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EDITORIAL

ECONOMIC RESEARCH

BNP PARIBAS

The bank for a changing world

EDITORIAL

A FRAGILE RECOVERY

Emerging countries have continued to recover since the beginning of the year, although the recovery remains fragile. Household confidence indicators are lagging behind those of business sentiment, illustrating the constraints on domestic demand: the pandemic risk persists, inflation is accelerating, and governments are facing rising financing costs, which reduces their fiscal manoeuvring room. Despite buoyant foreign trade, the horizon is not clear enough yet for investment to rebound. Fortunately, the vast majority of central banks have been maintaining a proactive stance so far, despite inflationary pressures. But monetary policy is bound to tighten across the board.

Real GDP growth continued to slow in the 27 main emerging countries in Q1 2021, although it held strong at 1% q/q, down from 3.5% in Q4 and 7.7% in Q3. For half of these countries, real GDP growth returned to or exceeded Q4 2019 levels. In general, exports were still the main growth engine, notably in Asia (China, Taiwan and Vietnam). Companies are rebuilding inventory, which is generating pricing pressures on commodities and raising transport costs. Private domestic demand is also picking up, but in a more hesitant manner, including in China, even though it is more advanced in the cycle than the other countries. Confidence indicators reflect this lag: for the large majority of countries, the Markit indexes for the manufacturing sector have returned to or surpassed pre-crisis levels, but this is not yet the case for household confidence indicators.

THE RECOVERY CONTINUES, BUT THE RISKS ARE MORE ON THE DOWNSIDE THAN ON THE UPSIDE.

There is still a major pandemic risk. New waves of Covid-19 infections were reported in Asia and Latin America in Q2 2021. The virus is mutating into more contagious variants, and vaccination coverage rates are still too low to ensure herd immunity (less than 10% in India and Indonesia, and less than 15% in Brazil and Russia, to cite only the countries with the largest populations). The authorities in several countries have had to reinstate lockdowns, and as a result, economic activity is expected to slow or even contract in several Asian and Latin American countries.

The upsurge in inflation is now widespread (in May, the median increase in the inflation rate was already 1.8 points above the 2020 average). Oil and agricultural commodities are the main drivers of inflation, which strains household purchasing power, notably for the most vulnerable households. In its most recent June outlook, the World Bank, following the IMF, reiterated its alarming estimates of the number of people who slid into poverty last year (nearly 100 million people live off less than USD 1.9 a day, or 164 million using a broader definition that also takes into account the deterioration of healthcare and education). Even under a recovery scenario, per capita income in 2023 will still be lower than in 2019 in at least 40% of the emerging and developing countries. In comparison, four years after the 2008-2009 shock, this figure was only 15%.

The upsurge in inflation also poses a problem for the central banks, because it will exceed the inflation targets in more than half of the countries that have them. Yet tightening monetary policy at this point in the cycle risks disrupting the recovery of domestic demand, and investment in particular. Monetary tightening would only make sense if it is necessary to anchor inflation expectations. On the whole, the central banks are taking care to be proactive.

Since the beginning of the year, governments have been faced with higher financing costs, both domestically and externally. The rebound in portfolio investment as a share of local currency public debt in H2 2020 helped contain the increase in bond yields that could have been triggered by swelling deficits. Since the beginning of the year, however, portfolio investment has been returning to normal levels (they were cut in half in H1 2021 compared to H2 2020), notably due to expectations of a tapering of US monetary policy. The big increase in debt ratios in 2020, will magnify the impact of higher bond yields on the interest burden, reducing by as much the fiscal manoeuvring room in case of a relapse into recession.

Lastly, it is uncertain that foreign direct investment (FDI) will recover. According to the CNUCED, the number of greenfield projects in the manufacturing sector – which was already tending to decline in the 2010s – was slashed in half in 2020. Project financing also declined through Q1 2021, and inertia is very strong (following the 2008-2009 crisis, it took two years for projects to pick up again). These two categories of FDI will make a smaller contribution to growth than during the previous crisis exit phases, because governments have less borrowing capacity and because multinational companies are planning to relocate their business.

Yet the rebound in commodity prices could stimulate investment and help raise the growth potential of the countries concerned. This was the case in Latin American countries in the 2000s, when the upward phase of the commodity price cycle increased potential growth rates by nearly a percentage point. But the current situation is not comparable to the 2000s. At that time, China had maximum leverage with a growth rate of 10%, nearly double its current rate.

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CHINA

THE ECONOMIC RECOVERY IS STILL MIXED

Economic growth rebounded very rapidly following the Covid-19 shock, but this rebound has also been characterised by mixed performances between sectors and between demand components. Growth of industrial production and exports accelerated vigorously until early 2021 and is now gradually returning to normal. Meanwhile, the services sector and private consumption were slower to rebound, and their recovery still proved to be fragile in Q2 2021. Consequently, the authorities are likely to be increasingly cautious about tightening economic policy. Even so, they should still give priority to slowing down domestic credit growth and adjusting the fiscal deficits.

Economic activity rebounded rapidly following the Covid-19 shock of early 2020, with real GDP returning to its pre-crisis level by the end of Q2 2020. The recovery reached a peak early this year, and real GDP growth rates should return to more normal levels in the quarters ahead. China's economic rebound has also been characterised by very mixed performances between sectors and between demand components. These imbalances were still visible in Q2 2021. Consequently, many corporates are still fragile , especially small enterprises in the services sector, and the labour market has not fully recovered yet, which in turn is hampering the recovery in household demand.

MIXED PERFORMANCES

Industrial activity rebounded rapidly in spring 2020, which enabled China to respond to the surge in world demand for manufactured goods and to win market share. Industrial production and export growth accelerated vigorously until early 2021. Since March, base effects have dissipated, growth rates have been normalizing, and supply shortages in some inputs have started to constrain activity. Industrial production growth averaged (a still robust) 9.3% year-on-year (y/y) in April-May, compared to 24.5% in Q1 2021. Industrial growth did not slow as much in value terms due to the acceleration in producer price inflation, which rose from 1.7% y/y in February to a record high of 9% in May. Meanwhile, merchandise exports increased by 30% y/y in April-May (in value terms), compared to 70% in Q1. Growth in the industrial sector and exports should continue to ease gradually in the months ahead.

In the services sector, activity contracted just as much as it did in industry during the lockdown of January-February 2020, but the rebound started later and has been less vigorous. Even so, since March 2021, the growth rate in services production has surpassed that of industrial production (+15.4% y/y in April-May).

Meanwhile, private consumption growth continues to recover, but it has slacked off in recent months. The performance of retail sales fell short of expectations in April-May, increasing by 13% y/y in volume terms (compared to 33.5% in Q1).

RISING INEQUALITIES WITHIN URBAN AREAS

Changes in household savings illustrate how cautious individuals are. According to our estimates, the household savings rate increased from 34.6% of disposable income in 2019 to 37.7% in 2020, and these extra savings have been only partially absorbed so far.

Firstly, private consumption remains hampered by persisting health risks. Although the pandemic is largely under control in China, temporary and localised restrictions on mobility are still regularly introduced in case of the emergence of new Covid-19 cases. This risk should diminish with the ongoing acceleration of the vaccination campaign. On June 10th, 43% of the population had received at least one dose of the vaccine, and 16% were fully vaccinated (source: ourworldindata.org).

FORECASTS

	2019	2020	2021e	2022e
Real GDP growth (%)	6.1	2.3	8.7	5.3
Inflation (CPI, year average, %)	2.9	2.5	1.7	2.8
Official budget balance / GDP (%)	-2.8	-3.7	-3.2	-3.0
Central government debt / GDP (%)	17.0	20.6	22.0	23.4
Current account balance / GDP (%)	0.7	2.0	2.1	1.7
Total external debt / GDP (%)	14.5	16.3	15.1	15.8
Forex reserves (USD bn)	3 108	3 217	3 272	3 312
Forex reserves, in months of imports	15.0	16.3	15.2	14.5

TABLE 1 e: ESTIMATES & FORECASTS SOURCE: BNP PARIBAS GROUP ECONOMIC RESEARCH

DIFFERENTIATED REBOUNDS

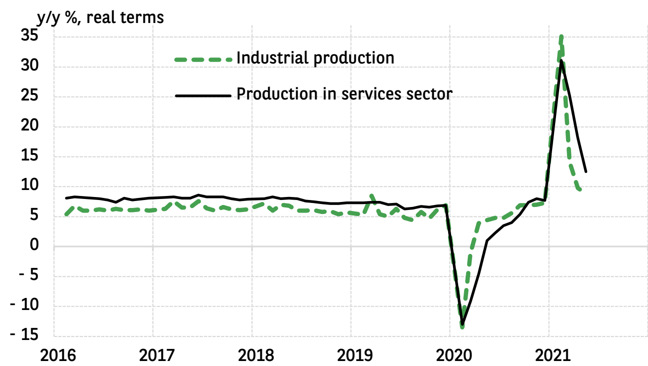

CHART 1 SOURCE: NBS

Although official unemployment rates continue to decline (the urban unemployment rate based on surveys fell to 5% in May, the same level as in May 2019), the labour market has yet to return to its pre-crisis situation. Job insecurity and underemployment have increased; youth unemployment rates remain particularly high (13.8% in May 2021 vs. 10.5% in May 2019); and job creation has been less dynamic (in Q1 2021, job creations were 8% below the Q1 2019 level). All of this has constrained the rebound in household income. This is especially true for low-income households, the category that ran up the biggest losses during the lockdown and accumulated fewer savings in 2020.

In urban areas, disposable income per capita declined by 2.2% in real terms for low-income households (after increasing 5.2% in 2019), whereas it rose by 2.3% for high-income households (compared to

+5.1% in 2019). Average real income of migrant workers stagnated in 2020. Rising inequalities and the difficulties of low-income households are contributing to delaying the turnaround in private consumption. Meanwhile, income inequalities between urban and rural areas have narrowed during the health crisis. In 2020, average disposable income per capita increased by 1.2% in real terms in the cities and by 3.8% in rural areas. The ratio between the two has declined slowly for several years, reaching 2.6 in 2020, and fell further in Q1 2021.

Consumer price inflation is still very mild and is unlikely to strain household spending, even though it has been accelerating over the past three months (to +1.3% in May from -0.2% y/y in February) after slowing throughout 2020 and early 2021. Food price inflation (+0.3% in May) is expected to remain low at least until fall, after flaring up in H2 2019 and H1 2020, and the increase in producer prices is having a limited impact on consumer prices. Core inflation has accelerated slightly (+0.9% in May), but remains lower than pre-crisis levels (it averaged 1.6% in 2019).

DOMESTIC INVESTMENT IS DICTATED BY ECONOMIC POLICY

After collapsing in Q1 2020 (-16% y/y in value), investment rebounded rapidly and rose by 3% in full-year 2020. Investment growth hit record highs in January-February 2021 (+35% y/y) due to large base effects, but it has since fallen back rapidly (to +5% y/y in May). Last year, the rebound in investment was mainly driven by real estate and public infrastructure projects, which were encouraged by policy stimulus measures. Therefore, the recent growth slowdown in investment in both sectors was largely expected given the gradual tightening in domestic credit conditions since Q3 2020 and the moderation in public spending.

In contrast, manufacturing investment picked up later in 2020 and is expected to continue to recover in 2021. It should be stimulated by the strong momentum in exports and industrial activity, very high industrial capacity utilisation rates, and the improvement in corporate profits. Despite a rather disappointing performance recently, we still expect manufacturing investment to strengthen in the short term.

INCREASINGLY CAUTIOUS WITHDRAWAL OF SUPPORT MEASURES

The authorities have shifted their priorities in recent months. Given the economy's strong performance after the Covid-19 shock, support measures have been withdrawn gradually. However, the authorities also admit that the economic recovery's foundations have remained "unstable", so they will probably be increasingly cautious when tightening economic policy.

Regarding monetary and credit conditions, the top priority is to slow debt growth and to combat financial-instability risks, primarily through prudential measures. Growth in total credit (social financing) slowed from 13.7% y/y in October 2020 to 11% in May 2021, driven by a slight decline in bank loan growth (60% of the total), a sharp slowdown in bond financing growth and the continued contraction in shadow banking credit. Total credit growth should continue to slow in the short term. In particular, property policy could be tightened further (with stricter rules for transactions, financing of developers or mortgage loans). At the same time, key policy rates are expected to stay stable,

DECELERATION IN DOMESTIC CREDIT GROWTH

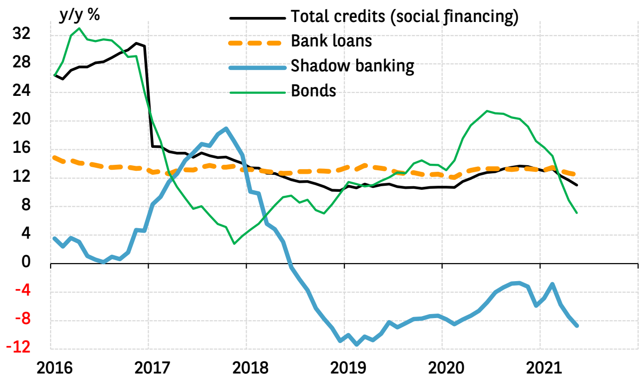

CHART 2

SOURCE: PBOC

and domestic liquidity will be maintained at sufficient levels to support manufacturing investment, boost the recovery of SMEs and the services sector, and avoid aggravating credit risks. The absence of strong inflationary tensions and appreciation pressure on the yuan should also provide incentives for the authorities to keep key interest rates unchanged.

On the fiscal policy front, priority will be given to adjusting the public accounts while continuing to provide support to the most vulnerable enterprises. Fiscal deficits swelled considerably in 2020: while the "official" deficit only increased to 3.7% of GDP from 2.8% in 2019, the consolidated deficit of the entire general government doubled last year. According to our estimates, it rose from RMB 4,600 bn in 2019, or 4.6% of GDP, to RMB 9,200 bn in 2020, or 9% of GDP.

Moreover, total government debt is moderate (it rose from 17% of GDP at year-end 2019 to 21% at year-end 2020 for the central government, and from 21.6% to 25.3% for local governments), but the debt load is unequally distributed. Above all, local governments are exposed to high contingent risks associated with the debt of their financing vehicles and other enterprises they own (according to the IMF estimates, the debt of financing vehicles was 38% of GDP at year-end 2020).

Signalling a cautious policy tightening move, the official deficit target for 2021 was lowered to 3.2% of GDP and the consolidated deficit of the entire general government should decline slightly to 7.5%. Deferrals/exemptions from taxes and social security contributions are unwound gradually, except for small enterprises. Public spending is moderated, in particular with a sharp slowdown in infrastructure investment growth – which contributes to both fiscal adjustment and domestic debt reduction efforts. As a matter of fact, new bond issues by local governments to finance infrastructure projects were cut back sharply in the first months of 2021.

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MORE TURBULENCE

The second wave of the pandemic seems to have passed after new cases peaked in May. Economic activity is unlikely to contract as much as it did last year, and the decline should be limited to the second quarter. Yet the second wave is estimated to have cost more than 2 percentage points of GDP, and it comes at a time when households are still struggling to recover from the impact of the first wave. In 2020, 75 million people dropped below the poverty line. Moreover, the rebound expected this year might not suffice to stabilise the public debt ratio, which could lead the rating agencies to downgrade India's sovereign rating. In this very uncertain environment, the rupee is not benefitting from the strength of India's external accounts.

ECONOMIC ACTIVITY CONTRACTED IN Q1 2021/2022

The second wave of the pandemic that swept India starting in March 2021 has triggered a sharp decline in activity. All indicators declined sharply in April (industrial output, VAT revenue, automobile and tractor sales, road traffic and employment rate) and these trends worsened in May. The pandemic did not spare a single region, but the ten hardest hit regions together account for 60% of India's GDP.

Despite its severity, the economic contraction should be much weaker than in 2020. Lockdowns were still highly localised, and many states decided not to shut down their factories. Economic activity is unlikely to contract by more than 10% in Q1 FY2021/2022 compared to the previous quarter (vs. a 25.9% contraction in the same period last year). Moreover, the economy should rebound gradually as of Q2 FY2021/2022, unless the country is hit by a third wave of the pandemic (only 4.2% of the population had received two doses of the vaccine at the end of June). Since mid-June, activity has rebounded slightly as health restrictions are lifted. The unemployment rate peaked at 13% in early June, compared to more than 23% at the height of the crisis in April 2020, and dropped back to 9.2% at the end of June. Similarly, household confidence indexes have begun to pick up slightly, especially those for rural households. According to the India Meteorological Department, the monsoon should be favourable this year, boosting the recovery in rural areas.

Yet a sharp rise in inflationary pressures could strain the recovery. In May, prices rose 6.3% year-on-year (y/y), reflecting a sharp increase in food and energy prices, and to a lesser extent, the constraints on supply chains and the rise in consumer goods in general. Excluding energy and food items, prices rose 7.2% y/y in May, the biggest increase since 2014. At the monetary policy committee meeting in June, the central bank held its key rates at 4%, and reiterated that it would continue to pursue an accommodating monetary policy as long as the recovery had not been confirmed, even though inflation had surpassed its target rate of 4%, plus or minus 2 percentage points. Consequently, India's central bank is likely to maintain its key policy rates unchanged through the end of the year.

For full fiscal year 2021/2022, economists revised downwards the consensus growth forecast by more than 2 percentage points to a range of between 8% and 10%, from 11% and 12%, previously. The World Bank is forecasting GDP growth of 8.3% this year and 7.5% in FY2022/2023.

SOCIAL RISKS ARE ON THE RISE

According to the Centre for Monitoring Indian Economy (CMIE), since the beginning of the Covid-19 pandemic in March 2020, 97% of households have reported a decline in purchasing power due to job losses, a situation that was accentuated by rising consumer prices. In 2020, according to the Pew Research Center, an estimated 75 million Indians dropped below the poverty line (defined as revenue of less than USD 2 a day). This brings the total to 134 million people, whereas it took 20 years to lift 248 million people out of poverty according to the World Bank. At the same time, the number of people living off daily revenue of between USD 2 and USD 10 increased to a total of 1.13 billion at year-end 2020.

The CMIE estimates that the second wave has already resulted in 25.3 million job losses at the end of May 2021 (including 15 million job losses in the month of May alone), mainly day workers who do not

FORECASTS

	2019	2020	2021e	2022e
Real GDP growth(1) (%)	4.2	-7.2	8.4	9.4
Inflation (1) (CPI, year average, %)	4.8	6.1	5.0	5.0
General Gov. Balance(1) / GDP (%)	-7.3	-14.8	-11.0	-9.5
General Gov. Debt(1)/ GDP (%)	72.2	89.8	90.0	91.5
Current account balance(1) / GDP (%)	-0.9	0.9	-0.6	-1.7
External debt(1)/ GDP (%)	19.9	21.6	21.0	20.5
Forex reserves (USD bn)	457	542	590	620
Forex reserves, in months of imports	7.7	11.0	9.1	9.2

(1): Fiscal year from April 1st of year n to March 31st of year n+1

TABLE 1

e: ESTIMATES & FORECASTS

SOURCE: BNP PARIBAS GROUP ECONOMIC RESEARCH

ECONOMIC INDICATORS

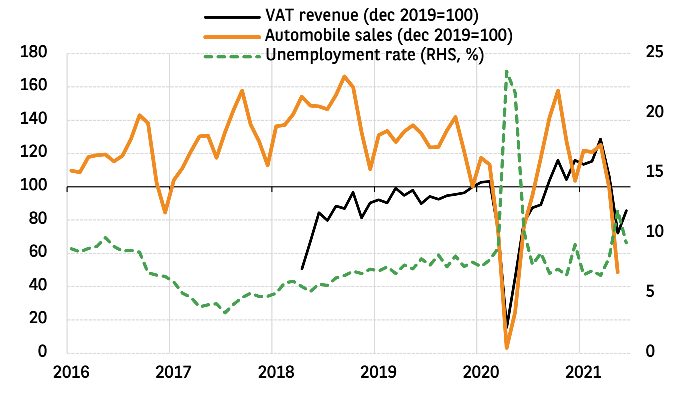

CHART 1

SOURCE: RBI, CMIE

benefit from any social protections. Yet unlike "regular" workers, those employed in the informal sector will find work more rapidly once the lockdown measures are lifted.

GREATER PRESSURES ON PUBLIC FINANCES

Already fragile before the Covid-19 crisis, India's public finances have deteriorated significantly in fiscal year 2020/2021 as public spending has increased sharply. The government deficit rose to 9.2% of GDP and debt (excluding the states' debt) swelled by more than 9 percentage points to 55.4% of GDP in the first three quarters of fiscal year 2020/2021. It is estimated that the deficit and debt of all public administrations could reach 14% of GDP and more than 87% of GDP in fiscal year 2020/2021.

In the FY2021/2022 budget bill presented in February 2021, the government decided to stimulate the recovery at the risk of further deteriorating public finances. It was forecasting a deficit of 6.8% of GDP, up from an average of 3.8% of GDP in the five years preceding the Covid-19 crisis. Although this is more than 2 percentage points lower than in fiscal year 2020/2021, the budget called for much higher spending (15.6% of GDP) than during the pre-Covid period. The government's outlook called for a primary deficit of 3.1% of GDP, which is also much higher than pre-crisis levels (0.7% of GDP on average in the five previous years).

With the second wave of the pandemic, there were increasing calls for a much vaster fiscal support package, even though fiscal revenues plummeted in April 2021 after new lockdown measures were implemented and the economy contracted. Yet the government has very little manoeuvring room. India's sovereign rating already has a negative outlook and the rating agencies could downgrade India to "non-investment grade" if the debt/GDP ratio were to deteriorate any further. According to our projections, the debt-to-GDP ratio would not be stabilised if growth were to fall below 9%.

SOLID EXTERNAL ACCOUNTS

There was a strong consolidation of India's external accounts in 2020. Despite an unfavourable domestic and international environment, India is still attractive for foreign investment.

In calendar year 2020, the current account balance showed an unprecedented surplus of 1.3% of GDP. This consolidation is mainly due to a nearly 2-point decline in the trade deficit. Imports contracted sharply due to declining domestic demand, which more than sufficed to offset the decline in exports.

At the same time, foreign direct investment (FDI) flows swelled by more than 27% to 2.5% of GDP (vs. an average of 1.8% of GDP over the five previous years). According to UNCTAD, India was the fifth largest recipient of FDI in 2020. FDI inflows were mainly driven by mergers and acquisitions, and concentrated primarily in information & communications technology, healthcare, infrastructure and energy.

Although portfolio investment declined compared to 2019, notably due to major capital outflows in Q1 2020, investment nonetheless accelerated rapidly in Q3 and Q4 2020. In full-year 2020, the net surplus came to 0.6% of GDP.

BALANCE OF PAYMENTS

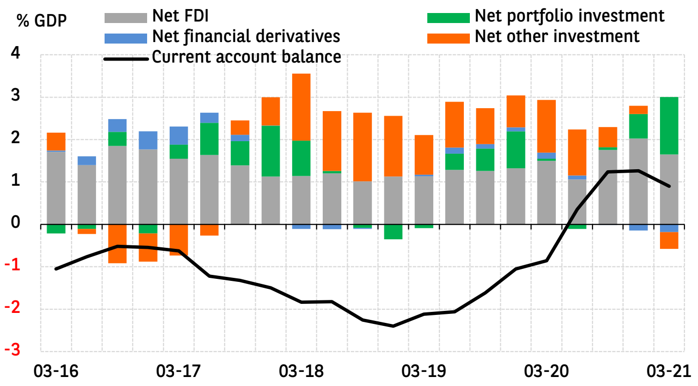

CHART 2

SOURCE: RBI

All in all, the balance of payments (excluding variations in foreign reserves) showed a surplus of 3.9% of GDP in 2020 (vs 2% in 2019).

In the first five months of the calendar year, the trade deficit rose significantly compared to the same period last year, although this seems to reflect a normalisation of the situation more than a real deterioration. Moreover, foreign direct investment remained solid (in the first four months). In contrast, portfolio investment showed a deficit in April similar in size to the one reported the previous year (once again due to the pandemic's spread and the economic contraction), which put downside pressure on the rupee.

Even so, India's external position is still solid. Foreign reserves peaked at USD 564 bn in mid-June 2021, the equivalent of 10.6 months of imports, and cover 1.8 times the country's short-term financing needs. External debt is still holding below the threshold of 22% of GDP.

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PHILIPPINES

CONSTRAINED RECOVERY

The health crisis is barely improving in the Philippines. After a particularly severe second wave, the number of new Covid-19 cases seems to have levelled off, albeit at a high level. Yet the full vaccination rate is very low, which means that the tight health restrictions which must be kept in place are weighing on domestic demand and the tourism sector. After contracting by more than 9% in 2020, GDP should rebound moderately in 2021. Even so, the country still has high growth potential thanks to the reforms undertaken over the past decade, which are paying off.

A SEVERE RECESSION IN 2020

The Philippines was one of the region's economies that the Covid-19 crisis hit hardest. The introduction of very strict health measures as of mid-March 2020 triggered an abrupt drop-off in business that heavily constrained domestic demand. Investment contracted by 27% and private consumption fell by 8% in 2020. At the same time, tourism revenues (which accounted for nearly 13% of GDP in 2019) plunged by about 80%.

All in all, despite the authorities' massive support (the central bank and the government implemented measures accounting for more than 14% of GDP), real GDP contracted by 9.3%. In comparison, GDP contracted by 3.4% on average in the ASEAN-5 countries.

THE HEALTH SITUATION IS PROVING HARD TO STABILISE

Growth is expected to rebound in 2021-2022, lifted primarily by the upturn in global demand, ongoing public policy support, and a huge base effect, although downside risks are still very strong.

A sharp rise in the number of Covid-19 cases since mid-March has cut short the economic recovery observed since the end of Q3 2020. After levelling off at 1,500 cases in mid-November, the number of new daily cases rose very rapidly, to nearly 10,000 new cases in early April 2021, which is significantly higher than the 4,500 new cases reported during the first peak in August 2020. After being gradually lifted, health restrictions had to be imposed again nationwide in mid-March. Measures were especially strict in the Manila metropolitan area, home of the nation's capital, which accounts for more than 70% of GDP. Moreover, the country's hospitals and intensive care units have extremely limited capacity.

GDP contracted again in Q1, down 12% quarter-on-quarter (q/q), after Q4 growth of 16% q/q, the only quarter of positive growth in 2020. The rebound in exports of goods and robust public demand (additional measures were announced in March 2021) failed to offset another decline in domestic demand.

The outlook for the rest of 2021 is mixed. On the one hand, the number of new daily cases has declined since mid-June, but remains relatively high (less than 5,500 new cases in early July). On the other, the vaccination rate is still low (only 2.6% of the population had received two doses of the vaccine at 5 July) because the government has encountered numerous supply problems. That said, the vaccination campaign should accelerate during H2 thanks to a large number of doses received via Covax. The government is aiming to vaccinate 65% of the population by 31 December 2021.

Consequently, it could take a long time to absorb the imbalance between the number of new cases and the vaccination rate, which means that health restrictions may have to be extended. This would have a lasting negative impact on domestic demand and the tourism sector.

FORECASTS

	2019	2020	2021e	2022e
Real GDP growth (%)	5.9	-9.3	5.1	6.8
Inflation (CPI, year average, %)	2.5	2.6	3.8	2.5
Government balance / GDP (%)	-3.5	-7.5	-6.0	-4.5
National government debt / GDP (%)	39.5	54.5	55.1	55.0
Current account balance / GDP (%)	-0.8	3.6	1.9	1.0
External debt / GDP (%)	87.8	109.8	104.4	103.5
Forex reserves (USD bn)	87.8	110.1	112.1	114.1
Forex reserves, in months of imports	6.9	10.1	11.1	9.8

TABLE 1 e: ESTIMATES & FORECASTS
SOURCE: BNP PARIBAS GROUP ECONOMIC RESEARCH

FULL VACCINATION RATES IN THE ASEAN COUNTRIES

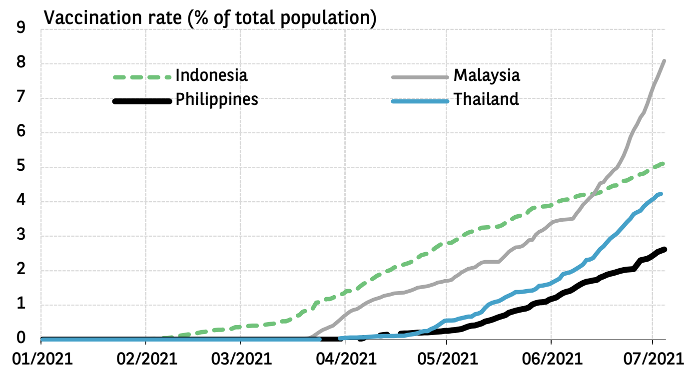

CHART 1 SOURCE: OUR WORLD IN DATA

SOLID MACROECONOMIC FUNDAMENTALS

Even so, despite the size of the shock and the prospects of a timid recovery in the short term, the country still has solid macroeconomic fundamentals.

External vulnerability remained very low in 2020 and could diminish even further: the peso has strengthened against the dollar, foreign reserves are rising, the current account balance has been positive (3.6% of GDP) for the first time since 2015. The downturn in imports and relatively resilient remittances from migrant workers have largely offset the decline in exports. The current account surplus is expected to shrink in the quarters ahead as imports pick up, in keeping with the rebound in economic growth. Ultimately, however, the economy's competitiveness should further strengthen exports (notably in the services sector).

After declining in 2019-2020, foreign direct investment (FDI) should rise again, bolstered by new government measures. According to the OECD, despite regular reforms since 2016, the Philippines still had one of the most restrictive frameworks for FDI of the ASEAN countries in 2019 (concerning the authorised thresholds for foreign stakes, filtering/authorisation mechanisms, restrictions on hiring non-residents for key positions, and other operating restrictions). This observation applies to virtually all sectors, including infrastructure projects that are being promoted by the government (such as maritime transport, road transport, and landline/mobile telecommunications).

The Corporate Recovery and Tax Incentives for Enterprises (CREATE) bill, passed in March 2021, should help improve the business climate and facilitate private investment projects with both resident and non-resident investors. Among its incentives, the bill proposes to reduce the corporate tax rate, which is currently one of the highest in the ASEAN countries, from 30% to 25%, and to make the tax cut retroactive to July 2020. Foreign companies would then benefit from a 1-point tax cut annually until the rate comes to 20% in 2027. Meanwhile, local small and mid-sized enterprises (SME) would benefit immediately from a tax rate of only 20%. Several other draft bills are also being discussed.

Similarly, the corporate tax reforms launched over the past decade have paid off. In early 2020, the government had sufficient fiscal manoeuvring room to provide massive support to the economy and the health system.

The public deficit rose significantly in 2020, to 7.5% of GDP from 3.5% in 2019, and will remain high in 2021-2022. Nonetheless, it should narrow gradually with the halting of support measures and the rebound in the economy. New measures to improve tax collection were also set up in 2020. They aim to offset the short-term increase in spending due to the Covid-19 crisis, and the medium-term shortfall in fiscal revenues due to the corporate tax cuts introduced by the CREATE bill. Fiscal consolidation could take time, however, and the presidential election scheduled for 2022 introduces some uncertainty concerning the economic policy that will be pursued by the next government.

The public debt rose to nearly 55% of GDP in 2020, from less than 40% in 2019, and it is expected to swell further in 2021-2022. The year 2020 "erased" more than 10 years of fiscal consolidation (public debt was 52% of GDP in 2009), but the debt profile is much more favourable today (longer maturities, a large share of the debt issued in the local market, and a sharp decline in the share of foreign currency debt). To help the government cover its financing needs, the central bank also announced that it would maintain the securities purchasing programme introduced in early 2020 at least through the end of 2021.

Lastly, the country still has very high growth potential, estimated at 6.5% a year, and this potential has not eroded despite the amplitude of the shock. With a diversified economy, a young population and ongoing reform efforts in 2020, productivity will get a boost in the medium to long term. Moreover, the unemployment rate has declined continuously from 2005 to year-end 2019, signalling a stronger labour market, even though the working age population is still growing.

Completed on 5 July 2021

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FOREIGN DIRECT INVESTMENT INFLOWS

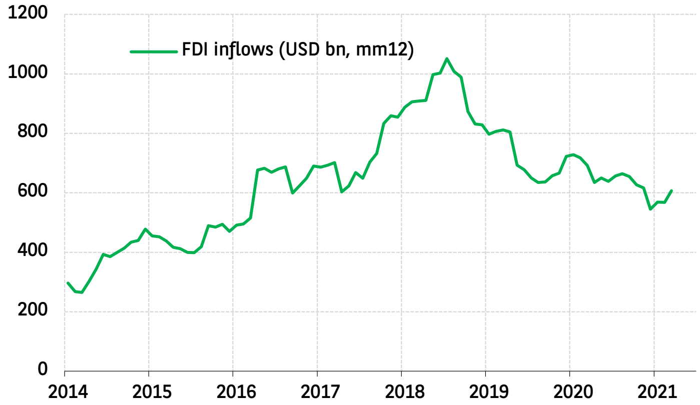

CHART 2

SOURCE: CENTRAL BANK

RUSSIA

RISKS UNDER CONTROL DESPITE THE LATEST COVID WAVE

After a modest contraction in 2020, the Russian economy has registered a solid growth rebound since March 2021 driven by the strength of domestic demand and exports. The third wave of the epidemic seen since June, alongside strong inflationary pressure and the resulting tightening of monetary policy, could, however, hold back the recovery. This said, the threats to the economy remain under control. Public finances have been boosted by a sharp rise in global oil prices and the debt refinancing risk is limited despite the latest US sanctions. Lastly, foreign exchange reserves cover the totality of external debt.

MARKED ECONOMIC RECOVERY SINCE MARCH

In 2020, despite particularly unfavourable circumstances (falling commodity prices and lower oil production under OPEC+ agreements), the economy contracted by only 3%. However, the recovery has been more gradual than in several other emerging economies. In the first quarter of 2021, real GDP had still not returned to its end-2019 level.

Since March, economic growth has accelerated significantly, driven by the strength of exports, substantial government expenditures and increased business and consumer confidence. In May, due mainly to the basis of comparison, growth hit 10.9% y/y according to the Ministry of Economic Development and indicators of economic activity in May are very encouraging. Household consumption has remained solid, helped by a drop in the unemployment rate (to 4.9% in May), even though this is still slightly higher than before the crisis. Meanwhile, corporate profits have continued to rise, particularly in the manufacturing and mining sectors, but also in wholesale and retail. Business failures have dropped to a level not seen since 2015. However, capacity utilisation rates remain modest (60% over the first five months of 2021, compared to 64% before the Covid-19 crisis).

At the June meeting of its monetary policy council, the Central Bank of Russia (CBR) estimated that the Russian economy could regain its pre-Covid level as from the second quarter of 2021.

Nevertheless, two threats remain in the second part of 2021: a third wave of the pandemic and a sharp rise in inflationary pressures.

Since the beginning of June, the number of new Covid-19 cases has risen sharply. At the end of June, restrictions due to the health situation remained modest. The government has not introduced a national lockdown, but restrictions at regional level have been introduced, forbidding non-essential activities for anyone considered not to be immunised against the virus. Meanwhile, the government has put increased pressure on citizens to get vaccinated. Public sector employees and those working in personal services must be vaccinated or risk losing their job. By the end of June, less than 12% of the population had been fully vaccinated.

Inflationary pressure represents the second factor that could undermine the recovery. Inflation hit 6% y/y in May (from 5.2% at the beginning of the year). This acceleration reflects the rapid rise in the price of food (due in particular to the rise in global cereal prices) and energy, but other factors also came into play. Indeed, inflation excluding food and energy also hit 6% y/y in May. According to the CBR, price increases are due in part to accelerating domestic demand, which encouraged companies to pass higher production costs on to clients in selling prices. Consumer inflation expectations also remain very high, albeit slightly lower in May than in April while real disposable income fell by 3.6% in Q1 2021.

FORECASTS

	2019	2020	2021e	2022e
Real GDP growth (%)	2.0	-3.0	4.0	2.5
Inflation (CPI, year average, %)	4.5	3.4	5.8	4.3
Central Gov. balance / GDP (%)	1.9	-3.9	-1.5	-0.7
Public debt / GDP (%)	13.8	19.3	18.5	18.0
Current account balance / GDP (%)	3.8	2.3	3.0	2.4
External debt / GDP (%)	28.5	31.6	31.0	28.5
Forex reserves (USD bn)	444	457	470	482
Forex reserves, in months of imports	15.1	17.6	17.5	16.5

TABLE 1 e: ESTIMATES & FORECASTS
SOURCE: BNP PARIBAS GROUP ECONOMIC RESEARCH

ECONOMIC INDICATORS

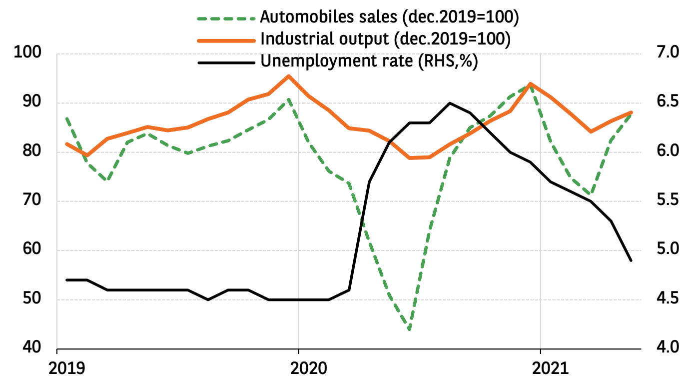

CHART 1 SOURCE: ROSSTAT

In an attempt to contain these inflationary pressures, the CBR raised its policy rates by 50bp at the latest meeting of its monetary policy committee, taking them to 5.5%, with further increases expected before the end of this year.

CONSOLIDATION OF PUBLIC FINANCES OVER THE FIRST FIVE MONTHS OF 2021

Despite being weakened somewhat by the Covid-19 crisis, the public finances remained solid in 2020. In 2021, the government plans to reduce the deficit from 3.8% of GDP to 2.3%, with debt rising slightly to 20.4%

of GDP. However, these forecasts could be revised downwards given the performance over the early part of 2021. Apart from anything else, the government's figures are based on very conservative assumptions for the oil price (USD 43.5 per barrel of Urals crude, against an average actual price of USD 61.6 between January and May 2021).

Over the first five months of the year, public finances were consolidated relative to the same period last year. This brought a very slender budget surplus despite a steep rise in public spending (up 10.3% y/y). Spending had already reached 42% of the full-year target (compared to an average of 37% over the past five years). The biggest increases have come in infrastructure spending and, to a lesser extent, debt interest payments, even though these remain extremely modest at 4.5% of revenue.

Over the same period, government revenue has increased by more than 18%, reaching nearly 50% of the full year target, due primarily to a very strong increase in revenue on oil and gas activities (28.4%) in line with the increase in global oil prices (the price of a barrel of Urals crude price denominated in rouble has increased by nearly 35% since the end of 2020) and the volumes exported. Non-oil and gas revenue also grew strongly, putting it 13.4% ahead of the same period last year.

Over the whole of 2021, the government plans to finance its deficit solely through issuing rouble-denominated debt on the domestic market. The implementation of the latest set of US sanctions, preventing US investors from buying Russian government debt on the primary market, took effect on 9 June. But this will not damage the government's ability to issue debt; issuance has remained fully subscribed by investors since this date. This said, since the announcement of these new sanctions, the share of domestic bonds held by foreign investors has fallen sharply; it stood at only 19.5% at the end of May, from 31.8% a year ago.

The government's debt refinancing risk is considered to be low. The debt profile is favourable (63% of debt is held by residents and 76% is denominated in roubles), and the National Wealth Fund will cover all of the government's financing requirements over the next two years.

EXTERNAL ACCOUNTS ALSO REMAIN STRONG

In 2020, Russia's external accounts remained solid, despite the 1.5 percentage point fall in the current account surplus (to 2.3% of GDP) and significant capital outflows from both resident and non-resident investors (net portfolio investment recorded a deficit of 1.7% of GDP over the full year). Foreign direct investment (excluding reinvestment), which was already structurally low, also dropped by nearly 68% over the year as a whole, taking it to less than 0.6% of GDP.

Faced with this pressure on external accounts, the central bank has allowed the rouble to float more freely in order to protect its foreign exchange reserves, despite the fact that it has sold currency on behalf of the finance ministry since March 2020 (in accordance with the fiscal rule of February 2017[1]). Over the full year, the rouble lost 15% against the US dollar, but foreign exchange reserves were consolidated.

Since January 2021, in line with the rise in international oil prices, the current account surplus has significantly increased, gaining 24.7% over the first five months of 2021. Meanwhile, private capital outflows, whilst smaller than in the same period last year, remained significant in the first quarter of 2021 (USD 11.8 billion), but they resulted mainly from banks' debt repayment.

INFLATION

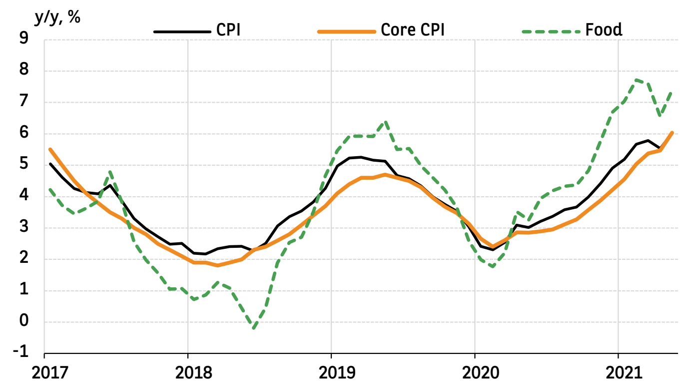

CHART 2

SOURCE: CBR

At the same time, forex purchases by the central bank resumed: they reached more than USD10 billion in the first half of 2021 (compared to net sales of USD 20 billion in 2020), thus limiting the appreciation in the rouble against the US dollar to just 2.7% over the first six months of the year.

In May 2021, foreign exchange reserves stood at USD 465 billion, covering 17 months of imports and the country's entire external debt (USD 459 billion in March 2021).

Russia remains highly exposed to the volatility in commodity prices and vulnerable to an increase in risk aversion amongst foreign investors, caused notably by the tightening of US sanctions (portfolio investment by non-residents, though lower, was still 17.3% of GDP at the end of 2020). The CBR has demonstrated its ability to manage tensions in external liquidity, but the use of the rouble as a variable of adjustment comes at the risk of creating inflationary pressures.

Completed on 5 July 2021

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1 The 2017 fiscal rule aims to reduce the sensitivity of the public finances and the rouble to the oil price. Thus when international prices exceed the price set in the budget, the finance ministry uses the excess revenue to build up the National Wealth Fund (by buying foreign currency via the central bank). Conversely, below certain price levels, the finance ministry sells liquid assets (in dollars) from the National Wealth Fund to cover its financing requirements.

POLAND

UNCHANGED POTENTIAL GROWTH

Covid-19 was only a temporary brake on Polish growth. The economy is outperforming its neighbours', with a shallower recession in 2020 and an earlier recovery. Credit risk appears to be under relatively good control, despite high levels of participation for the loan repayment moratorium scheme. Supply side constraints are even raising fears of a temporary overheating of the economy, with an increase in inflation. However, a strong current account surplus and the good control of government debt are stabilising factors. Poland's economic growth potential remains unchanged, even though the prospect of international tax harmonisation may slow down foreign investment.

IS THE ECONOMY ALREADY OVERHEATING?

The Polish economy is remarkably dynamic. Real GDP contraction in 2020 was one of the smallest in central Europe, and expected growth in 2021 and 2022 is faster than it was before Covid-19 struck. The manufacturing PMI hit fresh record levels and manufacturing production (more than 30% of GDP) has consistently been above its pre-Covid levels since October 2020.

Household consumption has proved particularly resilient, with retail sales returning to pre-crisis levels in the final quarter of 2020. A fresh wave of infections and the tightening of restrictions in March and April did result in a loss of activity. However, retail sales bounced back in May.

The Polish economy's solid performance is primarily the result of the strength of exports. The rapid acceleration in the final quarter of 2020 has continued into the beginning of 2021: exports are not only much higher than in 2020, but are also above their (pre-Covid) level of 2019. Poland is enjoying the full benefits of a powerful wave of investment in recent years (notably from FDI), which has expanded the country's export capacity.

The strength of exports has kept the current account in surplus (3.8% of GDP in 2021) despite the upturn in domestic demand. As a result, forex reserves are now at the comfortable level of nearly 6 months' imports.

The only negative point has been the marked acceleration in inflation. In May, the year-on-year increases in production prices and consumer prices hit 6.5% and 4.8% respectively, from 0.1% and 2.3% respectively in December 2020. This inflationary pressure has come in part from higher oil prices. On top of this, however, there has also been a significant rebound in capacity utilisation rates, a shortage of some inputs (labour, semiconductors, plastics, metals) and logistics issues. Corporates are facing pressure on their margins, as increases in their production costs are outpacing those in their selling prices.

In parallel, financing costs are set to rise. Inflationary pressures have also fed through into interest rates: yields on 10-year government bonds were 1.65% on 2 July, up from a low point of 1.15% at the end of January (although the July figure is still lower than the yield faced before the Covid crisis). For the time being, the Monetary Policy Committee remains divided on the opportunity to increase policy rates, with some members of the view that this rise in inflation will be transitory. However, the markets appear to be expecting a rise.

PUBLIC FINANCE: A TEMPORARY BLIP

Government debt increased by nearly 12 points of GDP in 2020, because of both the increase in the government deficit and the financing provided by public agencies.

FORECASTS

	2019	2020	2021e	2022e
Real GDP growth (%)	4.7	-2.7	5.3	5.4
Inflation (CPI, year average, %)	2.1	3.4	4.5	4.1
Gen. Gov. balance / GDP (%)	-0.7	-7.0	-4.0	-2.5
Gen. Gov. debt / GDP (%)	45.6	57.5	57.0	55.0
Current account balance / GDP (%)	0.5	3.5	3.8	3.7
External debt / GDP (%)	59.3	61.9	56.6	50.0
Forex reserves (EUR bn)	114.5	125.6	140.0	150.0
Forex reserves, in months of imports	5.1	5.9	5.9	5.7

TABLE 1 e: ESTIMATES & FORECASTS SOURCE: BNP PARIBAS GROUP ECONOMIC RESEARCH

MANUFACTURING PMI

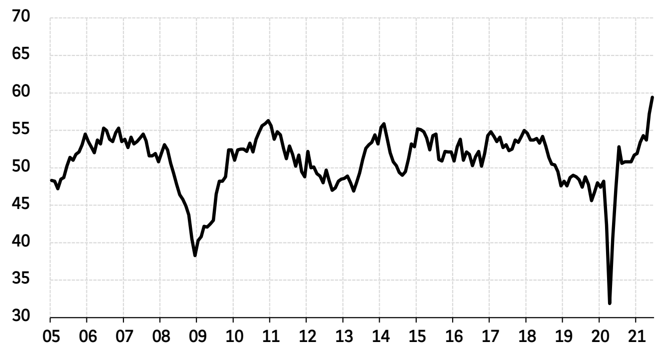

CHART 1 SOURCE: DATASTREAM

However, as the economy reopened, and with production capacity nearly fully used, the need for fiscal support has eased. It is now limited to those sectors most affected by social distancing measures. The fiscal cost of support measures should be limited to 1.7% of GDP in 2021, from nearly 4.5% of GDP in 2020.

Many measures were also financed by the country's development fund and the public development bank, BGK. These did not affect the budget balance but did contribute to the rise in government debt.

The financing of the deficit and extra-budgetary support measures was significantly helped by the purchasing of government (and governmentguaranteed) securities by the central bank. The bank now holds nearly PLN 143 bn (6.2% of GDP) of public debt on its balance sheet, equivalent to nearly half of the public debt issued since the onset of the pandemic.

Poland is likely to be one of the main beneficiaries of European recovery efforts. The country could receive nearly EUR 15 billion per year in subsidies over the first two years of the European Union's new multi-year budget (2021-2027), with loans on top of this if Poland uses this option. The time needed for negotiations before the implementation of the European recovery plan (coming on top of structural funds) is likely to delay the effective payment. A slight delay in payment will delay support to growth. Thus, the effect is likely to be stronger in 2022 than in 2021, providing a new driver to growth, as the current cyclical momentum will probably have been running out of steam by next year.

CREDIT RISK RELATIVELY WELL MANAGED

The authorities introduced a moratorium on repayments of loans to households and corporates, running initially until September 2020, and then limited just to corporates (and significantly less widely used) in the first half of 2021.

At the end of March 2021, 0.8% of loans were still covered by a running moratorium. However, 13.5% of loans (in value) had also benefited from a moratorium that has now expired. The non-performing loan rate on these was 4.6%, more or less in line with the European average. This figure is slightly higher than the 3.7% ratio for all loans, which had been stable for a year, even though lending by Polish banks to the private non-financial sector had not increased (meaning that non-performing loans have not been diluted).

Provisioning for loans covered by a moratorium hit banks' profitability. Their return on equity fell from 7.9% at end-2019 to 3.6% at end-2020. The Swiss franc mortgage issue has also required more provisioning: a ruling by the European Court of Justice has opened the way for loans to be cancelled and resulted in a growing number of claims in the Polish courts. Although the Supreme Court has yet to rule on the case, local banks began to write provisions at around 30% of their net income in 2020.

Against this background, the Polish banking system remains well capitalised, with an increase in its capital adequacy ratio to 17.8% by end-2020. The sector's exposure to real estate business (20% of total loans to the corporate sector) generated a limited non-performing loan rate of 3.2%.

ECONOMIC GROWTH PROSPECTS ARE UNAFFECTED

As has been the case everywhere, the Covid-19 pandemic brought productivity gains to a sudden stop (because of periods of under-activity linked to – admittedly sporadic – lockdown restrictions). But nothing suggests that the economy's growth potential has been lastingly damaged. Unemployment is now falling (6.1% in May, from 6.5% at its peak in February) although there is still unused capacity in the labour market. Moreover, Poland has continued to benefit, throughout 2020 and into the early months of 2021, from strong foreign direct investment, a source of both expansion in production capacity and productivity gains.

FDI INFLOWS (EUR BN, 12-MONTHS SUM)

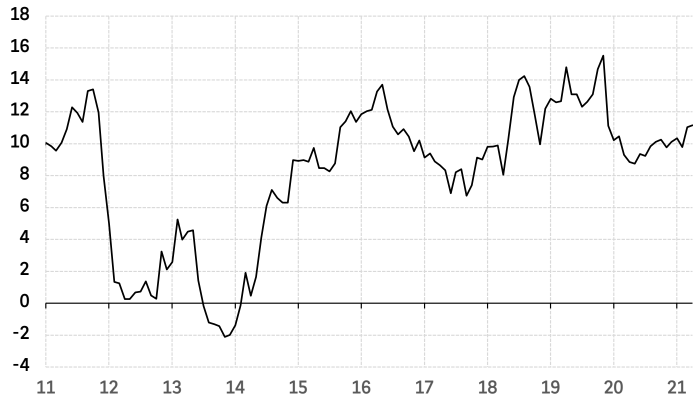

CHART 2

SOURCE: CEIC

The tax level, which is a pulling factor in Poland's attractiveness, may eventually vanish: the 2018 introduction of special economic areas has resulted in tax rates well below the 15% minimum rate now being discussed at an international level. The country has used this tax approach to attract new investors in the automotive industry and in business services mainly. This attractiveness remained strong throughout the pandemic. Similarly, Poland has one of the lowest tax rates on digital services (1.5%) amongst European nations, but such taxes are likely to be harmonised across the EU by 2023.

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ROMANIA

VIBRANT GROWTH

The Romanian economy is in the midst of a spectacular rebound. Real GDP has already returned to pre-Covid levels, and growth should reach 8.2% in 2021. But this performance has been accompanied by high fiscal and external deficits. Consequently, contrary to the other Central European countries, public debt is unlikely to narrow by 2022. Private-sector borrowers benefited from a moratorium on debt payments, but debt formerly under moratorium now presents a non-performing loan ratio of 10.9%. Nonetheless, the banking system should be able to absorb these losses. However, one factor worth monitoring is the rapid growth in housing loans.

GDP HAS ALREADY RETURNED TO PRE-COVID LEVELS

In Q1 2021, Romanian GDP returned to pre-pandemic levels, the first of the Central European countries to do so. Household consumption is the main growth engine: in April 2021, retail sales were 3.4% higher than pre-Covid levels.

Exports are also contributing increasingly to this dynamic momentum. In March-April 2021, exports were already 10% higher than the 2019 level, and they were the main driver of the key increase in manufacturing production in April, up 6.2% for the month.

Romania should continue to benefit from vibrant economic growth, thanks especially to the easing of health restrictions following two waves of the pandemic in Q4 2020 and Q1 2021, and to a buoyant international environment.

Inflation rose to a rapid 3.7% in May 2021, back to the pre-Covid level. The main cause of inflation is a base effect: the prices on some goods declined during the pandemic and are gradually returning to pre-crisis levels. This is notably the case with oil prices. The central bank has already communicated about a future monetary tightening, but with inflation slightly lower than in its neighbouring countries and an unemployment rate that is still higher than pre-crisis levels (5.7% in April 2021, vs 3.8% in early 2020), it can still bide its time a bit. Yet inflationary pressures should begin rising again by year-end 2021.

Romania's economic growth goes with imbalances. The country's twin deficits – fiscal and external – have both widened since 2017. The pandemic worsened the fiscal deficit while the current account deficit levelled off with the decline in imports. As economic growth returns to normal (and oil prices rise), the current account deficit is likely to widen again, to a projected 6.5% of GDP in 2021.

LESS FISCAL LEEWAY

The public deficit swelled before the Covid-19 crisis and the European authorities were about to launch an excessive deficit procedure. After a series of pension increases (+14% in September 2020 after +15% in 2019), the public deficit risks holding above the threshold of 3% of GDP, even after all the long-term fiscal consequences of Covid have been absorbed. Yet the 3% rule for the fiscal deficit was suspended after the pandemic broke out, and is unlikely to be reinstated for several years to come.

In January 2021, the constitutional court allowed the government to cancel an additional 40% increase in retirement pensions, which should help limit the deterioration of the fiscal deficit.

Even so, public debt is expected to continue swelling through the end of 2022, even though nominal GDP growth is strong. Fiscal consolidation is likely to be slower than for the other countries of Central Europe.

FORECASTS

	2019	2020	2021e	2022e
Real GDP growth (%)	4.1	-3.6	8.2	4.7
Inflation (CPI, year end, %)	3.8	2.6	3.5	3.5
Gen. Gov. balance / GDP (%)	-4.3	-9.2	-6.5	-4.5
Gen. Gov. debt / GDP (%)	35.3	47.3	49.0	50.0
Current account balance / GDP (%)	-4.6	-5.2	-6.5	-6.7
External debt / GDP (%)	49.2	57.7	55.3	53.3
Forex reserves (USD bn)	37.5	42.5	43.5	42.5
Forex reserves, in months of imports	4.5	5.6	4.9	4.4

TABLE 1

e: ESTIMATES & FORECASTS
SOURCE: BNP PARIBAS GROUP ECONOMIC RESEARCH

MANUFACTURING PRODUCTION

CHART 1

SOURCE: CEIC

Numerous support measures introduced in 2020 were renewed in 2021, including deferred tax payments. State-backed loans also amounted to 4% of GDP, and essentially cover loans maturing between 2023 and 2025.

The interest charge is also expected to rise (4.8% of fiscal revenue; 1.1% of GDP in 2019). In addition to a rising debt, the government must deal with the structurally higher cost of debt as well. Ten-year yields on RON government bonds rose to 3.4% at 1 July 2021, 60 basis points higher than in February. Moreover, they could rise even higher due to expectations of monetary tightening in response to accelerating inflation. The interest charge should rise to 2% of GDP by 2025. Higher financing costs in the local currency have encouraged the government to use the Eurobond market, which increases the share of public debt in foreign currencies (nearly 50%).

There is also a risk of fiscal slippage. The coalition government formed after the December 2020 elections confirmed the domination of the National Liberal Party (PNL), with Florin Citu as Prime Minister. Fiscal consolidation is still a future goal. Yet the previous government, which was also dominated by the PNL, failed to prevent Parliament from approving a substantial increase in pensions (the 40% increase mentioned above, which was later cancelled after a constitutional court decision). The fragility of the coalition implies upside risks for the public deficit and debt in the future.

In terms of financing, the central bank's support was limited, because its securities purchases (0.4% of GDP) aimed simply to smooth liquidity in the secondary market and not to finance the public debt. Implementation of the 2021-27 European budget and the European recovery plan should provide a bigger financial windfall, with potential cumulative disbursements of EUR 8 bn a year via subsidies in 2021 and 2022. This is the equivalent of nearly half of the projected fiscal deficit in both years.

CREDIT RISK: MANAGEABLE FOR THE MOMENT, BUT SEVERAL POINTS ARE WORTH MONITORING

The government granted the non-financial private sector a moratorium on debt payments. Applications were initially covered through the end of 2020, but the deadline was later extended to 31 March 2021 (with a maximum grace period of 9 months).

After peaking at 6% in June 2020, the share of loans still under the moratorium is very small. Few borrowers used the window opened by the waiver, and virtually all of the loans covered by the moratorium are now payable again. The non-performing loan ratio for these loans was 10.9% at the end of March 2021, compared to an average of 4.5% for the European Union. At the same date, however, the non-performing loan ratio for all Romanian bank loans outstanding held steady at 3.9%: the credit risk on loans subjected to the moratorium was offset by the natural increase in lending (+10% in May 2021). Moreover, provisions cover 61% of the non-performing loans that arose following the moratorium, one of the highest provisioning ratio in Europe.

The profitability of Romanian banks picked up strongly with a return on equity (ROE) of 17.1% in March 2021. The banks are benefiting from the elimination of the bank tax (although it was eliminated in January 2020, it was still payable in 2020 on net financial assets reported for 2019). Profitability has almost returned to the level that prevailed before the tax was introduced. The capital adequacy ratio rose to nearly 22% in March 2021. Consequently, Romanian banks seem to be well positioned to absorb any losses following the moratorium.

SOVEREIGN BOND RATE 10-YEAR (%)

CHART 2

SOURCE: DATASTREAM

The risks generated by the natural growth of lending, in contrast, could evolve differently. A major part of this lending is generated by housing loans for households. Over the past ten years, they have increased by nearly 12% a year on average, and are expected to rise further in 2021, by nearly 18%. In 2019, the household debt to income ratio was limited to 24%, but this figure has probably deteriorated with the Covid-19 crisis. Moreover, the European Banking Authority reports that the exposure of the Romanian banks to real estate companies has generated more doubtful loans at the end of March 2021 (13.9%) than the European average (2.5%).

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SERBIA

FAVOURABLE PROSPECTS

The Serbian economy was only moderately affected by the consequences of the Covid-19 pandemic in 2020. Activity barely contracted, whilst the central bank maintained an adequate level of foreign-currency liquidity against a background of significant euroisation of the economy. These good performances can be linked to the economy's attractiveness for international investors, as well as to past fiscal consolidation measures, which meant that the government had more scope to support the economy last year. In the short term, the recovery is likely to be strong, in particular thanks to exports, and inflation should remain under control. Looking further ahead, the ability of the authorities to maintain the economy's competitiveness will be crucial in reducing currency risk.

A RESILIENT ECONOMIC ACTIVITY

In 2020, economic activity withstood the fallout from the pandemic quite well, and the early signs of recovery in 2021 are encouraging. Real GDP contracted by only 0.9% in 2020. This good performance can be explained by three factors: the modest drop in household consumption (-2.5%) given the limited lockdown measures, various government measures to support corporates and household income (equivalent to more than 10% of GDP), and the strength of goods exports. Meanwhile, unlike other countries in the Western Balkans, the small share of tourism in GDP limited the drop in service sector activity.

In the first quarter of 2021, dynamic growth in investment (+10% y/y) and exports (+7.9% y/y) enabled real GDP to increase by 1.7% y/y, despite the fact that household consumption (-1.9% y/y) was still dented by the fallout from the pandemic. The short-term outlook is fairly positive due to a relatively high vaccination rate and an export sector that should benefit from the economic recovery in the Eurozone. Real GDP is likely to grow by around 5% this year.

In recent years, the Serbian economy has become more reactive to international economic conditions due to the growing weight of exports in GDP. Exports accounted for 52% of GDP in 2019, up from 23% in 2004, and are concentrated in the manufacturing sector. In the meantime, the role of the domestic market as an engine of growth has diminished – for both household consumption and public spending (from 13% of GDP in 2004 to 9% in 2019).

FORECASTS

	2019	2020	2021e	2022e
Real GDP growth (%)	4.2	-0.9	5.0	4.5
Inflation (CPI, year average, %)	1.9	1.5	2.5	2.5
Cent. Gov. balance / GDP (%)	-0.2	-8.1	-7.0	-2.5
Cent. Gov. debt / GDP (%)	53	57	60	59
Current account balance / GDP (%)	-6.9	-4.2	-5.3	-5.6
External debt / GDP (%)	66	71	65	62
Forex reserves (EUR bn)	13.4	13.5	15.1	15.7
Forex reserves, in months of imports	5.7	6.1	6.2	5.9

TABLE 1 e: ESTIMATES & FORECASTS
SOURCE: BNP PARIBAS GROUP ECONOMIC RESEARCH

CONTRIBUTION TO REAL GDP GROWTH

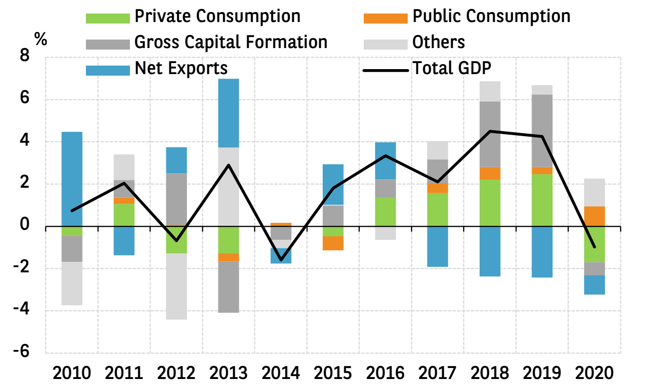

CHART 1 SOURCE: EUROPEAN COMMISSION, BNP PARIBAS

INFLATION SHOULD STAY UNDER CONTROL

In 2020, the National Bank of Serbia (NBS) adopted measures that allowed the country to avoid liquidity constraints. In addition to cutting its policy rate by 125bp to 1%, bank liquidity was boosted by an increase in currency swap transactions, repo transactions and purchases of public and private-sector securities. Even so, since March 2020, the central bank's balance sheet has only grown by the equivalent of 5% of GDP.

In the short term, the conduct of monetary policy is likely to prove more delicate. First, the health situation remains uncertain, meaning that monetary easing could continue to be necessary. Secondly, inflationary pressures have increased since the beginning of the year. The Consumer Price Index (CPI) rose by an annualised 3.6% in May 2021, compared to average inflation of 1.6% in 2020. Unsurprisingly, energy prices (and to a lesser extent food prices) were the main driver of inflation in the first half of 2021. CPI inflation is currently above the central bank's target of 3%, but remains below the 4.5% upper bound of its tolerance interval. We estimate that inflation will remain within this interval and fall back below the target rate in the second half of the year. The base effect that is driving up energy prices will gradually fade and we are not expecting a significant increase in oil prices on global markets in the second half. Overall, inflation is likely to remain moderate and reach 2.5% on average in 2021. Against this background, the central bank remains in a position to pursue an accommodating monetary policy that will help support domestic liquidity.

FISCAL CONSOLIDATION REMAINS RELEVANT

Due to the contraction in economic activity and policy stimulus measures, the government recorded a substantial deficit in 2020 (8.1% of GDP). The deficit is likely to remain high in 2021 (at an expected 7%

of GDP) given the persistence of the epidemic and the associated spending. However, public finances remain sound. As a matter of fact, when the Covid-19 crisis started last year, public accounts were in much better shape than a decade before. Fiscal consolidation efforts, helped by financial and technical support from the IMF, allowed the government to run budget surpluses in 2017 and 2018 and an almost balanced budget in 2019. The primary surplus averaged 2.5% of GDP between 2016 and 2019, compared to an average deficit of 2.9% of GDP between 2011 and 2015.

Government debt is nevertheless relatively high, at 57% of GDP in 2020, and thus represents a source of vulnerability given the high level of exposure to currency risk. Around 70% of debt is denominated in foreign currency, with 51% in euros and 12% in US dollars. The government has adopted a strategy of dinarisation of its debt in recent years. The issuance of medium-term and long-term debt (up to 20 years) in the local market is increasing – whereas the market was dominated by short-term debt securities up to 2017. The share of debt denominated in dinars has increased from 22% to 30% of the total since 2015.

A GOOD EXPORT PERFORMANCE

In 2020, Serbian exports stood up well to the economic contraction in the European Union (EU). Whilst EU imports of goods fell by 6% in volume terms, Serbian exports fell by only 3% in volume and 1.8% in value. According to the central bank, there were two explanations for this good performance. First, strong exports of agricultural products: although these represent only 7% of total exports, they grew by more than 11% in value in 2020, in part due to rising global prices. Secondly, strong FDI inflows in export-oriented sectors have supported a robust performance of exports of manufactured goods.

FOREIGN-CURRENCY LIQUIDITY PRESERVED

The ability of the central bank to limit foreign exchange volatility in periods of turbulence in international markets is particularly important for macroeconomic stability given the euroisation of a substantial part of the economy. In addition to the high portion of government debt that is denominated in foreign currency, around 60% of banks' balance sheets are also denominated in foreign currency, exposing banks to significant credit risks in the event of a major fall in the dinar.

Foreign-currency liquidity remained satisfactory in 2020, despite the slight fall in remittances from expatriate workers and in foreign direct investment. Principally thanks to the sharp reduction in repatriation of profits by international companies and the government's issue of Eurobonds, the NBS's forex reserves increased slightly (to EUR 13.5 billion by end-2020) and now cover more than six months of imports. The healthy level of forex reserves has allowed the NBS to intervene in the foreign exchange market to maintain the dinar's stability against the euro.

In the short term, the expected increase in forex reserves should allow the NBS to continue to manage exchange rate volatility. The current account deficit is likely to remain relatively high, but FDI inflows and government debt issues on international markets will cover this financing requirement. In addition, the European Central Bank has extended to March 2022 the availability of the EUR 1 billion precautionary line to help tackle any pressure on the currency.

FOREX RESERVES AND EXCHANGE RATE

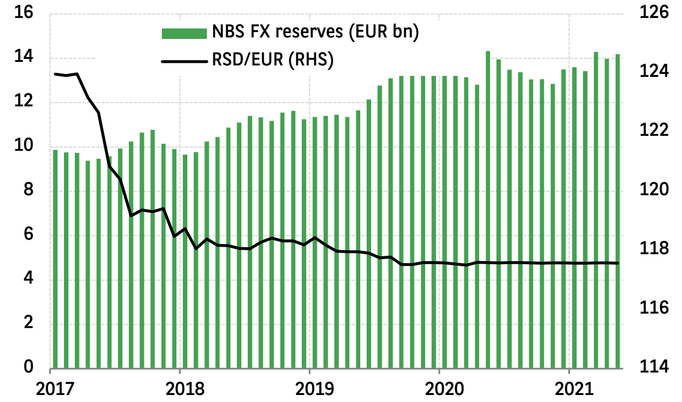

CHART 2 SOURCE: CENTRAL BANK, BNP PARIBAS

Serbia remains attractive to foreign investors. Since 2015, net FDI inflows have exceeded 6% of GDP on average. Over this period, coverage of the current account deficit by net FDI has averaged 140%. The bulk of FDI relates to the manufacturing sector (30% of the total since 2014) and, to a lesser extent, the financial sector (17%), where inflows have been driven notably by the privatisation of some state assets.

Prospects for external accounts are favourable, and the exchange rate policy adopted by the monetary authorities should continue to help to deal with international turbulence. However, some vulnerabilities remain. External debt remains high (71% of GDP in 2020) and debt servicing (interest and principal) has represented an average of 28% of exports of goods and services since 2014. With this in mind, Serbia's ability to continue to attract FDI and maintain its international competitiveness will be crucial for macroeconomic stability.

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BRAZIL

A SURPRISINGLY RESILIENT RECOVERY

The Brazilian economy has been surprisingly resilient given the challenging sanitary situation it faced in Q1. A more supportive external environment, a stronger recovery in services and a rebound in confidence, should help support the short-term outlook – especially as the epidemic slows down with improving vaccination coverage. Accelerating inflation continues to be a concern and could lead to a more vigorous tightening of monetary policy at the end of the summer. While the currency and portfolio investments stand to benefit from more aggressive rate hikes, the latter also risk slowing down the recovery and adversely affecting public finances. So far though, the sovereign has recorded better fiscal metrics than expected, which have translated into lower risk premiums.

COVID-19: A THIRD WAVE AVERTED SO FAR

Brazil which passed the somber mark of 500,000 Covid-19 deaths in June, seems to have avoided a dreaded third wave of infections so far. The country – which experienced its pandemic peak in late March/ early April, with daily death tolls exceeding 3,000 – saw some signs of resurgence in key epidemiological indicators again in early June, following the easing of restrictions in May. However, fears of a new wave have largely subsided with the acceleration of the vaccination campaign throughout June. This trend should continue in the short-term thanks in particular to vaccine deliveries scheduled for the second half of the year (with 42 million doses already expected in July.) These deliveries should help smooth out the pace of vaccinations. As of early July, 13.6% of the Brazilian population was fully vaccinated and 38% had received a first dose.

These relatively improved indicators have, however, been overshadowed in recent weeks by allegations of possible irregularities in vaccine procurement contracts. These revelations have emerged out of the Special Senate Covid Investigating Committee (CPI) – a commission of inquiry intended to shed light on the government's actions in managing the health crisis. Since the Committee's establishment, in April, the President's approval ratings have tumbled, popular protests have been on the rise while there has been a steady rise in the number of impeachment fillings with the head of the Chamber of Deputies. Against this backdrop, former President Lula continues to rise in the polls[1].

A RESILIENT ECONOMY IN THE FACE OF THE SECOND WAVE

Activity in Q1 surprised by its strength and led to significant upward revisions of growth forecasts in 2021. Despite a more virulent 2nd epidemic wave[2], the absence of a fiscal stimulus and the contraction of output in March, real GDP grew by 1.2% quarter-on-quarter (q/q) and 1% year-on-year (y/y). Private consumption held up better than expected, but it was above all the strong growth in investment (+ 4.6% q/q) and the accumulation of inventories that prevented GDP from falling over the period. In particular, commodity producers (agribusiness, mining sector, pulp and paper, beef industry) took advantage of a favourable external backdrop (high demand and prices, competitiveness of the currency) to invest.

Overall, economic activity fared well in Q2 despite a slow start to the quarter. The leading indicator of GDP produced by the Central Bank (IBC-BR) indeed posted a modest growth in April (+ 0.4%). However, in May, industrial activity recovered sharply after a notable drop in the pace of production between February and April, as a result of new restrictions in several States over the period. These signs of improvement were confirmed at the end of the quarter in survey data with a more rapid expansion of production in the manufacturing sector (manufacturing PMI at 56.4 in June vs. 53.7 in May) and a marked rebound of activity in services with the PMI index returning to expansion territory for the first time since the start of the year (services PMI at 53.9 in June against 48.3 in May, i.e. the strongest monthly progression in almost 8 years). The acceleration of inflation has so far not dampened household consumption despite a slight decline in real wages and a still relatively high level of unemployment (14.7% in April). Retail sales posted a gain for the third consecutive months in May, thanks to excessive savings

FORECASTS

	2019	2020	2021e	2022e
Real GDP growth (%)	1.4	-4.3	5.5	3.0
Inflation (CPI, year average, %)	3.7	3.2	6.5	4.0
Fiscal balance / GDP (%)	-5.8	-13.2	-7.2	-7.1
Gross public debt / GDP (%)	74	89	82	81
Current account balance / GDP (%)	-2.7	-0.9	0.7	-0.8
External debt / GDP (%)	35	42	51	47
Forex reserves (USD bn)	357	356	350	346
Forex reserves, in months of imports	17	21	19	18

e: ESTIMATES & FORECASTS

TABLE 1 SOURCE: BNP PARIBAS GROUP ECONOMIC RESEARCH

STRONG IMPROVEMENT IN TERMS OF TRADE

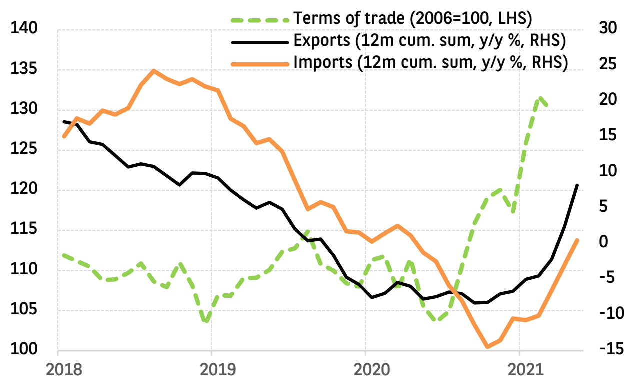

CHART 1 SOURCE: CAMEX, FUNCEX, BNP PARIBAS

1 In June, Lula's case for a possible running has been boosted after his acquittal by a federal judge in one of the corruption cases opened against him, for lack of evidence.
2 The epidemic claimed more lives in the first 4 months of 2021 than in the previous 9 months of 2020.

built up in H2 2020, emergency aid distributed since April and solid household credit growth (+ 7.8% y/y in May).

Short-term growth prospects should benefit from a still buoyant external environment and renewed optimism on behalf of businesses and households, as restrictions ease and vaccinations progress. Downside risks remain nonetheless: 1/ emergence of viral strains more resistant to vaccines 2/ drought perseverance 3/ a deterioration in the political climate 4/ a sharper acceleration of inflation. Some supportive measures have already been considered by the authorities to offset the effects of a lingering epidemic and rising prices. The government announced the extension for at least 3 months of the emergency aid package distributed to vulnerable households (from April to July initially). The authorities are also expected to increase the value of allowances under the Bolsa Familia program by some 60% by year-end. Credit lines of up to USD 50.7 bn will also be made available to farmers to stimulate agricultural output in 2021/22.

GROWING CONCERNS OVER INFLATIONARY PRESSURES

The stronger-than-expected recovery, the weakness of the real, the rise in commodity prices as well as climate-related factors are fueling persistent price pressures. In June, the IPCA consumer price index reached its highest level in nearly 5 years (+ 8.4% y/y), marking the 16th consecutive month of accelerating inflation. Since February 2020, the food component of the IPCA has increased by around 20% while the price of gasoline and cooking gas has increased by around 25%. Electricity bills have meanwhile jumped some 10% as a result of the drought which has affected the country for several months now[3].

Even if, for the moment, the transmission to core inflation remains limited (e.g. inflation in services is less than 2%), the departure of nearly 5 points of headline inflation compared to the target (3.75% +/- 1.5) suggests a faster than expected tightening of monetary policy in the second half of the year. The Central Bank (BCB) has already made three 75 basis point (bps) hikes in the SELIC rate since the start of the year and is projecting another 75 bps hike at its next meeting in August. A deterioration in inflation expectations could, however, prompt the authorities to tighten further at the end of the summer.

EASING OF SOVEREIGN RISK PREMIUMS

The fiscal balance and debt dynamics have improved despite the rate hikes in recent months as a result of 1/ stronger activity 2/ more dynamics revenues (due to the rise in inflation but thanks to significant gains on FX swaps recorded by the BCB), but also 3/ more limited expenditure (the late approval of the 2021 budget constrained spending). In May, the overall 12-month deficit stood at 9.1% of GDP (5.4% of GDP primary deficit + 3.7% of GDP interest charge), an improvement of 1.5 percentage points (pp) over a month, while gross debt meanwhile fell by 1.1pp to 84.5% of GDP, thanks in large part to higher nominal GDP growth.

The relative easing of tensions on fiscal accounts, coupled with progress over privatisations (eg. Electrobras, Cedae) as well as the presentation of the 2nd phase of the tax reform have favoured a reduction in sovereign risk premiums. Between March and early July, the 5-year CDS and EMBI + spreads fell by around 60 bps and 45 bps, respectively,

RATES: INFLATION, POLICY RATE, YIELDS ON GOVERNMENT BONDS

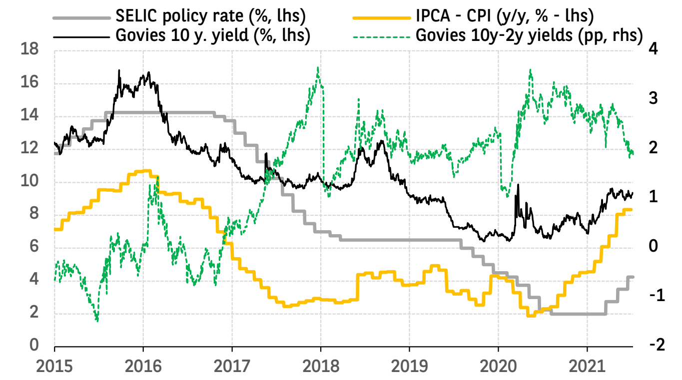

CHART 2 SOURCE: MACROBOND, BNP PARIBAS

while the spread between the 10-year and 2-year interest rates on government bonds fell by nearly 100 bps. The relative decrease in fiscal risks combined with the rise in the interest rate differential (SELIC-Fed Funds) and a weaker dollar also allowed the currency to regain some strength after its tumble in Q1 (~ 9%). The real, whose dynamics are increasingly decoupled from the commodity cycle and the country's terms of trade, reached its strongest level in a year at the end of June, falling below the 5 USD / BRL mark.

STRONGER EXTERNAL ACCOUNTS

A supportive external environment is helping to close the Brazilian current account imbalance. On a 12-month rolling basis, the current account deficit reached in May its lowest level in more than 13 years (USD 8.4 bn, 0.6% of GDP). This trend is expected to continue in the short term, as the country benefits from large trade surpluses, which since the start of the year, have been marked by a sharp acceleration of commodity exports, in particular iron ore and oil, but also meat. Unsurprisingly the price effect in exports data (+ 44% y/y in June) dominates the volume effect (+ 11% y/y in June). On the financial account, foreign direct investment (FDI) flows, which had fallen by around 50% in 2020 to stand at USD 34.2 bn (a 25-year low), have been relatively subdued over the first half of the year in part because repayments of inter-company loans have been higher than new disbursements. FDI should total around USD 50 bn in 2021 but are not expected to durably return to pre-crisis levels (USD 72 bn over the period 2015-2019) until at least 2023. On the other hand, portfolio investments have remained robust. Net flows from non-residents have been positive since August 2020 (with the exception of March) reaching USD 42 bn in May over 12 months – the highest level since 2015. Positive portfolio flows should be supported in the coming quarters by the rise in interest rates and the more broad-based recovery in economic activity. It is also worth noting that corporates – who a little over a year and half ago had bought dollars to deleverage abroad – are once again looking for external funding.

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3 Electricity in Brazil is produced mainly using hydroelectric plants. If water reservoirs reach low levels due to a lack of rain, as has been the case for the past few months, other, more expensive sources of energy must then be activated.

CHILE

NEW CHALLENGES

The economy should rebound strongly in 2021 thanks to a successful vaccination campaign, improved prospects for global growth and higher copper prices. According to the monthly economic index, in early Q2, real GDP returned to the pre-pandemic level of December 2019. Looking beyond 2021, economic growth prospects could be marred by persistent political tensions plaguing the country. Debates over the presidential election on the one hand and the process of drawing up a new constitution on the other will probably disrupt the implementation of economic policy as well as private sector investment decisions by both resident and non-resident investors.

ECONOMIC GROWTH REBOUNDS IN 2021

After plunging 5.8% in 2020, real GDP is expected to grow by 7% in 2021. The rebound in GDP observed in H2 2020 extended into H1 2021, driven mainly by improved global growth prospects (notably for Chile's main two trading partners, the US and China) and the upturn in copper prices, fuelled by strong demand from China.

Domestic demand also continued to rise in the first months of 2021, despite a spike in new Covid-19 cases since mid-January. The infection rate and the hospital bed occupancy rate continued to rise and have reached significantly higher levels than during the first wave of the pandemic in March 2020, despite the smooth rollout of the country's vaccination campaign. Consequently, the authorities had to reintroduce relatively tight health restrictions, which strained Q1 growth. By May, however, the central bank's monthly economic index (adjusted for seasonal variations) had virtually returned to the pre-pandemic level of December 2019, and the employment rate had bounced back to 51%, after plummeting to 45% in July 2020 (compared to a long-term average of about 58%).

Short-term prospects are rather favourable. From a health perspective, although the crisis is still going strong, the number of new Covid-19 cases, the infection rate and the hospital bed occupancy rate have declined continuously since mid-June. At the same time, the vaccination campaign continues to be a success. At the end of June, the government had beat its January targets: more than 85% of the over-50 age group and 53% of the 18-50 age group had received two doses of the vaccine. At the same date, 74% of the 18-50 age group had received at least one dose of the vaccine, and the vaccination campaign for 12-17 years old is slated to begin in July. Under this environment, and depending on the evolution of the pandemic in its neighbouring countries, the health restrictions should be gradually lifted over the course of the third quarter.

THE AUTHORITIES PROVIDE MASSIVE SUPPORT

The government and the central bank will continue to provide massive economic support, like they did in early 2020. The government's recovery plan, a multi-year programme launched in March 2020, was rounded out by new measures announced in March 2021 to offset the negative impact of reintroducing health restrictions on domestic demand. Amounting to a cumulative total of 13% of GDP, these measures aim to increase healthcare spending, subsidies for low-income households, and unemployment benefits, as well as to defer tax payments. Other measures include support for small and mid-sized enterprises (SME) via the state-owned bank Banco Estado, and a system of state-backed loans for companies and households via FOGAPE, the small business guarantee fund. A multi-year public investment plan was also launched.

FORECASTS

	2019	2020	2021e	2022e
Real GDP growth (%)	1.1	-5.8	7.5	3.0
Inflation (CPI, year average, %)	2.8	3.0	3.8	3.3
Central Gov. balance / GDP (%)	-2.8	-7.4	-4.7	-3.0
Public debt / GDP (%)	28.1	32.0	38.0	38.0
Current account balance / GDP (%)	-3.6	1.3	-1.0	-4.0
External debt / GDP (%)	70.0	81.1	72.0	72.6
Forex reserves (USD bn)	40.6	38.5	51.3	54.1
Forex reserves, in months of imports	4.8	5.5	5.3	4.8

TABLE 1

e: ESTIMATES & FORECASTS
SOURCE: BNP PARIBAS GROUP ECONOMIC RESEARCH

GDP GROWTH AND MONTHLY EMPLOYMENT INDICATORS

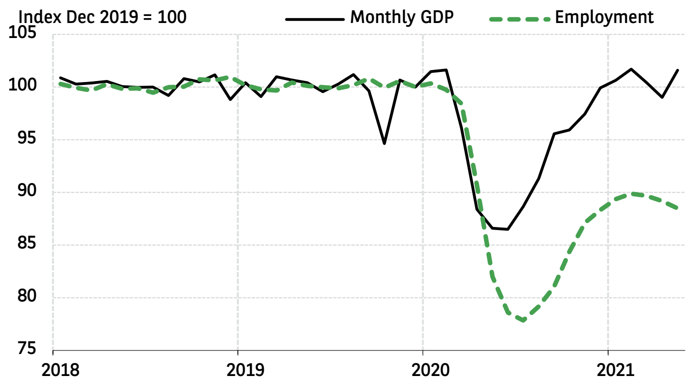

CHART 1

SOURCE: CENTRAL BANK

At the same time, the central bank cut its key policy rate by 125 basis points over a 3-month period, where it has held at the minimum rate of 0.5% since April 2020. The central bank also provided support for liquidity and lending to households and SME.

A large number of employees were also authorised to withdraw funds from their retirement savings on three occasions (in July and December 2020 and again in April 2021). According to IMF estimates, these withdrawals amounted to the equivalent of 15% of GDP in April 2021, and partially offset the loss of revenue caused by the pandemic.

Since May 2020, Chile has also benefitted from a 2-year arrangement with the IMF via a flexible credit line of USD 24 bn (roughly two thirds the amount of foreign reserves when the FCL was granted). Designed for crisis prevention and to reassure investors, the facility is reserved for countries that the IMF esteems to have "very solid" economic fundamentals. For the moment, only Chile, Colombia, Mexico, Peru and Poland have benefitted from FCLs. The IMF renewed its support in May 2021, esteeming that the country's economic fundamentals were still solid (moderate external vulnerability and a supportable, short-term deterioration in public finances triggered by its economic support plans).

In January 2021, the central bank also pledged to gradually increase the level of foreign reserves by USD 12 bn over 15 months. In May 2021, foreign reserves amounted to nearly USD 48 bn.

A PERSISTENTLY TENSE POLITICAL ENVIRONMENT

Unlike the economic situation, the political and social situation is deteriorating. The political crisis that broke out in October 2019 has not abated.

Faced with rising inequalities, unequal access to education and healthcare, and pension system reforms, rising popular discontent led to the outbreak of spontaneous protests in fall 2019. In response, the government has proposed a series of reforms and a new social pact, including the adoption of a new constitution.

After public consultations in October 2020, a large majority of Chileans confirmed that they wanted to abandon the current constitution (dating back to 1980, when Augusto Pinochet was in power). The new constitution must be drafted by a constitutional assembly comprised of newly elected members (and not current congressional members).

Elected in May 2021, the constitutional assembly is extremely divided: no one party has the number of votes necessary to pass amendments. As a result, the process of drafting a new constitution (which must be completed before year-end 2022) has been marked by the formation of numerous coalitions and endless discussions.

Moreover, independent, left and far-left parties won more seats than expected, to the detriment of the centre-right and right parties close to the government. Once again, this reflects popular aspirations for far-reaching social reforms, as well as the rejection of the government's party and the lack of confidence in the political establishment. These discussions have also mixed with debates about the elections, with presidential, congressional and regional elections scheduled for November (with the second round of the presidential election to be held in December).

This tense political climate, combined with haggling over the content of the new constitution (social rights, education, healthcare and retirement...), will have an impact on public finances, which could alarm national and foreign investors.

Moreover, investors did not really welcome the reform that enabled employees to dip into their retirement savings, in part because they run against the country's normal practices, and in part, because the withdrawals will have an impact on the medium to long-term equilibrium of the pension regimes. Although these withdrawals partially offset revenue losses in 2020, they also reduce the replacement rate for numerous employees (i.e. the percentage of earned income received by the employee when calculating pension rights). According to IMF estimates, about 25% of the contributors to pension funds withdrew all of their retirement savings during the first two rounds of withdrawals.

FOREIGN RESERVES AND THE EXCHANGE RATE

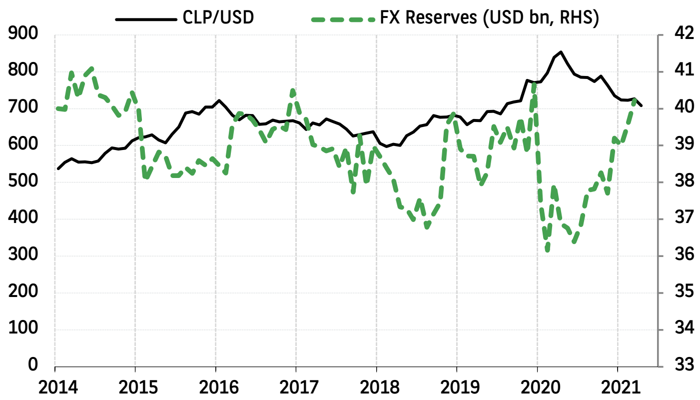

CHART 2 SOURCE: CENTRAL BANK

All in all, greater political instability and the prospects of deteriorating public finances could strain the country's investment prospects and medium-term growth outlook. Chile also suffers from structural weaknesses (dependence on commodities, decline in productivity in the mining sector). In April 2021, the IMF lowered its 5-year growth outlook to 2.5%, down from its previous forecast of 3.2% in October 2019.

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SAUDI ARABIA

A DIFFICULT ECONOMIC TRANSITION

The Saudi economy took a double hit in 2020: the consequences of the Covid-19 pandemic amplified the recessionary impact of falling oil prices and production. In addition to the economic consequences, these two exogenous shocks have had negative consequences for the reform process, and particularly for the dynamism of the private sector. The recovery expected in 2021 will be timid, due to a further slowdown in oil activity. Budget deficits are likely to persist over the medium term, resulting in an increase in government debt. Macroeconomic imbalances remain moderate, but the continued dependence on oil in the context of economic transition remains a significant source of vulnerability.

A DOUBLE SHOCK TO THE ECONOMY IN 2020

In 2020, the Saudi economy was hit by the drop in oil prices and by restrictions in response to the pandemic. Moreover, the fall in oil revenues forced the authorities to adopt fiscal measures that tended to accentuate the economic slowdown. Thus, the tripling of the VAT rate from 5% to 15% and the reduction in allowances partly offset the fall in oil revenues, but also affected household consumption, which represents 55% of GDP. Private consumption was down by 6.4% over 2020. Investment, which represents around a quarter of GDP, fell by 14% given the drop in public investment and the cyclically low level of capital expenditure in the oil industry. Lastly, export volumes dropped 11%, the biggest fall in twenty years, due to lower hydrocarbon exports. In net terms, this fall in exports was offset by the more than 25% collapse in imports as domestic demand dropped.

From a sector point of view, the quota policy established by OPEC+ producers (the OPEC members and Russia), and the overcompliance of Saudi Arabia with the quota of production, reduced oil GDP (around 40% of total GDP) by 6.7% over the course of 2020. Crude oil production was 6% lower in 2020, at 9.2 million barrels per day (mb/d) on average. Non-oil GDP contracted by 2.3%. Overall, GDP fell by 4.1%.

FORECASTS

	2019	2020	2021e	2022e
Real GDP growth (%)	0.3	-4.1	2.3	4.5
Inflation (CPI, year average, %)	-1.2	3.4	2.9	2.7
Central. Gov. balance / GDP (%)	-4.5	-11.2	-3.1	-2.5
Central. Gov. debt / GDP (%)	23	32	32	35
Current account balance / GDP (%)	4.8	-2.1	2.4	1.9
External debt / GDP (%)	23	30	30	32
Forex reserves (USD bn)	500	454	452	446
Forex reserves, in months of imports	27	30	29	28

e: ESTIMATES & FORECASTS

TABLE 1 SOURCE: BNP PARIBAS GROUP ECONOMIC RESEARCH

CONTRIBUTION TO GDP GROWTH

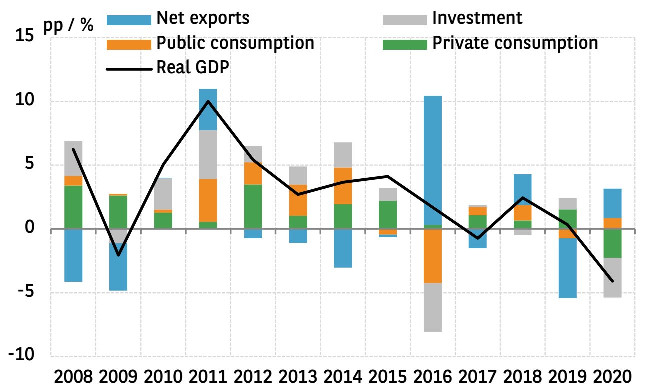

CHART 1 SOURCE: MINISTRY OF FINANCE, BNP PARIBAS

POOR CONDITIONS FOR REFORM

The double shock from oil prices and the pandemic had a particular impact on the Saudi economy given that the country is engaged in an ambitious economic development and diversification plan. This plan relies on two conditions: it needs substantial financial resources, and requires the development of the non-oil private sector in order to create jobs for Saudi nationals. The Public Investment Fund (PIF) is financing the plan, particularly its major infrastructure programmes, in the absence of significant foreign investment (since 2016, inflows of foreign direct investment have only averaged some 0.7% of GDP). A prudent recourse to borrowing, coupled with expected receipts from privatisations, should guarantee the PIF's financing for the short term at least.

As far as the second condition is concerned, the uncertainty from the pandemic has increased caution amongst economic agents. Since 2016, and the start of what has proved to be a lasting drop in oil revenues, private-sector activity has slowed down. It grew by an average of only 0.8% between 2016 and 2020, compared to 5.9% between 2011 and 2015. The ability of the private sector to record a sustained growth remains closely tied to the oil economy, with the uncertainty created by the pandemic representing an additional drag on the process.

At the same time, the medium- and long-term outlook for big oil producers has become more uncertain, given the common willingness to move towards the decarbonisation of economic activity at the global level. Against this background, the Saudi authorities have favoured a top-down approach to accelerate reforms, with substantial investment in infrastructure (new cities, transport, etc.) and a stepping up of measures to increase the Saudisation of the labour market.

A TIMID RECOVERY EXPECTED IN 2021

In Q1 2021, real GDP contracted by 3% year-on-year, due in particular to the drop in oil production. Over the full year, oil GDP is again likely to be down, probably by around 1%. Over the course of the first quarter, Saudi Arabia voluntarily cut its oil production by 1 mb/d above what was required under the OPEC+ agreement. The country's production quota increased in the second quarter and is set to rise further over the rest of the year. Crude oil production is likely to average around 9 mb/d in 2021. This scenario remains dependent on the cohesion between the members of the cartel, on global demand that is vulnerable to any resurgence in the pandemic and on the relative stability of output from producers outside the OPEC+ agreement.

When it comes to non-oil sectors, the outlook is positive, with a 4.7% growth expected in 2021, but with a high degree of uncertainty. Advanced indicators of economic activity (cement production, opening of letters of credit and withdrawals of cash) have moved in the right direction since the start of the year, but are very volatile. Household consumption grew by 1.3% y/y in Q1 2021, and is likely to benefit from a significant base effect in Q2. Daily mobility indicators moved back above their pre-pandemic levels about a month ago. Even so, current trends in the pandemic also give cause for caution. We estimate that less than 30% of the total population has been fully vaccinated. Meanwhile, a second wave of infections is now under way (the number of new daily infections is currently some 30% of the peak seen in June 2020). For the time being, most of the restrictions related to the pandemic have been lifted, but given the circumstances, a recovery in household spending remains uncertain.

The significant increase in oil prices expected this year is likely to help boost public spending, particularly investment, and feed growth in non-oil GDP. The PIF has drawn up a plan lasting until 2025, for annual investment into the Saudi economy of SR150 bn (equivalent to 5.7% of 2020 GDP). Real GDP is likely to grow by around 2.3% in 2021.

A PERSISTENT BUDGET DEFICIT

Due to the drop in oil prices and the need to support the economy (with measures equivalent to 2.7% of GDP), the government recorded a very high budget deficit of 11.2% of GDP in 2020. Revenue from taxes on goods and services (around 18% of total fiscal receipts) benefited from the increase in the VAT rate, but this was not enough to offset the fall in oil revenue (down 31% y/y) – which remains the main determinant of fiscal performance (accounting for some 60% of total receipts). The government has announced spending cuts of around 6% for 2021. The cuts in investment have been made possible by the transfer of a part of this expenditure to the PIF, but we remain cautious regarding current spending cuts against a background of rising consumer prices (with expected inflation of 2.9% in 2021) and the possible persistence of the pandemic. Even if oil prices increase significantly this year, they are likely to remain below the price that would balance the budget (the fiscal breakeven oil price). The total deficit for 2021 is projected at 3.1% of GDP.

Over the medium term, the limits on diversification of fiscal receipts and the increase in spending will probably mean that the fiscal breakeven price stays in a range from USD65 to USD70 per barrel, resulting in continued small fiscal deficits.

A MODEST INCREASE IN GOVERNMENT DEBT

Given the repeated large fiscal deficits since 2015 (averaging 10.6% of GDP), government debt has increased rapidly, but remains moderate (32% of GDP at end-2020). Currently, around 40% of the budget deficit is financed from government resources held at the central bank. These currently stand at around 18% of GDP. The remainder is financed by issuing debt on international markets (financing around 15% of the deficit) and on the domestic market. For the latter market, the government issues sukuks (debt securities that are sharia compliant) with long maturities of up to thirty years. The debt-financed share of the deficit looks set to grow, given the government's limited reserves at the central bank, low borrowing costs and the willingness to develop the domestic debt market. Under our central scenario, government debt is projected to reach 35% of GDP in 2023.

GOVERNMENT DEBT

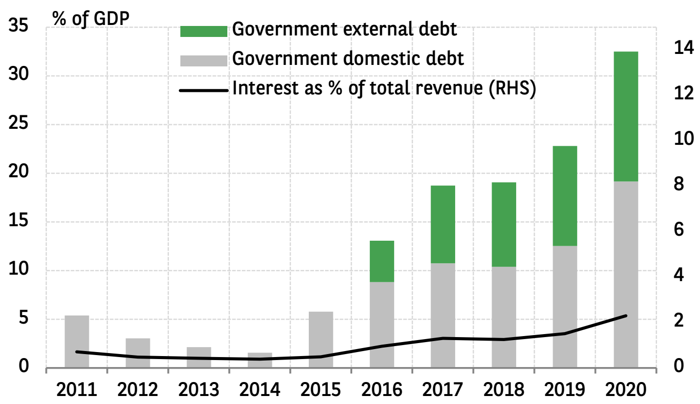

CHART 2

SOURCE: MINISTRY OF FINANCE, BNP PARIBAS

Macroeconomic risks remain moderate in the medium term, but there are some pressures on the public finances. The government's net asset position has been deteriorating slowly but steadily since 2015; the global drive to tackle climate change is weighing on prospects in the oil industry; and the introduction of economic reforms increases financing requirements and maintains the dependence on oil revenue in the short term.

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NIGERIA

STRUGGLING TO REBOUND

After declining 1.9% in 2020, Nigeria's GDP is unlikely to rebound but mildly in 2021 due to persistent and significant macroeconomic imbalances. Despite the first signs of stabilization, inflation is still very high, and several adjustments to the naira have failed to correct the dysfunctions in the foreign exchange market. Although the rebound in oil prices should help reduce somewhat the squeeze on external liquidity, it will surely take more than that to restore the confidence of investors. Without reforms and with no fiscal manoeuvring room, the economy will continue to be vulnerable to external shocks.

Nigeria did not escape recession last year, although it was smaller than expected, with GDP contracting only 1.9%. On top of restrictions to combat the pandemic, the country had to deal with massive capital outflows and plummeting oil revenues. The economy has picked up again since Q4 2020, after two quarters of contraction. Even so, its growth dynamics are fragile. GDP rose only 0.5% YoY in Q1 2021 despite a good performance in agriculture and an upturn in oil production (including condensates), which rose to 1.72 million barrels a day on average, up from 1.56 m b/d the previous quarter. Excluding agriculture and the oil sector, growth slowed to 0.3%, from 1% in Q4 2020, due to a downturn in the services sector (-0.4%) after the pandemic flared up again. GDP growth is expected to rebound, albeit mildly, starting in Q2 as the second wave of COVID-19 infections dissipates and oil prices rise. Yet with the unemployment rate now at 33% and GDP per capita (in PPP) falling back to the 2017 level, household consumption will have a hard time recovering. This is especially true given the slow pace of the vaccination campaign (only 1% of the population has received a first dose). Moreover, inflation is at a record high. Other major constraints are the persistent pressure on the currency and external liquidity, as well as the low level of fiscal leeway.

FORECASTS

	2019	2020	2021e	2022e
Real GDP growth (%)	2.3	-1.9	2.4	2.3
Inflation (CPI, year average, %)	11.5	13.2	16.8	12.4
Gen. Gov. balance / GDP (%)	-4.8	-6.1	-4.0	-4.4
Gen. Gov. debt / GDP (%)	25.0	29.4	29.6	30.8
Current account balance / GDP (%)	-3.6	-4.0	-1.8	-1.7
External debt / GDP (%)	11.5	12.7	13.2	13.6
Forex reserves (USD bn)	38.3	36.7	38.2	39.5
Forex reserves, in months of imports	4.6	6.1	5.7	5.7

e: ESTIMATES & FORECASTS

TABLE 1 SOURCE: BNP PARIBAS GROUP ECONOMIC RESEARCH

MONETARY ENVIRONMENT

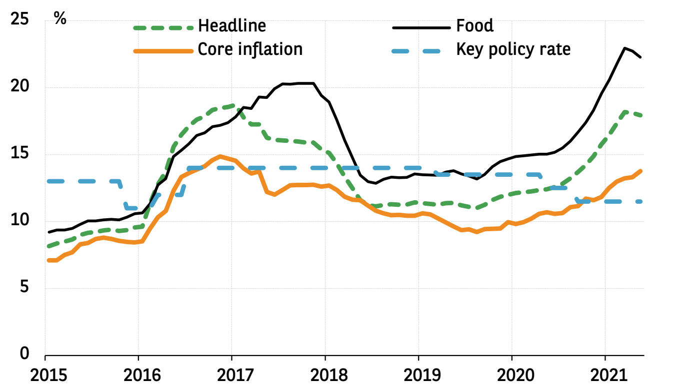

CHART 1 SOURCE: CENTRAL BANK

INFLATION AND THE EXCHANGE RATE: UNRESOLVED PROBLEMS

The monetary policy stance continues to raise numerous questions. Although inflation has risen constantly since mid-2019, the central bank decided to maintain its key rate (Chart 1). To bolster the economy at the height of the health crisis, the key rate was cut by 200 basis points to 11.5% in 2020. The sluggish pace of growth argues against a too early tightening of monetary policy. Inflation has also been showing signs of levelling off over the past two months, thanks to a slowdown in food prices (51.8% of the index). Yet headline inflation was still high at 17.9% in May, and core inflation rose again to 13.7%. Although the current shock on prices can be attributed in part to external factors that are beginning to wind down (mostly food supply constraints and the naira's devaluation), inflationary pressures are also being fed by the absence of a clear mandate for the central bank's targets and the recurrent monetisation of the fiscal deficit.

Efforts to stabilise the exchange rate are also generating major monetary distortions. Faced with the drop-off in oil exports, the authorities tried to protect forex reserves by limiting access to foreign currency and by adjusting the naira's official exchange rate on two occasions in 2020 before merging the official exchange rate with NAFEX rate (Chart 2) in May 2021. The AFEX rate is used in the majority of commercial and financial transactions. Although it is supposed to reflect an equilibrium of market forces, this rate is still controlled by the central bank. Naira is now trading at NGN 410 against the US dollar, up from NGN 306 in early 2020, a devaluation of 25%. The unification of the two exchange rates is a step forward, albeit a symbolic one, in the reform of the exchange rate regime. Yet it is still insufficient. The spread with the parallel rate continues to widen. The current premium is more than 20%, reflecting high demand for dollars fed in part by expectations of further devaluation. Another adjustment in the exchange rate seems inevitable. Adopting a more flexible exchange rate regime seems unlikely, however, despite the insistence of the IMF and the World Bank, which made it a prerequisite for unblocking a USD 1.5 bn loan. But the monetary authorities continue to oppose a move that they fear would strengthen the inflationary dynamics. This point is debatable: entire segments of the economy have already turned towards the parallel market to obtain foreign currencies. Compared to the previous oil shock, when imports of goods fell by nearly half between 2014 and 2017, the decline in imports was relatively limited in 2020 at 16%.

FRAGILE DYNAMICS OF THE EXTERNAL ACCOUNTS

The squeeze on external liquidity is expected to ease although it will not disappear. According to the central bank's preliminary estimates, the current account deficit narrowed significantly to USD 1.7 bn in Q1 2021, down from USD 5.2 bn in the previous quarter. This is essentially due to a rebound in remittances from the Nigerian diaspora (two thirds of current account non-oil revenues, even though they are still a quarter below pre-crisis level), and to travel restrictions (more than a quarter of current account spending). Moreover, the Nigerian economy has not benefited much from the rebound in oil prices so far. Exports even contracted during the quarter, down 8.6%, due to an unfavourable volume effect. Assuming India, the largest export outlet for Nigerian oil, does not slide into a protracted recession, the dynamics should improve in the months ahead, although without fully balancing the external accounts. At 1.8% of GDP in 2021, the current account deficit is expected to remain high, although that would be a big improvement over the 2020 level of 4% of GDP.

The financial horizon is also expected to clear up somewhat. The authorities are preparing to issue at least USD 3 bn in the international financial markets. With external government debt amounting to only 8% of GDP, and with the considerable easing of financing conditions in recent months, the bond issue should be well received. Moreover, with the IMF's general allocation of special drawing rights (SDR), Nigeria could receive funds of between USD 2.5 bn and USD 3 bn.

All in all, forex reserves could reach USD 38 bn at the end of the year, the equivalent of 5.7 months of imports of goods and services. As comfortable as the level of external liquidity may seem, it is much less certain that the situation in the forex market will return to normal. The monetary authorities must already clear a backlog of FX accumulated in 2020 (USD 2 bn for non-resident investors). The current economic environment seems propitious, but nothing says this will be sufficient to restore the attractiveness of Nigeria, given the uncertainty over the evolution in the foreign exchange regime. The stock of portfolio investments remains significant, despite massive capital outflows in Q1 2020. At year-end 2020, it totalled USD 27 bn (the equivalent of 73% of foreign reserves), including more than USD 11 bn in short-term debt issued in the local currency. And since the level of foreign direct investment is structurally low (averaging USD 2 bn over the past five years), Nigeria thus exhibits strong financial vulnerability both in terms of stock and flows. Above all, the economy is not sheltered from corrections in oil prices, which account for more than 90% of total exports.

OUTLOOK: RISK OF STAGNATION

Another constraint is the low level of government revenues. They contracted by nearly 2 points of GDP to only 6% of GDP in 2020, due to the downturn in oil prices and the economic shock. Despite a relatively small fiscal support package in 2020 (0.3% of GDP), budget deficit rose to 6% of GDP. Despite the expected upturn in oil revenues, it is still expected to reach at least 4% in 2021. Spending is rigid, and given the fragility of the social-economic environment, the authorities are adopting costly support measures, as illustrated by the reintroduction of oil subsidies (about 0.5 points of GDP). The accumulation of budget

MULTIPLE EXCHANGE RATES

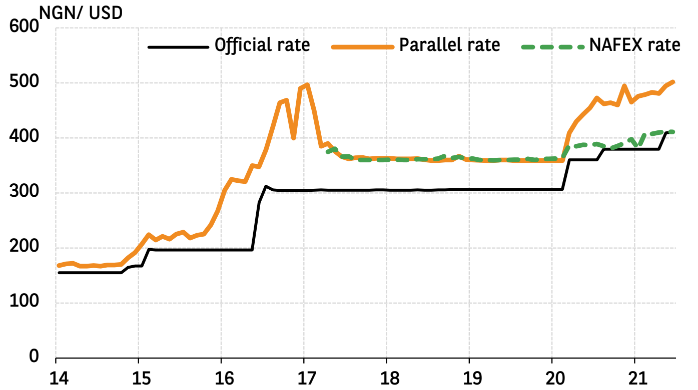

CHART 2 SOURCE: CENTRAL BANK, BLOOMBERG, ABOKIFX

deficits in recent years also goes hand in hand with a rapid increase in the public debt and interest cost. Interest payments are expected to absorb a quarter of fiscal revenues in 2021, up from less than 10% in 2014. Even so, the sustainability of the debt is not a problem since it is still moderate at 30% of GDP.

In the end, the rebound in GDP is likely to be very small at 2.4% in 2021, and growth should continue to be limited to 2-2.5% as of 2022. As a result, GDP growth will continue to fall short of population growth, as has been the case since 2015. It is thus vital to accelerate reforms. One positive point is that apparently the government has never been closer to passing the draft oil industry bill. At this stage, however, it is difficult to determine what impact it will have given the persistent safety and security issues. Most importantly, it will not resolve the problem of diversifying the economy, whose development is hampered by numerous structural constraints (lack of infrastructure) and a macroeconomic environment that is not propitious for investment (high inflation, dysfunctions in foreign exchange market).

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SOUTH AFRICA

A WELCOME EXPORT REVENUE WINDFALL

South Africa has been severely hit by the Covid-19 crisis, after already several years of very low economic growth and social and political tensions. Real GDP collapsed by 7% in 2020 and public finances have deteriorated significantly. However, South Africa has also benefitted from a strong improvement in its external accounts. The boom in export receipts has supported the rebound in activity and fiscal revenue over the past year. This better-than-expected macroeconomic performance has reassured investors and facilitated the coverage of the government's financing needs. However, in the medium term, challenges remain unchanged: large and difficult reforms remain necessary to elevate the country's growth potential and improve public debt sustainability.

The Covid-19 crisis has plunged South Africa into a severe economic and fiscal crisis, following several years of weak GDP growth and gradual deterioration in public accounts. Real GDP contracted sharply in 2020 and sovereign solvency worsened significantly due to the rapid increase in fiscal imbalances and public debt. Nonetheless, over the past year, macroeconomic performance has been better than initially feared, notably because South Africa has benefitted from a great improvement in its terms of trade. Strong export receipts have helped the rebound in fiscal revenue since Q3 2020. Current account surpluses have fueled ZAR appreciation, strengthened external liquidity, and contributed to lower financing stress for the government. In the meantime, President Ramaphosa appears to have strengthened his authority within the ruling ANC over the past year, which has contributed to an improved market sentiment as this enhances the prospects for structural reform.

Favourable external-account dynamics are reducing the sovereign's refinancing risk and currency pressure in the short term but, in the medium term, challenges remain unchanged: South Africa absolutely needs to strengthen its economic growth potential, which will in turn help reduce socio-political risks and improve its public-debt dynamics.

NET EXPORTS HAVE DRIVEN THE POST-COVID-19 REBOUND

Real GDP contracted by 7% in 2020, after it grew by a very low 0.8% per year on average in 2015-2019. Real GDP collapsed in Q2 2020 (-16.6% q/q) due to the lockdown, and has rebounded since mid-2020 (+13.7% q/q in Q3; +1.4% q/q in Q4 and +1.1% in Q1 2021), mostly supported by monetary and fiscal stimulus policy measures, surging export revenue and rebounding production in the mining sector. Meanwhile, construction activity and many services sectors relying on domestic demand have remained depressed.

After falling in April-May 2020, export receipts have rebounded vigorously, boosted by recovering volumes and, most importantly, soaring prices of exported commodities. Precious metals and mining products accounted for 46% of South Africa's total exports in 2020. Trade surpluses have exceeded USD 3.5 bn per month since March 2021 (vs. an average of USD 150 m per month in 2019), and the quarterly current account balance has been in surplus since Q3 2020. In the very short term, export growth performance should remain buoyant.

DOMESTIC DEMAND RECOVERY IS MORE DIFFICULT

Helped by monetary and fiscal support measures, household consumption has rebounded faster than domestic investment following the Covid-19 shock last year. In 2020 as a whole, it contracted by 5.4% in real terms. However, it may struggle to continue to recover going forward. Firstly, South Africa has been facing a third and particularly severe wave of infections since May. The number of cases has increased very rapidly in recent days, leading President Ramaphosa to announce new restrictions, with the country being moved to an adjusted level-4 lockdown for at least two weeks from June 28. This is likely to derail the economic growth momentum and makes forecasts uncertain pending faster progress in the vaccination campaign – at the end of June, only 5% of the population had received one dose of vaccine, vs. 1.6% at the end of May.

Secondly, private consumption should remain constrained by last year's sharp deterioration in the labour market; at end-Q1 2021,

FORECASTS

	2019	2020	2021e	2022e
Real GDP growth (%)	0.2	-7.0	4.7	2.1
Inflation (CPI, year average, %)	4.1	3.3	4.5	4.2
Government balance / GDP (%) 1	-6.7	-11.0	-9.2	-8.0
Government debt / GDP (%) 1	63.4	78.8	80.9	84.5
Current account balance / GDP (%)	-3.0	2.2	1.6	-1.7
External debt / GDP (%)	52.8	56.4	46.0	43.9
Forex reserves (USD bn)	48.9	47.4	52.0	48.3
Forex reserves, in months of imports	5.7	7.3	7.1	5.7

(1): Fiscal year from April 1st of year n to March 31st of year n+1

e: ESTIMATES & FORECASTS

TABLE 1 SOURCE: BNP PARIBAS GROUP ECONOMIC RESEARCH

EXPORT REVENUE WINDFALL

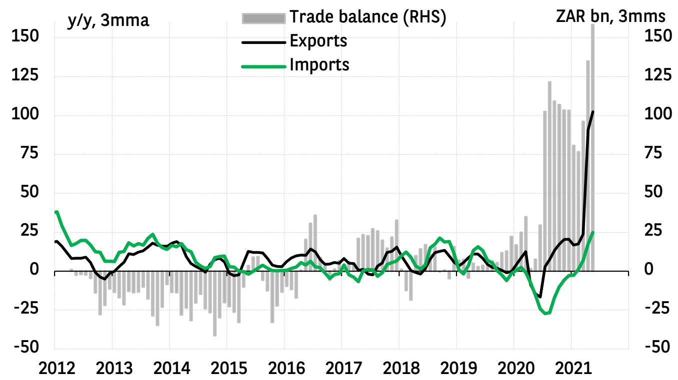

CHART 1 SOURCE: SARS

total employment was still 9% below its end-Q4 2019 level and the unemployment rate was 32.6%.

Meanwhile, many enterprises have reduced drastically their capital expenditure. After already several years of gradual decline, domestic investment collapsed by 17% in real terms in 2020, falling to a record low of 12.4% of nominal GDP. Corporates remain vulnerable and cautious, and wait for much further progress in structural reform. More generally, structural brakes on economic growth (such as deficient transport and energy infrastructure, corruption and weak human capital) will continue to hinder activity; in particular, episodes of electricity cuts are expected until at least late 2022 before energy supply is durably strengthened.

On the positive front, the monetary authorities are projected to maintain an accommodative policy stance in the very short term, even though inflation is starting to accelerate. Consumer price inflation rose from 3.1% y/y in December 2020 to 5.2% in May 2021, which is still within the central bank's targeted band of 3%-6%. Since July 2020, the policy (repo) rate has been maintained at a record low 3.5% and the real prime lending rate has remained close to 3.7%. This has supported a small recovery in loans to households in recent months but loans to corporates have continued to be weak. As a result, growth in total credit to the private sector has turned negative since March 2021 (reaching an average -1.3% y/y in March-May).

The low interest-rate environment and the extension of credit relief and regulatory forbearance measures will anyway continue to help corporates and households. When relief measures are unwound, sometime in the year ahead, banks' asset quality is expected to deteriorate (the non-performing loan ratio already increased to 5.2% at end-2020 from 3.9% at end-2019). The most vulnerable borrowers include households (which have a heavy debt burden, at 75% of disposable income at end-2020) and small enterprises.

On the fiscal front, although some support measures have been extended this year, the policy stance will be less supportive to activity in 2021 than last year due to the government's commitment to reducing its deficits.

PUBLIC FINANCE: SHORT-TERM RELIEF, MEDIUM-TERM WORRIES

Public finances weakened significantly due to the Covid-19 shock, following already several years of deterioration. Fiscal slippage worsened in 2019 as the government rescued the state-owned energy company Eskom, and then accelerated drastically in 2020 due to the economic recession and the large stimulus package (representing about 10% of GDP). The central government deficit rose to a (lower-than-expected) 11% of GDP in FY20/21 vs. 6.7% in FY19/20, due to soaring levels of primary deficit (6.4% of GDP) and interest payments (4.6%). National government debt rose to 79% of GDP in FY20/21 from 63% in FY19/20. In its budget plan that was published in February 2021, the government showed strong commitment to fiscal consolidation efforts and projected to reduce its deficit gradually from this year thanks to improved revenue and spending discipline.

In the short term, the sovereign's refinancing risk is low even if local bond yields are high (averaging 9.8% for government papers of over 10 years in H1 2021 vs. 9% in H2 2019). First, the government has been able to build some buffers in recent months thanks to its smaller-than-expected financing needs and continued issuance of domestic bonds amid an improved market sentiment. Second, there is abundant

EASING OF FINANCIAL TENSIONS

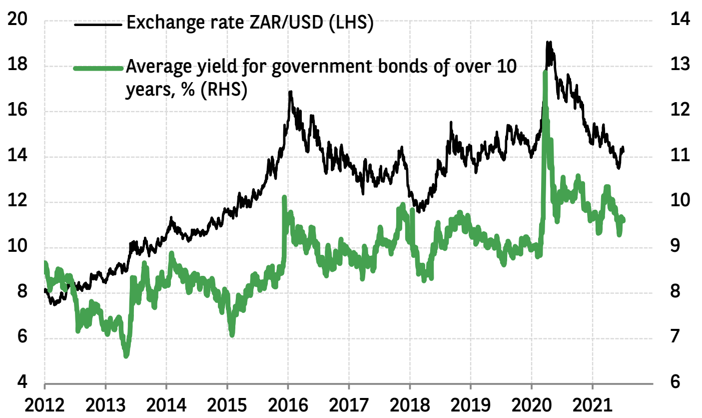

CHART 2 SOURCE: SARB

liquidity in the domestic financial system, and local banks still keep some room to buy more Treasury bonds and offset the impact of lower bond holdings by foreign investors (credit to the public sector and sovereign bond holdings rose to 17% of bank assets at end-2020 from 15% in Q1 2020). The share of foreigners stabilized at around 30% of total local-currency Treasury bonds since Q4 2020 (down from 37% at end-2019). The government is unlikely to need to resort to new multilateral loans like in 2020.

In the medium term, public debt dynamics are a major concern. Government debt will continue to grow (we project it to reach 87% of GDP at end-FY23/24), driven by wide (even though declining) fiscal imbalances and low GDP growth. This will keep the government particularly exposed to shifts in foreign investor sentiment and maintain pressures on local bond yields. Refinancing risk will trend upwards as a result. In order to improve public debt, fiscal consolidation and GDP growth prospects, the authorities will have to contain drastically growth in the public-sector wage bill, continue to restructure SOEs, and make progress in structural reforms. The political context has recently improved and become more conducive to such changes, and further steps in the right direction have been made (such as SOE management changes, continued transformation of Eskom, reform measures in the energy sector). However, socio-economic conditions have weakened significantly due to the Covid-19 crisis, and this will continue to make social welfare and public spending reductions particularly difficult. Moreover, the political landscape might deteriorate again, including in H2 2021 because of the municipal elections.

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