CEE Insights

Fixed Income and Foreign Exchange

Looking ahead this week…

Monday	Tuesday	Wednesday	Thursday	Friday
	HU: No rate change **HR:** Unemployment	**HR**: 1Q17 flash GDP	**PL**: Unemployment **RS**: Wages	**HU**: Unemployment **SK**: Producer Prices

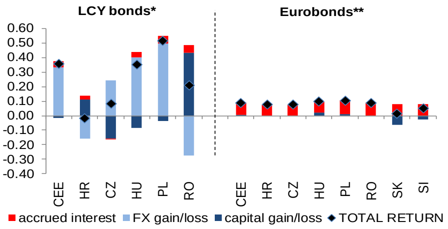
Click for: this week's detailed releases/events, market forecasts, macro forecasts

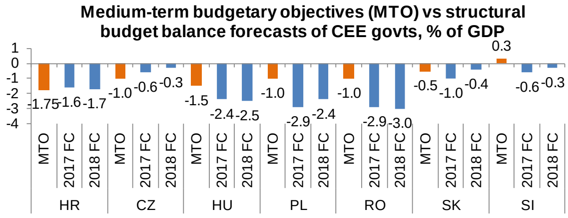
The coming week offers little in terms of new macro releases or events in CEE. Monday's calendar is practically empty, but we will have the 1Q17 GDP estimate coming from Croatia on Wednesday and an MPC meeting in Hungary on Tuesday. As for the former, we expect growth to have landed at 3.6% y/y, supported by a strong private consumption profile and ongoing robust export performance. In Hungary, the MPC meeting should be a non-event, with the base rate staying at 0.9% and the tone of the MPC remaining rather dovish, possibly indicating further easing, if necessary, with unconventional tools.

In case you missed it last week…

- We confirm our upward revision for 2017 GDP for Poland to 3.8% from 3.3% after good 1Q17 GDP data
- New forecasts for Hungary's GDP could be slightly below 4% for FY17, and between 4.6-5.1% for Romania after 1Q17 releases beat expectations
- Polish base rate left at 1.5% as expected, MPC tone rather dovish
- European Parliament voted to propose the start of Article 7 procedure against Hungary – no effect on markets
- For other events last week, please check respective countries: HR, CZ, HU, PL, RO, TR, SI, SK, SR

Chart sources: Erste Group Research, Convergence/Stability Programs





On Radar

We have mixed feelings about the structural budget balance forecasts of EU member CEE countries in their convergence/stability reports. More than half of them look good, at least at first sight. The Czech and the Slovak situation is not just favorable according to the respective governments, but in our view as well. In Croatia and Slovenia, however, the headline deficit is projected by us to be worse than the government expects, which could also mean somewhat worse development in terms of the structural figures (although, admittedly, we have been positively surprised in the recent past by these countries). We see much more concern in Hungary, Poland and Romania. With regard to Hungary and Poland, we are at least quite convinced that nominal shortfalls will not exceed the 3% of GDP threshold in the upcoming two years, even if the government in Hungary expects no convergence towards the MTO, and we see an optimistic path for structural balance improvement in Poland. For Hungary, potential GDP growth has likely been overestimated by the government, while in Poland, the lowering of the statutory age, increasing public investment, as well as the expected lowering of VAT after 2018 pose risks to meeting the MTO. A definite cause for concern is Romania, where the structural balance is to be the farthest away from the MTO next year and with no convergence towards it, even according to the super-bullish assumptions of the government. Although 1Q17 GDP beat all expectations by a wide margin, it is rather unlikely to be a result of the increase in potential output, and therefore should have little effect on the structural balance. If the headline deficits are to increase and positive output gaps widen, as we now expect, then the structural figures could actually worsen in Romania. (For further details, see the next page.)

While Romania is a definite cause for concern, Hungary and Poland will at least keep the headline deficit below 3% of GDP in the coming years

Ongoing fiscal easing in a number of CEE countries

'Can your country's budget balance realistically reach the MTO according to the most recent convergence report?'

Croatia: The MTO for Croatia is set at -1.75% of GDP and in 2017 and 2018 the government plans a budget deficit of -1.3% of GDP and -0.8% of GDP, respectively, which should translate into -1.6% of GDP and -1.7% of GDP of structural deficit figures. We are bit skeptical on two fronts regarding the plan and forecasts. Firstly, we see the budget deficit figure at a somewhat higher level, more precisely at -1.5% of GDP in both years, as there is always a risk of some fiscal slippages and there is still no clear view on union demands regarding wages. In addition, we are not sure whether the output gap will already be closed in 2017, given that this will be only the second year of more robust growth.

Czech Republic: For 2017, the central government budget deficit is approved to arrive at CZK 60bn, which is approx. in line with the mid-term budget target (-1% GDP). The MoF expects a structural deficit of -0.6% GDP in 2017 and -0.3% in 2018. However, the final figures will be better. First, the approved budget includes, in our view, a buffer. And second, favorable economic development will spill over into the fiscal policy figures. We expect a much lower overall deficit this year (CZK 30bn) and a structural deficit of roughly zero, but the current tax income and lower (than expected) expenditures should imply better results.

Hungary: The medium-term objective for the structural budget deficit target is 1.5% of GDP and is unlikely to be met in the coming years, as the government has been planning a higher deficit for 2017 and 2018 in preparations for the parliamentary elections in 2018. According to the latest Convergence Report of Hungary, the structural deficit may reach 2.5% and 2.4% of GDP in 2017 and 2018, respectively. We note that the GDP growth rate projection of 4.3% for 2018 is optimistic (vs. our forecast of 2.8%). In addition, the potential GDP growth rate is likely overestimated at 3.6% by about 1-1.5pp.

Poland: The Ministry of Finance expects the structural deficit to decrease by 0.4 pp and reach 2.9% and 2.4% of GDP in 2017 and 2018, respectively. The European Commission, in its latest forecast, remained critical in its evaluation of the consolidation efforts, as it sees the structural deficit in Poland at 3.2% and 3.1% of GDP in 2017 and 2018, meaning that the required 0.5pp consolidation will not be met. The main source of the MinFin's optimism in projecting such a decrease in the structural deficit is closing the VAT gap, which is, in our view, an ambitious goal. Further, the European Commission sees the possibility of a lower deficit only if the improved tax collection yields better than expected results. Another MinFin assumption is that consolidation of expenditures will also take place in the coming years. Yet, the lowering of the statutory age or increasing public investment (new budgeting period 2014-20) as well as the expected lowering of VAT by 1pp from 23% after 2018 pose risks to meeting the MTO in 2021 as declared in the convergence program.

Romania: The rise in potential GDP projected by the MinFin (4.5% for 2017) looks slightly optimistic and is based on a strong contribution from investments. Recent years have shown investments swinging up and down on a path that has been difficult to predict, while fiscal easing has so far failed to spur public investments (last year's relapse speaks volumes about this). In view of this, the risks for the structural deficit are that it will depart even more from the MTO assumed through the Fiscal Compact in 2012 (1% of GDP). Based on recent expansionary fiscal and wage policy, the structural budget deficit increased to 2.6% of GDP from 0.6% in 2015. Unless remedies are put in place, the deficit could expand further to 4% in 2017, especially as the local economy is cruising above its potential.

Slovakia: The Stability Report expects the MTO target of the structurally balanced budget (-0.5% of GDP) to already be reached in 2018, a year earlier than required. The 2018 nominal and structural deficits are expected to fall to 0.5% and 0.4% of GDP, respectively. There is no change for 2017 – the nominal deficit is expected at 1.3% of GDP, as the structural deficit should fall to 1% of GDP. The consolidation effort for 2017 and 2018 is expected at 0.4% and 0.6% of GDP, respectively. Overall if we remain on the right track, reaching the MTO next year could be realistic, given the good cyclical position of the economy and the favorable development of tax revenues. However, our fiscal deficit forecasts are slightly higher, at 1.5% and 0.8% of GDP for 2017 and 2018, respectively. Thus the question remains open for now.

Slovenia: The Slovenian MoF targets a rather optimistic deficit trajectory, as the deficit should be reduced from 1.8% of GDP in 2016 to 0.8% of GDP in 2017 and further to 0.2% of GDP in 2018. Part of the reduction should come from unclassified/undisclosed one-offs of 0.4% of GDP in both years, which we are taking with a grain of salt. While we also see the consolidation process continuing, we maintain a slightly more cautious stance, as higher compensation in the public sector implies higher pressure on the expenditure side, and consequently weighs on budget deficit levels. Our deficit projections stand at -1.7% of GDP and -1.5% of GDP for these two years.

Looking ahead

Date	Time	Country	Indicator	Period	Survey	Erste Est.	Prev.	Pre Comment
22. May			**No releases scheduled**					
23. May	11:00	**HR**	**Unemployment Rate**	Apr		***13.3%***	14.4%	*Unemployment figure mostly shaped by seasonal factors.*
	14:00	**HU**	**Target Rate**	May 23	*0.9%*	***0.9%***	0.9%	*No new measures or change in communication is expected; June meeting should be more exciting one.*
24. May	11:00	**HR**	**GDP (y/y)**	1Q P		***3.4%***	3.4%	*Strong consumption profile and robust exports supportive for figure.*
25. May	10:00	**PL**	**Unemployment Rate**	Apr	*7.7%*	***7.7%***	8.1%	*Unemployment rate to drop further and reach new, historically-low level.*
	12:00	**RS**	**Wages (y/y)**	Apr		***3.2%***	0.6%	*Wages maintaining upward trend, but stronger inflation exerting some downward pressure.*
26. May	9:00	**HU**	**Unemployment Rate**	Apr	*4.4%*	***4.4%***	4.5%	*Labor market should remain tight, short-term volatility may be driven by seasonality and expected changes in public works scheme*
	9:00	**SK**	**PPI (y/y)**	Apr		***3.2%***	3.0%	*Producer prices should mark steady rise in April, similarly to March.*

Sources: Bloomberg, Reuters

Major markets

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- The acceleration of the affair about ties between Donald Trump's campaign and Russian officials has triggered varying reactions on financial markets; however, the reactions were muted overall. The strongest reaction so far was shown in the EURUSD exchange rate. Good economic data coming out of the Eurozone also likely played a part on the euro's firming. But political events in the US had undeniably the strongest impact during the last days. On the treasury market, longer-term maturities reacted the most.
- It is hard to predict how the whole affair will evolve. The appointment of a special counsel is a clear indication that the scope of the investigation will be comprehensive and will take time. We therefore expect any news relating to the issue to continue to trigger market volatility. This week, for example, James Comey has been invited to testify in front of the House Oversight Committee on May 24, which will investigate whether the President tried to interfere with FBI investigations concerning his former national security advisor, Michael Flynn. The whole affair quite clearly still has the potential to grow bigger. However, the impact on financial markets should remain contained to relatively short-term swings, in our view. Any lasting impact seems unlikely for us, as the affair is highly unlikely to alter the solid course of the US economy.
- The first flash estimate for the manufacturing PMI of Germany, France and the Eurozone will be released this week (May 24). The Eurozone's industrial sentiment has been flying high for several months, especially in Germany. In April, sentiment even climbed to a six-year high. However, this optimism has not been reflected in the 1Q17 industrial production data; compared to 4Q16, industrial production remained static. In light of the dynamic development of sentiment in recent months, we expect no further improvement in May. The example of France also shows that good sentiment is currently no guarantee of dynamic growth (the French economy grew at below-average levels, with +0.8% y/y in 1Q17). Nevertheless, the economic outlook for the Eurozone remains positive in our assessment. The growth dynamic of German exports probably rose further in 1Q17. At present, we expect GDP growth of +1.8% y/y in the Eurozone in 2Q17.

Croatia

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- The April CPI figure landed at 1.4% y/y, slightly above our forecast. The biggest push for the headline figure came from 3.5% y/y growth in food prices and 9.7% y/y growth in fuel prices. Core inflation (excluding food and energy) remained at a relatively low 0.6% y/y.
- On Wednesday, we will see the flash estimate for 1Q17 GDP, which we expect to land at 3.6% y/y, supported by a strong private consumption profile and ongoing robust export performance.
- The markets showed steady performance, with the exchange rate staying at around 7.45 during the week, while yields on the bond market remained virtually flat, as the 2026 LCY curve is still moving close to the 3% mark.

Czech Republic

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- The preliminary GDP estimate indicates robust growth of 1.3% q/q and 2.9% y/y, due to solid domestic demand and the recovery in the Eurozone, which is positively affecting foreign demand.
- The current account surplus reached more than CZK 30bn in March, as it was positively affected by high demand for Czech goods from abroad and seasonal factors.
- Producer prices arrived at 0.3% m/m and 3.2% y/y. The figure was affected by higher wages growth, the recovery in the Eurozone and higher oil prices than in 2016.

Hungary

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- Nominal wages grew by 12.8% y/y in March, and by 11% in 1Q17. Net real wages grew by 8.2% y/y in the first quarter. The wage dynamics are due to the tight labor market conditions and the substantial increase in the minimum wage increase.
- The GDP growth rate reached 4.1% y/y (1.3% q/q SA) in 1Q17, led by industrial production and market-based services. The rebound in growth was partly due to the low base seen in 1Q16.

Poland

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- According to the flash estimate, 1Q17 accelerated visibly to 4.0% y/y, from 2.5% y/y in 4Q16. Although the structure of the growth will be released at the end of the month, we expect it to have been driven by domestic demand.
- The MPC left the policy rate flat at 1.5% and sustained its dovish stance. Glapinski sees no need to change the rate until the end of 2018, but there are some MCP members who would support a rate hike in mid-2017. At this point, inflationary pressure remains subdued and the risk of overshooting the target of 2.5% in the medium run has been low.
- The labor market has tightened further, with employment going up 4.6% y/y in April and wages grew 4.1% y/y/. So far, wage pressure has been moderate due to the inflow of workers from Ukraine.
- Industrial output fell 0.6% y/y in April, disappointing the market, which expected positive growth of 1.9% y/y. We believe that the slowdown was strongly impacted by negative calendar effects. Retail sales, on the other hand, sustained robust growth of 8.1% y/y in April, although the growth dynamics were below market expectations of 9.0% y/y.

Romania

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- GDP growth unexpectedly soared off the charts to 5.7% y/y in 1Q17, in parallel with a notable pickup in quarterly terms (+1.7%). Although the growth structure will only be released in three weeks, we expect industrial production and services for companies (particularly IT services) to have provided the most solid support. On the expenditures side, private consumption and probably a positive contribution from net exports were the main growth drivers behind the sterling GDP performance in the first quarter. Given the significant surprise, we put our GDP forecast for this year under revision. Provided that the 1Q17 data is confirmed by the National Institute of Statistics in early June, we expect the revised growth rate to be in the range of 4.6-5.1%.

- Despite projecting a wider positive output gap, the central bank cut its CORE 2 adjusted inflation forecast and therefore lowered the headline CPI forecast to 1.6% for December 2017, from the previous 1.7% and, more visibly, to 3.1% from 3.4% for end-2018. During the Q&A session after the Inflation Report press conference, Governor Isarescu admitted that the downward revision could bring with it a certain delay in central bank actions. He also mentioned that the next move could be to narrow the gap between lending and deposit rates.
- The current account balance ended the first quarter with a broader negative gap against 1Q16 (EUR 691mn), amid a widening trade deficit (goods) and further shrinking of the net gain in the service balance due almost entirely to a bigger shortfall from tourism services. Furthermore, the surplus of the 'secondary income balance' dropped more than EUR 340mn in the first three months, while inflows in the public sector dwindled noticeably.

Serbia

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- There were no major releases last week, so we would only mention that, despite a disappointing 1Q17 GDP estimate (1% y/y), the IMF kept the baseline forecast at 3% y/y. Our call of 3% y/y is under potential downward revision after the release of the final data on May 31.
- On the bond market, we could see the benchmark RSD 2023 bond yield moving steadily around 5.7%, unchanged from the week before.
- On the FX market, dinar gains continued, with the EUR/RSD moving close to and slightly below the 123 mark, suggesting that we could see NBS intervention in the upcoming days, as the Serbian central bank has shown that it reacts to all excessive volatility on the market (against both the appreciation and depreciation of the currency).

Slovakia

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- Flash GDP growth reached 3.1% y/y (0.8% q/q) in 1Q17, fully meeting our expectations. Employment growth stood at 2.1% y/y, marking a slight slowdown compared to 4Q16, but still suggesting very good performance. We expect that domestic demand, mostly household consumption, together with net exports were the main drivers of growth. Overall, we expect growth to average 3.1% this year, before speeding up to 3.7% in 2018.
- The Slovak debt management agency conducted two auctions of government bonds on May 15 (with a competitive and non-competitive round in each). Slovakia sold EUR 182mn worth of government bonds due in January 2027 at an average yield of 1.0346%. Another auction saw EUR 144.8mn of bonds maturing in January 2031 being sold at an average yield of 1.3898%. The bid-cover ratio was high, reaching 2.97 and 2.4 in the two competitive rounds, respectively.
- Consumer prices (and also HICP) increased by 0.8% y/y (0.1% m/m) in April, marking a marginally lower growth rate than forecasted. Core

inflation stood at 1.5% y/y, slightly below its previous level (1.7% y/y in March). We expected a slight slowdown in consumer price growth, as energy price base effects were expected to wane from March onwards and other price pressures are still not deep-rooted and may take some time to become more persistent. Our 2017 forecast remains at 1% (CPI average).

- Andrej Danko, leader of the second largest coalition party SNS (Slovak National Party) would like to push through a mandatory 13th and 14th wage according to recent media reports. No further details of the proposal have been released thus far, but it is interesting that even labor unions are not thrilled with the idea, as the increased costs could cause substantial harm to companies and the state.

Slovenia

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- With no important macro releases last week, the focus was on the potential larger privatization story, after the government announced that the European Commission gave the "green light" for the sale of 50% of shares in the completely state-owned Nova Ljubljanska Banka (NLB), the largest bank in Slovenia. Although this news is market-positive, we are still a bit cautious, as this story has been present in the media and political sphere for years, with no real progress during that time.
- Yields on bonds saw slight upward movements throughout the week, with the EUR 2027 edging up 5bp w/w and currently quoting around the 1.40% mark.

Capital market forecasts

Government bond yields	current	2017Q2	2017Q3	2017Q4	2018Q1
Croatia 10Y	2.96	3.00	3.00	3.10	3.10
spread (bps)	259	251	239	238	227
Czech Rep. 10Y	0.93	0.80	0.84	0.83	0.88
spread (bps)	56	31	23	11	5
Hungary 10Y	3.12	3.60	3.67	3.67	3.67
spread (bps)	275	311	306	295	284
Poland 10Y	3.33	3.65	3.82	3.98	4.11
spread (bps)	296	316	321	326	328
Romania10Y	3.72	4.25	4.35	4.50	4.75
spread (bps)	335	376	374	378	392
Slovakia 10Y	0.99	1.20	1.23	1.25	1.35
spread (bps)	62	71	62	53	52
Slovenia 10Y	1.40	1.40	1.50	1.60	1.70
spread (bps)	103	91	89	88	87
Serbia 7Y	5.49	5.80	6.00	6.00	6.25
spread (bps)	512	531	539	528	542
DE10Y (BBG)*	***0.37***	***0.49***	***0.61***	***0.72***	***0.83***

3M Money Market Rate	current	2017Q2	2017Q3	2017Q4	2018Q1
Croatia	0.58	0.40	0.40	0.45	0.45
3M forwards		-	-	-	-
Czech Republic	0.30	0.27	0.27	0.26	0.26
3M forwards		0.37	0.44	0.51	0.60
Hungary	0.15	0.05	0.05	0.05	0.05
3M forwards		0.19	0.23	0.30	0.37
Poland	1.73	1.75	1.74	1.75	1.79
3M forwards		1.79	1.78	1.81	1.88
Romania	0.86	1.30	1.50	1.90	2.10
3M forwards		0.85	1.10	1.19	1.65
Serbia	3.52	3.60	3.80	4.00	4.00
3M forwards		-	-	-	-
Eurozone	-0.33	-0.30	-0.30	-0.30	-0.30

FX	current	2017Q2	2017Q3	2017Q4	2018Q1
EURHRK	7.44	7.42	7.50	7.55	7.55
forwards		7.44	7.46	7.47	7.48
EURCZK	26.53	26.50	26.40	26.30	26.20
forwards		26.52	26.49	26.45	26.42
EURHUF	309.6	315.0	315.0	315.0	315.0
forwards		309.8	310.3	310.6	311.1
EURPLN	4.21	4.25	4.27	4.21	4.23
forwards		4.22	4.24	4.27	4.29
EURRON	4.56	4.57	4.60	4.62	4.65
forwards		4.57	4.58	4.60	4.62
EURRSD	123.0	124.0	124.5	124.5	124.5
forwards		-	-	-	-
EURUSD	1.12	1.08	1.10	1.12	1.12

Key Interest Rate	current	2017Q2	2017Q3	2017Q4	2018Q1
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	2.9	3.0	2.6
Czech Republic	4.6	2.3	2.8	2.9
Hungary	3.1	2.0	3.4	2.8
Poland	3.6	2.8	3.8	3.4
Romania	3.9	4.8	4.3	2.8
Serbia	0.8	2.8	3.0	3.4
Slovakia	3.8	3.3	3.1	3.7
Slovenia	2.3	2.5	3.1	3.0
CEE8 average	**3.5**	**3.0**	**3.5**	**3.1**

Average inflation (%)	2015	2016f	2017f	2018f
Croatia	-0.5	-1.1	1.4	1.3
Czech Republic	0.3	0.7	2.7	1.9
Hungary	-0.1	0.4	2.5	3.4
Poland	-0.9	-0.6	1.8	1.9
Romania	-0.6	-1.5	1.4	2.7
Serbia	1.4	1.1	2.4	3.1
Slovakia	-0.3	-0.5	1.0	2.0
Slovenia	-0.5	-0.1	1.6	2.0
CEE8 average	**-0.4**	**-0.4**	**1.9**	**2.2**

Unemployment (%)	2015	2016f	2017f	2018f
Croatia	16.3	13.1	10.9	9.7
Czech Republic	5.1	4.1	3.6	3.6
Hungary	6.8	5.1	4.3	4.1
Poland	10.6	8.9	7.9	7.7
Romania	6.8	6.0	5.9	5.8
Serbia	17.7	16.0	14.1	12.8
Slovakia	11.5	9.7	8.7	7.8
Slovenia	9.0	7.9	7.4	6.9
CEE8 average	**9.3**	**7.7**	**6.9**	**6.6**

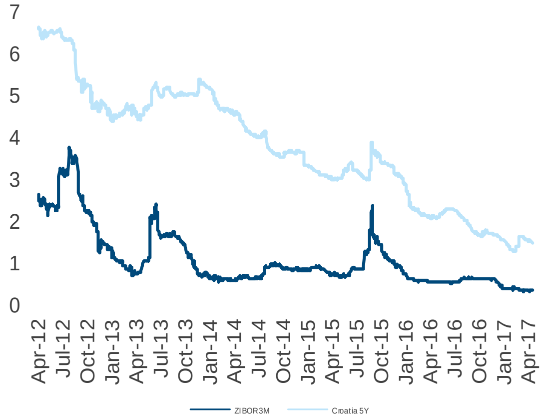
Public debt (% of GDP)	2015	2016f	2017f	2018f
Croatia	86.7	84.2	81.4	79.5
Czech Republic	40.3	37.2	35.7	35.9
Hungary	74.7	74.3	74.0	72.5
Poland	51.5	54.3	54.9	54.1
Romania	37.9	37.1	39.2	40.8
Serbia	74.7	72.9	69.4	68.9
Slovakia	52.5	51.9	51.7	50.5
Slovenia	83.4	79.2	77.9	75.9
CEE8 average	**53.7**	**53.6**	**53.5**	**53.0**

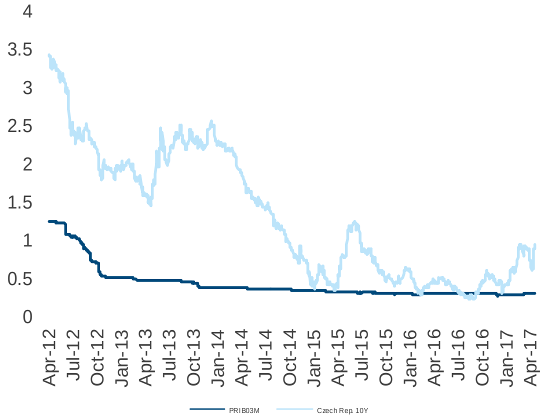
C/A (%GDP)	2015	2016f	2017f	2018f
Croatia	4.8	2.6	4.2	2.9
Czech Republic	0.9	2.1	1.2	1.4
Hungary	3.4	4.9	4.1	3.8
Poland	-0.2	-0.3	-0.6	-0.9
Romania	-1.2	-2.4	-3.3	-3.8
Serbia	-4.8	-4.2	-4.6	-4.8
Slovakia	0.2	-0.7	0.8	1.6
Slovenia	5.2	6.8	6.4	5.8
CEE8 average	**0.5**	**0.5**	**0.2**	**0.0**

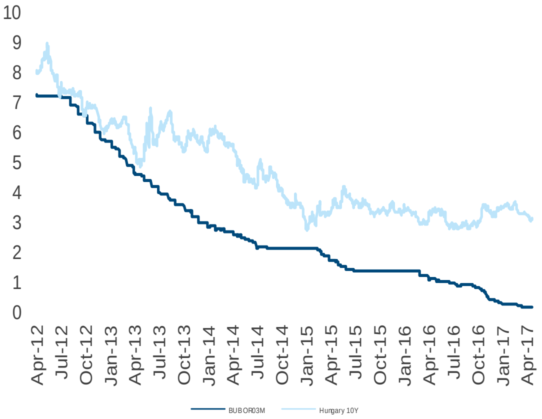
Budget Balance (%GDP	2015	2016f	2017f	2018f
Croatia	-3.4	-0.8	-1.5	-1.5
Czech Republic	-0.4	0.5	-0.6	-0.6
Hungary	-2.0	-2.2	-2.7	-2.5
Poland	-2.5	-2.4	-3.0	-2.9
Romania	-0.8	-2.8	-3.5	-3.6
Serbia	-3.8	-1.4	-1.2	-1.0
Slovakia	-2.7	-1.7	-1.5	-0.8
Slovenia	-2.9	-2.0	-1.7	-1.5
CEE8 average	**-2.0**	**-1.8**	**-2.4**	**-2.3**

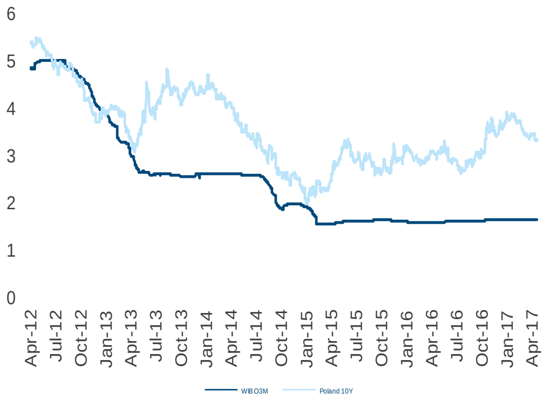
Note:*Information on past performance is not a reliable indicator for future performance. Forecasts are not a reliable indicator for future performance.

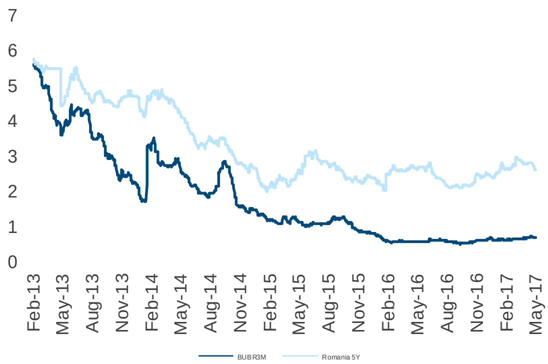
Appendix

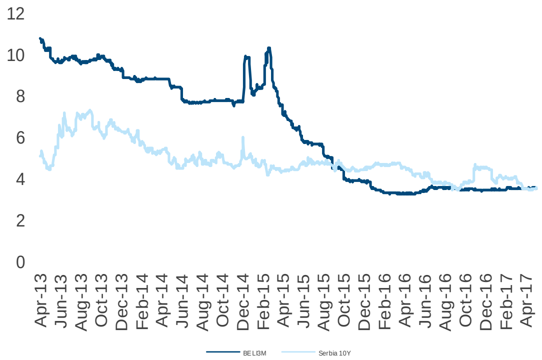


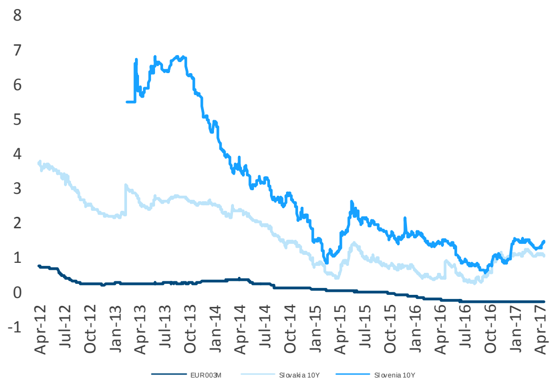












Note:*Information on past performance is not a reliable indicator for future performance. Forecasts are not a reliable indicator for future performance.

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