ECO EMERGING

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Editorial

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Eco EMERGING

ECONOMIC RESEARCH DEPARTMENT

BNP PARIBAS

The bank for a changing world

Editorial

Triple whammy

Emerging countries have been severely affected by the COVID-19 pandemic even though the official number of confirmed cases and deaths (excluding China) is still low compared to the figures for the developed countries. A wave of slowdowns and recessions is only just beginning, and the economic fallout will probably spread beyond 2020, because the real shock (shutdown of business due to confinement measures) is compounded by a financial shock and commodity price shock. Capital outflows and the freeze on bond issues in international markets increases refinancing risk in US dollars. Preventative safety nets are being set up to reduce defaults, but the solution for the most vulnerable countries is probably a sovereign debt moratorium or a debt relief.

■ Multiple shocks hit the emerging countries

The entire planet has been hard hit by the COVID-19 pandemic. According to the OECD, for a selection of nearly 50 developed and emerging countries, the supply-side shock generated by confinement measures could result in a loss of activity of at least 15% (the median is -25%). This is an unprecedented shock, surpassing even that of the 2008-2009 Global Financial Crisis (GFC), when no country reported more than a 5% decline in GDP from peak to trough. Granted, the periods of confinement will be followed by a rebound, like the one in China in March. But unlike the 2008-2009 crisis, the recoveries will not be synchronised. Asia will be the first to recover, followed by the countries of central Europe and then Latin America. Growth in the main emerging countries will be about 1% this year (0% excluding China), vs 4% in 2019. Latin America will be hit hardest, with a contraction of at least 2.5%.

For the emerging countries, the supply-side shock is coupled with a financial shock. Portfolio investment funds specialising in the emerging countries have reported massive withdrawals, which are also unprecedented compared to previous periods of financial stress. According to IIF (Institute of International Finance) estimates, there has been a cumulative outflow from portfolio investments of USD 95 bn since the beginning of the pandemic, compared to outflows of USD 20 bn during the GFC and Taper Tantrum. In March, there were no sovereign bond issues in foreign currencies.

Commodity producing countries will be especially hard hit because the dollar's appreciation will not offset the decline in global commodity prices. OPEC and Russia stroke a deal to reduce production by 10% but global demand has already reduced by 20% and oil stocks reached a record high, which suggests prices will remain low in the short term. World trade growth will probably be structurally lower because of industries relocation and the shortening of global value chains. This may have a negative impact on commodity prices.

Like in the developed countries, the governments and monetary authorities have reacted rapidly and in multiple ways. The central banks immediately sent strong signals of support for domestic liquidity, including key rate cuts, lower required reserve ratios and easier refinancing terms for banks. These support measures are all the more important for the emerging countries since domestic interest rates could come under pressure simply due to the drying up of external liquidity.

At the same time, most governments have announced economic stimulus plans. Of course, the amounts are not comparable since they comprise a wide range of solutions, from fiscal measures and effective spending (which will add to fiscal deficits) to the set-up of credit lines and guarantees (which are potential expenditures or debt). These are not budgetary impulse but measures aimed at maintaining activity. Multiplier effects are thus expected to be limited.

■ Towards a sovereign debt moratorium?

The shutdown of the international bond market has raised fears of USD refinancing risk. In 2020, many countries will have to face up to debt servicing charges on international debt representing at least 20% of their foreign reserves: Bahrain (47%), Turkey (30%), Ghana (27%), Nigeria (23%), Chile (22%), South Africa (21%), and Ukraine (21%). A priori, the risk of default is low for these countries. With the exception of Chile and Turkey, however, these countries have fragile economic structures that make them susceptible to protracted recessions. Investors will be keeping a close eye on them. Of these countries, Ghana and Senegal have officially requested IMF assistance.

Preventative safety nets are being set up to reduce defaults. For the moment, only a few of the emerging countries are covered by the swap lines announced between the Fed and other countries (Brazil, South Korea and Mexico). But the IMF is providing USD 100 bn in accelerated emergency financing, including USD 10 bn in the form of zero interest loans for the most vulnerable countries.

Another more radical option would be a sovereign debt moratorium or debt relief. The IMF has already approved a temporary debt flow relief (i.e. up-front grants to cover debt repayments) for 25 countries. G20 countries are expected to offer a moratorium on bilateral loans to end-2021. It is a first step that should be amplified. A moratorium would allow priority to be given to channelling funding towards their healthcare needs, and it would prevent the rating agencies from downgrading their sovereign ratings, which would only pour oil on the fire.

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China

Is the worst over?

China's population and its economy were the first to be struck by the coronavirus epidemic. Activity contracted abruptly during the month of February before rebounding thereafter at a very gradual pace. Although the situation on the supply side is expected to return to normal in Q2, the demand shock will persist. Domestic investment and consumption will suffer from the effects of lost household and corporate revenues while world demand is falling. The authorities still have substantial resources to intervene to help restart the economy. Central government finances are not threatened. However, after the shock to GDP growth, the expected upsurge in domestic debt ratios will once again aggravate vulnerabilities in the financial sector.

China, which was the first country to be hit by the coronavirus outbreak, reported a very sharp drop in activity after the population was put in lockdown, from the Chinese New Year celebrations at the end of January through the end of March or early April (rules and dates vary from region to region). The brutal shock was transmitted through numerous channels, ranging from a supply-side shock to a shock on domestic demand and exports, a revenue shock and a confidence shock. Activity has begun to rebound, and the authorities have launched stimulus measures that should help bolster the recovery. Major downside risks persist however. Lost corporate revenues, a deteriorated labour market and uncertainty over the pandemic's future course will hamper domestic demand. At the same time, the export sector is bound to be hit by the repercussions of the sanitary and economic crisis that is spreading worldwide. We expect to see an unprecedented contraction in real GDP in Q1 2020 (-8% year-on-year), followed by a rebound in economic growth starting in Q2. We have just revised down once again our real GDP growth projection for 2020.

An unprecedented shock

After the authorities imposed drastic measures to contain the epidemic, consumption of goods and services collapsed (Figure 2). Retail sales volumes declined by 23% year-on-year (y/y) in the first two months of 2020, with automobile sales entering a free fall (-78% y/y in February). Online retail sales were more resilient, but nonetheless contracted by 3% y/y in January-February due to the decline in sales of services and non-essential goods. Transport networks were paralysed (with passenger traffic down 84% y/y in February). Construction and the real estate sector were also hard hit (property sales were down 40% in the first two months of the year)[1].

The supply-side shock was just as severe since factories were forced to remain shuttered after Chinese New Year and the work force was put in lockdown. Industrial output plunged 13.5% y/y in real terms in the first two months of 2020 (vs. +5.8% in 2019). The shutdown of production lines and transport blockages contributed to the decline in merchandise exports (-17% y/y in January-February and -6% in March). Lastly, falling revenues and uncertainty over future growth prospects led corporates to drastically scale back investment in all major economic sectors. Total fixed-asset investment declined by 25% y/y in the first two months of the year.

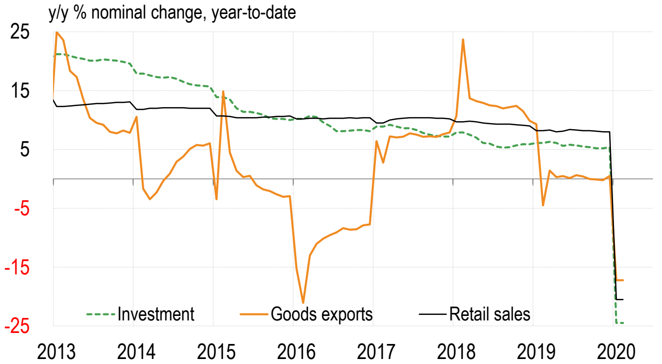
[1] Services account for 54% of GDP, including retail trade (10%), transport (4%) and real estate (7%). The industrial sector accounts for 39% of GDP, including construction (7%).

1-Forecasts

	2018	2019	2020e	2021e
Real GDP growth (%)	6.6	6.1	1.5	9.5
Inflation (CPI, year average, %)	2.1	2.9	3.1	2.0
Actual fiscal balance / GDP (%)	-4.1	-4.9	-6.5	-5.8
Current account balance / GDP (%)	0.4	1.2	1.0	0.6

e: BNP Paribas Group Economic Research estimates and forecasts

2- Collapse



Source: NBS

The epidemic's spread in China is currently contained and the economy is recovering. Restrictions have been lifted on domestic passenger traffic and merchandise transport (albeit still partially in Hubei) and export activity has started up again. At the end of March, the official work resumption rate was 98% for large industrial enterprises (and 85% in the province of Hubei) and more than 70% for small and medium-sized enterprises (SME). Yet production capacity utilisation rates are still far below pre-crisis levels (it was 77% in the industry in Q4 2019). Production facilities are expected to return to normal by the end of April for industry and by the end of Q2 for services (with the exception of tourism).

However, just as the supply-side shock is winding down, a new demand shock is taking shape. The collapse in world demand will rapidly undermine China's exports. Therefore, their protracted contraction will threaten the recovery in the manufacturing sector (which also continues to be affected by higher US tariffs). This should drive export-oriented corporates to reduce inventories and scale back investment. In addition, both households and corporates have been hit by a revenue shock, which will continue to squeeze domestic demand in the short term. Finally, there has been a severe erosion in confidence due to the pandemic and uncertainty over its future course.

The financial situation of many corporates has weakened and their capacity to invest and repay loans has deteriorated (profits of industrial enterprises declined by 38% y/y in the first two months of 2020, and eight SMEs out of ten reported cash-flow problems in early March). Total domestic debt of the corporate sector is excessively high, at 150% of GDP at year-end 2019 (more than two thirds of which are bank loans). The debt burden reduces corporates' resilience to shocks, and the increasing risk of default on bank loans and in the local bond markets could weaken the financial sector. In contrast, corporates' external debt in foreign currency is small (estimated at 7% of GDP) and is not a source of instability for China's external accounts, even if payment difficulties and refinancing risk increase.

Chinese consumers are expected to remain both constrained by their income loss and very cautious. Job market conditions deteriorated rapidly during the confinement period: the unemployment rate surged to 6.2% in February from 3.6% in December 2019. The shock will also be amplified by household indebtedness. Their debt-to-GDP ratio was 55% of GDP at the end of 2019, which is not excessively high yet. However, it has increased significantly over the past ten years. More importantly, the debt burden is much higher for low-income households, which are also more vulnerable to income shocks. Consequently, there is likely to be an even sharper downward adjustment in private consumption in the short term.

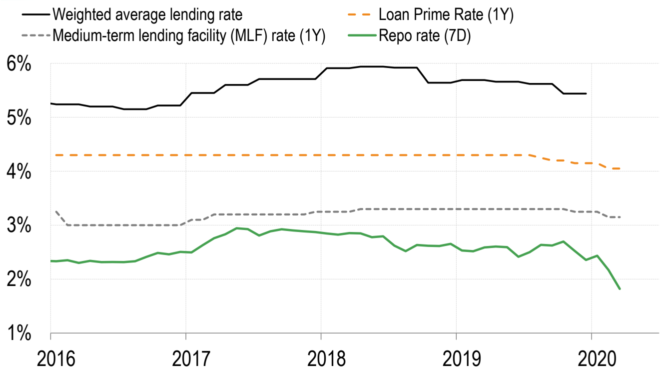
Actions on all fronts

Since February, the government and the central bank have launched a series of measures that aim: 1) to support corporates that have been hard hit by the coronavirus outbreak, help prevent defaults and bankruptcies, limit the risk of financial-sector instability and facilitate the economic recovery, and 2) to offset the decline in revenues and to stimulate investment and consumption. As the external environment deteriorates, Beijing is expected to bolster its stimulus measures in the weeks ahead.

Monetary conditions have been eased gradually since the beginning of the epidemic. The central bank has injected liquidity in the financial sector in order to meet demand (RMB 3 trn in the first two weeks of February). It initially opted for a moderate reduction in policy rates (the rate on medium-term lending facilities was lowered from 3.25% to 3.15% in February and then left unchanged in March), but recently stepped up the easing in interest rates (Figure 3). Special credit programmes have been introduced, such as an expansion of relending facilities (RMB 700 bn) and a special loan program by policy banks to help small firms (RMB 350 bn).

In mid-March, reserve requirement ratios were lowered by between 50 bp and 200 bp (depending on the bank) in order to free up RMB 550 bn for targeted loans. Banks have also been sent directives instructing them to cover the financing needs of corporates hit by the epidemic, refinance loans and reschedule loan

3- Lower interest rates



Source: Central Bank

repayments of clients facing difficulties. Prudential standards have been (moderately) eased for commercial banks, as well as the rules for issuing corporate equity and bonds.

On the fiscal front, the central government has opted for a relatively measured response until now. It has increased spending (notably on healthcare: +RMB 110 bn), exonerated companies from some social welfare contributions (RMB 500 bn) and taxes, reduced electricity rates for corporates by 5%, and announced fiscal incentives to stimulate domestic demand. Local governments also participate actively in stimulus efforts, notably by increasing investment in infrastructure projects (a traditional policy tool in China) and through direct aid for enterprises and households (such as reduced rent for land leases and the distribution of coupons). Beijing has substantially increased the local government bond issuance programme to finance infrastructure projects (RMB 850 bn in addition to the initial quota of RMB 1 trn for 2020).

Public finances can absorb the shock

The authorities' actions will play a key role in restoring economic growth. The central government has comfortable fiscal manoeuvring room and the central bank has ample liquidity cushions to ensure the stabilisation of the financial system. In contrast, the debt excess of the economy is constraining monetary policy as well as the investment capacity of local governments (their total debt already represents about 50% of GDP). Consequently, while it is highly likely that the central bank will continue to ease monetary conditions in the short term and that local governments will further increase investment, the central government will have to give priority to fiscal stimulus measures. Fiscal deficits will rise to historically high levels, but the central government's financing needs will be easily covered and its debt will remain moderate: it represented 16% of GDP at year-end 2019; it is almost entirely in local currency, and more than 90% of which is held by local investors.

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India

Limited resources to combat the pandemic

India was not spared the coronavirus pandemic. The economic slowdown will be all the more severe with a protracted lockdown of the population. The government also lacks the fiscal capacity of the other Asian countries to bolster its economy. Already strained by the economic slowdown of the past two years, public finances are bound to deteriorate further. Public debt could reach 75% of GDP by 2022. Refinancing risks are low, but the cost of borrowing could rise for the long term if the rating agencies were to sanction its public debt and deficit overruns. India still has sufficient foreign reserves to cover its short-term liabilities.

Economic growth: a mild recovery is cut short

Until February 2020, certain economic indicators suggested a strong rebound in activity, buoyed notably by accelerating export orders. Industrial output rebounded and electrical power generation swung back into positive growth rates after five months of contraction. Exports had picked up (+2.9% y/y in February after six months of contraction). Business survey results confirmed the rebound as well as a slight upturn in corporate lending. Domestic demand, in contrast, was still disappointing: automobile sales contracted for the 16th consecutive month and household confidence indicators continued to plunge.

The slight rebound in economic activity is unlikely to withstand the COVID-19 crisis. Growth will slow sharply between March and September 2020 and is likely to take a U-shaped profile. After contracting in fiscal year 2019/20 (by about 5% according to the latest official estimates), the economy could slow again, by almost 2 percentage points (pp). Another slowdown would present a major risk for the banking sector, which is still convalescing, and could lead to the erosion of public finances. The economic slowdown will be worsened by four negative shocks: tourism, exports, capital flight and the confinement of the population, announced on 25 March. The only positive shock is the decline in oil prices.

- Tourism revenues account for only 1% of GDP. During the SARS epidemic, tourism contracted by 20%. With the current pandemic, tourism revenues could contract by as much as 50%.
- Exports account for nearly 20% of GDP. If the global economy were to slow by 2 pp, then exports would contract by 11%. Yet the decline in export volumes should be offset by the positive impact of sharply lower oil prices. The oil bill accounted for 5% of GDP in 2019. If oil prices fall by more than 38% (from USD 61.9 in 2019/20 to USD 38 in 2020/21, based on oil forward contracts), then oil imports would be reduced by at least 2 pp and probably even more if we factor in the impact of the lockdown.
- One positive point: according to the central bank, a USD 10 decline in the price of oil per barrel would have a positive impact on growth of about 0.15 pp via household purchasing power gains (or a positive impact of 0.35 pp based on our oil assumptions). The impact would be slightly smaller, however, due to the tax increase on petroleum products adopted on 14 March 2020. Moreover, the lockdown could wipe out any positive effects.

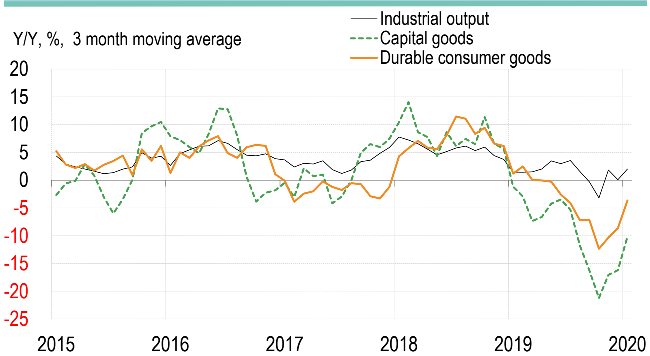
1-Forecasts

	2018	2019e	2020e	2021e
Real GDP growth (1) (%)	6.1	4.9	2.7	5.2
Inflation (1) (CPI, year average, %)	3.4	4.7	3.5	4.0
General Gov. Balance (1) / GDP (%)	-6.3	-7.3	-8.5	-7.3
Current account balance (1) / GDP (%)	-2.1	-0.8	-0.1	-1.0

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

e: BNP Paribas Group Economic Research estimates and forecasts

2- Industrial output



Source: CEIC

- The lockdown will trigger a decline in household consumption (59% of GDP) and delay investment projects (29% of GDP), especially since capital outflows will tighten financing conditions. Moreover, informal employment still predominates in the labour market (83% according to ILO), and undeclared workers might not benefit from any assistance during the lockdown period.

The final impact on growth will depend on the duration and severity of confinement. If the economy is partially paralysed for one quarter, then growth might slow to 2.7% in 2020/21. Yet if the entire economy is paralysed for two quarters, then GDP growth is likely to reach only 1.5% at best.

Limited support measures

Faced with intense financial market pressures and massive capital outflows, the central bank has already adopted several support measures since February to offset the rupee and dollar liquidity shortages. The central bank injected INR 1250 bn in liquidity as part of long-term repo operations (LTRO) and set up USD/INR foreign exchange swaps with a 6-month maturity for a total of USD 6.7 bn. From a fiscal perspective, the government announced an INR 1.7 trillion fiscal stimulus plan (0.8% of GDP) on 26 March. But the government has much less manoeuvring room than the other Asian countries given its high fiscal deficit and public debt, as well as the risk that rating agencies could downgrade its sovereign rating.

Without massive support not only for companies but also for households, the banking sector could be hard hit by a very sharp rise in credit risk, even though Indian companies are now in a better financial situation than in 2013-14. In Q3 2019, corporate debt amounted to 44.2% of GDP, compared to 52.9% in Q2 2013.

Low oil prices will support the rupee

Two opposing factors will have an impact on the external accounts: declining oil prices and massive capital outflows.

According to India's central bank, each USD 10 decline in the price of oil per barrel would have a positive impact on the current account balance of USD 10 bn. If oil prices averaged USD 38 a barrel in fiscal year 2020/21 (vs USD 61.9 in 2019/20), then the current account deficit, estimated at less than USD 30 bn in fiscal year 2019/20 (0.8% of GDP) could approach equilibrium during the year 2020/21.

Yet according to IFI data, capital outflows from equity and bond portfolios over the past seven weeks reached more than USD 20bn. In comparison, between May and November 2013, withdrawals from bond portfolios amounted to USD 14 bn over 28 weeks, while equity disposals were extremely limited.

At 31 March, the rupee's depreciation against the dollar was still mild at only 5.3% y/y. The monetary authorities intervened to stabilise the rupee, as illustrated by the slight decline in foreign exchange reserves (down USD 12 bn in 4 weeks). Yet given the risks to growth, we can assume that the decline will be much sharper in the weeks ahead, despite the persistently high spread between domestic and US interest rates.

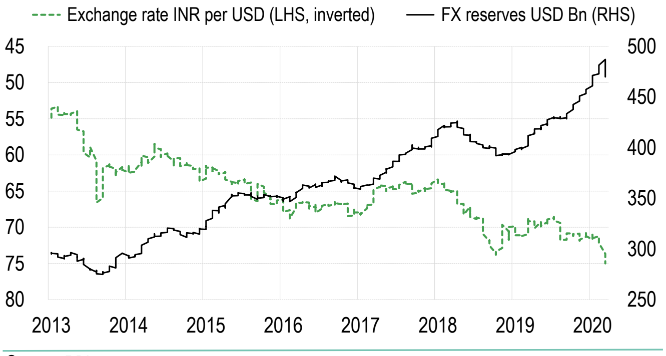
A priori, refinancing risks are small. The external debt is still moderate (20.1% of GDP). From a horizon of September 2020, debt servicing amounts to USD 239.4 bn (including USD 93 bn in non-resident deposits), while foreign reserves were reported at USD 474 bn on April, 3.

Public finances are expected to deteriorate

For the 2019/20 fiscal year ended 31 March 2020, India reported public finance overruns for the second consecutive year. The finance ministry is forecasting a 0.4 pp increase in the government deficit, to 3.8% of GDP (7.3% of GDP for all public administrations combined). Public debt probably exceeded 70% of GDP at the end of fiscal year 2019/20.

For fiscal year 2020/21, before the announcement of the stimulus plan, the government's target was to reduce the deficit by 0.3 pp to 3.5% of GDP. Under current conditions, however, this target no longer seems unrealistic. Granted, the decline in oil prices will

3- Downward pressure on the rupee and FX reserves



Source: RBI

reduce the cost of energy subsidies, but they have already fallen sharply since 2014 (to only 0.2% of GDP). The very sharp slowdown in household consumption and corporate revenues, in contrast, could trigger a decline in revenues of at least 2% of GDP. The government might also postpone the privatisation of certain state-owned companies given the collapse in the equity markets (privatisation proceeds were estimated at 0.9% of GDP in fiscal year 2020/21). At the same time, alongside the stimulus package (0.8% of GDP), government and state spending on healthcare will also increase. The central government deficit could rise to nearly 6% of GDP unless measures are taken to sharply cut back non-essential expenditures. Public debt could rise above 75% of GDP in fiscal year 2021/22. There is no immediate refinancing risk since the debt has a long maturity (10 years on average), is held by residents (more than 96%) and is denominated in rupees (97%). Yet the cost of borrowing is likely to rise if the credit agencies were to sanction these public finance overruns.

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Brazil

Tough luck

The massive economic shock resulting from the coronavirus sanitary crisis will delay Brazil's economic recovery, suspend the process of fiscal consolidation and stall progress on reforms. While the extent of the recessionary shock remains highly uncertain, measures – both fiscal and monetary – have been taken to mitigate the impact of confinement measures on economic activity, prevent a sharp upturn in unemployment and ensure that tensions over liquidity do not materialize into solvency problems. Intervention capacities on the monetary side are ample and contrast with those on the fiscal side, which are more limited due to the fragilities of public accounts. Brazil's financial markets, which came under significant stress in Q1, will continue to be challenged.

Stopped abruptly in its tracks

The coronavirus pandemic will halt Brazil's three-year long economic recovery in its tracks. The economy – which experienced a slight slowdown towards the end of 2019 – is expected to fall back into recession in 2020, a highly regrettable situation in light of the economy's encouraging signs in recent quarters.

The spread of the virus within the country's borders since March together with the deployment of confinement measures[1] is expected to lead to a contraction in economic activity in Q2 (simultaneous internal supply and demand shocks). The effects of the virus on the economy have already started to be felt towards the end of Q1. The PMI in the service sector fell by 16 points (34.5 vs 50.4 in February) – its largest drop since the inception of the time series. Meanwhile, the PMI in manufacturing fell below 50 for the first time in eight months (48.2 vs 52.3 in February) with subcomponents indicating lower levels of production, employment, and new orders as well as accelerating drops in foreign sales. Disruptions in global supply chains throughout Q1 have also resulted in longer delivery times and work backlogs comparable in magnitude to those which occurred during the truckers' strike (May 2018). Layoffs in the sectors have also reached a three-year peak. The automotive sector has also shown signs of weakening: alongside car sales which have dropped by 33% (m/m, sa) in March, car registrations have also retracted (-21% m/m).

Increasing pessimism on behalf of economic agents is palpable in survey data. The FGV confidence indicator in industry fell by almost 4 points in March (97.5) after increasing for four straight months while the FGV confidence indicator in services collapsed by 12 points (82.8). According to a Datafolha survey published on March 24, 79% of respondents believe that the Brazilian economy will be "strongly affected by the crisis", 57% that their income will decrease in the coming months while half believe the pandemic will hurt the economy "for a long time."

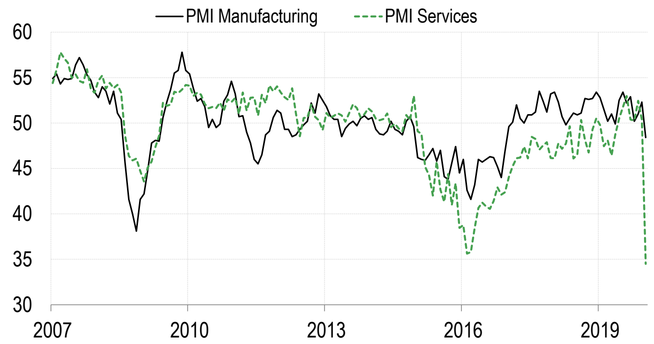
The recession is forecasted to reach -4% on an average annual basis. This forecast assumes a gradual recovery of economic activity in Q3 and a strong bounce back in Q4 without however returning to pre- crisis levels (asymmetric U type scenario).

1- Forecasts

	2018	2019	2020e	2021e
Real GDP growth (%)	1.3	1.1	-4.0	4.0
Inflation (CPI, year average, %)	3.7	3.7	3.2	3.2
Budget balance / GDP (%)	-7.1	-5.9	-12.5	-4.3
Current account balance / GDP (%)	-2.3	-2.9	-2.5	-3.4

e: BNP Paribas Group Economic Research estimates and forecasts

2- PMIs dropped in March



Source: IHS Markit

This scenario would allow the economy to benefit from a strong growth carry-over in 2021. Nonetheless, the forecast remains highly precarious reflecting the lack of precedents in assessing sudden stops and the significant uncertainties at this stage regarding i/ the capacity of the health infrastructure to cope with the epidemic, ii/ the actual effectiveness of confinement measures – given the high level of heterogeneity in the health response across states so far – as well as iii/ the magnitude of the impact of the crisis on the informal economy (54 mn workers, 41% of employment). Once the epidemic is under control, firms weakened by the crisis could also notably reduce their investment spending possibly weighing down the recovery.

External accounts : a cascade of shocks

The external demand shock brought about by the Covid-19 crisis alongside the unprecedented oversupply in the oil market is expected to keep commodity prices depressed and slowdown sales abroad. Brazil – a net oil exporter – whose exports of commodities

[1] The state of Sao Paulo, which represents approximately 40% of GDP, has implemented confinement measures since March 24th until April 22nd. Recent studies (e.g. OECD) show that some economies across the globe could lose the equivalent of 2 to 3 percentage points of GDP on average per month of strict confinement.

account for around 50% of foreign sales – will suffer from a deterioration in its terms of trade with the fall in oil prices (-61%), the price of sugar (-21%), corn (-14%) and cotton (-27%). The depreciation of the BRL – which dynamics closely mirror that of the commodity cycle and has, in recent months, suffered from appreciation in the USD – has meanwhile mechanically increased the cost of imports further eroding the purchasing power of exports. That said, the reduction in the trade surplus is expected to be limited by the concurrent decline in import volumes due to the recession and a weakened BRL. The trade balance could also benefit from certain commodity prices holding up their ground as seen in Q1 (e.g soybeans, coffee, beef, wheat, and iron ore). In 2020, the current account deficit should fall (-2.5% of GDP) with the decrease in the services balance deficit (-1.9% of GDP in 2019) and that of the primary income balance (-3.1% of GDP in 2019) which should benefit from the slowdown in transferred profits and dividends.

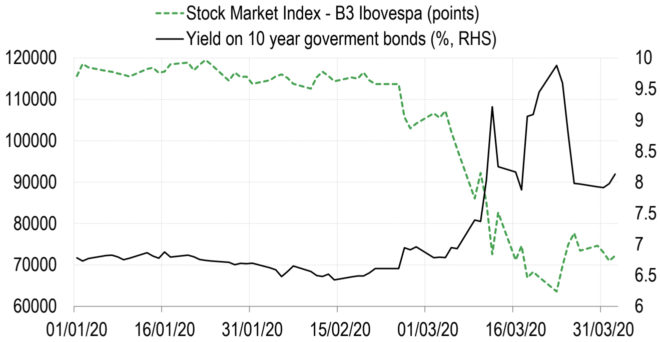
The pandemic has led to a strong surge in risk aversion triggering i/ significant capital outflows (non-residents have cumulatively pulled around USD 14bn from the stock market since January according to data from the IIF) as well as generating ii/ significant shocks to asset prices. From January to the end of March, the depreciation of the BRL reached -23% against the USD (reaching an all-time low of 5.25), the stock market suffered heavy losses (-45% at its lowest) and financial conditions in the secondary corporate and sovereign debt markets tightened sharply (the sale of government securities to generate liquidity pushed 10-year yields up by +310 bps at their highest point over the period). Despite the tightening of financial conditions and the drop in the BRL, rollover risks in foreign currency in the short term remain limited : i/ redemptions of USD denominated debt (bond debt + syndicated bank loans) is moderate in 2020 (~ USD 40 bn), ii/ open FX positions of corporates are limited, iii/ corporates with foreign currency debt are predominantly exporters and hold liquid assets offshore, iv/ FX reserves are abundant (~ 345 bn at the end of March), and v/ the BCB reinstated in March a USD 60 bn precautionary swap line with the Fed.

The authorities' response to the crisis

A number of steps were taken by political authorities to curb the spread of the virus. Borders were shut down and several states have declared a state of emergency and have put in place measures to reduce the mobility of people. However, containment measures have only been partial for the most part. They have also been a source of political tension between the various levels of government. Most state governors have pushed for tougher measures and have also asked Congress to take the lead in the fight against the pandemic given the failure of President Bolsonaro to recognize the gravity of the health situation.

Monetary authorities – through a combination of monetary easing and prudential measures – have taken significant steps to help contain systemic credit risks associated with the macroeconomic shock. Measures were deployed to alleviate tensions on BRL liquidity, facilitate the refinancing of banks and encourage them to renegotiate payment terms with households and businesses on roughly BRL 3200 bn of outstanding credit. Authorities have i/ cut the policy rate (7th consecutive) by 50 bps to 3.75% ii/ relaxed the

3- Dislocations across domestic financial markets



Source: B3, Macrobond

reserve requirement ratio on term deposits from 30% to 17%, iii/ relaxed capital and provisioning requirements iv/ bought back in –partnership with Treasury – sovereign debt securities in the secondary market v/ allowed riskier securities (corporate debt) to qualify as collateral in transactions with banks vi/ extended guarantees for certain types of deposits. The liquidity injection is estimated at BRL 1200 bn (16.7% of GDP) and the reduction in capital requirements at BRL 1150 bn (16.1% of GDP). At the same time, the BCB will continue to provide liquidity to the FX market via its swap cambial, repo programs and its spot interventions (USD 9.7 bn in March).

On the fiscal front, numerous announcements were made in the form of tax / financial relief, direct support and guarantees. Communication over the support provided has at times lacked clarity. By some estimates, measures amount so far to BRL 490 bn (6.8% of GDP)[2] and have been deployed to: i/ protect employment and the most vulnerable populations (BRL 268 bn): ii/ combat the pandemic (BRL 11.5 bn) iii/ alleviate the financial pressures of states and municipalities (BRL 85.5 bn) iv/ strengthen the working capital / cash flow positions of companies (BRL 123 bn).

By voting a "state of public calamity", Congress authorized the government to suspend its deficit targets and fiscal rules for 2020. The primary deficit (excluding interest payments) should thus largely exceed the BRL 124 bn (-1.6% of GDP) originally forecasted in the 2020 budget settling instead around BRL 515 bn (-7.3% of GDP, accounting for the contraction in GDP), which would bring the headline budget deficit to 12.5% of GDP. Current measures do not even take into account a possible post confinement stimulus package. Needless to say that concerns over the sustainability of Brazil's public debt – which could flirt in the neighborhood of 90% of GDP – cannot yet be put to rest.

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[2] Other estimates evaluate total support to around BRL 700 bn (9.8% of GDP). The minister of the economy, Paulo Guedes, estimates that support could reach north of BRL 800 bn.

Turkey

Prepared for (soft) landing?

The Turkish economy is facing problems of a sort it has dealt with in the past: a global crisis, that will trigger a sharp fall in exports, coupled with a contraction of external financing. Unlike in 2018, Turkey's economy does not appear to be overheating, whilst the fall in oil prices and the emergence of a current account surplus are two factors that will reduce the risk. That said, the relatively weak levels of currency reserves, the high level of external debt and the recent rise in non-performing loans are all significant risk factors. In front of the current shock, the economic policy response will have to address foreign currency liquidity needs properly in a context of dwindling capital flows.

The second shock in two years

Turkey is one of the last European countries to be hit by partial economic paralysis from COVID-19. Before the pandemic struck, economic growth had been accelerating including during the first quarter of 2020 (industrial production rose 7.3% y/y in the three months to end-January), as the country recovered from the recession experienced in the 2nd half of 2018 and responded to the rescue measures introduced since then.

This does not mean that the country will avoid a shock, as demonstrated by the first signs of deterioration of economic indicators in March. For example, the index of expected production levels at companies has slipped back to the low points seen during the 2018 crisis. At the same time, consumer surveys saw no deterioration in March, with consumer perceptions still dominated by the on-going disinflation.

The shock in the 2nd quarter of 2020 will be severe in two ways:

- Turkey will not escape the major shock to international trade that the pandemic has triggered. It is likely that there will be a substantial fall in exports (-20% in the second quarter), most notably in exports of goods and particularly vehicles (15% of total goods exports). Turkey will probably also see a fall in tourist numbers in the summer of 2020; tourism represents 20% of exports of goods and services.
- Secondly, as the COVID-19 pandemic affects the country, Turkey will see a sharp fall in domestic demand, with a contraction in household consumption. Investment will return to a downtrend, and could close the year 25% below its mid-2018 level.

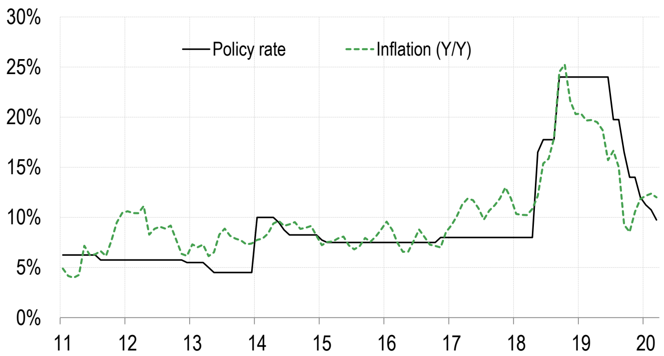
In the end, Turkish GDP is likely to decrease by -2% in 2020. With a high carry-over at the end of Q1 2020 of close to 4%, this implies strongly negative growth over the remainder of the year. Once the shock is over, we expect growth to rebound fairly strongly as of 2021. As shown in the 2018 crisis, the depreciation of the lira in difficult times helps absorb the shock. A weaker currency pushes up the prices (and thus reduces the level) of imports, helping support local production. The sudden narrowing of the trade deficit (from 6.9% of GDP in 2017 to 2.2% in 2019) reflects this. Credit supportive monetary policy is another fundamental factor expected in this rebound, in another parallel with the aftermath of the 2018 crisis: bank lending grew by 11% in 2019.

1- Forecasts

	2018	2019	2020e	2021e
Real GDP growth (%)	2.9	0.9	-2.0	4.5
Inflation (CPI, year average, %)	16.2	15.5	10.0	9.0
Budget balance / GDP (%)	-1.4	-3.5	-7.0	-4.5
Current account balance / GDP (%)	-2.4	1.1	3.0	1.0

e: BNP Paribas Group Economic Research estimates and forecasts

2- Inflation and policy rate



Source : Central Bank, Turkstat

Meanwhile, inflation is likely to fall in line with the sharp drop in oil prices. It is likely to average 10% over the year, slowing from 12.2% in the first quarter to around 8% at the year-end, before picking up a little again. However, a return to stronger growth in 2021 is likely to come too late to prevent a fresh rise in non-performing loans. These had already doubled between mid-2018 and the end of 2019, reaching 5.4% of total bank lending.

Whatever it takes in Turkish motion?

The assumption that Turkish growth will prove relatively resilient is based on the country's rapid economic policy response, with the announcement on March 17th of an arsenal of measures by the Central Bank backed by the announcement of a TRY 100 billion fiscal package (2.3% of GDP).

The Central Bank was the first to react, acting to protect the liquidity of the banking system and prevent both a contraction in credit and an increase in business payment defaults. The first element of its response was to cut its policy rate by 100 basis points, to 9.75%. This marked the continuation of a monetary easing cycle that began in July 2019 (cumulative 1425 basis points cut since then) and is now likely to continue.

The Central Bank then cuts its reserve requirement coefficient on foreign currency deposits by 500 basis points for banks that meet the credit growth constraints, thus freeing up USD 5.1 billion in foreign currency liquidity for the banks. Moreover, banks can use the Reserve Option Mechanism, which acts as an automatic countercyclical stabiliser allowing taking foreign currency liquidity when needed. This mechanism allows banks to keep a certain percentage of their lira reserve requirements in foreign currency or in gold. If needed, they can draw on these currencies. During the 2018 crisis, this made USD 30 bn available to them (of the USD 49 bn of reserve requirement in blocked accounts held in foreign currencies). At the end of March 2020, these reserves stood at USD 23 bn and were already coming into use by banks.

Meanwhile, the Central Bank has introduced dollar, euro and gold swap lines (at a rate 125 bp below its policy rate). It has announced TRY 60 bn (USD 9 bn) in credit lines to exporters and a 90-day extension of maturities for rediscount credits due to mature before 30 June (covering a total volume of USD 7.6 bn of credits), among other measures. It also announced that it would buy government debt in order to help finance the growing unemployment benefit system deficit and that it would accept asset-back securities and mortgage-backed securities as collateral in TRY and foreign currency Central Bank operations.

On top of this, the government extended the maturities on bank debt at all companies affected by COVID-19 by 90 days. Other major measures included the deferral by 6 months of VAT and social security contribution payments for the worst affected sectors (tourism, retail, metals, automotive, textiles) and the doubling from TRY 25 bn to TRY 50 bn of the loan guarantee fund.

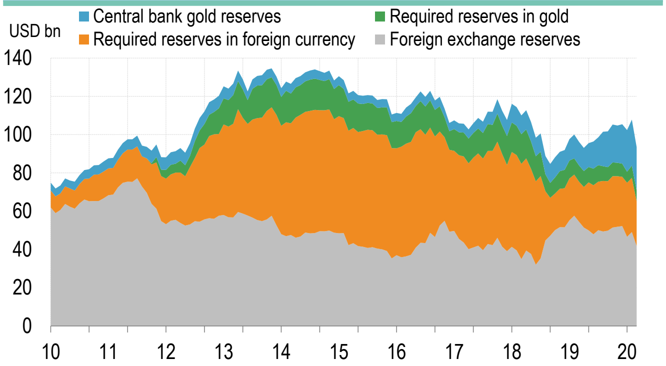
A relatively contained government debt ratio is an asset

There are no major worries about the public finances, despite the expansionist fiscal policy implemented since 2018. Nominal GDP growth had been strong (14% in 2019), wiping out the effect of a bigger budget deficit on the debt/GDP ratio.

It is likely that fiscal policy will remain highly supportive, particularly in tackling the social impact of COVID-19 (unemployment, healthcare costs), given that unemployment remains high (13.7% of the active population in the final quarter of 2019). Given the fiscal measures announced, and the expected adjustment of the automatic stabilisers, the deficit is likely to reach 7% of GDP, taking government debt towards 35% of GDP by the end of 2020. Whilst this would be a significant increase, the absolute ratio remains relatively low. It also remains likely that the government will extend its support measures to a larger number of sectors, as the fall in business levels spreads across the economy, resulting in a fresh increase in the budget deficit.

The Turkish policy mix is focused on maintaining significant credit growth, which helps support nominal GDP growth and facilitates public and private debt repayment. As a result, it is highly likely that the Central Bank will continue to cut its policy rate, maintaining negative real interest rates. The Turkish lira looks set to continue its depreciation trend with a significant likelihood that it will once again break through the threshold of TRY7 per dollar before the end of 2020. This would limit the imported disinflation from lower oil prices (which we expect to average USD 38/barrel over 2020, compared to $65 on average in 2019).

3- Decomposition of Turkish foreign exchange and gold reserves



Source: Central Bank

Lower oil prices are likely to boost the current account surplus in 2020, taking it to a rarely seen level of about 3% of GDP. However, a contraction of capital flows is also likely. If the rollover rate of the external debt of non-financial and banks is at least 70%, the downward pressure on currency reserves should be kept under control. This is an important factor given that reserves were only USD 43 bn in March 2020, excluding banks' required reserves held in foreign currencies.

According to the IIF, with just USD 2 bn of payments on dollar-denominated bonds, pressure on foreign currency liquidity will not come from the public sector. Instead it could come from Turkish banks and non-financial companies, with payments due of USD 10.5 bn and USD 12 bn respectively. Any difficulties in refinancing future payments could further increase credit risk.

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Romania

Walking on a tightrope

Romania's economy has become gradually unbalanced in recent years, ending 2019 with significant twin deficits, i.e. both a fiscal deficit and a current account deficit. An accommodative fiscal policy has stimulated growth and should continue to do so. Even so, Romania will not avoid a contagion effect due to the COVID-19 pandemic's economic fallout. The country is bound to slip into recession even though growth has already dwindled. Though foreign currency liquidity is still sufficient, its relatively low level could constrain monetary policy: a stable exchange rate is key for an economy that still has a significant amount of euro-denominated debt, albeit much less than before.

Romania will not avoid recession

In 2019, Romania's economy showed a few signs of cyclical overheating, with strong wage pressures (+11.6% y/y in November 2019), a resolutely expansionist fiscal policy, and a current account deficit that swelled to 4.7% of GDP in 2019.

Before the COVID-19 shock, however, growth was already beginning to wind down, notably due to the slump in the European automobile sector (23% of Romania's merchandise exports), which carried over to Romania's industrial production, with automobile production declining 4.3% y/y (3-month moving average for the period ended 31 January).

According to cyclical surveys available through March, household spending should weaken as consumers take into account their past and future loss of purchasing power, which should lead them to scale back plans for durable goods purchases. In 2019, household consumption contributed 4 percentage points (pp) of the country's 4.2% growth.

The COVID-19 shock will squeeze exports, which have already been in the midst of a slowdown (+1.9% in 2019 vs. +8.1% in 2018). Sluggish European demand (77% of Romania's merchandise exports) was already accompanied by plant closures, especially in the automobile sector. The expected decline in exports is likely to cut GDP growth by 4 percentage points. Faced with this environment, investment should contract by nearly 10% in 2020, after increasing 5.6% a year during the two previous years. Wage growth is also expected to halt abruptly, straining household consumption. Tourism will also be affected, but at 3% of GDP, its weighting is relatively small despite the sector's vibrant growth in recent years.

All in all, Romania is likely to report negative growth in 2020, estimated at -4.8%. Running a current account deficit, however, growth is dependent on the international situation, notably for financing. The main cyclical support factor will be the decline in oil prices, which are expected to average USD 38 a barrel this year, down from USD 65 in 2019. This should help hold down inflation to 2.8%, which would give monetary policy a little more leeway.

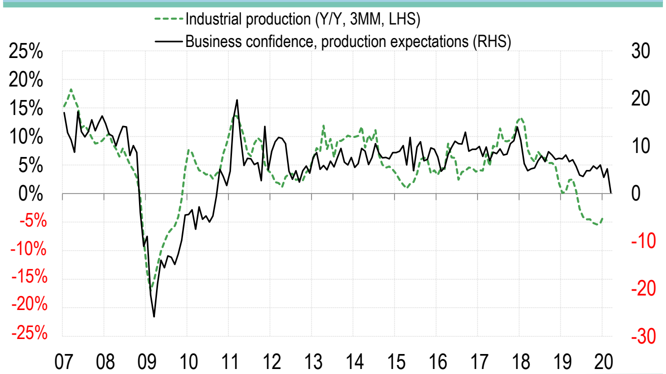
Yet the existence of major twin deficits at a time when financing will be much harder to secure implies a downside risk in terms of economic growth.

1- Forecasts

	2018	2019	2020e	2021e
Real GDP growth (%)	4.5	4.2	-4.8	6.3
Inflation (CPI, year average, %)	4.6	3.8	2.8	3.0
Budget balance / GDP (%)	-3.0	-4.2	-7.5	-5.9
Current account balance / GDP (%)	-4.4	-4.7	-1.9	-3.6

e: BNP Paribas Group Economic Research estimates and forecasts

2- Industrial production and production expectations



Source: Eurostat, DG Ecfin

Fiscal policy further at play

In 2019, Romania's public finances were marked by a fiscal deficit of 4.2% of GDP, which exceeds the 3% limit set down in the European treaties. The prospects of another budget overrun would have triggered an excessive deficit procedure. But with the COVID-19 crisis and the fiscal policy responses EU member states have taken, there is likely to be more leniency towards the 3% rule. Consequently we expect to see Romania's fiscal deficit continue to widen.

The first reason is that the ruling coalition led by Prime Minister Ludovic Orban's National Liberal Party (PNL) managed to stay in power, and a new government was formed in March 2020 (legislative elections are scheduled for December 2020). Last year's decision to increase pensions by 40% should take effect in September 2020. The second reason is the economic stimulus package that was adopted to cope with the impact of the COVID-19 crisis (2% of GDP). The stimulus includes funding for partial unemployment (to maintain 75% of wages), guaranteed loans for

SME (RON 10 bn initially, 1% of GDP), and the deferral of corporate tax payments due in the second quarter.

The government has also postponed loan repayment scheduled for companies and households for the next nine months, and stipulated that the cost of the measure would be carried by public finances, and not the banks, which would not need to set aside provisions. This is an important measure because it ensures that Romania's banking sector will have the capacity to absorb the rise in non-performing loans. Non-performing loans are still substantial, accounting for 4.6% of loans outstanding in Q3 2019, even though they have fallen sharply from the 2013 peak of 22% of loans outstanding. The reduction in the loan to GDP ratio (from 40% in 2008 to 26% at year-end 2019) is a risk-mitigation factor, but it must be paired with another risk factor: the steady increase in household loans (+27% over the past three years).

The Central Bank has also cut its key rate by 50 basis points to 2%, and narrowed the interest rate corridor. This reduced the Lombard rate, the key lending rate, by 100 bp to 2.5%, which is designed to help pull down interbank rates. It also implies the stability of the deposit facility rate (1.5%), to avoid penalising the Romanian leu exchange rate (RON). Despite a few ups and down, the leu had only lost 1% against the euro at the end of March 2020 compared to year-end 2019. The central bank also declared that it would provide the banking system with as much liquidity as necessary, via repo operations and purchases of RON-denominated public debt, to maintain liquidity at satisfactory levels. The central bank also said it was considering easing monetary policy further, either through policy rate cuts or lowering the required reserve ratio of banks.

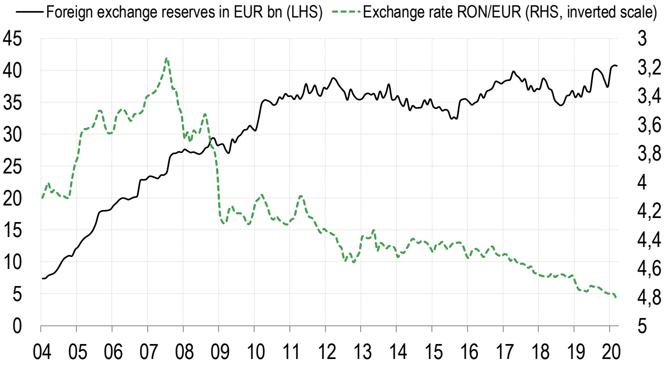
Twin deficits are limiting policy mix leeway

The public deficit is expected to widen sharply in 2020, to -7.5% of GDP, reflecting fiscal policy measures but also the impact of the probable increase in unemployment (4% of the active population at year-end 2019). Romania's twin deficits increase its vulnerability to a deterioration in financing conditions: 10-year yields on government local currency bonds rose to 5.8% on 16 March. Central bank purchases of public debt helped stabilise rates at 4.8% at the end of March, which is still high (close to the March 2019 level, even though inflation is lower now).

Until 2019, however, the widening of the fiscal deficit did not have a very big impact on the level of the public debt (36% of GDP in 2019), mainly because nominal growth was sufficient to stabilise the debt ratio. Things will be different in 2020 as the deficit widens and nominal growth declines. The public debt ratio could rise to 40% of GDP, which is still a reasonable level.

Yet the sharp drop in oil prices will reduce the current account deficit significantly, on top of a volume effect (fewer imports due to a contraction in domestic demand, notably due to a decline in investment). As a result, we are looking for a current account deficit of only 1.9% of GDP in 2020, vs 4.7% in 2019. This will limit the risk of a decline in foreign reserves, offsetting a possible contraction in capital flows. In September, Romania's sovereign debt will be incorporated in the Barclays Global Aggregate index, which should

3- Foreign exchange reserves and exchange rates



Source: CEIC

be supportive. Yet there is also the risk that the rating agencies could downgrade its sovereign rating due to the wider fiscal deficit.

Our central scenario still calls for a mild depreciation in the exchange rate towards RON 5 to the euro by the end of 2020 (from RON 4.83 at the end of March), even if there is further monetary easing. If the leu were to depreciate significantly, the risk would be much more moderate for households, whose foreign currency debt has declined from 60% of total household debt at year-end 2014 to 24% at year-end 2019. For non-financial companies, 42% of domestic credit is still denominated in foreign currencies (essentially the euro).

At 50% of GDP at the end of 2019, external debt has been cut back sharply thanks to debt reduction efforts following the 2013 crisis. It has begun to rise again in recent years for two reasons: government borrowing (EUR 40 bn in external debt) and intercompany loans (EUR 32.7 bn). Adding short-term debt to long-term debt reaching maturity in 2020, the total amount of external debt maturing in 2020 reaches USD 56 bn, the majority of which are intercompany loans. In a central scenario in which the financial consequences of the COVID-19 crisis remain moderate, this debt should be rolled over (since these loans are often tied to foreign ownership).

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Indonesia

A violent shock hits a solid economy

The Covid-19 crisis will have a huge impact on an economy that was already weakened slightly by the slowdown in global trade in 2019. Yet Indonesia's macroeconomic fundamentals are strong: its public finances are solid, the banking sector is robust and both companies and households have very little debt. The country has sufficient foreign reserves to cover its short-term financing needs. Yet the rupiah is bound to remain under fierce downward pressure: the current account deficit is only partially financed by foreign direct investment, and capital outflows have reached unprecedented levels since 31 January.

Growth

GDP growth slowed to 5% in 2019 from 5.2% in 2018. This is mainly due to the downturn in corporate productive investment in the midst of a sharp slowdown in global trade and falling commodity prices (attributable to US-China trade tensions). In Q1 2020, economic indicators suggest that growth will continue to slow. Industrial output contracted in January, and the ongoing decline in capital goods imports (for the 14th consecutive month) does not augur well for a rebound in investment. Retail sales also contracted in February for the third consecutive month, while automobile and motorcycle sales plunged.

Indonesia will not be spared from the economic fallout of the COVID-19 pandemic. At least it is less exposed to the slowdown in global trade than the other ASEAN countries like Malaysia, because it is not very integrated in global supply chains. The COVID-19 crisis will affect the economy via several channels: 1) the contraction in tourism, 2) the drop-off in commodity prices, and 3) the decline in domestic demand (especially as confinement measures are enforced).

The pandemic's impact on tourism revenues will not be as strong as for the other ASEAN countries like Thailand, since tourism accounts for only 1.4% of GDP. Even so, a 50% decline in tourism revenues would generate a 0.7 percentage point (pp) decline in GDP growth.

A 2 pp slowdown in world trade would trigger an 11% decline in Indonesian exports (which account for 20.7% of GDP), resulting in a 2.3 pp decline in GDP growth. Commodity prices fell sharply in Q1, with oil prices down 60%; palm oil, -22%; rubber, -6%; coal, -21%; and copper, -22%. This trend is expected to continue in Q2, placing a tight squeeze on corporate earnings and investment.

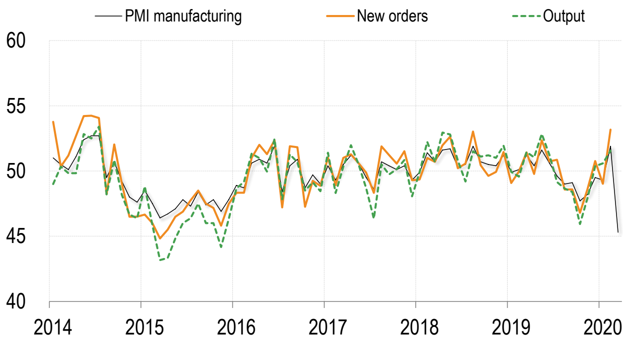
So far, the population has not been in lockdown, but if the coronavirus were to spread, stricter confinement measures would have to be introduced. A lockdown would have severe economic and social consequences that would be hard to alleviate given the importance of informal employment (55% of the labour market). In 2019, household consumption contributed more than 54% to growth. Assuming household consumption contracts in Q2 before rebounding thereafter in Q3, and assuming investment projects (29% of GDP) are postponed by companies until Q4 and by the government until 2021, then growth could slow by 4 pp to 1% before rebounding in 2021. If the coronavirus were to spread far and wide,

1- Forecasts

	2018	2019	2020e	2021e
Real GDP growth (%)	5.2	5.0	1.0	5.4
Inflation (CPI, year average, %)	3.3	2.8	2.3	2.7
Fiscal balance / GDP (%)	-1.8	-2.2	-5.1	-3.0
Current account balance / GDP (%)	-2.9	-2.7	-2.2	-2.0

e: BNP Paribas Group Economic Research estimates and forecasts

2- PMI manufacturing index: strong decline in March



Source: Markit

however, growth could contract at -0.4% according to the ministry of finance.

Support measures

Since the beginning of the crisis, the monetary authorities have lowered the policy rate by 50 bp to 4.5%. However, the central bank kept its key interest rates steady in April in order to sustain the rupiah.

Monetary authorities also lowered the required reserve ratios for commercial banks from 8% to 2%. Swap operations will be carried out every day to meet USD liquidity needs. As to fiscal policy, the government announced three economic stimulus packages for a total of nearly IDR 436 trillion (2.7% of GDP). Moreover, the government temporarily scrapped the fiscal deficit ceiling of 3% of GDP.

Key measures include the exemption of manufacturing sector employees from income taxes and a 30% corporate tax rebate for six months starting in April. Food subsidies for low income households will be expanded to cover 15.2 million individuals on 1 April.

Public finances remain solid

Indonesia's public finances are very solid. In 2019, the fiscal deficit and government debt were limited to 2.2% and 30.1% of GDP, respectively. Yet the slowdown in domestic activity and the contraction in foreign trade will strain government revenues. In the first two months of 2020, the fiscal deficit has already widened by 15% compared to the same period last year. The fiscal deficit is projected to reach 5.1% of GDP in 2020 but it could exceed this new target if the pandemic lasts for more than six months. The public debt ratio is also mild at 30.1% of GDP, but more than 60% is held by non-resident investors, and nearly 38% is denominated in foreign currencies, the vast majority in USD. Even so, from a 2020 horizon the refinancing risk is small because debt servicing amounts to only USD 10.2 bn, equivalent to 8.1% of foreign reserves.

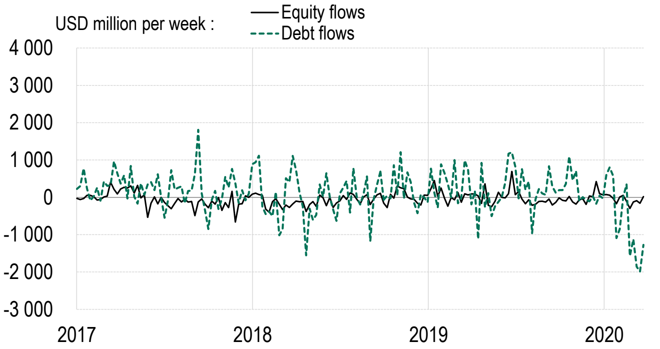
Refinancing risks are small

In Q3 2019, the debt ratio of households and non-financial companies was moderate at 17.8% and 22.7% of GDP, respectively, according to BIS data. According to the central bank, the situation of non-financial companies was satisfactory in 2019, even though it was weakened by the slowdown in global trade and declining commodity prices. In June 2019, the debt-to-equity ratio was still moderate at 0.58. Corporate assets covered commitments 1.86 times and the liquidity ratio was 1.21. Companies had satisfactory coverage of their debt servicing charges, with a debt coverage ratio of 70.5%, while earnings were 2.9 times interest payments alone. Yet the situation varies widely depending on the sector. Companies in the agricultural sector, and to a lesser extent the water, gas and electrical power utilities, were considered to be more fragile at year-end 2019.

Depreciation of the rupiah will automatically revalue the country's foreign currency debt. Since the beginning of the coronavirus outbreak, the rupiah has depreciated by more than 18% against the US dollar. Yet only 51% of corporate debt is denominated in foreign currencies. According to the IIF, international corporate bonds reaching maturity amount to only USD 5.3 bn in 2020 and USD 6.4 bn in 2021. International loan payments are much higher, estimated at an average of USD 17 bn in 2020 and 2021. On the whole, however, Indonesian companies can meet their payments on international debt denominated in foreign currency. The monetary authorities adopted strict regulations requiring companies to cover their foreign exchange risk as of 2015 (which were strengthened in 2016). In Q3 2019, the central bank estimated that 88% of companies had covered 90% of their positions. The most fragile companies are in construction, real estate, media and retailing, sectors that do not generate foreign currency revenues.

Lastly, the banking sector is also solid and has the capacity to handle an increase in credit risk. The doubtful loan ratio was only 2.5% of total loans outstanding at year-end 2019. Solvency ratios were very satisfactory, with a capital adequacy ratio (CAR) of 23.3%.

3- Significant capital outflows since January 31



Source: IIF

The rupiah is under fierce pressure

Indonesia is vulnerable to an external shock because commodities (excluding food) account for 51% of exports. It also depends on non-resident portfolio investments to finance the current account deficit (2.7% of GDP in 2019), because foreign direct investment (FDI) is insufficient (1.8% of GDP in 2019). Since 31 January, however, portfolio investment outflows have swelled to USD more than 11 bn according to IIF, compared to net inflows of USD 12 bn in 2019. In the short term, the rupiah is likely to remain under strong downward pressure, even though the current account deficit is contracting due to the decline in oil imports and the slowdown in domestic demand. Indonesia had foreign reserves of USD 113 bn at the end of March, which will largely suffice to cover the country's short-term financing needs.

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Philippines

Stopped in mid flight

The coronavirus crisis has hit a fast-growing economy, which expanded by more than 6% year-on-year in H2 2019 and looked set to continue at the same pace in 2020. The pandemic and the very strict lockdown imposed by the Duterte government will cause all the engines of growth to seize up: production will stop in the country's economic centre, the fall in domestic demand will be exacerbated by reductions in remittances from workers abroad and losses in the informal economy, tourism will collapse and exports of goods and services will follow suit. This is a substantial shock, but the strong macroeconomic fundamentals and the modest level of government debt give the authorities scope to introduce support measures.

The Philippines has enjoyed solid economic growth in recent years, driven by robust domestic demand and an expansion of the export base. Between 2012 and 2019, real GDP growth averaged 6.5% per year. It slowed to 5.5% year-on-year (y/y) in H1 2019 primarily due to a dip in investment, but then rebounded in H2 2019, reaching 6.2% y/y. This trend was set to continue into 2020 before it was brutally interrupted by the shock from the coronavirus epidemic.

The government imposed very strict lockdown measures in mid-March. The whole of the island of Luzon and its capital Manila were placed into quarantine for at least a month. As a result, economic activity is at a standstill in this region, which is home to 56 million people (53% of the country's population) and accounts for 73% of GDP (with Manila accounting for 36%). The health crisis will also have repercussions for sectors dependent on international demand, particularly tourism as well as remittances from workers abroad, which represent a significant source of support for domestic household consumption. As a result, all the private-sector engines of the Philippines' growth will be significantly weakened from March onwards. The economy could go into recession in S1 2020, before recovering gradually once the epidemic has passed its peak. The stimulus measures introduced by the authorities will be key in determining the pace of this recovery. We project real GDP growth at only 2% in 2020, the slowest rate since the crisis of 2009. Economic growth is then expected to bounce back to 6% in 2021, slightly below the Philippines' potential growth rate (Table 1).

The main engines of growth have seized up

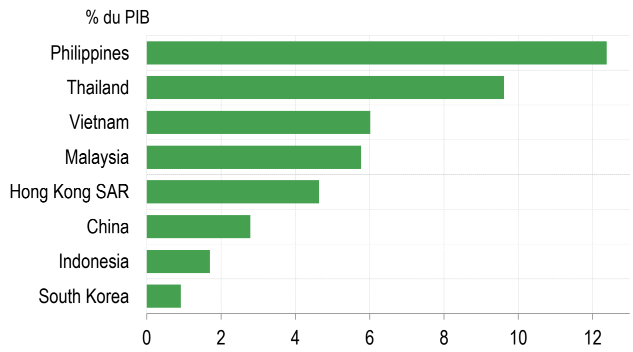
Private consumption accounts for 68% of GDP and has been the main driver of economic growth in recent years. In 2019, it rose by 5.8%, supported by the decline in inflation (from 5.9% y/y in Q4 2018 to 1.5% in Q4 2019), the strength of the labour market (the unemployment rate has continued to fall and reached 5.1%) and the strength of remittances from abroad (which reached USD 30 billion, or 8% of GDP). The lockdown in the country has produced a twin-pronged shock to consumption: firstly, households are limiting their purchases to essential goods, and secondly, they are suffering from lower incomes due to the interruption of production activity. In addition to the deterioration of the formal labour market, there will be losses in the informal sector and the probable reduction in remittances from workers abroad. The informal economy of the Philippines has shrunk over recent years but remains substantial: it still probably represents around two-thirds of employment and 30% of GDP. Household incomes are therefore likely to be lastingly weakened. As a result, after falling during the lockdown period in

1- Forecasts

	2018	2019	2020e	2021e
Real GDP growth (%)	6.2	5.9	2.0	6.0
Inflation (CPI, year average, %)	5.2	2.5	2.2	2.8
Government balance / GDP (%)	-3.2	-3.5	-4.5	-3.5
Current account balance / GDP (%)	-2.6	-0.1	-0.5	-1.2

e: BNP Paribas Group Economic Research estimates and forecasts

2- Contribution of the tourism sector to the economy



Source: WTTC, BNP Paribas

March and the early part of Q2 2020, private consumption growth is likely to recover only very gradually over the following quarters.

Activity in the tourist industry is likely to be at a standstill for several months. This sector plays a crucial role in the economy, estimated at 12% of GDP, which is the largest economic contribution of any major Asian country (Figure 2). Tourist receipts in the current account balance account for 7% of total foreign currency receipts (or nearly 3% of GDP).

Investment growth slowed markedly in 2019 (to 1.5% from 12.9% in 2018), as a result of delays in the implementation of the budget and interruptions to several public infrastructure projects, and also due to a tightening of credit conditions at the start of the year and weaker global demand prospects. Investment growth started to recover in H2 2019, particularly thanks to the resumption of construction projects, but this improvement has been stopped in its tracks by the outbreak of the virus. Despite a loosening of monetary policy, private investment is likely to remain depressed in the short term, due to the losses incurred by corporates during the health crisis and the deterioration of confidence. However, investment in public infrastructure projects is likely to recover more rapidly after the lockdown, driven by the government's "Build, build, build" programme (which projects infrastructure development spending to reach 7% of GDP in 2022, up from 3% in 2015).

Growth in exports of goods and services also started to slow in 2019 (to 3.2% in real terms, from 13.4% in 2018). Import growth fell even more sharply, and the contribution of net exports to real GDP growth was slightly positive, after four years in negative territory. In 2020, both exports and imports of goods and services are likely to contract, given the slowdown in domestic demand, the fall in world industrial production (on which sales of electronic goods and IT services from the Philippines depend), international trade and tourism.

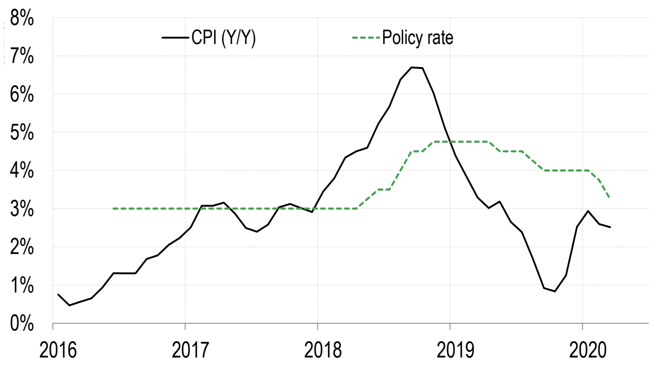
The central bank has room to act

The reduction in inflationary pressures has given the central bank (*Bangko Sentral ng Pilipinas*, or BSP) the room to ease its policy stance. Monetary policy is based on inflation-targeting, with a targeted range from 2% to 4%. Inflation has been below the 3% mark since June 2019. After a temporary uptick in December-January, it is likely to continue to weaken in the short term, due to low oil prices and weaker consumption. The BSP began to relax its monetary policy in Q2 2019, cutting its policy rate by 50 basis points (bp) between May 2019 and January 2020. Since the onset of the pandemic, it has quickened the pace of rate cuts. The policy rate was cut by 25 bp on 6 February and then a further 50bp on 19 March, taking it to 3.25% (Figure 3). Further cuts are likely in Q2 2020.

The central bank has also introduced measures to support liquidity in the banking sector and stimulate credit. Reserve requirement ratios have been lowered by 200 bp (to 12% for big banks) and prudential rules have been relaxed (such as reporting and provisioning rules). Banks have been encouraged to support their customers (reducing fees, extending repayment delays, etc.). The authorities enjoy some room to manoeuvre on the credit front as corporate debt levels are moderate (credit to the private sector represents less than 50% of GDP) and the banking sector is solid. In fact, banks have levels of liquidity and equity that are sufficiently comfortable to absorb an increase in non-performing loans (estimated at 2% of total loans in 2019). Yet, the banks will probably face episodes of stress and record a deterioration of profits in the short term. Their main sources of vulnerability come from the concentration of their portfolios on a few large local conglomerates as well as their exposure to the real estate market (which accounts for nearly 20% of total loans). Their exposure to currency risk is limited, as banks on the whole do not post currency mismatches in their balance sheets, and foreign-currency loans only account for about 10% of total loans.

Currency risk itself is limited, with the peso (PHP) supported by the spread between domestic and global interest rates, the Philippines' good macroeconomic fundamentals and the recent improvement in the current account deficit (only 0.1% of GDP in 2019). The peso appreciated slightly against the USD in 2019, and then has barely depreciated since the beginning of the health crisis in spite capital outflows. In contrast, and in line with world market trends, the Philippines' stock market suffered a very sharp correction in March (falling by 22%).

3- The central bank will cut interest rates further



Source : Central Bank, CEIC

Fiscal slippage under control

The government's initial stimulus package was small (PHP 27 billion, or 0.15% of GDP), coming on top of the public investment plan introduced in 2016. However, in response to the worsening health crisis and the growing shock to economic activity and household income, the government declared a state of emergency at the end of March and stepped up its support measures. It aims to support the healthcare sector, the most vulnerable workers and households, SMEs as well as the tourism and agriculture sectors. The budget deficit is expected to exceed 4% of GDP in 2020 (up from an initial target of 3.2%). Public finances are sufficiently solid to absorb the shock: government debt is low, it declined from 45% of GDP in 2015 to 42% in 2019, and two-thirds of it is in securities issued on the domestic market. The BSP has already announced that it will purchase government bonds for PHP 300 billion (1.6% of GDP). Therefore, the government should be in a position to cover its financing requirements in the short term, despite the correction in international bond markets (the EMBI spread on the Philippines' sovereign bonds widened from 67 bp to 280 bp in Q1 2020).

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Hong Kong

The Covid-19 crisis worsens the ongoing recession

The Covid-19 pandemic strikes an economy that has already been weakened by several quarters of decline in merchandise exports, tourism, private consumption and investment. Since February, the government has launched a major fiscal stimulus plan representing about 10% of GDP. The plan includes direct support measures in favour of corporates and households. Additional structural measures will be needed going forward, in order to fuel a sustainable rebound in private demand and bolster medium-term economic growth prospects. Thanks to abundant fiscal reserves and minimal debt, the government has comfortable manoeuvring room to pursue an expansionist policy for several years to come.

Another rude test

Economic growth has plummeted over the past two years. It dropped from 4% year-on-year (y/y) in H1 2018 to 1.9% in H2 2018 and 0.6% in H1 2019, before contracting by 2.8% in H2 2019. In Q1 2020, Hong Kong is expected to report its fourth consecutive quarter of negative quarterly growth in real GDP. The recession is likely to extend into the second quarter. Once the international environment improves, economic activity should begin to recover gradually, supported by stronger growth in mainland China and a major fiscal stimulus plan. Yet it could also continue to be hampered by persistently sluggish private-sector demand.

In 2019, and certainly also in Q1 2020, the contraction in real GDP was due to the sharp decline in both domestic demand (excluding public spending) and exports of goods and services. Private consumption plummeted in H2 2019 (-3.1% y/y, compared to +0.9% in H1 and +5.4% in 2018), disrupted by protest movements, the sharp decline in tourism inflows and the deterioration of the labour market. The situation abruptly worsened in February after confinement measures were enforced in mainland China and Hong Kong. Between August 2019 and January 2020, retail sales fell by more than 20% y/y each month, before collapsing by 47% in February (chart 2). Tourist inflows dropped to fewer than 200,000 visitors in February whereas Hong Kong still hosted 3.2 million visitors a month on average between August 2019 and January 2020 (down from 5.8 million visitors a month in H1 2019). Activity in the tourism sector is expected to remain at a standstill for several more weeks or even months. The impact on the economy will be significant: spending by tourists (78% of which were from China) in local retail shops accounts for about a third of Hong Kong's retail sales, and tourism accounts for an estimated 4.5% of GDP.

The downturn in the labour market was moderate in 2019, but is expected to worsen in H1 2020, restraining the rebound in private consumption. Employment and real wages dipped slightly in H2 2019. The unemployment rate rose from 2.8% in mid-2019 to 3.3% at year-end 2019, before hitting 3.7% in February 2020. Last but not least, the equity market correction (the Hang Seng index plunged 16% in Q1 2020) and the decline in real estate prices (-6% since mid-2019) should fuel negative wealth effects that will weigh on household consumption in the short term.

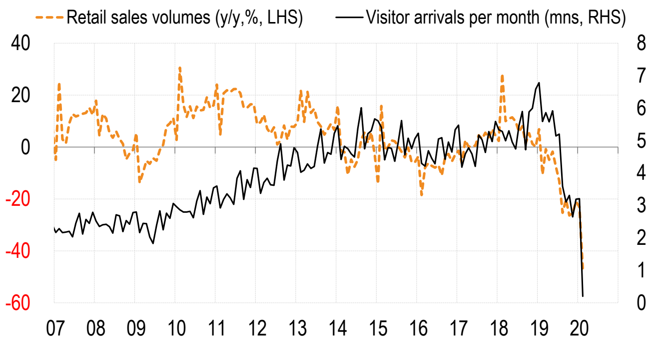
1- Forecasts

	2018	2019	2020e	2021e
Real GDP growth (%)	2.9	-1.2	-2.5	3.9
Inflation (CPI, year average, %)	2.4	2.9	2.1	2.4
Budget balance / GDP (%)	2.4	-1.3	-10.0	-5.8
Current account balance / GDP (%)	3.7	3.5	2.5	3.0

* Fiscal Year from April 1st of year N to March 31st of year N+1

e: BNP Paribas Group Economic Research estimates and forecasts

2- Tourist arrivals and retail sales: free fall



Source: CSD, Hong Kong Tourism Board

Investment collapsed in 2019 (-12% vs. +2% in 2018), pulled down by the erosion of business sentiment and economic growth prospects. The situation is likely to have deteriorated further in Q1 2020 due to the decline in economic activity and corporate losses. Private investment should remain depressed in the quarters ahead.

The contraction in tourism, global trade and China's external trade led to a decline in Hong Kong's exports and imports of goods and services in 2019. These trends will continue in 2020. Merchandise exports (99% of which are re-exports) were down 4% in 2019, and declined another 12% y/y in the first two months of 2020. In net terms, however, external demand made a positive contribution to real GDP growth (of 2.3 percentage points) in 2019, after making negative contributions in the three previous years.

Fiscal policy is increasingly expansionist

The government adopted a clearly expansionist fiscal policy in 2019 to address the contraction in private demand and the deterioration in business sentiment and household confidence. The 2019/20 budget included tax cuts, increased social welfare spending, and new investments in infrastructure, innovation and the development of technological hubs. Faced with the shock engendered by the coronavirus epidemic, the government announced two new, large stimulus packages in February and then in early April. The plans mainly call for one-off measures to curb the decline in domestic demand in the short term. In the future, the government will also need to round out its fiscal policy with more structural measures that aim to improve the social welfare system and improve access to housing, which would bolster private consumption and strengthen medium-term growth prospects.

The fiscal stimulus plan for 2019/20 accounted for 1.3% of GDP. The new stimulus packages introduced since February account for 10% of GDP. They aim, first, to strengthen Hong Kong's capacity to combat epidemics with the creation of a new Anti-Epidemic Fund (HKD 30 bn, or 1% of GDP) and, second, to support corporates and households in order to offset their revenue loss, boost domestic demand and encourage a rapid rebound in activity. The measures include: 1) cash payout of HKD 10,000 (nearly USD 1,300) to each permanent resident aged 18 or above, for a total of HKD 71 bn (2.5% of GDP); 2) tax and fee reliefs and other one-off relief measures (public services, rent for low-income housing…) for a total of HKD 81 bn (2.8% of GDP); 3) an employment subsidy scheme aimed at helping employers to pay wages for a period of six months (HKD 80 bn, or 2.8% of GDP); 4) relief measures for a list of specific sectors hit by the epidemic (tourism, construction…) for a total of HKD 21 bn or 0.7% of GDP; and 5) temporary job creation (HKD 6 bn, or 0.2% of GDP).

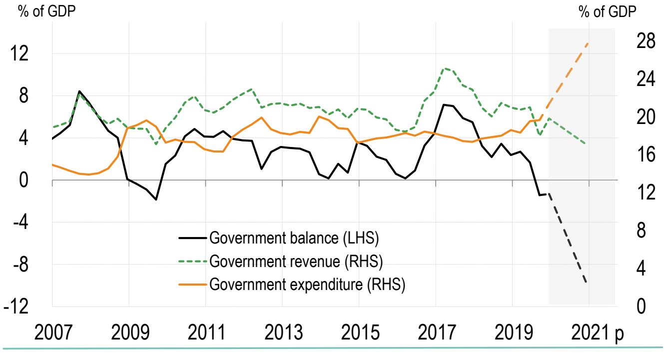
Hong Kong's monetary policy has also been loosened. Given the Currency Board arrangement, the Hong Kong Monetary Authority follows decisions of the US Fed. As a result, the base rate was cut from 2% to 0.86% in March. The authorities have also introduced lending programmes for SMEs (with low interest rates and state guarantees) and eased the prudential standards of banks to encourage them to cover corporate and household financing needs in the short term.

Public finances are solid enough to weather the shock

The government is expected to report a deficit of 1.3% of GDP in fiscal year 2019/20 (ended 31 March 2020): this would be its first deficit since 2003. In fiscal year 2020/21, the deficit could swell to 10% of GDP. The deficit should narrow thereafter as economic growth recovers and the government adjusts its fiscal policy. Even so, the government expects public finances to continue to report deficits over the next five years.

In fiscal year 2019/20, government revenue contracted by 5% and represented less than 20% of GDP (preliminary estimate), as tax revenues were hit by the recession, the equity market correction

3- Fiscal balance will now remain in deficit



Source: Hong Kong Treasury, BNP Paribas

and the property market downturn. Government expenditure increased by 15%, with an acceleration in Q1 2020 due to the first measures of the new stimulus package. In fiscal year 2020/21, revenue should decline significantly, while spending will continue to rise and reach a record level close to 28% of GDP, vs an average of 19% of GDP over the past five years (chart 3). The government has substantial manoeuvring room to absorb some slippage in its deficits in the short and medium term. Thanks to a solid tradition of fiscal discipline, it has reported surpluses over the past 15 years, despite the volatility of fiscal revenues (which rely on taxes, stamp duties and land premium). As a result, the government has managed to build up very comfortable fiscal reserves. In fiscal year 2019/20, reserves accounted for 39% of GDP and 23 months of fiscal spending (compared to 13 months in 2004/05). These reserves will be used to finance part of the upcoming deficits, which means they will diminish in the years ahead. Fiscal reserves should narrow to less than 15 months of fiscal spending by the end of fiscal year 2020/21, which still provides a very comfortable safety buffer. The central government could also opt for bond issues. It has a minimal debt burden, which is more than covered by assets: its 2004 international bond issue matured in 2019; and the bonds issued as part of a local market development programme (which are not used to finance the budget) account for less than 5% of GDP.

In contrast, corporate debt is very high (226% of GDP at end-September 2019) as is household debt (79%), which makes them a source of vulnerability in the current environment. Some will find it increasingly difficult to meet loan payments despite the relief offered by the authorities and creditors. Banks' average performance is likely to deteriorate in the months ahead, but the Hong Kong financial system as a whole is solid. Banks have sufficiently strong equity capital and liquidity to weather the shock.

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Egypt

Resilient economy: at least in the short term

The impact of the COVID-19 pandemic on the Egyptian economy will be significant and will result in a sharp economic growth slowdown this year. Growth is nevertheless likely to remain positive. In the short term, the expected deterioration in public finances is sustainable, and the government can deal with a temporary downturn in international investors' appetite for Egyptian debt. Foreign currency liquidity across the whole banking system has improved significantly in recent months, supporting the pound in the currency market. As a result, the financing of the current account deficit, repayment of foreign debt and the ability to cover massive capital outflows are all guaranteed for the short term.

Economic support measures

Faced with the COVID-19 pandemic, the government has so far taken measures to restrict movement and activity, but no confinement measures as such. All flights have been suspended. Economic support measures have come first in monetary form, with a 300 basis point cut in the Egyptian Central Bank's (CBE) policy rate. This took the CBE deposit rate from 12.25% to 9.25%. The CBE has also announced a number of measures aimed at the banking sector with a view to supporting economic activity, including the postponement of credit payments for six months for individuals and companies, a debt relief initiative for individuals at risk of default, a cut in the preferential interest rate reserved for targeted debtors, and the creation of a guarantee fund to back the tourist sector. Meanwhile, the government has introduced support measures for the private sector (loans at subsidised rates for industry, support for the hotel sector, direct support to certain households) for the equivalent of around 2% of GDP.

Sharp economic growth slowdown is expected

The economic growth slowdown will be substantial, but the structure of the Egyptian economy will help limit its extent. The sectors most vulnerable to the consequences of the epidemic, where the impact on growth will be significant, are manufacturing (16% of GDP), construction and real estate (16% of GDP) and tourism[1]. This sector only represents a small share of GDP (around 3% of the total), but its contribution to GDP growth has been significant in recent quarters, accounting for around 1 point out of total GDP growth of 5% to 6%. The extractive industries, agriculture, communications and healthcare (around 25% of GDP in total) are likely to be relatively less affected.

In fiscal year (FY) 2018/2019, real GDP growth was 5.6%. This pace was maintained in H1 2019/2020. In Q3 2019/2020, estimated growth was still largely positive albeit somewhat slower (we expect a figure of 5.0% y/y). To date, the economy has been relatively little affected by the international slowdown given the limited integration in international value chains. Restrictions on economic activity were introduced in March 2020 and will therefore mainly affect the final quarter of FY2019/2020 (-4.1% y/y). In FY2019/2020 as a whole, real GDP growth is likely to drop sharply but remain positive at 2.6%.

[1] According to the Ministry of International Cooperation, since the onset of the crisis, inbound tourism reservations have dropped by 80% in comparison to the same period last year.

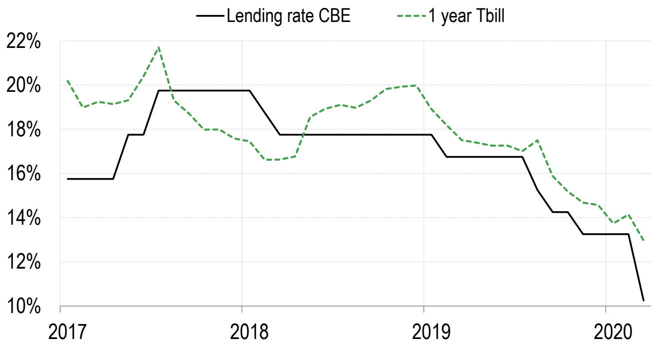
1- Forecasts

	2018	2019	2020e	2021e
Real GDP growth (%)	5.3	5.6	2.6	3.4
Inflation (CPI, year average, %)	21.5	13.4	5.9	7.5
Gen. Gov. balance / GDP (%)	-9.5	-8.0	-9.2	-9.8
Current account balance / GDP (%)	-2.0	-3.6	-4.1	-4.0

(*) Fiscal years T-1/T (July-June)

e: BNP Paribas Group Economic Research estimates and forecasts

2- Monetary easing and yields on Tbills



Sources : CBE, MoF

The economic consequences of the health crisis are likely to persist at least into the early months of FY2020/2021 and will affect the high season for tourism. At the same time, the fiscal capacity to support and revitalise the economy is constrained, whilst the drop in consumer living standards could limit the scope for recovery. Real GDP is expected to grow by 3.4% in FY2020/2021.

Stable inflation

In the short term, trends in consumer prices are likely to be influenced by two opposing factors: the inflationary effects of the possible disruption of the food supply chain (40% of the consumer price index), offset by the impact of lower oil prices. Prices for all oil products (apart from butane) are now linked to market prices, given the complete removal of subsidies. They are likely to be reviewed downwards for Q4 2019/2020. Overall, we are not making any significant changes to our inflation estimate, which we put at an annual average of 5.9% for FY2019/2020.

A sustainable fiscal position

The direct support fiscal measures announced so far remain relatively limited (around 2% of GDP) and will fall mainly in FY2020/2021. In addition, falling oil prices will reduce the subsidies for butane (other energy subsidies have already been removed), but this will have only a very marginal effect on total spending.

On the revenue side, direct and indirect tax income will fall, as will revenue from the Suez Canal (6% of government revenue in FY 2018/2019). Although the fall in revenue will directly affect the final quarter of the current fiscal year, stimulus spending will be spread over a longer period. Having been in surplus at 1.35% of GDP in FY2018/2019, the primary budget balance is likely to turn negative this year, at -0.3% of GDP. In FY2020/2021, the primary balance is likely to be in deficit by -1.8% of GDP, given the need for fiscal support to the economy and the fall in receipts.

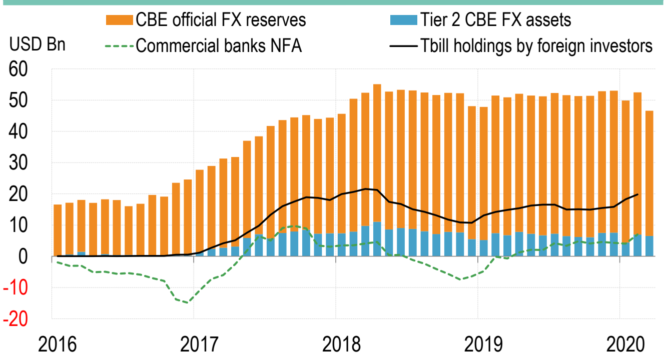
The hard-to-curb debt interest payments (47% of total revenue in FY2018/2019) are the main reason for significant and persistent budget deficits. The cut in the CBE's interest rate should reduce interest payments by 0.3% of GDP over a full year (they were equivalent to 9.5% of GDP in FY2018/2019). The potential savings linked to a cut in interest rates (a 100 bp cut is equivalent to around EGP 8 billion to EGP 10 billion in savings) will be partially offset by an increase in the rates on the treasury bills market due to increasing risk aversion, and reduced liquidity as a result of the withdrawal of foreign investors. As a result, the total budget deficit is likely to increase this year to some 9.2% of GDP.

Whilst the budget deficit remains under control, its financing will be ensured, despite the increasing scarcity of external financing. The liquidity of the local banking system appears sufficient to cover financing needs. Total CBE liabilities linked to open-market operations were equivalent to 13% of GDP in February 2020. The fall in yields on these transactions could encourage banks to turn instead to government securities.

Foreign currency liquidity is resilient

The consequences of the oil price fall for external accounts are mixed. By volume, the country is a net importer of oil products (both crude and refined) and has returned to a position as a net exporter of LNG (although in limited volumes). By value, the total hydrocarbon balance has been slightly negative during 2019, reflecting a lag between value and volume, which is linked to the nature of the agreement between the Egyptian national oil company (EGPC) and international oil companies. The expected collapse in oil prices in 2020 is likely to have a slightly positive effect on the trade balance. Conversely, the tourist sector is likely to be hit hard and we estimate that tourism revenues could fall by around 25% in FY2019/2020, before recovering in FY2020/2021 but without returning to the level of USD 12 billion achieved in FY2018/2019. Similarly, private transfers from expatriates are likely to be severely affected by the sharp economic slowdown in the Gulf, whilst Suez Canal receipts will suffer from the contraction of global trade and the fall in the oil price. The current account deficit is likely to increase to 4.1% of GDP in FY2019/2020 and then 4% in 2020/2021.

3- Banking system external liquidity



Source: CBE

In the short term, the foreign currency liquidity situation remains acceptable, even if confronted by capital outflows. In other words, the total of the current account deficit (USD 13 billion over a full year), amortisation on foreign debt (USD 7 bn in 2020) and those on T-bills held by foreign investors (around USD 20 bn in February 2020) is more than covered by total foreign currency assets held by the banking system as a whole. The net foreign asset position of commercial banks was positive to the tune of USD 7 bn in February 2020, whilst the CBE's foreign currency holdings currently stand at USD 47 bn (end-March 2020) if we add Tier 2 reserves (intended to cover part of portfolio flows) to official reserves.

However, although the external position appears solid for the short term, the worsening of the current account deficit and the likely reduction in portfolio inflows could bring to an end the pound's appreciation. Yet a number of factors are likely to limit any depreciation: a local debt market that remains attractive to international investors; foreign investment in the energy sector, although it could suffer from the depressed state of the oil market; and the renewed support of the Gulf monarchies should it be needed.

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United Arab Emirates

Towards a new crisis in Dubai?

As the most diversified economy of the Gulf countries and a major oil producer, the United Arab Emirates faces a double shock: the economic fallout of the COVID-19 pandemic and plummeting oil prices. The current situation risks accelerating the real estate market crisis in Dubai, which has been developing for several years, eroding the financial health of companies in the construction and services sectors. As credit risk rises, it will place a negative strain on banks. Although public finances seem healthy enough to handle the decline in oil revenues, public debt is bound to rise. The UAE's solid external position guarantees the dirham's peg to the US dollar.

An economy hit on two fronts

Like all of the economies of the Gulf countries, the United Arab Emirates (UAE) is currently being hit by a double shock: the fallout of the COVID-19 pandemic and the drop in oil prices. The structure of the UAE economy makes it particularly sensitive: Abu Dhabi is a major OPEC oil producer, and Dubai is especially dependent on tourism and the real estate sector. To slow the pandemic's spread, a number of restrictions were imposed on non-essential travel and economic activity.

For the moment, fiscal stimulus measures have been rather moderate at about 2% of GDP. They are comprised essentially of tax cuts, higher subsidies for water and electricity, and the strengthening of Ghadan 21, Abu Dhabi's small business development programme[1]. The central bank of the UAE (CBUAE) has cut its key rate by 125 basis points (bp) since the beginning of the year[2] and announced a USD 70 bn support package (17% of GDP) comprised of zero-interest rate collateralized loans to banks; postponed loan repayments for certain companies; the reduction in reserve requirements for demand deposits, the easing of prudential standards for SME loans; and lifting the ceiling on bank exposure to the real estate sector. Certain companies in the hardest hit sectors, such as the airlines, will also benefit from capital injections from the government.

Non-oil activity plummets

Growth has slumped in the UAE's non-oil sector since 2017, to less than 2%, due to the slowdown in activity in Dubai. Over the past three years, the Federation's most diversified economy (about 30% of total GDP), Dubai, has experienced a sharp slowdown in the real estate sector (15% of GDP) and a decline in the number of tourists (tourism accounts for at least 10% of GDP). What has been a structural slowdown so far is likely to become a contraction this year with the slowdown in construction projects, the temporary halting of tourist visits and the decline in global trade. An aggravating factor is the possible postponement by a year of World Expo 2020, initially planned for October, which would dash any hopes of a recovery in the second half of the year.

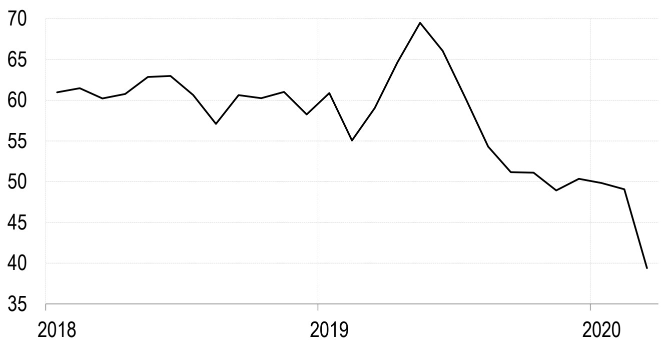
[1] This AED 50 bn programme (3.4% of GDP) was launched in 2019 to support the development of small and mid-sized enterprises (SME), notably in new technologies.
[2] The key rate cut (on 1-week CDs) was not really an economic support measure but reflects efforts by the CBUAE to keep pace with Fed decisions given the dirham's peg.

1- Forecasts

	2018	2019e	2020e	2021e
Real GDP growth (%)	1.7	1.9	-6.7	3.8
Inflation (CPI, year average, %)	3.1	-1.9	0.2	1.8
Gen. Gov. balance / GDP (%)	1.8	0.4	-8.3	-6.9
Current account balance / GDP (%)	1.0	7.3	-0.4	1.0

e: BNP Paribas Group Economic Research estimates and forecasts

2- PMI index non-oil private sector, new orders



Source: Markit

In Abu Dhabi, difficulties in the real estate sector also weigh on non-oil GDP growth (less than 1% since 2018). For the UAE as a whole, we estimate that non-oil GDP could contract by 5% in 2020 (from an estimated +1.1% in 2019).

Oil-sector GDP, which accounts for about 30% of the UAE's total GDP, is expected to report significant decline in 2020. The OPEC+ group (binding OPEC and Russia together in terms of production quotas) agreed to reduce oil production by 9.7 m b/d from May 2020. The UAE is the 3rd largest OPEC producer (11% of the total; 3.09 m b/d on average in 2019), and should cut oil production by 0.74 m b/d. Total oil production should decrease by about 10% on average in 2020.

Credit risk is expected to rise

All in all, we expect activity to contract by 6.7% in the UAE in 2020. Considering the drop in non-oil activity, which primarily affects Dubai, the UAE economy will mainly be hit by a significant rise in credit risk. For several years, government-related entities participating in the development of Dubai have been hit by the slowdown in the real estate sector. These heavily-indebted companies [3], which are mainly active in construction and real estate, will rapidly encounter liquidity problems.

Although residential property prices have fallen by about 30% since 2018, lower prices have not slowed the growth in supply in a market that was already suffering from surplus capacity. According to S&P, 2019 was a record year for Dubai for the delivery of residential property, and this record could be broken again in 2020. The possible cancellation of World Expo 2020 in Dubai will only accelerate the decline in demand and the drop in prices. Certain conglomerates have already approached their main creditors to try to renegotiate their debt, while others have seen their ratings downgraded by the rating agencies. Dubai's capacity to support ailing entities is constrained by limited fiscal resources. Issuance of costly external debt or support from Abu Dhabi could be needed to support those entities.

The banking sector is first in line

In the midst of an economic slowdown and a possible acceleration of the real estate sector's troubles, the quality of bank assets is likely to deteriorate. The doubtful loan ratio as a share of total loans has deteriorated regularly since 2017. According to the IMF, it rose to 6.5% at year-end 2019. The exposure of UAE banks as a whole to the construction and real estate sectors is equivalent to about a quarter of private-sector lending.

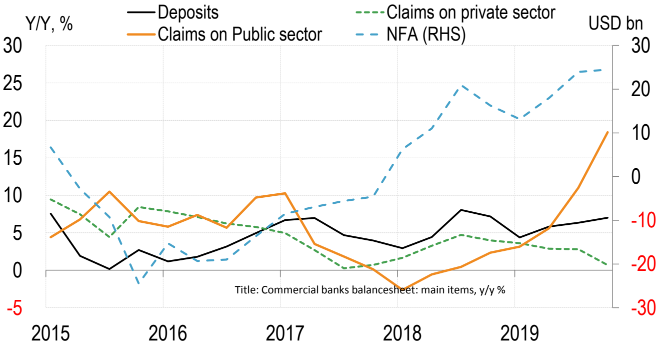
Since the bursting of the 2008 housing bubble, banks have strengthened their balance sheets, conglomerates have rescheduled their debt and real estate market speculation has slowed. For the financial sector, and thus for the economy as a whole, the real estate sector is no longer seen as a systemic risk. Yet the CBUAE recently took measures to relax prudential standards for banks, notably for SMEs. Another source of risk is the shutdown of businesses in many economic sectors and its impact on employment. Bank lending to the retail sector is equivalent to 11% of private-sector lending while consumer loans account for 25%.

On the resource front, the erosion of public finances could strain government deposits with banks. They accounted for 18% of total deposits at year-end 2019. Yet in the short term, Emirate banks are unlikely to face liquidity problems. Deposits, which are banks' main funding source, increased at an annual rate of 7% in December 2019, while private-sector lending (67% of total lending) stagnated (+0.7%). Signalling an absence of liquidity pressures, banks reported a net external surplus of USD 24 bn (5.9% of GDP) in December 2019, the highest level in 15 years.

Solid public finances

With the drop in oil revenues (about 50% of total revenues) and the implementation of fiscal stimulus measures, the UAE is expected to report a significant fiscal deficit in 2020. The expected decrease in

3- Commercial banks balance sheet: main tems



Source: IMF

oil production and the average 40% decline in oil prices during the year will significantly impact oil revenues. To offset partially the decline in fiscal revenues, the government could draw on the revenues of its sovereign funds. All in all, we expect a fiscal deficit equivalent to 8.3% of GDP in 2020 (USD 35 bn) and 6.9% of GDP in 2021.

The government has several options for financing the deficit. An international bond issue in 2019 (USD 10 bn) provided liquidity, and a USD 7 bn Eurobond was issued in April 2020. Lastly, the government has more than USD 800 bn (200% of GDP in 2019) in various sovereign funds, which could be a source of additional financing. Government debt is low, and could reach 28% of GDP in 2020.

A solid peg

External accounts are solid and the economy generates recurrent current account surpluses. Given the decline in oil prices and the contraction in world trade, the current account should show a deficit of 0.4% of GDP in 2020 (USD 1.8 bn). According to the IIF (Institute of International Finance), external debt amortisation (loans and bonds) will amount to USD 60 bn in 2020. The central bank had foreign reserves of USD 107 bn in 2019 (7.5 months of imports of goods and services). In this environment, and after taking into account the government's external assets, the dirham's peg to the US dollar is not at risk.

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[3] Total debt of the Dubai government and government-related entities which depend on it exceeds 100% of Dubai's GDP.

Morocco

Solid fundamentals to cope with the shock

The Moroccan economy will see significant consequences from the coronavirus pandemic. Tourism has been at a standstill since March and will remain so until May at the earliest. The automotive sector and remittances from the Moroccan diaspora will also be hit by the crisis in Europe. However, and provided that the situation improves in the second half of the year, Morocco should be able to avoid recession. Macroeconomic fundamentals are solid and the country will benefit from a substantial fall in oil imports. Moreover, the authorities have reacted swiftly to dampen the shock.

The Moroccan economy had been expected to see a return to more dynamic growth, after a mixed picture in 2019. Initially expected at 3.5%, economic growth has been revised downward to 2.3% by the Central Bank. Given the size of the shock that lies ahead, this could prove optimistic, even though we believe that the economy is likely to avoid recession this year. The authorities have reacted swiftly, and Morocco has only limited exposure to the turmoil in financial and commodity markets. Provided that there is a recovery in the second half of the year, real GDP growth could reach 0.5% in 2020, the lowest level in twenty years. However, forecasts are subject to big uncertainties.

Economy under pressure: the authorities act swiftly

In addition to a new fall of around 3% in the value added of the agricultural sector (12%-13% of GDP, 1/3 of employment) due to unfavourable weather conditions, the economy will also suffer from the effects of the coronavirus pandemic. Tourism has been at a standstill since March. Two-thirds of the tourist season comes from June onwards. But with 80% of tourists (excluding the Moroccan diaspora) coming from Europe, the losses will be significant in a sector that accounts for more than 8% of GDP, which is the highest level in the region (Chart 2). Channels of transmission will go beyond the sole tourism sector. Europe accounts for 60% of the Kingdom's exports, 68% of remittances from Moroccans living abroad and more than 70% of foreign investment. The automotive sector, which is now Morocco's leading source of exports, is particularly vulnerable, even though its development is not compromised.

A marked deceleration in non-agricultural growth is thus expected this year. However, it should not collapse. A monitoring committee has been established to respond to the effects of the pandemic. Deferrals of social contribution payments until end-June have already been announced, as have fixed-rate compensation payments for employees of companies in difficulty. Consideration is also being given to measures to help workers in the informal sector. This will be financed from a special fund of nearly MAD 30 billion (2.5% of GDP), of which MAD 10 billion will be provided by the government and the remainder by voluntary contributions.

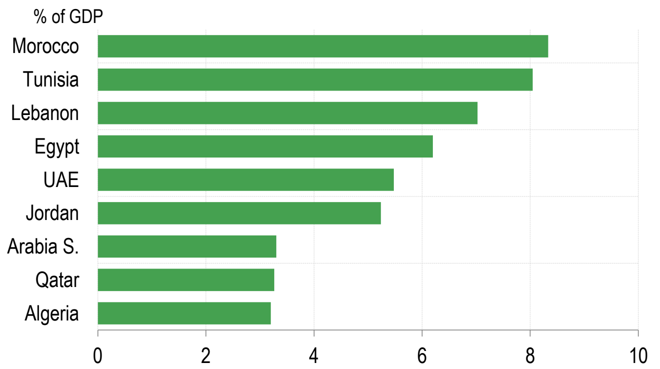
The Central Bank has also cut its policy rate by 25 basis points to 2%, and has introduced a series of measures that will triple the refinancing capacity of banks. With inflation fluctuating at around 1%, the monetary authorities have room for manoeuvre for further policy easing.

1- Forecasts

	2018	2019	2020e	2021e
Real GDP growth (%)	3.0	2.4	0.5	3.0
Inflation (CPI, year average, %)	1.8	0.3	0.7	1.2
Fiscal balance / GDP (%)	-3.7	-4.0	-5.0	-4.0
Current account balance / GDP (%)	-5.5	-4.6	-5.9	-4.1

e: BNP Paribas Group Economic Research estimates and forecasts

2- Contribution of the tourism sector to the economy



Source: WTTC

Other supportive factors should also be taken into consideration, notably the solidity of the financial system whose activity is funded thanks to a large base of domestic deposits and which has only a limited exposure to the tourism sector (less than 2% of outstanding loans). Banks look also well capitalized to cope with rising credit risk despite poor asset quality (the non-performing loan ratio is 8%). Above all, macroeconomic fundamentals are sufficiently robust to absorb a temporary shock.

External accounts: a manageable shock

With 15% of foreign-currency receipts generated by the tourism sector, automotive exports accounting for 27% of exports and remittances from the Moroccan diaspora representing 13% of current account receipts, pressure on external accounts will be strong. But as an oil importer, Morocco will also benefit from the marked fall in the price of the Brent. Even assuming a Brent close to USD40/barrel on average in 2020 (and thus a recovery in the second half of the year), imports of oil products would fall by more than 2 points of GDP, which would help to mitigate somewhat the deterioration of the current account deficit (5.9% of GDP in 2020 against 4.6% in 2019). At this level, the coverage of financing requirements could prove difficult, given the downward pressure on foreign direct investment. Net FDI flows fluctuate around 2% of GDP. Furthermore, a larger current account deficit cannot be ruled out. However, external account stability does not look threatened.

External debt is moderate at 45% of GDP, of which two-thirds have been taken out by the government or state-owned companies (with government guarantees) at long-term maturities. External debt of the private sector reaches only 7.5% of GDP and is mainly in the form of trade credits (70% of the total). In contrast to many other emerging economies, Morocco is thus largely insulated from the turmoil in international financial markets. Morocco's sovereign spreads have widened since the end of February but remain relatively low (Chart 3). However, a fresh eurobond issue, following that in November 2019, remains in the realm of the hypothetical given the current high levels of risk aversion towards emerging markets.

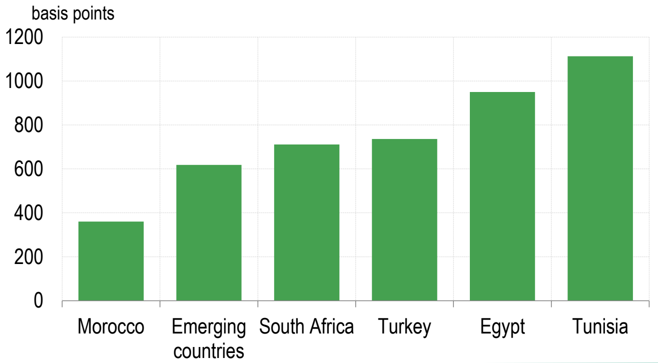
Forex reserves remain comfortable. At the end of 2019, they stood at USD25.3 billion, or the equivalent of 5.4 months of imports of goods and services. This is also three times the stock of short-term debt. In addition, the authorities went just to announce that they will draw on the IMF's Precautionary and Liquidity Line (PLL). Renewed in December 2018 for two years, the PLL makes a total of USD 3 billion available. This is not a loan but an insurance to protect an economy against an exogenous shock, which means that external public debt will be not impacted.

Greater exchange rate flexibility could also help to absorb the shock. The dirham's fluctuating band has been widened in early March from +/- 2.5% to +/-5%. Since the start of the reform in January 2018, the dirham has been remarkably stable and the Central Bank has virtually stopped intervening in the interbank market. Initial information suggests that this is still the case even if emerging pressures on the MAD suggest that monetary authorities could resume their interventions. That's said, any depreciation of the MAD would remain modest. Furthermore, the vulnerability of the economy to exchange rate fluctuations is reduced thanks to low inflation and the moderate external indebtedness of the government and corporates.

Spending cuts likely to help public finances

The situation in the public finances does not give cause for major concern, even though a reallocation of spending, or even cuts, look inevitable. The latest estimates of the Central Bank now assume a budget deficit of 4% of GDP in 2020, from an initial estimate of 3.8%. However, this slight increase of 0.2 points of GDP does not take account of the measures that the government might take to prop up the economy, starting with the allocation of MAD10 billion (0.8% of GDP).

3- Sovereign spreads



Source: JP Morgan

Civil service recruitment has already been frozen, other than for the health and interior ministries. Energy subsidies will also fall as gas prices come down. Even so, with subsidies accounting for barely 5% of total government spending, the potential gains in this area are limited. The greatest flexibility is to be found in capital expenditure. With a budget of MAD70 billion (21% of total spending), a 10% cut in CAPEX would reduce spending by 0.6 points of GDP. Therefore, we are not expecting a significant worsening of the budget deficit (5% of GDP).

The government will also continue to benefit from favourable conditions to meet its financing needs. The local debt market is captive with negligible participation of non-resident investors, and liquid. Despite central government debt of 65% of GDP, interest payments are moderate at 2.4% of GDP and 11% of tax receipts. Around 80% of central government debt is denominated in MAD.

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Kenya

Tough economic times forthcoming

Kenya's real GDP growth was subdued last year and it will come under stress in 2020 due to coronavirus outbreak effects. The lower GDP growth will further constrain the fiscal policy space whereas the country's forex receipts are also weakened by adverse climatic conditions. While political rivalries continue to complicate the implementation of fiscal policy, failure to reduce budget deficits will challenge the sovereign's debt solvency in the medium term. Meanwhile, monetary policy easing and emergency measures in the banking sector could hamper banking sector prospects, which had started to improve following the recent removal of the interest-rate cap law.

Pandemic impact on a subdued economic growth

Kenya is feeling the economic effects of the pandemic outbreak. According to a private-sector organization survey[1], more than 60% of businesses are affected by the measures taken around the world to contain the Covid-19 virus. This is notably due to Kenya's close ties with China, which accounts for about 20% of its imports. With the reduction of imports, some industrial inputs would need to be sourced elsewhere or substituted by local production. Some enterprises have therefore downsized their production capacity.

Additionally, exports to markets such as the Middle East and Europe are also affected. The most vulnerable exports include horticultural goods, especially tea and coffee (respectively 23% and 4% of total exports), whose prices slightly increased by about 4% in 2019 and have suffered diverging dynamics year-to-date (-3% for tea and +5% for coffee).

Moreover, since December 2019, an outbreak of locust swarms in East Africa devastated around 13% of Kenyan crops[2]. This could bring food insecurity, which is also exacerbated by conflicts in the Rift Valley region. Kenya should also suffer from a contraction in forex reserves, which are projected at USD 8.9 billion (5.3 months of imports) at the end of 2020.

Kenya's external imbalances remain large and should stay so even if the decline in the oil import bill offsets the decline in goods exports. Meanwhile, the foreign exchange market has also recently experienced some volatility, and the shilling (KSH) lost more than 4% against the dollar since the beginning of the year.

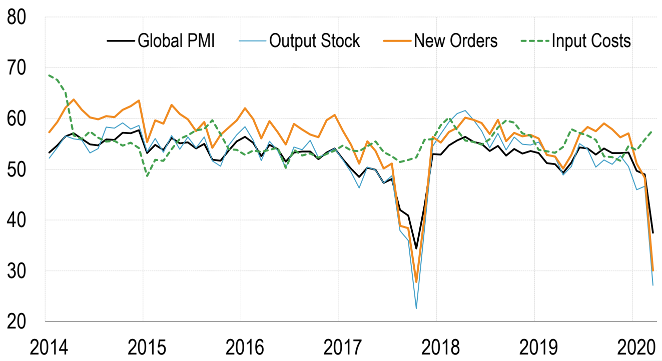
Airlines[3] and the tourism sector should also be affected, considering that Kenya is the third largest tourism economy of Sub-Saharan Africa, where tourism accounts for more than 8% of GDP, 15% of total exports and 8% of total employment. Construction and real estate sectors are also feeling the pinch, as development projects are suffering delays.

1- Forecasts

	2018	2019	2020e	2021e
Real GDP growth (%)	6.3	5.5	3.0	5.2
Inflation (CPI, year average, %)	4.7	5.6	6.3	5.2
Fiscal balance / GDP (%)	-6.9	-7.3	-7.6	-5.2
Current account balance / GDP (%)	-5.0	-4.7	-4.6	-4.6

e: BNP Paribas Group Economic Research estimates and forecasts

2- Deterioration of the private sector since the beginning of the year



Source: National Institut of Statistics

Therefore, economic growth is expected to fall to 3% in 2020, according to the most recent central bank forecasts. This follows a period of already subdued growth in 2019.

Although remaining within the 2.5%–7.5% target range of the central bank, consumer price inflation (CPI) is progressively increasing and spiked at 6.37% on February 2020, due to the related effects of coronavirus outbreak. This trend could reduce the room to maneuver of the central bank to ease the monetary policy in order to boost banking credit and domestic demand.

[1] The Kenya Private Sector Alliance (Kepsa)
[2] Tea represents 22% of Kenya's exports, and 3% of the harvest area is infested by locusts. Coffee accounts for 4% of total exports and 15% of its harvest area are covered by locust swarms.
[3] Even before air travel restrictions, national carrier Kenyan Airways announced a USD 8 million revenue loss, following flights' suspension to China after the first cases of coronavirus were detected.

Monetary and fiscal stimulus

The government has responded to the epidemic with tough measures on travel, mass gathering and isolation rules to curb the spread of the virus[4]. Yet the main sources of concern are related to the weakness of the health system and to job losses. While the World Bank would give USD 60 million to the health sector to deal with the outbreak, Kenya is also seeking emergency assistance from the IMF of up to USD 350 million. In the meantime, local stimulus measures have been introduced by the authorities.

In line with the accommodative stance of other African central banks, Kenya's last Monetary Policy Committee held on March 23rd cut the policy rate by 100 basis points (the third consecutive cut despite inflationary pressures). It has also reduced the reserve requirement ratio for commercial banks (to 4.25% from 5.25%, thus releasing an extra KSH 32.2 billion for lending to households and small businesses expected to suffer from reduced cash flows.

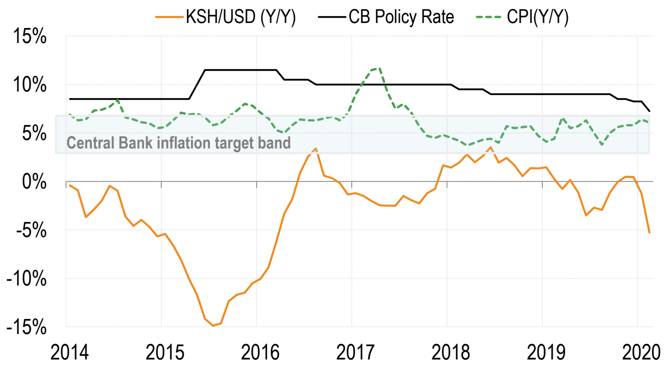
Additionally, on March 18th, the central bank issued a set of emergency measures to be applied in the banking system. These include: the extension of personal loan repayment delays by up to 12 months, restructuring of corporate credits, dropping charges on banking transactions with a mobile phone until the end of June; and the increase in the duration of repurchase agreement (repo) transactions with banks to 90 days from 28 days in order to ensure there is sufficient liquidity in the banking sector.

The government has also announced fiscal measures to be effective on April 1st, including tax relief for low-income households, reductions in both personal income and corporate tax[5], and a cut in the value-added tax (VAT) rates. The government also plans to release KSH 49 bn (USD 460 million) to cover suppliers' unpaid bills and KSH 10 bn to refund VAT to corporates in the next three months. Finally, additional spending totaling KSH 10 bn is being considered to support the most vulnerable people.

Public finances under big pressure

Public finances are expected to deteriorate due to the economic slowdown and support policy measures. They are also threatened by several issues. Firstly, the rivalries within the ruling party hinder the implementation of fiscal policy. The pace of fiscal consolidation has slowed since Ukur Kanacho was appointed new finance minister, taking over from Henry Rotich[6].

3- Currency depreciation and inflationary pressures



Source: National Institut of Statistics, Central Bank

Moreover, many infrastructure projects have stalled or generated inadequate returns to service the debt borrowed for their construction. Total debt service is rising with the total interest payments-to-fiscal revenue ratio doubling over the past three years (to 31% in 2019 from 16% in 2016).

As a result of the COVID-19 epidemic effects, the governement expects revenues to drop by an additional KHS 70 billion by the end of this current fiscal year. The budget deficit is expected to increase to 7.6% of GDP in 2020.

The government needs to issue additional bonds in the international market, as recently announced[7], and also needs a precautionary line from the IMF (USD 1.5 bn three-year stand-by credit facility). The first large debt maturity falling due (USD 2 bn) is scheduled at the end of 2024.

Finally, the central bank's measures in the banking sector could also challenge banking-sector prospects, which were starting to improve following the removal of the controversial Banking Amendment act[8] in November 2019.

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[4] These include the cancellation of all international flights (except cargo planes), the shutdown of bars and nightclubs, banned church congregations and weddings, and the capping of funeral gatherings to 15 people.
[5] Reduction of the pay as you earn tax (PAYE) from 30% to 25%; reduction of the Resident Income Tax from 30% to 25%; and reduction of the turnover tax rate from 3% to 1% for all Micro, Small and Medium Enterprises.
[6] On July 22nd, President Kenyatta ordered to arrest of Finance Minister Henry Rotich over alleged corruption surrounding the Kimwarer Dam and Arror Dam hydropower projects.
[7] On March 4th, the government announced a USD 1.5-billion issue by June, and a second possible bond issue in S2 2020.
[8] Approved in September 2016, the Bill limited commercial banks' interest rates to no more than 4 percentage points above the central bank's reference rate.

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