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"Recovery amid supply-chain and (geo)political risks"

1Q 2022

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Contents

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Recovery amid supply-chain and (geo)political risks

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- We expect the economies in EU-CEE[1] and in the Western Balkans to grow by around 4.0% in 2022 and by 4.4% in 2023, slowing from 5.1% in 2021. Pent-up consumer demand is expected to drive the recovery in 1H22, while capex and exports could be underpinned by fewer supply-chain disruptions in 2H22 and 2023. Grants and loans from NextGeneration EU (NGEU) will support public investment in 2022-23.
- Economic activity in all of these countries will likely return to pre-pandemic levels by the end of 2022, but not to the pre-pandemic growth trend.
- In Turkey, we expect economic growth of 4.7% in 2022 and of 4.1% in 2023, although risks to financial stability could undermine the positive effects of rate cuts.
- The Russian economy could grow by around 2.2% annually in 2022-23, returning close to potential as household incomes grow at a slower pace and the credit impulse turns negative. Planned transfers from the National Wealth Fund might fuel public investment.
- Inflation is likely to miss targets in 2022 as supply shocks could be larger and longer lasting than in Western Europe. Disinflation might be slowed by tight labor markets in Central Europe, where 2023 inflation targets are also threatened.
- Policy rates could be increased in 1H22 to 3% in Hungary and Romania, to 3.5% in Poland and to 4.5% in Czechia. The NBS could increase the key rate to 2% before year-end. The NBH, the NBR and the NBS might deliver additional tightening through liquidity management and FX interventions. Only the CNB is expected to cut 25bp before the end of 2022.
- Real policy rates could be kept low due to expected fiscal tightening in 2022 and the loss of households' purchasing power amid supply shocks. Prudential measures will tighten financial conditions where credit to households continues to rise at a fast pace.
- The CBRT and the CBR are likely to cut in 2022, but financial conditions could tighten in Turkey if USD-TRY surges further. We expect the CBR to take the policy rate to 5% by 2023, while, in Turkey, we expect a sharp reversal of rate cuts.
- In our view, the main (geo)political risks in 2022 stem from the stand-off between the EU and Hungary and Poland; tight parliamentary elections in Hungary; the migrant crisis at the eastern border of the EU; ethnic tensions in Bosnia-Herzegovina; fragile governing coalitions in Romania, Slovakia, Slovenia and Turkey; potential sanctions on Russia; gas deliveries to Europe and social unrest amid high energy and food prices.

An uneven recovery in 2021…

CEE has had an uneven economic recovery in 2021 in terms of strength and geographic patterns. CEE economies started the year on strong footing, but growth momentum slowed amid the third pandemic wave, only to accelerate again as economies reopened in the spring. In the second half of the year, supply-chain bottlenecks and higher commodity prices affected production and exports while driving inflation to its highest levels since the global financial crisis. A fourth pandemic wave reduced mobility and consumer spending in 4Q21. In EU-CEE, Croatia, Hungary, Poland, Romania and Slovenia have seen economic activity return to pre-pandemic levels, while the other countries of the region have lagged behind because global tourism and economic activity in the eurozone have failed to recover fully. Countries in the Western Balkans have shown a similar performance to EU-CEE. The exception is Serbia, whose economy had returned above the pre-pandemic trend of growth by mid-2021, alongside the economies of Russia and Turkey. However, momentum weakened towards the end of last year, similarly to EU-CEE.

…will affect carryover into 2022

With Serbia's exception, the result is a dismal carryover into 2022. While we expect CEE countries to resist tight lockdowns, weaker demand from the eurozone and the impact of higher food and energy costs on hand-to-mouth consumers could translate into slower growth in 1Q22.

[1]EU-CEE refers to CEE countries that are members of the EU: Bulgaria, Croatia, Czechia, Hungary, Poland, Romania, Slovakia and Slovenia.

Consumer spending could ease once pent-up demand is exhausted

CEE households have started spending out of their excess savings accumulated in 2020 (Chart 1) and borrowing more from banks, but a large share of the population has no access to emergency funding (Chart 2) and, thus, could see its purchasing power tumble if food, fuel and energy prices rise further. Most CEE households are likely to exhaust excess savings before mid-2022 with a combination of durable purchases and higher utility bills. As a result, we expect private-consumption growth in 1H22 to be robust but to moderate gradually, remaining resilient in 2H22 only in countries where real-wage growth will be positive. This could prove to be a high hurdle to overcome if wage bargaining in the spring of 2022 is concluded with supply and activity disruptions in the background. We are more optimistic that wage growth will rebound quicker in Hungary, Czechia, Slovenia and Poland, where vacancies are the highest in the EU and employment exceeds pre-pandemic levels. Unemployment has returned to pre-pandemic levels or could do so before the end of this year in Bosnia-Herzegovina, Croatia, Hungary, Poland, Russia, Serbia, Slovenia and Turkey. By the end of next year, only Czechia's unemployment rate might remain more than 0.5pp above pre-pandemic levels.

Real and nominal wage growth expected to accelerate in 2023

This will set the stage for tighter labor markets in 2023, when nominal wage growth could accelerate, especially if companies are slow to spend in 2022. Throughout CEE, disinflation could help accelerate real-wage growth and consumer spending in 2023. Despite tighter real monetary conditions, real-estate markets could remain hot as households have limited alternatives for investment.

SAVINGS WILL OFFER A TEMPORARY CUSHION AGAINST A SHARP RISE IN LIVING COSTS

Chart 1: Excess savings are expected to smooth consumption growth…

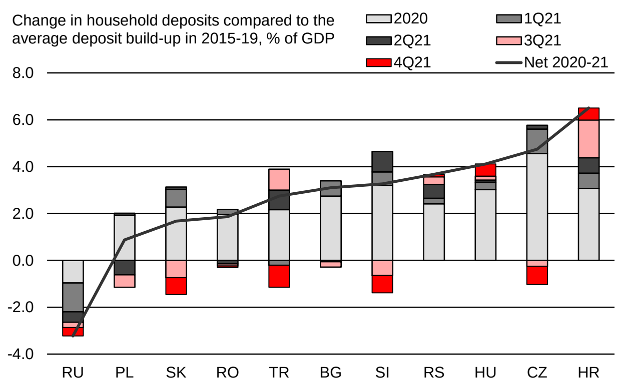
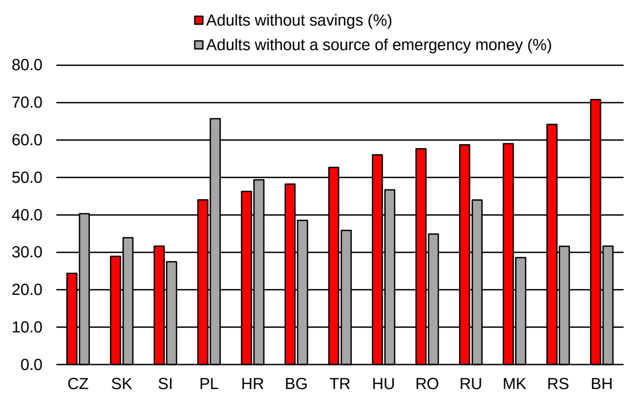


Chart 2: …but hand-to-mouth consumers will be hit by the rising cost of living



4Q21 refers to October-November 2021. Data for Turkey have been FX-adjusted. Source: central banks, national statistical offices, World Bank, UniCredit Research

Supply shocks: uncertainty could delay capex to 2H22 or 2023

Supply-chain bottlenecks could persist in 2022

In 1H22, CEE companies will struggle to maintain production at normal levels due to blockages affecting global value chains and due to high commodity prices. Supply bottlenecks contrast with strong demand and a large backlog of orders that bodes well for future exports. Whenever supply chains ran smoothly in 2021, exports were close to all-time highs, especially in Central Europe and Turkey. However, eurozone companies expect these bottlenecks to last beyond mid-2022, easing gradually in 2H22 and completely only in 2023. Absent further lockdowns, this scenario would still lead to higher exports in 2022 than in 2021, with further acceleration expected in 2023.

High energy prices will have long-lasting effects

Other supply shocks deemed temporary in 2021 are likely to persist in 2022. The price of natural gas could spike anew for countries that have no long-term gas-purchase contracts. Hungary is in the most favorable position, having secured a 15-year contract with Gazprom at a price of USD 220/1,000 cubic meters, the lowest price in the region, at the cost of stopping gas deliveries to Ukraine through flow reversals. Gas prices could decline only gradually if European countries start replenishing storage once winter is over. However, larger inventories might prevent price spikes similar to the ones from December 2021.

High natural-gas prices put pressure on other energy prices and are disrupting the production of chemicals, glass, metals and construction materials. Fertilizer plants will continue to function below full capacity, with farmer associations expecting the 2022 harvest to be 10-20% lower as a result. In addition, missing byproducts will affect producers of beverages and meat products (CO_2) and transporters (AdBlue). Lower output of metals, glass and construction materials could further delay the production of cars and electronics while affecting private building projects and infrastructure works under national recovery and resilience programs (NRRPs).

Uncertainty and capital utilization have yet to return to pre-pandemic levels

While companies have adapted to several waves of the pandemic, uncertainty remains much higher than before 2019 (Charts 3), and we expect this to influence private capex going ahead. If supply-chain bottlenecks start easing in 2H22 and disappear by 2023, companies could better assess the need for investment and activity expansion. There are other conditions to be met for capex to rebound: capital utilization has yet to return to pre-COVID-19 levels in all countries but Turkey and Hungary, while capital productivity (measured as GDP per capita) remains lower than before the pandemic in all countries but Slovenia (Chart 4).

UNCERTAINTY AND POOR CAPITAL UTILIZATION COULD LIMIT INVESTMENT IN 2022

Chart 3: Central-European companies are more uncertain about future production than their CEE peers

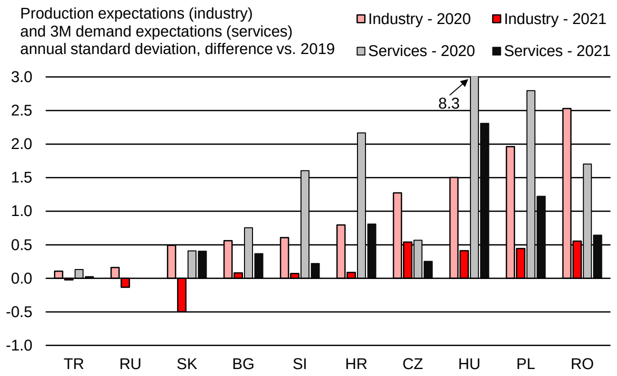
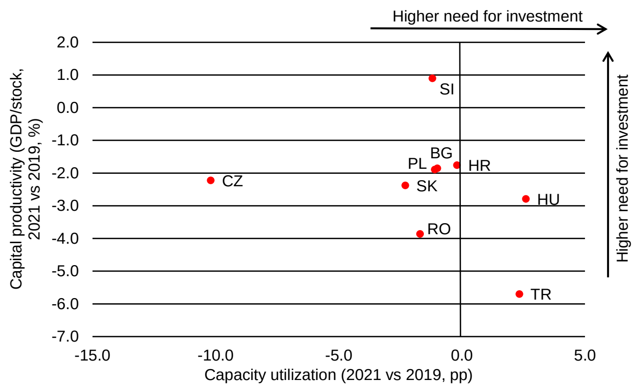


Chart 4: Capex could be delayed in countries with spare capacity and falling capital productivity



Source: Eurostat, AMECO, UniCredit Research

A gradual acceleration

We expect EU-CEE economies to grow by 4.0% in 2022 and by 4.3% in 2023…

…Russia to grow by 2.2% in 2022 and 2023…

…and Turkey to grow by 4.7% in 2022 and 4.1% in 2023

Considering all these factors, we expect EU-CEE economies to grow by 4.0% in 2022 and by 4.3% in 2023 (Charts 3 and 4), compared to 5.1% in 2021. Growth is likely to slow in countries that outperformed in 2021 (Hungary, Poland, Romania) and could remain close to 2021 levels in countries that have yet to recoup all pandemic-related losses. Our forecast assumes further improvements in travel and tourism, but incoming tourists will be fewer in 2022 than before COVID-19 in Bulgaria, Croatia, Czechia, Hungary and Turkey. In Russia, economic growth could slow to 2.2% in 2022 and 2023, from 4.2% in 2021, while in Turkey, it might moderate to 4.7% in 2022 and 4.1% in 2023, from 10.7% in 2021. In both countries, the slowdown should be stronger than in EU-CEE as domestic demand slows because of negative credit and fiscal impulses and falling real incomes.

Public investment will contribute more to growth in 2022-23

Private consumption will contribute less to growth in 2022-23 than in 2021 but will remain a major driver. At the same time, investment is likely to add more to growth than in 2020-21 as countries start spending money from the EU's Recovery and Resilience Facility (RRF). Most EU-CEE countries received 13% of their agreed allocation before the end of 2021, with amounts expected in 2022 of at least the same size. The impact on GDP growth could range from 0.2pp to 0.9pp in 2022 and from 0.5 to 1.3pp in 2023. The underperformers will be Hungary and Poland, which could reach an agreement on outstanding issues with the EU by mid-2022 at the earliest, with flows starting in 2H22 or later.

Outside the EU, both Serbia and Russia plan more public investment. The former leads the region with government investment equivalent to around 7% of GDP per year, while the latter is preparing to transfer some of its excess holdings in the National Wealth Fund (currently exceeding 5% of GDP) to investment projects prioritized after national projects were revamped. In Turkey, the government has tried to ease monetary conditions by cutting interest rates, but runaway TRY depreciation could jeopardize financial stability and will end in tighter financial conditions, in our view. Thus, the credit impulse is unlikely to turn positive for long, if at all.

Private investment might accelerate from 2H22 onwards…

Private capex in the region could rebound at a slower pace than public investment for several reasons. First, supply-chain blockages in manufacturing have postponed many investment projects, especially in the automotive sector. Relief is not expected before 2H22, with a stronger pickup in 2023. Second, most CEE companies have not hedged against higher energy costs, and their margins are likely to compress in 2022, affecting capex. Third, rate hikes could slow credit growth and turn the credit impulse negative in 2022. On a brighter note, investment co-financed with EU money is expected to accelerate in 2H22 and further in 2023.

…with exports strengthening in 2022-23

While domestic demand could slow in 2022, net exports are likely to contribute more to growth in 2022-23 if supply-chain bottlenecks and commodity prices ease gradually. Together with higher EU transfers and FDI, trade balances will likely contribute to larger extended basic balances. The exception could be Russia, although the impact of expected-lower commodity prices on Russia's export revenues might be offset by weaker imports due to slowing consumer demand.

ECONOMIC GROWTH IS EXPECTED TO BE ABOVE POTENTIAL IN 2022-23

Chart 5: Growth is to be driven mostly by consumption in 2022…

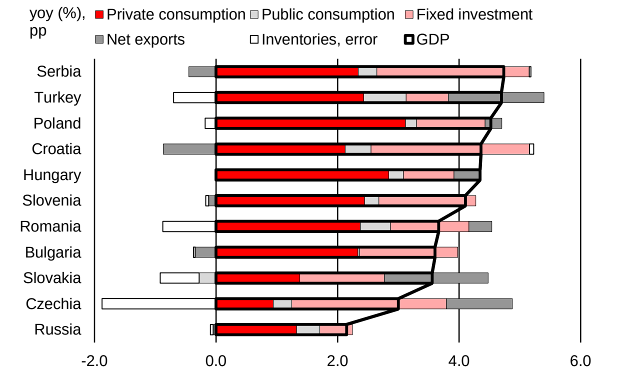
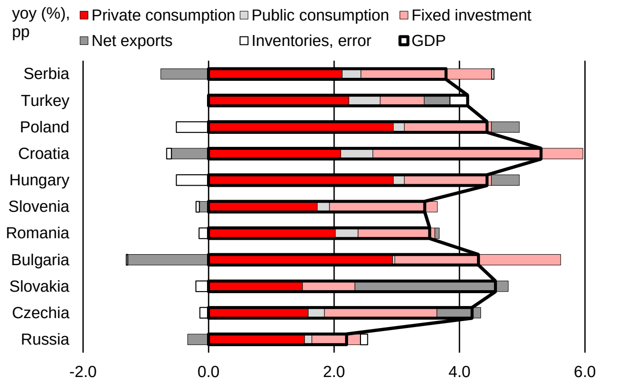


Chart 6: …with investment contributing more in 2023



Source: statistical offices, UniCredit Research

Inflation could peak before mid-2022

Inflation momentum accelerating at the start of 2022

CEE entered 2022 with consumer prices rising faster than during the summer and autumn of last year. Both cyclical and underlying inflation measures accelerated at the end of 2021. The former offers a glimpse into the diverse origin of inflationary pressure across the region (Charts 7 and 8). Supply shocks account for most inflation momentum in all countries but Czechia, with food prices taking over from fuel and energy prices as the main driver. This trend is likely to continue in 1H22. At the same time, demand pressure on prices (measured using cyclical prices of goods and services, excluding food and energy) varies widely across countries. In Central Europe, momentum in core inflation is much higher in Poland[2] than in Hungary and especially in Romania. This is no surprise given large transfers to households in Poland, with recently announced vouchers under Poland's so called Anti-Inflation Shield being inflationary as well. It is yet unclear if momentum will continue to decelerate in Czech demand-driven inflation. What is almost certain is that supply shocks will continue to account for 90% of Romanian inflation, as households are hit with higher energy and gas bills and real wage growth is likely to be negative in 2022.

…with food prices gradually taking over from energy prices

[2] Second in CEE to Turkey's.

By mid-2022, we expect food to account for most of the inflation momentum in Romania. Given the large weight of processed food in core inflation (over 40% in Romania), Romania's core inflation could top the 2022 ranking in Central Europe but not because of buoyant demand.

Russia is in a similar situation, with demand-driven cyclical inflation that excludes energy and food slowing since September. Meanwhile, momentum has accelerated in food-price inflation but also in non-cyclical inflation (due largely to utility prices).

In Serbia and Turkey, the pressure exerted by demand on inflation has increased since the autumn of 2021 and could rise further, albeit for different reasons. In Serbia, government spending and transfers will continue to increase ahead of general elections scheduled for 3 April. In Turkey, households could frontload consumption amid runaway inflation, further putting pressure on prices and on the TRY.

INFLATION MOMENTUM SHOWS THE DOMINANCE OF SUPPLY SHOCKS AND THE VARYING CONTRIBUTION OF DEMAND

Chart 7: Demand pressure on prices is higher in Poland and Czechia than in Hungary and Romania

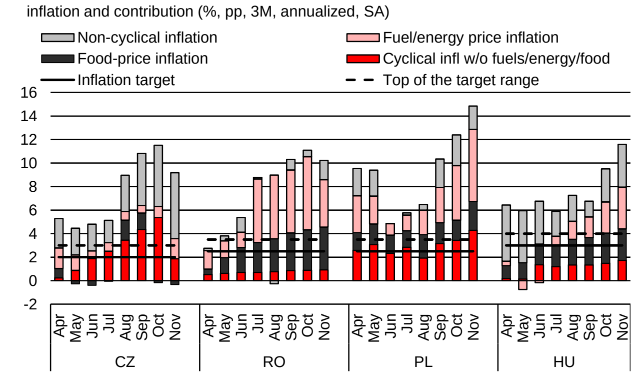
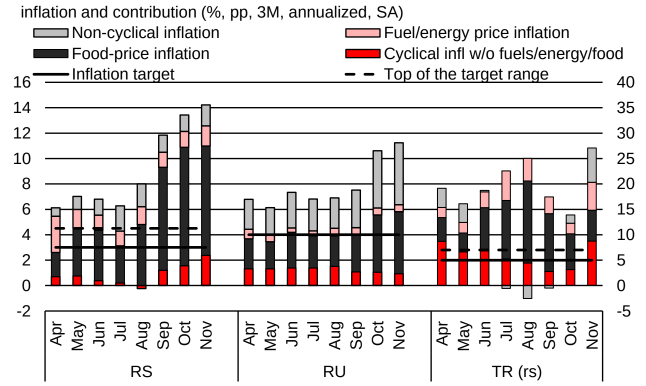


Chart 8: Demand pressure on prices is lower in Russia than in Serbia and especially Turkey



Source: statistical offices, UniCredit Research

Underlying inflationary pressure is highest in Czechia, Poland, Russia and Turkey

Weighted-median inflation (as a measure of underlying inflation) further emphasizes the difference in inflationary pressure across CEE countries (Charts 9-14). Underlying inflationary pressure is stronger in Czechia, Poland and Russia and much weaker in Romania, Serbia and Hungary. Except for Romania, there is no sign of underlying inflation decelerating.

More than a predictor of inflationary trends in 2022, underlying inflation hints at how quickly inflation could return to target once the first-round and second-round effects from supply shocks run their course. Broad-based inflation in Czechia and Poland suggests that households have weathered price increases so far without significantly reducing spending on goods and services. In Russia, supply-shocks are pervasive, but demand is unlikely to have the same traction as in Czechia or Poland due to weaker income growth. In addition, households have already reduced their savings rates to pre-COVID-19 levels and may not be able to squeeze them further to maintain the same pace of spending. Turkey is in a similar situation, with inflation being broad-based and generated mostly by large supply shocks (the chart is in the country section).

While headline inflation could be pushed much higher in 2022 by supply shocks, it is likely to return inside target ranges in 2023 in both Romania and Serbia. For the latter, slow convergence in regulated prices to EU levels will add to insufficient demand pressure and thereby lower inflation. These disinflationary factors are common to the Western Balkans.

UNDERLYING INFLATION: BROAD-BASED INFLATIONARY PRESSURE IN CZECHIA, POLAND AND RUSSIA

Chart 9: Czechia

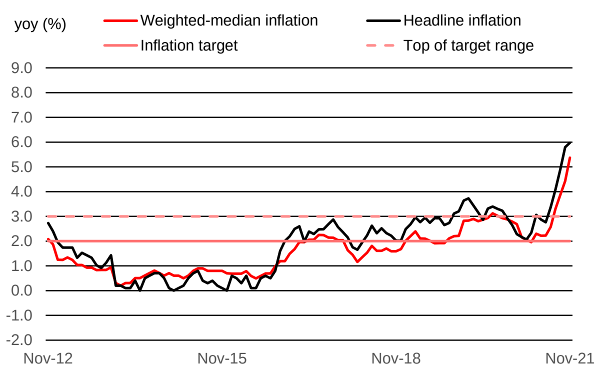


Chart 10: Hungary

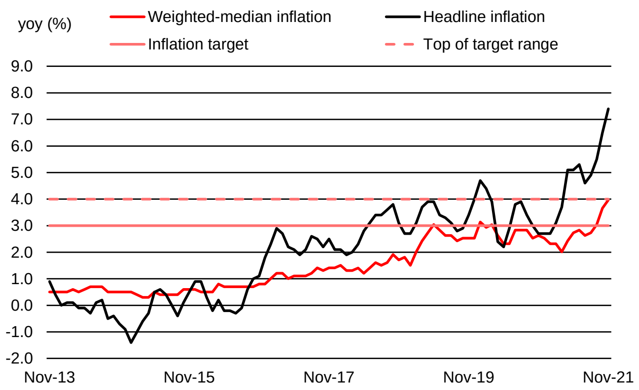


Chart 11: Poland

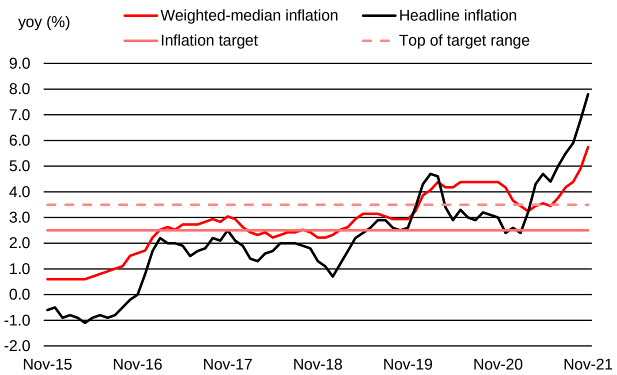


Chart 12: Romania

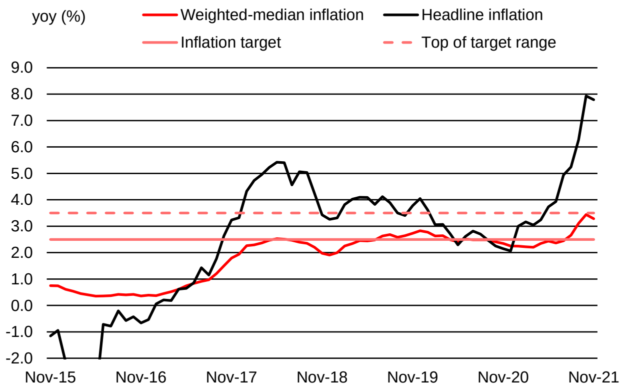


Chart 13: Russia

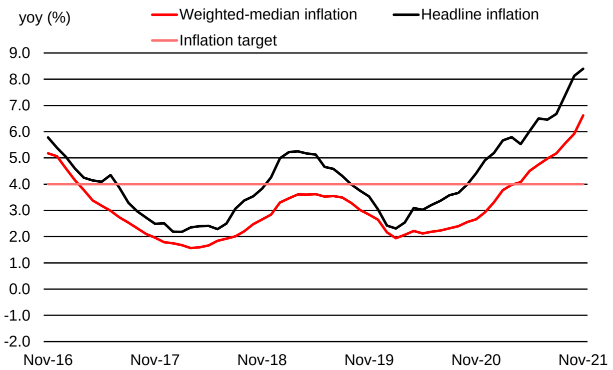
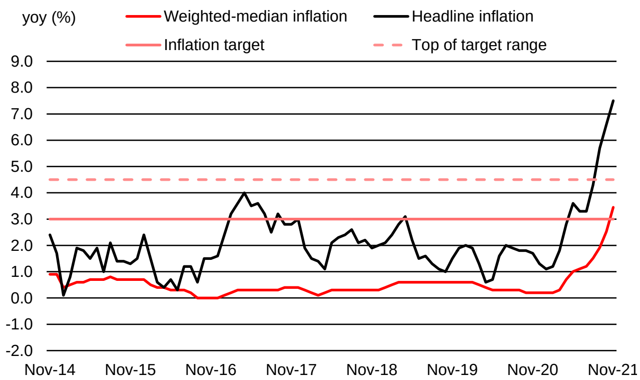


Chart 14: Serbia



Source: statistical offices, UniCredit Research

Inflation is expected to be outside target ranges in 2022…

Inflation will likely remain high throughout 2022, and we expect all central-bank inflation targets in CEE to be missed (Chart 15). The inflationary effects of supply shocks will likely last longer in CEE than in Western Europe due to several factors:

1. The pass-through of higher energy prices to producer and consumer prices will be greater than in the eurozone because very few CEE companies hedge the cost of their commodity purchases. Very high and volatile marginal prices paid on the balancing market will only amplify this effect. In countries where governments moved to protect households by capping energy and gas prices without compensating producers and distributors, companies are facing much higher prices that undermine the stability of their businesses.

This is the case especially in Poland and Romania. Far from slowing, producer prices rose faster in 4Q21 than in previous quarters. Where elections are upcoming, tariffs could increase after polls close (Serbia, Hungary).

2. Food prices will rise at a rapid pace at least in 1H22 due to pricey fuels and energy. Commodity traders report that wholesale prices were 2-2.5 times higher in 2021 than in 2020, despite a better harvest. The shortage of fertilizers could affect the 2022 harvest, fueling price rises in 2H22 and 1H23. The impact on headline inflation would be large because food accounts for 15-32% of CPI baskets in CEE. Some governments are discussing caps on some food prices, but they may disrupt local production as margins are squeezed by rising input costs. Temporary VAT cuts are a likelier solution, in our view, similar to those implemented for energy and gas.

3. The FX pass-through will be large and asymmetric, especially in Turkey, but also in Central Europe. A lower EUR-USD will add to import prices from outside the EU, especially for commodities.

4. Labor-market conditions will probably remain tighter and real-wage growth higher in CEE than in the eurozone. The exceptions are Romania, where employment continues to fall in low-value-added manufacturing; Bosnia-Herzegovina and Russia, where real-wage growth will likely return to pre-pandemic levels, consistent with lower growth in consumer spending.

…to return closer to targets in 2023…

In 2023, inflation could return close to targets in most CEE countries. The perennial exception, Turkey, could be joined by Poland, where the government's transfer program to households, combined with tight labor-market conditions and the most unfavorable structure of energy generation in CEE (around 80% of energy is produced using coal) could keep inflation outside the target range also next year. In Hungary and Czechia, where labor markets are similarly tight, household incomes will not benefit from similarly generous transfers after elections, while energy prices could pose a lower risk, either due to diversification (Czechia) or to preferential prices for Russian gas (Hungary).

…but not to go below targets like in pre-pandemic times

We believe that a return to below-target inflation (similar to pre-COVID-19 times) is unlikely in EU-CEE. There, the green transition is expected to raise energy prices (and, indirectly, producer and consumer prices) in the next decade. As discussed in the 4Q21 *CEE Quarterly*, a populist backlash against high energy and gas prices, which included calls that fiscal protection be given to fossil-fuel-based energy producers and that higher taxes be placed on green energy producers, bodes ill for a smooth transition away from coal. Countries are committed through NRRPs to funding the EU's green transition, but disbursements from the Recovery and Resilience Facility (RRF) of the NGEU are tied to reform commitments that may not be met fast enough to allow funds to be transferred according to schedule.

The EU's green transition poses inflationary risks, especially in Poland, Romania, Bulgaria and Serbia

As said above, Poland's reliance on coal makes it the most vulnerable in EU-CEE to higher energy prices. Poor energy policies in Romania and overreliance on Russian gas in Bulgaria and, outside EU-CEE, Serbia, raise risks that energy-price growth in these countries will be fast as well.

Monetary policy: six more months of tightening

Policy rates could peak at 3-3.5% in Hungary, Poland and Romania…

…at 2% in Serbia…

EU-CEE central banks are expected to further tighten monetary policy (Chart 16). However, their approach will depend on their assessment of the strength and length of inflationary shocks. The central banks of Hungary, Romania and Serbia would like to avoid tightening monetary conditions too much and will actively manage liquidity in addition to increasing interest rates. The goal is to raise money-market and implied interest rates above policy rates and prevent sizeable depreciation. Because of this additional tightening, we expect all three central banks to hike monetary-policy rates less than markets are pricing in, with the NBH and the NBR stopping around 3% and the NBS around 2%.

At the same time, we expect the NBH to take the 1W deposit rate to around 4.5%, while the NBR is likely to keep ROBOR rates close to 4% (the terminal Lombard rate, in our view) and implied interest rates even higher to protect against potential RON depreciation. Both the NBR and the NBS are likely to intervene in FX markets to cap volatility, further tightening liquidity when depreciation pressure is strong.

The NBP might continue to follow along, with hikes to around 3.5%, but the PLN could weaken compared to its regional peers if Poland's central bank does not tighten liquidity to push implied rates in line with the rest of the region. The NBP might intervene in the FX market to prevent lasting depreciation above EUR-PLN 4.70. With bond-purchasing programs now terminated, bond yields could rise further in Hungary and Poland, where, last year, central banks bought more than 70% of net issuance at the belly and long end.

…at 4.5% in Czechia and at 8.50% in Russia

The CNB and the CBR have decided to deliver most tightening by increasing interest rates, to 4.5% and 8.50%, respectively, although both have the option to allow their currencies to appreciate through intervention (by selling euros in Czechia and by purchasing fewer dollars in Russia). At the moment, neither central bank looks willing to use FX transactions to further tighten real monetary conditions.

Prudential regulation contributes to tighter financial conditions

Tightening has been doubled by prudential caps on borrowing, especially on mortgage loans, in Czechia, Romania and Russia. Other central banks could resort to similar measures to prevent the overheating of real-estate markets. This would weigh on credit impulses, which could decline from high levels in Czechia, Hungary, Poland and Romania while turning more negative in Russia and Serbia.

The CNB, the most hawkish central bank in CEE, could be the first one to cut rates in late 2022. We pencil in one 25bp rate cut, while acknowledging the high level of uncertainty.

Additional cuts are likely in Turkey…

…and no magic solution for stabilizing USD-TRY other than higher interest rates

The CBRT might continue to cut rates due to political pressure, but deeply negative real interest rates could accelerate TRY depreciation. Access to TRY by foreign investors and, at the extreme, by private-sector savers to FX could be limited by the CBRT in an effort to temporarily halt depreciation. At the time of writing, Turkish households had shifted 10% of their TRY deposits into the FX-protected deposits announced in late 2021. Ironically, low take-up would allow authorities to fulfill their obligations with limited costs if the TRY were to depreciate. Depreciation compensation only increases dollarization in the economy and shifts more of the burden onto the government. Right before publishing this CEE Quarterly, the depreciation compensation scheme has been partly extended to the companies (for those converting FX deposits into TRY-time deposits) however, the current maturity requirement of at least six months could prove unattractive for companies. However, authorities have not addressed the large stock of corporate external debt, whose repayment/rollover will continue to generate demand for USD in an economy hooked on credit and where marginal borrowing is having a declining impact on economic growth due to increasing leverage. Thus, we expect the TRY to depreciate further. As the CBRT plunges deeper into negative FX reserves, FX interventions may not prevent further TRY weakness. Eventually, interest rates will have to rise to stop the currency from depreciating, either through outright rate hikes (more likely if the opposition wins parliamentary elections) or through measures curtailing access to foreign currency.

Additional rate hikes are possible if inflation fails to fall in 2022

If supply shocks are more resilient than expected and inflation fails to decline in 2022, all central banks in Central Europe might be forced to hike rates above 4%, while the CBR would likely postpone rate cuts to 2023. However, we see very different risk magnitudes across countries, with Czechia, Hungary, Poland and Turkey seemingly more prone to strong demand pressure on prices than Romania, Russia and Serbia.

HIGHER INFLATION MET WITH HIGHER NOMINAL, NOT REAL INTEREST RATES

Chart 15: Target misses in 2022 but not in 2023

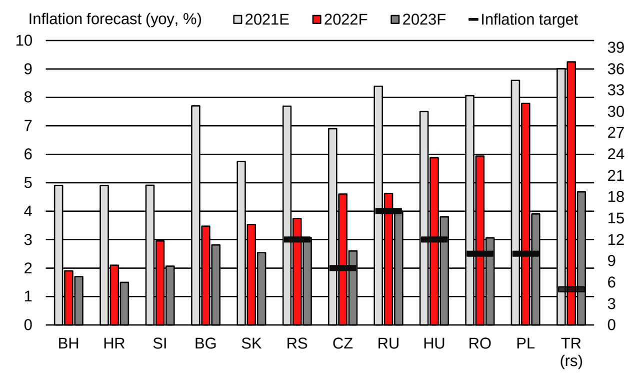
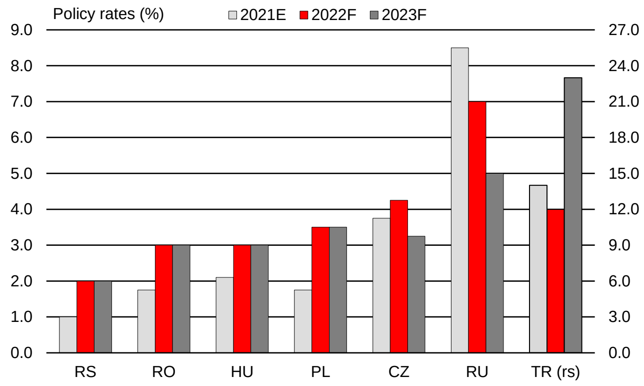


Chart 16: Most rate hikes will probably occur by mid-2022



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

Croatia is expected to adopt the euro on 1 January 2023, with Bulgaria following in 2024

Final preparations for the adoption of the euro in Bulgaria and Croatia will also be made in 2022. The latter looks better prepared and ready to phase out the kuna at the start of 2023. Bulgaria will have to make up for the time lost by last year's caretaker governments. However, we see a high probability of euro adoption in 2024. Thus, the eurozone is likely to welcome its twentieth and twenty-first members in the space of a year, its first new additions in eight years. Even more time could pass before any of the remaining EU-CEE countries join the monetary union.

Rate cuts are expected in 2023 only in Czechia and Russia

We see scope for monetary-policy easing in 2023 only in Czechia and Russia. We expect the CNB to cut its policy rate by 0.75pp, to 3.25%, with the CBR continuing rate cuts from 7% in 2022 to 5% in 2023 if inflation returns to target. If the opposition wins Turkish elections (which we still expect to happen in 2023), more-orthodox monetary policies could translate into a positive real policy rate next year.

We expect real policy rates to remain low…

While CEE central banks are willing to raise nominal interest rates due to high inflation, in our view, they are unlikely to accommodate high real interest rates for several reasons. First, they see supply shocks as having a negative impact on households' purchasing power, which, in turn, should lower core inflation in the medium term. As explained above, we see great variation in demand pressure on prices among CEE countries.

…amid fiscal tightening in 2022

Second, central banks expect fiscal policy to tighten as governments adjust back from pandemic spending. We hold a similar view, forecasting negative fiscal impulses in 2022 in all but two CEE countries (Chart 17). Government spending could drag on growth more in Central Europe than in the rest of CEE, with adjustment delayed to 2023 in Serbia (due to elections) and Bulgaria (due to comparison to thrifty fiscal spending in 2021).

Risks: the known unknowns

In our view, CEE countries face the following main political and geopolitical risks in 2022:

1. **The EU's standoff with Hungary and Poland.** In our view, markets are too complacent when pricing in a potential delay to NGEU disbursements to Hungary and Poland. Both countries failed to conclude an agreement with the European Commission (EC) because they have not upheld civil rights protected by European treaties, judicial independence and, in Hungary's case, procedures when allocating EU-funded projects. Instead of bridging the divide, the Polish Constitutional Court declared that local legislation has primacy over EU legislation, with the Hungarian Constitutional Court echoing this conclusion.

The Court of Justice of the European Union (CJEU) raised the stakes when it issued a ruling directed at Romania[3] in which it stated that judges can ignore rulings by national constitutional courts if they contradict European legislation. This ruling makes it very difficult for the EC and the Hungarian and Polish governments to reach a compromise.

Hungary is unlikely to get NGEU money before 2H22, Poland not before 2023

Hungary could reach an agreement with the EC after parliamentary elections are held in April. A win for the Hungarian opposition would make it easier to bridge the gap than if Fidesz returns to power. However, even Fidesz has an interest in getting NGEU money as soon as possible in order to reduce pressure on public finance. We do not expect a deal to be reached before mid-2022.

In Poland's case, an agreement will likely be even more difficult to reach. Poland's governing coalition could break if it gives into demands from European institutions, a risk that the Law and Justice party (PiS), the senior coalition partner, may not be ready to accept. Thus, we expect no NGEU disbursements to be made to Poland in 2022. Poland could lose NGEU funding if an agreement is not reached before the summer of 2023.

Risks do not stop here. An opinion issued by the Advocate General opened to door for the CJEU to restrict regular EU funds if it finds that the two countries do not uphold the rule of law. This would set an important precedent in the EU and would affect growth in the medium term in both Hungary and Poland.

Uncertain economic outlook after Hungarian elections

2. **Parliamentary elections in Hungary (expected to be held in April 2022).** Unlike in the past three elections, the result of upcoming parliamentary elections in Hungary could be close. The ruling Fidesz party could deepen its disagreements with Brussels if it remains in power, while a win for the united opposition would likely bring Hungary closer to the EU. In case of the latter, some reforms requested by the EU, such as improving judicial independence, would be hindered by recent appointments and changes to legislation, but the opposition could increase the transparency of public tenders, cut discretionary government outlays and ease constraints on the independent press and NGOs. Nevertheless, a win for the opposition could result in a rapid unlocking of NGEU funds to Hungary. That said, the heterogeneous opposition coalition will struggle to come up with a coherent economic program. This could hamper Hungary's famous efficiency in dealing with existing and potential investors, but policies that would chase away FDI remain unlikely. Different economic visions could erode the cohesion of a government formed by the current opposition, making it easier for Fidesz to return to power in a coalition with former political foes.

The migrant crisis as a negotiation tool

3. **The migrant crisis at the EU's eastern border.** Tensions between Belarus and its western neighbors could continue to simmer. If it escalates again, the EU will have to negotiate a solution with Belarus to halt the state of emergency in eastern Poland and to relieve pressure on Baltic borders.

Ethnic tensions in Bosnia-Herzegovina

4. **A strive for ethnic autonomy in Bosnia-Herzegovina.** The topic of ethnic autonomy will come to the fore as Bosnia-Herzegovina prepares for parliamentary elections that are to be held on 2 October 2022. While the leaders of Republika Srpska are asking for more autonomy, from raising a separate army to taxation, the Federation of Bosnia and Herzegovina (the Bosniak-Croatian entity) is also facing tensions. Trust in authorities is very low due to widespread corruption and slow progress on reforms. Politicians have tended to blame the complicated political structure and the institution of the High Representative for inefficient administration. Without deeper involvement by the EU and the US, tensions could escalate, widening ethnic rifts that have persisted since the Bosnian War. In our view, open conflict would impose too high a cost on the perpetrator, but we expect ethnic autonomy to increase further, thereby undermining the union.

Fragile coalitions in Romania, Slovakia, Slovenia and Turkey

5. **Fragile governing coalitions in Romania, Slovakia, Slovenia and Turkey.** Except for Slovenia, all of these coalitions enjoy comfortable majorities but have different policy priorities. The result is less efficiency in government, especially in Slovenia, which is to hold parliamentary elections in April 2022 and presidential elections in October 2022, and in Turkey, where the probability of early elections will rise if the government fails to halt its slide in opinion polls. We expect Turkish President Recep Tayyip Erdogan to avoid early elections until his poll numbers improve, although we see little scope of the AKP's and Mr. Erdogan's popularity rising in 2022.

[3] Ruling No. 230/2021 from 21 December 2021 is available on the Curia's website. It was available only in French, German and Romanian at the time of writing.

In Romania, the Social Democratic Party (PSD) should choose the country's next prime minister in mid-2023, but the coalition with the National Liberal Party (PNL) could break up around that time due to divergent economic priorities (for example, higher taxes desired by the PSD).

Serbia's EU accession could stall

6. **Serbia's EU accession.** Parliamentary elections scheduled for 3 April 2022 are expected to return the Serbian Progressive Party of President Aleksandar Vučić to power. Progress with regard to Serbia's EU accession would require reforms and an agreement with Kosovo. These have been difficult to achieve so far. We expect progress in Serbia's accession process to be slow.

Russia could be further isolated from financial markets in the event of sanctions

7. **The continued effect of geopolitical tensions on Russian financial assets and gas deliveries to Europe.** Tensions at Russia's border with Ukraine could accelerate procedures in the US Congress to impose tougher sanctions, including a ban on OFZ trading by US funds and, at the extreme, banning Russia from the SWIFT transfer system. Expected monetary easing in Russia and light positioning by US investors could offset the negative impact of additional sanctions on OFZs, as long as the Russian banking system retains access to SWIFT. However, Russian financial markets could remain more volatile than the country's low macroeconomic imbalances would suggest. Further isolation from global financial markets could affect capital inflows beyond portfolio investment, further undermining the country's low potential growth.

European gas inventories are insufficient to weather a halt in Russian deliveries

   If tensions between Russia and NATO escalate, and natural-gas deliveries to Europe are affected, CEE countries will be affected unevenly. According to our estimates (using data from Gas Infrastructure Europe and BP), which also take into account local gas production, only Romania and Hungary have sufficient gas inventories to last the winter (Chart 18). The other countries in CEE and Western Europe would have to ration consumption in February (at the latest) if deliveries from Russia cease. A likely spike in prices would affect all balancing markets and, thus, also countries with sufficient inventories.

High energy and food prices could lead to social unrest

8. **Social unrest as high energy and food prices sap living standards.** Many CEE governments have decided to cap energy prices during the current winter. However, large price increases loom in the coming spring. Moreover, failure to cap prices paid by companies could lead to much higher consumer prices, especially for food and transport services. Failure to address the energy crisis, especially in countries whose energy sectors are dominated by state-owned companies, could spark civil unrest and boost support for populist parties. At the time of writing, the Bulgarian government was the only one in CEE to offset part of the increase in energy prices paid by companies with windfall profits made by the state-owned energy producer. Romania capped prices for SMEs without specifying how losses will be shared among producers/distributors. More appeal for populists could push mainstream parties to espouse fringe policies and derail important reforms on the NGEU agenda, such as green and digital transitions.

GOVERNMENT POLICIES COULD SLOW ECONOMIC GROWTH IN 2022-23

Chart 17: Negative impulses across the board in 2022

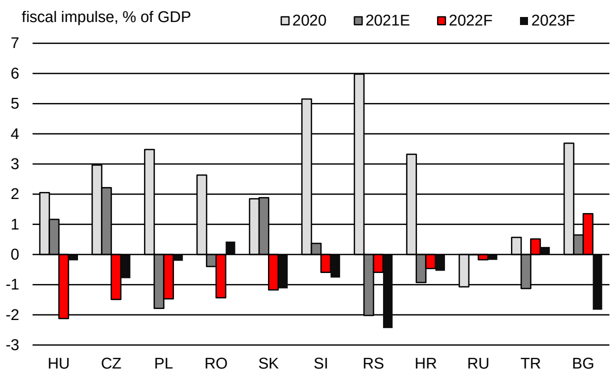
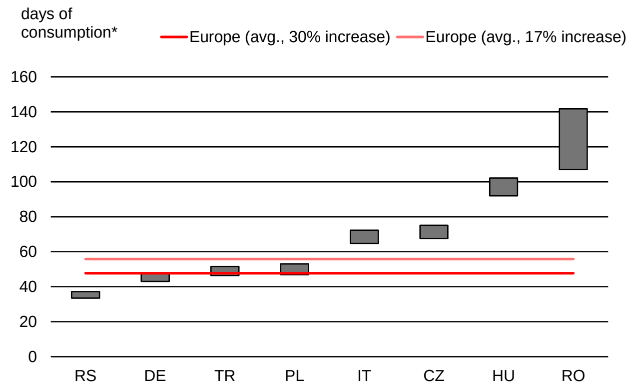


Chart 18: Current gas inventories will not last the winter



*estimated using deviations from average daily consumption in past winters

Source: statistical offices, Gas Infrastructure Europe, BP, UniCredit Research

OUR GLOBAL FORECAST

	GDP growth, %			CPI (Avg), %			Policy interest rate**, %			10Y bond yield (EoP), %			Exchange rate (LC vs.USD)		
	2021E	2022F	2023F	2021E	2022F	2023F	2021	2022F	2023F	2021	2022F	2023F	2021	2022F	2023F
Eurozone	5.2	3.9	2.9	2.6	3.2	1.4	-0.50	-0.50	-0.50				1.13	1.10	1.08
Germany*	2.7*	3.5*	3.7*	3.1	2.6	2.3				-0.18	0.00	0.30			
France	-6.7	4.0	2.6	1.6	1.9	1.0									
Italy	6.3	4.1	2.4	1.9	2.5	1.1				1.17	1.40	1.70			
UK	6.8	4.5	2.6	2.5	3.7	1.9	0.25	0.50	0.75				1.35	1.37	1.40
USA	5.5	3.5	2.7	4.7	4.7	2.0	0.25	0.75	1.50	1.51	2.00	2.15			
Oil price, USD/bbl													70	73	68

*Non-wda figures. Adjusted for working days: 2.7% (2021), 3.6% (2022) and 3.8% (2023): **Deposit rate for ECB

THE OUTLOOK AT A GLANCE

Real GDP (% change)	2020	2021E	2022F	2023F
EU-CEE	-4.0	5.1	4.0	4.3
Bulgaria	-4.4	3.6	3.6	4.3
Czechia	-5.8	2.4	3.0	4.2
Hungary	-4.7	6.5	4.3	4.9
Poland	-2.5	5.2	4.5	4.4
Romania	-3.9	6.4	3.7	3.5
Croatia	-8.1	9.5	4.4	5.3
Russia	-3.0	4.2	2.2	2.2
Serbia	-0.9	7.5	4.7	3.8
Turkey	1.8	10.7	4.7	4.1

CPI EoP (% change)	2020	2021E	2022F	2023F
EU-CEE	2.1	7.7	5.9	3.2
Bulgaria	3.8	7.7	3.5	2.8
Czechia	2.3	6.6	4.6	2.6
Hungary	2.7	7.9	5.9	3.8
Poland	2.4	8.6	7.8	3.9
Romania	2.1	8.1	5.9	3.1
Croatia	-0.7	4.9	2.1	1.5
Russia	4.9	8.4	4.6	4.0
Serbia	1.3	7.9	4.0	3.2
Turkey	14.6	36.0	37.0	18.7

C/A balance (% GDP)	2020	2021E	2022F	2023F
EU-CEE	-1.0	-1.7	-2.0	-1.1
Bulgaria	-0.3	-1.2	0.0	0.1
Czechia	3.6	-0.3	0.2	0.8
Hungary	-1.5	-2.9	-1.1	-0.6
Poland	2.9	-1.1	-2.2	-0.6
Romania	-5.0	-6.9	-6.6	-6.5
Croatia	-0.1	0.7	-0.6	-1.0
Russia	2.4	7.4	7.3	5.5
Serbia	-4.1	-4.2	-4.2	-4.2
Turkey	-4.9	-2.0	-0.6	-1.4

Extended basic balance (% GDP)	2020	2021E	2022F	2023F
EU-CEE	1.6	1.5	1.6	2.5
Bulgaria	4.5	1.7	4.1	4.8
Czechia	5.4	0.8	1.7	2.6
Hungary	2.4	-1.0	1.5	3.0
Poland	7.4	3.7	0.9	2.5
Romania	-2.2	-1.3	-0.8	-0.8
Croatia	3.6	6.4	5.6	5.4
Russia	2.7	6.8	4.9	3.5
Serbia	2.1	1.4	1.0	0.6
Turkey	-4.4	-1.1	0.2	-0.7

External debt (% GDP)	2020	2021E	2022F	2023F
EU-CEE	71.4	68.6	68.0	65.2
Bulgaria	65.3	61.5	56.8	54.1
Czechia	75.5	68.9	68.3	69.4
Hungary	150.8	143.2	126.2	111.2
Poland	62.7	54.3	49.4	45.9
Romania	42.9	48.0	51.3	54.3
Croatia	80.9	80.4	76.3	74.4
Russia	29.7	29.2	25.4	24.4
Serbia	65.8	62.1	60.8	61.0
Turkey	60.4	60.8	69.8	54.7

General gov't balance (% GDP)	2020	2021E	2022F	2023F
EU-CEE	-7.1	-6.1	-4.1	-3.1
Bulgaria	-3.4	-3.5	-4.3	-2.7
Czechia	-5.6	-7.3	-5.0	-4.0
Hungary	-8.0	-7.6	-4.8	-3.2
Poland	-7.1	-4.7	-2.6	-2.2
Romania	-9.4	-8.0	-6.2	-4.4
Croatia	-7.3	-4.5	-2.6	-2.4
Russia	-3.8	0.3	1.6	0.5
Serbia	-8.1	-4.0	-3.0	-1.5
Turkey	-5.2	-3.1	-4.8	-4.8

Gov't debt (% GDP)	2020	2021E	2022F	2023F
EU-CEE	55.0	55.4	54.0	53.6
Bulgaria	24.2	25.2	27.1	28.3
Czechia	37.7	42.6	44.4	45.4
Hungary	80.0	80.8	78.6	78.7
Poland	56.4	54.5	50.6	49.0
Romania	47.4	49.1	51.2	53.1
Croatia	87.3	82.9	79.6	76.1
Russia	18.4	18.6	19.0	19.8
Serbia	58.2	57.5	56.0	54.5
Turkey	39.7	45.9	42.4	38.3

Policy rate (%)	2020	2021	2022F	2023F
EU-CEE				
Bulgaria	-	-	-	-
Czechia	0.25	3.75	4.25	3.25
Hungary	0.60	2.40	3.00	3.00
Poland	0.10	1.75	3.50	3.50
Romania	1.50	1.75	3.00	3.00
Croatia	-	-	-	-
Russia	4.25	8.50	7.00	5.00
Serbia	1.00	1.00	2.00	2.00
Turkey	17.00	14.00	12.00	23.00

FX vs. EUR (EoP)	2020	2021	2022F	2023F
EU-CEE				
Bulgaria	1.96	1.96	1.96	1.96
Czechia	26.2	24.9	24.4	24.4
Hungary	365	369	360	365
Poland	4.61	4.60	4.65	4.65
Romania	4.87	4.95	5.08	5.18
Croatia	7.54	7.52	7.53	EUR
Russia	90.7	84.1	78.1	78.8
Serbia	117.6	117.6	117.8	118.4
Turkey	9.1	15.1	19.8	14.6

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)	-1.3	0.4	-0.6	-0.7	0.7	-6.9	-3.6	5.4	-1.2	-2.3	-0.2	1.0	-1.7	-3.5	4.0	0.2	-0.5	1.9	0.9
Extended Basic Balance (% of GDP)	1.2	2.4	3.6	1.6	5.6	-2.1	4.1	4.4	1.7	-1.5	2.9	3.0	0.3	-3.3	14.8	1.7	0.9	3.1	1.1
FX Reserves coverage (months of imports)	9.3	11.9	9.7	3.8	4.8	4.5	7.6	15.4	-	3.4	4.3	4.7	13.7	6.7	6.1	8.1	11.8	13.7	7.8
External Debt (excl.ICL, % of GDP)*	41.0	71.3	67.7	56.9	40.4	40.7	61.3	21.6	99.5	56.9	69.4	35.3	42.0	75.2	40.3	37.1	20.0	15.7	59.0
Short-term debt (% of GDP)	23.0	39.8	25.0	12.2	8.9	6.9	4.2	4.0	47.8	15.8	9.0	3.5	4.4	8.2	7.1	4.4	6.7	8.4	9.3
REER (Index, 2010=100)	107.2	104.1	99.7	83.5	89.0	99.8	128.4	79.9	-	42.8	103.0	81.0	140.7	80.8	106.9	90.5	109.3	128.3	-
Domestic Finances																			
Corporate debt (% of GDP)	43.7	50.2	63.3	58.0	43.3	39.4	46.3	57.5	54.3	65.7	51.3	27.2	53.0	107.9	45.1	36.9	54.6	156.8	18.3
Household Debt (% of GDP)	22.2	41.3	38.9	24.1	35.2	22.9	20.5	21.1	45.5	15.6	4.9	16.7	36.2	38.9	30.6	16.5	38.4	61.2	4.7
Nonresident holdings of LC gov.debt (% total)	0.7	29.7	-	23.2	26.0	17.2	18.5	32.1	54.5	3.4	-	17.4	9.0	-	28.4	22.8	-	11.1	-
Banking System																			
Credit Impulse (% of GDP)	1.9	1.5	-2.1	0.3	0.6	2.2	-2.4	1.9	0.3	-8.3	-2.2	-0.5	5.2	-2.3	-0.9	1.2	-1.9	-6.3	1.3
Loans/deposit ratio (%)	68.2	63.7	75.2	60.0	78.9	68.6	81.7	82.5	103.7	92.0	135.2	86.9	109.0	107.1	97.9	86.6	107.0	79.1	136.0
NPL (% of total loans)	7.3	2.4	6.9	2.2	3.4	3.7	3.5	7.5	2.4	3.2	33.3	2.4	2.4	1.4	5.1	3.2	7.9	1.8	5.0
Domestic Banks CAR (%)	22.4	21.5	25.6	19.5	19.9	23.1	21.7	12.4	20.8	17.8	21.6	18.4	16.9	14.3	16.9	25.2	15.6	14.5	26.2
Domestic Banks RoE (%)	10.6	12.1	9.8	12.8	1.4	13.6	8.0	24.6	9.8	12.5	34.7	16.1	15.0	20.9	8.5	11.6	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 (%)	-	3.75	-	2.40	2.25	2.00	1.00	8.50	0.00	14.00	9.00	5.50	9.25	4.00	3.75	3.50	4.00	4.35	38.00
Real policy rate (%)	-	-2.1	-	-5.0	-5.1	-5.9	-6.0	0.1	-5.6	-16.2	-0.9	-1.7	-0.7	-3.0	-1.6	1.6	-0.9	2.9	-8.7
Real Money market rate (%)	-	-1.8	-0.3	-4.1	-5.0	-4.8	-6.1	1.0	-6.1	-14.7	-1.9	-1.8	-0.8	-3.4	-1.8	1.8	-0.9	2.1	-12.4
Headline inflation (% yoy)	7.3	6.0	4.8	7.4	7.8	7.8	7.9	8.4	5.6	36.1	10.0	7.4	10.1	7.2	5.5	1.9	4.9	1.4	51.2
Core Inflation (% yoy)	2.7	7.8	3.6	5.3	4.7	5.5	3.5	8.7	6.0	31.9	7.9	5.9	7.6	6.4	3.3	1.6	6.1	1.0	55.5
GG Fiscal balance (% of GDP)	-2.9	-6.4	-5.6	-11.8	-2.8	-6.9	-2.7	-0.8	-6.1	-1.5	-3.3	-2.8	-4.8	-7.4	-6.4	-4.4	-6.6	-3.9	-2.5
GG Primary balance (% of GDP)	-2.3	-5.8	-3.8	-9.4	-1.7	-5.6	-2.4	0.0	-4.9	1.1	-0.6	-0.1	-0.6	-6.6	-2.3	-2.3	-3.2	N/A	-
Government Debt (% of GDP)	24.3	42.7	87.5	77.4	56.6	48.2	57.9	17.1	61.4	37.6	60.8	44.5	78.1	51.3	68.6	64.2	57.6	68.2	75.3
Markets																			
External Debt Spread (10Y, bp)**	67.7	-0.5	113.4	58.6	46.5	221.9	248.5	125.6	44.5	603.3	738.9	96.1	236.8	83.2	250.4	125.3	71.0	4.5	-
Local Currency Curve (5Y, %)***	0.1	3.3	0.2	4.6	4.1	4.8	3.5	8.5	-0.3	25.6	9.0	7.5	11.0	5.6	7.9	5.1	5.9	2.6	48.7
Local currency bond spread (2s10s)****	82.9	-67.8	37.7	33.2	29.8	84.4	140.1	9.0	78.7	-539.0	-26.0	42.1	250.0	108.0	283.0	-415.4	200.0	44.7	-368.0
CDS (5Y, bp)	80	47	112	70	67	123	136	170	62	550	616	155	290	125	280	135	143	40	2300
FX 3m implied volatility (%)	-	5.8	4.0	7.7	5.7	2.5	-	15.0	-	58.7	-	11.4	16.3	17.0	15.8	6.4	5.1	3.8	14.9
Structural* **																			
WEF Competitiveness Ranking	49	32	63	47	37	51	72	43	42	61	85	48	71	33	60	50	68	28	83
Unemployment (%)	4.8	2.6	8.0	3.9	3.5	5.3	10.8	4.3	6.8	11.2	9.9	4.0	12.1	8.4	34.9	6.5	7.0	5.1	8.3

** 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; ***** 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: Higher volatility as central-bank support dwindles

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- We forecast volatile but still-solid equity performance for developed markets in 2022, with returns in the 10% area. EM equities will face a difficult year, in our view, due to dwindling central bank support, slowing growth in China and lingering pandemic risks. We see 10Y UST yields moving towards the 2% mark and the curve bear-flattening on upcoming Fed hikes, which will also keep the USD relatively bid. We forecast EUR-USD at 1.10 by YE 2022.
- High uncertainty on the growth and inflation fronts as well as reduced accommodation by central banks argue for higher volatility going forward. A more-active portfolio management and exposure selection will be needed to navigate the expected swings in risk appetite.
- The market environment will be challenging for CEE local bonds. We think that CZGBs are better positioned to perform across CEE-3 and see the 10Y area on the POLGB curve and the 5-7Y area on the HGB curve as most exposed to risk. Among high yielders, there are plenty of tailwinds for ROMGBs, while geopolitical risks cloud the outlook for OFZs.

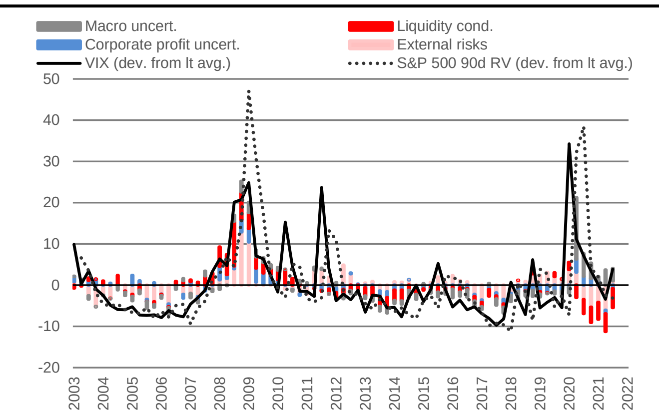
Increased challenges after a year of strong performance for risky assets

As the global economic recovery gains track, the ultra-accommodative monetary and fiscal policies that have characterized the past two years are set to be progressively reined in. However, some of the consequences of the crisis, such as high (gross) debt levels and large central bank balance sheets are likely to stay. Borrowing needs will remain elevated. Demographic trends, health care needs, environmental issues as well as increased attention to supply-chain resilience call for larger public and private investment over the coming years, while sticky inflation is a risk for the cost of borrowing. Liquidity will remain ample but central banks will navigate a scenario of slowing but still-high GDP growth and high inflation, seeking to reduce accommodation while avoiding an unwarranted tightening of financial conditions. Adding to the challenge, the crisis and years of low policy rates have increased uncertainty regarding the level of the neutral rate and, given the asymmetric costs of a misestimation, risk management considerations remain key for policy choices.

However, the direction is clear: the Fed looks set to speed up the tapering process and rate hikes will follow. Recent comments have also opened the discussion on the timing of the Fed's balance sheet run-off. We think that the Fed will hike twice in 2022 and three times in 2023 and that the hiking cycle will continue to take the Fed funds rate to a peak in the 2-2.5% area, but chances of a more front-loaded tightening have been rising in recent weeks. Other major developed market central banks will move in the same direction, at their own pace. As per the ECB, we see no move on rates over the forecast horizon, QE will be slowly reduced.

CHART 1: RISK AND RETURN

CHART 2: HIGH UNCERTAINTY (VIX AND ITS DRIVERS)



Source: Haver, Bloomberg, UniCredit Research

Several sources of uncertainty might lead to swings in risk appetite

Speculation about the speed and magnitude of central bank moves will add uncertainty to markets otherwise still guided by solid economic growth and improving corporate fundamentals and add to a long list of macroeconomic and political risks. Chart 2 shows a breakdown of the S&P 500 implied volatility (VIX) estimated based on measures of macroeconomic and corporate profit uncertainty, liquidity conditions and external (global) factors. The VIX is displayed as a deviation from its long-term average (approx. 20 points), while the stacked columns show the contribution of each factor to the fit of the model. Supply bottlenecks, elevated inflation and pandemic developments continue to pose risks to macroeconomic and corporate performance, and, while central bank liquidity will remain abundant, impulses will progressively be less positive. Meanwhile, economic/trade policy uncertainty and geopolitical risks need to be monitored carefully. Hence, 2022 might feature higher volatility, and while we do not think that this will prevent selected risky assets from posting a positive performance, risk-adjusted returns will be affected.

Equities: large upside but with higher risks

Developed market equities have interesting return prospects. Performance will be mostly driven by a solid trend in earnings growth and characterized by higher volatility compared to 2021. Monetary policy tightening might prove a headwind, particularly for market segments where valuations are elevated. Looking at the past two Fed rate-hike cycles, the performance of the S&P 500 starting from three quarters before the lift-off date (we expect the first hike in 3Q22) and during the following two years has been solid overall (7-10% annualized) but with returns being negative during several quarters and with maximum drawdowns in the 10% area. Such episodes suggest that an increase in equity volatility and short-lived periods where bond and equity performance are positively correlated might be in the cards. Central banks will likely act to avoid a material tightening in financial conditions; however, given the expected monetary policy outlook, the so-called Fed-put might lose its power. We forecast returns in the 10% area for European and US equities in 2022. After a weak 2021 and despite their relatively cheap valuations, EM equities will face a difficult year, in our view, due to dwindling central bank support, slowing growth in China and lingering pandemic risks.

Commodities: diverging outlook across market segments

Commodities did especially well in 2021, supported by the reflation story, strong demand and supply shortages. We think industrial metals will continue to benefit as public and private investment picks up. Energy prices might remain high in the short-term, but we see the market rebalancing towards lower oil prices in the coming quarters. Rising real rates and easing inflation fears pose a headwind to precious metals.

CHART 3: PE RATIO AND EQUITY-BOND CORRELATION

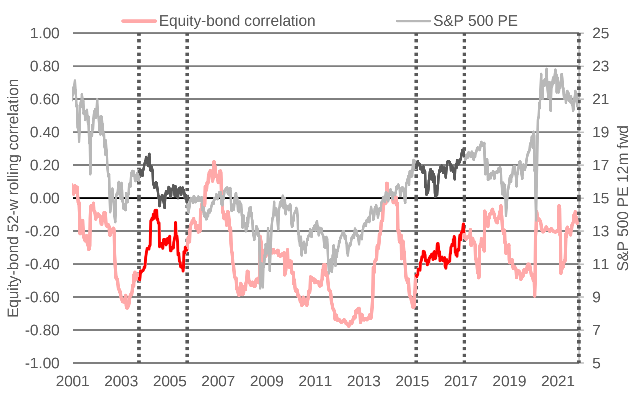
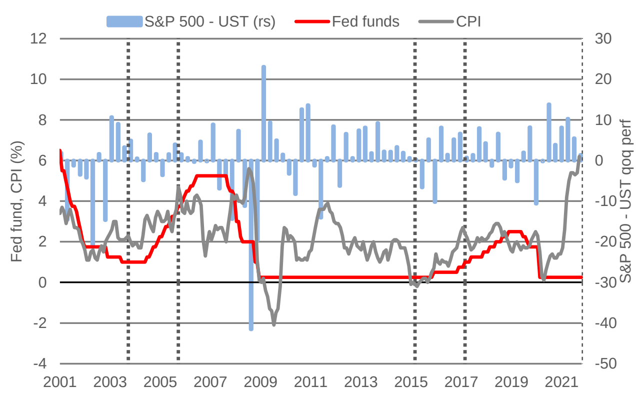


CHART 4: RELATIVE PERFORMANCE



Dotted lines indicate the two-year time span starting three quarters from the lift-off date of the Fed funds rate

Source: Bloomberg, UniCredit Research

Duration to pose a headwind for fixed-income performance

US growth and inflation outlooks call for higher yields at the long end, and we see the 10Y UST yield reaching 2% in late 2022, as real yields become less negative. However, as rate hikes kick in, a lasting bear-flattening trend will emerge. In the euro area, yields at the long end will rise slowly, given lower inflationary pressure and the more-cautious central bank, while the short end will stay pegged.

Hence, we believe that USTs and EGBs will deliver negative returns in 2022 and recommend a short-duration stance on both fixed-income markets. The Fed's action will offer continued support to the US dollar and widening rate differentials will, in our view, push EUR-USD towards 1.10 by YE 2022 and lower over the following years.

Credit exposure: risks from increased correlation with rates

Across riskier segments of the European bond market, higher carry will help offset interest-rate headwinds and there might be some room for spread compression over the course of 2022. Solid credit fundamentals, lingering demand for yield and a neutral supply picture support this view. We see more headwinds for US credit, due to higher interest rate and inflation risk, as well as more shareholder-friendly policies. A key risk for credit is the extent of correlation between rate and credit spread moves. Over the past thirty years, the correlation between changes in 10Y UST yields and BAA credit spreads in the US has been negative on average (approximately -0.50), with large swings particularly during times of stress. Central banks' asset purchases have contributed to more synchronous moves in rates and credit while pushing spreads to historically low levels. Abundant liquidity and low funding costs have fueled the supply of long-dated bonds, while yield enhancement strategies prevailed. In this context, fixed-income portfolios duration has been lengthening, which increases the risk of more indiscriminate position shedding and redemptions in case of a rapid rise in UST/Bund yields, thereby increasing the correlation between spreads and interest rate changes. This might be felt particularly where carry is low and/or positions are leveraged.

A still-strong US dollar, rising UST yields and a context of higher volatility in equity and credit markets create challenging conditions for EM bonds. We expect investors to be extremely selective and take a cautious approach when it comes to both duration and credit risk. Demand for yield is still there, but a high level of volatility weighs on carry plays.

CHART 5: EM HC BOND AND UST PERFORMANCE

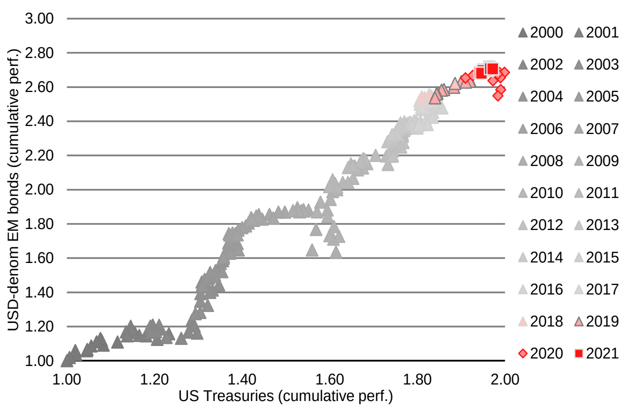
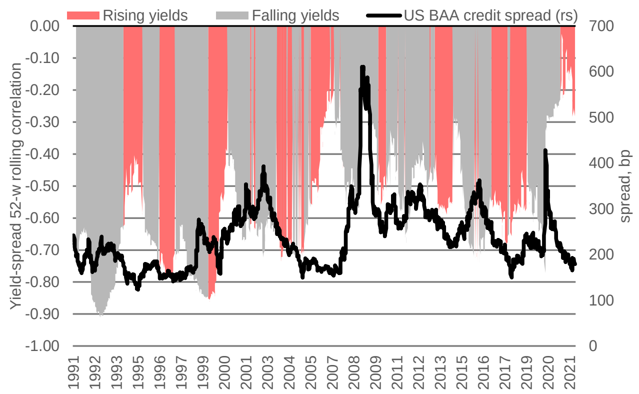


CHART 6: UST YIELDS AND CREDIT SPREADS



Source: Bloomberg, UniCredit Research

CEE bonds

A challenging environment for emerging markets would leave CEE assets relatively less exposed to risk given the solid fundamentals, the ties to the eurozone and manageable funding needs. Still, the weakening path we project for the euro against the USD and G10 majors, on the back of widening rate differentials, poses a headwind to regional assets. Performance across countries will vary depending on the combination of inflationary pressure, monetary and fiscal policy stimulus as well as political and geopolitical considerations.

Across CEE-4, inflation might still have some room to rise before easing significantly in the latter part of 2022. Central banks' tightening cycles will continue, but prospects differ across countries.

In Czechia, inflation will likely peak at above 8% before dropping towards 4.6% at the end of the year. The tightening cycle is nearly over, with likely additional 75bp to be delivered before the peak of this cycle is reached.

FRAs price in some more action by the central bank but with the peak eyed within the next six to nine months. In our view, the easing cycle that will follow might feature a 25bp move already in 2022 and continue into 2023. Hence, the overall monetary and inflation outlook should be supportive for CZGBs relative to regional peers. At the front end, CZGB still feature higher yield levels than HGBs and POLGBs. Despite a widening rate differential, positioning on the CZK is already long and EUR-CZK might have little downside left.

The POLGB and HGB curves are upward sloping up until the 5Y area, mirroring expectations of more sizable central bank action and possibly higher inflation risk. In Poland, inflation might peak in double-digit territory (highest in the region) before easing to below 8% by year-end, a still-high level in absolute terms and compared to regional peers. NBP action on rates – we expect official rates to be lifted to 3.5% – might not be enough to prevent inflation fears from driving local yields higher, and it falls short of what the market is pricing in. Moreover, lacking the support of central bank asset purchases, medium and long-term maturities of the curve could find little interest below the 4% mark, which might challenge the rate-hike-driven bear-flattening trend.

CHART 7: CEE-3 LOCAL CURVES

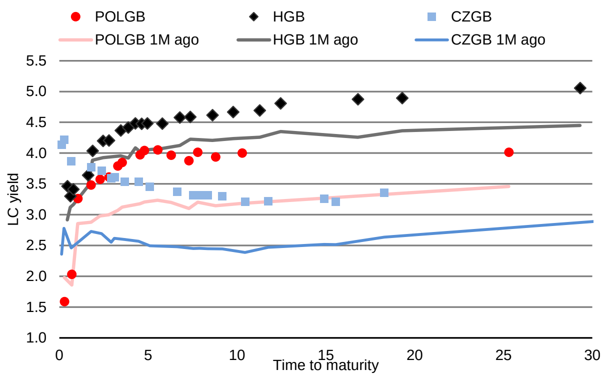
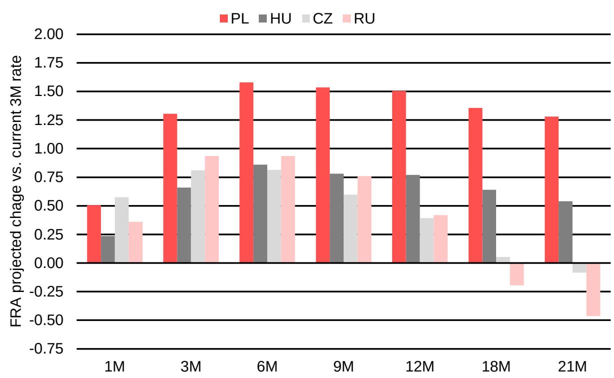


CHART 8: EXPECTED CHANGE IN SHORT-TERM RATES



Source: Bloomberg, UniCredit Research

In Hungary, the first few months of 2022 might be particularly challenging. Inflation will continue to move higher before falling in 2H, fiscal policy is likely to stay very accommodative ahead of the election round, while the NBH will progressively take the policy rate towards 3% and the 1W deposit rate to around 4.5%. Markets price in nearly 75p in hikes for 2022 and the local yield-curve slope is all in the 2-5Y segment. Domestic demand is unlikely to support bonds trading at negative ASW levels and thus interest for bonds shorter than 10Y is likely to be limited. In this context, the 5-7Y area of the curve appears most exposed to sell-off risk. More conservative fiscal policy following the elections might pave the way to solid demand.

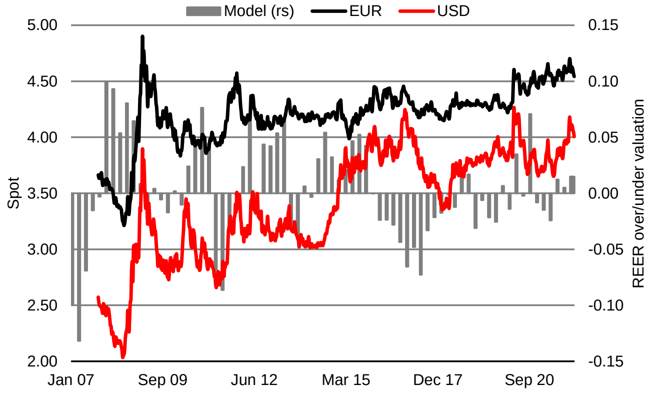
Romania features the most attractive levels and plenty of tailwind for the performance of local bonds. Inflation will likely peak at above 9% in the earlier part of the year before decreasing steadily to below 6%, the premium related to political and rating uncertainty should drop, domestic demand should stay healthy, and positioning will likely have room to catch up after the difficult 4Q21. The lack of significant FX risks should contribute to the attractiveness of ROMGBs in the region, and bonds beyond 5Y trading at 5% and higher yields would be the best pick. Monetary tightening is not expected to take official rates beyond 3%, leaving ROMGBs with a large premium. A change in sentiment would require increased interest by foreigners in the region.

Despite very high yields, a monetary-policy outlook that will feature rate cuts in 2022 and 2023, and solid fundamentals, interest in the Russian local curve might be limited due to geopolitical risks. Consequently, ROMGBs might be a more attractive pick among high yields in the region. The RUB has room to rally this year, while less-positive rate differentials might weigh on the currency in 2023.

Updating our REER models

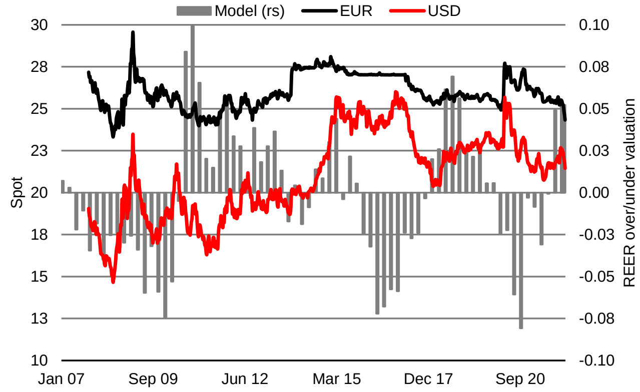
PLN

- The zloty has staged a sizable recovery over the past few weeks, following a buildup of depreciation pressure in November 2021. EUR-PLN fell below 4.55, and the REER PLN recovered by nearly 5pp, returning above its average for the past three years.
- In REER terms, the zloty is broadly in line with our model's fair value. NBP action on rates might not be enough to support the currency given inflation fears, with political noise providing an additional headwind.
- We expect EUR-PLN to remain in the 4.55-4.65 range throughout 2022. Risks are that the PLN will weaken compared to regional peers.



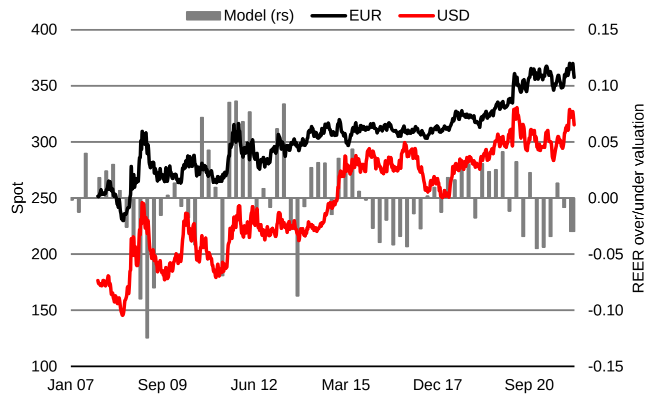
CZK

- CZK strength has accelerated in the last few weeks, with EUR-CZK breaking below 24.5 and approaching 24.2, which is where the CNB would like to see it.
- In REER terms, the CZK is nearly 6% higher than it was in early 2020 before the pandemic crisis. At this level, the CZK looks moderately overvalued according to our model, but remains undervalued according to the central bank.
- The tightening cycle for the CNB is likely to end before mid-2022; the CNB will most likely take the policy rate to 4.5%. This would be the peak rate for this cycle, and easing would follow, possibly starting already in 2022. We expect EUR-CZK to level off at 24.4 in late 2022.



HUF

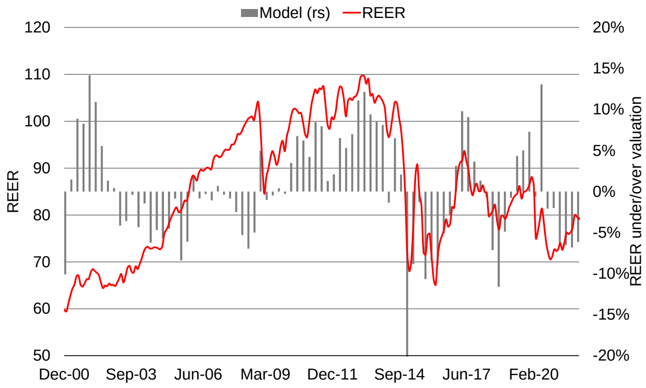
- Along with regional peers, the HUF has also recovered in REER terms in recent weeks, returning to levels prevailing at the beginning of October 2021, while EUR-HUF has fallen towards 355.
- Despite its recent recovery, the HUF still looks slightly undervalued in REER terms in our model. However, the distance from fair value is very modest.
- The first part of the year might prove challenging for HUF-denominated assets given inflationary pressure and political risk. The NBH's rate-hike path will continue, and we expect the policy rate to reach 3% (and the 1W deposit rate 4.5%), with a risk of further action if inflation pressure does not ease. Implied rates will be kept higher via liquidity sterilization. We expect EUR-HUF to be at 360 at YE 2022.



Source: Haver, Bloomberg, UniCredit Research

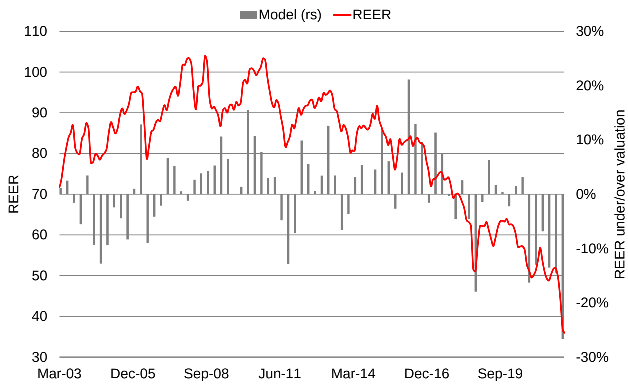
RUB

- The REER RUB has moved sideways over the past three months, stabilizing from October peaks as USD-RUB moved towards 75.
- According to our model, the RUB looks moderately undervalued in REER terms. Monetary tightening will continue to offer support in the short term, but the CBR's easing cycle might start already in 2022 and continue in 2023. Geopolitical developments still pose a risk for RUB-denominated assets that could underwhelm the impact of tight monetary policy.
- We expect USD-RUB to trend lower towards 71, which is our forecast for YE 2022, provided geopolitical risks do not materialize. We expect weakening pressure to resurface in 2023, driving the pair gradually higher.



TRY

- The Turkish lira has shown huge volatility in recent months, with the USD-TRY falling below 11 from mid-December peaks before rising again to the 13.5-14.0 area.
- In REER terms, the TRY is also close to mid-November levels and is shown as largely undervalued in our model, but this very large gap is unlikely to be closed over the coming months.
- We forecast USD-TRY will rise further towards 18 by YE 2022. Deeply negative real rates and the CBRT's easing bias speak for further weakness. Reserve depletion and/or liquidity restrictions might slow this move.



Source: Haver, Bloomberg, UniCredit Research

Countries

Bulgaria

Baa1 stable/BBB stable/BBB stable*

Outlook

More-severe and longer-lasting supply bottlenecks and higher-than-expected inflation are likely to slow the pace of growth this year, compared with our previous forecast. All four parties supporting Bulgaria's new coalition government have agreed that low vaccination rates and high inflation are the immediate challenges they face. Apart from these, the government aims to eradicate corruption, reform the judiciary, streamline state institutions and adopt the euro in 2024, as originally planned.

Strategy

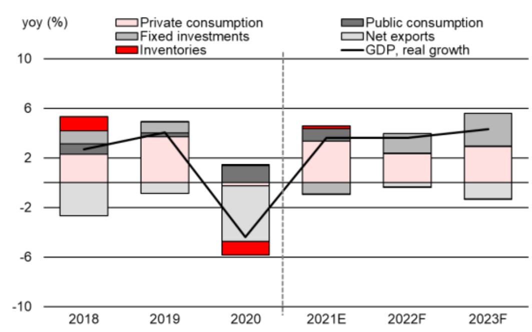
Bulgaria entered 2022 without a new budget law. The MinFin is expected to submit the draft budget law in January and the Parliament is likely to pass it in February. To meet its funding needs we expect Bulgarian sovereign to issue BGN 2.8bn of bonds in the domestic market, on top of EUR 3.250mn worth of bonds issued externally in the 2H22.

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

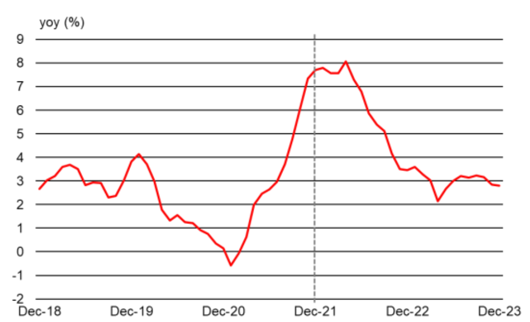
KEY DATES/EVENTS

- 21 Jan.: sovereign rating review from Fitch
- Mid-Feb., Early-Mar.: 4Q21 GDP (flash, structure)
- Mid-Feb.: labor force survey data for 4Q21
- End-Mar.: nationwide house-price index for 4Q21

GDP GROWTH FORECAST



INFLATION FORECAST



Source: National Statistical Institute, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2019	2020	2021E	2022F	2023F
GDP (EUR bn)	61.6	61.3	66.5	74.0	80.5
Population (mn)	7.0	6.9	6.9	6.8	6.8
GDP per capita (EUR)	8 855	8 867	9 684	10844	11888
Real economy, change (%)					
GDP	4.0	-4.4	3.6	3.6	4.3
Private consumption	6.0	-0.4	5.1	3.5	4.4
Fixed investment	4.5	0.6	-4.5	8.5	13.3
Public consumption	2.0	8.3	5.5	0.1	0.2
Exports	4.0	-12.1	8.7	8.1	7.3
Imports	5.2	-5.4	8.0	7.9	8.4
Monthly wage, nominal (EUR)	648	709	787	845	924
Real wage, change (%)	7.5	7.7	7.7	1.3	6.4
Unemployment rate (%)	4.2	5.1	5.4	5.0	4.3
Fiscal accounts (% of GDP)					
Budget balance	2.1	-3.4	-3.5	-4.3	-2.7
Primary balance	2.7	-3.1	-5.0	-2.2	-1.9
Public debt	19.6	24.2	25.2	27.1	28.3
External accounts					
Current account balance (EUR bn)	1.1	-0.2	-0.8	0.0	0.1
Current account balance/GDP (%)	1.9	-0.3	-1.2	0.0	0.1
Extended basic balance/GDP (%)	5.0	4.5	1.7	4.1	4.8
Net FDI (% of GDP)	2.0	3.5	1.6	1.9	2.4
Gross foreign debt (% of GDP)	62.3	65.3	61.5	56.8	54.1
FX reserves (EUR bn)	24.8	30.8	29.3	30.9	33.5
Months of imports, goods & services	7.4	10.4	8.0	7.3	7.0
Inflation/monetary/FX					
CPI (pavg)	3.1	1.7	3.3	6.0	3.0
CPI (eop)	2.7	3.8	7.7	3.5	2.8
LEONIA (eop)	-0.61	-0.70	-0.53	-0.50	-0.48
USD/BGN (eop)	1.74	1.60	1.72	1.78	1.81
EUR/BGN (eop)	1.96	1.96	1.96	1.96	1.96
USD/BGN (pavg)	1.75	1.71	1.66	1.76	1.79
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

Growth to remain lackluster amid inflation-related woes

Tight supply and high inflation are expected to take a toll on growth

We have lowered our real GDP growth forecast for 2022 to 3.6% yoy (from 3.9%), amid supply bottlenecks and the expectation that high inflation will last longer than anticipated previously. We now expect 4.3% real GDP growth in 2023, when the unemployment rate is also forecast to go down to levels consistent with full employment, according to our baseline scenario.

The health situation is projected to gradually improve in 2022

The outlook for the economy will continue to depend on how the coronavirus pandemic develops. The Omicron variant of COVID-19 is adding to the headwinds in the short term and is forecast to dampen economic activity in 2022. However, we assume that the effectiveness of current vaccines will not fade substantially and that the share of the vaccinated population will slowly rise, although it is likely to remain below the level needed to achieve collective immunity. Under these assumptions, the health situation should improve, and the negative impact of new pandemic waves on the growth trajectory should be more limited than in the past.

We have substantially raised our inflation forecast for 2022

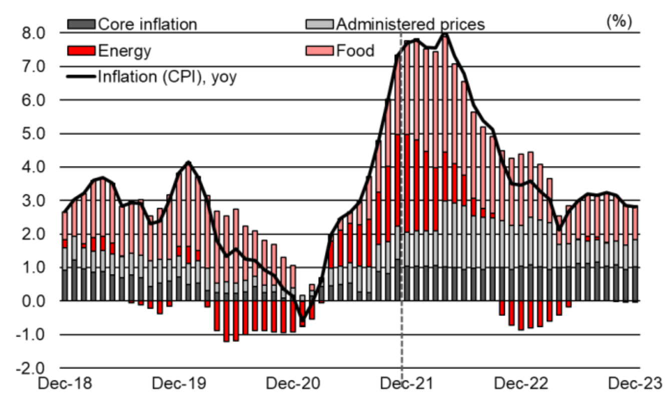
We expect average CPI inflation to rise to 6.0% yoy in 2022 before falling back to 3.0% in 2023 (see chart). We still think that high inflation mostly reflects temporary factors, including elevated energy prices, supply bottlenecks and base effects. However, inflation has recently become more broadly based and is likely to last longer. This is because supply bottlenecks, which have weighed on production and pushed up core prices substantially, are expected to normalize back to pre-pandemic levels only in 2023, significantly later than we had previously anticipated. Furthermore, there are two country-specific reasons why inflation in Bulgaria is likely to be perhaps even higher than in the rest of the CEE region. First, a rapid increase in food prices is likely to prove more persistent, in our view, because an ongoing shortage of fertilizers is likely to cut harvest volumes in 2022. If this scenario materializes, headline inflation will increase to a larger degree in Bulgaria than in the rest of the CEE region, because food accounts for the largest share of Bulgaria's CPI basket. Second, the pass-through of higher commodity prices to consumer prices in Bulgaria is likely to be amplified by the fact that the country has a relatively large number of sectors that are characterized by elevated concentration, which suggests that Bulgaria's share of companies with large pricing power is significant as well.

There is no indication that high inflation will lead to higher labor costs

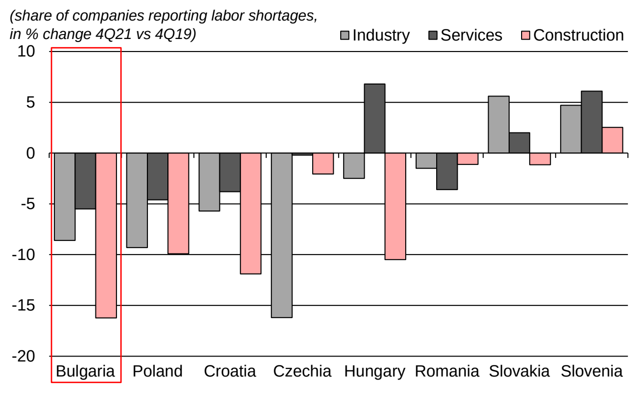
Our inflation forecast assumes household electricity and central-heating prices will rise by 15% in April 2022. Feedback from higher costs to higher prices and wages (so-called second-round effects) is likely to be small, in our view. This is because employment rate suggest that there is still some slack in Bulgaria's labor market. Also importantly, the share of business managers reporting labor shortages now compared to the period before the start of the pandemic is significantly smaller in Bulgaria than in the rest of the CEE region (see chart).

The composition of GDP growth is likely to change. Private consumption will contribute less to growth in 2022 than in 2021. This mostly reflects higher consumer price inflation, which in 2022, is set to cut disposable to a much larger degree than in 2021.

WE EXPECT HIGH INFLATION TO PERSIST



BULGARIA HAS SMALLER LABOR SHORTAGES THAN THE CEE



Source: Eurostat, National Statistical Institute, UniCredit Research

Weaker pension and public-sector wage growth will cut into consumption growth

Higher inflation has hurt consumer confidence

However, this is not the only reason why we expect that consumption growth will be weaker in 2022. The boost from election-induced increases in public sector wages and pensions is fading, and the economy faces the prospect of less-expansionary fiscal policy. The draft budget for 2022 envisages public-sector wages and pensions rising by 5% and 8% respectively, which is broadly in line with expected inflation and only around a third of the 15% increase in public-sector wages and 22% rise in pensions reported last year. Private-sector wage increases would not help much either, since wage bargaining will take place in a context of persistent supply bottlenecks and higher commodity prices, which will limit the capacity of the employees to negotiate any marked rise in wages. Against this backdrop, we expect households to use some of their savings to cushion the impact from this squeeze in the real income, but low consumer confidence (see charts) suggests that consumption growth is likely to be only modest.

Public capex is set to accelerate from 2022 onwards

In contrast, investment are likely to pick up, driven by stronger public capex, while private capex is set to rebound at a slower pace, due to supply bottlenecks lasting for longer than we had expected previously. Importantly, public capex in green transition and digitalization financed by Next Generation EU (NGEU) funds will boost potential growth, if the needed reforms are made.

A comprehensive coalition agreement was signed

All four parties supporting the new government have signed a comprehensive coalition agreement. This has helped address ideological differences among them and was instrumental in reducing uncertainty as to the priorities of the new government. Apart from its immediate challenges, which include low vaccination rates and high inflation, the government aims to eradicate corruption, streamline the state and adopt the euro in 2024, as originally planned.

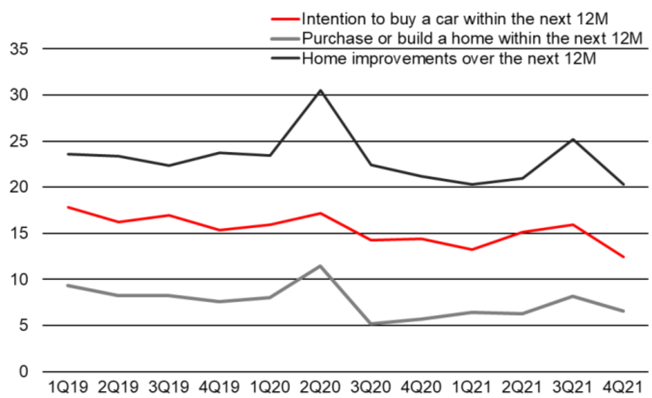
Euro adoption in 2024 remains an important priority

Economic policy will be shaped by a need to strike the balance between two priorities: to sustain the ongoing economic recovery, after a prolonged and painful health crisis, on one side, and to preserve the medium-term sustainability of public finances ahead of Bulgaria's adoption of the euro, on the other. To this end, the government aims to reduce public administration, improve tax collection, cut administrative burden and reexamine the structure and functions of regulatory agencies, while also shortening the mandates of those sitting in their governing bodies.

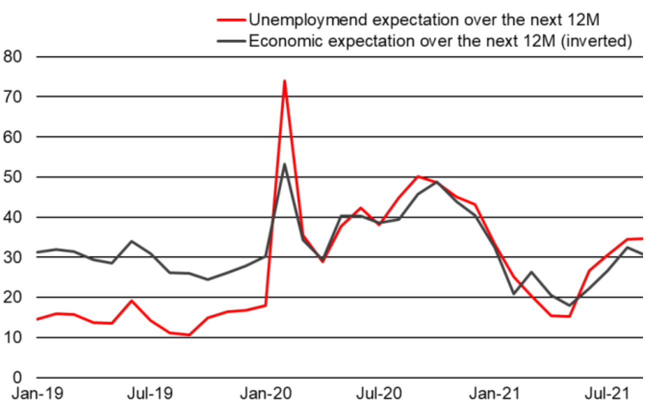
A shift back to neoliberal policies seems to be underway

A shift back to neoliberal policies also includes reducing the tax burden for high-income households, in the form of cutting inheritance tax and abolishing so-called weekend tax, as well as taxing income from bank deposits. SMEs will also benefit, as the threshold for VAT registration will increase. At the same time, it is encouraging that an agreement was reached to raise child benefits and improve spending control in the health sector, while abandoning the GERB's plans to replace the existing state monopoly with a poorly regulated private oligopoly. Positively, the government also plans to prepare a list of projects to apply for loans from the NGEU facility, which will raise the volume of green transition and digitalization related capex.

HOUSEHOLDS ARE NOT IN THE MOOD FOR HIGH-VALUE PURCHASES



HOUSEHOLDS' EXPECTATIONS ARE GETTING WORSE



Source: Eurostat, UniCredit Research

The next Eurobond may come on top of EUR 3bn

Bulgaria's cash deficit remained low despite an ongoing health crisis

The Min Fin posted a cash deficit equivalent to 3.1% of GDP last year. Better-than-expected fiscal outrun last year reflects a combination of factors, including inflation fueled surge in tax revenues, cutback in public capex (to estimated 3% of GDP compared to 4.8% envisaged in the plan) and transfer back into the budget of BGN 490mn, which were in a special extra-budgetary account designed to finance the completion of the Hemus highway. In addition to that, two large one-off payments helped provide a solid boost to tax revenues in 2021. These were an advance payment of BGN 683mn from Gazprom (for reserving a large part of the capacity of a new gas pipeline that provides an extension to the TurkStream gas pipeline) and a BGN 660mn fee for granting on concession the Sofia airport to the France-based investor Meridiam.

Bulgaria abandoned its plan to tap the Eurobond market on 2021

Repeated failure to form a stable government forced Bulgarian authorities to abandon plans to tap the Eurobond market last year. To meet its funding needs, Min Fin issued a record high BGN 3.8bn of bonds on the domestic market. This came on top of EUR 511mn of low-cost funding received under the EU's SURE financial assistance instrument.

Bulgaria's budget law for 2022 is not ready yet

Bulgaria entered 2022 without a new budget law. The Mini Fin will submit the draft budget in January and the Parliament is likely to pass the bill in February. Revision is likely in June, as the government would need more time to translate the new policies envisaged in the coalition agreement into fresh amendments in the country's consolidated fiscal program.

Build up of a huge reserve, using fiscal revenues over performance in 2021, will help reaching deficit target in 2022

We expect Bulgaria's budget deficit to amount to 4.3% of GDP this year. This is close to the upper part of the targeted range envisaged in the coalition agreement. Risks to meet budget deficit target seems small. This is because smaller public sector wages and pensions increases are envisaged in 2022, while BGN 1.2bn social spending this year would be financed from a special off-budget fund, which was created using fiscal revenues over performance in 2021.

Bulgaria's next Eurobond is likely to reach EUR 3.3bn in size

When debt repayments of BGN 2.8bn are added sovereign finding needs rise to slightly more than 6% of GDP in 2022. To meet these funding needs, we expect BGN 2.8bn of bonds to be issued in the domestic market, on top of EUR 3.250mn worth issued externally in 3Q22. If our projection is broadly right, the fiscal reserves will go moderately down, to 5.7% of GDP, by the end of 2022 (from 6.4% in 2021), while the public-debt-to-GDP ratio would rise to 27.1%.

GOVERNMENTAL GROSS FINANCING REQUIREMENTS

EUR bn	2021E	2022F	2023F
Gross financing requirement	**2.7**	**4.8**	**4.0**
Budget deficit	2.0	3.2	2.3
Amortization of public debt	0.7	1.6	1.7
Domestic	0.5	0.2	0.3
Bonds	0.5	0.2	0.3
Bills	0.0	0.0	0.0
Loans/other	0.0	0.0	0.0
External	0.2	1.4	1.4
Bonds and loans	0.0	1.3	1.2
IMF/EU/other IFIs	0.2	0.2	0.2
Financing	**2.7**	**4.8**	**4.0**
Domestic borrowing	1.9	1.4	1.3
Bonds	1.9	1.4	1.3
Bills	0.0	0.0	0.0
Loans/other	0.0	0.0	0.0
External borrowing	0.6	3.4	3.1
Bonds and loans	0.0	3.3	3.0
IMF/EU/other IFIs	0.6	0.1	0.1
Privatization/other	0.0	0.0	0.0
Fiscal reserves change (- =increase)	0.2	0.0	-0.4

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2021E	2022F	2023F
Gross financing requirement	**13.1**	**13.7**	**13.8**
C/A deficit	0.8	0.0	-0.1
Amortization of medium- and long-term debt	3.3	4.6	4.4
Government/central bank	0.2	1.4	1.4
Banks	0.5	0.6	0.8
Corporates/other	2.6	2.5	2.2
Amortization of short-term debt	9.0	9.2	9.4
Financing	**13.1**	**13.7**	**13.8**
FDI (net)	1.1	1.4	1.9
Portfolio equity, net	-1.5	-0.2	-0.5
Medium and long-term borrowing	3.2	4.6	5.5
Government/central bank	0.6	3.4	3.1
Banks	0.7	1.0	0.8
Corporates/other	1.9	0.3	1.6
Short-term borrowing	9.2	9.4	9.8
EU structural and cohesion funds	0.8	1.6	1.9
Other	-1.3	-1.5	-2.3
Change in FX reserves (- = increase)	1.6	-1.7	-2.6
Memoranda:			
Nonresident purchases of LC gov't bonds	0.0	0.0	0.0
International bond issuance, net	0.0	2.0	1.8

Source: Bulgarian National Bank, Ministry of Finance, UniCredit Research

Croatia

Ba1 stable/BBB- stable/BBB positive*

Outlook

We are raising our GDP growth estimate for 2021 to 9.5% due to better-than-expected economic performance in the first three quarters and the improvement in overall sentiment after the tourism season delivered results that were above the most optimistic expectations. In 2022, growth should remain solid but weaker due to negative carryover from 4Q21. We project growth of 4.4%. This should be driven by investment acceleration boosted by EU funding and solid private consumption. In 2023, growth may accelerate to 5.3% on momentum created by investment and the expected adoption of the euro, which may push exports. The authorities will be intent on implementing all the policies necessary for euro adoption approval at the beginning of July 2022. This likely includes government deficit consolidation to below the 3% threshold and a further debt ratio decrease.

Strategy

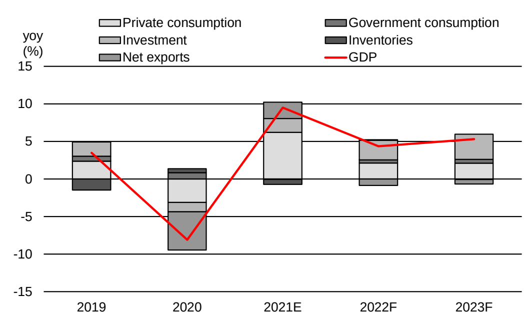
Bond spreads vs. Bunds could compress further as euro adoption approaches. We expect strong demand for new EUR issuance.

Author: Hrvoje Dolenec, Chief Economist Croatia (Zagrebacka banka)

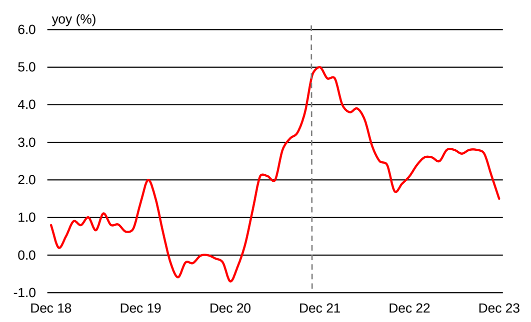
KEY DATES/EVENTS

- 25 Feb.: 4Q21 & FY21 GDP
- 31 Mar.: 4Q21 & FY21 BoP
- 21 Apr.: EDP notification
- 18 Mar.: rating update from S&P

GDP GROWTH FORECAST



INFLATION FORECAST



Source: Eurostat, CNB, Crostat, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

EUR bn	2019	2020	2021E	2022F	2023F
GDP (EUR bn)	55.6	50.2	56.5	60.7	65.5
Population (mn)	4.1	4.0	4.0	4.0	4.0
GDP per capita (EUR)	13,677	12,410	14,022	15,148	16,431
Real economy, change (%)					
GDP	3.5	-8.1	9.5	4.4	5.3
Private consumption	4.0	-5.3	10.4	3.5	3.5
Fixed investment	9.8	-6.1	8.7	12.5	14.9
Public consumption	3.3	4.1	-0.2	2.0	2.5
Exports	6.8	-22.7	27.0	11.9	9.5
Imports	6.5	-12.3	18.6	12.4	9.6
Monthly gross wage, nominal (EUR)	1182	1224	1274	1323	1395
Real wage, change (%)	3.0	2.4	1.4	0.9	3.0
Unemployment rate (%)	6.6	7.5	7.8	6.3	5.0
Fiscal accounts (% of GDP)					
Budget balance	0.3	-7.3	-4.5	-2.6	-2.4
Primary balance	2.5	-5.2	-2.8	-1.1	-1.0
Public debt	71.1	87.3	82.9	79.6	76.1
External accounts					
Current account balance (EUR bn)	1.7	-0.1	0.4	-0.4	-0.6
Current account balance/GDP (%)	3.0	-0.1	0.7	-0.6	-1.0
Extended basic balance/GDP (%)	10.8	3.6	6.4	5.6	5.4
Net FDI (% of GDP)	6.1	1.6	2.1	1.6	1.4
Gross foreign debt (% of GDP)	73.5	80.9	80.4	76.3	74.4
FX reserves (EUR bn)	18.6	18.9	24.6	27.2	29.3
Months of imports, goods & services	7.8	9.3	10.1	9.8	9.6
Inflation/monetary/FX					
CPI (pavg)	0.8	0.1	2.5	3.2	2.5
CPI (eop)	1.4	-0.7	4.9	2.1	1.5
Central bank reference rate (eop)	0.3	0.05	0.05	0.05	EUR
USD/FX (eop)	6.65	6.14	6.64	6.85	EUR
EUR/FX (eop)	7.44	7.54	7.52	7.53	EUR
USD/FX (pavg)	6.62	6.61	6.36	6.73	EUR
EUR/FX (pavg)	7.41	7.53	7.52	7.53	EUR

Source: Eurostat, CNB, UniCredit Research

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

Growth to be driven by investment and euro momentum

Following recent developments, we revise our growth projection for 2022 to 4.4% and introduce our projection for 2023 at 5.3%

The strong performance of the economy in 3Q21, due to tourism and private consumption, lost momentum in 4Q21, according to recent data. In 4Q21, industrial production and exports of goods growth decelerated as a reflection of lost momentum in the eurozone and most of CEE. Furthermore, retail sales have moderated, according to recent data releases. This slowdown will not significantly harm overall 2021 performance but will result in negative carryover to 2022.

Growth in 2022 and 2023 should be driven by investment

This is reflected in our projections for 2022. We now project growth of 4.4% (previously 5.3%) in 2022 and 5.3% in 2023. We expect growth to be driven by investment in the next two years, fueled by the remaining allocation from the 2014-2020 EU budget (almost EUR 5bn not spent though earmarked) and NGEU allocations (including the advance from 2021, almost EUR 3.3bn should be received by the end of 2023). In 2023, the adoption of the euro will probably provide an additional boost to growth through an increase in exports of goods. However, the import dependance of final demand will take a toll on growth in the next two years.

Private consumption and public spending should decelerate in 2022

Employment is set to rise further due to rising demand…

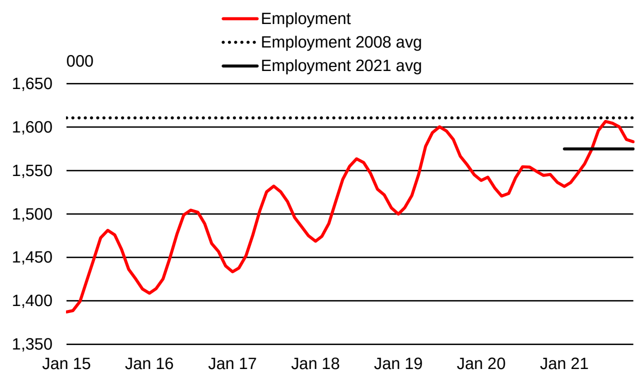
…but still without any greater impact on real-wage growth

Growth of private consumption and public spending will likely moderate in 2022. Expansion of private consumption will probably be curbed by declining confidence and shrinking savings buffers while a likely increase in inflation will moderate growth of real income despite the further increase in wages and employment we expect. Currently, both wage and employment growth are constrained by the slowdown in economic expansion. In summer 2021, the number of employed was close to the historical high of 2008 of more than 1.6 million, but the number of unemployed at some 8% (or 140,000) was higher than in 2019. Since then, the unemployment rate has begun to decrease again toward 7%. However, the population of Croatia has dropped by an estimated 6.5% since 2008, so the above figures point to increased activity rate and an improving employment rate (the highest since 2015). In 2022 and 2023, we see rising demand for labor, especially in construction, tourism-linked sectors, IT and some areas of manufacturing. Employment should grow between 1% and 2% a year, while the unemployment rate should decline to below 6%. However, wage growth may decelerate in 2022, especially net wages due to the fading effect of income tax changes in 2021. With rising inflation, both gross and net real wage will increase only mildly, less than 1% yoy.

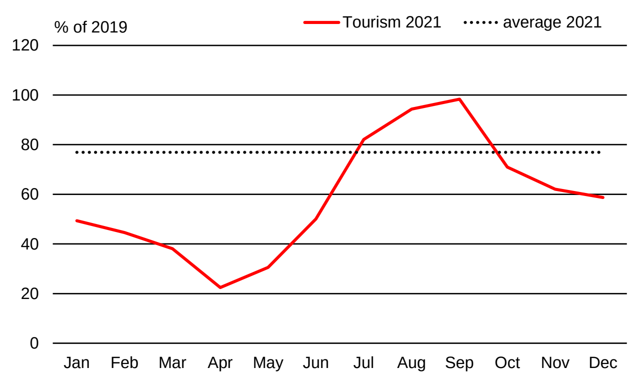
Inflation should accelerate at the beginning of the year before easing somewhat in 2H22 (but less so than in the eurozone)

We expect Inflation to accelerate, continuing the trend from late-2021, and follow the euro inflation path. In 2022, average inflation will likely rise to 3.2% following higher levels of inflation in 1H22 with moderation toward the end of 2022. The main source of inflation should be energy prices, with some risk that food prices may become another driver in 2022. However, for most of 2023 inflation should remain well above that of the eurozone; the adoption of the euro should cause some price convergence despite the efforts of the authorities to prevent unfair and unjustified price adjustments during conversion.

EMPLOYMENT HAS BENEFITED FROM THE RECOVERY BUT…



…SOME SECTORS HAVE YET TO CLOSE THE GAP



Source: Crostat, HNB, UniCredit Research

Euro adoption dominant story for Croatian economy in 2022 and 2023

The main story for the Croatian economy in 2022 and 2023 will be euro adoption. In September 2021, the Croatian authorities set 1 January 2023 as the official target date, a date agreed with the European Commission. Since then, activities to achieve adoption by this date have intensified. Besides nominal convergence criteria (Croatia is expected to align with the convergence criteria for joining), the government will be implementing the measures within its action plan for participation in ERM II (since July 2020) with defined regulatory implementation (eight measures in four areas) and the activities envisaged in the national euro changeover plan. National changeover plan activity is expected to intensify after the (presumably positive) European Council decision in early July 2022 (after two years of ERM participation), but there is some preparatory activity already underway, especially in the financial sector. An official campaign promoting euro adoption and informing the public has not yet been launched but the European Commission and the Croatian authorities have signed a partnership agreement to do this jointly.

Activities intensified with full public campaign to be initiated in early 2022…

…while mid-year and final decision on eligibility and accession date approaching

Convergence report to be initial milestone

In terms of process, an important milestone before the final formal decision is the convergence report, which is expected to be released in May/June. The report delineates both sustainable economic convergence and the compatibility of national legislation with the treaties and statutes of the ESCB and the ECB, as well as the requirements for the Croatian central bank to become an integral part of the Eurosystem.

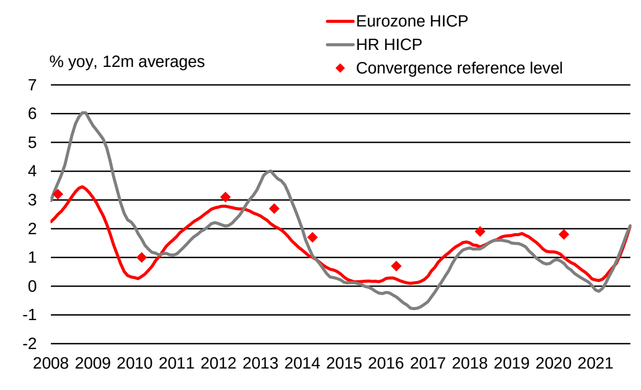
Nominal convergence criteria likely to be fulfilled though some uncertainty surrounding price stability and fiscal stability

Current expectations are that all nominal convergence criteria will be met, although with some uncertainty regarding the price stability and fiscal stability criteria. Exchange-rate stability and long-term interest-rate stability criteria will surely be met. The ability of Croatia to meet price stability criteria has been questioned lately but inflation in Croatia is closely following the path of inflation in the eurozone. As in the past the inflation reference rate has always been set above average eurozone inflation, this assures us criteria will be likely met. Regarding fiscal stability, Croatian metrics worsened during the pandemic recession, but the general government deficit is expected to shrink to below the 3% of GDP threshold while the general government debt ratio is already on a sustainable declining path, though above the 60% of GDP threshold. However, as the fiscal rules in the EU have been suspended until 2023, Croatia is currently not subject to the Excessive Deficit Procedure. Therefore, the criteria of fiscal stability should be in the end met regardless of the recent fiscal performance, though government wants to present additional assurances.

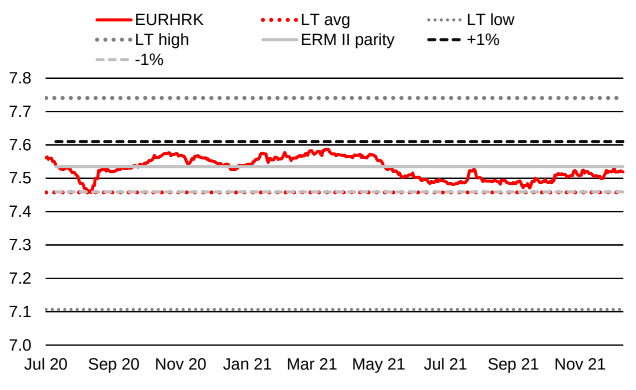
On fiscal front, fiscal consolidation efforts to be significant with final goal in mind

Returning to Croatia's fiscal position, the finance ministry intends to insist on fiscal consolidation after two years of divergence from its pre-pandemic policy. However, despite its intention to regain control of expenditure, especially in the health care sector, the ministry places more emphasis on increased revenue from economic activity growth in 2022 and 2023. The experience of the expenditure trajectory in 2020 and 2021 (expenditures increase above the plan) points to some risk. However, our baseline view is that targets will be achieved as the authorities are eager to support the euro adoption process.

INFLATION PATH ALIGNING WITH EUROZONE WHILE…



…EXCHANGE-RATE VOLATILITY CONTINUES TO DECLINE.



Source: Eurostat, ECB; Crostat, HNB, UniCredit Research

Yields to compress further as euro adoption approaches

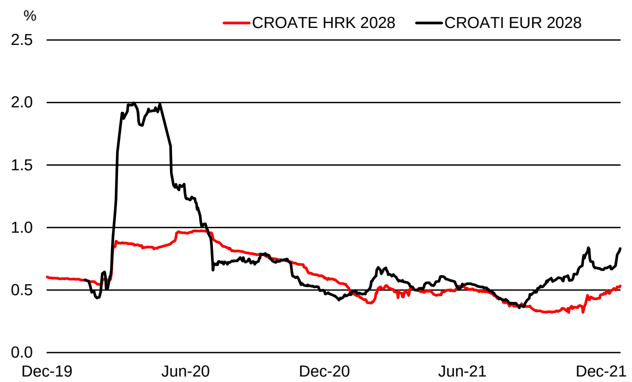
CROATI spreads could compress further, with CROATI EUR 2031 standing out

With a year left until Croatia adopts the euro, debt remains cheap, in our view. Spreads should correct both in local vs. foreign debt, but also compared to Bunds. This is especially true for CROATI EUR 2031, but also for CROATI EUR 2033 and 2041.

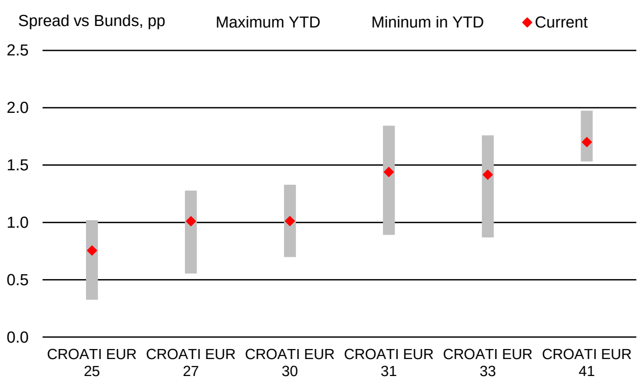
We expect strong demand for new EUR issuance

The position can be expressed either outright, or by playing the potential spread compression against Bunds. The biggest issue for investors looking to increase positions in Croatian bonds remains bond scarcity. Therefore, we expect very strong demand when EUR bond will be issued. We expect EUR 2bn issued in 2022 and the same amount next year.

FISCAL IMPROVEMENT SUPPORTS YIELDS ASSOCIATED WITH EUR-DENOMINATED CROATIAN DEBT…



…AS DO LOW YIELDS ON HRK-DENOMINATED CROATIAN DEBT



Source: Croatian ministry of finance, Bloomberg, UniCredit Research

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2021E	2022F	2023F
Gross financing requirement	**9.8**	**10.1**	**9.3**
Budget deficit	2.5	1.6	1.6
Amortization of public debt	7.3	8.5	7.8
Domestic	5.5	6.6	6.0
Bonds	0.8	2.0	1.5
Bills	3.1	3.2	3.2
Loans	1.6	1.4	1.3
External	1.9	1.9	1.8
Bonds and loans	1.8	1.8	1.7
IMF/EU/other international financial institutions	0.1	0.1	0.1
Financing	**9.8**	**10.1**	**9.3**
Domestic borrowing	5.8	6.8	6.5
Bonds	1.2	2.3	2.0
Bills	3.2	3.2	3.2
Loans	1.4	1.3	1.3
External borrowing	4.0	3.3	2.8
Bonds	2.0	2.0	2.0
IMF/EU/other IFIs	2.0	1.3	0.8
Privatization/other	0.0	0.0	0.0

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2021E	2022F	2023F
Gross financing requirement	**11.4**	**11.7**	**9.6**
C/A deficit	-0.4	0.4	0.6
Amortization of medium- and long-term debt	4.8	4.3	4.1
Government/central bank	1.9	1.9	1.8
Banks	0.6	0.4	0.3
Corporates/other	2.3	2.0	2.0
Amortization of short-term debt	7.0	7.0	4.9
Government/central bank	0.6	2.0	0.9
Banks	2.4	2.5	2.0
Corporates/other	4.0	2.5	2.0
Financing	**11.4**	**11.7**	**9.6**
FDI (net)	1.2	1.0	1.0
Portfolio equity, net	0.4	-0.3	-1.0
Medium and long-term borrowing	5.4	4.8	4.2
Government/central bank	4.0	3.3	2.8
Banks	0.5	0.5	0.4
Corporates/other	0.9	1.0	1.0
Short-term borrowing	7.0	4.9	4.4
EU structural and cohesion funds	2.0	2.8	3.2
Other	1.0	1.0	0.0
Change in FX reserves (= increase)	-5.6	-2.5	-2.2
Memoranda:			
Nonresident purchases of LC gov't bonds	n.a.	n.a.	n.a.
International bond issuance, net	0.9	0.7	0.8

Source: CNB, Croatian ministry of finance, UniCredit Research

Czechia

Aa3 stable/AA- stable/AA- stable*

Outlook

We expect Czech GDP to grow by 3.0% in 2022 and 4.2% in 2023, reaching its pre-pandemic level in 4Q22 under a more sustained recovery starting in 2H22. Fixed capital formation should become the main growth engine in 2022. Inflation could peak in 1Q22 at above 8%, higher than previously thought, slowing private consumption. The CNB's interest rates are close to a peak, but policy easing may only arrive in 2023 and only if there are signs of fiscal consolidation.

Strategy

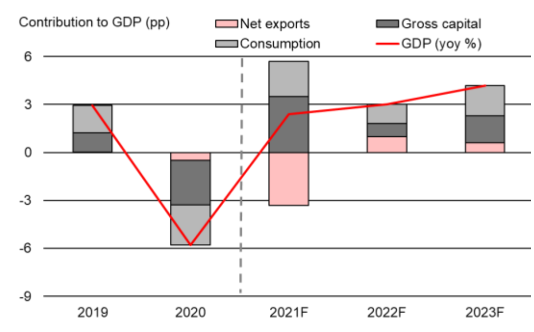
The koruna is likely to appreciate less than the CNB expects in the absence of direct FX interventions. CZGBs are expected to outperform Central European peers.

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

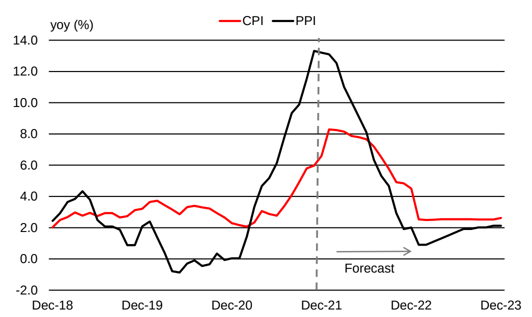
KEY DATES/EVENTS

- 3 Feb., 31 Mar.: CNB policy meetings
- 1 Feb., 31 Mar.: GDP (flash, structure)
- 12 Jan., 14 Feb., 10 Mar.: CPI
- 4 Feb.: rating update from Moody's

GDP GROWTH FORECAST



INFLATION FORECAST



Source: CZSO, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

EUR bn	2019	2020	2021E	2022F	2023F
GDP (EUR bn)	225.7	215.4	237.7	268.0	289.4
Population (mn)	10.7	10.7	10.7	10.7	10.7
GDP per capita (EUR)	21,151	20,133	22,209	25,035	27,012
Real economy, change (%)					
GDP	3.0	-5.8	2.4	3.0	4.2
Private consumption	2.6	-6.8	3.4	2.0	3.4
Fixed investment	5.9	-7.2	1.5	9.5	6.3
Public consumption	2.5	3.4	3.1	1.5	1.3
Exports	1.4	-7.0	5.1	4.3	6.0
Imports	1.5	-6.9	10.3	3.1	5.4
Monthly wage, nominal (EUR)	1347	1349	1483	1645	1758
Real wage, change (%)	5.0	-0.1	2.7	-0.4	3.3
Unemployment rate (%)	2.8	3.6	3.8	3.6	3.4
Fiscal accounts (% of GDP)					
Budget balance	0.3	-5.6	-7.3	-5.0	-4.0
Primary balance	1.0	-4.8	-6.5	-4.1	-3.0
Public debt	30.0	37.7	42.6	44.4	45.4
External accounts					
Current account balance (EUR bn)	0.7	7.7	-0.8	0.4	2.3
Current account balance/GDP (%)	0.3	3.6	-0.3	0.2	0.8
Extended basic balance/GDP (%)	3.1	5.4	0.8	1.7	2.6
Net FDI (% of GDP)	2.4	1.3	0.7	1.1	1.3
Gross foreign debt (% of GDP)	75.7	75.5	68.9	68.3	69.4
FX reserves (EUR bn)	133.4	135.4	150.5	151.0	151.5
Months of imports, goods & services	10.5	11.8	11.2	10.1	9.4
Inflation/Monetary/FX					
CPI (pavg)	2.8	3.2	3.8	6.8	2.5
CPI (eop)	3.2	2.3	6.6	4.5	2.6
Central bank target	2.0	2.0	2.0	2.0	2.0
Central bank reference rate (eop)	2.00	0.25	3.75	4.25	3.25
3M money market rate (Dec avg.)	2.18	0.35	3.50	4.30	3.35
USD/FX (eop)	22.6	21.4	22.0	22.2	22.6
EUR/FX (eop)	25.4	26.2	24.9	24.4	24.4
USD/FX (pavg)	22.9	23.2	21.7	22.2	22.4
EUR/FX (pavg)	25.7	26.4	25.6	24.6	24.4

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

The taste of inflation

Poor performance of automotive is a drag on the economy

By the end of 3Q21, Czechia had given one of the worst economic performances in the EU since the start of COVID, with GDP staying 3.1% below the 4Q19 level. Apart from sharply rising input prices, sea transport and, lately, energy, which are common to all producers in Europe, a particular problem for Czech manufacturing is its reliance on the automotive sector. The sector remains the worst hit by supply-side disruptions, which come on top of surging prices. Obviously, the situation is causing a disproportionate drag on the economy due to manufacturing accounting for 25% and automotive alone for 5.3% of (directly measured) GVA in 2019. The aforementioned headwinds for industrial output could ease in 2022, without fully abating before 2H22.

Poor productivity gains are unlikely to change for the better when the pandemic ends

Meanwhile, the manufacturers' topline has been hit. Firstly, just-in-time deliveries are no longer applicable, driving inventories sharply up. In 1Q21-3Q21, inventories added CZK 165bn (5% of GDP), twice more than in any other year. Unfinished cars waiting for chip deliveries are estimated to have accounted for less than a quarter of inventories. Secondly, labor force utilization has dropped, not only due to production irregularities but also more workers on sick leave, in quarantine or taking a caregiving break. As a result, productivity per worker has remained at 2017 levels. In a very tight labor market (with unemployment at 2.6%), poor productivity gains are unlikely to change for the better when the pandemic ends.

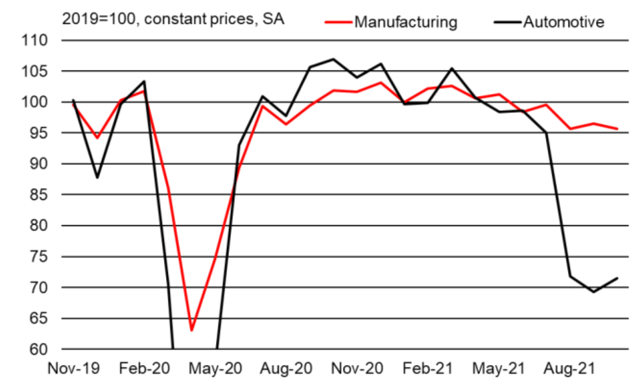
Supply-side constraints are not serious enough to discontinue production…

Our fear that global supply-side constraints would offset optimistic household spending proved unfounded. On the one hand, there have been no reports of companies discontinuing production due to supply bottlenecks. Meanwhile, demand remains solid, which facilitates an easier pass-through of higher input costs to output prices. Nor has business activity taken much of a hit from the current wave of COVID-19 infections, which is slowly subsiding.

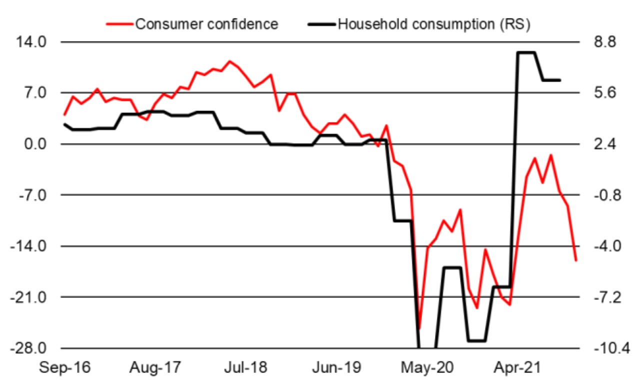
…but high inflation, initially driving private consumption upwards, may lead to stagflation later

However, headline inflation is set to peak higher than previously thought (we pencil in 8.3% yoy in January 2022), with domestic factors responsible for at least half of the price increase. This has initially driven private consumption upwards (as households try to speed up their purchases) but falling purchasing power could dent consumer spending in 2022. Average wages are not projected to exceed their pace of growth from 2021 (estimated at 6.7%), while average inflation may hit 6.8%. Income tax cuts are not under consideration, while the minimum wage will be increased by 6.6%, much less than in past years. As a result, households will have to work more hours or tap their extra savings from 2020-21 to boost their spending in 2022, which only some will do. Thus, real private consumption is seen expanding by a modest 2.0%.

AUTOMOTIVE UNDERPERFORMING MANUFACTURING AGAIN



CONSUMER CONFIDENCE DECLINES WITH INFLATION FEARS



Source: CZSO, IHS Markit, UniCredit Research

Fixed capital formation should take over the role of the main engine

With consumers contributing less to economic growth, fixed capital formation should take over as the main engine, pushing GDP growth to 3.0% in 2022 and 4.2% in 2023 from an expected 2.4% in 2021. First, companies are expected to boost productivity by investing more in machinery and equipment. After two years of capex decline, the low base will enhance the growth rate. Second, the expansion of investment into dwellings is set to continue for a while, as housing starts are still increasing. Third, the stock of unfinished infrastructure projects remains high. Infrastructure investment has declined slightly in 2021, which we attribute to insufficient construction capacities and, possibly, negotiations on price adjustments for projects signed before a sharp increase in input prices. Fourth, funding from the Next Generation EU has started and may speed up green investment, which has been rather limited in the Czech Republic. Altogether, we expect fixed capital formation to expand by 9.5% in 2022 and 6.3% in 2023. The pre-pandemic GDP level could be reached in 4Q22. The recovery is expected to accelerate from 2H22 onwards.

Investment in machinery, dwellings, unfinished infrastructure projects and green investments will play a role

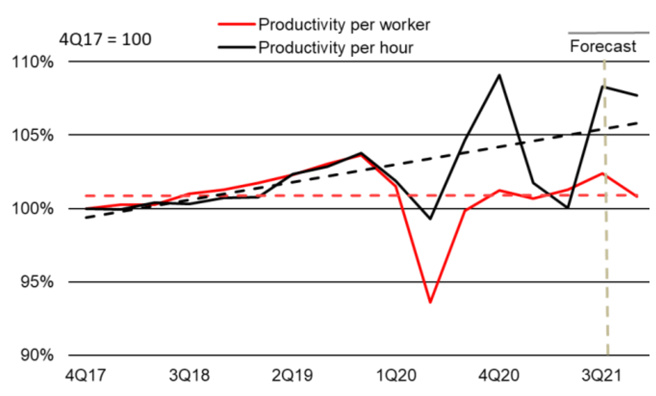
The policy rate could peak at 4.50%, with a first rate cut possible already this year

Following the December repo rate hike to 3.75%, interest rates are believed to be close to a peak in the cycle. The CNB already surpassed rate hike expectations embedded in its autumn forecast and could go all the way to 4.50% in 1H22. We expect the key assumptions from last autumn to stay intact in the CNB's February forecast. The short-term inflation outlook could be pushed somewhat higher. To what extent that affects the interest rate path depends on if additional inflation arrives from regulated prices or core items. A first rate cut of 25bp could be delivered before year-end, followed by 75bp more in 2023. In an environment of above-potential GDP growth and full employment, rate cuts could be justified by a negative fiscal impulse and/ or the koruna appreciating meaningfully. The former condition will hopefully be achieved in 2022. Meeting the latter condition would probably be contingent on the Czech economy growing faster than the rest of Europe. The rising CZK-EUR interest rate differential alone may not be a sufficient driver for a koruna appreciation when global flows remain negative for EUR-USD. Our end-2022 target of EUR-CZK 24.40 is higher than the CNB's projection of 24.20. The wedge between our and the CNB's FX forecast could widen even more in 2023, when we expect limited average appreciation of the CZK, but the same year-end level as in 2022.

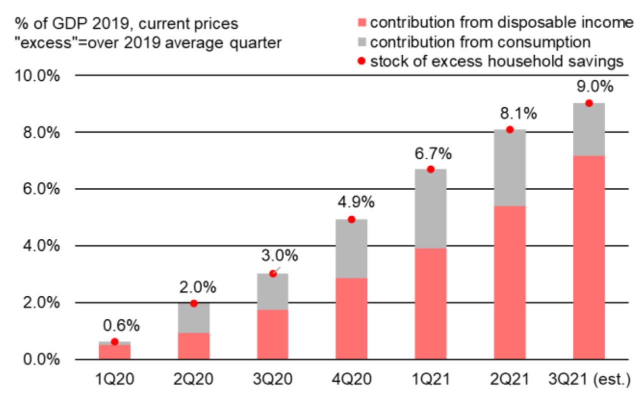
New government's economic policy remains shrouded in many uncertainties

The new five-party coalition government has ambitions to bring down the 2022 budget deficit, prepared by the former government, by more than 1pp of GDP to less than 5% of GDP. Apart from that, however, crucial uncertainties around economic policies persist. The coalition agreement, signed just after the October elections, contained a rather conflicting wish list from individual parties, and it will require much effort to rework it into a consistent government agenda. In our view, clear lines in the agenda include the country's pro-EU and NATO orientation, as well as the energy mix relying on nuclear and (temporarily) natural gas. Major uncertainties pertain to 1. The pace of fiscal consolidation; 2. Key reforms in health care and pensions; and 3. Euro adoption.

PRODUCTIVITY PER HOUR TRENDING UP SLOWLY WHILE PER WORKER MEASURE REMAINS FLAT



ACCUMULATED HOUSEHOLD EXCESS SAVINGS DRIVEN BY HIGHER INCOME AS WELL AS RESTRICTED CONSUMPTION



Source: Czech Fiscal Council, CZSO, UniCredit Research

The appreciation conundrum

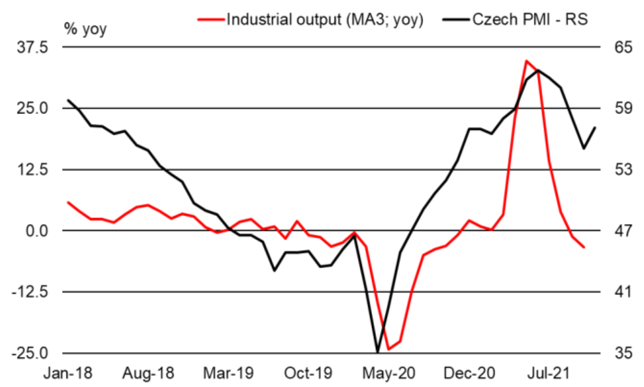
Koruna appreciation likely to fall short of CNB expectations

The CNB's forecast includes significant koruna appreciation. With external trade expected to improve gradually in 2022 (owing to better exports), FDI likely to rise and EU transfers increasing, balance-of-payments flows could offer more support to the currency. However, heavy long-koruna positions and fluctuating short-term implied rates could dent appreciation. While the CNB continues to exclude this option, direct FX interventions would address both appreciation and liquidity drainage, if the central bank considers a stronger currency important to complement rising interest rates in tightening real monetary conditions.

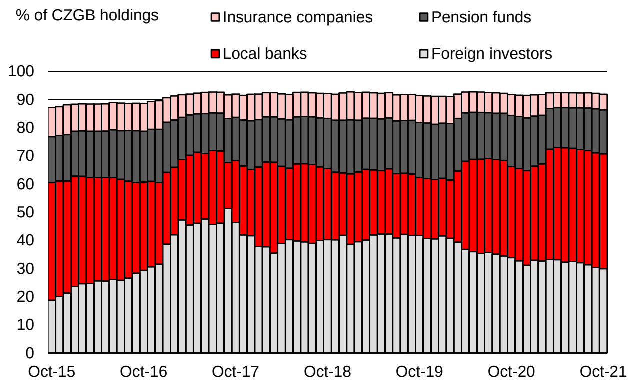
CZGBs could continue to outperform peers in 1Q22

CZGBs could remain some of the best-performing bonds relative to Central European peers in 2022. With other regional central banks ending bond purchases, CZGBs will benefit from better domestic demand than regional peers.

MANUFACTURING PMI IS GOOD AT PREDICTING CHANGES IN INDUSTRIAL OUTPUT MOMENTUM



ISSUANCE FOCUSED ON MATURITIES OF 10-13Y



Sources: CNB, Bloomberg, UniCredit Research

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2021E	2022F	2023F
Gross financing requirement	**25.4**	**22.1**	**20.4**
Budget deficit	17.3	13.2	11.5
Amortization of public debt	8.1	8.8	8.8
Domestic	6.1	6.0	8.8
Bonds	5.0	5.8	8.5
Bills	1.0	0.0	0.2
Loans	0.1	0.1	0.1
External	2.0	2.8	0.0
Bonds and loans	2.0	2.8	0.0
IMF/EU/Other IFIs	0.0	0.0	0.0
Financing	**25.4**	**22.1**	**20.4**
Domestic borrowing	25.4	21.6	19.9
Bonds	25.3	21.3	19.6
Bills	0.0	0.2	0.2
Loans	0.1	0.1	0.1
External borrowing	0.0	0.5	0.5
Bonds	0.0	0.5	0.5
IMF/EU/Other IFIs	0.0	0.0	0.0
Privatization/Other	0.0	0.0	0.0

Source: CNB, MoF, CZSO, UniCredit Research

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2021E	2022F	2023F
Gross financing requirement	**102.7**	**112.3**	**99.2**
C/A deficit	0.8	-0.4	-2.2
Amortization of medium and long term debt	9.6	6.1	4.5
Government/central bank	4.7	4.8	0.9
Banks	2.4	0.5	1.3
Corporates/other	2.5	0.9	2.3
Amortization of short-term debt	92.4	106.6	97.0
Government/central bank	6.1	8.6	7.0
Banks	52.9	59.0	56.0
Corporates/other	33.4	39.0	34.0
Financing	**102.7**	**112.3**	**99.2**
FDI (net)	1.6	2.8	3.7
Portfolio equity, net	-2.1	-0.4	-0.8
Medium and long-term borrowing	8.5	9.8	10.7
Government/central bank	3.6	8.5	7.1
Banks	2.4	0.5	1.3
Corporates/other	2.5	0.9	2.3
Short-term borrowing	106.6	97.0	81.6
EU structural and cohesion funds	3.3	3.6	3.6
Change in FX reserves (- = increase)	-15.1	-0.5	-0.5
Memoranda:			
Nonresident purchases of LC govt bonds	3.6	8.0	6.6
International bond issuance, net	0.0	-2.3	0.5

Hungary

Baa2 stable/BBB stable/BBB stable*

Outlook

The Hungarian economy could grow by around 4.3% in 2022 and by 4.9% in 2023. Private consumption and fiscal spending will drive growth in 1H22, with exports and private capex accelerating thereafter. The fiscal adjustment is likely to start after parliamentary elections are held in April, with the negative fiscal impulse weighing on public investment and consumption. We expect inflation to peak at around 8% in 1Q22 and end 2022 around 5%. The target could be met in 2023. We expect the NBH to increase the policy rate to 3% and the 1W deposit rate to 4.5% in 1H22. Even if the Fidesz were to lose the parliamentary elections, it could return to power in a coalition with former foes if the opposition cannot agree on a governing program.

Strategy

High funding needs in 1Q22, ahead of the elections, could temporarily push HGB yields higher.

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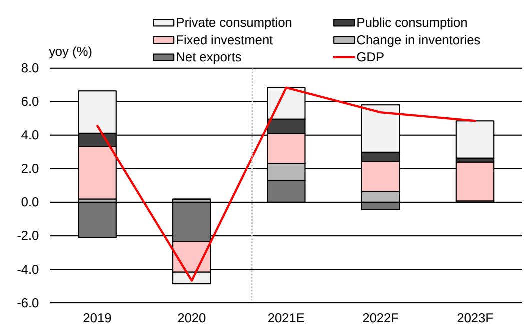
Dr. Ágnes Halász, Head of Economics & Strategic Analysis Hungary (UniCredit Bank Hungary)

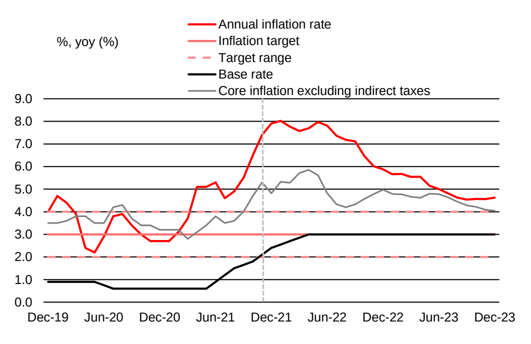
KEY DATES/EVENTS

- 14 Jan., 11 Feb., 9 Mar.: CPI
- 25 Jan, 22 Feb, 22 Mar: monetary policy decisions
- Every Thursday: 1W deposit rates
- 15 Feb., 2 Mar.: 4Q21 GDP (flash, structure)
- 28 Jan., 11 Feb., 25 Mar.: rating updates by Fitch,S&P,Moody's

GDP GROWTH FORECAST



INFLATION FORECAST



Source: HCSO, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

EUR bn	2019	2020	2021E	2022F	2023F
GDP (EUR bn)	146.1	136.0	149.9	163.9	177.2
Population (mn)	9.7	9.7	9.7	9.7	9.6
GDP per capita (EUR)	14,983	13,992	15,476	16,979	18,420
Real economy, change (%)					
GDP	4.6	-4.7	6.5	4.3	4.9
Private consumption	5.0	-1.4	3.6	5.6	4.2
Fixed investment	12.8	-6.9	6.8	3.2	7.3
Public consumption	4.2	0.1	4.5	1.3	-0.4
Exports	5.4	-5.9	9.3	8.4	8.4
Imports	8.2	-3.5	8.2	8.1	7.6
Monthly wage, nominal (EUR)	1131	1150	1211	1325	1414
Real wage, change (%)	7.6	6.2	2.4	2.2	3.3
Unemployment rate (%)	3.4	4.0	4.1	3.5	3.4
Fiscal accounts (% of GDP)					
Budget balance	-2.1	-8.0	-7.6	-4.8	-3.2
Primary balance	0.1	-5.6	-5.1	-2.2	-0.5
Public debt	63.9	80.0	80.8	78.6	78.7
External accounts					
Current account balance (EUR bn)	-1.0	-2.1	-4.4	-1.9	-1.1
Current account balance/GDP (%)	-0.7	-1.5	-2.9	-1.1	-0.6
Extended basic balance/GDP (%)	1.2	2.4	-1.0	1.5	3.0
Net FDI (% of GDP)	0.1	1.9	0.4	1.5	1.9
Gross foreign debt (% of GDP)	96.7	150.8	143.2	126.2	111.2
FX reserves (EUR bn)	26.5	31.8	29.1	30.0	31.6
Months of imports, goods & services	2.7	3.6	2.8	2.4	2.3
Inflation/Monetary/FX					
CPI (pavg)	3.6	3.3	5.1	7.3	4.8
CPI (eop)	4.0	2.7	7.9	5.9	3.8
Central bank target	3.0	3.0	3.0	3.0	3.0
Central bank reference rate (eop)	0.90	0.60	2.40	3.00	3.00
3M money market rate (Dec avg)	0.16	0.75	3.80	3.59	3.00
USD/FX (eop)	294.7	297.4	326	327	338
EUR/FX (eop)	330.5	365.1	369	360	365
USD/FX (pavg)	290.7	308.0	303	321	333
EUR/FX (pavg)	325.4	351.2	359	357	360

Source: Eurostat, HCSO, NBH, UniCredit Research

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

Plugging a fiscal hole

Optimistic consumers and fiscal largess will drive growth in 1H22…

Despite international tourism remaining impaired and manufacturing suffering from supply shortages, Hungary's economy recovered faster than most of its CEE peers from the COVID-19-induced slump. The main explanations are optimistic consumers and fiscal largess. In 2020, Hungarian households increased their savings rate, a process that started unwinding in 2H21 and may continue in 2022. The government cushioned the purchasing power of consumers by keeping gas prices unchanged, by capping fuel prices and by increasing energy prices by less than cost uptick in 2021. Price protection is likely to continue until the parliamentary elections, which are expected in April 2022. Mortgage payments were frozen for 1H22. In addition, the government announced wage increases in 2022 for soldiers (10%), employees at cultural venues (20%) and teachers (20%). Pensioners will get a 5% raise that will not match inflation.

… as the government is fighting for reelection in April

The government is attempting to ensure its reelection, which looked all but certain a year ago. However, a united opposition under the conservative candidate Peter Marki-Zay is running neck-in-neck with the ruling Fidesz, threatening to oust it from power after 12 years. As a result, public spending accelerated in 2H21, with the 12M-rolling cash budget deficit at around 9.5% of GDP in December 2021, at least 2% of GDP higher than in any other CEE country. The deficit could remain very large in 1H22 if the government wants to keep the economy running hot. We see four main directions of spending.

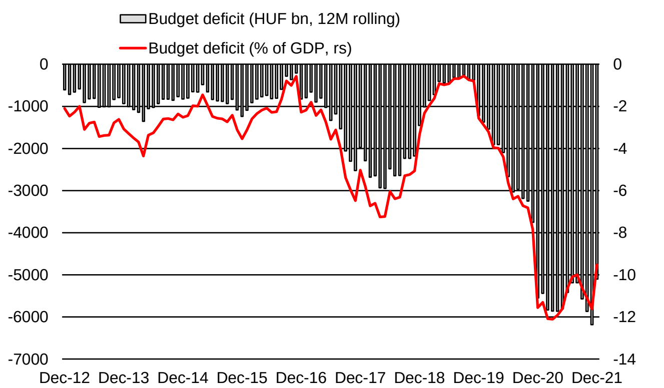
In 2022, Hungary will continue to register the highest cash budget deficit in CEE…

1. Support for local companies. Around 33,000 SMEs will have access to regulated utility prices, with the state covering the subsidy and, thus, cushioning their margins. Protectionist measures could add to the export ban on construction materials.
2. Support for foreign investors. Hungary will ask the EU to accept a higher ceiling of state support for foreign investors, as the impressive stream of new projects builds up. Four Korean companies could add to Hungary's tally of producers of electric vehicles and components, cementing the country's position in the global top 10. This is a very impressive achievement of the Fidesz government.
3. Replacement for missing EU transfers. NGEU funds are likely to be delayed until after the elections, as Fidesz is not expected to cave into the EU's demands on the rule of law. In addition, the Court of Justice of the EU could decide to withhold regular EU transfers given objections raised as to how Hungary organized tenders and chose the winning bids. We forecast a further drop in EU transfers in 1H22, with the missing money having to be borrowed from abroad if the government wants to keep spending on public investment.
4. Further pre-election transfers to households if the polls do not turn in Fidesz' favor.

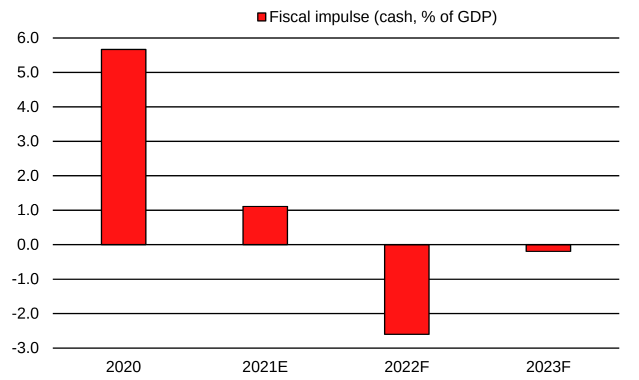
… with a sharp slowdown in spending after the elections

We expect public spending to slow sharply after the elections, with the fiscal impulse turning negative in 2H22 and the budget deficit falling to around 4.8% of GDP on accruals as the government prepares to cut public investment by 1.9% of GDP and other expenses by 1.2% of GDP. In 2023, the budget deficit could fall further to around 3.2% of GDP.

COVID AND ELECTIONS WIDENED THE BUDGET DEFICIT



THE FISCAL IMPULSE WILL TURN NEGATIVE IN 2022



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

Exports could rebound if supply blockages disappear in 2023

With supply-chain bottlenecks expected to ease in 2H22 and disappear in 2023, foreign demand could take over as the main growth driver. This would also re-accelerate FDI, which was put on hold by supply issues in manufacturing. However, the large import content of both manufacturing exports and FDI will limit the impact on GDP. Other types of investment may not fare as well in 2022. Public infrastructure projects will suffer from missing EU funds, while the housing market could be affected by higher borrowing costs.

GDP could grow by 4.3% in 2022 and by 4.9% in 2023

As a result, we expect economic growth to slow to 4.3% in 2022 and 4.9% in 2023 from 6.5% in 2021. While the economy is still expected to expand above potential, growth could fall short of public expectations of 6-7% growth in 2022-23, raising risks of a larger-than-planned budget deficit. Consumers are likely to support the further recovery of the economy as labor market conditions will remain tight and new investment will put pressure on wage growth in the private sector. This pressure could be more subdued in 1H22 if car companies are still plagued by disruptions. All Hungarian car factories expect supply issues to reduce production in 1H22.

The EBB will be much smaller in 2022 than before COVID-19

We expect the key rate at 3% and the 1W deposit rate at 4.5% in 2022

Problems affecting supply chains and transporters (who are struggling to hire drivers and source AdBlue for diesel-powered lorries) added to lower EU transfers and FDI and led, in 2021, to the first negative extended basic balance Hungary has registered since 2010. While the EBB could turn positive in 2022-23, its size will remain much lower than in previous years, leaving the HUF more vulnerable to portfolio flows. Besides inflation, this is a reason why we expect the NBH to lift the 1W deposit rate to around 4.5% in 1H22, while the policy rate could be increased to around 3%. More rate hikes may be on the cards if inflation is stickier than the NBH expects. That said, liquidity sterilization could be enough to lift implied rates above 4% for most of 2022, even if the policy rate remains lower. In 2023, the 1W deposit rate could be aligned to the repo rate at 3%, but we expect no cuts in the key rate.

Inflation is likely to miss the target in 2022

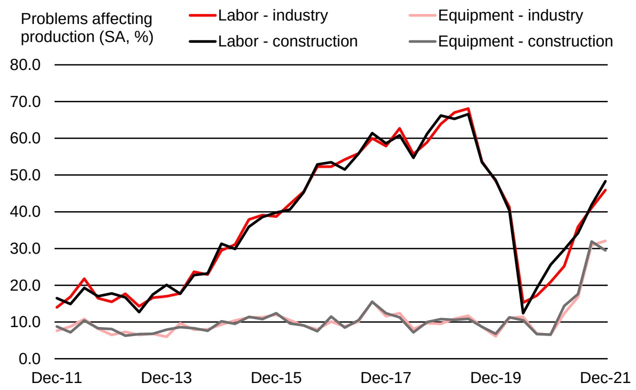
Inflation could peak at around 8% in 1H22 after the government capped energy and fuel prices. However, subsequent disinflation could be slowed by the unwinding of price caps and by higher food prices, with the inflation target likely to be missed in 2022. In 2023, core inflation could remain above target if labor-market conditions are tight, but smaller supply shocks may help the NBH to meet the inflation target.

Election on a knife's edge

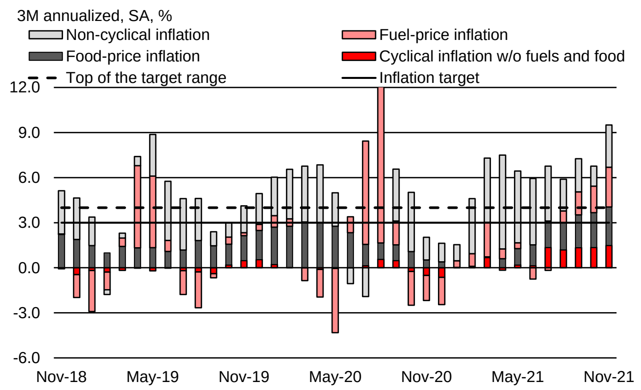
Fidesz could return to power even if it loses the election

At the time of publishing this CEE Quarterly, the probability of a government change following parliamentary elections is around 50%, in our view. An opposition government would mend relations with the EU and unlock NGEU funding, but could struggle to come up with a coherent economic plan and with all reforms required by European institutions, as many positions in administration and the judicial system will continue to be held by Fidesz appointees. While we do not expect an opposition government to chase away foreign investors, new projects might prove more difficult to attract. Eventually, a heterogenous opposition government could collapse, opening the way for Fidesz to return to power in a coalition with former foes.

MISSING LABOR AND INPUTS CONTINUE TO AFFECT OUTPUT



SUPPLY SHOCKS REPRESENT 2/3 OF INFLATION MOMENTUM



Source: HCSO, Eurostat, UniCredit Research

HGBs: demand may fall short of supply in 1Q22

High issuance needs in 1Q22…

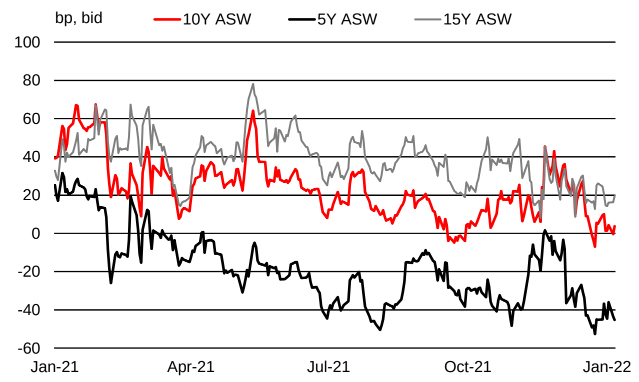
Hungary's issuance is likely to continue apace in 1Q22, for at least two reasons: the government is preparing for elections and the expected NGEU funds will not come before mid-year. If Hungary wants to spend on infrastructure projects, it might have to issue abroad in 1Q22 as regular EU fund flows could also dry out amid several infringement procedures.

…could lead to higher yields in 1Q22, especially in the belly of the curve…

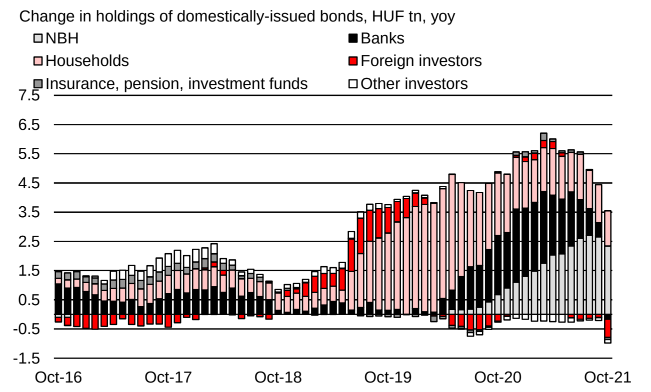
…before a potential rally later in the year

Meanwhile, demand for HGBs could be affected by little scope for purchases by the local buyside. Commercial banks reduced their sovereign-bond holdings by around 2.5% of assets between May and October, freeing up some space to buy. They will probably prefer bonds with maturities of more than 10Y, where the asset-swap spread (ASW) has widened. In our view, the belly is in danger of further sell-off due to rising inflation and negative ASW. After elections, HGBs could rally amid much lower funding needs, regardless of the election's outcome.

THE ASW REMAINS NEGATIVE AT THE BELLY OF THE CURVE



NET BOND PURCHASES WILL PLUMMET, UNLESS ASW SPREADS INCREASE FURTHER



Source: Bloomberg, UniCredit Research

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2021E	2022F	2023F
Gross financing requirement	**36.3**	**30.7**	**27.5**
Budget deficit	16.6	13.2	10.9
Amortization of public debt	19.7	17.5	16.6
Domestic	17.1	15.3	11.5
Bonds	8.7	6.8	5.2
Bills	1.8	1.5	2.3
Loans & retail securities	6.6	7.0	4.0
External	2.6	2.2	5.1
Bonds	1.7	1.6	2.9
IMF/EU/Other IFIs	0.9	0.6	2.2
Financing	**36.3**	**30.7**	**27.5**
Domestic borrowing	26.6	22.2	23.0
Bonds	13.7	10.6	11.9
Bills	1.8	2.3	2.1
Loans & retail securities	11.1	9.3	9.0
External borrowing	7.3	7.0	4.5
Bonds	6.3	5.0	3.0
IMF/EU/Other IFIs	1.0	2.0	1.5
Change in fiscal reserves (- = increase)	2.4	1.5	0.0

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2021E	2022F	2023F
Gross financing requirement	**24.9**	**19.6**	**21.9**
C/A deficit	4.0	2.8	2.7
Amortization of medium and long-term debt	8.7	6.1	11.7
Government/central bank	3.5	1.7	5.6
Banks	3.7	2.9	3.8
Corporates/other	1.5	1.5	2.3
Amortization of short-term debt	12.3	10.7	7.6
Financing	**24.9**	**19.6**	**21.9**
FDI (net)	0.5	2.4	3.3
Portfolio equity, net	-1.5	-0.5	0.0
Medium and long-term borrowing	10.6	8.3	8.4
Government/central bank	6.4	6.0	5.1
Banks	2.8	1.5	1.9
Corporates/other	1.4	0.9	1.4
Short-term borrowing	10.7	7.6	7.2
EU structural and investment funds	2.3	1.9	3.0
Change in FX reserves (- = increase)	2.2	-0.1	0.0
Memoranda:			
Non-resident purchases of LC govt bonds	-0.9	-1.0	0.6
International bond issuance, net	4.6	3.4	0.1

Source: NBH, Ministry of Finance, UniCredit Research

Poland

A2 stable/A- stable/A- stable*

Outlook: The Polish economy could grow by around 4.5% in 2022 and 4.4% in 2023, with consumers driving the recovery in 1H22. Private investment and exports could take over from 2H22 onwards if supply-chain bottlenecks subside. Inflation could peak above 10% in 2Q22, ending 2023 at around 7.7% and 2023 at 3.9%. The NBP could hike further to 3.5% in 2022 but might need to manage liquidity in order to prevent depreciation episodes. Poland stands to lose NGEU funding if Justice Minister Zbigniew Ziobro and the Constitutional Court continue to ignore CJEU rulings.

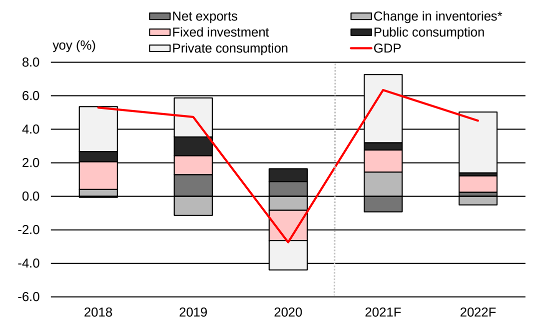
Strategy: A further selloff in POLGBs may be prompted by higher inflation, end of NBP bond purchases, limited rate hikes and a lower EUR-USD.

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

KEY DATES/EVENTS

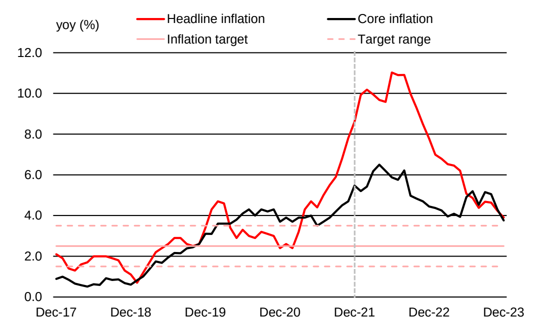
- 8 Feb., 8 Mar.: monetary policy decisions
- 15 Feb., 15 Mar., 31 Mar.: CPI
- 18 Feb.: rating update from Fitch
- 15/28 Feb.: 4Q21 GDP (flash, structure)

GDP GROWTH FORECAST



*adjusted with the statistical error

INFLATION FORECAST



Source: Statistics Poland, NBP, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

EUR bn	2019	2020	2021E	2022F	2023F
GDP (EUR bn)	533.7	522.9	567.3	637.4	698.0
Population (mn)	38.4	38.4	38.4	38.4	38.4
GDP per capita (EUR)	13885	13605	14760	16581	18158
Real economy, change (%)					
GDP	4.7	-2.5	5.2	4.5	4.4
Private Consumption	4.0	-2.9	5.9	5.4	5.0
Fixed Investment	6.1	-8.9	9.1	6.3	7.6
Public Consumption	6.5	5.1	1.5	1.0	1.0
Exports	5.2	0.1	11.6	6.1	6.4
Imports	3.0	-1.2	16.2	5.9	6.0
Monthly wage, nominal (EUR)	1199	1215	1283	1383	1500
Real wage, change (%)	4.2	1.3	3.2	-1.0	3.2
Unemployment rate (%)	5.4	5.9	6.0	5.4	5.1
Fiscal accounts (% of GDP)					
Budget balance (w. PFR)	-0.7	-7.1	-4.7	-2.6	-2.2
Primary balance (w. PFR)	0.5	-5.9	-3.4	-1.3	-0.9
Public debt (w. BGK and PFR)	45.6	56.4	54.5	50.6	49.0
External accounts					
Current account balance (EUR bn)	2.5	15.3	-6.5	-14.0	-4.0
Current account balance/GDP (%)	0.5	2.9	-1.1	-2.2	-0.6
Extended basic balance/GDP (%)	4.4	7.4	3.7	0.9	2.5
Net FDI (% of GDP)	1.9	2.1	3.0	1.7	1.7
Gross foreign debt (% of GDP)	59.5	62.7	54.3	49.4	45.9
FX reserves (EUR bn)	103.3	112.8	128.1	122.9	127.5
Months of imports, goods & services	4.6	5.2	4.8	4.0	3.8
Inflation/Monetary/FX					
CPI (pavg)	2.3	3.4	5.1	9.8	5.4
CPI (eop)	3.4	2.4	8.6	7.8	3.9
Central bank target	2.50	2.50	2.50	2.50	2.50
Central bank reference rate (eop)	1.50	0.10	1.75	3.50	3.50
3M money market rate (Dec avg)	1.70	0.21	2.35	3.70	3.70
USD/FX (eop)	3.80	3.76	4.06	4.23	4.31
EUR/FX (eop)	4.26	4.61	4.60	4.65	4.65
USD/FX (pavg)	3.84	3.90	3.86	4.14	4.25
EUR/FX (pavg)	4.30	4.44	4.57	4.60	4.60

Source: Statistics Poland, NBP, UniCredit Research

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

Short-term fixes to cushion households

Weak position in parliament…

The comfortable poll lead of the ruling Law and Justice (PiS) was gradually eroded in 2021. The gap to the Civic Platform (PO) narrowed despite PiS' muscular reaction to the migrant crisis on its border with Belarus. Refusal to let refugees in was popular with voters, but goodwill was wiped out by the resurging pandemic and the loss of purchasing power. In our view, this leads to several outcomes in 2022: **1.** no early elections; **2.** a longer-than-expected standoff with the EU on recovery funds; and **3.** more populist spending. If the PiS is trying to avoid early elections, it will have to keep the 19 MPs of United Poland (UP) in the coalition. The UP leader, Justice Minister Zbigniew Ziobro, has been at the forefront of legislative changes opposed by European institutions and against which the Court of Justice of the EU (CJEU) and the European Court of Human Rights have ruled repeatedly. A recent ruling from the CJEU[4] will make it very difficult for the European Commission (EC) to compromise with Poland on NGEU for as long as Mr. Ziobro and the Constitutional Court do not backtrack on decisions taken in 2020-21. Thus, we see no NGEU disbursements in 2022. Poland would have until June 2023 to avoid losing all anti-pandemic funding, which would affect its investment plans under the Polish New Deal.

…could lead to long-term standoff with the EU…

…and no NGEU funds for Poland

Additional transfers to households…

High inflation and the slowing recovery will force the PiS to spend more on transfers to households. Besides increasing pensions and the minimum wage while reducing taxation for low and mid earners through the Polish New Deal[5], the government announced the Anti-inflation Shield that will pay PLN 4.1bn in vouchers to families affected by higher energy prices. The package is likely to be inflationary. In addition, the government will cut VAT on electricity from 23% to 5% until the end of May 2022 and on natural gas from 23% to 8% for the same period, as well as excise duties on energy prices. However, tax cuts will be offset by the planned price increases announced by the regulator (24% for energy and 54% for gas). Assuming tax cuts expire in June, inflation could peak above 10% in 3Q22, ending the year around 7.7%. Inflation could peak slightly lower if the government cuts VAT for heating and fuels, a measure discussed at the time of writing. However, such temporary cuts will have no impact on year-end inflation. We assume that food prices will continue to increase much faster than the inflation target due to a sharp rise in wholesale prices across Europe. Both headline and core inflation are unlikely to return inside the target range in 2023, as private consumption could continue to grow above 5% in 2022-23.

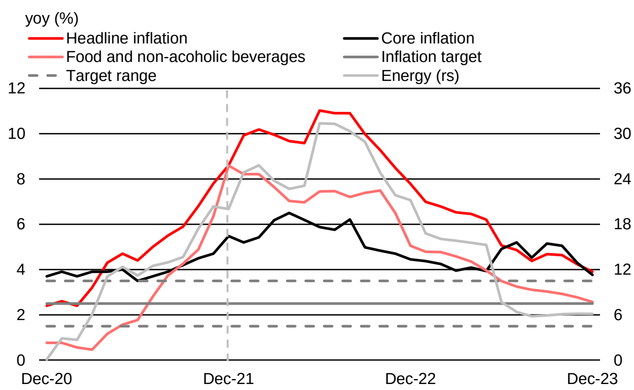
…and tax cuts for energy and gas

Inflation to remain above target in 2022-23…

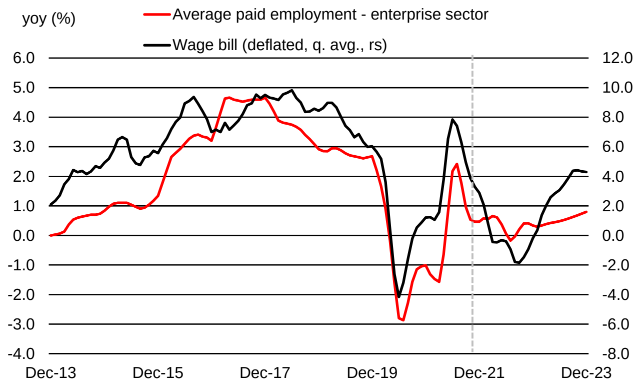
…leading to negative real wage growth in 2022

While real wage growth is likely to be negative in 2022, consumption will benefit from government transfers, pension and wage hikes, as well as households spending the remaining 1.1% of GDP in excess savings accumulated in 2020-21. In addition, we expect employment to increase further with a mix of local and immigrant workers.

MOST INFLATION COMPONENTS WILL BE ABOVE TARGET



THE REAL WAGE BILL AFFECTED BY SUPPLY SHOCKS



Source: Statistics Poland, UniCredit Research

[4] Ruling No 230/2021 : 21 December 2021 published at https://curia.europa.eu/jcms/jcms/p1_3597304/en/

[5] Details in previous CEE Quarterlies.

Faster income growth in 2023

In 2023, wages are expected to grow in real terms, with the real wage bill rising by more than 4%. However, what sets Poland apart in EU-CEE is the scope and dynamics of public support to households, funded with an impressive improvement in tax collection. These transfers accelerated since 2016 and pushed underlying inflation above the target range in 2018-19.

Fastest fiscal adjustment in EU-CEE

Better tax collection is behind Poland's EU-CEE-topping budget adjustment in 2021 that allows the government to reduce the budget deficit to around 2.6% of GDP in 2022 and 2.3% of GPD in 2023, the lowest in EU-CEE. Unlike regional peers, the Polish government used very cautious assumptions in its 2022 budget draft (4.6% GDP growth, 3.3% inflation), which leave room for a large overshoot in budget revenues. In addition, the government had fiscal reserves of around 6% of GDP at the end of November 2021, some of which could cover part of 2022's funding needs. Thus, we expect public debt to fall below 50% of GDP by the end of 2023.

The NBP could hike to 3.5% in 2022…

…but liquidity management may be needed as well

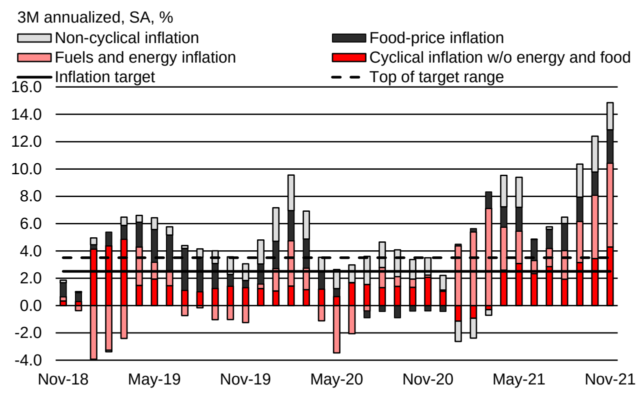
The NBP could increase the policy interest rate to 3.5% in 2022. Despite dovish messages from NBP President Adam Glapinski, inflation is likely to peak at the highest level in EU-CEE and its composition shows the largest contribution of domestic demand to inflationary pressure among regional peers. Rate hikes might not be enough to stabilize the PLN. More active liquidity management could better prop the currency and ensure mor efficient monetary transmission. Nine out of ten MPC members will be replaced (or reconfirmed) in 2022, including Mr. Glapinski, whose mandate ends in June. While the Senate candidates (chosen by the opposition) are unlikely to change the balance in the MPC, the Sejm and the country president could prefer more hawkish MPC members, or at least, more nuanced views on the persistence of inflation.

GDP growth could be around 4.5% in 2022 and 4.4% in 2023

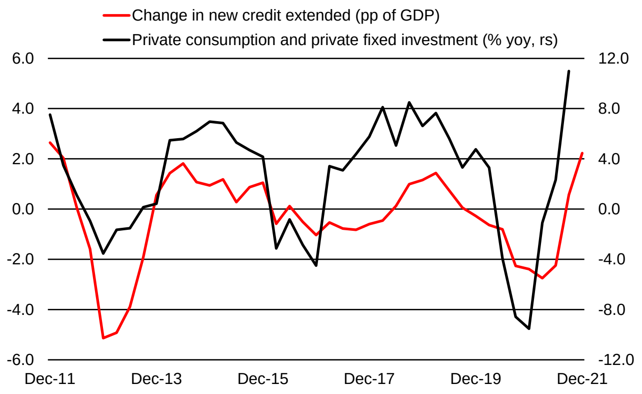
Investment and exports will take over from consumption in 2H22 and beyond

Despite negative fiscal and credit impulses, we expect the economy to grow above potential in 2022-23, by around 4.5% per year. Private consumption is likely to be the main driver in 1H22. Once excess savings are exhausted, consumption could be outpaced by investment and, gradually, by exports, as we expect supply-chain bottlenecks to start easing in 2H22 and be eliminated in Europe by 2023, with car manufacturing lagging. Investment could be dominated by private capex and construction. The former will benefit from strong demand for manufactured goods. In our view, the PLN remains competitive and exports of manufacturing with low added value could be stronger than in the rest of the region. Poland continues to be the most attractive construction market in the region and we expect the expansion of logistics, industrial and residential projects to accelerate in 2022-23. At the same time, infrastructure projects will lack EU transfers, with Poland at risk of diminished regular payments from the EU budget if the CJEU rules that rule of law can be a condition for such disbursements as well. More importantly, the lack of NGEU funding will delay the energy transition, which is paramount for the EU country with the highest dependency on coal-generated power.

INFLATIONARY PRESSURE IS BROAD-BASED AND ACCELERATING



MONETARY TIGHTENING EXPECTED TO DAMPEN THE POSITIVE CREDIT IMPULSE IN 2022



Source: Statistics Poland, NBP, UniCredit Research

Higher POLGB yields likely in 1Q22

POLGBs could sell off further…

…as the NBP ended its bond purchases…

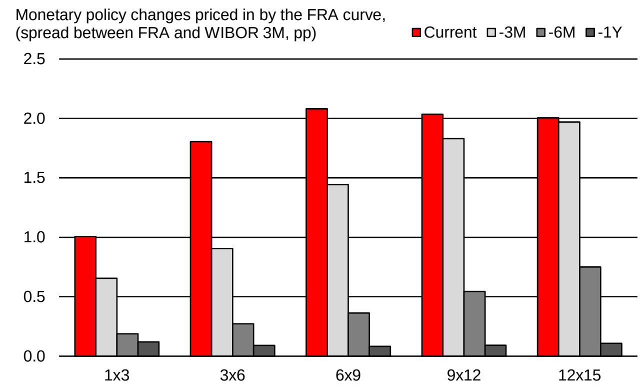
…and if the NBP hikes less than priced in by markets…

POLGBs sold off in 4Q21, as we expected. We see reasons for a further selloff. The most important is that the NBP will not purchase additional bonds. Having been by far the largest net buyer of bonds in 2020 (with more than 70% of the net change in outstanding POLGBs), the NBP cannot be replaced by local buyers, who expect inflation to increase further and push yields above current levels. We believe that a breach of 4% in the 5-10Y segment is only a matter of time. Meanwhile, foreign investors are unlikely to provide the missing demand. Besides inflation, the negative view of the EUR vs the USD is affecting demand for all local-currency bonds in EU-CEE. In addition, the NBP is unlikely to hike as much as markets currently price in, while Mr. Glapinski could continue to sound more dovish than the inflation outlook would require. This could lead to episodes of PLN depreciation if inflation exceeds consensus.

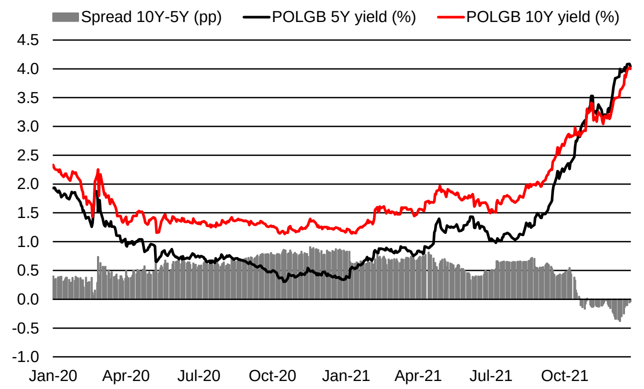
… and inflation is higher and stickier than expected

The POLGB curve inverted in the 5-10Y segment of the curve as the inflation spike is considered temporary. As inflation continues to rise, the longer end could sell off more than the belly of the curve, with investors likely to price in higher inflation for longer. The primary market is not a risk for POLGBs, given ample fiscal reserves.

NBP HIKES COULD FALL SHORT OF MARKET EXPECTATIONS



10Y POLGB COULD SELL OFF MORE THAN THE BELLY



Source: Bloomberg, UniCredit Research

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2021E	2022F	2023F
Gross financing requirement	**47.2**	**42.0**	**40.5**
Budget deficit	18.0	13.2	12.8
Amortization of public debt	29.1	28.8	27.7
Domestic	21.7	23.3	23.5
Bonds	16.9	20.2	20.5
Bills	2.4	0.0	0.0
Loans/Other	2.4	3.1	3.0
External	7.4	5.5	4.2
Bonds	6.9	4.5	3.7
Loans, IFIs, other	0.5	1.0	0.5
Financing	**47.2**	**42.0**	**40.5**
Domestic borrowing	44.5	33.9	35.0
Bonds	38.4	28.1	30.0
Bills	0.0	0.0	0.0
Loans/PFR/Other	6.1	5.8	5.0
External borrowing	2.5	2.0	4.0
Bonds	0.0	1.0	2.0
Loans, IFIs, other	2.5	1.0	2.0
Change in fiscal reserves/Other (-=increase)	0.2	6.2	1.5

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2021E	2022F	2023F
Gross financing requirement	**108.4**	**116.8**	**109.3**
C/A deficit	8.0	14.0	4.0
Amortization of medium and long-term debt	51.6	51.8	52.7
Government/central bank	9.1	7.5	6.2
Banks	16.1	15.3	14.5
Corporates/Other	26.4	29.0	31.9
Amortization of short-term debt	48.7	51.0	52.6
Financing	**108.4**	**116.8**	**109.3**
FDI (net)	16.0	10.7	11.5
Portfolio equity, net	-1.5	-1.0	0
Medium and long-term borrowing	32.1	34.4	39.3
Government/central bank	3.0	3.5	6.5
Banks	8.1	7.7	7.3
Corporates/Other	21.1	23.2	25.5
Short-term borrowing	50.0	53.5	52.9
EU structural and cohesion funds	10.7	9.0	10.1
Other	0.0	5.0	0.0
Change in FX reserves (- = increase)	1.1	5.2	-4.5
Memoranda:			
Nonresident purchases of LC govt bonds	-1.2	-0.4	0.7
International bond issuance, net	-6.9	-3.5	-1.7

Source: Statistics Poland, NBP, UniCredit Research

Romania

Baa3 stable/BBB- stable/BBB- negative*

Outlook

We expect GDP to grow by 3.7% in 2022 and by 3.5% in 2023, with downside risks. Private consumption should be the main growth driver in 1H22, with investment taking over if Romania receives loans and grants from NGEU equivalent to more than 2% of GDP and if building construction remains buoyant. High food and energy prices could keep inflation around 6% at the end of 2022 but loss of purchasing power is likely to slow consumption and inflation in 2023. We expect the NBR to hike its key rate to 3% and to keep implied interest rates above 4% for most of 2022. EUR-RON is likely to move to a 5.00-5.10 range in 2022.

Strategy

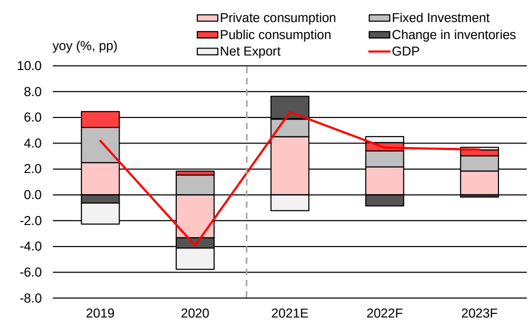
Despite the many reasons for ROMGBs to rally, performance will depend on foreign interest. ROMANI issuance will remain high.

Authors:
Dan Bucsa, Chief CEE Economist (UniCredit Bank, London)
Anca Maria Negrescu, Senior Economist Romania (UniCredit Bank Romania)

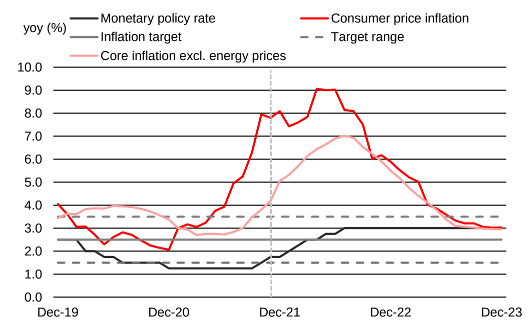
KEY DATES/EVENTS

- 9 Feb.: monetary-policy decision
- 14 Jan., 14 Feb., 14 Mar.: CPI
- 15 Feb., 8 Mar.: 4Q21 GDP (flash, structure)
- no rating updates in 1Q22

GDP GROWTH FORECAST



INFLATION FORECAST



Source: National Statistical Institute, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

EUR bn	2019	2020	2021E	2022F	2023F
GDP (EUR bn)	223.2	218.2	241.4	262.0	276.4
Population (mn)	19.4	19.3	19.2	19.1	19.1
GDP per capita (EUR)	11,488	11,290	12,581	13,690	14,469
Real economy, change (%)					
GDP	4.2	-3.9	6.4	3.7	3.5
Private consumption	3.9	-5.3	7.4	3.5	3.0
Fixed investment	12.9	6.8	5.5	5.0	4.7
Public consumption	7.3	1.7	0.3	3.7	2.7
Exports	5.4	-9.7	11.9	7.3	6.0
Imports	8.6	-5.1	13.5	5.4	5.0
Monthly wages, nominal (EUR)	1069	1116	1174	1230	1281
Real wages, change (%)	8.9	3.6	1.9	-0.4	2.0
Unemployment rate (%)	3.9	5.0	5.5	4.7	4.0
Fiscal accounts (% of GDP)					
Budget balance	-4.4	-9.4	-8.0	-6.2	-4.4
Primary balance	-3.3	-8.0	-6.4	-4.5	-2.7
Public debt	35.3	47.4	49.1	51.2	53.1
External accounts					
Current account balance (EUR bn)	-10.9	-11.0	-16.6	-17.2	-17.9
Current account balance/GDP (%)	-4.9	-5.0	-6.9	-6.6	-6.5
Extended basic balance/GDP (%)	-1.7	-2.2	-1.3	-0.8	-0.8
Net FDI (% of GDP)	2.2	1.4	3.4	3.5	3.5
Gross foreign debt (% of GDP)	33.3	42.9	48.0	51.3	54.3
FX reserves (EUR bn)	32.9	37.4	40.5	46.0	49.8
Months of imports, goods & services	4.0	4.9	4.4	4.7	4.8
Inflation/monetary/FX					
CPI (pavg)	3.8	2.7	5.0	7.7	3.9
CPI (eop)	4.0	2.1	8.1	5.9	3.1
Central-bank target	2.50	2.50	2.50	2.50	2.50
Central-bank reference rate (eop)	2.50	1.50	1.75	3.00	3.00
3M money-market rate (Dec. avg.)	3.12	2.04	2.83	3.86	3.84
USD-RON (eop)	4.26	3.97	4.37	4.62	4.80
EUR-RON (eop)	4.78	4.87	4.95	5.08	5.18
USD-RON (pavg.)	4.24	4.24	4.16	4.53	4.73
EUR-RON (pavg.)	4.75	4.84	4.92	5.04	5.12

Source: Eurostat, NSI, UniCredit Research

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

Reforms for money

The PSD-PNL coalition postpones a political crisis to 2023

Political uncertainty declined with the formation of a grand coalition comprising the Social Democratic Party (PSD) and the National Liberal Party (PNL). The ethnic Hungarian party UDMR ensures that the coalition has a constitutional majority, although we do not expect it to be used. The current coalition was formed for two main reasons: to prevent reforms to the justice system and to make the most of the RRF money that is to fund Romania's National Recovery and Resilience Program. Romania is the only country in the EU-CEE to have requested all available grants (EUR 14.2bn) and loans (EUR 14.9bn) from the RRF.

Romania will struggle to absorb all of the RRF money it has applied to receive due to delayed reforms…

…especially in the judicial system

Romania received EUR 3.8bn (1.6% of GDP) in RRF pre-funding (13% of the loans and grants it applied for). In our view, it will be hard for Romania to stick to the disbursement schedule[6] due to the busy reform agenda it implies, but we expect 2022 disbursements to be around 2.3% of GDP. Some reforms that had to be implemented in 2021-22 to unlock EUR 2.9bn of funding in April 2022 have yet to be addressed, among them, a masterplan for rail infrastructure, reforming the pension system, fighting corruption and improving court independence. With Romania at risk of triggering an infringement procedure due to the existence of a chamber investigating magistrates, EC Vice President Věra Jourová has urged the Romanian government to reform the country's justice system. In December, a ruling by the Court of Justice of the EU (CJEU)[7] made recommendations under the EU's Mechanism for Cooperation and Verification (an instrument designed to monitor judicial reform) compulsory for Romania. The ruling also allows judges to disregard decisions made by the Constitutional Court when they contradict European legislation.

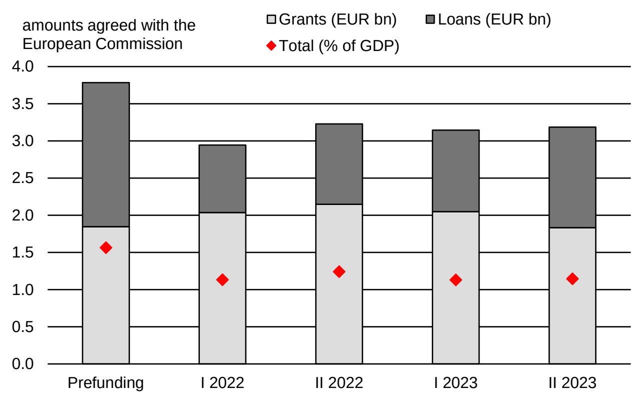
RRF conditionality will force a fiscal adjustment

We see a risk that RRF disbursements from 2023 onwards will be lower than planned. The new PSD-PNL-UDMR alliance has kept the amount of spending on pensions below 9.4% of GDP (a threshold agreed upon in RRF negotiations), limiting pension increases to around 10% and postponing planned special pensions for mayors. Thus, in our view, the government is unlikely to return to pre-COVID-19 largess. We expect the budget deficit (calculated using accruals) to decline from around 8% of GDP in 2021 to 6.2% of GDP in 2022 and to 4.4% of GDP in 2023. Risks are skewed to the upside but are not enough to push public debt above 55% of GDP.

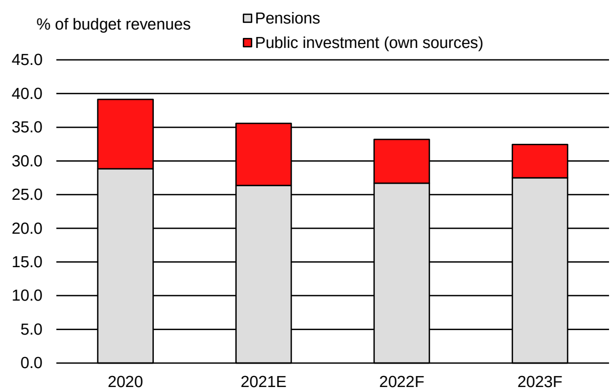
GDP growth could slow to 3.7% in 2022 and to 3.5% in 2023

However, public policy may well take a toll on economic growth, which we expect to slow to 3.7% in 2022 and 3.5% in 2023, from 6.4% in 2021. Public investment could fall short of the planned 7% of GDP due to smaller-than-planned outlays from the budget. We expect building projects to grow at a slower pace amid tightening financial conditions, with logistics and industrial buildings performing best. While new mortgage lending could slow in 2022, we do not expect house prices to fall. Adjusted for wage growth, they remain the lowest in CEE.

PLANNED DISBURSEMENTS FROM THE RRF



INVESTMENT COULD BE SACRIFICED TO CAP DEFICITS



Source: EC, Ministry for European Funds, NSI, UniCredit Research

[6] around EUR 2bn in grants and at least EUR 1bn in loans every six months, for the equivalent of around 2% of GDP per year
[7] Judgement No. 230/2021 published on the website of the CJEU, CURIA - Press releases - Court of Justice of the European Union (europa.eu)

Uncertain legislative outlook could curtail capex

Productive investment could be curtailed by tighter monetary conditions and by Romania's uncertain tax environment. The government might impose a solidarity tax on companies with a turnover of more than EUR 100mn. Adding to the PSD's history of anti-business measures (such as Ordinance 114/2018), this could drive away potential foreign investors, in our view. The most pressing investment for Romania's economic stability is in offshore gas fields. State-owned Romgaz is buying Exxon's rights to Black Sea gas fields, but extraction could be delayed for years due to a lack of legislation and the political clout of intermediaries that import gas from Gazprom. In 2023, the contribution from investment to GDP growth could decline further if the country falls behind in its reform schedule and fails to receive all RRF funds.

Household income could be affected by falling employment and low wage growth

Private consumption could slow once pent-up demand is exhausted, probably in 1H22. Thereafter, labor-market conditions will be unfavorable for a fast rise in real income and pensions will increase less than living costs in 2022. Employment in manufacturing with low added value could decline further as high commodity prices and rising minimum wages eat into margins, which will have already been affected by the strong RON. In addition, real wage growth is unlikely to match inflation in 2022 if small wage increases in manufacturing and the administration offset higher indexation in leisure services and IT. The PSD would like to replace the flat personal income tax with a progressive system. If this measure is implemented (no earlier than 2023, in our view), private consumption could slow more than we currently expect.

Inflation could end 2022 around 6%...

…and return to its target range in 2023

If household incomes fall in real terms in 2022, inflation could ease in 2023. Until then, Romania may be confronted with very fast food-price growth, which we expect to end 2022 close to 10%. This would explain half of headline inflation and more than two-thirds of core inflation. With wholesale prices more than doubling in 2021 compared to 2020, bakery, dairy and imported-food prices could add to higher fuel and energy prices, slowing disinflation to around 6% by end-2022. Stronger disinflation could be prompted by VAT cuts for energy products, debated at the time of writing this report. Inflation could return to the target range in 2023 if supply shocks subside.

We expect rate hikes to 3% and implied rates to be above 4% in 2022

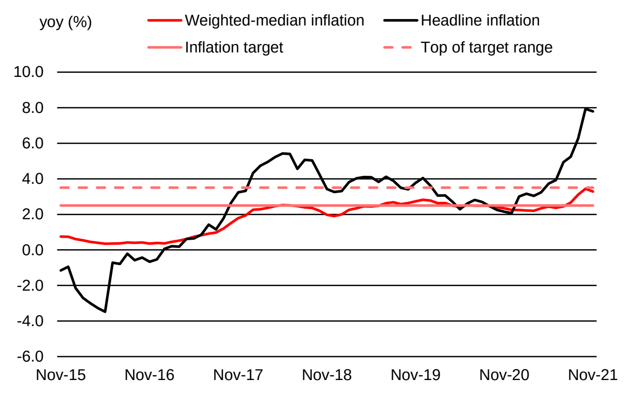
EUR-RON could shift to 5.00-5.10 in 1Q22

The NBR's November inflation report suggests a similar inflation outlook. As a result, we expect rate hikes to stop around 3% in 2022, with liquidity sterilization and FX interventions pushing implied interest rates above 4% whenever there is pressure on the RON. The NBR could let EUR-RON move to a 5.00-5.10 range in 1Q22, which would be insufficient to offset a further loss of external competitiveness. The RON is the most expensive EU currency, and this is reflected in Romania's C/A deficit, which is likely to remain above 6% of GDP in 2022-23. The negative extended basic balance could be covered by RRF loans, at least in 2022.

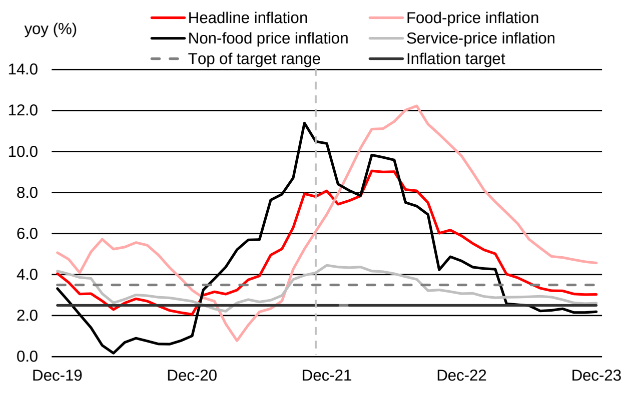
The governing coalition could dissolve in mid-2023

We expect the current government to last until mid-2023. By then, we think that economic visions within the coalition could diverge further, with the PSD probably managing to impose higher taxes at the cost of pushing the PNL into opposition before Romania's 2024 elections.

ROMANIA IS THE ONLY EU-CEE COUNTRY WHERE UNDERLYING INFLATION IS INSIDE THE TARGET RANGE



SUPPLY SHOCKS WILL REMAIN THE MAIN DRIVERS OF INFLATION



Source: NSI, UniCredit Research

A ROMGB rally needs demand from foreign investors

Approaching an inflation peak, valuation and light positioning become arguments for a ROMGB rally…

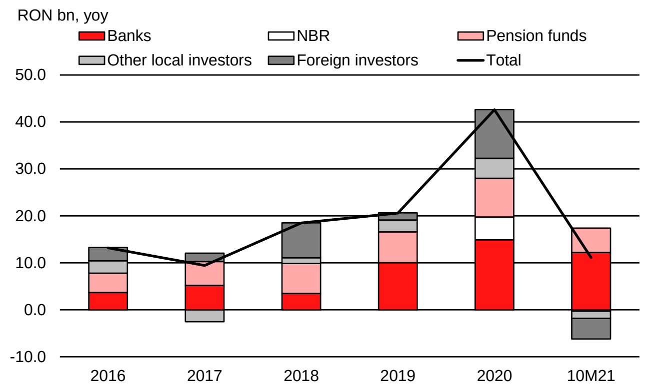
There are several reasons why we think ROMGBs should perform well in 2022: **1.** We expect inflation to decline. **2.** ROMGBs have the highest real yields among local-currency bonds in the EU (calculated using expected inflation). **3.** At least part of their risk premium stemming from potential downgrades to junk status and political uncertainty should be priced out, in our view. **4.** Local pension funds, which need returns above inflation, are likely to purchase an increasing amount of bonds as inflation approaches a peak. **5.** ROMGBs are the most attractive local-currency bonds in CEE when limited FX volatility is considered. **6.** There is scope for local banks to buy more government bonds, which represent 15.4% of their assets. **7.** Foreign investors tend to underweight ROMGBs, having reduced their holdings in 2021 by around 3pp by October, to 17.2% of outstanding ROMGBs.

…but foreign demand will be paramount

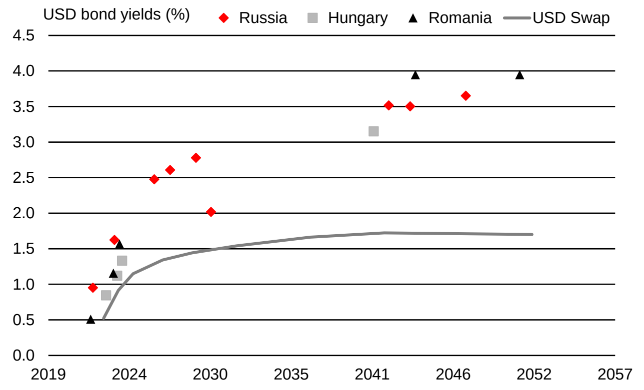
ROMANI issuance of around EUR 10bn is expected in 2022

However, a ROMGB rally would need foreign investors to accept these arguments. They might be deterred by large FX issuance (around EUR 10bn in 2022). The first ROMANI issuance could come in January, with long-term EUR and USD-denominated bonds the cheapest in CEE. In addition, Romania's ministry of finance needs to be more flexible when managing its fiscal reserves, allowing them to decline more when demand for ROMGBs declines.

LOCAL INVESTORS PURCHASE THE MOST ROMGBS



ROMANI USD BONDS ARE CHEAPER THAN RUSSIAN ONES, DESPITE THE LATTER'S EXPOSURE TO GEOPOLITICAL RISK



Source: Ministry of Finance, NBR, NSI, Bloomberg, UniCredit Research

GOVERNMENT'S GROSS FINANCING REQUIREMENTS

EUR bn	2021E	2022F	2023F
Gross financing requirement	**27.4**	**27.9**	**25.1**
Budget deficit	17.2	15.3	12.2
Amortization of public debt	10.2	12.6	12.9
Domestic	10.2	9.7	11.5
Bonds	7.9	8.1	10.2
Bills	1.0	1.3	1.0
Loans	1.3	0.3	0.3
External	0.0	2.9	1.4
Bonds and loans	0.0	2.9	1.4
IMF/EU/other IFIs	0.0	0.0	0.0
Financing	**27.4**	**27.9**	**25.1**
Domestic borrowing	14.8	14.8	15.0
Bonds	10.5	11.8	12.0
Bills	1.3	1.0	1.0
Loans and retail bonds	3.0	2.0	2.0
External borrowing	10.6	13.0	10.0
Bonds	7.0	10.0	8.0
IMF/EU/other IFIs	3.6	3.0	2.0
Fiscal reserve change (- = increase)	2.0	0.2	0.2

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2021E	2022F	2023F
Gross financing requirement	**41.2**	**45.4**	**44.3**
C/A deficit	16.6	17.2	17.9
Amortization of medium and long-term debt	9.7	12.4	11.0
Government/central bank	1.1	4.2	3.1
Banks	2.8	2.5	2.2
Corporates/other	5.8	5.7	5.7
Amortization of short-term debt	14.9	15.8	15.4
Financing	**41.2**	**45.4**	**44.3**
FDI (net)	8.3	9.1	9.6
Portfolio equity, net	0.1	0.1	0.1
Medium and long-term borrowing	19.8	20.8	17.7
Government/central bank	11.8	13.1	10.3
Banks	2.5	2.2	2.0
Corporates/other	5.5	5.4	5.4
Short-term borrowing	15.4	15.0	14.6
EU structural and cohesion funds	5.2	6.0	6.0
Change in FX reserves (- = increase)	-7.6	-5.6	-3.8
Memoranda:			
Nonresident purchases of LC gov't bonds	1.9	1.4	1.3
International bond issuance, net	7.0	7.1	6.6

Source: NBR, ministry of finance, NSI, UniCredit Research

Slovakia

A2 stable/A+ stable/A stable*

Outlook

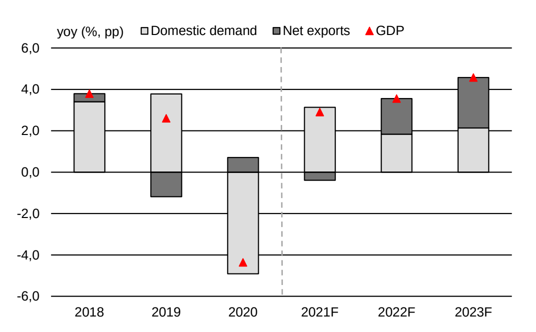
We expect Slovakia's GDP to grow by 3.6% in 2022 and by 4.6% in 2023 and to reach pre-pandemic levels in 2Q22. This economic rebound is expected to be temporarily slowed early in 2022 by a winter pandemic wave, accentuated by Slovakia's low vaccination rate and by supply-chain bottlenecks, mainly in the key car sector. Economic growth is expected to accelerate from 2H22 as supply-chain bottlenecks and the pandemic are likely to ease. Growth will be led by consumption and supported by pent-up demand and tightening labor-market conditions, as well as by public-investment, which is expected to be driven by inflows from the EU. Real wage growth is likely to remain low due to inflation accelerating above 5% and peaking at 7% in 1Q22. NGEU drawdown is likely to accelerate beyond 2023 due to a lack of reform progress as a result of rising political instability. General elections scheduled for February 2024 could slow fiscal tightening, keeping the budget deficit above 3% of GDP in 2022-23.

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

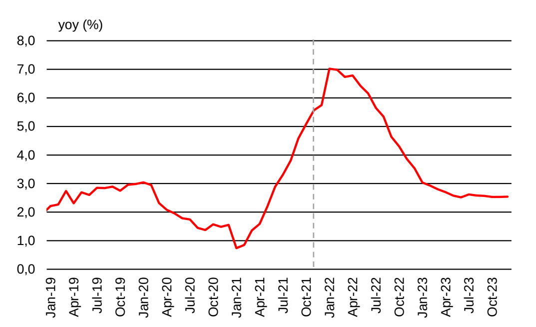
KEY DATES/EVENTS

- 10 Jan., 10 Feb., 10 Mar.: industrial production
- 14 Jan., 14 Feb., 15 Mar.: CPI
- 14-15 Feb., 3-4 Mar.: 4Q21 GDP (flash, structure)
- 18 Mar.: rating update from Fitch

GDP RECOVERY TO BE DRIVEN BY BOTH DOMESTIC DEMAND AND NET EXPORTS



INFLATION TO PEAK AT 7% IN 1Q22



Source: SOSR, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

EUR bn	2019	2020	2021E	2022F	2023F
GDP (EUR bn)	94.0	92.1	97.5	106.7	114.6
Population (mn)	5.5	5.5	5.5	5.5	5.5
GDP per capita (EUR)	17 243	16 871	17 868	19 553	20 989
Real economy, change (%)					
GDP	2.6	-4.4	2.9	3.6	4.6
Private consumption	2.6	-1.3	0.3	2.4	2.7
Fixed investment	6.7	-11.6	0.7	7.1	4.1
Public consumption	4.6	0.9	1.5	-1.5	0.0
Exports	0.8	-7.3	8.1	8.1	8.2
Imports	2.1	-8.2	8.8	6.5	6.0
Monthly wage, nominal (EUR)	1 092	1 133	1 204	1 277	1 357
Real wage, change (%)	5.0	1.8	3.1	0.4	3.5
Unemployment rate (%)	5.8	6.7	6.9	6.3	5.3
Fiscal accounts (% of GDP)					
Budget balance	-1.3	-5.5	-6.7	-4.7	-3.5
Primary balance	-0.1	-4.9	-5.3	-3.3	-2.2
Public debt	48.1	59.7	61.1	58.5	57.0
External accounts					
Current account balance (EUR bn)	-2.5	-0.3	-1.5	-1.2	-0.8
Current account balance/GDP (%)	-2.7	-0.4	-1.6	-1.1	-0.7
Extended basic balance/GDP (%)	0.2	-1.3	0.0	1.9	1.6
Net FDI (% of GDP)	2.2	-2.1	0.3	1.3	0.5
Gross foreign debt (% of GDP)	112.2	120.5	118.0	114.0	110.4
FX reserves (EUR bn)	EUR	EUR	EUR	EUR	EUR
Months of imports, goods & services	-	-	-	-	-
Inflation/monetary/FX					
CPI (pavg)	2.7	1.9	3.1	5.6	2.7
CPI (eop)	3.0	1.6	5.7	3.5	2.5
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
Real effective exchange rate, 2000=100					
Change (%)					

Source: Eurostat, SOSR, UniCredit Research

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

Growth slowed by supply shocks and low vaccine take-up

Slovakia's low vaccination rate is expected to slow a consumption rebound in the winter

Slovakia's low vaccination rate, which is the third lowest in the EU and does not yet exceed 50% of the total population or 70% of the critical population (those over the age of 60), exacerbates pandemic waves and leads to strict measures being put in place, especially in winter. We therefore expect to see that the nationwide lockdown imposed in November hindered household consumption in the first quarter of this year. The negative effects of trade and contact-services closures have at least been partially mitigated by weak enforcement of restrictions and by the expenditure structure of Slovak households, which tend to spend a lot on staples (the most in the EU) and little on contact services and transport. As the pandemic subsides, household consumption, supported by pent-up demand, should drive economic growth from 2Q22 on.

Consumption recovery is expected to restart in the spring…

…led by pent-up demand and tight labor-market conditions

Recovery in consumption will be supported by a tight labor market. The fall in unemployment will only temporarily be slowed by the winter wave of the pandemic. Employment growth is likely to be underpinned by the opening of additional production capacity in the car sector in 2H22. However, unemployment is unlikely to return to its 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. Unlike in previous years, wage increases will not be supported by the public sector in 2022. Furthermore, real wage growth will be slowed by rising inflation in 2022, accelerating in 2023 thanks to renewed wage increase in the public sector due to approaching general elections (expected to be held in early in 2024).

Inflation could peak in 1Q22 and slow thereafter

Inflation could peak at the beginning of 2022 at 7.0%, driven by faster growth in the prices of food and tradable goods (boosted by higher demand and input prices) as well as an increase in regulated energy prices in January 2022. Stable wage growth will spill over into market-services prices, probably preventing rapid disinflation later in 2022. Inflation is thus expected remain above 3.5% until the end of 2022 and above 2.5% in 2023.

Supply-chain bottlenecks are likely to ease from 2H22 but not disappear before 2023

Resilience to pandemic waves has increased in manufacturing, but production has been slowed by supply-chain bottlenecks, mainly in the key car sector. Furthermore, rising energy prices have dragged on production in energy-intensive sectors like basic materials and chemicals. Supply-chain bottlenecks could start easing in 2H22 but are not expected to fully dissipate before 2023.

Investment to be supported by last-minute drawdown of EU funds

We expect GDP to grow by 3.6% in 2022 and by 4.6% in 2023, with a light start into 2022 and a gradual acceleration thereafter. In 2H22 and especially in 2023, economic growth should be supported by public investment from the late drawdown of EU funds from the 2014-20 budgetary period. Meanwhile, NGEU grants could accelerate only after 2023 due to a lack of needed reform progress. Private investment could recover gradually from 2H22 onwards. At the same time, residential real estate will continue to be affected by a missing amendment to the Building Act, which is unlikely to be approved anytime soon due to controversy surrounding the prepared draft.

Fiscal efforts are expected to be slowed by approaching general elections

Tax reform is expected to simplify labor taxes and to cut corporate tax…

…but is unlikely to be implemented before 2023

We expect that fiscal spending will drag on economic growth due to necessary post-pandemic consolidation. The government deficit may reach 4.9% of GDP in 2022 (down from 6.5-7% of GDP in 2021) and further decline to 3.4% GDP in 2023. However, fiscal adjustment is likely to be slowed by general elections scheduled for February 2024. Public debt could remain above 60% of GDP, which exceeds all debt-brake thresholds, so far left unchanged by the governing coalition. The ministry of finance proposed a tax reform, suggesting significant simplification of labor taxes and levies (one 19% tax paid by employees and one 39% social contribution paid by employers), the lowering of corporate taxes from 21% to 19% and increased support for families. The reform should be fiscally neutral, as it is to be offset by higher taxes on the self-employed, banks and oligopolies/monopolies, and by lowering defense expenditure below NATO requirements. Unclear support for this reform inside the governing coalition could postpone implementation to 2023 or later. Growing tensions in the governing coalition also threaten budget execution and reforms to which the government has committed itself in return for access to NGEU funds. 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

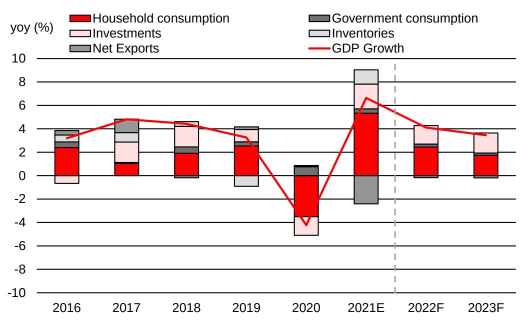
The Slovenian economy is facing some headwinds ahead of parliamentary elections scheduled in 2Q22. Supply-chain disruptions will continue to affect production and an improvement is not expected until the second half of 2022. High inflation is a headwind for both households and corporates and we expect it to remain above 4% in 1H22. We expect GDP to grow 4.1% in 2022, after 6.7% in 2021, driven by consumption and government investment. In 2023, we see growth at 3.4%. Bond issuance will be supported by ECB purchases.

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

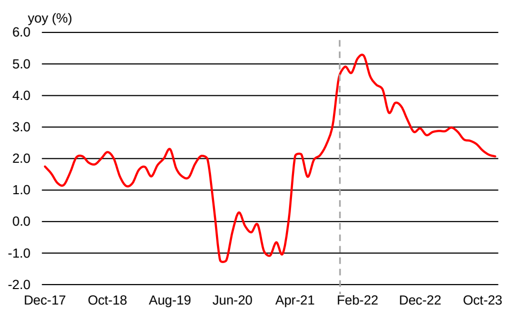
KEY DATES/EVENTS

- 28 Feb: 4Q21 GDP
- 10 Feb, 10 Mar: Industrial production
- 20 May.: Fitch to update sovereign rating
- 22 Apr: Moody's to update sovereign rating
- 10 Jun: S&P to update sovereign rating

GDP GROWTH FORECAST



INFLATION FORECAST



Source: SURS, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2019	2020	2021E	2022F	2023F
GDP (EUR bn)	48.4	46.9	50.9	55.1	58.4
Population (mn)	2.1	2.1	2.1	2.1	2.1
GDP per capita (EUR)	23,167	22,312	24,172	26,131	27,711
Real economy, change (%)					
GDP	3.3	-4.2	6.6	4.1	3.4
Private Consumption	4.8	-6.6	10.2	4.5	3.2
Fixed Investment	5.5	-8.2	11.4	8.2	8.5
Public Consumption	2.0	4.2	1.9	1.3	1.1
Exports	4.5	-8.7	12.2	8.6	8.2
Imports	4.7	-9.6	16.8	9.4	8.9
Monthly wage, nominal (EUR)	1,754	1,858	1,961	2,059	2,169
Real wage, change (%)	2.6	6.2	3.6	1.0	2.7
Unemployment rate (%)	4.5	5.0	4.7	4.5	4.2
Fiscal accounts (% of GDP)					
Budget balance	0.4	-7.7	-6.4	-5.3	-4.0
Primary balance	2.1	-6.1	-4.7	-3.7	-1.4
Public debt	65.6	79.8	77.7	76.4	75.5
External accounts					
Current account balance (EUR bn)	2.9	3.5	2.5	2.7	2.7
Current account balance/GDP (%)	6.0	7.4	4.9	4.8	4.6
Extended basic balance/GDP (%)	8.6	8.5	9.6	11.2	10.6
Net FDI (% of GDP)	1.6	-0.6	1.8	1.8	1.7
Gross foreign debt (% of GDP)	91.5	101.9	100.1	97.2	95.4
FX reserves (EUR bn)					
Months of imports, goods & services					
Inflation/Monetary/FX					
CPI (pavg)	1.7	-0.3	1.9	4.0	2.6
CPI (eop)	2.0	-1.2	4.9	3.0	2.1

Source: SURS, Eurostat, UniCredit Research

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

Headwinds ahead of elections

Economic headwinds ahead of the elections

The Slovenian economy is facing some headwinds ahead of parliamentary elections that are expected to take place in 2Q22.

Supply-chain disruption and skills shortages are likely to continue

Supply-chain disruptions will continue to affect production and this is not expected to improve until the second half of 2022. European Commission's surveys show that the share of Slovenian companies reporting equipment as a limit to production remained high in 4Q21. This is particularly prevalent in the automotive, electronics, electrical equipment, and wood sectors, although also other sectors also appear to be affected. We expect the impact of supply-chain bottlenecks and commodity prices to moderate in 2H22. Companies are also reporting skills shortages in various sectors, which are likely to remain an issue for an extended period.

Inflation likely to remain high in 1H22

High inflation is a headwind for both households and corporates and we expect it to remain above 4% in 1H22. Similar to other countries, the high level of inflation has been driven by global food prices, energy prices, and more recently by core inflation due to more expensive imports caused by supply-bottlenecks and strengthening domestic demand. We expect inflation to gradually slow in 2H22 towards 3.0% by the end of the year, driven by base effects in energy prices and food prices and lower core inflation as supply-bottlenecks ease.

Labor market improving but skills shortages in some sectors

The labor market is improving, providing further support to household spending, but there are shortages in various sectors. Unemployment has been falling on a yoy basis since April and employment has risen by around 2% yoy since June. The registered unemployment rate was 6.8% in October, the lowest level since 2008. Wage growth has been slowing in the public sector while in the private sector has been picking up, reaching 5.7% yoy in September, likely reflecting the reopening and labor shortages.

Growth at 4.1% in 2022

Despite the headwinds, growth will be driven by consumption and public investment. We expect GDP to grow 4.1% in 2022, after 6.6% in 2021. Consumption will be supported by pent-up demand, improvement in the labor market, private-sector wage growth, and pension increases (5.4%). Public investment will also be an important driver, with government capital expenditure expected to rise by 40% to almost EUR 3.6bn (6.2% of GDP). Public investment will be partly funded by RFF (planned at EUR 285mn) and funding from the EU budget from the previous 2014-20 program and the new 2021-27 program (EUR 600mn in 2022). Net exports will likely remain a drag.

Growth at 3.7% in 2023

In 2023, we see growth at 3.4% supported by EU funding, private consumption and investment, and a continued recovery in Slovenia's main trading partners.

Government debt to resume its downward trends

The fiscal deficit will likely narrow from 6.4% in 2021 to 5.3% in 2022 as the COVID-19 support measures are phased out – like in 2021, the implementation risk relates to capital expenditure. In 2023, we expect the budget deficit to be 4% of GDP. We expect government debt to decline from 77.7 in 2019 to 76.4 in 2021 and further to 75.5% in 2023.

Issuance in 2022 supported by ECB asset purchases

In 2022, financing needs will be EUR 5.0bn according to the funding plan (EUR 2.3bn in repayments, which also appears to include some buybacks as total repayments for 2022 are EUR 1.4bn, and EUR 2.7bn to finance the government deficit). These will be covered through the issuance of bills and bonds. At the beginning of January, Slovenia already issued EUR 1.75bn in bonds. Slovenian bonds will likely continue to be supported by ECB purchases in 2022, which we estimate at EUR 1.5-2.0bn, therefore around 55-75% of net issuance. In 2023, repayments will be EUR 2.3bn while the planned deficit is EUR 1.5bn.

Elections in 2022: uncertainty outcome

The next parliamentary elections will take place in 2Q22, on 24 April at the earliest, according to Slovenian President Borut Pahor. The outcome of the elections has become increasingly uncertain. Different opinion polls are showing different pictures. According to some polls, the center-left opposition Constitutional Arch Coalition (KUL) continues to lead in opinion polls. The KUL includes List of Marjan Šarec (LMS) the Social Democrats (SD), The Left (Levica) and the Party of Alenka Bratušek (SAB). Other polls shows that the parties that make up the current governing coalition, the Slovenian Democratic Party (SDS) and the New Slovenia – Christian Democrats party (Nsi), have a better chance of forming a government, via a potential alliance with the new political alliance Let's Connect Slovenia (PoS). New political formations, such as PoS, the Robert Golob List, Our Country (ND) and Green Action are gaining strength, but their projected share of the vote varies significantly across opinion polls. In addition, overall, the percentage of undecided voters remains high, close to 20%.

Bosnia and Herzegovina

B3 stable/B stable/not rated*

Outlook

Having reported GDP growth of 5.5% for 2021, Bosnia and Herzegovina's (B&H) economic recovery appears to be much stronger than we expected. In our view, this is due to the country's very soft restrictive measures. However, bright economic performance has been almost completely overshadowed by the country's worst political crisis since war in the Balkans ended and the Dayton Peace Accords were concluded in 1995. Therefore, forecasts for 2022 and 2023 are largely dependent on the development of the political situation – one should keep in mind that general elections are to be held by the end of 2022. Further recovery of the economy is expected to be driven by personal consumption, strong growth in export-oriented sectors of the economy and investment activity. In the event of a quick and smooth resolution of the current political crisis, GDP could grow by 3.5% in 2022 and by 3.4% in 2023.

Author:
Hrvoje Dolenec, Chief Economist Croatia (Zagrebacka banka)

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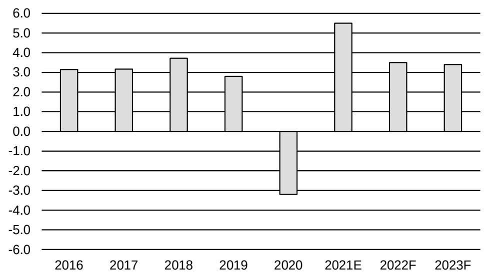
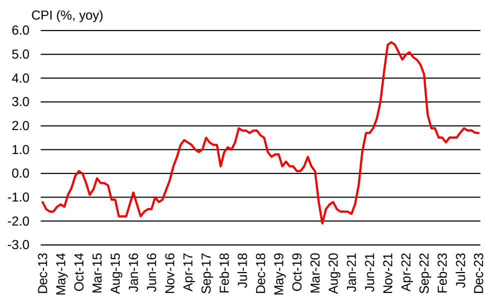
KEY DATES/EVENTS

- 20 Jan.: foreign trade 2021
- 25 Jan.: CPI 2021
- 25 Jan.: industrial production 2021
- 31 Mar.: balance of payments 2021
- 31 Mar. GDP 4Q21

GDP-GROWTH FORECAST



INFLATION FORECAST



Source: UniCredit Research

MACROECONOMIC DATA AND FORECASTS

EUR bn	2019	2020	2021E	2022F	2023F
GDP (EUR bn)	18.0	17.5	18.8	20.2	21.2
Population (mn)	3.5	3.5	3.5	3.4	3.4
GDP per capita (EUR)	5169	5038	5442	5869	6202
Real economy, change (%)					
GDP	2.8	-3.2	5.5	3.5	3.4
Monthly wage, nominal (EUR)	727	755	786	816	841
Real wage, change (%)	3.7	4.9	2.3	0.2	1.4
Unemployment rate (%)	33.3	33.8	32.5	31.5	29.0
Fiscal accounts (% of GDP)					
Budget balance	2.1	-3.9	-2.7	-2.0	-1.2
Primary balance	2.8	-3.1	-1.8	-1.0	-0.3
Public debt	32.4	36.0	38.0	39.0	39.2
External accounts					
Current account balance (EUR bn)	-0.5	-0.7	-0.8	-0.8	-0.7
Current account balance/GDP (%)	-2.8	-3.8	-4.2	-4.1	-3.4
Extended basic balance/GDP (%)	-0.2	-1.1	-1.2	-1.3	-0.5
Net FDI (% of GDP)	1.5	1.7	2.2	1.9	2.1
Gross foreign debt (% of GDP)	64.3	66.0	63.3	60.4	58.0
FX reserves (EUR bn)	6.4	7.1	8.3	8.4	8.5
Months of imports, goods & services	7.8	10.0	9.7	9.1	8.6
Inflation/monetary/FX					
CPI (pavg.)	0.6	-1.0	1.8	3.6	1.6
CPI (eop)	0.3	-1.6	4.9	1.9	1.7
1M money-market rate (Dec. avg.)	-0.44	-0.55	-0.55	-0.52	-0.50
USD/FX (eop)	1.75	1.59	1.75	1.78	1.81
EUR/FX (eop)	1.96	1.96	1.96	1.96	1.96
USD/FX (pavg.)	1.75	1.72	1.65	1.76	1.81
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 serious political crisis overshadows recovery prospects

A strong recovery has been almost completely overshadowed by B&H's worst political crisis since war in the Balkans ended and the Dayton Peace Accords were concluded in 1995

Stronger than expected recovery of economic activity in Bosnia and Herzegovina in 2021 has been almost completely overshadowed by the country's worst political crisis since war in the Balkans ended and the Dayton Peace Accords were concluded in 1995. The current crisis started during the summer, when several controversial points emerged: disagreement over the legality of the new High Representative, Christian Schmidt's, mandate; changes in the criminal code imposed by the outgoing High Representative Valentin Inzko and a lack of agreement with regard to changes to B&H's election law (in line with rulings by B&H's Constitutional Court and the European Court of Human Rights). This resulted in Bosnian-Serb representatives' boycott of the activities of central state institutions. None of those controversial points has been resolved, and the political situation further deteriorated before it finally escalated on 10 December, when the parliament of the Republic of Srpska voted to return competencies from the state level to the level of that entity. In accordance with these conclusions, the parliament of the Republic of Srpska should pass laws within six months to form an army, an indirect tax-collection authority and a high judicial and prosecutorial council. Although these conclusions have no legal significance for now, translating them into law could mark the beginning of a process of secession by the Republic of Srpska from Bosnia and Herzegovina. Mr. Schmidt has already stated that these decisions are unconstitutional and inconsistent with the Dayton Accords. Ambassadors from the largest EU states and the US have made similar statements. For now, it is not clear if the proposals, which were announced by Bosnian-Serb leader Milorad Dodik, who serves as the Bosnian-Serb representative in B&H's presidency, are a political posturing or reflect real intentions. Either way, they have still upset the political situation in Bosnia and Herzegovina after months of partial boycotting by Bosnian-Serb politicians of activities of the parliament, council of ministers and presidency of B&H. It could lead to more-serious political conflicts, but, in practice, decision-making at the central institutions of B&H has not yet completely stopped. A prolonged boycott could, however, bring the functions of central state institutions to a halt and jeopardize economic activity, in particular foreign investment and financing. Another area of political concern is that there is a lack of consensus regarding B&H's new election law. This could also further complicate the political situation in the country, given that general elections are due to take place in autumn 2022. The main points of contention involve the opposing views of Bosnian and Croatian politicians, who are seeking to reconcile EU and US mediators.

The current political crisis was escalated by announcements of the return of competencies from the state level to the level of the entity of the Republic of Srpska

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 political problems described however have not impeded B&H's economic recovery so far. In 1H21, GDP grew by 7% yoy, and the strong recovery of economic activity, according to high-frequency data, has continued, also during 2H21. Our estimate is that GDP growth for the full year will reach 5.5%, with more upside than downside risks. In case of a quick and smooth resolution of the ongoing political crisis, GDP is expected to grow by 3.5% in 2022 and by 3.4% in 2023. In both years, growth is expected to be driven by an acceleration in exports of goods and services as well as in personal consumption. Further impetus for continued growth is expected from increased investment activity. Additional support for growth should come from a pronounced increase in remittances. This is very important because the new arrangement with the IMF, which provides B&H with substantial financing, will not be concluded anytime soon, in our view.

If not impeded by political turmoil, growth should reach 3.5% in 2022 and 3.4% in 2023

B&H's C/A deficit is likely to narrow to -4.1% of GDP in 2022 and -3.4% in 2023 and should be covered by FDI and financing from international financial institutions and the EU

B&H's C/A deficit is expected to narrow, not only because of larger remittances but also due to much higher growth in exports of goods and services in comparison with imports. Deficit is expected to reach -4.1% in 2022 and -3.4% in 2023. Most of the projected C/A deficit is expected to be covered by FDI (1.9% of GDP in 2022 and 2.1% of GDP in 2023) and the rest by financing from the IMF, the EU and other financial institutions.

North Macedonia

Not rated/BB- stable/BB+ Neg*

Outlook

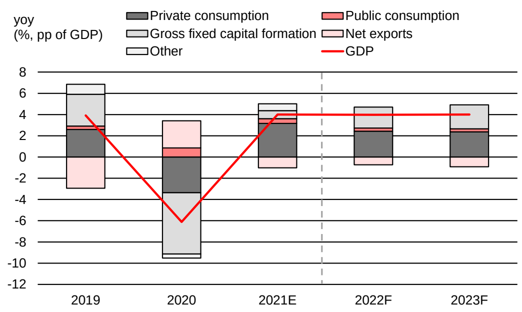
We expect GDP growth in North Macedonia to amount to 4.0% in 2022 and 2023, after it reached 4% in 2021. The main driver of growth will likely be public investment and consumption. North Macedonia's fiscal deficit will likely narrow to an amount equivalent to 4% of GDP in 2022 and remain at a similar level in 2023, with government debt increasing further. Inflation will probably remain above 5% yoy in 1H22 before slowing towards 3% yoy in the reminder of the year. We expect the country's 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)

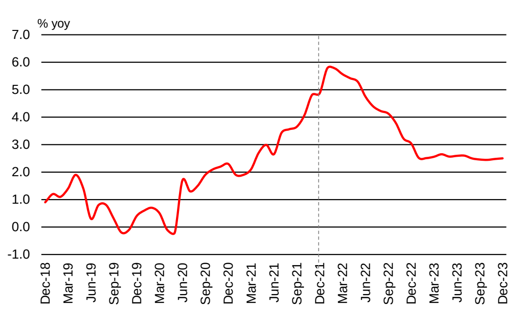
KEY DATES/EVENTS

- 2 Mar.: 4Q21 GDP
- 31 Jan., 4 Mar., 31 Mar.: industrial production
- 18 Feb.: rating update by S&P

GDP GROWTH FORECAST



INFLATION FORECAST



Source: state statistics office, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

EUR bn	2019	2020	2021E	2022F	2023F
GDP (EUR bn)	11.2	10.7	11.4	12.4	13.2
Population (mn)	2.1	2.1	2.1	2.1	2.1
GDP per capita (EUR)	5,355	5,078	5,450	5,921	6,309
Real economy, change (%)					
GDP	3.9	-6.1	4.0	4.0	4.0
Private consumption	3.5	-4.6	4.3	3.3	3.2
Gross capital formation**	8.7	-16.1	2.4	6.3	7.0
Public consumption	2.5	6.4	3.0	2.0	2.0
Exports	8.9	-10.9	14.4	10.6	8.1
Imports	10.1	-10.9	11.9	8.8	7.2
Monthly wage, nominal (EUR)	609	660	693	724	756
Real wage, change (%)	4.3	7.0	1.7	-0.1	1.9
Unemployment rate (%)	17.3	16.4	16.0	15.4	14.8
Fiscal accounts (% of GDP)					
Budget balance (central government)	-2.0	-8.2	-5.5	-4.0	-4.0
Primary balance (central government)	-0.8	-7.0	-4.4	-2.9	-3.0
Government debt (general government)	40.2	51.0	54.0	56.0	57.0
External accounts					
Current account balance (EUR bn)	-0.4	-0.4	-0.3	-0.3	-0.3
Current account balance/GDP (%)	-3.3	-3.4	-2.6	-2.4	-2.6
Extended basic balance/GDP (%)	0.0	-1.9	0.0	0.6	0.5
Net FDI (% of GDP)	3.2	1.5	2.6	3.0	3.0
Gross foreign debt (% of GDP)	72.4	80.3	87.0	86.0	85.0
FX reserves (EUR bn)	3.3	3.4	3.7	3.5	3.5
Months of imports, goods & services	4.6	5.3	5.0	4.2	3.8
Inflation/monetary/FX					
CPI (pavg)	0.8	1.2	3.2	4.6	2.5
CPI (eop)	0.4	2.3	4.9	3.0	2.5
Central bank target	-	-	-	-	
Central bank reference rate (eop)	2.25	1.50	1.25	1.25	1.25
USD-MKD (eop)	55.0	50.2	54.5	56.0	57.0
EUR-MKD (eop)	61.5	61.7	61.6	61.6	61.6
USD-MKD (pavg)	55.0	54.0	52.2	55.3	56.5
EUR-MKD (pavg)	61.5	61.7	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

2022: challenges and opportunities

We expect growth, driven by domestic demand, to amount to 4% in 2022 and 2023

We expect growth, driven by domestic demand, to amount to 4% in 2022, after it registered 4% in 2021.

Consumption is expected to be supported by wage growth, including an increase in the public-sector wage bill of around 3.5% yoy, pent-up demand and rising remittances. Investment should be boosted by a significant increase in government investment, which, according to North Macedonia's 2022 budget, should amount to 60%, taking into account the 2021 outcome. This should bring central-government capital expenditure to a level equivalent to 5% of GDP in 2022. We expect export growth to remain solid in 2022, but its impact on growth will likely be more than offset by increasing imports due to the import content of exports and solid domestic demand. We expect growth in 2023 to be driven by still-solid consumption growth and faster investment.

Downside risks to our forecasts are related more to supply-chain bottlenecks, notably in the automotive sector and the pandemic, given North Macedonia's low rate of vaccine uptake.

Inflation is likely to stay above 5% in 1H22

We project that inflation will probably remain above 5% yoy in 1H22 before slowing towards 3% yoy in the reminder of the year. The increase in inflation since the beginning of in 2021, from 2% yoy to 4.8% in November, has been driven by food prices, energy prices, and core inflation, due to an increase in transport prices in July, supply-chain bottlenecks and price increases related to reopening. Inflation will likely increase further in the coming months and stay close to 5% in 1H22. Thereafter, we expect inflation to slow towards 3% yoy due to base effects in energy, food and transport prices, assuming the impact of supply-chain bottlenecks begins to wane and global energy prices stabilize.

Narrower deficit in 2022, but government debt is likely to continue to increase

The central government's deficit could narrow from our estimated 5.5% of GDP in 2021, to around 4% of GDP in 2022. For 2022, the government plans a deficit equivalent to 4.3% of GDP, but with an ambitious plan for capital expenditure (and therefore with the risk of a smaller-than-envisaged deficit, as in 2023). In 2023, we assumed that the government's fiscal deficit will remain at 4.0% of GDP. Government debt is likely to continue to increase in 2022 and 2023, although remaining below 60% of GDP

Lower funding needs in 2022

In 2022, we expect financing needs to be lower due to lower repayments (around EUR 200mn, compared to EUR 700mn in 2021) and a smaller deficit. However, North Macedonia could do some pre-financing in view of higher repayments in 2023 (around EUR 1bn). Its financing plan for 2022 includes EUR 400mn in domestic borrowing, similarly to 2021, and EUR 350mn in foreign borrowing (a third of what was initially planned for 2021).

The new government majority should ensure political stability, at least in the short term

The new government majority should ensure political stability, at least in the short term. After a narrowly failed no-confidence vote, a small opposition party, Albanian Alternative, joined the governing collation comprising the social democrats (SDSM) and the Albanian Democratic Union of Integration (DUI). The government can now count on the support of 64 out of 120 members of the National Assembly, and this should guarantee some stability, at least in the short term.

Formal start of EU accession negotiations is expected to occur in 1H22

The priority will be to start EU accession negotiations, which have been vetoed by Bulgaria, and to deal with the current challenges posed by the energy crisis and the pandemic. We continue to expect the formal opening of EU accession negotiations to take place in 1H22, and the new Bulgarian government has signaled a constructive approach toward the dispute between the two countries.

Russia

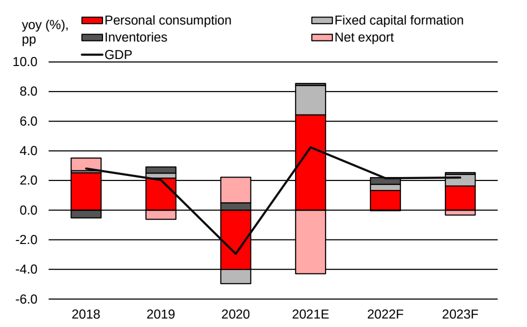
Baa3 stable/BBB- stable/ BBB stable*

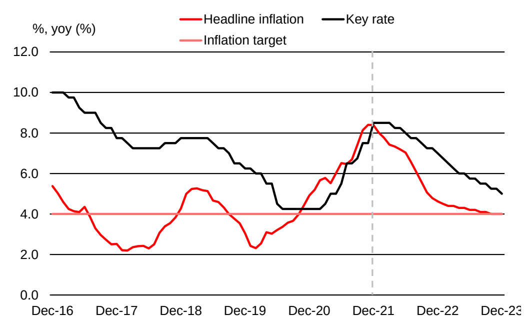
Outlook
We expect economic growth to slow to around 2.2% in 2022-23, with a return to potential being supported by consumer spending in 1H22 and exports thereafter. Investment could pick up from 2023 onwards amid large transfers from the National Welfare Fund and easier real monetary conditions. We expect inflation to slow to below 5% in 2022 before returning to the 4% target in 2023. As a result, the CBR could cut its policy rate to 7% in 2022 and 5% in 2023. The RUB could appreciate slightly in 2022 but not in 2023.

Strategy
Potential rate cuts and an undervalued RUB make OFZs attractive, but geopolitical risk will overwhelm financial considerations.

Authors:
Artem Arkhipov, Head of Macroeconomic Analysis and Research Russia (UniCredit Russia)
Ariel Chernyy, Economist (UniCredit Russia)

KEY DATES/EVENTS
- 12 Jan., 9 Feb., 9 Mar.: CPI
- 11 Feb., 18 Mar.: monetary-policy meetings
- 2 Feb.: 4Q21 GDP (flash)
- 18-22 of each month: monthly economic data
- 14 Jan., 4 Feb.: rating updates from Moody's and S&P

GDP GROWTH FORECAST


INFLATION FORECAST


Source: CBR, Rosstat, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

EUR bn	2019	2020	2021E	2022F	2023F
GDP (EUR bn)	1507.0	1297.1	1386.0	1640.1	1765.4
Population (mn)	147.0	147.0	146.9	146.9	146.8
GDP per capita (EUR)	10252.0	8825.0	9433.1	11167.4	12027.9
Real economy, change (%)					
GDP	2.0	-3.0	4.2	2.2	2.2
Private consumption	3.2	-8.6	8.5	2.4	2.8
Fixed investment	1.5	-4.3	6.7	2.5	3.5
Public consumption	2.4	4.0	1.3	2.0	0.6
Exports	0.7	-4.3	1.0	4.4	2.5
Imports	3.4	-12.0	15.6	4.6	4.0
Monthly wage, nominal (EUR)	674.1	635.9	660.8	794.3	855.9
Real wage, change (%)	4.8	3.8	3.0	2.0	2.0
Unemployment rate (%)	4.6	5.9	4.7	4.7	4.8
Fiscal accounts (% of GDP)					
Budget balance	1.8	-3.8	0.3	1.6	0.5
Primary balance	2.5	-3.1	1.1	2.4	1.4
Public debt	13.2	18.4	18.6	19.0	19.8
External accounts					
Current account balance (EUR bn)	58.4	31.6	102.8	119.7	97.7
Current account balance/GDP (%)	3.9	2.4	7.4	7.3	5.5
Extended basic balance/GDP (%)	4.5	2.7	6.8	4.9	3.5
Net FDI (% of GDP)	0.6	0.2	-0.7	-2.4	-2.1
Gross foreign debt (% of GDP)	29.1	29.7	29.2	25.4	24.4
FX reserves (EUR bn)	386.4	363.9	436.0	505.9	556.2
Months of imports, goods & services	13.1	14.4	14.4	15.2	16.3
Inflation/monetary/FX					
CPI (pavg.)	4.5	3.4	6.7	6.5	4.3
CPI (eop)	3.0	4.9	8.4	4.6	4.0
Central bank target	4.0	4.0	4.0	4.0	4.0
Central bank reference rate (eop)	6.3	4.3	8.5	7.0	5.0
3M money market rate (Dec avg.)	6.6	4.9	9.3	7.3	5.3
3M money market rate (year avg.)	7.8	5.4	6.7	8.0	6.3
USD-RUB (eop)	61.9	73.9	74.3	71.0	73.0
EUR-RUB (eop)	69.3	90.7	84.1	78.1	78.8
USD-RUB (pavg.)	64.7	72.2	73.7	71.2	72.0
EUR-RUB (pavg.)	72.5	82.5	87.2	78.8	77.8

Source Rosstat, CBR, UniCredit Research

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

Slowing back to potential

Economic growth is likely to slow in 2022-23…

The Russian economy recovered strongly in 2021, with GDP growth reaching 4.2% yoy. Accelerated demand growth increased inflation pressure, which, alongside multi-year high levels of global food-price inflation and persistent supply-chain bottlenecks resulted in inflation ending 2021 at 8.4%, its highest level in five years.

However, the effect of key drivers of growth in 2021 – increasing utilization of production factors, budget support, spending of precautionary savings accumulated during 2020 and low interest rates – should be much lower or even reverse in 2022-23.

…due to lower employment growth and stable capital utilization…

1. **Unused production factors.** Most of the growth Russia registered in 2021 was driven by bringing workers temporarily laid off during 2020 back to work and powering up temporarily idled production facilities. In the labor market, this process is already complete – unemployment has fallen to pre-crisis lows (4.3% in November 2021), and the labor participation rate is higher than it was in 2019. We do not expect the unemployment rate to fall much further. Yet the labor shortage will slow economic growth if pandemic travel restrictions prevent a significant number of migrant workers (on whom industries like construction or agriculture are heavily dependent) from returning to Russia. Similarly, the scope for increasing capacity utilization is limited, in our view.

…lower fiscal support…

2. **Budget support.** Budgetary spending increased rapidly in 2020 and remained elevated in 2021, but in 2022, it is expected to decline even in nominal terms, according to Russia's latest budget law. In 2023, fiscal spending is likely to continue increasing, but the bulk of this increase in spending could go to national defense and security, while spending on economic measures and social support will likely remain almost unchanged. Even though non-oil and gas revenues are expected to grow, budget spending may not be growth-conducive in 2022-23. There might be some support from quasi-fiscal measures, such as the allocation of some National Wealth Fund money to infrastructure investment, but the impact of such measures could be felt mostly beyond our current forecast horizon.

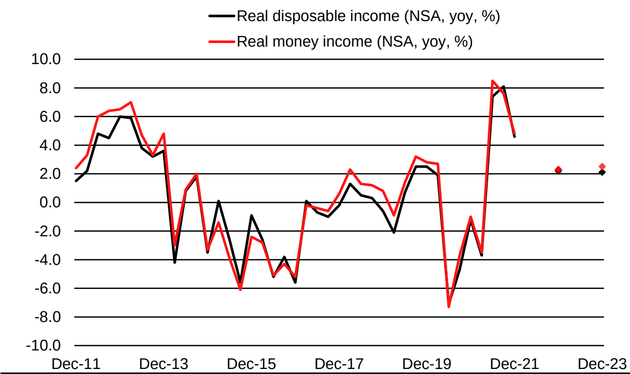
…the gradual exhaustion of precautionary savings…

3. **Spending of precautionary savings.** During 2020, part of the fall in demand was attributed to an increase in precautionary savings. Russian households' four-quarter rolling savings rate peaked in 4Q20-1Q21 at about 8.4%, compared to pre-crisis levels of below 4%. It had fallen by end-2021 to about 5.0-5.5%. Most of the winding down of excess savings has already occurred. Thus, consumption may not receive the same support from falling savings rates in 2022 and beyond.

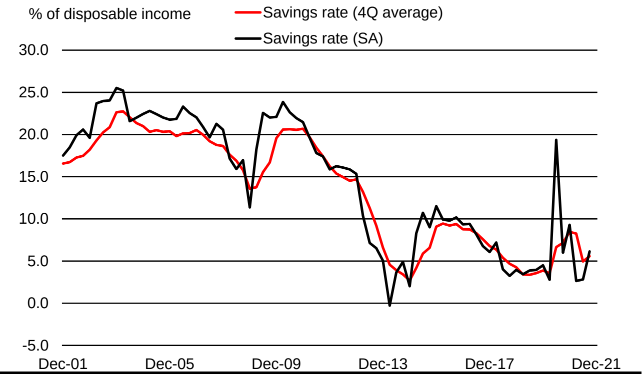
… and tighter real monetary conditions

4. **Tight real monetary conditions.** To fight high inflation, the CBR had to aggressively hike rates throughout 2021, taking the key rate to 8.5% by year-end, with the bulk of tightening occurring in 2H21. Given long lags in monetary transmission, loan and deposit rates will likely remain considerably higher than in 2021, depressing investment activity and demand for durable goods and mortgages. The average key rate will be almost 2pp higher in 2022 compared to 2021, even if the CBR returns to policy easing in 2022, as we expect.

REAL INCOME GROWTH IS LIKELY TO SLOW IN 2022-23



THE SAVINGS RATE IS BACK TO PRE-COVID-19 LEVELS



Source: IHS Markit, Rosstat, UniCredit Research

GDP growth could be around 2.2% in 2022-23

Summing up, we expect much more modest growth in domestic demand in 2022, resulting in a much weaker GDP growth rate compared to 2021. We expect the Russian economy to grow by 2.2% in 2022, and this number would be even lower were it not for exports contributing almost 1pp to growth in 2022. This is much larger than usual, as we expect that sales of oil and oil products could grow in line with an OPEC+ deal and that non-oil and gas exports could benefit from better global growth as supply-chain bottlenecks subside from 2H22 onwards.

Inflation is likely to return to target by 2023…

…with the CBR cutting to 7% in 2022 and 5% in 2023

The flip side of subdued domestic-demand growth will be a reduction in inflationary pressure. Inflation accelerated strongly during 2021 and was broad-based, driven by a combination of demand and supply shocks (including elevated consumer demand); lingering supply-chain bottlenecks and the resulting increase in costs (according to PMI surveys, manufacturers have recently faced the largest input price pressure since 1999); and, lastly, record-high increases in global food prices. Most inflationary factors look temporary and are likely to weaken in 2022, with only global food-price inflation remaining a wildcard and one-off factors (like a fertilizer shortage) possibly influencing the harvest in 2022. Thus, we expect disinflation to take hold in 2022, its pace depending on how persistent local supply shocks and inflation expectations will be. We expect inflation to fall to about 4.6% by end-2022, with both upside and downside risks elevated. The CBR is expected to return to policy easing once it is sure that inflation risks are declining, and we expect the key rate to be at 7.00% by the end of this year and at 5.0% in 2023 as inflation could return to the 4% target. The CBR is planning to conduct a policy review in 2022, after which it could reduce its inflation target. CBR officials have already said that the 4% target might be too high for Russia in the current economic environment. If the target is revised, interest rates could fall further in 2024 and beyond.

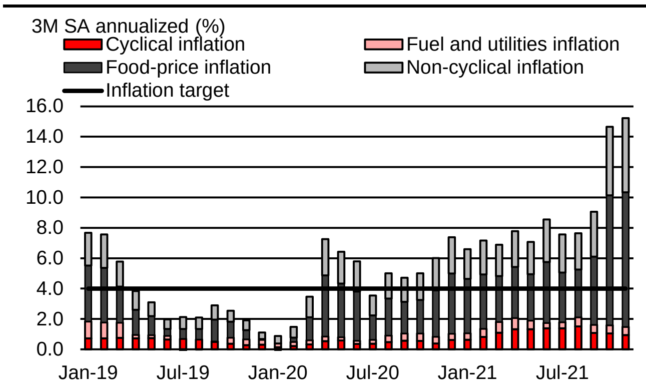
Investment is likely to be supported by spending from the National Wealth Fund

From 2023 onwards, we expect investment to be supported by lower interest rates and multi-year transfers from the National Wealth Fund of up to RUB 2.5tn, or 2.1% GDP. These are likely to go towards loans and capital injections to companies involved in infrastructure projects. Thus, fixed investment could become the key driver of GDP growth. The process could be slow though. In 2023, investment growth will likely speed up only to about 3.5% (from below 2.5% in 2022). As a result, GDP growth could remain around 2.2% yoy in 2023.

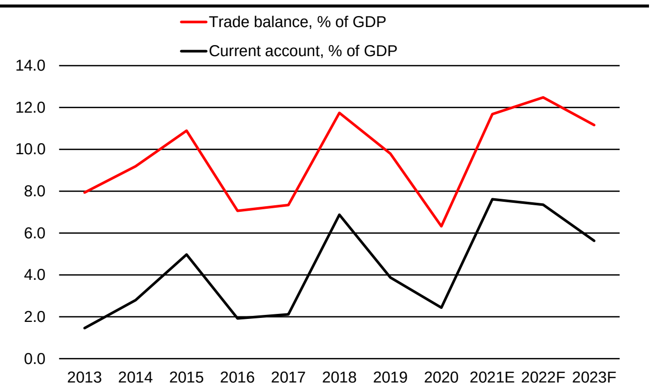
The RUB is expected to appreciate in 2022 but not in 2023

The RUB still has some upside potential in 2022, given expectations of export increases. We forecast oil exports to grow by about 10% in volume terms, in line with the OPEC+ deal. During 2021, demand for imports and the size of capital outflows were surprisingly high. Even so, we think the ruble is undervalued now and has the potential to reach a fair value of about USD-RUB 71 by end-2022 if no significant geopolitical risks materialize. As rate differentials between the RUB and key funding currencies decline in 2023, export growth slows and imports continue to expand in line with the economy, we expect the ruble to resume weakening. Depreciation is likely to be gradual, with the currency still supported by relatively high oil prices and a very strong budget position. We expect USD-RUB to be at 73 by end-2023.

FOOD ACCOUNTS FOR 60% OF INFLATION MOMENTUM



LARGE C/A SURPLUSES COULD PERSIST



Source: CBR, Rosstat, UniCredit Research

Russian financial assets: the burden of geopolitical risk

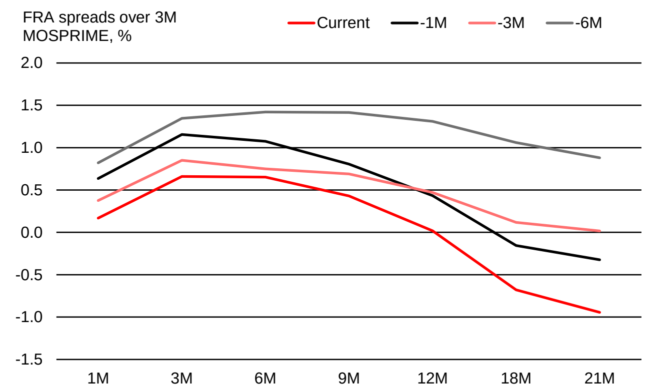
Valuation is attractive for OFZs and the RUB…

The case for OFZs and the RUB remains strong from a financial point of view. With the CBR's policy rate seeming to be close to its peak, and with inflation likely to fall in 2022, OFZs look attractive. An undervalued RUB and lower issuance needs than in 2021 could also contribute to a potential rally. However, demand for bonds remains lukewarm amid geopolitical tensions.

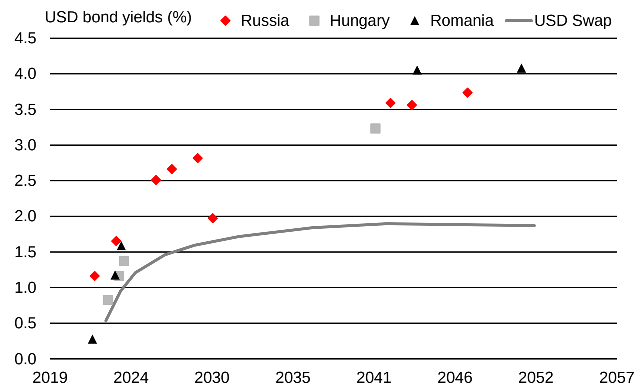
…but geopolitical risk remains a deterrent for larger inflows

We believe that open conflict in Ukraine can be avoided, as NATO is unlikely to extend an invitation to Ukraine and Georgia to join. However, the specter of a military standoff could continue to affect OFZs and the RUB unless tensions decline. In our view, a threat to exclude Russian financial companies from the SWIFT payment network is more important than a potential US ban on trading OFZs in the secondary market, given the light positioning of US investors there.

THE MARKET SEES INTEREST RATES AS CLOSE TO THEIR PEAK



SIZEABLE RISK IS PRICED INTO BONDS, GIVEN STRONG FUNDAMENTALS



Source: Russian Ministry of Finance, CBR, UniCredit Research

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2021E	2022F	2023F
Gross financing requirement	**7.9**	**-9.6**	**4.4**
Budget deficit	-4.0	-25.5	-8.8
Amortization of public debt	11.9	15.9	13.2
Domestic	11.3	13.5	9.9
Bonds	11.3	13.5	9.9
Bills	--	--	--
Loans	0.0	0.0	0.0
External	0.6	2.5	3.2
Other	0.0	0.0	0.0
Financing	**7.9**	**-9.6**	**4.4**
Domestic borrowing	42.7	40.3	40.8
Bonds	42.1	39.6	40.8
Bills	--	--	--
Loans	0.6	0.7	0.0
External borrowing	3.5	3.0	3.1
Bonds	3.5	3.0	3.1
Loans	0.0	0.0	0.0
Privatization	0.0	0.0	0.0
Revaluation	0.0	0.0	0.0
Change in budget accounts, "-": increase	-38.3	-52.9	-39.5

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2021E	2022F	2023F
Gross financing requirement	**-15.7**	**-29.8**	**-6.2**
C/A deficit	-102.8	-119.7	-97.7
Amortization of medium and long-term debt	48.4	50.6	52.3
Government/central bank	3.6	3.8	3.5
Banks	5.5	4.5	5.1
Corporates/Other	39.4	42.3	43.7
Amortization of short-term debt	38.7	39.3	39.2
Financing	**-15.7**	**-29.8**	**-6.2**
FDI (net)	-9.3	-38.9	-36.5
Portfolio investments (net)	-9.3	-2.4	-1.9
Medium and long-term borrowing	41.8	44.8	55.3
Government/central bank	4.5	6.6	10.0
Banks	0.1	-5.8	-0.9
Corporates/Other	37.3	44.0	46.2
Short-term borrowing	37.7	38.7	39.2
other investment (net)	-33.3	-17.2	-21.5
Change in FX reserves (- = increase)	-43.3	-54.9	-40.9
Memoranda:			
Nonresident purchases of LC gov't bonds	0.8	3.6	6.9
International bond issuance, net	2.9	0.5	-0.2

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

Serbia

Ba2 stable/BB+ positive/BB+ stable*

Outlook

We expect GDP to grow by 4.7% in 2022 and by 3.8% in 2023, after growing by 7.5% in 202. Fiscal metrics are set to improve, but this means the fiscal impulse will be negative. Monetary policy will probably be kept loose in an attempt to support growth, but the NBS will face very high inflation and pressure on the currency. We expect the NBS to hike its policy rate to 2% in an attempt to relieve depreciation pressure. Inflation will likely remain above its target range until 4Q22, with upside risks. We expect the dinar to remain stable and the NBS to intervene in case depreciation pressure arises. Early parliamentary elections are scheduled for spring 2022.

Strategy

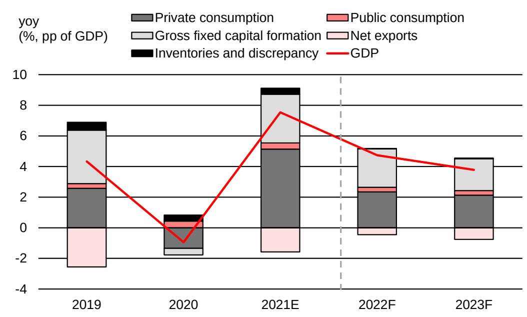
While Serbia's growth and fiscal story appear solid, the limited scope for a rally is based on the valuation of SERBGBs relative to their peers and general risk appetite.

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

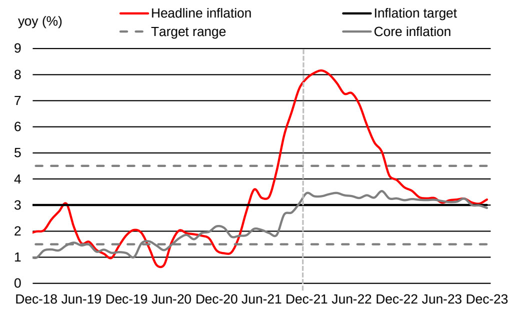
KEY DATES/EVENTS

- 13 Jan., 10 Feb., 10 Mar: NBS monetary-policy meetings
- 12 Jan., 22 Feb., 11 Mar: CPI inflation
- 31 Jan, 28 Feb: 4Q21 GDP (flash, structure)
- 25 Feb, 4 Mar: Fitch and Moody's to update sovereign rating

GDP GROWTH FORECAST



INFLATION FORECAST



Source: Statistic Office of the Republic of Serbia, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2019	2020	2021E	2022F	2023F
GDP (EUR bn)	46.0	46.8	52.9	58.1	62.0
Population (mn)	6.9	6.9	6.9	6.8	6.8
GDP per capita (EUR)	6,623	6,783	7,700	8,508	9,118
Real economy, change (%)					
GDP	4.3	-0.9	7.5	4.7	3.8
Private consumption	3.7	-1.9	7.5	3.4	3.1
Fixed investment	17.2	-1.9	14.1	10.5	8.3
Public consumption	1.9	2.8	2.5	2.0	2.0
Exports	7.7	-4.2	21.4	11.2	9.2
Imports	10.7	-3.6	20.1	10.0	8.8
Monthly wages, nominal (EUR)	643	706	766	820	865
Real wages, change (%)	8.5	7.8	4.2	0.6	2.7
Unemployment rate (%)	11.6	10.1	11.6	10.0	9.5
Fiscal accounts (% of GDP)					
Budget balance	-0.2	-8.1	-4.0	-3.0	-1.5
Primary balance	1.8	-6.1	-2.2	-1.4	0.2
Public debt	52.9	58.2	57.5	56.0	54.5
External accounts					
Current account balance (EUR bn)	-3.2	-1.9	-2.2	-2.4	-2.6
Current account balance (% of GDP)	-6.9	-4.1	-4.2	-4.2	-4.3
Extended basic balance/GDP (%)	0.8	2.1	1.4	1.0	0.6
Net FDI (% of GDP)	7.7	6.3	5.7	5.2	4.8
Gross foreign debt (% of GDP)	61.4	65.8	62.1	60.8	60.9
FX reserves (EUR bn)	13.5	13.8	16.7	17.4	18.1
Months of imports, goods & services	5.8	6.3	6.1	5.4	5.0
Inflation/Monetary/FX					
CPI (pavg)	1.8	1.6	4.1	6.5	3.3
CPI (eop)	1.8	1.3	7.9	4.0	3.2
Central bank target	3.0	3.0	3.0	3.0	3.0
Central bank reference rate (eop)	2.25	1.00	1.00	2.00	2.00
3M money market rate (Dec avg)	1.67	0.94	0.93	2.00	2.00
USD/FX (eop)	104.9	95.7	103.9	107.1	109.8
EUR/FX (eop)	117.6	117.6	117.6	117.8	118.4
USD/FX (pavg)	105.2	103.2	99.4	105.9	108.2
EUR/FX (pavg)	117.9	117.6	117.6	117.6	118.1

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

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

Fast growth is underpinned by rising domestic demand

We expect growth to amount to 4.7% in 2022 and to 3.8% in 2023

We expect GDP to grow by 4.7% in 2022 and by 3.8% in 2023, after having grown by 7.5% in 2021, with a carryover of 2.5pp from 2021.

Growth is expected to be supported by government investment

Growth will be supported by government investment in 2022, which is planned to increase by 20% in 2022 (and reach a level equivalent to 7% of GDP), mainly due to infrastructure, health and green projects. This should add around 1pp to GDP growth.

Private investment is expected to pick up moderately and face various headwinds

Private investment growth will probably pick up moderately. We expect it to accelerate from an estimated 6.5% in 2021 to 9% in 2022. Various sources of headwinds are likely to weigh on companies' willingness to invest: **1.** in 1H22, supply-chain bottlenecks and slower growth in Serbia's main trading partners; **2.** in 2H22, higher electricity prices (these are capped at EUR 75 MWh until June [current prices at the regional exchanges are around EUR 300/MWh]). On a positive note, recent lending data showed a small uptick in lending to companies for investment purposes (left chart).

Consumption growth should be supported by wage and pension increases but limited by high inflation

After rebounding strongly in 2021, consumption growth will probably moderate to around 3.5% in 2022, reflecting the exhaustion of pent-up demand and lower real disposable income growth on the back of high inflation. Consumption will be supported by increases in public-sector wages and pensions (7% and 5.5% respectively), a planned hike in the minimum wage (9.2%) and continued improvement in the labor market (right chart). However, higher average inflation (6.4% vs. 4.1% in 2021) will likely limit gains in real income. Caps on food prices and frozen utility prices will support disposable income before elections, but utility prices will likely rise in 2H22.

Net exports will likely subtract from growth in 2022

We expect export growth to be offset by a rise in imports, leading to a negative contribution by net exports in 2022.

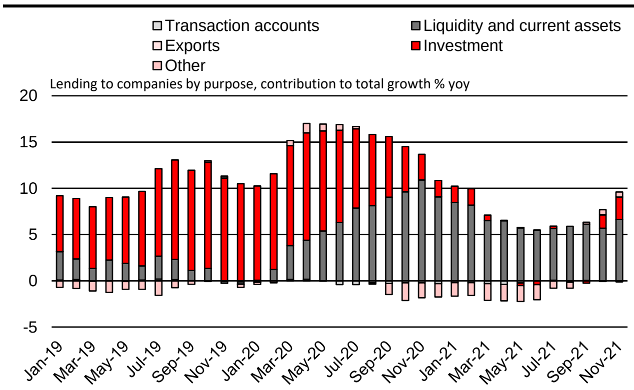
Growth is expected to amount to 3.8% in 2023

In 2023, we expect growth to amount to 3.8%, still driven by domestic demand, with net exports detracting from growth.

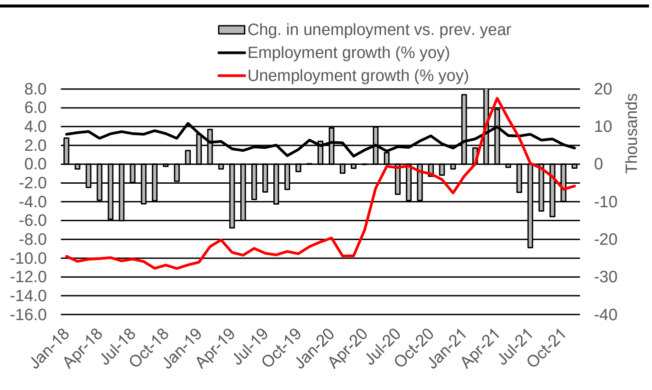
Better fiscal metrics mean negative fiscal impulses

Fiscal metrics are set to improve, but this means that fiscal impulses will be negative. The planned fiscal deficit of 3% of GDP in 2022, after an estimated 4% of GDP in 2021, could turn out to be lower due to assumptions used to calculate expenditure, and this could be a buffer for fiscal risks. According to Serbia's Fiscal Council, assumptions used to calculate pensions, subsidies for the country's anti-crisis guarantee scheme, the procurement of goods and services and transfers to the Republic Health Insurance Fund could lead to EUR 400mn of savings, equivalent to around 0.7% of GDP. This could act as a buffer to absorb potential risks related to, for example, an energy crisis, losses at Srbijagas, EPS or further support being granted to AirSerbia (the latter three are not explicitly considered in the current budget). Government debt is likely to decline from 57.5% of GDP in 2021 to 56.0% of GDP in 2022. A small deficit in 2023, planned to amount to 1.5% of GDP, could reduce debt further, to 54.5% of GDP.

PRIVATE INVESTMENT SHOWS SIGNS OF RECOVERING



UNEMPLOYMENT CONTINUES TO FALL



Source: Statistic Office of the Republic of Serbia, European Commission, Haver, UniCredit Research

Monetary policy faces high inflation and pressure on the currency

Monetary policy will probably be aimed at supporting growth by being kept loose, but it will face very high inflation and pressure on the currency. We have now penciled in an increase to 2% in 2022, in addition to a further tightening of liquidity conditions.

Inflation is likely to return inside its target range only in 4Q22

Inflation will probably peak at slightly above 8% in 1Q22 and remain above 7% in 1H22. Thereafter, its path will primarily depend on **1.** assumptions about core inflation, **2.** the expected increase in utility prices and **3.** the extent of base effects in vegetable and fruit prices. We assume core inflation will remain around 3.5% due to the absence of significant demand pressure and thanks to the stability of the currency. Utility prices are planned to remain unchanged in 1H22 but will have to rise eventually in 2H22 to reflect market conditions. The extent of the potential hike is very uncertain as it will depend on markets and the willingness of the government to subsidize energy provided to households. We assume that there will be a 5% hike in both gas and electricity prices, but there are risks that these increases will be greater. A high base for vegetables and fruit prices in 2H22 should imply significant base effects, but due to food prices being high currently, the extent of these effects is very uncertain. We expect inflation to return inside its target range only in 4Q22. Risks are to the upside. In 2023, we expect inflation to hover around 3%.

The CAD is expected to remain covered by FDI, and the dinar is likely to remain stable

Serbia's current-account deficit (CAD) will likely remain large, but we do not foresee financing risks. We expect Serbia's CAD to amount to around 4.2% of GDP in 2022 and 2023. We believe that the CAD will continue to be financed with FDI, which has remained resilient during the pandemic and is projected to amount to close to 5% of GDP in 2022 and 2023. After experiencing appreciation pressure for most of 2021, the dinar has come under depreciation pressure in recent months, but the NBS has intervened in the market to stabilize the currency. We expect the exchange rate to remain stable and the NBS to intervene should depreciation pressure arise.

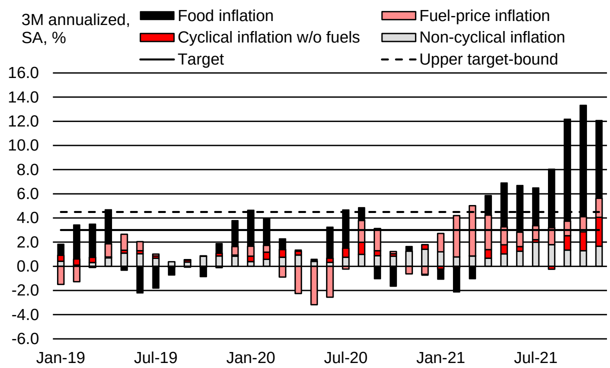
There has been progress with regard to EU accession, but normalization of relations with Kosovo remain the main hurdle

Serbia opened four new chapters in its EU accession process. According to new methodology, these are grouped into a category pertaining to green agendas and sustainable connectivity. This means that Serbia has opened 22 out of 35 total chapters. In addition, Serbia will hold a referendum on changes to its constitution with regard to its judiciary on 16 January. These are needed to bring it into alignment with the EU and should guarantee the independence of its judiciary. However, progress in EU accession requires various reforms and an agreement with Kosovo, and these have been difficult to achieve so far.

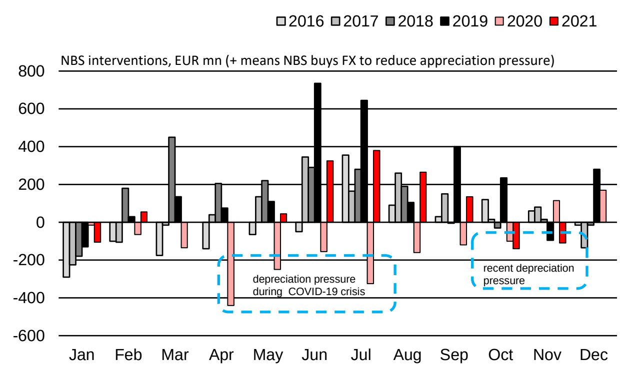
Early elections are scheduled for 2022

Early parliamentary elections are scheduled for spring 2022, along with presidential and local elections. The party of President Aleksander Vučić and its allies are very likely to retain their majority in Serbia's National Assembly. There has been little progress made in a dialogue with opposition parties after many of them boycotted elections in June 2020. Protests have elevated the prominence of environmental issues. As a result of these protests, the government was pressured into withdrawing a controversial law on expropriation, and plans pertaining to a contested lithium mine were put on hold. So far, the opposition does not seem to be able to harness the energy and votes of the protest movement.

INCREASE IN CYLCICAL INFLATION DRIVEN BY FOOD



RECENT DEPRECIATION PRESSURE ON THE CURRENCY

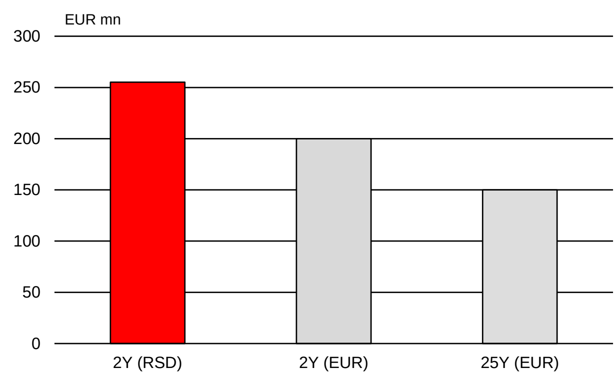


Source: NBS, SORS, UniCredit Research

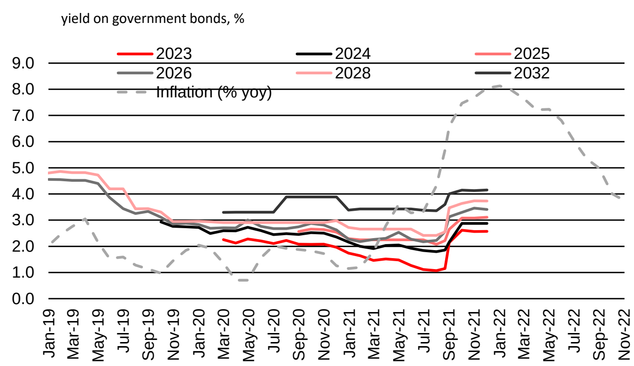
Funding is to come mainly from SERBGBs and IFIs

Serbia's total financing needs for 2022 amount to EUR 5.4 (EUR 3.6bn of repayments). These are to be covered as follows: 1. domestic borrowing (EUR 2.0bn), 2. international financial institutions (IFIs) and foreign government lending (EUR 2.6bn) and 3. and fiscal reserves (EUR 0.8bn). The significant amount of IFI funding compared to recent years also reflects a new IMF Special Drawing Rights allocation, approved and disbursed in August 2021, of around EUR 750mn (it is currently included in the FX reserves of the NBS and it will be disbursed to the government starting from January). There is no Eurobond envisaged, but the budget law assumes the possibility of a Eurobond being issued to enable project financing. In 1Q22, Serbia's government plans to issue around EUR 600mn of SERBGBs (left chart). The short maturities are targeted to local banks. SERBGBs look expensive compared to their peers. In our view, scope for a SERBGB rally in 2022 is very limited. While Serbia's growth and fiscal story appear solid, the limited scope for a rally is based on the valuation of SERBGBs relative to their peers and general risk appetite.

SERBGB ISSUANCE PLAN FOR 1Q22



REAL YIELDS ARE STILL NEGATIVE



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

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2021E	2022F	2023F
Gross financing requirement	**4.9**	**5.4**	**4.7**
Budget deficit	2.1	1.8	0.9
Amortization of public debt	2.8	3.6	3.8
Domestic	1.4	2.4	2.8
Bonds	1.3	2.1	2.6
Bills	0.0	0.0	0.0
IFIs/others	0.1	0.3	0.2
External	1.4	1.2	1.0
Bonds	0.6	0.0	0.0
IFIs/others	0.8	1.2	1.0
Financing	**4.9**	**5.4**	**4.7**
Domestic borrowing	1.5	2.0	2.5
Bonds	1.5	2.0	2.5
Bills	0.0	0.0	0.0
Others	0.0	0.0	0.0
External borrowing	3.8	2.6	2.0
Bonds	2.8	0.0	1.0
IFIs/others	1.0	2.6	1.0
Fiscal reserves change (- =increase)	-0.4	0.8	0.2

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2021E	2022F	2023F
Gross financing requirement	**6.0**	**6.0**	**6.0**
C/A deficit	2.2	2.4	2.6
Amortization of medium- and long-term debt	3.1	2.7	2.6
Government/central bank	1.9	1.6	1.5
Banks	0.5	0.5	0.4
Corporates	0.6	0.7	0.7
Amortization of short-term debt	0.7	0.9	0.8
Government/central bank	0.0	0.0	0.0
Banks	0.6	0.8	0.8
Corporates	0.1	0.1	0.0
Financing	**6.0**	**6.0**	**6.0**
FDI (net)	3.0	3.0	3.0
Medium and long-term borrowing	5.2	3.9	3.3
Government/central bank	4.2	2.9	2.3
IFIs/others	1.0	2.6	1.0
Banks	0.4	0.4	0.4
Corporates	0.6	0.6	0.6
Short-term borrowing	0.5	0.5	0.5
Other	0.2	-0.7	-1.0
Change in FX reserves (- = increase)	-2.9	-0.7	-0.7
Memoranda:			
Non-resident purchases of LC gov't bonds	-0.1	-0.1	-0.2
International bond issuance, net	2.2	0.0	1.0

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

Turkey

B2 negative/B+ negative/BB- negative*

Outlook

We expect the Turkish economy to grow by 4.7% in 2022 and by 4.1% in 2023. The CBRT might lower rates further in 2022 if political pressure continues. However, excessive currency depreciation may lead to tighter financial conditions and threaten financial stability. Meanwhile, the surge in the cost of living is weighing on the approval of the AKP and of President Recep Tayyip Erdogan ahead of the general election (likely to be held in 2023), as inflation could remain above 50% for most of this year. We expect the CBRT to return to a more orthodox monetary policy if the opposition wins the elections and commits to its price-stability mandate by maintaining a positive real policy rate, which could trigger an appreciation of TRY with a recovery in capital inflows.

Strategy

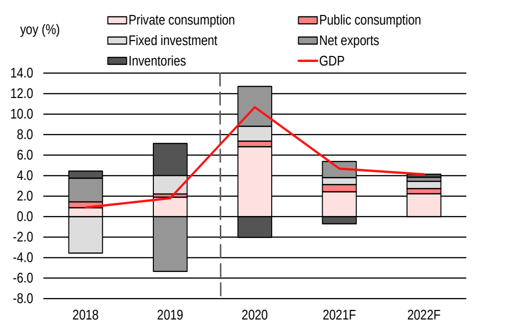
TRY depreciation will likely continue as long as the CBRT's easing bias continues and real rates remain deeply negative. The government could opt for further reserve depletion or liquidity restrictions to slow the pace of depreciation.

Author:
Gokce Celik, Senior CEE Economist (UniCredit Bank, London)

KEY DATES/EVENTS

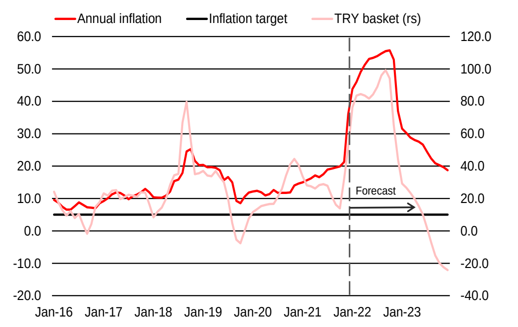
- 3 Feb., 3 Mar.: inflation data
- 20 Jan., 17 Feb., 17 Mar.: monetary-policy decisions
- 28 Feb.: 4Q21 GDP
- 11 Feb.: Fitch's rating review

GDP GROWTH FORECAST



Source: Turkstat, UniCredit Research

INFLATION FORECASTG



Source: Turkstat, CBRT, Bloomberg, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

EUR bn	2019	2020	2021E	2022F	2023F
GDP (EUR bn)	680.2	626.9	637.1	578.0	766.0
Population (mn)	82.6	83.4	84.4	85.4	86.4
GDP per capita (EUR)	8237	7519	7548	6767	8865
Real economy, change (%)					
GDP	0.9	1.8	10.7	4.7	4.1
Private consumption	1.5	3.2	11.5	4.0	3.7
Fixed investment	-12.4	7.2	5.5	2.8	2.9
Public consumption	4.1	2.2	3.7	5.2	3.7
Exports	4.6	-14.8	20.9	9.3	5.6
Imports	-5.4	7.6	2.6	2.9	4.7
Monthly wage, nominal (EUR)	753	634	591	520	675
Real wage, change (%)	2.7	-4.9	1.5	1.5	2.0
Unemployment rate (%)	13.7	13.1	12.1	12.0	12.3
Fiscal accounts (% of GDP)					
Budget balance	-5.3	-5.2	-3.1	-4.8	-4.8
Primary balance	-3.0	-2.5	-0.4	-2.0	-2.2
Public debt	32.6	39.7	45.9	42.4	38.3
External accounts					
Current account balance (EUR bn)	4.8	-31.0	-12.6	-3.6	-10.8
Current account balance/GDP (%)	0.7	-4.9	-2.0	-0.6	-1.4
Extended basic balance/GDP (%)	1.5	-4.4	-1.1	0.2	-0.7
Net FDI (% of GDP)	0.8	0.6	0.8	0.9	0.8
Gross foreign debt (% of GDP)	54.7	60.4	60.8	69.8	54.7
FX reserves (EUR bn)	71.7	41.0	63.7	60.9	62.0
Months of imports, goods & services	4.3	2.6	3.1	2.8	2.6
Inflation/monetary/FX					
CPI (pavg)	15.7	12.3	19.6	50.4	24.6
CPI (eop)	11.8	14.6	36.0	37.0	18.7
Central bank target	5.0	5.0	5.0	5.0	5.0
Central bank reference rate (eop)	12.00	17.00	14.00	12.00	23.00
3M money market rate (Dec avg.)	11.80	16.60	15.79	15.00	23.00
USD/TRY (eop)	5.95	7.44	13.30	18.00	13.50
EUR/TRY (eop)	6.67	9.08	15.08	19.80	14.58
USD/TRY (pavg)	5.68	7.03	8.90	16.41	16.46
EUR/TRY (pavg)	6.35	8.05	10.49	18.20	17.82

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.

Brewing a perfect storm

Turkey has pursued a low interest rate policy at all costs

In 2021, the Turkish authorities reverted to a policy of low interest rates at all costs, risking both economic and political consequences. Excessive currency depreciation could lead to tighter financial conditions and threaten financial stability. Meanwhile, the surge in the cost of living is weighing on the approval of the ruling AKP and of President Recep Tayyip Erdogan ahead of the general elections, which will be held no later than 18 June 2023.

With the possibly further of easing in the cards in early 2022

Back to orthodox monetary policy in 2H23 if the opposition wins

The CBRT has lowered its policy rate by 5pp since September 2021 and could cut further due to political pressure. The central bank has intervened in the FX market and introduced a new deposit scheme compensating TRY deposits for currency depreciation, to curb FX demand by locals, so far. We think additional measures to defend the currency might include the rationing of TRY liquidity in the offshore market to discourage short-TRY positions and restrictions on conversion from TRY to FX. Such measures could lead to a significant backlash from the populace. Moreover, the financial conditions might already be tightening, contrary to the government's intent, due to country risk premiums and market rates creeping higher. While the government could use moral suasion to ensure that banks are lending, private banks might prove more reluctant to extend loans. We expect the CBRT to return to a more orthodox monetary policy if the opposition wins the elections and commits to its price-stability mandate by maintaining a positive real policy rate.

Households frontloading consumption ahead of a dramatic rise in inflation

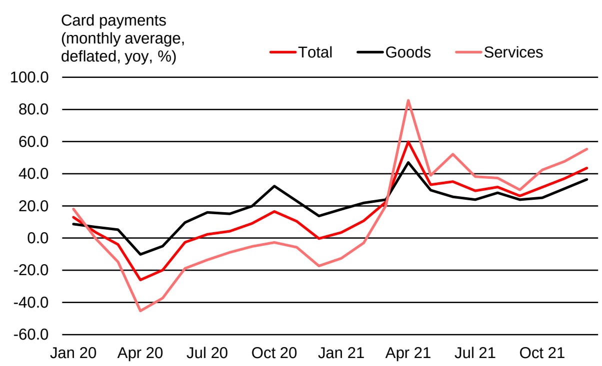
Despite negative real interest rates, investments could lose momentum

Currency depreciation and rising inflation expectations have caused households to frontload their consumption. This attitude might have supported private consumption growth in 4Q21, as suggested by the elevated credit card spending. The 50% rise in the net minimum wage (which could imply a similar increase in economy-wide wage growth) could help this trend to continue in 1H22 as households could lower their savings rate further due to deeply negative real yields and spend more on durables and real estate. That said, the continued rise in inflation could wipe out the real wage growth going forward, leading to a loss in consumption momentum. Investment appetite might continue among exporters given robust external demand, but the non-tradable sector may be less keen to finance new capex given the less certain outlook for domestic demand and the possible difficulty in accessing long-term financing.

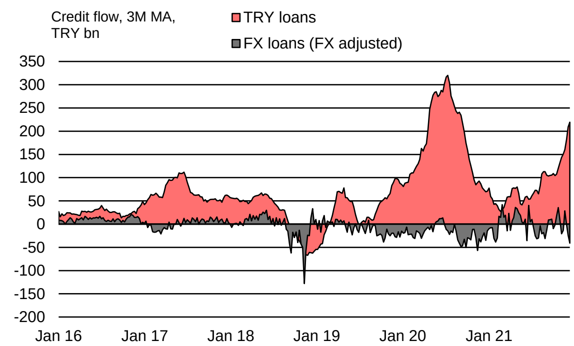
Government likely to increase budget deficit in an attempt to ease inflation burden

With the credit impulse likely to be weak and temporary, the budget deficit will widen as the government increases transfers and waives tax revenues to compensate for part of the loss in purchasing-power. The budget deficit likely ended last year at around 2% of GDP (IMF defined: 3.1% of GDP). This was significantly below the government's target (3.5%) as tax revenues were stronger, even though TRY 103bn (1.5% of GDP) of revenue was waived to help curb inflation. The government could waive a similar amount of revenue in 2022 while also subsidizing some of the minimum wage increase, in addition to increasing transfer payments to low-income earners.

HOUSEHOLDS ARE FRONTLOADING THEIR SPENDING



LENDING GROWTH COULD SLOW DUE TO TIGHTER FINANCIAL CONDITIONS



Source: CBRT, Turkstat, UniCredit Research

The accommodative fiscal policy stance will likely be maintained in 1H23, in the run up to the general elections. Consequently, we expect the budget deficit to widen to 3.9% of GDP in 2022 and 4.0% of GDP in 2023 (IMF defined: 4.8% of GDP for both 2022 and 2023).

External demand will continue to support growth

External demand could be supportive if economic activity in the eurozone starts to accelerate from mid-2022. Currency depreciation will contribute to the narrowing of the current account deficit by making Turkey more attractive as a tourist destination while weighing on imports. We expect net tourism revenue to exceed USD 24bn next year (more than 90% of the 2019 level) and USD 27bn in 2023. That said, a higher energy import bill could briefly halt the narrowing of the current account deficit in 1Q22 while contributing to a slower adjustment later on, along with other factors including a possible rebound in gold imports if households try to protect their savings from depreciation and low interest rates. If capital inflows resume in the aftermath of the elections, the current account deficit could start to widen in 2023.

GDP growth to slow down to 4.7% in 2022, despite high carryover…

… and to 4.1% in 2023

We expect growth to slow to 4.7% in 2022, from 10.7% in 2021, despite the carryover exceeding 2pp. In 2023, growth could ease further to 4.1%. The government's efforts to stimulate growth through additional fiscal spending and lending ahead of the elections could fail as financial conditions might remain tighter than the policy rate suggests. If the opposition continues to gain ground and wins the presidential and parliamentary elections, we expect to see a return to orthodox economic policies. This would imply tighter monetary policy along with a significant improvement in capital inflows to the country, due to better investor sentiment.

Inflation to hover above 50% for most of 2022, with risks remaining skewed to the upside…

…and remain above 25% until late 2023.

Inflation will continue to rise rapidly, likely breaching 50% in 2Q22, and hovering above this level for most of the year. The exchange rate pass through will be the main driver of the rise while the minimum wage hike will contribute cost-push inflationary factors. The authorities could try to limit some of the price pressure by temporarily cutting or waving tax on several consumption items, in addition to attempting to impose outright price controls. While an easing of global commodity and transport prices and sizeable base effects could help push annual inflation down from November 2022 onwards, it might remain above 25% until 2H23, when potential TRY appreciation could lend support to disinflation.

Elections to be held in June 2023

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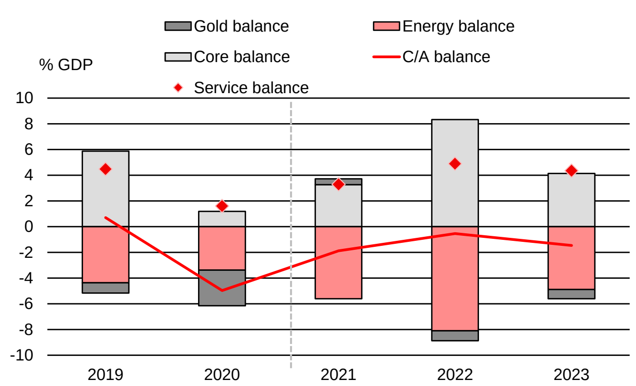
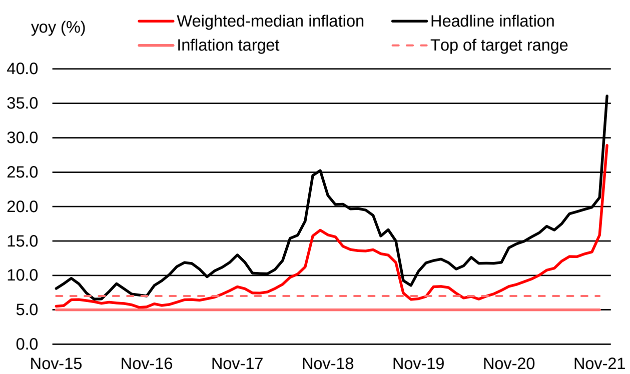
As mentioned before, we continue to expect presidential and parliamentary elections to be held on 18 June 2023 as Mr. Erdogan attempts to improve his poll numbers with economic measures. Moreover, the ruling AKP and MHP intend to change election law, and for these changes to become effective, elections need to be held at least a year after the changes are signed into the law. That said, the probability of early elections in 2H22 could increase if the government's slide in the opinion polls causes the coalition to disintegrate.

CURRENT ACCOUNT TO MOVE TOWARDS BALANCE



THE RISE IN MEDIAN INFLATION STEEPENS



Source: Turkstat, CBRT, UniCredit Research

No end in sight for TRY depreciation

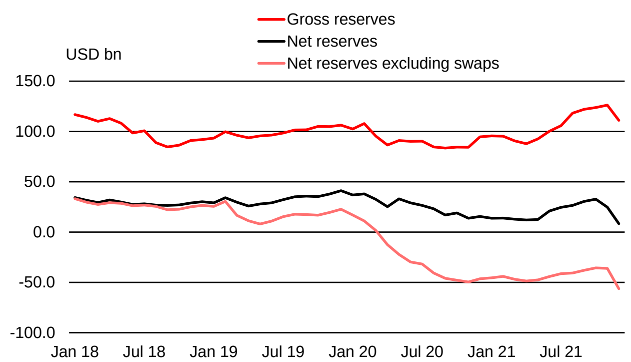
The authorities hope current account surplus will curb depreciation pressure…

The authorities seem to sign up on the view that their low-interest, fast-depreciation policy will push the current account into a sustainable surplus, which will help cover local FX demand and therefore alleviate the depreciation pressure. However, the current account balance switched to deficit in November and might remain there over the winter. Moreover, given the rise in Turkey's risk premium, the rollover ratios of private-sector debt could decline, requiring additional FX demand for repayments.

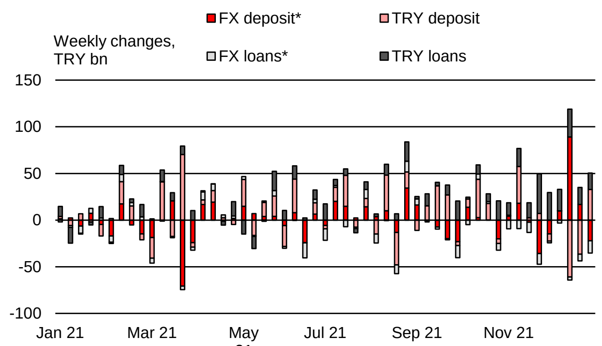
…yet the TRY slide is set to continue

The CBRT intervened in the FX market, selling USD 7.3bn in direct interventions in December although the drop in net reserves (excluding swaps) hinted at a cumulative depletion of USD 19bn, according to our calculations. The newly introduced deposit scheme might have helped curb the additional FX demand by locals. However, it is unlikely to suffice to stabilize the depreciation pressure on its own as depositors under this scheme would bear deep negative yields, amid the rising inflation, should exchange rate stabilize and, could switch to alternative assets. Thus, we expect USD-TRY to rise to 18.0 in 2022 if elections are not brought forward.

LOW LEVEL OF RESERVES IMPLIES LIMITED ROOM FOR



DOMESTIC FX DEMAND COULD RE-ACCELERATE



*TRY equivalent of weekly changes in FX deposits and loans (USD denominated)

Source: Haver, Bloomberg, CBRT, BRSA, UniCredit Research

GOVERNMENT'S GROSS FINANCING REQUIREMENTS

EUR bn	2021E	2022F	2023F
Gross financing requirement	***54.8***	***49.0***	***60.0***
Budget deficit	*19.9*	*27.8*	*36.8*
Amortization of public debt	*35.0*	*21.1*	*23.1*
Domestic	*28.4*	*14.2*	*16.3*
Bonds	*28.4*	*13.9*	*16.3*
Bills	*0.0*	*0.3*	*0.0*
Loans	*0.0*	*0.0*	*0.0*
External	*6.5*	*6.9*	*6.8*
Bonds	*5.3*	*5.9*	*5.6*
Loans	*1.2*	*1.0*	*1.2*
Financing	***54.8***	***49.0***	***60.0***
Domestic borrowing	*36.8*	*35.5*	*44.2*
Bonds	*36.2*	*35.5*	*44.2*
Bills	*0.6*	*0.0*	*0.0*
Loans	*0.0*	*0.0*	*0.0*
External borrowing	*9.4*	*7.1*	*8.6*
Bonds	*8.5*	*5.9*	*7.4*
Loans	*1.0*	*1.2*	*1.2*
Privatization/other	*7.8*	*5.1*	*5.7*
Fiscal reserves change (- =increase)	*0.8*	*1.2*	*1.5*

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2021E	2022F	2023F
Gross financing requirement	**159.8**	**157.6**	**162.0**
C/A deficit	12.6	3.6	10.8
Amortization of medium and long-term debt	50.4	40.4	32.7
Government/central bank	6.5	6.9	6.8
Banks	27.2	22.7	14.5
Corporates/other	16.7	10.7	11.3
Amortization of short-term debt	96.8	113.7	118.5
Financing	**159.8**	**157.6**	**162.0**
FDI (net)	5.1	5.0	5.8
Portfolio equity, net	-1.1	0.0	1.5
Medium and long-term borrowing	55.3	32.4	34.7
Government/central bank	10.3	7.1	10.4
Banks	22.9	17.1	13.7
Corporates/other	22.1	8.1	10.6
Short-term borrowing	107.0	115.7	120.0
Other	14.4	0.0	0.0
Change in FX reserves (- = increase)	-21.0	4.6	0.0
Memoranda:			
Nonresident purchases of LC gov't bonds	0.8	0.0	1.8
International bond issuance, net	3.1	0.0	1.8

Source: CBRT, Turkish ministry of finance, UniCredit Research

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

Notes

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Glossary

A comprehensive glossary for many of the terms used in the report is available on our website: https://www.unicreditresearch.eu/index.php?id=glossary

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