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Erste Group Research Horoscope 2015: CEE shows resilience as domestic demand kicks in, but Eurozone growth to remain fragile

Central and Eastern Europe: CEE economies to benefit from revived domestic demand; 2.5% average growth rate in CEE vs. 1.1% in Austria and Eurozone in 2015; at least one central bank to continue with rate cuts

Eurozone: recovery to remain fragile; no ECB interest rate hike until 2Q 2017

Russia & Middle East: Lower oil price and sanctions against Russia will lead to an economic downturn, increasing the pressure on households and struggling companies

Brazil & China: continuing recession in Brazil; China's slowed economy to be stimulated with EUR 90bn

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Amid new geopolitical instability financial markets proved resilience of the CEE region since the direct impact of the sanctions imposed by Russia on CEE is close to zero. CEE should also be able to cope with a freeze in delivery of natural gas via Ukraine for a period of 3-6 months. Falling demand in Ukraine and Russia shaved off about 1pp from export growth but had no visible impact on the growth dynamics in CEE which profits from domestic demand starting to kick in. In principle, a lower oil price is positive due to lower input costs. "Should the currently low oil price stay at these levels for a longer period of time, it will boost local purchasing power and support domestic demand, which has a positive impact on the global economic growth. However, it clearly has a softening effect on inflation, which should keep monetary policy supportive," says Fritz Mostböck, Head of Erste Group Research.

Due to major changes in energy and commodities prices, some of the largest currencies such as the Brazilian Real and the Russian Ruble are likely to remain volatile. The strengthening of the US Dollar/USD vs. most currencies compels investors to reassess their investments in other currencies, which leads to higher volatility in many market segments. Equity markets have recently started to show more volatility. "As the QE3 program of the Fed is now over, we are gradually coming to the end of a phase of low volatility in the stock markets. Emerging markets will probably be affected more than developed markets since currency volatility is a much greater risk factor to investments in the former," adds Mostböck.

For Austria, Erste Group analysts expect growth rates to pick up to a certain degree in spring 2015 after the very subdued development of the Austrian economy in the second half of 2014. Driving factors are the generally dynamic development of the global economy, the strong position of Austrian businesses, the high level of inflation versus other Eurozone countries, and the reforms planned by the Austrian government. Erste Group forecasts for Austria in 2015 a GDP growth rate of 1.1%.

Central and Eastern Europe: CEE economies to benefit from revived domestic demand; 2.5% average growth rate in CEE vs. 1.1% in the Eurozone in 2015; at least one central bank to continue with rate cuts
A good mix of revived domestic demand and increased investments will be the pulling forces of growth for CEE economies in 2015. Household consumption grew more than 2% in the Czech Republic, Romania and Poland in Q3 2014 and investments are finally contributing to growth by 1.4pp on average. Thus, the growth in CEE is not solely export-driven which increases the resilience of growth in CEE against potentially worsening external demand. The period of drastic fiscal consolidation and deleveraging is over with the exception of Croatia and Serbia, as delayed

fiscal consolidation will continue to drag on these two economies. “Overall, CEE economies are to grow by 2.5% in 2015 on average which is twice as fast as the 1.1% expected for the Eurozone,” states Mostböck. The Hungarian economy will slow down as this year’s increase in public spending will not be repeated. With a GDP growth of 3.1% in 2015, Poland should remain the fastest growing economy in CEE for the fifth consecutive year. The Czech Republic is expected to grow by 2.4%, Hungary 2.3% and Slovakia 2.5% in 2015.
Inflation has been undershooting central banks’ inflation targets by a considerable margin in CEE. Erste Group Research expects Romanian central bank to deliver a 25bp rate cut already in January, while the Polish and Hungarian central banks might start to think about rate cuts only if inflation readings continue to be very low and market sentiment is favorable.

Eurozone: recovery to remain fragile; no ECB interest rate hike until 2Q 2017
The Eurozone was hit by the financial crisis and the following sovereign debt crisis, which led to a renewed downturn of the economies. In 2014, the conflict between Russia and Ukraine caused renewed harm to the region. With substantially underutilized resources especially on the labor market only slowly diminishing, growth prospects remain on a low level. “The fragile state of the economies of the Eurozone countries combined with geopolitical risks and the ongoing need to consolidate public budgets lead us to expect only a moderate recovery in the Eurozone,” concludes Mostböck. Accordingly, unemployment rates will decline only slowly and inflation pressures are not expected. This will allow the ECB to maintain its extremely expansive monetary stance for some time. Erste Group Research analysts expect the unemployment rate and inflation to justify a first rate hike only in Q2 2017.

Russia & Middle East: Lower oil price and sanctions against Russia will lead to an economic downturn, increasing the pressure on households and struggling companies
The Russian banking sector is currently under pressure from several directions. The significant drop of the oil price - if it persists - will put pressure on Russia’s oil industry, with weaker companies struggling to repay debts. “The lower oil price and sanctions against Russia will lead to an economic downturn next year, increasing the pressure on households, which will suffer higher unemployment and loss of purchasing power as inflation will remain significantly ahead of wage increases,” foresees Mostböck. For corporate and household loans, the share of non-performing loans is likely to rise. An additional source of possible stress for Russian banks is funding. Due to the conflict with Ukraine, Russian banks do not have access to financing from Western countries in various currencies, which has been a significant source in the past. At the same time, Ruble funding has become more expensive, as the Russian National Bank had to increase interest rates significantly to counter the exchange rate slide. “The crucial determinant for this scenario is the oil price. The longer the current low prices persist, the bigger the risk for Russian banks,” highlights Mostböck.

Largely peaceful protests of the Arab Spring starting in 2010 in the Arab world and the Middle East prompted the handover of power and establishment of democratic parties, but also persistent military conflicts, disrupting these regions and markets. The ongoing conflict in Syria and tense political situation in other countries of the region might, from today’s perspective, cause uncertainty. The forces of the so-called Islamic State are still in power and control large parts of Syria and Iraq. Other unresolved trouble spots are constantly generating conflict in Gaza or Pakistan and challenging the Muslim world. The timing of unexpected events is difficult to predict, but it is not hard to imagine a possible escalation. Such a conflict would stress financial markets and global economies at least temporarily, and oil and commodity prices particularly in the longer run.

Brazil & China: continuing recession in Brazil; China’s slowed economy to be stimulated with EUR 90bn
Economic growth has practically come to a standstill in Brazil. Since 2Q, Latin America's largest economy has been in recession. Industrial production and retail sales have exhibited a negative trend. As a result, the expectations of purchasing managers in the manufacturing industry continue to point downward. The slowdown in China's high growth rate also continues. One reason for the slowdown is the ongoing shift in economic output from manufacturing to the services sector. To stimulate China’s economy, investments with a total volume of approx. EUR 90bn have been approved, among them 16 train stations and five airports. In order to counter the slowdown in growth, central banks have taken various measures. In any case, if the downturn in these large threshold countries continues, it will have a negative effect on global markets.