CEE Insights

Fixed Income and Foreign Exchange

Looking ahead this week…

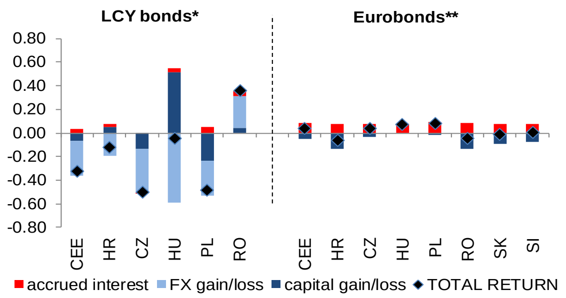
Monday	Tuesday	Wednesday	Thursday	Friday
PL: Unemployment **RS:** Wages		**HU**: Unemployment **SK**: Producer Prices	**CZ**: No rate change	**SI, PL**: Inflation **HR, RS**: Industry, Retail Sales

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

This week will offer just a few macro releases in CEE. The most important event to watch could be the rate setting meeting of the Czech National Bank. We have recently received many comments from bank board members. First, Vice-Governor Tomsik said that the recent appreciation helps the CNB with monetary policy tightening. Governor Rusnok also said that the continuing strengthening of the koruna could be a reason for a slower raising of rates, while M. Mora delivered similar statements. All in all, we expect a hike in November, as the CNB will have a new forecast at that time and more detailed information about ECB policy. In Romania, we might see additional news regarding the new government to be put forward by the Social Democrats. The new establishment could push forward the party's program more forcefully, with potentially greater risk of deficit slippage.

In case you missed it last week…

- Parliament toppled government in Romania in move initiated by governing party head Dragnea
- CNB bank board members said FX appreciation could potentially delay first rate hike in Czech Republic
- Hungary's MNB kept policy rate unchanged at 0.9% as expected, 3M depo facility capped at HUF 300bn
- Workers in Slovak VW plant ended the strike after they reached the agreement on wage increase
- For other events last week, please check respective countries: HR, CZ, HU, PL, RO, TR, SI, SK, SR



On Radar

If the EU moves towards deepening of integration as proposed by new French President Macron, the question arises of what to do with countries that voluntarily stay out of monetary union, despite their commitment to adopt when meeting all criteria. At present, most of them meet all criteria, or meeting them would be effortless, so there is just a lack of political will to do so. There has been a lot of criticism directed towards CEE countries recently for cherry-picking and, according to leaked information, the EC intends to set a clear deadline (2025) for adoption of the euro by non-member countries. It seems that the planned overhaul of Cohesion Policies after 2020 and greater focus on solidarity restricted to Eurozone members only (countries that have shown the will to integrate) may give a new push to CEE countries that aim to be 'in the core'. Despite all of these shifts, euro adoption is still not a topic in CEE countries other than Croatia. The youngest EU member country is going to intensify its public debate related to euro adoption in autumn, when the central bank will publish its euro costs and benefits analysis. According to the most recent Euro Barometer, almost half of Croats think that the country will adopt the euro in five years. On the other extreme are still the Czechs, where nearly half of respondents think that the country will never adopt the euro. (For further details, see the next page.)

CEE countries want to advance more in economic convergence and be more competitive before joining the Eurozone.

Among CEE countries, only Croatia is thinking about early euro adoption

'Have recent calls for deeper EU integration triggered discussion about euro adoption in CEE countries?'

Croatia: At the beginning of 2017, there were a lot of media reports on the 'informal agreement' between PM Plenkovic and Governor Vujcic that the government and central bank would put euro adoption among the top priorities on the policy agenda. However, political instability and several other situations (e.g. Agrokor) have moved the focus and recently we have not seen much progress on this matter. However, regained political stability, the end of the excessive deficit procedure and announced cost-benefit analysis of euro adoption from the Croatian National Bank (due in September) could bring the attention of policy makers back to this important question. In addition, the Croatian Banking Association initiated a conference on this topic to be held during summer (representatives of banks, the central bank and government), during which we could see a lot of media attention, bringing discussion on euro adoption back to the covers of the popular media.

Czech Republic: Public opinion is still tilted against the euro, and this also spills over into the negative attitude of many Czech politicians. For this reason, we do not see any significant change in public debate or a higher willingness to join the Euro Area. However, besides the political factors stemming from higher demand for tighter economic cooperation among several EU representatives, we also expect rising demand for joining the Eurozone from Czech firms, due to the high openness of the Czech economy, and this should intensify in the future. An optimistic estimate is that the Czech Republic could join the Eurozone in around 2025.

Hungary: Currently, there is no official target date for euro adoption; however, the economic policy has not given up its intention of joining the Eurozone. Despite the fact that the importance of deeper integration has emerged on the EU level and the topic has been in focus to a greater extent for a while, Hungary is expected to maintain its wait-and-see stance on the issue. According to Economic Minister Mihály Varga, the lack of a unified fiscal policy coupled with a common monetary policy could make it impossible to maintain a common currency system. Although Hungary more or less meets the nominal convergence criteria, entering the ERM2 is still not on the agenda, as the economic policy seeks to increase the country's competiveness and make progress in the field of real convergence before adopting the common currency.

Poland: We do not see a high probability of euro adoption in the coming years. Although three out of four main Maastricht criteria are fulfilled (the only exception is the ERM II program, in which Poland is not taking an active part), public opinion is strictly against the euro. Recently, Minister of Development and Finance Morawiecki said that the Polish economy is not ready to adopt the euro and in fact there is no need to enter the Eurozone. He claims that, after adoption of the euro, Poland would lose its main advantage, meaning its independent monetary policy. That is in line with comments from Jaroslaw Kaczynski (the leader of the ruling Law and

Justice party) that adoption of the euro would significantly lower the quality of life in Poland and decrease the competitiveness of Polish export.

Romania: Euro adoption has been a moving target in Romania over the past ten years that has never been tackled too seriously. With no clear-cut agenda, officials have usually contented themselves to only noticing that Romania has to catch up to the Eurozone average GDP/capita and that more has to be done in terms of improving productivity to sustainably lift the country's economic potential (strong need for structural reforms, increasing EU funds absorption, developing infrastructure, etc.). Romania's GDP/capita at PPS reached 55.8% of the Eurozone's in 2016, from 48.2% five years ago. Arguably, if the country continues to gain 1.5pp per year on the Eurozone and assuming that the convergence point for the GDP/capita stands at 70%, Romania will need around ten years to be able to join the single currency area. In a bid to adopt the euro, Romania will also have to address the significant regional disparities when it comes to GDP/capita.

Looking ahead

Date	Time	Country	Indicator	Period	Survey	Erste Est.	Prev.	Pre Comment
26. Jun.	10:00	**PL**	**Unemployment Rate**	May	*7.4%*	***7.4%***	7.7%	
	12:00	**RS**	**Wages (y/y)**	May			-2.7%	
28. Jun.	9:00	**HU**	**Unemployment Rate**	May	*4.3%*	***4.5%***	4.6%	*After increase seen in previous month, another declining process may have started, thanks to seasonal patterns*
	9:00	**SK**	**PPI (y/y)**	May		***2.3%***	2.4%	*Producer prices should rise at pace similar to April's, as inflationary pressures are reappearing this year*
29. Jun.	13:00	**CZ**	**Target Rate**	Jun	*0.05%*	***0.05%***	0.05%	*CNB will keep interest rates on hold, in our view; we expect first hike in November 2017, due to strong wage growth, solid domestic demand and significant increase in property prices*
30. Jun.		**HR**	**Current Account Balance (quarterly)**	1Q			-696.5	
		RO	**Unemployment Rate**	May			4.3%	
	9:00	**CZ**	**GDP (q/q)**	1Q F	*1.3%*	***1.3%***	1.3%	*Solid domestic and improving foreign demand positively affected GDP growth in 1Q17*
	9:00	**CZ**	**GDP (y/y)**	1Q F	*2.9%*	***2.9%***	2.9%	*GDP growth in y/y terms will be slightly below 3% this year, due to both domestic and foreign demand development; also, just slight appreciation of koruna will contribute positively to GDP growth*
	9:00	**HU**	**PPI (y/y)**	May			4.4%	
	9:00	**HU**	**Trade Balance**	Apr F			878.0	
	10:30	**SI**	**CPI (y/y)**	Jun		***1.3%***	1.5%	*Inflation is maintaining its stable pattern*
	11:00	**HR**	**Industrial Production (y/y)**	May		***-0.8%***	-0.6%	*Base effects are playing key role*
	11:00	**HR**	**Retail Sales (y/y)**	May P		***2.5%***	2.8%	*Figure are mostly shaped by seasonal factors*
	11:00	**HR**	**Wages (y/y)**	Apr			2.5%	
	12:00	**RS**	**Industrial Production (y/y)**	May		***1.6%***	-2.6%	*Fading effects of lower energy production and stronger domestic demand are supportive for figure*
	12:00	**RS**	**Retail Sales (y/y)**	May		***2.5%***	-0.9%	*Stabilizing inflation and positive sentiment are playing supportive role*
	12:00	**RS**	**Trade Balance**	May			-284.0	
	14:00	**PL**	**CPI (y/y)**	Jun P			1.9%	

Sources: Bloomberg, Reuters

Major markets

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- This week (June 30), the flash June industry PMI data for the Eurozone will be released. In May, headline inflation declined to +1.4% y/y, largely due to waning base effects from energy prices. Core inflation, however, remained largely unchanged, at +0.9% y/y in May. Because of further waning base effects from energy prices, we expect a slight decrease of headline inflation to +1.2% y/y to 1.3% y/y for June. Conversely, and for the first time in a considerable period, we anticipate a sustainable (not based on seasonal effects) slight increase of core inflation to +1.0% y/y. Based on the Eurozone's pursued economic recovery, we expect core inflation to marginally rise to 1.2% y/y by the end of the year. For 2017, we estimate headline inflation unchanged at +1.5% y/y, on average.
- This week, the decrease of oil prices continued. The price Brent, for instance, has declined 20% compared to this year's highs seen at the beginning of the year. The stated reason for the falling prices is the favorable supply situation. In particular, US producers have increased their production volumes and appear unimpressed by the falling prices so far. Another contributor is the increased production in Libya and Nigeria, which are exempt from the OPEC cutbacks. We assume that the latest price development will not have any significant impact on US or Eurozone central banks yet. However, if the downward trend continues and, as a consequence, a prolonged price slack becomes likely, it could be relevant especially for the ECB (as they struggle harder to elevate the inflation rate to the desired level), more so than the US Fed.

Croatia

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- Unemployment in May landed at 11.7%, slightly above our 11.6% call. The fall in the unemployment rate is mostly supported by seasonal factors, but also by the general improvement on the labor market. We expect an additional fall of the figure in the coming period and stronger seasonal effects in the summer months.
- Yields on the bond market maintained a stable performance throughout the week, with the longer end of the domestic curve remaining unchanged. Appreciation pressures on the Croatian kuna were subdued last week, with the EUR/HRK standing at 7.42 vs. the 7.40 recorded the week before.

Czech Republic

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- CNB board members recently cooled expectations for a fast interest rate hike. First, Vice-Governor V. Tomsik said that the recent appreciation helps the CNB with monetary policy tightening. In his view, the current appreciation tendency should imply a shift of the interest rate hike from 3Q17 to 4Q. Governor J. Rusnok said that the continuing strengthening of the koruna could be a reason for a slower raising of rates. He also added that, although a hike could come in 3Q17, this is more of a 'model calculation'. M. Mora delivered similar statements, saying that the current level could imply a hike in 3Q, but the pace of the current appreciation might postpone the increase.

- To sum up, CNB representatives are considering a hike in 2H17, as pro-inflationary factors (high wage growth, core inflation above the target and high increases in property prices) probably outweigh the reasons for a slower pace of monetary tightening (loose monetary policy in the Eurozone and the expected slowdown in Czech inflation at the turn of 2017/18). However, the recent FX appreciation poses an additional anti-inflationary risk. We expect a hike in November, as the CNB will have a new forecast at that time and more detailed information about ECB policy. We see the risks as balanced. A significant positive surprise in wage growth could imply a hike in September. On the other hand, koruna appreciation below EURCZK 26 or negative wage growth data could postpone any hike until the beginning of 2018.

Hungary

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- At the June rate setting meeting, the policy rate remained unchanged at 0.9%. The quantitative limitation on the 3M deposit was announced at HUF 300bn at the end of September, after the HUF 500bn planned for the end of June. The tone of the MPC remained dovish. In its Inflation Report, the staff reduced its forecasts for the annual average inflation rates, to 2.4% in 2017 and to 2.8% in 2018. The staff sees downside risks to inflation and upside risks to GDP growth. Based on the above, we continue to think that the 3M policy rate of 0.9% will not change until end-2019, and we see additional room for the 3M BUBOR interest rate to decrease. We think that normalization of interest rates is unlikely before 2019.
- The gross wage increase in the economy accelerated to 14.6% y/y in April, while it reached 11.9% y/y in the first four months of the year. Due to the expected continuation of wage outflow and still moderate level of CPI inflation rates, real wages in the economy should rise by 7-8% y/y this year. This could create a stable base for the expected improvement in consumer demand. We expect GDP growth to reach 3.7% in 2017.

Poland

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- Industrial output growth accelerated to 9.1% y/y in May (from -0.6% y/y in April). The solid expansion of industry was supported by one-off factors, in particular more working days in May. We expect industrial output to maintain a solid pace of expansion; however, we see limited space for further acceleration, as recent PMI numbers suggest stabilization of the growth.
- Retail sales maintained solid growth at 8.4% y/y in May, still below market expectations of 9.1% y/y. The strong growth of retail sales confirms that private consumption should remain the main driver of the growth in the second quarter.

Romania

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- The Romanian Parliament toppled the Grindeanu government after 241 MPs voted for the no-confidence motion initiated by the Social-Democrat Party (PSD) and the Alliance of Liberals and Democrats (ALDE). On Monday, PSD and ALDE will submit their proposal for the PM position to President Iohannis. We assume the ruling coalition will try to respect the integrity conditions for the PM position required by Iohannis, which increases the chances of a swift approval in the Parliament of the new government. The economic agenda of the new government could remain anchored to the current economic program of PSD, which strikes a difficult balance between further expansionary fiscal measures and maintaining the budget deficit within 3% of GDP. Given the stance of PM Grindeanu, who was criticized for being somewhat out of line with the PSD economic and political program, we suspect that the new finance establishment would lean towards program measures, with potentially more risks of deficit slippage, which is why we maintain our current view of the 2017 deficit at 3.4% of GDP.

Serbia

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- Start of the proceedings for the elections of new prime minister Brnabic is expected on Saturday assembly of the parliament. However, final vote is expected during the week. It is also interesting to mention that president Vucis (as SNS leader) proposed formation of the Ministry of European Integration, which can be seen as an important step on Serbian EU path.
- S&P and Fitch affirmed their ratings for Serbia at BB- with positive and stable outlook, respectively. Both agencies stressed the importance of the notably improved fiscal position, solid economic outlook and solid progress on the precautionary deal with the IMF. As the main risk factors in the mid run, the rating agencies see still unreformed SOEs, pressures on the healthcare and pension systems and low participation in the labor force.
- On the bond market, we saw the benchmark RSD 2023 bond yield inch lower to 5.60%, supported by the clearer political situation and somewhat stronger portfolio inflows from abroad.
- Appreciation pressures on the dinar strengthened again last week and the EUR/RSD reached a new record level in 2017 of 121.4. The NBS intervened again on the buy side with EUR 30mn. We expect the appreciation pressures to remain present in the coming period, but then to fade away after the summer months, with the EUR/RSD stabilizing in the 123-123.5 region).

Slovakia

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- The workers of Slovakia's VW plant in Bratislava have been on strike since June 20, demanding a 16% wage hike spread over this year and the next. The management of the company improved its offer to a 9% hike spread over two years, but this has been rejected by the unions. Further negotiations are on the way. VW production in Slovakia has been largely suspended. The impact of the strike depends on its length. The Institute of Financial Policy (at the MinFin) estimates that daily sales of

Slovak VW amount to EUR 6.3mn. Thus, if the strike went on for 12 days, the loss would amount to 0.1% of GDP.

- The Slovak debt management agency conducted two auctions of government bonds. Slovakia sold EUR 160.1mn worth of government bonds due in May 2026 at an average yield of 0.7059%. Another auction saw EUR 201.8mn of bonds maturing in March 2037 being sold at an average yield of 1.7287%. The bid-cover ratio was high, reaching 2.93 and 1.68 in the two competitive rounds, respectively.
- Unemployment fell by 0.39pp to 7.35% in May, a record low for Slovakia. Compared to a year ago, the number of unemployed is down by almost 57tsd, mainly due to strong employment growth. Job vacancies are still numerous, suggesting we may expect the favorable development to continue. Yet, there is already a lack of qualified labor in some sectors, especially in industry, which is partly solved by employing workers from abroad (altogether 41tsd in May, up 12tsd compared to a year ago).
- The OECD’s latest outlook for Slovakia foresees good growth both this year and the next, at 3.3% and 4.1%, respectively (higher than our forecasts of 3.1% in 2017 and 3.7% in 2018). The country survey focuses on numerous aspects, mainly healthcare, education, public finances and public sector efficiency. A particularly pressing issue remains the integration of the Roma population, as well as improving their health and education standards.

Slovenia

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- In the absence of major macro releases last week, we would like to mention that the Slovenian Sentiment Indicator continued to improve in June. The recorded 12.3 percentage points shows that the indicator was 2.8pp higher than in May 2017 and 7.9pp higher on a yearly basis. This is important because we should see releases on short-term indicators this week, which should also show a continuation of the positive developments. We have recently increased our FY17 growth outlook to 3.7% after the stellar 1Q17 GDP performance in Slovenia.
- ·Yields on the bond market continued their downward trajectory, with the benchmark EUR 2027 yield falling to 1%, from the 1.1% recorded a week earlier.

Capital market forecasts

Government bond yields	current	2017Q3	2017Q4	2018Q1	2018Q2
Croatia 10Y	2.83	3.00	3.10	3.10	3.20
spread (bps)	257	246	241	231	228
Czech Rep. 10Y	0.95	0.82	0.85	0.88	0.90
spread (bps)	69	28	16	9	-2
Hungary 10Y	2.93	3.67	3.67	3.67	3.67
spread (bps)	268	313	298	288	275
Poland 10Y	3.20	3.44	3.62	3.75	3.91
spread (bps)	295	290	293	296	299
Romania10Y	3.74	4.10	4.30	4.40	4.60
spread (bps)	349	356	361	361	368
Slovakia 10Y	0.82	1.23	1.25	1.35	1.38
spread (bps)	57	69	56	56	46
Slovenia 10Y	1.06	1.30	1.40	1.50	1.50
spread (bps)	81	76	71	71	58
Serbia 7Y	5.40	5.80	6.00	6.25	6.25
spread (bps)	515	526	531	546	533
DE10Y (BBG)*	***0.25***	***0.54***	***0.69***	***0.79***	***0.92***

3M Money Market Rate	current	2017Q3	2017Q4	2018Q1	2018Q2
Croatia	0.62	0.40	0.45	0.45	0.45
3M forwards		-	-	-	-
Czech Republic	0.30	0.32	0.49	0.49	0.50
3M forwards		0.37	0.43	0.49	0.57
Hungary	0.15	0.05	0.05	0.05	0.05
3M forwards		0.19	0.20	0.25	0.27
Poland	1.73	1.74	1.75	1.79	1.79
3M forwards		1.79	1.78	1.83	1.88
Romania	0.83	1.00	1.30	1.50	1.70
3M forwards		0.96	0.99	1.39	1.83
Serbia	3.54	3.50	3.50	3.80	4.00
3M forwards		-	-	-	-
Eurozone	-0.33	-0.30	-0.30	-0.30	-0.30

FX	current	2017Q3	2017Q4	2018Q1	2018Q2
EURHRK	7.42	7.50	7.55	7.55	7.40
forwards		7.42	7.44	7.46	7.47
EURCZK	26.30	26.10	26.00	25.80	25.70
forwards		26.29	26.26	26.21	26.21
EURHUF	309.2	313.0	315.0	315.0	315.0
forwards		309.5	309.8	310.2	310.7
EURPLN	4.23	4.23	4.21	4.22	4.18
forwards		4.26	4.28	4.30	4.33
EURRON	4.58	4.60	4.62	4.65	4.67
forwards		4.59	4.60	4.62	4.64
EURRSD	121.8	123.0	123.5	123.5	123.6
forwards		-	-	-	-
EURUSD	1.12	1.10	1.12	1.12	1.12

Key Interest Rate	current	2017Q3	2017Q4	2018Q1	2018Q2
Croatia	0.50	0.30	0.30	0.30	0.30
Czech Republic	0.05	0.05	0.25	0.25	0.25
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	4.25
Eurozone	0.00	0.00	0.00	0.00	0.00

Macro forecasts

Real GDP growth (%)	2015	2016f	2017f	2018f
Croatia	2.2	3.0	2.7	2.4
Czech Republic	4.6	2.3	2.9	2.8
Hungary	3.1	2.0	3.7	2.8
Poland	3.6	2.8	3.8	3.4
Romania	3.9	4.8	5.1	3.9
Serbia	0.8	2.8	2.5	3.0
Slovakia	3.8	3.3	3.1	3.7
Slovenia	2.3	2.5	3.7	3.2
CEE8 average	**3.6**	**3.0**	**3.7**	**3.3**

Average inflation (%)	2015	2016f	2017f	2018f
Croatia	-0.5	-1.1	1.4	1.3
Czech Republic	0.3	0.7	2.5	2.0
Hungary	-0.1	0.4	2.2	3.2
Poland	-0.9	-0.6	1.8	1.9
Romania	-0.6	-1.5	1.4	2.7
Serbia	1.4	1.1	3.4	3.8
Slovakia	-0.3	-0.5	1.0	2.0
Slovenia	-0.5	-0.1	1.5	1.5
CEE8 average	**-0.4**	**-0.4**	**1.9**	**2.2**

Unemployment (%)	2015	2016f	2017f	2018f
Croatia	16.3	13.1	10.9	10.0
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	8.6	7.8
Slovenia	9.0	8.0	7.3	6.6
CEE8 average	**9.3**	**7.7**	**6.9**	**6.6**

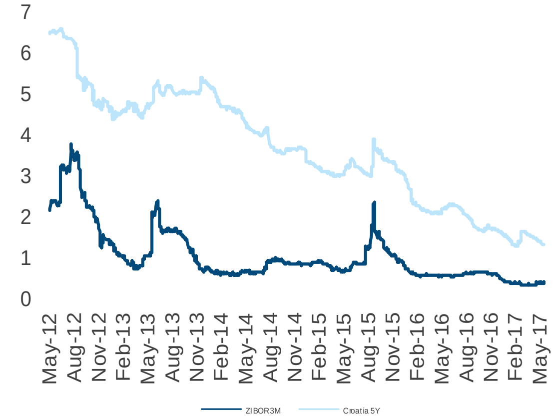
Public debt (% of GDP)	2015	2016f	2017f	2018f
Croatia	86.3	83.7	81.4	79.5
Czech Republic	40.3	37.2	35.7	35.9
Hungary	74.7	74.1	74.0	72.5
Poland	51.5	54.3	54.9	54.1
Romania	38.0	37.6	37.7	38.2
Serbia	74.7	72.9	69.4	68.9
Slovakia	52.5	51.9	51.7	50.5
Slovenia	83.4	79.0	76.6	74.8
CEE8 average	**53.7**	**53.7**	**53.2**	**52.6**

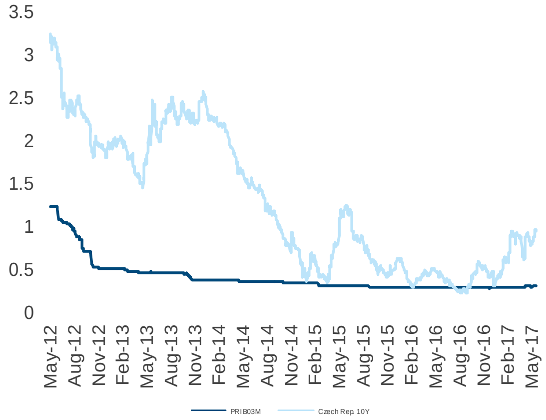
C/A (%GDP)	2015	2016f	2017f	2018f
Croatia	4.8	2.6	4.1	2.5
Czech Republic	0.9	2.1	0.8	0.6
Hungary	3.4	4.9	4.1	3.8
Poland	-0.2	-0.3	-0.6	-0.9
Romania	-1.2	-2.3	-3.2	-3.8
Serbia	-4.8	-4.2	-5.0	-5.2
Slovakia	0.2	-0.7	0.8	1.6
Slovenia	5.2	6.8	6.4	5.9
CEE8 average	**0.5**	**0.5**	**0.1**	**-0.2**

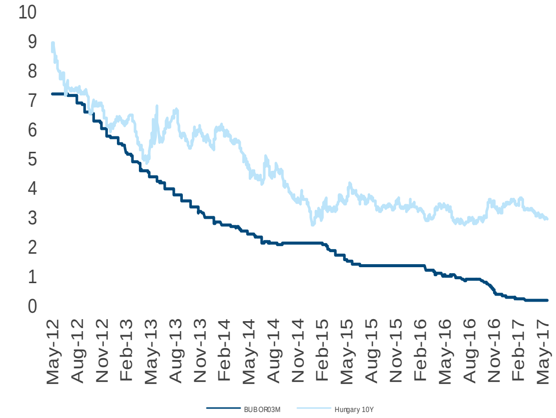
Budget Balance (%GDP	2015	2016f	2017f	2018f
Croatia	-3.4	-0.8	-1.5	-1.5
Czech Republic	-0.4	0.5	-0.4	-0.4
Hungary	-1.6	-1.8	-2.7	-2.5
Poland	-2.5	-2.4	-3.0	-2.9
Romania	-0.8	-3.0	-3.4	-3.4
Serbia	-3.8	-1.2	-0.8	-0.6
Slovakia	-2.7	-1.7	-1.5	-0.8
Slovenia	-2.9	-1.8	-1.3	-1.1
CEE8 average	**-1.9**	**-1.8**	**-2.3**	**-2.2**

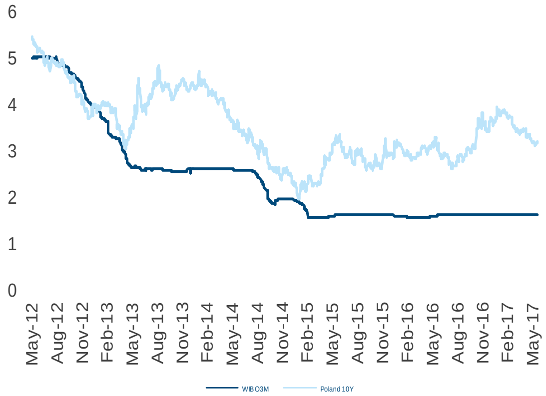
Note:*Information on past performance is not a reliable indicator for future performance. Forecasts are not a reliable indicator for future performance.

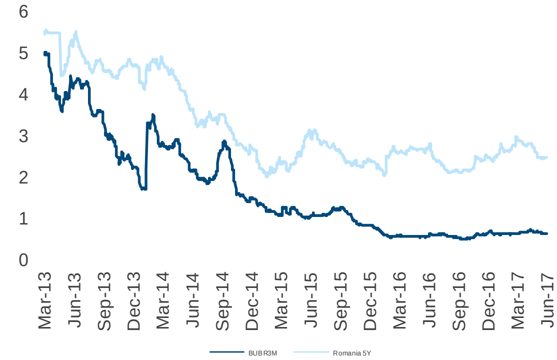
Appendix

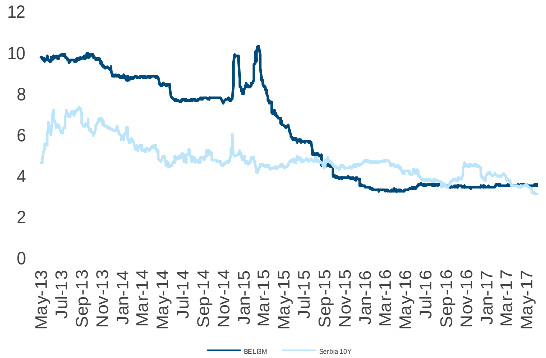


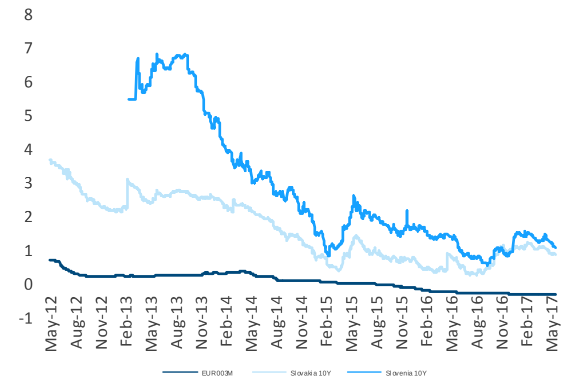












Note:*Information on past performance is not a reliable indicator for future performance. Forecasts are not a reliable indicator for future performance.

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