

CEE Insights

Fixed Income and Foreign Exchange

Looking ahead this week...

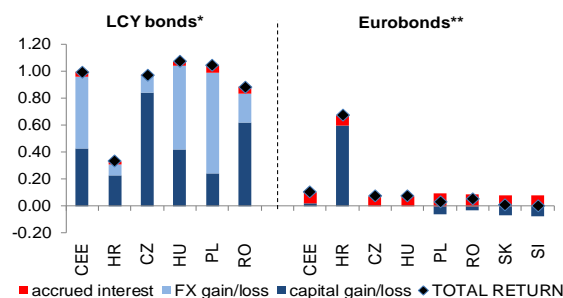
Monday	Tuesday	Wednesday	Thursday	Friday
HR: Inflation	HU: Target rate PL: Wages	PL: Industrial output, retail sales, PPI	SK: Unemployment RS: Current Account CZ: PPI	HR: Unemployment SI: PPI

Click for: [this week's detailed releases/events](#), [market forecasts](#), [macro forecasts](#)

This week, the Hungarian central bank is broadly expected to keep the policy rate unchanged. Despite the increase of core inflation in recent months, the MPC is likely to sound dovish, with the relatively strong forint being the source of concern for the MPC members. In Poland, industrial output and retail sales should maintain solid growth, confirming the robust performance of the economy in the second quarter. Labor market data (growth of nominal wages and employment) should point to further tightening. The unemployment rate is expected to drop in Croatia and Slovakia. In Croatia, the inflation rate should ease slightly in June, following the trend we observed in other CEE countries, while PPI releases in Poland and the Czech Republic should confirm that inflation has been losing momentum.

In case you missed it last week...

- MPC minutes published last week hinted that CNB is ready to hike rates in Aug-Sep
- Serbian central bank left rates unchanged at 4%
- Fitch affirmed Romania's rating at BBB- with stable outlook despite fiscal uncertainties
- In Croatia Fitch kept the rating unchanged at BB
- Inflation rate dropped in Hungary, Poland and Slovakia in June and increased in Romania
- For other events last week, please check respective countries: [HR](#), [CZ](#), [HU](#), [PL](#), [RO](#), [TR](#), [SI](#), [SK](#), [SR](#)



On Radar

CEE countries have barely begun spending the EU funds available in this programming period, as during the first two years, they were busy drawing funds related to the previous programming period. Romania had the slowest start, spending only 0.5% of its total EU funds budget as of June, while Hungary and Poland, with spending levels marginally above 4% of their budgets, lead in drawing EU funds. However, regarding the value of contracted projects, Hungary has already decided on more than 50% of the total amount of available funds, which is outstanding among its peers. Other countries have approved from 10% of all projects (Romania, the Czech Republic, Croatia) to around 20% (Poland, Slovakia, Slovenia). Thus, EU fund flow will intensify only in the years to come and will be oriented toward financing infrastructure in transport and energy projects, as 27% of all EU funds are allocated to that area (ERDF and CF Funds). As experience from the previous budgeting period shows, EU fund drawing is likely to peak only after 2020, when CEE countries will be facing tight deadlines to not compromise the utilization of EU funds. (For further details, see the [next page](#).)

CEE countries have spent less than 5% of the EU funds budget they have for 2014-20 and received approval for projects worth less than 1/5 of the overall budget. Hungary is an outlier, with projects worth 50% of the budget already approved.

EU fund inflow into CEE will intensify in 2019-20 and peak in 2021-22

'How successful are CEE countries in contracting/spending the EU funds in this programming period?'

Croatia: The Croatian EU funds budget for 2014-20 stands at EUR 12.7bn. When looking at the implementation progress, we can say that Croatia has not been successful so far, as only 12% of the budget is decided and only 1% spent (EUR 143mn). However, we saw some acceleration in 2016 compared to the last couple of years. Most of the financing came from ERDF (around EUR 120mn), while the Youth Employment Initiative (EUR 10mn) also played an important role, as Croatia has one of the highest rates of youth unemployment in the EU. Budget by theme figures suggest that Croatia plans the most funding in the Environment and Protection & Resource Efficiency category and Competitiveness of SMEs, which is important, due to the still relatively difficult access to finance (low level of capitalization).

Czech Republic: The Czech Republic has been notably unsuccessful in the spending of EU funds in this programming period. Currently, only 1.5% of the total budget has already been sent to the Czech Republic. Moreover, the volume of requests to the European Commission for payments in terms of the total approved budget arrived at just 4.4%. Such shares are the lowest compared with previous programming periods. Thus, in our view, although we expect some improvement in the coming years, the Czech Republic will again finish projects at the last minute. For this reason, the GDP growth in 2022 will probably be very high.

Hungary: According to the EC's statistics, Hungary has spent only 4.2% of total available EU funds (including co-financing) planned for this programming period. However, regarding the value of decided projects, it already reached more than 50% of the total amount of available funds, which is outstanding among regional peers. These figures show the government's strong commitment to drawing a majority of EU funds as early as possible and actively justify its plans for the use of EU funding. Moreover, as the 2018 elections are approaching and the expected pickup in investments and GDP growth is strongly dependent on the utilization of EU funds, currently the government is actively pre-financing the already decided projects. This was the reason why the cash-based budget deficit amounted to HUF 700bn in June; thus, the 1H17 budget deficit reached almost 80% of the FY deficit target.

Poland: Over this budgeting period, Poland will benefit from EU funds amounting to EUR 86bn and the total budget will amount to over EUR 104bn (including the national budget for co-financing). So far, 4.1% of the funds has been spent and 22% has been allocated to selected projects. The Ministry of Development would like to allocate 50% of the funds by year-end. As a relatively small part of the EU funds was spent so far, we would expect an investment boost only in the years to come, especially considering the delay between allocation and actual spending. The biggest

part of the 'EU funds pie' constitutes funding for ERDF (45.3% of total financing), which includes investment in the areas of Research and Innovation, the Digital Economy, SME Competitiveness and the Low Carbon Economy. Already 22.7% (around EUR 10bn) has been allocated within the ERDF fund. Transportation and energy is another important area of investment, with a budget as high as EUR 28bn, covered by ERDF and CF funds.

Romania: Romania made a hesitant start in attracting EU funds under the 2014-20 European financial framework, but authorities have lately started to streamline the procedures, which might speed up the absorption process in the next few quarters. Besides these administrative topics, a key issue remains the capability of the government to secure adequate co-financing in the context of the significant social bias of the state budget at present and possible fiscal consolidation efforts in the future, with lower public spending across major spending categories. Romania benefits from European Structural and Investment Funds of EUR 30.8bn earmarked for 2014-20 plus a national component for co-financing of EUR 5.6bn. The data presented by the EC shows that, out of total funds of EUR 36.4bn, only EUR 4.2bn has been allocated to selected projects so far (11.4%) and only EUR 166mn was spent under the selected projects (0.5%). The European Agricultural Fund for Regional Development has achieved the best results so far in terms of financial resources allocated to selected projects in the pipeline (27.8% of its total budget). The governing program has ambitious targets in the area of EU funds, with an absorption rate of 72.5% by the end of 2020 and 100% by 2023.

Slovakia: Slovakia's EU fund absorption for the current programming period 2014-20 has increased somewhat compared to last year, but remains fairly lukewarm. As of the end of March, 3.5% out of the total EUR 20.08bn has been spent (the EU part comprises most of the total allocated amount: EUR 15.3bn, national co-financing stands at EUR 4.7bn). The figure regarding the overall allocated amount (project pipeline) is better, at 19.8%. The latest May numbers from the Finance Ministry suggest some improvement in the allocated and spent amounts, but still fall short of a more pronounced acceleration in EU fund absorption. Slovakia is likely to speed up its use of EU funds closer to the end of the period, as could have been observed in the previous 2007-13 allocation.

Slovenia: Slovenia has so far been one of the top performers in the EU with respect to EU funding and the Slovenian investment story is mostly determined by the allocation of EU funds. The recent data shows that Slovenia has kept its favorable position, as more than 25% of the EUR 4.9bn budget is already decided. The most funding was related to the Cohesion Fund and European Social Fund, where Slovenia withdrew a total of EUR 155mn. As for the structure of the planned financing in this cycle, the Slovenian government plans the biggest programs in the category of Competitiveness of SMEs, totaling EUR 1bn.

Looking ahead

Date	Time	Country	Indicator	Period	Survey	Erste Est.	Prev.	Pre Comment	
17. Jul.	11:00	HR	CPI (y/y)	Jun		1.0%	1.1%	Lower clothing and footwear prices drove most pronounced downside pressures in June	
	11:00	HR	CPI (m/m)	Jun			-0.2%		
18. Jul.	14:00	HU	Target Rate	Jul	0.9%	0.9%	0.9%	No change is expected in policy rate or toolkit; statement is likely to remain dovish	
	14:00	PL	Wages (y/y)	Jun	5.0%	5.1%	5.4%		Robust growth of nominal wage supported by increasing employment
19. Jul.	14:00	PL	Industrial Production (y/y)	Jun	3.9%	3.2%	9.1%	Industry to expand at moderate pace, as PMI index stabilized around 53; moreover, lower number of working days is negative for growth dynamics	
	14:00	PL	Retail Sales (y/y)	Jun	6.8%	5.8%	8.4%		Level of household spending has been high, supported by tight labor market conditions
	14:00	PL	PPI (y/y)	Jun	2.1%	2.2%	2.5%		PPI is expected to stabilize
20. Jul.		RS	Current Account Balance (monthly)	May			-79.4		
		SK	Unemployment Rate	Jun		7.3%	7.4%	Another slight decrease of unemployment rate was seen in June	
	9:00	CZ	PPI (y/y)	Jun	1.7%	2.0%	2.3%	Lower oil prices are behind slowdown in producer prices; this effect was partly mitigated by higher labor costs	
21. Jul.	10:30	SI	PPI (y/y)	Jun			2.4%		
	11:00	HR	Unemployment Rate	Jun		10.9%	11.7%	Seasonal support keeping headline figure on strong downward pattern	

Sources: Bloomberg, Reuters

Major markets

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- The most important foreseeable event this week will be the ECB Council meeting on Thursday. Markets will be looking for any hints on whether the ongoing economic data will trigger a change of monetary policy soon.
- Draghi's speech has moved the risks toward an earlier reduction of asset purchases. Nonetheless, we continue to believe that this week's ECB Council meeting is more likely to disappoint market expectations in this regard. We think that the Council's statement as well as the following press conference by President Draghi will not contain any significant changes.

Croatia

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- Preliminary results for the May trade balance revealed strong trends on the export side, with the latter rising 8.4% y/y vs. a flat import performance on the annual level.
- In Croatia, in line with expectations, Fitch kept the rating unchanged at BB last Friday, keeping also the outlook stable. The rationale brought no major surprises, as fiscal consolidation was praised, while the growth outlook was trimmed to 2.6% in 2017, courtesy of Agrokor-related effects.
- Yields on the bond market showed limited movements throughout the week, with the longer end of the domestic curve staying practically flat w/w, while the newly issued 15Y EUR-linked tenor in its first week of trading remained around the 3.30% mark. On the other hand, we saw more developments on the exchange rate side, where mounting pressures have thus far triggered a third FX intervention, with the CNB buying EUR 101.5mn (at 7.42 EUR/HRK), thereby taming the excess volatility. With seasonal support starting to reach its fullest potential in the coming weeks, we expect the appreciation pressures to remain pronounced.

Czech Republic

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- The minutes from the June monetary policy meeting show that the bank board sees the May forecast as being fulfilled very well. As the forecast contains a hike in 3Q17 and in 2018, we expect that the majority of bank board members will vote for the interest rate increase at either the August or September meeting. Although the minutes confirmed that there is no strong consensus among bank board members about the timing of the first hike, we see the August meeting as having a slightly higher probability.
- CPI inflation arrived at 0.0% m/m and 2.3% y/y in June. The positive seasonal effect associated with the beginning of the holiday season and higher food prices was offset by lower prices of fuel. As the figure was in line with expectations, the data release had almost no impact on markets.
- The unemployment rate arrived at 4.0% in June, from the 4.1% reached in May. The seasonal factor and firm foreign demand for industrial output are the main factors behind the labor market tightening.

Hungary

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- The headline CPI inflation rate decelerated to 1.9% y/y in June. Seasonally-adjusted core inflation jumped to 2.4% y/y, indicating that the deceleration of the headline rate was mostly driven by non-core items (such as fuel and unprocessed food), while the inflation of services remained moderate.
- Construction output volume expanded 35.4% y/y in May. In a monthly comparison, the growth rate rose to 7.5% SWDA.

Poland

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- The drop of the inflation rate from 1.9% y/y in May to 1.5% y/y in June was driven by low commodity prices as well as lower than expected growth of food prices. Such a development is in line with the MPC's expectations of easing inflationary pressure later this year. MPC member Ancyparowicz said that the current NBP forecast suggest no need for a policy rate hike before 2019.
- Core inflation remained flat at 0.8% y/y in June, confirming the limited demand pressure in the economy, despite the tight labor market.
- The current account deficit arrived at EUR 179mn. The trade balance was negative at EUR 200mn.

Romania

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- Industrial production rebounded in May after a soft patch in April, explained mainly by a calendar effect related to the Easter holidays. The May growth rate (17.3% y/y) was the highest in the last four years and was driven by the export-oriented manufacturing sector, which advanced by no less than 18.6% y/y. The short-term outlook for industry is positive, as new orders in manufacturing increased strongly in May, while managers' sentiment went up slightly in June, according to a survey released by the EC. We see this data as positive for keeping the trade deficit under control in the context of a strong rise in household consumption.
- The inflation rate increased to 0.85% y/y in June, from 0.64% y/y in May. In m/m terms, inflationary pressures were still subdued (0.04%), as strong household consumption has not translated yet into higher consumer prices. We continue to see inflation going up in 2H17, but the upward path could be a bit milder than previously estimated, due to the softer increase in food prices, especially in the volatile component.
- We have pared back our inflation forecast for December to 1.9% y/y, from the previous 2.2%. While we maintain the inflation forecast for end-2018 at 2.9% y/y, we now see upside risks to our baseline scenario, depending on what measure the government will take to stem the budget deficit expansion.

Serbia

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- Inflation picked up in June to 3.6% y/y, fully in line with our forecast. We are in agreement with the NBS in expecting that the inflation figure will continue moving around 3.5% y/y, mostly shaped by seasonal factors and the fading base effect of oil prices. This development was also supportive for the decision by the NBS Executive Board to keep the key rate at 4% last week. In our baseline scenario, the NBS should keep the key rate unchanged throughout the year.
- Appreciation pressures on the dinar continued last week, prompting the NBS to intervene three times on the buy side with a total of EUR 105mn (looking at YTD data, the NBS has bought EUR 640mn and sold EUR 345mn on the FX market to tame volatility on both sides). After the interventions, the EUR/RSD was hovering around the 120 level. We expect the appreciation pressures to remain present in the coming period, but fade away after the summer months, with the EUR/RSD stabilizing in the 123-123.5 region. We saw no major developments on the bond market, with the benchmark RSD 2023 yield standing at 5.6%.

Slovakia

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- Consumer prices increased by 1% y/y in June, slightly slower than expected. On a monthly basis, consumer prices remained unchanged. Food prices climbed 0.4% m/m, whereas prices in transport fell 0.7% m/m, as fuel prices decreased 3.2% m/m. Core inflation slipped to 1.7% y/y in June (from 1.9% previously). Overall, June presents a halt in the consumer price growth and shows that price pressures remain volatile and may need more time to become deep-rooted and persistent. Our 2017 forecast remains unchanged at 1% (CPI average).
- Industrial production growth reached 5.1% y/y in May, close to our above-consensus expectations (5.4%). Metal production was the largest contributor to the growth in May, as it increased 17.4% y/y. Car production remained sluggish, falling 0.5% y/y. Construction production broke the two-month spell of increases and fell 2.1% y/y in May (-4.9% m/m). After April's slump linked to calendar and Easter effects, IP growth rebounded nicely in May. We expect that industrial production will keep growing at a brisk rate in the months ahead, although the summer months will see some volatility related to summer breaks at the major car plants, as well as the effect of VW's June strike. Our 2017 GDP forecast remains unchanged at 3.1%.
- The Slovak National Bank is raising the counter-cyclical buffer for banks. From August 2018 onwards, banks will have to set aside 1.25% of their capital as a counter-cyclical cushion. The current rate that comes into effect this August is set at 0.5%. The central bank wants to prevent the economy from overheating, as household debts in Slovakia are rising rather fast (there is also convergence at play, but the measure is meant to be precautionary)

Slovenia

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- Following a significant retail trade increase (+7.7% y/y), industrial production brought another strong performance, growing 9.1% y/y, supported by a solid growth pattern across all major production sectors. On the trade balance side, we saw robust double-digit expansion, where 16.8% y/y import growth overpowered the 14.1% y/y export increase.
- We saw no major developments on the bond market, with yields remaining in a narrow band as the EUR 2027 curve still moves around the 1.20% mark.

Capital market forecasts

Government bond yields					
	current	2017Q3	2017Q4	2018Q1	2018Q2
Croatia 10Y	2.80	3.00	3.10	3.10	3.20
spread (bps)	222	244	240	230	231
Czech Rep. 10Y	0.98	1.20	1.18	1.18	1.20
spread (bps)	40	64	48	38	31
Hungary 10Y	3.09	3.30	3.35	3.40	3.44
spread (bps)	251	274	265	260	255
Poland 10Y	3.31	3.44	3.62	3.75	3.91
spread (bps)	273	288	292	295	302
Romania10Y	4.14	3.90	4.10	4.30	4.30
spread (bps)	356	334	340	350	341
Slovakia 10Y	0.96	1.23	1.25	1.35	1.38
spread (bps)	38	67	55	55	49
Slovenia 10Y	1.16	1.30	1.40	1.50	1.50
spread (bps)	58	74	70	70	61
Serbia 7Y	5.35	5.80	6.00	6.25	6.25
DE10Y (BBG)*	0.58	0.56	0.70	0.80	0.89

3M Money Market Rate					
	current	2017Q3	2017Q4	2018Q1	2018Q2
Croatia	0.60	0.40	0.45	0.45	0.45
Czech Republic	0.30	0.42	0.43	0.49	0.50
Hungary	0.15	0.05	0.05	0.05	0.05
Poland	1.73	1.74	1.75	1.79	1.79
Romania	0.87	0.80	0.95	1.15	1.18
Serbia	3.53	3.50	3.50	3.80	4.00
Eurozone	-0.33	-0.30	-0.30	-0.30	-0.30

FX					
	current	2017Q3	2017Q4	2018Q1	2018Q2
EURHRK	7.41	7.50	7.55	7.55	7.40
forwards		7.41	7.43	7.45	7.47
EURCZK	26.09	26.10	26.00	25.80	25.70
forwards		26.06	25.99	25.97	25.97
EURHUF	306.6	313.0	315.0	315.0	315.0
forwards		306.8	307.0	307.5	307.9
EURPLN	4.22	4.23	4.21	4.22	4.18
forwards		4.24	4.26	4.28	4.30
EURRON	4.56	4.58	4.62	4.60	4.61
forwards		4.57	4.59	4.61	4.63
EURRSD	120.1	123.0	123.5	123.5	123.6
forwards		-	-	-	-
EURUSD	1.14	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	0.18	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

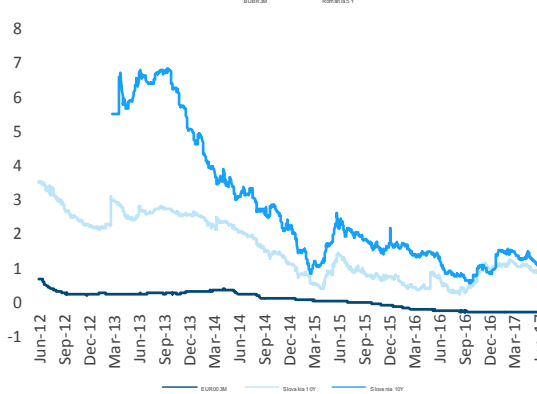
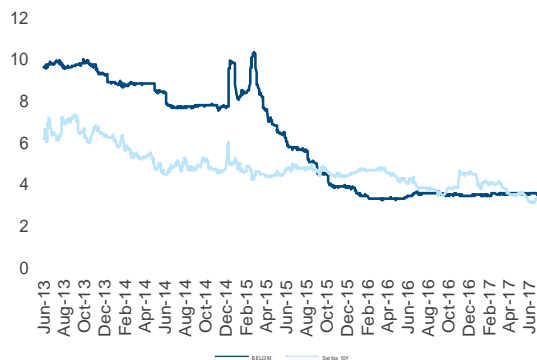
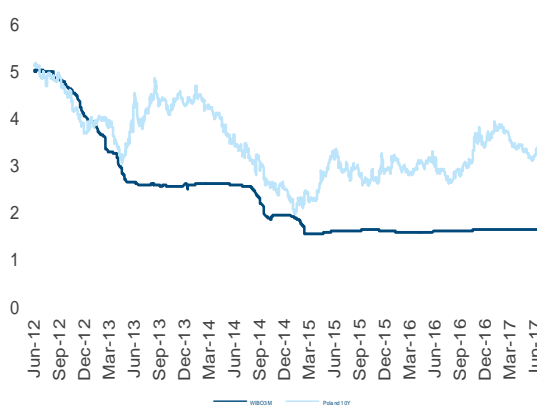
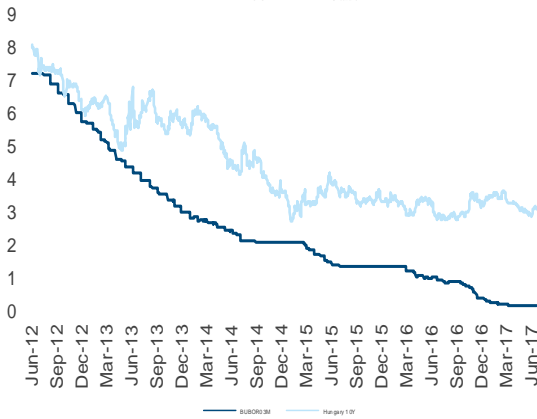
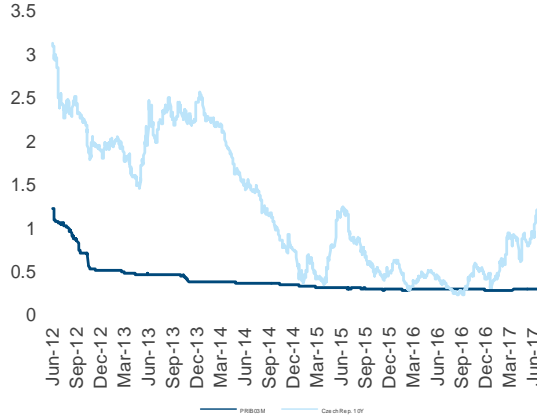
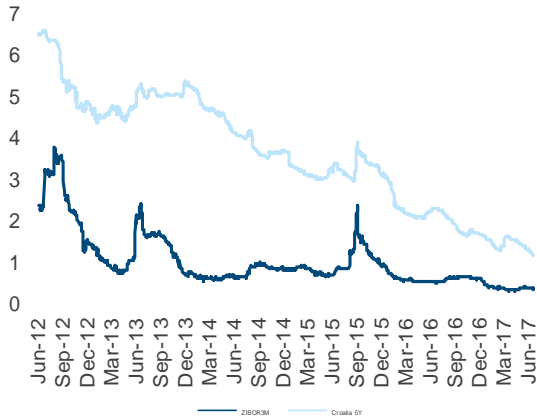
Macro forecasts

Real GDP growth (%)	2015	2016f	2017f	2018f	Average inflation (%)	2015	2016f	2017f	2018f	Unemployment (%)	2015	2016f	2017f	2018f
Croatia	2.2	3.0	2.7	2.4	Croatia	-0.5	-1.1	1.4	1.3	Croatia	16.3	13.1	10.9	10.0
Czech Republic	4.6	2.3	2.9	2.8	Czech Republic	0.3	0.7	2.5	2.0	Czech Republic	5.1	4.1	3.6	3.6
Hungary	3.1	2.0	3.7	2.8	Hungary	-0.1	0.4	2.2	3.2	Hungary	6.8	5.1	4.2	4.1
Poland	3.6	2.8	3.8	3.4	Poland	-0.9	-0.6	1.8	1.9	Poland	10.6	8.9	7.9	7.7
Romania	3.9	4.8	5.1	3.9	Romania	-0.6	-1.5	1.0	3.3	Romania	6.8	6.0	5.4	5.5
Serbia	0.8	2.8	2.5	3.0	Serbia	1.4	1.1	3.4	3.8	Serbia	17.7	16.0	14.1	12.8
Slovakia	3.8	3.3	3.1	3.7	Slovakia	-0.3	-0.5	1.0	2.0	Slovakia	11.5	9.7	8.6	7.8
Slovenia	2.3	2.5	3.7	3.2	Slovenia	-0.5	-0.1	1.5	1.5	Slovenia	9.0	8.0	7.3	6.6
CEE8 average	3.6	3.0	3.7	3.3	CEE8 average	-0.4	-0.4	1.8	2.3	CEE8 average	9.3	7.7	6.8	6.5

Public debt (% of GDP)	2015	2016f	2017f	2018f	C/A (%GDP)	2015	2016f	2017f	2018f	Budget Balance (%GDP)	2015	2016f	2017f	2018f
Croatia	86.3	83.7	81.4	79.5	Croatia	4.8	2.6	4.1	2.5	Croatia	-3.4	-0.8	-1.5	-1.5
Czech Republic	40.3	37.2	35.7	35.9	Czech Republic	0.9	2.1	0.8	0.6	Czech Republic	-0.4	0.5	-0.4	-0.4
Hungary	74.7	74.1	72.0	70.7	Hungary	3.4	5.5	4.3	4.0	Hungary	-1.6	-1.8	-2.7	-2.5
Poland	51.5	54.3	54.9	54.1	Poland	-0.2	-0.3	-0.6	-0.9	Poland	-2.5	-2.4	-2.8	-2.7
Romania	38.0	37.6	37.7	38.1	Romania	-1.2	-2.3	-3.2	-3.8	Romania	-0.8	-3.0	-3.4	-3.4
Serbia	74.7	72.9	69.4	68.9	Serbia	-4.8	-4.2	-5.0	-5.2	Serbia	-3.8	-1.2	-0.8	-0.6
Slovakia	52.5	51.9	51.7	50.5	Slovakia	0.2	-0.7	0.8	1.6	Slovakia	-2.7	-1.7	-1.5	-0.8
Slovenia	83.4	79.0	76.6	74.8	Slovenia	5.2	6.8	6.4	5.9	Slovenia	-2.9	-1.8	-1.3	-1.1
CEE8 average	53.7	53.7	53.0	52.4	CEE8 average	0.5	0.6	0.2	-0.2	CEE8 average	-1.9	-1.8	-2.2	-2.1

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

Appendix



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