CEE Quarterly

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"A year of crucial choices"

1Q 2024

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A year of crucial choices

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- We expect the economies in EU-CEE[1] to grow by around 3% in both 2024 and 2025, with similar growth rates in the Western Balkans. We expect GDP to grow by 2.9% in 2024 and 4.0% in 2025 in Turkey and by 1.3% in 2024 and 2025 in Russia.
- Private consumption is likely to lead the growth rebound, helped by faster real wage growth, rising borrowing amid lower interest rates and a positive wealth effect from house prices.
- Investment could recover amid larger FDI and transfers from the RRF, but we expect capex and exports to contribute to growth from 2H24 at the earliest.
- We see budget deficits below 3% of GDP in 2024-25 in Bosnia-Herzegovina, Bulgaria, Croatia, Czechia and Serbia, with negative fiscal impulses in most CEE countries. The fiscal adjustment will be slowed by a busy election schedule.
- We expect pro-EU parties to win most of the EU-CEE seats in the European Parliament, with Poland leading a revived EU-CEE group that will argue for deeper economic and political integration in Europe. Hungary and Slovakia risk being marginalized.
- Other elections are unlikely to significantly change the political landscape, despite rising nationalism and disengagement. However, the 2024-25 elections will be the last ones before CEE politicians will be forced to tackle tougher demographic and economic challenges.
- We forecast inflation targets will be missed, except for those in Serbia and Russia in 2024-25, and Czechia in 2025.
- We expect policy interest rates to be cut in all CEE countries, with real interest rates remaining slightly positive in 2024-25. A narrower carry and real appreciation amid cost increases might lead to currency depreciation.
- Stable capital flows will cover C/A deficits in all CEE countries except Bosnia-Herzegovina, Romania and Turkey, where additional funding will come from international financial institutions, sovereign external borrowing and private borrowing from abroad, respectively.
- In our view, the main decisions to be made in CEE are **1**. Bulgaria's euro adoption in 2025, rather than in 2026; **2**. faster enlargement negotiations between the EU, the Western Balkans, Moldova and Ukraine; **3**. Poland and Romania consolidating their geopolitical position on NATO's Eastern flank; and **4.** more support for Ukraine. In our opinion, the main risks are **1.** a further populist tilt from mainstream parties, **2.** rating downgrades, **3.** weak foreign demand leading to recession, **4.** Russian gains in Ukraine, **5.** a return to political dominance over monetary policy in Turkey and **6.** political instability.

2024 is the biggest election year on record

2024 is the biggest election year in the world's history. In CEE, only 2004 came close to the number of polls expected this year. Compared to twenty years ago, these elections might have a more significant impact on domestic and European politics. We expect a further move to the right, although most voters in CEE prefer a strong social safety net[2]. There are three main reasons for this turn, all interconnected: the rise of populist nationalism, youth disengagement and mistrust in the state.

1. Nationalism and disengagement in a busy election year

Populist nationalism has infused the political mainstream throughout CEE. What turns some of the most ethnically homogenous countries in the world to nationalism and outright xenophobia? A craving for identity and dislike of immigration. Reaffirming national identity has been a counter-reaction to globalization (which enhanced inequality) and migrant flows[3].

[1] EU-CEE refers to CEE countries that are members of the EU: Bulgaria, Croatia, Czechia, Hungary, Poland, Romania, Slovakia and Slovenia.
[2] "Taking stock of shock" by Kristen Ghodsee and Mitchell Orenstein is a great overview of the social consequences of CEE's transition from communism to capitalism.
[3] How migration is pushing Europe to the right (ft.com)

National identity in CEE is often defined in antithesis to the EU

In addition, the worse-off in EU-CEE are disappointed that EU integration has failed to increase living standards for all citizens, blaming European integration for rising inequality. In our view, the dislike of immigration is yet to become a big rallying cause as it has in Southern and Western Europe. Post-communist CEE has witnessed only two big immigration waves: the 2015-16 migration crisis, when the Balkans and Central Europe were used as transit routes to Western Europe by approximately 2mn people and the 4.2mn Ukrainian refugees, whose dramatic circumstances and similarity to those in the recipient countries made them easier to integrate. Before the Russia-Ukraine conflict, net immigration was positive in Czechia, Hungary, Slovakia, Slovenia, Russia and Turkey, with net emigration pervasive elsewhere in EU-CEE and Western Balkan countries[4]. Yet even in countries where politicians have been vilifying migrants (especially in Hungary, where net immigration has been the highest in EU-CEE), a large majority of voters are comfortable with immigrants[5] and less than 10% of the population sees immigration as a major issue for their country (although three times as many people see it as a big issue for the EU – Chart 1). We expect the poor to oppose economic immigration more forcefully before the end of the decade if governments fail to tackle inequality.

CEE voters see immigration more as a European than a national issue

Nationalism in CEE often takes the shape of a glorified (and largely fictitious) past. In most countries, this is inherited from the nationalist turn of late communism[6], but European trends cannot be dismissed as CEE societies move closer to Western European ones not only economically, but also in aspirations and qualms[7].

Nationalism is also used as means to attack liberalism, with Hungarian Prime Minister Viktor Orban's dream of an illiberal democracy rooted in the national state[8] echoed widely by nationalist and Euroskeptic parties in EU-CEE. Loosely defined external risks are used to curb judicial independence and affect other institutions on which liberal democracies rely.

Widespread mistrust in public institutions

The assault against democratic institutions has been facilitated by the electorate's mistrust in the state. After joining the EU, most CEE countries failed to further tackle corruption or increase the accountability of public spending. This has increased since the COVID-19 pandemic and also after the Russian invasion of Ukraine, with governments assuming additional powers, first to control the disease and later on to pass legislation more easily. In Hungary, for example, the state of emergency has not been lifted since the outbreak of the COVID-19 pandemic, almost four years ago. High levels of corruption (Chart 2) and low efficiency of public spending have reduced the electorate's trust not only in state institutions but also in democracy and the importance of elections. This mistrust takes different forms: a large part of the urban middle class is arguing for lower taxes and a smaller public footprint in the economy. The poor and the young either feel disengaged from politics or are increasingly turning to extremist parties.

Youth disengagement shifts political priorities to the elderly

Youth disengagement[9] and distrust in democracy could be especially damaging in the long term. In many CEE countries, they continue to fuel emigration, with the brain drain entering its third decade. By now, this is probably the biggest drag on CEE's potential growth, both in terms of available labor force and scope to increase productivity. Those who choose to stay vote in very small numbers, thus allowing politicians to focus on more disciplined voter groups, such as pensioners and state employees. The opposition win in Poland seemed to buck this downtrend in youth engagement, but the youth vote was not the main driver. The victory was mostly achieved in small towns and villages, where many voters aged 35 and older soured on the Law and Justice (PiS) party[10].

[4] Net migration – European Union | Data (worldbank.org)
[5] Integration of Immigrants in the European Union – June 2022 – Eurobarometer survey (europa.eu)
[6] The Bulgarian political scientist Ivan Krastev has written extensively about this topic, including in his book published with Stephen Holmes in 2020, *The Light That Failed*.
[7] A good overview, albeit also a harshly worded critique of Krastev and Holmes, can be found here: *The roots of right-wing populism in Central and Eastern Europe: at the nexus of neoliberalism and the global culture wars,* Euro Crisis in the Press (lse.ac.uk)
[8] Orbán: Liberal Democracy Has Become 'Liberal Non-Democracy' (hungarytoday.hu)
[9] Can democracy survive 2024? (ft.com)
[10] How PiS lost power in its heartland | Notes From Poland

MIGRATION AND CORRUPTION ARE SKEWING VOTING INTENTIONS TO THE RIGHT

Chart 1: Immigration is seen as an EU, rather than a CEE issue

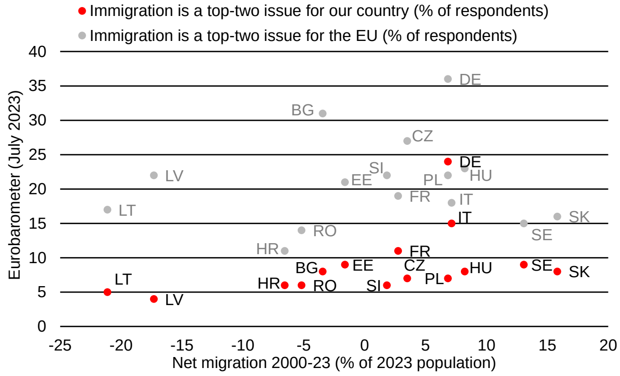
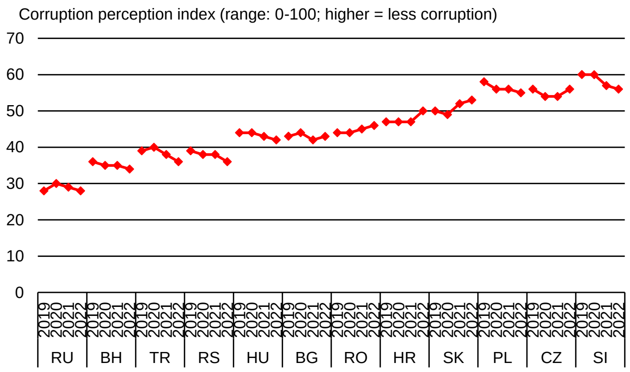


Chart 2: No progress in tackling corruption since previous elections



Source: World Bank, European Commission, Transparency International, UniCredit Research

2024 elections unlikely to revitalize democratic reforms in CEE

Will the 2024 elections revitalize democratic reforms in CEE? Hardly, in our view. The dominance of post-communist political elites is entrenched in Croatia, Hungary, Romania and the Western Balkans, not to mention Russia. Where alternatives have emerged in the past decade (e.g. Bulgaria, Czechia, Slovenia and Slovakia), the political spectrum remains fragmented, reducing the scope for efficient and speedy reforms.

2024-25 is the last election cycle before demographics worsen significantly in CEE

However, we do not subscribe to the doom scenarios that predict a complete reversal of the democratic reforms that CEE has undergone over the past 35 years. Globalization in reverse, poor demographic trends and a thriftier EU will force many political parties in CEE to reckon with the challenges they will face before the end of the decade: falling potential growth, rising old-age dependency ratios and much less scope for populist public spending. Thus, we see 2024-25 as the last election cycle in CEE before reality forces politicians to become more pragmatic. Their reaction will probably drive further economic differentiation in growth and convergence with Western European economies. Paradoxically, we see the Western Balkans as having more scope for reforms than EU-CEE as they try to join European institutions. Stronger institutions in Czechia and Slovenia could be a good predictor of better economic performance than in countries with weaker institutions, such as Bulgaria and Romania.

2. Election outlook: a further shift to the right

Populism affects fiscal discipline

Elections for the European Parliament (EP) will take place between 6 and 9 June and will be the first elections to be held this year in most EU-CEE countries (Table 1). The 2024 election is the first in which mainstream, centrist parties have embraced some of the populist agenda of former fringe parties. The desire to limit immigration to Europe ranks high among voters' preferences, as does a cocktail of low taxation for the active middle class and social protection for pensioners and the worse-off, which inevitably leads to looser fiscal constraints. Both Western European and CEE parties are embracing these agendas. In CEE, which is not first in line to receive migrants as long as the Turkish-Bulgarian and Belarusian-Polish borders remain secure, the plan to resettle immigrants at a European level is the most unpopular pan-European project.

EP elections are a poor predictor of other election results

EP elections are often a protest vote that flatters the appeal of fringe and populist parties with a Euroskeptic agenda because the turnout is small (less than a third of the electorate in some EU-CEE countries). While many mainstream voters feel (wrongly, in our view) that EP elections have little impact on their lives, protest voters are more willing to express their frustration. This could well be the case in Romania, where the nationalist and Euroskeptic Alliance for the Unity of Romanians (AUR) could come second. In Poland, the far-right Confederation, which underperformed in last year's parliamentary elections, might witness a revival, while PiS aims to secure more than 20 seats in the EP.

In Bulgaria and Slovenia, nationalists and autonomists could do better than they did in the most recent parliamentary elections. In Hungary and Slovakia, which are ruled by Euroskeptics, the governing parties can hope for a strong showing.

Pro-EU parties will receive most EU-CEE EP seats

However, the small size of most EU-CEE countries would give Euroskeptics too few seats in the EP to rival their Western European brethren, with only PiS (a member of the European Conservatives and Reformists, a Euroskeptic group in the EP) expected to have more than 20 MEPs and Fidesz in Hungary (unaffiliated in the EP) likely to have more than 10 MEPs out of the 208 EP seats allotted to former communist countries. As a result, we expect Euroskeptic parties in CEE to account for around 25-30% of EU-CEE MEPs, around 5pp more than the proportion expected at the EU level (Chart 3). All EU-CEE countries are likely to take a hardline stance on curbing immigration from outside the EU, thus mirroring the positions of their populace. This is valid even for the pro-European ruling parties of Poland and Romania.

Most EU-CEE parties likely to support further political and economic integration in the EU

With Donald Tusk back as Polish prime minister, we expect EU-CEE to be more united and proactive in European affairs, with Hungary and Slovakia as potential dissenters in political matters. The rest of the block would favor a common European security policy, perhaps including a European army if Donald Trump returns to the White House, as well as EU enlargement (even in the stepwise manner advocated by French President Emmanuel Macron).

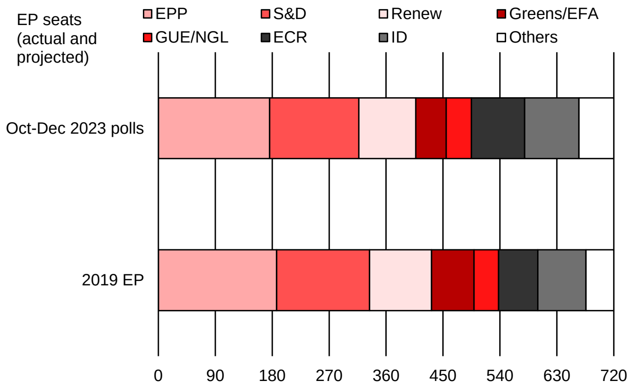
In economics, this block would favor common European borrowing, which, together with the EU budget, could help fund the costly energy transition away from overreliance on coal and Russian oil and gas. Past fiscal rectitude has given way to a more relaxed attitude to spending in most EU-CEE countries and we do not expect the region to support rapid fiscal adjustment.

BUSY ELECTION YEAR MIGHT RESULT IN A MORE RIGHT-LEANING EUROPEAN PARLIAMENT

Table 1: Busy election schedule ahead

	Election type
Bosnia-H	2024: Local (6 Oct)
Croatia	2024: EP (9 Jun), parliament (before 22 Jul), president (Dec)
Czechia	2024: EP (7-8 Jun); 2025: parliament (before Oct)
Hungary	2024: EP and local (9 Jun)
Poland	2024: EP (9 Jun), local (7/21 Apr); 2025: president (before Aug)
Romania	2024: EP (9 Jun), local (before 22 Sep), president (Nov-Dec), parliament (after 6 Dec)
Russia	2024: president (15-17 Mar)
Turkey	2024: local (31 Mar)

Chart 3: Euroskeptics expected to gain in EP elections, while remaining a minority[11]



Source: European Parliament, national electoral authorities, national parliaments, UniCredit Research

We expect the EU to dilute its checks on pro-EU governments in EU-CEE

Since traditional Western European parties belonging to the Socialist, Liberal and Popular groups in the EP are likely to end up with fewer MEPs than in 2019, we expect pro-European CEE governments to receive concessions from Brussels on a range of topics, such as the speed of fiscal adjustment and tackling corruption. Thus, most EU-CEE governments could end up supporting the EU, while diluting its checks and balances and, as a result, reducing its efficiency in imposing its principles in all member states. If this happens, the appetite for EU expansion in some North-Western capitals is likely to decline further.

[11] EPP is the European People's Party (center-right), S&D is the Progressive Alliance of Socialists and Democrats, Renew includes liberal pro-European parties, Greens/EFA is the alliance of green parties and the European Free Alliance (mostly regional parties), GUE/NGL is the Left in the European Parliament, ECR are the European Conservatives and Reformists, while ID is the Identity and Democracy group. Most Euroskeptics are included in the ECR and ID groups.

As a result, we believe that the most realistic aim of candidate countries is to join a deep and comprehensive customs union with the EU, a very good outcome for economies in the Western Balkans, Moldova and Ukraine.

Elections are unlikely to remake the political landscape in CEE

Besides EP elections, the more consequential polls in EU-CEE are, in our view:

1. **Local elections in Poland**, expected in April 2024. If the current governing coalition runs on common platforms, it could further reduce PiS's footprint in the administrations of large cities, while confirming its solid results in medium-sized towns. More power at the local level for the new government and a less stringently controlled state-owned media would increase their likelihood of defeating PiS in the 2025 presidential elections, which would allow the coalition government to more quickly overturn PiS's controversial legislative changes that curbed judicial independence and social rights. As we argue in the country section, the presidential election could spell the end of the current governing coalition if it cannot agree on a common candidate. This is our baseline scenario at the moment.
2. **Local, parliamentary and presidential elections in Romania**[12]. While we expect a similar coalition comprising the Social Democrats (PSD) and the Liberals (PNL) to emerge from these elections, the prospect of higher taxation on the middle class from 2025 onwards could further reduce the PNL's electoral base and probably bring the Hungarian minority party, UDMR, back into government. For the first time since 2000, the PSD could see its preferred candidate win a presidential election, in a runoff. The last time that the PSD had a double victory, in 2000, the main opposition party, the Cristian Democratic National Peasant Party, was ejected from parliament and frontline politics.
3. **Parliamentary and presidential elections in Croatia**. We expect the ruling HDZ to confirm its position as the strongest Croatian party, having ruled over an unprecedented growth spurt in the post-Yugoslav history of Croatia that culminated in euro adoption and inclusion in the free-movement Schengen area. We would expect President Zoran Milanovic to be reelected, with his soft Euroskepticism unlikely to change the country's positions on European issues.
4. **Local elections in Turkey**, scheduled for 31 March 2024. Having won both parliamentary and presidential elections in 2023, the ruling Justice and Development Party (AKP) will attempt to dislodge the opposition from some of the large cities it currently runs. Istanbul and Ankara are the priorities. While the opposition will run separate candidates, affecting its chances of success, incumbent mayors remain popular in Turkey's most populous cities and the election could be on a knife edge. If Turkish President Recep Tayyip Erdogan refrains from interfering in economic policies ahead of the election, we expect Turkish financial assets to rally, as explained in the country section.
5. **Local elections in Hungary**, to be held together with EP elections on 9 June. Like Turkey's AKP, Fidesz is widely expected to do well in rural areas, but these elections will test whether a disunited opposition can hold on to some of the larger cities (especially Budapest) after its disappointing results in 2022's parliamentary elections. Losses in large cities could bring opposition parties back to the negotiating table if they wish to avoid being outvoted by the ruling Fidesz for another generation.
6. **Presidential elections in Russia**, to be held on 15-17 March 2024. Assured of reelection, President Vladimir Putin will try to match or exceed the support from the 2018 elections, when he won 76.7% of the vote on a 67.5% turnout. This election will be a referendum on the conflict in Ukraine and its impact on Russian society. The election will have significant economic consequences because we expect fiscal policy to tighten once Mr. Putin secures another mandate, thus removing the biggest support to economic growth in 2022-23.

[12] The timing remains uncertain. Normally, local elections should be held not later than 22 September, presidential elections before the end of November (with a second round in late November or early December) and parliamentary elections not earlier than 6 December. However, the junior coalition partner, the National Liberal Party (PNL) would prefer to hold local elections together with one of the other elections.

3. Elections to postpone fiscal adjustment

In 2023, carry trades fueled large liquidity surpluses on CEE interbank markets and drove foreign investors to CEE local-currency bonds. Enjoying abundant liquidity, CEE governments postponed fiscal adjustment, accepting having to pay higher yields and, in some cases, reduce debt duration.

The fiscal impulse turns negative in most CEE countries

Thus, 2024 starts with limited scope for fiscal stimulus, but also for lowering budget deficits. In 2024, the fiscal impulse should be negative in all CEE countries except Bulgaria, Croatia and Turkey, while in 2025 it might be positive in Czechia, Serbia and Bulgaria (Chart 4). However, risks remain skewed towards a slower adjustment. There are few exceptions to fiscal looseness as CEE prepares for a busy election schedule in 2024-25. Budget deficits are expected to fall below 3% of GDP in Bosnia-Herzegovina, Bulgaria, Serbia, Croatia and Czechia. At the other extreme, Hungary, Poland, Romania, Slovakia and Turkey will continue to run budget deficits of more than 4% of GDP in 2024, with limited scope to reduce them to close to 3% of GDP in 2025 (Chart 5). In Russia, budget deficits stem from the war effort and limited tax receipts from exports, rather than electoral concerns.

Budget deficits will exceed 3% of GDP in 2024-25 in most CEE countries

Most CEE governments are yet to remove the support given to households following the pandemic and 2022's energy shock. These subsidies, combined with rising pensions and borrowing costs, will further squeeze non-discretionary public spending in 2024. If the EU and rating agencies threaten corrective measures and downgrades in 2024, we expect governments to push for limited fiscal tightening in 2025 with a combination of smaller subsidies for households (Hungary, Poland, Turkey), higher taxes (Poland, Romania) and lower public spending (Czechia, Romania, Slovakia). Markets could force CEE countries to reduce budget deficits as global sovereign bond issuance (net of central-bank purchases) will be the highest on record in 2024. This is why we expect 2024 to be more of a carry story, than one of capital gains and CEE borrowing costs falling significantly. Government spending on interest will continue to rise in 2024, more so in countries with high borrowing needs and short debt duration, such as Hungary[13] and Turkey.

SLOW FISCAL ADJUSTMENT THROUGHOUT CEE

Chart 4: Negative fiscal impulses…

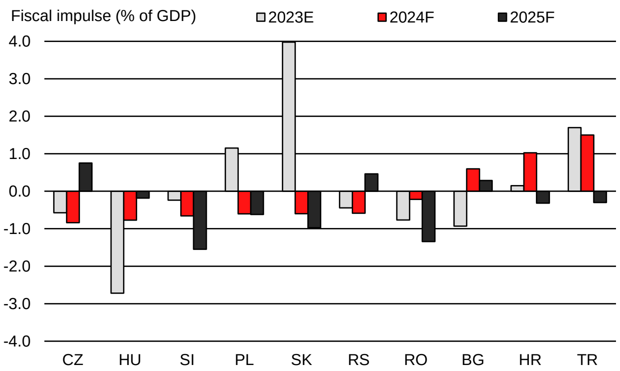
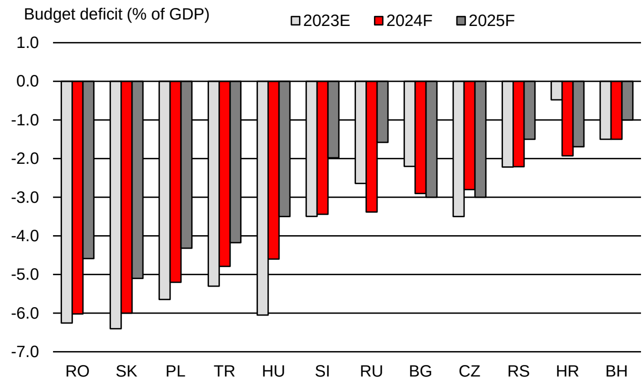


Chart 5: …insufficient to return budget deficits below 3% of GDP



Source: Eurostat, national statistical offices, ministries of finance, UniCredit Research

[13] Some Hungarian retail bonds are linked to last year's average inflation (17.6%), thus making retail inflation-linkers by far the most onerous bonds in the EU.

The take-up of RRF funds could accelerate in 2024

Transfers from the EU should bridge part of the governments' non-discretionary spending gap in EU-CEE by funding the green transition and digital infrastructure, energy independence from Russia and further integration into European transport networks. Yet the take-up from the Recovery and Resilience Facility (RRF) and RePowerEU remains underwhelming, with Slovakia, Romania and Croatia having made the most of the opportunity (Table 2). We expect disbursements to accelerate in 2024-25, led by Poland, Croatia and Romania.

In 2024 we expect a first RRF disbursement to Poland and none to Hungary

The new government in Warsaw could unlock RRF funding in 2H24 if President Andrzej Duda and the Polish courts do not oppose legislative changes regarding human rights, judicial independence and the primacy of European law. We expect Poland to receive only one RRF disbursement in 2024 due to limited reforms. In contrast, Hungary will not unfreeze RRF funding in 2024, in our view, with insufficient progress in implementing and monitoring legislation adopted under pressure from the European Commission (EC). The appeal of RRF funding will decline as the end of the scheme approaches (2026). We expect the Hungarian government to unlock most of the EUR 13bn in structural and cohesion funds by delivering the needed reforms. Absorption is unlikely to be smooth if the EC is not satisfied with the pace of reforms.

EBB positive in all but three countries…

Extended basic balances (EBB = C/A + FDI + EU transfers) will improve further, being negative only in Bosnia-Herzegovina, Romania and Turkey by 2025 (Chart 6). However, trade balances will continue to be affected by scarring in energy-intensive manufacturing[14], with savings in energy imports being gradually overtaken by higher purchases of missing industrial inputs. Real currency appreciation amid a rapid rise in input and labor costs will also drag on exports. Thus, trade balances will improve in countries where the pipeline of new FDI projects is significant, where currencies will depreciate to improve price competitiveness and where governments implement industrial policies to protect those sectors affected by the energy shock and those deemed strategic (although such policies are yet to be implemented).

…where the gap is covered from other sources

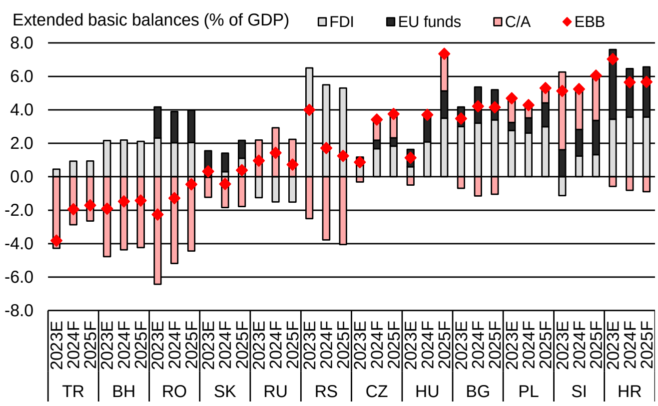
The three countries that will not cover their C/A deficits with stable capital inflows will rely on transfers from international financial institutions (Bosnia-Herzegovina), government borrowing from abroad (Romania) and private borrowing from abroad (Turkey), with FX reserves likely to rise in 2024-25. Russia is a unique case as the currency structure of its export revenues (mostly in EM currencies) does not match that of its imports and its external debt (more in EUR and USD), leading to a rising deficit of Western currencies, despite trade surpluses.

STABLE CAPITAL INFLOWS IMPROVING GRADUALLY

Table 2: RRF disbursements expected to pick up in 2024

(EUR bn)	Prefunding and 2022-23 tranches	Received funding (% of allotment)	Disbursements expected in 2024
Bulgaria	1.4	24.1	1.5
Croatia	2.9	29.5	2.3
Czechia	2.0	21.6	1.2
Hungary	0.0	0.0	0.0
Poland	4.5	7.9	7.0
Romania	9.1	32.1	2.6
Slovakia	2.7	41.7	1.5
Slovenia	0.3	10.7	0.5
Total	**22.9**	**17.7**	**16.6**

Chart 6: Positive EBB in most CEE countries



Source: European Commission, central banks, national statistical offices, UniCredit Research

[14] Mainly metals, chemicals, food, construction materials and glass.

4. Economic growth in 2024-25: the CEE consumer returns

Economic growth expected to accelerate in 2024-25

We expect domestic demand to rebound throughout CEE in 2024, helping EU-CEE and the Western Balkans grow by 2.8%, Turkey by 2.9% and Russia by 1.3% (Chart 7). Base effects will help in EU-CEE, where private consumption and investment were weak in 2023. Precautionary savings accumulated by CEE households and companies since the start of the COVID-19 pandemic were largely exhausted by mid-2023, while real wages started growing only in late summer in Central Europe. As inflation falls further, financial conditions ease and capex resumes, we expect demand to accelerate in the private sector in 2025 compared to 2024 (Chart 8). Fiscal tightening could offset stronger private-sector demand, keeping GDP growth flat in 2025 in EU-CEE (2.9%) and Russia (1.3%), while we expect economic growth to accelerate in the Western Balkans (3.1%) and Turkey (4.0%).

DOMESTIC DEMAND EXPECTED TO POWER ECONOMIC GROWTH IN 2024-25

Chart 7: Private consumption is expected to rebound in 2024

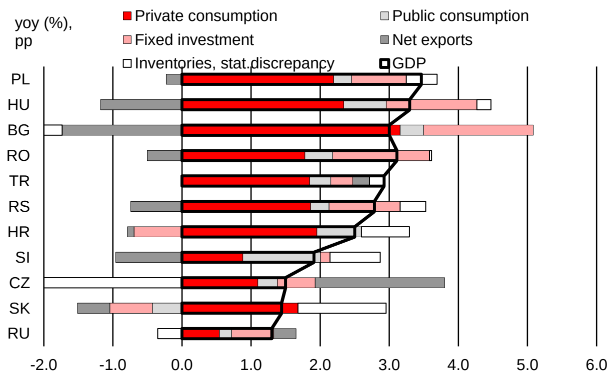
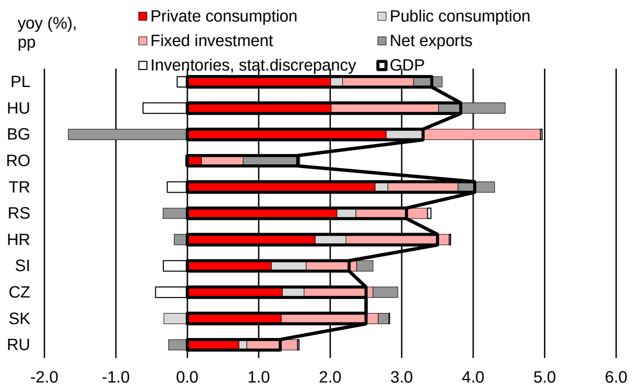


Chart 8: … with investment recovering more strongly in 2025



Source: statistical offices, Eurostat, UniCredit Research

We expect private consumption to rebound in 2024-25

We expect private consumption to rebound in 2024 in countries where it fell in 2023 (Czechia, Hungary, Poland and Slovakia) or was very weak (Serbia and Slovenia), while remaining robust in Croatia and Romania. In all of these countries, politicians are likely to try to woo voters ahead of elections. In Bulgaria and Turkey, where parliamentary elections took place last year, we expect consumption to grow at a slower pace than in 2023, with tighter financial conditions behind the slowdown in Turkey. In Russia, we expect fiscal policy to tighten after presidential elections and real monetary conditions to remain tight as the central bank tries to prevent domestic demand from growing too fast compared to supply.

Consumer sentiment points to an improving outlook and we expect more optimism ahead as real wage growth is likely to accelerate amid labor shortages (Chart 9). As financial conditions ease, especially in the second part of 2024, we forecast faster loan growth and a positive credit impulse that is likely to persist into 2025. Finally, we expect house prices to increase once lending thaws, providing a positive wealth effect for households.

Investment growth slowed by crowding out and poor foreign demand

In comparison, we expect investment to recover at a slower pace for two main reasons: the crowding out of infrastructure spending and weak external demand**.** With governments unlikely to reduce outlays to households, EU transfers will play a more important role in public investment. Projects financed by the 2021-27 EU budget are likely to pick up more, as many reach maturity in 2024. Poland and Serbia might lead the region, while Hungary and Slovakia could lag.

Capex might rebound in 2H24

CEE needs capex as it attempts to transition its sizeable car sector to electric mobility (with significant success), to complement labor shortages and replace some of the obsolete production capacity. Despite weak demand from the eurozone, the only CEE countries where production capacities are underutilized[15] are Hungary and Romania and, to a lesser extent, Slovakia**.** However, we do not expect companies already present in CEE to invest significantly before demand recovers in the eurozone (which our colleagues covering the eurozone assume will happen from 2H24 at the earliest). Adding much higher funding costs compared to recent years, we think that a gradual rebound in capex will contribute more to growth in 2H24 and especially in 2025.

In 2025, tighter fiscal policy could weigh on growth in Hungary and Romania

Besides Turkey and Russia, there are some EU-CEE exceptions to our recovery story. In Hungary, the government will have to reduce energy subsidies for households as the cost of borrowing and subsidies for households exceeds 7% of GDP. Thus, the Hungarian government faces either a protracted period of high deficits, which would threaten the country's investment grade due to stock imbalances being too high for a BBB rating, or lower subsidies and weaker private consumption. We think the latter is preferable with two years left to the next parliamentary election. In Romania, we expect labor taxation to increase significantly in 2025 for microenterprises, authorized persons and employees making more than the average wage in order to pay for large pension increases. Thus, a significant hit to the middle class's disposable income is likely to slow consumption growth well below potential in 2025-26.

Export recovery linked to pipeline of investment

We also see differentiation in export growth**.** We expect Hungary, Poland, Slovakia and Slovenia to outperform in manufacturing owing to recent and ongoing FDI projects. Even in countries where industrial policies have not been designed to attract more FDI in manufacturing, foreign investment accelerated in 2023 owing to near-shoring and friend-shoring, as well as capex in electric mobility. Poland, Romania, Czechia and Hungary benefit from investment in logistics and industrial space, with an acceleration expected in 2024-25 if trade recovers in Europe and globally. Croatia, Czechia, Hungary and, to a lesser extent, Bulgaria and Turkey will benefit from tourist flows. However, little to no investment in new accommodation since the COVID-19 pandemic could lead to most additional gains coming from higher prices, rather than more tourist arrivals.

PRIVATE CONSUMPTION LIKELY TO RECOVER MORE QUICKLY THAN INVESTMENT AND EXPORTS

Chart 9: We expect real wage growth to accelerate this year

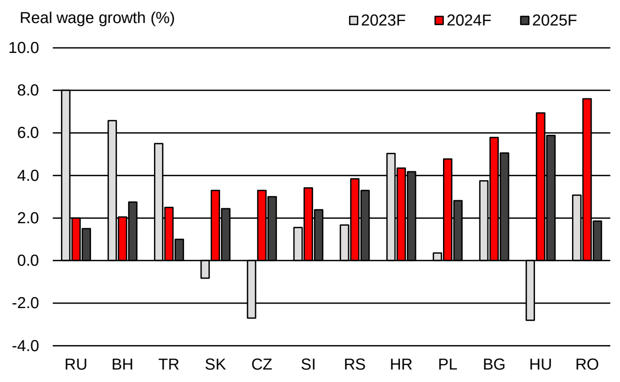
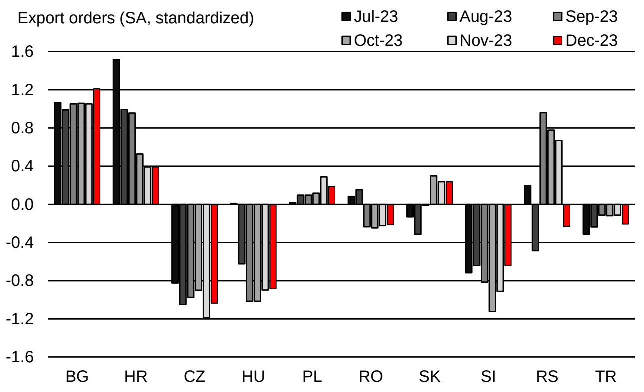


Chart 10: Export orders suggest a weak 1H24 for CEE manufacturing



Source: national statistical offices, European Commission, UniCredit Research

[15] According to Eurostat data, current utilization is more than one standard deviation below long-term average capacity utilization in Hungary and Romania and below the long-term average in Slovakia.

Terms-of-trade improvement and private-sector net savings rebalanced current accounts

Lower energy imports will help trade balances, as CEE entered the second half of the heating season with unprecedented gas inventories and the weather is expected to be mild and wet[16]. In addition, scarring and the rapid adoption of solar panels for household heating and electricity might prevent energy demand from returning to levels seen before Russia's invasion of Ukraine.

5. Disinflation to prompt rate cuts in 2024-25, despite target misses

Disinflation to continue, most targets to be missed due to…

Below, we summarize our inflation and interest rate forecasts, which were detailed in a recent publication[17]. We expect inflation to fall further, especially in 2024, but to remain outside target ranges this year in all countries but Serbia and Russia, with the target being met next year also in Czechia. In our view, several factors will prevent headline inflation from returning to target.

…the exhaustion of non-core disinflationary factors…

The main disinflation factors from 2023 are either weakening or may not persist in 2024 and 2025. The fall in inflation was supported in 2023 by lower food and energy prices. Cheaper food would require another bumper harvest in 2024, which not certain. Energy prices could fall in early 2024 as natural-gas and electricity prices fell more than 55% below their levels from January 2023. However, this decline has more to do with large gas inventories and high output of wind and hydro power at a time when energy demand remains low. If the effects of scarring subside and energy-intensive factories increase their output, prices could rise again.

…the removal of measures that suppressed prices…

Low inflation also reflected temporary inflation suppression by governments, be it through price caps (Bulgaria, Hungary, Poland, Romania, Serbia and Slovenia), compulsory price discounts (Hungary), indirect-tax cuts (Hungary and Poland) or large subsidies for energy prices (Hungary, Serbia, Slovakia and Turkey). These measures have a fiscal cost that governments cannot support if they want to reduce budget deficits. Thus, we expect most of these measures to be reversed, fueling inflation mostly after the 2024-25 elections.

…currency depreciation…

CEE currencies are too strong. Sharp real appreciation due to rising producer and consumer prices, as well as labor costs, has not been offset by nominal depreciation due to supportive carry. With interest spreads to developed markets falling, we see more scope for currency depreciation and for a larger FX pass-through to inflation.

…and resilient core inflation

Core inflation will fall at a slower pace than in 2023 if domestic demand is supported by fiscal spending and wage growth at a time when companies have not passed all cost increases from 2022-23 on to consumers. Real wage growth will accelerate in 2024 and remain high in 2025. Labor shortages are only partly being offset by economic immigration. If manufacturing and exports recover in the second part of 2024, the pressure on wages would increase further and, coupled with pre-election transfers to households, should boost retail sales and margins.

Main disinflationary risk: supply exceeding demand of core goods

The main disinflationary risk comes from lingering bullwhip effects following the COVID-19 pandemic. If supply exceeds weak demand, especially on developed markets, the prices of core goods could fall in 2024. However, we see this risk being mitigated by stronger consumer demand in CEE and the possibility that shortages will arise again if global demand strengthens.

We expect the CNB to cut to 4.50% in 2024 and 3.5% in 2025,…

Even though we see most CEE central banks missing their targets, we expect them to cut rates this year. After starting its easing cycle in December 2023, we believe that the CNB will accelerate rate cuts in 2024 once it has assessed how high contractual prices reset in the private sector at the start of 2024 and how strongly wages increase in 1Q24. If real wage growth stays close to 3%, around 1pp above productivity growth, as we expect, the CNB might cut by more than 25bp at this year's meetings, taking the key rate to 4.5% by the end of this year and to 3.5% in 2025, where the easing cycle could end.

[16] Seasonal forecasts | Copernicus. This would be the perfect combination for CEE, as it would require limited depletion of gas storages and precipitation would support hydro and nuclear power generation.
[17] EEMEA Country Note – CEE: rate cuts to outpace disinflation and fiscal adjustment in 2024-25, 1 December 2023.

…the NBP to cut to 5% in 2024 and 4% in 2025,…

We expect the NBP to resume rate cuts in 2Q24, once inflation falls temporarily inside the target range, but to end them at 5% once inflation exceeds 3.5% again. We forecast rates will be cut to 4% in 2025. At the time of writing, the Polish governing coalition is considering whether to submit a motion to the State Tribunal against NBP President Adam Glapinski. If such a motion is submitted, proceedings could last for years. Uncertainty might result in slower rate cuts and would be detrimental to the implementation of macroeconomic and financial measures in Poland, given the need to coordinate monetary, prudential and fiscal policies.

…the NBH to cut to 6% in 2024 and 4% in 2025,…

We see the NBH continuing to cut rates, albeit at a slower pace than the government would like. If the Hungarian central bank meets expectations and lowers the repo rate to 6% this year and 4% in 2025, it might support a tiered interest system that would maintain a high carry for foreigners while reducing the cost of funding at least for local borrowers. The election of a new governor in 2025 could result in a more dovish Monetary Council.

…the NBR to cut to 6% in 2024 and 4% in 2025,…

We still believe that the NBR could start cutting rates in 2H24, but the scope for easing is narrowing due to loose fiscal policy and electoral noise. For now, we are maintaining our call for 25bp cuts at every monetary-policy meeting scheduled for the second half of the year, taking the repo rate to 6% and ROBOR rates close to 5% by the end of 2024 if there is no depreciation pressure. Tighter fiscal policy would allow the NBR to cut the policy rate to 4% in 2025. We expect NBR Governor Mugur Isărescu to secure another five-year mandate in the spring, which would leave monetary policy unchanged with an emphasis on a tightly managed exchange rate. We see the NBR to returning to slow, stepwise depreciation this year by allowing EUR-RON to climb to a 5.00-5.10 range.

…the NBS to cut to 5.50% in 2024 and 4.50% in 2025,…

We expect the NBS to start cutting once the ECB eases, reducing the key rate to 5.50% this year and 4.50% next year. Reducing loan euroization should be a priority for the Serbian central bank to increase the effectiveness of monetary transmission. We see a very small risk of RSD depreciation in 2024-25.

…the CBRT to remain on hold at 45% in 2024 and to cut to 25% in 2025,…

In 2023, the CBRT bolstered its credibility with rate hikes and policy normalization. Its attempt to increase FX reserves by allowing the private sector to releverage externally is progressing. If Turkish President Recep Tayyip Erdogan does not interfere in monetary policy before local elections, we expect the CBRT to gradually reduce inflation and financial risks, ushering in significant capital inflows. We do not expect potential TRY appreciation to last due to excessive real gains that would eventually weigh on the C/A deficit. We expect the policy rate to remain flat at 45% this year, with cuts to 25% in 2025.

RATE CUTS WILL CONTINUE DESPITE TARGET MISSES

Chart 11: Disinflation will continue in 2024-25 without reaching targets

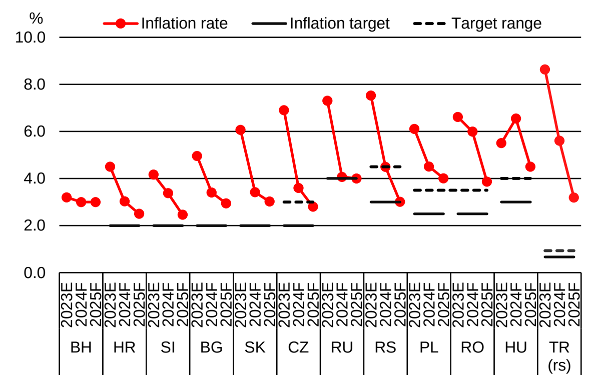
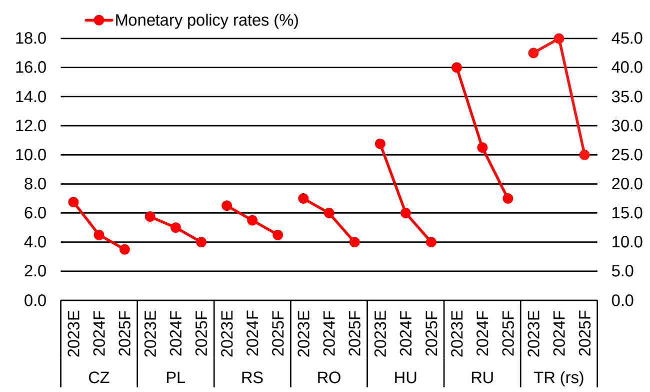


Chart 12: Positive real interest rates by 2025 amid target misses



Source: central banks, national statistical offices, UniCredit Research

…and the CBR to cut to 10.5% in 2024 and 7% in 2025

We see the CBR cutting its key rate to 10.5% in 2024 if inflation returns gradually to target and to 7% in 2025, thus maintaining a high real interest rate in order to prevent rapid loan growth and renewed price pressure due to the reopening of a positive output gap.

Limited scope for bond rallies in CEE

With most yield curves in CEE inverted and fiscal policy likely to remain loose, we see limited scope for bond rallies in CEE, especially in 2024. CEE local-currency bonds will be attractive if the EUR remains strong, which might offset the risk of currency depreciation. Hedging the FX risk leaves little on the table in CEE compared to other EM local-currency bonds (Chart 13). We anticipate the risk of shorter-duration local-currency bond issuance, which defeats the purpose of not issuing in FX. The shorter the duration, the more debt costs are dependent on short-term rates, which are a factor of depreciation pressure and available liquidity.

Hungary is a case in point, since it relies heavily on expensive retail bonds redeemable on demand. The Romanian ministry of finance could also reduce the average maturity of ROMGB issuance if demand is weak, although it has the option to spend some of its sizeable fiscal reserves, which cover more than six months of gross funding needs. Romania has been balancing shorter-term local issuance with longer-term ROMANI. Unlike some market participants, we do not anticipate rapid RON depreciation that could affect solvency. Instead, we see extensive public debt in foreign currency (exceeding half of total public debt) being one of the reasons for slow RON depreciation ahead. Thus, in our view, the risk of persistent C/A deficits fueled by the strong RON far outweighs the risk of rapid currency depreciation increasing the cost of servicing the country's debt.

The 2024 convergence trades: CZGB, CROATI, BGARIA

In a year when risk-on episodes are likely to alternate with risk-off ones, we see very few trades that could last throughout the year. Instead, we expect strong fundamental stories to better anchor yields regardless of risk appetite. One such case is that of CZGBs, which benefit from the highest ex-ante real yields among CEE local-currency bonds and from a more credible fiscal-adjustment plan than in neighboring countries. In addition, eurozone convergence trades have not run their course, with Croatian and Bulgarian bonds remaining expensive compared to Southern European sovereign bonds if Bulgaria remains on track to adopt the euro in 2025.

Polish bonds and the TRY could rally in 1H24

From the short-term trades, we highlight Polish bonds in 1H24. Budding conflicts between the new governing coalition on one side and Polish President Andrzej Duda and courts filled with PiS appointees on the other suggest that reform momentum could wane by the summer, when all the good news should be priced in. Similarly, we see TURKGBs performing well if the CBRT remains independent, but the scope for lower yields, especially at the front of the curve, is wider in 2025 if financial conditions ease, while the long TRY trade could be one of the best in 1H24.

CEE BOND VALUATION: MORE VALUE IN CREDIT

Chart 13: FX hedging reduces the appeal of CEE bonds

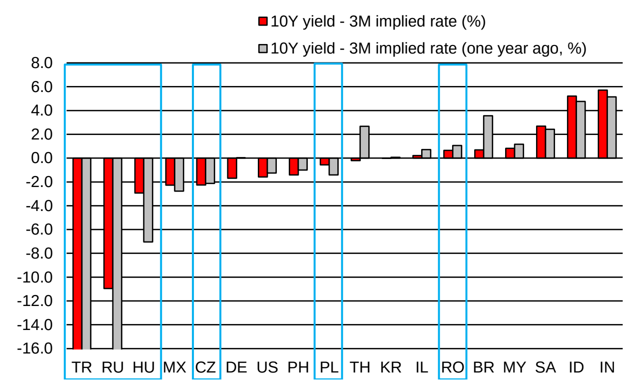
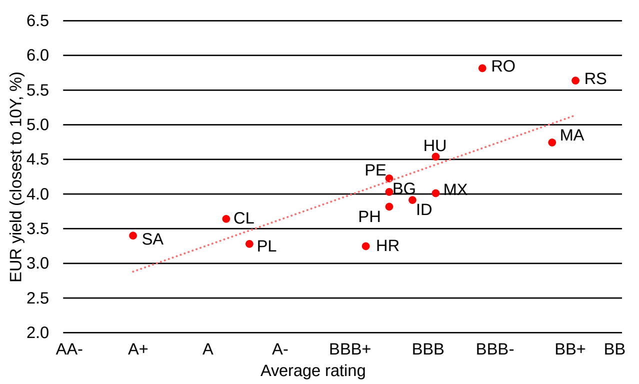


Chart 14: CEE EUR bonds are not expensive



Source: Bloomberg, UniCredit Research

The start of 2024 has been busy with foreign-currency issuance. Poland has covered 27.4% of its expected FX bond issuance for 2024 and Hungary a third, with Slovenia achieving 37.5% of its bond issuance plan. The first quarter of the year usually brings in a lot of issuance and we expect other sovereign issuers to follow.

In terms of valuation, Chart 14 shows that most CEE EUR bonds trade close to their rating average, with ROMANI and SERBIA bonds looking cheaper, as usual. In Romania's case, this comes from a lack of secondary-market management, excessive issuance at times of market stress (due to tight regulation that does not allow for flexibility) and individual bonds with small outstanding amounts, which affects liquidity.

6. Opportunities and risks: the need to carefully assess choices

Important choices to be made by CEE countries extend past elections. If carried through, they could drive future convergence trades in financial assets.

Bulgaria poised to adopt the euro in 2025

1. Bulgaria is expected to implement the remaining measures to join the eurozone in 2025 or 2026 at the latest. We expect adoption to happen next year, as parliament has adopted all post-ERM II commitments and is expected to pass amendments to the central-bank law before the end of January. Inflation remains the most problematic of nominal criteria, but we expect the benchmark to be tweaked in Bulgaria's favor if all other requirements are met.

   Parliament also rejected the request of a referendum for euro adoption, with the filo-Russian party Vazrazhdane referring the case to the Constitutional Court. We expect the latter to reject the request. Even if a referendum is held, it would be binding for the government if more than half of registered electorate casts a vote, which is unlikely, in our opinion.

Faster negotiations between the EU and candidate countries

2. Negotiations between the EU and the Western Balkans, Ukraine and Moldova to join the customs union might speed up. In economic terms, this would be the most important achievement for candidate countries. The EU's willingness to advance negotiations might be enhanced by geopolitical threats and a further decline in globalization. The EU lined up EUR 6bn in a Growth Plan for the Western Balkans to accelerate convergence[18].

Poland and Romania's geopolitical importance

3. Poland and Romania, the largest countries on NATO's eastern flank, will have to raise their security spending as the conflict in Ukraine drags on. The former has taken decisive steps to beef up its defense systems. The latter needs to define its military strategy in the Black Sea.

More support for Ukraine

4. Support for Ukraine in its conflict with Russia needs to be revived, having suffered from war fatigue and pro-Russian propaganda throughout CEE. Disagreement concerning the transit of Ukrainian grain have shown that these tensions can spill over into local politics. Efforts by Turkey to secure maritime grain transport and by Romania to significantly expand transit and exports through its ports to 14mn tons of Ukrainian grain in 2023 will need to be redoubled through more support from Central European countries, especially Poland. Opposition from Polish farmers and upcoming elections could affect this process.

Main risks to our outlook

In our opinion, the main risks in CEE are:

Pervasive populism

1. **A further populist tilt of mainstream parties in CEE if populist nationalists do well in EP elections:** Populism leads to short-term policies with negative long-term effects on fiscal policy, public investment and democratic institutions. Populist promises would further delay fiscal adjustment, increasing funding needs and raising borrowing costs for the whole economy. A nationalist wave of privatization reversals would further burden public coffers and lead to lower productivity at newly acquired companies. CEE economies are not mature enough to withstand international competition and improve public services without foreign capital.

[18] Commission presents a new Growth Plan for the Western Balkans including €6 billion in grants and loans to accelerate economic convergence with the EU - European Commission (europa.eu).

At the same time, populist measures, such as sectoral taxes, have already led multinational companies to repatriate more profit and choose debt as a form of foreign investment due to its better tax treatment. Finally, curbing institutional independence because of imaginary external risks or pressure from the EU would further undermine democracy in EU-CEE at a time when some of the pre-accession progress has already been reversed.

Potential rating downgrades

2. **Rating downgrades:** We highlighted the risk of rating downgrades in our June CEE Quarterly (page 14). Paradoxically, we believe that the risk of rapid downgrades has fallen in the past six months, even though the fiscal outlook for CEE has worsened. One reason is good market access, which has allowed CEE governments to amass significant fiscal reserves. A second reason is the poor state of the global economy, which has made CEE less of an outlier among EM. While we would expect the rating outlook to worsen for countries that delay fiscal adjustments (Hungary, Poland and Romania especially), rating downgrades are more of a medium-term risk, in our view, and would require a further worsening of stock imbalances or, in Hungary's case, lack of progress in reducing them.

   The return of the excessive deficit procedure (EDP) of the European Commission is unlikely to have a major short-term impact on fiscal policy in CEE. Given our current forecasts, we expect EDP to be reopened for Romania and opened for Slovakia, Poland, Hungary and maybe Slovenia. Most of these countries are likely to miss the 0.5% of GDP annual correction target at least in 2024, but we see insignificant repercussions as mainstream parties will point to the risk of a higher vote share for fringe parties if the fiscal adjustment starts in an election year. More importantly, the current framework agreed upon in the European Council excludes green investment from the EDP threshold only in 2024-26, which means EU-CEE will have to renegotiate the terms later in the decade.

A foreign-demand driven recession

3. **Weak foreign demand leading to recession:** While our colleagues covering developed markets expect both the US and the eurozone economies to avoid recession in 2024, the risk looms large for the small, open economies of CEE and has increased since our last *CEE Quarterly* was published last June. This situation could cause consumers to turn bearish again, capex might be postponed and governments would struggle to cover their funding needs, leading to tighter financial conditions that would only exacerbate the economic downturn. In such a scenario, we see Czechia, Hungary, Slovakia and Slovenia as being more vulnerable to a recession than Poland, Romania, the Western Balkans and Turkey. With CEE export orders having bottomed out, such a dire scenario may be averted.

Russian gains in Ukraine

4. **Russian gains in Ukraine:** With European and US military support for Ukraine falling, this risk has risen and more analysts are questioning whether Russia now has the upper hand in its two-year conflict with its western neighbor[19]. For CEE, any uncertainty would be bad economically, since it might lead to renewed migrant flows, stymie new investment and stifle trade in the Black Sea. However, the political fallout could be more important if worries on the pro-Ukrainian eastern NATO flank are met with calls to appease Russia from Western capitals. This would only be compounded if Donald Trump is reelected as US president and decides to end US support for Ukraine and/or to take the US out of NATO.

A return to political dominance over monetary policy in Turkey

5. **A return to political dominance over the central bank in Turkey:** This risk has fallen recently as Mr. Erdogan has refrained from commenting on CBRT decisions for more than six months. With less than three months remaining until local elections, the Turkish economy would greatly benefit from an independent central bank that offers clarity on its policies and ushers in capital flows needed to fund external shortfalls and replenish FX reserves.

[19] Two examples of such reporting: "Putin seems to be winning the war in Ukraine – for now" (economist.com) and "Is Putin Winning In Ukraine? Fiona Hill Says, 'He's About To. And It's on Us'" POLITICO

Political instability ahead of elections

6. **Political instability:** This risk is less of a regional issue than it was six months ago. We would highlight some countries in which government failure would impact economic policies and markets mainly by increasing uncertainty and delaying fiscal adjustments. Poland's heterogenous governing coalition is struggling to pass legislation due to opposition from President Duda and PiS-appointed judges. If this deadlock persists, we could see early elections if the 2024 budget is not passed or the coalition collapse after April's local elections. Even if the government manages to pass some reforms, the risk of a breakup would reappear close to the presidential elections, as we detail in the country piece. At the same time, PiS might splinter if it loses local elections, with traditionalists and pro-market conservatives at odds about which direction to follow. We believe that a change in the governing coalition or even early elections are likely in 2025 at the latest.

   In Romania, the governing coalition could break up before parliamentary elections to allow the junior partner, the National Liberal Party (PNL) to redefine itself in opposition to the Social Democrats (PSD). The coalition is likely to regroup after the elections, although the expected tax increases might antagonize the PNL's pro-market faction. If the PNL splits, a majority could be ensured by coopting the Hungarian minority party and by attracting defectors from AUR.

   A similar situation is possible in Czechia ahead of parliamentary elections, which are expected to take place by October 2025. The need to pass decisive reforms to reduce the budget deficit may not be backed by all coalition parties, leading to political deadlock.

   In Bulgaria, the current alliance between the long-term ruling GERB and its partners, who defined themselves in opposition to mainstream parties, might end, although the country might manage to join the eurozone before this happens.

OUR GLOBAL FORECAST

	GDP growth, %			CPI (Avg), %			Policy interest rate**, %			10Y bond yield (EoP), %			Exchange rate (LC vs.USD)		
	2023E	2024F	2025F	2023E	2024F	2025F	2023	2024F	2025F	2023	2024F	2025F	2023	2024F	2025F
Eurozone	0.5	0.5	1.2	5.4	2.3	1.8	4.00	3.25	2.25	2.49	2.80	2.65	1.10	1.13	1.15
Germany*	-0.4*	0.4*	1.3*	5.9	2.5	1.7				2.02	2.40	2.30			
France	0.9	0.8	1.1	4.9	2.4	1.7									
Italy	0.7	0.6	1.1	5.7	2.2	1.8				3.70	4.05	3.80			
UK	0.5	-0.3	0.8	7.4	3.1	1.9	5.25	4.50	2.75				1.27	1.28	1.21
USA	2.4	1.0	1.0	4.1	2.6	1.8	5.50	4.25	3.25	3.80	4.15	3.80			
Oil price, USD/bbl													83	89	82

* Non-wda figures. Adjusted for working days: -0.2% (2023), 0.4% (2024) and 1.4% (2025). **Deposit rate for ECB

THE OUTLOOK AT A GLANCE

Real GDP (% change)	2022	2023E	2024F	2025F
EU-CEE	4.3	0.5	2.8	2.9
Bulgaria	3.9	1.9	3.0	3.3
Czechia	2.4	-0.4	1.5	2.5
Hungary	4.6	-0.8	3.3	3.8
Poland	5.3	0.4	3.5	3.4
Romania	4.6	1.4	3.0	1.6
Croatia	6.3	2.2	2.5	3.5
Russia	-2.1	2.5	1.3	1.3
Serbia	2.5	2.5	2.8	3.1
Turkey	5.5	4.2	2.9	4.0

CPI EoP (% change)	2022	2023E	2024F	2025F
EU-CEE	16.8	6.1	4.6	3.6
Bulgaria	16.9	4.9	3.4	2.9
Czechia	15.8	6.9	3.6	2.8
Hungary	24.5	5.5	6.5	4.5
Poland	16.6	6.1	4.5	4.0
Romania	16.4	6.6	6.0	3.9
Croatia	13.1	4.5	3.0	2.5
Russia	11.9	7.3	4.1	4.0
Serbia	15.1	7.5	4.5	3.0
Turkey	64.3	64.8	42.0	24.0

C/A balance (% GDP)	2022	2023E	2024F	2025F
EU-CEE	-5.0	-0.6	-0.5	-0.1
Bulgaria	-1.4	-0.7	-1.2	-1.1
Czechia	-6.1	-0.3	1.2	1.4
Hungary	-8.1	-0.5	0.2	2.2
Poland	-2.4	1.4	0.8	0.9
Romania	-9.3	-6.4	-5.2	-4.4
Croatia	-2.8	-0.6	-0.8	-0.9
Russia	10.9	2.2	2.9	2.2
Serbia	-6.8	-2.5	-3.8	-4.1
Turkey	-5.5	-4.3	-2.9	-2.7

Extended basic balance (% GDP)	2022	2023E	2024F	2025F
EU-CEE	-0.7	2.3	2.9	4.0
Bulgaria	1.9	3.5	4.2	4.2
Czechia	-3.1	0.9	3.4	3.7
Hungary	-3.5	1.1	3.7	7.4
Poland	1.8	4.7	4.3	5.3
Romania	-3.6	-2.3	-1.3	-0.5
Croatia	5.0	7.0	5.7	5.7
Russia	5.4	1.0	1.4	0.7
Serbia	0.3	4.0	1.7	1.3
Turkey	-4.6	-3.8	-1.9	-1.7

External debt (% GDP)	2022	2023E	2024F	2025F
EU-CEE	71.2	68.1	64.9	63.4
Bulgaria	51.6	46.3	43.3	40.9
Czechia	65.6	61.3	60.7	59.9
Hungary	149.1	141.4	131.2	123.1
Poland	53.9	48.9	45.8	45.4
Romania	50.4	52.1	49.6	49.9
Croatia	72.9	81.5	78.6	76.4
Russia	17.3	19.5	21.5	23.0
Serbia	69.3	64.3	63.1	62.6
Turkey	50.7	46.1	47.0	43.3

General gov't balance (% GDP)	2022	2023E	2024F	2025F
EU-CEE	-4.0	-5.0	-4.6	-3.9
Bulgaria	-2.9	-2.2	-2.9	-3.0
Czechia	-3.2	-3.5	-2.8	-3.0
Hungary	-6.2	-6.1	-4.6	-3.5
Poland	-3.7	-5.6	-5.2	-4.3
Romania	-6.2	-6.3	-6.0	-4.6
Croatia	0.1	-0.5	-1.9	-1.7
Russia	-2.2	-2.6	-3.4	-1.6
Serbia	-3.2	-2.2	-2.2	-1.5
Turkey	-2.2	-6.4	-4.8	-4.2

Gov't debt (% GDP)	2022	2023E	2024F	2025F
EU-CEE	51.2	51.7	53.5	54.0
Bulgaria	22.1	21.9	23.1	24.6
Czechia	44.2	44.3	44.9	45.4
Hungary	73.9	73.7	72.9	70.6
Poland	49.1	49.9	53.9	55.3
Romania	47.2	49.3	50.9	52.2
Croatia	68.2	63.8	61.4	58.6
Russia	14.9	16.2	20.0	21.0
Serbia	55.7	53.5	52.0	50.9
Turkey	30.8	31.1	34.8	33.5

Policy rate (%)	2022	2023	2024F	2025F
EU-CEE				
Bulgaria	-	-	-	-
Czechia	7.00	6.75	4.50	3.50
Hungary	18.00	10.75	6.00	4.00
Poland	6.75	5.75	5.00	4.00
Romania	6.75	7.00	6.00	4.00
Croatia	-	-	-	-
Russia	7.50	16.00	10.50	7.00
Serbia	5.00	6.50	5.50	4.50
Turkey	9.00	42.50	45.00	25.00

FX vs. EUR (EoP)	2022	2023	2024F	2025F
EU-CEE				
Bulgaria	1.96	1.96	1.96	1.96
Czechia	24.1	24.7	25.0	25.0
Hungary	400	383	398	410
Poland	4.69	4.35	4.40	4.50
Romania	4.95	4.97	5.05	5.15
Croatia	7.53	EUR	EUR	EUR
Russia	75.7	99.2	116.4	130.0
Serbia	117.3	117.2	117.6	118.0
Turkey	20.0	32.5	44.6	52.9

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)	-0.9	-0.2	-1.1	-4.9	1.0	-5.7	-2.5	3.3	-3.0	-4.9	5.2	-0.6	-1.6	-3.4	-1.5	0.3	-1.0	1.8	-1.8
Extended Basic Balance (% of GDP)	4.9	1.8	6.4	-2.1	3.8	-2.0	4.3	2.1	-2.3	-4.5	5.3	0.8	0.9	0.3	0.8	1.3	-0.7	1.0	-1.2
FX Reserves coverage (months of imports)	9.5	6.9	-	3.6	4.3	5.0	7.2	14.3	-	2.3	5.0	3.6	10.7	4.4	2.1	5.2	7.6	12.4	2.8
External Debt (excl.ICL, % of GDP)*	32.3	61.5	59.9	64.8	35.4	35.4	66.6	11.7	82.7	45.9	83.1	33.0	34.1	70.6	41.3	29.0	18.4	13.5	43.7
Short-term debt (% of GDP)	19.2	34.8	26.5	18.4	9.5	7.4	0.2	-	40.1	16.1	5.2	3.5	3.7	7.7	8.7	3.7	7.2	7.5	7.8
REER (Index, 2010=100)	112.1	122.0	104.0	99.0	108.6	106.5	137.6	89.1	-	47.4	95.7	107.2	65.6	87.8	105.1	92.5	109.0	113.4	-
Domestic Finances																			
Corporate debt (% of GDP)	34.5	47.2	76.4	104.3	38.8	36.6	42.4	62.1	54.6	51.5	51.4	21.0	50.9	91.1	46.4	32.4	59.3	166.0	18.8
Household Debt (% of GDP)	21.9	37.2	30.2	19.9	24.6	20.6	18.8	20.0	44.4	12.2	4.5	16.2	34.3	46.4	0.0	15.7	40.3	62.0	4.0
Nonresident holdings of LC gov.debt (% total)	0.3	28.0	-	15.9	15.2	24.2	15.8	39.4	47.8	1.9	-	15.1	7.4	-	26.1	14.9	-	8.5	-
Banking System																			
Credit Impulse (% of GDP)	-0.8	-1.4	-0.7	-1.1	-3.3	-2.6	-4.9	-	-1.2	-1.3	3.6	0.3	-5.6	-6.8	-2.8	-0.2	1.9	-0.4	2.8
Loans/deposit ratio (%)	70.3	62.5	69.4	69.4	66.0	69.5	78.1	85.6	108.2	80.2	99.3	93.0	121.5	113.0	95.9	90.6	114.1	78.2	151.3
NPL (% of total loans)	4.4	1.7	3.9	2.5	2.4	2.7	3.2	4.2	1.9	1.5	37.9	2.2	2.9	1.8	4.7	2.4	4.1	1.7	2.9
Domestic Banks CAR (%)	21.8	22.8	23.3	21.8	20.1	21.6	22.2	12.3	19.7	18.3	25.0	19.5	17.4	15.4	17.6	27.4	16.6	15.1	31.0
Domestic Banks RoE (%)	21.7	17.5	16.9	22.3	13.5	21.3	18.1	22.5	8.7	42.1	56.7	18.9	12.3	15.5	14.9	16.9	15.5	7.0	-

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 (%)	-	6.75	-	10.75	5.75	7.00	6.50	16.00	-	42.50	16.00	11.25	11.75	8.25	8.25	6.00	6.50	4.35	100.00
Real policy rate (%)	-	-0.2	-	5.3	-0.3	0.4	-1.4	-23.4	-	-13.5	10.4	6.3	7.2	4.1	2.5	3.3	0.9	4.7	-10.7
Real Money market rate (%)	-	-0.2	-0.7	4.5	-0.8	-0.4	-2.1	-2.4	-2.3	-11.9	10.4	6.1	6.7	4.3	2.3	4.2	1.6	3.3	-15.7
Headline inflation (% yoy)	5.4	6.9	4.7	5.5	6.1	6.6	8.0	7.4	6.2	64.8	5.1	4.7	4.7	3.9	5.6	2.6	5.6	-0.4	160.9
Core Inflation (% yoy)	7.1	3.9	5.8	7.6	7.3	8.4	7.0	6.4	6.6	70.6	5.7	5.1	4.4	4.1	4.5	2.0	4.1	0.6	170.3
GG Fiscal balance (% of GDP)	-1.7	-3.4	-0.4	-7.6	-4.7	-4.6	-2.9	-2.6	-4.7	-2.7	-16.3	-3.9	-7.5	-2.3	-5.7	-3.7	-6.4	-4.5	-3.1
GG Primary balance (% of GDP)	-1.2	-2.8	1.0	-3.3	-3.3	-4.0	-1.1	-1.5	-3.6	-0.2	-13.2	-0.7	-1.0	-1.3	-0.9	-1.8	-3.0	-	-
Government Debt (% of GDP)	20.7	44.3	66.5	75.0	48.4	49.1	51.8	16.2	59.6	30.5	81.7	41.2	72.3	56.2	74.0	52.7	58.8	79.3	62.7
Structural																			
Unemployment (%)	5.5	2.8	6.7	4.0	2.7	5.4	9.2	2.9	6.2	8.5	-	2.7	7.5	8.7	31.9	5.3	8.7	5.0	5.7

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

Legend
Low vulnerability
Moderate vulnerability
Significant vulnerability
High vulnerability

CEE strategy: fading carry tailwinds call for a more-selective approach to EM exposure

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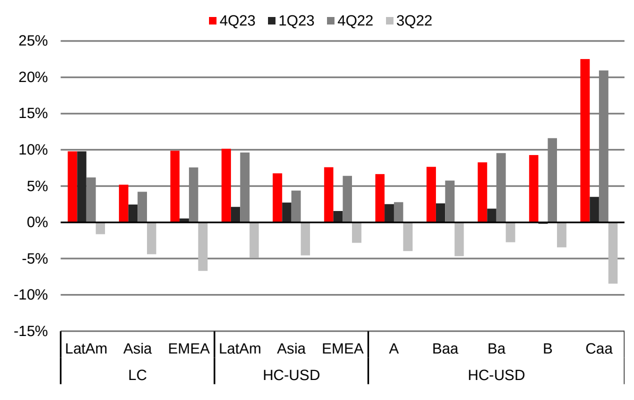
- EM bonds delivered solid returns in 2023, ending the year with positive momentum. Across the CEE region, total return was often in the double digits, owing to disinflation and carry. Return prospects for 2024 remain positive, but developments in core markets might lead to a challenging start of the year. Interesting expected returns for core bonds and shrinking central-bank liquidity should raise the bar for crossover investment while tight credit spreads will likely make investors more selective regarding EM exposure.
- Local bonds in the CEE region are set to deliver decent performance in 2024, supported by continuation of a disinflationary trend and official rate cuts. We expect curve steepening and fiscal development as being key to long-term bond performance. CZGBs have the best price-return prospects, while HGBs and ROMGBs are mainly a carry story. FX developments should be carefully monitored.

Recent performance

The past year has been marked by volatility in fixed income, with large gyrations in core yields and in the value of the USD. Major central banks acted to stem demand to make sure inflation was on a desired path, while growth and inflation outlooks remained uncertain amid vivid geopolitical risk. Still, good returns in 1Q and 4Q allowed large parts of the global fixed-income market to close the year with solid performance. The Bloomberg EM hard-currency bond index posted returns of 9% for the year, while the local-currency aggregate total return was 6%. LatAm delivered outstanding performance. EMEA managed to recover in 4Q, and the CEE region in particular closed the year with double-digit returns. Hungary was among the outliers, with carry and disinflation contributing to 20%+ returns for 2023. Performance across EM was often well in excess of the 3-4.5% returned by USTs and the 3-8% returned by core EGBs, and rather close to the performance of European and US high-yield, where spread tightening added to already-attractive carry levels, while signs of stress were still very modest despite an expected deterioration in credit fundamentals.

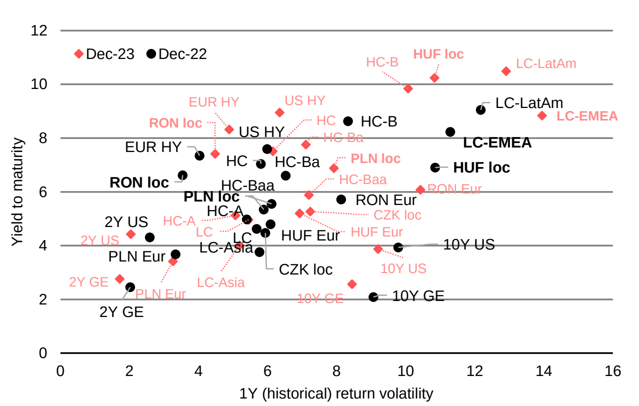
Following repricing in yields, carry contributed to a great extent to performance and allowed EM bonds to weather high volatility among core yields and unstable appetite for risk. Indeed, interest-rate volatility as measured by the Merrill Lynch Option Volatility Estimate Index remained historically high throughout 2023, fueled by changing market views regarding the US labor market, the inflation outlook and the evolution of monetary policy. Risk appetite also proved wobbly, with global equities moving sideways for most of the year, before rebounding on the prospect of a lower federal funds rate in 2024. EM equities underperformed during the entire year, dragged down by losses across China and most of Asia.

CHART 1: TOTAL RETURNS



Total returns for the period, Bloomberg indices.

CHART 2: RISK-REWARD COMBINATIONS



Source: Bloomberg, UniCredit Research

ECB and Fed: from higher-for-longer to steep rate cuts

Following the December Fed and ECB meetings, markets seem to have consolidated their view that there would be a steep decline in policy rates in 2024. Forward rates on USD OIS curves point to an overnight rate between 125bp and 150bp lower than current levels and then a rapid move towards the 3.0-3.5% area, where USD rates are expected to level off from late 2025. We agree with the idea that the Fed will return rates to the 3% area, a level that would not be too far from neutrality, although we expect this adjustment to be more gradual and less front-loaded, with cuts starting in 2Q24. In the eurozone, recent repricing in terms of rate-cut expectations suggests an even larger shift, with the ECB seen as starting to cut rates early next year and proceeding swiftly to take the depo rate to about 2.5% by YE 2024 and close to 2% by mid-2025. Based on recent rhetoric and on lingering uncertainty on wage growth prospects, we think the ECB's rate-cut cycle will only start in mid-2024 and continue very gradually before reaching normality probably in early 2026. Hence, our forecasts are more cautious than what is priced into forwards, especially on the EUR curve, which translates into asymmetric risks for core yield levels in the short term.

Core yields have front-loaded rate cuts and face short-term repricing risks

Long-term core yields have fully priced in a return to neutral levels for policy rates and might be attaching too little probability to a scenario where a return to target levels of inflation takes longer, possibly because of supply shocks related to geopolitical developments or due to resilient labor markets. Only in October was the prevailing market paradigm centered around the notion of "higher-for-longer" so that attention was squarely on elevated borrowing needs, increasing debt, quantitative tightening (QT) and normalizing term premiums. 10Y UST yields hit 5% before a huge rally took the 10Y below 4% by year-end. Markets fears were probably exaggerated in October, but current levels might reflect an overly optimistic view on bonds. Hence, we think that less-supportive seasonal patterns and increased attention on supply needs (while QT continues) might put pressure on long-term yields in early 2024. This also applies to Bunds and EGBs more in general, which posted very positive performances in 4Q23. Still, we think the medium-term path for USTs and Bunds will be positive. Disinflation will lead to more appetite for bonds, while official rate cuts are fueling bull-steepening. In the short-term, a return towards 2.25-2.50% for 10Y Bunds and to 4.25-4.50% for 10Y USTs would increase the appeal of medium-to-long-term bonds, particularly when reinvestment risk is factored in, and call for a more-positive view on duration. Over the next two years, we think that carry will remain a key source of return for core bonds.

CHART 3: FED AND ECB RATE PATHS

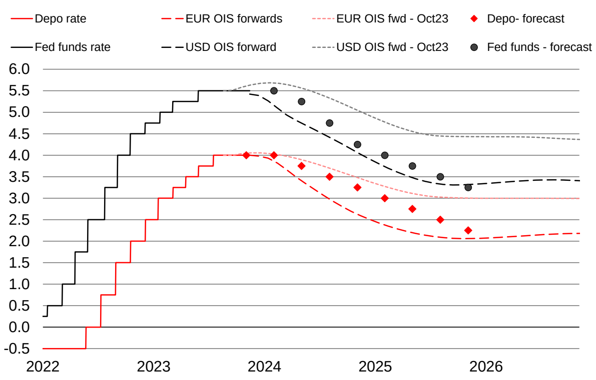
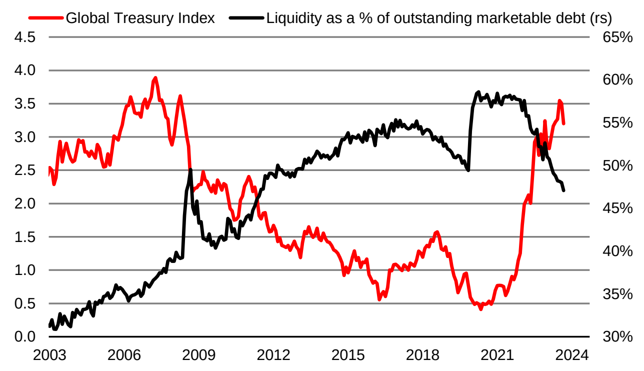


CHART 4: SHRINKING CENTRAL-BANK BALANCE SHEETS



Fed, SNB, ECB, BoJ balance sheets and global FX reserves. Bloomberg Global Agg. Treasury Index

Source: Macrobond, Bloomberg, UniCredit Research

Shrinking balance-sheet liquidity

The balance sheets of central banks continue to shrink, with almost USD 5tn of liquidity having been drained from the system since YE 2021 (20% of the total). The ECB greatly contributed to this trend, as maturing refinancing operations added to QT. FX reserves also dropped sharply worldwide. Hence, central-bank liquidity as a share of world GDP or of outstanding global debt has plummeted. Over the past decade, along with ample central-bank liquidity, depressed risk-free rates have contributed to pushing demand towards higher-yielding investments, which resulted in higher levels of duration, credit or liquidity risk in investors' portfolios. With nominal bond yields trading at higher levels compared to the past decade and with core real yields in positive territory, the need to look for yield in remote corners of the market is fading, and highly rated bonds are likely to start to make up an increasing share of portfolios.

Corporate credit spreads in core markets

Corporate credit has weathered the tightening cycle relatively well thanks to solid fundamentals and relatively low duration. Carry kept up returns in 2023, with spread tightening adding to that in 4Q. Looking ahead, default rates and the risk of a deep recession are likely to remain contained, while risk-free rates are expected to fall. Hence, we expect European IG and HY NFI credit to post decent total returns in 2024, mainly thanks to carry, but risks should not be ignored. Refinancing risks loom, as a large share of the cheap quantitative-easing era's borrowing will have to be refinanced at a much higher cost, while the profitability outlook remains challenging. This will result in gradually deteriorating credit fundamentals. Lower central-bank liquidity and a more-positive view toward high-grade bonds will translate into de-risking and a more-selective approach toward credit. Meanwhile, credit spreads on higher yielding market segments face asymmetric risks after the recent tightening.

Carry has been a key source of return, also for EM bonds. Tightening cycles started and came to an end before those of the Fed and of the ECB. The large rate differentials that were built up in the past few quarters fueled carry trades, and positions were later supported by rate-cut prospects. Rate differentials are currently much tighter than they were one year ago for most EM regions, and carry tailwinds have already started to fade. Moreover, shrinking central-bank liquidity, decent return prospects on core paper and compressed credit spreads will limit appetite for EM paper. Hence, investors are set to become more selective in picking exposure, with an increasing role being played by fundamental developments. On the positive side, Fed rate cuts and a slowdown in US economic growth should weigh on the USD, which we expect to progressively lose strength over the next two years.

CHART 5: LOCAL GOVIES CARRY AND FX VOLATILITY

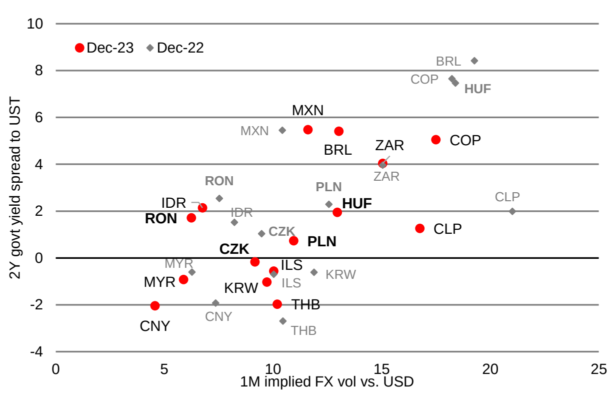
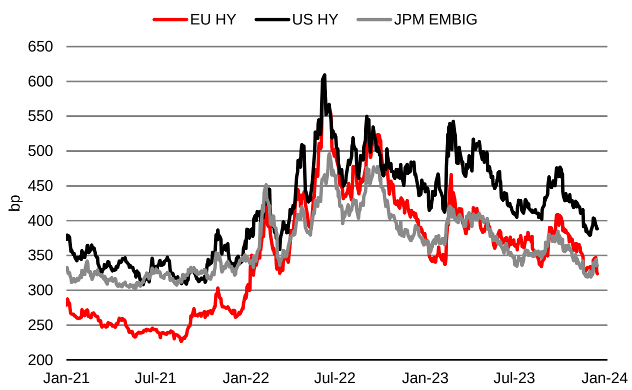


CHART 6: CREDIT SPREADS



Source: Bloomberg, UniCredit Research

EM portfolio flows

Improving market sentiment in the latter part of 2023 contributed to positive flows into EM portfolios. Debt portfolios recorded modest but steady inflows. The picture regarding equities was a tad more mixed, with China remaining a drag, while the EM aggregate managed to recover some outflows recorded during the summer.

Since the pandemic crisis, exposure to EM equities has been flat overall, while debt-portfolio outflows have been sizable (exposure is USD 200bn lighter based on IIF data). This should limit downside risks for EM bonds and could pave the way for the re-building of positioning if macroeconomic conditions improve. Acceleration of the recovery in China could be a potential catalyst.

Hard-currency bonds in CEE

EUR-denominated CEE sovereign paper is very much exposed to the dynamics of the European rate market, although it has shown less-pronounced compression in credit spreads. In case of a repricing in European long-term yields and credit spreads, they are likely to be affected. On the other hand, recent moves have increased the attractiveness of high-yielding bonds in the CEE region. These could also present an interesting way to diversify away from the likely impact of front-loaded EGB issuance. Bonds issued by Romania, Hungary and Serbia look attractive at the belly of the curve, where EGB yields are trading at rich levels. Romania will likely tap the EUR market with a green bond in early 2024. This would be the first test for green issuance in the region and a successful placement would likely see other issuers follow suit. Croatia, Bulgaria and Poland EUR-curve shapes mimic those issued by countries in the EU periphery. Hence, the front end and the 10Y are probably better picks than the rich 5Y area. As far as USD-denominated paper is concerned, Serbia and Poland might offer alternatives to Romania and Hungary.

Local-currency bonds CEE

Local bonds in the CEE regions are set to deliver decent performance in 2024, owing to a continuation of the disinflationary trend and monetary policy moving more decisively in terms of rate cuts, especially from mid-year onward, when the ECB is expected to also have started rate cuts. Monetary-policy actions will push curves steeper but an increase in T-Bill issuance in 1H might slow the decline in yields at the front end. Risks from the fiscal side and from inflation, which differ across CEE countries, will potentially add to term premiums. CZGBs could be the strongest convergence story in core eurozone paper in 2024, while POLGBs might benefit from a political dividend as the country moves closer to the EU. However, we think this is a story for 1H24, as political risk might resurface later on. Politics might also cast a shadow over ROMGBs, as elections in Romania might keep attention focused on fiscal developments. Loose fiscal policy and sticky inflation could also be a potential source of headwinds to HGBs, which share rating risks with ROMGBs. HGBs relatively high carry is probably going to remain a key source of demand and turn out to be the main driver of performance. Risks of a repricing in core yield levels as well as in European corporate spreads at the beginning of 2024 could present an additional challenge to local CEE bonds, which might also face FX-depreciation pressure over the next two years. With investors being more selective with regard to EM bonds, positive fiscal stories might tilt the balance in favor of regional bonds.

CEE: fading support from interest-rate carry

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- Although core market yields have likely peaked, short-term rate-cut expectations seem too aggressive, especially in the eurozone. Push back from the Fed and the ECB against premature rate-cutting expectations could spark volatility in CEE currencies.
- Barring the escalation of geopolitical risks, we expect a weaker USD trend. The expected narrowing in USD and EUR interest-rate differentials is consistent with EUR-USD trading in the 1.10-1.13 range this year.
- Although a weaker USD tends to be supportive of CEE currencies, tightening global liquidity makes us cautious about the outlook for emerging-market (EM) assets in general. We expect selective capital inflows to the CEE region, as narrowing interest-rate differentials make carry trade investments less attractive.
- The improvement in extended basic balances that should occur as trade deficits narrow and foreign direct investment (FDI) likely picks up will mute external vulnerabilities and allow CEE central banks to narrow positive interest-rate premiums. Weak eurozone manufacturing activity and loose fiscal positions still pose downside risks to trade balances in countries with strong ties to the European manufacturing cycle and with stimulative domestic economic policies.
- A narrowing interest-rate premium may halt the sharp real appreciation trend of CEE currencies observed since 2020, while the TRY may enjoy real appreciation following significant monetary tightening.
- The PLN's strength is likely to fade later in the year as focus shifts to fiscal adjustment needs and political instability. The CZK may become more stable as the ECB begins to cut rates, helped by Czechia's having the lowest inflation in the region. The HUF is likely to underperform its regional peers as domestic policies prioritize growth over further disinflation. Tighter monetary conditions and slowing domestic demand may help to slow depreciation pressure on the TRY and the RUB amid structural FX shortages in Turkey and Russia.

Moderately weaker USD, cooling rate-cut expectations

Narrowing interest-rate differentials may lift EUR-USD into the 1.10-1.13 range in 2024

External conditions became more supportive of CEE currencies in 4Q23, as headwinds from USD strength reversed, core market rates passed recent peaks and energy prices softened. We expect both the Fed and the ECB to start cutting rates in June 2024 as core inflation trends slow. This could create room for more rate cuts in the CEE region without triggering excessive FX volatility. Nonetheless, the dovish shift in market expectations in December signals an easing path that we see as too aggressive compared to our expectations, especially in the eurozone. A faster Fed easing path may narrow the differential between key USD and EUR rates from 150bp currently to 100bp by end-2024. The narrowing interest-rate differential is consistent with a weaker USD, although structural weakness in eurozone growth is likely to limit EUR gains. Our baseline forecast projects that EUR-USD will rise towards 1.13 by end-2024 and to 1.15 by late 2025. The main risks to our forecast, such as escalating geopolitical conflicts and/or a eurozone recession triggering earlier ECB rate cuts, point towards a stronger USD. For more details on our core market views, see our UniCredit Macro & Markets 2024-25 Outlook.

Upward correction in core market interest rates and European manufacturing recession are key external risk factors for CEE FX

A firm push back from the Fed and the ECB against premature rate-cutting expectations and a subsequent upward correction in core market yield curves could spark volatility in CEE currencies, especially with regard to the HUF, which has been trading with high correlation to global risk sentiment. The other key external risk factor driving CEE currencies in the coming months may be the evolution of the outlook regarding eurozone manufacturing. Recently disappointing German confidence indicators and weak backlogs in supply chains point to extended manufacturing weakness, which may weigh on EUR satellite currencies, especially the CZK and the HUF, given the Czech and Hungarian economies' strong links to German manufacturing supply chains.

Weak external demand may also lead to further postponement of FDI in the region, posing downside risks to the improvement in extended basic balances that we project in our baseline forecasts. That escalating geopolitical tensions could lead to a renewed rise in energy prices also remains a valid external risk factor for CEE currencies, given CEE economies' large dependence on energy imports.

CHART 1: NARROWING INTEREST-RATE DIFFERENTIALS POINT TO A MODERATELY WEAKER USD

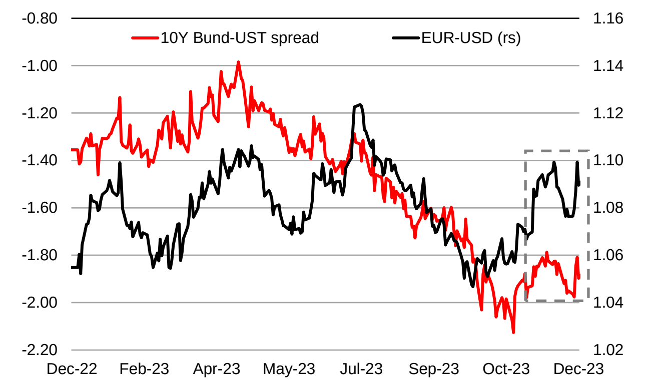
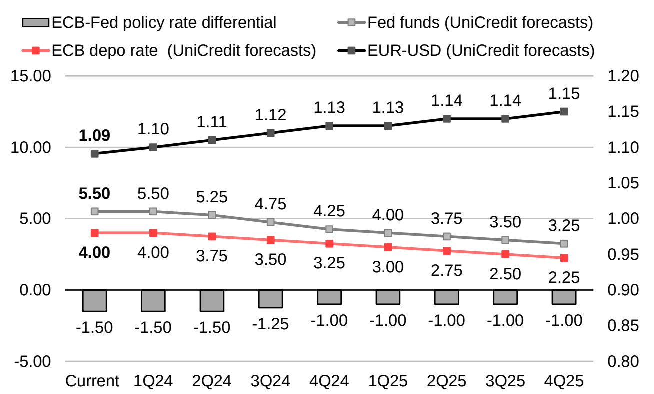


CHART 2: OUR FED AND ECB BASELINE SCENARIOS POINT TO A HIGHER EUR-USD THAT IS STILL WITHIN 1.10-1.13 IN 2024



Source: Bloomberg, UniCredit Research

While fiscal positions will remain loose in most CEE economies, with more contributions to improving external positions in 2025 than in 2024, rising private sector savings should continue to support the narrowing of external deficits in 2024. In addition to lower drag from energy imports on the trade balances of energy importers, domestic demand contraction (amid tightening monetary conditions) and a sharp negative real-income shock have supported adjustment in structural external shortfalls. We also expect FDI inflows to support external positions and FX stability by reducing dependence on debt-generating external funding sources.

Political risks are key local factors to watch given the heavy election calendar ahead

Among local drivers, politics could pose a key risk to our forecasts given the heavy election calendar ahead, with risks centered around fading political support for more-market-friendly central-bank governance in Turkey; further fiscal slippage in Hungary, Romania and Poland and the potential breakup of the new opposition coalition government in Poland, all of which point to weaker currencies.

Narrowing carry supports better alignment with fair value

Tightening global liquidity makes us more cautious about EM FX, despite the weaker USD outlook

A weak USD historically tends to support EUR satellite CEE currencies. However, tightening global liquidity conditions as major central banks continue to unwind their balance sheets make us cautious regarding capital flows to EM. We think significant narrowing in interest-rate premiums offered by local markets in CEE will reduce leveraged inflows and that capital inflows will likely be more selective, displaying a preference for markets that show potential for strong structural growth and a positive shift in local policy, like Poland and Turkey.

Stock vulnerabilities may weigh on currencies as investors unwind carry trades

Stock vulnerabilities may weigh on currencies in those countries that have relied heavily on short-term external financing, exposing balance of payments to hot money inflows, and this may be partly reversed as the positive carry rate shrinks. We think the HUF stands out with regard to stock vulnerability, given the increased role of short-term external debt financing in the balance-of-payments gap in 2022 and early 2023.

CHART 4: THE HUF HAS THE HIGEST CORRELATION WITH EUR-USD AMONG THE CEE CURRENCIES

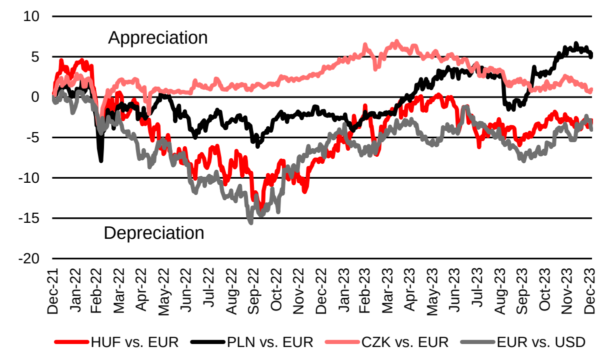
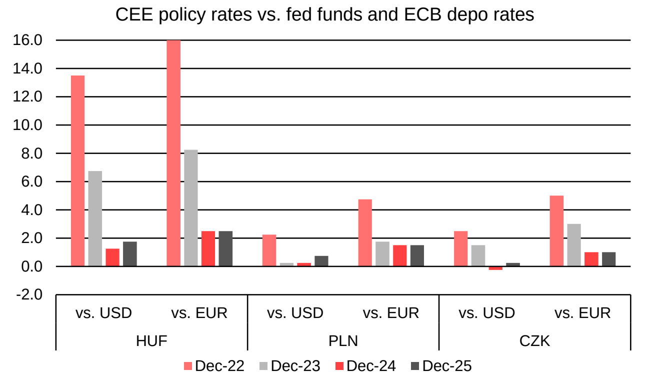


CHART 4: THE GAP BETWEEN INTEREST-RATE PREMIUMS AND CORE MARKET YIELDS MAY NARROW FURTHER



Source: Bloomberg, UniCredit Research

High interest-rate carry and narrowing external structural shortages supported massive real FX appreciation in CEE

As central banks in the CEE region delivered rate hikes in 2021-2022 faster than major developed-market central banks, widening interest-rate carry has supported significant appreciation in real effective exchange rates (REER). REER-based valuation has become more stretched as positive real interest-rate premiums have prevented adjustment in nominal exchange rates, while wages and input costs have been growing faster relative to the region's main trading partners. As positive interest-rate premiums narrow, CEE currencies may unwind some of the significant real appreciation they have experienced since 2020 amid rising wages and input costs.

Narrowing positive carry should open the door to adjustments in valuation

The CZK, which was the most overvalued CEE currency in mid-2023 according to calculations based on consumer-price growth differences, has already started this adjustment, which, together with recent PLN appreciation, has narrowed CPI-based valuation gaps. Valuations show a different relative rank according to producer-price trends, which is a more relevant indictor of competitiveness in the tradable sector. Due to Hungary's having the highest producer price index (PPI) growth in the region since 2022, the HUF became the most overvalued currency in the CEE. Its massive real appreciation trend is likely to increase pressure on the NBH to loosen monetary conditions. We think narrowing positive carry should open the door to adjustments closer to fair value in HUF and PLN. The TRY and the RUB look cheaper according to CPI-based REER-valuation metrics. However, both currencies are likely to remain under nominal depreciation pressure given structural FX shortages in Turkey and Russia.

CHART 5: REAL APPRECIATION IN CEE CURRENCIES MAY SLOW AS INTEREST-RATE PREMIUMS NARROW

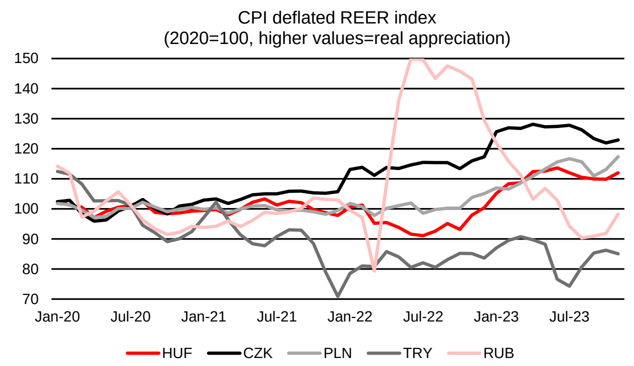
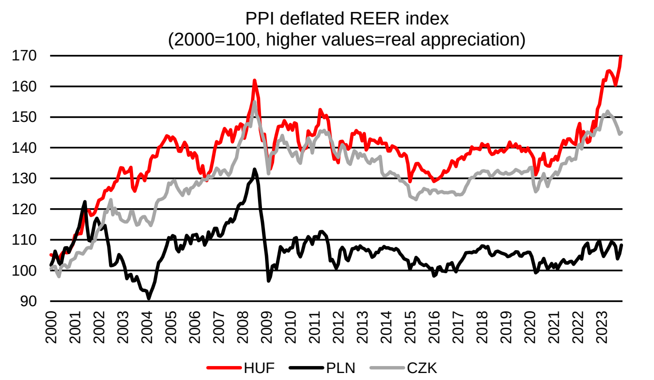


CHART 6: FASTER PPI GROWTH IN HUNGARY DELIVERED THE LARGEST LOSS IN HUF COMPETITIVENESS SINCE 2020



Source: Bank for International Settlements, ECB, Macrobond, UniCredit Research

Overview of our CEE FX forecasts

PLN gains, supported by capital inflows and a halt in NBP cuts, may start to be eroded in late-2024

The post-election PLN rally has pushed EUR-PLN to pre-pandemic lows, and this has been supported by improved risk perception and a halt in NBP rate cuts against a dovish shift in core market yields. We still see room for further moderate PLN gains in 1Q24, and this may drive EUR-PLN below 4.25 if global risk appetite remains strong. However, valuations suggest there is limited room for sustained PLN appreciation, as both inflation and wages are expected to remain elevated this year amid boosts in post-election public spending. A market-friendly policy shift by Poland's new government, a quick resolution of access to EU funds and a strengthening institutional framework may support capital inflows to Poland from corporate and portfolio investors. As we expect the NBP to remain on hold until at least March, a temporary widening in the interest-rate premium relative to the region may contribute to EUR-PLN bottoming out around 4.25 before the NBP resumes rate cuts. After local elections in April and elections for the European Parliament in June, we expect markets to focus on the need for fiscal adjustment, as Poland's fiscal deficit is likely to remain above 5% of GDP this year. We think it will be challenging to reach agreement over austerity measures in the governing coalition, given large differences in the economic policy agendas of the parties that make up Poland's governing coalition, and this may raise concerns about political stability in the run up to presidential elections in 2025. Therefore, we expect the PLN to trade closer to its fair-value levels, and project that EUR-PLN will move close to 4.40 by year-end following the partial reversal of recent PLN gains.

The HUF may underperform its CEE peers as outstanding high carry erodes

The HUF failed to benefit from a mid-December announcement about the opening of access to EUR 10.2bn of EU cohesion funds, while an additional EUR 20bn of funds allocated under the Recovery and Resilience Facility (RRF) and the 2021-27 cohesion funds remain locked by rule-of-law-related conditions and other horizontal conditions that Hungary still needs to address. Inflows of EU funds remain subject to close monitoring, and tensions with the EU are unlikely to ease following Hungary's veto of financial aid to Ukraine in the joint EU budget, which may keep risk premium elevated. Fiscal slippage in 2023 and 2024 and elevated debt (as state acquisitions and infrastructure investment are being funded by fiscal or quasi fiscal debt) will keep the risk of credit-rating downgrades in the spotlight. On the positive side, lower energy prices and compression in domestic demand supported quick adjustment of Hungary's external balance, which we expect to remain in surplus this year, muting external FX vulnerabilities. As a result of ongoing NBH rate cuts, the positive carry offered by the HUF is likely to erode the most among the CEE currencies. We think the HUF might end up being the CEE currency that is most exposed to stock vulnerabilities as carry-trade investors unwind positions that financed Hungary's external financing gap in 2022 and 1H23. As inflation is likely to stay around 6% in 2024 and as tight labor-market conditions keep wage growth in double-digit territory, the NBH is likely to face increasing pressure to loosen monetary conditions and accommodate a weaker forint, as the focus of policy shifts from inflation to growth. We think still-elevated carry will keep HUF depreciation muted in the first half of the year, when we expect EUR-HUF to trade in the 380-390 range. Pickup in domestic demand and market perception of a dovish shift in NBH governance may push EUR-HUF closer to 400 in late-2024, while the risk of sustained and sharp HUF depreciation could be muted by Hungary's positive basic balance as FDI inflows pick up.

The outlook for EUR-CZK looks balanced following further adjustment above 25.0

The delay in CNB cuts to 4Q23 may be followed by a faster decline in CZK rates next year if incoming data about wage and price setting at the beginning of the year are consistent with further disinflation. The CNB may deliver cuts in steps larger than 25bp this year, thereby narrowing the CZK's interest-rate premium versus the EUR. The narrowing interest-rate differential is consistent with EUR-CZK rising further, hitting 25.0 in 1Q24 and peaking around 25.20. Market expectations that the CNB policy rate will decline below 3.5% by end-2024 seem too aggressive. We expect the CNB to deliver fewer cuts than implied by the central bank's staff projections, thereby maintaining 0.7-0.8% positive real rates and a 100bp spread over ECB rates throughout our forecast horizon. As inflation in Czechia may slow to around 3.5% from January, the CZK's relative valuation is likely to improve compared to its CEE peers.

The CNB's relatively cautious stance and fiscal consolidation, combined with a stable current-account surplus and large FX reserves, may support stabilization of EUR-CZK in 2H24 around 25. As 2025 will be an election year, Czechia's fiscal outlook looks less certain beyond 2024, which may lead to increased CZK volatility in the run up to elections next year.

Structural FX shortage to keep USD-RUB on a gradually rising path

The Russian economy is coping with a structural FX shortage. Although the country reported a surplus in its trade balance, the share of hard currencies in Russia's export revenues has shrunk, and the amount of hard currency payments abroad exceeds hard currency revenues. The CBR's monetary tightening by hiking the policy rate from 7.5% to 16% between June and December was aimed at curbing domestic demand to cool inflation pressure and dampen import demand. We expect that softening inflation will create room for rate cuts to around 10% this year but that the CBR will keep real rates in positive territory to contain import growth. Recent RUB consolidation supported by capital-control measures targeting large exporters is likely to be temporary, as the structural adjustment in the trade balance will take longer and may be slowed by increased spending in the run up to presidential elections in March. We expect USD-RUB to remain below the key psychological level of 100 in 1H24, and this may be followed by a gradual rise towards 103 by year-end.

A pickup in capital inflows and the CBRT's tightening measures may dampen TRY weakness

In Turkey, the CBRT is close to ending the rate-hiking cycle that started in May, following the recalibration of economic policy after elections and the endorsement of tighter monetary policy to support disinflation by President Recep Tayyip Erdogan. We expect interest rates to peak at 45%, with rate cuts expected to start only in 2025. The CBRT aims to mute domestic-demand-driven inflation pressure with interest-rate hikes and tighter lending conditions, and this should help ease the country's structural FX shortage. The CBRT has been managing FX liquidity to keep TRY weakening under control while the private sector has been unwinding FX positions. We expect that a peak being reached in TRY rates may encourage capital inflows around the time of local elections in March, if there is no shift in market-friendly monetary-policy governance and if the risk of additional fiscal spending subsides. Light foreign positioning on local capital markets is a signal that there is room for a pickup in inflows, which may open the door for real appreciation in the TRY. However, Turkey's structural FX shortage has left more upside potential in local bonds than FX, which is likely to stay on a gradually depreciating path. We expect the pace of TRY depreciation to slow, keeping USD-TRY below 40 this year.

CHART 7. WE EXPECT FADING PLN STRENGTH, STABLE CZK IN THE MEDIUM TERM AND GRADUAL HUF DEPRECIATION

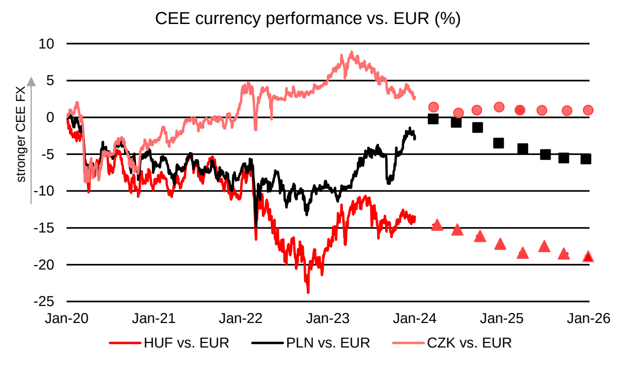
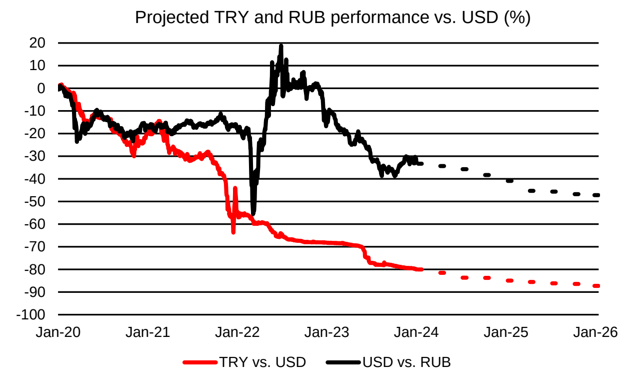


CHART 8. STRUCTURAL FX SHORTAGE MIGHT KEEP TRY AND RUB ON A GRADUAL DEPRECIATION PATH



Source: Bloomberg, Macrobond, UniCredit Research

Countries

Bulgaria

Baa1 stable/BBB stable/BBB positive*

Outlook

Bulgaria's government has consolidated its position after successfully passing constitutional amendments and after the most recent public opinion polls reconfirmed that there has not been a major increase in support for euro-sceptic parties.

Real GDP growth is likely to accelerate to 3% in 2024 and further to 3.3% in 2025 on the back of improved absorption of EU funds, which will boost investment, and a tight labor market, which will help solid wage growth push private consumption.

Euro adoption remains a key priority that will shape policymaking in the forecast period. To this end, the government aims to achieve a budget deficit below the 3% of GDP mark and to concentrate on the reforms needed to unlock the significant volume of EU funding that Bulgaria is entitled to receive in the next several years.

Strategy

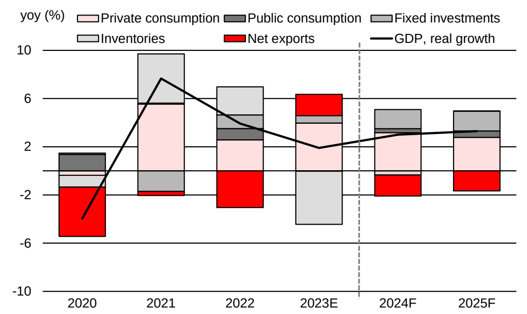
Increased external borrowing and more spending from fiscal reserves will cover higher sovereign funding needs this year.

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

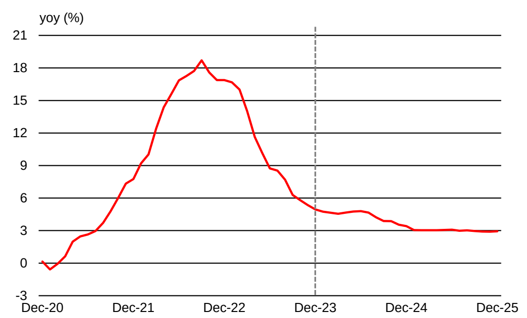
KEY DATES/EVENTS

- 26 Jan: sovereign rating review by Moody's
- Mid-Feb, early Mar: 4Q23 GDP (flash, structure)
- Mid-Feb: labor-force survey data for 4Q23
- End-Mar: nationwide house-price index for 4Q23

GDP GROWTH FORECAST



INFLATION FORECAST



Source: National Statistical Institute, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2021	2022	2023E	2024F	2025F
GDP (EUR bn)	71.1	85.8	96.9	105.4	113.5
Population (mn)	6.5	6.4	6.4	6.3	6.3
GDP per capita (EUR)	10 899	13 307	15 176	16 658	18 117
Real economy, change (%)					
GDP	7.7	3.9	1.9	3.0	3.3
Private consumption	8.5	3.9	6.0	4.6	4.0
Fixed investment	-8.3	6.5	3.4	8.7	8.5
Public consumption	0.4	5.5	-0.1	2.0	3.1
Exports	11.2	11.6	-0.8	3.5	4.4
Imports	10.7	15.0	-3.0	5.5	6.1
Monthly wages, nominal (EUR)	798	900	1021	1124	1215
Real wages, change (%)	9.0	-2.5	3.7	5.8	5.1
Unemployment rate (%)	5.3	4.1	4.3	4.0	3.8
Fiscal accounts (% of GDP)					
Budget balance	-4.0	-2.9	-2.2	-2.9	-3.0
Primary balance	-3.5	-2.5	-1.7	-2.4	-2.5
Public debt	23.4	22.1	21.9	23.1	24.6
External accounts					
Current-account balance (EUR bn)	-1.2	-1.2	-0.7	-1.2	-1.2
Current-account balance/GDP (%)	-1.7	-1.4	-0.7	-1.2	-1.1
Extended basic balance/GDP (%)	1.1	1.9	3.5	4.2	4.2
Net FDI (% of GDP)	1.8	2.4	3.0	3.2	3.4
Gross foreign debt (% of GDP)	58.1	51.6	46.3	43.3	40.9
FX reserves (EUR bn)	34.6	38.4	38.3	32.6	28.9
Months of imports, goods & services	9.4	7.4	7.9	6.1	4.9
Inflation/monetary/FX					
CPI (pavg)	3.3	15.3	9.7	4.3	3.0
CPI (eop)	7.8	16.9	4.9	3.4	2.9
LEONIA Plus (eop)	-0.53	1.82	3.80	3.15	2.42
USD-BGN (eop)	1.65	1.86	1.81	1.73	1.70
EUR-BGN (eop)	1.96	1.96	1.96	1.96	1.96
USD-BGN (pavg)	1.73	1.85	1.80	1.75	1.72
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

Euro adoption to shape policymaking

There have been no major shifts in the approval ratings of key parties

Eight months after a general election in April and two months after a municipal election in October, there have been no major shifts in the approval ratings of the main political parties in the country, according to public opinion polls conducted at the end of last year. At the same time, support for euro-sceptic parties has failed to increase by much. In our view, this suggests that polarization in the Bulgarian society is slowly decreasing and that the share of voters who support compromise as a means to address country's challenges remains significant.

Constitutional amendments will help reduce corruption

The parties supporting the government agreed on constitutional amendments to improve the functioning of the judiciary system and to reduce corruption. The amendments limit the functions of the prosecution service to criminal lawsuit procedures, thereby divesting it of powers to exercise general supervision as to the legality of acts and steps taken by state bodies. The constitutional amendments set up a special mechanism for the investigation of the prosecutor general if he or she is suspected of committing a publicly prosecutable offence. They also ensure that most of the members of the Supreme Judiciary Council are elected directly by judges, which should limit the ability of politicians to interfere with the work of the court.

Amendments will improve the balance of power between institutions

The constitutional amendments should improve the balance of power between state institutions. They deny the president full discretion to appoint a caretaker prime minister and limit his or her choice to a small number of predefined high-ranking state officials. If early elections need to be held, the parliament will not be dissolved and will retain its credentials until the MPs from the next legislature are sworn in. According to the amendments, the president must schedule parliamentary elections within two months after the appointment of a caretaker cabinet. Importantly, a two-thirds majority will be required when the parliament elects members of the regulatory authorities. Lastly, the amendments envisage that persons with dual nationalities will be eligible to become members of both the administration and the parliament.

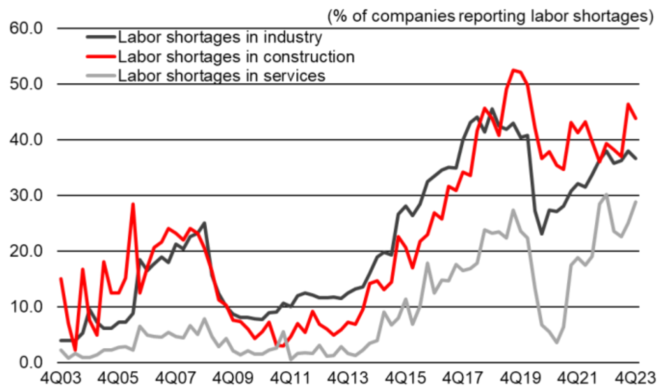
GDP growth to accelerate

The pace of economic expansion is likely to gain more-solid momentum in 2024, with real GDP growth accelerating to 3% yoy. GDP growth could accelerate further to around 3.3% in 2025, when we expect private capex and exports to rebound amid stronger foreign demand.

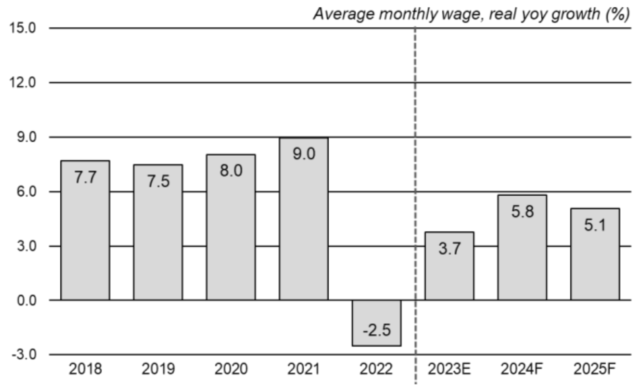
Private consumption will remain resilient

According to the demand-side components of GDP, private consumption will remain the key driver. Disinflation will help the purchasing power of incomes to rise, while deepening labor shortages (see chart) will keep real wage growth (see chart) above productivity. Although to a lesser degree, private consumption will draw support from rising public transfers envisaged in the state budget. These transfers include a 20% rise in Bulgaria's minimum wage, 12% growth in the average pension and double-digit increases in some social spending. However, real growth in consumption is likely to lose some momentum in 2024, compared to 2023.

DEEPENING LABOR SHORTAGES ARE PART OF THE PICTURE



REAL WAGE GROWTH LOOKS SET TO REBOUND IN 2024



Source: Eurostat, National Statistical Institute, UniCredit Research

The latter will be driven by a sizeable downward base effect and a deceleration in retail credit growth, as borrowing costs associated with BGN-denominated loans are likely to rise, although the scale and timing of such increases seem highly uncertain at the moment.

Better EU-fund absorption should push investment recovery

Gross fixed-capital formation is set to play a key role in acceleration of GDP growth in both 2024 and 2025. After tangible deceleration of growth in 2022 and 1H23, fixed investments are likely to post a solid rebound. The latter mostly reflects our expectation for a significant increase in public capex, as absorption of EU funds has improved, following a prolonged period of political uncertainty when many infrastructure projects had come to a standstill. Residential construction is likely to lose some momentum but will nevertheless remain relatively high due to a large volume of newly started residential construction over the past several years (see chart). Deceleration in residential construction is likely to be more than offset by strong growth in machinery and equipment investment. We think that most projects in 2024 will aim to increase energy efficiency rather than to expand production capacity. However, increasing signs of de-risking from China, along with a rebound in external demand envisaged in our global scenario, should help projects aimed at expanding production capacity to rise in 2025.

Foreign direct investment (FDI) to rise amid stronger foreign demand

Disinflation to slow in 2024

Disinflation will play a key role in boosting demand in 2024 and 2025. Easing commodity prices, base effects and government measures to cap price rises for essential commodities all helped push consumer-price inflation down to 5.4% at the end of November (see chart). However, we expect disinflation to slow in 2024 and particularly in 2025. Somewhat lower commodity prices envisaged in our global baseline macro scenario will help reduce consumer-price inflation in 2024 and, to a somewhat smaller degree, further in 2025. At the same time, double-digit labor-cost increases are likely to keep service prices sticky, while the withdrawal of VAT cuts envisaged in the 2024 state budget will put pressure on the prices of some essential goods, such as bread, flour, electricity, gas and central heating. Finally, there are several sectors in the local economy where companies have significant pricing power, which is likely to further undermine the strength of disinflationary forces acting in the period of the forecast.

The impact of past inflationary shocks fade away

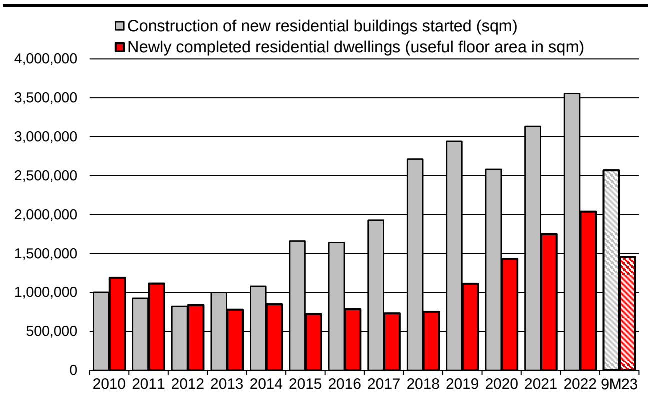
Euro adoption remains a key policy priority

Economic policy will be shaped by a need to strike a balance between two main priorities: to sustain strong income growth on one side and to preserve the medium-term sustainability of public finances ahead of euro adoption next year on the other. To this end, the Bulgarian government aims to achieve a budget deficit in line with the EU's 3% of GDP rule in both 2024 and 2025, after running a cash deficit equivalent to 2.8% of the country's GDP in 2023.

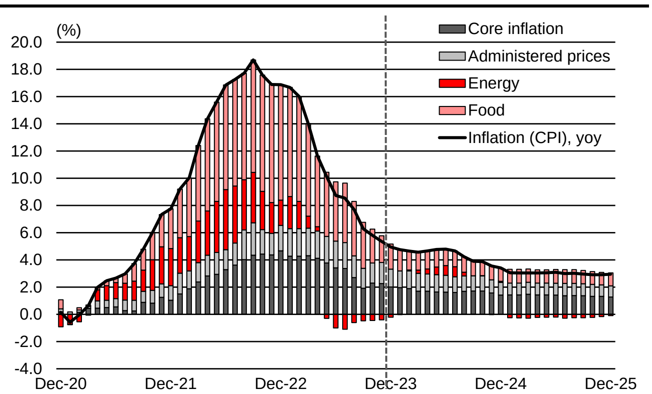
Stronger progress in EU funds absorption lies ahead

All but 4 of the 66 requirements linked to the second tranche of the country's Recovery and Resolution Plan (RRP) have been implemented, and funds are expected to be released in February. Stronger progress ahead looks likely, in our view, because Bulgarian authorities say they are strongly committed to the reforms envisaged in the country's RRP, while requirements linked to the payment of the next three tranches look somewhat less challenging to implement.

CONSTRUCTION OF RESIDENTIAL BUILDINGS TO REMAIN HIGH



DISINFLATION IS SET TO SLOW IN 2024 AND FURTHER IN 2025



Source: National Statistical Institute, UniCredit Research

Increase in debt issuance looks likely this year

The Bulgarian government met its budget-deficit target last year

Bulgaria's ministry of finance posted a cash deficit equivalent to 2.8% of GDP last year. The result is in line with both the government target and the limit established in the Stability and Growth Pact. What is more, the result is far better than the 6.4% of GDP deficit envisaged in the forecast of the caretaker government in March 2023, which, at that time, put at risk euro entry in 2025.

Fiscal policy to support growth this year

The consolidated fiscal program for 2024 contains several measures aimed at supporting economic growth. The state budget envisages increasing funding allocated to pensions and health care, as well as to other social costs related to an aging population, by around 1pp of GDP. This will be added on top of an increase in public capex equivalent to around 1pp of GDP, which should contribute to domestic-demand expansion this year.

Some important spending increases are envisaged this year

Fiscal revenues are set to increase in broadly the same proportions, keeping the country's budget deficit at 3% of GDP. These include discontinued support for households (introduced to mitigate the impact from a cost-of-living crisis in 2020), equivalent to 0.2% of GDP; a higher contribution payment (including due to a higher income cap for contribution payments), equivalent to 0.4% of GDP; higher taxes (due to the introduction of a 15% minimum profit tax on large companies plus higher taxes on gambling), equivalent to 0.2% of GDP. The rest should come from higher EU funding plus measures to improve tax collection, which include but are not limited to the compulsory preliminary declaration of cargo associated with high fiscal risk. This already helped boost collection last year when it was launched for the first time.

Dangerous fiscal slippage looks very unlikely

Risks that there will be a major deterioration in the country's budget deficit seem small. This is because high inflation and measures to improve collection will continue pushing revenues higher, while delays to some projects in the public capex program could easily save billions of leva.

External borrowing will dominate the picture

We expect to see a moderate increase in debt issuance to BGN 9.8bn this year, from BGN 7.4bn last year. A moderately larger volume of maturing debt and a somewhat larger cash deficit will be behind higher anticipated debt issuance in 2024. We think the government will satisfy only a small portion of its funding needs on the domestic bond market (BGN 500mn), while external borrowing (EUR 4.75bn) will dominate the picture. A small decline in fiscal reserves will likewise play a part in covering the funding needs of the Bulgarian sovereign in 2024.

GROSS GOVERNMENTAL FINANCING REQUIREMENTS

EUR bn	2023E	2024F	2025F
Gross financing requirement	**4.5**	**5.2**	**5.8**
Budget deficit	2.7	3.2	3.4
Amortization of public debt	1.7	2.0	2.4
Domestic	0.3	0.3	2.2
Bonds	0.3	0.3	2.2
Bills	0.0	0.0	0.0
Loans/other	0.0	0.0	0.0
External	1.4	1.7	0.2
Bonds and loans	1.2	1.5	0.0
IMF/EU/other IFIs	0.2	0.2	0.2
Financing	**4.5**	**5.2**	**5.8**
Domestic borrowing	0.0	0.3	1.3
Bonds	0.0	0.3	1.3
Bills	0.0	0.0	0.0
Loans/other	0.0	0.0	0.0
External borrowing	3.8	4.8	4.5
Bonds and loans	3.8	4.8	4.5
IMF/EU/other IFIs	0.0	0.0	0.0
Privatization/other	0.0	0.0	0.0
Change in fiscal reserves (- =increase)	0.6	0.2	0.0

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2023E	2024F	2025F
Gross financing requirement	**22.7**	**23.5**	**21.9**
C/A deficit	0.7	1.2	1.2
Amortization of medium- and long-term debt	5.4	5.4	3.6
Government/central bank	1.4	1.7	0.2
Banks	1.1	1.0	1.1
Corporates/other	2.9	2.7	2.3
Amortization of short-term debt	16.6	16.9	17.2
Financing	**22.7**	**23.5**	**21.9**
FDI (net)	2.9	3.4	3.9
Portfolio equity, net	-1.3	-1.0	0.0
Medium and long-term borrowing	5.8	5.8	4.4
Government/central bank	3.8	4.8	4.5
Banks	1.0	1.1	1.2
Corporates/other	1.0	-0.1	-1.3
Short-term borrowing	16.9	17.2	17.5
EU structural and cohesion funds	1.1	2.3	2.0
Other	-2.8	-9.9	-9.4
Change in FX reserves (- = increase)	0.1	5.8	3.6
Memoranda:			
Nonresident purchases of LC gov't bonds	0.0	0.0	0.0
International bond issuance, net	2.6	3.3	4.5

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

Croatia

Baa2 positive/BBB+ positive/BBB+ positive*

Outlook

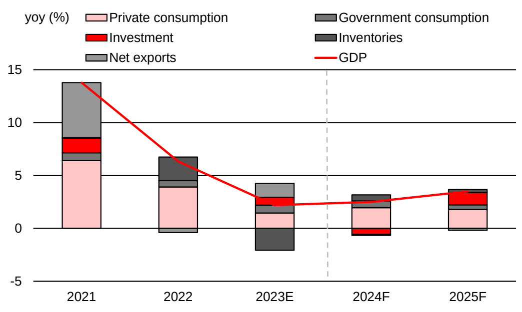
We expect GDP growth to pick-up from 2.2% in 2023 to 2.5% in 2024. Both forecasts were lowered slightly, from 2.6% and 2.4%, respectively, reflecting actual GDP figures for 1Q-3Q23 and weaker-than-expected external demand in 2H23. As investment is likely to contract, other components of domestic demand should step in. Private consumption growth is accelerating as real income recovers while the fiscal proposal for 2024 will bring in expansion in spending in a super election year in Croatia (EU elections, general elections and presidential elections). In 2025, we expect growth to accelerate to 3.5%, driven by a recovery in investment and net external demand. Inflation is decelerating and we see it declining towards 3% by the end of 2024 and to 2.5-3% throughout 2025. In the general elections and EU elections, according to recent polls, the current HDZ government and prime minister enter 2024 with the advantage, the same is signaled for the current president in the presidential elections.

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

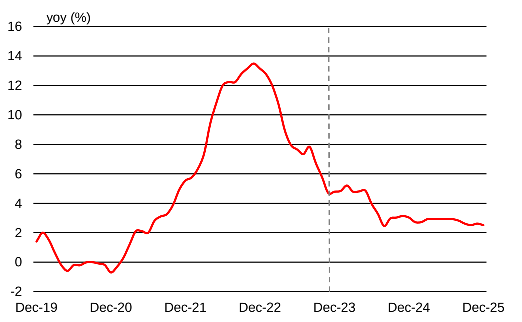
KEY DATES/EVENTS

- 2 Feb, 1 Mar: CPI
- 27 Feb: Q4 & FY23 GDP
- 15 Mar: S&P rating review

GDP GROWTH FORECAST



INFLATION FORECAST



Source: Eurostat, CNB, Crostat, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

EUR bn	2021	2022	2023E	2024F	2025F
GDP (EUR bn)	58.4	68.0	73.1	77.8	82.8
Population (mn)	3.9	3.9	3.8	3.8	3.8
GDP per capita (EUR)	15,058	17,635	19,069	20,395	21,814
Real economy, change (%)					
GDP	13.8	6.3	2.2	2.5	3.5
Private consumption	10.7	6.7	2.5	3.3	3.0
Fixed investment	6.6	0.1	4.0	-3.0	6.6
Public consumption	3.0	2.7	3.5	3.0	2.0
Exports	32.7	27.0	-3.0	3.0	4.9
Imports	17.3	26.5	-5.0	3.1	5.1
Monthly gross wages, nominal (EUR)	1276	1380	1573	1709	1828
Real wages, change (%)	1.5	-2.5	5.0	4.4	4.2
Unemployment rate (%)	7.6	7.1	6.5	6.1	5.5
Fiscal accounts (% of GDP)					
Budget balance	-2.5	0.1	-0.5	-1.9	-1.7
Primary balance	-1.3	1.5	0.7	-0.7	-0.5
Public debt	77.9	68.2	63.8	61.4	58.6
External accounts					
Current account balance (EUR bn)	0.6	-1.9	-0.4	-0.6	-0.7
Current account balance/GDP (%)	1.0	-2.8	-0.6	-0.8	-0.9
Extended basic balance/GDP (%)	8.5	5.0	7.0	5.7	5.7
Net FDI (% of GDP)	5.2	5.4	3.4	3.6	3.6
Gross foreign debt (% of GDP)	80.8	72.9	81.5	78.6	76.4
FX reserves (EUR bn)	25.0	27.8	3.5	3.7	4.1
Months of imports, goods & services	9.8	7.5	0.9	0.9	0.9
Inflation/monetary/FX					
CPI (pavg)	2.6	10.8	8.0	3.8	2.8
CPI (eop)	5.5	13.1	4.5	3.0	2.5
3M money-market rate (Dec. avg.)	n.a.	n.a.	EUR	EUR	EUR
USD/FX (eop)	6.64	7.06	EUR	EUR	EUR
EUR/FX (eop)	7.52	7.53	EUR	EUR	EUR
USD/FX (pavg)	6.36	7.16	EUR	EUR	EUR
EUR/FX (pavg)	7.52	7.53	EUR	EUR	EUR

Source: Eurostat, CNB, UniCredit Research

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

Reverting to domestic sources of growth

We forecast GDP growth at 2.5% in 2024 and 3.5% in 2025

We expect GDP growth to pick-up from 2.2% in 2023 to 2.5% in 2024. Both forecasts were lowered slightly from 2.4% and 2.6% respectively. The revision reflects actual GDP figures for 1Q-3Q23 and weaker-than-expected external demand in 2H23, with the latter also likely to affect GDP performance in 2024. We expect growth in 2024 to be mainly driven by private consumption, which started to accelerate in 2023 due to a boost from real income recovery and much better economic sentiment than in the eurozone, while the government budget proposal for 2024 confirmed an expansion in spending (more than an 11% increase in central government expenditure). Investment is likely to decline due to a strong base effect from 2023, when final efforts were being made to spend the EU budget allocations for 2014-20, and the EU Solidarity Fund. Net exports will subtract slightly from growth. In 2025, we see GDP growth picking up to 3.5%, driven by the recovery in investment (including full absorption of NGEU and an acceleration in spending 2021-27 EU budget allocations) and external demand.

Main drivers of growth in 2024 should be private and public consumption before investment and external demand join in 2025 to accelerate growth

EU funding is a strong source of funding for Croatia, where the country so far stands out as top CEE performer in terms of the absorption of its NGEU allocation

EU funds will continue to play an important role for Croatia, with the focus now on funding through NGEU allocations and the 2021-27 EU budget allocations. While the absorption of funds from the EU budget is still slow (the 2024 budget envisages less than 10% of the around EUR 13bn allocation for 2021-27 will be absorbed), the absorption of NGEU funds is proceeding quickly, with Croatia using among the largest proportion of their allocated funds in the EU and the most among the CEE countries. The European Commission (EC) recently disbursed the third tranche of the grant component which, at EUR 700mn, pushed the absorption to EUR 2.9bn (53% of the EUR 5.5bn grant allocation). The EC has also confirmed modifications to Croatia's National Recovery and Resilience Plan (NRRP), including EUR 269mn of REPowerEU allocations and EUR 4.4bn of loans within the instrument. Soon (likely in 2024), Croatia intends to absorb another two tranches of the grant component (totaling EUR 1.05bn) and EUR 1.2bn of the loan allocation. The allocation from the 2021-27 budget is unlikely to have much of an impact on investment until 2025.

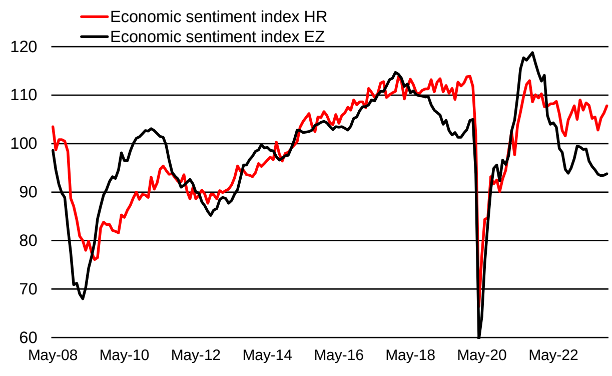
Employment to increase further at a slower pace, with unemployment reaching a historical low

With employment at its highest level since the 1990s, employment growth might slow in 2024 (from above 2% to 1-1.5% yoy). The employment rate among 15-64-year-olds rose to over 65% and the activity rate to more than 70% in 2023, while the unemployment rate fell to close to 6%. The number of employed persons has not been higher since the 1990s, with more than 1.65mn people registered as employed on average during 2023. We forecast employment to increase further throughout 2024 and 2025, but at a slower pace, bringing the unemployment rate well below 6% in 2025.

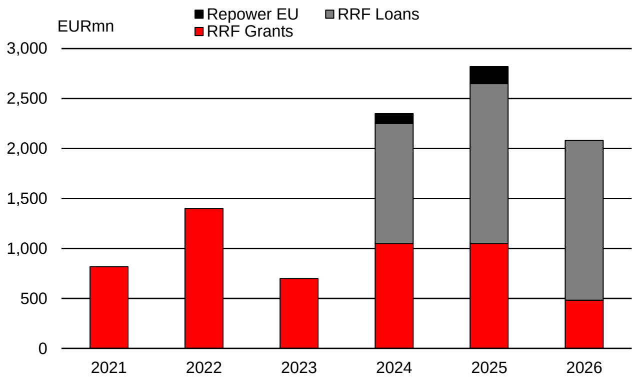
Labor market tightness resulted in real wage recovery

Given the current trends in the labor market, it is unsurprising that real wages (after 15 months of decline in real terms) started to recover in 2023 once inflation eased. On an annual level, real wages increased by an average 3.5% (with nominal wages accelerating) in 2023, with growth likely to continue in 2024 at an average pace of between 4.5 and 5% before slowing slightly in 2025.

ECONOMIC SENTIMENT GAP VS EUROZONE WIDENED



NGEU ABSORPTION SHOULD BE SUPPORTIVE



Source: European Commission, Croatian Ministry of Finance, Crostat, HNB, UniCredit Research

Disinflation should continue in 2024 with inflation likely to reach 3% by the end of 2024…

…and drop below 3% in 2025

Disinflation is likely to continue in 2024. Inflation has been slowing since the beginning of 2023 mainly driven by energy, food and, to a lesser extent, core inflation, and had dipped below 5% by the end of 2023. Prices for industrial products are contributing to disinflation, while inflation in services prices appears to be stickier. Tourism prices have driven services inflation over the last two years, yet Croatian services prices are comparatively very low compared to average prices in eurozone (around 60% of EU average) which implies that services inflation will likely be the source of higher inflation in Croatia compared to the eurozone in the medium term. In 2024, we forecast inflation to drop toward 3% by the end of year and to move between 2.5% and 3% in 2025. We see upside risk to our forecast, mostly due to solid domestic demand and rising wages, as well as external factors such as geopolitical risk.

Higher fiscal spending in 2024 will not threaten fiscal rules

The fiscal deficit is likely to widen in 2024, reflecting 2023 hikes to public sector wages and pensions and other transfers ahead of this year's elections. Inflation over the past two years has benefitted fiscal revenue, with Croatia's fiscal balance coming close to balance. However, according to the government's budget proposal for 2024, the fiscal balance will register a deficit of 1.9% of GDP in 2024, with a risk that it could be even wider this year. Central government expenditure is planned to increase by more than 11%, mainly driven by expenditure on employees (more than a 30% increase in wages and different add-ons), pensions, and different transfers, while revenues are expected to rise in line with inflation (around 3%). Following different adjustments, the general government deficit, according to the European System of Accounts (ESA 2010), should reach 1.9% of GDP during 2024 (from 0.5% of GDP in 2023) and decline slightly in 2025. Though the 2025 budget will be likely be prepared by a new government and will depend on its strategy, we expect it to follow a low-deficit approach.

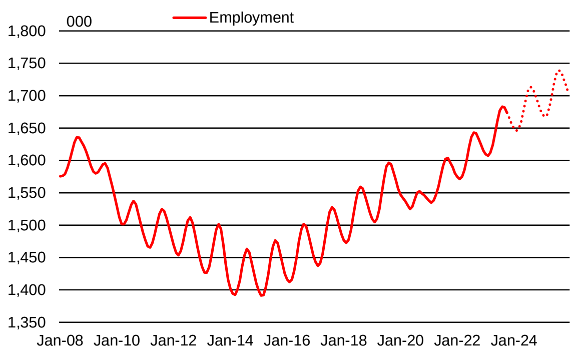
Sovereign rating with positive outlook opens the opportunity to reach A grade in 2024

After the 2022 upgrades of Croatia's sovereign rating, rating agencies appeared to be in wait-and-see mode in 2023. However, due to solid growth and fiscal performance and improving debt metrics, all three agencies assigned a positive outlook this year. If the debt/GDP ratio declines further and the economic environment does not deteriorate, this opens the potential for the sovereign to be upgraded to an A rating (by Fitch and S&P). However, the agencies may hold back before the planned elections.

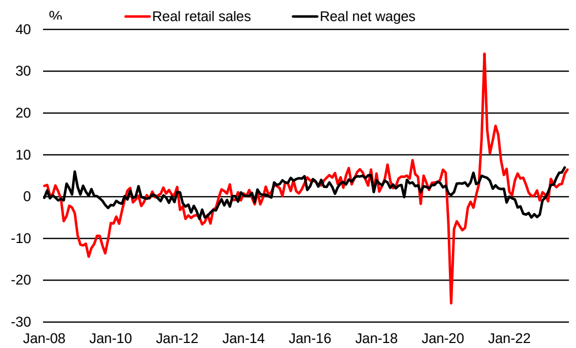
2024 is super election year for Croatia

2024 will be super-election year for Croatia. In early June, EU parliamentary elections will be held. The initial idea to have general elections in parallel seems to have been abandoned, although there has been no clear communication of when they will be organized (most likely in the autumn). Finally, presidential elections will be held at the end of December. The polls show the incumbent HDZ with a clear lead, with its government, led by its leader and prime minister Andrej Plenković to continue its domination of the local political ecosystem. There is also no sign of a viable candidate to challenge current president Zoran Milanović as the strongest opponent and disruptor to the current government, though he has not confirmed yet he will run for another term.

EMPLOYMENT LIKELY TO GROW BUT AT SLOWER PACE



REAL INCOME RECOVERY WORKS WELL FOR CONSUMPTION



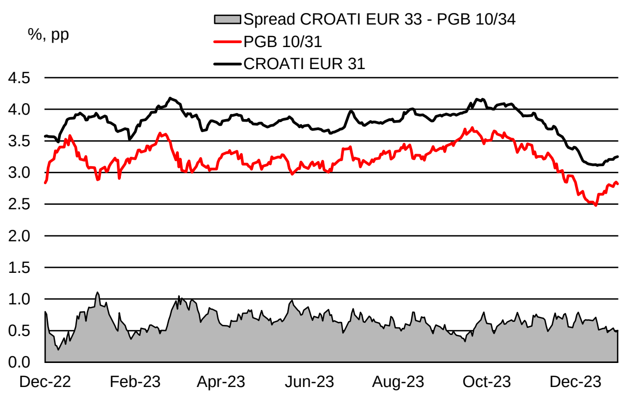
Source: Eurostat, Crostat, Croatian Ministry of Finance, UniCredit Research

CROATI: watching issuance, fiscal needs and rating outlook

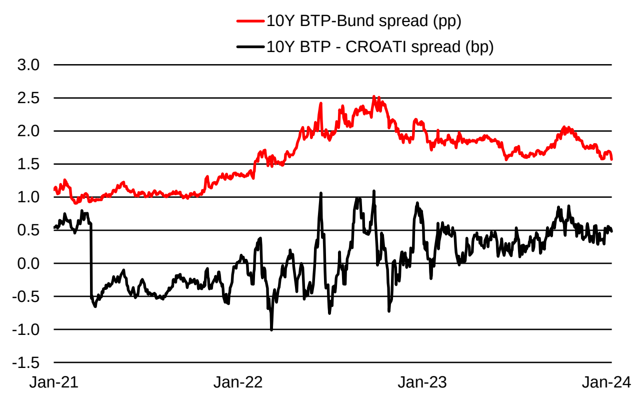
Debt ratio trajectory seems attractive, while government funding is oriented towards capital markets using strong demand for retail placements

Considering the previously discussed approach to spending, but keeping the deficit under control, in 2024 we may see a further decline in the public debt ratio, although the deficit will require an increase in funding. The main approach of the finance ministry is to continue funding it through capital markets. Positive outcomes from the placement of retail bonds and retail T-bills, taking advantage of the low interest rates on bank deposits and a lack of interest from individual investors for other instruments on capital markets in 2023 gives the ministry more options in 2024 (the ministry of finance plans to place EUR 4.5bn through bonds compared to EUR 3.2bn of redemptions). Regarding the international market, there will certainly be one Eurobond issue (around EUR 1.5bn) early in 2024 to align with the redemption profile. The rating upgrade potential will likely offer some spread-tightening prospects.

CHEAP CROATI MORE RESILIENT IN SELLOFFS THAN EUROZONE PEERS



UPWARD TREND IN SPREADS TO EUROZONE PERIPHERY



Source: Croatian Ministry of Finance, Bloomberg, UniCredit Research

GOVERNMENT'S GROSS FINANCING REQUIREMENTS

EUR bn	2023E	2024F	2025F
Gross financing requirement	**7.9**	**9.0**	**11.3**
Budget deficit	0.4	1.5	1.4
Amortization of public debt	7.6	7.5	9.9
Domestic	5.4	4.9	7.6
Bonds	1.5	1.9	3.3
Bills	2.7	2.0	2.0
Loans	1.2	1.0	2.3
External	2.2	2.6	2.3
Bonds and loans	2.0	2.5	2.2
IMF/EU/other international financial institutions	0.1	0.1	0.1
Financing	**7.9**	**9.0**	**11.3**
Domestic borrowing	6.3	6.2	8.2
Bonds	3.3	3.0	4.0
Bills	2.0	2.0	3.0
Loans	1.0	1.2	1.2
External borrowing	1.6	2.8	3.1
Bonds	1.5	1.5	1.5
IMF/EU/other international financial institutions	0.1	1.3	1.6
Privatization/other	0.0	0.0	0.0

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2023E	2024F	2025F
Gross financing requirement	**19.9**	**19.1**	**17.8**
C/A deficit	0.4	0.6	0.7
Amortization of medium- and long-term debt	5.7	4.9	4.6
Government/central bank	2.2	2.6	2.3
Banks	0.3	0.3	0.3
Corporates/other	3.2	2.0	2.0
Amortization of short-term debt	13.8	13.6	12.5
Government/central bank	6.5	6.0	6.0
Banks	3.0	2.5	2.5
Corporates/other	4.3	5.1	4.0
Financing	**19.9**	**19.1**	**17.8**
FDI (net)	2.7	2.9	2.9
Portfolio equity, net	0.3	0.5	0.5
Medium and long-term borrowing	3.0	4.2	4.5
Government/central bank	1.6	2.8	3.1
Banks	0.4	0.4	0.4
Corporates/other	1.0	1.0	1.0
Short-term borrowing	8.3	6.6	6.6
EU structural and cohesion funds	3.1	2.3	2.5
Other	3.0	2.8	1.2
Change in FX reserves (= increase)	-0.4	-0.2	-0.4
Memoranda:			
Nonresident purchases of LC gov't bonds	n.a.	n.a.	n.a.
International bond issuance, net	0.3	0.2	0.0

Source: CNB, Croatian Ministry of Finance (cash basis), UniCredit Research

Czechia

Aa3 stable/AA- stable/AA- negative*

Outlook

We are becoming cautiously optimistic regarding prospects for private consumption, while fixed capital formation is expected to see only sluggish growth. As a result, GDP may grow by 1.5% in 2024, less than previously estimated, accelerating to 2.5% in 2025. Inflation is forecast to hit 3-4% in January, with limited downward potential thereafter. The ČNB may cut the repo rate to 4.5% by the end of 2024. The public sector deficit is projected to drop below 3% of GDP in 2024, but difficult economic reforms are yet to be accomplished.

Strategy

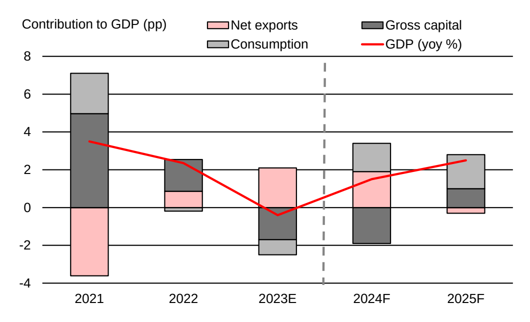
Fiscal tightening and valuation are likely to support CZGBs in 2024, even if the ČNB cuts less than the market expects.

Authors: Pavel Sobíšek, Chief Economist Czech Republic (UniCredit Bank Czech Republic and Slovakia),
Jirí Pour, Economist (UniCredit Bank Czech Republic and Slovakia)

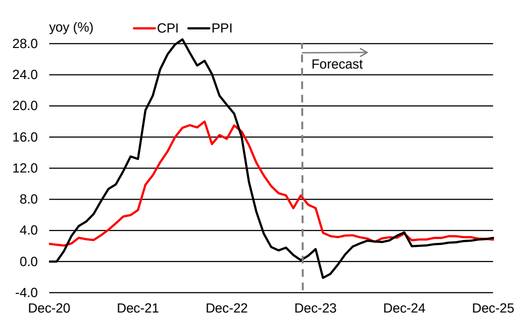
KEY DATES/EVENTS

- 02 Feb, 29 Mar: ČNB policy meetings
- 20 Jan, 01 Mar: 4Q23 GDP (flash, structure)
- 11 Jan, 15 Feb, 11 Mar: CPI
- 2 February: Moody's rating review
- 23 February: Fitch rating review

GDP GROWTH FORECAST



INFLATION FORECAST



Source: CZSO, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

EUR bn	2021	2022	2023E	2024F	2025F
GDP (EUR bn)	238.1	276.2	306.0	310.8	327.4
Population (mn)	10.5	10.8	10.9	10.8	10.8
GDP per capita (EUR)	22,677	25,667	28,144	28,910	30,402
Real economy, change (%)					
GDP	3.5	2.4	-0.4	1.5	2.5
Private Consumption	4.1	-0.7	-3.2	2.5	3.0
Fixed Investment	0.7	3.0	2.1	2.0	3.5
Public Consumption	1.4	0.6	3.4	1.4	1.5
Exports	6.8	7.2	2.8	3.5	3.8
Imports	13.2	6.3	0.0	1.5	3.7
Monthly wage, nominal (EUR)	1493	1641	1811	1862	1976
Real wage, change (%)	1.9	-8.5	-2.7	3.3	3.0
Unemployment rate (%)	3.8	3.4	3.6	3.6	3.5
Fiscal accounts (% of GDP)					
Budget balance	-5.1	-3.2	-3.5	-2.8	-3.0
Primary balance	-4.3	-2.1	-2.2	-1.4	-1.6
Public debt	42.0	44.2	44.3	44.9	45.4
External accounts					
Current account balance (EUR bn)	-6.6	-16.9	-1.0	3.9	4.6
Current account balance/GDP (%)	-2.8	-6.1	-0.3	1.2	1.4
Extended basic balance/GDP (%)	-0.6	-3.1	0.9	3.4	3.7
Net FDI (% of GDP)	0.5	2.5	0.7	1.7	1.8
Gross foreign debt (% of GDP)	74.0	65.6	61.3	60.7	59.9
FX reserves (EUR bn)	153.3	131.3	131.0	133.0	135.0
Months of imports, goods & services	11.0	7.6	8.1	8.3	8.1
Inflation/Monetary/FX					
CPI (pavg)	3.8	15.1	10.7	3.2	3.0
CPI (eop)	6.6	15.8	6.9	3.6	2.8
Central bank target	2.0	2.0	2.0	2.0	2.0
Central bank reference rate (eop)	3.75	7.00	6.75	4.50	3.50
3M money market rate (Dec avg)	3.50	7.26	6.85	4.55	3.60
USD/FX (eop)	22.0	22.6	22.7	22.1	21.7
EUR/FX (eop)	24.9	24.1	24.7	25.0	25.0
USD/FX (pavg)	21.7	23.4	22.2	22.4	21.9
EUR/FX (pavg)	25.6	24.6	24.0	24.9	25.0

Source: CZSO, Czech National Bank, UniCredit Research

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

Better growth and fiscal prospects

Weak activity in 3Q23 was due to one-offs, not heralding the start of a new recession

Poor GDP data in 3Q23 (-0.5% qoq / -0.7% yoy), the worst since the COVID-19 era, was affected by several one-offs and is unlikely to herald the start of a new recession. Car production was suffering from supply-side constraints related to flooding in Slovenia. According to a survey, up to 20% of Czechs took advantage of cheaper retail goods in neighboring Poland, some of them regularly. Moreover, energy consumption by households tumbled in 3Q23 (electricity -5.3% yoy, natural gas -28.2% yoy), driven by saving measures taken as well as mild September weather. We estimate that lower energy consumption alone may have knocked down real GDP by 0.3% yoy (seasonally adjusted).

In 4Q23, headwinds eased but fundamentals remained weak, allowing for only marginal sequential GDP growth, with an ongoing annual decline. One point to consider is that the fiscal consolidation package comes into force from the start of 2024. The package consists of dozens of individual measures that will create a combined negative fiscal impulse of 1.1% of GDP in 2024, according to the ČNB. While the measures did not eat into household purchasing power in 4Q23, they probably dampened consumer expectations, as the legal process was underway while inflation remained high. As a result, some households probably increased their savings further in anticipation of economic hardship in early 2024.

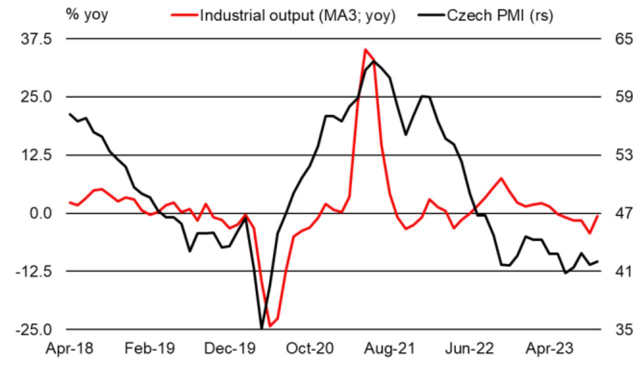
Prospects for spending in 2024 are turning cautiously optimistic

Looking into 2024, household spending prospects are turning cautiously optimistic. First, real wages are set to grow more quickly from 1Q24 onwards, after nine poor quarters. Second, projected monetary easing by the ČNB may drive households to spend some of their extra savings or at least the interest earned on their savings over past two years, the latter worth 1.6% of GDP. Third, VAT on food is set to drop in Czechia from 15% to 12%, while it will return to 5% from 0% in Poland, probably from 2Q24, which may bring some Czechs back to local stores. All in all, we expect private consumption to expand by 2.5% in 2024, speeding up to 3.0% in 2025.

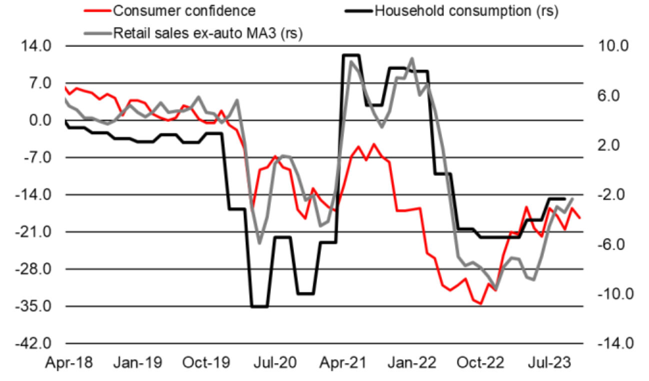
We expect inflation to fall, without entering the 1-3% target band

With expected nominal wage growth of 6-7% in 2024, it is crucial that inflation drops meaningfully for households to boost real spending. We do expect it to fall but not necessarily as low as the upper bound of the ČNB's 1-3% target range. On the one hand, little external price pressure is assumed. On the other hand, we are concerned about turn-of-the-year price adjustments for services and, to a lesser extent, food, in response to cost increases from 2023. In addition, service providers could take the opportunity of the expected improvement in household purchasing power to pass on more of the cost increases to households. Government policies will also add to consumer price growth, mainly due to the hike in energy prices (the distribution component up 67% for electricity and 39% for gas).

OUTPUT CONTRACTION PREDICTED BY MANUFACTURING PMI IS DELAYED BY BASE EFFECT IN AUTO SECTOR



FURTHER RISE IN CONSUMER CONFIDENCE WOULD BE NEEDED TO SIGNAL A CONSUMPTION REBOUND



Source: CZSO, UniCredit Research

Government policies will add to price growth at the start of 2024

It is uncertain how much this will influence inflation, as the consumer basket is set to undergo its biennial reweighting in January 2024. In 2025, the year of next general elections, we expect external inflationary shocks to be stronger than domestic ones.

Fixed capital formation likely to grow by just 2.0% in 2024

We forecast fixed capital formation to grow by only 2.0% in 2024. The efficiency and security of energy and input supply, as well as the availability of labor, will continue to be the key topics for private projects. On a negative note, no major greenfield investment appears to be in the pipeline after the government failed to convince Volkswagen to build one of its gigafactories in Czechia. On a more positive note, we expect some previously delayed residential building projects to go ahead in 2H24 once interest rates are on a clear downward path. Public investment may remain broadly stable. Projects co-financed by the 2021-27 EU budget are still not out of their initial stages, but RRF-funded projects could gather momentum slowly despite a limited pipeline. By 2025, production-capacity-related private projects may become more frequent, giving fixed capital formation an additional boost. The current account is projected to return to a small surplus in 2024 for the first time in three years, as the inventory sell-off improves net exports and dividend outflows ease due to lower corporate profits in 2023.

Destocking will affect GDP structure over the whole of 2024-25

In the past two years, inventories rose by 6-9% of GDP above the pre-COVID level, depending on methodology, more than elsewhere in EU-CEE. This is why we expect Czechia's inventory cycle to be uncorrelated to that of neighboring countries. We expect destocking to affect Czech GDP structure over the whole of 2024-25 by lowering gross capital formation and raising net exports. However, the intensity of the process remains uncertain, as value chains may start to change their modus operandi towards higher inventory needs.

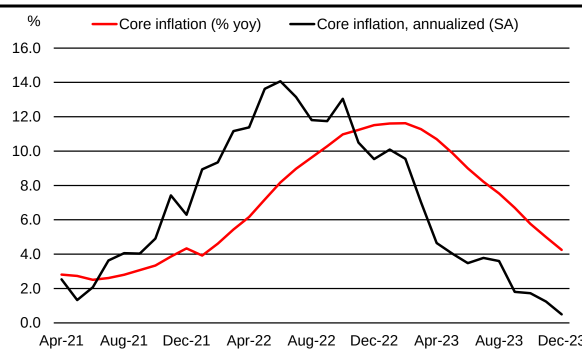
We see the repo rate at 4.5% by end-2024, which would be 1pp above the ČNB's forecast

We expect the ČNB to cut the repo rate at most of its 2024 meetings, with some steps larger than 25bp. We estimate the repo rate will reach 4.5% by the end of 2024, which would be a full percentage point above the level forecast by the ČNB itself. Our more cautious view is consistent with inflation remaining above the ČNB's tolerance band. The rate cutting may then continue in 2025 to approach a neutral level of 3.25-3.50%.

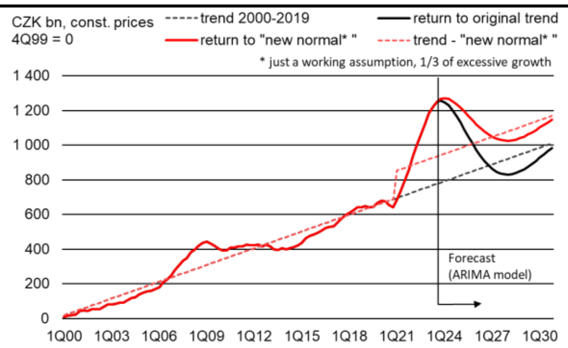
Limited scope for additional fiscal adjustment

We expect the fiscal consolidation package to push the government deficit below 3% of GDP in 2024. However, more difficult reforms are yet to be implemented and the political window of opportunity will start to close soon. Higher energy prices appear to be the most contentious issue, angering both households and businesses. While in this case the government's tough line seems to be justifiable from an economic perspective, the same cannot be said about its approach to protests by hospital doctors, who have won the promise of considerable salary hikes without any savings in the healthcare system. The government is also set to introduce the most important changes to the pay-as-you-go pension system for decades, probably raising the retirement age beyond 65, which may trigger public resistance. Thus, the scope for more good news on the fiscal side is small, while the risk of political instability will rise ahead of the 2025 general elections.

ANNUALIZED CORE INFLATION BELOW 2% SUGGESTS THE DISINFLATION PROCESS IS ONGOING



DESTOCKING WILL ALTER PREVIOUS ACCUMULATION OF INVENTORIES, CAUSING A SHIFT IN 2024-25 GDP STRUCTURE



Source: CZSO, ČNB, UniCredit Research

Fiscal tightening and valuations bode well for CZGBs

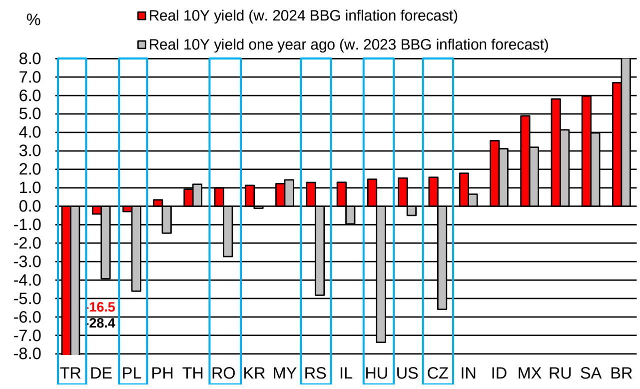
Fiscal adjustment and valuations support CZGBs…

Czechia is the only Central European country where the budget deficit could fall below 3% of GDP in 2024. The expected fiscal adjustment comes on the back of the most ambitious tightening program implemented in EU-CEE since COVID-19. A return to fiscal rectitude could increase the appeal of CZGBs at a time when they have the highest real yields (ex-ante) among tradable CEE bonds. Moreover, the spread to Bunds is also above its long-term average, offering a cushion in case of lower risk appetite and increasing the scope of a potential rally.

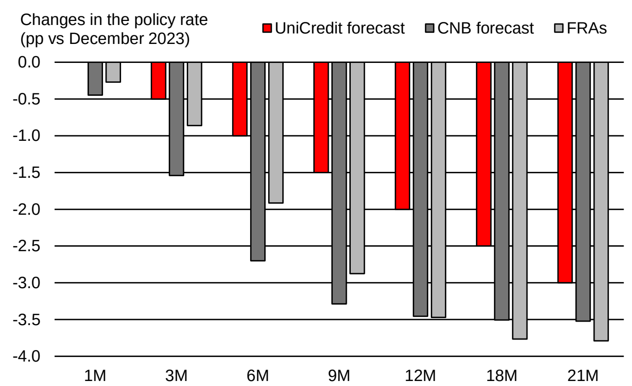
…even if the ČNB cuts less than the market is pricing in

While the market is pricing in more rate cuts than we expect before the end of 2024 (3.5pp, in line with the ČNB), fewer cuts (2pp in our forecast) would still bull-steepen the yield curve, in our view. Positioning is skewed in favor of real-money, long-term holders and could benefit from a higher EUR-USD in 2024.

CZGBS HAVE THE HIGHEST EX-ANTE REAL YIELDS IN CEE



THE MARKET IS PRICING IN TOO MANY CUTS, IN OUR VIEW



Sources: ČNB, Bloomberg, UniCredit Research

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2023E	2024F	2025F
Gross financing requirement	**17.1**	**17.2**	**22.0**
Budget deficit	10.7	8.7	9.8
Amortization of public debt	6.4	8.5	12.2
Domestic	6.4	8.0	11.2
Bonds	6.3	7.0	10.6
Bills	0.0	1.0	0.5
Loans	0.1	0.1	0.1
External	0.0	0.5	1.0
Bonds and loans	0.0	0.5	0.0
IMF/EU/Other IFIs	0.0	0.0	1.0
Financing	**17.1**	**17.2**	**22.0**
Domestic borrowing	16.6	16.7	21.5
Bonds	15.5	16.1	21.2
Bills	1.0	0.5	0.2
Loans	0.1	0.1	0.1
External borrowing	0.5	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: ČNB, MoF, CZSO, UniCredit Research

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2023E	2024F	2025F
Gross financing requirement	**114.6**	**97.2**	**101.5**
C/A deficit	1.0	-3.9	-4.6
Amortization of medium and long-term debt	4.6	4.5	3.1
Government/central bank	2.4	1.0	1.0
Banks	0.7	1.6	0.6
Corporates/other	1.5	1.9	1.5
Amortization of short-term debt	109.1	96.5	103.0
Government/central bank	16.2	11.0	12.0
Banks	47.1	35.9	40.0
Corporates/other	45.8	49.6	51.0
Financing	**114.6**	**97.2**	**101.5**
FDI (net)	2.1	5.2	6.0
Portfolio equity, net	-1.4	-1.2	-1.2
Medium and long-term borrowing	6.5	6.6	5.7
Government/central bank	4.4	3.1	3.6
Banks	0.7	1.6	0.6
Corporates/other	1.5	1.9	1.5
Short-term borrowing	103.6	85.0	89.4
EU structural and cohesion funds	3.6	3.6	3.6
Other	0.0	0.0	0.0
Change in FX reserves (- = increase)	0.3	-2.0	-2.0
Memoranda:			
Nonresident purchases of LC govt bonds	4.4	2.6	3.1
International bond issuance, net	0.0	0.5	0.5

Hungary

Baa2 stable/BBB- stable/BBB negative*

Outlook

We expect the Hungarian economy to post negative growth of -0.8% in 2023 but it could see growth of 3.3% in 2024 and 3.8% in 2025 amid recovering internal demand. Growth prospects are blurred by the muted global export demand, however new battery manufacturing capacities will partly counterbalance this. The biggest question remains what to expect regarding EU funds. We are not positive that we will see quick progress on the parts not blocked by the conditionality mechanism, as these require additional reforms that are not likely to be implemented anytime soon. Reliance on internal debt financing provides some support for the government in negotiations for EU funds but costly debt financing slows economic growth. We expect the central bank to decrease rates at a much slower pace, in line with sticky inflation. The terminal rate is expected at 6% and 4% in 2024 and 2025, respectively.

Strategy

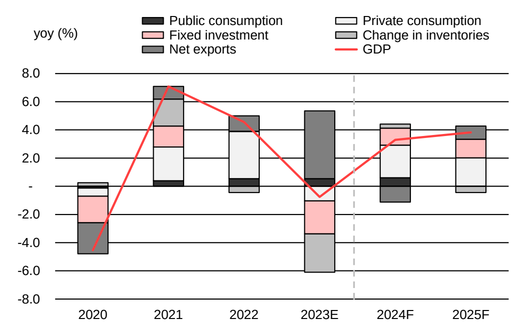
Demand and rate cuts will support HGBs with short maturities. We expect the HUF to depreciate gradually in the coming years.

Author: Zsolt Becsey, Chief Economist Hungary (UniCredit Bank Hungary), **Dan Bucșa,** Chief CEE Economist (UniCredit Bank London)

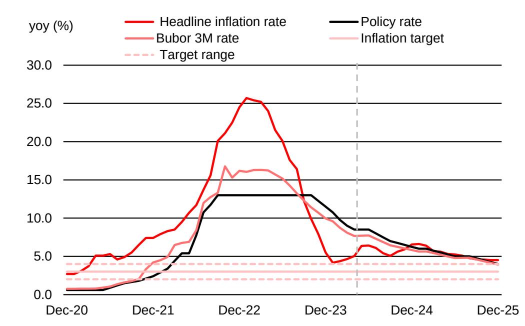
KEY DATES/EVENTS

- 20 Jan, 27 Jan, 3 Mar: rating review from Fitch, S&P, Moody's
- 9 February, 8 March: CPI
- 30 January, 27 February, 26 March: monetary-policy decisions
- 14 February, 5 March: 4Q23 GDP (flash, structure)

GDP GROWTH FORECAST



INFLATION FORECAST



Source: HCSO, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

EUR bn	2021	2022	2023E	2024F	2025F
GDP (EUR bn)	154.8	169.4	194.8	211.4	225.9
Population (mn)	9.8	9.7	9.7	9.6	9.6
GDP per capita (EUR)	15,846	17,404	20,108	21,918	23,517
Real economy, change (%)					
GDP	7.1	4.6	-0.8	3.3	3.8
Private consumption	4.6	6.5	-2.0	4.6	3.9
Fixed investment	5.8	0.1	-9.6	5.2	5.8
Public consumption	2.0	2.9	2.9	3.2	0.0
Exports	8.3	12.6	1.2	5.7	7.2
Imports	7.3	11.6	-3.8	7.4	6.7
Monthly wage, nominal (EUR)	1182	1260	1503	1662	1787
Real wage, change (%)	3.5	1.2	-2.8	6.9	5.9
Unemployment rate (%)	4.0	3.6	3.9	3.6	3.4
Fiscal accounts (% of GDP)					
Budget balance	-7.2	-6.2	-6.1	-4.6	-3.5
Primary balance	-4.9	-3.4	-2.0	-1.1	-0.4
Public debt	76.8	73.9	73.7	72.9	70.6
External accounts					
Current account balance (EUR bn)	-6.3	-13.8	-1.0	0.3	5.0
Current account balance/GDP (%)	-4.1	-8.1	-0.5	0.2	2.2
Extended basic balance/GDP (%)	0.6	-3.5	1.1	3.7	7.4
Net FDI (% of GDP)	2.1	2.4	0.6	2.1	3.5
Gross foreign debt (% of GDP)	154.2	149.1	141.4	131.2	123.1
FX reserves (EUR bn)	30.8	30.8	34.6	33.8	40.3
Months of imports, goods & services	3.0	2.3	2.8	2.7	3.1
Inflation/Monetary/FX					
CPI (pavg)	5.1	14.5	17.6	5.5	5.2
CPI (eop)	7.4	24.5	5.5	6.5	4.5
Central bank target	3.0	3.0	3.0	3.0	3.0
Central bank reference rate (eop)	2.40	18.00	10.75	6.00	4.00
3M money market rate (Dec avg)	3.80	16.07	10.52	5.98	4.09
USD-HUF (eop)	325.7	375.7	347.0	352.2	356.5
EUR-HUF (eop)	369.0	400.3	383.1	398.0	410.0
USD-HUF (pavg)	303.1	372.5	352.9	352.5	353.2
EUR-HUF (pavg)	356.6	390.1	380.7	388.3	402.6

Source: Eurostat, HCSO, NBH, UniCredit Research

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

Return to potential growth as adjustment continues

We expect GDP to grow by 3.3% in 2024 and 3.8% in 2025

Although Hungary exited recession during the summer, the rebound looks slow. Consumption is weak amid disparities in income development. Lower income deciles are currently topping up their depleted savings, while top deciles are restraining borrowing activities amid high interest rates and lower availability of subsidized lending schemes. With deleveraging on the fiscal side and missing fresh EU funds, fixed capital accumulation remains very weak, likely falling by 9.6% last year. Despite the positive contribution of public consumption and inventories, we estimate that GDP contracted by 0.8% in 2023. We forecast this year's growth at 3.3%, driven by consumption and investment, with most of it coming from base effects and more certainty regarding private investment plans. The net financing position of the country is currently very favorable amid demand destruction for energy and stable world commodity prices. However, this shall not be extrapolated as we expect export demand to face a mixed picture while the risks of commodity price shocks still exist. Hungary is the largest importer of energy in CEE and remains reliant on Russian energy sources, with few diversification plans.

Muted global demand counterbalanced by new production capacities

The outlook for Hungary's manufacturing and exports is mixed. First, the 2024 outlook for European economies (especially Germany) is muted. Second, weak demand in China could indirectly affect exports and reduce the cost competitiveness of Hungarian exports. Third, the backlog of orders amassed since the COVID-19 pandemic has been exhausted and export orders are weak at the start of the year. On a more optimistic note, we expect new battery plants to become fully operational this year, with at least 30 GWh of new capacity likely to contribute to output, but not significantly to net exports. Many inputs (including energy) are imported, while demand will depend on a swift rebound at European carmakers.

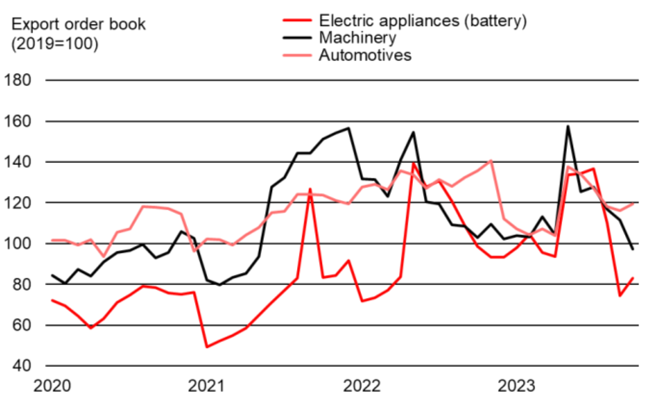
Stable foreign-fund inflows in 2024 and 2025

We expect a positive extended basic balance (EBB) both in 2024 and 2025, driven by FDI. These projects will first be a drag on the C/A due to their import needs, thus the moderate increase in C/A in 2024 but could boost exports from 2025 on. We expect the capital account to amount to around 1.5% of GDP in 2024 and 2025, enabled by larger inflows of EU funds than in 2022-23.

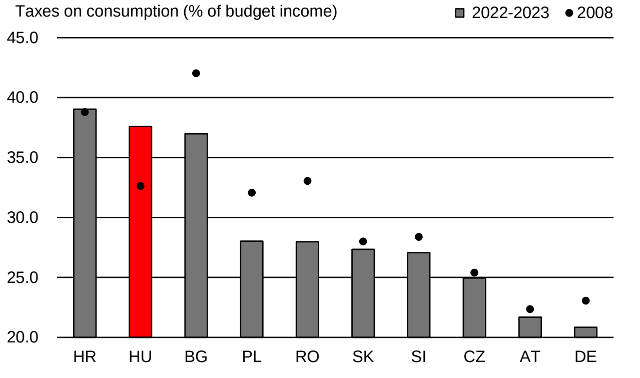
EU fund inflows to restart, full disbursement remains unlikely

The government unlocked the EUR 10.2bn blocked by the European Commission and received an advance payment from the Recovery and Resilience Facility (RRF) of EUR 1bn, however there is still no progress on at least 8 of the 27 milestones needed to unlock the rest of the funds (approximately EUR 17bn in grants). Moreover, the government passed a bill that forbids foreign funding for Hungarian political parties and NGOs. This could threaten future disbursements if the EC finds evidence of the government impacting the functioning of Hungarian entities financed from the EU budget.

EXPORT ORDERS ARE FALLING SINCE THE SUMMER



STRONG PRIVATE CONSUMPTION IS INFLATIONARY BUT NECESSARY FOR BUDGET STABILITY



Source: Eurostat, HCSO, UniCredit Research

We forecast year-end inflation at 6.8% in 2024 and 5.0% in 2025…

While current core-price dynamics are in line with the NBH's target, we forecast inflation will miss the target both in 2024 (6.5%) and 2025 (4.5%). Announced government measures will add roughly 1.4pp to headline inflation next year, with the most important increases applied to excise duties, the road tax and packaging fees. Indexation of telecom service prices could add 0.2-0.4% to headline inflation in March. With constant pressure on the budget, we expect administered prices to be raised, starting with utility prices (sewage, water and garbage collection). In addition, we forecast headline inflation will re-accelerate in April-May due to base effects.

… and the policy rate at 6% this year and 4% in 2025

We do not anticipate a policy reaction as most of these small spikes will be labelled as transitory, and monetary policy will rather focus on short-term dynamics. We expect the NBH to cut the policy rate to 6% in 2024 and to 4% in 2025, with the central bank having to mind potential flare-ups in inflation expectations. As the carry narrows further, the NBH will have to balance rate cuts with potential pressure on the currency stemming from fiscal and political risks. The government and the NBH will have to find a solution for refinancing maturing loans that were granted at preferential rates in the past decade. Monetary-policy transmission to lending rates remains the weakest in CEE and refinancing loans at market prices would increase non-performing loans and future lending rates. Hence, new subsidized lending schemes with deferred costs could be on the table for 2024. The NBH's gradual approach to monetary easing is likely to further clash with the government's expectations of fast rate cuts, although the faster adjustment should be in fiscal policy.

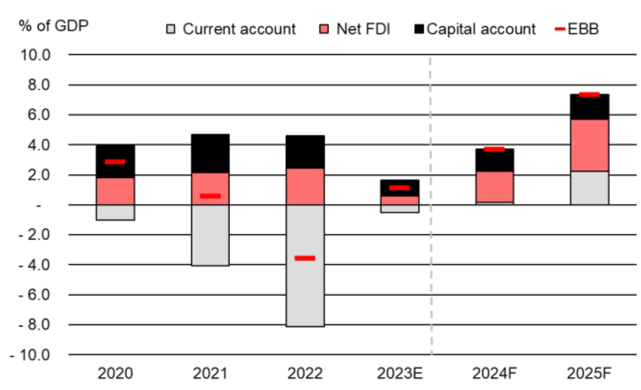
The budget deficit is likely to exceed 3% of GDP in 2024-25

High debt but domestic contribution supports the government

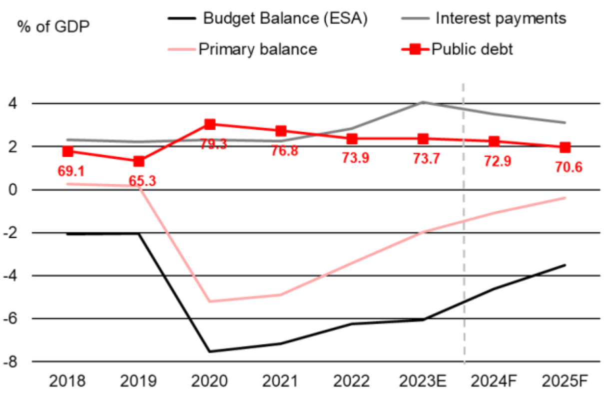
Hungary's fiscal adjustment is too gradual for the country to avoid the excessive deficit procedure (EDP) in 2024. We do not expect the budget deficit to fall below 3% of GDP in 2024-25 as this would require a primary balance net of energy subsidies of more than 3% of GDP in a year when Hungary will hold elections for local authorities and the European Parliament. The government changed its decade-long guidance from meeting the Maastricht criterion to gradually reducing the deficit. Public debt rose to 75% of GDP in 3Q23. Suffering from worse stock imbalances than its peers, Hungary relies on a low share of FX in total debt (27%) and high retail ownership of bonds (20% of total debt). This strategy comes at the cost of very high retail-bond yields and low debt duration, leaving Hungary more vulnerable to financial shocks. Trying to reduce this risk, the Hungarian debt management agency (AKK) already started to offer significantly lower yields for its new inflation linker. Failure to reduce the overall stock of public debt (which exceeds the BBB median by almost 20% of GDP) leaves Hungary vulnerable to rating downgrades if debt does not decline again.

We expect the ruling Fidesz party to win more than half of Hungary's European Parliament mandates on 9 June. On the same day, the party is likely to win in local elections, although the opposition remains the favorite to retain its seats in Budapest.

POSITIVE EBB EXPECTED TO INCREASE FURTHER



FALLING FISCAL IMPULSE DUE TO HIGH DEBT SERVICE



Source: HCSO, NBH, UniCredit Research

Demand and rate cuts to support short-term HGBs

The HGB curve could bull-flatten

Hungary's AKK managed to cover its funding needs in 2023 by lowering the average maturity of wholesale bonds from 8.5 years in 2022 to 6.9 years in 2023 (although the average maturity of outstanding HUF debt remained at 5 years) and by selling more retail bonds. The results are impressive, despite the country's large gross funding needs (the highest in CEE due to the large debt stock). As the NBH continues to cut rates, we expect the HGB curve to bull-steepen in 2024, while remaining inverted.

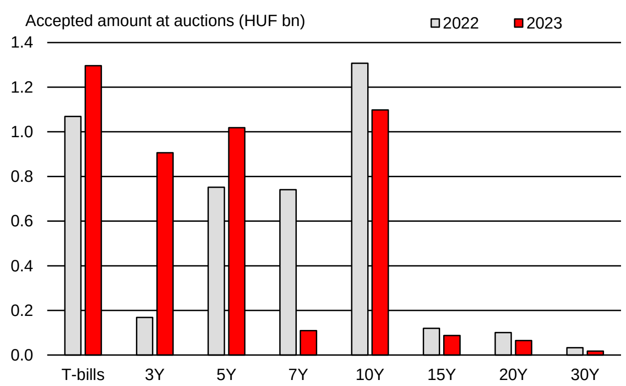
Funding costs to remain high in 2024

In 2024, the AKK faces contradicting trends: while the cost of wholesale issuance will fall, that of retail inflation linkers will rise in line with average inflation for 2023 (17.6%). One way to counterbalance this would be to issue more abroad, but the Hungarian government is defending its investment grade rating by keeping the share of FX in sovereign debt below 30%.

HUF depreciation on the cards to recoup some of the lost cost competitiveness

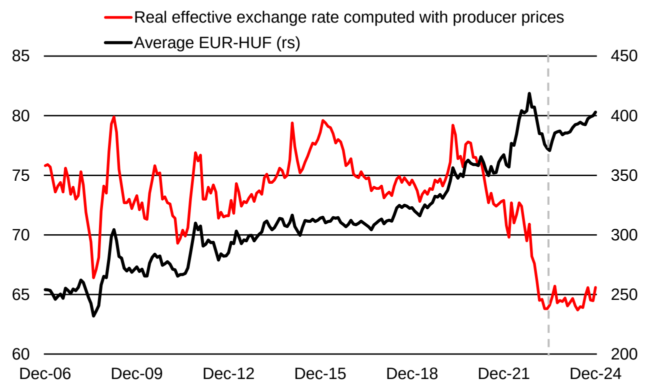
We expect the HUF to depreciate gradually as carry narrows. Fast increases in production and labor costs have reduced the competitiveness of the Hungarian currency, but this divergence should be recouped gradually in the coming years.

DECLINING AVERAGE MATURITY OF HGB ISSUANCE IN 2023



* Only T-bills maturing after the end of the year of issuance

GRADUAL HUF DEPRECIATION WILL REVERSE LITTLE OF THE PRODUCTION COST INCREASE



Source: Debt Management Agency, Bloomberg, UniCredit Research

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2023E	2024F	2025F
Gross financing requirement	**31.9**	**34.1**	**29.6**
Budget deficit	12.1	12.1	10.0
Amortization of public debt	19.8	22.0	19.7
Domestic	15.3	19.3	16.9
Bonds	6.8	5.8	6.4
Bills	1.5	3.9	4.7
Loans & retail securities	7.0	9.5	5.8
External	4.5	2.7	2.7
Bonds	2.6	2.4	2.6
IMF/EU/Other IFIs	1.9	0.3	0.2
Financing	**31.9**	**34.1**	**29.6**
Domestic borrowing	21.2	21.6	21.2
Bonds	8.2	7.0	6.7
Bills	3.9	2.8	3.4
Loans & retail securities	9.1	11.8	11.1
External borrowing	10.5	12.7	8.4
Bonds	8.5	10.0	5.9
IMF/EU/Other IFIs	2.0	2.7	2.5
Change in fiscal reserves (- = increase)	0.2	-0.2	0.0

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2023E	2024F	2025F
Gross financing requirement	**20.4**	**21.3**	**14.3**
C/A deficit	1.0	-0.3	-5.0
Amortization of medium and long-term debt	8.5	12.7	12.2
Government/central bank	2.9	5.2	5.7
Banks	3.8	5.3	3.9
Corporates/other	1.8	2.2	2.6
Amortization of short-term debt	10.9	9.0	7.1
Financing	**20.4**	**21.3**	**14.3**
FDI (net)	1.2	4.4	7.9
Portfolio equity, net	-1.5	-2.5	-1.0
Medium and long-term borrowing	19.0	12.9	9.1
Government/central bank	14.5	8.9	4.9
Banks	2.7	2.1	2.0
Corporates/other	1.8	1.9	2.3
Short-term borrowing	9.0	7.1	5.5
EU structural and investment funds	2.0	3.1	3.7
Change in FX reserves (- = increase)	-3.8	0.8	-6.5
Memoranda:			
Non-resident purchases of LC govt bonds	1.8	0.5	0.5
International bond issuance, net	5.9	7.6	3.3

Source: NBH, Hungarian Ministry of Finance, UniCredit Research

Poland

A2 stable/A- stable/A- stable*

Outlook: We expect GDP growth to accelerate to 3.5% in 2024 as private consumption recovers due to real wage growth and fiscal transfers. The economy could maintain a similar growth pace in 2025 if looser financial conditions and a moderate recovery in external demand offset the negative fiscal impulse. We forecast that inflation will fall to 4.5% at the end of this year and to 4% a year later. The NBP could lower its policy rate to 5% in 2Q24, with additional rate cuts bringing it to 4% in 2025.

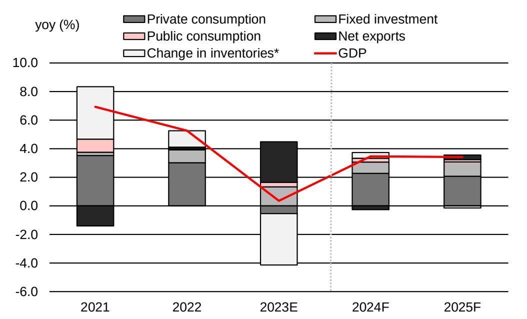
Strategy: Investor demand for PLN-denominated financial assets could rise in 1H24, owing to reform momentum.

Authors: Dan Bucsa, Chief CEE Economist (UniCredit Bank, London)**), Gökçe Çelik,** Senior CEE Economist (UniCredit Bank, London)

KEY DATES/EVENTS

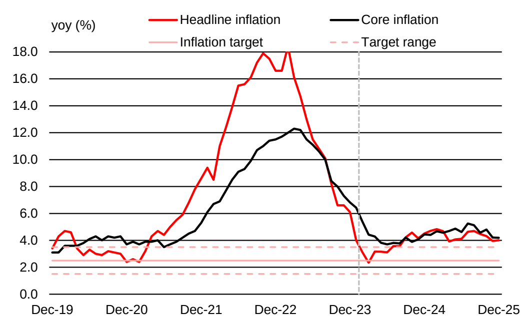
- 7 February, 6 March: monetary-policy decisions
- 15 Jan, 15 Feb, 15 Mar: CPI
- 22 March: rating update from Moody's
- 14, 29 February: 4Q23 GDP (flash, structure)

GDP GROWTH FORECAST



*adjusted to take into account statistical errors

INFLATION FORECAST



Source: Statistics Poland, NBP, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

EUR bn	2021	2022	2023E	2024F	2025F
GDP (EUR bn)	576.2	654.2	751.9	858.6	899.6
Population (mn)	37.9	37.8	37.7	37.6	37.5
GDP per capita (EUR)	15199	17305	19945	22836	23994
Real economy, change (%)					
GDP	6.9	5.3	0.4	3.5	3.4
Private consumption	6.1	5.3	-0.9	4.0	3.7
Fixed investment	1.2	4.9	7.4	4.1	5.2
Public consumption	5.0	0.3	1.8	1.5	1.0
Exports	12.3	6.7	-2.5	3.8	5.2
Imports	16.1	6.8	-7.9	4.8	5.1
Monthly wages, nominal (EUR)	1285	1413	1631	1891	1952
Real wages, change (%)	3.3	-1.3	0.4	4.8	2.8
Unemployment rate (%)	6.4	5.4	5.2	4.9	4.8
Fiscal accounts (% of GDP)					
Budget balance (w/ PFR)	-1.8	-3.7	-5.6	-5.2	-4.3
Primary balance (w/ PFR)	-0.8	-2.6	-4.5	-4.0	-3.1
Public debt (w/ BGK and PFR)	53.6	49.1	49.9	53.9	55.3
External accounts					
Current-account balance (EUR bn)	-7.4	-15.7	10.9	6.6	8.0
Current-account balance/GDP (%)	-1.3	-2.4	1.4	0.8	0.9
Extended basic balance/GDP (%)	3.3	1.8	4.7	4.3	5.3
Net FDI (% of GDP)	3.8	3.7	2.8	2.6	3.0
Gross foreign debt (% of GDP)	53.8	53.9	48.9	45.8	45.4
FX reserves (EUR bn)	128.1	137.3	147.4	168.3	199.4
Months of imports, goods & services	4.9	4.1	4.5	4.5	5.1
Inflation/monetary/FX					
CPI (pavg)	5.1	14.4	11.4	3.6	4.4
CPI (eop)	8.6	16.6	6.1	4.5	4.0
Central-bank target	2.50	2.50	2.50	2.50	2.50
Central-bank reference rate (eop)	1.75	6.75	5.75	5.00	4.00
3M money-market rate (Dec. avg.)	2.35	7.11	5.85	5.10	4.10
USD/FX (eop)	4.06	4.40	3.94	3.89	3.91
EUR/FX (eop)	4.60	4.69	4.35	4.40	4.50
USD/FX (pavg)	3.86	4.46	4.20	3.87	3.92
EUR/FX (pavg)	4.57	4.69	4.54	4.30	4.45

Source: Statistics Poland, NBP, UniCredit Research

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

High expectations for the new government

Reform momentum could be stronger in 1H24

The new Polish government faces a busy agenda of reforms to unlock RRF funds and realign national legislation with that of the EU. We expect the governing coalition to try in 2024 to uphold unpopular changes made by PiS and replace political appointees in state-owned media and enterprises. Despite the EU-accession treaty binding Poland to observing the primacy of EU legislation over local laws, the PiS-appointed majority in the Constitutional Tribunal (CT) might slow reform momentum. The parliamentary majority would be able to start replacing CT judges from December 2024 onwards, appointing a new majority by 2027. At the time of writing, Polish President Andrzej Duda had not accepted the government's 2024 budget, which could trigger early elections. Even if the budget is adopted, the governing coalition could break after local elections, expected in April 2024, if reform momentum stalls. Much depends on Mr. Duda's plans once his mandate ends in 2025. An international career would need the backing of PM Donald Tusk.

Risks of the coalition breaking in 2025

The political situation might become more complicated in 2025, when presidential elections could pit candidates from different coalition parties against each other. Rafal Trzaskowski, the mayor of Warsaw and a defeated presidential candidate in 2020, and Szymon Holownia, the speaker of the Sejm and leader of Poland 2050, could both run to replace Mr. Duda. In addition, coalition members are unlikely to deliver on all election promises, with the Left most likely to make concessions regarding its very liberal social program.

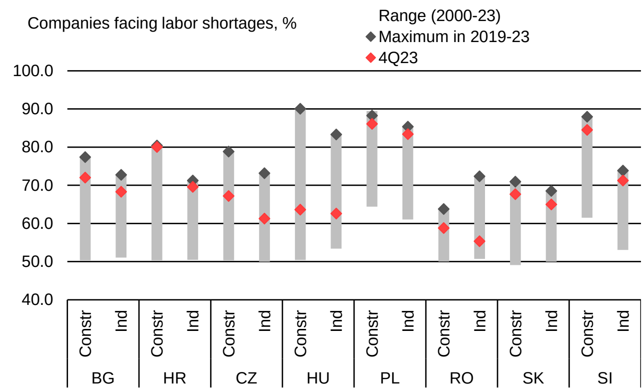
Large budget deficits amid a busy election schedule

We expect the budget deficit to remain above 5% of GDP in 2024 as spending will remain high amid a busy election calendar. The new coalition will try to deliver on its diverse election promises, including increasing child support (from PLN 500 to PLN 800 per child) and generous wage hikes (30% for teachers and 20% for public-sector workers). Stronger domestic demand could support tax revenues, with a further boost from higher dividends paid by state-owned companies. The cost of extending an energy-price freeze for households and vulnerable businesses to the end of 1H24 is planned to be financed by a windfall tax on oil company PKN Orlen. The government could prioritize curbing the budget deficit in 2025, not to risk a disruption to EU funds from the opening of an excessive deficit procedure, with most saving measures to come after the presidential elections (likely to be held in 3Q25). As a result, we expect Poland to return to running budget deficits of below 3% of GDP in 2026 or later.

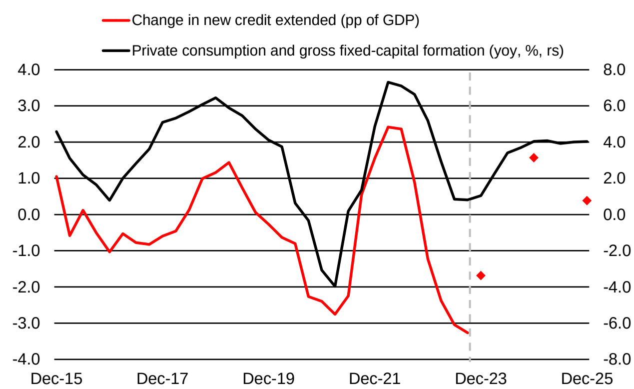
We expect GDP growth to amount to 3.5% this year…

We expect GDP growth to accelerate to 3.5% this year, from 0.4% in 2023, driven by a rebound in private consumption. Real wage growth turned positive in 2023 and will likely pick up more this year, supported by the highest labor shortages in EU-CEE and planned minimum-wage hikes. Higher fiscal transfers to households will also help boost disposable income.

POLAND HAS THE TIGHTEST LABOR MARKET IN THE REGION



THE CREDIT IMPULSE COULD BOOST GROWTH IN 2024-25



Source: Eurostat, Statistics Poland, UniCredit Research

Even if flows of structural EU funds remain low in 2024, as new projects tend to accelerate during the second half of an EU budget (2025-27), we expect to see additional disbursements from the RRF and higher FDI. In addition, the Polish real-estate market remains the most attractive in CEE, especially in its industrial and warehousing components, which benefit the most in the CEE from nearshoring and friendshoring. We expect the negative impact from destocking, which dragged down 2023 growth significantly, to disappear in 2024.

…and 3.4% in 2025

We forecast GDP growth of 3.4% in 2025, helped by strong domestic demand. A negative fiscal impulse could be offset by looser lending conditions following rate cuts, thereby boosting private consumption and investment. We expect a market-wide solution to address CHF-denominated loans after the presidential elections at the latest, with the market regulator KNF preparing a hybrid solution that would help clarify the outlook for the local banking system. Net exports could also contribute to GDP growth, in a change from 2024. We expect investment in Poland's energy transition to pick up from 2025 onwards, helped by sizeable EU transfers.

Poland will run one of the highest EBB in the region

Weaker net exports will translate into narrower C/A surpluses in 2024 and 2025. However, the start of RRF fund flows will add to structural and cohesion funds, and net FDI flows should bring Poland's extended basic balance to above 5% of GDP, among the highest in the region. For the RRF funds, we assume that the requested first tranche of EUR 6.9bn will arrive in spring 2024, after a prepayment of EUR 5bn from the RePowerEU program was received in December 2023. However, additional disbursements might be more difficult to unlock if the pace of reforms slows in 2H24. We expect additional RRF disbursements of EUR 12bn in 2025.

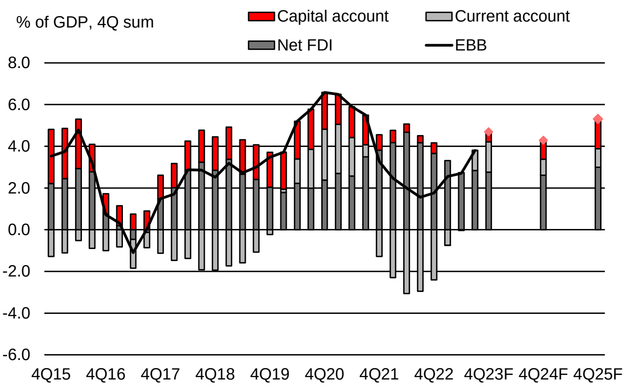
Rapid disinflation is expected to occur in early 2024…

Inflation could ease into the target interval already in 1Q24, albeit temporarily. The government postponed the resumption of VAT on food items to 2Q24, which will amplify the expected disinflation in 1Q24. However, high real wage growth and loose fiscal policy will slow deceleration in core inflation. Moreover, retail energy prices are likely to rise in July. Energy companies asked the regulator to raise retail electricity and natural-gas tariffs significantly in 2024. However, end-user prices will rise less, as the price freezes based on consumption volumes have been extended until the end of 1H24. The new government is considering rolling back these measures from 2H24 onward, but the presidential elections to be held in 2025 will likely compel the government to proceed gradually.

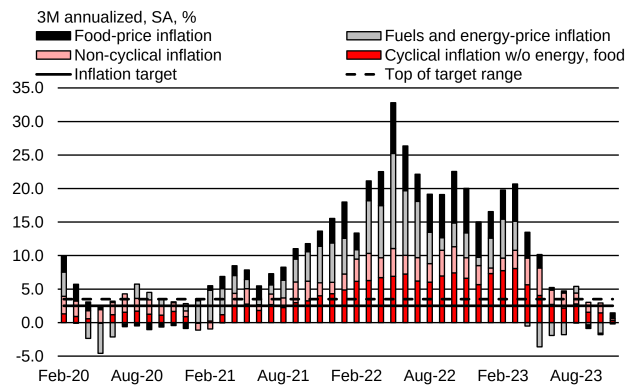
…paving the way for rate cuts in 2Q24

Turning more cautious after the elections, the NBP will likely extend its pause in the current easing cycle to March. However, rate cuts could resume in 2Q24, when annual inflation is expected to fall below the policy rate, implying positive ex-post real rates. We expect the NBP to lower its key rate to 5% by the end of 1H24, but potential risks related to political uncertainty could motivate the NBP to maintain its recently adopted cautious stance in the remainder of the year. We expect additional cuts to bring the interest rate to 4% in 2025.

THE EBB WILL RISE WITH EU FUNDS



INFLATION MOMENTUM SLOWED DOWN



Source: Statistics Poland, NBP, UniCredit Research

Reform momentum to boost PLN-denominated assets in 1Q

Funding needs will be large in 2024

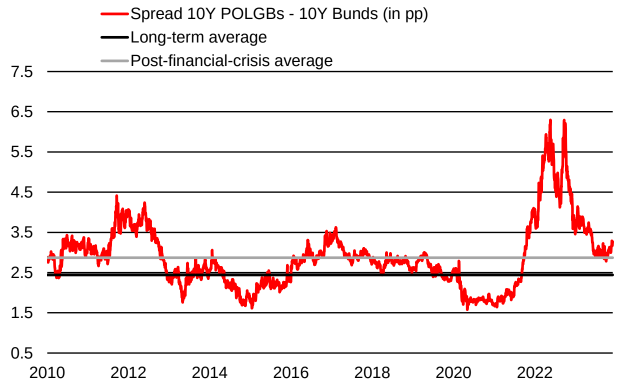
An elevated budget deficit means that financing needs and issuance will be higher this year than in 2023. Net borrowing needs amount to PLN 252bn (6.8% of GDP), and the government is planning to cover most of this by tapping the domestic bond market. Planned gross issuance in the domestic market amounts to PLN 280bn (7.6% of GDP). Tapping the international market in the first week of the year, the government has already secured EUR 3.75bn of external borrowing, which corresponds to a quarter of the total Eurobond issuance it planned for 2024.

Reform momentum could support PLN-denominated assets in 1H24

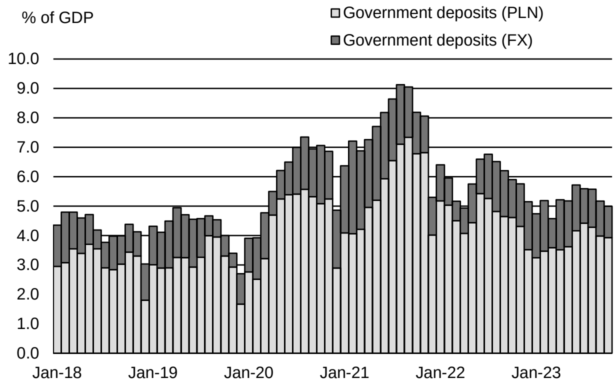
Despite higher supply, we think POLGBs will be attractive, especially in 1H24, owing to goodwill for the new government and transfers from the EU. The spread to Bunds could fall below its post-financial-crisis average. So far, it has tightened little after the recent election. If investor appetite is weaker than expected or the new administration fails to advance reforms, the government could tap its large fiscal buffers, which amount to around 5% of GDP.

We expect to see a similar pattern in the PLN exchange rate. EUR-PLN could dip temporarily to 4.20 or even lower if risk appetite is strong at the start of 2024, only to depreciate later when reform momentum could stall.

HIGHER DEMAND COULD TIGHTEN POLGB SPREADS



FISCAL RESERVES STAND AT 5% OF GDP



Source: Bloomberg, ministry of finance, UniCredit Research

GROSS GOVERNMENT FINANCING REQUIREMENTS

EUR bn	2023E	2024F	2025F
Gross financing requirement	**80.1**	**87.0**	**90.0**
Budget deficit	45.5	48.1	42.4
Amortization of public debt	34.6	38.9	47.5
Domestic	28.2	30.6	41.0
Bonds	23.5	24.4	25.0
Bills	0.0	0.0	11.0
Loans/other	4.8	6.1	5.0
External	6.4	8.3	6.5
Bonds	5.4	7.3	5.5
Loans, IFIs, other	0.9	1.0	1.0
Financing	**80.1**	**87.0**	**90.0**
Domestic borrowing	46.2	65.2	62.0
Bonds	36.1	44.7	40.0
Bills	0.0	11.0	12.0
Loans/PFR/other	10.1	9.5	10.0
External borrowing	15.3	19.6	23.7
Bonds	10.0	14.6	15.5
Loans, IFIs, other	5.2	5.1	8.2
Change in fiscal reserves/other (-=increase)	18.6	2.2	4.3

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2023E	2024F	2025F
Gross financing requirement	**106.3**	**109.4**	**94.8**
C/A deficit	-10.9	-6.6	-8.0
Amortization of medium and long-term debt	56.1	54.2	48.9
Government/central bank	8.7	10.8	9.0
Banks	16.8	16.0	15.2
Corporates/other	30.5	27.5	24.7
Amortization of short-term debt	61.1	61.8	53.8
Financing	**106.3**	**109.4**	**94.8**
FDI (net)	20.8	22.4	26.9
Portfolio equity, net	-1.5	1.0	1.0
Medium and long-term borrowing	58.7	61.5	59.1
Government/central bank	13.7	24.0	26.3
Banks	16.0	12.8	10.6
Corporates/other	29.0	24.7	22.3
Short-term borrowing	62.7	54.6	43.1
EU structural and cohesion funds	3.6	7.8	12.8
Other	-19.0	-17.0	-17.0
Change in FX reserves (- = increase)	-18.9	-20.9	-31.2
Memoranda:			
Nonresident purchases of LC gov't bonds	-2.9	3.3	1.6
International bond issuance, net	4.6	7.2	10.0

Source: Statistics Poland, NBP, UniCredit Research

Romania

Baa3 stable/BBB- stable/BBB- stable*

Outlook

We expect the economy to grow by 3% in 2024 and by 1.6% in 2025, with the government tightening fiscal policy only after the elections scheduled for 2024. Domestic demand will drive growth this year, with exports likely to play a more important role in 2025. We expect inflation to miss the target in 2024-25, with the NBR cutting rates to 6% in 2024 and 4% in 2025. We see EUR-RON moving to a 5.00-5.10 range in 1Q24. The wide C/A deficit will remain fully funded by FDI, EU transfers and sovereign debt issuance abroad. We expect the current governing coalition to remain in power after this year's elections.

Strategy

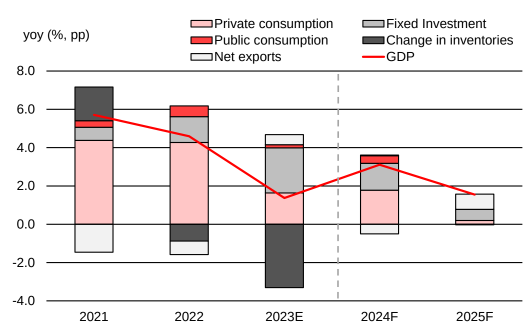
Romanian bonds likely to be a carry, rather than a convergence story in 2024 due to loose fiscal policy and higher capital requirements for the local banks' holdings of bonds. We expect good demand for Romania's first EUR green bond.

Authors: Dan Bucșa, Chief CEE Economist (UniCredit Bank London), **Mihai Jugravu**, Economist (UniCredit Bank Romania)

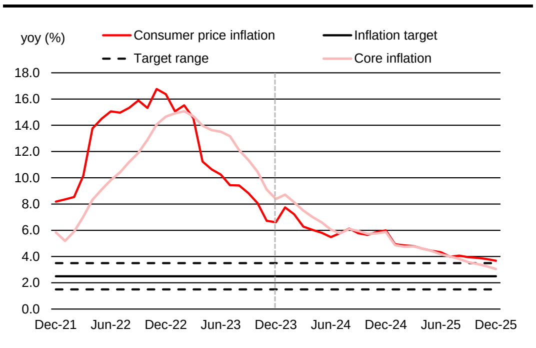
KEY DATES/EVENTS

- 13 Feb: monetary policy decisions
- 14 Feb, 13 Mar: CPI
- 24 Mar: rating update from Fitch
- 14 Feb, 8 Mar: 4Q23 GDP (flash, structure)

GDP GROWTH FORECAST



INFLATION FORECAST



Source: NIS, NBR, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

EUR bn	2021	2022	2023E	2024F	2025F
GDP (EUR bn)	241.7	286.6	322.9	350.7	372.7
Population (mn)	19.2	19.1	19.1	19.1	19.0
GDP per capita (EUR)	12,596	14,979	16,902	18,386	19,566
Real economy, change (%)					
GDP	5.7	4.6	1.4	3.0	1.6
Private Consumption	7.2	6.9	2.6	2.6	0.3
Fixed Investment	2.9	5.6	9.7	4.8	2.1
Public Consumption	1.8	3.1	1.0	1.9	-0.2
Exports	12.6	9.6	-0.4	3.7	4.7
Imports	14.8	9.9	-2.2	3.8	2.4
Monthly wage, nominal (EUR)	1175	1303	1481	1670	1756
Real wage, change (%)	2.0	-2.2	3.1	7.6	1.9
Unemployment rate (%)	5.6	5.6	5.5	5.4	5.5
Fiscal accounts (% of GDP)					
Budget balance	-7.1	-6.2	-6.3	-6.0	-4.6
Primary balance	-5.6	-4.2	-4.2	-3.9	-2.4
Public debt	48.5	47.2	49.3	50.9	52.2
External accounts					
Current account balance (EUR bn)	-17.5	-26.6	-20.8	-18.2	-16.5
Current account balance/GDP (%)	-7.2	-9.3	-6.4	-5.2	-4.4
Extended basic balance/GDP (%)	-1.4	-3.6	-2.3	-1.3	-0.5
Net FDI (% of GDP)	3.7	3.7	2.3	2.0	2.0
Gross foreign debt (% of GDP)	56.5	50.4	52.1	49.6	49.9
FX reserves (EUR bn)	40.5	46.6	59.8	58.6	63.4
Months of imports, goods & services	4.3	4.0	5.0	4.7	4.8
Inflation/Monetary/FX					
CPI (pavg)	5.0	13.7	10.5	6.3	4.9
CPI (eop)	8.2	16.4	6.6	6.0	3.9
Inflation target	2.50	2.50	2.50	2.50	2.50
Central bank reference rate (eop)	1.75	6.75	7.00	6.00	4.00
3M money market rate (Dec. avg.)	3.01	7.57	6.22	5.32	3.93
USD/FX (eop)	4.37	4.64	4.56	4.47	4.48
EUR/FX (eop)	4.95	4.95	4.97	5.05	5.15
USD/FX (pavg)	4.16	4.68	4.57	4.52	4.48
EUR/FX (pavg)	4.92	4.93	4.95	5.02	5.10

Source: Eurostat, National Institute of Statistics (NIS), UniCredit Research

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

Policy inaction in election year

Busy election schedule in 2024

2024 will be a busy political year, with elections for the EP (9 June), local administrations (no later than 22 September), president (probably before the end of November, maybe with local elections) and parliament (after 6 December). The timing of elections will be extremely important. The Liberals (PNL) wish to hold local elections with those for parliament or president to leverage on their popular mayors. Their senior coalition partner, the Social Democrats (PSD), seem to be heading for a clear win in parliamentary elections, according to opinion polls.

Loose fiscal policy in 2024, budget deficit close to 6% of GDP

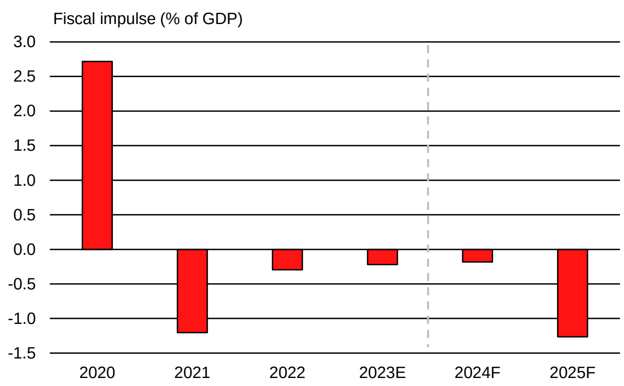
The government offered its supporters two increases in pensions (by more than 40% cumulatively in January and September), two in wages for teachers (in January and June, for a total of 20%) one for other public-sector employees (by more than 10%), and one in the minimum wage (by around 12%). While Prime Minister Marcel Ciolacu hopes to keep the budget deficit below 5% of GDP in 2024, we think this goal is unattainable, given insufficient offsetting measures. As always, the government committed to improve tax collection, although this never happened in an election year. It also aims to reduce public spending by streamlining employment in administration (for details, please see the EEMEA Country Note - Romania: short-term patch for long-term fiscal problems, 29 September 2023). We see at least three more risks that could keep this year's budget deficit close to 6% of GDP:

1. Higher spending for goods and services due to the cost of organizing up to five election rounds and to covering the funding gap of local administrations.
2. Lower indirect-tax revenues (in percent of GDP) due to poor tax compliance in rural retail stores and for custom duties, which tend to worsen in election years.
3. Arrears accumulated in 2023 and paid this year. While some of them will be assigned to the 2023 budget (wages and compensations of public employees), some could be carried over to 2024 (e.g., in the health sector, public procurement and investment).

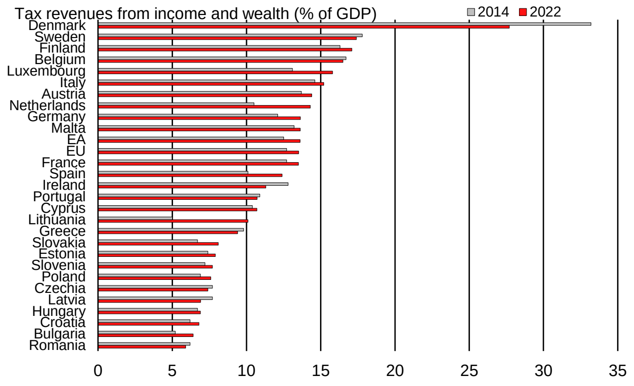
The budget deficit to fall to 4.6% of GDP in 2025 and below 3% of GDP in 2027

Mr. Ciolacu ruled out any tax increase in 2024, but presented two options for raising tax receipts from 2025 onwards. The first assumes that the flat personal income tax of 10% will be replaced with a progressive tax system. The second assumes that all taxes will be unified at 16%. This would imply higher taxes on incomes, microenterprises and authorized individuals, thus closing tax loopholes that past PSD administrations opened in 2016-19. We see a combination of both plans as more likely to reduce the budget deficit below 3% of GDP. Thus, we expect progressive tax levels for income and profits, the further closing of tax loopholes for microenterprises and authorized individuals, as well as higher taxes on property and commodity extraction. Excise duties on fuels, tobacco and alcohol are likely to be raised every year, while the price cap on electricity and natural gas might be removed in 2025. These measures would allow to reduce the budget deficit towards 3% of GDP by 2027 and stabilize public debt by 2026.

MINIMAL FISCAL ADJUSTMENT IN 2022-24



ROMANIA HAS THE LOWEST LABOR TAX BURDEN IN THE EU



Source: Ministry of finance, NIS, Eurostat, UniCredit Research

PSD and PNL likely to remain in power after the 2024 elections

We see risks of the PSD-PNL coalition breaking before elections because the government will have to commit to some tax increases before 2025 (opposed by PNL) and because the PNL might try to reassume its anti-PSD stance from the previous elections. However, the two parties are likely to end up in another coalition after this year's elections, probably with renewed support from the Hungarian minority party, UDMR. We expect the nationalist, populist Alliance for the Unity of Romanians (AUR) to do better in EP elections (which are usually protest elections) than in parliamentary elections. Its president, George Simion, could make it to the second round of presidential elections. We believe that the latter have little importance for economic policies in Romania because the Constitutional Court reduced presidential powers over the last decade.

We forecast GDP growth at 3% in 2024 and 1.6% in 2025

We expect the economy to grow by 3% this year, boosted by fast real-income growth and public spending. Building projects could gradually add to infrastructure works in boosting value added, as financial conditions are likely to ease further, especially in 2H24. We see industry and exports lagging in 2024 due to weak foreign demand, scarring in energy-intensive sectors and poor price competitiveness in low value-added sectors. In 2025, we forecast domestic demand to grow at a much slower pace due to tax increases, with GDP advancing by just 1.6%. Better foreign demand could limit the damage, without offsetting the loss of purchasing power we expect from higher taxes on the middle class.

We expect inflation at 6.0% in 2024 and 3.9% in 2025

We do not see inflation returning inside the target range in 2024 (6.0%) because of strong consumer demand and higher taxes, nor in 2025 (3.9%) because of higher indirect taxes. The NBR could start rate cuts in 2H24 only if the budget deficit can be financed without pressure on yields and the RON. We still expect 1pp in cuts to 6% this year, but the scope is narrowing. Even if the NBR starts cutting later than its regional peers, financial conditions will not be tighter because the Romanian central bank allowed interbank rates to fall close to the overnight deposit rate of 6% by leaving excess liquidity in the interbank market. We expect rate cuts to 4% in 2025, when the budget deficit will tighten faster.

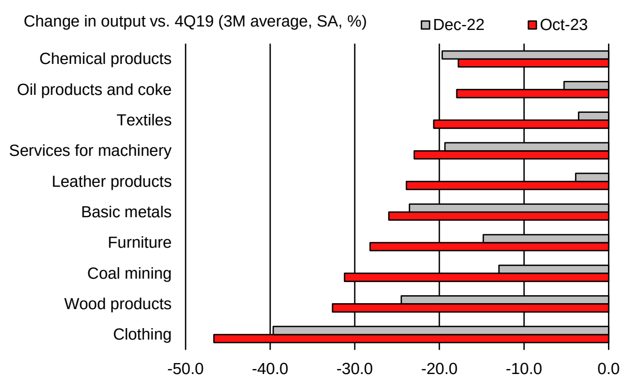
The RON could lose around 1.5% in 1Q24

In 2024, the NBR could allow EUR-RON to move into a 5.00-5.10 range, returning to 0.1 RON depreciation per year. This will only slow the RON's real appreciation. Romania's structural C/A deficit has widened to more than 5% of GDP, but a strong currency is not the most important culprit: a volatile tax and regulatory system, and poor infrastructure have undermined foreign and domestic investment into productive capacities, with aggregate supply lagging aggregate demand. The NBR can do little to offset this imbalance, but the economy would benefit from a gradual move to a more loosely managed exchange rate.

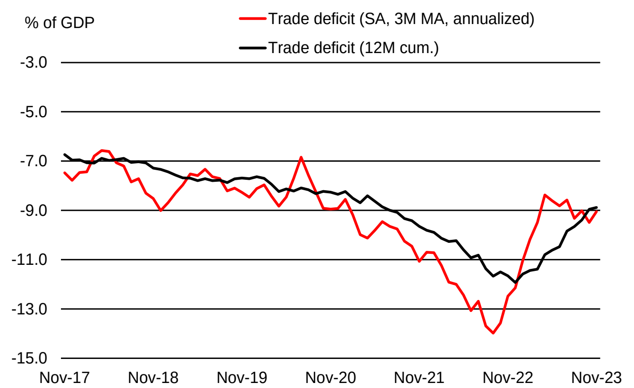
The C/A deficit will remain wide but fully funded

In 2024-25, the C/A deficit will remain fully funded by EU transfers, FDI and sovereign external borrowing. We expect FX reserves to grow further, even if the NBR might have to defend the RON through spot interventions in risk-off episodes. A slow rise in public and external debt should prevent downgrades to the sovereign rating, in our view.

SCARRING AND LOW COMPETITIVENESS AFFECT INDUSTRY



WIDENING TRADE DEFICIT AFTER CORRECTION IN ENERGY



Source: NBR, NIS, UniCredit Research

A carry rather than a convergence story

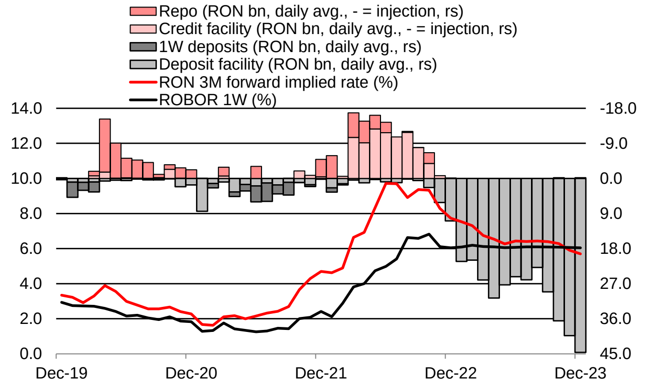
Romanian bonds affected by loose fiscal policy and change in risk weighting at banks

With limited to no fiscal adjustment expected this year, we do not see ROMGBs as a yield-convergence story before the government will announce tax increases (probably in December 2024). Ample liquidity on the local market should be beneficial for ROMGBs, but the increase in risk-weighting for sovereign bonds to 50% in 2024 could affect some of the largest banks that were buyers of local debt. Potential RON depreciation in 1Q24 adds to risks.

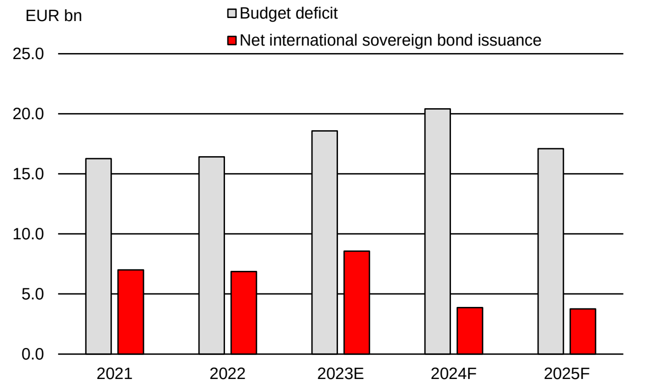
We expect good demand for a EUR green bond in early 2024

Besides the regular January issuance, the ministry of finance is likely to issue a green EUR bond in 2024 (with a target of EUR 1bn), adding to its very large fiscal reserves. Even assuming a EUR 3bn depletion of government coffers in December 2023, the ministry of finance probably could cover more than 6 months of gross funding out of its fiscal reserves, which are the largest in CEE (in % of GDP). Despite a larger budget deficit in absolute value, we expect net issuance on foreign markets in 2024 to be EUR 3.9bn, less than half that of last year, although good demand could prompt the ministry of finance to exceed the issuance plan.

UNPRECEDENTED LIQUIDITY SURPLUS KEEPS ROBOR RATES CLOSE TO THE DEPOSIT-FACILITY RATE



NET FX ISSUANCE LIKELY TO FALL SIGNIFICANTLY THIS YEAR



Source: NBR, Bloomberg, UniCredit Research

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2023E	2024F	2025F
Gross financing requirement	**31.6**	**33.5**	**29.9**
Budget deficit	18.6	20.4	17.1
Amortization of public debt	13.0	13.0	12.8
Domestic	11.3	8.8	9.2
Bonds	10.5	7.5	7.9
Bills	0.5	1.0	1.0
Loans	0.3	0.3	0.3
External	1.7	4.2	3.5
Bonds and loans	1.7	3.6	3.2
IMF/EU/Other IFIs	0.0	0.6	0.3
Financing	**31.6**	**33.5**	**29.9**
Domestic borrowing	24.0	22.0	19.0
Bonds	19.0	17.0	16.0
Bills	1.0	1.0	1.0
Loans and retail bonds	4.0	4.0	2.0
External borrowing	12.6	10.0	9.0
Bonds	10.3	7.5	7.0
IMF/EU/Other IFIs	2.3	2.5	2.0
Fiscal reserves change (- =increase)	-5.0	1.5	1.9

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2023E	2024F	2025F
Gross financing requirement	**46.6**	**47.1**	**42.4**
C/A deficit	20.8	18.2	13.5
Amortization of medium- and long-term debt	12.9	14.3	13.9
Government/central bank	2.6	5.0	5.0
Banks	4.8	4.0	3.1
Corporates/Other	5.4	5.4	5.9
Amortization of short-term debt	12.5	14.2	14.6
Financing	**46.6**	**47.1**	**42.4**
FDI (net)	7.5	7.1	7.6
Portfolio equity, net	0.6	0.1	0.1
Medium and long-term borrowing	25.0	17.6	17.6
Government/central bank	14.6	9.6	10.2
Banks	4.3	3.2	2.2
Corporates/Other	6.0	4.8	5.3
Short-term borrowing	14.2	14.6	14.6
EU structural and cohesion funds	6.0	6.6	7.2
Change in FX reserves (- = increase)	-6.6	1.2	-4.7
Memoranda:			
Net foreign purchases of LC govt bonds	3.3	0.5	2.0
International bond issuance, net	8.6	3.9	3.8

Source: NBR, NIS, Ministry of finance, Eurostat, UniCredit Research

Slovakia

A2 negative/A+ stable/A- stable*

Outlook

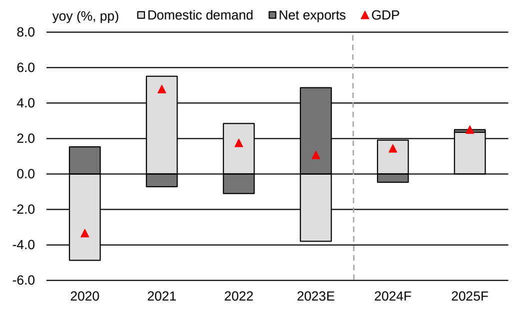
Economic growth will be shaped by an unconventional approach to budget consolidation. Slovakia's new populist government is increasing budget expenditures directed to households, heightening the need for new measures on the revenue side of the budget. The higher tax burden will act as a drag on private investment. Conversely, increased budget expenditure is likely to temporarily boost domestic consumption, which should also be supported by receding inflation and a tight labor market. Apart from consumption, GDP growth is likely to be supported by gradually rebounding external demand and public investment funding via the RRF, especially in 2025. However, utilization of the RRF is being called into question by new policies. We forecast that GDP growth will accelerate to 1.4% in 2024 and to 2.5% in 2025. The pace of fiscal consolidation is not likely to be sufficient to reduce the budget deficit to below 3% of GDP in this electoral cycle or to decrease public debt, which we expect will hover close to 60% of GDP, surpassing the upper limit of Slovakia's debt brake. This could lead to a downgrade in the country's credit rating and to an increase in its risk premium. The governing coalition might bolster its power in presidential elections this spring. The current parliament speaker, Peter Pellegrini, is the main favorite. His main challenger will be former Minister of Foreign Affairs Ivan Korčok.

Author: Ľubomír Koršňák, Chief Economist Slovakia (UniCredit Bank Czech Republic and Slovakia)

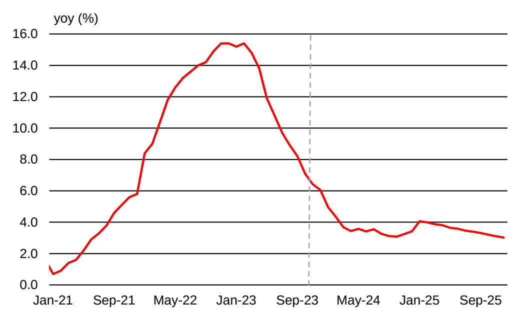
KEY DATES/EVENTS

- 10 Jan, 9 Feb, 8 Mar: industrial production
- 15 Jan, 15 Feb, 15 Mar: CPI
- 14 Feb: Flash 4Q23 GDP
- 7 Mar: 4Q23 GDP structure

GDP GROWTH FORECAST



INFLATION FORECAST



Source: SOSR, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

EUR bn	2021	2022	2023E	2024F	2025F
GDP (EUR bn)	100.3	109.6	121.0	126.6	134.5
Population (mn)	5.4	5.4	5.4	5.4	5.4
GDP per capita (EUR)	18 423	20 186	22 277	23 331	24 813
Real economy. change (%)					
GDP	4.8	1.8	1.1	1.4	2.5
Private consumption	2.7	5.7	-2.3	3.0	2.3
Fixed investment	3.5	4.5	5.8	-2.5	5.8
Public consumption	4.2	-4.2	0.5	-2.5	-2.0
Exports	10.5	3.0	-1.0	2.5	4.8
Imports	11.7	4.2	-6.0	3.2	5.0
Monthly wage. nominal (EUR)	1 211	1 304	1 432	1 532	1 625
Real wage. change (%)	3.6	-4.5	-0.8	3.3	2.4
Unemployment rate (%)	6.8	6.1	6.0	5.9	5.7
Fiscal accounts (% of GDP)					
Budget balance	-5.2	-2.0	-6.4	-6.0	-5.1
Primary balance	-4.1	-1.0	-5.3	-4.7	-3.7
Public debt	61.1	57.8	59.3	60.7	60.7
External accounts					
Current-account balance (EUR bn)	-4.0	-8.0	-1.4	-2.3	-2.4
Current-account balance/GDP (%)	-4.0	-7.3	-1.2	-1.8	-1.8
Extended basic balance/GDP (%)	-1.5	-4.1	0.3	-0.4	0.4
Net FDI (% of GDP)	1.3	2.1	0.0	0.3	1.1
Gross foreign debt (% of GDP)	132.7	126.4	124.0	121.5	118.6
FX reserves (EUR bn)	EUR	EUR	EUR	EUR	EUR
Months of imports, goods & services	-	-	-	-	-
Inflation/monetary/FX					
CPI (pavg)	3.2	12.8	10.7	3.6	3.5
CPI (eop)	5.8	15.4	6.1	3.4	3.0

Source: Eurostat, Statistical Office of the Slovak Republic (SOSR), UniCredit Research

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

New government, new promises

Economic growth to slowly accelerate amid real wage growth and rebounding external demand

Economic growth is set to gradually recover, helped by rising household consumption, amid fiscal transfers and receding inflation and a rebound in global trade from 2H24 onwards. Public investment is expected to be restarted in 2025, driven by the RRF. Fiscal consolidation and relatively tight monetary policy will impede the growth of private investment, especially for SMEs. GDP growth is projected to climb from an estimated 1.1% in 2023 to 1.4% in 2024 and to 2.5% in 2025.

Insufficient fiscal tightening to keep deficit above 3% of GDP and debt close to 60% of GDP…

…possibly triggering credit-rating downgrades

The new populist government of Prime Minister Robert Fico has increased redistribution in public finances. Simultaneously, it has committed to budget consolidation starting in 2024 but at a pace that will keep the deficit above 3% of GDP throughout the current parliamentary term without reducing public debt. Public debt is expected to remain close to 60% of GDP, which is well above the upper limit of Slovakia's debt brake, which is currently set at 54% of GDP and is projected to be decreased to 50% of GDP by 2027. Additionally, the government increased the starting point of consolidation in 2023, largely due to a one-off pension benefit amounting to 0.4% of GDP. The deficit of public finances should decrease by 0.5pp, to 6% of GDP, this year, followed by a 1pp decline in next three years. Consolidation should gain momentum toward the end of the electoral cycle, undermining its credibility. Therefore, a credit-rating downgrade and an increase in risk premiums cannot be ruled out.

Public expenditure is set to rise alongside tax burdens

A consumption rebound is expected to be driven by transfers from the public budget and by real-wage growth

Planned fiscal consolidation will rely on higher revenues from a new 30% tax on bank profits, a prolongation of the spread tax on Russian oil, the reintroduction of tax licenses cancelled in 2018, a 1% increase in health insurance (paid by employers) and higher excise taxes on tobacco and liquor. Additional measures considered for 2025 include introducing a sugar tax and increasing progressivity in personal-income taxation. Spending cuts are expected to be marginal, such as reducing the contribution to the second pension pillar from 5.5% to 4%. On the contrary, the government will increase transfers to households by raising pensions and mortgage subsidies and by extending energy subsidies to keep prices flat. These will increase household income and consumption. Real wage growth will also be supported by receding inflation, which is expected to moderate to 3.6% in 2024, owing to prolonged energy-price subsidies and easing inflation in the prices of goods, while service-price inflation will still be driven by strong wage growth. The country's labor shortage will be addressed via immigration, increasingly from outside Europe.

Higher tax burden to drag on private investment

Large FDI projects in the pipeline

A higher tax burden on the corporate sector will dampen investment and hinder potential growth. Nonetheless, several significant investment projects in the automotive sector are expected to materialize by 2025 and to start production in 2026. A fifth automotive plant (Volvo) will be established in the east, near Košice, with planned production of 250,000 electric cars annually. The country's first battery factory, including R&D, will be located in the southwest. It is to have a capacity of 20GWh per year (initial phase) as a Slovak-Chinese joint venture, while Porsche plans to start battery-subcomponent production in the west of the country in 2026. Increased electricity demand will at least temporarily be met by a fourth block of the Mochovce nuclear power plant, which is expected to be completed in 2025, with production starting in 2026.

Public investment is to be driven by the RRF…

…but has been called into question by new government policies

Public investment will be supported by resources from the RRF. Slovakia has already received three payments totaling EUR 2.1bn (out of a total of EUR 6.4bn). The European Commission is currently evaluating the country's request for fourth payments (EUR 0.9bn). We expect RRF inflows to support economic growth mostly in 2025. EU payments may be endangered by new policies aimed at changing how the country addresses corruption and administers justice.

Presidential elections are to be held in March

Presidential elections will be held in March and elections to the European Parliament in June. Mr. Pellegrini, current Speaker of Parliament, is seen as the frontrunner in the presidential elections. His main challenger will be Mr. Korčok, who is running as an independent candidate and is mainly supported by opposition liberals from Progressive Slovakia (PS) and Liberty and Solidarity (SaS).

Slovenia

A3 stable/AA- stable/A stable*

Outlook

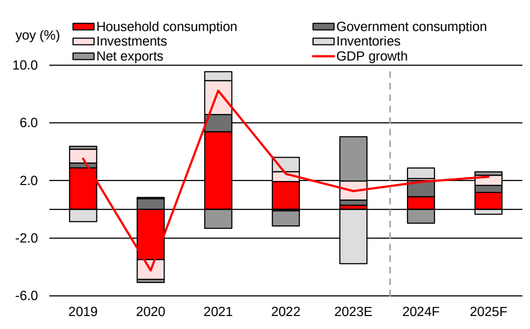
We expect growth to pick up from an estimated 1.3% in 2023 to 1.9% in 2024, driven by a recovery in private consumption, a large increase in government consumption and some build-up of inventories. Investment will probably grow modestly after its big rise in 2023, while we expect net exports to subtract from growth. In 2025, we expect growth to pick up to 2.3%, driven by a further increase in consumption, a pickup in investment and the contribution from net exports turning slightly positive. We expect disinflation to continue in 2024, albeit at a slower pace, with inflation slowing to 3.4% at end-2024 and further to 2.5% at the end of 2025. Service-price inflation will likely remain stickier amid strong growth. The fiscal deficit will probably remain above 3% of GDP in 2024 before narrowing to 2% of GDP in 2025. Funding needs will amount to EUR 5.3bn in 2024. Of this, repayments will amount to EUR 2.5bn, which we expect to be covered mostly with bond issuance and, in part, with fiscal reserves.

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

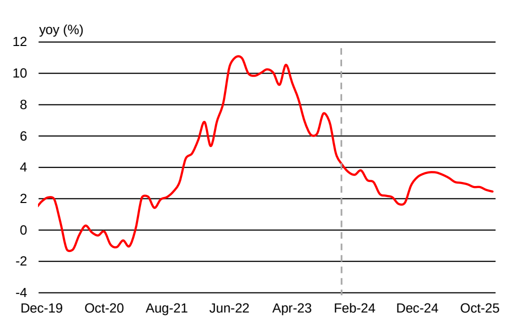
KEY DATES/EVENTS

- 14 Feb: 4Q23 GDP
- 6 Feb, 29 Feb, 29 Mar: CPI inflation

GDP GROWTH FORECAST



INFLATION FORECAST



Source: Slovenia statistical office (SURS), UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2021	2022	2023E	2024F	2025F
GDP (EUR bn)	52.3	57.0	62.0	64.9	68.4
Population (mn)	2.1	2.1	2.1	2.1	2.1
GDP per capita (EUR)	24,803	27,061	29,421	30,801	32,456
Real economy, change (%)					
GDP	8.2	2.5	1.3	1.9	2.3
Private consumption	10.3	3.6	0.5	1.6	2.2
Fixed investment	12.6	3.5	6.8	0.7	3.5
Public consumption	6.1	-0.5	1.9	6.0	2.5
Exports	14.5	7.2	-4.0	1.7	4.2
Imports	17.8	9.0	-7.8	3.1	4.3
Monthly wage, nominal (EUR)	1,970	2,024	2,206	2,342	2,471
Real wage, change (%)	4.1	-6.1	1.6	3.4	2.4
Unemployment rate (%)	4.5	4.0	3.6	3.5	3.5
Fiscal accounts (% of GDP)					
Budget balance	-4.6	-3.0	-3.5	-3.4	-2.0
Primary balance	-3.4	-1.9	-2.4	-2.2	-0.7
Public debt	74.4	72.3	69.5	68.5	67.0
External accounts					
Current-account balance (EUR bn)	1.7	-0.6	2.9	1.6	1.8
Current-account balance/GDP (%)	3.3	-1.0	4.6	2.4	2.7
Extended basic balance/GDP (%)	7.0	2.0	5.1	5.2	6.0
Net FDI (% of GDP)	0.8	2.3	-1.1	1.2	1.3
Gross foreign debt (% of GDP)	97.4	90.9	91.9	91.2	89.8
FX reserves (EUR bn)					
Months of imports, goods & services					
Inflation/monetary/FX					
CPI (pavg)	1.9	8.8	7.4	2.8	3.1
CPI (eop)	4.9	10.3	4.2	3.4	2.5

Source: SURS, Eurostat, UniCredit Research

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

A gradual recovery driven by consumption in 2024

Consumption will be the main driver of growth

We expect growth to pick up from an estimated 1.3% in 2023 to 1.9% in 2024, driven by a recovery in private consumption, a large increase in government consumption and some build-up of inventories. Such a recovery in consumption should be driven by an improvement in real income as inflation decreases and as private nominal wage growth remains solid amid a tight labor market and a moderate increase in public-sector wages (5%). A large increase in government consumption will reflect legal changes related to supplementary health insurance, which technically shifts growth from private to public consumption. Inventories will probably increase in 2024 after having undergone big reductions in 2023. On the other side, investment, after experiencing significant growth in 2023 due to both private and government investment, will probably remain shallow in 2024. Growth in government investment will probably be unchanged but remain high (at 5% of GDP, supported by EU funds), while growth of private investment will likely slow, reflecting high borrowing costs. Net exports will likely act as a drag, as imports recover and exports remain sluggish amid weak external demand.

We expect growth to pick up in 2025

In 2025, we expect growth to pick up to 2.3%, driven by a further increase in consumption, a pickup in investment and the contribution from net exports turning slightly positive.

Disinflation should continue in 2024 but at a slower pace

After inflation fell from a peak of 10.5% in March to 4.2% in December 2023, we expect disinflation to continue in 2024, albeit at a slower pace. We expect to see inflation at 3.4% at end-2024, with such a fall driven by lower prices for core goods and base effects in food-price inflation. Service prices will likely remain stickier due to strong wage growth. Energy-price inflation will continue to be mitigated by government price caps on gas and electricity, which have been extended, and by an exemption from energy-related levies introduced in November 2023. In 2025, we expect to see inflation at 2.5% by year-end, with the further slowdown driven by core prices and food prices, while energy-price inflation will work in the opposite direction due to base effects. Risks to our inflation outlook are related to commodity prices and stickier service-price inflation due strong expected wage growth.

The government deficit will likely remain above 3% of GDP in 2024

The deficit in 2023 will likely be much lower than planned, probably around 3.5% of GDP due to underspending, which has been a common feature in the past few years. The deficit for 2024 is planned to amount to 3.8% of GDP, which would therefore imply a widening of the deficit. When one-offs related to floods and mitigation of the impact of energy prices are excluded, the deficit will likely be lower, probably around 3% of GDP. We forecast Slovenia's fiscal deficit for 2024 at 3.4% of GDP, as we assume that the country's capital expenditure will be lower than planned, a common feature of previous years. While recent reform of the EU's economic governance has created some uncertainty, we do not expect the European Commission to open a deficit-based excessive-deficit procedure for Slovenia in 2024. In 2025, we expect the deficit to narrow to 2.0% of GDP. Slovenia's debt/GDP ratio will remain high but will likely edge down from 69.5% in 2023 to 68.5% by 2024 and to 67.0 in 2025, driven by high nominal GDP growth. Medium-term fiscal challenges will remain. EU fund flows will likely be EUR 1bn in 2024, of which EUR 500mn from RRF.

Further bond issuance in the reminder of the year

Funding needs will amount to EUR 5.3bn in 2024. Of this, repayments will amount to EUR 2.5bn, which we expect to be covered mostly via bond issuance (including a portion in retail bonds) and, in part (EUR 600mn), via fiscal reserves, which we estimate amounted to EUR 7.5bn as of October 2023, based on government deposits at Slovenia's central bank and at other banks. The government already issued EUR 1.5bn of a 10-year bond at the beginning of January. In 2025, we estimate that Slovenia's funding needs will amount to close to EUR 3.7bn, and, of this, repayments will amount to EUR 2.4bn.

The current government is likely to be more stable than previous ones

We continue to think that the coalition government that was formed following elections in April 2022 and is made up of three parties – Freedom Movement, the Social Democrats and Levica –could be more stable than the previous government, which was comprised of a larger number of parties. The government has a majority of seats (53 of 90) in the National Assembly.

Bosnia and Herzegovina

B3 stable/B+ stable/not rated*

Outlook

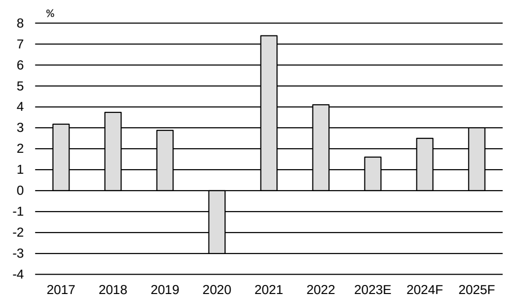
We are keeping our GDP estimate for 2023 at 1.6% and the forecast for 2024 at 2.5%. Growth in 2024 will likely pick up, driven by a recovery in private consumption, as real income recovers, reflecting disinflation. A positive factor behind this outlook is that governments were formed in Bosnia and Herzegovina (BiH) and its main entities more swiftly than usual after the latest general elections in October 2022. So, we also expect to see more of a contribution from public spending, which should be easier to implement with all the layers of government formed in 2023. In 2025, we expect growth to accelerate to 3.0%, private consumption to recover further, investment to increase and net external demand to improve. In addition, the prospects of BiH becoming a candidate for EU membership pushed the government to adopt the reform agenda needed to meet the requirements for opening negotiations for accession. The decision on BiH's EU candidate status was postponed to March 2024.

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

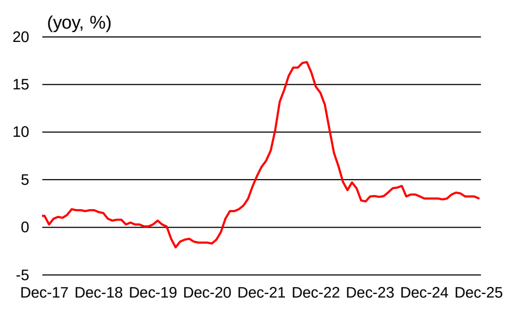
KEY DATES/EVENTS

- 25 Jan: foreign trade 2023
- 25 Jan: CPI 2023
- 2 February: S&P and Moody's rating review
- March: EC progress report on BiH
- 25 Mar: balance of payments 2023
- 25 Mar: 4Q23 & 2023 GDP

GDP GROWTH FORECAST



INFLATION FORECAST



Source: UniCredit Research

MACROECONOMIC DATA AND FORECASTS

EUR bn	2021	2022	2023E	2024F	2025F
GDP (EUR bn)	20.01	23.27	24.62	26.12	27.76
Population (mn)	3.45	3.43	3.42	3.40	3.39
GDP per capita (EUR)	5800	6783	7210	7682	8202
Real economy, change (%)					
GDP	7.4	4.1	1.6	2.5	3.0
Monthly wage, nominal (EUR)	789	881	998	1054	1117
Real wages, change (%)	4.4	-2.1	6.6	2.1	2.8
Unemployment rate (%)	32.5	30.1	29.0	27.5	25.5
Fiscal accounts (% of GDP)					
Budget balance	0.6	0.9	-1.5	-1.5	-1.0
Primary balance	1.3	1.8	-0.6	-0.3	0.2
Public debt	34.6	29.6	29.5	29.3	28.5
External accounts					
Current-account balance (EUR bn)	-0.5	-1.0	-1.2	-1.1	-1.2
Current-account balance/GDP (%)	-2.4	-4.5	-4.8	-4.4	-4.2
Extended basic balance/GDP (%)	0.8	-1.3	-1.9	-1.5	-1.4
Net FDI (% of GDP)	2.3	2.5	2.2	2.2	2.1
Gross foreign debt (% of GDP)	24.1	20.8	20.3	20.1	20.2
FX reserves (EUR bn)	8.4	8.2	8.3	8.7	9.2
Months of imports, goods & services	9.3	6.7	6.3	6.2	6.2
Inflation/monetary/FX					
CPI (pavg.)	2.0	14.0	6.3	3.5	3.2
CPI (eop)	6.4	14.8	3.2	3.0	3.0
1M money-market rate (Dec. avg.)	-0.58	1.88	3.85	3.20	2.45
USD/FX (eop)	1.72	1.83	1.77	1.73	1.70
EUR/FX (eop)	1.96	1.96	1.96	1.96	1.96
USD/FX (pavg.)	1.66	1.86	1.81	1.75	1.72
EUR/FX (pavg.)	1.96	1.96	1.96	1.96	1.96

Source: 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.

Rebuilding the hope for EU accession

We are keeping our estimate for GDP growth at 1.6% in 2023 and our forecast at 2.5% for 2024, while we forecast that GDP will grow by 3.0% in 2025

We are keeping our GDP growth estimate for 2023 at 1.6% and forecast for 2024 at 2.5%. In 2024, we expect growth to be driven by a recovery in private consumption, as inflation recedes, and by public investment. In 2025, we expect growth to pick up further, driven by a recovery in external demand on top of recoveries in private consumption and public investment. Since spring 2023, key layers of government have been formed (after elections in October 2022) more swiftly than in the past, and this should support public investment and spending by the government. Although BiH's fiscal policy is expected to remain prudent, government will likely be able to increase spending more than it was able to under its previous fiscal policy (limited through technical budgets).

Inflation is set to decelerate, though rises in wages and public consumption may work against it

Despite higher spending by both individuals and government, deceleration of inflation should continue. We expect inflation to hover in the 3-4% range in 2024 and then around 3% during 2025. The main drivers of inflation, food and energy prices but also transport and housing prices, will gradually weaken and leave room for inflation deceleration. However, a recovery in wages, as noted during recent months, and a rise in domestic demand will likely work against such deceleration and keep inflation above levels that prevailed prior to the pandemic.

The relatively swift formation of governments after elections resulted in changes to BiH's sovereign credit rating

A tough reform agenda lies ahead, but there is evidence of political willingness to press ahead…

…even though progress was stalled and resulted in the postponement of an unconditional EC recommendation to open EU accession negotiations

The swift formation of governments at the state level and at entity levels after elections in 2022 consolidated the political structure of BiH. Rating agencies praised this development, triggering an outlook change to positive as a first step and then even a one-notch upgrade by S&P in late summer. Though BiH is known for its frequent political stalemates, the government(s) seem to be focused on implementing a reform agenda. The reform agenda is based on the European Commission's (EC) stipulations regarding potential BiH EU membership from May 2019 (it includes 14 key priorities) and the commitments BiH agreed to take on when its EU candidate status was approved in December 2022. We think BiH has demonstrated a political willingness to implement the reform agenda, with several laws pertaining to these priorities having been debated in parliament and four laws having been adopted in August and September; the laws address integrity of the judiciary, torture prevention, the status of foreigners and freedom to access information. However, in our view, recent developments, mainly in Republika Srpska, go against the positive momentum BiH has built, thus undermining constitutional and legal order in the country. Therefore, sufficient progress by the date of issuance the progress report in November had not been achieved, postponing a decision by the EC to issue an unconditional recommendation that membership negotiations be opened and causing the EC to recommend that accession negotiations be opened only after BiH achieves a necessary degree of compliance with the membership criteria. The EC is to report to the European Council on BiH's progress in this regard in March 2024 at the latest. We think a positive outcome here would improve overall business and political sentiment in the country.

BiH's fiscal deficit is likely to widen but to remain under control

BiH's solid fiscal performance has continued. One of the main drivers of this has been the fact that both the federal and state governments have operated with technical budgets that included only mandatory expenditures. Inflation supported revenue collection and thus supported fiscal performance by enabling the administration to operate with a small deficit. We expect BiH's deficit to widen (to around 1.5% of GDP) as the country implements the aforementioned reform agenda but expect the deficit to remain contained over the next few years while authorities follow the recommendations of foreign (financial) institutions with regard to boosting capital spending and keeping current spending under control.

Risks are related to the unpredictable nature of local politics and the economic performance of BiH's main trading partners

Risks to BiH's outlook are mainly related to the unpredictable nature of BiH's domestic politics, which could affect implementation of the reform agenda; investor perception and sentiment and the outlook associated with BiH's credit rating. External risks are mostly related to the performance of the country's main trading partners and to energy prices (BiH imports most of its energy commodities, except electricity, of which BiH is a net exporter).

Russia

Rating withdrawn / not rated / withdrawn*

Outlook

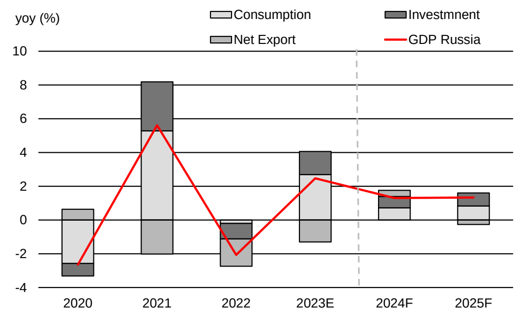
We expect GDP growth to slow from around 2.5% in 2023 to 1.3% in 2024-25. This year, fiscal policy will be the main growth driver, while private consumption and investment will decelerate amid tighter financial conditions and base effects. We expect inflation to return close to target in 2024 amid high risks from expected RUB depreciation and very tight labor-market conditions. We expect the CBR to start cutting rates in 2H24, with a prudent approach to lending to avoid overheating. Long-term growth prospects are affected by the shortage of labor and productive capacities.

Authors: Artem Arkhipov, Head of Macroeconomic and Markets Research Russia (UniCredit Russia)

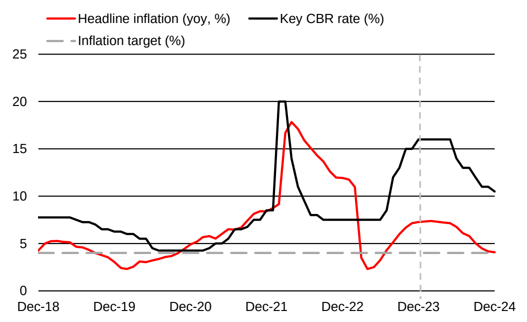
KEY DATES/EVENTS

- 14 Feb, 13 Mar: CPI
- 16 February, 22 March: monetary-policy decisions
- 15-17 March: presidential election

GDP GROWTH FORECAST



INFLATION FORECAST



Source: CBR, Rosstat, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

EUR bn	2021	2022	2023E	2024F	2025F
GDP (EUR bn)	1,552	2,070	1,816	1,630	1,496
Population (mn)	147	147	147	147	147
GDP per capita (EUR)	10,561	14,098	12,372	11,109	10,191
Real economy, change (%)					
GDP	5.6	-2.1	2.5	1.3	1.3
Private consumption	10.0	-1.4	4.9	1.1	1.4
Fixed investment	9.1	3.3	11.9	2.7	3.1
Public consumption	2.9	2.8	5.6	0.9	0.6
Exports	3.3	-13.9	-4.8	-9.6	0.5
Imports	19.1	-15.0	5.5	-14.4	2.4
Monthly wage, nominal (EUR)	657	882	805	741	682
Real wage, change (%)	4.5	0.3	8.0	2.0	1.5
Unemployment rate (%)	4.8	3.9	3.2	3.4	3.7
Fiscal accounts (% of GDP)					
Budget balance	0.4	-2.2	-2.6	-3.4	-1.6
Primary balance	1.2	-1.3	-1.5	-1.8	0.0
Public debt	15.5	14.9	16.2	20.0	21.0
External accounts					
Current account balance (EUR bn)	103	226	40.0	47.7	33.5
Current account balance/GDP (%)	6.7	10.9	2.2	2.9	2.2
Extended basic balance/GDP (%)	5.3	5.4	1.0	1.4	0.7
Net FDI (% of GDP)	-1.4	-5.5	-1.3	-1.5	-1.5
Gross foreign debt (% of GDP)	27.3	17.3	19.5	21.5	23.0
FX reserves (EUR bn)	412	390	389	378	382
Months of imports, goods & services	13.0	13.5	12.5	12.7	13.7
Inflation/monetary/FX					
CPI (pavg.)	6.7	13.8	5.9	6.1	4.0
CPI (eop)	8.4	11.9	7.3	4.1	4.0
Central bank target	4.0	4.0	4.0	4.0	4.0
Central bank reference rate (eop)	8.5	7.5	16.0	10.5	7.0
3M money market rate (Dec avg.)	8.5	7.6	15.9	10.6	7.1
3M money market rate (year avg.)	6.0	10.9	10.3	13.3	8.9
USD-RUB (eop)	74.3	70.3	89.7	103	113
EUR-RUB (eop)	84.1	75.7	99.2	116	130
USD-RUB (pavg.)	73.7	69.6	85.8	96.8	109
EUR-RUB (pavg.)	87.2	74.1	92.9	109	125

Source: Rosstat, CBR, UniCredit Research

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

Fiscal-powered recovery

2023 GDP growth of around 3% exceeded expectations

The Russian economy grew faster than expected in 9M23, with authorities believing that GDP growth would exceed 3% in 2023. This high activity has its roots in both supply and demand. On the demand side, fiscal spending stimulated the economy at the beginning of the year. The credit impulse took over during 2-3Q23, boosting consumption and investment by accelerating retail and corporate lending to around 20% yoy. In addition, sanctions had a smaller-than-expected impact on external demand and import substitution. On the supply side, producers became more optimistic amid robust private and public-sector demand. This increased production, pushing industrial-production growth above 5% yoy and the economy to close to capacity. As a result, the outlook for 2024-25 is mixed.

Fiscal policy will boost GDP growth in 2024…

We believe there are reasons to expect that activity will continue to expand in 2024, helped by strong carry-over from 4Q23 and higher public spending. In the 2024 budget, authorities committed themselves to increasing spending by 15.7% yoy. It is unclear whether this increase is to be directed towards productive investment, but even social outlays ahead of presidential elections or for other types of public consumption would support the economy.

…especially ahead of presidential elections in March 2024

President Vladimir Putin has confirmed his intention to run in the presidential election scheduled for 15-17 March 2024. The only unknown would be his re-election score. Aiming for high support, Mr. Putin is likely to favor higher social spending, similar to what happened before the 2018 election. In 2023, fiscal discipline and predictability helped cover large gross borrowing. While authorities expect the 2024 budget deficit to amount to RUB 1,595bn, or 0.9% of GDP, our outlook for budget revenues is more conservative. As a result, we forecast the deficit to grow to 3.4% of GDP this year. Additional increases in budget spending may prove more difficult to fund if they are maintained in the long term and if the budget signals fiscal consolidation in the coming years.

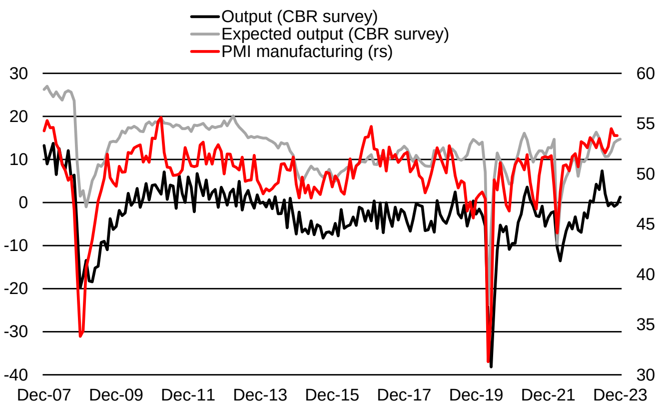
Prudent monetary policy addressing short-term and structural issues

We expect monetary policy to offset a portion of fiscal easing and to contain economic activity. Indeed, financial conditions tightened significantly in 2H23; the CBR hiked the key rate from 7.5% in July to 16% in December to fight inflation, which means rate cuts are unlikely to be quick. The previous hiking cycle was triggered by risks to financial stability and was rapidly unwound once capital controls were introduced. We expect inflation to end 2023 close to 7.5% yoy, well above the CBR's 4% target. Inflation seems to be rooted in demand growth outpacing supply, of which there are abundant signs: labor-market shortages, strong import demand, delayed consumption, strong demand for borrowing, etc.

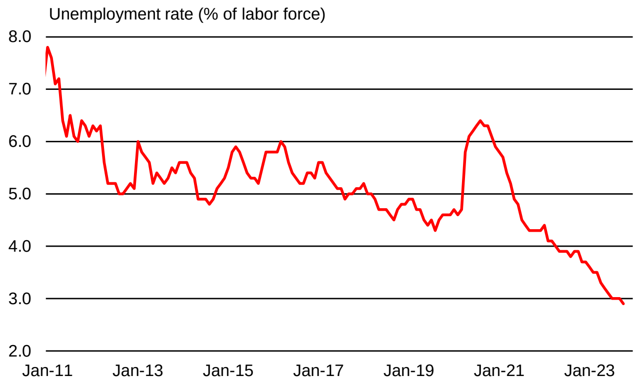
Tightest labor-market conditions on record

Russia's unemployment rate fell below 3% in November, its lowest level on record. As a result, pressure on wages is also very high. In real terms, they increased by 7.4% yoy in 9M23.

SENTIMENT INDICATORS SUGGEST BUSINESS OPTIMISM



THE UNEMPLOYMENT RATE IS AT AN ALL-TIME LOW



Source:, Rosstat, Bank of Russia, UniCredit Research

This is related to mobilization, crowding out by defense-related sectors and emigration last year due to mobilization, but fundamentally, this is a demographic issue. As a result, we expect tight labor-market conditions to exert protracted pressure on inflation and to drag on Russia's economic growth potential in the medium term.

Consumption growth to slow gradually

We expect consumer demand to grow by about 1.1% in 2024, decelerating from 5% in 2023. In 2023, delayed demand was an important driver of consumer spending. In 2023, uncertainty was very high. The savings rate jumped to crisis levels, and supply chains in some sectors broke down (e.g., for cars and home appliances). In 2023, supply chains for consumer goods recovered, with supplies from China gaining market share. Favorable lending conditions during 1H23 supported this trend, while the tightening cycle in 3Q23 helped accelerate purchases. Tight financial conditions will lead to a negative credit impulse in 2024, but budget spending and the drawing from savings should help the economy avoid a hard landing. A similar reaction to financial conditions was observed in corporate behavior as well. In 2025, the negative fiscal impulse could be offset by looser financial conditions, keeping GDP growth close to 1%.

The RUB is likely to depreciate further

For years, imports accounted for around 20.5% of GDP. The supply-chain issue in 2022 caused this figure to decline, but rapid economic recovery in 2023 brought acceleration of import demand as well. As a result, Russia's trade balance shrank below its structural level, while FX liquidity fell due to the currency mismatch between debt and import payments (mostly denominated in USD and EUR) and export revenues (which are increasingly denominated in other currencies, such as CNY or RUB). In order to stabilize the exchange rate, the CBR attempted to reduce import demand via higher rates, while the government tightened controls on exports. However, we see scope for further RUB deprecation due to tighter sanctions ahead, technology imports (which could increase production capacity) and a persistent output gap. Thus, we expect USD-RUB to be at 103 in 2024, with the FX pass through boosting inflation and inflation expectations.

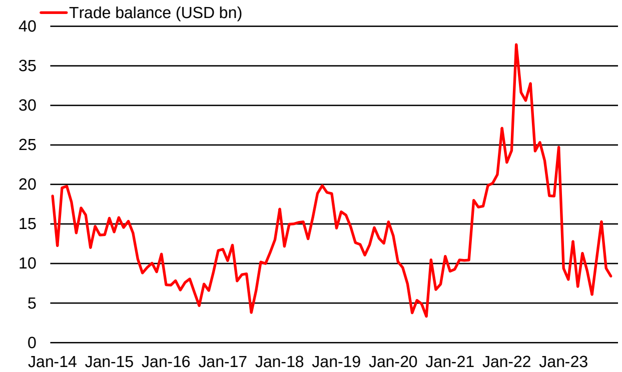
We expect rate cuts only in 2H24

The CBR is aware of these inflationary risks, and while further hikes do not seem likely (according to comments made by the CBR during a recent press conference and due to the declining efficiency of new hikes at these levels), the monetary authorities can keep the key rate high for a prolonged period. We do not expect the CBR to turn to policy easing before June 2024, and the average key rate for 2024 is expected to exceed 12%. Tight policy will help calm prices at the end of 2024, when we expect headline inflation to amount to 4-4.5%.

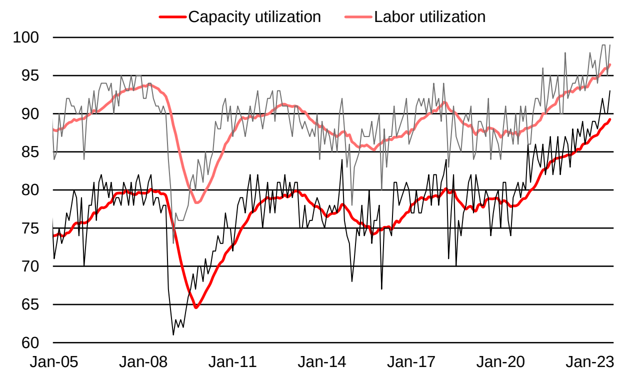
Long-term factors should keep GDP growth close to 1% in 2025

High interest rates, adoption of more-prudent fiscal policy and the exhaustion of spare capacity will be a negative signal for medium-to-long-term growth prospects. In 2025, with stable inflation close to the CBR target and USD-RUB at its new equilibrium level of 110-115, the economy could grow by around 1.3%, in our view.

SHRINKING TRADE SURPLUS



VERY HIGH RESOURCE UTILIZATION



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

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2023E	2024F	2025F
Gross financing requirement	**59.4**	**65.4**	**33.0**
Budget deficit	47.9	55.2	23.6
Amortization of public debt	11.5	10.3	9.4
Domestic	11.5	10.3	9.4
Bonds	11.5	10.3	9.4
Bills	--	--	--
Loans	0.0	0.0	0.0
External	0.0	0.0	0.0
Financing	**59.4**	**65.4**	**33.0**
Domestic borrowing	50.0	79.3	33.1
Bonds	50.0	79.3	33.1
Bills	--	--	--
Loans	0.0	0.0	0.0
External borrowing	0.0	0.0	0.0
Bonds	0.0	0.0	0.0
Other	0.0	0.0	0.0
Privatization/Other	0.0	0.0	0.0
Change in budget accounts ("+": decrease)	9.4	-13.9	-0.1

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

Serbia

Ba2 stable/BB+ stable/BB+ stable*

Outlook: The new EU growth plan for the Western Balkans will provide an opportunity for Serbia to make decisive steps towards EU accession. The plan allows some of the benefits of EU membership to be frontloaded, including funding and some access to the single market, in return for implementing reforms and engagement in normalizing relations with Kosovo. The incentives are attractive but there are implementation risks. We expect GDP growth to pick up to 2.8% in 2024, from an estimated 2.5% in 2023, driven by stronger consumption and investment, and to increase further to 3.1% in 2025. The fiscal deficit is planned to be 2.2% of GDP in 2024, similar to the level in 2023, before narrowing to 1.5% GDP in 2025. We expect inflation to fall below the upper bound of the central bank's target range (4.5%) in 4Q24 and the National Bank of Serbia (NBS) to start cutting interest rates from June.

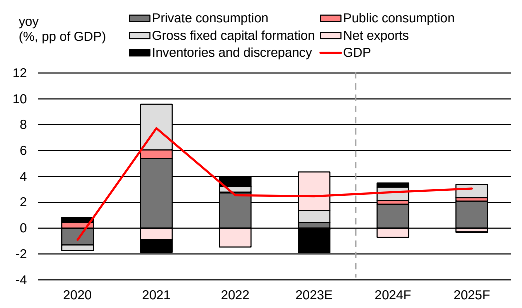
Strategy: In 1Q24, issuance will likely be focused on local-currency bonds.

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

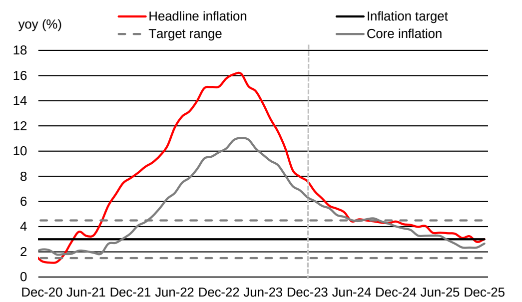
KEY DATES/EVENTS

- 8 Feb, 7 Mar: NBS monetary policy decision
- 12 Jan, 19 Feb, 12 Mar: CPI inflation
- 31 Jan, 29 Feb: 4Q23 GDP
- 9 Feb: Fitch to update sovereign rating
- 16 Feb: Moody's to update sovereign rating

GDP GROWTH FORECAST



INFLATION FORECAST



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

MACROECONOMIC DATA AND FORECASTS

	2021	2022	2023E	2024F	2025F
GDP (EUR bn)	53.3	60.4	69.2	74.6	79.2
Population (mn)	6.8	6.7	6.7	6.6	6.6
GDP per capita (EUR)	7,805	9,067	10,321	11,236	12,048
Real economy, change (%)					
GDP	7.7	2.5	2.5	2.8	3.1
Private consumption	7.8	4.0	0.6	2.7	3.0
Fixed investment	15.7	1.9	3.8	4.3	4.1
Public consumption	4.1	0.4	-0.7	1.8	1.8
Exports	20.5	16.6	1.8	4.1	5.7
Imports	18.3	16.1	-2.2	4.5	5.4
Monthly gross wages, nominal (EUR)	772	879	1006	1096	1167
Real wages, change (%)	5.1	1.6	1.7	3.8	3.3
Unemployment rate (%)	11.4	9.7	9.6	9.4	9.0
Fiscal accounts (% of GDP)					
Budget balance	-4.3	-3.2	-2.2	-2.2	-1.5
Primary balance	-2.6	-1.7	-0.4	-0.1	0.4
Public debt	57.1	55.7	53.5	52.0	50.9
External accounts					
Current-account balance (EUR bn)	-2.3	-4.1	-1.7	-2.8	-3.2
Current-account balance (% of GDP)	-4.2	-6.8	-2.5	-3.8	-4.1
Extended basic balance/GDP (%)	2.6	0.3	4.0	1.7	1.3
Net FDI (% of GDP)	6.9	7.1	6.5	5.5	5.3
Gross foreign debt (% of GDP)	68.4	69.3	64.3	63.1	62.6
FX reserves (EUR bn)	16.6	20.0	24.9	26.5	28.6
Months of imports, goods & services	6.0	5.3	6.3	6.1	6.0
Inflation/monetary/FX					
CPI (pavg)	4.1	12.0	12.4	5.0	3.6
CPI (eop)	7.9	15.1	7.5	4.5	3.0
Central-bank target	3.0	3.0	3.0	3.0	3.0
Central-bank reference rate (eop)	1.00	5.00	6.50	5.50	4.50
3M money-market rate (Dec avg)	0.93	4.79	5.71	5.50	4.50
USD/FX (eop)	103.9	110.2	105.9	104.1	102.6
EUR/FX (eop)	117.6	117.3	117.2	117.6	118.0
USD/FX (pavg)	99.4	111.7	107.7	105.6	103.6
EUR/FX (pavg)	117.6	117.5	117.3	117.4	117.9

Source: Bloomberg, Eurostat, Statistical Office of the Republic of Serbia, NBS, public debt agency, UniCredit Research

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

An opportunity to progress on EU accession

An opportunity to progress with EU accession

The new EU growth plan for the Western Balkans[20] will provide an opportunity for Serbia to make decisive steps towards EU accession, especially after the recent elections gave the ruling party a strong mandate to take Serbia closer to the EU[21]. The plan allows some of the benefits of EU membership to be frontloaded, including funding and some access to the single market, in return for implementing reforms and engaging in normalizing relations with Kosovo. Missing this opportunity is one of the main risks to the outlook.

Significant amount of funding and access to some areas of the EU single market

The plan envisages significant funding, EUR 6bn in 2024-27 for the region, of which Serbia could receive EUR 3.8bn, according to its GDP share in the region. This comes on top of the IPA III funds (EUR 13bn for the region). Integration in some areas of the single market will be another appealing feature[22] and will be conditional on developing a common regional market.

Conditions: implementing reforms

To obtain these benefits, countries will have to implement the reforms envisaged in the chapters for EU accession, the "acquis", with progress reviewed semiannually starting from 3Q24. There will likely be a particular focus on the areas of rule of law and fundamental rights, where Balkan countries have lagged (left chart). Such reforms could be politically costly and the benefits delayed, however the EU plan provides significant incentives to implement them.

Conditions: normalizing relations with Kosovo

Serbia will also have to engage constructively in the normalization of its relations with Kosovo. We continue to believe the agreement on the EU proposal to normalize relations between Kosovo and Serbia in February 2023 was a decisive breakthrough. While there has been no progress on implementation, pressure from the EU and the US to move forward will likely intensify, therefore we see the possibility of some progress in 2024.

An opportunity too good to be missed, but there are risks

The opportunities provided by the EU plan, are very attractive. Nevertheless, there are risks. Implementation of reforms could be too costly politically or lack the necessary political consensus. Tensions with Kosovo could increase anew, or the two parties could fail to engage constructively.

GDP growth will likely pick up in 2024, driven by domestic demand

Despite external demand remaining weak, we expect GDP growth to pick up to 2.8% in 2024, from an estimated 2.4% in 2023, mainly driven by stronger consumption and, to a lesser extent, investment. Growth in 2024 will benefit from an estimated carry-over of 1.3pp.

Improvement in real income will support consumption

After stagnating in 2023, consumption will probably become the main driver of GDP growth in 2024, as disinflation and wage growth boosts real income and financial conditions start to ease. The minimum wage will rise by 17.8%, public sector wages will increase by 10% and pensions by 15%. Wage growth in the private sector will probably remain resilient amid tight labor market conditions in some sectors. Financial conditions will likely start to ease from June, when we expect the NBS and the ECB to start reducing interest rates, with the NBS outpacing the ECB.

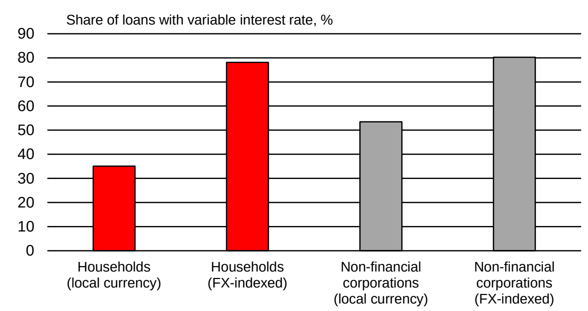
REFORMS FOR EU ACCESSION LAGGING IN SOME AREAS

Cluster	State of play
1. Fundamentals	
Public administration reform	
Rule of law and fundamental rights	
Economic Criteria	
Pub. procurement, stats, fin. controls	
2. Internal market	
3. Competitiveness and inclusive growth	
4. Green agenda and connectivity	
5. Resources, agriculture, cohesion	
6. External relations	

Legend	
Early stage	
Some level of preparation	
Moderately prepared	
Good level of preparation	
Well advanced	

Note: the state of play is calculated as the average of the state of play of the various sub-indices of the clusters as published in the European Commission Serbia 2023 Report

LOWER RATES WILL EASE THE REPAYMENT BURDEN



*It should be noted that the share of FX-indexed loans for households is 47%, while it is 83% for non-financial corporations

Source: European Commission, National Bank of Serbia, UniCredit Research

[20] New growth plan for the Western Balkans The plan is a proposal by the European Commission but it is expected to be adopted by the European Council in 1Q24.

[21] For details see our EEMEA Macro Flash Serbia: SNS receives strong mandate to take Serbia closer to the EU, 18 December 2023

[22] For details, please see the Communication from the European Commission on the new growth plan for the Western Balkans, box on page 3-5

Investment will also pick up

Investment growth will also likely pick up. Public investment is planned to rise by around 5% in nominal terms to around 7% of GDP, mainly due to the implementation of infrastructure projects. Private investment growth is expected to accelerate, supported by strong FDI, easing supply bottlenecks and lower production costs. Stellantis will start to produce the new electric Fiat Panda in Serbia, probably in 2H24, which should also support private investment. Easing financial conditions in 2H24 will start to relieve the repayment burden for companies given the high share of loans with variable interest rates (right chart on the previous page).

Net exports becoming a drag

After a large contribution in 2023 due lower energy imports, net exports will probably subtract from growth as imports recover and export growth remains moderate, while inventories, which were the main drag on growth in 2023, will probably increase somewhat.

We expect growth to pick up to 3.2% in 2025

In 2025, we expect growth to pick up to 3.1%, as disinflation continues, financial conditions ease further, and external demand picks up.

Current-account deficit to widen but likely to remain covered by FDI

While the current account deficit will likely widen from an estimated 2.5% of GDP in 2023 to 3.8% of GDP in 2024, as imports recover and exports growth picks up only moderately, the deficit will likely continue to be covered by FDI. This also applies to 2025, when the deficit will likely widen to around 4% of GDP. We expect the RSD to remain stable, supported by the NBS' large reserves.

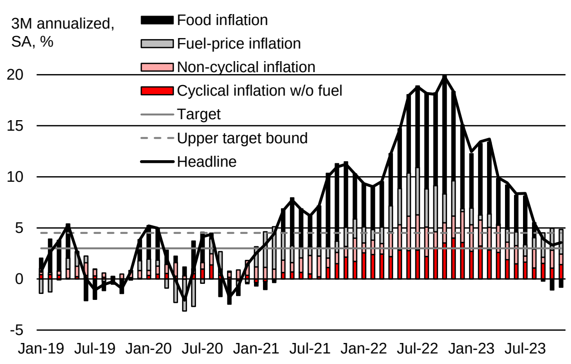
The fiscal deficit is planned to narrow in 2024 and 2025

The fiscal deficit for 2023 was probably lower than planned and we expect it at 2.2% of GDP compared to a target of 2.8% of GDP. The planned deficit of 2.2% of GDP for 2024 appears achievable, also considering reduced support for energy companies and the absence of the one-off payments seen in 2023. In 2025, the government deficit is planned to be 1.5% of GDP, in line with the new fiscal rule. Public debt is likely to decline from 53.5% of GDP in 2023 to 52.0% of GDP in 2024 and further to 50.8% in 2025. Fiscal risks remain related to state-owned energy companies, in the event of another energy crisis.

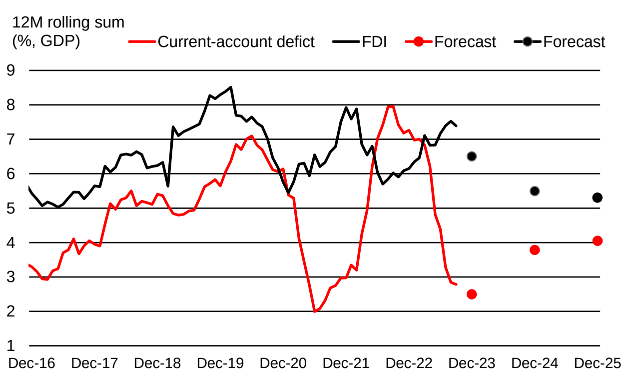
Inflation likely to reenter the target range in 4Q24

We expect inflation to fall below the upper bound of the central bank's target range (4.5%) in 4Q24. After falling below 7.6% yoy in December, inflation will likely slow further, driven by food and core prices, albeit at a slower pace than in 2023 as the scope for base effects in food prices will be smaller and core inflation might be stickier. We see two main risks: renewed supply shocks for energy and food prices and stickier-than-expected core inflation due to strong wage and pension increases. Inflation will probably reach the 3% target by the end of 2025. We expect the NBS to start reducing interest rates in June.

INFLATION MOMENTUM POINTS TO SLOWER DISIFNLATION



CURRENT-ACCOUNT DEFICIT TO REMAIN COVERED BY FDI

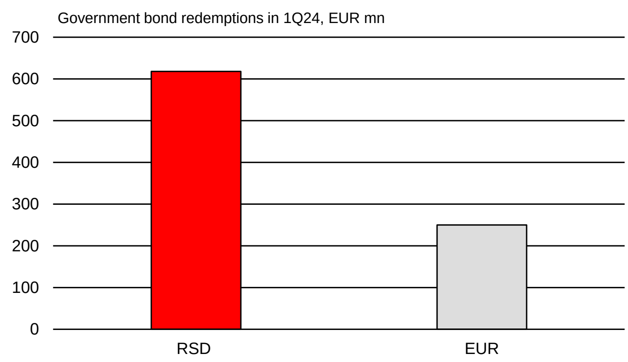


Source: Statistical Office of the Republic of Serbia, NBS, UniCredit Research

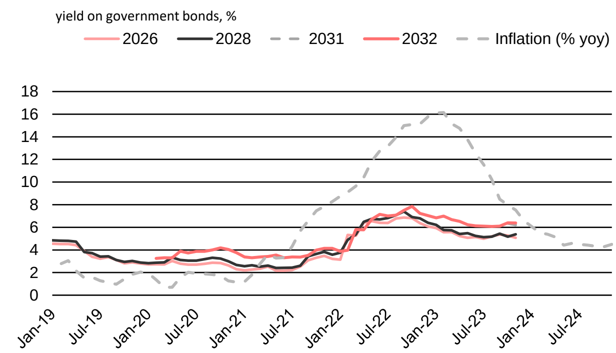
Funding in 1Q24 to focus on local-currency issuance

Funding needs amount to EUR 6.6bn in 2024, EUR 1.6bn for the deficit and EUR 5.0bn in repayments (we assume EUR 3.6bn in foreign repayments, including the UAE loans, and EUR 1.4bn in domestic repayments). As usual, the government's borrowing plan is well in excess of needs (EUR 9.3bn vs. EUR 6.7bn) in order to allow flexibility to choose the funding source depending on market conditions. The plan envisages EUR 2.0bn in domestic borrowing, EUR 2.0bn in Eurobonds and EUR 5.3bn in foreign loans, which also includes lending from international financial institutions (IFIs). In our financing table below, we assume a lower amount of foreign loans, although there is significant uncertainty about the final funding mix. The remaining IMF stand-by arrangement funding (EUR 1.2bn) will be considered as precautionary. In 1Q24, funding will focus on local-currency issuance. Implementation of reforms would allow for lower yields spreads.

SERBGB REDEMPTIONS IN 1Q24



REAL YIELDS CLOSE TO TURN POSITIVE



Source: NBS, Serbian Ministry of Finance, public debt agency, Statistical Office of the Republic of Serbia, UniCredit Research

GROSS GOVERNMENT FINANCING REQUIREMENTS

EUR bn	2023E	2024F	2025F
Gross financing requirement	**6.8**	**6.6**	**5.0**
Budget deficit	1.5	1.6	1.2
Amortization of public debt	5.3	5.0	3.8
Domestic	3.4	1.6	2.3
Bonds	3.0	1.4	2.0
Bills	0.0	0.0	0.0
IFIs/others	0.4	0.2	0.3
External	1.9	3.4	1.5
Bonds	0.0	0.0	0.0
IFIs/others	1.9	3.4	1.5
Purchase of financial assets	0.0	0.0	0.0
Financing	**6.8**	**6.6**	**5.0**
Domestic borrowing	2.0	2.0	2.0
Bonds	2.0	2.0	2.0
Bills	0.0	0.0	0.0
Other	0.0	0.0	0.0
External borrowing	4.8	4.5	3.5
Bonds	1.7	2.0	1.0
IFIs/others	3.1	2.5	2.5
Fiscal reserves change (- =increase)	0.1	0.1	-0.5

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2023E	2024F	2025F
Gross financing requirement	**8.0**	**6.5**	**9.0**
C/A deficit	4.1	1.7	2.8
Amortization of medium- and long-term debt	2.5	3.5	4.8
Government/central bank	1.2	2.1	3.5
Banks	0.5	0.6	0.6
Corporates	0.7	0.8	0.8
Amortization of short-term debt	1.4	1.3	1.3
Government/central bank	0.0	0.0	0.0
Banks	1.0	1.0	1.1
Corporates	0.4	0.3	0.3
Financing	**8.0**	**6.5**	**9.0**
FDI (net)	4.3	4.5	4.1
Medium and long-term borrowing	5.4	5.2	6.0
Government/central bank	4.2	4.0	4.8
IFIs/others	3.5	2.1	2.5
Banks	0.5	0.5	0.5
Corporates	0.7	0.7	0.7
Short-term borrowing	1.2	1.1	1.2
Other	0.3	0.5	-0.7
Change in FX reserves (- = increase)	-3.2	-4.8	-1.6
Memoranda:			
Non-resident purchases of LC gov't bonds	0.0	0.2	0.1
International bond issuance, net	1.7	2.0	1.0

Source: Bloomberg, NBS, Serbian Ministry of Finance, public debt agency, Statistical Office of the Republic of Serbia, UniCredit Research

Turkey

B3 positive/B positive/ B stable*

Outlook: Growth will slow to 2.9% this year due to weaker private consumption. We expect growth to accelerate to 4% in 2025 as financial conditions ease and support domestic demand. Net exports could be barely positive in 2024 but will contribute to growth more next year. We expect inflation to peak above 70% in 2Q24 before easing to 42% by the end of this year and to 24% in 2025. While the CBRT could leave its policy rate at its peak this year, we expect to see rate cuts to 25% by the end of next year.

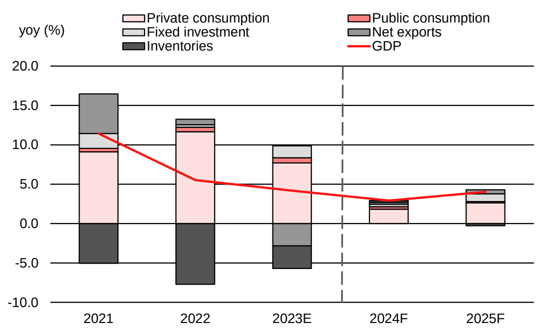
Strategy: Demand for TURKGBs should increase more visibly after local elections are held in March 2024.

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

KEY DATES/EVENTS

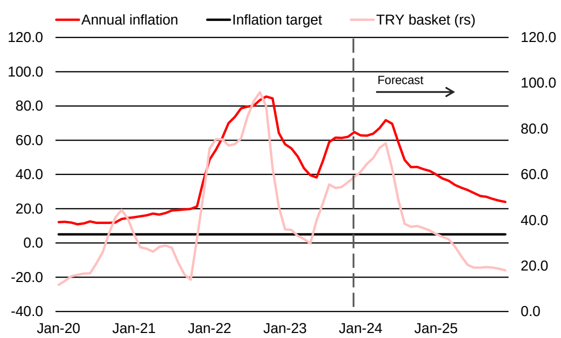
- 5 Feb, 4 Mar: inflation data
- 25 Jan, 22 Feb, 21 Mar: monetary-policy decisions
- 29 Feb: 4Q23 GDP data
- 8 Mar: Fitch rating review
- 31 Mar: Local elections

GDP GROWTH FORECAST



Source: Turkish Statistical Institute (TurkStat), UniCredit Research

INFLATION FORECAST



Source: TurkStat, CBRT, Bloomberg, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

EUR bn	2021	2022	2023E	2024F	2025F
GDP (EUR bn)	692.0	857.0	995.9	1063	1169
Population (mn)	84.7	85.3	86.3	87.2	88.2
GDP per capita (EUR)	8173	10049	11543	12181	13260
Real economy, change (%)					
GDP	11.4	5.5	4.2	2.9	4.0
Private consumption	15.4	19.0	11.1	2.5	3.6
Fixed investment	7.2	1.3	6.3	1.3	4.0
Public consumption	3.0	4.2	5.0	2.3	1.3
Exports	25.1	9.9	-2.0	3.9	6.2
Imports	1.7	8.6	11.4	3.1	4.5
Monthly wages, nominal (EUR)	603	636	690	733	783
Real wages, change (%)	10.3	2.2	5.5	2.5	1.0
Unemployment rate (%)	12.0	10.5	9.6	10.4	10.7
Fiscal accounts (% of GDP)					
Budget balance	-4.2	-2.2	-6.4	-4.8	-4.2
Primary balance	-1.7	-0.1	-3.8	-2.0	-1.5
Public debt	40.4	30.8	31.1	34.8	33.5
External accounts					
Current account balance (EUR bn)	-6.1	-46.8	-42.6	-30.5	-31.0
Current account balance/GDP (%)	-0.9	-5.5	-4.3	-2.9	-2.7
Extended basic balance/GDP (%)	0.0	-4.6	-3.8	-1.9	-1.7
Net FDI (% of GDP)	0.9	0.9	0.5	0.9	0.9
Gross foreign debt (% of GDP)	54.2	50.7	46.1	47.0	43.3
FX reserves (EUR bn)	63.9	77.6	84.3	91.7	97.2
Months of imports, goods & services	3.1	2.6	2.9	3.2	3.2
Inflation/monetary/FX					
CPI (pavg)	19.6	72.3	53.9	55.0	30.3
CPI (eop)	36.0	64.3	64.8	42.0	24.0
Central bank target	5.0	5.0	5.0	5.0	5.0
Central bank reference rate (eop)	14.00	9.00	42.50	45.00	25.00
3M money market rate (Dec avg.)	15.98	10.29	44.06	45.00	25.00
USD/TRY (eop)	13.3	18.7	29.5	39.5	46.0
EUR/TRY (eop)	15.1	20.0	32.5	44.6	52.9
USD/TRY (pavg)	8.9	16.7	24.2	35.6	43.0
EUR/TRY (pavg)	10.5	17.5	26.2	39.2	48.3

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.

Trying to rebalance amid weak external demand

Local elections could be tight in big cities

Turkey is preparing to hold local elections in March 2024 amid a slowing economy due to tight monetary policy. The ruling coalition will try hard to take back the country's large cities, particularly Istanbul and Ankara, and could try to stimulate domestic demand before Turks head to the polls, albeit at a smaller scale than in previous elections. The current majors in both cities will rerun, as the candidates of the main opposition party, CHP, and could benefit significantly from their popularity with the electorate. That said, the opposition faces a significant drawback. In contrast to their strategy to cooperate and run joint candidates in 2019 local elections, the opposition parties are set to nominate different candidates this time.

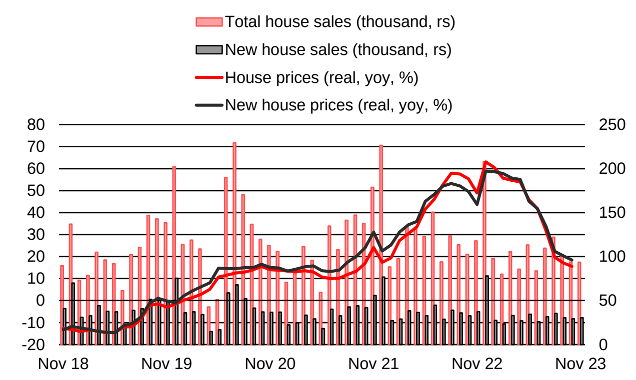
Authorities are trying to rebalance the economy, with little support from net exports this year

Growth could slow below potential, to 2.9%, in 2024. Authorities are trying to rebalance the economy, but weak economic activity among Turkey's trade partners will likely imply a minor contribution, if any, from net exports. Both export and domestic orders were particularly weak among clothing, chemical, non-metallic-mineral and metal producers at the end of last year. Populist pre-election policies including the 49% hike in minimum-wage from January could mitigate a slowdown in private consumption in 2024. However, the government intends to avoid the mid-year wage hikes delivered in the past two years, and this should limit full-year real-wage growth. Consumer-loan growth has eased; it was around 10% at the end of 2023. While we might see some attempts to support selected borrowers, e.g. through lower-cost mortgage campaigns, lending conditions will likely remain tight. The stabilization of inflation expectations will also discourage households' tendency to bring demand forward. Consequently, private-consumption growth could slow visibly this year. High rates could drag on investment, as the excessive returns that real estate delivered during the loose monetary policy period ease. Higher capital inflows, especially in the form of long-term borrowing from abroad, could support reconstruction activity in the earthquake-hit region, as well as the private sector's appetite for capex investment.

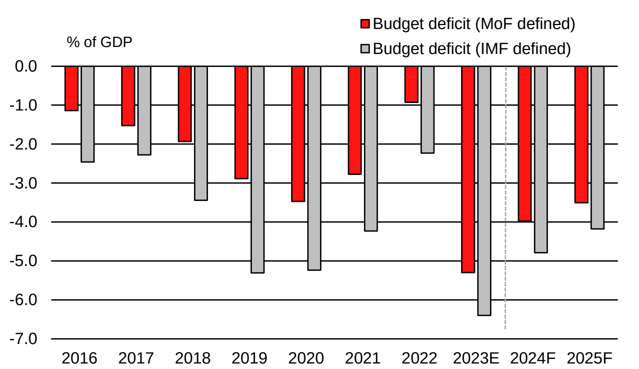
The budget deficit will widen in 2024 and ease only gradually in 2025

The budget deficit could exceed this year 4% of GDP (IMF defined: 4.8% of GDP) and narrow only gradually, to 3.5% of GDP (IMF defined: 4.2% of GDP) in 2025. The budget deficit likely ended 2023 around 5.3% of GDP (IMF defined: 6.4% of GDP), 1.1% of GDP below the government's target in its Medium-Term Program. Earthquake-related transfers have accelerated sharply in December 2023. Turkish President Recep Tayyip Erdoğan stated that 46,000 houses would be built by the end of 2023, which is significantly lower than the 319,000 he had promised to build within a year in March 2023. This means there is still a lot to do in the region and, therefore, earthquake-related spending could remain larger in 2024. Moreover, slower domestic demand will imply a deceleration in tax-revenue growth, which was strong in 2023. The government could find it more feasible to cut the deficit in 2025, when monetary policy will already be easing, lowering the need for a loose fiscal stance.

REAL HOUSE PRICE GROWTH IS EASING



THE BUDGET DEFICIT WILL REMAIN ELEVATED IN 2024



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

Slower economic activity will lift the unemployment rate from single-digit levels

The unemployment rate could rise gradually, as growth is expected to remain below potential this year and next. The unemployment rate fell below 9% in October for the first time in a decade, after the economy grew above potential for 13 quarters. However, a part of the recent decline in unemployment can be explained by lower labor-force participation, implying that labor-market dynamics might be weaker than the drop in the unemployment rate suggests. Moreover, leading indicators (PMI) have also hinted at lower employment going forward. Consequently, we expect the full-year unemployment rate to rise gradually, from 9.6% in 2023 to 10.7% in 2025.

GDP growth is expected to accelerate in 2025 due to lower rates and stronger external demand

We expect GDP growth to accelerate to 4% next year as financial conditions ease and support private consumption and investment. The contribution from net exports will also become more meaningful as economic activity in major economies, especially in Europe, recovers.

C/A deficit to ease towards 2.7% of GDP by the end of next year

Turkey's C/A deficit will continue to narrow, to 2.9% of GDP in 2024 and 2.7% of GDP in 2025. The 12M energy deficit might come down further in 2024, but the bulk of the decline (due to lower energy prices) should now be behind us. Gold imports started to decelerate only in September after rate hikes accelerated, curbing speculative demand. We expect to see further decline in gold imports and the core deficit (excluding energy and gold) to stabilize in 2024, after doubling in 2023, due to tight monetary policy. Exports will help narrow the C/A deficit more in 2025 if external demand recovers.

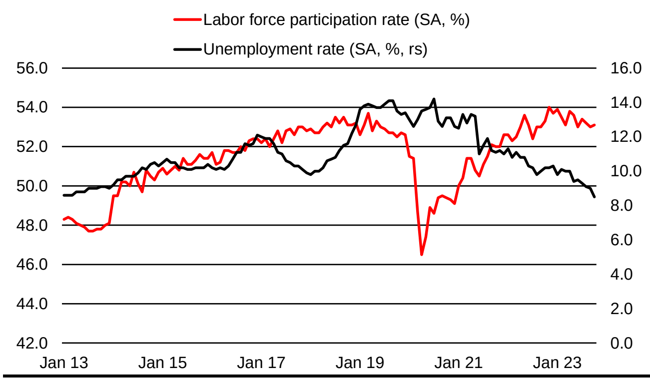
Inflation is expected to peak in May and to decelerate sharply in the remainder of the year

Inflation is expected to continue to rise in 1H24, with large minimum-wage hike feeding into additional cost pressure, especially in service prices in early 2024. The initial disinflationary impact of free natural-gas allocation was partly reversed in late 2023, but the final correction will come in May, leading annual inflation to peak above 70%. Base effects will turn significantly disinflationary over the summer, and the downtrend should continue thereafter amid tight monetary conditions. TRY depreciation might accelerate briefly around the local elections implying some additional inflationary pressure. However, the magnitude of adjustment is unlikely to match that of 2023. We expect the TRY to appreciate in real terms from 2H24 onward, as long as capital inflows accelerate after the elections.

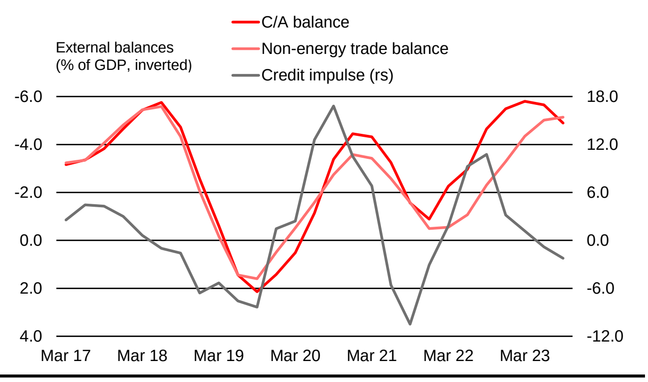
The CBRT could maintain its policy rate at its peak for this year before lowering it to 25% in 2025

The CBRT will likely end its rate-hike cycle this month, at 45%. The central bank saw the level of lending rates as sufficiently tight in November 2023, when the policy rate was hiked to 40%. Consequently, we think the motive for the following rate hike(s) is to encourage depositors to shift from FX to TRY. The CBRT's multiple goals, including to anchor inflation expectations, to replenish FX reserves and to roll back an FX-protected TRY deposit scheme will require a tight monetary-policy stance for an extended period. We think the central bank could keep its policy rate at 45% this year and lower it to 25% in 2025. However, we cannot rule out rate cuts starting already in 2024, especially if economic activity slows more than we expect. This could limit the decline in inflation expectations and, consequently, lead to slower disinflation in 2025.

UNEMPLOYMENT MIGHT HAVE DIPPED IN 4Q23



TIGTHER LENDING CONDITIONS TO CURB C/A DEFICIT



Source: TurkStat, CBRT, UniCredit Research

Year of Turkish assets?

Capital inflows could recover more strongly after local elections…

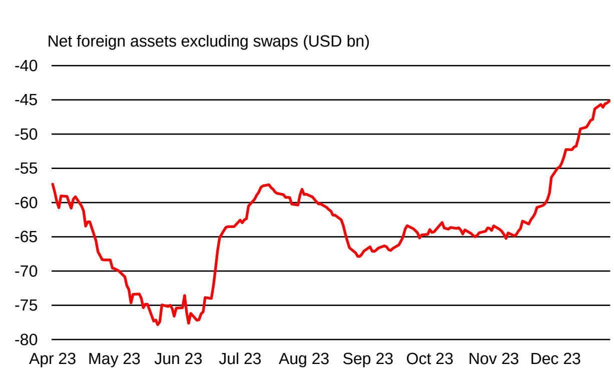
Capital inflows started to improve in 2H23, especially after monetary tightening turned more decisive at the end of summer. Banks' long-term external-debt rollover ratios have picked up as the country's risk premium has come down. Portfolio inflows have shown signs of revival recently, as the CBRT lowered security holding requirements for banks, allowing TURKGB yields to rise. We expect investor appetite to pick up more visibly once economic-policy uncertainty declines after local elections although inflows to the local bond market might even accelerate before that.

…helping the CBRT replenish its FX reserves

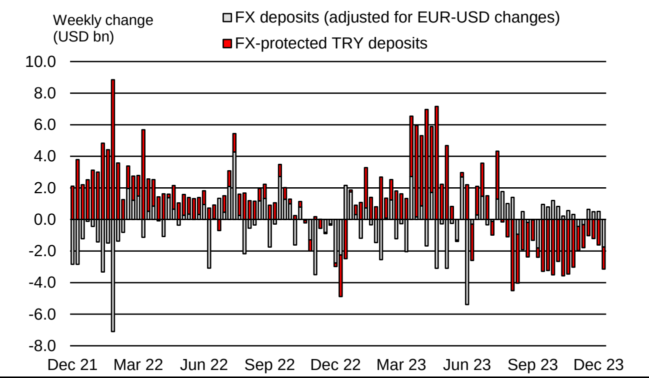
The pickup in capital inflows bodes well for the CBRT's plans to restock its reserves. While gross FX reserves have increased since June, they mostly reflect higher swaps with local banks. However, the CBRT's net FX position (excluding FX swaps) also started to improve in late 2023.

The CBRT is also trying to roll back its FX-protected TRY deposit scheme. The higher policy rate, along with other regulatory measures (including conversion targets imposed on banks), has already helped bring down the volume, without leading to too much pressure on the currency, as the bulk of the shift was into conventional TRY-denominated deposits rather than FX-denominated deposits.

THE CBRT'S NET FX POSITION IS IMPROVING



THE STOCK OF FX-PROTECTED TRY DEPOSITS IS FALLING



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

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2023E	2024F	2025F
Gross financing requirement	**87.4**	**77.9**	**70.8**
Budget deficit	63.1	50.9	48.8
Amortization of public debt	24.3	27.1	21.9
Domestic	17.2	17.5	10.4
Bonds	16.5	17.4	9.7
Bills	0.7	0.1	0.6
Loans	0.0	0.0	0.0
External	7.1	9.5	11.6
Bonds	5.4	8.2	10.1
Loans	1.7	1.4	1.4
Financing	**66.1**	**77.9**	**70.8**
Domestic borrowing	49.6	49.5	47.1
Bonds	49.5	48.7	46.6
Bills	0.2	0.8	0.5
Loans	0.0	0.0	0.0
External borrowing	11.1	18.2	15.1
Bonds	9.2	13.6	11.6
Loans	1.8	4.5	3.6
Privatization/other	30.4	8.3	7.6
Fiscal reserves change (- =increase)	-3.8	2.0	0.9

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2023E	2024F	2025F
Gross financing requirement	**230.4**	**239.5**	**225.5**
C/A deficit	42.6	30.5	31.0
Amortization of medium and long-term debt	50.6	45.6	30.0
Government/central bank	7.1	9.5	11.6
Banks	23.5	24.3	9.5
Corporates/other	20.0	11.8	8.9
Amortization of short-term debt	137.2	163.4	164.6
Financing	**230.4**	**239.5**	**225.5**
FDI (net)	4.6	10.0	11.1
Portfolio equity, net	1.3	2.7	3.1
Medium and long-term borrowing	61.4	67.0	43.1
Government/central bank	12.9	23.2	20.0
Banks	28.7	29.7	11.9
Corporates/other	19.8	14.2	11.1
Short-term borrowing	166.1	167.8	175.3
Other	-3.0	0.0	0.0
Change in FX reserves (- = increase)	0.0	-8.1	-7.1
Memorandums:			
Nonresident purchases of LC gov't bonds	1.8	5.0	4.9
International bond issuance, net	3.8	5.4	1.4

Source: CBRT, Turkey's 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

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