9 April 2020

CEE Sovereigns

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Fiscal and rating impact from Covid-19 crisis

Countries in focus

- Czech Republic
- Hungary
- Poland
- Romania
- Bulgaria
- Croatia
- Serbia

Overview of fiscal and central bank measures in CEE

Country	Fiscal Measures	Central Bank Measures
Czech Republic	• Interest free loans and guarantees for businesses affected by coronavirus • Debt moratorium on the repayment of corporate & retail loans for 3-6 months in the form of opt-in • General waiver of fines for late payment of personal and corporate income tax; cash support for sole-traders • “Kurzarbeit” partially compensating wage cost for companies impacted adversely by the outbreak	• Two cuts of 50bp and 75bp, lowering rates from 2.25 to 1% • Lowering of the countercyclical capital buffer rate from 1.75% to 1% • Enhanced liquidity-providing measures for banks, which were active during the global financial crisis (from once a week to three times a week) • Weakening of macroprudential measures for mortgages
Hungary	• Debt moratorium for businesses and households • Hungarian ‘Kurzarbeit’ & job creation programme • Financing local enterprises, interest-rate and guarantee-subsidized loans	• Funding for Growth Scheme Go! & Bond for Growth Scheme to support financing • Quantitative Easing – government bond buying on the secondary market • Long-term collateralised loan facility and 1-week deposit facility
Poland	• Preferential loans to enterprises for maximum 3-year period • Wage subsidies for employees of affected businesses or self-employed • Increased loan guarantees for enterprises	• Two 50bp cuts, lowering rates from 1.5% to 0.5% • Slashing of the mandatory reserve which released PLN40bn of liquidity • De-facto QE to also include state guaranteed bonds beyond POLGBs
Romania	• Covering up to 75% of the average gross wage for laid-off workers • Loan guarantees and subsidized interest for SME’s • Swift VAT reimbursement, suspending foreclosures and tax control	• 50bp cut in the key rate to 2.00% • 100bp cut of the Lombard rate • Purchasing government bonds from the secondary market
Bulgaria	• Covering 60% of employee’s wages in affected sectors • Tax deferrals • Increased healthcare sector wages	
Croatia	• Subsidies for net minimum wages for three months • Income and profit tax deferrals for at least three months • Loan rescheduling & loan guarantees for SMEs	• FX rate stabilization through sizeable interventions • Government bond purchases, with a possible extension to pension funds and insurance companies • 5Y liquidity injection at 0.25%
Serbia	• Wage subsidies for SME employees for three months • Paying 50% of the net minimum wage for three months to employees in large private sector companies • Loan guarantees for SMEs • Three-month deferment of labour taxes and social security	• 50bp cut in the key rate to 1.75% • Liquidity provisions through swap auctions • Repo auctions at the 0.75% deposit facility rate • 3-month moratorium on all repayments under bank loans and financial leasing agreements.

Source: ING

Trieu Pham, CFA
EM Sovereign Debt Strategist
London +44 20 7767 6746
trieu.pham@ing.com

Rafał Benecki
Chief Economist, Poland
Warsaw +48 22 820 4696
rafał.benecki@ingbank.pl

Piotr Poplawski
Senior Economist, Poland
Warsaw +48 22 820 4078
piotr.poplawski@ingbank.pl

Jakub Seidler
Chief Economist, Czech Republic
Prague +420 257 474 432
jakub.seidler@ing.com

Valentin Tataru
Economist, Romania and Balkans
Bucharest +40 31 406 8991
valentin.tataru@ing.com

Péter Virovácz
Senior Economist, Hungary
Budapest +36 1 235 8757
peter.virovacz@ing.com

SEE THE DISCLOSURES APPENDIX FOR IMPORTANT DISCLOSURES & ANALYST CERTIFICATION

In this note we turn our attention to fiscal balance sheets in the CEE region and the impact on sovereign ratings. For our latest economic forecasts, please see here (link).

A growth contraction across the board and recently announced fiscal support packages will see a spike in fiscal deficits and debt ratios in 2020. This shouldn't pose a problem for Bulgaria, Czech Republic and Poland thanks to moderate debt ratios, but could wipe out hard-achieved gains for Croatia, Hungary and Serbia over the last years. Despite a low debt stock, Romania's 7.9% of GDP fiscal deficit will add to mounting fiscal concerns.

Domestic bond markets are poised to be the key avenue to finance higher budgetary needs, in some countries supported by central bank purchases (Croatia, Hungary, Poland and Romania). However, sovereigns will also turn to the Eurobond market and multilateral funding sources.

On ratings, CEE sovereigns, with all except for Serbia in investment grade territory, started favourably into 2020. Rating agencies had assigned eight positive outlooks (notably for Bulgaria, Croatia, Hungary and Serbia) and only one negative outlook (Romania) ahead of the crisis. With the onset of the crisis, upgrades appear unlikely, but we also don't expect any downgrades for 2020. However, rating pressure is likely to ramp up in Romania where we could see Fitch moving the outlook to negative.

Czech Republic

The government introduced a set of measure to mitigate the adverse impact on the Czech sole-traders and companies affected by the Covid-19 outbreak. Apart from the direct cash help to sole-traders, some form of "Kurzarbeit" was introduced, partially compensating wage cost for companies impacted adversely by the outbreak. In total, CZK100bn (1.8% of GDP) of direct support and CZK900bn (16% of GDP) of indirect support in the form of guarantees were announced by the Czech government.

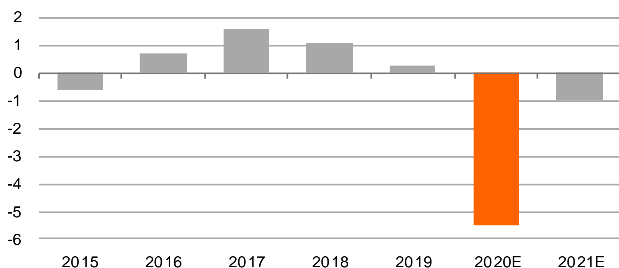
Growth: We revised GDP dynamics downwards to -4% YoY this year, followed by a 3.5% rebound in 2021. The most adverse fall in economic activity is expected in 2Q20. The Ministry of Finance revised its forecast on 6 April and expects the economy to fall by 5.6% this year (vs -4.8% YoY in 2009) followed by 3.1% growth in 2021. The main risk jeopardizing a recovery of the Czech economy in 2H20 is weakened foreign demand given Covid-19 measures taken abroad, in our view.

Fiscal: From an initially planned deficit of CZK40bn, the government revised its 2020 deficit towards CZK200bn. The total government deficit (including also municipalities and health insurance companies) is expected to reach 4% of GDP this year (CZK230bn) after a 0.3% GDP surplus in 2019, according to new MinFin projections. As such, debt/GDP should increase from 30.8% to 35.2%. We believe, however, that the total deficit might be even higher around CZK350bn due to adverse consequences of the Covid-19 outbreak, and we pencil in a 5.5% of GDP deficit this year. The MinFin already started strong issuance activity in recent weeks, issuing more than CZK185bn of CZGBs and CZK69bn of T-bills since March. Given redemptions of CZK denominated bonds of around CZK150bn this year and a soaring deficit the MinFin will continue its issuance activity in period ahead. However, main financing needs will be concentrated in CZK denominated bonds and EUR-denominated issuance under local law, which started last year, will be just a complementary source.

External: The Czech central bank has a record-high FX-reserve of around 60% of GDP at its disposal, as a heritage of the FX-floor regime from 2013-2017. It already indicated a willingness to enter the FX-market, if CZK continues in abrupt weakening. Given the size of its FX reserves, signalling power of the CNB is high.

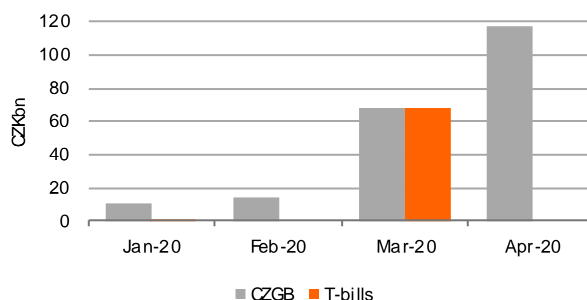
Rating (Aa3/AA-/AA-): Given the relatively strong fiscal performance over previous years and total low indebtedness, among the four lowest in the EU, we don't expect negative rating pressure for the Czech Republic.

Fig 1 Government balance (% of GDP)



Source: MinFin, ING

Fig 2 MinFin issuance in 2020 (CZKbn)



Source: MinFin, ING

Hungary

Despite Hungary facing a lot of criticism regarding its fiscal policy (mainly debating its procyclicality), the government reduced the budget deficit year-by-year, planning this year's target at 1% of GDP. The budget has already contained a reserve up to almost 1% of GDP. In this respect, Hungary is facing this crisis in a relatively good fiscal balance. Despite the media headlines talking about an 18-20% of GDP fiscal package, this figure is exaggerated from a fiscal point of view. The three-step package (first step in end-March, second in early-April) contains budget restructuring, extra burden on different sectors (eg, bank levy) and steps from the NBH. In "new money", we rather see the package worth around 2% of GDP in 2020. The main target is the labour market (wage support, job creation), while from a business perspective, the most affected sectors (tourism, construction, leisure activities, healthcare) and SMEs are in the forefront of the programme.

Growth: Our latest official 2020 GDP forecast sits at -0.8% but it is under revision now and we'd rather say this could be the best-case scenario for Hungary. We have mixed news as some of the manufacturers lengthened their lockdowns, while others – mainly tied to Chinese supply chains – restarted factories. Despite a rather moderate fiscal stimulus, we still believe in a V-shaped recovery, but from now on, every month of the recent shutdown will shave off roughly 1ppt GDP growth from our 'best-case' scenario.

Fiscal: We are less optimistic than the latest official 2020 target, which sees the deficit/GDP jumping from 1% to 2.7%. Even with our best-case scenario complemented by the extra fiscal spending, we see the deficit at rather 4%. Consequently, we estimate the debt-to-GDP ratio jumping to 70%.

The funding of the extra deficit is still a bit unclear, but the package will be partially covered by new taxes, the built-in reserve and the NBH also paid into the budget. The Debt Management Agency (AKK) has heavily relied on the retail sector, but now we hardly see this to continue. AKK has already ramped up HGB issuance in 2Q, and the banking sector is supported by the NBH's new long-term collateralised loan (where bonds can be used as collateral, so there is a multiplicative effect). The central bank is ready to buy government bonds in the secondary market. QE details are coming mid-April. If the situation worsens from a financing point of view, we see Eurobond issuance as an option too.

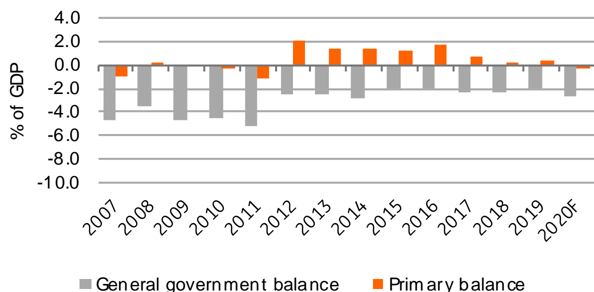
External: As the balance sheet of the NBH is small (~30% of GDP), it can easily afford the QE. The FX ratio of the total debt is sitting at 15.3% (as of Feb-20), so the AKK still have room to issue Eurobonds, as the target range for this ratio is unofficially set to 10-20%.

Rating (Baa3/BBB pos/BBB): S&P and Fitch upgraded Hungary to BBB in early 2019 mainly on strong growth and external deleveraging, with the former having assigned a positive outlook in February 2020.

Meanwhile, Moody's has been more reluctant and kept the BBB- rating, despite noting broad improvements in credit metrics over the last few years. We see Hungary maintaining its fiscal

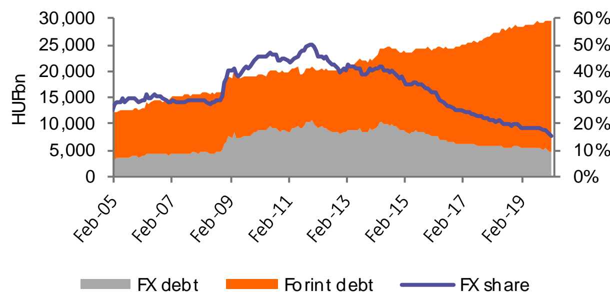
consciousness after the crisis, so fiscal prudence should remain an anchor going forward. However, developments in politics and regarding institutions, including the controversial "Coronavirus Law", can add negative rating pressure. The power itself means nothing until it is not used, so Hungary can get away with it, but we can't rule out a negative outlook.

Fig 3 General government / primary balance (% of GDP)



Source: AMECO, Ministry of Finance, ING

Fig 4 FX share of public debt



Source: AKK, ING

Poland

Poland launched an anti-crisis programme of about 9% of GDP (of which 1.7% is direct support), followed by a second programme worth 0.8% of GDP (all direct support), and finally financial aid worth 4.5% of GDP (all direct support-loans convertible to subsidies). The first two programmes will be funded by POLGB issuance, and the third one through bonds with government guaranties (by the Polish Development Fund). These will be purchased by the NBP. The central bank had to unveil increasingly aggressive measures to support the local debt market. Those included lowering the reserve requirement for local banks (so they can extend their bond holdings by around PLN40bn), cutting interest rates and purchases of debt (scale of these purchases was not announced).

Growth: Poland is expected to enter a recession in 2Q20. GDP is likely to contract by 4.5% YoY this year, reflecting a country lockdown, a massive rise in unemployment and weak external demand. The local labour market is relatively flexible, eg, reflecting a large number of people on civil, rather than regular labour contracts. Hence unemployment should exceed 10% in the year-end vs 5.5% now. This will substantially affect consumer demand over the coming quarters. Private investments recovery should be very slow as well, given global uncertainty and low demand for credit even before the outbreak.

Fiscal: We estimate 2020 net borrowing needs for the state budget at PLN172bn (7.8%GDP), up from just PLN15bn we envisaged before the outbreak (and PLN24bn in the budget bill). Borrowing needs of the Polish Development Fund (PFR) should reach PLN90-100bn (4.5% of GDP). We estimate NBP to buy about 8% of GDP of state and PFR needs. Still, Poland enters the downturn in a relatively sound fiscal position – public debt reached 46% of GDP at the end of 2019. The general government deficit should reach 12% in 2020, but EU fiscal rules are suspended while the NBP takes over much of the new borrowing needs. The fiscal package is high and requires high QE - potentially PLN negative, but the strong anti-crisis programme should smooth the GDP slowdown and lead to a more robust restart of the economy, eventually supporting fiscal sustainability.

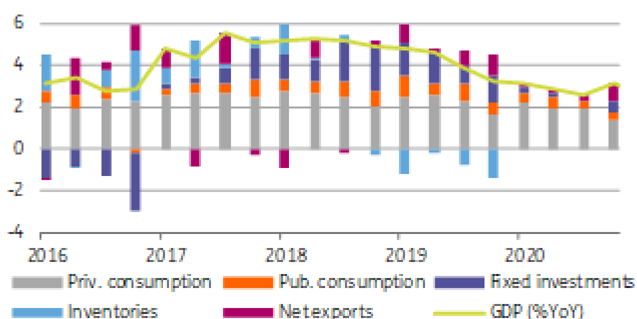
External: Poland exports should prove relatively resilient to the crisis among CEEs. The share of durable goods production (particularly cars) is lower compared to the region. Experiences from Asia suggest those are mostly affected during the outbreak. Also, around half of Poland's massive service exports (12% of GDP) should be relatively resilient, such as shared services. The condition of some local banks may be a concern if PLN continues to depreciate – unlike Hungary, FX mortgages are still a problem. Still, usually during periods of market stress Polish banks face a large inflow of retail deposits, rather than an outflow.

Rating (A2/A-/A-): We're little concerned on Poland's ratings given the economy's resilience as well as the sound fiscal starting point.

Fitch recently affirmed the A- rating, highlighting the diversified economy, lower exposure to trade and tourism among CEE economies, benefits from lower energy prices, a flexible exchange rate and a current account close to balance. Moreover, the rating agency noted Poland's strong track record of adherence to the expenditure rule and a successful fiscal consolidation after the 2008/09 crisis.

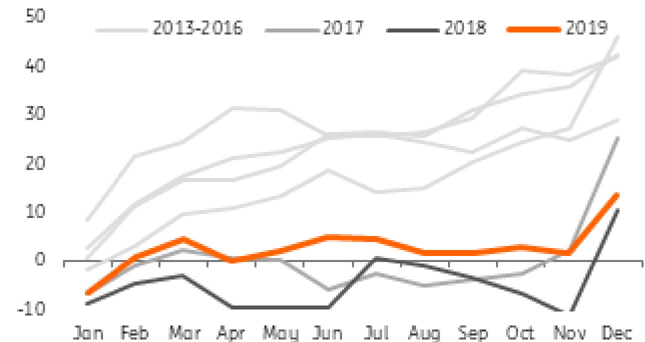
Some concerns among rating agencies are driven by the dispute with the EU on judicial changes which, according to Fitch, could negatively affect investor perception on governance indicators over time. Moody's would consider lower EU funds as a negative rating factor.

Fig 5 Real GDP (%YoY) and contributions (ppt)



Source: GUS, ING

Fig 6 Budget deficit YTD (PLNbn)



Source: Ministry of Finance, ING

Romania

Faced with limited fiscal space, the up-to-date government response to the pandemic looks relatively unpretentious compared to other CEE peers, amounting to less than 3.0% of GDP. The main support measure is to pay up to 75% of the average gross salary for the technical unemployment. It applies only for the period covered by the state of emergency. Official estimates say that up to 1 million people could benefit from this measure, but we tend to believe that this is understated and expect the number to be up to 50% higher. At its peak, it could cost the government RON6-7bn per month.

Growth: We have recently revised our 2020 growth forecast to -6.6% and see little reason to turn more optimistic. Our main worry is that the much-hoped V-shaped recovery due to start in 3Q20 could turn into an L-shaped one the longer the lockdown lasts. Not all sectors are suffering to the same extent of course, with somewhat better dynamics expected from agriculture, healthcare, IT&C and even construction.

Fiscal/external: The current crisis found Romania with relatively large twin deficits. On the C/A side we could see an improvement this year as imports are likely to plunge faster than exports. We estimate the C/A deficit to narrow towards 3.0% of GDP.

On the fiscal side however, we expect a marked deterioration due to an ill-fated combination of lower GDP, lower revenues and higher expenses. We forecast a 7.9% fiscal gap in 2020 but acknowledge there are many unknowns at this point. We assume that the 40% pension hike will not be applied. The financing needs should increase by at least RON40bn for the remainder of 2020. Consequently, we estimate debt/GDP rising to 42.1% in 2020 from 35.4% in 2019.

As per official statements, the deficit funding will be mainly from the local market, followed by external markets and IFIs. NBR's intention to purchase bonds from secondary markets will help to raise funds from the domestic market. Nevertheless, in order to have a meaningful impact, this measure will – in our view – need to go beyond the immediate objective of "consolidating structural liquidity in the banking system". This is because we think that the MinFin's funding

needs are simply too large and immediate for the market to accommodate it. Therefore, larger (than probably intended) purchases will be required from the NBR.

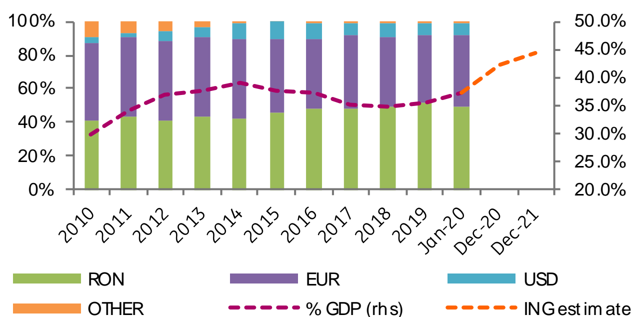
Ratings (Baa3/BBB- neg/BBB-): Our base case remains no downgrade for 2020 but a negative outlook by Fitch is on the cards.

S&P placed Romania's BBB- rating on negative outlook in December 2019 on fiscal slippage and additional risks coming from the pension hike law (with a 40% hike included in the baseline scenario), the upcoming election cycle and an economic slowdown. We don't see imminent downgrade risks but whether the sovereign will lose its investment grade rating depends on whether policymakers can tighten fiscal policies beyond 2020, tying Romania's fate to the election outcome.

There is a chance for Fitch to revise the outlook on the BBB- rating to negative (1 May review date). In our conversations with Fitch, concerns circled around the lack of a credible medium-term plan to reverse the steady fiscal deterioration over the last years, further put off the lack of a clear government mandate until the elections. The ongoing virus spread comes at an unfortunate timing and could be just what's needed to reinforce a negative outlook.

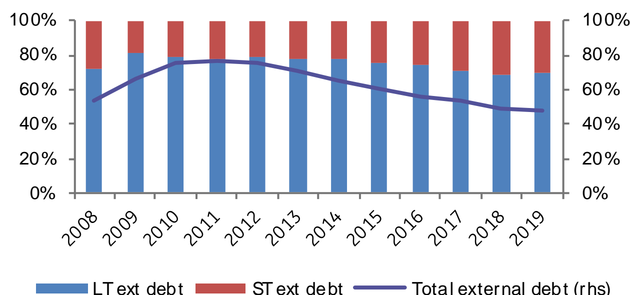
We expect Moody's to retain its stable outlook for now, despite concerns that the Covid-19 outbreak will lead to higher government debt while the absence of early elections will see a delay of corrective measures. Our understanding is that Moody's places a stronger focus on institutional strength where we have seen improvements over the last year. We also note that Moody's rating scorecard outcome for Romania has been lifted to Baa1-Baa3 (from Baa2-Ba1 previously).

Fig 7 Public debt composition and dynamics



Source: Ministry of Finance, ING

Fig 8 External debt split (% of GDP)



Source: Ministry of Finance, NBR, ING

Bulgaria

Compared to the Covid-19 spread in Western countries or even its CEE peers, Bulgaria looks less affected so far judging by the number of casualties. The measures aimed at containing the spread of the virus are nevertheless having much of the same economic effect as in most of the other countries, as most of the economy is in lockdown.

Growth: The Bulgarian Parliament has already approved a budget revision envisaging a fiscal gap of 3.0% of GDP and a GDP contraction of 3.0%. Both measures – but mainly the GDP contraction - look understated to us. We estimate the economy will contract by 6.2% this year and grow by 5.2% in 2021. A recovery of the output to pre-crisis levels might not come before the second part of 2022, while a recovery in the unemployment rate could take even longer.

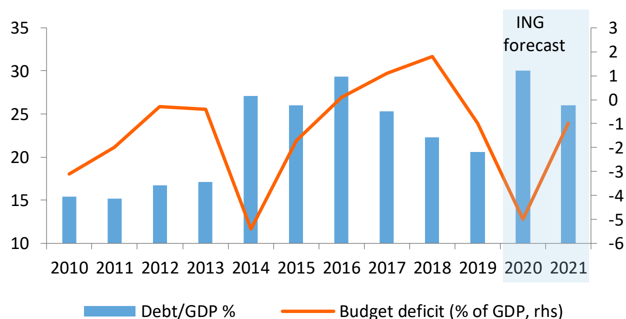
Fiscal: The government's main support measure to help businesses affected by the crisis is to cover of 60% of the worker's wages affected by the crisis. Other measures include tax deferrals, interest-free consumer loans and loan guarantees to companies. We believe that the budget deficit could be kept in check to the 3.0% established limit, but this will put pressure on funding the big infrastructure projects which have been maintained up and running this period. Hence, we believe

that another budget revision will be needed in the second part of the year to allow the deficit to rise towards 5.0% of GDP.

The Bulgarian parliament has approved increasing the debt ceiling limit on state debt to BGN10bn this year, which means just over 8.0% of GDP, although the planned deficit is only BGN3.5bn. The government will tap both domestic and international markets (after a four-year pause), but also IFI's. With a debt-to-GDP ratio of around 20%, we believe that the government will not have major issues in financing this year's expenses even under an extreme scenario of utilising the entire BGN10bn limit.

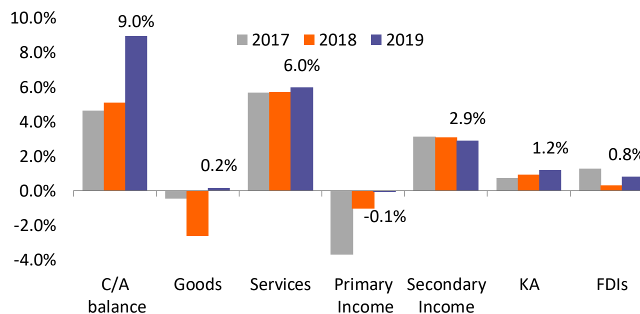
Rating (Baa2 pos/BBB pos/BBB pos): Bulgaria entered 2020 with three positive outlooks, making it a standout in the EM sovereign space. Very strong credit metrics, notably government debt/GDP around 20% in 2019 and net external creditor position supported by C/A surpluses, imply limited concerns on ratings. However, repeated postponement of ERM II entry, likely by another year to 2021, and a temporary fiscal bump means that we won't see upgrades in 2020. However, we believe that the positive outlooks can be carried over to 2021 should this crisis prove to be temporary.

Fig 9 Deficit rebounding



Source: Bloomberg, ING

Fig 10 External balances offering some comfort



Source: NSI, ING

Croatia

Croatia's already well-known tourism dependency lays the ground for quite a dreadful economic contraction this year. The government laid ahead some packages worth roughly 8-9% of 2019 GDP, the bulk of it being used to preserve jobs. The central bank (HNB) has also deployed its heavy ammunition, injecting 5Y liquidity at 0.25%, permanently releasing over HRK6bn by cutting reserve requirements to 9.0%, reducing its weekly repo rate to 0.05% and – of paramount importance – buying bonds from the secondary market. Parliamentary elections are due to take place this autumn (no fixed date yet) with the ruling HDZ coalition regaining its lead in the opinion polls.

Growth: the combination of plunging tourism numbers (government officials estimate a 75% fall in overnight stays under the central scenario) and having Italy as a main trading partner will add insult to an economy already injured by the social distancing measures implemented. We see the GDP contraction at 7.1% in 2020, followed by a 4.5% advance in 2021. The government measures aimed at supporting the business environment (mainly tax/loan payments deferrals and minimum wage subsidies) will act more as a backstop rather than pure economic stimulus, although we are mildly optimistic that public investments will not succumb to cost-optimization pressures.

Fiscal/external balances: The fiscal support package and contracting GDP will mean the end of a decent track-record of fiscal discipline in recent years. From a quasi-balanced budget, we now expect the fiscal deficit to reach the 7.0% area this year, with a lot of uncertainty coming from revenues behaviour. This will push the debt-to-GDP above 80% (from 71% in 2019), virtually erasing most of the painfully difficult improvements achieved over the last years. Financing the soaring deficit will most likely fall onto the local market, where the HNB already indicated it

stands ready to act if necessary, by buying over HRK4.2bn of bonds in the secondary market in March. We expect the MinFin to tap the market relatively frequently in the following period, as the €6-7bn to be financed this year are not allowing for opportunistic issuance. We believe that the local investors – pension funds, insurers and banks – will support the issuance plan, although yield-wise Croatia still trades quite tight versus similarly rated peers.

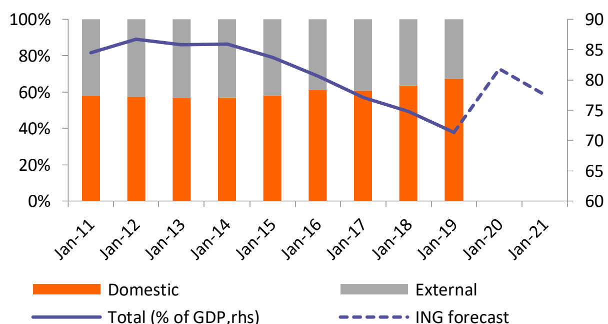
The surplus liquidity environment will add to FX pressures, but with ample FX reserves the HNB will keep things in check. The central bank sold over €2bn in March, showing strong commitment to FX stability (or rather stabilisation for the time being). We maintain our 7.55 forecast for the year-end EUR/HRK.

Rating (Ba2 pos/BBB-/BBB-): Croatia reached investment grade status following upgrades by S&P (to BBB- sta) and Fitch (to BBB- pos) last year. The current shock however hits Croatia among the hardest in CEE with some reversal in hard-achieved progress on reducing external and government debt over the last years. Beyond Fitch's recent revision of the outlook back to stable (from positive), we don't expect imminent negative rating pressure. However, with a health warning that negative pressure would build up if this crisis continues into the summer.

Despite the high vulnerabilities, both S&P and Fitch see Croatia better positioned thanks to the strong fiscal and external performances over the last years, with prudent fiscal policies expected to remain in place beyond 2020. Moreover, FX reserves remain ample. Risks come, however, from a prolonged Covid-19 pandemic, with S&P seeing risks of a more negative budgetary impact if the tourism is significantly impacted.

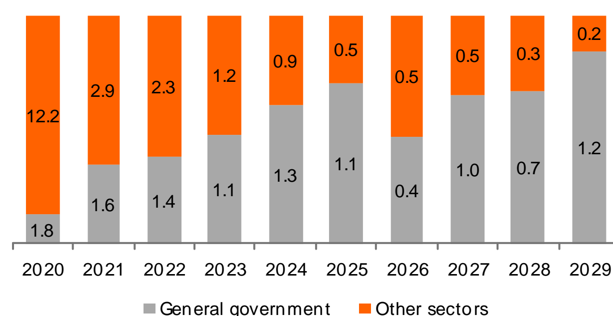
Croatia also has a positive outlook at Moody's, albeit with ratings two notches lower at Ba2. An upgrade is unlikely although we believe that the rating agency will stick to the positive outlook for now.

Fig 11 General government debt



Source: HNB, ING

Fig 12 Gross external debt projection (EUR bn)



Source: HNB, ING

Serbia

Being one of the quickest and boldest to react both on the monetary and fiscal front among its Balkan peers, Serbia finds itself hit by the current pandemics just when the economy was on the verge of a complete turnaround. The government's support package exceeds 10% of GDP, but less than half of it is an actual direct spending. The parliamentary, provincial and local elections - due in April - have been postponed indefinitely.

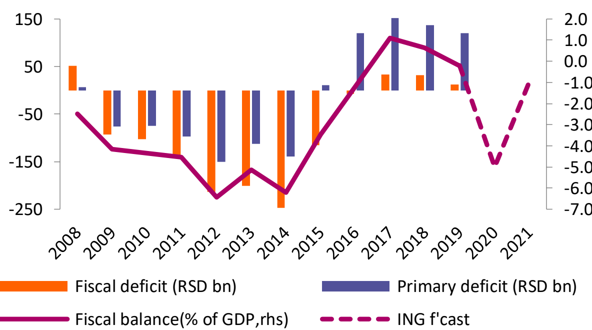
Growth: While no longer than one month ago we were still optimistic on Serbia's growth prospects, the depth of the current pandemics is forcing us to review our forecast and call for a -2.2% contraction of the economy in 2020. Even under this scenario, Serbia could be one of the least affected economies in the region. Moreover, the sustained public investment activity looks set to continue and even accelerate this year which lays the ground for what we believe to be a strong rebound of the economy in 2021. We see GDP advancing by 6.3% next year. The central bank still has room to lower the borrowing costs and we expect the key rate to reach 1.25% by the year end.

Fiscal impact/funding needs: The balanced budget from 2019 offers a good starting point to stimulate the economy. We see the fiscal deficit reaching 5.0% this year, meaning roughly €2.3bn to be financed plus €3.2bn in debt maturities. The government estimates that most of these funds (around two-thirds) will be covered from the internal market (budgetary reserves and domestic bond issuance). This still leaves around €2bn for the external markets which – given the circumstances – could prove challenging to raise. The large share of the FX-denominated public debt – c.72% is the weak link in the chain, forcing the central bank to preserve RSD stability against the euro. The IMF-recommended metric for the debt-to-GDP ratio not to exceed 60% looks difficult to meet but could be achieved in our view. It will require, however, a tight control over public finances, which is traditionally more problematic in electoral years.

Rating (Ba3 pos/BB+ pos/BB+): Like Croatia, Serbia has gone through upgrades by S&P and Fitch to BB+ in 2019. The most recent decision has seen Fitch affirming Serbia's rating (27 March), noting the country's minimal exposure to tourism, the positive impact of lower energy prices, increased FX reserves and moderate non-resident holdings of government debt. Lastly, prudent fiscal policies in the last years (supported by IMF involvement) provide the government with the necessary fiscal room to react.

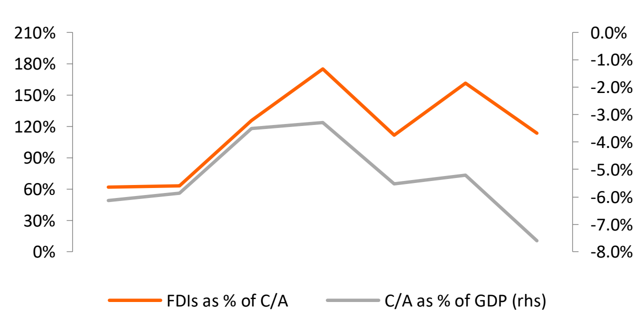
Meanwhile, S&P and Moody's have attached positive outlooks on the BB+ and Ba3 ratings, respectively. Temporary setbacks in growth, fiscal gains and FDI inflows mean that Serbia will likely have to wait some time for the first investment grade rating. Nonetheless, we believe there is a chance for Serbia to keep the outlook positive given the economy's resilience and a prudent fiscal policy setting. Key risks rather come from contingent liabilities from weak SOEs and a high FX debt share.

Fig 13 Fiscal balances under stress



Source: MinFin, ING

Fig 14 So far, FDIs have saved the day



Source: NBS, ING

Research Analyst Contacts

Developed Markets		Title	Telephone	Email
London	Chris Turner	Global Head of Markets and Regional Head of Research, UK & CEE	44 20 7767 1610	chris.turner@ing.com
	James Smith	Economist, Developed Markets	44 20 7767 1038	james.smith@ing.com
	Carlo Cocuzzo	Economist	44 20 7767 5306	carlo.cocuzzo@ing.com
	Petr Krpata	Chief EMEA FX and IR Strategist	44 20 7767 6561	petr.krpata@ing.com
	Francesco Pesole	FX Strategist	44 20 7767 6405	francesco.pesole@ing.com
	Wenyu Yao	Senior Commodities Strategist	44 20 7767 6909	wenyu.yao@ing.com
	Antoine Bouvet	Senior Rates Strategist	44 20 7767 6279	antoine.bouvet@ing.com
	Oleksiy Soroka	Senior High Yield Credit Strategist	44 20 7767 5695	oleksiy.soroka@ing.com
Amsterdam	Marieke Blom	Chief Economist, Netherlands	31 20 576 0465	marieke.blom@ing.com
	Maarten Leen	Head of Macro Economics	31 20 563 4406	maarten.leen@ing.com
	Teunis Brosens	Senior Economist, Eurozone	31 20 563 6167	teunis.brosens@ing.com
	Bert Colijn	Senior Economist, Eurozone	31 20 563 4926	bert.colijn@ing.com
	Raoul Leering	Head of International Trade Analysis	31 20 576 0313	raoul.leering@ing.com
	Joanna Konings	Senior Economist, International Trade Analysis	31 20 576 4366	joanna.konings@ing.com
	Timme Spakman	Economist, International Trade Analysis	31 20 576 4469	timme.spakman@ing.com
	Marcel Klok	Senior Economist, Netherlands	31 20 576 0465	marcel.klok@ing.com
	Jeroen van den Broek	Global Head of Sector Research	31 20 563 8959	jeroen.van.den.broek@ing.com
	Maureen Schuller	Head of Covered Bond Strategy and Financials Research	31 20 563 8941	maureen.schuller@ing.com
	Benjamin Schroeder	Senior Rates Strategist	31 20 563 8955	benjamin.schroder@ing.com
	Suvi Platerink Kosonen	Senior Credit Analyst, Financials	31 20 563 8029	suvi.platerink@ing.com
	Nadège Tillier	Senior Credit Analyst, Utilities and Head of Corporates Research	31 20 563 8967	nadege.tillier@ing.com
	Hendrik Wiersma	Senior Credit Analyst, TMT	31 20 563 8961	hendrik.wiersma@ing.com
	Alyssa Gammoudy	Credit Analyst, Consumer	31 20 563 8902	alyssa.ouled.gammoudy@ing.com
	Timothy Rahill	Credit Strategist	31 20 563 8170	timothy.rahill@ing.com
	Roelof-Jan van den Akker	Head of Technical Analysis	31 20 563 8178	roelof-jan.van.den.akker@ing.com
Brussels	Peter Vanden Houte	Chief Economist, Belgium, Luxembourg	32 2 547 8009	peter.vandenhoute@ing.com
	Julien Manceaux	Senior Economist, France, Belgium, Switzerland	32 2 547 3350	julien.manceaux@ing.com
	Philippe Ledent	Senior Economist, Belgium, Luxembourg	32 2 547 3161	philippe.ledent@ing.com
	Steven Trypsteen	Economist, Spain, Portugal	32 2 547 3379	steven.trypsteen@ing.com
	Charlotte de Montpellier	Economist, Switzerland	32 2 547 3386	charlotte.de.montpellier@ing.com
Frankfurt	Carsten Brzeski	Chief Economist, Eurozone and Global Head of Macro	49 69 27 222 64455	carsten.brzeski@ing.de
	Inga Fechner	Economist, Germany, Austria	49 69 27 222 66131	inga.fechner@ing.de
Milan	Paolo Pizzoli	Senior Economist, EMU, Italy, Greece	39 02 55226 2468	paolo.pizzoli@ing.com
New York	Padhraic Garvey	Regional Head of Research, Americas	1 646 424 7837	padhraic.garvey@ing.com
	James Knightley	Chief International Economist	1 646 424 8618	james.knightley@ing.com

Emerging Markets		Title	Telephone	Email
New York	Gustavo Rangel	Chief Economist, LATAM	1 646 424 6464	gustavo.rangel@ing.com
London	Trieu Pham	Emerging Markets Sovereign Debt Strategist	44 20 7767 6746	trieu.pham@ing.com
	Egor Fedorov	Senior Emerging Markets Credit Analyst	44 20 7767 6150	egor.fedorov@ing.com
Czech Rep	Jakub Seidler	Chief Economist, Czech Republic	420 257 47 4432	jakub.seidler@ing.com
Hong Kong	Iris Pang	Economist, Greater China	852 2848 8071	iris.pang@asia.ing.com
Hungary	Péter Virovácz	Senior Economist, Hungary	36 1 235 8757	peter.virovacz@ing.com
Philippines	Nicky Mapa	Senior Economist, Philippines	632 479 8855	nicholas.mapa@asia.ing.com
Poland	Rafal Benecki	Chief Economist, Poland	48 22 820 4696	rafal.benecki@ingbank.pl
	Piotr Poplawski	Senior Economist, Poland	48 22 820 4078	piotr.poplawski@ingbank.pl
	Jakub Rybacki	Economist, Poland	48 22 820 4608	jakub.rybacki@ingbank.pl
	Karol Pogorzelski	Economist, Poland	48 22 820 4891	karol.pogorzelski@ingbank.pl
Romania	Valentin Tataru	Economist, Romania	40 31 406 8991	valentin.tataru@ing.com
Russia	Dmitry Dolgin	Chief Economist, Russia and CIS	7 495 771 7994	dmitry.dolgin@ingbank.com
Singapore	Rob Carnell	Regional Head of Research, Asia-Pacific	65 6232 6020	robert.carnell@asia.ing.com
	Prakash Sakpal	Economist, Asia	65 6232 6181	prakash.sakpal@asia.ing.com
	Warren Patterson	Head of Commodities Strategy	65 6232 6011	warren.patterson@asia.ing.com
Turkey	Muhammet Mercan	Chief Economist, Turkey	90 212 329 0751	muhammet.mercan@ingbank.com.tr

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AMSTERDAM	BRUSSELS	LONDON	NEW YORK	SINGAPORE
Tel: 31 20 563 8955	Tel: 32 2 547 2111	Tel: 44 20 7767 1000	Tel: 1 646 424 6000	Tel: 65 6535 3688
Bratislava	**Frankfurt**	**Madrid**	**Paris**	**Sofia**
Tel: 421 2 5934 6111	Tel: 49 69 27222 62400	Tel: 34 91 789 8880	Tel: 33 1 56 39 32 84	Tel: 359 2 917 6400
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Tel: 54 11 4310 4700	Tel: 90 212 335 1000	Tel: 39 02 89629 3610	Tel: 82 2 317 1800	Tel: 48 22 820 4696
Dublin	**Kiev**	**Moscow**	**Shanghai**	
Tel: 353 1 638 4000	Tel: 380 44 230 3030	Tel: 7 495 755 5400	Tel: 86 21 2020 2000	

Research offices: legal entity/address/*primary securities regulator*

Amsterdam	ING Bank NV, Bijlmerplein 888, Amsterdam, 1102 MG, Netherlands. *Netherlands Authority for the Financial Markets*
Brussels	ING Belgium SA/NV, Avenue Marnix 24, Brussels, Belgium, B-1000. *Financial Services and Market Authority (FSMA)*
Bucharest	ING Bank NV Amsterdam - Bucharest Branch, 48 Iancu de Hunedoara Bd, 011745, Bucharest 1, Romania. *Financial Supervisory Authority, Romanian National Bank*
Budapest	ING Bank NV Hungary Branch, Dozsa Gyorgy ut 84\B, H - 1068 Budapest, Hungary. *National Bank of Hungary*
Frankfurt	ING-DiBa AG, Theodor-Heuss-Allee 2, 60486 Frankfurt, Germany. *Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin)*
Hong Kong	ING Bank NV, Hong Kong Branch, 8/F, Three Pacific Place, 1 Queens' Road East, Hong Kong. *Hong Kong Securities and Futures Commission*
Istanbul	ING Bank AS, ING Bank Headquarters, Resitpasa Mahallesi Eski Buyukdere Cad. No.8, 34467 Sariyer, Istanbul, Turkey. *Capital Markets Board*
London	ING Bank NV London Branch, 8-10 Moorgate, London EC2R 6DA, United Kingdom. *Financial Conduct Authority*
Manila	ING Bank NV Manila Branch, 20/F Tower One, Ayala Triangle, Ayala Avenue, 1226 Makati City, Philippines. *Philippine Securities and Exchange Commission*
Milan	ING Bank NV Milano, 250, Viale Fulvio Testi, 20126, Milano, Italy. *Commissione Nazionale per le Società e la Borsa*
Moscow	ING Bank (Eurasia) JSC, 36, Krasnoproletarskaya ulitsa, 127473, Moscow, Russia. *The Central Bank of Russia*
New York	ING Financial Markets LLC, 1133 Avenue of the Americas, New York, NY 10036, United States. *Securities and Exchange Commission*
Prague	ING Bank NV, Prague Branch, Českomoravská 2420/15, Prague 9, Czech Republic. *Czech National Bank*
Singapore	ING Bank NV Singapore Branch, 1 Wallich Street, 12-01 Guoco Tower, Singapore 078881. *Monetary Authority of Singapore*
Warsaw	ING Bank Slaski SA, 34, ul. Sokolska, Katowice, 40-086, Poland. *Polish Financial Supervision Authority*

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