CEE Quarterly

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“Time for policy normalization”

4Q 2021

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Time for policy normalization

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- We expect economies in EU-CEE[1] and in the Western Balkans, to grow by around 6% in 2021 and 4.6% in 2022. Turkey's economy could grow by 9.7% in 2021 and 5.5% in 2022. In Russia, GDP growth could slow from 4% in 2021 to 2.4% in 2022.
- Before the end of 2022, output gaps could turn positive in Hungary, Poland, Romania, Russia, Serbia, Slovenia and Turkey.
- Pent-up demand is driving the recovery in 2021, helped by savings accumulated in 2020, and rising wages and employment. Exports are contributing to growth owing to strong demand for cars, a bumper harvest, returning foreign tourists and, in Turkey, to competitive gains amid currency depreciation.
- In 2022, investment could contribute more to growth, helped in EU-CEE by disbursements from the EU's Recovery and Resilience Facility (RRF), in Russia by spending from National Wealth Fund and in Turkey by looser financial conditions.
- Public policies are a risk to medium-term growth due to populist spending triggering a limited fiscal adjustment, a backlash against green energy, poor implementation of structural reforms and nationalist agendas affecting economic goals.
- Supply-chain bottlenecks, rising energy prices and buoyant consumer demand could keep inflation outside target ranges for longer than central banks currently expect. Further monetary tightening is needed to ensure price stability.[2]
- Due to structurally tight labor-market conditions, we expect inflation in EU-CEE to diverge from that in the eurozone in the coming years, forcing EU-CEE central banks to tighten further. The CBR might need to keep the real interest rate positive due to structural rigidities. The CBRT gave up its inflation mandate, with potential consequences on financial stability.

Consumer optimism in CEE…

CEE enters the last quarter of 2021 and a fourth pandemic wave with confident consumers and circumspect entrepreneurs. More pent-up demand was unleashed over the summer, with retail sales, tourism and leisure services benefiting the most. Abundant job openings, rising wages and budget handouts led to an unprecedented level of optimism in some countries, where households are expecting to increase spending and savings at the same time.

…contrasts with supply shocks affecting companies.

However, this boon for consumers is not shared by companies, with output stalling or declining in 3Q21 in many sectors. Supply-chain bottlenecks have risen further and surveys[3] have postponed the recovery to 2Q22 at the earliest. A strong wave of COVID-19 infections in Asia led to lockdowns and further disruptions to production and deliveries to Europe. It is important to note that Europe and the US are facing the longest delays and largest backlogs in deliveries globally (Chart 1), which is also a sign that demand is recovering at a faster pace in developed economies (DM) than in emerging markets (EM). This is a curse for CEE (due to volatile production and exports) but also a blessing. A DM-driven recovery will benefit this region because it caters much more to DM than to EM. Chart 2 shows that DM exports to the world are rising faster than EM exports, despite higher commodity prices boosting the latter.

Supply disruptions emerge as a bigger issue than demand for CEE producers…

Whenever global supply chains have run smoothly in 2021, exports and industrial production have risen to their highest levels on record in EU-CEE and Turkey. CEE producers of cars and durable goods speak of unprecedented demand that cannot be met in a timely manner due to missing parts, such as semiconductors, metal components, paints and chemicals produced using natural gas. Scrambling for supplies raises marginal costs, as do higher transport fares and storage fees. As a result, higher costs spill over to sectors unaffected by global supply

[1] EU-CEE refers to CEE countries that are members of the EU: Bulgaria, Croatia, Czechia, Hungary, Poland, Romania, Slovakia and Slovenia.
[2] Our current inflation and monetary-policy outlook is laid out in the EEMEA Special Topics – CEE: High time for rate hikes, published on 16 September.
[3] For example, "Global light vehicle production impacts now expected well into 2022", IHS Markit, 19 August

issues. Buoyant demand means that producers can pass higher production costs onto consumers, albeit gradually. This alters the pass-through of producer prices to consumer prices, which was much smaller before the COVID-19 pandemic, especially in Central Europe.

…and central banks.

The more these supply-chain bottlenecks persist, the more protracted and severe the second-round effects on consumer prices are likely to be. While international organizations such as the OECD are now reckoning with a longer and broader-based inflationary wave than previously thought, very few CEE central banks have a similar reasoning, with the CBR and the CNB being the notable exceptions. In our EEMEA Special Topics – CEE: High time for rate hikes, published on 16 September, we laid out at length our view on why disinflation may be slower than expected in 2022 and why monetary policy needs to tighten sooner rather than later. Otherwise, inflation expectations could become unmoored, and bringing them back to target might force central banks to raise rates and tighten financial conditions more and for longer.

DEVELOPED MARKETS ARE DRIVING THE CURRENT RECOVERY

Chart 1: Supplier delivery times are higher in DM than in EM…

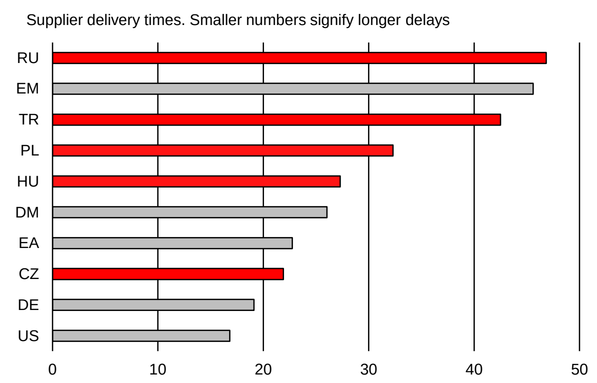
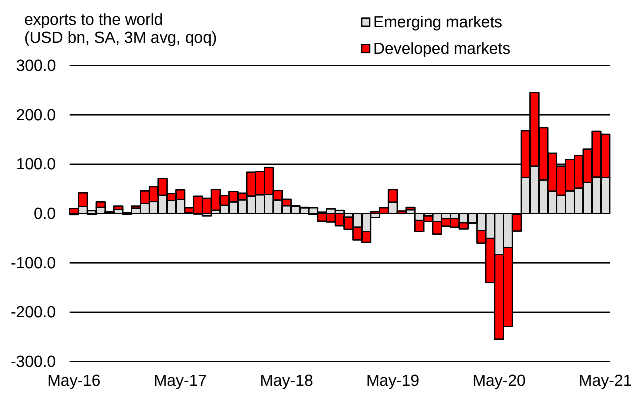


Chart 2: …but DM exports are outpacing EM exports



Source: IHS Markit, HALPIM, IMF, UniCredit Research

Supply shock: how long is temporary?

Energy and gas prices to feed into inflation for up to a year

A big hit to inflation expectations comes from spiraling energy and natural gas prices (Chart 3). Where prices have been liberalized, households saw their energy bills go up by 10-60% in a matter of months (Bulgaria, Romania and Turkey). Where governments continue to regulate energy prices, these increases will be spread out (Croatia, Poland and Russia) or will be subsidized by governments looking for re-election (Hungary and Slovakia). Considered as temporary by CEE authorities, these price shocks could feed into consumer price inflation via first and second round effects for up to a year.

Gas shortage will not be resolved quickly

The spike in gas prices is due to a combination of higher demand, empty storage facilities and limited additional supply from Russia. We believe that these issues will not be resolved very quickly. With winter approaching, demand will remain high throughout Europe. Gas storage facilities are less than half full in most European countries and they are unlikely to be replenished before the cold weather sets in. Gazprom has been covering all its long-term contracts, but it is taking only a third of the additional capacity offered on the Yamal-Europe pipeline that crosses through Belarus and Poland, and none of the additional capacity offered on pipelines crossing Ukraine. One official explanation is the poor state of pipelines crossing Ukraine, which are in dire need of (costly) refurbishment. In addition, the scope to increase production is limited. In 8M21, Russia's natural gas production increased by 12% compared to 8M20, when the level of production was already high. Thus, increasing Russian exports to Europe could primarily be a matter of increasing production, which requires significant investment. In 2020, Gazprom extracted more than 500bn cubic meters of gas, from which it covered two-thirds of Russian consumption and exported 179bn cubic meters outside the CIS through existing pipelines. Total exports of gas were 204bn cubic meters in 2020, meaning that only around 12% of exports were in LNG and other products.

Thus, Russia could increase deliveries to Europe, but not by enough to fully cover demand, even if Germany approves the opening of the Nord Stream 2 pipeline. Moreover, Nord Stream 2 could take months to reach full transport capacity and we do not expect it to be fully operational before mid-2022. Global competition for available gas is another problem for Europe in general and CEE in particular. Strong demand from Asia will add to price pressure.

Meanwhile, Europe cannot cover the missing supply from alternative sources. While Norway's Equinor, the second-largest gas exporter to the EU, is increasing deliveries from two offshore fields, LNG imports are curbed by aggressive Asian competitors. So far, European importers seem to be losing the bidding war for US and Middle Eastern LNG. Europe's own energy supply is being hit by two shocks, namely the gradual winding down of production in the Groningen gas field[4] and the shutdown of nuclear power plants in Germany.

As a result, we expect gas prices to peak this winter and fall gradually thereafter, failing to return to previous low levels. This means that second-round effects from higher energy prices are likely to boost inflation for most of 2022. Few CEE companies hedged their energy costs, having gotten used to years of declining natural gas prices and public subsidies to the coal sector. Production costs continue to rise in EU-CEE (Chart 4), from chemicals to metal producers, and the pass-through to consumer prices could run parallel to the direct impact on energy prices for households. Food production, which is energy intensive, could see most of the benefits of a bumper harvest being offset by higher production costs.

Central banks are right to point out that higher energy bills will reduce disposable income for lower earners and, probably, slow down consumer spending, but this may be less of a concern for the urban middle class, which accounts for most of the demand for durable goods and services. This means that core inflation could be resilient to the negative impact of energy prices on the consumer's wallet.

SUPPLY SHOCKS TO PRICES ARE LARGER AND MORE RESILIENT THAN CEE CENTRAL BANKS ADMIT

Chart 3: Public policies determine energy and gas price increases

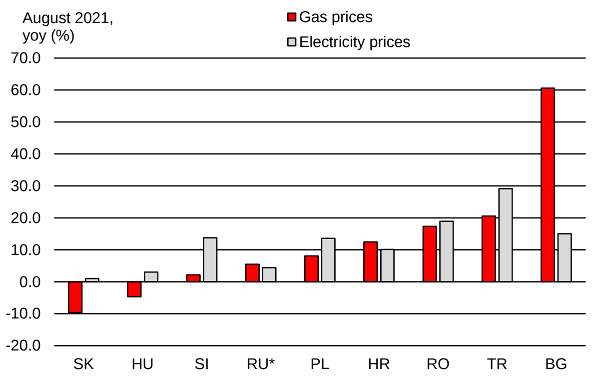
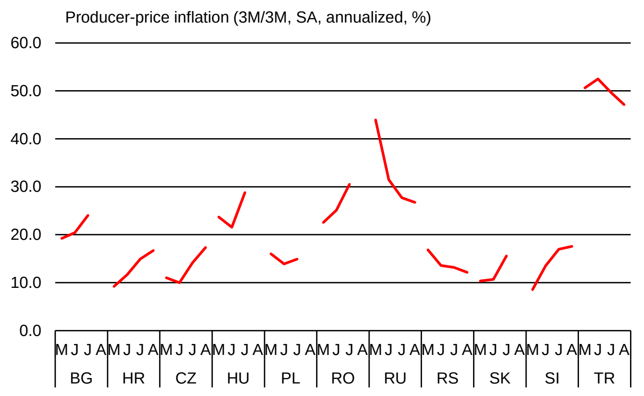


Chart 4: PPI inflation is rising throughout EU-CEE and remains high in Russia and Turkey



*Russia: July instead of August.

Source: national statistical offices, Eurostat, UniCredit Research

[4] Which used to provide more than 10% of the EU's gas consumption at the start of the millennium and is scheduled to close by the end of 2022.

Cyclical and underlying inflation are rising…

Momentum in cyclical inflation is far from slowing throughout CEE, as inflation drivers could shift from services to goods. As price increases broaden, underlying inflation measures are also moving up. Our favorite indicator, weighted median inflation, is rising throughout CEE, and is above the target range in Poland and Turkey, and higher than the central target in Czechia and Romania[5].

…boosting expectations of wage growth

High expected inflation could combine with high vacancies to boost wage growth in 2022 and beyond. Companies will try to dampen expectations in 1Q22 by pointing to disruptions in activity, but this may prove unsuccessful since labor shortages cannot be offset by increasing capex in the short term. However, nominal wage growth is unlikely to accelerate in 2022 due to new employment being skewed towards lower-earning sectors, such as leisure, tourism, retail services and construction.

Euphoric consumers ignore pandemic risks

Labor shortages are approaching pre-pandemic levels

Given rising labor shortages (Chart 5), which have become structural, it is ironic that on 23 September, the leaders of Czechia, Hungary, Poland, Serbia and Slovenia signed a declaration against immigration as a solution to population decline. In Czechia, immigrants already account for 13% of the labor force. In Hungary, which together with Czechia has the greatest worker shortages in the EU, the nationalist government broke one of its main promises and opened its borders to migrant workers from beyond its neighboring countries. In Poland, which has been leading EU tables of immigrant-employee numbers for five years, inflows of foreign workers increased by a third in 2021, recouping 2020 outflows. The rise could accelerate further, as companies in agriculture, construction, tourism and leisure services are looking for more migrant labor. Russia has similar worker shortages due to fewer arrivals from the Caucasus and Central Asia, but travel could rebound as society shrugs off the danger of the virus. The only CEE countries where labor is plentiful are Turkey and those in the Western Balkans. Even in Turkey, we expect unemployment to fall in 2022 after failing to do so for a decade. Emigration from the Western Balkans to Western and Central Europe is likely to continue.

Bulgaria, Romania and Russia most affected by fourth wave of pandemic…

For households, the prospect of easily available work and rising wages is completely offsetting the specter of a fourth wave of COVID-19. This is more a sign of pandemic fatigue than it is that the threat is over. Vaccination rates are lower in CEE than in Western Europe, with Bulgaria, Romania and Russia having vaccinated less than a third of their population. All three countries are currently undergoing another surge in hospitalizations and deaths (Chart 6). None of their governments did enough to prepare for the fourth wave, in our view, and the threat of new restrictions is rising as intensive-care units fill up again. In Hungary and the Western Balkans, where the Sinopharm vaccine was used extensively, it is unclear how protected the fully vaccinated are. However, we do not expect tight lockdowns in any of these countries, but rather a reintroduction of some of the inefficient measures that were implemented before, such as curfews (which tend to artificially increase movement and contact at rush hours) and mobility limits in open spaces and leisure venues (but not in public transport or supermarkets). The most affected might once again be schoolchildren and those suffering from non-COVID-related illnesses. Test-track-isolate frameworks are still not implemented anywhere in CEE and the authorities seem more willing to lock down schools than to test students to control the spread while providing them with offline education and allowing social contact.

…but could have limited impact on economic activity

Economic activity could be less affected that in any of the previous COVID-19 waves for several reasons. First, companies have adapted to on and off restrictions. Second, vaccination rates are higher among active people in all CEE countries, sometimes significantly so. Third, the population has adapted to the pandemic and people often isolate voluntarily when necessary, without altering their spending behavior. Fourth, most of the services that moved online will remain there. Fifth, Western European governments might refrain from imposing tight restrictions where vaccination rates exceed 80%. This would ensure that demand from the eurozone for CEE exports remains resilient. As a result, we expect the fourth wave to slow economic growth, rather than halt it.

CHART 5: LABOR SHORTAGES FAST APPROACHING PRE-COVID LEVELS

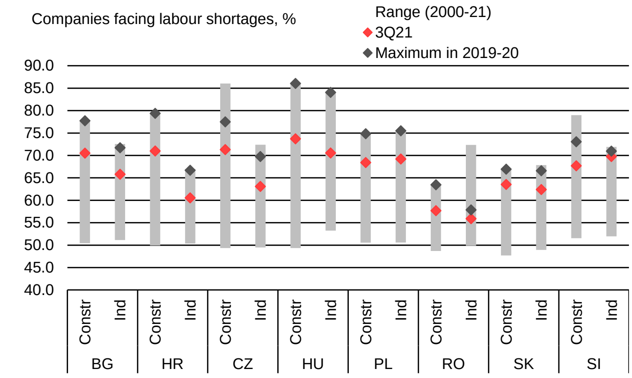
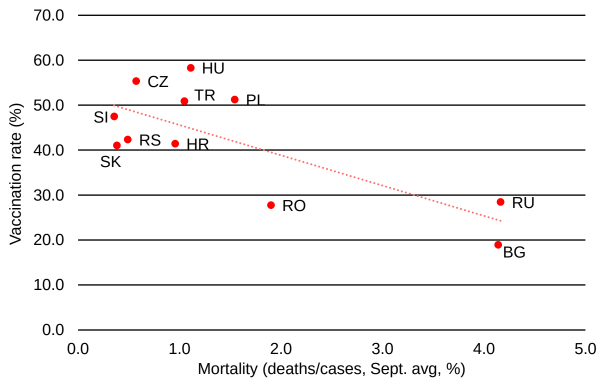


CHART 6: COVID-19 DEATH RATES ARE HIGH IN COUNTRIES WITH LOWEST VACCINATION RATES



Source: CEE governments, Oxford University, Imperial College London, UniCredit Research

Public policies: the easy option is often the wrong one

Poor quality of public policies remains the biggest risk to growth in CEE. We see several threats to full economic recovery, namely:

Rating improvements unlikely amid limited fiscal adjustment

1. **Slower fiscal adjustment**. This is true especially in countries facing elections or those with unstable governments, such as Bulgaria, Czechia, Hungary, Slovenia and Slovakia (Chart 7). As domestic demand rebounded faster than expected, governments used windfall budget revenues to increase spending, rather than reduce budget deficits. Yet the additional spending did not always go into investment, but to more social and pork-barrel outlays. In many cases, governments revised budget deficits that included scant provision for additional threats (such as potential costs related to other pandemic waves), which exposes them to running larger budget deficits than previously planned. This means that public debt will likely be sticky and remain well above 2019 levels in all CEE countries (Chart 8), postponing rating upgrades to late 2022 or beyond.

Green transition hampered by populism

2. **A populist backlash against green energy**. Higher gas and oil prices, and the EU's focus on the green transition should have made it clear for CEE governments that renewables are a better option than fossil fuels for future energy generation. Instead, governments supported energy producers that use fossil fuels and vowed to subsidize their costs while threatening renewable energy producers with higher taxes and/or a reduction in green certificates included in retail prices. This only underlines the difficulties that the green transition faces in CEE. We wrote in last quarter's issue of this publication[6] about the social and economic costs that could derail green agendas. The current episode of surging energy prices solidifies our concerns.

Weak reform momentum

3. **Poor implementation of structural reforms**. In EU-CEE, it is very early to judge the efficiency of spending from the RRF, but the reform agendas that governments agreed to are already falling behind schedule in countries that signed an agreement with the European Commission. Political instability appears to be playing a bigger role than constraints related to the pandemic. Improving the efficiency and transparency of public spending is the biggest issue to be tackled. This is paramount to increasing the impact of EU grants on GDP growth. As we showed in the 3Q21 CEE Quarterly, this efficiency has fallen and is likely to be even lower for RRF funding than for regular transfers from the EU budget. In Russia, the decision to spend from the National Welfare Fund (NWF) was made

[5] The aforementioned EEMEA Special Topics – CEE: High time for rate hikes from 16 September outlines our detailed views on inflation in CEE.
[6] 3Q21 CEE Quarterly, pp. 15-19

without fully addressing the bottlenecks that have made the implementation of the country's National Projects more cumbersome, three years after their announcement. A revamp of the National Projects earlier this year narrowed the focus to social security for the needy, digital transition and, less likely to be implemented, less red tape, more efficient courts and a reduced presence of the state in the economy.

Nationalism is a threat to economic development

4. **Nationalist agendas affecting economic priorities**. Hungary and Poland are enmeshed in a political dispute with European institutions over the primacy of national law over EU law. EU treaties make very clear that the latter overrules the former, but this has not stopped Budapest and Warsaw from trying to avoid implementing rulings of the Court of Justice of the European Union (CJEU) and the European Court of Human Rights (ECHR) that demand more independence for Hungarian and Polish courts, and alignment with EU laws protecting minorities. Neither country can afford a protracted standoff with the EC. The Hungarian government decided to borrow heavily from abroad to replace RRF grants that were expected in late 2021 and early 2022. The Polish government drafted the 2022 budget without any RRF transfers. In our view, these are short-term fixes, rather than long-term solutions. The Hungarian government might acquiesce after the parliamentary elections expected in spring. The alternative is lower growth, more public debt and energy dependency remaining very high for the rest of the decade. The Polish government could split if the courts are given more independence and the justice minister (who is also the general prosecutor) loses some of his powers. The alternative is a watering down of the Polish New Deal, the growth program on which the ruling Law and Justice party (PiS) is staking its re-election in 2024. The tradeoff between more nationalism and higher economic growth is very dangerous for both governments. Ultimately, their electoral success is due to improving living standards, and an ideological shift away from Europe could sap their approval ratings. We see risks of agreements with the EC being delayed into 2022.

Ethnic tensions between Serbia and Kosovo are affecting a process of regional economic integration that started with Serbia, North Macedonia and Albania under the Open Balkan initiative. While the Open Balkan project cannot be a replacement for European integration, it could eliminate trade barriers in the Western Balkans and create a larger, more attractive market for foreign companies that hope for regulatory convergence with the EU. A fragmented region divided on nationalist criteria has few economic advantages.

CHART 7: LITTLE TO NO ADJUSTEMENT IN STRUCTURAL BUDGET DEFICITS IN 2021

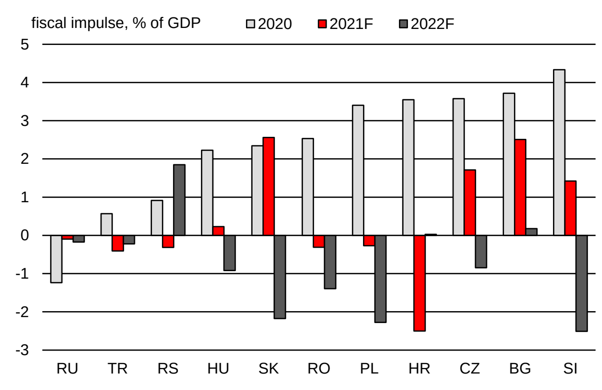
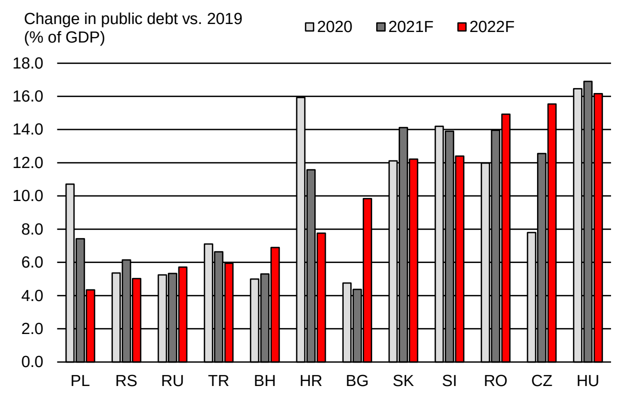


CHART 8: PUBLIC DEBT IS LIKELY TO REMAIN MUCH HIGHER THAN BEFORE COVID-19



Source: CEE governments, AMECO, UniCredit Research

Two solid years of growth ahead

We expect GDP to grow by 6% in 2021 and 4.6% in 2022 in EU-CEE…

…by 9.7% and 5.5% in Turkey and by 4% and 2.4% in Russia

Despite all the hindrances, we have upgraded both our growth and inflation forecasts for 2021-22 to account for a faster rebound in domestic and foreign demand, a better harvest and tourism season in 2021, and more fiscal spending than we previously envisaged. We expect EU-CEE to grow by around 6% in 2021 and 4.6% in 2022 (Charts 9 and 10). As always, the Western Balkans are likely to grow at similar rates. In Turkey, GDP could grow by 9.7% in 2021 and 5.5% in 2022, while in Russia economic growth might slow from 4% in 2021 to 2.4% in 2022. Output gaps are likely to turn positive before the end of next year in Turkey, Romania, Hungary, Serbia, Poland, Slovenia and Russia.

Consumption and exports driving growth in 2021…

Private consumption will be the main driver of the recovery, owing to savings accumulated in 2020 and fast wage growth. Net exports will contribute to growth in very few countries, with Turkey standing out. Significant TRY deprecation has made Turkish exports more competitive on European markets, especially for low value-added products and affordable household goods and electronics. Strong demand for cars could help Hungarian and Slovak exporters. Both Croatia and Turkey benefited from more tourist arrivals compared to last year.

…with investment playing a stronger role in 2022

Next year, economic growth is expected to slow closer to potential as pent-up demand is eliminated. We expect investment to contribute more to growth in 2022 as EU-CEE countries start receiving RRF funding, Russia starts spending from the National Wealth Fund and the Turkish private sector benefits from easier financial conditions. Some of the large inventories built up in 2021 (due to unfinished industrial output and/or a bumper harvest) could be drawn down.

TWO YEARS OF STRONG ECONOMIC GROWTH

Chart 9: GDP growth supported by consumption in 2021…

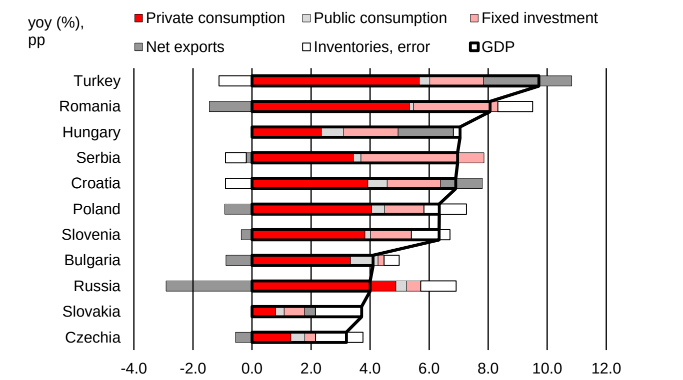
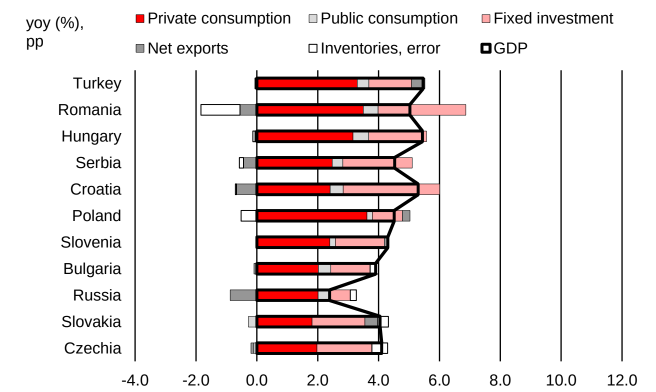


Chart 10: …with investment contributing more in 2022



Source: statistical offices, UniCredit Research

Monetary policy: a structural rather than a cyclical uptick

With inflation likely to be sticky and positive output gaps opening again, monetary policy will have to tighten further in 2022 (Charts 11 and 12). While we discussed the likely scenarios in the aforementioned Special Topics piece, the question is whether central banks should prepare for a permanent shift in their inflation regimes.

Inflation pressure stoked by structural pressure on labor market in EU-CEE

In the past, EU-CEE central banks have said that inflation cannot diverge significantly or for long from eurozone inflation because EU-CEE countries are small, open economies that continue to deepen their economic integration with the single-currency area. The big difference comes, in our opinion, from labor-market tension, which is far more pressing in EU-CEE than it is in the eurozone. While a recent discussion paper published by the Fed argues that inflation expectations do not matter for inflation (in the US), wage bargaining in EU-CEE is a potent way of translating them into income growth and demand pressure on prices, and increasingly so. By choosing to stay in a region such as EU-CEE, where marginal labor supply is limited, foreign companies expose themselves to the risk of rapidly rising wages in exchange for more institutional, economic and fiscal predictability than in other EM. The outcome could well be higher inflation in EU-CEE over the longer term, with prices converging with those in the eurozone as incomes converge as well.

Structural rigidities could require long-term positive real rate in Russia

In Russia, board elections at the CBR raise the question of whether the current proactive monetary policy will continue in 2022 and beyond. The CBR's success in taming inflation argues in favor of cautious monetary policy in a country where structural rigidities remain very high. This means that the real interest rate could remain positive for a long time.

The CBRT has given up its inflation mandate

In contrast, the CBRT seems to have given up its battle with inflation by cutting the link between interest rate cuts and inflation rates. Ultimately, this could bring about more volatility in money and financial markets, further reducing the impact of the credit impulse on economic growth. If investors decide to test the resilience of TRY-denominated assets, the CBRT could be forced to tighten, bringing the credit expansion to an abrupt halt. This stop-and-go pattern is likely to continue in the coming years, affecting predictability and investment.

Monetary policy could benefit from focusing on inflation, rather than growth

Ultimately, monetary policy should not be responsible for underpinning economic growth anywhere in CEE, if economic and institutional reforms are advancing slowly, if at all. Yet central-bank activism in developed countries since the global financial crisis has also altered the behavior of CEE central banks. A return to pre-2008 central-bank independence may be untenable. But long-term financial stability might require monetary authorities in CEE to take a step back and focus on inflation as a threat to purchasing power, economic convergence and predictability.

MONETARY TIGHTENING NEEDED TO TAME INFLATIONARY PRESSURE

Chart 11: Inflation likely to remain high in 2022…

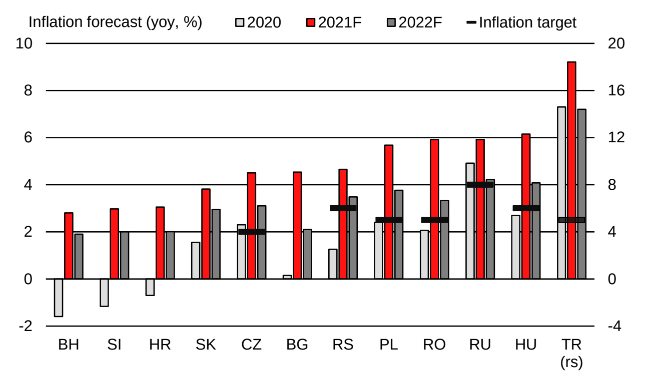
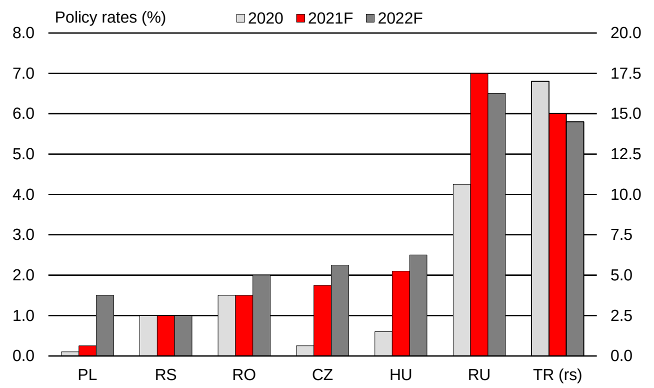


Chart 12: …requiring tight monetary policy



Source: statistical offices, central banks, ministries of finance, UniCredit Research

OUR GLOBAL FORECAST

	GDP growth, %			CPI (Avg), %			Policy interest rate, %			10Y bond yield (EoP)**, %			Exchange rate (LC vs.USD)		
	2020	2021F	2022F	2020	2021F	2022F	2020	2021F	2022F	2020	2021F	2022F	2020	2021F	2022F
Eurozone	-6.5	5.0	4.3	0.3	2.3	1.8	-0.50	-0.50	-0.50				1.22	1.19	1.22
Germany*	-4.9*	3.0*	5.0*	0.5	3.1	1.7				-0.57	-0.20	0.00			
France	-8.0	6.0	4.2	0.5	1.5	1.4									
Italy	-8.9	6.1	4.2	-0.1	1.8	1.4				0.55	0.70	1.25			
UK	-9.8	6.4	5.9	0.9	2.2	3.0	0.10	0.10	0.10				1.37	1.39	1.43
USA	-3.4	5.8	3.9	1.2	4.4	3.3	0.25	0.25	0.25	0.91	1.75	2.25			
Oil price, USD/bbl													43	68	63

*Non-wda figures. Adjusted for working days: -4.9% (2020), 3.0% (2021) and 5.1% (2022): **Deposit rate for ECB Source: UniCredit Research

THE OUTLOOK AT A GLANCE

Real GDP (% change)	2019	2020	2021F	2022F
EU-CEE	4.0	-4.1	5.9	4.6
Bulgaria	3.7	-4.2	4.1	3.9
Czechia	3.0	-5.8	3.2	4.1
Hungary	4.6	-5.0	7.0	5.4
Poland	4.7	-2.7	6.3	4.5
Romania	4.1	-3.9	8.1	5.0
Croatia	2.9	-8.0	6.9	5.3
Russia	2.0	-3.0	4.0	2.4
Serbia	4.2	-1.0	7.0	4.5
Turkey	0.9	1.8	9.7	5.5

CPI EoP (% change)	2019	2020	2021F	2022F
EU-CEE	3.4	2.0	5.2	3.4
Bulgaria	3.8	0.1	4.5	2.1
Czechia	3.2	2.3	4.5	3.1
Hungary	4.0	2.7	6.1	4.1
Poland	3.4	2.4	5.7	3.8
Romania	4.0	2.1	5.9	3.3
Croatia	1.4	-0.7	3.1	2.0
Russia	3.0	4.9	5.9	4.2
Serbia	1.8	1.3	4.7	3.5
Turkey	11.8	14.6	18.5	14.4

C/A balance (% GDP)	2019	2020	2021F	2022F
EU-CEE	-0.4	1.1	0.1	0.2
Bulgaria	1.8	-0.7	-1.5	1.5
Czechia	0.3	3.6	2.2	1.0
Hungary	-0.7	-1.5	-0.6	-0.3
Poland	0.5	3.5	1.5	2.0
Romania	-4.9	-5.2	-6.1	-6.2
Croatia	2.8	-0.4	0.8	0.3
Russia	3.9	2.4	5.8	4.4
Serbia	-6.9	-4.3	-4.0	-4.2
Turkey	0.9	-5.2	-2.7	-2.7

Extended basic balance (% GDP)	2019	2020	2021F	2022F
EU-CEE	2.7	4.1	3.2	3.8
Bulgaria	4.8	3.9	2.3	6.8
Czechia	3.1	5.4	3.7	2.5
Hungary	1.2	2.4	2.0	3.3
Poland	4.1	7.5	5.3	5.9
Romania	-1.7	-2.9	-2.5	-1.4
Croatia	6.4	3.7	5.8	4.6
Russia	4.5	2.7	4.5	3.5
Serbia	0.8	2.0	1.3	1.2
Turkey	1.7	-4.6	-2.0	-2.1

External debt (% GDP)	2019	2020	2021F	2022F
EU-CEE	67.2	74.9	71.0	65.7
Bulgaria	62.6	66.1	62.4	59.1
Czechia	75.7	75.5	76.0	79.1
Hungary	96.7	150.8	142.8	123.6
Poland	59.1	57.1	50.2	43.1
Romania	33.3	42.5	45.8	46.1
Croatia	75.3	82.4	80.7	77.7
Russia	29.1	29.7	27.9	25.0
Serbia	61.5	66.3	65.0	63.1
Turkey	57.2	62.8	60.0	59.8

General gov't balance (% GDP)	2019	2020	2021F	2022F
EU-CEE	-1.1	-7.1	-6.9	-4.5
Bulgaria	2.1	-3.4	-5.5	-5.0
Czechia	0.3	-6.2	-7.3	-5.6
Hungary	-2.1	-8.1	-7.6	-5.8
Poland	-0.7	-7.0	-6.2	-3.0
Romania	-4.4	-9.2	-8.3	-6.4
Croatia	0.3	-7.4	-3.1	-1.6
Russia	1.8	-3.8	0.3	0.6
Serbia	-0.2	-8.1	-4.5	-2.8
Turkey	-5.3	-5.2	-4.5	-4.6

Gov't debt (% GDP)	2019	2020	2021F	2022F
EU-CEE	44.2	55.4	54.0	52.8
Bulgaria	19.7	24.4	24.0	29.5
Czechia	30.3	38.1	42.9	45.8
Hungary	63.9	80.4	80.8	80.1
Poland	45.6	56.3	53.0	49.9
Romania	35.3	47.3	49.3	50.2
Croatia	72.8	88.7	84.4	80.6
Russia	13.2	18.4	18.5	18.9
Serbia	52.9	58.2	59.0	57.9
Turkey	32.7	39.8	39.3	38.7

Policy rate (%)	2019	2020	2021F	2022F
EU-CEE				
Bulgaria	-	-	-	-
Czechia	2.00	0.25	1.75	2.25
Hungary	0.90	0.60	2.10	2.50
Poland	1.50	0.10	0.25	1.50
Romania	2.50	1.50	1.50	2.00
Croatia	-	-	-	-
Russia	6.25	4.25	7.00	6.50
Serbia	2.25	1.00	1.00	1.00
Turkey	12.00	17.00	15.00	14.50

FX vs. EUR (EoP)	2019	2020	2021F	2022F
EU-CEE				
Bulgaria	1.96	1.96	1.96	1.96
Czechia	25.4	26.2	25.4	25.0
Hungary	331	365	353	355
Poland	4.26	4.61	4.60	4.55
Romania	4.78	4.87	4.97	5.05
Croatia	7.44	7.54	7.53	7.53
Russia	69.3	90.7	85.7	86.0
Serbia	117.6	117.6	117.6	117.8
Turkey	6.67	9.08	11.07	12.69

Source: National statistical agencies, central banks, UniCredit Research

EM VULNERABILITY HEATMAP

	BG	CZ	HR	HU	PL	RO	RS	RU	SK	TR	UA	MX	BR	CL	SA	ID	IN	CN	AG
External Liquidity																			
Current account (% of GDP)	-1.5	2.7	-0.3	-2.1	2.3	-6.7	-2.2	3.5	1.0	-3.8	0.4	2.8	-1.3	-1.1	2.9	-0.1	0.9	2.1	0.7
Extended Basic Balance (% of GDP)	1.4	4.7	3.9	-1.0	5.9	-3.2	4.0	4.4	0.4	-3.2	0.4	4.6	0.6	-1.7	1.3	1.2	2.6	3.3	1.3
FX Reserves coverage (months of imports)	8.5	11.8	10.3	3.0	5.2	4.8	6.9	16.3	-	2.9	4.6	4.9	15.3	6.6	7.1	8.6	13.3	14.5	8.6
External Debt (excl.ICL, % of GDP)*	62.4	73.0	71.0	60.0	41.9	40.5	60.1	21.7	100.2	61.5	75.2	39.9	43.7	72.9	48.0	37.6	21.4	16.1	68.9
Short-term debt (% of GDP)	24.3	39.1	25.6	12.5	9.2	7.1	4.2	4.0	48.7	16.3	10.1	3.7	4.5	7.6	8.4	4.4	7.4	8.9	10.4
REER (Index, 2010=100)	105.2	104.6	101.3	87.3	92.8	98.7	128.2	77.3	-	51.8	97.6	83.1	134.9	82.1	111.2	89.9	108.4	125.4	-
Domestic Finances																			
Corporate debt (% of GDP)	44.8	50.1	64.9	58.1	44.3	39.0	47.6	61.2	54.4	69.3	48.6	27.2	53.6	115.4	50.4	37.7	58.5	159.2	18.3
Household Debt (% of GDP)	24.6	41.6	41.0	24.0	35.4	21.7	20.5	21.1	45.6	15.9	5.4	17.6	36.6	39.9	31.1	16.6	38.4	61.3	5.2
Nonresident holdings of LC gov.debt (% total)	0.7	32.1	-	24.1	15.9	17.6	20.8	33.8	42.7	5.5	-	18.5	9.2	-	29.6	25.2	-	10.1	-
Banking System																			
Credit Impulse (% of GDP)	0.8	1.5	-2.8	-0.7	-2.2	1.3	-0.5	4.3	-0.5	-2.1	2.7	-3.0	6.2	-9.6	-4.0	-0.2	-1.8	-4.8	1.3
Loans/deposit ratio (%)	67.8	61.4	76.4	61.9	79.5	68.2	85.7	82.3	103.0	99.1	133.2	88.5	105.2	107.2	98.8	87.7	107.2	78.1	135.9
NPL (% of total loans)	7.7	2.6	7.2	2.7	3.2	3.8	3.5	8.8	2.4	3.7	39.9	2.4	2.2	1.5	5.1	3.2	7.9	1.8	5.0
Domestic Banks CAR (%)	22.9	22.0	25.4	21.2	20.1	23.9	22.2	12.5	20.8	17.5	22.6	18.4	16.5	14.8	16.9	24.3	15.6	14.5	25.5
Domestic Banks RoE (%)	10.0	8.8	8.1	13.2	3.5	13.0	7.7	17.5	9.8	10.3	22.5	16.1	13.0	20.7	8.5	11.8	20.7	10.4	-

BG = Bulgaria, BR = Brazil, CL = Chile, CN = China, HR = Croatia, CZ = Czech Republic, HU = Hungary, IN = India, ID = Indonesia, MX = Mexico, PL = Poland, RO = Romania, RU = Russia, RS = Serbia, SK =Slovakia, SA = South Africa, TR = Turkey, UA = Ukraine. *External debt incl ICL for CZ, RS, TR, MX, CL and SA

*External debt incl. ICL for CZ, RS, TR, MX, CL and SA

Source: Haver, Bloomberg, National Statistics Offices, Central Banks, IMF, UniCredit Research

Legend
Low vulnerability
Moderate vulnerability
Significant vulnerability
High vulnerability

EM VULNERABILITY HEATMAP (CONTINUED)

	BG	CZ	HR	HU	PL	RO	RS	RU	SK	TR	UA	MX	BR	CL	SA	ID	IN	CN	AG
Policy																			
Policy Rate, nominal (%)	-	0.75	0.05	1.65	0.10	1.25	1.00	6.75	0.00	19.00	8.00	4.50	5.25	0.75	3.50	3.50	4.00	4.35	38.00
Real policy rate (%)	-	-3.4	-3.05	-3.1	-5.1	-4.0	-3.2	0.1	-3.8	-0.2	-2.0	-1.0	-4.0	-3.8	-1.1	1.9	-1.3	3.7	-8.9
Real Money market rate (%)	-	-3.0	-3.1	-3.0	-5.0	-3.6	-3.3	0.5	-4.3	0.6	-2.7	-1.2	-4.5	-3.2	-1.3	2.1	-1.4	2.8	-12.2
Headline inflation (% yoy)	3.7	4.1	3.1	4.9	5.5	5.3	4.3	6.7	3.8	19.3	10.2	5.6	9.7	4.8	4.7	1.6	5.3	0.6	51.4
Core Inflation (% yoy)	1.1	4.8	1.8	3.6	3.9	4.3	1.8	7.1	4.5	16.8	7.2	4.8	6.3	3.8	3.1	1.6	5.8	1.1	55.5
GG Fiscal balance (% of GDP)	-3.8	-7.5	-7.4	-10.7	-6.5	-8.2	-2.1	-2.4	-6.8	-1.7	-4.4	-2.4	-7.4	-7.1	-7.4	-2.3	-6.8	-4.3	-4.4
GG Primary balance (% of GDP)	-3.3	-6.7	-5.5	-8.6	-5.3	-6.9	0.0	-1.5	-5.5	0.9	-	0.3	-3.8	-6.2	-3.3	-4.1	-3.5	-	-
Government Debt (% of GDP)	23.9	44.1	91.3	81.0	56.2	49.3	58.3	18.1	60.3	40.4	60.7	44.6	78.6	48.8	68.8	64.5	58.9	65.4	85.8
Markets																			
External Debt Spread (10Y, bp)**	52.9	4.2	106.1	59.3	29.5	182.8	169.3	101.3	38.3	520.5	537.2	93.0	234.3	79.9	289.9	136.4	76.8	-11.8	-
Local Currency Curve (5Y, %)***	0.0	1.9	0.1	2.6	1.5	3.5	2.2	7.2	-0.5	18.8	5.7	6.9	10.6	5.0	7.6	5.2	5.7	2.7	48.1
Local currency bond spread (2s10s)****	56.2	18.3	22.3	94.6	145.9	105.7	233.1	14.5	98.9	-76.0	308.6	145.0	250.0	108.0	283.0	-406.2	205.6	39.4	-283.4
CDS (5Y, bp)	66	53	124	81	82	122	130	134	72	450	450	159	290	126	286	138	124	44	2180
FX 3m implied volatility (%)	-	4.1	4.0	6.1	5.3	2.3	-	10.0	-	17.3	-	9.7	16.6	15.6	15.7	7.1	5.0	4.1	15.2
Structural*****																			
IBRD Doing Business	61	41	51	52	40	55	44	28	45	33	64	60	124	59	84	73	63	31	126
WEF Competitiveness Ranking	49	32	63	47	37	51	72	43	42	61	85	48	71	33	60	50	68	28	83
Unemployment (%)	4.9	2.8	6.7	4.1	6.1	5.1	10.5	4.5	6.9	12.0	10.5	4.4	14.1	9.5	34.4	6.3	8.3	5.1	10.1

** Spread between 10Y EUR government bond yields and the corresponding German government bond yields for BG, HR, HU, PL, RO. For CZ, the spread refers to the 5Y yield. For the other countries, the spread is computed with respect to US government bond yields; *** Data for UA refer to the generic USD bond. Data for HR refer to the 4Y bond; **** Data for UA refer to the generic USD bond. Data for CL refer SA to the spread between 8Y and 2Y bond and 9Y and 2Y bond respectively. Data for HU refer to spread between 10Y and 3Y bond; *****IBRD and WEF indicators for 2019

Source: Haver, Bloomberg, National Statistics Offices, Central Banks, IMF, UniCredit Research

Legend
Low vulnerability
Moderate vulnerability
Significant vulnerability
High vulnerability

CEE strategy: financial conditions remain easy, risks are on the rise

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- Global financial conditions remain easy, in spite of short-lived spikes in volatility. However, recent tensions related to China are fueling a more cautious approach to EM. We expect risk appetite to remain healthy in the latter part of the year but gains by risky assets are likely to slow. Long-term UST yields appear too low given the direction of monetary policy in the US and current growth and inflation outlooks. In such a scenario, we think that the USD will remain within recent ranges over the coming quarters.

- While EUR-denominated CEE bonds continue to offer attractive pickups on EGB curves, it is on local curves where opportunities might be more interesting, as inflationary risks and the pace of central-bank tightening are shaping market dynamics.

- Russian bonds remain a top pick in the region, across both hard-currency and local-currency curves. We prefer ROMGBs to ROMANI and project increasing headwinds for HGBs where rate hikes might not be enough to flatten the curve as the NBH tapers asset purchases. Meanwhile, bear flattening might shape the POLGB curve while providing some upside to the PLN.

Muted performance in 3Q

Overall, broad EM bond indices have delivered a flat performance during 3Q, after a more-solid 2Q. In the year to date, the performance of hard-currency and local-currency bonds has been slightly negative, with LatAm contributing to such losses to a great extent. Longer-dated bonds have just underperformed the front end. Hence, aggregate EM bonds performance has not been too different from the negative returns posted by long-dated USTs and the MSCI EM index, while they have been significantly lower than the returns associated with European and US high-yield bonds (of approximately 5% YTD). Return dispersion has been less extreme than in previous quarters. Spread dynamics have been more contained, as shown by the return gap between highly rated and sub-investment-grade segments of the Bloomberg-Barclays USD-denominated EM bond index, as opposed to the very large dispersion seen in 2Q. Where performance differed the most across market segments was among local-currency bonds, with LatAm underperforming (losing over 10%), EMEA down 3% and Asia slightly positive. The mood towards Asian bonds soured more recently, as a result of Chinese regulatory initiatives and China's real-estate sector coming into the spotlight. CEE was relatively unaffected.

CHART 1: EM BOND PERFORMANCE

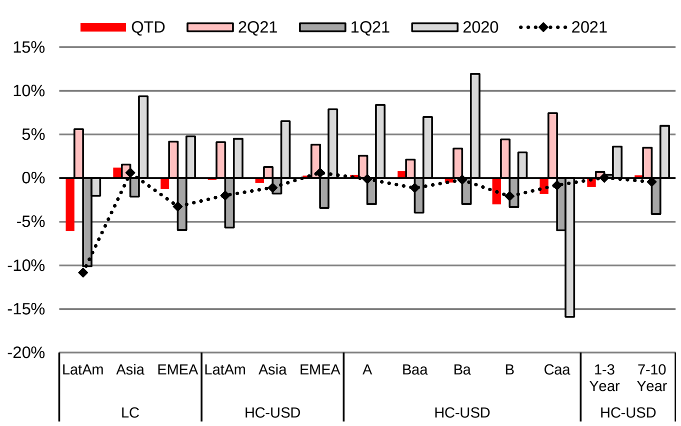
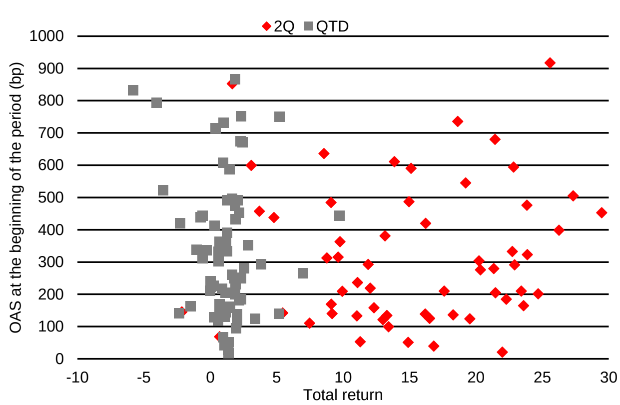


CHART 2: RETURN DISPERSION ON HARD-CURRENCY BONDS



Source: Bloomberg, UniCredit Research

UST yields look too low given economic and monetary-policy outlooks in the US

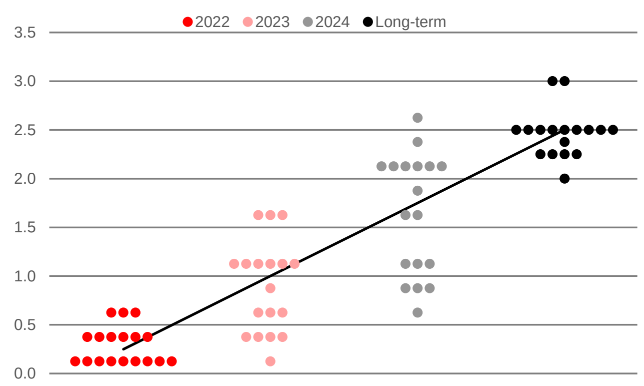
The FOMC's September meeting consolidated our expectations that asset purchases will be tapered before year-end, and barring negative surprises, such an announcement could come as soon as the FOMC's November meeting. Moreover, the Fed's language indicates that tapering is likely to occur at a relatively quick pace, with asset purchases possibly ending around mid-2022. The subsequent step would be to hike rates. The Fed's dot-plot suggests an even split for a hike already in 2022, while median projections point to three rate hikes in 2023 and an additional three hikes in 2024, which would take the federal funds rate to 1.75%. Extending the tightening cycle further at the same pace would take policy rates to the expected long-term level of 2.5% by the end of 2025. We forecast two hikes in 2023 and possibly an additional two in 2024. The Fed is set to progressively rein in its accommodative measures while the US economy is set to return to its pre-pandemic growth trend later this year and will likely grow above potential for several quarters. Meanwhile, after setting new lows in the summer, the 10Y UST real yield has risen to the -0.85% area. In our view, negative surprises on the growth front, the impact of the delta variant and less-relaxed market sentiment, particularly with regard to EM, might have contributed to keep real yields low. However, at these levels, the long end of the US curve does not seem consistent with current growth and inflation outlooks and the direction of monetary policy. We think that real yields will gradually move towards 0-0.5%, where we see their fair value, and that the 10Y yield will approach 2% over the coming quarters. Duration risks are not over, and while the market is still relaxed, we think it is a matter of time before the entire US curve shifts north.

USD will likely stay within recent ranges for the coming months, but monetary-policy divergence between the Fed and the ECB will become more material in late 2023

In such a scenario, the weakening process we had envisaged for the USD is likely to be slower. Thus, we expect EUR-USD to rise moderately over the coming months, while remaining within the narrow (6%) range that has prevailed over the past 12 months. Indeed, while global growth has slowed in recent months, the medium-term outlook remains solid, and risk appetite should stay healthy, even though equity gains seem set to moderate over the coming quarters. This will limit the upside to the USD from ongoing policy normalization in our view.

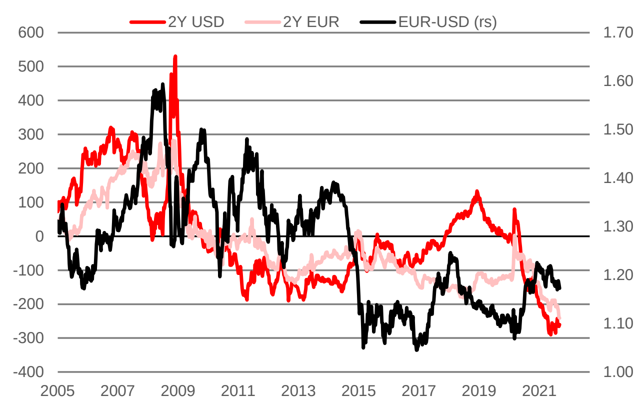
However, the economic recovery in the euro area has lagged that of the US, and the ECB will likely maintain an accommodative stance for several more quarters, extending asset purchases possibly beyond 2022. Hence, as we approach the end of next year, EU and US monetary policy is likely to diverge in a more substantial way. Widening policy-rate differentials might push EUR-USD outside of recent ranges and fuel more sustained USD strength, which we expect to shape market dynamics in 2023.

CHART 3: FED DOT PLOT



The line indicates median dot projections.

CHART 4: 2Y REAL RATES AND EUR-USD



Real rates were calculated from swap curves.

Source: Bloomberg, UniCredit Research

Healthy financing conditions but rising risks

The multi-month recovery in equity prices across developed markets continues, and so far, corrections have been short-lived and limited in magnitude. EM equities have faced a more challenging environment given the rise of regulatory crackdowns in China. Credit spreads remain tight across US and European markets, and low real yields have helped keep global financing conditions easy. However, the impact of expansionary fiscal and monetary policy on risky asset valuations seems to be priced in, and during the next few months, gains will be more dependent on the evolution of GDP and earnings growth. This should reduce the scope for large gains. Moreover, with momentum losing some pace, risky assets will be more exposed to negative news at a time when major developed-market central banks have changed course and are prepared to start withdrawing accommodative measures. Liquidity remains abundant, and low real yields and spreads across developed markets will continue to fuel the hunt for yield. However, investors might be less willing to add risk to their portfolios in the coming months, including across EM, where we expect a more selective approach will be favored.

A more cautious approach to EM

Indeed, portfolio flows into EM assets suggest that investors have maintained a cautious stance toward the region since mid-August, when large outflows were recorded as news of regulatory crackdowns in China affected market sentiment. More recently, outflows have started to prevail again, and lingering negative news is likely to accelerate this trend, potentially leading to more indiscriminate shedding of positions. The events related to Evergrande seem set to contribute to that. Here, risks go beyond the single name and have brought back into the spotlight China's likely slowdown in growth over the medium term, the large corporate debt pile and, in this context, the potential implications of rebalancing the economy away from investment (particularly in real estate) and towards consumption.

CHART 5: EQUITY IMPLIED VOLATILITY AND CREDIT SPREADS

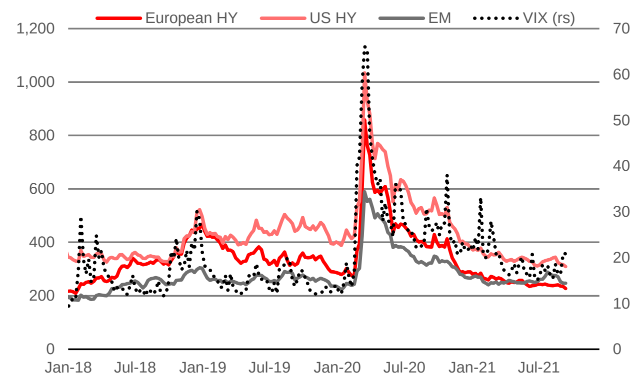
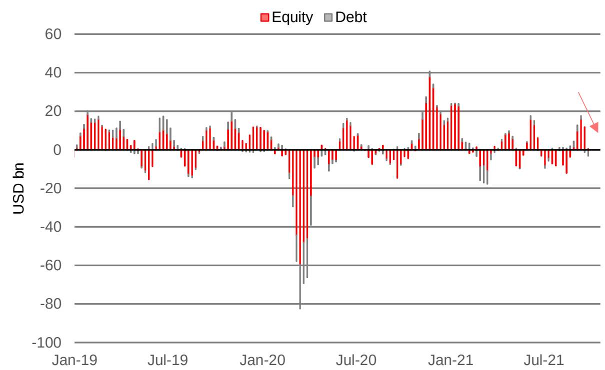


CHART 6: PORTFOLIO FLOWS INTO EM



4-week rolling sum

Source: Institute of International Finance, Bloomberg, UniCredit Research

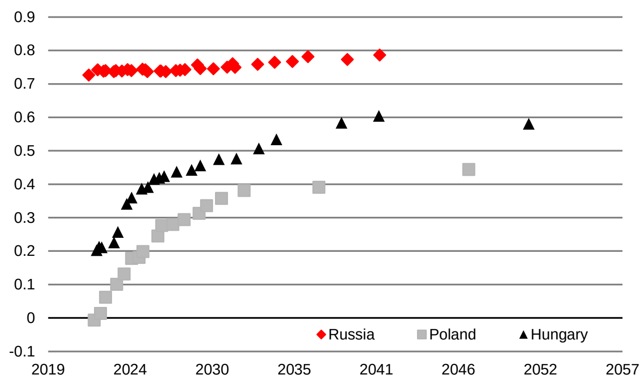
Tensions from Chinese real estate

China's regulatory crackdown and tensions in the country's domestic real-estate market (centered around Evergrande) have contributed to the cautious stance taken towards EM assets in the latter part of 3Q20. The move to increase regulation and improve data privacy and national security and the clampdown on excess leverage by Chinese authorities flag a shift in policy goals, and this is unlikely to be reversed soon. Hence, while policymakers are likely to step in to avoid too large a spillover to the rest of the economy at a time when growth is slowing, their intervention might feature short-lived relaxations of the rules and liquidity provisions but is unlikely to hinder underlying adjustments in the structure of the economy. One of the factors that might shape the extent of the spillover is the risk that larger portfolio adjustments will be made due to losses across Chinese real estate. Chinese corporate bonds account for nearly 8% of the total outstanding amount of large benchmark indices, such as the JPMorgan CEMBI diversified index. Financials and real estate make up most of the Chinese share and add up to nearly 5% of the total outstanding amount (with real estate adding to nearly 2% on its own). With regard to equities, Chinese companies account for about a third of the MSCI EM index. However, this index is skewed towards tech and financials, while the weight of real estate is negligible. Within the MSCI China index, real estate accounts for less than 5%, while financials account for nearly 15%. Hence, the immediate portfolio implications of tension in the Chinese real-estate sector might be limited due to its modest weight in large EM bond and equity benchmark indices. Such tension would however become significant if market fears were to spillover into China's broader financial sector, potentially triggering large portfolio adjustments and a more widespread sell-off across the EM space. Beyond direct portfolio impacts, mapping financial interlinkage between China and the rest of the world is a daunting challenge. One way to measure this is to look at global bank exposure to Chinese counterparties. Data on this from the Bank for International Settlements (BIS) suggest that bank exposure to China is low in the US, across the eurozone and even in Japan. The UK appears to be more vulnerable. Such exposure there amounts to 6% of (national) GDP when counterparties in the bank and non-bank private sectors are taken into account. This refers to the entire economy, while specific exposure to the real-estate sector accounts for a fraction of the total. Trade linkage is tighter, given China's large role in global trade. Indeed, China accounts for some 12% of all global imports of goods and is highly integrated in global value chains. Moreover, China is key importer of base metals, and within its domestic economy, the construction sector is a large consumer of such commodities. Hence, a sharp real-estate slowdown might have far reaching consequences via commodity markets, affecting producers/exporters across the word and weighting on a large part of EM.

The implications of Germany's elections

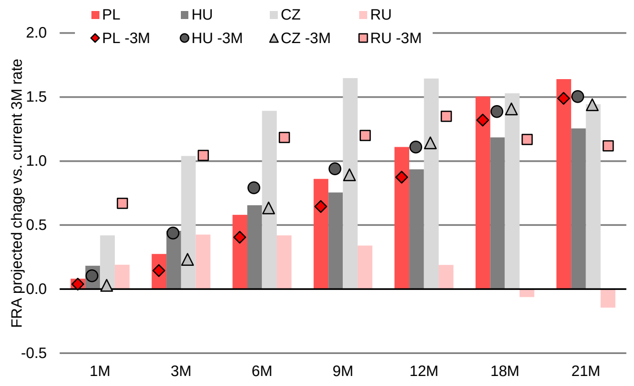
As we enter the final months of the year, political developments in Germany will remain on market radars, as coalition talks will probably take a substantial amount of time. Party votes on a coalition treaty could also take place, and there are no legal deadlines for collation talks. Therefore, it might not be until early next year before a new government is formed. From a market perspective, the key issue will be the direction of Germany's fiscal policy and its consequences for the rest of the EU. In our view, the pandemic (but especially Germany's recent flood disaster) may have strengthened the determination of policymakers to improve public infrastructure and to fight climate change. Large public investment in infrastructure but also more-flexible and faster approval procedures to increase the generation and use of renewable energy are needed for such ambitious goals to be reached. That said, visibility with regard to the magnitude of possible fiscal spending as well as with regard to sources of funding is still low at this stage and will be debated in the months to come, but the direction of fiscal policy seems set if the aforementioned goals are to be addressed. This will, in turn, influence Germany's stance at a time when the shape of the EU's post-pandemic fiscal rules is going to be discussed. A German government that is more committed to Europe and to further integration would likely be good news for eurozone assets and for the euro. Given lingering ECB asset purchases and the Bunds scarcity, higher funding needs in the ballpark of 1-1.5% of GDP for the next 5-10Y years (as currently projected) should not be a game changer for yield levels in the short term, but over time, this might contribute to the normalization of higher Bund yields. The broader impact of this on sentiment could be material and might feature renewed interest in on EGB periphery and CEE bonds as well as the euro, with positive spillovers on CEE currencies. Hence, a more positive scenario for CEE bonds and currencies could be progressively priced in.

CHART 7: RISK-ADJUSTED YIELDS



Local yield curves have been scaled according to 3M FX volatility (EUR pairs).

CHART 8: PROJECTED POLICY-RATE CHANGE



Source: Bloomberg, UniCredit Research

While EUR-denominated CEE bonds continue to offer attractive pickups on EGB curves, it is on local curves where opportunities might be more interesting, as inflationary risk and central banks' pace of tightening are shaping market dynamics.

OFZs remain a top pick in the region

Russian international bonds have been tightening over the past quarter. On the EUR-curve, they are trading in line with ROMANI up to the 5Y and a tad richer at longer maturities. Local bonds were under pressure as CBR tightening drove sizable bear flattening of the curve. This took the entire curve north of the 7% mark, which we consider the peak of the policy rate for the current tightening cycle. If inflation fears subside, as expected, the CBR could cut back to 6% in 2022, boosting OFZ performance. Given that the RUB is trading just below its 12-month average against the USD and still significantly weaker than before the crisis, OFZ carry appears very attractive.

ROMGBs offer better opportunities than ROMANI

EUR-denominated ROMANI have widened somewhat over the past three months at longer maturities, displaying some steepening on the credit-spread curve. The short end has traded sideways and is nearly flat compared to Russian government bonds, while at the long and extra-long ROMANI have cheapened significantly in relative terms and now offer a large pickup. Supply pressure is a key risk to monitor. EUR 3bn worth are expected to be sold by year-end, and issuance seems set to remain strong in the coming year. At shorter tenors, comparable yield levels and rolldown make Russian EUR-denominated bonds a more attractive pick, also compared to periphery EGBs. ROMGBs might offer more opportunities. Rate hikes are possible already this year, but the peak of the cycle would likely not exceed 2% if inflationary pressure fades into next year, as we expect. Hence, while there might be some room for curve flattening; 3Y+ maturities trading north of 3% should not be affected much, while the level of carry remains interesting. Moreover, FX volatility seems set to remain low, 4.90-5.00 might be the reference EUR-RON range for the NBR, as long as political tensions do not escalate.

Increasing headwinds for Hungarian bonds and the HUF

Hungarian EUR-denominated bonds have recovered their summer widening and are currently trading in line with periphery EGBs. At the long end, their spread to Polish EUR-denominated bonds has widened significantly during the last few weeks and might have room to return to early-summer levels. However, supply remains a risk with regard to REPHUNs, as the NBH tapers purchases of HGBs. The central bank seems set to deliver two more hikes before year-end, taking the policy rate to 2-2.1%. Inflationary pressure remains strong. The tightening cycle might continue into 2022, possibly taking rates to 2.5%. Such hikes might however not be enough to flatten the curve. Inflationary risks linger, and the decision to further reduce HGB purchases is likely to keep the long end under pressure. This is particularly the case, given the NBH's key role in absorbing supply, the likely increase in funding needs as we head into 1Q, (typically when issuance picks up) and the risk of a delay in Next Generation EU transfers. Moreover, slow rate tightening at a time of rising inflationary risk might keep the HUF under pressure.

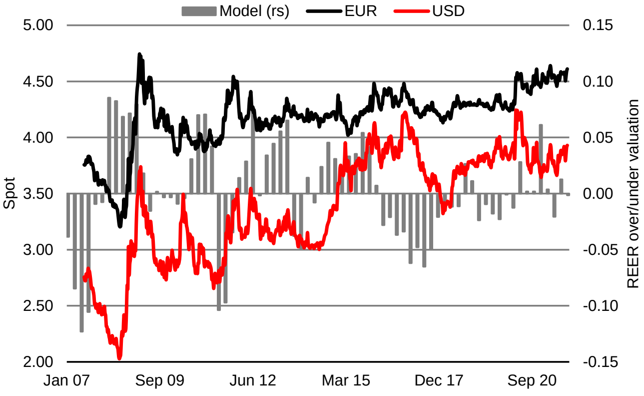
Room for a flatter POLGB curve and for stronger PLN and CZK

The curve of EUR-denominated Polish government bonds has tightened over the past three months, with the extra-long end lagging somewhat. The front end and the belly are broadly in line with EUR swaps and EUR-denominated Czech government bonds. The local curve might offer more interesting trade opportunities if (as we expect) the NBP will play catch up with the policy-rate levels of its regional peers in order to stabilize inflation in 2022. In such a scenario, there would likely be sizable flattening and a stronger PLN. Our view is more aligned to forwards, on CZK rates. More hikes might have to be delivered by the CNB, and this would further contribute to expected-solid CZK performance.

Updating our REER models

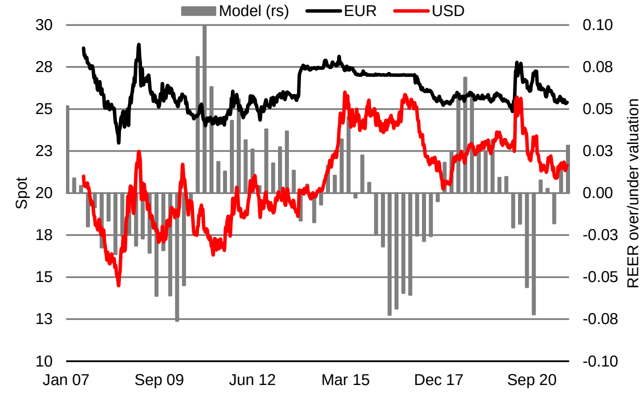
PLN

- The zloty has been trading within a 5-6% range in REER terms over the past year, while EUR-PLN has so far failed to approach its pre-COVID-19 trading range.
- In REER terms, the currency looks a tad undervalued, and we expect to see a more marked recovery over the course of 2022. We think that the NBP will have to act to address inflationary pressure, and the path towards rate hikes we envisage is steeper than forwards.
- However, the short-term picture for PLN remains challenging, and tightening might be pushed into 2022, when we expect EUR-PLN to fall back towards the lower end of the 4.45-4.55 range.



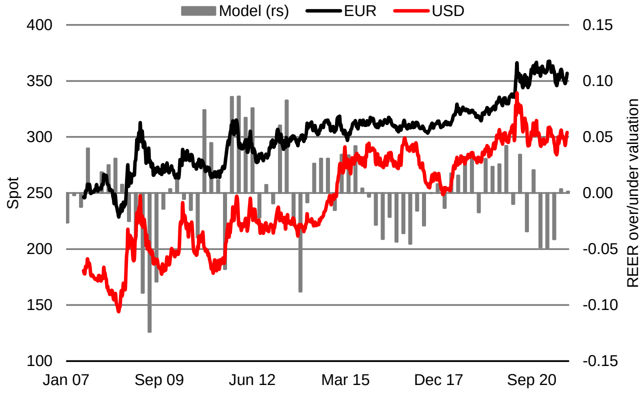
CZK

- The CZK has been strengthening steadily in recent months, outperforming regional peers. In REER terms, it has more than recovered from crisis-induced pressure. It is currently valued higher than it was in early 2020.
- Our model flags the currency as moderately overvalued in REER terms, but we believe that the CZK will stay well supported over the coming months.
- We expect EUR-CZK to progressively approach 25.0 over the coming quarters, as the CNB retains a hawkish stance. If inflationary pressure lingers, rates could be taken above 2.25% (our forecast) by 1H21.



HUF

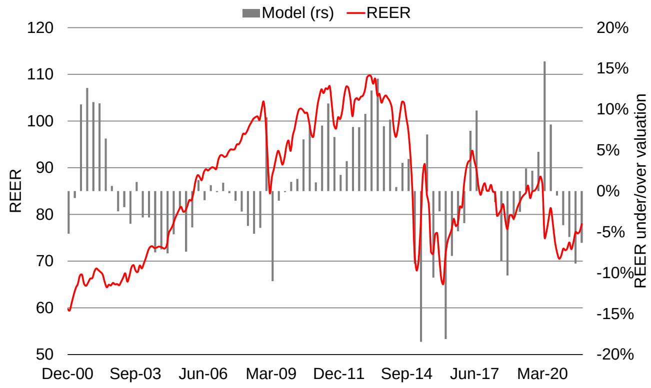
- In REER terms, the HUF is about in line with levels prevailing before the current crisis. The EUR-HUF has traded within a narrow range over the past 12 months and is currently near its 12-month average.
- Valuation considerations seem unlikely to trigger a move by the HUF in either direction. Our model for the REER shows the currency as just a tad overvalued.
- The performance of the HUF will be shaped by the rate-hike path of the NBH. We think that policy rates could reach 2.10% by year-end, but inflationary pressure might call for more hikes in 2022. We forecast EUR-HUF within the 353-357 range for the coming quarters.



Source: Haver, Bloomberg, UniCredit Research

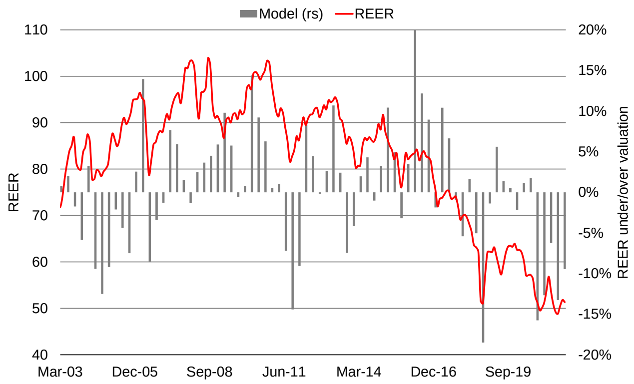
RUB

- The RUB has been recovering steadily in REER terms over the past few months. However, it still remains significantly weaker than it was before the current crisis, and in our model, it is shown as undervalued.
- USD-RUB has approached the lower end of its trading range over the past 12 months, and we expect to see it moving further towards 70 over the coming quarters.
- The CBR will likely deliver another rate hike during the next few months, but we think that a peak could be reached at 7%. Slowing inflation in 2022 would allow for policy rates to be cut back towards 6.5%.



TRY

- The recent 1% rate cut by the CBRT took markets by surprise and triggered a quick sell-off, with the USD-TRY reaching new record highs.
- In REER terms, the TRY is well below its pre-crisis average. Our model shows the currency as undervalued, but this is a gap we do not expect will be recovered anytime soon. The risk is for more weakness over the coming months.
- The rate-cute cycle might continue over the next few months, and the TRY's performance will likely set the pace. We expect USD-TRY to be at 9.30 by YE 2021 and at 10.40 by YE 2022.



Source: Haver, Bloomberg, UniCredit Research

Countries

Bulgaria

Baa1 stable/BBB stable/BBB positive*

Outlook

The failure of the vaccination campaign and the sharp fall in public capex has triggered a downward revision of our growth forecast. We now expect 4.1% growth in 2021 (from 4.4%) and 3.9% in 2022 (from 4.1%). The next parliamentary elections will be held together with the first round of the presidential elections on 14 November. Polls show that support for the protest parties has declined, as voters appear to be disappointed by their repeated failure to form a government. We see a coalition between the protest parties and the left wing BSP as the most likely post-election scenario. A coalition between GERB and some of the smaller right-wing parties should also not be ruled out, especially if some of nationalist formations make it into the next parliament.

Strategy

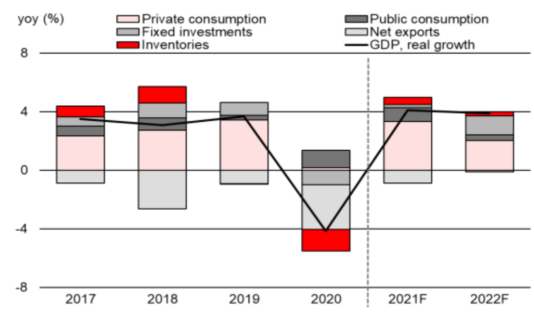
The sovereign is likely to meet its 2021's funding needs by running down its ample fiscal reserve. Sovereign funding needs are set to rise in 2022, as the health crisis continues and some disbursements due in 2021 were postponed. To this end, Bulgaria is likely to tap the Eurobond market in 1Q22. The volume of the new Eurobond issue is likely to reach EUR 3.5bn.

Author: Kristofor Pavlov, Chief Economist Bulgaria (UniCredit Bulbank)

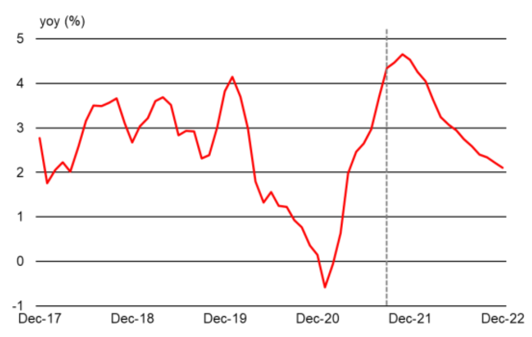
KEY DATES/EVENTS

- 14 Nov: presidential and parliamentary elections
- 15 Nov: labor force survey data for 3Q21
- 22 Oct, 16 Nov, 07 Dec: GDP data (revised data for 2020, 3Q21 flash estimate and structure)

GDP GROWTH FORECAST



INFLATION FORECAST



Source: National Statistical Institute, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2018	2019	2020	2021F	2022F
GDP (EUR bn)	56.1	61.2	60.6	65.4	70.6
Population (mn)	7.0	7.0	6.9	6.9	6.8
GDP per capita (EUR)	8 016	8 809	8 768	9 523	10355
Real economy, change (%)					
GDP	3.1	3.7	-4.2	4.1	3.9
Private consumption	4.4	5.5	0.2	5.0	3.0
Fixed investment	5.4	4.5	-5.1	1.1	7.0
Public consumption	5.4	2.0	7.5	5.2	2.2
Exports	1.7	3.9	-11.3	6.6	8.0
Imports	5.7	5.2	-6.6	7.5	7.5
Monthly wage, nominal (EUR)	586	648	709	787	843
Real wage, change (%)	7.7	7.5	7.7	8.4	4.2
Unemployment rate (%)	5.2	4.2	5.1	5.5	4.7
Fiscal accounts (% of GDP)					
Budget balance	2.0	2.1	-3.4	-5.5	-5.0
Primary balance	2.7	2.7	-3.0	-5.1	-4.6
Public debt	21.8	19.7	24.4	24.0	29.5
External accounts					
Current account balance (EUR bn)	0.5	1.1	-0.4	-1.0	1.1
Current account balance/GDP (%)	0.9	1.8	-0.7	-1.5	1.5
Extended basic balance/GDP (%)	3.2	4.8	3.9	2.3	6.8
Net FDI (% of GDP)	1.3	1.9	3.2	2.2	2.6
Gross foreign debt (% of GDP)	66.3	62.6	66.1	62.4	59.1
FX reserves (EUR bn)	25.1	24.8	30.8	30.0	31.2
Months of imports, goods & services	8.0	7.4	10.4	8.6	8.0
Inflation/monetary/FX					
CPI (pavg)	2.8	3.1	1.7	2.6	3.0
CPI (eop)	2.7	3.8	0.1	4.5	2.1
Central-bank reference rate (eop)	-0.50	-0.61	-0.70	-0.63	-0.55
USD/BGN (eop)	1.71	1.74	1.60	1.63	1.59
EUR/BGN (eop)	1.96	1.96	1.96	1.96	1.96
USD/BGN (pavg)	1.66	1.75	1.71	1.64	1.61
EUR/BGN (pavg)	1.96	1.96	1.96	1.96	1.96

Source: Bulgarian National Bank, Eurostat, National Statistical Institute, UniCredit Research

*long-term foreign-currency credit ratings as provided by Moody's, S&P and Fitch, respectively

Slow vaccination rollout will take its toll on the economy

We have made a downward revision to our growth forecast

We have lowered our real GDP growth forecast for 2021 to 4.1% (from 4.4%) and for 2022 to 3.9% (from 4.1%). Output is now likely to recover to its pre-pandemic level in 1Q22 (from 4Q21 in the previous forecast), while a fall in the unemployment rate to levels close to those associated with full employment is now expected in 2023 (from mid-2022 in the previous forecast).

Low vaccination rate means the health crisis is not over

There are three main reasons why we have lowered our GDP growth forecast. First, the vaccination campaign has failed to produce the desired results (see chart). Since the start of the campaign the rollout of the vaccines has been so slow that Bulgaria is unlikely to reach collective immunity any time soon, given the evidence of a decrease in vaccine efficacy over time. Against this disappointing backdrop, the spread of the highly transmissible Delta variant has driven a sharp rise in virus cases, hospitalizations and deaths in September (see chart). In response to the start of the fourth wave, the caretaker government tightened containment measures and promised to prolong provision of fiscal support to households and business hit by the pandemic.

The fourth wave will take its toll on the economy

Despite soft containment measures and very loose compliance, the fourth wave will take its toll on the economy. Tourist arrivals this winter will be lower than they might have been, as people are likely to be reluctant to visit a country where health-related risks remain elevated. Consumption will suffer, because people will probably continue to behave cautiously and maintain some sort of voluntary physical distancing until the fourth wave starts to subside at some point later this year. The public sector will have to provide more fiscal support to households and businesses suffering from the negative impact of the fourth wave of the pandemic, causing the budget deficit to increase.

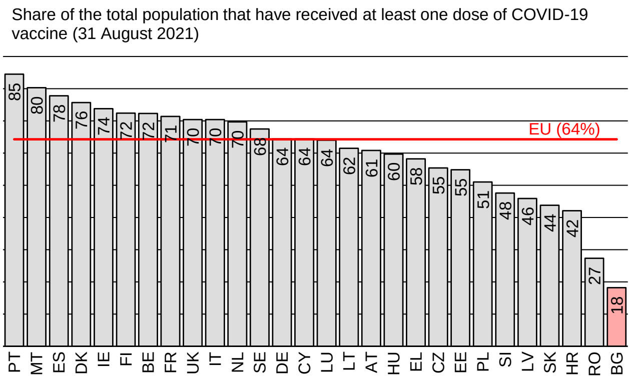
Transition to a new government delayed the completion of some infrastructure projects

Second, another wave of the COVID-19 pandemic was not the only downside risk to our baseline macroeconomic scenario that has materialized. Similar to what happened in 2013, the caretaker government discontinued some of the large infrastructure projects initiated under GERB. This has reversed the positive trend of rising public capex over the past several years, pushing them down to an expected 3.5% of GDP in 2021. If this forecast materializes, public capex this year will be lower than both those posted last year (4.3% of GDP) and the budget target for 2021 (4.8%). This is bad news for growth in 2021 and perhaps in 2022, unless the new government urgently restarts these projects once it is formed in December.

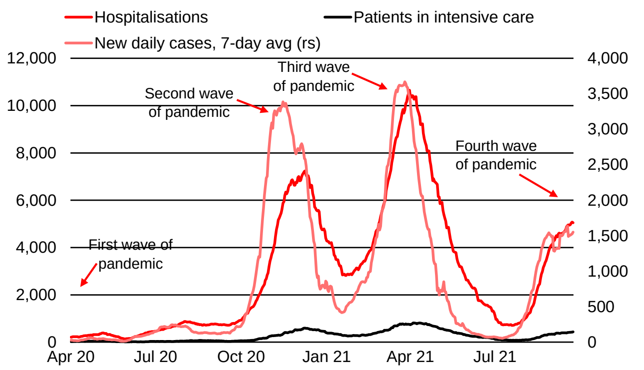
Delays in the RRP submission has negatively affected the investment recovery

Finally, the authorities have not yet submitted the country's Recovery and Resilience Plan (RRP). This means that the positive impact that we expected the RRP to have on the economy this year will not materialize and the positive impact next year may likewise be smaller than we anticipated earlier. In the worst case, the delayed submission of the RRP will shorten the period in which the country can use money from the NextGenerationEU (NGEU) facility, thereby reducing the overall utilization rate. Our macro scenario assumes Bulgaria will absorb 90% of the funding the country is eligible to draw from the NGEU. We will keep this assumption intact for now but will closely watch the underutilization risk and will factor it into our future forecasts, if necessary.

ROLLOUT OF VACCINES HAS BEEN DISSPOINTIGLY SLOW



THE FORTH WAVE HIT THE COUNTRY IN EARLY AUGUST



Source: Worldometer, Ministry of Health, UniCredit Research

Wheat harvest surprised on the positive side

On the positive side, the wheat harvest this year reached 7mn tons, from 4.6mn last year. This will boost GVA in the agriculture sector moderately but will not fully offset the negative impact on growth stemming from the slow vaccination campaign and the drop in public capex.

Fiscal support is likely to reach 7% of GDP in 2021

The fourth wave of the COVID-19 pandemic forced the government to prolong the fiscal support measures. Thus, fiscal support is likely to rise to 5.1% of GDP this year, from 4% of GDP initially envisaged in the state budget. When adding all pension and public sector wages increases this year, the fiscal support is likely to have reached almost 7% of GDP, according to our calculations.

At around 4% of GDP, the country's cash deficit will be the lowest in CEE this year

The caretaker government has focused on reducing cash deficit in the budget as an important priority. To this end, the authorities cut back public capex to its lowest level in two decades, while also postponing 0.5% of GDP in payments due to private road construction companies. As a result, the cash deficit is unlikely to exceed 4% of GDP this year (5.5% on accrual basis), but will increase again next year to 5.2% of GDP (and 5% of GDP on an accrual basis), according to our forecast.

Tight deadlines envisaged in the constitution made it even more difficult to form a government

Bulgaria's political scene was thrust into uncertainty after all three attempts to form a government failed and the president dissolved parliament for a third time this year. Deep fragmentation within parliament proved an insurmountable hurdle to end the political deadlock. This was further aggravated by the lack of experience of local politicians in forming large and complex coalitions that are supported by multiple players with diverse ideological backgrounds. Tight deadlines did not help either. Bulgaria's constitution allows parties only a few weeks to form a government, unlike in some other countries, where it is normal for coalition talks to take several months.

In November, Bulgarians will head to the polls for a third time this year

The next parliamentary elections will be held simultaneously with the first round of the presidential elections on 14 November. The same six parties that are in the current parliament are likely to be represented in the next one, according to opinion polls available in mid-September. Three small nationalist parties, Vazrazhdane, NFSB and VMRO, have a chance of surpassing the threshold for parliamentary entry, especially if they form some sort of alliance.

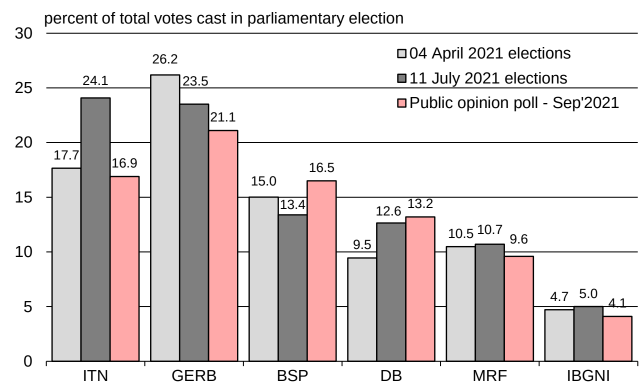
Failure to form a government is likely to reduce support for protest parties

After the election in July, support for the protest parties (including the three parties – ITN, DB and IBGNI – that benefited most from the protest against GERB) rose to 112 MPs, from 92 MPs in April. However, following their failure to form a government for a second time this year, the combined support for the protest parties has dropped to some 100 MPs, according to recent polls. Support for the two main parties (the right wing GERB and the left wing BSP) has risen as a result.

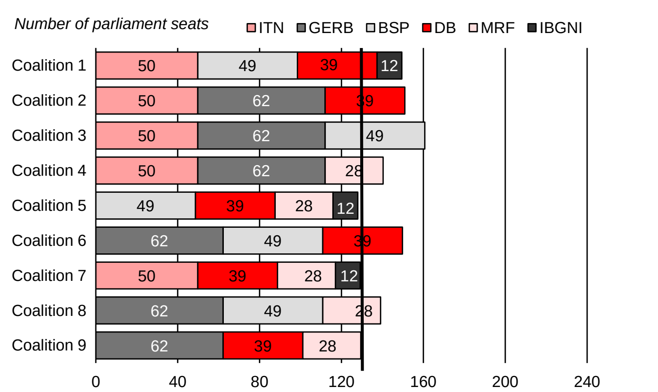
Coalition between the main left wing party, the BSP, and the protest parties remains our most likely scenario

Of the nine possible coalitions in the next parliament, we see only two as feasible (see chart). The first is essentially a repetition of the coalition between the three protest parties plus the main left wing BSP. Although these four parties have repeatedly failed to put a coalition agreement together, we still think they have the strongest chance of forming the next government. Whereas in the past it had seemed certain that the GERB would be excluded from the coalition talks, they are now running first in the opinion polls, which has increased GERB's chances of getting back into power, especially if some of the nationalist parties make it into the next parliament.

SUPPORT FOR THE PROTEST PARTIES IS LIKELY TO GO DOWN



ONLY TWO POSSIBLE COALITIONS SEEMS FEASIBLE TO US



Source: Central Election Commission, Alpha Research poll, UniCredit Research

A new Eurobond issue is likely early next year

In the absence of a new Eurobond issue, the sovereign is likely to meet its funding needs this year by running down its fiscal reserve

Keeping cash deficit close to 4% of GDP this year will enable the sovereign to meet its finding needs without tapping the Eurobond market. The issuance of domestic bonds is likely to increase to BGN 1.8bn by the end of the year, from BGN 1.0bn issued by mid-September. This would come on top of EUR 511mn of low-cost funding under the SURE financial assistance instrument, and the running down of funds available in the fiscal reserve to 4.0% of GDP by the end of the current year, from 7.3% of GDP at the end of 2020.

Sovereign funding needs are set to rise next year

However, we have significantly revised our cash budget deficit forecast for 2022 to 5.2% of GDP, from 2.4% of GDP. This reflects a combination of two main developments. First, the failure to bring health crisis to an end, which has translated into more fiscal support needed not only in 2021 but also in 2022. Second, the postponement of payments due to private businesses for road maintenance and reconstruction projects carried out in 2021 is likely to add an amount equivalent to around 0.5% of GDP to fiscal spending next year.

The volume of the next Eurobond issue is likely to be around EUR 3.5bn

To meet its increased funding needs next year, the Bulgarian sovereign is likely to tap the Eurobond market in 1Q22. The volume of the new Eurobond issue is likely to be around EUR 3.5bn. On top of that, we expect domestic borrowing of around BGN 2bn, while the low-cost borrowing from the NGEU program is likely to reach EUR 2bn in 2022.

Public debt is forecast to peak at around 33% of GDP in 2023-24…

…before stabilizing at that level in the medium term

If our projection is broadly right, the fiscal reserve will increase to 5.7% of GDP at the end of 2022, from 4% of GDP in the end of 2021, and around 8% on average in the past decade. As vaccination rates increase and gradually come closer to the levels needed to reach collective immunity, the government will likely start withdrawing fiscal support in 2023. This would result in sovereign funding needs decreasing and public debt stabilizing at around 33% of the country's GDP in the 2023-24 period.

THE GOVERNMENT'S GROSS FINANCING REQUIREMENTS

EUR bn	2020	2021F	2022F
Gross financing requirement	**2.6**	**3.3**	**5.3**
Budget deficit	1.8	2.6	3.7
Amortization of public debt	0.7	0.7	1.6
Domestic	0.5	0.5	0.2
Bonds	0.5	0.5	0.2
Bills	0.0	0.0	0.0
Loans/other	0.0	0.0	0.0
External	0.2	0.2	1.4
Bonds and loans	0.0	0.0	1.3
IMF/EU/other IFIs	0.2	0.2	0.2
Financing	**2.6**	**3.3**	**5.3**
Domestic borrowing	0.6	0.9	1.0
Bonds	0.6	0.9	1.0
Bills	0.0	0.0	0.0
Loans/other	0.0	0.0	0.0
External borrowing	1.9	0.6	5.6
Bonds and loans	2.5	0.0	3.5
IMF/EU/other IFIs	-0.6	0.6	2.1
Privatization/other	0.0	0.0	0.0
Fiscal reserves change (- =increase)	0.1	1.8	-1.4

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2020	2021F	2022F
Gross financing requirement	**13.5**	**13.4**	**12.8**
C/A deficit	0.4	1.0	-1.1
Amortization of medium and long-term debt	4.0	3.4	4.7
Government/central bank	0.2	0.2	1.4
Banks	0.5	0.6	0.6
Corporates/other	3.2	2.7	2.6
Amortization of short-term debt	9.2	9.0	9.2
Financing	**13.5**	**13.4**	**12.8**
FDI (net)	1.9	1.4	1.8
Portfolio equity, net	-0.6	-1.8	-1.4
Medium and long-term borrowing	6.4	3.2	5.0
Government/central bank	1.9	0.6	5.6
Banks	0.6	0.7	1.0
Corporates/other	4.0	2.0	-1.6
Short-term borrowing	9.0	9.2	9.4
EU structural and cohesion funds	0.8	1.1	1.9
Other	1.9	-0.5	-2.8
Change in FX reserves (- = increase)	-6.0	0.8	-1.1
Memoranda:			
Nonresident purchases of LC gov't bonds	0.0	0.0	0.0
International bond issuance, net	2.5	0.0	2.3

Source: Bulgarian National Bank, ministry of finance, UniCredit Research

Croatia

Ba1 stable/BBB- stable/BBB- stable*

Outlook

We are raising our GDP-growth forecast for 2021 due to Croatia's better-than-expected economic performance to date and the improvement in overall sentiment after the tourism season there delivered results that were above expectations. In 2022, growth should remain strong, following investment acceleration boosted by EU funding and revived tourism prospects. Our new growth projections are 6.9% in 2021 and 5.3% in 2022, compared to our previous forecasts of 5.4% and 5.5% respectively. Private consumption and tourism are recovering faster than previously expected. Recovery in investment, however, will be very much driven in the medium term by how efficiently EU funds are absorbed and how well Croatia's National Recovery and Resilience Plan (RRP) is implemented, while the initial effects of fund inflows is already noted in budget revenues. In parallel, Croatia's government will try to pursue a fast-track euro-adoption agenda by leveraging the opportunity afforded by the suspension of EU fiscal rules until 2023.

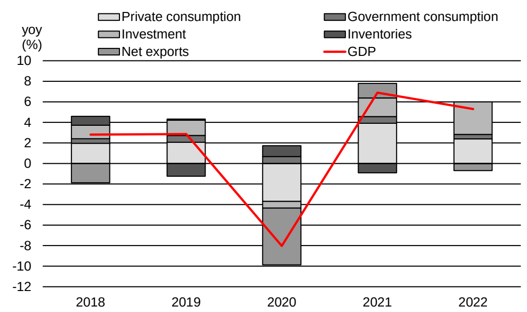
Strategy

Author: Hrvoje Dolenec, Chief Economist (Zagrebačka banka)

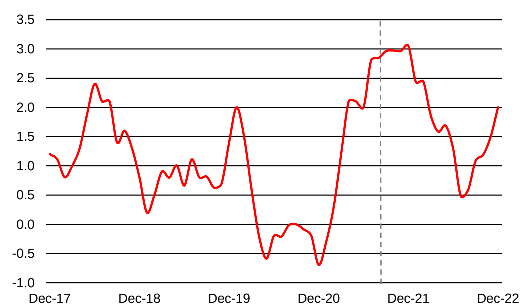
KEY DATES/EVENTS

- September/October: medium term public debt Strategy
- 21 October: EDP notification
- November: 2022 budget proposal
- 26 November: 3Q21 GDP

GDP GROWTH FORECAST



INFLATION FORECAST



Source: Eurostat, CNB, Crostat, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

EUR bn	2018	2019	2020	2021F	2022F
GDP (EUR bn)	52.0	54.3	49.3	53.8	57.5
Population (mn)	4.1	4.1	4.0	4.0	4.0
GDP per capita (EUR)	12,715	13,349	12,186	13,360	14,351
Real economy, change (%)					
GDP	2.8	2.9	-8.0	6.9	5.3
Private consumption	3.3	3.6	-6.4	6.5	4.0
Fixed investment	6.5	7.1	-2.9	7.8	13.5
Public consumption	2.3	3.4	3.4	3.0	2.0
Exports	3.7	6.8	-25.0	25.0	12.5
Imports	7.5	6.3	-13.8	18.2	12.3
Monthly gross wage, nominal (EUR)	1139	1182	1224	1270	1322
Real wage, change (%)	3.4	3.0	2.4	1.7	2.6
Unemployment rate (%)	8.4	6.6	7.5	7.2	6.1
Fiscal accounts (% of GDP)					
Budget balance	0.2	0.3	-7.4	-3.1	-1.6
Primary balance	2.5	2.5	-5.4	-1.2	0.1
Public debt	74.3	72.8	88.7	84.4	80.6
External accounts					
Current account balance (EUR bn)	0.9	1.5	-0.2	0.5	0.2
Current account balance/GDP (%)	1.8	2.8	-0.4	0.8	0.3
Extended basic balance/GDP (%)	4.7	6.4	3.7	5.8	4.6
Net FDI (% of GDP)	1.6	1.9	1.9	1.9	1.9
Gross foreign debt (% of GDP)	82.2	75.3	82.4	80.7	77.7
FX reserves (EUR bn)	17.4	18.6	18.9	21.8	23.3
Months of imports, goods & services	7.9	7.9	9.3	9.4	8.9
Inflation/monetary/FX					
CPI (pavg)	1.5	0.8	0.1	2.1	1.5
CPI (eop)	0.8	1.4	-0.7	3.1	2.0
3M money market rate (Dec avg.)	0.49	0.35	-	-.	-
USD/FX (eop)	6.47	6.65	6.14	6.18	6.03
EUR/FX (eop)	7.42	7.44	7.54	7.53	7.53
USD/FX (pavg)	6.28	6.62	6.61	6.28	6.08
EUR/FX (pavg)	7.41	7.41	7.53	7.53	7.53

Source: Eurostat, CNB, UniCredit Research

*long-term foreign currency credit rating provided by Moody's, S&P and Fitch, respectively

Recovery to support 2023 euro accession target

We see an improved growth outlook, with projections of 6.9% in 2021 and 5.3% in 2022…

…based on improved performance up to the end of August 2021 in private consumption and tourism and in Croatia's investment outlook

Investment performance will have major impact on growth performance in 2022 and 2023 following absorption of EU funding and private initiatives in some areas

Following the realization of the most optimistic summer 2021 scenario for tourism, with private consumption bursting into recovery, we are revising our projections for the remainder of 2021 and 2022. We see an improved growth outlook for 2021, with tourism performing at around 80% of 2019's results, at 6.9% yoy (versus our previous projection of 5.4%). This would still leave GDP some 1.5% below 2019's level, but this gap could be closed during 1H22, reflecting our projection of 5.3% growth in full 2022 and provided that the pandemic does not strengthen again in the following months and especially in the winter to provoke another period of closures and a downturn in business operations. However, at that speed, the gap versus the trend line from 2019 would be met at the best in late 2023. This certainly can be accelerated by fast and efficient absorption of Next Generation EU funding, although even the government's timeline for the implementation of Croatia's RRP envisages that most of the proposed projects will be implemented only in 2023 and 2024. That said, investment acceleration and double-digit growth rates are projected for 2022 and 2023 due to accelerated spending of the remainder of 2014-20's structural-instrument implementation, where most new investment was linked to infrastructure projects (transport and utilities). This should be joined by residential real-estate investment while Croatia's tourism industry has now found the impetus for further investment.

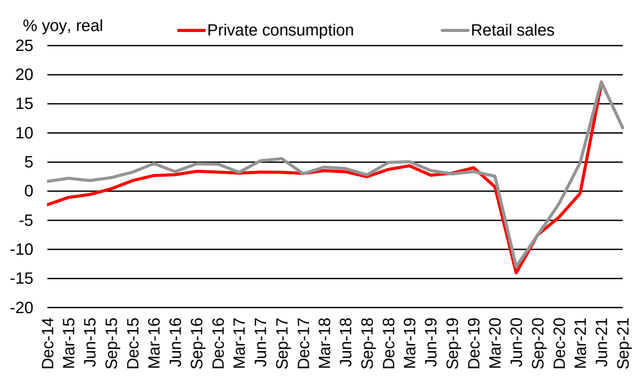
After approval of Croatia's RRP, the next challenge is its implementation, in terms of investment and reform measures

The risk for the investment outlook lies in its implementation. The European Commission approved the RRP for Croatia in July. From an initial fund-flow plan and project-implementation timeline, it is clear that there will be quite a lag between tranche inflows and the actual absorption of funds by implemented projects. Though this seems beneficial for budget performance and government funding needs, it raises questions about RRP ambitions and its actual effects on short-term GDP growth. However, Croatia has quite a plan in terms of the implementation of reform measures (77 measures supported by 152 projects) linked to Croatia's RRP. Those measures should, among everything else, act as a response to country-specific recommendations for Croatia within European semester and therefore address known flaws in the economy.

Recovery in exports of goods and tourism is increasing exports' impact on GDP, and this might be fueled by euro accession, as it was by EU accession in the past

Exports of goods (real growth of 21% yoy in 1H) are another strong driver of growth following trends in international-trade recovery. According to the data, such growth has been broadly based across goods and activities sectors. Even geographically, the growth of exports has been spread out, although most of this has been linked to EU countries that are Croatia's main trading partners: Italy, Germany, Slovenia, Austria, Bosnia and Herzegovina and now even Hungary (a large increase in exports can be attributed to trade in crude oil, mostly where the price of oil has had a significant impact). We expect export growth to decelerate but to continue to contribute strongly in 2021 and 2022. Combined with the export of services, its significance to Croatia's GDP is catching up with private consumption – actually, its significance is expected to equal that of private consumption once Croatia has adopted the euro. This should further boost export performance, as EU accession did in 2013.

RECOVERY OF SPENDING FASTER THAN EXPECTED…



…BUT EXPORTS OF GOODS PERFORMED EVEN BETTER.

Source: Crostat, HNB, European Commission Business Survey

Recovery on the labor market fares better than expected, though it needed large subsidies during pandemic…

Heavily impacted by the pandemic and supported by government subsidies in 2020, Croatia's labor market has recovered significantly during 2021. Since the spring, demand has been greater than it was during the same period in 2019. Therefore, employment has also increased. In July, the number of employees registered with Croatia's pension institute reached its highest level since before the financial crisis of 2008-09 (above 1.6mn). A strong cycle in construction and recovered tourism were the largest sources of demand, although manufacturing was also a source of demand thanks to increases in production and exports. With regard to the former two sectors, the availability of labor may create a bottleneck, although tourism may not face another bottleneck before next season. However, for construction, to the availability of labor may be a bigger issue, given prospects pertaining to construction activity in the medium term. Unemployment was still above 7%, but it might have dipped below that threshold during the summer if some shadow employment was taken into account by labor-market surveys. However, the number of unemployed is still some 9-10% higher than it was in 2019 due to the fact that, during 2020, a larger number of expat workers returned from abroad. Wages in Croatia have continued to grow, but their increase on an annual basis has been driven more by income-tax changes (lower tax rates since January) than by demand and are effects are visible more in net wages.

… so we face again potential bottlenecks in some sectors despite level of unemployment.

Supported by tax changes from beginning of the year, wages received a boost for growth but real gross wages still grow moderately (2.6% yoy).

Euro accession plan is accelerated, 2023 target recently signaled both by authorities and by European Commission.

Croatia's euro-accession plan has been accelerated, as we announced in previous publications. Authorities just recently – after a visit by European Commission Vice President Valdis Dombrovskis – signaled a 2023 accession as a goal. Therefore, we have now incorporated this into our baseline scenario. That the EU's fiscal rules have been suspended until 2023 allows Croatia to remain beyond the reach of excessive deficit procedure until then, and this has relaxed pressure on its fiscal criteria and allowed attention to be focused on the other commitments outlined in the letter of intention Croatia submitted when it joined the European Exchange Rate Mechanism II in July 2020. Such commitments might be easier for Croatia to meet at the moment.

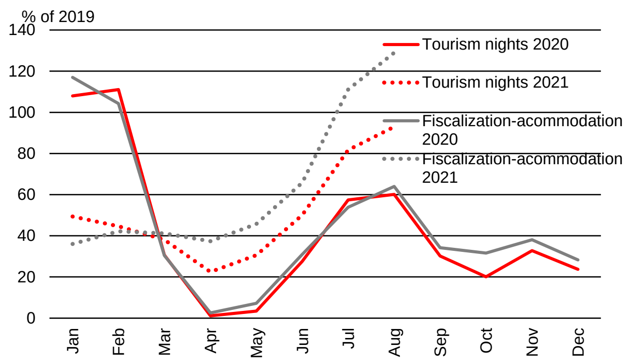
Fiscal position is getting improved, despite all the costs and risks, revenue inflow over the summer is likely to result with lower deficit figures…

With regard to fiscal developments, 1H developments pertaining to Croatia's budget performance were challenging, and the government was forced to step in with budget amendments when it agreed to deal with health-sector debt. Already then, the government signaled that there would be another round of amendments in autumn after it evaluates the tourism season, which seems to have been good in terms of budget revenues (which exceeded those brought in during the 2019 tourism season), and is able to gain a clear view of the revenues associated with the RRP in 2021 (in total, these should amount to EUR 1.5bn in 2021). That said, we are revising our forecast pertaining to Croatia's deficit. We now project a deficit equivalent to 3.1% of GDP (vs. 4.5%) and expect that bigger revenues will not result in an increased appetite for spending. In other words, we expect Croatia's Ministry of Finance to continue to be strict when dealing with budgetary requests that might arise from ministries encouraged by Croatia's recent fast recovery.

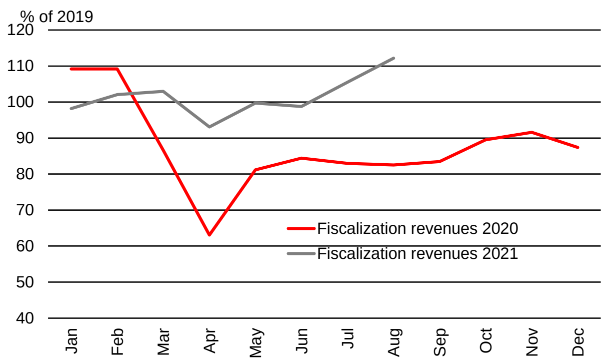
…lowering funding needs in following period

Therefore, we do not expect Croatia to undertake new borrowing in 2021, while its funding needs may remain limited in 2022, when we expect that it may only issue one international bond.

STRONG PERFORMANCE OF TOURISM IN MAIN SEASON…



…BENEFICIAL FOR FISCAL REVENUES.



Source: MoF, HNB, UC Research

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2020	2021F	2022F
Gross financing requirement	**11.1**	**8.8**	**8.8**
Budget deficit	3.6	1.6	0.9
Amortization of public debt	7.5	7.2	7.9
Domestic	5.7	5.3	6.0
Bonds	1.7	0.8	1.9
Bills	3.4	3.1	3.2
Loans	0.6	1.5	0.9
External	1.8	1.9	1.9
Bonds and loans	1.7	1.8	1.8
IMF/EU/other international financial institutions	0.1	0.1	0.1
Financing	**11.1**	**8.8**	**8.8**
Domestic borrowing	8.6	5.4	6.5
Bonds	4.3	1.2	2.2
Bills	3.4	3.2	3.2
Loans	0.9	1.0	1.0
External borrowing	2.5	3.4	2.4
Bonds	2.0	2.0	1.8
IMF/EU/other international financial institutions	0.5	1.4	0.6
Privatization/other	0.0	0.0	0.0

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2020	2021F	2022F
Gross financing requirement	**12.5**	**9.9**	**9.7**
C/A deficit	0.2	-0.5	-0.2
Amortization of medium and long term debt	5.3	5.0	4.8
Government/central bank	1.8	1.9	1.9
Banks	0.5	0.5	0.4
Corporates/other	3.0	2.6	2.5
Amortization of short-term debt	7.0	5.4	5.1
Government/central bank	4.0	2.0	2.0
Banks	2.0	2.9	2.6
Corporates/other	1.0	0.5	0.5
Financing	**12.5**	**9.9**	**9.7**
FDI (net)	1.1	1.1	1.1
Portfolio equity, net	0.1	-0.5	-0.3
Medium and long-term borrowing	4.7	4.8	3.9
Government/central bank	2.5	3.4	2.4
Banks	0.7	0.5	0.5
Corporates/other	1.5	0.9	1.0
Short-term borrowing	5.6	5.6	4.9
EU structural and cohesion funds	1.3	1.6	1.4
Other	0.2	0.0	0.2
Change in FX reserves (= increase)	-0.6	-2.7	-1.5
Memoranda:			
Nonresident purchases of LC gov't bonds	-	-	-.
International bond issuance, net	1.0	0.9	0.5

Source: CNB, Croatian ministry of finance, UniCredit Research

Czechia

Aa3 stable/AA- stable/AA- stable*

Outlook

We expect Czech GDP to grow by 3.2% in 2021 and 4.1% in 2022, recovering at a slower pace than the rest of Central Europe. The potential for considerable pent-up household demand and ongoing supply-side bottlenecks have led us to raise our GDP forecast marginally and our CPI inflation forecast substantially. The CNB has every reason to continue tightening its policy. The government's draft budget sees almost no improvement in the structural imbalance in 2022. Elections could result in protracted negotiations as three political coalitions try to form a government.

Strategy

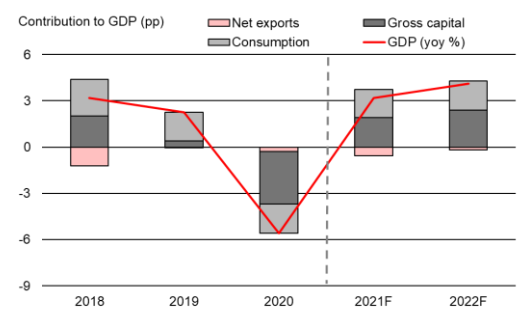
The hawkish CNB will support the CZK, while local demand could help CZGBs outperform their regional peers.

Author: Pavel Sobíšek, Chief Economist Czech Republic (UniCredit Bank Czech Republic and Slovakia)

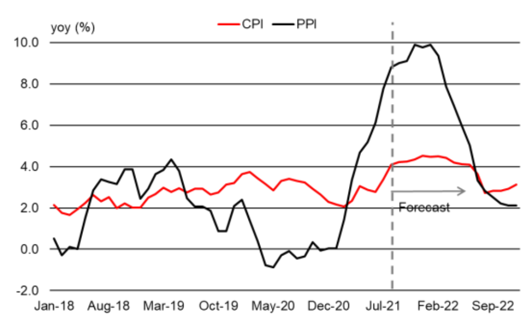
KEY DATES/EVENTS

- 8-9 October: parliamentary election
- 4 November, 22 December: ČNB policy meetings
- 29 October, 30 November: GDP (flash, structure)
- 11 October, 10 November, 10 December: CPI

GDP GROWTH FORECAST



INFLATION FORECAST



Source: CZSO, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

EUR bn	2018	2019	2020	2021F	2022F
GDP (EUR bn)	211.2	225.7	215.4	236.1	255.9
Population (mn)	10.6	10.7	10.7	10.7	10.7
GDP per capita (EUR)	19,877	21,151	20,135	22,033	23,860
Real economy, change (%)					
GDP	3.2	3.0	-5.8	3.2	4.1
Private consumption	3.5	2.6	-6.8	2.8	4.2
Fixed investment	10.0	5.9	-7.2	1.4	7.0
Public consumption	3.8	2.5	3.4	2.3	-0.5
Exports	3.7	1.4	-7.0	9.3	4.2
Imports	5.8	1.5	-6.9	10.8	4.6
Monthly wage, nominal (EUR)	1250	1329	1347	1479	1595
Real wage, change (%)	5.9	3.5	1.2	3.3	2.8
Unemployment rate (%)	3.2	2.8	3.6	3.9	3.6
Fiscal accounts (% of GDP)					
Budget balance	0.9	0.3	-6.2	-7.3	-5.6
Primary balance	1.7	1.0	-5.3	-6.5	-4.7
Public debt	32.1	30.3	38.1	42.9	45.8
External accounts					
Current account balance (EUR bn)	0.9	0.7	7.7	5.3	2.5
Current account balance/GDP (%)	0.4	0.3	3.6	2.2	1.0
Extended basic balance/GDP (%)	1.6	3.1	5.4	3.7	2.5
Net FDI (% of GDP)	0.9	2.4	1.3	1.0	1.1
Gross foreign debt (% of GDP)	81.5	75.7	75.5	76.0	79.1
FX reserves (EUR bn)	124.5	133.4	135.4	147.0	150.0
Months of imports, goods & services	10.0	10.5	11.8	11.0	10.3
Inflation/Monetary/FX					
CPI (pavg)	2.1	2.8	3.2	3.3	3.6
CPI (eop)	2.0	3.2	2.3	4.5	3.1
Central bank target	2.0	2.0	2.0	2.0	2.0
Central bank reference rate (eop)	1.75	2.00	0.25	1.75	2.25
3M money market rate (Dec avg.)	2.01	2.18	0.35	1.90	2.35
USD/FX (eop)	22.47	22.62	21.39	21.17	20.33
EUR/FX (eop)	25.73	25.41	26.25	25.40	25.00
USD/FX (pavg)	21.74	22.93	23.20	21.55	20.66
EUR/FX (pavg)	25.64	25.67	26.44	25.65	25.20

Source: CZSO, CNB, UniCredit Research

*long-term foreign-currency credit rating provided by Moody's, S&P and Fitch respectively

Echoes of a shortage economy

Recovery has been uneven across components

In mid-2021, real GDP was still 4.8% below the pre-pandemic peak of 4Q19 as economic sectors recovered unevenly. Private consumption was 4% short of its peak but is expected to catch up at a solid pace in 2H21. Public spending has been growing throughout the pandemic. Fixed capital formation was 5.8% lower in 2Q21 than it was in 4Q19, a moderate contraction compared to previous economic crises. After a marginal rundown in 2020, companies accumulated significant inventories (1.5% of annual GDP) in 1H21, which we suspect may represent an accumulation of safety stock and unfinished production rather than unfinished capex projects. Net exports took 0.7pp from annual GDP between 4Q19 and 2Q21, a third of which was due to a deterioration in the balance of services.

Household spending optimism and global supply-side constraints are key factors for the GDP outlook

Neither the past GDP structure, nor current economic conditions give us reason to substantially alter the picture we formed three months ago. That said, household spending optimism and global supply-side constraints do need to be factored into the outlook for the rest of 2021 and for 2022. The two factors may broadly offset each other in terms of GDP, but their effect on inflation and the trade balance will be compounded.

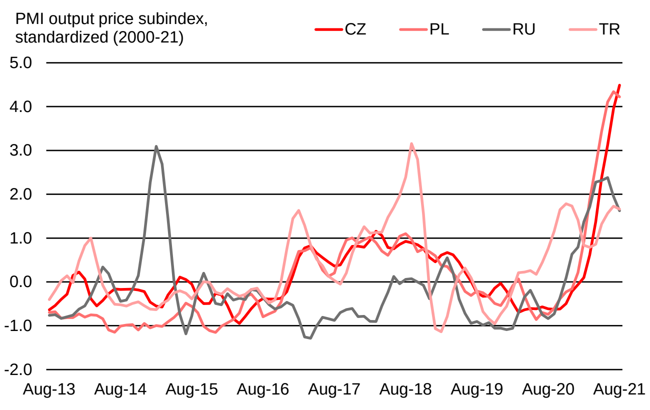
Household savings since the start of the pandemic create the potential for considerable pent-up demand

Since the start of the pandemic, households have been accumulating extra savings. Looking at the dynamics of after-tax labor income versus household spending and ignoring a rise in social benefits, savings accumulated through the six quarters ending 2Q21 accounted for 10.5% of household spending in 2019. This creates the potential for considerable pent-up demand. Going forward, unemployment is also expected to be lower (3.8% on average for 2021) and wage growth higher (6.5% for 2021) than projected before. This will stem from a combination of the tight labor market and government policies. For 2022, negotiations concerning public-sector wages and the minimum wage have not yet concluded, but the proposal of an 18% hike in the minimum wage made by the labor minster surprised even the trade unions. We project total real wage growth of 2.2% next year.

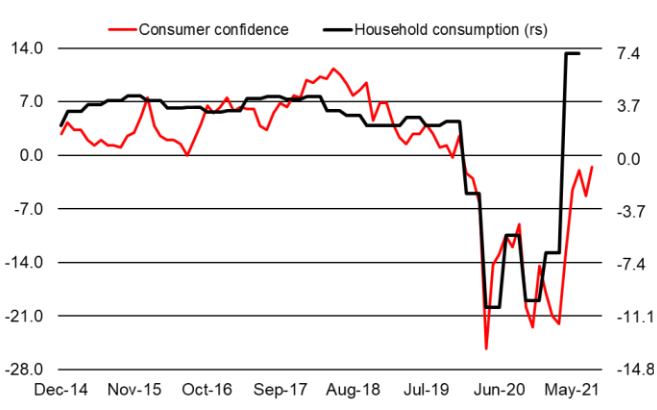
The shortage of semiconductors and sharply rising sea freight transport costs have boosted PPI…

In contrast, global supply-side bottlenecks are set to last longer than previously thought. These primarily affect output in Czechia through two channels – the shortage of semiconductors and sharply rising prices of sea freight transport. The former channel is causing delays in the local output of a limited, but crucial, number of products, notably cars. This is causing delays and shortages in the supply of many intermediate and finished goods, driving up their prices. Analyzing the world input-output tables, we find Czechia to be one of the most vulnerable economies to such price increases. If the sea transport prices remain at current levels, they are likely to lift Czech PPI by 2.3pp. Supply managers surveys and IHS Markit studies suggest that these disruptions will last at least until 2Q22.

OUTPUT PRICES ARE RISING AT THEIR FASTEST PACE EVER



PENT-UP DEMAND EVIDENT IN CONSUMPTION SPIKE



Source: CZSO, IHS Markit, UniCredit Research

…and acted as a drag on industrial output

In the long run, reshoring and near-shoring strategies may emerge to move more production to Europe. This may be reinforced by EU-wide policies of avoiding overdependence on imports of strategic products from politically instable or unfriendly territories.

The situation will help create new opportunities for local manufacturers. In 2022, however, inefficiencies in the transition process are expected to continue, slowing output and productivity growth. Labor shortages are also likely to constrain the development of additional manufacturing capacity. This constraint is particularly relevant for Czechia as a country with one of the lowest unemployment rates in the EU. With over 13% of the total workforce accounted for by non-residents, the capacity for more labor immigration is also limited. Under these circumstances, we also doubt that NGEU grants (with the first tranche of CZK 24bn or 0.4% of GDP having just been approved for Czechia) will help boost GDP growth materially in 2022.

On balance, we are revising our forecast for GDP growth marginally upwards and our forecast for CPI inflation more substantially upwards. We also expect to see a deterioration in Czechia's C/A

On balance, we are upgrading our GDP outlook marginally, to 3.2% for 2021 and to 4.1% for 2022 and lifting our inflation outlook substantially, to 3.3% on average for 2021 and to 3.6% for 2022. In annual terms, inflation may peak around 4.5% in late 2021 or early 2022, when we expect most external cost shocks will have been absorbed. Thereafter, inflation could stay elevated due to strong domestic demand. The combination of ebbing import prices and high domestic demand should push down foreign-trade surpluses. Alongside a slow resumption of tourist arrivals, this may deteriorate Czechia's C/A balance. Such a change will not alter the country's solid external surplus but may, at the margin, delay CZK appreciation. We are not changing our relatively conservative EUR-CZK forecast for now but are only pointing out risk.

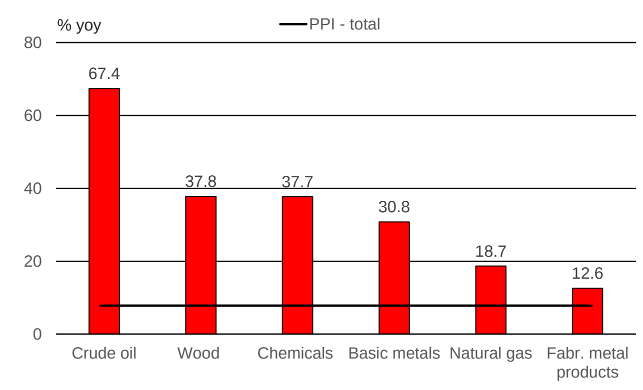
In our baseline scenario, we expect two more CNB rate hikes this year and two more in 1H22

The CNB has every reason to continue tightening monetary policy. If it opts to act in line with its legal mandate, it should hike the repo rate rather fast, in order to prevent second-round inflationary effects from fully developing. We expect an additional 50bp in hike(s) in 4Q21, while two more increases of 25bp are assumed for 1H22. With the repo rate at 2.25% by mid-2022, the CNB may take a break to assess the impact of tightening. Whether that will be the end of the hiking cycle remains open.

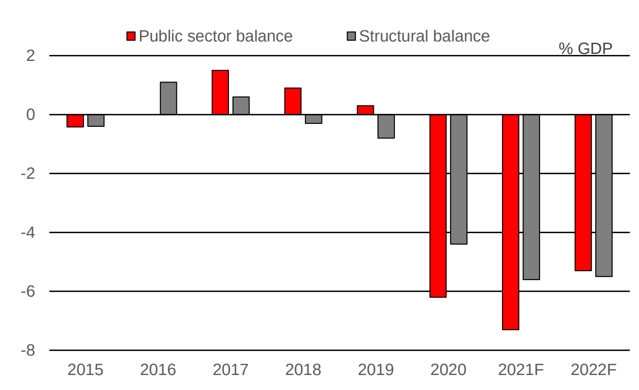
Loose fiscal policy is more likely to continue than not

Opinion polls for general elections on 8-9 October show the ANO Movement of Prime Minister Andrej Babiš winning with about 27% of the vote. The other two major blocks, center-right coalition Spolu and the coalition of the Pirate Party and Mayors (Pirate/STAN), are in a statistical tie, with just over 20% of the vote each. Neither of these two coalitions seem willing to form a government with ANO, which leaves only two options: **1.** Mr. Babiš will have enough votes to form a majority with smaller far-right and far-left parties. **2.** Spolu and Pirate/STAN gain a majority. President Miloŝ Zeman could add to political uncertainty if he throws his weight behind his favorite, Mr. Babiš, regardless of the election results. As a result, loose fiscally policy is likely to continue, with public indebtedness rising in the coming years. This is already certain for 2022, with the central government's proposed deficit to amount to almost 6% of GDP.

JULY PPI RISE (7.8% YOY) WAS DRIVEN BY A FEW LARGE CATEGORIES OF INPUTS



ALMOST NO IMPROVEMENT IN THE STRUCTURAL BALANCE IS EXPECTED FOR PUBLIC FINANCE IN 2022



Source: Czech Fiscal Council, CZSO, UniCredit Research

An outperformer in Central Europe

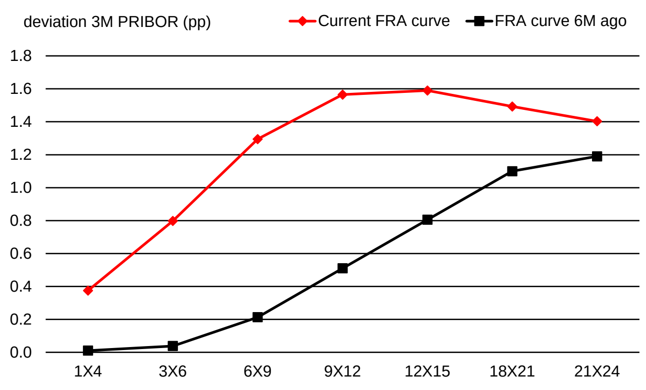
Hawkish CNB bodes well for CZK and CZGBs in 4Q21 in comparison to peers…

The CNB's hawkish stance is positive for CZK-denominated financial assets. By increasing interest rates, the CNB provides support to the CZK. The expected tightening in monetary conditions includes a stronger currency. In case the CZK fails to appreciate, the CNB could deliver more hikes, further supporting carry. As argued above, support from flows in balance of payments will remain strong.

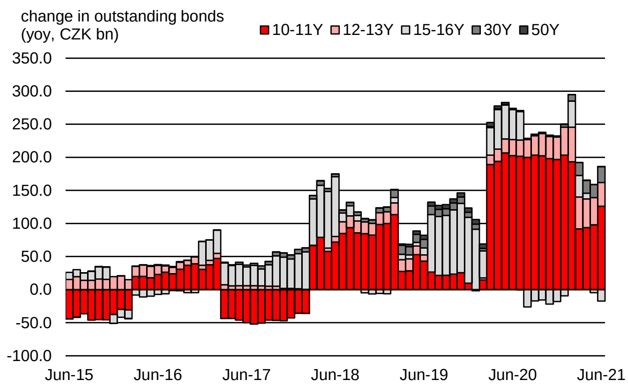
… even if DM bonds are sold off

Strong support from local investors sets CZGBs apart in Central Europe. This helped CZGBs perform better than their peers in 2Q21 and 3Q21, even though fiscal policy in Czechia was loosened as well. The government primarily issued bonds with maturities of 10-13Y, yet the 10Y ASW spread to Bunds narrowed slightly as another sign of market stability. Despite narrow spreads, we expect CZGBs to outperform Central European bonds if Bunds and USTs are sold off.

MARKET PRICING IS IN LINE WITH OUR EXPECTATIONS FOR HIKES



ISSUANCE FOCUSED ON MATURITIES OF 10-13Y



Sources: CNB, Bloomberg, UniCredit Research

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2020	2021F	2022F
Gross financing requirement	**19.9**	**25.2**	**24.2**
Budget deficit	13.4	17.2	14.3
Amortization of public debt	6.5	8.0	9.9
Domestic	5.6	6.0	7.1
Bonds	5.4	5.0	6.2
Bills	0.2	1.0	0.9
Loans	0.0	0.0	0.0
External	1.0	2.0	2.8
Bonds and loans	1.0	2.0	2.8
IMF/EU/Other IFIs	0.0	0.0	0.0
Financing	**19.9**	**25.2**	**24.2**
Domestic borrowing	19.5	24.3	23.2
Bonds	18.4	23.3	22.8
Bills	1.0	0.9	0.3
Loans	0.1	0.1	0.1
External borrowing	0.4	0.9	1.0
Bonds	0.3	0.9	1.0
IMF/EU/Other IFIs	0.1	0.0	0.0
Privatization/Other	0.0	0.0	0.0

Source: CNB, MoF, CZSO, UniCredit Research

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2018E	2019F	2020F
Gross financing requirement	**100.4**	**96.7**	**103.8**
C/A deficit	-7.7	-5.3	-2.5
Amortization of medium and long term debt	7.5	9.6	8.3
Government/central bank	3.5	4.7	5.0
Banks	1.9	2.4	0.8
Corporates/other	2.1	2.5	2.5
Amortization of short-term debt	100.6	92.4	98.0
Government/central bank	6.4	6.1	8.0
Banks	58.7	52.9	56.5
Corporates/other	35.5	33.4	33.5
Financing	**100.4**	**96.7**	**103.8**
FDI (net)	2.8	2.3	2.8
Portfolio equity, net	-1.4	-2.1	-0.4
Medium and long-term borrowing	7.5	9.6	8.3
Government/central bank	3.5	4.7	5.0
Banks	1.9	2.4	0.8
Corporates/other	2.1	2.5	2.5
Short-term borrowing	90.3	95.2	92.6
EU structural and cohesion funds	3.2	3.3	3.6
Other	0.0	0.0	0.0
Change in FX reserves (- = increase)	-2.0	-11.6	-3.0
Memoranda:			
Nonresident purchases of LC govt bonds	0.2	6.6	8.1
International bond issuance, net	0.3	0.9	-1.8

Hungary

Baa3 positive/BBB stable/BBB stable*

Outlook

The Hungarian economy could grow by around 7% in 2021 and by 5.4% in 2022. Private consumption will benefit from pent-up demand, tight labor-market conditions and fiscal transfers ahead of next spring's parliamentary elections. Capex could be slowed by persistent supply-chain bottlenecks until mid-2022, while RRF funding could be delayed by legal issues. As a result, the EBB will be smaller than initially expected, but will remain positive and supportive for the HUF. We expect the NBH to hike to 2.0-2.1% this year and to 2.5% in 2022 because inflation is unlikely to fall as fast as the central bank expects.

Strategy

The HUF stopped being a funding currency in CEE and its carry could allow it to appreciate in real terms in 2022. HGB yields could rise to 4-5% if the NBH pursues its announced tapering of bond purchases.

Authors:
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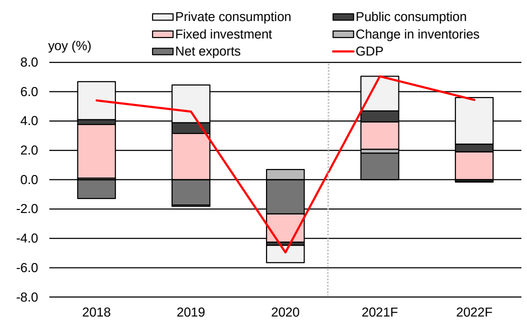
Dr. Ágnes Halász, Head of Economics & Strategic Analysis Hungary (UniCredit Bank Hungary)

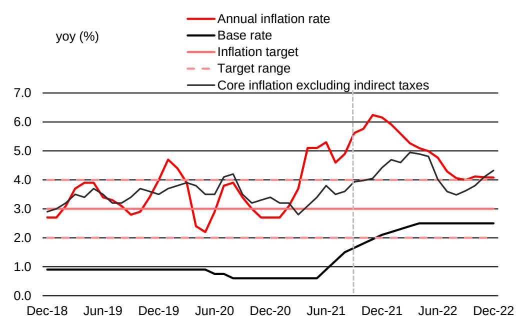
KEY DATES/EVENTS

- 8 October, 9 November, 8 December: CPI
- 19 Oct, 16 Nov,14 Dec: monetary policy decisions
- 16 November, 1 December: 3Q21 GDP (flash, structure)
- 4-10 October: second primary for opposition PM candidate
- No rating updates in 4Q21

GDP GROWTH FORECAST



INFLATION FORECAST



Source: HCSO, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

EUR bn	2018	2019	2020	2021F	2022F
GDP (EUR bn)	136.0	146.1	136.0	151.6	167.9
Population (mn)	9.8	9.7	9.7	9.7	9.7
GDP per capita (EUR)	13,901	14,983	13,992	15,656	17,389
Real economy, change (%)					
GDP	5.4	4.6	-5.0	7.0	5.4
Private consumption	5.1	5.1	-2.3	4.5	6.2
Fixed investment	16.4	12.8	-7.3	7.2	7.3
Public consumption	1.7	4.0	-1.1	3.9	2.8
Exports	5.0	5.8	-6.8	12.9	8.7
Imports	7.0	8.2	-4.4	11.0	9.1
Monthly wage, nominal (EUR)	1035	1131	1150	1222	1340
Real wage, change (%)	7.9	7.6	6.2	2.6	4.1
Unemployment rate (%)	3.6	3.4	4.0	4.1	3.5
Fiscal accounts (% of GDP)					
Budget balance	-2.1	-2.1	-8.1	-7.6	-5.8
Primary balance	0.2	0.2	-5.7	-5.1	-3.3
Public debt	67.5	63.9	80.4	80.8	80.1
External accounts					
Current account balance (EUR bn)	0.3	-1.0	-2.1	-0.9	-0.5
Current account balance/GDP (%)	0.2	-0.7	-1.5	-0.6	-0.3
Extended basic balance/GDP (%)	4.7	1.2	2.4	2.0	3.3
Net FDI (% of GDP)	2.2	0.1	1.9	0.5	1.4
Gross foreign debt (% of GDP)	99.6	96.7	150.8	142.8	123.6
FX reserves (EUR bn)	25.8	26.5	31.8	35.3	37.9
Months of imports, goods & services	2.9	2.7	3.6	3.4	3.2
Inflation/Monetary/FX					
CPI (pavg)	2.9	3.6	3.3	4.8	4.7
CPI (eop)	2.7	4.0	2.7	6.1	4.1
Central bank target	3.0	3.0	3.0	3.0	3.0
Central bank reference rate (eop)	0.90	0.90	0.60	2.10	2.50
3M money market rate (Dec avg)	0.13	0.16	0.75	2.00	2.50
USD/FX (eop)	281	295	297	294	291
EUR/FX (eop)	322	331	365	353	355
USD/FX (pavg)	270	291	308	297	291
EUR/FX (pavg)	319	325	351	355	353

Source: Eurostat, HCSO, NBH, UniCredit Research

*long-term foreign currency credit rating provided by Moody's, S&P and Fitch, respectively

Tough choices

Hungary in need of short-term growth drivers

Hungary's GDP has recovered from its pandemic slump and the authorities have taken note. The government is looking for ways to boost growth before next spring's parliamentary elections, while the central bank has started normalizing monetary policy at a brisk pace. Yet not everything is running smoothly in the Hungarian economy: supply-chain bottlenecks are affecting car and car-part production, as well as productive investment, while travel restrictions have starved the local tourism sector of non-European arrivals. This implies that Hungary needs to find an alternative growth model, at least in the short term, to keep up with its neighbors.

GDP could grow by 7% in 2021 and 5.4% in 2022…

…relying on fiscal spending ahead of elections…

…that could postpone additional rating upgrades

We expect GDP to grow by around 7% in 2021 (of which 4.3pp is accounted for by the carryover from 2020) and by 5.4% in 2022. Compared to our previous forecast, consumption will play a larger role than investment. The government is staking next year's re-election on a program of transfers aimed at most categories of voters. One monthly payment of personal income taxes will be returned to contributors. The young (especially families with children) and retirees will also receive larger payments from the government. The funds will largely come from two sources: windfall budget revenues, as the economy recovered faster than expected, and an unambitious fiscal adjustment that could translate into the highest cash budget deficits in CEE in 2021-22. We expect the budget deficit to be 7.6% of GDP in 2021 on accruals, with a cash deficit of almost 11% of GDP. In 2022, both the cash and accruals-based deficits could fall by around 3% of GDP. Thus, public debt is likely to remain at around 80% of GDP in both years, starting to decline only from 2023 onwards. As a result, Hungary's rating improvement might be put on hold until 2023 or later.

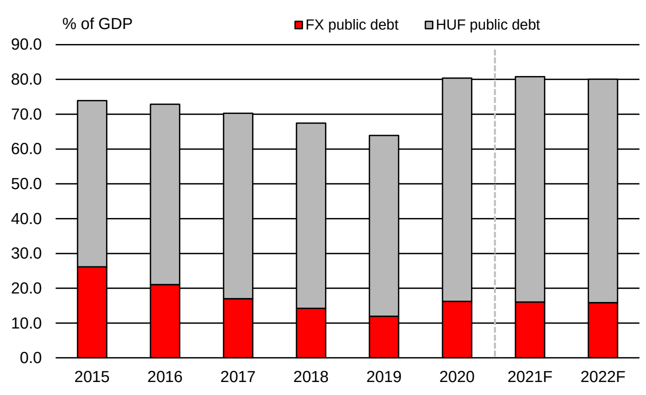
RRF funding could be postponed further due to legal issues

Fiscal targets were moved once more in September as it became apparent that the European Commission would delay the approval of Hungary's national recovery and resilience program. The EC asked the government to improve tender procedures and transparency in fund allocation, but also made disbursements conditional on abiding by EU laws protecting LGBTQ+ rights. Preparing for a standoff that could extend into 2022, the government tapped foreign bond markets in September for the equivalent of 3.3% of GDP. This is needed to prevent public investment from falling further as disbursements from the 2021-27 EU budget are yet to start. In our view, the government cannot afford to forgo RRF grants, even if their expected impact on potential and actual growth is one of the smallest in EU-CEE. Reaching a common ground may require concessions from the Hungarian authorities. Yet Fidesz, whose domestic communication relies on a very tough line against the EU, may find it hard to sell any such concessions to its base ahead of elections.

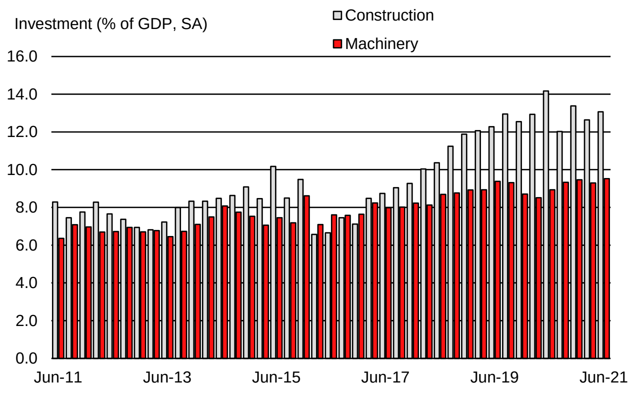
Capex postponed due to supply-chain bottlenecks

Private investment is recovering at a slower pace than the authorities expected, mainly due supply-chain bottlenecks. In the car sector, the lack of semiconductors and other supplies such as paint and metal parts could postpone the expansion of production capacity to 2H22.

PUBLIC DEBT IS UNLIKELY TO FALL IN 2021-22



INVESTMENT IS YET TO ACCELERATE



Source: Ministry of Finance, AKK, KSH, UniCredit Research

Labor and material shortages are affecting construction

Meanwhile, construction companies are struggling to source labor and construction materials, whose exports will be restricted from October. Demand for housing remains buoyant and house prices failed to correct significantly during the COVID pandemic, thus increasing the risk of a future bubble. This is especially true as mortgage loans continue to accelerate, while housing supply will lag by at least half a year.

Inflation could end 2021 at around 6%...

…falling more slowly in 2022 than the NBH expects

Consumer spending rebounded impressively after the spring lockdown, with spending in restaurants almost matching pre-pandemic levels even in the absence of US and Asian tourists. The broad-based pressure on prices could push annual inflation to close to 6% by year-end. While the NBH expects headline inflation to fall quickly thereafter, reaching the 3% target by mid-2022, we are less optimistic about the pace of disinflation for at least three reasons. First, consumption will continue to run hot. In our view, momentum in cyclical inflation is yet to peak and will take a while to cool down. We expect demand to push food and other goods prices higher. Second, supply-chain bottlenecks could lead to higher prices for durables and home improvement goods, with a return to normal production and distribution expected in 2H22. Third, the government could raise some regulated prices after the elections. So far this year, energy prices have been flat in Hungary. We attribute this to price suppression before the elections. Even if European electricity and gas prices decline next year from this year's highs, the correction needed in Hungary could be significant if prices are realigned to regional levels. The alternative is high subsidies and, thus, higher budget deficits.

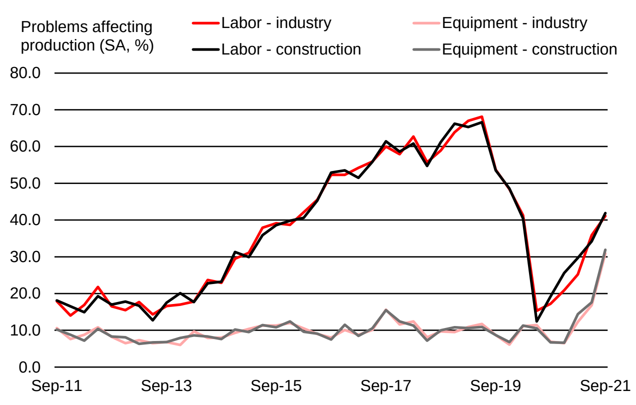
We expect rate hikes to 2.0-2.1% by year-end and to 2.5% in 2022

Since the spring, the NBH has turned much more hawkish and delivered all the rate hikes it promised. We expect interest rates to increase by around 15bp per month in 2021, reaching 2-2.1% by the end of 2021. Even if the NBH would like to end rate hikes in 2021, our more cautious view of disinflation implies further rate increases to 2.5% by mid-2022. With the highest carry in Central Europe, the HUF could fluctuate close to current levels in 2022, offsetting some of the real depreciation registered since March 2020. However, the HUF's external competitiveness should not be affected.

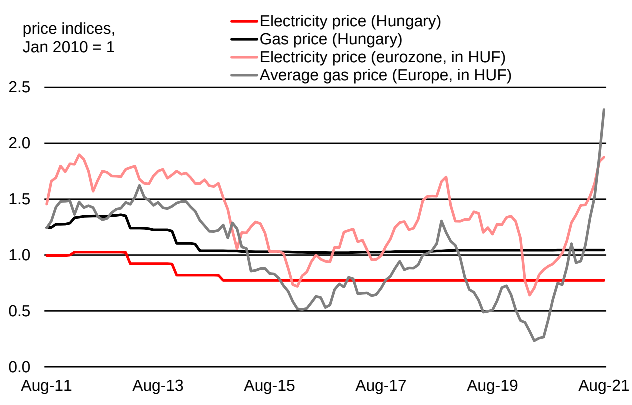
The EBB will be smaller than previously expected, but will remain positive

The trade surplus will remain mostly a matter of solving supply-chain bottlenecks. During the short periods this year when production ran smoothly, Hungary registered record industrial production and exports. Exports of services will depend on travel restrictions and transport companies finding enough lorry drivers to ensure smooth deliveries to and from Western Europe. We expect Hungary's extended basic balance to remain in surplus in 2021-22, even though FDI and EU transfers could make a smaller contribution than previously expected. However, external debt could increase if the government replaces missing EU grants with bonds issued abroad. While we expect FDI to pick up strongly from 2H22 onwards, its structure will be important. Since mid-2020, foreign investors seem to have preferred debt over equity financing, probably for tax purposes. In addition, dividend payments have been very large, dwarfing reinvested profits.

SUPPLY CONSTRAINTS INCREASINGLY AFFECTING OUTPUT



ELECTRICITY AND GAS PRICES ARE BEING KEPT FLAT



Source: HCSO, Eurostat, World Bank, UniCredit Research

Mind the hikes (and the tapering)

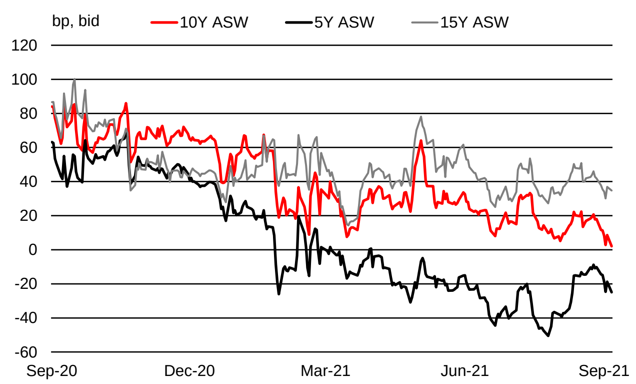
HGB yields could climb to 4-5% if the NBH tapers bond purchases

As we argued in our *EEMEA Special Topics* – CEE: High time for rate hikes, the NBH will find it hard to taper bond purchases without triggering a bear-steepening of the curve. By remaining committed to the long end of the HGB curve, the NBH could help the curve bear-flatten as rate hikes continue. If the NBH pursues its plan to taper QE, the sell-off at the long end will be determined by the external environment. A benign environment for EM could cap the 10Y yield at around 4%, while a risk-off situation could take it around 1pp higher. This is because local banks will need bonds to sell off more than swaps to increase bond purchases.

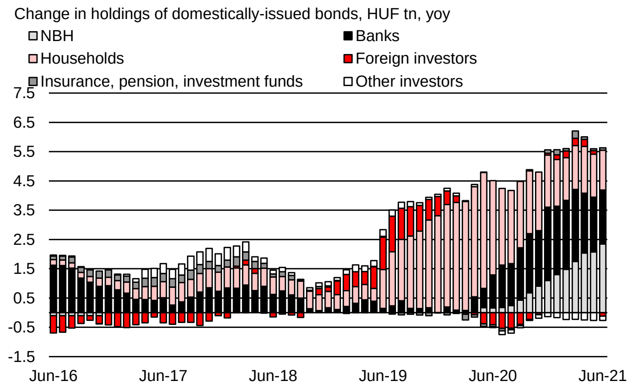
Limited risk of HUF depreciation

The market adapted its rate-hike expectations after the NBH reduced the pace to 15bp per month at its September meeting. The rising carry could prevent adverse seasonality from affecting the HUF in the short term. The HUF has been replaced by the PLN as the preferred funding currency in CEE.

LOCAL BANKS ARE UNLIKELY TO SIGNIFICANTLY INCREASE DEMAND FOR HGBS UNLESS ASW SPREADS ARE RISING



THE NBH IS THE LARGEST BUYER OF BONDS, ESPECIALLY AT THE LONG END



Source: Bloomberg, UniCredit Research

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2020	2021F	2022F
Gross financing requirement	**35.3**	**36.3**	**30.3**
Budget deficit	15.8	16.5	14.8
Amortization of public debt	19.5	19.8	15.5
Domestic	16.8	17.2	15.0
Bonds	7.8	8.8	6.3
Bills	2.0	1.8	1.8
Loans & retail securities	7.0	6.6	7.0
External	2.7	2.6	0.5
Bonds	2.5	1.7	0.0
IMF/EU/Other IFIs	0.2	0.9	0.5
Financing	**35.3**	**36.3**	**30.3**
Domestic borrowing	28.8	26.8	27.8
Bonds	17.2	13.8	16.0
Bills	1.7	1.8	2.8
Loans & retail securities	9.9	11.2	9.0
External borrowing	7.5	7.3	2.5
Bonds	6.5	6.3	2.0
IMF/EU/Other IFIs	1.0	1.0	0.5
Change in fiscal reserves (- = increase)	-1.0	2.2	0.0

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2020	2021F	2022F
Gross financing requirement	**23.9**	**21.8**	**19.4**
C/A deficit	2.1	0.9	0.5
Amortization of medium and long-term debt	10.4	8.7	8.2
Government/central bank	3.9	3.5	1.9
Banks	5.3	3.7	4.3
Corporates/other	1.2	1.5	2.0
Amortization of short-term debt	11.4	12.3	10.7
Financing	**23.9**	**21.8**	**19.4**
FDI (net)	2.6	0.7	2.4
Portfolio equity, net	-1.1	-1.5	-0.5
Medium and long-term borrowing	13.2	12.3	7.5
Government/central bank	7.6	8.1	3.5
Banks	4.0	2.8	2.6
Corporates/other	1.6	1.4	1.4
Short-term borrowing	12.3	10.7	9.0
EU structural and investment funds	2.7	3.2	3.6
Change in FX reserves (- = increase)	-5.9	-3.5	-2.7
Memoranda:			
Non-resident purchases of LC govt bonds	0.1	0.8	1.0
International bond issuance, net	4.0	4.6	2.0

Source: NBH, Ministry of Finance, UniCredit Research

Poland

A2 stable/A- stable/A- stable*

Outlook: The Polish economy could grow by around 6.3% in 2021 and 4.5% in 2022, with upbeat consumers driving the recovery. Investment is likely to grow at a slower pace than previously expected as Poland has failed to agree with the EC on rule-of-law conditionality for RRF funding. The government faces a tradeoff between an agreement with EU potentially leading to a breakup of the coalition and lower EU transfers. Private capex could be weaker while supply-chain bottlenecks persist. The NBP may be forced to take the key rate to 1.50% in 2022 in reaction to persistent and broad-based inflationary pressure.

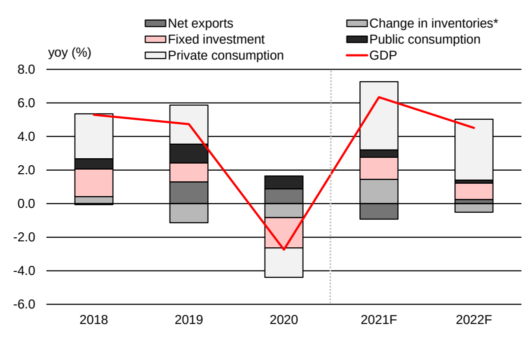
Strategy: A further selloff in POLGBs may be prompted by lack of rate cuts, potential tapering of bond purchases and less appetite for EM bonds.

Author: Dan Bucsa, Chief CEE Economist (UniCredit Bank, London)

KEY DATES/EVENTS

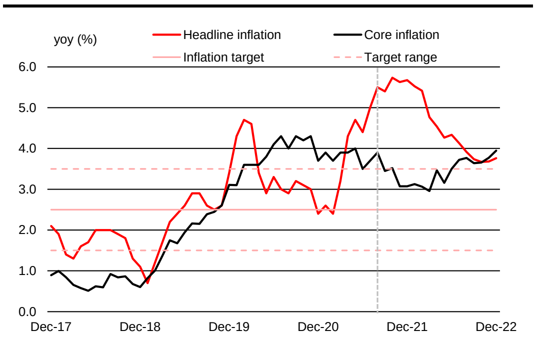
- 6 Oct, 3 Nov, 8 Dec: monetary policy decisions
- 1/15 Oct, 29 Oct/15 Nov, 30 Nov/15 Dec: CPI
- 1 October, 29 October: rating updates from S&P, Moody's
- 12/30 Nov: 3Q21 GDP (flash, structure)
- 30 September: Constitutional Tribunal rules on primacy of Polish law over EU law

GDP GROWTH FORECAST



*adjusted with the statistical error

INFLATION FORECAST



Source: Statistics Poland, NBP, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

EUR bn	2018	2019	2020E	2021F	2022F
GDP (EUR bn)	497.6	533.7	522.9	571.0	626.4
Population (mn)	38.4	38.4	38.4	38.4	38.4
GDP per capita (EUR)	12,948	13,885	13,605	14,855	16,295
Real economy, change (%)					
GDP	5.3	4.7	-2.7	6.3	4.5
Private Consumption	4.5	4.0	-3.0	7.0	6.2
Fixed Investment	9.3	6.1	-9.7	7.6	5.6
Public Consumption	3.5	6.5	4.4	2.3	1.0
Exports	7.0	5.2	-0.1	13.3	7.1
Imports	7.6	3.0	-1.9	16.4	7.2
Monthly wage, nominal (EUR)	1134	1199	1215	1281	1386
Real wage, change (%)	5.3	4.2	1.3	3.4	2.8
Unemployment rate (%)	6.1	5.4	5.9	6.0	5.5
Fiscal accounts (% of GDP)					
Budget balance (w. PFR)	-0.2	-0.7	-7.0	-6.2	-3.0
Primary balance (w. PFR)	1.1	0.5	-5.7	-4.9	-1.7
Public debt (w. BGK and PFR)	48.8	45.6	56.3	53.0	49.9
External accounts					
Current account balance (EUR bn)	-6.5	2.6	18.1	8.9	12.3
Current account balance/GDP (%)	-1.3	0.5	3.5	1.5	2.0
Extended basic balance/GDP (%)	3.4	4.1	7.5	5.3	5.9
Net FDI (% of GDP)	2.6	1.6	1.6	1.7	1.7
Gross foreign debt (% of GDP)	63.6	59.1	57.1	50.2	43.1
FX reserves (EUR bn)	96.5	103.3	112.8	115.5	118.8
Months of imports, goods & services	4.5	4.6	5.3	5.1	4.9
Inflation/Monetary/FX					
CPI (pavg)	1.7	2.3	3.4	4.5	4.3
CPI (eop)	1.1	3.4	2.4	5.7	3.8
Central bank target	2.50	2.50	2.50	2.50	2.50
Central bank reference rate (eop)	1.50	1.50	0.10	0.25	1.50
3M money market rate (Dec avg)	1.72	1.70	0.21	0.38	1.68
USD/FX (eop)	3.76	3.80	3.76	3.83	3.73
EUR/FX (eop)	4.30	4.26	4.61	4.60	4.55
USD/FX (pavg)	3.61	3.84	3.90	3.81	3.72
EUR/FX (pavg)	4.26	4.30	4.44	4.56	4.51

Source: Statistics Poland, NBP, UniCredit Research

*long-term foreign currency credit rating provided by Moody's, S&P and Fitch, respectively

Ideology vs. economics

Political volatility reduces the efficiency of public policies

The Polish government is finding it increasingly difficult to implement its parliamentary agenda. A controversial law aimed at pushing US-owned Discovery to sell the NTV24 news channel to a local investor drove the small Agreement party out of the governing coalition, leaving the Law and Justice party (PiS) with minority support in parliament. The law is set to fail, even after being backed in the Sejm (the lower house) by Kukiz'15. This is a temporary solution for the PiS. If it continues to back the government, Kukiz'15 stands to lose the few protest voters that still support it and fail to re-enter parliament. To make matters worse, the remaining junior coalition partner, United Poland of Justice Minister Zbigniew Ziobro, is threatening to leave the coalition if the government caves in to demands from the EC and the Court of Justice of the EU (CJEU).

The standoff with EU institutions is a structural, rather than a superficial one

Mr. Ziobro has been at the forefront of political appointments to the judiciary, including judges, the National Council of the Judiciary and the Supreme Court. The CJEU and the European Court of Human Rights have ruled against these changes and the EC decided to postpone the approval of Poland's Recovery and Resilience Program (RRP) until the government backtracks on some of these judicial changes. Thus, the government of Prime Minister Mateusz Morawiecki is facing the choice of caving into demands from European institutions to get money from the RRF or aligning himself with his justice minister and risking the economic agenda laid out in the Polish Deal, which we discussed in the 3Q21 issue of this publication. However, the gap that needs to be bridged is wider than many analysts assume. Poland is questioning the primacy of European law over Polish legislation, something that EU treaties make very clear.

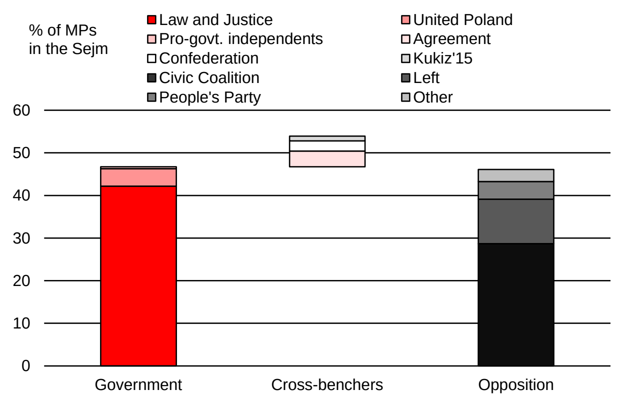
Early elections may not lead to a stable coalition

If Mr. Ziobro leaves the government, the PiS could be forced to call early elections before reaping the benefits of the Polish Deal. Even so, polls show the PiS winning more than 30% of potential vote, having recently been strengthened by its opposition to migrant arrivals from Belarus. The PiS is at least 10pp ahead of the Civic Platform (PO), whose erstwhile leader, Donald Tusk, is back in Polish politics after leading the European Council. Mr. Tusk's return improved the PO's approval rating by clawing back support from Poland 2050, a centrist, pro-European party, but not from the PiS. Even after early elections, the PiS might have to rely on the right-wing Confederation to advance its agenda, while the PO would have to form a broad coalition with Poland 2050, the Left and the People's Party to oust the PiS from power.

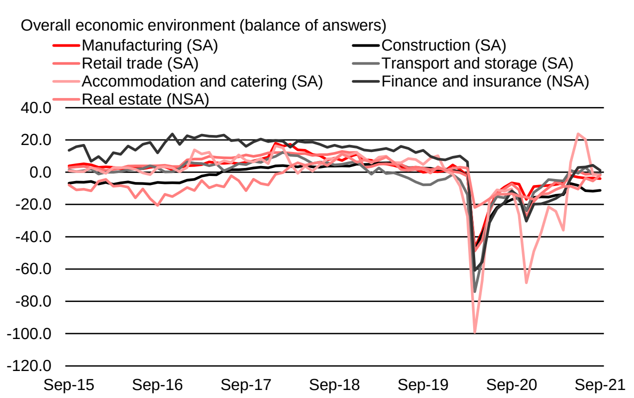
Poland needs RRF funding to implement the New Deal

In order to advance its economic program, the PiS needs the RRF money to start flowing. The 2022 budget does not include such grants, but the New Deal's pledge to broaden transfers to young families and entrepreneurs, as well as old voters may crowd out ambitious investment plans. The alternative is a wider deficit than the planned 2.8% of GDP in 2022.

THE GOVERNMENT LOST ITS MAJORITY



RECOVERY STALLING IN 3Q21



Source: Sejm, Statistics Poland, Eurostat, UniCredit Research

Fiscal tightening could continue…

…and Poland could reach a deal with the EU on the RRF

We expect the budget deficit to halve next year from around 6% of GDP in 2021. This implies a small adjustment in structural terms, a rare feat in CEE. We assume that the government will gradually implement the changes requested by the EU courts in order to open the tap of EU money. As a result, we see public investment funded by the RRF starting later than previously expected, at a time when companies are reluctant to increase capex due to supply-chain bottlenecks and a lack of workers, especially in construction. Migrant labor was more than a third higher in June 2021 than in the same month last year, with more foreign workers needed in agriculture, construction and leisure services. In industry, where Polish workers are more in demand, labor shortages are the third highest in CEE. By mid-2022, unemployment could be back to pre-COVID levels of below 5.5%.

We expect GDP growth to be 6.3% in 2021 and 4.5% in 2022

We expect strong consumer demand to push GDP growth to around 6.3% in 2021 and 4.5% in 2022. We have downgraded our forecast for investment and exports, mostly due to supply-chain bottlenecks and delayed disbursements from the EU. This would mean the Polish economy returning to a positive output gap before the end of next year.

Inflation could miss the target in both 2021 and 2022…

…as cyclical and structural inflation remain high.

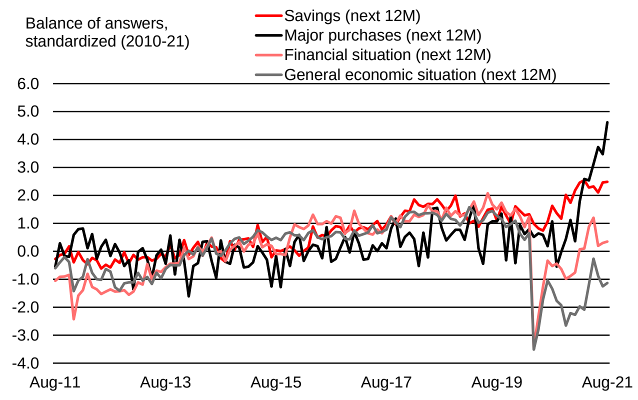
We expect annual inflation to peak in 4Q21 at around 5.7%. Subsequent disinflation might be insufficient to take the headline rate back inside the target range before the end of 2022. Supply shocks and strong demand could result in higher core inflation. Meanwhile, energy prices are likely to be raised slightly more next year than in 2021, following the recent surge in natural gas prices. Contrary to the opinions expressed by a majority of MPC members, price pressure is broad based and remains strong. Inflation momentum shows that both cyclical and non-cyclical inflation are resilient. Weighted median inflation suggests that underlying price pressure is much stronger than in the rest of Central Europe.

The probability of a dovish hike in 2021 is falling…

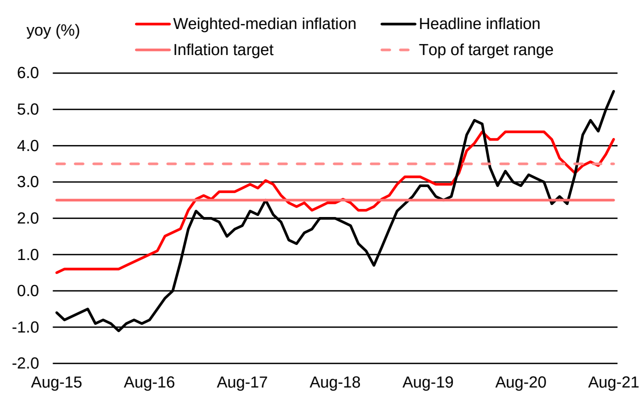
…but the policy rate could be taken to 1.5% in 2022.

While we still expect a cautious rate hike to 0.25% before year end, we admit that the probability of a tightening cycle starting in 2021 has fallen further. If a majority of MPC members are not convinced by existing evidence, a few more months of high inflation may do little to change their minds. The balance could change next year, when nine out of ten mandates end, seven of which before the end of March. The mandate of NBP President Adam Glapinski will end in June. The more the MPC waits, the faster rate hikes may have to be. We still expect the policy rate to be taken to 1.5% before the end of 2022. Rate hikes could allow the PLN to strengthen next year, approaching its fair value. Trade flows suggest that the PLN is competitive, with the trade balance shrinking mostly due to larger energy imports. The extended basic balance will remain positive, but portfolio outflows could continue if bonds sell off further.

CONSUMERS PREDICT UNPRECEDENTED DEMAND AND SAVINGS



UNDERLYING INFLATION IS THE HIGHEST IN CENTRAL EUROPE



Source: Eurostat, Statistics Poland, NBP, UniCredit Research

POLGBs likely to sell off further

POLGBs could sell off further…

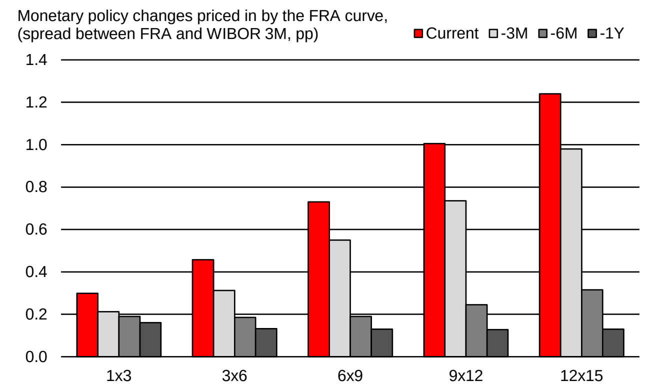
…especially if the NBP tapers bond purchases

There are several reasons why POLGBs could sell off further in 4Q21 First, investors are worried about the central bank's reluctance to hike. The market is pricing in significant hikes for the next 12 months, but investors could be disappointed and use the PLN as a funding currency. Second, some MPC members argue that bond purchases should be tapered before raising rates. As we argued in EEMEA Special Topics – CEE: High time for rate hikes, 16 September, smaller bond purchases could lead to a selloff as the NBP accounts for 90% of the net increase in outstanding POLGBs. Third, appetite for EM assets might decline, further reducing foreign exposure to POLGBs.

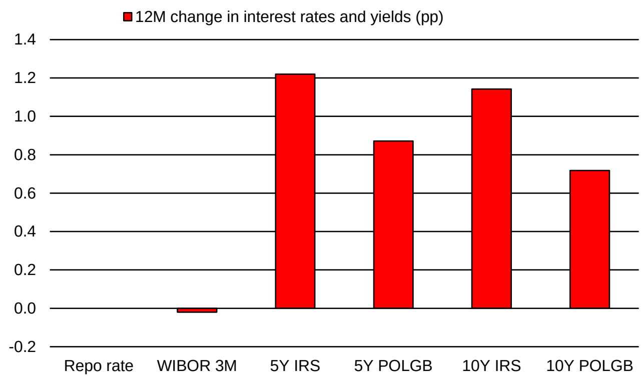
The government has covered funding needs for 2021

That said, the government can react to a potential POLGB selloff and reduce issuance significantly towards the end of the year. The ministry of finance managed to cover all the official funding needs for this year by the end of August and has enough time to pre-fund around a fifth of next year's needs. In addition, the government has the equivalent of 6.6% of GDP in fiscal reserves.

THE MARKET EXPECTS SIGNIFICANT HIKES



BONDS SELLING OFF DESPITE NBP PURCHASES



Source: Bloomberg, UniCredit Research

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2020	2021F	2022F
Gross financing requirement	**57.3**	**47.3**	**42.6**
Budget deficit	36.3	18.1	13.2
Amortization of public debt	20.9	29.2	29.3
Domestic	16.0	21.8	23.8
Bonds	14.6	17.0	20.6
Bills	0.0	2.4	0.0
Loans/Other	1.4	2.4	3.2
External	4.9	7.4	5.6
Bonds	3.4	6.9	4.6
Loans, IFIs, other	1.5	0.5	1.0
Financing	**57.3**	**47.3**	**42.6**
Domestic borrowing	54.1	44.6	37.6
Bonds	40.9	38.5	31.6
Bills	2.4	0.0	0.0
Loans/PFR/Other	10.7	6.1	5.9
External borrowing	9.0	2.5	2.0
Bonds	3.7	0.0	1.0
Loans, IFIs, other	5.3	2.5	1.0
Change in fiscal reserves/Other (-=increase)	-5.8	0.2	3.0

Source: Statistics Poland, NBP, UniCredit Research

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2020	2021F	2022F
Gross financing requirement	**80.8**	**90.1**	**96.0**
C/A deficit	-18.1	-8.9	-12.3
Amortization of medium and long-term debt	48.7	51.5	51.9
Government/central bank	7.8	9.1	7.6
Banks	13.3	16.1	15.3
Corporates/Other	27.6	26.3	28.9
Amortization of short-term debt	50.2	47.4	56.5
Financing	**80.8**	**90.1**	**96.0**
FDI (net)	8.6	9.8	10.5
Portfolio equity, net	3.2	-1.5	-1.0
Medium and long-term borrowing	35.1	32.0	34.5
Government/central bank	3.6	3.0	3.7
Banks	9.3	8.1	7.7
Corporates/Other	22.2	21.0	23.1
Short-term borrowing	46.6	48.5	49.9
EU structural and cohesion funds	12.6	11.4	14.4
Other	-9.4	-7.5	-9.0
Change in FX reserves (- = increase)	-15.9	-2.7	-3.2
Memoranda:			
Nonresident purchases of LC govt bonds	-8.0	-1.2	-0.3
International bond issuance, net	0.3	-6.9	-3.6

Romania

Baa3 negative/BBB- stable/BBB- negative*

Outlook

We expect GDP to grow at 8.1% in 2021 and 5% in 2022. Political uncertainty will probably result in an unstable government, ultimately affecting the quality of public policies. We expect growth to rely more on consumption than on investment compared to previous forecasts, with budget deficits kept close to values agreed with the EU and public debt remaining around 50% of GDP in 2021-22. Fiscal uncertainty and a wider C/A deficit could postpone rating upgrades to late 2022 or 2023. We expect the NBR to raise the repo rate to 2% by 1H22 and allow a move of the EUR-RON to a 5.00-5.10 range by early 2022 at the latest.

Strategy

We prefer ROMGBs to ROMANIs as the convergence trend is put on hold, at least temporarily.

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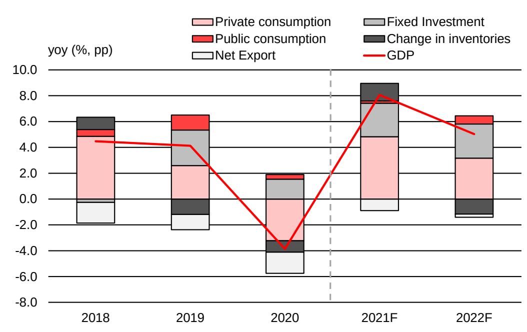
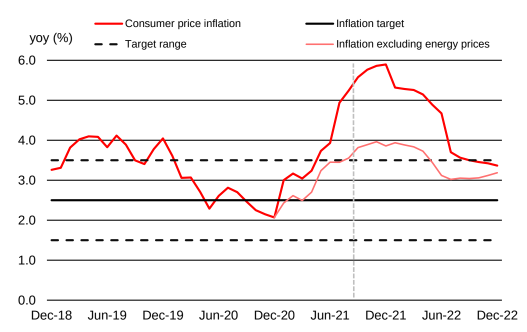
KEY DATES/EVENTS

- 5 October, 9 November: monetary policy decision
- 12 October, 10 November, 13 December: CPI
- 16 November, 7 December: 3Q21 GDP (flash, structure)
- Before 22 October: parliament votes on new government (if the CC rules out a vote limited to new ministers)
- 15, 22 October: rating updates from Moody's and S&P, Fitch

GDP GROWTH FORECAST



INFLATION FORECAST



Source: UniCredit Research

MACROECONOMIC DATA AND FORECASTS

EUR bn	2018	2019	2020E	2021F	2022F
GDP (EUR bn)	204.5	223.0	218.2	242.1	259.8
Population (mn)	19.5	19.4	19.3	19.2	19.1
GDP per capita (EUR)	10,470	11,480	11,290	12,620	13,578
Real economy, change (%)					
GDP	4.5	4.1	-3.9	8.1	5.0
Private Consumption	7.7	4.1	-5.2	7.9	5.2
Fixed Investment	-1.1	13.0	6.8	10.5	10.4
Public Consumption	3.3	6.9	2.0	0.9	3.7
Exports	5.3	4.6	-9.7	14.6	8.5
Imports	8.6	6.8	-5.1	15.1	8.2
Monthly wage, nominal (EUR)	965	1069	1116	1177	1233
Real wage, change (%)	29.7	8.9	3.6	2.8	2.8
Unemployment rate (%)	4.2	3.9	5.0	5.3	4.5
Fiscal accounts (% of GDP)					
Budget balance	-2.9	-4.4	-9.2	-8.3	-6.4
Primary balance	-1.5	-3.3	-7.8	-6.8	-4.9
Public debt	34.7	35.3	47.3	49.3	50.2
External accounts					
Current account balance (EUR bn)	-9.5	-10.9	-11.4	-14.7	-16.1
Current account balance/GDP (%)	-4.6	-4.9	-5.2	-6.1	-6.2
Extended basic balance/GDP (%)	-1.3	-1.7	-2.9	-2.5	-1.4
Net FDI (% of GDP)	2.4	2.2	0.9	2.3	2.5
Gross foreign debt (% of GDP)	33.4	33.3	42.5	45.8	46.1
FX reserves (EUR bn)	33.1	32.9	37.4	40.5	43.9
Months of imports, goods & services	4.3	4.0	4.9	4.4	4.4
Inflation/Monetary/FX					
CPI (pavg)	4.6	3.8	2.7	4.5	4.3
CPI (eop)	3.3	4.0	2.1	5.9	3.3
Central bank target	2.50	2.50	2.50	2.50	2.50
Central bank reference rate (eop)	2.50	2.50	1.50	1.50	2.00
3M money market rate (Dec avg)	3.05	3.12	2.04	1.69	1.84
USDRON (eop)	4.07	4.26	3.97	4.14	4.14
EURRON (eop)	4.66	4.78	4.87	4.97	5.05
USDRON (pavg)	3.94	4.24	4.24	4.11	4.15
EURRON (pavg)	4.65	4.75	4.84	4.92	5.04

Source: Eurostat, NSI, UniCredit Research

*long-term foreign-currency credit rating at Moody's, S&P and Fitch, respectively

Missed opportunities

The political crisis has no stable solution…

Our call for the governing coalition lasting until 2022 proved too optimistic, with the partnership between the senior National Liberal Party (PNL) and the USR-Plus ending in acrimony. While the coalition could reform in October, a new government might have a limited shelf life as the judicial reforms proposed by the USR-Plus are not among the priorities of the PNL, its Hungarian-minority partner, the UDMR, or of Romania's President, Klaus Iohannis. The alternatives are a new PNL-USR-Plus-UDMR government or a minority PNL-UDMR government with support from the Social Democrats (PSD). In our view, neither will feature PNL president Florin Cîțu as prime minister without interventions from the Constitutional Court. Any emerging government is unlikely to last until the 2024 legislative elections.[7]

… translating into more inefficient public policies…

… but not into more public debt

An unstable governing coalition will likely lead to a less ambitious economic agenda as well. Populist spending to appease regional PNL and UDMR leaders and, if needed, the PSD, could crowd out public investment without significantly affecting the budget deficit. With automatic stabilizers keeping the budget deficit at 2.9% of GDP in 7M21 and the Ministry of Finance likely to spend some of its large fiscal reserves, public debt could peak at around 50% of GDP, more than 10pp lower than the post-COVID median for BBB-rated countries. Despite this, rating agencies might postpone upgrades in order to assess the budget execution in 2022 and to see whether the government doles out more populist spending, especially for non-discretionary social-security payments and public wages.

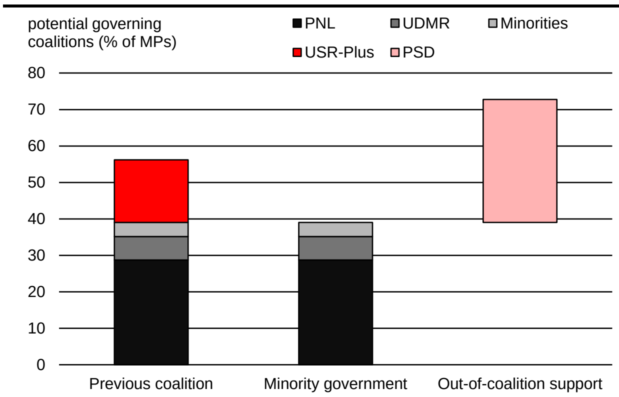
The budget structure might change, with deficits expected above 8% in 2021 and 6% in 2022

The budget deficit could still be around 8.3% of GDP in 2021 and 6.4% of GDP in 2022 (both computed using accruals). This is in line with official forecasts. The Fiscal Council considers that the cash budget deficit of 7.1% of GDP planned by the government could be 0.5% of GDP larger in 2021 due to missing revenues from 5G licenses and more spending on pensions. In addition, the government is mulling a subsidy to partly cover the cost of heating for worse-off consumers between November 2021 and March 2022. This cost is not included in the amended budget, although the subsidy will be partly offset by higher budget revenues coming from state-owned energy producers.

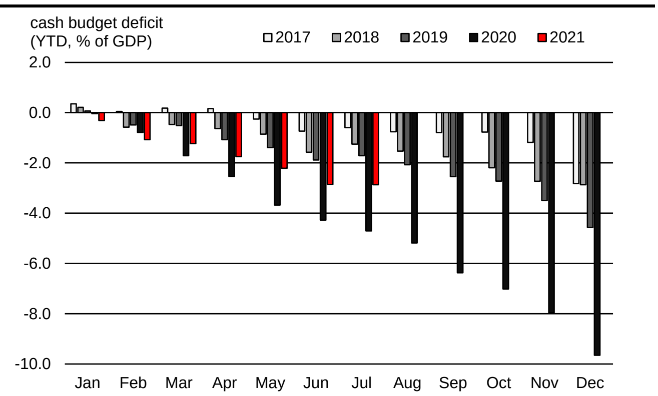
We expect GDP growth at 8.1% in 2021 and 5% in 2022

Even if the structure of public spending worsens compared to our previous expectations, economic growth may not be affected in the short term. We expect GDP to expand in real terms by around 8.1% yoy in 2021 (with 5pp due to the carryover from 2020) and by 5% in 2022. However, the structure of growth could change to rely more on private and public consumption, and less on investment. Private consumption will benefit from pent-up demand, falling savings rates, a higher minimum wage and a potential rebound in consumer lending.

ONLY TWO GOVERNING COALITIONS POSSIBLE



BUDGET DEFICIT SHRINKING AS THE ECONOMY RECOVERS



Source: ministry of finance, Romanian Parliament, UniCredit Research

[7] For details, please see our EEMEA Macro Flash – Romania's political crisis: no quick way out, 27 September.

Labor market could underpin growth less than in CE

In contrast, wage growth will underpin household spending less than in Central Europe (CE) as employment in manufacturing could fall further, offsetting part of the new hiring in construction and services. In addition, public-sector wages will grow at a much slower pace than in 2016-19, with real wage growth falling below 5% in 2021-22 from 11% yoy in 2016-19.

Grants from the EU will increase in 2022 and beyond

Private investment could be postponed if supply-chain bottlenecks persist

Romania will be able to boost public investment, with its National Recovery and Resilience Program approved by the European Commission at the end of September. The first transfers could arrive before the end of 2021. NGEU grants and delayed transfers from the 2014-20 EU budget will support public investment in 2022 and beyond. However, the implementation and quality of projects funded out of national resources could suffer if the government fails to gain a majority in parliament or manages to get only a weak one. Private investment in exporting sectors, especially car manufacturing, may be delayed until 2H22 if supply-chain bottlenecks persist. Building projects could grow at a slower pace than demand for housing due to labor shortages and competition for available labor from state-funded infrastructure works. Romanian workers returning from Britain are insufficient to cover the labor shortage.

The C/A deficit will not be covered by EU funds and FDI

One short-term effect of growth that relies more on consumption than previously expected is a wider C/A deficit. The external shortfall was already visible in 2020 and is opening further in 2021, being only partly covered by EU funds and FDI. This could add to rating agencies' reluctance to upgrade Romania in 2022. The trade deficit with goods is widening due to high natural gas prices, which are resulting in larger imports of chemicals and fuels, and due to lower price competitiveness, which boosts food imports and affects manufacturing exports. Besides insufficient supply in Europe, there are several domestic reasons for the rise in gas prices, such as 2018 legislation favoring gas imports over local production, the delay of gas extraction from the Black Sea and low competition on the local market.

EUR-RON could trade in a 5.00-5.10 range by 1Q21

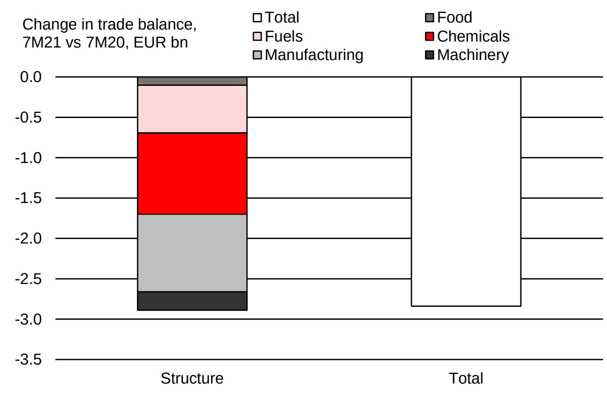
Rate hikes could start in November and end at 2%

EUR-RON is likely to move to a 5.00-5.10 range in 1Q22 at the latest. If the political crisis is protracted and affects the trust of foreign investors, the NBR could let EUR-RON move above 5.00 before year-end. We also expect the central bank to start increasing interest rates in November 2021, with two more hikes in 1Q22. A policy rate of 2% would bring Romania in line with its regional peers. The NBR could hike to 2.5% if the fiscal adjustment slows in 2022.

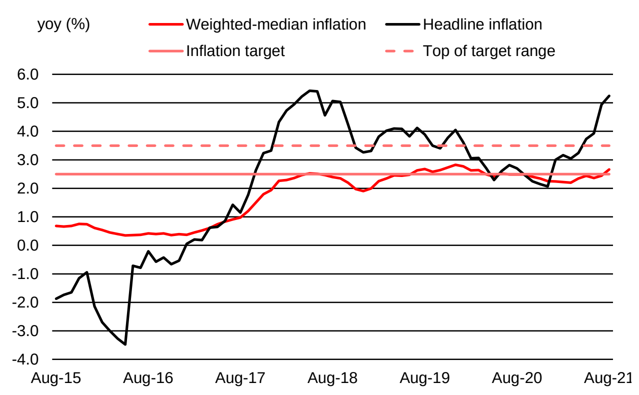
Limited underlying inflation pressure

Additional hikes are unwarranted, in our view, as inflation is set to drop next year. From the second half of 2022, supply shocks could keep headline inflation close to the top of the target range. However, underlying inflation remains close to target, suggesting a return below 3.5% by the monetary-policy horizon. Cyclical inflation is also slowing, albeit from very high levels. The government could cap energy prices in 2022, which would increase the probability of inflation returning inside the target range before the end of next year.

THE TRADE DEFICIT IS WIDENING RAPIDLY



LIMITED UNDERLYING INFLATION WARRANTS LIMITED HIKES



Source: Ministry of Health, NSI, UniCredit Research

Convergence trade on hold

Rating upgrades and convergence trade on hold…

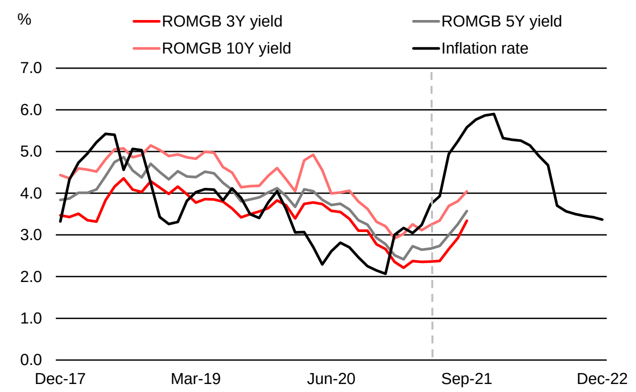
In recent years, foreign investors have overweighted ROMANI bonds given their attractive yields and a convergence story that promised rating upgrades and narrower spreads to Central European peers. Recent political events suggest that investors may have been too optimistic. While we do expect the fiscal outlook to improve and public debt to remain below EU-CEE and BBB averages, rating upgrades could be delayed to late 2022 or 2023. This, in addition to expected EUR issuance, means we still see ROMANI as an attractive yield story, but not a capital-gain story.

…probably until late 2022 or 2023

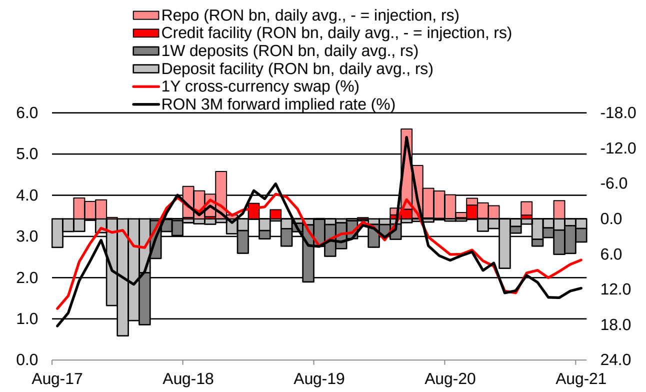
We prefer ROMGBs over ROMANIs

We prefer ROMGBs over ROMANIs as we expect inflation and funding needs to fall next year. As we argued in EEMEA Special Topics – CEE: High time for rate hikes, 16 September, inflation has a better chance of staying close to target in the medium term in Romania than in Hungary or Poland. Rate hikes from the NBR should help bear-flatten the curve and we prefer long-end bonds. There are two caveats to our constructive ROMGB story: **1.** Higher inflation before year-end (if investors ignore the steep drop in 1Q22) and **2.** RON depreciation expected in 1Q22, which might shave off 1-1.4% from returns.

5Y AND 10Y REAL ROMGB YIELDS ARE POSITIVE WHEN COMPUTED WITH 1Y EXPECTED INFLATION



SHORT-TERM LIQUIDITY IS TIGHTENING AHEAD OF EXPECTED RATE HIKES



Source: NBR, NSI, Bloomberg, UniCredit Research

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2020	2021F	2022F
Gross financing requirement	**29.6**	**28.1**	**27.4**
Budget deficit	21.1	17.9	15.4
Amortization of public debt	8.5	10.2	12.0
Domestic	6.5	10.2	9.4
Bonds	5.8	7.9	8.1
Bills	0.4	1.0	1.0
Loans	0.3	1.3	0.3
External	2.0	0.0	2.6
Bonds and loans	2.0	0.0	2.6
IMF/EU/Other IFIs	0.0	0.0	0.0
Financing	**29.6**	**28.1**	**27.4**
Domestic borrowing	17.9	14.8	16.0
Bonds	15.9	11.8	14.0
Bills	1.0	1.0	1.0
Loans and retail bonds	1.0	2.0	1.0
External borrowing	15.2	11.1	8.0
Bonds	11.7	9.6	6.0
IMF/EU/Other IFIs	3.5	1.5	2.0
Fiscal reserve change (- = increase)	-3.5	2.3	3.4

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2020	2021F	2022F
Gross financing requirement	**38.5**	**39.3**	**42.4**
C/A deficit	11.4	14.7	16.1
Amortization of medium and long-term debt	12.1	9.7	12.1
Government/central bank	3.2	1.1	3.9
Banks	3.1	2.8	2.5
Corporates/Other	5.9	5.8	5.7
Amortization of short-term debt	15.0	14.9	14.1
Financing	**38.5**	**39.3**	**42.4**
FDI (net)	1.9	5.6	6.4
Portfolio equity, net	0.1	0.1	0.1
Medium and long-term borrowing	22.3	20.2	16.8
Government/central bank	14.6	12.2	9.1
Banks	2.8	2.5	2.2
Corporates/Other	5.0	5.5	5.4
Short-term borrowing	14.5	13.7	13.4
EU structural and cohesion funds	2.9	3.0	6.0
Change in FX reserves (- = increase)	-3.1	-3.4	-0.3
Memoranda:			
Nonresident purchases of LC govt bonds	1.9	2.1	1.7
International bond issuance, net	9.7	9.6	3.4

Source: NBR, MoF, NSI, UniCredit Research

Slovakia

A2 stable/A+ stable/A negative*

Outlook

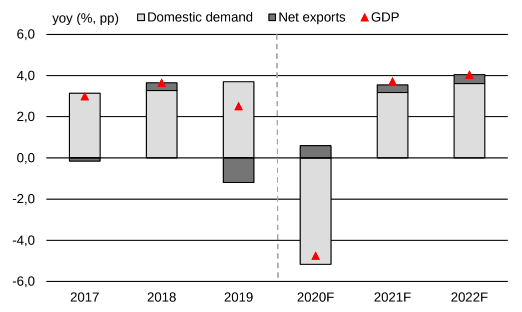
We expect Slovakia's GDP to grow by 3.7% in 2021 and 4% in 2022, reaching pre-pandemic levels at the turn of this year. The economic rebound will be led by consumption, supported by pent-up demand and tightening labor-market conditions. The low vaccination rate is likely lead to regional restrictions but not a nationwide lockdown, the fourth COVID-19 wave having a milder impact on the economy than previous waves of the pandemic. Bottlenecks in several supply chains are affecting key parts of local manufacturing, including the car sector, and are likely to slow the economic rebound and temporarily increase inflation towards 5%. From next year, we expect public investment to support growth, driven by inflows from the EU budget and the NGEU. Fiscal tightening has been postponed until 2023, the pre-election year, while rising political instability is slowing reform progress.

Author: L'ubomír Koršnák, Chief Economist Slovakia (UniCredit Bank Czech republic and Slovakia)

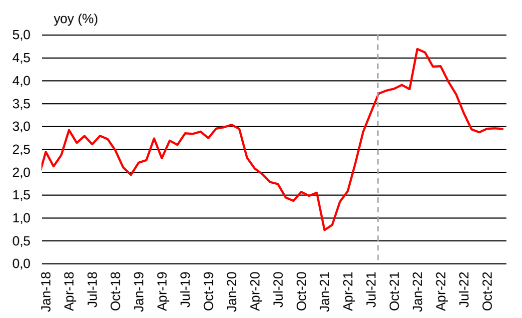
KEY DATES/EVENTS

- 11 Oct, 10 Nov, 10 Dec: industrial production
- 14 Oct, 12 Nov, 14 Dec: CPI
- 16 Nov: flash 3Q21 GDP
- 3 Dec: 3Q21 GDP structure

GDP RECOVERY TO BE DRIVEN BY REBOUNDING DOMESTIC DEMAND



INFLATION TO ACCELERATE ABOVE 3%



Source: NSI, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

EUR bn	2018	2019	2020	2021F	2022F
GDP (EUR bn)	89.4	93.9	91.6	97.5	105.2
Population (mn)	5.4	5.5	5.5	5.5	5.5
GDP per capita (EUR)	16,405	17,216	16,775	17,860	19,276
Real economy, change (%)					
GDP	3.7	2.5	-4.8	3.7	4.0
Private consumption	4.2	2.6	-1.1	1.4	3.2
Fixed investment	2.7	6.6	-12.0	3.5	8.7
Public consumption	0.1	4.6	0.3	1.5	-1.5
Exports	5.2	0.8	-7.5	11.0	9.5
Imports	5.0	2.1	-8.3	10.9	9.4
Monthly wage, nominal (EUR)	1,013	1,092	1,133	1,194	1,268
Real wage, change (%)	3.6	5.0	1.8	2.7	2.4
Unemployment rate (%)	6.5	5.8	6.7	6.9	6.1
Fiscal accounts (% of GDP)					
Budget balance	-1.0	-1.4	-6.2	-7.7	-4.7
Primary balance	0.4	-0.1	-4.9	-6.3	-3.3
Public debt	49.9	48.5	60.6	62.6	60.7
External accounts					
Current account balance (EUR bn)	-2.0	-2.5	-0.3	-0.3	-0.5
Current account balance/GDP (%)	-2.2	-2.7	-0.4	-0.3	-0.5
Extended basic balance/GDP (%)	0.0	0.2	-1.3	1.3	2.5
Net FDI (% of GDP)	1.3	2.2	-2.1	0.3	1.3
Gross foreign debt (% of GDP)	114.9	112.4	121.2	119.0	115.2
FX reserves (EUR bn)	EUR	EUR	EUR	EUR	EUR
Months of imports, goods & services	-	-	-	-	-
Inflation/monetary/FX					
CPI (pavg)	2.5	2.7	1.9	2.7	3.6
CPI (eop)	1.9	3.0	1.6	3.8	2.9
Central bank reference rate (eop)	EUR	EUR	EUR	EUR	EUR
USD/FX (eop)	EUR	EUR	EUR	EUR	EUR
EUR/FX (eop)	EUR	EUR	EUR	EUR	EUR
USD/FX (pavg)	EUR	EUR	EUR	EUR	EUR
EUR/FX (pavg)	EUR	EUR	EUR	EUR	EUR

Source: Eurostat, NSI, UniCredit Research

*long-term foreign currency credit rating provided by Moody's, S&P and Fitch, respectively

Supply-chain bottlenecks slowing the recovery

The autumn pandemic wave…

... could affect the economy less than previous waves

Slovakia expects another strong pandemic wave in the autumn after the summer respite that cannot be prevented due to the low level of vaccination, at just above 50% of the adult population. Nevertheless, the negative effects on the economy should be milder than in previous waves. The autumn wave of the pandemic is likely to result in a series of regional restrictions, but not a nationwide lockdown. Furthermore, even in the most affected regions, a complete closure of contact services is not expected, unlike in previous waves of the pandemic. Manufacturing was resilient throughout the spring pandemic wave, as demand from key export markets was very strong. Thus, the higher vaccination rate in key Western European markets should continue to support strong demand in 4Q21. In addition, vaccination rates are lower in economically weaker regions in central and eastern Slovakia, while the more industrialized west of the country might avoid tough restrictions. However, the recovery could be slowed by global supply-chain bottlenecks in the coming quarters. These are present mainly in the automotive and construction sectors, and to a lesser extent in other areas of manufacturing. Slovak carmakers estimate that the semiconductor issue should peak in 3Q21, but the problems could persist until mid-2022. We expect GDP to increase by 3.7% this year followed by 4% growth in 2022, reaching the pre-pandemic level at the turn of the year.

Several bottlenecks in supply chains are raising volatility and slowing manufacturing growth

Household consumption continues to rebound

… as unemployment has already peaked…

… and labor-force shortages may accelerate the transfer of higher prices onto wages

Household consumption is likely to rebound further, backed by pent-up demand and despite the expected new wave of the pandemic. Household optimism has recovered quickly. Unemployment peaked early in the year at just above 7%. The end of temporary furlough schemes could slow the decline in unemployment in 4Q21, rather than push it up again. Employment growth is likely to be supported by the opening of additional production capacity in the car sector in 2H22. However, unemployment is unlikely to return to the pre-pandemic level before 2023 due to rising productivity. As a result of regional disparities, labor shortages have already started to re-emerge in the west of the country, especially in manufacturing. In a return to pre-pandemic conditions, labor immigration and wage pressure could rise again. Tight labor-market conditions may allow the transfer of rising price pressure onto wages. Moreover, wage growth will be supported by an increase in the minimum monthly wage to EUR 646. Real wages are thus likely to continue to rise by 2-3% yoy, supporting household spending.

Inflation to peak in 1Q22

Inflation is likely to peak at the beginning of 2022 at just above 4.5%, driven by accelerating rises in the prices of food and tradable goods (boosted by rising demand and input prices), as well as an increase in regulated energy prices in January. Stable wage growth will spill into market-services prices, probably preventing rapid disinflation later in 2022.

Investment to be supported by NGEU grants

Private investment could recover gradually from 2H21 onwards, supported by VW's EUR 1bn (1.1% of GDP) investment in a luxury car plant (VW Passat, Skoda Superb) with production scheduled to start in 2023. Transfers from the EU budget and the NGEU will boost public investment, with a marked acceleration expected in 2022-23, driving the local construction sector. At the same time, residential real estate will still face supply issues as developers are waiting for an amendment to the Building Act, which is unlikely to be approved any time soon due to controversy surrounding the prepared draft.

Fiscal tightening postponed until 2023

The ministry of finance revised the expected 2021 budget deficit from 10.3% to 8.8% of GDP. Some chapters still seem to overestimate spending, so we expect the 2021 budget deficit to reach 7.7% of GDP. The government does not plan to undertake significant fiscal tightening next year, postponing fiscal consolidation to 2023 (the pre-election year). Public debt will remain above 60% of GDP, exceeding all the debt brake thresholds, which remain deactivated at least until 2022. The governing coalition failed to amend the debt brake.

Political instability threatens fiscal goals and reform progress

Growing tensions in the governing coalition threaten budget plans and the implementation of reforms to which the government committed itself in the NGEU. The governing coalition continues to hold a majority even after the collapse of coalition member Za ľudí, as most of its MPs joined the parliamentary group of another coalition party, SaS. Parliamentary and presidential elections should take place in 2024. The next local elections are expected to be held in autumn 2022.

Slovenia

A3 stable/AA- stable/A stable*

Outlook

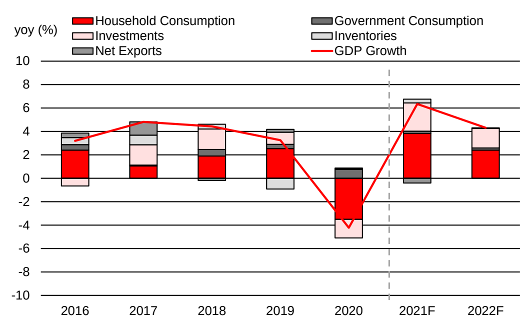
We are revising up our GDP forecasts for 2021 from 5% to 6.3%, reflecting better than expected growth in 2Q21. The persistence of supply-chain bottlenecks and an expected slowdown in global growth in 4Q21 are likely to slow the pace of recovery. In 2022, we see growth at 4.5% The fiscal deficit is planned to remain large in 2021, at 8.3% of GDP (vs. 8.2% in 2020), but the composition is likely to be different than originally planned, with higher COVID-19 related expenditure and lower investment. EU funding will play an important role in the recovery. Around over 80% of planned finance needs for 2021, estimated at EUR 7.6bn, have been covered, and we do not see the country having difficulty in covering the remaining needs. The next parliamentary elections will take place in June 2022 and the center-left opposition Constitutional Arch Coalition (KUL) is leading the opinion polls.

Author: Mauro Giorgio Marrano, Senior CEE Economist (UniCredit Bank, Vienna)

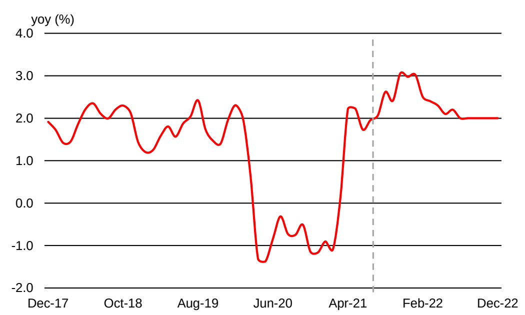
KEY DATES/EVENTS

- 30 Nov: 3Q21 GDP
- 11 Oct, 10 Nov, 10 Dec: Industrial production
- 8 Oct: Moody's to update sovereign rating
- 3 Dec: Fitch to update sovereign rating
- 10 Dec: S&P to update sovereign rating

GDP GROWTH FORECAST



INFLATION FORECAST



Source: SURS, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2018	2019	2020	2021F	2022F
GDP (EUR bn)	45.9	48.4	46.9	50.7	53.9
Population (mn)	2.1	2.1	2.1	2.1	2.1
GDP per capita (EUR)	22,136	23,167	22,309	24,035	25,601
Real economy, change (%)					
GDP	4.4	3.3	-4.2	6.3	4.3
Private Consumption	3.6	4.8	-6.6	7.3	4.5
Fixed Investment	9.7	5.5	-8.2	13.0	8.4
Public Consumption	3.0	2.0	4.2	1.0	1.0
Exports	6.2	4.5	-8.7	12.9	8.0
Imports	7.1	4.7	-9.6	14.8	8.7
Monthly wage, nominal (EUR)	1,681	1,754	1,858	1,970	2,068
Real wage, change (%)	1.4	2.6	6.2	4.4	2.8
Unemployment rate (%)	5.1	4.5	5.0	4.7	4.3
Fiscal accounts (% of GDP)					
Budget balance	0.7	0.4	-7.7	-8.3	-5.0
Primary balance	2.7	2.1	-6.1	-6.6	-3.4
Public debt	70.3	65.6	79.8	79.5	78.0
External accounts					
Current account balance (EUR bn)	2.7	2.9	3.5	3.5	3.5
Current account balance/GDP (%)	6.0	6.0	7.4	6.8	6.5
Extended basic balance/GDP (%)	9.4	8.6	8.0	10.0	9.8
Net FDI (% of GDP)	2.0	1.6	-0.6	1.8	1.9
Gross foreign debt (% of GDP)	91.9	91.5	101.9	100.1	97.6
FX reserves (EUR bn)					
Months of imports, goods & services					
Inflation/Monetary/FX					
CPI (pavg)	1.9	1.7	-0.3	1.6	2.2
CPI (eop)	1.4	2.0	-1.2	3.0	2.0

Source: SURS, Eurostat, UniCredit Research

*Long-term foreign-currency credit rating at Moody's, S&P and Fitch, respectively

The pace of recovery is likely to moderate

We are raising our growth projection for 2021

We are revising up our GDP forecasts for 2021 from 5% to 6.3%, reflecting better than expected growth in 2Q21. GDP was only 0.2% below its pre-pandemic level in 2Q21, although the gap is different depending on the sector. Industrial production and part of the services sector activity have already surpassed their pre-pandemic level. However, activity in some sectors like accommodation, food services, leisure and entertainment is still well below the pre-pandemic crisis, with turnover for most of these sectors still between 15% and 30% lower. The recovery in tourism has been slow, with tourist arrivals in the three months to July still 40% below the level is the same months of 2019, and a full recovery is unlikely before 2023.

Supply-chain bottlenecks and a global slowdown likely to affect growth in the near term

The persistence of supply-chain bottlenecks and an expected slowdown in global growth in 4Q21 are likely to slow the pace of recovery. European Commission's surveys show that share of companies reporting equipment as a limit to production increased significantly in 2Q21 and 3Q21 in some sectors. This concerns in particular the automotive, other transport equipment, electronics, and wood sectors, although also other sectors appear to be affected. The impact on production appears to be confirmed by the slowdown in electricity consumption in the industry during the summer. Growth will likely continue to be supported by a further recovery in consumption, on the back of further improvements in the labour market and the high saving rate, and public investment.

Growth at 4.5% in 2022

In 2022, we see growth at 4.5% supported by EU funding, private consumption and investment, and faster growth in Slovenia's main trading partners.

Large fiscal deficit in 2021 due to higher capital expenditure and support measure

The fiscal deficit is planned to remain large in 2021, at 8.3% of GDP (vs. 8.2% in 2020), but the composition is likely to be different than originally planned. At central level, much higher COVID-19 related expenditure between January and August, three times more than planned for the whole 2021 (with the large part being employee allowances), has been offset by much lower capital expenditure and stronger revenues. Regarding capital expenditure, at central level, only 25% of the amount planned for 2021 has been implemented in January, and the full implementation in the remaining months of the year appears very unlikely. The government deficit is likely to narrow to around 5% in 2022 as the COVID-19 measures are phased out. Despite the large deficit in 2021, government debt is likely to narrow slightly due to the reduction of the government cash buffers, and fall further in 2022.

EU funding available to support the recovery

EU funding will play an important role in the recovery. The country is set to receive EUR 2.5bn under the Recovery and Resilience Facility (RRF) between 2021 and 2026, EUR 1.8bn in grants and EUR 705mn in loans. The government expects RFF grants of EUR 300mn in 2021, of which EUR 231mn already disbursed as pre-financing, and EUR 600mn in 2022 and RFF loans of EUR 36mn in 2022. In addition to the RRF, Slovenia has available funding from MFF 2014-20 (EUR 1.0bn) and MFF 2021-27 (EUR 3.3bn).

Most of financing needs for 2021 are covered

Around over 80% of planned finance needs for 2021, estimated at EUR 7.6bn, have been covered, and we do not see the country having difficulty in covering the remaining needs. The government can rollover part of the bills expiring in 4Q21 (EUR 1bn) and use the significant fiscal reserves (EUR 8bn of government deposits at the end of July). Slovenian government bonds will be supported by ECB purchases, which we estimate at around EUR 3.5bn in 2021 (EUR 2.3bn already purchased). In 2022, we estimate financing needs at EUR 4.2bn (EUR 1.5bn in repayments and EUR 2.7bn to finance the government deficit), which are likely to be covered with bond issuance. Slovenian bonds will likely continue to be supported by ECB purchases in 2022.

Elections in 2022: the opposition coalition is leading the opinion polls

The next parliamentary elections will take place in June 2022 and the centre-left opposition Constitutional Arch Coalition (KUL) is leading the opinion polls. KUL includes Marjan Šarec List (LMS) the Social Democrats (SD), Levica, and the Party of Alenka Bratusek (SAB). According to the latest opinion polls, KUL has a share of preferences of respondents of 28%-34% which compares with 15-18% of SDS and 3%-5% of Nsi, the current government coalition parties. The rest of the preferences go to other parties, with a share of 5.5%-6.5%, undecided, around 26%, and people that do not intend to vote, around 7%.

Bosnia and Herzegovina

B3 stable/B stable/not rated*

Outlook

According to available high-frequency data, Bosnia and Herzegovina's economic recovery in 1H21 seems to be somewhat stronger than we expected due to the early relaxation of restrictive measures. However, given that 2Q21 GDP figures have not yet been released, for now, we are keeping our GDP-growth forecasts at 3.2% for 2021 and at 3.9% for 2022, bearing in mind that the performance of the economy could be even better. The recovery is expected to be driven by personal consumption, strong growth in export-oriented sectors of the economy and investment activity. The main risks are associated with an unstable political environment. This is reflected, among other things, in the postponement of the resumption of negotiations with the IMF regarding a new financial-assistance arrangement.

Authors:
Hrvoje Dolenec, Chief Economist Croatia (Zagrebacka banka)
Nenad Golac, Senior Economist (Zagrebacka banka)
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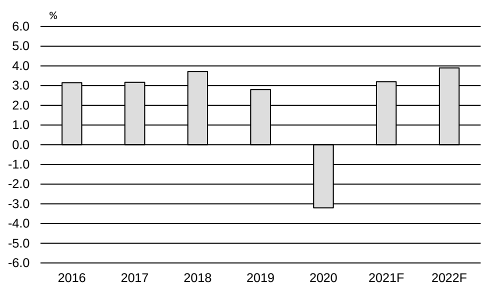
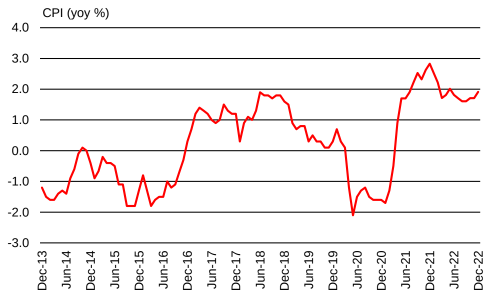
KEY DATES/EVENTS

- 20 Dec: CPI November 2021
- 20 Dec: foreign trade Jan-Nov 2021
- 24 Dec: industrial production November 2021
- 30 Dec: balance of payments 3Q21
- 30 Dec: GDP 3Q21

GDP-GROWTH FORECAST



INFLATION FORECAST



Source: UniCredit Research

MACROECONOMIC DATA AND FORECASTS

EUR bn	2018	2019	2020	2021F	2022F
GDP (EUR bn)	17.10	18.05	17.38	18.17	19.24
Population (mn)	3.50	3.49	3.48	3.46	3.45
GDP per capita (EUR)	4891	5169	5002	5252	5585
Real economy, change (%)					
GDP	3.7	2.8	-4.3	3.2	3.9
Monthly wage, nominal (EUR)	697	727	755	782	805
Real wage, change (%)	1.7	3.7	4.9	2.3	1.0
Unemployment rate (%)	36.0	33.3	33.8	33.0	32.0
Fiscal accounts (% of GDP)					
Budget balance	1.5	2.1	-4.7	-4.2	-2.8
Primary balance	2.4	2.8	-3.9	-3.3	-1.9
Public debt	34.3	32.4	37.4	37.7	39.3
External accounts					
Current account balance (EUR bn)	-0.6	-0.6	-0.6	-0.5	-0.6
Current account balance/GDP (%)	-3.3	-3.1	-3.2	-2.5	-2.9
Extended basic balance/GDP (%)	0.6	-0.3	-0.4	0.6	0.4
Net FDI (% of GDP)	3.0	2.0	1.9	2.1	2.4
Gross foreign debt (% of GDP)	64.4	64.3	66.6	62.9	58.9
FX reserves (EUR bn)	5.9	6.4	7.1	7.6	7.7
Months of imports, goods & services	7.3	7.8	10.0	9.2	8.7
Inflation/monetary/FX					
CPI (pavg.)	1.4	0.6	-1.0	1.3	1.9
CPI (eop)	1.6	0.3	-1.6	2.8	1.9
1M money-market rate (Dec. avg.)	-0.36	-0.44	-0.55	-0.54	-0.52
USD/FX (eop)	1.71	1.75	1.59	1.63	1.59
EUR/FX (eop)	1.96	1.96	1.96	1.96	1.96
USD/FX (pavg.)	1.66	1.75	1.72	1.64	1.61
EUR/FX (pavg.)	1.96	1.96	1.96	1.96	1.96

Sources: Central Bank of Bosnia and Herzegovina, Agency for Statistics of Bosnia and Herzegovina, UniCredit Research

*long-term foreign-currency credit ratings are provided by Moody's, S&P and Fitch, respectively.

A strong recovery is threatened by political turmoil

A strong recovery has been overshadowed by political turmoil. Three major political issues have emerged: the appointment of a new High Representative, a dispute over changes to the criminal code by the outgoing High Representative (which triggered a boycott by Bosnian Serb politician of central institutions) and a lack of consensus for making changes to B&H's election laws

Strong recovery of economic activity in Bosnia and Herzegovina in recent months has been overshadowed by political turmoil. Several controversial points have emerged, the most important being **1.** disagreements over the legality of the new High Representative's mandate, **2.** changes in the criminal code imposed by the outgoing High Representative and **3.** the lack of an agreement with regard to changes to B&H's election law in line with rulings by Bosnia and Herzegovina's Constitutional Court and the European Court of Human Rights. The first problem arose with the appointment of a new High Representative (Christian Schmidt). Milorad Dodik, the Bosnian Serb representative serving as B&H's president at the time, challenged its legality, arguing that his appointment should be voted on by the UN Security Council. He also expressed the view that the office of the High Representative in B&H should be abolished, which is in line with the position of Russia and inconsistent with the position of Western countries. Nevertheless, the new representative took office in early August, as the term of the former (Valentin Inzko) expired at the end of July. Mr. Dodik and other Bosnian Serb politicians have announced that they do not intend to cooperate with him. The second problem arose on 26 July, when, in a joint meeting, all Bosnian Serb political parties (opposition and ruling ones) decided not to participate in joint institutions of B&H starting from 27 July until the issue involving imposed changes to the country's criminal code by the outgoing High Representative in B&H is resolved. The changes include the introduction of prison sentences of up to five years for genocide deniers and for any glorification of war criminals, including the naming of streets or public institutions after them. From that day, all Bosnian Serb politicians from Republic of Srpska have been boycotting all activities of the Parliament, Council of Ministers and Presidency of B&H. Although their boycott is a serious political problem and can lead to more-serious political conflicts, in practice, decision-making at the central institutions of B&H has not yet been completely stopped. A prolonged boycott could, however, completely paralyze the functioning of central state institutions and jeopardize the smooth running of economic activity, in particular foreign investment and financing. The third problem, the lack of consensus regarding the new election law, could also further complicate the political situation, given that general elections are due to take place in autumn 2022.

Political problems have not impeded B&H's strong economic recovery so far. The recovery has been driven by a huge acceleration in exports of goods and services as well as in personal consumption. The main drivers of growth should be activity in export-oriented manufacturing sectors, followed in 2022 by a stronger recovery in personal consumption

The political problems described however have not impeded B&H's economic recovery so far. According to high-frequency data, strong recovery of economic activity in 2Q21 and in the beginning of 3Q21 was driven by a huge acceleration in exports of goods and services as well as in personal consumption. In the remainder of 2021, we expect the recovery to be driven primarily by export-oriented industrial activity and stronger growth in construction activity, further supported by strong growth in personal consumption and in exports of goods and services. GDP growth is expected to speed up in 2022, additionally supported by a more-pronounced recovery in personal consumption as an increase in remittances is expected to accelerate.

B&H's C/A deficit is likely to narrow to a record low of -2.5% of GDP in 2021 and should be covered by FDI, financing from international financial institutions and the EU

B&H's C/A deficit is narrowing due to much higher growth in exports of goods and services in comparison with imports, and this is likely to reach a record low equivalent to -2.5% of GDP for the whole year. A marginal widening is expected to occur in 2022 (to -2.9% of GDP) with the continuation of strong economic recovery due to the structural characteristics of the economy. Most of the projected C/A deficit is expected to be covered by FDI (2.1% of GDP in 2021) and the rest by financing from the IMF, the EU and other financial institutions. In that regard, the IMF recently disbursed about EUR 300mn (1.6% of GDP) of unconditional support to B&H as part of a general Special Drawing Rights allocation to all IMF members to support liquidity and economic recovery, and the EU announced the first tranche of its support of about EUR 250mn.

Moody's and S&P affirmed their credit ratings of B&H at the beginning of September

Possible further delays caused by current political turmoil to negotiations with the IMF regarding a new financial-assistance arrangement do not present a downside risk to our growth projections for this year (as financing is already secured) but may hinder acceleration of growth in the next few years. Moody's and S&P affirmed their credit ratings of B&H (B3 with stable outlook and B with stable outlook respectively) at the beginning of September.

North Macedonia

Not rated/BB- stable/BB+ Neg*

Outlook

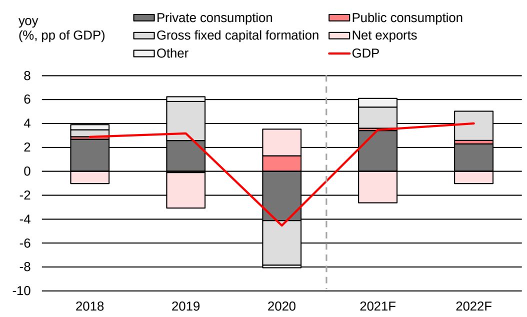
We expect GDP growth of 3.5% in 2021 after GDP had contracted by 4.1% in 2020. The main growth driver will likely be public investment and consumption. North Macedonia's fiscal deficit will likely narrow to 6.5% of GDP in 2021, with government debt increasing further. North Macedonia is unlikely to issue more debt internationally in 2021; the remaining funding needs will be covered by domestic issuance, international financial institutions and fiscal reserves. We expect the country's historical dispute with Bulgaria to be resolved and EU-accession negotiations to be formally opened in 1H22.

Author: Mauro Giorgio Marrano, Senior CEE Economist (UniCredit Bank, Vienna)

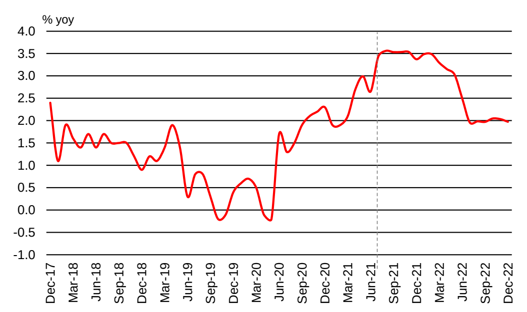
KEY DATES/EVENTS

- 7 Dec: 3Q21 GDP
- 29 Oct, 30 Nov, 30 Dec: Industrial production
- 5 Nov: rating update by Fitch

GDP GROWTH FORECAST



INFLATION FORECAST



Source: state statistics office, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

EUR bn	2018	2019	2020E	2021F	2022F
GDP (EUR bn)	10.7	11.2	10.8	11.5	12.2
Population (mn)	2.1	2.1	2.1	2.1	2.1
GDP per capita (EUR)	5,116	5,318	5,135	5,459	5,823
Real economy, change (%)					
GDP	2.9	3.2	-4.5	3.5	4.0
Private consumption	3.7	3.5	-5.6	4.7	3.1
Gross capital formation**	1.7	9.5	-10.2	5.2	7.0
Public consumption	1.5	-0.8	10.1	1.3	2.0
Exports	12.8	7.2	-10.9	13.0	9.8
Imports	10.7	8.9	-10.5	12.7	8.4
Monthly wage, nominal (EUR)	579	609	660	693	727
Real wage, change (%)	4.2	5.1	8.3	5.0	5.0
Unemployment rate (%)	20.7	17.3	16.4	16.2	15.8
Fiscal accounts (% of GDP)					
Budget balance (central government)	-1.8	-2.0	-8.1	-6.5	-3.5
Primary balance (central government)	-0.6	-0.8	-6.9	-5.3	-2.4
Government debt (general government)	40.6	40.2	51.0	53.5	54.5
External accounts					
Current account balance (EUR bn)	0.0	-0.4	-0.4	-0.4	-0.4
Current account balance/GDP (%)	-0.1	-3.3	-3.5	-3.3	-3.3
Extended basic balance/GDP (%)	5.7	0.0	-1.5	-0.6	-0.1
Net FDI (% of GDP)	5.6	3.3	1.9	2.7	3.1
Gross foreign debt (% of GDP)	73.0	72.7	80.2	83.0	82.0
FX reserves (EUR bn)	2.9	3.3	3.4	3.2	3.2
Months of imports, goods & services	4.4	4.6	5.3	4.5	4.1
Inflation/monetary/FX					
CPI (pavg)	1.5	0.8	1.2	2.9	2.6
CPI (eop)	0.9	0.4	2.3	3.4	2.0
Central bank target	-	-	-	-	-
Central bank reference rate (eop)	2.50	2.25	1.50	1.25	1.25
USD-MKD (eop)	53.7	55.0	50.2	51.8	50.5
EUR-MKD (eop)	61.50	61.5	61.7	61.6	61.6
USD-MKD (pavg)	52.2	55.0	52.6	51.0	51.1
EUR-MKD (pavg)	61.5	61.5	61.6	61.6	61.6

**Gross capital formation also includes inventories. The national statistics office does not publish a separate quarterly series for gross fixed capital formation.

Source: state statistics office, ministry of finance, National Bank of the Republic of North Macedonia, Bloomberg, UniCredit Research

*long-term foreign currency credit rating as provided by Moody's, S&P and Fitch, respectively

Further recovery with some near-term headwinds

We expect growth of 3.5% in 2021 and 4.1% in 2022

We expect GDP growth of 3.5% in 2021 after GDP had contracted by 4.1% in 2020. After average growth of 5.2% yoy in 1H21, first data for 3Q21 show a mixed picture. While growth in retail trade remained strong, annual growth in manufacturing showed a renewed broad-based contraction, probably in part due to the impact of supply-chain bottlenecks in North Macedonia and its main trading partners. In 4Q21, growth is likely to slow on the back of persistent global supply-chain bottlenecks and an expected global slowdown weighing on external demand. In 2022, growth could strengthen to around 4%, driven by the economic recovery in North Macedonia's main trading partners and higher domestic demand.

Public investment will probably play a smaller role than initially expected

The contribution of public investment is likely to be smaller than initially expected. The budget 2021 envisages an almost doubling of government capital expenditure, which should have brought it to over 4% of GDP. However, implementation appears to be lagging behind as only 30% of it was implemented between January and July. While an acceleration of expenditure is likely in the final months of the year, reaching the planned amount appears ambitious.

Consumption supported by wages and pensions increases, and improvement in the labor market

At the same time, the recovery in consumption has been stronger than anticipated and will continue to be supported by the increase in public-sector wages, pensions and the improvement in the labor market. The budget 2021 included an increase of more than 6% for wages and allowances and 4% for social transfers. In addition, the latest data show that the pace of decline in the unemployed has started to revert, and there are first indications of employment starting to pick up.

Inflation likely to remain close to 3.5% before starting to slow towards 2% in 1Q22

Inflation will probably remain close to 3.5% yoy before starting to slow in 1Q22. The increase in inflation since the beginning of the year was driven by food prices, in particular the non-seasonal increase in fresh-vegetables prices, energy prices and prices for transport services in July. We expect inflation to start to slow at the end of 1Q22 due to the base effect in oil prices, with a more pronounced slowdown in 2H22 due to base effects in food and transport services prices, which should bring inflation to around 2% at year-end. The main risks relate to commodity prices and the supply-chain bottlenecks.

Narrower deficit in 2021 but government debt likely to continue to increase

The central government deficit as a percentage of GDP is likely to narrow from around 8% to 6.5% in 2021, reflecting an improvement in the economic outlook and the expiration of most support measures. The deficit could turn out to be smaller if the underspending in capital continues (only 30% of the planned capital expenditure has been implemented and the revenue side continues to perform well). This could also provide a buffer in case additional spending related to the pandemic is needed. Large deficits in 2021 and 2022 mean that government debt will likely increase during these two years. Looking ahead, the fiscal consolidation plan targets a reduction in the government deficit to 2.5% of GDP by 2025 through the improvement of revenue collection and a reduction in, and a restructuring of, current expenditure.

Remaining funding needs for 2021 to be covered by domestic issuance and IFI funding

We expect the remaining financing needs for 2021 to be covered by fiscal reserves, domestic issuance and IFI funding. We estimate financing needs for the remainder of the year at around EUR 600mn, which we expect to be covered, in part, with fiscal reserves (total available EUR 700mn at the end of August), the remaining planned domestic borrowing (EUR 120mn) and IFI loans (we estimate around EUR 250mn, including the IMF emergency assistance). In 2022, financing needs will likely be lower due to lower repayments (around EUR 400mn compared to EUR 850mn in 2021) and a smaller deficit, however North Macedonia might do some pre-financing in view of higher repayments in 2023 (around EUR 1bn). We expect EU funding to play an increasing role considering the announced Economic and Investment Plan for the Western Balkans.

Formal start of EU-accession negotiations expected in 1H22

The formal start of EU-accession negotiations will probably take place in 1H22. The start of negotiations was blocked again at the European Council meeting in June, with Bulgaria vetoing the opening of negotiations due to a dispute involving historical, identity and language issues. Since then, political parties in Bulgaria have not been able to form a government, hence there has been no progress on the bilateral negotiations. We think the veto will eventually be lifted, possibly in 1H22.

Russia

Baa3 stable/BBB- stable/ BBB stable*

Outlook

The Russian economy reached pre-pandemic levels of output in 3Q21, but economic growth is decelerating. While sentiment and indicators suggest that the pandemic is less of an impediment to consumer spending, official support to the economy will shift from post-pandemic and pre-election spending to investment. With an OPEC+ agreement in place, Russia's C/A surplus would increase despite declining oil prices. A positive carry would support the RUB to appreciate in 2022 in both real and nominal terms. But following a solid 4% growth rate this year, GDP might grow by only 2.4% in 2022 amid tight monetary conditions and decelerating inflation. The CBR could hike once more to 7% this year, cutting to 6.5% in 2022 as inflation falls towards target. The CBR is planning a policy review in 2022 that could reduce the inflation target to 3%, in line with long-term inflation pressure.

Strategy

RUB assets could benefit from falling inflation, more CBR cuts than the market prices in and low reliance on foreign funding.

Authors:
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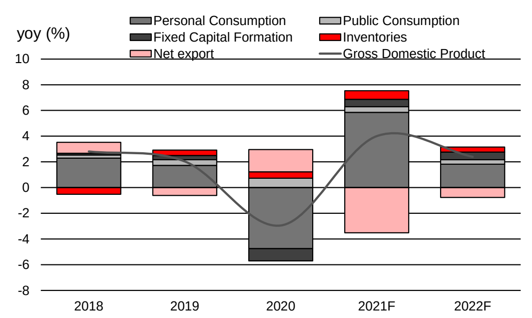
Ariel Chernyy, Economist (UniCredit Russia)

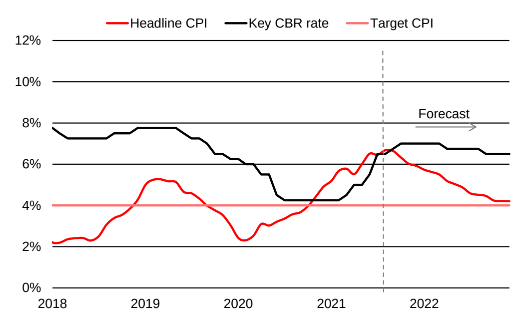
KEY DATES/EVENTS

- 6 October, 3 November, 8 December: CPI
- 22 October, 17 December: monetary policy meetings
- 10 November, 15 December: 3Q21 GDP (flash, structure)
- 18-22 of each month: monthly economic data
- 3 December: rating update from Fitch

GDP GROWTH FORECAST



INFLATION FORECAST



Source: CBR, Rosstat, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

EUR bn	2018	2019	2020	2021F	2022F
GDP (EUR bn)	1404.4	1507.0	1297.1	1346.0	1448.4
Population (mn)	147.0	147.0	147.0	146.9	146.9
GDP per capita (EUR)	9,555	10,252	8,825	9,161	9,862
Real economy, change (%)					
GDP	2.8	2.0	-3.0	4.0	2.4
Private consumption	4.3	3.2	-8.6	9.2	3.6
Fixed investment	0.6	1.5	-4.3	2.2	3.2
Public consumption	1.3	2.4	4.0	1.8	2.0
Exports	5.6	0.7	-4.3	1.6	3.9
Imports	2.7	3.4	-12.0	15.1	7.7
Monthly wage, nominal (EUR)	591	674	636	654	707
Real wage, change (%)	8.5	4.8	3.8	3.0	2.0
Unemployment rate (%)	4.8	4.6	5.9	5.0	4.8
Fiscal accounts (% of GDP)					
Budget balance	2.6	1.8	-3.8	0.3	0.6
Primary balance	3.4	2.5	-3.1	1.1	1.4
Public debt	12.1	13.2	18.4	18.5	18.9
External accounts					
Current account balance (EUR bn)	96.4	58.4	31.6	78.1	64.0
Current account balance/GDP (%)	6.9	3.9	2.4	5.8	4.4
Extended basic balance/GDP (%)	5.5	4.5	2.7	4.5	3.5
Net FDI (% of GDP)	-1.4	0.6	0.2	-1.3	-0.9
Gross foreign debt (% of GDP)	28.2	29.1	29.7	27.9	25.0
FX reserves (EUR bn)	324.2	386.4	363.9	409.7	432.0
Months of imports, goods & services	11.3	13.1	14.4	14.3	13.5
Inflation/monetary/FX					
CPI (pavg.)	2.9	4.5	3.4	6.1	5.1
CPI (eop)	4.3	3.0	4.9	5.9	4.2
Central bank target	4.0	4.0	4.0	4.0	4.0
Central bank reference rate (eop)	7.75	6.25	4.25	7.00	6.50
3M money market rate (Dec avg.)	8.6	6.6	4.9	7.3	6.8
3M money market rate (year avg.)	7.7	7.8	5.4	6.1	7.0
USD-RUB (eop)	69.5	61.9	73.9	72.0	70.5
EUR-RUB (eop)	79.5	69.3	90.7	85.7	86.0
USD-RUB (pavg.)	62.7	64.7	72.2	73.6	71.2
EUR-RUB (pavg.)	74.0	72.5	82.5	87.5	86.8

Source Rosstat, CBR, UniCredit Research

*long-term foreign-currency credit rating at Moody's, S&P and Fitch, respectively

Recovery and inflation losing steam

The Russian economy reached pre-pandemic levels of output in 3Q21, and economic growth is decelerating

The Russian economy reached pre-pandemic levels of output in 3Q21 but high-frequency indicators, especially forward-looking indices, suggest that economic growth is decelerating. Over the summer, PMIs fell below 50 in both manufacturing and services, implying a contraction in activity. Supply-chain bottlenecks persist, slowing output growth and putting pressure on input and output prices. Labor-market conditions have tightened, with unemployment falling to pre-COVID levels and vacancies remaining close to historic highs. Insufficient migrant labor due to closed borders is adding to labor shortages, especially in construction and agriculture.

Sentiment and spending indicators suggest that the pandemic is less of an impediment to consumer spending

On the demand side, consumption is more resilient as wage growth benefits from tight labor-market conditions. However, the biggest boost to consumer demand comes from rapid growth in consumer lending and the savings rate falling back to (already very low) pre-COVID levels. One-off payments to pensioners and military personnel ahead of Duma elections added 0.4% of GDP to household income. Sentiment and spending indicators suggest that the pandemic is less of an impediment to consumer spending, despite only 27% of the population being fully vaccinated.

After winning a majority in the Duma, United Russia is expected to address several priorities. The first is digitalization, which is aimed at improving the functioning of the state. Second comes the slowly progressing economic integration with Belarus. In early September, the presidents of the two countries signed several documents meant to accelerate the process, although we expect very little progress to be made before the current presidential term ends in 2024.

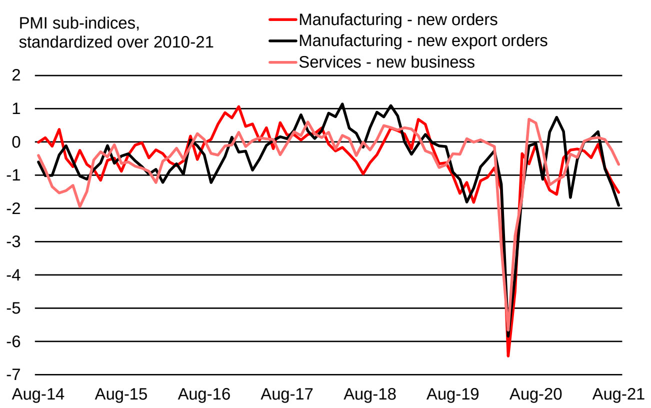
Support to the economy will shift in the coming quarters from post-pandemic and pre-election spending to investment…

Third, official support to the economy will shift in the coming quarters from post-pandemic and pre-election spending to investment. Support to various disadvantaged groups (which this year could cost up to RUB 700bn or 0.6% of GDP) will be phased out. Adding tighter monetary and financial conditions, and higher debt service for mortgage borrowers, lower transfers to households could slow consumer spending in 2022.

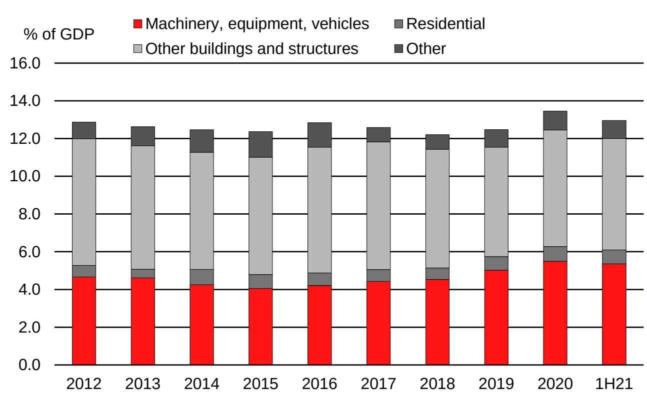
…for which the authorities are preparing to start spending money from the NWF

At the same time, the authorities have agreed to start spending in excess of 7% of GDP from the National Wealth Fund (NWF). Currently, there is USD 190bn (equivalent to approximately 12% of GDP) in the NWF. The authorities wish to direct around RUB 1.4tn (10% of the NWF) to various projects in 2021-24. Since spending will probably be minimal in 2021, almost RUB 500bn will be available annually in 2022-24. Planned spending on highways and railroads, and new production facilities in manufacturing industries could increase the share of investment in GDP, support private capex and improve potential growth. However, the track record of public investment is mixed at best, with national projects still delayed due to poor planning. If drawdowns from the NWF cover recurring spending, the risk is that public spending will increase in the long term once excess funds from the NWF are exhausted.

PMIS SUGGEST ECONOMIC ACTIVITY IS DECELERATING



FAILURE TO BOOST INVESTMENT IN THE PAST DECADE



Source: IHS Markit, Rosstat, UniCredit Research

Trade surplus boosted by oil and gas exports

Exports will depend on the speed of the global recovery. Supply shortages of natural gas are boosting Russian exports and may continue to do so at least in 1Q22. If OPEC+ keeps production in line with the agreement currently in place, Russia's oil output and exports might increase by approximately 15% in 2022, leading to a larger C/A surplus even if oil prices decline from current levels to around USD 60/bbl. Larger exports would be partly offset by an increase in imports, especially in services.

No large increase in gas supply to Europe expected in the short term

After significant gas consumption during the previous winter, Russian gas stores were depleted in line with those in Europe. Thus, Russian gas producers prioritizes filling local stores over increasing export sales. Although the domestic gas market is heavily regulated when it comes to retail prices for households, companies are not insured from price jumps. Despite Russian gas production growing to 760bn m^3 in 2021, the highest volume on record (thanks to investment in previous years), most of the additional production will be used to meet elevated local demand. Thus, the opening of Nord Stream 2 looks like a medium-term opportunity and a way to mitigate transit risks on other routes, rather than a way to boost sales in the short term. Higher exports from other Russian producers (e.g. of LNG) would not change the situation in the short term due to their smaller production and transport capacities.

The RUB could appreciate in 2022 in real and nominal terms

Trade flows will add to a positive carry in supporting the RUB, which could appreciate in 2022 in both real and nominal terms. We expect USD-RUB to touch 70 in the coming quarters, although in the long term the currency is likely to depreciate in nominal terms.

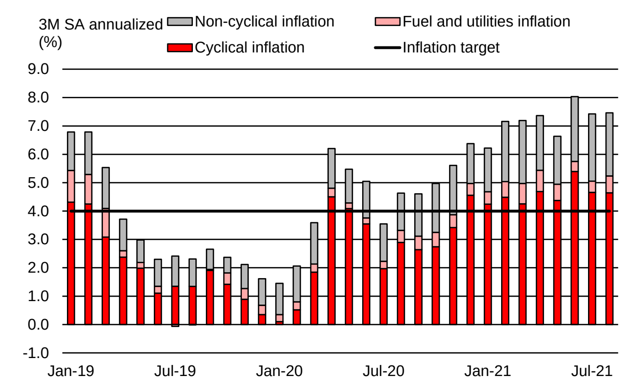
GDP could grow by 4% this year, and by 2.4% in 2022…

The above-mentioned trends imply that GDP growth will remain above potential in the coming quarters, slowing in 2022. Following a solid 4% growth rate this year, GDP could increase by 2.4% in 2022. A similar picture would be observed in inflation, which could end 2021 at around 6%, meaning the CBR missing its inflation target for a second year in a row. The good news is that inflation momentum (3M SA annualized inflation) seems to have peaked in June. The bad news is that it continues to be sticky and could delay disinflation. In 2022, inflation could fall to 4.2% due to base effects, the resolution of supply-chain bottlenecks and slower growth in consumer demand amid tighter financial conditions. Tighter capital requirements for retail lending are likely to slow the increase in lending volumes in 2022.

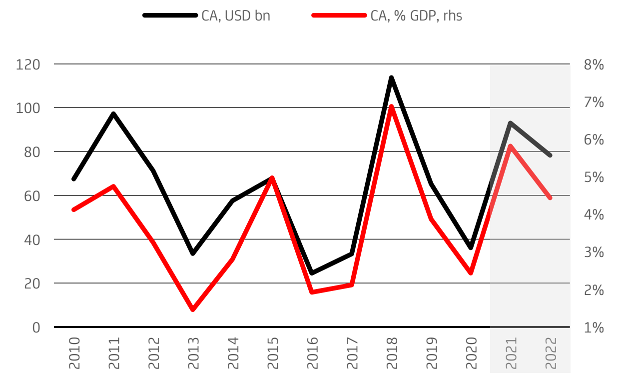
…amid tight monetary and financial conditions

In response to accelerating inflation, monetary conditions tightened rapidly. The Bank of Russia is likely to raise the policy rate to 7% before year-end, citing broad-based inflationary pressure. Thus, the ex-ante real policy rate could end 2021 above 2.5%, one of the highest levels in EM. In 2022, we expect the CBR to maintain a large, positive real interest rate, even after cutting the key rate to 6.5% or lower. The CBR leadership is planning a policy review in 2022, during which the inflation target might be decreased, potentially to 3%. We believe that this is in line with underlying inflationary pressure in normal times.

INFLATION MOMENTUM PEAKED IN JUNE, BUT REMAINS HIGH



THE CURRENT ACCOUNT SURPLUS COULD RISE IN 2021



Source: CBR, Rosstat, UniCredit Research

Russian financial assets – a likely outperformer in EM

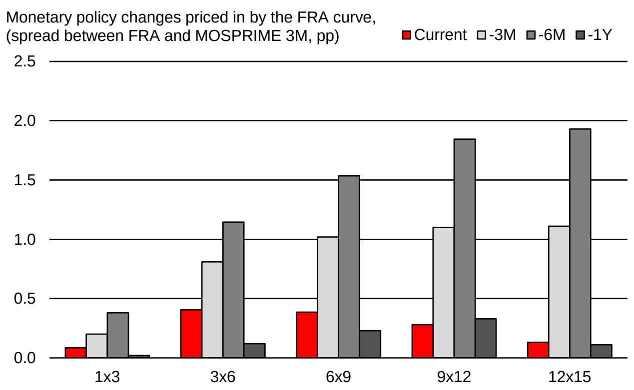
RUB assets look attractive among EM peers…

With the CBR approaching the end of the tightening cycle, we believe that RUB rates, OFZs and the RUB are attractive compared to Russia's EM peers. Expected cuts in 2022 will benefit short-term rates, while the RUB will continue to be supported by the high carry and little to no reliance on foreign funding. In our view, the market is pricing too little in cuts for next year and this provides additional opportunities for a rally if inflation falls, as expected.

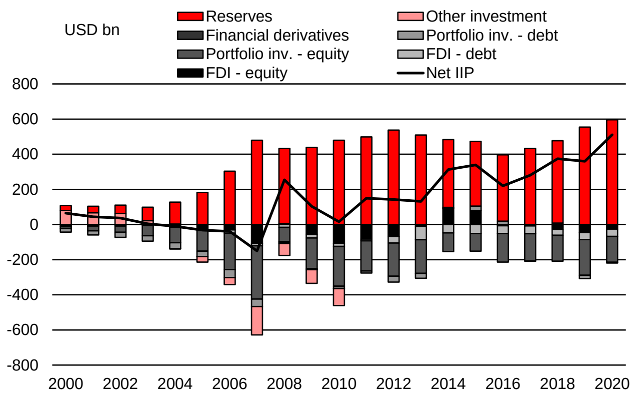
…and benefit from little reliance on foreign funding

The net international investment position (NIIP) continues to improve as Russia accumulates reserves. Adding low public debt, Russia's sovereign rating should improve further, were it not for potential (geo)political risks. Sanctions on secondary OFZ trading by US entities, which are currently being considered by the US Congress, could be mitigated by the country's low reliance on foreign funding.

THE MARKET IS PRICING TOO LITTLE IN CUTS FOR 2022



RISING NIIP SUPPORTS THE RUB



Source: Russian Ministry of Finance, CBR, UniCredit Research

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2020	2021F	2022F
Gross financing requirement	**61.5**	**8.4**	**6.3**
Budget deficit	49.7	-3.4	-8.2
Amortization of public debt	11.8	11.8	14.4
Domestic	7.0	11.3	12.2
Bonds	7.0	11.3	12.2
Bills	--	--	--
Loans	0.0	0.0	0.0
External	4.8	0.6	2.2
Bonds	4.8	0.6	2.2
Loans	0.0	0.0	0.0
Other	0.0	0.0	0.0
Financing	**61.5**	**8.4**	**6.3**
Domestic borrowing	62.9	42.5	36.6
Bonds	62.8	41.9	35.9
Bills	--	--	--
Loans	0.1	0.6	0.7
External borrowing	3.6	3.5	2.7
Bonds	3.6	3.5	2.7
Privatization	0.0	0.0	0.0
Revaluation	0.0	0.0	0.0
Change in fiscal reserves (- = increase)	-4.9	-37.6	-33.0

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2020	2021F	2022F
Gross financing requirement	**61.1**	**6.7**	**17.7**
C/A deficit	-31.2	-78.1	-64.0
Amortization of medium and long term debt	41.7	46.4	46.2
Government/central bank	3.5	3.5	4.3
Banks	3.0	4.5	3.8
Corporates/Other	35.2	38.4	38.0
Amortization of short-term debt	50.5	38.5	35.6
Financing	**61.1**	**6.7**	**17.7**
FDI (net)	3.1	-17.6	-12.7
Portfolio investments (net)	-23.9	-7.6	-1.5
Medium and long-term borrowing	20.9	32.0	40.3
Government/central bank	5.5	3.7	5.3
Banks	-20.4	-5.0	-5.5
Corporates/Other	35.8	33.3	40.5
Short-term borrowing	40.1	36.5	34.0
Other investment (net)	8.8	-0.4	-10.1
Change in FX reserves (- = increase)	12.1	-36.2	-32.4
Memoranda:			
Nonresident purchases of LC gov't bonds	1.1	0.0	0.8
International bond issuance, net	-1.2	2.9	0.5

Source: CBR, Rosstat, Russian Ministry of Finance, UniCredit Research

Serbia

Ba2 stable/BB+ stable/BB+ stable

Outlook

We expect GDP to grow by 7.0% in 2021 and by 4.5% in 2022. Better fiscal performance means the government deficit for 2021 could amount to 4.5% of GDP, compared to the 7% initially envisaged. In 2020, the deficit could decline to close to 3% in 2022, and public debt could resume its downward trend. Inflation is likely to remain around the upper limit of the target range before falling back to 3.5% by end-2022. If the NBS remains on hold, by mid-2022, it could face a trade-off between FX intervention and higher interest rates. Early parliamentary elections are scheduled for spring 2022, along with presidential and local elections.

Strategy

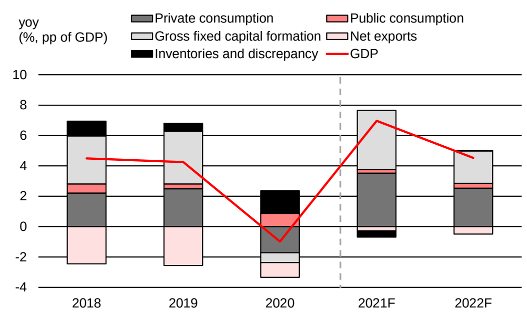
SERBGBs look expensive compared to their peers, but Serbia's fiscal story is solid and its inflation outlook is benign. In our view, the scope for a further SERBGB rally in 2022 is very limited.

Author: Mauro Giorgio Marrano, Senior CEE Economist (UniCredit Bank, Vienna)

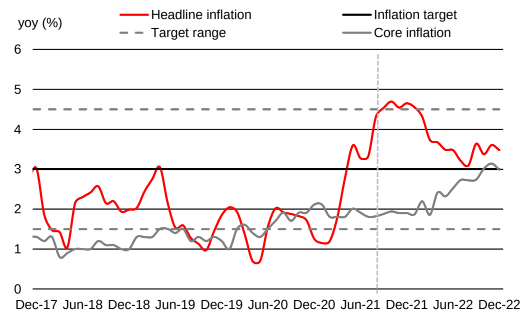
KEY DATES/EVENTS

- 7 Oct, 9 Nov, 9 Dec: NBS monetary policy meetings
- 12 Oct, 12 Nov, 13 Dec: CPI inflation
- 30 Nov: 3Q21 GDP
- 10 Dec: S&P to update sovereign rating

GDP GROWTH FORECAST



INFLATION FORECAST



Source: SORS, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2018	2019	2020	2021F	2022F
GDP (EUR bn)	42.9	46.0	46.5	51.4	55.4
Population (mn)	7.0	6.9	6.9	6.9	6.8
GDP per capita (EUR)	6,143	6,618	6,727	7,484	8,108
Real economy, change (%)					
GDP	4.5	4.2	-1.0	7.0	4.5
Private consumption	3.1	3.6	-2.5	5.1	3.8
Fixed investment	17.5	17.2	-2.8	17.5	8.7
Public consumption	3.7	2.0	5.6	1.4	2.0
Exports	7.5	7.7	-5.9	17.1	9.0
Imports	10.8	10.7	-3.5	14.3	8.2
Monthly wage, nominal (EUR)	580	643	706	757	802
Real wage, change (%)	2.0	8.5	7.8	3.8	2.3
Unemployment rate (%)	14.1	11.6	10.1	11.5	10.0
Fiscal accounts (% of GDP)					
Budget balance	0.6	-0.2	-8.1	-4.5	-2.8
Primary balance	2.8	1.8	-6.1	-2.7	-1.1
Public debt	54.4	52.9	58.2	59.0	57.9
External accounts					
Current account balance (EUR bn)	-2.1	-3.2	-2.0	-2.0	-2.3
Current account balance (% of GDP)	-4.8	-6.9	-4.3	-4.0	-4.2
Extended basic balance/GDP (%)	2.5	0.8	2.0	1.3	1.2
Net FDI (% of GDP)	7.4	7.7	6.2	5.3	5.4
Gross foreign debt (% of GDP)	62.2	61.5	66.3	65.0	63.1
FX reserves (EUR bn)	12.1	13.5	13.8	15.1	15.6
Months of imports, goods & services	5.8	5.8	6.3	5.8	5.4
Inflation/Monetary/FX					
CPI (pavg)	2.0	1.8	1.6	3.3	3.6
CPI (eop)	2.0	1.8	1.3	4.7	3.5
Central bank target	3.0	3.0	3.0	3.0	3.0
Central bank reference rate (eop)	3.00	2.25	1.00	1.00	1.00
3M money market rate (Dec avg)	3.04	1.67	0.94	0.88	1.10
USD/FX (eop)	103.4	104.9	95.7	96.4	94.2
EUR/FX (eop)	118.2	117.6	117.6	117.6	117.8
USD/FX (pavg)	100.2	105.2	103.2	97.8	94.9
EUR/FX (pavg)	118.3	117.9	117.6	117.6	117.6

Source: Bloomberg, Eurostat, SORS, NBS, Public Debt Agency, UniCredit Research

*The long-term foreign-currency credit rating is provided by Moody's, S&P and Fitch, respectively.

Domestic demand to power growth

We confirm our GDP-growth forecasts for 2021 at 7% and at 4.5% for 2022

We confirm our GDP-growth forecasts of 7% for 2021 (-1% in 2020) and of 4.5% for 2022. Our forecasts imply that Serbian GDP growth will already be close to 5% above its pre-pandemic level at end-2021 and 10% above that level at end-2022.

Growth is likely to be driven by domestic demand

While supply-chain bottlenecks and a softening of global growth are likely to weigh on external demand until mid-2022, domestic demand will continue to power growth.

Significant capital expenditure is in the pipeline for 2H21 and 2022

Government capital expenditure is planned to increase significantly in 2H21 and 2022. According to Serbia's 2021 budget, capital expenditure of RSD 270bn (4.4% of GDP) remains to the be implemented between August and December, out of the total amount planned (RSD 430bn, or 7% of GDP). While completion of the plan appears ambitious, if 70% of the remaining expenditure is implemented, this would add around 1.5pp to growth in 2H21. Government capital expenditure is planned to remain high in 2022, at 7% of GDP, which implies 20% growth adding over 1pp to GDP growth. We expect private investment to also contribute to growth, as uncertainty surrounding the pandemic diminishes and interest rates remain low.

Consumption growth has been supported by wage increases and improvement in the labor market

Consumption will likely be supported by wage and pension increases, a hike in the minimum wage and recovery of the labor market. Public-sector wages were increased by over 5% in 2021, and a 4.5% hike is planned in 2022. Pensions were increased by 5.9% in 2021, and a similar increase is planned for 2022, according to Serbia's indexation formula. However, in the run-up to presidential, parliamentary and local elections in spring, additional increases are likely, given fiscal overperformance to date. The minimum wage will rise by 9.2% in 2022. Improvement in the labor market will support consumption. After fallout from the pandemic was limited thanks to support measures, unemployment started to fall in May (right chart).

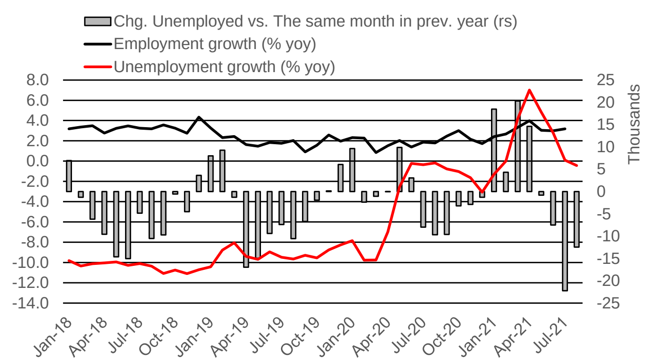
Net exports will likely subtract from growth in 2020

Global growth will likely improve in 2H22. However, we expect this improvement in exports to be offset by a rise in imports, leading to a negative contribution by net exports in 2022.

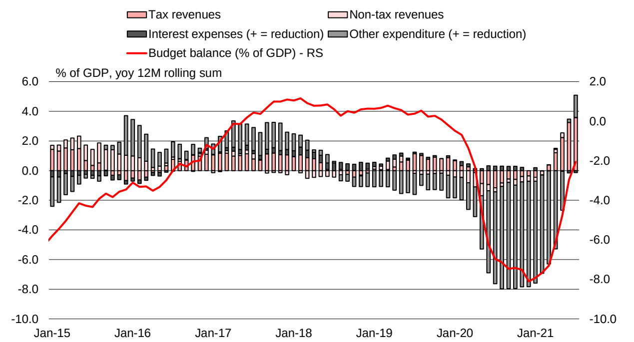
Fiscal space for potential extensions of COVID-19 support measures and pre-electoral spending

Better-than-expected fiscal performance implies fiscal space for extensions of COVID-19 support measures and pre-electoral spending. In January-July, the general government deficit amounted to RSD 6bn, compared to a planned deficit of RSD 186bn. According to the ministry of finance, the over performance is due to better revenue collection, although it probably also reflects lower-than-envisaged capital expenditure. If this outperformance in revenues is maintained and if capital expenditure for the reminder of the year amounts to RSD 190bn (3% of GDP), some COVID-19 support measures are extended and there is pre-electoral spending on public-sector wages and pensions, the deficit could amount to 4.5% of GDP, compared to the 7% initially envisaged. In 2022, the deficit will likely narrow to close to 3%, reflecting the phasing out of fiscal support measures, resulting in government debt as a percentage of GDP falling slightly from 59.0% to 57.9%

UNEMPLOYMENT STARTED TO DECLINE IN MAY



IMPROVEMENT IN FISCAL PERFORMANCE



Source: SORS, European Commission, Haver, UniCredit Research

Inflation is likely to remain around the upper limit of the target range before falling back

Inflation is likely to remain around the upper limit of the target range before falling back. After reaching 4.3% yoy in August, with core inflation still stable around 2% yoy, inflation will probably increase further to 4.7% yoy by year-end, driven by base effects in food prices. Then, we expect it to remain around the upper limit of the target range (4.5% yoy) in 1Q22. In 2Q22, we project that inflation is likely to start slowing, driven by lower inflation in food and energy prices, and with core inflation on a gradual upward trend. We expect to see inflation at 3.5% yoy at end-2022. The main risks are oil prices and global supply-chain disruptions.

NBS will try to keep the policy rate unhanged

With inflation likely to remain within the target range and core inflation still below target, the NBS is likely to try to keep its policy rate unchanged. Hikes could be prompted by sustained pressure on the currency if appetite for EM assets sours next year. If the NBS remains on hold, by mid-2022, Serbia will have the lowest carry in CEE, and the central bank could face a trade-off between FX intervention and higher interest rates. FX reserves remain comfortably high.

CAD to remain covered by FDI

The current-account deficit (CAD) will likely remain large, but we do not foresee financing risks. We project that the CAD, after narrowing to 4.3% of GDP in 2020, will amount to 4.0% of GDP in 2021 and to 4.3% of GDP in 2022. We expect the CAD to continue to be financed through FDI, which remained very resilient in 2020 and 2021, at around 6% of GDP (left chart).

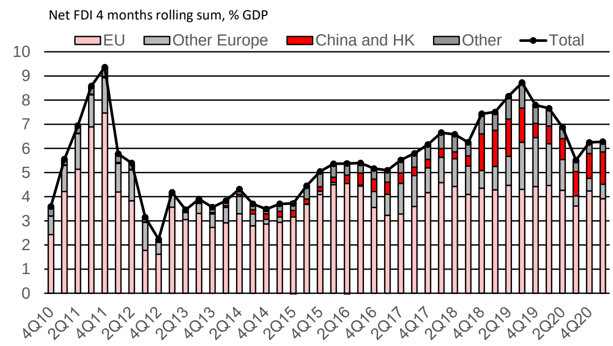
Negotiations with Kosovo: no breakthrough is in sight

There was little progress in talks about the normalization of relations between Serbia and Kosovo over the summer. There are no indications that a breakthrough is in sight. Most recently, there was a flare up of tensions in relation to Kosovo's decision to ban vehicles with Serbian license plates. A meeting between Serbian President Aleksandar Vučić and Kosovo Prime Minister Albin Kurti, planned for September following the meeting in July, was cancelled. The main outcome of the talks continues to be that the dialogue continues.

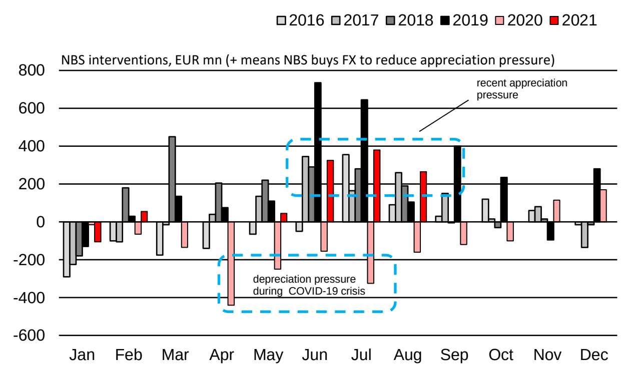
Early elections are scheduled for 2022

Early parliamentary elections are scheduled for Spring 2022 along with presidential and local elections. The party of Mr. Vučić and its allies are very likely to retain their majority in Serbia's National Assembly. The focus will be on the dialogue with opposition parties after a large number of them boycotted elections in June 2020. The dialogue facilitated by the European Parliament (EP) between government and part of the opposition has resumed. The government has also started a dialogue with the opposition parties that refused EP mediation, At the time of writing, an agreement with the opposition parties does not appear to be in sight. Therefore, it cannot be ruled out that some of them might boycott elections again. The government has also been challenged by the environmental movement, which is a relatively new element of the Serbian political landscape. However, the environmental movement has not formed a political party yet. Therefore, it might not play a direct role in the forthcoming elections.

RESILIENT FDI CONTINUES TO COVER THE CAD



APPRECIATION PRESSURE ON THE DINAR

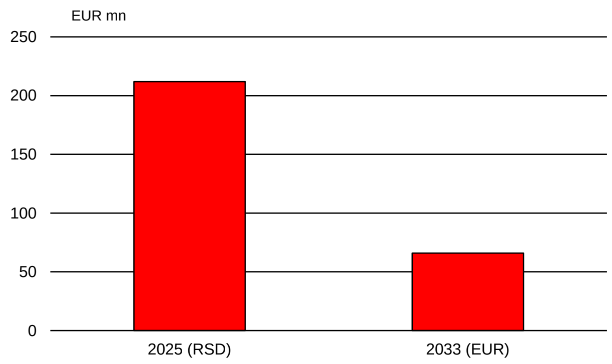


Source: NBS, SORS, UniCredit Research

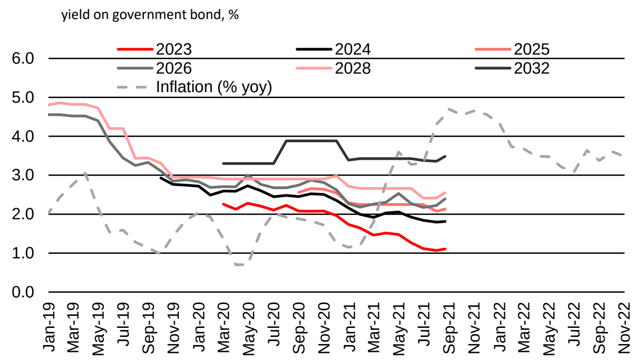
Limited issuance in 4Q21

The government plans to issue EUR 212mn of SERGBS in local currency and EUR 66mn in euro in 4Q21. The remaining financing needs for the reminder of the year, which we estimate at EUR 2.0bn, are to be covered with the remaining domestic issuance (EUR 0.3bn), IFIs lending (EUR 0.3bn), and fiscal reserves (EUR 2.5bn). In 2022, we expect financing needs to be lower, EUR 4.5bn (vs. EUR 5.5bn in 2021). SERBGBs look expensive compared to their peers, but Serbia's fiscal story is solid and its inflation outlook benign. In our view, scope for a further SERBGB rally in 2022 is very limited.

SERBGB ISSUANCE PLAN FOR 4Q21



REAL YIELDS ARE LESS NEAGATIVE THAN THOSE OF MOST CEE COUNTRIES



Source: NBS, Ministry of Finance, Public Debt Agency, SORS, UniCredit Research

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2020	2021F	2022F
Gross financing requirement	**6.6**	**5.5**	**4.5**
Budget deficit	3.8	2.3	1.6
Amortization of public debt	2.8	3.2	2.9
Domestic	1.5	1.6	1.9
Bonds	1.4	1.3	1.3
Bills	0.1	0.1	0.1
IFIs/others	0.0	0.2	0.5
External	1.3	1.6	1.0
Bonds	1.0	0.6	0.0
IFIs/others	0.3	1.0	1.0
Financing	**6.6**	**5.5**	**4.5**
Domestic borrowing	3.0	2.0	2.6
Bonds	2.7	2.0	2.5
Bills	0.1	0.0	0.1
Others	0.2	0.0	0.0
External borrowing	3.4	3.6	1.5
Bonds	3.0	2.8	1.0
IFIs/others	0.4	0.8	0.5
Fiscal reserves change (- =increase)	0.2	0.0	0.4

Source: Bloomberg, NBS, Ministry of Finance, Public Debt Agency, SORS, UniCredit Research

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2020	2021F	2022F
Gross financing requirement	**6.0**	**7.5**	**6.9**
C/A deficit	2.0	2.0	2.3
Amortization of medium- and long-term debt	3.0	4.6	3.7
Government/Central Bank	1.7	1.9	1.3
Banks	0.7	0.8	0.5
Corporates	0.6	2.0	2.0
Amortization of short-term debt	1.0	0.9	0.9
Government/Central Bank	0.0	0.0	0.0
Banks	0.9	0.8	0.8
Corporates	0.1	0.1	0.1
Financing	**6.0**	**7.5**	**6.9**
FDI (net)	2.9	2.7	3.0
Medium and long-term borrowing	5.0	6.1	4.2
Government/central bank	3.9	4.0	2.0
IFIs/others	0.4	0.8	0.5
Banks	0.6	0.5	0.4
Corporates	0.5	1.7	1.8
Short-term borrowing	1.0	0.6	0.6
Other	-2.7	-1.3	-0.5
Change in FX reserves (- = increase)	-0.2	-0.6	-0.4
Memoranda:			
Nonresident purchases of LC govt bonds	-0.1	0.1	0.2
International bond issuance, net	2.0	2.2	1.0

Turkey

B2 negative/B+ stable/BB- stable*

Outlook

Turkey's economy could grow by 9.7% this year and by 5.5% next year. Inflation is expected to start to decelerate gradually from November onward, and to reach 18.4% at the end of this year and 14.4% next year. Following a 1pp cut in September, the CBRT could lower its policy rate by another 3pp by the end of 2021, and eventually to 14.5% in 2022.

Strategy

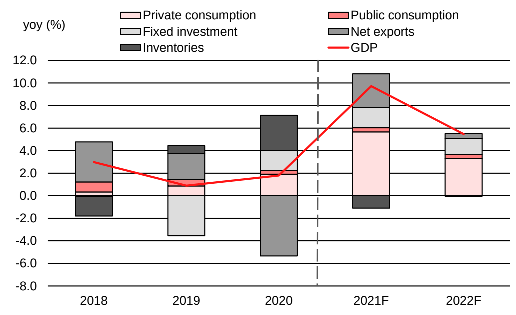
Rate-cut expectations could attract inflows into the local bond market, helping TRY weather risks in the short term.

Author: Gökçe Çelik, Senior CEE Economist (UniCredit Bank, London)

KEY DATES/EVENTS

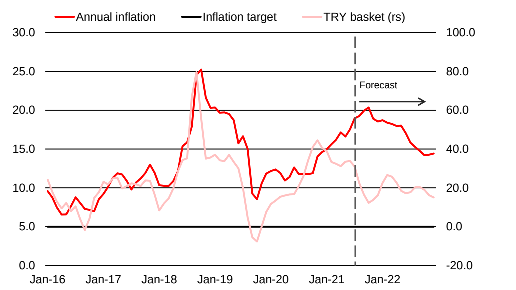
- 4 Oct, 3 Nov, 3 Dec: inflation data
- 21 Oct, 18 Nov, 16 Dec: monetary-policy decisions
- 30 Nov: 3Q21 GDP
- 3 Dec: Moody's rating review

GDP GROWTH FORECAST



Source: Turkstat, UniCredit Research

INFLATION FORECAST



Source: Turkstat, CBRT, Bloomberg, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

EUR bn	2018	2019	2020	2021F	2022F
GDP (EUR bn)	667.3	680.2	626.9	645.9	664.0
Population (mn)	81.4	82.6	83.4	84.4	85.4
GDP per capita (EUR)	8197	8237	7519	7653	7774
Real economy, change (%)					
GDP	3.0	0.9	1.8	9.7	5.5
Private consumption	0.6	1.5	3.2	9.5	5.5
Fixed investment	-0.2	-12.4	7.2	6.9	5.5
Public consumption	6.5	4.1	2.2	2.5	2.8
Exports	8.8	4.6	-14.8	20.4	9.1
Imports	-6.2	-5.4	7.6	6.2	8.0
Monthly wage, nominal (EUR)	696	753	634	639	641
Real wage, change (%)	-0.4	2.7	-4.9	7.2	2.9
Unemployment rate (%)	11.0	13.7	13.1	12.6	12.3
Fiscal accounts (% of GDP)					
Budget balance	-3.4	-5.3	-5.2	-4.5	-4.6
Primary balance	-1.5	-3.0	-2.5	-1.8	-1.6
Public debt	30.2	32.7	39.8	39.3	38.7
External accounts					
Current account balance (EUR bn)	-18.5	6.0	-32.6	-17.3	-18.0
Current account balance/GDP (%)	-2.8	0.9	-5.2	-2.7	-2.7
Extended basic balance/GDP (%)	-1.6	1.7	-4.6	-2.0	-2.1
Net FDI (% of GDP)	1.2	0.8	0.6	0.6	0.6
Gross foreign debt (% of GDP)	55.7	57.2	62.8	60.0	59.8
FX reserves (EUR bn)	63.5	71.7	41.0	66.0	59.4
Months of imports, goods & services	3.5	4.3	2.6	3.5	3.0
Inflation/monetary/FX					
CPI (pavg)	16.3	15.7	12.3	17.9	16.3
CPI (eop)	20.3	11.8	14.6	18.5	14.4
Central bank target	5.0	5.0	5.0	5.0	5.0
Central bank reference rate (eop)	24.00	12.00	17.00	15.00	14.50
3M money market rate (Dec. avg.)	24.70	11.80	16.60	16.00	14.50
USD/TRY (eop)	5.29	5.95	7.44	9.30	10.40
EUR/TRY (eop)	6.07	6.67	9.08	11.07	12.69
USD/TRY (pavg)	4.84	5.68	7.03	8.45	9.94
EUR/TRY (pavg)	5.69	6.35	8.05	10.11	12.06

Source: Turkstat, CBRT, Turkey's ministry of finance, Bloomberg, UniCredit Research

*Long-term foreign-currency credit ratings are provided by Moody's, S&P and Fitch respectively.

Rate cuts in session

We are revising our growth forecasts from 7.5% to 9.6% for 2021 and from 3.5% to 5.5% for 2022

We are revising our 2021 growth forecast to 9.7% from 7.5% as 2Q21 GDP data, along with the revisions to the previous quarters, showed that growth in 1H21 was stronger than we initially expected. We are also revising our forecast for next year, from 3.5% to 5.5%, due to now higher carry-over from 2021 and an earlier and faster than expected start to the CBRT's easing cycle (this is to be followed by lending expansion).

The rebound in the service sector likely drove growth in 3Q21

Turkey's economy likely gained momentum in 3Q21, with the service sector (especially hospitality and leisure activities) benefitting the most from reopening. In contrast, industrial production signaled that the manufacturing sector began 2H21 on a rather weak note, but this seems mostly due to effects from a bridge holiday in July, in our view. This will likely be compensated for by a swift recovery in August. Indeed, details of (sectoral) PMI data suggest that most sectors increased their output volumes in August, despite headwinds from supply-chain bottlenecks (in the form of extended delivery times) especially for machinery, non-metallic mineral products, and car producers. While the sectoral confidence index hinted at improved sentiment in construction, the sector continues to be limited by financial conditions. Contractors halted operations for 15 days in September to protest high cement prices. On the demand side, card-spending data hinted at continued growth in private consumption.

Credit impulse is coming back

Going forward, growth should regain support from credit impulse. Quarterly credit impulse turned positive in 3Q21, driven by a surge in consumer lending. To curb the latter, Turkey's banking regulator lowered the maximum maturity for personal loans that exceed TRY 50,000 to two years from three years in September. Although these measures could partially drag on consumer loan growth, overall credit impulse should pick up further with the help of the CBRT's frontloaded rate cuts, supporting domestic demand from 4Q21 onward (this should become more visible in 2022).

Strong export performance to continue next year

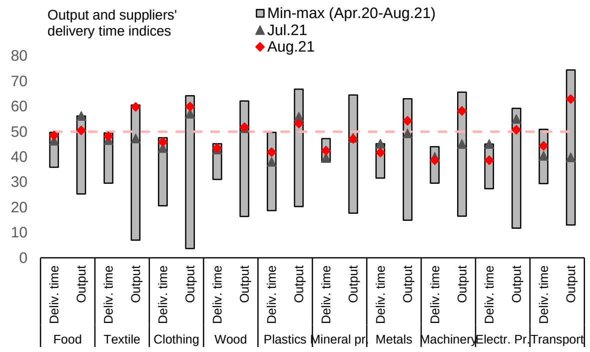
Export growth could remain strong in 2022, as Turkish producers recoup competitiveness in both the EU and outside EU markets and as tourism revenue likely moves closer to pre-pandemic levels. Credit expansion should support domestic demand next year unless TRY comes under significant pressure, forcing the CBRT to scale down or reverse the rate cuts.

Service sector leads job creation after reopening

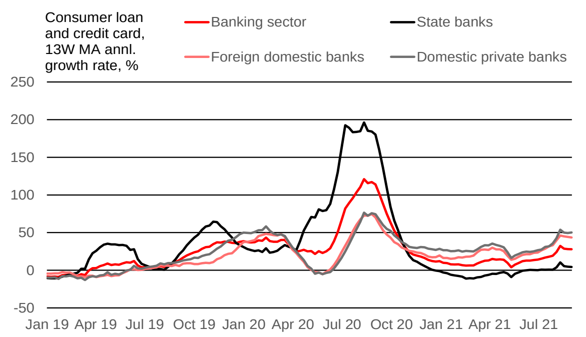
The expiration of Turkey's layoff ban might have played a role in the employment drop in the industry and construction sectors

The labor market has shown a mixed performance following reopening. Job creation in the service sector remained strong in July, after employment in this sector made a full recovery to pre-pandemic levels in June. However, the industry and construction sectors recorded layoffs in July, following the expiration of a layoff ban at the end of 2Q21. In our view, it is too early to assess the impact of the layoff ban. Total employment is now up by 4% from its February 2019 level and back to mid-2018 levels. Hiring expectations over the next three months in the service and industry sectors look promising, indicating a further rise in employment. With labor-force participation also picking up now, we expect to see a gradual decline in the unemployment rate, from 13.1% in 2020 to 12.6% in 2021 and to 12.3% in 2022.

PRODUCERS ARE TRYING TO WEATHER SUPPLY BOTTLENECKS



CONSUMER LOANS ACCELERATED OVER THE SUMMER



Source: Istanbul Chamber of Industry, CBRT, Turkstat, UniCredit Research

Adjustments to Turkey's current account have mainly been driven by a partial recovery in tourism revenues…

…with limited support from merchandise trade balance

Turkey's current-account deficit narrowed from 5.2% of GDP in 2020 to 3.7% of GDP in July. We expect to see further adjustment, to 2.7% of GDP by year-end, primarily driven by a recovery in the service balance. Tourism revenue came in at USD 6.9bn in the first seven months. We expect to see a more visible recovery in 2H21, to bring full-year revenue to USD15bn (52% of 2019) despite a decrease in tourism from the UK over the summer. Meanwhile, the trade balance is likely to improve only slightly in 2021, as the higher energy import bill and wider core (excluding gold and energy) deficit balance out a decline in gold imports. The trade deficit could increase next year, especially if gold imports pick up again, keeping Turkey's current-account deficit flat despite a further recovery in tourism revenues.

The government will likely achieve its budget-deficit target for this year, given strong performance so far

The government's budget-deficit target for this year, at 3.5% of GDP, remains attainable. The deficit stood at only 1.7% of GDP (IMF-defined 3.2% of GDP) in August. However, 12-month rolling tax revenue figures currently include deferred tax payments during 4Q20. Therefore, these will likely decelerate in 4Q21. Moreover, actual revenue relief (via a sliding-scale tax scheme for gasoline prices, a withholding-tax cut for TRY-denominated deposits and VAT cuts for food services) should prove larger than initially anticipated. In May, Turkey's treasury projected a total of TRY 48bn (0.7% of GDP) for these items. Tax relief for food services and TRY-denominated deposits has been extended beyond initial deadlines. Meanwhile, consumption-tax revenue from gasoline and natural-gas products amounted to only TRY 26bn (about 1/3 of the year-end target) between January and August. Despite these downside risks, strong economic activity should help the government reach the budget target this year.

Headline inflation should start to decline with the base effects

Core inflation will continue to decelerate, although the service component could prove sticky for longer

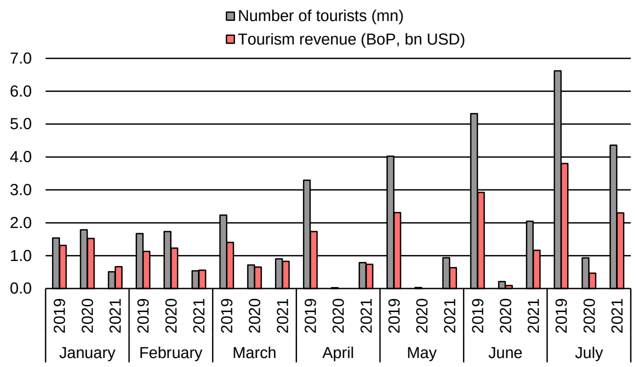
Headline inflation is expected to decelerate from November onward due to disinflationary base effects. However, strong domestic demand and cost pressures related to supply-chain bottlenecks will likely slow disinflation. We expect annual inflation to peak above 20% in October (if energy price hikes are introduced next month) before easing to 18.5% at the end of the year and to 14.4% in 2022. Meanwhile, an additional decline in core inflation from its current (16.8%) might be more limited, as the fall in service prices (which make up roughly half of the core basket but only 29% of the consumer basket) could lag, due to their backward-looking nature. We expect core inflation to decrease from 15.9% at the end of 2021 to 14.1% at the end 2022.

An early election is unlikely to be called at least for a year if the government goes through with electoral-law changes

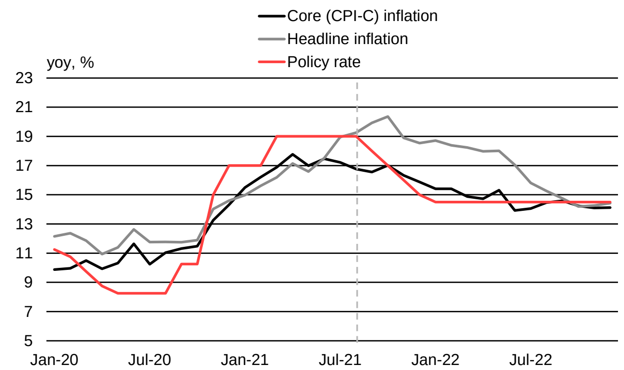
.

Turkey's next parliamentary and presidential elections should happen on or before 18 June 2023. Following the CBRT's rush to ease monetary policy, we have received questions as to whether this could have occurred in preparation for an early election. While an early election is not currently part of our baseline assumption, we are monitoring the governing AKP-MHP alliance's ongoing preparations to introduce a bill on electoral-law amendments as an indicator for the earliest possible date for an early election. According to Turkey's Constitution (Article 67), amendments to the electoral laws shall not apply to the elections to be held within one year from the entry-into-force of the amendments. Consequently, the earliest date for an early election would be a year after the bill is signed into law. The two parties are still negotiating over the contents of the draft. Once finalized, the bill will be brought to parliament.

GRADUAL RECOVERY IN TOURISM REVENUES



RATE-CUT CYCLE TO BRING POLICY RATE DOWN TO 14.5%



Source: Turkstat, CBRT, UniCredit Research

Easing cycle might give short-term boost to TURKGBs

Tourism revenues, portfolio flows and light debt repayments supported TRY in 3Q21

Since June, the TRY has benefitted from a narrowing current-account deficit, light external debt repayment by the private sector and the government and some revival in portfolio inflows over the summer. In 3Q21, stock and local bond markets attracted USD 0.5bn and USD 1.2bn of inflows respectively. The latter brought the share of foreign investors in TURKGBs from 4% in 1Q21 to 4.6% in 2Q21.

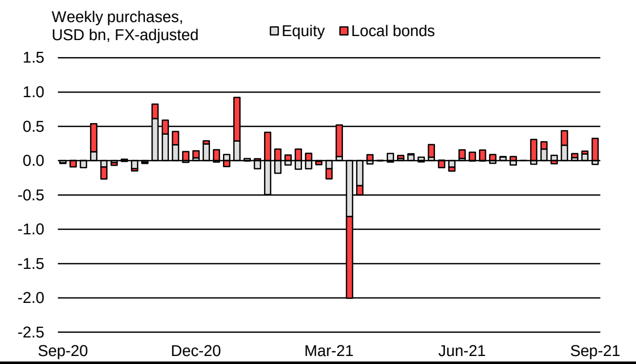
The CBRT might lower its policy rate by another 3pp until year end

The CBRT started the easing cycle with a 1pp cut in September. The central bank could attempt to maintain this pace to bring its policy rate to, as low as, 15% before the year end, should TRY's carry remain. We do not see much room for further easing in 2022, beyond a measured cut to 14.5%[8].

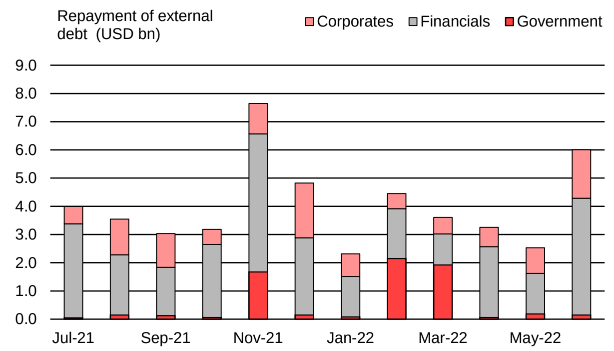
Continuation of easing cycle could attract flows into the local bond market, helping the TRY to weather pressure from trade and financial flows

Further rate-cut expectations from the CBRT in 4Q21 could attract additional foreign flows into the local bond market. This, along with still-high carry, could help the TRY weather depreciation pressure from a seasonally higher current-account deficit and a busier external-debt payment calendar in 4Q21. However, such a rally might prove short, especially if markets start positioning for Fed tightening and reduce exposure to EM financial assets.

Inflows to bond market resumed in 3Q21



Higher debt repayments in the final months of the year



Source: Haver, Bloomberg, CBRT, Turkey's ministry of finance, UniCredit Research

GOVERNMENT'S GROSS FINANCING REQUIREMENTS

EUR bn	2020	2021F	2022F
Gross financing requirement	**65.6**	**65.8**	**55.9**
Budget deficit	32.9	29.2	30.4
Amortization of public debt	32.7	36.6	25.5
Domestic	27.1	30.2	19.1
Bonds	21.9	30.0	19.1
Bills	5.2	0.2	0.0
Loans	0.0	0.0	0.0
External	5.6	6.4	6.4
Bonds	4.1	5.3	5.3
Loans	1.5	1.2	1.2
Financing	**65.6**	**65.8**	**55.9**
Domestic borrowing	55.8	45.1	40.3
Bonds	52.8	45.0	40.3
Bills	3.0	0.1	0.0
Loans	0.0	0.0	0.0
External borrowing	8.5	9.3	8.1
Bonds	7.3	8.4	7.3
Loans	1.1	1.0	0.7
Privatization/other	10.6	7.4	6.5
Fiscal reserves change (- =increase)	-9.3	3.9	1.0

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2020	2021F	2022F
Gross financing requirement	**165.0**	**160.0**	**164.9**
C/A deficit	32.6	17.3	18.0
Amortization of medium and long-term debt	48.6	47.4	38.9
Government/central bank	5.6	6.4	6.4
Banks	26.1	26.7	20.6
Corporates/other	16.9	14.2	11.9
Amortization of short-term debt	83.8	95.3	108.0
Financing	**165.0**	**160.0**	**164.9**
FDI (net)	4.0	4.2	4.1
Portfolio equity, net	-3.7	-0.8	1.0
Medium and long-term borrowing	38.0	51.6	38.6
Government/central bank	4.1	11.0	8.1
Banks	21.5	24.7	19.0
Corporates/other	12.5	15.9	11.5
Short-term borrowing	100.8	109.6	115.6
Other	-1.9	6.6	0.0
Change in FX reserves (- = increase)	27.8	-11.1	5.6
Memoranda:			
Nonresident purchases of LC gov't bonds	-5.2	1.7	0.0
International bond issuance, net	3.2	3.1	2.1

Source: CBRT, Turkey's ministry of finance, UniCredit Research

[8]For details, please see EEMEA Macro Flash Turkey: Rate cut cycle begins earlier than expected published on 24 Sep 2021.

Acronyms and abbreviations used in the CEE Quarterly

- BNB – Bulgarian National Bank
- C/A – current account
- CBR – Central Bank of Russia
- CBRT –Central Bank of the Republic of Turkey
- CE – Central Europe
- CEE – Central and Eastern Europe
- CNB – Czech National Bank
- DM – developed markets
- EA – euro area
- EC – European Commission
- ECB – European Central Bank
- EDP – Excessive Deficit Procedure of the European Commission
- EM – emerging markets
- EMU – European Monetary Union
- EU – European Union
- FCL – Flexible Credit Line (from the IMF)
- FDI – foreign direct investment
- IFI – international financial institutions
- IMF – International Monetary Fund
- MoF – Ministry of finance
- NBH – National Bank of Hungary
- NBP – National Bank of Poland
- NBR – National Bank of Romania
- NBS – National Bank of Serbia
- NBU – National Bank of Ukraine
- PLL – Precautionary and Liquidity Line (from the IMF)
- PM – prime minister
- PPP – public – private partnership
- qoq – quarter on quarter
- sa – seasonally adjusted
- SBA – Stand-by Arrangement (with the IMF)
- SOE – state-owned enterprise
- WB – World Bank
- yoy – year on year
- ytd – year to date
- w. PFR - with Polski Fundusz Rozwoju
- w. BGK - with Bank Gospodarstwa Krajowego (BGK)”

Notes

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