

Sunday Wrap

Happy Sunday,

This is the last Sunday Wrap before I take a break to devote my summer weekends to other things. Of course, you'll hear from me, or from my team, if we see anything that deserves your immediate attention. Rest assured, your UniCredit Research friends never sleep.

I'll use this last pre-summer Sunday email to discuss the big picture of where we stand in this increasingly fragile "world in transition" and what it means for monetary policy across the world and for markets. Please bear with me, if it runs a tad longer than normal.

I'll structure my story along the following headlines:

- **Politics: The Trump-threat of a trade war is increasing, but he may have overstepped on Russia. In Europe, we may have seen the peak of nationalism – although not in Turkey.**
- **The global economy is still okay, but the risk is now very high, and if trade policies don't make a U-turn very soon, we'll see a measurable impact on growth already next year.**
- **The world's central banks, including the Fed, ECB and BoE, are struggling to figure out how to react to this threat. They are clearly nervous about the impact on growth, but they haven't (yet?) begun to modify their communication on policy normalization. In contrast, the PBoC is taking increasingly aggressive action.**
- **And where does this all leave markets? My guess for the next couple of months.**

Erik F. Nielsen, Global Head of CIB Research,
Group Chief Economist
(UniCredit Bank, London)
+44 207 826-1765
erik.nielsen@unicredit.eu

Bloomberg:
UCGR, UCFR

Internet:
www.research.unicredit.eu

1. Politics:

In Ed Luce's wonderful "Lunch with the FT" this weekend, 95-year old Henry Kissinger says: "I think Trump may be one of those figures in history who appears from time to time to mark the end of an era and to force it to give up its old pretences. It doesn't necessarily mean that he knows this, or that he is considering any great alternative. It could just be an accident." And as this happens, "it would be ironic if [the rest of the West manages to stand on its own feet], but it's not impossible".

As you'll know from my previous notes, I share the view that Trump is more of a symptom of a big shift (reversal of years of increasingly skewed income distribution, which is very much the result of globalization and technological developments, as well as the rise of China) than the instigator of change. That said, and as partly illustrated in Europe, this big – and maybe, ultimately, inevitable – shift can be managed in several ways, and Trump's way is just about the second worst imaginable. (The worst being war, as usually happened in history when dominance changed hands.)

I'll make two points on Trump and US policies: One of fear, and one of (some) hope. And then I'll summarize the signs of hope in Europe, where the worst parts of nationalism may have peaked:

My US fear: In a nutshell, I see no let-up in Trump's determination, and ability, to wreck the global trading system via trade wars on multiple fronts – trade wars the US will surely "lose badly", but at a cost to the rest of the world as well, of course.

Last Thursday, the US Commerce Department conducted its hearing on the threat to national security of foreign autos (no kidding!), and it seems almost a given that Secretary Ross will soon recommend an import tariff of 25% on all autos and auto parts, which Trump surely will be more than happy to implement. Mexico will be the biggest casualty, followed by Germany, Japan and Canada. The EU is sending Juncker to Washington for talks on Wednesday, while threatening retaliation. I'll eat my hat if Juncker manages to persuade the US to stop the madness!

Also this past week, Trump said that he is prepared to expand US tariffs on China to include all USD 500bn worth of US annual Chinese imports. A few weeks ago, the Chinese promised retaliation when the US identified USD 200bn as the next target (beyond the first USD 50bn), but with total imports of US goods into China of less than USD 200bn, it's getting tricky for China to retaliate "proportionately". After Trump's latest threat of an escalation to USD 500bn, a Chinese government spokesman said that China would love to buy more in the US, but claimed the US won't sell [what they want] to China. I'll return to the Chinese response, which is expanding to monetary policy easing and FX policies, when I get to the monetary policy discussion below.

My US hope: While the majority of the US population does not support import tariffs (latest opinion poll suggests 39% in favor, while 56% oppose), Trump feels on political safe ground on the trade issue because tariffs still play well in key swing states. However, he cannot feel on politically safe grounds on his Russia policy, where he has stepped over at least two, if not three, red lines within this past week.

The first two mishit in his triple Russia bogey within a week (the Helsinki press conference and his ambivalent response to Putin's idea that Russia can interview Americans, including former ambassador McFaul, in the US) led to severe rebukes from his key constituencies, namely Fox News, Wall Street Journal's editorial board and Republicans in the Senate.

Fox and WSJ demanded an immediate correction of Trump's statement that he trusted Putin more than the US intelligence community on the issue of Russian interference in the election – and they got it via Trump's absurd claim that he simply misspoke when he said "would" instead of "wouldn't". Even then, in a Washington Post/ABC poll conducted between Wednesday and Friday, and published this morning, 50% of Americans disapprove of Trump's handling of the meeting with Putin, while 33% approve (with a sizable 18% having no opinion – but hey, "this is America"). Quite amazingly, in my view, 66% of Americans identifying themselves as Republicans approve of Trump's handling of the meeting.

Better bipartisanship was on display when the Senate voted a whopping 98-0 to reject Putin's idea of Russian interviews of Americans in the US. And Trump got the message; he rushed out to clarify that – after all – he doesn't support that either.

The third mishit was his invitation, with no prior consultation with even his most important advisors, to Putin to come to the US this fall. That one has led to much reported headshaking among senior officials, but no explicit rebuke – so far.

As CNN reported yesterday, the Russia missteps have led several key officials and Trump supporters to worry about the fuel he has provided to the Mueller investigation, which has now shown incredibly detailed knowledge of specific Russian GRU officials' hacking Democratic Party officials before the election. Meanwhile, new reports of improper conduct by Trump and his handlers before the elections have surfaced, while separate investigators have charged a Russian woman in DC for being part of a claimed elaborate Russian attempt to infiltrate the GOP, including through the National Rifle Association. You couldn't make this up, even if you tried.

I still think Trump will survive at least until the 2020 election, unless indisputable evidence of "Treason, Bribery or High Crimes and Misdemeanors" emerges. Short of that, and regardless of smoking guns and what have you, he is unlikely to be removed from office. The Democrats may win the House (and, thereby, be able to impeach him, assuming there are enough smoking guns), but they are unlikely to win the Senate and can, therefore, not convict him. And even if they do win both the House and the Senate, they would probably not want to remove him (assuming no indisputable evidence) because the Democratic leadership might prefer to run against Trump in 2020, rather than against Pence.

So, tighten your seatbelts for at least another two years of destructive US politics.

Meanwhile, politics look a little better in Europe, where nationalists seem to be on the defensive now.

In Germany, Merkel not only survived the Seehofer attack, but came out stronger. Indeed, in Bavaria, opinion polls ahead of the October 14 state election suggest that the CSU's relentless focus on immigrants is not paying off. The latest poll, by Kontrovers, shows the CSU dropping another 3pp to 38% (and hence well below the absolute majority they have enjoyed for decades; in the last election achieved with 48% of the votes), AfD remains unchanged at a relatively modest 12%, while the Greens have advanced 2pp to 16% and the SPD by 1pp to 13%.

I wouldn't be surprised if the Bavarian leadership of Markus Söder will blame Seehofer for the CSU's likely poor performance in October. After all, it was he, who first championed the immigration-focused attacks on Merkel. If so, Seehofer might be out of the federal government later this year, and life for Merkel would be a good deal easier. No surprise that Merkel looked quite pleased with herself when she walked to the last press conference on Friday, before heading on vacation. This is chess for her, and I rather suspect she enjoys the game, not least because she knows that she is good at it.

In Italy, the balancing act between the two coalition partners continues, but is unlikely to break down in the next few months. On the big issue of EU and euro membership, in an interview with the Washington Post yesterday, Salvini (reluctantly) agreed that he has changed his mind, and is now in favor of Italy's membership – no doubt because he can read Italian opinion polls, which tell him that an Italy-exit would be a losing proposition as the population does not agree with the extreme end of nationalism. (The interview is here: [The Washington Post](#))

On more pedestrian matters, the Italian budget's fiscal and macro targets will need to be agreed on by the end of September, while the budget law will need to be approved by mid-October. You'll want to be in close contact with our Chief Italian Economist, Loredana Federico, when this discussion gets under way in Rome in (probably early) September.

Meanwhile in Central Europe, nationalism's attack on the independence of key institutions is running into the barriers established by their EU membership. While Poland is heading slowly for an Article 7 vote in the European Council (which, admittedly, will be blocked by Hungary), Hungary itself faces a vote in the European Parliament on September 12 on the start of Article 7 investigations. Romania is the latest arrival to this dubious club, with the Venice Commission issuing a preliminary opinion that recommends easing of the control of the government on judges and prosecutors. Nothing will happen during the summer break, but reactions from the European Commission are likely to follow, setting the stage for a heated autumn for all three countries. Stay tuned with our Chief CEE Economist, Dan Bucsa, when this begins to unfold.

The one exception to the signs of a reversal of nationalism in the European timezone is Turkey, where the combination of: (i) a charismatic leader, (ii) years of good growth (partly earned, partly borrowed, partly lifted by the global recovery), (iii) regional upheavals, (iv) a swayable population making democracy relatively weak, and (v) the lack of a European anchor has delivered a democratically-sanctioned transition to a strong presidential regime that controls everything from the military to the judicial system to economic and monetary policies. As a result, markets may be rattled by presidential decrees during the summer that'll further reduce the separation of powers. Hence, further selloffs in the TRY and sovereign yields are possible. As a result, the CBRT may have to tighten further and its first chance to do so will come next week, on 24 July. Markets are already pricing a 100bp rate hike, and I doubt that they'll exceed that.

2. The global economy.

In their July update, the IMF said that they still expect global GDP growth at just short of 4% this year and again next year, but that growth has become less even (more in the US, less in the eurozone, UK and Japan) and that the risk from trade tensions has increased. In IMF-speak: "The balance of risks has shifted further to the downside, including in the short term." We agree with this.

There seems broad consensus that, irresponsible as it is, US fiscal policy has been boosting US growth so far this year – and Trump is certainly taking credit for it (and he seems to think it'll last). However, in a research piece published this past week, Professor Benjamin Born et al shows that there has been no effect on the US economic performance of Trump so far – neither good nor bad. Born & Co let an algorithm determine an appropriate counterfactual for US GDP developments since Trump's inauguration (basically a weighted average of several countries, which the model has determined, along with the weights, as the most accurate counterfactual to the US, or, as these German professors call it, the US "Doppelgänger"). The bad news for Trump is that the US hasn't performed any different – neither better nor worse – since he became president than the (appropriately weighted) average of several other countries. Their piece is here: [Stable genius: Estimating the 'Trump effect' on the US economy](#)

Whether the US has received a short-term boost or not, the risk to growth from trade infringements is very important – and very dangerous. I have discussed in recent weeks the estimates from various international organizations of the effects of, e.g. a 10% tariff on everything in and out of the US (i.e. a cost to global GDP of about 1%, including some 2.5% for the US), but this past week, Antoine Berthou et al published in Banque de France's excellent Eco Notepad series a piece in which they, on the back of their own model, **(i)** confirmed these estimates, and **(ii)** showed that if you add the likely subsequent fall in productivity, higher financing costs and decline in investment, the negative effect on global GDP could be as high as 3% over two years. To be clear, this would send the world into recession, which is usually identified as global growth of 2.5% or less, partly as China will not go to zero, and most other EM countries will need more due to their population growth. (The BdF piece is here: [Quantifying the losses from a global trade war.](#))

Of immediate concern is the US threat of 25% tariffs on their auto imports. If they were to be implemented, the first-round effects on EU GDP could be on the order of 0.2%, hitting Germany the hardest with a drag of up to 0.6%. The high exposure of Germany stems from the relatively high share of the auto sector in German gross value added (4.5%) and the (also high) share of German auto exports to the US in total exports (2.9%).

Some of the CEE countries, most notably the Czech Republic and Hungary, have a higher concentration of value-added from the auto sector in their economy than Germany, but their exposure to the US is considerably smaller. However, once second round effects are included, hitting suppliers and other parts of the value chain, CEE is likely to be hit significantly by a US auto tariff as well. (Two days after Trump's inauguration in January 2017, I sat in a conference in Budapest listening to PM Orban praising Trump's inauguration address (while denouncing the EU) and – explicitly – his "America First" dictum. I would be curious if Orban feels the same way today.)

Now, talking about Trump's obsession with German cars, and the CEE region's dependency on the auto sector, including German manufacturers, here is a little summer detail for you on the importance of German automakers:

You may have noticed that Putin was chauffeured around in Helsinki last week in his new Aurus Senat limousine, flown in from Moscow, as leaders from big countries do.

Previously, Putin was driven in a Mercedes S600 (Yeltsin had a Soviet era Zil, but they went out of business years ago), but when Putin turned increasingly nationalistic some ten years ago, he ordered a Russian car for himself. As a result, the so-called Kortezh project got under way to develop an appropriate car for the country's president. Finally, the gigantic Aurus Senat was delivered to the Kremlin in April this year (and it was – of course - longer than the US president's so-called Beast). But don't look too closely under the hood. It turns out that Kortezh engineers couldn't develop a sufficiently smooth and reliable engine and powertrain for this enormous car – so, underneath the impressive Russian designed and built chassis, you'll find ... a Porsche engine, imported from Germany.

It seems that not only Hungarian and Czech GDP is dependent on German auto technology, but also, apparently, Russian political prestige.

Alright, back to more serious stuff:

3. Central banks.

Without a doubt, every major central banker around the world is worried about the threat of protectionism, and the impact it'll have on growth. But when it comes to their reaction function, the central banks face a dilemma: While the lower growth might call for monetary easing, the higher inflation, stemming from a protectionist shock, might call for monetary tightening.

I say "might call for monetary tightening" because the central banks could choose to look through the increase in inflation, assuming it's not the beginning of many years of constant tariff increases, pushing inflation higher over a longer period of time – even if that may be a questionable assumption these days! But even if they chose to look through it (and tighten policies), a world of trade infringements will lead to a lower potential growth rate, which in turn, will require a generally tighter monetary policy stance.

Caught between a rock and a hard place, the key central banks have (so far) chosen to keep their "normalization narrative", while characterizing the emerging protectionism (and the signs of where this is going) as "a risk".

When it comes to the Fed, Trump doesn't like the implied message of continued rate hikes. In an interview with CNBC this past week he said that "I don't like all this work that we're putting into the economy and then I see rates going up", which triggered a steepening of the curve, as markets (strangely) thought this would lead the Fed to abandon some of the planned hikes – and to a outcry from commentators that it might (or even should) lead the Fed to do more, just to prove its independence.

This is nonsense, of course. First, and being fair to Trump, he also said in the interview that while "I'm not happy about it ... I'm letting them do what they feel is best". Second, as I have discussed on multiple occasions when people wonder about ECB independence, central bank independence means that you don't react to statements on monetary policy from the politicians. You don't follow their wishes, but neither do you "punish" them, by doing the opposite. Frankly, it's an absurd idea that they would - or should. (We may learn more on the Fed thinking when we get to the Jackson Hole conference on August 23-25, but I very much doubt that their narrative is about to change.)

The Bank of England's dilemma is even greater because of their additional uncertainty stemming from Brexit. The week after next, they'll decide on interest rates, and – in spite of already lousy growth and all – they are sending every signal they can that they'll hike rates. In our view, this would be a mistake.

The ECB has already announced the end of QE, but did so with fancy "enhanced forward guidance" (whatever that means), telling us that the first rate hike won't happen until after the summer of 2019, at the earliest. This means that there isn't much traditional ammunition in the ECB's arsenal should a slow-down occur without upward inflation risks, hence calling for policy stimulus.

Indeed, the ECB discussions I'm having with clients now are all about what they can do in terms of stimulus, if, or when, that'll be needed. The answer is that if you need policy easing when rates are at the zero-bound, the obvious response would be a targeted fiscal easing. And if monetary easing were to be needed, the tool would be another dose of (maybe fine-tuned) TLTRO. Beyond that – if a downturn were to turn into a crisis-like decline – QE would have to be expanded to e.g. equities and/or (better) we would see a new level of policy coordination between the fiscal and monetary authorities in Europe, including fiscal expansion and QE. (To be sure, the risk of a downturn so severe that such extreme measures were to be needed seems very low indeed.)

And talking about TLTRO, there is one major central bank that puts its money where its fears are, namely the PBoC – but only after having (unsuccessfully) called for fiscal easing.

The PBoC has really gone to work the last 6-8 weeks, officially because of fear of protectionism, but I suspect also – if related – because of the selloff in lower-rated Chinese corporate credits.

Following on their whopping 10% expansion (month-on-month) in outstanding liquidity to banks via their Medium Term Lending Facility (the MLF) in June alone, and their surprise (dovish) rate decision three weeks ago, the PBoC announced further easing measures this past week, by expanding ultra-cheap liquidity via the MLF, with incentives for banks to expand lending to corporations and to buy bonds issued by firms, rated AA+ and below. In most ways, this is TLTRO-on-steroids.

The PBoC has been explicit about their determination to counter the negative effects on growth of US tariffs, and a huge amount of extremely cheap (and somewhat targeted) credit is clearly one of their tools.

The problem, however, is that with the MLF, the central bank is fuelling the number one Chinese economic vulnerability, namely corporate leverage. This is something I have been discussing for the last year, and seeing them pushing that same envelope even further in the face of a possible slowdown is very worrisome. As suggested by the PBoC, the fiscal channel would be a much better response, but when the fiscal agent won't go to work, the monetary one must (a good reminder that it's not only in Europe, with our complexity of one central bank and many fiscal agents, that policy coordination is sub-optimal.)

In contrast, and returning to my point on the ECB and the TLTRO, eurozone firms do not suffer from excessive leverage; indeed, as Marco Valli and Loredana Federico discussed in our Economics Thinking piece this past week, eurozone companies, particularly in the periphery, have already delivered sizable deleveraging of their balance sheets (much more so than US counterparts), and have, as a result, generated rather robust balance sheets. Marco and Loredana's paper is here, in case you missed it: [Eurozone firms are more resilient to a tightening of financial conditions](#)

The other tool the Chinese are now employing, if unannounced, is the exchange rate. Within the last month, the CNY has taken the sharpest rate of depreciation against the dollar in years (bringing the level down to where it was about a year ago), and it has also dropped significantly against other currencies, including the euro. That's quite something for a managed currency in a country that didn't experience any crisis in that period! And Trump, the astute observer, is not happy. He noted in that same CNBC interview that the "Chinese currency was dropping like a rock ... and that puts us at a disadvantage."

Beyond rousing Trump's anger, it's a dangerous game the Chinese are playing here: Controlling your capital account while massaging your currency lower opens up two key risks:

First, your trading partners other than the US (the countries with whom you presumably would like to organize a coordinated approach to the US trade madness, and maybe one day like to get excited about the "Belt and Road Initiative") are not going to be happy with this version of "China First" policy. You push this envelope, and an FX-war could break out.

Second, your own (wealth-owning) citizens won't like their savings to be trapped in a depreciating currency, so you increase the risk of disruptive capital flight, thereby delaying the day you can make your currency more appropriately convertible. A big topic for another day!

And that leads me to my conclusions:

4. Markets.

What does this mix of high-risk politics, still good economic growth (but with increasing risks), and central bank policies-in-dilemma mean for markets in the next couple of months?

Here is my guess – not forecasts, and not recommendations. Just guesses:

The US curve will flatten as the Fed ploughs ahead, and decent demand for the long end prevents yields from moving much higher. (We have now learned that the April-May period of 10-year yields above 3% was triggered to a large extent by Russian creditors liquidating virtually their entire near-USD 100bn holding of Treasuries in the aftermath of sanctions; an event that is very unlikely to be repeated.)

A continued bear flattening in the US will probably be supportive for equities because that's the norm as it (usually) reflects still beautiful growth dynamics and good earnings. Since 1985, there have been 65 months of a bear flattening US yield curve, and during these periods, the S&P gained on average about 1% per month, as pointed out by my colleague, Christian Stocker.

Now, incidentally, if we get a little more than that, namely 2.2% during the next month, then – as Christian notes with excitement – we'll celebrate in exactly one month from today, on August 22, the longest bull market (defined as a period of a 20% increase in stock prices) since WW-II. The current bull market started in March 2009, and if the S&P 500 gains another 2.2% by August 22, then it'll break the 114 months record set during October 1990 – March 2000. Let's do it!

In this scenario, European yields will probably not do a lot, but we may be in for some sovereign spreads tightening. There is an awful lot of talk about the effect on peripheral spreads early next year as QE ends, but I don't share the general worry, partly because of the size of the stock on the Eurosystem's balance sheets, and the continued underweight by many large institutional and sovereign investors.

More importantly, we'll first have to get through August, and that's a month of heavy Italian and Spanish redemptions (of more than EUR 20bn in each country), particularly at the beginning of the month. That feels to me as a period of likely re-tightening of spreads. And as our Cross Asset Strategist, Elia Lattuga, argues, if the positive mood stays for a bit after that, financials and HY, which have been hammered lately, might be tightening in sympathy.

And currencies? My guess is for a short term strengthening of the dollar and continued weakening for the CNY – and more trouble for sterling because of the UK Brexit chaos.

To be clear, those are all guesses, and nothing more than that – and all disclaimers apply. And do note that my record in calling markets these past few months has been pretty appalling in several instances.

So, what better excuse to take a bit of time off! I remind you that all research shows that time off leads to higher productivity, more creativity and better health. But then again, for the next 3-4 weeks it's only my weekends I'll be taking off to see if my wife still recognizes me. And if she does, I'll take a couple of weeks' vacation in late August.

The Sunday Wrap will be back in early September; I already have a long list of exciting topics I'll like to write about. Can't wait, to be honest.

Best wishes for a hopefully enjoyable summer.

Erik

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j) UniCredit Bank Czech Republic and Slovakia, Slovakia Branch, Šancova 1/A, SK-813 33 Bratislava, Slovakia

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k) UniCredit Bank Romania, Bucharest 1F Expozitiei Boulevard, 012101 Bucharest 1, Romania

Regulatory authority: National Bank of Romania, 25 Lipscani Street, 030031, 3rd District, Bucharest, Romania

l) UniCredit Bank AG New York Branch (UniCredit Bank, New York), 150 East 42nd Street, New York, NY 10017

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UniCredit Research*

Macro Research



Erik F. Nielsen
Group Chief Economist
Global Head of CIB Research
+44 207 826-1765
erik.nielsen@unicredit.eu



Dr. Ingo Heimig
Head of Research Operations
& Regulatory Control
+49 89 378-13952
ingo.heimig@unicredit.de

Head of Macro Research



Marco Valli
Head of Macro Research
Chief European Economist
+39 02 8862-0537
marco.valli@unicredit.eu

European Economics Research



Dr. Andreas Rees
Chief German Economist
+49 69 2717-2074
andreas.rees@unicredit.de



Dr. Loredana Federico
Chief Italian Economist
+39 02 8862-0534
loredanamaria.federico@unicredit.eu



Stefan Bruckbauer
Chief Austrian Economist
+43 50505-41951
stefan.bruckbauer@unicreditgroup.at



Daniel Vernazza, Ph.D.
Chief UK & Senior Global Economist
+44 207 826-7805
daniel.vernazza@unicredit.eu



Tullia Bucco
Economist
+39 02 8862-0532
tullia.bucco@unicredit.eu



Edoardo Campanella
Economist
+39 02 8862-0522
edoardo.campanella@unicredit.eu



Walter Pudschedl
Economist
+43 50505-41957
walter.pudschedl@unicreditgroup.at



Chiara Silvestre
Economist
chiara.silvestre@unicredit.eu



Dr. Thomas Strobel
Economist
+49 89 378-13013
thomas.strobel@unicredit.de

US Economics Research



Dr. Harm Bandholz, CFA
Chief US Economist
+1 212 672-5957
harm.bandholz@unicredit.eu

EEMEA Economics Research



Dan Bucsa
Chief CEE Economist
+44 207 826-7954
dan.bucsa@unicredit.eu



Mauro Giorgio Marrano
Senior CEE Economist
+43 50505-82712
mauro.giorgiomarrano@unicredit.de



Artem Arkhipov
Head, Macroeconomic Analysis
and Research, Russia
+7 495 258-7258
artem.arkhipov@unicredit.ru



Anna Bogdyukovich, CFA
Russia
+7 495 258-7258 ext. 11-7562
anna.bogdyukovich@unicredit.ru



Hrvoje Dolenc
Chief Economist, Croatia
+385 1 6006 678
hrvoje.dolenc@unicreditgroup.zaba.hr



Dr. Ágnes Halász
Chief Economist, Head, Economics and
Strategic Analysis, Hungary
+36 1 301-1907
agnes.halasz@unicreditgroup.hu



Ľubomír Koršňák
Chief Economist, Slovakia
+421 2 4950 2427
lubomir.korsnak@unicreditgroup.sk



Anca Maria Negrescu
Senior Economist, Romania
+40 21 200-1377
anca.negrescu@unicredit.ro



Kristófor Pavlov
Chief Economist, Bulgaria
+359 2 9269-390
kristofor.pavlov@unicreditgroup.bg



Pavel Sobíšek
Chief Economist, Czech Republic
+420 955 960-716
pavel.sobisek@unicreditgroup.cz

UniCredit Research, Corporate & Investment Banking, UniCredit Bank AG, Arabellastrasse 12, D-81925 Munich, globalresearch@unicredit.de
Bloomberg: UCCR, Internet: www.research.unicredit.eu

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