CEE Insights

Fixed Income and Foreign Exchange

Looking ahead this week…

Monday	Tuesday	Wednesday	Thursday	Friday
HR: Inflation **SK**: Unemployment			**RS**: Inflation **PL, HR**: Unemployment	**RS, SI**: PPI **RS:** Wages

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

This week, the release calendar is relatively empty in CEE. Only January inflation data for Croatia and Serbia will be worth watching. After the relatively steep increases of inflation rates for other CEE countries published last week, we expect inflation to jump as well in Croatia (to 0.6%, from 0.2%) and Serbia (to 1.8%, from 1.6%).

In case you missed it last week…

- GDP figures surprised to upside in Romania (4.8%), Poland (2.7%) and Slovakia (3.1%), but fell short of expectations in Hungary (1.6%) and Czech Republic (1.7%)
- Inflation topped expectations in Poland (1.8% y/y), Romania (0.1%) and Slovakia (0.7%), in line with expectations in Hungary (2.3%)
- NBS kept base rate unchanged at 4% in Serbia
- PM Vucic may become top candidate for president, announcement caused market turbulence in Serbia
- Industry and retail sales surprised to upside in Poland
- For other events last week, please check respective countries: HR, CZ, HU, PL, RO, TR, SI, SK, SR

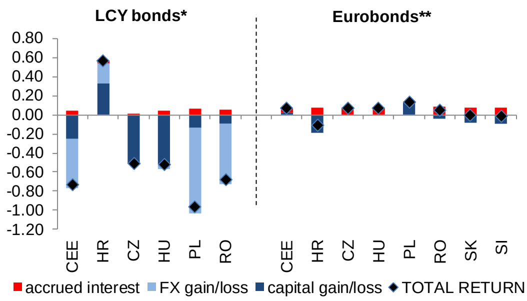
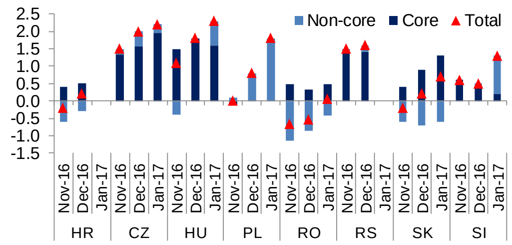


Chart of the Week: Headline inflation up, core inflation mixed across CEE countries in the last few months.

Inflation (y/y, percent) in last 3 months



On Radar

Inflation releases for January mostly confirmed that food and energy price increases indeed drove the headline inflation figures to notably higher levels than a few months earlier. Deflation fears are now very much over - the January reading came in above zero even in Romania, despite the ongoing VAT cut. While non-core items definitely show an increase, core inflation figures reflect a somewhat different picture. In the Czech Republic and Slovakia, for example, core inflation also increased notably, while in Poland the reading is still close to zero, and Slovenia even shows a declining trend in this regard. Hungary's core inflation, which has had a number higher than even Serbia's, was stagnating. Overall, we hiked the average inflation forecast for Hungary from 2.3% to 2.5% for 2017, and increased it for Slovakia to 1% from 0.7%. Overall, consumer prices could increase by 1.6% on average in CEE this year, from the -0.4% in 2016. The numbers are still at or below central bank targets in most countries. Therefore, monetary policy should not react quickly, apart from the Czech Republic, where the high inflation will likely prompt the CNB to exit the FX regime in April. In Romania and Poland, we see a likely tightening only next year, while in Hungary, as reinforced by recent central banker comments, the easing bias should remain rather strong. (For further details, see the next page.)

While inflation increased quite quickly in recent months and deflationary threats are over, inflation remains below targets in most CEE countries

Inflation is still below targets in most CEE countries

'Do you see risks to stronger inflation growth this year than previously anticipated after recent data releases?'

Croatia: Although the headline inflation figure returned to positive territory in December 2016, inflationary pressures in Croatia are still low, and the December data showed that CPI was at 0.2% y/y. Core inflation is also at still relatively low levels (CPI excluding energy and food at 0.3% y/y). For 2017, we see the inflation pattern stabilizing, owing to a gradual revival of demand-side pressures, but even more so to less supportive cost-side developments. Some pressures on headline inflation could come from the energy side, as the Croatian government is changing some regulations regarding electricity and gas, which could lead to a milder increase of prices of these energy products. However, lower VAT on electricity should subdue potential upside pressure on electricity prices (regarding fees for renewable energy), while future developments of gas prices are relatively ambiguous (liberalization could lead to both a gradual decrease and a gradual increase of prices). Bottom line, currently there are no major risks to our baseline scenario, where we see FY17 CPI moving at around 1.5% y/y. We see the inflation pattern as comfortable enough to allow for an ongoing lax monetary policy stance.

Czech Republic: Headline inflation arrived at 2.2% y/y in January. The figure was a positive surprise for market analysts as well as for the CNB. Moreover, the inflation outlook is positive. The increasing inflation pressures are driven by prices of food and fuel on the one side and by solid domestic demand and wage growth on the other (core inflation at 2.0% y/y). Moreover, the imported part of inflation was less anti-inflationary at the 2016/17 turn. For the CNB, higher inflation could now be a risk, which supports the view that the CNB will exit from the FX cap early (most likely in April).

Hungary: The January release reaffirmed our view that CPI inflation will accelerate this year as the effect of low fuel prices fades. In light of the actual January data and the new weights, we revised our annual CPI inflation rate forecast by 0.2ppt to 2.5% for 2017. We continue to see upside risks stemming from the fast-paced wage growth; the translation into higher consumer prices may significantly materialize around 4Q17/1Q18, according to our estimate. In addition, we see upside risks stemming from the rising prices of commodities and unprocessed food, as well. We note that, even though there are no visible downside risks, we cannot rule out that, in preparation for the 2018 parliamentary elections, the government will reduce the VAT rate(s) even further or administer price controls in a 'creative' way.

Poland: The inflation rate surged to 1.8% y/y in January, falling within the target band (2.5% +/-1pp). Although such a strong increase is fully driven by external factors, namely transport and food prices, such a development poses an upside risk to our current inflation forecast at 1.3% this year. Even though we believe that the inflationary pressure will ease in the coming months as base effects fade out, average inflation may land closer to 2% this year. On the other hand, demand pressure remains very limited, as core inflation has been close to zero recently. We thus believe that the central

bank should not be hasty with interest rate hikes, even if rising headline CPI may tempt hawkish MPC members to begin with monetary tightening.
Romania: The inflation rate turned positive in Romania in January at 0.1% y/y, but this was due to a base effect, namely the elimination from the calculation formula of a deep cut in the VAT rate from January 2016. Apart from this, demand-side inflationary pressures are still weak, as suggested by the adjusted CORE2 inflation, which rose slightly to 0.5% y/y in January, from 0.3% y/y in December last year. We foresee a gradual rise in headline inflation towards 2.2% y/y in December 2017, but inflation is likely to remain close to the midpoint of the NBR's target (2.5%), pointing thus towards an unchanged key rate at 1.75% this year. Risks of higher inflation in 2017 come from a negative supply shock, but the NBR is unlikely to respond to it with a premature tightening of the monetary policy. On the other hand, risks of stronger growth in consumer prices are higher in 2018, due to the gradual accumulation of demand-side pressures.

Serbia: In Serbia, we do not expect major surprises regarding price developments in the coming period. We expect a gradual pick-up in prices and see the FY17 CPI figure moving around 2.5% y/y, supported by the low base effect, stabilizing oil prices and stronger domestic demand. It is also important to notice that Serbia had a solid agricultural season, so we do not expect upside shocks from the food component, which comprises almost a third of total CPI. Also, inflation expectations in the business and financial sector are anchored, in line with our view. In addition, as the NBS lowered the target band, we see monetary policy makers ready to react in the case of some excessive cost-side pressures on the headline inflation figure.

Slovakia: Consumer prices rose 0.7% y/y (core inflation +1.3% y/y) in January, exceeding our expectations. Apart from higher transport and healthcare prices, food prices increased more than anticipated. The latter may partly be attributed to base effects (the effect of last year's lower VAT on selected foodstuffs disappeared) and partly suggests that a catching-up with the development of food commodity prices on world markets is happening. Overall, the pick-up in the inflation pace may be faster than anticipated earlier. We have thus increased our 2017 forecast to 1% on average. Regarding monetary policy, though, it is unlikely that the ECB will alter its stance in the near future. Inflation still has some way to go before the ECB would consider reducing/halting its asset purchases. The Governing Council is looking at a set of four conditions (mid-term price stability, durable convergence to the ECB's goal, self-sustenance, i.e. without relying on non-standard monetary policy, and spread throughout the Eurozone - not just in a few countries). Nonetheless, the ECB will have to keep a careful eye on the price development this year.

Slovenia: Inflation has been gradually rebounding since 2H16, with the gap between the headline figure and core CPI also starting to narrow as the year progressed, thus pointing to the fade-out of the downward cost-side pressures. So far, 2017 has brought strong acceleration in the inflation footprint, with CPI posting its highest (1.3% y/y in January 2017) rate since November 2013. We see such a positive footprint continuing, as low base effects, less benign cost-side developments and stronger demand-side pressures push the headline figure towards higher territory, resulting in an expected average 2017 CPI slightly above the 1% mark (vs. -0.1% y/y in 2016).

Looking ahead

Date	Time	Ctry	Release	Period	Survey	Erste	Prior	Pre Comment
20. Feb.		**HR**	**CPI (y/y)**	Jan		***0.6%***	0.2%	*January release seen bringing additional acceleration of CPI recovery, with low base effect and stronger food & energy prices driving upside movements*
		HR	**CPI (m/m)**	Jan			-0.2%	
		SK	**Unemployment Rate**	Jan		***8.8%***	8.8%	*Unemployment rate in January should be very similar to December level, but overall positive trend of lower unemployment rates should continue this year*
23. Feb.		**HR**	**PPI (y/y)**	Jan				
23. Feb.	10:00	**PL**	**Unemployment Rate**	Jan	*8.7%*	***8.7%***	8.3%	*Unemployment rate to increase, due to seasonal reasons*
	12:00	**RS**	**CPI (y/y)**	Jan		***1.8%***	1.6%	*Inflation keeps its stable upward trend, supported by stabilizing oil prices and stronger domestic demand*
	12:00	**RS**	**CPI (m/m)**	Jan			-0.1%	
		HR	**Unemployment Rate**	Jan		***15.3%***		*Seasonal movements likely influenced the monthly uptick in unemployment rate trajectory*
24. Feb.	10:30	**SI**	**PPI (y/y)**	Jan			0.5%	
	12:00	**RS**	**PPI (y/y)**	Jan			2.3%	
	12:00	**RS**	**Wages (y/y)**	Jan			2.5%	

Sources: Bloomberg, Reuters

Major markets

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- On Tuesday, the first flash estimate for February's industry PMI data will be released for the Eurozone, Germany and France. In January, industry sentiment climbed, against all expectations, to a 5½- year high of 55.2 index points. Geographically, sentiment in January was encouraging in all important countries, with Austria exhibiting the highest reading among Eurozone countries, with 57.3 index points. Sentiment benefited from higher volumes of total new business and new export orders (3-year high). The surveyed companies attributed the growth to both the recent depreciation of the euro and to signs of improving global market demand.
- The center of the market's attention was Fed Chair Yellen's statement in front of committees of the US House of Representatives and the US Senate this week. From our perspective, the testimonies did not contain any significant changes and merely confirmed the current course of slow rate hikes, as was signaled at the last FOMC meetings. The FOMC remains on course for its forecast of three interest rate hikes this year and it is hardly a surprise to expect the first rate hike before mid-year, which is what Yellen signaled. Through her statements, Yellen triggered immediate yield increases. We consider an interest rate hike in March as unlikely and assume April or June to be more probable.

Croatia

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- In the most recently published EC winter forecasts, Croatia's growth outlook was upgraded to 2.8% for 2016 and, more notably, 3.1% for 2017 (+0.6pp vs. EC's autumn report). These forecasts are broadly in line with our expectations as well, as we also see growth acceleration being carried out on the back of the strong domestic demand performance, on both the private consumption and investment sides, while net exports are seen playing a less supportive role, amid intensified import pressures.
- The exchange rate moved in a tight band throughout the week, currently settling around the 7.45 mark, where we see improving fundamentals continuing to anchor the currency footprint more strongly than usual at this time of year. On the bond side, we saw no major changes, with the HRK 2026 moving around the 2.75% mark and the newly issued 11Y tenor a few notches higher vs. that level.

Czech Republic

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- The preliminary estimate of GDP growth in 4Q16 arrived at 0.2% q/q and 1.7% y/y. The current figure is a negative surprise. However, it could have been affected by a temporary decline in inventories or by a high volume of imports, due to solid domestic demand, in our view.
- The current account deficit reached CZK 22bn in December. The figure was affected by dividend outflows and higher oil prices. In 2016, the overall current account surplus arrived at CZK 73.6bn

Hungary

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- **The economy grew just 1.6% y/y in 4Q16**, well below previous expectations. In FY16, GDP grew by 2% y/y, after the 3.1% y/y seen in 2015. The Statistical Office said in a short comment that market-based services and agriculture contributed positively to GDP growth, while industry stagnated and construction remained a drag on growth in 4Q16. Despite the weaker than expected 4Q figures, economic growth should accelerate in 2017, mainly driven by domestic consumption and investments. We expect the economy to grow by 3.4% y/y in 2017.
- In January, the 12-month CPI inflation rate accelerated further, to 2.3%, from the 1.8% published for last December. The main reason for the further increase in the 12-month rate was the base effect, as low fuel prices continued to disappear from the figures. The seasonally-adjusted core inflation rate remained practically stable, standing at 1.6% y/y in January. CPI inflation should further accelerate in the coming months, remaining above 2% y/y this year and reaching 2.5% y/y on average. The 3% inflation goal could be reached next year.

Poland

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- Jaroslaw Kaczynski (PiS leader) said that the government could not take any actions on FX loan conversion that would shake the banking system. The market treated Kaczynski's comment as a final and binding decision that there will be no forced FX conversion. The government will proceed with the bill on FX spread return, while banks will be encouraged to convert FX loans through other regulations.
- 4Q16 GDP arrived at 2.7% y/y, consistent with growth dynamics at 2.8% in 2016. The structure (due at the end of the month) will show what factors were behind the very strong q/q growth of 1.7%.
- Inflation surged to 1.8% y/y in January, above market expectations of 1.7% y/y. The rise of the headline CPI is fully driven by external factors (mainly commodity and food prices).
- Nominal wages grew 4.3% y/y in January, in line with market expectations. The big surprise, however, was the 4.5% y/y growth of employment (up from 3.1% y/y in December).
- Industrial production growth accelerated to 9% y/y in January and retail sales went up 11.4% y/y. The strong beginning of the year suggests that the economic slowdown was indeed temporary.

Romania

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- Real GDP grew by 1.3% q/q (s.a. data) and 4.7% y/y in 4Q16, gaining speed from the 0.5% q/q seen in 3Q16. No breakdown of these figures has been released so far, but we think that gross fixed capital formation might have grown faster than in the previous quarter, while household consumption probably remained very strong. Full-year economic growth was 4.8% in 2016. We foresee this year's economic growth at 4.3%, with a key contribution from domestic demand.
- The inflation rate increased to 0.1% y/y in January, from -0.5% y/y in December, and turned positive after one and a half years with negative

readings in y/y terms. The increase in inflation in early 2017 is mainly the result of a base effect, once the significant cut in the VAT rate from January 2016 (-4pp) was dropped from the calculation formula. Our estimation indicates a gradual rise in inflation towards 2.2% in December 2017, close to the midpoint of the NBR's target (2.5%), allowing the central bank to comfortably maintain the key rate at 1.75%.

Serbia

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- The NBS kept the key rate unchanged at 4%, as monetary policy makers expect a gradual pick-up in the inflation trajectory, but are also keeping an eye on the expected FED moves in the coming months. Looking forward, we expect the NBS to start to raise the key rate in 2H17, after the elections and FED June decision (the most probable date of the first hike).
- On the bond market, we saw a milder upward twitch in yields, probably reflecting the current political uncertainty, with the benchmark RSD 2022 yield increasing by 5bp, moving around 5.65%.
- Political uncertainties spilled over onto the FX market as well, as the EUR/RSD moved back towards the 124 mark, after the dinar recorded some gains at the beginning of the last week.

Slovakia

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- According to the flash release, GDP growth averaged 3.3% last year, in line with our expectations. 4Q16 growth stood at 3.1% y/y (0.8% q/q), slightly above our and the consensus forecast of 2.9% y/y. For 2017, we expect solid GDP growth at 3.1%, driven by both domestic and foreign demand. The gradual return of investment should also positively contribute to the growth this year.
- Consumer prices increased by 0.7% y/y in January, above expectations. Prices in transport rose by 4.9% y/y, prices in healthcare by 4.6% y/y and food and soft drinks prices increased by 1.4% y/y. Core inflation went up to 1.3% y/y. Overall, January inflation surprised to the upside, despite not reflecting the recent energy price changes. The development of food prices in particular was strong on a m/m basis. We expect inflation to pick up this year, but the pace may be faster than anticipated earlier. We have thus increased our 2017 forecast to 1% on average.
- Fitch confirmed Slovakia's rating at A+ with stable outlook. The agency expects brisk economic growth, driven by good household consumption and a strong labor market, aided also by reinvigorated investment growth. The banking sector remains stable and public finances should remain in check, with public debt expected to decrease over time.
- Slovakia sold EUR 300mn of T-bills maturing in November at an average interest rate of -0.25% in the past week.

Slovenia

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- The December unemployment rate fully matched our expectations, as the headline figure increased to 10.8%, with seasonal movements driving the monthly uptick in the headline figure (+0.4pp). Nevertheless, labor market trends continue to show ongoing improvement, with the average 2016 unemployment rate landing at 11.2%, thus pointing to a strong 1.1pp compression vs. the 2015 figure.

- We continue to see favorable labor market developments, underpinning consumption's importance in the growth profile (with this factor also described in the EC winter forecasts as the main growth engine, with growth projected to accelerate in 2017, i.e. seeing it slightly higher vs. our FY17 GDP forecast).
- Yields on the bond market maintained stable movements, with EUR 2026 remaining steady around the 1% mark.

Capital market forecasts

Government bond yields	current	2017Q1	2017Q2	2017Q3	2017Q4
Croatia 10Y	2.73	3.00	2.90	2.80	2.80
spread (bps)	243	260	242	221	209
Czech Rep. 10Y	0.58	0.56	0.75	0.84	0.83
spread (bps)	27	16	27	25	12
Hungary 10Y	3.58	3.21	3.08	3.05	3.05
spread (bps)	327	281	260	246	234
Poland 10Y	3.82	3.40	3.55	3.45	3.60
spread (bps)	351	300	307	286	289
Romania10Y	3.63	4.00	4.25	4.35	4.50
spread (bps)	333	360	377	376	379
Slovakia 10Y	1.08	1.10	1.20	1.25	1.30
spread (bps)	78	70	72	66	59
Slovenia 10Y	1.48	1.10	1.10	1.20	1.30
spread (bps)	117	70	62	61	59
Serbia 7Y	5.65	5.50	5.50	5.60	6.00
DE10Y (BBG)*	***0.31***	***0.40***	***0.48***	***0.59***	***0.71***

3M Money Market Rate	current	2017Q1	2017Q2	2017Q3	2017Q4
Croatia	0.62	0.45	0.45	0.45	0.45
3M forwards		-	-	-	-
Czech Republic	0.28	0.28	0.27	0.27	0.26
3M forwards		0.33	0.31	0.33	0.38
Hungary	0.24	0.05	0.05	0.05	0.05
3M forwards		0.34	0.49	0.62	0.76
Poland	1.73	1.70	1.73	1.73	1.75
3M forwards		1.79	1.81	1.88	1.98
Romania	0.83	0.90	1.30	1.50	1.90
3M forwards		0.65	1.11	1.54	1.97
Serbia	3.53	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	7.44	7.55	7.50	7.50	7.60
forwards		7.44	7.45	7.47	7.49
EURCZK	27.02	27.01	26.50	26.47	26.36
forwards		26.99	26.89	26.82	26.76
EURHUF	308.3	315.0	315.0	315.0	315.0
forwards		308.4	308.9	309.6	310.2
EURPLN	4.33	4.36	4.38	4.35	4.32
forwards		4.34	4.36	4.39	4.41
EURRON	4.52	4.53	4.57	4.60	4.62
forwards		4.53	4.54	4.56	4.58
EURRSD	124.0	123.5	123.5	124.0	124.0
forwards		-	-	-	-
EURUSD	1.07	1.08	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	2.9
Czech Republic	4.6	2.3	2.7	3.2
Hungary	3.1	2.0	3.4	2.8
Poland	3.6	2.5	3.0	3.4
Romania	3.9	4.8	4.3	2.8
Serbia	0.8	2.7	3.1	3.4
Slovakia	3.8	3.3	3.1	3.7
Slovenia	2.3	2.6	2.6	2.7
CEE8 average	**3.5**	**2.8**	**3.2**	**3.2**

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	2.5	3.0
Poland	-0.9	-0.6	1.3	1.4
Romania	-0.6	-1.5	1.4	2.7
Serbia	1.7	1.1	2.4	3.1
Slovakia	-0.3	-0.5	1.0	2.0
Slovenia	-0.5	0.0	1.5	1.9
CEE8 average	**-0.4**	**-0.4**	**1.6**	**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	9.0	8.7	8.5
Romania	6.8	6.0	5.9	5.8
Serbia	17.7	16.0	15.6	15.2
Slovakia	11.5	9.6	8.7	7.8
Slovenia	9.0	8.0	7.5	6.9
CEE8 average	**9.3**	**7.8**	**7.3**	**7.1**

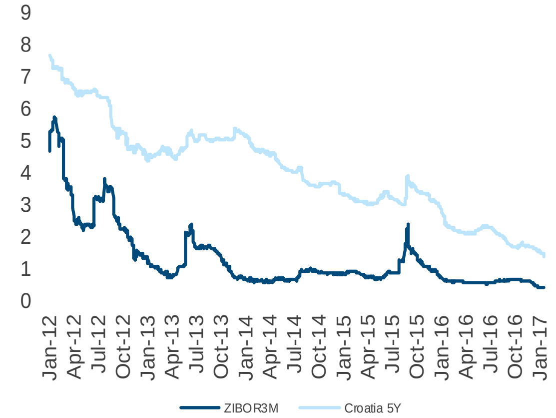
Public debt (% of GDP)	2015	2016f	2017f	2018f
Croatia	86.7	84.9	83.2	80.7
Czech Republic	40.3	37.2	35.7	35.9
Hungary	74.7	74.3	74.0	72.5
Poland	51.5	51.9	52.4	52.1
Romania	37.9	37.1	39.2	40.8
Serbia	74.7	73.8	73.0	72.6
Slovakia	52.7	52.4	52.4	51.6
Slovenia	83.4	80.0	79.1	77.5
CEE8 average	**53.7**	**52.8**	**52.8**	**52.5**

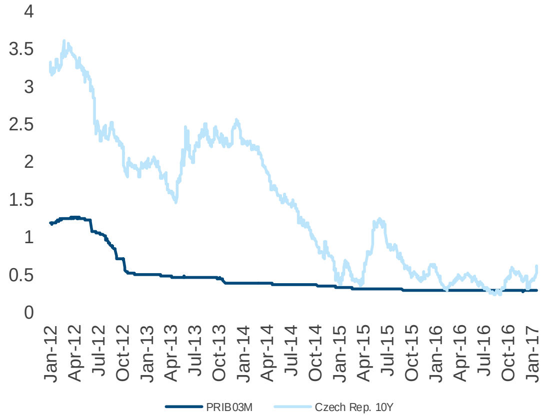
C/A (%GDP)	2015	2016f	2017f	2018f
Croatia	5.1	2.8	2.3	1.5
Czech Republic	0.9	2.1	1.3	1.4
Hungary	3.4	5.0	4.6	4.5
Poland	-0.2	-0.3	-0.6	-0.9
Romania	-1.2	-2.6	-3.3	-3.8
Serbia	-4.8	-4.2	-4.6	-4.8
Slovakia	-1.3	1.3	2.0	3.0
Slovenia	5.2	6.8	6.3	5.7
CEE8 average	**0.4**	**0.7**	**0.3**	**0.1**

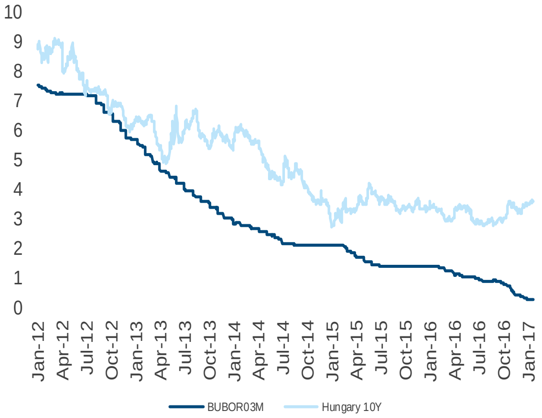
Budget Balance (%GDP	2015	2016f	2017f	2018f
Croatia	-3.2	-1.6	-2.0	-1.6
Czech Republic	-0.4	0.5	-0.6	-0.6
Hungary	-2.0	-2.2	-2.7	-2.5
Poland	-2.5	-2.5	-3.0	-2.9
Romania	-0.8	-2.8	-3.5	-3.6
Serbia	-3.8	-2.1	-1.9	-1.7
Slovakia	-2.7	-2.2	-1.5	-1.2
Slovenia	-2.9	-2.5	-2.0	-1.7
CEE8 average	**-2.0**	**-2.0**	**-2.4**	**-2.3**

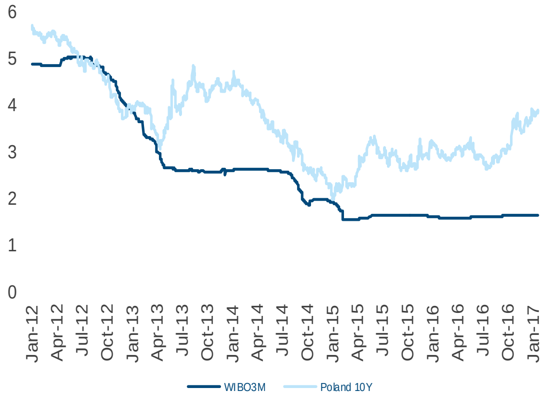
Note:*Information on past performance is not a reliable indicator for future performance. Forecasts are not a reliable indicator for future performance.

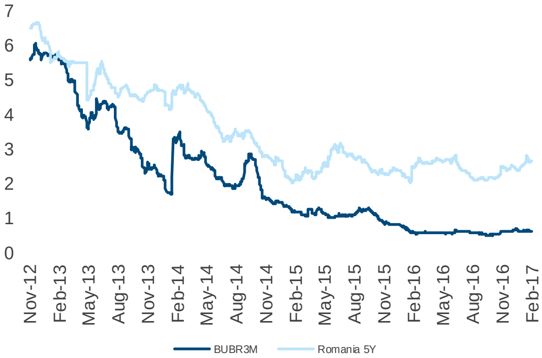
Appendix

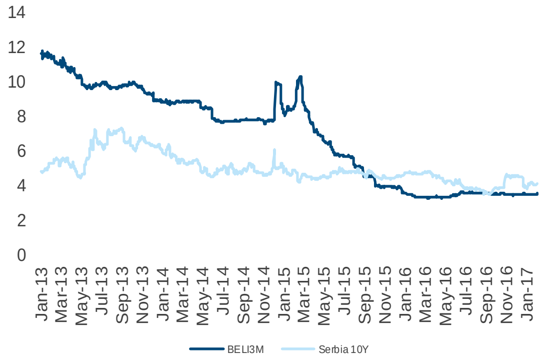


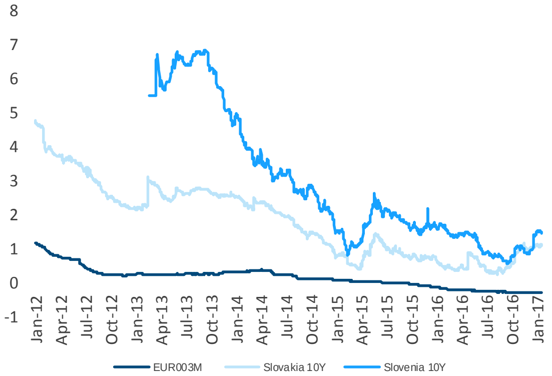












Note:*Information on past performance is not a reliable indicator for future performance. Forecasts are not a reliable indicator for future performance.

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