CEE Insights

Fixed Income and Foreign Exchange

Looking ahead this week…

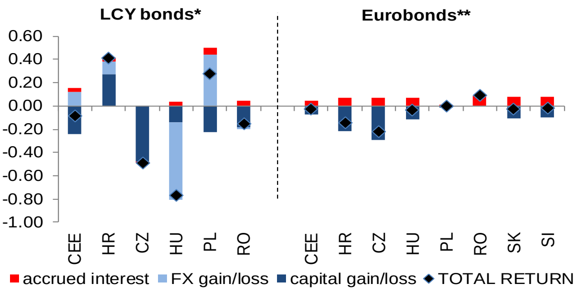
Monday	Tuesday	Wednesday	Thursday	Friday
HR: Unemployment rate	**HU**: No rate change	**PL**: Unemployment **RS**: Wages		**SK**: Industrial producer prices

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

We see a fairly empty macro release calendar for the week ahead. Even the rate setting meeting in Hungary is of little concern on Tuesday - not only because the base rate will likely remain unchanged at 0.9% (the rate on the 3M sterilization instrument has lost much of its role anyway), but because we already know the level at which the instrument will be capped at end-1Q17. The relatively strong HUF could be a concern, but the MNB has not voiced any worry over it yet, while FX swaps remain a tool to weaken the currency if the MNB so desires. Looking at the recent data, inflows into the Czech market also likely abated, decreasing the risk of a quick exit from the CZK cap regime and lowering the already small likelihood of negative rates.

In case you missed it last week…

- Croatia plans to issue HRK 5.5bn in bonds in 1Q17, quite substantial amount
- Slovenia issued EUR 1.3bn in 10Y & 28Y bonds
- Serbia flagged its intention to issue EUR 1bn in euro-denominated paper, for first time since 2013
- Slovakia also tapped market in 8Y, 9Y and 12Y bonds in amount of approx. EUR 560mn
- Just CZK 10bn demand at 6M T-bill auction indicates inflows into Czech market likely declined in recent days
- Positive surprises in Polish data indicate upside risks to our inflation forecast
- For other events last week, please check respective countries: HR, CZ, HU, PL, RO, TR, SI, SK, SR



On Radar

Unemployment is on a declining path across CEE. We expect the average 9.3% figure of 2015 for unemployment to drop to around 7.5% on average over the course of this year. In a few countries, this has already translated into hefty wage increases, most notably in Hungary and Romania, although public wages have also contributed to the strong increase in the latter. Looking around in the private sector, typical real wage growth levels expected for 2017 are still not excessive in many countries, ranging roughly between 2% and 5% in Croatia, the Czech Republic, Poland, Slovakia and Slovenia. In Serbia, real wage growth in the private sector was already 5% last year and the improving growth momentum suggests an even higher pace in 2017. The two outliers (Hungary, Romania) are expected to show much stronger growth than these levels, however. In Romania, nominal wages might soar roughly 9% this year, meaning 7-8% real wage growth, which is substantially above real GDP growth. Similar real gross wage growth is expected for Hungary. As for the latter two, substantial wage growth could translate into a deterioration in the current account balance, but underlying inflationary trends are not expected to increase above central bank targets. Monetary authorities could stay put. (For further details, see the next page.)

Increasing - but uneven - wage growth across CEE, due to declining unemployment

Wage growth increases gradually, should give boost to consumption this year

'Has the tightening of labor markets translated into wage pressures?'

Croatia: Wage pressures remain fairly weak, as wages continued to grow below 2% y/y in 2016, suggesting only modest acceleration compared to 2015. Given that, following a long recession, the economy is still in a fairly early phase of recovery (as is the labor market), we see only modest wage pressures in the mid run. A one-off in 2017 should come from wage hikes in the public sector, and in the mid-run from the ongoing labor market recovery, driven not only by increasing employment, but also emigration trends that are making the labor supply scarcer.

Czech Republic: The labor market remains strong in the Czech economy. The seasonally-adjusted unemployment rate is currently below 4%, which means that the possibility of it falling further is very limited. As domestic and foreign demand are still solid, the favorable economic developments spill over into higher wages and then into inflation pressure. This development will continue in this and the next year. In nominal terms, we expect wage growth to arrive at 4.4% in 2016, 4.6% in 2017 and 4.9% in 2018.

Hungary: Wage pressure has already materialized in Hungary, as the nominal wage increase has accelerated substantially over the course of 2016, thanks to the tightening of the domestic labor market. In the period between January and November, the average gross wage growth rate reached 6.6% y/y, while net wages rose by 8.2% on average, due to the 1ppt PIT decrease and the loosening conditions of the family tax credit. Since the unemployment rate dropped to 4.5% by end-2016, very close to the level of full employment, while the general minimum wage was raised by 15%, and the minimum wage for qualified workers with a trade was increased by 25% this year, wage dynamics should accelerate even further this year, bolstering GDP growth via strengthening household consumption. We believe that the wage pressure should translate into consumer price inflation; we expect a material impact on consumer prices at the earliest at end-2017/early-2018.

Poland: Labor market conditions have been continuously improving over the course of the last year. Employment grew 3% on average and the unemployment rate dropped to the historically low rate of 8.2%. Despite the tightening labor market, wage growth accelerated in comparison to 2015, but overall growth dynamics remained relatively moderate, averaging 4.1% last year, with increasing immigration from Ukraine likely a factor mitigating any more pronounced wage increase. This year, the nominal wage should maintain similar growth dynamics; however, real wage growth is likely to be weaker, due to the increasing inflation rate.

Romania: As economic growth gained speed in 2016, Romania began to feel the squeeze of a tightening labor market, with unemployment falling to 6% last year, from 6.8% in 2015. Although Romania has been faced with a chronic workforce shortage for years (more than 2mn citizens are working abroad), this weakness burst forth recently, when the economy not only closed the gap on its potential, but is now rising above it. The insufficient work force, coupled with repeated hikes in the public pay scale and negative inflation, pushed the real wage up almost 15% in 2016.

Serbia: Although we have seen a notable improvement on the labor market, with the average 1-3Q16 unemployment rate moving to 16%, from 17.6% in the same period last year, real wages in the economy recorded a relatively mild increase, with the Jan-Nov16 figure standing at 2.6% y/y. However, to get a clearer view, we looked at the wage dynamics across the sectors, which showed that the private sector (manufacturing and services) recorded solid 5% y/y real growth on average, while public sector wages (administration, education and health) stagnated or even recorded negative real growth. Thus, we can say that economic recovery and tightening of the labor market led to an increase of cost side pressures in the private sector, while the public sector reflected the effects of consolidation measures (cuts in public wages in 2015). Looking forward, for 2017, we expect to see a continuation of upside pressures in the private sector, given the expected acceleration of the growth momentum, while public wages should also post stronger growth, as January 2017 brought 2-4% wage hikes in that sector.

Slovakia: The labor market has seen a sustained improvement in recent years. Employment growth accelerated, helping to bring down the unemployment rate. Real wage growth sped up accordingly, reaching 4.2% in 2014 and overshadowing nominal growth, due to mild deflation - a trend that continued throughout 2015-16. However, real wages grew at a slower rate in 2015 (3.2%) before reaching 3.7% on average during 1-3Q16. The tightening labor market is likely to exert wage pressures only gradually and unevenly across the sectors. Whereas some industrial sectors are already reporting shortages of skilled labor, others do not have this problem. Furthermore, the high number of long-term unemployed persists. Overall, we expect real wage growth at 3.4% and nominal growth at 4.1% this year.

Slovenia: The restored growth momentum and steady unemployment rate decline supported some wage acceleration in 2016, though on the 12M basis we are still below 2% y/y, i.e. fairly modest. Looking down the road, we see room for some acceleration, as the above-mentioned factors are anticipated to remain in place. Stronger wage inflation, on the other hand, remains limited by fairly high labor costs.

Looking ahead

Date	Time	Ctry	Release	Period	Erste	Survey	Prior	Pre Comment
23-Jan	11:00	**HR**	**Unempl. Rate**	Dec	***14.8***		14.4%	*Headline figure seen additionally edging up on monthly level in December*
24-Jan	14:00	**HU**	**Base Rate**	Jan	***0,9%***	*0.9%*	0.9%	*No new measures are expected, dovish rhetoric should be retained, additional liquidity should be squeezed out of 3M deposit on Wednesday*
25-Jan	10:00	**PL**	**Unempl. Rate**	Dec	***8.3%***	*8.3%*	8.2%	*Unemployment rate to increase only marginally*
	12:00	**RS**	**Real Gross Wage**	Dec	***2.4%***		2.0%	*Wage dynamics shaped by seasonal factors and stronger labor market performance*
27-Jan	9:00	**SK**	**PPI y/y**	Nov	***-2%***		-2.6%	*Smaller fall in producer prices is expected*

Sources: Bloomberg, Reuters

Major markets

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- This week (24.01), manufacturing PMI data for January for the Eurozone, Germany and France will be released. In December 2016, industry sentiment climbed to a 5½-year high. Even in France and Italy, sentiment improved in December quite markedly as well. Overall, we expect an unchanged slight acceleration of GDP growth for the Eurozone in 1Q17 to 1.8% y/y.
- Last week, UK PM Theresa May for the first time outlined details on the UK's intentions for the Brexit negotiations (the UK is expected to deliver its withdrawal request by the end of March). In general, May wants a clear cut and intends to leave the EU and the single market. From the capital markets' perspective, it is good that May has shed some light on the fundamental intentions of the British government, which brings more clarity, which is always welcome on markets. While consumer and industrial sentiment in the UK are on the rise, companies and value chains will have to adapt to the changing circumstances during the coming quarters and years. According to media reports, Scotland's Prime Minister Nicola Sturgeon already stated that, based on the recent statements from May, the likelihood of a second independence referendum for Scotland has risen.
- In an attempt to counter any speculation, the ECB president made it very clear in his prepared introductory statement that the recent somewhat stronger than expected inflation numbers did not change the current policy stance. With this, Draghi made it quite clear to the markets that they should not bet on an early end/reduction of the ECB's asset purchases. We confirm our forecast for the ECB to keep its course unchanged until far into the second half of this year. Towards the end of the year, the ECB should communicate plans on how it will proceed in 2018.

Croatia

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- December CPI came in a few notches below our expectation, with the headline figure reverting to positive territory, posting 0.2% y/y growth. On the monthly level, inflation declined 0.2%, with seasonally lower clothing and footwear prices amid sales season generating the most pronounced downside pressures. Although average CPI landed at -1.1% for 2016, we see the recent positive turn extending into 2017, with a low base effect, stabilized cost side pressures and a stronger domestic demand profile supporting a gradual inflation pick-up ahead and average inflation close to 1.5% in 2017.
- After a two-week break, the MoF will return to the T-bill market this Tuesday, aiming to place HRK 700mn in 1Y papers, ahead of the maturing HRK 683mn. In addition, FinMin Maric announced that the MoF will tap the bond market. First in line will be a local issue, looking to roll over a maturing HRK 5.5bn tenor at the beginning of February. We see a smooth auction, with no details on the tenor yet, but working with the assumption of HRK 6-7bn in issuance. Later in 1Q, the MoF also announced that it would seek to tap the Eurobond market, likely going with EUR 1.25-1.5bn in size placed at the long end of the curve.
- As for the market performance, the exchange rate moved in the middle part of the 7.50-7.55 band throughout the week, while the 10Y HRK yield stayed practically flat around the 2.90% mark.

Czech Republic

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- Industrial producer prices arrived at 0.5% m/m and -0.4% y/y in December, from the -1.3% y/y reached in November. Producer prices were driven mainly by higher oil prices and solid domestic and foreign demand.
- CNB Governor Jiri Rusnok said that the current inflation is approaching its desirable level, in his view. Thus, he does not see its current development as a temporary swing. Moreover, he said that there are reasons for appreciation as well as for depreciation after the exit from the FX cap.
- CNB Vice Governor M. Hampl said that mid-2017 is still the most likely time for the exit from the FX cap. He also reiterated that EURCZK appreciation after the exit is not guaranteed, as the currency could even depreciate. His comments are in line with current CNB communication. The next monetary policy meeting will be held in two weeks, when the CNB will discuss its new forecast.

Hungary

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- Construction output volume plummeted 14.4% y/y in November, but in a monthly comparison, construction output rose by 1.7% SWDA. The monthly figures confirm that the construction sector has started to stabilize. However, as long as base effects dominate, annual figures should reflect the struggle, since EU funds temporarily abated in 2016.
- Gross nominal wages grew by 8.2% y/y, while net nominal wages soared 9.8% y/y in November. The YTD growth rates of gross and net wages were 6.6% and 8.2%, respectively, excluding the effect of public workers.

Poland

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- Employment went up 3.1% y/y in December, in line with expectations, while the nominal wage grew 2.7% y/y, disappointing the market. Nevertheless, labor market conditions continue to improve, with the unemployment rate dropping to an all-time low.
- Industrial output grew 2.3% y/y in December, while nominal retail sales went up 6.4% y/y, both beating the market consensus. The further drop in construction output, which fell 'only' 8% y/y, was another piece of good news, suggesting that investment activity is likely to improve in 4Q16. It also signals a change of the trend, which is positive for economic growth in the coming quarters.
- The PPI index increased sharply to 3% y/y in December, surprising the market to the upside. It suggests that headline inflation is likely to follow that trend in the coming months, as the increase will be driven by increasing commodity prices.

Romania

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- The C/A deficit (12-month rolling sum) widened to EUR 4.1bn in November, from EUR 3.9bn in October, due to a slight increase in the trade deficit in the goods segment. On a positive note, the surplus in the services balance (mainly transport and IT&C services), along with higher inflows of EU subsidies for agriculture in recent months, cushioned the widening of the C/A deficit. Risks for a widening of the C/A deficit to above 3% of GDP in 2017 have increased, due to strong household consumption.
- The minutes of the MPC meeting from January 6 show that NBR board members consider that inflationary pressures from aggregate demand were muted in 3Q16. The positive output gap and inflationary pressures associated with rising demand are likely to be weak in the short term and inflation could be below the level previously forecasted by the NBR in the coming quarters. Some board members noted that pressures on the C/A deficit were contained, even if economic growth was strong in 2015-16, with one explanation being the better capacity of local production to cover domestic demand. The tone of the minutes supports our view of an unchanged key rate at 1.75% throughout 2017

Serbia

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- FinMin Vujovic announced that Serbia could tap the international markets by May (after the presidential election), by issuing a EUR 1bn Eurobond for the first time since 2013. However, there is no formal decision on this matter yet. We are still a bit skeptical, as both local political and external factors could postpone the decision or even prevent it from happening (the RS government has put Eurobond issuance in all financing plans since 2013, but skipped the issuance).
- The continuation of capital outflows led to the EUR/RSD hitting the 124 mark, despite the total of EUR 60mn in NBS interventions on the sell side (YTD EUR 165mn). However, we did not see any major reaction on the bond market, as the banks' absorption potential kept yields relatively flat, with the benchmark RSD 2022 yield still hovering around the 5.60% mark.

Slovakia

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- The Slovak debt management agency conducted three auctions of government bonds on January 16 (with a competitive and non-competitive round in each). Slovakia sold EUR 112.5mn worth of government bonds due in November 2024 at an average yield of 0.407%. Another auction saw EUR 150.9mn of bonds maturing in January 2029 being sold at an average yield of 1.207%. The third auction concerned EUR 297.7mn of bonds maturing in May 2026 sold at an average yield of 0.887%. The bid to cover ratio stood within 1.6-2.1.
- HICP confirmed the annual increase of inflation to 0.2% y/y (+0.1% m/m) in December. The yearly average for 2016 stands at -0.5%.
- Unemployment, as measured by the labour bureaus, fell by 0.02pp to 8.76% in December as employment growth kept lending a helping hand. Number of job vacancies is still fairly high thus we expect the favourable

development of falling unemployment rate to continue in the coming months.

- Independent utilities regulator URSO was recently in the spotlight in the media, after Slovak PM Fico criticized it for its recent price directive. URSO issued a price directive last year, claiming it will decrease the fees on average this year, yet fixed fees were meant to go up. Some groups of households, as well as firms and boroughs in central Slovakia, would end up paying more for electricity and gas, despite the lower prices of the commodities themselves. The PM held a meeting with URSO's head and called for a reassessment of the policy. Right after the meeting, URSO pledged that the regulator will issue a new price directive shortly, which will not present higher energy prices for the previously affected groups.

Slovenia

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- The November unemployment rate closely matched our expectation, with the headline figure declining by 0.1pp on the monthly level, i.e. standing at 10.4%, while also trending 1.3pp lower y/y. Ongoing positive developments on the labor market side should continue to support the consumption pattern ahead, further sustaining its importance in the growth profile.
- It was a busy week for the MoF, with two bond issues - one new benchmark and one reopening. The MoF thus placed EUR 1bn in a new EUR 2027 tenor at 63bp+mid-swaps, while also reopening the existing EUR 2045 tenor by issuing EUR 300mn at 112+MS. Investor interest was strong, with the reported book size for both issues in excess of EUR 2.45bn.
- We see these placements further favoring the already comfortable Slovenian financing position (with the cash position suggesting it being pre-funded into 2018) and diligently extending their debt profile towards longer EUR dates. Following new placements, yields on the bond market showed a mild upside move, with the 10Y curve rising to 1.05%, i.e. +10bp w/w.

Capital market forecasts

Government bond yields	current	2017Q1	2017Q2	2017Q3	2017Q4
Croatia 10Y	2.88	3.00	2.90	2.80	2.80
spread (bps)	247	264	248	229	213
Czech Rep. 10Y	0.39	0.44	0.37	0.43	0.51
spread (bps)	-2	8	-5	-8	-16
Hungary 10Y	3.44	3.21	3.08	3.05	3.05
spread (bps)	304	285	266	254	238
Poland 10Y	3.72	3.40	3.55	3.45	3.60
spread (bps)	331	304	313	294	293
Romania10Y	3.36	3.60	3.65	3.70	3.75
spread (bps)	296	324	323	319	308
Slovakia 10Y	1.05	1.10	1.20	1.25	1.30
spread (bps)	65	74	78	74	63
Slovenia 10Y	1.38	1.10	1.10	1.20	1.30
spread (bps)	97	74	68	69	63
Serbia 7Y	5.60	5.50	5.50	5.60	6.00
DE10Y (BBG)*	***0.41***	***0.36***	***0.42***	***0.51***	***0.67***

3M Money Market Rate	current	2017Q1	2017Q2	2017Q3	2017Q4
Croatia	0.69	0.45	0.45	0.45	0.45
3M forwards		-	-	-	-
Czech Republic	0.28	0.28	0.27	0.27	0.26
3M forwards		0.27	0.24	0.22	0.23
Hungary	0.28	0.50	0.50	0.50	0.50
3M forwards		0.32	0.40	0.50	0.61
Poland	1.73	1.70	1.73	1.73	1.75
3M forwards		1.80	1.84	1.92	2.01
Romania	0.82	0.85	1.00	1.05	1.10
3M forwards		0.98	0.98	1.37	2.00
Serbia	3.47	3.50	3.50	3.50	3.50
3M forwards		-	-	-	-
Eurozone	-0.33	-0.25	-0.25	-0.25	-0.25

FX	current	2017Q1	2017Q2	2017Q3	2017Q4
EURHRK	7.52	7.55	7.50	7.50	7.60
forwards		7.52	7.54	7.55	7.57
EURCZK	27.02	27.01	26.50	26.47	26.36
forwards		26.96	26.83	26.74	26.71
EURHUF	309.0	315.0	315.0	315.0	315.0
forwards		309.4	310.1	310.9	311.7
EURPLN	4.37	4.40	4.38	4.37	4.33
forwards		4.39	4.41	4.44	4.47
EURRON	4.49	4.50	4.51	4.51	4.51
forwards		4.50	4.51	4.53	4.56
EURRSD	124.0	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	2.9	2.7
Czech Republic	4.6	2.4	2.7	3.2
Hungary	3.1	2.1	3.4	2.8
Poland	3.6	2.5	3.0	3.4
Romania	3.8	4.5	3.2	3.3
Serbia	0.8	2.7	3.0	3.3
Slovakia	3.8	3.3	3.1	3.7
Slovenia	2.3	2.6	2.6	2.7
CEE8 average	**3.5**	**2.8**	**3.0**	**3.3**

Average inflation (%)	2015	2016f	2017f	2018f
Croatia	-0.5	-1.1	1.5	1.9
Czech Republic	0.3	0.7	2.2	1.9
Hungary	-0.1	0.4	2.3	3.0
Poland	-0.9	-0.6	1.3	1.7
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**	**1.5**	**2.0**

Unemployment (%)	2015	2016f	2017f	2018f
Croatia	16.3	13.7	12.1	11.2
Czech Republic	5.1	4.1	4.0	4.0
Hungary	6.8	5.1	4.3	4.1
Poland	10.6	9.2	8.7	8.5
Romania	6.8	6.7	6.8	6.7
Serbia	17.7	16.0	15.6	15.2
Slovakia	11.5	9.8	9.2	8.3
Slovenia	9.0	8.0	7.5	6.9
CEE8 average	**9.3**	**8.0**	**7.5**	**7.2**

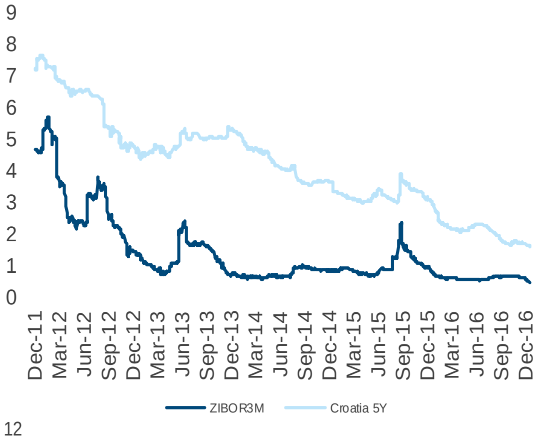
Public debt (% of GDP)	2015	2016f	2017f	2018f
Croatia	86.7	84.9	83.2	80.8
Czech Republic	40.3	37.2	35.7	35.9
Hungary	74.7	74.3	74.0	72.5
Poland	51.5	53.9	54.4	54.1
Romania	38.4	40.4	41.8	42.3
Serbia	74.7	73.8	73.0	72.6
Slovakia	52.7	52.6	52.7	51.8
Slovenia	83.4	80.0	79.1	77.5
CEE8 average	**53.7**	**54.1**	**54.0**	**53.5**

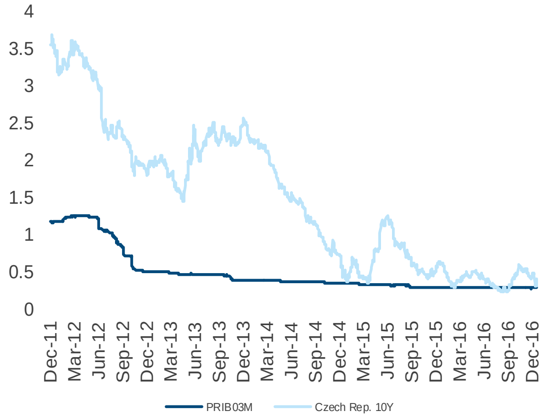
C/A (%GDP)	2015	2016f	2017f	2018f
Croatia	5.1	2.8	2.3	1.5
Czech Republic	0.9	2.1	1.3	1.4
Hungary	3.4	5.0	4.6	4.5
Poland	-0.2	-0.3	-0.6	-0.9
Romania	-1.1	-2.2	-2.5	-2.7
Serbia	-4.8	-4.2	-4.6	-4.8
Slovakia	-1.3	0.6	1.2	2.3
Slovenia	5.2	6.8	6.3	5.7
CEE8 average	**0.4**	**0.7**	**0.3**	**0.2**

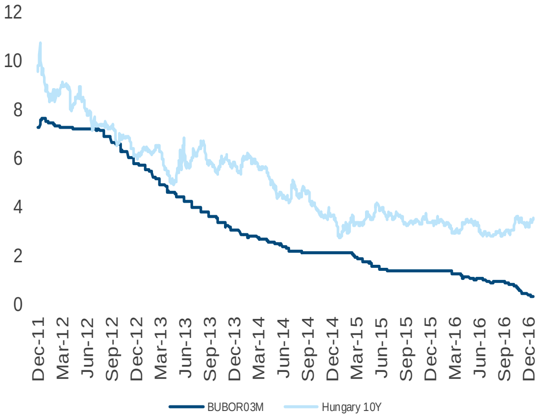
Budget Balance (%GDP	2015	2016f	2017f	2018f
Croatia	-3.2	-1.6	-2.0	-1.6
Czech Republic	-0.4	0.5	-0.6	-0.6
Hungary	-2.0	-2.2	-2.7	-2.5
Poland	-2.5	-2.5	-3.0	-2.9
Romania	-0.7	-2.9	-3.0	-3.0
Serbia	-3.8	-2.1	-1.9	-1.7
Slovakia	-2.7	-2.2	-1.5	-1.2
Slovenia	-2.9	-2.5	-2.0	-1.7
CEE8 average	**-2.0**	**-2.0**	**-2.4**	**-2.2**

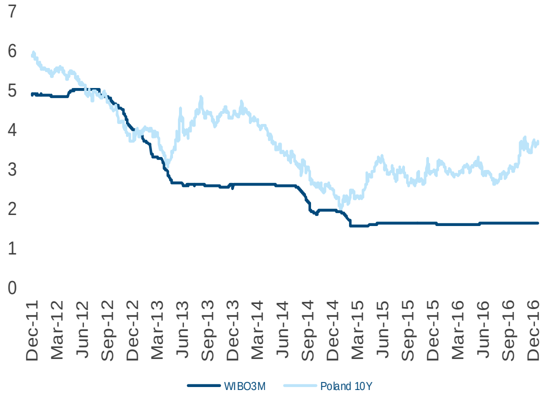
Note:*Information on past performance is not a reliable indicator for future performance. Forecasts are not a reliable indicator for future performance.

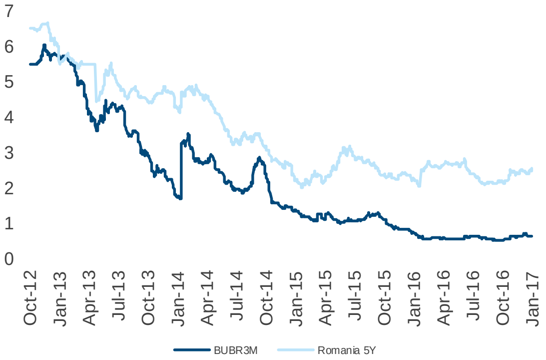
Appendix

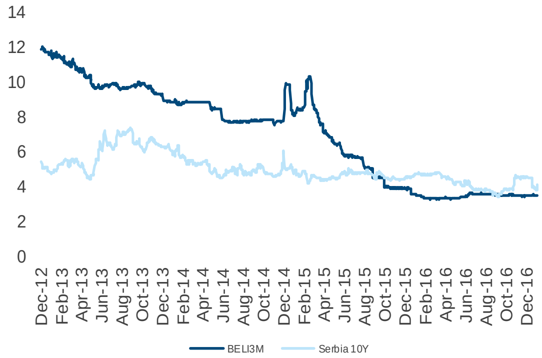


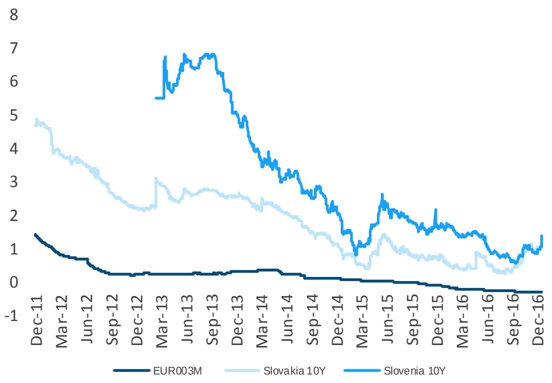












Note:*Information on past performance is not a reliable indicator for future performance. Forecasts are not a reliable indicator for future performance.

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