ECO EMERGING

2ND Quarter 2021

EDITORIAL

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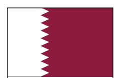

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The bank for a changing world

EDITORIAL

RACING AGAINST TIME

In their spring outlook, the IMF economists expect to see a multi-speed (and incomplete) recovery of the global economy in 2021. Indeed, speed is the key word for 2021 because the emerging countries are racing against time on several fronts. In our eyes, the greatest short-term risks are linked to the race between the rollout of vaccinations and the spread of the pandemic, and between higher food prices and the partial catching-up of revenues for low-income households. If this divergence persists, we could see a rise in social risks, which may have a much more destabilisation capacity than financial risks.

In their spring outlook, the IMF economists expect to see a multi-speed recovery of the global economy in 2021, albeit an incomplete one. Nothing really different from the major crises of the past. Yet speed seems to be the key word for 2021, because the emerging countries are in the midst of a race against time on several fronts.

A race against time between the rollout of vaccinations and the spread of the pandemic

A new wave of Covid-19 cases has broken out since mid-March, just as vaccination campaigns are beginning to roll out. On the positive side, the number of vaccine doses, and fully vaccinated people for that matter, is rising faster than the number of reported new cases in virtually all countries. But the percentage of the vaccinated population is still low, except in such emblematic cases as Israel and Chile, and to a lesser extent, in Hungary and Morocco. Looking beyond this handful of countries, vaccination rates are highest in Central and Eastern Europe and in Turkey, at between 5% and 10%. In the Asian and Latin American countries, vaccination rates are no more than 2%, with the exception of Singapore. But in Latin America, unlike the industrialised Asian countries, the pandemic does not seem to be coming under control, far from it. Brazil is the country where the situation is the most alarming, with a number of vaccinations barely higher than the number of new cases, and a very low vaccination coverage.

A race against time between rising commodity prices and the catching-up of household revenues

Commodity prices have picked up strongly since mid-2020, with metal and oil prices leading the way, followed by agricultural products since Q4. The recovery has even accelerated since early 2021. For net commodity exporting countries, this factor reduces the balance of payment risk, and even sovereign risk. However, it is an aggravating factor for social risks, especially food price inflation, which hits the poorest populations. IMF experts estimate that an additional 98 million people fell below the poverty line last year, with 68 million new cases of malnutrition, mainly due to the decline in revenues, but also to higher food prices. Agricultural commodity prices are already 20% higher than the 5-year average, and close to the peak levels of 2008 and 2011. Yet revenues are bound to catch up only partially, even though employment in the emerging countries generally responds more rapidly to growth than it does in the advanced countries.

A race against time between the turnaround in fiscal revenues and heavier debt servicing charges

In 2020, public debt for all of the emerging and developing countries rose by about 10 points of GDP. Yet the interest burden continued to diminish due to the ongoing decline in interest rates. This will no longer be the case in 2021, mainly because public debt is swelling, but also because of tighter monetary policy, not only in the United States, but also in the emerging countries themselves. This raises borrowing costs for governments. If we compare 2021-2022 to the period 2019-2020, the ratio between interest charges and fiscal revenues will increase for about two thirds of the main emerging countries. For most of them, this ratio is still moderate or even low (only 10% of the emerging countries have a ratio of more than 20%). Among the emerging countries, government solvency is not a real threat, even for the most fragile countries in this respect (South Africa, Brazil and India). But it does create an additional constraint, making it harder to maintain income support measures (which are set to expire in the vast majority of countries) or at least putting a damper on investment.

A race against time between the return to normal of corporates' turnover and the end of moratoriums on repaying bank loans and the maturing of liquidity loans doled out since the beginning of the pandemic.

Despite the recession, bank lending to households and companies has increased by more than 5% in half of the emerging countries. Moreover, the monetary authorities or bank supervisory boards have granted banks a longer period for classifying late payments as doubtful loans. As a result, doubtful loan ratios will rise sharply this year, undoubtedly more than during the 2008 crisis. Fortunately, capitalisation of the banking system has been strengthened over the past decade.

In our eyes, the biggest risks in the very short term are linked to the race against time between the number of vaccinations and the spread of the pandemic, and between rising food prices and the catching-up of revenues for low-income households. If this divergence persists, we could see a rise in social risks, which may have a much more destabilisation capacity than financial risks.

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SHIFTING TOWARDS A MEDIUM-TERM PERSPECTIVE

At the end of the annual "Two Sessions", China's major political event, Beijing announced its economic targets for 2021 as well as the priorities of its new five-year plan. By setting this year's real GDP growth target at simply "more than 6%", which is lower than forecasts, the authorities are signalling that the economic recovery following the Covid-19 crisis is no longer the main focus of concern. In the short term, they will continue to cautiously tighten monetary policy and gradually scale back fiscal support measures. Above all, the authorities have affirmed their medium-term development strategy, which aims to boost innovation and drastically expand China's technological independence.

THE RECOVERY HAS PEAKED, ECONOMIC GROWTH REMAINS VIGOROUS

The Chinese economy ended the year 2020 on a solid note with real GDP growth of 6.5% year-on-year (y/y) in Q4. Industrial production and exports continued to report robust performances that went beyond a simple catching-up movement. Meanwhile, private consumption and the services sector continued to close the gap after they entered the rebound phase much later following the Q1 2020 lockdown.

Economic indicators for the first part of 2021 are hard to interpret due to major base effects generated by the abrupt shutdown of activity in Q1 2020. In fact, in the first two months of 2021, the growth rates for industrial production, activity in the services sector, investment and retail sales were all abnormally high on a year-on-year basis (above 30%).

On the supply side, industrial production was still robust in the first two months of the year, in spite of a few signs of a slowdown in the automotive sector (which accounts for about 15% of industrial activity) resulting from the global shortage of microchips. Industrial production was largely supported by strong external demand. Exports rose 60% y/y in January-February 2021, driven by sales of technological goods and medical devices, as well as consumer goods and automotive parts.

Meanwhile, the momentum of domestic demand growth has lost some of its vigour at the beginning of 2021, with the notable exception of real estate investment. Private consumption of goods and services was curbed by new lockdown restrictions that were introduced in late January and February in response to a surge in contaminations in the regions around Beijing and Northeast China. In addition, the situation of households is still fragile, undermined by last year's downturn in income and a weaker labour market. After falling continuously since spring 2020, the urban unemployment rate rose to 5.5% in January-February from 5.2% in December. Besides, the share of precarious jobs remains higher than pre-crisis levels. Finally, about 5 million migrant workers who lost their jobs in Q1 2020 (and are not counted among the official unemployed) have yet to find work again (286 million jobs were held by migrant workers at year-end 2020).

Private consumption is expected to strengthen in the short term, if for no other reason than the improvement in the health situation. The epidemic is under control, lockdown restrictions have been lifted and the vaccination campaign – which was very slow through mid-March – is projected to accelerate. The authorities also seem to be planning a few temporary measures to encourage household spending.

FORECASTS

	2019	2020e	2021e	2022e
Real GDP growth (%)	6.1	2.3	9.2	5.3
Inflation (CPI, year average, %)	2.9	2.5	1.8	2.8
Official budget balance / GDP (%)	-2.8	-3.6	-3.2	-3.0
Central government debt / GDP (%)	17.0	19.5	20.8	22.2
Current account balance / GDP (%)	0.7	1.9	2.1	1.7
Total external debt / GDP (%)	14.5	16.3	15.1	15.8
Forex reserves (USD bn)	3 108	3 217	3 272	3 312
Forex reserves, in months of imports	15.0	16.3	15.2	14.5

e: ESTIMATES & FORECASTS

TABLE 1 SOURCE: BNP PARIBAS GROUP ECONOMIC RESEARCH

A DYNAMIC PROPERTY SECTOR, FOR HOW LONG?

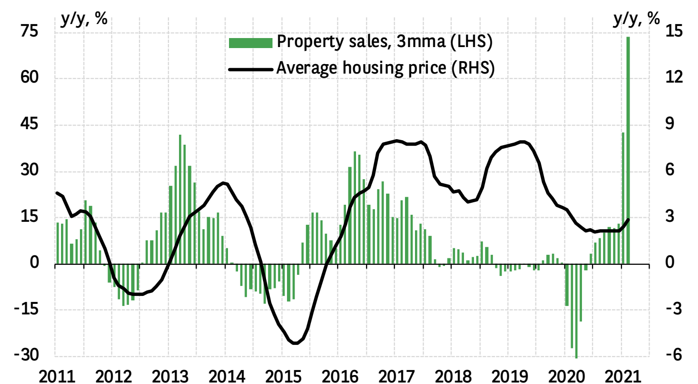

CHART 1 SOURCE: NBS, MACROBOND

As to investment, enterprises in the manufacturing sector have been very cautious in January-February. Manufacturing investment is nonetheless expected to gain momentum in the short term becauseexport prospects remain strong, industrial capacity utilization rates are high (78% in Q4 2020, the highest level in three years) and corporate profits are on the rise. This goes along with a rebound in producer prices (+1% y/y in January-February, after 18 months of deflation), driven up by higher industrial commodity prices. Additionally, the authorities' plans to increase investment in the technology sectors should rapidly become visible.

CAUTIOUS NORMALISATION OF ECONOMIC POLICY

Following the annual plenary sessions of the National People's Congress (NPC) and the Chinese People's Political Consultative Conference (CPPCC) in March – two core institutions of China's political system – the authorities announced their key macroeconomic targets for 2021. They are calling for real GDP growth of "more than 6%" and inflation of 3%. By setting an economic growth target well below forecasts, the authorities are signalling that the economic recovery is no longer the main focus of their concerns. They are enlarging the manoeuvring room of economic policy, notably to better combat risks in the financial sector.

In the short term, the authorities are aiming to contain growth in corporate and local government debt, which rose sharply last year (total domestic debt of the non-financial sector was estimated at 280% of GDP at year-end 2020, up from 255% at year-end 2019). Yet this must be orchestrated carefully, without undermining the economic recovery or aggravating the difficulties of corporates that have been hit by last year's epidemic shock.

Credit policy will be tightened cautiously, mainly by adjusting the prudential framework. Moreover, the authorities will slow infrastructure projects, which are mainly financed through domestic bond issues by local governments. Beijing very moderately scaled back quotas of bond issues authorised in 2021 for both the local and central governments. Total quotas were reduced to RMB 7,200 bn in 2021 from RMB 8,500 bn in 2020. In addition, the authorities also lowered the government's "official" deficit target to 3.2% of GDP in 2021, from 3.6% of GDP in 2020. These cutbacks signal a very gradual and prudent withdrawal of fiscal and quasi-fiscal support measures in the year ahead.

Investment growth in public infrastructure has already slowed in recent months, a trend that is bound to continue. In contrast, there were still no signs of slowdown in property investment in early 2021, despite new prudential rules imposed on real estate developers since August 2020. Low domestic interest rates and ample household savings have continued to encourage real estate transactions. House price inflation even accelerated slightly in January-February (+2.7% y/y) after holding relatively stable since spring 2020.

THE 14TH FIVE-YEAR PLAN

Last month the authorities also unveiled the targets for the new Five-Year Plan for 2021-2025. At the heart of Beijing's strategy is the development of the technology sector. China aims to sharply reduce its dependence on foreign technological knowhow and goods, and to become a world leader in the scientific field. Spending on research & development will be increased by at least 7% a year (after a 10% increase in 2020), with a special focus on boosting fundamental research efforts and increasing the number of patents with a high technical content (from 6.3 patents per 10,000 residents in 2020 to 12 patents in 2025). This should accelerate China's catching-up movement with the more advanced countries. Moreover, the manufacturing sector will have to continue to rise the value chain, and the share of the digital economy is projected to be increased from 7.8% of GDP in 2020 to 10% in 2025. The authorities have announced several measures to help corporates, including tax deductions and subsidies.

The 14th Five-Year Plan also calls for other reforms, which were not spelled out in detail, but yet the country's challenges and medium to long-term goals are well identified. Beijing is striving to achieve "common prosperity". On the one hand, China's industrial, economic and social development will certainly rely on technology. On the other, priority will also be given to bolstering the health and social protection system, wealth redistribution and reducing inequalities, and reforming the hukou permanent resident system to improve access to public services for the entire population.

CHINA'S R&D SPENDING TO BE STRENGTHENED

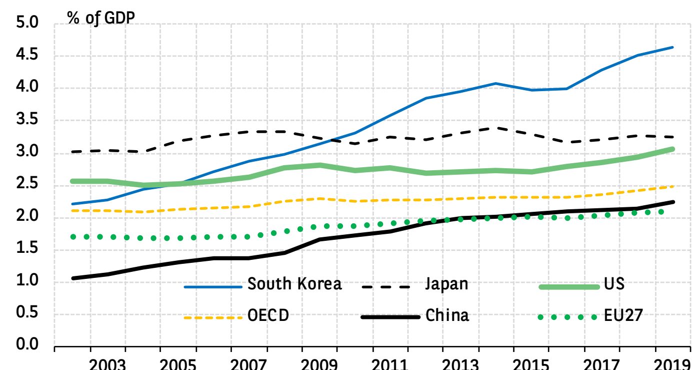

CHART 2 SOURCE: OECD DATA (2021), GROSS DOMESTIC EXPENDITURES OF R&D

China's ageing population was also identified as a major challenge. The median age of the Chinese population rose from 30.8 in 2010 to 38.4 in 2020 (similar to that of the US); the active population has been declining continuously since 2013; and the dependency ratio rose from 36.5% of the active population in 2010 to 41.4% in 2020. Measures are being explored to encourage natality, to postpone the retirement age (which is currently only age 50-55 for women and age 60 for men) and to extend the average duration of university education. Improvements in education, coupled with investments in innovation, are aimed at boosting productivity. Lastly, the "quality of economic growth" will also be improved by developing green industries and promoting measures to fight climate change; Beijing's goal is to be carbon neutral by 2060.

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INDIA

MANY RISKS THREATENING THE RECOVERY

The economic recovery could be weakened by a second wave of Covid-19 and a fresh surge in inflation. With the government seeking to step up the pace of reforms to support growth over the medium term and improve the business environment, the number of protests against the moves is mounting, with protestors' ire directed particularly at the privatisations that the government is counting on to cut its budget deficit. In the banking sector, banks currently are able to deal with the expected rise in credit risk. Nevertheless, in order to support a resumption of lending growth, a new injection of capital into state-owned banks has already been planned, alongside the creation of a defeasance structure.

ECONOMIC RECOVERY WEAKENED BY RISING INFLATION AND A SECOND WAVE OF COVID-19

According to government estimates, real GDP for the 2020-21 fiscal year, that ended on 31 March 2021, contracted by 7.7% (having grown by 4.2% in the 2019-20 fiscal year). In the 2021-22 fiscal year, the central bank forecasts a recovery of 10.5%. But this recovery could be jeopardised either by a second wave of Covid-19 or by strong inflationary pressures.

Since March, the number of Covid-19 cases has increased significantly, particularly in the State of Maharashtra, which accounts for a substantial 14.5% of the total economy. On 4 April, the government therefore decided to impose a curfew in the State and to close 'non-essential' stores. Other States have already imposed new restrictions and further health measures may be introduced given that a very small share of the population has been vaccinated (2.9% had received a first vaccine dose by the end of March).

Meanwhile, there has been a resurgence in inflation (to 5% year-on-year in February, from 4.1% in January), due in particular to rising food prices and higher transport costs as the result of rising oil prices. This could also weaken the recovery, given that these two categories account for 39% and 8.6% respectively of the typical Indian household budget. Against a background of rising US long rates, the Indian central bank may therefore elect to tighten its monetary policy to tackle inflation and support the currency, even though inflation was still below its target of 4% +/- 2 points at the end of February.

A BUDGET THAT DEPENDS ON PRIVATISATION RECEIPTS

The public finances are structurally fragile due to a narrow fiscal base and a continued high level of rigid expenditures, despite the reduction in government subsidies since 2014.

They have been further weakened by the economic crisis that followed the Covid-19 epidemic. According to the Finance Ministry, the government deficit could reach 9.5% of GDP for the 2020-21 fiscal year, with the general government deficit hitting 15% of GDP. Over the first ten months of 2020-21, the increase in the deficit came mainly from a rise in spending, particularly in the form of subsidies to the poorest households, which doubled their share of total spending to nearly 19%[1].

For the fiscal year that runs from 1 April 2021 to 31 March 2022, the Finance Ministry predicts that the government deficit will be reduced to 6.8% of GDP and the general government fiscal deficit to 11.0% of GDP.

FORECASTS

	2019	2020e	2021e	2022e
Real GDP growth(1) (%)	4.2	-7.2	12.5	4.1
Inflation (1) (CPI, year average, %)	4.8	6.2	4.9	4.6
General Gov. Balance(1) / GDP (%)	-7.3	-14.8	-11.0	-9.5
General Gov. Debt(1)/ GDP (%)	72.2	89.8	90.0	91.5
Current account balance(1) / GDP (%)	-0.9	0.3	-0.9	-1.7
External debt(1)/ GDP (%)	19.9	21.5	21.0	20.5
Forex reserves (USD bn)	457	542	590	620
Forex reserves, in months of imports	7.7	11.0	9.1	9.2

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

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

PRICES STARTED TO RISE AGAIN IN FEBRUARY

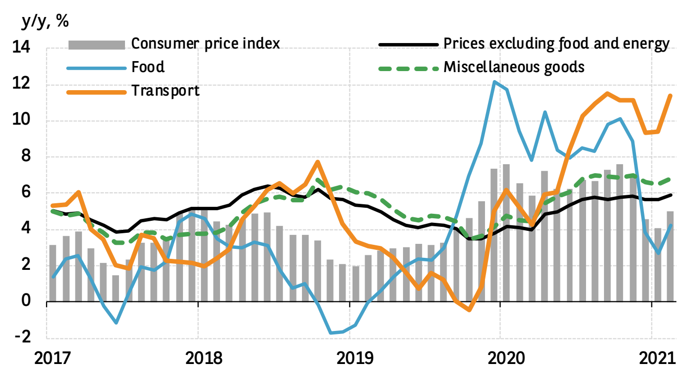

CHART 1 — SOURCE: RBI

The government plans to reduce its deficit by 18.5%, thanks to an increase in tax revenues as a result of an economic recovery and a sharp increase in revenue from the privatisation of state-owned companies (including two banks, an insurance company, electricity distribution companies, railways and the Air India airline). But the target for cash raised from privatisations (0.8% of GDP from an average of 0.4% over the past three years) looks particularly ambitious, given continued high levels of volatility in equity markets and the repeated waves of protest against the privatisations.

1 Part of the food subsidy spending in 2020-21 was accounted for by settlement of delayed payments by the government to the Food Corporation of India.

Total public spending is likely to remain stable (resulting in a two-point reduction in spending as a percentage of GDP). Indeed it could even increase as the government is planning to boost spending on health and infrastructure investment.

It would therefore seem that the government is prioritising support to the economic recovery over consolidation of the public finances, which remains somewhat theoretical. According to the ratings agency Fitch, government debt could thus climb above 90% of GDP in 2020-21 and stay at that level over the next five years. For the time being, there is little threat when it comes to refinancing debt. That said, the sharp rise in debt servicing costs (32% higher in 2020-21) is a source of concern, especially as government receipts remain extremely low. Interest payments are likely to hit more than 42.5% of government revenue in 2021-22, seven points higher than in 2019-20. Elsewhere, inflationary pressure could result in an increase in yields on long-term government bonds, which at the beginning of April remain contained at 6.2% (for 10-year bonds), in other words still below their level from before the Covid-19 crisis.

BANKING SECTOR: THE GOVERNMENT ANNOUNCES THE CREATION OF A DEFEASANCE STRUCTURE

In its latest Financial Stability Report, published in January 2021, the central bank noted that the banking sector was in a more solid, albeit still fragile, position in Q3 2020 than it has been for the last five years. The share of non-performing loans was lower, at 7.5%, provision cover higher, at 72.4% of non-performing loans, and solvency ratios more comfortable, at 15.8%. Meanwhile, up until December 2020, banks continued to increase provisions in the expectation of an increase in non-performing loans, whilst not actually recording the loans as such. The deterioration in the quality of their assets will be recognised from the second quarter of 2021, as the Supreme Court confirmed (in March 2021) that the moratorium on repayments that was in force between March and August 2020 could not be extended beyond August 2020 and that regularisation of the situation should take place in March. Nevertheless, according to the ratings agencies and the central bank, banks should be in a position to cope with an increase in lending risk, even though the central bank estimates that the share of non-performing loans is likely to hit 13.5% in Q3 2021. The main source of concern lies more in their possible need to recapitalise to meet their solvency ratios, whilst also being able to expand credit supply at a time when they are having to increase provisions. Against this background, the government included in its budget for the year an injection of INR200 billion in additional capital (0.2% of GDP) for the state-owned banks, following on from a recapitalisation of a similar amount in the previous fiscal year. However, even these sums are far below the INR 1.9 trillion to INR2.2 trillion that ratings agency Moody's estimates is needed.

To help clean up bank balance sheets and support the recovery in bank lending, the government has announced the creation of a defeasance structure. For the time being, no details have been provided. The transfer of non-performing loans would free up capital, currently being used to bolster provisions for lending.

In addition, since May 2020 the government and the Reserve Bank of India have adopted policies to support households and companies, particularly small and medium-sized enterprises. Even so, despite the relaxation of monetary policy by the central bank, which has trimmed

BANK LENDING REMAINS SLUGGISH

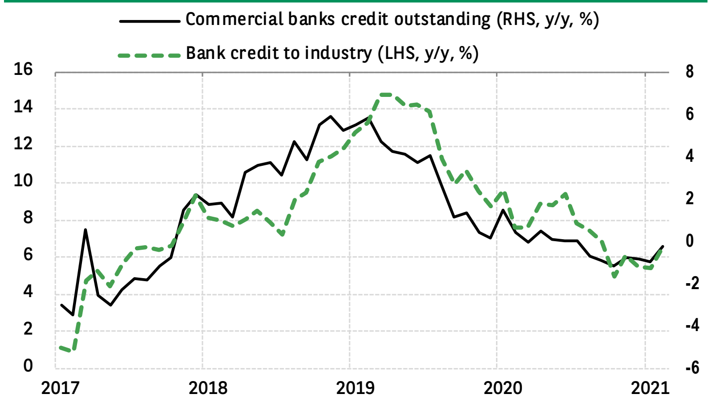

CHART 2

SOURCE: RBI

130bp off average lending rates (policy rates were cut by 115bp between January 2020 and March 2021), the rate of growth remains modest.

Excluding loans for the purchase of food, lending to households has decelerated, and lending to large companies has contracted due to a fall in their investment. These larger companies have not required financial support to get them through the crisis; although revenue fell sharply, profits increased due to the falls in labour costs and commodity prices over much of 2020.

Lending to medium-sized companies (18% of total lending) has stood out with extremely strong growth since September (up 19.1% year-on-year in January 2021), under the government-guaranteed Emergency Credit Line Guarantee Scheme, which was introduced on 23 May 2020 and closed on 31 March 2021. This scheme was specifically designed to address the financing needs of small and medium-sized businesses. According to the government, by the end of January 2021, INR 1.9 trillion in bank loans (excluding non-bank financial companies) have been made under this programme (36.6% of loans made over the year).

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INDONESIA

A MODEST RECOVERY

Having contracted by 2.1% in 2020, the Indonesian economy is likely to see only a modest recovery in 2021. Domestic demand is struggling to recover. Consumer sentiment remains weak and any resurgence in the pandemic could undermine the recovery, at a time when a very low percentage of the population has been vaccinated. Moreover, despite the highly expansionary monetary policy, bank lending has continued on its downward trend. The financial position of Indonesian companies prior to the Covid-19 crisis was more fragile than those of ASEAN peers, and they are likely to seek to consolidate their positions rather than invest in an uncertain future. The banking sector remains solid and well-placed to deal with an expected increase in credit risk.

A MODEST RECOVERY IN 2021

Real GDP contracted in 2020 (by 2.1%) for the first time since 1998. Besides, the recovery in 2021 is likely to be modest and below potential.

In the fourth quarter of 2020, economic activity still contracted by 2.2% compared to the same quarter in 2019 and, in the first two months of 2021, it was still smaller than it was at the end of 2019. Domestic demand, which is the main engine of growth, remains fragile. Retail sales were still 24% below their pre-crisis level and the increase in oil prices could hold back the recovery, even though in February, consumer price inflation, at 1.4% year-on-year, was well below the monetary authorities' target of 3% +/-1 pp.

Consumer confidence remains depressed. Consumers have been hit hard by the crisis due to health measures and the loss of income resulting from the fall in employment, with a substantial share of the population having no social protection. The Indonesian central statistical agency estimates informal employment at more than 60% of the total. In addition, the latest surveys of both consumers and corporates showed that the situation in the labour market has remained fragile through the early months of 2021.

Business leaders seem to be more confident than consumers. The manufacturing sector PMI index was above 50 in March, for the fifth month in a row. The increase in imports (excluding oil and gas) in February, and particularly that in capital goods, confirmed the recovery in industry. That said, investment is unlikely to recover to any significant degree until the second half of this year. Although business leaders view financial conditions as better than before the Covid-19 crisis, the terms of lending appear less flexible. In addition, capacity utilisation rates, whilst rising, remain below their long-term average.

The recovery could, however, be undermined by another epidemic wave, although since the beginning of February it seems to have lost intensity. Vaccination levels remain far too low to protect the population from a possible new wave. By the end of March, only 2.4% of the population had received a first dose of the vaccination.

Against this background, the Indonesian central bank cut its policy rate by 25 basis points (bp) to 3.5% in February, in order to bolster the economy, at a time when other central banks were raising their rates. This took the total cut in rates since February 2020 to 150bp. The relaxation of monetary policy could, however, be disrupted by an increase in oil prices and the rise in US long-term rates. This has resulted in capital outflows and downward pressure on the rupiah, which has lost 4.3% against the dollar over the first three months of 2021.

FORECASTS

	2019	2020e	2021e	2022e
Real GDP growth (%)	5.0	-2.1	4.2	4.6
Inflation (CPI, year average, %)	2.6	2.0	1.6	2.1
Gen. Gov. balance / GDP (%)	-2.2	-6.2	-5.8	-4.5
Gen. Gov. debt / GDP (%)	30.7	40.7	43.5	45.8
Current account balance / GDP (%)	-2.7	-0.4	-1.0	-2.1
External debt / GDP (%)	36.0	39.4	40.0	40.2
Forex reserves (USD bn)	122	129	134	142
Forex reserves, in months of imports	7.1	7.3	7.4	7.6

e: ESTIMATES & FORECASTS

TABLE 1 SOURCE: BNP PARIBAS GROUP ECONOMIC RESEARCH

DOMESTIC DEMAND IS STRUGGLING TO RECOVER

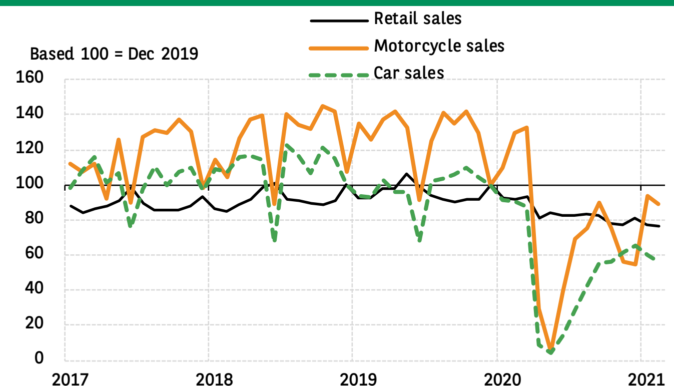

CHART 1 SOURCE: BI

A BUDGET TO SUPPORT RECOVERY

In 2021, the Indonesian economy will benefit from a 7% increase in public spending relative to 2020[1]. In particular, the finance ministry plans to increase infrastructure investment by 47.3%, alongside increases in spending on social security and health, education, and new generation IT and communication equipment. To help finance infrastructure spending, a sovereign wealth fund has been created with an initial contribution of USD5 billion from the government, which

1 Over the first two months of 2021, spending increased by 1.2%.

hopes that this will be topped up to USD20 billion by a mix of private and public investment.

Despite economic growth recovering to between 4.5% and 5%, the finance ministry estimates that the increase in government revenues will be a modest 6.7%.

Thus, the government expects only a limited reduction in its fiscal deficit, taking it from 6.2% of GDP in 2020 to 5.5% in 2021. Moreover, the government's target of cutting its deficit to 3% of GDP by 2023 looks difficult to achieve, unless with a drastic cut in spending, as reductions in company tax rates and various other tax cuts included in the 'Omnibus Law' will affect government receipts.

Against this background, the government's debt will rise by around three points of GDP in 2021, taking it to 43.5%. This will nevertheless be lower than in other ASEAN countries, such as Malaysia. There are, however, two remaining areas of concern: interest payments will account for more than 21.4% of receipts, whilst the domestic bond market will be unable to cover the government's entire financing needs. Moreover, since March 2020, foreign investors have limited purchases of rupiah-denominated Indonesian debt. By January 2021, they held 24.9% of the total stock, down from 38.6% at the end of 2019. To address this issue and control borrowing costs, the central bank will continue to purchase government bonds on the primary market, as it did in 2020.

VERY EXPANSIONARY MONETARY POLICY

The central bank helped support the economy through 2020 by adopting a very expansionary monetary policy. In addition to policy rate cuts, it injected the equivalent of IDR 750.4 trillion (4.9% of GDP), not only through purchases of government bonds for a total of IDR 473.5 trillion (3% of GDP), but also through substantial cuts in statutory reserve requirements for banks, which increased liquidity across the sector by IDR 155 trillion. As a result, the liquidity coverage ratio hit 226.2% in Q2 2020.

In February 2021, to help support a recovery in lending, the central bank also removed the deposit requirement on mortgages and car loans (for banks with a non-performing loan ratio of less than 3.5%). However, the fall in the average lending rate has been limited. Rates on lending for investment have come down by only 90bp on average, and those for consumer lending by just 50bp.

The economic policies adopted jointly by the government and central bank have helped support the actors most affected by the crisis, in particular small and medium-sized enterprises, which have benefited from debt restructuring and government-guaranteed loans. Despite this, overall bank lending has contracted. In January 2021, lending to business was still 4% lower than in January 2020, whilst lending to households had risen by only 0.6%. Banks remain extremely cautious in their lending policies.

CREDIT RISK REMAINS UNDER CONTROL

The banking sector has remained solid so far, despite a fall in profitability. Returns on assets and returns on equity fell to 1.5% and 10.2%, respectively, by the end of 2020 (from 2.5% and 16% at end-2019).

BANK LENDING CONTINUES TO CONTRACT

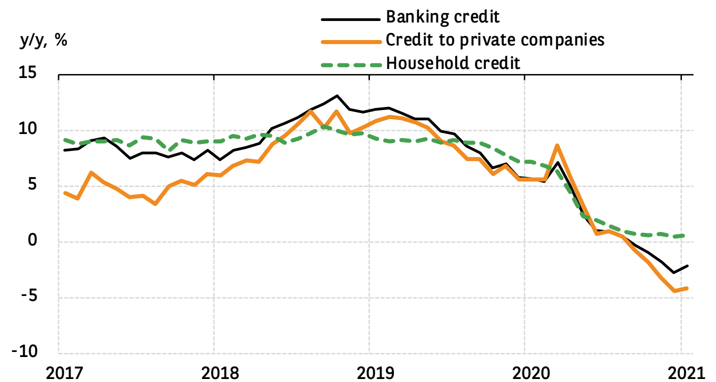

CHART 2 SOURCE: BI

At the end of 2020, asset quality remained more than satisfactory: the non-performing loan ratio was just 3.2% in February 2021 (from 2.8% a year earlier). However, this ratio varies from one segment to the next (it is nearly 4.9% in retail) and in all likelihood is understated; banks can wait until 31 March 2022 before categorising loans as non-performing. Meanwhile, according to S&P, loan restructuring increased by 18% in 2020.

At the same time, the position of companies, which was already fragile before the Covid-19 crisis[2], has further deteriorated following a contraction in revenue. According to the central bank, the interest coverage ratio (a measure of the number of times a company could make the interest payments on its debt with its EBIT) was only 0.5 on average in Q2 2020. The ratio was below 1 in all economic sectors apart from mining. This is a trend that threatens a sharp rise in credit risk.

Overall, however, banks still have the capacity to deal with the expected deterioration in the quality of their assets. They have increased provisions (the provisioning rate jumped to 66.3% in Q3 2020, from 53.3% at the end of 2019) and their capital adequacy ratio remained very comfortable in December 2020, at 23.8%.

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2 According to the IMF's Article IV report in March 2021, the financial position of Indonesian companies was more fragile than in other ASEAN countries at the end of 2019. The IMF estimates that at end-2019, debt stood at 27% of assets, against 22% in the rest of the ASEAN zone. Moreover, for 56% of companies (compared to less than 40% in Malaysia), profits were less than twice their interest costs.

THAILAND

WAITING FOR THE RETURN OF TOURISTS

After a severe recession in 2020, economic growth will rebound moderately in 2021-2022. The main growth engines – private consumption and the tourism industry – were weakened by the abrupt shutdown of economic activity as of Q2 2020, and the dynamics of the recovery will continue to depend on the evolution of the health situation. As in 2020, the authorities will take advantage of the comfortable manoeuvring room built up prior to the crisis to provide economic support. In the medium to long term, political tensions, exacerbated by the economic crisis, will continue to strain Thailand's long-term growth potential.

A LACKLUSTRE RECOVERY

After contracting by 6.1% in 2020, real GDP is expected to recover in 2021 and 2022, rising by 3.2% and 4%, respectively. Domestic demand has been drained by the economic shutdown in Q2 2020 (when GDP contracted by more than 12% y/y) and by strict social distancing measures maintained throughout most of H2. Despite massive government support, private consumption and investment contracted at an average annual rate of 1% and 4.8%, respectively. The absence of foreign tourists, supply disruptions and the desynchronisation of Asian supply chains also triggered a drop-off in exports of goods and services, down 19.4%.

Looking beyond a base effect, economic growth is expected to rebound moderately in 2021. Growth will get some support from the manufacturing and export sectors, which have been recovering since July according to monthly statistics. Given the composition of Thailand's exports, however, it will not benefit fully from the dynamic momentum of the electronics sector observed in the other ASEAN countries (electronics accounted for less than 15% of Thailand's 2019 exports).

In the short term, the dynamics of the recovery will continue to hinge on the evolution of the health situation. A new wave of Covid 19 cases, with the ensuing restrictions that would entail, could hamper and even halt an already fragile recovery.

Although the pandemic has not hit Thailand very hard so far –in early April 2021, it reported 95 deaths and fewer than 30,000 cases, or only 419 cases per million inhabitants– the government had to reintroduce severe restrictions between mid-December and mid-February (including curfews and the closing of schools, bars and restaurants, measures that had been gradually lifted between May and August 2020). During this period, the number of daily new cases averaged more than 300, after holding below 5 between May and November. Since mid-February, the number of new cases has levelled off at slightly under 100.

As a result of the restrictions, the rebound in domestic demand came to a halt in Q1 2021. After improving continuously since last July, consumer confidence indexes and household consumption declined in January and February. Weakened by the 2020 decline in household revenues and the under-utilisation of production capacity, private consumption and investment are both expected to remain sluggish at least through H1 2021. Production capacity utilisation rates have improved since June 2020, rising to 64% in February 2021 from 51% in May 2020, but they are still well below the pre-crisis 2019 level of 68%.

The tourism sector, which represents in the broad sense of the term more than 20% of GDP, will continue to be anaemic this year. The government announced several measures to spark a recovery in tourism. Since the beginning of December, foreign visitors from 56 countries have been authorised to enter Thailand (prior to that, the country's borders were closed), albeit under very strict conditions: visitors must stay at least one month, including a 14-day quarantine period. As of 1 April, the quarantine period was reduced to 10 days, except for countries where the majority of cases are Covid-19 variants.

Above all, the government announced that it plans to open the country's main tourist destinations more widely as of 1 July, three months earlier than the rest of the country. To accomplish this, the inhabitants of these areas (notably the Phuket Islands and Ko Samui) will be given priority for vaccinations, and the quarantine period for

FORECASTS

	2019	2020e	2021e	2022e
Real GDP growth (%)	3.7	-6.2	3.2	4.0
Inflation (CPI, year average, %)	1.3	-0.8	0.4	0.3
Gen. Gov. balance / GDP (%)	-2.3	-5.1	-4.9	-3.7
Gen. Gov. debt / GDP (%)	41.1	49.4	55.1	55.3
Current account balance / GDP (%)	7.3	3.3	2.6	4.9
External debt / GDP (%)	31.5	34.7	33.7	32.6
Forex reserves (USD bn)	224	258	270	287
Forex reserves, in months of imports	9.0	15.0	11.0	11.0

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

FOREIGN TOURISTS (MILLIONS OF PERSONS PER MONTH)

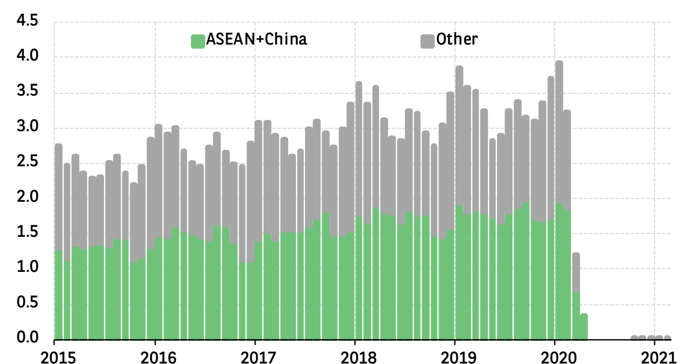
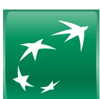


CHART 1 SOURCE: MINISTRY OF TOURISM



vaccinated tourists will be reduced to one week.

According to central bank estimates, these measures could allow Thailand to welcome a total of three million tourists in 2021. Over the past ten years, the number of tourists has increased continuously to nearly 40 million in 2019. Although very low, the central bank's estimates still seem to be optimistic. Vaccination campaigns have encountered numerous delays, not only in Thailand but also in the other Asian countries (in 2019, tourists from other ASEAN countries and China accounted for more than 55% of the total), and the government is having trouble procuring the necessary number of doses. Consequently, it seems highly unlikely that the number of tourists will increase rapidly, or that tourism revenues will recover significantly before Q1 2022.

ECONOMIC POLICY IS STILL ACCOMMODATING

As in 2020, the authorities will continue to provide economic support. On the whole, all of these measures, including state-backed guarantees, accounted for nearly 10% of GDP in 2020. The Thai government is taking full advantage of the manoeuvring room at its disposal: the fiscal deficit was limited through 2019 (at an average of nearly 3% of GDP between 2015 and 2019), fiscal savings were substantial, and the public debt was mild (41% of GDP in 2019), with a favourable profile. The government announced new support measures in early February equivalent to 1.3% of GDP (mainly in the form of tax exemptions and transfers to the most vulnerable households), and further measures could be taken over the course of the year.

The public deficit is expected to level off at about 5% of GDP in 2021, and the public debt will swell for the second consecutive year (to about 55% of GDP, up from 49% in 2020), without significantly increasing the vulnerability of public finances, at least not in the short term.

Similarly, monetary policy will remain accommodating. After lowering its key rate by 75 basis points to 0.5% in 2020, the central bank has maintained the monetary status quo ever since. Further rates cuts are unlikely in 2021, but new measures could be announced to make it easier for SMEs and households to access lending.

ONGOING POLITICAL TENSIONS

The ongoing social and political crisis is hampering the country's medium- and long-term growth prospects and undermining its attractiveness, straining tourism revenues and discouraging domestic and foreign investment.

Social tensions rose significantly again in 2020. The poor track record on executing the reforms promised during the 2019 elections combined with the economic crisis have exacerbated feelings of mistrust towards the authorities.

Pro-democracy demonstrations have been held since last July. Initially led by students, these protests have rapidly spread to include a greater share of the population. The protesters' demands are extremely diverse, ranging from the economic situation to the military junta's repressive reforms. The demonstrations had to be halted in December and January after social distancing measures were reinstated and Bangkok was put under a strict lockdown (the city was not only the main site of demonstrations, but the surrounding province also had the highest virus infection rate).

FDI INFLOW (% OF GDP)

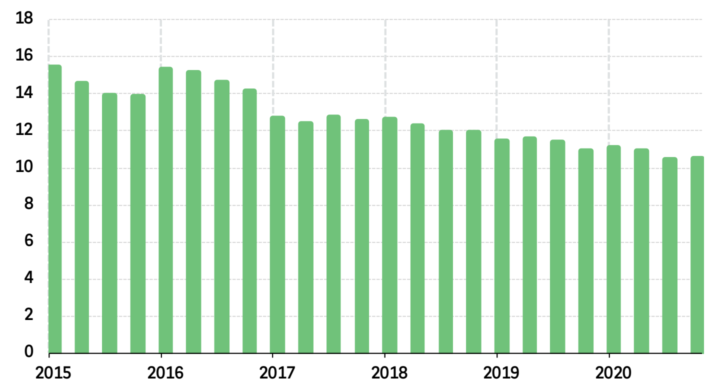


CHART 2 SOURCE: CENTRAL BANK

Demonstrations flared up again in early February. The political climate is still tense and could deteriorate further once the health crisis has stabilised. The protesters' biggest demand is for the government to modify the constitution to reduce the army's influence on domestic politics and the various public institutions. This demand is unlikely to be met. The military junta came to power after a coup in 2014, drafted a constitution in its favour in 2016 and then ratified it in 2017. The country's political and economic life is organised around a "strategic plan" (written by the military junta with its own interests in mind), and enshrined in the constitution. The 2019 elections strengthened the military junta's control over the country.

Yet the resurgence of political tensions and the multiplication of popular demands in the months and years ahead do not necessarily signal that a radical regime change is in the works. Given the country's political and social functioning as well as its recent political history, these tensions are more likely to persist without ever resolving the underlying social and political crisis.

Political risk is Thailand's main structural weakness and remains the biggest threat to economic growth. In the short to medium term, the mistrust of domestic and foreign investors will hinder the recovery, which in turn will strain the rebound in household revenues and the prospects for a healthier labour market. It will also handicap the country's positioning within Asian supply chains. Thailand's chronic political instability also hampers the implementation of the structural reforms needed to adapt to an ageing population, the lack of infrastructure, and the growing risk that the country will remain mired in a middle income trap.

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BRAZIL

AN INCREASINGLY PREOCCUPYING SITUATION

The health crisis continues to worsen – undermining the economy to a point of entertaining a recessionary risk in the first half of 2021. In this context, confidence has plummeted and financial markets have retreated. The vaccination campaign – after facing significant logistical challenges – has finally begun to accelerate since mid-March and with the concomitant introduction of new restrictive measures, the hope is that the epidemic curve will reach an inflection point over the next two months. Faced with rising inflation and inflation expectations, the Central Bank launched its monetary tightening cycle, which – against a backdrop of slowing economic activity and a high sovereign interest burden – has exacerbated budgetary pressures and risks. Although weakened by the crisis, financial soundness indicators of the banking sector remain very favourable.

COVID-19: A CRITICAL SITUATION…

Confronted with the spread of the P1 variant of the coronavirus (emanating from the Amazon region) while simultaneously dealing with shortages of drugs and oxygen – Brazil has been experiencing its darkest hour of the pandemic so far. The epidemic continues to accelerate in most regions with the exception of a few states in the South where the situation has stabilized. The variant, which is between 1.4 and 2.2 times more contagious – is responsible for the majority of new cases and is increasingly affecting younger people (over 30% are under the age of 60). The mortality rate has doubled in a month to such extent that at the end of March, Brazil accounted for a quarter of new deaths worldwide. In 17 of the 26 states, the occupancy rate of intensive care units is higher than 90% including three states which no longer have any beds available. Recent studies show that the variant could be resistant to antibodies produced by (a) previous infections and (b) certain vaccines – thereby facilitating reinfections.

The deployment of vaccines – launched in mid-January – has so far been insufficient to slow the progression of the epidemic. At the end of March 8.5% of the population had received a first dose of a vaccine (about 2% had received two doses). Faced with vaccine shortages, several states have had to halt their vaccination campaign (including Rio de Janeiro). Since mid-March however, the pace of vaccinations has accelerated and is expected to ramp up in April as more doses become available (Brazil has called upon virtually all vaccine suppliers for doses and federal authorities have authorized local governments and private companies to place orders). Assuming the pace of vaccinations holds at some 600,000 shots per day and lockdown restrictions, recently imposed by local officials, are effective (including curfews, the closing of non-essential businesses, moving up school holidays) – the epidemic could reach an inflection point towards the end of May. Brazil is still aiming to vaccinate at least half of its population by the end of 2021.

FORECASTS	2019	2020e	2021e	2022e
Real GDP growth (%)	1.4	-4.3	2.5	3.0
Inflation (CPI, year average, %)	3.7	3.2	6.5	4.0
Fiscal balance / GDP (%)	-5.8	-13.2	-9.4	-8.2
Gross public debt / GDP (%)	74	89	91	94
Current account balance / GDP (%)	-2.7	-0.9	-0.4	-1.9
External debt / GDP (%)	37	43	41	39
Forex reserves (USD bn)	357	356	350	346
Forex reserves, in months of imports	17	21	19	18

e: ESTIMATES & FORECASTS

TABLE 1 SOURCE: BNP PARIBAS GROUP ECONOMIC RESEARCH

DAILY COVID-19 VACCINATIONS

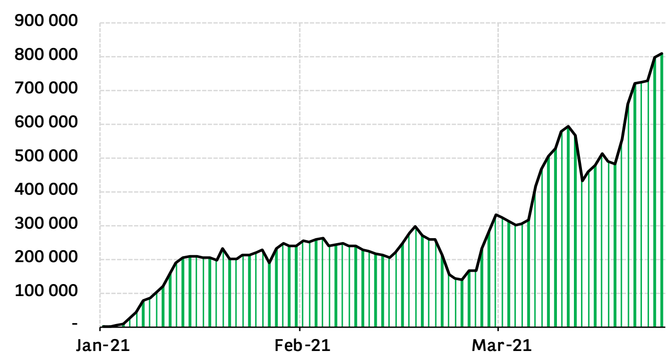

CHART 1 SOURCE: OWID

…WITH POTENTIALLY HIGH POLITICAL STAKES

Faced with an increasingly dire health situation, rising inflation and the return on the political scene of former President Lula (2003-2011), President Bolsonaro has come under increased pressure and his popularity – once bolstered by a generous emergency aid package in the wake of the first epidemic wave – is eroding, even within parts of his own political base. Also, the decision in February by the Republic's Public Prosecutor to dismantle the anti-corruption operation *Lava Jato* (which sent Lula to prison), and the annulment of the former President's sentence[1] by a judge of the Supreme Court have revived speculations about a possible electoral battle between the two men in 2022.

HEADING TOWARDS A CONTRACTION OF GDP IN Q1… AND Q2

Undermined by the worsening dynamics of the epidemic and the withdrawal of fiscal support measures, activity indicators in Q1 have lost steam and are pointing to a likely contraction of sequential GDP in the first quarter. January's resilient performance proved to be short-lived as industrial production reversed in February (-0.7% m/m) – contracting for the first time in 10 months driven by lower automotive and mining production. According to March PMI indices, activity conti-

1 Lula was however not exonerated and will be judged by a Federal court in Brasilia deemed "more competent" to examine the four existing cases against the former President.

nued to contract in the services sector for the third consecutive month, and manufacturing production also declined. On the demand side, the expiration of emergency support measures reduced the consumption capacity of households. Lastly, despite the depreciation of the BRL and large improvements in the country's terms of trade, net exports will likely make a more modest contribution to growth than originally anticipated owing to the faster increase in imports (largely due to purchases of oil rigs by Petrobras). As such, the Q1 trade surplus (USD 1.65 bn) was two times smaller than market forecasts.

The short-term outlook has also weakened and there is an increasing risk that the economy could experience a technical recession in H1. Granted, household consumption will get a boost from a new round of emergency aid voted in March, but the package will be much more limited in terms of size and reach. Also, rising inflation and plummeting household confidence (-10 points in March) point to increased caution on the part of consumers. On the supply side, although agriculture should continue to be resilient, the services sector will suffer from recently imposed mobility restrictions. Several factors are also likely to undermine industrial activity, including (i) slowing production in the manufacturing sector as new orders have declined, (ii) the likely continued slowdown in civil construction seen since January, and (iii) the temporary suspension of production by seven big automotive manufacturers in April. The automotive sector, which saw its sales collapse in 2020 (-21.6%), was also marked by the shut down in January of three Ford production plants – the company having decided to pull out of the Brazilian market. Economic prospects should be more favourable in the second half of the year (wider rollout of vaccinations, stronger global growth). The extension in time of lockdown restrictions will remain an important downside risk to growth (according to the Independent Fiscal Institute, when 50% of activity is paralysed, GDP falls by about 1 percentage point).

The weakness in the stock market (-6%) and the currency (~10%) witnessed since the beginning of the year are symptomatic of the concerns hovering over the economy. Such retreats are also a reflection of a rise in political risks due to (i) fears of greater state interventionism (the appointment by Bolsonaro of an army reserve general at the head of Petrobras has temporarily caused the oil giant's stock price to lose 20%), but also (ii) concerns over a rise in populism with increased risks of fiscal slippage. The market's perception of increased sovereign risk (the 5-year CDS has increased from 145 bps to 224 bps since January, while sovereign risk premia on 10-year yields are close to their 2015 peak) – has materialized just as BRL 350 bn (4.7% of GDP) of sovereign bond debt matures in April – a record.

MONETARY TIGHTENING CYCLE AND FISCAL PRESSURE POINTS

The faster-than-expected rise in the IPCA consumer price index (+5.2%, in February, driven by higher transportation costs in particular), has prompted the Brazilian Central Bank (BCB) to lift its policy rate in March – a first in 6 years. The 75 bps hike in the SELIC (previously held at 2% since August 2020) is the first of several tightening actions aimed at normalizing monetary conditions in the economy. The BCB foresees inflation at 5% at the end of the year, close to the upper range of its target (3.75%, +/- 1.5 pp).

The BCB wants to avoid a de-anchoring of inflation expectations in a context of the continued weakness of the BRL, rising commodity prices and higher risk premia –driven by increased fiscal uncertainty. The hike in rates also comes at a time when investors' appetite for emerging markets assets is somewhat waning with the rise in real terms of long

USD BRL VS TRADE-WEIGHTED DOLLAR INDEX

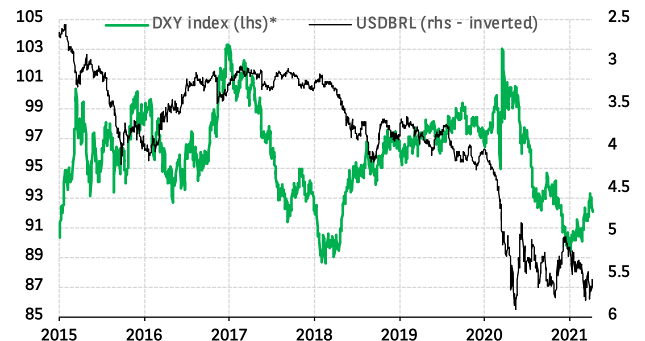

CHART 2

*A rise in the index indicates an appreciation of the USD

SOURCE: MACROBOND

rates in the US. The appreciation of the US dollar that it sustains could indeed incur a greater inflationary risk by increasing the price of imports. However, as the epidemic escalates and the economy slows down, rising rates represent an additional source of fiscal risk. A one percentage point (pp) increase in the SELIC represents an additional interest charge of about BRL 30 bn to 35 bn for the Treasury amounting to about 2/3rd of the emergency aid approved in March. This comes at a time when pressures on the spending cap have been mounting, culminating in a deadlock between congressional leaders and the government over final approval of the budget. The government's manoeuvring room to increase –already quite limited– discretionary spending (about 5% of the budget) will likely be even tighter this year[2].

BANKING SECTOR: STRONG RESILIENCE

In 2021, as repayments on loans (restructured during the crisis) progressively come due, banks will witness an increase in non-performing loans. A weaker repayment capacity on behalf of both households and corporates will in part drive this process. Household debt has risen and so has unemployment (14.7% s.a, in January); the labour market participation rate declined by some 5.1 pp in 2020 while the real wage bill continued to contract early in 2021 – pushing household debt service ratios to rise rapidly. Corporates – which have now experienced their third recession over the past 6 years – also report higher debt ratios. However, thanks to higher precautionary savings and emergency credit support programmes (Pronampe, PEAC), they exhibit better liquidity ratios, notably with respect to short-term debt.

Banks – despite experiencing sharp falls in profits and ROE– are still well positioned to absorb losses on their balance sheet as well as handle liquidity shocks. The banking system displays (i) high capital adequacy ratios (regulatory capital to risk-weighted assets of 16.7%) (ii) very good coverage of short-term liabilities by liquid assets (iii) low dependence on market financing, with a loan-to-deposit ratio of more than 90% (iv) relatively low non-performing loans ratios (90-day delinquencies have oscillated between 3% and 4% over the past five years) and (v) banks' balance sheets tend to have little exposure to currency risk. Even if they have declined, banks' intermediation margins remain high (interest rate spreads of 15.6 pp). Finally, the BCB's stress tests also demonstrate a good resistance of banks' portfolios to a rise in interest rates.

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2 The Treasury and the Independent Fiscal Institute noted that the budget approved by Congress in March significantly underestimated mandatory spending. Once adjusted, this will lead to a further decline in discretionary spending (the budget in its current form would otherwise break the spending cap, the Federation's main fiscal rule).

MEXICO

A FRAGILE RECOVERY

Thanks to a strong Q4 rebound, the contraction in real GDP was limited to 8.2% in 2020, the public deficit did not swell as much as expected, and 2021 growth prospects were given a boost. Yet the recovery is still fragile: private consumption and investment have both taken a lasting hit from the 2020 crisis, and the export sector will not benefit fully from the expected rebound in US growth. The crisis also exacerbated concerns about the vulnerability of public finances and the decline in investment, which will undermine medium to long-term growth prospects.

STRONGER-THAN-EXPECTED REBOUND

Real GDP contracted 8.2% in 2020. The economy was hard hit by the collapse of domestic demand due to lockdown measures and the drop-off in external demand, mainly from the United States (80% of total exports). Prospects continued to erode during the first three quarters (at the end of Q3, real GDP was expected to decline by more than 10% in 2020), but the strong Q4 rebound helped limit the decline in full-year GDP and to improve the growth prospects for 2021 and 2022.

Even so, the recovery is still fragile and GDP is unlikely to grow by more than 4% in 2021. Exports will be the main growth engine, fuelled by the rebound in the US economy and by the American Recovery Plan. In contrast, domestic demand will remain weak, undermined by the drop-off in activity in Q2 2020 (real GDP contracted 18.7% y/y), and by extremely limited government support. Public spending will barely increase again this year after the government reiterated its determination to pursue the austerity programme announced at the beginning of it's mandate. After providing massive economic support in 2020[1], the central bank is also likely to make more limited interventions in 2021. Our scenario calls for the key policy rate to be maintained at the current rate of 4%.

THE HEALTH SITUATION IS STILL FRAGILE

The risks are on the downside due to the fragility of the health situation. The vaccination campaign has fallen behind initial targets, and the number of new daily cases is still relatively high. At the end of March, the number of people who had received their first dose of the vaccine was slightly below 5.5 million (less than 4.5% of the total population), while 750,000 had received their second dose (barely more than 0.5% of the population). According to recent government announcements, the vaccination rate should accelerate in the days ahead. The goal is to vaccinate half of the population with two doses by the end of the first half, and the entire population before the end of 2021. These targets do not seem to be very realistic given the difficulties the government has had in procuring the necessary doses and the pace of the vaccination campaign so far.

Moreover, the health emergency that was declared in February 2020 is still in effect, as well as the colour coding system[2] set up last May to indicate the level of restrictions in vigour in each state. After holding steady at about 5,500 new cases since June, the number of daily new cases rose continuously between mid-November and the end of January, peaking at 17,000 new cases. At that time, virtually all states were in the red zone. The number of new daily cases has fallen continuously ever since, to slightly below 4,500 cases at the end of March, when 8 states were still "orange", 3 were "green" and the other 21 were "yellow".

FORECASTS

	2019	2020e	2021e	2022e
Real GDP growth (%)	0.1	-8.2	4.0	2.7
Inflation (CPI, year average, %)	3.7	3.4	3.9	3.7
Budget balance / GDP (%)	-1.7	-2.3	-4.1	-4.8
Public debt / GDP (%)	46.4	50.8	52.3	54.5
Current account balance / GDP (%)	-0.2	2.5	0.9	0.5
External debt / GDP (%)	37.7	41.2	41.8	42.5
Forex reserves (USD bn)	180.0	195.0	203.0	209.0
Forex reserves, in months of imports	3.5	4.3	4.5	4.1

e: ESTIMATES & FORECASTS

TABLE 1 SOURCE: BNP PARIBAS GROUP ECONOMIC RESEARCH

TWO SPEED RECOVERY

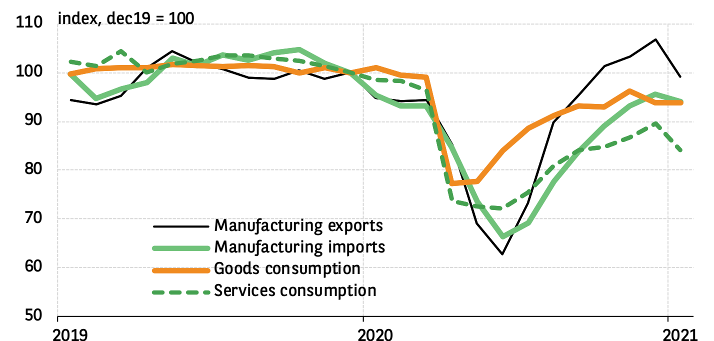

CHART 1 SOURCE: CENTRAL BANK

PUBLIC FINANCE CONCERNS

The public deficit was not as high as feared in 2020, at 2.3% of GDP, compared to 1.7% in 2019, thanks to a very tight grip on public spending (economic support measures barely totalled more than 1% of 2020 GDP), higher Q4 revenues (thanks to the increase in oil prices, and to a lesser extent, the rebound in growth) and the postponement of a financial transfer to Pemex, the state-owned oil company. Naturally, the public debt ratio did not increase as much either, at 50.8% of GDP, compared to 46.4% in 2019.

1 The key rate was lowered by 300 basis points to 4%, and a series of economic support measures were set up during the summer for a total of nearly 4% of GDP.
2 Green, yellow, orange and red, depending on the virus infection rate and hospital occupancy. Restrictions are at maximum levels in the red zones.

Despite this relatively good performance, the fiscal situation is still difficult and pressures could even worsen. Contrary to the government's 2021 fiscal targets (stabilisation of the deficit at about 2.5% of GDP over the next two years), we expect the public deficit to increase to 4.1% of GDP in 2021. As in its previous budgets, the government's forecasts seem to be overly optimistic and will be hard to reach, not only in terms of GDP growth, but also for Pemex's financial situation and oil production. The government's 2021 production target is 1.86 million barrels per day (mb/d). In 2020, the target was 1.95 mb/d, but in the end, production actually came to only 1.65 mb/d.

Given the feeble rebound in domestic demand, fiscal revenues are unlikely to rise much. Moreover, social pressure and the ongoing deterioration of Pemex's situation will probably require massive, recurrent government transfers in the quarters ahead, which should significantly increase spending as of 2021. Moreover, to offset the loss of revenue in 2020, the government has already drawn heavily on the oil sovereign wealth fund. The remainder will probably be used in 2021, but the remaining amount will not suffice (0.2% of GDP at year-end 2020, compared to more than 1.5% of GDP at year-end 2019). The remainder of available fiscal savings and any central bank transfers will not suffice to provide a sustainable solution, further reinforcing the need for fiscal reform.

Under these circumstances, public debt is expected to exceed 52% of GDP in 2021 and to continue to swell in 2022, bringing the public debt ratio to the highest level in more than 40 years. The deterioration in public debt dynamics, higher contingent risks pertaining to Pemex, the erosion of the sovereign wealth fund and the absence of structural reforms could make the government more vulnerable to changes in investor sentiment. Although public debt still has a favourable profile, with about 80% denominated in local currency, more than 30% is held by non-resident investors.

INVESTMENT DECLINES AGAIN

Structural fragilities, such as a low investment rate and the deterioration in business sentiment, existed well before the outbreak of the Covid-19 crisis and will continue to strain growth prospects in the short to medium term. Some of these weaknesses have even been exacerbated over the past 12 months, including a rather opaque economic policy and questions about the private sector's participation in certain key segments of the economy. The electricity sector reform that was approved in early March 2021 strengthens the role of state-owned companies to the detriment of the private sector, which could place a lasting damper on investment.

Investor mistrust could be strengthened by the outcome of June's elections, including legislative elections as well as elections for 15 state governors. According to the polls, the popularity of President Andres Manuel Lopes Obrador (AMLO) is very high (above 60% since the beginning of his mandate), and the president is personally implicated in the campaigns for the legislators as well as for the 15 gubernatorial candidates from his party. Morena, the presidential party, and its two allies, the centre-left PT and the centre-green PVEM, are expected to hold onto a majority of seats in the Chamber of Deputies (currently, the three coalition parties have 300 seats out of a total of 500). Given this configuration, the government should have no trouble implementing the reforms it is planning for the second part of its mandate.

GFCF

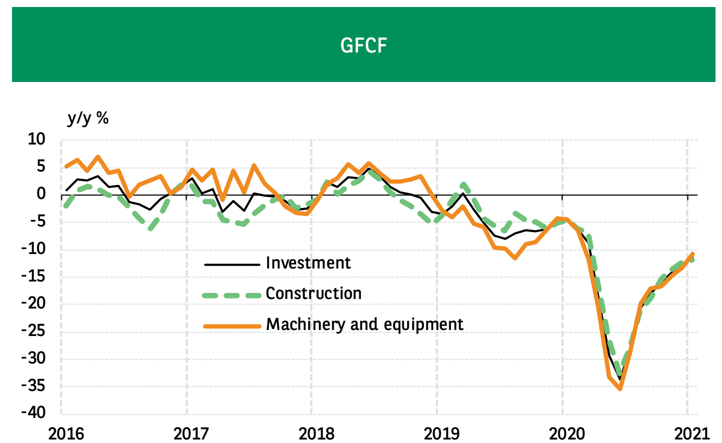

CHART 2 SOURCE: NATIONAL INSTITUTE OF STATISTICS AND GEOGRAPHY

In the medium term, the mistrust felt by local and foreign investors could spread to all sectors of the economy. We expect investment to decline again in 2021: the investment rate has already fallen from 23.6% of GDP in 2016 to 19.3% in 2020, according to the latest IMF figures. Similarly, net inflows of foreign direct investment (FDI), which have declined since mid-2018, are expected to contract again in 2021. All in all, despite the rebound in growth in the very short term, we do not expect Mexican GDP to return to the pre-crisis level (year-end 2019) before the end of 2022. The country's potential growth rate has been revised to 2%, from close to 2.5% at the end of 2019.

Completed on 9 April 2021

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GROWTH AMID IMBALANCES

The November 2020 announcement that monetary policy would move in a new direction had tamed financial tensions. However, as the Central Bank Governor was removed in March 2021, uncertainty came back. Exchange rate depreciation pressures have reappeared and interest rates and risk premiums have risen. Growth support will be the top policy priority, but at the price of maintaining significant macroeconomic imbalances. Credit risk is not reflected into the non-performing loan ratio but the forbearance period which is allowing the postponement of their reporting will end at mid-2021. The observed corporate investment recovery is welcomed, as a precondition to improve potential growth, but other conditions such as productivity growth are still missing.

HISTORY REPEATING ITSELF

Turkey's 2020 economic performance came as a big surprise, with a GDP growth of 1.8% (a rather rare performance worldwide), but also with much bigger-than-expected imbalances: the current account deficit swelled to 5.1% of GDP and inflation hit 14.6% year-on-year in December. Against this background, the exchange rate depreciated sharply and volatility largely surpassed that of most of the other emerging currencies.

The outlook for 2021 is not different, with growth over-performance, high inflation and a very fragile exchange rate. This environment is mainly the by-product of monetary policy changes: after a heightened period of monetary tightening (+875 basis points between November 2020 and March 2021), which temporarily stabilised the Turkish lira, the removal of the Central Bank Governor on 21 March 2021 has raised expectations for a more discretionary policy.

Since 2011, Turkey's monetary policy has followed switches between a series of accommodating phases with regard to inflation followed by periods of late tightening: maintaining the key rate too low for too long only stirred up inflation via demand fuelled by domestic lending. Moreover, high inflation fed and maintained the depreciation of the lira, which exerted feedback pressures towards monetary policy tightening. A 10% currency depreciation generally leads to a 2 percentage point increase in inflation after 3 months (see *Conjoncture* of January 2021). This explains why inflation accelerated in Q1 2021.

Notwithstanding significant GDP growth, the local economy is fragile. Turkey still has a dual labour market with a substantial informal sector. Unemployment exceeds the official rate (12.2% in January 2021) and the Covid period has increased the gap. According to Turkstat's alternative estimate using a methodology closer to International Labour Office (ILO) guidelines, unemployment was closer to 30%. In early March some restrictions introduced during the second wave of the pandemic were lifted, but they had to be reinstated after the number of new cases surged again from the end of March (surpassing 40,000 new cases per day for the first time on 1 April). Tourism is bound to be affected again this summer (foreign currency revenues are expected to be 50% lower than normal, after -80% in 2020): the pandemic is still spreading actively both internationally and locally, even though vaccination programmes are underway (10.8% of the Turkish population had received a first shot at 31 March).

With low tourism revenues, rising oil prices and the depreciation of the Turkish lira (which encourages gold purchases, which is imported), the current account deficit will remain high (4% of GDP) and will not be covered by net capital inflows. The situation will be exacerbated

FORECASTS

	2019	2020e	2021e	2022e
Real GDP growth (%)	0.9	1.8	4.5	3.5
Inflation (CPI, year average, %)	15.5	12.3	16.4	11.0
Budget balance / GDP (%)	-3.5	-4.8	-4.0	-3.0
Public debt / GDP (%)	32.8	40.4	42.0	41.0
Current account balance / GDP (%)	1.2	-5.1	-4.0	-3.0
External debt / GDP (%)	57.1	61.0	63.4	64.0
Forex reserves (USD bn)	79.0	50.0	40.0	44.0
Forex reserves, in months of imports	4.2	2.8	2.1	2.2

e: ESTIMATES & FORECASTS

TABLE 1 SOURCE: BNP PARIBAS GROUP ECONOMIC RESEARCH

EXCHANGE RATE: TRY PER USD

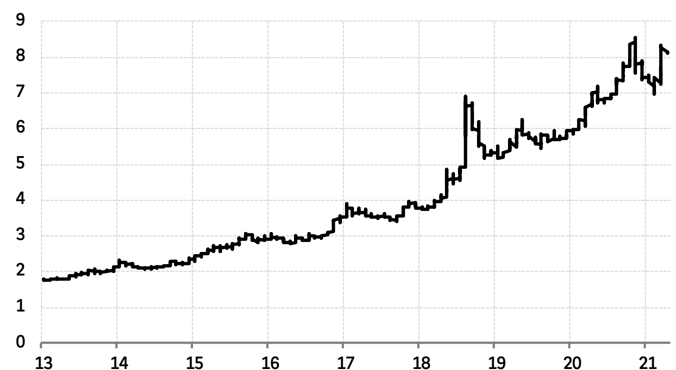

CHART 1 SOURCE: CEIC, BNP PARIBAS

by uncertainty over monetary policy and by the rise in US long-term rates. As a result, foreign reserves and the exchange rate will remain under pressure.

This scenario also implies that domestic interest rates will remain at high levels, notably on public debt. Before 21 March, short-term rates were already high due to the restrictive monetary policy in place since November, but the yield curve was rather strongly inverted (with lower

yields for longer maturities). Since then, the yield curve has flattened. The yield on 3-year instruments (the average maturity of government bonds issued locally in TRY) was 18.5% on 6 April. The sovereign risk premium has also returned to nearly the level that prevailed at the end of October 2020 (with a CDS premium of 445bp at 6 April, vs 304 bp at 21 March).

MIND CREDIT RISK

Although the public debt ratio is relatively moderate at 40% of GDP, structurally higher interest rates and currency depreciation (nearly half of Turkey's debt is in foreign currency) restrict the current policy space, because the interest expenditure is likely to reach 3 points of GDP in 2021. The resurgence of the coronavirus and the impact of accelerating inflation on the local population are likely to trigger new public spending. In parallel, monetary policy will no longer be tightened – it could even be eased in the next few months.

Given their determination to contain the deficit, the authorities are likely to continue using off-balance sheet items to further support the economy (drawing on public banks or unemployment funds). Under this environment, credit dynamics will be a key factor. In spring 2020, lending was used as the main support mechanism for the economy, much more so than in the other emerging countries. In contrast, monetary tightening in November 2020 resulted in a contraction in lending in early 2021. It switched from a credit impulse of nearly 7 points of GDP in Q2 2020, to a negative flow of nearly 1 point of GDP at Q1 2021. Reserve requirement ratios were raised in several phases (the latest was on 24 February), which helped draw down the banking sector's lending capacity. Although the future direction of credit policy is not clear yet, the restrictive policy in place is unlikely to be extended beyond Q1 2021.

The strong increase in lending (bank loans to corporates reached 40% of GDP in 2020 from 30% a year earlier) and the 3-month moratorium on loan payments by non-financial companies in Q2 2020 delayed the risk of an increase in non-performing loans (NPL). As a share of total loans outstanding, the NPL ratio even declined from 5.2% in February 2020 to 4.1% in February 2021. The regulator established tolerance for late loan payments, which would not be classified as NPLs until mid-2021 (extension of the late payment from 90 days to above 180 days to be considered non-performing). For the stage 2 loans, which are loans that are likely to become (but are not yet) non-performing, classification rule was extended from 30 days to above 90 days. Yet the volume of stage 2 loans increased to nearly 1.7% of total loans outstanding, raising fears that there would be a similar increase in the NPL ratio after the end of the forbearance period.

At the same time, the banks have increased their equity capital. They managed to maintain their CET1 ratio at 14% in February 2021, the same as in February 2020. It means that the banks managed to cover their increased exposure to credit risk. Meanwhile, the return on assets (ROA) did not change much, at about 1.5%.

CORPORATE INVESTMENT IS RECOVERING

The significant increase in lending in Q2 2020 certainly supported companies that were short of liquidity (due to higher inventories and late payments), but it also fuelled a rebound in corporate investment. Investment in machinery and equipment rose 21% in 2020, contributing nearly 2 points to GDP growth, ahead even of household consumption, which contributed around 1.9 points.

3-YEAR GOVERNMENT BOND RATE (%)

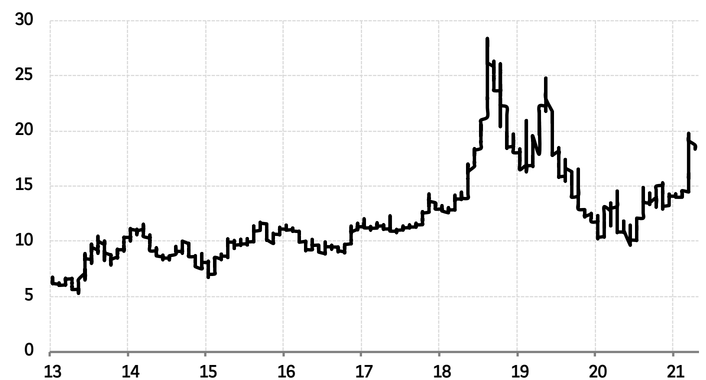

CHART 2

SOURCE: REFINITIV, BNP PARIBAS

The year 2021 is likely to show a more limited growth, mainly because credit dynamics will not be the same. Yet this will not prevent another upturn in corporate investment, which is especially welcome because Turkey's growth potential has been undermined by sluggish investment in 2018-19 and by a reduction in total factor productivity since 2013. Imports of capital goods have picked up, unlike many other items, which contributed slightly to the deterioration in the external deficit.

In the past, when Turkish growth accelerated, it was often the result of an accumulation of capital. Yet the decrease in the level of total factor productivity suggests that other measures must be adopted, notably to support greater participation of the working age population in the formal labour market. It may help to generate positive externalities between physical capital and human capital. Two years of sluggish growth (0.9% in 2019 and 1.8% in 2020) have eroded the level of employment, which was already weak, underscoring the need for new efforts in order to return to more stable growth.

Completed on 9 April 2021

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UKRAINE

TAKING ADVANTAGE OF A FAVOURABLE ENVIRONMENT

The country weathered the difficulties of 2020 relatively well, notwithstanding the recession that Covid-19 produced and the drying up of private capital inflows. Thanks to the improvement in the terms of trade, the current account surplus was sufficient to balance the existing gap. Over recent years, Ukraine has been able to improve its fiscal management, which helped to secure the support of international financial institutions. The challenge for the months ahead lies in a resumption of capital inflows and in the planned reforms to encourage investment and increase potential growth. It will be important to keep an eye on reforms in the banking sector, which relate both to the consolidation of the sector and to the improvement of the prudential and supervisory framework.

FINANCING NEEDS ARE LIKELY TO BE COVERED

Facing a massive shock, the Ukrainian economy has demonstrated an unusual level of resilience. Indeed, Ukraine saw its currency reserves increase in 2020, despite private capital inflows' sudden stop. This is a new phenomenon in the country's recent history. It has helped ensure that the Covid crisis has been weathered better than previous crises, such as those of 2008 and 2014.

Although the country has not avoided recession and the public finances have come under pressure, it has managed to meet its financing needs. It was mainly done through the current account balance, which went from a deficit of USD 4.1 billion in 2019 to a substantial surplus of USD 6.6 billion (an improvement of nearly USD 11 billion). This improvement offset the drop in net inflows of private capital in 2020 compared to 2019, which was of a similar amount. Meanwhile, payments from international financial institutions came to only USD 3 billion, net of repayments of earlier loans.

The improvement in the terms of trade and the structure of exports played a key role in the shift in the current account. The fall in exports was held at only 2%, whilst imports fell by nearly 11%, in part due to the fall in oil prices. Exports benefited in H1 2020 from strong demand for agricultural products (particularly cereals). After this, the industrial recovery seen throughout Europe in the second half of 2020 resulted in very strong growth in steel exports in volume terms, made even stronger in value terms as prices soared.

However, the fragile nature of the balance of payments remains a significant topic for 2021. The current account surplus is likely to shrink, under the effect of falling cereal exports (drop in volumes) and rising oil prices. Meanwhile, even if private capital inflows resume, they will be partly offset by relatively substantial debt repayments, most notably the USD 4 billion debt maturing in the third quarter. Against this background, the country will require the continued support of the IMF.

However, it is possible that the planned USD3 billion will only be partially disbursed, with the February tranche already having been delayed. Given that the country will have to repay USD 1.5 billion to the IMF, net receipts could be limited. Even so, the prospect of an allocation of Special Drawing Rights (SDRs) by the IMF could more than cover the shortfall: given Ukraine's quota in the IMF, nearly USD 4 billion could be allocated (even before taking into account the possibility that advanced economies could forego their share in favour of emerging economies). This would help address the challenge of covering financing needs and suggests a fresh increase in foreign currency reserves over time.

FORECASTS

	2019	2020e	2021e	2022e
Real GDP growth (%)	3.2	-4.0	4.4	3.8
Inflation (CPI, year average, %)	7.9	2.7	7.5	5.7
Gen. Gov. balance / GDP (%)	-2.0	-7.5	-5.5	-2.5
Gen. Gov. debt / GDP (%)	50.1	64.5	66.0	64.0
Current account balance / GDP (%)	-2.7	4.6	1.1	-0.3
External debt / GDP (%)	78.7	83.4	77.3	73.9
Forex reserves (USD bn)	25.3	29.1	31.4	30.0
Forex reserves, in months of imports	4.0	5.7	5.6	5.1

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

TERMS OF TRADE (EXPORT PRICES OVER IMPORT PRICES): Y/Y CHANGE

CHART 1 SOURCE: CEIC, BNP PARIBAS

If IMF payments resume as planned, and the allocation of SDRs comes rapidly, the modest rise in the hryvnia since the beginning of the year could continue despite a growing inflation differential. Inflation accelerated to 7.5% year-on-year in February 2021 (from 2.6% in October 2020), due mainly to the prices of food, electricity and gas. Monetary policy may be tightened beyond the 50bp increase in interest rates implemented in 21Q1 (from the record low level of 6%).

IMPLEMENT FURTHER BANKING REFORMS

The monetary policy easing in the first half of 2020 (500bp cut in the policy rate) allowed bank lending rates to be reduced to record lows. This helped bolster lending growth in 2020, over and above the existing subsidised loan schemes (the so-called 5-7-9 plan), which, despite being expanded, accounted for only 0.5% of GDP. Bank lending to the non-financial private sector increased by 9% based on a constant perimeter (see next paragraph). However, this lending growth against the background of a recession suggests new non-performing loans to come, for which banks have made provisioning. This situation led the central bank to introduce various measures. It extended into 2021 a programme that in 2020 had resulted in the restructuring of 10% of consumer loans and 7% of business loans. The risk weighting associated with consumer loans should be increased in 21H2 from 100% to 150%. Convergence towards Basel and EU standards is likely to resume, after marking time in 2020. Lastly, an asset quality review and stress test exercise will involve the 30 biggest banks.

These stricter rules look necessary given that the banking system has in the past generated significant volumes of non-performing loans, with a lengthy resolution. Thus in 2020, banks were still restructuring non-performing loans that appeared in 2015-16. These still stood at 41% of total loans by the end of the year, from 48.4% in 2019. Moreover, the final average recovery rate remains low (9% according to the World Bank).

The reduction of the frequency of non-performing loans and the effectiveness of the restructuring of those that do arise are the driving forces behind the legal reforms that the government wants to introduce in order to improve the legal security of loans issued and the transparency of financing in general. These reforms also form part of the IMF's conditions for the next tranche of aid to Ukraine. The difficulties experienced in introducing them also explains the disbursement delay of the February 2021 tranche of the IMF's loan to Ukraine.

INCREASE FISCAL SPACE THROUGH LOWER DEBT

In the recent past, the cleaning up of the banking system has created a substantial cost and contributed to the deterioration of the public finances. After the 2015-16 crisis, the country's main bank, PrivatBank, had to be nationalised. Now, the constraints that Ukraine faces in financing its needs make it necessary to look towards reducing government debt in future. The high level of interest rates on the hryvnia, reflecting the level of risk, is a drag on this process as it incentivises external borrowing denominated in currencies with lower interest rates. However, it exposes to a risk of an increased debt service in the case of hryvnia depreciation.

In parallel, government debt is likely to continue to rise in 2021, towards 66% of GDP. The continuation of the Covid-19 epidemic, with a 3rd wave observed in March 2021, and the slow roll-out of vaccinations in Ukraine, suggests that the bulk of the stimulus programme will remain in place in 2021. The government deficit will remain high, at 5.5% of GDP, from 7.5% in 2020. Moreover, whilst IMF support in 2020 served directly to finance the budget, an allocation of SDRs can only benefit the central bank. This would suggest that until IMF support payments resume, the government will have to finance itself on the domestic market at higher interest rates. The scale of interest expenditure, at 3.5% of GDP in 2021, shows the need to reduce borrowing in order to increase fiscal space.

YIELD CURVE

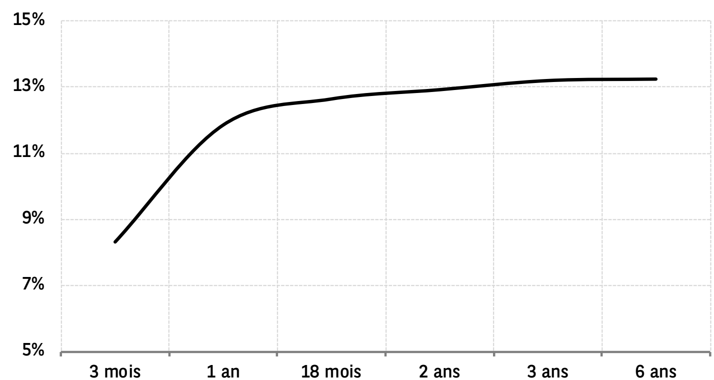

CHART 2

SOURCE: REFINITIV, BNP PARIBAS

INCREASING POTENTIAL GROWTH

Ukraine also needs to focus on attracting Foreign Direct Investment (FDI), in order to limit its external debt (83.4% of GDP in 2020) but also to enhance potential growth. FDI inflows recovered in 2016 but dried up again in 2020. In order to attract future investment, the government has passed a new law in 21Q1 guaranteeing the stability of the legal framework (rule of law). It is also giving foreign investors tax breaks, exemptions from import duties, and preferential property taxes. The aim of this law is to move up the value chain, by making industrial sectors eligible and including businesses in the extractive industries (e.g. iron ore) only if processing and enrichment takes place in Ukraine.

Recent years have brought early successes, notably in the field of IT services, but Ukraine needs sustained investment in its physical and human capital, which has been held back by a series of crises. Thus total factor productivity only regained its 2008 level in 2019. At the same time, the capital stock (notably infrastructure) has dwindled steadily over recent years, when measured at constant prices. Lastly, the number of people employed has also fallen over the past few years, with the emigration of more highly-trained workers. The net result of all this is the limiting of potential growth that now needs to be addressed.

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EGYPT

CONTINUED IMPROVEMENT IN FISCAL PERFORMANCE

The Egyptian economy proved to be resilient last year. Economic growth remained positive thanks to fiscal support, and the main macroeconomic metrics did not deteriorate significantly thanks notably to international support. The good fiscal performance was noteworthy, and will help maintain the attractiveness of Egyptian debt. This said, it would be wise to remain cautious. On the one hand, the rate of vaccination is slow and the pandemic is still active; on the other hand, the external accounts remain vulnerable, and the improvement in the external energy balance seen in 2020 may not continue in the short term.

ECONOMIC ACTIVITY PROVES RESILIENT

Over the past year, the economic consequences of the pandemic have been contained and restrictive measures have been relatively limited. According to official data, the Covid-19 mortality rate has been fairly low compared to the rest of the region, but the country is currently seeing a second wave of cases, which is lasting longer than the first wave and proving harder to curb. For the time being, the vaccination campaign has been limited. Some two million doses of vaccine have been received (some given by China and some from the Covax programme) and a total of 8 million is expected by the end of May. This remains low given a total population of 100 million, roughly half of whom are aged over 24. Egypt should be in a position to manufacture vaccines domestically within the next few months. Given these conditions, the health situation remains a significant source of uncertainty that could continue to weigh on the Egyptian economy.

Over the first three quarters of 2020, real GDP growth was positive, at 1.3% y/y on average, thanks mainly to domestic consumption, which benefited from public spending support. From a sector point of view, the main areas that drove growth were, unsurprisingly, construction, real estate and retail. These sectors benefited firstly from the continuation of major infrastructure and urban development projects and secondly from the government redistribution of purchasing power to households. These same elements should help growth remain positive throughout the fiscal year 2020/21, at 3.1%, although this will be lower than the 3.8% reported for 2019/20, due mainly to the fall in tourist frequentation.

Although uncertainty remains high, we expect a significant rebound in growth, to 5.3%, in 2021/22. In addition to the traditional driving forces of the construction sector and consumer spending, three factors are likely to support this scenario: 1/ a draft budget that will boost domestic demand, whilst placing the emphasis on structural spending; 2/ an upturn in gas production thanks to renewed growth in Asia, which is likely to underpin liquefied natural gas (LNG) prices; and 3/ a very gradual recovery in tourism.

THE GRADUAL IMPROVEMENT OF PUBLIC FINANCES LOOKS SET TO CONTINUE

The situation of public finance should continue to improve even if debt service remains a strong constraint. Despite a challenging economic environment, the budget deficit was more or less stable in 2019/20, at 8% of GDP. Over the past year, fiscal policy has focused on supporting consumer purchasing power, particularly for civil servants and the poorest groups in society, and increasing health spending. Moreover debt service saw a slight dip as a consequence of the downward cycle in interest rates that began in 2018-19. After a peak of 11.4% in 2019, the apparent interest rate on total central government debt was 10.9% in 2019-20.

In general terms, the increase in receipts will allow a continued improvement in the public finances in 2020/21, despite the cost of measures to support the economy. Over the first half of 2020/21, the fiscal performance improved, with receipts up more than 16%

FORECASTS

	2019	2020e	2021e	2022e
Real GDP growth (%)	5.6	3.8	3.1	5.3
Inflation (CPI, year average, %)	13.4	5.6	4.7	6.8
Central. Gov. balance / GDP (%)	-8.0	-8.0	-7.2	-7.0
Central. Gov. debt / GDP (%)	84	90	94	93
Current account balance / GDP (%)	-3.6	-3.1	-3.9	-2.9
External debt / GDP (%)	36	34	34	33
Forex reserves (USD bn)	45	38	42	43
Forex reserves, in months of imports	8.0	6.1	6.9	7.5

(1): Fiscal years from July 1st of year n to June 30th of year n+1

e: ESTIMATES & FORECASTS

TABLE 1 SOURCE: BNP PARIBAS GROUP ECONOMIC RESEARCH

GOVERNMENT BUDGET BALANCE (% OF GDP)

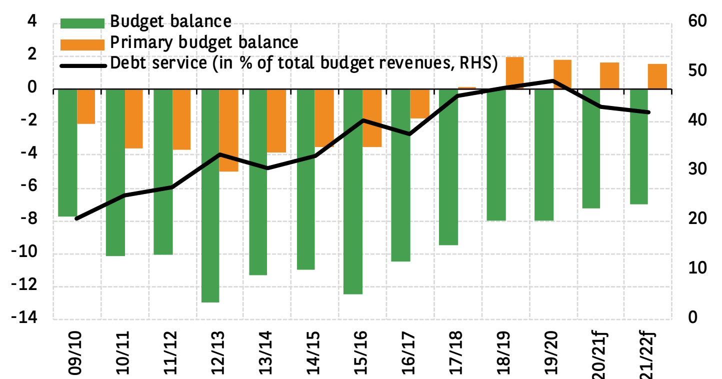

CHART 1 SOURCE: MINISTRY OF FINANCE, BNP PARIBAS

on the same period in the previous year (thanks in particular to an exceptional tax on the highest incomes), whilst spending increased by only 9.6%. This trend continued during Q3 2020/21 according to the ministry of finance. As a result, the government is again likely to generate a primary surplus (equivalent to around 1.6% of GDP) and the budget deficit will be reduced to 7.2% of GDP. However, while debt servicing costs are falling in value terms, they remain very high as a percentage of government revenue (48% in 2019/20), limiting fiscal flexibility. Although this ratio will also continue to fall (42% forecast for 2021/22), it will remain high over the medium term. The pace of falls in interest rates is likely to slow, whilst the IMF's concessional financing will make up a smaller share of the total from 2021/22 onwards. Meanwhile, growth in revenue is likely to remain modest over the medium term. According to the IMF, revenue will reach 22% of GDP in 2024/25, from 19% in 2018/19. Overall, therefore, debt servicing costs will still represent around one-third of revenue over the medium term.

The budget for 2021/22 is currently in its discussion and approval phase. The government's budget target (a deficit equal to 6.6% of GDP) is tightly linked to an economic recovery, and is currently suffering from the lack of any clearly identified new sources of revenue. Two factors could get in the way of the planned deficit reduction: the increase in the overall wage bill and the end of the exceptional tax on income. We expect a deficit of 7% of GDP in 2021/22.

Government debt will remain high over the medium term, given the persistent budget deficit and real interest rates that have moved back into positive territory since 2020. We expect it to peak at 94% of GDP by the end of the current fiscal year, before gradually falling back to 89% of GDP by 2023/24.

CONTINUED EXTERNAL VULNERABILITY

Although the public finances have continued to improve despite difficult economic circumstances, external accounts remain a source of vulnerability. In 2020, the collapse in tourism and the increased short-term volatility of international capital markets hit the country's foreign currency liquidity. The country's external liquidity was stable thanks to international financial support, the high levels of remittances from Egyptians abroad and a fall in imports. The central bank's foreign currency reserves stood at USD 40.3 billion in March 2021 (from USD 45 billion a year earlier), to which we can add USD 8.6 billion in Tier II currency reserves, whilst the net external position of commercial banks had returned to its pre-crisis level of USD7 billion. State-owned banks, which make up half of total bank assets, play an active role in the monetary authorities' exchange rate policy. The current account deficit is likely to grow, reaching 3.9% of GDP in 2020/21, due mainly to the fall in tourist income (expected to be around 40%). The high level of portfolio investment flows and disbursement from the IMF will ensure a satisfactory level of foreign currency liquidity over the short term. The outlook is less certain for 2021/22. We expect a slight fall in the current account deficit in value terms (to USD 14.7 billion) but much higher principal repayments of external debt than in 2020/21. According to the IMF, these are likely to total USD 17.5 billion (from USD 14.2 billion in 2020/21). Meanwhile, trends in international capital flows could be less favourable to emerging economies, given the rise seen in US long yields. Even so, the expected slowing in the downward cycle of Egyptian interest rates, the limited currency risk and the good fiscal performance should help protect the attractiveness of Egyptian sovereign debt.

CENTRAL BANK FOREIGN EXCHANGE RESERVES (USD BN)

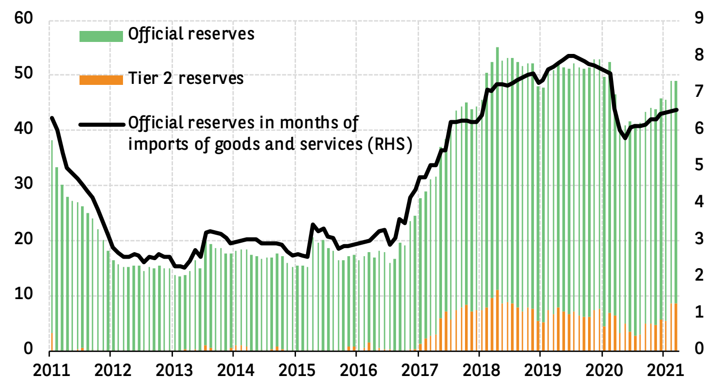

CHART 2 SOURCE: CBE, BNP PARIBAS

THE IMPROVEMENT IN THE ENERGY BALANCE MAY PROVE TEMPORARY

The energy balance improved significantly in 2020, under the combined effect of a fall in domestic demand and an increase in demand from Asia at the end of the year. In the short term, the trend in the energy balance remains fairly uncertain and the surplus seen in 2020 might not be repeated. In the domestic market, demand for oil products (both crude and refined) has been falling steadily over the past five years, due particularly to cuts in subsidies. In 2020, demand fell by around 13% due to the economic slowdown. On the supply side, crude oil production continued to decline, dropping 6% in 2020, due particularly to a lack of investment in new production capacity. At the same time, the production and export of refined oil products continued to grow, thanks to the expansion of production capacity. In volume terms, the external balance on refined products was positive for the first time ever in 2020 (17,000 barrels/day), but the overall balance of trade in oil (including crude) remained significantly negative (-101,000 barrels/day). In value terms, the data available suggests that there was a small nominal surplus, of USD 54 million, in Q3 2020. Meanwhile, LNG exports picked up towards the end of 2020 driven by rising demand and prices in Asia. Over the 2020/21 fiscal year, these exports are likely to total USD 1-2 billion. The prospects for LNG exports remain uncertain for the short term. LNG is sold on the spot market where prices see considerable volatility, and may drop below the Egyptian breakeven price, thus limiting exports.

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QATAR

A FAVOURABLE OUTLOOK

The Qatari economy began 2021 under relatively favourable conditions: thought the regional embargo ended, the Covid-19 pandemic is still active. Despite the fall in oil prices in 2020, the fiscal and current account deficits remained limited. Over the medium term, the development of new gas export capacity should further strengthen an already solid macroeconomic position. The main source of vulnerability remains banks' external indebtedness, which is very high and continues to grow as the economy's expansion accelerates. However, government support is guaranteed, and the external position of the banks should be restored as a result of the expected slowdown in lending and increase in deposits.

A MODEST ECONOMIC REBOUND IN 2021

Two events, pulling in opposite directions, stood out at the beginning of 2021: the lifting of the embargo that had affected Qatar since 2017, and a second wave of the Covid-19 pandemic. The economic consequences of the ending of the embargo are positive in terms of trade and financial flows, but should not be overstated. Whilst the embargo was in force, the Qatari economy was able to diversify its sources of supply and improve its autonomy.

As far as the public health situation is concerned, the death rate due to the pandemic is one of the lowest in the Gulf. However, the number of new cases continues to rise, and new restriction measures have been imposed recently. Government support to the economy in 2020 was substantial, at around 14% of GDP, the bulk of which consisted of support for bank liquidity and a system of restructuring and guaranteeing loans. Despite this, GDP fell 3.7% in 2020, with a 2% year-on-year decline in oil and gas production (40% of GDP) and, more importantly, a sharp drop in non-oil sectors (down 4.6% year-on year), particularly construction, which accounts for 12% of total GDP and contracted by 4%.

In 2021, the economy is likely to return to growth, but the rebound will remain modest at around 1.9%. Oil and gas production is likely to increase only slightly, but progress in the vaccination campaign and the benefits of the lifting of sanctions should boost growth in the second half. GDP will probably return to 2019 levels in 2022, with the expected ending of restrictions relating to the pandemic and the knock-on effects of hosting the football World Cup.

Non-oil GDP has been the main engine of growth over the last decade, but over the medium term the oil and gas sector will take over as the main source of growth due to the development of substantial liquefied natural gas (LNG) production capacity. Production is likely to grow by 60% by 2027. Growth prospects in non-hydrocarbon sectors will be more limited, given the small size of Qatar's population and the limited attractiveness of its economy outside the oil and gas sector. The main sources of economic diversification remain in the downstream sectors of the oil and gas industry.

FORECASTS	2019	2020e	2021e	2022e
Real GDP growth (%)	-0.4	-3.7	1.9	3.6
Inflation (CPI, year average, %)	-0.6	-2.6	1.8	2.9
Gen. Gov. balance / GDP (%)	1.0	-1.7	4.2	3.3
Gen. Gov. debt / GDP (%)	50	48	47	46
Current account balance / GDP (%)	2.4	-2.5	5.8	3.9
External debt / GDP (%)	123	139	134	135
Forex reserves (USD bn)	38	38	45	54
Forex reserves, in months of imports	6.8	7.0	8.0	9.0

e: ESTIMATES & FORECASTS

TABLE 1 SOURCE: BNP PARIBAS GROUP ECONOMIC RESEARCH

ECONOMIC ACTIVITY (% Y/Y)

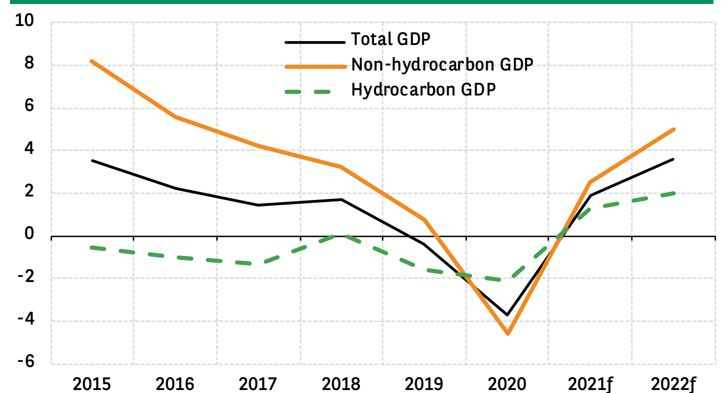

CHART 1 SOURCE: PLANNING AND STATISTICS AUTHORITY, BNP PARIBAS

LNG EXPORT PROSPECTS

In 2017, Qatar brought to an end a twelve-year moratorium on expansion of LNG production capacity, and undertook a USD 50 billion expansion plan that is likely to increase LNG exports by more than 60% by 2027, to some 126 million tonnes per year. Long-term LNG supply contracts will remain as the bedrock of Qatar's commercial policy, but the launch of a dedicated structure could increase sales on the spot market up to some 20% of total sales, depending on market conditions.

At a global level, the LNG market is becoming increasingly competitive, with a notable strong increase in exports from the USA (shale gas), which in just a few years has become the world's third largest exporter, overtaking Russia. That said, prospects for the Qatari LNG industry remain favourable over the medium to long term. In general terms, although it still produces greenhouse gas emissions, burning LNG is less polluting than burning oil or coal. According to the International Energy Agency, growth in demand for LNG will be outstripped only by demand for renewable energy over the medium term. In addition,

Qatari LNG enjoys some of the lowest production costs in the market. Asia, its traditional market, is likely to remain the region seeing the strongest growth in demand for gas.

SOLID PUBLIC FINANCES AND EXTERNAL BALANCES

In 2020, the fall in oil prices resulted in a drop in fiscal revenue. Some 85% of total revenue comes from the oil and gas sector. However, we estimate that the budget deficit remained modest, at 1.7% of GDP, thanks notably to a reduction in investment spending. Direct fiscal support to the economy was limited and the government avoided any increase in current spending. Between 2016 and 2019, public sector investment was very high, accounting for more than 40% of total spending, but this cycle now seems to have come to an end with the completion of the bulk of the infrastructure related to the 2022 World Cup.

In 2021 and 2022, the budget should return to surplus given the expected increases in oil prices and control over spending. The fiscal breakeven oil price is around USD 50, the lowest level in the Gulf States. Over the medium term, the sharp increase in revenue from LNG exports will bring a significant improvement in the budget.

The external accounts are dominated by hydrocarbon exports (more than 85% of total exports, including 64% from LNG). The trade balance has a large structural surplus, equivalent to 25% of GDP on average between 2015 and 2019. In 2020, the current account ran a deficit equivalent to 2.5% of GDP. The rebound in oil prices should help the current account move back into surplus in the short term. As with the public accounts, the introduction of new LNG export capacity should help generate significant current account surpluses over the medium term.

Total external debt is very high (139% of GDP in 2020) and has been climbing steadily. This level of debt is not, in and of itself, a threat to the emirate's solvency. Government assets are greater than 200% of GDP.

IS BANKS' EXTERNAL DEBT A VULNERABILITY?

Notwithstanding the above, the composition of external debt is a source of economic vulnerability. Part of this debt (around 15% of the total) has been contracted by the government and by private non-financial companies. The rest consists of Qatari bank debts to foreign counterparts. External bank debt has built up continually over recent years due to a lack of local resources to cover domestic demand for lending. Annual growth in claims on the private sector (around 60% of total domestic credit) has averaged 13% since 2015 (7.4% for the public sector), whilst deposits grew by an average of only 2.3% over the same period. Total bank assets represent around 240% of GDP. Against this background, banks have called on external resources (37% of total bank resources in 2020) in the form of non-resident deposits (37% of total external liabilities) and interbank loans (48%), with the remainder consisting of debt issued on international markets. The net foreign asset position of the banking system has been negative since 2009 and has worsened significantly since 2018, with a doubling of net external liabilities. It reached USD 112 billion in December 2020, or some 75% of GDP.

This situation creates a double vulnerability: for the banking system, and to a lesser extent for the government. The increased dependence on external financing makes the banking system vulnerable to any economic or political event that could affect the confidence of external lenders in Qatar. Meanwhile, the government has significant involvement in the banking sector, both in the form of deposits (around 30% of total domestic deposits) and through significant stakes in banks' capital. Thus banks' external liabilities can be considered as contingent liabilities for the government. However, we believe that there are a number of factors that limit the scale of this vulnerability. Because of its close ties to the government, the banking sector enjoys very favourable external credit ratings. In case of difficulty, government support to the sector is substantial. For example, deposits from the government, which has significant resources, rapidly offset the withdrawal of a segment of non-resident deposits following the embargo in 2017. Over the medium term, we would expect banks' net external liabilities to be reduced. On the credit side, financing requirements are also likely to slow, following the completion of major infrastructure investments. On the resource side, the increase in government revenue as a result of greater LNG exports will result in bigger, less volatile public sector deposits.

COMMERCIAL BANKS' BALANCE SHEET: MAIN ITEMS (Y/Y %)

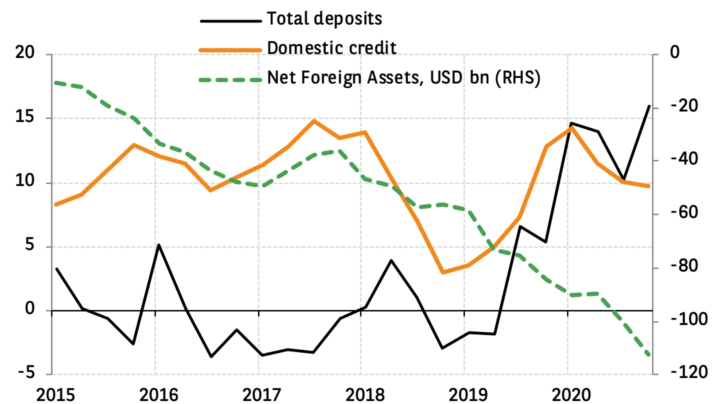

CHART 2 SOURCE: IMF, BNP PARIBAS

Completed on 9 April 2021

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IVORY COAST

WELL POSITIONED TO RECOVER

So far, the economy has posted a fairly good resilience to the pandemic shock. Although economic growth slowed sharply in 2020, it nonetheless remained in positive territory. Above all, the economy is expected to rebound strongly this year, buoyed by domestic demand and easing political tensions after a busy electoral calendar. The country's debt situation is also not as alarming compared to the other African countries. Even so, the sharp deterioration in public finances in 2020 calls for fiscal consolidation, which could prove to be difficult without a sustainable increase in fiscal revenue. This could weigh on the growth prospects of an economy that is increasingly dependent on public investment.

The horizon is getting brighter. President Ouattara was re-elected in November 2020 after a campaign season seeped in violence, in which the opposition refused to participate, contesting the incumbent's legitimacy to run. The busy electoral calendar came to an end with legislative elections in early March. The presidential party RHDP managed to conserve its majority against a reinvigorated opposition. More importantly, the legislative elections were held without major incidents, paving the way for a less tense political environment. Investors were also reassured by the continuity of economic policy, as illustrated by the country's successful return to the international financial markets in November 2020 and again in February 2021. With average growth of 8% since 2012, President Ouattara has a positive economic track record for his first two terms in office. Ivory Coast is also one of the few African countries that managed to avoid recession in 2020, thanks notably to good control over the pandemic, and the deterioration of public and external accounts was less significant than most of its peers. The economy is thus expected to rebound strongly this year. Even so, the situation is not without risks.

PUBLIC FINANCES: GRADUAL CONSOLIDATION

The consolidation of public finances will be one of the main challenges to address. Budget deficit more than doubled to 5.6% of GDP in 2020 (chart 1), mainly due to an increase in expenditure of more than 3 percentage points. Government revenue (excluding grants) fell 5% short of the initial target, but was nonetheless fairly resilient (+4% year-on-year), which spared the government from having to reallocate spending. As a result, public investment rose nearly 30% in 2020, whereas cuts were being considered at the beginning of the health crisis. According to the IMF, Ivory Coast should trim its budget deficit to 4.7% of GDP in 2021 before gradually converging with the economic and monetary union's target of 3% of GDP by 2023. The path to fiscal consolidation would thus help to keep government debt below 50% of GDP without undermining the economic recovery.

Although the situation as a whole still seems manageable, numerous factors weigh on fiscal prospects. Prior to the health crisis, Ivory Coast reported one of the region's worst performances in terms of tax collection at only 12% of GDP, reflecting a relatively complex fiscal system with numerous exemptions. The gradual withdrawal of support measures introduced during pandemic is unlikely to have more than a very mild effect on the fiscal performance: estimated at 1.5% of GDP in 2020, the emergency package will only be reduced by half a point in 2021. To reduce the deficit, the government is also counting on an upturn in fiscal revenues generated by the economic rebound as well as on fiscal reforms. Caution is warranted, however, based on a repeated series of poor performances in the past. Another source of concern is the authorities' ability to contain the growth of expenditures.

FORECASTS

	2019	2020e	2021e	2022e
Real GDP growth (%)	6.2	1.2	5.5	6.5
Inflation (CPI, year average, %)	0.8	2.4	2.5	2.0
Gen. Gov. balance / GDP (%)	-2.3	-5.6	-4.7	-3.5
Central. Gov. debt / GDP (%)	38.8	47.8	48.6	49.2
Current account balance / GDP (%)	-2.7	-3.9	-3.6	-3.2
External debt / GDP (%)	27.6	31.9	32.4	32.1
Forex reserves (USD bn)	7.4	8.9	8.8	8.7
Forex reserves, in months of imports	6.8	8.6	7.6	6.7

e: ESTIMATES & FORECASTS

TABLE 1 SOURCE: BNP PARIBAS GROUP ECONOMIC RESEARCH

DETERIORATION OF PUBLIC FINANCES

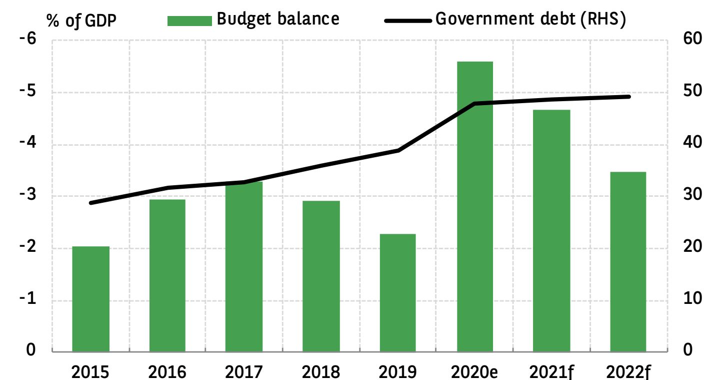

CHART 1 SOURCE: MOF, IMF, BNP PARIBAS

So far, this has been achieved through strict control over current spending, in particular the wage bill of public sector employees, which accounted for 25% of total expenditures in 2020 down from 32.2% in 2014. Yet the fragile social context in the aftermath of the health crisis as well as the busy electoral calendar fuel risk of slippages on this front, which means that public investment may have to play the role of adjustment variable. There is some manoeuvring room, however, since capital expenditure accounts for more than a quarter of the budget. Yet this can only be a temporary solution.

DEBT IS SUSTAINABLE BUT NEEDS TO BE MONITORED CLOSELY

Compared to other African issuers, the Ivory Coast's debt situation looks to be less risky, in terms of the level and structure. But its upward momentum needs to be contained. On the positive side, the next peak of amortization of Eurobonds are not until the end of the decade. Indeed, although Eurobond issuances in recent years have increased the share of external debt held by private creditors (33% of debt outstanding at year-end 2020, up from 24% in 2013), they also have served to extend its maturity. The average maturity of the debt has increased from 5.5 years in 2013 to 8.3 years in 2020. As Ivory Coast taps the market mainly in euros, debt vulnerability to exchange rate is also contained thanks to the peg.

Covering financing needs should not be difficult. The country continues to be supported by donors and has regular access to the local and international financial markets. Moreover, the country's participation in the G20 debt moratorium did not reflect any strong liquidity pressures. The gains were small (0.4% of GDP in 2020) and will remain that way in 2021. Like the other eligible countries, the government did not want to include private creditors in order to preserve its attractiveness and credit quality with the rating agencies. Among other factors, this explains the relatively low level of Ivory Coast's sovereign spreads, which are less than 400 basis points.

However, the rise in public debt (+20 points of GDP since 2014) and a greater recourse to international debt markets have also led to a sharp increase in the debt's interest burden, which now absorbs 13% of government revenues (excluding grants), up from 7% in 2014. This situation risks getting worse unless progress is made towards mobilising domestic resources. Reducing budget deficit will be also necessary.

TOWARDS A REBOUND IN 2021, BUT UNCERTAINTY THEREAFTER

The economy was fairly resilient to the Covid-19 shock in 2020. After a limited contraction to -1.6% y/y in Q2, growth returned into positive territory in Q3 (0.7%) following a significant easing of restrictive measures. Growth continued to gain momentum in Q4 (1.9%). The economy is modestly exposed to the tourism sector, and benefited from favourable terms of trade thanks to the resilience of global cocoa prices and fall in oil imports. As a result, it did not suffer from pressures other than the disruption of foreign trade generated by the pandemic. According to the Central Bank of Western African States (BCEAO), growth is estimated at 1.2% in 2020, which nonetheless marks an abrupt slowdown.

In 2021, growth is forecast at between 5.5% and 6%, bolstered by the intensification of major infrastructure projects and the rebound in domestic demand. The upturn in imported commodity prices, and energy prices in particular, are likely to have only a mild inflation impact thanks to the stabilizing mechanisms of CFA franc. Inflation was only 2.3% in January 2021. Consequently, a premature tightening of monetary policy by the regional central bank (BCEAO) is unlikely. The key policy rate was lowered by 50 basis points to 4% in 2020, which helped support the growth of banks' loans to the private sector (+11% y/y). In the short term, the lift of loan payment deferrals introduced during the crisis is expected to be manageable.

INVESTMENT RATE

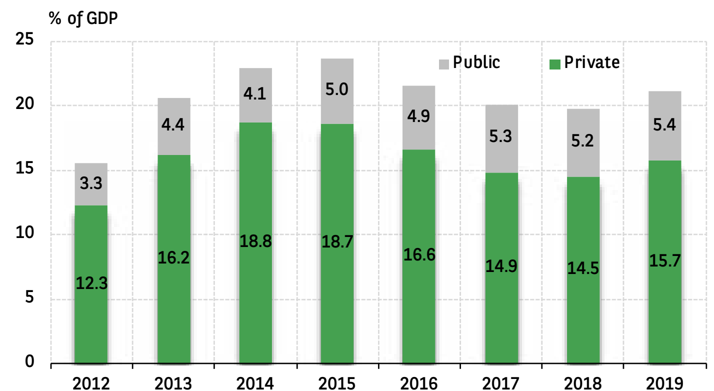

CHART 2 SOURCE: BCEAO, NATIONAL STATISTICAL OFFICE

According to the IMF, this concerned only 5% of bank credit outstanding in mid-2020 at the Western African Economic and Monetary Union's level. It is probable that credit risk, like economic growth, was more resilient in Ivory Coast than in the other economies in the region.

In the short term, of course, the country's economic rebound depends on maintaining the pandemic under control. Granted, Ivory Coast was one of the first African countries to receive vaccines thanks to the Covax initiative. Yet in early March, the vaccination campaign was only just getting underway and will be a very long process.

Beyond that, maintaining a robust growth in coming years will be closely correlated to reforms. Despite undeniable potential, Ivory Coast growth model is still weakened by numerous structural fragilities, starting with its increased dependence on public investment (chart 2). Yet the need to consolidate public finances will make it hard to maintain these dynamics. The decline in the private sector investment rate since 2015 also reflects low structural transformation. Despite a broadening of exports base, it is still concentrated on soft commodities, especially cocoa (more than 40% of exports). The economy is thus vulnerable to exogenous shocks. But growth is not inclusive enough either. All of these challenges are clearly included in the National Development Plan (2021-25).

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KENYA

RELATIVELY SPARED FROM THE CRISIS BUT WEAKENED

Although Kenya was spared a recession in 2020, the Covid-19 shock exacerbated the country's economic vulnerabilities. The risk of excessive public debt is especially high, and despite financial support provided by multilateral and bilateral creditors, budget management will remain a big challenge in the short and medium terms. The level and structure of the debt expose the government to solvency risk. Fortunately, reforms are expected to reduce this risk, and the IMF financing programme recently granted to the Kenyan authorities should support these efforts and help reassure non-resident investors.

A DYNAMIC BUT UNCERTAIN RECOVERY

Although Kenya was spared a recession in 2020, the pandemic had a significant impact on the economy, which is largely driven by the services sector. At the height of the crisis in Q2 2020, GDP contracted nearly 6% year-on-year. The Central Bank of Kenya (CBK) cut its key rate on two occasions, lowering it by a total of 125 basis points to 7%. In addition to fiscal support measures (estimated at 0.5% of GDP), other measures were taken to inject liquidity, including a 100bp reduction in the reserve requirement ratio to minimise the impact of the shock and allow the exchange rate to act as an adjustment variable. All in all, full-year 2020 GDP growth is estimated to near zero.

The rebound in GDP growth is expected to continue in 2021 with a full-year growth of nearly 5%. Yet the current environment is still marred by a high level of uncertainty. This is mainly due to the high risk of a new wave of contaminations and further restrictions on business. In early March, the Kenyan authorities implemented new preventive measures and restrictions to combat a surge in new Covid-19 cases. The prospects of recovery will continue to hinge on the spread of the pandemic and the rollout of a vaccination campaign. To date, the country has received nearly a million doses of the AstraZeneca vaccine as part of the Covax initiative[1]. The authorities' goal is to vaccinate half of the population by mid-2023.

In January, the IMF granted Kenya a financing programme to help support the recovery phase, with funding of USD 2.4 bn over three years. The programme will support fiscal consolidation efforts in particular, to help the Kenyan government contain the growing risk of excessive debt.

THE FISCAL DEFICIT AND PUBLIC DEBT ARE MORE VULNERABLE

Already hit structurally by budget mismanagement, the fiscal deficit swelled last year in the midst of the crisis (to 8.5% of GDP in 2020, compared to a 2015-2019 average of 7.9% of GDP). The accumulation of deficits has driven up the public debt, which increased even more as the fiscal pressure intensified due to crisis management: the revenue collected in fiscal year 2019/20 fell far short of forecasts, while expenditures were much higher than expected. The public debt has now swelled to nearly 70% of GDP (+15% in nominal value compared to 2019), the critical threshold defined by the IMF to indicate a high risk of excessive debt.

Already present before the crisis, this excessive debt risk is now a major source of vulnerability. Attesting to this situation, S&P downgraded the country's sovereign rating from B+ to B in early March 2021. Moreover, with more than a third of the debt comprised of commercial loans, its very structure implies a considerable cost. Interest on the external debt has doubled since 2015 due to the reduction in the share of concessional loans (they now account for less than a quarter of Kenya's debt). The government has had to face up to the sharp drop in fiscal and export revenue over the past year, which has sharply undermined its debt servicing capacity. The government is also exposed to currency risk because half of debt outstanding is denominated in foreign currency (67% in USD). In 2020, the Kenyan shilling depreciated by 10% against the US dollar.

FORECASTS

	2019	2020e	2021e	2022e
Real GDP growth (%)	5.4	-0.1	7.6	5.7
Inflation (CPI, year average, %)	5.2	5.3	5.0	5.0
Cent. Gov. balance / GDP (%)	-7.7	-8.4	-8.1	-6.7
Cent. Gov. debt / GDP (%)	62.1	68.7	71.5	72.9
Current account balance / GDP (%)	-5.8	-4.8	-5.3	-5.4
External debt / GDP (%)	46.8	47.2	45.9	45.0
Forex reserves (USD bn)	9.5	8.9	7.2	7.9
Forex reserves, in months of imports	6.1	4.9	4.2	4.6

e: ESTIMATES & FORECASTS

TABLE 1 SOURCE: BNP PARIBAS GROUP ECONOMIC RESEARCH

UNPRECENTED CONTRACTION OF THE ECONOMIC ACTIVITY

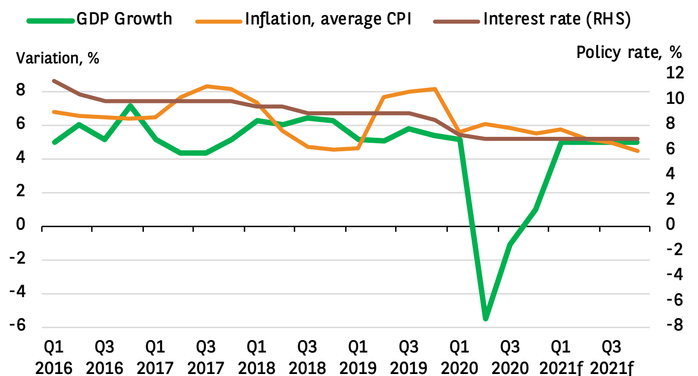

CHART 1 SOURCE: CENTRAL BANK, BNP PARIBAS

1 This initiative of the UN and its partner countries aims to guarantee that all countries have equitable access to safe and effective vaccines.

TEMPORARY SUPPORT MEASURES

To address this situation, the country has benefited from a debt servicing moratorium with the Paris Club of international creditors. Initially reluctant to join the Debt Service Suspension Initiative (DSSI), fearing it would send a negative signal to bond investors and reduce its access to the market, Kenya was finally granted a 6-month holiday on debt payments by the Paris Club between January and June 2021, saving the country about USD 300 million. Debt payments to Chinese creditors were also suspended over this same period, representing savings of about USD 345 million. These amounts will have to be paid back over a 5-year period starting in 2023. The Kenyan government has pledged to continue honouring the amounts due to its multilateral creditors.

All in all, the financial relief is both limited and temporary. It will ease the liquidity squeeze and will enable the funds to be reallocated to support the recovery, but it does not resolve the structural problem of debt sustainability. The amount saved (USD 545 million) accounts for only 20% of overall servicing of its external public debt in 2021. Moreover, the amounts at stake are rather small compared to the country's overall external financing needs, which are equivalent to about 6% of GDP in 2021 (USD 6.7 bn). Debt servicing will still account for about 27% of exports, exceeding the IMF's indicative prudential threshold of 23%.

Alongside these measures, Kenya reached an agreement with the IMF for a 38-month, USD 2.4 bn financing programme subject to a quarterly review. The funding should be used in principle to support recovery efforts, streamline expenditures, and broaden the tax base. These reforms are necessary to ensure debt sustainability in the medium term and to contain the related risks, which are straining the local bank system. Already strapped with a high doubtful debt ratio (14.14% in December 2020, 2.1 percentage points higher than in December 2019), the banking system is largely exposed to sovereign risk, and to the solvency risk of parastatal or state-owned companies: nearly a third of all banking sector loans are comprised of public debt. This also creates a crowding out effect for private sector lending.

THE POLITICAL CALENDAR COULD DELAY FISCAL CONSOLIDATION

Measures to improve public finance management will remain the focus of attention in the months ahead. The government has said it is determined to favour borrowing from multilateral and bilateral creditors, which allows it to lock in more favourable interest rates.

Depending on the amounts obtained through official creditors, the Treasury of Kenya also intends to raise funds in the international bond market this year. The bond issue will be used to pre-finance future debt payments at a time when interest rates are still relatively attractive, but susceptible to deteriorate[2]. At mid-March, the Kenyan 10-year government bonds yield was 12.8%, up from 12.7% in mid-March 2019.

The political calendar suggests that these fiscal consolidation efforts could be postponed and limited in scope. With a constitutional referendum scheduled for June 2021 and general elections to be held in 2022, there is reason to doubt that the government will be able to concentrate on measures to clean up public finances in the months ahead.

RISING PUBLIC DEBT LEVEL AND BURDEN

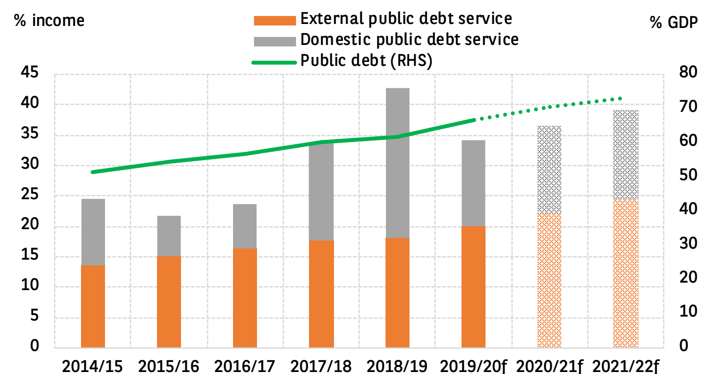

CHART 2 SOURCE: NATIONAL TREASURY, CENTRAL BANK, BNP PARIBAS

The Building Bridge Initiative (BBI) has major implications for the next elections because it aims to redefine the government's structure. The initiative is still being debated in Parliament, because both its content and form are controversial at a time when gatherings are banned and the organisation of the referendum will be very costly.

Non-resident investors have managed to look beyond the political risks in recent years, and Kenya's attractiveness could be preserved under these circumstances. Foreign investors are still necessary as a source of financing and new source of growth. The private bond market's resilience in recent months relative to the regional market illustrates the persistent attractiveness of Kenya's economy. The sovereign bond issue expected later this year will set the tone. Seen in this light, the new IMF financing programme is a positive factor.

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2 Expectations of rising inflation and higher interest rates in the advanced countries (notably the US) have a negative impact on the attractiveness of emerging market bonds for investors: it reverses the yield/risk ratio.

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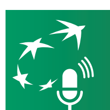

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