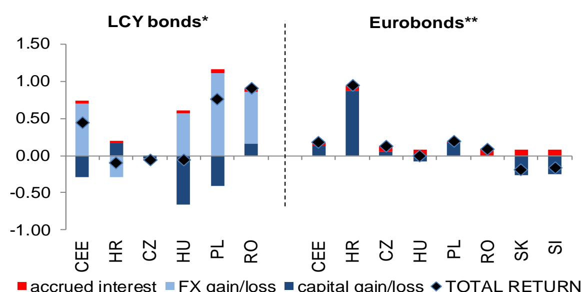
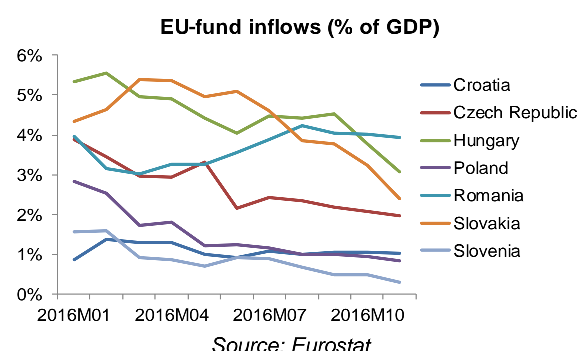


Chart of the week:
EU fund inflows fell in most countries continuously throughout 2016, but 2017 should mark a strong change in this pattern. In 2017, investments could again become supportive for GDP growth in CEE.



Source: Eurostat

On Radar

Investments suffered a large blow, due mainly to the significant slowdown in EU-induced inflows in 2016 in CEE countries. While this is expected to change substantially this year, looking at Eurostat data until November 2016, there is no change in the downward trend yet. Looking at the rather favorable budgetary figures in many CEE countries (i.e. the Czech Republic, Hungary and Romania), the decline of public investments is a major contributor to the improving balance (with EU funds playing a key role). The change of the pattern does not just mean that government deficits could increase next year (which is also fuelled by fiscal relaxation, especially in Romania and Hungary), but also that economic growth could pick up a bit of the steam lost last year due to a much stronger contribution from investments. The main exception to this pattern is Romania, where fiscal relaxation was so substantial last year that a slowdown of growth is inevitable. (For further details, see the next page.)

EU fund inflows fell in most countries continuously throughout 2016

Investments to pick up steam this year due to EU funds

'Are there signs that EU-funded investments could pick up soon?'

Croatia: In 2016, we could see acceleration of net EU fund inflows, which increased from around 0.4% of GDP in 2015 to slightly above 1% of GDP in the first three quarters of 2016. Such an acceleration was recorded on both the secondary and capital accounts of the BoP, with the latter having the leading role, suggesting that this inflow should also be recorded in the gross capital formation data. Looking forward, we expect positive developments ahead, with EU fund inflows standing around 1-1.5% of GDP in the coming years, which represents a significant improvement when compared to recent years. However, such levels are still below the absorption potential and below the level recorded in peer countries.

Czech Republic: Investments were rather muted in 2016 and we expect them to gradually increase in 2017. Government capital spending in 2016 reached CZK 85bn and the government expects it to grow to CZK 104bn in 2017. Moreover, the approaching parliamentary elections in autumn 2017 could speed up some investments. On the other hand, the insufficient amount of prepared investment projects presents a risk of lower investment.

Hungary: According to official government statistics, about HUF 1,570bn (about EUR 5.1bn or 4.5% of GDP) worth of EU structural fund related disbursements were made in the current EU budget cycle by the end of the first week of 2017. Since there was a - temporary - hiccup in the EU fund related investment over the course of 2016, the contribution of gross fixed capital formation to GDP growth was negative last year. We expect investments to contribute visibly to GDP growth in 2017, as the disbursement of EU funds should accelerate; in addition, the utilization of the disbursed amounts should run up as well. Our estimate for the 2017 GDP growth rate is 3.4%.

Poland: EU-funded investment was a weak point of the last year, dragging growth down. Although we do expect higher EU funds inflow this year, so far, there has been no hard evidence that the trend has changed. The flow of EU funds in 2016 (Jan-Nov) was lower by roughly 1.2% of GDP compared to the same period of the previous year. However, there is a light at the end of the tunnel - the drop in the construction sector softened in November, and if such a development continues, it is likely that EU-funded investments are about to accelerate, supporting the growth of investment that we expect to see in 2H17.

Romania: EU-funded investments have gained some speed, beginning with the spring of 2016 in Romania, but their monthly evolution remained erratic. As a result, gross fixed capital formation in the entire economy grew at a slower pace than household consumption in the first three quarters of 2016. Documents and procedures for the absorption under the 2014-20 European financial framework are streamlined at present by local authorities and a gradual recovery of EU funds could be seen in the short term. The government expects absorption of EU structural and investment funds of EUR 20bn by the end of 2020 and EUR 31bn by 2023. The main challenges to the absorption of EU structural funds in the next one or two years are

budgetary constraints related to the co-financing part of the EU-funded projects.

Serbia: As a candidate country, Serbia has access to various pre-accession funds, but only active programs have so far been implemented under IPA funds. As there are no official reports on fund withdrawals, we can only say that, in 2016, we could see some stronger inflows on the secondary account of the government sector in the BoP, most likely related to current transfers from IPA. The latest EU report on Serbia indicates that the country has made some progress on IPA fund absorption and that newly developed e-platforms should additionally improve the absorption rate. However, we do not expect significant contributions from these funds to the overall economic activity in the short run, as most of the IPA programs are aimed at important, but 'soft' investments in the institutional framework, human capital, etc. As for capital investments, Serbia is expected to continue to rely on bilateral deals with its traditional partners, such as UAE and China

Slovakia: Economic growth accelerated in 2015, mainly thanks to faster EU fund absorption (2007-13 funds). An expected correction came last year, as EU fund drawing returned to lower levels and investments became a drag on domestic demand. The figures for the new programming period 2014-20 are quite low at the moment – just 1.94% out of the allocated EUR 14bn was approved by the end of November 2016. EU-funded investments from the new programming period should be picking up this year, although the pace is difficult to predict. The targeted amount by the end of 2017 is around EUR 632mn (4.5% of the total).

Slovenia: In the 2007-13 EU budget framework, Slovenia was one of the countries with the highest absorption rate, above 80%, and we expect a similar performance in the 2014-20 budgetary cycle. As for the recent BoP component developments, as already mentioned, for 2016, we could see a notable reduction of EU related funds on the capital account, while the current account recorded a milder slowdown. As Slovenian gross fixed capital formation was strongly determined by EU related funds, we could also see some slowdown in capital investments in 2016, while waiting for new EU funding to kick in. However, as new programs and projects start to unwind, we expect positive contributions from EU funds in the coming period.

Looking ahead

Date	Time	Ctry	Release	Period	Erste	Survey	Prior	Pre Comment
9-Jan	11:00	**HR**	**Trade Balance**	Oct			-4544 m	
	9:00	**HU**	**Trade Balance**	Nov	***929 m***	*830 m*	903 m	*Trade surplus should remain massive, despite fact that export growth might continue to struggle*
	8:00	**RO**	**Trade balance**	Nov	***-1000 m***		-971 m	*Trade balance is under pressure from rising imports of consumer goods in context of loose fiscal policy*
10-Jan	9:00	**CZ**	**CPI m/m**	Dec	***0.3%***	*0.3%*	0.3%	*Inflation in m/m terms has jumped, due primarily to food prices*
	9:00	**CZ**	**CPI y/y**	Dec	***1.9%***	*1.9%*	1.5%	*Inlfation in y/y terms is driven by food and energy price rises*
11-Jan	0:00	**PL**	**Target Rate**	Jan	***1.5%***	*1.5%*	1.5%	*Policy rate to remain flat; although growth disappointed in 3Q16, inflation rate has been rising*
	9:00	**CZ**	**Retail Sales y/y**	Nov	***5.4%***	*4.6%*	0.5%	*Retail sales are supported by strong labor market and positive household sentiment*
	9:00	**CZ**	**Ind. Prod. y/y**	Nov	***5.4%***	*4.9%*	2.0%	*Industrial production driven by domestic and foreign demand*
12-Jan	8:00	**RO**	**Ind. Prod. y/y**	Nov	***0.9%***		0.8%	*Industrial production is disappointing at present, in spite of strong growth of domestic demand*
	9:00	**RO**	**C/A balance m/m**	Nov	***-400 m***			*Higher external imbalance, due to wider trade deficit in goods segment*
	11:00	**HR**	**PPI y/y**	Dec			-2.9%	
13-Jan	9:00	**HU**	**CPI y/y**	Dec	***1.6%***	*1.6%*	1.1%	*CPI inflation should continue to accelerate due to fading effect of fuel prices*

Sources: Bloomberg, Reuters

Major markets

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- Friday's labor market data in the US for December showed an increase in non-farm payrolls by 156,000 vs. the consensus of around 175,000. However, the November data was revised up to 204,000 (from 178,000 estimated earlier). The unemployment rate edged up to 4.7%, but annual wage growth amounted to 2.9%, the highest pace since 2009. The picture overall points to a strong labor market in the US. The data release confirms our expectation for four 25bp hikes this year. We expect the next rate hike at the FOMC's March meeting.

Croatia

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- The macro figures brought limited surprises. Retail trade expanded 2.7% y/y W.D.A. in November, a moderation from the robust 5.3% y/y seen in October, but this was also due significantly to a pronounced base effect. Going into 4Q, the consumption pattern remains quite robust, suggesting yet another solid contribution from private consumption to GDP formation in 4Q16.
- The 3Q CA figures showed the anticipated deterioration on the annual level, as the one-off related to the CHF conversion in 2015 faded from the figures; hence, 3Q brought a 15% lower surplus and, on the 4Q trailing basis, the surplus declined by 1.3pp to 3.3% of GDP. The trade balance came under some pressure amid reviving domestic demand, while tourism once again strongly supported the services side. We see CA standing slightly below 3% of GDP in 2016 and remaining in a comfortable (around 2% of GDP) surplus in 2017 as well.
- On the political side, the ongoing INA-MOL story continued to dominate the media space. The current plan by the government suggests they would seek to sell 25% of the state-owned electricity company (via an IPO) to fund the buyback of the Hungarian stake in INA. Details remain scarce. Hence, the potential impact on public finances remains hard to estimate, but the process should clearly bring some uncertainty down the road.

Czech Republic

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- Industrial production in the Czech Republic arrived at 7.0% y/y and 1.7% m/m in November. The figure was influenced by the higher number of working days, as the calendar-adjusted growth arrived at 4.5% y/y. Industrial production in the Czech Republic is still solid, as it is driven by domestic as well as foreign demand. However, the data on industrial output is highly volatile, even after the adjustment for the number of working days.
- The Czech National Bank intervened on the market in the amount of EUR 0.524bn (CZK 14.15bn) in November. The amount was lower compared to October, when the Czech National Bank bought foreign exchange worth about EUR 3.961bn (CZK 106.95bn). Even though the capital inflow was probably muted in December as well, we foresee its increase in 1Q17, as the likely termination of the FX commitment is approaching.

- In November 2016, according to preliminary data on external trade, the trade balance ended in a surplus of CZK 10.8bn, which was an increase of CZK 1.1bn y/y. The total balance y/y was favorably influenced mainly by a decrease of the deficit in 'chemicals and related products'. The total balance was unfavorably affected by a y/y deepening of the deficit in 'mineral fuels' and a decrease of the surplus in 'machinery and transport equipment'.

Hungary

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- The unemployment rate further declined in September-November, to 4.5%, from the 4.7% published for August-October, while the number of employed people increased by 142 thousand compared to the same period of the previous year. The actual figure proved lower than both the market consensus and our estimate of 4.7%. Next year, the unemployment rate is expected to be stabilized at a low level. Low unemployment and the expected sharp wage increases pose some upward risks to both our GDP and inflation forecasts for 2017.
- Manufacturing PMI in December stood at 52.2, following the 56.6 seen in November.
- Industrial production grew by 0.6% y/y in November both in unadjusted and working-day adjusted terms, after the 2.1% yearly decline, published for October. Industrial performance should remain weak in the coming quarters, as one of the biggest car manufacturers will stop production due to a factory upgrade, while the fragile Eurozone conjuncture poses downside risks to Hungarian industrial developments.
- Retail sales volume growth exceeded expectations and grew by 4.7% y/y both in unadjusted and working-day adjusted terms. Retail sales should continue to strengthen over the course of 2017, due to the significant net real wage growth.
- The CF-based budget deficit (excluding local councils) amounted to HUF 848.3bn in FY2016. The January-November CF-based budget balance showed a surplus of HUF 59.3bn, thus the last month of the year brought an extremely high deficit of HUF 908bn. This was primarily due to high expenditures relating to EU development projects. The ministry added that the ESA-based deficit could have stood at 2% of GDP last year, while public debt could have been around 74% of GDP, after 74.7% of GDP, seen in 2015.

Poland

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- The flash CPI showed that the inflation rate accelerated in November to 0.8% y/y, beating market expectations of 0.5% y/y. Such a development suggests that we may see the inflation rate well above 1% y/y in 1Q17, as base effects will be in place.
- The PMI index arrived at 54.3, the highest level since July 2015. Such a strong rebound was visible in all sub-indices and exports grew for the first time since September. Moreover, costs of production increased visibly and the price level of final goods picked up, suggesting that the inflation rate may surprise to the upside in the coming months.

- The zloty has strengthened toward 4.37 vs. the EUR. Relatively strong monthly indicators support such a development; however, international sentiment and strong data from the US economy may limit the appreciation potential.

Romania

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- The new government backed by the Social Democrat Party, the Alliance of Liberals and Democrats and ethnic minorities won the confidence vote in the Parliament by a wide margin (295 : 133 votes). Drafting the state budget for 2017 with a deficit of maximum 3% of GDP in the context of additional fiscal easing measures is a top priority for the new government. Senior members of the ruling coalition assured investors that Romania would comply with the European fiscal rules. We think that reaching a 3% budget deficit is extremely challenging in the context of the current governing program and some fiscal compensatory measures might be needed. We have put our macroeconomic forecasts under revision.
- The NBR has kept the key rate unchanged at 1.75% as widely expected due to fiscal uncertainties. Minimum reserves for RON and FX liabilities of credit institutions have been also left unchanged. Inflation is seen in positive territory in 1Q17 by the NBR, but its increase could be slower than initially estimated. During the press conference, Governor Isarescu said there were risks stemming from the post-election situation. We foresee the key rate unchanged at 1.75% throughout 2017 as inflation could remain within the NBR's target.

Serbia

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- Effective from January 1, the minimum hourly wage in Serbia was increased from RSD 121 to RSD 130 and pensions increased by 1.5%. In addition, we should also see an increase of wages in some parts of the public sector by 3-6%. These measures were negotiated with the IMF, as Serbia exceeded all fiscal targets in 2016, owing to the better than expected growth performance and stronger budget performance (vs. the initially planned 3.5%, the deficit should stand around 4% of GDP).
- The FX market continued to show signs of stronger volatility, mostly reflecting the effects of year-end FX position adjustments in the banking and corporate sectors. However, after the EUR 90mn NBS intervention on the buy side, the EUR/RSD stabilized and is now hovering around the 123.5 mark. The bond market, on the other hand, showed no major movements, with the benchmark RSD 2022 yield moving around 5.6%.

Slovakia

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- The cash state deficit reached EUR 0.98bn last year, lower than projected and the lowest in eight years. The better than expected result was due to higher tax revenue, especially the higher than foreseen corporate tax intake. However, the actual ESA deficit, which looks at public finances on an accrual basis, is likely to be higher.

- Retail sales growth reached 3.9% y/y in November (1.2% m/m), exceeding expectations and finally catching up with the good underlying fundamentals. Fundamentally, favorable labor market development together with good consumer sentiment should foster retail sales growth.
- Economic sentiment improved by 3 points to 103.8 in December, on the back of better construction, industry and consumer sentiment. Sentiment in the retail trade sector remained unchanged, whereas service sector confidence decreased. The 3-month moving average stands at 102.7, suggesting a continuation of the solid economic growth in 4Q16.
- Producer prices decreased by 2.6% y/y in November, in line with our expectations. Compared to the previous month, producer prices rose by 0.5% m/m.

Slovenia

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- December CPI landed at 0.5% y/y, wrapping up the FY16 average figure at -0.1% y/y. Detailed data showed that the December figure was mostly shaped by rising food prices (1.7% y/y) and gradual stabilization of fuel prices. However, broadly speaking, support for the headline figure came from services (1.6% y/y), while goods prices kept a neutral role. Looking forward, we see some gradual pick-up in the inflation rate in the coming months, with the FY17 figure moving back into positive territory.
- The yield on the EUR 2026 came under milder upside pressure and stood at 0.88%, mostly reflecting the upside movements of the benchmark Bund, while the spread remained relatively flat.

Capital market forecasts

Government bond yields

	current	2017Q1	2017Q2	2017Q3	2017Q4
Croatia 10Y	3.02	3.00	2.90	2.80	2.80
spread (bps)	270	266	250	231	217
Czech Rep. 10Y	0.49	0.67	0.47	0.48	0.49
spread (bps)	16	33	7	-1	-14
Hungary 10Y	3.32	3.21	3.08	3.05	3.05
spread (bps)	300	287	268	256	242
Poland 10Y	3.51	3.40	3.25	3.20	3.35
spread (bps)	318	306	285	271	272
Romania10Y	3.57	3.60	3.65	3.70	3.75
spread (bps)	325	326	325	321	312
Slovakia 10Y	1.02	1.10	1.20	1.25	1.30
spread (bps)	69	76	80	76	67
Slovenia 10Y	0.96	1.10	1.10	1.20	1.30
spread (bps)	63	76	70	71	67
Serbia 7Y	5.68	5.50	5.50	5.50	5.50
DE10Y (BBG)*	***0.32***	***0.34***	***0.40***	***0.49***	***0.63***

3M Money Market Rate

	current	2017Q1	2017Q2	2017Q3	2017Q4
Croatia	0.85	0.75	0.70	0.70	0.70
3M forwards		-	-	-	-
Czech Republic	0.29	0.28	0.28	0.27	0.27
3M forwards		0.29	0.27	0.25	0.24
Hungary	0.39	0.50	0.50	0.50	0.50
3M forwards		0.40	0.45	0.51	0.59
Poland	1.73	1.70	1.73	1.73	1.75
3M forwards		1.79	1.81	1.84	1.88
Romania	0.80	0.85	1.00	1.05	1.10
3M forwards		0.99	1.03	1.33	2.04
Serbia	3.45	3.50	3.50	3.50	3.50
3M forwards		-	-	-	-
Eurozone	-0.32	-0.25	-0.25	-0.25	-0.25

FX

	current	2017Q1	2017Q2	2017Q3	2017Q4
EURHRK	7.52	7.60	7.50	7.50	7.60
forwards		7.55	7.58	7.61	7.63
EURCZK	27.02	27.02	27.02	27.02	26.43
forwards		26.94	26.87	26.79	26.73
EURHUF	314.8	315.0	315.0	315.0	315.0
forwards		315.6	316.2	316.8	317.5
EURPLN	4.44	4.43	4.40	4.41	4.39
forwards		4.47	4.50	4.52	4.54
EURRON	4.52	4.50	4.51	4.51	4.51
forwards		4.53	4.55	4.57	4.59
EURRSD	123.5	123.5	123.5	124.0	124.0
forwards		-	-	-	-
EURUSD	1.06	1.06	1.08	1.10	1.12

Key Interest Rate

	current	2017Q1	2017Q2	2017Q3	2017Q4
Croatia	0.50	0.30	0.30	0.30	0.30
Czech Republic	0.05	0.05	0.05	0.05	0.05
Hungary	0.90	0.90	0.90	0.90	0.90
Poland	1.50	1.50	1.50	1.50	1.50
Romania	1.75	1.75	1.75	1.75	1.75
Serbia	4.00	4.00	4.00	4.00	4.00
Eurozone	0.00	0.00	0.00	0.00	0.00

Macro forecasts

Real GDP growth (%)	2015	2016f	2017f	2018f
Croatia	1.6	2.7	2.5	2.5
Czech Republic	4.6	2.6	2.6	3.0
Hungary	3.1	2.1	3.4	2.8
Poland	3.9	2.4	3.0	3.4
Romania	3.8	4.5	3.2	3.3
Serbia	0.8	2.6	2.9	3.2
Slovakia	3.8	3.3	3.1	3.7
Slovenia	2.3	2.6	2.6	2.7
CEE8 average	**3.7**	**2.8**	**3.0**	**3.2**

Average inflation (%)	2015	2016f	2017f	2018f
Croatia	-0.5	-1.0	0.7	1.2
Czech Republic	0.3	0.6	2.0	1.9
Hungary	-0.1	0.4	1.9	3.0
Poland	-0.9	-0.6	0.9	1.4
Romania	-0.6	-1.6	1.2	2.0
Serbia	1.7	1.1	2.4	3.1
Slovakia	-0.3	-0.6	0.7	2.0
Slovenia	-0.5	0.0	1.5	1.9
CEE8 average	**-0.4**	**-0.4**	**1.3**	**1.8**

Unemployment (%)	2015	2016f	2017f	2018f
Croatia	16.3	15.3	14.1	13.4
Czech Republic	5.1	4.2	4.3	4.2
Hungary	6.8	5.2	4.5	4.5
Poland	10.6	9.2	8.7	8.5
Romania	6.8	6.7	6.8	6.7
Serbia	17.7	16.6	16.0	15.6
Slovakia	11.5	9.8	9.2	8.3
Slovenia	9.0	8.0	7.5	6.9
CEE8 average	**9.3**	**8.1**	**7.7**	**7.4**

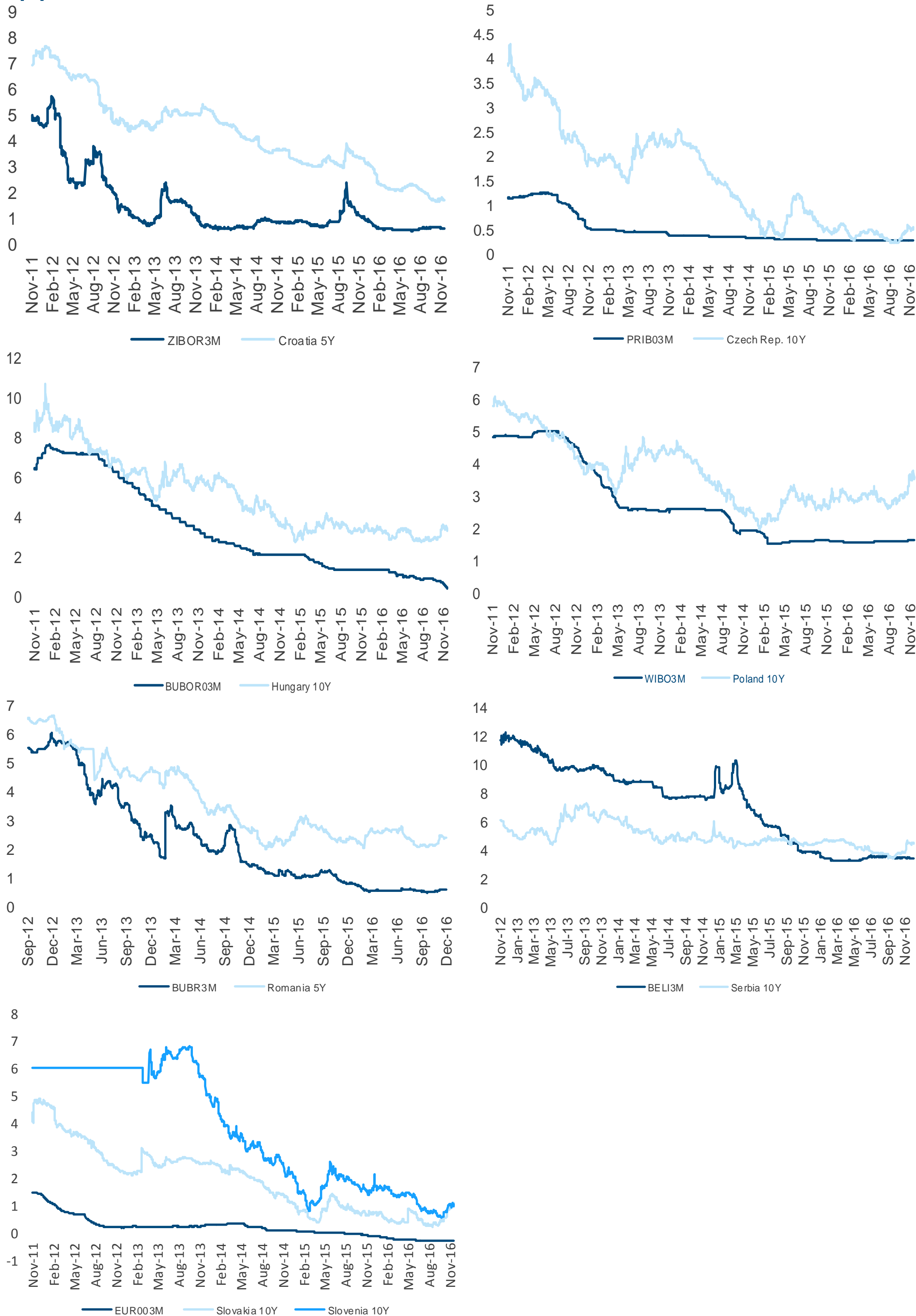
Public debt (% of GDP)	2015	2016f	2017f	2018f
Croatia	86.7	86.0	84.6	83.3
Czech Republic	40.3	37.2	36.0	36.4
Hungary	74.7	74.3	74.0	72.5
Poland	51.5	51.9	52.4	52.1
Romania	38.4	40.4	41.8	42.3
Serbia	75.9	74.5	73.8	72.3
Slovakia	52.7	52.6	52.7	51.8
Slovenia	83.4	80.0	79.1	77.5
CEE8 average	**53.8**	**53.4**	**53.4**	**53.0**

C/A (%GDP)	2015	2016f	2017f	2018f
Croatia	5.1	2.9	2.0	1.0
Czech Republic	0.9	1.9	1.4	1.1
Hungary	3.4	6.0	4.6	4.5
Poland	-0.2	-0.3	-0.6	-0.9
Romania	-1.1	-2.2	-2.5	-2.7
Serbia	-4.8	-4.6	-4.8	-5.0
Slovakia	-1.3	0.6	1.2	2.3
Slovenia	5.2	6.8	6.3	5.7
CEE8 average	**0.4**	**0.7**	**0.3**	**0.1**

Budget Balance (%GDP	2015	2016f	2017f	2018f
Croatia	-3.2	-1.7	-2.2	-2.0
Czech Republic	-0.4	0.5	0.2	-0.2
Hungary	-2.0	-2.2	-2.7	-2.5
Poland	-2.5	-2.5	-3.0	-2.9
Romania	-0.7	-2.9	-3.0	-3.0
Serbia	-3.8	-2.3	-2.1	-1.8
Slovakia	-2.7	-2.2	-1.5	-1.2
Slovenia	-2.9	-2.5	-2.0	-1.7
CEE8 average	**-2.0**	**-2.0**	**-2.2**	**-2.2**

Note:*Information on past performance is not a reliable indicator for future performance. Forecasts are not a reliable indicator for future performance.

Appendix



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