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Emerging Europe outlook

As divergent as ever

Group Economics
Emerging Markets

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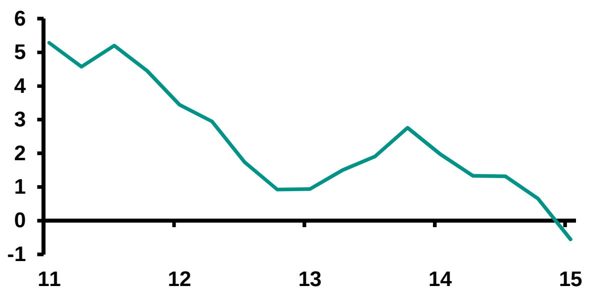
- **Regional growth contracted in first quarter of the year, but this masks strong differences within the region**
- **Although Russia and Ukraine are in a deep recession, Eastern European economies are booming**
- **Meanwhile, in Turkey, growth has eased due to uncertainty surrounding the elections and tight monetary policy**

First contraction since the global financial crisis…

The economies in emerging Europe as a whole shrank by 0.6% yoy in the first quarter of this year, according to our estimates. This marked the first contraction since the global financial crisis. However, it is important to note that this rather dire economic backdrop masks significant differences within the region. Not surprisingly, Russia and Ukraine are on one side of the spectrum. In Russia, significantly higher inflation has dented household and firms' purchasing power. This is the result of the past fall in the ruble that in turn was sparked by the sharp drop in oil prices at the end of last year. As a result, GDP declined by 2.2% yoy in Q1, following a modest expansion of 0.4% in the final quarter of last year. What is more, incoming data are suggesting that the recession deepened, and a contraction of around 6% yoy in Q2 seems to be on the cards. More positively, timelier data show that inflation has started to come down, which together with ongoing easing by the central bank, should help the recession to abate in the second half of the year. In Ukraine, the situation is even more dire due to the ongoing conflict in the East of the country. Consequently, the economy has fallen off a cliff, and shrank by a staggeringly high 17.2% yoy in Q1

Emerging Europa contracts for first time since crisis

Weighted GDP, %yoy



Source: Thomson Reuters Datastream

…but sun shines in Central Europe…

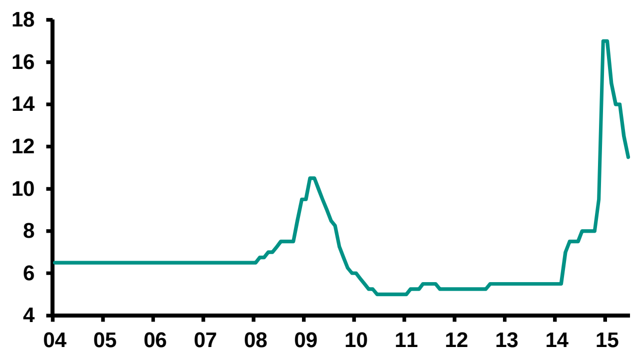
However, on the other and sunnier side of the spectrum are countries in Central Europe, such as Poland, Czech Republic and Hungary (CE3). Broadly speaking, two trends are at play here. Firstly, CE3 countries are benefitting from rising exports. With trade exposures to Russia and Ukraine being limited, the upswing in the eurozone, CE3 countries' main trading partners, is providing a strong lift to trade. Moreover, domestic demand in these economies is also strengthening. As a result, first quarter GDP releases were upbeat. In Poland, strong domestic demand helped GDP to grow by 1.0% qoq/ 3.6% yoy, while in Hungary firm external demand was behind the 0.8% qoq/3.5% yoy rise. And then the Czech Republic. Here, GDP surged by 4.2% yoy and by 3.1% qoq in Q1. While special factors were at play, this was the highest number on record. Although growth in the region should moderate somewhat, showing payback for the stellar performance in Q1, the economies in central Europe are clearly in good health.

…while growth in Turkey has moderated

Meanwhile, growth in Turkey has continued to moderate. It fell from 2.6% yoy in Q4 to 2.3% in Q1, a level that is clearly below Turkey's potential growth rate given the country's rising population. The softening of growth is attributable to the uncertainty surrounding the elections and due to the relatively tight policy of the central bank. However, industrial production growth, which tends to move in tandem with GDP growth, has recently picked up somewhat. This suggests that the economy has gained more momentum going into Q2, though growth is expected to remain modest.

More rate cuts to come in Russia

CBR, policy rate, %



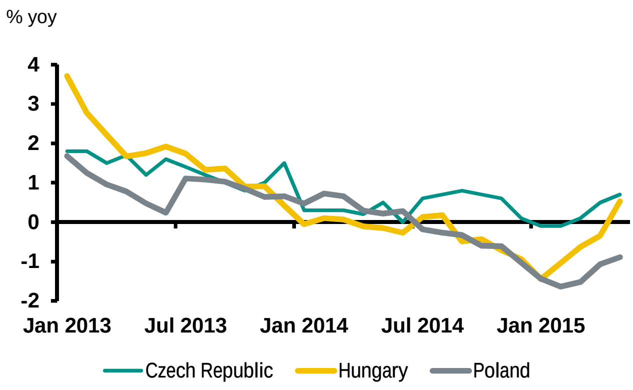
Source: Thomson Reuters Datastream

Russia's central bank will continue to ease…

Central bank policy is equally divergent within the region. Russia's central bank (CBR) has continued to loosen policy. The CBR had been forced to hike rates all the way to 17% in order to defend the ruble when the country was in the midst of a financial crisis at the end of last year. But is has started to loosen policy as calmness in financial markets has returned and inflation has peaked. Since the start of the year, it has cut its policy rate by a cumulative 550bps. We think that this process has further to go and see the CBR's policy rate at 9% at the end of this year.

…while Turkey's central bank is likely to tighten
However, Turkey's central bank is likely to tighten its policy further. Although the CBRT left its policy rates on hold during its June meeting, it struck a slightly more hawkish tone. While the statement was mostly unchanged compared to previous month, it left out the phrase that "cautious monetary policy along with prudent fiscal and macroprudential policies are having a favourable impact on inflation". This is because inflation has been on a renewed upward trend. Granted, food price inflation is coming down, helped by better agricultural conditions, but the weakening of the lira that we have seen since the end of last year will continue to underpin consumer prices. While the CBRT has already pushed interbank rates to the upper bound of its interest rate corridor, we think that it ultimately must hike its key rates. Indeed, besides stubbornly high inflation, a weak lira and possible market unrest as the Fed starts to tighten policy are all factors that argue for a tighter policy stance. As such, we expect the CBRT to raise its key rates by 50bps in the remainder of the year.

CE3 economies moving out of deflation



Source: Thomson Reuters Datastream

Easing cycle in Eastern Europe mostly over…
Meanwhile, the easing cycle in Eastern European countries seems to have mostly ended. This reflects that as a result of the strong economic performance, these countries are slowly moving out of deflation. As a result, in the beginning of June, the Polish central bank (NBP) kept its key rate on hold, at 1.5%, for the third time in a row. The NBP signalled that deflation risks were abating as inflation has become less negative. Given the strengthening of the economy, we think that inflation will continue to firm. Ultimately, this should prompt the NBP to shift to a tightening stance with the first rate hike likely to come in the second half of 2016. Meanwhile, the Czech central bank's policy has also remained unchanged with the central bank (CNB) keeping its policy rate close to zero and its currency low by maintaining the peg to the euro at EUR/CZK 27. The central bank has signalled that it intends to keep the peg in place until at least 2016H2, and we think that we have to wait for the first rate hike even longer.

…though central bank of Hungary will ease a bit more
Although inflation, as in the Czech Republic, has turned positive in Hungary as well, Hungary's central bank (MNB) has continued its easing cycle with baby steps. During its latest meeting, it cut its benchmark rate by another 15bps to 1.50%, while signalling that the inflation outlook points to 'further slight easing'. As such, the central bank should cut rates one or two more times by 15bp in coming months. But they are likely to remain on hold once the Fed starts its tightening cycle. However, if we were to take a step back from all this, the bigger picture is more or less the same as in Poland and the Czech Republic. The economy will slowly start to generate inflationary pressures and the MNB will most likely move to a tightening stance in 2016H2.

Economic growth

% yoy	14Q3	14Q4	15Q1	2014	2015	2016
Czech Republic	2.2	1.4	4.2	2.0	3.5	3.0
Hungary	3.3	3.3	3.5	3.6	3.0	2.5
Poland	3.3	3.3	3.6	3.4	3.5	4.0
Romania	3.0	2.7	4.3	2.8	3.0	3.5
Russia	0.9	0.4	-2.2	0.6	-4.0	0.5
Turkey	1.9	2.6	2.3	2.9	3.0	3.5
Ukraine	-5.4	-14.8	-17.2	-6.8	-10.0	1.5
Regional average	1.3	0.7	-0.6	1.3	-1.0	1.9

Source: ABN AMRO, EIU, Thomson Reuters Datastream

Three broad trends in emerging European currencies
In thinking about what this all means for emerging European currencies three broad trends appear. We expect the Russian ruble to strengthen in line with slightly higher oil prices in the remainder of this year and next year. We should also see a strengthening in the Polish Zloty and, after the peg is removed, in the Czech Koruna. This is because both the NBP and the CNB are likely to begin their tightening cycles earlier than the ECB. We are, however, more cautious on the Hungarian forint. Despite a strong improvement in the country's current account surplus, the government's unorthodox policies make the country vulnerable to potential capital outflows. Fed tightening, due to Turkey's vast current account deficit, should also negatively affect the lira, which we expect to continue to weaken against the dollar.

Emerging Europe should start to growing again in 2016
The good news is that after contracting by 1% in 2015, emerging Europe as a whole should start to grow again next

year. This reflects that growth in both Ukraine and Russia is set to return. Granted, developments in Ukraine make it very difficult if not impossible to forecast what will happen, but Russia's economic prospects are easier to predict. With inflation set to continue to decline as the impact of the past drop in the ruble falls out of the annual comparison, the burden of higher prices on households will continue to recede. Together with ongoing monetary easing, this should help consumption to find some footing. In turn, this should prompt companies to take some of their investment plans off the shelf, helping the economy to stabilise, and eventually to return to modest growth in 2016. A stronger eurozone recovery and a strengthening of domestic demand should, on balance, help growth to step up a bit in CE3 countries, while a better trade outlook should also be beneficial to Turkey's economy.

Greece, Fed and geopolitics biggest risks

So what would be the main risks to our scenario? Although our base case remains that Greece will remain in the eurozone, its problems and the threat of a euro exit have clearly increased over the past days. A Grexit and the resulting unrest on financial markets would almost certainly lead to a slower eurozone recovery, and there would be contagion effects to Eastern Europe, implying that economic prospects of the region will be less favourable. Still, if Greece were to leave the eurozone, we think that, due to intervention by policymakers, calm will be restored relatively quickly. If that is the case, the eurozone economy should eventually regain its footing. A final risk relates to the Fed's tightening cycle. While markets slowly seem to get used to the idea that the Fed's tightening cycle will advance later this year, there remains a particularly big difference between the amount of rate hikes that we think will eventually materialize and what markets are currently pricing in. This could be worrisome for Turkey as the country's vast current account deficit continue to make it dependent on foreign capital inflows. While not our base case, these could reverse quickly in the case of market unrest, as seen during the tapering tantrum in 2013.

Main economic indicators/forecasts

GDP growth (%)	2013	2014	2015e	2016e	Inflation (%)	2013	2014	2015e	2016e
Emerging Asia	6.5	6.4	6.3	6.4	Emerging Asia	4.7	3.5	2.7	3.2
Emerging Europe	1.8	1.3	-1.0	1.9	Emerging Europe	5.3	6.3	11.2	5.3
Latin America	2.4	1.0	0.3	2.0	Latin America	8.9	12.6	13.5	11.5
Middle East/North Africa	1.5	3.0	2.9	4.1	Middle East/North Africa	13.5	7.4	7.1	6.8
Emerging markets total	**4.6**	**4.4**	**3.9**	**4.8**	**Emerging markets total**	**6.5**	**5.8**	**6.1**	**5.2**
Eurozone	-0.4	0.9	1.8	2.3	Eurozone	1.3	0.5	0.4	1.7
US	2.2	2.4	2.7	3.1	US	1.5	1.6	0.4	2.4
World	3.2	3.3	3.2	3.8	World	4.3	3.9	3.7	3.8

Budget balance (%GDP)	2013	2014	2015e	2016e	Current account (%GDP)	2013	2014	2015e	2016e
Emerging Asia	-2.5	-2.5	-2.5	-2.5	Emerging Asia	1.0	2.0	2.5	2.0
Emerging Europe	-1.5	-1.5	-3.0	-2.0	Emerging Europe	-1.5	0.0	1.0	0.0
Latin America	-3.0	-4.5	-5.5	-4.0	Latin America	-3.0	-3.0	-3.5	-3.0
Middle East/North Africa	0.5	-2.0	-7.0	-4.0	Middle East/North Africa	8.5	5.5	-1.0	1.0
Eurozone	-2.9	-2.4	-2.3	-2.0	Eurozone	2.6	2.9	3.2	3.1
US	-4.1	-2.8	-2.5	-2.2	US	-2.4	-2.3	-2.3	-2.4

Source: EIU, ABN AMRO Group Economics ** figures Emerging Markets regions are rounded*

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